QUARTERLY **INSIGHTS**

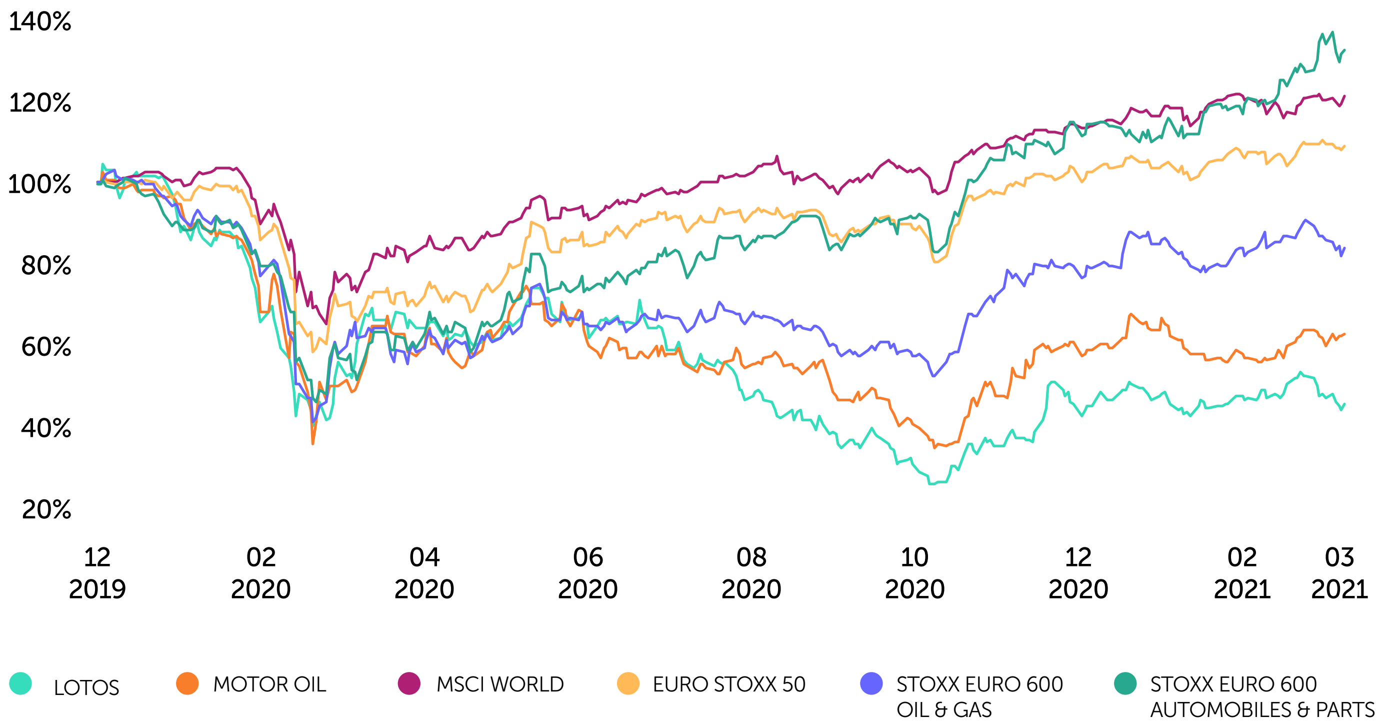
HOLD ASSET MANAGEMENT — THE CENTRAL-EUROPEAN VALUE-BASED EQUITY SPECIALIST

CEE REFINERIES

A BET ON THE CYCLICAL RECOVERY AT "COVID DISCOUNTED" PRICES

With wide-scale vaccinations underway, mobility will inevitably get back on track soon, driving a reacceleration of the global economy. Easy monetary policies coupled with unprecedented fiscal stimuliare further boosting the speed of the recovery. Cyclical stocksgot their ticket to the bull train in early November of 2020 with the Pfizer vaccine rollout and the victory of the Democratci Party in the US and have been running wild since then. Most stocks have already erased their "COVID-loss". However, there are still hidden corners of the stock universe where some equities lag behind. Oil refining industry in Central and Eastern Europe is one of these pockets, where some companies' performance hardly reflects anything of the recovery hence provide contrarian investors with an attractive opportunity. In this paper we are going to detail our mid- and long-term outlook on the sector and show two regional companies, the Greek Motor Oil and the Polish Lotos, as investment opportunities with attractive risk/reward characteristics.

