

# BNPP Polska (BNP.WA)

## Closer to the Merger: Upgrading to Buy

- **Buy** — Yesterday KNF (Polish FSA) approved the acquisition of BGZ by BNP Paribas, the parent company of BNPP Polska, and obliged BNP Paribas to merge BGZ with BNPP Polska. Given the unknown share swap parity and business risks related to the merger process and achieving forecast synergies, we continue to base our target price for the bank on a weighted average of our stand-alone and post-merger valuations but given the progress in the merger, we increase the weight of the post-merger scenario to 65% from 55% and consequently we increase our TP to ZI 73 from ZI 67.1 previously and upgrade the stock to Buy from Neutral.
- **The bigger scale should allow improved profitability** — We think that the merger with BGZ will lead to ZI c.240m annual cost savings (c15% of the combined cost base) and will allow an increase in ROE to 11-12% in 2017 from 5.8% in 2013.
- **Reduced estimates due to external factors** — Taking into account higher-than-anticipated financial gain in 2Q14 on the one hand and increased probability of interest rate cuts on the other hand, we increase our 2014 EPS estimate by 2% but lower 2015E by 25% and 2016E by 5%.
- **FX mortgage risk** — The relatively high exposure to FX mortgages remains, in our opinion, the biggest bank's risk factor at the moment (for legal background see [Polish Banks: What is the Risk of "Hungarian-style" Solution for FX Mortgages?](#)), followed by integration-related risks (lower-than-expected post-merger savings or the negative impact of the merger on revenues) and high operational leverage, making the bank relatively highly exposed to a decline in revenues (as demonstrated by the high impact of 5% cut of 2015 NII projection on EPS estimate).
- **Higher free-float after the merger** — After the expected merger with BGZ, the free float in the new bank will decline, according to our estimates, to c. 5%. KNF obliged BNP Paribas to increase the free-float in the merged bank to at least 12.5% till June 2016 (i.e. ZI c.0.7bn) and to at least 25% plus one share till end of 2018 (ZI 1.4bn).

- Estimate Change
- Target Price Change
- Rating Change

<b>Buy</b>	<b>1</b>
<i>from Neutral</i>	
Price (02 Sep 14)	ZI54.12
Target price	ZI73.00
<i>from ZI67.10</i>	
Expected share price return	34.9%
Expected dividend yield	0.0%
<b>Expected total return</b>	<b>34.9%</b>
Market Cap	ZI1,825M
	US\$570M

### Price Performance (RIC: BNP.WA, BB: BNP PW)



### BNPP Polska (PLN)

Year to 31 Dec	2012A	2013A	2014E	2015E	2016E
Net Income (ZIM)	30.8	102.3	102.8	122.9	202.4
Diluted EPS (ZI)	1.17	3.56	3.29	3.65	6.00
Diluted EPS (Old) (ZI)	1.17	3.56	3.22	4.85	6.31
PE (x)	46.3	15.2	16.4	14.8	9.0
P/BV (x)	0.9	0.9	0.9	0.8	0.7
DPS (ZI)	0.00	0.00	0.00	0.00	0.00
Net Div Yield (%)	0.0	0.0	0.0	0.0	0.0
ROE (%)	2.0	5.8	5.2	5.6	8.6

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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	2012	2013	2014E	2015E	2016E
<b>Valuation Ratios</b>					
P/E adjusted (x)	46.3	15.2	16.4	14.8	9.0
P/E reported (x)	46.3	15.2	16.4	14.8	9.0
P/BV (x)	0.9	0.9	0.9	0.8	0.7
P/Adjusted BV diluted (x)	0.9	0.9	0.9	0.8	0.7
Dividend yield (%)	0.0	0.0	0.0	0.0	0.0
<b>Per Share Data (Zl)</b>					
EPS adjusted	1.17	3.56	3.29	3.65	6.00
EPS reported	1.17	3.56	3.29	3.65	6.00
BVPS	60.33	62.90	62.84	66.48	72.49
Tangible BVPS	59.28	61.61	61.52	64.97	70.74
Adjusted BVPS diluted	60.33	62.90	62.84	66.48	72.49
DPS	0.00	0.00	0.00	0.00	0.00
<b>Profit &amp; Loss (Zlm)</b>					
Net interest income	545	538	573	618	738
Fees and commissions	146	150	148	157	165
Other operating Income	124	136	105	101	106
<b>Total operating income</b>	<b>814</b>	<b>823</b>	<b>825</b>	<b>877</b>	<b>1,009</b>
Total operating expenses	-607	-569	-572	-580	-582
<b>Oper. profit bef. provisions</b>	<b>207</b>	<b>254</b>	<b>253</b>	<b>297</b>	<b>427</b>
Bad debt provisions	-154	-116	-113	-133	-174
Non-operating/exceptionals	0	0	0	0	0
<b>Pre-tax profit</b>	<b>54</b>	<b>138</b>	<b>140</b>	<b>164</b>	<b>253</b>
Tax	-23	-35	-37	-41	-51
Extraord./Min. Int./Pref. Div.	0	0	0	0	0
<b>Attributable profit</b>	<b>31</b>	<b>102</b>	<b>103</b>	<b>123</b>	<b>202</b>
Adjusted earnings	31	102	103	123	202
<b>Growth Rates (%)</b>					
EPS adjusted	-28.6	205.2	-7.6	10.7	64.7
Oper. profit bef. prov.	13.8	22.5	-0.2	17.3	43.8
<b>Balance Sheet (Zlm)</b>					
<b>Total assets</b>	<b>20,831</b>	<b>21,117</b>	<b>22,463</b>	<b>24,189</b>	<b>26,274</b>
Avg interest earning assets	21,153	20,485	21,264	22,730	24,587
Customer loans	16,160	16,583	17,863	19,512	21,463
Gross NPLs	1,943	1,479	1,294	1,345	1,453
<b>Liab. &amp; shar. funds</b>	<b>20,831</b>	<b>21,117</b>	<b>22,463</b>	<b>24,189</b>	<b>26,274</b>
Total customer deposits	10,065	10,894	11,869	12,848	14,132
Reserve for loan losses	1,202	1,089	890	867	885
Shareholders' equity	1,731	1,805	2,119	2,242	2,444
<b>Profitability/Solvency Ratios (%)</b>					
ROE adjusted	2.0	5.8	5.2	5.6	8.6
Net interest margin	2.58	2.62	2.69	2.72	3.00
Cost/income ratio	74.6	69.2	69.3	66.1	57.7
Cash cost/average assets	2.8	2.7	2.6	2.5	2.3
NPLs/customer loans	12.0	8.9	7.2	6.9	6.8
Reserve for loan losses/NPLs	61.9	73.6	68.8	64.5	60.9
Bad debt prov./avg. cust. loans	0.9	0.7	0.7	0.7	0.9
Loans/deposit ratio	160.6	152.2	150.5	151.9	151.9
Tier 1 capital ratio	9.5	9.7	10.3	10.1	9.9
Total capital ratio	13.8	12.4	12.8	12.4	11.9

## Closer to the Merger

Figure 1. Polish Banks – Market Multiples and Ratios, 2014E-2016E (Polish Zloty)

Company	RIC	Current Price	Rating	Target Price	P/E			P/BV			ROE			Dividend Yield		
					2014E	2015E	2016E	2014E	2015E	2016E	2014E	2015E	2016E	2014E	2015E	2016E
PKO BP	PKO.WA	38.50	2	43.0	14.7	12.0	11.2	1.8	1.6	1.5	12.4%	14.0%	13.9%	3.39%	4.16%	4.47%
Pekao	PEO.WA	181.50	1	192.0	17.7	16.2	14.1	2.0	2.0	1.9	11.4%	12.2%	13.8%	5.51%	6.06%	7.16%
Bank Millennium	MILP.WA	8.15	3	6.9	15.3	13.5	12.0	1.7	1.6	1.5	11.6%	12.3%	12.9%	3.27%	3.71%	4.18%
ING BSK	INGP.WA	136.50	2	135.0	16.1	14.8	13.1	1.8	1.8	1.7	12.1%	12.1%	13.1%	4.67%	5.06%	5.71%
mBank	MBK.WA	470.00	2	492.0	14.8	13.7	11.5	1.8	1.7	1.6	12.6%	12.9%	14.7%	5.05%	5.47%	6.50%
Getin Noble Bank	GNB.WA	2.66	3H	2.5	13.0	11.1	10.5	1.3	1.2	1.1	10.7%	11.1%	10.6%	0.00%	0.00%	3.15%
Alior Bank	ALRR.WA	76.13	2H	90.0	16.4	13.5	10.8	1.8	1.6	1.4	12.3%	12.9%	14.1%	0.00%	0.00%	0.00%
BNPP Polska	BNP.WA	55.38	1	73.0	16.8	15.2	9.2	0.9	0.8	0.8	5.2%	5.6%	8.6%	0.00%	0.00%	0.00%
Median					16.1	13.7	11.5	1.8	1.6	1.5	12.1%	12.3%	13.8%	3.39%	4.16%	4.47%
Average					15.7	13.8	11.7	1.7	1.6	1.5	11.5%	12.1%	13.2%	2.94%	3.30%	4.12%

