BOŚ DOM MAKLERSKI

WSE Analytical Coverage Program

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Ferro

Sector: Construction materials
Fundamental rating: Hold (–)
Market relative: Neutral (–)
Price: PLN 13.70
12M EFV: PLN 17.1 (–)

Market Cap: US$ 77 m
Bloomberg code: FRO PW
Av. daily turnover: US$ 0.02 m
12M range: PLN 11.90-15.20
Free float: 31%

Investment summary

We value Ferro via DCF FCFF approach and also compare it to a pool of listed construction materials companies on the basis of EV/EBITDA, EV/EBIT and P/E multiples. Our ultimate 12M EFV for Ferro rests at PLN 17.1 per share. We initiate the coverage of the Company with LT fundamental Hold recommendation and ST relative Neutral rating. Even though our valuation of Ferro's equities is significantly above the current market price and the Company is a beneficiary of an upturn on the housing market in Europe, it should be remembered that the implementation of the adopted strategy will burden the Company's financial results in 2019-2020.

Ferro's activity consists in the manufacturing and sales of sanitary installation and heating fittings and sanitation equipment under its own brands as well as under the brand names of its customers. The Company operates in over 30 European countries and its export sales, in particular on the Central and Eastern European markets, constitute over 60% of Ferro's revenues. The Company supplies the wholesalers as well as DIY shop chains. The production is carried out in the Czech Republic while imported goods come mainly from China.

Ferro's financial results improvement should accelerate along with the implementation of the strategy announced in March based on: (i) organic growth, (ii) introduction of new products on the market and developing new distribution channels, (iii) geographic expansion, and (iv) M&As. According to the Company's estimates, these activities (excluding M&As) should help generate revenues of PLN 700 million and EBITDA of over PLN 90 million in 2023.

Expanding the product offer with their improved availability will lead to an increase in demand for working capital. Average capex should not exceed PLN 10 million per annum. Ferro adopted the dividend policy assuming the payment of a dividend in the amount of at least 50% of the Company's net income and a maximum Group's ND/EBITDA ratio at 2.5x.

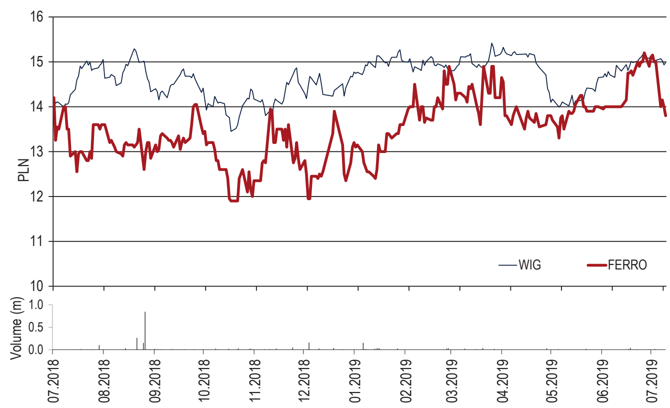
Guide to adjusted profits
Income tax settlement.

Key data

IFRS consolidated		2018	2019E	2020E	2021E
Sales	*PLN m*	405.6	434.0	464.3	496.8
EBITDA	*PLN m*	57.3	55.3	56.9	63.3
EBIT	*PLN m*	53.6	50.4	50.9	56.3
Net profit	*PLN m*	37.7	37.8	38.3	42.6
EPS	*PLN*	38.6	37.8	38.3	42.6
EPS yoy chg	*%*	1.8	1.8	1.8	2.0
FCFF	*PLN m*	-3	-2	1	11
Net debt	*PLN m*	91.6	89.8	104.6	101.2
P/E	*x*	7.7	7.7	7.6	6.8
Adj P/E	*x*	7.5	7.7	7.6	6.8
EV/EBITDA	*x*	6.7	6.9	7.0	6.2
EV/EBIT	*x*	7.1	7.6	7.8	7.0
DPS	*PLN*	0.35	1.12	1.12	1.14
Gross dividend yield	*%*	2.6	8.2	8.2	8.3
No. of shares (eop)	*m*	21.2	21.2	21.2	21.2

