Kernel

3Q14 earnings review

INVESTMENT CAPITAL UKRAINE
INVESTMENT BANKING

Recommendation
Neutral
Target price
PLN48

Sector
Agribusiness

Ticker in Bloomberg
KER PW

THURSDAY, 4 JUNE, 2014

RESEARCH INSIGHT

Market reaction to Kernel's 3Q report strengthened our view that sentiment towards the stock is picking up. What is needed now in order to promote a sustained share price recovery is a successful turnaround in farming operations. However, this might be difficult to secure given overwhelming risks to grain prices and uncertain execution. We view the period through September as critical for the outlook and maintain a Neutral rating for the time being.

3Q earnings did not disappoint with strong performance observed across the board. With an improved crush margin and grain trading spread persisting during Feb-Mar, we expected to see strong profits in the third quarter driven by bulk oil and grain trading operations. Results delivered did not disappoint with pro-forma EBITDA of US$90m exceeding our expectations (US$73m). The grain trading arm sported a margin of US$25/t (~3x the recent norm) while bulk oil earned a very solid US$189/t. Good results were obscured by a one-off loss on VAT receivables and negative revaluation of biological assets which reduced headline earnings by US$60m.

Management offered an upbeat outlook on farming operations which, however, is subject to extensive downside risks. Operating expenses are seen flat y/y, while yields for corn and soybeans are projected to increase 27% and 57%, respectively, on the back of earlier revisions to production plans. Management also hopes that grain prices will at least stay flat going forward. Under such circumstances, the company might turn a decent profit on farming in FY15, but there are extensive downside risks to this outcome. Meeting projected yields might be challenging as Kernel's huge farming division has proven to be difficult to operate in the past. In addition, pricing could deteriorate across the grain and oilseed complexes should the US corn and soybean crops meet expectations.

Investors' reaction to earnings was encouraging but looming risks in farming weigh on our investment thesis. The market's reaction to the 3Q report and accompanying call was encouraging and flagged a melt up in market sentiment towards the stock. However, from a strategic standpoint, Kernel needs a successful turnaround in farming to ensure a sustained share price recovery. Unfortunately, execution and especially pricing pose a major threat to management's restructuring effort in the near-term with uncertainty extending into September. Therefore, we remain Neutral for the time being while keeping price target at PLN48.

Key data on company's shares

	Data as of 3 June 2014
Current price (PLN)	30
3m ADT (US$ 000)	3,753
52-week price range (PLN)	23-55
Mkt Cap (US$m)	791
Enterprise value (US$m)	1,521
Shares out (m)	79.7
Free float	61%
Exchange	Warsaw

Note: market exchange rate PLN3.04 per US$.
Source: Company, Bloomberg

Key financial figures

(US$m)	2013	2014E	2015F
Sales	2,797	2,369	2,256
Pro-forma EBITDA	273	237	262
Pro-forma Net profit	88	33	83
EPS (US$)	1.10	0.41	1.04

Source: Company, ICU

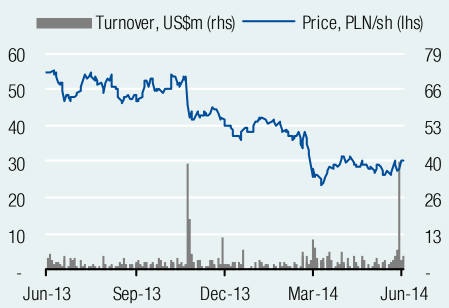
Key ratios

	LTM	2014E	2015F
EV/EBITDA	6.6	6.4	5.8
P/E	49.8	23.8	9.5
EV/Sales	0.6	0.6	0.7

Source: Bloomberg, ICU

Share price performance

Trailing 12 months



Source: Bloomberg.

Research team

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Table 1. 3Q14 results overview

