Citi Research
Equities

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Diversified Banks
CEEMEA │ Poland

BNPP Polska (BNP.WA)

Fate of Merger Is Key: Initiating With a Neutral Rating

- Initiation of Coverage

- **Consistently Building Position in Poland: Neutral** — We initiate coverage of BNP Paribas Bank Polska (BNPP Polska) with a Neutral rating and Zl67.1 TP. BNPP Polska, the Polish subsidiary of BNP Paribas Group, is currently a small (15th in terms of loans) bank focused on multinational companies and affluent retail clients.
- **Merger in Prospect: We Assume a 55% Probability of Success** — In December 2013 BNP Paribas Group reached an agreement with Rabobank for the acquisition of BGZ. The Group awaits regulatory approval to close the transaction and merge BGZ with BNPP Polska, potentially creating the 7th biggest lender in Poland. Approval is far from assured, but on balance we think it is more likely than not. For valuation purposes we attribute a probability of 55% to a successful merger.
- **Low ROE Now …** — BNPP Polska's ROE is low (5.8% in 2013) due to low assets per branch. We think that 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 8.9% in 2016. Under a stand-alone scenario, our standard WEV (based on ROTE) model values the stock at Zl 52.6.
- **… Should Rise Post Merger …** — Assuming BNPP Polska merges with BGZ and the merged bank generates cost synergies of about 15% of combined costs, we estimate it could achieve c11% ROE (excluding merger costs) in 2016. In a post-merger scenario, our WEV (based on ROTE) model values the stock at Zl 78.9.
- **… But Regulatory Approval Still Pending** — Given pending regulatory approval of the purchase/merger, the unknown share swap parity and business risks related to the merger process and achieving forecast synergies, we base our TP (Zl 67.1) on a weighted average of our stand-alone (45% weight) and post-merger (55%) valuations. Success/failure of the merger could turn us more positive/negative on the shares.
- **Business Risks** — Other risks to our TP: Macro risks (economic growth, Russia/ Ukraine); industry risks (competition, regulation); company-specific risks (dependence on main shareholder; high share of FX loans; and high operational leverage).

Neutral	**2**
Price (16 Jun 14)	Zl58.90
Target price	Zl67.10
Expected share price return	13.9%
Expected dividend yield	0.0%
Expected total return	**13.9%**
Market Cap	Zl1,986M
	US$653M

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

BNPP Polska (PLN)

Year to 31 Dec	2012A	2013A	2014E	2015E	2016E
Net Income (ZlM)	30.8	102.3	100.4	163.4	212.8
Diluted EPS (Zl)	1.17	3.56	3.22	4.85	6.31
Diluted EPS (Old) (Zl)	1.17	3.56	3.22	4.85	6.31
PE (x)	50.4	16.5	18.3	12.2	9.3
P/BV (x)	1.0	0.9	0.9	0.9	0.8
DPS (Zl)	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	5.1	7.4	8.9

Andrzej Powierza
+48-22-690-3566
andrzej.powierza@citi.com

Simon Nellis
+44-20-7986-4012
simon.nellis@citi.com

Fiscal year end 31-Dec	2012	2013	2014E	2015E	2016E
Valuation Ratios					
P/E adjusted (x)	50.4	16.5	18.3	12.2	9.3
P/E reported (x)	50.4	16.5	18.3	12.2	9.3
P/BV (x)	1.0	0.9	0.9	0.9	0.8
P/Adjusted BV diluted (x)	1.0	0.9	0.9	0.9	0.8
Dividend yield (%)	0.0	0.0	0.0	0.0	0.0
Per Share Data (Zl)					
EPS adjusted	1.17	3.56	3.22	4.85	6.31
EPS reported	1.17	3.56	3.22	4.85	6.31
BVPS	60.33	62.90	63.20	68.04	74.35
Tangible BVPS	59.28	61.61	61.88	66.53	72.61
Adjusted BVPS diluted	60.33	62.90	63.20	68.04	74.35
DPS	0.00	0.00	0.00	0.00	0.00
Profit & Loss (Zlm)					
Net interest income	545	538	568	650	731
Fees and commissions	146	150	142	146	155
Other operating Income	124	136	111	120	126
Total operating income	**814**	**823**	**822**	**916**	**1,012**
Total operating expenses	-607	-569	-574	-571	-571
Oper. profit bef. provisions	**207**	**254**	**248**	**345**	**441**
Bad debt provisions	-154	-116	-113	-140	-175
Non-operating/exceptionals	0	0	0	0	0
Pre-tax profit	**54**	**138**	**134**	**204**	**266**
Tax	-23	-35	-34	-41	-53
Extraord./Min. Int./Pref. Div.	0	0	0	0	0
Attributable profit	**31**	**102**	**100**	**163**	**213**
Adjusted earnings	31	102	100	163	213
Growth Rates (%)					
EPS adjusted	-28.6	205.2	-9.8	50.6	30.2
Oper. profit bef. prov.	13.8	22.5	-2.4	39.1	28.0
Balance Sheet (Zlm)					
Total assets	**20,831**	**21,117**	**21,590**	**23,506**	**25,607**
Avg interest earning assets	21,153	20,485	20,691	21,663	23,593
Customer loans	16,160	16,583	17,814	19,595	21,555
Gross NPLs	1,943	1,479	1,493	1,551	1,585
Liab. & shar. funds	**20,831**	**21,117**	**21,590**	**23,506**	**25,607**
Total customer deposits	10,065	10,894	10,464	11,511	12,662
Reserve for loan losses	1,202	1,089	1,089	1,089	1,089
Shareholders' equity	**1,731**	**1,805**	**2,131**	**2,294**	**2,507**
Profitability/Solvency Ratios (%)					
ROE adjusted	2.0	5.8	5.1	7.4	8.9
Net interest margin	2.58	2.62	2.75	3.00	3.10
Cost/income ratio	74.6	69.2	69.9	62.4	56.4
Cash cost/average assets	2.8	2.7	2.7	2.5	2.3
NPLs/customer loans	12.0	8.9	8.4	7.9	7.4
Reserve for loan losses/NPLs	61.9	73.6	72.9	70.2	68.7
Bad debt prov./avg. cust. loans	0.9	0.7	0.7	0.8	0.9
Loans/deposit ratio	160.6	152.2	170.2	170.2	170.2
Tier 1 capital ratio	9.5	9.7	10.8	10.4	10.3
Total capital ratio	13.8	12.4	13.3	12.7	12.4

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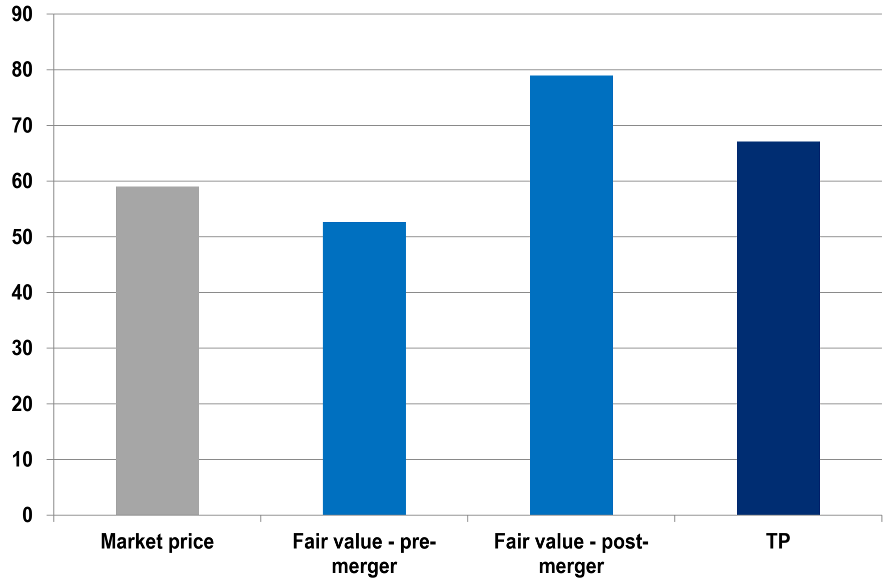
Contents

BNP Paribas Bank Polska

Figure 1. BNPP Polska – Market Price vs. Fair-value in Pre-merger and Post-merger Scenario and Target Price (Polish Zloty in million)



Source: Citi Research

Investment Summary

Initiating Coverage with a Neutral Rating, TP Zl 67.10

We rate BNPP Polska Neutral. 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.9% in 2016. 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 purchase/ 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 (45% weight) and post-merger (55%) valuations. Our preferred exposures to the Polish Financials is the Buy-rated insurer PZU (PZU.WA; Zl450.00; TP Zl 480). We don't have any Buy-rated banks. Among our Neutral rated banks, taking into account the balance of upside and downside risks, we prefer Pekao (TP Zl 193) and ING BSK (TP Zl 124.2).

Small Subsidiary of a Large Parent

A small universal bank, created through the merger of Fortis Bank Polska with Dominet Bank…

BNP Paribas Bank Polska (BNPP Polska) is a small universal bank, created through the merger of Fortis Bank Polska (the former Pierwszy Polsko-Amerykanski Bank) with Dominet Bank and the transfer of part of the banking business of the BNP Paribas branch in Poland (but we note that BNP Paribas continues to service some large domestic companies and institutions directly through the branch, offering them predominantly Capital Market products). The BNP Paribas Group supports its Polish subsidiary by providing funding and sharing know-how (e.g. in corporate and transaction banking, personal finance and digital banking).

…is planned to be merged with BGZ…

On December 5, 2013, the BNP Paribas Group reached an agreement with Rabobank on the acquisition of a 98.5% stake in BGZ for Zl 4.2bn. BGZ is a medium-sized universal bank focused on clients from Food&Agri industries. The acquisition is subject to regulatory approvals. After the BGZ purchase and completion of the required legal procedure, BNP Paribas Group has stated that it intends to merge BGZ with BNPP Polska.

…and become a Top 10 bank in Poland

In terms of loans, deposits and number of branches, we calculate BNPP Polska ranks as somewhere between the 14th and 17th largest bank in Poland while BGZ is ranked between the 10^{th} and 12^{th} largest. The merged bank (assuming no branch closures) would create the 5^{th} biggest bank in terms of number of branches (including franchised outlets), 7^{th} in terms of loans and 8^{th} in terms of deposits.

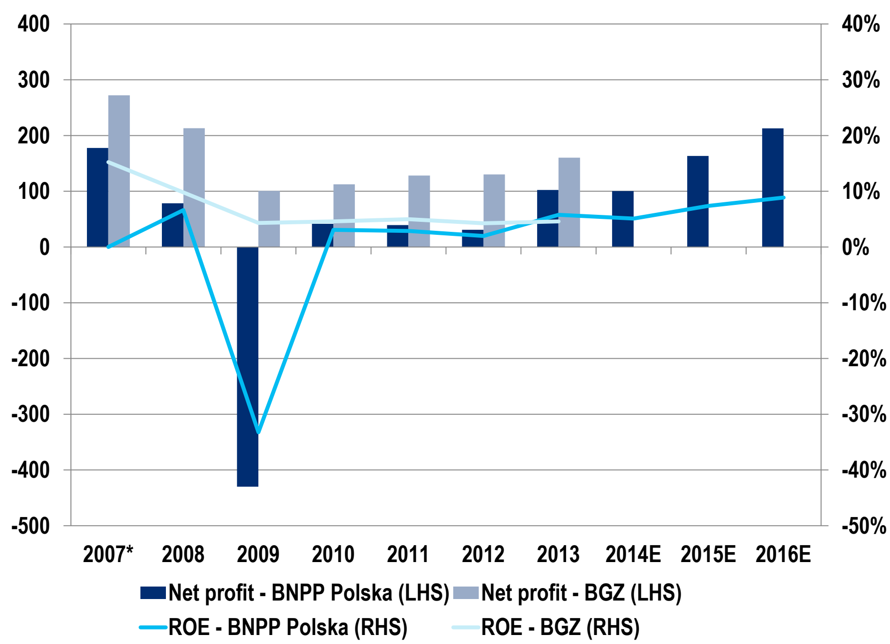
Historically the bank has been strong in consumer finance and corporate banking

The bank's predecessors were focused on affluent individuals and companies (Fortis Bank Polska), as well as on consumer finance, including cash and car loans (Dominet Bank) and BNPP Polska maintains a strong position in these sub-segments (e.g. according to the bank's estimates, it has 10% market share in documentary trade and it maintains relationships with 14.5% of multinationals within the top 2,000 corporate clients in Poland, while its market shares in new production of consumer loans and car loans are, respectively, about 5% and about 9%).

BGZ is focused on Food&Agri

BGZ offers a comprehensive range of banking products for retail and corporate clients. In contrast to other universal banks in Poland, it focuses more on small and medium-sized towns. The bank is the leader in F&A banking in Poland with a 27% market share in lending to farmers, according to our calculations. In selected areas, its market position is much stronger (e.g. in overdraft loans to farmers) but in other areas it is much weaker. For example, in farmers' deposits BGZ's market share, according to our calculations, is just 13%.

Figure 2. BNPP Polska and BGZ – Net Profit And ROE, 2007*-2013 (Polish Zloty in million/Percentage)



*Stand-alone data for 2007 for BNPP Polska

Source: Company data, Citi Research estimates

Low Profitability of BNPP Polska and BGZ Despite Continued Restructuring

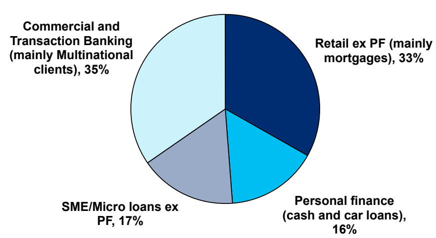
The bank's predecessors' appetite for growth led to a Zl 430m net loss in 2009

Dominet's appetite for growth in the risky segment of high-margin consumer loans and Fortis Bank Polska's efforts to boost the sale of loans and innovative FX products led to a significant loss in 2009, when the bank had to book Zl 216m in provisions on Dominet consumer loans and Zl 327m on Fortis Bank Polska's corporate exposures.

ROE increased significantly in 2013 but remains low (6%)…

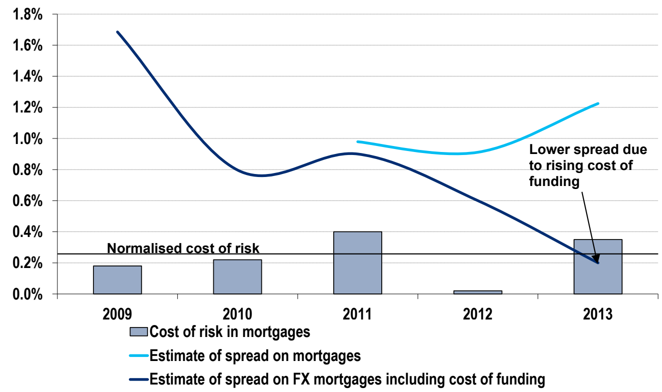
The reduction of risk cost post 2009 allowed BNPP Polska to reach profitability in the following years, but ROE remains low (6% in 2013), due partly to legacy assets (thin-margin FX mortgages still constitute 34% of retail loans) and partly to low revenues generated by new sales (according to our estimates, the yield on consumer loans is c3-4 p.p. lower vs. peers focused on higher-risk clients).

Figure 3. BNPP Polska – Loan Structure, 2013 (Percentage)



Source: Company data, Citi Research

Figure 4. BNPP Polska – Estimated Profitability of Mortgage Lending, 2009-2013 (Percentage)

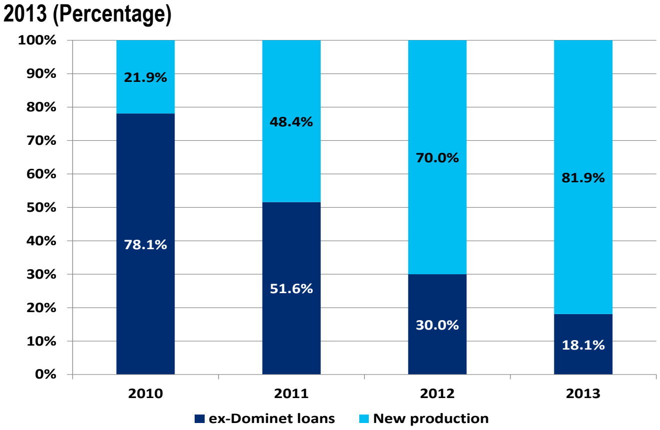


Source: Company data, Citi Research estimates

A continued run-off of legacy assets…

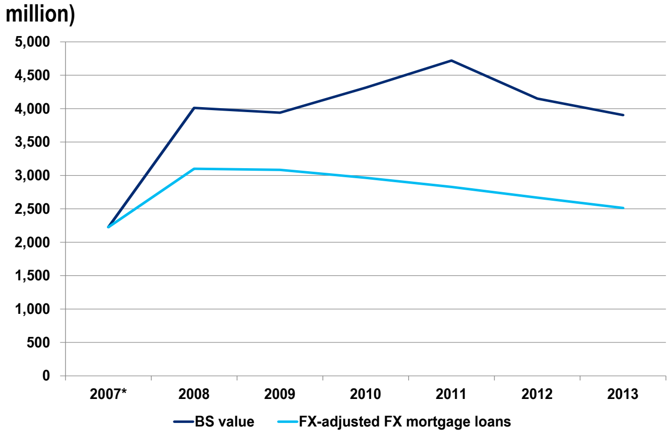
However, we see the bank's profitability as benefitting from the continued run-off of legacy assets. The share of Dominet loans in Personal Finance loans declined to 18% in 2013 (Zl c.0.5bn) from 78% in 2010 while thin-margin FX mortgages (FX adjusted) declined -6% yoy in 2013. The NPL ratio declined to 8.4% in 2013 from 11.2% in 2012 and 15.5% in 2010, followed by the decline in cost of risk (including provisions for legal risks) to 71bp from 94bp and 143bp, respectively.

Figure 5. BNPP Polska – Structure of Personal Finance Loans, 2010-2013 (Percentage)



Source: Company reports and Citi Research

Figure 6. BNPP Polska – FX Mortgages, 2007-2013 (Polish Zloty in million)



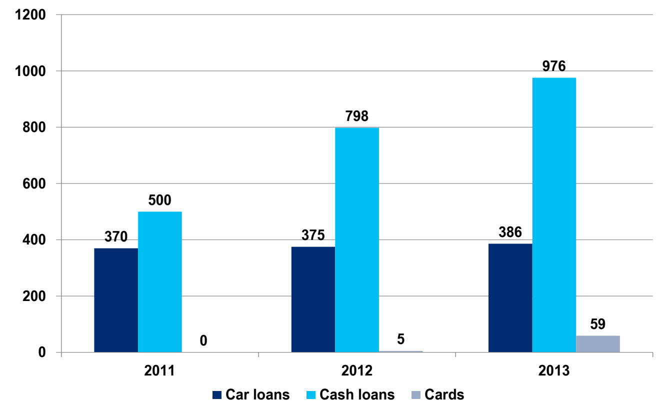
*Stand-alone data for 2007

Source: Company reports and Citi Research

…coupled with rising sales of profitable products bodes well for the future

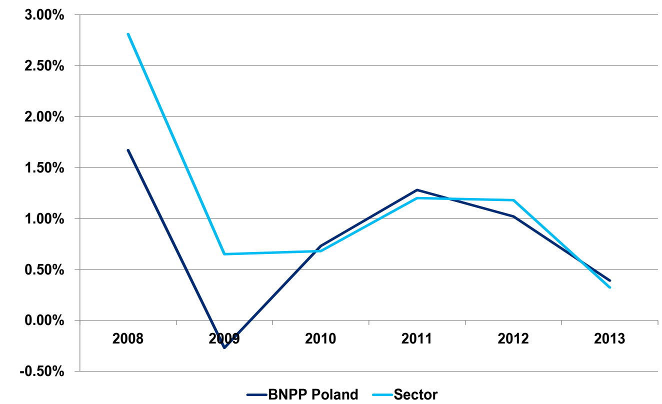
Simultaneously, BNPP Polska increased new sales of Personal Finance loans (+21% yoy in 2013), improved the yield on new cash lending by 3 p.p. (December 2013 vs. December 2010), reduced administrative cost (-6% yoy in 2013) and closed the gap between its cost of deposit funding and the sector average.

Figure 7. BNPP Polska – Production of Personal Finance Loans, 2011-2013 (Polish Zloty in million)



Source: Company reports and Citi Research

Figure 8 : BNPP Polska – Spread on Retail Zloty Deposits vs. Sector, 2008-2013 (Percentage)



Source: Company reports, NBP and Citi Research

2013 results positively impacted by lower administrative and risk costs

The improvement in the bank's ROE, to 5.8% in 2013 from 2% in 2012 (Figure 8), was driven by lower administrative cost (-6% yoy) and lower net provisioning (-24% yoy despite Zl 20m provisions for legal risk arising from client litigation related to derivative products sold before 2009). We note the decline in labour costs (-4.6% yoy) was caused mainly by the release of the provision for headcount restructuring (Zl +4.4m in 2013 vs. Zl -13m in 2012) and underlying costs grew 1.3% yoy due to higher bonuses and full year consolidation of BNP Paribas Factor. The implemented savings plan led to lower rent, IT and telecommunication costs and general costs declined -4% yoy while depreciation and amortization dropped 24% yoy. Total revenues grew just 1% but given the macro environment (declining interest rates and low demand for banking products) we believe the small growth in revenues was a success (total revenues of the commercial banks declined 3% in 2013).

In 1Q14 net profit declined 20% yoy due to high base affected by a one-off item (in 1Q13 earnings were supported by a Zl 19.1m gain on pre-payment of funding to the parent group) and underlying net profit grew 61% yoy and 2% qoq, driven by 1.3% yoy lower administrative costs and 33% lower net provisioning.

BGZ

Despite a 23% yoy increase in net profit BGZ's ROE remains low (4.6%)

In 2013 the bank's net profit rose 23% yoy but ROE remained relatively low (4.6%). Profitability was positively affected by lower administrative costs (the positive effect of the restructuring plan started in 2012), lower provisioning (due mainly to lower provision on corporate loans) and a low effective tax rate (the decline to 21% vs. 25% in 2012 versus a statutory rate of 19% looks to be a result of the yoy changes in created and released provisions).

BGZ's low profitability appears to be due to low fee income and low assets per branch

We note that despite having different client bases BGZ and BNPP Polska score similarly in terms of key profitability and efficiency ratios. As in the case of BNPP Polska, BGZ's low profitability appears to be due to low fee income and low assets per branch, with the result that, despite low costs per branch, the bank's cost-to-income is relatively high.

In 1Q14 the bank's net profit rose 51% yoy, driven by higher net interest income (+12% yoy) and net fees (+8 yoy) as well as lower administrative costs (-2.5%), while net provisioning rose 76% yoy.

Double-digit ROE in 3-4 years after the merger

BNP Paribas Group expects that the merged bank will reach a double-digit ROE within 3 to 4 years after the merger

BNP Paribas Group has said it expects that the merged entity (BNPP Polska + BGZ) will reach a double-digit ROE within 3 to 4 years after the merger. The improvement in profitability is targeted to be achieved through a combination of revenue and cost synergies.

Revenue synergies not lower than 5% of the combined revenues

BNP Paribas Group intends to reach revenue synergies of at least 5% of combined revenues owing to:

- A material increase in Personal Finance product sales to BGZ's retail client base;
- Leverage of BNPP Polska's strong transactional product base with BGZ corporate clients; and
- Offering BGZ's online platform Optima to BNPP Polska's urban clients.

Cost synergies in the range of between 10% and 15% of combined costs

BNP Paribas Group is looking for cost synergies in the range of between 10% and 15% of the combined cost base of the two banks and is planning to achieve these saving through:

- Network optimization;
- IT migration;
- Centralization of the two banks' headquarters and central functions; and
- Other operating cost synergies, including reducing marketing expenses as well as telecommunication and real-estate costs.

We don't assume any revenue synergies…

We see upside potential for the merged bank's revenues, from higher consumer lending to BGZ clients and increased sale of investment products to clients of both banks, but simultaneously we note the downside risks. Implementation of BNPP Polska's conservative risk management in the combined bank could result in a 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.

…but we think that cost synergies of c.15% of combined costs are achievable

On the other hand, based the bank's comments on potential branch closures, its expansion plans in Poland, and the levels of HQ/general cost savings historically achieved as a result of bank mergers in Poland, we think that cost synergies close to the upper end of the bank's guidance range (10%-15% of combined costs) are achievable (see later in the note for detailed estimates).

Figure 9. BNPP Polska and BGZ – Pro-Forma P&L Statement*, 2011-16E (Polish Zloty in million)

Pro-Forma	**2011**	**2012**	**2013**	**2014E**	**2015E**	**2016E**
NII	1,407	1,565	1,553	1,691	1,886	2,067
Net fees	410	444	426	431	450	474
Other revenues	212	274	286	249	260	276
Total revenues	**2,030**	**2,282**	**2,265**	**2,371**	**2,596**	**2,817**
Administrative costs	-1,537	-1,630	-1,550	-1,597	-1,634	-1,434
Pre-provision income	**492**	**652**	**716**	**774**	**962**	**1,383**
Net provisioning	-272	-424	-365	-355	-406	-464
Other revenues	2	0	-11	-5	-5	-5
Pre-tax profit	**223**	**228**	**340**	**414**	**551**	**914**
Tax	-55	-67	-77	-89	-110	-180
Minorities	0	0	0	0	0	0
Net profit	**168**	**161**	**262**	**325**	**441**	**734**
Loans	40,869	42,483	42,881	45,892	50,481	54,911
Deposits	31,824	37,007	37,387	38,984	42,882	46,543
Equity					6,558	6,771
Assets	55,887	58,078	56,894	59,701	64,967	70,096
ROE-BNPP	NA	2.0%	5.8%	5.1%	7.4%	8.9%
ROE-Pro forma	**NA**	**NA**	**NA**	**NA**	**NA**	**11.0%**

Note: To simplify comparison with other Polish banks, for which we do not have forecasts beyond 2016, we assume achievement of full cost synergies in 2016 (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. We have assumed that BNPP Polska would issue shares to BGZ shareholders and BGZ would be valued at the price agreed by BNP Paribas Group and Rabobank Group. Should the bank be valued at a lower price, the combined equity would be lower and consequently ROE would be higher.

Source: Company data, Citi Research estimates

We think the bank will be close to achieving its mid-term target of double-digit ROE…

Stand-alone BNPP Polska plans to increase ROE to more than 10% in the medium term through:

- 6%-8% annual growth in revenues;
- In-line with inflation growth in administrative costs (it believes this should allow a reduction in the cost-to-income ratio to below 60% from 69% in 2013); and
- Further improvement of the risk profile (NPLs are targeted to decrease to below 8% over the medium term from 8.4% at the end of 2013).

…in 2016E when we forecast 9% ROE and ROTE

Given still low profitability (6% ROE in 2013) and high competition in the Polish banking industry, we acknowledge that these targets could be viewed as ambitious; however, the progress to date in the bank's restructuring gives us comfort that BNPP Polska will come close to achieving its key financial target around 2016. Our model arrives at a normalised cost of risk of 85bp (vs. the bank's guidance of 70bp) and, on this basis, we estimate that reaching our 9% ROE forecast (close to the bank's target of 10%) in 2016 requires 7% annual growth in revenues (i.e. in the middle of the bank's medium-term target range of 6%-8% compounded annual growth in revenues) and flat administrative costs (vs. the bank's guidance of costs rising below inflation).

