22 August 2005

Update

BRE Bank Securities

Food

Poland

Polmos Lublin Accumulate

PLMS.WA; PLS.PW (New)

Bitter (pill) to swallow

Current price	**PLN 31.30**
Target price	**PLN 35.00**
Market cap	PLN 143 m
Free float	PLN 65 m
Average daily trading (3M)	PLN 0,7 m

The 1H 2005 results and the defeat in the battle over Polmos Białystok were a bitter pill to swallow for the investors of Polmos Lublin. It is worth to notice though, that the company has increased its gross profit on sales during this period, in spite of the revenues decline. Lower costs of production made it possible. Poor results on the remaining levels of activity however, are due to several one-off events. We estimate that after their exclusion, the 1H 2005 result would be similar to 1H 2004 one. We update our forecasts and set the target price in a 9-month horizon at PLN 35. This values Polmos Lublin at 10% discount to Polmos Białystok (stock price) and much bigger discount to prices paid by CEDC for controlling stakes of Bols and Polmos Białystok.

Shareholder Structure

Jabłonna	37.84%
ING TFI	5.03%
AMPLICO TUnŻiR	6.12%
AIG OFE	5.08%
Others	45.93%

Sector Strategy

Poland is the fourth market of vodka sales in the world. The value of Polish market is estimated at over PLN 16 bn. The most dynamically growing segment of the market is flavored vodka segment and it will remain such in the coming years. Moreover the switching of consumption into higher price categories occurs. In the recent years we assume market growth at the level of 1-3%.

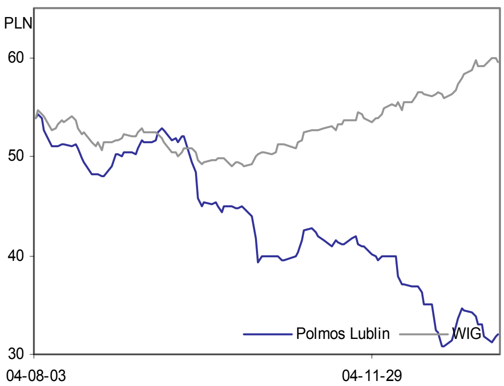
Company Profile

Polmos Lublin with a ca. 6% share in the Polish market of vodka (higher in terms of value and lower in terms of volume) is the unchallenged leader in the flavored vodka segment (31% share in this category). The renowned product of Polmos Lublin - Wódka Żołądkowa Gorzka constituted 90% of the company's revenues in 2004.

Important Dates

30.09 - 1H report
04.11 - 3Q report

KGHM vs. WIG



Krzysztof Radojewski
(48 22) 697 47 01
Krzysztof.Radojewski@dibre.com.pl
www.brebrokers.com.pl

Poor 1H 2005 results

During the first half of 2005 the company has reported PLN 132.2 m of revenues (PLN 135.5 m in 1H 2004) and a net loss of PLN 3.9 m (profit of PLN 5.1 m in 1H 2004). Lower than expected sales results from the conflict with the main distributor, CEDC. Worse net profit is however the result of fewone-off effects:

- the cost of participation in Polmos Białystok privatization tender of (PLN 4.4 m)
- the expense of management redundancy payments (PLN 0.8 m) and
- reserves for disputed tax liabilities (PLN 1.4 m).

New management

The previous management' main mistake was lack of reaction to the loss of the market to Balsam Pomorski (main competing brand to Polmos Lublin's Żołądkowa). In June Marek Malinowski became the new president. He was previously (2002-2004) responsible for sales and marketing in the company. During his term the company has doubled its market share, expanded product portfolio and also broke even.

New products in all price segments

The company introduced a new flavored vodka into the economic segment - Balsam Kresowy. Since September the new brand of WŻG is to be introduced as well into the segment of premium, along with „pure vodka". The new products will extend the company's portfolio and will let Polmos Lublin keep control over different market segments.

Small acquisitions

There are a few brands and producers on the market to acquire. The potential targets are Polmos Bielsko-Biała and Polmos Szczecin. After the latest CEDC acquisitions the only threatening rival of Polmos Lublin in the battle over further brands' acquisitons seems to be Sobieski Dystrybucja. The management estimates that the possible takeovers could add 2-3% market share. In our forecasts we do not take into consideration the additional revenues from acquisitions.

(PLN m)	2003	2004	2005F	2006F	2007F
Revenues	304.8	338.6	317.8	393.8	410.6
Excise duty excluded	90.9	108.9	94.5	115.9	121.7
EBITDA	12.8	26.2	10.2	24.4	29.0
EBITDA margin	*14.1%*	*24.0%*	*10.8%*	*21.0%*	*23.8%*
EBIT	10.9	20.1	7.4	19.7	23.9
Net profit	6.4	12.5	1.8	14.2	17.7
Cash earnings	8.4	18.6	4.5	18.9	22.8
P/E	14.9	11.4	81.3	10.1	8.1
P/CE	11.3	7.7	31.8	7.6	6.3
P/BV	2.6	2.9	0.7	0.6	0.6
EV/EBITDA	10.0	3.7	10.6	4.4	3.7

Since 2005 results according to IFRS

Summary:

1. Due to the convergence of a series of unfavourable extraordinary events, 2005 can be written off as a loss. In 1H, sales revenues fell as a result of a conflict with CEDC and the aggressive expansion of Balsam Pomorski. Moreover, several factors appeared that additionally encumbered the operating results PLN 5 mn (including administrative costs PLN 2.5 mn higher in relation to 1H 2004) and the result on financial activity PLN 4.4 mn (costs of competing for Polmos Białystok). It is important to note that, despite the almost 8% decline in sales (excluding excise), gross profit on sales increased by almost 6% thanks to lower costs of manufacturing products. After adjusting the result for 1H by one-off factors, net profit is similar to that reported in 1H 2004, which in light of the drop in sales can be considered as a good result.

