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PBG

Sector: Construction
Fundamental rating: Hold (→)
Market relative: Overweight (→)
Price: PLN 238.0
12M EFV: PLN 348.0 (↓)

Market Cap.: US$ 1,522 m
Reuters code: PBGG.WA
Av. daily turnover: US$ 2.02 m
Free float: 67%
12M range: PLN 238.00-399.00

Quarterly results corner; 2Q08E preview

PBG's consolidated 2Q08 results – to be released on August 13 - are likely to be rather mediocre, we believe (regarding the details please refer to *Figure 1* on the next page). Due to expanding portfolio of the environmental protection contracts we forecast the Company's quarterly sales to reach c. PLN 528.9 million, a 68% yoy increase which would be much above the market's dynamics (in April and May the construction output grew yoy by 23% and 16.6%, respectively). However, such an impressive yoy pace of growth in unlikely to recur at the gross profit on sales level, we believe. Specifically, we envisage erosion of the Company's gross profit on sales margin (11.2% in 2Q08E vs. 16.3% in 2Q07) which will result from three reasons, in our view. First, Hydrobudowa 9, PBG's 69% subsidiary, puts a drag on the Company's results (this company is still executing some old long-term contracts realizing 0% gross profit on sales margin on them). Second, appreciation of PLN vs. EUR will take its toll (PBG represents strong FX exposure, as most of environmental protection contracts are EUR-denominated). Third, in our opinion in 2Q08 the Company and its subsidiaries (e.g. Hydrobudowa Polska) had to relay in a larger degree on subcontractors, which enabled the Company to pump up its contract portfolio and accelerate its sales, however at the cost of somewhat lower profitability. Consequently, we forecast the Company's gross profit on sales at PLN 59.2 million, only a 16% yoy increase.

We forecast PBG's operating profit to grow by c. 37% yoy to PLN 43.3 million, however with the driving force in the form of an one-off item, we believe. Specifically, PBG is likely to show c. PLN 13.5 million profit on revaluation of land (c. 8.7 ths sq m) situated in Poznań. At the pre-tax level we forecast only a slight 3% yoy increase (to PLN 42.3 million), due to higher leverage and, consequently, higher financial costs in 2Q08 vs. 2Q07 (please note, however, that higher yoy financial costs in 2Q08 should be partially offset by profits from FX hedging). Regarding the Company's quarterly bottom line, in turn, we forecast a 13% decrease to PLN 27.7 million. Please note, however, that the straightforward comparison might be misleading as PBG recognized deferred tax assets in its P&L account for 2Q07, while in our 2Q08 quarterly results forecast we assume a standard statutory 19% effective tax rate.

To sum up, the Company's 2Q08 are unlikely to be inspiring. Although PBG is to post impressive revenues (68% growth yoy), due to the rising cost base, unfavorable FX changes, as well as mediocre earnings quality (non-cash one-off gain on revaluation of land), we expect the Company's consolidated 2Q08 showing to leave the market rather unimpressed. Hence, we believe that the impact of such posting may be at best neutral for the share price performance (negative impact cannot be precluded).

Financial forecast

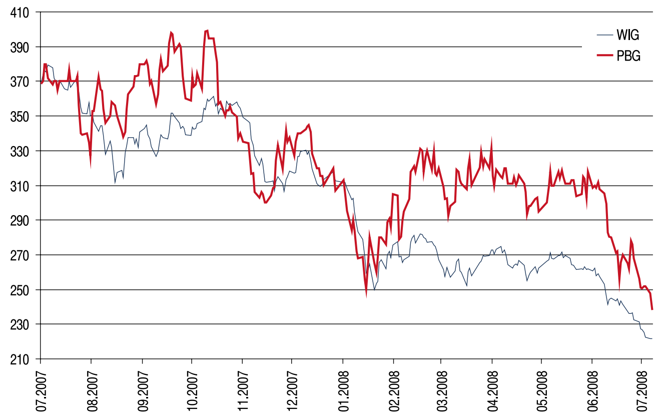
We do not change our forecast for PBG.

