

LUG

Shedding light on NewConnect



Initiating coverage

PLN 2.30
Buy

Target price: PLN 3.18

WIG index
57 383.98

NC index
85.94

Number of shares
36.0m

MCAP
82.8m

Free float
11.2m

LUG

Industrials
Poland

Shedding light on NewConnect

PLN	2006	2007E	2008E	2009E
Revenues	50	75	93.5	104.5
EBIT	3.4	5.1	7.8	8.8
Net profit	2.4	3.5	6.8	8.0
EPS	n/a	0.11	0.19	0.22
P/E (x)	34.5	23.6	12.2	10.4
EV/EBITDA	n/a	12.9	9.5	8.4
ROE (%)	31.6	35.9	17.3	17.5

Shareholder structure: Iwona Wtorkowska & Ryszard Wtorkowski 69.1%, OPERA TFI 17.4%, free float 13.5%

We initiate coverage of LUG with a Buy recommendation. Our target price is PLN 3.18 per share. This represents an upside of 38% from the issue price.

Financial Forecast: We forecast net earnings at PLN 6.8m in 2008 (revenues PLN 93.5m), PLN 8.0m in 2009 (sales growth to PLN 104.5m) and PLN 9.6m in 2010. Subsequently the rate of growth is expected to slightly slow down, but there is room for stable growth and continued high profitability.

Valuation: The final valuation is obtained by using both the comparison model and the discounted cash flows model. The valuation based on the DCF model is PLN 124.6m, or PLN 3.46 per share. Comparison of LUG with its peer companies gives PLN 129.5m, or PLN 3.60 per share. The final valuation, with 10% IPO discount, suggests that currently the stock is undervalued and has a 38% growth potential.

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Investment summary

- Doubled capacity should provide growth** **LUG – one of the leading manufacturers of lighting fittings in Poland:** LUG is one of three Polish listed companies operating in the lighting market. The competitors, namely ES-System (PLN 175m forecast revenue in 2007) and Lena Lighting (PLN 126m), are bigger than LUG (PLN 75 m). The only factor limiting the increase in the company's market share is its production capacity, which is fully utilized. LUG plans to double that capacity within the next two years, mainly using the capital raised through the private placement. That should provide a growth potential for the company.
- High-margin products** **Exploring a market niche:** LUG operates in the market for tailor-made products, where it can fully utilize its competitive advantages. LUG offers high-quality products (comparable with those offered by its Western European competitors) at much lower prices. Cheaper competitors, mainly from the Far East, usually operate in the low-quality and retail markets, which is not LUG's primary market segment.
- Flexible offer** **Flexibility:** Due to its well-diversified product portfolio and modern equipment, LUG is able to quickly adjust to specific market demand.
- Expanding market, New profitable regions** **Positive prospects for the market:** The Polish economy is expected to maintain high GDP growth for several more years, which makes the domestic market revenues quite safe. Profits relating to the vast number of infrastructural projects in Poland are expected to be an additional source of future gains, because almost every project of that kind requires illumination (airports, roads, stadiums, commercial and industrial buildings). Furthermore, the company plans to intensify its sales in regions with booming economies, such as Eastern Europe (e.g. Ukraine, Russia) and the Middle East, where LUG is quickly gaining market share due to its well-recognized brand.

Key investment risks

Worldwide economic situation. LUG operates in a market that strongly depends on the economic situation, so revenues may fluctuate widely in line with the business cycle. A slump in the Eastern European market, which generates a third of the company's sales (based on 1H 2007 data), or in Poland, which accounts for a half of the revenues, might be particularly harmful.

Regulatory risk. The company's financial results depend strongly on the tax shield resulting from its functioning in a special economic zone (the cumulative benefit till the year 2014 is estimated at around PLN 14m). Some unfavourable legislative changes may affect the company's forecast net profit.

Environmental protection risk. The company must comply with both domestic and EU environmental rules. Some unintentional operational errors in this area or adverse legislative changes may generate additional expenditures.

Currency risk. As a substantial share of the company's sales is accounted for by exports (almost 50% currently, expected to growth to 60% according to the company's plans) there is a risk relating to unfavourable currency exchange movements. LUG hedges against this risk using derivative instruments (primarily forward contracts). Some of currency risk is being naturally hedged by purchasing of materials in EUR.

Changes in customers' attitudes and habits. LUG's products are dedicated to use in public buildings, which makes functionality, quality and design of the fittings the primary choice factors, and revenues may decline if customer habits change. The company constantly monitors market trends and participates in the most prestigious trade fairs in order to identify customer preferences. Most of LUG's products are tailor-made products which significantly reduces the risk.