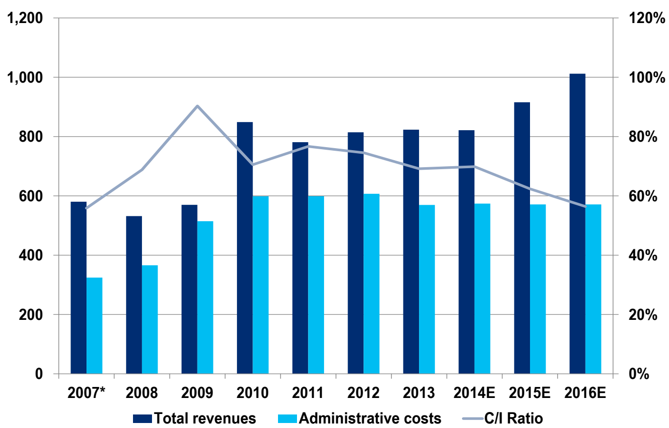
Figure 10. BNPP Polska – Summary of Forecasts, 2008-2016E

	2008*	2009	2010	2011	2012	2013E	2014E	2015E	2016E
NII	396	422	585	573	545	538	568	650	731
Net Fees	178	149	159	140	146	150	142	146	155
Other revenues	-43	-1	105	67	124	136	111	120	126
Total revenues	**532**	**570**	**849**	**781**	**814**	**823**	**822**	**916**	**1,012**
Administrative costs	-366	-515	-599	-599	-607	-569	-574	-571	-571
Pre-provision income	**166**	**55**	**250**	**182**	**207**	**254**	**248**	**345**	**441**
Provisions	-63	-576	-193	-109	-154	-116	-113	-140	-175
Pre-tax profit	**103**	**-521**	**57**	**73**	**54**	**138**	**134**	**204**	**266**
Tax	-24	91	-16	-34	-23	-35	-34	-41	-53
Net Profit	**78**	**-430**	**42**	**39**	**31**	**102**	**100**	**163**	**213**
Loans	14,823	13,812	13,151	16,647	16,160	16,583	17,814	19,595	21,555
Deposits	6,368	9,226	8,195	8,882	10,065	10,894	10,464	11,511	12,662
Assets	19,869	20,294	18,539	22,479	20,831	21,117	21,590	23,506	25,607
Equity	1,218	1,369	1,334	1,404	1,731	1,805	2,131	2,294	2,507
ROE	**6.6%**	**-33.2%**	**3.1%**	**2.9%**	**2.0%**	**5.8%**	**5.1%**	**7.4%**	**8.9%**
ROA	0.5%	-2.1%	0.2%	0.2%	0.1%	0.5%	0.5%	0.7%	0.9%
NIM	2.4%	2.2%	3.1%	2.9%	2.6%	2.6%	2.7%	3.0%	3.1%
Cost-to-income	69%	90%	71%	77%	75%	69%	70%	62%	56%
Loan-to-deposits	233%	150%	160%	187%	161%	152%	170%	170%	170%
Tier 1	7.3%	9.3%	9.4%	7.9%	9.5%	9.7%	10.8%	10.4%	10.3%
CAR	9.9%	13.4%	13.6%	11.5%	13.8%	12.4%	13.3%	12.7%	12.4%

Note: * 2008 Ratios calculated on the end of the year data.

Source: Company data, Citi Research estimates

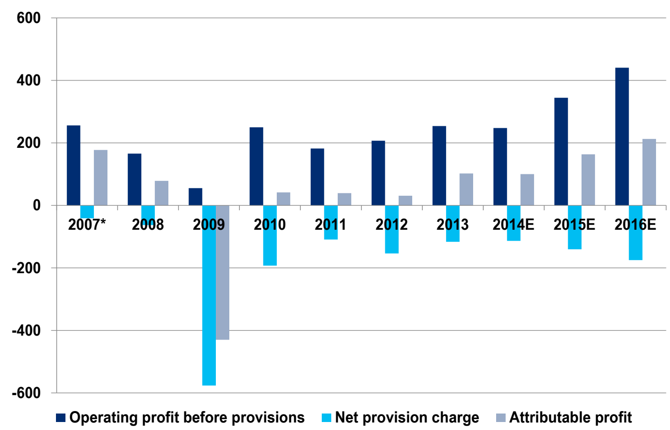
Figure 11. BNPP Polska – Revenues and Administrative Costs, 2007-2016E (Polish Zloty in million)



*Stand-alone data for 2007

Source: Company data, Citi Research estimates

Figure 12. BNPP Polska – Pre-Provision Income, Net Provisioning and Net Profit, 2007-2016E (Polish Zloty in million)



*Stand-alone data for 2007

Source: Company data, Citi Research estimates

Time for Marathon Runners

In the coming years we expect a gradual improvement in sector profitability

In 2013 the bank's results were negatively affected by cyclical (lower interest rates, higher provisioning) and structural (FX mortgages weighing on the bank's profitability and clients' demand for mortgage loans) factors. However, the sector's results in 2013 surprised on the upside, due mainly to relatively quick deposit re-pricing post rate cuts and better-than-expected asset quality.

Poland remains an underpenetrated banking market, especially in corporate and mortgage loans. In the coming years we expect a gradual improvement in sector profitability, driven by accelerated lending, positively affected by improving sentiment and rebounding macro conditions (hence we prefer banks that are well prepared for loan growth and equipped with a strong funding and capital base). We see upside risk for bank earnings from increasing revenues from the sale of investment products. On the other hand, we see downside risk from rising regulation and potential litigation related to formerly sold products, including FX mortgages and unit-linked products. Due to the combination of an advantageous macro environment and stricter regulation, we think that banks focused on gradual and balanced growth of their client base, new production, assets and revenues will be well positioned to outpace more aggressive players.

Valuation

We value Polish banks using standard Warranted Equity Valuations (WEV) based on return on equity (ROE) and return on tangible equity (ROTE) and an Economic Value Added (EVA) valuation. All three of these methods are based on estimated return on capital. In our opinion, such an approach is the appropriate method to value banks because, given the capital requirements set by regulators, the bank's ability to generate a return on the capital determines the level of future growth and dividend payout. Out of three methods, we prefer a Warranted Tangible Equity Valuation because we believe it best reflects a bank's return on capital, as the tangible equity is closer to the regulatory capital than reported capital is, hence we set our target prices at the basis of a Warranted Tangible Equity Valuation. We cross-check our WEV and EVA valuation methods using comparative multiple analysis (mainly comparison of P/E multiples).

Standard Warranted Equity Valuation

Our Standard Warranted Equity Valuation model is based upon the formula:

Price / Book value = (Sustainable RoE – growth) / (Cost of equity – growth)

while the Warranted Tangible Equity Valuation is based on the following formula:

Price / Tangible Book value = (Sustainable RoTE – growth) / (Cost of equity – growth)

When valuing Polish banks we assume a sustainable growth rate of 4.5% and sustainable ROE close to our estimates of 2016 ROE/ROTE. We assume costs of equity (COE) in a range of 10-10.5%, depending on the share of FX mortgages in the bank's loans

Figure 13. Polish Banks – Share of FX Mortgage Loans in Total Loans (2013) and Assumed Cost of Equity (Percentage)

	Share of FX Mortgage loans	Assumed COE
BNPP Polska	**22%**	**10.0%**
Millennium	42%	10.5%
GNB	30%	10.5%
mBank	32%	10.0%
PKO BP	14%	10.0%
Pekao	5%	10.0%
ING BSK	3%	10.0%
Alior	NA	10.0%

Source: Company data, Citi Research estimates

We set our TP for BNPP Polska at Zl 65.2, based on the weighted average of our WEV (based on ROTE) valuations of the current BNPP Polska (Zl 52.6 per share) and the bank created through the planned merger with BGZ (Zl 78.9 per share).

The transaction still requires at least two regulatory approvals (one to purchase BGZ by French BNP Paribas and the second to merge BGZ with BNPP Polska) as well as resolution of the issues arising out of the initiation of the merger between BGZ Rabobank Polska. We are not aware of any regulatory or legal restrictions that would prevent the BNPP Polska/BGZ deal from closing, hence we see the deal as on balance more likely to succeed than not. However, given the complexities outlined above, as well as uncertainties relating to future share swap parity, execution risk and achievement of forecast synergies, we see the risk of deal failure as far from negligible. For valuation purposes, we assume that the probability of a successful merger is 55%.

Figure 14. BNPP Polska – Summary of Valuation

	BNPP Polska	Post the merger with BGZ	TP
EVA	64.6	NA	
Warranted Equity Valuation	51.6	72.7	
Warranted Equity Valuation - ROTE	52.6	78.9	
Average	56.3	75.8	
Weights/Price Target	**45%**	**55%**	**67.1**
Current share price			59
Upside / (Downside)			13.7%
DPS (2013E)			0.00
Dividend yield (%)			0%
Total Return			**13.7%**

Source: Citi Research estimates

Figure 15. BNPP Polska – Sensitivity of the Pre-Merger WEV (Polish Zloty)

				ROE		
		6.9%	**7.9%**	**8.9%**	**9.9%**	**10.9%**
COE	**8%**	45.4	64.4	83.3	102.2	121.1
	9%	34.8	49.4	63.9	78.4	92.9
	10%	28.1	39.8	51.6	63.3	75.0
	11%	23.5	33.3	43.0	52.8	62.6
	12%	20.1	28.4	36.8	45.2	53.5

Source: Citi Research estimates

Figure 16. BNPP Polska – Sensitivity of the Post-merger WEV (Polish Zloty)

				ROE		
		9.0%	**10.0%**	**11.0%**	**12.0%**	**13.0%**
COE	**8%**	81.3	99.4	117.5	135.6	153.6
	9%	62.4	76.3	90.1	104.0	117.9
	10%	50.4	61.5	72.7	83.9	95.1
	11%	42.0	51.4	60.7	70.1	79.4
	12%	35.9	43.9	51.9	59.9	67.9

Source: Citi Research estimates

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

				ROTE		
		7.1%	**8.1%**	**9.1%**	**10.1%**	**11.1%**
COE	**8%**	48.1	66.5	85.0	103.5	122.0
	9%	36.9	51.0	65.2	79.4	93.6
	10%	29.8	41.2	52.6	64.1	75.5
	11%	24.8	34.4	43.9	53.5	63.0
	12%	21.2	29.4	37.6	45.7	53.9

Source: Citi Research estimates

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

				ROTE		
		10.5%	**11.5%**	**12.5%**	**12.0%**	**13.0%**
COE	**8%**	95.6	111.6	127.5	119.5	135.5
	9%	73.4	85.6	97.8	91.7	103.9
	10%	59.2	69.1	78.9	74.0	83.9
	11%	49.4	57.7	65.9	61.8	70.0
	12%	42.3	49.3	56.3	52.8	59.9

Source: Citi Research estimates

Economic Value Added Model

To value Polish banks we also apply an Economic Value Added (EVA) valuation model approach. This model arrives at a valuation by adding discounted EVA flows (adjusted profits minus required capital charges) to adjusted starting book value. A terminal value is calculated using a standard perpetuity formula based on forecast EVA flows to 2015 and an assumption of a discount rate and a perpetual growth rate. Valuing BNPP Polska we use the same discount rate as used in our WEV (10.0%) and a of perpetual growth assumption 4.5%.

Comparative Multiple Valuation

In the table below we present P/E and P/BV trading multiples for our coverage universe of Polish banks. In our opinion, due to the bank's depressed profitability (2013 ROE of 6% vs. listed Polish banks median of 11.5%) it would not be appropriate to apply large bank multiples to BNPP.

Figure 19. Polish Banks – Market Multiples, 2013-2016E

Company	RIC	Current Price	Rating	Target Price	P/E				P/BV				ROE			
					2013	2014E	2015E	2016E	2013	2014E	2015E	2016E	2013	2014E	2015E	2016E
PKO BP	PKO.WA	40.10	2	43.0	15.5	15.3	12.5	11.6	2.0	1.8	1.7	1.6	13.0%	12.4%	14.0%	13.9%
PEKAO	PEO.WA	191.70	2	193.0	18.1	18.3	15.2	13.6	2.1	2.1	2.1	2.0	12.0%	11.7%	13.8%	15.1%
Bank Millennium	MILP.WA	8.22	3	5.60	18.6	16.4	14.9	14.0	1.9	1.7	1.6	1.5	10.5%	11.0%	11.4%	11.4%
ING BSK	INGP.WA	130.00	2	124.20	17.6	16.3	13.4	12.3	2.0	1.9	1.8	1.7	11.5%	11.7%	13.5%	14.0%
mBank	MBK.WA	501.20	2	498.0	17.5	15.8	14.1	12.2	2.1	2.0	1.9	1.8	12.2%	12.7%	13.5%	14.9%
Getin Noble Bank	GNB.WA	3.18	3H	3.24	21.1	14.3	10.8	10.3	1.8	1.6	1.4	1.3	8.8%	11.6%	13.7%	12.9%
Alior Bank	ALRR.WA	83.06	2H	87.7	23.2	17.6	14.1	11.4	2.4	2.0	1.7	1.5	11.0%	12.5%	13.5%	14.5%

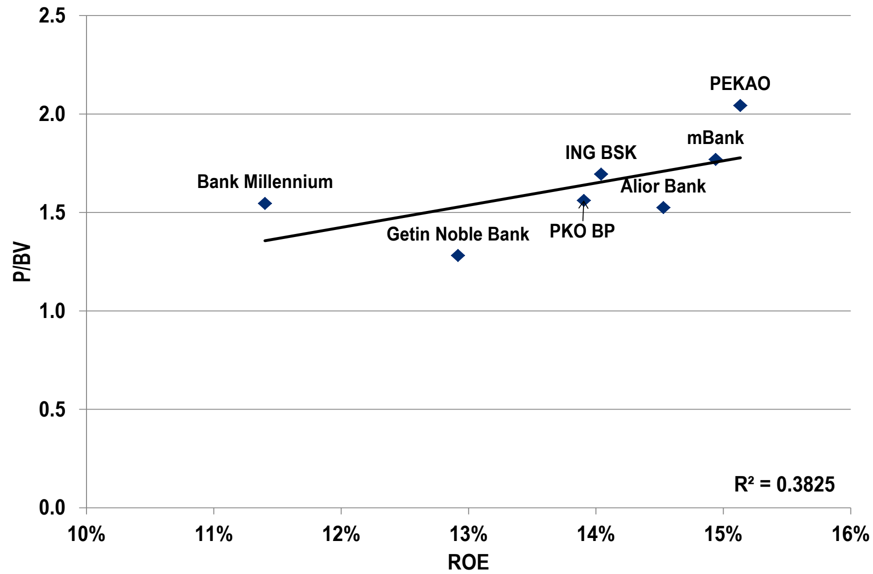
Source: Powered by dataCentral, June 13th, 2014 prices

Figure 20. Polish Banks – Dividend Adjusted PE, 2013-2016E

Company	RIC	Current Price	Rating	Target Price	Dividend Adjusted P/E			
					2013	2014E	2015E	2016E
PKO BP	PKO.WA	40.10	2	43.0	15.5	14.8	11.9	11.1
PEKAO	PEO.WA	191.70	2	193.0	18.1	16.4	13.8	12.2
Bank Millennium	MILP.WA	8.22	3	5.60	18.6	15.5	14.1	13.2
ING BSK	INGP.WA	130.00	2	124.2	17.6	15.2	12.4	11.4
mBank	MBK.WA	501.20	2	498.0	17.5	14.8	13.1	11.2
Getin Noble Bank	GNB.WA	3.18	3H	3.24	21.1	14.3	10.7	10.1
Alior Bank	ALRR.WA	83.06	2H	87.7	23.2	17.6	14.1	11.4

Source: Powered by dataCentral, June 13th, 2014 prices

Figure 21. Polish Banks – ROE vs. P/BP, 2016E



Source: Powered by dataCentral, June 13th, 2014 prices

Investment 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. (See Valuation section, above.) (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.

Macro Risks

- **Escalation of Russia-Ukraine conflict**

In our opinion the potential escalation of the Russia-Ukraine conflict is a material indirect risk to our forecasts for Polish banks. In our model we assume a rebound in the Polish economy with real GDP growth reaching 3.4% in 2014 and 3.6% in 2015 vs. 1.6% in 2013, in line with Citi economists' forecasts. The potential further worsening in EU-Russia relations leading to lower Polish-Russia trade and to a worsening of sentiment could negatively impact the Polish economy and lead to lower lending and a higher cost of risk than we assume currently.

Sector-Specific Risks

- **High competition in the sector leading to low profitability of smaller players**

Polish banking market is highly competitive but we expect that competition will gradually diminish

We believe there are about 15 banks with aspirations to be universal banks operating in the whole country and offering the whole range of banking services. Some banks compete by offering more attractive prices and such aggressive marketing strategies of a few players sometimes have a contagious effect on the whole sector. We note, however, that some investors have recently decided to exit Poland and we expect that competition in the Polish banking market may gradually diminish. Another factor that may lead to lower competition in the sector is some banks' limited access to funding (we think that this was the key reason for the recent significant increase in the average sector mortgage spread).

- **Regulation and tax risks**

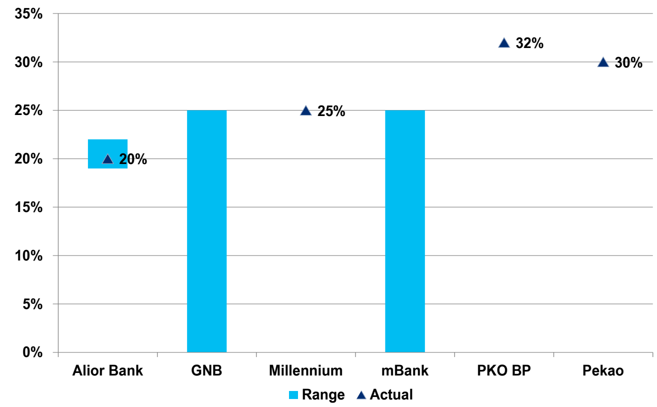
  – ***Bancassurance***

In December 2013 KNF (Polish regulator) published a draft of the new recommendation on bancassurance

A popular model of consumer lending in Poland is to acquire clients by offering attractive (i.e. relatively low) interest rates on loans (coupled with fast and easy procedures), while the bank earns fees on the sale of insurance products related to the loan (life insurance, insurance against unemployment, etc.).

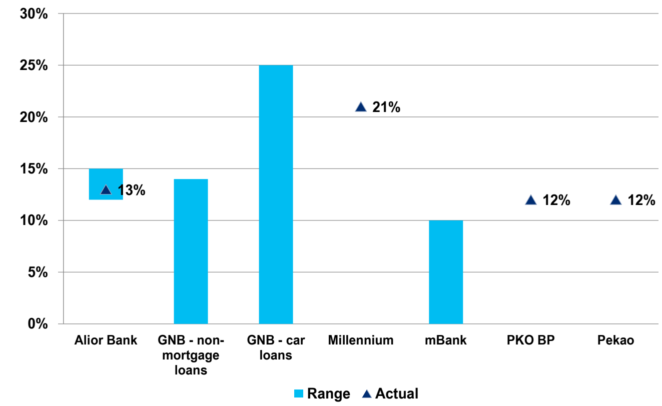
In December 2013 KNF (Polish regulator) published draft new recommendations on bancassurance. The draft included a very wide definition of related products and implies that many banks might have to change their accounting methodology (the commission income from insurance products linked with loans should be recognized in net interest income through the effective interest rate method).

Figure 22. Polish Bank – Upfront Bancassurance Fees on Mortgage Loans, 2013 (Percentage)



Source: Company data, Citi Research

Figure 23. Polish Bank – Upfront Bancassurance Fees on Non-Mortgage Loans, 2013 (Percentage)



Source: Company data, Citi Research

At BNPP Polska, the majority of loan-related products are amortised during the loan life and presented in net interest income

BNPP Polska did not change its bancassurance methodology in 2013. All insurance commissions from loan-related products are amortised during the loan life and presented in net interest income unless the premium is paid by clients monthly (then it is presented as fee income, together with fees related to overdrafts and credit cards insurance).

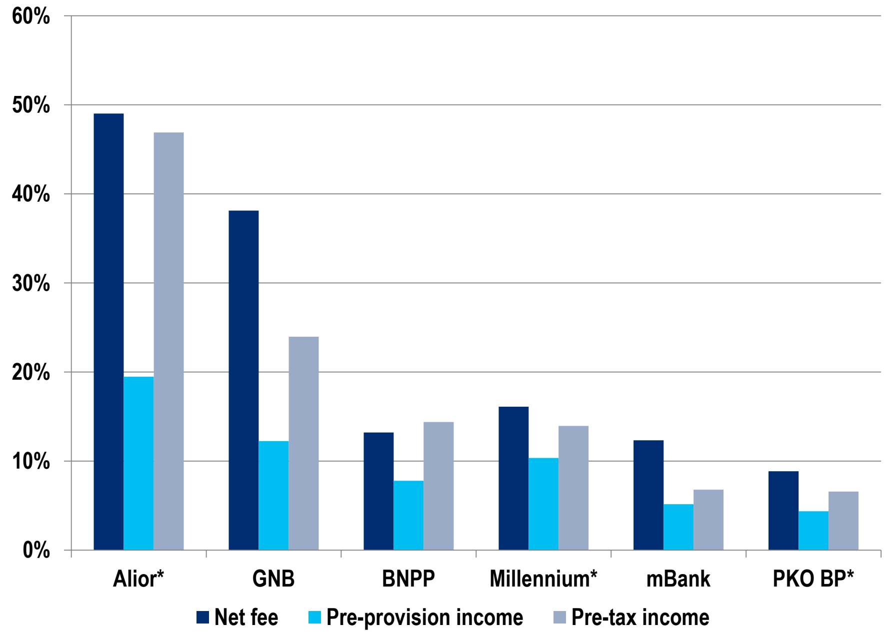
The other important provision proposed in the draft is the banks' obligation to choose what role they will play in the case of each specific insurance product: e.g. will the bank be the insurance agent or an insured entity, benefiting from the insurance coverage? Only in the case that the bank is the insurance agent and is not receiving any compensation from an insurer, is the bank entitled to receive the insurance commission, but even then the commission should be proportional to borne costs. When the bank is insured and uses insurance to manage its own credit risk it is not allowed to get any insurance commission but it is allowed to receive reimbursement of its costs from the client (e.g. through increased lending spread).

The recommendation introduces many organizational and administrative obligations for the banks and their employees, starting from front-office employees (obliged to pass relevant trainings) to the management board (obliged to set internal rules regarding bancassurance, including procedures to select insurance partners) and to the supervisory board (that on quarterly basis has to monitor the number of declined claims and supervise the implementation of proper accounting standards).

The bank may try to replace insurance commissions with lending fees (we note that currently due to the lack of a cap on lending fees and broadly the same accounting method, there are no incentives for banks to prefer insurance commission to lending fees) but clients may be less willing to pay the same amount as a normal fee rather than as an insurance premium so we expect a slightly negatively impact on bank revenues.

Due to relatively small net fees from insurance (Zl 20m in 2013) we think that BNPP Polska is relatively unexposed to the risk related to implementation of the proposed recommendation but, given the bank's focus on growing in consumer finance its earnings will depend on a quick and flexible reaction to potential changes in the consumer finance market post the implementation of the bancassurance recommendation.

Figure 24. Polish Banks – Share of Bancassurance Fees in Net Fees, Pre-provision Income and Pre-tax Income, 2013 (Percentage)



* fee income

Source: Company data, Citi Research

– ***Interchange fee***

The interchange fees will be reduced to 0.5% from 1.2%-1.3% currently

According to new regulations on card payments, interchange fees will be reduced to 0.5% in July 2014 from c1.2%-1.3% now. We note that bank revenues from cards declined materially in 2013 because at the beginning of the year Visa and MasterCard unilaterally significantly reduced interchange fees from 1.6%/1.64% previously to 1.25%/1.11% on debit cards and from 1.45%/1.5% to 1.3%/1.3% on credit cards, respectively.

Figure 25. Polish Banks – Interchange Fee (Percentage)

	2012	2013-1H14	After July 2014
Debit card			
Visa	1.60%	1.25%	max. 0.5%
MasterCard	1.64%	1.11%	max. 0.5%
Credit card			
Visa	1.45%	1.30%	max. 0.5%
MasterCard	1.50%	1.30%	max. 0.5%

Source: Company data, Citi Research

Due to low interchange fee income, BNPP Polska is relatively less affected

Due to low interchange fee income BNPP Polska is relatively less affected by the changes in interchange fees.

– ***Bank levy***

The levy (officially dubbed "a prudential levy") will be paid by banks into a special sub-fund (a stability fund) created by the BFG

The law introducing a bank levy (officially dubbed "a prudential levy") came into force in 2013. The levy is paid by banks into a special sub-fund (a stability fund) created by the BFG (Bank Guarantee Fund) and will be used for the restructuring of banks having problems. It is based off risk-weighted assets (RWAs, total capital requirement multiplied by 12.5) and thus the impact on profitability depends on the bank's return on risk-weighted assets. The bank levy is not tax-deductible.

The rate of the levy is set every year by the BFG Board in a range of between 0% and 0.2%, in line with a counter-cyclical approach. The rate was set at 0.009% for 2013 and at 0.037% for 2014. We think that following the counter-cyclical approach and given the potential costs of credit union resolution (see: Polish Financial Weekly - Will Banks Have to Pay For the Problems of Credit Unions? and Polish Financial Weekly - Will Clients Sue Polish Banks for Unfair FX Rates?) the rate may be increased next year and we assume it reaches 0.08% of RWAs in 2015.

Recently the Ministry of Finance submitted to the government a draft of a new law on the Bank Guarantee Fund that will create a new Resolution Fund…

In April 2013 the Ministry of Finance submitted to the government a draft of a new law on the Bank Guarantee Fund (BFG). The new bill will outline bank resolution procedures (replacing normal insolvency law procedures when it is required to enhance financial stability or to reduce costs borne by public institutions) and will create a new Resolution Fund, funded by a contribution of up to 20bp of risk weighted assets by the banks.

The new Resolution Fund will be introduced on top of the current contribution to the BFG deposit guarantee fund (potentially up to 30bp of risk-weighted assets, currently the rate is set at 10bp) and prudential levy, funding a BFG stabilisation fund (potentially up to 20bp, currently 3.7bp).

We do not think that the proposed new levy for a resolution fund suggests that the burden will exceed our current expectations

We do not think that the proposed new levy for a resolution fund suggests that the burden will exceed our current expectations (10bp for guarantee fund and 8bp for other funds). We don't see the political will to penalise banks, nor do we see fundamental reasons to set the total rate at a level higher than 20bp.

We don't see the political will to penalise banks…

There are two reasons why we think that Polish politicians, at least the ruling PO-PSL coalition (the next parliamentary election should take place in autumn 2015), do not intend to penalise banks by significantly increasing the tax and regulatory burden for banks:

- Firstly, the government has worked extremely slowly on introducing legislation required to implement the "banking tax": the Prime Minister first expressed his intention to implement such levy in mid-2010 — it took more than three years to implement the new law.

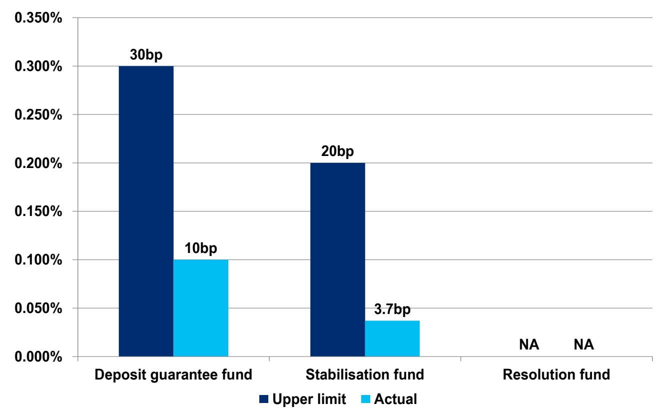
- Secondly, the current rates of the banks' contributions to the deposit guarantee fund (10bp) and to the stabilization fund (3.7bp) are materially below the upper limits (30bp and 20bp, respectively), suggesting that there is limited desire to fully exploit the legal possibilities to tap the banks.

…nor do we see fundamental reasons to set the total rate at a level higher than 20bp

We don't see any fundamental reasons to expect the aggregated contribution to the stabilisation and resolution funds to rise to above the 8bp we assume from 2015. The European Commission's proposal for a directive establishing a framework for the recovery and resolution of credit institutions and investments firms sets a 10-year target for the available financial means of financial institutions responsible for

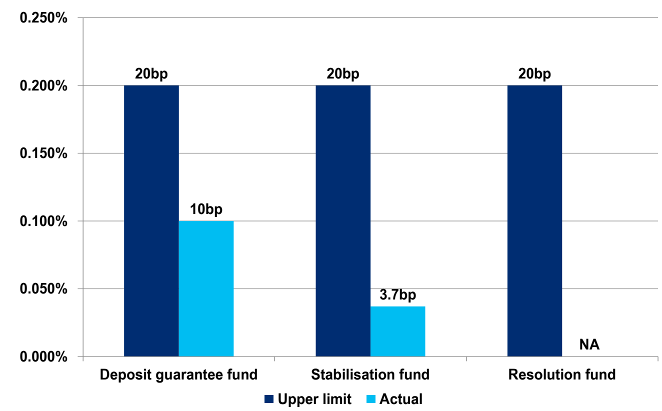
bank resolution at 1% of guaranteed deposits. We estimate that this implies a target fund of Zl 6bn while an annual contribution at 8bp would be Zl c700m. We therefore conclude that the target level should be reached in around 8-9 years.

