

21 August 2012 | 28 pages

Diversified Banks (GICS) | Banks (Citi)
CEEMEA | Poland

Bank Pekao SA (BAPE.WA)

Surplus Capital Conundrum: Downgrading to Neutral

- Fairly Valued, Downgrade to Neutral** — Given the significant difference between valuing the bank using reported capital (ROE 14%, implied target valuation of ZI 137) and normalised capital (ROE 21%, implied target valuation of ZI 174), the key question remains will the bank ever be able to deploy or return surplus capital? We maintain our assumption of a 40% probability that surplus capital is deployed/returned and modify our target price to ZI 152 from ZI 157, driven by a slight earnings downgrade and the fact that the bank has gone ex dividend. Given recent strong share performance, we downgrade our rating to Neutral from Buy.
- Surplus Capital** — Given heightened global macro-economic uncertainty we do not expect the regulator to consent to Pekao paying high dividends or buying back shares. However, we are more optimistic that tough economic conditions may create consolidation opportunities that could allow the bank to deploy excess capital via M&A.
- Capturing Share** — We are not concerned about Pekao's strategy to increase its market share ahead of an anticipated slowdown in the economy. In 2009 Pekao missed an opportunity to capture share and we are glad to see the bank is not making this mistake again. We believe that due to its large client base and experienced management it will keep credit risk under control. On the other hand, this strategy is unlikely to successfully absorb substantial amounts of excess capital.
- Credit Headwinds** — Rising NPLs, falling provision coverage, and significant exposure to the construction sector lead us to remain bearish on the outlook for credit quality. Moreover, we don't subscribe to the widely held view that Pekao's loan book is lower-risk than at PKO BP's as our analysis suggests that 90-day overdue loans are higher at Pekao than at PKO BP.
- Minor Earnings Downgrade** — We lower our EPS estimates by a marginal 1.2% in 2012, 1.0% in 2013 and 1.3% in 2014, driven a reduction in our NIM assumptions.

- Company Update
- Rating Change
- Target Price Change
- Estimate Change

Neutral	2
<i>from Buy</i>	
Price (17 Aug 12)	ZL157.50
Target price	ZL152.00
<i>from ZL157.00</i>	
Expected share price return	-3.5%
Expected dividend yield	5.5%
Expected total return	2.0%
Market Cap	ZL41,325M
	US\$12,531M

Price Performance (RIC: BAPE.WA, BB: PEO PW)



Bank Pekao SA (PLN)

Year to 31 Dec	2010A	2011A	2012E	2013E	2014E
Net Income (ZLM)	2,525.6	2,899.4	2,786.9	2,739.0	3,395.0
Diluted EPS (ZL)	9.63	11.05	10.62	10.44	12.94
Diluted EPS (Old) (ZL)	9.63	11.05	10.75	10.55	13.11
PE (x)	16.4	14.3	14.8	15.1	12.2
P/BV (x)	2.0	1.9	1.8	1.8	1.7
DPS (ZL)	6.80	5.38	8.60	8.60	10.00
Net Div Yield (%)	4.3	3.4	5.5	5.5	6.3
ROE (%)	13.1	14.0	12.6	11.9	14.2

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Fiscal year end 31-Dec	2010	2011	2012E	2013E	2014E
Valuation Ratios					
P/E adjusted (x)	16.4	14.3	14.8	15.1	12.2
P/E reported (x)	16.4	14.3	14.8	15.1	12.2
P/BV (x)	2.0	1.9	1.8	1.8	1.7
P/Adjusted BV diluted (x)	2.0	1.9	1.8	1.8	1.7
Dividend yield (%)	4.3	3.4	5.5	5.5	6.3
Per Share Data (ZL)					
EPS adjusted	9.63	11.05	10.62	10.44	12.94
EPS reported	9.63	11.05	10.62	10.44	12.94
BVPS	76.89	81.07	87.12	88.96	93.30
Tangible BVPS	74.24	78.39	84.36	86.11	90.37
Adjusted BVPS diluted	76.86	81.05	87.09	88.93	93.27
DPS	6.80	5.38	8.60	8.60	10.00
Profit & Loss (ZLm)					
Net interest income	4,104	4,558	4,809	5,015	5,431
Fees and commissions	2,368	2,449	2,320	2,349	2,525
Other operating Income	807	739	758	803	849
Total operating income	7,279	7,746	7,887	8,167	8,804
Total operating expenses	-3,656	-3,679	-3,731	-3,931	-4,025
Oper. profit bef. provisions	3,622	4,067	4,156	4,236	4,779
Bad debt provisions	-589	-544	-750	-908	-655
Non-operating/exceptionals	0	0	0	0	0
Pre-tax profit	3,034	3,523	3,406	3,329	4,124
Tax	-571	-684	-663	-645	-799
Extraord./Min. Int./Pref. Div.	63	60	44	56	70
Attributable profit	2,525	2,899	2,787	2,739	3,395
Adjusted earnings	2,526	2,899	2,787	2,739	3,395
Growth Rates (%)					
EPS adjusted	4.7	14.7	-3.9	-1.7	24.0
Oper. profit bef. prov.	4.3	12.3	2.2	1.9	12.8
Balance Sheet (ZLm)					
Total assets	134,090	146,590	152,792	162,742	173,970
Avg interest earning assets	126,246	132,477	141,848	149,732	159,782
Customer loans	84,859	99,961	102,223	110,328	119,253
Gross NPLs	5,714	6,320	7,462	8,275	7,751
Liab. & shar. funds	134,090	146,590	152,792	162,742	173,970
Total customer deposits	99,807	108,437	111,065	119,042	127,592
Reserve for loan losses	4,052	4,423	4,892	5,490	5,774
Shareholders' equity	20,174	21,271	22,858	23,341	24,479
Profitability/Solvency Ratios (%)					
ROE adjusted	13.1	14.0	12.6	11.9	14.2
Net interest margin	3.25	3.44	3.39	3.35	3.40
Cost/income ratio	50.2	47.5	47.3	48.1	45.7
Cash cost/average assets	2.8	2.6	2.5	2.5	2.4
NPLs/customer loans	6.7	6.3	7.3	7.5	6.5
Reserve for loan losses/NPLs	70.9	70.0	65.6	66.3	74.5
Bad debt prov./avg. cust. loans	0.7	0.6	0.8	0.9	0.6
Loans/deposit ratio	85.0	92.2	92.0	92.7	93.5
Tier 1 capital ratio	17.6	17.0	19.0	18.3	18.1
Total capital ratio	17.6	17.0	19.0	18.3	18.1

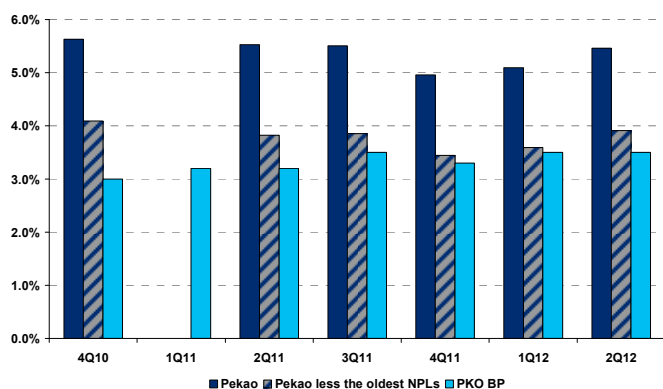
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Bank Pekao in Snapshots

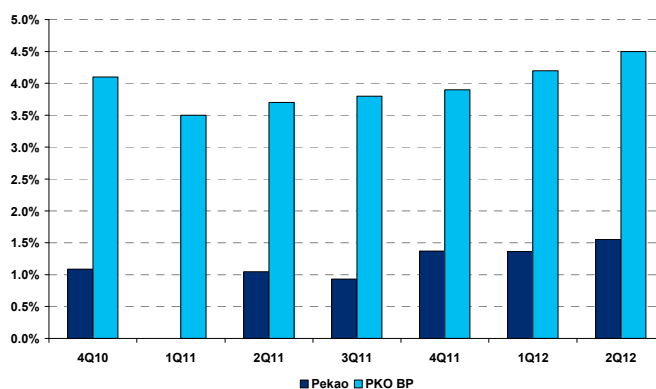
Pekao had more 90 days overdue loans than PKO BP and fewer performing loans classified as impaired

Figure 1. Pekao vs. PKO BP – 90 days Overdue Ratio, 4Q10-2Q12 (Percentage)



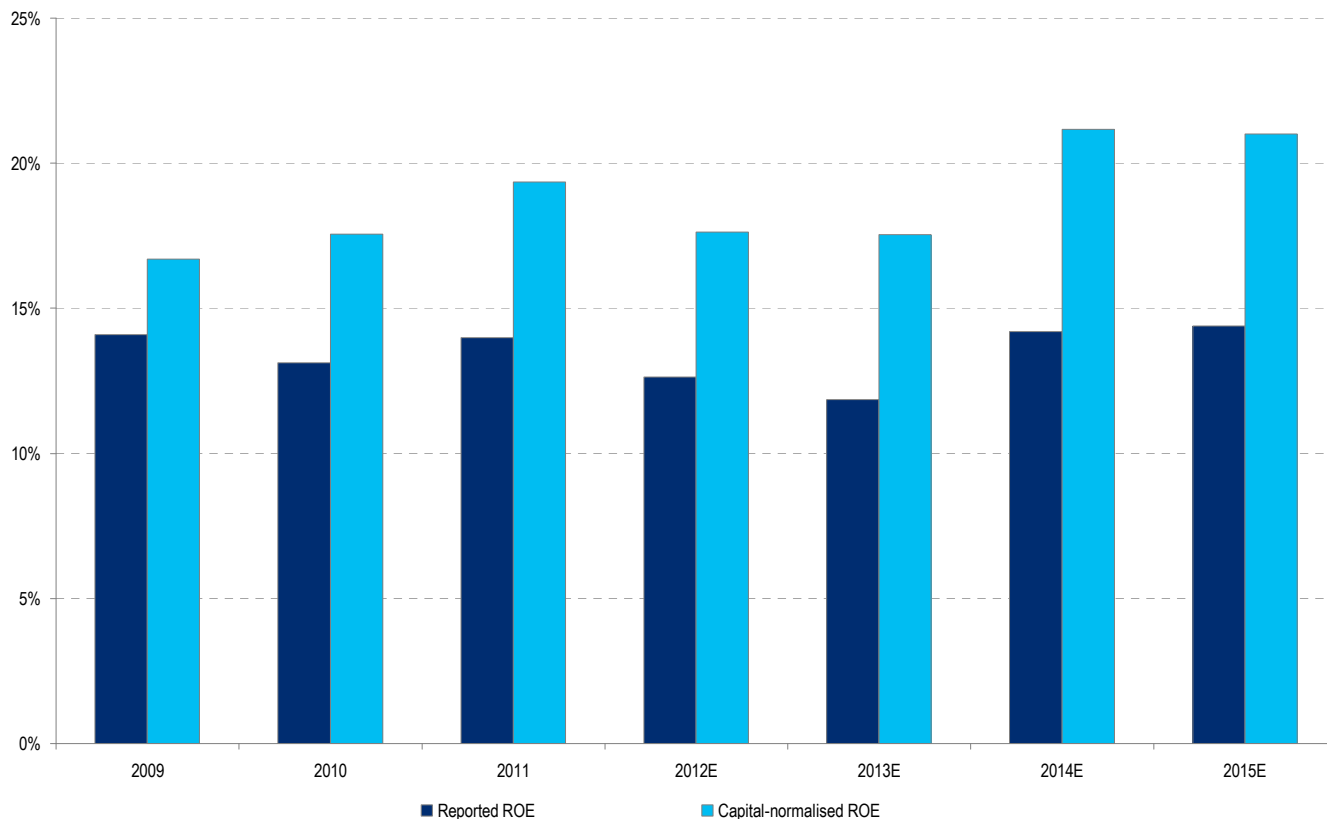
Source: Company reports, Citi Research

Figure 2. Pekao vs. PKO BP – Performing Loans Classified as Impaired, 4Q10-2Q12 (Percentage)



