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Quarterly Results Preview

PBG

Sector: Construction
Fundamental rating: Hold (→)
Market relative: Overweight (→)
Price: PLN 192.1
12M EFV: PLN 305.0 (↓)

Market Cap.: US$ 973 m
Reuters code: PBGG.WA
Av. daily turnover: US$ 2.06 m
Free float: 67%
12M range: PLN 192.10-357.90

Quarterly results corner; 3Q08E preview

PBG is to release its 3Q08 financial positing on November 13. We expect the Company's quarterly numbers to be good, with material yoy growth of reported sales and profits. Such financial posting, however, should be in line with market's expectations; consequently, rather neutral market reaction may follow upon the release.

We believe that PBG's fat portfolio of environmental protection contracts should constitute the main driving force behind the Company's sales in 3Q08, which we forecast at PLN 508.5 million, 45% up yoy. Envisaged strong top line, together with expected material yoy growth of the Company's operating margin (we forecast it at 9.8% in 3Q08 vs. 6.8% in 3Q07) should translate into impressive (109%) growth of the Company's quarterly operating profit, which we forecast at PLN 49.7 million. We see a few reasons for the yoy operating margin improvement. First, in 3Q07 Hydrobudowa Polska, the Company's 61%-owned subsidiary, finalized the 'Kraków Płaszów' contract which caused margin erosion in the base period ('Kraków Płaszów' was a long-term contract for the construction of a sewage treatment plant on which HBP booked c. PLN 12 million of additional costs in 3Q07). Second, we forecast falling share of overhead costs in the Company's quarterly sales (such trend has been visible in PBG's results for past couple of quarters). Third, in 3Q08 PBG is likely to recognize profits from FX in its gross profit on sales line, whereas in the base period they had been booked by the Company below the operating profit level (as financial gain). Fourth, the Company's poor financial posting for the base period stemmed from material yoy increase of construction material prices and salaries during 1-3Q07, which was not the case this quarter, we believe.

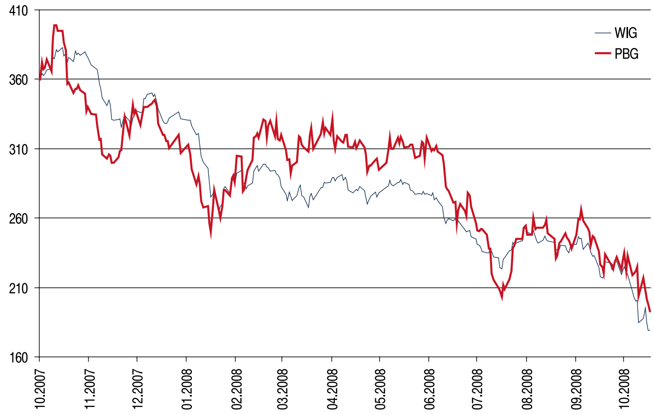
At the 3Q08 pre-tax and at the bottom line we expect 'only' 49% and 38% yoy growth, respectively, which might be attributed to: (i) growing minorities' share in the Group's profits (please note that majority of 'water' contracts are executed by Hydrobudowa Polska, which is a 61% subsidiary of PBG), and (ii) yoy hike of financial costs, due to yoy increase of PBG's net debt and growing cost of debt financing (please note that in 2Q08 PBG booked financial costs of PLN -20.2 million vs. PLN -8 million in 2Q07). We forecast the Company's quarterly pre-tax profit and the net profit at, respectively, PLN 44.7 million and PLN 25.5 million. Summing up, PBG's 3Q08 results should came out strong with impressive yoy increase of the operating profit, which – however – is unlikely to surprise the market (please refer to *Figure 1* on the next page, regarding the details of our forecast).

