



RESEARCH REPORT

Pekao

Banks

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Warsaw, 23.02.04

Pioneer could not save the quarter

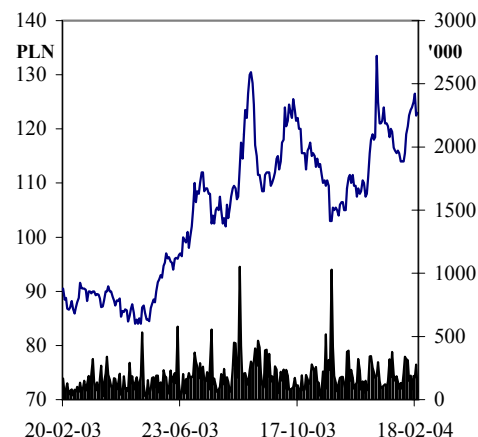
• As usually, quarterly results showed Pekao's weakness. The bank is continuing to lose retail clients (135 thous. accounts and 87 thous. payment cards were lost in 4Q), its loan portfolio is shrinking (-2.9%) and the volume of deposits is falling (including bonds, the decline amounted to 3.3%). Due to the investment funds noting a worse quarter, Pioneer was unable to compensate for these negatives, both in terms of volume (assets managed by the funds grew only 1.8%, as a result of which total savings fell 1.7%), and the result (commission income fell 7.8%).

• Interest margins increased slightly and smaller losses on bonds allowed income to increase in relation to 3Q (+2.0%). However, costs, mainly due to higher amortisation, grew more (+4.6%) and operating profit again fell (-1.6%). In comparison to previous quarters, costs of provisions increased (PLN -183 mn vs. PLN -74 mn in 3Q), causing both gross and net profit to fall (-35% and -36% respectively). The bank managed to neutralise the effect of calculating tax assets and despite the costs connected with this, Pekao noted an effective tax rate (26%) similar to the statutory rate.

• The bank itself generated a smaller profit in 2003 than in the previous year, while the increase in Group profit is due to better results of subsidiary companies. Nevertheless, Pekao remains the most profitable large publicly traded bank, even despite the bank "missing out" on market growth. Paradoxically this could be taken as a positive, as it shows that the bank could increase profitability if it stops losing market share.

• Pekao announced that in 2004 it intends to concentrate on mortgage loans and loans for small and medium-size enterprises (SME) as well as investment funds and credit cards. We concur in principle with the adopted strategy. The question is whether the bank will be able to meet its own goals. Despite numerous reservations (which we present in the report) for the first time in several quarters, we have the impression that Pekao's presentation contained more than just words. In our opinion, the management board understands what methods are needed to change the bank's course; better products and appropriate motivation on the part of employees. (The management board not only tied the general business goals with the goals in individual MBO programs, but also held a series of meetings with mid-level management in order to show what is expected from them.)

• It seems that we are more favourable disposed to the new management board than the majority of domestic observers, who are disappointed by the lack of hard numbers and the "soft style" of management presented by the president. We shall see who is right in six months at the earliest (in our opinion the first quarter will not be the turning point). Until then, we do not expect much good news, but we do believe that any possible weakness in the share price would be an opportunity to accumulate the bank's shares. We are maintaining our investment recommendation HOLD.



Recommendation **HOLD**

Price 123
Valuation 104

Basic Data

Number of shares (mn) 166,1
Free float (PLN mn) 8 072
Market cap (PLN mn) 20 433

Shareholders Structure

UCI 53,05%
EBRD 3,31%
State Treasury 4,14%
Others 39,51%

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| | Net interest income (PLN mn) | PBA (PLN mn) | Gross profit (PLN mn) | Net profit (PLN mn) | No. Shares (mn) | EPS (PLN) | EPS growth (%) | P/E | BVPS (PLN) | P/BV | DPS (PLN) | Dividend rate (%) |
|-------|------------------------------|--------------|-----------------------|---------------------|-----------------|-----------|----------------|-----|------------|------|-----------|-------------------|
| 2001 | 2 890 | 4 796 | 1 766 | 1 252 | 165,7 | 7,6 | 48% | 16 | 41 | 3,0 | 3,8 | 3,1% |
| 2002 | 2 868 | 4 798 | 1 173 | 770 | 165,7 | 4,6 | -39% | 26 | 42 | 2,9 | 4,2 | 3,4% |
| 2003F | 2 375 | 4 073 | 1 279 | 919 | 166,1 | 5,5 | 19% | 22 | 43 | 2,9 | 4,6 | 3,7% |
| 2004F | 2 226 | 4 194 | 1 437 | 1 151 | 166,6 | 6,9 | 25% | 18 | 45 | 2,7 | 6,0 | 4,9% |
| 2005F | 2 071 | 4 249 | 1 485 | 1 204 | 166,6 | 7,2 | 4% | 17 | 47 | 2,6 | 7,0 | 5,7% |

NOTE: F - BRE Bank Securities forecast

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Looking Back (4Q 2003 results)

