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Haitong Bank in a report from 23rd November re-initiates coverage of two Polish refining companies with a mixed view on the companies' prospects: analysts have a BUY on Grupa Lotos with FV PLN 97.30 and NEUTRAL on PKN Orlen with FV PLN 105.21.

Valuation Methodology

PKN Orlen: Haitong Bank valuation approach for PKN Orlen Group uses two methods: DCF and peer valuation. Analysts calculate the final FV as the weighted average of the two results with equal weights.

Grupa Lotos: Haitong Bank valuation approach for Grupa Lotos uses two methods: sum of the parts (SOTP) and peer valuation. The Sum-of-the-parts method involves a discounted cash flow valuation to estimate upstream and downstream businesses' intrinsic value separately. Analysts calculate the final FV as the weighted average of the two results with 50% and 50% weights for SOTP and relative valuation, respectively.

Risks to Fair Value

PKN Orlen:

Risks and threats to the Orlen Group's business which may affect financial results and valuation:

1. MARKET RISKS

- Commodity risk – related to changes in refining and petrochemical margins on sales of products, Brent/Urals differential, crude oil and product prices, and prices of CO2 emission allowances.
- Currency risk – related to economic currency exposure.
- Interest rate risk – related to changes in cash flows caused by interest rate movements, resulting from the fact that certain assets and liabilities held by the Group have interest income and expense driven by floating interest rates.

2. SECTOR RISKS

Fuel consumption. The overall economic situation has a material effect on fuel consumption levels and thus has a bearing on the sales and prices of the ORLEN Group's products and its financial position.

3. STRATEGIC RISKS

The upstream projects carried out by the ORLEN Group are subject to a number of geological and operational risks, which may prevent the Group from earning expected profits. Implementation of such projects may be delayed or may fail to succeed, chiefly because of high exploration risk inherent in this type of business, cost overruns, lower-than-expected crude and gas prices, higher-than-expected fiscal burden, adverse changes in sectoral regulations, shortage of equipment and qualified staff, bad weather, or difficulty finding partners to share the risks and costs related to project implementation. Project execution may often entail using new and advanced technologies, which are expensive to develop, acquire and implement and may not operate as expected.

Downstream projects are primarily exposed to the risk of delay vs our forecasts.

Grupa Lotos:

Risk of delay in strategic projects development

- Risk of delay in development of EFRA Project (DCU project)
- Risk of delay in development of key upstream projects

Political and legal risks

- Tensions between China and USA. Iran sanctions and crisis in Venezuela, i.e. all political events resulting in volatility of crude and petroleum fuels.

Price risk

- Commodity and petroleum product price risk – operating results are largely dependent on the difference between the price of petroleum products and the price of crude oil. Key risk to our FV estimates are realized fuel cracks in the future. On page 51 of the report Haitong Bank presents different scenarios regarding realized fuel prices. For instance analysts note that if 2018 average cracks are going to be repeated in 2020 the estimated 2020 positive effect from EFRA will drop from 2.5 USD/bbl to 1 USD/bbl
- Currency risk – the Polish złoty (PLN) is the reporting and functional currency for the company and the majority of other Lotos Group companies, while the trading prices of crude oil and petroleum products are generally denominated in, or tied to, the US dollar (USD)
- Interest rate risk – Grupa Lotos is exposed to interest rate risk, with interest rates growth translating into increased costs of servicing debt under floating-rate borrowings.

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