PGNiG (date issued: June 30, 2009)

What Is The Real Price Of The Qatar Gas Contract?

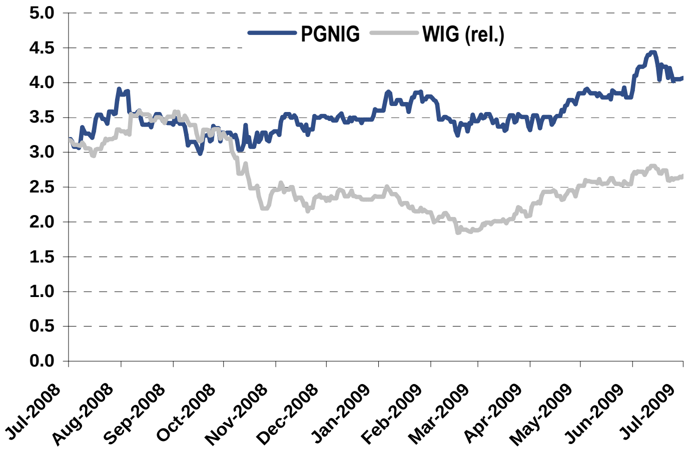
PGNiG	
Closing price: 30.06.2009	4.06
Rating/Risk	Buy/Medium Risk(1M)
Target price	4.57
Analyst	Włodek Giller: 48-22-690-3563

A 20-year contract with Qatargas signed

PGNiG has announced that it has signed a 20-year contract for LNG supplies with Qatargas Operating Company. PGNiG will receive approximately 1.5bn cubic metres of gas per annum (11% of current Polish consumption), the price of which will be based on the three-month average Brent price. Average annual value of the shipments based on current Brent is USD550m. The supplies will start in 2014, when the LNG terminal in Swinoujscie in Northern Poland is constructed by a state-owned Gas System transmission company.

The deal is to provide Poland with diversified gas supplies, as currently approximately 9bn cubic metres of gas per annum (64% of the country's consumption) have been supplied from Russia and Central Asia. From PGNiG's point of view, **the contract may indicate a higher cost of purchased gas**, however, as LNG long-term contract prices are usually 10%-20% higher compared to longterm gas supplied through pipelines. In that sense, **PGNiG minority shareholders may need to pay a "political price" for diversification of gas fuel supplies to Poland**.

How big such a cost will be – if any – will largely depend on a more shareholder - oriented approach by the Polish energy regulator URE towards PGNiG (which is not likely soon, in our view), as well as on the pace of liberalisation of the domestic gas market (which we believe is more likely).



Source: DMBH

PGNIG (mln PLN)	2007A	2008A	2009P	2010P	2011P
Sales	16,652	18,432	19,749	17,941	18,036
EBITDA	2,282	2,226	3,418	4,311	4,427
EBIT	852	801	1,886	2,687	2,731
Net income	917	866	1,550	2,250	2,407
EPS (PLN)	0.2	0.1	0.3	0.4	0.4
EBITDA Margin	13.7%	12.1%	17.3%	24.0%	24.5%
EBIT Margin	5.1%	4.3%	9.5%	15.0%	15.1%
ROE	4.4%	4.2%	7.3%	9.9%	9.6%
P/E	26.2	27.7	15.5	10.7	10.0
P/BV	1.1	1.2	1.1	1.0	0.9

Source: DMBH

Polish Oil & Gas

Company description

PGNiG is a vertically-integrated gas company in Poland. The company holds oil & gas production, transmission, storage and distribution assets. It has a share in the main international pipeline that transports gas from Russia through Poland to Germany. It also owns an oil business (5-6% of total revenues), which is not regulated, while the gas business is heavily regulated.

Investment strategy

We rate PGNiG Buy/Medium Risk (1M) with a target price of Zl 4.57. We base our bullish stance on the expected positive developments of the company's bottom line in 2009, as PGNiG is likely to benefit from the declining cost of imported Russian gas and from zloty / dollar rate stabilisation. All this should gradually improve margins in 2009 and give PGNiG strong earnings momentum in the second half of the year.

