UniCredit
Markets & Investment Banking

Equity Research

Company Update | **Construction & Materials** | **Poland** | **11 March 2009**

PBG

More concerned with debt

We downgrade PBG from Buy to HOLD, having cut our target price by 11% to PLN 219/share. We have revised our earnings forecast downwards significantly by 15% to PLN 241mn for 2010, mainly on lower gross margin assumptions (mainly in the water construction segment, where the competition on smaller and medium contracts appears to be increasing) and higher expected financial costs. We note that as of end-2008, PBG's net debt reached PLN 751mn, more than doubled YoY. Although we still view PBG as a well-managed company and an almost pure play on EU-financed infrastructure construction, we note that this is the most leveraged company within our construction coverage, which we see as the major risk. The stock is trading at 2009E P/E of 13.6x and EV/EBITDA of 8.8x, respective 43% and 46% premiums to peers.

- **PBG's current backlog of PLN 6.3bn translates to a backlog/2009 revenues ratio of 2.1x, one of the strongest within our construction coverage**. We note, however, that according to our estimates, ca. PLN 2.7bn is to be completed in 2009 and PLN 1.9bn in 2010 (covering 90% and 57% of our revenue forecasts, respectively), with the remaining almost PLN 1.6bn to be recognized in 2011-2013.
- **Net debt increased significantly to PLN 751mn as of end-2008**, ca. PLN 230mn above our expectations (which translates to PLN 17/share). Although we are not concerned about PBG's access to financing (available credit limits of PLN 1.75bn), we note the higher than previously expected financial costs in 2009-2010, as we expect net debt to decline to PLN 492mn only in 2010.
- **PBG is trading at 2009E P/E and EV/EBITDA ratios of 13.6x and 8.8x**, respective 43% and 46% premiums to peers. Our target price, reduced by 15% to PLN 219, offers 5% upside. Downgrade to HOLD.

	2006	2007	2008	2009E	2010E
Revenues (PLNmn)	674.3	1,407.0	2,089.3	3,010.9	3,390.6
EBITDA (PLNmn)	88.5	168.1	270.3	409.6	442.1
EBIT (PLNmn)	72.0	139.3	223.4	348.9	373.4
Net profit (PLNmn)	52.2	104.3	158.0	206.7	240.9
EPS (PLN)	4.34	7.77	11.77	15.39	17.94
CEPS (PLN)	5.71	9.91	15.26	19.91	23.05
BVPS (PLN)	30.52	55.90	75.27	90.66	108.60
P/E (x)	58.9	39.5	16.7	13.6	11.7
P/CE (x)	44.7	31.0	12.8	10.5	9.1
P/BV (x)	8.4	5.5	2.6	2.3	1.9
EV/EBITDA (x)	38.5	26.4	12.5	8.8	7.5
EV/Sales (x)	5.1	3.2	1.6	1.2	1.0
ROIC (%)	10.6	14.3	16.2	17.6	17.1
Dividend yield (%)	0.0	0.0	0.0	0.0	0.0

Source: PBG, UniCredit Research

Hold (prev. Buy)

Price on 9 March 2009	**PLN 209.50**
Target price (prev. PLN 246.00)	**PLN 219.00**
Upside to TP (%)	4.5
Cost of equity (%)	12.6
High/Low (12M) (PLN)	331.00/175.30

INVESTMENT HIGHLIGHTS

- **Construction company specializing in oil & gas engineering and environmental construction**
- **High exposure to expected EU transfers to Polish infrastructure projects**

STOCK TRIGGERS

- **New significant contracts**
- **Acquisitions**

STOCK DATA

Reuters/Bloomberg	PBGG.WA/PBG PW
Average daily volumes ('000)	25.1
Free float (%)	66.5
Market capitalization (PLNmn)	2,813.6
No. of shares in issue (mn)	13.4
Shareholders	J. Wisniewski 33.47%; ING Pension Fund 6.80%;

UPCOMING EVENTS

1Q 2009 results	15 May 2009
2Q 2009 results	17 August 2009
FY 2008 results	31 August 2009

Source: Thomson Datastream

STOCK PERFORMANCE (CH. %)

	1M	3M	6M
absolute	-3.0	-18.0	-43.0
rel. to MSCI EME	2.9	-1.6	13.7
rel. to MSCI Poland	11.7	32.3	59.2

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Sound 4Q earnings, but net debt increasing significantly

Sound 4Q results with net profit of PLN 73.5mn, up 75% YoY, 15% above our expectations…

PBG has reported sound 4Q results with net profit of PLN 73.5mn, up 75% YoY, 15% above our expectations and 11% above the market consensus. We note, however, that we were more conservative with our 2008 earnings expectations than the company's FY management guidance of PLN 158mn, while the reported figures appeared to be actually in line with the guidance. The key findings regarding 4Q results are as follows:

- **Revenues amounted to PLN 720mn, up 22% YoY and in line with our expectations**. In the segmental breakdown for FY 2008, 66% of revenues came from environmental construction, 13% from oil & gas construction, 9% from fuel storage construction, 9% from general and industrial construction and 8% from road construction.

