

Handlowy

Reduce (from Accumulate)

TP: PLN 75

Recommendation downgrade

- Rating downgrade to Reduce from Accumulate with 12M TP up to PLN 75 from 74
- We lift our 2015E earnings estimates by 5% and make no changes to 2016E and 2017E forecasts
- Trading at 16.8x P/E, 1.5x P/BV

9 February 2016

Valuation turns rich. Downgrade to Reduce

Since the beginning of the year Handlowy was the best performing stock among Polish banks gaining 8.5% vs. a 5.6% drop of WIG Banks index and a 3.9% decline of WIG. While the bank remains more than peers resistant to political issues (no CHF risk) and offers solid 5.7% DY, we believe its competitive advantages are already more than priced in. At our estimates Handlowy is trading at 16.8x P/E and 1.5x P/BV, with 24% and 38% premium to peers. On the back of reviewed 4Q15 expectations we lift our 2015E net profit estimate by 5% and leave our 2016E and 2017E forecasts unchanged. We lift our TP to PLN 75 from PLN 74 previously, but due to share price performance we downgrade our rating for Handlowy to Reduce from Accumulate.

4Q15 driven by strong cost control and a rebound in financial income. 4Q15 numbers in Handlowy will be determined by strong cost control and improved QoQ result on financial operations and investment securities. We expect Handlowy to report 4Q15 net profit of PLN 105m (-49% YoY, -25% QoQ) or PLN 158m (-23% YoY, +12% QoQ) excluding SK Bank (PLN 64m) and Mortgage Stability Fund (PLN 1m) contributions.

No changes to 2016E earnings estimates. On the back of reviewed 4Q15 expectations we lift our 2015E net profit estimate by 5% and leave our 2016E and 2017E forecasts unchanged. We now expect 2016E adjusted net profit to drop 9% YoY to PLN 605m. Our 2016E earnings estimates are 2% above consensus.

Solid DY and no-CHF risk more than priced in. Handlowy is free of CHF risk and offers one of the best DY in the sector (5.7%). We believe though, that its competitive advantages are already more than priced in. At our estimates Handlowy is trading at 16.8x P/E and 1.5x P/BV, with 24% and 38% premium to peers.

Strong exposure to interest rate cuts and bond gains. While we expect NII to finally start to rebound in 4Q15 (+2% QoQ) Handlowy was one of the banks that suffered the most due to recent interest rates cuts (NII down 16% YoY in 2015E). Its revenue structure remains also under strong influence of volatile bond gains and trading income (financial and other income dropped 33% YoY in 2015E). While in our base case scenario we do not expect further interest rate cuts, potential fiscal policy easing would put much more pressure on Handlowy than its peers and would result in a much steeper earnings drop in 2016E than we expect.

Figure 1. Handlowy – Key data, 2012-2017E

	2012	2013	2014	2015E	2016E	2017E
Net profit (PLNm)	970	973	947	613	605	656
YoY change (%)	32%	0%	-3%	-35%	-1%	8%
ROE (%)	14.0%	13.2%	12.9%	8.6%	8.9%	9.5%
P/E (x)	10.5	10.5	10.8	16.6	16.8	15.5
P/BV (x)	1.4	1.4	1.4	1.5	1.5	1.5
DPS (PLN)*	5.8	7.2	7.4	4.5	4.4	4.8
DY (%)*	7.4%	9.2%	9.5%	5.7%	5.6%	6.1%

* from the year's earnings. Source: Company data, Vestor DM estimates

Company data

Rating	Reduce
Target Price (PLN)	75.0
Market Price (PLN)	78.0
Upside/downside	-4%
Previous rating	Accumulate
Previous Target Price (PLN)	74.0
Min (52W)	61.1
Max (52W)	105.8
Market cap (PLNm)	10,191
Avg. 3M Turnover (PLNm)	4.5

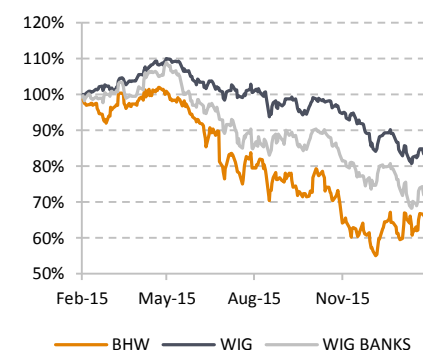
Shareholders

	%
Citibank Overseas IC	75.0%
Other	25.0%

Company description

Citi Handlowy is a universal bank with over 3% market share in assets and 44 branches. Corporate loans constitute 65% of the bank's loan book, cash loans 15%, credit card loans 12% and mortgage loans 7%.

Handlowy vs. WIG vs. WIG Banks 12M relative price performance rebased



Source: Bloomberg, Vestor DM

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In preparing this document Vestor 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.

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