

- We maintain our Buy rating for Pekao with TP slightly down to PLN 148 from PLN 152
- We make minor changes to our 2018/19E adjusted net profit estimates (0%, -2%, respectively)

## Potential still unrealized. Buy maintained.

On the back of 1Q18 results and the Management guidance we leave our 2018/19E earnings estimates for Pekao broadly unchanged. We trim our 12M TP to PLN 148 from PLN 152 previously and maintain our Buy rating. In our view, Pekao remains one of the most attractive banking stocks in our coverage. It offers decent EPS growth (15% YoY in 2018/19E), healthy and sustainable dividend (6.7/7.0% DY from 2017/18E earnings), ROE growth potential (to 11.2% in 2019E from 9.7% in 2018E) and is well positioned to expected acceleration in private investments. With marginal FX mortgage book it is also much less than peers exposed to regulatory risk. Thus, current valuation of Pekao at 14.0x P/E and 1.4x P/BV, broadly in line with peers, we see as attractive.

**1Q18 results in line with consensus...** 1Q18 net profit came in at PLN 392m (12% YoY, -63% QoQ) and was in line with consensus. Better than expected NII, financial and other income and provisions were offset by lower F&C and higher costs...

**...but outlook for 2018 remains positive.** In the following quarters the Management further NIM expansion and improvement in fees. Relatively low cost of risk is said to be recurrent and costs – although higher in 2-3Q18 due to expected additional staff costs – should put no further pressure on the bank's earnings in the long term.

**2018/19E estimates broadly unchanged.** 1Q18 results and the Management guidance prompted us to leave our 2018/19E earnings estimates broadly unchanged (0/-2%). We expect 15% YoY net profit growth in 2018E followed by 15% YoY increase also in 2019E. Our 2018/19E earnings estimates are 3/4% below consensus forecasts.

**Attractive valuation, with material discount to historical average.** At our estimates Pekao is trading at 14.0x 2018E P/E and 1.37x P/BV, with 6% discount and broadly in line with peers. In our view though, Pekao deserves a trading premium due to the following reasons: 1) decent EPS growth, 2) above average profitability (we assume 2018/19E ROE at 9.7/11.2% vs. 9.7/10.5% sector average), 3) healthy and sustainable dividend (we assume 6.7/7.0% DY from 2017/18E earnings), 4) relatively low regulatory risk (marginal FX mortgages exposure). The valuation appears attractive also comparing to historical levels (10/18% discount to 1Y/3Y average at 1YF P/E and 7/13% discount at P/BV).

**Acquisition of Alior a threat or a chance?** While uncertainty relating to potential acquisition of Alior puts pressure on the share price performance, we believe that Pekao – through scale effect, digitalization and changed risk profile - could eventually benefit from the merger in the long term.

Figure 1. Pekao – Key data, 2015-2020E

	2015	2016	2017	2018E	2019E	2020E
Net profit (PLNm)	2 292	2 279	2 475	2 230	2 572	2 912
YoY change (%)	-16%	-1%	9%	-10%	15%	13%
Adjusted net profit (PLNm)	2 411	1 959	1 944	2 230	2 572	2 912
YoY change (%)	-11%	-19%	-1%	15%	15%	13%
ROE (%)	9.7%	9.8%	10.7%	9.7%	11.2%	12.5%
P/E (x)	12.9	15.9	16.0	14.0	12.1	10.7
P/BV (x)	1.33	1.36	1.34	1.37	1.35	1.32
DPS (PLN)	8.7	8.7	7.9	8.3	9.6	10.9
DY* (%)	7.3%	7.3%	6.7%	7.0%	8.1%	9.2%

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

### Company data

Rating	Buy
Target Price (PLN)	148.0
Market Price (PLN)	118.7
Upside/downside	25%
Previous rating	Buy
Previous Target Price (PLN)	152.0
Min (52W)	112.9
Max (52W)	141.4
Market cap (PLNm)	31,155

### Shareholders

	%
PZU	20.0%
PFR	12.8%
UniCredit	6.3%
Other	60.9%

### Company description

**Pekao** is the second largest bank in Poland with over 10% market share in assets and 851 branches. The bank has a strong exposure to corporate loans (52% of the loan book) and PLN mortgage loans (35%). Consumer loans constitute 10% of the bank's loan book and exposure to FX mortgages is marginal (3%).

