

May 27, 2015

Kernel

Buy on strong farming and ongoing deleveraging

Ukraine's largest sunflower oil producer Kernel will report its 3QFY15 financials on May 28. We expect to see strong quarterly financials, underpinned by all business segments operating at high capacity load and solid profitability. Thus, Kernel is on track to report an all-time high EBITDA in FY2015 with a robust outlook for FY2016. We argue the consensus is underestimating its earnings for FY2015-16, with the stock trading at a compelling level of 3.9x EV/EBITDA, based on consensus expectations. The sunflower seed crusher has halted its expansion CapEx and M&A activity, focusing on deleveraging, which will drive the market value of equity. Kernel is the most liquid equity name in the Ukrainian universe and is set to benefit from subsiding military risks after the stock was beaten up following the Russian invasion of the Crimea and Donbas regions in spring 2014. We assign a BUY recommendation to KER PW, with a target price of PLN 83, implying a 125% upside.

Strong 3QFY15 financials expected. We project Kernel will report USD 77 mln in EBITDA for 3QFY15 (Jan-Mar 2015), a 2.5x yoy jump, which will lead to EBITDA of USD 300 mln in 9MFY15 (a 3.3x yoy surge). These expected results are based on the turnaround in Kernel's farming segment, contrary to last year's loss, as well as the high capacity load of its crushing operations (85% in 9MFY15 vs. 77% a year ago) and solid margins. An 18% yoy advance in export terminal throughput in 3QFY15, enhanced by Ukraine's rich grain harvest, will contribute to Kernel's financial result during the quarter.

Positive surprise on FY2015 EBITDA looming. The consensus estimates EBITDA at USD 335 mln in FY2015, while the company has already reported USD 223 mln in the first half of FY2015, or 67% of the annual estimate. Historically, Kernel has delivered just 27-55% of its annual EBITDA during its first half. We forecast Kernel's EBITDA at USD 370 mln in FY2015, or 10% higher than the consensus, assuming just normal operating performance by the year end. The stock trades at 3.9x forward EV/EBITDA on consensus projections, and at 3.3x based on our numbers, compared to the historical average of 6.6x during 2010-2015. This indicates an enticing entry level.

Deleverage will boost market value of equity. The company plans to minimize CapEx at the level of USD 55 mln and abstain from M&A activity in FY2015. The 3.7x yoy higher net operating cash flow in FY2015 (USD 302 mln) will be channeled mainly to deleveraging, thus strengthening the balance sheet and creating room to expand its market value of equity. We expect net debt to decline 34% yoy to USD 438 mln by the end of FY2015, and by another 75% yoy to USD 109 mln throughout FY2016, under current capital structure, as FCF will rise from almost breaking even in FY2014 to USD 247 mln in FY2015 and to USD 349 mln in FY2016.

Strong outlook for key business segments. The main variable of Kernel's financials – its farming segment – is enjoying sliding production costs caused by hryvnia devaluation. Crops will be harvested in autumn 2015 at even lower costs (by 10-15% yoy) due to hryvnia swings. Combined with higher expected yields, this set the stage for another strong farming year in FY2016, even against volatile commodity prices. Anticipated availability of sunflower seeds in the region will ensure high capacity loads and solid margins for the crushing segment.

Selected financial items

	FY2011	FY2012	FY2013	FY2014	FY2015E	FY2016E
Revenue, USD mln	1,899	2,072	2,797	2,393	2,308	2,420
EBITDA, USD mln	310	322	288	223	370	393
EPS, adj. on FX changes, USD/share	2.81	2.58	1.28	-0.11	2.60	3.15
DPS, USD/share	0	0	0	0	0.25	0.25
FCF, USD mln	-70	-285	38	-1	247	349
Net debt, USD mln	590	599	627	665	438	109

