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Banks: 2018 Q1 Earnings Season Recap

Poland

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The Q1'18 results came as a positive surprise: the aggregate net profit was 6% above the consensus. All banks that we cover reported profits exceeding the expectations for the first time in more than 30 quarters. Yet the Q1'18 results still imply that the annual consensus should be 7% lower, although we were expecting a 12% lower consensus before the earnings were published. We are certain that the gap to the market expectations will be bridged, in large part if not in whole, by an increase of retail volumes. In Q1'18, the banks kept up a strong production of new loans including both mortgages (+17% Y/Y) and NMLs (+10% YoY according to our estimates). The net interest income and the net fee and commission income lagged behind and stood modestly below the consensus. The net interest margin was also a disappointment as it shrank by as much as 8 bps. Q/Q. Equally disappointing was the production of new corporate loans (+0.4% Y/Y). Although the quarter was shorter, interest costs grew 1.2% Q/Q while interest income dropped -1.7% Q/Q. The growth of interest costs and the margin may be explained by deposit price pressures. In our opinion, Q1'18 was the weakest quarter this year. Low market valuations open investment opportunities. We estimate potential growth of 16% on an aggregate basis.

Q1'18 results look great at first sight

All of the banks that we cover reported net profits hitting or exceeding the consensus in Q1'18. However, only 25% of the banks reported net interest income above the consensus and 37.5% reported net fee and commission income above the consensus. In addition, 62.5% of the banks reported operating expenses exceeding the consensus, which suggests that the inflation of wages and IT projects was underestimated. On the other hand, the cost of risk in the sector came as a positive surprise (below the consensus in 87.5% of the banks) and stood at 65 bps. in Q1'18 compared to 94 bps. in Q4'17. Importantly, while Q1 was the worst quarter since 2013 as measured by the number of bankruptcies, corporate loan loss provisions dropped most sharply (-54% Q/Q and -3% Y/Y). The Q1 results suggest that the consensus should be 7% lower. However, assuming stabilization of margins in 2H'18, fee and commission increases and record-high sales of retail loans, the consensus is within reach for the banks even if its structure could change. Lending volumes could come as a positive surprise later this year while adverse developments may include a new CHF law, wage inflation and the corporate CoR.

Who are the best and the worst performers?

In our opinion, the best performers included ALR, BHW and PKO, where the annual consensus has the biggest potential to grow subject to continued recurrent results net of one-offs. On the other hand, the annual consensus of ING, BZW and PEO is at risk and may be compromised by 8.5%, 11.1% and 12.2%, respectively. Still, all that ING has to do to close the gap is grow its assets, and BZW offers an attractive dividend which could be more than PLN 2.5 billion in 2019.

What is the industry's outlook?

The sentiment around the industry has largely weakened both in Poland and Emerging Europe. The WIG Banks index has lost 7% (in EUR) and MSCI EM Financials has lost 5% since the opening of the earnings season. On the other hand, WIG Banks' 12M FWD P/E stands at a 12% discount to the 5Y average. In our opinion, Q1'18 was the worst quarter this year in the Polish banking industry. Although the current results imply that the consensus should be 7% lower, the gap will be bridged, in large part if not in whole, by an increase of retail volumes. Based on our 2019 rate hike scenario, we think it reasonable to overweight the sector, in particular Alior Bank and Bank Handlowy.

Summary of Q1 2018 bank sector earnings results

(PLN m)	Q1'17	Q4'17	Q1'18	Y/Y	Q/Q	Consensus
Net interest income	7,617.1	8,334.3	8,244.4	8.2%	-1.1%	8,284.8
Fee income	2,755.1	2,886.1	2,890.5	4.9%	0.2%	2,896.5
Operating costs	5,877.6	5,402.3	6,129.5	4.3%	13.5%	4,905.3
Provisioning	1,315.4	1,902.4	1,318.7	0.3%	-30.7%	1,480.0
Net income	2,015.7	3,252.1	2,745.8	36.2%	-15.6%	2,590.1
NIM (%)	2.76	2.88	2.95	+0.19	+0.07	
CoR (%)	0.78	0.77	0.79	+0.01	+0.02	
ROE (%)	8.59	9.59	9.77	+1.18	+0.18	

Source: Dom Maklerski mBanku; Consensus estimates provided by PAP

Bank Stock YTD Price Change

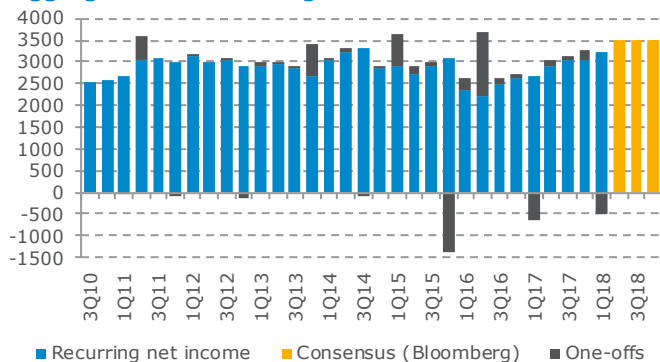
Banks	YTD
PKO BP	-11.8%
Pekao	-13.1%
BZ WBK	-10.7%
mBank	-7.6%
ING BSK	-7.7%
Alior Bank	-12.3%
Millennium	-7.2%
Handlowy	-1.1%
Getin Noble Bank	-34.6%
Idea Bank	-69.9%
Unicredit	-6.6%
Getin Holding	-50.0%
BOŚ	+5.9%
Santander	-16.9%
WIG-Banks	-10.9%
WIG	-9.2%

2018 YTD Actual / FY2018E

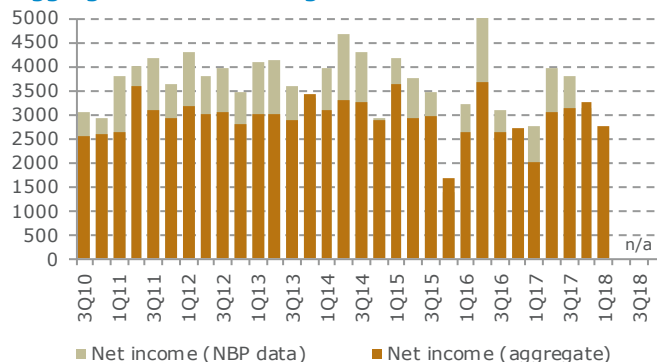
Banks	YTD
PKO BP	+22%
Pekao	+17%
BZ WBK	+18%
ING BSK	+20%
Millennium	+21%
Handlowy	+23%
Alior Bank	+22%
Getin Noble Bank	n.m.
Aggregate	+21%

Quarterly net income figures (PLN m)

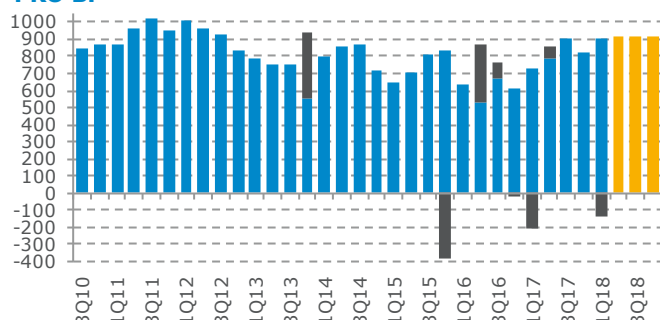
Aggregate sector earnings



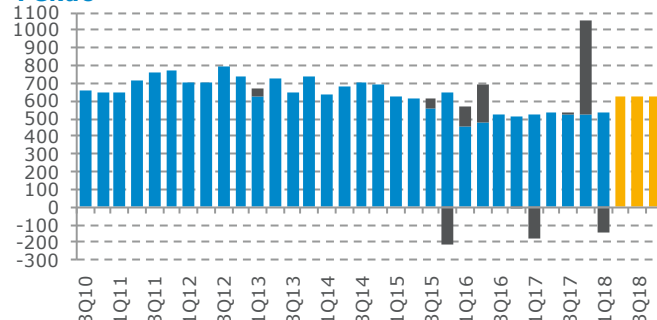
Aggregate sector earnings vs. central bank statistics



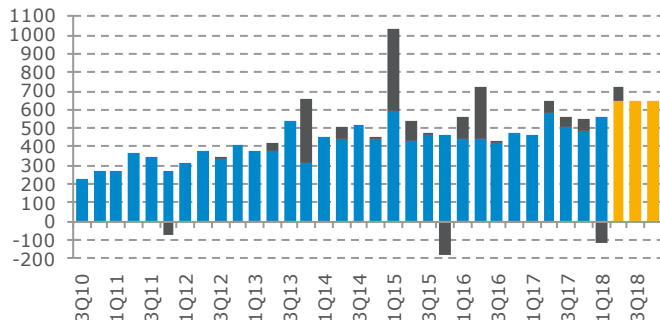
PKO BP



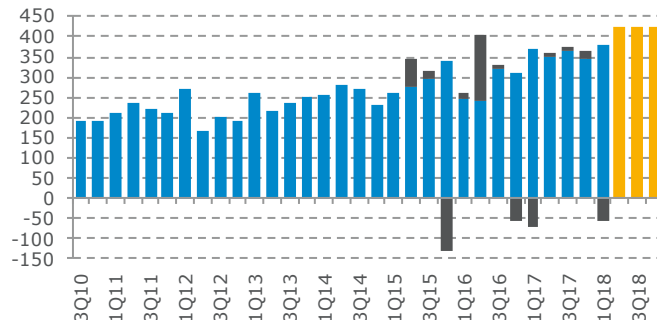
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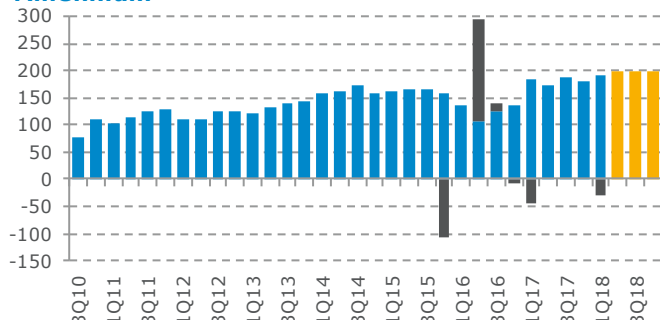
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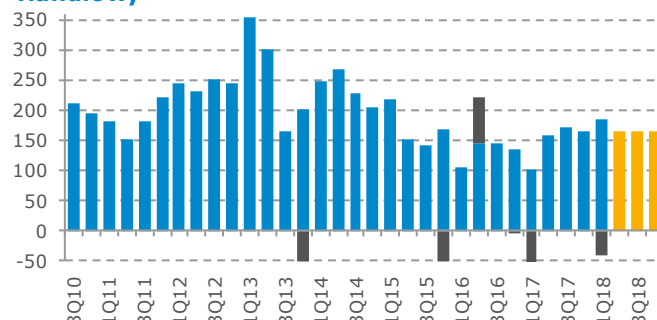
ING BSK



