

# Polish Banks

## Sector update

- We upgrade PEO (to a Buy from Accumulate), BZW (to Accumulate from Neutral) and PKO (to Neutral from Reduce)...
- ... maintain our rating for ING (Neutral), BHW (Neutral) and GNB (Reduce)...
- ... and downgrade Alior (to Accumulate from Buy), MIL (to Reduce from Neutral) and mBank (to Sell from Reduce)

## 2018 outlook: Strong year ahead

After solid 2017E, the banking sector in Poland appears to be facing strong two years ahead. We expect aggregate net profit growth of 9 banks in our coverage to increase in 2018E by 16% YoY supported by solid loan growth, a decent increase of revenues, flattish costs and provisions. In 2019E earnings growth should accelerate to +18% YoY boosted by interest hikes. Banks are helped by strong macro environment and less regulatory risks. Due to strong capital position more banks should be able to pay dividends and CHF conversion seems still distant. We upgrade our ratings for Pekao (to a Buy from Accumulate), BZ WBK (to Accumulate from Neutral) and PKO BP (to Neutral from Reduce), maintain for ING BSK (Neutral), Handlowy (Neutral) and Getin Noble Bank (Reduce) and downgrade our ratings for Alior (to Accumulate from a Buy), Millennium (to Reduce from Neutral) and mBank (to Sell from Reduce).

**Strong two years for the banking sector ahead.** In 2018E we expect 9 banks in our coverage to report solid 16% YoY aggregate net profit growth supported by strong macro driving total revenues up 6% YoY. We expect aggregate NII to grow by 8% YoY, fees to increase by 6% YoY and costs and provisions to remain broadly flat (both +2% YoY). Earnings growth should continue also in 2019E (+18% YoY), driven by NIM expansion on the back of assumed 50bps rate hikes.

**Valuations justified by EPS growth and ROE recovery.** WIG-Banks index is trading at 1YF P/E 15.4x which implies 5% and 7% premium to 1Y and 5Y historical average and, in our view, is justified by double digit EPS growth. At 1YF P/BV of 1.43x, which at 8% CoE and c. 10% ROE implies 3% long-term growth, WIG Banks valuation is far from excessive, we believe. We expect sector ROE to materially improve over the next two years from 8.7% in 2017E (at median) to 9.6% in 2018E and 10.5% in 2019E.

**Pekao, Alior and BZ WBK our top picks.** PEO (Buy), ALR (Accumulate) and BZW (Accumulate) are our most preferred bank. We rate Sell MBK and Reduce GNB and MIL.

**Key risks to our forecasts.** CHF issue lost its first spot on the risk radar, in our view. Slower than expected interest hike path is the main risk to our forecasts and the sentiment towards Polish banks, we believe.

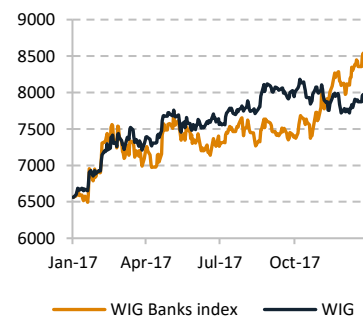
**Which banks are the most exposed to interest rates hikes?** In our earnings estimates we assume 2x25bp interest rates hikes in 3Q-4Q18. In this note we present detailed analysis of all the drivers affecting sensitivity of banks to interest rates changes.

**Figure 1. Polish Banks – Changes in ratings and valuations**

Bank	Rating	12M TP	Current price	Upside/downside	Previous rating	Previous 12M TP
PKO BP	Neutral ↑	45.0	44.3	2%	Reduce	35.0
Pekao	Buy ↑	152.0	134.3	13%	Accumulate	139.0
BZ WBK	Accumulate ↑	442.0	408.4	8%	Neutral	370.0
mBank	Sell ↓	443.0	496.0	-11%	Reduce	393.0
ING BSK	Neutral ➡	222.0	215.0	3%	Neutral	193.0
Handlowy	Neutral ➡	86.0	83.0	4%	Neutral	75.0
Millennium	Reduce ↓	8.9	9.4	-5%	Neutral	7.7
Alior	Accumulate ↓	87.0	78.0	12%	Buy	80.0
Getin Noble Bank	Reduce ➡	1.55	1.71	-9%	Reduce	1.40