		3Q14 Reported IFRS	+/-	3Q14 Reported Pro-forma	3Q13 Reported Pro-forma	Δ y/y	3Q14 Est.	Δ Rep. / Est.	4Q14 Est.
EBITDA									
Bulk sunflower oil	$ mn	50	-	50	36	37%	47	8%	42
Bottled sunflower oil	$ mn	7	-	7	6	13%	5	20%	5
Oilseed crushing	$ mn	57	-	57	42	34%	52	9%	48
Grain	$ mn	33	-	33	5	579%	24	39%	13
Export terminals	$ mn	8	-	8	5	62%	8	0%	6
Silo services	$ mn	8	-	8	5	53%	7	24%	5
Grain handling and marketing	$ mn	49	-	49	15	223%	38	28%	24
Farming	$ mn	(22)	15	(6)	(1)	317%	(8)	-26%	(1)
Other	$ mn	(54)	45	(9)	(9)	6%	(9)	10%	(6)
Total	$ mn	**30**	**60**	**90**	**47**	**91%**	**73**	**23%**	**65**
EBITDA margin									
Bulk sunflower oil	%			16.2%	12.0%	4.1	15.8%	0.4	14.7%
Bottled sunflower oil	%			20.2%	14.4%	5.8	18.9%	1.3	18.8%
Oilseed crushing	%			16.5%	12.3%	4.2	16.1%	0.5	15.1%
Grain	%			10.6%	2.0%	8.6	7.0%	3.6	6.0%
Export terminals	%			61.6%	55.8%	5.8	58.8%	2.8	50.0%
Silo services	%			61.7%	49.9%	11.8	50.0%	11.7	60.0%
Grain handling and marketing	%			14.7%	5.9%	8.8	10.6%	4.1	9.8%
Farming	%			-17.7%	-12.3%	(5.4)	-22.2%	4.4	-20.0%
Total	%			**13.4%**	**7.9%**	**5.5**	**10.7%**	**2.7**	**11.7%**

Table 2. Earnings forecast revision

		2014			2015		
		New Est.	Old Est.	Δ New - Old	New Est.	Old Est.	Δ New - Old
EBITDA							
Bulk sunflower oil	$ mn	142	138	3%	159	158	0%
Bottled sunflower oil	$ mn	29	24	19%	22	22	0%
Oilseed crushing	$ mn	171	162	5%	181	180	0%
Grain	$ mn	59	46	30%	43	43	0%
Export terminals	$ mn	27	28	-5%	28	28	0%
Silo services	$ mn	47	45	5%	27	29	-7%
Grain handling and marketing	$ mn	134	119	12%	98	100	-2%
Farming	$ mn	(34)	(35)	-5%	12	12	0%
Other	$ mn	(33)	(32)	3%	(29)	(29)	0%
Total	$ mn	**237**	**213**	**11%**	**262**	**263**	**0%**
EBITDA margin							
Bulk sunflower oil	%	14.0%	13.5%	0.5	14.3%	14.3%	0.0
Bottled sunflower oil	%	20.5%	18.5%	2.1	16.1%	16.1%	-
Oilseed crushing	%	14.8%	14.0%	0.7	14.5%	14.5%	(0.0)
Grain	%	5.5%	4.1%	1.4	4.6%	4.6%	-
Export terminals	%	58.2%	59.5%	(1.3)	55.5%	55.6%	(0.1)
Silo services	%	57.9%	55.0%	2.9	45.0%	45.0%	(0.0)
Grain handling and marketing	%	11.0%	9.5%	1.5	9.5%	9.7%	(0.2)
Farming	%	-12.4%	-13.0%	0.6	4.2%	4.2%	-
Total	%	**10.0%**	**8.8%**	**1.2**	**11.6%**	**11.7%**	**(0.1)**

