Equity Markets

Sector review

Poland

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Polish contractors

Switch from Polimex to PBG

Construction & building materials

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Polish construction is booming. Construction shares have had a spectacular run and now trade at demanding valuations. Our top pick is PBG (BUY). We advise investors to switch from Polimex, which we downgrade to SELL.

Polish construction output reached €23.2bn in 2005, a level comparable with much smaller European countries such as Ireland and Portugal. In Spain, a country of comparable size and population to Poland, construction output was 5.2x larger than Poland's in 2005.

We expect CAGR growth of 8% in construction output 2006-08F. Inflow of EU-accession funds, increased corporate investment and soaring housing prices underpin growth in construction output well above the rate of GDP growth. Growth is sustainable for at least the next three years if not over a longer period of time. We believe civil engineering and housing will lead the growth of the Polish construction market in years to come.

We initiate coverage of PBG with a BUY rating and a target price of PLN213. The company offers better earnings momentum and faces relatively less intense competition. Its order book equals 4x 2005 company revenue and yet we expect sizeable new signings before the end of 2006. The stock trades at an 18% discount to peers based on 2007F PER of 26.0x and a 32% discount based on a 2007F three-year PEG ratio of 0.7x.

We downgrade Polimex to SELL with a revised TP of PLN120. Polimex mis-priced some contracts for the construction of a wastewater treatment plant, so its margins will suffer in 2007. It trades at a premium to PBG on 2007F PER of 29.2x and a 2007F three-year PEG ratio of 1.8x.

We initiate on Budimex with a HOLD, TP PLN78. We forecast a major improvement in profitability, but it is an expensive play on turnaround as it trades on a 2007F PER of 34.5x and a 2007F PEG ratio of 0.9x.

Budimex: initiating coverage

Bloomberg ticker	BDX PW
Price (PLN) (19/09/06)	78.3
Target price (PLN)	78.0
Rating	Hold
Market cap (US$m)	642
Free float (%)	41
2007F PER (x)	34.5
2007F 3-yr PEG (x)	0.9

PBG: initiating coverage

Bloomberg ticker	PBG PW
Price (PLN) (19/09/06)	175
Target price (PLN)	213
Rating	Buy
Market cap (US$m)	690
Free float (%)	61
2007F PER (x)	26.0
2007F 3-yr PEG (x)	0.7

Polimex: downgrade to SELL

Bloomberg ticker	PXM PW
Price (PLN) (19/09/06)	138.1
Target price (PLN)	120 (prev. 71.5)
Rating	Sell (prev. Hold)
Market cap (US$m)	677
Free float (%)	87
2007F PER (x)	29.2
2007F 3-yr PEG (x)	1.8

Contents

Summary

Polish construction output is in the early stages of a sustainable growth period that is very well underpinned by the inflow of EU-accession funds, increased capex spend by the corporate sector and by rising prices in the housing market. Total construction output reached PLN94bn in 2005, or €23.4bn, a level comparable with much smaller European countries such as Ireland and Portugal. In the first eight months of 2006, construction output grew by 9.1%, despite a very long and severe winter. We expect CAGR growth of 8% in construction output in 2006-08F and the individual segments should show even faster growth. Budimex's management expects civil engineering to post 14% CAGR in 2006-08F from what is a very low historical level of spend. We believe civil engineering and housing will lead the growth of the Polish construction market in years to come.

Budimex is the largest Polish construction company by revenue, active in general and infrastructure construction as well as housing development. Profitability has suffered in recent years and in 1H06 from low margins in road construction and from a PLN104m accumulated gross loss on the Okecie airport terminal contract. The future looks rosier for the company following the recently-signed annex to the Okecie contract, which will cut losses. Margins in non-housing construction are inching up but remain vulnerable to rising steel prices and the advancing costs of subcontractors. The company has the highest exposure to the booming housing market of the three companies covered in this note, and housing margins are set for rapid expansion. The company targets a 50bp yearly improvement in gross margin adjusted for the effects of forex, which were 6.1% in 2004 and 5.9% in 2005.

PBG commenced operations in 1994 as a family engineering company providing construction services for various types of oil and gas installations, largely for the state-owned integrated gas company, PGNIG. More recently, PBG has successfully expanded into hydro- and civil engineering and general/environmental construction. The company generates the highest sales growth and by far the highest operating margins among its peers. In 2002-05, PBG grew its revenue/net profit by a CAGR of 36%/98%, respectively. Its backlog is equivalent to 4x company revenue in 2005, and we expect a number of sizeable signings by the end of 2006. We project three-year CAGR in revenue/net profit of 54%/44% in 2006-08F.

Polimex is a growth company but not a growth stock at current valuations. Management has also warned us on possible losses on contracts for construction and modernisation of a number of wastewater treatment plants. Polimex has steel structure manufacturing and galvanising plants that contribute more equally throughout the year, so the revenue and earnings contribution in the second half of the year is lower compared to pure contractors. Therefore, we expect Polimex's results in 2H06 to show lower growth rates in earnings compared to Budimex and PBG.

Recommendations

We rate PBG a BUY

We rate PBG a **BUY** for three principal reasons. First, its order book is the largest versus last year's revenue of the three companies. Second, we forecast continued rapid growth in earnings higher than for Polimex and, unlike in the case of Budimex (which is expected to post very high growth in earnings from a minimal base in 2005) from an already elevated base in 2005. Finally, as a niche player, PBG is less exposed to competition, and has successfully penetrated a segment that is not only characterised by superior margins but which is also witnessing significantly higher growth in construction spend such as in hydro-engineering and environmental construction.

We downgrade Polimex to SELL

We downgrade Polimex from hold to **SELL**. We forecast the lowest growth in earnings for Polimex in 2H06 and in the next three years within our universe of three construction companies. Our major concern is the number of loss-making contracts in wastewater treatment, worth a total of PLN166m. Finally, the company's working capital management is of a significantly worse quality compared to its peers, with an estimated cash conversion of 60 days in 2006 compared to 46 days for PBG and seven days for Budimex. Polimex acts as a subcontractor in a greater share of contracts compared to Budimex, which greatly increases the company's need for working capital funding.

We rate Budimex a HOLD

Budimex is a story of recovery in margins. Margins in non-housing construction are inching up but remain vulnerable to rising steel prices and the advancing costs of subcontractors. Margins in housing are set for significant expansion in quarters to come as the prices of apartments soar and the company sells an increasing number of housing units. We rate the company as a **HOLD** as we believe the turnaround is already priced in.

Valuation and target prices

Parallel assumptions to calculate WACC

We have used discounted cash flow models with a 10-year projection and we use similar assumptions to calculate the WACC. We have used the forecast yield of 10-year sovereign bonds as a proxy for risk-free-rates. Equity risk premium is the standard 5% we use to calculate the cost of equity for Polish companies. Beta is based on the correlation of weekly returns of individual stocks against the WIG index over the period of the last five years. To calculate the cost of debt, we use spreads over the three-month WIBOR rate of 100bp for Budimex, 70bp for PBG and 70bp for Polimex, which are our estimates of the cost of incremental debt for these companies. The terminal growth rate is 2%.

Figure 1 summarises the assumptions we have made when forecasting cash flows.

Fig 1 DCF assumptions summary (%)

	Budimex	PBG	Polimex
3-yr CAGR in revenue	10	54	14
10-yr CAGR in revenue	7	21	11
3-yr CAGR in NOPAT	233	55	18
10-yr CAGR in NOPAT	58	20	13
10-yr average annual working capital need	10	57	72
10-yr average capex to revenue	1	4	2

Source: ING estimates

Fig 2 Budimex discounted cash flow model (PLNm)

Yr to Dec	2006F	2007F	2008F	2009F	2010F	2011F	2012F	2013F	2014F	2015F	2016F
Revenue	**2,977**	**3,388**	**3,614**	**3,877**	**4,087**	**4,276**	**4,474**	**4,683**	**4,901**	**5,130**	**5,370**
EBITDA	**66**	**85**	**98**	**124**	**151**	**175**	**201**	**211**	**221**	**231**	**242**
EBITDA margin	2.2	2.5	2.7	3.2	3.7	4.1	4.5	4.5	4.5	4.5	4.5
EBIT	**45**	**61**	**72**	**97**	**123**	**145**	**170**	**178**	**186**	**195**	**204**
EBIT margin	1.5	1.8	2.0	2.5	3.0	3.4	3.8	3.8	3.8	3.8	3.8
Tax rate	19	19	19	19	19	19	19	19	19	19	19
Tax on EBIT	(9)	(12)	(14)	(18)	(23)	(28)	(32)	(34)	(35)	(37)	(39)
NOPAT	**37**	**49**	**59**	**79**	**99**	**118**	**138**	**144**	**151**	**158**	**165**
Depreciation	21	24	25	27	29	30	31	33	34	36	38
Working capital	(17)	(14)	(8)	(11)	(10)	(9)	(9)	(7)	(7)	(8)	(8)
Capex	(30)	(34)	(36)	(39)	(41)	(43)	(45)	(47)	(49)	(51)	(54)
Free cash flow	**11**	**26**	**40**	**56**	**77**	**96**	**115**	**123**	**129**	**135**	**141**

Source: ING estimates

Fig 3 Budimex WACC assumptions and DCF results (PLNm)

Yr to Dec	2006F	2007F	2008F	2009F	2010F	2011F	2012F	2013F	2014F	2015F	2016F
Debt/(equity+debt) ratio	0.2	0.2	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1
RFR (%)	5.1	5.0	5.2	5.3	4.7	4.2	4.2	4.2	4.2	4.2	4.2
Equity premium (%)	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
Beta (x)	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Cost of equity (%)	8.8	8.6	8.9	8.9	8.3	7.9	7.9	7.9	7.9	7.9	7.9
Cost of debt @ 100bp (%)	5.2	5.2	4.8	4.2	4.1	4.1	4.1	4.1	4.1	4.1	4.1
After-tax cost of debt (%)	4.2	4.2	3.9	3.4	3.3	3.3	3.3	3.3	3.3	3.3	3.3
WACC (%)	**7.7**	**7.6**	**7.8**	**7.9**	**7.5**	**7.2**	**7.3**	**7.3**	**7.4**	**7.4**	**7.5**
DFCF	2.6	23	34	44	57	67	74	73	71	69	
Sum of DFCF	515										
Terminal growth rate (%)	2										
Terminal value	1,230										
Enterprise value	**1,745**										
Current net debt/(cash)	(84)										
Equity value	**1,829**										
No of shares (m)	25.5										
Per share (PLN)	**71.7**										

Source: ING estimates

Fig 4 PBG discounted cash flow model (PLNm)

Yr to Dec	2006F	2007F	2008F	2009F	2010F	2011F	2012F	2013F	2014F	2015F	2016F
Revenue	**785**	**1,215**	**1,506**	**1,681**	**1,830**	**1,977**	**2,137**	**2,311**	**2,499**	**2,704**	**2,927**
EBITDA	**101**	**148**	**191**	**214**	**251**	**271**	**282**	**294**	**305**	**317**	**328**
EBITDA margin	12.9	12.2	12.7	12.7	13.7	13.7	13.2	12.7	12.2	11.7	11.2
EBIT	**81**	**118**	**154**	**172**	**205**	**222**	**229**	**236**	**243**	**249**	**255**
EBIT margin	10.4	9.7	10.2	10.2	11.2	11.2	10.7	10.2	9.7	9.2	8.7
Tax rate	19	19	19	19	19	19	19	19	19	19	19
Tax on EBIT	(15)	(22)	(29)	(33)	(39)	(42)	(44)	(45)	(46)	(47)	(48)
NOPAT	**66**	**96**	**125**	**139**	**166**	**180**	**185**	**191**	**197**	**202**	**207**
Depreciation	20	30	38	42	46	49	53	58	62	68	73
Working capital	(97)	(106)	(75)	(44)	(44)	(37)	(37)	(40)	(43)	(46)	(50)
Capex	(94)	(49)	(60)	(62)	(64)	(67)	(68)	(69)	(70)	(73)	(79)
Free cash flow	**(106)**	**(28)**	**27**	**75**	**104**	**124**	**134**	**140**	**147**	**151**	**151**

Source: ING estimates

Fig 5 PBG WACC assumptions and DCF results (PLNm)

Yr to Dec	2006F	2007F	2008F	2009F	2010F	2011F	2012F	2013F	2014F	2015F	2016F
Debt/(equity+debt) ratio	0.4	0.4	0.5	0.4	0.4	0.4	0.3	0.3	0.3	0.3	0.2
RFR (%)	5.1	5.0	5.2	5.3	4.7	4.2	4.2	4.2	4.2	4.2	4.2
Equity premium (%)	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
Beta (x)	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Cost of equity (%)	8.3	8.1	8.4	8.4	7.8	7.4	7.4	7.4	7.4	7.4	7.4
Cost of debt @ 70bp (%)	4.9	4.9	4.9	4.5	3.9	3.8	3.8	3.8	3.8	3.8	3.8
After-tax cost of debt (%)	4.0	4.0	4.0	3.6	3.1	3.1	3.1	3.1	3.1	3.1	3.1
WACC (%)	**6.5**	**6.4**	**6.4**	**6.4**	**5.9**	**5.7**	**5.9**	**6.0**	**6.2**	**6.3**	**6.4**
DFCF	(25.9)	(26.2)	23.1	61.1	81.3	92.5	93.2	91.3	89.2	85.5	
Sum of DFCF	565.1										
Terminal growth rate (%)	2.0										
Terminal value	1,841.0										
Enterprise value	**2,406.1**										
Current net debt/(cash)	41.9										
Equity value	**2,364.2**										
No of shares	12.0										
Per share (PLN)	**196.5**										

Source: ING estimates

Fig 6 Polimex discounted cash flow model (PLNm)

Yr to Dec	2006F	2007F	2008F	2009F	2010F	2011F	2012F	2013F	2014F	2015F	2016F
Revenue	**2,129**	**2,393**	**2,701**	**2,997**	**3,255**	**3,564**	**3,893**	**4,243**	**4,615**	**5,012**	**5,434**
EBITDA	**129**	**145**	**169**	**193**	**221**	**242**	**265**	**288**	**314**	**341**	**369**
EBITDA margin	6.1	6.0	6.2	6.4	6.8	6.8	6.8	6.8	6.8	6.8	6.8
EBIT	**97**	**104**	**123**	**142**	**166**	**182**	**198**	**216**	**235**	**256**	**277**
EBIT margin	4.6	4.3	4.5	4.7	5.1	5.1	5.1	5.1	5.1	5.1	5.1
Tax rate	19	19	19	19	19	19	19	19	19	19	19
Tax on EBIT	(18)	(20)	(23)	(27)	(32)	(35)	(38)	(41)	(45)	(49)	(53)
NOPAT	**79**	**84**	**100**	**115**	**134**	**147**	**161**	**175**	**191**	**207**	**224**
Depreciation	32	41	46	51	55	61	66	72	78	85	92
Working capital	(147)	17	(109)	(61)	(55)	(63)	(68)	(72)	(77)	(82)	(87)
Capex	(53)	(69)	(54)	(57)	(59)	(61)	(70)	(81)	(83)	(85)	(87)
Free cash flow	**(89)**	**73**	**(18)**	**48**	**77**	**84**	**89**	**95**	**109**	**125**	**143**

Source: ING estimates

Fig 7 Polimex WACC assumptions and DCF results (PLNm)

	2006F	2007F	2008F	2009F	2010F	2011F	2012F	2013F	2014F	2015F	2016F
Debt/(equity+debt) ratio	0.3	0.3	0.3	0.3	0.2	0.2	0.2	0.2	0.16	0.14	0.13
RFR (%)	5.13	4.99	5.22	5.27	4.67	4.20	4.20	4.20	4.20	4.20	4.20
Equity premium (%)	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
Beta (x)	0.71	0.71	0.71	0.71	0.71	0.71	0.71	0.71	0.71	0.71	0.71
Cost of equity (%)	8.7	8.5	8.8	8.8	8.2	7.8	7.8	7.8	7.8	7.8	7.8
Cost of debt @ 70bp (%)	4.9	4.9	4.9	4.5	3.9	3.8	3.8	3.8	3.8	3.8	3.8
After-tax cost of debt (%)	4.0	4.0	4.0	3.6	3.1	3.1	3.1	3.1	3.1	3.1	3.1
WACC (%)	**7.1**	**7.0**	**7.3**	**7.4**	**7.0**	**6.7**	**6.8**	**6.9**	**7.0**	**7.1**	**7.1**
DFCF	-88	67	-15	38	57	59	59	58	62	66	
Sum of DFCF	364										
Terminal growth rate (%)	2										
Terminal value	1,367										
Enterprise value	**1,732**										
Current net debt/(cash)	50										
Equity value	**1,682**										
No of shares (m)	15.2										
Per share (PLN)	**110**										

Source: ING estimates

We have used our estimated cost of equity in 2006 to arrive at our target prices for individual companies.