Source: Company data, Concorde Capital estimates

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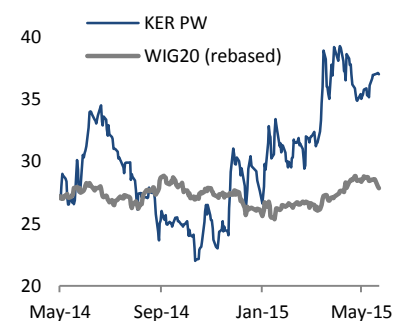
Bloomberg ticker	KER PW
Recommendation	BUY
Current price, PLN	36.8
Target price, PLN	83
Upside, %	125%
No. of shares, mln	79.7
MCap, USD mln	791
Free float, %	61.8%
Free float, USD mln	488.9
Net debt, 2015E	438
Annual div.yield	2.5%

Ownership structure

Namsen LTD (A.Verevskyy)	38.2%
Other	61.8%

Source: Company data, Concorde Capital, Bloomberg

Price performance, PLN



Source: Bloomberg

EBITDA to jump 1.6x in 3Q and 3.3x in 9MFY15

We expect Kernel to report USD 77 mln in EBITDA for 3QFY15 (+155% yoy). The key driver will have been its farming segment, which reported losses throughout FY2014 and which we project will have been strongly reversed this year, generating EBITDA of USD 256 per hectare (vs. minus USD 114 in 2014).

65% of EBITDA in 3QFY15 will be generated by its sunflower seed crushing segment, based on our numbers. Along with the company's guidance of USD 185-190 EBITDA per ton of bulk oil in FY2015, we project USD 175/t EBITDA for 3QFY15, after USD 203/t reported in 2QFY15. According to its trading update for 3QFY15, Kernel maintained close to a full crushing capacity load of 94% during the quarter, having processed 704 kt of sunflower seed (-1% yoy).

We project its export terminal business to earn around USD 7 per ton of transhipped cargo, totalling USD 8 mln during the quarter, on par with last year's amount. In 9MFY15, the segment will generate EBITDA of USD 25 mln (+19% yoy). Based on our assumptions, grain trading will report a 5% EBITDA margin in 3QFY15 and for the full year.

Kernel's quarterly EBITDA breakdown, USD mln

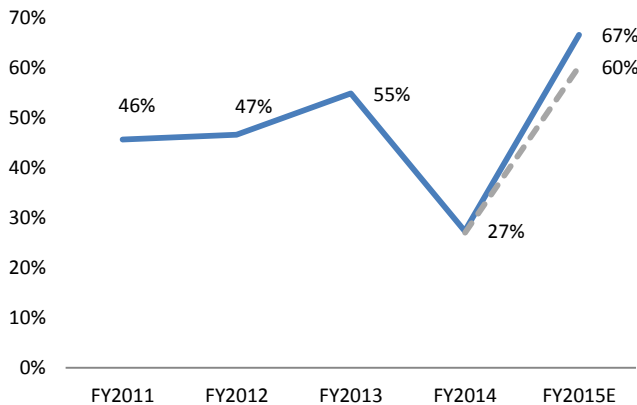
	1QFY14	2QFY14	3QFY14	4QFY14	1QFY15	2QFY15	3QFY15E	4QFY15E
Bulk oil	1	49	50	52	41	57	44	35
Bottled oil	4	13	7	3	4	9	6	6
Export terminal	4	9	8	6	7	11	8	5
Silo services	5	30	8	-3	5	13	6	2
Grain trading	9	4	33	13	18	15	14	8
Farming	-6	-42	-22	25	11	44	13	28
Sugar&discontinued	0	0	1	0	3	0	0	0
Other	-13	-5	-55	36	-7	-6	-14	-14
Total	3	58	30	132	81	142	77	71

