

- mBank – Upgrade to Buy from Neutral, TP up to PLN 507 from 498
- Handlowy – Upgrade to Accumulate from Neutral, TP up to PLN 116 from 115
- Alior Bank – Upgrade to Neutral from Reduce, TP up to PLN 85 from 80

Upgrading mBank, Handlowy and Alior Bank

Share prices performance, ongoing discussion related to CHF mortgage loans and 4Q results prompted us to upgrade three stocks, that in our view, are worth paying attention to: 1) mBank (upgrade to Buy from Neutral, TP up to PLN 507 from PLN 498), as, in our view, the CHF risks are already reflected in the share price, 2) Handlowy (upgrade to Accumulate from Neutral, TP up to PLN 116 from PLN 115) as the bank is free of CHF exposure and offers best-in sector DY, and 3) Alior Bank (Upgrade to Neutral from Reduce, TP up to PLN 85 from PLN 80), as the bank reported strong 4Q14 numbers and was the worst performing banking stock over the last month.

mBank - CHF risk priced-in. While we still believe the risk of worst case scenarios assuming forced conversion of CHF loans at the below market rate cannot be entirely excluded, we apply only 10% probability to such solution. Thus, after 13% share price drop since the SNB decision, we see mBank trading at 15.7x adjusted P/E and 1.6x P/BV as attractively valued. Its material CHF exposure (25% of total loans) will weight on revenues, in our view. This however, coupled with assumed probability of CHF forced conversion, is already priced in, in our view. The bank proved to be more resistant to interest rates cuts than peers and offers healthy dividend yield (3.9%).

Handlowy – Less risk, more reward. We agree, that Handlowy's earnings should suffer more than peers' in 2015E due to its high exposure to card business and vulnerability to interest rates cuts. However, even at our conservative estimates (we expect 14% YoY net profit drop in 2015E to PLN 811m, 6% below consensus), the current valuation at 17.4x 2015E P/E and 1.9x P/BV offers attractive risk/reward profile, we believe. Handlowy is free of the CHF exposure and provides stable and the highest dividend yield in the sector (6.9%).

Alior Bank – Upgrade to Neutral. Over the last month Alior Bank was the worst performing stock among banks dropping 4.7% and underperforming WIG Banks index by 7.2 p.p. Given the solid 4Q14 numbers, no CHF exposure and strong, although decelerating, loan growth, the current valuation at 17.0x P/E and 1.6x P/BV sounds fair, in our view. Due to lowered risk-free-rate assumption we increase our 12M TP to PLN 85 from PLN 80 and - on the back of share price correction – we upgrade our rating for Alior Bank from Reduce to Neutral.

Figure 1. mBank, Handlowy, Alior Bank – DII ratings and valuations

PLN unless otherwise stated

Bank	Rating	12M TP	Current price	Upside/downside	Previous rating	Previous 12M TP
mBank	Buy	507.0	435.3	16.5%	Neutral	498.0
Handlowy	Accumulate	116.0	108.0	7.5%	Neutral	115.0
Alior Bank	Neutral	85.0	78.6	8.1%	Reduce	80.0

Source: DII research estimates

mBank

Rating	Buy
Target Price (PLN)	507.0
Share Price (PLN)	435.3
Upside/Downside	16%
Previous rating	Neutral
Previous Target Price (PLN)	498
Market cap (PLNm)	18,395

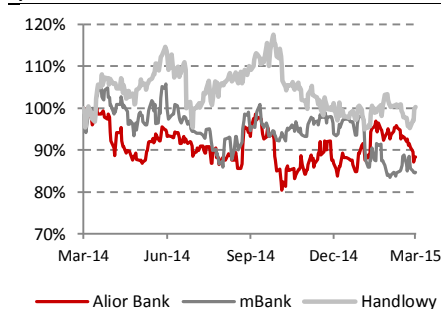
Handlowy

Rating	Accumulate
Target Price (PLN)	116
Share Price (PLN)	108
Upside/Downside	7.5%
Previous rating	Neutral
Previous Target Price (PLN)	115
Market cap (PLNm)	14,144

Alior Bank

Rating	Neutral
Target Price (PLN)	85.0
Share Price (PLN)	78.6
Upside/Downside	8%
Previous rating	Reduce
Previous Target Price (PLN)	80
Market cap (PLNm)	5,751

mBank, Handlowy, Alior Bank: 12M relative price performance



Source: Bloomberg, DI Investors

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Bank Handlowy - Over the last twelve months, DI Investors issued two neutral recommendations concerning Bank Handlowy, dated on: 22nd of April 2014 and 12th of January 2015.

Alior Bank - Over the last twelve months, DI Investors issued one neutral recommendation dated 12th January 2015.

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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 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.

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