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Banks - A PKO-PEO Merger: Revisiting The Idea

PEO PW; PKO PW | Banks, Poland

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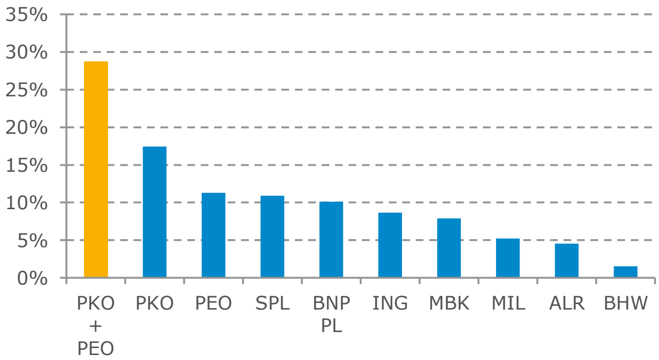
Inspired by the holiday shopping rush, and, perhaps more importantly, by a radio interview yesterday in which State Assets Minister, Jacek Sasin, cited the consolidation of 'companies from the same or similar sectors' to create 'local champions' able to compete with top European players, as the direction he wanted to follow, we decided to revisit the possibility of a merger between Poland's two largest banks, Pekao and PKO BP. The first time we considered such a union and put it forward as an interesting idea from the point of view of financial markets was in our banking sector update last year, but we feel that our arguments have since become even more compelling looking at the current valuations of both banks and given market timing. Below, we argue in ten short points that a tie-up of PKO with PEO would benefit both sets of minority shareholders, as well as state finances.

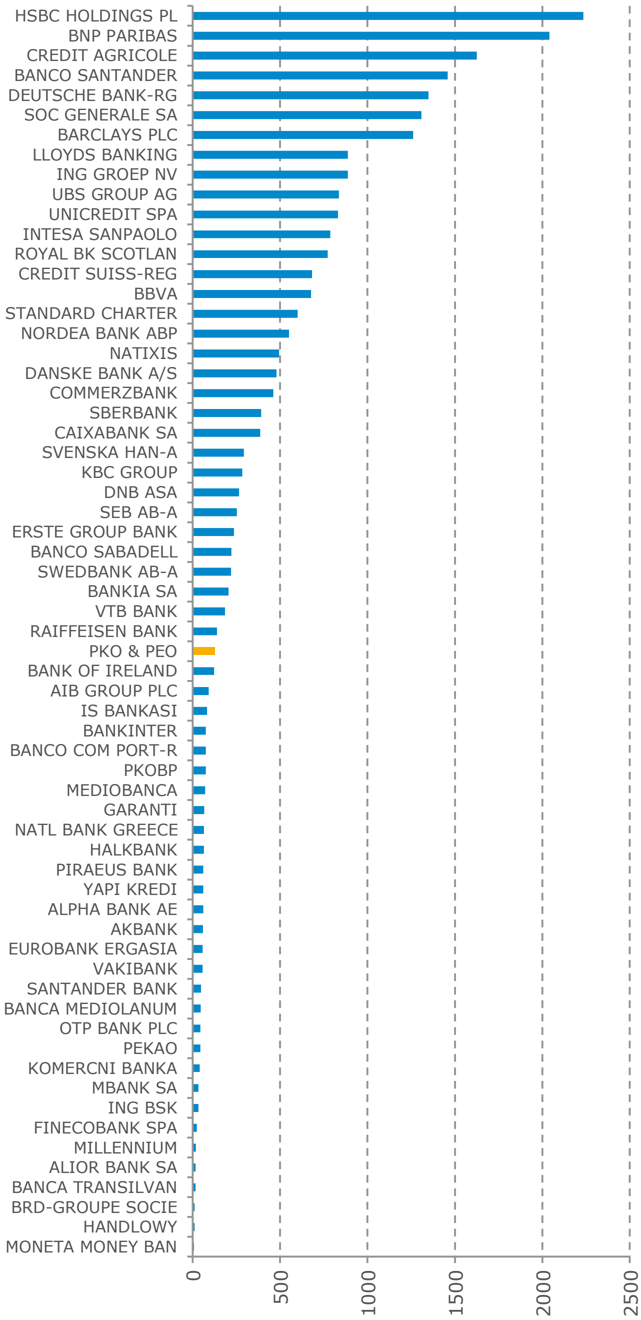
1. **The merged PKO BP would have total assets of PLN 543 billion (EUR 126 billion)**, a loan book of PLN 369bn, and a deposit base of PLN 407bn. The loan book would be broken down as follows: PLN 179bn mortgages (45% of total), PLN 45bn other consumer loans (11%), and PLN 170bn corporate lending (44%). With **assets of EUR 126bn, the new PKO would come close in size to Raiffeisen Bank International (EUR 154bn), and it would outdistance Komercni Banka and Moneta Money Bank,** but have a considerable gap to Erste Group (EUR 267bn). The Bank would have the **potential to embark on a mission of regional expansion** on an equal footing with its CEE peers, thus fulfilling the vision of Minister Sasin.
2. The merged bank's domestic market share would be roughly 29%, of which 26% in corporate loans, 42% in home loans, and 15% in other consumer lending. **A 29% market share does not constitute excessive concentration from an antitrust perspective**. The 42% mortgage ownership is a potential problem, or it can be viewed as an opportunity to carve toxic loans out into a separate entity, ostensibly as an effort to address excess control. In short, the merged PKO would be the runaway leader in all main kinds of banking services.

