Banks | Poland

Polish Banks

Sector update

- **We downgrade Alior Bank (to Neutral), Handlowy (to Sell) and Millennium (to Reduce), upgrade mBank (to Reduce) and ING BSK (to Accumulate) and maintain our ratings for PKO BP (Neutral), BZ WBK (Neutral), Pekao (Reduce) and Getin Noble Bank (Neutral).**
- **We expect adjusted net profit of 9 banks in our coverage to drop 19% YoY in 2016E followed by 15% YoY growth in 2017E**

Vestor DOM MAKLERSKI

equity research

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Disappointing 1Q16 ahead

Since the low in January, Polish banks have already gained 20%, partly erasing the loss in 2015. However, the earnings outlook remains poor: in 2016E we expect 19% YoY drop of adjusted net profit compared to 12% YoY consensus drop. While we expect 15% YoY earnings recovery in 2017E, this assumption may yet prove too optimistic. 1Q16 results will be disappointing and should trigger consensus downgrades, we believe. The unresolved CHF issue is a risk to our forecast as we assume only PLN 2bn cost for the sector. In this tough environment valuation at 16.0x P/E and 1.3x P/BV (average ROE of 7.9%) appears demanding, in our view. We downgrade Alior Bank (to Neutral from a Buy), Handlowy (to Sell from Reduce) and Millennium (to Reduce from Neutral), upgrade mBank (to Reduce from Sell) and ING BSK (to Accumulate from Neutral) and maintain our ratings for PKO BP (Neutral), BZ WBK (Neutral), Pekao (Reduce) and Getin Noble Bank (Neutral).

Poor 2016E earnings outlook. Due to the banking tax we expect reported net profit of 9 banks in our coverage to decline in 2016E by 5% YoY. On an adjusted basis (excluding one-off items both in 2015 and 2016E, but including the banking tax) we assume aggregate net profit to decrease 19% YoY with Alior being the only bank to report earnings growth (+7% YoY). 4Q15 coupled with expected 1Q16 results prompted us to cut our 2016E net profit estimates for Pekao (-8%), BZ WBK (-3%), Handlowy (-10%), Millennium (-7%) and Alior (-13%) and lift for PKO BP (5%), ING BSK (5%) and Getin Noble Bank (10%). With our forecasts we are 3-12% below consensus.

Disappointing 1Q results ahead. 1Q16 was the first quarter for banks with the new banking tax. Due to the new levy we expect aggregate net profit of 9 banks in our coverage to drop 18% YoY. However, even if we exclude the banking tax and material one-off items, we forecast barely 1% YoY earnings growth. We expect relatively strong numbers in mBank (+23% YoY on adjusted basis) with strong core revenues and declining provisions (-33% YoY), in PKO BP (+16% YoY) supported by rebounding NIM and in ING BSK (+11% YoY) with strong lending volumes growth.

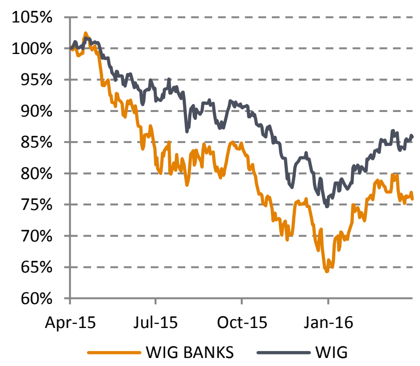
ING BSK (Accumulate, TP PLN 135) is our top pick. Until the sentiment improves and political risk declines, out of the 9 banks in our coverage we prefer ING BSK (Accumulate, TP PLN 135), with a dynamic growth profile, stable dividend and marginal CHF exposure.

Figure 1. Polish Banks – Vestor DM ratings and valuations

Bank	Rating	12M TP	Current price	Upside/ downside	Previous rating	Previous 12M TP
PKO BP	Neutral ▬	28.0	26.3	7%	Neutral	27.0
Pekao	Reduce ▬	147.0	160.6	-8%	Reduce	148.0
BZ WBK	Neutral ▬	304.0	288.0	6%	Neutral	269.0
mBank	Reduce ⬆	316.0	331.7	-5%	Sell	317.0
ING BSK	Accumulate ⬆	135.0	121.8	11%	Neutral	123.0
Handlowy	Sell ⬇	73.0	82.1	-11%	Reduce	75.0
Millennium	Reduce ⬇	5.3	5.49	-3%	Neutral	5.6
Alior Bank	Neutral ⬇	74.0	69.8	6%	Buy	71.0
Getin Noble Bank	Neutral ▬	0.58	0.54	6%	Neutral	0.60

Source: Vestor DM

WIG Banks vs. WIG – relative price performance 12M



Source: Bloomberg, Vestor DM

Bank	Rating	12M TP (PLN)
PKO BP	Neutral	28.0
Pekao	Reduce	147
BZ WBK	Neutral	304
mBank	Reduce	316
ING BSK	Accumulate	135
Handlowy	Sell	73
Millennium	Reduce	5.3
Alior Bank	Neutral	74
Getin Noble	Neutral	0.58

Source: Vestor DM

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Vestor emphasizes that this document is going to be updated at least once a year.

