13 November 2008

Update

BRE Bank Securities

Banks

Poland

Pekao

BAPE.WA; PEO.PW

Hold

(Reiterated)

Current price	**PLN 110.5**
Target price	**PLN 136.2**
Market cap	PLN 28.9bn
Free float	PLN 11.0bn
Avg daily trading volume (3M)	PLN 147.89m

Shareholder Structure

UniCredit	59.36%
State Treasury	3.96%
Other	36.68%

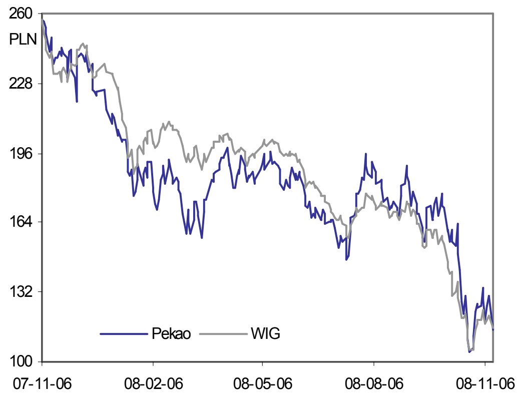
Sector Outlook

The bank industry is feeling the ripple effects of the turmoil observed in international markets, and faces the consequences of the general economic slowdown. As interbank financing becomes harder to get, loan-granting polices will be tightened. The loans/deposits ratio will reach 108%. As financing is becoming a problem, banks are increasingly aggressive in the fight for deposits. We believe this will put significant pressure on their net interest margins, and predict a 12% drop in next year's earnings. As a result, return on equity will decrease from 22% (2008F) to 18% (2009F).

Company profile

After the merger with BPH, Pekao became one of the biggest banks in the CEE region in terms of volumes (assets, loans, deposits). The operational integration of both banks was completed this year. At the moment, Pekao is growing volumes at a rate second to its main rival, PKO BP, which has become the number one bank in loans and deposits.

Pekao vs. WIG



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Shrinking Market Presence

The quality Pekao's third-quarter earnings was disappointing. Recurring income items have been more or less flat on a year to date basis, but display a downward trend compared to the pro-forma figures for FY2007. Deposits in Q308 continued to decrease, pulled down mainly by declining corporate deposits, although household deposits were also growing slower than the average market rate. As a result, the ratio of loans to deposits reached 86% in the period in spite of relatively sluggish lending.

We stand by our view of Pekao. Like we predicted, the bank is losing market share, which is reflected in decreasing revenues. We do not see any room for further cut costs save for existing cost-containment measures and cost synergies. We set our revised per-share price target on Pekao at PLN 136.2, and reiterate a hold rating in anticipation of future earnings revisions, even though our inclination is to underweight the stock versus other banks.

Can costs of risk be kept low?

Provisions in the third quarter approximated PLN 38m (20 bps of average net loans), and Pekao stressed that this was an effect of its prudent lending policy and a conservative approach. The bank's costs of risk are indeed following a trend opposite to that observed at most banks, but, in our view, low costs of risk recorded in FY2008 (a decline to 30 bps from 48 bps and ca. 90 bps in past years) do not necessarily mean equally low levels in FY2009. A cooling economy will be the ultimate test of Pekao's lending policy: if costs of risk remain low while other banks struggle with defaults, the policy works. Unfortunately, the real source of heightened risk during an economic slowdown are corporate customers, who currently represent 60% of Pekao's gross loans.

Trimming dividends

We expect Pekao to cut back dividends next year, and forget the plan to raise nominal payouts each year, even if only by one grosz. As the market wavers, capital is the bank's main strength. The Management say that it is too early to make dividend declarations, especially given current market settings, but we plan to take the possibility of payout trimming into account in our next research report on Pekao.

(PLN m)	2006	2007	2008F	2009F	2010F
Net interest income	4 082	4 323	4 704	4 846	5 162
Net interest margin	3.7%	3.6%	3.7%	3.6%	3.5%
Income f/ bank oper	7 328	8 314	7 905	8 009	8 499
Operating income	3 588	4 510	4 572	4 202	4 503
Pre-tax income	3 494	4 342	4 500	3 793	4 058
Net income	2 562	3 547	3 632	3 060	3 274
ROE	20.7%	23.1%	23.9%	19.1%	19.5%
P/E	7.2	5.2	8.0	9.5	8.8
P/BV	1.3	1.3	1.8	1.8	1.7
D/PS	9.00	9.60	9.82	8.27	8.85
Dividend Yield	8.1%	8.7%	8.9%	7.5%	8.0%

