WOOD & COMPANY

PBG

Buy

Upgrade from Hold

Price: PLN 150.5
Price target: PLN 188.8
(From PLN 228)

Too oversold

We upgrade PBG to BUY from Hold, but reduce our price target (PT) by 17% to PLN 188.8 (from PLN 228), due mainly to the downward revisions to our forecasts and the recent de-rating of the construction stocks in Poland on multiple valuations. Our sensitivity analysis suggests that, at its current price, the street expects a -2% terminal growth rate (we estimate 1%) and a 50bps higher WACC than we utilise, or a 50bp lower gross margin and 200bp lower sales growth than in our model. The situation in the Polish construction market is far from perfect; the expected reduction in infrastructure spending, the delays in power energy tenders or margin pressure are just a couple of the issues to name. On the other hand, we do not believe PBG's future is as bleak as the market currently expects. Firstly, we still believe that the power energy tenders may finally begin within the next six months. Secondly, the declining contribution from the margin-dilutive segments (stadiums and roads) should be offset gradually by increases in the margin-accretive energy, oil&gas and industrial segments, which should lift margins. Thirdly, after its recent strong sell-off, PBG is currently trading at its lowest historical single-digit P/E ratios of 10.5x-9.2x 2011-12E. The stock is too oversold at present, in our opinion.

Contrary to the general perception in the market of an unfavourable long-term outlook for the construction sector in Poland, we believe that there will still be a lot of opportunities for PBG after the EURO 2012 football championships, in terms of infrastructure, and general and industrial construction, but mainly in the energy segment. The current value of the tenders submitted (or in the pre-qualification stage) by PBG totals PLN 51bn. If it manages to repeat its "success ratio" from 2010 of around 12%, it could win tenders worth PLN 6.1bn in total, which would cover two years' worth of revenues on average.

There are also several risks associated with PBG's operational activities, including penalties for delays in completing its stadium contracts, working capital and salary pressures, and liquidity needs. The likelihood of some of these risks materialising (liquidity or fines) is rather limited, in our opinion, and some of the risk has been reduced recently (for instance, the agreement with Narodowe Centrum Sportu (NCS) to extend its stadium contract in Warsaw until 30 November, announced on 8 June). On the other hand, the risk of salary pressures is a real possibility, in our opinion, but we have already implemented higher labour costs into our model, increasing the SG&A ratio to 4.5% from 4% in 2010 (PBG's SG&A costs will be up by PLN 22m yoy in 2011, on our estimates).

The stock has underperformed the WIG20 heavily ytd, by 34%, making it the worst-performing stock in the WIG20 index ytd.

Expected Events

2Q11 results	31 August 2011
3Q11 results	14 November 2011

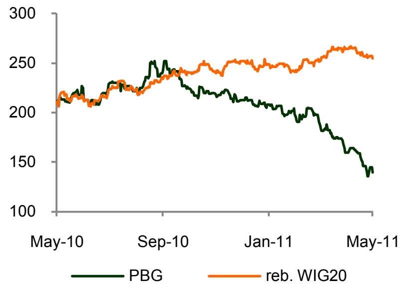
Key Data

Market Cap	EUR 0.5bn
Free Float	50 %
Shares Outstanding	14.3m
Average daily volume	EUR 2m
Major Shareholder	Jerzy Wisniewski(CEO), 41.4%
Bloomberg Code	PBG PW
WIG20 Index	2,852

Price Performance

52-w range (PLN)	131 – 252
YTD PLN Performance	-28.6%
Relative YTD PLN Performance	-34.2%

PBG price performance



	Sales (PLNm)	Net Profit (PLNm)	EPS (PLN)	EPS gr (%)	PER (x)	EV/EBITDA (x)	ROE (%)	ROA (%)	PEG (x)
2013E	3,232	254	17.8	8%	8.5	5.3	10.3%	4.5%	1.6
2012E	3,105	235	16.4	15%	9.2	6.2	10.5%	4.4%	0.8
2011E	2,904	205	14.3	-7%	10.5	7.5	10.2%	4.2%	2.0
2010	2,740	221	15.4	14%	9.7	8.8	12.1%	4.6%	1.3
2009	2,578	187	13.5	12%	11.2	8.2	12.6%	4.7%	1.7
2008	2,091	166	12.3	30%	12.2	10.4	14.8%	5.8%	0.6

EQUITY RESEARCH

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Closing Prices as of June 10, 2011

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Outlook not as gloomy as it first appears

Declining tenders in the infrastructure segment, the ongoing margin pressure due to the increasing costs of materials, and delays in the power energy sector all demonstrate that sentiment in the Polish construction sector has been very poor in recent months. The bad sentiment surrounding PBG has been magnified by the delay in and subsequent cancelling of its deal with OHL, and the considerable media newsflow regarding delays in its stadium contracts and the risk of penalties

We agree that the outlook for construction companies in Poland is challenging but, on the other hand, we would argue that it is unlikely that there will be a complete investment drought for PBG, and a sharp decline in its revenues and earnings after the EURO 2012 football championships.

Firstly, the biggest construction companies in Poland currently have robust backlogs equal to, on average, one and a half to two years' revenues, which should cover the transition period between existing and new contracts.

Secondly, we have been quite surprised by recent press and market panic about the collapsing of spending on infrastructure projects. It is commonly expected that, after the investment spree related to EURO 2012, there will be a drop in infrastructure projects after 2012. On the contrary, however, we believe there is still a lot of work to be done on the country's road and railway infrastructure, and also in the general and industrial construction segments.

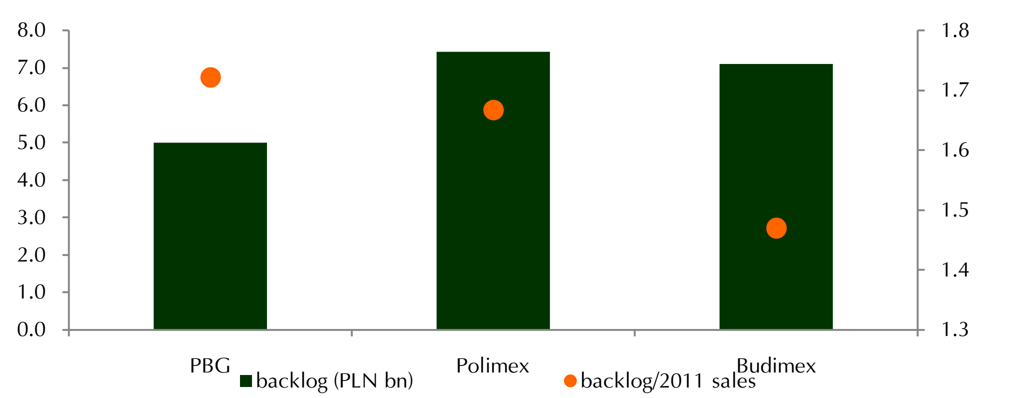
Thirdly, the power energy sector: a never-ending story for the Polish construction companies, but it appears that power energy companies will soon be able to launch their first tenders for power energy blocks (we expect in 2H11). PBG's most advanced stage for such a tender is in Opole, worth PLN 10-12bn.

Lastly, with a declining contribution from the margin-dilutive infrastructure segment, and the expected higher contribution from the margin-accretive energy, oil&gas, general and industrial construction segments, construction companies' overall consolidated margins should improve gradually, in our opinion.

Robust backlogs secure growth for the next three years

The investment spree related to the upcoming EURO 2012 football championships has pumped up construction companies' backlogs, which are at record high levels currently. The truth is that it is very hard to maintain such high levels of investment for long periods, so a drop in infrastructure spending after 2012 is inevitable, in our opinion. In the meantime, construction companies have been able to build up levels that cover, on average, one and a half to two years' revenues. Of the three largest construction companies, PBG has the best backlog coverage ratio of 1.72x, followed by Polimex at 1.67x and Budimex at 1.47x.

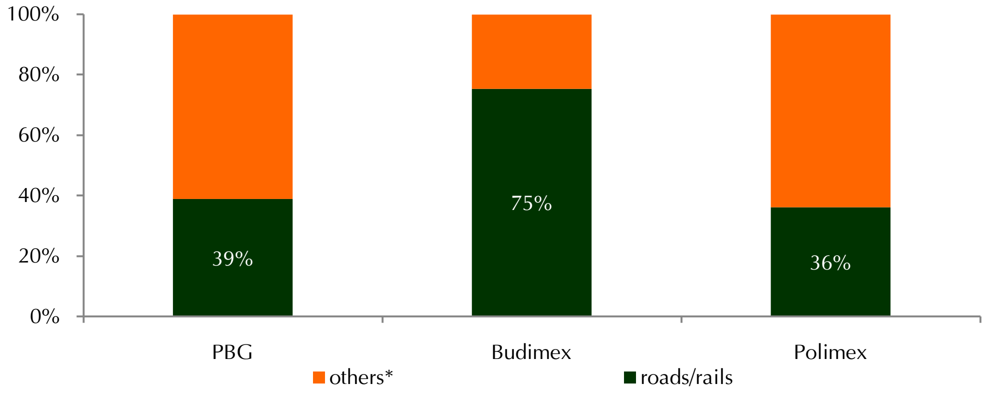
Polish construction: backlog coverage ratios



Source: Bloomberg, Wood Research

It is worth noting that the structure of PBG's and Polimex's backlogs is diverse across the different sectors, reducing the risk of dependence on one sector. Budimex's backlog relates mostly to infrastructure (75% of its PLN 7.1bn backlog).