Source: Vestor DM

**WIG Banks vs. WIG – relative price performance 12M**



Source: Bloomberg, Vestor DM

Bank	Rating	12M TP (PLN)
PKO BP	Neutral	45.0
Pekao	Buy	152
BZ WBK	Accumulate	442
mBank	Sell	443
ING BSK	Neutral	222
Handlowy	Neutral	86.0
Millennium	Reduce	8.9
Alior Bank	Accumulate	87.0
Getin Noble	Reduce	1.55

Source: Vestor DM

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- PEAKAO S.A. WAS PUBLISHED ON THE 24<sup>th</sup> OF OCTOBER 2017 AND INCLUDED A ACCUMULATE RECOMMENDATION,
- BANK ZACHODNI WBK S.A. WAS PUBLISHED ON THE 24<sup>th</sup> OF OCTOBER 2017 AND INCLUDED A NEUTRAL RECOMMENDATION,
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- ALIOR BANK S.A. WAS PUBLISHED ON THE 24<sup>th</sup> OF OCTOBER 2017 AND INCLUDED A BUY RECOMMENDATION,
- GETIN BANK S.A. WAS PUBLISHED ON THE 22<sup>nd</sup> OF OCTOBER 2017 AND INCLUDED A REDUCE RECOMMENDATION.

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A description of the organization mechanisms of Chinese walls aimed to prevent the conflicts of interest:

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  - i. the internal reporting system is to provide immediate information to the persons responsible for overseeing compliance with the principles set out in the Regulations for the event of a conflict of interest or risk of its origin;
  - ii. supervising their own transactions made by individuals, periodic inspection and assessment of the effectiveness of implemented by Vestor control systems and procedures; conducting the legally required registers and records, primarily registry conflicts of interest associated with a significant risk of damage to client interests;
- d) Refusal of action: the right to refuse the Vestor activity to the client, if given the commitment to specific activity on behalf of another client Vestor cannot effectively manage potential conflicts of interest, or prevent this regulatory restrictions or internal regulations;
- e) The division of functions: the organization of employees' tasks are aimed at eliminating cases simultaneously or one after the other following the exercise of the employee's duties within the various services provided by the Vestor, if that could have a negative impact on the proper management of conflicts of interest;
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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 valuation (including ROE-p/BV model),
- 3) Target multiple,
- 4) Scenario analysis,
- 5) Dividend discount model (DDM),
- 6) net asset value (NAV),
- 7) Sum of the parts,
- 8) Discounted residual income model (DRIM),
- 9) Risk-adjusted net present value (rNPV).

The discounted cash flows valuation method (DCF) is based on discounted expected future cash flows. The method includes all cash flows the issuer is expected to generate in a given period and the cost of money over time. However, the DCF valuation method requires a number of assumptions and is very sensitive to changes in parameters used in the model. Small changes in assumptions may result in material changes in the valuation.

The comparative valuation method is based on the rule of "one price". The advantages of the method include 1) a small number of parameters to be estimated, 2) the fact that there is a relatively large number of indicators for companies being compared, 3) The method is well-known among investors, 4) valuation is based on current market conditions. On the other hand, a comparative valuation is strongly sensitive to the valuation of the companies classified as peers and may lead to a simplified picture of the company valued.

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 simplicity and applicability to almost all of the companies. The target multiple approach is a highly subjective method, though.

The scenario analysis approach is based on the probability weighted valuation for three sets of assumptions: Bear case, base case and bull case with a different probability assigned. The base case is based on the assumptions included in financial forecasts and DCF valuation. The bear/bull case scenarios present a 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. A complexity and sensitivity to probability weights assumption may be found as disadvantages.

The dividend discount model (DDM) valuation is based on discounted future dividends that are expected to be paid out by the company over a period of time. The DDM model includes real cash streams that are expected to be received by shareholders and may be applied to companies with long-term dividend payout history. However, the DDM valuation method requires a number of assumptions.

The net asset value (NAV) approach considers the underlying value of the company's individual assets net of its liabilities. Among the advantages of the NAV approach are its applicability to asset holding companies and the fact that data required are usually easy to reach. On the other hand the NAV approach does not take into account future changes in revenues or income and can underestimate the value of intangible assets.

The sum of the parts approach values a company on the back of valuations of its separate divisions. The method is applicable to companies with very different business profiles, but requires identification of peers for business divisions comparison, what may be difficult to achieve.

The discounted residual income model includes equity at the end of a given financial year, excess equity (return on equity over cost of equity) the company is expected to generate in the estimation period and a discounted residual value post-estimation period. On one hand, the method includes profitability of the company compared to a cost of equity, but on the other hand it is strongly dependent on a number of parameters and assumptions.

