

Company Analysis

Construction

5th of April 2013

Merko Ehitus

In Line with the Sector

Analyst: Joonas Joost, Arno Tara

Contact: +372 6 802 791, arno.tara@lhv.ee

Neutral

Fair value range (EUR): 7.25 - 7.85

Share price (EUR): 7.10

Symbol: MRK1T ET

Forecast (EUR)	2012	2013E	2014E	2015E
Sales (m)	249.1	251.7	258.7	278.6
Gross profit (m)	17.9	22.6	20.4	26.1
EBIT (m)	7.4	11.6	9.2	13.8
Net profit (m)	7.6	10.8	8.4	12.8
Earnings per share	0.43	0.61	0.48	0.72
Dividends per share	0.30	0.20	0.20	0.32
Sales growth (%)	13.6	1.0	2.8	7.7
Net profit growth (%)	-154.2	41.6	-21.8	51.9
Gross profit margin (%)	7.2	9.0	7.9	9.4
EBIT margin (%)	3.0	4.6	3.6	5.0
Net profit margin (%)	3.1	4.3	3.3	4.6

Valuation	2012	2013E	2014E	2015E
Price/Sales (x)	0.5	0.5	0.4	0.4
Price/Earnings (x)	16.4	11.6	14.9	9.8
Price/Book (x)	1.1	1.0	0.9	0.8
EV/EBITDA (x)	12.9	8.7	10.0	6.9
Dividend Yield (%)	4.2	2.8	2.8	4.5



Key ratios	Performance
Market cap. (m)	126
EV (m)	126
Net debt (m)	0
ROE (%)	6.7
No. of shares (m)	17.7
	1M (%) 9.2
	6M (%) 21.4
	12M high (€) 7.30
	12M low (€) 5.60
	Next report Week 7

Quick Overview

Following the disclosure of its Q4 results, which beat our estimates across the board, Merko has announced the addition of several new contracts to its backlog and said it is looking to pursue opportunities to develop property in all three Baltic capitals. While the outlook for the Estonian construction sector for the next few years is not the brightest, we believe Merko has all the necessary pieces in place to post significant improvements in 2013, as the relative importance of property development increases. For now, Merko's outlook mirrors the recovery of demand in the Baltic residential and commercial sector and, after revising our estimates, we lifted our fair value range from EUR 6.20-6.90 to EUR 7.25-7.85.

Company Performance

Our revenue estimate for 2013 remains unchanged at EUR 251.7m, while those for 2014 and 2015 have been revised to EUR 258.7m and EUR 278.6m respectively.

The latest surveys from the Estonian Institute of Economic Research have shown a slight decrease in the confidence of those companies active in the country's construction market. The Association of Construction Entrepreneurs expects a decrease in volumes between 5.0% and 10.0% in 2013, with no increase in prices. As the EU's budget period concludes, public-sector demand has decreased. At the same time, private demand has continued to pick up, although this is unlikely to offset the declines in the public sector's role this year. New orders have become scarce, leading us to expect further declines in the construction market in 2014.

With its exposure to the Latvian and Lithuanian markets (though admittedly small) and the property development sector, we believe Merko is positioned well to maintain its turnover at the levels seen in 2012 and perhaps improve it ever so slightly in 2013 and 2014. At the same time, we have reduced our sales estimates for 2014-2015, taking into account Merko's comments about abandoning its ambitious targets for 2015, i.e. to achieve a sales split of 35%-30%-25%-10% among Estonia, Latvia, Lithuania and other markets. For comparison, during 2012, 81.1% of total revenues were generated in Estonia, while 15.4% came from Latvia and 3.5% from Lithuania.

Profitability Estimates

In Q4 Merko easily surpassed our profit estimates and posted its biggest gross margin for the last ten quarters. This strength was derived in part from apartment sales in Latvia and Lithuania, new and profitable projects in the buildings and facilities segments, and the prior recognition of problematic projects.

Decreasing demand and high levels of supply have been features of a tough and highly competitive market, which has limited mark-ups and depressed the margins earned on new works. Companies that have booked projects with decent margins could benefit as they are able to squeeze the margins paid to subcontractors desperate for business. Additionally, the expected shift in the market from infrastructure and road construction towards more housing and property development is another factor contributing to an improvement in margins in 2013. These factors, together with higher than expected margins in Q4, triggered an upward revision in our profitability estimates for 2013. We expect Merko to turn in pre-

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tax profit of EUR 12.2m for 2013 (previous estimate EUR 10.2m). In spite of this, our 2014 and 2015 estimates have dipped, reflecting the reduced profitability of many new contracts and lower levels of turnover compared to our previous estimates. We see pre-tax profits of EUR 9.8m and EUR 14.4m for 2014 and 2015, respectively (previous estimates EUR 15.0m and EUR 19.4m).