Source: Company reports, Citi Research

Figure 3. Pekao – Reported vs. Normalised Capital ROE, 2009-2015E



Source: Company reports, Citi Research estimates

Surplus Capital Conundrum

Given Pekao's overcapitalization (Core Tier 1 of 18.5% in 2Q12) a crucial issue when assessing the investment case for Pekao is determining if (and when) the bank's surplus capital (c.ZI 8-9bn assuming normalized capital at a Tier 1 of 10%) will be utilized. If it is it could be:

- deployed through organic growth;
- deployed through acquisition; and/or
- returned to shareholders in the form of dividends or share buybacks.

Pekao would have to grow loans by 85% to deploy excess capital organically; this is not realistic, in our view

Deploying ZI 8bn of the surplus capital through organic growth would mean granting ZI 80bn new loans (85% of Pekao's current stock of loans). In our opinion, it is unrealistic to expect such rapid lending growth in the coming years, especially keeping in mind the anticipated slowdown in the economy. Hence we don't assume that surplus capital will be deployed organically.

We think the regulator is unlikely to allow the bank to pay special dividends or buyback shares

Taking into account global uncertainties we are not optimistic that the Polish regulator will allow Pekao to deliver high dividends, special dividends, or share buybacks. Indeed, we reduce our dividend payout forecast from more than 90% to about 80%. Hence, we assign 0% probability to the scenario that Pekao returns surplus capital to shareholders.

But tough macro-economic conditions may give rise to M&A opportunities...

On the other hand, given continued deleveraging by many European banks, we are more optimistic that attractive M&A opportunities may arise. We can also envisage a scenario where a bank with a high share of low-margin/high-risk mortgage loans could decide to spin-off the non-FX retail business. We remind investors that Pekao has consistently publicly expressed that it is opportunistically looking at M&A opportunities where the risk is low and the valuation reasonable. We assign a 40% probability to such a scenario.

...leading us to still value the stock assuming a 40% probability that excess capital is successfully deployed

We continue to set our target price as the weighted average of our Warranted Equity Valuations (WEV) based on reported and normalized capital and still apply a 40% weight to the valuation method based on normalized capital.

Valuation

Our Target Price of ZI 152 per share is derived from the weighted average of our Standard Equity Valuations based on reported (60% weight) and capital-normalized (40% weight) ROE.

Our Standard Warranted Equity Valuation of ZI 137 per share is based on the formula: $\text{Price} / \text{Book value} = (\text{Sustainable ROE} - \text{growth}) / (\text{Cost of equity} - \text{growth})$. We assume sustainable return on equity of 14.0%, a sustainable growth rate of 4.5% and a cost of equity of 10.5%. Given the bank's overcapitalization (Tier 1 at 18%), we value the bank also on the capital-adjusted base and, assuming capital normalised ROE of 21%, arrive at fair value of ZI 174 per share on this basis. Our Economic Value Added Valuation of ZI 184 per share is equal to the sum of the net present value of the bank's future economic value-added (earnings adjusted for excess equity, less a capital charge reflecting the opportunity cost of capital). We set our target price at ZI 152 using a weighted average of our standard Warranted Equity Valuations based on reported (60% weight) and capital-normalised (40% weight) ROE.

Figure 4. Pekao – Summary of Valuation (Polish Zloty)

EVA	184
Warranted Equity Valuation - reported capital	137.2
Warranted Equity Valuation - normalized capital	174.4
Price Target	152.0
Current share price	157.5
Upside / (Downside)	-3.5%
DPS (2012E)	8.60
Dividend yield (%)	5.5%
Expected Total Return (ETR)	2.0%

Source: Citi Research

Figure 5. Pekao – Warranted Equity Valuation based on reported ROE (Polish Zloty)

Sustainable ROE	14.00%
2014E COE	10.50%
Growth	4.50%
Target P/BV multiple	1.58
2014E BVPS	93.3
2014E Target Value Per Share	147.7
Months to Discount to Dec 2013	16
Discounted	129.3
2013E DPS	8.6
Months to Discount to Aug 2013	10
Discounted	7.9
Value per share	137.2
Implied Upside / (Downside)	-14.2%

Source: Citi Research

Figure 6. Pekao – Warranted Equity Valuation based on capital-normalized ROE (Polish Zloty)

Sustainable ROE	21.00%
2014E COE	10.50%
Growth	4.50%
Target P/BV multiple	2.75
2014E Normalised BVPS	55.4
2014E Target Value Per Share	152.3
Months to Discount to Dec. 2013	16
Discounted	133.3
2013E DPS	8.6
Months to Discount to Aug. 2013	10
Discounted	7.9
2014E Surplus capital per share	37.9
Months to Discount to Dec. 2013	16
Discounted	33.2
Value per share	174.4
Implied Upside / (Downside)	9.1%

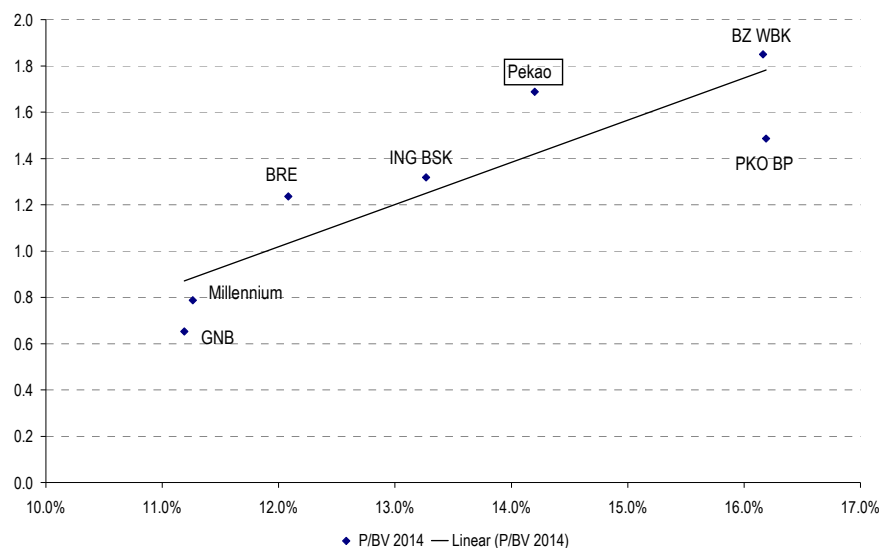
Source: Citi Research

Figure 7. Polish Banks – Valuation Table (Prices in Polish Zloty)

	Current Price	Rating	Target Price	P/E			P/BV			ROE		
				2012E	2013E	2014E	2012E	2013E	2014E	2012E	2013E	2014E
BZ WBK	227.9	1	264.0	12.9	14.1	11.8	2.0	2.0	1.8	16.5%	14.1%	16.2%
PKO BP	34.98	1	39.7	11.1	12.0	9.6	1.8	1.6	1.5	16.4%	14.0%	16.2%
BANK MILLENNIUM	3.7	1	3.9	10.6	13.9	7.4	0.9	0.9	0.8	8.9%	6.4%	11.3%
ING BSK	82.0	1	89.0	13.5	16.3	10.3	1.5	1.4	1.3	11.6%	8.9%	13.3%
Getin Noble Bank	1.7	1	2.0	7.6	6.7	6.2	0.8	0.7	0.7	11.9%	11.6%	11.2%
KREDYT BANK	14.76	1H	18.4	31.3	97.2	18.2	1.2	1.2	1.2	4.1%	1.3%	6.6%
PEKAO	157.50	2	152.0	14.8	15.1	12.2	1.8	1.8	1.7	12.6%	11.9%	14.2%
BGZ	71.3	2	72.5	21.2	22.9	9.8	1.1	1.0	0.9	5.3%	4.7%	10.1%
BRE	315.00	3	273.0	11.8	13.9	10.5	1.4	1.3	1.2	13.0%	9.8%	12.1%

Source: Powered by dataCentral (Prices as of August 17)

Figure 8. Polish Banks – P/BV vs. ROE, 2014E



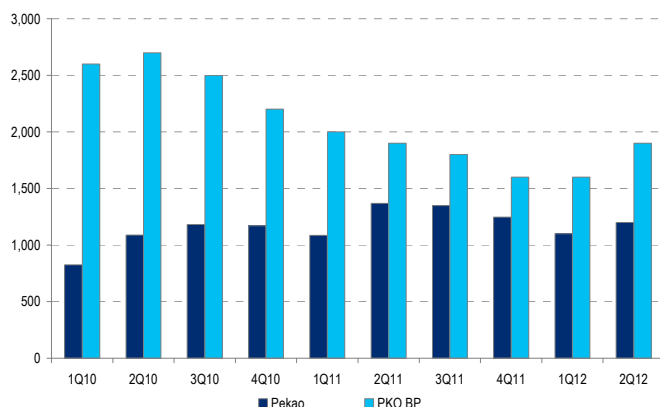
Source: Powered by dataCentral

Opportunistically Capturing Share

In contrast to peers, Pekao has maintained a high pace of loan growth in a more challenging environment

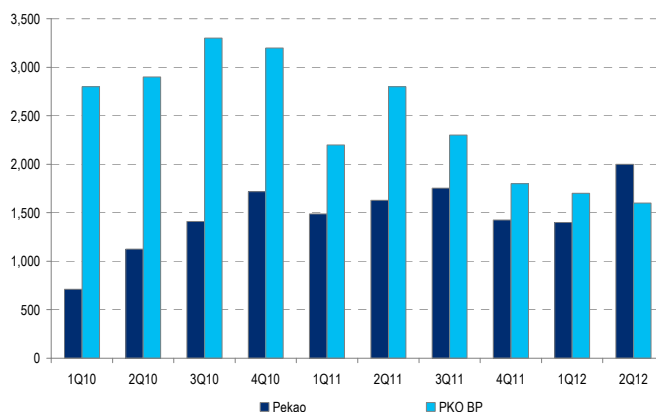
Citi economists expect Polish GDP growth to slow from 4.3% in 2011 to 2.7% in 2012 and 2.4% in 2013. The slowing economy, coupled with deteriorating asset quality (especially in consumer loans), increased regulatory constraints, and funding constraints, has led many Polish banks to tighten underwriting standards in 2011 and 1H12. In contrast to this trend, Pekao has maintained a high pace of lending, and increased its market share. In mortgage lending Pekao has even managed to capture share from PKO BP, which has been market leader for quite some time (for a detailed comparison of profitability of both banks see [Bank Pekao SA \(BAPE.WA\) - Second Among Titans – Maintaining Buy](#)).