Pekao's quarterly results again disappoint

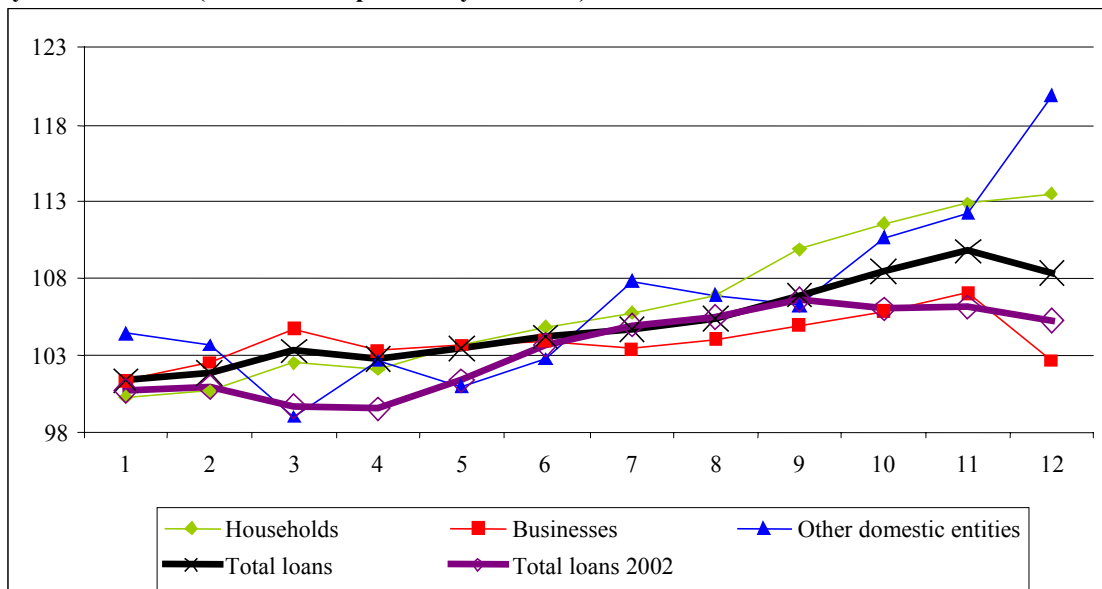
The pessimists again turned out to be right. The bank's results were close to the lower limit of analysts' expectations, mainly due to higher provisions and slightly lower income.

| | 4Q 03 | 4Q 02 | 4Q 03/ 4Q 02 | 3Q 03 | 4Q 03/ 3Q 03 |
|----------------------------|------------|------------|-----------------|------------|-----------------|
| Loans | 26 528 | 29 395 | -9.8% | 27 363 | -3.1% |
| Deposits | 45 955 | 48 378 | -5.0% | 46 102 | -0.3% |
| Interest result ("pure") | 599 | 714 | -16.1% | 575 | 4.1% |
| Profit on banking activity | 989 | 1 372 | -27.9% | 989 | 0.0% |
| Costs | -597 | -581 | 2.7% | -571 | 4.6% |
| Operating profit | 408 | 853 | -52.1% | 415 | -1.6% |
| Provisions | -183 | -269 | -31.7% | -74 | 149.2% |
| Gross profit | 225 | 487 | -53.9% | 345 | -34.8% |
| Net profit | 161 | 329 | -51.0% | 252 | -35.9% |

Balance sheet items

Against earlier hopes, signs of a growth in the loan portfolio did not appear in 4Q, but this could have been expected following the recently published statistics of the National Bank of Poland. According to data of the central bank, corporate borrowing fell substantially in December (the traditional seasonal effect was particularly strong this year).

Dynamic of loans (December of previous year = 100)



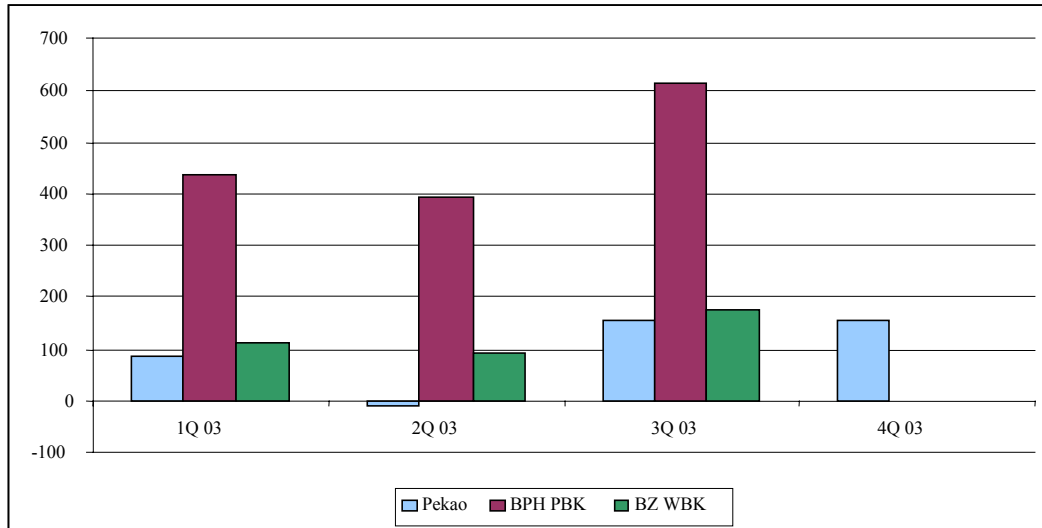
Source: NBP, BRE Bank Securities

In December 2003, corporate loans in the sector fell by PLN 5.6 bn, or 4.1%, while the quarterly decline amounted to 2.2%. In particular, the foreign currency loans of private business were repaid (-6.2%). The quarterly decline in corporate loans in Pekao was stronger than the sector average (-3.4%), but this should come as no surprise due to the limited attractiveness of the bank's offer on the market of large loans and the fact that the bank is only now preparing a more attractive offer for small and medium-size enterprises (SME). Nor have we forgotten about the repayment of a loan for a central investment, which reduced the total value of loans in 4Q PLN 56 mn (0.2% of the portfolio).

The market weakness of Pekao is even more evident on the retail market. While the sector's lending activity for households continues to grow (+3.3% in 4Q), Pekao's portfolio has shrunk 1.0%. The bank announced that overdrafts, retail loans for purchasing means of transport and cash loans declined in 2003.