2. We estimate that 2006 results will be similar to 2004 results because of several factors:

   - The introduction of new products in all price segments to offset the loss resulting from the decline in sales of WŻG,
   - The modernised and expanded production base will lower costs of production,
   - The change in management board will lower administrative costs in the company,
   - The amortisation of the WŻG trade mark according to IFRS will not encumber the financial result in 2006 (PLN 4.2 mn in 2004)

3. We used an updated DCF model as well as a comparison to Polmos Białystok in order to conduct a valuation. In the first method, we obtained a result of PLN 34. In the second, we assume that Polmos Lublin should contain a 10% discount in relation to Polmos Białystok due to the smaller diversification of the product portfolio, lower volume of sales and export potential. Considering market forecasts of results for Polmos Białystok as well as our forecast of 2006 net profit for Polmos Lublin of PLN 13.7 mn, we obtain a valuation with the P/E ratio of PLN 36.1, which is somewhat higher than our valuation with the DCF model. Using the EV/EBITDA ratio, the valuation increases to PLN 51.1, which could be too high due to the fact that Polmos Białystok has stabile cash flow and results on the operating level. Therefore, we calculated the final price as the arithmetic average of the DCF method and the P/E comparative method, which amounts to PLN 35.

Comparative valuation of Polmos Lublin

	price	net profit 2006	P/E 2006	EBITDA 2006	EV/EBITDA 2006
Polmos Białystok*	78.2	66.5	14.0	81.9	11.4
Discount	10%	-	12.6	-	10.2
Polmos Lublin – resultant price	**43.6**	13.7	36.1	24.0	51.1

Source: BRE Bank Securities
**average of market forecasts*

4. The recent acquisition of vodka producers Bols (PLN 71 mn for 1% of the market) and Polmos Białystok (PLN 53 mn for 1% of the market) by CEDC raised the average price paid for 1% of the market from PLN 14 mn to PLN 26 mn. Taking this price into consideration as well as Polmos Lublin's approximate 6% market share, we obtain a valuation of the company of PLN 156 mn, or PLN 34 per share. The current market valuation of the company is below this value and, in our opinion, does not represent the company's potential or possibilities of increasing its market share.

5. Considering the above arguments, after updating our forecasts, our 9-month valuation of Polmos Lublin amounts to PLN 35 and we recommend accumulating shares of the company. This valuation implies a P/E ratio of 11.5 for 2006.

Conflict with the main client – CEDC

In 2004 Polmos Lublin terminated the distribution contract with Ambra.

In 2004, Polmos Lublin changed the way it distributes products. It terminated the contract with the company Ambra, which distributed 98% of production. The company had to develop its own logistics base and hire more employees. However, the operation helped it lower the costs and become independent of the main client. Since then, the majority of sales has been realised through wholesalers, none of which had a significant market share. However, as a result of consolidation and the acquisition of wholesalers by CEDC, this entity became the leader of the wholesale distribution market of alcoholic beverages.

Battle over Polmos Białystok affected many levels.

In mid-April the management board of Polmos Lublin announced it had submitted a binding offer to purchase a 51% stake in Polmos Białystok. Several days later the information appeared that CEDC, responsible for 35% of the company's distribution, ceased accepting its products. Polmos Lublin submitted a motion regarding this matter to the Competition and Consumer Protection Office (UOKiK) to start proceedings regarding the practice of unfair competition in fulfilling the terms of the contract by CEDC.

The new president, Marek Malinowski, ended the dispute with CEDC.

CEDC stated that the entire event was a reaction to the high level of inventories of Żołądkowa Gorzka and other Polmos Lublin products. In turn, Polmos Lublin considered the conflict as part of the competition to gain control of Polmos Białystok. The new president of Polmos Lublin, Marek Malinowski, will aim to improve the quality of cooperation with the distributor. According to his annoucements, this conflict has been definitively ended and further cooperation should translate into better results in the second half of the year.

The market of producers and distributors is strongly consolidated.

Due to strong competition on the market of wholesale spirits distributors, it is difficult to avoid a dependence from CEDC, which controls approximately 30% of the wholesale market of alcohol distribution. This competitor joining the group of alcohol producers had a major impact on the situation of the entire market. Wódka Żołądkowa Gorzka has strong market penetration (98%), which means it is attractive for retailers. They usually have at least two suppliers and it can be assumed that strong brands will find their way to traditional channels of distribution. The company's management board wants to protect itself against repeating similar situation in the future and to develop its own alternative channels of distribution, excluding wholesale distributors and gaining better control over the retail trade. Activity of this type, together with taking away from CEDC the distribution to chain of wholesale stores, should reduce CEDC's share in total distribution to 20%.

The conflict with the leading client worsened 2Q results.

We pointed out this risk factor in our analytical report prior to the IPO. It was difficult however, to estimate its significance. The conflict with CEDC exerted a considerable influence on 2Q results and therefore will impact full-year results as well. In our forecasts, we assume that the dispute is finally over and beginning in 2H 2005 the distribution of products will occur without any problems. In this context, we consider activities aimed to broaden alternative channels of distribution and the control over retail level as beneficial for the company.

Żołądkowa Gorzka vs. Balsam Pomorski

Inexpensive Balsam Pomorski will find its place in the segment of flavoured vodkas.

Balsam Pomorski appeared on the market at the end of 2003 with a price similar to that of Gorzka Żołądkowa. After lowering the price by several zlotys Balsam Pomorski began to obtain an increasingly greater share in the market of flavoured vodkas, also contributing to increasing its size by 20%. Despite the fact that it was in the economy segment, for some consumers it became a substitute product for Gorzka Żołądkowa and took away part of its market.

In the initial stage of entering the market, vodkas in the economy segment take share from more expensive vodkas.

The situation was similar in the case of Starogardzka's aggressive entry on the market of pure vodkas. In 2002, Starogardzka (economy segment) had a 3% market share in comparison with the leader – Absolwent (mainstream segment), which had a market share of 21%. One year later Starogardzka increased its share to 8% at the expense of Absolwent, whose share fell to 16%. The following year, further growth in Starogardzka's market share was not at the expense of Absolwent, which is gradually rebuilding its position. Using a similar analogy to the market of flavoured vodkas, it can be estimated that following the aggressive entry of Balsam Pomorski capturing a portion of Żołądkowa Gorzka's market, the situation will stabilize. Data from the last six months show that the shares of these two brands in the market of flavoured vodkas has stabilized.

