

Energomontaż Południe

Investment opinion & recommendation

With high exposure to construction for the power sector – the segment with probably the most attractive LT outlook within the construction industry, Energomontaż Południe (EPD) should currently rank among the most preferred construction equity exposures, with financial markets likely to discount the envisaged improvement in financial results stemming from expenditure growth on power unit renovation and capacity expansion in the near future (the sector's outlays may reach as much as PLN 100-200 billion by 2025). We believe that due to (i) acquisitions scheduled for 2010 (which are likely to enlarge the Company's execution potential and support EPD with design activity (enabling it to perform contracts as general contractor)), and (ii) cooperation with PBG – its strategic shareholder (boasting excellent project management skills), the Company may become one of the key players in implementing investments in the Polish power sector and boost its profits in the coming years. While it is true that investments in Poland are to gather pace no sooner than in one or two years, thanks to its established position in Germany (where the investment program is currently in progress), the Company is succeeding in developing its backlog and has already partially secured sales for both 2010 and 2011. Aside from its core business operations, we believe that due to the recovering housing market in Poland, EPD's residential activities will finally begin to bring fruits and generate impressive cash flows within the next two years (these may even reach PLN 72 million, according to our estimates).

Given the double-digit valuation gap, our belief that this is the right time to discount the upcoming growth in expenditure on power unit construction and our preference towards small and medium-sized contractors rather than large firms (given their flexibility to adjust the potential rebound in construction costs in 2H10), we maintain our LT fundamental Buy recommendation for EPD. We also maintain our ST market-relative Overweight stance. Although in light of uninspiring 2Q10E results, the achievement of our FY10 profits forecast (projected >20% yoy net profit increase) might appear challenging on the first sight, we believe that there will be a material yoy improvement in profits in 2H10 (due to completed in-depth restructuring at Amontex and an expected rebound in residential apartment sales volumes). In addition, further expected backlog development may constitute another factor supporting the Company's market share price in the coming months (we expect the Company to win contracts worth approx. PLN 150-200 million).

Quarterly results corner; 2Q10E preview

Energomontaż Południe is to release its 2Q10 financial results on August 31 (within the 1H10 semi-annual report). We expect

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Sector: Construction
Fundamental rating: Buy (→)
Market relative: Overweight (→)
Price: PLN 4.10
12M EFV: PLN 4.86 (→)

Market Cap.: US\$ 91 m
Reuters code: EMPD.WA
Av. daily turnover: US\$ 0.11 m
Free float: 53%
12M range: PLN 3.91-5.50

Guide to adjusted profits

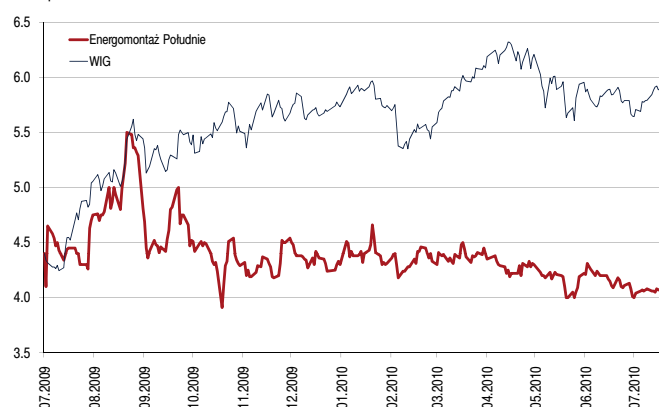
No factors necessitating adjustments.

Key data

IFRS consolidated		2009	2010E	2011E	2012E
Sales	PLN m	275.7	419.2	503.8	484.7
EBITDA	PLN m	30.2	35.5	42.7	45.0
EBIT	PLN m	23.5	26.6	30.7	30.8
Net profit	PLN m	14.3	17.3	23.3	23.6
EPS	PLN	0.30	0.24	0.33	0.33
EPS yoy chng	%	-10	-17	34	1
Net debt	PLN m	65.6	10.2	-1.7	-6.8
P/E	x	13.9	16.8	12.5	12.3
P/CE	x	9.5	11.1	8.2	7.7
EV/EBITDA	x	8.7	8.5	6.8	6.3
EV/EBIT	x	11.2	11.3	9.4	9.2
EV/Sales	x	1.0	0.7	0.6	0.6
Gross dividend yield	%	2.6	1.8	2.2	3.0
No. of shares (eop)	m	48.4	71.0	71.0	71.0

Source: Company, DM IDMSA estimates

Stock performance



Source: ISI

Upcoming events

1. Release of 2Q10 financial results: August 31, 2010

Catalysts

1. Efficient expansion on the German market
2. Signing large contracts in the power segment (e.g. worth c. PLN 5 billion power unit in Koźnice)
3. Synergies with PBG
4. Pick up in volume of flats sold
5. Growing prices of dwellings
6. Growing demand on steel structures

Risk factors

1. Inefficient expansion on the German market
2. Delays in the start of the investments in the power sector in Poland
3. Possible lack of expected synergies with PBG
4. Upturn in construction material prices and subcontracting costs
5. Prolonging stagnation in a steel structures market

the Company's net profit to be weaker yoy (albeit, with c. 60% yoy rise of EBIT), which – in our view – should evoke rather neutral market reaction following flat net profit in 1Q10.