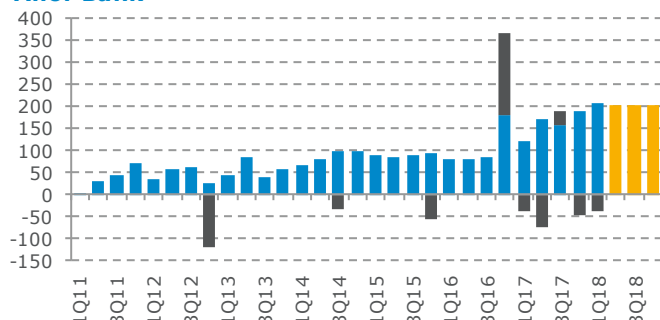
Millennium



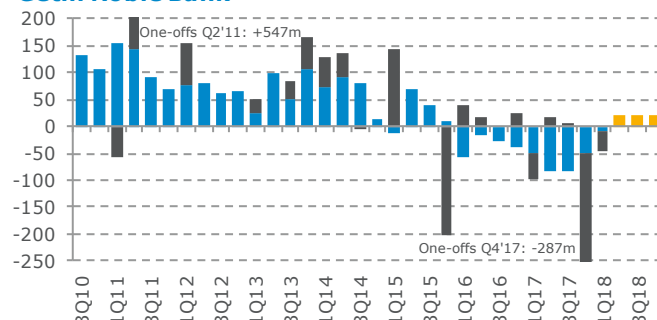
Handlowy



Alior Bank

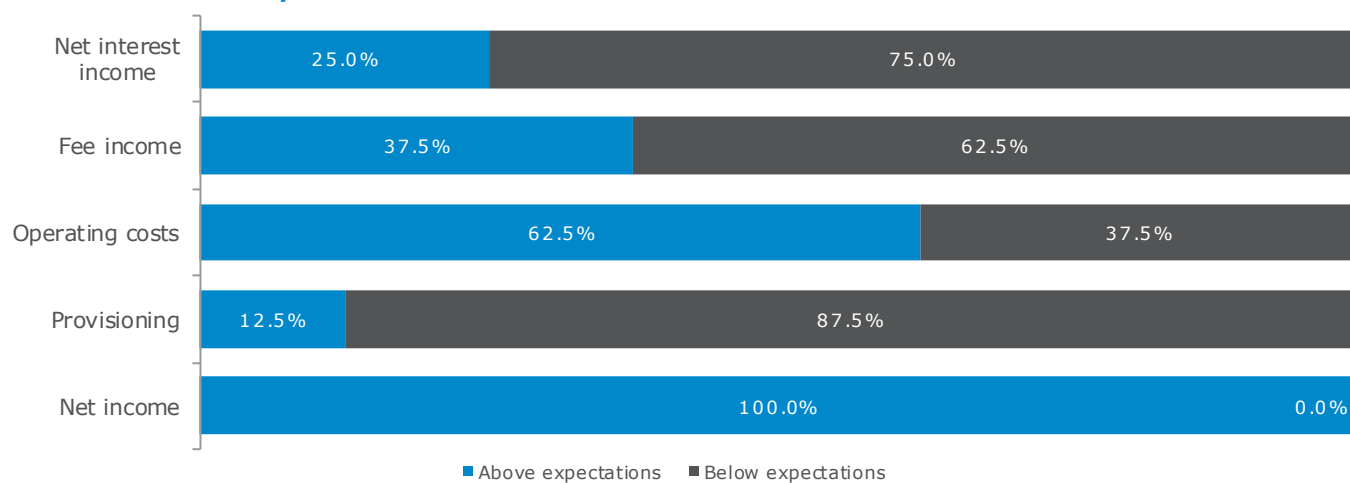


Getin Noble Bank

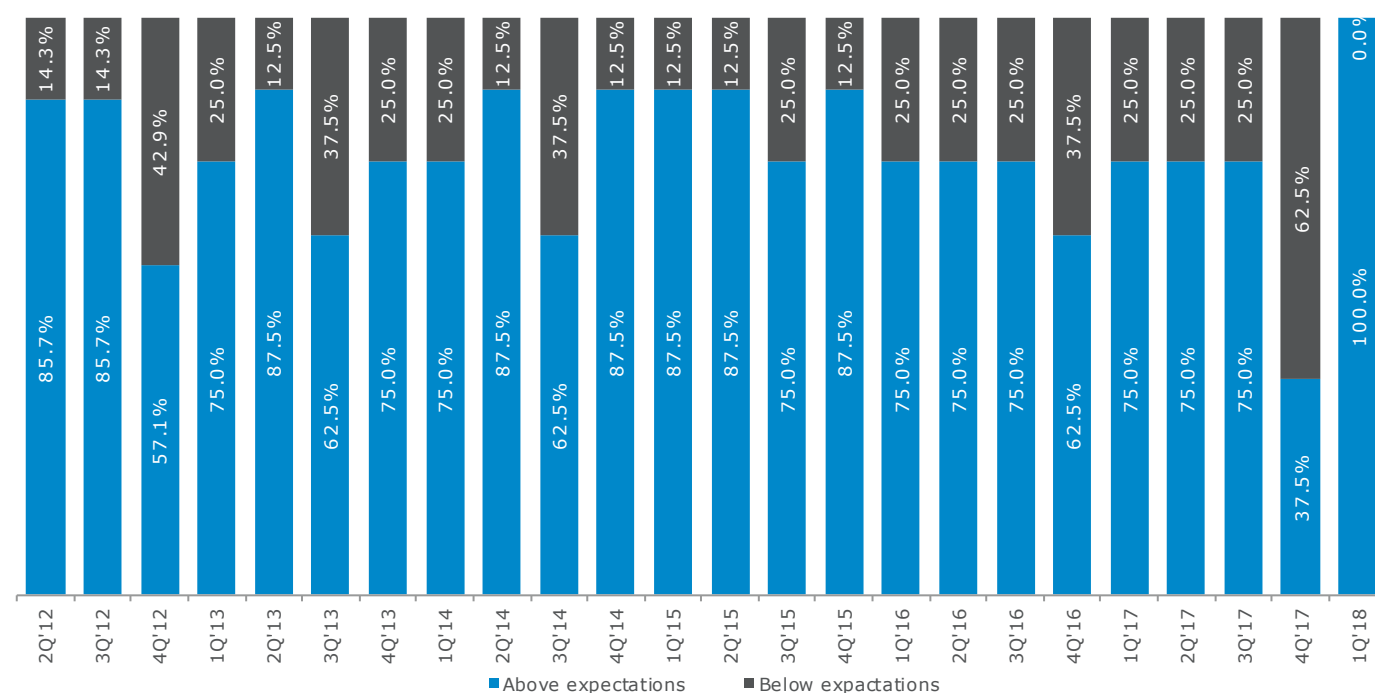


Source: Dom Maklerski mBanku

Q1 2018 results vs. expectations



Historical earnings performance vs. market expectations



Quarterly earnings results vs. consensus forecasts

	Q2'14	Q3'14	Q4'14	Q1'15	Q2'15	Q3'15	Q4'15	Q1'16	Q2'16	Q3'16	Q4'16	Q1'17	Q2'17	Q3'17	Q4'17	Q1'18
PKO	1%	2%	4%	-1%	7%	7%	20%	3%	1%	5%	-3%	3%	3%	4%	-1%	8%
PEO	3%	4%	1%	4%	3%	4%	15%	7%	12%	8%	3%	7%	2%	2%	9%	0%
BZW	3%	4%	4%	10%	6%	4%	9%	8%	10%	0%	8%	2%	13%	0%	0%	1%
ING	3%	0%	7%	11%	20%	6%	12%	8%	8%	17%	-6%	4%	-2%	1%	0%	2%
MIL	-1%	3%	6%	10%	11%	1%	-11%	3%	-8%	2%	4%	17%	2%	3%	0%	4%
BHW	7%	-8%	5%	6%	-2%	-3%	9%	-1%	11%	-3%	2%	-30%	5%	8%	0%	25%
ALR	2%	7%	10%	13%	2%	2%	5%	6%	1%	4%	3.6x	6%	7%	24%	1%	3%
GNB	7%	-37%	-81%	11%	19%	-1%	21%	-4.8x	-91%	1.2x	-4.1x	29%	45%	-1%	3.1x	-22%

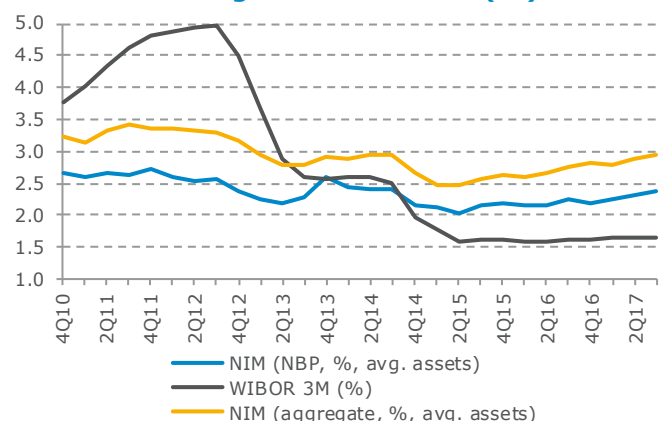
Source: Dom Maklerski mBanku

Net Interest Income

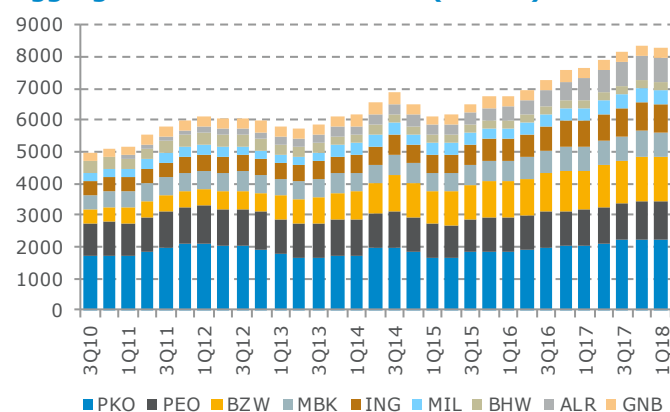
Net interest income was the biggest disappointment in Q1'18 and each of the covered banks reported a drop of the net interest margin during the quarter. NIM shrank by 8 bps. Q/Q to 2.89%. To explain the lower NII in Q1, the banks point out that the quarter was shorter (two days less) while deposit and loan price pressures mounted. However, interest income dropped 1.7% Q/Q while interest costs grew 1.2% Q/Q in Q1/18, which challenges the shorter quarter theory. In our opinion, NIM may still be under pressure in Q2 but should recover in 2H'18 driven by sales of retail loans. The pressure on the margins will come from continued strong demand for retail deposits. We stand by our interest rate scenario of 50 bps. hikes in each of the next two years.