Fig 8 Target price and expected US$ absolute total return

	Budimex	PBG	Polimex
DCF (PLN)	71.7	197	110
Cost of equity (%)	8.8	8.3	8.7
12 months rolling target price (PLN)	**78.0**	**213**	**120**
Current price (PLN)	78.3	175	138
Change in the share price (%)	-0	22	-13
2006F dividend yield (%)	0	0	1
Expected total return (%)	**-0**	**22**	**-13**

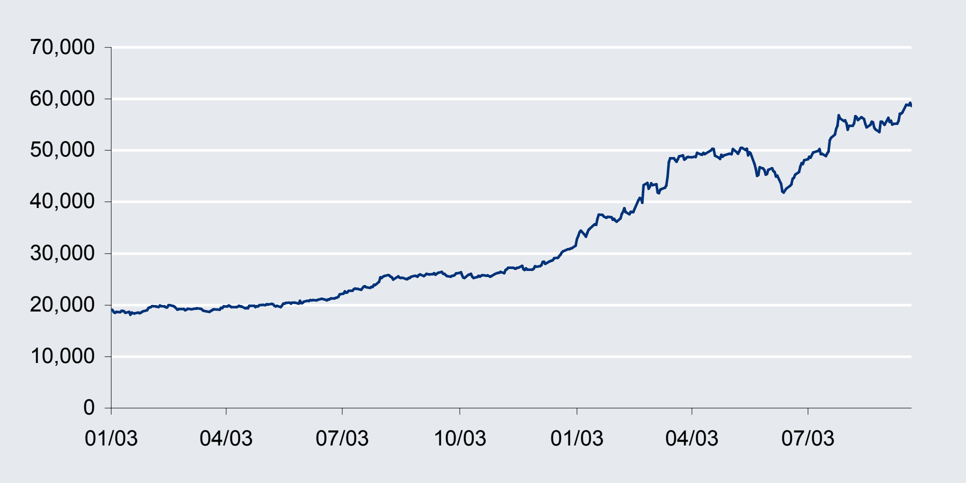
Source: Company data

Earnings-based multiples

Shares look expensive

The Polish construction sector has had a spectacular run since 2005. The WIG Construction index surged 63% in 2005 and 91% YTD and was the best-performing sector on the WSE. Our universe trades at average 2007F PER of 29.9x and 2007F three-year PEG of 1.2x. PBG is the least expensive stock based on 2007F PER and 2007F EV/EBITDA multiples, while Budimex is relatively attractive based on 2007F three-year PEG and 2007F EV/sales multiples.

Fig 9 WIG Construction index



Source: Bloomberg

Fig 10 Comparison of EPS-based multiples

Company	Price (PLN) (19/09/06)	Target price (PLN)	Rating	Mkt cap (US$)	PER (x) 2005	2006F	2007F	3-yr CAGR in EPS (%) 2006-08F	PEG ratio (x) 2005	2006F	2007F
Budimex	78.3	78.0	Hold	642	983.6	58.8	34.5	226.1	10.8	0.3	0.9
PBG	175	213	Buy	690	51.1	40.1	26.0	38.1	0.8	1.1	0.7
Polimex	138	120 (prev. 71.5)	Sell (prev. Hold)	677	47.1	33.3	29.2	24.2	2.0	1.4	1.8
Average					**360.6**	**44.0**	**29.9**	**96.1**	**4.5**	**0.9**	**1.2**

Source: ING estimates

Fig 11 Comparison of EV-based multiples

Company	Price (PLN) (19/09/06)	Target price (PLN)	Rating	Mkt cap (US$)	EV/sales (x) 2005	2006F	2007F	EV/EBITDA (x) 2005	2006F	2007F
Budimex	78.3	78.0	Hold	642	0.6	0.6	0.5	72.1	25.5	19.9
PBG	175	213	Buy	690	4.7	2.6	1.9	38.4	19.9	15.6
Polimex	138	120 (prev. 71.5)	Sell (prev. Hold)	677	1.2	1.2	1.2	20.9	16.7	16.2
Average					**2.2**	**1.4**	**1.2**	**43.8**	**20.7**	**17.3**

Source: ING estimates

Risk factors

Budimex is the most exposed to both rising steel prices ...

Construction steel prices are reaching new high levels in 2H06. Budimex is the most exposed to an increase in steel prices, followed by PBG, as the maturity of its contracts is higher compared to peers and the company relies on subcontractors for the delivery of steel structures. The company has informed us that the prices for subcontractors are rising faster than the prices for general contractors. Polimex has historically made profits on steel inventory in periods of advancing steel prices.

... and hikes in interest rates

The probability of interest rate increases in Poland before the end of 2006 has increased in the last few days. MPC member Marian Noga saw it necessary to hike rates by 25bp in December 2006, and again by 25pb in June 2007. The market's current expectations are for a marginally earlier first hike, and a later second hike. Another member of the MPC, Dariusz FIilar, has made comments suggesting an October rate hike and an eventual increase to 5% from 4.25% currently. We estimate Budimex has the lowest but still comfortable EBITDA-to-interest costs ratio of 8.4x in 2007F compared to 9.1x for PBG and 12.6x for Polimex.

Polimex has a number of loss-making contracts

Construction companies often suffer from loss-making contracts. The Okecie contract killed Budimex's profitability in 2004-05 but the signing of the annex to the Okecie airport contract should cut losses on this contract. Polimex's contracts in wastewater treatment are making losses and we not aware of any large loss-making contracts for PBG.

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Companies

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Poland

Budimex

Expect a turnaround in margins

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Initiating coverage

Hold

Target price (12 mth)

PLN78.0

Bloomberg

BDX PW

Construction & building materials

Price (19/09/06)

PLN78.3

We initiate on Budimex with a HOLD rating and a DCF-based TP of PLN78. Signing of the annex to the Okecie contract should mark the end of a long period of minimal profitability. Housing margins are set for rapid expansion.

Budimex remains the largest general contractor in Poland. It is active in general and infrastructure construction as well as housing development. Margins in non-housing construction are inching up but remain vulnerable to rising steel prices and the advancing costs of subcontractors.

The order book stands at PLN3.2bn, or 129% of 2005 revenue. General construction accounts for 55% of the order book, infrastructure 41% and environmental construction 4%.

The Okecie terminal contract has wiped out profitability. The total growth loss sustained on this contract has reached PLN104m. On 15 November, the company signed a US$49m annex, and it should cut its losses on this contract going forward.

Turnaround play. While we forecast a significant improvement in profitability, the stock is a somewhat expensive play on turnaround as it trades at a 2007F PER of 34.5x and a 2007F PEG ratio of 0.9x.

Forecasts and ratios

Yr to Dec	2003	2004	2005	2006F	2007F	2008F
Revenue (PLNm)	2,147	2,151	2,703	2,977	3,388	3,614
EBITDA (PLNm)	103	31	23	66	85	98
Net income (PLNm)	45	8	2	34	58	70
EPS (PLN)	1.78	0.33	0.08	1.33	2.27	2.76
PER (x)	44.0	238.9	983.6	58.8	34.5	28.4
PEG (x)	Negative	Negative	10.8	0.3	0.9	1.1
EV/Sales (x)	0.9	0.8	0.6	0.6	0.5	0.4
EV/EBITDA (x)	18.4	58.2	72.1	25.5	19.9	16.3
P/BV (x)	3.9	3.8	3.8	3.6	3.3	2.9
ROE (%)	9.3	1.6	0.4	6.3	9.9	10.8

Source: Company data, ING estimates

12-month forecast returns (%)

Share price	(0.3)
Dividend	0.0
12m f'cst total return	**(0.3)**

Key ratios (%)

	2006F	2007F
EBITDA margin	2.2	2.5
Operating margin	1.5	1.8
Net debt/equity	(46.3)	(58.5)
DPS (PLN)	0.0	0.0
Dividend yield	0.0	0.0

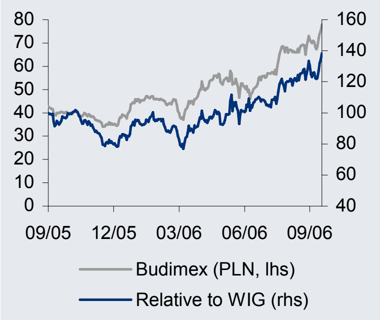
Quarterly data

(PLNm)	2Q06	3Q06F
Revenue	766.7	898.6
EBITDA	9.9	23.8
EBIT	4.9	18.5
Net profit	1.8	15.6

Share data

No. of shares (m)	25.5
Daily t/o (US$m)	0.4
Free float (%)	41
Mkt cap (US$m)	642
Mkt cap (PLNm)	1,997

Share price performance



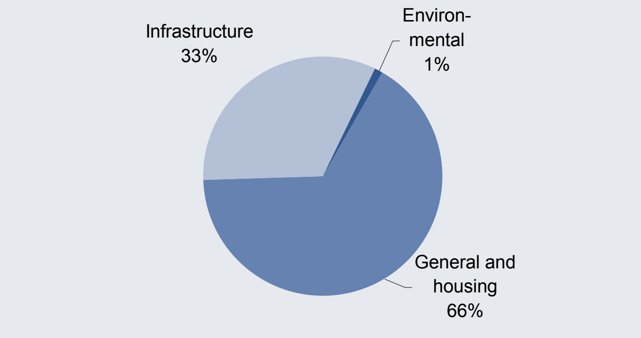
Source: Bloomberg

Background

The largest construction company in Poland

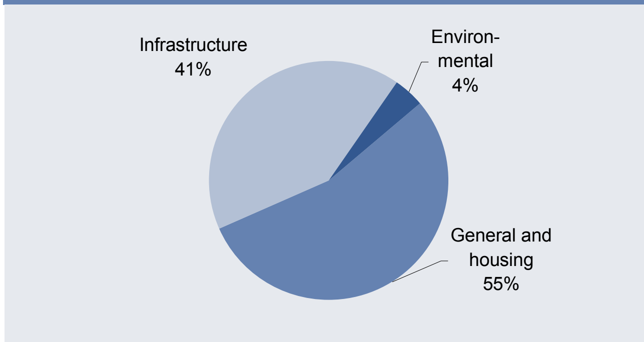
Budimex is the largest construction company in Poland, with a share, in 2005, of 6.4% in the market for construction companies employing at least nine workers, up from 5.7% in 2004. The company operates as a contractor focused on general and housing construction, infrastructure and environmental construction. The public sector accounts for 54% of revenue and Poland makes up 82% of sales. Ferrovial of Spain is the main strategic investor in Budimex and controls 59% of the company's equity and voting rights.

Fig 1 Breakdown of revenue (2005) ...



Source: Company data

Fig 2 ...current backlog



Source: Company data

Leading road construction company

Budimex is the leading road construction company in Poland. Road construction has seen an encouraging pick up in activity. Budimex's management estimates that total spend on road construction should increase by 33% in 2006 and that growth should remain in double-digit territory in years to come. According to government estimates, the combined spend on infrastructure construction should average €1.3bn in 2004-06 and we believe this should double to €2.6bn in the period 2007-13F, spurred by the influx of EU funds. According to management, margins in road construction are slowly inching up but they remain low and they do not fully cover the general expenses of the segment. As a majority of contracts in road construction are signed in euro, companies bid low and try to hedge euro revenue at a satisfactory forward rate that improves the overall profitability of the contracts.

Budimex's order book stands at PLN3.2bn

As Budimex is the largest construction company in Poland, the composition of its order book gives an accurate picture of market trends. This shows an increasing share of infrastructure and environmental construction and a rising share of public sector investors. Budimex's order book stands at PLN3.2bn for 2H06 and beyond and has increased by approximately 50% versus September 2005. We estimate that general construction accounts for 55% of the order book, infrastructure 41% and environmental construction for 4%. In 2005, general construction contributed 66% of group revenue, infrastructure construction added 33% and environmental construction made up 1%.

Fig 3 Budimex largest contracts

Date signed	Investor	Contractor	Subject	Value (m)	Completion
15/09/06	PPL	BDX	Annex to Okecie terminal contract	US$49	Nov-07
12/09/06	General Directory for State Motorways and Highways	BDX	Chojnice ring-road	PLN145	Sep-08
30/08/05	Mostostal Warszawa	BDX	Production of mineral mixes	PLN60	Dec-08
30/08/06	Neinver Polska	BDX	Construction of shopping centre	PLN73	May-07
03/07/06	Cracow Development Agency	BDX and PeBeKa Lublin	Szybki Tramwaj Project	PLN212	May-08
21/06/06	City of Warsaw	BDX	Reconstruction of Plac Saski	PLN165.0	Jun-09
14/06/06	General Directory for State Motorways and Highways	BDX	State Motorway No 50	PLN32.4	Jun-07
23/05/06	Sanitec Kolo	BDX	Construction of production plant	PLN34	Apr-07
16/05/06	BRE Locum	BDX	Construction of housing complex	PLN62	Sep-07
12/05/06	General Directory for State Motorways and Highways	BDX	State Motorway No 7 (Kiezmark-Jazowa)	PLN84.9	Dec-07
27/04/06	Polish Post	BDX	Construction of Distribution Centre in Wroclaw	PLN85.4	Apr-07
05/04/06	Bytom Commune	BDX	Construction of Gornoslaska ring road	PLN67.0	Jun-08
30/03/06	Hotel System Dzwirzyno	BDX	Construction of five-star hotel in Dzwirzyno	PLN24.6	Jun-07
20/03/06	Prison Service in Lublin	BDX	Construction of penitentiary in Opole Lubelskie	PLN41.3	Mar-09
28/02/06	Tarczynski SA	BDX	Construction of meat processing facility	PLN57.6	Jan-07
27/02/06	General Directory for State Motorways and Highways	BDX and PRM Mosty Lodz (7/3 share)	S-8 Wyszkow ring road	PLN208.5	May-08
15/02/06	Wroclaw Commune	BDX	Reconstruction of Plac Grunwaldzki	PLN70.7	Aug-07
09/02/06	City Park	BDX	Construction & modernisation of office-housing complex in Poznan	PLN66.3	Aug-07
23/01/06	City of Plock	BDX and Polbud Pomorze	Construction of local motorways	PLN87.4	Jan-07
05/01/06	Forum Gliwice	BDX	Construction of commercial outlet in Gliwice	PLN191	Mar-07
20/12/05	City of Cracow	BDX and consortium	Construction of sport arena in Krakow Czyzyny	PLN169.7	Nov-07
03/11/05	General Directory for State Motorways and Highways	BDX	S-5 and S-10 construction (Bygdoszcz-Stryszek)	PLN60.1	N/A
17/10/05	Bre.locum	BDX	Housing complex in Lodz	PLN12.6	Oct-06
17/10/05	City of Katowice	BDX	Construction of Regional Court in Katowice	PLN49.2	Oct-08
19/09/05	Voest Alpine	BDX	Construction works at Sedzimir coal mine	PLN85.8	Aug-07
26/08/05	General Directory for State Motorways and Highways	BDX	A6 Kijewo-Klucze road construction	PLN93.7	Jun-07
12/07/05	Music Academy Cracow	BDX	Symfonia Music and Science Center Cracow	PLN45.2	Dec-06
11/07/05	Turret Polska	BDX	Construction of housing complex	PLN92.9	Jan-07
04/05/05	Targowyj kwartal - Nosowsybirsk	BDX	Construction of commercial-office complex in Nowowsybirsk	PLN171.7	Nov-06
09/02/05	City of Poznan and Aquanet	BDX and consortium	Central water treatment plant	PLN144.7	Nov-06
19/01/05	TWS Warsaw	BDX	Housing complex, Libska street, Warsaw	PLN31.9	Dec-06
10/01/05	City of Jelenia Gora	BDX and consortium	Construction of water & sewage system	PLN58.3	Dec-07
20/12/04	ZWIK Szczecin	BDX and Cestar	Construction of water & sewage system elements	PLN80.0	Mar-08
09/11/04	Health Ministry of Russian Federation	BDX	Reconstruction of clinicum in Moscow	PLN99.1	Sep-07
06/10/04	General Directory for State Motorways and Highways	BDX	S-8 ring road construction	PLN88.8	Nov-06
29/09/04	General Directory for State Motorways and Highways	BDX	State way No50 reconstruction Gora Kalwaria - Minsk Mazowiecki	PLN103.3	Oct-06
28/06/02	PPL	BDX and Ferrovial	Construction of Okecie Airport terminal	US$199	2008

Source: Company data

Growth in civil engineering to remain in double-digit territory

Following the recession-driven decline in revenue in 2002-03, Budimex's management increased the prices for its construction services in 2004. This led to a minimal increase in revenue and a decline in the order book. It was a determined policy of the management to eliminate low-profitability contracts in anticipation of a cyclical upturn in construction demand. In 2005, construction output in Poland grew by 7.4% and Budimex's revenue soared by 26%. In 1H06, the market grew by 9.2% and Budimex's revenue increased by 17%. The company expects an 8.9% increase in the construction market in 2006, driven by a 16% increase in the civil engineering segment. Within the civil engineering segment, management expects transport-related construction to increase by 33% and power construction by 12% in 2006. According to management estimates, the civil engineering segment should continue to grow at double-digit rates of 13.5% and 12.4% in 2007 and 2008 respectively, as it is the outright beneficiary of EU funds, and as government and local municipalities are increasing absorption of the funds.