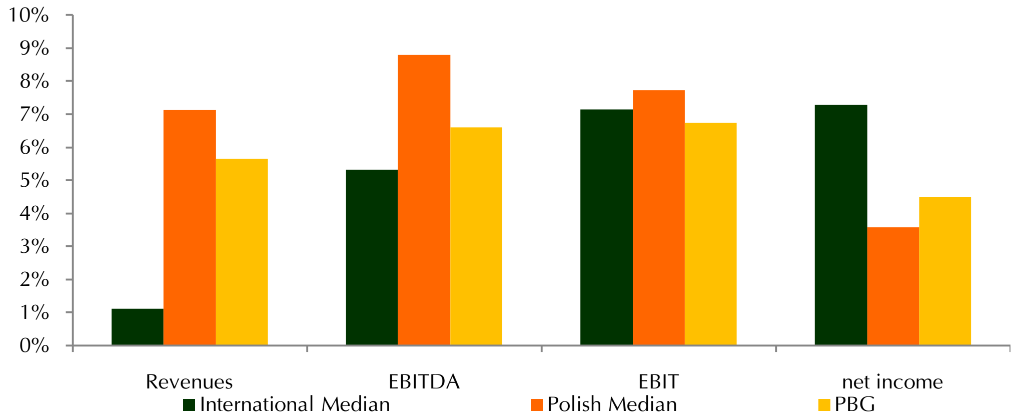
Polish construction: the structure of the backlogs



Source: Bloomberg, Wood Research, others – oil&gas, water, industrial&residential, chemicals, production, energy, general construction

The market expects a high level of revenue coverage from the backlogs to be reflected in Polish construction companies' growth rates for the next three years. Despite the expected drop in infrastructure spending, the 2010-13E CAGRs for PBG and the other Polish construction companies are still positive and superior to international companies.

2010-13E CAGRs: PBG vs. its international and Polish peers



Source: Bloomberg, Wood Research

Robust backlogs can help companies survive periods of lower construction investment. On the other hand, we do not believe there will be an investment drought in the Polish construction sector as we see many potential tenders in the pipeline, especially in the oil&gas and energy segments, where PBG can monetise more than the average Polish construction company.

We agree that the construction sector will not have an easy time in terms of competition and margins, but we also believe that the outlook is not as dark as has been presented by mass media. There is still a lot of work to be done in the construction sector in Poland and the natural winners should be the biggest companies as they have broader competencies and can better manage their costs. Also, we believe the balance of investments will move from infrastructure into oil&gas and energy, which should work in PBG's favour, as it has the required competencies already (oil&gas) and has built up an alliance with Alstom that should enable it to run for lucrative energy contracts.

Construction sector – project pipelines and outlook

One of the market's concerns on PBG relates to the risk of a declining backlog and sales in the future. In 1Q11, PBG submitted tenders worth PLN 5.1bn in total, winning PLN 0.4bn, with its so-called "success ratio" reaching 7%. The current value of the tenders submitted (or in the pre-qualification stage) by PBG amounts to PLN 50.5bn. If the company manages to repeat its success ratio from 2010 of around 12%, it could win tenders worth PLN 6.1bn in total, which would cover two years' worth of revenues, on average.

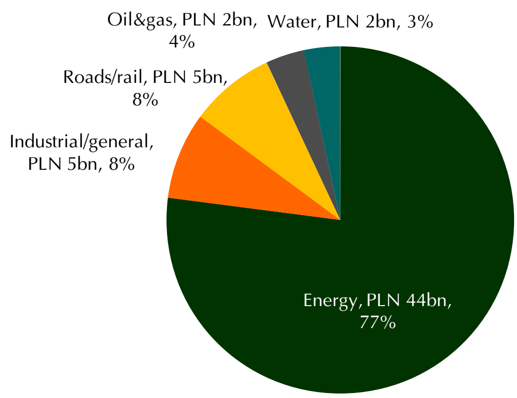
PBG: efficiency in tenders

(PLN bn)	2008	2009	2010	1Q11	2011E
Submitted tenders	19.1	25.7	32.5	5.1	50.5
Signed contracts	2.8	3.9	3.8	0.4	6.1
Success ratio	*14.6%*	*15.2%*	*11.7%*	*7.0%*	*12%*

Source: Wood Research, company data

In addition, PBG has projects at the preparation stage worth PLN 8.5bn and is to apply for contracts worth PLN 59bn in total. Of this amount, PLN 44bn (c.77%) pertains to energy, PLN 2.1bn (c.3.5%) to oil&gas, PLN 4.5bn (7.6%) to roads&rails, PLN 4.6bn to general and industrial construction, and PLN 2bn to water.

PBG: value and contribution of tenders submitted or in pre-qualification



Source: Wood Research

This clearly shows that there are a lot of projects in PBG's pipeline that could offset the inevitable reduction in infrastructure spending. Hence, the outlook is not as negative as the market commentators believe, in our opinion.

Oil&gas

PBG grew its business based on oil&gas projects with PGNiG. After many years of experience, we believe it is true to say that PBG is one of the most qualified and experienced construction companies in the gas segment. Its recently-won contract (worth PLN 2.2bn) for building the LNG terminal for Gaz-System illustrates this, in our opinion.

PGNiG was and still is one of PBG's biggest clients, delivering 19% of its revenues (PLN 520m) in 2010 and 16.8% (PLN 432m) in 2009. The largest contribution came from the LMG contract, worth PLN 1.4bn, signed in 2008 and lasting until 2H13. For 2011-13E, revenues from the gas segment should also grow as LMG is still running, while the recently-won LNG contract should add around PLN 200-250m per year until 2014, on our estimates. However, the market is worried that, when the LMG and LNG contracts mature, PBG will not be able to offset them with other contracts. Although we do not exclude such a risk, the number and value of the projects in PBG's pipeline are promising, in our opinion:

- ✓ According to Wood's estimates, PGNiG could, up until 2014, spend capex of around PLN 15bn on increased domestic natural gas production, an increase in the capacity of its underground gas storage facilities, the diversification of gas supplies and the construction of the pipeline interconnection between Polish and foreign gas systems. In recent years, PBG's stake in PGNiG's capex amounted to 11-14%. Assuming that PBG manages to keep this stake, it could book up to around PLN 1.6-2.1bn, or PLN 450-600m yearly, until 2014, on our estimates.
- ✓ On the other hand, Gaz-System, an operator of polish gas pipelines and an investor in the LNG terminal, is to invest more in the extension of gas pipelines in Poland, with the size of the potential investments being up to PLN 5bn by 2013. Again, PBG seems to us to be the natural and biggest beneficiary of this.
- ✓ In addition, there are potential projects with PKN Orlen and Lotos going forward. According to Wood's estimates, these companies are to spend PLN 9.7bn and PLN 3.1bn, respectively, by 2014, on the construction of crude oil pipelines, increasing the oil processing capacity of their oil infrastructure. However, in this area, Polimex seems to have better competencies than PBG.

Based on the information we have received from PBG, the company is at the pre-qualification stage and should soon submit bids in the oil&gas segment worth PLN 2.1bn in total.

No.	Project	Segment	Leader	Budget (PLN m)
1	PMGZ Husów	Gas	PBG	50
2	Modernisation of airport deposit MPS, Gdynia	Fuels	PBG	25
3	Two deposits 100k m3 each, BS Miszewko Strzalkowskie, Stage II	Fuels	PBG	80
4	Hermanowice	Gas	PBG	20
5	Gas pipeline DN 700 Gustorzyn-Odolanów: Stage I – gas pipeline DN 700 Gustorzyn – Turek, stage II – pipeline DN 700 Turek - Odolanów	Gas	PBG	650
6	Gas pipeline DN 800 Swinoujscie-Szczecin	Gas	PBG	370
7	Gas pipeline DN 700 Szczecin-Gdansk, stage I pipeline DN 700 Płoty-Karlino	Gas	PBG	240
8	Gas pipeline MOP 8,4 Mpa DN700, Rembelszczyzna-Gustoszyn	Gas	PBG	630
	TOTAL			**2,065**

Source: PBG

Energy

We bear in mind that when speaking about energy contracts, it is like speaking about a Yeti: everyone has heard about them but no-one has seen them. Having said that, however many times these projects have been delayed, they should start sooner or later, as there is a shortage of energy in Poland and the infrastructure is outdated and needs to be replaced.

Below, we present the biggest energy tenders in the pipeline.

