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Haitong Bank in a report from August 13 (08:00) keeps PKO BP at BUY (FV PLN 26.2).

Valuation Methodology

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 PKO BP. 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 bill adjustment: We estimate a total PLN 30bn (almost 5x higher compared to the previous PLN 6bn) cumulative loss for the banking sector stemming from restructuring of the CHF portfolio. We take into account the Polish Bank Association's (ZBP's) expected PLN 60bn loss on the portfolio of CHF mortgages to individuals, based on the assumption that the loan will be switched to PLN at the historical exchange rate and repaid at the CHF LIBOR rates, and we assume 60% of clients will go to court and 80% will win their court case. 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 10.5% (down from 11%). We assume a terminal ROE for PKO at 8.4% (vs 10.7% before). We use a riskfree rate of 3.0% (down from 3.5%, based on the long-term 10Y Polish Government Bond Yield assumption).

Forecast revisions: We lowered our '20-21E NI by 15% and 23% to PLN 3.02bn (-25% YoY) and PLN 3.27bn (+8% YoY), respectively.

We have adjusted earnings for: 1) lowering interest rate assumptions; 2) rising assets following stronger-than-expected deposit growth; 3) minor adjustments in operating expenses plus positive effect of release of Swedish tax provision (some PLN 300m, booked in 4Q20 costs); 4) higher net provisioning in both the corporate and consumer segment due to macroeconomic assumptions caused by the COVID-19 outbreak; 5) increased CHF mortgage portfolio provisioning to 2.3% from 2% annually.

Our earnings expectations differ from consensus by +28%/+29% for '20-21E, respectively. This is, in our opinion, mainly due to the highly unpredictable effect of the COVID-19 pandemic especially in terms of volumes and risk costs as well as different interest rate assumptions in the mid-term.

Risks to Fair Value

Macro related: Risks of a different macroeconomic scenario, especially in light of the highly unpredictable outcome of the COVID-19 outbreak, both in terms of magnitude and length, including: i) interest rates; ii) asset quality/cost of risk; iii) volume growth in Poland.

Interest rate related: Material difference in size and timing of Central Bank interest rate changes versus our base assumption of flat interest rates at 0.1% through 2022 and increase to 0.5% in 2023.

Volume growth significantly below/above our expectations.

Funding costs: Competitive rise in deposit rates and/or relatively high share of wholesale funding whose pricing is vulnerable to global market sentiment and may provide downside risk.

FX rate: Relatively high exposure to FX risk of its CHF mortgage portfolio (PKO BP has a 22% market share in the CHF mortgage market with a loan book of PLN 22.4bn accounting for 9.7% of its loan book and 54% of equity).

CHF portfolio: Although the main risks the market sees are currently connected with the length and magnitude of the global crisis due to the COVID-19 pandemic, the CHF mortgage risk remains valid. Recent sharp PLN currency weakening is a disadvantage and may prompt more people to take court action against the banking sector including PKO BP. As of 2Q20, the portfolio of court cases amounted to PLN 776m (3.7% of the CHF mortgage portfolio). PKO has put aside provisions of PLN 776m, i.e. 3.1% of the portfolio and 85% of the court case portfolio. As of 4Q19, management has provided a sensitivity analysis of the legal provisioning on the mortgage portfolio, i.e. a 20% change in the number of cases would change the provisions by PLN 62m (i.e. 0.3% of the portfolio) and a change to the horizon by 1 year would add PLN115m (i.e.0.5% of the portfolio).

Dividend: Scenario of dividend pay-out might not materialize in the future or PFSA may soften/temper the dividend pay-out criteria.

Regulatory risk:

- CHF mortgages: The restructuring of foreign currency housing loans may materialize in a different way to our base scenario or/and add additional costs, i.e. spread bill.
- Any new regulatory requirements concerning minimum adequacy ratios and/or dividends.
- 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. This is especially valid in the light of the COVID-19 virus outbreak.

Volume growth significantly below/above our expectations.

Ownership related: PKO is state controlled (29.43%), thus we see a risk of non-market-oriented decisions.

- The press has previously reported (source: Parkiet Daily 18/05/19) that the bank could potentially become involved in the resolution of the Idea Bank capital-shortage problems TCR<1%.
- Risk of CEO departure: There has been press speculation about the potential departure of the CEO (Rzeczpospolita daily 09/11/2019). The new Ministry of State Assets is expected to carry out an audit of state-controlled companies and make personnel changes based on the outcome. The market regards Zbigniew Jagiello (more than 10 years as CEO) as a highly skilled manager, responsible for the transition of the old-fashioned state-owned bank into a digital universal bank with a competitive offer to all client segments. If it happens, we believe this could ultimately be a political decision with no justifiable grounds.

Valuation:

- Higher Risk Free Rate (lowers valuation).
- Change in market sentiment to 'risk on', with a preference for dividend stocks (downside).

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