Sources: Company, ICU

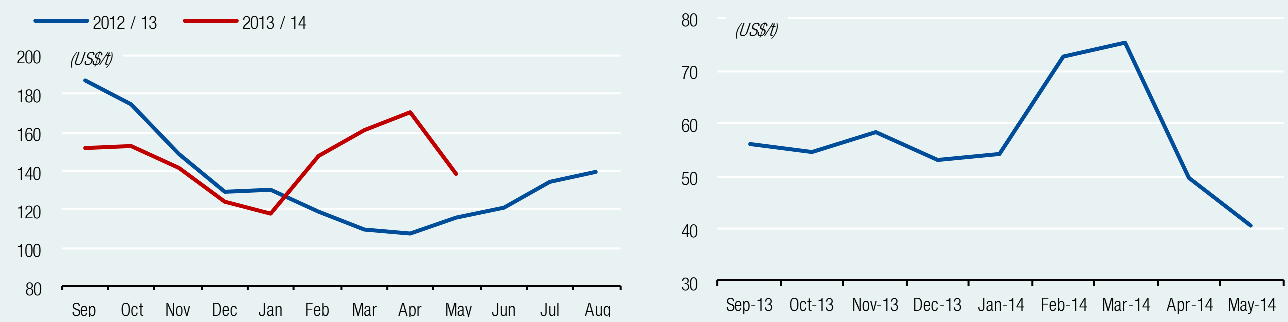
Results overview

Kernel delivered a strong performance in 3Q14 with pro-forma EBITDA of US$90m, which, however, was obscured by a big one-off loss on the translation of VAT receivables (which was widely expected) and a non-cash loss stemming from the negative revaluation of biological assets. Those two items reduced headline earnings by a combined US$60m to result in unadjusted EBITDA of US$30m. When stripped of these distortions, operating results appear quite strong as both key segments of grain trading and bulk oil enjoyed upbeat margins amidst favorable market conditions. Grain trading operations posted a margin of US$25/t (3.0x the normal profit over the past two years) while bulk oil reported a profit of US$189/t on favorable crush margin that prevailed during the quarter. Other business segments also contributed to the strong performance as farming posted a moderate loss on residual grain sales, while profits in silos and bottled oil, much to our surprise, were not particularly affected by local currency weakness.

Upbeat results were driven by unique market conditions, some of which did not last beyond 3Q. The domestic crush margin that was tracking below the previous year up until January has taken a sharp turn upward during Feb-Mar in the wake of a recovery in the export prices for sunflower seed products that was not met by an adequate increase in SFS procurement prices due to volatility in exchange rate. Meanwhile, the grain trading margin benefited from a combined effect of the following: i) an elevated fob-to-exw spread that occurred during Feb-Mar due to sharp hryvnia depreciation; and ii) VAT reimbursement on grain export sales that temporarily existed during Jan-Mar before it was canceled on 1-Apr. Meanwhile, current market conditions indicate that a healthy bulk oil margin continues to benefit crushers half-way through the fourth quarter, while the grain trading margin seems to have dropped down to normal levels after temporary supportive factors had wound down.

Chart 1. Kernel enjoyed improved market conditions during Feb-Mar

Crush margin per ton of sunflower seeds *Corn fob-to-exw price spread*



Source: APK-Inform, ICU

Outlook discussion

Lowered guidance met a muted reaction as all eyes turn to FY15. As a part of earnings release, management announced an updated guidance for the current year with the full-year EBITDA now expected at just US$170m compared to US$250m before. That barely caught anyone by surprise as investors were bracing for downgrade after a massive second-quarter loss in the farming division and a sharp hryvnia depreciation in Feb-Mar. The issue did not raise a single question on the call while previously it was always a topic of hot debate. Now all eyes have turned to the next year with a particular focus on the possible result of farming operations that have been a major headwind during FY14.

Management eyes improved farming performance already next year but uncertainty is particularly high. Farming as a main swing factor in the short term was heavily discussed on the Friday call when the CEO voiced the hope that farming operations could turn a decent profit in FY15. This would require significantly improved crop yields and favorable selling prices since operating expenses are guided to be flat year-on-year. Honestly, we are not entirely convinced of successful execution on the part of management. Moreover, we see overwhelming risks with respect to grain price developments that might threaten management's restructuring effort.

Kernel expects significantly improved yields in FY15, but this should be taken with caution. Following certain tweaks to production plans that had already been discussed, management hopes to achieve a major leap in yields. According to guidance, corn and soybeans, two crops that have been among the weakest spots over the past few years, are projected to jump 27% and 57%, respectively, this year and surpass the national average. While certainly possible, these estimates require a healthy dose of skepticism, in our view. Kernel's huge farming division has proven to be difficult to operate and it would be naive for investors to embrace an imminent turnaround with little evidence, especially this early in the season when critical development stages are still ahead. That's why we would rather assume a wait-and-see approach before we get the first readings from the fields in Sep.

Table 3. **Management targets much higher yields this year**

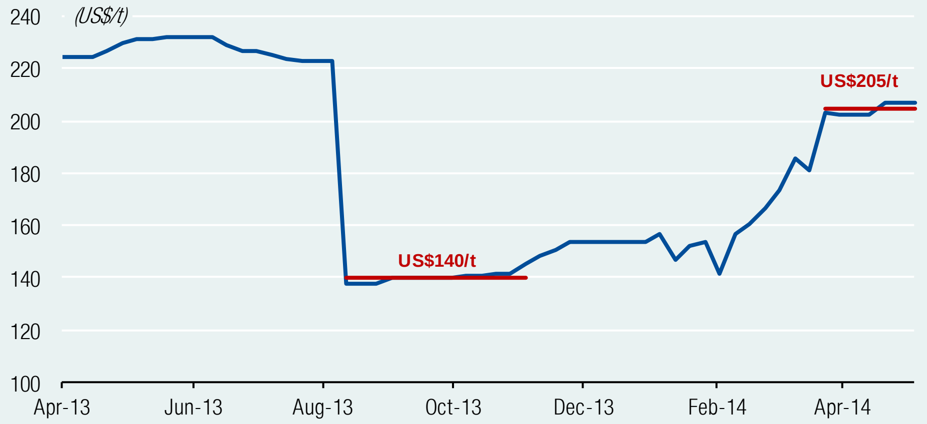
	Share in crop rotation	Crop yields Target CY2014	CY2013	Differential
Corn	48%	**7.0**	5.5	27%
Wheat	8%	4.5	4.4	3%
Sunflower seeds	18%	2.3	2.1	11%
Soybeans	18%	**2.2**	1.4	57%

