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Special Comment

BRE Bank Securities

Construction

Poland

PBG

PBG PW; PBGG.WA

Buy

(Reiterated)

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Controlled Temporary Increase in Net Debt

Current price: PLN 95.2; Target price: PLN 152.4

PBG's second-quarter earnings were in line with our expectations at the operating level and higher than them at the bottom line. The latter feat is a result of higher-than-expected financing income (PLN 3.4m vs. -PLN 3.4m forecasted) and lower-than-expected tax (effective tax rate = 12.9%). At the conference for investors, PBG spent most of the time on a discussion of the increase in the Group's debt and we would like to focus on this issue as well here. Operating cash flows amounted to –PLN 376.3m in H1 2011, and to –PLN 195.0m in Q1 alone. Net debt, including leasing and bonds, amounted to PLN 1.33bn at the end of Q2. Should this debt level persist through the end of the year, the risk would appear that loan covenants would be exceeded slightly (net debt / EBITDA <3.5 for all bank loans). We believe that the Group's debt will decline by the end of the year, despite the acquisition of Rafako planned for Q4. Our net debt forecast for the end of the year, including the Rafako takeover, is PLN 1067.8m (net debt / EBITDA = 2.9, which is close to PBG's own target). PBG expects that its cash flows from operations will improve thanks to operating activities, but also divestments. All in all, operations could reduce debt by PLN 883.7m, and divestments by PLN 576.4m. The impact of some of these actions will be visible already in Q3-Q4 2011, and of others not until 2012/2013. The factors that may lead to net debt reduction in the future have been described in detail below. We do not assume any divestments in our forecasts. We expect that cash flows from operating activities will be close to zero in Q3'11. A greater improvement is possible in Q4'11, at the same time when the payment for the stake in Rafako falls due. The improvement will continue in 2012. PBG has rightfully decided to incur the risk of a temporary increase in debt in order to build Poland's most competent power-plant construction group. We stand by our forecasts and buy rating.

Expected changes to PBG's net debt

Item	Value (PLN m)	Timeline
Current debt and debt after Rafako acquisition		
Net debt as of the end of Q2 2011	1 331.2	-
Impact of Rafako acquisition on consolidated net debt	496.3	-
Net debt after the acquisition	**1 827.5**	**-**
Improvement in cash flows from operating activities		
Reversal of negative cash flows from road construction contracts	265.0	Mostly Q4 2011. also Q3 2011 i Q1 2012
Overdue payment for Baltic Arena	80.0	Q3/Q4 2011 (invoicing in September 2011)
Reurn of loan security deposit	38.0	Q3 2011 (has already happened)
Payables from local authorities	100.0	n/a (settlement or litigation)
Zeroing of loans to investors	264.3	Q3 2011 - 2012 (gradually q/q)
"Year-end effect"	196.5	Q4 2011
Growth in power plant construction. reduction of road construction activities	-	2013
Total	943.3	
Net debt	**883.7**	
Disinvestments		
Skalar office building	120.0	H1 2011 / 2012
Strateg Capital	280.0	H1 2011 / 2012
Home sales adjusted for future construction outlays	131.4	H1 2011 - H1 2013
Land in Bydgoszcz	45.0	H1 2012 - 2013
Total	576.4	
Net debt	**307.8**	

Source: BRE Bank Securities, PBG

Acquisition of Rafako: A PLN 496.3m increase in net debt

We estimate that the acquisition of Rafako will boost PBG's net debt by PLN 496.3m. We estimate the cost of the 65.8% stake at PLN 699.3m, including PLN 42m already spent on the acquisition of a 5.03% at a price of ca. PLN 12/share. The remaining components of the total is the cost of the purchase of a 49.92% stake at PLN 15.54 per share (PLN 539.9m) and the cost of the purchase of a 10.85% stake in the tender offer at PLN 15.54 apiece (PLN 117.4m). The assumption that a tender offer for a 10.85% stake will be made at PLN 15.54 per share is a conservative one (the Company might be able to buy more shares earlier at market prices). PBG maintains that bank financing for the transaction has already been secured. Neither PBG nor Elektrim can withdraw from the Rafako transaction without risking a PLN 100m penalty.

Reversal of negative cash flows on road construction contracts

In H1'11, PBG generated negative cash flows of –PLN 265m on road construction contracts, including
-PLN 200m on the contract for the construction of a stretch of the A4 motorway (Hydrobudowa Polska), and
-PLN 65m on the contract for the construction of a stretch of the A1 motorway (Aprivia)

The source of the negative cash flows are payment terms, which allow for invoicing only after certain "milestones" have been reached. Subcontractors, however, provide cheap services only when they are paid quickly, often as soon as within 10-15 days. A similar effect can be observed for all infrastructural companies at the moment, i.e. Budimex, Polimex Mostostal, Mostostal Warszawa, ZUE. These payment terms, to which the General Directorate for National Roads and Motorways (GDDKiA) has been sticking very closely, are also a reflection of the GDDKiA's heavy spending and the situation of Poland's national budget.