- **Gross profit amounted to PLN 129.7mn, up 38% YoY and 7% above our expectations**. Gross margin amounted to 18.0%, up more than 2 percentage points YoY and 1.4 percentage points above our expectations, which we view positively.

- **EBIT amounted to PLN 80.8mn, up 27% YoY, but 9% below our expectations**. On the positive side, we note the better control over SG&A costs than anticipated, as SG&A costs were 7% below our expectations. On the other hand, however, the operating level has been negatively affected by significant other operating costs (net) amounting to PLN 15.1mn vs. PLN 3.6mn other operating income (net) expected. The company has not presented a quarterly breakdown of the other operating costs, but we note that in FY 2008, the company reported significant receivables write-downs of more than PLN 7mn.

- **Net profit amounted to PLN 73.5mn, up 75% YoY and 15% above our expectations**. This resulted from two things: 1) net financial income of PLN 9.9mn vs. PLN 2.3 net financial costs expected; and 2) lower than anticipated income tax of PLN 11.7mn. We note that in 4Q the company reported FX gains related to revaluation of balance sheet positions amounting to almost PLN 22mn, as well as interest income of ca. PLN 10mn. Interest costs (related to bank debt and bonds issued) amounted to ca. PLN 19mn in 4Q.

…but net debt of as much as PLN 751mn as of end-2008 and negative operating cash flow of PLN 256mn in 2008

- **As of end-2008, PBG's net debt amounted to as much as PLN 751mn** (more than doubled YoY from PLN 314mn a year earlier), which translates to net debt/EBITDA of 2.8x, which is the highest ratio within our construction coverage.

- **PBG reported negative operating cash flow of PLN 256mn in FY 2008**, mainly on the back of a significant increase in receivables (up by PLN 534mn YoY vs. an increase in payables of only PLN 93mn YoY).

PBG: 4Q 2008 RESULTS REVIEW

PLNmn	4Q 2008	4Q 2007	YoY, %	2008	2007	YoY, %	4Q 2008E	Diff. %	Market consensus	Diff. %
Revenues	**720**	**592**	***22***	**2,089**	**1,407**	***48***	**730**	***-1***	**730**	***-1***
COGS	591	498	*19*	1,751	1,192	*47*	609	*-3*	-	-
Gross profit	**129.7**	**94.3**	***38***	**338.1**	**215.0**	***57***	**121.2**	***7***	**-**	**-**
SG&A	33.9	27.4	*24*	106.8	81.5	*31*	36.5	*-7*	-	-
Other operating income	-15.1	-3.4	*348*	-7.8	5.9	*-233*	3.6	*n.m.*	-	-
Operating profit	**80.8**	**63.5**	***27***	**223.4**	**139.3**	***60***	**88.4**	***-9***	**85.8**	***-6***
Net financial costs	-9.9	2.5	*n.m.*	9.9	-7.0	*n.m.*	2.3	*n.m.*	-	-
Pre-tax profit	**90.6**	**61.1**	***48***	**213.5**	**146.4**	***46***	**86.0**	***5***	**-**	**-**
Income tax	11.7	11.6	*1*	25.8	26.7	*-3*	16.3	*-28*	-	-
Minority interest	-5.4	-7.5	*-27*	-29.7	-15.4	*93*	-5.5	*-1*	-	-
Net profit	**73.5**	**42.0**	***75***	**158.0**	**104.3**	***52***	**64.2**	***15***	**66.3**	***11***
Gross margin (%)	*18.0*	*15.9*	-	*16.2*	*15.3*	-	*16.6*	-	-	-
EBIT margin (%)	*11.2*	*10.7*	-	*10.7*	*9.9*	-	*12.1*	-	*11.8*	-
Net margin (%)	*10.2*	*7.1*	-	*7.6*	*7.4*	-	*8.8*	-	*9.1*	-

Source: PBG, PAP, UniCredit Research

Earnings revision

2009 net profit forecast unchanged at PLN 207mn, but cut by 15% to PLN 241mn for 2010…

We have left our 2009 earnings forecast almost unchanged at PLN 207mn, but reduced our earnings forecast by 15% to PLN 241mn for 2010 on the back of slightly lower revenue expectations and downward revisions in gross margin assumptions.

