

Warsaw, September 18, 2019

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Haitong Bank in a report from September 17 (08:00) upgrades Alior Bank to BUY from Neutral (PLN 49.7 FV) and maintains its BUY on Bank Pekao (PLN 125.3 FV).

Valuation Methodology

- **Alior Bank**

Valuation – we use a Dividend Discount Model (DDM) with a 90% weighting and a Polish banks' peer multiples' analysis with a 10% weighting to value Alior. Our FV is based on the weighted average of these two methodologies.

Sensitivity – we provide two sensitivity analyses for our fair value estimate wherein we examine two sets of variables: (i) ROE and perpetuity growth rates; and (ii) equity risk premium and the risk-free rate.

CHF bill adjustment – we estimate a total PLN 12bn (+95% from previous scenario of PLN 6.16bn loss for the sector stemming from the CHF mortgage bill) cumulative loss for the banking sector stemming from the legal risk of the CHF portfolio. This takes into account a portfolio of CHF mortgages to individuals at PLN 103.5bn (June 2019) and a 20% participation rate worth a PLN 60bn loss for the sector. We are aware that given the large number of assumptions this calculation has a very high margin of error. Subsequently we apply a market share weighted portion of this loss per share to individual banks.

Main assumption changes – we apply a cost of equity of 9.5%. We assume a terminal ROE at 9.3% (vs 10.0% before). We use a risk-free rate of 3.5% (based on the 10Y Polish Government Bond Yield).

- **Bank Pekao**

Valuation: we use a Dividend Discount Model (DDM) with a 50% weighting and a Polish banks' peer multiples' analysis with a 50% weighting to value Bank Pekao. Our FV is based on the weighted average of these two methodologies.

Sensitivity: we provide two sensitivity analyses for our fair value estimates wherein we examine two sets of variables: (i) ROEs and perpetuity growth rates; and (ii) equity risk premium and the risk-free rate.

CHF risk adjustment: we estimate a total PLN 12bn (+95% from previous scenario of PLN 6.16bn loss for the sector stemming from the CHF mortgage bill) cumulative loss for the banking sector stemming from the legal risk of the CHF portfolio. This takes into account a portfolio of CHF mortgages to individuals at PLN 103.5bn (June 2019) and a 20% participation rate worth a PLN 60bn loss for the sector. We are aware that given the large number of assumptions this calculation has a very high margin of error. Subsequently we apply a market share weighted portion of this loss per share to individual banks.

Main assumption changes: we apply a cost of equity of 8.5% (unchanged). We assume a terminal ROE for PEO at 12.0% (vs 12.1% before). We use a risk-free rate of 3.5% (based on the 10Y Polish Government Bond Yield).

Risks to Fair Value

- **Alior Bank**

Macro related: risk of different macroeconomic scenario including: i) interest rates; ii) assets quality/cost of risk; iii) volume growth in Poland.

Dividend: faster than expected return to dividend payment.

Volume growth: significantly below/above our expectations.

Strategic targets related: we assume ALR does not deliver on its 2020 strategic target ROE.

Acquisition related:

- Although the talks with PEO concerning a potential merger had been cancelled, the press continues to speculate that ALR may be involved in further acquisitions of troubled banks and financial institutions in Poland, including BOS Bank with a low ROE and low capital adequacy ratio (Puls Biznesu, November 8, 2018).

Regulatory risk – any new regulatory requirements concerning minimum adequacy ratios.

- Potential liquidity squeeze in the banking sector (commercial / cooperative segment) and financial institutions (SKOK segment) may lead to a larger contribution to the BFG fund.
- The most recent ruling of the Court of Justice of the EU that banks and other financial institutions should return a portion of all costs linked to a consumer loan to clients in the event of an early repayment. An assessment is hard to make as the key assumptions are not available, but based on some PLN0.7bn-PLN 1.4bn cost for the sector and some 7.5% ALR market share we estimate up to PLN 100m costs for Alior Bank. This may add to the pressure on fee income going forward.
- ALR has been granting cash loans with one of the largest values (up to 200k, for up to 12 years) and specialises in high ticket consolidation loans. Large ticket loans have lately been on the radar of the supervisory bodies.

Asset quality – relatively higher risk appetite reflected in its higher– than-average cost of risk and NPLs. High exposure to the SME segment may cause higher than anticipated provisions at the bottom of the cycle.

Ownership related: ALR is indirectly state-controlled (via PZU - 32.22% stake), thus we see a risk of non-market oriented decisions.

- Risk of ongoing changes to the management board (3rd CEO since acquisition)

Capital needs: any significant increase in appetite for loan growth could trigger a capital increase given its most modest margin in relation to the minimum requirements.

Valuation:

- Higher Risk Free Rate (lowers valuation)
- Change in market-wise sentiment towards dividend stocks.

- **Bank Peak**

Macro related: Risk of different macroeconomic scenario including: i) interest rates; ii) assets quality/cost of risk; iii) volume growth in Poland.

Dividends: Any further cuts to the PEO's dividend policy in the event of potential acquisition or changes to the regulations.

Volume growth significantly below/above our expectations

Strategic targets related: We assume PEO will not deliver on its 2020 strategic targets (ROE, C/I and net profit)

Lower assets quality: As it comes with faster growth of volumes, PEO might compromise on the risk taken. Moreover PEO targets higher yield consumer loans and SMEs, i.e. segments where the risk is naturally higher.

Acquisition related: PEO finished talks with ALR with no merger concluded. However PEO's capital buffer makes it potentially attractive to other companies seeking to do M&A. Therefore risks of overpaying for assets and/or not delivering upon potential synergy targets persist.

Regulatory risk – Any new regulatory requirements concerning minimum adequacy ratios/and/or dividends.

- Lately, the press has reported (source: Parkiet Daily 18/05/19) that the bank could potentially become involved in the resolution of Idea Bank's capital-shortage problems - TCR<3%.
- Higher/lower impact of the recent CJEU ruling demanding banks return a portion of all costs to a client paying back the loan prematurely. An assessment is hard to make as the key assumptions are not available, but based on some PLN0.7bn-PLN 1.4bn cost for the sector and some 5.1% market share we estimate up to PLN 70m costs for PEO (3% of 2019E NI). The impact may be lower given the low upfront fee and smaller loan tickets at PEO, or higher if the sector assessment proves to be too optimistic.

Ownership related: PEO is indirectly state controlled (via PZU and PFR controlling) and thus we see a risk of non-market oriented decisions.

Potential share overhang:

- Although denied by PFR (source: PAP Biznes 15/11/18), any lowering of the dividend payout could trigger a decision by PFR to withdraw from its investment (12.8% stake). According to a statement from PZU's CFO, the company is committed to Bank Pekao as a strategic investment and therefore it would pick up any potential stake supply from co-owner PFR.
- Unicredit's stake in PEO remains at 6.26% i.e. 16.46m shares. This is backed by Pekao Equity-Linked Certificates, which were sold to investors at the time of the transaction with PFR and PZU at 85.85% value. The expiry date is at or before 15/12/2019. According to our understanding those certificates are usually hedged by short sell transactions and thus the expiry date should not lead to a major supply of shares at the market around expiry date. Yet we see this as a risk and/or a potential factor weighing on the sentiment.

Valuation:



- Higher Risk Free Rate (lowers valuation)
- Change in the market-wise sentiment towards dividend stocks.

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