After Covec withdrew from the construction of two motorway stretches, the GDDKiA has started to make payments earlier, and construction companies have noted this change. According to PBG, road construction outlays and inflows will not balance until Q1 2012. Nonetheless, cash flows in H2 should be much higher than the costs incurred in the period. Moreover, cash flows may increase at the end of Q4'11 ("year-end effect").

Payment of overdue receivables for Baltic Arena

PBG has ca. PLN 80m in unpaid receivables for the Baltic Arena stadium in Gdańsk. An agreement with the investor has already been reached (the source of the dispute was a two-week delay in completion). In September, PBG will issue an invoice for the full amount. It should receive the funds in late Q3 or early Q4.

Loan security deposit

In Q2 2011, PBG recorded a PLN 38m outflow due to the need to provide loan security. The funds have already been returned to PBG.

Contract receivables from local authorities

At the conference for investors, the CEO added that PBG had ca. PLN 100m worth of disputed receivables on contracts for big cities. According to him, 100% of work was paid for with 60% of the price. The CEO hopes that a settlement is possible, as the other option is litigation. In the past few months, ZUE was able to successfully overcome a similar problem.

Zeroing loans to investors

In order to improve contract margins, PBG has been granting loans to investors. At the end of Q2 2011, they amounted to PLN 264.3m. The objective is to materially reduce this figure. The loans are to be repaid in H2 2011 and in 2012. In Q2 2011, PBG granted loans for a total of PLN 25m, while PLN 33m worth of loans was paid back.

"Year-end effect"

Towards the end of each year, investors tend to make earlier payments in order to spend the money budgeted for the year. This can be seen clearly in both the public and the private sectors. In Q4 2010, PBG's consolidated cash flows amounted to +PLN 262m. Assuming that Q4'11 cash flows amount to 75% of last year's flows, this gives a total of PLN 196.5m additional net cash.

Growth in power-plant construction, declining importance of road construction

We reiterate the view that the impact of big power-plant construction contracts could be the exact reverse of the effect of big road contracts. Road contracts generated weak margins and weak cash flows. Power plant contracts could provide strong earnings and cash flows. By way of example, the contract for the Opole power plant foresees a 10% advance for the contractor. If PBG were Alstom's subcontractor and was responsible for PLN 2.5bn worth of work (in accordance with its declaration), it could receive an advance of PLN 250m. Of course, we cannot be sure that the advance would be precisely this high, because PBG will not be the unit's general contractor. Most likely, it would be in the position to negotiate with Alstom (higher margins and slower cash flows, or the converse). Both power utilities and Alstom have surplus liquidity.

The road construction segment, in turn, could lose importance, because PBG is considering gradually phasing out the expressway and motorway construction business. Most likely, in the future it will limit itself to local roads.

Office building sale

PBG says it wants to sell its "Skalar" office building in Poznań. We estimate the value of the property, which has a leasable area of 14,200 square meters, at PLN 120.0m (based on the assumption of EUR 13/sqm monthly rental rates and 7% yield). We believe the building will soon reach a 70% occupancy rate. The timing of its sale and the resulting cash inflows (the payment may be divided into installments) will probably depend on the rate at which the spaces are leased. We expect the sale to take place in late 2011 or early 2012.

Sale of Strateg Capital

PBG says it wants to sell its construction aggregate mining company Strateg Capital as a way of recovering costs (PLN 130m) and reducing debt by the amount of Strateg's debt (PLN 150m), resulting in a total debt reduction by PLN 280m. We expect the sale to be finalized some time in 2012.

Housing sales

We estimate PBG's profits from sales of housing developments at PLN 131.4m (PLN 200.4m revenue less PLN 68.9m building costs). The profits will be received gradually as construction progresses. The most lucrative of PBG's residential projects, expected to bring in nearly PLN 100m, is located in Kiev, Ukraine. The inflow of revenues from these projects will be preceded by cash inflows from buyer advances.

Forecast of residential real estate profits and costs (PLN m)

	Revenue			COGS		
Project	**2011**	**2012**	**2013**	**2011**	**2012**	**2013**
Złotowska 51	17.6			12.7		
Dolina Potęgowska Stage I	16.4			14.5		
Quadro House		15.5	15.5		12.0	12.0
Residential estate E1			31.3			37.4
Ministerski Projekt Mieszkaniowy E1	15.6	73.0	15.6	11.8	55.1	11.8
Total	**49.6**	**88.4**	**62.4**	**39.0**	**67.1**	**61.2**

Source: BRE Bank Securities

Land sale

PBG owns a land property in Bydgoszcz zoned for a retail establishment with a leasable area of ca. 61,000 square meters. The property cost PLN 45m, and we believe it can be sold for a comparable price. However, PBG is holding off the sale until it obtains building permits, after which it will probably be able to get a higher price.