Budimex signed a US$49m annex to the Okecie contract

The loss-making contract for the construction of the Okecie airport terminal in Warsaw wiped out the majority of Budimex's profits in 2004 and 2005. The company signed a US$199m contract in 2002 but failed to properly hedge multi-currency cash flows. Renegotiations of the terms of the contract with the investor proved very difficult and the company accumulated a gross loss on the contract reaching PLN104m, or PLN69m if the effects of currencies hedging are accounted for by the end of 1H06. On 15 November, Budimex signed an annex to the Okecie contract worth US$49m, which postponed completion of the terminal to November 2007. According to management, the loss sustained on the Okecie terminal contract should not increase further following the signing of the annex.

Fig 4 Budimex results, gearing and margins (PLNm)

	1Q05	2Q05	3Q05	4Q05	1Q06	2Q06
Revenue	404	663	853	783	482	767
EBITDA	9	1	13	(30)	8	10
EBIT	3	(6)	8	(34)	3	5
Net profit	0	0	1	0	1	2
Total assets	1,939	1,966	2,169	1,942	1,710	2,048
Total equity	520	520	520	520	522	525
Cash	192	224	305	494	342	295
Total debt	57	67	136	125	155	211
Net debt	(135)	(157)	(170)	(368)	(187)	(84)
Margins						
EBITDA	2.2	0.1	1.5	(3.8)	1.7	1.3
EBIT	0.8	(0.8)	0.9	(4.3)	0.7	0.6
Net	0.0	0.0	0.2	0.1	0.2	0.2

Source: Company data

Budimex plans to sell 1,200 apartments in 2006 and 2,000 apartments in years to come

Of the three companies under our coverage in Polish construction, Budimex has the largest housing construction operation. The company sold 441 apartments with a total space of 280,000m^2 in 2005 and plans to sell 1,200 apartments in 2006 and 2,000 apartments in the following three years. Revenue from housing development increased by 53% in 2005 to PLN133m and by 46% in 1H06 to PLN89m and made up 7% of group revenue in 1H06. EBIT margin on housing sales was 17% in 2Q06 compared to 5% in 2Q05 and 12% in 1Q06 and is expected by management to improve. Budimex recognises revenue only at the time of the signing of notary act, and it has sold almost all of the apartments currently under construction at significantly higher prices compared to 2005.

We expect housing revenue to reach 7% of consolidated revenue in 2006

We expect revenue from housing development to reach PLN204m in 2006, or 7% of consolidated revenue. Budimex sells approximately 60% of its apartments in Warsaw (the most robust housing market in Poland), 20% in Cracow and 20% in Poznan. Management targets average IRR of 28%+. Average housing prices in Warsaw grew by 30% over the last 12 months to PLN6,200/m^2 while we estimate the construction cost is approximately PLN2,500-3,000/m^2. Wide-spreading mortgage loans, rising disposable income, a housing deficit of over 1m apartments and finally, an inflow of foreign speculative capital, is quickly lifting housing prices in Warsaw as well as in the other major cities of Poland. Management is optimistic about housing prices in Warsaw and expects prices to peak at above PLN10,000/m^2 within the next few years.

Strategy

Budimex's strategy is to fortify its position in general and road construction through organic growth, to increase its housing development activity in order to sell at least 2,000 apartments per annum, and to enter the railway construction segment.

Management seeking acquisitions in railway construction

Management is seeking acquisitions in the railway construction segment which is small in size, with estimated annual sales of PLN1.2-1.5bn in 2005, but which is expected to see the highest growth rate of all the construction segments in Poland due to the massive current modernisation spend of the railway network. According to the government, estimated total spend on the modernisation of railways should average PLN3.5bn in 2007-13, with 70% of funds being provided by the EU and the rest by the government and Polish State Railways (PKP). The market for railways modernisation is very hermetic with just a handful of companies such as Tarpol (owned by Polimex), PRK7 and PRK Poznan that receive orders from PKP. Budimex's management is well aware of this opportunity and plans acquisitions to establish bridgeheads in a potentially lucrative segment.

Financial statements

We expect non-housing construction revenue to increase by 8% in 2006F

We forecast a 10%/14%/7% increase in revenue in 2006F/07F/08F, respectively. As Budimex is the largest construction company in Poland, we have assumed that it would grow its non-housing construction revenue in line with the markets: that is by 8% in 2006F, 9% in 2007F and 7% in 2008F. The share of high-margin housing revenue is expected to increase from 5% in 2005 to 7% in 2006F and to 11% in 2007F and 2008F.

SG&A expenses to reach 4.2% of revenue

Budimex successfully cut SG&A expenses from PLN188 in 2001 (7.5% of revenue) to just PLN135m in 2005 (5.0% of revenue) and PLN61m in 1H06 (4.9% of revenue). A reduction was possible due to lower employment and rigid control of overhead costs. In our estimates, we assume SG&A expenses reach 4.0% of revenue in 2008F and beyond, which is in line with management's target.

Outstanding working capital management

Working capital management is very good compared to other domestic peers, although management points to several drawbacks inherent in the days-based conversion ratios. The most serious drawback is the limitation of accounting for long-term contracts. Budimex recognises revenue and costs based on actual work progress irrespective of the issuance of an invoice by a client or for payables by a supplier. Still, the conventionally calculated cash conversion ratio fell from 35 days in 2003 to just six days in 2005 due to a shortening of receivables turnover from 93 days to 65 days and an extension of payables payments from 79 days to 89 days. Part of the policy introduced by Ferrovial is a focus on cash generation, and in fact Budimex is the only company of the three under our analysis in this note to have a net cash position, not a surprise given the very low operating margins at the end of 1H06.

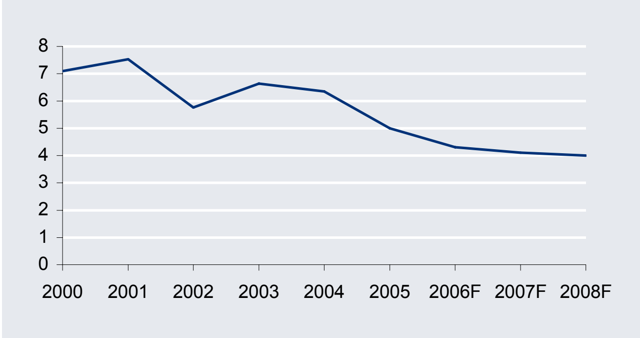
Profitability is expected to increase

The company targets a 50bp yearly improvement in gross margin adjusted for the effects of forex, which were 6.1% in 2004 and 5.9% in 2005. Profitability is expected to increase as: (1) margins in general construction are moving up in the industry, currently largely for subcontractors, but it is only a matter of time before general contractors start to witness the uplift in margins as well, in our view; (2) housing operations in large cities generate superior margins for Budimex, and given that Budimex recognises revenue at the time of change in ownership of an apartment, the impact of rapidly-growing housing prices is yet to be seen in the company results; and (3) the Okecie airport contract should no longer generate losses for Budimex. We assume an increase in the target margin by 30bp to 6.2% in 2006F but by a more visible 90bp in 2007F to 7.1%. We expect EBIT margin of 1.5% in 2006F, 1.8% in 2007F and 2.0% in 2008F. In the long-term, we expect EBIT margin of 3.8% thanks to higher gross profit margin and a decline in SG&A expenses.

Fig 5 Adjusted gross margin on sales

Source: Company data, ING estimates

Fig 6 SG&A ratio



Source: Company data, ING estimates

Risk factors

Wages in the construction sector increased 8.7% YoY in July

Rising construction costs are the major risk factor in our estimates for Budimex. Prices obtained by subcontractors are increasing faster than prices obtained by general contractors. Wages of skilled workers are rising due to emigration. Wages in the construction sector increased 8.7% YoY in July and 4.7% in the first seven months of 2006, compared to the corresponding period of 2005.

Steel prices on the rise again

Steel prices started to rise again in 4Q05 and this year, although the increase in prices for construction steel are not as steep as those for flat sheets. EU steel prices showed a remarkably strong recovery over 1H06. Despite the summer slowdown, the latest figures are now, in some cases, above the peak values reached in the previous cycle. The MEPS Composite All Products Carbon Steel Price, expressed in euro, has already surpassed the previous peak. In October 2004, the figure stood at €556 per tonne. That level was surpassed in July 2006 when it reached €562 per tonne. MEPS forecasts that the price will rise further to €581 per tonne in October. Increases announced by some mills for 4Q06 should be at least partially successful, though the producers may not get all they want.

MEPS July average transaction price for long products €495 per tonne

The MEPS average transaction price for flat products last month was €606 per tonne – slightly higher than the previous peak of €602 per tonne in January 2005. The increase from June to July this year was around 2%, largely because of higher extras on galvanised sheet, as producers attempted to pass through their escalating zinc costs. In long products, the last pinnacle was €499 per tonne reached in September 2004. This has not yet been exceeded in the current cycle: the MEPS July average transaction price for long products was €495 per tonne. MEPS forecasts that this will rise to €507 per tonne in October, before declining as construction activity undergoes its seasonal slowdown.

Company guidance is for adjusted gross margin of 6.0-6.5% in 2006

For now, Budimex's management is maintaining its guidance of gross margin (adjusted for the effects of hedging) of 6.0-6.5% in 2006 (our estimate is 6.2%) but it will have a clear picture on profitability trends after the 3Q06 results are released in mid-November.

Fig 7 Income statement (PLNm)

Yr to Dec	2003	2004	2005	2006F	2007F	2008F
Sales	**2,147**	**2,151**	**2,703**	**2,977**	**3,388**	**3,614**
COGS	(1,940)	(2,118)	(2,576)	(2,771)	(3,147)	(3,354)
Gross profit	**207**	**32**	**127**	**205**	**241**	**260**
Selling expenses	(24)	(29)	(25)	(24)	(24)	(25)
Administration costs	(119)	(107)	(110)	(104)	(115)	(119)
Other operational income	39	9	(21)	9	(17)	(18)
Result on hedging	0	125	52	(21)	0	0
EBITDA	**103**	**31**	**23**	**66**	**85**	**98**
DDA	(33)	(26)	(21)	(21)	(24)	(25)
EBIT	**71**	**5**	**2**	**45**	**61**	**72**
Interest received	10	19	18	25	21	25
Interest paid	(5)	(4)	(4)	(10)	(10)	(10)
Other financial income	5	(11)	(10)	(18)	0	0
Income from disposal of assets	(4)	0	0	0	0	0
Extraordinary loss	(0)	0	0	0	0	0
Goodwill	(6)	0	0	0	0	0
Negative goodwill	5	0	0	0	0	0
Pre-tax profit	**76**	**8**	**6**	**42**	**71**	**87**
Tax	(31)	(1)	(6)	(8)	(14)	(16)
Other deduction	0	0	0	0	0	0
Profits from associated companies	(1)	2	1	0	0	0
Minority profits	1	(1)	1	0	0	0
Net profit	**45**	**8**	**2**	**34**	**58**	**70**

Source: Company data, ING estimates

Fig 8 Balance sheet (PLNm)

Yr to Dec	2003	2004	2005	2006F	2007F	2008F
Inventory	88	146	279	300	340	363
Long-term contracts	0	220	252	483	483	483
Receivables	464	509	450	495	563	601
Derivatives	26	79	72	23	23	23
Other short-term assets	194	46	49	22	22	22
Cash and cash equivalents	200	343	494	437	539	629
Total current assets	**971**	**1,343**	**1,595**	**1,760**	**1,971**	**2,121**
PPE	97	100	97	106	116	127
Real estate investments	68	45	15	9	9	9
Intangible assets	15	14	11	11	11	11
Investments in associated costs	73	101	97	98	98	98
Other long-term financial assets	33	20	19	17	17	17
Long-term receivables	52	92	56	51	51	51
Deferred tax and other assets	46	40	50	63	63	63
Total fixed assets	**386**	**411**	**344**	**355**	**365**	**376**
Total assets	**1,357**	**1,754**	**1,939**	**2,115**	**2,337**	**2,497**
Trade creditors	394	598	654	704	799	852
Short term debt	19	32	102	102	102	102
Other creditors	166	425	465	501	568	606
Total current liabilities	579	1,056	1,222	1,307	1,470	1,560
Long-term debt	20	23	23	78	78	78
Provisions and accruals	217	87	97	97	97	97
Other long-term liabilities	0	64	75	75	75	75
Total non-current liabilities	**236**	**174**	**195**	**249**	**249**	**249**
Total liabilities	**816**	**1,229**	**1,416**	**1,556**	**1,720**	**1,809**
Share capital	128	146	146	146	146	146
Reserve capital	464	362	371	373	407	465
Other reserve capital	23	4	0	3	3	3
Accumulated profit/loss	(150)	0	0	0	0	0
Net profit	45	8	2	34	58	70
Total shareholder funds	510	520	520	556	614	685
Minorities and negative goodwill	**32**	**5**	**3**	**3**	**3**	**3**
Total funding	**1,357**	**1,754**	**1,939**	**2,115**	**2,337**	**2,497**

Source: Company data, ING estimates

Fig 9 Cash flow statement (PLNm)

