HAITONG

Warsaw, September 19, 2019

Marta Czajkowska-Bałdyga, Analyst, Haitong Bank

Haitong Bank in a report from September 18 (08:00) upgrades PZU to NEUTRAL from SELL (FV PLN 38.0).

Valuation Methodology

We value PZU using a DDM and an excess return on capital method. We also use peer multiple valuations, but only for comparison purposes.
Our final fair value is an average of a DDM and excess return on capital method (each with a 50% weighting). Using a DDM, we derive a fair value of PLN 29.7 while using the excess return on capital method we arrive at PLN 26.0. On top of that, we add PZU's share in our fair value for both Alior Bank (PLN 2.5) and Bank Pekao (PLN 7.6). Our fair value for PZU is estimated at PLN 38.0, implying 0% potential to the current share price.
Main assumptions: Our cost of equity estimate is 8.5% with an equity risk premium of 5%, beta of 1.0x and a risk free rate of 3.5% (based on the 10Y Polish Government Bond Yield). We assume a terminal ROE for PZU at 20.0%
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.

Risks to Fair Value

- Interest rates volatility – may not only have an impact on the financial results of both insurance and banking operations but also on equity under the Solvency II regime. An increase in interest rates would be difficult in the short term (depresses bond prices), but healthy in the longer term because it would restore yields and profitability.
- Change in dividend prospects due to i.e. M&A activity, payout of excess capital (not included in our forecast), etc;
- Non-life segment – potential margin pressure from renewed price competition and/or claims increase;
- Life segment – potential margin pressure from higher competition and adverse aging trends; upside potential coming from adoption of the EU law, i.e. General Data Protection Regulation (GDPR). This is a set of rules created to protect the privacy of EU citizens. According to a Polish Insurance Chamber representative (Puls Biznesu 17/01/2019) if it's adopted with no changes this may push up policy prices in the life segment due to the potential for the customer to withdraw the sensitive data from the system at any time;
- Banking segment – Lower/higher earnings of the PZU group banks' potential increase / decrease in market interest rates could lead to an improvement/deceleration in earnings; potential slowdown of GDP could lead to higher risk costs; potential higher / lower demand or/and competition could lead to higher / lower volume growth;
    - Risk of the banking assets impairment – PZU has bought Alior Bank (@average price of some PLN 65-69 per share vs the current price of PLN 41) and Bank Pekao (@ PLN 123 per share vs current price of PLN 107). Both banks are fully consolidated and thus any impairment recognition would go through equity until such a time the insurance company lost control over this asset. According to recent statements from CFO, Alior Bank passed an end 1H19 impairment test, hence showing no risk of a major write-down for the insurer.
- Investment income – PZU group is exposed to a change in valuation of various asset classes (debt instruments, equities, derivatives, FX rates, etc. A change in capital market performance could put the income under pressure / or boost it potentially;
- Further potential cost savings initiatives are not included in our forecasts;
- Regulatory risks - We do not incorporate material positive/negative regulations, among other PPE, regulations concerning claims for general damages for the pain caused by the vegetative state of a relative injured in an accident, regulations concerning maximum fees in the investment fund business (currently in the legislative process – includes a gradual introduction of a cap on up-front fees to max. 2% in 2022);

- Risk of higher insurance guarantee fund (UFG) contribution – The current regulation sets the annual contribution to the UFG as 1.3% of GWP from MTP liability of motor vehicle owners and farmers' liability. According to the PM chancellery legislative agenda for 3Q19, insurance companies may be burdened with contributions to the planned Support Fund run by UFG and dedicated to granting repayable support to troubled insurers. According to recent statements from UFG representatives (Puls Biznesu 17/09/2019), the contribution should be maintained at current levels due to lower compensation payments from the fund. Thus the risk of a higher contribution is not incorporated in our forecast.

- M&A risks – Both in insurance, banking as well as the asset management segment, PZU could potentially face the risk of mispricing and/or M&A implementation risk in a potential transaction;
- Risks embedded in the insurance business, i.e. catastrophic or extraordinary risks may have an adverse impact on earnings
- Risks related to state-ownership, i.e. changes to management board, politically influenced decisions. Last year (bankier.pl 15/11/2018) the CFO has stated that PZU considers Bank Pekao (20% owned) a strategic asset and would be interested in increasing its stake up to 33.8% if the state-controlled development fund - PFR (13.8% shareholder of Bank Pekao) - were interested in divesting (shares were bought at PLN 123 per share and currently the stake is worth some PLN 3.88bn. This would however require issuing Tier 2 capital in order to ensure the dividend payment and still have an above average Solvency II ratio.

IMPORTANT DISCLOSURES