Source: Company data, Concorde Capital estimates

Consensus seems to underestimate Kernel's EBITDA for 2015-16

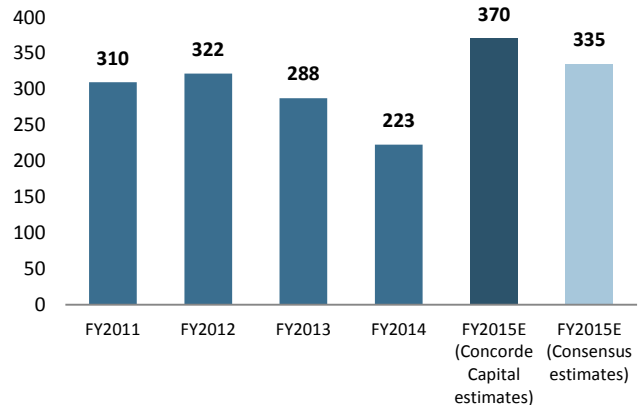
Despite our assumptions foreseeing normal business operations by the year end, our EBITDA forecast (USD 370 mln) exceeds the current consensus estimate (USD 335 mln) by 10%. In 1HFY15, Kernel already reported USD 223 mln of EBITDA, or 67% of the full-year consensus expectation, while historically the first two quarters have contributed to the actual annual result by no more than 55%. This sets the stage for positive surprises, in our view.

1H EBITDA as % of annual result, consensus & Concorde estimates



Source: Company data, Concorde Capital estimates

Annual EBITDA, USD mln

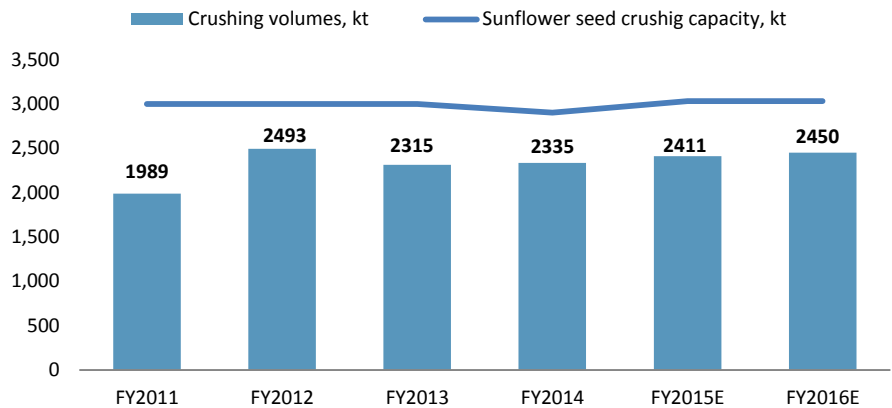


Source: Company data, Concorde Capital estimates, Bloomberg

Crushing business to run at full steam

Kernel has increased sunflower seed processing by 15% yoy to 1.9 mmt in 9MFY15, thus capacity load grew to 85% during the period from 77% a year ago. It is consistent with the company's guidance of crushing 2.4-2.5 mmt of seed in FY2015 (+3 to +7% yoy). The reason behind the rise is an uninterrupted availability of sunflower seeds on the market, compared to a significant shortfall in 1QFY14, which had impacted the annual result. So far, nothing similar to that has been observed in Kernel's key business segment performance, and the company may reach another operating performance high in FY2015-16, which was last observed in FY2012. We project Kernel will produce 1,061 kt of sunflower oil in FY2015 (+3% yoy) and sell 927 kt of bulk oil (almost flat yoy) at a 16% yoy higher EBITDA margin of USD 190/t. Thus, bulk and bottled oil sales will spark an 13% yoy increase in EBITDA to USD 201 mln in FY2015, we expect.

Kernel's sunflower seed crushing vs. capacities

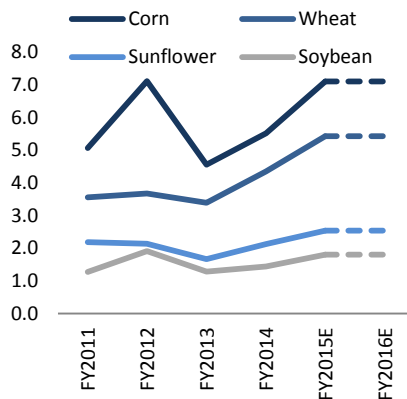


Source: Company data, Concorde Capital estimates

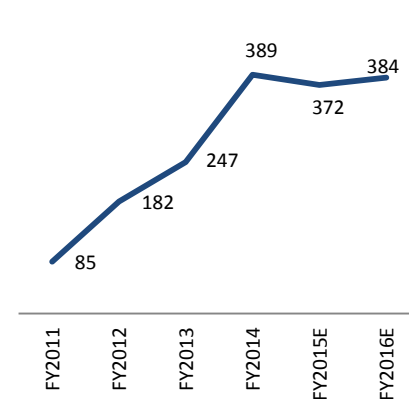
Recovery in farming on yields and cost cutting