Source: Powered by dataCentral, prices as of September 1<sup>st</sup>, 2014

## Investment Summary

### The acquisition of BGZ by BNP Paribas approved

**BNP Paribas, the parent company of BNPP Polska, has announced the public tender of BGZ shares in August...**

**...and the acquisition was approved by the regulator in September**

**According to the amended sale agreement, BNP Paribas group will purchase 90% stake in BGZ**

On August 25, 2014, BNP Paribas (the parent company of BNPP Polska) announced a public bid on 56m shares, i.e. 100% of BGZ shares at ZI 80.47 per share (this values the whole bank at ZI 4.5bn). The public tenders will start on September 12, 2014 and will last to October 17, 2014 (but the deadline may be extended). The bid was conditional as exceeding a 50% stake in the bank required KNF approval. The approval was granted on September 2, 2014. We note that EC, acting as the antimonopoly body, has earlier approved the transaction.

The sale of Rabobank's 98.5% stake in BGZ to BNP Paribas Group for ZI 4.2bn was agreed in December 2013. Taking into account the regulator's suggestions and reflecting the merger of BGZ with Rabobank Polska (forced by KNF and completed in June 2014), on June 16, 2014 Rabobank and BNP Paribas amended the sale agreement and decided that Rabobank will keep 5.6m BGZ shares (i.e. 10% of the bank's outstanding shares). According to the agreement between BNP Paribas and Rabobank, the agreed price for BGZ shares may be changed — if it is revised upward, consequently the price in the public bid will be amended.

### The planned merger of BNPP Polska with BGZ

#### The regulator should support the merger

**We expect the regulator will applaud the BNP Paribas plan to merge two banks**

According to the public bid announcement, BNP Paribas intends to merge BNPP Polska with BGZ to create a mid-sized universal bank. In July 2014 BNP Paribas Group, BNPP Polska, BGZ and Rabobank signed an agreement on cooperation and data sharing, and launched a integration committee. The merger of BNPP Polska with BGZ is one of the obligations set by regulator on BNP Paribas and thus, we don't see material legal risk for the merger. According to KNF's demands, the merger will be completed through the takeover of BNPP Polska by BGZ and the merged bank will operate under the name, including the full name of BGZ (Bank Gospodarki Żywnościowej) or the abbreviation BGZ.

### Expected share swap parity

BNP Paribas has declared that the key parameters of the planned merger, including the proposed share swap parity, will be announced by BGZ and BNPP Polska before the end of the public tender. Previously the representatives of BNPP Polska had indicated that merger parity will be based on the two banks' relative contribution to the merged company and they noted that the profitability of both is similar.

**We think BNPP Polska's shareholders will get a c.31-34% stake in the combined bank**

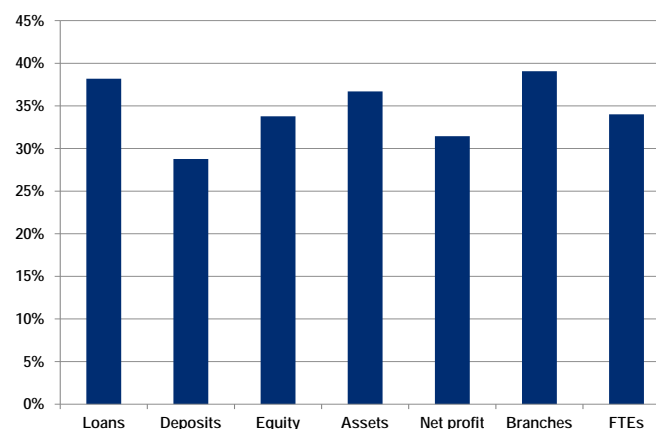
Taking into account 1H2014 financial data, the pro-forma share of BNPP Polska in the combined entity would be in the range of 29% (share in deposits) to 38% (the share in loans). We would expect the parity to be based, like in previous mergers in Poland, on the bank's earnings and equity, implying that BNPP Polska's shareholders would get a c.31%-34% stake in the combined bank.

Figure 2. BNPP Polska and BGZ – Comparison of the Key Balance Sheet, P&L and Business Data, 1H14 (Polish Zloty in million)

	BNPP	BGZ	Sum	BNPP's share
Loans	17,870	28,919	46,789	38%
Deposits	11,408	28,253	39,661	29%
Equity	2,066	4,049	6,115	34%
Assets	22,481	38,775	61,256	37%
Net profit	50	108	158	31%
Branches	250	390	640	39%
FTEs	2,845	5,520	8,365	34%

Source: Company data, Citi Research

Figure 3. BNPP Polska and BGZ – Share of BNPP Polska in the Potential Combined Bank, 2013 (Polish Zloty in million)



Source: Company data, Citi Research

### Higher free-float

**KNF required the free-float to be increased to 25% by the end of 2018**

After the planned merger with BGZ, the free float in the new bank will decline, according to our estimates, to c. 5%. KNF has obliged BNP Paribas to increase the free-float in the merged bank to at least 12.5% till June 2016 (i.e. ZI c.0.7bn, assuming the current BNPP share price) and to at least 25% plus one share till end of 2018 (ZI 1.4bn).

## The bigger scale should allow improved profitability

Figure 4. BNPP Polska and BGZ – Pro-Forma P&L Statement\*, 2011-2017E (Polish Zloty in million)

Pro-Forma	2011	2012	2013	2014E	2015E	2016E	2017E
NII	1,407	1,565	1,553	1,702	1,867	2,128	2,294
Net fees	410	444	426	450	474	498	523
Other revenues	212	274	286	197	200	205	213
<b>Total revenues</b>	<b>2,030</b>	<b>2,282</b>	<b>2,265</b>	<b>2,349</b>	<b>2,542</b>	<b>2,831</b>	<b>3,030</b>
Administrative costs	-1,537	-1,630	-1,550	-1,575	-1,627	-1,576	-1,482
<b>Pre-provision income</b>	<b>492</b>	<b>652</b>	<b>716</b>	<b>774</b>	<b>914</b>	<b>1,255</b>	<b>1,548</b>
Net provisioning	-272	-424	-365	-357	-481	-484	-526
Other revenues	2	0	-11	-2	-5	-5	-5
<b>Pre-tax profit</b>	<b>223</b>	<b>228</b>	<b>340</b>	<b>415</b>	<b>428</b>	<b>766</b>	<b>1,017</b>
Tax	-55	-67	-77	-93	-94	-152	-174
Minorities	0	0	0	0	0	0	0
<b>Net profit</b>	<b>168</b>	<b>161</b>	<b>262</b>	<b>323</b>	<b>335</b>	<b>614</b>	<b>843</b>
Loans	40,869	42,483	42,881	47,950	52,608	57,207	62,213
Deposits	31,824	37,007	37,387	40,975	44,864	48,710	52,890
Equity					6,759	6,962	7,212
Assets	55,887	58,078	56,894	62,620	67,897	73,187	78,921
ROE-BNPP	NA	2.0%	5.8%	5.2%	5.6%	8.6%	9.8%
ROE-BGZ	NA	4.3%	4.6%	5.7%	5.0%	7.3%	7.6%
ROE-combined	NA	3.5%	5.0%	5.6%	5.2%	7.7%	8.3%
<b>ROE-Pro forma</b>	<b>NA</b>	<b>NA</b>	<b>NA</b>	<b>NA</b>	<b>NA</b>	<b>8.9%</b>	<b>11.9%</b>

Note: We assume achievement of full cost synergies in 2017 (vs. the bank's guidance of "in 3 to 4 year from the getting a regulatory approval", i.e. in 2017-2018) \*\* Equity of the merged bank will depend on the decided method of the merger..

Source: Company data, Citi Research estimates

We think that the merger with BGZ will lead to ZI c.240m annual cost savings (c15% of the combined cost base) and will allow ROE to increase to 11-12% in 2017 from 5.8% in 2013.

