



# ANALYTICAL REPORT

## Bank Millennium

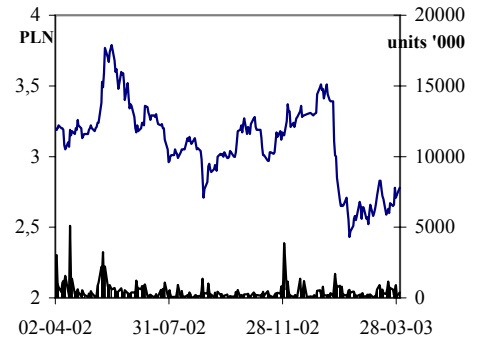
### Banks

ISSN 1508-308X

Warsaw, 24.04.03

### Penultimate profitable quarter?

- The net profit generated by Bank Millennium in 1Q 2003 was higher than we expected (PLN 30 mn vs. an expected PLN 22 mn), and despite this we are disappointed with the bank's results. The bank fell short of our forecast concerning income, noted higher costs, operating profit before provisions was almost zero and the positive net result was achieved due to adopting less conservative principles regarding the creation of general risk reserves as well as to the positive result in the item income tax.
- Following the change in principles of creating the risk reserve, the bank's possibilities for dissolving it in the future declined. According to information received from the bank, it also results that the bank will effectively pay taxes throughout 2003, therefore a further positive influence with respect to income tax should not be expected.
- In 1Q 2003 approximately 83% of Millennium's net profit originated from the consolidation of PZU, but in connection with BCP reducing its commitment in Eureko, the bank decided to cease consolidating the insurer. As a result, beginning next quarter the bank's profit and loss account will be trimmed by approximately PLN 20-25 mn per quarter.
- The finalisation of the Polcard sale should be wrapped up in coming months (2 or 3Q). For Millennium this means an extra PLN 46 mn gross (PLN 33 mn net) will be booked in one of the next quarters. At that time, it would appear that the potential for generating profits from one-time transactions will be exhausted and the entire burden of generating profits will fall to core activity.
- Is the bank able to achieve a decent operating profitability (before provisions)? Results for 1Q dashed our hopes that the restructured bank will be able to maintain income from core activity on the level noted in 2002. On the side of costs, despite small declines, the result of reducing employment 23% is not visible. Therefore, in our opinion, even recovering the operating profitability noted last year would be a success. With the potential for profits from one-time transactions coming to an end, results will be substantially lower than last year.
- We hoped that 1Q would bring the first signs showing the positive effects of restructuring that was completed last year. Unfortunately, the bank's results dashed these hopes. As a result, we are lowering our forecasts and lowering the target price from PLN 2.95 to PLN 2.50 as well as downgrading the recommendation for Bank Millennium from Hold to REDUCE.



### Recommendat **REDUCE**

**Price** 2,82  
**Target price** 2,50

### Basic Data

No. of shares (units mn) 849  
 Free float (PLN mn) 438  
 Market cap (PLN mn) 2 395

### Structure of Shareholders

BCP 50%  
 Eureko 20%  
 Others 30%

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	Net interest income (PLN mn)	Profit on bank act. (PLN mn)	Gross profit (PLN mn)	Net profit (PLN mn)	No. shares (mn)	EPS (PLN)	EPS growth (5)	P/E	BVPS (PLN)	P/BV	DPS (PLN)	Dividend payout rate
2001	589	1 035	-74	20	849	0,05	-64,8%	60,3	1,73	1,6	0,00	0,0%
2002	669	1 394	-35	184	849	0,22	363,2%	13,0	2,07	1,4	0,00	0,0%
2003F	612	1 086	-55	-4	849	-0,01	-	-	2,02	1,4	0,00	0,0%
2004F	658	1 179	18	16	849	0,02	-	149,5	2,04	1,4	0,00	0,0%

F - BRE Bank Securities forecast.