The growth in mortgage loans, which increased during the year only PLN 352 mn, did not compensate for this. The weak position in mortgage loans had a negative influence on the bank's dynamic of balance sheet items and in other retail loans – on the bank's margin. This is illustrated in the chart below.

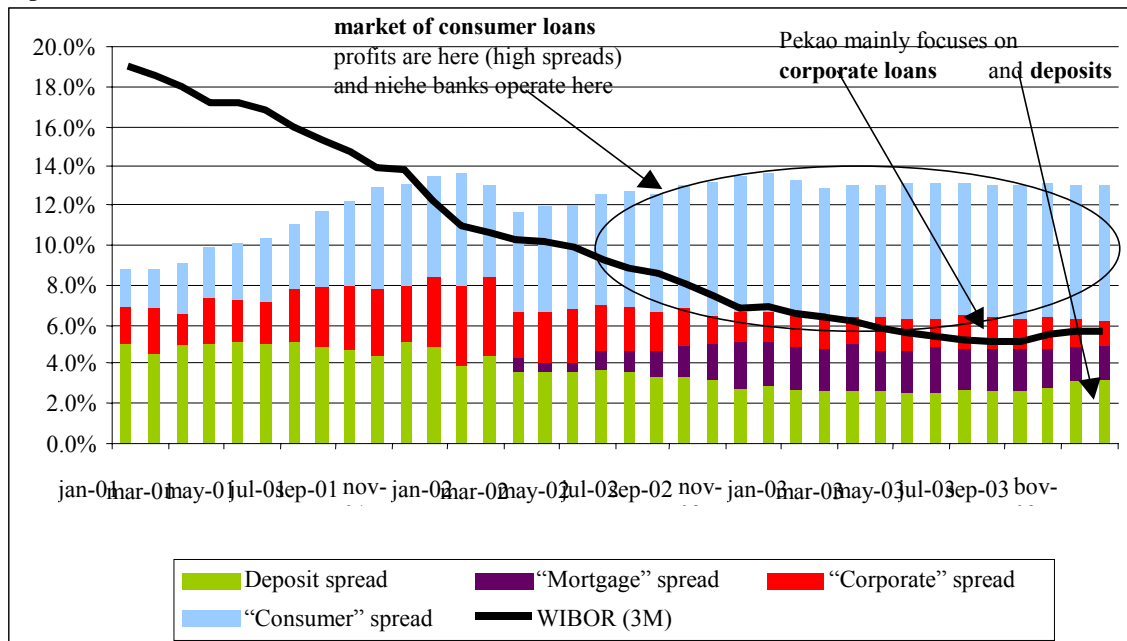
Quarterly increase in mortgage loans (PLN mn)



Source: banks, BRE Bank Securities

The new procedure for extending loans made a slight improvement in the sales results of mortgage loans possible in 3Q, but 4Q did not see a further improvement, which should raise flags in light of the record increases expected in BPH PBK. Pekao has a long way to regain a significant market share, but it appears that the bank has taken the initial steps in this direction. Subsequent procedures for improving the loan approval process were introduced (the application period has been shortened to 8 working days), the product offer is to be broadened and distribution channels are to be expanded through cooperation with mediators as well as a growth in the number of salesmen. Without significant successes on the mortgage market, Pekao will not be able to increase loans at a rate equal to the sector average.

Spreads in the sector



Source: NBP, BRE Bank Securities



In our opinion, the absence of Pekao in segments that, despite huge drops in interest rates, have maintained high spreads, is even more painful for the bank, and particularly for its results. This is particularly evident in regard to various types of consumer credit (automobile, overdrafts, instalment loans, credit cards). While we understand the bank's intention of limiting the most risky loan categories (we do not accept the argument that there is no money to be made on them – it is all a question of proper evaluation of risk and appropriate vindication procedures – but not every bank has to be a specialist in every field), in our opinion, neglecting the credit card market was a big mistake. However, signs are appearing here that the bank is aware of its mistakes, which is the first step to correcting the situation.

The bank noted a minimal decline in deposits (-0.3% q/q). Unfortunately, as deposits in the sector grew (+3.4%), this means another quarter in which the bank has lost market share. Moreover, due to the smaller increase in assets of the investment funds (assets of funds managed by Pioneer increased only PLN 175 mn, against an average of approximately 1.5 in the three previous quarters), the bank's situation in the savings market is weakening. The number of accounts managed by the bank is also steadily declining (135 thous. retail accounts and 7.4 thous. corporate accounts were lost in 4Q) as is the number of active payment cards (-87 thous.). In our opinion, the outflow of clients is unavoidable. Old and newly established banks are attracting new clients not only from the group of people who have not yet used banking services, but primarily from other banks and the second largest retail bank will certainly lose clients. Pekao's weakness lies in the fact that its offer is not sufficiently attractive and, as a result, the bank is unable to obtain enough new clients to compensate for the outflow of old clients.

Income

Interest income ("pure") increased slightly in 4Q (+4% q/q, NIM 3.75% against 3.57% in 3Q). Unfortunately, the bank again noted a loss on SWAP operations (PLN 26 mn) and the margin including these operations remained virtually unchanged (3.58% against 3.50 in 3Q and 3.52% in 2Q). The level of margins noted a year earlier (in 4Q 2002, NIM was 4.35%) have long been forgotten, and it is no surprise that interest income fell 16% y/y.

In accordance with expectations, the bank noted lower commission income in 4Q than in the previous quarter (-8% q/q, but + 11% y/y). Loan commissions were low the entire time, while on the company level costs appeared connected with servicing payment card payments by a spun off company. Despite the fact that in terms of investment funds, this quarter was not as successful as 3Q, the bank's income did not suffer much for this reason.

