BRE Bank Securities S.A.

RESEARCH REPORT

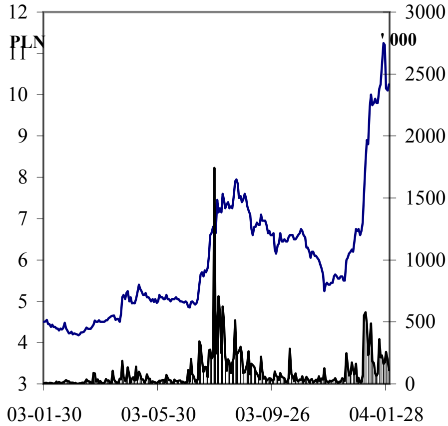
Rafako

Electrical Engineering

ISSN 1508-308X

Warsaw, 04.02.04

Return after years



The future looks bright for Rafako. Market liberalisation, privatisation and the development of production potential are factors that will increase the level of investments in the power generating sector over the next decade. A factor that will accelerate market liberalisation and the liberalisation of electricity prices will be the termination of long-term contracts. Administrative regulations concerning this issue should be ready at mid-year. Fully aware that competition will be appearing on the power market, producers are already beginning work on modernising production capacity. According to information received from Rafako, the value of tenders in which the company will participate this year is twice that noted the previous year. The value of modernisation work necessary in the power industry over the course of the next 5-6 years is estimated at PLN 35 bn.

Considering the increased investments in the power sector as well as investments connected with environmental protection, based on the DCF model, we estimate the value of one Rafako share at PLN 14.2. This year will be a period of acquiring new contracts for the company, but their influence on results will not be completely visible until 2005. At the current share price and the forecast of 2004 results, the company is listed with a P/E of 14.6 and EV/EBITDA of 6.15 (i.e. on a level similar to the median for the selected group of mid caps on the WSE). Nevertheless, we believe that, together with the inflow of good news connected with contracts and prospects for improving results in 2005, Rafako shares will outperform the market. The above-mentioned ratios for 2005 are 8.5 and 4.0, respectively.

Tenders involving large projects, which will have a major influence on company results over the next 2-4 years, should be resolved in 2004. The tender for building the power unit at the Bełchatów Power Station will be resolved in 1Q 2004. The value of this tender is approximately EUR 800 mn. Rafako and Alston Power are participating in the tender as a consortium. The company's share of the contract is estimated to total at least PLN 500 mn. Work on this project is scheduled to take three years (2004-2007). The second large project is PAK. In connection with an agreement between Elektrim and the State Treasury, as well as EBRD and commercial banks resuming the financing of this venture, the investment should begin in 1Q 2004. Rafako's share in this project is estimated at EUR 47 mn. Moreover, the company is participating in tenders for the construction of a flue gas desulphurisation installation at the Kozienice Power Station (approximately EUR 45 mn) and the delivery of boilers to power stations in Szczecin and Belarus (approximately EUR 80-100 mn).

Recommendation	**BUY**
Price	**10,50**
Valuation	**14,20**

Basis Data	
No. of shares ('000)	17 400
Free float	45%
Market cap (PLN '000)	182 700

Shareholder Structure	
Elektrim S.A.	49,89%
OFE Bankowy	5,04%
Others	45,07%

Analyst

Michał Marczak
tel (22) 697 47 38
fax (22) 697 47 43
Michal.Marczak@breinwest.com.pl

Dom Inwestycyjny BRE Banku S.A.
ul. Wspólna 47/49
00-490 Warsaw, skr. poczt. 21

www.brebrokers.com.pl

	Sales (PLN mn)	EBIT (PLN mn)	Net profit (PLN mn)	Cash earn. (PLN mn)	Price (PLN)	EPS (PLN)	P/E	BVPS (PLN)	P/BV	CEPS (PLN)	P/CE	EV/EBDIT
2001	416	3	-6	7	11	-0,3	-32,2	8	1,3	0,4	25,3	13,9
2002	557	15	9	21	11	0,5	20,1	9	1,2	1,2	8,6	6,7
2003F	443	14	6	16	11	0,3	31,2	9	1,2	0,9	11,6	7,4
2004F	610	20	13	22	11	0,7	14,6	9	1,1	1,3	8,2	6,1
2005F	727	30	21	31	11	1,2	8,5	11	1,0	1,8	5,8	4,0

NOTE: F - BRE Bank Securities forecast

In January 2004, Rafako announced it had won the tender for constructing flue gas desulphurisation installations in the two power units at the Bełchatów Power Station. The value of the contract is approximately EUR 63 mn. According to sector analysts, this increases the company's chances for further work in Bełchatów connected with the "super contract" (i.e. building a new power unit). Should the Alstom Power - Rafako consortium lose the tender, it is very likely that the company will be a subcontractor for the company winning the contract (a Japanese firm).