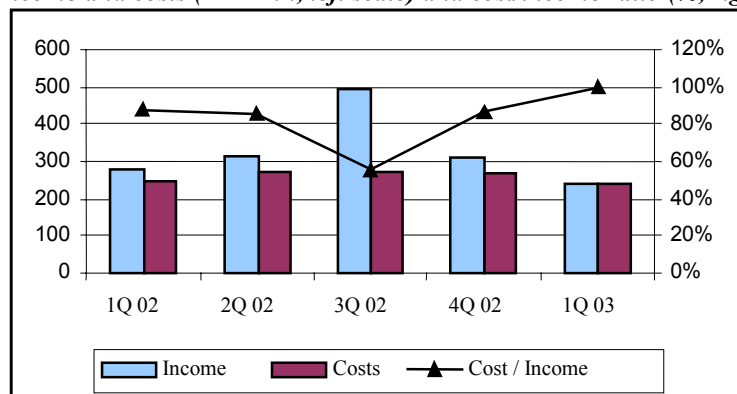
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**Why is the situation bad?****1Q 2003 results**

	1Q03	1Q02	Change (%)	Deviation from consensus	Deviation from BRE Bank forecast
Net interest income	142	156	-9%	N/A	-9%
Profit on banking activity	232	283	-18%	N/A	-12%
Costs	-240	-246	-2%	N/A	4%
Operating profit	1	35	-98%	N/A	-98%
Net provisions	-12	-31	-61%	N/A	-69%
Gross profit	-22.9	-5.0	-	N/A	-
Net profit	30	47	-36%	N/A	38%

Source: Bank, BRE Bank Securities

The net profit generated by Bank Millennium was higher than we expected (PLN 30 mn vs. an expected PLN 22 mn), and despite this we are disappointed with the bank's results. The bank noted a **lower income than we expected** (-12%) and higher costs (+4%), as a result of which operating profit before provisions was almost zero, amounting to PLN 0.7 mn. **The cost/income ratio was on a level of 99.7%**, which is the best illustration of the bank's inability to generate income significantly exceeding costs.

**Income and costs (PLN mn, left scale) and cost/income ratio (% , right scale)**

Source: Bank, BRE Bank Securities

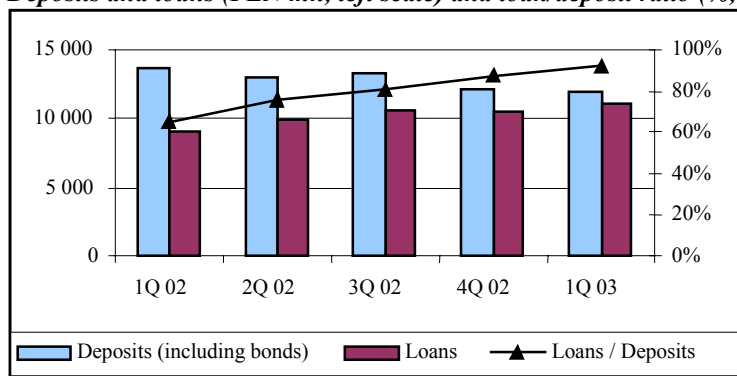
Why such a low operating profit before provisions? Simply stated, it turned out the king has no clothes. Q1 results exposed the weakness of Polish banks in terms of income, and Millennium in particular. When income from one-time transactions dried up (the bank generated PLN 226 mn on the sale of the pension fund alone in 2H 2002, which accounted for 16% of income), attention turned to income from strictly banking activity. In this case as well, there was no income that increased profit as occurred last year: **there were no spectacular capital profits on bonds** like last year when sharply falling interest rates translated into an increasingly higher valuation of debt papers. Millennium's 18% drop in profit on banking activity, in comparison with Q1 2002, **could be a foretaste of what other banks will show in results for 1Q 2003.**

How much of Bank Millennium's low income is due to the situation of the bank itself and how much is due to the general condition of the sector? In our opinion, the reason for the declines is due to external factors, but the bank disappointed us as, **due to the completion of restructuring, we expected the bank to be able to manage substantially better than the competition** and maintain recurrent income on last year's level.

