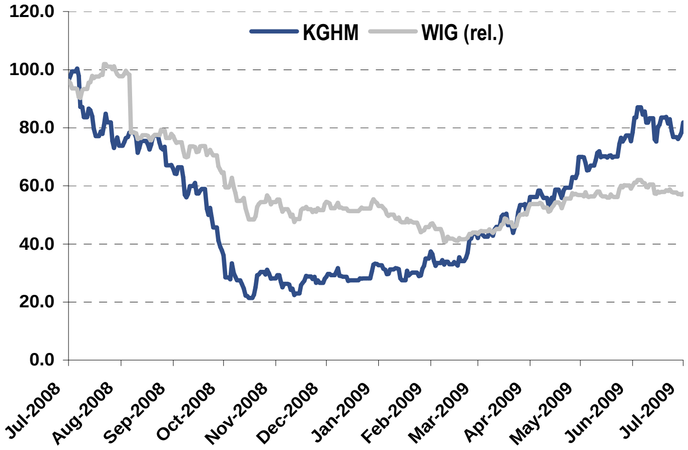
KGHM (date issued: July 8, 2009)

Copper Price Upgrade Triggers TP & EPS Upward Revision

KGHM	
Price: 8.07.2009	78.50
Rating/Risk	Hold/High Risk(2H)
Target price	81.00
Analyst	Rafał Wiatr: 48-22-690-3757

On 08 July 2009 we raised target price for the stock to Zl 81 from previous Zl 44.1 on the back of upward revision of 2009-2011 EPS numbers triggered by copper price revision. We maintained our Hold/High Risk (2H) Rating.

- **Copper price upgrade** — Our global commodities team has upgraded commodity price forecasts on the more constructive long-term outlook. The 2010/11 outlook for copper is improving due to: visible excess inventory, limited excess supply, copper intensive China demand, investment buying, and further out, chronic supply constraints.
- **Price up some 50% but 2H09 pullback possible** — We increase our 2009-11 copper price by 13%, 52% and 50% to US$4,012/t, US$5,512/t and US$6,614/t respectively. However, some pullback in 2H09 is likely as restocking in China comes to an end and imports slow.
- **Forecast upgrade** — On the back of a revised copper price we raise our 2009- 11E EPS numbers substantially to Zl 9.86, Zl 13.45 and Zl 14.80 respectively (from Zl 6.01, Zl 1.73 and Zl 3.86). Please note that due to the high breakeven point related to high production costs, KGHM EPS numbers are very sensitive to changes in the expected copper price.
- **TP upgrade, Hold rating maintained** — We upgrade our TP to Zl 81 driven by our upward EPS revision, but maintain our Hold rating following its strong performance. With our new forecast we see KGHM as being reasonably valued versus its peers on 2009-10E earnings, a strong balance sheet while benefiting currently from the still resistant copper price and weak domestic currency. For some investors, KGHM may be perceived as a hedge against potential further currency weakness.



Source: DMBH

KGHM (mln PLN)	2007A	2008A	2009E	2010E	2011E
Sales	12,183	11,303	9,148	10,374	10,894
EBITDA	5,101	4,078	2,881	3,825	4,152
EBIT	4,682	3,596	2,352	3,253	3,540
Net income	3,799	2,920	1,972	2,689	2,961
EPS (PLN)	19.0	14.6	9.9	13.4	14.8
EBITDA Margin	41.9%	36.1%	31.5%	36.9%	38.1%
EBIT Margin	38.4%	31.8%	25.7%	31.4%	32.5%
ROE	44.5%	29.9%	18.9%	25.2%	24.4%
P/E	4.3	5.6	8.3	6.1	5.5
P/BV	1.8	1.5	1.6	1.5	1.3

Source: DMBH

KGHM

Company description

KGHM is the sixth-largest producer of copper in the world, with production of over 500,000 tonnes (some 2.7% of global production). It is also the world's second-largest silver producer, with output of around 1,100 tonnes, around 7% of global production. Sales of copper constitute 80% of revenues, and silver around 15%. It is a high-cost copper producer due to nature of its mines, with production cost at US$3,500-4,000/t. KGHM is still under state control, with strong labour unions. The company has stakes in mobile and fixed-line telephony. Some 34% of copper is sold in Poland, 22% in Germany, 15% in France and 10% in China. The major markets for silver sales are the UK (56%), Germany (18%), Belgium (13%) and Poland (9%).

Investment strategy

We rate KGHM Hold/High Risk (2H) as the stock offers exposure to the strong copper market expected in years 2010 and 2011 and at the same time it offers a hedge to potential zloty weakness. Although KGHM currently benefits (especially visible in 1Q09 and to be the case also in 2Q09) from the still resistant copper market and weak domestic currency as well as favourable copper hedging, the latter two elements should be much less supportive in 2H09 as the zloty gained some ground and favourable copper hedges should disappear. However, favorable copper prices and the potential high dividend out of 2009 earnings should be supportive for the stock. Risk still exists from the strengthening of the local currency, likely upturn in copper production cost in the remainder of the year and the risk of a copper price reversal in 2H09 as expected by our mining team.

Valuation

Using multiples-based (PE, EV/EBITDA) and SOTP valuation methods, we derive a valuation range for KGHM of Zl 59 to Zl 93 per share; however, in setting a target price of Zl 81, which we derive by valuing the mining assets at Zl 55/share using mid-cycle PE of 5x, telco assets at Zl 19.1/share (based on PE and EV/EBITDA multiples and the recent transaction when TDC was selling its stake) with the reminder being cash at the end of 2010. In the mean time we also expect investors to receive a dividend payment of Zl 8.9/share out of 2009 earnings in mid-year 2010.

Risks

We rate KGHM as High Risk based on its high-cost position, which is difficult to reverse and raises the profitability breakeven point. On the other hand, strong earnings this year and high cash position on the balance sheet at the end of the year increase probability of a large dividend payment in 2009. Still, we believe that the stock is susceptible to changes in copper prices and Zl/US$ exchange rates, therefore its earnings volatility is much higher than for the average Polish company. The following risk factors may cause the share price to deviate from our target price: higher-than-expected salary increases and increased union demands for bonus payments and unexpectedly large hedging losses both constitute downside risks. At the same time, potential upside risk factors include an unexpected significant strengthening of the US$ versus zloty, announcement of deep redundancy program, higher than-expected copper prices for 2009 and 2010, higher-than-expected silver prices, and a very successful disposal of the fixed-line and mobile telephony business.

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Recommendation date – Date of original version of the report.

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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.

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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 **
07/11/2007	3H	110,00	125,20
07/07/2008	1H	140,00	93,30
01/09/2008	1H	115,00	74,90
30/09/2008	1H	85,00	49,95
28/10/2008	1H	40,00	25,20
01/04/2009	2H	44,10	46,45

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%

*) re all recommendations delivered by Citigroup Global Markets / Dom Maklerski Banku Handlowego

**) 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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