Source: Company, DM BOŚ SA estimates

Stock performance



Source: Bloomberg

Upcoming events

1. Release of 1H19 financial results: September 17
2. Release of 3Q19 financial results: November 18

Risk factors

1. Economic slowdown (economic growth rate deceleration on the markets crucial for the Company translating into falling demand and with the negative impact on financial results)
2. Falling demand for new flats (new housing projects generate about a quarter of demand for the Company's products)
3. Lower frequency of renovations (replacement demand generates c. 75% of demand for the Company's products/goods)
4. High prices of construction materials (falling demand for finishing materials)
5. Manpower shortage (qualified staff needed due to the market expansion)
6. Wage pressure
7. High/volatile raw materials prices (in particular of copper and zinc)
8. Unfavorable/volatile FX rates (38%/25% of revenues in PLN/CZK and 90%/10% of foreign supplies costs in US$/EUR; currency risk when PLN and CZK weaken against US$ and EUR)
9. Introduction of own brands by shopping chains (c. 33% of the Company's turnover realized in large-format chains)
10. Lack of attractive acquisition targets/high valuations

Catalysts

1. Stable demand for new apartment flats (time delay between the construction and fit-out works)
2. Development of the market for renovations (new design elements introduction, increasing frequency of renovations)
3. Expansion on European markets
4. Strengthening presence on the existing markets
5. New products (expanding the product offer)
6. Repositioning of the Company's own brands (new upper segment brands)
7. Favorable/stable FX rates
8. Favorable/stable raw materials prices
9. Brand promotion (intensifying on-line activities)
10. Potential acquisitions (if beneficial from the Group's perspective)

Competitive advantages

1. Product offer development
2. Geographic expansion
3. Products quality certified
4. The Company's own production plant in Znojmo

BASIC DEFINITIONS
A/R turnover (in days) = 365/(sales/average A/R))
Inventory turnover (in days) = 365/(COGS/average inventory))
A/P turnover (in days) = 365/(COGS/average A/P))
Current ratio = ((current assets – ST deferred assets)/current liabilities)
Quick ratio = ((current assets – ST deferred assets – inventory)/current liabilities)
Interest coverage = (pre-tax profit before extraordinary items + interest payable/interest payable)
Gross margin = gross profit on sales/sales
EBITDA margin = EBITDA/sales
EBIT margin = EBIT/sales
Pre-tax margin = pre-tax profit/sales
Net margin = net profit/sales
ROE = net profit/average equity
ROA = (net income + interest payable)/average assets
EV = market capitalization + interest bearing debt – cash and equivalents
EPS = net profit/ no. of shares outstanding
CE = net profit + depreciation
Dividend yield (gross) = pre-tax DPS/stock market price
Cash sales = accrual sales corrected for the change in A/R
Cash operating expenses = accrual operating expenses corrected for the changes in inventories and A/P, depreciation, cash taxes and changes in the deferred taxes

DM BOŚ S.A. generally values the covered non bank companies via two methods: comparative method and DCF method (discounted cash flows). The advantage of the former is the fact that it incorporates the current market assessment of the value of the company's peers. The weakness of the comparative method is the risk that the valuation benchmark may be mispriced. The advantage of the DCF method is its independence from the current market valuation of the comparable companies. The weakness of this method is its high sensitivity to undertaken assumptions, especially those related to the residual value calculation. Please note that we also resort to other valuation techniques (e.g. NAV-, DDM- or SOTP-based), should it prove appropriate in a given case.

Banks
Net Interest Margin (NIM) = net interest income/average assets
Non interest income = fees&commissions + result on financial operations (trading gains) + FX gains
Interest Spread = (interest income/average interest earning assets)/ (interest cost/average interest bearing liabilities)
Cost/Income = (general costs + depreciation)/ (profit on banking activity + other net operating income)
ROE = net profit/average equity
ROA = net income/average assets
Non performing loans (NPL) = loans in 'basket 3' category
NPL coverrage ratio = loan loss provisions/NPL
Net provision charge = provisions created – provisions released

