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BZ WBK to merge with Kredyt Bank

Current price: PLN 14.10

On 28 February, Santander and KBC announced their intention to merge BZ WBK with Kredyt Bank. 18.9m new shares in BZ WBK will be issued and exchanged for Kredyt Bank shares at the following ratio: 6.96 shares in BZ WBK for 100 Kredyt Bank shares. The valuations underpinning the merger are PLN 226.4 per share in the case of BZ WBK and PLN 15.75 per share in the case of Kredyt Bank. In our opinion, both prices imply very high 2011 P/BV multiples relative to the market valuations of other Polish banks (2.25x for BZ WBK and 1.40x for Kredyt Bank). Since the merger will be based on share swap, the implied valuation of Kredyt Bank must be considered in conjunction with the implied valuation of BZ WBK. In our opinion, due to, among other things, its insufficient liquidity, the BZ WBK stock is overvalued relative to PKO BP and Pekao by ca. 19% (based on 2011 P/BV). As a result, the high valuation of BZ WBK inflates the valuation of Kredyt Bank. A normalized valuation for BZ WBK (to the average for PKO BP and Pekao, i.e. 1.89x 2011 P/BV) implies a PLN 13.27 per-share valuation for Kredyt Bank (1.18x 2011 P/BV), i.e. 6% below February 28 closing price. Note that while the market could use this transaction as a valuation benchmark for other smaller banks, we see this expectation as an overly optimistic one, because it assumes that there would be other entities willing to acquire Polish banks, and that the banks taken over would generate similar synergies. Under this scenario, speculative upside for the Millennium stock has been exhausted, since it is currently trading at 2011 P/BV of 1.16x, while there is some room for the Get Bank stock, which is currently priced at 1.0x 2011 P/BV. A more optimistic approach to the transaction, i.e. that is that the valuation of BZ WBK is fair, entails a buy cue for Polish banks with 15-30% upside potential. We have suspended our rating for Kredyt Bank as we prepare the forecasts and the rating for the merged bank.

BZ WBK to merge with Kredyt Bank

Santander and KBC announced a plan to merge their Polish subsidiaries BZ WBK and Kredyt Bank. BZ WBK will issue 18.91m new shares, which will be allocated to Kredyt Bank shareholders at the following exchange ratio: 6.96 new BZ WBK shares for 100 Kredyt Bank shares. The parties expect to finalize the deal and register the merger in court in Q4 2012, after the necessary approvals have been received (from the Financial Supervision Authority, the Polish antitrust office, the European Commission and the banks' shareholders).

In addition, it was agreed that KBC will continue to finance Kredyt Bank for three years upon effective merger of the two banks (i.e. most likely through December 2015) in the amount of CHF 3bn in the first year, CHF 2.5bn in the second year and CHF 2bn in the third year (the gradual reduction reflecting natural mortgage portfolio amortization). Moreover, the merged bank will distribute shares in KBC TFI investment funds under a non-exclusive agreement for no less than two years following the merger, and Santander will acquire a 100% stake in Żagiel from KBC (Żagiel may be merged with Santander Consumer Bank Poland).

Santander will control a 76.5-81.5% stake in the merged bank

Immediately upon the merger, Santander will control 76.5% of the new bank's equity (vs. 96.2% in BZ WBK currently), and KBC will control a 16.4% stake (vs. 80% in Kredyt Bank now). The other shareholders will control 7.1% of the shares. However, Santander has undertaken to assist KBC in bringing its holding to below 10% by buying an up to 5% stake from it at PLN 226.4 per share and selling these shares to investors that have already expressed their interest. The European Bank of Reconstruction and Development announced that it had been invited to invest EUR 80m in BZ WBK shares, which would give it a ca. 1.6% stake in the equity of the merged bank. In addition, earlier press reports mentioned the American fund Apax as a party that might be interested in the transaction. In a separate announcement, KBC revealed that it was planning to sell the remaining shares at a price that would maximize their value.

Given these post-merger changes in shareholder structure, Santander will eventually control a 76.5-81.5% stake in the merged bank, KBC 0% and the other shareholders between 18.5-23.5%. It should be noted that Santander is going to partially meet its commitment to the KNF which has it maintain free float at no less than 25%.