Paradoxically, the financial problems of Elektrim were good for the company. The company was not restructured through the liquidation of some production and design departments, which was done by competitive firms. As a result, just before the expected investment boom in the power sector the company maintained high production capacity, which currently facilitates its acquisition of turnkey contracts or contract work as a subcontract.

In the longer term, cooperation with Alstom, with which the company bids on major contracts (the firms mutually supplement their offers) is an opportunity for the company. Alstom, which is gradually extracting itself from a difficult financial situation, provides Rafako an opportunity to further increase sales on foreign markets. At present, revenues generated on foreign markets account for approximately 35% of Group revenues. According to assurances from the Management Board, in connection with Poland's entry to the EU, prospects for the company in this regard are promising.

Approximately ¾ of the boilers installed in Polish thermal-electric power plants originate from Rafako. The company possesses complete documentation of these installations, which gives it an important advantage over the competition in regard to their modernisation. In regard to technology, the company does not differ from foreign competitors, and surpass them in terms of production capacity. Even in the case of losing tenders, Rafako is frequently chosen by the winners as one of the subcontractors. The fact that Rafako is a subcontractor in selected projects for the largest competitor on the market – Foster Weeler (Łagisza Power Station, Matra Power Station - Hungary) illustrates the company's market position.

Following Poland's accession to the EU and the launch of environmental protection funds (tightening norms on the emission of pollutants), an increase in investment outlays on flue gas desulphurisation installations (thermal-electric power plants) as well as investments in municipal waste management can be expected. Modern waste incinerators are an increasingly more common method of solving this problem in the EU. Rafako has foreign experience in this type of project.

Long-term contracts (LTC) were contracts concluded between electricity producers and Polskie Sieci Elektroenergetyczne (Polish Power Grid Operator - PSE), in which PSE was obligated to receive a defined quantity of electricity for a defined price. As approximately 80% of electricity is purchased on the basis of LTCs, the existence of these contracts makes it impossible to create a real electricity market and to establish a market price for electricity. Therefore, the government prepared a draft bill terminating the LTCs and will send it to parliament. Electricity producers will be compensated in an amount equal to the discounted difference between the higher price guaranteed in the LTCs and the expected lower market price. Terminating the LTCs (i.e., liberalising the electricity generating market) will push up prices in relation to current market prices and result in a decline in relation to the average price in deliveries covered by the long-term contracts. The relation of these prices is PLN 118 to PLN 156 per kWh. This means that competition will step in on the Polish power sector, forcing firms to make investments.

Risk factors

Rafako primarily specialises in the manufacture of pulverised fuel fired boilers. Fluidised bed boilers, which do not require, among others, an additional flue gas desulphurisation installation, are a newer technology. The company has less experience in this assortment, which theoretically lowers its chances for obtaining contracts which involve precisely fluidised bed boilers. In Polish conditions, "classic" pulverised fuel fired boilers have two fundamental advantages: they are more efficient in cases of large fluctuations in demand for electricity (in annual and daily terms) and the fuel used by the domestic power industry is more effectively used precisely in the case of pulverised fuel fired boilers.

Elektrim, Rafako's principal shareholder, remains a risk factor in investing in the company's shares. A portion of the company's contracts is realised by an Elektrim subsidiary – Megadex, which creates a risk of showing value added in the company wholly owned by Elektrim.

Due to the small dilution of the value of contracts, the risk of a client declaring bankruptcy is a characteristic feature of Rafako's activity, particularly when modernising an ineffective power plant. Following the termination of long-term contracts and the liberalisation of electricity prices, "expensive" producers that do not complete restructuring on time could go bankrupt, which would mean significant losses for the company even in the case of a relatively small contract. However, it should be pointed out that the company has an opportunity to cooperate with the "least expensive" electricity producers in Poland (Bełchatów, PAK).