LUG – company profile

Brief description

Products

LUG commenced its business operations in 1989. The family company is based in Zielona Góra (near the German border). Its primary business is the production of lighting fittings.

The company's offering consists of over 600 models of fittings designed for various places. LUG distinguishes the following groups of products:

- Office fittings
- Industrial fittings
- Exterior fittings
- Decorative fittings

LUG's products are used primarily by the construction industry. The main types of buildings where the lighting fittings are used include:

- Office buildings (conference rooms, sales or administrative rooms, etc.),
- Retail centres (malls, shops, etc.),
- Industrial buildings.

Exterior fittings are used primarily to illuminate car parks, streets, highways, petrol stations and other similar places. This market segment has become very strong recently because of significant infrastructure projects.

The last of the main groups of products consists of fixtures for decorative purposes. They are used to illuminate both historical or monumental buildings and individual houses or flats.

Figure: LUG: Sales structure – products

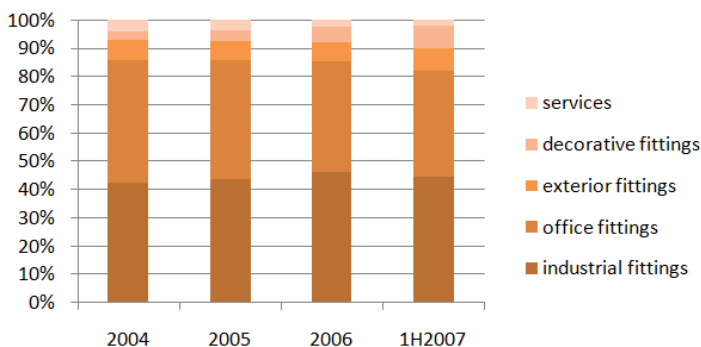
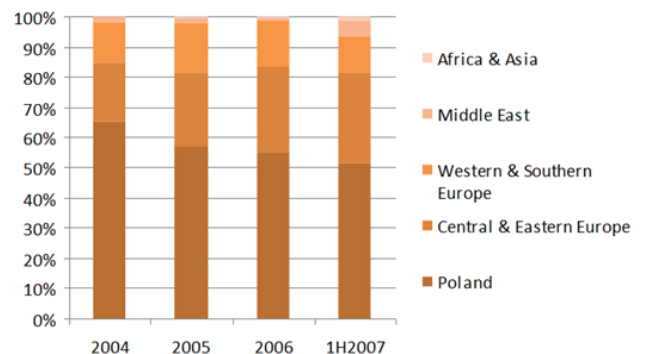


Figure: LUG: Sales structure - markets



Source: LUG

Sales structure

LUG has a diversified sales structure in terms of geographical markets. Domestic sales account for over 50% of the total. The remaining revenues are generated in various regions of the world. A significant part of output is directed to both Eastern and Western Europe. Recently LUG has been expanding into new profitable markets, such as the Middle East (especially the UAE, Kuwait, Qatar, etc.) and Africa.

Management Board**Experienced and professional Management Board**

Currently the Management Board of LUG consists of four members:

- **Ryszard Wtorkowski** – President. Company founder and major shareholder, he has almost 20 years of experience in the lighting industry, which enables him to successfully manage LUG's business.
- **Małgorzata Konys** – Board member, Chief Financial Officer. With LUG since 1998.
- **Mariusz Ejsmont** – Board member, Chief Technical Officer.
- **Tomasz Rozwalka** – Board member, Chief Sales Officer.

Private placement

PLN 20.7m from private placement

In 2007 LUG decided to raise capital through private placement. A total of 11,135,705 shares were offered, of which 2,142,855 sold by the Wtorkowski family and 8,992,850 new shares issued the company, raising about PLN 20.7m.

The next step in the development is the listing of the company's shares on NewConnect, the Warsaw Stock Exchange's market dedicated to innovative companies.

Objectives of the Private Placement

The capital raised through the private placement will be invested as follows:

- construction of a new production/warehouse/office building – PLN 15m (partially financed by bank credit)
- process line – PLN 7m (partially financed by bank credit)
- working capital increase – PLN 3m

The main objective of the offering was to finance capital expenditures relating to the construction and outfitting of a factory to be built in the Special Economic Activity Zone in Zielona Góra.

The total usable area of the new headquarters will be about 8,000 sq. metres. The company is currently conducting negotiations with the contractors who will carry out construction and installation works related to this project.

In 2007, LUG also plans to purchase a modern powder coating line (automatic painting line) for metal coffers and other metal parts. The innovative technological solutions will allow the company to achieve even better quality of fitting elements as well as high efficiency during all stages of production, in line with the highest technological levels worldwide.