Figure 9. Pekao vs. PKO BP – Cash Loans Production, 1Q10-2Q12
(Polish Zloty in million)



Source: Company reports, Citi Research

Figure 10. Pekao vs. PKO BP – Mortgage Loans Production, 1Q10-2Q12
(Polish Zloty in million)



Source: Company reports, Citi Research

We think Pekao is in a good position to capture lending market share without increasing risk materially

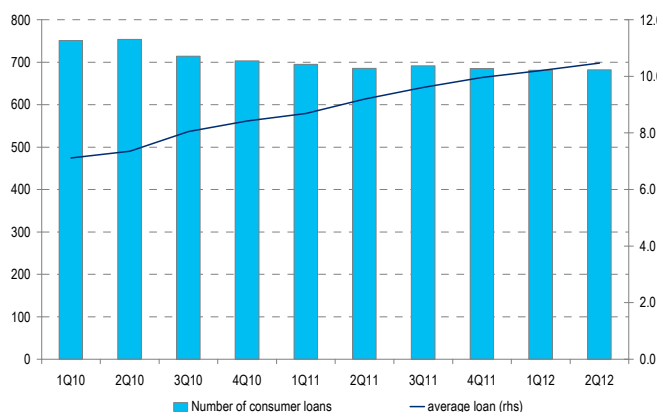
We are not particularly concerned about Pekao's attempts to increase market share in lending (including mortgage and cash loans) just ahead of an expected slowdown in the economy. Pekao missed an opportunity to capture share in 2009 in the wake of the global financial crisis that was successfully exploited by ING BSK (especially in mortgage loans and lending to municipalities) and PKO BP (in lending to big corporate and SMEs). With the competition unable or unwilling to lend again, Pekao is making sure that it doesn't miss this opportunity again. We welcome this development; we believe the bank is in a strong position to capture share, given its superior capital and liquidity position.

Higher lending will lead to higher provisioning but we think that, due to its large client base and experienced management, the bank will be able to manage credit risk and the total balance of higher net interest income and higher provisioning will be positive.

But the worry is that, so far, that increased lending activity has not led to an improvement in margin

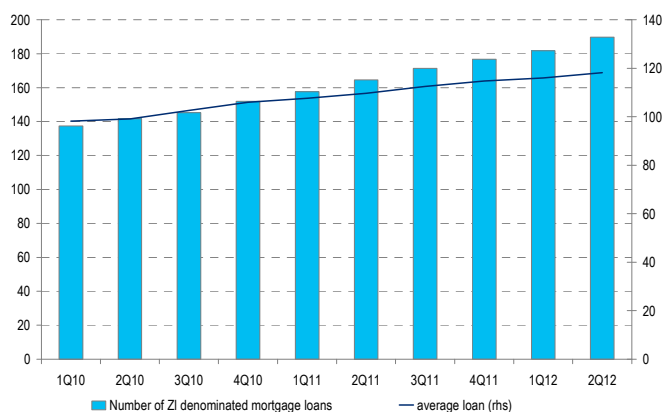
In our opinion, the bigger problem is that, so far, the increased lending activity of Pekao has not led to an increase in net interest margin (NIM). We think that it is caused by the structure of the loan growth, driven by low-margin Zloty mortgage loans (+24% yoy) and lending to large corporate clients (+20% yoy vs. +8% yoy in the higher-margin Mid and Small segment). We note that growth in cash loans (+13% yoy) comes from larger-sized loans – the size of the average loan grew +14% yoy. Due to higher price sensitivity in this segment vis-à-vis smaller cash loans, we expect that the margin on cash loans has declined.

Figure 11. Pekao - Number (thousands) and Average Value of Consumer Loans (Polish Zloty in thousands), 1Q10-2Q12



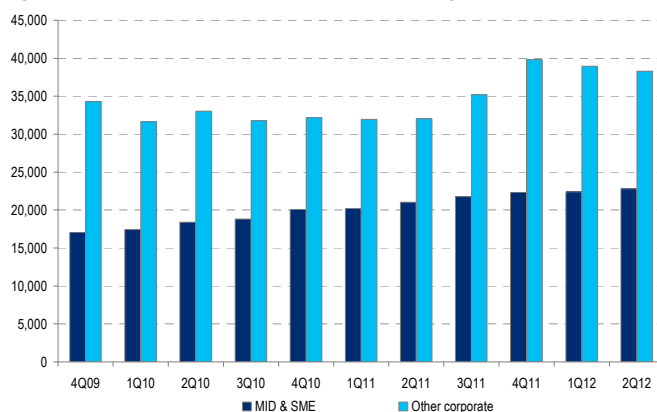
Source: Company reports, Citi Research

Figure 12. Pekao - Number (in thousands) and Average Value of Mortgage Loans (Polish Zloty in thousands), 1Q10-2Q12



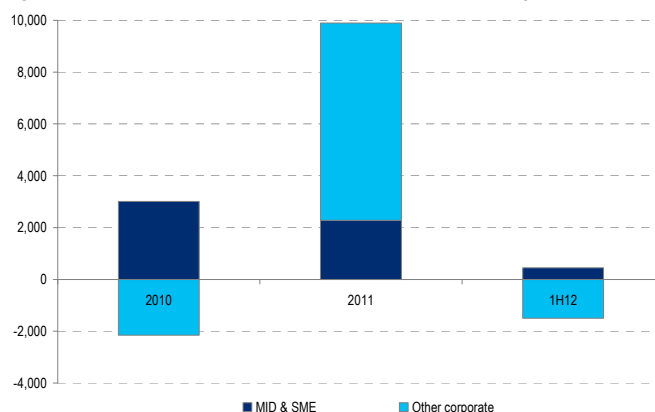
Source: Company reports, Citi Research

Figure 13. Pekao – Corporate Loans (Polish Zloty in million), 4Q09-2Q12



Source: Company reports, Citi Research

Figure 14. Pekao – Corporate Loans Growth (Polish Zloty in million)



Source: Company reports, Citi Research

Credit Quality Headwinds

We don't subscribe to the widely held view that Pekao's loan book is lower-risk than PKO BP's

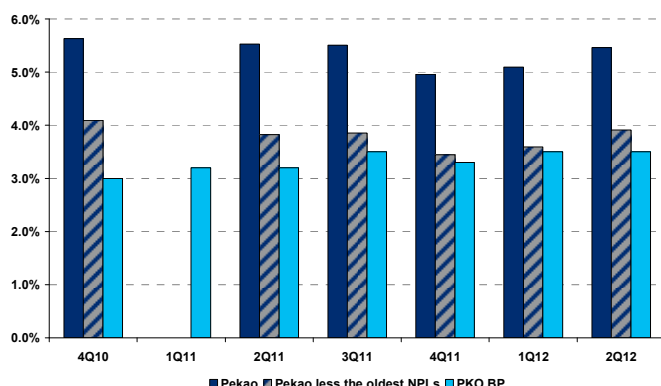
90 day overdue loans are higher in Pekao than PKO BP

Despite lower-than-expected provisioning in 2Q12 we maintain our view that cost of risk will rise. This is because we don't think the risk profile of Pekao's loan portfolio is substantially better than its peers, especially vs. PKO BP.

We note that the difference between Pekao's NPL ratio (7.3%, 7.0% excluding its Ukrainian subsidiary) and PKO BP's (8.7% on a consolidated basis and 7.9% on a stand-alone basis) is due predominantly to the fact that Pekao has a lower share of performing loans – loans with a delay in payment – that are classified as impaired (1.6% in Pekao vs. 4.5% in PKO BP). On the other hand, the share of 90 days overdue loans in both banks is not that different at roughly 3.9% for Pekao vs. 3.5% for PKO BP. We note that to take into account that PKO BP sells NPLs on a regular basis we have deducted 5-year overdue loans from the calculation.

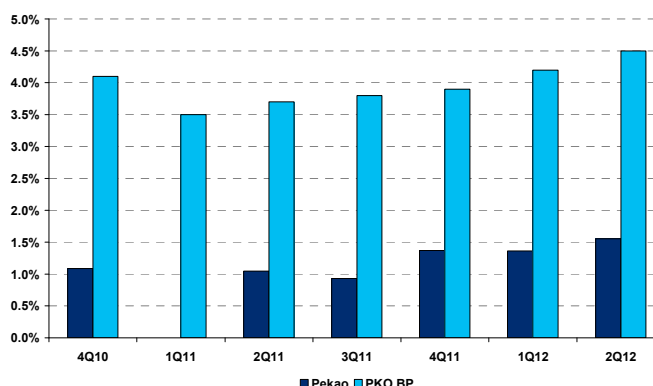
Pekao attributes the lower share of performing loans classified as impaired to fewer restructured loans in its portfolio and generally lower risk of its portfolio. But, given the similar share of 90 days overdue loans, we find it difficult to believe that Pekao's loan portfolio is of much better quality than peers'. While we cannot rule out that PKO BP has a higher share of restructured loans classified as impaired, given the bank's lower share of corporate lending to total loans vs. Pekao, we think it seems improbable.

Figure 15. Pekao vs. PKO BP – 90 days Overdue Ratio, 4Q10-2Q12 (Percentage)



Source: Company reports, Citi Research

Figure 16. Pekao vs. PKO BP – Performing Loans Classified as Impaired, 4Q10-2Q12 (Percentage)



Source: Company reports, Citi Research

Lower provision coverage of NPLs not of major concern...

