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Special comment

**Building Materials**

Poland

# Polimex Mostostal

**Accumulate**

MOSD.WA; PXM.PW

(Reiterated)

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## Q1 2010 Results Structurally Weak

**Current price: PLN 4.61; Target price: PLN 5.16**

We consider Q1 2010 earnings rather weak for a number of reasons: gross profit was boosted by reversed provisions in the amount of PLN 10.5m; margin in Manufacturing plunged to 12.1%; cash flows were negative at -PLN 273.5m; subsidiaries posted weak manufacturing profits; earnings approached consensus only thanks to one-off events. All the same, we believe the stock remains attractive in the context of approaching power-engineering investments in Poland. The first big contracts for the modernization of the Bełchatów power plant will be awarded in June (long-term contracts worth several hundred million zloty each). As many of Polimex's subsidiaries are mostly subcontractors, the Company stands a good chance of improving its margins in 2012 and beyond. On the other hand, we believe the market consensus is overly optimistic for FY 2010. Our own forecasts are 6% and 7.1% lower, respectively. We believe the Company's current order backlog (see page 2) gives no potential for higher revenues. One risk factor are margins in Manufacturing (inter alia due to increases in the price of steel). In case earnings in the segment deteriorate, the Company's results may be several percent lower than even our forecasts, which are among the lowest in the market. Despite these risk factors, we believe the opportunities related to the growth of the Polish power market carry more weight and we reiterate an accumulate rating.

### Reported vs. forecasted Q1 2010 results

	Q1 2010	Q1 2010F	Differ.	PAP consensus	Differ.	Q1 2009	Change
Sales	771.8	791.3	-2.5%	744.7	3.6%	831.6	-7.2%
Gross profit	85.2	83.3	2.2%	-	-	111.5	-23.6%
Pct. margin	11.0%	10.5%	-	-	-	13.4%	-
EBIT	31.9	27.0	18.2%	32.6	-2.2%	57.5	-44.6%
Pct. margin	4.1%	3.4%	-	4.4%	-61.4%	6.9%	-
Pre-tax profit	21.7	16.4	32.0%	-	-	51.3	-57.7%
Pct. margin	2.8%	2.1%	-	-	-	6.2%	-
Net profit	16.8	9.8	70.8%	15.8	6.5%	34.2	-50.8%
Pct. margin	2.2%	1.2%	-	2.1%	177.8%	4.1%	-

Source: BRE Bank Securities, Polimex Mostostal

Polimex posted revenue and gross profit very close to forecasts. Gross margin was 11% (9.8% after adjustment for provisions with potential impact on gross profit (PLN 10.5m), forecast: 10.5%). We do not like the structure of revenues and gross profit in individual segments, especially Manufacturing, Roads and Railroads.

The Group posted weak earnings in Manufacturing. Revenues were weak at PLN 97.4m (PLN 164.0m in Q1'09), with as much as PLN 40.4m in intra-group sales (which could indicate weak external demand), and the gross margin was very low at 12.1%. The structure of these weak earnings is as follows: the Siedlce plant performed better, but manufacturing segments of Stalfa, Energomontaż Pólnoc and Coifer disappointed. The weak earnings in Manufacturing could stem from low revenue (winter, fixed costs) and higher steel prices. We are awaiting developments in Q2'10, though we do admit the continued increases in steel prices may exert pressure on margins. Profitability was very good in Roads and Railroads, much higher than is typical for this business. This might be a consequence of provision reversals, or of a very advantageous contract mix in the quarter.

SG&A expenses were in line at PLN 55.2m (we expected PLN 55.1m). The gross profit was PLN 30.0m vs. PLN 28.3m forecasted. Other net operating income was ca. PLN 1.85m (we expected -PLN 1.3m) and other finance expenses were almost exactly in line (PLN 11.8m vs. PLN 11.7m), though slightly different in structure (lower interest expense, higher F/X losses). Equity in income of associates was in line at PLN 1.5m (vs. PLN 1.25m forecasted). Effective tax rate was 24%. Minority interest diverged considerably from our forecasts at PLN -0.3m (vs. -PLN 3.45m forecasted and PLN 6.6m in Q1'09). The low minority profit was attributable to the manufacturing subsidiaries and manufacturing segments at selected subsidiaries (e.g. Energomontaż Pólnoc).

**Quarterly results by business segment**

(PLN m)	Actuals		Forecast	
	Revenue	Gross margin	Revenue	Gross margin
Manufacturing	97.4	12.1%	178.8	14.5%
Roads and Railroads	94.4	16.4%	60.0	8.5%
Construction	263.6	9.4%	240.8	9.5%
Power engineering	143.6	11.4%	175.8	9.0%
Chemical engineering	172.8	9.8%	136.0	10.0%

Source: BRE Bank Securities, Polimex Mostostal

**Consolidated vs. standalone earnings**

(PLN m)	Consolidated	Standalone	Difference
Sales	771.8	545.4	226.4
Gross profit	85.2	60.0	25.1
Pct. margin	11.0%	11.0%	11.1%
EBIT	31.9	40.5	-8.6
Pct. margin	4.1%	7.4%	-3.8%
Pre-tax profit	21.7	26.6	-4.9
Pct. margin	2.8%	4.9%	-2.2%
Net profit (ex. minority interest)	16.5	24.2	-7.8
Pct. margin	2.1%	4.4%	-3.4%

Source: BRE Bank Securities, Polimex Mostostal

**Changes in provisions in Q1 2010 which may have increased gross profit**

(PLN m)	Increases	Reductions	Net	Typical classification
Contract and other costs	3.5	4.2	-0.7	COGS
Employee benefits	5.7	12.0	-6.3	SG&A / COGS
Provision for losses	1.0	1.5	-0.5	COGS
Provision for warranty repairs	1.1	4.1	-3.0	COGS / Other operating expenses
Total	11.4	21.9	-10.5	

Source: BRE Bank Securities, Polimex Mostostal

**Earnings adjusted for potential changes in provisions**

(PLN m)	Q1 2010 unadjusted	Q1 2010 adjusted
Sales	771.8	761.3
Gross profit	85.2	74.7
Pct. margin	11.0%	9.8%
EBIT	31.9	21.4
Pct. margin	4.1%	2.8%
Pre-tax profit	21.7	11.2
Pct. margin	2.8%	1.5%
Net profit (ex. minority interest)	16.5	8.0
Pct. margin	2.1%	1.0%

Source: BRE Bank Securities, Polimex Mostostal

**Contract backlog**

(PLN m)	Q1 2010	Q1 2009
Chemical engineering	600	975
Power engineering	954	720
Construction	1801	1980
Roads and railroads	1402	1038
Manufacturing *	1972	1490
<b>Total</b>	<b>6729</b>	<b>6203</b>
<b>Total ex. Manufacturing</b>	<b>4757</b>	<b>4713</b>

Source: BRE Bank Securities, Polimex Mostostal; \* the portfolio in Manufacturing is an estimate based on general provisions of product supply contracts



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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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