The aggregate net interest income of the covered Polish banks dropped by 1.1% Q/Q in Q1'18 (+8.2% Y/Y) and was somewhat below the consensus. On an individual basis, only 25% of the banks reported NII above the consensus, much less than in Q4'17 (75% of the banks above the consensus). The industry reported an increase of the share of retail loans in the portfolio (57% in Q1'18 vs 55% in Q4'17) and an increase of the share of term deposits (45% in Q1'18 vs 43% in Q4'17). The banks expect NIM to improve further with sales of retail loans. On the other hand, faced with growing sales of retail loans, some of the banks have launched deposit-raising campaigns which add to the cost of financing in the short term. NIM (based on average assets) dropped most sharply in Alior Bank (-20 bps.) followed by ING, Millennium and Handlowy (-13 bps.).

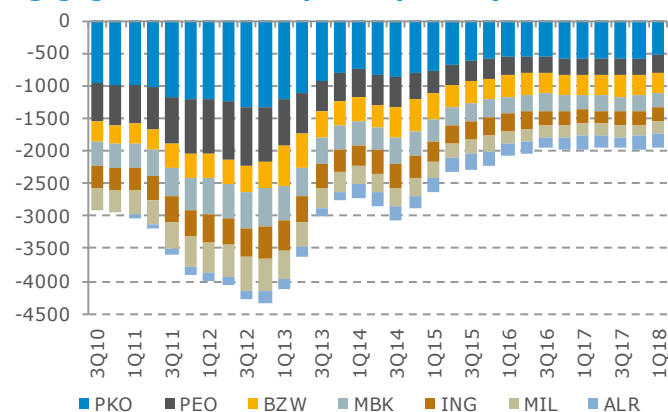
Net interest margin vs. 3M WIBOR (%)



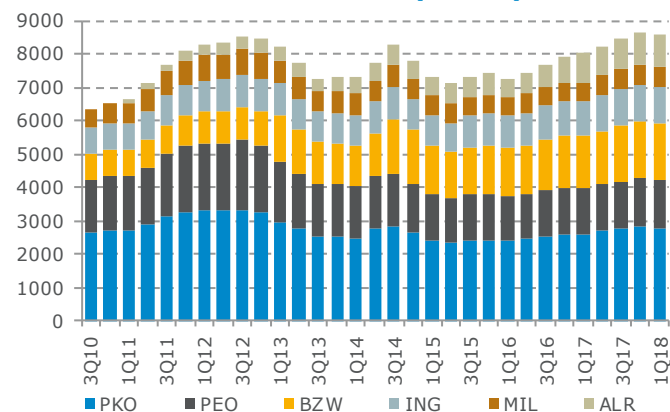
Aggregate net interest income (PLN m)



Aggregate interest expense (PLN m)



Evolution of interest revenue (PLN m)



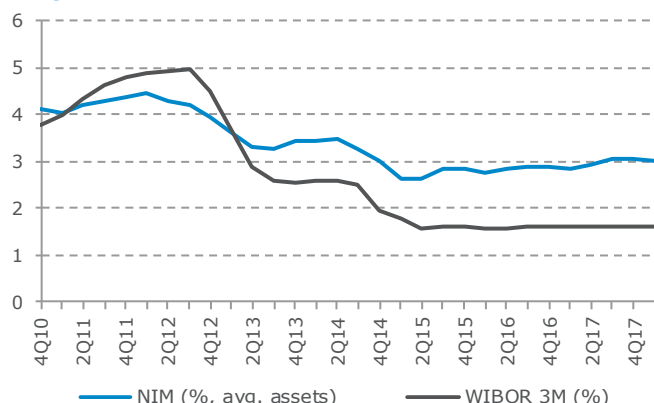
Change in quarterly NIM (over avg. assets)

	Q2'14	Q3'14	Q4'14	Q1'15	Q2'15	Q3'15	Q4'15	Q1'16	Q2'16	Q3'16	Q4'16	Q1'17	Q2'17	Q3'17	Q4'17	Q1'18
PKO	0.02	-0.23	-0.23	-0.38	-0.02	0.22	0.00	-0.07	0.05	0.05	0.00	-0.03	0.09	0.11	0.02	-0.07
PEO	0.04	-0.12	-0.28	-0.03	-0.09	0.02	0.05	0.11	0.05	0.06	-0.08	-0.04	0.08	0.02	-0.03	-0.05
BZW	0.11	0.58	-0.64	-0.08	-0.04	0.13	0.06	-0.07	0.05	0.14	0.06	-0.11	0.13	0.06	0.07	-0.06
ING	-0.09	0.00	-0.08	-0.12	0.04	0.08	0.02	0.03	0.01	0.28	0.06	-0.01	0.08	0.07	0.00	-0.13
MIL	0.09	-0.07	-0.20	-0.16	-0.13	0.08	0.05	0.01	0.18	-0.03	0.00	0.01	0.15	0.06	0.00	-0.13
BHW	0.08	-0.05	-0.43	0.00	-0.17	-0.07	0.09	0.00	0.15	0.19	0.06	-0.09	0.10	0.10	0.20	-0.13
ALR	0.36	0.00	-0.23	-0.13	-0.05	-0.03	-0.07	-0.07	-0.03	0.20	0.26	-0.10	0.36	-0.14	-0.18	-0.20
GNB	-0.07	0.09	-0.34	-0.37	0.06	0.11	0.22	-0.10	0.02	0.06	0.11	-0.04	0.02	0.06	0.01	-0.05
NBP*	0.00	0.00	-0.50	-0.50	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00

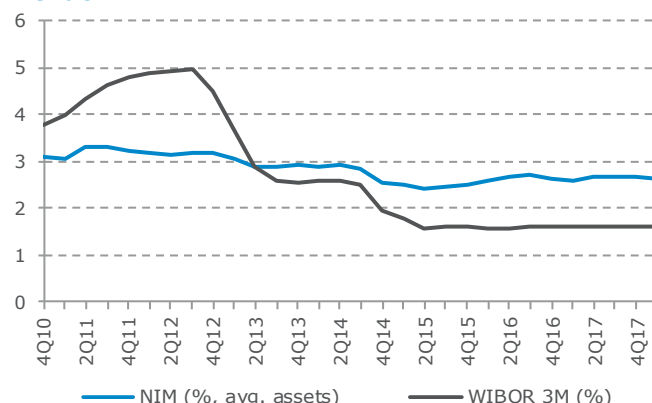
Source: Dom Maklerski mBanku; *NBP reference rate

