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How OFEs are impacting stock prices

Equity Market, Poland

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In 2013, pension reform plans affecting the operation of privately-run pension funds (OFEs), giving rise to speculation about a possible flood of equity, were among the main reasons behind the weak performance of the Polish stock market. Over the past few weeks, OFEs have been selling off their equity assets leading up to the February 3rd target date for the mandatory 51.5% asset shift (calculated based on AUM as of 31 January, set to be mainly government bonds and cash) to the state-run pension system ZUS. In our view, however, the sell-off itself had a much less negative impact on stock prices than the speculation of short-term investors trying to predict the next moves of OFEs.

According to our calculations, OFEs no longer have to sell off equities today. Each fund has gathered enough cash in our view to comply with the 51.5% asset shift requirement. The table below shows our estimates as regards each OFE's asset holdings at the end of January. These estimates are based on value calculations for different asset classes as of 31 December 2013, adjusted for lower equity portfolio values depressed by the drop in the WIG index (to 49,800 points from 51,284 points at the end of December) and the January transfer from ZUS to OFEs of retirement premiums estimated at PLN 800m allocated pro rata. Under the new pensions law, aside from Treasury bonds and bonds issued by the government-run bank BKG, the February asset shifts must also include government-backed debt. Accordingly, the "other debt" column in the following table factors in BKG bonds and municipal bonds totaling PLN 18.2 billion. This compares to a September 2013 valuation of government-backed debt at PLN 20.2 billion, which suggests our calculations may be about two billion off, but this error works in favor of OFEs.

Roughly speaking, assuming WIG stays at 49,800 points and OFEs do not make any investment, after the 51.5% asset outflow, the equity component at OFEs in early February will reach 84.3%, with the cash component in the ballpark of 6.3%. Note also that the new law sets floors for OFE investment in equities at 75% of total AUM through 2014, 55% in 2015, 35% in 2016, and 15% in 2017.

Another milestone for OFEs after the February asset shift will be the four-month window given to the Polish citizens to decide whether they want to continue to invest a portion their retirement contributions with OFEs or transfer the whole of their savings to the ZUS. How many of the future retirees OFEs manage to retain remains to be seen. The most pessimistic projections envision a 'churn' rate as high as 90%. How will future OFE inflows and outflows be shaped depending on the number of citizen opt-ins? As far as inflows are concerned, private funds are set to receive a total of about PLN 4.8 billion through July in pension contributions from the ZUS. Further, they stand to receive PLN 1.3 billion dividends this year. Assuming a 10% retention rate (i.e. assuming that OFEs retain 10% of the contributions received to date), inflows from contributions would total PLN 350m. At 50% retention rate, the contribution inflows increase to an estimated PLN 1.75bn. As for outflows, under the rule that all of an individual's private retirement savings with OFEs are to be transferred to the state ten years prior to retirement, the asset transfers from OFEs to the ZUS will total PLN 4.4bn. Adjusted for this, the future OFE inflows depending on the rate of customer retention can range from PLN 2 billion (at 10%) to PLN 3.5 billion (at 50%). In 2015, assuming a 5% increase in dividend receipts, a 3% increase in monthly pension contributions (against higher salaries), and PLN 2.3bn outflows under the 10-years-to-retirement rule projected by the Finance Ministry, OFEs could see net outflows of PLN 70m at 10% retention rate or inflows of PLN 3.4bn at 50% retention rate.

Estimate of OFE assets at 1 February 2014

(PLN bn)	Total AUM at 31.Jan**	Assets to be shifted to ZUS				Remaining assets		
		total	T-bonds	other debt*	cash	cash	equity	other
Allianz	9.0	4.6	4.1	0.5	0.00	0.09	3.6	0.6
PZU	39.6	20.4	14.5	5.1	0.83	1.04	16.1	2.1
Aviva	65.9	33.9	27.0	5.0	1.99	3.07	26.7	2.2
AEGON	12.5	6.4	5.4	0.5	0.58	0.47	5.0	0.6
WARTA	4.0	2.0	1.8	0.5	0.00	0.16	1.6	0.2
Amplico	23.7	12.2	10.6	1.1	0.47	0.78	9.9	0.8
Pekao	4.5	2.3	2.0	0.3	0.00	0.04	2.0	0.1
Nordea	13.4	6.9	5.9	1.1	0.00	0.15	5.4	0.9
PKOBP	13.0	6.7	6.3	0.7	0.00	0.42	5.4	0.5
Pocztalio	5.6	2.9	2.5	0.4	0.00	0.04	2.4	0.3
AXA	18.4	9.5	8.6	1.0	0.00	0.84	7.1	1.0
ING	71.3	36.7	30.3	0.9	5.50	1.53	29.6	3.4
Generali	14.8	7.6	7.1	0.9	0.00	0.39	6.0	0.8
TOTAL	295.7	152.3	126.0	18.2	9.37	9.01	120.8	13.5

*bonds issued by the government-owned bank BKG, municipal bonds,

** assets adjusted for WIG movements (December'13 - January'14 = 49,800) and retirement premium receipts from ZUS - PLN 800m

Source: DM mBanku based on PTE reports

The opt-in or -out declarations that Poles will be filling out between April and July will also include the possibility to change OFEs. As a result, assuming the resulting contribution transfers between OFEs are made in cash, this can mean substantial exchange of cash between the different funds in August. Poles to date have been rather passive when it came to choosing the best fund to manage their retirement savings, and they have largely stuck with the funds that were randomly assigned to them by a lottery system. Faced with an actual choice (the act of writing down of the name of the old fund is a kind of a choice in itself), many may decide to make a change. When their members switch funds, OFEs settle this by offsetting their mutual flows. Therefore, a mass reshuffle in August can mean that some funds with weaker customer ratings will need to have large quantities of free cash to allow their former members to transfer out to competition. The scale of this reshuffle is hard to predict at this point.

What will OFEs do?

Operating under the new pensions regime, OFEs can be expected to sell off equity holdings during times of downturn in a shift from the past trend of OFEs stabilizing the market by buying up stocks. Do we expect such a sell off in the next few months? We do not. Given the optimistic projections for the Polish economy, and hence also the stock market, we believe OFEs will want to retain high stakes in risky assets. Because their main priority after February is to offer the highest returns possible as an incentive for existing and prospective customers at from April until August, it is in their best interest right now that the WIG going forward remain on an upward trend (this marks a 180 degree shift from the situation of the last few weeks when any gain in the WIG meant OFEs stood to lose more nominally of their AUM to the ZUS on February 3rd).

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 Dom Maklerski mBanku S.A.:**

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