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Special Comment

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SWG PW; SWGR.WA

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Results for Q3 2011

Current price: PLN 32.27

In Q3 2011, Seco/Warwick posted record-strong revenue and EBIT results. A clear improvement was observed in all segments, and Retech LLC was the only subsidiary that failed to increase revenues. At the operating level, the Company benefitted from the depreciation of the PLN and the BYR (Belarusian ruble) to the EUR and the USD (which boosted the margins of SW S.A. and ThermAL, respectively). In addition, an operational leverage effect was observed thanks to the strong order backlog at the onset of the year (PLN 233.4m). Q4'11, which is seasonally the strongest quarter for the Company, looks good as well: at the end of Q3'11, the order backlog amounted to PLN 239.4m. Moreover, SW S.A. and ThermAL will continue to benefit from the depreciation of the local currencies to the EUR and the USD. According to our estimates, even after an impairment charge on the fixed assets of SW Tianjin (USD 0.4m), FY 2011 sales could reach PLN 397.9m, with the operating profit at PLN 44.3m and the net profit at PLN 30.2m. On the other hand, our estimates show that since its WSE debut, the price of the Seco/Warwick stock has been closely correlated with the Company's order backlog reports. Durable goods orders are determined by expectations with regard to future economic situation. According to our estimates, the IMS US index (for orders) and PMI EU are 6M leading indicators of the size of Seco/Warwick's order backlog. We expect a smaller order backlog in the upcoming months, which, despite strong current results, will be treated as a signal to sell. In combination with the low liquidity of the stock (the average turnover volumes in the past three months amounted to PLN 0.26m), this could lead to a plunge in its value. According to preliminary estimates, the Company is currently trading at FY11 P/E of 11.1 and EV/EBITDA of 7.1. We believe that at such relatively high multiples, Seco/Warwick is a risky investment. Therefore, we would recommend withholding purchases, or even disposing of the shares.

2011 Q3 results

Seco/Warwick's Q3 2011 revenue amounted to PLN 110.5m, representing an increase of 105.2% relative to the same period a year ago. This strong revenue growth was the consequence of the expansion of the order backlog since the start of the year on the one hand, and of the takeover of Retech in December 2010 on the other (sales would have been PLN 91.3m lower in Q1-Q3 2011 had it not been for the acquisition of the remaining 50% in the subsidiary). In Q3'11, the fastest growth was observed for melting furnaces (+836.7% y/y), aluminum processing (+439.2% y/y) and the CAB line (+54.0% y/y). Sales of vacuum furnaces increased by 17.6% y/y. Revenues increased the fastest for ThermAL (formerly Eltherma, +103.7% y/y), Seco/Warwick Corp. (+82.7% y/y) and Seco/Warwick S.A. (+34.3% y/y). Retech LLC was the only subsidiary to see a reduction in sales (by 15.4% y/y) as some of the contracts were shifted onto future quarters (in late 2010, Retech's order backlog was at a two-year high of PLN 121.4m).

Summary of Q3 2011 results

(PLN m)	3Q'10	3Q'11	Change	1-3Q'10	1-3Q'11	Change
Sales revenues	53.9	110.5	105.2%	118.8	265.3	123.3%
Vacuum furnaces	24.0	28.3	17.6%	48.0	55.0	14.7%
CAB	5.4	8.3	54.0%	10.2	21.0	105.3%
Atmosphere furnaces	16.6	29.8	80.2%	40.2	65.7	63.6%
Aluminum process	1.6	8.6	-	2.4	18.8	-
Melting furnaces	2.8	26.6	-	4.8	80.8	-
Unallocated items	3.4	8.8	159.7%	13.3	23.9	79.9%
EBIT	4.3	21.8	410.4%	-3.4	23.7	-
EBIT margin	*7.9%*	*19.7%*	-	*-2.9%*	*8.9%*	-
EBITDA	5.5	23.3	325.5%	0.2	28.3	-
EBITDA margin	*10.2%*	*21.1%*	-	*0.2%*	*10.7%*	-
Net profit	4.0	13.3	235.1	0.1	14.4	-

Source: Seco/Warwick; BRE Bank Securities

In Q3'11, consolidated operating profit amounted to PLN 21.8m, i.e. four times the figure recorded in the same period of the preceding year. The Management had promised an improvement in operating margins upon publication of H1 results (during that period, the Company closed the low margin nuclear energy contracts of Seco/Warwick S.A.) In September, operating income was further boosted by the depreciating PLN (by 18.4% vs. the USD and by 10.7% vs. the EUR) and BYR (by 10.3% to the USD and by 13.3% to the EUR).