Estimated market share of merged PKO/PEO



Source: Dom Maklerski mBanku

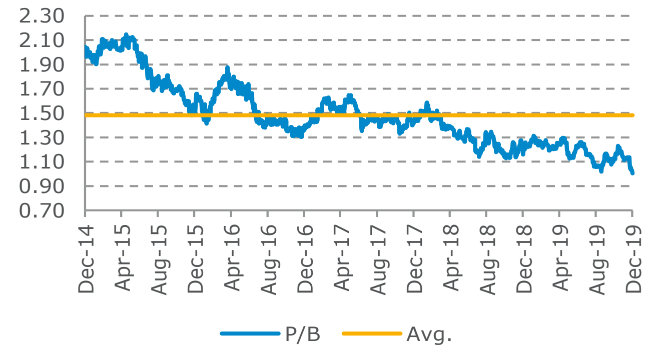
Largest European banks by assets (EUR bn, 2018 statistics)



Source: Bloomberg, Dom Maklerski mBanku

3. **The reasons why we peg PKO BP as the acquiring party include its less attractive valuation compared to PEO, and its substantial capital surplus of approximately PLN 11bn.** PEO's average P/B ratio for the last six months indicates a 13% premium over today's price, which we believe minority shareholders would accept as reasonable, and it implies a valuation of 1.1x. **At these levels, the acquisition would be a bargain considering Pekao's size and quality as a business (improving profitability, dividends, conservative balance sheet).** Further, we believe the transaction could be structured to include a share-swap for the existing controlling shareholders of Pekao (PZU, PFR), who paid a much higher price for their shares.

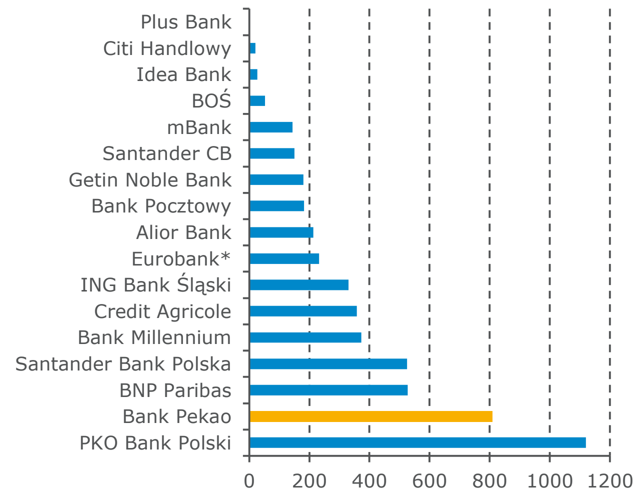
PEO 12M forward P/B (x)



Source: Bloomberg, Dom Maklerski mBanku,

4. Because of Pekao's attractive valuation, **the merger would not result in much goodwill.**
5. As a shareholder in the largest bank in Poland, **PZU**, which is Poland's #1 insurance company, would gain **access to a much larger prospective customer base (cross sell),** and it could take over the insurance business of PKO.
6. **PKO BP would have to raise as much as PLN 17bn through an equity issue in order to finance the merger, but** even so its post-merger EPS would be boosted by anywhere between **10% and 40% assuming synergy** at 0.9% of assets.
7. **The new PKO would stand to extract as much as PLN 1.9bn in merger synergies** (an estimate based on averages from recent deals). **Pekao currently runs 809 branches** (making it the 2nd-largest network in Poland after PKO), and in 2020 it is forecast to generate labor costs of PLN 1.6bn.

Polish bank branch count in Q3'19



Source: PRnews.pl, Dom Maklerski mBanku

8. **The dis-synergy potential of the merged PKO seems limited**. Both banks being under state control, consumer attrition after the merger would most likely be minimal.
9. **We see the merger, and the resulting synergy, as a strategy to more smoothly navigate a slowing economy**, the way BZ WBK and Kredyt Bank were able to weather negative momentum by joining forces in 2013.
10. **Last but not least, the merger would solve the problem of Pekao's outdated banking technology:** PKO boasts that its fintech systems are among the most advanced in the world.

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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