Figure 26. Polish Banks – Current Contributions to the BFG



Source: BFG, Sejm and Citi Research

Figure 27. Polish Banks – Proposed Contributions to the BFG



Source: BFG, Sejm and Citi Research

Company-Specific Risks

■ Dependence on funding from the parent

Liabilities to related entities amounted to Zl 5.8bn (30% of total assets)

At the end of 2013, the total liabilities of the bank (stand-alone data) to related entities amounted to Zl 5.8bn (32% of unconsolidated total liabilities and 30% of total assets). The biggest part of this was comprised of short- and medium-term loans from the parent group, mostly in CHF (Zl 4.0bn) used to fund CHF mortgages granted in the previous years.

Figure 28. BNPP Polska – Loans Received from the Parent Group, 2008-2013 (Polish Zloty/CHF/EUR in million)

	2008	2009	2010	2011	2012	2013
PLN in PLN	1,488	450	450	1,410	800	800
CHF in CHF	1,349	1,911	1,424	1,364	1,335	1,170
EUR in EUR	803	323	673	473	210	180
CHF in PLN	3,779	5,286	4,505	4,956	4,521	3,956
EUR in PLN	3,350	1,325	2,663	2,087	859	746

Source: Company data, Citi Research

In January 2014 BNPP Polska signed with the BNP Paribas Group an agreement regarding secured funding. A new credit line of up to CHF 810m, collateralised on the bank's stock of mortgages, will partially replace the current funding from the parent bank.

According to the bank's funding strategy, BNP Paribas Group will continue to provide funding for the stock of CHF loans and support BNPP Polska in funding EUR-denominated loans, while zloty lending will be funded mainly by local deposits.

The bank's earnings are sensitive to the cost of intra-group funding

Due to the share of intra-group funding, the bank's earnings are sensitive to the cost of intra-group funding. The re-pricing of loans from the group, utilised by BNPP Polska to fund FX mortgages, negatively affected the bank's net interest income in 2013 by Zl 18m. We note that, according to our estimates, the cost of CHF borrowings (c100bp) is still materially lower than the peer group's costs (estimated at c160bp), hence we still see potential further re-pricing of intra-group funding as a risk to earnings.

■ Dependence on the parent's strategy

BNPP Polska benefits from the parent's support to organic growth and is dependent on its parent regarding potential M&A

We believe BNPP Polska is also dependent on the parent's strategy, both in the area of the organic growth (the BNPP Group transfers the group's best practices in banking, including Personal Finance, to its Polish subsidiary) and regarding potential M&A.

Changes in BNPP Group's strategy may affect BNPP Polska's earnings and valuation

The BNPP Group has demonstrated that it is determined to increase its footprint in Poland. Our forecasts for BNPP Polska are based on the assumption that the bank will continue to benefit from the parent's support and, owing to that, it will increase its profitability. If the BNPP Group changes its strategy and gives up plans to develop its Polish business or decides to operate in Poland mainly directly via a branch approach, future earnings of BNPP Polska may materially differ from our forecasts, leading to a materially different valuation than arrived at based on our forecasts. We note that potential modifications to BNPP Group's strategy might be triggered by future changes in European banking regulations, including hypothetical access of Poland to Banking Union (which may make it easier to operate in EU countries through branches instead of operating through locally domiciled subsidiaries). BNPP Group has undertaken to the regulator that it will not convert BNPP Polska into a branch until 2017.

■ High share of FX mortgages

FX mortgages constitute 22% of the bank's gross loans

At the end of 2013, FX mortgages constituted 22% of the bank's gross loans. The high share of FX mortgages not only negatively affects the bank's profitability but also exposes the bank to four risks:

FX mortgages might be funded by zloty deposits and FX swaps or through FX wholesale funding

– Liquidity risk — There are two ways to fund the stock of FX loans: the cheaper but more risky method is to use zloty deposits and hedge currency risk with FX swaps/CIRS (zloty funding is relatively inexpensive but due to the maturity gap between short-term deposits and long-term loans it exposes the bank to liquidity risk and the bank would need to collect new deposits should the zloty weaken); the more expensive but more prudent method is to use medium-term wholesale funding (but due to limited access to the market for many banks, including BNPP Polska, this has led to dependence on funding from their parent).

The bank's capital ratios decline when the zloty weakens

– Capital risk — The capital requirements in banks with high stocks of FX loans, including FX mortgages, fluctuate in line with FX rate fluctuations and zloty weakness causes an increase in capital requirements and hence a decline in the banks' Tier 1 ratios (the impact on Total CARs can be mitigated through matching the currency structure of the subordinated debt with the balance sheet FX structure).

Lending in FX to clients without FX revenues exposes the bank increased credit …

– Credit risk — FX loans granted to clients with zloty income expose the clients to FX risk, which can lead to a deterioration of asset quality and thus increased credit risk for the banks – as yet, the significant depreciation of the zloty vs. CHF since July 2008 hasn't led to this scenario materialising because lower rates have offset the impact of the weaker zloty and monthly installments haven't changed materially (practically all FX-denominated loans are floating-rate loans); however, in a scenario of zloty weakness combined with rising CHF interest rates asset quality may deteriorate.

… and reputation risks

– Reputation risk — Clients negatively impacted by zloty weakness may blame banks for their problems and accuse the banks of mis-selling:

- We note the rising number of litigation cases against banks selling FX-denominated mortgages. The clients claim that they weren't properly informed about the FX risks they were taking or claim that the FX rate was set illegally by the banks.
- We think that paradoxically improvement in the macro environment and positive outlook for wages and real estate prices, which may trigger rising interest in moving up the property ladder, may lead to an increased number of legal actions against banks started by clients that were able to pay their (practically unchanged vs. 2008) monthly installments but find they are unable to cover in cash the negative equity on their FX mortgages (the surplus of the loan value, increased due to zloty depreciation, over the property value).
- Given the upcoming three elections within 1.5 years in Poland, we cannot rule out the risk that the problems of FX borrowers become a political topic in the future, although as yet none of the strongest political parties has included that issue into its political agenda.

■ **High operational leverage due to high cost-to-income ratio**

A potential decline in revenues might have material negative impact on the bank's profitability

Due to the bank's high cost-to-income ratio (69% in 2013), BNPP Polska's earnings are very sensitive to revenue dynamics. We assume that the bank's focus on intensified client acquisition and the sale of new more profitable loans and cross-sell will lead to 7% revenue CAGR in 2013-2016 and to a material improvement in the cost-to-income ratio (to 56% in 2016) and in ROE (to 9% from 6%). However, operational leverage works in both directions, and a potential decline in revenues would have a material negative impact on the bank's profitability.

Company Overview and Strategy

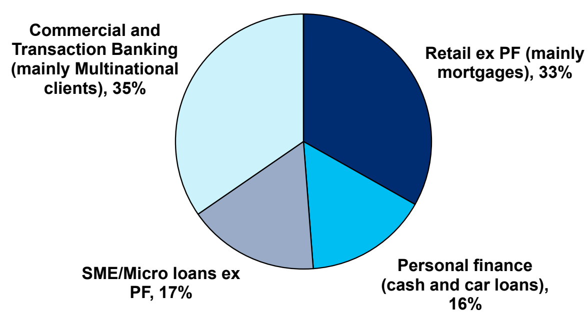
Company Overview

The Bank Business Profile

A small universal bank

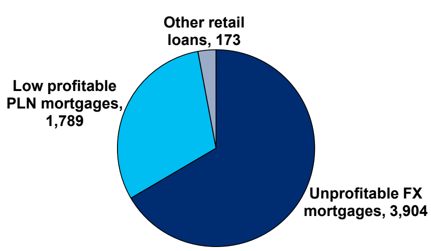
BNP Paribas Bank Polska (BNPP Polska) is a small universal bank. At the beginning of January 2014, based on Central Bank and company data, the bank ranked as the 15th largest in terms of loans, 16th in terms of deposits and 14th in terms of branches (in the calculation we include franchised branches of other branches). The bank's distribution network consists of 224 retail branches and 9 business centres. BNPP Polska services c3,000 corporate clients (of which over 60% are multinationals), c366,000 individual clients and c34,000 SMEs and Micro Enterprises. The Personal Finance business line, which is part of retail banking, has c149,000 clients.

Figure 29. BNPP Polska – Loan Structure, 2013 (Percentage)



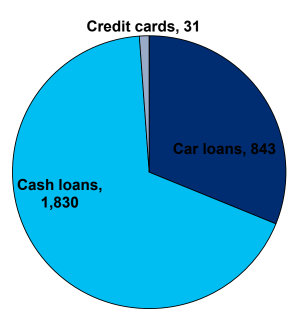
Source: Company data, Citi Research

Figure 30. BNPP Polska – Retail Individuals (ex. Personal Finance) Loan Structure, 2013 (Polish Zloty in million)



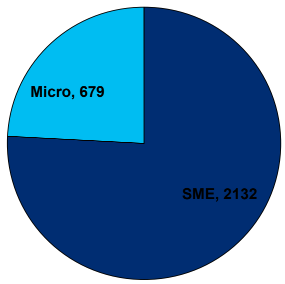
Source: Company data, Citi Research

Figure 31. BNPP Polska – Personal Finance Loan Structure, 2013 (Polish Zloty in million)



Source: Company data, Citi Research

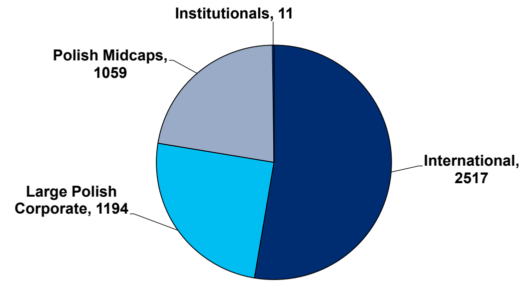
Figure 32. BNPP Polska – SMEs/Micro (ex. Personal Finance) Loan Structure*, 2013 (Polish Zloty in million)



Note: Unconsolidated

Source: Company data, Citi Research

Figure 33. BNPP Polska – Commercial and Transaction (CTB)) Loan Structure*, 2012 (Polish Zloty in million)



Note: Unconsolidated

Source: Company data, Citi Research

Bank's History

A long presence of BNP Paribas in Poland

BNP entered Polish market in 1990, 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)**.

The bank was created through the merger of corporate and upper retail focused PPAB/Fortis…

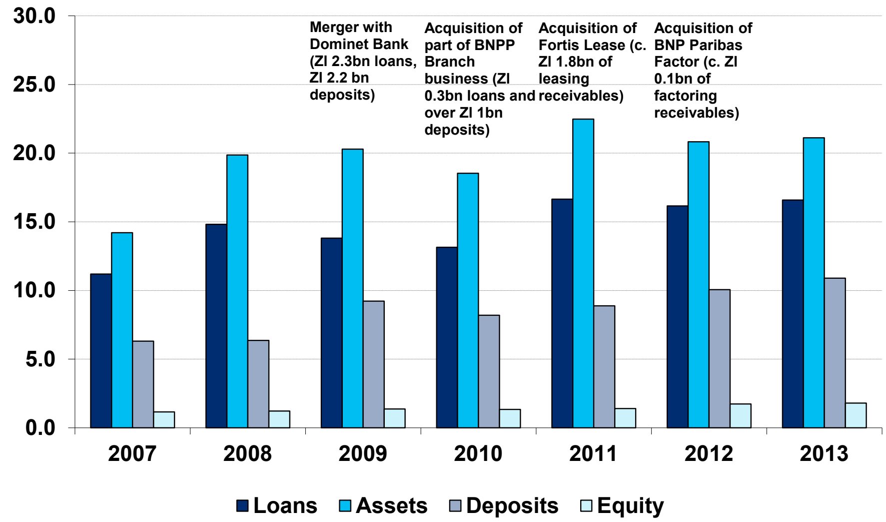
… with consumer finance specialised Dominet Bank…

BNP Polska was founded in 1990 as **Pierwszy Polsko-Amerykanski Bank** (PPAB) and since 1994 has been listed on the Warsaw Stock Exchange. In 1999 Fortis group acquired PPAB and in 2000 it renamed it **Fortis Bank Polska**. The bank was focused on corporate and affluent retail clients and had 670 employees and 13 branches (skewed to Southern Poland). In 2007 Fortis Group acquired **Dominet Bank**, the consumer finance-oriented bank with a strong position in cash and car loans, employing 1,094 people and owning 225 branches.

…and a transfer of part of the business of BNPP Polish branch

The next milestone in the bank's history was 2009 when BNP Paribas Group acquired 75% of Fortis Bank NV/SA, the Belgium-incorporated bank being the mother company of Fortis Bank Polska. Post the acquisition, BNP Paribas merged Fortis Bank Polska with Dominet, rebranded the merged entity into **BNP Paribas Fortis Polska** and in 2010 started to transfer part of the business of its Polish branch to the bank, finally renamed **BNP Paribas Bank Polska** in 2011 and rebranded to BNP Paribas.

Figure 34. BNPP Polska – Loans, Deposits, Assets and Shareholders Equity, 2007-2013 (Polish Zloty in billion)



Source: Company data, Citi Research

Capital Group and Shareholder Structure

The capital group consists of the bank, the leasing and factoring companies and the investment fund manager

BNP Paribas is the parent company of the group, consisting of an investment fund manager (TFI BNP Paribas Polska) and two companies acquired from the parent group: a leasing company (Fortis Lease Polska), acquired in 2011 for Zl 95m and a factoring company (BNP Paribas Factor), purchased in 2012. In February 2014, in the attempt to reduce costs, the leasing business was transferred from the subsidiary to the bank.

The bank is 85% owned by the BNP Paribas Group

As a result of the recent capital increase, the stake of BNP Paribas Group in BNPP Polska was reduced 85.0% from 99.9% previously.

BNP Paribas Group operates in Poland also through …

The BNP Paribas Group has several another businesses in Poland, including:

… its branch (BNP Paribas – Branch Poland)…

- BNP Paribas – Branch Poland (in 2010 BNPP Polska acquired part of the banking business of the BNP Paribas branch in Poland, paying Zl 335m for relations with 150 capital groups (350 legal entities), including Zl 257m loans and more than Zl 1bn deposits; since then the bank has focused on the current services for corporate clients, including lending, structured finance, cash management, trade finance, leasing, factoring and fixed income products, while the branch services the biggest corporate and institutional clients (including large Polish corporate clients operating in energy, oil&gas and telecommunication industries) and provides more sophisticated investment banking services.

… two leasing companies (BNP Paribas Lease Group and Arval) …

- Two leasing companies: BNP Paribas Lease Group (specialised in vendor finance, especially funding purchase of agriculture equipment and machinery), Arval Service Lease Poland (specialised in fleet management).

- CLAAS Financial Services (specialized in providing funding for purchase of agriculture equipment).

…a pension fund manager PTE Pocztylion and an insurer TUZ Cardif Polska…

- A pension fund manager PTE Pocztylion (33.3% stake).
- A life insurer TUZ Cardif Polska and Cardif Services Sp. z o.o (in Poland operates also Cardif Assurances Risques Divers S.A. – Branch Poland).

… plus a branch of BNP Paribas Securities Services and a real estate company

- BNP Paribas Securities Services — Branch Poland.
- A real estate company BNP Paribas Real Estate Advisory and Property Management Poland (plus a minority indirect stake in Klepierre Polska).

BNP Paribas has a 50% stake in French Sygma Banque…

Another financial company closely related to BNP Paribas operating in Poland is Sygma Banque. The BNP Paribas Group owns 50% of LaSer Cofinoga, which owns Sygma Banque. The remaining 50% in LaSer Cofinoga is held by Galeries Lafayette, a French retailer. On September 19, 2012 Galeries Lafayette exercised a put option to sell its 50% stake in LaSer Cofinoga to the BNP Paribas Group and on April 11, 2014, the EU cleared the acquisition. The transaction hasn't been completed yet.

…active in Polish consumer finance market

Sygma Bank, the Polish branch of the French Sygma Banque, operates in consumer finance market, offering installment loans, credit cards and cash loans. 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 relations with all car dealers that cooperated with Cetelem Bank Polska).

Corporate Governance

Management

Experienced management team

The bank's management board consists of 8 persons:

- Frederic Amoudru (CEO, Country Manager) has 29 years of experience (in 2003-2009 he was a Head of Territory for India BNPP and in 1997-2003 a Head of BNPP Singapore's Asset Restructuring and Recovery Group); at the bank since 2009.
- Jan Bujak (CFO, responsible for Finance and Legal departments) has 21 years of experience; at the bank since 1992 and CFO since 2003.
- Stephane Rodes (Head of Corporate and Transaction Banking) has 20 years of experience (formerly he was a Head of Corporate Banking in Russia for BNPP IRB); at the bank since 2010.
- Michel Thebault (Head of Personal Finance) has 13 years of experience (previously he was General Manager of TEB UCB, the Turkish greenfield mortgage subsidiary of BNPP Group); at the bank since 2008.
- Adam Parfiniewicz (Head of Retail Banking) has 20 years of experience (formerly he was CEO and Sales Director of Expander Advisors); at the bank since 2012.
- Wojciech Kemblowski (Chief Risk Officer) has 20 years of experience (previously he was Head of Credit Risk Management and Managing Director of Credit Risk Area in Raiffeisen Polska); at the bank since 2011.
- Jaromir Pelczarski (Head of Operations and Support Services) has 19 years of experience (formerly he was IT specialist at the bank); at BNPP Polska since 1994 and on the management board since 2003.

- Marta Oracz (Head of Human Resources) has 21 years of experience; at the bank since 1992 and on the management board since 2010.

Three independent members of the supervisory board

The bank's supervisory board consists of 8 members, including three independent members (Jaroslaw Bauc, the former CEO of Polkomte and current CFO of PGNiG, is the deputy chairman of the board, plus Andrzej Wojtyna, the former member of the Monetary Policy Council, and Monika Bednarek, Vice-President of Polish Confederation of Private Employers Lewiatan and former CEO of Eurozet Group).

Capital Increase

The bank issued 5.027m new shares at Zl 46

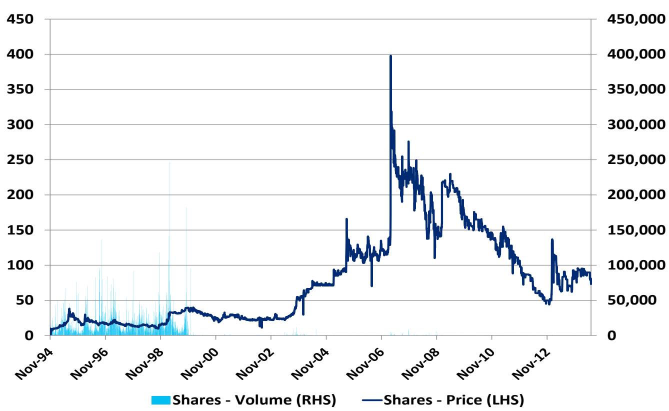
The reduction in the nominal value of each share from Zl 50.00 to Zl 45.46, decided by the bank's AGM in April 2013, was registered by the court in May 2013. On April 7, 2014 the Extraordinary Shareholders Meeting decided to issue up to 5.027m new shares (up 14.91% of the shares outstanding post the capital increase) without pre-emptive right. The issue price was set by a management board at Zl 46 and the bank successfully issued 5.027 new shares, collecting Zl 231m (net proceeds, i.e. deducting the costs of capital increase and the public offering, reached Zl 218m).

Stock Price Performance

The bank's shares have been traded on the Warsaw Stock Exchange since 1994 but from 1999 to May 2014 liquidity was very limited

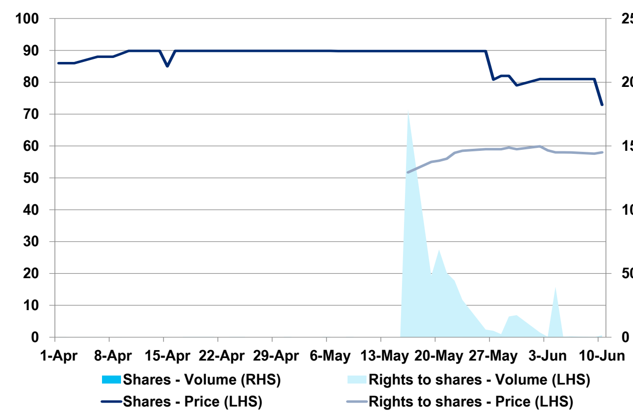
The bank's shares have been traded on the Warsaw Stock Exchange since 1994 but from 1999 to May 2014 liquidity was limited (free-float declined to about 1% in 1999 and 0.1% in 2009). Post the recent capital increase, the free-float has risen to 15% but the new issued shares are still traded separately as allotment-certificated. Since the start of trading (i.e. since May 16, 2014) the average daily turnover on BNPP Polska allotment certificates has been Zl 1.6m vs. only Zl 0.002m on BNPP Polska shares. As of June 10 (latest day of trading) the price of allotment certificates was Zl 58 while on June 12 the share price was Zl 59, 28% above the issue price.

Figure 35. BNPP Polska – Stock Price Performance and Volume, 1994 - June 10th, 2014 (Zl/ shares in units)



Source: Powered by dataCentral

Figure 36. BNPP Polska – Stock Price and Allotment Certificates Performance and Volume, Apr14 - Jun 10th, 2014 (Zl/ shares in units)



Source: Powered by dataCentral

Bank's Financial Performance and Strategy

Zl 430m Net Loss in 2009

In 2009 the bank created Zl 216m provisions on Dominet's loans...

The bank's 2009 results were negatively driven by three factors:

- Deterioration of the asset quality of Dominet's consumer loans (Dominet's NPL ratio rose to 29.3% at the end of 2009 and led to creation of Zl 216m provisions).

… and Zl 327m on corporate loans…

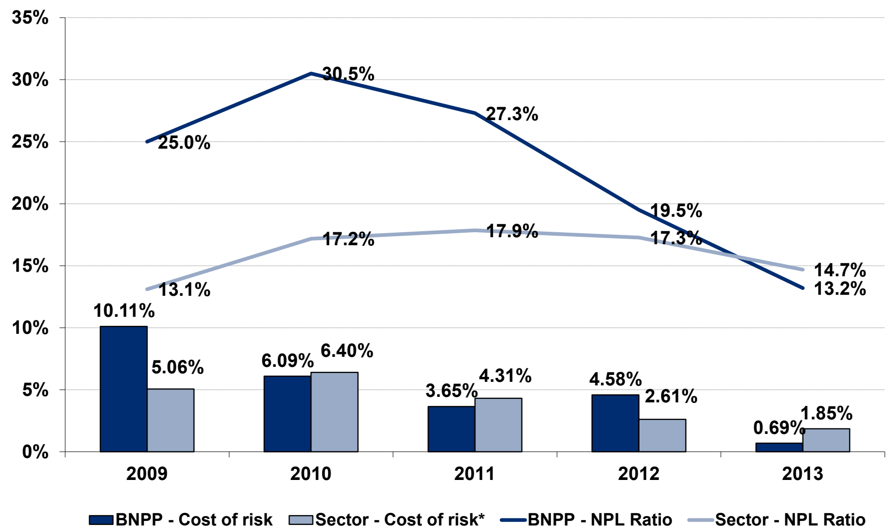
- Significant provisions in corporate banking due to the slowdown in the economy plus due to client losses on FX derivatives sold by Fortis Bank Polska (corporate NPL ratio reached 22.1%, triggering Zl 327m of provisions).

…while cost of funding materially increased

- A material increase in the cost of funding due to increased competition for deposits post the Lehman bankruptcy and a sharp decline in interest rates.

Due to the aggressive growth strategies of both Dominet and Fortis Bank Polska, the magnitude of the earnings deterioration was high but the same drivers affected profitability of other Polish banks in 2009.

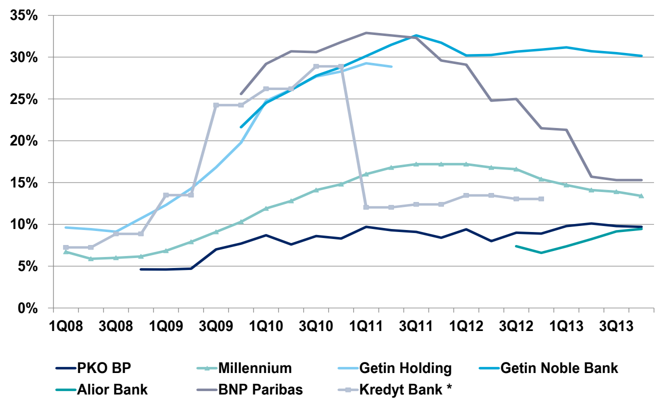
Figure 37. BNPP Polska – Consumer Loan NPL Ratio and Cost of Risk* vs. Sector, 2009-2013 (Percentage)**



Note: *Cost of risk – unconsolidated data for the bank **9M13 average for sector cost of risk

Source: Company data, NBP and Citi Research

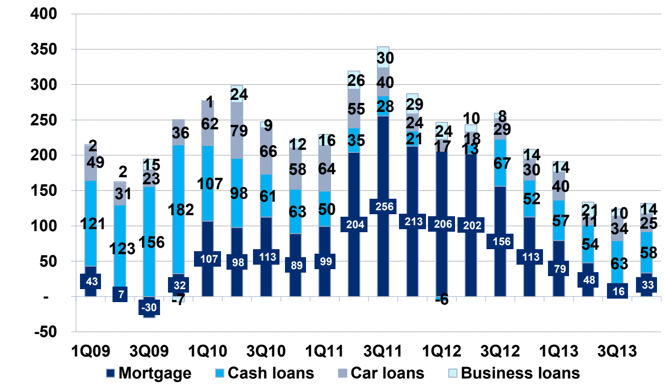
Figure 38. Polish Banks – Consumer NPL Ratio, 1Q08-4Q13 (Percentage)



*Semi-annual data for Kredyt Bank

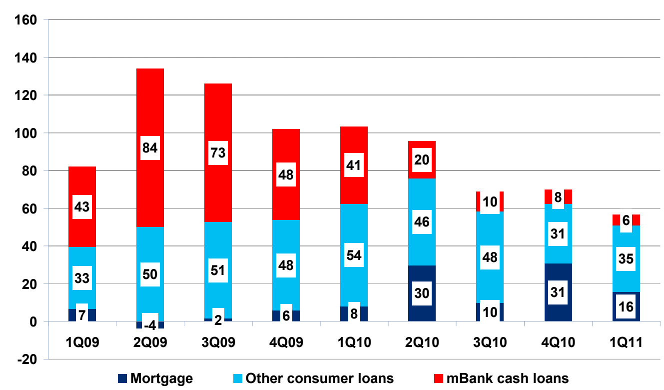
Source: Company data and Citi Research

Figure 39. Getin Noble Bank – Provisioning, 1Q09-4Q123 (Polish Zloty in million)



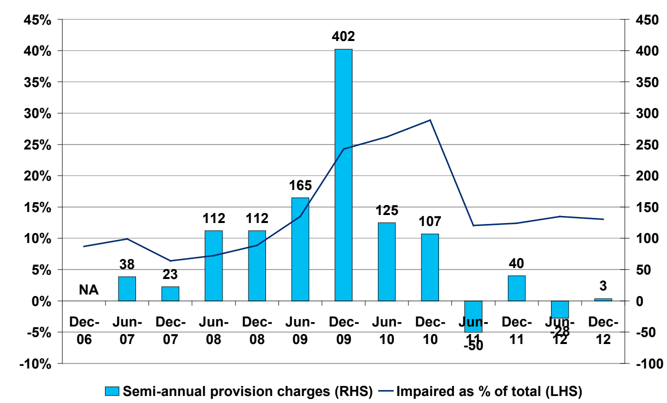
Source: Company data, Citi Research

Figure 40. mBank – Retail Provisioning, 1Q09-1Q11 (Polish Zloty in million)



Source: Company data, Citi Research

Figure 41. Kredyt Bank – Cash and Instalment Loan NPL Ratio (Percentage) and Provisioning (Polish Zloty in million), Dec 06-Dec 12



Source: Company data, Citi Research

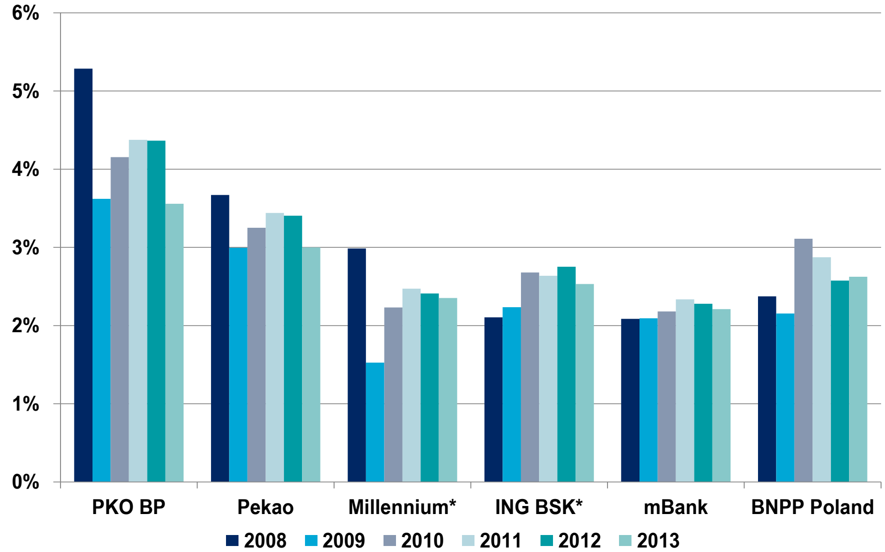
Figure 42. Polish Banks – Provisions on FX Derivatives Booked Against Revenues and in the Provisioning Line, 4Q08-1Q09 (Polish Zloty in million)

	4Q08			1Q09			Accumulated
	Revenues	Provisions	Total	Revenues	Provisions	Total	Total
Total	924	297	1,221	314	290	604	2,155
Citi coverage universe	573	184	757	107	234	341	1,097
PKO BP*	120	0	120	0	0	0	120
Pekao	0	72	72	30	0	30	102
Millennium	152	0	152	-22	59	37	189
ING BSK	163	66	229	68	45	113	342
BRE	57	28	84	0	70	70	155
Banks not under coverage	351	113	464	207	57	264	728
BPH	11	0	11	7	0	7	18
Fortis Bank Polska	209	0	209	96	0	96	313

Note: * Excluding Zl 175 on loans granted to companies having problems due to FX products acquired from another banks.