1 REFINERS HAVE BEEN LAGGING BEHIND THE OIL SECTOR, OTHER CYCLICALS AND MARKET INDICES TILL THE END OF MARCH 2021 (USD)



SOURCE: BLOOMBERG, HOLD ASSET MANAGEMENT

KEY SECTORAL OBSERVATIONS AND OUTLOOK

The global refining industry and the investor sentiment towards refining stocks suffered an unprecedented, multi-factor shock in 2020. The demand for oil products collapsed due to the pandemic, which happened in a period when large new refinery capacity investments with multiyear lead times have been finalized and put into operation. In addition 'investors' fear of structural headwinds blown by the electrification of the global transportation industry widened. Cleaner and greener political agendas of China, Europe and the US increased the popularity of BP's pessimistic future oil demand outlook, the so-called "early peak oil demand" scenario. So clearly both cyclical and structural factors contributed to the poor performance of the refining stocks.

2 MODEL REFINING MARGIN OF LOTOS
(USD/BBL)

SOURCE: LOTOS, HOLD ASSET MANAGEMENT

> **Oil to plunge 85% to 11mbpd by 2050.**
> IRENA

> **The world may never return to the pre-pandemic oil demand level of about 100 mbpd**
> BP

However, we believe that the fears are overexaggerated. On the cyclical side we think that with the help of the wide-scale vaccination people will move, drive and fly again helping the global oil demand to almost fully recover by 2022/23. We forecast that only a tiny part of the oil consumption will be permanently curbed by home office and online conferences. On the supply side we see promising signs as well. So far 1,5-2 million barrel per day permanent refinery closures have helped the supply demand gap to narrow and we expect further rationalisations. This fuels our optimism that the refinery industry will not remain in dust forever and the "survivors" (i.e. the advanced, complex refineries) will be able to book mid-cycle margins in a couple of years' time. We note that although the spot refinery margins barely increased from their lows forward margins started to pick up in January reflecting the upcoming market tightening.

On the longer term outlook of the refining sector we are more optimistic than the consensus. Although we recognize the structural headwind of green alternative technologies and we even agree with the peak oil demand and subsequent demand decline outlook but we very much differ on the timing of it. As Bill Gates said: "People always overestimate the change that will occur in the next two years and underestimate the change that will occur in the next ten." This can be especially true today when cyclical headwinds are mixed up with structural ones. Psychologically it is easy to mix up the cyclical and structural reasoning and draw the wrong conclusion that current subdued refining margins are the consequence of accelerating structural factors. We are of the view that the increasing global population and the rising living standards in the emerging hemisphere will continue to elevate the oil hunger of the global economy, while the penetration growth of the e-cars and the innovation of other substituting technologies will take longer. Passenger electric cars are quite close to conventional ICE cars in economic viability but still remain dependent on green subsidies by the State. However, the alternative technologies of the road, water and air transportation are in their infancy and are way out of the money today. Therefore, we expect global oil demand continuing to rise till the mid 2030s.

MOTOR OIL – AN OWNER OPERATED GREEK REFINING COMPANY

Motor Oil is our key pick in the sector. It is a Greek downstream oil company controlled by the Vardinoyannis family, which operates Greece's largest and most complex Corinth refinery, located close to Athens. Motor Oil also owns two retail networks with approximately 1300 filling stations grabbing circa 30% of the market's share. In cycle-average environment the refining segment delivers 80% of the EBITDA while the remaining 20% is contributed to the retail segment.