At the financing level, the Company posted a PLN 3.8m loss on the valuation of derivatives used to hedge cash flows. Altogether, net financing expenses amounted to -PLN 3.4m.

Net profit amounted to PLN 13.3m (+235.1% y/y). The companies that recorded a clear improvement in earnings were SW S.A. (PLN 6.3m, +57.5%), Retech LLC (PLN 1.6m vs. -PLN 0.3m loss in Q3'10) and ThermAL (PLN 6.8m, +423.1% y/y). Seco/Warwick Corp broke even in Q3'11 (vs. -PLN 0.8m in Q3'10), and SW Allied (India) saw a loss on a par with Q3'10 (-PLN 1.1m). SW Retech (China) doubled the loss posted for H1'11 (-PLN 0.6m).

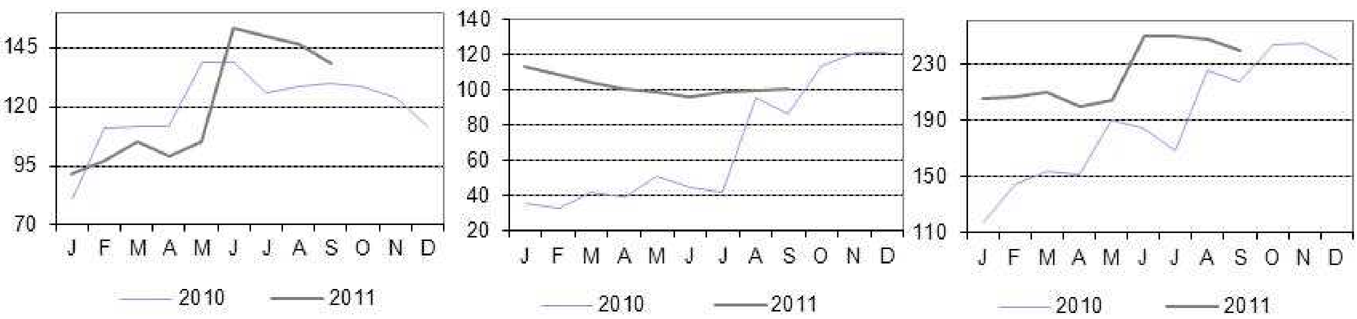
Among the important events of Q3’11, it is worth noting the clear improvement in the margins of SW S.A. and ThermAL following the depreciation of the local currencies to EUR and USD (the companies' net margins amounted to 15.2% and 20.6%, respectively). An additional improvement in ThermAL's margins was a consequence of the restructuring process that the Company had been undergoing since the start of the year (reduction in selling, general and administrative and other efforts). Retech LLC undershot the Management’s expectations as work on newly-won contracts started with (4.8% net margin in Q3'11 vs. 7.7% in Q2'11 and -0.8% in Q3'10). Seco/Warwick Corp. continued with the Phoenix turnaround program (the Company broke even after the initial three quarters of the year vs. -PLN 3.8m loss in Q1-Q3 2010). In the near future, Seco/ Warwick Corp is planning to hire new employees, expand its network of agents and increase its activity in the market. The margins of SW Allied in Q3’11 were negatively impacted by increased depreciation expenses (acquisition of office spaces) and by losses on waste utilization contracts (the Management has decided to reexamine the prospects of this business line).

As of the day of publication of the report for Q3’11, Seco/Warwick has not received the payment for a 50% stake in SW Tianjin sold to a Chinese partner for USD 600k. In the view of this delay, a court motion is being prepared for the subsidiary to be dissolved. In such a case, the Group will have to book a USD 400k impairment charge (the Chinese partner has paid USD 200k so far). The Management is yet to decide whether the charge is to be booked in Q4’11 or in 2012.

