BRE Bank Securities

RESEARCH REPORT
Polish Banks

Banks

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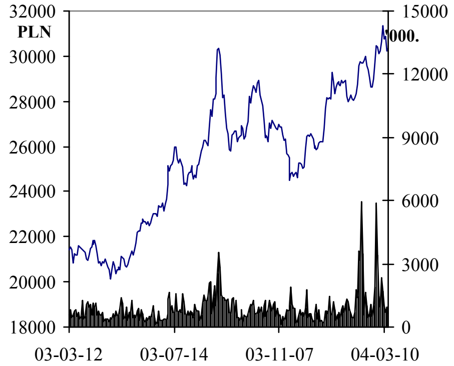
Slight Improvement in Operating Profit



- Profits of the majority of banks were once again lower than the market consensus. The market was surprised by high general expenses (accumulation of annual costs in Bank Handlowy, restructuring costs in BZ WBK) and increased costs of provisions (specific provisions in Pekao, general risk reserve in BPH PBK and Millennium). Tax encumbrances were higher in accordance with expectations, but Pekao and BZ WBK skilfully neutralised the effect of revaluating tax assets.

- As opposed to 3Q, the final quarter of 2003 was more favourable for banks in terms of profits from financial operations (smaller losses on bonds in the majority of banks) than fee and commission income (generally a small decline).

- It is unlikely that volumes will grow rapidly (corporate loans fell seasonally in December and increased only slightly in January) and therefore the level of costs will remain most important for a bank's results. The leaders in this regard are BPH PBK and ING BSK. In 2004, BZ WBK should improve its ratios, but will remain behind these two banks as well as Pekao.

- Sector data shows that the risk of a worsening in the quality of the loan portfolio continues. Therefore, the decline in costs of provisions will be the factor improving profit only in some banks in 2004 (ING BSK, and Pekao to a smaller degree). Lower taxes as well as a slow improvement in profitability on the level before provisions, the first signs of which appeared at the end of 2003, will have a positive effect on improving profitability. Moderate investments of enterprises as well as by the low dynamic of incomes of the population will limit volume growth.

- Investor confidence that banks' results will improve more than we forecast has already been discounted in the share prices of banks. Therefore, we have a rather negative attitude to the sector.

	Recommendation	Market price	Target price
Pekao	**Hold**	125	102
BPH PBK	**Sell**	419	265
BZ WBK	**Reduce**	85,4	74
Millennium	**Reduce**	3,13	2,5
Kredyt Bank	**Sell**	8,75	5,4
ING BSK	**Hold**	391,5	366
Handlowy	**Reduce**	70	49

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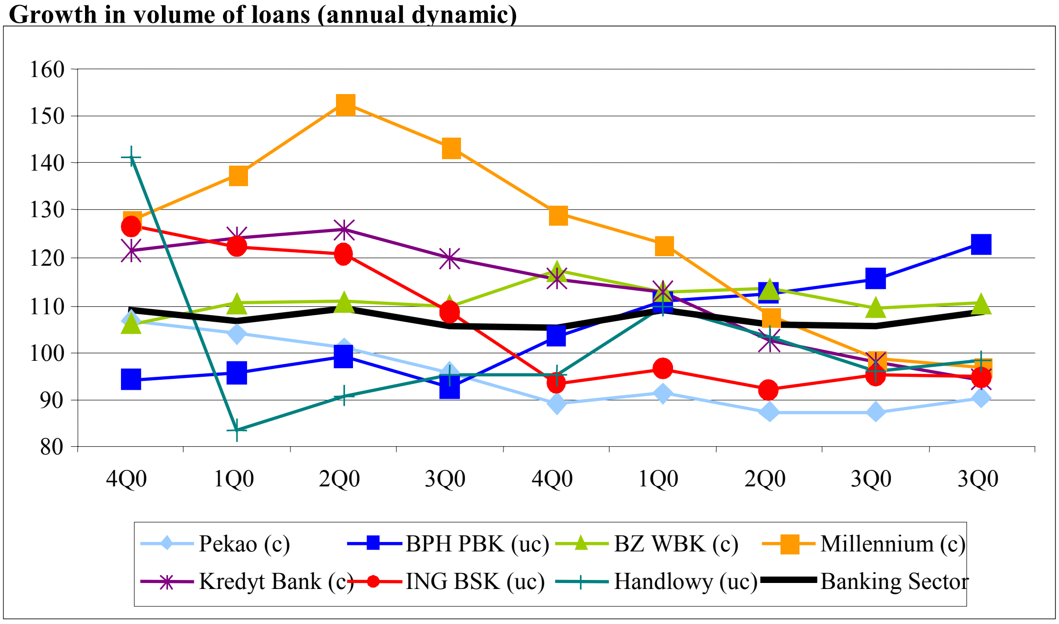
	P/E				ROE				P/BV			
	2002	4Q (an)	**2003F**	**2004F**	**2002**	4Q (an)	**2003F**	**2004F**	**2002**	4Q (an)	**2003F**	**2004F**
Pekao	26,9	32,2	22,6	18,1	11%	9%	13%	16%	2,9	2,9	2,9	2,7
BPH PBK	92,8	52,6	36,1	20,2	3%	4%	6%	11%	2,4	2,3	2,3	2,2
BZ WBK	22,8	-	48,3	16,8	12%	-3%	5%	14%	2,5	2,4	2,5	2,2
Millennium	14,5	166,6	65,0	17,8	11%	1%	2%	8%	1,5	1,5	1,5	1,4
Kredyt Bank	-	-	-	16,6	-22%	-507%	-135%	12%	0,8	2,8	2,8	1,7
ING BSK	33,1	67,7	101,7	17,5	6%	3%	2%	10%	1,8	1,9	1,9	1,7
Handlowy	37,7	72,1	39,0	24,2	4%	2%	4%	6%	1,5	1,5	1,5	1,5

The Banking Sector following 4Q

As is our tradition, following the end of the reporting season we present a ratio comparison of banks' results.

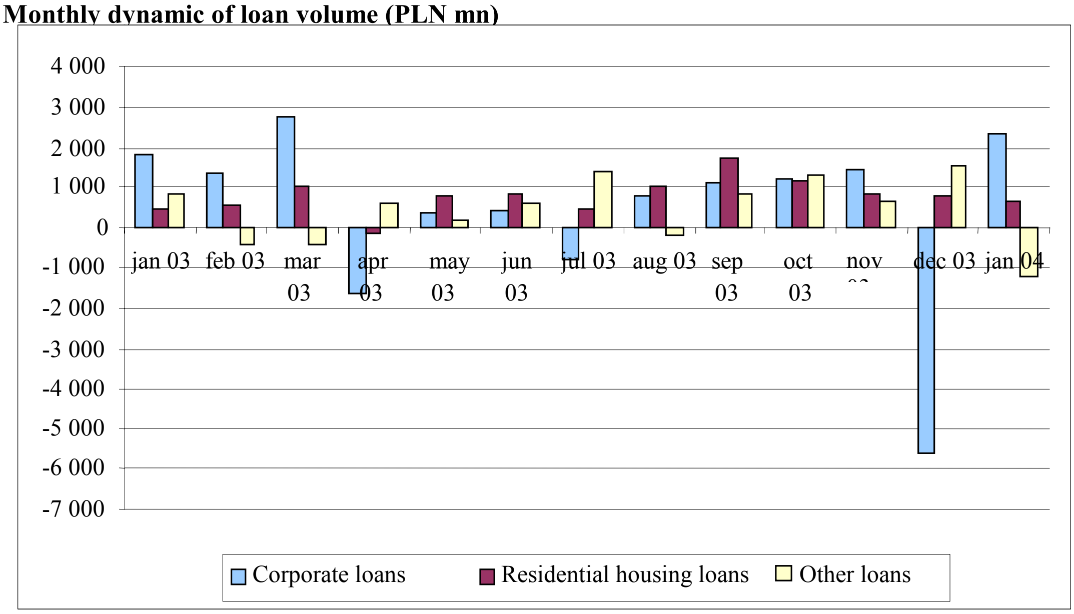
Growth in volume of loans (annual dynamic)



Source: banks, NBP, BRE Bank Securities

Just as the previous quarter, only two publicly traded banks have reported a higher dynamics of lending activity than the sector average. The consistent policy of BPH PBK is paying off and the bank has strengthened its leading position even more, pulling further away from BZ WBK. The remaining banks continue to note a decline in volumes, with Pekao leading in this regard.

