Banks | Poland

# Polish Banks

Sector update

- **We downgrade mBank to Neutral from Buy, upgrade Millennium to Accumulate from Neutral and remain Neutral on BZ WBK**
- **We increase our 12M TP of BZ WBK to PLN 405 from PLN 368, of Millennium to PLN 8.2 from PLN 7.6 and decrease our 12M TP for mBank to PLN 495 from PLN 507**

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EQUITY / RESEARCH

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## 1Q15 preview: Downgrading mBank, upgrading Millennium

**In this report, we present our 1Q15 estimates for the banks in our coverage. We update also our estimates and ratings for BZ WBK, mBank and Millennium. Due to share price performance we downgrade our rating for mBank to Neutral from Buy and cut TP to PLN 495 from PLN 507. While we still believe the forced conversion scenario is rather unlikely, the current valuation at 17.7x adjusted P/E, 1.8x P/BV seems fair in our view. We upgrade our rating for Millennium to Accumulate from Neutral with 12M TP up to PLN 8.2 from PLN 7.6. We expect the bank to show strong 1Q15 numbers and valuation at 14.8x P/E and 1.5x P/BV remains attractive in our view. For BZ WBK we increase our 12M TP to PLN 405 from PLN 368, but maintain our Neutral rating.**

**1Q15 preview: 15% YoY decline in adjusted earnings; YoY growth only at Alior and BZ WBK; steep declines in Getin Noble Bank, mBank, PKO BP and Handlowy.** We expect 9 banks in our coverage to report on aggregate 15% YoY adjusted net profit drop (or +6% YoY growth of reported numbers). We expect Alior and BZ WBK to report earnings growth (adjusted +17% YoY and +4% YoY respectively) and Getin Noble Bank, mBank and PKO BP to see steep declines (-92% YoY, -30% YoY and -21% YoY, respectively).

**Small changes to EPS estimates.** On the back of 2014 numbers, recent interest rates cuts and expected 1Q15 results we cut our 2015E earnings estimates by 2% for BZ WBK, by 1% for mBank and lift by 2% for Millennium. We increase also slightly our 2016E estimates by 1% for BZ WBK and Millennium with no changes in mBank forecasts. With our 2015E estimates for BZ WBK and mBank we are 10% below consensus (not including one-offs). Our estimates for Millennium are 2% below consensus.

**Upgrading Millennium, Downgrading mBank.** Due to share price performance we downgrade our rating for **mBank** to Neutral from Buy and cut TP to PLN 495 from PLN 507. While we still believe the forced conversion scenario is rather unlikely, the current valuation at 17.7x adjusted P/E, 1.8x P/BV seems fair in our view. We increase our rating for **Millennium** to Accumulate from Neutral with 12M TP up to PLN 8.2 from PLN 7.6. We expect the bank to show relatively strong 1Q15 numbers and valuation at 14.8x P/E and 1.5x P/E, that is with 16% and 17% discount to peers remains attractive in our view. For **BZ WBK** we increase our 12M TP to PLN 405 from PLN 368, but maintain our Neutral rating.

**Figure 1. Polish Banks – DII ratings and valuations**

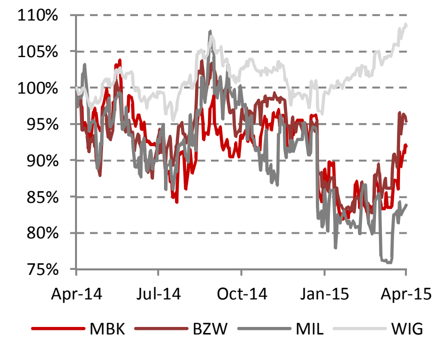
*PLN unless otherwise stated*

| Bank | Rating | 12M TP | Current price | Upside/ downside | Previous rating | Previous 12M TP |
|---|---|---|---|---|---|---|
| BZ WBK | Neutral | 405.0 | 378.0 | 7.1% | Neutral | 368.0 |
| mBank | Neutral | 495.0 | 483.6 | 2.4% | Buy | 507.0 |
| Bank Millennium | Accumulate | 8.2 | 7.3 | 12.3% | Neutral | 7.6 |

*Source: DII research estimates*

| BZ WBK | |
|---|---|
| Rating | Neutral |
| Target Price (PLN) | 405 |
| Upside/Downside | 7.1% |
| Previous rating | Neutral |
| Previous Target Price (PLN) | 368 |
| **mBank** | |
| Rating | Neutral |
| Target Price (PLN) | 495 |
| Upside/Downside | 2.4% |
| Previous rating | Buy |
| Previous Target Price (PLN) | 507 |
| **Millennium** | |
| Rating | Accumulate |
| Target Price (PLN) | 8.2 |
| Upside/Downside | 12.3% |
| Previous rating | Neutral |
| Previous Target Price (PLN) | 7.6 |

**BZW, MBK, MIL, WIG – 12M relative price performance**




*Source: Bloomberg, DII research*

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Millennium - over the last twelve months, DI Investors issued reduce recommendation dated 12 January 2015 with target price marked as 8.1PLN and one neutral recommendation dated 29th January 2015 with target price marked as 7.6PLN and another reduce recommendation dated 22nd April 2014 with target price 8PLN when the market price was 8.6PLN. DI Investors may act as a market maker for the shares of the Issuer in the future.

mBank - over the last twelve months, DI Investors issued buy recommendation dated 13th March 2015 with target price marked as 507PLN when the current price was 435.3PLN, two neutral recommendations: one dated 29th January 2015 with target price marked as 498PLN when the current price was 471.3PLN, and the second neutral recommendation dated 12 January 2015 with target price marked as 547PLN when the current price was 505PLN. DI Investors may act as a market maker for the shares of the Issuer in the future.