Source: Company data, Citi Research calculations

Figure 43. Polish Banks – Net Interest Margin on AIEA, 2008-2013 (Percentage)



*including swaps

Source: Company data, Citi Research

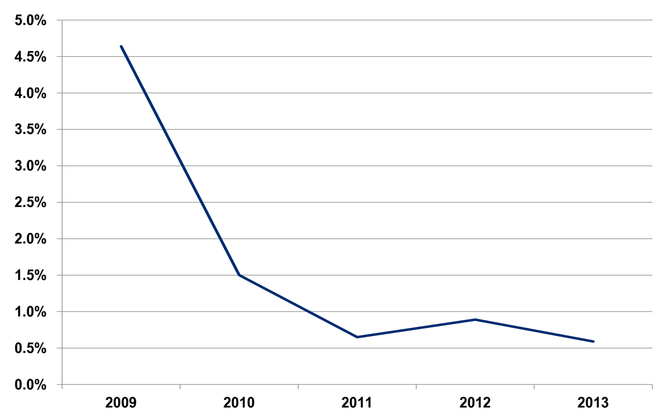
The Recovery Plan and Improving Profitability

Due to the Zl 430m net loss in 2009, the bank had to implement a recovery plan, approved by the KNF.

In recent years, the bank's management took several actions to improve its profitability, including:

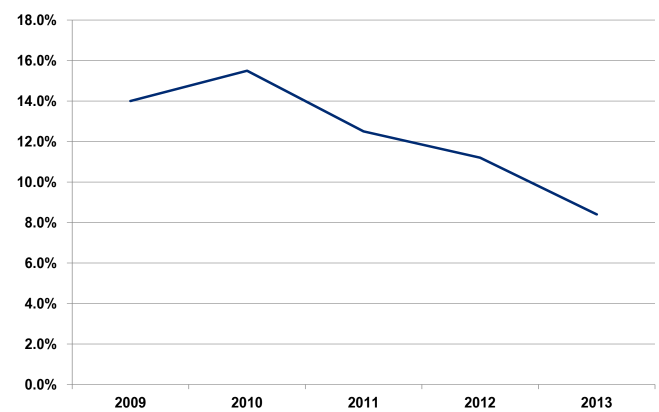
- **Implementation of more prudent risk management:** Due to changes in the underwriting policy in line with BNP Paribas Group risk standards, building an efficient platform to process, grant and collect Personal Finance loans, and intensified workout efforts on the corporate and retail books, the NPL ratio declined to 8.4% in 2013 from 11.2% in 2012 and 14.0% in 2009, and the (stand-alone) cost of risk dropped to 59bp from 89bp in 2012 and 464bp in 2009.

Figure 44. BNPP Polska – Cost of Risk, 2009-2013 (Percentage)



Source: Company data, Citi Research

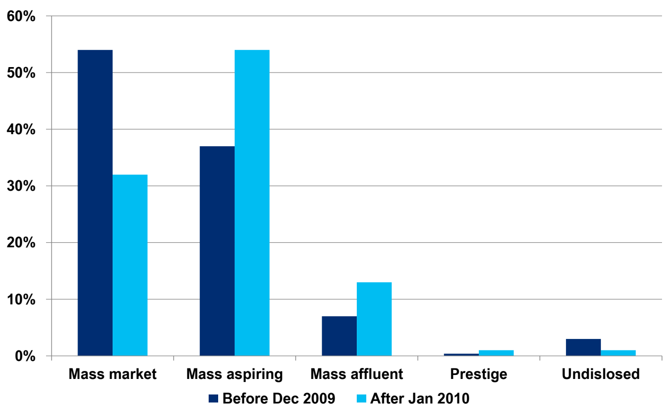
Figure 45. BNPP Polska – NPL Ratio, 2009-2013 (Percentage)



Source: Company data, Citi Research

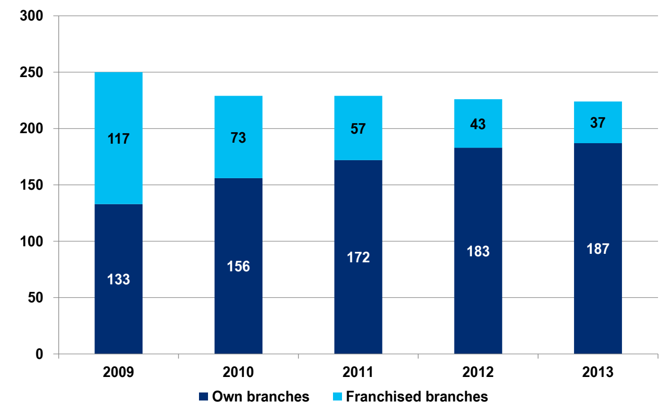
- **Relaunch of the business model** in both retail and corporate banking: for example, switching from high-risk, high-margin to lower-risk, lower-margin products led to improvement in risk-adjusted margin in retail banking and integration of BNP Paribas's corporate banking activity in Poland.
- **Optimising the distribution network,** including conversion of the majority of franchise branches into own branches, continued process of branch closing, opening, merging or reallocation plus introduction of sales effectiveness and motivating bonus system.

Figure 46. BNPP Polska – Structure of Current Stock of Personal Finance Loans by Date of Origination (Percentage)



Source: Company data, Citi Research

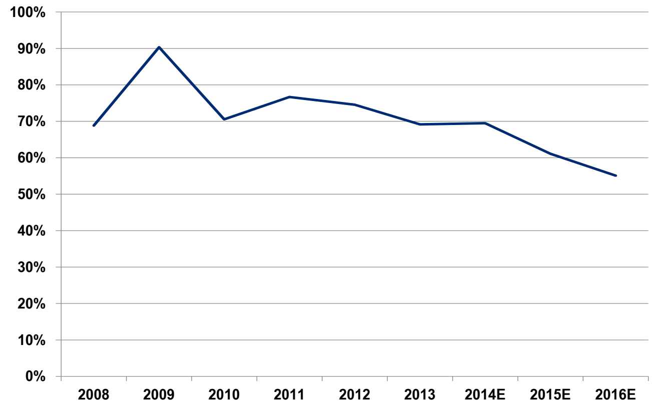
Figure 47. BNPP Polska – Branches, 2009-2013



Source: Company data, Citi Research

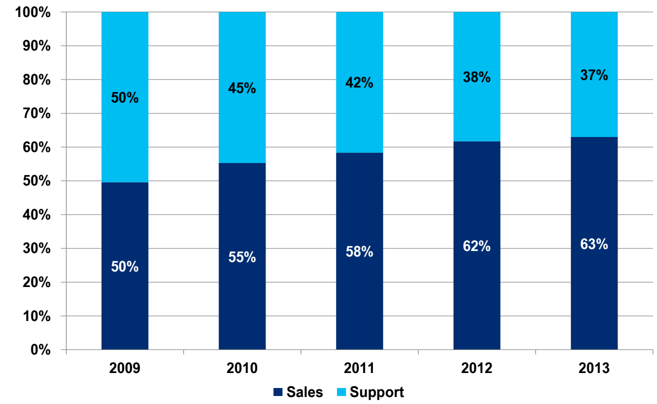
- **Cost optimization**:
  - In 2009, the bank implemented a plan to reduce headcount by 361 full-time employees (FTEs) but in the end the reduction was limited to 263 persons,
  - in 2012-13 the bank implemented the new "Triathlon" program targeting Zl 87m cost savings annually through the planned 355 FTEs reduction (actually 303 FTEs were made redundant and 60 internally replaced) and other optimisation initiatives, including improvements in automation, organisation structure simplification, insourcing/outsourcing, process improvement, contract negotiation, delayering, marketing tasks reprioritisation, standardisation, and simplification of product scopes.
  - BNPP Polska is participating in the group's global saving program "Simple & Efficient" and intends to achieve around Zl 26m of annual cost savings by the end of 2015.

Figure 48. BNPP Polska – Cost-to-Income, 2008-2013 (Percentage)



Source: Company data, Citi Research estimates

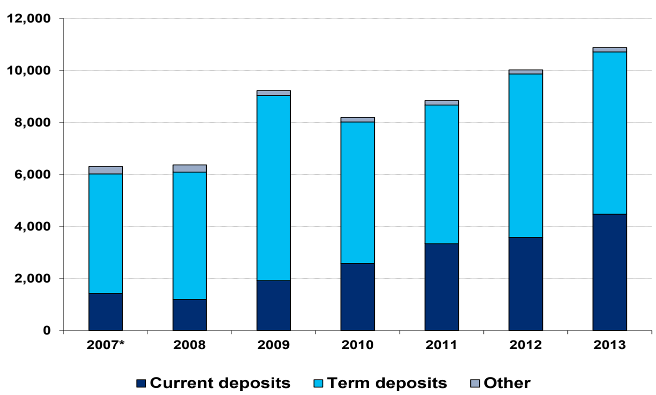
Figure 49. BNPP Polska – FTEs Structure, 2009-2013



Source: Company data, Citi Research

- **Improvement the bank's funding structure:** including increased share of current accounts.
- **Gradual growth in zloty-denominated performing loans**.

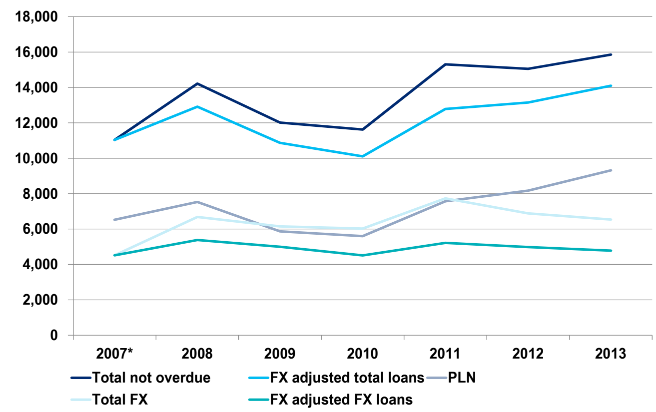
Figure 50. BNPP Polska – Deposit Structure, 2007*-2012 (Polish Zloty in million)



*Stand-alone data for 2007

Source: Company data, Citi Research

Figure 51. BNPP Polska – Loans, 2007*-2013 (Polish Zloty in million)



*Stand-alone data for 2007

Source: Company data, Citi Research

Rising ROE to 5.8% in 2013 from 2% in 2012 due to lower administrative and risk costs

The improvement in the bank's ROE to 5.8% in 2013 from 2% in 2012 was driven by lower administrative cost (-6% yoy) and lower net provisioning (-24% yoy despite Zl 20m provisions for legal risks arising from client litigation related to derivative products sold before 2009). We note that the decline in labour costs (-4.6% yoy) was caused mainly by a release of the provision for headcount restructuring (Zl +4.4m in 2013 vs. Zl -13m impact of provision created in 2012) and underlying costs grew 1.3% yoy due to higher bonuses and full-year consolidation of BNP Paribas Factor. The implemented saving plan led to lower rent, IT and telecommunication costs and general costs declined -4% yoy while depreciation and amortization dropped 24% yoy. Total revenues grew just 1%, but given the macro environment (declining interest rates and low demand for banking products) we believe the positive change in revenues was a success (total revenues of the commercial banks declined 3%).

The Bank's Strategy

Plan for 2009-2010

In 2009-2010 the bank focused on …

According to the strategy implemented post acquisition by the BNP Paribas Group, in 2009-2010 the bank focused on:

… building a universal bank …

- building a universal bank, taking advantage of former Fortis Bank Polska position in affluent and business client segment and former Dominet Bank in the mass client segment;

… reducing operating costs by Zl 100m in two years due to merger synergies …

- reducing operating costs by Zl 100m in two years due to merger synergies (reductions of overlapping positions, product and system integrations);

… improvement in cost management …

- improvement in cost management;

… improving efficiency in product development and marketing …

- improving efficiency in product development and marketing: focusing on the sale of existing products and investing only in selected strategic products, i.e. term deposits and transactional banking (including internet banking, cash management); the relationships built through transactional services were utilised to reduce risk costs and build a base of current accounts;

… and strengthening deposit base

- strengthening the deposit base (both retail and corporate) through increased marketing rather than through high pricing.

Post-2010 Mission, Vision and Strategy

2010-2015 Mission, Vision and Strategy

In 2010, the bank's management board and supervisory board approved BNPP Polska's 2010-2015 Mission, Vision and Strategy. The bank's ambition was to create a strong universal bank, offering a wide range of products for individual clients (including private banking), micro and SMEs, as well as for domestic and international corporate clients. The bank didn't rule out acquisitions but focused on organic growth towards 2015. The key parts of the strategy were:

- Focus on individual clients from Mass Aspiring and Mass Affluent segments;
- Strengthen the position in corporate banking;
- Intensify marketing efforts to strengthen BNP Paribas brand in Poland;
- Active creation of products in new areas;
- Branch network reorganisation and development, e.g. through opening new branches with a focus on big cities and towns with the highest business potential;
- Implement the integrated multichannel business model (branches, Internet Banking, Mobile Banking, Call Centre Channel) to increase sale efficiency;
- Further growth in Personal Finance, namely in personal and car loans;
- Develop Wealth Management and Investment Fund business;
- Launch factoring business;
- Strengthen leasing, cash management and trade finance activity;
- Provide high quality of risk management.

The Pillars of the Bank's New Strategy and its Medium-Term Financial Targets

Three pillars of the new strategy …

The bank's current strategy is based on three pillars:

… to complement a strong position in servicing top international clients with growth in Mid-Caps …

- In Commercial and Transactional Banking, the bank intends to complement a strong position in servicing the top international clients with growth in Mid-Cap and Public sectors;

… to implement "acquisition & activation" strategy in retail banking and …

- In Retail Banking BNPP Polska plans to continue growing, leveraging best-in-class Personal Finance expertise to increase number of active clients and improving network profitability through "acquisition & activation" strategy and further efficiency improvement;

… increase underlying profitability

- Increase underlying profitability by focusing on optimal price-point, operating efficiency and risk management.

In medium term the bank intends to achieve above 10% ROE

The bank's main medium-term financial targets are:

- 6%-8% CAGR in revenues, driven by volume growth, margin improvement and intensified cross-sell;
- Lower cost-to-income ratio to below 60% (vs. 69% in 2013), due to keeping cost base flat;
- Reduce NPL ratio to below 8% (vs. 8.4% at the end of 2013), via a shift in the client mix to lower-risk mass aspiring and mass affluent, proactive work-out of legacy book and more prudent underwriting policy;
- Increase ROE to above 10% (vs. 5.8% in 2013) due to high operating leverage;
- Keep consolidated zloty loan-to-deposit ratio below 115% (vs. 105% in 2013) (zloty loans are expected to remain self-funded);
- Maintain Tier 1 Ratio above 9.0% (vs. stand-alone 10.3% and consolidated 9.7% at the end of 2013)

Profitable Corporate and Transactional Banking Segment

Focus on client and revenue diversification

In Corporate and Transactional Banking (CTB), the bank plans:

- to maintain and further develop strong position with multinational clients;
- to expand penetration in mid-cap and the public sector client segments;
- to continue diversification of revenues (NII/net fees mix) and to become a leader in structured finance;
- to keep liquidity and cost of risk under control;
- to continue leveraging BNPP's local and international product offering, as well as access to the group's network.

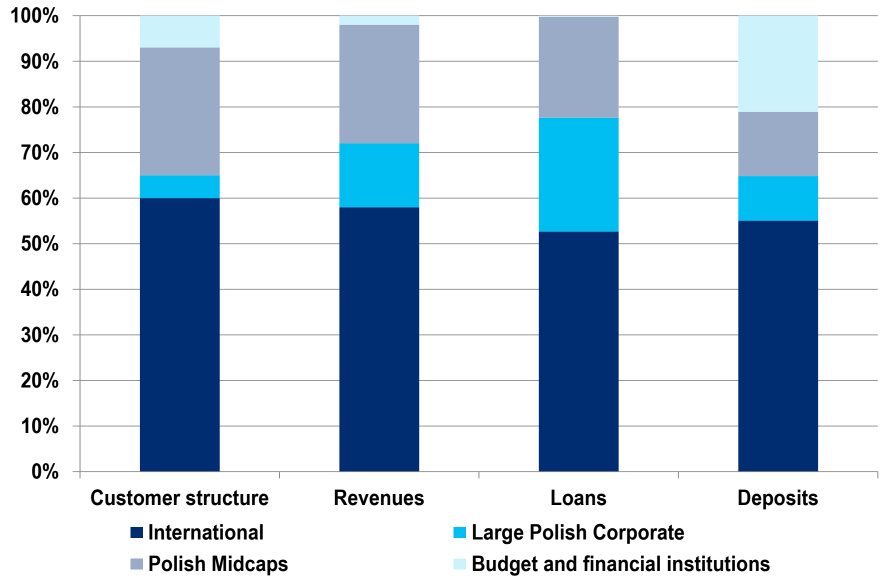
The full range of corporate banking products

The bank offers a full range of corporate banking products with a clear strategy of financing customers' needs and maintaining an adequate share of non-credit products to cross-sell. BNPP Polska provides its clients cash management, fixed-income and FX products, deposits and trade finance services, as well as structured finance, real estate finance, investment loans, leasing facilities and factoring, which are key to establishing and maintaining relationships with customers.

Network of 9 business centers

The Corporate and Transaction Banking distribution network consists of relationship managers in 9 business centers located in large cities countrywide and 6 retail branches with single relationship managers dedicated to CTB clients, assisted by experts from the head office (specialised in more advanced products) and from leasing and factoring business lines.

Figure 52. BNPP Polska – Corporate and Transaction Banking (CTB) Client Structure*, 2013 (Percentage)



Note: Unconsolidated data for loans and deposits

Source: Company data, Citi Research

The 9th biggest corporate lender with a strong position among multinational clients

At the end of 2013, CTB gross loans amounted to Zl 6.1bn and deposits to Zl 4.9bn. According to the bank's estimation, BNPP Polska was the 9th largest bank in Poland in terms of stock of corporate loans. The bank has relationships with 14.5% of multinationals within the top 2,000 corporates in Poland. Indeed, the number of international clients serviced by BNPP Polska exceeds the number of corporate clients classified by mBank and ING BSK in the top client group (K1 in mBank and Strategic in ING BSK). We attribute the bank's position in the multinational segment to the strength and know-how of the parent bank and its French and Belgian roots.

SME clients in other banks are a part of corporate banking, while in BNPP Polska they are serviced by the retail banking division

Business clients classified by BNPP Polska as SMEs (companies with an annual turnover of between EUR 1.2m and Zl 60m) and serviced within the Retail Banking division at other banks are classified as corporate clients (K3 group in mBank and medium companies in ING BSK) — we note, however, that loans to SMEs according to IFRS breakdown are reported as loans to business entities.

Figure 53. Polish banks – Business Clients Segmentation, 2013

BNPP				mBank				ING BSK			
Segment name	**Number of clients**	**Share**	**Criteria**	**Segment name**	**Number of clients**	**Share**	**Criteria**	**Segment name**	**Number of clients**	**Share**	**Criteria**
Multinationals	1,799	16%									
Large caps	157	1%	> Zl 600m	K1	1,255	8%	> Zl 500m	Strategic	663	2%	> 500 m
Mid-caps	824	7%	Zl 60-600m	K2	5,022	31%	Zl 30-500m	Large	3,100	10%	Zl 40m-500m
Total corporate clients	**2,975***	**26%**			**6,277**	**38%**			**3,763**	**12%**	
SMEs	8,433	74%	> EUR 1.2m or full accounting	K3	10,056	62%	Zl 3-30m	Medium	28,600	88%	>EUR 1.2m
Total business clients	**36,790**	**100%**			**16,333**	**100%**			**32,363**	**100%**	

Note: *Including 195 institutional clients

Source: Company data, Citi Research

Number of corporate clients grew by 9% yoy in 2013

In 2013 the number of business clients with turnover above Zl 60m grew 9% yoy, mainly due to strong growth in large Polish companies as well as in public sector and institutions. In the next few years the bank plans to continue client acquisition in the mid-cap segment, leveraging expertise in servicing multinationals and large corporations. The bank wants to accompany its clients in their development, especially in international trade, cash management and financing. Currently BNPP Polska's market share in the mid-cap segment is much lower than the large Polish banks'.

CTB profitability supported by positive provisioning

We note that in 2011-13 the high profitability of the Corporate and Transaction Banking division was partly caused by positive provisioning (more released provisions than created), driven by the gain on sold Vistula loans (the bank hasn't quantified the impact of the NPL sale on its earnings but we note that in 3Q13, when the sale took place, CTB division released Zl +22m provisions vs. average Zl 3m released in 1H13).

Loss-Making Retail Division

Under-Utilised Retail Platform

BNPP Polska Intends to acquire and activate mass aspiring and mass affluent clients

In retail banking the bank says it intends to leverage its good quality, but under-utilised network through a material increase in the number of active clients. It continues to develop a proactive "acquisition & activation" strategy based on a few 'hook' products (mainly cash loans), bundled cross-selling products and account opening or activation. BNPP Polska will optimise its distribution network (including boosting efficiency, profitability and visibility). The bank wants to further develop its digital banking platform and has refocused on mass aspiring and mass affluent segments. It acts in line with the responsible lending principle to prevent excessive indebtedness of customers (currently the bank does not offer FX loans to individual customers except Private Banking customers).

More than 220 branches in 50 cities

The bank's distribution network consists of 224 branches (in the target range of between 200 and 230 branches) located in 50 cities, internet banking, mobile banking and call centre. The retail banking department services c366,000 individuals, including 149,000 Personal Finance clients.

Personal Finance Inside Bank Model

Strong Pan-Europe franchise

We believe BNPP Group is an expert in consumer finance. According to the company, its Personal Finance (PF) division operates in 20 countries and is number 1 in France, Spain, Portugal and Europe, number 2 in Italy and top 3 in Czech Republic, Hungary and Bulgaria in terms of volume. It operates through an extensive network of Point of Sales (PoS), namely retail stores and car dealerships or directly to clients either online or through its customer relation centers. In some countries it runs under separate brands (e.g. Cetelem, Findomestic and AlphaCredit) and in others it operates within the group's retail banking network ("Personal Finance Inside" approach), with the latter strategy applied in Poland.

Cash loans sold through branches and car loans through car dealers

In Poland, within the Personal Finance business line the bank offers cash loans, car loans and credit cards. Cash loans are sold mostly through the bank's retail branches (88% of sales in 2013), while car loans are mostly sold by car dealers (73%). The bank cooperates with more than 1,500 new and used car dealers (including the network of used car dealers operating under the bank's Autotu brand). The supportive channels are call centre and selected financial brokers.

The fourth bank in car financing (the second in used car sub-segment)

BNPP Polska has the fourth-largest position (8% market share) in car financing, according to the company, and is especially strong in the used car sub-segment (the number 2 position after Getin Noble Bank and 12% market share). It says it plans to consolidate its current position in the used car market, gain market share in cars less than 10 years old and increase cross-sell of insurance and bank accounts (cross-sell ratio for motor own damage insurance has reached 15% and for bank accounts 25%). In the new car sub-segment, the bank intends to double its current market share through entering into partnership agreements with car makers and continue to improve margins. In June 2014 the bank entered into partnership agreements with Hyundai and Kia importers. Hyundai cars are sold in Poland through the network of 56 dealers (operating 65 points-of-sale) and Kia through 63 dealers (75 points-of-sales). In 2013 the share of these car brands in the sale of new cars in Poland amounted to 5.8% and 6.0%, respectively.

Revitalizing Autotu

The bank is revitalising the Autotu network: it has rebranded dealer shops and is improving its product offer (e.g. extending guarantees for car maintenance). BNPP Polska says it plans to recruit 60 new Autotu PoS in addition to the existing 120 ones. The offer for car dealers includes a loyalty programme (volume-based commission) and stock financing. The target is to increase loan sales through the Autotu network threefold in the next three years.

Focus on big ticket cash loans and the launch of the on-line lending

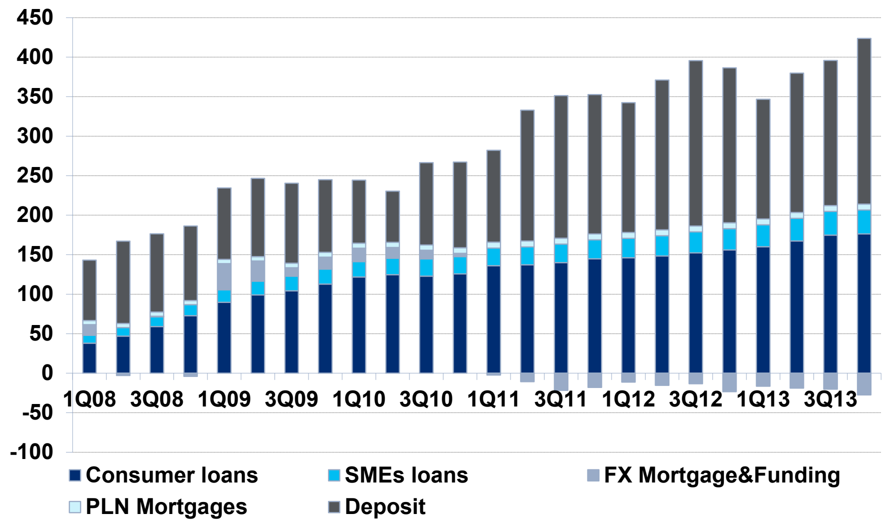
In cash loans the bank focuses on big ticket, mass aspiring and mass affluent sub-segments: according to bank's calculation, the average cash loan ticket (Zl 25,000) is one of the biggest in the market (the bigger average ticket is at Alior, Zl 31,000, while in major universal banks an average ticket is much lower: e.g. Zl 15,000 in PKO BP or Zl 8,000 in Pekao). In 2013 BNPP Polska launched fully on-line sales of cash loans ("i-gotówka") and the bank says it is satisfied with the generated number of on-line loan applications.

Our Take

Crowded market of consumer lending

The bank's strategy to grow in consumer finance isn't unique — practically all listed universal banks, historically skewed to corporate banking and mortgage loans, have recently repositioned and started to expand in consumer finance (e.g. Pekao in retail banking focuses on zloty mortgages and cash loans, mBank has materially increased share of non-mortgage retail loans in recent years, while ING BSK in 2013 started a marketing campaign to boost sale of cash loans). We see mBank and Alior Bank as the most successful examples of growing profitability through the increased sale of consumer loans (in Figure 44 below we illustrate mBank's success in generating increased net interest income (NII) from growing in retail).

