3 December 2010

Update

BRE Bank Securities

Oil & Gas
Poland

PKN Orlen

PKNA.WA; PKN PW

Reduce

(Downgraded)

Current price	**PLN 46.49**
Target price	**PLN 40.70**
Market cap	PLN 19.9bn
Free float	PLN 13.4bn
Avg daily trading volume (3M)	PLN 103.1m

Shareholder Structure

State Treasury	27.52%
AVIVA OFE	5.08%
Others	67.40%

Sector Outlook

Refining margins have returned to their pre-crisis levels, however, OECD demand remains week while refiners across the world are about to launch new capacities, making for grim prospects for oil refiners in the next few years. Speculative hikes in oil prices, fueled mainly by EUR/USD exchange rates, are putting an additional squeeze on refining margins.

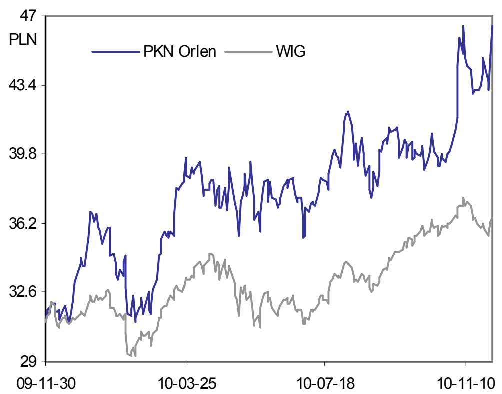
Company Profile

PKN Orlen is the largest refinery in the CEE region, with 27 million tons of annual capacity. In addition to crude refining, PKN Orlen is also active in the chemicals industry via its subsidiary Anwil, and in petrochemicals through BOP. In 2005, PKN Orlen took over the Czech "Unipetrol" group, followed by the acquisition of Lithuania's Mazeikiu Nafta in 2006.

Important dates

26.01 - Q4'10 earnings estimate
12.02 - Q4'10 earnings report

PKN Orlen vs. WIG



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Competition May Intensify in Poland

Since our last research update the price of the PKN Orlen stock has risen by 15%, mostly because it has been riding a wave of optimism in the petroleum market which we find unwarranted given the inflow of poor fundamental data from the fuel markets in the developed countries. In addition to the lack of prospects for an improvement in the industry's macroeconomic conditions, we note the risk of tightening competition in Poland as Lotos aims to maximize sales from its new installations in Poland, where it can get a high "land premium". Note also the high internal consumption of petroleum at the Płock refinery, which will put additional pressure on margins if crude oil prices stay high. Finally, the CEO's recent words have undermined expectations that a high dividend is coming as soon as next year, and in our opinion, a further risk for such a scenario comes from investment projects (acquisition of upstream projects, construction of a power plant). In this context, we are downgrading our rating to reduce without changing our forecasts and valuation.

Margins Will Be Under Pressure, Domestic Competition May Tighten

We believe the current optimism in the petroleum market is out of phase with fuel demand data from the developed countries, which remain weak (negative y/y growth for gasoline, big diesel inventories in the USA), and the good outlook for China does not warrant it either, given that the country accounts for just 10% of global consumption. In addition, considerable pressure on crack spreads may materialize next year as new refining capacity is opened. In Poland, we expect intensified competition and a reduction in the "land premium", as Lotos will aim to maximize domestic sales of the output of its new installations (an additional 2.5 Mt of products, mostly gasoline and JET, i.e. categories where it will compete directly with Orlen as imports have been low until now). Even if benchmark margins remain stable, the profitability of Polish refineries will suffer; plus, we should not forget that this year's results are being boosted by a LIFO effect (over PLN 900m after Q3), and that the major overhaul of Mazeikiu Nafta, postponed last year, will take place in 2011.

Outlook for Dividends Not So Certain

Working capital optimization and the sale of mandatory reserves, with margins rebounding from their crisis levels, facilitated a reduction in net debt to ca. PLN 10bn. This, coupled with the expectation of a reduction in investment outlays, generated expectations of generous dividends. However, the CEO's proclaimed skepticism means a more cautious stance is warranted. In our opinion, given that the potential for capacity expansion in the petrochemical segment is running out, the Company is likely to revise its strategy and increase investment budgets in such areas as electricity generation and upstream, which will make bigger payouts to shareholders impossible.

(PLN m)	2008	2009	2010F	2011F	2012F
Revenue	79 533.0	67 928.0	82 211.0	88 844.2	94 943.6
EBITDA	888.4	3 665.0	5 216.2	4 956.1	5 523.5
EBITDA margin	*1.1%*	*5.4%*	*6.3%*	*5.6%*	*5.8%*
EBIT	-1 603.0	1 097.0	2 730.4	2 131.2	2 650.5
Net income	-2 505.2	1 308.7	2 126.7	1 915.8	2 177.4
DPS	1.62	0.00	0.00	1.03	0.94
P/E	-	15.2	9.3	10.4	9.1
P/CE	-	5.1	4.3	4.2	3.9
P/BV	1.1	1.0	1.0	0.9	0.8
EV/EBITDA*	39.6	9.0	6.2	6.7	5.8
DYield	3.5%	0.0%	0.0%	2.2%	2.0%

**excluding Polkomtel and strategic reserves*

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List of abbreviations and ratios contained in the report:
EV *– net debt + market value*
EBIT *– Earnings Before Interest and Taxes*
EBITDA *– EBIT + Depreciation and Amortisation*
P/CE *– price to earnings with amortisation*
MC/S *– market capitalisation to sales*
EBIT/EV *– operating profit to economic value*
P/E *– (Price/Earnings) – price divided by annual net profit per share*
ROE *– (Return on Equity) – annual net profit divided by average equity*
P/BV *– (Price/Book Value) – price divided by book value per share*
Net debt *– credits + debt papers + interest bearing loans – cash and cash equivalents*
EBITDA margin *– EBITDA/Sales*

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ACCUMULATE – we expect that the rate of return from an investment will range from 5% to 15%
HOLD – we expect that the rate of return from an investment will range from –5% to +5%
REDUCE – we expect that the rate of return from an investment will range from -5% to -15%
SELL – we expect that an investment will bear a loss greater than 15%
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Previous ratings issued for PKN Orlen

Rating	Accumulate	Accumulate	Hold	Hold
Rating date	2010-02-03	2010-03-08	2010-04-08	2010-11-02
Price on rating day	34.20	35.35	39.40	40.21
WIG on rating day	39904.02	40354.28	43562.01	46229.60