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Special Comment

BRE Bank Securities

Banks

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Pekao

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Reduce

(Reiterated)

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Pekao reports in-line Q1'12 results

Current price: PLN 145.0; Target price: PLN 135.0

At PLN 711m, Pekao's Q1 2012 net income displayed 10% expansion from the year-ago figure and 8% contraction from the quarter before, and it came in line with the consensus estimate of PLN 704m and topped our PLN 682m estimate by 4%. Overall income matched our estimate on slightly lower-than-expected operating expenses and loan-loss provisions. Fee income was weak, and trading income was boosted by proceeds from a loan portfolio sale. Pekao's Q1 2012 net income figure accounts for 26% of our FY2012 estimate of PLN 2741m which assumes 5% year-on-year contraction. The bank's Management say they will be aiming to repeat the net income result from last year in 2012. Based on our forecasts, Pekao is trading at 13.9x P/E, showing a 9% premium to sector averages and a 15% premium relative to PKO BP, prompting a reiterated reduce rating.

Flat loan growth due to strong zloty

Pekao's loan portfolio displayed flat q/q growth, with retail loans rising 1% and corporate loans decreasing 2%, led by an appreciating zloty. Adjusted for FX effects, the corporate portfolio shows q/q uptick of 1-2%. In retail the strongest growth was recorded in mortgage loans (+4% q/q) and cash loans (+2% q/q) – the two strategic lines. Other retail loans (including foreign-currency mortgages) fell 5%. Pekao sold 1.4bn-worth of mortgage loans in Q1 2012 (-2% q/q, -6% y/y) and extended PLN 1.1bn cash loans (-12% q/q, +1% y/y).

Deposits rise thanks to lack of seasonal slowdown and acceleration in retail

Pekao's deposits expanded 1% q/q in Q1 2012 thanks to a 2% increase in retail savings. Corporate deposits edged down 1%, showing a lack of seasonal deceleration caused by withdrawals. There was a considerable drop in repo and sell-buy-back transactions (-70% or PLN -3.2bn q/q), but it was almost fully offset by receipts from government units (+44% or PLN +2.4bn q/q) and non-bank financial institutions (+14% or PLN +1.3bn q/q). The ratio of loans to deposits improved by 30bps to 87.9% compared to Q4'11.

Interest income depressed by lower margins on interest-bearing assets

Like most banks, Pekao experienced 1% contraction to PLN 1193m in interest income. Unlike other banks, however, this contraction was a consequence of downward pressure not on interest-bearing liabilities, but on interest-bearing assets. Despite an increase in both interest-bearing assets (+1% q/q) and market interest rates (+7bps to 4.88% on average 3M WIBOR), interest income was flat. On the other hand, a 2% q/q increase in interest expenses was more than justified by the higher interest rates. In our view, the q/q contraction in margins on interest-bearing assets (-16bps q/q) may have been due to lower yields on the bond portfolio amid rising interest rates. The net interest margin on total assets fell 9bps to 3.25%.

Lowest fee income in three years

Fee income continued on a downward trend inQ1, falling 7% q/q and 8% y/y at PLN 551m – the lowest level since Q1 2009. The reasons included a 9% drop in loan fees (probably on lower cash loan sales) and a 10% drop in other fees (due to lower corporate customer transaction volumes and customers switching to electronic and mobile banking which generate lower fees). Pekao's CEO admitted that maintenance of steady fee income in 2012 will be a challenge.

Trading income boosted by one-time gain

As predicted, trading income showed 13% q/q drop to PLN 158m in Q1 2012. It received a major, PLN 42m boost from investment operations (+54 q/q, +19% y/y) which, we think, may have included a bond portfolio sale. Other trading activity produced weak results, with income down 20% y/y and 25% q/q at PLN 115m.

Operating expenses remain under control

Operating costs surprised on the upside, decreasing 1% q/q to PLN 911m from an already low Q4 2011 base boosted by charge reversals. Payroll expenses increased 4% from the low quarter-before base, but they were 2% lower than a year earlier at PLN 479m. At the same time, the number of Pekao employees fell by 3%, meaning that average monthly cost per employee was virtually flat y/y. Non-payroll costs increased 8% compared to Q1 2011 due to higher marketing expenses, but they were 7% lower than in Q4 2011. Pekao's CEO says costs in 2012 will be increasing at a rate below inflation. After an uptick of just 1% in Q1, we anticipate a slight acceleration in the following quarters.

Steady loan loss provisions

Loan loss provisions rose just 3% q/q and 1% y/y in Q1 2012, and they were 6% lower than expected. This was partly owed to a PLN 10m reversal of an off-balance-sheet exposure allowance (a customer decided not to use a credit facility), and partly to a 30% q/q drop to PLN 56m in provisions for retail loans. Corporate loan provisions increased 9% q/q to PLN 71m. The share of non-performing loans in total loans deteriorated by 14bps q/q to 6.7% in Q1 2012, led by a 16bp deterioration to 11.6% in retail loans. The quality of corporate loans remained flat at 3.5%. The ratio of provisions to NPLs declined by 90bps to a still high 72.1%.

