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Ceramika Nowa Gala

Sector: Construction materials
Fundamental rating: Buy (→)
Market relative: Overweight (→)
Price: PLN 3.08
12M EFV: PLN 3.6 (↑)

Market Cap.: US\$ 63 m
Reuters code: CERM.WA
Av. daily turnover: US\$ 0.10 m
Free float: 75%
12M range: PLN 2.74-3.50

▲ **3Q10E results.** CNG is to publish its 3Q10 financial results on November 15. We believe that the 3Q10 results will be decent, with sales higher yoy and an increase at the NP level. Thus, we believe that 3Q10 results should be warmly welcomed by the financial community.

▲ **The recovery on the domestic construction materials market should be already visible in the Company's top line.** We forecast CNG's 3Q10 consolidated sales at PLN 55 million, 8% up yoy. A recovery on the construction materials market, which began in June, has been continuing. Moreover, it should be remembered that the ceramic tiles prices have been declining till 3Q09, which means that in 2H10 the prices should be already at least more or less comparable yoy. It appears also that the demand at the premium-end of the market has slightly switched from very expensive imported tiles to the domestic ones (the sales of CNG's and Cersanit's premium products behaved better in 1H10 than the economy segment and we believe this trend should continue in 2H10).

▲ **After seven consecutive quarters of yoy EBIT drop, it should finally go up in 3Q10.** With higher sales and average price (mainly due to changes in the product mix) we expect a slight profitability improvement. We forecast the Company's 3Q10 consolidated EBIT margin at 14% vs. 13% in 3Q09 and a mere 8% in 2Q10. It would imply, respectively, 10% and 113% yoy and qoq EBIT growth in 3Q10E. The Company recognized net financial cost of PLN 1 million in the base quarter of 3Q09 and we expect similar value in 3Q10. Thus, we forecast pre-tax profit to grow by 14% yoy in 3Q10. Assuming slightly higher effective tax rate (17% in 3Q10 vs. 15% in 3Q09), we forecast the Company's 3Q10 consolidated NP at PLN 5.5 million, up 11% yoy.

▲ **FY10E NP up.** We have incorporated 3Q10 projections into our financial model for the Company. As a result, we have made some small upgrade of FY10E NP. We project 2010 NP at PLN 9 million, 14% above our previous forecast. It seems that after a massive drop till mid-May 2010, the demand started to improve. Although we are more inclined to expect gradual than a sudden demand recovery, such a scenario would mean that the worst times might have been already behind the Company.

After the launch of Cersanit's additional capacity in the Ukraine, supply on the domestic market has increased, creating additional competition for products manufactured by Ceramika Gres, CNG's subsidiary. However, CNG's re-positioning strategy (to the higher segment of the market) should bring fruits, in our view. Given CNG's

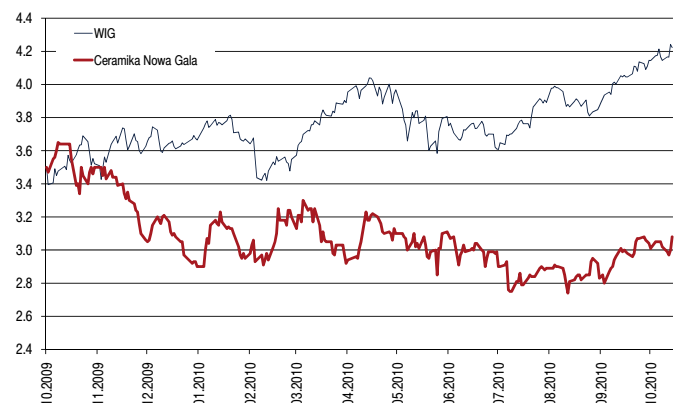
Guide to adjusted profits
No factors necessitating adjustments.

