Construction

Poland

PBG

PBG PW; PBGG.WA

Suspended

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Liquidation or Administration and Beyond

Current price: PLN 14.6; Target price: -

PBG and its subsidiaries Hydrobudowa and Aprivia have filed for bankruptcy protection to break the deadlock in their negotiations with banks as to the size and nature of collateral required to secure possible bridge financing. We believe the filings can serve two possible purposes: either they were designed to move the negotiations along and finally reach an agreement with the lenders, or they are a move designed to put pressure on the banks to accept PBG's terms. In the less likely case that the latter proposition is true, the bankruptcy filing could indeed speed up the decision-making process of banks and provide PBG with the bridge financing needed to continue ongoing contracts. The three PBG companies filed to be put in to liquidation as well as administration, and it is for the court to decide which solution better secures the interests of creditors. Liquidation always means winding-up of the business and an asset sell-off. In case of PBG, it would entail stoppage of contracts mandating the cashing of performance bonds by customers. Liquidation would also leave PBG's shareholders with nothing. PBG's creditors would have no choice but to accept a considerable debt haircut (banks have priority over other claims). In turn, administration seems a more favorable solution for all the stakeholders, in particular the holders of PBG's unsecured bonds and certain subcontractors. It would also mean PBG could continue as a going concern. We hope the court will choose to put the PBG Group members into administration. A ruling should be issued in a matter of weeks. The company's creditors will probably propose their own settlement terms, which must be approved through a majority vote (50% plus one vote) of voting creditors whose claims are equivalent to at least two-thirds of the combined debts of all the PBG companies filing for bankruptcy protection. Once it reaches an agreement with the creditors, PBG can continue its operations in the market for gas and oil engineering (where it has a long track record) and power engineering. In the mean time, however, until the court decides which type of bankruptcy is the more appropriate, and until we know with more degree of certainty what kind of future lies ahead of PBG, we are suspending ratings for the company.

Why file for bankruptcy?

PBG signed a standstill agreement with its financing banks, following which the banks froze some of the company's accounts pending approval of its bridge loan application. As a consequence, PBG became unable to pay subcontractors for work performed on certain construction sites, leading to work stoppages and a string of bankruptcy cases brought in by the subcontractors. The banks finally agreed to extend bridge financing to PBG by June 1st, but on terms which PBG felt it was unable to meet. We suspect that these terms would have prevented the company from continuing to restructure its debts through bond issues (due to onerous collateral which would limit the possibility of offering collateral to other lenders).

PBG's settlement proposals

PBG and Hydrobudowa (but not Aprivia) filed preliminary proposals to creditors. Option A provides for forgiveness of PLN 920m and repayment of PLN 1.43bn of the debts. Option B provides for forgiveness of PLN 690m and repayment of PLN 1.43bn of the debts, combined with conversion of PLN 230m of the loans to equity.
Option A would mean a 31% debt haircut for PBG and a 56% haircut for Hydrobudowa.
Option B would mean a 19% haircut for PBG and a 51% haircut for Hydrobudowa, combined with conversion of 12% of PBG's debt into equity at PLN 40 per share, and conversion of 5% of Hydrobudowa's debt into equity at PLN 1 per share.

These proposals seem advantageous for PBG's shareholders, which means they may not be as acceptable for the voting majority of creditors needed to approve them. We expect the creditors to submit their own terms, most probably including:
- smaller haircuts;
- establishment of installment plans for the outstanding amounts (a solution which could be of interest to banks);
- greater dilution or a dilution option (a solution which would be of more interest to bondholders than banks).

It is impossible to guess at this stage how the situation will pan out. Once the court confirms administration, negotiations of the settlement terms can take up to a year. Judicial procedures have accelerated lately in Poland, but bankruptcy cases in the construction industry filed between 2001 and 2006 were known to last between a year and three years. The most successful of such voluntary bankruptcy cases included Energomontaż Północ (40% haircut, no dilution), Naftobudowa (35% haircut, no dilution), Mostostal Zabrze (40% haircut, debt-to-equity conversion at PLN 1 a share despite negative equity). The least successful cases, which led to liquidation of the filing companies, included KPBP-BICK, Mostostal Gdańsk, Espebepe, Beton Stal, Elektromontaż Export, and PIA Piasecki.

