

Change in recommendation

Construction

Poland

PBG

Estimates on target, valuation demanding

Previously: Buy

Hold

Bloomberg: PBG PW

06/01/07

Previously: PLN213

Price: PLN256

12-mth target: PLN243

- **PBG's 2007 guidance is bang in line with our estimates but below market consensus. The company plans to issue 1.4m rights to fund both organic growth and acquisitions.**
- **The share price is above our revised target price of PLN243 and we thus downgrade our rating from Buy to HOLD.**

Share issue. PGB plans to issue 1.4m pre-emptive shares. The company wants to collect PLN300-420m to finance acquisitions and rising working capital needs. Book building begins 22 January and closes 24 January. The record date for pre-emptive rights is 17 January.

Destination of new resources. The company plans to inject PLN200-250m into working capital. Another PLN60-100m will be spent on acquisitions. Management plans to take over three to five local road construction companies as well as Slovakian peer Gas & Oil Engineering. One acquisition should be announced already at the end of January, and another later in 1Q07. The company needs PLN20-30m for tangible asset capex (mainly on new equipment), and PLN10-25m on expenditures connected with foreign expansion and the opening of sales offices in Norway and Canada. PBG also plans to spend PLN10-15m on integrating its IT system with those of Hydrobudowa Slask and Hydrobudowa Wloclawek.

View on the sector. With our downgrade of PBG to **HOLD** we now have no Buy ratings on Polish contractors. We think large construction companies have already reached generous valuations. We remain negative on Polimex (PXM PW; price PLN151, Sell, TP PLN120) as we see it as a growth stock but not attractive at current valuations. Budimex (BDX PW; price PLN74.3, Hold, TP PLN78) posted disappointing 3Q06 results. The mild winter might enable the construction sector to post strong 4Q06 figures and hence could provide upside for Budimex shares.

Forecasts and ratios

	2004	2005	2006F	2007F	2008F	2009F
Revenue (PLNm)	216	409	785	1,215	1,506	1,681
EBITDA (PLNm)	28	50	101	148	191	214
Net income (PLNm)	13	36	52	81	109	124
EPS (PLN)	1.48	3.43	4.37	6.73	9.02	10.27
PER (x)	173.4	74.7	58.6	38.0	28.4	24.9
EV/EBITDA (x)	66.6	55.4	28.3	22.2	17.2	15.3
P/BV (x)	12.9	15.2	7.5	7.0	5.6	4.6
ROE (%)	15.0	22.5	19.4	20.2	21.9	20.2

Source: Company data, ING estimates

12-month forecast returns (%)

Share price	(5.1)
Dividend	0.0
12m f'cst total return	(5.1)

Key ratios (%)

	2007F	2008F
EBITDA margin	12.2	12.7
Operating margin	9.7	10.2
Net debt/equity	74.9	82.0
DPS (PLN)	0.0	0.0
Dividend yield	0.0	0.0

Quarterly data (PLNm)

	3Q06	4Q06F
Revenue	205	363
EBIT	30	34
Net income	20	20
EPS	1.6	1.6

Share data

No. of shares (m)	12.0
Daily t/o (US\$m)	1.6
Free float (%)	61
Mkt cap (US\$m)	1,036
Mkt cap (PLNm)	3,067

Share price performance



Source: Bloomberg

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Streamlined group structure. In December 2006, Hydrobudowa Slask and Hydrobudowa Wloclawek signed a merger agreement and will soon operate as one entity Hydrobudowa Polska (HP). PGB will remain majority shareholder of HP with a 76% controlling stake. The transaction should be completed at the end of 1H07 as it needs approval of Financial Supervisory Commission (KNF). With pro-forma revenues of PLN229m in 2005, the merged company will create a domestic powerhouse in hydro-engineering second to no other domestic company and placing it in pole position to obtain the largest contracts in the industry.

Shareholder structure. Majority shareholder Jerzy Wisniewski (36.4% shares and 52.4% votes) will acquire 115,000 privileged shares from Tomasz Woroch and after the issue remain majority shareholder with 50.14% voting rights. Until mid-January, Tomasz Woroch will additionally float 200,000 shares on the WSE.

2007 guidance. The company issued 2007 guidance, which is bang in line with our expectations. Revenues should increase 72.1% YoY to PLN1.2bn, while net profit should grow 57.4% to PLN82m.

Fig 1 2007 guidance and market consensus (PLNm)

	2005	2006F	PBG	2007F ING	Consensus
Revenues	409	702	1,208	1,215	1,149
EBIT	41	78	118	118	129
Net profit	36	52	82	81	90

Source: Bloomberg, company data and ING estimates

Backlog. PBG Group announced that it has a backlog of PLN2bn versus PLN1.6bn at end-September 2006. In October 2006, the company signed a letter of intent regarding the construction of a LNG terminal for Norway's Lyse Gass worth €70m. Construction has already been initiated. Completion of the project is foreseen within the next 36 months. In December, PBG signed a PLN255.5m contract for the construction of fuel tanks for NATO. Both contracts were previously indicated by management and included in our financial model.