Pipeline of power energy tenders

Project	Investor	Fuel	Capacity (MW)	Est. value (PLN bn)
Opole	PGE	Coal	1800	10
Kozienice	Enea	Coal	900	6
Włocławek	PKN Orlen	Gas	500	1
Stalowa Wola	Tauron	Gas	400	1
Jaworzno	Tauron	Coal	910	5
Turow	PGE	Coal	460	2
Ostroleka	Energa	Gas	1000	6
Północ power plant	Kulczyk	Gas	1800	11
				42.4

Source: PBG

As demonstrated above, the scale of the potential investments is enormous and should easily offset the infrastructure segment, in our opinion. Of course, these amounts concern the total value of the contracts, and construction works should contribute a smaller portion. It is estimated that on a coal power block, construction works can reach around 30% of the total value of a contract, while in the gas power block, they can reach around 30-40%. Hence, of the total amount of power energy contracts, the value of construction works can be worth around PLN 15-16bn. The energy pie is big enough for most of the Polish construction companies to be able to take a share of it. Construction representatives also expect that, as the energy construction works are more complex and the risk involved is higher due to the higher value of the contracts and their duration, the margins should also be above average (probably comparable with the level of the margins in the oil&gas segment, around 20%).

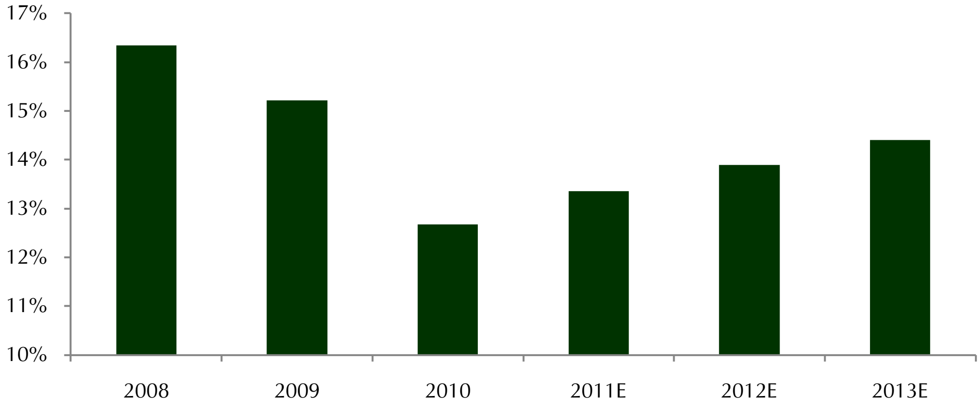
Below, we present the list of energy projects that PBG is, or will be, running for.

No.	Project	Budget (PLN m)
1	Modernisation of heating system in Biedrusko	70
2	Power energy block in Włocławek (gas-steam)	1,600
3	Power energy block in Koziennice, 900MW (coal)	5,000
4	Waste management system in Poznan	700
5	Power Island (steam turbines) for CCGT Wrocław	5,000
6	Stalowa Wola power block, 400MW, (steam-gas)	1,600
7	De-nitrification installation for PKN ORLEN	350
8	Opole power plant	9,000
9	Jaworzno power plant, 800-910MW (coal)	5,000
10	Desulphurization system for PKN ORLEN	600
11	Construction works for power plant	1,500
12	Turow power plant	2,500
13	Two new power blocks, Polnoc power plant, Kulczyk	11,000
	TOTAL	**43,920**

Source: PBG

With a declining contribution from the margin-dilutive infrastructure sectors and the increasing contribution of the margin-accretive oil&gas and energy sectors, PBG's consolidated margins should improve gradually, in our opinion.

PBG: gross margins, 2009-13E



Source: Wood Research

Others segments

Apart from oil&gas and energy, which are, in our opinion, the key segments for PBG currently, the company is running for contracts in other segments. A full list of the tenders in the pre-qualification stage, or that have already been submitted, are listed below.

No.	Project	Segment	Leader	Budget (PLN m)
1	Modernisation of Odra river	Water	PBG	80
2	Construction works on Wroclaw water loop	Water	PBG	400
3	Construction of waste recycling plant	Industrial/Energy	PBG	860
4	S17 express way, track Kurow-Lublin-Piaski, work 3	Roads	PBG	200
5	S17 express way, track Kurow-Lublin-Piaski, work 4	Roads	PBG	180
6	Dike modernisation Blizanowice-Trestno	Water	PBG	20
7	Dike/embankment modernisation Kotowice-Siedlce	Water	PBG	40
8	Dike modernisation on Old Odra, Psie Pole-railway bridge in Poznan	Water	PBG	400
9	Construction of waste disposal for Plock region	Industrial/Energy	PBG	300
10	Raciborz storage reservoir	Water	PBG	800
11	S8 express way, Sycow-Kepno-Sieradz-A1 (Lodz), track 1: Sycow-Kepno, 15,3 km	Roads	HBP	300
12	S8 express way, Sycow-Kepno-Sieradz-A1 (Lodz), track 2: Kepno-Wieruszow, 16,6 km	Roads	HBP	400
13	S8 express way, Sycow-Kepno-Sieradz - A1 (Lodz), track 3: Kepno - Wieruszow - Walichnowy, 13,1 km	Roads	APRIVIA	250
14	S8 loop Walichnowy – loop Wroclaw (A1)	Roads	APRIVIA	400
15	S8 express way, loop Walichnowy – loop Wroclaw (A1), track 3	Roads	APRIVIA	150
16	S8 express way, loop Walichnowy – loop Wroclaw (A1), track 4	Roads	APRIVIA	500
17	S8 express way, loop Walichnowy – loop (A1), track 5	Roads	APRIVIA	1,200
	TOTAL			**6,480**

Main risks

One of the reasons for the weak sentiment towards PBG's stock is that the market sees numerous potential risks that could materialise and hamper the company's results in the future. The risk of a potential drop in the company's backlogs in the coming years is, of course, possible, but we believe that PBG's pipeline and the size of its potential investments can mitigate this risk.

In addition to the above risk, further risks are associated with penalties for delays in its stadium contracts, salary pressures and problems with liquidity.

Stadium contracts

The stadium contracts and the problems surrounding the A2 highway track (being built by the Chinese firm, COVEC) are the hottest topics in the media currently. Public interest in PBG's three stadium contracts was expected to be high from the very beginning. The unfavourable weather conditions in 2010 and changes to the contract's specifications (a removable grass field was added) have resulted in the contract being delayed and it will not be finished by the initial scheduled date (30 June 2011). The running time until EURO 2012 and the approaching elections in Poland have led to increasing pressure and tensions. Narodowe Centrum Sportu (the National Sports Centre (NCS), an investor in the Warsaw stadium) has publicly announced its dissatisfaction with the stage of the works. Highways and stadiums have become a national problem, focused on currently and commented on by everyone (including politicians).

Last week, NCS and PBG signed an agreement extending the construction works until 30 November 2011, but still within the initial budget of PLN 1.25bn. This scenario is very different from the potential one recently presented by the press, which stated that the consortium could pay a PLN 1.2m fine per day for the delay, for up to 14 days, then PLN 6m per day thereafter. Two fundamental questions arise at this stage, in our opinion: will the consortium have to pay the penalties anyway, and will it be able to finish the contract within budget if the scope of the works has been expanded?

The answer to first question is no, in our opinion. The new completion date is 30 November and if the stadium is finished by then, no penalties will be incurred. The only penalties that PBG could potentially face relate to the costs of cancelling two sporting events: the Red Bull X-Fighters event, scheduled for 6 August, and the football match between Poland and Germany, scheduled for 6 September. According to speculation in the press, the potential fines could amount to PLN 10m.

The answer to the second question is not as obvious. We could learn from Hydrobudowa, that "to finish a stadium within a budget" refers to the scope of the works agreed when the original contract was signed. Anything exceeding this scope would have to be paid for separately, with signed additional annexes to the base contract. What would this mean for PBG (and Hydrobudowa)? In our opinion, it would mean that the contract will not deliver negative margins. Conservatively, we assume that the margins will be close to zero on PBG's stadium contracts (both the national stadium in Warsaw and the stadium in Gdansk).

Workforce migration to Germany

The German labour market was opened up to Poland in May 2011, making it easier for German companies to hire Polish workers. Germany is currently experiencing a shortage of IT specialists, electricians and construction workers.

This raises the question of whether the opened German labour market will result in the migration of construction workers and consequent salary pressure.

It is hard to answer this question with any certainty, but we can look at an analogous case as Germany is not the first country to have opened its borders to Polish workers. Since 1 May 2009, Poles have been able to work in 13 countries in the so-called "old EU" (except for Germany and Austria). During this time, we have not observed a mass migration of the construction labour force. This is probably due to the fact that the economic crisis had a larger impact on the countries outside Poland. Of course, we appreciate that we cannot take the case in Germany and apply it blindly to Poland because:

- ✓ The German economy is on a strong growth path with increasing investments, and this could naturally increase the demand for workers outside Poland.
- ✓ Poland and Germany are close trade partners and neighbouring countries, so it is easier for workers to migrate to Germany than to other countries.