The growth in prices of raw materials and steel creates a risk that increased costs of material purchases will not be passed on the end client. This primarily concerns current contracts. We expect that, in the case of new projects, all bidders will include increased material costs in their offers, which will not negatively impact gross margins on sales in the long-term.

Assumptions to the DCF model

	2004F	2005F	2006F	2007F	2008F	TV
EBIT	**20**	**30**	**33**	**36**	**40**	**40**
Tax rate	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%
Taxes	4	6	6	7	8	8
NOPLAT	**16**	**24**	**27**	**29**	**32**	**33**
Amortisation	10	10	10	10	11	11
CAPEX	-10	-12	-12	-12	-12	-11
CWC	-14	-3	-8	-9	-5	-8
FCF	1	19	17	19	26	25
DFCF	1	16	13	12	15	
WACC						
Cost of capital	11.6%	11.6%	11.6%	11.6%	11.6%	10.1%
Risk rate	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%
Beta	0.9	0.9	0.9	0.9	0.9	0.9
Cost of debt	7.6%	7.6%	7.6%	7.6%	7.6%	6.1%
Risk free rate	7.1%	7.1%	7.1%	7.1%	7.1%	5.6%
Spread	0.5%	0.5%	0.5%	0.5%	0.5%	0.5%
Net debt / EV	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
WACC	**11.6%**	**11.6%**	**11.6%**	**11.6%**	**11.6%**	**10.1%**

Growth in perpetuity	2.00%
PV TV	183
DFCF	58
Net debt	-7
Valuation	247
Valuation per share	**14.2**

Market ratios for mid caps

	Kęty	Polfa	Farmacol	PGF	Orbis	Echo	Sanok	Groclin	Lentex	Forte	Relpol	**Median**	**Rafako**	**Rafako**
price (PLN)	**131**	**229**	**24**	**49**	**26.0**	**70.2**	**136**	**119**	**26.5**	**10.9**	**77.3**		**10.7**	**14.5**
P/E 2004	14.5	10.9	12.6	13.1	28.4	17.6	11.6	15.4	11.6	11.2	14.9	**13.1**	**14.3**	**19.4**
dyn EPS; end 2003 - end 2005 (CAGR)	21%	21%	9%	21%	2%	N/A.	38%	18%	54%	32%	48%	**0.2**	**94%**	**94%**
P/E 2003	18.6	13.9	13.6	16.6	21.9	21.7	19.3	19.1	24.5	16.1	23.7	**19.1**	**31.8**	**43.0**
PEG	**0.90**	**0.67**	**1.56**	**0.80**	**9.59**	**N/A**	**0.51**	**1.05**	**0.45**	**0.51**	**0.49**	**0.7**	**0.34**	**0.46**
P/E 2005	**12.8**	**9.5**	**11.5**	**11.4**	**20.9**	**N/A**	**10.1**	**13.7**	**10.3**	**9.3**	**10.8**	**11.1**	**8.5**	**11.5**
div yield – 2003 – 2004 ave	2.0%	0.0%	0.0%	2.5%	1.7%	0.0%	0.0%	0,0%	4.9%	0.0%	0.0%		**0.0%**	**0.0%**
EV/EBITDA 2004	9.4	6.2	8.4	8.1	9.8	12.6	6.4	10.1	4.8	5.3	7.7	**8.1**	**6.2**	**8.4**
EV/EBITDA 2005	8.3	5.1	7.7	7.1	8.3	N/A	5.4	9.0	4.3	4.5	6.8	**6.9**	**4.2**	**5.8**
ROIC 2004	16%	16%	13%	13%	4%	N/A	31%	15%	7%	10%	8%		**5%**	**5%**