Backlog and Property Development Situation

At the end of 2012, Merko's backlog stood at EUR 190.0m, which it considered a decent level. During the first three months of 2013, the company has announced contracts to build a SPA-Hotel at Narva-Jõesuu in Estonia, as well as apartments in Jurmala, Latvia, for a combined value of EUR 18.5m. In addition, the operator of the Selver supermarket chain, Tallinna Kaubamaja (TKM 1TET), announced that it had contracted Merko to build a 6,500 sqm hypermarket just outside of Tallinn, Estonia, in 2013. The price of the latter was not disclosed.

Merko is also rolling out its residential developments, with 116 apartments sold in Q4, another 155 in inventory at the end of 2012 and a further 240 under construction. 197 apartments are scheduled to be completed in 2013, bringing the number available for sale during the year to 352. For our part, we do not expect the full amount to be sold. During 2012 Merko sold a total of 235 apartments, while 390 were available (both in inventory at the beginning of year and completed during the year).

Supported by low interest rates and a limited supply of new flats over the past few years, the level of real estate transactions and the degree to which prices have moved have been reasonable, leaving Merko with the impression that sufficient potential exists to start new developments in all the three Baltic capitals. The company can easily move forward with plans utilising land plots it has held for a number of years. Although, in the long term, the company wishes to reduce its holdings of land (currently EUR 39.5m or 17.6% of assets), it is still looking to acquire plots in promising locations.

Dividend Expectation for 2012

The company has not given any firm indications of its dividend policy. Historically, it has paid out around 20% of its annual earnings during 'normal' years. No dividends were paid for the loss making 2011, but, with a net profit of just EUR 1.2m in 2010, the company paid out a DPS of EUR 0.10. Given the improved performance in 2012, we consider a DPS of EUR 0.13 to be the lowest reasonable amount to expect. However, with the company abandoning its previously ambitious growth targets, the capital needed for the coming years is definitely lower than previously estimated and this would allow for higher dividends for 2012. Although resting on Merko's strong balance sheet, in our opinion, it would not pose much of a challenge for the company to pay out dividends of more than 100% of 2012 earnings. The company has been pretty conservative when taking decisions on how to distribute its profits. We therefore believe a reasonable DPS expectation for 2012 would be EUR 0.20, which at Thursday's close of EUR 7.18 would yield 2.8%.

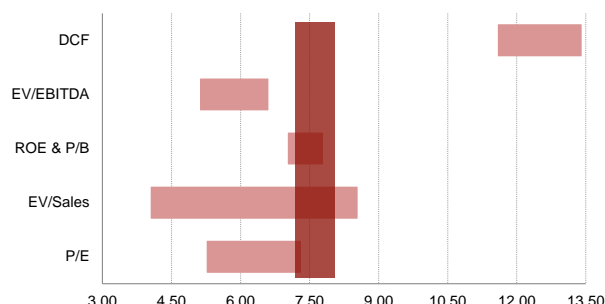
Valuation

We have updated our fair value range to EUR 7.25-7.85, from our previous range of EUR 6.20-6.90. The increase stems largely from revised profit estimates for 2013. As previously, the updated range also reflects a mix of shorter-term peer and DCF valuations, which is driven by the sector's longer-term 'normal' profitability level. As we believe the setback in 2014 will be short-lived and we are still relatively early in 2013, our peer valuation

assigns a weight of 80% to our estimates for 2013, with 20% for 2014.

We have also revised the inputs to our DCF valuation, which, compared to the previous value range of EUR 12.30-15.20, suggests a new range of EUR 11.45-13.25. However, at this point, we do not see any triggers for the share price to move closer to the long-term DCF value, as earnings in the coming years will still lag behind the sector's 'normal' levels. Our new fair value range for Merko Ehitus is EUR 7.25-7.85 and we reiterate our "Neutral" recommendation.