Yr to Dec	2003	2004	2005	2006F	2007F	2008F
EBIT	**71**	**5**	**2**	**45**	**61**	**72**
DDA	(33)	(26)	(21)	(21)	(24)	(25)
EBITDA	**103**	**31**	**23**	**66**	**85**	**98**
Tax paid	(31)	(1)	(6)	(8)	(14)	(16)
Gross operating cash flow	**72**	**30**	**17**	**58**	**71**	**81**
Change in working capital	**163**	**100**	**(17)**	**(17)**	**(14)**	**(8)**
Net operating cash flow	**236**	**130**	**(0)**	**41**	**58**	**74**
Net interest paid	5	15	15	15	10	15
Other net expenses	1	(11)	(10)	(18)	0	0
Cash after financial obligations	**242**	**133**	**4**	**38**	**68**	**88**
PPE investment	80	(29)	(18)	(30)	(34)	(36)
Other investment	(139)	93	40	81	0	0
Change in other assets	(39)	(20)	27	(7)	0	0
Ch in LT contracts, provisions & accruals	174	(350)	(22)	(231)	0	0
Change in other liabilities and subsidies	(237)	64	11	0	0	0
Other assets and liabilities	88	189	31	35	68	37
Cash before financing	**169**	**81**	**74**	**(114)**	**102**	**89**
Change in equity	(36)	47	6	3	0	0
Change in short term debt	(39)	13	71	0	0	0
Change in long term debt	(10)	3	0	55	0	0
Cash after financing	**83**	**144**	**151**	**(56)**	**102**	**89**
Cash year end	**200**	**343**	**494**	**437**	**539**	**629**
Cash balance sheet	**200**	**343**	**494**	**437**	**539**	**629**

Source: Company data, ING estimates

Fig 10 Ratios (%)

Yr to Dec	2003	2004	2005	2006F	2007F	2008F
Margins						
Gross	9.6	1.5	4.7	6.9	7.1	7.2
EBITDA	4.8	1.4	0.9	2.2	2.5	2.7
EBIT	3.3	0.2	0.1	1.5	1.8	2.0
Pre-tax	3.6	0.4	0.2	1.4	2.1	2.4
Net	2.1	0.4	0.1	1.1	1.7	1.9
Profitability						
ROE	9.3	1.6	0.4	6.3	9.9	10.8
ROA	4.5	0.7	0.1	2.0	3.1	3.4
Gearing						
EBITDA/interest costs (x)	20.3	8.1	6.3	6.4	8.4	9.6
Debt to assets	2.9	3.1	6.5	8.5	7.7	7.2
Debt to equity	7.6	10.5	24.1	32.3	29.3	26.3
Net debt to equity	(31.5)	(55.5)	(70.9)	(46.3)	(58.5)	(65.5)
Working capital ratios						
Days of inventory	21	20	30	38	37	38
Days of receivables	93	83	65	58	57	59
Days of payables	79	86	89	89	87	90
Cash conversion days	35	17	6	7	7	7

Source: Company data, ING estimates

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PBG

Playing leapfrog

Initiating coverage

Buy

Target price (12 mth)

PLN213

Bloomberg

PBG PW

Construction & building materials

Price (19/09/06)

PLN175

We initiate coverage on PBG with a BUY rating and a TP of PLN213. PBG generates the highest sales growth and by far the highest operating margins among its peers. We forecast an impressive CAGR of 38% in 2006-08F EPS.

Fast-growing niche player. PBG is currently the fastest-growing construction company in Poland. Having started out with a focus on the construction of installations for the production, storage and transmission of crude oil and natural gas, and with a traditionally close business relationship with PGNIG, the company has more recently successfully expanded into hydro- and civil engineering and general/environmental construction.

The order book is at a historical high record level of PLN1.6bn, or 391% of 2005's revenues. The order book for 2007 is PLN700m, or 58% of estimated revenues.

Discount valuation. The stock trades at an 18% discount to local peers based on 2007F PER of 26.0x. We expect newsflow to remain positive in months to come: new signings with Lyse Gass and PGNIG, as well as upward revisions in company guidance, should close the discount to peers.

Forecasts and ratios

Yr to	2003	2004	2005	2006F	2007F	2008F
Revenue (PLNm)	181	216	409	785	1,215	1,506
EBITDA (PLNm)	21	28	50	101	148	191
Net income (PLNm)	11	13	36	52	81	109
EPS (PLN)	1.57	1.48	3.43	4.37	6.73	9.02
PER (x)	111.5	118.5	51.1	40.1	26.0	19.4
PEG (x)	1.5	2.9	0.8	1.1	0.7	0.8
EV/Sales (x)	7.4	6.0	4.7	2.6	1.9	1.5
EV/EBITDA (x)	63.3	46.0	38.4	19.9	15.6	12.2
P/BV (x)	38.8	8.8	10.4	5.1	4.8	3.8
ROE (%)	40.4	15.0	22.5	19.4	20.2	21.9

Source: ING

12-month forecast returns (%)

Share price	21.7
Dividend	0.0
12m f'cst total return	**21.7**

Key ratios (%)

	2006F	2007F
EBITDA margin	12.9	12.2
Operating margin	10.4	9.7
Net debt/equity	55.6	52.8
DPS (PLN)	0.0	0.0
Dividend yield	0.0	0.0

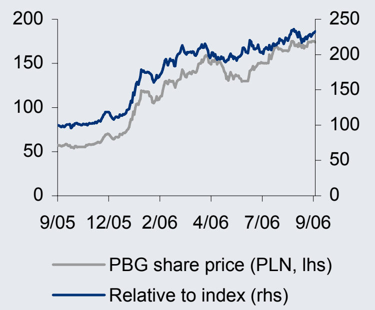
Quarterly data (PLNm)

	2Q06	3Q06F
Revenue	139.9	227.7
EBITDA	15.6	29.0
EBIT	12.0	25.0
Net profit	8.1	17.8

Share data

No. of shares (m)	12.0
Daily t/o (USm)	0.5
Free float (%)	61
Mkt cap (US$m)	690
Mkt cap (lc m)	2,105

Share price performance



Source: Reuters

Background

Family engineering company…

PBG began operations in 1994 as a family engineering company providing construction services for various types of oil and gas installations, largely for the state-owned integrated gas company, PGNIG. To fund its growing financing requirements in the face of the anticipated upswing in demand for its services, as well as to finance planned acquisitions, PBG floated on the WSE in June 2004 at a price of PLN32 per share. In January 2006, PBG completed a secondary public offering at a price of PLN92 per share and raised funds to acquire companies in hydro-engineering construction. Company founder Jerzy Wisniewski remains the largest shareholder and holds 36% of equity and 52.4% of voting rights.

Fig 1 Share issue history

Series	Date	Issue amount	Nominal value (PLN)	Issue price (PLN)	Share amount
A, B series	2003/12/01	7,200,000	1.0	1.0	7,200,000
C series	2004/03/10	3,000,000	1.0	32.0	10,200,000
D series	2004/03/10	330,000	1.0	1.12	10,530,000
E series	2005/12/10	1,500,000	1.0	92.0	12,030,000

Source: Company data

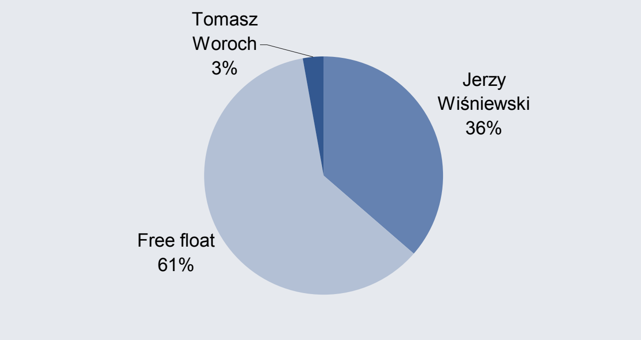
… active in a number of niche segments, most of which see limited competition

PBG is active in a number of niche segments. It designs and builds installations for the production of natural gas and crude oil for PGNIG, where its market share is close to 80%. It has one significant domestic competitor, Naftomontaz Krosno, plus rather sluggish competition from ABB. PBG builds steel pipelines and structures for the transmission of natural gas, crude oil and water, where it estimates its market share at 20%. Competition comes from several domestic companies, including Naftomontaz Krosno, Pol-Acqua and other construction companies owned by PGNIG. PBG builds fuel depots for gas and oil companies, an area where it competes with Hydrobudowa 6, Polimex and Bilfinger Berger. The most competitive segment is the construction of wastewater treatment plants, an area with visible competition from a number of Polish and foreign companies and a relatively low market share of 8%. Renovation of wastewater treatment plants and hydro-engineering are also segments with limited competition. Competition comes solely from foreign companies such as Per Aarslef, Diringer&Schiedel, Ludwig Pfeifer, SkanskaBilinger Berger and Ferrovial. PBG, following the recent acquisitions of HW and HS, currently holds a 50% market share. Foreign companies in environmental protection are generally less active in Poland compared to general construction or road construction. This leaves ample room for growth for domestic players, PBG among them.

Eighth largest construction company in Poland by revenue

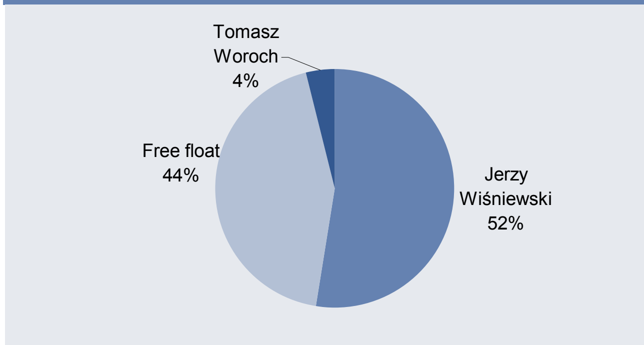
PBG has grown rapidly to become the eighth largest construction company in Poland by revenue in 2005. The company also had the highest EBIT margin among its peer group of 10.1 % in 2005. It has the highest profitability in the sector as a result of the lucrative margins gained in the highly specialised, limited-competition segment of engineering and construction services for oil and gas companies' exploration, and limited competition in hydro-engineering construction.

Fig 2 PBG shareholder structure – shares



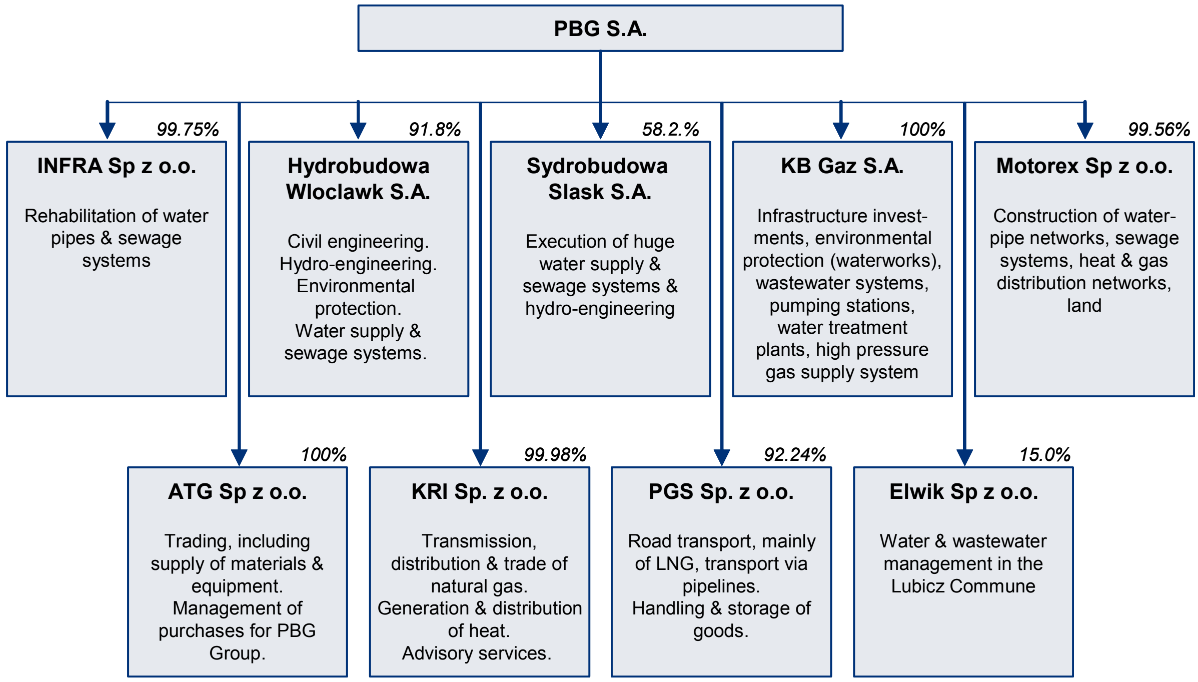
Source: Company data

Fig 3 PBG shareholder structure – votes



Source: Company data

Fig 4 Company structure



Source: Company data

Environmental construction and hydro engineering lead the growth

Management's strategy to focus not only on oil and gas construction services is visible in the revenue breakdown. Among the divisions, environmental construction and hydro-engineering have become leading growth drivers, with a 40% share in 2005 revenues (up from 23% in 2004) followed by general construction (20.2% up from 12.2% in 2004). After 1H06, environmental protection's share in revenues increased to over 63%, but this result was influenced by the lengthening tender process of PGNIG's oil and gas distribution and transmission contracts.

Fig 5 Revenue breakdown

PBG group revenues-business segments	1H06	(%)	2005	(%)	2004	(%)
Sale of services	**214,233**	**98.93**	**387,347**	**94.81**	**195,383**	**90.42**
Transmission	17,245	7.96	51,464	12.60	58,918	27.27
Distribution	2,932	1.35	5,062	1.24	8,502	3.93
E&P	16,246	7.50	19,418	4.75	42,437	19.64
Fuel storage	11,325	5.23	52,547	12.86	5,018	2.32
General construction, road, highway infrastructure	12,132	5.60	82,679	20.24	26,414	12.22
Environmental construction and hydro-engineering	136,752	63.15	162,966	39.89	50572	23.40
Exploration and distribution of water, wastewater management	1,753	0.81	2,864	0.70	2,794	1.29
Distribution of oil and gas	15,848	7.32	10,347	2.53	728	0.34
Sale of goods	**2,310**	**1.07**	**21,192**	**5.19**	**20,703**	**9.58**
Total revenues	**216,543**		**408,539**		**216,086**	

Source: Company data

Major takeovers

PBG acquired HW in 2005...

Among the major recent acquisitions, two conducted in the hydro-technology sector were of strategic importance. PBG controls a 91.8% stake in **Hydrobudowa Wloclawek (HW)** which it acquired through a capital increase. It has been the majority shareholder since August 2005. Through the acquisition, PBG gained access to know-how, engineers, skilled workers and other credentials. Among other projects, HW participated in the construction of the Poludnie wastewater treatment plant in Warsaw, and the acquisition of HW by PBG increases the chances of PBG receiving a contract for the construction of the Czajka wastewater treatment plant in Warsaw, a PLN1bn project planned for the coming years. HW's revenue reached PNL165m in 2006, up 40% from PLN118m in 2005 and its 2005 net profit was PLN1.4m compared to PLN4m in 2004.

...and HS in 2006

Hydrobudowa Slask (HS) is a listed company in which PBG controls a 58.2% stake acquired through a capital increase in February 2006. PBG consolidated the balance sheet of HS in 1Q06 but the profit & loss statement and cash flow statement will be consolidated only from 2Q06. In 2005, HS's revenues reached PLN111m, while the net loss amounted to PLN117m as a consequence of unprofitable contracts signed during the construction downturn in 2003. As a result, PBG created PLN46m of provisions as of the end of 1Q06. HS is experienced in hydro-engineering and operates mostly in the Silesian region. The company's 1H06 financials improved significantly YoY, as the company reached breakeven. In 2007F, net profit margin should come close to PBG's and reach 8-10%.

Management seeks bridgeheads into road and housing construction

Management has announced plans to enter housing and road construction. The company signed its first contract in housing construction worth PLN144.5m in May. PBG, acting as general contractor, will execute the construction of residential and commercial buildings in the area of Swinoujscie. Road construction is a different subject. The company plans to acquire three-to-five companies operating in regional markets for the construction of local roads with annual revenue up to PLN100m. Highway and motorways construction is dominated by large foreign companies and Budimex, and despite significant growth in spend, contractors suffer from the very low profitability of contracts. Therefore, in our view, the decision to focus on smaller local contracts makes sense. Further acquisitions should be announced in 2006.

Backlog

Backlog stands at PLN1.6bn

The backlog of contracts for 2H06-09 is PLN1.6bn or 391% of 2005 revenue. The backlog breakdown is PLN530/700/315/86m for 2H06/2007/2008/2009 and should increase significantly as the capital group has posted its offers in tenders worth more than PLN1bn. In 2006, PBG plans to participate in approximately 700 tenders compared to 500 tenders in 2005.