NIM vs. WIBOR 3M

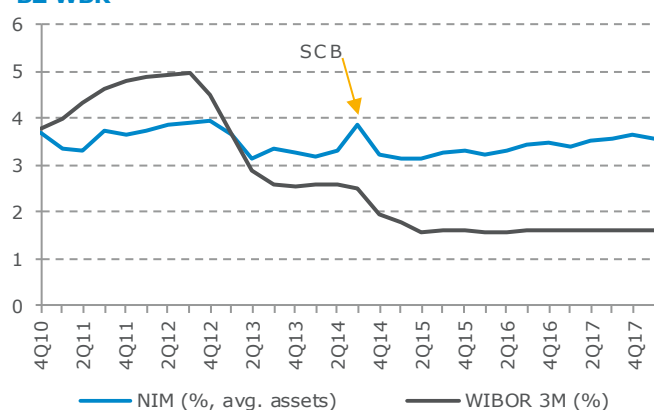
PKO BP



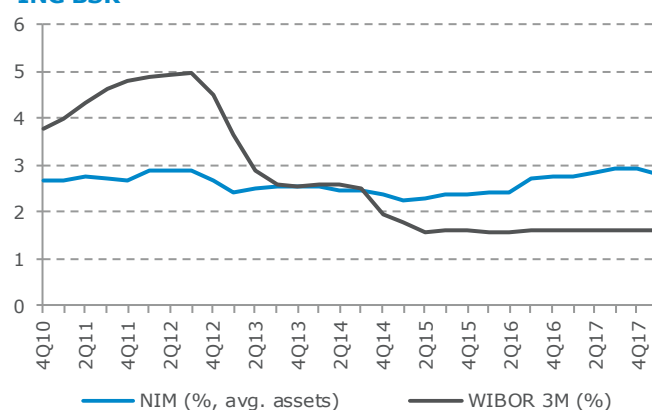
Pekao



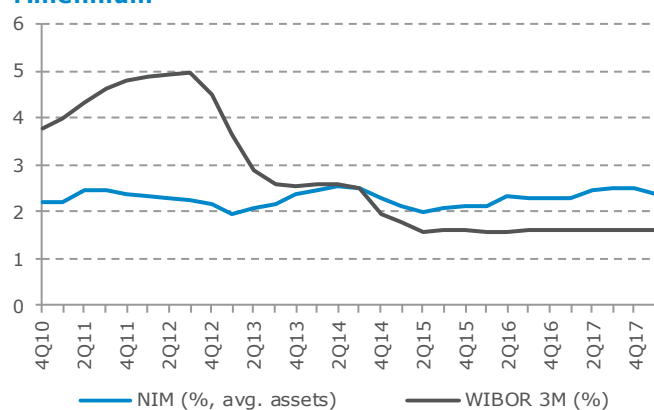
BZ WBK



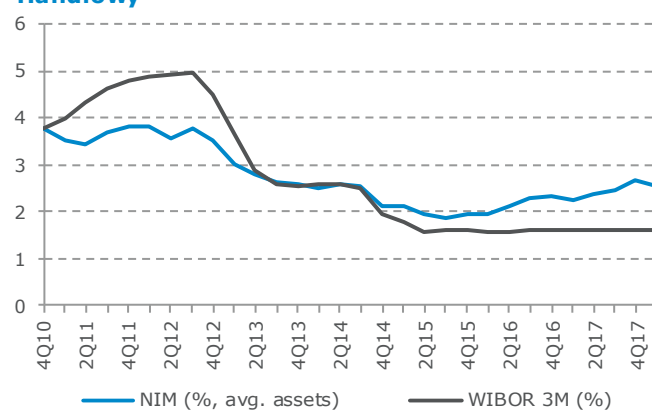
ING BSK



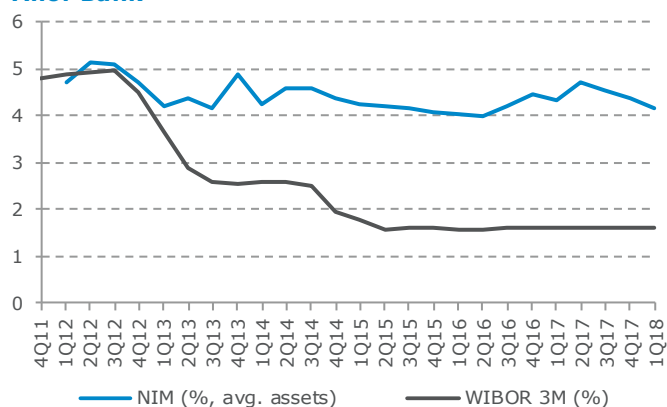
Millennium



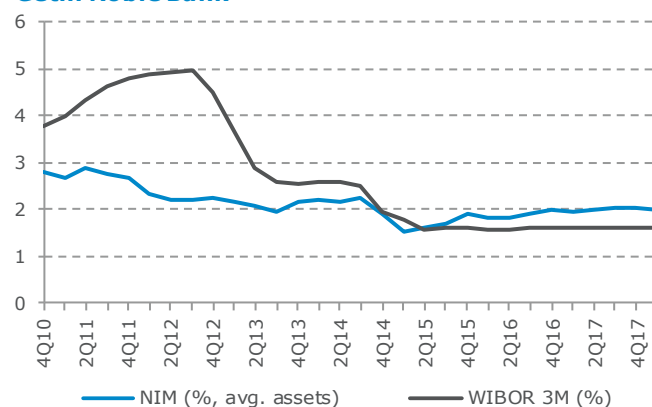
Handlowy



Alior Bank



Getin Noble Bank



Source: Dom Maklerski mBanku

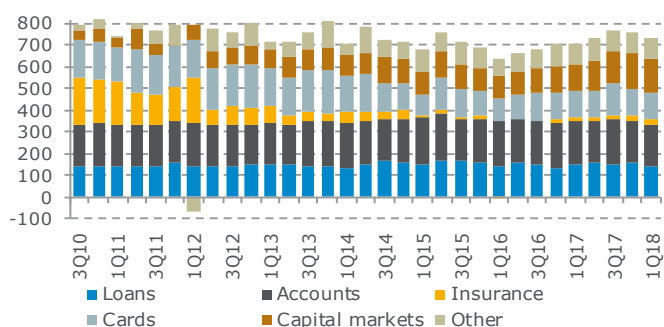
Fee Income

The net fee and commission income was flat Q/Q, as expected, but gained 4.9% Y/Y. We expect that banks will continue to raise fees in the coming quarters (PKO BP's raise takes effect in August) although fees and commissions to average assets are much higher than in the Czech Republic or Austria. Any further increase of fees and commissions could be blocked by rising pressures on deposit prices, as seen in the Czech Republic.

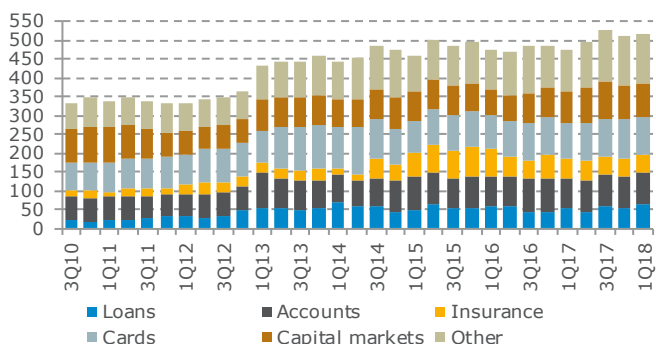
37.5% of the covered banks reported NFC above the consensus (62.5% in Q4'17). NFC's Y/Y increase was largely generated by capital market commissions (+15.0% Y/Y), which puts in question continued growth during the year. Adverse developments include the growth rate of card commissions (+0.4% Y/Y) and the falling growth rate of lending fees (+2.1% Y/Y). The best performer in the light of the consensus was ING BSK (+3.7% above the consensus) while the worst performer was Getin Noble Bank (-18.4% below the consensus).

Quarterly fee income of Polish banks (PLN m)

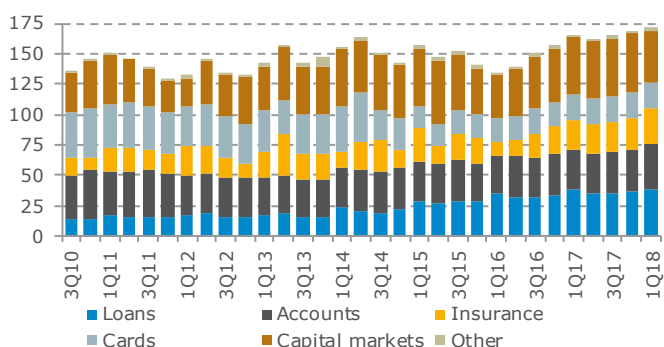
PKO BP



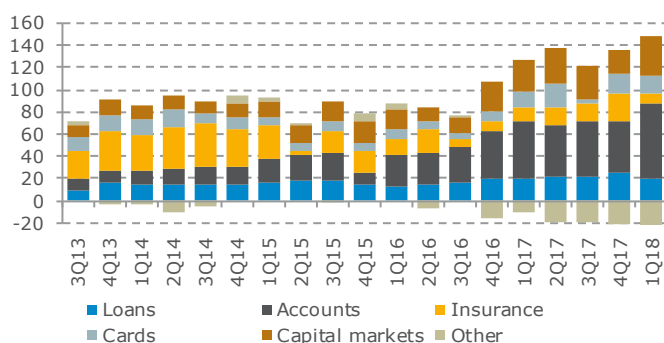
BZ WBK



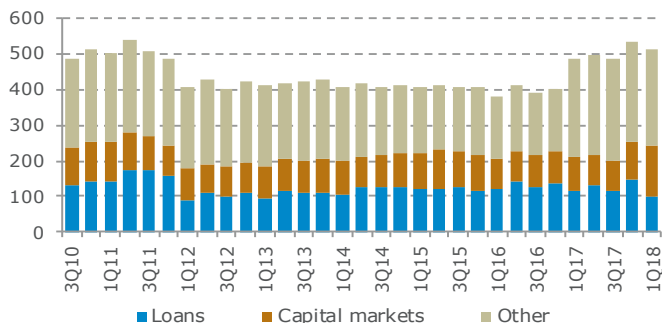
Millennium



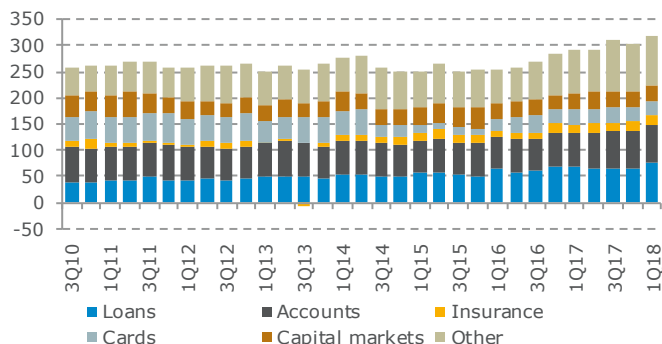
Alior Bank



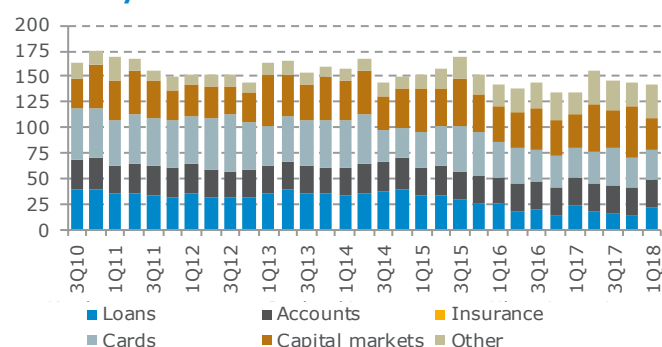
Pekao



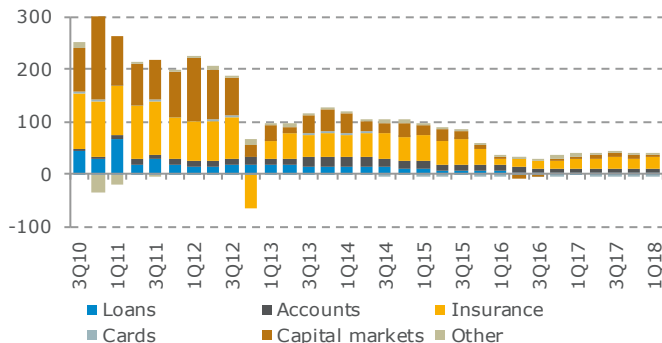
ING BSK



Handlowy



Getin Noble Bank



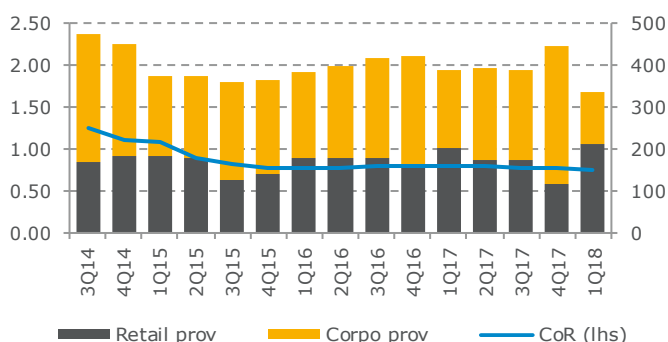
Source: Dom Maklerski mBanku

Cost of Risk

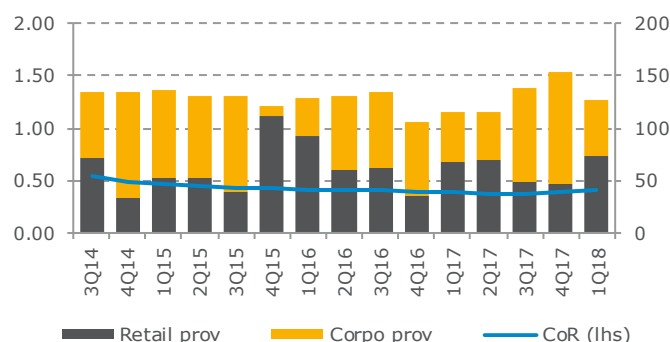
The cost of risk was the brightest spot during the quarter. The decrease of loan loss provisions was driven by the corporate segment (-3% Q/Q and 54% Y/Y), which may be surprising in view of the number of bankruptcies in the quarter (+13% Y/Y). The banks believe that CoR in the retail segment will still be supported by macroeconomic conditions, yet they see a looming risk to corporate LLPs, especially in the construction sector. The risk has not yet affected bankruptcies: 35 construction companies went bankrupt in Q1'18 compared to the long-term average of 34 bankruptcies.