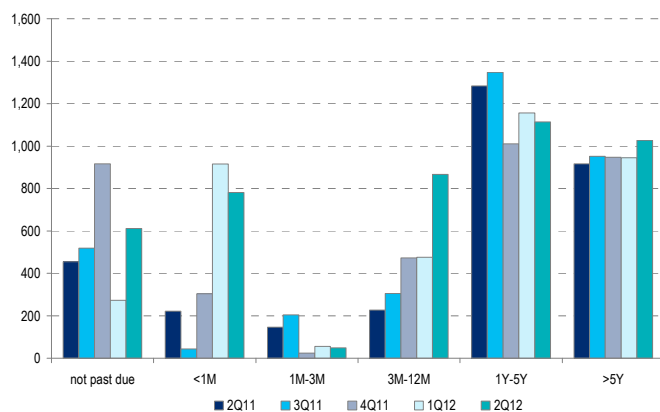
We are relatively unconcerned by the low coverage of new impaired loans by new provisions (in 2Q12 impaired loans grew by ZI 640m qoq vs. the increase in provisions by ZI 114m qoq, implying 18% coverage ratio of new impaired loans). It is quite normal that deterioration in asset quality in the first stage is reflected in a rising NPL ratio and rising provisioning but falling provision coverage ratio. In the second stage the NPL ratio stabilizes but provisioning remains high, leading to improving provision coverage. The reason is that provision coverage of loans that are booked as impaired for the first time is relatively low (or relatively low provisions are required/needed for loans that are booked as impaired for the first time) as they tend to first migrate to the highest (best) classification category of impaired loans. The new provisioning requirements mirror the old NBP asset quality and provisioning regulations, which involved three categories of impaired loans (substandard, doubtful and lost) with three required coverage ratios (20%, 50% and 100%, respectively).

We note that the decline in Pekao's coverage ratio (to 67% in 2Q12 from 72% in 1Q12 and 76% in 2Q11) was caused by lower coverage of individually impaired loans (46% vs. 51% and 57%, respectively) while coverage of collectively (portfolio) impaired loans was broadly unchanged (82% vs. 82% and 81%, respectively). The growth in impaired loans was caused mainly by the increase in more than 3 months but less than one year overdue individually impaired loans (to ZI 867m from ZI 475m in 1Q12) and the share of that category in all individually impaired loans increased to 19% in 2Q12 from 12% in 1Q12 and 7% in 2Q11. Not only did this drive the decline in total provision coverage but the provision coverage ratio of this category also declined (to 25% from 30% and 35%, respectively).

...but provisioning and provision coverage likely to rise in coming quarter

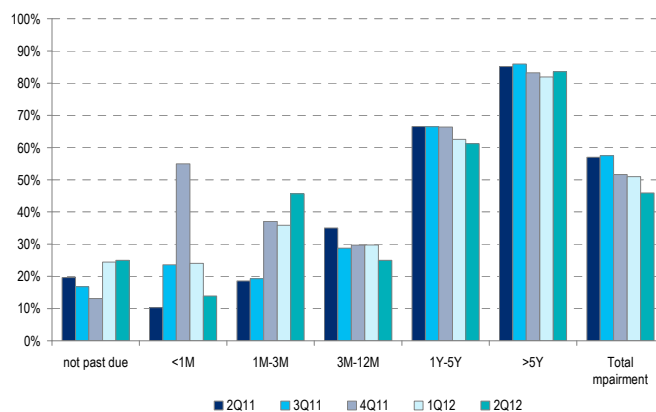
In summary, we don't see Pekao's provisioning in 2Q12 as conservative but we also don't find any reasons to consider it inadequate. Nevertheless, as we expect NPLs for the sector (and Pekao as well) to rise in the coming quarters and, in the next stage, for provision coverage to be rebuilt, we therefore expect Pekao's cost of risk to increase rather than decrease in the coming quarters.

Figure 17. Pekao – Individually Impaired Credit Exposure, 2Q11-2Q12 (Polish Zloty in million)



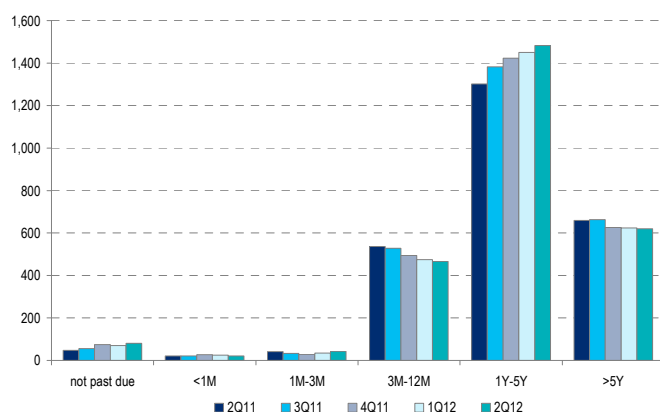
Source: Company reports, Citi Research

Figure 18. Pekao – Coverage of Individually Impaired Credit Exposure, 2Q11-2Q12 (Percentage)



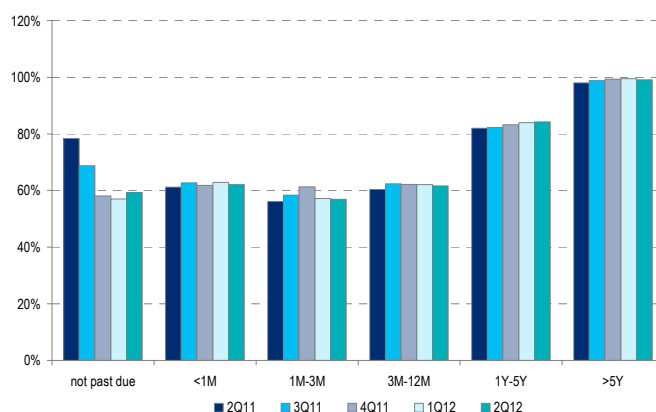
Source: Company reports, Citi Research

Figure 19. Pekao – Collectively Impaired Credit Exposure, 2Q11-2Q12 (Polish Zloty in million)



Source: Company reports, Citi Research

Figure 20. Pekao – Coverage of Collectively Impaired Credit Exposure, 2Q11-2Q12 (Percentage)

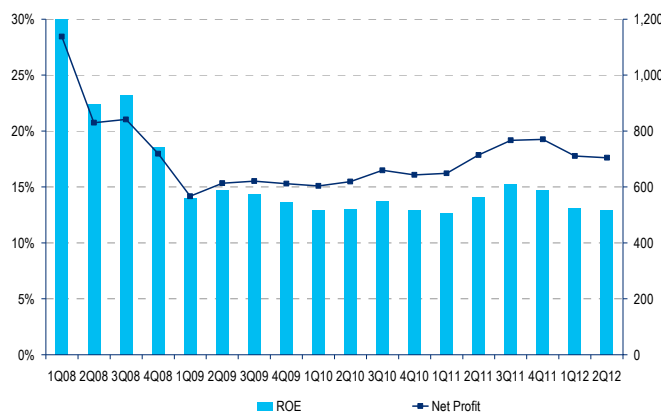


Source: Company reports, Citi Research

We note that in 2010 ([Bank Pekao vs. BRE Bank - Living in the Same World, but Worlds Apart](#)) we compared cost of risk in Pekao and BRE and our conclusion was that most likely the difference between provisioning in both banks was caused by lower provisioning on FX options in Pekao as BRE and other banks released some of the provisions created earlier against FX options. This doesn't mean that Pekao's provisioning was too loose, only that it was looser than peers'.

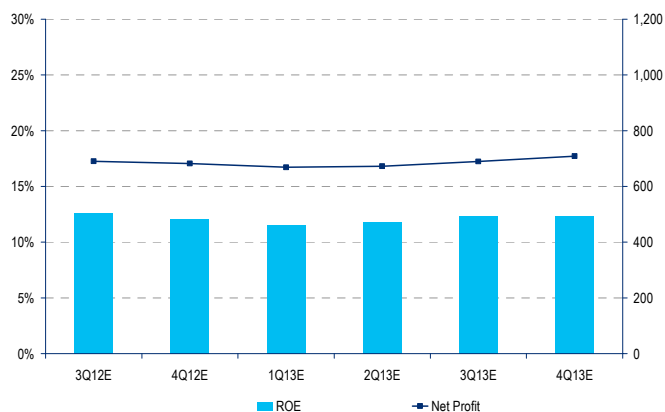
Downgrading EPS by 1%

Figure 21. Bank Pekao – Reported Net Profit and ROE, 1Q08-2Q12 (Polish Zloty in million/Percentage)



Source: Company reports, Citi Research

Figure 22. Bank Pekao – Forecast Net Profit and ROE, 3Q11-4Q13E (Polish Zloty in million/Percentage)



Source: Citi Research

We lower our EPS forecasts by 1.2% in 2012, 1.0% in 2013 and 1.3% in 2014

Taking the trends seen in the 2Q12 results, recent sector developments, and management guidance (with the exception of risk cost, where we remain more bearish than management) into account, we lower our EPS estimates by a marginal 1.2% in 2012, 1.0% in 2013 and 1.3% in 2014.

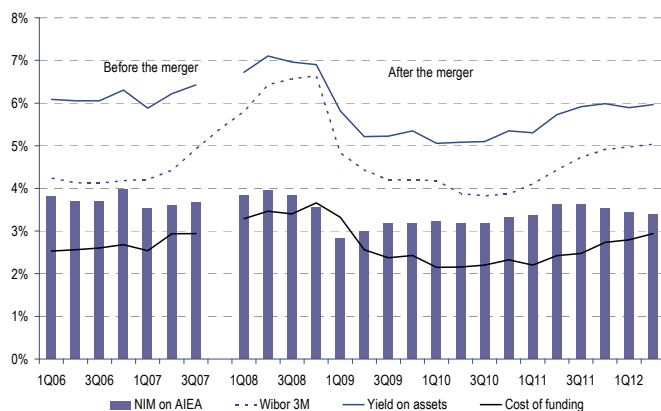
Lower-Than-Expected NIM

In 2Q12 net interest income (NII) grew 5% yoy but declined 0.6% qoq. The decline was caused by a small drop in net interest margin (3.38% from 3.43% in 1Q12) while average interest earning assets grew by 0.7% qoq. Loans increased by 1.5% qoq and deposits decreased by 2.1% qoq.