### Volume growth and a reduction in branch network may improve the combined bank's profitability

In our initiation of BNPP Polska ([BNPP Polska \(BNP.WA\) - Fate of Merger Is Key](#)) we analysed the reasons for the low profitability of both banks. The biggest weakness of both banks appears to be low volumes per branch and low net fee income per assets. We understand the strategy of attracting clients with low prices (leading to low fees per assets) but it makes sense only if the bank manages to build scale and thus achieve cost advantage. The merged bank can increase assets or deposits per branch only through acceleration of volume growth or the reduction in branch numbers. We understand the BNP Paribas Group plans to combine both.

### BNP Paribas Group plans to close at least 11% of combined branches

An indication of the plans regarding branch closure is the bank's forecast that, post the merger, the combined bank in terms of number of branches will be behind Getin Noble and ahead of Eurobank. At the end of June 2014, 640 total branches were operated by BNPP Polska (250) and BGZ (390), while, as of the end of 2013, Getin Noble had 554 branches and Eurobank 485. This implies the bank plans to close at least 86 branches (13% of combined number) but not more than 155 (24%) – given the BNP Paribas plan to build a strong presence in Poland, we think the number of branches closures will be closer to the lower end of the range (somewhere between 13% and 15% of the combined network).

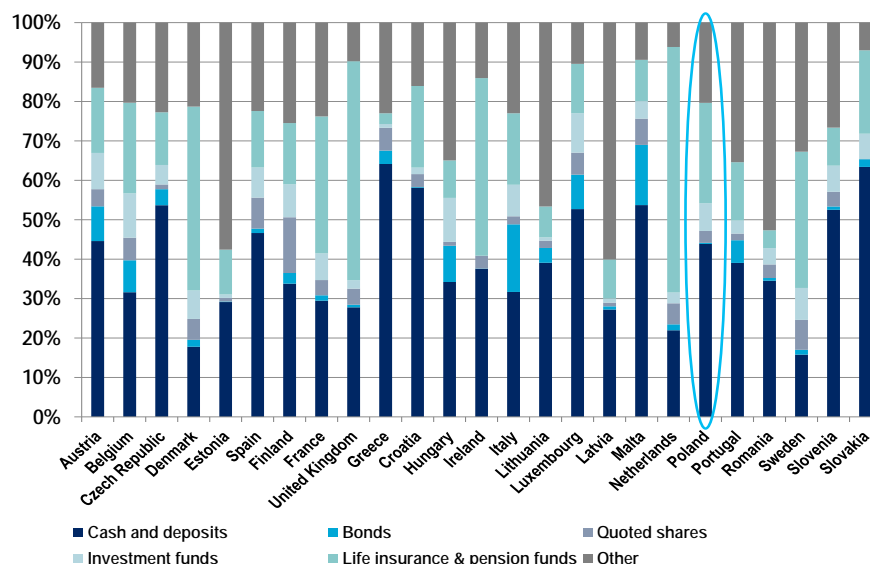
### More active marketing may help to leverage the attractive branch network

More active marketing, targeted at leveraging the market's sixth largest branch network, and one of the most geographically diversified, should allow the bank to accelerate asset growth.

**Upside risk from sales of investment products**

Both banks have low revenues from selling investment products. Given the relatively low savings of Polish households and still relatively high share of bank deposits in total savings, we are very positive on the growth outlook for the investment product market. The combination of BNPP's investment fund manager (TFI BNP Paribas Polska) and the experienced BGZ brokerage house may help the merged bank to participate in the growth we expect in fees from investment products ([Polish Financial Services - Investment Products – Trust Is the Name of the Game](#)).

Figure 5. Europe – Structure of Households Savings, 2013 (Percentage)



Source: Eurostat

**Conservatively we usually do not assume any revenue synergies**

We see upside potential for the merged bank, but simultaneously, we note the downside risks. Implementation of BNPP Polska's conservative risk management in the combined bank could result in the loss of part of the BGZ client base in the event that such clients find that their ability to obtain loans is reduced. Changes in product mix and pricing post the merger could also result in a degree of client loss. At this stage we don't know whether post the integration the bank might decide to launch a strong marketing campaign targeted at acquiring new clients and how successful any such campaign may be. Taking all of this into account, similar to other merger situations, we do not factor any revenue synergies from the planned integration of BNPP Polska and BGZ into our model.

**We think that cost synergies of 10%-15% of combined costs are achievable**

On the other hand, we think that cost synergies close to the upper end of the bank's guidance range (10%-15% of combined costs) are achievable (see table below for detailed calculations, based on historical bank mergers in Poland).

Figure 6. BNPP Polska and BGZ – Estimation of Potential Cost Synergies, 2013 (Polish Zloty in million)

	BNPP	BGZ	Combined	BGZ share	Savings*	as % of the combined	Pro-forma*
Staff costs	279	475	754	63%	127	17%	627
Average headcount	2,805	5,527	8,331	66%	1333	16%	6,998
Monthly cost per head	8,280	7,167	7,542	NA	-75	-1%	7,467
General costs	261	401	662	61%	100	15%	562
Rents	68	94	162	58%	16	10%	146
Technology and IT	37	76	113	67%	28	25%	85
Marketing	34	61	95	64%	19	20%	76
External services	73	93	166	56%	25	15%	141
KNF	2	4	6	67%	0	0%	6
BFG*	17	29	46	64%	0	0%	46
Other	33	48	81	59%	12	15%	69
Depreciation and amortisation	45	99	144	69%	14	10%	130
Total costs	584	976	1,560	63%	242	15%	1,319

Note: BFG costs are reported by BNPP Polska in other costs but we include them into the cost analysis because a majority of Polish banks report BFG costs as part of general costs. Due to better comparability

Source: Company data, Citi Research estimates (\*)

Figure 7. BNPP Polska and BGZ – Estimation of Potential Headcount Reduction, 2013 (Polish Zloty in million)

Headcount structure (FTEs)	BNPP	BGZ	Combined	BGZ share	Savings*	as % of the combined	Pro-forma*
Headquarters	927	1,363	2,290	60%	687	30%	1,603
Network	1,730	4,030	5,760	70%	576	10%	5,184
Other	137	134	271	49%	81	30%	190
Total	2,794	5,527	8,321	66%	1344	16%	6,977

Source: Company data, Citi Research estimates (\*)

Figure 8. BNPP Polska and BGZ – Administrative Costs to Average Assets, 2013 (Polish Zloty in million/Percentage)

	BNPP	BGZ	Combined	Pro-forma*
Average assets	20,974	36,512	57,486	57,486
Staff costs per assets	1.33%	1.30%	1.31%	1.09%
General costs per assets*	1.24%	1.10%	1.15%	0.98%
Amortisation per assets	0.21%	0.27%	0.25%	0.23%

Note: \* Including BFG costs reported by the bank in "Other operating costs" item line

Source: Company data, Citi Research estimates (\*)

**Even assuming a lack of revenue synergies we believe the combined bank may reach 11%-12% ROE**

Even assuming no revenue synergies, we believe the combined bank may reach 11%-12% ROE, i.e. close to the less profitable listed medium-sized banks (we forecast 13.3% ROE in 2017 for Millennium and 11.2% for Getin Noble). We assume achievement of full cost synergies in 2017 (vs. the bank's guidance of "in 3 to 4 year from the getting a regulatory approval", i.e. in 2017-2018). Taking into account the completed merger of BGZ with Rabobank Poland, in our forecasts we have included Rabobank Poland. Our forecasts do not include the impact of two future M&A actions forced by the regulator, i.e. the transfer of the part of the banking business of BNP Paribas – Branch Poland and the merger with Sygma Bank.



## The acquisition of part of BNP Paribas's banking business in Poland and the merger with Sygma Bank

BNP Paribas was obliged by the regulator to transfer selected parts of BNP Paribas-Branch Poland to the new merged bank and to merge the new bank operation with Sygma Bank.

### A transfer of the selected parts of BNP Paribas – Branch Poland operations

The history of the BNP Paribas – Branch Poland starts in 1990 when BNP entered the Polish market, setting up a representative office in Warsaw and in 1994 establishing a joint-venture with Dresdner Bank (BNP-Dresdner Bank). In 2001 it acquired 100% of the joint-venture, renamed BNP Paribas Bank Polska and in 2006 converted it into a branch (BNP Paribas - Branch Poland). In 2010, post the acquisition of the Polish business of Fortis Group, BNP Paribas transferred part of the banking business of its Polish branch (relationships with 150 capital groups or 350 legal entities, including ZI 257m of loans and more than ZI 1bn of deposits) to BNPP Polska. Since then BNPP Polska has focused on providing services for corporate clients, including lending, structured finance, cash management, trade finance, leasing, factoring and fixed income products, while the branch has serviced the biggest corporate and institutional clients (including large Polish corporate clients operating in energy, oil & gas and telecommunication industries) and has provided more sophisticated investment banking services.

