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Haitong Bank in a report from March 15 (08:00) keeps Bank Pekao at BUY (FV PLN 83.7).

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 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 up to a PLN 40bn cumulative loss for the banking sector stemming from restructuring of the CHF portfolio. We take into account the latest proposal from KNF on self-regulations of the sector based on the assumption of reaching agreement with clients, that the loan will be switched to PLN at the historical exchange rate and repaid at the WIBOR rate with historic margin. 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 or specific bank guidance where available. KNF lately disclosed its estimates on the conversion costs at PLN 34.5bn, but this included only outstanding loans.

Main assumption changes: We apply a cost of equity of 9.0% (down from 9.5% previously, based on a change in the beta factor to 1.2 from 1.3). We extended the model by one year to 2024. We assume a terminal ROE for PEO at 8.3% (up from 7.7% previously). We use a risk-free rate of 3.0% (based on the longterm 10Y Polish Government Bond Yield assumption).

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 2023.

Volume growth significantly below/above our expectations.

Competition: Intensified competition for loans/deposits resulting in lower spreads on assets/liabilities.

Dividends: Any cuts to PEO's dividend policy.

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.

CHF loan exposure: The bank stopped granting FX loans in 2003 and acquired most of the denominated portfolio in 2007 from BPH. The total portfolio is some PLN2.9bn (1.9% of portfolio, 3% market share) now, largely CHF-denominated loans.

KNF has disclosed the preliminary estimates of costs that Polish banks would face from different scenarios of FX mortgage conversion. The scenarios are based on matters that the on March 25th the Supreme Court is sitting to rule on. KNF estimates that banks would face up to:

- PLN 34.5bn losses from FX mortgage conversion under the KNF's head proposal with interest based on the WIBOR rate (only outstanding portfolio),
- PLN 70.5bn losses from a deal annulment if the cost of capital is accounted for based on the WIBOR rate,
- PLN 78.5bn cost from conversion with interest based on the LIBOR rate,
- PLN 101.5bn losses from the deal annulment, if the capital is returned, but with no interest,
- PLN 234bn losses from annulment of contracts if no capital is returned under a court verdict,

Our base scenario remains PLN 40bn costs for the sector (combination of voluntary conversion and court cases), as we believe the 100% agreements under the KNF's head conversion proposal should be ruled out.

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

Idea Bank acquisition related: Although the portfolio related risks are covered by BFG guarantees, the acquisition will also involve PEO's HR to some extent, thus could be time & resource consuming.

Acquisition related: 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. This could possibly put pressure on the dividend, or cancel it entirely depending on the potential deal structure.

- PEO finished talks with ALR with no merger concluded in August'18. However, merger reports are back on the agenda (Parkiet daily, 26/05/2020). However, this has been denied by the 3 sides: PZU/PEO/ALR and the Idea acquisition could dampen further speculation in the midterm.

Regulatory risk:

- 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.

Valuation:

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

IMPORTANT DISCLOSURES