CoR was 65 bps. in Q1'18 vs 94 bps. in Q4'17 and 67 bps. in Q1'17. In Q1'18, 87.5% of the covered banks reported CoR below the consensus, which was 11% better than expected. Corporate LLPs dropped 54% Q/Q and 3% Y/Y while retail LLPs dropped 10% Q/Q but increased 1.5% Y/Y. The biggest positive surprise came from Bank Handlowy (-76% below the consensus) followed by GNB (35% below the consensus) and Millennium (21% below the consensus).

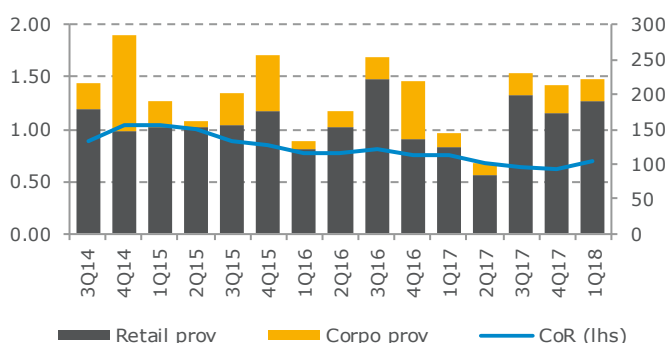
PKO BP



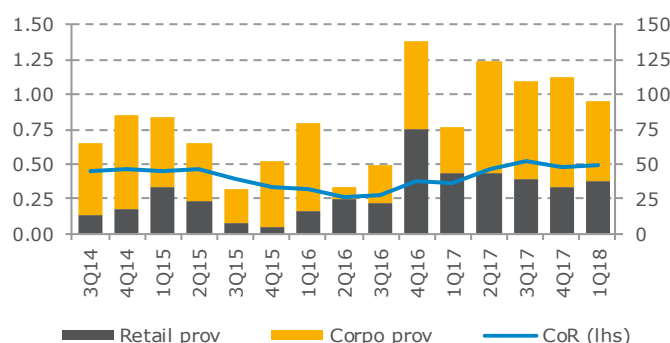
Pekao



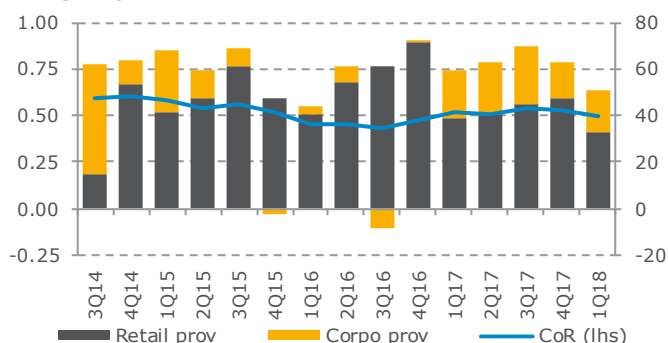
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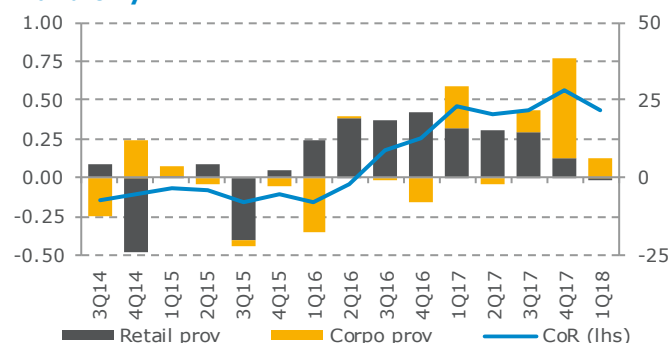
ING BSK



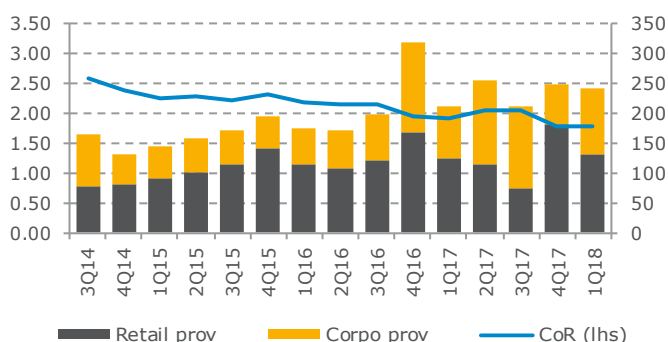
Millennium



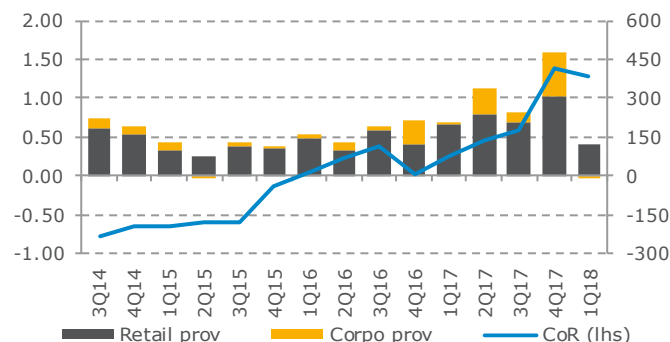
Handlowy



Alior Bank



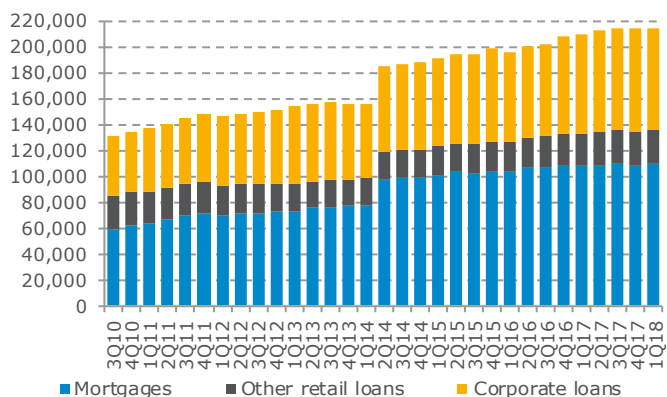
Getin Noble Bank



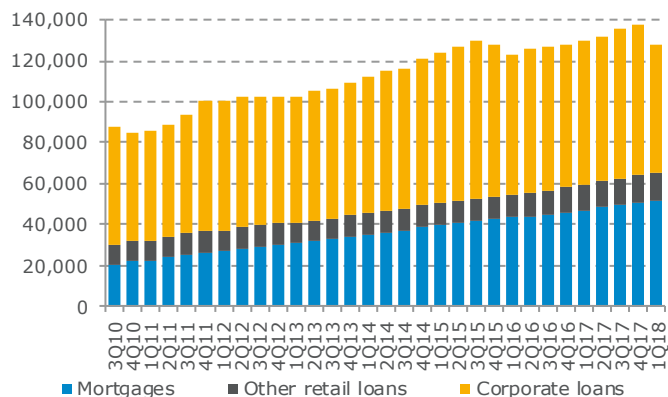
Source: Dom Maklerski mBanku

Quarterly loan growth (PLN m)

