Quarterly Results Review

IDMSA
DOM MAKLERSKI

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# PBG

**Sector**: Construction
**Fundamental rating**: Hold (→)
**Market relative**: Overweight (→)
**Price**: PLN 315
**12M EFV**: PLN 361 (→)

**Market Cap.**: US$ 1,923 m
**Reuters code**: PBGG.WA
**Av. daily turnover**: US$ 2.75 m
**Free float**: 67%
**12M range**: PLN 250.10-428.00

## Quarterly results corner; 1Q08 review

The Company's 1Q08 results (released on May 14, after the session) proved good, outperforming the market consensus estimates (and our expectations) of sales, EBIT and net income by 18%, 72% and 23%, respectively (regarding the details, please refer to the *Figure 1*). The Company's sales reached PLN 307.3 million, an impressive 127% growth yoy with the main reason behind that being, we believe, fat backlog of environmental protection contracts being executed mostly by the Company's subsidiaries, among others (i) Hydrobudowa 9 (69.3% subsidiary of PBG, which was fully consolidated in 1Q08 as opposed to 1Q07), and (ii) Hydrobudowa Polska (PBG's 61% subsidiary). Regarding the profitability, the gross profit on sales margin decreased from 15.5% to 13.2%, which might be attributed to the old loss-making contracts being still executed by Hydrobudowa 9. Please note, however, that due to efficient cost control and – the way we see it – positive effect of the intra-group synergies (a number of acquisitions had been completed by the Company last year), PBG reduced the share of general administration costs in sales from 10.1% in 1Q07 to 7.1% in 1Q08 and, consequently, the operating profit hiked by 198% yoy, beating the market consensus by impressive 72% (the EBIT margin amounted to 6.8% vs. 5.1% in 1Q07). The triple-digit pace of growth of the sales and operating profit did not recur at the bottom line level, though (the quarterly NI grew 'merely' 46% yoy, and reached PLN 14.8 million). The reason for this was the artificially high base of 1Q07, boosted by one-off profits at Hydrobudowa Śląsk (currently Hydrobudowa Polska) from the divestment of its stake in Mostostal Zabrze. The transaction in question fueled the Company's quarterly pre-tax profit and bottom line in 1Q07 by c. PLN 12.6 million and PLN 10.2 million, respectively. To sum up, the Company's 1Q08 financial posting proved good, much above the market expectations. At the same time, these results confirm our belief that the management's forecast for 2008 is based on very conservative assumptions.

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

| IFRS consolidated PLN m | 1Q08A | 1Q08E (IDM) | 1Q08E consensus | 1Q08 vs. IDM/ consensus | 1Q07 |
|---|---|---|---|---|---|
| Sales | 307.3 | 262.0 | 260.0 | ↑/↑ | 135.6 |
| EBIT | 20.6 | 12.3 | 12.0 | ↑↑/↑↑ | 6.9 |
| NI | 14.8 | 11.8 | 12.1 | ↑/↑ | 10.2 |

*Source: Company, PAP, DM IDMSA estimates*

## Financial forecast

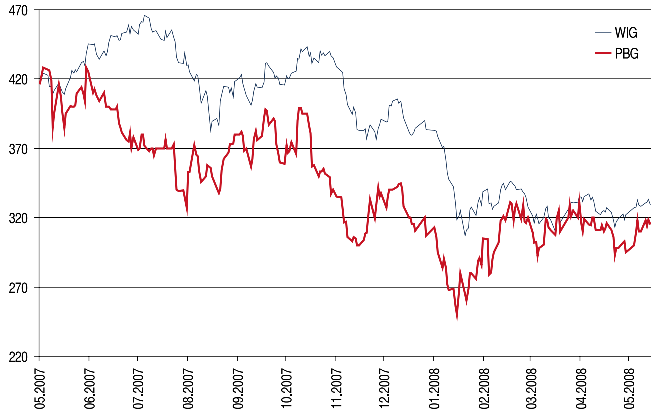
We keep our financial forecast intact.

Key data

| IFRS consolidated | | 2007 | 2008E | 2009E | 2010E |
|---|---|---|---|---|---|
| Sales | *PLN m* | 1,377.3 | 1,871.2 | 2,357.8 | 3,136.3 |
| EBITDA | *PLN m* | 136.3 | 248.6 | 320.1 | 466.9 |
| EBIT | *PLN m* | 106.3 | 219.1 | 288.4 | 433.6 |
| Net profit | *PLN m* | 101.8 | 150.5 | 194.2 | 298.5 |
| EPS | *PLN* | 7.58 | 11.21 | 14.46 | 22.23 |
| EPS yoy chng | *%* | 68 | 48 | 29 | 54 |
| Net debt | *PLN m* | 257.4 | 441.4 | 426.8 | 439.6 |
| P/E | *x* | 41.5 | 28.1 | 21.8 | 14.2 |
| P/CE | *x* | 32.1 | 23.5 | 18.7 | 12.7 |
| EV/EBITDA | *x* | 32.9 | 18.8 | 14.5 | 10.0 |
| EV/EBIT | *x* | 42.2 | 21.3 | 16.1 | 10.8 |
| EV/Sales | *x* | 3.3 | 2.5 | 2.0 | 1.5 |
| 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: www.money.pl*