Q308 Roundup

- For another quarter in a row, Pekao was losing market share in both the retail, and corporate business. In consequence, the ratio of loans to deposits increased to 86%. To keep this ratio below 100%, the bank can either keep down the pace of loan growth and thus slow down assets and revenues, or launch a deposit offensive.
- In our view, Pekao is not able to match industry averages when it comes to deposit expansion. There is a downward trend in corporate deposits which is likely to continue into next year, offering a prospect of slow, single-digit growth rates for banks across the board. Given Pekao's large portfolio of corporate deposits, such a slowdown means a significantly impaired lending potential.
- Increased competition for retail deposits leads to tighter margins. Pekao has to accept this fact if it wants to attract household savings to finance the lending business.
- Pekao reported a zero increase in the number of current accounts compared to the second quarter (4.3 million in Q308), and only a slight lift from 4.2 million recorded in December 2007. Other account types demonstrated a very meager upward shift.
- Pekao's decreasing expenses are owed mainly to downsizing. The employee headcount has fallen by 502 since January, with as many as 361 employees leaving in Q308. Other expense items remain more or less flat. We expect to see increasing cost synergies in the coming quarters, which will strengthen the operating income, but which might not be enough to offset eroding revenues.
- Pekao reported very low costs of risk in the third quarter, posting charge-offs of only PLN 38m (20 bps of average net loans). At the same time, the bank recognized an additional PLN 14m allowance in connection with an NPL sale, adjusted for which the costs of risk are only PLN 24m (ca. 13 bps of average net loans). Pekao emphasizes that such low costs of risk compared to other banks are possible thanks to its conservative approach to lending. In our view, low costs of risk recorded in FY2008 (a decline to 30 bps from 48 bps and ca. 90 bps in preceding years) do not necessarily mean equally low levels next year. Pekao set aside higher reserves than other banks in past periods, and can therefore keep them lower now. But the imminent economic cooling will be the ultimate test of the bank's lending policy: if costs of risk remain low while other banks struggle with defaults, the policy works.
- The biggest loan losses will probably be recorded in the corporate segment. Defaults will also surely materialize in the retail segment, however, the exposure in case of individuals is minuscule compared to business borrowers. Currency market volatility has heightened the risks entailed in foreign-currency mortgage loans, however, the burden of FCY loan payments is still much lighter than in the case of zloty loans. In our view, the risks posed by foreign-currency borrowers are the same as in the case of any other customer, and depend on employment and income. Banks which offer foreign-currency loans face the risk of having to secure the currencies to continue lending, and can theoretically be helped by the Central Bank in case of difficulty. The current trend to cut back foreign-currency financing will level the playing field for Polish banks, without affecting their respective growth rates.

Third-Quarter Results

Pekao posted a Q308 bottom-line income in line with expectations. Adjusted for a nonperforming loan sale, net income amounted to PLN 764m vs. our expected PLN 796m, and was flat relative to the second quarter (after adjustment for an estimated PLN 65m gain from the sale of MasterCard, Q208 net income amounted to PLN 777m). This represents a decline from the first-quarter's adjusted bottom-line income of PLN 785m. It seems that Pekao manages to keep posting flat net income figures only thanks to decreasing expenses and low reserves.

All in all, Pekao's third-quarter performance was less than stellar. Interest income decreased relative to the second quarter, and is weaker on a year-to-date basis than the averages recorded by other banks. Fee income fell short of expectations due to lower fees generated non-trading operations. We expected a Q308 fee income of PLN 609.5m, including a non-trading fee income at the same level as in Q208, meanwhile, the bank reported a PLN 40m quarter-on-quarter decline. Trading fees were slightly lower than expected, but were not the main factor which contributed to the fee total missing our estimates. Trading income also missed forecasts. If we took hedging gains from trading income and posted them under interest income, then interest income shows a minor, less-than-1% uptick from Q208. The improvement is still smaller than seen by other banks.

Other net operating income included a PLN 118m (we expected PLN 70m) gain from the sale of nonperforming loans, whose impact on pre-tax income was smaller at PLN 104m because the bank had to recognize an additional allowance of PLN 14m. The sale reduced Q308 net income by PLN 77.2m, suggesting a very high effective tax rate applied to the transaction.

