Banks | Poland

Pekao

Neutral (from Reduce)

TP: PLN 156

Recommendation upgrade

- **We lift our TP to PLN 156 from PLN 147 and upgrade our rating to Neutral from Reduce**
- **We lift our adjusted net profit estimates by 5% in 2016E and by 2% in 2017E.**

Vestor DOM MAKLERSKI

equity research

14 June 2016

Staying on the safe side. Upgrade to Neutral.

We lift our 12M TP of Pekao to PLN 156 from PLN 147 previously and upgrade our rating to Neutral from Reduce. We believe that as long as the FX conversion issue remains unsolved non-CHF banks, including Pekao, should outperform. At our estimates the bank is trading at 1.6x P/BV, with 68% premium to peers, but with 4% and 14% discount to 1Y and 3Y average, respectively. Pekao offers sustainable dividend yield (5.6%) and a capital buffer (Tier I at 18.4%) necessary in case of tightened regulatory requirements. While banking tax puts pressure on volumes, 1Q16 proved that deceleration in lending is partly offset by NIM growth.

As long as the FX conversion issue remains unsolved, non-CHF banks, incl. Pekao should outperform... Pekao, with c. PLN 4.5bn of FX mortgages (4% of total loans or 10% of mortgage book), has hardly any exposure to the regulatory CHF risk. We believe that as long as the FX conversion issue remains unsolved non-CHF banks, including Pekao should outperform.

…even despite material trading premium to peers. At our estimates Pekao is trading at 1.6x P/BV, with 68% premium to peers, but with 4% and 14% discount to 1Y and 3Y average, respectively. While multiples look high, we believe that a non-FX, strongly capitalized, dividend bank like Pekao deserves a premium to peers given ongoing regulatory uncertainty and increased political risk.

Slowdown in lending volumes partly offset by rising NIM. In 1Q16 Pekao's loan book declined -1% YoY (-4% QoQ) vs. 6% YoY growth in 2015 and 11% YoY in 2014. However, NIM increased to 2.68% from 2.58% in 4Q15 and NII came in 2% above consensus. While the banking tax puts pressure on volumes, reduction of low-margin exposures positively affects NIM. In 2016E we expect total loans to grow 3% YoY and NIM to increase to 2.64% from 2.57% in 2015.

We lift our 2016E and 2017E net profit estimates by 5% and 2%, respectively. On the back of 1Q16 results and management guidance we lift our adjusted net profit estimates by 5% in 2016E and by 2% in 2017E. We now expect 2016E adjusted earnings at PLN 1,940m (-23% YoY) and reported at PLN 2,202m (-4% YoY), broadly in line with the CEO guidance of a single digit YoY drop. Our 2016E and 2017E adjusted figures are 6% below and in line with consensus, respectively.

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

	2013	2014	2015	2016E	2017E	2018E
Net profit (PLNm)	2 785	2 715	2 292	2 202	2 282	2 574
YoY change (%)	*-5%*	*-3%*	*-16%*	*-4%*	*4%*	*13%*
Adjusted net profit (PLNm)	2 785	2 715	2 504	1 940	2 282	2 574
YoY change (%)	*-5%*	*-3%*	*-8%*	*-23%*	*18%*	*13%*
ROE (%)	12.0%	11.4%	9.7%	8.3%	9.7%	10.9%
P/E (x)	13.8	14.2	16.8	19.8	16.8	14.9
P/BV (x)	1.6	1.6	1.6	1.6	1.6	1.6
DPS (PLN)	10.0	10.0	8.7	8.2	8.5	9.6
DY* (%)	6.8%	6.8%	5.9%	5.6%	5.8%	6.6%

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

Company data

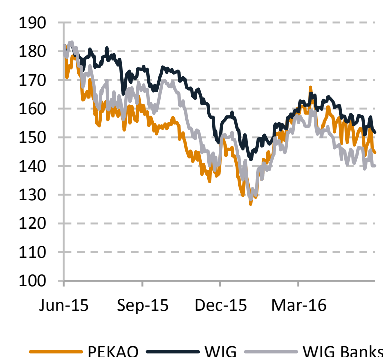
Rating	Neutral
Target Price (PLN)	156.0
Market Price (PLN)	146.5
Upside/downside	6.5%
Previous rating	Reduce
Previous Target Price (PLN)	147.0
Min (52W)	123.6
Max (52W)	180.7
Market cap (PLNm)	38,452
Avg. 3M Turnover (PLNm)	49.1

Shareholders	%
UniCredit	50.1%
Other	49.9%

Company description

Pekao is the second largest bank in Poland with 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 31%, 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

Michał Fidelus
(+48) 22 378 9212
Michal.Fidelus@vestor.pl

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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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