On the back of the strong PLN 6.3bn backlog, of which ca. PLN 2.7bn is to be completed in 2009, we have revised our 2009 revenue forecast upwards by 11% to PLN 3,011mn. Our 2010 revenue forecast has been cut slightly by 3% to PLN 3,391mn.

…mainly on downward revisions of gross margin assumptions and implementation of greater financial costs

We have revised our gross margin assumptions downwards, from 17.3% to 16.6% for 2009 and from 17.2% to 15.9% for 2010. Major cuts are related to the segments of 'water' (environmental, hydro-construction and renovations) and road construction, where the increasing competition on smaller tenders has generated greater margin pressure. We have cut our gross margin assumptions in 'water' construction by 1.1 percentage points to 15.5% for 2009 and by 2.4 percentage points to 13.8% for 2010. In road construction, we expect the margin of 17.6% reported in 2008 to be sustained in 2009, falling then to 16.6% in 2010.

PBG's much larger than previously anticipated net debt as of end-2008, amounting to PLN 751mn, results in higher net financial costs expectations, more than doubled vs. our previous forecasts, to PLN 45mn in 2009 and PLN 37mn in 2010.

In all, we currently expect 2009 net profit of PLN 206.7mn, up 31% YoY, and PLN 240.9mn in 2010, up 17% YoY.

PBG: EARNINGS REVISION

	2008			2009E			2010E		
PLNmn	**Reported**	**Expected**	***Diff. %***	**New**	**Old**	***Ch. %***	**New**	**Old**	***Ch. %***
Sales	2,089	2,100	*0*	3,011	2,718	*11*	3,391	3,489	*-3*
EBIT	223	231	*-3*	349	328	*6*	373	419	*-11*
Net profit	**158**	**149**	***6***	**207**	**207**	***0***	**241**	**285**	***-15***

Source: PBG, UniCredit Research

Key risks to our forecasts

Risk of more fierce competition – not only on small and medium size contracts

4. **Competition risks and related margin pressure – mainly in general and environmental construction**. According to the CFO, the increased competition on smaller contracts in infrastructure, valued up to ca. EUR 30mn, is already visible, with the number of players competing for a given contract almost doubling within a period of several months. According to the company, the competitive situation regarding larger tenders remains rather unchanged for the moment, but we see it as a potential risk.

Risk of not obtaining the financing for the USD 210mn contract in Armenia

5. **The financing for the USD 210mn Armenian contract (Nairit plant reconstruction) has not yet been secured.** According to the company, it is still in talks with the banks to secure the financing for this project. The value of this contract is included in the backlog, accounting for ca. 13% of the company's current PLN 6.3bn backlog. We note that in the current environment with limited access to external financing, obtaining the financing for this contract in Armenia may be challenging and in our view there is a risk of cancellation of this contract from the backlog. If so, this would decrease the company's current backlog quite significantly (by more than 10%).

   In our model, we have assumed that first revenues from this contract should be recognized in 1Q 2010. However, if the risk of cancellation materializes, then our 2010E revenues would only be 52% covered by the backlog (down from current 57%).

Upside risk to our forecasts related to potential understating of the impact of falling construction material and subcontractor prices

6. **Upside risk related to more positive impact than we anticipate of declining material and subcontractor costs.** According to the CFO, since October 2008 the costs of subcontractors have fallen significantly, by ca. 20-30%, which appears to us to be a potential positive short-term trigger for general contractors. On the other hand, given increased competition and more severe margin pressure in new tenders, we assume the positive impact of falling construction material and subcontractor prices for FY 2009E earnings to be rather limited.

   PBG's contracts are mainly signed on a lump sum basis. In the case of large contracts, PBG bears the risk together with its subcontractors since most of the subcontractor costs and a significant part of material costs are fixed at the moment of signing the contract. Therefore, our discussions with the company indicate that no significant improvement in profitability is expected due to declining construction material and subcontractor costs, although the company admitted that in some cases, much lower pressure on the cost side may be seen than had been previously expected.

Valuation: TP down by 11% to PLN 219

**TP at PLN 219, based on:
1) 75% DCF at PLN 234;
2) 25% relative valuation at PLN 172**

Our target price calculation methodology is based 25% on peer comparison and 75% on our DCF valuation. The 12-month target price implied by the DCF valuation amounts to PLN 234/share, while the peer comparison implies a 12-month target price of PLN 172/share. On this basis, we set our target price at PLN 219/share (down by 11% from the previous PLN 246/share). Based on 5% upside to the current price, we are downgrading PBG from Buy to HOLD.