Having reported a loss of USD 44 mln in FY2014, farming is set for a financial turnaround as yields have bottomed out, having grown by 16-28% yoy in FY2015 (as harvested in autumn of the 2014 calendar year). Subject to weather conditions, yields may improve further in FY2016, following a 8-43% yoy increase in fertilizer application. Another positive development for this export-oriented segment, where 40-45% of production costs have been hryvnia-denominated, is 60% hryvnia depreciation since the beginning of 2014. Its positive impact will extend to FY2016, we estimate, and we project rather robust profitability per hectare in FY2015 and FY2016 of USD 256 and USD 265, respectively. A possible legislative reinstatement of export VAT redemption, starting early FY2016, is among the future drivers of the farming segment.

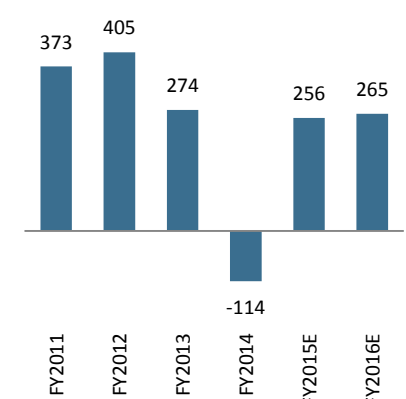
Evolution of crop yields, t/ha



Harvested land, ths ha



Farming EBITDA per hectare, USD

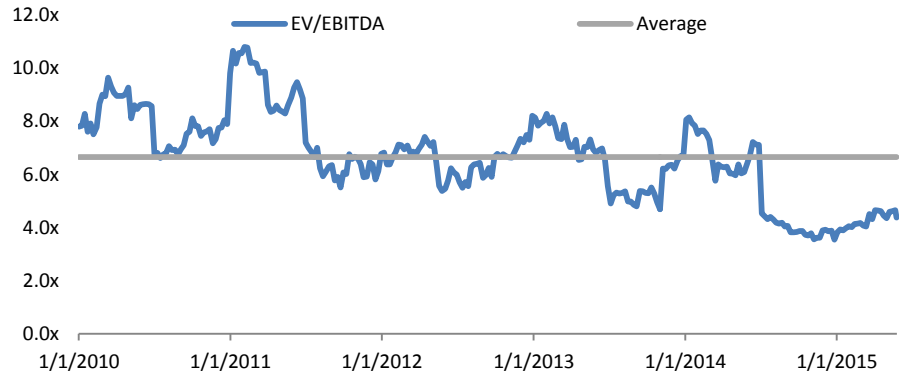


Source: Company data, Concorde Capital estimates

Valuation

Kernel's stock has been trading in the range of 3.5-10.6x on its forward EV/EBITDA multiple since the beginning of 2010, according to Bloomberg. The average historical multiple for the period is 6.6x, while we suggest that the 6-8x valuation range on its forward EV/EBITDA ratio is justified.

Kernel EV/EBITDA



Source: Bloomberg, Concorde Capital estimates

We assign 6x as a target for the EV/EBITDA multiple. Accounting for our projections of FY2015 EBITDA of USD 370 mln and net debt of USD 438 mln, we derive the target price for the stock at PLN 83/share (USD 22/share), implying a 125% upside. Employing consensus projections for EBITDA and net debt, we arrive at an implied price of PLN 68/share (USD 18/share), returning a 84% potential upside.