Other flavoured vodkas are not a threat to WŻG.

Other less well known brands also compete on the market of flavoured vodkas, such as Herbowa Gorzka (Polmos Wrocław) and Krupnik (Grupa Belvedere), which are potential threats to WŻG. However, due to lack of price advantage, we assume they will not take market share from WŻG. It is also important to note the second most important brand on the market of flavoured vodkas – Żubrówka. After purchasing Polmos Białystok, CEDC could focus its attention on promoting its flavoured vodka. On the other hand, CEDC is split between its role as a distributor and its new role of producer. The company has to consider the profits and benefits from the two functions. In connection with this, we rather expect these two brands to coexist and strengthen their positions, as it has been so far, for two reasons:

- WŻG it not a direct threat to Żubrówka, as each brand is targeted to a different group of consumers,
- Żubrówka sells well abroad, and therefore CEDC can be expected to promote this product on foreign markets to a greater extent.

Share of flavoured vodkas in total spirits market (quantity)

Company	Brand	4 - 5 2004 share	4 - 5 2005 share
Polmos Lublin	**Żołądkowa Gorzka**	**6.4%**	**5.0%**
Polmos Białystok	Żubrówka	3.6%	3.3%
Sobieski Dystrybucja	Balsam Pomorski	0.5%	3.1%
Sobieski Dystrybucja	Krupnik	0.6%	0.6%
Polmos Wrocław	Herbowa Gorzka	0.4%	0.3%

Source: Polmos Lublin presentation

The previous board miscalculated the threat posed by Balsam Pomorski.

In its strategy, the former management board of Polmos Lublin underestimated Balsam Pomorski's impact on WŻG's sales and did not react quickly enough through introducing its own flavoured vodka in the economy segment. By the end of June 2005 Balsam Pomorski had taken a portion of Żołądkowa's share in the market of flavoured vodkas. Basing on the example of Absolwent and Wódka Starogardzka, we assume that Żołądkowa Gorzka's position will stabilize. The company currently has an approximate 30% share in this market. However, it is not the same market that it was one year ago, as Balsam Pomorski's entry contributed to increasing its size. In terms of the entire vodka market, Polmos Lublin's share has fallen by 1.4%.

We believe that aggressive marketing activity will allow WŻG to recover a portion of lost market share. In our updated forecasts we estimate that the company will sell more than 9 mn litres of WŻG this year (almost 12 mn in 2004). Intensifying promotional activities, the management board wants to return in 2006 to the sales of 12 mn litres annually. In our opinion, it will be difficult to bring back the sales to the level noted before the emergence of Balsam Pomorski. We believe sales of 10 – 11 mn litres annually are more realistic.

New strategy includes entering all price segments.

The company's new strategy assumes entering all price segments – a new flavoured vodka in the economy segment, Balsam Kresowy, is already on store shelves. The management board believes this will not result in cannibalising the main brand. This is a lower quality vodka than WŻG, however, according to the board, it is better than Balsam Pomorski. Lower margins are realized on cheaper vodkas, but a presence in all price segments will allow the company to reach a broader group of consumers and gain better control of the market. We perceive this element of the new strategy as positive for the future development of the company. Greater diversification of the product portfolio lowers the risk of losing market share as a result of a change in the fashion for drinking alcohol or the preferences of consumers.

Product offer of Polmos Lublin

Market segment	Brands
Economy	Balsam Kresowy (in offer)
Lower mainstream	Żubr Strong pure vodka (in offer)
Mainstream	WŻG, WGŻ with mint, flavoured vodkas (cherry, nut, raspberry, cranberry – to be offered),
Premium	WŻG Premium (beginning in September), Wódka Czysta Premium (beginning in September), Nalewki Kresowe (in offer)

Source: company

Consolidation and Growing Competition in the Sector

Competition and consolidation are intensifying in the sector…

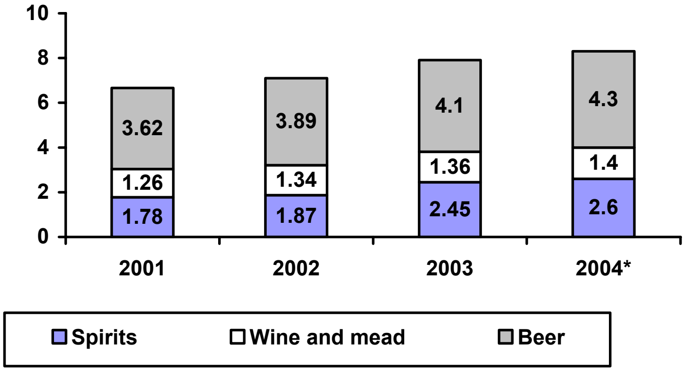
The 30% reduction in the excise tax in 2002 led to an increase in the consumption of vodka by Poles, contributed to shrinking the grey economy and an increase in the legal alcohol market in Poland. The annual average rate of market growth in terms of volume in 2002-2004 amounted to 9.8%. Flavoured vodkas noted the most significant growth in terms of quantity during this period.

The alcohol market in Poland, which is the fourth largest in the world, is quite attractive. The state-owned Polmos' have been undergoing privatisation since 2001. The sector has been characterized recently by consolidation and increasing competition. Following CEDC's acquisitions of Bols and Polmos Białystok for record high sums, the structure of competitors on the market of spirits producers has changed.

…and this trend will continue.

Competition in the sector of alcoholic beverages can be expected to increase in the near future. Experts from CASE-Doradcy estimate that the consumption of alcohol per capita in Poland will grow from the current 7.9 litres to 8.9 litres in 2010. Therefore the market has growth potential, although there is also no lack of players. Despite the strengthening of competition in the sector of spirits, there is also a risk that the fashion of consuming alcoholic beverages will change and consumers will drink less vodka and more beer and wine. Wine constitutes the biggest threat, as the beer consumption per capita (77-78 litres annually) is close to the average level of 80-88 litres annually noted in Europe, which indicates the market is saturated. In connection with the above, pressure on margins and strong competition in acquiring subsequent production plants and brands can be expected, along with strong competition within the framework of the entire sector of alcoholic beverages.