The bank's management expects NII in 2012 to remain at least at the 2011 level

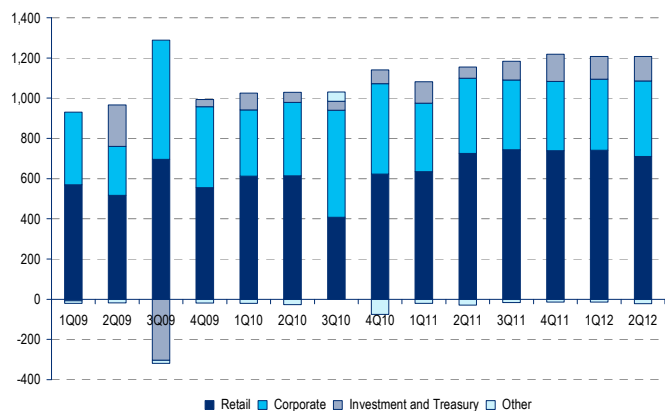
The bank's management expects NII to remain at least at the same level as in 2011 this year but indicated that they will make an effort to generate some growth. Given lower than expected NIM in 2Q12 we slightly reduce (by c5bp) our estimate of NIM in 2012, 2013 and 2014 and assume flat margin in 2H12 (3.39% in FY2012) and a small decline in NIM in 2013 (to 3.35%, driven by lower interest rates). This drives a small reduction in our NII estimates (-2% in 2012, -3% in 2013 and -3% in 2014). We note that we expect NII to grow 5% yoy in 2012 so we are more optimistic than management.

Figure 23. Bank Pekao – Yield on Assets and Cost of Funding, 1Q06-2Q12 (Percentage)



Source: Company reports, Citi Research

Figure 24. Bank Pekao – NII by Divisions, 1Q09-2Q12 (Polish Zloty in million)



Source: Company reports, Citi Research

Seasonally Stronger Fees

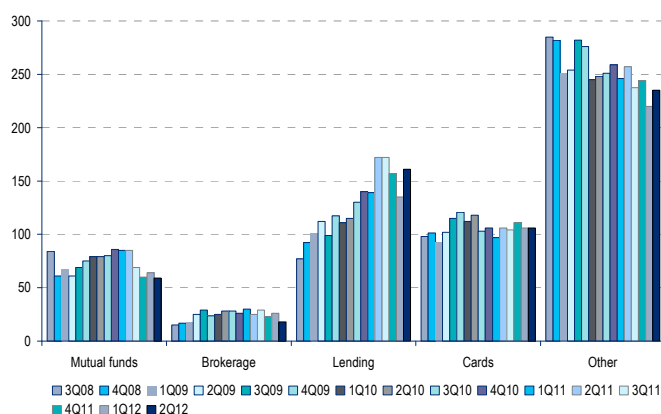
In 2Q12 net fees grew 5% qoq due to higher lending fees (Zl 161m vs. Zl 135m in 1Q12) and other fees (Zl 234m vs. Zl 220m, due partly to seasonally higher account and transfer fees).

Pekao's management warned of continuous pressure on account and transfer fees due to high competition and client migration to on-line platforms.

Pekao's management has warned of continuous pressure on account and transfer fees due to high competition and client migration to on-line banking platforms. But management also noted that thanks to the higher share of active Internet clients the bank was able to reduce costs.

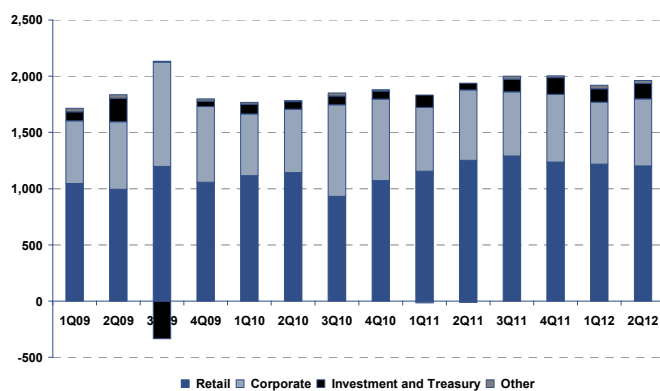
Given relatively low customer migration to internet banking (especially in comparison with ING BSK) we assume that the pressure on account and transfer fees will continue. We make only small changes in our net fee estimates (-1.5% in 2012, -0.8% in 2013 and -0.8% in 2014), taking into account low brokerage and investment fund fees.

Figure 25. Bank Pekao – Breakdown of Net Fees, 3Q08-2Q12 (Polish Zloty in million)



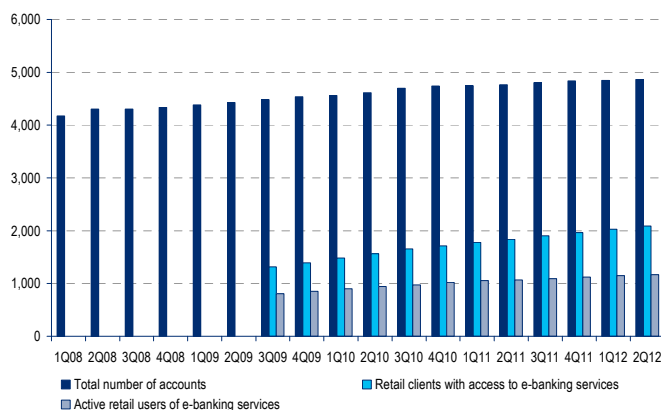
Source: Company reports, Citi Research

Figure 26. Bank Pekao – Total Revenues by Divisions, 1Q09-2Q12 (Polish Zloty in million)



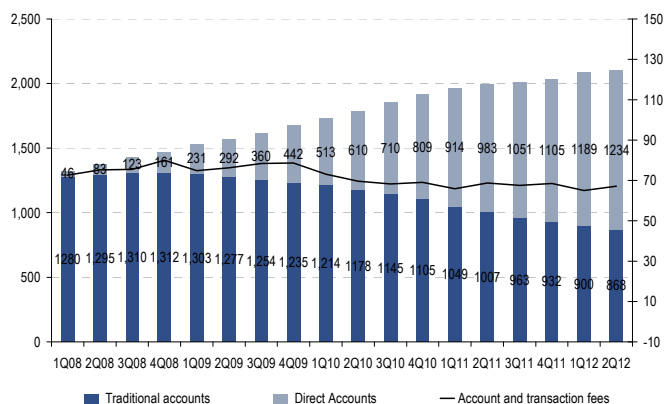
Source: Company reports, Citi Investment Research and Analysis

Figure 27. Pekao – Clients and Accounts, 1Q08-2Q12



Source: Company reports, Citi Research

Figure 28. ING BSK – Accounts and Fees (Polish Zloty in million), 1Q08-2Q12



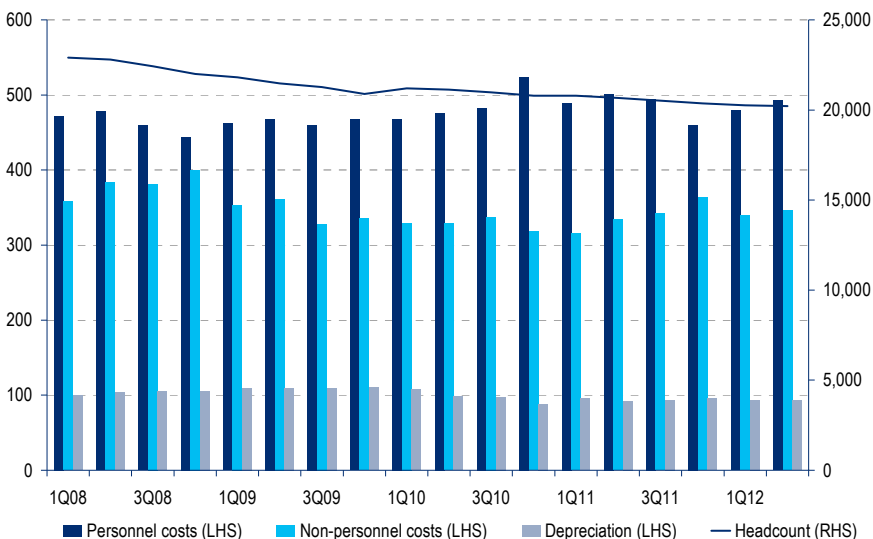
Source: Company reports, Citi Research

Costs Under Control (As Always)

Despite the bank's guidance of rising costs from rebranding, in 2Q12 administrative costs grew just 0.5% y/y.

Despite the bank's guidance of rising costs from rebranding, in 2Q12 administrative costs grew just 0.5% yoy, negatively affected by general costs (+3.7% yoy) while staff costs declined by 1.7% yoy (headcount was reduced by 2.2% yoy). Taking into account the continuous focus on cost control, we reduce our estimates of administrative costs by 1.3% in 2012, 2.4% in 2013 and 2.5% in 2014.

Figure 29. Pekao – Headcount and Costs (Polish Zloty in million), 1Q08-2Q12



Source: Company reports, Citi Research

Lower Risk or Lower Provisioning?

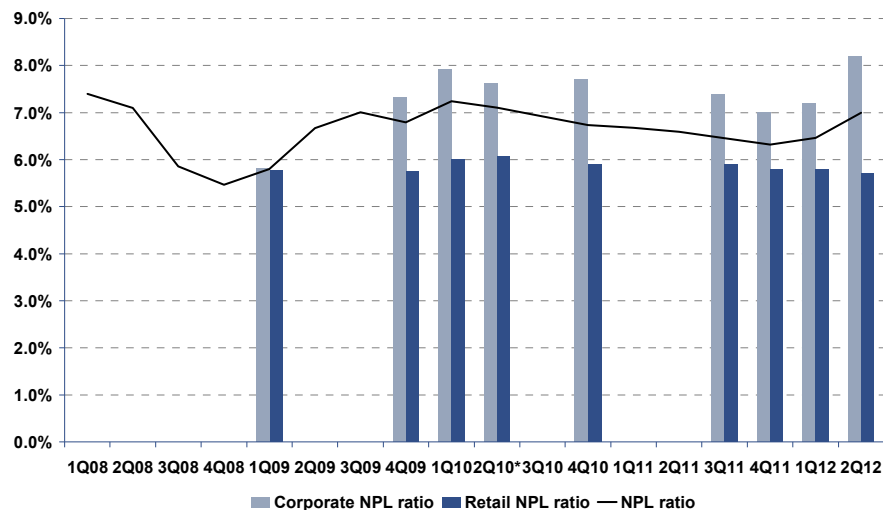
In 2Q12 Pekao reported rising cost of risk (72bp vs. 58bp in 1Q12) driven by higher corporate provisioning...