From the commentary to the quarterly results presented by the bank it would appear that in 4Q Pekao did not bear a loss on bonds (the annual loss on the result from the valuation and sale of securities and the derivatives securing them amounted to PLN 22.6 mn, while following 1-3Q it amounted to PLN 25.6 mn and therefore in 4Q the bank earned PLN 3 mn). The loss on financial operations is largely due to the loss on SWAP operations (PLN -26 mn) and on the sale of Pekao Tel-Aviv (PLN -10 mn).

Other costs and income were higher than in previous quarters, largely due to accruals, the balance of which was PLN +17 mn relative to the range of PLN -4/+4 mn noted in previous periods.

Generally, income was slightly higher in relation to 3Q (+2%), but 30% lower than one year ago (but at that time the bank noted an accumulation of profits on bonds).

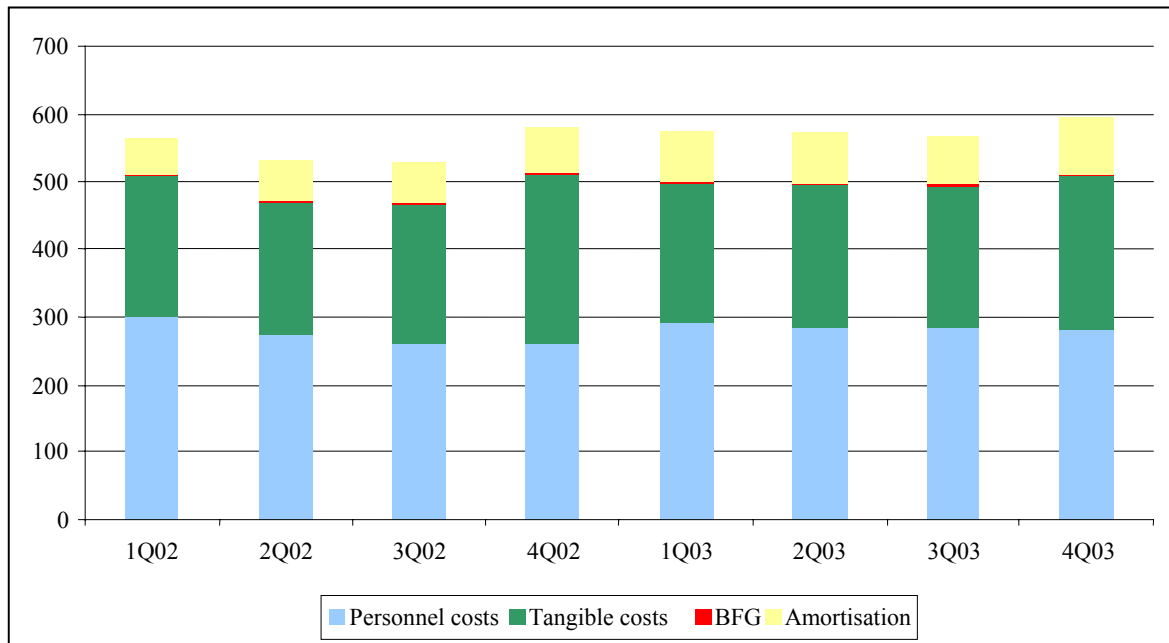
Costs

Costs are traditionally higher in 4Q (+5% q/q, +3% y/y), but this year the higher costs were mainly the result of higher amortisation (+18% q/q, +28% y/y), with operating costs and administrative costs remaining virtually unchanged. In 4Q, personnel costs again fell slightly (-1.1% q/q, +8% y/y), while tangible costs grew (+8% q/q, -10% y/y).

The bank explained the annual growth in personnel costs (PLN +48.3 mn, +4.4%) by the increase in incentive components of wages and salaries (it should be stressed that the bank assigned these costs to all quarters and did not encumber only 4Q with them). The sale of Pekao Tel-Aviv as well as subsequent layoffs also had a positive impact on costs. Group employment fell in 2003 by 641 people as a result of the departure of 700 people within the framework of group layoffs and selective new hires.

Tangible costs fell PLN 5.5 mn in 2003 (-0.6%). As part of cost control measures, the bank managed to reduce costs of security and rent, while costs of postal services increased (probably due to sending information to clients transferred to the new IT platform) as did costs of consulting services.

Quarterly costs of Pekao (PLN mn)



Source: bank, BRE Bank Securities

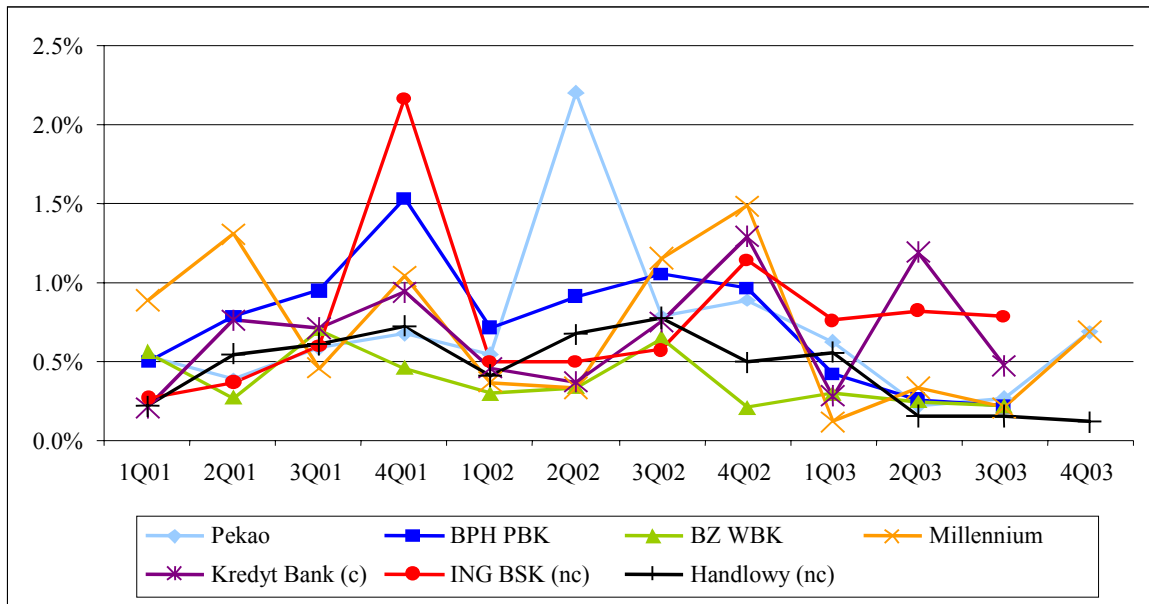
Operating profit and costs of provisions