Shareholder structure

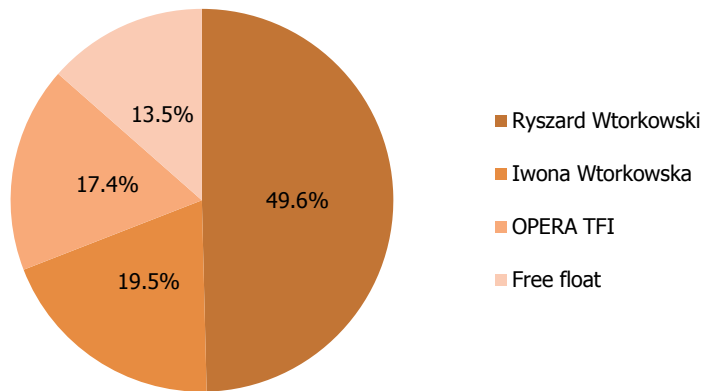
Insiders & institutional investor stabilize shareholder structure

Before the private placement, the company's CEO, Ryszard Wtorkowski, controlled 74% of the shares of the company, while his wife, Iwona Wtorkowska, controlled the remaining 26%. After the IPO, the Wtorkowski family controls altogether 69% of the shares and voting rights, while the other shareholders hold 31%, of which the stake held by the mutual funds managed by Opera TFI amount to 17.4%.

Mr Ryszard Wtorkowski	49.6%
Mrs Iwona Wtorkowska	19.5%
Funds managed by OPERA TFI	17.4%
Free float	13.5%

The presence of an institutional investor in LUG's shareholder structure suggests an expectation of future growth of financial results.

Figure: LUG: Shareholder structure



Source: LUG

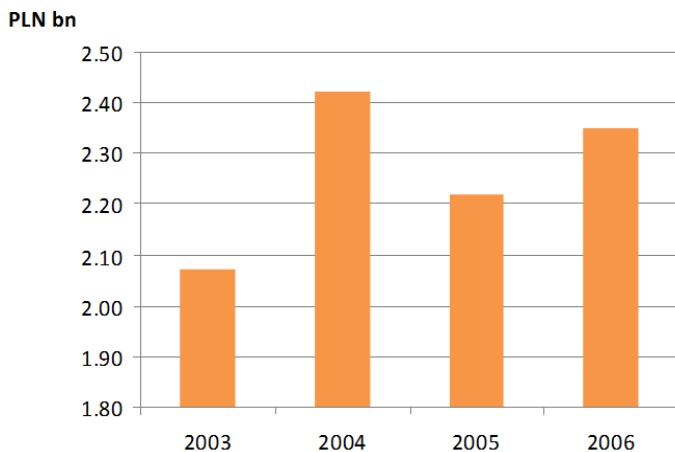
Industry

Big market without dominant players

The strong worldwide economic growth during the last three years (particularly robust in the emerging markets) as well as the rapid development of the Polish construction sector have created a favourable environment for growth in the lighting sector. The value of the entire Polish lighting market in 2006 was PLN 2.35bn.

The Polish lightning market is fragmented. In 2006, two WSE-listed companies, ES-System and Lena Lighting, had combined sales of PLN 250m, which gave them approximately 10% of the market. The remainder of the market is divided between small, local companies and distributors of cheaper, lower quality products.

Figure: LUG: Size of the lighting fittings market



Source: GUS (Polish Statistical Office)

Positive prospects for the market

The Polish lighting market is characterized by strong growth prospects. The main factors fuelling the growth include:

- the expanding construction market,
- a deficit of infrastructure,
- growing efficiency,
- investments in modern technologies.