Provisions rose to ZI 168m (72bp) in 2Q12 from ZI 136m (58bp) in 1Q12 and ZI 134m (67bp) in 2Q11 driven by higher corporate provisioning (ZI 92m vs. ZI 71m and ZI 22m, respectively) while retail provisioning was only slightly higher qoq (ZI 71m vs. 57m in 1Q12) and materially lower yoy (ZI 114m). Reclassification of some construction loans drove an increase in the NPL ratio to 7.0% from 6.5% in 1Q11 and 6.6% in 2Q11, while provision coverage of NPLs dropped to 67% from 72% and 76%, respectively.

... but we maintain our assumption that provisioning in the bank will grow in line with the market trend.

We maintain our assumption of rising provisioning, in line with the sector trend, and expect cost of risk to increase from 64bp in 2011 to 79bp in 2012 and 90bp in 2013 (we note that we still expect provisioning in Pekao to remain below the market average).

Figure 30. Pekao – NPL Ratio, 1Q08-2Q12 (Percentage)



Source: Company reports, Citi Research

Summary of Quarterly Results

Figure 31. Bank Pekao - Quarterly Income Statement, 1Q10-2Q12 (Polish Zloty in million)

IFRS Group	1Q11	2Q11	3Q11	4Q11	1Q12	2Q12	chg qoq	chg yoy	2Q12E	Act vs Est	2Q12 Cons	Act vs Cons
Net Interest Income	1,061	1,125	1,166	1,205	1,193	1,185	-0.6%	5.3%	1,192	-0.5%	1,202	-1.4%
Net Fee & Commission Income	597	645	612	595	551	579	5.2%	-10.2%	573	1.1%	567	2.1%
Financial Income	145	136	155	153	115	128	11.1%	-5.8%	152	-15.8%		
Other Income	13	20	67	49	61	69	12.7%	242.3%	25	176.9%		
Total Revenue	1,817	1,926	2,001	2,002	1,920	1,962	2.2%	1.8%	1,942	1.0%	1,905	3.0%
Labour Costs	-490	-501	-495	-460	-479	-493	2.8%	-1.7%	-508	-3.0%		
General Costs	-316	-334	-342	-364	-339	-346	2.1%	3.7%	-353	-1.8%		
Depreciation	-96	-93	-93	-96	-93	-93	-0.4%	0.4%	-95	-2.3%		
Operating Expenses	-901	-928	-931	-919	-912	-932	2.2%	0.5%	-956	-2.5%	-941	-0.9%
Operating Profit	916	998	1,070	1,083	1,008	1,029	2.1%	3.1%	986	4.4%	964	6.8%
Provision Charge	-136	-134	-137	-137	-136	-168	24.2%	25.5%	-234	-28.0%	-190	-11.5%
Associate Income	21	18	17	14	12	14	15.2%	-26.8%	12	9.7%		
Profit Before Tax	801	882	950	960	884	874	-1.1%	-0.9%	764	14.4%	810	8.0%
Tax	-150	-166	-181	-187	-172	-168	-2.2%	1.5%	-145	15.8%		
Profit After Tax	651	717	769	773	713	706	-0.9%	-1.4%	619	14.1%		
Minorities	-3	-2	-2	-2	-2	-2	3.8%	-9.6%	-3	-26.5%		
Net Profit	648	714	766	771	711	704	-0.9%	-1.4%	616	14.3%	660	6.8%
EPS (Zl)	2.5	2.7	2.9	2.9	2.7	2.7	-0.9%	-1.4%	2.3	14.3%		
Average Diluted Number of Shares (m)	262	262	262	262	262	262	0.0%	0.0%	262	0.0%		

Source: Company reports, PAP, Citi Research estimates

Figure 32. Bank Pekao - Quarterly Key Balance Sheet Items, 1Q10-2Q12 (Polish Zloty in million)

IFRS Group	1Q11E	2Q11	3Q11	4Q11	1Q12	2Q12	chg qoq	chg yoy	2Q12E	Act vs Est
Net client lending	78,986	81,796	86,526	92,816	93,124	94,475	1.5%	15.5%	94,056	0.4%
Total Assets	133,361	131,153	142,466	146,590	147,268	148,311	0.7%	13.1%	148,740	-0.3%
Customer deposits	97,325	97,314	103,827	108,437	109,066	106,753	-2.1%	9.7%	111,248	-4.0%
Minorities	78	81	83	85	85	87	2.6%	7.6%	88	-0.9%
Equity (ex Minorities)	20,699	19,796	20,534	21,271	22,086	21,486	-2.7%	8.5%	21,290	0.9%
Total liabilities & Equity	133,361	131,153	142,466	146,590	147,268	148,311	0.7%	13.1%	148,740	-0.3%
Interest Earning Assets	125,564	123,688	134,231	138,686	139,508	140,758	0.9%	13.8%	140,903	-0.1%
BVPS (Zl)	78.9	75.5	78.3	81.1	84.2	81.9	-2.7%	8.5%	81.1	0.9%

Source: Company reports, Citi Research estimates

Figure 33. Bank Pekao - Quarterly Key Ratios, 1Q10-2Q12 (Polish Zloty in million)

IFRS Group	1Q11	2Q11	3Q11	4Q11	1Q12	2Q12	2Q12E
NIM on AIEA	3.37%	3.61%	3.62%	3.53%	3.43%	3.38%	3.40%
NIM on Total Ave. Assets	3.17%	3.40%	3.41%	3.34%	3.25%	3.21%	3.22%
Net Fee & Commission Income/Total Income	32.9%	33.5%	30.6%	29.7%	28.7%	29.5%	29.5%
Net Fee & Commission Income/Deposits	0.6%	0.7%	0.6%	0.5%	0.5%	0.5%	0.5%
Cost/Income	49.6%	48.2%	46.5%	45.9%	47.5%	47.5%	49.2%
Cost/Avg. Assets	2.69%	2.81%	2.72%	2.54%	2.48%	2.52%	2.58%
Effective tax rate	18.7%	18.8%	19.1%	19.5%	19.4%	19.2%	19.0%
Provisions/Avg Net Loans	0.69%	0.67%	0.65%	0.61%	0.58%	0.72%	1.00%
Equity/Assets	15.6%	15.2%	14.5%	14.6%	15.1%	14.5%	14.4%
Loans/Deposits	81.2%	84.1%	83.3%	85.6%	85.4%	88.5%	84.5%
Loans/Total Assets	59.2%	62.4%	60.7%	63.3%	63.2%	63.7%	74.8%
ROE	12.7%	14.1%	15.2%	14.7%	13.1%	12.9%	11.4%
ROA	1.94%	2.16%	2.24%	2.13%	1.93%	1.91%	1.66%
Tier 1 Ratio (%)	18.5%	18.3%	17.1%	17.0%	18.8%	18.5%	NA
Group Employees	20,789	20,668	20,509	20,357	20,256	20,215	20,256

Source: Company reports, Citi Research estimates

Summary of Changes in Estimates

Figure 34. Pekao – Changes in Income Statement, 2012-2014E (Polish Zloty in million)

GROUP	2012E			2013E			2014E		
	OLD	NEW	Chg.	OLD	NEW	Chg.	OLD	NEW	Chg.
Net Interest Income	4,910	4,809	-2.1%	5,187	5,015	-3.3%	5,626	5,431	-3.5%
Net Fee & Commission Income	2,356	2,320	-1.5%	2,369	2,349	-0.8%	2,546	2,525	-0.8%
Financial Income	104	67	-35.5%	142	142	0.0%	142	142	0.0%
Other Income	622	691	11.0%	626	661	5.5%	669	707	5.6%
Total Revenue	7,992	7,887	-1.3%	8,324	8,167	-1.9%	8,983	8,804	-2.0%
Labour Costs	-1,985	-1,960	-1.2%	-2,059	-1,998	-3.0%	-2,121	-2,056	-3.1%
General Costs	-1,412	-1,393	-1.4%	-1,553	-1,526	-1.7%	-1,567	-1,540	-1.7%
Depreciation	-385	-378	-1.8%	-417	-407	-2.3%	-440	-430	-2.3%
Operating Expenses	-3,782	-3,731	-1.3%	-4,028	-3,931	-2.4%	-4,128	-4,025	-2.5%
Operating Profit	4,211	4,156	-1.3%	4,296	4,236	-1.4%	4,855	4,779	-1.6%
Provision Charge	-760	-750	-1.3%	-926	-908	-1.9%	-668	-655	-2.0%
Share of Profits (Losses) of Companies Consolidated by Equity Accounting	51	54	7.5%	62	68	9.7%	75	82	9.7%
Profit Before Tax	3,502	3,460	-1.2%	3,432	3,396	-1.0%	4,262	4,206	-1.3%
Tax	-669	-663	-0.9%	-652	-645	-1.0%	-810	-799	-1.3%
Profit After Tax	2,833	2,797	-1.2%	2,780	2,751	-1.0%	3,452	3,407	-1.3%
Extraordinary items	0	0	na	0	0	na	0	0	na
Minorities	-11	-10	-7.2%	-12	-12	0.0%	-12	-12	0.0%
Net Profit	2,822	2,787	-1.2%	2,768	2,739	-1.0%	3,440	3,395	-1.3%
EPS (Zl)	10.8	10.6	-1.2%	10.5	10.4	-1.0%	13.1	12.9	-1.3%
DPS (Zl)	9.0	8.6	-4.4%	10.0	8.6	-14.0%	11.0	10.0	-9.1%
Average Diluted Number of Shares (m)	262.5	262.5	0.0%	262.5	262.5	0.0%	262.5	262.5	0.0%

Source: Citi Research

Figure 35. Pekao – Changes in Balance Sheet Estimates, 2012-2014E (Polish Zloty in million)

GROUP	2012E			2013E			2014E		
	OLD	NEW	Chg.	OLD	NEW	Chg.	OLD	NEW	Chg.
Cash and NBP Balances	5,131	5,131	0.0%	5,387	5,387	0.0%	5,656	5,656	0.0%
Interbank placements	5,865	5,865	0.0%	6,159	6,159	0.0%	6,467	6,467	0.0%
Financial Assets & Securities	34,738	33,678	-3.1%	36,017	34,914	-3.1%	37,341	36,194	-3.1%
Net client lending	98,824	97,331	-1.5%	106,971	104,838	-2.0%	115,788	113,480	-2.0%
Fixed assets	1,844	1,844	0.0%	1,918	1,918	0.0%	1,994	1,994	0.0%
Other assets	9,370	8,944	-4.6%	10,010	9,527	-4.8%	10,696	10,180	-4.8%
Total Assets	155,772	152,792	-1.9%	166,461	162,742	-2.2%	177,943	173,970	-2.2%
Interbank borrowing	4,795	4,795	0.0%	5,275	5,275	0.0%	5,802	5,802	0.0%
Client deposits	116,877	111,065	-5.0%	125,271	119,042	-5.0%	134,268	127,592	-5.0%
Other liabilities	11,221	13,981	24.6%	12,617	14,979	18.7%	13,747	15,980	16.2%
Minorities	94	93	-0.8%	106	105	-0.7%	118	117	-0.7%
Equity (ex Minorities)	22,785	22,858	0.3%	23,192	23,341	0.6%	24,008	24,479	2.0%
Total liabilities & Equity	155,772	152,792	-1.9%	166,461	162,742	-2.2%	177,943	173,970	-2.2%
BVPS (Zl)	87	87	0.3%	88	89	0.6%	92	93	2.0%

