CA IB

PLN 10.8

HOLD

Impel
Support Services
Poland

Company Update

Target price PLN 11

Is this the bottom???

WIG index
24,239

# of shares
15m

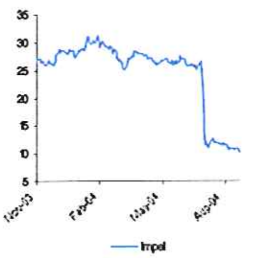
MCAP
PLN 162m
US$ 45m

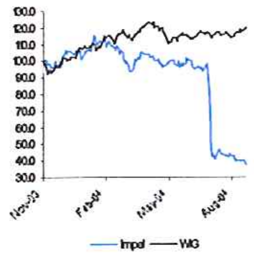
Free float
PLN 67m
US$ 19m

IMPL.WA/IPL PW

	2000	2001	2002	2003	2004E	2005E	2006E
Revenues (PLNm)	239.5	336.1	406.4	449.1	550.9	630.9	724.6
EBIT (PLNm)	3.0	8.4	24.4	25.7	(55.1)	(16.9)	7.8
Net profit (PLNm)	4.7	(0.2)	34.5	22.0	(52.8)	(16.5)	7.9
EPS (PLN)	0.45	(0.02)	3.35	1.87	(3.37)	(1.10)	0.53
CEPS (PLN)	2.27	1.32	5.03	3.54	(1.99)	0.42	2.08
BVPS (PLN)	5.4	5.4	8.7	15.8	10.7	9.6	10.2
P/E (x)	23.9	n.a.	3.2	5.8	n.a.	n.a.	20.5
P/CE (x)	4.8	8.2	2.1	3.0	n.a.	n.a.	5.2
P/BV (x)	2.0	2.0	1.2	0.7	1.0	1.1	1.1
EV/Sales (x)	0.48	0.39	0.29	0.04	0.21	0.21	0.18
EV/EBITDA (x)	8.4	6.0	2.9	0.4	n.a.	23.0	4.3
Dividend yield (%)	0.0	0.0	9.4	3.5	0.0	0.0	0.0

Shareholder structure: Grzegorz Dzik 33.5%, Józef Biegaj 25.3%





- **2Q earnings were hit by cuts in subsidies.** Impel reported an overall net loss of PLN 21m on the back of lower subsidies, which tumbled to PLN 2.9m from PLN 19m in 1Q 2004. Moreover, while top-line growth was better than expected at 21% in 1H, margins deteriorated in security and catering although they were better in cleaning. Given that in 1H the company reported a net loss of PLN 17.3m, we expect FY 2004 to end with a net loss of PLN 53m.

- **The new restructuring programme is the main challenge facing the company over the next 12-24 months.** Impel aims to improve the single employee efficiency rate by at least 10-15% in the next 12-24 months to return to profitability on an EBIT level. In addition, management plans to cut the administration and mid-management level costs by 20% or PLN 20m this year. As a result we expect the company to deliver a positive EBIT margin of 1.1% in 2006. In our view, this target appears to be achievable as Impel has some hidden reserves, especially in sales margins, which can differ greatly (from 2% to 20%).

- **The government is said to be working on new regulations that would be more favourable for Impel, but previous subsidy levels will not be restored.** For the time being, state subsidies have been cut by 85-90% to PLN 2.7m per quarter. However the government is currently drafting new regulations, which may result in slightly higher subsidies of PLN 5m per quarter or PLN 20m per annum from 2005.

- **Our DCF-valuation of the stock dropped to PLN 10.8/share from PLN 31/share, mainly as a consequence of lower subsidies.** In our DCF model we have assumed a moderate improvement in EBIT margins to a long-term sustainable level of 5% by 2010. The current share price of PLN 10.8 appears to reflect all the bad news, and therefore we maintain our HOLD rating. However, we do not see any short-term trigger that could justify a re-rating. The market will want to see the first signs of a successful implementation of the restructuring programme before again taking a more favourable view on the stock.

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Please note that the information at the back forms an integral part of this report.