As costs grew faster than income, operating profit once again suffered (-2% q/q, -52% y/y). A comparison with 4Q 2002 is particularly unfavourable as this is a comparison of the bank's weakest quarterly performance for three years with the best quarter in the bank's history (or rather the Group's history, as this a discussion of the consolidated result).

Following the very low net provisions in 2 and 3Q, the bank signalled that higher costs of credit risk should be expected in 4Q, but we were unaware that this meant a return to the level of net provisions noted in 1Q 2003 – the final quarter in which the entire sector was engaged in creating provisions.

The bank did not give convincing reasons for the growth in costs of provisions in 4Q. Therefore, we must rely on fundamental data: in the last period the percentage share of non-performing loans increased (from 21.8% in September to 24.7%), which to some degree resulted from the decline in total loans.

Net provisions as a % of the average loan portfolio



Source: banks, BRE Bank Securities

It appears that the entire sector traditionally notes higher net provisions in 4Q than in earlier quarters (as shown by the cases of Bank Millennium and Pekao, not to mention Kredyt Bank). Of course, this is not the case in all banks. ING BSK creates high provisions in earlier quarters making it possible to maintain (and possibly even lower) net provisions. We expect BZ WBK to again note low costs of credit risk and BPH PBK will also note similar success this period (which however could raise concerns by those investors that remember the bank's earlier problems with the quality of the portfolio and view the bold development of foreign currency loan activity with a critical eye).

Gross profit, taxes and net profit

Gross profit totalled only PLN 225 mn, but the level of taxation was a pleasant surprise. Despite additional costs, connected with calculating tax assets (approximately PLN 80 mn), taxes on gross profit were similar to the statutory rate and the effective rate amounted to 26%. This partly resulted from tax benefits from the sale of Pekao Tel-Aviv (approximately PLN 30 mn), and probably in part from the optimisation of taxes (this could mean increased taxation next year but due to the reduced tax rate it is much to the bank's advantage).

Net profit totalled PLN 161 mn in 4Q. This result would have been worse if the effect of the lowered valuation of marketable securities, shown as PLN 104 mn in capital from revaluation, had appeared in the profit and loss account. If the bond market does not improve, a loss in this amount will encumber the bank's future results.

Summary of results

Annualised ROE in 4Q was 9.1%. In addition, against all appearances, year-end results are bad: the improvement in relation to 2002 is due to better results of subsidiary companies (primarily the higher profit noted by CDM, and lower losses of the leasing company), while the result of the bank itself worsened (the bank's gross result fell from PLN 1355 mn in 2002 to PLN 1311 mn in 2003, i.e. by 3.2%).

On the other hand, comparing the results of Pekao with those of other banks we will most likely again have to state that the largest publicly traded bank remains the most profitable bank. Besides, return on equity and not market share or growth in assets is what should be of the utmost interest to investors. The fact that Pekao achieves the best results, despite the bank ignoring signs of economic recovery, is a plus for the bank. Other banks have already reacted to the recovery, increasing loan activity and despite this are noting worse results. They are unable to improve results much, but Pekao, if it finally takes the bull by the horns has a chance to strengthen its position as the most profitable publicly traded bank. But will Pekao's market shares finally stop declining?



Looking Forward (Prospects for the future)

Pekao's priorities for 2004

The bank announced that it will focus on mortgage loans and loans for small and medium-size enterprises (SME) as well as on the investment funds and credit cards.

As for principles, we concur with the presented strategy. We do not believe in the “we will do everything” type of approach, and the choice of priorities is, in our opinion, the correct choice. The problem lies elsewhere: will the bank be able to implement the tasks it has set for itself – for almost two years we have heard about the planned growth in income only to view the “Ready for Expansion” presentation once again.

Mortgage loans

Pekao assumes the strong growth in the market of mortgage loans will continue (expecting a 29% growth in 2004) and believes this is the most important product in acquiring and holding on to clients and in cross-selling. Due to activities undertaken Pekao hopes to quickly recover market share.

We are pleased that the bank has stopped blaming the small increase in loan activity on external circumstances (it stated earlier that foreign currency loans, which the bank limited according to plan, were more popular on the market), and has begun working on the quality of its own offer. The bank's presentation mentioned a desire to enrich the offer by introducing flexible payment programs as well as combinations of mortgage loans and overdrafts (therefore, this would be a form of mimicking the very popular Multiplans). As can be seen, Pekao is finally looking at the competition and taking steps to systematically improve its offer.

Loans for SMEs

In regard to other loans, the bank is focusing on the SME sector as well as on growth in selected segments of medium-size enterprises. This does not imply resigning from large corporate clients, but the bank will place an emphasis on profitability and not on a growth in total assets.

The development strategy in the SME sector, potentially correct, raises serious concerns. At first glance, this sector has significant growth potential and the bank has the possibility of obtaining a competitive advantage, as in order to be profitable, servicing SMEs should be based on a model similar to servicing retail clients and Pekao has considerable experience in this regard. Moreover, a key role in obtaining SME clients will be played by the large branch network, which other banks do not have.