BZ WBK - over the last twelve months, DI Investors issued three neutral recommendations: one dated 29th January 2015 with target price marked as 368 PLN when the current price was 342.7PLN, the second dated 12 January 2015 with target price marked as 393PLN, when the current price was 376PLN, and third one dated 19th September 2015 with target price marked as 413PLN when the current price was 400PLN. DI Investors may act as a market maker for the shares of the Issuer in the future.

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Buy/Accumulate/Neutral/Reduce/Sell – means that, according to the authors of this document, the stock price may perform materially better/better/neutrally/worse/materially worse than the cost of equity of the respective stock.

The recommendation system of DI Investors is based on determination of target prices and their relations to current prices of financial instruments; in addition, when recommendations are addressed to a wide range of recipients, two methods of valuation are required.

In preparing this document DI Investors applied at least two of the following valuation methods:

1) discounted cash flows (DCF),

2) comparative,

3) target multiple,

4) scenario analysis,

5) dividend discount model (DDM),

6) NAV,

7) Sum of the parts.

8) Discounted residual income model

9) ROE-P/BV model

The discounted cash flows (DCF) valuation method is based on discounting expected future cash flows. The main advantage of the DCF valuation is the fact that this method takes into account all cash streams the issuer is expected to reach and the cost of money over time. From the other hand, DCF valuation method requires a number of assumptions and is very sensitive to changes in parameters used in the in the model. Small changes in inputs can result in large changes in the value of a company.

The comparative valuation method is based on the rule of "one price". The advantages of this method are small number of parameters that need to be estimated, the fact that there is a relatively large number of indicators for companies being compared, the method is well-known among investors and the valuation is based on current market conditions. From the other hand a valuation derived from the comparative valuation method is considerably sensitive to the valuation of the companies classified as peers and can lead to simplification of the picture of the company.

The target multiple valuation approach is based on the assumption that the value of the company should be equal to pre-specified values of selected price multiples. The advantage of this method is its applicability to each company. From the other hand the target multiple approach is a highly subjective method.

The scenario analysis approach is based on the probability weighted valuation for three sets of assumptions: Bear case (20% probability), base case (60% probability) and bull case (20% probability). The base case is based on the assumptions and estimates which we have included in our financial forecasts and DCF valuation. In the bear/bull case scenarios we have analyzed the valuation sensitivity towards negative/positive changes in various assumptions including market size, market shares, profitability, growth, capex, valuation multiples etc. The advantage of this method is presentation of various scenarios and valuation sensitivity. As an disadvantage we find its complication and sensitivity towards probability weights assumption.

The dividend discount model (DDM) valuation uses predicted dividends that are expected to be paid out by the company and discounts them back to present value. The advantages of the DDM valuation method are its applicability to companies with long-term dividend payout history and the fact that it takes into account real cash streams that are expected to receive by equity-owners. From the other side the DDM valuation method requires a number of assumptions regarding dividend payouts.

The net asset value approach considers the underlying value of the company's individual assets net of its liabilities. Some of the advantages of the NAV approach are its applicability to asset holding companies and the fact that data required to perform the valuation are usually easily available. From the other hand the valuation derived from net asset value approach does not take into account future changes in sales or income and can understate the value of intangible assets.

The sum of the parts approach values a company by determining what its divisions would be worth if it was broken up and spun off or acquired by another company. The advantage of this method is a possibility to apply different valuation methods to different divisions. As an disadvantage we find scarcity of comparable basis for the respective business lines.

The discounted residual income model valuation is based on discounted excess equity flows the company is able to deliver. The main advantage of this method is that it is based on return on equity adjusted by cost of equity. The important disadvantage is that it is based on the income statement so does not include actual cash flows, but may fluctuate depending on accounting method.

The ROE-P/BV model valuation is based on the regression line with valuation-to-book value (P/BV) depending on the return on equity the company is able to deliver. The main advantage of the method is that it includes the correlation of valuation with profitability. The main disadvantage is that it does not fully take into account earnings dynamics.

Terminology used in the recommendation:

P/E – price-earnings ratio

PEG - P/E to growth ratio

EPS - earnings per share

P/BV – price-book value

BV – book value

EV/EBITDA – enterprise value to EBITDA

EV – enterprise value (market capitalization plus net debt)

EBITDA – earnings before interest, taxes, depreciation, and amortization

EBIT – earnings before interest and tax

NOPAT – net operational profit after taxation

FCF - free cash flows

ROE – return on equity

WACC - weighted average cost of capital

CAGR – cumulative average annual growth

CPI – consumer price index

COE – cost of equity

L-F-L – like for like

Recommendation definitions:

Buy - indicates a stock's total return to exceed more than 1.5x respective cost of equity over the next twelve months.

Accumulate - indicates a stock's total return to exceed more than respective cost of equity over the next twelve months.

Neutral - indicates a stock's total return to be in range of 0% to respective cost of equity over the next twelve months.

Reduce - indicates a stock's total return to be in range of minus respective cost of equity to 0% over the next twelve months.

Sell - indicates a stock's total return to be less than minus respective cost of equity over the next twelve months.