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Special comment



Banks

Poland

Pekao

BAPE.WA; PEO.PW

Hold

(Reiterated)

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No Revival in Loans

Current price: PLN 163.9; Target price: PLN 172.8

At PLN 603m, net income was in line with our expectations (PLN 596m), but slightly below market consensus (PLN 619m). Fee income disappointed (PLN 572m vs. PLN 623m forecasted and PLN 613m a quarter earlier), which was to a certain extent offset by higher-than-expected trading income (PLN 171m vs. PLN 159m forecasted). Expenses surprised on the upside, undershooting our forecast by nearly 4%. Loan-loss provisions were in line with expectations. The Bank's loan portfolio shrank for another quarter in a row (-5% q/q, -12.5% y/y) due to weak demand in the corporate segment. We expect this situation to persist in FY 2010, although in H2 2010 we can expect an improvement vs. the very weak first quarter. We believe there is little potential for further earnings improvement unless lending accelerates. The Bank does have room for growth in this respect. After Q1'10, its capital adequacy ratio was 18.4% (with only the profit for FY 2009 factored in), which depresses the ROE (12.9%). Effective capital management would entail these two numbers being swapped. The Bank does not preclude acquisitions, and it has enough capital for these. Still, we do not expect it to buy BZ WBK. We see no reason to revise our forecasts. We expect the Bank to earn PLN 2.67bn this year. In Q1'10, the Bank met 23% of our FY projection. We have adjusted our target price for dividends (day of record is 17 May, and shares went ex-dividends on 13 May). This reduces the per share target price by PLN 2.9, to PLN 172.8 per share.

## Reported vs. forecasted Q1 2010 results

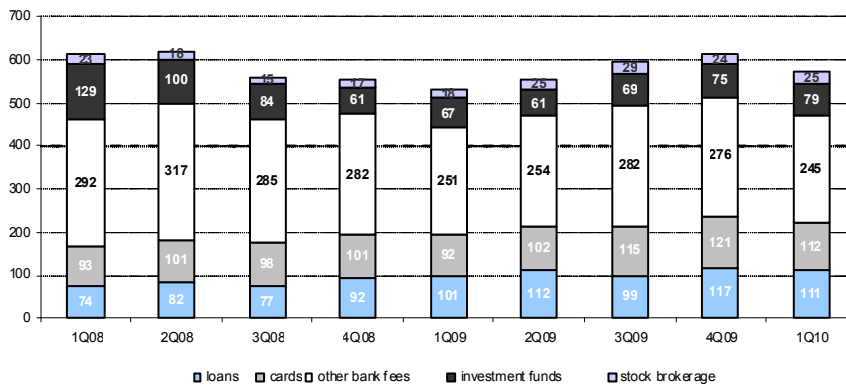
(PLN m)	Q1'10F	Differ.	Q1'10	Change	Q1'09	2010F	Change	2009	Q1'10/2010F
Interest income	994	1.1%	1 005	10.5%	910	4 314	-11.9%	3 802	23.3%
Fee income	623	-8.2%	572	8.2%	529	2 542	-10.0%	2 289	22.5%
NIM	3.1%	-	3.1%	-	2.7%	3.2%	-	2.9%	-
Income f. banking oper.	1 777	-1.6%	1 748	3.2%	1 694	7 553	-6.5%	7 063	23.1%
Operating expenses	-937	-3.6%	-904	-2.3%	-925	-3 823	-3.9%	-3 673	23.6%
Operating income*	859	0.3%	861	9.1%	789	3 806	-8.9%	3 466	22.6%
Provisions	-140	-0.3%	-140	-52.6%	-92	-571	-6.6%	-534	24.5%
Pre-tax profit	740	0.2%	742	4.4%	711	3 306	-9.3%	2 998	22.4%
Net profit	596	1.0%	603	6.4%	566	2 661	-9.4%	2 412	22.6%

