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Special comment

Construction

Poland

Maciej Stokłosa
(48 22) 697 47 41
maciej.stoklosa@dibre.com.pl

PBG

PBGG.WA; PBG.PW

Reduce

(Reiterated)

Q4 2009 – All That Glitters Is Not Gold

Current price: PLN 215.0; Target price PLN 173.2

The 2009 fourth-quarter results of PBG came ahead of expectations thanks to one-time events. We think that the bulk of the provision reversals made in the second half of 2009, totaling PLN 22.2m, were credited to fourth-quarter profits. Moreover, the period's bottom-line figure was boosted by PLN 10m losses attributable to minority shareholders. After adjustment for the one-offs, the Q409 earnings results prove weaker than predicted, and this applies also to subsidiary Hydrobudowa, the source of the majority of the provision reversals. We believe that PBG's market valuation factors in expectations of sustained high future margins which, in our view, will not pan out (the share of high-margin contracts in PBG's order backlog is decreasing, and competition in the construction industry is heating up). What is more, we expect strong competition to weigh on PBG's revenues in 2011, plus, the company's attempts at branching out of its "natural habitat" without adequate human resources and know-how raises concerns over the profitability of new contracts. This can be interpreted as the first sign that future margins will be retreating from their current highs. We are reiterating a reduce rating on PBG.

On a 14% lower-than-expected revenue, PBG generated a higher-than-expected gross margin (16.6% vs. expected 14.7%). By discontinuing cumulative reporting of intercompany eliminations, which are now presented separately for each segment, PBG made it impossible to conduct period-over-period comparisons. The Q409 gross profit was influenced by reversed provisions for potential contract losses (we suspect that the bulk of the PLN 22.2m reversals made in H2 2009 were booked in Q4 2009 profits). Assuming that the amount credited to the fourth-quarter profit was PLN 15.3m (67% of the total reversals), the adjusted gross profit would have been PLN 138.9m (gross margin would have been slightly ahead of estimates at 15.0%).

SG&A expenses amounted to PLN 27.3m, less than our PLN 29.9m estimate, while other net operating expenses exceeded expectations at PLN 9.0m (we expected PLN 4.3m). Other net financial expenses were lower than predicted (PLN 5.5m) at PLN 2.8m. Tax was in line. Minority interests produced a loss of PLN 10m versus an expected profit of PLN 14.3m, as a result of the following accounting operation:
Hydrobudowa Polska, which is 62.74% controlled by PBG, owns a 100% interest in Hydrobudowa 9 and consolidates its earnings since January 2009. Normally, therefore, PBG should recognize 37.26% of the earnings of Hydrobudowa 9 under minority interests. However, under IAS 27, implemented in Q4 2009, the majority shareholder should consolidate the whole of the earnings of a subsidiary in which it holds an interest of less than 100% so long as the subsidiary reports negative equity (as is the case of Hydrobudowa 9, whose equity was a negative PLN 125m at year-end 2009). If it had not been for IAS, the profits attributable to minority interests reported by PBG would have been at least PLN 13.8m, representing 37.26% of the Q409 profit of Hydrobudowa Polska (PLN 37.0m). PBG will continue to consolidate the financial statements of Hydrobudowa 9 until the latter achieves a positive equity, which means that it will book additional gains over the next few years. Hydrobudowa 9's negative equity could be an effect of provisions for contract losses recognized before the takeover by PBG.

Reported vs. forecasted Q4 2009 results of PBG

	Q4 2009*	Q4 2009F	difference	Consensus Estimates	difference	Q4 2008	change
Revenue	926.9	1082.0	-14.3%	1066.0	-13.0%	720.3	28.7%
Gross profit	154.2	159.1	-3.1%	-	-	129.7	18.8%
Gross margin	16.6%	14.7%	-	-	-	18.0%	-
EBIT	117.8	124.9	-5.6%	127.0	-7.2%	80.8	45.9%
EBIT margin	12.7%	11.5%	-	-	-	11.2%	-
Pre-tax income	115.1	119.4	-3.6%	-	-	90.6	26.9%
Pre-tax margin	12.4%	11.0%	-	-	-	12.6%	-
Net income	101.5	82.4	23.3%	87.8	15.6%	73.5	38.1%
Net margin	11.0%	7.6%	-	8.2%	-	10.2%	-

*Source: PBG, F - forecasts by BRE Bank Securities, Consensus estimates by PAP; * earnings calculated based on the difference between FY 2009 consolidated report and Q3 2009 earnings*

Reported vs. forecasted Q4 2009 results of Hydrobudowa Polska

	Q4 2009*	Q4 2009F	differ.	Q4 2008	change
Revenue	625.8	548.0	14.2%	384.0	63.0%
Gross profit	63.1	49.3	28.0%	26.6	137.6%
Gross margin	10.1%	9.0%	-	6.9%	-
EBIT	43.8	29.3	49.4%	-6.4	-783.1%
EBIT margin	7.0%	5.4%	-	-1.7%	-
Pre-tax income	42.6	31.2	36.3%	1.0	4291.4%
Pre-tax margin	6.8%	5.7%	-	0.3%	-
Net income	37.0	28.6	29.7%	6.0	515.5%
Net margin	5.9%	5.2%	-	1.6%	-