Business model

- Construction growth** LUG operates in the lighting fittings industry, which is strongly connected with the building industry. The main customers for LUG's products are construction companies, which use them to illuminate various buildings or places. The economic cycle in the Polish infrastructure industry has entered the growth phase and is expected to continue growing for at least several years. Poland has a significant gap to fill, so large funds from the government, commercial companies and the European Union are going to be spent on this during the next decade.
- High-quality products** Poland's light fitting market is fragmented. LUG positions itself in the high-quality segment, which enables it to achieve higher margins. The wide range of products offered allows customers to adjust purchases to their needs and expectations. Most of LUG's products are tailor-made products designed by LUG's own product design department.
- Diversified & attractive markets** LUG pays great attention to foreign markets. The focus is very wide. Traditionally a large part of production has been sold in Eastern Europe, where the construction and infrastructure sectors have also been seeing growth. The company continues to develop its activities in that region. Its affiliate, LUG Ukraina, promotes the LUG brand on the other side of the Polish eastern border with a view to gaining a significant market share in Ukraine.
- Petrodollars are easy to spend** During the past few years there has been noticeable expansion to other continents. Its well-known brand and the remarkably strong growth of the building sector in the Middle East allow the company to increase revenues generated by this region. New target markets in sight include Africa and Asia.
- Technologically advanced production facilities** LUG systematically modernizes and upgrades its production facilities. In 2005 the company purchased a cable machining and cutting line as well as a process line for manufacturing aluminium reflectors, allowing the company to streamline and automate production. In 2006 the company continued to invest in its technical infrastructure. Among other things, it purchased a revolver press for cutting fitting parts from sheets, as well as digital sheet flanging machines and hydraulic flanging machines. The investment in digitally-controlled machines for cutting and machining metal details used in the production of lighting fitting casings, increased the company's production capabilities, enabled the implementation of new lighting fitting designs in production, and ensured a high quality of completed products. Funds raised from the private placement will allow the company to purchase high-quality equipment and offer products to the most demanding and choosy customers.

Highly-qualified and experienced staff

Employees are LUG's strong point. The staff are highly skilled and creative, enabling the company to conduct its business effectively. Management puts strong emphasis on development and improvement of the staff's skills and talents, which allows LUG to maintain satisfaction and prevent employment problems. The number of employees has been systematically increasing for several years. LUG currently employs almost 200 workers (a 40% increase in workforce compared with 2005). The highly-qualified and experienced staff guarantees product quality and timely distribution.

Financial statements

The historical financial results of LUG are given below.

The main factor shaping the financial results of LUG during the past three years has been the significant growth in the scale of its operations, which can be seen in the increasing sales, EBIT and net profit.

What is a very positive thing about LUG's financial results is the stable level of margins and profitability ratios. The growth in revenues achieved by gaining market share and expanding to new markets did not worsen the company's efficiency.

Analysis of the cash flow statement reveals the company's consistent ability to generate cash from operations and a stable policy of investments.

Figure: INCOME STATEMENT

PLN millions	2003	2004	2005	2006
Sales	20.61	20.94	30.39	49.96
Operating costs	20.00	18.91	27.12	46.46
Other operating income	0.70	0.28	0.21	0.46
Other operating cost	0.40	0.81	1.04	0.61
Operating profit (loss)	0.92	1.50	2.43	3.34
EBIT	1.02	2.27	2.68	3.56
Depreciation & Amortization	0.29	0.37	0.64	0.92
Interest expense	0.95	0.28	0.45	0.57
Profit (loss) before taxes	0.06	1.99	2.23	2.98
Taxes	0.05	0.34	0.42	0.63
Net profit (loss)	0.01	1.64	1.80	2.35

Source: LUG

Figure: BALANCE SHEET

PLN millions	2003	2004	2005	2006
Total assets	10.66	11.96	17.23	22.54
Fixed assets	3.35	3.67	5.32	6.37
Intangibles	0.01	0.17	0.11	0.04
Tangibles	3.21	3.45	5.07	5.97
Long term investments	0.07	0.05	0.05	0.11
Current assets	7.32	8.28	11.91	16.16
Inventories	2.68	3.92	5.37	6.64
Receivables	4.38	4.21	5.95	8.02
Cash & Cash Equivalents	0.24	0.12	0.37	0.97
Equity & Liabilities	10.66	11.96	17.23	22.54
Equity	2.08	3.62	5.28	7.44
Payables	3.65	3.92	6.29	10.02
Short term debt	3.07	2.49	2.83	2.13
Long term debt	1.45	1.09	1.13	0.61

Source: LUG

Figure: CASH FLOW STATEMENT

PLN millions	2003	2004	2005	2006
Cash flow from operations	0.92	1.28	1.83	4.01
Cash flow from investing	(0.55)	(0.76)	(1.78)	(1.47)
Cash flow from financing	(0.47)	(0.64)	0.20	(1.94)
Cash flow	(0.09)	(0.12)	0.25	0.61

Source: LUG

Figure: FINANCIAL RATIOS

	2003	2004	2005	2006
ROA	0.09%	13.71%	10.45%	10.43%
ROE	0.48%	45.30%	34.09%	31.59%
operating margin	4.46%	7.16%	8.00%	6.69%
net margin	0.05%	7.83%	5.92%	4.70%
debt/assets ratio	80.49%	69.73%	69.36%	66.99%

Source: LUG

DCF valuation

Discounted cash flow valuation was conducted using the free cash flow to firm model.