In our opinion, the problem lies elsewhere. We wonder whether the SME market will in fact be profitable and whether Pekao is in a position to propose an attractive offer to this group of clients.

In some countries (e.g., Austria), the SME market is considered a deficit-bearing market, as market competition forced margins too low to compensate for the credit risk. While the structure of the banking system in Poland is different (the share of non-profit lending institutions, such as cooperative banks and cooperative savings and credit unions, is small), but due to the considerable interest in the SME sector by banks, we expect strong competition and fear that it will consist in “buying” clients with low interest rates on loans. Loan risk management tools, which remain underdeveloped, can lead to lowering the risk evaluation of lending to small firms, as a result of which banks properly evaluating risk will lose the market and the “growth leaders” will pay for momentary success with large provisions.

Even if the SME market develops on a firm foundation, we doubt whether Pekao will generate much success on it in 2004. Activities planned by the bank are either a repetition of steps announced by the bank for almost two years (e.g., a combined model for servicing affluent clients and SMEs), or an effort to make up lost ground relative to competitors, which have been offering similar solutions for some time (joint servicing together with group entities, e.g., leasing companies). Offering Pekao24 services in the passive form (i.e., without the possibility of performing operations) to owners of small and micro-size firms, mentioned among the bank's achievements, is an embarrassment. A fully functional product is planned to be introduced this year, but until it is Pekao will remain far behind other banks offering services for SMEs.



Investment funds

The bank expects the investment fund market to grow 25% in 2004 and set itself the goal of strengthening its position as leader on this market. In order to achieve this goal, the bank wants to develop cross-selling, enrich products (benefiting from Pioneer's experience), improve management efficiency in client relations as well as improve wealth management in order to obtain additional funds as well as new clients. The latter goal probably involves Xelion. At present, we are not favourably disposed to the development of this company, as its business profile is unclear. If Xelion, only 50% of which is controlled by the bank, obtains clients for PPIM, in which Pekao is a minority shareholder, it will in fact mean a loss of the bank's share in income from asset management. This would mean failure in the last segment in which successes were noted.

Cards

The bank's goal is to increase the number of active cards through shifting the focus from debit cards to credit cards due to the ASP system. A big campaign among clients, a complete review of the card issuing process and product enrichment are planned. Pekao expects to benefit from outsourcing card operations to a data processing centre (the bank spun off this activity to a separate company, for which it plans to obtain a sector investor).

We believe credit cards should be considered a product the client believes is not essential, but which allows the bank to generate significant income on the weakness of clients, which at some point will be enticed by the credit limit. As such, convenient procedures are a necessary, but inadequate, condition to achieve success in this field. Cards must be sold and practically forced onto the client in every conceivable way. As long as Pekao's clients are not "attacked" by the bank's employees, extolling the virtues of this product, and as long as they are not flooded with unordered cards with information that they require only telephone activation, it will be difficult to believe that Pekao will be a significant player on the credit card market. The decision to develop such a firm as Xelion outside the bank can be seen as an expression of fears regarding the effectiveness of Pekao's sales department, which does not bode well for the planned offensive on the credit card market.

However, we are very pleased the bank acknowledges that it has a weak position on the credit card market. Earlier statements by bank representatives who told investors tales about the bank's strong position, resulting from its partnership with LOT, provided no indications for improvement as they showed that the bank had no idea where money could be made.

Transactions

Pekao has set itself the goals of upgrading current accounts and increasing income from transaction fees. This goal involves increasing income from retail clients and increasing the volume of transactions with corporate clients (teams are to be created tasked with increasing share in the market of servicing foreign trade transactions).

Encouraging clients to upgrade accounts for "higher shelf" products is nothing new, but we fear the bank may not be successful in this endeavour. Client flight from Pekao shows that many people do not consider the bank's offer competitive in terms of costs or quality (and most probably the relation of the two). A large segment of clients is dissatisfied with the increasingly higher fees for plans which may have been broadened with new services, but not necessarily with services increasing the functionality of the account from the point of view of the given individual (e.g., overlapping Assistance insurance). Therefore, we have doubts whether the bank will manage to convince a large percentage of clients to change their accounts for more expensive accounts, and with the steady stream of clients leaving the bank, this would mean a decline in commissions from accounts in 2004.

Summary

Despite numerous reservations, for the first time in several quarters, we have the impression that Pekao's presentation contained more than just words. In our opinion, the management board understands what methods are needed to change the bank's course; better products and appropriate motivation on the part of employees.

It will be recalled that the bank continues to improve procedures for granting mortgage loans (the new procedures were once considered revolutionary, now each quarter brings further improvements), is watching the competition and imitating it. However, most important, the bank acknowledges its weakness



on the markets of mortgage loans and credit cards and this is progress in relation to the bank's earlier "head-in-the-sand" attitude.

It should mainly be stressed that the bank has taken steps to motivate employees. The management board not only tied the general business goals with the goals in individual MBO programs, but also held a series of meetings with mid-level management in order to show what is expected from them.