Source: Hydrobudowa Polska, F - forecasts by BRE Bank Securities

PBG's earnings in Q4 2009 were improved by the release of contract and guarantee provisions and minority losses. Below, we present our estimate of the group's recurrent earnings, on the assumption that 67% of the provisions released were for Q4 2009. Our calculation of recurrent earnings factors in the impact of IAS 27 on minority profits. Under IAS 27, it is necessary not to recognize part of the profits/losses of minority shareholders of Hydrobudowa Polska (in the part that corresponds to the profit of Hydrobudowa 9). If Hydrobudowa 9 did not have negative equity, instead of PLN 10m minority loss PBG would report a PLN 13.8m minority profit for Q4 2009. The difference that arises reduces recurrent profits for Q4 2009.

Estimated Recurrent earnings of Hydrobudowa and PBG

(PLN m)	Q4 2009 recurrent	Q4 2009 nominal	Difference
Sales revenue	926.9	926.9	0.0
Gross profit	138.9	154.2	-15.3
% margin	15.0%	16.6%	-
EBIT	102.5	117.8	-15.3
% margin	11.1%	12.7%	-
Pre-tax profit	99.8	115.1	-15.3
% margin	10.8%	12.4%	-
Net profit	62.4	101.5	-39.1
% margin	6.7%	11.0%	-

Source: BRE Bank Securities, PBG; earnings calculated based on the difference between FY 2009 consolidated report and Q3 2009 earnings

Changes in the provisions of PBG and Hydrobudowa Polska (PLN m)

(PLN m)	Q4 2009	Q2 2009	Q4 2008	Q4/Q2 2009 change
Grupa PBG	53.2	75.5	88.5	-22.2
Hydrobudowa Polska	39.0	64.9	80.8	-25.9

*Source: BRE Bank Securities, Hydrobudowa Polska, PBG; * earnings calculated based on the difference between FY 2009 consolidated report and Q3 2009 earnings*

FY2009 results by business segment

(PLN m)	Gas & Oil	Hydro-engineering	Fuels	Construction	Roads	Other	Total
PBG							
Revenue	399.8	996.0	83.3	881.2	187.0	30.6	2578.0
Gross profit	84.3	121.1	7.7	136.8	29.7	12.5	392.1
Gross margin	21.1%	12.2%	9.2%	15.5%	15.9%	40.9%	15.2%
Hydrobudowa Polska							
Revenue	4.2	840.1	22.3	729.6	24.1	55.3	1675.6
Gross profit	0.0	100.1	-12.4	71.7	0.3	5.0	164.7
Gross margin	0.1%	11.9%	-55.8%	9.8%	1.3%	9.1%	9.8%

Source: BRE Bank Securities, Hydrobudowa Polska, PBG

Michał Marczak tel. (+48 22) 697 47 38
Managing Director
Head of Research
michal.marczak@dibre.com.pl
Strategy, Telco, Mining, Metals, Media

Research Department:

Marta Jeżewska tel. (+48 22) 697 47 37
Deputy Director
marta.jezewska@dibre.com.pl
Banks

Analysts:

Kamil Kliszcz tel. (+48 22) 697 47 06
kamil.kliszcz@dibre.com.pl
Fuels, Chemicals, Energy, Retail

Piotr Grzybowski tel. (+48 22) 697 47 17
piotr.grzybowski@dibre.com.pl
IT, Media

Maciej Stokłosa tel. (+48 22) 697 47 41
maciej.stoklosa@dibre.com.pl
Construction, Real-Estate Developers

Jakub Szkopek tel. (+48 22) 697 47 40
jakub.szkopek@dibre.com.pl
Manufacturers

Sales and Trading:

Piotr Dudziński tel. (+48 22) 697 48 22
Director
piotr.dudzinski@dibre.com.pl

Marzena Łempicka-Wilim tel. (+48 22) 697 48 95
Deputy Director
marzena.lempicka@dibre.com.pl

Traders:

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

Grzegorz Stępien tel. (+48 22) 697 48 62
grzegorz.stepien@dibre.com.pl

Tomasz Dudź tel. (+48 22) 697 49 68
tomasz.dudz@dibre.com.pl

Michał Jakubowski tel. (+48 22) 697 47 44
michal.jakubowski@dibre.com.pl

Tomasz Jakubiec tel. (+48 22) 697 47 31
tomasz.jakubiec@dibre.com.pl

Grzegorz Strublewski tel. (+48 22) 697 48 76
grzegorz.strublewski@dibre.com.pl

"Private Broker"

Jacek Szczepański tel. (+48 22) 697 48 26
Director
jacek.szczepanski@dibre.com.pl

Paweł Szczepanik tel. (+48 22) 697 49 47
Sales
pawel.szczepanik@dibre.com.pl

Dom Inwestycyjny
BRE Banku S.A.
ul. Wspólna 47/49
00-950 Warszawa
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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