Source: BRE Bank Securities

Profit and Loss Account

(PLN mn)	**1999**	**2000**	**2001**	**2002**	**2003F**	**2004F**	**2005F**	**2006F**	**2007F**	**2008F**
Revenues	**434.6**	**367.1**	**415.6**	**557.2**	**442.5**	**609.5**	**726.5**	**799.2**	**879.1**	**967.0**
Costs	374.2	325.6	384.7	490.0	371.8	527.8	631.1	697.5	770.8	851.8
Gross profit (loss) on sales	**60.5**	**41.5**	**30.9**	**67.2**	**70.7**	**81.7**	**95.4**	**101.7**	**108.3**	**115.2**
Cost of sales	8.0	8.3	8.3	7.8	10.6	11.2	11.7	12.3	12.9	13.6
Administrative costs	26.6	22.1	20.9	21.9	20.2	22.2	23.4	24.5	25.8	27.0
Net profit (loss) on sales	**25.8**	**11.0**	**1.7**	**37.5**	**39.9**	**48.3**	**60.3**	**64.9**	**69.7**	**74.6**
Other operating revenues	16.9	14.2	8.5	7.7	3.1	0.0	0.0	0.0	0.0	0.0
Other operating costs	31.3	21.0	7.3	29.9	29.2	28.7	30.2	31.7	33.3	34.9
EBIT	**11.3**	**4.2**	**3.0**	**15.3**	**13.8**	**19.6**	**30.2**	**33.2**	**36.4**	**39.7**
Financial revenues	14.2	29.7	5.7	5.3	8.7	4.3	4.8	2.5	2.9	3.4
Financial costs	21.3	22.3	14.5	10.1	9.4	7.8	7.8	7.8	7.8	7.8
Profit (loss) on sale of holdings	0.0	0.0	1.3	0.0	-0.3	0.0	0.0	0.0	0.0	0.0
Profit on economic activity	**4.2**	**11.6**	**-4.6**	**10.5**	**12.8**	**16.1**	**27.1**	**27.9**	**31.5**	**35.3**
Result on extraordinary events	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Goodwill write-off	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Negative goodwill write-off	-3.9	-1.4	-0.7	-0.7	-0.3	0.0	0.0	0.0	0.0	0.0
Gross profit (loss)	**8.1**	**13.0**	**-3.8**	**11.3**	**13.1**	**16.1**	**27.1**	**27.9**	**31.5**	**35.3**
Income tax	0.0	0.0	1.2	2.3	6.8	3.1	5.2	5.3	6.0	6.7
Other reductions	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Share in profits	1.6	0.2	-0.4	0.6	-0.1	0.0	0.0	0.0	0.0	0.0
(Profits) losses of minorities	0.6	0.3	-0.3	-0.5	-0.3	-0.5	-0.5	-0.5	-0.5	-0.5
Net profit (loss)	**10.3**	**13.5**	**-5.7**	**9.1**	**5.9**	**12.5**	**21.5**	**22.1**	**25.0**	**28.1**
	1999	**2000**	**2001**	**2002**	**2003F**	**2004F**	**2005F**	**2006F**	**2007F**	**2008F**
Gross profit margin on sales	13.9%	11.3%	7.4%	12.1%	16.0%	13.4%	13.1%	12.7%	12.3%	11.9%
Operating profit margin	2.6%	1.1%	0.7%	2.7%	3.1%	3.2%	4.2%	4.2%	4.1%	4.1%
Gross profit margin	1.9%	3.6%	-0.9%	2.0%	3.0%	2.6%	3.7%	3.5%	3.6%	3.7%
Net profit margin	2.4%	3.7%	-1.4%	1.6%	1.3%	2.1%	3.0%	2.8%	2.8%	2.9%
ROE	7.4%	9.2%	-4.1%	6.1%	3.9%	7.6%	11.5%	10.6%	10.7%	10.7%
ROA	2.8%	3.5%	-1.6%	2.3%	1.7%	3.0%	4.4%	4.1%	4.3%	4.3%