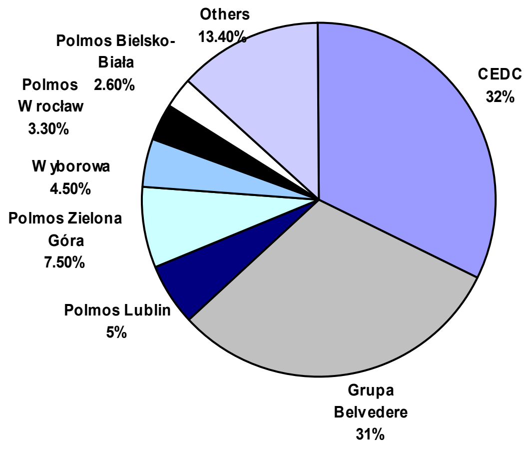
Structure of alcoholic beverages consumption per capita in Poland (in litres of 100˚ alcohol per capita)



Source: BRE Bank Securities based on CASE – Doradcy report
**forecast of CASE - Doradcy*

Spirits producers in Poland (quantity)

CEDC and Sobieski are among the largest vodka producers in Poland.



Source: BRE Bank Securities proforma estimates (results for 2004, not including effects of cannibalism) based on CASE-Doradcy report

Change in Market Situation Following CEDC Acquisitions

The wholesaler entry on the market of producers…

The entry of the largest network of alcohol wholesalers in Poland on the spirits market significantly changes the situation of the entire market:

1. It creates the second largest producer of alcohol on the market,
2. Vertical integration changes the producer-wholesaler relationship, which could have an influence on margins and preferences for a specific group of products,
3. It creates further pressure on market consolidation and the establishment of a third strong player.

…for record high sums significantly changes the situation on the market.

CEDC's recent purchase transactions of Bols and Polmos Białystok for record high amounts indicate just how attractive the Polish alcohol market is perceived. It can be assumed that these prices are too high due to the fact that in the dual role of distributor and producer, CEDC has greater possibilities of setting margins at various stages of sales. Following CEDC's transactions, the average price paid for a 1% share of the alcohol market jumped from PLN 14 mn to PLN 26 mn.

Sales transactions of spirits producers

Date	Investor	Polmos	Stake	Price of stake (PLN mn)	Quantity share in market	Price for 1% share in market (PLN mn)
VII.2005	CEDC	Białystok	61%	1060	20%	53
IV.2005	CEDC	Bols	100%	850	12%	71
I. 2003	V&S Vin&Spirit AB	Zielona Góra	85%	129	7.50%	20.3
X. 2002	Bartimpex	Wrocław	85%	65	3.50%	21.7
VII.2002	Caribbean Distillers Corp.Ltd.	Łańcut	85%	14	3%	5.5
IX. 2001	Jabłonna	Lublin	80%	16	4%	5
VIII.2001	Belvedere	Starogard	80%	36	6%	7.5
VII. 2001	Pernod Ricard	Poznań	80%	300	15%	25
Average						**26**
Median						**21**

Source: BRE Bank Securities

Polmos Lublin will become one of average-size players on the market...

The hunter or the hunted?

In the new market realties Polmos Lublin will become one of several average-size players and will have to acquire another player or brand in order to maintain its market position. This is in line with the strategy of the company. Several of the state-owned Polmos' are, of course, on the top of the takeover list. The new president is particularly interested in Polmos Bielsko-Biała, the producer of Advocaat and Extra Żytnia. Considering the company's share in the market and the average price paid for alcohol producers in recent years, it's value can be estimated at approximately PLN 70 mn.

According to president Malinowski, there are still several less famous brands for sale in Poland, but due to the ambiguous rules of the game, acquiring them is difficult. The company's management board is interested in acquisitions of Polish brands with long historiey and potentials which have not yet been fully exploited, as well as in brands from neighbouring markets. The acquisition of one brand can be expected this year.

...and will continue to seek acquisition opportunities...

Polmos' not yet privatised

Producer	Main brands
Polmos Józefów	Żytnia, Z Czerwoną Kartką
Polmos Toruń	Copernicus, Batory Vodka, Toruńska
Polmos Szczecin	Starka, Wirtuoz, Nestor
Polmos Bielsko-Biała	Wiśniówka, Advocaat, Adler, Original Polish, Extra Żytnia
Warszawska Wytwórnia Wódek Koneser	Luksusowa, Królewska, Pan Tadeusz
Polmos Łódź	Columbus, Delikatesowa, Klubowa
Polmos Sieradz	Alaska Gold, Grenlandia Wódka Wyborowa

Source: BRE Bank Securities based on CASE – Doradcy report

...and is itself becoming an attractive takeover target.

However, even acquiring other small producers will not have a significant influence on the market position of Polmos Lublin. A natural consequence of the further development of the situation on the market of spirits producers is the leaders strengthening their positions. However, more reasonable solution seems to be allocating the market among themselves instead of competing against each other. Everything indicates that Polmos Lublin, which was looking to acquire Polmos Białystok just several months ago, is currently an attractive takeover target itself. Żołądkowa Gorzka would be an ideal compliment to the product portfolio of CEDC, and therefore it can be assumed that one possible scenario is the acquisition of Polmos Lublin by CEDC.

According to the public offering, the company's principal shareholder is obligated not to sell its shares before the end of 2007. Approximately 46% of shares are publicly traded, but Janusz Palikot, who will appear at the top of PO's electoral list in Lublin, has actual control over the company. If a valuation based on the average price paid for 1% of the market in the last several years is considered, Polmos Lublin, with a 6% market share, is worth approximately PLN 156 mn, or PLN 34 per share. Using the price that CEDC paid for Polmos Białystok this valuation increases to PLN 70 per share. The company's current valuation is similar to the lower of these values and, in our opinion does not reflect its potential or possibilities of increasing its market share.

Market Environment

The growth in excise in the near future should correspond to the growth in inflation.