As in the entire sector, Millennium's deposit base is shrinking and even including savings bonds, the decline amounted to 13.1% in comparison with 1Q 2002 and 1.2% in comparison with 4Q 2002. The steady growth in loan activity is good news (22.9% increase in comparison with 1Q 2002 and 4.4% with 4Q 2002) as is the fact that it is mainly driven by the growth in the volume of retail loans (their share in total loans increased from 25% last year to 32% at present).



*Deposits and loans (PLN mn, left scale) and loan/deposit ratio (% , right scale)*



Source: Bank, BRE Bank Securities

The bank explained the interest margin on interest-bearing assets remaining on the level noted in 1Q 2002 (3.9%) by the increase in the share of loans in interest-bearing assets (from 57% to 74%), although it should be noted that **in comparison with 4Q 2002 the margin fell 0.6 p.p.** The decline in the margin could be connected with lower income from SWAP operations. Despite our hopes, this decline was not compensated by the increase in the loan margin (we expected the larger share of retail loans to translate into larger interest spreads).

The bank's changes in the method of presenting commissions paid to loan mediators hinder making a precise evaluation of the dynamic of **commission income**, which totalled PLN 49 mn and increased 5% in comparison with data published last year. We note that in the current financial report, Q1 2002's net interest income was increased from the PLN 47 mn shown last year to PLN 58 mn, while the change in the method of presentation, introduced in 2H 2002, was explained by the presentation of costs borne on commissions for loan mediators in the items: interest income and interest costs. Therefore, the bank's explanation that payments to outside loan mediators was the reason for the lower commission income in the final quarter is unclear (perhaps this involves a different group of mediators than those whose services are settled by net interest income). The lower commission income is a reflection of the trend common for other banks: a decline in the volume of transactions and clients shifting toward less expensive channels of distribution.

In regard to other income, the bank noted **much lower income from financial operations** (-68.5% in comparison with 1Q 2002, which the bank explained by the lack of profits on the bond portfolio) and **higher income from foreign currency operations** (a 53% growth in comparison with 1Q and 10% in comparison with 4Q 2002).

Finally, profit on banking activity fell both in comparison with 1Q and 4Q 2002 (18% and 17% respectively, and total income 14% and 23%).

Unfortunately, declining income was not fully compensated by declining costs. **Costs fell** (2.4% in comparison with 1Q 2002 and 11% with 4Q 2002), but this decline is smaller than the decline in income as well as smaller than the decline in employment (-23%). Employment costs alone fell 7% - while personnel costs could not be expected to fall at the same rate as employment (individuals performing simple duties and earning less than the average wage paid by the bank are made redundant), an overall control of costs (e.g., a reduction in the board's emoluments, which last year accounted for almost 7% of total personnel costs) could be expected.

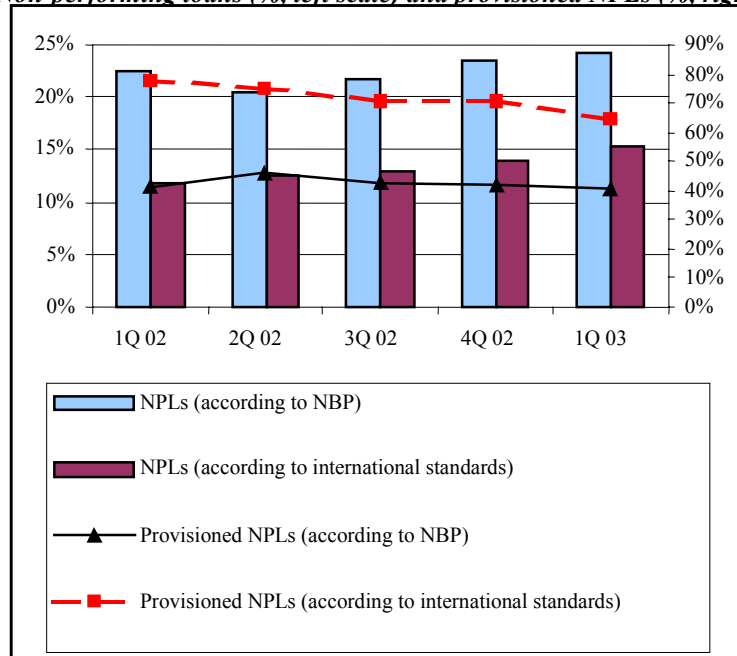
### **If the situation is so bad, why is it good (on the level of net profit)?**