Balance Sheet

(PLN mn)	1999	2000	2001	2002	2003F	2004F	2005F	2006F	2007F	2008F
ASSETS	**374**	**384**	**354**	**396**	**350**	**416**	**490**	**537**	**589**	**651**
Fixed assets	**173**	**183**	**116**	**135**	**111**	**119**	**125**	**129**	**135**	**140**
Intangible fixed assets	10	7	6	4	3	3	3	3	3	3
Goodwill from consolidation	0	0	0	0	0	0	0	0	0	0
Tangible fixed assets	64	67	63	56	53	54	56	58	59	61
Long-term receivables	3	6	0	0	0	0	0	0	0	0
Long-term investments	55	49	32	52	36	36	36	36	36	36
Accruals	40	54	16	23	19	26	30	33	36	40
Current assets	**201**	**201**	**238**	**261**	**239**	**297**	**365**	**407**	**454**	**511**
Inventories	37	22	28	31	31	35	42	46	51	57
Short-term receivables	151	171	164	114	98	135	168	184	203	223
Short-term investments	13	7	10	55	62	60	77	89	103	125
Accruals	0	0	35	61	48	66	79	87	96	106
	1999	**2000**	**2001**	**2002**	**2003F**	**2004F**	**2005F**	**2006F**	**2007F**	**2008F**
LIABILITIES AND EQUITY	**374**	**384**	**354**	**396**	**350**	**416**	**490**	**537**	**589**	**651**
Shareholders' equity	**139**	**146**	**138**	**148**	**152**	**165**	**186**	**208**	**233**	**262**
Stock capital	35	35	35	35	35	35	35	35	35	35
Capital paid-up and unsubscribed	0	0	0	0	0	0	0	0	0	0
Own shares	0	0	0	0	0	0	0	0	0	0
Reserve capital	159	67	74	82	87	93	105	127	149	174
Revaluation reserve capital	15	15	15	13	13	13	13	13	13	13
Other reserve capital	0	0	0	0	0	0	0	0	0	0
Profit (loss) from previous years	-80	15	20	10	12	12	12	12	12	12
Net profit (loss)	10	13	-6	9	6	13	21	22	25	28
Charges	0	0	0	0	0	0	0	0	0	0
Capital of minorities	**3**	**3**	**3**	**3**	**3**	**3**	**3**	**3**	**3**	**3**
Negative goodwill	**4**	**2**	**1**	**1**	**0**	**0**	**0**	**0**	**0**	**0**
Liabilities and reserves	**229**	**233**	**211**	**243**	**195**	**248**	**300**	**325**	**352**	**386**
Reserves for liabilities	19	23	19	15	12	17	22	24	27	30
Long-term liabilities	7	9	4	3	2	3	3	3	3	3
Short-term liabilities	135	140	159	153	124	161	186	202	219	238
Accruals	68	60	29	72	57	66	89	96	103	116

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

Department of Institutional Sales and Analysis:

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

Grzegorz Domagała tel. (+48 22) 697 48 03
Assistant Director
Grzegorz.Domagala@breinwest.com.pl

Sales:
Michał Skowroński tel. (+48 22) 697 49 68
Michal.Skowronski@breinwest.com.pl
Emil Onyszczuk tel. (+48 22) 697 49 63
Emil.Onyszczuk@breinwest.com.pl
Marzena Łempicka tel. (+48 22) 697 48 95
Marzena.Lempicka@breinwest.com.pl
Grzegorz Stępień tel. (+48 22) 697 48 62
Grzegorz.Stepien@breinwest.com.pl
Tomasz Roguwski tel. (+48 22) 697 48 82
Tomasz.Roguwski@breinwest.com.pl

Analysts:
Hanna Kędziora tel. (+48 22) 697 47 37
Hanna.Kedziora@breinwest.com.pl
Chemicals, pharmaceuticals, household appliances, foodstuff industry

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

Andrzej Powierża tel. (+48 22) 697 47 42
Andrzej.Powierza@breinwest.com.pl
Banks, insurance, others

Witold Samborski tel. (+48 22) 697 47 36
Witold.Samborski@breinwest.com.pl
IT, construction, others

Przemysław Smoliński tel. (+48 22) 697 49 64
Przemyslaw.Smolinski@breinwest.com.pl
Assistant Analyst, technical analysis

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*

Recommendations of BRE Bank Securities:
A recommendation is valid for a period of 3-6 months, unless a subsequent recommendation is issued within this period.
BUY – we expect that the rate of return from an investment in a company's shares will be at least 15% higher than the WIG
ACCUMULATE – we expect that the rate of return from an investment in a company's shares will be 5%-15% higher than the WIG
HOLD – we expect that the rate of return from an investment in a company's shares will be within +/-5% in relation to the WIG
REDUCE – we expect that the rate of return from an investment in a company's shares will be 5%-15% lower than the WIG
SELL – we expect that the rate of return from an investment in a company's shares will be at least 15% lower in relation to the WIG

Strong and weak points of valuation methods used in recommendations:
DCF – acknowledged as the most methodologically correct method of valuation; it consists in discounting financial flows generated by a company; its weak point is the significant susceptibility to a change of forecast assumptions in the model
Multiple – based on a comparison of valuation multipliers of companies from a given sector; simple in construction, reflects the current state of the market better than DCF; weak points include substantial variability (fluctuations together with market indices) as well as difficulty in the selection of the group of comparable companies.