Monthly dynamic of loan volume (PLN mn)

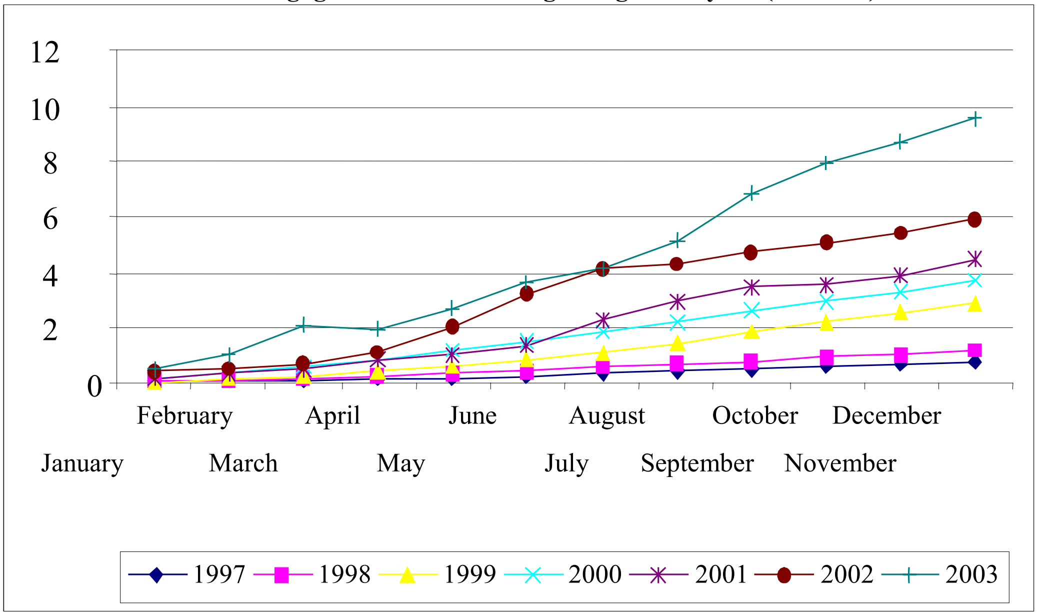


Source: NBP, BRE Bank Securities

The growth rate of residential housing loans weakened in the sector (partly due to stabilisation of the zloty exchange rate), but they remain the motor driving the growth in the entire loan portfolio. The seasonal decline in corporate loans occurred in December, but the growth in other loans was strong (4Q noted the most significant growth during the entire year). However, this was followed in

January by a reversal of roles: corporate loans made up for part of December's decline and the volume of other loans fell. Residential housing loans were stabile, but the monthly growth was less than that noted at the end of the year.

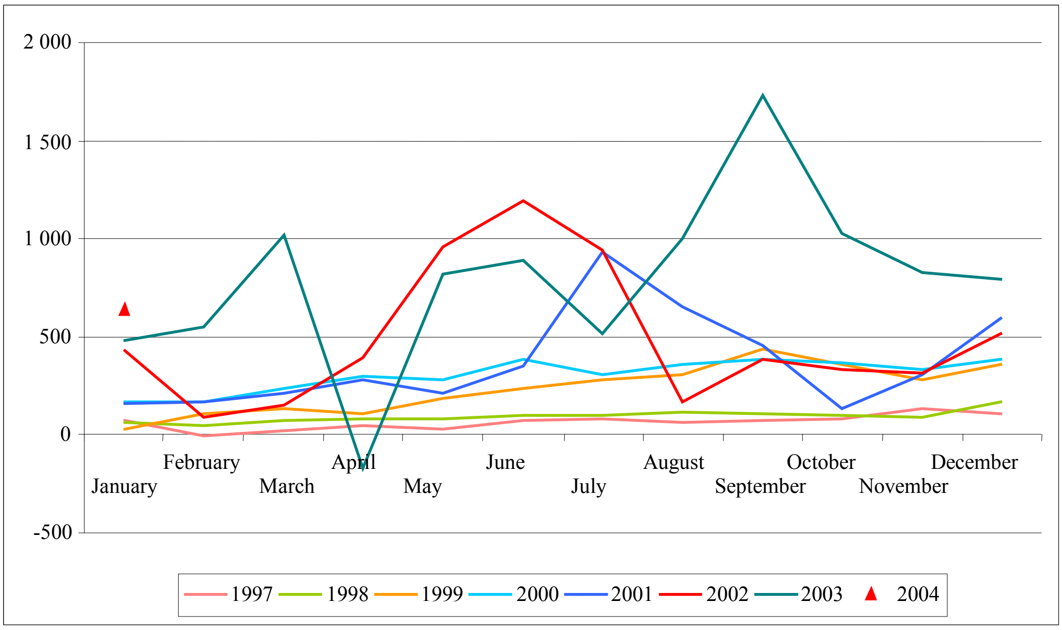
Growth in volume of mortgage loans since the beginning of the year (PLN mn)



Source: NBP, BRE Bank Securities

Despite the fact that September's PLN 1.7 bn growth in the volume of residential housing loans was not repeated in subsequent months and monthly dynamics in volumes declined, it was precisely the end of the year that resulted in 2003 noting a much larger increase in comparison to 2002.

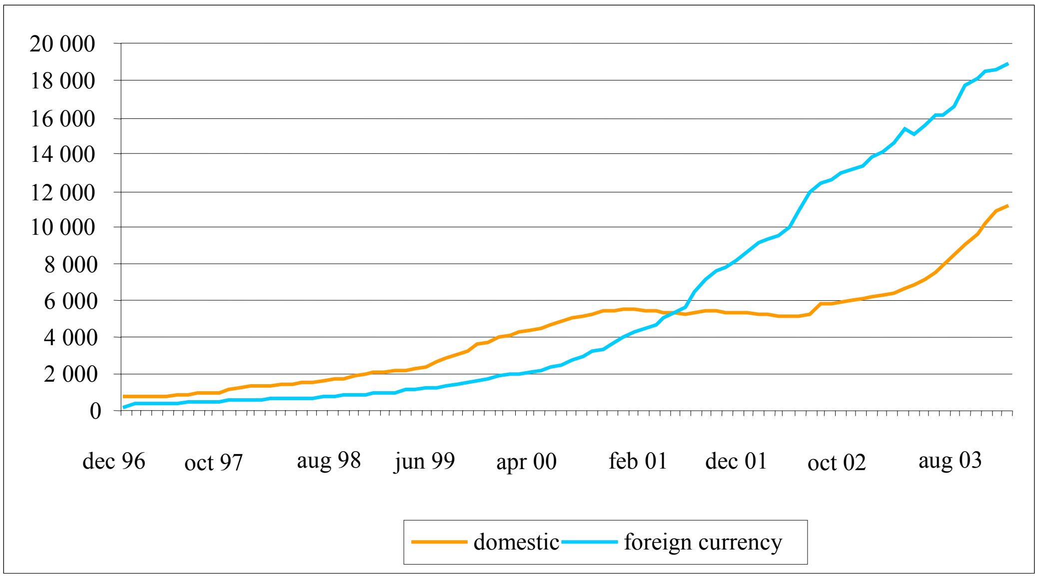
Monthly growth in the volume of mortgage loans (PLN mn)



Source: NBP, BRE Bank Securities

Despite lower monthly income than that noted at the end of last year, this year looks pretty good. January's growth amounted to PLN 645 mn against PLN 490 mn the previous year and PLN 429 mn two years ago.