The following assumptions were used for the purposes of the valuation :

- effective tax rate – 19% in 2007, 5% in 2008, 0% until 2014
- free cash flow residual growth rate = 3.0%
- risk free rate = 5.5%
- equity risk premium = 5%
- beta = 1.2
- cost of debt = 6%
- debt/assets ratio = 0.4
- net working capital level increasing at the rate of sales growth

Figure: DCF VALUATION

PLN millions	2007	2008	2009	2010	2011	2012
Sales	75.06	93.49	104.63	129.30	138.37	148.05
EBIT	5.11	7.78	8.77	10.25	11.80	12.98
Tax	1.01	0.38	0.00	0.00	0.00	0.00
NOPLAT	4.43	7.40	8.77	10.25	11.80	12.98
Amortization	1.15	1.53	1.62	1.81	1.96	2.15
Capex	3.01	21.50	3.80	4.00	4.00	3.70
ΔNWC	1.54	6.16	1.96	2.18	3.22	3.22
FCFF	1.03	(18.74)	4.63	5.88	6.54	8.21
Residual value						128.9
ΣDCF	107.47					
Net debt	1.94					
Net inflow	19.03					
SUM	124.56					
Per share	3.46					

Source: LUG, WDM Securities estimates

Comparative valuation

Close peers on WSE

Two companies from the lighting industry listed on the WSE were chosen for comparative analysis. Lena Lighting and ES-System are comparable in size and scope of operations. Due to our conservative attitude, both companies were given equal weights of 0.5, in spite of that LUG is more comparable in terms of profitability and business model to ES-System, which is more expensive than Lena Lighting.

The P/E (weight 0.6) and MC/S (weight 0.4) ratios for 2007–2009 were used in the analysis. The adopted weights were 0.3 (for 2007), 0.4 (for 2008) and 0.3 (for 2009).

Figure: COMPARATIVE VALUATION

Company	Price	MCAP (PLNm)	P/E			MC/S		
			2007	2008	2009	2007	2008	2009
Lena Lighting	8.20	203	16.7	14.5	12.6	1.6	1.4	1.2
ES-System	8.55	366	28.2	23.5	19.6	2.1	1.8	1.5
Mean			22.4	19.0	16.1	1.9	1.6	1.3
LUG's Valuation (PLNm)			87.0	129.7	129.2	138.9	146.9	139.7
Weight			0.15	0.20	0.15	0.15	0.20	0.15
Final Valuation		129.54						
Per share		3.60						

Source: Reuters, WDM Securities estimates

The multiplier method implied LUG's value at PLN 129.54 m, or PLN 3.60 per share.

Final valuation

The comparative method and the DCF method were both given equal weights of 0.5 for the purposes of determining the final valuation. IPO discount equal 10% was applied.

Comparable value = PLN 3.60 / share

DCF value = PLN 3.46 / share

Final valuation = PLN 3.18 / share

Disclaimer

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Definitions of terms and ratios

DCF – discounted cash flow
 EBIT – earnings before interest and taxes (operating profit + financial income)
 EBITDA – earnings before interest, taxes, depreciation & amortization
 EPS – earnings per share (net earnings / number of shares issued)
 EV – enterprise value
 EV/EBITDA – EV to EBITDA ratio (EV / EBITDA)
 FCF – free cash flow to equity
 MC/S – market capitalization to sales ratio (market capitalization / sales)
 MCAP – market capitalization (market price * number of shares issued)
 NOPLAT – net operating profit less adjusted taxes
 NWC – net working capital
 P/E – price to earnings ratio (market price / EPS)
 ROA – return on assets (net earnings / assets)
 ROE – return on equity (net earnings / equity)

Advantages and disadvantages of used valuation methods

DCF (discounted cash flow) method – a widely used and methodologically correct method; discounts cash flows generated by the company using an appropriate discount rate, sensitivity to assumptions makes it value susceptible to changes in forecasts used in the model.

Comparative method – widely used and comprehensible; compares the company to similar enterprises using a set of financial ratios; sensitive to the selection of peer companies and to the current market situation.

Recommendations

BUY – the target price significantly exceeds the current market price, the expected rate of return on the investment is positive.

HOLD – the target price does not vary significantly from the current market price, the expected rate of return on investment is inconsiderable.

SELL – the target price is significantly lower than the current market price, the expected rate of return is negative.

Previous recommendations

This publication constitutes the first recommendation concerning the company's shares provided by WDM S.A.

Structure of recommendations issued by WDM S.A. in 4Q'2007

BUY	2	(100%)
HOLD	0	(0%)
SELL	0	(0%)

All prices and indexes reflect market values as of November 14 2007.