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Haitong Bank in a report from June 19 (08:00), reiterates its BUY recommendation for Stalprodukt but lowers FV considerably to PLN 362.69 per share from PLN 611, mainly on the recent underperformance of the zinc segment stemming from lower than expected mine production at the Boleslaw mine. Nonetheless, Haitong Bank still likes Stalprodukt because of: 1) its cheap-looking multiples; 2) forthcoming ramp-up of the new tank hall project; and 3) possible mine extension in the Laski mining area, although their base-case valuation does not include this project.

Valuation Methodology

Our valuation approach for Stalprodukt uses two methods: a discount cash flow (DCF) and peer valuation. We calculate the final FV as the average of the two results with equal weightings.

Risks to Fair Value

Risk related to Arcelor Mittal switching off its furnace In Krakow

Due to a massive turnaround in macro factors such as high carbon prices in 2H18 and ineffective tariffs on cheap steel imported from the East, Arcelor Mittal decided to halt its blast furnace and steep plant in Krakow in September. The company did not specify for how long the shutdown may last, which depends on the condition of steel market. If the shutdown turns out to be permanent due to a lack of reaction from EU authorities, there is a risk that Mittal's project on HiB steel won't even start operations.

For Stalprodukt there is PLN 74m of operating margin at risk, according to our calculations, which may result in a ca. PLN 24 per share lower DCF valuation.

Macroeconomic Environment

The results of the Group, and especially the steel profiles segment's activities, are heavily dependent on general economic conditions and in particular on the development of the general and road construction industry. The GDP growth rate is a good indicator of general economic conditions.

We think that exposure to highly cyclical industries poses a threat in the event of an unexpected economic slowdown. We believe a weaker macroeconomic environment would result in volumes and price drops, especially in the steel profiles segment.

High Competition between Producers of Cold-Formed Profiles and Companies Running Steel Service Centers

Competition among the producers of cold formed profiles and companies running steel service centers is an important risk factor affecting the fulfilment of the sales targets adopted by the Group. The Group also has to compete with imports of finished products which enjoy competitive feedstock prices. In this context it is worth pointing out that the total import volumes of cold formed profiles in 2016 reached 222,000 tons, which is an increase of 23.9% compared to 2015. As the company sells commodity products, imports of cheaper substitutes may negatively affect sales volumes.

Consequences of the EcoDesign Directive

The Tier 2 EcoDesign Directive, which takes effect in 2021, will compel transformer producers to purchase the highest grades of electrical steel sheets, i.e. the ones with the lowest core loss levels. If STP does not adjust its product offer to the new market requirements it may face the risk of lost sales volumes in the electrical steel segment.

Risks Related to Zinc Segment Activities

- FX risk
- risk from fluctuating prices of energy source materials,
- risk from fluctuating prices of CO2 emission rights,
- approaching liquidation of the ”Olkusz-Pomorzany” mine (possibility of flooding),

- fluctuating prices of zinc concentrates and limited access to raw materials resulting from increased global demand,
- equity consolidation in the zinc sector in the mining and metallurgical areas,
- risk in relation to coke and electricity prices.

IMPORTANT DISCLOSURES