The risk-adjusted net present value (rNPV) is a method used to forecast future cash flows in high-risk projects. In biotechnology, rNPV method involves forecasting future cash flows and applying probability rates of different phases of drug development. The main advantage of this method is the fact that it takes into account probability of success. The disadvantage of this method is the large number of assumptions and the high level of computational complexity.

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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Company	Recommendation Data	Analyst	TP	Current price at the time of publication of the recommendation	Recommendation	Time
Eurocash	2017-01-11	Jakub Rafat	41	40.6	Hold	12M
Pekao	2017-01-13	Michał Fidelus	147	128	Buy	12M
Mex Polska	2017-02-02	Aleksandra Jakubowska	11.9	7.7	Not rated	12M
ING BSK	2017-02-03	Michał Fidelus	158.0	167.0	Reduce	12M
GTC	2017-02-06	Marek Szymański	8.6	8.5	Neutral	12M
PKN	2017-02-15	Beata Szparaga	96.0	86.9	Accumulate	12M
Lotos	2017-02-15	Beata Szparaga	48.0	43.1	Accumulate	12M
PKO BP	2017-02-22	Michał Fidelus	32.5	35.1	Reduce	12M
Pekao	2017-02-22	Michał Fidelus	147.0	145.0	Neutral	12M
BZ WBK	2017-02-22	Michał Fidelus	357.0	370.6	Neutral	12M
mBank	2017-02-22	Michał Fidelus	368.0	419.9	Sell	12M
ING BSK	2017-02-22	Michał Fidelus	167.0	177.9	Reduce	12M
Handlowy	2017-02-22	Michał Fidelus	75.0	82.0	Reduce	12M
Millennium	2017-02-22	Michał Fidelus	6.4	7.0	Reduce	12M
Alior	2017-02-22	Michał Fidelus	75.0	66.0	Buy	12M
Getin Noble Bank	2017-02-22	Michał Fidelus	2.56	2.1	Buy	12M
Dom Development	2017-02-23	Marek Szymański	69.0	63.7	Accumulate	12M
LC Corp	2017-02-23	Marek Szymański	2.6	2.0	Buy	12M
Robyg	2017-02-23	Marek Szymański	4.0	3.0	Buy	12M
Eurocash	2017-02-24	Jakub Rafat	36.0	35.0	Hold	12M
KGHM	2017-03-02	Marcin Stebakow	152.0	131.5	Buy	12M
Emperia	2017-03-09	Jakub Rafat	79	73	Accumulate	12M
PKN	2017-03-23	Beata Szparaga	105.0	105.0	Neutral	12M
Lotos	2017-03-23	Beata Szparaga	52.0	57.9	Reduce	12M
Eurocash	2017-03-28	Jakub Rafat	36	32	Accumulate	12M
Altus	2017-04-05	Michał Fidelus	19.0	14.5	Buy	12M
Quercus	2017-04-05	Michał Fidelus	7.2	6.5	Accumulate	12M
Marvipol	2017-04-06	Marek Szymański	17.0	13.3	Not rated	12M
Mex Polska	2017-04-07	Aleksandra Jakubowska	12.1	7.3	Not rated	12M
Archicom	2017-04-19	Marek Szymański	22.5	16.2	Not rated	12M
Grupa Azoty	2017-04-25	Katarzyna Włodarczyk	62.1	68.9	Sell	12M
Mercator Medical	2017-04-27	Aleksandra Jakubowska	25.1	18.0	Not rated	12M
KGHM	2017-05-11	Marcin Stebakow	121	116	Neutral	12M
JSW	2017-05-11	Marcin Stebakow	112	78	Buy	12M
11 Bit Studios	2017-05-12	Jakub Rafat	255.8	177.2	Buy	12M
Warimpex	2017-05-29	Marek Szymański	5.66	5.11	Not rated	12M
Kruk	2017-06-02	Michał Fidelus	316.0	300.9	Neutral	12M
Vigo System	2017-06-12	Beata Szparaga-Waśniewska	468	372	Not rated	12M