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



Source: Bloomberg, Vestor DM

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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;
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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.

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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36/2017	Warimpex	2017-05-29	Marek Szymański	5.66	5.11	Not rated	12M
37/2017	Kruk	2017-06-02	Michał Fidelus	316.0	300.9	Neutral	12M
38/2017	Vigo System	2017-06-12	Beata Szparaga-Waśniewska	468	372	Not rated	12M
39/2017	Ciech	2017-06-13	Katarzyna Włodarczyk	72.3	65.4	Neutral	12M
40/2017	Wawel	2017-06-14	Marcin Stebakow	1368.0	1175	Buy	12M
41/2017	Colian	2017-06-30	Marcin Stebakow	3.48	3.50	Not rated	12M
42/2017	Marvipol	2017-07-13	Marek Szymański	18.0	12.7	Not rated	12M
43/2017	PKO BP	2017-07-24	Michał Fidelus	34.0	35.8	Reduce	12M
44/2017	Pekao	2017-07-24	Michał Fidelus	140.0	128.0	Accumulate	12M
45/2017	BZ WBK	2017-07-24	Michał Fidelus	349.0	362.5	Reduce	12M
46/2017	mBank	2017-07-24	Michał Fidelus	380.0	460.0	Sell	12M
47/2017	ING BSK	2017-07-24	Michał Fidelus	191.0	189.0	Neutral	12M
48/2017	Handlowy	2017-07-24	Michał Fidelus	71.0	68.1	Neutral	12M
49/2017	Millennium	2017-07-24	Michał Fidelus	7.1	7.5	Reduce	12M
50/2017	Alior	2017-07-24	Michał Fidelus	68.0	60.5	Accumulate	12M
51/2017	Getin Noble Bank	2017-07-24	Michał Fidelus	1.58	1.45	Neutral	12M
52/2017	Grupa Azoty	2017-07-28	Katarzyna Włodarczyk	75.0	67.6	Accumulate	12M
53/2017	JSW	2017-08-09	Marcin Stebakow	102.0	90.5	Buy	12M
54/2017	Ciech	2017-08-10	Katarzyna Włodarczyk	68.0	62.5	Neutral	12M
55/2017	Lotos	2017-08-21	Beata Szparaga-Waśniewska	56.0	51.0	Neutral	12M
56/2017	Getback	2017-08-25	Michał Fidelus	26.6	21.8	Accumulate	12M
57/2017	KGHM	2017-08-28	Marcin Stebakow	153.0	126.0	Buy	12M
58/2017	Wawel	2017-08-30	Marcin Stebakow	1153	990	Buy	12M
59/2017	Mercator Medical	2017-09-07	Aleksandra Jakubowska	23.1	18.0	Not rated	12M
60/2017	Kruk	2017-09-14	Michał Fidelus	340.0	311.0	Accumulate	12M
61/2017	Bogdanka	2017-09-21	Marcin Stebakow	95.0	78.0	Buy	12M
62/2017	JSW	2017-09-28	Marcin Stebakow	107	93	Buy	12M
63/2017	MZN Property	2017-10-04	Aleksandra Jakubowska	2.0	1.45	Not rated	12M
64/2017	Warimpex	2017-10-11	Marek Szymański	7.3	6.73	Not rated	12M
65/2017	ATC Cargo	2017-10-13	Marcin Stebakow	3.0	2.0	Not rated	12M
66/2017	LPP	2017-10-19	Marek Szymański	6962.0	7960.0	Sell	12M
67/2017	CCC	2017-10-19	Marek Szymański	322.0	265.3	Buy	12M
68/2017	PKO BP	2017-10-24	Michał Fidelus	35.0	36.7	Reduce	12M
69/2017	Pekao	2017-10-24	Michał Fidelus	139	125.2	Accumulate	12M
70/2017	BZ WBK	2017-10-24	Michał Fidelus	370	356	Neutral	12M
71/2017	mBank	2017-10-24	Michał Fidelus	393	452.5	Reduce	12M
