Ukraine
Consumer | Food
Company Update

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Kernel

Strong balance sheet to lead to further M&As or special dividend payment

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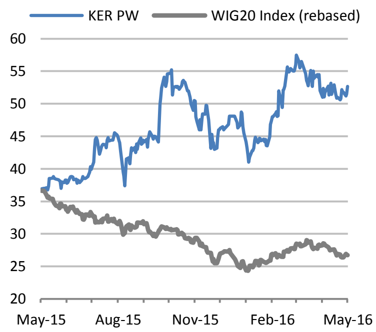
Bloomberg ticker	KER PW
Recommendation	**BUY**
Current price, PLN	51.0
Target price, PLN	100.0
Upside, %	96%
No. of shares, mln	79.7
MCap, USD mln	1032
Free float, %	60.7%
Free float, USD mln	626.1
Net debt, 2016E	199
Annual div. yield	1.9%

Ownership structure

Namsen LTD (A. Verevskyy)	39.3%
Other	60.7%

Source: Company data, Concorde Capital, Bloomberg

Price performance, PLN



Source: Bloomberg, Concorde Capital estimates

Ukraine's largest sunflower oil producer Kernel (KER PW) will report its 3QFY16 (Jan-Mar 2016) financials on May 30. We suggest looking out for the latest positive indicators of Kernel's resilient business model. In FY2016, the robust performance of the company's farming and infrastructure will mostly outweigh the weaker result of its sunflower oil segment. Kernel is on track to reduce leverage to 0.5x in its net debt/EBITDA by June 2016, despite increasing crushing capacities and higher market share. As a deleveraged balance sheet isn't an end in itself, we expect Kernel either to continue M&As in FY2017 or pay out a special dividend. We affirm our BUY recommendation for KER PW, based on its attractive 3.3x EV/EBITDA forward multiple, and we are upgrading its target price to PLN 100/share, implying a 96% upside.

Current mix of business segments mitigates volatility. We expect Kernel to report EBITDA of USD 91 mln for 3QFY16, supporting our estimate of USD 370 mln in FY2016 (-7% yoy). Despite the decline, we would call such a result solid, given that Kernel earned its best EBITDA ever in FY2015. The current portfolio of business segments helps to keep the group's result relatively stable: oil segment suffered from FX rate volatility in November-February, while its farming benefited from the devaluation of hryvnia. The crushing margin recovery due to expiration of tolling agreement and stable FX hryvnia rate that we expect in FY2017 would contribute to ensure another strong financial year.

Growing larger and reducing the leverage. With new capacities and access to working capital in hand, Kernel boosted its oil output 7% yoy in 9MFY16 and outperformed local sunflower oil sector, which endured a 10% yoy drop. The company's share in Ukraine's bulk oil production grew to 34% in 9MFY16 from 29% last year. Meanwhile, we project Kernel's net CapEx will be limited at USD 56 mln in FY2016E (USD 24 mln last year). As a result, the company will generate FCF in FY2016 of USD 148 mln, quite abundant and for the second year in a row. The modelled total debt cut by USD 125 to USD 332 mln will improve Kernel's total debt-to-equity ratio to 0.3x by June 2016, vs. 0.5x last year.

FY2017 promises a bunch of triggers for Kernel's stock. We wouldn't expect Kernel to bring its net debt to or below zero. So with FCF at least at the level of FY2016E (USD 148 mln), the company is set to continue its M&A activity, which will boost its market power in Ukraine or pay out a special dividend. Both options have been discussed as viable and possible by management.

Net debt "hides" portion of equity value throughout the year. Kernel relies on short-term debt to fund its working capital needs, which usually peak by 2Q and land at a lower level by 4Q. We are estimating Kernel's target price based on its net debt of USD 199 mln as of June 2016, which implies an attractive forward EV/EBITDA ratio of 3.3x. Should net debt of USD 466 mln as, of end December 2015, be used for valuation (which isn't justified in our view), the implied forward multiple would be 4.1x, or 21% higher. As Kernel releases part of its working capital by the end of FY2016, the stock may turn out to be "surprisingly cheaper," only due to such seasonal fluctuations in the capital structure. The "hidden value" will be unveiled along with the publication of its 4QFY16 books, scheduled for October 2016.

