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Haitong Bank in a report from December 6 (08:00) upgrades recommendations for companies from the banking sector:

- **Bank Handlowy** (BUY, FV up 12% to PLN 57.70)
- **Bank Pekao** (NEUTRAL from Buy, FV up 8% to PLN 104.50)
- **PKO BP** (SELL from Buy, down 13% to 30.50)

Valuation Methodology

- **Bank Handlowy**

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 Polish banks. 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 30bn (almost 5x higher compared to previous PLN 6bn) cumulative loss for the banking sector stemming from restructuring of the CHF portfolio. Taking 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 switch to PLN at the historical exchange rate and repaid at the CHF LIBOR rates, assuming 60% of clients will go to the court and 80% will win the 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 8.9% from 8.5%. We assume a terminal ROE for BHW of 9.8% (unchanged). We use a risk-free rate of 3.5% (based on the long-term 10Y Polish Government Bond Yield assumption).
Forecast revisions: Following a higher than expected corporate segment cost of risk, fuelled by one-off cases and worse-than-expected NII, we lower our 2019E-21E net profit by 11% to PLN 466m (-27% YoY), by 7% to PLN 606m (+30% YoY) and 8% to PLN 669m (+10% YoY), respectively.

- **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 30bn (almost 5x higher compared to previous PLN 6bn) cumulative loss for the banking sector stemming from restructuring of the CHF portfolio. Taking 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 switch to PLN at the historical exchange rate and repaid at the CHF LIBOR rates, assuming 60% of clients will go to the court and 80% will win the 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 10.0% up from 8.5% previously. We assume a terminal ROE for PEO at 11.0% (vs 12.0% before). We use a risk-free rate of 3.5% (based on the long-term 10Y Polish Government Bond Yield assumption).
Forecast revisions: We have adjusted our 2019-2021E earnings for: 1) betterthan-expected 3Q19 results; 2) expected result of September's CJEU ruling concerning the return of the early repayment of consumer loan fees (annual negative impact of some PLN 100m on NII, fading over time); 3) higher BFG fees (some PLN 70m annually); 4) introduction of the gradual portfolio provisioning of FX loans following the less favourable court rulings (PLN 38m, i.e. 1% of the portfolio in 4Q19E and PLN 76m, i.e. 2% of the portfolio in the following years). We revised 2019-21E NI by -2%/-9%/-6%. We forecast 2019E20E NI of PLN 2.19bn (-4% YoY), PLN 2.49bn (+14% YoY) and PLN 2.72bn (+9% YoY), respectively.

- **PKO BP**

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 previous PLN 6bn) cumulative loss for the banking sector stemming from restructuring of the CHF portfolio. Taking 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 switch to PLN at the historical exchange rate and repaid at the CHF LIBOR rates, assuming 60% of clients will go to the court and 80% will win the 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 11.0% (up from 8.5% previously), mainly on the back of a higher beta (higher risk for the bank). We assume a terminal ROE for PKO at 10.0% (vs 11.8% before). We use a risk-free rate of 3.5% (based on the long-term 10Y Polish Government Bond Yield assumption).

Forecast revisions: We have adjusted our 2019-2021E earnings for: 1) better-thanexpected 3Q19 results; 2) expected result of September's CJEU ruling concerning return of the early repayment of consumer loan fees (annual negative impact of some PLN 160m on NII, fading over time); 3) higher BFG fees (some PLN 120m annually); 4) introduction of the gradual portfolio provisioning of the FX loans following the less favourable court rulings (PLN 230m, i.e. 1% of the portfolio in 4Q19E and PLN 460m, i.e. 2% of the portfolio in the following years). We left our 2019E NI unchanged at PLN 4.28bn (+15% YoY) but lower our 2020-21E NI by 8% and 11% to PLN 4.04bn (-6% YoY) and PLN 4.36bn (+8% YoY), respectively.

Risks to Fair Value

- **Bank Handlowy**

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

Interest rate related: Material difference in the size and timing of Central Bank interest rate changes versus our base assumption, i.e. flat interest rates by the end of 2022. (BHW has the highest sensitivity among Polish banks).

Volume growth significantly below/above our expectations.

Equity market development – some 40% of fee income comes from the equity market related business, thus it is sensitive to market conditions.

Trading income volatility: Above-average sensitivity to trading income, which is volatile in nature, carries upside/downside risk to earnings

Dividends: Risk that BHW might need to limit dividend payouts (below 75%) due to regulatory changes / possibility that BHW will be able to improve the dividend to above 75% without retained earnings in the mid-term.

Securities yield curve: Above-average sensitivity of NII to securities income carries risks in the event of a lower/higher than anticipated yield on securities.

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

o 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:

o Higher Risk Free Rate (lowers valuation).

o Change in market sentiment towards dividend stocks (upside risk).

- **Bank Pekao**

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 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.

o 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%.

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:

o 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.

o 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 sentiment.

Valuation:

o Higher Risk Free Rate (lowers valuation)

o Change in the market-wise sentiment towards dividend stocks.

- **PKO BP**

Macro related: Risks of a different macroeconomic scenario 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 flat interest rates through 2021 (PKO has the second highest sensitivity among Polish banks).

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 23% market share in the CHF mortgage market with a loan book of PLN 23.5bn accounting for 11% of its loan book and 59% of equity).

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

Regulatory risk –

o CHF mortgages: The restructuring of foreign currency housing loans may not materialize, may be done in a different way to our base scenario or/and additional costs, i.e. spread bill.

o Any new regulatory requirements concerning minimum adequacy ratios and/or dividends.

o 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.

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.

o The press has 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<3%.

o CEO has admitted looking into the acquisition of mBank (08/10/2019, Parkiet daily);a mBank should be acquired by state-owned bank (22/10/2019, businessinsider.com)

Valuation:

o Higher Risk Free Rate (lowers valuation)

o Change in market sentiment to 'risk on', with a preference for dividend stocks (downside)

IMPORTANT DISCLOSURES