Tier-1 at all-time high of 18.9%

Pekao's Tier-1 ratio improved by 189bps q/q to a record-high 18.9%, thanks mainly to the addition of retained 2011 earnings to regulatory capital. We estimate that Pekao had surplus capital of nearly PLN 7.7bn over the capital adequacy ratio of 12% as of 31 March 2012. As a result, it reported low return on equity of 13.1% (in our opinion, the ROE on normalized capital is ca. 17.3%).

Overview of quarterly earnings

(PLN m)	1Q11	2Q11	3Q11	4Q11	1Q12	Y/Y	Q/Q	1Q12P	differ.
Interest income (incl. swaps)	1 061	1 125	1 192	1 205	1 193	*12%*	*-1%*	1 187	*1%*
Fee income	597	645	612	595	551	*-8%*	*-7%*	564	*-2%*
Trading income	147	130	173	180	158	*7%*	*-13%*	160	*-1%*
Income from banking operations	**1 805**	**1 900**	**1 976**	**1 981**	**1 901**	***5%***	***-4%***	**1 911**	***-1%***
Other income (net)	8	15	23	15	16	*97%*	*6%*	10	*59%*
Non-interest income	**752**	**789**	**807**	**791**	**724**	***-4%***	***-8%***	**734**	***-1%***
Total income	**1 813**	**1 915**	**1 999**	**1 996**	**1 917**	***6%***	***-4%***	**1 921**	***0%***
Payroll expenses	-490	-501	-495	-460	-479	*-2%*	*4%*	-500	*-4%*
D&A expenses	-96	-93	-93	-96	-93	*-2%*	*-2%*	-96	*-3%*
Non-payroll expenses	-314	-332	-340	-362	-338	*8%*	*-7%*	-345	*-2%*
Total costs	**-899**	**-926**	**-928**	**-918**	**-911**	***1%***	***-1%***	**-941**	***-3%***
Operating income before provisions	**914**	**988**	**1 070**	**1 078**	**1 006**	***10%***	***-7%***	**980**	***3%***
Loan loss provisions	-134	-135	-138	-131	-136	*1%*	*3%*	-145	*-6%*
Equity in profits/losses of associates	21	29	17	14	14	*-34%*	*-1%*	10	*36%*
Pre-tax income	**801**	**882**	**950**	**960**	**884**	***10%***	***-8%***	**845**	***5%***
Tax	-150	-166	-181	-187	-172	*15%*	*-8%*	-161	*7%*
Minority interests	-3	-2	-2	-2	-2	*-18%*	*-5%*	-3	*-15%*
Net income	**648**	**714**	**766**	**771**	**711**	***10%***	***-8%***	**682**	***4%***
Interest margin (on total assets) (%)	3.17	3.40	3.48	3.34	3.25			3.24	
Non-interest income / Total income (%)	41.5	41.2	40.4	39.6	37.8			38.2	
Costs/Income (%)	49.6	48.4	46.4	46.0	47.5			49.0	
Cost of risk (bps)	66	65	63	57	57			61	
Effective tax rate	18.7	18.8	19.1	19.5	19.4			19.0	
Net loans	81 892	84 643	89 391	95 679	95 915	*17%*	*0%*	95 599	*0%*
Assets	133 361	131 153	142 466	146 590	147 268	*10%*	*0%*	146 601	*0%*
Deposits	97 271	97 269	103 795	108 419	109 064	*12%*	*1%*	108 190	*1%*
Equity	20 699	19 796	20 534	21 271	22 086	*7%*	*4%*	21 954	*1%*
Loans/Assets (%)	61.4	64.5	62.7	65.3	65.1			65.2	
Deposits/Assets (%)	72.9	74.2	72.9	74.0	74.1			73.8	
Loans/Deposits (%)	84.2	87.0	86.1	88.2	87.9			88.4	
Equity/Assets(%)	15.5	15.1	14.4	14.5	15.0			15.0	
NPL/Loans (%)	7.0	6.9	6.8	6.6	6.7			n/a	
Provisions/NPL (%)	74.4	74.4	75.1	73.0	72.1			n/a	
CAR (%)	18.5	18.4	17.1	17.0	18.9			n/a	
Tier-1 capital ratio (%)	18.5	18.4	17.1	17.0	18.9			n/a	
ROA (%)	1.94	2.16	2.24	2.13	1.93			1.86	
ROE (%)	12.7	14.1	15.2	14.7	13.1			12.6	

Source: Pekao, BRE Bank Securities

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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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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%
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