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

Interest income was in line with expectations. Interest margin on total assets increased by ca. 5bps, in line with our expectations. We believe the source of this improvement lies in the declining cost of financing, which was made possible by the outflow of big corporate deposits witnessed towards the end of last year. We believe that in the coming quarters it will be increasingly difficult to improve interest income on the basis of the deposit margin, due to the declining market interest rates (3M WIBOR currently stands at 3.85% vs. 4.1% at the end of March, and the average for Q1'10 was even higher). We need to wait until next year, when interest rates are expected to grow, to see a bigger improvement in the deposit margin. One opportunity for an improvement in interest income is accelerated lending and putting an end to the downward trend affecting the loan portfolio. We expect the first positive signals in H2 2010, though the improvement will be moderate.

Fee income was much lower than expected (PLN 572m vs. PLN 623m) due to a very prominent plunge in the so-called "other banking fees". We expected less impactful seasonal effects than last year, but the decline in client activity (as witnessed by, for example, the decline in loan and deposit volumes), the tough winter and seasonal effects (Q1 vs. Q4) led to a big decline in this area. We expect this part of fee income to start increasing gradually, all the more so that we expect greater business activity in lending.

### Fee income (PLN m)

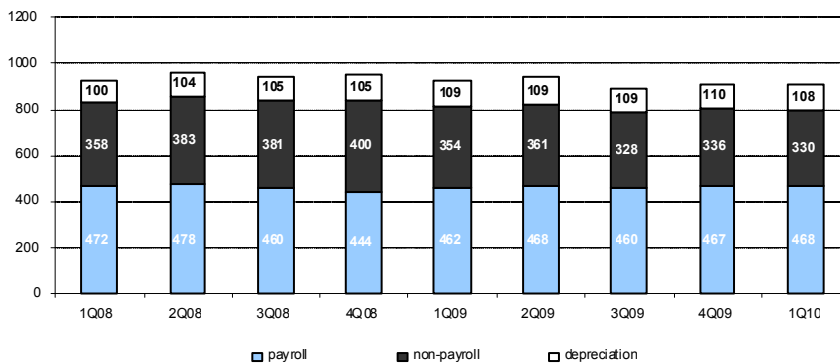


Source: BRE Bank Securities, Pekao

Costs provided another surprise on the upside, declining by PLN 9m vs. the preceding quarter. A careful approach to costs and a very low cost / income ratio (51% after Q1'10 and 51.4% in 2009) make Pekao stand out in the sector. We believe such effective cost management may continue, but will do little to help improve earnings further.

In Q1'10 the Bank consolidated its call center, which increased employee headcount by 321. The Management's comments to the report state that excluding consolidated subsidiaries, headcount declined by 52. The consolidation of the call center increased payroll expenses, but reduced non-payroll expenses.

### Operating expenses (PLN m)



Source: BRE Bank Securities, Pekao

### Asset quality

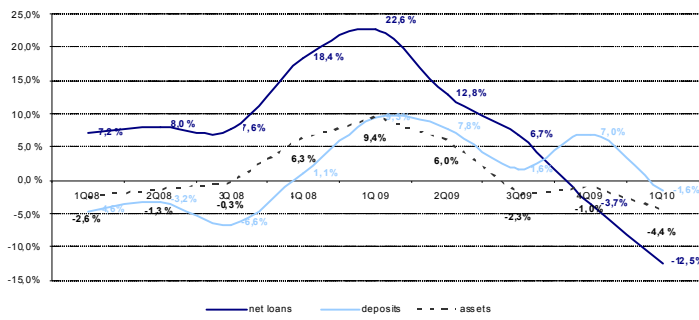
The NPL portfolio increased by PLN 106m during the quarter, which shows that the rate of NPL expansion is much slower than in H1'09 (PLN 0.5bn per quarter). The Bank showed the breakdown of its NPLs. Out of the PLN 5.8bn total, PLN 1.7bn were in the retail segment (+PLN 71m q/q) and PLN 4.1bn in the corporate segment (+PLN 35m). Year-on-year, retail NPLs increased by a mere PLN 77m, which is surprisingly low. The ratio of NPLs to total loans barely budged (from 5.8% at the end of Q1'09 to 6% now). In the corporate segment, NPLs increased by PLN 0.44bn, and the NPL/total loans ratio from 5.8% to 7.9%. These numbers are still below market averages for corporate loans and only a little higher than retail averages. We believe in FY 2009 most of the Bank's provisions were created in the corporate segment, and this year most of them will be in the retail segment.