Implications for valuation

According to the announcement, the share exchange ratio in the transaction is based on a PLN 226.4 per-share valuation for BZ WBK (2% below the closing price on the day preceding the announcement), and Kredyt Bank has been valued at PLN 15.75 per share (32% above market price from the preceding day). These prices entail 2011 P/BV multiples of 2.25x for BZ WBK (with 2011 ROE at 16.9%) and 1.40x for Kredyt Bank (with 2011 ROE at 11.1%). We consider these multiples too high relative to the current valuations of Polish banks. BZ WBK's valuation implies a 19% premium on 2011 P/BV relative to the average for PKO BP and Pekao (1.89x), while Kredyt Bank's valuation implies a 33% premium on 2011 P/BV relative to the average for Millennium and Get Bank (1.05x). Because the merger is expected to generate synergies, the implied valuation of Kredyt Bank most likely factors some of them in. This means that the standalone valuation of Kredyt Bank should incorporate a premium to peers which are comparable to it, but which are not expected to deliver synergy effects. We estimate this premium at 5-10%.

Because the transaction will take the form of share swap, either Kredyt Bank or BZ WBK need to be taken as a point of reference. Our estimates treat BZ WBK as the starting point, given its stronger standing in the market.

Scenario 1: BZ WBK valuation in the transaction is close to market value

If we assume that the 2.25x 2011 P/BV valuation of BZ WBK is a fair one, this would constitute a positive signal for the valuation of the entire banking industry in Poland, not just Kredyt Bank. We believe bigger banks, such as PKO BP or Pekao, should be trading at a P/BV level comparable to BZ WBK's, and smaller banks, such as Millennium or Get Bank, at a level comparable to Kredyt Bank's inclusive of a 5-10% takeover premium. This entails a 15-30% upside potential for bank stocks.

Scenario 2: BZ WBK valuation is inflated

Because the implied 2011 P/BV valuation of BZ WBK reflects a 19% premium over the average for PKO BP and Pekao, it can be considered too high, all the more so that BZ WBK generates a ROE comparable to PKO BP's (16.9%). Assuming that the fair value of BZ WBK is 1.89x 2011 P/BV (or PLN 190.4 per share, 16% below the current market price), we get a PLN 13.7 per-share valuation for Kredyt Bank (1.18x 2011 P/BV). The current price of the Kredyt Bank stock is 6% above this price. In the case of Millennium, a 2011 P/BV multiple of 1.18x entails a per-share price of PLN 4.46 (3% above the current market price), and in the case of Get Bank, PLN 2.17 per share (19% above the current market price). Note that these valuations could serve as reference levels if these banks were being taken over or if they could deliver synergy effects comparable to those expected from the Kredyt Bank takeover.

Net synergies will total PLN 631m in 2013-2015

Santander has quantified its expectations with regard to cost and revenue synergies that the merged bank is expected to generate in 2013-2015. They will amount to PLN 56m in 2013, PLN 226m in 2014 and PLN 349m in 2015, i.e. PLN 631m total. The main source of margin improvement will be cost synergies, which might reach PLN 322m gross (or PLN 258m net) in 2015 (= 12% of the 2011 costs of the merged entity). The cost synergies will be stem primarily from marketing expenses, centralized purchases within the Santander group, branch network optimization and the introduction of a single IT platform. Santander is planning to close only some of the overlapping branches and does not foresee mass layoffs. As far as revenue synergies are concerned, they are expected to reach PLN 114m gross (or PLN 91m net) in 2015, i.e. 2% of 2011 revenues of the merged entity. They are primarily expected in insurance product sales, asset management services, increased cross selling among Kredyt Bank clients and increased F/X gains.

Net profit of the merged bank to grow at 21% on average in 2012-2015

In addition, Santander disclosed its expectations with regard to the earnings to be generated by the merged bank in 2012-2015. Average growth of 21% p.a. is expected in this period. Note that the 2012-2013 net income forecast that Santander has prepared for BZ WBK exceeds the current market consensus by 11-14%, while the 2012-2013 projection for Kredyt Bank exceeds market expectations by 4-7% and our forecasts by 10-15%.