Source: Citi Research

Figure 36. Pekao – Changes in Key Ratios Estimates, 2012-2014E (Percentage)

GROUP	2012E		2013E		2014E	
	OLD	NEW	OLD	NEW	OLD	NEW
NIM on AIEA	3.60%	3.39%	3.40%	3.35%	3.45%	3.40%
NIM on Total Ave. Assets	3.25%	3.21%	3.22%	3.18%	3.27%	3.23%
Net Fee & Commission Income/Total Income	29.5%	29.4%	28.5%	28.8%	28.3%	28.7%
Net Fee & Commission Income/Deposits	2.02%	2.09%	1.89%	1.97%	1.90%	1.98%
Cost/Income	47.3%	47.3%	48.4%	48.1%	45.9%	45.7%
Cost/Avg. Assets	2.50%	2.49%	2.50%	2.49%	2.40%	2.39%
Effective tax rate	19.1%	19.2%	19.0%	19.0%	19.0%	19.0%
Dividend Payout Ratio	83.7%	81.0%	94.8%	82.4%	83.9%	77.3%
Provisions/Avg Net Loans	0.79%	0.79%	0.90%	0.90%	0.60%	0.60%
Equity/Assets	14.7%	15.0%	14.0%	14.4%	13.6%	14.1%
Loans/Deposits	84.6%	87.6%	85.4%	88.1%	86.2%	88.9%
Loans/Total Assets	63.4%	63.7%	64.3%	64.4%	65.1%	65.2%
ROE	12.8%	12.6%	12.0%	11.9%	14.6%	14.2%
ROA	1.87%	1.86%	1.72%	1.74%	2.00%	2.02%
NPLs/Total Loans	6.6%	6.6%	6.5%	6.5%	6.0%	6.0%
Provision Coverage of NPLs	71.6%	72.5%	75.5%	76.6%	79.7%	80.7%
RWA/Total Assets	74.0%	71.0%	75.0%	71.0%	75.0%	71.0%
Tier 1 Ratio	17.2%	19.0%	16.2%	18.3%	15.8%	18.1%
Group Employees	20,256	20,013	20,256	19,814	20,256	19,814

Source: Citi Research

Annual Financials

Figure 37. Pekao – Profit and Loss, 2007-2014E (Polish Zloty in million)

GROUP	2007	2008	chg	2009	chg	2010	chg	2011	chg	2012E	chg	2013E	chg	2014E	chg
Net Interest Income	2,718	4,509	65.9%	3,802	-15.7%	4,104	7.9%	4,558	11.1%	4,809	5.5%	5,015	4.3%	5,431	8.3%
Net Fee & Commission Income	2,161	2,342	8.3%	2,289	-2.3%	2,368	3.5%	2,449	3.4%	2,320	-5.3%	2,349	1.3%	2,525	7.5%
Financial Income	390	649	66.5%	827	27.6%	740	-10.5%	589	-20.4%	577	-2.0%	703	21.7%	749	6.6%
Other Income	89	351	295.8%	242	-31.3%	66	-72.5%	150	125.7%	181	20.5%	100	-44.6%	100	0.0%
Total Revenue	5,358	7,851	46.5%	7,160	-8.8%	7,279	1.7%	7,746	6.4%	7,887	1.8%	8,167	3.6%	8,804	7.8%
Labour Costs	-1,397	-1,875	34.1%	-1,856	-1.0%	-1,950	5.1%	-1,946	-0.2%	-1,960	0.7%	-1,998	1.9%	-2,056	2.9%
General Costs	-1,000	-1,513	51.3%	-1,388	-8.2%	-1,314	-5.3%	-1,355	3.1%	-1,393	2.7%	-1,526	9.6%	-1,540	0.9%
Depreciation	-339	-414	22.2%	-441	6.6%	-392	-11.3%	-377	-3.6%	-378	0.2%	-407	7.6%	-430	5.6%
Operating Expenses	-2,737	-3,802	38.9%	-3,686	-3.0%	-3,656	-0.8%	-3,679	0.6%	-3,731	1.4%	-3,931	5.4%	-4,025	2.4%
Operating Profit	2,621	4,050	54.5%	3,474	-14.2%	3,622	4.3%	4,067	12.3%	4,156	2.2%	4,236	1.9%	4,779	12.8%
Provision Charge	-192	-263	36.7%	-535	103.3%	-589	10.1%	-544	-7.6%	-750	38.0%	-908	21.0%	-655	-27.9%
Associate Income	153	123	-19.5%	58	-52.8%	68	17.6%	70	2.5%	54	-22.3%	68	24.1%	82	21.6%
Profit Before Tax	2,582	3,910	51.4%	2,997	-23.3%	3,102	3.5%	3,593	15.8%	3,460	-3.7%	3,396	-1.9%	4,206	23.8%
Tax	-438	-722	64.9%	-576	-20.2%	-571	-0.9%	-684	19.7%	-663	-3.0%	-645	-2.7%	-799	23.8%
Profit After Tax	2,144	3,188	48.7%	2,421	-24.1%	2,531	4.5%	2,909	15.0%	2,797	-3.8%	2,751	-1.7%	3,407	23.8%
Extraordinary Income	18	353	na	0	na	0	na	0	na	0	na	0	na	0	na
Minorities	-7	-13	85.3%	-10	-25.9%	-5	-46.9%	-10	89.7%	-10	6.7%	-12	16.2%	-12	0.0%
Net Profit	2,155	3,528	63.7%	2,412	-31.6%	2,525	4.7%	2,899	14.8%	2,787	-3.9%	2,739	-1.7%	3,395	24.0%
Net Profit After Adjustments	2,137	3,175	48.6%	2,412	-24.0%	2,526	4.7%	2,899	14.8%	2,787	-3.9%	2,739	-1.7%	3,395	24.0%
EPS (Zl)	12.3	13.5	9.2%	9.2	-31.7%	9.6	4.7%	11.0	14.8%	10.6	-3.9%	10.4	-1.7%	12.9	24.0%
DPS (Zl)	9.6	0.0	na	2.9	na	6.8	134.5%	5.4	-20.9%	8.6	59.9%	8.6	0.0%	10.0	16.3%
Average Diluted Number of Shares (m)	175	262	49.9%	262	0.1%	262	0.0%	262	0.0%	262	0.0%	262	0.0%	262	0.0%

Source: Company reports, Citi Research estimates

Figure 38. Pekao – Balance Sheet, 2007-2014E (Polish Zloty in million)

GROUP	2007	2008	chg	2009	chg	2010	chg	2011	chg	2012E	chg	2013E	chg	2014E	chg
Cash and NBP Balances	5,122	9,934	93.9%	9,620	-3.2%	5,969	-38.0%	4,886	-18.1%	5,131	5.0%	5,387	5.0%	5,656	5.0%
Interbank placements	16,960	7,909	-53.4%	7,203	-8.9%	6,259	-13.1%	5,586	-10.7%	5,865	5.0%	6,159	5.0%	6,467	5.0%
Financial Assets & Securities	26,527	27,185	2.5%	29,917	10.1%	33,197	11.0%	32,535	-2.0%	33,678	3.5%	34,914	3.7%	36,194	3.7%
Net client lending	66,658	79,078	18.6%	76,380	-3.4%	77,804	1.9%	92,816	19.3%	97,331	4.9%	104,838	7.7%	113,480	8.2%
Fixed assets	2,021	1,906	-5.7%	1,822	-4.4%	1,822	0.0%	1,773	-2.7%	1,844	4.0%	1,918	4.0%	1,994	4.0%
Other assets	6,808	5,929	-12.9%	5,673	-4.3%	9,040	59.3%	8,994	-0.5%	8,944	-0.6%	9,527	6.5%	10,180	6.9%
Total Assets	124,096	131,941	6.3%	130,616	-1.0%	134,090	2.7%	146,590	9.3%	152,792	4.2%	162,742	6.5%	173,970	6.9%
Interbank borrowing	9,942	14,993	50.8%	8,479	-43.4%	7,641	-9.9%	5,901	-22.8%	4,795	-18.7%	5,275	10.0%	5,802	10.0%
Client deposits	89,944	90,889	1.1%	97,250	7.0%	99,807	2.6%	108,437	8.6%	111,065	2.4%	119,042	7.2%	127,592	7.2%
Other liabilities	9,463	10,022	5.9%	6,516	-35.0%	6,385	-2.0%	10,896	70.7%	13,981	28.3%	14,979	7.1%	15,980	6.7%
Minorities	81	89	10.7%	83	-6.8%	83	-0.2%	85	3.1%	93	8.8%	105	12.9%	117	11.4%
Equity (ex Minorities)	14,667	15,947	8.7%	18,288	14.7%	20,174	10.3%	21,271	5.4%	22,858	7.5%	23,341	2.1%	24,479	4.9%
Total liabilities & Equity	124,096	131,941	6.3%	130,616	-1.0%	134,090	2.7%	146,590	9.3%	152,792	4.2%	162,742	6.5%	173,970	6.9%
Interest Earning Assets	72,737	127,613	75.4%	126,224	-1.1%	126,267	0.0%	138,686	9.8%	145,011	4.6%	154,454	6.5%	165,110	6.9%
BVPS (Zl)	56	61	8.6%	70	14.7%	77	10.2%	81	5.4%	87	7.5%	89	2.1%	93	4.9%

Source: Company reports, Citi Research estimates

Figure 39. Pekao – Key Ratios, 2007-2014E (Percentage)