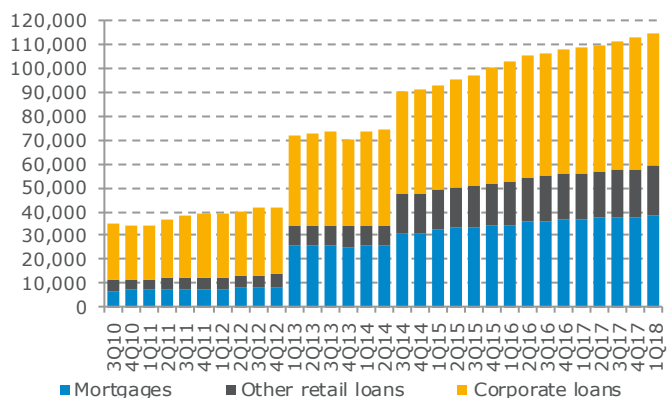
PKO BP



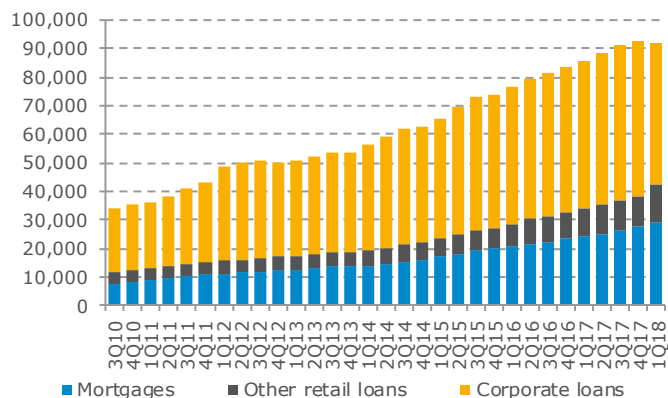
Pekao



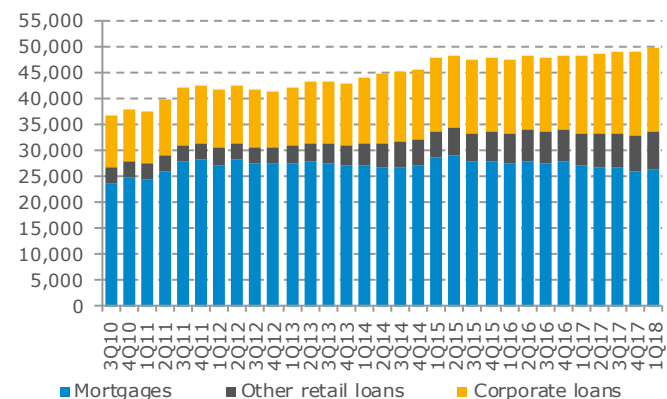
BZ WBK



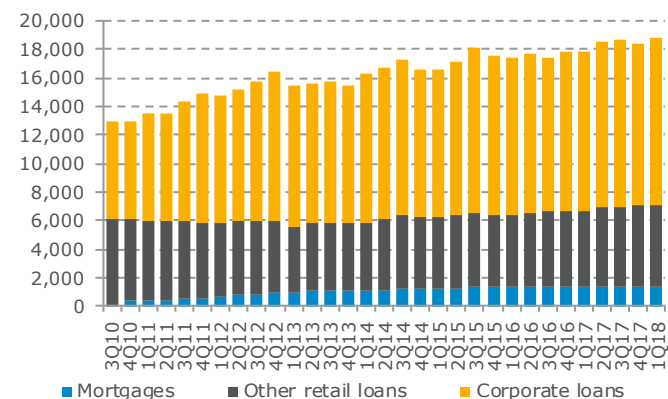
ING BSK



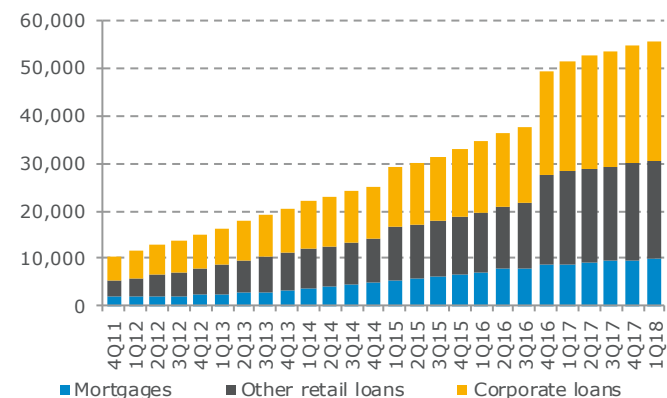
Millennium



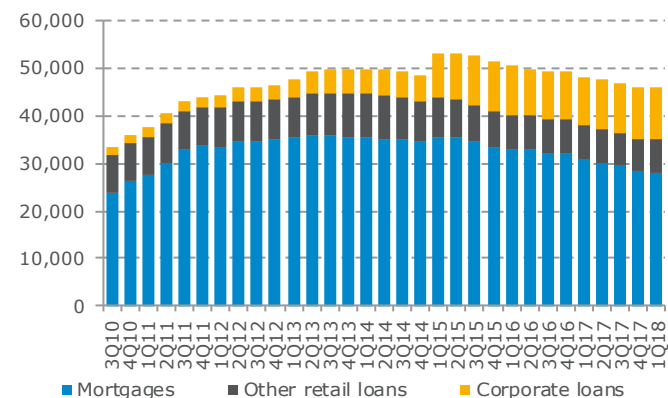
Handlowy



Alior Bank



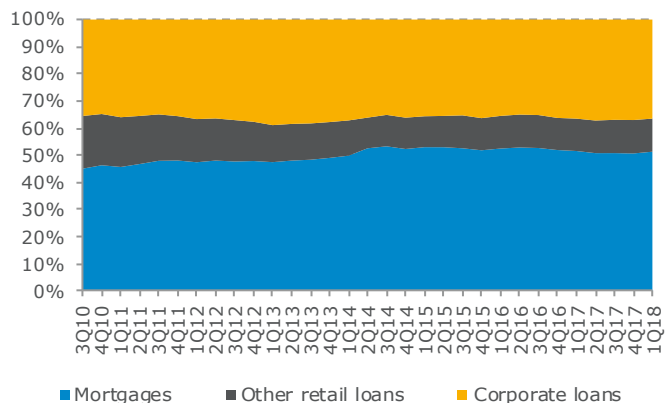
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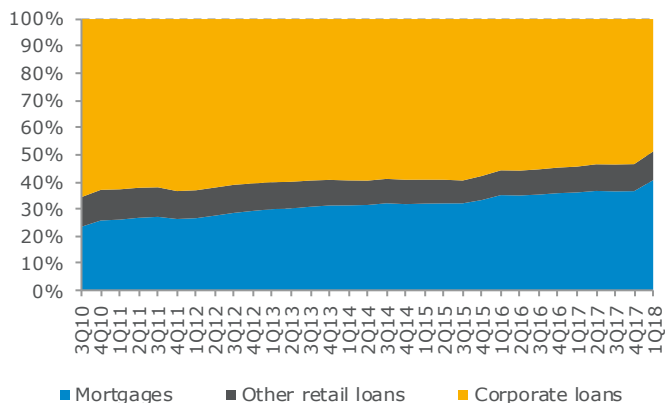
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Loan Composition

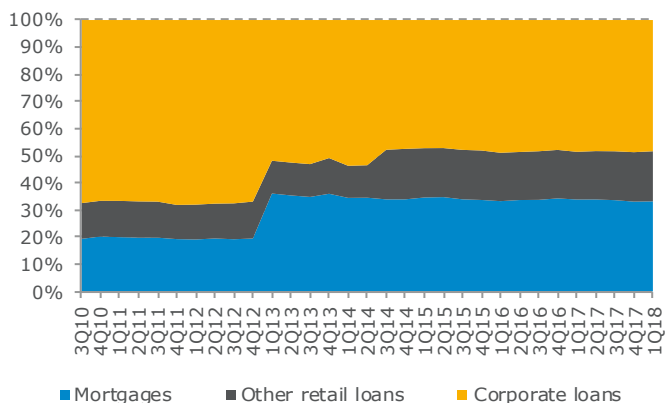
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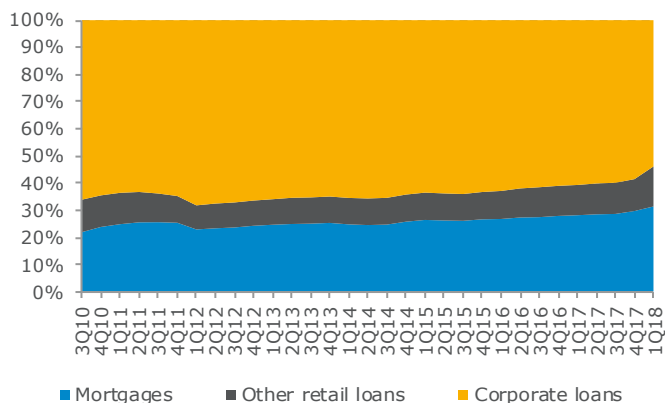
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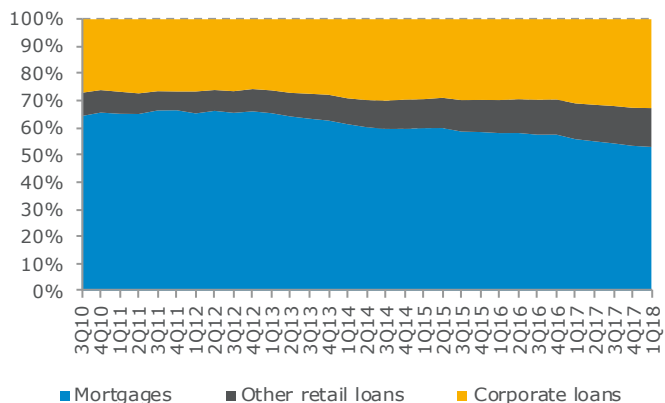
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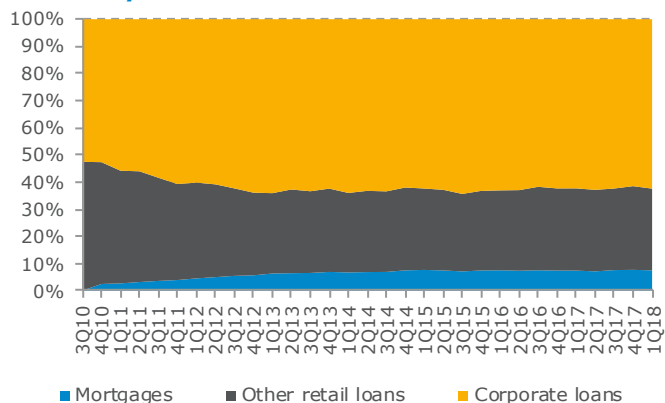
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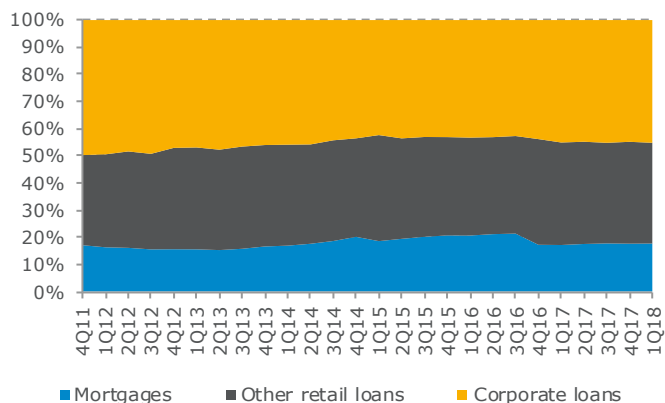
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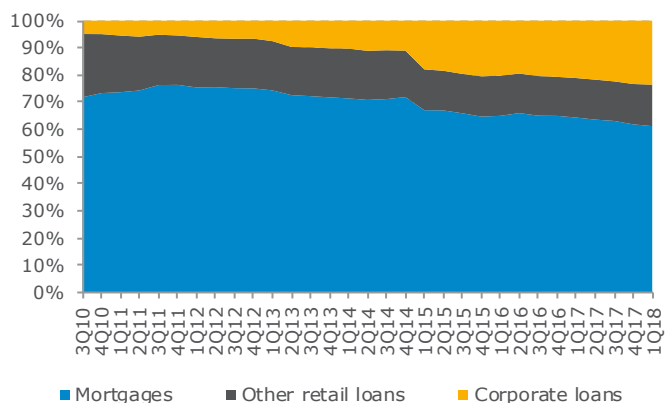
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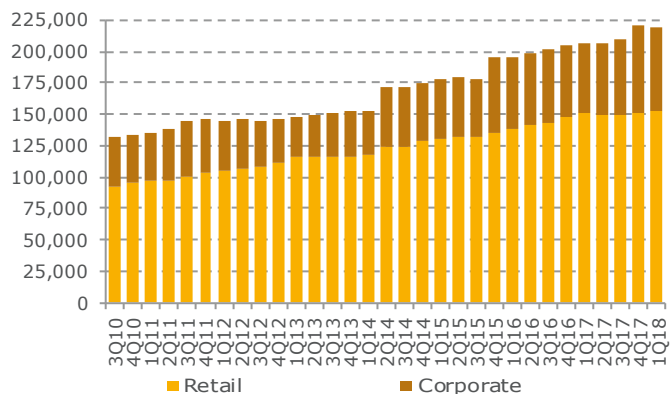
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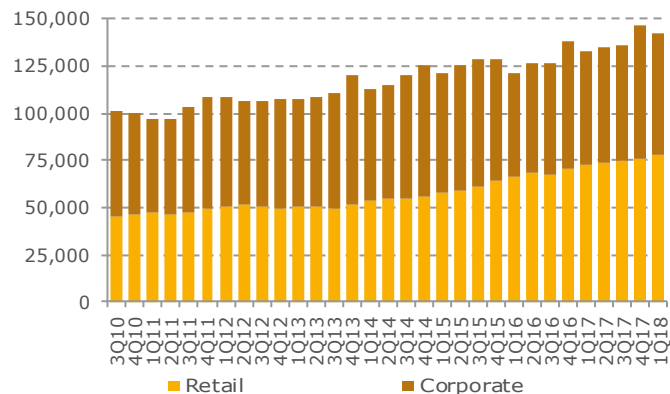
Source: Dom Maklerski mBanku