### Upcoming events

1. Release of 2Q08 results: August 13, 2008
2. Release of 3Q08 results: October 13, 2008

### Catalysts

1. PBG wining the battle for PGNiG contracts
2. Winning contract for the construction of the second line of metro in Warsaw
3. Winning other large environmental protection contracts
4. Further M&A's this year could prove shareholder-value-accretive

### Risk factors

1. Suspension of PGNiG tenders
2. PBG loses the battle for large contracts (among others for PGNiG)
3. Growing prices of construction materials and salaries

## Valuation

Our 12M EFV of PBG continues to dwell at PLN 361.

## Recommendation

We keep both our LT fundamental Hold rating and ST market-relative Overweight bias intact.

## Investment story

PBG constitutes probably the best vehicle to capture the growth in the influx of EU funds. Please note that the next three years should bring spending on environmental protection at a level of c. PLN 51 billion, and around half of that should constitute investments in sewage disposal and water protection, which drive the Company's results. 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 may allow 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 this year should bring further acquisitions. It is likely that PBG will acquire PRG Metro, a company that should support PBG in the prospective construction of a second metro line in Warsaw, which we believe may prove value-accretive, providing a conditional future upside to our current valuation of PBG's equities.

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 see numerous triggers on the horizon which should be supportive for the share price performance of PBG, mainly in the form of large tenders to be completed. Within the next few months at least two large contracts with a total value of c. PLN 2.0 billion are expected to be finalized. We believe that PBG is well-positioned to win at least one of them.

## Drivers

- *1. Further M&A's.* The M&A-oriented strategy should be followed and bring further acquisitions this year. We believe that the next acquisition target could be a road-building company. Moreover, as Hydrobudowa Polska (PBG's 76% subsidiary) aims to take part in the construction of the second metro line in Warsaw (in a consortium with German Alpine Bau and Spanish FCC Construction), PRG Metro (a company that played a key role in construction of the first line) can become acquisition target (so far relevent intent letter has been signed).

- *2. Tenders for c. PLN 7 billion to be completed this year.* This year should bring the completion of tenders for an impressive c. PLN 7 billion. First, there are two tenders announced by PGNiG, which is to speed up its investment process. The first one is a contract for the construction of an underground gas storage facility in Wierzchowice (PLN 1.0 billion), and the second one is a contract for construction of the Lubiatów-Międzychód-Grotów crude oil plant (PLN 1.4 billion). Second, there is a contract for the construction of the second line of tube in Warsaw for the value of c. PLN 4 billion. Third, there are contracts for the construction of stadiums in Poznan and Wroclaw for the value of c. PLN 1 billion. We believe, PBG is well positioned to win at least one of them.

**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* | 12% | 12% | 281.6 | 319 | – |
| - | → | - | *17.02.2008* | - | - | - | 317.9 | 319 | → |
| - | → | - | *21.02.2008* | - | - | - | 326.7 | 352 | ↑ |
| - | → | - | *30.03.2008* | - | - | - | 325.0 | 358 | ↑ |
| - | → | - | *14.04.2008* | - | - | - | 311.0 | 357 | ↓ |
| - | → | - | *29.04.2008* | - | - | - | 318.0 | 361 | ↑ |
| - | → | - | *15.05.2008* | - | - | - | 315.0 | 361 | → |

***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* | 281.6 | 12% |
| - | → | - | *17.02.2008* | - | 317.9 | - |
| - | → | - | *21.02.2008* | - | 326.7 | - |
| - | → | - | *30.03.2008* | - | 325.0 | - |
| - | → | - | *14.04.2008* | - | 311.0 | - |
| - | → | - | *29.04.2008* | - | 318.0 | - |
| - | → | - | *15.05.2008* | - | 315.0 | - |

***Distribution of IDM's current recommendations***

| | Buy | Hold | Sell | Suspended | Under revision |
|---|---|---|---|---|---|
| Numbers | 23 | 14 | 4 | 0 | 0 |
| Percentage | 56% | 34% | 10% | 0% | 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 | 0 | 0 |
| Percentage | 40% | 60% | 0% | 0% | 0% |

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

| | Overweight | Neutral | Underweight | Suspended | Under revision |
|---|---|---|---|---|---|
| Numbers | 19 | 11 | 11 | 0 | 0 |
| Percentage | 46% | 27% | 27% | 0% | 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 | 4 | 1 | 0 | 0 | 0 |
| Percentage | 80% | 20% | 0% | 0% | 0% |

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