Despite the minimal operating profitability (before provisions), the bank generated a net profit of PLN 30 mn and an **annualised return on equity (ROE) of 6.8%**. The positive net result was due to the change in principles of creating a general risk reserve, the positive result in the item income tax as well as consolidating the result of the PZU group.



Net provisions totalled only PLN -12.4 mn, which according to the bank resulted from the improvement in managing credit risk as well as from the change in the policy relative to the general reserve (caused by signs of an improvement in the economic situation in Poland).

*Non-performing loans (% , left scale) and provisioned NPLs (% , right scale)*



Source: Bank, BRE Bank Securities

The information above raises serious doubts. First, data concerning non-performing loans are not a source for optimism. **The growth in non-performing loans according to international standards is particularly unsettling.** This data suggests that a worsening in the situation is occurring not only from a purely formal point of view but simply due to increasingly more loans not being repaid on time. Second, it is difficult to detect unequivocal signals in the economy testifying to an improvement in the situation of businesses. Therefore, the increasingly lower level of provisioned non-performing loans gives rise for concern.

To date the bank has maintained the general reserve on a level of 1.5% of corporate and mortgage loans as well as 2.5% of other retail loans. Currently, **the bank decided to maintain the mandatory reserve on the minimum level required by the regulator**, which is only 1.5% of consumer loans (non-mortgage retail loans). This most probably means the dissolution of a portion of the general reserve (basically the change in principles only involves the creation of new reserves but we suspect that the bank repeated the operation from 1H 2002, when it dissolved a portion of this reserve). The exact level of the general reserve for the end of 1Q is not known.

The bank announced that its gross loss totalled PLN -23 mn (we expected a loss of PLN 10 mn). However, **the settlement of income taxes was positive** (PLN +16.7 mn), which the bank owes to the fact that some costs, not acknowledged earlier as costs of obtaining income, could be acknowledged as costs in tax terms in 1Q 2003. Such was the case in 1, 2 and 3Q 2002.

The majority of the bank's net profit again originates from the consolidation of PZU profit. **PZU group profit booked by the bank totalled PLN 36 mn**, which including the PLN 11 mn of goodwill amortisation, increased the bank's net profit PLN 25 mn (83% of the total profit of the Millennium group).

**Why will the situation become worse?**

The **finalisation of the Polcard sale** should be wrapped up in coming months (2 or 3Q). For Millennium this means an extra PLN 46 mn gross (PLN 33 mn net) will be booked in one of the



next quarters. At that time, it would appear that the potential of one-time transactions and booking operations, propping up the bank's profit, will be exhausted:

- The change in the policy with respect to creating a general reserve **reduced the possibility of dissolving it in the future.**
- According to information received from the bank, it also results that the bank will effectively pay taxes throughout 2003; therefore **it is difficult to expect a positive balance of income tax settlements** in coming quarters.
- **The bank decided to cease consolidating PZU beginning in 2Q of this year.** This decision was explained by the fact that BCP reduced its commitment in Eureko to 5%. Therefore, beginning next quarter, the bank's profit and loss account will see a quarterly reduction of approximately PLN 25-30 mn originating from Millennium booking the relevant portion of the insurer's profit. On the other hand, by not consolidating PZU the bank will include dividends received from the insurer in its income and it will not encumber statements with the costs of amortising goodwill (approximately PLN 11 mn per quarter). As Millennium's financial statements do not currently contain the PZU result, **a separate valuation of the insurer should be made in valuating the bank.**
- **We see no opportunities for the bank to conduct subsequent transactions,** which would generate one-time capital profits. For legal and business reasons, we believe the sale of holdings in PZU is unlikely.