### BNP Paribas Group owns French Sygma Banque active in Polish consumer finance market

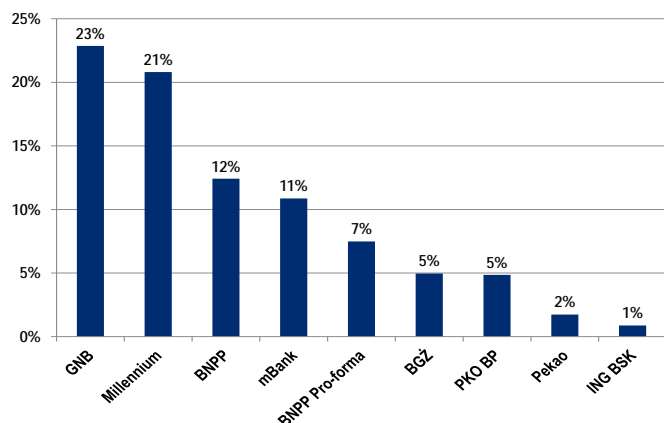
Sygma Bank is the Polish branch of the French Sygma Banque. For years BNP Paribas Group has owned 50% of LaSer Cofinoga, which controls Sygma Banque and in July 2014 it acquired the remaining stake from Galeries Lafayette. The Polish branch of Sygma Bank operates in consumer finance market, offering installment loans, credit cards and cash loans. It provides consumer finance products to clients of Praktiker, REAL and RTV EuroAGD and is the market leader in terms of issued credit cards (nearly 1m). We note that in 2009 Sygma Bank acquired from BNP Paribas Group Cetelem Bank Polska, a small Polish bank specialised in consumer finance (installment loans, cash loans and car loans). In 2009 the installment and cash lending business of Cetelem Bank was transferred to Sygma Bank, while new car lending was transferred to BNPP Polska (the bank took over key employees in charge of the business and business relationships with all car dealers that cooperated with Cetelem Bank Polska).



## Risk factors

The relatively high exposure to FX mortgages remains, in our opinion, the bank's biggest risk factor at the moment (for legal background see [Polish Banks: What is the Risk of "Hungarian-style" Solution for FX Mortgages? - Good, Bad and Ugly Scenarios](#)), followed by integration-related risks (lower-than-expected post-merger savings or the negative impact of the merger on the revenues) and high operational leverage, making the bank relatively highly exposed to a decline in revenues.

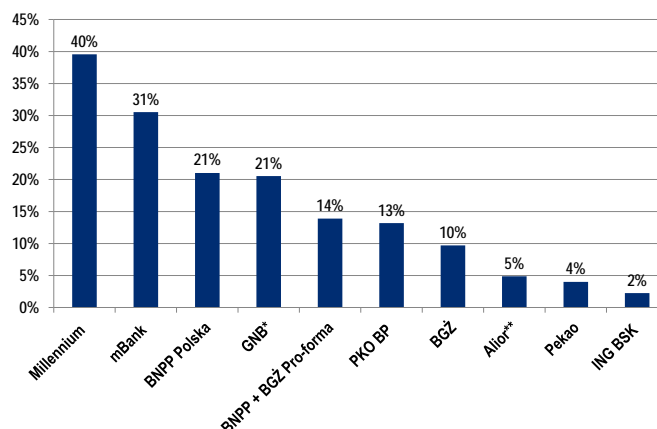
Figure 9. Polish Banks – Impact of the Potential Ruling on FX Spreads on Bank Equity, 2Q14 (Percentage)



Note: \*We assume the banks will have to return to clients FX spread charged at the moment of loan granting and repayment, in the calculation we include also the loss of the future revenues from the FX spreads on future loan repayment, historical spread estimated as the average of spreads as of June 6th in 2005-2014; the actual impact may be higher as our calculation don't include FX spread on paid interest rates; Equity as of 2Q14

Source: Company reports, banks' websites and Citi Research

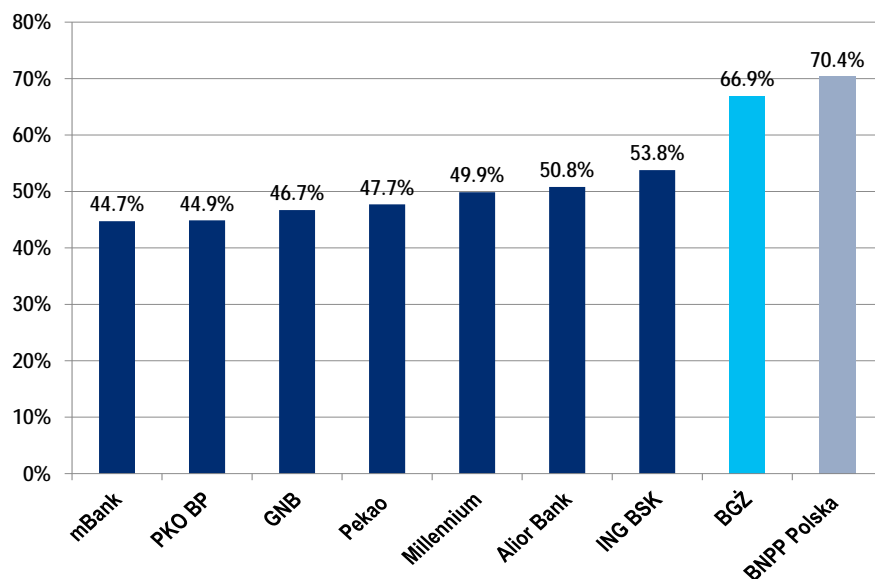
Figure 10. Polish Banks – Share of FX mortgages in Loan Portfolio, 2Q14 (Percentage)



Note: \*Citi estimates \*\* FX retail loans

Source: Company reports and Citi Research

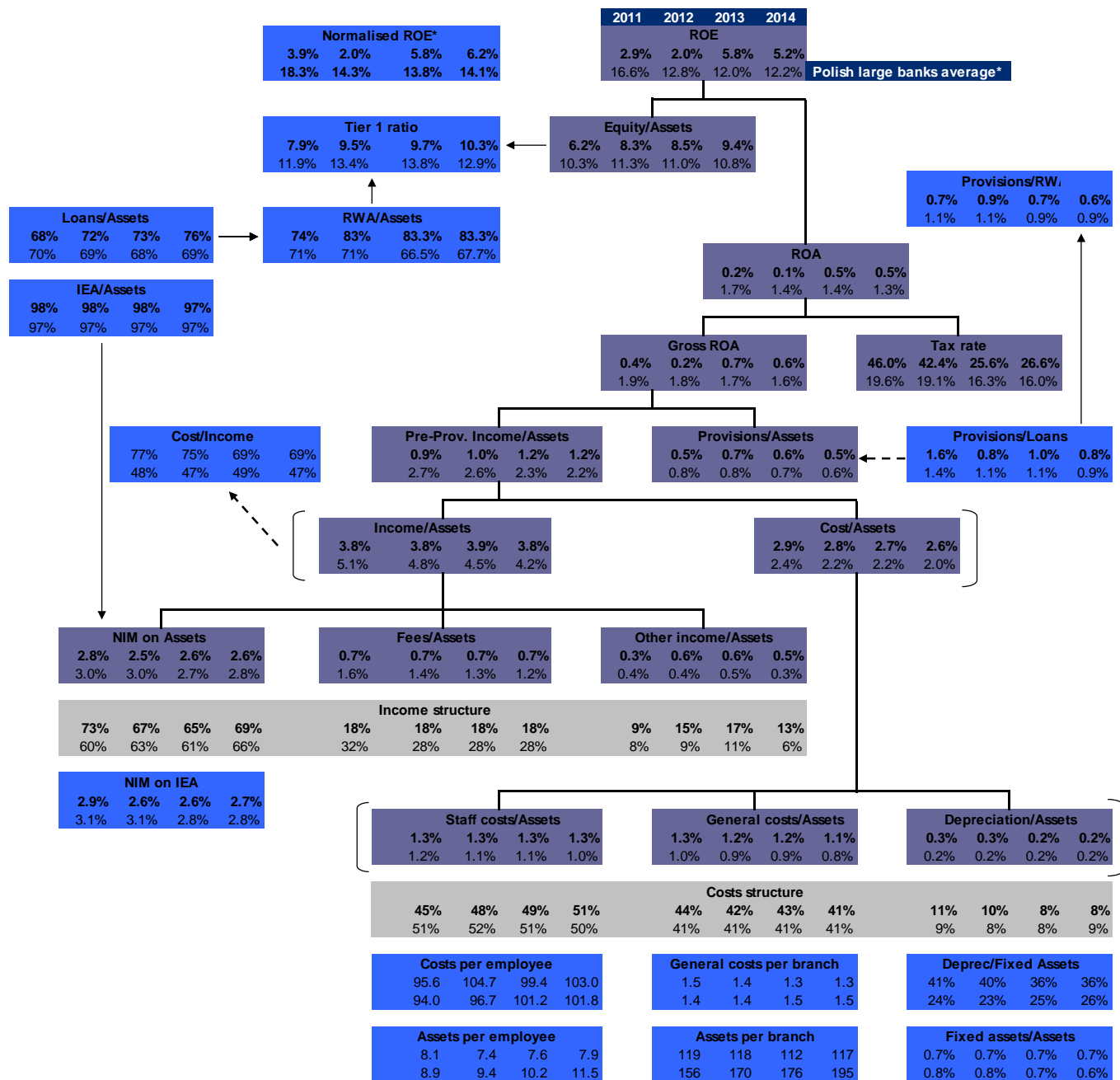
Figure 11. Polish Banks – Cost to Income Ratio, 1H14 (Percentage)