The date on the first page of this report is the date of preparation and publication of the document.

Over the last three months, excluding recommendation contained in this report, Vestor issued 1 Buy recommendation, 0 Accumulate recommendation, 2 Neutral recommendations, 5 Reduce recommendations and 2 Sell recommendations. The proportion of issuers number corresponding to each of the above directions of recommendation, for which Vestor has rendered investment banking services within last 12 months is 74 %. Over the last three months, excluding recommendation contained in this report, Vestor issued 9 reports (recommendations) acting within the Equity Research Partner service for the Issuers without pointing the investment direction or target price.

PKO BP – Over the last twelve months, Vestor issued one accumulate recommendation dated 11th June 2015 with target price 36PLN, one neutral recommendation dated 28th October 2015 with target price 30PLN, another accumulate recommendation dated 11th December 2015 with target price 28.6PLN and another neutral recommendation dated 11th January 2016 with the target price 27PLN. Vestor may act as a market maker for the shares of PKO BP now and in the future.

BZ WBK – Over the last twelve months, Vestor issued one neutral recommendation dated 24th April 2015 with the target price 405PLN, another neutral recommendation dated 11th June 2015 with the target price 350PLN, one reduce recommendation dated 28th October 2015 with target price 302PLN, another neutral recommendation dated 11th December 2015 with the target price 288PLN and another neutral recommendation dated 11th January 2016 with the target price 269PLN.

mBank - Over the last twelve months, Vestor issued one buy recommendation dated 13th March 2015 with target price 507PLN, one neutral recommendation dated 24th April 2015 with the target price 495 PLN, another neutral recommendation dated 11th June 2015 with the target price 465PLN, one sell recommendation dated 28th October 2015 with target price 323PLN, one neutral recommendation dated 11th December 2015 with the target price 318PLN, another neutral recommendation dated 11th January 2016 with the target price 302PLN and one sell recommendation dated 17th March 2016 with the target price 317PLN.

Millennium - Over the last twelve months, Vestor issued one accumulate recommendation dated 24th April 2015 with the target price 8.2PLN, another neutral recommendation dated 11th June 2015 with the target price 7.1PLN, another neutral recommendation dated 28th October 2015 with target price 6.3PLN, one buy recommendation dated 11th December 2015 with the target price 5.8PLN and another neutral recommendation dated 11th January 2016 with the target price 5.6PLN.

Getin Noble - Over the last twelve months, Vestor issued one reduce recommendation dated 11th June 2015 with target price 1.40PLN, one sell recommendation dated 28th October 2015 with target price 0.74PLN, one neutral recommendation dated 11th December 2015 with the target price 0.60PLN and another neutral recommendation dated 11th January 2016 with the target price 0.6PLN.

Pekao - Over the last twelve months, Vestor issued one neutral recommendation dated 11th June 2015 with the target price 188PLN, one accumulate recommendation dated 28th October 2015 with the target price 170PLN, another accumulate recommendation dated 11th December 2015 with the target price 170PLN, another accumulate recommendation dated 11th January 2016 with the target price 148PLN and one reduce recommendation dated 6th April 2016 with the target price 148PLN. Vestor may act as a market maker for the shares of Pekao now and in the future.

ING BSK - Over the last twelve months, Vestor issued one buy recommendation dated 11th June 2015 with the target price 166PLN, one accumulate recommendation dated 28th October 2015 with the target price 138PLN, another accumulate recommendation dated 11th December 2015 with the target price 138PLN and one neutral recommendation dated 11th January 2016 with the target price 123PLN.

Bank Handlowy - Over the last twelve months, Vestor issued one accumulate recommendation dated 11th June 2015 with the target price 113PLN, another accumulate recommendation dated 28th October 2015 with the target price 91PLN and another accumulate recommendation dated 11th December 2015 with the target price 91PLN, another accumulate recommendation dated 11th January 2016 with the target price 74PLN and one reduce recommendation dated 9th February 2016 with the target price 75PLN.

Alior - Over the last twelve months, Vestor issued one neutral recommendation dated 11th June 2015 with target price 94PLN, another neutral recommendation dated 28th October 2015 with target price 85PLN, one accumulate recommendation dated 12th November 2015 with target price 83PLN, another accumulate recommendation dated 11th December 2015 with the target price 83PLN and one buy recommendation dated 11th January 2016 with the target price 71PLN.

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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.

Sell - indicates a stock's total return to be less than minus respective cost of equity over the next twelve months.