Forecast assumptions for 2004

| Profit and loss account item | Pekao assumption | BRE Bank Securities comment |
|-------------------------------|--|--|
| Net interest income | Net interest income stable due to growth in commercial portion of bank and decline in debt portfolio | In our opinion, margins will fall in the second half of the year. If the bank manages to realise its declared goals, there will be a chance to compensate this decline with higher volumes. Despite all, we forecast interest income will fell 6%. |
| Net fee and commission income | Strong growth resulting from <ul style="list-style-type: none"> • sales of investment funds, • cards as well as • fee increases | We forecast a repeat of the 2003 result and an approximate 14% growth in commissions. We expect higher income from the management of fund assets (greater assets and larger share of stock funds) as well as higher income from new card products. On the other hand, we fear a further outflow of clients dissatisfied with increasingly higher fees. |
| Operating costs | Small growth mainly due to amortisation | We forecast a 3% growth in costs caused by much higher amortisation (+16%) and a slight growth in total costs (+3%), with personnel costs stable (outflow of employees will be offset by new hires, salesmen, as well as wage hikes) |
| Operating result | Positive result due to improvement in income | We expect a small increase (+3%). |
| Costs of credit risk | Small decline caused by introduction of new lending procedure and better economic environment... | ...and mainly due to the fact that the increase in the portfolio in recent years has been small. If only Pekao Leasing would stop causing problems!!! Although on this point we are probably more optimistic than the bank itself, expecting net provisions to fall to 150 bp, or (nominally) 20%. |

Based on these forecasts, we expect a net profit of PLN 1150 mn (if we accepted the bank's assumptions concerning the stability of interest income and only a slight improvement in the costs of provisions, our net profit forecast would be more than PLN 1200 mn). This corresponds to a ROE of 15.6%, and therefore most probably the highest among publicly traded banks.

In accordance with the new option program, adopted by the EGMS in July 2003, the possibility of realising the option is dependent on, among others, the bank achieving a consolidated ROE in 2004 not lower than that resulting from the financial plan approved by the bank's supervisory council. At that time, we expected the bank would reveal the planned level of return on equity, but it turns out that the level of this parameter, on which the acquisition of the right to assume 1.66 mn shares by eligible employees depends (which is an event significant for investors) remains confidential.

It seems that we are more favourable disposed to the new management board than the majority of domestic observers, who are disappointed by the lack of hard numbers and the "soft style" of management presented by the president. We shall see who is right in six months at the earliest (in our opinion the first quarter will not be the turning point). Until then, we do not expect much good news, but we do believe that any possible weakness in the share price would be an opportunity to accumulate the bank's shares.

**PROFIT AND LOSS ACCOUNT**

| | 2000 | 2001 | 2002 | 2003F | 2004F | 2005F | 2006F |
|--|----------------|----------------|----------------|----------------|----------------|----------------|----------------|
| Net interest income | 2 660 | 2 895 | 2 868 | 2 375 | 2 226 | 2 071 | 2 340 |
| Interest income | 7 300 | 7 403 | 5 348 | 3 915 | 3 931 | 3 922 | 4 131 |
| Interest expenses | (4 641) | (4 508) | (2 479) | (1 540) | (1 705) | (1 851) | (1 791) |
| Non-interest income | 1 534 | 1 887 | 1 929 | 1 698 | 1 968 | 2 178 | 2 412 |
| Net fee and commission income | 1 098 | 1 252 | 1 226 | 1 403 | 1 599 | 1 791 | 2 006 |
| Foreign exchange differences | 283 | 380 | 413 | 286 | 277 | 291 | 306 |
| Result on financial operations | 153 | 254 | 291 | 9 | 91 | 96 | 101 |
| Profit on banking activity | 4 194 | 4 782 | 4 798 | 4 073 | 4 194 | 4 249 | 4 753 |
| Other net operating income | 319 | (27) | (26) | 15 | 25 | 25 | 25 |
| Total banking income | 4 512 | 4 756 | 4 771 | 4 088 | 4 219 | 4 274 | 4 778 |
| Non-interest costs | (2 645) | (2 350) | (2 207) | (2 315) | (2 386) | (2 446) | (2 561) |
| Personnel costs | (1 354) | (1 240) | (1 106) | (1 144) | (1 140) | (1 163) | (1 221) |
| Amortisation | (399) | (235) | (243) | (305) | (354) | (365) | (376) |
| Other costs | (892) | (875) | (858) | (866) | (892) | (918) | (964) |
| Operating profit before costs of provisions | 1 867 | 2 406 | 2 564 | 1 773 | 1 833 | 1 829 | 2 217 |
| Net provisions | (682) | (657) | (1 404) | (503) | (410) | (358) | (406) |
| Gross profit | 1 171 | 1 764 | 1 173 | 1 279 | 1 437 | 1 485 | 1 825 |
| Income tax | (385) | (516) | (392) | (362) | (287) | (282) | (347) |
| Group | 8 | 6 | (12) | 2 | 1 | 1 | 1 |
| Net profit | 795 | 1 254 | 770 | 919 | 1 151 | 1 204 | 1 479 |
| Dividends paid | 0 | (630) | (693) | (764) | (1 000) | (1 166) | (1 172) |

CORE RATIOS

| | | | | | | | |
|--------------------------------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|
| Net interest margin (total assets) | 4.1% | 4.0% | 4.1% | 3.7% | 3.5% | 3.1% | 3.3% |
| Net interest margin (working assets) | 4.5% | 4.4% | 4.5% | 4.0% | 3.7% | 3.4% | 3.5% |
| Interest spread | 3.9% | 3.7% | 4.0% | 3.6% | 3.3% | 2.9% | 3.0% |
| Costs / Income | 58.6% | 49.4% | 46.3% | 56.6% | 56.6% | 57.2% | 53.6% |
| Costs / Assets | 4.1% | 3.3% | 3.2% | 3.6% | 3.7% | 3.7% | 3.6% |
| Personnel costs / Income | 30.0% | 26.1% | 23.2% | 28.0% | 27.0% | 27.2% | 25.5% |
| Net provisions / Operating profit | 36.5% | 27.3% | 54.8% | 28.4% | 22.4% | 19.6% | 18.3% |
| Net provisions / Total loans | 2.3% | 2.0% | 4.5% | 1.8% | 1.5% | 1.2% | 1.2% |
| Non-interest income / Total income | 41.1% | 39.1% | 39.9% | 41.9% | 47.2% | 51.5% | 51.0% |
| Operating profit / Assets | 2.9% | 3.3% | 3.7% | 2.8% | 2.9% | 2.8% | 3.1% |
| ROE | 16.7% | 20.1% | 11.1% | 12.9% | 15.6% | 15.7% | 18.5% |
| ROA | 1.2% | 1.7% | 1.1% | 1.4% | 1.8% | 1.8% | 2.1% |