Selected financial items

	FY2011	FY2012	FY2013	FY2014	FY2015	FY2016E
Revenue, USD mln	1,899	2,072	2,797	2,393	2,330	2,271
EBITDA, USD mln	310	322	288	223	397	370
EPS, adj. on FX changes, USD/share	2.81	2.58	1.28	-0.11	3.12	3.04
DPS, USD/share	0	0	0	0	0.25	0.25
FCF, USD mln	-70	-285	38	-1	380	148
Net debt, USD mln	590	599	627	665	327	199

Source: Company data, Concorde Capital estimates

Strong infrastructure and farming to offset lower margins in crushing in FY2016

We project Kernel will report EBITDA of USD 91 mln in 3QFY16 (-21% yoy) and USD 78 mln in 4QFY16 (+33% yoy). Its annual EBITDA will decline 7% yoy to USD 370 mln: lower performance in its bulk oil production segment will be mostly offset by improvements in its farming, grain trading and silo services segments.

We base our estimates on the following guidance from management for FY2016:

- Seed crushing of around 2.7 mmt (+7% yoy), as a result of an existing tolling agreement for additional capacities of 560 kt;
- Crushing margin of USD 120-130/t (we are sticking to the lower bound of the range);
- EBITDA of the farming segment to be around USD 130 mln (+33%).

We assume that the reinstatement of export VAT redemption as of January 2016 will increase the EBITDA margin of its grain trading segment to 9% in 3QFY16-4QFY16, compared to 4-6% in previous quarters, causing 8% yoy growth in the segment's EBITDA to USD 64 mln in FY2016.

Kernel's quarterly EBITDA breakdown, USD mln

	1QFY15	2QFY15	3QFY15	4QFY15	1QFY16	2QFY16	3QFY16E	4QFY16E	FY2015	FY2016E	*change, % yoy*
Bulk oil	41	57	69	26	23	35	34	38	193	130	*-33%*
Bottled oil	4	9	4	4	3	7	5	5	21	20	*-2%*
Export terminal	7	11	11	8	6	12	12	8	37	37	*2%*
Silo services	5	13	1	0	5	16	1	0	18	21	*15%*
Grain trading	18	15	23	4	10	11	25	18	59	64	*8%*
Farming	11	44	12	31	16	74	20	20	98	130	*33%*
Sugar & discontinued	3	0	0	1	0	0	0	0	4	0	*-100%*
Other	-7	-6	-5	-15	-8	-10	-5	-10	-33	-33	*0%*
Total	**81**	**142**	**115**	**59**	**55**	**145**	**91**	**78**	**397**	**370**	*-7%*

Source: Company data, Concorde Capital estimates

Kernel's crushing volume in 9MFY16 (July 2015 to March 2016) grew 7% yoy to 2,037 kt of sunflower seed, in line with management's projections of 2.7 mmt in FY2016. We estimate the company produced 896 kt of sunflower oil in 9MFY16 (+7% yoy). Thus, Kernel has outperformed the Ukrainian sector's result, which faced a 19% yoy decline in crushing volumes to 5,925 kt and 10% yoy decrease in oil production to 2,656 kt during the period, as Ukrstat's data imply. The share of Kernel's sunflower oil production grew to 34% compared to 29% a year ago.

Exceeding the sector's production pace became possible due to a tolling agreement for 450 kt of sunflower seed capacities, signed in two parts in September and December 2015. The agreement was the precursor to Kernel's acquisition of these crushing capacities, located in the Kirovohrad region and totalling 560 kt as of February 2016. The deal might be closed by September 2016, according to management, just before the sunflower seed harvest. If adjusted for the divestiture of two crushing plants in Russia in mid-April, Kernel's crushing capacities grew 2% yoy to 3.2 mmt.