Given a well-developed backlog and the fact that flooding did not materially affect the Company's construction projects in 2Q10, we

forecast c. 40% yoy increase in quarterly sales (up to PLN 94.2 million). As EPD's operating profit margin was supported by EUR vs. PLN appreciation in 2Q10 (which is favourable for Energomontaż given the high share of export contracts in its backlog) we project an approx. 60% yoy increase in quarterly operating profit (up to PLN 7.4 million). However, at the bottom line level we forecast softer yoy result, due to the Company's net FX exposure being hedged in 2Q10, and – as a consequence – we project an FX loss of as much as PLN -5 million in 2Q10. Please note that we do not expect any profit from residential development activity to stand out in the Company's P&L, given the low sales volumes in 2Q10.

Financial forecast

Our financial forecast for EPD remains unchanged. We forecast the Company's net profit at PLN 17.3 million in 2010 (a 21% increase) and at PLN 23.3 million in 2011 (up 34% yoy). The main assumptions behind our projections are (i) the positive contribution of Amontex in 2H10 (following recent restructuring, we expect the subsidiary to operate well in the second half of the year), and (ii) a rebound in residential sales volumes (on the back of our expectation of a sales rebound, we forecast that EPD will generate operating profit of approx. PLN 4 million from project development activity this year).

Valuation

Our 12M EFV assessment remains intact at PLN 4.86 per share.

Fig. 1 Energomontaż Południe; 2Q10 and 1H10 results' forecast

IFRS consolidated PLN m			yoy		yoy		Realisation of FY		Realisation of FY	
			change		change		figures in 2Q:		figures in 1-2Q:	
	2Q10E	2Q09		1-2Q10E	1-2Q09		2010E	2009	2010E	2009
Sales	94.2	67.3	40%	146.6	121.4	21%	22%	24%	35%	44%
Gross profit on sales	12.2	9.7	26%	13.8	17.1	-19%	24%	25%	27%	43%
Gross profit on sales margin	13.0%	14.5%	-	9.4%	14.1%	-	-	-	-	-
EBIT	7.4	4.6	61%	4.1	6.1	-33%	28%	20%	15%	26%
EBIT margin	7.9%	6.8%	-	2.8%	5.0%	-	-	-	-	-
Pre-tax profit	1.8	1.9	-4%	3.6	3.4	8%	8%	11%	16%	19%
Pre-tax margin	1.9%	2.8%	-	2.5%	2.8%	-	-	-	-	-
Net profit	1.5	1.8	-20%	1.9	2.4	-20%	8%	13%	11%	17%
Net margin	1.6%	2.7%	-	1.3%	2.0%	-	-	-	-	-

Source: Company, DM IDMSA estimates

BASIC DEFINITIONS

A/R turnover (in days) = $365/(\text{sales}/\text{average A/R})$

Inventory turnover (in days) = $365/(\text{COGS}/\text{average inventory})$

A/P turnover (in days) = $365/(\text{COGS}/\text{average A/P})$

Current ratio = $(\text{current assets} - \text{ST deferred assets})/\text{current liabilities}$

Quick ratio = $(\text{current assets} - \text{ST deferred assets} - \text{inventory})/\text{current liabilities}$

Interest coverage = $(\text{pre-tax profit before extraordinary items} + \text{interest payable})/\text{interest payable}$

Gross margin = $\text{gross profit on sales}/\text{sales}$

EBITDA margin = $\text{EBITDA}/\text{sales}$

EBIT margin = EBIT/sales

Pre-tax margin = $\text{pre-tax profit}/\text{sales}$

Net margin = $\text{net profit}/\text{sales}$

ROE = $\text{net profit}/\text{average equity}$

ROA = $(\text{net income} + \text{interest payable})/\text{average assets}$

EV = $\text{market capitalization} + \text{interest bearing debt} - \text{cash and equivalents}$