Key data

IFRS consolidated		2007	2008E	2009E	2010E
Sales	*PLN m*	1,377.3	1,871.2	2,357.8	3,136.3
EBITDA	*PLN m*	136.3	248.6	320.1	466.9
EBIT	*PLN m*	106.3	219.1	288.4	433.6
Net profit	*PLN m*	101.8	150.5	194.2	298.5
EPS	*PLN*	7.58	11.21	14.46	22.23
EPS yoy chng	*%*	68	48	29	54
Net debt	*PLN m*	257.4	441.4	426.8	439.6
P/E	*x*	31.4	21.2	16.5	10.7
P/CE	*x*	24.3	17.8	14.2	9.6
EV/EBITDA	*x*	25.3	14.6	11.3	7.8
EV/EBIT	*x*	32.5	16.6	12.6	8.4
EV/Sales	*x*	2.5	1.9	1.5	1.2
Gross dividend yield	*%*	0.0	0.0	0.0	0.0
No. of shares (eop)	*ths.*	13,430	13,430	13,430	13,430

Source: Company, DM IDMSA estimates

Stock performance



Source: www.money.pl

Upcoming events

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

Catalysts

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

Risk factors

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

Fig. 1 *PBG; 2Q08 results forecast*

IFRS consolidated			yoy chng			yoy chng	realization of the FY figures in 2Q		realization of the FY figures in 1-2Q	
PLN m	**2Q08E**	**2Q07**		**1-2Q08E**	**1-2Q07**		**2008E**	**2007**	**2008E**	**2007**
Sales	528.9	314.8	68%	836.2	449.4	86%	28%	23%	45%	33%
Gross profit on sales	59.2	51.3	16%	99.9	71.5	40%	19%	27%	32%	38%
Gross profit on sales margin	*11.2%*	*16.3%*	-	*11.9%*	*15.9%*	-	-	-	-	-
EBIT	43.3	31.7	37%	63.9	37.5	70%	20%	30%	29%	35%
EBIT margin	*8.2%*	*10.1%*	-	*7.6%*	*8.4%*	-	-	-	-	-
Pre-tax profit	42.3	41.1	3%	64.3	55.4	16%	20%	29%	31%	39%
Pre-tax margin	*8.0%*	*13.1%*	-	*7.7%*	*12.3%*	-	-	-	-	-
Net profit	27.7	31.8	-13%	42.5	40.8	4%	18%	31%	28%	40%
Net margin	*5.2%*	*10.1%*	-	*5.1%*	*9.1%*	-	-	-	-	-

Source: Company, DM IDMSA estimates

Valuation

We slightly decrease (by 2% to PLN 348 per share from PLN 356 previously) our 12M EFV assessment for PBG, due to upward adjustment of the definite period risk-free rate assumption (to the current level of LT Treasuries' market yields).

Recommendation

The expected weakness of the Company's 2Q08 recurring profits should be more than offset, we believe, by the awaited upgrade of the management FY2008 forecast (to materialize in 3Q08) as well as the expected award of further large contracts (Wierzchwice, metro in Warsaw, etc). Consequently, despite mediocre 2Q08E results outlook, we do not change our ST market-relative Overweight bias for PBG. We also keep our LT fundamental Hold rating intact.

Investment opinion

PBG constitutes probably the best vehicle to capture the growth in the influx of EU funds. Please note that the next three years should bring spending on environmental protection at a level of c. PLN 51 billion, and around half of that should constitute investments in sewage disposal and water protection, which drive the Company's results. We believe PBG should maintain its leading market position as far as the execution of environmental protection and hydro construction contracts is concerned. Moreover, entering the road construction business allows the Company to unlock additional value from realization of complex projects, in our view.

The high growth potential of the Company is reinforced by its M&A strategy. We believe this year should bring further acquisitions. It is likely that PBG will acquire PRG Metro, a company that should support PBG in the prospective construction of a second metro line in Warsaw, which we believe may prove value-accretive.

We like PBG's foreign expansion (Gas & Oil Engineering in Slovakia, Excan Oil and Gas Engineering in Canada) which, we believe, is the way to build a reference for foreign expansion once the flow of EU funds declines. We see numerous triggers on the horizon which should be supportive for the share price performance of PBG, mainly in the form of large tenders to be completed. This year should bring the completion of large tenders for an impressive c. PLN 6.9 billion (Wierzchowice, metro in Warsaw, stadiums). We believe that PBG is well-positioned to win at least one of them.