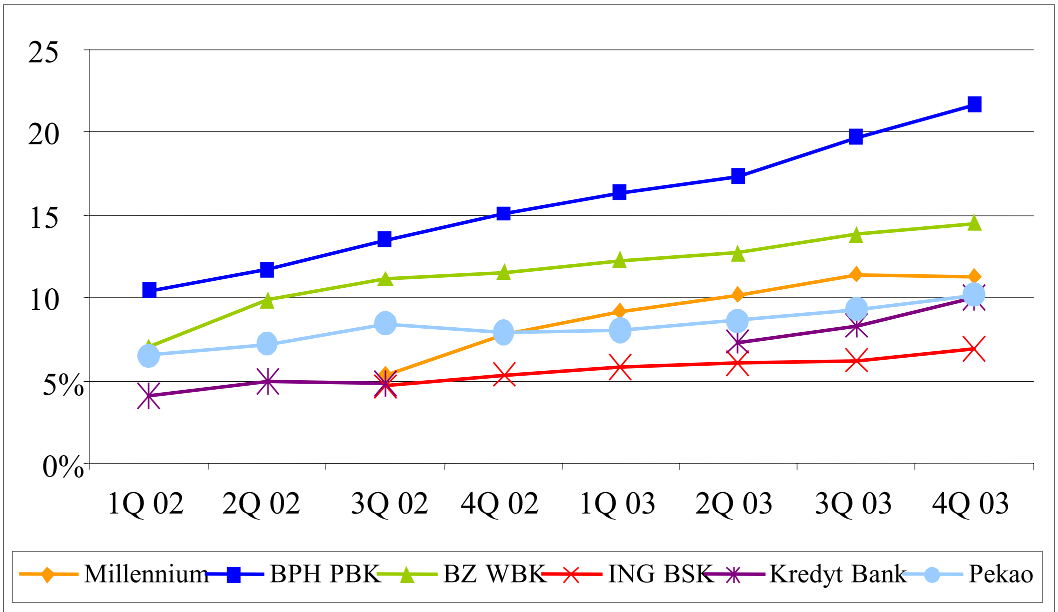
Volume of domestic and foreign currency (*) housing loans (q/q)



Source: NBP, BRE Bank Securities
(*) including PLN loans indexed to the foreign currency exchange rate

The final months of 2003 confirmed the earlier observed recovery in zloty loans and the decline in the popularity of foreign currency loans. In 4Q, zloty loans increased PLN 1.8 bn, and foreign currency loans PLN 0.8 bn, which illustrates the clear change in client preferences (PLN 0.3 mn and PLN 0.9 bn, respectively one year ago). A huge surge in zloty-denominated mortgage loans could occur in 2004, although in January volumes were even: foreign currency loans totalled PLN 333 mn and zloty loans PLN 312 mn.

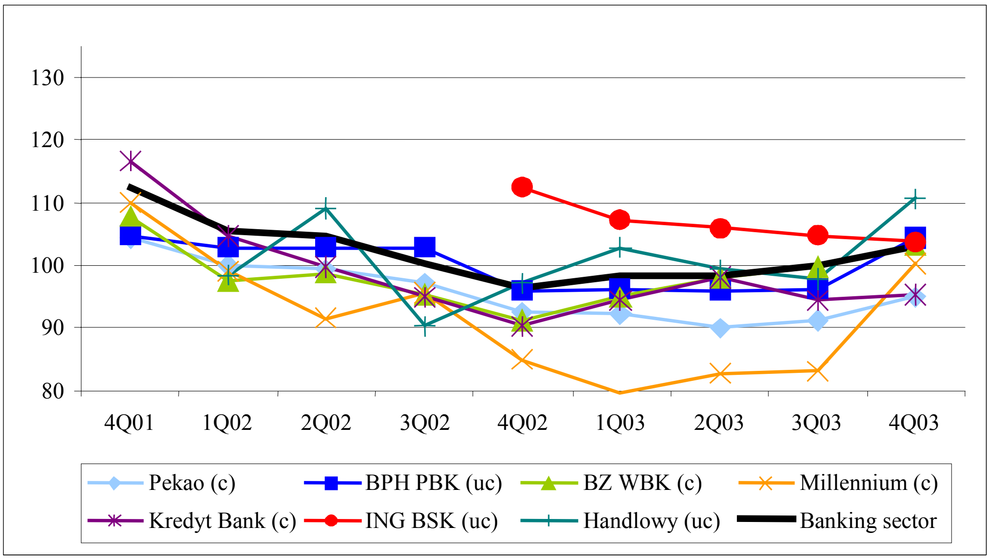
Share of mortgage loans in total loans



Source: banks, BRE Bank Securities

Clients turning away from foreign currency loans could be the explanation for the declining dynamics of growth in the share of mortgage loans in the portfolio of Millennium. It should be stressed that despite the change in client preferences BPH PBK did quite well; as even concentrating on loans denominated in Swiss franks, the bank had a very good 4Q (PLN 0.7 bn growth in volume). Pekao slightly improved sales of residential housing loans, but it does not appear that banks, which have been focusing on zloty loans for some time, took advantage of the favourable change in client preferences.

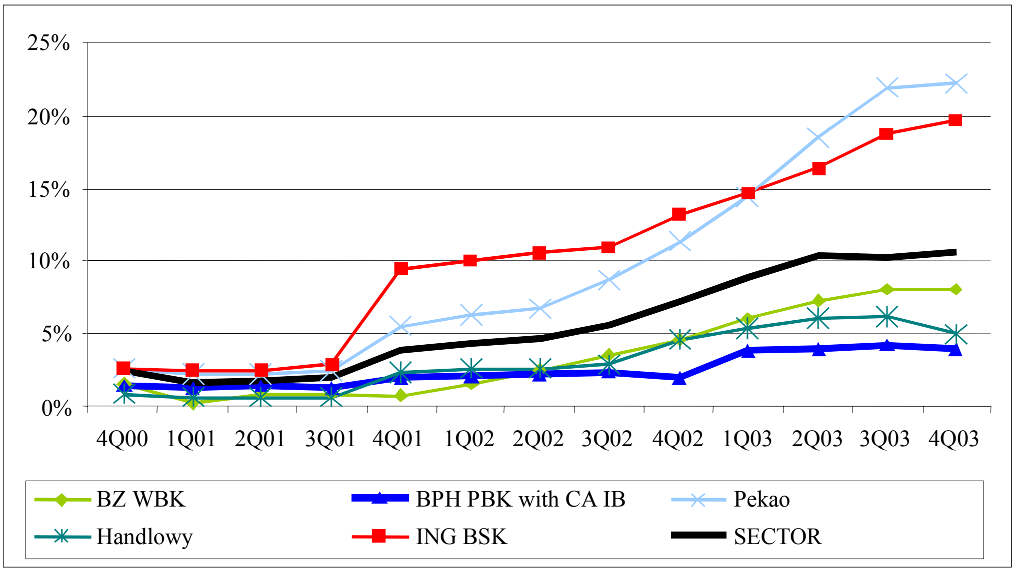
Growth in volume of deposits (annual dynamics)



Source: banks, BRE Bank Securities

This year's particularly strong seasonal growth in corporate deposits at the end of the year meant very good results for Bank Handlowy and BPH PBK. Kredyt Bank, from which substantial funds were withdrawn after the bank announced its huge loss in 2003, as well as the now traditional Pekao, noted the smallest dynamics.