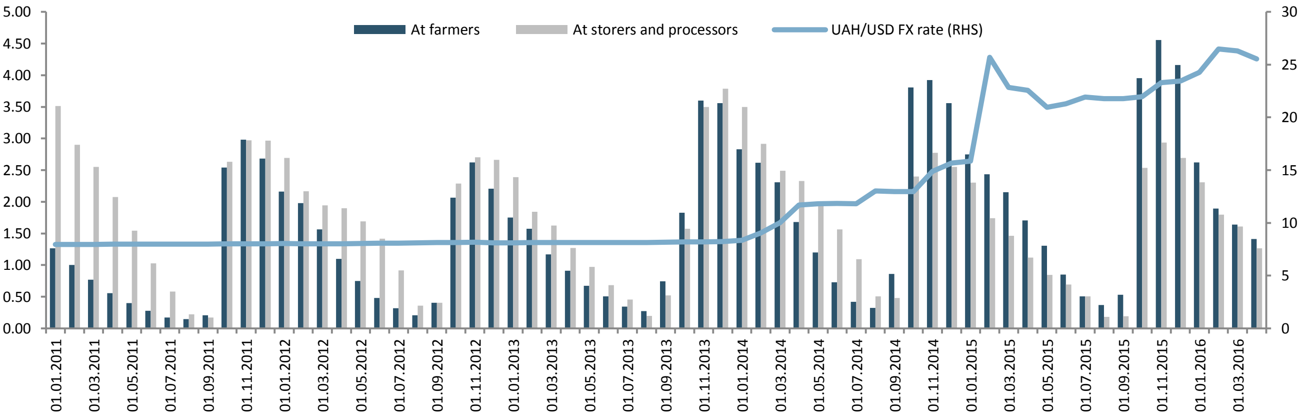
We attribute the sector's adverse results to Russia's occupation of certain parts of the Donetsk and Luhansk regions, where crushing capacities were located, as well as lower availability of working capital for small crushers, which has driven many of them out of the market.

Kernel's higher sunflower oil production was outweighed by a reduction in its crushing margin. The EBITDA margin in its bulk oil sales fell 37% yoy to USD 127/t in 1HFY16, compared to USD 203/t a year ago.

Two reasons, subject to possible reversal next year, have caused the lower margins:

1) Charges to the counterparty of the tolling agreement;
2) Widespread expectations of hryvnia depreciation as of end 2015-early 2016 made farmers more reluctant to sell seed. Stockpiles at farmers reached historical highs, and were much larger than that at storages and processors, according to data from Ukrstat. This in contrast to what happened in 2011-13, when farmers tried to sell out stocks of seed as soon as possible, as the statistics imply.

Sunflower seed stocks at farmers, and at storage facilities and processors' sites, kt



Source: The State Statistic Service of Ukraine (Ukrstat), Bloomberg

The tolling agreement for crushing capacities in the Kirovohrad region expires in September and will become ownership over the facilities. Combined with the recent stability of the hryvnia, this ensures the availability of seed, which promises a high capacity load and strong margins.

In the farming segment, Kernel's EBITDA per hectare will grow 32% yoy to USD 337/ha in FY2016, driven by steep hryvnia devaluation, according to guidance from management of USD 130 mln. This will be close to the sector's median of USD 324/ha.

Reported profitability per hectare by Ukrainian farmer

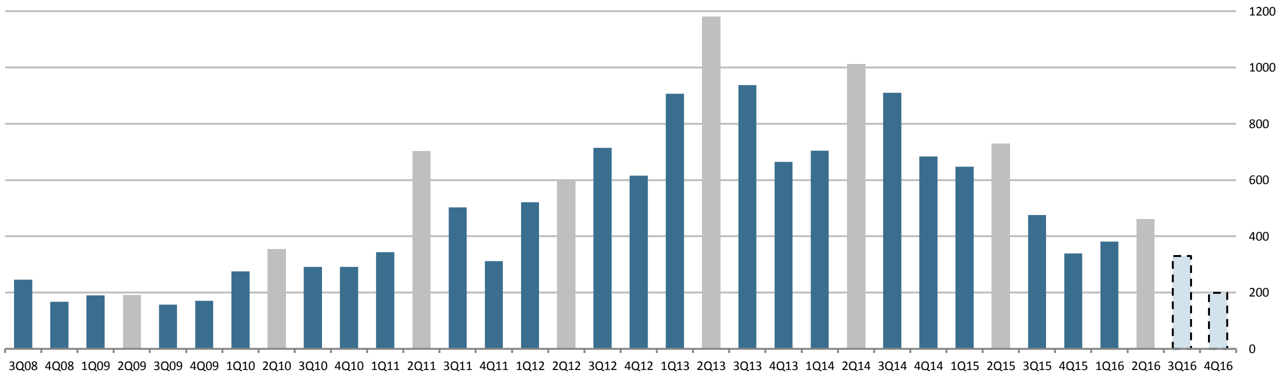
EBITDA/ha, USD	2011	2012	2013	2014	2015
Ukrlandfarming	1056	858	448	378	324
Kernel (calendar 2015=Kernel's FY2016)	**405**	**274**	**-114**	**256**	**337**
MHP	484	448	136	294	276
Astarta	267	290	255	344	258
IMC	274	329	401	509	562
Agroton	205	142	47	223	244
KSG Agro	685	406	33	205	484
Median	**405**	**329**	**136**	**294**	**324**