Key data

IFRS consolidated		2009	2010E	2011E	2012E
Sales	PLN m	165.5	170.3	188.3	225.6
EBITDA	PLN m	25.1	31.2	39.5	45.9
EBIT	PLN m	6.7	13.0	21.1	26.4
Net income	PLN m	5.2	9.1	14.1	17.6
EPS	PLN	0.09	0.16	0.25	0.31
EPS yoy change	%	-75	73	55	25
FCFF	PLN m	11.2	16.0	15.4	1.6
Net debt	PLN m	79.7	72.0	60.0	62.5
P/E	x	33.5	19.3	12.5	10.0
P/CE	x	7.4	6.4	5.4	4.7
EV/EBITDA	x	10.2	7.9	6.0	5.2
EV/EBIT	x	38.3	19.1	11.2	9.0
Gross dividend yield	%	0.0	0.0	1.6	2.4
Number of shares	m	57.0	57.0	57.0	57.0

Source: Company, DM IDMSA estimates

Stock performance



Source: ISI

Upcoming events

1. Release of 3Q10 consolidated results: November 15, 2010

Catalysts

1. Demand for construction materials
2. Foreign sales structure development
3. Entering new markets

Risk factors

1. Lower than expected demand in Poland
2. Interest rate and currency risk
3. Political and operational risk due to planned acquisition abroad
4. Merger with a foreign entity; lower than expected sales effects; difficulties in management

scale of operations, we believe that it would be more profitable to concentrate on premium products allowing to generate higher margins, the scale effects in the entry or economy segments will be difficult to achieve. Moreover, although the problem of an overcapacity on the domestic market is very painful, it seems that the premium segment, where imports

still exist, is the lowest. It seems that the economy slowdown forces consumers to look for cheaper products of the same quality, which also means that the penetration of Western markets, extremely difficult for Polish ceramic tile producers so far, should be slightly easier. Nevertheless, we remain sceptical regarding CNG's hopes to develop sales in Western countries.

▲ **12M EFV up.** We have introduced only minor fine tuning to our financial model for CNG. Nevertheless, valuation horizon

forward shift increased our 12m EFV assessment for CNG by 6% to PLN 3.6 per share (from PLN 3.4 per share).

▲ **Buy + Overweight – both maintained.** With a double-digit upside to our current 12M EFV we still recommend to Buy and Overweight CNG's shares. 3Q10 should already bring results' improvement at all levels of the income statement. Moreover, our view that the pace of demand drop on the domestic construction materials market has lost its momentum will hopefully find its confirmation in the Company's 3Q10 results.

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)	
Ceramika Nowa Gala									
Hold	-	28.01.2008	-	11.01.2009	-38%	5%	4.45	5.10	-
-	→	-	24.02.2008	-	-	-	4.75	5.10	→
-	→	-	30.03.2008	-	-	-	4.52	5.20	↑
-	→	-	21.04.2008	-	-	-	4.15	5.24	↑
-	→	-	29.04.2008	-	-	-	4.05	5.24	→
-	→	-	15.05.2008	-	-	-	4.40	5.24	→
-	→	-	01.06.2008	-	-	-	4.21	5.24	→
-	→	-	29.06.2008	-	-	-	3.67	5.08	↓
-	→	-	16.07.2008	-	-	-	3.50	5.07	↓
-	→	-	28.07.2008	-	-	-	3.49	5.07	→
-	→	-	17.08.2008	-	-	-	3.89	5.17	↑
-	→	-	31.08.2008	-	-	-	3.79	5.17	→
-	→	-	28.09.2008	-	-	-	3.80	5.17	→
-	→	-	13.10.2008	-	-	-	3.26	4.40	↓
-	→	-	29.10.2008	-	-	-	3.27	4.40	→
-	→	-	19.11.2008	-	-	-	3.05	3.90	↓
-	→	-	30.11.2008	-	-	-	2.89	3.90	→
Hold	→	11.01.2009	-	07.01.2010	14%	-23%	2.67	3.90	→
-	→	-	29.01.2009	-	-	-	2.60	3.30	↓
-	→	-	08.02.2009	-	-	-	2.50	3.30	→
-	→	-	26.02.2009	-	-	-	2.06	2.70	↓
-	→	-	08.03.2009	-	-	-	2.28	2.70	→
-	→	-	05.04.2009	-	-	-	2.30	2.70	→
-	→	-	28.04.2009	-	-	-	2.75	2.70	→
-	→	-	17.05.2009	-	-	-	2.70	2.70	→
-	→	-	08.06.2009	-	-	-	2.66	2.70	→
-	→	-	08.07.2009	-	-	-	2.68	2.70	→
-	→	-	22.07.2009	-	-	-	2.82	2.70	→
-	→	-	02.08.2009	-	-	-	3.10	2.70	→
-	→	-	31.08.2009	-	-	-	3.31	2.70	→
-	→	-	12.10.2009	-	-	-	3.64	2.70	→
-	→	-	19.10.2009	-	-	-	3.39	3.20	↑
-	→	-	14.12.2009	-	-	-	3.17	3.20	→
Hold	→	07.01.2010	-	25.07.2010	-7%	-10%	3.04	3.20	→
-	→	-	03.02.2010	-	-	-	3.06	3.20	→
-	→	-	01.03.2010	-	-	-	3.13	3.20	→
-	→	-	29.03.2010	-	-	-	3.03	3.20	→
-	→	-	25.04.2010	-	-	-	3.10	3.20	→
-	→	-	17.05.2010	-	-	-	3.08	3.20	→
-	→	-	14.06.2010	-	-	-	3.00	3.20	→
-	→	-	19.07.2010	-	-	-	2.83	3.20	→
Buy	↑	25.07.2010	-	Not later than 25.07.2011	8%	0%	2.84	3.40	↑
-	→	-	31.08.2010	-	-	-	2.83	3.40	→
-	→	-	12.10.2010	-	-	-	2.97	3.40	→
-	→	-	14.10.2010	-	-	-	3.08	3.60	↑