Fig 6 Key contracts

Date signed	Investor	Contractor	Subject	Value (m)	Completion
30/08/06	Bytom Waterworks & Sewage System	Hydrobudowa Slask	Improvement of sewage system in Bytom	PLN31.5	08/07
28/08/06	Wloclawek Waterworks & Sewage System	Hydrobudowa Wloclawek & Infra Sp z o.o.	Extension of water supply system in Wloclawek	PLN37.3	08/07
22/08/06	Naftobudowa Sp z o.o.	PBG	Reconstruction and enlargement of fire installation at oil station Rejnowiec	PLN19.6	06/07
18/08/06	Bydgoszcz Waterworks & Sewage System	Infra Sp z o.o.	Modernisation of sewage pipelines	PLN114	10/09
24/07/06	Aquanet S.A.	Hydrobudowa 9 (consortium leader), PBG (consortium partner)	Modernisation of water treatment system in Poznan	PLN52.4	03/09
24/06/06	Slupsk Waterworks & Sewage System	Hydrobudowa Wloclawek (consortium leader)	Extension of water-supply system in Slupsk	€1.9	N/A
14/06/06	Municipality of Wroclaw	Hydrobudowa Wloclawek (consortium leader: constructor of 80% of contract amount), PBG S.A. (consortium participant: constructor of 20% of contract amount	Extension of water-supply system in Oporow II estate	€22.9	04/08
09/06/06	Elblag Waterworks & Sewage System	PBG S.A. and Hydrobudowa Włocławek (in consortium with Przedsiebiorstwo Budownictwa i Instalacji 'ABT' Badora i Spolka Sp. Jawna and Przedsiebiorstwo Konserwacji Urzadzen Wodnych i Melioracyjnych 'PEKUM' Sp. z o.o.	Construction of Krolewiecka water treatment plant (SUW) and the extension of water supply system in Elblag	€15.8	06/08
25/05/06	Eko Power Sp. z o.o.	PBG S.A.	Construction of residential and commercial buildings in the area of Swinoujscie	PLN144.5	05/09
23/05/06	Tarnow Waterworks Sp. z o.o.	Hydrobudowa Wloclawek (in consortium with Pro Log Sp. z o.o. and PBG S.A.)	Construction of sanitary sewerage system in the communes of Skrzyszow and Tarnow	PLN5.9	08/08
25/04/06	NATO investments department	PBG S.A.	Modernisation and enlargement of fuel depot in Gardei	PLN23.0	04-05/08
08/02/06	Maxer Sp. z o.o. in bankruptcy	PBG S.A	The construction of Malczyce water step on the Odra river	PLN102.1	12/09
22/12/04	Bydgoszcz Waterworks & Sewage System	Hydrobudowa Wloclawek (in consortium with Wielobranżowe Przedsiębiorstwo Produkcyjno-Usługowe "ALFA" Sp. z o.o. and Zakład Instalacji Wod-Kanalizacyjnej i C.O. Wojciech Woźniak)	Construction of the main pumps of sewage system	€13.9	2007
29/11/05	Gliwice Waterworks and Sewage System	Hydrobudowa Włocławek S.A.	Modernisation of sewage treatment system	€4.8	10/06
23/11/05	TESGAS S.A	PBG S.A	LNG installation with pipelines	PLN17.3	10/06
14/11/05	City of Cracow	PBG S.A with Hydrobudowa Slask	Modernisation of sewage treatment facility	PLN9.7m	07/07
20/10/05	Latvijas Gaze Akciju Sabiedriba	PBG S.A. (in consortium with Pall Poland Sp. z o.o.)	Reconstruction of underground gas warehouse	€7.4	10/06
30/06/05	NATO	PBG S.A.	Modernisation and enlarging of MPS	PLN31.1	09/07
28/06/05	Warsaw Waterworks & Sewage System	PBG S.A. (in consortium	Construction of pump installation	PLN30	06/07
09/12/04	Szczecin Waterworks & Sewage System	PBG S.A. (in consortium with DIRINGER & SCHEIDEL Rohrsanierung GmbH & Co. KG.)	Renovation of sewage system network	€42	2007
17/09/04	Wloclawek Waterworks & Sewage System	PBG S.A. in consortium	Modernisation and rebuilding of sewage system facility	€16.5	2007

Source: Company data

PBG has a chance to win contracts on three projects run by PGNIG…

In May, PBG won the tender for the construction of a nitrogen removal plant for PGNIG in Grodzisk Wielkopolski. The losing contenders appealed the result of the tender. The court dismissed the appeal on 15 August and PBG's management expects to sign a contract worth approximately PLN430m. The tender for the PLN400m contract to build the Wierzchowice gas storage facility for PGNIG was cancelled and PBG's management expects PGNIG to be awarded the tender again within six months. By the end of 2006, PGNIG also intends to announce the tender for the development of PGNIG's largest gas and oil field Lubiatow-Miedzychod-Grotow (LMG), worth an estimated PLN430m.

… and is very close to signing a contract with Lyse Gass

Among the major projects to be announced in September/October 2006 are the NATO fuel and lubricant storage project valued at an estimated PLN250m, as well as the construction of the LNG plant for Lyse Gass of Norway, worth €60m. Signing a contract with Lyse should pave the way for PBG to potentially sign a lucrative contract in the Scandinavian market. Statoil announced the tender for construction of a LNG plant valued at €22m. It remains to be seen when the Warsaw municipality will announce the proposed PLN1bn tender to build the Czajka wastewater treatment plant Czajka and PBG intends to form a consortium to submit a compelling offer.

Fig 7 SWOT analysis

Strengths	**Weaknesses**
Full order book	Lack of experience in merging new entities with unstable financial situation
Leader in the segment of oil and gas construction and environmental construction	
State-of-the-art.-technology	
High quality	
Track record	
Opportunities	**Threats/Risks**
EU funding	Entry into the residential construction sector
Positive completion of Norwegian LNG contract might result in further foreign signings	Shortage in qualified workforce
	Deterioration of profit margins in case of acquisitions in the local road construction market

Source: ING

Financial statements

Organic growth in revenue was 59% in 1Q06; 32% in 2Q06

The quarterly results of PBG have seen revenues increase significantly, with revenue growth of 97% YoY in 1Q06, 64.5% in 2Q06, as the growing order book and the acquisition of Hydrobudowa Wloclawek (HW), which PBG consolidated from 4Q05, underpinned the growth. Company EBIT increased by 225% YoY and 77% in 1Q06 and 2Q06 respectively. We estimate that the consolidation of HW contributed PLN15m to revenue in 1Q06 and PLN28m in 2Q06, so organic growth in revenues was 59% in 1Q06 and 32% in 2Q06.

Gearing is moderate

The ratio of net debt to trailing 12m EBITDA was 1.25x in 2Q06, and we estimate that PBG could still take on up to PLN80m in new debt to fund growth without running the risk of excessive gearing. The EBITDA/interest cost ratio was also at a fully comfortable level of 3.9x in 2Q06.

Fig 8 Quarterly results (PLNm)

	1Q05	2Q05	3Q05	4Q05	1Q06	2Q06
Revenue	39	85	116	169	77	140
EBITDA	4	10	19	23	10	12
EBIT	2	7	13	19	7	12
Net profit	1	5	19	12	2	10
Total assets	280	334	651	662	843	858
Total equity	144	152	169	183	316	333
Cash	27	28	119	82	149	101
Total debt	75	91	217	215	199	181
Net debt	48	63	97	134	50	80
Margins (%)						
EBITDA	9.5	12.0	16.6	13.7	13.0	8.9
EBIT	5.3	8.0	11.4	10.9	8.7	8.5
Net	2.5	5.8	16.8	6.9	3.1	7.1

Source: Company data

EBIT margin should remain in double-digit territory

PBG EBIT margin was 8%/10%/10% in 2003/04/05, respectively, thanks to less intense competition in lucrative niche segments. We expect a temporary decline to 9.7% in 2007F due to the full-year consolidation of HS but the EBIT margin should remain in double-digit territory beyond 2007, chiefly because the company is in the advanced stages of tendering for a number of large contracts announced by PGNIG.

Company's official forecast is set for an upward revision in October

Management's official forecast is for PLN702m in revenue and PLN47m in net profit in 2006. We regard those forecasts as too conservative, as PBG has announced several sizeable contracts in the last few months and the integration of Hydrobudowa Slask is proceeding as planned. We expect an upward revision of the forecast possibly in October, before the publication of 3Q06 results on 14 November. We estimate revenue of PLN785m and net profit of PLN52m in 2006.

Fig 9 Income statement (PLNm)

Yr to Dec	2003	2004	2005	2006F	2007F	2008F
Sales	**181**	**216**	**409**	**785**	**1,215**	**1,506**
COGS	(135)	(166)	(329)	(617)	(960)	(1,182)
Gross profit	**45**	**51**	**80**	**168**	**255**	**324**
Selling expenses	(0)	(2)	(3)	(5)	(8)	(10)
Administration costs	(23)	(23)	(31)	(60)	(92)	(114)
Other operational income	(1)	2	4	(2)	(6)	(8)
EBITDA	**21**	**28**	**50**	**101**	**148**	**191**
DDA	(7)	(6)	(9)	(20)	(30)	(38)
EBIT	**14**	**22**	**41**	**81**	**118**	**154**
Interest received	2	4	5	4	3	7
Interest paid	(6)	(7)	(11)	(16)	(16)	(22)
Other financial income	(8)	0	3	0	0	0
Income from disposal of assets	2	0	0	0	0	0
Income from selling stakes in subordinate units	11	0	8	0	0	0
Goodwill	(1)	(0)	0	0	0	0
Pre-tax profit	**14**	**19**	**45**	**69**	**105**	**139**
Tax	(3)	(6)	(8)	(13)	(20)	(26)
Minority profits	0	(1)	(1)	(4)	(4)	(4)
Net profit	**11**	**13**	**36**	**52**	**81**	**109**

Source: Company data

Fig 10 Balance sheet (PLNm)

Yr to Dec	2003	2004	2005	2006F	2007F	2008F
Inventory	2	5	12	22	35	43
Long-term contracts	25	27	124	124	124	124
Receivables	62	155	224	430	665	825
Investments in associated companies	0	1	0	0	0	0
Other short-term assets	2	6	29	29	29	29
Cash and cash equivalents	11	44	82	50	97	236
Total current assets	**102**	**238**	**471**	**656**	**951**	**1,257**
PPE	41	48	177	252	270	293
Goodwill	0	3	5	66	66	66
Intangible assets	0	1	4	4	4	4
Investments in associated companies	2	4	0	0	0	0
Other long-term financial assets	16	9	4	26	26	26
Long-term receivables	0	0	1	1	1	1
Deferred tax and other assets	5	2	3	3	3	3
Total fixed assets	**64**	**68**	**196**	**353**	**371**	**394**
Total assets	**166**	**306**	**666**	**1,009**	**1,322**	**1,650**
Trade creditors	45	83	136	255	397	489
Short term debt	31	45	138	150	200	300
Other creditors	11	1	6	11	18	22
Total current liabilities	88	129	280	417	615	811
Long-term debt	41	28	80	100	130	150
Provisions and accruals	5	3	5	5	5	5
Other long-term liabilities	0	3	113	113	113	113
Subsidies	0	0	4	4	4	4
Total non-current liabilities	**45**	**34**	**202**	**222**	**252**	**272**
Total liabilities	**133**	**163**	**482**	**638**	**867**	**1,083**
Share capital	7	11	11	12	12	12
Reserve capital	16	117	125	290	342	423
Other reserve capital	0	4	8	8	8	8
Forex and hedging	0	0	4	4	4	4
Accumulated profit/loss	(2)	(4)	(7)	(7)	(7)	(7)
Net profit	11	14	36	52	81	109
Total shareholder funds	**33**	**143**	**178**	**360**	**440**	**549**
Minorities	**0**	**1**	**7**	**11**	**15**	**19**
Total funding	**166**	**306**	**666**	**1,009**	**1,322**	**1,650**

Source: Company data

Fig 11 Cash flow statement (PLNm)

Yr to Dec	2003	2004	2005F	2006F	2007F	2008F
EBIT	**14**	**22**	**41**	**81**	**118**	**154**
DDA	(7)	(6)	(9)	(20)	(30)	(38)
EBITDA	**21**	**28**	**50**	**101**	**148**	**191**
Tax paid	(3)	(6)	(8)	(13)	(20)	(26)
Gross operating cash flow	**18**	**23**	**42**	**88**	**128**	**165**
Change in working capital	**14**	**(58)**	**(23)**	**(97)**	**(106)**	**(75)**
Net operating cash flow	**32**	**(35)**	**19**	**(9)**	**23**	**90**
Net interest paid	(5)	(3)	(6)	(12)	(13)	(15)
Other net expenses	5	0	10	0	0	0
Cash after financial obligations	**32**	**(38)**	**23**	**(22)**	**9**	**75**
PPE investment	16	(13)	(138)	(94)	(49)	(60)
Other investment	1	(10)	(24)	(60)	0	0
Change in other assets	(9)	9	3	(22)	0	0
Change in long-term contracts, provisions & accruals	(5)	(4)	(95)	0	0	0
Change in other liabilities and subsidies	0	3	114	0	0	0
Other assets and liabilities	(23)	(22)	(4)	5	6	4
Cash before financing	**13**	**(76)**	**(120)**	**(193)**	**(33)**	**19**
Change in equity	2	107	13	130	0	0
Change in short term debt	(2)	14	93	12	50	100
Change in long term debt	(8)	(12)	52	20	30	20
Cash after financing	**5**	**33**	**38**	**(32)**	**47**	**139**
Cash year end	**11**	**44**	**82**	**50**	**97**	**236**
Cash balance sheet	**11**	**44**	**82**	**50**	**97**	**236**

Source: Company data

Fig 12 Ratios (%)

	2003	2004	2005	2006F	2007F	2008F
Margins						
Gross	25.0	23.4	19.6	21.4	21.0	21.5
EBITDA	11.6	13.1	12.3	12.9	12.2	12.7
EBIT	7.9	10.3	10.1	10.4	9.7	10.2
Pre-tax	7.6	8.9	11.1	8.8	8.6	9.2
Net	6.3	6.1	8.8	6.6	6.7	7.2
Profitability						
ROE	40.4	15.0	22.5	19.4	20.2	21.9
ROA	11.0	7.7	10.2	9.2	10.1	9.8
Gearing						
EBITDA/interest costs (x)	3.3	4.2	4.6	6.4	9.1	8.7
Debt to assets	43.3	24.0	32.8	24.8	25.0	27.3
Debt to equity	221.2	51.6	122.9	69.5	74.9	82.0
Net debt to equity	188.3	20.9	76.8	55.6	52.8	39.0
Working capital ratios						
Days of inventory		8	9	10	11	12
Days of receivables		184	169	152	165	181
Days of payables		141	122	116	124	137
Cash conversion days		50	57	46	51	56

Source: Company data

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Poland

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Polimex

Look out for loss-making contracts

Previously: Hold

Sell

Target price (12 mth): Previously PLN71.5

PLN120

Bloomberg

PXM PW

Construction & building materials

Price (19/09/06)

PLN138.1

Polimex is a growth construction company. The share has tripled in the last 12 months and trades at 2007F PER of 29.2x and a 2007F three-year PEG ratio of 1.8x. We downgrade to SELL on valuation.

Merger with ZREW is positive for shareholders. Management expects to close the deal in 2006. A merger should boost EPS and fortify and streamline company structure in the lucrative power construction segment.

Polimex's current order book stands at PLN3.9bn, or 212% of 2005's group revenue, including the estimated revenue from manufacturing 2H06-08F. Total value of order book: PLN1.2/1.6/1.1bn in 2H06/07F/08F.

Revision of estimates. We increase our estimates for 2006 net profit by 10% on higher revenue and margin estimates but keep our 2007F estimate unchanged due to the mis-pricing of a number of contracts.