On the other hand, because of infrastructure investment and the potential for energy contracts, Poland is, and most probably will remain, one of the biggest construction sites in Europe. This is illustrated by the fact that many international construction companies have already entered or want to enter the Polish market. In our opinion, the future prospects for the construction segment look much better in Poland than other European countries, and this could be a sufficient reason for Polish construction workers to stay in Poland. We also believe that construction workers are less mobile than workers in other sectors; for example, IT specialists are most often very young, without family obligations, and with more of a hunger for international experience.

Therefore, we are mainly concerned about increasing salary pressures, and we expect the outlook for this to become clearer during this year and next, when infrastructure works will be at their peak and there could be a labour force shortage. We have reflected this fact in our model and forecast PBG's SG&A ratio to increase to 4.5% in 2011, from 4% in 2010.

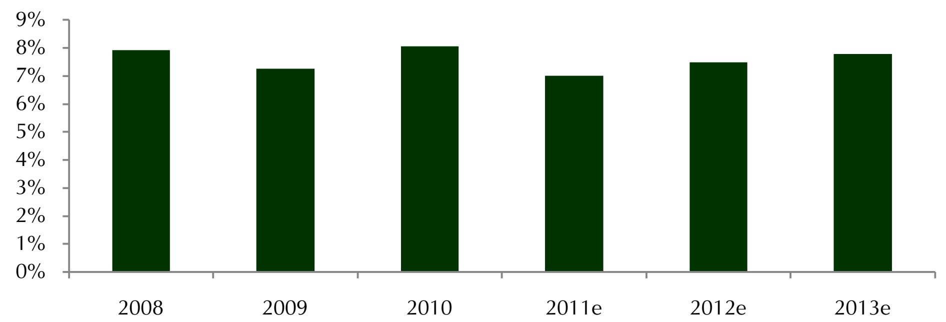
Liquidity

PBG is one of the most indebted construction companies in Poland. Hence, apart from the risks related to its business activity, investors are also concerned about its liquidity and solvency risks. Apart from this, having cash on the balance sheet is also important for energy contracts, which are larger in scale (and need more working capital) and also require guarantees.

At the end of 1Q11, PBG's net debt reached slightly above PLN 1bn and it has several debt covenants that have not been breached. According to our estimates, there is only a limited risk that they will be breached in the future. The covenants are:

- ✓ The net income margin should not be lower than 5.3%.

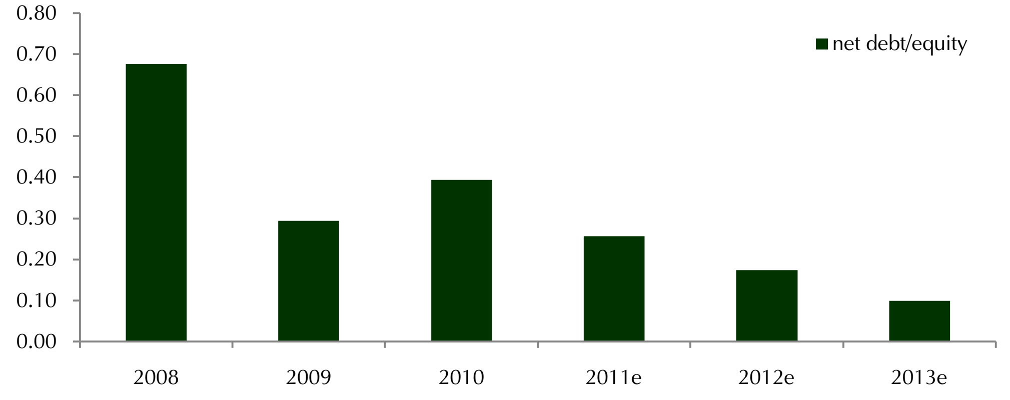
PBG: net income margins, 2008-13E



Source: Wood Research

- ✓ Gearing, measured by the net debt-to-equity ratio, should not be higher than 1.9x.

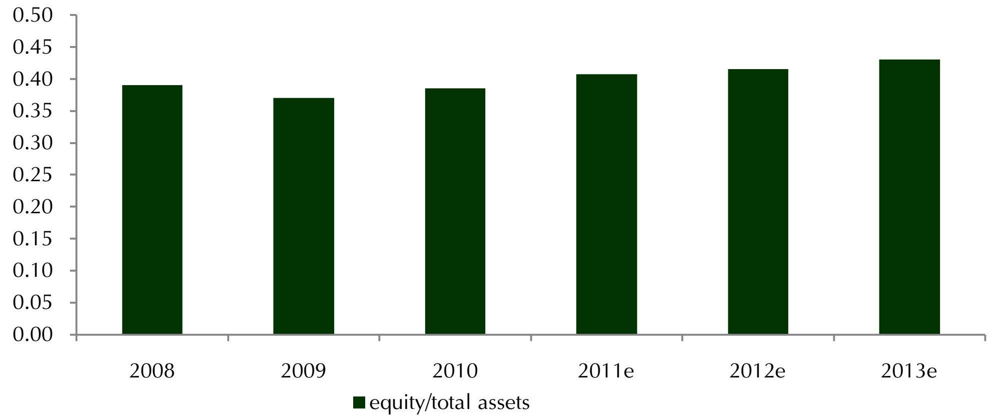
PBG: gearing, 2008-13E



Source: Wood Research

- ✓ The equity-to-total-assets ratio should not be lower than 0.3x.

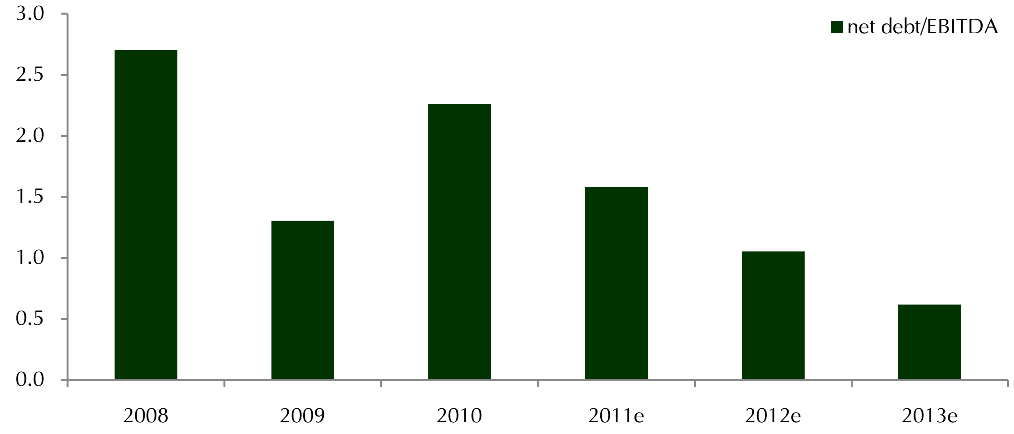
PBG: equity to total assets ratio, 2008-13E



Source: Wood Research

- ✓ The net debt-to-EBITDA ratio should be no higher than 3.5x.

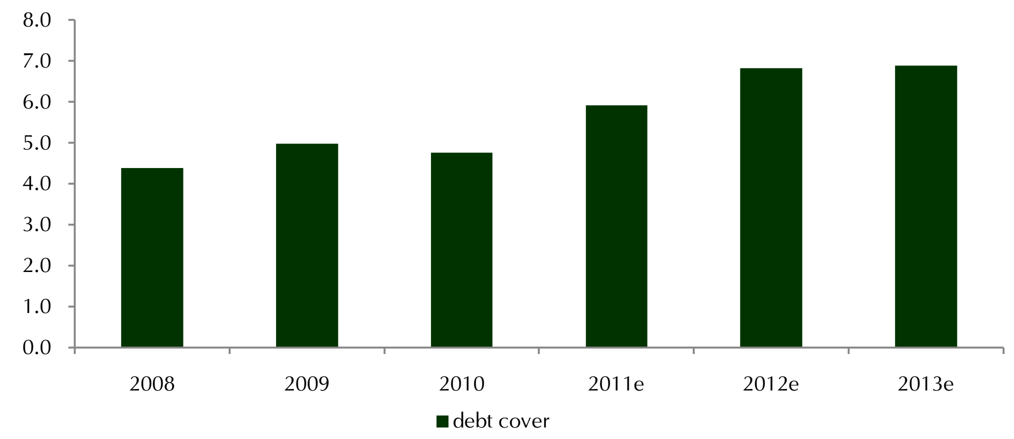
PBG: net debt/EBITDA, 2008-13E



Source: Wood Research

- ✓ The debt cover ratio should not be lower than 2.0x. The debt cover is measured by net income + D&A + debt interests/debt interests.

PBG: net debt/EBITDA, 2008-13E



Source: Wood Research

None of the covenants presented above are in danger of being breached, according to our forecasts.

When looking at the liquidity ratios, the picture also looks relatively positive, in our opinion, with each of them at relatively safe levels.