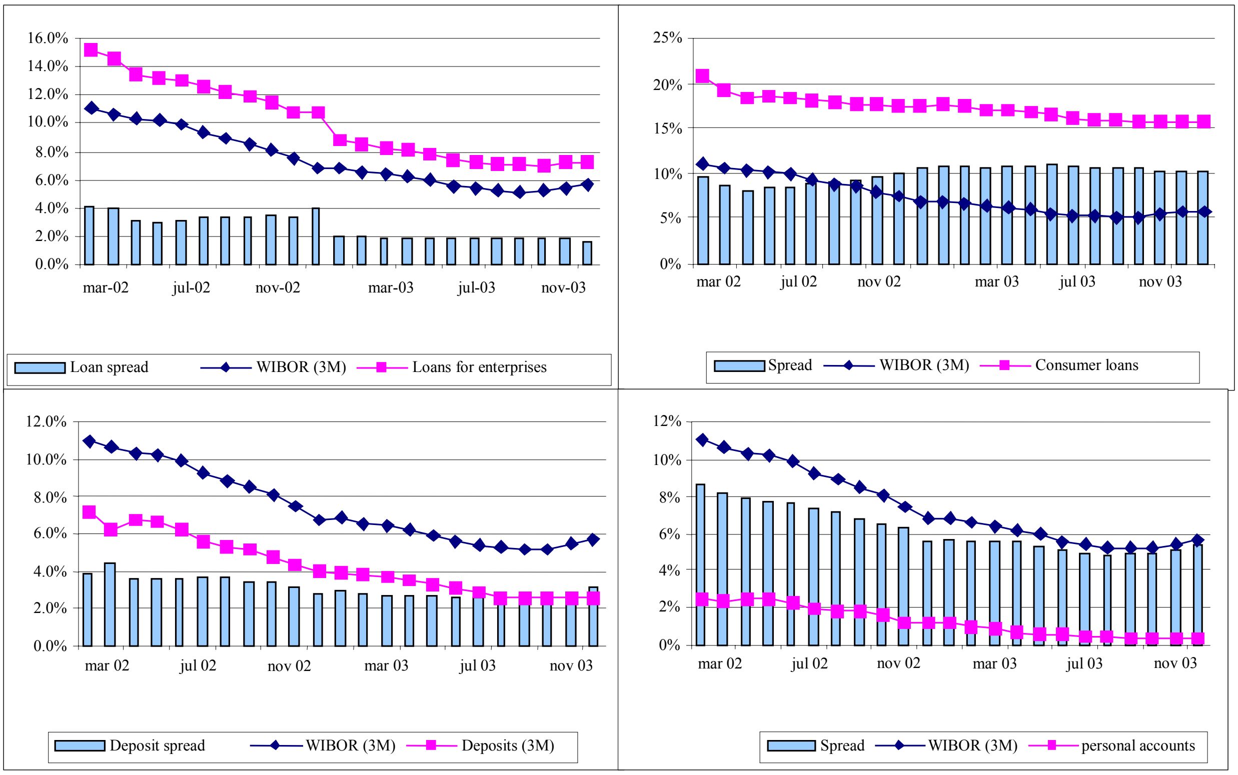
Assets of investment funds as a % of deposits



Source: banks, hoga.pl, BRE Bank Securities

Despite the slowdown on the market of investment funds, the ING Group managed to increase its share in total funds of clients (due to the 12% dynamic of growth in assets managed the Investment Fund Society – TFI), the value of which at the end of 2003 amounted to 19.6% of the volume of deposits. Despite the slower increase in 4Q, the leader in this regard remains Pekao (22.2%), and excluding ING, other financial groups lag far behind. The decline in Bank Handlowy's analysed ratio is due not only to the growth in deposits (+10% in 4Q), but also to the decline in assets managed by the bank's TFI (-13% in 4Q).

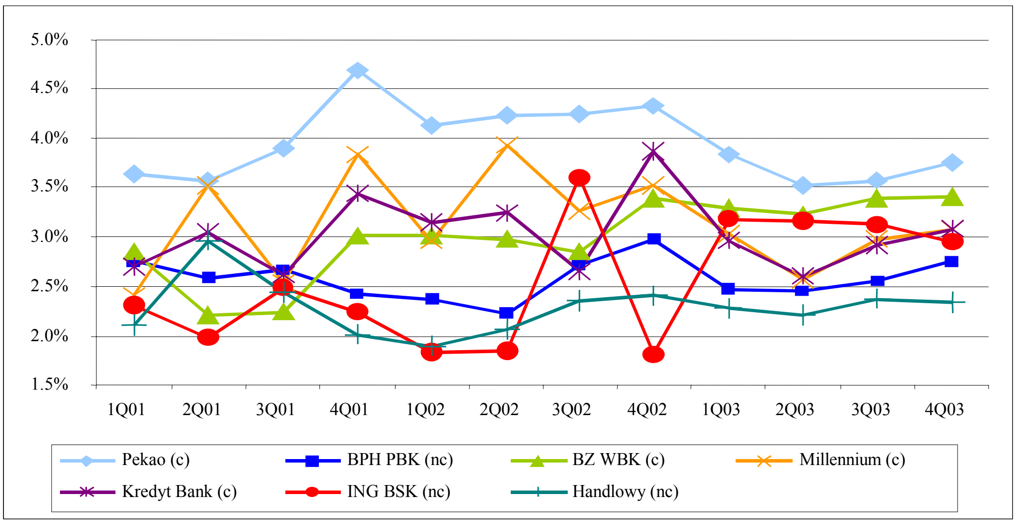
Interest rates and spreads in the sector



Source: NBP, BRE Bank Securities

The National Bank of Poland's new methodology of calculating loan interest (until November 2002, banks presented their offers, since December – actual interest negotiated by banks) shows the low profitability of this segment of the market. Even worse, subsequent declines in corporate loan spreads were noted in December. However, due to a growth in market interest rates (higher WIBOR) the situation on the side of deposits improved. Banks generally managed to keep the level of interest on deposits low, due to which deposit spreads are growing. However, several banks introduced new, higher interest-bearing deposit products and it could be feared that even if interest rates on traditional products are maintained at the current level, average interest costs of banks will grow.

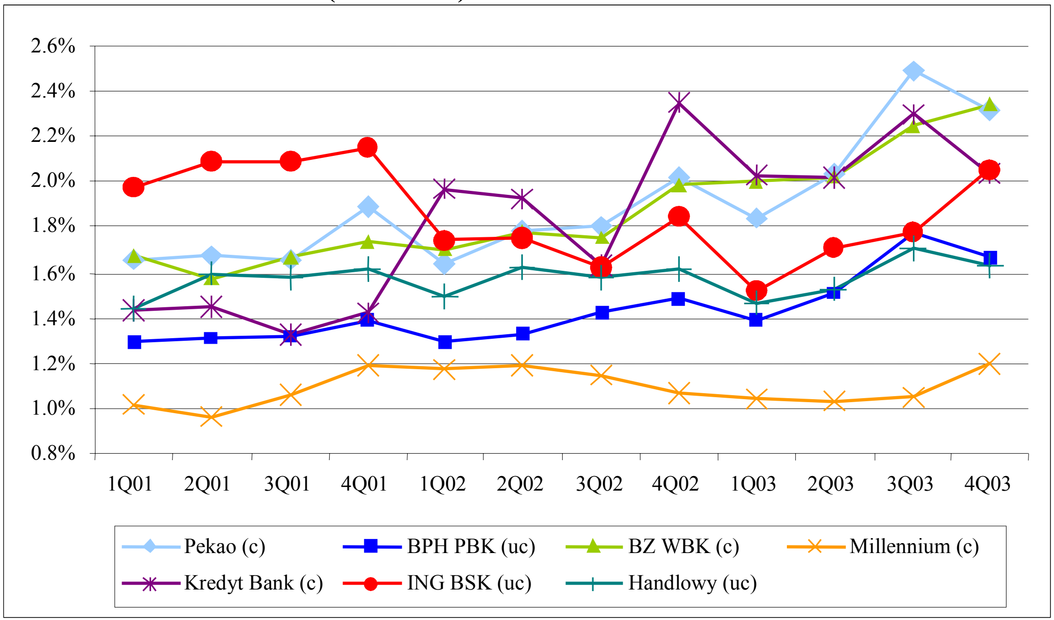
Annualised interest margins(*)



Source: banks, BRE Bank Securities
(*) interest margins excluding SWAP operations, excluding Millennium and ING BSK since 1Q 2003.

The increase in deposit spreads in the sector translated into better results for publicly traded banks, which generally increased interest margins in 4Q. The exception was ING BSK.