The current excise tax accounts for a significant portion of the price of a bottle of vodka on store shelves. This is a price component on which producers have no influence. In the income statement, it is shown in both revenues and costs. Despite the fact that it has no influence on the level of generated profit, it does indirectly play an important role in the spirits industry:

- It has an influence on the total consumption of alcohol,
- It has an influence on the size of the hidden economy,
- A hike in excise can be used by producers to raise margins.

Despite the reduction of excise in 2003 it remains relatively high in comparison with other European countries. The risk of a drastic increase in excise appears marginal, while possible hikes should be similar to the growth in inflation.

Personnel Changes and New Strategy

The new president is tasked with rebuilding the company's image and market position...

On 6 July, the company announced the dismissal of president Wiesław Skrobowski and two other members of the management board – Magdalena Jarus (sales and marketing) and Sylwester Maćkowiak (exports and development). The new president is Marek Malinowski, associated with the Polmos Lublin Group since 2000 and a member of the management board since 2001. He restructured the company at the turn of 2001 and 2002 and has been responsible for sales and marketing since 2002. Together with Janusz Palikot, Waldemar Wasiluk and Zbigniew Borowy, he remained an executive of Polmos Lublin until fall 2004. During Marek Malinowski's tenure with Polmos Lublin, the company increased market shares, developed the product portfolio and broke even.

...and will not receive an annual 4% premium from net profit...

The personnel changes in the management board cost the company PLN 0.8 mn (severance packages), but in our forecasts, we assume that over the longer term this will allow the company to lower administrative costs, only as a result of lack of the 4% annual premium from net profit for president Skrobowski. The new management board is tasked to increase market share and lower operating costs through consolidation and growth in the segment of flavoured vodkas as well as an aggressive sales policy. Small and medium-size acquisitions in the segments of vodkas and products with a low alcohol content are also expected.

...as was the case with the previous president...

The nomination of the previous president was made with the privatisation of Polmos Białystok in mind, which could have been merged with Polmos Lublin, creating a strong player on the spirits market. This management board neglected the company's current operating activity while competing for the producer of Żubrówka. Marek Malinowski, who has sales experience, could help the company boost sales. However, the question arises of whether entering various segments of the market will not occur at the expense of margins. The company currently operates in the mainstream segment, which is an attractive segment in terms of realised margins. Introducing a new flavoured vodka in the economy segment (Balsam Kresowy) will help to increase the volume of sales, but will also have an influence on lowering the overall margin.

Characteristics of the Polmos Lublin management board

Previous board	Current board
Under estimated the threat from Balsam Pomorski	Plans to increase sales of key brands and enter all price segments
Lost market share and reacted too slowly to aggressive entry of Balsam Pomorski in the segment of inexpensive flavoured vodkas	Plans to recover the company's market position
Entangled in conflict with CEDC	Ended conflict with main distributor
Competing for Polmos Białystok, which cost the company PLN 4.4 mn, was a disaster	Will focus on acquisitions and development of less well known, but prospective Polish brands with long market history

Source: BRE Bank Securities

Results for 1H 2005 according to IFRS

Results for 1H 2004 and 1H 2005

Income statement (PLN '000)

	1H 2005	1H 2004	change %
Net sales revenues including excise	**132.2**	**153.5**	**-13.9%**
Excise	**88.8**	**106.5**	**-16.6%**
Net sales revenues excluding excise	43.4	47.1	**-7.8%**
Manufacturing costs	16.2	21.0	**-22.6%**
Operating costs	**24.0**	**17.6**	**36.1%**
EBITDA	3.4	9.6	**-65.0%**
EBIT	1.6	8.2	**-81.0%**
Net profit (loss)	-3.9	5.1	**-176.1%**

Source: Company

2Q 2005 results were additionally encumbered by the costs of battling for Polmos Białystok, estimated at PLN 4.4 mn

Several key factors exerted an influence on 1H 2005 results, which were prepared for the first time according to IFRS:

- The conflict with CEDC, the company's key client, which ceased to distribute Polmos Lublin products in April,
- The loss of market share to the less expensive Balsam Pomorski – since last year Balsam Pomorski's market share has increased from 0.5% to 3.1% as the growth in sales of Balsam Pomorski brought with it a growth in the market, WŻG's share in the overall vodka market fell from 6.4% to 5.0%,
- The one-off cost of severance packages (PLN 0.8 mn) for the management board – however, the change in the board will generate savings of PLN 2.5 mn in 2H,
- The one-off cost of competing for Polmos Białystok (PLN 4.4 mn) – mainly comprising financial and legal consulting costs and obtaining sources of financing, these costs are very high,
- The PLN 1.4 mn reserve for contentious liabilities from 2003 to the revenue office, which additionally encumbered the operating result; according to the board, the possible outflow of cash should not exceed PLN 200 thous,
- The decline in costs of manufacturing products sold (sugar, distillate, bottles), which helped the company to offset the negative effects of one-off factors – we assume that they will increase in subsequent years to the average level noted in 2003-2004.

Forecasted Margins

Polmos Lublin owes its success in previous years to Wódka Żołądkowa Gorzka. This vodka belongs to the mainstream segment and generates attractive margins. The decline in sales of WŻG as a result of the conflict with CEDC, the negligence of the previous management board and the appearance of Balsam Pomorski are all worrying phenomena. The management board believes that more intensive marketing activity will help the main brand recover the level of sales noted in previous years (1 mn litres per month). However, it appears that the market is not the same market as it was one year ago. We cautiously estimate that due to

We forecast a downward trend in the margin over the longer term.

promotional activity the company will manage to sell 10 – 11 mn litres of WŻG annually. The introduction of new products from lower price shelves will help to increase sales, but also lower the level of realised margins. The size of the margin in subsequent years will largely depend on the skill of the management board to create new brands in the premium segment. In September, the company will introduce a premium segment version of WŻG aimed at more affluent consumers as well as a new brand of pure vodka. Predicting the market success of the new brands is encumbered with significant risk. Therefore we take a cautious approach to this issue in our forecasts. An additional threat to the margin is distribution consolidation and the increased significance of modern trade (i.e., chain stores), which usually puts pressure on the margins of producers. Considering the above factors, in our forecasts we cautiously assume a downward trend in the margin.