PBG: solvency ratios, 2008-13E

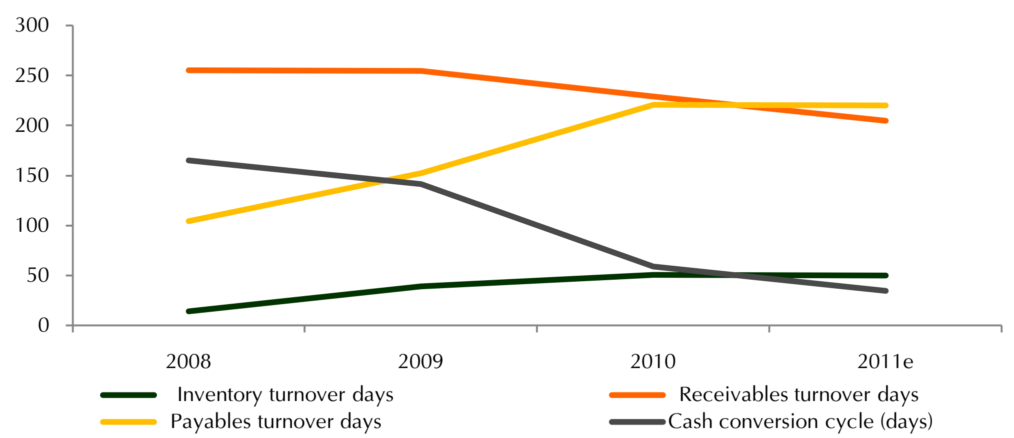
	2008	2009	2010	2011E	2012E	2013E
Current ratio	1.6	1.6	1.6	1.6	1.7	1.8
Quick ratio	1.6	1.5	1.4	1.4	1.5	1.6
Cash ratio	0.3	0.5	0.6	0.6	0.6	0.7

Source: PBG, Wood Research

Working capital management

Working capital management is also one of the issues that investors follow closely, especially since PBG is not a benchmark setter in this field. Due to the increasing contributions from the company's long-term contracts, such as LMG and the stadium contracts, its working capital requirements have also increased. Although the contribution from the stadium contracts should decline soon, PBG's other long-term contracts will still weigh on its revenue structure (the highways and the LNG terminal); hence, we expect its working capital to remain at a level comparable to 2010 in the future.

PBG: working capital management, 2008-11E



Source: PBG, Wood Research

Valuation

We value PBG at PLN 195 on our DCF model and PLN 182.6 on our peer group comparison. Giving both an equal weighting, this leads us to a 12M PT of **PLN 188.8** per share, 25% upside to its current share price. As a result, we upgrade the stock to **BUY** from Hold. Since the beginning of the year, the stock has underperformed the WIG20 index heavily, by 34%, being the worst-performing counter in the index ytd.

DCF valuation

When valuing PBG using our DCF methodology, we have used a six-year forecast for the free cash flow (FCF). The key assumptions in our DCF model are as follows:

- ✓ The full consolidation of Hydrobudowa Polska. We do not believe that Hydrobudowa's share price will return to PLN 3.5-4.0, which would be the only argument for OHL to execute the transaction.
- ✓ That PBG manages to buy back at least 5.7m of Energomontaz Poludnie's shares, and increase its stake to at least 33%, but not above 50%, and will continue to consolidate via the equity consolidation method.
- ✓ Our valuation is based on our FCF forecasts for 2011-16E and our net debt forecast at the end of 2011.
- ✓ A risk free rate for the FCF forecasts of 5.75% and a terminal growth rate for the FCF of 1%.
- ✓ A beta of 1.0. Bloomberg reports a beta of 0.7 but, due to the stock's limited liquidity and its volatile nature over the past few months, we believe it is better to take a more cautious stance and lift the beta to a neutral level of 1.0.

DCF valuation

(PLN m)	2010	2011E	2012E	2013E	2014E	2015E	2016E	>2016
EBIT	271.3	271.2	307.7	329.9	365.1	344.4	335.2	
Tax rate	19%	19%	19%	19%	19%	19%	19%	
NOPAT	220.9	219.7	249.3	267.2	295.8	278.9	271.5	
D&A	47.1	53.8	54.8	55.9	57.1	58.2	59.4	
Capex	-144.1	-167.4	-84.3	-85.8	-87.4	-73.5	-91.6	
Change of working capital	182.2	271.8	-39.5	-44.4	-47.9	47.9	22.5	
FCF	**306.1**	**377.9**	**180.3**	**193.0**	**217.6**	**311.4**	**261.8**	
FCF change			*-52%*	*7.0%*	*12.7%*	*43.2%*	*-15.9%*	*1.0%*
WACC calculation								
Debt/equity	30.1%	24.1%	23.9%	23.6%	23.3%	21.5%	20.3%	20.3%
Risk free rate	5.5%	5.8%	5.8%	5.8%	5.8%	5.8%	5.8%	5.8%
Credit premium	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%
Market premium	5.0%	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%	5.0%
Beta	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Cost of debt	5.3%	5.5%	5.5%	5.5%	5.5%	5.5%	5.5%	5.5%
Cost of capital	10.5%	10.3%	10.3%	10.3%	10.3%	10.3%	10.3%	10.8%
WACC	**8.9%**	**9.1%**	**9.1%**	**9.1%**	**9.1%**	**9.2%**	**9.3%**	**9.7%**
PV (FCF)	306.1	359.9	151.5	148.5	153.4	200.4	153.7	1,167
PV (RV)								1,788
net debt								400
12M valuation								2,787
# of shares (m)								14.3
12m value/share (PLN)								**195.0**

Source: Wood Research

Comparative valuation

We have compared PBG to both its international and domestic peers. The final result of our comparative valuation is a 50/50 weighted average of the two peer groups and equal weights for the two multiples EV/EBITDA and P/E. Each year has an equal 33% weight in the valuation process.

Peer group valuation

Company	EV/EBITDA			P/E			CAGR 2010-13E			
	2011E	2012E	2013E	2011E	2012E	2013E	Revenues	EBITDA	EBIT	Net income
PBG	8.0	8.2	7.9	11.0	8.6	7.3	7.3%	16.2%	27.5%	27.5%
BUDIMEX	1.5	1.4	1.4	9.4	9.5	8.6	0.2%	3.1%	7.0%	-3.8%
POLIMEX-MOSTOSTAL	6.7	7.0	6.3	11.0	8.4	7.1	-2.9%	7.6%	12.9%	44.3%
TRAKCJA POLSKA	2.2	2.2	1.9	23.4	10.4	10.0	4.9%	3.9%	8.5%	14.3%
ERBUD SA	8.9	8.5	3.5	14.3	11.6	10.0	-1.4%	8.9%	9.4%	11.9%
ELEKTROBUDOWA	9.0	9.4	8.4	8.4	12.6	11.8	2.0%	1.8%	2.4%	-1.7%
MOSTOSTAL WARSZAWA	3.8	3.8	2.8	12.0	11.7	11.3	3.4%	-1.6%	-0.3%	5.8%
Polish peers median	**6.7**	**7.0**	**3.5**	**12.4**	**11.6**	**10.6**	**2.0%**	**3.9%**	**8.5%**	**11.9%**
Polish peers average	***5.7***	***5.8***	***4.6***	***21.5***	***15.3***	***12.7***	***1.7%***	***4.8%***	***8.6%***	***6.0%***
BAUER AG	5.5	4.9	4.5	11.0	8.6	7.3	7.3%	16.2%	27.5%	27.5%
FOMENTO DE CONSTRUC	7.1	6.9	6.7	9.4	9.5	8.6	0.2%	3.1%	7.0%	-3.8%
HEIJMANS N.V.-CVA	6.4	5.6	5.1	10.9	8.4	7.1	-2.9%	7.6%	12.9%	44.3%
HOCHTIEF AG	4.2	2.7	2.4	22.9	10.2	9.8	4.9%	3.9%	8.5%	14.3%
SACYR VALLEHERMOSO	22.6	21.0	19.2	14.1	11.4	9.9	-1.4%	8.9%	9.4%	11.9%
SKANSKA AB-B SHS	5.0	6.7	6.4	8.3	12.5	11.6	2.0%	1.8%	2.4%	-1.7%
STRABAG SE-BR	2.8	2.7	2.7	12.2	11.9	11.5	3.4%	-1.6%	-0.3%	5.8%
BILFINGER BERGER SE	8.4	8.0	7.8	12.8	12.1	11.5	1.4%	1.1%	3.1%	-3.0%
FERROVIAL	12.1	11.2	10.4	78.6	48.4	32.7	-2.1%	-1.8%	1.5%	-55.2%
ACCIONA	8.0	7.3	6.8	22.3	19.3	15.8	4.6%	9.9%	14.5%	17.6%
Int peers median	**6.7**	**6.8**	**6.5**	**12.5**	**11.6**	**10.7**	**1.7%**	**3.5%**	**7.7%**	**8.8%**
Int peers average	***8.4***	***7.7***	***7.2***	***21.3***	***16.0***	***12.6***	***1.7%***	***4.9%***	***8.6%***	***5.8%***
MEDIAN	**6.7**	**6.9**	**6.3**	**12.5**	**11.6**	**10.6**	**1.7%**	**3.5%**	**7.7%**	**8.8%**
AVERAGE	***6.3***	***6.2***	***6.1***	***20.3***	***15.3***	***12.6***	***1.7%***	***4.8%***	***8.6%***	***5.9%***
PBG	7.5	6.2	5.3	10.5	9.2	8.5	7.3%	16.2%	27.5%	27.5%
PBG vs. peers	13%	-10%	-15%	-16%	-21%	-20%	329%	366%	255%	212%
Valuation (PLN m)			2,610							
12M value/share (PLN)			**182.6**							

Source: Wood Research, Bloomberg

Sensitivity

We have prepared a sensitivity analysis based on our terminal growth rate and WACC calculations. Currently, PBG stock is trading at PLN 150.5, which means that the market expects 0.5-1.0ppt higher WACC than we do and a negative terminal growth rate (-2%). Bearing in mind that many investments and projects are still in the pipeline, we believe that the market is underestimating the counter.