For another quarter in a row, Pekao recorded a decline in deposits by 2% compared to Q208 and 7% versus Q307. This decrease was driven by a declining market of corporate savings which rose 3% Q/Q but fell almost 1% compared to December 2007. By comparison, Pekao lost 3% and 14% respectively of corporate accounts in the period. Household deposits expanded at a below-average pace, as most noticeably reflected in year-to-date growth rates which are 9% for Pekao and 16% on average for the entire banking industry. On a quarter-on-quarter basis, the gap is much narrower. That said, since corporate savings represent over one-half of Pekao's total deposit base, loss of business accounts affects the bank more than it affects the deposit volumes of the industry as a whole. Corporate deposits account for 52% of total deposits in case of Pekao, compared to the industry average of 26.5%, or 43.6% if we add other non-retail deposits.

Pekao's deposit portfolio (PLN m)

	4Q07	1Q08	2Q08	3Q08	Q/Q	YTD
Corporations*	52711	45341	46752	45196	-3.3%	-14.3%
Individuals	38484	39934	40556	42072	3.7%	9.3%
TOTAL	91195	85275	87308	87268	0.0%	-4.3%

Source: BRE Bank Securities, Pekao
** incl. deposits by government units and REPO, SBB transactions*

The rate of loan growth is slower than market averages (4% q/q, 8% y/y), but the ratio of loans to deposits was up to 86% at the end of Q308. We are maintaining our outlook on Pekao. The bank is losing market share, which is reflected in its earnings performance and balance-sheet structure. There has been no change of trends in its recurring operations.

The table below shows Pekao's third-quarter results versus our estimates, with the NPL gain recognized under "other net operating income" rather than against provisions as we had originally assumed.

Reported vs. forecasted results (PLN m)

	3Q08F	differ.	3Q08	change	3Q07	3Qs08F	differ.	3Qs08	change	3Qs07
Net interest income	1 185	-4.2%	1 135	3.1%	1 101	3 450	-1.4%	3 400	7.1%	3 174
Net fee income	610	-8.3%	559	-26.1%	757	1 839	-2.7%	1 789	-21.6%	2 283
NIM	3.8%		3.6%		3.5%	3.7%		3.6%		4.3%
Income f/banking operations	1 994	-6.7%	1 861	-11.1%	2 093	5 842	-2.3%	5 708	-10.0%	6 341
Operating expenses	-984	-4.0%	-945	2.3%	-923	-2 877	-1.4%	-2 838	2.5%	-2 770
Operating income*	1 102	-3.3%	1 065	-9.0%	1 170	3 575	-1.0%	3 539	-0.9%	3 571
Provisions	-74	-49.2%	-38	n/a	-78	-196	-18.6%	-159	n/a	-284
Pre-tax income	1 056	-0.4%	1 052	-6.8%	1 129	3 476	-0.1%	3 472	2.1%	3 402
Net income	852	-1.3%	841	-9.8%	933	2 820	-0.4%	2 809	1.9%	2 756

Source: BRE Bank Securities, Pekao
** before provisions*

The next table presents the same figures after adjustment for the NPL sale (we estimated a PLN 70m charge to pre-tax income and a PLN 56.7m charge to net income, while the bank recognized PLN 118m under "other banking income," added PLN 14m to provisions, and posted a PLN 77.2m charge against net income). The accumulated results generated during three quarters only include the third-quarter one-time event (we did not factor in the partial divestiture of CDM Pekao and MasterCard completed in the preceding quarters).

Forecasted vs. reported quarterly results (PLN m, adjusted)

	3Q08F	differ.	3Q08	change	3Q07	3Qs08F	differ.	3Qs08	change	3Qs07
Net interest income	1 185	-4.2%	1 135	3.1%	1 101	3 450	-1.4%	3 400	7.1%	3 174
Net fee income	610	-8.3%	559	-26.1%	757	1 839	-2.7%	1 789	-21.6%	2 283
NIM	3.8%		3.6%		3.5%	3.7%		3.6%		4.3%
Income f/banking operations	1 994	-6.7%	1 861	-11.1%	2 093	5 842	-2.3%	5 708	-10.0%	6 341
Operating expenses	-984	-4.0%	-945	2.3%	-923	-2 877	-1.4%	-2 838	2.5%	-2 770
Operating income*	1 032	-8.2%	947	-19.0%	1 170	3 505	-2.4%	3 421	-4.2%	3 571
Provisions	-74	-68.1%	-24	n/a	-78	-196	-25.7%	-145	n/a	-284
Pre-tax income	986	-3.9%	948	-16.0%	1 129	3 406	-1.1%	3 368	-1.0%	3 402
Net income	796	-4.0%	764	-18.1%	933	2 763	-1.1%	2 731	-0.9%	2 756