Quarterly deposit growth (PLN m)

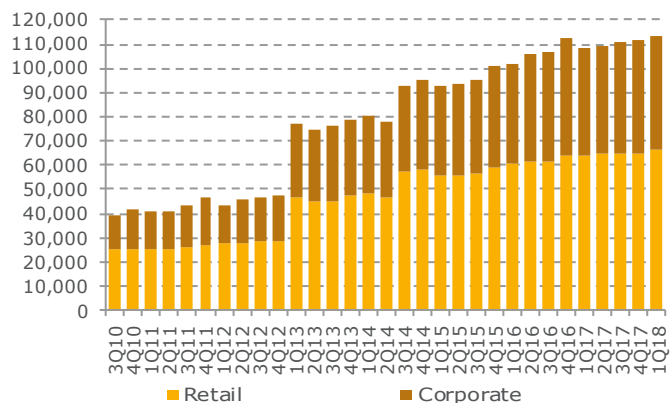
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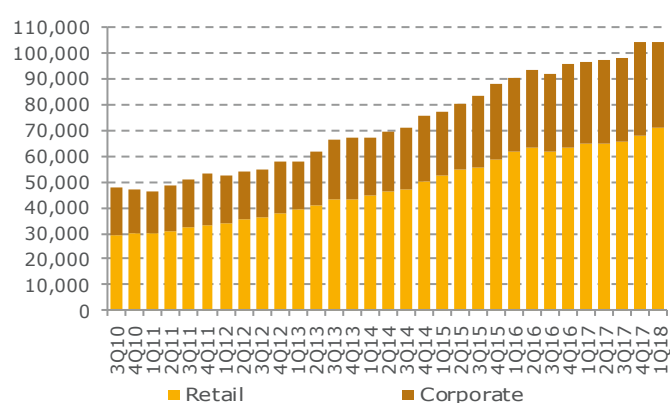
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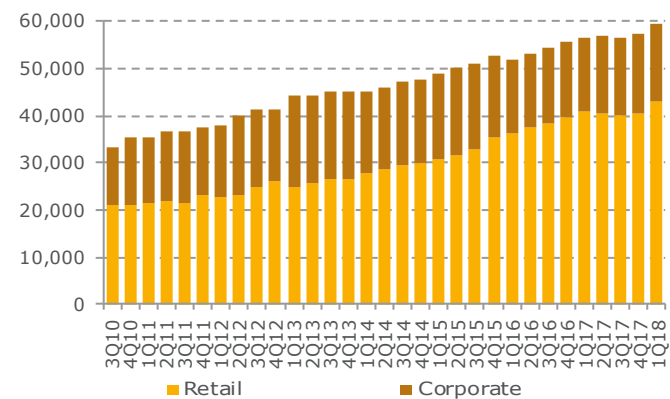
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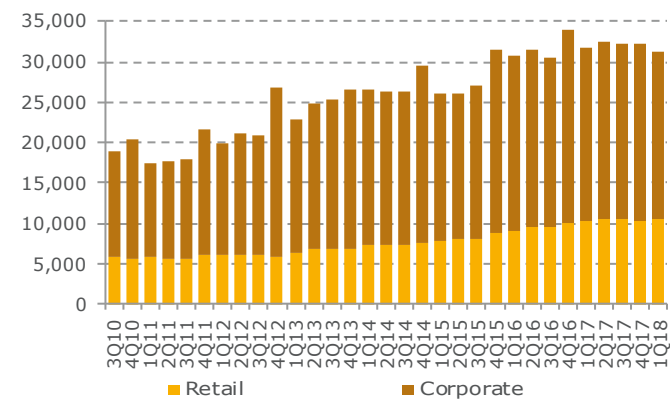
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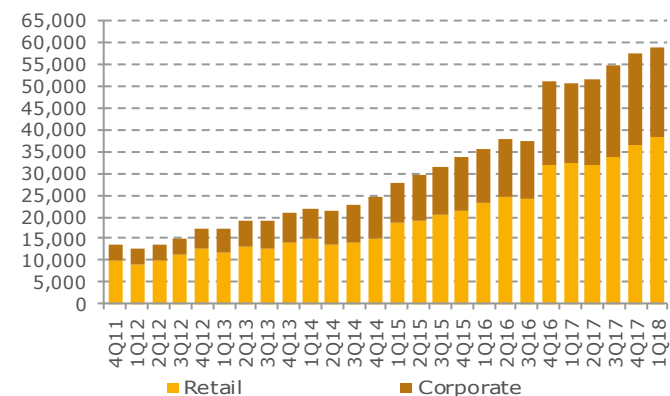
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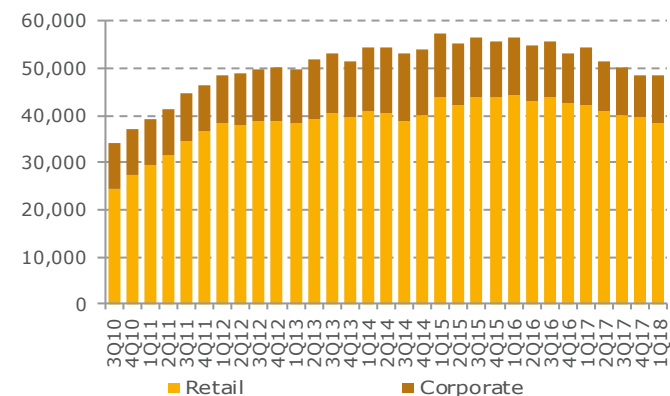
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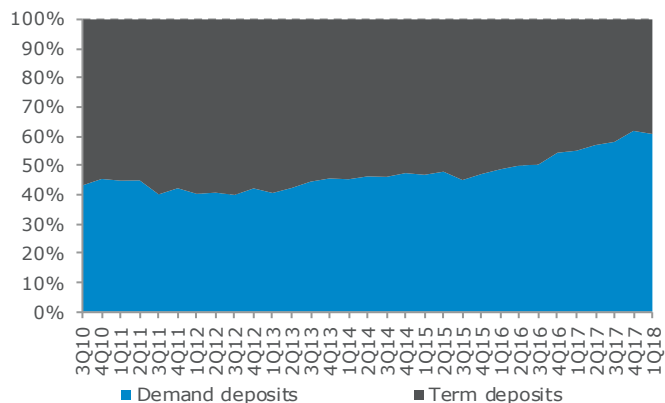
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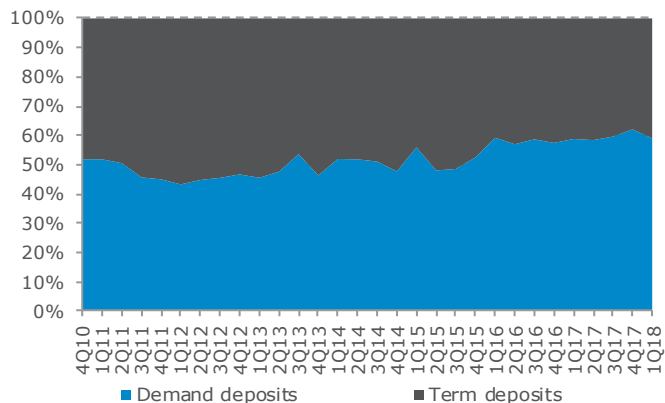
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Deposit Composition