Sensitivity analysis: terminal growth rate and WACC

		WACC						
		8.2%	8.7%	9.2%	9.7%	10.2%	10.7%	11.2%
	-4%	151	147	144	141	138	135	133
	-2%	172	166	162	157	153	149	146
TGR	1%	224	213	204	195	188	181	175
	2%	253	238	226	215	205	197	189
	3%	292	272	255	240	227	216	207

	WACC						
	8.2%	8.7%	9.2%	9.7%	10.2%	10.7%	11.2%
-4%	-23%	-24%	-26%	-28%	-29%	-31%	-32%
-2%	-12%	-15%	-17%	-20%	-22%	-24%	-25%
1%	15%	9%	4%	0%	-4%	-7%	-10%
2%	29%	22%	15%	10%	5%	1%	-3%
3%	50%	39%	30%	23%	16%	11%	6%

Source: Wood Research

Below, we have prepared a sensitivity analysis based on changes in gross margins and sales growth. Our base case scenario assumes a gross margin of 13.4% in 2011E. Looking at the table below, if the gross margin is 1ppt higher than our assumptions, PBG's value (based on our DCF model) increases to PLN 217 per share, 11% higher than our current valuation. On the other hand, if the gross margin is 1ppt lower than our assumptions, PBG's share price drops to PLN 174 (also by 11%). The current market valuation of PLN 150 per share assumes that the market expects around a 0.5-1.0ppt lower gross margin and around 2% lower sales growth than we do.

Sensitivity analysis: gross margins and sales growth

		Gross margin = base scenario exp. 13.4% in 2011E						
		-1.5%	-1.0%	-0.5%	0.0%	0.5%	1.0%	1.5%
	-4%	112	120	129	138	147	156	165
	-2%	136	146	156	166	175	185	195
Sales	0%	163	174	185	195	206	217	228
	2%	192	204	216	228	240	252	264
	4%	224	237	250	264	277	290	303

	Gross margin = base scenario exp. 13.4% in 2011E						
	-1.5%	-1.0%	-0.5%	0.0%	0.5%	1.0%	1.5%
-4%	-43%	-38%	-34%	-29%	-25%	-20%	-15%
-2%	-30%	-25%	-20%	-15%	-10%	-5%	0%
0%	-17%	-11%	-6%	0%	6%	11%	17%
2%	-2%	4%	11%	17%	23%	29%	35%
4%	15%	21%	28%	35%	42%	48%	55%

Source: Wood Research

We have also prepared a DuPont table. A constant reduction in the ROE is due mainly to the decreasing net margin, resulting from the constantly increasing competition and the rising contribution from the margin-dilutive segments, such as stadiums and infrastructure, and also from the reduction in the company's asset turnover ratio. If PBG manages to increase the contribution of the margin-accretive contracts (such as energy) or limit its debt level, which could hamper its bottom line, then the ROE should increase in the future.

PBG: DuPont analysis, 2008-13E

DuPont	**2008**	**2009**	**2010**	**2011E**	**2012E**	**2013E**
Net margin	7.9%	7.3%	8.1%	7.1%	7.6%	7.9%
Asset turnover	2.3	2.5	1.7	1.7	1.8	1.8
Leverage multiplier	0.8	0.7	0.9	0.9	0.8	0.7
ROE	**14.8%**	**12.6%**	**12.1%**	**10.2%**	**10.5%**	**10.3%**

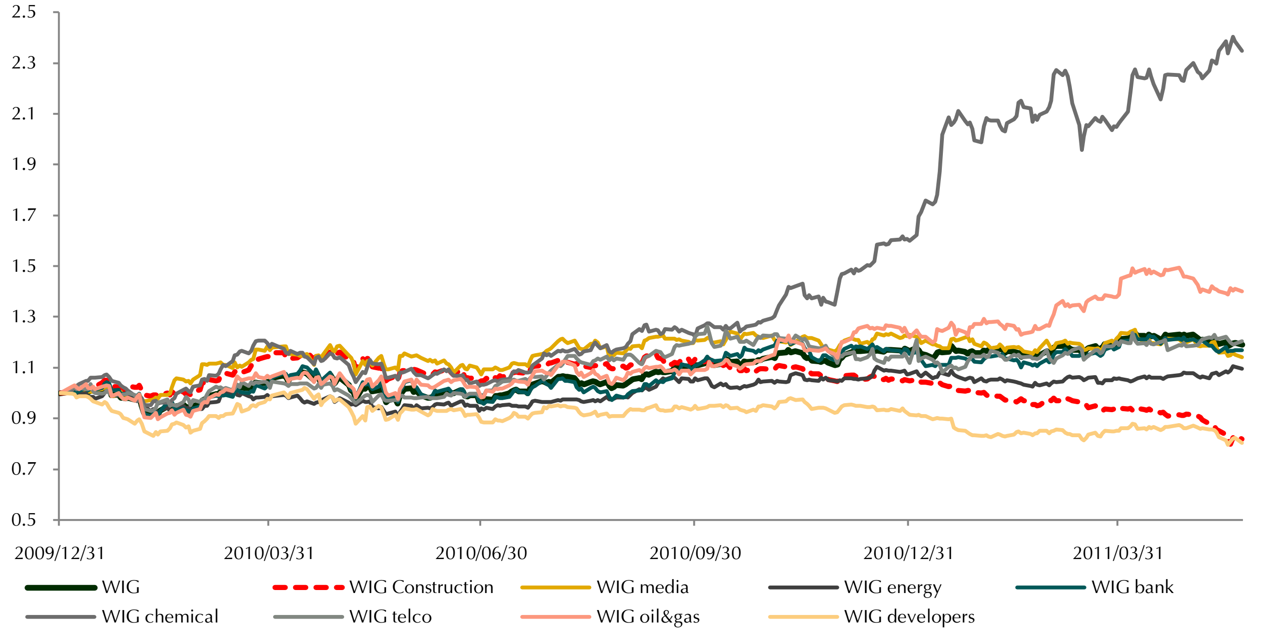
Source: PBG, Wood Research

Valuation gap

Sell-off in the construction sector?

The construction sector has not performed well recently and, since the beginning of 2010, it has been one of the worst-performing sectors in the Warsaw Stock Exchange and ytd.

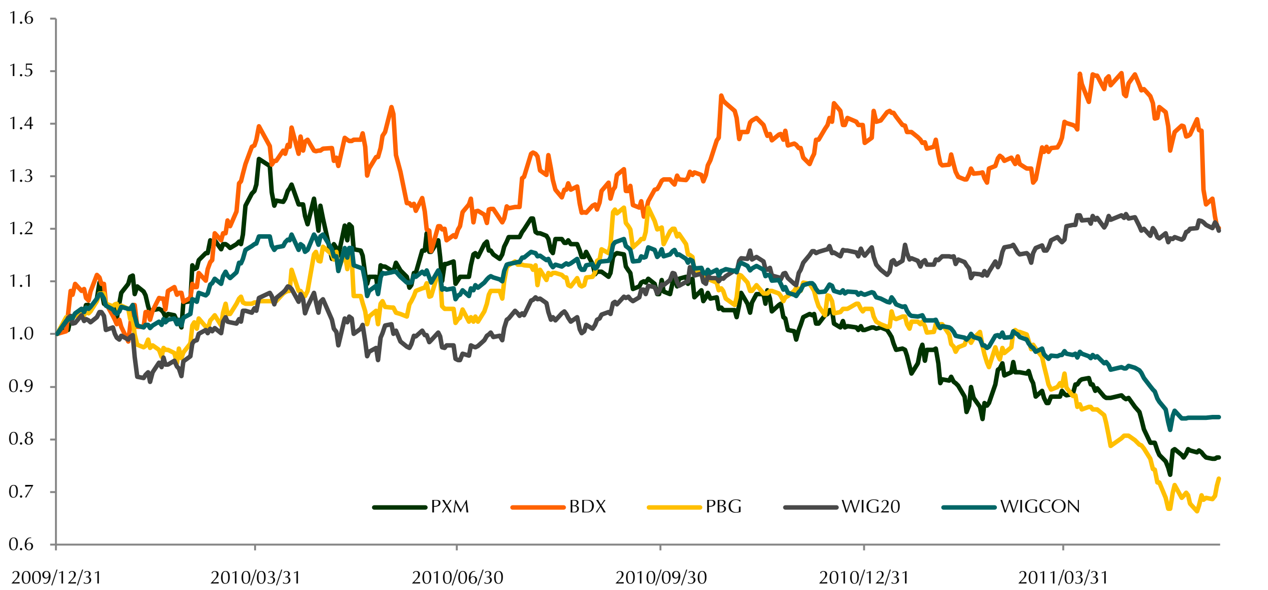
PBG: relative price performance versus the WIG20 ytd



Source: Bloomberg

PBG is one of the biggest construction companies in Poland but it was, and still is, a clear underperformer, similar to Polimex. The indisputable leader in the segment is Budimex, which usually delivers a relatively good set of results and pays a robust dividend, with a yield of around 7%.