Source: BRE Bank Securities, Pekao
** before provisions*

Overview of adjusted quarterly results**** (PLN m)

	1Q07	2Q07	3Q07	4Q07***	1Q08	2Q08	3Q08	Q/Q	Y/Y
Loans	65836.6	67637.3	69489.5	69701.8	70576.3	72151.4	74757.3	3.6%	7.6%
Deposits	91247.3	89593.6	92808.2	89944.1	87031.3	88062.6	86660.6	-1.6%	-6.6%
Assets	125616.3	122592.3	127473.1	124096.2	122399.5	121653.0	127102.5	4.5%	-0.3%
Net interest income	1012.0	1061.3	1101.0	1148.6	1122.7	1142.4	1134.9	-0.7%	3.1%
Net fee income	708.3	817.7	756.5	649.3	610.9	618.7	559.2	-9.6%	-26.1%
Trading income	215.8	253.6	235.8	175.2	107.9	179.9	166.9	-7.2%	-29.2%
Income f/ banking operations**	1936.1	2132.6	2093.3	1973.2	1841.4	1941.0	1861.0	-4.1%	-11.1%
Other net operating income**					63.7	20.5	31.0	51.6%	n.a.
Banking income**	1936.1	2132.6	2093.3	1973.2	1905.2	1961.5	1892.0	-3.5%	-9.6%
Operating expenses	-896.9	-949.7	-923.5	-1034.7	-929.2	-964.4	-944.8	-2.0%	2.3%
Operating income*	1039.2	1182.9	1169.9	938.5	976.0	997.0	947.2	-5.0%	-19.0%
Provisions	-101.8	-104.7	-78.0	-35.6	-50.3	-71.6	-23.6	-67.1%	-69.8%
Operating income	937.4	1078.2	1091.9	902.9	925.7	925.5	923.6	-0.2%	-15.4%
Equity in income of associates	33.8	44.5	36.8	37.8	37.4	30.8	24.6	-20.4%	-33.3%
Pre-tax income	971.2	1122.7	1128.7	940.7	963.1	956.3	948.1	-0.9%	-16.0%
Tax	-187.0	-223.6	-193.3	-162.4	-175.0	-175.8	-180.6	33.3%	-6.5%
Minority interests	-2.5	-2.4	-2.9	-5.1	-3.3	-3.5	-3.4	-2.2%	16.4%
Net income	781.7	896.7	932.6	771.8	784.7	777.1	764.2	-6.5%	-18.1%

Source: BRE Bank Securities, Pekao
** before provisions*
*** the bank provided pro-forma estimates of pre-merger trading income and other net operating income. Trading income, income from banking operations, and other net operating income are not comparable from year to year. The reported figures are comparable starting from operating income.*
**** Q407 income statement are pro-forma results*
***** adjusted for the following one-time events: Q107 – divestiture of CU PTE (PLN 179m credited to banking income, PLN 144m to net income); Q108 – partial divestiture of CDM Pekao (PLN 435.6m credited to other net operating income, PLN 353m to net income); Q208 – sale of interests in MasterCard (an estimated PLN 65m added to trading income); Q308 – NPL sale (PLN 118m to other net operating income, PLN 14m additional provisions; PLN 77.2m charge to net income).*

Overview of quarterly results (PLN m)

