Quarterly Results Review

IDMSA DOM MAKLERSKI

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# PBG

**Sector**: Construction
**Fundamental rating**: Hold (→)
**Market relative**: Overweight (→)
**Price**: PLN 198.3
**12M EFV**: PLN 305.0 (→)

**Market Cap.**: US$ 966 m
**Reuters code**: PBGG.WA
**Av. daily turnover**: US$ 1.98 m
**Free float**: 67%
**12M range**: PLN 180.00-345.00

## Investment story

PBG constitutes probably the best vehicle to capture the growth in the influx of EU funds. Please note that next three years should bring spending on environmental protection at a level of c. PLN 51 billion. Around half of that should constitute investments in the sewage disposal and water protection, which drive the Company's results (due to high exposure to EU funds, PBG's future results appear to be largely independent from the GDP growth rate). We believe PBG should maintain its leading market position as far as the execution of environmental protection and hydro construction contracts is concerned. Moreover, entering the road construction business allows the Company to unlock additional value from realization of complex projects, in our view. The high growth potential of the Company is reinforced by its M&A strategy. We believe next year may bring further acquisitions. We like PBG's foreign expansion (Gas & Oil Engineering in Slovakia, Excan Oil and Gas Engineering in Canada) which, we believe, is the way to build a reference for foreign expansion once the flow of EU funds declines. We also like the Company's expanding portfolio of lucrative gas & oil contracts which should enable PBG to successively improve its margins. Finally, we see some triggers on the horizon which should be supportive for PBG's share price performance.

## Quarterly results corner; 3Q08 review

PBG published its 3Q08 consolidated results on November 6, after the closing of the session. The Company's 3Q08 sales and net profit proved to be in line with the market consensus, while the operating profit outperformed the market expectations by c. 7% (regarding the details please refer to *Figure 1* below).

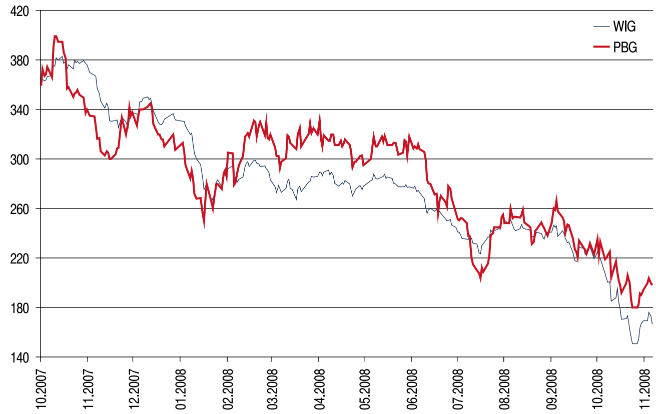
PBG increased its quarterly sales yoy by impressive 51%, due to fat portfolio of environmental protection contracts (these contracts continued to generate over 50% of the Company's quarterly sales). Strong top line, together with yoy growth of the Company's operating margin (from 9.2% in 3Q07 to 10.6% in 3Q08) translated into an impressive 75% yoy growth of the operating profit, which reached PLN 57.8 million (exceeding the market consensus and our forecast by c. 7% and 16%, respectively). We see the following reasons for the yoy margin

Key data

| IFRS consolidated | | 2007 | 2008E | 2009E | 2010E |
|---|---|---|---|---|---|
| Sales | *PLN m* | 1,377.3 | 2,110.0 | 2,692.4 | 3,559.4 |
| EBITDA | *PLN m* | 136.3 | 269.6 | 361.1 | 509.2 |
| EBIT | *PLN m* | 106.3 | 240.1 | 329.4 | 475.9 |
| Net profit | *PLN m* | 101.8 | 151.2 | 206.0 | 307.9 |
| EPS | *PLN* | 7.58 | 11.26 | 15.34 | 22.92 |
| EPS yoy chng | *%* | 68 | 49 | 36 | 49 |
| Net debt | *PLN m* | 257.4 | 531.5 | 533.5 | 551.6 |
| P/E | *x* | 26.2 | 17.6 | 12.9 | 8.6 |
| P/CE | *x* | 20.2 | 14.7 | 11.2 | 7.8 |
| EV/EBITDA | *x* | 21.4 | 11.8 | 8.9 | 6.3 |
| EV/EBIT | *x* | 27.5 | 13.3 | 9.7 | 6.8 |
| EV/Sales | *x* | 2.1 | 1.5 | 1.2 | 0.9 |
| Gross dividend yield | *%* | 0.0 | 0.0 | 0.0 | 0.0 |
| No. of shares (eop) | *ths.* | 13,430 | 13,430 | 13,430 | 13,430 |