PBG: relative price performance versus the WIG20 ytd

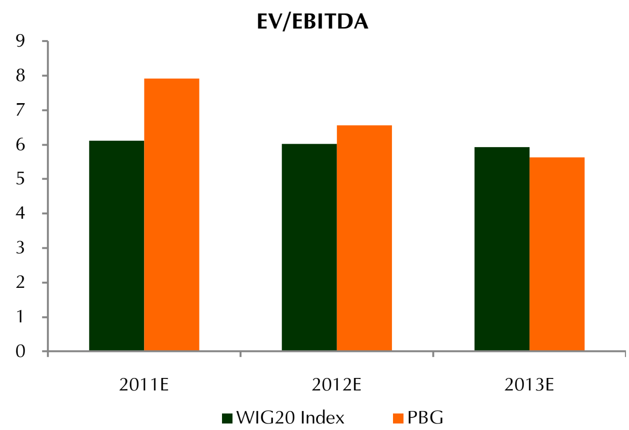


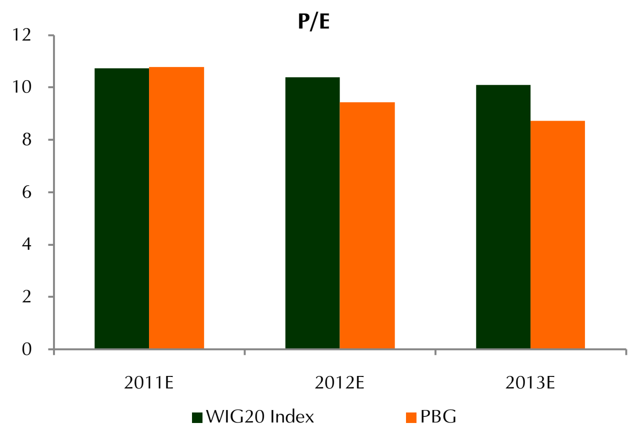
Source: Bloomberg

Trading at its lowest P/E historically

PBG's heavy sell-off and its underperformance have resulted in it currently trading at its lowest one-digit P/E ratio historically, and the discount should widen going forward, based on current market estimates. PBG is still trading at an EV/EBITDA premium compared to the other WIG20 constituents, due to it having one of the highest debt levels within the Polish construction industry (a net debt-to-EBITDA ratio of 2.1x in 2010).

PBG: 2010-12E EV/EBITDA and P/E versus the WIG20

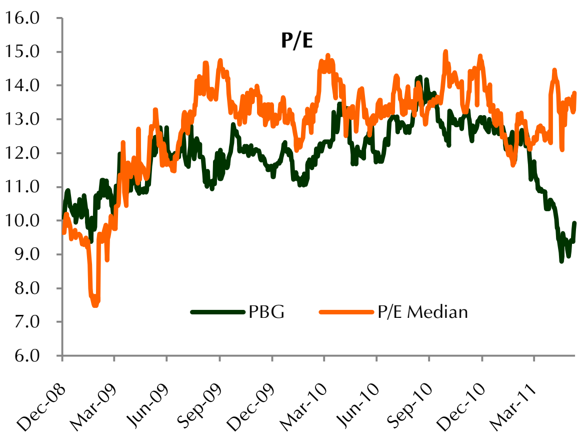


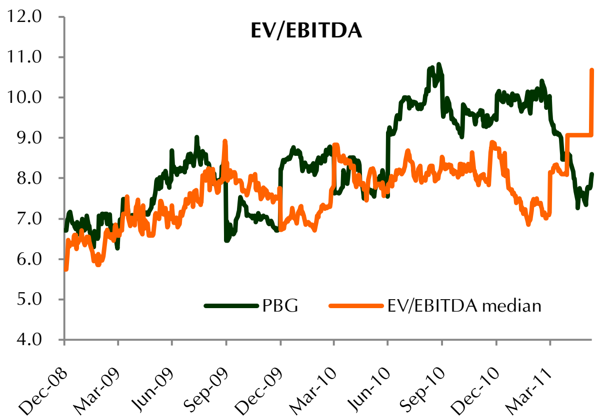


Source: Bloomberg, Wood Research

PBG has been trading in line with its construction peers over the past two years (due partly to its above-average margins) and also at a premium on an EV/EBITDA basis (purely because of its high debt). Given the potential for oil&gas and power energy investment, and PBG's market position as one of the biggest potential beneficiaries, we believe that PBG does not deserve to be traded at such a huge discount to its Polish peers.

PBG: P/E and EV/EBITDA versus its international peers

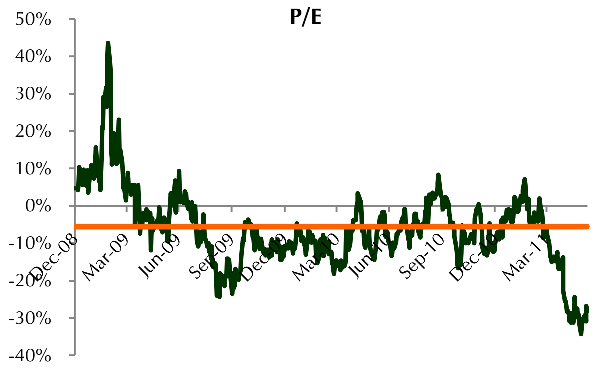


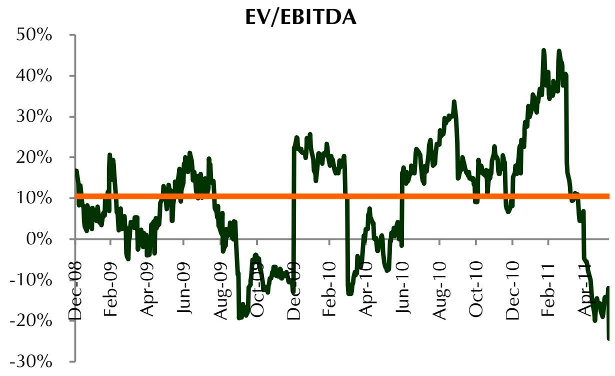


Source: Bloomberg

Due to the strong sell-off, PBG's P/E ratio is now at its largest discount historically, and its EV/EBITDA ratio, usually higher than its peers, has moved to its highest-ever discount from quite a significant premium. It is also clear that the company's de-rating and sell-off happened quite quickly, which may indicate that it was not driven fundamentally. The significant increase of its median EV/EBITDA ratio is, in our opinion, due mainly to the recent downward revision of the street's forecasts for the construction sector as a whole (the result of margin pressure and concerns over future backlogs).

P/E and EV/EBITDA: premium/discount





Source: Bloomberg

1Q11 – rear view

PBG reported its 1Q11 results on 12 May 2011; they were slightly below our and the market's expectations on the top line, but above on the bottom line. The EBIT was fully in line with our and the market's forecasts.