EPS = $\text{net profit}/\text{no. of shares outstanding}$

CE = $\text{net profit} + \text{depreciation}$

Dividend yield (gross) = $\text{pre-tax DPS}/\text{stock market price}$

Cash sales = $\text{accrual sales corrected for the change in A/R}$

Cash operating expenses = $\text{accrual operating expenses corrected for the changes in inventories and A/P, depreciation, cash taxes and changes in the deferred taxes}$

DM IDM S.A. generally values the covered non bank companies via two methods: comparative method and DCF method (discounted cash flows). The advantage of the former is the fact that it incorporates the current market assessment of the value of the company's peers. The weakness of the comparative method is the risk that the valuation benchmark may be mispriced. The advantage of the DCF method is its independence from the current market valuation of the comparable companies. The weakness of this method is its high sensitivity to undertaken assumptions, especially those related to the residual value calculation. Please note that we also resort to other valuation techniques (e.g. NAV-, DDM- or SOTP-based), should it prove appropriate in a given case.

KEY TO INVESTMENT RANKINGS

This is a guide to expected price performance in absolute terms over the next 12 months:

Buy – fundamentally undervalued (upside to 12M EFV in excess of the cost of equity) + catalysts which should close the valuation gap identified;

Hold – either (i) fairly priced, or (ii) fundamentally undervalued/overvalued but lacks catalysts which could close the valuation gap;

Sell – fundamentally overvalued (12M EFV < current share price + 1-year cost of equity) + catalysts which should close the valuation gap identified.

This is a guide to expected relative price performance:

Overweight – expected to perform better than the benchmark (WIG) over the next quarter in relative terms

Neutral – expected to perform in line with the benchmark (WIG) over the next quarter in relative terms

Underweight – expected to perform worse than the benchmark (WIG) over the next quarter in relative terms

The recommendation tracker presents the performance of DM IDMSA's recommendations. A recommendation expires on the day it is altered or on the day 12 months after its issuance, whichever comes first. Relative performance compares the rate of return on a given recommended stock in the period of the recommendation's validity (i.e. from the date of issuance to the date of alteration or – in case of maintained recommendations – from the date of issuance to the current date) in a relation to the rate of return on the benchmark in this time period. The WIG index constitutes the benchmark. For recommendations that expire by an alteration or are maintained, the ending values used to calculate their absolute and relative performance are: the stock closing price on the day the recommendation expires/ is maintained and the closing value of the benchmark on that date. For recommendations that expire via a passage of time, the ending values used to calculate their absolute and relative performance are: the average of the stock closing prices for the day the recommendation elapses and four directly preceding sessions and the average of the benchmark's closing values for the day the recommendation expires and four directly preceding sessions.

Banks

Net Interest Margin (NIM) = $\text{net interest income}/\text{average assets}$

NIM Adjusted = $(\text{net interest income adjusted for SWAPs})/\text{average assets}$

Non interest income = $\text{fees\&commissions} + \text{result on financial operations (trading gains)} + \text{FX gains}$

Interest Spread = $(\text{interest income}/\text{average interest earning assets})/(\text{interest cost}/\text{average interest bearing liabilities})$

Cost/Income = $(\text{general costs} + \text{depreciation} + \text{other operating costs})/(\text{profit on banking activity} + \text{other operating income})$

ROE = $\text{net profit}/\text{average equity}$

ROA = $\text{net income}/\text{average assets}$

Non performing loans (NPL) = loans in 'substandard', 'doubtful' and 'lost' categories

NPL coverage ratio = $\text{loan loss provisions}/\text{NPL}$

Net provision charge = $\text{provisions created} - \text{provisions released}$

DM IDM S.A. generally values the covered banks via two methods: comparative method and fundamental target fair P/E and target fair P/BV multiples method. The advantage of the former is the fact that it incorporates the current market assessment of the value of the company's peers. The weakness of the comparative method is the risk that the valuation benchmark may be mispriced. The advantage of the fundamental target fair P/E and target fair P/BV multiples method is its independence of the current market valuation of the comparable companies. The weakness of this method is its high sensitivity to undertaken assumptions, especially those related to the residual value calculation.

Assumptions used in valuation can change, influencing thereby the level of the valuation. Among the most important assumptions are: GDP growth, forecasted level of inflation, changes in interest rates and currency prices, employment level and change in wages, demand on the analysed company products, raw material prices, competition, standing of the main customers and suppliers, legislation changes, etc.

Changes in the environment of the analysed company are monitored by analysts involved in the preparation of the recommendation, estimated, incorporated in valuation and published in the recommendation whenever needed.

