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Special comment

**Construction**

Poland

# Polimex Mostostal Reduce

MOSD.WA; PXM.PW

(Reiterated)

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## Second-Quarter Earnings in Line, That Is Weak

**Current price: PLN 4.50; Target price: PLN 4.27**

Polimex Mostostal's earnings for Q2 2010 are in line with expectations, i.e. considerably weaker than last year. The deterioration was caused by the Manufacturing segment at subsidiaries (mostly Coifer, but also Energomontaż Północ and others). The gross margin was slightly higher than our 10.6% projection at 10.8%. However, SG&A expenses also exceeded our forecast (PLN 64.5m vs. PLN 56.8m). All in all, profit on sales fell short of expectations (PLN 47.3m vs. PLN 50.8m). The EBIT, however, was very much in line thanks to other net operating income. The source of the discrepancy observed at the net level is the failure to recognize tax credits on account of investment in a special economic zone. They will be recognized towards the end of the year. Our estimate of the effective tax rate was 5%, in actuality, it was 26.5%. To sum up, these earnings suggest Polimex's subsidiaries may face profitability issues this year. Earnings attained in some of the segments (Roads & Railroads, Construction) are still very high and we do not believe they can be sustained at this level in 2011. Therefore, we expect the Company's standalone earnings to be under pressure in 2011. We expect a Y/Y decline in earnings in 2010, and flat performance in 2011. Improvement will not come until 2012. As a technical aside, note that for the first time Polimex published data on pre-tax profit by segment, which, when compared with gross profit data, makes it possible to estimate fixed costs attributable to individual segments. We are reiterating a reduce rating on Polimex Mostostal.

### Actual vs. forecasted earnings, PAP consensus

(PLN m)	Q2 2010	Q2 2010F	Difference	PAP 'consensus	Difference	Q2 2009	Change
Revenue	1034.3	1015.0	1.9%	1067.0	-3.1%	1176.4	-12.1%
Gross profit	111.7	107.6	3.8%	-	-	132.0	-15.4%
Pct. margin	10.8%	10.6%	-	-	-	11.2%	-
EBIT	50.3	49.5	1.8%	47.0	7.1%	65.8	-23.5%
Pre-tax profit	41.6	36.6	13.6%	-	-	55.5	-25.1%
Net profit	25.9	31.4	-17.6%	26.0	-0.5%	37.9	-31.8%

Source: BRE Bank Securities, Polimex Mostostal

Revenue was in line with expectations. The gross margin was slightly higher than our 10.6% projection at 10.8%. As far as the performance of the individual segments in concerned, of note is the very low gross margin in Manufacturing (1.0%) and the very high margins in Construction and Roads & Railroads (6.1% and 4.5%, respectively). The weak performance of the manufacturing segment has to do with losses generated by subsidiaries, in particular Coifer. Standalone pre-tax margin was still very high at 9.3%, which we attribute to high capacity utilization. Outside the parent company, capacity utilization was very low in the second quarter. Since Q3 2010, Polimex Mostostal will transfer some of its own orders to Coifer in order to improve the subsidiary's order backlog. The excellent earnings posted by Construction and Roads & Railroads stem from work on old contracts, signed back in 2008. We expect the segments' margins to decline in the following quarters.

### Earnings in Q2 2010 by segment

Segment	Q2 2010 consolidated			Q1 2010 consolidated			Q2 2010 standalone		
	Revenue	Pre-tax profit	Pct. margin	Revenue	Pre-tax profit	Pct. margin	Revenue	Pre-tax profit	Pct. margin
Manufacturing	158.9	1.5	1.0%	97.4	1.3	1.3%	120.7	11.2	9.3%
Construction	268.2	16.3	6.1%	243.8	6.0	2.5%	262.3	13.4	5.1%
Power engineering	200.5	10.4	5.2%	143.6	4.9	3.4%	124.9	5.9	4.7%
Chemical engineering	235.3	14.1	6.0%	172.8	9.7	5.6%	152.2	6.4	4.2%
Roads & Railroads	155.4	6.9	4.5%	94.4	9.7	10.3%	82.3	1.1	1.3%
Other	16.1	1.1	6.6%	19.8	0.3		1.7	-1.0	-60.0%
Intercompany eliminations		-8.8			-10.2			8.1	
<b>Total</b>	<b>1034.3</b>	<b>41.6</b>	<b>4.0%</b>	<b>771.8</b>	<b>21.7</b>	<b>2.8%</b>	<b>744.1</b>	<b>45.1</b>	<b>6.1%</b>

Source: BRE Bank Securities, Polimex Mostostal

General expenses exceeded our expectations at PLN 64.5m vs. PLN 56.8m. They are in line with our FY forecast of the Company's earnings. Other net operating income was PLN 3.1m (we forecasted other operating expenses of PLN 1.3m). The main drivers in this category was a PLN 1.6m gain on PP&E sales and fees and penalties (PLN 1.6m).

All in all, the EBIT was in line, but the profit on sales fell short of expectations (PLN 47.3m vs. PLN 50.8m). Other net financial expenses came in at PLN 9.1m (vs. PLN 14.1m forecasted). The positive surprise in this case was brought about by a PLN 6.6m gain on the sale of financial assets. Share of income of associates was PLN 0.3m vs. PLN 1.3m expected. The effective tax rate proved much higher than anticipated (26.5% vs. 5%). Contrary to our expectations, in Q2 2010 Polimex did not use tax credits related to its special economic zone investment. Minority profits came in at PLN 5.0m vs. PLN 3.4m forecasted, due to a better-than-expected performance on the part of Naftobudowa and Energomontaż Pólnoc. All in all, the bottom line undershot expectations, but mostly because the Company did not use its tax credits.

### Order backlog excluding consortium partners

(PLN bn)	2010	2011	2012	2012+	Total
Contracts signed	2.1	2.5	1.2	0.4	6.2
Contracts at final stage of negotiation	0	0.7	0.7	0.2	1.6

Source: BRE Bank Securities, Polimex Mostostal

### Comparison of pre-tax and gross margins by segment in H1 2009

(PLN m)	Revenue	Gross profit	Pct. margin	Pre-tax profit	Pct. margin	Fixed costs, one offs	Pct. of revenue
Manufacturing	302.1	70.5	23.3%	2.8	0.9%	67.7	22.4%
Construction	568.2	45.6	8.0%	22.3	3.9%	23.3	4.1%
Power engineering	422.7	54.8	13.0%	15.3	3.6%	39.5	9.3%
Chemical engineering	403.0	47.1	11.7%	23.8	5.9%	23.3	5.8%
Roads & Railroads	317.1	15.8	5.0%	16.6	5.2%	-0.9	-0.3%
Other	40.6	9.7	23.9%	1.4	3.4%	8.3	20.5%
Intercompany eliminations				-19.0			
<b>Total</b>	<b>2053.7</b>	<b>243.4</b>	<b>11.9%</b>	<b>63.2</b>	<b>3.1%</b>	<b>180.2</b>	<b>8.8%</b>

Source: BRE Bank Securities, Polimex Mostostal



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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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