Valuation

We set our target price of Zl 4.57 at the average of two SOTP valuation methodologies. In the first method, we calculate the DCF value of the company's three businesses: extraction & production, distribution and storage & trade. To the DCF value, we add the value of the lease agreement for domestic transmission (the assets that will be transferred to state-owned OSP Gaz-System within the next two years in the form of dividend in kind). We also add PGNIG's 49.74% stake in the international transmission business, Europol Gaz. In the second method, in order to value the extraction & production business, we value the company's gas & oil deposits. For the distribution and storage & trade divisions, we use a price-to-book value (P/BV) measure, calculated on a return on equity (ROE)/cost of equity (COE) basis (assuming the relation of ROE/COE should be equal to P/BV). The remaining parts of PGNiG (domestic and international transmission) we calculate the same way as in the first method.

Risks

We rate PGNiG Medium Risk based on our assessment of industry- and company specific risk factors. High volatility on oil markets is the main threat to our purchased gas cost estimates for PGNiG. We currently use a USD 90 long-term oil price estimate to calculate gas price cost. Potentially exceeding that value by the oil price may lead to deterioration of our forecasts for PGNiG. Another important risk is the dollar/zloty rate. Potential further strengthening of dollar/zloty may negatively impact our estimates. We do not assume significant movements of the Polish currency versus US dollar. If the impact on the company from any of these factors proves to be more negative than we anticipate, the stock will likely have difficulty achieving our financial and price targets. Likewise, if any of these factors proves to have less of an effect than we anticipate, the stock could materially outperform our target.

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„LOW" (L) - means that the company's profits and dividends are predictable. Suitable for conservative investors.

„MEDIUM" (M) - in a moderate degree of profits and dividends are predictable, to match the average investor.

„HIGH" (H) - profits and dividends are less predictable, suitable for aggressive investors.

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Buy (1) (expected total return of 15% or more for Low_Risk stocks, 20% or more for Medium-Risks stocks, 30% or more for High-Risks stocks and 40% or more for Speculative stocks);

Hold (2) (5% - 15% for Low_Risk stocks, 10% - 20% for Medium-Risks stocks, 15% - 30% for High-Risks stocks, i 20% - 40% for Speculative stocks);

Sell (3) (5% or less Low_Risk stocks, 10% or less for Medium-Risks stocks, 15% or less for High-Risks stocks, i 20% or less for Speculative stocks);

The definitions of terms applied in the report:

EBIT – operational profit

EBITDA – EBIT + amortization

P/E – the Price-to-earnings per share

EV – market capitalization + net financial debt

WACC – The weighted average cost of capital

BV – book value

ROE – return on equity

Ratings and Target Price History

Date	Rating	Target Price	Closing Price **
10/10/2006	1M	3,95	3,43
30/01/2007	1M	4,50	3,85
19/06/2007	2M	5,35	4,94
27/06/2008	2M	3,84	3,34
20/10/2008	1M	4,18	3,18
07/05/2009	1M	4,57	3,85

Rating distribution– 30/06/2009 *

Rating:	DMBH Coverage	% of companies in each rating category that are investment banking clients (DMBH)	Citi Investment Research Global Fundamental Coverage	% of companies in each rating category that are investment banking clients
Buy (1)	42%	0%	41%	46%
Hold (2)	40%	0%	38%	45%
Sell (3)	18%	0%	21%	39%

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**) closing price of recommendation issuance date

Valuation methods used (two of listed below)

Discounted Cash Flow Model – the valuation is based on future expected cash flows discounted at weighted average cost of capital (WACC). Strengthens: the approach takes into account all net cash flows to the company and the time value of money. Disadvantages: large number of parameters to be estimated and significant sensitivity of the valuation outcome to assumptions made by an analyst.

Multiples Valuation – Based on comparison of a company's multiples (P/E, P/BV, EV/EBIT, EV/EBITDA ratios) with an average (or median) multiples for its peers. Strengthens: small number of parameters to be estimated, a valuation outcome relating to current market conditions, simplicity. Weaknesses: sensitivity to chosen multiples peers and market conditions.

EVA – Economic Value Added approach is based on residual income which reflects the total value added of company's operations. Residual income is defined as the difference between the return made on the investment and the composite cost of its financing. This valuation methodology is: sensitive to assumptions on long term growth. The valuation outcome is not market determined. The advantages of EVA: considering the cost of capital, capitalizing expenses with potential multiperiod benefits.

SOTP – Sum of the Parts approach is calculated as a sum of independent valuations (using DCF or multiples approach) of all segments of the company decreased by net debt (debt minus cash and equivalents). The main disadvantage of this approach is that it requires a large number of parameters to be estimated and assumptions to be made (for each business of the company). The key advantage of SOTP methodology is that it reflects more precisely the picture of the company operating in different industries.

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