GROUP	2007	2008	2009	2010	2011	2012E	2013E	2014E
NIM on AIEA	3.96%	3.67%	3.00%	3.25%	3.44%	3.39%	3.35%	3.40%
NIM on Total Ave. Assets	3.66%	3.52%	2.90%	3.10%	3.25%	3.21%	3.18%	3.23%
Net Fee & Commission Income/Total Income	40.3%	29.8%	32.0%	32.5%	31.6%	29.4%	28.8%	28.7%
Net Fee & Commission Income/Deposits	2.4%	2.6%	2.4%	2.4%	2.3%	2.1%	2.0%	2.0%
Cost/Income	51.1%	48.4%	51.5%	50.2%	47.5%	47.3%	48.1%	45.7%
Cost/Avg. Assets	3.69%	2.97%	2.81%	2.76%	2.62%	2.49%	2.49%	2.39%
Effective tax rate	16.9%	18.5%	19.2%	18.4%	19.0%	19.2%	19.0%	19.0%
Dividend Payout Ratio	116.8%	0.0%	31.5%	70.6%	48.7%	81.0%	82.4%	77.3%
Provisions/Avg Net Loans	0.52%	0.36%	0.69%	0.76%	0.64%	0.79%	0.90%	0.60%
Equity/Assets	11.9%	12.2%	14.1%	15.1%	14.6%	15.0%	14.4%	14.1%
Loans/Deposits	74.1%	87.0%	78.5%	78.0%	85.6%	87.6%	88.1%	88.9%
Loans/Total Assets	53.7%	59.9%	58.5%	58.0%	63.3%	63.7%	64.4%	65.2%
ROE	22.9%	23.0%	14.1%	13.1%	14.0%	12.6%	11.9%	14.2%
ROA	2.91%	2.76%	1.84%	1.91%	2.07%	1.86%	1.74%	2.02%
NPLs/Total Loans	7.8%	5.5%	6.8%	6.7%	6.3%	6.6%	6.5%	6.0%
Provision Coverage of NPLs	84.1%	87.2%	76.8%	74.1%	73.2%	72.5%	76.6%	80.7%
Tier 1 Ratio (%)	12.1%	12.2%	16.2%	17.6%	17.0%	19.0%	18.3%	18.1%
Group Employees	22,926	21,992	20,874	20,783	20,357	20,013	19,814	19,814

Source: Company reports, Citi Research estimates

Bank Pekao SA

Company description

Bank Pekao is Poland's second-largest bank, 59.4% owned by UniCredit. The bank has c.12% asset market share, 1,058 outlets, and serves c.5m customers.

Investment strategy

Given Pekao's overcapitalization (Core Tier 1 of 18.5% in 2Q12) the crucial question is if and when Pekao's surplus capital (c.ZI 8-9bn assuming normalized capital at Tier 1 equals 10%) is utilized and how it will be used. Given the slowdown in the economy, we doubt that the bank will be able to achieve significant loan growth. Taking into account global uncertainties, we see also a low likelihood of the regulator allowing high dividends. More likely, in our view, is Pekao taking advantage of M&A opportunities, if they appear. Hence we maintain our assumption of a 40% probability that surplus capital will be used. Given that we see this as already reflected in the price, we rate the stock Neutral.

Valuation

Our Standard Warranted Equity Valuation of ZI 137 per share is based on the formula: $\text{Price} / \text{Book value} = (\text{Sustainable ROE} - \text{growth}) / (\text{Cost of equity} - \text{growth})$. We assume sustainable return on equity of 14.0%, a sustainable growth rate of 4.5% and a cost of equity of 10.5%. Given the bank's overcapitalization (Tier 1 at 18%), we value the bank also on the capital-adjusted base and, assuming capital normalised ROE of 21%, arrive at fair value of ZI 174 per share on this basis. Our Economic Value Added Valuation of ZI 184 per share is equal to the sum of the net present value of the bank's future economic value-added (earnings adjusted for excess equity, less a capital charge reflecting the opportunity cost of capital). We set our target price at ZI 152 using a weighted average of our standard Warranted Equity Valuations based on reported (60% weight) and capital-normalised (40% weight) ROE.

Risks

The following risk factors could cause the share price to deviate significantly from our target price: 1) the bank's conservative risk and capital management may lead to lower lending growth and dividend payment than we anticipate and 2) provisioning, low in the last slowdown (2009), could surprise negatively in the next slowdown/recession period due to a lower buffer of over-provisioning.

Notes

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Appendix A-1

Analyst Certification

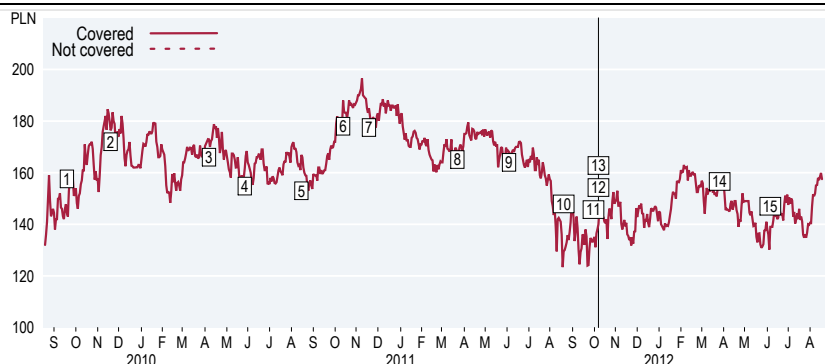
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IMPORTANT DISCLOSURES

Bank Pekao SA (BAPE.WA)

Ratings and Target Price History Fundamental Research

Analyst: Andrzej Powierza
Covered since March 2 2011



	Date	Rating	Target Price	Closing Price
1	18-Sep-09	*2L	*151.50	144.40
2	19-Nov-09	2L	*190.00	176.40
3	7-Apr-10	2L	*192.00	172.90
4	27-May-10	*1L	*179.50	161.60
5	16-Aug-10	1L	*183.00	166.90

* Indicates change

	Date	Rating	Target Price	Closing Price
6	13-Oct-10	*2L	183.00	188.00
7	18-Nov-10	2L	*201.00	185.00
8	23-Mar-11	*1L	*195.30	166.50
9	3-Jun-11	1L	*186.00	168.00
10	19-Aug-11	1L	*190.00	129.60

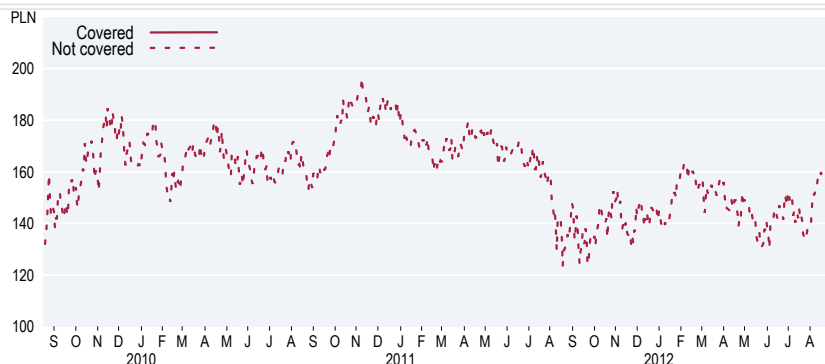
	Date	Rating	Target Price	Closing Price
11	30-Sep-11	1L	*171.00	134.20
12	7-Oct-11	Stock rating system changed		
13	7-Oct-11	*1	171.00	140.00
14	27-Mar-12	1	*173.00	156.60
15	6-Jun-12	1	*157.00	139.00

Rating/target price changes above reflect Eastern Standard Time

Bank Pekao SA (BAPE.WA)

Ratings and Target Price History Best Ideas Research Relative Call (3 Month)

Analyst: Andrzej Powierza
Covered since March 2 2011



* Indicates change

Rating/target price changes above reflect Eastern Standard Time

DMBH is a market maker in the publicly traded equity securities of Bank Pekao SA. DMBH rating distribution versus Investment Banking service provision in the past 12 months as at 30th June 2012 is as follows: Buy (1) representing 51% of the DMBH coverage 0% of which are IB clients, Hold (2) representing 41% of the DMBH coverage 0% of which are IB clients, Sell (3) representing 8% of the DMBH coverage 0% of which are IB clients.

DMBH rating distribution versus Investment Banking service provision in the past 12 months as at 30th June 2012 is as follows: Buy (1) representing 51% of the DMBH coverage 0% of which are IB clients, Hold (2) representing 41% of the DMBH coverage 0% of which are IB clients, Sell (3) representing 8% of the DMBH coverage 0% of which are IB clients.

DMBH rating distribution versus Investment Banking service provision in the past 12 months as at 30th June 2012 is as follows: Buy (1) representing 51% of the DMBH coverage 0% of which are IB clients, Hold (2) representing 41% of the DMBH coverage 0% of which are IB clients, Sell (3) representing 8% of the DMBH coverage 0% of which are IB clients.

DMBH rating distribution versus Investment Banking service provision in the past 12 months as at 30th June 2012 is as follows: Buy (1) representing 51% of the DMBH coverage 0% of which are IB clients, Hold (2) representing 41% of the DMBH coverage 0% of which are IB clients, Sell (3) representing 8% of the DMBH coverage 0% of which are IB clients.

DMBH rating distribution versus Investment Banking service provision in the past 12 months as at 30th June 2012 is as follows: Buy (1) representing 51% of the DMBH coverage 0% of which are IB clients, Hold (2) representing 41% of the DMBH coverage 0% of which are IB clients, Sell (3) representing 8% of the DMBH coverage 0% of which are IB clients. DMBH is a market maker in the publicly traded equity securities of BRE Bank SA.

DMBH has received compensation from Bank Zachodni WBK for providing market maker services in the past 12 months. DMBH is a market maker in the publicly traded equity securities of Bank Zachodni WBK. DMBH rating distribution versus Investment Banking service provision in the past 12 months as at 30th June 2012 is as follows: Buy (1) representing 51% of the DMBH coverage 0% of which are IB clients, Hold (2) representing 41% of the DMBH coverage 0% of which are IB clients, Sell (3) representing 8% of the DMBH coverage 0% of which are IB clients.

DMBH rating distribution versus Investment Banking service provision in the past 12 months as at 30th June 2012 is as follows: Buy (1) representing 51% of the DMBH coverage 0% of which are IB clients, Hold (2) representing 41% of the DMBH coverage 0% of which are IB clients, Sell (3) representing 8% of the DMBH coverage 0% of which are IB clients.

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DMBH rating distribution versus Investment Banking service provision in the past 12 months as at 30th June 2012 is as follows: Buy (1) representing 51% of the DMBH coverage 0% of which are IB clients, Hold (2) representing 41% of the DMBH coverage 0% of which are IB clients, Sell (3) representing 8% of the DMBH coverage 0% of which are IB clients.

A member of the household of Andrzej Powierza, Analyst, holds a long position in the securities of PKO BP.

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Simon Nellis

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