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Special comment

**Construction**

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Reduce

(Reiterated)

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Good Q2 Showing, But Our Outlook Stays the Same**Current price: PLN 223.0; Target price PLN 194.0**

PBG published consolidated earnings ahead of the forecast consensus. According to our estimates, this positive surprise is 60% due to a better-than-expected showing on the part of Hydrobudowa. We discuss the subsidiary's earnings further down in this commentary. The key factors to pay attention to are high gross margins (15.4% consolidated, thanks to excellent margins in Hydroengineering and Gas&Oil) and high other net operating expenses (PLN 6.0m consolidated). The consolidated earnings may only partially be attributed to released provisions (in H1, provisions declined by PLN 12.3m, of which at least PLN 8m came in Q1). In addition, the Company reported positive cash flows from operations (+PLN 59.6m). To sum up, we believe that PBG is in its peak form in 2010, just like Budimex. PBG surprised us on the upside with the structure of its earnings, and Budimex may do so as well, when its earnings for H1 2010 are published. The high margins are primarily attributable to old contracts, whose timing was very good (2008, early 2009). With time, the impact of these contracts on the Company's earnings will be reduced. The Hydroengineering segment, which used to be very profitable for PBG, has no growth perspectives. The Group is getting more revenue, but in less profitable segments (roads). Despite the good performance of Budimex and PBG, which could lead to a revision in our FY10 earnings forecast, we believe the signals coming from other companies will raise doubts as to whether comparable or better earnings are possible in 2011. We are reiterating a negative rating on PBG.

Actual vs. forecasted earnings, consensus

(PLN m)	Q2 2010	Q2 2010F	Difference	Consensus estimates (PAP)	Difference	Q2 2009	Change
Revenue	729.3	719.3	1.4%	719.0	1.4%	599.4	21.7%
Pre-tax profit	112.0	93.5	19.8%	-	-	86.7	29.2%
Pct. margin	15.4%	13.0%	-	-	-	14.5%	-
EBIT	73.9	63.7	15.9%	69.0	7.0%	67.7	9.0%
Pre-tax profit	74.1	59.5	24.5%	-	-	69.3	7.0%
Net profit	62.5	51.2	22.2%	53.0	18.0%	46.9	33.3%

Source: PBG, BRE Bank Securities

Revenue was only slightly higher than expected, but the gross margin was another story at 15.4% vs. 13% forecasted. The increase in margins cannot be attributed to released provisions. In H1 2010, provisions declined by PLN 12.3m, including reversals of at least PLN 8m in Q1 (with PLN 8m reversed at Hydrobudowa 9). As for the individual segments, the very high margin in Gas&Oil stands out (thanks to the very profitable contracts with PGNiG signed in 2008). We should also take note of the Hydroengineering segment, whose excellent earnings may, in turn, be a consequence of the completion of old, very profitable and highly specialist contracts. Profitability is also high in the Road Construction segment, but what we believe is going on in this case is a reversing of the losses incurred in Q1'10 (H1 gross margin in the segment = 9.2%). In turn, the margin was low in Industrial and Housing Construction, which includes the stadium contracts.

Earnings of PBG by segment

Segment	Revenue	Gross margin
Gas and oil engineering	138.1	28.6%
Hydroengineering	174.4	23.5%
Housing & industrial construction	330.1	5.7%
Roads	76.6	14.6%
Other	10.1	15.8%

Source: BRE Bank Securities, PBG

General expenses were lower than expected at PLN 32.2m vs. PLN 34.7m forecasted, but other net operating expenses were higher (PLN 6m vs. PLN 5m expected). The main cost items in this category in H1 2010 were write-downs on receivables (PLN 13.2m) and penalties and damages (PLN 15m). On the other hand, other finance expenses figured to -PLN 0.2m, where we expected PLN 4.2m. The effective tax rate was 15.7%. All in all, the PLN 62.5m bottom line was 22% higher than expected by us and 18% above consensus forecast.