PBG: PEER COMPARISON (POLISH PEERS)

Company	Ticker	Rating	Price	12M TP	Upside	MCAP	P/E (x)			EV/EBITDA (x)		
			(PLN)	(PLN)	to TP (%)	(PLNmn)	2008	2009E	2010E	2008	2009E	2010E
Budimex	BDX PW	BUY	58.35	69.0	18.3	1,490	12.5	12.3	12.5	6.8	7.0	6.8
Polimex	PXM PW	HOLD	2.76	3.1	12.3	1,282	11.9	9.5	10.3	6.6	6.0	5.9
Pol-Aqua	PQA PW	HOLD	14.50	15.5	6.9	399	11.8	9.5	11.1	5.5	4.9	4.8
Median							**11.9**	**9.5**	**11.1**	**6.6**	**6.0**	**5.9**
PBG	PBG PW	HOLD	209.50	219.0	4.5	2,814	16.7	13.6	11.7	12.5	8.8	7.5
Premium/(discount) to peers (%)							***40***	***43***	***6***	***90***	***46***	***27***

Source: Company data, UniCredit Research

PBG is trading at double-digit premiums to peers for 2009

PBG is trading at 2009E P/E of 13.6x and EV/EBITDA of 8.8x, respective 43% and 46% premiums to peers.

Financial statements

PBG: EARNINGS STATEMENT

PLNmn	2005	2006	2007	2008	2009E	2010E
Net revenues	**408.5**	**674.3**	**1,407**	**2,089**	**3,011**	**3,391**
COGS	337.4	558.2	1,192	1,751	2,512	2,850
Gross profit	71.2	116.1	215.0	338.1	498.5	540.8
SG&A	33.8	54.2	81.5	106.8	154.0	173.4
Other operating items	4.0	10.0	5.9	-7.8	4.4	6.0
EBITDA	50.2	88.5	168.1	270.3	409.6	442.1
Depreciation	8.8	16.6	28.8	46.8	60.7	68.7
EBIT	**41.3**	**72.0**	**139.3**	**223.4**	**348.9**	**373.4**
Net financials	-4.0	2.0	-7.0	9.9	45.5	37.3
Pre-tax profit	45.3	69.9	146.4	213.5	303.4	336.0
Tax	8.4	15.0	26.7	25.8	57.6	63.8
Minorities/associates	-0.9	-2.7	-15.4	-29.7	-39.1	-31.3
Net profit	**36.1**	**52.2**	**104.3**	**158.0**	**206.7**	**240.9**
EPS (PLN)	3.4	4.3	7.8	11.8	15.4	17.9

Source: PBG, UniCredit Research

PBG: CASH FLOW STATEMENT

PLNmn	2005	2006	2007	2008	2009E	2010E
Net profit	36.1	52.2	104.3	158.0	206.7	240.9
Depreciation	8.8	16.6	28.8	46.8	60.7	68.7
Other non-cash	-114.9	151.3	-26.1	-38.8	-5.5	-2.3
Cash earnings	-70.0	220.1	107.0	166.1	261.9	307.3
Change in WC	-26.7	-306.6	-232.3	-408.9	-316.8	-4.1
Capex	-141.7	-106.2	-77.7	-152.9	-60.2	-67.8
Free cash flow	-238.3	-192.7	-202.9	-395.7	-115.2	235.4
Ch. in investment	13.1	-34.3	-79.8	-211.9	61.1	25.2
Dividends	0.0	0.0	0.0	0.0	0.0	0.0
New capital/(debt)	263.2	196.4	641.7	487.0	21.5	-68.7
Change in liquid funds	38.0	-30.5	359.0	-120.6	-32.5	191.9

Source: PBG, UniCredit Research

PBG: BALANCE SHEET

PLNmn	2005	2006	2007	2008	2009E	2010E
Fixed assets	195.6	372.4	713.1	869.9	869.5	868.6
Working capital	242.2	435.8	665.4	1,081	1,407	1,415
Capital employed	437.8	808.2	1,379	1,951	2,276	2,283
Shareholders equity	177.6	367.2	750.7	1,010.9	1,218	1,458
Net debt/(cash)	249.8	333.9	314.9	751.2	783.7	491.8
Other liabilities	33.3	122.2	376.2	292.6	379.1	437
Total assets	666.3	1,045	2,259	2,857	3,376	3,668

Source: PBG, UniCredit Research