Warsaw, May 11, 2020

Marta Czajkowska-Bałdyga, Analyst, Haitong Bank

Haitong Bank in a report from May 8 (08:00) keeps Alior Bank at SELL (FV PLN 11.4).

Valuation Methodology

Valuation: Valuation: We use a Dividend Discount Model (DDM) with a 80% weighting and a Polish banks' peer multiples' analysis with a 20% weighting to value Alior. Our FV is based on the weighted average of these two methodologies.

Sensitivity: We provide two sensitivity analyses for our fair value estimate wherein we examine two sets of variables: (i) ROE 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 vs the 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% (down from 10.5%). We extended the model by one year until 2023. We assume a terminal ROE at 5.1% (vs 6.4% before). We use a risk-free rate of 3.0% (down from 3.5%, based on the long-term 10Y Polish Government Bond Yield assumption).

Forecast revisions: We have revised our forecasts based on the following factors: 1) lower interest rate assumptions; 2) lower profitability of the consumer lending business, based on the implications of September's CJEU ruling concerning the return of fee from the early repayment of consumer loans; 3) lower loan & deposit growth; 4) lower fees; 5) higher net provisioning in both the corporate and consumer segment due to macroeconomic assumptions caused by the COVID-19 outbreak. Thus we have lowered our 2020E NI estimate to a net loss of PLN 154m from net profit of PLN 466m, by 96% to PLN 17m in 2021E, and to net profit of PLN 307m in 2022E.

Our 2020E net loss forecast of PLN 154m differs from consensus net profit at PLN 39m. At the same time our 2021-22E net profit is below consensus by -95%/-43% respectively.

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 0.5% through 2021 and increase to 1.25% in 2022.

Funding costs: Competitive rise in deposit rates.

Dividend: Faster than expected return to a dividend payment.

Volume growth significantly below/above our expectations.

Regulatory risk: Any new regulatory requirements concerning minimum adequacy ratios.

- 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.
- Upside risk to the NII impact of the Court of Justice of the EU ruling concerning return a portion of all banks' costs linked to a consumer loan to clients in the event of an early repayment. The bank reported a PLN 64m NII impact in 1Q20, thus we see an upside risk to the current estimate of a PLN 320m negative annual impact if the positive development continue.
- ALR has been granting cash loans with one of the largest values (up to PLN 200k, for up to 12 years) and specialises in high ticket consolidation loans. This may prove risky in the wake of unemployment rising. Large ticket loans have lately been on the radar of the supervisory bodies.

Asset quality: Relatively higher risk appetite reflected in its higher–than-average cost of risk and NPLs. High exposure to the SME and consumer loans segment may cause higher than anticipated provisions at the bottom of the cycle.

Ownership related: ALR is indirectly state-controlled (via PZU and PFR - 32% stake), thus we see a risk of non-market oriented decisions.

- Risk of changes to the management board (3rd CEO since acquisition)
- Risk of ownership changes

Capital needs: Any significant increase in appetite for loan growth could trigger a capital increase given its most modest margin in relation to the minimum requirements.

Strategy related: Alior Bank has presented a new 2020-22 strategy – risk of not delivering on its targets.

Valuation:

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