Prospects for the Future

Polmos Lublin has good prospects for the future...

Polmos Lublin is broadening the product portfolio and planning to enter all price segments, which will grant it better control over the market. In Poland, the dynamics of growth in the market of flavoured vodkas continues to be higher than that for the overall vodka market. Completion of investments in the installation for the fractional distillation of alcohol and the production line for bottling vodka will allow the company to increase production capacity and lower production costs, making it possible to compete with strong players on the alcohol market. The company has a significant level of cash as well as considerable possibilities for financing acquisitions of other producers or brands. The share of revenues from exports in total revenues is growing – in 1H 2005 this share accounted for 4% of total sales against 1% in the previous year. Despite the fact that the scale of exports is not significant at this time, it does generate high margins. In light of these factors, we believe the company's growth prospects are very good.

Risk Factors

...however, further market success is encumbered with several risk factors.

1. The risk that the strong growth in the alcohol market in recent years was only due to consumers turning away from the hidden economy. The dynamics of further growth could be much lower. The consumption of specific beverages in turn, will depend on the fashion for drinking in the society. The consumption of flavoured vodkas has increased rapidly in recent years. However, consumption could shift to other alcoholic beverages.

2. The risk that the management board will not rebuild sales of WŻG to the level noted in 2004. The introduction of economy brands in turn, which is relatively the easiest, will lower the level of margins and the overall sales margin. Premium brands will help, but it is currently difficult to estimate their success on the very competitive market.

3. The risk of a dependence on a strong client, which as a result of a takeover will also become the largest producer of spirits on the Polish market. The management board plans to reduce CEDC's share in total distribution to 20% of total sales. Nevertheless, the share will remain significant.

Assumptions for Valuation Updated

The company's situation since the public offering has worsened as a result of the factors mentioned earlier. Although the management board describes these factors as one-off, it cannot be ignored that consolidation processes and the intensification of competition will lower the attractiveness of this sector for small and medium-size players.

As a result of the change in the structure of sales, the share of revenues from WGŻ in total sales will fall to 75%.

The most important elements exerting an influence on updating the valuation are:

- The decline in sales of WŻG in 2005 and lower sales in subsequent years, and therefore a drop in the margin on sales – the management board believes it can rebuild sales to 12 mn litres annually. In our opinion, following the entry of Balsam Pomorski the market shrank for WŻG and we cautiously assume that the company will sell 9 mn litres of WŻG this year, increase sales to 10 mn litres next year and growth in subsequent years will be limited, *According to IFRS, the trade mark is not subjected to amortisation.*

- The increase in sales of low margin products – Balsam Kresowy (we cautiously assume sales of 100 thous litres per month),
- Not amortising the trade mark – according to IFRS, the trade mark is considered an intangible fixed asset and is not subjected to amortisation, only to an annual test for loss in value,
- Conservative assumptions concerning sales of new products and brands as well as margins obtained on their sales,
- Excluding revenues from entering the segment of beverages with a low alcohol content from forecasts – due to the fact that their introduction is in question and encumbered with significant uncertainty,
- Excluding the incentive programme for the president from forecasts (additional remuneration totalling 4% of net profit annually).

Update of assumptions of results' forecasts in 2005/2006

Forecast element	Previous forecast	Current forecast	Effect in 2006 (current vs. previous forecast)
Sales of WŻG	WŻG sales of 12 mn litres in 2005, growth of 4.5%, 3%, 2% and 1% in subsequent years	Sales forecast lowered – 10 mn litres in 2006, 10.5 mn in 2007, growth of 2% and 1% in subsequent years	Revenues from WGŻ PLN 60 mn lower
Sales of new pure vodkas	Conservative assumptions concerning new brands - Żubr Strong, pure vodka in the premium segment as well as a new premium variety of WŻG	no change	no change
Acquisitions	We did not include the acquisition of producers and trade marks existing on the market	no change	no change
Beverages with a low alcohol content	Conservative assumptions in regard to entering the segment of beverages with a low alcohol content	None	revenues by PLN 26 mn lower
Sales of Balsam Kresowy	None	Conservative assumptions of 700 thous litres in 2005, 1200 thous in 2006, and 3% annual growth in subsequent years	Revenues by PLN 28 mn higher
Share in market of pure vodkas	Conservative assumptions concerning sales of unflavoured vodkas – with a target share in the market of unflavoured vodkas of 1%	no change	no change
Terminal growth rate	We adopted a level of 0% for the rate of FCF growth following 2013	no change	no change
Company president's incentive programme	4% of net profit beginning in 2006	No incentive programme	Company valuation PLN 9.5 mn higher
Amortisation of WŻG trade mark	Included	Not applicable (according to IFRS)	Amortisation PLN 6 mn lower

Source: BRE Bank Securities

Valuation

We conducted a valuation employing the DCF method for the beginning of 2006 as well as the comparative method. In the first method we updated the risk free rate to 4.9% in comparison to the previous report and, due to the increased investment risk, we raised beta to 1.2. After updating the forecasts presented above we obtained a valuation of PLN 34.

In the second method, we adopted shares of Polmos Białystok as the comparative base, to which we applied a 10% discount. It is important to note that these two companies are not fully comparable due to a number of factors:

- Polmos Białystok has a diversified product portfolio, is the leader in the category of unflavoured vodkas, and ranks second with respect to flavoured vodkas,
- Polmos Białystok has stabile financial results,
- It is difficult to estimate the effects of the CEDC acquisition of Polmos Białystok and its place in the CEDC Group.

We believe that including 2005 in the valuation, the result of which will be encumbered with the negative influence of one-off events, is unjustified. Therefore, we included only 2006 in the valuation. In this way, we obtained a valuation of PLN 36.1 using the P/E ratio and PLN 51.1 using the EV/EBITDA ratio. The latter result could be too high due to the fact that Polmos Białystok has stabile cash flow and results on the operating level. Therefore, we calculated the final valuation as the arithmetic average of the DCF result and the P/E comparative valuation, which amounts to PLN 35.