ANNUAL GROWTH RATE

| | | | | | | | |
|----------------------|--------|---------|---------|---------|--------|--------|-------|
| Net profit | 363.4% | 57.7% | (38.6%) | 19.4% | 25.2% | 4.6% | 22.9% |
| Operating profit | 77.0% | 28.8% | 6.6% | (30.9%) | 3.4% | (0.2%) | 21.2% |
| Total banking income | 27.7% | 5.4% | 0.3% | (14.3%) | 3.2% | 1.3% | 11.8% |
| Net interest income | 30.1% | 8.9% | (0.9%) | (17.2%) | (6.3%) | (6.9%) | 13.0% |
| Non-interest income | 24.3% | 0.4% | 2.3% | (10.0%) | 16.4% | 10.6% | 10.6% |
| Non-interest costs | 6.7% | (11.2%) | (6.1%) | 4.9% | 3.1% | 2.5% | 4.7% |

**BALANCE SHEET (PLN mn)**

| | 2000 | 2001 | 2002 | 2003F | 2004F | 2005F | 2006F |
|-------------------------------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|
| Cash and Central Bank balances | 3 385 | 4 264 | 3 175 | 3 146 | 3 240 | 3 370 | 3 640 |
| Due from financial sector | 8 902 | 8 727 | 7 499 | 6 117 | 6 646 | 6 021 | 8 146 |
| Debt securities | 20 298 | 20 538 | 21 323 | 23 053 | 22 362 | 21 691 | 22 341 |
| Customer loans | 31 581 | 32 951 | 29 395 | 26 528 | 28 120 | 31 494 | 36 219 |
| Equity investments | 619 | 754 | 546 | 542 | 597 | 656 | 689 |
| Fixed assets | 2 200 | 1 952 | 2 057 | 2 162 | 2 270 | 2 339 | 2 409 |
| Other assets | 2 733 | 4 936 | 1 088 | 1 460 | 1 548 | 1 625 | 1 674 |
| Total assets | 69 717 | 74 121 | 65 084 | 63 009 | 64 783 | 67 196 | 75 118 |
| Liabilities to financial sector | 7 461 | 7 931 | 4 371 | 5 076 | 5 280 | 5 491 | 5 601 |
| Deposits | 50 204 | 52 368 | 48 378 | 45 955 | 46 874 | 48 749 | 51 674 |
| Securities | 560 | 329 | 1 208 | 514 | 616 | 739 | 813 |
| Subordinated debt | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Other liabilities | 5 847 | 6 589 | 4 060 | 4 289 | 4 417 | 4 417 | 8 835 |
| Share equity | 5 644 | 6 850 | 7 043 | 7 155 | 7 576 | 7 780 | 8 175 |
| Share capital | 166 | 166 | 166 | 166 | 167 | 167 | 168 |
| Total equity and liabilities | 69 717 | 74 121 | 65 084 | 63 009 | 64 783 | 67 196 | 75 118 |

ASSET ANALYSIS

| | | | | | | | |
|-------------------------------|-------|-------|-------|-------|-------|-------|-------|
| Share of NPLs in total loans | 11.9% | 14.2% | 20.0% | 22.7% | 23.6% | 23.3% | 20.4% |
| NPLs / Assets | 5.7% | 6.7% | 10.1% | 11.0% | 11.8% | 12.5% | 11.2% |
| Provisions / NPLs | 54.3% | 49.6% | 57.5% | 60.2% | 58.8% | 56.6% | 60.3% |
| Provisions / Total loans | 6.5% | 7.0% | 11.5% | 13.7% | 13.8% | 13.2% | 12.3% |
| Provisions / Assets | 3.1% | 3.3% | 5.8% | 6.6% | 6.9% | 7.1% | 6.7% |
| Non-provisioned NPLs / Equity | 32.2% | 36.7% | 39.8% | 38.5% | 41.4% | 46.7% | 40.7% |

BALANCE SHEET RATIOS

| | | | | | | | |
|-------------------------|-------|-------|---------|--------|-------|-------|-------|
| Equity / Assets | 8.1% | 9.2% | 10.8% | 11.4% | 11.7% | 11.6% | 10.9% |
| Loans / Assets | 45.3% | 44.5% | 45.2% | 42.1% | 43.4% | 46.9% | 48.2% |
| Deposits / Assets | 72.0% | 70.7% | 74.3% | 72.9% | 72.4% | 72.5% | 68.8% |
| Loans / Deposits | 62.9% | 62.9% | 60.8% | 57.7% | 60.0% | 64.6% | 70.1% |
| Growth rate of loans | 18.4% | 4.3% | (10.8%) | (9.8%) | 6.0% | 12.0% | 15.0% |
| Growth rate of deposits | 11.7% | 4.3% | (7.6%) | (5.0%) | 2.0% | 4.0% | 6.0% |
| Growth rate of assets | 16.0% | 6.3% | (12.2%) | (3.2%) | 2.8% | 3.7% | 11.8% |

Previous recommendations issued for Pekao

| | | | |
|---------------------------------------|------------|------------|------------|
| Recommendation | Hold | Hold | Hold |
| Date issued | 2003-09-10 | 2003-11-19 | 2003-12-09 |
| Price on day of recommendation | 111.50 | 110.50 | 109.00 |
| WIG on day of recommendation | 19983.97 | 19674.12 | 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.