Banks | Poland

Handlowy

Buy (from Neutral)

TP: PLN 63

Recommendation upgrade

- **We upgrade our rating for Handlowy to a Buy from Neutral with TP down to PLN 63 from PLN 74.5**
- **We cut our EPS estimates by 17% in 2019E and by 8% in 2020E**

Vestor DOM MAKLERSKI

equity research

5 September 2019 07:40

Attractive risk-reward profile. Upgrade to a Buy.

We cut our 12M TP for Handlowy to PLN 63 from PLN 74.5 previously, but due to share price drop we upgrade our rating to a Buy from Neutral. In 1H19 Handlowy's earnings disappointed, negatively affected by increased BFG contribution (1Q19) and rising corporate provisions (2Q19). We cut our 2019/20E EPS estimates deeply (by 17/8%), but we believe that Handlowy appears as an attractive investment opportunity due to the following reasons: 1) With expected DY 6.3% it remains the best- or one of the two best yielding banks in Poland, 2) Even though we assume adjusted cost of risk to grow, we expect a decent EPS rebound in 2020E (24% YoY), 3) Result on financial operations of the bank has become much more recurrent, 4) The bank is attractively valued (with 20/31% discount to 1/3Y average at 1YF P/BV), 5) Handlowy is free of CHF related risk.

Deep cuts to 2019/20E earnings estimates. Higher than previously expected BFG contribution (paid in 1Q19) coupled with weak 1H19 numbers (marked by additional corporate provisions) prompted us to cut our 2019/20E earnings estimates by 17/8%. Now, after 15% YoY adjusted net profit drop in 2019E, we expect 24% YoY rebound in 2020E. Our earnings forecasts are 4% below and 2% above consensus, respectively.

Concerns over provisioning reflected in forecasts. In 2Q19 corporate provisions in Handlowy jumped to PLN 77m from PLN 5m in 1Q19. The deterioration was driven not only by Kania (PLN 53m), but also by additional provisions related to other corporate clients. We agree that provisioning has become an issue for Handlowy. We note however, that this is already reflected in our forecasts – after 30bp cost of risk in 2018 and 83bp in 2019E, we assume 52bp in 2020E and 56bp in 2021E.

The best-yielding bank in Poland. We expect Handlowy to continue its dividend policy and assume 75% payout ratio over the next two years (in line with the bank's strategy). With expected DPS PLN 3.2 and dividend yield 6.3%, Handlowy remains the best- or one of the two best yielding banks in Poland.

Valuation far below historical average. Handlowy is currently trading with 15/26% discount to 1/3Y average at 1YF P/E and with 20/31% discount at 1YF P/BV. While the bank has failed in terms of EPS delivery this year, still strong capital position and very solid dividend outlook make the current valuation attractive, we believe.

Result on financial operations much more recurrent. Over the last 3 years result on financial operations in Handlowy has become much more recurrent part of the business adding on average c. PLN 90-100m quarterly to the company's revenues. Given much better predictability we would no longer agree that the bank deserves a trading discount due to volatility of its key business lines.

Figure 1. Handlowy – Key data, 2016-2021E

	2016	2017	2018	2019E	2020E	2021E
Net profit (PLNm)	602	536	639	555	678	720
YoY change (%)	*-4%*	*-11%*	*19%*	*-13%*	*22%*	*6%*
Adjusted net profit (PLNm)	544	536	639	545	678	720
YoY change (%)	*-20%*	*-1%*	*19%*	*-15%*	*24%*	*6%*
ROE adjusted (%)	8.0%	7.8%	9.1%	7.7%	9.3%	9.6%
P/E adjusted (x)	12.2	12.4	10.4	12.2	9.8	9.2
P/BV (x)	0.98	0.96	0.94	0.93	0.90	0.87
DY (%)*	8.9%	8.1%	7.3%	6.3%	7.6%	8.1%

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

Company data

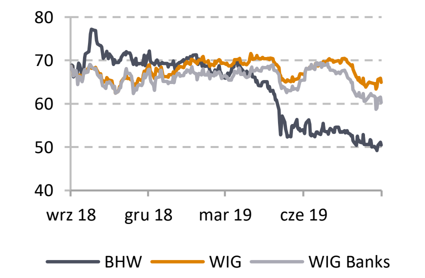
Rating	Buy
Target Price (PLN)	63.0
Market Price (PLN)	50.9
Upside/downside	24%
Previous rating	Neutral
Previous Target Price (PLN)	74.5
Min (52W)	47.6
Max (52W)	72.3
Market cap (PLNm)	6,651

Shareholders	%
Citibank Overseas	75.0%
Other	25.0%

Company description

Handlowy is a universal bank in Poland with 2.6% market share in assets, c. 2% in loans and 2.5% in deposits. Corporate loans stand for over 60% of the bank's loan book and retail loans are dominated by consumer lending (c. 30% of the loan book, incl. 15% in credit cards). PLN denominated mortgage loans stand for 8% of the bank's book. At the end of 2Q19 Handlowy had 22 branches.

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



Source: Bloomberg, Vestor DM

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THE LAST RECOMMENDATION ISSUED TO THE COMPANY HANDLOWY WAS PUBLISHED ON THE 10th OF JANUARY 2018 AND INCLUDED A NEUTRAL RECOMMENDATION.

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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;

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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.

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 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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