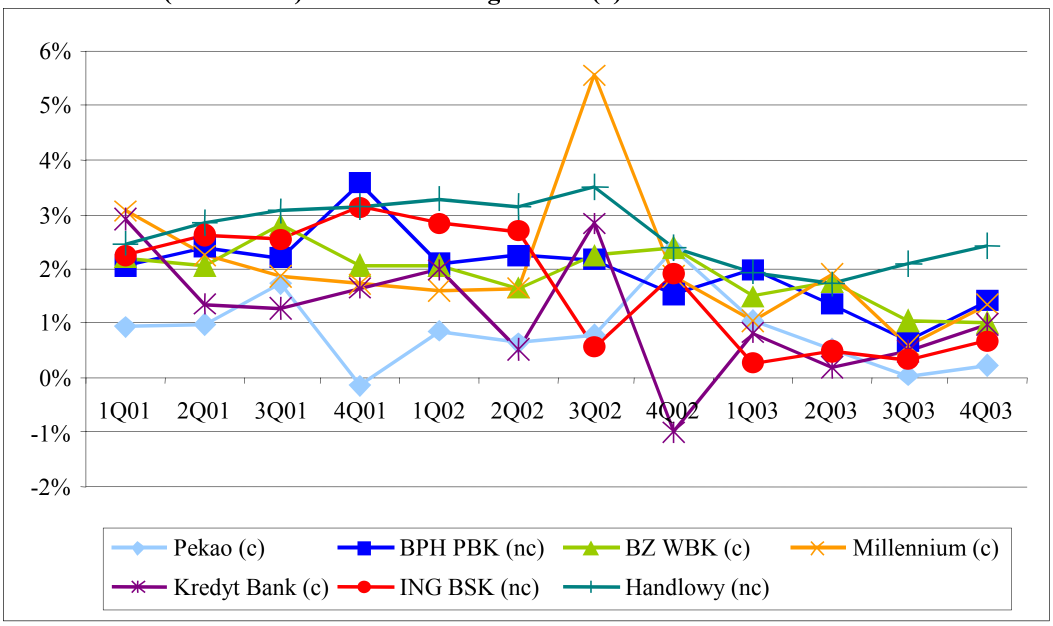
Fee and commission income (annualised) as a % of assets



Source: banks, BRE Bank Securities

The final quarter of the year could not measure up to the spectacular 3Q in terms of fee and commission income. In the majority of banks (the exceptions were ING BSK and BZ WBK as well as Millennium) fee and commission income as a percentage of assets fell. However, it should be stressed that despite the drop in comparison to the previous quarter, fee and commission income was higher in all banks than that reported in 2Q. Also noteworthy was the growth in fee and commission costs, which was one of the main reasons for the lower net fee and commission income.

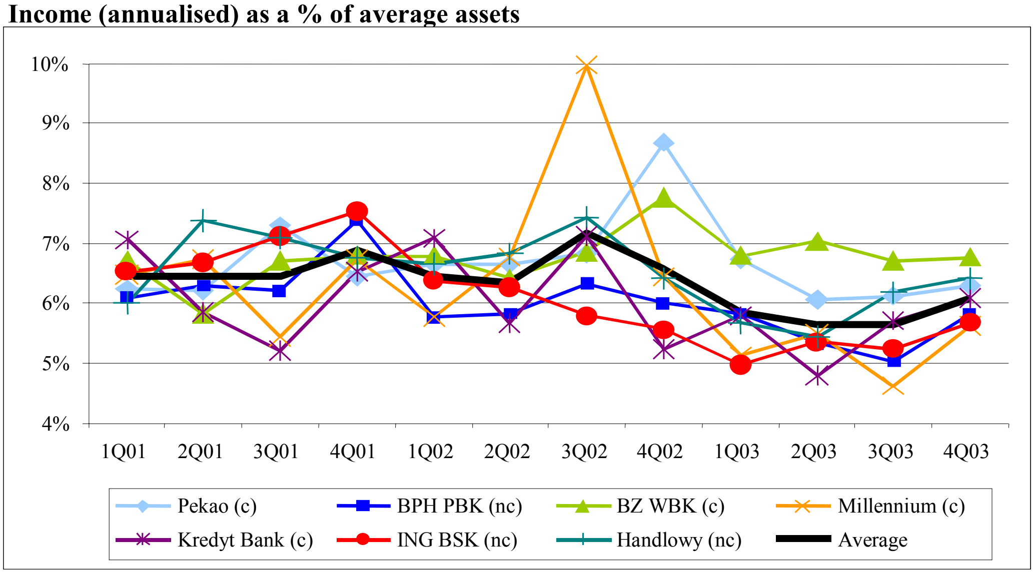
Other income (annualised) as a % of average assets (*)



Source: banks, BRE Bank Securities
(*) including SWAP operations, excluding Millennium and ING BSK since 1Q 2003

The end of 2003 was not as bad as 3Q and the majority of banks (excluding BZ WBK) increased other income (lower losses on bonds). Bank Handlowy remained the leader in terms of other income, but this was again due to an extraordinary transaction (the sale of the PTE). If market interest rates were to be cut again, banks may again periodically note a profit on bonds and could even more than compensate for the losses noted in 2H 2003, but the "Eldorado" period of 2002 characterised by high profits for the bond portfolio and continually high income on SWAP operations, will not return. We maintain the opinion that only Bank Handlowy and BPH PBK could count on significant other income.

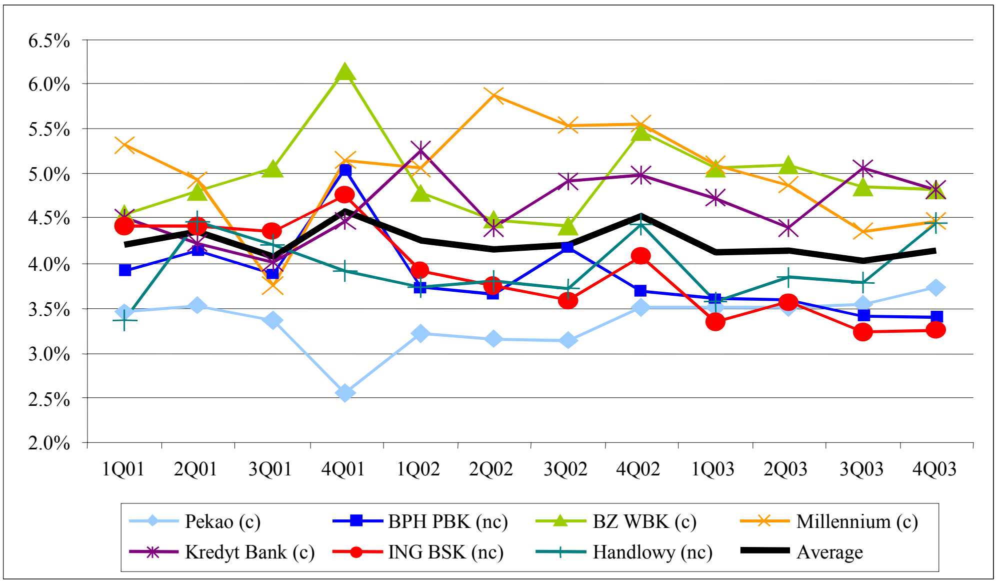
Income (annualised) as a % of average assets



Source: banks, BRE Bank Securities

Higher interest margins and lower losses on bonds more than compensated banks for the decline in net fee and commission income and income (as a percentage of assets) increased in all analysed banks. BZ WBK remained the leader, but the rest of the group is closing in. Due to the sale of the PTE, Bank Handlowy noted a growth in the profitability of assets. Pekao also improved its result. BPH PBK and Bank Millennium halted their downward trends. In the case of the latter bank, due to the sale of the automobile loan portfolio, the bank's income will fall in 2004, but its assets will simultaneously fall 10%. The result should be an increase in the income/ assets ratio.

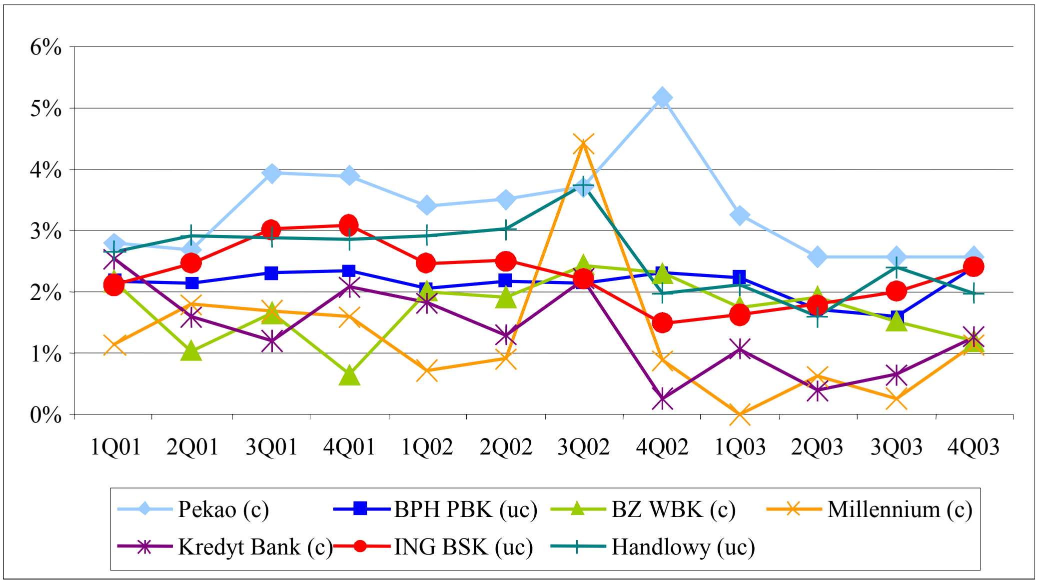
Total costs (annualised) as a % of average assets