Comparative Valuation

Comparative valuation of Polmos Lublin

	price	Net profit 2006	P/E 2006	EBITDA 2006	EV/EBITDA 2006
Polmos Białystok*	78.2	66.5	14.0	81.9	11.4
Discount	10%	-	12.6	-	10.2
Polmos Lublin – resultant price	**43.6**	13.7	36.1	24.0	51.1

Source: BRE Bank Securities
**average of market forecasts*

DCF Valuation

		2006F	2007F	2008F	2009F	2010F	2011F	2012F	2013F	>2013F
										g=0%
Revenues		394	408	421	432	443	452	461	470	
revenues excluding excise		116	119	122	124	126	127	129	130	
Dynamics		22.7%	2.7%	2.3%	1.5%	1.6%	1.2%	1.2%	1.2%	
EBIT margin		16.6%	17.3%	17.2%	17.5%	17.4%	17.4%	17.4%	17.4%	
EBIT		19.3	20.5	20.9	21.7	21.8	22.1	22.4	22.7	
Tax rate		21%	21%	21%	21%	21%	21%	21%	21%	
Taxes		4.0	4.3	4.4	4.5	4.6	4.6	4.7	4.8	
NOPLAT		15.2	16.2	16.5	17.1	17.2	17.4	17.7	17.9	
Amortisation		4.7	5.2	5.5	5.7	6.0	6.0	6.0	6.0	
Investments in fixed assets and intangible fixed assets		4.0	4.0	4.0	5.7	6.0	6.0	6.0	6.0	
Change in working capital		-14.3	-2.7	-2.5	-2.0	-2.1	-1.7	-1.7	-1.7	
FCF		1.6	14.8	15.5	15.1	15.1	15.8	16.0	16.2	157
Risk free rate		4.9%	4.9%	4.9%	4.9%	4.9%	4.9%	4.9%	4.9%	5.6%
Risk premium		5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%
Beta		1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2
Cost of capital		10.9%	10.9%	10.9%	10.9%	10.9%	10.9%	10.9%	10.9%	11.6%
Credit premium		1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%
Cost of debt		5.9%	5.9%	5.9%	5.9%	5.9%	5.9%	5.9%	5.9%	6.6%
Debt / EV		20.0%	20.0%	20.0%	20.0%	20.0%	20.0%	20.0%	20.0%	20.0%
WACC		9.7%	9.7%	9.7%	9.7%	9.7%	9.7%	9.7%	9.7%	10.3%
Discount factor		0.91	0.83	0.76	0.69	0.63	0.58	0.52	0.48	
DCF		1.5	12.3	11.8	10.5	9.5	9.1	8.4	7.7	74.9
Sum of DCF and discounted terminal value (PLN mn)	145.6									
Net debt (PLN '000)	8.6									
goodwill (PLN '000)	154.3									
Number of shares ('000)	4.53									
price (PLN)	**34.0**									

Analysis of DCF valuation susceptibility to changes in beta and risk free rate

	0.80	**0.90**	**1.00**	**1.10**	**1.20**
3.6%	41.5	40.2	39.1	38.0	**37.1**
4.6%	39.1	38.0	37.1	36.2	**35.4**
5.6%	**37.1**	**36.2**	**35.4**	**34.7**	**34.0**
6.6%	35.4	34.7	34.0	33.4	**32.9**
7.6%	34.0	33.4	32.9	32.3	**31.8**

Income Statement (PLN '000)

	2003	2004	2005F	2006F	2007F	2008F
Net sales revenues	**304.8**	**338.6**	**317.8**	**393.8**	**407.9**	**421.1**
Net revenues excluding excise	**90.9**	**108.9**	**94.5**	**115.9**	**119.1**	**121.8**
Costs of products sold	**-41.4**	**-48.9**	**-37.7**	**-54.5**	**-55.4**	**-56.8**
Gross profit (loss) on sales	263.4	289.7	280.1	339.3	352.5	364.3
Gross profit excluding excise	49.5	60.0	56.8	61.4	63.7	65.0
Gross profit margin on sales	54%	55%	60%	53%	54%	53%
Costs of sales	-231.5	-246.2	-238.6	-293.9	-305.2	-316.0
of which excise	-213.9	-229.8	-223.3	-277.9	-288.8	-299.3
Administrative costs	-21.4	-21.9	-28.4	-25.9	-26.4	-26.9
Net profit (loss) on sales	10.6	21.7	13.2	19.6	20.9	21.4
Net profit margin on sales	12%	20%	14%	17%	18%	18%
EBITDA	12.8	26.2	10.2	24.0	25.8	26.4
EBITDA margin	14%	24%	11%	21%	22%	22%
EBIT	**10.9**	**20.1**	**7.4**	**19.3**	**20.5**	**20.9**
EBIT margin	12%	18%	8%	17%	17%	17%
Financial revenues	0.5	0.6	2.3	0.9	0.7	0.9
Financial costs	-2.7	-3.6	-7.5	-2.7	-2.3	-2.3
Gross profit (loss)	8.7	17.1	2.2	17.4	19.0	19.5
Taxes	-2.3	-4.5	-0.5	-3.7	-4.0	-4.1
Net profit (loss)	**6.4**	**12.5**	**1.8**	**13.7**	**15.0**	**15.4**
Net profit margin	7%	12%	2%	12%	13%	13%

Balance Sheet (PLN '000)