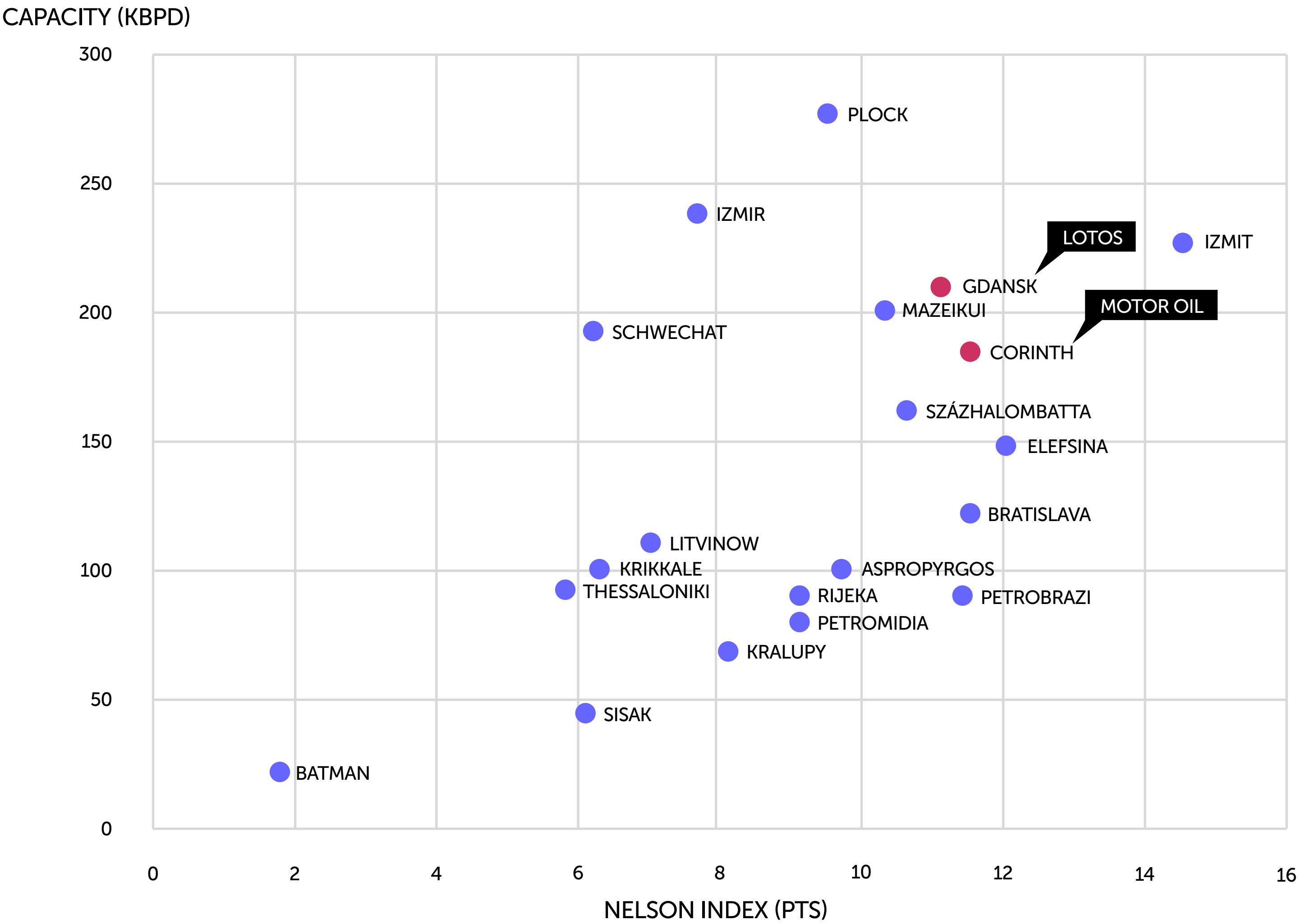
Historical financial figures confirm that the company's owner-operated nature has coupled with well- established and proven cash flow generation and capital allocation track record. The company delivered well timed (anti-cyclical) capacity additions and upgrades in 2005 and 2010. The investment cost per unit of capacity has been lower versus the majority of CEE refineries and its annual maintenance capex of a unit of capacity is similarly lower. On the earnings side the company's historical margin capture, meaning EBITDA per unit of capacity versus the benchmark refining margins has been also wider than its peers. Higher margin capture with lower capex intensity have been enabling Motor Oil to achieve industry leading cash flow per barrel and return on invested capital (ROIC). On the top of this,its profitability remained more resilient in the downturn of the 2008/09 and the current COVID-crisis versus its peers.

Being a coastal refinery and exporting 70% of the production is challenging. The company doesn't enjoy the so-called inland premium that many European refiners located inland benefit from.

However, Motor Oil is still able to turn this disadvantage into a strength. As a technologically advanced, highly flexible coastal refinery having almost 50 years of experience, it learnt how to arbitrage the Mediterranean region both on the feedstock and on the product side.

3 REFINERS IN CENTRAL AND SOUTH EASTERN EUROPE

CAPACITY AND NELSON INDEX



The Nelson Complexity Index (NCI) is a measure of the sophistication of an oil refinery, where more complex refineries are able to produce lighter, more heavily refined and valuable products from a barrel of oil.