Source: Company reports and Citi Research

## Dupont Analysis

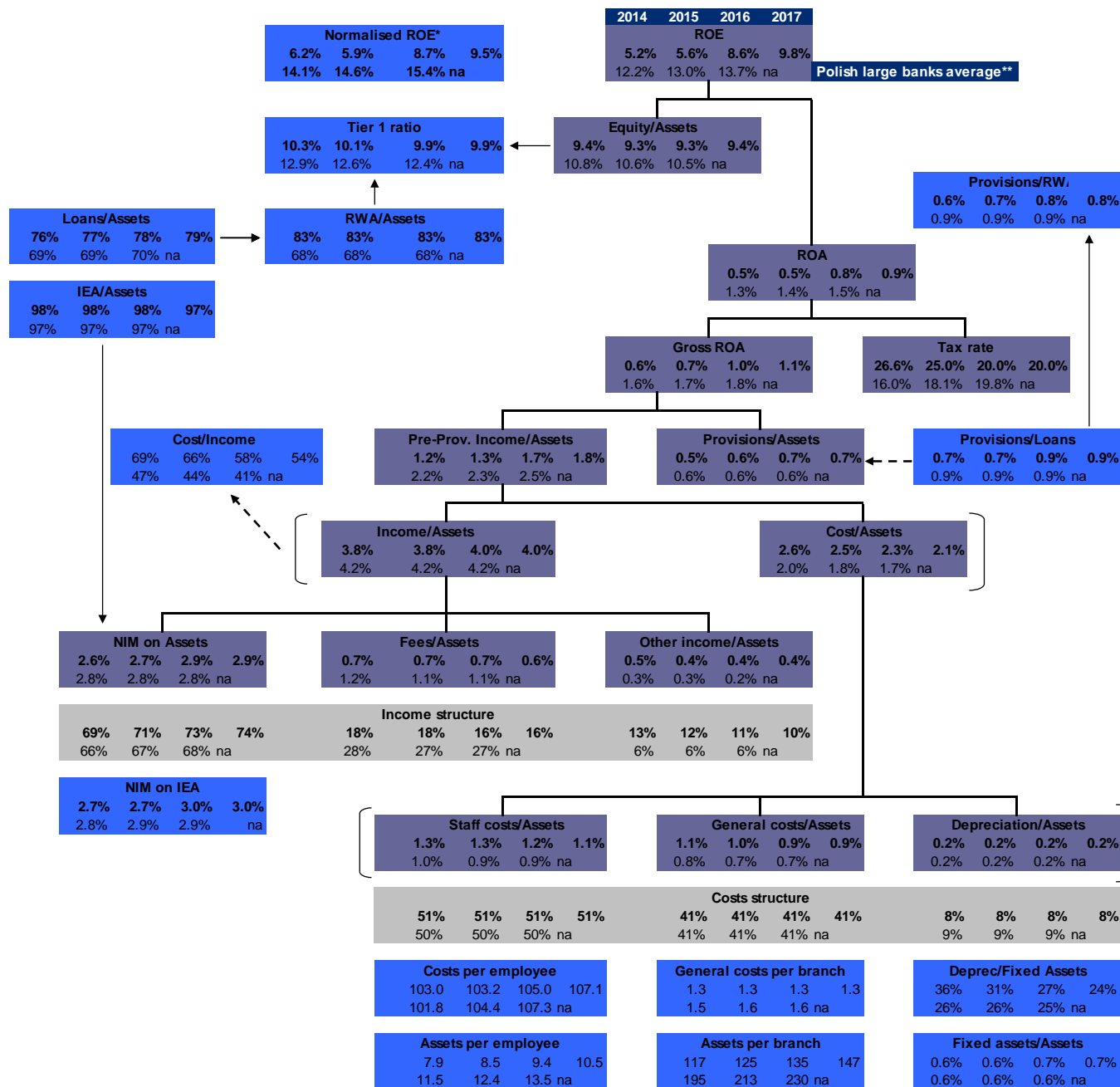
Figure 12. BNPP Polska – ROE Decomposition, 2011-2014E (Percentage)



Note: \*Normalised ROE calculated assuming 10% Tier 1; \*\*Citi coverage excluding Alior Bank and BNPP Polska

Source: Company reports and Citi Research

Figure 13. BNPP Polska – ROE Decomposition, 2014E-2017E (Percentage)



Note: \*Normalised ROE calculated assuming 10% Tier 1; \*\*Citi coverage excluding Alior Bank and BNPP Polska

Source: Company reports and Citi Research

## Estimate Changes

Taking into account 2Q14 results and macro trends, we have increased our 2014 EPS estimates by 2% but lowered 2015E by 25% and 2016E by 5%. The main drivers are:

- Taking into account the slightly lower than we projected NIM in 2Q14 and the changed outlook for interest rates, we have lowered our NIM assumption to 2.69% from 2.75% this year, to 2.72% from 3.00 in 2015, and to 3.00% from 3.10% in 2016 — this has led us to reduce NII forecasts by 5% in 2015 while 2014 and 2016 NII estimates have been raised by 0.8% and 0.9%, respectively, because the positive impact of increased projections of interest earning assets outpaced the negative impact of lower NIM assumptions.
- Given solid net fee income in 2Q14, we have raised our net fee estimates by 4% this year, 8% the next year and 7% in 2016.
- Taking into account realized gains on AFS securities in 2Q14, we have increased projections of financial income in 2014 by 3% but reduced them going forward (by 2% in 2015 and 2% 2016).

We have also revised our pro-forma forecasts for the merged bank. Taking into account the completed merger of BGZ with Rabobank Poland, the increased probability of interest rate cuts and the expected negative impact of Russian sanctions on risk costs in Polish Food&Agri lending, we have reduced our net profit forecasts by 1% this year, 24% next year and 1% in 2016.

Our forecasts do not include the transfer of the part of the banking business of BNP Paribas – Branch Poland nor the merger with Sygma Bank – Branch Poland.

## Valuation

Given the unknown share swap parity and business risks related to the merger process and achieving forecast synergies, we continue to base our target price for the bank on a weighted average of our stand-alone and post-merger valuations, but given the progress in the merger, we increase the weight of the post-merger scenario to 65% from 55% and consequently we increase our TP to Zł 73 from Zł 67.1 previously. Our valuations of BNPP Polska shares in the stand-alone and post-merger scenarios were affected by EPS reductions (described in the previous section) and by the rolling forward our base valuation year from 2016 to 2017.