	2003	2004	2005F	2006F	2007F	2008F
Fixed assets	33.0	57.6	95.7	95.0	93.8	92.3
Intangible fixed assets	2.6	31.3	51.7	51.2	50.7	50.3
Tangible fixed assets	16.9	19.5	37.2	37.0	36.3	35.3
Long-term investments	11.5	3.3	3.3	3.3	3.3	3.3
Current assets	61.4	93.1	113.9	132.8	157.9	172.3
Inventories	6.4	6.8	6.5	7.4	7.6	7.8
Short-term accounts receivable	54.1	72.9	63.6	78.8	81.6	84.2
Short-term investments	0.3	13.2	13.2	0.0	0.0	0.0
Cash	0.5	0.2	30.6	46.6	68.8	80.3
Short-term deferred charges and accruals	0.9	5.4	5.4	5.4	5.4	5.4
Total assets	**95.3**	**156.1**	**215.0**	**233.2**	**257.2**	**270.0**
Shareholders' equity	37.0	49.5	138.2	151.5	174.3	186.0
Liabilities, of which:	55.7	104.7	75.0	79.9	81.1	82.2
Long-term credits and loans	2.0	16.6	15.6	15.6	15.6	15.6
Short-term credits and loans	11.9	29.6	19.6	19.6	19.6	19.6
trade liabilities	7.2	8.0	7.5	9.3	9.7	10.0
tax liabilities	29.7	41.3	23.1	26.2	27.0	27.9
Others	1.0	1.5	1.5	1.5	1.5	1.5
Accruals and deferred income	2.6	1.8	1.8	1.8	1.8	1.8
Total liabilities	**95.3**	**156.1**	**215.0**	**233.2**	**257.2**	**270.0**

Cash Flow Statement (PLN '000)

	2003	2004	2005F	2006F	2007F	2008F
Cash flow on operating activity	**40,7**	**18,0**	**-4,6**	**7,2**	**18,3**	**19,3**
Net profit (loss)	6,4	12,5	1,8	13,7	15,0	15,4
Amortisation	2,0	6,4	2,7	4,7	5,2	5,5
Shares in profits (dividends)	1,5	2,4	0,0	0,0	0,0	0,0
Change in working capital	32,3	-0,9	-9,1	-11,2	-1,9	-1,7
Other adjustments	3.7	8.0	0.0	0.0	0.0	0.0
Cash flow on investment activity	**-18.2**	**-43.1**	**-21.0**	**9.2**	**-4.0**	**-4.0**
Inflows	0.2	14.1	0.0	13.2	0.0	0.0
Outflows	-18.3	-57.2	-21.0	-4.0	-4.0	-4.0
Purchase of intangible and tangible fixed assets	-7.7	-38.5	-21.0	-1.0	-2.0	-2.0
Sale of investments in real estate and intangible fixed assets	0.1	4.0	0.0	13.2	0.0	0.0
Financial assets	-10.5	-14.9	0.0	0.0	0.0	0.0
Other investment expenses	-0.1	0.0	0.0	-2.0	-1.5	-1.5
Cash flow from financial activity	**-22.5**	**24.8**	**55.9**	**-0.4**	**7.8**	**-3.7**
Inflows	2.7	32.3	67.0	0.0	11.3	0.0
Net income from share issue	2.0	0.0	67.0	0.0	11.3	0.0
Credits and loans	0.7	0	0	0	0	0
Outflows	-25.2	-7.5	-11.1	-0.4	-3.4	-3.7
Dividends	0.0	0.0	0.0	-0.4	-3.4	-3.7
Repayment of credits and loans	-23.5	0.0	-11.1	0.0	0.0	0.0
Interest	-1.6	-2.8	0.0	0.0	0.0	0.0
Others	0.0	-4.7	0.0	0.0	0.0	0.0
Net cash flow	**0.0**	**-0.4**	**30.4**	**16.0**	**22.2**	**11.5**
Opening cash balance	0.5	0.5	0.2	30.6	46.6	68.8
Closing cash balance	**0.5**	**0.2**	**30.6**	**46.6**	**68.8**	**80.3**

Institutional Sales and Research:

Tomasz Mazurczak tel. (+48 22) 697 47 35
DISA Director
Tomasz.Mazurczak@breinwest.com.pl
Strategic Analysis

Michał Marczak tel. (+48 22) 697 47 38
DISA Deputy Director
Michal.Marczak@breinwest.com.pl
Telecommunications, raw materials, metals, media, hotels

Grzegorz Domagała tel. (+48 22) 697 48 03
DISA Deputy Director

Grzegorz.Domagala@dibre.com.pl

Sales:

Michał Skowroński tel. (+48 22) 697 49 68
Michal.Skowronski@dibre.com.pl

Emil Onyszczuk tel. (+48 22) 697 49 63
Emil.Onyszczuk@dibre.com.pl

Marzena Łempicka tel. (+48 22) 697 48 95
Marzena.Lempicka@dibre.com.pl

Grzegorz Stępień tel. (+48 22) 697 48 62
Grzegorz.Stepien@dibre.com.pl

Dzielnicki Adrian tel. (+48 22) 697 48 82
Adrian.Dzielnicki@dibre.com.pl

Joanna Niedziela tel. (+48 22) 697 48 54
Joanna.Niedziela@dibre.com.pl

Aleksander Mazur tel. (+48 22) 697 48 69
Aleksander.Mazur@dibre.com.pl

Analysts:

Witold Samborski tel. (+48 22) 697 47 36
Chief analyst
Securities Broker
Witold.Samborski@dibre.com.pl
Construction, others

Przemysław Smoliński tel. (+48 22) 697 49 64
Analyst
Przemyslaw.Smolinski@dibre.com.pl

Jacek Borawski tel. (+48 22) 697 48 88
Senior Analyst
Jacek.Borawski@dibre.com.pl
Technical Analysis

Sławomir Sklinda tel. (+48 22) 697 47 41
Analyst
Slawomir.Sklinda@dibre.com.pl
Chemicals

Andrzej Lis tel. (+48 22) 697 47 42
Analyst
Andrzej.Lis@dibre.com.pl
IT

Krzysztof Radojewski tel. (+48 22) 697 47 01
Analyst
Krzysztof.Radojewski@dibre.com.pl
Pharmaceuticals

Marta Jeżewska tel. (+48 22) 697 47 37
Analyst
Marta.Jeżewska@dibre.com.pl

Dom Inwestycyjny
BRE Banku S.A.
ul. Wspólna 47/49
00-950 Warszawa
skr. pocztowa 21
www.dibre.com.pl

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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Recommendations are updated at least once every nine months.

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BRE Bank Securities S.A. has not previously issued a recommendation for Polmos Lublin.