Valuation of KER PW on EV/EBITDA multiple

	Implied price on Concorde Capital estimates	Implied price on consensus estimates
Current share price, PLN	36.8	36.8
FX rate for PLN/USD	3.7	3.7
Number of shares, mln	79.7	79.7
Current equity value, USD mln	791	791
Net debt, as of eop, USD mln	438	530
Current EV, USD mln	1 229	1 321
FY2015E EBITDA projected	370	335
Implied forward 2015 EV/EBITDA	3.3	3.9
Average historical forward EV/EBITDA (2010-15)	6.6	6.6
EV/EBITDA target multiple	6.0	6.0
Estimated implied EV, USD mln	2 222	2 010
Estimated implied equity value, USD mln	1 785	1 480
Implied price, USD/share	22	19
Implied price, PLN/share	83	69
<i>Implied upside</i>	<i>125%</i>	<i>87%</i>

Source: Concorde Capital estimates, Bloomberg

For comparison purposes, we provide the forward EV/EBITDA ratios for Kernel's peers.

Kernel compared to peers on its forward EV/EBITDA multiple

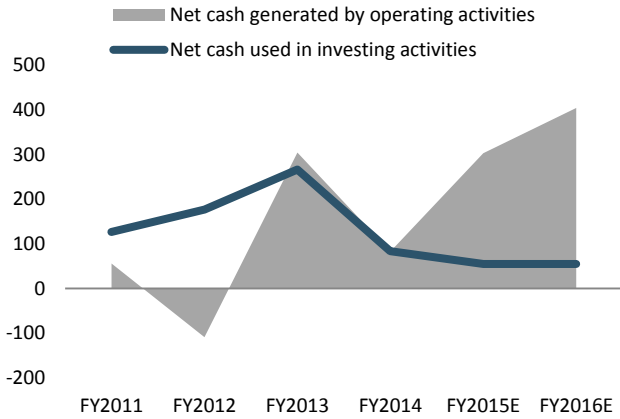
	Current market capitalization	Net debt, 2015E	Enterprise value (EV)	EBITDA, 2015E	EV/EBITDA 2015
Bunge	13 044	3 045	16 089	2 235	7.2
Wilmar	16 218	14 505	30 723	2 369	13.0
Archer-Daniels-Midland	32 446	5 026	37 472	3 982	9.4
Thai Vegetable Oil	532	57	589	68	8.7
China foods	2 194	114	2 308	146	15.8
Andersons	1 249	458	1 707	196	8.7
Median					9.1
Kernel	791	530	1 321	335	3.9

Source: Concorde Capital estimates, Bloomberg

Deleveraging to boost equity value

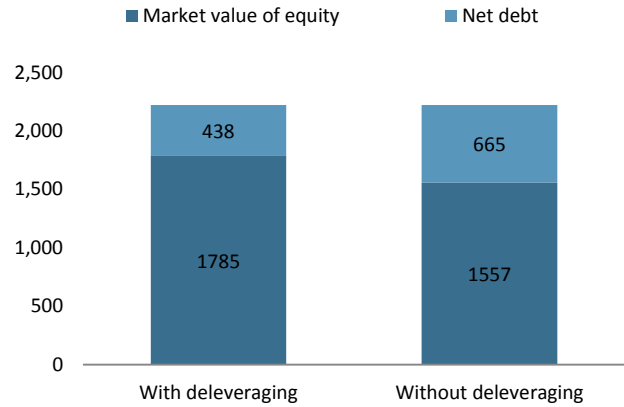
The company has chosen to minimize capital expenditures at USD 55mln in FY2015, and has invested, in fact, a tiny USD 14 mln in 1HFY15, or 41% less yoy. We expect the company will remain that conservative, in terms of investments, in the coming years as well. Based on this, we project the company's net debt to decrease by 34% yoy to USD 438 mln by the end of FY2015. This factor alone will cause a 15% increase in the estimated market value of its equity, compared to the case of unchanged net debt.