Figure 54. mBank – Estimation of Retail NII, 1Q08-4Q13 (Polish Zloty in million)



Source: Company data, Citi Research estimates

We like the "acquisition & activation" strategy

In our view, what distinguishes BNPP Polska from competitors is the method of client acquisition. The majority of the bank's focus is on retail account acquisition and it has tried to cross-sell consumer products to current accounts owners. According to BNPP Polska's representatives, such strategies are too expensive, as the banks have to spend up to Zl 700 per new client while future revenues are unknown due to the difficulty of using cross-sell to cherry-pick customers. BNPP Polska's strategy is to use consumer loans as the 'hook' product ("to acquire"), bundled with other products ("to activate"). According to the bank's data, 28% of new clients are acquired through the sale of cash loans, 43% by offering daily banking services, i.e. current and saving accounts (but many of these clients are inactive), 7% through term deposits and 7% through car loans. We think that bank's "acquisition & activation" strategy may need more time to generate a significant increase in revenues but is more efficient than peers' strategy to acquire new current accounts.

M&A Upside Potential

BNPP Group Buying BGZ

BNP Paribas Group agrees to acquire 98.5% stake in BGZ for Zl 4.2bn and plans to merge it with BNPP Polska …

On December 5, 2013, BNP Paribas Group reached an agreement with Rabobank on the acquisition of a 98.5% stake in BGZ for Zl 4.2bn. BGZ is a medium-sized universal bank focused on clients from Food&Agri industries. The acquisition is subject to regulatory approvals. Once the transaction is executed and approved by regulators the BNP Paribas Group says it intends to merge BGZ with BNPP Polska.

… although BGZ is still in the merger process with Rabobank Poland

Fulfilling the regulator's requirements, BGZ has started a merger process with Rabobank's fully-owned Polish subsidiary Rabobank Poland and in December 2013 received approval for the merger. Taking into account a signed preliminary agreement to sell only BGZ (i.e. not Rabobank Poland) to BNP Paribas Group, Rabobank asked KNF for permission to stop the merger process. Rabobank is still awaiting the regulator's approval and hence the bank continues to work on the merger with Rabobank Poland. On May 30, 2014, BGZ's AGM approved the merger with Rabobank Poland and decided on the issuance of 5m new shares to Rabobank Poland's shareholders. We note that the assets of Rabobank Polska dropped from Zl 4.9bn in October 2013 to Zl 3.7bn in April 2014 (loans declined from Zl 2.5bn to Zl 2.1bn and deposits from Zl 0.9bn to Zl 0.7bn).

BNP Paribas Group expects that the merged BNPP Polska and BGZ will reach a double-digit ROE within 3 to 4 years after the merger

BNP Paribas Group expects that the merged BNPP Polska and BGZ will reach double-digit ROE within 3 to 4 years after the merger. The improvement in profitability is targeted to be achieved through a combination of revenue and cost synergies.

Targeted revenues synergies not lower than 5% of combined revenues

BNP Paribas Group intends to reach revenue synergies not lower than 5% of combined revenues owing to:

- A material increase in Personal Finance products sale to BGZ's retail client base.
- Leveraging BNPP Polska's strong transactional product base with BGZ corporate clients.
- Offering BGZ's online platform Optima to BNPP Polska's urban clients.

Targeted cost synergies in the range of between 10% and 15% of the combined costs

The BNP Paribas Group is looking for cost synergies in the range of between 10% and 15% of combined costs and is looking to achieve these saving through:

- Network optimization.
- IT migration.
- Centralization of the two banks' headquarters and central functions.
- Other operating cost synergies, including reducing marketing expenses as well as telecommunication and real-estate costs.

BGZ Business Model

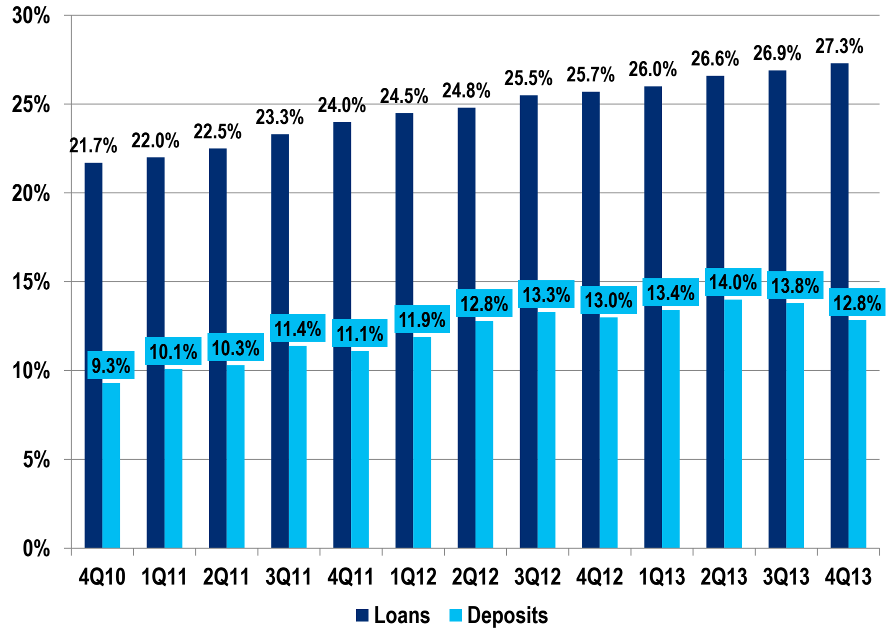
BGZ is a medium-sized Polish universal bank specialising in Food & Agriculture (F&A) banking

BGZ is a medium-sized universal bank, specialising in Food and Agriculture (F&A) banking and focusing on small towns with populations of between 20,000 and 150,000. Excluding state-owned BGK, at the beginning of January 2014 BGZ was Poland's 10th largest commercial bank in terms of assets and deposits, 11th in terms of loans and number of branches and 12^{th} in terms of number of retail current accounts, according to our calculations.

The bank's focus on small and medium-sized towns …

BGZ offers a comprehensive range of banking products for retail and corporate clients. In contrast to other universal banks in Poland, it focuses more on small and medium towns. The bank is the leader in F&A banking in Poland with 27% market share in lending to farmers, based on our calculations. In selected areas, its market position is much stronger (e.g. in overdraft loans to farmers) but in other areas it is much weaker. For example, in farmers' deposits its market share is just 13% according to our calculations.

Figure 55. BGZ – Market Share in Farmer Loans and Deposits, 4Q10-4Q13 (Percentage)



Source: Company data, NBP and Citi Research

… is reflected in its distribution network

BGZ's branch network is complementary to its strategy to service local communities and a majority of BGZ 397 branches are located in towns with a population of between 10,000 and 150,000. Its distribution network also consists of 13 outlets performing only cash services, 419 ATMs located in the bank's branches (ATMs were sold to IT Card in December 2013 but are still branded with the BGZ logo), 4,718 third-party operated ATMs available to clients for free and alternative distribution channels (e.g on-line banking and telephone banking), including its purely on-line business, branded OptimaBGZ. BGZ has 7 corporate centres located in Poland's largest cities (Warsaw, Gdansk, Krakow, Lublin, Poznan and Katowice as well as the international desk located in Warsaw) and 44 business centres dedicated to service SME clients. It also sells retail products, namely mortgage and cash loans plus credit cards, through 55 local agents and 22 national-wide financial intermediaries.

BGZ's History

Formerly the parent bank for cooperative bank …

The history of BGZ goes back to 1919, when Bank Rolny (The Agricultural Bank) was founded. Formally Bank BGZ was established in 1975 as an association of 1,663 cooperative banks that held a 46% stake in the bank. The majority stake (54%) was held by the State Treasury. It specialised in lending to state-owned food-processors and farms plus to cooperative farms while cooperative banks were entitled to service private farmers and small private-owned craft and trade companies. In 1994, BGZ was transformed into a joint stock company but the State Treasury still controlled BGZ, owning 65.9% of shares while cooperative banks held 34.1%.

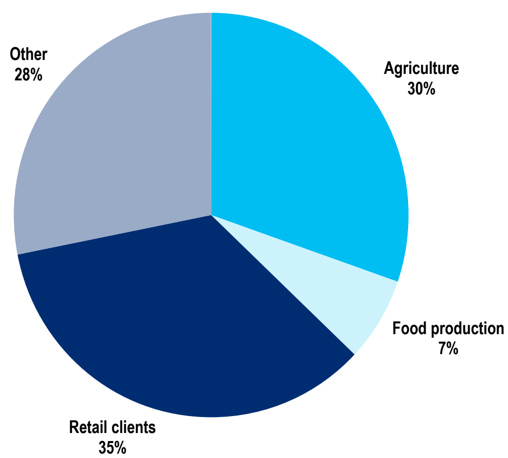
… BGZ is now a universal commercial bank majority owned by Rabobank

In 2002, BGZ ceased being an associate bank for cooperative banks and since then it has not been part of the system of cooperative banks. It operates as a normal commercial bank but it continues to focus on servicing farmers and food producers, taking advantage of its experience in that segment. In the subsequent years, the bank restructured its branch network and invested in new branches. In 2000-2002

BGZ opened 45 branches in big cities under the brand name "Integrum" but later re-branded them as BGZ. Over the course of 2004-2008 the Dutch cooperative bank, Rabobank, acquired a 59.35% stake in BGZ. In 2011 it was listed and the State sold a 12% stake to institutional and retail investors. In 2012 Rabobank announced a public tender for BGZ's shares, purchased shares from the State Treasury and private investors and increased its stake to 98.5%.

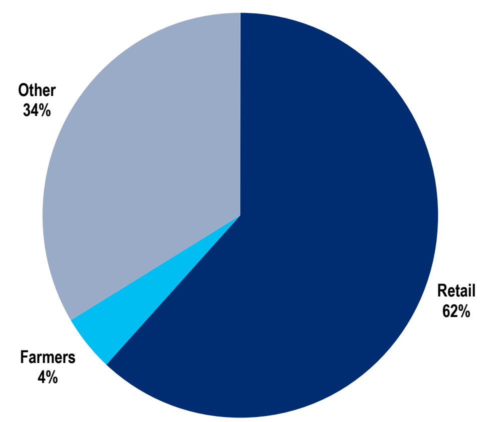
BGZ Main Products

Figure 56. BGZ – Loans Structure, 2013 (Percentage)



Source: Company data, Citi Research

Figure 57. BGZ – Deposits Structure, 2013 (Percentage)



Source: Company data, Citi Research

F&A (37% of loans) and retail lending (35%) dominate the loan book

The two biggest parts of BGZ's loan portfolio are loans to Food & Agricultural clients (37% of total loans) closely followed by retail loans (35%), while loans to other (non F&A) institutional clients amounted to 28% of total loans as of end 2013.

In F&A the bank offers …

In F&A banking, BGZ's main products are:

… long-term investment loans subsidised by the Polish government …

- **Preferential loans:** long-term investment loans, subsidised by the Polish government, paying the difference between the bank interest income (set by the government, currently not more than 1.5x the NBP's rediscount rate and the rate for the debtor (0.4 x the bank's interest income but at least 3%). The preferential loans are created to finance the agriculture and food-processing industry – each year the Agency for Restructuring and Modernisation of Agriculture (ARiMR) sets a maximum amount of subsidised loans and a maximum amount of subsidies to be paid in a given year.
- **"Agro Progres" loans":** long-term (up to 30 years) flexible investment loan, being an alternative funding to preferential loans;
- **"Agro Ekspres" loans:** this BGZ proprietary product is a medium- and long-term (1-5 years) working capital loan (up to Zl 2m), secured exclusively by a mortgage on agriculture land (loan-to-value up to 70%). Given the simplified but strict procedure, the loan can be approved and disbursed within a day. Nevertheless, BGZ's last reported data suggest that the quality of these loans continues to be good.
- **Working capital and investment loans to micro-entrepreneurs with the guarantees of the state-controlled bank BGK ("de minimis" program);**

- **… short- and long-term loans to pre-finance projects refinanced from EU structural funds …**

- **EU structural loans:** short- and long-term loans to finance different projects (in F&A and other industries as well as investments of municipalities in local infrastructure) co-funded from EU structural funds. EU funding is available only after the investments are complete, hence recipients of EU funds need bridge financing from banks or other financial institutions. The loans are granted on commercial terms (interest is not subsidised) but, as the clients are entitled to future funding from the EU, they tend not to be particularly price-sensitive. Indeed, clients are willing to pay a premium in exchange for assistance provided by the bank to prepare an application for EU funding. The bank's competitive advantage is its application verification system, which leads to a very limited number of negative decisions of institutions granting EU funds. We note that BGZ grants structural loans only after the project has been approved for financing by the institution responsible for granting EU funds.

… medium- and long-term working capital loans secured by mortgages on land …

- **Other loans, e.g.** crop purchase loans, “Green energy” loans (product line of loans launched in 2009 to finance construction and installation of wind turbine or heat from biomass or biogas) and agro chain financing products (a complex financing solution for the whole chain of agriculture production, from fertiliser producer to farmers and to food producers).

… plus current account packages giving access to agricultural market data and …

- **“Plan Agro” package,** a complete package of products for farmers consisting of a current account, saving account, free medical insurance and a dedicated info-line providing agricultural market data and detailed regional weather forecasts.

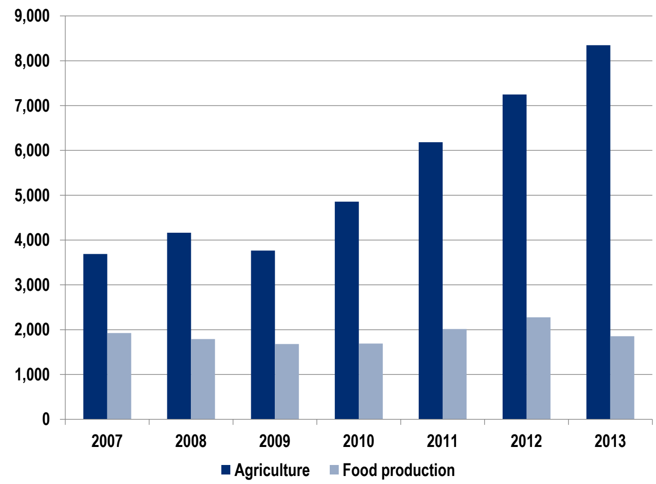
… insurance products

- **Insurance products:** BGZ has entered into an agreement with Concordia (the Polish subsidiary of the German mutual insurer, specialising in agriculture insurance) and offers a wide range of products targeting farmers’ insurance needs, e.g. compulsory insurances (including third-party liability and subsidised insurance against natural forces), crop insurance, insurance of agro machinery and personal insurance.

BGZ’s success is based on its proprietary farmer-tailored credit approval process

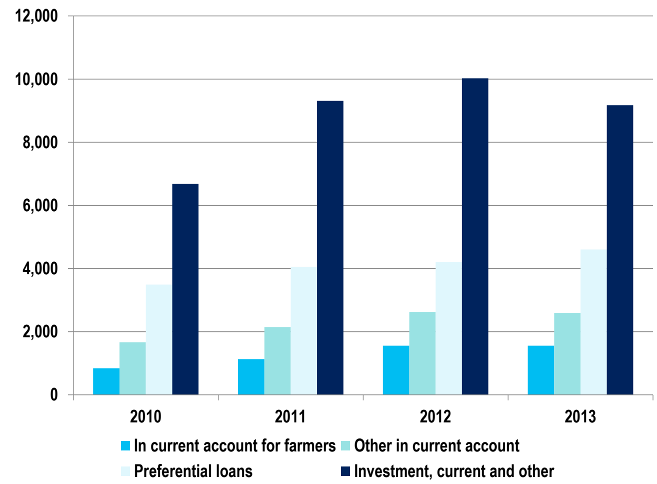
BGZ’s competitive advantage is its unique farmer-tailored credit approval process. As farmers in Poland are not required to keep books and aren’t subject to either corporate or personal income tax, assessing their income and their payment capacity is very difficult. BGZ’s proprietary credit approval process developed over many years is thus a key competitive advantage. Based on the amount of arable land owned by a farmer, the types of crops grown and livestock held, coupled with its database on achievable yields, BGZ appears well positioned to assess the ability of farmers to repay loans.

Figure 58. BGZ – Loans to Farmers and Food Production, 2007-2013 (Polish Zloty in million)



Source: Company data, Citi Research

Figure 59. BGZ – Institutional Loans, 2007-2013 (Polish Zloty in million)



Source: Company data, Citi Research

In ex-F&A corporate banking BGZ focuses on SMEs and Micro enterprises

In corporate banking, ex-F&A, BGZ focuses on SMEs (defined as companies with an annual turnover of between Zl 10m and Zl 60m) and Micro enterprises (annual turnover below Zl 10m or enterprises without full accounting). It offers a standard range of products including current accounts and deposits, overdraft and investment loans as well as multi-functional credit lines for large corporates and SMEs.

In retail banking, BGZ attracts clients by current accounts and mortgage loans …

In retail banking, BGZ's key products are:

- **Current accounts,** used to build a database of clients to facilitate cross-selling of lending and other products with mitigated risk;
- **Mortgage loans,** being the main retail lending products (84% of retail loans, 29% of total loans), but with the declining annual sales (Zl 1,009m in 2013, -28% yoy), 37% of mortgage loans are denominated in FX but since April 2009 BGZ hasn't offered CHF mortgages and, since May 2009, any FX mortgages;
- **Cash loans –** looking for higher-margin products BGZ significantly increased the sale of cash loans (Zl 828m in 2013, +60% yoy) but their share in total loans is still relatively low (10% of retail loans and 4% of total loans);
- **On-line deposit and saving products offered under OptimaBGZ brand.**

… and offers a wide range of savings and card products

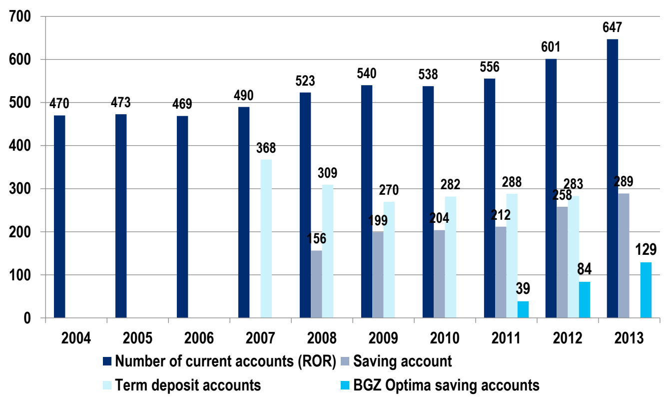
BGZ offers also a wide range of savings products and retail deposits are an important source of funding (62% of total deposits). BGZ also sells investment funds products (the revenues from investment fund distribution grew to Zl 10m in 2013 from Zl 6m in 2012). It also offers brokerage services (the brokerage house is an internal unit of the bank) and cash transfers (cooperating with non-banking financial institutions transferring services to and from Poland).

OptimaBGZ

In 4Q11 BGZ launched OptimaBGZ, an on-line bank for middle class and affluent clients in large cities, focused on saving products with attractive rates and on investment products. The direct bank is run under a new brand, distinct from BGZ's and Rabobank's brands, with the aim of providing an additional source of funding for BGZ and as a way to enter a new market of middle class and affluent clients living in large cities. In preparing this new venture, BGZ has taken advantage of Rabobank's know-how in the field of on-line banking, proved by the successful roll-

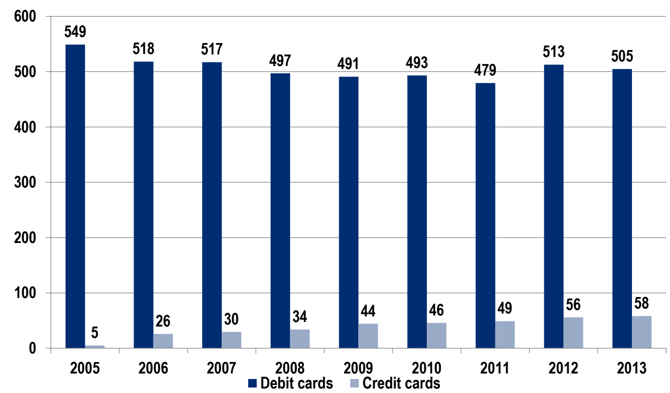
out of similar projects in other countries. At the end of 2013 the number of saving accounts in OptimaBGZ grew to 129,100 (+54% yoy) and the collected deposits reached Zl 4.15bn (+23% yoy, 25% of total retail deposits).

Figure 60. BGZ – Accounts, 2004-2013 (Thousands)



Source: Company data, Citi Research

Figure 61. BGZ – Debit and Credit Cards, 2005-2013 (Thousands)



Source: Company data, Citi Research

BGZ Capital Group

BGZ's capital group consists of the bank, a small real-estate company …

The capital group of BGZ consists of BGZ, a 100%-owned subsidiary active in real-estate, BFN Actus, and an associated company, BGZ Leasing, a leasing company 49% owned by BGZ and 51% by De Lage Landen, a member of the Rabobank Group. BNF Actus is not material in comparison to BGZ's assets and profits (in 2010 the company reported assets of Zl 63m and net loss of Zl 2m) and the company's main assets are real estate located in Wroclaw (valued at Zl 63.9m).

… and an associated leasing company (49% held)

BGZ acquired a 49% stake in BGZ Leasing in 2008. The total book value of BGZ's investment in the company is Zl 35m (Zl 42m acquisition price less a Zl 7m negative revaluation of the stake). In 2013, BGZ Leasing reported a net loss of Zl 23m. We don't know if the stake in the leasing subsidiary will be kept by BGZ after the sale or if it will repurchased by Rabobank Group.

Figure 62. BGZ Leasing – Main Financials, 2007-2013 (Polish Zloty in million)

	2007	2008	2009	2010	2011	2012	2013
Assets	54	206	381	677	1,007	1,074	1,013
Leasing receivables	12	157	327	585	871	955	892
Equity	39	40	39	64	94	94	72
Net profit	-1	0	0	3	5	-1	-23

Source: Company data, Citi Research

BGZ Strategy

BGZ's business model is based on taking advantage of the differences between it and its peers:

F&A is the fast-growing sector and BGZ benefits from its intellectual capital in this area

- **Leadership in Food&Agri banking:** F&A is the fast growing sector with significant banking opportunities. BGZ, due to its strong F&A network, knowledge of the sector, and know-how of Rabobank, looks to have a significant competitive advantage.

Growth potential in smaller towns is bigger and the competition lower

- **Strong presence in small and medium towns:** BGZ, relative to other medium-sized universal banks, which are focused on the development of branch networks in big cities, has a strong distribution network in small and medium towns, where we see growth potential as higher and competition lower.

"Community banking" model: Combines the product line of a universal bank with the relationship banking approach of cooperative banks

- **"Community" banking model:** BGZ tries to combine the product line and the distribution network of a universal bank with the relationship banking approach of cooperative banks (empowering branch directors, possessing local knowledge, with significant operating responsibility and autonomy).

In corporate banking, BGZ says it intends to focus on SMEs and Micro companies and to strengthen its leadership in the F&A banking market. In retail banking, BGZ focuses on product development and building relationships. It estimates that an increase in retail revenues will be driven predominantly by lending products, specifically mortgages, credit cards and consumer loans but it also wants to increase revenues from low capital-intensive, higher-margin products (e.g. insurance).

The branch network expansion program was just completed

Growth in retail banking is to be supported by utilization of the expanded branch network. The number of branches grew from 225 in 2007 to 400 in 2012 but declined to 397 in 2013. We note that BGZ declares that it has completed its branch expansion program even though the current number of branches is lower than 423 planned in 2011, when BGZ intended to be present in every county ("powiat") in Poland except around 20, where it was, according to its calculations, uneconomical to establish a branch.

Summary of BGZ Financials

In 2013 BGZ's net profit rose 23% yoy but ROE remained relatively low (4.6%)

In 2013 BGZ's net profit rose 23% yoy but ROE remained relatively low (4.6%). The profitability was positively affected by lower administrative costs, lower provisioning and a lower effective tax rate (the decline to 21% vs. 25% in 2012 and statutory rate of 19% appears to be due to the yoy changes in created and released provision).

- The decline in administrative costs was the result of the restructuring program implemented in 2012:
  - Staff costs dropped 5% yoy due to reduced headcount (average number of FTEs declined 2.6% yoy), lower bonuses and lower restructuring provision.
  - General costs declined 5% yoy, driven by lower marketing spends and renegotiation of agreements with suppliers, leading to lower external services and IT costs.
  - Depreciation and amortization rose 5% yoy, affected by investments in new CRM system and in the 11 branches opened at the end of 2012 and in 1Q13.
- Lower net provisioning was caused by lower provisioning on loans to large corporate clients (the decline was mainly attributed to a high base the year before, as BGZ was hurt by the financial problems of large construction companies in 2012), partly offset by the growth in provisions on loans to SMEs. In retail lending, mortgage provisioning declined while provisioning of consumer loans rose in line with the growth stock of loans. The changes in provisioning methodology led to Zl 23m higher provisions in 2013 (vs. Zl 33m positive impact of methodology changes in 2012).

Total revenues declined 1.7% yoy, mainly due to lower net fees while net interest income was broadly flat

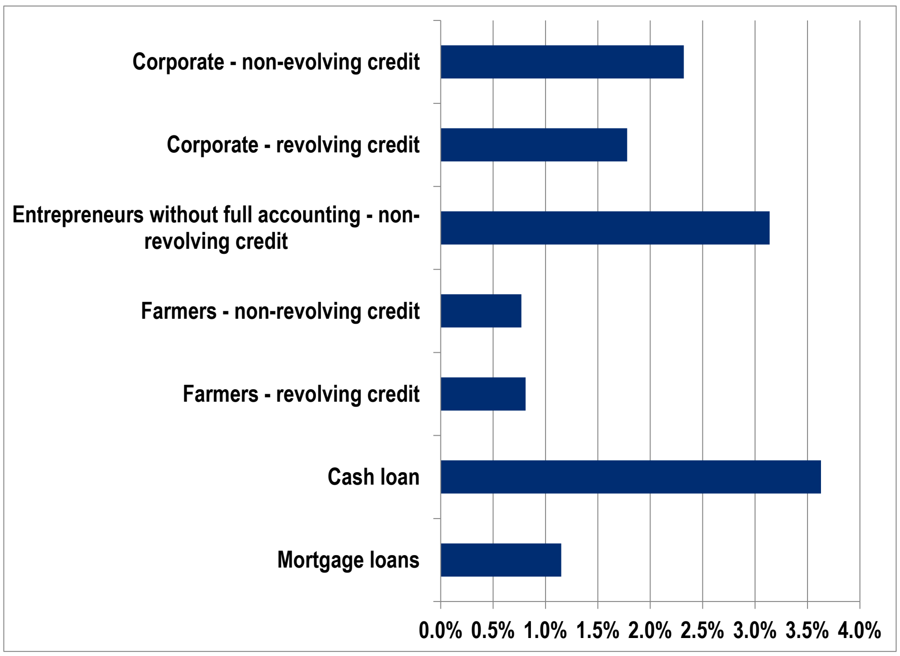
Total revenues declined 1.7% yoy, mainly due to lower net fees (-7% yoy) while net interest income was broadly flat (-0.4% yoy).

- The decline in net fees was caused mainly by lower lending and insurance fees (mainly due to implemented changes in bancassurance accounting – we note that BGZ implemented changes prospectively, i.e. it hasn't re-stated its historical financial statements) while brokerage fees rose yoy, positively affected by higher volumes and the renegotiation of distribution agreements with selected asset managers.

- Due to the implementation of interest rate hedging, begun in 2Q13, BGZ managed to offset the negative impact of lower rates on interest income from preferential loans by income from derivatives (the interest rate on these products is set as the NBP rediscount rate multiplied by 1.5 or 1.6 and thus the change in interest rates multiplied the impact on the bank's interest income).

- Net other operating income was positively affected by a recovery of a fully written-off loan to one food industry client, a release of Zl 8m provision on a fine imposed by the antimonopoly office in 2006 and lower yoy operational costs (in 2012 BGZ booked Zl 6m provision on operation losses in two branches).

Figure 63. BGZ – Probability of Default (PD) of the Main Types of Loans, 2013 (Percentage)



Source: Company reports

In recent years BGZ's profitability was negatively affected by increased cost of risk in lending to corporate and SMEs. The mortgage NPL ratio at BGZ is higher than the industry average, reflecting the focus on higher-risk clients living in smaller towns. BGZ continues to benefit from high quality of loans to farmers.