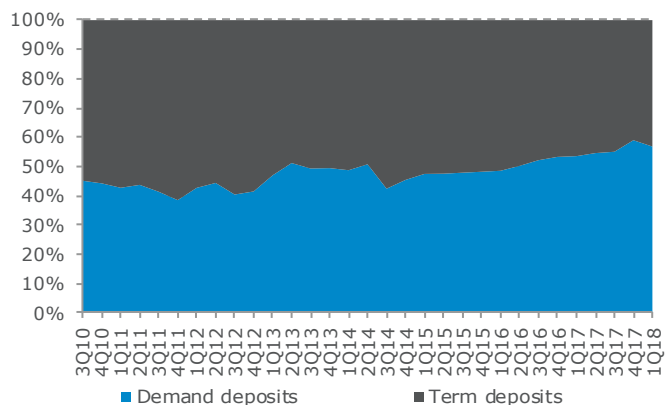
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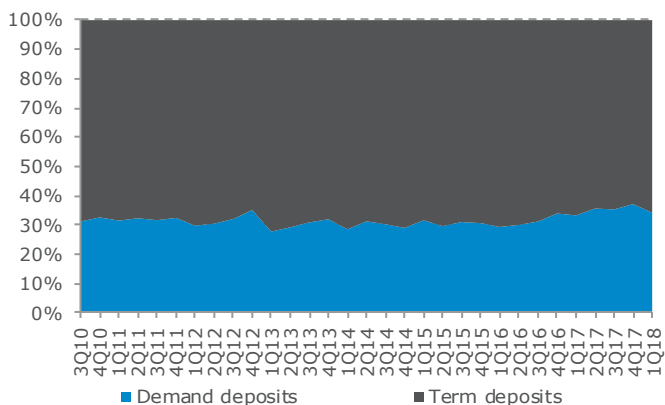
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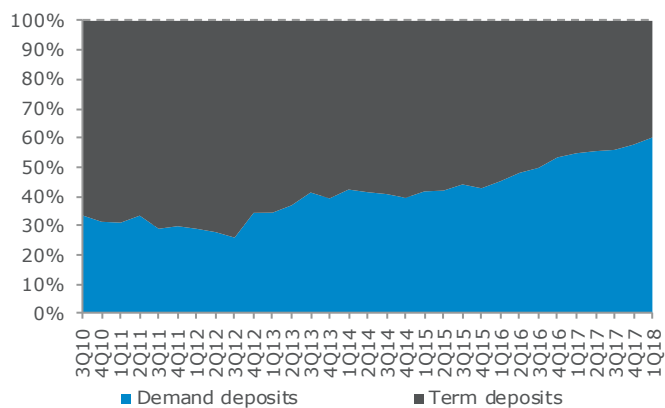
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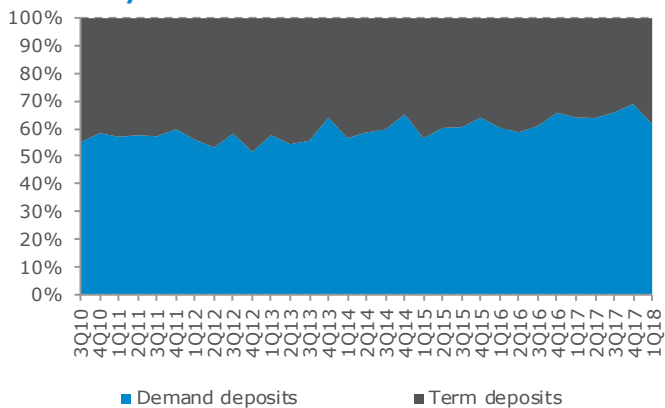
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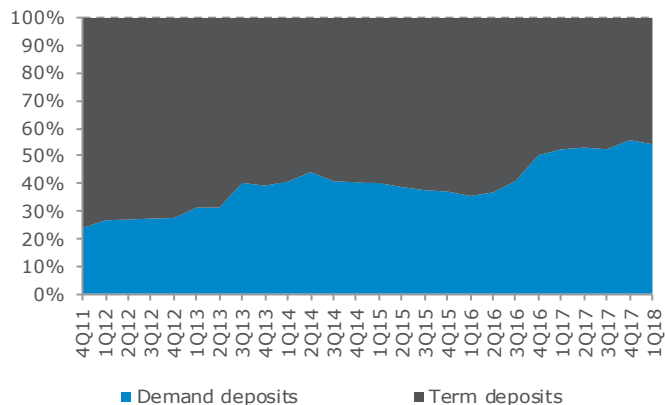
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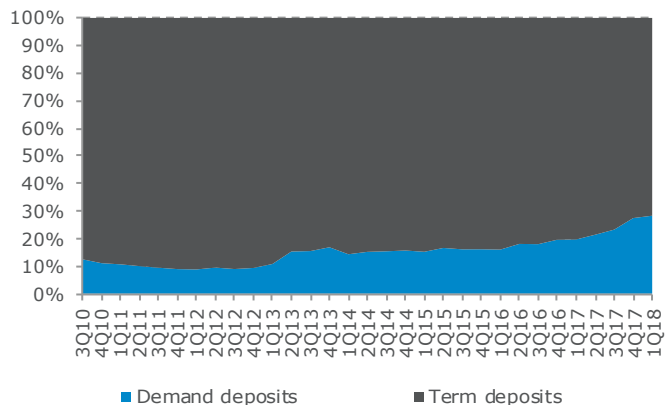
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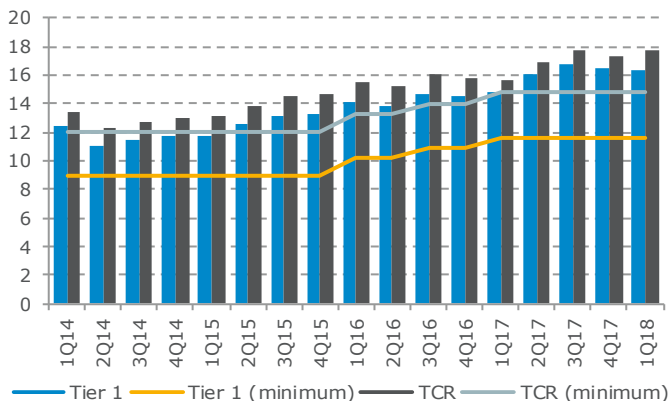
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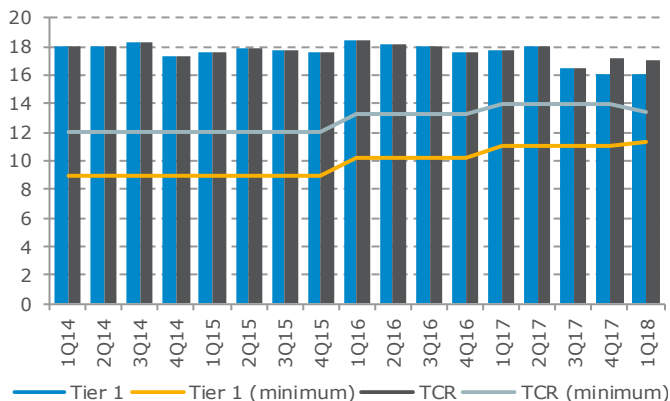
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CET1 Ratios (actual vs. minimum requirements)

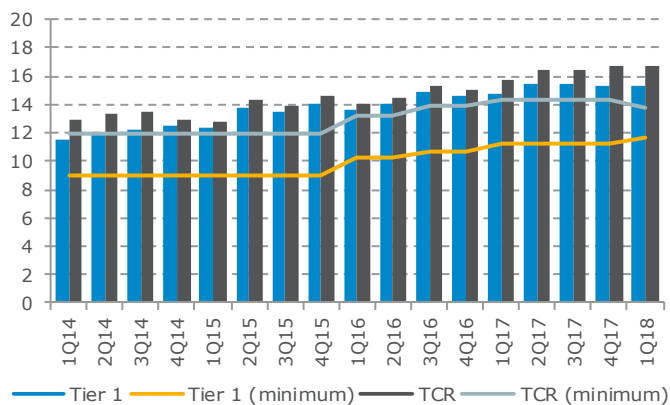
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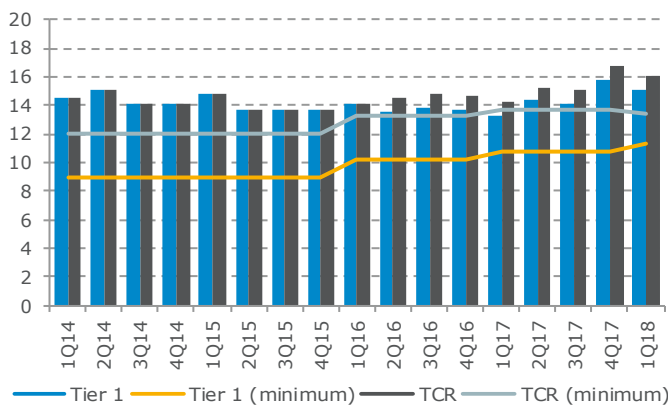
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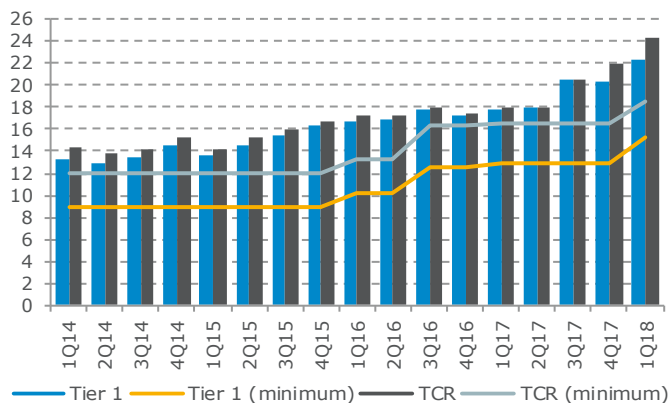
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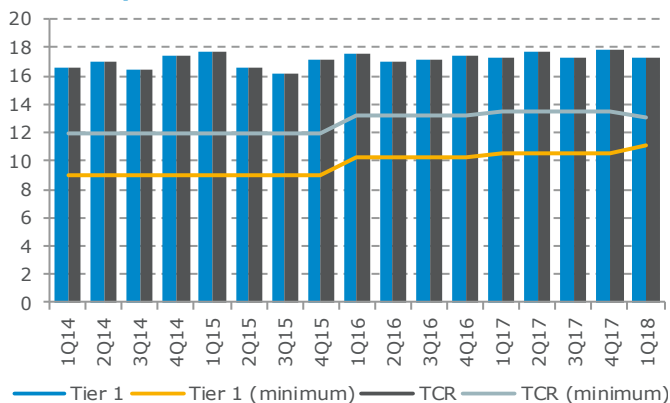
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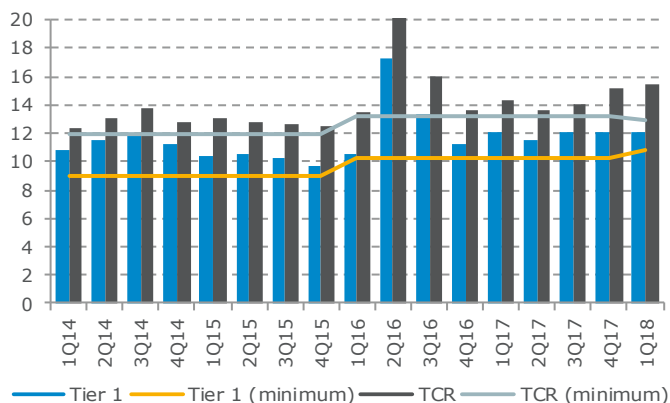
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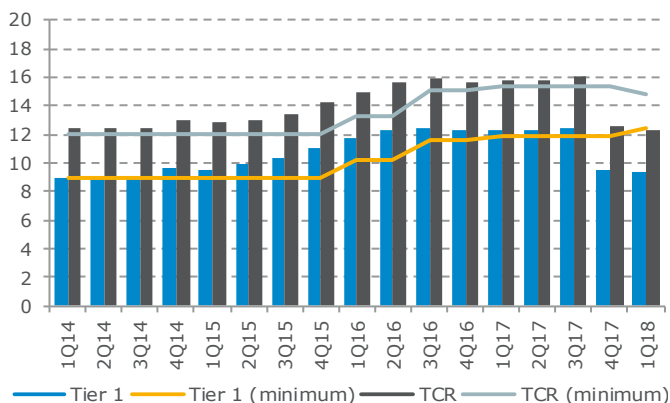
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Source: Dom Maklerski mBanku

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

OVERWEIGHT (OW) – a rating which indicates that we expect a stock to outperform the broad market
NEUTRAL (N) – a rating which indicates that we expect the stock to perform in line with the broad market
UNDERWEIGHT (UW) – a rating which indicates that we expect the stock to underperform the broad market

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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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mBank S.A. has a cash service agreement in place with Pekao and a phone subscription agreement in place with Orange Polska S.A.

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Relative – 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.

Economic profits – discounting of future economic profits; the weak point is high sensitivity to changes in the assumptions made in the valuation model.

Discounted Dividends (DDM) – discounting of future dividends; the weak point is high sensitivity to changes in the assumptions as to future dividends made in the valuation model.

NAV – valuation based on equity value, one of the most frequently used method in case of developing companies; the weak point of the method is that it does not factor in future changes in revenue/profits of a company.

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