Key data

IFRS consolidated		2007	2008E	2009E	2010E
Sales	*PLN m*	1,377.3	2,110.0	2,692.4	3,559.4
EBITDA	*PLN m*	136.3	269.6	361.1	509.2
EBIT	*PLN m*	106.3	240.1	329.4	475.9
Net profit	*PLN m*	101.8	151.2	206.0	307.9
EPS	*PLN*	7.58	11.26	15.34	22.92
EPS yoy chng	*%*	68	49	36	49
Net debt	*PLN m*	257.4	531.5	533.5	551.6
P/E	*x*	25.3	17.1	12.5	8.4
P/CE	*x*	19.6	14.3	10.9	7.6
EV/EBITDA	*x*	20.8	11.5	8.6	6.1
EV/EBIT	*x*	26.7	13.0	9.5	6.6
EV/Sales	*x*	2.1	1.5	1.2	0.9
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 3Q08 results: November 13, 2008

Catalysts

1. Signing new large environmental protection and specialist construction contracts (e.g. waste incineration plant in Poznań and Kraków for the value of c. PLN 1.1 billion)
2. Signing contracts related to EURO 2012 (e.g. stadium in Poznan for c. PLN 550 million)

Risk factors

1. FX exposure (most of environmental protection contracts are EUR-denominated)
2. Prolonging administrative procedures may negatively affect smooth absorption of EU funds' inflow by investors (public sector)
3. Hike of financial costs

Financial forecast

We have revised our financial forecast for PBG, due to (i) strong contract portfolio (positive impact), (ii) higher financial costs (negative impact), and (iii) growing minorities' interest in the Company's profits (negative impact). Consequently, our EBIT forecast goes up by c. 8-13% for years 2008-2011

Please note that the figures have been removed from this publication intentionally.

and by <4% beyond 2011, while the NP forecast increases by 1-6% for the 2008-2010 period, yet declines by c. 4-6% beyond. Regarding the details, please refer to *Figure 2* above.

Valuation

Due to growing post-2010E minority interest in the Company's profits and an upward adjustment of risk-free rate assumption (to the current level of LT Treasuries market yield), our 12M EFV for PBG goes down by 11% to PLN 305 per share (from PLN 348 per share).

Recommendation

We keep our LT fundamental Hold recommendation for PBG, as the Company's equities are still priced with a premium to the peers (which we deem, however, justified), despite material decline of the share price of PBG in recent time. Given the Company's short-term outlook, we see a few triggers, mostly in the form of: (i) large contracts, which are – the way we see it – likely to be won by PBG (waste incineration plants in Kraków and Poznań of the value of c. PLN 1.1 billion, lucrative gas contracts which are likely to be released by KRI, stadiums) and (ii) possible upward adjustment of the management FY08 financial forecast.

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 or next year should bring further acquisitions. 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.

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*	-32%	14%	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*	-	-	-	318.00	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	↓
-	→	-	*28.07.2008*	-	-	-	245.00	348.00	→
-	→	-	*04.08.2008*	-	-	-	248.00	348.00	→
-	→	-	*31.08.2008*	-	-	-	238.00	348.00	→
-	→	-	*28.09.2008*	-	-	-	232.00	348.00	→
-	→	-	*19.10.2008*	-	-	-	192.10	305.00	↓

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	14%
-	→	-	*17.02.2008*	-	317.90	-
-	→	-	*21.02.2008*	-	326.70	-
-	→	-	*30.03.2008*	-	325.00	-
-	→	-	*14.04.2008*	-	311.00	-
-	→	-	*29.04.2008*	-	318.00	-
-	→	-	*15.05.2008*	-	315.00	-
-	→	-	*01.06.2008*	-	318.00	-
-	→	-	*29.06.2008*	-	268.00	-
-	→	-	*08.07.2008*	-	238.00	-
-	→	-	*28.07.2008*	-	245.00	-
-	→	-	*04.08.2008*	-	248.00	-
-	→	-	*31.08.2008*	-	238.00	-
-	→	-	*28.09.2008*	-	232.00	-
-	→	-	*19.10.2008*	-	192.10	-

Distribution of IDM's current recommendations

	Buy	Hold	Sell	Suspended	Under revision
Numbers	18	25	3	1	0
Percentage	38%	53%	6%	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	2	3	0	1	0
Percentage	33%	50%	0%	17%	0%

Distribution of IDM's current market relative recommended weightings

	Overweight	Neutral	Underweight	Suspended	Under revision
Numbers	18	18	10	1	0
Percentage	38%	38%	21%	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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