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Special Comment

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Construction

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'Polish Consortium' Awarded Opole Power Plant Project

PGE picked the bid submitted by the "Polish consortium" comprising Rafako. Polimex Mostostal and Mostostal Warszawa in the tender for the construction of two power generation units at the Opole power plant. Alstom Power's bid was rejected for formal reasons. This comes as a major surprise to us: we expected that, being the lowest bidder, Alstom would win the contract. The value of the "Polish" bid was PLN 9,397m, and Alstom Power's was slightly lower (PLN 9,378m). The allocation of work to individual consortium members is yet to be decided; our estimates are presented below. If Rafako, Polimex and Mostostal Warszawa are the general contractors on the project, our 2013+ revenue and earnings forecasts for them may need an upward revision. It should be remembered that the contract has not been signed yet, and that Alstom can appeal, first to PGE and then to the National Chamber of Appeals. These procedures could last until January, which makes Q1 2012 a realistic timing for the signing of the contract. PGE's example might strengthen the resolve of other utilities with regard to investing. We reiterate our view that all the major contracts where the bidding procedures are at an advanced stage will end up awarded. In addition, the outlook for the construction industry is good in such areas as waste incineration plants (big cities, PLN 3.3bn), gas pipelines and installations (including PLN 3.3bn worth of LNG terminal infrastructure), power networks (investment set to double from under PLN 0.8bn to nearly PLN 1.6bn).

Comparison of bids for Opole project

(PLN m)	Gross price	Net price	MW	EUR/MW
Alstom	11 441	9 378	1 800	1.31
Rafako, Polimex, Mostostal	11 558	9 397	1 800	1.32

Source: BRE Bank Securities, companies

What might the margin be?

Our preliminary, conservative gross margin projection for the contract is 10%. In practice, the margin will be reviewed as design work scheduled for 2012 progresses, and then as the actual contract work does.

A portion of the margin will not be recognized until contract completion, depending on whether the technical risks assumed in the budget materialize or not. The general contractor is responsible for the technical parameters of the unit. If all goes smoothly, the margin may turn out to be much higher, e.g. 20%.

Change in construction costs: risks and opportunities

The price in the contract is CPI-linked, which reduces the risks stemming from a possible increase in construction costs. Two scenarios are possible:

a) an economic revival and/or inflation growth driven by monetary expansion, sharp increases in commodity prices, construction costs outpacing the consumer price index – the margin on the contract goes down;
b) economic slowdown in the EU and USA, declining investment outlays in China, declining demand for commodities; PPI grows below CPI and the margin on the contract goes up.

Allocation of work to consortium partners

The CEO of Polimex Mostostal estimates that Polimex may get a 42% share of the work on the contract (PLN 4bn), with 34-35% going to Rafako (PLN 3.2-3.3bn) and 23-24% to Mostostal Warszawa (PLN 2.2-2.3bn). We consider this declaration premature, since the precise allocation of the work has not been determined yet. All that is known is that Rafako will be responsible for the boiler island, Polimex for the mechanical section and Mostostal Warszawa for coal supply facilities. A lot of the work could be done either by Polimex Mostostal, or by Mostostal Warszawa (e.g. water installations).

Individual work areas were priced separately, which means that, for example, Rafako could generate a higher margin on the boiler portion than Polimex on the mechanical portion, or vice-versa. In addition, subcontracting for other consortium members is possible – for example, Mostostal Warszawa's subsidiary Remak could assemble the pressure part of the boiler for Rafako. The PLN 4bn figure cited by the CEO of Polimex could include subcontracting work and supplies to other consortium members.

Our preliminary estimates had Rafako perform 35-40% of the work at the general contracting level, with 35% going to Polimex Mostostal and 25-30% to Mostostal Warszawa.

It is worth noting that the contract, if signed, will have the biggest impact on Rafako, given the companies' revenues and order backlogs.

Value of the Opole contract vs. revenues, order backlogs

(PLN m)	Share of the work	Value	Share of work / 2011 revenues	Order backlog	Value of work / order backlog
Rafako	37.5%	3 552.7	318%	1 800.0	197%
Polimex Mostostal	35.0%	3 315.8	73%	8 700.0	38%
Mostostal Warszawa	27.5%	2 605.3	92%	3 400.0	87%

Source: BRE Bank Securities, companies

Impact of the contract award on earnings forecasts:

a) Rafako

Our most recent model for Rafako factors in a scenario whereby the company provides PLN 1.8bn worth of subcontracting work to Alstom. If Rafako is a general contractor instead, it could be able to generate higher earnings in 2013 and beyond; in 2013/2014, our revenue forecast may be beaten by PLN 350m.

b) Polimex Mostostal

Our valuation model for Polimex assumes that it will only be a subcontractor in new power unit construction contracts. We project its revenues in the power engineering sector at PLN 946.7m in 2011 (this assumption has not changed) and PLN 1615.3m in 2014. A general contractor on the Opole project will get ca. PLN 829m in additional revenues per year. Thus, our revenue forecast for Polimex in 2014 could go up by PLN 200m.

More importantly, work on the Opole contract will allow Polimex to greatly increase its labor force utilization (over 14k employees, mostly in power engineering and manufacturing segments) as well as increased capacity utilization in steel constructions. Thus, the Opole contract makes the expected increase in Polimex's margins in 2013 and beyond more likely.

c) Mostostal Warszawa

Our valuation model for Mostostal Warszawa did not assume that it would win a power-engineering contract. We only assumed that subsidiary Remak could increase its revenues thanks to increased demand for its services. The Opole contract will greatly expand the company's order backlog for 2013, from ca. PLN 800m now to PLN 1450m. This means that

- the backlog will be filled at 50% one year in advance,
- Mostostal could focus on picking high-margin contracts, which is an important argument in favor of a scenario of an improvement in its earnings in 2013.

d) PBG

Rafako has been taken over by PBG, and PBG's indirect stake in the contract may amount to PLN 3.55bn. The CEO of PBG assumed that if Alstom wins the contract, PBG would get a PLN 2bn share of the work, and Rafako a further PLN 2bn. However, in our forecasts we assumed that PBG's total share would be lower at PLN 2.7bn.

The Opole contract award will support our earnings growth forecasts for PBG's power engineering segment in the upcoming years.

e) Other companies

The Opole contract will boost demand for subcontracting services of such companies as Remak, Energomontaż Południe, Energoinstal, Mostostal Zabrze, Elektrobudowa, Elektrotim. In addition, other companies may get a piece of the pie, e.g. Ulma (formwork supply), Hydrobudowa Polska and Instal Kraków (water intallations), Prochem (design work).

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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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