In 1Q14 the bank's net profit rose 51% yoy, driven by higher net interest income (+12% yoy) and net fees (+8 yoy) as well as by lower administrative costs (-2.5%) while net provisioning rose 76% yoy.

Benchmarking to Peers

Profitability of BNPP Polska and BGZ is low if compared with profitability of other listed Polish banks. The main reasons are:

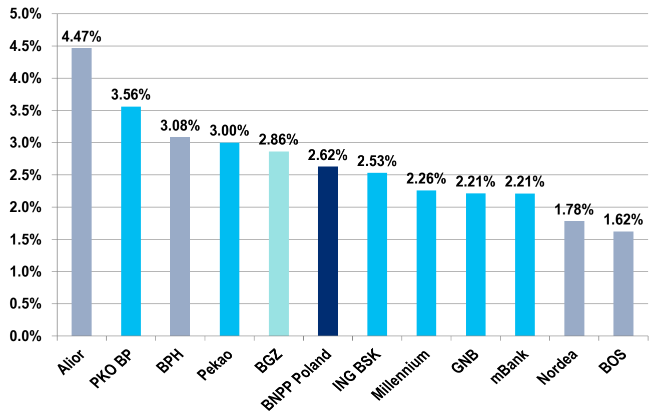
- relatively (i.e. vs. the loan structure) low net interest margin;
- low fee income, due mainly to relatively low revenues from insurance, small asset management business, low number of clients paying by the bank's cards and lack of any other fee generating business line (e.g. card processing, offered to third-party ATM network, etc.) – we note that the level of net fees to average assets is highly correlated with banks' ROE;
- relatively (i.e. vs. average assets) high administrative costs.

Figure 64. Polish Banks – Profitability of Listed Banks, 2013 (Polish Zloty in million/Percentage)

	BNPP Polska	BGZ	Alior	BPH	Nordea	BOS	PKO BP	Pekao	mBank	ING BSK	Millennium	GNB
NII	**538**	**1,015**	**999**	**980**	**592**	**278**	**6,722**	**4,444**	**2,226**	**2,043**	**1,220**	**1,298**
Net fees	**150**	**276**	**275**	**429**	**39**	**110**	**3,006**	**2,132**	**835**	**977**	**589**	**419**
Other revenues	136	150	266	127	112	113	979	864	613	224	198	139
Total revenues	**823**	**1,442**	**1,540**	**1,536**	**743**	**501**	**10,707**	**7,440**	**3,674**	**3,243**	**2,006**	**1,856**
Admin costs	-569	-980	-847	-1,132	-519	-366	-4,623	-3,444	-1,678	-1,821	-1,090	-880
Pre-provision income	**254**	**462**	**693**	**404**	**224**	**135**	**6,084**	**3,996**	**1,995**	**1,422**	**917**	**976**
Provisioning	**-116**	**-249**	**-405**	**-139**	**-112**	**-60**	**-2,038**	**-645**	**-478**	**-267**	**-234**	**-624**
Other		-11			-16		-2	59		38	-2	5
Pre-tax	**138**	**202**	**288**	**265**	**97**	**75**	**4,044**	**3,411**	**1,518**	**1,193**	**681**	**357**
Tax	-35	-42	-60	-60	-37	-9	-816	-655	-309	-231	-145	24
Minorities and other				-12			2	30	-3	0		19
Net profit	**102**	**160**	**228**	**192**	**60**	**66**	**3,230**	**2,785**	**1,206**	**962**	**536**	**400**
					to average assets							
NII (on AIEA)	**2.62%**	**2.86%**	**4.47%**	**3.08%**	**1.78%**	**1.62%**	**3.56%**	**3.00%**	**2.21%**	**2.53%**	**2.26%**	**2.21%**
NII (on assets)	**2.56%**	**2.78%**	**4.29%**	**2.91%**	**1.79%**	**1.58%**	**3.43%**	**2.87%**	**2.16%**	**2.48%**	**2.22%**	**2.13%**
Net fees	0.71%	0.76%	1.18%	1.27%	0.12%	0.62%	1.53%	1.38%	0.81%	1.19%	1.07%	0.69%
Other revenues	0.65%	0.41%	1.14%	0.38%	0.34%	0.64%	0.50%	0.56%	0.59%	0.27%	0.36%	0.23%
Total revenues	**3.93%**	**3.95%**	**6.61%**	**4.56%**	**2.25%**	**2.84%**	**5.46%**	**4.81%**	**3.56%**	**3.94%**	**3.65%**	**3.04%**
Admin costs	2.71%	2.68%	3.64%	3.36%	1.57%	2.07%	2.36%	2.23%	1.63%	2.21%	1.98%	1.44%
Pre-provision income	**1.21%**	**1.27%**	**2.97%**	**1.20%**	**0.68%**	**0.76%**	**3.10%**	**2.58%**	**1.93%**	**1.73%**	**1.67%**	**1.60%**
Provisioning	**0.55%**	**0.68%**	**1.74%**	**0.41%**	**0.34%**	**0.34%**	**1.04%**	**0.42%**	**0.46%**	**0.32%**	**0.43%**	**1.02%**
Other	0.00%	-0.03%	0.00%	0.00%	-0.05%	0.00%	0.00%	0.04%	0.00%	0.05%	0.00%	0.01%
Pre-tax	**0.66%**	**0.55%**	**1.23%**	**0.79%**	**0.29%**	**0.42%**	**2.06%**	**2.21%**	**1.47%**	**1.45%**	**1.24%**	**0.58%**
Tax	0.17%	0.12%	0.26%	0.18%	0.11%	0.05%	0.42%	0.42%	0.30%	0.28%	0.26%	-0.04%
Minorities	0.00%	0.00%	0.00%	-0.04%	0.00%	0.00%	0.00%	0.02%	0.00%	0.00%	0.00%	0.03%
Net profit	**0.49%**	**0.44%**	**0.98%**	**0.57%**	**0.18%**	**0.37%**	**1.65%**	**1.80%**	**1.17%**	**1.17%**	**0.97%**	**0.65%**
Equity-to-assets	8.5%	9.8%	8.6%	15.0%	7.1%	8.0%	12.6%	14.8%	9.8%	10.0%	9.4%	7.5%
Loan-to-deposit	**152.2%**	**99.3%**	**99.8%**	**171.1%**	**186.9%**	**91.3%**	**102.3%**	**84.3%**	**110.6%**	**77.6%**	**92.2%**	**88.1%**
Loans-to-assets	78.5%	73.5%	76.9%	69.3%	82.5%	65.5%	75.1%	63.7%	65.4%	60.6%	72.9%	71.3%
ROE	**5.8%**	**4.6%**	**11.1%**	**8.0%**	**2.6%**	**4.5%**	**13.0%**	**12.0%**	**12.2%**	**11.5%**	**10.5%**	**8.8%**
Cost-to-income	**69.2%**	**68.0%**	**55.0%**	**73.7%**	**69.8%**	**73.1%**	**43.2%**	**46.3%**	**45.7%**	**56.2%**	**54.3%**	**47.4%**

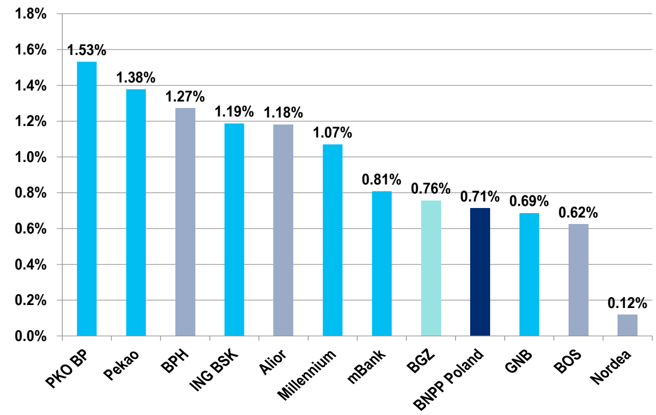
Source: Company data, Citi Research

Figure 65. Polish Banks – NII on AIEA, 2013 (Percentage)



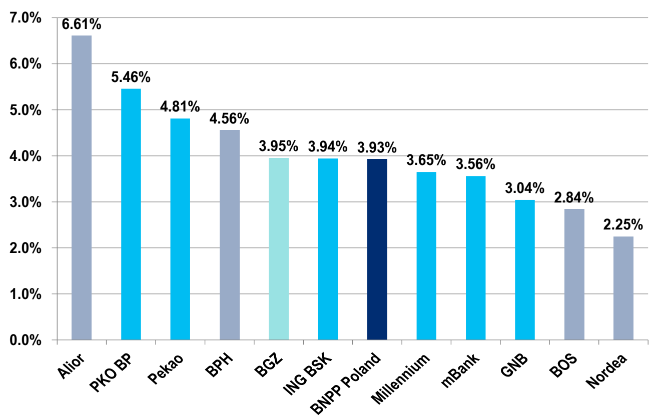
Source: Company data, Citi Research

Figure 66. Polish Banks – Net Fees to Average Total Assets, 2013 (Percentage)



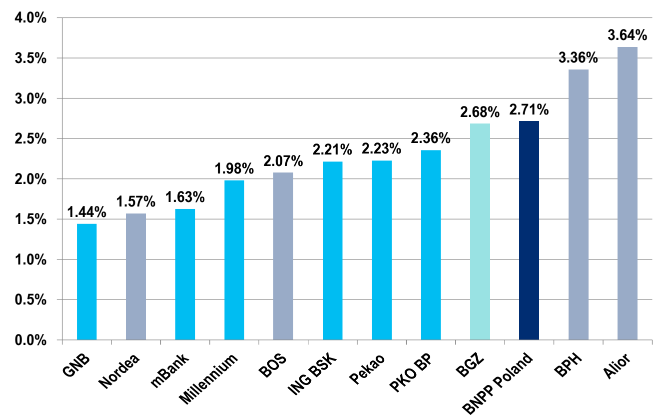
Source: Company data, Citi Research

Figure 67. Polish Banks – Total Revenues to Average Total Assets, 2013 (Percentage)



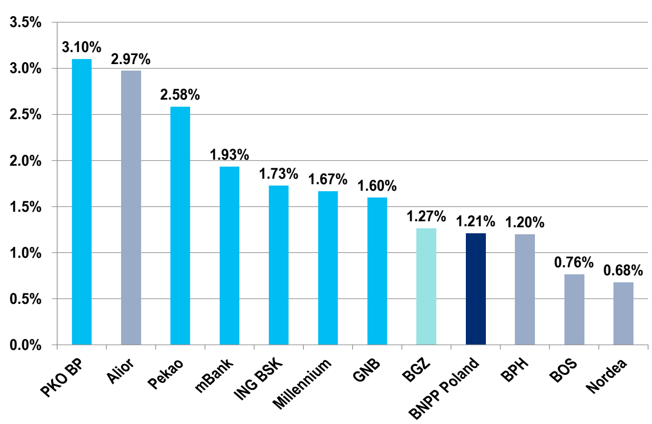
Source: Company data, Citi Research

Figure 68. Polish Banks – Administrative Costs to Average Total Assets, 2013 (Percentage)



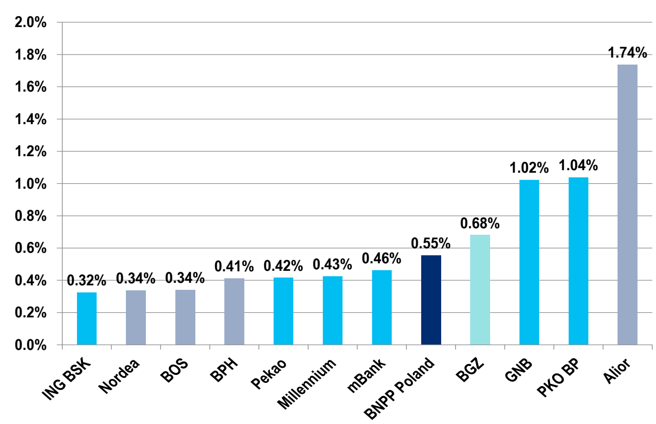
Source: Company data, Citi Research

Figure 69. Polish Banks – EBIT to Average Total Assets, 2013 (Percentage)



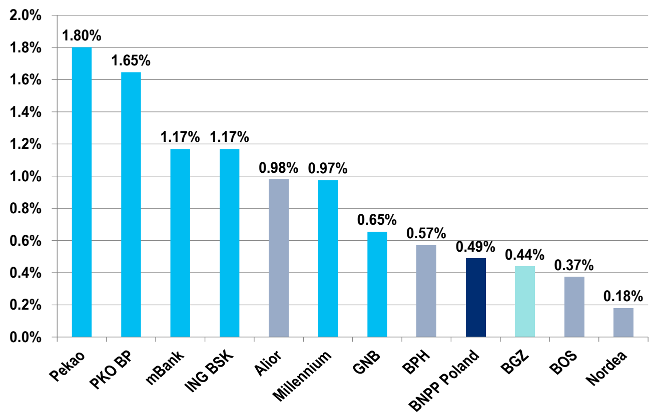
Source: Company data, Citi Research

Figure 70. Polish Banks – Provisioning to Average Total Assets, 2013 (Percentage)



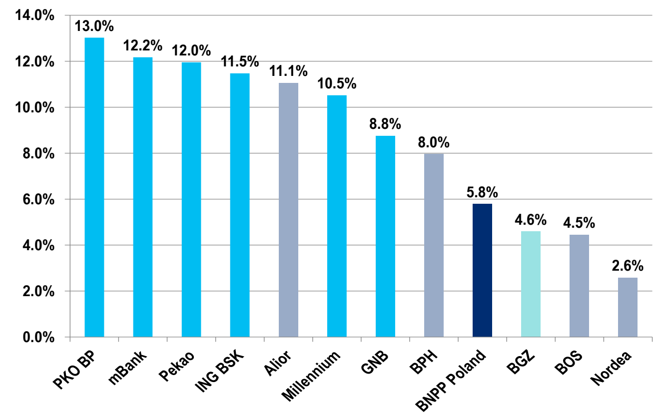
Source: Company data, Citi Research

Figure 71. Polish Banks – ROA, 2013 (Percentage)



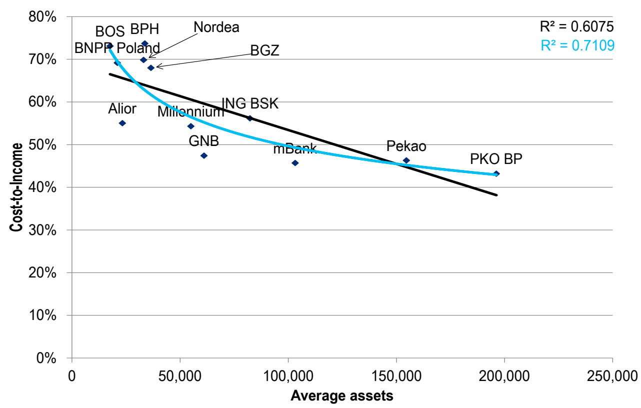
Source: Company data, Citi Research

Figure 72. Polish Banks – ROE, 2013 (Percentage)



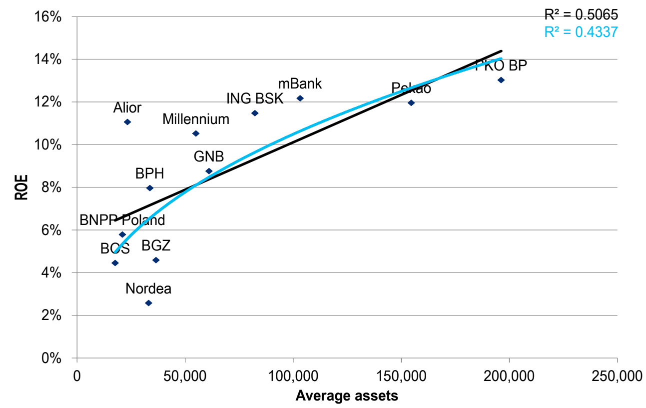
Source: Company data, Citi Research

Figure 73. Polish Banks – Cost to Income Ratio vs. Average Assets, 2013 (Percentage/Polish Zloty in million)



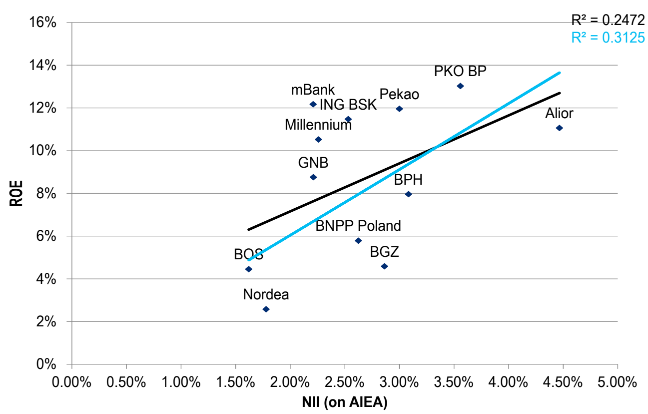
Source: Company data, Citi Research

Figure 74. Polish Banks – ROE vs. Average Assets, 2013 (Percentage/Polish Zloty in million)



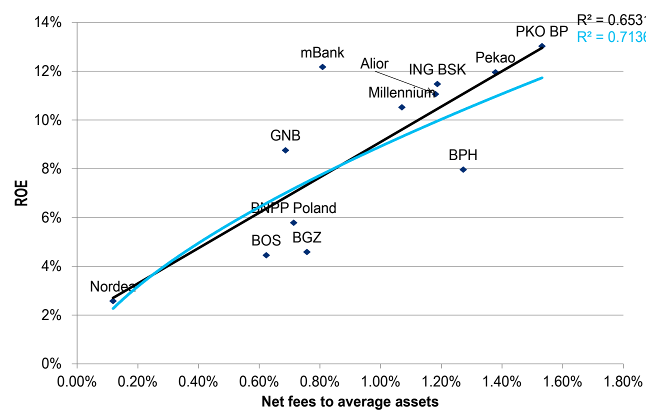
Source: Company data, Citi Research

Figure 75. Polish Banks – ROE vs. NII on AIEA, 2013 (Percentage)



Source: Company data, Citi Research

Figure 76. Polish Banks – ROE vs. Net Fees to Average Assets, 2013 (Percentage)



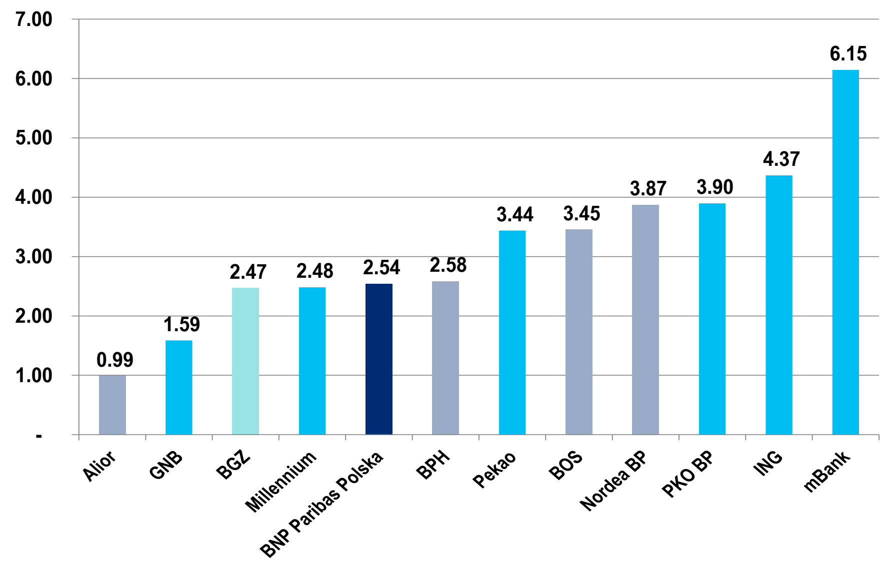
Source: Company data, Citi Research

Relatively low costs per branch

Costs per branch are lower than in many large universal banks

The high administrative costs per assets may be attributed to the low assets of the banks but we note that the 2013 costs per branch (Zl 2.54m per annum in BNPP Polska and Zl 2.47m in BGZ) are lower than in many large universal banks and slightly higher than in the closest peer, showing the limited room for cost efficiency improvement.

Figure 77. Polish Banks – Administrative Costs Per Branch*, 2013 (Polish Zloty in million)



* The comparison is distorted by the bank's different mix of owned and franchised branches

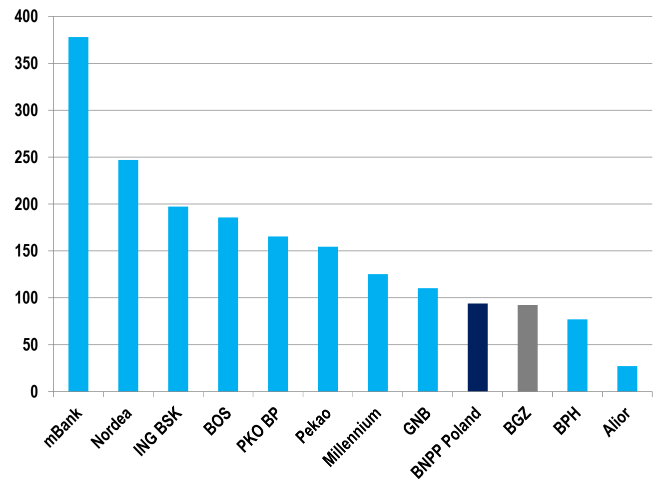
Source: Company data, Citi Research

Low Assets per Branch Is the Key Problem

Low volume per branch looks to be the main reason for the bank's low profitability

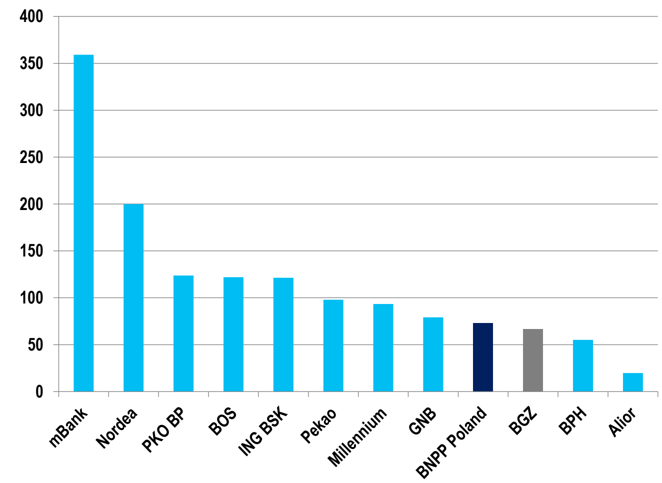
Low volume per branch (assets, loans, deposits and current accounts) in BNPP Polska and BGZ looks to be the main reason for the bank's low profitability.

Figure 78. Polish Banks – Average Assets per Branch, 2013 (Polish Zloty in million)



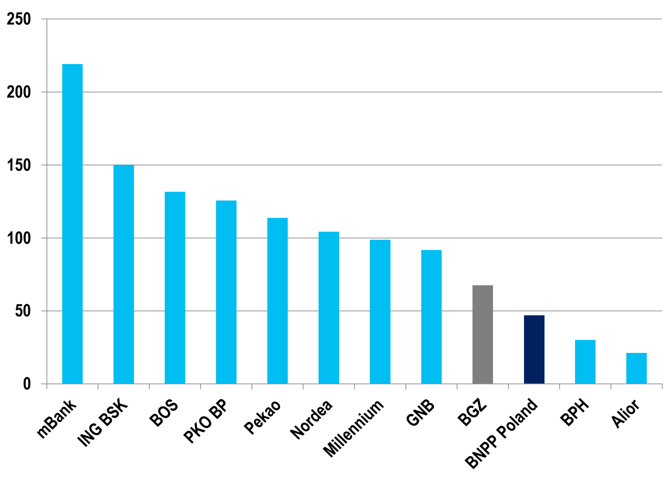
Source: Company data, Citi Research

Figure 79. Polish Banks – Average Loans per Branch, 2013 (Polish Zloty in million)



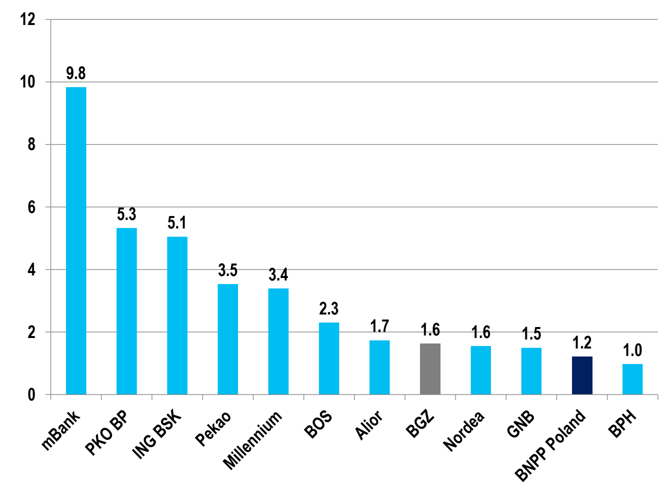
Source: Company data, Citi Research

Figure 80. Polish Banks – Average Deposits per Branch, 2013 (Polish Zloty in million)



Source: Company data, Citi Research

Figure 81. Polish Banks – Current Accounts per Branch, 2013 (Thousands)



Source: Company data, Citi Research

Similar to closest peers' sale of cash loans per branch in BNPP Polska, much lower in BGZ

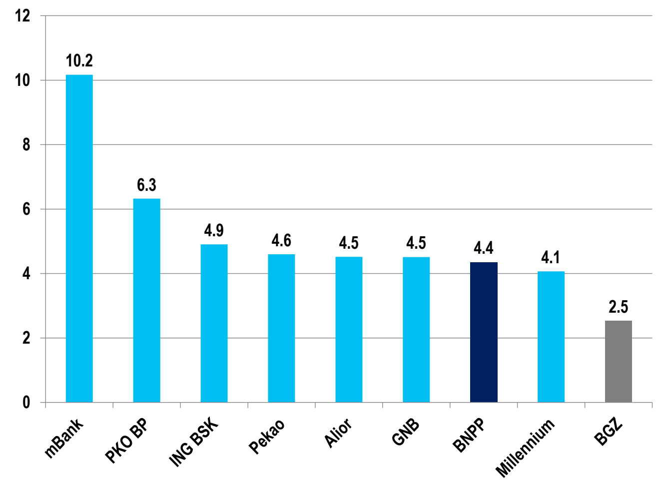
The sale of cash loans per branch in BNPP Polska is comparable with the sale of the most aggressive listed consumer lenders, Alior Bank, and Getin Noble Bank. We attribute higher sales in Pekao and PKO BP to different branch formats (bigger but also more expensive, as shown above, branches), higher base of clients and better brand recognition. mBank's statistics are not comparable due to the bank's different business model (its distribution focuses on on-line channels). BGZ, despite delivering an impressive 60% yoy increase in consumer loan production, is still significantly behind peers (just Zl 2.5m annual sales of consumer loans per branch).

Figure 82. Polish Banks – Sale of Consumer Loans, 2013 (Polish Zloty in million)

Loan production	BNPP	BGZ	Alior	GNB	Pekao	PKO BP	Millennium	mBank	ING BSK
Car loans	386			1,649					
Cash loans	976	1,009	3,881	2,499	4,603	7,500	1,785	2,776	2045
Total consumer loan production	**1,362**	**1,009**	**3,881**	**4,148**	**4,603**	**7,500**	**1,785**	**2,776**	**2,045**
Number of branches	224	397	859	554	1,001	1,186	439	273	417
Cash loan per branch	**4.4**	**2.5**	**4.5**	**4.5**	**4.6**	**6.3**	**4.1**	**10.2**	**4.9**

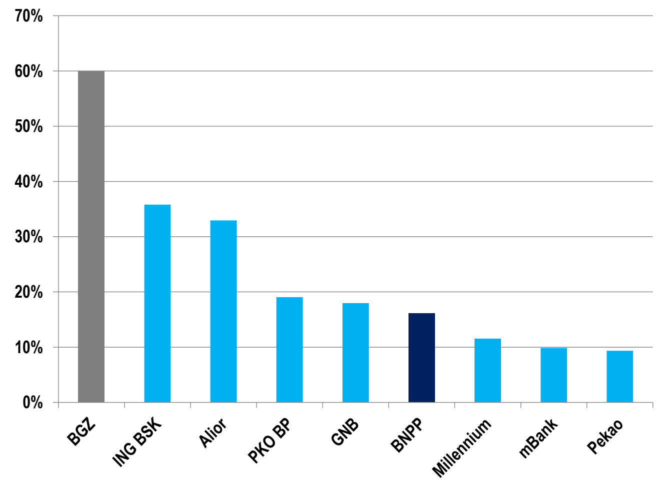
Source: Company data, Citi Research

Figure 83. Polish Banks – Sale of Cash Loans per Branch, 2013 (Polish Zloty in million)



Source: Company data, Citi Research

Figure 84. Polish Banks – Annual Change of Cash Loans New Production, 2013 (Percentage)



Source: Company data, Citi Research

The high sales per branch bodes well for BNPP Polska's revenues while the low base at BGZ implies room for growth

The high and still rising sales per branch bodes well for BNPP Polska's revenues while the low base at BGZ implies room for growth in sales post the merger. We note, however, that due to differences between BNPP Polska's (repositioning to mass affluent segment urban clients) and BGZ's (mass segment clients living in smaller towns) client bases, the risk profile at both banks is different. The question is whether the merged bank will be able to increase lending to BGZ's clients without exceeding the maximal level of risk accepted by BNPP Polska.

