Banks | Poland

Polish Banks

Sector update

- **Higher assumed probability of forced CHF conversion (60% vs. 10% previously) made us downgrade PKO BP (to Accumulate), Millennium (to Neutral) and Getin Noble Bank (to Reduce).**
- **We remain buyers of ING BSK, maintain Accumulate rating for Handlowy and Neutral rating for Pekao, BZ WBK, mBank and Alior**

EQUITY / RESEARCH

11.6.2015

Risk off: No rebound till elections (at least)

While at the beginning of the year rates cuts appeared as the biggest risk for the banking sector in Poland, due to upcoming parliamentary elections, this is politics that appears as the most significant risk factor for banks in coming quarters. Thus, CHF mortgages and a threat of a new banking levy will weigh on share prices of banks, we believe. We increase probability of forced CHF conversion to 60% from 10% previously and include it in our target prices. As a result we downgrade PKO BP (to Accumulate from Buy, TP of PLN 36), Millennium (to Neutral from Accumulate, TP PLN of 7.1) and Getin Noble Bank (to Reduce from Neutral, TP PLN 1.4). We remain buyers of ING BSK (TP of PLN 166), maintain Accumulate for Handlowy (TP of PLN 113) and maintain Neutral rating for Pekao (TP of PLN 188), BZ WBK (TP of PLN 350), mBank (TP of PLN 465) and Alior (TP of PLN 94).

Rising CHF conversion risk. At the end of May, ZBP presented the second set of proposals relating to CHF mortgages. The solutions though, including maintaining the six-pack or creating a Stabilization and Restructuring Fund, do not solve the problem, in our view. We expect further pressure on banks, especially having incoming parliamentary elections. We do not assume forced conversion at exchange rate from the day of taking the loan (as proposed by the President elect), but we believe, that conversion at pre-SNB exchange rate is much more likely now than before. We apply 60% probability to this solution (vs. 10% previously) and include it in our target prices.

New banking tax ahead? Due to upcoming elections we see an increased likelihood of a new banking tax (initially proposed by PiS in 2011, calculated as 0.39% of assets). According to our estimates impact of the new tax on 2016E earnings of banks would range between 17% and 62% with Handlowy and Pekao affected the least and Getin Noble Bank the most. While the potential impact is huge, we do not include a new tax in our estimates, as changes on the political scene are dynamic and difficult to predict.

ING BSK our favourite stock. In a tough and risky environment, that, we believe, will last at least until Autumn elections, ING BSK (Buy) remains our favorite name. Out of other non-CHF banks we prefer Handlowy (Accumulate) to Pekao (Neutral) and Alior (Neutral). Out of CHF-exposed banks we prefer PKO BP (downgrade from Buy to Accumulate). We remain Neutral on BZ WBK and mBank and downgrade Millennium (from Accumulate to Neutral) and Getin Noble Bank (from Neutral to Reduce).

Figure 1. Polish Banks – DII ratings and valuations

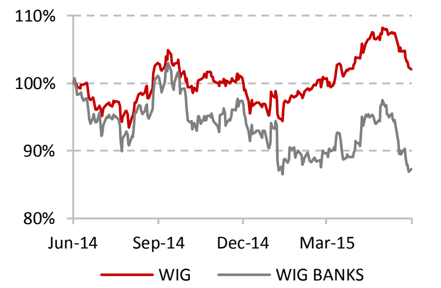
Bank	Rating	12M TP (PLN)	Current price (PLN)	Upside/ downside	Previous rating	Previous 12M TP
PKO BP	Accumulate	36.0	32.5	10.9%	Buy	39.0
Pekao	Neutral	188.0	175.5	7.1%	Neutral	187.0
BZ WBK	Neutral	350.0	327.6	6.8%	Neutral	405.0
mBank	Neutral	465.0	445.0	4.5%	Neutral	495.0
ING BSK	Buy	166.0	134.0	23.9%	Buy	155.0
Handlowy	Accumulate	113.0	103.30	9.4%	Accumulate	116.0
Millennium	Neutral	7.1	6.56	8.2%	Accumulate	8.2
Alior Bank	Neutral	94.0	90.8	3.5%	Neutral	85.0
Getin Noble Bank	Reduce	1.40	1.43	-2.1%	Neutral	2.1