Market-relative recommendation tracker

Relative recommendation		Issue date	Reiteration date	Expiry date	Price at issue/ reiteration (PLN)	Relative performance
Ceramika Nowa Gala						
Neutral	-	28.01.2008	-	21.04.2008	4.45	-7%
-	→	-	24.02.2008	-	4.75	-
-	→	-	30.03.2008	-	4.52	-
Overweight	↑	21.04.2008	-	30.11.2008	4.15	25%
-	→	-	29.04.2008	-	4.05	-
-	→	-	15.05.2008	-	4.40	-
-	→	-	01.06.2008	-	4.21	-
-	→	-	29.06.2008	-	3.67	-
-	→	-	16.07.2008	-	3.50	-
-	→	-	28.07.2008	-	3.49	-
-	→	-	17.08.2008	-	3.89	-
-	→	-	31.08.2008	-	3.79	-
-	→	-	28.09.2008	-	3.80	-
-	→	-	13.10.2008	-	3.26	-
-	→	-	29.10.2008	-	3.27	-
-	→	-	19.11.2008	-	3.05	-
Neutral	↓	30.11.2008	-	28.04.2009	2.89	-6%
-	→	-	11.01.2009	-	2.67	-
-	→	-	29.01.2009	-	2.60	-
-	→	-	08.02.2009	-	2.50	-
-	→	-	26.02.2009	-	2.06	-
-	→	-	08.03.2009	-	2.28	-
-	→	-	05.04.2009	-	2.30	-
Underweight	↓	28.04.2009	-	07.01.2010	2.75	-26%
-	→	-	17.05.2009	-	2.70	-
-	→	-	08.06.2009	-	2.66	-
-	→	-	08.07.2009	-	2.68	-
-	→	-	22.07.2009	-	2.82	-
-	→	-	02.08.2009	-	3.10	-
-	→	-	31.08.2009	-	3.31	-
-	→	-	12.10.2009	-	3.64	-
-	→	-	19.10.2009	-	3.39	-
-	→	-	14.12.2009	-	3.17	-
Neutral	↑	07.01.2010	-	29.03.2010	3.04	-4%
-	→	-	03.02.2010	-	3.06	-
-	→	-	01.03.2010	-	3.13	-
Underweight	↓	29.03.2010	-	25.07.2010	3.03	-6%
-	→	-	25.04.2010	-	3.10	-
-	→	-	17.05.2010	-	3.08	-
-	→	-	14.06.2010	-	3.00	-
-	→	-	19.07.2010	-	2.83	-
Neutral	↑	25.07.2010	-	31.08.2010	2.84	-6%
Overweight	↑	31.08.2010	-	Not later than 31.08.2011	2.83	5%
-	→	-	12.10.2010	-	2.97	-
-	→	-	14.10.2010	-	3.08	-

Distribution of IDM's current recommendations

	Buy	Hold	Sell	Suspended	Under revision
Numbers	26	27	15	1	0
Percentage	38%	39%	22%	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	2	0	1	0
Percentage	40%	40%	0%	20%	0%

Distribution of IDM's current market relative recommended weightings

	Overweight	Neutral	Underweight	Suspended	Under revision
Numbers	22	31	15	1	0
Percentage	32%	45%	22%	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	2	1	1	1	0
Percentage	40%	20%	20%	20%	0%

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