Manufacturing and galvanising expand capacity. Polimex has built a new production hall for a steel structure in Siedlce in order to increase sales to a leading client, Peri of Germany. This is expected to add PLN100m in revenue in 2007. The new steel galvanising plant in Czestochowa faces delays but should contribute PLN80-90m to revenue starting from 2008.

Forecasts and ratios

Yr to PLN	2003	2004	2005	2006F	2007F	2008F
Revenue (PLNm)	1,239	1,701	1,842	2,129	2,393	2,701
EBITDA (PLNm)	99	108	103	129	145	169
Net income (PLNm)	28	37	43	61	76	92
EPS (PLN)	2.11	2.52	2.93	4.15	4.73	5.62
PER (x)	65.3	54.7	47.1	33.3	29.2	24.6
PEG (x)	N/A	2.2	2.0	1.4	1.8	1.3
EV/Sales (x)	2.2	1.3	1.2	1.0	0.98	0.9
EV/EBITDA (x)	27.0	20.5	20.9	16.7	16.2	13.9
P/BV (x)	18.3	8.8	7.2	5.0	4.7	4.2
ROE (%)	22.1	19.6	16.2	17.3	16.9	17.6

Source: Company data, ING estimates

12-month forecast returns (%)

Share price (lc)	(13.2)
Dividend (lc)	0.6
12m f'cst total US$ return	**(12.6)**

Key ratios (%)

	2006F	2007F
EBITDA margin	6.1	6.0
Operating margin	4.6	4.3
Net debt/equity	24.3	4.4
DPS (PLN)	0.8	0.9
Dividend yield	0.6	0.7

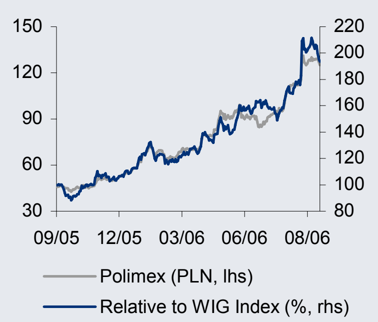
Quarterly data (PLNm)

	2Q06	3Q06F
Revenue	517.0	657.6
EBITDA	38.6	42.6
EBIT	31.9	28.7
Net income	18.8	21.0

Share data

No. of shares (m)	15.2
Daily t/o (US$m)	0.6
Free float (%)	87
Mkt cap (US$m)	677
Mkt cap (PLNm)	2,106

Share price performance



Source: Bloomberg

Update

Backlog at PLN3.9bn

The value of Polimex's current order book stands at PLN3.9bn, or 212% of 2005 group revenue. The total value of the order book breaks down as follows: PLN1.2/1.6/1.1bn in 2H06/07F/08F, respectively. The current order book is sufficient for Polimex to deliver on our 2006 revenue estimate of PLN2.1bn, as company revenue reached PLN934m in 1H06. We understand that a number of contracts for the construction of water sewage treatment worth in total PLN166m are not profitable due to unhedged revenues in euros. We expect losses from this contract to put some pressure on the profitability of the group in quarters to come, as the invoicing on the contract is at an early stage, and there is little room to manoeuvre left to negotiate the value of the contract, which is financed largely from EU funds.

Results

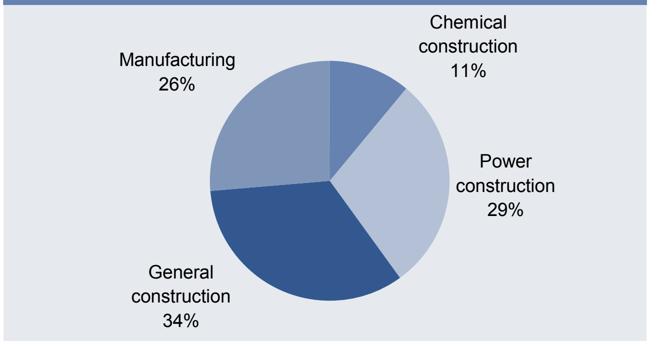
Polimex's revenue/EBIT/net profit grew by 19%/39%/38% respectively, YoY in 2Q06, driven by a significant increase in the order book and a decline in the SG&A cost ratio from 7.5% to 6.3%. The gross profit margin slipped from 14.0% in 2Q05 to 13.5% in 2Q06 due to lower profitability in the manufacturing segment. In 1H06, Polimex reported revenue/EBIT/net profit of PLN933/59/33m respectively, an increase of 15%/48%/49%, respectively.

Fig 1 Polimex results, gearing and margins (PLNm)

	1Q05	2Q05	3Q05	4Q05	1Q06	2Q06
Revenue	379	435	478	517	416	517
EBITDA	24	30	36	9	34	39
EBIT	17	23	29	3	27	32
Net profit	9	14	10	6	15	19
Total assets	1,106	1,034	1,077	1,108	1,081	1,229
Total equity	281	272	277	293	317	319
Cash	94	72	84	86	64	60
Total debt	106	150	186	98	116	109
Net debt	13	78	102	12	51	50
Margins						
EBITDA	6.4	6.8	7.6	1.8	8.1	7.5
EBIT	4.4	5.3	6.0	0.5	6.5	6.2
Net	2.3	3.1	2.1	1.2	3.5	3.6

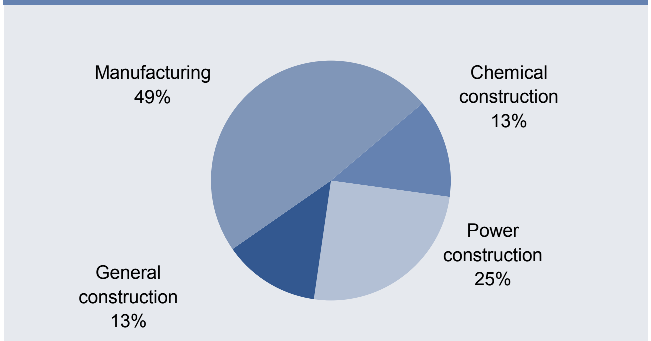
Source: Company data

Fig 2 Breakdown of revenue….



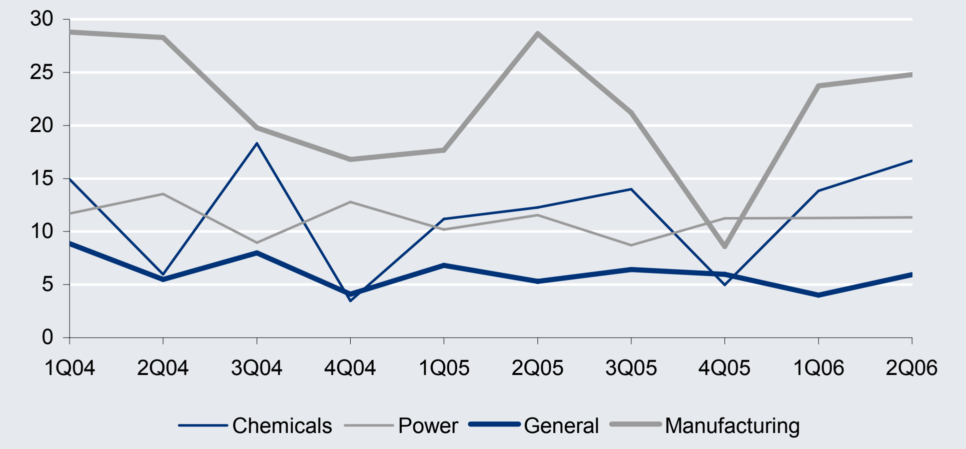
Source: Company data

Fig 3 ...and gross profit, 1H06



Source: Company data

Fig 4 Gross profit margin development by segment



Source: Company data

Mergers and acquisitions

Management intends to complete the merger with ZREW by the end of 2006

Polimex has announced a share swap parity in a friendly merger with its 48%-controlled power construction subsidiary ZREW (PLN304, Not Rated, Bloomberg ZRW PW). Polimex will issue 1.032m of new shares to minority investors in ZREW and the share swap parity is 2.3 new shares of Polimex in exchange for 1.0 new share of ZREW. The share swap parity is positive for shareholders of Polimex as: (1) the ratio is better than the one implied by the market capitalisations of the two companies'; (2) it is better than our expectations; and (3) it is accretive to the 2007F EPS of the merged company. ZREW reported 1H06 revenue of PLN141m, down 15% from PLN166m in 1H05 and net profit of PLN9.2m, up 124% from PLN4.13m in 1H06. Management intends to complete the merger by the end of 2006.

Fig 5 ZREW financial summary (PLNm)

	2001	2002	2003	2004	2005	1H05	1H06
Revenue	112	128	195	293	332	166	141
EBIT	5	5	7	13	17	4	7
Net profit	5	3	4	7	7	4	9
Total assets	58	57	103	164	173	183	157
Equity	33	34	38	99	107	92	63
Cash	7	4	5	11	14	N/A	N/A
Margins (%)							
EBIT	4.7	3.8	3.6	4.4	5.1	2.3	5.0
Net	4.2	2.5	2.3	2.5	2.2	2.5	6.5
Returns (%)							
ROA	N/A	5.5	5.5	5.6	4.3	N/A	N/A
ROE	N/A	9.4	12.1	10.8	7.1	N/A	N/A

Source: Company data

EP is a turnaround story

Polimex has also invested PLN40m to take up a 13% stake in Energomontaz Polnoc (EP), another listed company active in power construction. Polimex bought the shares in the market and through the capital increase in 3Q06. EP is a classic turnaround story of a company that saw significant net losses in three out of the last five years and whose assets have shrunk by 55% since 2000. EP has already been through a painful debt restructuring and reported healthy margins in 1H06. Polimex's management has gained plenty of experience in managing financially distressed companies, and with the injection of capital we expect EP to continue posting healthy margin in 2006. Co-operation in tenders and the contract with Polimex should generate growth in revenue and continued improvement in profitability in 2007 and onwards.

Fig 6 Energomontaz Polnoc financial summary (PLNm)

	2001	2002	2003	2004	2005	1H05	1H06
Revenue	351	301	255	200	230	122	102
EBIT	(26)	5	(29)	11	(30)	(31)	6
Net profit	(37)	3	(49)	2	(32)	(30)	6
Total assets	286	234	195	197	153	187	157
Equity	81	84	42	89	58	54	63
Cash	4	4	5	4	8	8	10
Margins (%)							
EBIT	(7.4)	1.6	(11.2)	5.4	(13.0)	(25.7)	6.3
Net	(10.5)	0.8	(19.0)	1.2	(13.7)	(25.0)	6.2
Returns (%)							
ROA	N/A	1.0	(22.6)	1.2	(18.0)	N/A	N/A
ROE	N/A	3.1	(76.8)	3.6	(42.8)	N/A	N/A

Source: Company data

Huge modernisations of power plants

The acquisition of EP will fortify Polimex's position in the power construction segment. EP is a key company to obtaining potentially rewarding contracts from BOT, the country's largest power and mining company, which has commenced a €1.6bn investment programme to build a new power block and to refurbish an existing power block. Alstom Power of France will be a general contractor on the projects and domestic power construction companies are scrambling to get on the list of subcontractors. Modernisation of another power plant, Lagisza, will cost €500m and the company secured funding for this just a couple of weeks ago. The modernisation of the PAK ignite coal-fuelled power plant held by Elektrim is also well underway. Polimex's power construction arm will seek contracts from all of these projects.

Investments

Polimex expanding its most profitable business…

Polimex is expanding its most profitable business of steel structure production and zinc galvanising. The company has built a production plant in Siedlce to solely serve Peri GmbH, the German producer of construction supports that is Polimex's leading client in steel structures. The new plant should generate annual sales of PLN100m in 2007. Polimex has also purchased land and is seeking permits to build a new zinc galvanising plant in Czestochowa. The new plant should have annual capacity of 40,000t of steel structures compared with 78,000t of combined capacity at Polimex's two existing galvanising plants. These should start production in 2008F and add PLN80-90m in annual revenue. These two investments should remove the current bottlenecks in the most profitable segments of Polimex's business, boost reported margins and allow penetration of clients in southern Poland. The manufacturing segment reported gross profit margin of 23.5% in 2004, 20.2% in 2005 and 24.3% in 1H06.

Real estate activities should contribute to revenue and profits in 2007 with significant uptake

In October 2005, Polimex bought a rather decrepit but well-located Hotel Warszawa in the centre of Warsaw opposite the Central Bank HQ for €6.3m. Since the purchase, Polimex's management has obtained several proposals for co-operation from hotel operators and real estate developers to either work together on the project or to sell it. Polimex has commenced reconstruction of the hotel, and intends to add 8,000m^2 of luxury apartments and invite a hotel operator to run it, or it will to sell it. We view this investment as delivering a high return for Polimex in the medium term. Additionally, Polimex has bought attractively located land in Cracow borough Podgorze and aims to start selling 200 apartments in 2007. We expect an announcement on housing real-estate developments in Warsaw in the coming months. The first profits from the real estate activities are expected in 2007F, with a significant uptake in 2008.

Fig 7 PMS largest contracts

Date signed	Investor	Contractor	Subject	Value (m)	Completion
08/08/06	PKP Polskie Linie Kojelowe	Torpol and consortium	Design and reconstruction of Koluszki-Widzew Lodz railway	PLN48.0	Apr-08
04/08/06	Pfleiderer Grajewo	PMS	Turnkey project of new HDF/MDF production facility	PLN89.1	N/A
13/07/06	Mondi	PMS	Construction of production facility in Mszczonow	PLN23.9	Feb-07
06/07/06	STEICO S.A.	ZREW	Reassembly of biomass boiler house elements	PLN12.7	N/A
21/06/06	ITT S.p.A.	Naftobudowa	Construction and delivery of refinery furnace	PLN12.4	N/A
20/06/06	PKP Polskie Linie Kojelowe	PMS and consortium	Reconstruction of Warszawa-Zachodnia, Warszawa-Wschodnia railway inc Tunnel	PLN24.5	N/A
20/05/06	LKAB-Kiruna, Alstom Power Sweden AB	PMS	Delivery and construction of steel construction and installation of equipment	PLN51.7	N/A
09/05/06	Warbud	PMS	Delivery and construction of 3.400t steel construction for the construction of 'Galeria Legnicka'	PLN27	Oct-06
26/04/06	Rybnik power plant	PMS and consortium	Pollution desulphurisation installation at Rybnik power plant	PLN119	Aug-08
06/04/06	Vattenfall Heat Poland	ZREW	Modernisation of heaters in Elektrocieplownia Zeran & Turbine preparation works at EC Siekierki	PLN14.7	N/A
26/01/06	PKN	Polimex-Sices Polska	Crude oil desulphurisation installation	€25.5	Jan-08
20/01/06	Polmos Wrocław	PMS and consortium	Construction of esters production plant	PLN41	Mar-07
07/12/05	Alstom power environment	PMS	Assemble of nitrogen installation	PLN14.8	Dec-07
22/11/05	Przyjazn Coking Plant	PMS and consortium	Modernisation of production line for carbon derivatives	PLN404	May-07
29/11/05	Polish government	PMS and consortium	Modernisation of Public Veterinary Institute in Pulawy	PLN27.8	May-07
08/11/05	Drogowa Trasa Średnicowa S.A	PMS and consortium	Road infrastructure	PLN96.9	Oct-06
07/11/05	YIT Industrial	Naftobudowa	Construction of pipelines	PLN5.0	2006
14/10/05	ABB Lummus	Naftobudowa	Construction of technological furnaces	PLN3.2	2006
12/10/05	Radkok	PMS and consortium	Project and construction of waste utilisation facility	EUR20.2	Oct-07
30/09/05	Lotos	ZREW	Construction services	PLN4.9	2006
29/08/05	Poznan heat and power plant	ZREW	Maintenance services	PLN6 pa	2012
09/08/05	STOEN	ZREW	Design and construction of transformators	PLN7.8	2006
23/06/05	Przyjazn Coking Plant	PMS and consortium	Construction of coking battery	PLN175	Sep-07
28/06/05	NATO	PMS and consortium	Rebuilding sea coast	PLN198	2007
23/12/04	ZWIK Szczecin	PMS and consortium	Modernisation of sewage treatment facility	€17.80	Dec-07
30/11/04	Heat and power plant Wybrzeze	PMS and consortium	Modernisation of water installation	PLN28	Dec-06
03/11/04	Ruda Slaska City Council	PMS and consortium	Modernisation of sewage treatment facility	€9.80	Nov-07
27/04/04	Ruda Slaska City Council	PMS	Sewage treatment facility	€6.30	Dec-06
28/07/04	Dublin Waterworks and Sewage System Administration	PMS and consortium	Sewage treatment facility	€5.90	Dec-06

Source: Company data

Financial statements

Possible losses on Pomorzany contract

We have revised our 2006 and 2007 forecasts to account for the growing order book of orders and the expansion of capacity in steel structure production in Siedlce. Our 2007 net profit forecast remains unchanged, as we factor in possible losses on the Pomorzany contract, which management expects to make a loss even though its completion is scheduled for the end of 2007.