Order backlog

The Group's order backlog currently amounts to PLN 239.4m, inclusive of Retech LLC which was acquired in late 2010 (PLN 101m). It should be noted, however, that the figure does not include contracts acquired by Seco/Warwick Allied, which totaled PLN 97.2m at the end of Q3'11.

2010 and 2011 order backlog for SW S.A., SWC, SWT, SW China (L), Retech LLC (M) and Seco/Warwick Group ex. SW Allied (R) (PLN m)



Source: Bloomberg; Seco/Warwick; BRE Bank Securities

Outlook for the following quarters

Including Retech LLC, Seco/Warwick's order backlog as of the end of Q3'11 is at the second-highest level ever (it was equally high in October-November 2010). Moreover, the fourth quarter tends to be the strongest season for margins and sales, and the Company will continue to benefit from the weakness of the PLN and the BYR to the USD and the EUR throughout the quarter (in Q3, the effect was chiefly visible in September). According to our preliminary estimates, the Company could record as much as PLN 15.9m in net profit in the quarter (taking into account a USD 400k impairment charge for the assets of SW Tianjin). If so, FY11 multiples amount to 11.1 (P/E) and 7.1 (EV/EBITDA).

Overview of FY 2011 results

(PLN m)	1Q'11	2Q'11	3Q'11	4Q'11F	2011F
Sales revenues	70.7	84.0	110.5	132.6	397.9
Operating profit	0.3	1.6	21.8	20.6	44.3
margin	*0.5%*	*1.9%*	*19.7%*	*15.5%*	*11.1%*
Net profit	-0.5	1.6	13.3	15.9	30.2
margin	*-0.7%*	*1.9%*	*12.0%*	*12.0%*	*7.6%*

Source: Seco/Warwick,, BRE Bank Securities

If Seco/Warwick keeps its order backlog at this level in the ensuing quarter, it should be able to continue improving its earnings in the following year. The Management does not expect the problems with the margins on contracts for power utilities observed in H1'11 to recur in H1 2012, which means that the low base of H1’11 would spur fast profit growth in H1’12.
In Q4’11, the Company is facing a high y/y base of comparison due to a one-off effect stemming from the acquisition of Retech LLC (+PLN 11.3m negative goodwill). Whole we expect the Company to beat its Q4’10 results with regard to revenues, operating profit and EBITDA, last year’s high base may prevent net income from growing.

Overview of Q4 2011 results

(PLN m)	4Q'11F	4Q'10	Change
Sales revenues	132.6	73.0	81.6%
Operating profit	20.6	8.2	150.1%
margin	*15.5%*	*11.3%*	-
Net profit	15.9	18.1	-12.4%
margin	*12.0%*	*24.8%*	-