Source: Company data, Concorde Capital estimates

The key capital expenditures will be maintenance costs and the first spending tranche to acquire the 560 kt crushing plant. So we project CapEx at USD 68 mln in FY2016, compared to USD 25 mln last year. The outflow will be partly compensated with proceeds of USD 12 mln from the sale of two Russian crushing plants.

Kernel's net debt has demonstrated a certain seasonal pattern: net debt usually peaks in 2Q (ending in December), along with inventories, and then subsides in 4Q (by June). We project net debt at USD 199 mln as of June 2016 (-40% yoy) as the company pursues deleveraging and limits its CapEx budget. We suggest using the year-end net debt for valuation, compared to debt throughout the year, which has been volatile.

Seasonality of Kernel's net debt, mln USD



Source: Company data, Concorde Capital estimates

Valuation

Kernel's stock trades at a forward EV/EBITDA multiple of 3.3x, which implies a hefty discount of 65% to the median of international peers of 9.5x.

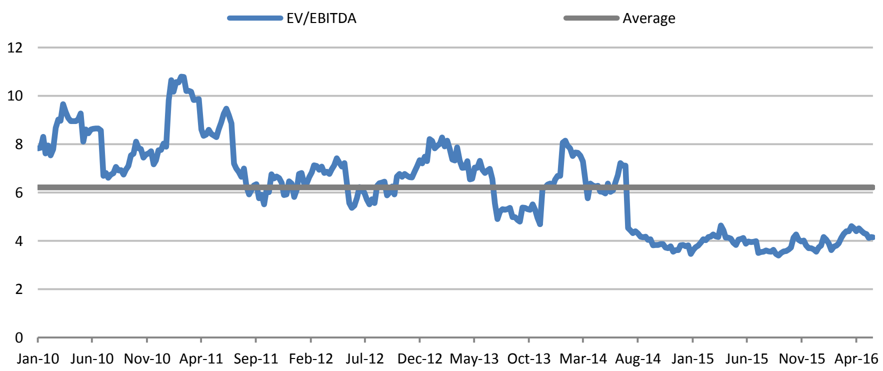
Kernel compared to peers on its forward EV/EBITDA multiple

	Current market capitalization	Net debt, 2016E	Enterprise value (EV)	EBITDA, 2016E	EV/EBITDA 2016
Archer-Daniels-Midland	23,403	5,688	29,091	2,996	9.7
Wilmar	15,160	13,371	28,531	2,372	12.0
Bunge	8,745	3,581	12,326	1,863	6.6
Andersons	967	450	1,417	126	11.2
China foods	965	187	1,152	195	5.9
Thai Vegetable Oil	658	(33)	625	65	9.5
Median					**9.5**
Kernel	**1,032**	**199**	**1,232**	**370**	**3.3**
Discount to peers					*-65%*

Source: Concorde Capital estimates, Bloomberg

In our valuation of Kernel's stock, we rely on its own historical EV/EBITDA range. Since 2010, Kernel traded in the range of 3.5-10.6x on its forward EV/EBITDA multiple, and the average historical multiple for the period was 6.2x.

Kernel's EV/EBITDA



Source: Bloomberg, Concorde Capital estimates

We maintain the target for the company's EV/EBITDA multiple assigned at a level of 6x. Accounting for our projections of FY2016 EBITDA of USD 370 mln and net debt of USD 199 mln as of June 2016, we derive the target price for the stock at PLN 100/share (USD 25/share), returning a 86% 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	51.0	51.0
FX rate for PLN/USD	3.9	3.9
Number of shares, mln	79.7	79.7
Current equity value, USD mln	1,032	1,032
Net debt, as of eop, USD mln	199	247
Current EV, USD mln	1,232	1,279
FY2016E EBITDA projected	**370**	**368**
Implied forward 2016 EV/EBITDA	3.3	3.5
Average historical forward EV/EBITDA (2010-15)	6.6	6.6
EV/EBITDA target multiple	**6.0**	**6.0**
Estimated implied EV, USD mln	2,218	2,205
Estimated implied equity value, USD mln	2,018	1,958
Implied price, USD/share	25	25
Implied price, PLN/share	**100**	**97**
Implied upside	*96%*	*90%*