Figure 14. BNPP Polska – Summary of Valuation

	BNPP Polska	Post the merger with BGZ	TP
EVA	73.4		
Warranted Equity Valuation	61.7	75.6	
Warranted Equity Valuation - ROTE	62.4	79.1	
Average	65.8	77.4	
Weights/Price Target	45%	65%	73
Current share price	55.38	55.38	55.38
Upside / (Downside)			30.0%
DPS (2014E)			0.00
Dividend yield (%)			0%
Total Return			30.0%

Source: Citi Research estimates

Figure 15. BNPP Polska – Warranted Equity Valuation

	BNPP Polska	Post the merger with BGZ
Sustainable ROE	9.8%	11.9%
COE	10.0%	10.0%
Growth	4.50%	4.5%
Target P/BV multiple	0.96	1.35
2017E BVPS	80	70
2017E Target Value Per Share	77	94
Months to Discount to Sep 2015	28	28
Discounted	62	76
2015E DPS	0	0
Months to Discount to Sep 2015	10	10
Discounted	0	0
2016E DPS	0	0
Months to Discount to Sep 2015	22	22
Discounted	0	0
Value per share	61.7	75.6
Upside / (Downside)	11.3%	36.5%

Source: Citi Research estimates

Figure 16. BNPP Polska – Warranted Equity Valuation – ROTE

	BNPP Polska	Post the merger with BGZ
Sustainable ROTE	10.0%	13.0%
COE	10.0%	10.0%
Growth	4.50%	4.50%
Target P/TBPS multiple	1.00	1.55
2017E TEPS	78	64
2017E Target Value Per Share	77.9	98.9
Months to Discount to Sep 2015	28	28
Discounted	62.4	79.1
2014E DPS	0.0	0.0
Months to Discount to Sep 2015	10	10
Discounted	0.0	0.0
2015E DPS	0.0	0.0
Months to Discount to Sep 2015	22	22
Discounted	0.0	0.0
Value per share	62.4	79.1
Upside / (Downside)	12.6%	42.9%

Source: Citi Research estimates

Figure 17. BNPP Polska – Sensitivity of the Pre-Merger WEV (Polish Zloty)

		ROE					
		7.8%	8.8%	9.8%	10.8%	11.8%	
COE	8%	63.0	82.0	101.1	120.2	139.3	
	9%	47.9	62.5	77.0	91.5	106.0	
	10%	38.4	50.0	61.7	73.3	84.9	
	11%	31.8	41.4	51.1	60.7	70.4	
	12%	27.0	35.2	43.4	51.5	59.7	

Source: Citi Research estimates

Figure 18. BNPP Polska – Sensitivity of the Post-Merger WEV (Polish Zloty)

		ROE					
		9.9%	10.9%	11.9%	12.90%	13.90%	
COE	8%	90.5	107.3	124.0	140.8	157.5	
	9%	68.9	81.6	94.4	107.2	119.9	
	10%	55.2	65.4	75.6	85.8	96.0	
	11%	45.7	54.2	62.6	71.1	79.6	
	12%	38.8	46.0	53.2	60.4	67.5	

Source: Citi Research estimates

Figure 19. BNPP Polska – Sensitivity of the Pre-Merger WEV-ROTE (Polish Zloty)

		ROTE					
		8.0%	9.0%	10.0%	11.0%	12.0%	
COE	8%	65.1	83.7	102.3	120.9	139.5	
	9%	49.6	63.7	77.9	92.0	106.2	
	10%	39.7	51.0	62.4	73.7	85.1	
	11%	32.9	42.3	51.7	61.1	70.5	
	12%	27.9	35.9	43.9	51.8	59.8	

Source: Citi Research estimates

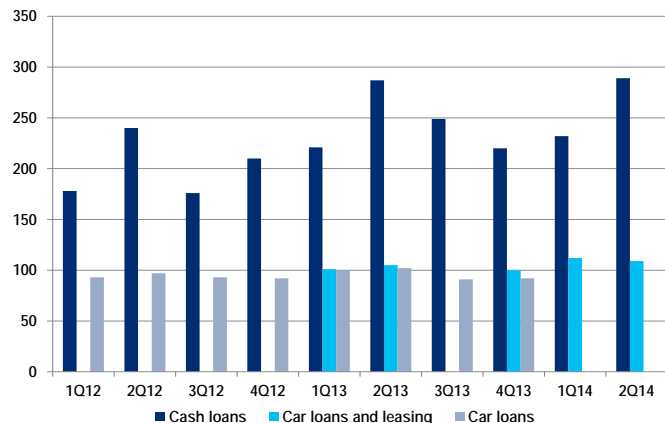
Figure 20. BNPP Polska – Sensitivity of the Post-Merger WEV-ROTE (Polish Zloty)

		ROTE					
		11.0%	12.0%	13.0%	14.00%	15.00%	
COE	8%	99.3	114.5	129.8	145.1	160.4	
	9%	75.6	87.2	98.8	110.4	122.1	
	10%	60.5	69.8	79.1	88.5	97.8	
	11%	50.1	57.9	65.6	73.3	81.0	
	12%	42.6	49.1	55.7	62.2	68.7	

Source: Citi Research estimates

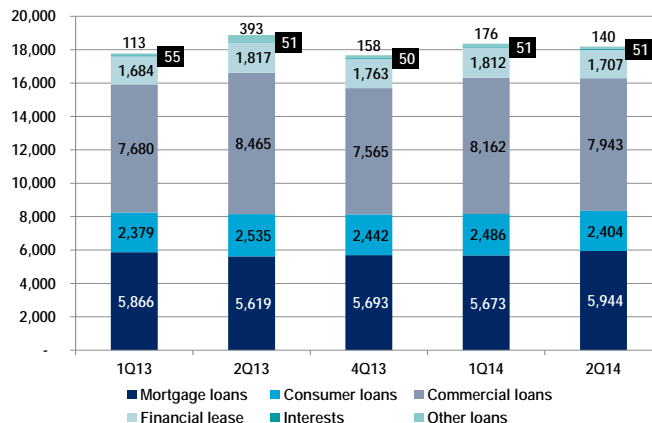
## The Recent Trends Illustrated

Figure 21. BNPP Polska – Loans Production, 1Q12-2Q14 (Polish Zloty in million)



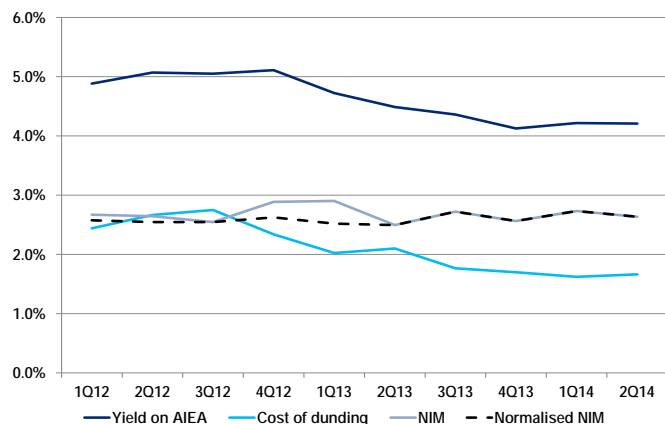
Source: Company reports

Figure 22. BNPP Polska – Loans Structure, 1Q13-2Q14 (Polish Zloty in million)



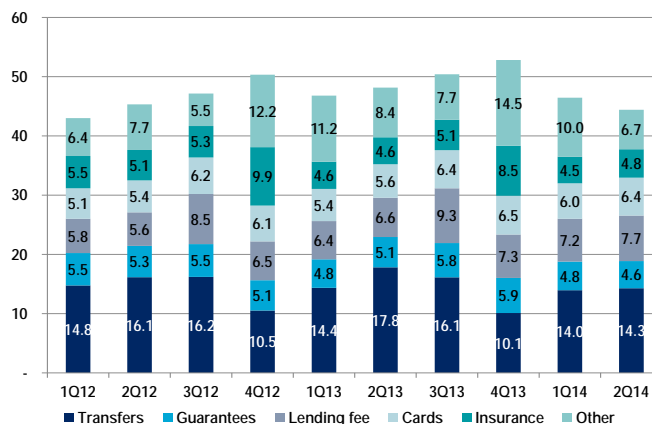
Source: Company reports

Figure 23. BNPP Polska – Yield on Average Interest Earning Assets, Cost of Funding, Net Interest Margin, 1Q12-2Q14 (Percentage)



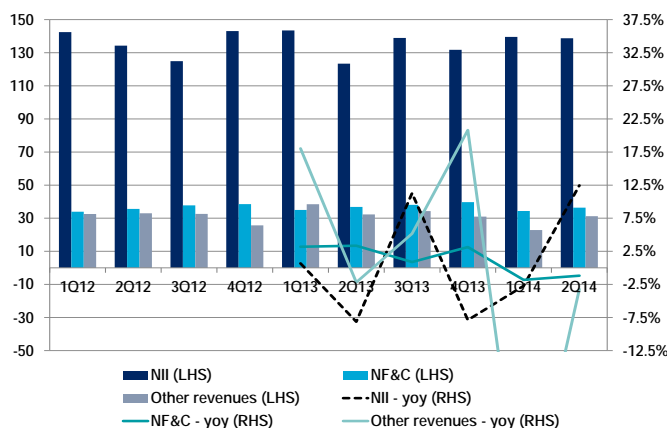
Source: Company reports and Citi Research