*Source: Company, DM IDMSA estimates*

Stock performance




*Source: ISI*

### Upcoming events

1. GUS: October construction output data release: November 20
2. GUS: November construction output data release: December 18

### Catalysts

1. Signing new large environmental protection contracts co-financed by EU
2. Signing new LT and high-margin gas&oil contracts
3. Signing contracts related to EURO 2012 (stadiums)

### Risk factors

1. FX exposure (most of environmental protection contracts are EUR-denominated)
2. Prolonging administrative procedures may negatively affect smooth absorption of EU funds' inflow by investors (public sector)
3. Hike of financial costs

***Fig. 1*** *PBG; 3Q08 results compared to expectations*

| IFRS consolidated PLN m | 3Q08A | 3Q07A | yoy change | 3Q08 market consensus | 3Q08E IDM | 3Q08A vs. consensus/IDM |
|---|---|---|---|---|---|---|
| Sales | 543.2 | 360.2 | 51% | 523.0 | 508.5 | →/↑ |
| EBIT | 57.8 | 32.9 | 75% | 53.9 | 49.7 | ↑/↑ |
| NI | 34.5 | 20.8 | 66% | 33.8 | 25.5 | →/↑↑ |

*Source: Company, PAP, DM IDMSA estimates* increase in 3Q08: (i) low base (additional PLN 12 million costs related to 'Kraków Płaszów' contract in the base period), (ii) better quality of the current contract portfolio (please note that Hydrobudowa 9, a subsidiary of PBG, reached its BEP in 3Q08), (iii) falling share of the overhead costs in the Company's quarterly sales (this trend has been visible in the Company's results for past couple of quarters and stems from positive effects of intra group synergies and effects of scale), and finally (iv) decrease of the construction material prices. The Company's 3Q08 pre-tax profit increased by 85% yoy (to PLN 54.1 million) on the back of yoy decline of financial costs. At the bottom line, in turn, the Company recorded 'only' 66% yoy growth, due to growing minorities' share in the Group's profits (please note that 'water' contracts are executed by Hydrobudowa Polska, which is a 61% subsidiary of PBG). Summing up, PBG's 3Q08 financial posting is strong, with material yoy growth of profits, yet broadly in line with the market expectations. Consequently, the market reaction to such financial posting should be rather neutral, we believe.

## Financial forecast

We keep our financial forecast for the Company intact.

## Valuation

Our 12M EFV for PBG continues to dwell at PLN 305 per share.

## Recommendation

We keep our LT fundamental Hold recommendation for PBG (the Company's equities are priced with a premium to the local peers, which we deem justified). Given the Company's short-term outlook, we see a few triggers, mostly in the form of: (i) large contracts, which are – the way we see it – likely to be won by PBG (waste incineration plants in Kraków and Poznań, lucrative gas tenders, which are likely to be announced by KRI and PGNiG, stadiums), or (ii) strong 4Q08 financial posting expected. Consequently, our ST market-relative Overweight bias for PBG's equities remains unchanged.

**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 IDM 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
**NIM Adjusted** = (net interest income adjusted for SWAPs)/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 + other operating costs)/ (profit on banking activity + other operating income)
**ROE** = net profit/average equity
**ROA** = net income/average assets
**Non performing loans** (NPL) = loans in 'substandard', 'doubtful' and 'lost' categories
**NPL coverrage ratio** = loan loss provisions/NPL
**Net provision charge** = provisions created – provisions released

DM IDM 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

The recommendation tracker presents the performance of DM IDMSA's recommendations. A recommendation expires on the day it is altered or on the day 12 months after its issuance, whichever comes first. 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.