Member of HVB Group

2Q: It can only get better

As expected Impel showed very weak results in 2Q, reporting a net loss of PLN 20.9m on the back of much lower subsidies, which dropped to PLN 2.9m from PLN 19m in 1Q. Overall, 1H 2004 had a loss of PLN 17.3m vs. a profit of PLN 15.4m in the corresponding period of 2003. The recent changes in the regulatory environment will affect the company's earnings in 2H 2004 as well; however, there the likelihood is increasing that the government will introduce a number of new regulations that should be more favourable for Impel.

Total revenues increased by 21% YoY in 1H and approximately 23% in 2Q vis-à-vis the average quarterly revenues in 2003. The strongest growth was achieved in cleaning +11.5% QoQ (+39.8% YoY in 1H 2004) and security +8.1% QoQ (+15.2% YoY in 1H 2004). Catering performance was slightly weaker, at +6.2% QoQ (+13.5% YoY in 1H 2004). Overall the growth in the three main segments was stronger than expected, at 25.7% in 1H vs. our revised forecasts of 23%.

Table 1: **Revenue breakdown**

PLNm	2Q 2004	1Q 2004	Ch. (%)	1H 2004	1H 2003	Ch. (%)
Cleaning	62.4	55.9	11.5	118.3	84.6	39.8
Security	51.4	47.6	8.1	99.0	85.9	15.2
Catering	13.9	13.1	6.2	27.0	23.8	13.6
Total three segments	**127.7**	**116.6**	**9.5**	**244.3**	**194.3**	**25.7**

Source: Impel

Margins on products (excluding subsidies and overheads costs) were rather weak in 2Q. Security and catering brought losses of PLN 2.9m and PLN 1.0m, respectively. Only cleaning was profitable with a small profit of PLN 0.4m. Overall consolidated EBIT exclusive of subsidies was negative at PLN 24.7m vs. a loss of PLN 14.8m in 1Q 2004. The result was approximately PLN 10m weaker than in 1Q, primarily driven by the additional restructuring costs of PLN 1.5m, PLN 1.8m in changes in the regulatory environment and additional losses incurred by Impel subsidiaries totalling PLN 2.5m. Nevertheless, the company expects much better results in 2H as the benefits of internal restructuring will gradually materialise.

The level of subsidies booked in P&L dropped to PLN 2.9m. The company expects that in the worst-case scenario the level of subsidies will be maintained at PLN 2.5-3.0m quarterly. Thus total subsidies in 2004 would be approximately PLN 27m vs. our previous forecast of PLN 87m, which is some PLN 60m less. In addition we have taken into account some additional restructuring costs, which may total as much as PLN 14m this year.

At the end of June Impel had PLN 105m in cash. In 2Q, it received some PLN 17m of subsidies in cash although it booked only PLN 2.9m, with a provision created for the balance. Impel will likely continue to receive the money from subsidies under the old scheme until February 2005, when it will have to conclude the final settlement for 2004.

Table 2: **2Q 2004 Earnings summary (PAS, consolidated)**

PLNm	2Q 2004	1H 2004	1H 2003	1H 04/1H 03 Ch. (%)	1Q 2004
Revenues	138.3	268.9	221.9	21.2	130.6
COGS	137.1	268.3	217.1	23.6	130.0
Gross profit on sales	1.3	0.6	4.7	(87.1)	0.6
Gross margin (%)	*0.9*	*0.2*	*2.1*	*n.a.*	*0.5*
SG&A	23.4	39.2	25.5	53.8	15.1
EBITDA	(15.9)	(6.5)	25.7	n.a.	9.4
Depreciation	5.9	11.1	9.1	21.7	5.2
Subsidies	2.9	22.0	45.0	(51.2)	19.0
EBIT	(21.8)	(17.5)	16.6	n.a.	4.2
EBIT margin (%)	*(15.7)*	*(6.5)*	*7.5*	*n.a.*	*3.2*
Net financials	0.7	1.5	(2.1)	(171.4)	0.7
Pre-tax profit	(21.5)	(17.1)	14.5	n.a.	4.4
Taxation	1.1	0.4	1.3	(69.8)	(0.7)
Net profit (loss)	(20.6)	(17.3)	15.4	n.a.	3.3

Source: Impel

Continuing uncertainty on future subsidies

Following the publication of the government Regulation on Subsidies to Companies Employing Disabled Individuals (the 'regulation'), Impel sought the opinion of a number of legal authorities. These came to the conclusion that the regulation does not fully comply with other Polish regulations, that it is more restrictive than EU regulations and, in addition, its implementation was in violation of Polish law.