Other divestments and savings

PBG's other planned savings measures include about 250 job cuts at Hydrobudowa Polska expected to generate monthly fixed-cost savings of approximately PLN 600-700 thousand. Moreover, PBG wants to reorganize the real estate holdings of Energomontaż Południe (by moving the company's HQ to another location and selling the office building in Katowice).

PBG posts in-line Q2 2011 results

PBG's Q2 2011 results came in line with expectations. On a higher-than-forecasted revenue and a lower-than-expected gross margin (11.3% vs. 13.3% because of the General Construction segment), the company generated in-line gross profit and EBIT figures. Other operating expenses were in line, and other net financing income amounted to PLN 3.4m (we expected PLN 3.4m expenses). After a low tax (the effective tax rate was 12.9%), the bottom-line profit came ahead of our estimate.

An operating cash flow of a negative PLN 181.3m came as no surprise after an earlier Q2 earnings release of subsidiary Hydrobudowa. According to PBG's Management, the negative OCF of PLN 376.3m generated in the first half of 2011 was due mainly to Hydrobudowa's 'A4' motorway contract (PLN -200m) and Aprivia's 'A1' motorway contract (PLN -65m).

PBG's YTD order backlog for 2012 and later years is worth about PLN 3.3bn. The company reported some insignificant changes in provisions resulting in a PLN 0.9m increase in the overall balance (a PLN 5.0m increase in performance bond provisions, a PLN 3.5m increase in provisions for contract losses, offset by a PLN 7.5m reduction in other provisions).

Reported vs. forecasted Q2 2011 results

(PLN m)	2Q 2011	2Q 2011F	difference	Consensus	difference	2Q 2010	change
Revenue	979.2	842.8	16.2%	832.0	17.7%	729.3	34.3%
Gross profit	110.5	112.1	-1.5%	-	-	112.0	-1.4%
%	*11.3%*	*13.3%*	-	-	-	*15.4%*	-
EBIT	81.7	79.0	3.5%	78.5	4.1%	73.9	10.6%
%	*8.3%*	*9.4%*	-	*9.4%*	-	*10.1%*	-
Pre-tax profit	85.1	75.5	12.7%	-	-	74.1	14.8%
Net profit	73.5	59.9	22.7%	57.2	28.4%	62.5	17.5%
%	*7.5%*	*7.1%*	-	*6.9%*	-	*8.6%*	-

Source: PBG, F - forecasts by BRE Bank Securities, Consensus estimates by PAP

Q1 and Q2 results by operating segment

(PLN m)	Q2 2011			Q1 2011		
	Revenue	Gross Profit	Margin %	Revenue	Gross Profit	Margin %
Gas & Oil Engineering	310.7	62.7	20.2%	144.9	26.8	18.5%
Hydroengineering	158.1	22.7	14.3%	71.1	15.2	21.4%
General Construction	237.4	7.8	3.3%	134.0	10.1	7.6%
Road Construction	254.1	12.6	5.0%	123.1	1.9	1.5%
Other	19.0	4.6	24.4%	4.5	1.3	29.0%
Total	979.2	110.5	11.3%	477.6	55.3	11.6%

Source: PBG, BRE Bank Securities

Note that PBG has made adjustments to its 2010 earnings figures including an equity reduction by PLN 13.8m EBIT lowered by PLN 11.1m, and net profit slashed by PLN 33.9m. The adjustments to pre-tax profit stemmed from recognition of a PLN 5.6m provision for contract losses, reclassification of a derivative from equity to income (PLN 22.1m), and a revision to the annual earnings of subsidiary Energomontaż Południe (PLN 5.4m).
The contract provision was booked disappointingly late, but the other adjustments are of non-cash nature.

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List of abbreviations and ratios contained in the report.
EV *– net debt + market value (EV – economic value)*
EBIT *– Earnings Before Interest and Taxes*
EBITDA *– EBIT + Depreciation and Amortisation*
PBA *– Profit on Banking Activity*
P/CE *– price to earnings with amortisation*
MC/S *– market capitalisation to sales*
EBIT/EV *– operating profit to economic value*
P/E *– (Price/Earnings) – price divided by annual net profit per share*
ROE *– (Return on Equity) – annual net profit divided by average equity*
P/BV *– (Price/Book Value) – price divided by book value per share*
Net debt *– credits + debt papers + interest bearing loans – cash and cash equivalents*
EBITDA margin *– EBITDA/Sales*

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