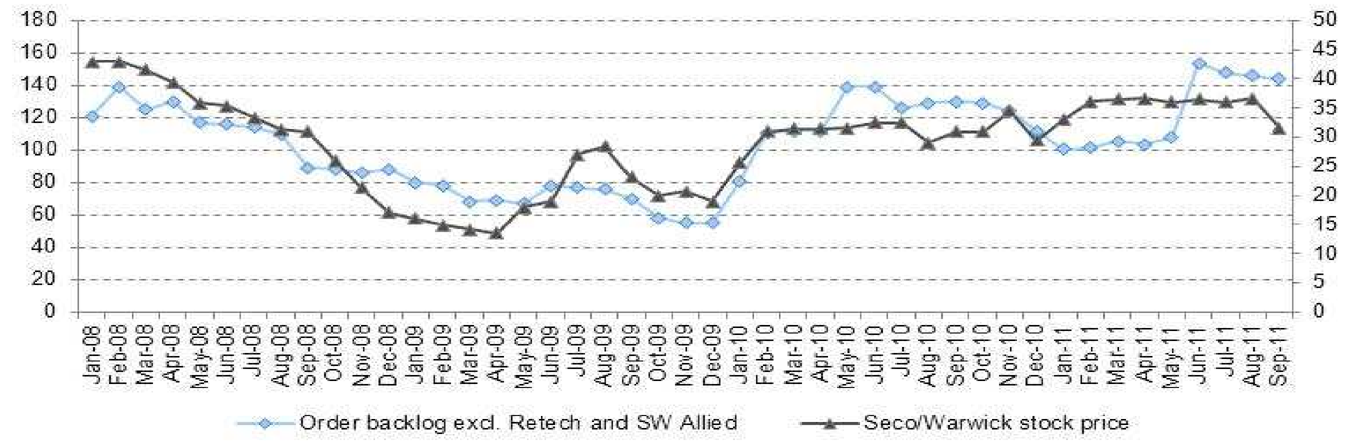
Source: Seco/Warwick; BRE Bank Securi-

Perfect correlation between stock price and order backlog

However, the outlook for operating earnings improvement in Q4'11 and H1'12 may not be enough to send the stock rallying. According to our estimates, since the start of 2008 (i.e. since listing) the Company's order backlog (excluding Retech LLC and SW Allied) has been a perfect leading indicator for the stock price.

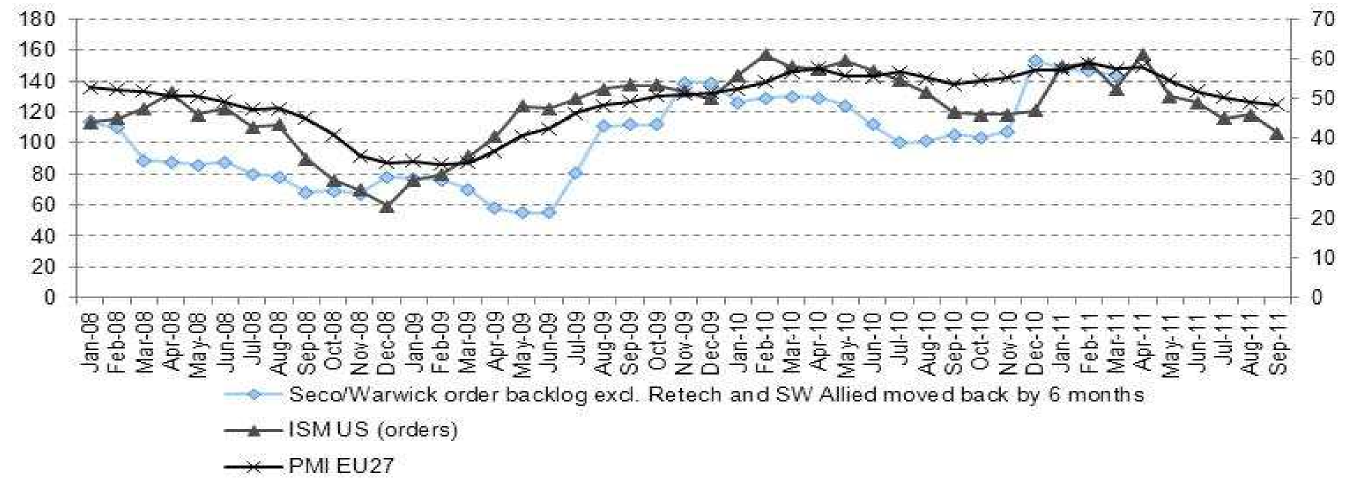
When production companies face shrinking orders, sooner or later they decide to cut investment. According to our estimates, there is a perfect correlation between Seco/Warwicks order backlog moved back by 6 months and the leading indicators of sentiment in manufacturing. Thus, in the following months Seco/Warwick's order backlog should shrink as leading indicators fall. In this case, it is highly likely that despite good earnings, investors will decide to sell the stock in expectation of a deterioration in future results. Given the low liquidity (the average daily turnover in SW shares over the past three months has been PLN 0.26m), a relatively strong decline in share price cannot be ruled out.

Seco/Warwick order backlog (excl. Retech LLC and SW Allied, PLN m, left scale) and share price (PLN, right scale)



Source: Bloomberg; Seco/Warwick; BRE Bank Securities

Seco/Warwick order backlog (excl. Retech LLC and SW Allied) moved back by 6 months (PLN m; left scale) vs. ISM US (orders) and PMI EU27(pts; right scale)



Source: Bloomberg; Seco/Warwick; BRE Bank Securities

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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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HOLD – we expect that the rate of return from an investment will range from –5% to +5%
REDUCE – we expect that the rate of return from an investment will range from -5% to -15%
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