Banks | Poland

Pekao

Reduce (from Accumulate)

TP: PLN 148

Recommendation downgrade

- We maintain our TP unchanged at PLN 148, but downgrade our rating to Reduce from Accumulate
- We reduce our adjusted net profit estimates by 10% in 2016E and by 4% in 2017E.
- Demanding valuation at 20.8x P/E, 1.8x P/BV

Vestor DOM MAKLERSKI

equity research

6 April 2016

Downgrade to Reduce on valuation grounds

Since the beginning of the year Pekao was one of the best performing banks gaining 10% and outperforming WIG by 7pp and WIG Banks index by 6pp. We acknowledge Pekao's strong balance sheet, immaterial CHF exposure, high capital ratios and sustainable dividend yield (from 2016E earnings we expect 5.2%), but we believe this is already more than priced in. Moreover, we believe Pekao's lending growth model is at risk given the banking tax. Due to lower loan growth assumptions, we are cutting our 2016E adjusted net profit estimates by 10%, to PLN 1,997m, 3% below consensus. At our 2016E estimates, Pekao is trading at 20.8x P/E and 1.8x P/BV, with 35% and 30% premium to peers and 27% above its 5Y average. We maintain our 12M TP at PLN 148, but due to share price performance we downgrade our rating to Reduce from Accumulate.

Declining chance of upside risk from potential acquisitions. With c. PLN 5.0bn of surplus capital Pekao might have been an active player in the M&A market, especially given declining prices of assets on the back of banking tax implementation. Given the recent acquisition of Bank BPH by Alior Bank we see a lower chance of an upside risk coming from a potential takeover.

Lending volumes growth under pressure from the banking tax. Pekao used to be an outperformer in terms of lending volumes growth (12% YoY vs. 9% YoY in peers in 3Q15 or 11% YoY vs. 9% YoY in 2014, respectively). We see a risk, that the business model based on lending growth might be under pressure given the implementation of the banking tax. In 2016E we expect net loans to grow +6% YoY vs. 6% YoY in 2015.

We cut our 2016E and 2017E net profit estimates by 10% and 4%. On the back of 4Q15 results and management guidance we cut our 2016E and 2017E adjusted net profit estimates by 10% and 4%, respectively. Our reported 2016E numbers remain unchanged as we include a PLN 174m one-off related to Visa and c. PLN 100m release of provisions due to sales of NPLs. We now expect 20% YoY adjusted net profit drop in 2016E (to PLN 1,997m) and 18% YoY rebound in 2017E. Our net profit forecasts are broadly in line with consensus (3% below and 1% above, respectively).

P/E at top end of relative and absolute valuation range. At our 2016E estimates Pekao is trading at 20.8x P/E and 1.8x P/BV, with 35% and 30% premium to peers. At P/E the bank is trading with 27%, 17% and 14% premium to 5Y, 3Y and 1Y average, respectively. At P/BV the bank is trading broadly in line with long-term average (-4%, -6%, +1%, respectively).

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

	2013	2014	2015	2016E	2017E	2018E
Net profit (PLNm)	2 785	2 715	2 292	2 219	2 352	2 573
YoY change (%)	*-5%*	*-3%*	*-16%*	*-3%*	*6%*	*9%*
Adjusted net profit (PLNm)	2 785	2 715	2 504	1 997	2 352	2 573
YoY change (%)	*-5%*	*-3%*	*-8%*	*-20%*	*18%*	*9%*
ROE (%)	12.0%	11.4%	9.7%	8.5%	10.0%	10.9%
P/E (x)	14.9	15.3	18.1	20.8	17.6	16.1
P/BV (x)	1.8	1.7	1.8	1.8	1.8	1.7
DY* (%)	6.3%	6.3%	5.5%	5.2%	5.6%	6.1%

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

Company data

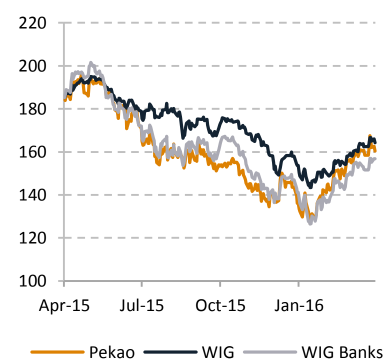
Rating	Reduce
Target Price (PLN)	148
Market Price (PLN)	158
Upside/downside	-6%
Previous rating	Accumulate
Previous Target Price (PLN)	148
Min (52W)	124
Max (52W)	197
Market cap (PLNm)	41,470
Avg. 3M Turnover (PLNm)	60.2

Shareholders	%
UniCredit	50.1%
Other	49.9%

Company description

Pekao is the second largest bank in Poland with is 11% market share in assets and almost 1th branches across the country. The bank's loan book is dominated by corporate loans (58%) and mortgage loans (PLN 30%, FX 4%). Consumer loans stand for 9% of total loans.

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



Source: Bloomberg, Vestor DM

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The recommendation system of Vestor 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 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.

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