Different spreads on consumer loans reflect different risk profiles

BNPP Polska's spread on consumer loans is close to the spread at Alior, the bank targeting urban clients, and materially below spread of banks targeting clients living in small towns (Getin Noble and BGZ). We attribute the difference in spreads on consumer loans to the different risk profile of clients and to BNPP Polska's "acquisition & activation" strategy (the bank treats cash loans as the 'hook' product to acquire clients – to some extend the same strategy is applied by Alior). We note the gradual increase in BNPP Polska's spread on new cash loan production by 3pp in December 2012 vs. December 2010 but we see limited room for further re-pricing unless the bank accepts higher-risk clients.

Figure 85. Polish Banks – Spread on Consumer Loans, 2011-2013 (Percentage)

	2011	2012	2013	Mix
BNPP	**9.40%**	**9.00%**	**9.30%**	**cash loans about 75%**
BGZ	**NA**	**NA**	**12.53%**	**cash loans about 65%**
GNB	11.36%	12.65%	13.56%	cash loans about 55%
Alior	8.58%	10.91%	9.08%	cash loans above 90%
Pekao	11.82%	10.89%	10.14%	cash loans about 70%

Source: Company data, Citi Research

More active (and smarter) marketing may help

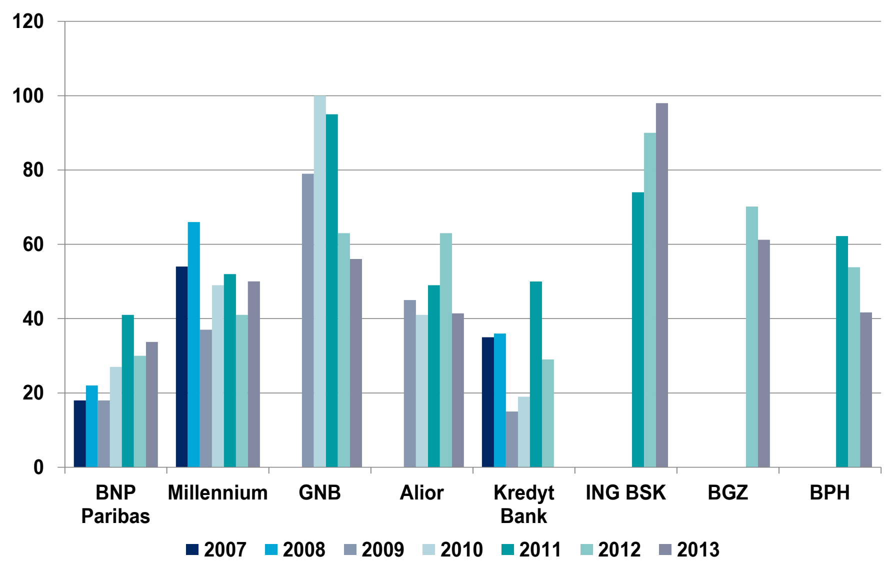
Low brand awareness, partly due relatively low marketing spends

Both BNPP Polska and BGZ need more banking relationships with clients to increase volumes, revenues and profitability. Weak brand awareness may be one of the reasons for the relatively low number of clients. In none of the brand awareness surveys that are available to us did BNPP Polska rank in the Top 10. We think that the low awareness of the bank is partly caused by relatively low marketing spending in the recent six years (some banks invested heavily in their brands over that period).

The merged banks, keeping marketing costs at BGZ's level and spending smarter, should achieve a material improvement in brand recognition

We note that marketing spending at BGZ is materially higher than at BNPP Polska and even exceeded marketing spending at Alior. BGZ, probably also due to more active marketing, managed to accelerate client acquisition, but compared to Alior's, GNB's or Millennium's spend, there looks to be more for the bank to achieve in terms of generating brand recognition. The merged banks, keeping marketing costs at BGZ's level and spending smarter, should achieve a material improvement in brand recognition, in our view.

Figure 86. Polish Banks – Marketing Expenses, 2007-2013 (Polish Zloty in million)



Source: Company data, Citi Research

Potential Merger Synergies

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

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 a bank cheap for clients (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 the acceleration of volume growth or the reduction in branch numbers. We understand the BNP Paribas Group plans to combine both.

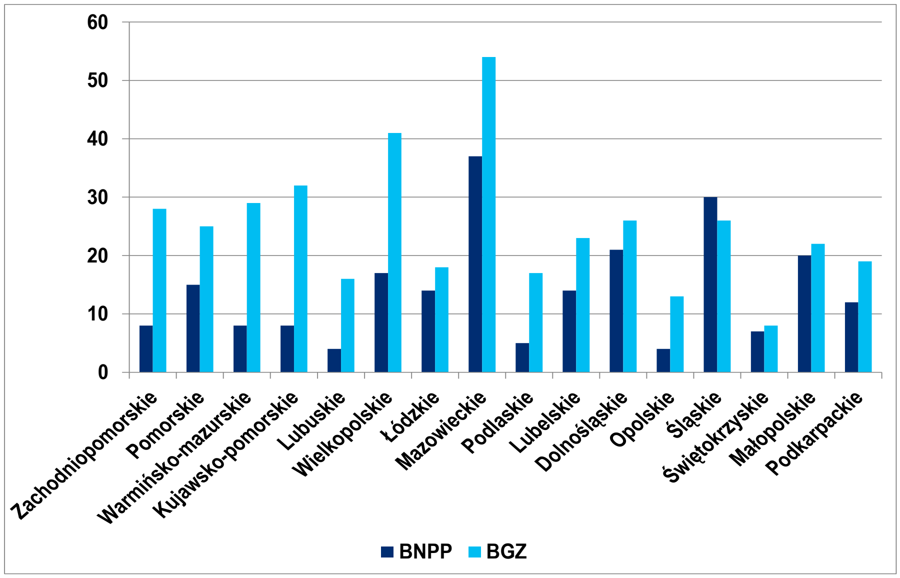
BNP Paribas Group plans to close at least 11% of combined branches

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 2013, 621 total branches were operated by BNPP Polska (224) and BGZ (397), while Getin Noble had 554 branches and Eurobank (as of the end of 2012) 446. This implies the bank plans to close at least 67 branches (11% of combined number) but not more than 175 (28%) – given BNP Paribas' plans to build a strong presence in Poland we would expect the number of branch closures to be closer to the lower end of the range (somewhere between 10% and 15% of combined network).

More active marketing may help to leverage attractive branch network

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

Figure 87. BNPP Polska and BGZ – Branches Per Regions, 2013

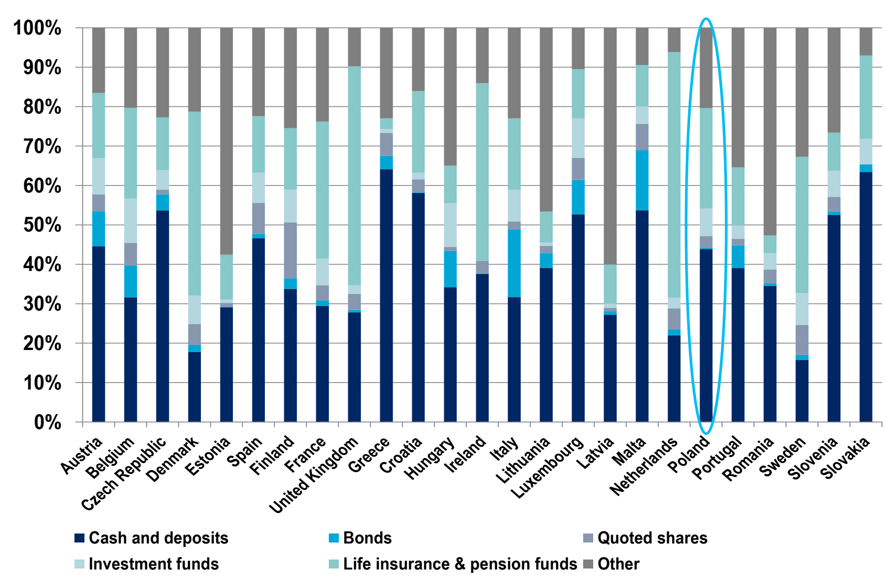


Source: Company reports

Upside risk form investment product sale

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 88. 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 a 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, based the bank's comments on potential branch closures, its expansion plans in Poland, and the levels of HQ/general cost savings historically achieved as a result of bank mergers in Poland, 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 breakdown of our estimated cost synergies)

Figure 89. 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 90. 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 91. 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 11.5% ROE in 2016 for Millennium and 13.1% for Getin Noble). To simplify comparisons with other Polish banks, for which we do not have forecasts beyond 2016, we assume achievement of full cost synergies in 2016 (vs. the bank's guidance of "in 3 to 4 year from the getting a regulatory approval", i.e. in 2017-2018). We note we have assumed that BNPP Polska would issue shares to BGZ shareholders and BGZ would be valued at the price agreed to by BNP Paribas Group and Rabobank Group. Should the bank be valued at lower price, the combined equity would be lower and consequently ROE would be higher. In our forecasts we do not include Rabobank Poland.

Figure 92. BNPP Polska and BGZ – Pro-Forma P&L Statement*, 2011-16E (Polish Zloty in million)

Pro-Forma	**2011**	**2012**	**2013**	**2014E**	**2015E**	**2016E**
NII	1,407	1,565	1,553	1,691	1,886	2,067
Net fees	410	444	426	431	450	474
Other revenues	212	274	286	249	260	276
Total revenues	**2,030**	**2,282**	**2,265**	**2,371**	**2,596**	**2,817**
Administrative costs	-1,537	-1,630	-1,550	-1,597	-1,634	-1,434
Pre-provisionion income	**492**	**652**	**716**	**774**	**962**	**1,383**
Net provisioning	-272	-424	-365	-355	-406	-464
Other revenues	2	0	-11	-5	-5	-5
Pre-tax profit	**223**	**228**	**340**	**414**	**551**	**914**
Tax	-55	-67	-77	-89	-110	-180
Minorities	0	0	0	0	0	0
Net profit	**168**	**161**	**262**	**325**	**441**	**734**
Loans	40,869	42,483	42,881	45,892	50,481	54,911
Deposits	31,824	37,007	37,387	38,984	42,882	46,543
Equity					6,558	6,771
Assets	55,887	58,078	56,894	59,701	64,967	70,096
ROE-BNPP	NA	2.0%	5.8%	5.1%	7.4%	8.9%
ROE-Pro forma	**NA**	**NA**	**NA**	**NA**	**NA**	**11.0%**

Note: To simplify comparison with other Polish banks, for which we do not have forecasts beyond 2016, we assume achievement of full cost synergies in 2016 (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. We have assumed that BNPP Polska would issue shares to BGZ shareholders and BGZ would be valued at the price agreed by BNP Paribas Group and Rabobank Group. Should the bank be valued at a lower price, the combined equity would be lower and consequently ROE would be higher.

Source: Company data, Citi Research estimates

Parity Estimates

We think BNPP Polska's shareholders will get c.34%-39% stake in the combined bank

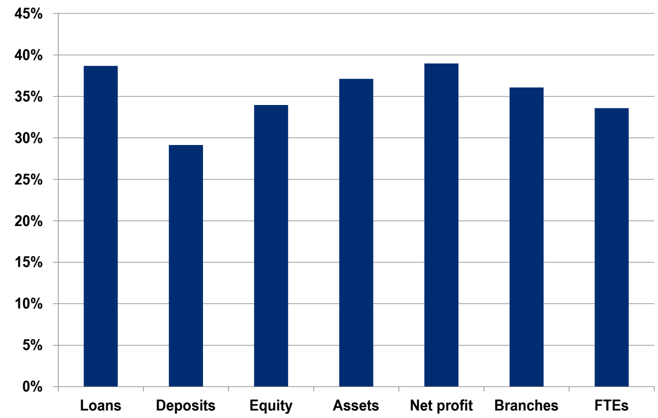
Taking into account 2013 data, the pro-forma share of BNPP Polska in the combined entity would be in the range of 29% (share in deposits) to 39% (the share in loans and net profit). We would expect the parity to be based, as in previous mergers in Poland, on the bank's earnings and equity, implying that BNPP Polska's shareholders would get a c.34%-39% stake in the combined bank.

Figure 93. BNPP Polska and BGZ – Comparison of the Key Balance Sheet, P&L and Business Data, 2013 (Polish Zloty in million)

	BNPP	BGZ	Sum	BNPP's share
Loans	16,583	26,298	42,881	39%
Deposits	10,894	26,493	37,387	29%
Equity	1,805	3,509	5,314	34%
Assets	21,117	35,777	56,894	37%
Net profit	102	160	262	39%
Branches	224	397	621	36%
FTEs	2,794	5,527	8,321	34%

Source: Company data, Citi Research

Figure 94. BNPP Polska and BGZ – Share of BNPP Polska in the Potential Combined Bank, 2013 (Polish Zloty in million)



Source: Company data, Citi Research

Other M&A Options?

We cannot rule out intra-group mergers

Apart from external acquisitions, we cannot rule out intra-group mergers, for example further integration with BNP Paribas' Polish branch or the consolidation of the Polish branch of Sygma Banque. We note that some other banks controlling more than one bank in Poland have been forced by the regulator to merge their Polish banking subsidiaries. We also note that Credit Agricole, another bank operating in Poland through a Polish bank and a branch, has decided to merge the activities of both entities.

Industry Overview

Sector Key Data

Figure 95. Polish Banks – Sector Key Data, 2001-2013 (Polish Zloty in million)

	NII	Revenue	Costs	GOP	Provisions	Pre-tax Profit	Net Profit	Loans	Assets	Deposits	Equity
2001	13,814	27,147	16,548	10,599	-5,299	5,300	3,917	226,832	448,201	271,000	35,951
2002	14,389	26,849	16,990	9,858	-6,527	3,331	1,983	238,718	443,122	261,095	38,477
2003	13,656	25,020	16,932	8,088	-3,987	4,101	2,064	258,707	463,289	269,844	38,124
2004	14,972	27,163	17,535	9,628	-2,295	7,333	6,663	266,807	509,756	281,570	40,005
2005	16,723	27,401	15,751	11,650	-1,514	10,136	8,585	238,021	547,175	301,976	51,592
2006	18,723	30,771	16,824	13,947	-1,552	12,396	10,306	291,953	618,714	336,809	55,394
2007	21,670	36,471	19,093	17,378	-1,470	15,908	13,039	384,170	712,576	374,720	64,169
2008	26,402	41,910	21,668	20,242	-4,854	15,389	12,555	531,462	926,430	439,394	77,359
2009	26,376	49,777	27,359	22,418	-12,306	10,112	8,278	641,226	1,057,376	567,169	103,800
2010	30,899	52,684	28,011	24,673	-10,466	14,206	11,420	698,532	1,159,358	620,363	115,980
2011	34,979	57,039	29,260	27,779	-8,185	19,594	15,539	800,699	1,294,715	698,598	128,903
2012	35,480	58,483	30,359	28,125	-8,852	19,272	15,524	810,403	1,352,974	723,984	146,611
2013	34,141	56,418	30,204	26,214	-7,563	19,053	15,426	838,737	1,407,180	775,400	153,898

Source: NBP, KNF and Citi Research

Figure 96. Polish Banks – Sector Key Ratios, 2001-2013 (Percentage)

	NIM	C/I	Cost/Assets	Risk cost	ROE	ROA	LDR	Equity/Assets	Growth yoy			
									Loans	Assets	Deposits	Equity
2001	3.22%	61.00%		2.34%	10.90%	0.90%	83.70%	8.00%				
2002	3.23%	63.30%	-3.81%	2.80%	5.20%	0.40%	91.40%	8.70%	5%	-1%	-4%	7%
2003	3.01%	67.70%	-3.74%	1.60%	5.40%	0.50%	95.90%	8.20%	8%	5%	3%	-1%
2004	3.08%	64.60%	-3.60%	0.87%	16.70%	1.40%	94.80%	7.80%	3%	10%	4%	5%
2005	3.16%	57.50%	-2.98%	0.60%	16.60%	1.60%	78.80%	9.40%	-11%	7%	7%	29%
2006	3.21%	54.70%	-2.89%	0.59%	18.60%	1.80%	86.70%	9.00%	23%	13%	12%	7%
2007	3.26%	52.40%	-2.87%	0.43%	20.30%	2.00%	102.50%	9.00%	32%	15%	11%	16%
2008	3.22%	51.70%	-2.64%	1.06%	16.20%	1.50%	121.00%	8.40%	38%	30%	17%	21%
2009	2.65%	50.80%	-2.76%	2.10%	8.20%	0.90%	113.10%	9.80%	21%	14%	29%	34%
2010	2.79%	53.20%	-2.53%	1.56%	10.40%	1.00%	112.60%	10.00%	9%	10%	9%	12%
2011	2.85%	51.30%	-2.38%	1.09%	12.70%	1.30%	114.60%	10.00%	15%	12%	13%	11%
2012	2.68%	51.90%	-2.29%	1.10%	11.30%	1.20%	111.90%	10.80%	1%	4%	4%	14%
2013	2.48%	53.54%	-2.15%	-0.90%	10.02%	1.10%	108.17%	10.94%	3%	4%	7%	5%

Source: NBP, KNF and Citi Research

2013 in the rear-view mirror

The key sector trends

In our opinion 2013 was a year of NIM management and usage of accumulated reserves

- **Changes in the asset mix** was driven by:

  – a gradual repayment of low-margin FX mortgages (the FX-adjusted drop in stock of FX-denominated mortgages reached 5%) – the process may further accelerate in coming years due to an increased number of borrowers buying new flats and selling the old ones, funded by FX mortgages;

  – selective banks' approach to zloty mortgage lending – only banks with access to cheap funding were active in mortgage lending;

  – rising production of high-margin consumer loans – given the rising competition both from universal banks (cross-selling consumer loans to own clients) and institutions specialized in consumer lending (benefiting from regulatory easing) we think the current market leaders may have problems with maintaining the pace of growth.

- **Deposit re-pricing** – The most successful strategy was to shorten maturity of funding through increasing the share of corporate term deposits (on average shorter-term than retail deposits) or current and saving retail accounts (current accounts usually have interest rates close to zero, the rate on savings accounts is floating – we note however that the EU Payment Service Directive led to lengthening the process of saving account re-pricing). Despite different strategies implemented by Polish banks to minimise the negative impact of lower rates on revenues, net interest income (NII) of Polish commercial banks declined in 2013 by 3%.

- **Broadly flat net fees,** negatively affected by lowered interchange fee and constant client migration to cheaper on-line channels, and positively affected by gradually rising fees from sale of investment products (mainly third-party products, including structured products and investment funds).

- **Usage of accumulated reserves**, e.g.: booking gains on bonds, gains on subsidiaries and releasing of superfluous IBNR provisions allowed to offset the negative impact of lower rates in net interest income.

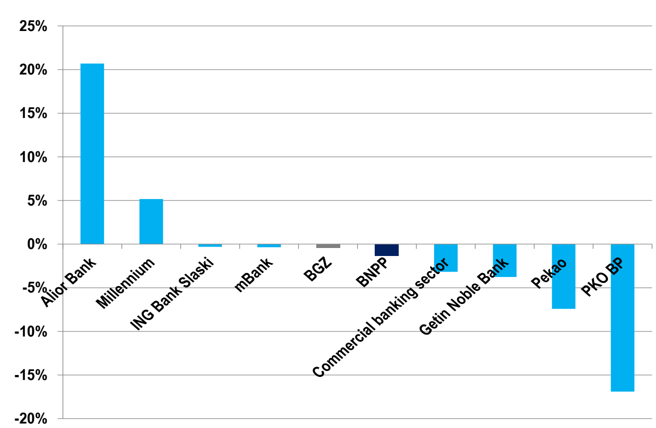
- **Lower-than-Expected Provisioning**:

  – In corporate loans the deterioration in asset quality happened mainly in 2012, when the companies from construction sector were affected by losses on big contracts; in 2013 the biggest companies haven't faced significant financial difficulties but the quality of SME loans deteriorated because smaller companies are more exposed to macro trends.

  – In consumer loans, post the 4-year tightening cycle, the quality of the new production was so good that the deterioration in macro conditions hasn't impacted the loans quality; the sector NPL ratios were also positively affected by sale of NPLs to debt collectors.

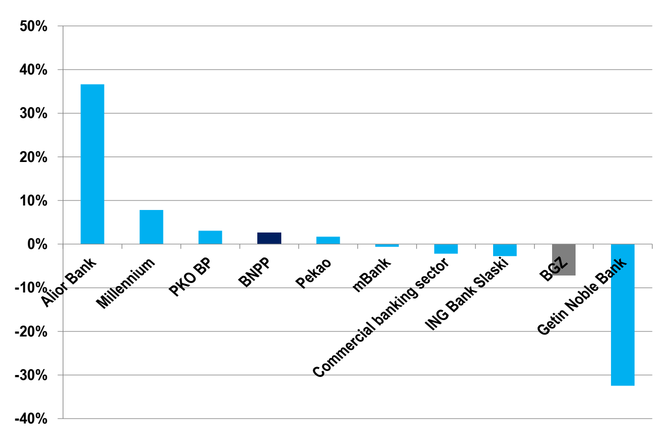
  – Reported asset quality of mortgage loans remains solid but to some extent it may be affected by the banks' passive approach to non-performing loans – we don't know whether NPL and coverage ratios will not have to be increased when banks start the more active overdue loan collection or start selling mortgage NPLs to companies specialized in debt collections (the first big ticket sale of mortgage loan was announced on April 1, 2014).

Figure 97. Polish Banks – Yoy Change of Net Interest Income, 2012-2013 (Percentage)



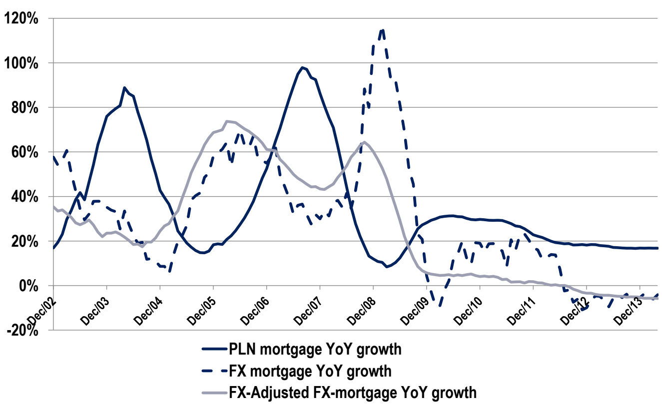
Source: Company reports, KNF and Citi Research

Figure 98. Polish Banks – Yoy Change of Net Fees, 2012-2013 (Percentage)



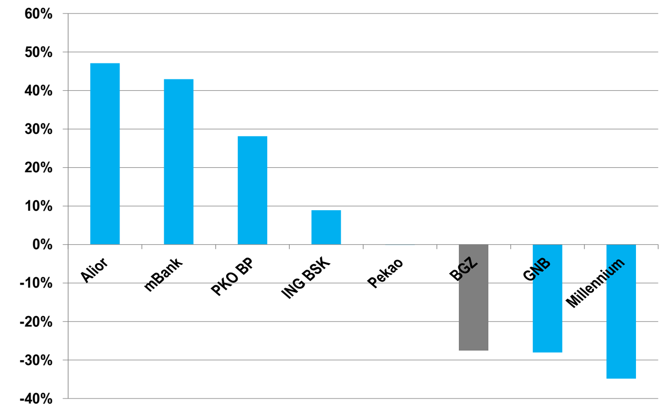
Source: Company reports, KNF and Citi Research

Figure 99. Polish Banks — Mortgage Yoy Growth, Dec02–Apr14 (Percentage)



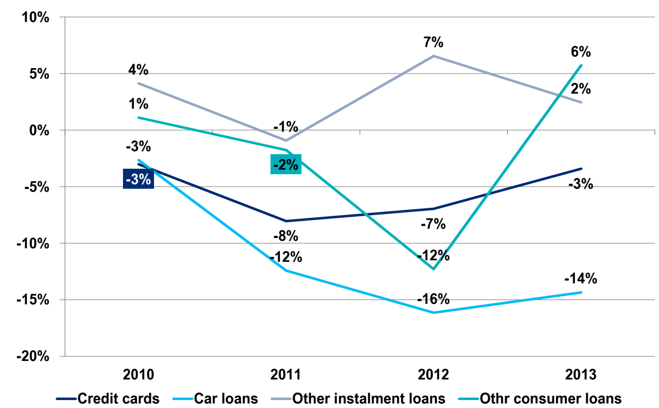
Source: NBP and Citi Research

Figure 100. Polish Banks – Yoy Change of Mortgage Loans Production, 2012-2013 (Percentage)



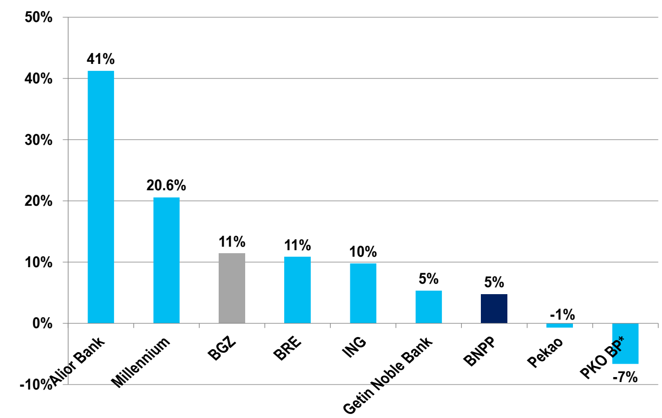
Source: Company data, Citi Research

Figure 101. Polish Banks – Yoy Change in Stock of Consumer Loans Value, 2010-2013 (Percentage)



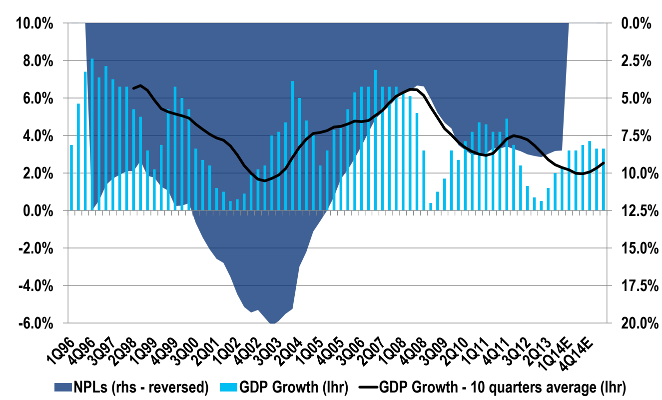
Source: KNF and Citi Research

Figure 102. Polish Banks – Yoy Change of Stock of Consumer Loans, 2013 (Percentage)



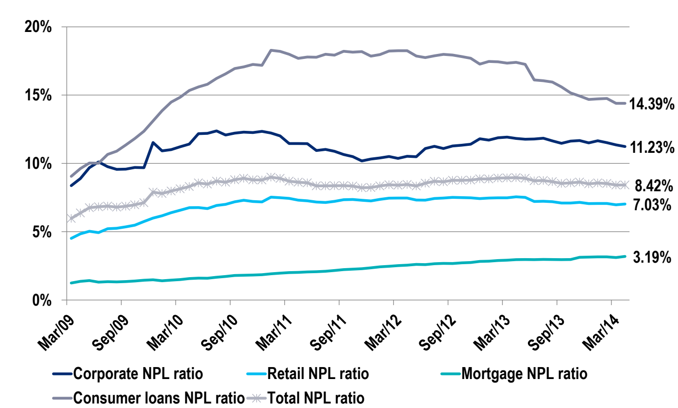
Source: Company data, Citi Research

Figure 103. Polish Banks – NPL Ratio vs. GDP, 1Q96-4Q14E (Percentage)