Figure 24. BNPP Polska – Structure of Fees Revenues, 1Q12-2Q14 (Polish Zloty in million)



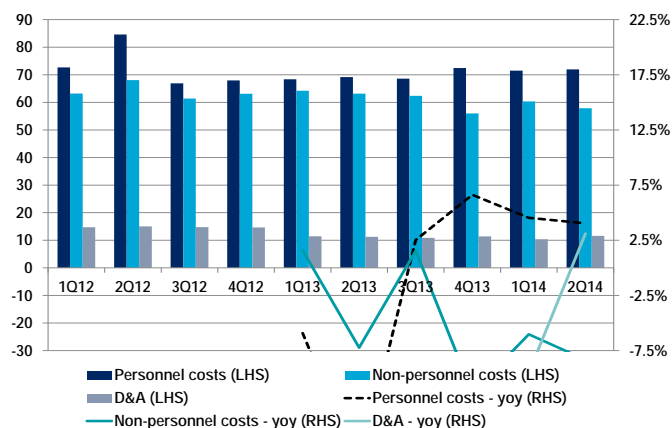
Source: Company reports and Citi Research

Figure 25. BNPP Polska – Revenues Structure and YoY Change, 1Q12-2Q14 (Polish Zloty in million/Percentage)



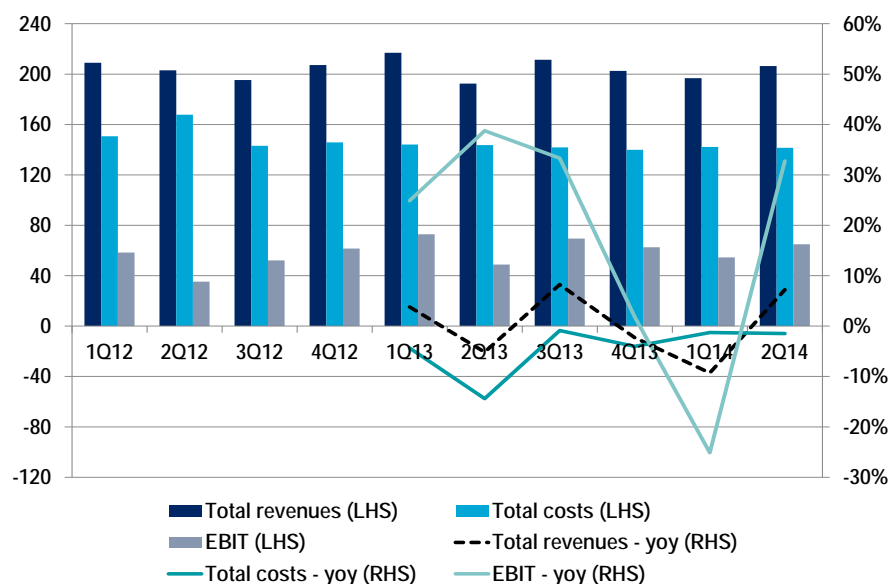
Source: Company reports and Citi Research

Figure 26. BNPP Polska – Costs Structure and YoY Change, 1Q12-2Q14 (Polish Zloty in million/Percentage)



Source: Company reports and Citi Research

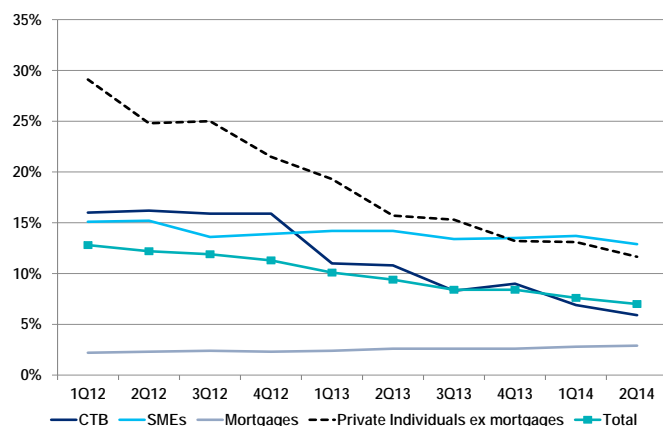
Figure 27. BNPP Polska- Total Revenues, Total Costs, EBIT and YoY Change, 1Q12-2Q14 (Polish Zloty in million/Percentage)



Source: Company reports and Citi Research

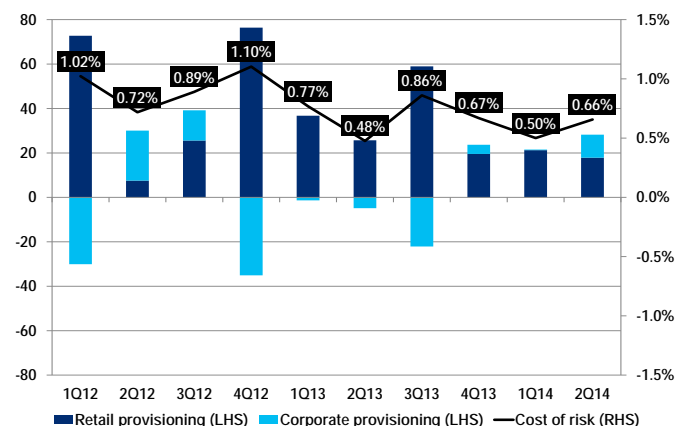


Figure 28. BNPP Polska – Non-Performing Loans, 1Q12-2Q14 (Percentage)



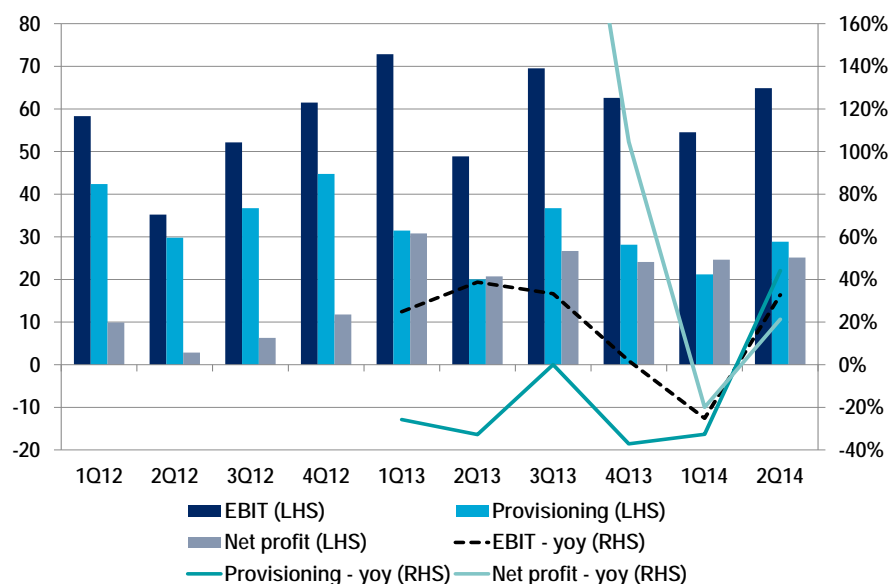
Source: Company reports and Citi Research

Figure 29. BNPP Polska – Provisioning and Cost of Risk, 1Q12-2Q14 (Polish Zloty in million/Percentage)



Source: Company reports and Citi Research

Figure 30. BNPP Polska – EBIT, Provisioning, Net Profit and YoY Changes, 1Q12-2Q14 (Polish Zloty in million/Percentage)



Source: Company reports and Citi Research

## BNPP Polska

### Company description

BNP Paribas Bank Polska, majority-owned by BNP Paribas Group, is a small (15th in terms of loans) bank focused on multinational companies and affluent retail clients. In December 2013 BNP Paribas Group reached an agreement with Rabobank for the acquisition of BGZ (a medium-sized Polish universal bank specialized in Food&Agri). The Group awaits regulatory approval to close the transaction and merge BGZ with BNPP Polska, potentially creating the 7th biggest lender in Poland.