Net operating cash flow vs. capital investments, USD mln



Source: Company data, Concorde Capital estimates

12M effect on Kernel equity value from deleveraging, USD mln



Source: Concorde Capital estimates

Operating model assumptions

	FY2011	FY2012	FY2013	FY2014	FY2015E	FY2016E
Hryvnia exchange rate, UAH/USD	7.9	8.0	8.0	9.1	17.7	24.0

Assumptions on key business segments	FY2011	FY2012	FY2013	FY2014	FY2015E	FY2016E
Sunflower oil						
Annual oil production (estimated), kt	875	1097	1019	1027	1061	1078
Bulk oil sales, kt	821	828	1040	920	927	977
Bottled oil sales, '000 litres	118	132	108	94	105	107
EBITDA per '000 litres of bottled oil, USD/t	224	242	238	282	244	240
EBITDA per ton of bulk oil, USD/t	214	201	166	164	190	185

Grain & infrastructure						
Export terminal throughput, kt	2121	1809	3209	3926	4832	5074
Ukrainian terminal	2121	1809	2910	2782	3498	3673
Taman	-	-	299	1145	1334	1401
EBITDA per ton in UA terminal, USD/t	8	8	9	10	9	9
Profit per ton of Taman terminal, USD/t	-	-	-7	3	3	3
Grain sales, kt	1810	2123	3022	4244	4770	5009
Grain trading EBITDA margin, %	12%	5%	1%	6%	5%	5%
Silo services EBITDA margin, %	35%	36%	42%	53%	50%	50%

Farming						
Crop production, kt	218	550	614	1375	1796	1805
grain, kt	154	423	473	1056	1499	1541
oilseeds, kt	64	127	140	319	297	264
Harvested land, '000 ha	85	182	247	389	372	384
EBITDA of farming, USD mln	32	74	68	-44	95	102
EBITDA per hectare, USD per hectare	373	405	274	-114	256	265

Revenue breakdown, USD mln	FY2011	FY2012	FY2013	FY2014	FY2015E	FY2016E
Bulk oil	1158	1192	1528	1079	975	1026
Bottled oil	152	203	183	133	123	126
Export terminal	33	29	49	45	53	60
Silo services	27	51	46	74	52	72
Grain trading	571	599	972	1054	1059	1112
Farming	55	171	193	290	340	341
Sugar&discontinued	0	13	29	35	24	0
Reconciliation	-96	-186	-204	-317	-317	-317
Total	1899	2072	2797	2393	2308	2420

EBITDA breakdown, USD mln	FY2011	FY2012	FY2013	FY2014	FY2015E	FY2016E
Bulk oil	176	167	173	151	176	181
Bottled oil	26	32	26	27	26	26
Export terminal	18	14	27	27	31	32
Silo services	9	18	19	39	26	36
Grain trading	66	27	13	59	55	58
Farming	32	74	68	-44	95	102
Sugar&discontinued	0	17	-4	0	3	0
Other	-18	-29	-34	-37	-41	-41
Total	310	319	288	223	370	393

Financials

Income statement, USD mln	FY2011	FY2012	FY2013	FY2014	FY2015E	FY2016E
Revenue	1899	2072	2797	2393	2308	2420
Net IAS 41 gain	0	0	15	-17	2	0
Cost of sales	-1440	-1614	-2361	-1968	-1702	-1788
Gross profit	460	457	451	408	608	632
<i>Gross margin, %</i>	24%	22%	16%	17%	26%	24%
SGA	-208	-266	-316	-340	-287	-287
Other operating income	26	66	67	60	49	48
Operating profit	277	257	201	129	293	318
<i>Operating profit margin, %</i>	15%	12%	7%	5%	13%	13%
Financial costs, net	-42	-63	-75	-72	-63	-51
Foreign exchange gain (loss), net	2	5	3	-99	-149	0
Other income / (expenses), net	-28	-3	-6	-52	-10	-10
Share of profit / (losses) of joint venture	0	0	-2	4	5	5
PBT	208	196	121	-90	75	262
Income tax	18	9	-6	-11	-11	-11
Net profit/ (loss) from continuing operations	226	206	115	-102	64	251
Profit / (loss) from discontinued operations	0	5	-10	-6	-6	0
Net profit / (loss)	226	211	105	-107	58	251
<i>Net margin, %</i>	12%	10%	4%	-4%	3%	10%
<i>No. of shares</i>	79.7	79.7	79.7	79.7	79.7	79.7
EPS adj., USD/share	2.81	2.58	1.28	-0.11	2.60	3.15
DPS, USD/share	0	0	0	0	0.25	0.25
Total dividends paid, USD mln	0	0	0	0	20	20
EBITDA, USD mln	310	322	288	223	370	393
<i>EBITDA margin, %</i>	16%	16%	10%	9%	16%	16%