As a result, the entire burden of generating profits will rest on core activity. In our opinion, Millennium's banking business cannot bear this burden. Our answer to the most important question, is the bank able to achieve a decent operating profitability (before provisions), is no. **Results for 1Q dashed our hopes that the restructured bank will be able to maintain income from core activity on the level noted in 2002.** On the side of costs, despite small declines, the result of reducing employment 23% is not visible. Therefore, in our opinion, even recovering the operating profitability noted last year would be a success. With the potential for profits from one-time transactions coming to an end, results will be substantially lower than last year.

#### **Summary and recommendation**

We hoped that 1Q would bring the first signs showing the positive effects of restructuring that was completed last year. Unfortunately, the bank's results dashed these hopes. As a result, we are lowering our forecasts and **lowering the target price from PLN 2.95 to PLN 2.50 as well as downgrading the recommendation from Hold to REDUCE.** Simultaneously, we maintain the opinion that the bank's shares could be attractive should BCP decide to sell its holdings, but so far there is no reliable information that would point to this scenario playing out.



*Assumptions for DDM model*

	2003	2004	2005	2006	+
Risk free rate	5.7%	5.7%	5.7%	5.7%	5.0%
Risk premium	5.3%	5.3%	5.3%	5.3%	5.00%
<b>Expected rate of return</b>	<b>11.0%</b>	<b>11.0%</b>	<b>11.0%</b>	<b>11.0%</b>	<b>10.0%</b>

Source: BRE Bank Securities

*DDM valuation*

	2003	2004	2005	2006	+
BVPS (PLN)	2.0	2.0	2.2	2.4	
ROE (%)	-0.3%	0.9%	6.9%	10.4%	11%
EPS (PLN)	-0.01	0.02	0.14	0.24	
EPS growth (%)	-102%	-463%	668%	65%	4%
Target P/BV					1.17
Future value					2.83
<b>Discounted future value</b>					<b>2.07</b>
Dividend	0.0	0.00	0.00	0.08	
<b>Discounted dividend</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.06</b>	<b>0.06</b>
<b>Profit from sale of PZU (discounted)</b>					<b>0.38</b>
<b>Target price (12. 2003)</b>					<b>2.50</b>

Source: BRE Bank Securities

*Ratios for selected banks in the region*

Banks	P/E			ROE			P/BV		
	2002	2003F	2004F	2002	2003F	2004F	2002	2003F	2004F
OTP	13.5	12.0	9.5	25.2%	23.2%	24.1%	3.07	2.54	2.07
Komercni Banka	11.8	10.1	8.9	23.5%	22.2%	21.3%	2.48	2.06	1.74
Handelsbank	11.3	9.7	N/A	21.1%	20.9%	N/A	2.20	1.88	N/A
<b>Average</b>	<b>12.2</b>	<b>10.6</b>	<b>9.2</b>	<b>23.3%</b>	<b>22.1%</b>	<b>22.7%</b>	<b>2.6</b>	<b>2.2</b>	<b>1.9</b>
<b>Polish banks</b>									
BIG BG (c)	12.9	-	166.8	11.4%	-0.4%	0.8%	1.35	1.38	1.37
BPH PBK (nc)	51.3	31.7	26.5	2.6%	4.1%	4.9%	1.33	1.29	1.33
BRE (nc)	-	N/A	N/A	-18.9%	N/A	N/A	1.07	N/A	N/A
BZ WBK (c)	16.7	14.2	11.7	11.7%	12.1%	13.3%	1.81	1.64	1.48
Handlowy (nc)	26.3	20.5	17.1	4.2%	5.6%	7.8%	1.11	1.11	1.11
ING BSK (nc)	26.2	20.7	17.2	5.7%	6.8%	7.8%	1.45	1.37	1.30
Kredyt Bank (c)	-	32.4	10.1	-17.5%	2.6%	8.2%	0.87	0.85	0.81
Pekao (c)	18.4	12.9	11.9	11.1%	15.1%	15.7%	2.01	1.90	1.85
<b>Average</b>	<b>25.3</b>	<b>22.1</b>	<b>37.3</b>	<b>1.3%</b>	<b>6.6%</b>	<b>8.4%</b>	<b>1.4</b>	<b>1.4</b>	<b>1.3</b>