DM BOŚ S.A. generally values the covered banks via two methods: comparative method and fundamental target fair P/E and target fair P/BV multiples method. The advantage of the former is the fact that it incorporates the current market assessment of the value of the company's peers. The weakness of the comparative method is the risk that the valuation benchmark may be mispriced. The advantage of the fundamental target fair P/E and target fair P/BV multiples method is its independence of the current market valuation of the comparable companies. The weakness of this method is its high sensitivity to undertaken assumptions, especially those
related to the residual value calculation. Assumptions used in valuation can change, influencing thereby the level of the valuation. Among the most important assumptions are: GDP growth, forecasted level of inflation, changes in interest rates and currency prices, employment level and change in wages, demand on the analysed company products, raw material prices, competition, standing of the main customers and suppliers, legislation changes, etc. Changes in the environment of the analysed company are monitored by analysts involved in the preparation of the recommendation, estimated, incorporated in valuation and published in the recommendation whenever needed.

KEY TO INVESTMENT RANKINGS

This is a guide to expected price performance in absolute terms over the next 12 months:
Buy – fundamentally undervalued (upside to 12M EFV in excess of the cost of equity) + catalysts which should close the valuation gap identified;
Hold – either (i) fairly priced, or (ii) fundamentally undervalued/overvalued but lacks catalysts which could close the valuation gap;
Sell – fundamentally overvalued (12M EFV < current share price + 1-year cost of equity) + catalysts which should close the valuation gap identified.

This is a guide to expected relative price performance:
Overweight – expected to perform better than the benchmark (WIG) over the next quarter in relative terms
Neutral – expected to perform in line with the benchmark (WIG) over the next quarter in relative terms
Underweight – expected to perform worse than the benchmark (WIG) over the next quarter in relative terms

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Relative performance compares the rate of return on a given recommended stock in the period of the recommendation's validity (i.e. from the date of issuance to the date of alteration or – in case of maintained recommendations – from the date of issuance to the current date) in a relation to the rate of return on the benchmark in this time period. The WIG index constitutes the benchmark. For recommendations that expire by an alteration or are maintained, the ending values used to calculate their absolute and relative performance are: the stock closing price on the day the recommendation expires/ is maintained and the closing value of the benchmark on that date. For recommendations that expire via a passage of time, the ending values used to calculate their absolute and relative performance are: the average of the stock closing prices for the day the recommendation elapses and four directly preceding sessions and the average of the benchmark's closing values for the day the recommendation expires and four directly preceding sessions.

Distribution of DM BOŚ's current recommendations

	Buy	Hold	Sell	Suspended	Under revision
Numbers	36	35	10	8	0
Percentage	40%	39%	11%	9%	0%

Distribution of DM BOŚ's current recommendations for the companies which DM BOŚ has supplied with material investment services within the last 12 months

	Buy	Hold	Sell	Suspended	Under revision
Numbers	3	4	1	2	0
Percentage	30%	40%	10%	20%	0%

Distribution of DM BOŚ's current market relative recommended weightings

	Overweight	Neutral	Underweight	Suspended	Under revision
Numbers	34	37	10	8	0
Percentage	38%	42%	11%	9%	0%

Distribution of DM BOŚ's current market relative recommended weightings for the companies which DM BOŚ has supplied with material investment services within the last 12 months

	Overweight	Neutral	Underweight	Suspended	Under revision
Numbers	3	3	1	2	0
Percentage	33%	33%	11%	22%	0%

LT fundamental recommendation tracker

Analyst	Recommendation		Report date	Reiteration date	Distribution date	Expiry date	Performance	Relative performance	Price at issue/ reiteration*	EFV (12 months)	
Ferro											
Sylwia Jaśkiewicz	Hold	–	*21.07.2019*	-	*22.07.2019*	*21.07.2020*	-	-	13.70	17.10	–

** prices at issue/reiteration are the closing prices at the report or reiteration date*

Market-relative recommendation tracker

Analyst	Relative Recommendation		Report date	Reiteration date	Distribution date	Expiry date	Price at issue/ reiteration*	Relative performance
Ferro								
Sylwia Jaśkiewicz	Neutral	–	*21.07.2019*	-	*22.07.2019*	*21.07.2020*	13.70	-

** prices at issue/reiteration are the closing prices at the report or reiteration date*

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