Source: banks, BRE Bank Securities

Bank Handlowy's cost / assets ratio worsened in relation to 3Q. In 4Q, the bank booked costs connected with accessing the IT systems of Citigroup and costs of its employees participating in the incentive programme. Other than that, there were no changes: Kredyt Bank and BZ WBK had the highest cost ratios, Millennium's ratio was also high. In 2004, the situation should improve in the case of the first two banks: from the beginning of the year for BZ WBK and gradually over the course of the year for Kredyt Bank. For purely mathematical reasons, Millennium's situation will worsen, as the sale of the automobile loan portfolio will result in assets declining and therefore an increase in the ratio (from the current 4.47% to 5.02%). No big changes are expected in the group of the least expensive banks. Due to the dynamic growth in assets and persistently controlling costs, BPH PBK should reduce the ratio even further. In comparison with BPH PBK, ING BSK will not appear as good, due to the smaller growth in assets. Pekao's costs of amortising the IT system could grow, which with a small dynamic of assets will have an unfavourable influence on the analysed ratio.

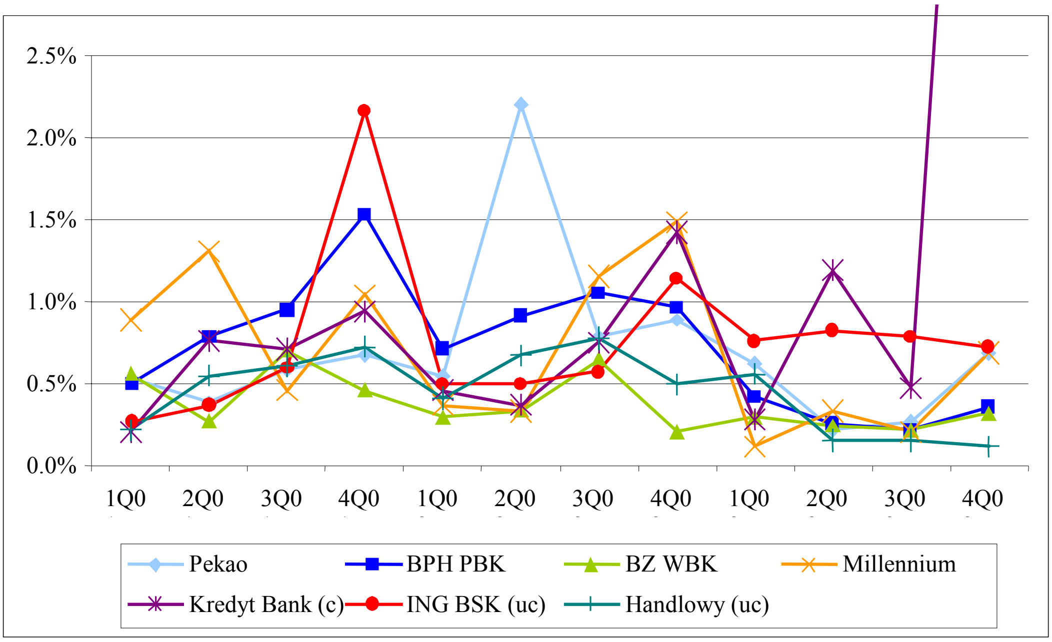
Operating profit before provisions (annualised) as a % of average assets



Source: banks, BRE Bank Securities

The growth in operating profit noted by the majority of banks is certainly good news (the exceptions were Bank Handlowy, in which the growth in costs exceeded the growth in income, and BZ WBK, but in the case of this bank normalised operating profit again improved, but only minimally). Even more than the previous quarter it can be seen that costs are key for the level of operating profit, and therefore banks noting the highest costs earn the lowest profits. Limiting costs together with a systematic small increase in income paid off in the case of ING BSK with an increase in operating profit for the fourth consecutive quarter. BPH PBK again reversed the downward trend and pulled ahead of BZ WBK (the banks have had very similar operating profit/ assets ratios since the beginning of 2002). This year should bring an improvement in the profitability ratios of Millennium (the effect of a lower denominator) as well as Kredyt Bank (restructuring), but these banks will remain far behind the leaders. In turn, the best banks should hold on to their levels of profitability: we do not see an opportunity for significant improvement, as the majority of these banks have limited possibilities to cut costs further and income will be under pressure due to competition (which in fact is only just beginning) and the moderate rate of increase in lending activity (limited business investments, small increase in incomes of the population).

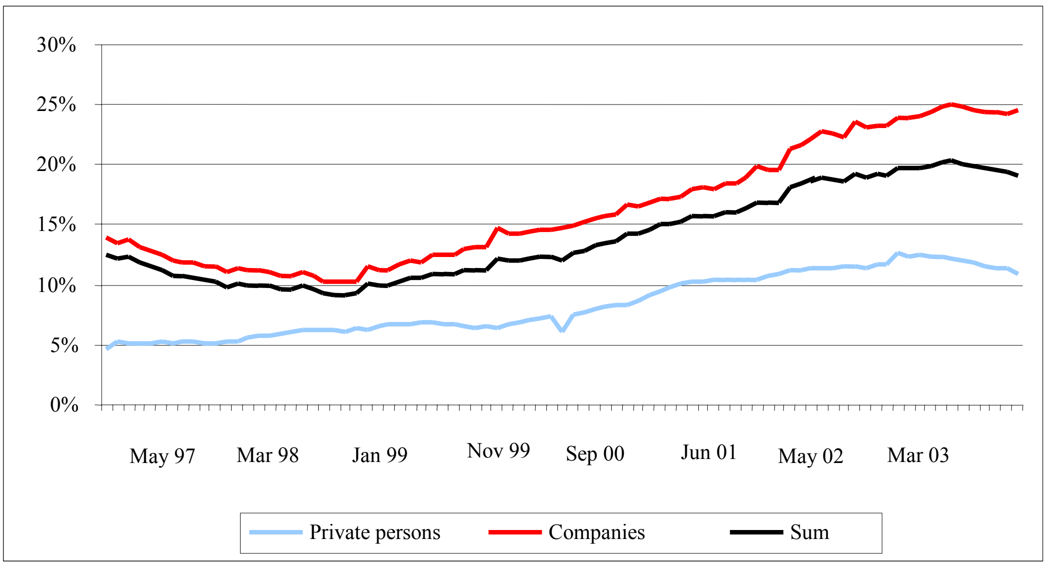
Quarterly net provisions as a % of average loan balance



Source: banks, BRE Bank securities

Net provisions in 4Q are traditionally higher than in the remaining quarters of the year, but in various banks there were various reasons for this. Kredyt Bank created earlier planned provisions in order to fully cover the credit risk, including the lower value of secured collateral. Pekao created higher provisions than the record low provisions in the two previous months and also one of the highest in the sector. Due to increasing the general risk reserve, Bank Millennium and BPH PBK reported higher net provisions. ING BSK's net provisions were stabile (very high, but opportunities exist to limit them in 2004), BZ WBK's were low and Bank Handlowy's net provisions were very low.