LHV Fair Value Range: EUR 7.25-7.85



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Income statement (EURm)	2007	2008	2009	2010	2011	2012	2013E	2014E	2015E
Sales	352.2	297.4	203.3	171.9	219.3	249.1	251.7	258.7	278.6
Gross profit	49.8	48.6	22.1	12.8	-3.6	17.9	22.6	20.4	26.1
EBITDA	35.1	23.1	10.8	4.8	-11.1	9.9	13.8	11.4	16.0
Depreciation	-1.8	-2.1	-2.4	-2.4	-2.2	-2.5	-2.2	-2.1	-2.1
EBIT	33.3	21.0	8.4	2.4	-13.3	7.4	11.6	9.2	13.8
Pre-tax profit	37.8	21.3	7.7	1.8	-14.0	7.9	12.2	9.9	14.4
Tax	-2.0	-1.7	-0.5	-0.7	-0.1	-0.3	-1.3	-1.4	-1.5
Minority	-1.0	-0.5	0.3	0.2	0.1	0.0	-0.1	-0.1	-0.1
Net profit	34.8	19.1	7.4	1.2	-14.1	7.6	10.8	8.4	12.8
Balance sheet (m)	2007	2008	2009	2010	2011	2012	2013E	2014E	2015E
Intangible assets	0.8	0.8	1.5	1.5	1.4	1.4	1.3	1.2	1.2
Tangible assets	11.5	13.4	18.1	21.3	18.4	18.4	18.6	18.9	19.5
Long-term investment assets	18.6	16.6	15.6	20.8	28.9	26.3	26.3	26.3	26.3
Other non-current assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total non-current assets	30.9	30.7	35.2	43.6	48.7	46.1	46.2	46.4	47.0
Inventory	129.4	116.2	98.2	93.0	87.8	82.8	82.0	82.5	87.1
Receivables	76.8	50.2	42.6	46.4	65.1	60.8	58.5	57.2	58.7
Cash & short-term assets	13.1	49.7	48.6	12.5	18.7	35.3	42.0	46.7	52.5
Total current assets	219.4	216.0	189.4	152.0	171.6	179.0	182.5	186.5	198.2
Total assets	250.3	246.8	224.6	195.6	220.3	225.0	228.7	233.0	245.3
Equity	128.8	132.6	135.9	124.7	109.2	116.9	124.2	129.1	138.4
Provisions	0.1	2.1	2.4	3.6	6.8	6.2	5.3	4.5	3.9
Long-term debt	29.1	34.5	5.6	14.0	24.8	21.1	22.4	21.7	22.3
Current portion of long-term debt	19.5	13.2	28.6	12.6	16.6	16.3	13.9	13.5	13.8
Accounts payable	70.7	64.2	52.8	42.8	68.4	69.4	66.8	67.3	69.4
Other short-term liabilities	1.1	0.6	0.3	0.0	0.0	0.0	0.0	0.0	0.0
Total short-term debt	90.2	77.4	81.4	55.4	85.0	85.7	80.7	80.8	83.2
Total equity & debt	250.3	246.8	224.6	195.6	220.3	225.0	228.7	233.0	245.3
Cash flow statement (m)	2007	2008	2009	2010	2011	2012	2013E	2014E	2015E
Cash flow bef chg working cap.	29.7	29.2	14.0	-18.6	-5.3	10.3	13.8	11.4	16.0
Cash flow bef investments	-31.2	43.6	23.5	-7.2	-12.3	3.5	13.6	11.8	11.1
Cash flow bef financials	-35.9	27.2	10.8	9.2	-3.6	16.2	11.3	9.4	8.4
Net cash flow	-30.0	20.0	-10.0	-13.3	8.5	16.9	6.8	4.8	5.8
Cash beg of period	43.2	13.1	32.9	23.0	9.9	18.5	35.3	42.0	46.7
Cash eof period	13.1	32.9	23.0	9.9	18.5	35.3	42.0	46.7	52.5
Key ratios	2007	2008	2009	2010	2011	2012	2013E	2014E	2015E
Sales growth	24.8%	-15.5%	-31.6%	-15.4%	27.6%	13.6%	1.0%	2.8%	7.7%
EBITDA growth	na	-34.2%	-53.1%	-55.6%	-330.4%	-189.2%	39.8%	-17.5%	40.0%
EBIT growth	-17.7%	-37.0%	-59.7%	-71.8%	-659.5%	-155.6%	56.6%	-20.2%	49.7%
Pre-tax profit growth	-7.8%	-43.7%	-64.0%	-76.9%	-892.9%	-156.3%	53.8%	-18.7%	46.2%
Net profit growth	-6.3%	-45.1%	-61.2%	-83.4%	-1245.9%	-154.2%	41.6%	-21.8%	51.9%