Fig 8 Forecast revision (PLNm)

	2006F			2007F		
	New	**Old**	**Δ, %**	**New**	**Old**	**Δ, %**
Revenue	2,129	2,107	1	2,393	2,228	7
EBITDA	129	116	11	145	130	11
EBIT	97	84	15	104	97	7
Net profit	61	56	10	76	76	(0)

Source: ING estimates

Fig 9 Income statement, IFRS (PLNm)

Yr to Dec	2003	2004	2005	2006F	2007F	2008F
Sales	**1,239**	**1,701**	**1,842**	**2,129**	**2,393**	**2,701**
COGS	(1,025)	(1,470)	(1,613)	(1,848)	(2,080)	(2,342)
Gross profit	**214**	**231**	**229**	**281**	**314**	**359**
Selling expenses	(24)	(32)	(28)	(32)	(36)	(41)
Administration costs	(87)	(102)	(95)	(109)	(123)	(139)
Other operational income	(4)	11	(3)	(10)	(10)	(11)
EBITDA	**99**	**108**	**103**	**129**	**145**	**169**
DDA	(36)	(28)	(28)	(32)	(41)	(46)
EBIT	**63**	**80**	**75**	**97**	**104**	**123**
Interest received	3	7	14	5	7	9
Interest paid	(14)	(27)	(22)	(10)	(11)	(12)
Dividends received	2	0	0	0	0	0
Income from disposal of assets	1	0	0	0	0	0
Extraordinary loss	(0)	0	0	0	0	0
Goodwill	(4)	0	0	0	0	0
Negative goodwill	1	0	0	0	0	0
Pre-tax profit	**52**	**59**	**68**	**93**	**100**	**120**
Tax	(16)	(12)	(16)	(18)	(19)	(23)
Profits from associated companies	(0)	4	(2)	0	0	0
Minority profits	(8)	(15)	(7)	(14)	(5)	(6)
Net profit	**28**	**37**	**43**	**61**	**76**	**92**

Source: Company data, ING estimates

Fig 10 Balance sheet, IFRS (PLNm)

Yr to Dec	2003	2004	2005	2006F	2007F	2008F
Inventory	116	147	117	141	167	197
Receivables	380	506	577	733	742	879
Pre-payments	10	19	6	6	6	6
Cash and cash equivalents	42	59	86	118	227	218
ST financial assets	0	30	3	0	0	0
Total current assets	**547**	**761**	**789**	**998**	**1,142**	**1,301**
Tangible assets	177	224	214	235	263	272
Real estate investment	35	17	35	35	35	35
Intangible assets	9	1	2	2	2	2
Shareholdings in associated companies	11	26	25	25	25	25
Financial assets	0	15	12	50	50	50
Deferred tax	11	0	33	43	43	43
Total fixed assets	**243**	**283**	**319**	**389**	**418**	**426**
Total assets	**790**	**1,045**	**1,108**	**1,387**	**1,560**	**1,727**
Trade creditors	196	281	379	413	464	523
Short term debt	143	124	62	62	91	91
Other creditors	115	253	161	184	207	233
Total current liabilities	**454**	**658**	**602**	**659**	**763**	**847**
Long-term debt	15	33	36	157	157	157
Provisions and accruals	131	45	106	138	138	138
Total non-current liabilities	**146**	**78**	**142**	**296**	**296**	**296**
Total liabilities	**600**	**736**	**743**	**954**	**1,059**	**1,143**
Share capital	19	19	15	16	16	16
Share premium	0	15	15	84	84	84
Treasury shares	(86)	(63)	(7)	(7)	(7)	(7)
Forex impact on equity	1	(2)	(0)	(0)	(0)	(0)
Reserve capital	183	197	171	171	171	171
Retained profits and loss carry forward	23	75	99	153	217	293
Total shareholder funds	**140**	**240**	**293**	**418**	**481**	**558**
Minorities	48	69	72	15	20	26
Negative goodwill	1	0	0	0	0	0
Total funding	**790**	**1,045**	**1,108**	**1,387**	**1,560**	**1,726**

Source: Company data, ING estimates

Fig 11 Cash flow statement, IFRS (PLNm)

Yr to Dec	2004	2005	2006F	2007F	2008F
EBIT	**80**	**75**	**97**	**104**	**123**
DDA	(28)	(28)	(32)	(41)	(46)
EBITDA	**108**	**103**	**129**	**145**	**169**
Tax paid	(12)	(16)	(18)	(19)	(23)
Gross operating cash flow	**96**	**87**	**111**	**126**	**146**
Change in working capital	(71)	57	(147)	17	(109)
Change in prepayments, provisions & other financial assets	(95)	101	36	0	0
Net operating cash flow	**(71)**	**245**	**0**	**143**	**37**
Net interest paid	(20)	(8)	(4)	(4)	(3)
Dividends paid	(7)	0	(7)	(12)	(15)
Cash after financial obligations	**(98)**	**238**	**(11)**	**127**	**19**
PPE investment	(75)	(18)	(53)	(69)	(54)
Other investment	(17)	(17)	0	0	0
Change in other assets	126	(121)	(25)	23	26
Cash after capex	**(64)**	**82**	**(89)**	**80**	**(9)**
Disposal of own shares	48	0	0	0	0
Redemption of own shares	0	3	0	0	0
Change in short term debt	(19)	(62)	0	29	0
Change in long term debt	17	3	121	0	0
Cash after financing	**(17)**	**27**	**32**	**110**	**(9)**
Cash year end	**59**	**85**	**118**	**227**	**218**
Cash in balance sheet	**59**	**86**	**118**	**227**	**218**

Source: Company data, ING estimates

Fig 12 Ratios (%)

Yr to Dec	2003	2004	2005	2006F	2007F	2008F
Margins						
Gross	17.3	13.6	12.4	13.2	13.1	13.3
EBITDA	8.0	6.4	5.6	6.1	6.0	6.2
EBIT	5.1	4.7	4.1	4.6	4.3	4.5
Pre-tax	4.2	3.5	3.7	4.4	4.2	4.4
Net	2.3	2.2	2.4	2.9	3.2	3.4
Profitability						
ROA		4.1	4.0	4.9	5.2	5.6
ROE		19.6	16.2	17.3	16.9	17.6
Gearing						
EBITDA/interest costs (x)	7.0	4.0	4.7	13.4	12.6	13.8
Debt to assets	20.0	15.0	8.8	15.8	15.9	14.4
Debt to equity	112.8	65.2	33.3	52.5	51.6	44.5
Net debt to equity	83.2	40.7	4.0	24.3	4.4	5.4
Working capital ratios						
Days of inventory		33	30	26	27	28
Days of receivables		95	107	112	113	110
Days of payables		59	75	78	77	77
Cash conversion days		69	62	60	63	61

Source: Company data, ING estimates

Industry analysis

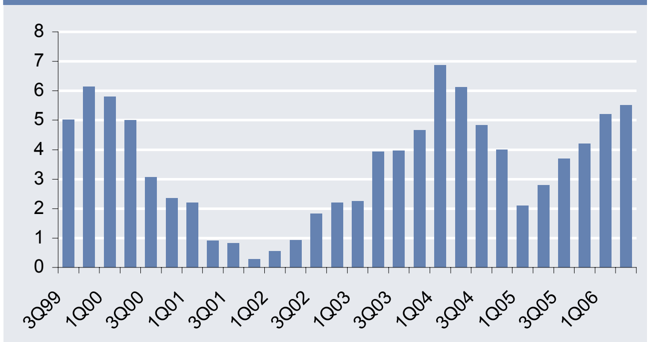
Accession to the EU, combined with healthy GDP growth, are the main factors behind the upturn

The Polish construction industry is in a very strong condition currently, and we believe the construction boom is sustainable over the next three years. Accession to the EU, combined with healthy GDP growth, is a key factor behind the upward trend of the construction industry in Poland. This sector struggled with an economic downturn between 2000 and 2003, but has recorded a rebound and returned to growth since then. In 2005, construction output grew at a level of 7.4% and the growth tendency in the first eight months of 2006 has been maintained (a 9.1% increase), despite a very long and severe winter.

Excellent GDP growth figures

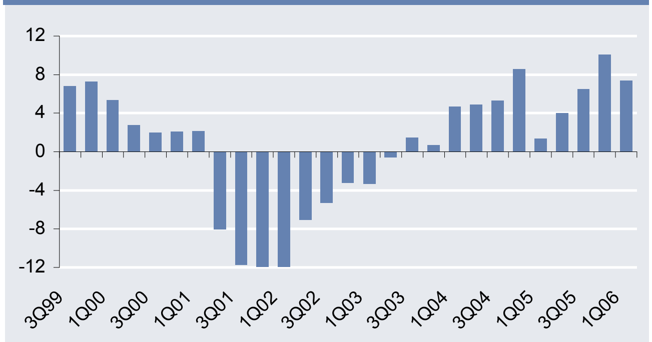
We expect GDP growth of 5.5%/4.7%/4.9% in 2006F/07F/08F, respectively, stimulated by robust consumer spend, foreign direct investment, an increase in company investments and an improvement in productivity. In 2Q06, GDP growth reached 5.5% and topped the already impressive 1Q06 growth of 5.2%. Growth figures exceeding 5% were most recently seen back in 2000, and in 1Q04 and 2Q04 (which saw 6.9% and 6.1% growth respectively).

Fig 13 GDP growth (real %ch)



Source: Main Statistical Office

Fig 14 Fixed investments growth (real %ch)

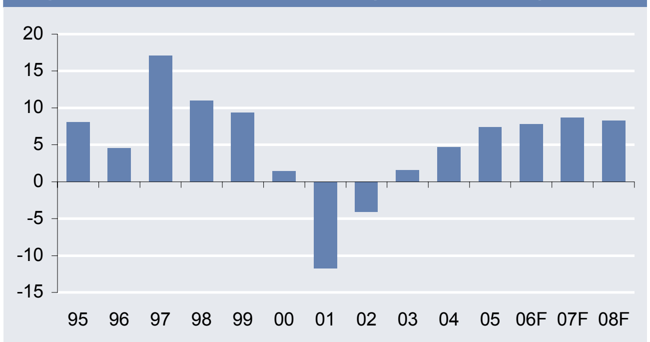


Source: Main Statistical Office

Construction output grew by an impressive 12.4% in the period January-August 2006

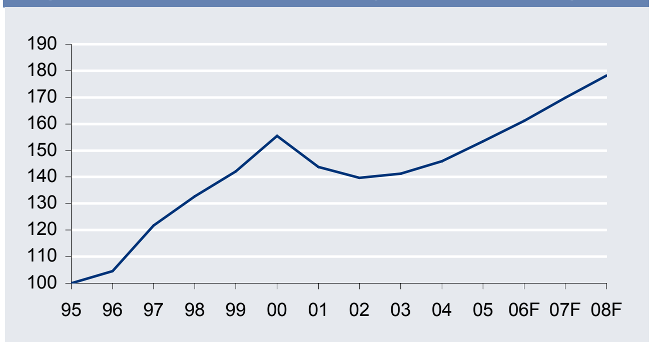
Construction output has recovered from the 2000-03 downturn and beat the all-time high seen at the beginning of 2005. Construction output grew by an impressive 12.4% in the period January-August 2006. Despite extraordinary growth figures, we assume a 7.8% increase in construction output in FY06 followed by 8.7%/8.3% in 2007/08F respectively.

Fig 15 Construction output (real %ch YoY)



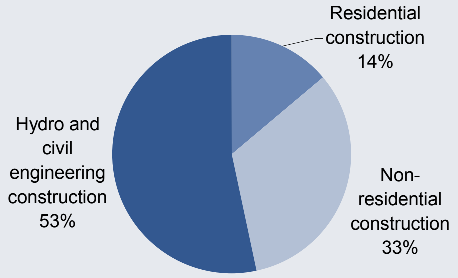
Source: Main Statistical Office

Fig 16 Construction output (rebased to 1995)



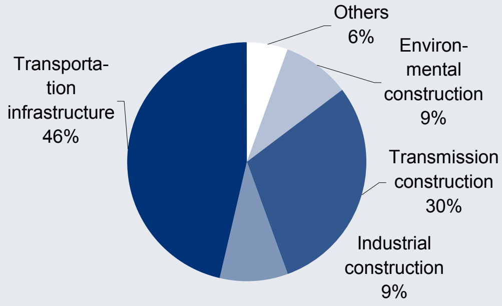
Source: Main Statistical Office

Fig 17 Construction output structure



Source: Main Statistical Office

Fig 18 Hydro-engineering construction split



Source: Main Statistical Office

EU funding

EU funds: 2007-2013 foresees expenditures totalling €80.5bn

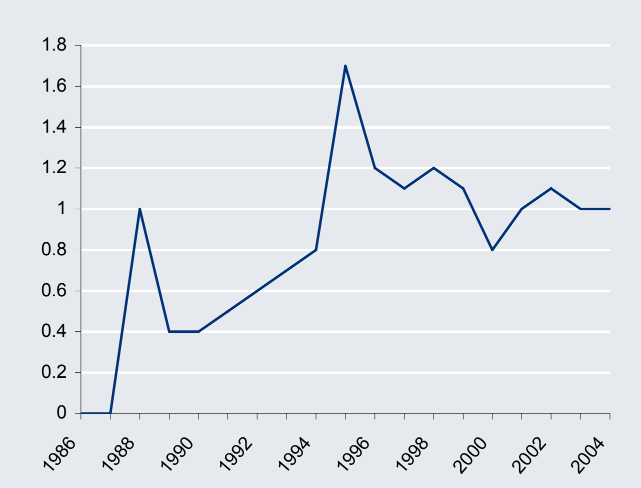
One of the major drivers of a construction volume increase in Poland will be EU funding. Poland has been granted the highest amount of funds of all EU member states for the period 2007-13. Final negotiations have set Poland's limit at €59.5bn. Including the obligatory domestic public or private share in the investments, total funds available within the context of EU grants total €80.5bn. Of this, €31.1-33.1bn is due to be spent on infrastructure and environmental protection projects, including domestic participation (amounting to roughly 30% of funding) or PLN18.2bn annually. For 2004-06, annual expenditures on infrastructure and environmental protection amount to approximately PLN5bn.

