Banks | Poland

Handlowy

Neutral (from Sell)

TP: PLN 73.0

Recommendation upgrade

- **We maintain our TP unchanged at PLN 73, but upgrade our rating to Neutral from Sell**
- **We remain our 2016-2018E net profit estimates broadly unchanged.**

Vestor DOM MAKLERSKI

equity research

16 May 2016

Upgrade to Neutral.

Over the last month Handlowy lost 12% underperforming WIG Banks index by 5.5pp. While the bank lags in terms of NIM rebound and will suffer from a deep earnings drop in 2016E (adjusted net profit -18% YoY) negatively affected by lower gains on bonds and weaker trading result (total -26% YoY), we see its current valuation as fair. At our estimates Handlowy is trading at 17.0x adjusted P/E and 1.4x P/BV. Trading premium to peers (16% and 8%, respectively) is justified in our view, given high sustainable dividend yield (6.1%) and lower regulatory risk (no CHF exposure). On the back of 1Q16 results and Management guidance we lift our net profit estimates slightly (by 2% in 2016E, 1% in 2017E and 3% in 2018E). We maintain our 12M TP at PLN 73, but due to share price performance we upgrade our rating to Neutral from Sell.

1Q16 results in line, supported by one-off items. 1Q16 net profit of Handlowy came in at PLN 104m (-52% YoY, -12% QoQ), in line with consensus. Provisions surprised positively, but net fees were 5% below consensus and the numbers were marked by weak trading income and supported by c. PLN 10m one-off. In the following quarters the Management expects trading result to normalize, NIM to improve and costs to drop YoY.

Minor changes to 2016-2018E forecasts. On the back of 1Q16 results and the Management guidance we make minor changes to our net profit estimates (+2% in 2016E, +1% in 2017E and +3% in 2018E). We now expect adjusted net profit at to drop 18% YoY in 2016E (to PLN 554m) followed by 10% YoY growth in 2017E. Our 2016-2017E estimates are 4% below consensus.

Risk-off priced in. While 1Q16 results exposed Handlowy's dependence on bond and trading result (net profit down 52% YoY driven by 68% drop of financial and other income) we believe, the bank's risk-off strategy is already priced in. In 2016E we expect trading result to drop -21% YoY (to PLN 230m) and gains on bonds -37% YoY (PLN 92m).

Premium to peers justified by sustainable dividend and lower regulatory risk. Following the 12% share price drop over the last month, at our estimates Handlowy is trading at 17.0x adjusted 2016E P/E and 1.4x P.BV, with 16% and 8% to peers respectively. In our view Handlowy deserves a trading premium due to sustainable dividend yield (we expect 6.1% from 2016E earnings) and much lower regulatory risk (no CHF exposure).

Figure 1. Handlowy – Key data, 2013-2018E

	2013	2014	2015	2016E	2017E	2018E
Net profit (PLNm)	973	947	626	606	609	691
YoY change (%)	*0%*	*-3%*	*-34%*	*-3%*	*1%*	*13%*
Adjusted net profit (PLNm)	973	947	679	554	609	691
YoY change (%)	*0%*	*-3%*	*-28%*	*-18%*	*10%*	*13%*
ROE adjusted (%)	13.2%	12.9%	9.5%	8.0%	8.8%	9.8%
P/E adjusted (x)	9.7	9.9	13.9	17.0	15.5	13.6
P/BV (x)	1.3	1.3	1.4	1.4	1.3	1.3
DPS (PLN)*	7.2	7.4	4.7	4.4	4.4	5.0
DY (%)*	9.9%	10.3%	6.5%	6.1%	6.1%	7.0%

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

Company data

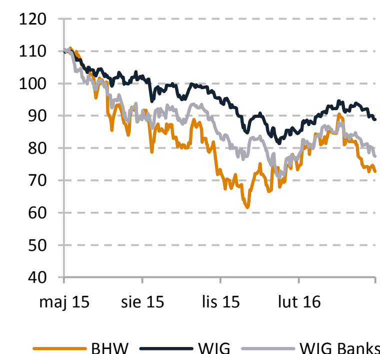
Rating	Neutral
Target Price (PLN)	73.0
Market Price (PLN)	72.0
Upside/downside	1%
Previous rating	Sell
Previous Target Price (PLN)	73.0
Min (52W)	61.1
Max (52W)	103.4
Market cap (PLNm)	9,407
Avg. 3M Turnover (PLNm)	3.6

Shareholders	%
Citibank Overseas	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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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.

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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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