Source: DII research estimates

PKO BP	
Rating	Accumulate
Target Price (PLN)	36.0
Upside/Downside	10.9%
Pekao	
Rating	Neutral
Target Price (PLN)	188
Upside/Downside	7.1%
BZ WBK	
Rating	Neutral
Target Price (PLN)	350
Upside/Downside	6.8%
mBank	
Rating	Neutral
Target Price (PLN)	465
Upside/Downside	4.5%
ING BSK	
Rating	Buy
Target Price (PLN)	166
Upside/Downside	23.9%
Handlowy	
Rating	Accumulate
Target Price (PLN)	113
Upside/Downside	9.4%
Millennium	
Rating	Neutral
Target Price (PLN)	7.1
Upside/Downside	8.2%
Alior Bank	
Rating	Neutral
Target Price (PLN)	94.0
Upside/Downside	3.5%
Getin Noble Bank	
Rating	Reduce
Target Price (PLN)	1.40
Upside/Downside	-2.1%

Source: Bloomberg, DII research

WIG Banks vs. WIG – 12M relative price performance



Source: Bloomberg, DII research

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The date on the first page of this report is the date of preparation and publication of the document.

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PKO BP – Over the last twelve months, DI Investors issued buy recommendation concerning PKO BP dated 19th September 2014 with target price 47PLN when the current price was 39.7PLN, second buy recommendation dated 12th January 2015 with target price 43PLN when the current price was 36.6PLN, third buy recommendation dated 29th January 2015 with target price 39PLN when the market price was 34.4PLN. DI Investors may act as a market maker for the shares of PKO BP now and in the future.

PEKAO - Over the last twelve months, DI Investors issued one accumulate recommendation concerning PEKAO dated 12th August 2014 with target price 190 PLN when the target price was 171 PLN, neutral recommendation dated 19th September 2014 with target price 195 PLN when the current price was 194 PLN, second neutral recommendation dated 12th January 2015 with target price 183PLN when the current price was 179PLN, third neutral recommendation dated 29th January 2015 with the target price 187PLN when the current price was 184.7PLN. DI Investors may act as a market maker for the shares of PEKAO now and in the future.

BZ WBK – Over the last twelve months, DI Investors issued one neutral recommendation concerning BZ WBK dated 19th September 2014 with target price 413 PLN when the current price was 400 PLN, second neutral recommendation dated 12 January 2015 with target price 393PLN when the current price was 376PLN, third neutral recommendation dated 29th January 2015 with the target price 368PLN when the current price was 342.7PLN and fourth neutral recommendation dated 24th April 2015 with the target price 405PLN when the current price was 378PLN. DI Investors may act as a market maker for the shares of BZ WBK in the future.

mBank - Over the last twelve months, DI Investors issued one neutral recommendation dated 12th January 2015 with target price 547PLN when the current price was 505PLN, second neutral recommendation dated 29th January 2015 with the target price 498PLN when the current price was 471.3 PLN, one buy recommendation dated 13th March 2015 with target price 507PLN when the current prices was 435.3PLN and another neutral recommendation dated 24th April 2015 with the target price 495 PLN when the market price was 483.6PLN . DI Investors may act as a market maker for the shares of mBank in the future.

ING BSK - Over the last twelve months, DI Investors issued one buy recommendation concerning ING BSK dated 12th January 2015 with target price 157PLN when the current price was 138PLN, second buy recommendation dated 29th January 2015 with the target price 155PLN when the current price was 136.9PLN.

Bank Handlowy - Over the last twelve months, DI Investors issued one neutral recommendation concerning Bank Handlowy dated 12th January 2015 with target price 116PLN when the current price was 108PLN second neutral recommendation dated 29th January 2015 with the target price 115PLN when the current price was 107.1PLN and one accumulate recommendation dated 13th March 2015 with target price 116PLN when the current price was 108PLN.

Millennium - Over the last twelve months, DI Investors issued one reduce recommendation concerning Millennium dated 12th January 2015 with target price 8.1PLN when the current price was 8.2PLN, one neutral recommendation dated 29th January 2015 with the target price 7.6PLN when the market price was 7.4PLN and one accumulate recommendation dated 24th April 2015 with the target price 8.2PLN when the current price was 7.3PLN.

Alior Bank - Over the last twelve months, DI Investors issued one neutral recommendation concerning Alior Bank dated 12th January 2015 with target price 82PLN when the target price was 79.5PLN, one reduce recommendation dated 29th January 2015 with the target price 80PLN when the current price was 84.7PLN and one neutral recommendation dated 13th March 2015 with target price 85PLn when the current price was 78.6PLN.

Getin Noble - Over the last twelve months, DI Investors issued one buy recommendation concerning Getin Noble dated 20th August 2014 with the target price 3,30 PLN when the current price was 2,64 PLN, second buy recommendation dated 12th January 2015 with target price 2.65PLN when the current price was 2.3PLN, second neutral recommendation dated 29th January 2015 with the target price 2.1PLN when the current price was 1.9PLN. DI Investors may act as a market maker for the shares of Getin Noble in the future.

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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.

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