Gross margin	14.1%	16.3%	10.9%	7.5%	-1.6%	7.2%	9.0%	7.9%	9.4%
EBITDA margin	10.0%	7.8%	5.3%	2.8%	-5.0%	4.0%	5.5%	4.4%	5.7%
EBIT margin	9.5%	7.0%	4.2%	1.4%	-6.1%	3.0%	4.6%	3.6%	5.0%
Pre-tax margin	10.7%	7.1%	3.8%	1.0%	-6.4%	3.2%	4.8%	3.8%	5.2%
Net profit margin	9.9%	6.4%	3.7%	0.7%	-6.4%	3.1%	4.3%	3.3%	4.6%
ROE		14.6%	5.5%	0.9%	-12.0%	6.7%	9.0%	6.7%	9.6%
ROA		8.4%	3.6%	1.1%	-6.4%	3.3%	5.1%	4.0%	5.8%
Equity/Total assets	51.5%	53.7%	60.5%	63.8%	49.6%	52.0%	54.3%	55.4%	56.4%
Net debt/Equity	0.28	-0.01	-0.11	0.11	0.21	0.02	-0.05	-0.09	-0.12
Per share data	2007	2008	2009	2010	2011	2012	2013E	2014E	2015E
EPS	1.97	1.08	0.42	0.07	-0.80	0.43	0.61	0.48	0.72
EPS growth	-6.3%	-45.1%	-61.2%	-83.4%	-1245.9%	-154.2%	41.6%	-21.8%	51.9%
DPS	0.00	0.22	0.70	0.10	0.00	0.30	0.20	0.20	0.32
Dividend yield	0.0%	8.0%	14.0%	1.1%	0.0%	4.2%	2.8%	2.8%	4.5%
Payout ratio	0.0%	20.7%	167.6%	144.0%	0.0%	69.6%	32.8%	41.9%	44.5%
BVPS	7.28	7.49	7.68	7.05	6.17	6.61	7.02	7.29	7.82
Net debt per share	1.79	-0.14	-0.85	0.75	1.23	0.01	-0.42	-0.75	-1.02
Valuation	2007	2008	2009	2010	2011	2012	2013E	2014E	2015E
Share price	13.00	2.80	5.02	9.05	7.08	7.08	7.10	7.10	7.10
Market cap	230.1	49.6	88.9	160.2	125.3	125.3	125.7	125.7	125.7
EV	265.5	47.6	74.4	174.3	148.0	127.4	119.9	114.1	109.4
PE	6.6 x	2.6 x	12.0 x	130.3 x	-8.9 x	16.4 x	11.6 x	14.9 x	9.8 x
P/CE	7.8 x	1.7 x	6.4 x	-8.6 x	-23.5 x	12.1 x	9.1 x	11.0 x	7.9 x
P/Sales	0.8 x	0.2 x	0.4 x	1.0 x	0.7 x	0.5 x	0.5 x	0.4 x	0.4 x
P/B	2.1 x	0.4 x	0.5 x	1.4 x	1.4 x	1.1 x	1.0 x	0.9 x	0.8 x
EV/Sales	0.8 x	0.2 x	0.4 x	1.0 x	0.7 x	0.5 x	0.5 x	0.4 x	0.4 x
EV/EBITDA	7.6 x	2.1 x	6.9 x	36.3 x	-13.4 x	12.9 x	8.7 x	10.0 x	6.9 x
EV/EBIT	8.0 x	2.3 x	8.8 x	73.2 x	-11.1 x	17.2 x	10.3 x	12.3 x	7.9 x
Dividend yield	0.0%	8.0%	14.0%	1.1%	0.0%	4.2%	2.8%	2.8%	4.5%
Free cash flow yield	-15.6%	54.8%	12.2%	5.8%	-2.9%	12.9%	9.0%	7.5%	6.7%

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Recommendation structure

Buy – Expected return of more than 10% within 12-18 months (including dividends)

Neutral – Expected return from -5% to 10% within 12-18 months (including dividends)

Sell - Expected return less than -5% within 12-18 months (including dividends)

Not rated - No recommendation

Under review – Recommendation is under observation due to specific event

LHV – Estonia

Tartu mnt 2
Tallinn, 10145
Estonia
Tel: +372 6 800 400
Fax: +372 6 800 402
info@lhv.ee

LHV – Latvia

Dunties Street 6
Riia, LV-1013
Latvia
Tel: +371 6 750 2100
Fax: +371 6 750 2102
info@lhv.lv

LHV – Lithuania

Gyneju 16
Vilnius, LT-01109
Lithuania
Tel: +370 5 204 7 204
Fax: +370 5 204 7 207
info@lhv.lt

LHV – Finland

Mannerheimintie 40
Helsinki, 00100
Finland
Tel: +358 01080 2252
Fax: +358 095658 8601
info@lhv.fi

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