Source: Company data, Concorde Capital estimates

Balance sheet, USD mln	FY2011	FY2012	FY2013	FY2014	FY2015E	FY2016E
Assets						
Receivables	116	143	151	100	97	80
Prepayments and other current	123	118	110	57	70	65
Inventory	561	405	270	300	295	270
Biological assets	16	155	247	183	182	150
Taxes recoverable and prepaid	235	238	210	156	130	130
Held for sale	0	0	23	12	12	12
Cash and cash equivalents	130	83	79	65	198	402
Total current assets	1181	1142	1090	873	984	1109
PPE	678	722	763	643	621	602
Other	335	236	508	403	403	403
Total non-current assets	1013	958	1272	1046	1024	1005
Total assets	2194	2100	2362	1919	2008	2114
Liabilities & Equity						
Payables	43	26	47	33	30	29
ST borrowings and current portion of LT	451	268	450	483	503	392
Other	247	140	203	81	81	81
Total current liabilities	741	434	700	597	614	502
LT borrowings	269	414	257	248	133	119
Other	29	27	53	43	43	43
Total non-current liabilities	298	441	309	291	176	162
Issued capital	2	2	2	2	2	2
Retained earnings	720	832	947	849	1036	1267
Non-controlling interest	73	30	17	1	1	1
Other	360	362	386	179	179	179
Total equity	1154	1226	1352	1031	1218	1449
Total liabilities & Equity	2194	2100	2362	1919	2008	2114

Source: Company data, Concorde Capital estimates

Cash flow statement, USD mln	FY2011	FY2012	FY2013	FY2014	FY2015E	FY2016E
Operating activities						
(Loss) / Profit before income tax	208	194	110	-97	75	262
D&A	32	69	90	94	77	75
Other	34	27	88	199	206	51
Operating profit before WC changes	275	290	288	196	359	388
Working capital changes	-180	-335	135	-1	18	78
Cash generated from operations	95	-45	423	195	377	466
Finance costs paid	-36	-59	-76	-72	-63	-51
Income tax paid	-3	-5	-43	-40	-11	-11
Net cash generated by operating activities	56	-109	304	82	302	404
Investing activities						
Purchase of PPE	-50	-54	-93	-50	-55	-55
Other	-76	-123	-173	-33	0	0
Net cash used in investing activities	-126	-176	-266	-83	-55	-55
Financing activities						
Change in total debt	-18	215	-45	7	-95	-125
Dividends paid	0	0	0	0	-20	-20
Net cash financing activities	124	220	-48	7	-115	-145
Effect of FX change	-1	0	0	-13	0	0
Net decrease in cash and cash equivalents	52	-65	-10	-7	133	204
Cash, boy	58	110	83	73	65	198
Cash, eoy	110	83	73	65	198	402

Source: Company data, Concorde Capital estimates

Financial analysis items	FY2011	FY2012	FY2013	FY2014	FY2015E	FY2016E
FCF, USD mln	-70	-285	38	-1	247	349
Total debt, USD mln	720	682	706	731	636	511
Net debt, USD mln	590	599	627	665	438	109
Net debt/EBITDA	1.9	1.9	2.2	3.0	1.2	0.3
Total debt/equity	0.6	0.6	0.5	0.7	0.5	0.4

Source: Company data, Concorde Capital estimates

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