Drivers

- *1. Further M&A's.* The M&A-oriented strategy should be followed and bring further acquisitions this year. We believe that the next acquisition target could be a road-building company. Moreover, as Hydrobudowa Polska (PBG's 61% subsidiary) aims to take part in the construction of the second metro line in Warsaw (in a consortium with German Alpine Bau and Spanish FCC Construction), PRG Metro (a company that played a key role in construction of the first line) became an acquisition target (HBP has allready signed conditional agreements concerning purchase of 56.5% stake in the company).

- *2. Large tenders for c. PLN 6.9 billion to be completed this year.* This year should bring the completion of large tenders for an impressive c. PLN 5.6 billion. First, there is tender announced by PGNiG, which is to speed up its investment process (contract for the construction of an underground gas storage facility in Wierzchowice (PLN 1.0 billion)), Second, there is a contract for the construction of the second line of tube in Warsaw for the value of c. PLN 4.9 billion. Third, there are contracts for the construction of stadiums in Poznan and Wroclaw for the value of c. PLN 1 billion. We believe, PBG is well positioned to win at least one of them.

BASIC DEFINITIONS

A/R turnover (in days) = 365/(sales/average A/R))
Inventory turnover (in days) = 365/(COGS/average inventory))
A/P turnover (in days) = 365/(COGS/average A/P))
Current ratio = ((current assets – ST deferred assets)/current liabilities)
Quick ratio = ((current assets – ST deferred assets – inventory)/current liabilities)
Interest coverage = (pre-tax profit before extraordinary items + interest payable/interest payable)
Gross margin = gross profit on sales/sales
EBITDA margin = EBITDA/sales
EBIT margin = EBIT/sales
Pre-tax margin = pre-tax profit/sales
Net margin = net profit/sales
ROE = net profit/average equity
ROA = (net income + interest payable)/average assets
EV = market capitalization + interest bearing debt – cash and equivalents
EPS = net profit/ no. of shares outstanding
CE = net profit + depreciation
Dividend yield (gross) = pre-tax DPS/stock market price
Cash sales = accrual sales corrected for the change in A/R
Cash operating expenses = accrual operating expenses corrected for the changes in inventories and A/P, depreciation, cash taxes and changes in the deferred taxes

DM IDM S.A. generally values the covered non bank companies via two methods: comparative method and DCF method (discounted cash flows). The advantage of the former is the fact that it incorporates the current market assessment of the value of the company's peers. The weakness of the comparative method is the risk that the valuation benchmark may be mispriced. The advantage of the DCF method is its independence from the current market valuation of the comparable companies. The weakness of this method is its high sensitivity to undertaken assumptions, especially those related to the residual value calculation. Please note that we also resort to other valuation techniques (e.g. NAV-, DDM- or SOTP-based), should it prove appropriate in a given case.

Banks

Net Interest Margin (NIM) = net interest income/average assets
NIM Adjusted = (net interest income adjusted for SWAPs)/average assets
Non interest income = fees&commissions + result on financial operations (trading gains) + FX gains
Interest Spread = (interest income/average interest earning assets)/ (interest cost/average interest bearing liabilities)
Cost/Income = (general costs + depreciation + other operating costs)/ (profit on banking activity + other operating income)
ROE = net profit/average equity
ROA = net income/average assets
Non performing loans (NPL) = loans in 'substandard', 'doubtful' and 'lost' categories
NPL coverrage ratio = loan loss provisions/NPL
Net provision charge = provisions created – provisions released

DM IDM S.A. generally values the covered banks via two methods: comparative method and fundamental target fair P/E and target fair P/BV multiples method. The advantage of the former is the fact that it incorporates the current market assessment of the value of the company's peers. The weakness of the comparative method is the risk that the valuation benchmark may be mispriced. The advantage of the fundamental target fair P/E and target fair P/BV multiples method is its independence of the current market valuation of the comparable companies. The weakness of this method is its high sensitivity to undertaken assumptions, especially those related to the residual value calculation.

Assumptions used in valuation can change, influencing thereby the level of the valuation. Among the most important assumptions are: GDP growth, forecasted level of inflation, changes in interest rates and currency prices, employment level and change in wages, demand on the analysed company products, raw material prices, competition, standing of the main customers and suppliers, legislation changes, etc.

Changes in the environment of the analysed company are monitored by analysts involved in the preparation of the recommendation, estimated, incorporated in valuation and published in the recommendation whenever needed.