SOURCE: COMPANY DATA, HOLD ASSET MANAGEMENT

In our proprietary valuation, we calculated that with normalized, cycle-average refinery margins the intrinsic value of Motor Oil is 19EUR per share, that provides circa 50% upside*. This quantitative upside can be upped by a qualitative premium. Owner operated companies with the capability of value creation tend to outperform in the long run. Investors usually assign valuation premium to this ownership characteristic hence owner operated companies seldom trade at discounted prices. We believe that in the current unique situation Motor Oil is a very attractive investment opportunity for investors with a contrarian and owner operated bias.

* 03/26/2021

LOTOS – A STATE OWNED POLISH INTEGRATED OIL COMPANY

Our second industrial pick might be surprising from ownership perspective as it is the exact opposite of Motor Oil but we think that the significantly larger discount to its fair value well compensates investors for the risk of State ownership. It is traded at 42 PLN which is similar to its March 2020 low. Lotos is a Polish integrated oil company with business operations in Poland, Norway and Lithuania. Polish State holds majority ownership (53%) in the company. Oil refining is the key business unit of Lotos delivering circa 70% of the EBITDA in a normalized, mid cycle environment. Its oil refinery, which is located in Gdansk is one of Europe's most advanced and complex refineries. The upstream segment that operates both onshore and offshore contributes roughly 25% to the EBITDA, while its retail network of 511 filling station is a minor 5% contributor.

Our team had done thorough research on the company and developed our own proprietary valuation. We identified that Lotos operational leverage to the refining cycle is higher than it was before, hence its free cash flow could expand much more than investors/analysts anticipate. Why? The company invested significant capital into its refinery upgrade (finalized in Q3 2019), that basically eliminated all the high sulphur fuel oil (HSFO) production (10% of its output slate) and converted it into diesel production. Historically the HSFO was traded with 15 USD discount to the feedstock oil price, while diesel had 15 USD premium. This investment could have resulted in immediate large profit if the pandemic hadn't emerged. Due to the COVID crisis the diesel margins collapsed along with the diesel&HSFO spread,that prevented the company from monetizing this investment so far, keeping potential FCFF expansion hidden from investors.

In our valuation, we calculated that with normalized, mid-cycle level refinery margins and 60 USD oil price, the intrinsic value of Lotos share is circa 86 PLN, providing almost 100% upside*. That is by far the highest among the regional peers. However certain risk factors make us cautious when it comes to position sizing. A state owned company deserves a discount. In addition, Polish government intends to merge the company with PKN which - if it happens - can be value dilutive for the minority investors. The acquisition saga in which PKN emerges as the acquirer has been on the table for years. Meeting the conditions set by the European Commission first Lotos needs to divest 30% of its crown-jewel Gdansk refinery and dispose 70% of its retail network. Disposals in a suboptimal case could end up in value destruction. We think that this saga is one of the reasons driving investors' focus away from the fundamentals and keeps Lotos shares at subdued levels.

However the merger is still uncertain. From time to time we hear various Polish politicians voice their opposition to the deal. Besides Lotos shareholders will have the chance to block the deal if less than 80% of the quorum in the GSM backs the divestment of the refinery to a separate unit. Lotos shareholders most probably will be aware of the price tag of the divestments to a third party player at the time of the vote but will not know how much PKN will be willing to pay for Lotos shares. PKN aims to come up with an offer by the end of 2021 the earliest. Minority shareholders of Lotos should keep in mind that if the divestments will be accepted then it will be easy for PKN to grab the controlling stake of Lotos as the State and the State owned pension funds own 56 percent of the shares. In our view the most optimal scenario would be Lotos remaining a standalone company. Should PKN succeed in taking Lotos over shareholders will still have the optionality to exit at the offer price. At that point accepting the offer will still not be mandatory as lower the offer price the higher the likelihood of a large minority rejecting the offer in hopes of receiving a better deal some time in the future. Rest assured as PKN grabs control it won't be an easy road ahead.

Nevertheless time is on our side. As the global recovery continues, investors will likely rediscover value in Lotos in coming months. Last but not least, let's not forget that PKN could also offer a premium for Lotos shares. This latter fact was the reason, besides the healthy fundamentals, why Lotos shares topped 100 PLN in early 2019.

* 03/26/2021