Sources: Company

Favorable grain prices are essential for improved farming profits. Without supportive grain prices, it will be next to impossible to achieve a sharp profit recovery in the farming business in FY15. Management hopes that prices will at least stay flat going forward, which would effectively mean significantly higher selling prices year-on-year after a pronounced recovery observed during Dec-Apr (a local exw corn price of US$205/t with VAT in Apr-May versus US$140/t in Sep-Nov). Whether this price level holds will depend on production prospects in the US that will be driving new crop prices through the end of the year. The market currently is bracing for a drop in soybean prices in the first place as US plantings are projected to rise 6.5% this year on the back of persistently high prices. However, corn may also come under pressure if yields fall in line with the trend, which would mean another big crop for the US given historically high acreage. Of course, it would be premature to call for an imminent price drop before the crops go past their critical development stages but downside risks are obvious and should not be ignored.

Chart 2. Domestic grain prices recovered dramatically in recent months

Domestic corn price, exw (VAT incl)



Source: APK-Inform, ICU

Investment view

The market's reaction to the 3Q report and accompanying call was encouraging and flagged a melt up in market sentiment towards the stock. However, from a strategic standpoint, Kernel needs a successful turnaround in farming to ensure a sustained share price recovery. Unfortunately, execution and especially pricing pose a major threat to management's restructuring effort in the near-term with uncertainty extending into September. Therefore, we remain Neutral for the time being while keeping price target at PLN48.

Table 4. Kernel. Valuation summary

	Price					Rating		
	PT new	PT old	Current	Upside	Horizon	New	Old	Action
US$/share	15.8	15.8	10.0	59%	Dec-15	Neutral	Neutral	Maintain
PLN/share	48	48	30					

Source: ICU

Reaction to earnings flags an improved investor confidence toward the shares. 3Q results, despite being remarkably strong, were not particularly important per se, as they could not offer any practical insight into the next year's performance while the market focus has switched entirely toward FY15. However, it was an important test of market sentiment which confirmed that the general public is becoming more comfortable with the outlook and gradually starts to consider current valuations as an opportunity. A 9% jump in the share price on Monday and broad participation on the call were indicative of this fact, in our view.

For the true recovery to occur, we need a successful turnaround in the lagging farming division. Poor results of farming have become the main culprit for the share price performance at present. Once it is removed, we can reasonably expect the stock to appreciate into the 40s in a sustainable manner unless there is a major shock to the core oilseed crushing division.

A successful turnaround is conditional upon progress in operational efficiency and a favorable pricing environment. In order to turn a meaningful profit on farming operations Kernel has to deliver better crop yields this calendar year, while grain prices should at least not deteriorate by much. Otherwise, the recovery might be muted if there is any. Unfortunately, execution and especially pricing pose a major threat to management's restructuring effort in the near-term with uncertainty extending into September. Hence, proper caution should be exercised so as to avoid being caught in the trap of excessive optimism.

Possible expulsion from WIG20 is a short-term overhang but may also offer a chance for a speculative profit. The results of the next quarterly revision to the WIG20 index basket should be announced on 13-Jun. If Kernel is withdrawn, there will be immediate selling pressure and detrimental long-term repercussions for liquidity. However, should this event not occur, a short squeeze becomes theoretically possible if there is a significant amount of short interest built up in anticipation of expulsion.

Disclosures

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This research publication has been prepared by the analyst(s), whose name(s) appear on the front page of this publication. The analyst(s) hereby certifies that the views expressed within this publication accurately reflect her/his own views about the subject financial instruments or issuers and no part of her/his compensation was, is, or will be directly or indirectly related to the inclusion of specific recommendations or views within this research publication.

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Buy: Forecasted 12-month total return greater than 20%

Hold: Forecasted 12-month total return 0% to 20%

Sell: Forecasted 12-month total return less than 0%

Note: total return is share price appreciation to a target price in relative terms plus forecasted dividend yield.

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