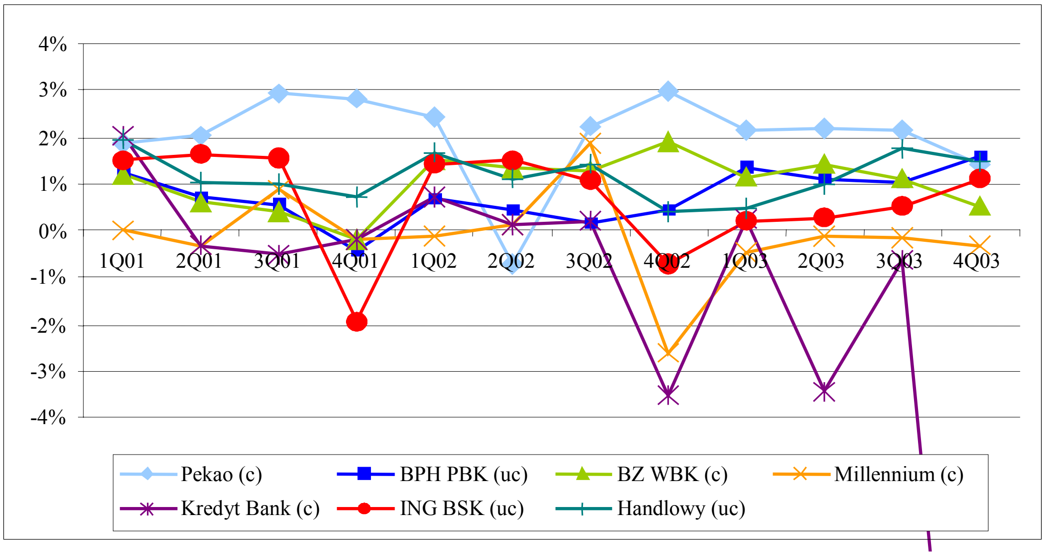
Non-performing loans as a % of total loans



Source: NBP, BRE Bank Securities

The share of non-performing loans in the entire sector fell from 19.7% to 19.1% in 4Q, but this was due to the improvement in the group of loans for private individuals (decline from 11.6% to 10.9%), as the quality of the corporate portfolio continues to worsen (the non-performing loans ratio was 24.6% at the end of the year against 24.4% three months earlier). Even worse, January saw a worsening in ratios for all groups of debt (11.0% for private individuals, 24.8% for businesses and 19.4% for the entire portfolio). In the first month of the year, the volume of non-performing loans for private individuals increased PLN 143 mn, and PLN 920 mn for businesses. Should this trend be confirmed in February, 1Q results could again disappoint investors counting on a further decline in credit risk.

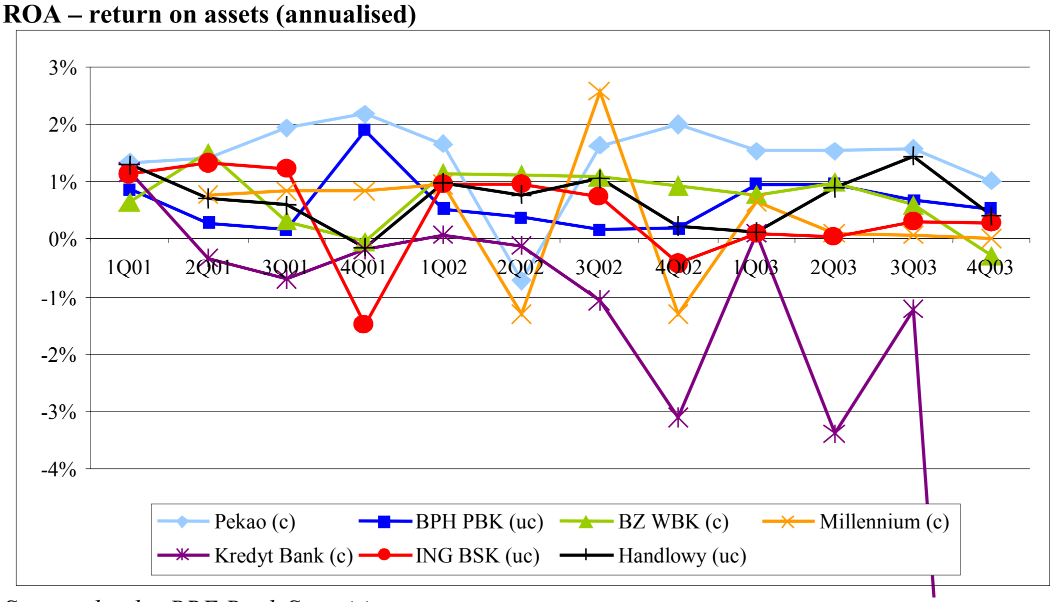
Gross profit (annualised) as a % of average assets



Source: banks, BRE Bank Securities

Due to distortions on the level of taxes, it is worth looking at gross profitability (before taxes). In this regard, Pekao lost its leading position, overtaken by Bank Handlowy (with the lowest provisions in the group of analysed banks) and BPH PBK (growth in operating profit before provisions). In the case of ING BSK, “provision leverage” kicked in and with the high costs of credit risk, the small growth in operating profit translated into a substantial growth in gross profit.

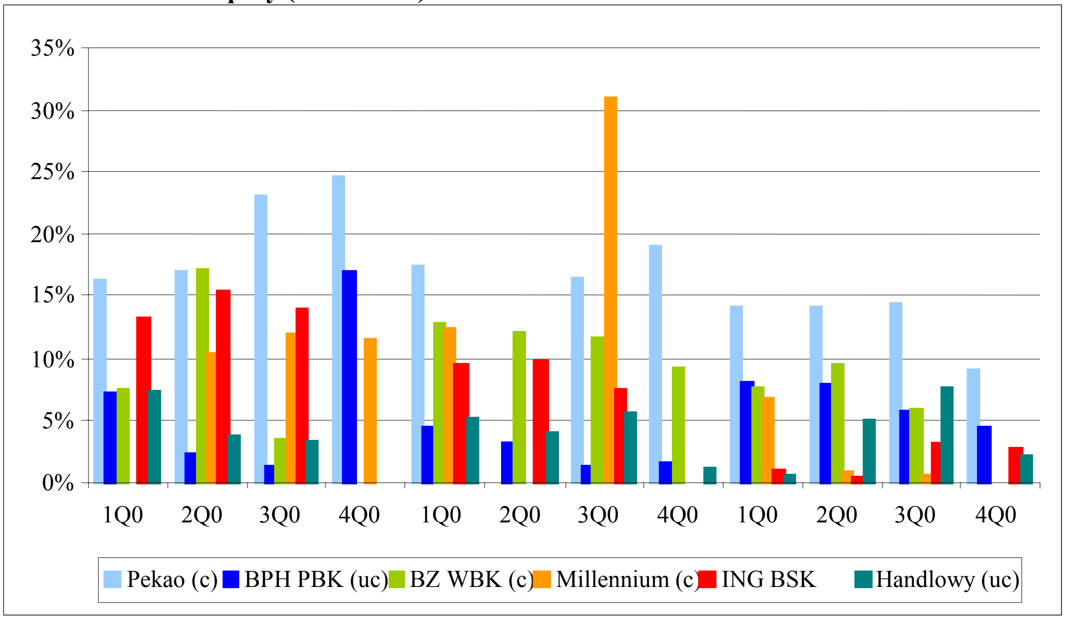
ROA – return on assets (annualised)



Source: banks, BRE Bank Securities

The improvement in profitability on the level of operating profit before provisions is not evident on the net level, mainly due to higher provisions, and not (as could be expected) to higher taxes, as banks largely managed to neutralise costs connected with revaluating tax assets (BPH PBK and ING BSK were the most hard hit). Annualised ROA fell in all banks, the least in ING BSK and Millennium (but it is on a very low level in both banks).

ROE – return on equity (annualised)



Source: banks, BRE Bank Securities

None of the banks had (an annualised) return on equity above 10%, and only Pekao broke the 5% threshold. Considering the fact that the majority of banks managed to neutralise the influence of one extraordinary factor (the higher tax encumbrance), this is not a good omen for 2004. It is relatively easy to show why results will improve for ING BSK (continuing improvement in operating profit as well as provisions approximately PLN 150 mn lower), BZ WBK (maintaining high profitability and reducing costs PLN 100 mn) and BPH PBK (greater income from banking activity as well as a PLN 70 mn profit from the sale of GBG). However, it is more difficult to pinpoint the source of improvement for the results of Pekao (we forecast slightly lower costs of provisions and a slow improvement in regard to income), Bank Handlowy, Millennium and Kredyt Bank.

Valuation and Recommendation

Bond yields have fallen since our last sector report, which we have taken into consideration in valuating shares. We adopted 6.6% as the risk free rate for the next 10 years.