Net income forecasts

(PLN m)	2011	2012F	2013F	2014F	2015F
Forecasts prepared by Santander:					
BZ WBK	1 184	1 477	1 741	2 002	2 308
Kredyt Bank	327	275	320	369	412
Net synergies			56	226	349
Net income of the merged bank	**1 512**	**1 752**	**2 117**	**2 597**	**3 069**
Our forecasts					
Kredyt Bank	327	234	275	324	373
Difference vs. Santander's forecasts		-15%	-14%	-12%	-10%
Market expectations					
BZ WBK	1 184	1 319	1 504	-	-
Difference vs. Santander's forecasts		-11%	-14%	-	-
Kredyt Bank	327	263	304	342	-
Difference vs. Santander's forecasts		-4%	-5%	-7%	-

Source: Santander, Bloomberg, BRE Bank Securities

No. 5 plus No. 8 = No. 3 in the market

The merger of BZ WBK (Poland's third bank based on total assets) and Kredyt Bank (Poland's eight) will create the third-biggest bank in the country with an 8.6% market share in total assets, 8.5% share in total loans and 9.6% share in total deposits. The merged bank will be particularly strong in corporate banking, with a 14% market share, and it will be weaker in SME and consumer lending. The new bank will also have a liquid balance sheet with a loans/deposits ratio of ca. 90% (pro-forma for Q4 2011). Its capital adequacy ratio will be 14.7%, and its Tier-1 ratio, 12.2% (pro-forma for year-end 2011).

Market shares (Q4 2011)

	BZ WBK	Kredyt Bank	Merged bank
Assets	5.0%	3.5%	8.6%
Total loans	4.8%	3.7%	8.5%
Corporate	11.2%	3.1%	14.3%
Retail	2.4%	4.4%	6.8%
Mortgages	2.4%	5.7%	8.2%
Total deposits	6.0%	3.6%	9.6%
Corporate	8.7%	5.0%	13.7%
Retail	5.8%	3.8%	9.6%
Branches	5.3%	7.6%	12.9%

Source: BZ WBK, Kredyt Bank, NBP, KNF

Pro-forma results for 2011 for the merged bank

(PLN m)	BZ WBK	Kredyt Bank	Merged bank
Interest income	2 069	1 150	3 219
Fee income	1 358	315	1 673
Trading income	347	81	428
Income from banking operations	**3 774**	**1 546**	**5 320**
Other net operating income	-1	79	79
Total income	**3 773**	**1 625**	**5 399**
Payroll expenses	-977	-443	-1 420
D&A expenses	-216	-90	-306
Non-payroll expenses	-682	-467	-1 149
Total costs	**-1 875**	**-1 000**	**-2 875**
Operating income before provisions	**1 898**	**626**	**2 524**
Loan loss provisions	-367	-199	-566
Equity in profits/losses of associates	11	4	15
Pre-tax income	**1 542**	**431**	**1 974**
Tax	-316	-104	-419
Minority interests	-43	0	-43
Net income	**1 184**	**327**	**1 512**
Interest margin (on total assets) (%)	3.66	2.69	3.24
Non-interest income/Total income (%)	45.2	29.2	40.4
Costs/Income (%)	49.7	61.5	53.2
Cost of risk (bps)	104	71	89
Effective tax rate	20.5	24.1	21.3
Net loans	38 017	29 086	67 103
Total assets	59 873	42 003	101 876
Deposits	46 829	28 043	74 873
Equity	7 356	3 066	10 421
Loans/Assets (%)	63.5	69.2	65.9
Deposits/Assets (%)	78.2	66.8	73.5
Loans/Deposits (%)	81.2	103.7	89.6
Equity/Assets (%)	12.3	7.3	10.2
NPL/Loans (%)	5.5	8.2	6.7
Provisions/NPL (%)	65.3	56.0	60.3
CAR (%)	15.1	12.5	14.7
Tier 1 capital ratio (%)	13.2	8.7	12.2
ROA (%)	2.10	0.77	1.52
ROE (%)	16.9	11.1	15.2

Source: BZ WBK, Kredyt Bank

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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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