(PLN m)	1Q10	2Q10	3Q10	4Q10	1Q11	yoy	2010	2011E	yoy	1Q cons	1Q Wood
Revenues	469	729	733	809	478	2%	2740	3509	28%	515	565
EBITDA	36	86	85	113	45	26%	319	468	47%	45	45
EBIT	24	74	74	101	33	40%	273	417	53%	33	33
Net profit	18	63	59	85	24	36%	224	266	19%	21	22
Gross margin	*10.4%*	*15.4%*	*13.1%*	*11.2%*	*11.6%*		*12.7%*	*15.0%*			*10.8%*
EBITDA margin	*7.6%*	*11.8%*	*11.6%*	*13.9%*	*9.4%*		*11.7%*	*13.3%*			*7.9%*
SG&A ratio	*5.3%*	*4.4%*	*3.0%*	*3.8%*	*5.6%*		*4.0%*	*4.0%*			*5.0%*

Source: Company data

Revenues: the industrial and residential construction segment was still the biggest revenue generator, with PLN 134m (Wood's forecast: PLN 200m), but it was only slightly ahead of the road segment, which delivered PLN 123m (Wood's forecast: PLN 120m) as a result of the recently-signed infrastructure contracts. The water segment's importance is declining in the company's revenue structure and delivered PLN 71m vs. PLN 128m a year ago (Wood's forecast: PLN 130m). On the other hand, oil&gas increased to PLN 145m vs. PLN 91m in 1Q10 (Wood's forecast: PLN 100m). PBG's current backlog amounts to PLN 5bn (33.6% pertains to oil&gas, 38.8% to roads, 19.3% to industrial construction and the remaining 8.3% to the water segment). Of the backlog, PLN 2.6bn relates to 2011 and PLN 2.4bn to 2012+. In 1Q11, PBG placed offers worth PLN 5.1bn in total, out of which PLN 355m was signed. As a result, its success ratio was 7% versus 11.7% for the whole of 2010.

Profitability: the increasing contribution of the margin-dilutive infrastructure segment did not affect its margins negatively, which actually increased yoy. This was mainly because of the low base from a year ago, when margins were hampered by the severe winter conditions. The gross margin reached 11.6% vs. 10.4% in 1Q10 (Wood expected 10.8%), the EBIT margin was 7% (vs. 5.1% in 1Q10, Wood expected 5.8%), and the net margin was 5% (vs. 3.8% in 1Q10, Wood expected 3.9%). The SG&A ratio remained almost unchanged at 5.6% vs. 5.3% a year ago (Wood expected 5%). The operating cash flow in 1Q11 amounted to -PLN 194m and the net debt position increased to over PLN 1bn from PLN 726m a year ago.

Suspension of the acquisition talks with OHL: a day before the release of its 1Q11 results, PBG suspended its acquisition talks with OHL over the sale of

Hydrobudowa and Aprivia. The main reason was the very strong recent sell-off of Hydrobudowa and the huge valuation gap between the current market price and the price agreed at the beginning of the talks. To reiterate, in September 2010, PBG signed a letter of intent with OHL to sell a 51% stake in Hydrobudowa Polska for PLN 431m and a 50.1% stake in Aprivia for PLN 75m. PBG stated that OHL could re-enter talks if Hydrobudowa's share price returns to the same levels as in September 2010 (of around PLN 3.5). Although the negotiations have been suspended, OHL still wants to co-operate with the PBG Group on common projects and tenders.

2011 guidance: management maintained its full-year guidance, which assumes the generation of PLN 2.3bn in revenues, PLN 230m in EBIT and PLN 200m in net income. Bearing in mind the very low probability that OHL will buy Hydrobudowa (due to the condition that Hydrobudowa's share price returns to PLN 3.5. from PLN 2 currently; 75% upside). It is also very likely that PBG will consolidate Hydrobudowa fully for the whole of 2011. This means that an upward update to the company's 2011 guidance is also possible, most probably after the company's 2Q11 results in September, in our opinion.

Changes to our forecasts

Downward revisions due to the tougher market environment

We have revised our forecasts downwards to reflect the tougher market environment and the fewer than previously expected contracts in the future. Our 2011 full-year numbers are above management's guidance (sales of PLN 2.3bn, EBIT of PLN 230m and net income of PLN 200m).This is because we assume that PBG will not be able to sell Hydrobudowa; therefore, it will have to consolidate it for the whole of 2011. In 2011, we expect Hydrobudowa to generate around PLN 1.6bn in revenues and PLN 36m in net income. Additionally, we assume that PBG will succeed partially in buying the Energomontaz Poludnie shares and increase its stake to 33% from 25% currently, and still consolidate it via the equity method. We expect Energomontaz Poludnie to add around PLN 5m to PBG's bottom line.

	2011E			2012E			2013E		
(PLN m)	**New**	**Old**	**diff**	**New**	**Old**	**diff**	**New**	**Old**	**diff**
Revenues	2,904	3,509	-17%	3,105	3,603	-14%	3,232	3,544	-9%
EBITDA	325	468	-31%	363	457	-21%	386	466	-17%
EBIT	271	417	-35%	308	403	-24%	330	411	-20%
Net income	204	266	-23%	232	262	-11%	252	279	-10%

Source: Wood Research

Wood versus market consensus

On our updated numbers, in 2011, we are slightly above the market's expectations on the top line but below on the bottom line, most probably because we are assuming the full consolidation of Hydrobudowa Polska at PBG, ruling out acquisition by OHL.

	2011E			2012E			2013E		
(PLN m)	**Wood**	**Cons**	**diff**	**Wood**	**Cons**	**diff**	**Wood**	**Cons**	**diff**
Revenues	2,904	2,831	3%	3,105	2,885	8%	3,232	3,137	3%
EBITDA	325	337	-3%	363	348	4%	386	378	2%
EBIT	271	276	-2%	308	279	10%	330	295	12%
Net income	204	218	-6%	232	219	6%	252	243	3%

Source: Wood Research

Financials

INCOME STATEMENT

(PLN m)	2008	2009	2010	2011E	2012E	2013E
Total sales	**2091.4**	**2578.0**	**2740**	**2904**	**3105**	**3232**
COGS	1749.5	2185.9	2123	2516	2674	2732
Gross profit	**341.9**	**392.1**	**347**	**388**	**431**	**465**
SG&A	108.0	109.8	109	131	134	145
Other income/costs	-1.0	4.1	33	14	10	10
EBITDA	**278.0**	**333.6**	**318**	**325**	**363**	**386**
Depreciation	45.1	47.1	47	54	55	56
Income from associates	2.3	1.1	0	0	0	0
Operating income	**232.9**	**286.5**	**271**	**271**	**308**	**330**
Net financial income	-12.0	-28.1	-7	-14	-7	-4
Profit before taxes	**223.2**	**259.5**	**264**	**263**	**301**	**326**
Income tax	26.0	38.9	49	50	57	62
Minorities	31.7	33.6	-6	8	9	10
Net profit	**165.5**	**187.0**	**221**	**205**	**235**	**254**

BALANCE SHEET

(PLN m)	2008	2009	2010	2011E	2012E	2013E
Shareholders equity (incl min. interest)	1115	1483	1831	2016	2231	2465
Net debt	752	577	653	294	108	-92
Other liabilities	202	278	211	211	211	211
Capital employed	**2068**	**2339**	**2696**	**2521**	**2550**	**2584**
Fixed assets	**917**	**1012**	**1599**	**1736**	**1766**	**1796**
Inventories	69	234	294	345	366	374
Receivables	1463	1423	1657	1740	1800	1800
Payables	502	454	631	787	912	912
Other assets	-883	-784	-1485	-2087	-2294	-2297
Working capital net	**1151**	**1327**	**1096**	**785**	**784**	**789**

CASH FLOW

(PLN m)	2008	2009	2010	2011E	2012E	2013E
Net profit	165.5	262.6	267.6	204.8	234.8	254.3
Depreciation	45.1	47.1	47.1	53.8	54.8	55.9
Change in working capital	-563.1	121.0	182.2	271.8	-39.5	-44.4
Other cash flow items	132.2	-85.9	-62.9	0.0	0.0	0.0
Net cash from operations	**-220.2**	**344.8**	**434.0**	**530.4**	**250.2**	**265.8**
Capex and acquisitions net	-174.9	-352.0	-530.0	-190.9	-84.3	-85.8
Free cash flow	**-395.1**	**-7.2**	**-96.0**	**339.4**	**165.9**	**180.0**
Change in debt	436.7	-174.6	75.9	-359.4	-185.9	-200.0
Shares issued	292.2	181.8	0.0	0.0	0.0	0.0
Dividend paid	0.0	0.0	-20.0	-20.0	-20.0	-20.0

KEY RATIOS

	2008	2009	2010	2011E	2012E	2013E
PER (x)	12.2	11.2	9.7	10.5	9.2	8.5
EV/EBITDA (x)	10.4	8.2	8.8	7.5	6.2	5.3
BVPS (PLN)	69.1	97.6	112.3	125.2	140.2	156.6
P/BV	2.2	1.5	1.3	1.2	1.1	1.0
P/Sales (x)	1.0	0.8	0.8	0.7	0.7	0.7
ROE (%)	14.8%	12.6%	12.1%	10.2%	10.5%	10.3%
ROA (%)	5.8%	4.7%	4.6%	4.2%	4.4%	4.5%
ROIC (%)	6.1%	4.8%	7.8%	4.0%	4.5%	4.6%
EV/S (x)	1.4	1.1	1.0	0.8	0.7	0.6
Net debt/Equity	81%	41%	41%	16%	5%	-4%
Net debt/EBITDA (x)	2.7	1.7	2.1	0.9	0.3	-0.2

Source: Company data, Wood Research

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13/06/2011	**BUY**	
13/06/2011		**PLN 188.8**

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BUY: The stock is expected to generate total returns of over 15% during the next 12 months as measured by the target price.
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