Source: Concorde Capital estimates, Bloomberg

Operating model assumptions

Assumptions on key business segments	FY2011	FY2012	FY2013	FY2014	FY2015	FY2016E
Sunflower oil						
Annual oil production (estimated), kt	875	1097	1019	1027	1110	1182
Bulk oil sales, kt	821	828	1040	920	1030	1084
Bottled oil sales, '000 litres	118	132	108	94	99	106
EBITDA per ton of bulk oil, USD/t	214	201	166	164	187	120
EBITDA per '000 litres of bottled oil, USD/t	224	242	238	282	207	189
Grain&infrastructure						
Export terminal throughput, kt	2121	1809	3209	3926	4822	5485
Ukrainian terminal	2121	1809	2910	2782	3487	3811
Taman	-	-	299	1145	1334	1674
EBITDA per ton in UA terminal, USD/t	8	8	9	10	11	10
Profit per ton of Taman terminal, USD/t	-	-	-7	2	4	4
Grain sales, kt	1810	2123	3022	4244	4744	4665
Grain trading EBITDA margin, %	12%	5%	1%	6%	6%	8%
Silo services EBITDA margin, %	35%	36%	42%	53%	43%	53%
Farming						
Crop production, kt	218	550	614	1375	1796	1867
grain, kt	154	423	473	1056	1499	1534
oilseeds, kt	64	127	140	319	297	333
Harvested land, '000 ha	85	182	247	389	383	386
EBITDA of farming, USD mln	32	74	68	-44	98	130
EBITDA per hectare, USD per hectare	373	405	274	-114	256	337

Source: Company data, Concorde Capital estimates

Revenue breakdown, USD mln	FY2011	FY2012	FY2013	FY2014	FY2015	FY2016E
Bulk oil	1158	1192	1528	1079	1100	1158
Bottled oil	152	203	183	133	114	114
Export terminal	33	29	49	45	55	47
Silo services	27	51	46	74	42	40
Grain trading	571	599	972	1054	1053	907
Farming	55	171	193	290	310	452
Sugar&discontinued	0	13	29	35	26	0
Reconciliation	-96	-186	-204	-317	-371	-445
Total	**1899**	**2072**	**2797**	**2393**	**2330**	**2271**

EBITDA breakdown, USD mln	FY2011	FY2012	FY2013	FY2014	FY2015	FY2016E
Bulk oil	176	167	173	151	193	130
Bottled oil	26	32	26	27	21	20
Export terminal	18	14	27	27	37	37
Silo services	9	18	19	39	18	21
Grain trading	66	27	13	59	59	64
Farming	32	74	68	-44	98	130
Sugar&discontinued	0	17	-4	0	4	0
Other	-18	-29	-34	-37	-33	-33
Total	**310**	**319**	**288**	**223**	**397**	**370**

Financials

Income statement	FY2011	FY2012	FY2013	FY2014	FY2015	FY2016E
Revenue	**1899**	**2072**	**2797**	**2393**	**2330**	**2271**
Net IAS 41 gain	0	0	15	-17	-7	5
Cost of sales	-1440	-1614	-2361	-1968	-1810	-1740
Gross profit	460	457	451	408	512	536
Gross margin, %	*24%*	*22%*	*16%*	*17%*	*22%*	*24%*
SGA	-208	-266	-316	-340	-267	-215
Other operating income	26	66	67	60	83	49
Operating profit	**277**	**257**	**201**	**129**	**328**	**305**
Operating profit margin, %	*15%*	*12%*	*7%*	*5%*	*14%*	*13%*
Financial costs, net	-42	-63	-75	-72	-69	-59
Foreign exchange gain (loss), net	2	5	3	-99	-153	0
Other income / (expenses), net	-28	-3	-6	-52	-11	-11
Share of profit / (losses) of joint venture	0	0	-2	4	5	6
PBT	**208**	**196**	**121**	**-90**	**101**	**242**
Income tax	18	9	-6	-11	0	0
Net profit/ (loss) from contrinuing operations	226	206	115	-102	101	242
Profit / (loss) from discontinued operations	0	5	-10	-6	-5	0
Net profit / (loss)	**226**	**211**	**105**	**-107**	**96**	**242**
Net margin, %	*12%*	*10%*	*4%*	*-4%*	*4%*	*11%*
No. of shares	79.7	79.7	79.7	79.7	79.7	79.7
EPS adj.	2.81	2.58	1.28	-0.11	3.12	3.04
DPS	0	0	0	0	0.25	0.25
Total dividends paid, USD mln	0	0	0	0	20	20
EBITDA	**310**	**322**	**288**	**223**	**397**	**370**
EBITDA margin, %	16%	16%	10%	9%	17%	16%