KEY TO INVESTMENT RANKINGS

This is a guide to expected price performance in absolute terms over the next 12 months:
Buy – fundamentally undervalued (upside to 12M EFV in excess of the cost of equity) + catalysts which should close the valuation gap identified;
Hold – either (i) fairly priced, or (ii) fundamentally undervalued/overvalued but lacks catalysts which could close the valuation gap;
Sell – fundamentally overvalued (12M EFV < current share price + 1-year cost of equity) + catalysts which should close the valuation gap identified.

This is a guide to expected relative price performance:
Overweight – expected to perform better than the benchmark (WIG) over the next quarter in relative terms
Neutral – expected to perform in line with the benchmark (WIG) over the next quarter in relative terms
Underweight – expected to perform worse than the benchmark (WIG) over the next quarter in relative terms

The recommendation tracker presents the performance of DM IDMSA's recommendations. A recommendation expires on the day it is altered or on the day 12 months after its issuance, whichever comes first. Relative performance compares the rate of return on a given recommended stock in the period of the recommendation's validity (i.e. from the date of issuance to the date of alteration or – in case of maintained recommendations – from the date of issuance to the current date) in a relation to the rate of return on the benchmark in this time period. The WIG index constitutes the benchmark. For recommendations that expire by an alteration or are maintained, the ending values used to calculate their absolute and relative performance are: the stock closing price on the day the recommendation expires/ is maintained and the closing value of the benchmark on that date. For recommendations that expire via a passage of time, the ending values used to calculate their absolute and relative performance are: the average of the stock closing prices for the day the recommendation elapses and four directly preceding sessions and the average of the benchmark's closing values for the day the recommendation expires and four directly preceding sessions.

LT fundamental recommendation tracker

Recommendation		Issue date	Reiteration date	Expiry date	Performance	Relative performance	Price at issue/ reiteration (PLN)	12M EFV (PLN)	
PBG									
Hold	–	*06.02.2008*	-	*Not later than 06.02.2009*	-15%	3%	281.60	319.00	–
-	→	-	*17.02.2008*	-	-	-	317.90	319.00	→
-	→	-	*21.02.2008*	-	-	-	326.70	352.00	↑
-	→	-	*30.03.2008*	-	-	-	325.00	358.00	↑
-	→	-	*14.04.2008*	-	-	-	311.00	357.00	↑
-	→	-	*29.04.2008*	-	-	-	302.80	361.00	↑
-	→	-	*15.05.2008*	-	-	-	315.00	361.00	→
-	→	-	*01.06.2008*	-	-	-	318.00	361.00	→
-	→	-	*29.06.2008*	-	-	-	268.00	356.00	↓
-	→	-	*08.07.2008*	-	-	-	238.00	348.00	↓

Market-relative recommendation tracker

Relative recommendation		Issue date	Reiteration date	Expiry date	Price at issue/ reiteration (PLN)	Relative performance
PBG						
Overweight	–	*06.02.2008*	-	*Not later than 06.02.2009*	281.60	3%
-	→	-	*17.02.2008*	-	317.90	-
-	→	-	*21.02.2008*	-	326.70	-
-	→	-	*30.03.2008*	-	325.00	-
-	→	-	*14.04.2008*	-	311.00	-
-	→	-	*29.04.2008*	-	302.80	-
-	→	-	*15.05.2008*	-	315.00	-
-	→	-	*01.06.2008*	-	318.00	-
-	→	-	*29.06.2008*	-	268.00	-
-	→	-	*08.07.2008*	-	238.00	-

Distribution of IDM's current recommendations

	Buy	Hold	Sell	Suspended	Under revision
Numbers	24	17	4	1	0
Percentage	52%	37%	9%	2%	0%

Distribution of IDM's current recommendations for companies that were within the last 12M IDM customers in investment banking

	Buy	Hold	Sell	Suspended	Under revision
Numbers	3	2	0	1	0
Percentage	50%	33%	0%	17%	0%

Distribution of IDM's current market relative recommended weightings

	Overweight	Neutral	Underweight	Suspended	Under revision
Numbers	19	20	6	1	0
Percentage	41%	43%	13%	2%	0%

Distribution of IDM's current market relative recommended weightings for the companies that were within the last 12M IDM customers in investment banking

	Overweight	Neutral	Underweight	Suspended	Under revision
Numbers	3	2	0	1	0
Percentage	50%	33%	0%	17%	0%

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