Consequently POPON (Polish Organisation of Employers of the Disabled) is preparing an appeal to the Constitutional Court to replace this regulation with a new one, which would probably take effect from the beginning of 2005.

Unofficially the Polish government is said to already be preparing a new Directive, which may turn out to be more favourable for Impel. In general, we understand that companies employing disabled individuals would be able to choose between two options:

1. the level of subsidies will be set as a percentage of minimum salary multiplied by the number of disabled individuals employed. Impel estimates that in this case it could receive approximately 30% of the previous subsidies, with no requirement to provide any additional documentation.

2. a higher level of subsidies than in scenario 1, based on detailed calculations and documentation of the costs related to the employment of disabled individuals, may be applied for; however, this could result in a significant risk that relevant authorities could question the calculation outcome or methodology.

In addition, the Polish government and Parliament are said to be planning to introduce a modification of the regulation related to the employment of disabled individuals in which both the government directive and the parliamentary act would be in compliance with each other and with EU law.

In the meantime, the Antimonopoly Office has rendered a formal opinion on Impel's appeal according to which the company is now allowed to receive any state subsidies, as a EUR 15m cap is applicable from May 2004 until May 2007, and does not include the subsidies received prior to 2004 as had been previously rumoured. This decision implies that Impel is currently allowed to receive state subsidies at the level of PLN 2.5-3.0m quarterly, however the new regulations will in all likelihood maintain the three-year EUR 15m cap.

Implications for Impel's subsidies

In 1Q 2004 Impel received PLN 19m in subsidies and an additional PLN 2.9m in 2Q. In 2H, we expect another PLN 6m, which would result in total subsidies of PLN 27.2 for the FY, which is approximately PLN 60m less than had been expected this year.

In 2005 we should consider two scenarios:

- in the worst-case scenario the company will receive no more than PLN 12m in subsidies if no changes are made in the regulation.
- if the government were to introduce a new regulation (as detailed earlier), then we would expect the total level of subsidies to reach PLN 20m, some 30% lower than in FY 2004.

Restructuring

In response to the cut in subsidies, the company has started a number of internal restructuring initiatives that are primarily aimed to achieve three goals:

- **To reduce the level of central and administration costs by 20% by the end of 2004,** which should result in cost savings of PLN 20m per annum from 2005.
- **To improve the per employee rate of efficiency by 10-15% in the next two years.** Impel plans to achieve this goal by changing the employment structure from a full-time basis to a part-time basis. This is expected both to improve flexibility and to increase the efficiency of each employee. Therefore we expect the total headcount to remain flat in 2005 vs. 2004, although revenues are expected to increase by 15%.
- **To reduce the level of unprofitable contracts.** Approximately 15% of the existing contracts are currently unprofitable; the company aims to reduce this level to approximately 2-7%. Unprofitable contracts are primarily those in which the work could be performed primarily by Impel employees who have a disability (some 60-80% of the total workforce). Therefore the cut in subsidies will require the cancellation of some contracts while in other cases the company will have to seek a price increase. Although this may affect revenue growth next year, Impel expects to recover through new contract acquisitions. Revenue growth of 21% exceeded our expectation already in 1H 2004. Therefore our revised forecast anticipates the growth rate to be maintained at 15% in 2005 although some contracts could be cancelled.

We estimate the overall additional restructuring costs at PLN 14m this year, including PLN 3m of consulting fees. However these costs should cease to exist next year.