### Balance-sheet trends

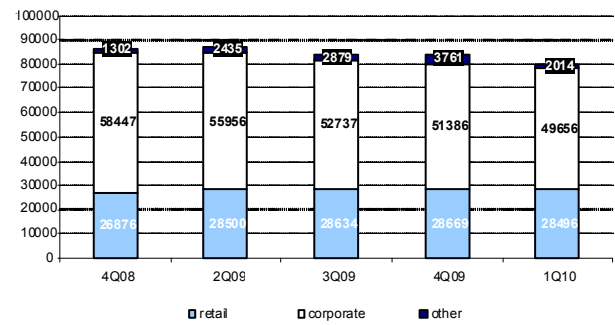
Since Q1'07, the Bank's assets have fluctuated within the PLN 120-134bn bracket (PLN 128bn after Q1'10). In Q1'10, Pekao reduced its exposure to cash and central bank balances, but increased to securities available for trading. The decline in net loans by PLN 3.75bn during the quarter was by and large reflected by a decline in total assets (PLN 2.7bn). Since Q1'09, the loan portfolio has been shrinking consistently. In Q1'10, it declined by nearly 5% q/q and 12.5% y/y. We believe in the following quarters this downward trend will be less prominent. We believe the high negative growth rates in Q1'10 are a consequence, inter alia, of a high base of comparison. We have been observing weak growth in loans for several quarters, but the scale of this phenomenon did not become clear until Q1'10. A fairly important factor is also the appreciation of the zloty, q/q and in particular y/y.

The main driver of the decline in the loan portfolio is the decline seen in corporate loans. In addition, in Q1'10 the repo portfolio shrank as well, which reduced "other" client receivables. Within the corporate segment, the declines are the most profound for loans to big corporations, which is the factor responsible for the q/q decline in the portfolio. Year-on-year, the lending slowdown can be seen in all subsegments.

### Change in volumes Y/Y



### Gross loans (PLN m)



Source: BRE Bank Securities, Pekao

### Quarterly earnings overview

(PLN m)	1Q09	2Q09	3Q09	4Q09	1Q10	Q/Q	Y/Y
Loans	86 553	82 412	79 754	79 484	75 735	-4.7%	-12.5%
Deposits	95 147	93 439	88 073	97 250	93 582	-3.8%	-1.6%
Assets	133 884	128 203	124 212	130 616	127 928	-2.1%	-4.4%
Interest income	910	948	970	974	1 005	3.2%	10.5%
Fee income	529	554	594	613	572	-6.6%	8.2%
Trading income	256	314	202	201	171	-14.8%	-33.2%
Income f/ banking operations	1 694	1 816	1 765	1 787	1 748	-2.2%	3.2%
Other operating income	20	12	33	11	16	48.0%	-19.3%
Banking income	1 714	1 828	1 798	1 798	1 764	-1.9%	2.9%
Operating expenses	-925	-938	-897	-913	-904	-1.0%	-2.3%
Operating income before provisions	789	890	901	886	861	-2.8%	9.1%
Provisions	-92	-152	-151	-138	-140	1.2%	52.6%
Operating income	698	737	750	747	721	-3.6%	3.3%
Share of profit of associates	13	18	15	19	21	9.1%	59.3%
Pre-tax income	711	755	765	766	742	-3.2%	4.4%
Tax	-141	-141	-142	-152	-137	-9.9%	-3.1%
Minority interests	-3	-1	-2	-3	-2	-24.1%	-33.2%
Net profit	566	613	620	612	603	-1.5%	6.4%

Source: BRE Bank Securities, Pekao



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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

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**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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