Second-quarter earnings of Hydrobudowa Polska

Hydrobudowa Polska also generated good earnings in the second quarter, ahead of our expectations at the gross margin level (10.2% vs. 8.2%). The excellent margin is largely a consequence of the very high profitability in Hydroengineering (18.8% gross margin), which we believe cannot be replicated. Hydrobudowa Polska's good gross margins are not a consequence of provisions adjustments (provisions declined by PLN 8m in H1'10, but this happened in the first quarter). The only negative factor affecting earnings was negative operating cash flow (-PLN 28.5m in Q2). To sum up, these earnings are ahead of our expectations, but we doubt they can be replicated. We do not believe this positive earnings surprise could entail an FY10 profit much ahead of what the Management is suggesting in press interviews (PLN 40m).

Actual vs. forecasted earnings of HP, PAP consensus

(PLN m)	Q2 2010	Q2 2010F	Difference	Consensus estimates (PAP)	Difference	Q2 2009	Change
Revenue	471.5	444.0	6.2%	450.0	4.8%	341.6	38.0%
Pre-tax profit	48.2	36.4	32.3%	-	-	33.5	43.9%
<i>Pct. margin</i>	<i>10.2%</i>	<i>8.2%</i>	-	-	-	<i>9.8%</i>	-
EBIT	24.5	19.2	27.3%	24.0	1.9%	26.4	-7.5%
Pre-tax profit	23.0	14.9	54.6%	-	-	36.4	-36.8%
Net profit	22.2	14.9	49.3%	21.2	4.7%	37.1	-40.2%

Source: Hydrobudowa Polska, BRE Bank Securities

Earnings of HP by segment

Segment	Revenue	Gross margin
Gas and oil engineering	-	-
Hydroengineering	147.0	18.8%
Housing & industrial construction	304.0	7.1%
Roads	8.3	1.8%
Other	12.2	-9.7%

Source: Hydrobudowa Polska, BRE Bank Securities

Possible alliance with an infrastructure maintenance company

PBG announced that within 3-4 weeks it was going to enter into a strategic alliance with a major European infrastructure maintenance company which operates railroads, roads, medical facilities and shopping malls. At present, PBG is working on two projects of this type, one in Poland and one in Ukraine. The Company's future partner is also a construction company. By teaming up with it, PBG will be able to acquire competences in tunnel, railway, subway and water reservoir construction. We do not know how big this line of business is supposed to get. We consider this piece of news neutral. As shown by various examples from the market, the business can be highly or moderately profitable, or loss-making. Infrastructure maintenance, which can basically be equated with public-private partnerships, is being considered by most construction companies, including unlisted ones. They start thinking about PPP whenever there are not enough high-margin projects in the market. Their hope is that they will get contracts for both maintenance and construction, the latter usually more profitable than other contracts available in the market.

Contract Opportunities

PBG is bidding for power engineering contracts at power plants in Opole, Koźienice, Jaworzno and Stalowa Wola (new unit construction) and Bełchatów (upgrades). The Company has been qualified for the tender for the construction of an underground gas storage facility in Kosakowo. Bids, expected to reach several hundred million zloty, are due on 18 October. PBG is also attempting to get foreign gas and oil engineering contracts. For now, the Company has not disclosed which contract these are, due to their non-public nature. PBG has been saying that it wants to land such contracts abroad for several years. This line of business was successfully pursued by Polimex Mostostal's subsidiaries. In Ukraine, PBG is preparing to launch stage 2 of the construction of a housing project. In Bulgaria, delays occurred in the process of EU funds acquisition (PBG could be involved in environmental engineering contracts there). The CEO estimates that in late 2010 or early 2011, the value of the Group's order backlog might reach PLN 5-6bn. Our forecast is based on an optimistic scenario as far as new order acquisition is concerned. The scenario may fail to play out, in which case our future earnings forecasts would have to be revised downward.



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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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