Potential signings. In 1H07, PBG hopes to sign two large contracts. In mid-February, PGNiG should announce the winner of the development of its largest gas and oil field Lubiatow-Miedzychod-Grotow (LMG) worth an estimated PLN430m. Possible signing is not likely until 2Q07 as court appeals from competitors usually delay the process. The tender for the construction of the 'Czajka' wastewater treatment plant in Warsaw worth €260m could generate around €115m additional revenues as PGB Group placed its offer in a consortium with Budimex. With the strong composition of the consortium, we rate its chances of winning the Czajka contract as relatively high.

Our new target price is PLN243. We revise our DCF-based target price from PLN213 to PLN243 as we lower the equity risk premium for all Polish companies from 5.0% to 4.5% and shift our valuation point four months forward for PBG.

Downgrade from Buy to HOLD. PBG delivered on investors' expectations of sizeable new signings and together with subsidiaries has signed contracts worth PLN0.6bn since September 2006. The share price has reflected this and increased 46.3% since September. The shares trade at a 2007F PER of 38.0x, a 15.3% premium to the average for Budimex and Polimex. While we acknowledge the long-lasting nature of the construction boom in Poland and the company's robust growth prospects, we believe its valuation is demanding with a 2007F PEG of 1.2x using the three-year EPS

CAGR of 33%. The rationale for the capital increase is sound given that the company has no presence in the road construction segment and given the clear need to fund both won as well as prospective contract.

Fig 2 Comparison of EPS-based multiples

Company	Price	Target price	Rating	Mkt cap	PER (x)			EPS CAGR (%)	PEG (x)		
	(PLN)	(PLN)			(US\$m)	2005	2006F	2007F	2006F-08F	2005	2006F
Budimex	74.3	78.0	Hold	590	904.4	54.1	31.7	226.1	10.0	0.2	0.8
PBG	256	243	Hold	1,010	74.7	58.6	38.0	38.1	1.1	1.5	1.2
Polimex	151	120	Sell	814	56.6	40.0	35.1	24.2	2.4	1.7	2.2
Average					345.3	50.9	34.9	96.1	4.5	1.1	1.4

Prices as of 4 January 2007. Source: ING estimates

Risks. The major risks to our recommendation could be continuing wage increases on the one hand and emigration of qualified workforce to EU15 countries on the other. The construction sector is experiencing the highest wage increases within the Polish economy, while the shortage of high-class specialists has already forced several subcontractors to quit their contracts and resulted in construction delays.

Disclosures Appendix

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	100%	

* Percentage of companies in each rating category that are Investment Banking clients of ING Financial Markets LLC or an affiliate.

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Buy: Forecast 12-mth absolute total return greater than +15%

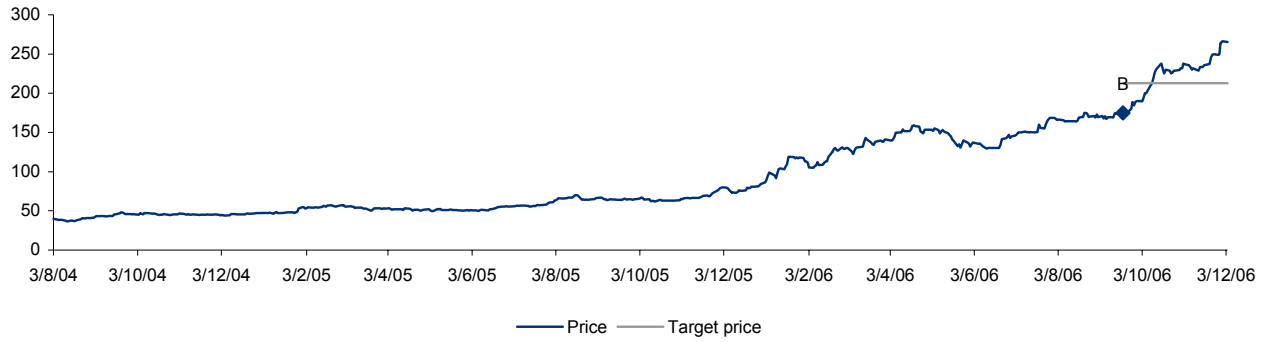
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Sell: Forecast 12-mth absolute total return less than -5%

Total return: forecast share price appreciation to target price plus forecast annual dividend. Price volatility and our preference for not changing recommendations too frequently means forecast returns may fall outside of the above ranges at times.

Research published prior to 15/12/05: EMEA equities' ratings were based on US dollar total returns; Western Europe's were based on: absolute return +25%, Strong Buy; greater than +10%, Buy; +10% to -10%, HOLD; lower than -10%, Sell.

PRICE AND RATINGS CHART: PBG (PBGG.WA)



Current analyst/s

SB = Strong Buy; B = Buy; H = Hold; S = Sell; NR = Not Rated; R = Restricted

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