Ciech	2017-06-13	Katarzyna Włodarczyk	72.3	65.4	Neutral	12M
Wawel	2017-06-14	Marcin Stebakow	1368.0	1175	Buy	12M
Colian	2017-06-30	Marcin Stebakow	3.48	3.50	Not rated	12M
Marvipol	2017-07-13	Marek Szymański	18.0	12.7	Not rated	12M
PKO BP	2017-07-24	Michał Fidelus	34.0	35.8	Reduce	12M
Pekao	2017-07-24	Michał Fidelus	140.0	128.0	Accumulate	12M
BZ WBK	2017-07-24	Michał Fidelus	349.0	362.5	Reduce	12M
mBank	2017-07-24	Michał Fidelus	380.0	460.0	Sell	12M
ING BSK	2017-07-24	Michał Fidelus	191.0	189.0	Neutral	12M
Handlowy	2017-07-24	Michał Fidelus	71.0	68.1	Neutral	12M
Millennium	2017-07-24	Michał Fidelus	7.1	7.5	Reduce	12M
Alior	2017-07-24	Michał Fidelus	68.0	60.5	Accumulate	12M
Getin Noble Bank	2017-07-24	Michał Fidelus	1.58	1.45	Neutral	12M
Grupa Azoty	2017-07-28	Katarzyna Włodarczyk	75.0	67.6	Accumulate	12M
JSW	2017-08-09	Marcin Stebakow	102.0	90.5	Buy	12M
Ciech	2017-08-10	Katarzyna Włodarczyk	68.0	62.5	Neutral	12M
Lotos	2017-08-21	Beata Szparaga-Waśniewska	56.0	51.0	Neutral	12M
Getback	2017-08-25	Michał Fidelus	26.6	21.8	Accumulate	12M
KGHM	2017-08-28	Marcin Stebakow	153.0	126.0	Buy	12M
Wawel	2017-08-30	Marcin Stebakow	1153	990	Buy	12M
Mercator Medical	2017-09-07	Aleksandra Jakubowska	23.1	18.0	Not rated	12M
Kruk	2017-09-14	Michał Fidelus	340.0	311.0	Accumulate	12M
Bogdanka	2017-09-21	Marcin Stebakow	95.0	78.0	Buy	12M
JSW	2017-09-28	Marcin Stebakow	107	93	Buy	12M
MZN Property	2017-10-04	Aleksandra Jakubowska	2.0	1.45	Not rated	12M
Warimpex	2017-10-11	Marek Szymański	7.3	6.73	Not rated	12M
ATC Cargo	2017-10-13	Marcin Stebakow	3.0	2.0	Not rated	12M
LPP	2017-10-19	Marek Szymański	6962.0	7960.0	Sell	12M
CCC	2017-10-19	Marek Szymański	322.0	265.3	Buy	12M
PKO BP	2017-10-24	Michał Fidelus	35.0	36.7	Reduce	12M
Pekao	2017-10-24	Michał Fidelus	139	125.2	Accumulate	12M
BZ WBK	2017-10-24	Michał Fidelus	370	356	Neutral	12M
mBank	2017-10-24	Michał Fidelus	393	452.5	Reduce	12M
ING BSK	2017-10-24	Michał Fidelus	193	191.2	Neutral	12M
Handlowy	2017-10-24	Michał Fidelus	75.0	70.0	Neutral	12M
Millennium	2017-10-24	Michał Fidelus	7.7	7.55	Neutral	12M
Alior Bank	2017-10-24	Michał Fidelus	80.0	70.2	Buy	12M
Getin Noble	2017-10-24	Michał Fidelus	1.40	1.53	Reduce	12M
Marvipol	2017-10-24	Marek Szymański	19.0	13	Not rated	12M
KGHM	2017-11-23	Marcin Stebakow	134	114.25	Buy	12M
JSW	2017-11-29	Marcin Stebakow	86.8	90.2	Reduce	12M
Vigo System	2017-12-05	Beata Szparaga-Waśniewska	455	305	Not rated	12M
LW Bogdanka	2017-12-07	Marcin Stebakow	75	95	Accumulate	12M
Śnieżka	2017-12-08	Aleksandra Jakubowska	63	69	Not rated	12M
Dom Development	2017-12-14	Marek Szymański	90	83.4	Accumulate	12M
Atal	2017-12-14	Marek Szymański	43	41.0	Neutral	12M
LC Corp	2017-12-14	Marek Szymański	3.3	2.7	Buy	12M
Robyg	2017-12-14	Marek Szymański	4.1	3.5	Accumulate	12M
Lokum Deweloper	2017-12-14	Marek Szymański	23	16.55	Buy	12M
Archicom	2017-12-14	Marek Szymański	23	15.39	Not rated	12M