Fig 19 EU funds 2007-13 (€bn)

Operational programme	Share (%)	EU funding	Public funding, domestic	Private funding, domestic	Total
16 regional operating programmes	26.7	15.90	2.59	4.36	22.9
Eastern Poland OP	3.7	2.20	0.36	0.60	3.2
Infrastructure and Environmental Protection OP	35.8	21.30	3.47	5.84	30.6
Human Capital OP	13.6	8.10	1.32	2.22	11.6
Competitive Economy OP	11.8	7.00	1.14	1.92	10.1
European Territorial Co-operation	1.0	0.60	0.10	0.16	0.9
Technical Assistance OP	0.3	0.20	0.03	0.05	0.3
Others	7.1	4.20	0.68	1.15	6.0
	100.0	**59.50**	**9.69**	**16.30**	**85.5**

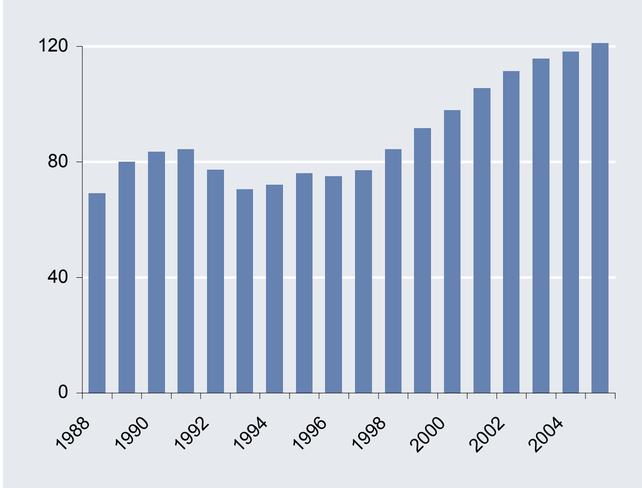
Source: National Cohesion Strategy, Ministry of Regional Development, ING

Fig 20 Net EU transfers (% of GDP), Spain



Source: *Enlargement, two years after: an economic approach*, DG Economic and Financial Affairs Occasional Paper, May 2006

Fig 21 Spanish construction production (€bn)



Source: Eurostat

Spanish construction industry since EU accession

Spain, an EU member since 1986, has received €117.6bn worth of EU funds in the last 20 years (€211bn in 2004 prices). In the initial years after accession, the impact on the economy was limited, as fund flows did not exceed 1% of GDP. Additionally, Spain was hit by a residential construction crisis which led to a decrease in production in the years 1992-93. EU fund flows in the years 1990-1996 saw stable growth and reached 1.7% of GPD at the end of 1996. During the years that followed, the industry grew constantly and reached €121.2bn by the end of 2005. This growth was stimulated by governmental projects (envisaged €120bn in infrastructure investments in the years 2000-07) and an overall improvement of the economy (increasing wages, falling unemployment rates and declining interest rates).

Construction projects expenditure under operating programmes total €32-34bn

The largest portion of the funds for infrastructure and environmental protection are being granted under the Infrastructure and Environmental Operating Programme (IEOP). In the years 2007-13, combined EU, public and private funds related to this programme should reach €30.6bn. Detailed analysis of the remaining operational programmes has revealed that 16 Regional Operating Programmes (ROPs) will allocate 30-40% of funds on infrastructure under Priority 3 (Regional Transport System) and Priority 4 (Investments in Environmental Protection Programmes). This results in another €7-9bn of investment 2007-13. The Operating Program Eastern Poland will provide further incentives for the construction sector.

Road construction

Road construction will receive €8bn out of the €15.2bn earmarked for transportation projects within EIOP. Together with an estimated domestic share of €2bn, total road infrastructure under IEOP will exceed €10bn. An estimated €1bn will be input from the Eastern Poland Programme, while ROP will add another €4-6bn. Total expenditure on road construction should come in at €15-€17bn. Governmental plans include the construction of 500km of new highways as well as 1,650km state motorways.

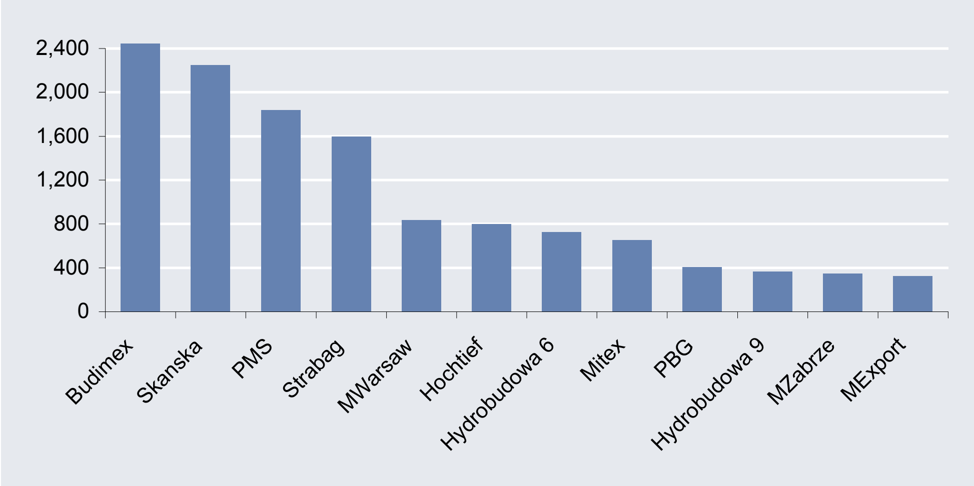
Railways

The value of railway projects under IEOP will approximate €4.5bn. Adding €1.1bn in domestic participation, railways will see investments worth €5.4bn. The programme foresees construction of 1,000km of railways and the purchase or modernisation of trains and coaches. The biggest projects include the Warsaw-Gdansk, Warsaw-Lodz and Poznan-Radom routes. The remaining funds under IEOP are to be spent on energy projects.

Environmental protection

Environmental protection is second on the government's priority list. According to the Regional Development Ministry, Poland has to invest €25m in order to adapt to EU standards by 2010. The projected 2007-13 figures are significantly lower than this, with €4.3bn granted from EIOP. This will be supplemented by a €1.4bn domestic contribution. We estimate that under the Eastern Poland Programme, environmental protection projects will profit by a further €1bn, while the ROP projects might amount to €4bn. Total environmental protection funds will amount to €10.7bn.

Fig 22 Construction companies – revenues (2005)



Source: Bloomberg, ING

Company investment outlays

PGNIG's capex 2005-08 will translate into nearly €9bn worth of projects for the construction industry

In its issuance prospectus, PGNIG presented 2005-08 investment plans totalling PLN8.75bn, PLN4.8bn of which for transmission and distribution infrastructure. The aim of these projects is to increase the company's competitiveness on the one hand and to ensure the safety of Poland's resource supply side on the other. PGNIG is planning the construction of a LNG installation in Grodzisk worth PLN120m. Work should be initiated soon as legal protests about the project have been rejected by the courts. A more important project is the construction of a LNG hub to be located either in Swinoujscie or Gdansk. This project is currently subject to profitability studies. Expenditures related to construction works amount to €300m. Construction works should finish by 2011. Another enormous capital-intensive project will be the construction of installations for the Lubiatow-Miedzychod-Grotow exploration. The project costs for this are now estimated to exceed the initially planned PLN400m.

Grupa Lotos and NATO – oil and gas construction dominating

Grupa Lotos has announced proposed 2006-12 investment expenditures in the range of PLN6.5bn to PLN7.3bn, or around four times 2005's capex (which reached PLN250m). Major investments include the construction of a LPG and heating gas logistics platform to increase crude oil throughput to 10.5m tonnes annually. More than PLN1.3bn will be spent on the construction of ten oil storage facilities in the period 2006-09 and the reconstruction of seven military airports and two hubs within the confines of the NATO Investments Division.

Belchatow Power Station, €1.6bn programme

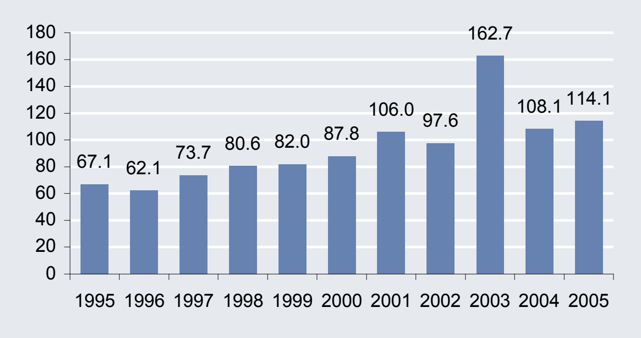
Significant investment outlays related to the modernisation of infrastructure are also planned among heating and power plants. The need to adapt to EU environmental regulations, while lacking comparable financial aid for waste and water management companies, is forcing the energy industry to bear long-term loans. Another major investment project still to come will be conducted at the EC Belchatow power station. EC Belchatow plans an outlay of €1.6bn, whereof €830bn will be spent on the construction of a new block (an agreement has been signed with Alstom), while the remainder will cover modernisation of existing blocks.

Residential construction market

Tremendous deficit of houses and dwellings

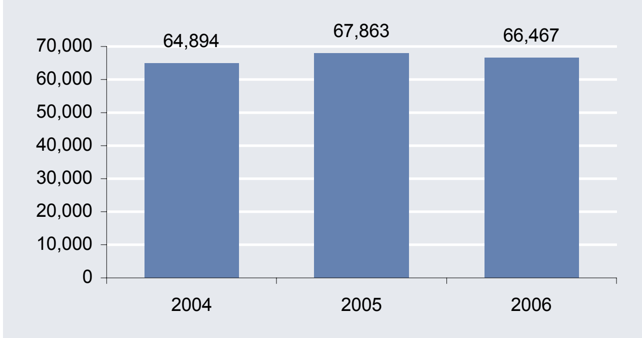
The residential construction market is characterised by a deep imbalance of supply and demand. It is thought that the deficit of dwellings in Poland exceeds 1m. This is an enormous number considering that, on average, over the past five years around 100,000 housing units have been constructed, climbing to a 13-year high as of end 2005.

Fig 23 Number of new dwellings (000)



Source: Main Statistical Office

Fig 24 Number of dwellings January-July (000)



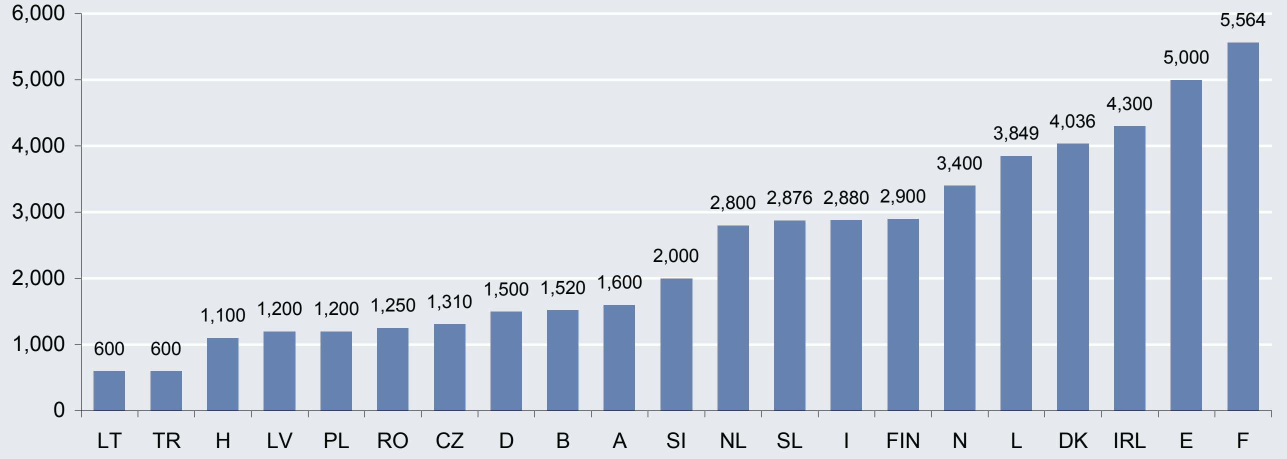
Source: Main Statistical Office

In 2005, slightly more than 114,000 housing units were completed, a 5.8% YoY increase. January-August 2006 figures show, however, a 2.0% decrease, a rather surprising result considering the huge demand for new apartments. In 2006, average dwelling prices in Warsaw have increased 29% YTD, amounting to PLN6,200, or €1,550 per m^2, higher than in Berlin (€1,500) or Brussels (€1,520).

Low interest rates and foreign investors are the main demand drivers

According to real estate developers, price increases are not only driven by domestic demand but also by individual and institutional foreign investors. UK-, Ireland- and Spain-based funds have purchased up to 30% of the total housing units sold. Increases in real wages have also had an impact on price growth. In August 2006, real wages increased by 5.3% YoY versus a 2.8% YoY increase in August 2005. Relatively low interest rates, backed by the banks' competitiveness in the mortgage loans market, were other drivers of domestic demand for new dwellings. The value of mortgages granted increased by PLN14.6bn, the highest annual increase in Poland's history. In 2006, the previous year's figure was exceeded as early as the beginning of September. Mortgage loans granted by banks to individual investors totalled PLN64.9bn as of the end of August 2006.

Fig 25 Average price per m² for an apartment in the capital city as of end 2005 (€/m²)



Source: ING

Threats

Workforce shortage

Industry representatives that we have interviewed hardly recognise any major threats to the current positive outlook. Shining industry prospects backed by increasing company deposits, GDP growth and EU funding seem to negate any downside risk. The only negative aspect related to the ongoing boom are the significant wage increases and the emigration of Poland's qualified workforce to EU15 countries. It has become a challenge to recruit high-class specialists at a reasonable salary in Poland. Although wages in the construction industry have increased by 4.8% YoY in the period January-July 2006 versus a 4.9% YoY corporate wage growth, the dynamics in recent months have increased sharply, especially in the last few months. In June, wages in the construction industry grew 9.3% YoY, while in July the increase was 8.7%.

Soaring steel prices

EU steel prices showed a remarkably strong recovery in 1H05. Despite the summer slowdown, the latest figures are now in some cases above the peak values reached in the previous cycle. The rise in steel prices in 2004 came at an unprecedented pace and intensity. Between September 2003 and December 2004, average European steel values increased by a dramatic 91% in US dollar terms. In euro terms (because of the currency's appreciation against the US dollar) the escalation was 62%, still an impressive rise.

Steel super-cycle?

There was, at that time, a global shortage of steel, something that had not been seen for many decades. Such high steel prices were widely considered as a one-off at the time. No-one then would have predicted that within two years values would be back at these record levels. The 'stronger-for-longer' theory that traditional commodity market cycles that last a few years are being superseded by a lengthier period of general economic growth that will keep prices for steel and other metals at higher-than-historical levels seems to be becoming a reality.

MEPS expects steel prices to peak in October

The MEPS Composite All Products Carbon Steel Price, expressed in euros, has already surpassed the previous peak. In October 2004, the figure stood at €556 per tonne. That level was matched in July 2006 when it reached €562 per tonne. MEPS forecasts that the price will rise further to €581 per tonne in October. The MEPS expects the increases announced by some mills for the fourth quarter to be at least partially successful, though the producers may not get all they want. MEPS also thinks that prices will weaken slightly through 4Q06 and into 2007..

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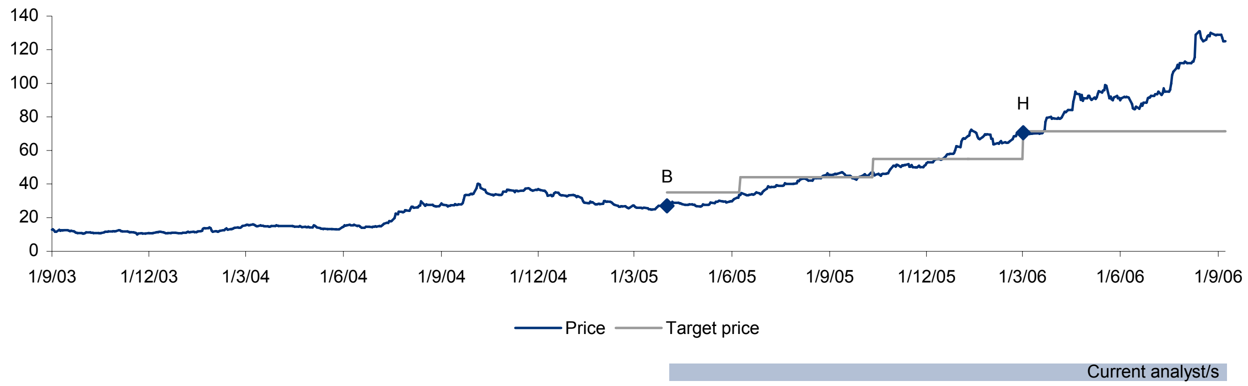

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