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Special Comment

BRE Bank Securities

Construction

Poland

Polimex Mostostal

Suspended

PXM PW; MOSD.WA

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Standstill and then debt conversion?

Current price: PLN 0.69

Polimex has commenced negotiations with banks to determine the terms of a standstill agreement during which the creditors will refrain from any collection efforts. At the same time, the Company continues to pay its current obligations to subcontractors and other business partners. The standstill agreement is expected to remain in force for a period of four months, through to the end of October. During that time, a report will be drafted on Polimex's financial standing and its capacity to generate cash from existing construction contracts. The report will serve as a basis for the formulation of a new financing structure for the Company. A team of experts from UniCredit CAIB Poland, DM PKO BP, and ING Securities has been appointed to draft the report, and provide advisory services. It is worth noting that these three institutions are members of larger financial groups that have extended considerable amounts of credit to Polimex. In our opinion, the standstill arrangement is a sign of concern on the part of the creditors about Polimex's financial health, and their lack of confidence in the Company's Management Board (the creditors are demanding an independent audit). Nevertheless, the agreement is going to protect Polimex against possible loan terminations by smaller financing providers or lenders who have secured better-quality collateral from the Company. Unfortunately – and this is a source of the most concern for us – a new financing structure can result in dilution of Polimex's existing shareholders (through a stock issue or conversion of straight bonds to convertible bonds. We do not think Polimex is under threat of imminent bankruptcy at the moment. While the new financing structure is being worked out, we are suspending coverage of Polimex.

What makes Polimex's situation different from PBG's?

When it comes to the timeliness of payments to vendors, Polimex is currently at the point where its now-insolvent rival PBG was back in late 2011 / early 2012. Gradually, the Company has started to fall 2 months or more months behind on invoice payments, exceeding the industry "standard" which is 2-3 weeks. The difference compared to PBG is that the latter's troubles started after the end of the high construction season. Meanwhile, Polimex has started to fall into arrears at the height of the season, at the most capital-intensive stage. There are numerous other differences which can be summarized as follows:

- Polimex has a large order backlog (PLN 11.4bn at 31 March 2012).
- Polimex's involvement in road construction is two-thirds that of PBG's, and its net debt is over 40% lower.
- Polimex has made much more progress with asset divestitures (the Company has sold several properties, and it is moving forward with sales of three subsidiaries: Sefako, Energomontaż Północ Gdynia, and Torpol).
- Polimex is just starting to experience payment delays over 2 months. At the time of its bankruptcy filing, PBG was over six months overdue on certain invoices.
- Polimex issues guarantees for the borrowings of its subsidiaries, but not the reverse (which means these subsidiaries can continue to function regardless of what the situation is at the parent company).

The characteristics that Polimex and PBG share include:

- Growth driven by acquisitions,
- A lack of a controlling shareholder which could provide capital injections,
- An aggressive business model based on a presence in all sectors of the construction industry,
- Delays on road contracts (two stretches of the A4 motorway in case of Polimex).

A far cry from bankruptcy

Failure to obtain standstill protection, and a subsequent bankruptcy filing, is the absolute worst-case scenario faced by Polimex. In our view, the possibility of bankruptcy, whether it entails liquidation or just reorganization, is very low. Any lenders that may decline to sign the standstill agreement will be smaller and weaker banks with small exposures, such as DZ Bank which extended a PLN 13.2m loan to Polimex, due on 31st October 2012. Larger institutions recognize that temporary standstill is much less risky than if they were to back out of financing Polimex altogether. The main standing concern is a potential debt-to-equity conversion. Polimex's bondholders can call for redemption of the bonds, although they should keep in mind that the bonds are unsecured and that if Polimex goes bankrupt they can expect a haircut and a long wait before they recover just a portion of their investment.

Divestitures

The three subsidiaries that Polimex has put up for sale, Sefako, Torpol, and Energomontaż Północ Gdynia, are estimated to be worth a combined PLN 250-300m. We believe these companies will eventually find buyers, the only problem being that this may happen later rather than sooner. Sefako manufactures small power boilers. Energomontaż is in the rather lucrative business of supplying steel structures for offshore applications. Torpol is a railroad developer. One of the potential buyers is the Industrial Development Agency (ARP) which, however, needs a go-ahead from the State Treasury. As for other options, any direct state aid, for example through an investment in Polimex bonds, has to be approved by the European Commission.

Lender exposure to Polimex loans by value (PLN m)

Institution	2011	Maximum amounts drawn
Pekao (incl. Pekao OFE, Pioneer Pekao TFI)	239.9	289.9
PKO BP (incl. PKO TFI)	141.5	214.5
BPH	0.0	57.0
BOŚ	0.0	50.0
Union Investment TFI	45.9	45.9
Aviva OFE	42.8	42.8
BGŻ	0.0	35.0
KBC TFI	32.4	32.4
Millennium TFI	27.8	27.8
IDEA TFI	24.8	24.8
PZU OFE	21.2	21.2
Aviva Investors Poland TFI	14.1	14.1
DZ Bank	13.2	13.2
Legg Mason TFI	5.1	5.1
TFI PZU	3.5	3.5
AXA TFI	1.0	1.0
DnB Nord	0.2	0.2
Other	44.4	44.4
Banks that have terminated financing		-35

Source: BRE Bank Securities, institutions, Polimex

Upcoming due dates on Polimex debt

- Pekao S.A.; PLN 200m facility due on 31 July 2012
- BPH; PLN 10m facility due on 31 August 2012
- BOŚ; PLN 50m facility due on 3 July 2012
- PLN 100m bonds maturing on 25 July.

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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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