	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08	3Q08	Q/Q	Y/Y
Loans	65836.6	67637.3	69489.5	69701.8	70576.3	72151.4	74757.3	3.6%	7.6%
Deposits	91247.3	89593.6	92808.2	89944.1	87031.3	88062.6	86660.6	-1.6%	-6.6%
Assets	125616.3	122592.3	127473.1	124096.2	122399.5	121653.0	127102.5	4.5%	-0.3%
Net interest income	1012.0	1061.3	1101.0	1148.6	1122.7	1142.4	1134.9	-0.7%	3.1%
Net fee income	708.3	817.7	756.5	649.3	610.9	618.7	559.2	-9.6%	-26.1%
Trading income	394.8	253.6	235.8	175.2	107.9	244.9	166.9	-31.9%	-29.2%
Income f/ banking operations**	2115.1	2132.6	2093.3	1973.2	1841.4	2006.0	1861.0	-7.2%	-11.1%
Other net operating income**					499.3	20.5	149.0	628.3%	n.a.
Banking income**	2115.1	2132.6	2093.3	1973.2	2340.8	2026.5	2010.0	-0.8%	-4.0%
Operating expenses	-896.9	-949.7	-923.5	-1034.7	-929.2	-964.4	-944.8	-2.0%	2.3%
Operating income*	1218.2	1182.9	1169.9	938.5	1411.6	1062.0	1065.2	0.3%	-9.0%
Provisions	-101.8	-104.7	-78.0	-35.6	-50.3	-71.6	-37.6	-47.5%	-51.8%
Operating income	1116.4	1078.2	1091.9	902.9	1361.3	990.5	1027.6	3.7%	-5.9%
Equity in income of associates	33.8	44.5	36.8	37.8	37.4	30.8	24.6	-20.4%	-33.3%
Pre-tax income	1150.2	1122.7	1128.7	940.7	1398.7	1021.3	1052.1	3.0%	-6.8%
Tax	-221.0	-223.6	-193.3	-162.4	-257.8	-188.1	-207.4	10.3%	7.3%
Minority interests	-2.5	-2.4	-2.9	-5.1	-3.3	-3.5	-3.4	-2.2%	16.4%
Net income	926.6	896.7	932.6	771.8	1137.5	829.7	841.4	1.4%	-9.8%

Source: BRE Bank Securities, Pekao
** before provisions*
*** the bank provided pro-forma estimates of pre-merger trading income and other net operating income. Trading income, income from banking operations, and other net operating income are not comparable from year to year. The reported figures are comparable starting from operating income.*

Revised Valuation

We made downward revisions to our target-price calculations for Pekao to account for the downturn in bank stock prices which occurred since our previous Research Update. We are not revising our financial forecasts for the bank, although we might do so in the near future. The revised assumptions affect relative valuation, but not DDM estimations. Cost-of-equity estimates are unchanged at 10.82%.

Relative Valuation

	P/BV		PBV/ROE		P/E	
	2008F	2009F	2008F	2009F	2008F	2009F
BZW	1.4	1.3	6.7	7.7	7.4	8.1
BHW	1.0	1.0	7.3	6.9	7.4	7.0
BSK	1.1	1.0	5.9	7.4	6.5	7.7
KRB	1.1	1.1	8.7	9.9	9.0	10.2
MIL	1.0	1.0	5.7	8.0	6.0	8.3
PKO	2.0	1.8	7.2	8.2	7.9	8.7
NBL	1.3	1.1	4.8	5.5	5.5	6.0
average	1.3	1.2	6.6	7.6	7.1	8.0
premium/discount to average	43.2%	54.1%	16.4%	22.2%	12.4%	18.5%
median	1.1	1.1	6.7	7.7	7.4	8.1
premium/discount to median	61.6%	67.5%	14.7%	21.6%	8.0%	17.1%
weights			20%	20%	30%	30%
Pekao	1.8	1.8	7.7	9.3	8.0	9.5
EPS for Pekao					13.86	11.67
BVPS for Pekao	60.3	62.1				
ROE*BVPS			14.38	11.85		
Price based on the average	77.2	71.7	94.9	90.4	98.3	93.3
Price based on the median	68.4	66.0	96.3	90.8	102.3	94.4

Source: BRE Bank Securities

We set our revised per-share price target on Pekao at PLN 136, and reiterate a hold rating in anticipation of future earnings revisions.

Valuation summary (PLN/share)

SUMMARY	
Gordon model	157.6
relative valuation	94.6
average	**126.1**
9MTP	**136.2**

Source: BRE Bank Securities

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List of abbreviations and ratios contained in the report:
***EV** – net debt + market value*
***EBIT** – Earnings Before Interest and Taxes*
***EBITDA** – EBIT + Depreciation and Amortisation*
***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 6-9 months, unless a subsequent recommendation is issued within this period. Expected returns from individual recommendations are as follows:
BUY – we expect that the rate of return from an investment will be at least 15%
ACCUMULATE – we expect that the rate of return from an investment will range from 5% to 15%
HOLD – we expect that the rate of return from an investment will range from –5% to +5%
REDUCE – we expect that the rate of return from an investment will range from -5% to -15%
SELL – we expect that an investment will bear a loss greater than 15%
Recommendations are updated at least once every nine months.

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Previous recommendations issued for Pekao

recommendation	under revision	Hold	Reduce	Hold	Hold
date issued	2008-05-15	2008-06-17	2008-08-06	2008-09-30	2008-10-07
price on day of recommendation	191.00	185.10	192.00	167.00	160.00
WIG on day of recommendation	48321.35	45819.40	42118.25	36854.78	34832.29