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Haitong Bank in a report from January 8 (08:00) keeps Bank Pekao at BUY (FV PLN 74.8).

### **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.

**Main assumption changes:** we apply a cost of equity of 9.5% (unchanged). We assume a terminal ROE for PEO at 7.7% (up from 7.6% previously). We use a risk-free rate of 3.0% (based on the long-term 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 further cuts to PEO's dividend policy.

**Strategic targets related:** We assume PEO will not deliver on its 2020 strategic targets (ROE at 11%-12%), partly due to changes in the environment (lower rates, COVID-19 outlook).

**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.

- CHF mortgage lawsuits dynamic increased, while coverage ratio still above average: PEO had 445 lawsuits (+154 cases, +53% QoQ in 3Q20) with a total b/s value of exposure at PLN 125bn (+59% QoQ), while it made provisions of PLN 105m (+41% QoQ, i.e. 4.3% of the outstanding portfolio). The coverage ratio remains above avg @83% (94% in 2Q20).

- Capital buffer sufficient to cover KNF scenario: KNF approached the sector in December with a proposal to solve mounting legal risks connected with CHF mortgage loans: a solution that would not favour clients with FX mortgage over PLN borrowers. KNF's working scenario includes agreements with clients to convert loans to a PLN mortgage loan at a WIBOR rate plus margin available at the time of drawing the loan. We estimate the sector to bear up to a PLN 40bn cost for this solution. This implies PEO's share would be PLN 1.2bn. At the same time we estimate Bank Pekao's Tier 1 capital surplus at some PLN 9.5bn excess the min. Tier 1 capital (@ 9.3% in '21E)

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 3 sides: PZU/PEO/ALR and the Idea acquisition could dampen further speculation in the midterm.
- According to Reuters agency (04/02/2020) PEO has filed an offer to acquire mBank from Commerzbank.

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**

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