PBG's settlement propositions

(PLN m)	PBG	Hydrobudowa Polska	Aprivia
Long-term debt			
Loans	450.0		n/a
Financial leases	7.0	8.5	n/a
Other	40.5	14.3	n/a
Short-term debt			
Loans	829.2	331.1	n/a
Financial leases	0.9	3.0	n/a
Trade creditors	267.4	384.5	n/a
Other	4.2	10.6	n/a
Total debt	**1 599.1**	**751.9**	n/a
Option A settlement			
Canceled debt	495.7	421.1	n/a
Amounts still due	1 103.4	330.8	n/a
Option B settlement			
Canceled debt	303.8	383.5	n/a
Amounts still due	1 103.4	330.8	n/a
Debt to be converted to equity	191.9	37.6	n/a

Source: BRE Bank Securities, PBG, Hydrobudowa

Past fates of Polish construction companies (PLN m)

Company	Situation	Date	Terms	Equity at the time	Net earnins for the year
Budimex	Takeover (Ferrovial)	Apr. 2000	Ca. PLN 32/share	526.8	7.9
Unibud	Merger with Budimex	1999	-	-	-
Mostostal Kraków	Takeover (Budimex)	2000	-	-	-
Mostostal Warszawa	Takeover (Acciona)	2001	Tender offer at PLN 24 /share	149.5	2.2
Mostostal Warszawa	Stock issue	Dec. 2005	Cum-rights issue (PLN 12)	88.5	-29.3
Mostostal Warszawa	Tender offer	Jun. 2006	PLN 20/share, unsuccessful		-
Exbud	Takeover (Skanska)	2000	Ca. PLN 40/share	231.0	-129.9
Exbud	Tender offer (Skanska)	2002	Ca. PLN 40/share	-48.9	-
Mostostal Zabrze	Administration	2003-2006	40% haircut, debt-to-equity conversion at PLN 1/share	1.8	-19.6
Mitex	Takeover (Eiffage)	2002	Ca. 16/share	121,6	-
GPRD	Takeover (Skanska)	2002	n/a	-	-
Energomontaż Północ	Administration	2003	40% haircut, no dilution	42.2	-48.5
KPBP-BICK	Liquidation	2003-2005	-	-16.7	-23.3
Mostostal Gdańsk	Liquidation	2003-2005	-	-161.7	-7.7
Espebepe	Liquidation	2001-2002	-	-67.4	-15.8
Hydrobudowa Śląsk	Takeover (PBG)	2006	PLN 28.5/share	-3.8	-
Beton Stal	Liquidation	2001/2005	-	-	7.2
Elektromontaż Export	Liquidation	2007	-	-52.5	-115.3
PIA Piasecki	Liquidation	2003	-	-208.6	-319
Naftobudowa	Administration	2003/2005	35% haircut, no dilution	19.6	-13.7

Source: BRE Bank Securities

Implications of PBG bankruptcy for subcontractors and suppliers

Once PBG is put into administration, its liabilities will become part of the bankruptcy estate and the subject of settlement proceedings, with the exception of:

I) Secured debt (which can be enforced against collateral), and

II) Amounts owed to subcontractors who reported their claims to the project owners (the claims of these subcontractors will be satisfied by the project owners against performance bonds - 10% of contract guarantees issued by banks ort insurance companies).

Aside from banks, PBG's **secured creditors** include **Rafako,** which extended a PLN 30m loan to Hydrobudowa against two

sets of collateral: a real property and assignment of contract fees. We believe these are enough to minimize Rafako's potential losses.