*LT fundamental recommendation tracker*

| Recommendation | | Issue date | Reiteration date | Expiry date | Performance | Relative performance | Price at issue/ reiteration (PLN) | 12M EFV (PLN) | |
|---|---|---|---|---|---|---|---|---|---|
| **PBG** | | | | | | | | | |
| Hold | – | *06.02.2008* | - | *Not later than 06.02.2009* | -30% | 21% | 281.60 | 319.00 | – |
| - | → | - | *17.02.2008* | - | - | - | 317.90 | 319.00 | → |
| - | → | - | *21.02.2008* | - | - | - | 326.70 | 352.00 | ↑ |
| - | → | - | *30.03.2008* | - | - | - | 325.00 | 358.00 | ↑ |
| - | → | - | *14.04.2008* | - | - | - | 311.00 | 357.00 | ↓ |
| - | → | - | *29.04.2008* | - | - | - | 318.00 | 361.00 | ↑ |
| - | → | - | *15.05.2008* | - | - | - | 315.00 | 361.00 | → |
| - | → | - | *01.06.2008* | - | - | - | 318.00 | 361.00 | → |
| - | → | - | *29.06.2008* | - | - | - | 268.00 | 356.00 | ↓ |
| - | → | - | *08.07.2008* | - | - | - | 238.00 | 348.00 | ↓ |
| - | → | - | *28.07.2008* | - | - | - | 245.00 | 348.00 | → |
| - | → | - | *04.08.2008* | - | - | - | 248.00 | 348.00 | → |
| - | → | - | *31.08.2008* | - | - | - | 238.00 | 348.00 | → |
| - | → | - | *28.09.2008* | - | - | - | 232.00 | 348.00 | → |
| - | → | - | *19.10.2008* | - | - | - | 192.10 | 305.00 | ↓ |
| - | → | - | *29.10.2008* | - | - | - | 191.50 | 305.00 | → |
| - | → | - | *06.11.2008* | - | - | - | 198.30 | 305.00 | → |

*Market-relative recommendation tracker*

| Relative recommendation | | Issue date | Reiteration date | Expiry date | Price at issue/ reiteration (PLN) | Relative performance |
|---|---|---|---|---|---|---|
| **PBG** | | | | | | |
| Overweight | – | *06.02.2008* | - | *not later than 06.02.2009* | 281.60 | 21% |
| - | → | - | *17.02.2008* | - | 317.90 | - |
| - | → | - | *21.02.2008* | - | 326.70 | - |
| - | → | - | *30.03.2008* | - | 325.00 | - |
| - | → | - | *14.04.2008* | - | 311.00 | - |
| - | → | - | *29.04.2008* | - | 318.00 | - |
| - | → | - | *15.05.2008* | - | 315.00 | - |
| - | → | - | *01.06.2008* | - | 318.00 | - |
| - | → | - | *29.06.2008* | - | 268.00 | - |
| - | → | - | *08.07.2008* | - | 238.00 | - |
| - | → | - | *28.07.2008* | - | 245.00 | - |
| - | → | - | *04.08.2008* | - | 248.00 | - |
| - | → | - | *31.08.2008* | - | 238.00 | - |
| - | → | - | *28.09.2008* | - | 232.00 | - |
| - | → | - | *19.10.2008* | - | 192.10 | - |
| - | → | - | *29.10.2008* | - | 191.50 | - |
| - | → | - | *06.11.2008* | - | 198.30 | - |

*Distribution of IDM's current recommendations*

| | Buy | Hold | Sell | Suspended | Under revision |
|---|---|---|---|---|---|
| Numbers | 17 | 26 | 4 | 1 | 0 |
| Percentage | 35% | 54% | 8% | 2% | 0% |

*Distribution of IDM's current recommendations for companies that were within the last 12M IDM customers in investment banking*

| | Buy | Hold | Sell | Suspended | Under revision |
|---|---|---|---|---|---|
| Numbers | 2 | 3 | 0 | 1 | 0 |
| Percentage | 33% | 50% | 0% | 17% | 0% |

*Distribution of IDM's current market relative recommended weightings*

| | Overweight | Neutral | Underweight | Suspended | Under revision |
|---|---|---|---|---|---|
| Numbers | 19 | 15 | 13 | 1 | 0 |
| Percentage | 40% | 31% | 27% | 2% | 0% |

*Distribution of IDM's current market relative recommended weightings for the companies that were within the last 12M IDM customers in investment banking*

| | Overweight | Neutral | Underweight | Suspended | Under revision |
|---|---|---|---|---|---|
| Numbers | 3 | 2 | 0 | 1 | 0 |
| Percentage | 50% | 33% | 0% | 17% | 0% |

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