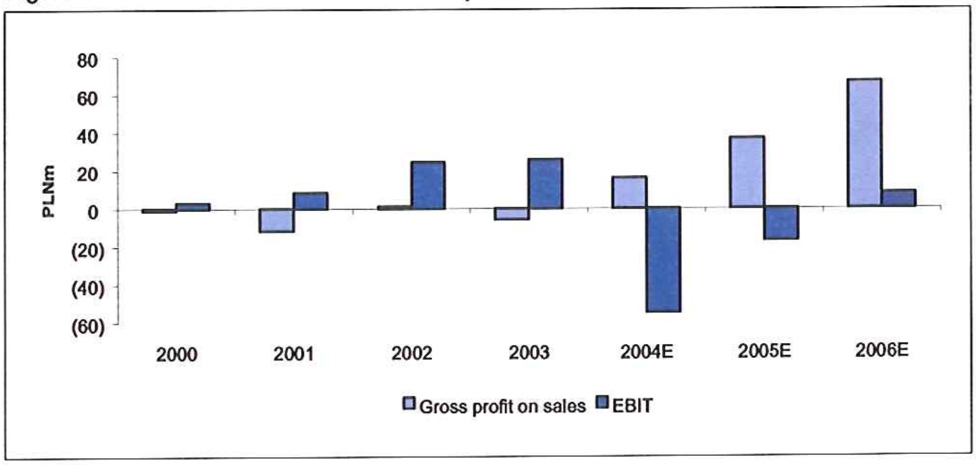
New 2004-2005 Earnings Forecast

Impel has officially retracted its earnings forecast for 2004 following the drop in subsidies. The company previously expected revenues of PLN 537m and a net profit of PLN 29m. While the top-line guidance still seems realistic, the bottom-line will, of course, look much worse.

CA IB expectations:

- We have cut our earnings forecast on the back of lower subsidies. We are looking for an overall loss of PLN 52.8m (in 2004) and PLN 16.5m (2005), implying EPS of minus PLN 3.37 in 2004 and negative PLN 1.1 in 2005.
- Revenues are projected at PLN 550m in 2004, an increase of approximately 2.5% over our previous projections due to new contracts acquisitions and already stronger than expected revenue growth in 1H 2004. In 2005, revenues are projected to increase by 15% to PLN 630m, which is some 1.8% better than the previous forecast.
- Total subsidies are expected to reach PLN 27m in 2004. In 2005 we assume only PLN 20m of subsidies vs. our previous PLN 94m. This forecast apparently is based on the assumption of a somewhat friendlier regulatory regime than today, however still being on the conservative side we have implemented an assumption that Impel will not be documenting its additional costs.
- Restructuring costs, which are estimated at PLN 14m, should result in significant growth in efficiency. In our model we have assumed that the revenues per employee will increase by 10% in 2005 and 5% in 2006 (in real terms). This is in line with management guidance.
- Consequently, EBIT is seen in the red at PLN 55m in 2004 and PLN 17m in 2005. However, gross profit on sales should be positive at PLN 16m in 2004 and PLN 37m in 2005 vs. our previous estimates of PLN 19m and PLN 25m, respectively.

Figure 1: **Forecasted trends of EBIT and profit on sales**



Source: Impel, CA IB estimates

- Impel will be probably forced to book some additional losses from a tax shield. In 2002 the company's auditor permitted a PLN 14.5m tax shield to be booked as a one-off gain since the auditor expected the company to fully utilise the tax shield in the next five years. However, given the current regulatory situation the company could be forced to reverse this booking, which would result in additional non-cash losses of approximately PLN 8-10m already in 2H 2004. This additional loss is not included in our FY 2004 forecast.