Source: Company data, Concorde Capital estimates

Balance sheet, USD mln	FY2011	FY2012	FY2013	FY2014	FY2015	FY2016E
ASSETS						
Receivables	116	143	151	100	56	60
Prepayments and other current	123	118	110	57	77	81
Inventory	561	405	270	300	159	230
Biological assets	16	155	247	183	147	150
Taxes recoverable and prepaid	235	238	210	156	88	110
Held for sale	0	0	23	12	2	2
Cash and cash equivalents	130	83	79	65	129	132
Total current assets	**1181**	**1142**	**1090**	**873**	**659**	**766**
PP&E	678	722	763	643	535	527
Other	335	236	508	403	272	272
Total non-current assets	**1013**	**958**	**1272**	**1046**	**807**	**799**
Total assets	**2194**	**2100**	**2362**	**1919**	**1466**	**1565**
LIABILITIES&EQUITY						
Payables	43	26	47	33	27	29
ST borrowings and current portion of LT	451	268	450	483	367	257
Other	247	140	203	81	63	63
Total current liabilities	**741**	**434**	**700**	**597**	**458**	**349**
LT borrowings	269	414	257	248	89	75
Other	29	27	53	43	28	28
Total non-current liabilities	**298**	**441**	**309**	**291**	**117**	**103**
Issued capital	2	2	2	2	2	2
Retained earnings	720	832	947	849	926	1148
Non-controlling interest	73	30	17	1	1	1
Other	360	362	386	179	-38	-38
Total equity	**1154**	**1226**	**1352**	**1031**	**891**	**1113**
Total liabilites and equity	**2194**	**2100**	**2362**	**1919**	**1466**	**1565**

Source: Company data, Concorde Capital estimates

Cash flow statement, USD mln	FY2011	FY2012	FY2013	FY2014	FY2015	FY2016E
Operating activities						
(Loss) / Profit before income tax	208	194	110	-97	97	242
D&A	32	69	90	94	68	64
Other	34	27	88	199	173	59
Operating profit before WC changes	**275**	**290**	**288**	**196**	**339**	**365**
Working capital changes	-180	-335	135	-1	147	-103
Cash generated from operations	**95**	**-45**	**423**	**195**	**486**	**263**
Finance costs paid	-36	-59	-76	-72	-68	-59
Income tax paid	-3	-5	-43	-40	-13	0
Net cash generated by operating activities	**56**	**-109**	**304**	**82**	**405**	**203**
Investing activities						
Purchase of PPE	-50	-54	-93	-50	-25	-68
Other	-76	-123	-173	-33	0	12
Net cash used in investing activities	**-126**	**-176**	**-266**	**-83**	**-24**	**-56**
Financing activities						
Change in total debt	-18	215	-45	7	-289	-125
Dividends paid	0	0	0	0	-20	-20
Net cash financing activities	**124**	**220**	**-48**	**7**	**-309**	**-145**
Effect of FX change	-1	0	0	-13	-12	0
Net decrease in cash and cash equivalents	**52**	**-65**	**-10**	**-7**	**59**	**3**
Cash, boy	58	110	83	73	65	129
Cash, eoy	110	83	73	65	129	132

Source: Company data, Concorde Capital estimates

Financial analysis items	FY2011	FY2012	FY2013	FY2014	FY2015	FY2016E
FCF, USD mln	-70	-285	38	-1	380	148
Total debt, USD mln	720	682	706	731	456	332
Net debt, USD mln	590	599	627	665	327	199
Net debt/EBITDA	1.9	1.9	2.2	3.0	0.8	0.5
Total debt/equity	0.6	0.6	0.5	0.7	0.5	0.3

Source: Company data, Concorde Capital estimates

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