Costs of capital

	2004-2013	2014 and beyond
Risk free rate	6.6% (*)	5.6% (**)
Risk premium	5%	5%

(*) market yield of 10-year bonds
(**) implied yield of Italian 20-year bonds

Growth rate

2004-2007	2008-2018	After 2018
Individual based on model	6.5%	4.5%

Forecast of "terminal" ROE

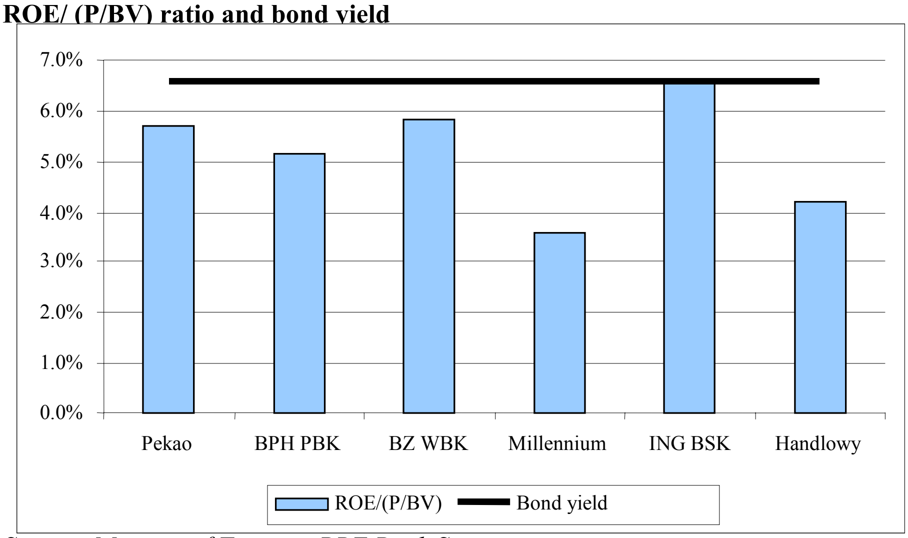
	Pekao	BPH PBK	BZ WBK	Millennium	Kredyt Bank	ING BSK	Handlowy	Sector
Interest margin	2.6%	2.2%	2.7%	2.7%	2.6%	2.6%	2.1%	2.6%
F&O/ assets	1.2%	1.2%	1.2%	1.0%	1.3%	1.0%	1.5%	1.0%
Other income/ assets	0.4%	0.6%	0.4%	0.3%	0.3%	0.4%	0.6%	0.4%
Total income/ assets	4.2%	4.0%	4.3%	4.0%	4.2%	4.0%	4.2%	4.0%
Costs/ assets	-2.0%	-2.1%	-2.6%	-2.6%	-2.6%	-2.2%	-2.2%	-2.3%
Costs/ income	*-48%*	*-53%*	*-60%*	*-65%*	*-63%*	*-55%*	*-52%*	*-57%*
Operating profit/ assets	2.2%	1.9%	1.7%	1.4%	1.6%	1.8%	2.0%	1.7%
Provisions	-0.7%	-0.9%	-0.5%	-0.7%	-0.7%	-0.7%	-1.0%	-0.7%
Pre-tax profit	1.5%	1.1%	1.2%	0.7%	0.9%	1.1%	1.0%	1.0%
Net profit	1.2%	0.9%	1.0%	0.6%	0.7%	0.9%	0.8%	0.8%
ROE	**19.7%**	**13.8%**	**15.8%**	**11.3%**	**11.2%**	**14.5%**	**13.1%**	**13.4%**

Valuations and recommendations

	Target ROE	Implied target P/BV	Valuation	Price	Growth/ downward potential	Recommendation
Pekao	19.7%	2.5	**102**	**125**	-18%	Hold
BPH PBK	13.8%	1.5	**265**	**419**	-37%	Sell
BZ WBK	15.8%	1.8	**74**	**85**	-13%	Reduce
Millennium	11.3%	1.1	**2.53**	**3.13**	-19%	Reduce
Kredyt Bank	11.2%	1.1	**5.42**	**8.75**	-38%	Sell
ING BSK	14.5%	1.6	**366**	**392**	-6%	Hold
Handlowy	13.1%	1.4	**49**	**70**	-30%	Reduce

The simplest method of analysing the profitability of investing in banking shares consists in comparing the ROE / (P/BV) ratio (which shows the profit from investing PLN 1.0 in one share of a given bank) with the yield on treasury bonds. The recent drop in bond prices has resulted in them becoming a much more attractive investment, which is illustrated in the chart below (presenting the ratio calculated on the basis of the average prospective ROE in 2004-2006 and the yield on 10-year bonds).

ROE/ (P/BV) ratio and bond yield



Source: Ministry of Finance, BRE Bank Securities

Previous recommendations issued for Pekao S.A.

Recommendation	Hold	Hold	Hold	Hold
Date issued	2003-09-10	2003-11-19	2003-12-09	2004-02-23
Price on day of recommendation	111.50	110.50	109.00	123.00
WIG on day of recommendation	19983.97	19674.12	20066.46	23333.88

Previous recommendations issued for BPH PBK S.A.

Recommendation	Sell	Sell	Sell	Sell
Date issued	2003-09-10	2003-10-31	2003-12-09	2004-03-11
Price on day of recommendation	312.00	337.50	342.00	426.00
WIG on day of recommendation	19983.97	20757.40	20066.46	23910.67

Previous recommendations issued for BZ WBK S.A.

Recommendation	Hold	Hold	Reduce
Date issued	2003-09-10	2003-12-09	2004-03-09
Price on day of recommendation	79.50	76.00	87.50
WIG on day of recommendation	19983.97	20066.46	24243.21

Previous recommendations issued for Millennium S.A.

Recommendation	Reduce	Reduce
Date issued	2003-09-10	2003-12-09
Price on day of recommendation	3.12	2.57
WIG on day of recommendation	19983.97	20066.46

Previous recommendations issued for Kredyt Bank S.A.

Recommendation	Hold	Hold	Sell	Sell
Date issued	2003-09-10	2003-11-05	2003-12-03	2003-12-09
Price on day of recommendation	10.60	10.50	7.75	8.15
WIG on day of recommendation	19983.97	20399.03	19850.94	20066.46

Previous recommendations issued for ING BSK S.A.

Recommendation	Hold	Hold	Hold
Date issued	2003-09-10	2003-12-09	2004-01-29
Price on day of recommendation	260.00	316.00	395.00
WIG on day of recommendation	19983.97	20066.46	21829.92

Previous recommendations issued for Bank Handlowy S.A.

Recommendation	Reduce	Reduce
Date issued	2003-09-10	2003-12-09
Price on day of recommendation	54.00	57.00
WIG on day of recommendation	19983.97	20066.46

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List of abbreviations and ratios contained in the report.
EV *– net debt + market value (EV – economic value)*
EBIT *– Earnings Before Interest and Taxes*
EBITDA *– EBIT + Depreciation and Amortisation*
PBA *– Profit on Banking Activity*
P/CE *– price to earnings with amortisation*
MC/S *– market capitalisation to sales*
EBIT/EV *– operating profit to economic value*
P/E *– (Price/Earnings) – price divided by annual net profit per share*
ROE *– (Return on Equity) – annual net profit divided by average equity*
P/BV *– (Price/Book Value) – price divided by book value per share*
Net debt *– credits + debt papers + interest bearing loans – cash and cash equivalents*
EBITDA margin *– EBITDA/Sales*

Recommendations of BRE Bank Securities
A recommendation is valid for a period of 3-6 months, unless a subsequent recommendation is issued within this period.
BUY – we expect that the rate of return from an investment in a company's shares will be at least 15% higher than the WIG
ACCUMULATE – we expect that the rate of return from an investment in a company's shares will be 5%-15% higher than the WIG
HOLD – we expect that the rate of return from an investment in a company's shares will be within +/-5% in relation to the WIG
REDUCE – we expect that the rate of return from an investment in a company's shares will be 5%-15% lower than the WIG
SELL – we expect that the rate of return from an investment in a company's shares will be at least 15% lower in relation to the WIG

The present report expresses the knowledge as well as opinions of the authors on day the report was prepared.

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Strong and weak points of valuation methods used in recommendations:
DCF – acknowledged as the most methodologically correct method of valuation; it consists in discounting financial flows generated by a company; its weak point is the significant susceptibility to a change of forecast assumptions in the model
Multiple – based on a comparison of valuation multipliers of companies from a given sector; simple in construction, reflects the current state of the market better than DCF; weak points include substantial variability (fluctuations together with market indices) as well as difficulty in the selection of the group of comparable companies.