72/2017	ING BSK	2017-10-24	Michał Fidelus	193	191.2	Neutral	12M
73/2017	Handlowy	2017-10-24	Michał Fidelus	75.0	70.0	Neutral	12M
74/2017	Millennium	2017-10-24	Michał Fidelus	7.7	7.55	Neutral	12M
75/2017	Alior Bank	2017-10-24	Michał Fidelus	80.0	70.2	Buy	12M
76/2017	Getin Noble	2017-10-24	Michał Fidelus	1.40	1.53	Reduce	12M
77/2017	Marvipol	2017-10-24	Marek Szymański	19.0	13	Not rated	12M
78/2017	KGHM	2017-11-23	Marcin Stebakow	134	114.25	Buy	12M
79/2017	JSW	2017-11-29	Marcin Stebakow	86.8	90.2	Reduce	12M
80/2017	Vigo System	2017-12-05	Beata Szparaga-Waśniewska	455	305	Not rated	12M
81/2017	LW Bogdanka	2017-12-07	Marcin Stebakow	75	95	Accumulate	12M
82/2017	Śnieżka	2017-12-08	Aleksandra Jakubowska	63	69	Not rated	12M
83/2017	Dom Development	2017-12-14	Marek Szymański	90	83.4	Accumulate	12M
84/2017	Atal	2017-12-14	Marek Szymański	43	41.0	Neutral	12M
85/2017	LC Corp	2017-12-14	Marek Szymański	3.3	2.7	Buy	12M
86/2017	Robyg	2017-12-14	Marek Szymański	4.1	3.5	Accumulate	12M
87/2017	Lokum Deweloper	2017-12-14	Marek Szymański	23	16.55	Buy	12M
88/2017	Archicom	2017-12-14	Marek Szymański	23	15.39	Not rated	12M
1/2018	PKO BP	2018-01-08	Michał Fidelus	45	44.3	Neutral	12M
2/2018	Pekao	2018-01-08	Michał Fidelus	152	134.3	Buy	12M
3/2018	BZ WBK	2018-01-08	Michał Fidelus	442	408.4	Accumulate	12M
4/2018	mBank	2018-01-08	Michał Fidelus	443	496	Sell	12M
5/2018	ING BSK	2018-01-08	Michał Fidelus	222	215	Neutral	12M
6/2018	Handlowy	2018-01-08	Michał Fidelus	86	83	Neutral	12M
7/2018	Millennium	2018-01-08	Michał Fidelus	8.9	9.4	Reduce	12M
8/2018	Alior	2018-01-08	Michał Fidelus	87	78	Accumulate	12M
9/2018	Getin Noble Bank	2018-01-08	Michał Fidelus	1.55	1.71	Reduce	12M
10/2018	PKN	2018-01-09	Beata Szparaga-Waśniewska	117	106.7	Neutral	12M
11/2018	Lotos	2018-01-09	Beata Szparaga-Waśniewska	54	57.4	Reduce	12M
12/2018	PKP Cargo	2018-02-14	Marcin Stebakow	68	58.8	Buy	12M
13/2018	BZ WBK	2018-02-21	Michał Fidelus	436	385.8	Buy	12M
14/2018	Wielton	2018-02-23	Marcin Górnik	15.3	12.36	Buy	12M
15/2018	Selvita	2018-03-20	Beata Szparaga-Waśniewska	85	59	Not rated	12M
16/2018	JSW	2018-03-22	Marcin Stebakow	99	95.3	Neutral	12M
17/2018	Marvipol Development	2018-03-26	Marek Szymański	8.9	8.7	Not rated	12M
18/2018	Kruk	2018-03-28	Michał Fidelus	286	208	Buy	12M
19/2018	British Automotive Holding	2018-03-28	Marek Szymański	10.5	8.3	Not rated	12M
20/2018	Aplisens	2018-04-04	Michał Wojciechowski	15.1	12.9	Buy	12M
21/2018	Wielton	2018-04-05	Marcin Górnik	16.0	13.7	Buy	12M
22/2018	KGHM	2018-04-16	Marcin Stebakow	110.0	92.0	Buy	12M
23/2018	LPP	2018-04-18	Marek Szymański	9000	8965	Neutral	12M
24/2018	CCC	2018-04-18	Marek Szymański	310	272	Buy	12M
25/2017	mBank	2018-04-19	Michał Fidelus	441	439	Neutralnie	12M
26/2017	AC	2018-04-23	Marcin Górnik	38.5	40.8	Redukuj	12M
27/2017	MZN Property	2018-05-08	Aleksandra Jakubowska	2.2	1.9	Brak	12M