LT fundamental recommendation tracker

Recommendation		Issue date	Reiteration date	Expiry date	Performance	Relative performance	Price at issue/reiteration (PLN)	12M EFV (PLN)
Energomontaż Południe								
Hold	-	01.12.2008	-	03.04.2009	28%	30%	2.36	3.40 -
-	→	-	09.01.2009	-	-	-	2.65	4.00 ↑
-	→	-	11.01.2009	-	-	-	2.65	4.00 →
-	→	-	08.02.2009	-	-	-	2.53	4.00 →
-	→	-	08.03.2009	-	-	-	2.47	4.00 →
Buy	↑	03.04.2009	-	06.07.2009	52%	33%	3.01	5.00 ↑
-	→	-	05.04.2009	-	-	-	3.01	5.00 →
-	→	-	15.05.2009	-	-	-	3.59	5.00 →
-	→	-	17.05.2009	-	-	-	3.59	5.00 →
-	→	-	08.06.2009	-	-	-	4.50	5.00 →
Hold	↓	06.07.2009	-	28.04.2010	-4%	-33%	4.58	4.50 ↓
-	→	-	08.07.2009	-	-	-	4.47	4.50 →
-	→	-	02.08.2009	-	-	-	4.75	4.50 →
-	→	-	31.08.2009	-	-	-	4.81	4.50 →
-	→	-	12.10.2009	-	-	-	4.40	4.50 →
-	→	-	05.11.2009	-	-	-	4.19	4.50 →
-	→	-	14.12.2009	-	-	-	4.36	4.50 →
-	→	-	07.01.2010	-	-	-	4.42	4.50 →
-	→	-	03.02.2010	-	-	-	4.40	4.50 →
-	→	-	17.02.2010	-	-	-	4.42	4.50 →
-	→	-	01.03.2010	-	-	-	4.30	4.50 →
-	→	-	29.03.2010	-	-	-	4.39	4.50 →
Buy	↑	28.04.2010	-	Not later than 28.04.2011	-4%	-2%	4.28	4.86 ↑
-	→	-	17.05.2010	-	-	-	4.20	4.86 →
-	→	-	14.06.2010	-	-	-	4.20	4.86 →
-	→	-	19.07.2010	-	-	-	4.08	4.86 →
-	→	-	21.07.2010	-	-	-	4.10	4.86 →

Market-relative recommendation tracker

Relative recommendation		Issue date	Reiteration date	Expiry date	Price at issue/reiteration (PLN)	Relative performance
Energomontaż Południe						
Neutral	-	01.12.2008	-	03.04.2009	2.36	30%
-	→	-	09.01.2009	-	2.65	-
-	→	-	11.01.2009	-	2.65	-
-	→	-	08.02.2009	-	2.53	-
-	→	-	08.03.2009	-	2.47	-
Overweight	↑	03.04.2009	-	31.08.2009	3.01	37%
-	→	-	05.04.2009	-	3.01	-
-	→	-	15.05.2009	-	3.59	-
-	→	-	17.05.2009	-	3.59	-
-	→	-	08.06.2009	-	4.50	-
-	→	-	06.07.2009	-	4.58	-
-	→	-	08.07.2009	-	4.47	-
-	→	-	02.08.2009	-	4.75	-
Neutral	↓	31.08.2009	-	05.11.2009	4.81	-15%
-	→	-	12.10.2009	-	4.40	-
Overweight	↑	05.11.2009	-	17.02.2010	4.19	0%
-	→	-	14.12.2009	-	4.36	-
-	→	-	07.01.2010	-	4.42	-
-	→	-	03.02.2010	-	4.40	-
Neutral	↓	17.02.2010	-	14.06.2010	4.42	-10%
-	→	-	01.03.2010	-	4.30	-
-	→	-	29.03.2010	-	4.39	-
-	→	-	28.04.2010	-	4.28	-
-	→	-	17.05.2010	-	4.20	-
Overweight	↑	14.06.2010	-	Not later than 14.06.2011	4.20	-4%
-	→	-	19.07.2010	-	4.08	-
-	→	-	21.07.2010	-	4.10	-

Distribution of IDM's current recommendations

	Buy	Hold	Sell	Suspended	Under revision
Numbers	25	29	13	1	0
Percentage	37%	43%	19%	1%	0%

Distribution of IDM's current recommendations for companies that were within the last 12M IDM customers in investment banking

	Buy	Hold	Sell	Suspended	Under revision
Numbers	2	3	0	1	0
Percentage	33%	50%	0%	17%	0%

Distribution of IDM's current market relative recommended weightings

	Overweight	Neutral	Underweight	Suspended	Under revision
Numbers	19	32	16	1	0
Percentage	28%	47%	24%	1%	0%

Distribution of IDM's current market relative recommended weightings for the companies that were within the last 12M IDM customers in investment banking

	Overweight	Neutral	Underweight	Suspended	Under revision
Numbers	1	1	3	1	0
Percentage	17%	17%	50%	17%	0%

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