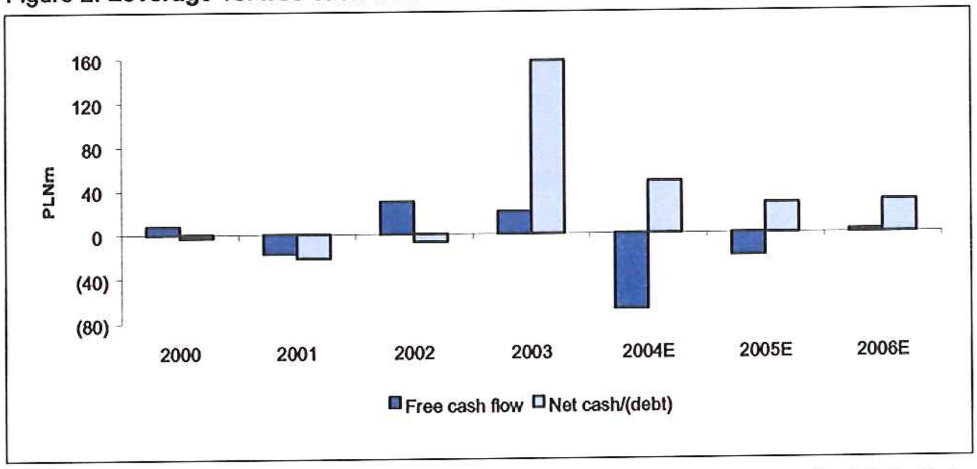
- In 2004-2005 capex is seen at the previous levels of PLN 28m PLN 19m, respectively. However, this could be scaled back if Impel were to decide to abandon its investments in primarily catering.

- No dividends are expected due to losses from the current activity.

- Free cash flow will be negative at PLN 67.8m in 2004 and PLN 20.2m in 2005 (we have included only booked subsidies). Consequently the net cash level will drop to PLN 47m at the end of 2004 and PLN 27m at the end of 2005, down from PLN 157m at the end of 2003. In 2003 the company received approximately PLN 154m net from its IPO; however, in 2004 Impel concluded a share buyback of PLN 37m and paid out PLN 5.6m in dividends. In our model we have conservatively assumed that cash flows from subsidies will be PLN 0.91m monthly from May until the end of 2004 although the company is likely to receive larger amounts until the end of 2004, while in February 2005 the final settlement must be made.

Overall though we must emphasise that the forecasts will have to be taken with a grain of salt given the current uncertainty as to the future subsidy regime.

Figure 2: **Leverage vs. free cash flow**



Source: Impel, CA IB estimates

Valuation

With EBIT and net profit being negative in 2004 and 2005, we are unable to use multiples to value the stock. We thus applied a DCF-model although this may be more of a theoretical exercise because the key question will be whether management will be able to turn the company around in the next 18 to 24 months.

Table 3: **DCF**

PLNm	2004E	2005E	2006E	2007E	2008E	2009E	2010E
Revenues	550.9	630.9	724.6	760.9	798.9	838.9	880.8
EBITDA	(33.)6	5.9	31.1	39.7	49.7	60.5	72.4
EBIT	(55.1)	(16.9)	7.8	15.2	24.0	33.6	44.0
EBIT margin (%)	(10.0)	(2.7)	1.1	2.0	3.0	4.0	5.0
EBIT*(1-effective tax rate)	(55.1)	(16.9)	6.3	12.3	19.4	27.2	35.7
Depreciation and amortization	21.5	22.8	23.3	24.5	25.7	27.0	28.3
Total capital expenditure	(28.0)	(19.0)	(19.0)	(24.5)	(25.7)	(27.0)	(28.3)
Change in working capital	(8.5)	(7.5)	(9.8)	(10.3)	(10.9)	(11.4)	(12.0)
Free cash flows to the firm	(70.1)	(20.6)	0.7	2.0	8.6	15.8	23.7
Discounted FCF	(65.7)	(17.1)	0.6	1.3	4.9	8.1	10.8

Source: CA IB estimates

Table 4: **DCF summary**

NPV of free cash flows	**(57)**
Perpetual tax adjusted EBIT growth rate (%)	4.0
Terminal value (PLNm)	284
NPV of Terminal value (PLNm)	129
Enterprise value (PLNm)	72
Current net debt (PLNm)	(91)
Equity value (PLNm)	**163**
No. of shares (m)	15.0
Value per share (PLN)	**10.8**

Source: CA IB estimates

Our DCF model indicates a value of PLN 10.8/share. Our valuation is based on some key long-term assumptions. Overall we expect the company to improve its operating margin to the levels observed in Western Europe; thus, Impel should return to a 5% EBIT margin in 2010. This implies a 1-percentage point improvement every year between 2006 and 2010. In the meantime we have maintained Beta at 1.23, while the long-term risk-free rate is expected at 7.5%.