### Investment strategy

We estimate the implementation of the bank's strategy to intensify sale of consumer loans to mass affluent clients and to increase penetration of domestic large corporate clients will increase ROE to c.10% in 2017. We see scope for further growth in profitability through the merger with BGZ, which we would expect to pave the way for significant cost synergies (we estimate potential synergies at c.15% of combined costs). Given pending regulatory approval of the merger, the unknown share swap parity and business risks related to the merger process and achieving forecast synergies, we base our target price for the bank on a weighted average of our stand-alone (35% weight) and post-merger (65%) valuations and rate BNPP Polska Buy.

### Valuation

Our Economic Value Added Valuation of ZI 73.4 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). Our Standard Warranted Equity Valuation of ZI 61.7 per share is based upon the formula:  $\text{Price} / \text{Book value} = (\text{Sustainable RoE} - \text{growth}) / (\text{Cost of equity} - \text{growth})$ . In the "no merger" scenario we assume a sustainable ROE of 9.8% and use a cost of equity of 10.0% and a sustainable growth rate of 4.5%. In our Warranted Tangible Equity Valuation we assume a 10.0% ROTE and arrive at a fair value of ZI 62.4. In the "post-merger" scenario we assume ROE of 11.9% and ROTE of 13.0% and arrive at fair value estimates of ZI 75.6 and ZI 79.1, respectively. In line with the approach we adopt for the rest of our coverage universe, our target price is based upon the ROTE approach and set at ZI 73 as the weighted average of the post-merger valuation (65% weight) and the stand-alone valuation (35% weight).

### Risks

We see a number of risks to our target price.

At the macro level we highlight the following risks: (1) The economy may perform better or worse than we anticipate and lead to higher or lower provisioning and slower or higher loan growth than we expect. (2) In our opinion, potential escalation of the Russia-Ukraine conflict is a material downside risk to our forecasts for Polish banks.

For Polish banks in general, we highlight (1) The Polish banking market is rather fragmented and increased/reduced competition could put more/less pressure on margins and earnings than we currently assume. (2) The impact on the banks of Polish regulatory and tax policies could differ from our assumptions.

Specifically for BNPP Polska: (1) We derive materially differing 'stand-alone' and 'post-merger' valuations for BNPP Polska. Consequently, regulatory approval or rejection of the merger has material implications for our valuation. In addition, should the merger obtain approval, implementation may be more or less successful than our post-merger scenario envisages. (2) The bank is highly dependent on its parent bank in terms of funding and strategy. (3) The bank has a high share of FX loans in its loans portfolio and high operational leverage, which increase risks around our forecasts.

## Appendix A-1

### Analyst Certification

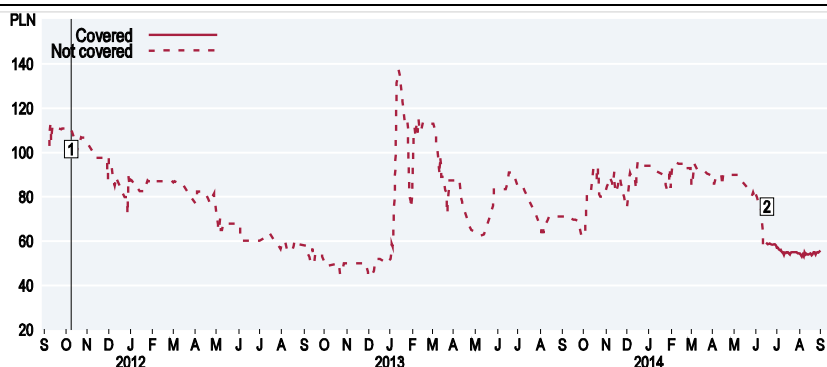
The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

### IMPORTANT DISCLOSURES

#### BNPP Polska (BNP.WA)

##### Ratings and Target Price History Fundamental Research

Analyst: Andrzej Powierza  
Covered since June 17 2014



	Date	Rating	Target Price	Closing Price
1	8-Oct-11	Stock rating system changed		

\* Indicates change

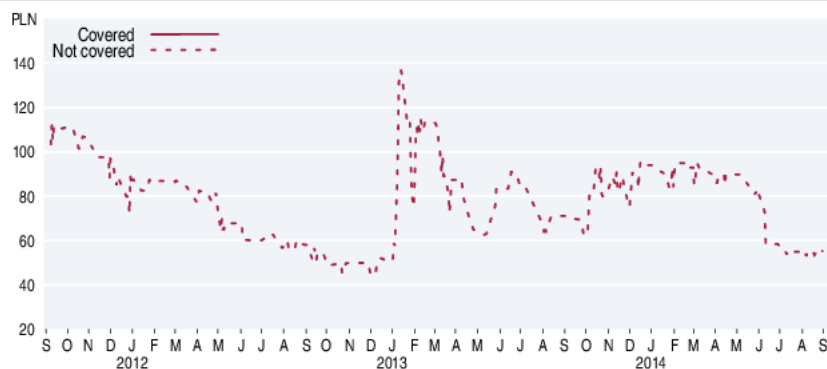
	Date	Rating	Target Price	Closing Price
2	17-Jun-14	*2	*67.10	58.97

Rating/target price changes above reflect Eastern Standard Time

#### BNPP Polska (BNP.WA)

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

Analyst: Andrzej Powierza  
Covered since June 17 2014



\* Indicates change

Rating/target price changes above reflect Eastern Standard Time

DMBH rating distribution versus Investment Banking service provision in the past 12 months as at 30th June 2014 is as follows: Buy (1) representing 26% of the DMBH coverage 0% of which are IB clients, Hold (2) representing 42% of the DMBH coverage 0% of which are IB clients, Sell (3) representing 32% 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 2014 is as follows: Buy (1) representing 26% of the DMBH coverage 0% of which are IB clients, Hold (2) representing 42% of the DMBH coverage 0% of which are IB clients, Sell (3) representing 32% 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 2014 is as follows: Buy (1) representing 26% of the DMBH coverage 0% of which are IB clients, Hold (2) representing 42% of the DMBH coverage 0% of which are IB clients, Sell (3) representing 32% of the DMBH coverage 0% of which are IB clients.

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DMBH is a market maker in the publicly traded equity securities of PKO BP. DMBH rating distribution versus Investment Banking service provision in the past 12 months as at 30th June 2014 is as follows: Buy (1) representing 26% of the DMBH coverage 0% of which are IB clients, Hold (2) representing 42% of the DMBH coverage 0% of which are IB clients, Sell (3) representing 32% 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 2014 is as follows: Buy (1) representing 26% of the DMBH coverage 0% of which are IB clients, Hold (2) representing 42% of the DMBH coverage 0% of which are IB clients, Sell (3) representing 32% of the DMBH coverage 0% of which are IB clients DMBH acts as a dealer and regularly trades in the securities of Alior Bank.

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

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#### Citi Research Equity Ratings Distribution

<i>Data current as of 30 Jun 2014</i>	<b>12 Month Rating</b>			<b>Relative Rating</b>		
	Buy	Hold	Sell	Buy	Hold	Sell
Citi Research Global Fundamental Coverage	49%	40%	12%	0%	100%	0%
% of companies in each rating category that are investment banking clients	55%	53%	46%	0%	54%	0%

#### Guide to Citi Research Fundamental Research Investment Ratings:

Citi Research stock recommendations include an investment rating and an optional risk rating to highlight high risk stocks.

**Risk rating** takes into account both price volatility and fundamental criteria. Stocks will either have no risk rating or a High risk rating assigned.

**Investment Ratings:** Citi Research investment ratings are Buy, Neutral and Sell. Our ratings are a function of analyst expectations of expected total return ("ETR") and risk. ETR is the sum of the forecast price appreciation (or depreciation) plus the dividend yield for a stock within the next 12 months. The Investment rating definitions are: Buy (1) ETR of 15% or more or 25% or more for High risk stocks; and Sell (3) for negative ETR. Any covered stock not assigned a Buy or a Sell is a Neutral (2). For stocks rated Neutral (2), if an analyst believes that there are insufficient valuation drivers and/or investment catalysts to derive a positive or negative investment view, they may elect with the approval of Citi Research management not to assign a target price and, thus, not derive an ETR. Analysts may place covered stocks "Under Review" in response to exceptional circumstances (e.g. lack of information critical to the analyst's thesis) affecting the company and / or trading in the company's securities (e.g. trading suspension). As soon as practically possible, the analyst will

publish a note re-establishing a rating and investment thesis. To satisfy regulatory requirements, we correspond Under Review and Neutral to Hold in our ratings distribution table for our 12-month fundamental rating system. However, we reiterate that we do not consider Under Review to be a recommendation.

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