Further, **Energomontaż Południe** (EPD) provided guarantees for PBG's bank loans toward the end of 2011, which means it is liable for a portion of its parent company's debt. EPD has stated recently that it intended to contest the validity of these guarantees based on some technical errors allegedly made by the bank. We do not know how strong the company's case is, and there is a possibility that the issue will end up in court. In the worst-case scenario, Energomontaż Południe will have to file for bankruptcy protection as well.

PBG's **secured subcontractors** include the companies Atrem, Elektrobudowa, Qumak Sekom, and Tesgas.
Elektrobudowa and **Qumak Sekom** have reported the whole of their claims under the National Stadium contract to the stadium's owner, NCS. What is more, the third member of the PBG/Hydrobudowa consortium which built the stadium was Alpine Bau which is required to take over responsibility for any claims if the other members are unable to satisfy them. Failing that, the subcontractors can apply to NCS.

Atrem did not report all of its claims from PBG to project owners, but it did take measures to minimize its exposure to the risks arising in case of PBG's bankruptcy. These measures include the possibility to satisfy certain unsecured claims against construction equipment, and we believe they give Atrem adequate protection against major losses.

Tesgas also reported only a part of its claims to the project owners, and it has refrained from initiating a collection procedure against PBG, which is a long-term customer. The outstanding unreported fees exceed PLN 12m. If PBG is put into administration, they will probably be reduced and postponed.
Tesgas had net cash of PLN 14.9m at 31 March 2012, and it had recognized its accounts receivable from PBG on the balance sheet in an amount exceeding PLN 20m, including the PLN 12m unsecured claims. This means that PBG's bankruptcy will have no impact on the company's balance sheet. The reported claims can be recovered with the help of project owners.

Implications for ongoing contracts

PBG can continue ongoing construction contracts while in administration, but it is bound to run into hurdles. Any fees it will be required to pay to its subcontractors and suppliers accruing after the administration ruling will have to be covered from day-to-day cash resources. Moreover, many companies will probably pass on working for an insolvent customer. More willing subcontractors can no doubt be found in gas and oil engineering and power plant projects, some of which PBG can hand over to **Rafako** with the project owners' approval**.** As for road projects, where PBG has huge delinquencies, subcontractor claims can be possibly partly satisfied from payment guarantees issued by the road owner, the national road authority GDDKiA.

Is PBG capable of taking on new contracts?

While in administration, PBG will be banned from competing in new contract tenders held by government bodies, but it can continue to bid in tenders which are already ongoing, according to its lawyers.

In continuing bids, the project owners can always find some reason not to hire a company with serious financial issues. On the other hand, PBG can always appeal any unjustly lost contract awards.

When PBG is in administration, **Rafako** will take responsibility for generating new business and acquiring contracts, which will be mainly contracts for power plants and waste incineration plants. PBG can help increase its subsidiary's hit rate by providing skilled staff and experience.

Further, PBG can secure new business for itself by offering its services as subcontractor to major players like OHL and Alpine Bau. Switching roles with former subcontractors is another option.

As for the road business, we expect Hydrobudowa and Aprivia to significantly downsize their workforce after completion of ongoing contracts, and we anticipate gradual discontinuation of this line.

Ernst&Young Audit

Ernst & Young is preparing an independent report regarding PBG's financials, which will serve as a basis for a FY2012 and FY2013 earnings guidance. The report is scheduled to be ready by mid-June. We expect the guidance to foretell a net loss of PLN 200-400m in 2012, paired with balance-sheet cleaning and recognition of losses on road contracts. For 2013, we are betting that PBG's bottom line can be in the black again, and that cash flows can return to the positive territory.

Any more bankruptcies within the PBG Group?

We expect the bankruptcy filings of the parent companies comprising the PBG Group to be followed by similar filings by the smaller subsidiaries, including Betpol, Dromost, PRID, PRG Metro, KWG, PBG Technologia, PBG Erigo, and PBG Dom. Some of these companies, particularly those who have negative equities, will be wound up.

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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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