**Financial data and ratios****PROFIT AND LOSS ACCOUNT (PLN mn)**

	2000	2001	2002	2003	2004	2005	2006
<b>Net interest income</b>	<b>770</b>	<b>589</b>	<b>669</b>	<b>612</b>	<b>658</b>	<b>767</b>	<b>843</b>
Interest income	2 795	2 716	1 932	1 612	1 572	1 803	2 052
Interest expenses	-2 025	-2 127	-1 262	-1 000	-914	-1 035	-1 209
<b>Non-interest income</b>	<b>605</b>	<b>446</b>	<b>725</b>	<b>474</b>	<b>521</b>	<b>589</b>	<b>653</b>
Net fee and commission income	255	214	217	223	264	303	334
Foreign exchange differences	55	58	70	88	105	126	152
Result on financial operations	294	174	437	162	152	160	168
<b>Profit on banking activity</b>	<b>1 375</b>	<b>1 035</b>	<b>1 394</b>	<b>1 086</b>	<b>1 179</b>	<b>1 357</b>	<b>1 496</b>
Other operating income	-33	136	24	26	29	33	34
<b>Total banking income</b>	<b>1 342</b>	<b>1 171</b>	<b>1 417</b>	<b>1 112</b>	<b>1 209</b>	<b>1 389</b>	<b>1 530</b>
<b>Non-interest costs</b>	<b>-1 636</b>	<b>-956</b>	<b>-1 078</b>	<b>-925</b>	<b>-954</b>	<b>-992</b>	<b>-1 031</b>
Personnel costs	-488	-404	-405	-364	-374	-392	-410
Depreciation	-557	-127	-126	-127	-134	-140	-147
Other costs	-591	-426	-547	-433	-446	-460	-474
<b>Operating profit before costs of provisions</b>	<b>136</b>	<b>215</b>	<b>339</b>	<b>187</b>	<b>254</b>	<b>397</b>	<b>500</b>
Net provisions	-138	-254	-337	-231	-237	-235	-230
Others	8	-34	-37	-11	0	0	0
<b>Gross profit</b>	<b>6</b>	<b>-74</b>	<b>-35</b>	<b>-55</b>	<b>18</b>	<b>162</b>	<b>270</b>
Income tax	0	-8	96	14	-5	-42	-70
Subordinated entities	50	102	123	36	3	3	3
<b>Net profit</b>	<b>56</b>	<b>20</b>	<b>184</b>	<b>-4</b>	<b>16</b>	<b>123</b>	<b>203</b>
Dividends paid	0	0	0	0	0	0	-68

**BASIC RATIOS**

Net interest margin (total assets)	4.5%	3.1%	3.5%	3.1%	2.9%	2.9%	2.8%
Net interest margin (working assets)	5.8%	4.1%	4.5%	3.9%	3.5%	3.5%	3.3%
Interest spread	6.8%	5.5%	4.9%	3.9%	3.5%	3.5%	3.4%
Costs / Income	92%	82%	76%	83%	79%	71%	67%
Costs / Assets	9.5%	5.0%	5.6%	4.6%	4.2%	3.8%	3.4%
Personnel costs / Income	28%	34%	29%	33%	31%	28%	27%
Net provisions / Operating profit	101%	118%	99%	123%	93%	59%	46%
Net provisions / Total loans	1.8%	3.4%	3.5%	1.9%	1.5%	1.2%	1.0%
Non-interest income / Total income	32%	50%	53%	45%	46%	45%	45%
Operating profit / Assets	0.8%	1.1%	1.8%	0.9%	1.1%	1.5%	1.6%
<b>ROE</b>	<b>3%</b>	<b>1%</b>	<b>11%</b>	<b>0%</b>	<b>1%</b>	<b>7%</b>	<b>10%</b>
<b>ROA</b>	<b>0.3%</b>	<b>0.1%</b>	<b>1.0%</b>	<b>0.0%</b>	<b>0.1%</b>	<b>0.5%</b>	<b>0.7%</b>

**ANNUAL GROWTH RATE**

Net profit	-83%	-65%	826%	-102%	-463%	668%	65%
Operating profit	-62%	58%	58%	-45%	36%	56%	26%
Total banking income	65%	-13%	21%	-22%	9%	15%	10%
Net interest income	48%	-24%	14%	-9%	8%	17%	10%
Non-interest income	96%	2%	29%	-33%	10%	13%	10%
Non-interest costs	68%	-42%	13%	-14%	3%	4%	4%

**BALANCE SHEET (PLN mn)**

	1999	2000	2001	2002	2003	2004	2005
Cash and Central Bank balances	456	466	283	292	303	318	334
Due from financial sector	1 833	1 687	804	709	523	787	1 036
Debt securities	5 222	4 955	3 029	2 727	1 909	1 336	1 470
Customer loans	6 369	8 448	10 552	13 718	17 833	21 399	24 609
Equity investments	1 223	427	1 327	1 128	1 241	1 365	1 501
Fixed assets	2 239	960	936	955	983	1 013	1 043
Other assets	839	2 173	1 029	1 059	1 091	1 124	2 281
<b>Total assets</b>	<b>18 181</b>	<b>19 926</b>	<b>18 726</b>	<b>21 342</b>	<b>24 638</b>	<b>28 097</b>	<b>33 030</b>
Liabilities to financial sector	2 230	2 307	2 339	3 158	3 631	3 994	4 394
Deposits	12 503	13 695	11 714	12 300	14 391	16 550	19 860
Securities	300	303	552	1 657	2 154	2 800	3 641
Subordinated debt	0	283	322	322	322	322	322
Other liabilities	1 514	1 868	2 044	2 187	2 406	2 574	2 754
Share equity	1 630	1 471	1 755	1 718	1 734	1 857	2 059
Share capital	425	849	849	849	849	849	849
<b>Total equity and liabilities</b>	<b>18 181</b>	<b>19 926</b>	<b>18 726</b>	<b>21 342</b>	<b>24 638</b>	<b>28 097</b>	<b>33 030</b>

**ASSET ANALYSIS**

Share of NPLs in total loans	19%	19%	25%	22%	17%	14%	12%
NPLs / Assets	7%	8%	14%	14%	12%	11%	9%
Provisions / NPLs	24%	47%	44%	39%	39%	39%	39%
Provisions / Total loans	5%	9%	11%	9%	7%	5%	5%
Provisions / Assets	2%	4%	6%	6%	5%	4%	4%
Non-provisioned NPLs / Equity	57%	59%	84%	106%	106%	99%	89%

**BALANCE SHEET RATIOS**

Equity / Assets	9%	7%	9%	8%	7%	7%	6%
Loans / Assets	35%	42%	56%	64%	72%	76%	75%
Deposits / Assets	69%	69%	63%	58%	58%	59%	60%
Loans / Deposits	51%	62%	90%	112%	124%	129%	124%
Growth rate of loans	-28%	33%	25%	30%	30%	20%	15%
Growth rate of deposits	10%	10%	-14%	5%	17%	15%	20%
Growth rate of assets	13%	10%	-6%	14%	15%	14%	18%

**Previous recommendation issued for Bank Millennium S.A.**

<b>recommendation</b>	HOLD
<b>date issued</b>	02-04-2003
<b>price on day of recommendation</b>	2.80
<b>WIG on day of recommendation</b>	13910.34

*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*