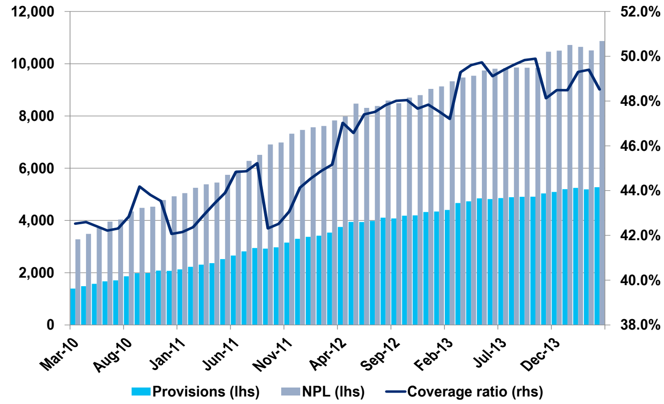
Source: NBP, GUS, Citi Economists and Citi Research

Figure 104. Polish Banks — NPL Ratio, Mar09 – Apr14 (Percentage)



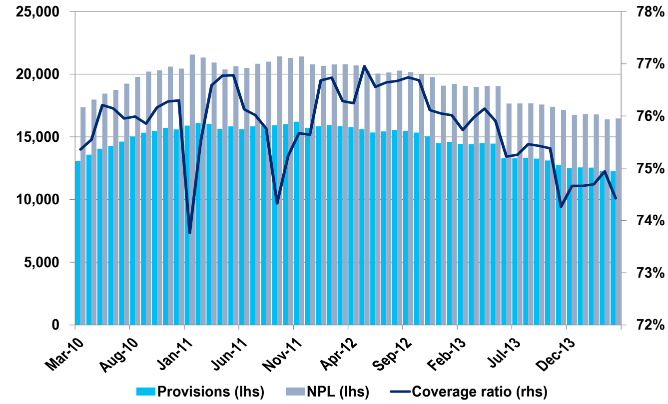
Source: KNF and Citi Research

Figure 105. Polish Banks – Mortgage Loans Coverage Ratio, Provisions and NPL, Mar 09 – Apr4 (Polish Zloty in million, Percentage)



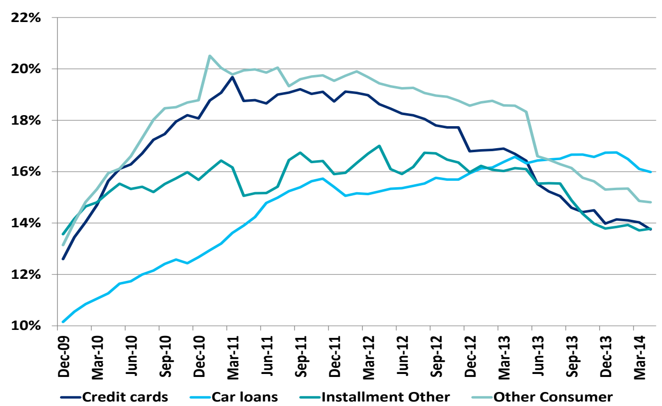
Source: NBP and Citi Research

Figure 106. Polish Banks – Consumer Loans Coverage Ratio, Provisions and NPL, Mar 09 – Apr14 (Polish Zloty in million, Percentage)



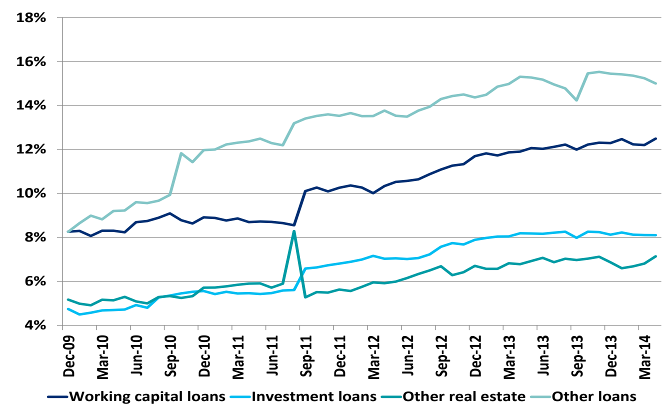
Source: NBP and Citi Research

Figure 107. Polish Banks – Consumer NPL Ratios, Dec 09 – Apr14 (Percentage)



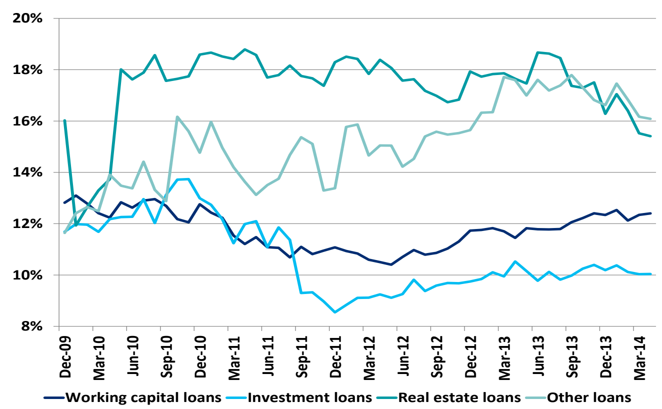
Source: KNF and Citi Research

Figure 108. Polish Banks – Other Retail NPL Ratios, Dec 09 - Apr14 (Percentage)



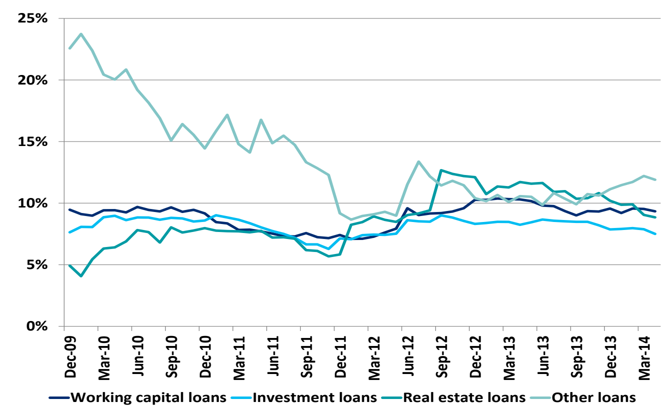
Source: KNF and Citi Research

Figure 109. Polish Banks – Mid-cap Companies' NPL Ratios, Dec 09 – Jan 14 (Percentage)



Source: KNF and Citi Research

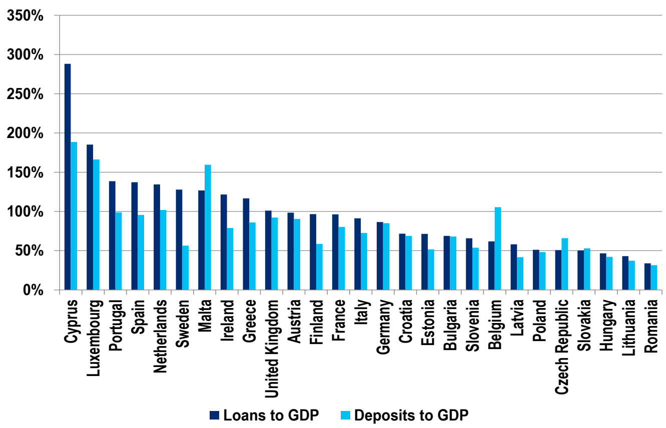
Figure 110. Polish Banks – Large Companies' NPL Ratios, Dec 09 – Jan 14 (Percentage)



Source: KNF and Citi Research

Medium-Term Growth Potential

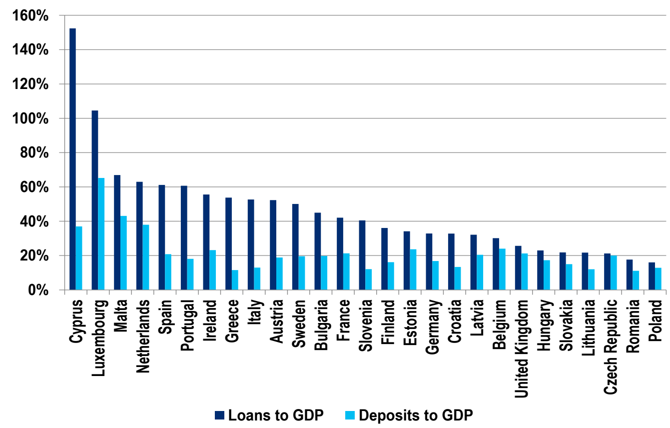
Figure 111. Europe – Loans* and Deposits* vs. GDP, 2013 (Percentage)



*To Non-financial institutions and Households

Source: ECB, Eurostat and Citi Research

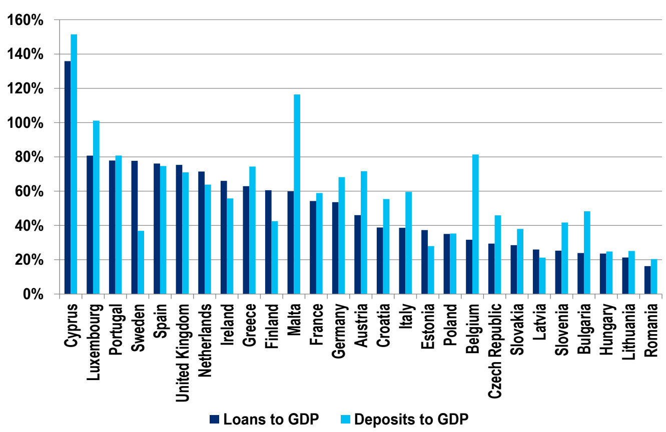
Figure 112. Europe – Corporate Loans* and Deposits* vs. GDP, 2013 (Percentage)



*Non-financial institutions

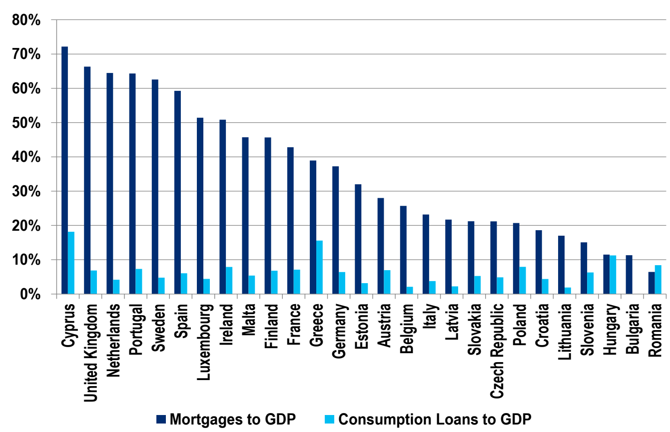
Source: ECB, Eurostat and Citi Research

Figure 113. Europe – Households Loans and Deposits vs. GDP, 2013 (Percentage)



Source: ECB, Eurostat and Citi Research

Figure 114. Europe – Mortgage and Consumption Loans vs. GDP, 2013 (Percentage)



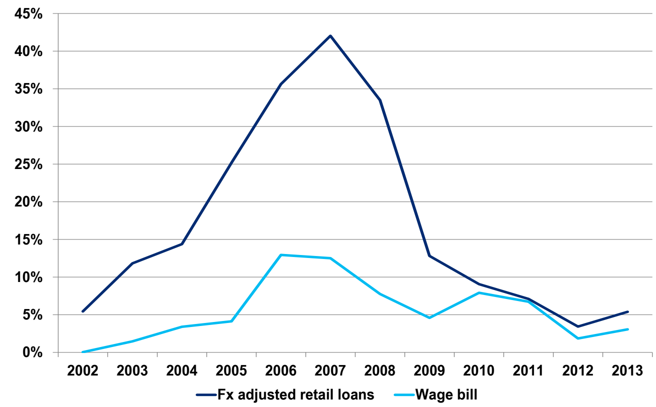
Source: ECB, Eurostat and Citi Research

Poland remains an under-banked country so we still see room for growth, especially in corporate and mortgage loans, where the gap between Poland and European peers is the biggest.

In our opinion, the trigger for loan growth will be improvement in sentiment of retail and corporate clients and thus Russia-Ukraine crisis is the main macro risk to our positive scenario

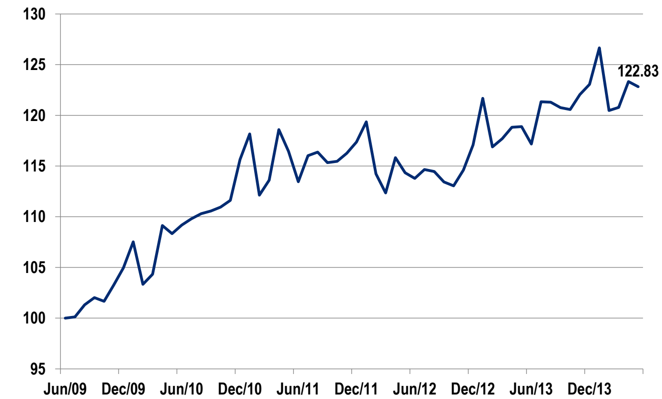
In our opinion, the trigger for loan growth will be the improvement in sentiment of retail and corporate clients. We think that declining macro risks globally, and especially in Europe, and rising confidence may prompt companies to start to invest first and hire next, while improvement in the labour market may encourage individual clients to consider buying new flats or houses. The potential escalation of the Russia-Ukraine conflict is the biggest risk to our positive scenario as a decline in companies' and individuals' confidence may undermine the emerging rebound in the Polish economy. We note that historically changes in wages have been highly correlated with retail loan dynamics (FX adjusted).

Figure 115. Polish Banks – FX-adjusted Growth in Retail Loans vs. Growth in Wage Bill, 2002-2013 (Percentage)



Source: NBP, GUS and Citi Research

Figure 116. Mortgage Availability Index of Open Finance and TVN BiS, Jan09-May14 (Points)



Source: Open Finance and TVN BiŚ

Citi economists forecast GDP growth to accelerate to 3.4% in 2014 and 3.6% in 2015

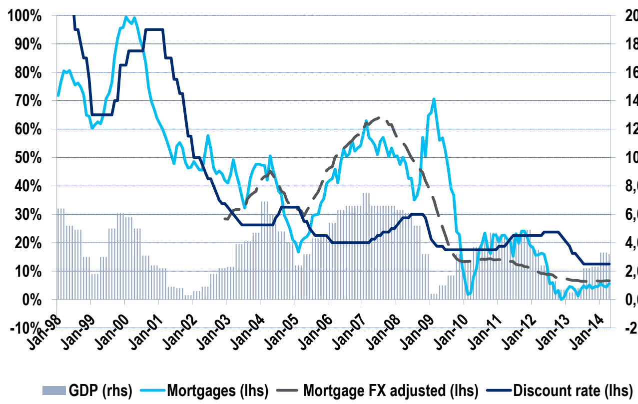
According to Citi's economists, the Polish economy will start to gradually recover (in 4Q13 Polish GDP expanded by 2.3% yoy vs. 2.2% yoy in 3Q13 and 0.7% yoy in 4Q12, hence quarterly growth has significantly accelerated). Citi's economists forecast GDP growth to accelerate to 3.4% in 2014 and 3.6% in 2015 (vs. 1.6% in 2013 and 2.0% in 2012).

Figure 117. Poland – Macro Data and Forecasts, 2006-2015F

POLAND	2006	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Summary Data										
Nominal GDP, US$ bn	342	426	534	433	470	517	490	516	554	589
Nominal GDP, local currency bn	1,060	1,177	1,276	1,345	1,417	1,528	1,595	1,632	1,698	1,796
GDP per capita, US$	8,969	11,185	13,994	11,347	12,210	13,404	12,721	13,416	14,395	15,321
Population, mn	38.1	38.1	38.1	38.2	38.5	38.5	38.5	38.5	38.5	38.5
Unemployment, % of labour force	14.9	11.2	9.5	12.1	12.4	12.5	13.4	13.4	12.4	11.7
Economic Activity										
Real GDP, % yoy	**6.2**	**6.8**	**5.1**	**1.6**	**3.9**	**4.5**	**2.0**	**1.6**	**3.4**	**3.6**
Real investment growth % yoy	16.1	24.3	4.0	-11.5	9.3	11.2	-4.0	-4.7	8.3	4.5
Real consumption growth % yoy	5.2	4.6	6.1	2.0	3.4	1.6	1.0	1.2	2.5	3.0
private consumption growth % yoy	5.0	4.9	5.7	2.1	3.2	2.6	1.3	0.8	2.7	3.2
Real export growth, % yoy	14.6	9.1	7.1	-6.8	12.1	7.7	3.9	4.6	5.9	6.5
Real import growth, % yoy	17.4	13.7	8.0	-12.4	13.9	5.5	-0.7	1.2	6.7	7.5
Prices, Money & Credit										
CPI, % yoy	1.4	3.9	3.4	3.7	3.2	4.6	2.6	0.8	1.4	2.6
CPI, % avg	1.0	2.5	4.2	3.5	2.6	4.3	3.7	0.9	0.8	2.5
Nominal wages, % yoy	5.0	9.1	10.5	4.2	3.6	4.9	3.5	2.6	5.0	4.8
Policy interest rate, %, eop	4.00	5.00	5.00	3.50	3.50	4.50	4.25	2.50	2.50	3.25
1 month inter-bank rate, %, eop	3.96	5.52	5.61	3.76	3.66	4.77	4.21	2.61	2.62	3.35
Long-term yield, %, eop	5.20	5.93	5.46	6.24	6.07	5.91	3.73	4.34	4.20	4.80
PLN/US$, eop	2.90	2.46	2.98	2.87	2.96	3.41	3.10	3.02	3.15	2.94
PLN/US$, avg	3.10	2.76	2.39	3.10	3.01	2.96	3.25	3.16	3.06	3.05
PLN/EUR, eop	3.83	3.58	4.17	4.11	3.96	4.42	4.09	4.15	4.28	4.09
PLN/EUR, avg	3.89	3.78	3.52	4.33	3.99	4.12	4.19	4.20	4.22	4.18

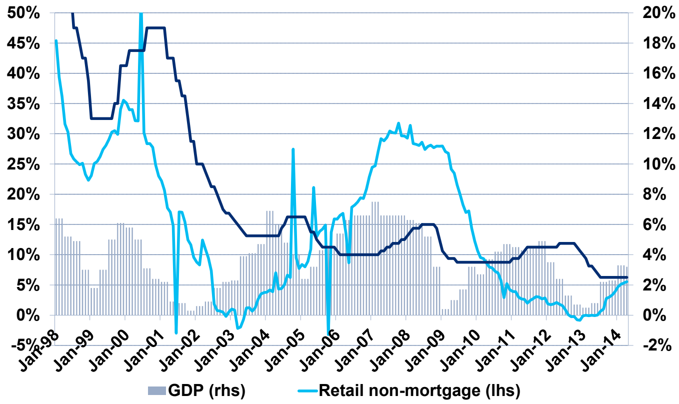
Source: National Statistics Office, Citi Research (economists' forecasts)

Figure 118. Polish Banks – Mortgage Loans Growth vs. GDP Growth and Interest Rate, Jan98-Apr14 (Percentage)



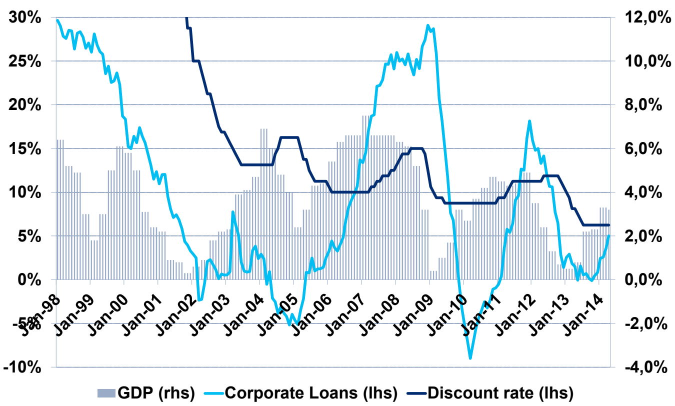
Source: NBP, GUS and Citi Research

Figure 119. Polish Banks – Consumer Loans Growth vs. GDP Growth and Interest Rate, Jan98-Apr14 (Percentage)



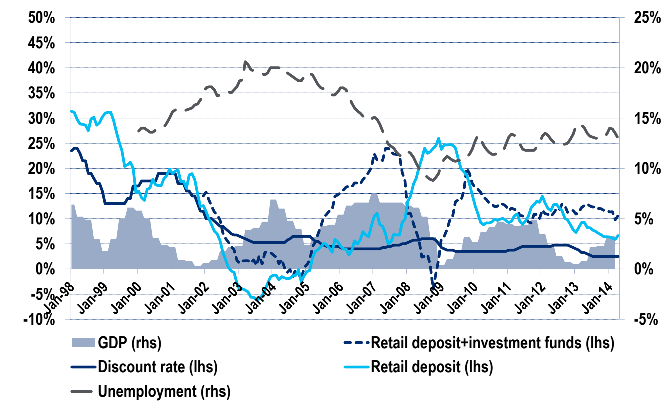
Source: NBP, GUS and Citi Research

Figure 120. Polish Banks – Corporate Loans Growth vs. GDP Growth and Interest Rate, Jan98-Apr14 (Percentage)



Source: NBP, GUS and Citi Research

Figure 121. Polish Banks – Retail Deposits Growth vs. GDP Growth, Unemployment and Interest Rate, Jan98-Apr14



Source: NBP, GUS and Citi Research

In 2014 we think the highest growing segment will be zloty-denominated mortgages

Historically dynamics in corporate lending tend to lag GDP growth dynamics so we expect an acceleration in corporate lending at the end of 2014 and at the beginning of 2015. In 2014 we think the highest growing segment will be zloty-denominated mortgages rising c15%-20% yoy (vs. +17% yoy in 2013) while the decline in FX-denominated mortgages will accelerate and will reach c7% yoy and the growth in total mortgages will be in the range of between 4% and 6%. We forecast retail non-mortgage loans to rise c.7-10%.

Consolidation and Repositioning

2013 was the year of several acquisitions

2013 was the year of several M&A transactions:

- Getin Noble Bank acquired:
  - DnB Nord's banking business in Poland (excluding FX mortgages),
  - the small Dexia Bank Polska and
  - the private banking business of DZ Bank Polska;

- PKO BP purchased Polish assets of Nordea, including the bank, the leasing company, the life insurer and the portfolio of the loans to Polish blue-chips held on Nordea AB's balance sheet (the transaction completed in April 2014);
- BNP Paribas Group agreed with Rabobank on the acquisition of BGZ.

At the beginning of 2014 Deutsche Bank merged its two Polish banks. We note also that Carlo Tassara Group is in the process of a sale of its 33% stake in Alior.

We think consolidation in Polish of banking sector will continue and we view banks outside the Top 10 as being natural candidates for M&A, but due to potential changes in the strategy of some other strategic investors, often forced by their capital constraints, we don't exclude the possibility that Top 10 banks will also be put up for sale. The results of EU asset quality reviews (AQRs) and stress tests may trigger the next wave of the consolidation in the Polish banking industry as the better transparency regarding the bank capital strength may prompt the weakest to decide to sell and the strongest to buy Polish banking assets, in our view.

We don't expect consolidation to lead to materially lower competition in the sector as in our opinion the banks staying in Poland will continue to strive for the market share in rising market and some of them may favour growth over current profitability.

2014 and Beyond Investment Themes

We think that 2014 will be a year of improving macro conditions and rising lending hence we prefer banks that are well equipped for growth – e.g., well-funded and well-capitalised banks. In our opinion, the main themes in 2014 will be:

Regulation, legislation and litigation risks

- Regulation, legislation and litigation risks, sometimes creating new business opportunities, e.g.:
  - CRR/CRD 4 implementation is having a limited impact on capital ratios but in the longer term should force banks to increase the share of long-term funding, including mortgage-backed securities (the banks with mortgage bank subsidiaries are better positioned than the rest, in our view);
  - lower interchange fee since July 2014 - only the banks with a rising number of active clients are able to offset the lower fees by higher volumes;
  - EU-wide asset quality review (AQR) and stress tests (the increased transparency should enable a better comparison of asset quality in different banks, but due to different business models, including different approaches to selling NPLs to companies specialising in debt collection, comparability will be limited);
  - the potential implementation of a bank resolution regulation and a new contribution to the resolution fund (if based on RWAs or non-insured funding it would less negatively impact the earnings of banks with high ROA);
  - the new KNF recommendation on bancassurance, affecting the business model of consumer lending in the sector (the more innovative banks, which quickly find a new pricing model, should benefit); and
  - a risk of rising fines from UOKiK (the antimonopoly office) and legal claims from clients, suing banks regarding FX mortgages and multi-year investment products.

A launch of the first big-ticket sales of non-performing mortgage loans

- A launch of the first big-ticket sales of non-performing mortgage loans – the prices in these transactions may become a benchmark for assessment of the prudency of banks' provision coverage.

Increasing capital returns to shareholders

- Increasing capital returns to shareholders.

Outperformance of "provincial banks" over "big city banks"

- Outperformance of "provincial banks" over "big city banks" (driven by macro recovery when the difference between the strongest and the weakest regions tends to shrink) due to client and branch network structure.

Gradually rising revenues from investment products

- Gradually rising revenues from investment products – banks haven't yet started to push the sales of investment funds to mass clients but we have seen signs of rising sales of third-party investment products (including investment funds and structured products – Polish Financial Services - Investment Products – Trust Is the Name of the Game);

Deteriorating spreads

- Deteriorating spreads, partially offsetting the positive impact of rising (starting in 2H14) interest rates: lower retail lending spreads due to rising competition in consumer and mortgage lending, lower corporate lending spreads due to lower risk profile, and higher funding costs due to increased competition for deposits and rising share of longer-term funding.

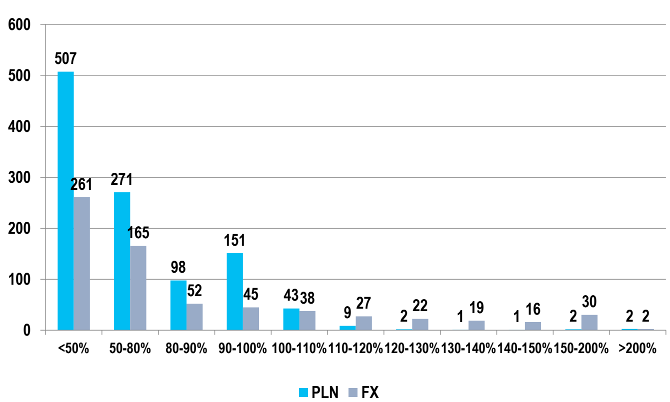
Two Sides of Mortgage Lending

Will "Mortgage Prisoners" Be Freed?

Imprisoned in your own house

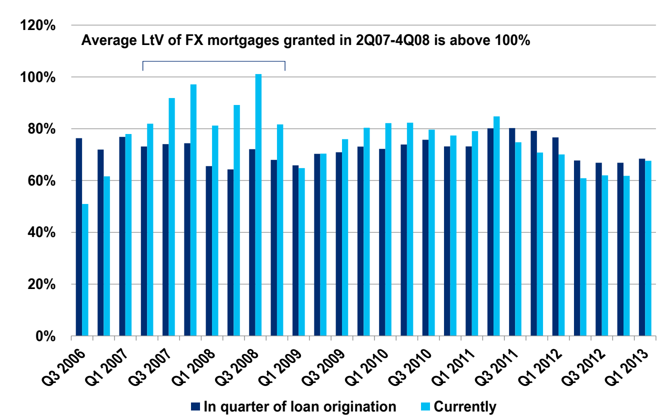
We view the high number of households with negative equity on their mortgage loans as one of the main headwinds for the Polish mortgage market. According to a KNF (Polish FSA) survey among banks, about 213,000 of loans (c12% of total) have a loan-to-value (LTV) ratio above 100% (out of which 58,800 are zloty-denominated and 154,200 are FX-denominated loans). For 132,500 loans (16,000 zloty and 116,500 FX-denominated) the LTV ratio exceeds 110%. The main driver of this has been zloty weakness against CHF and EUR (vs. 2008 peak levels) and declines in flat prices in 2008-13.

Figure 122. Polish Banks – Loan-to-Value Structure (by Number of Loans), 2013 (in thousand)



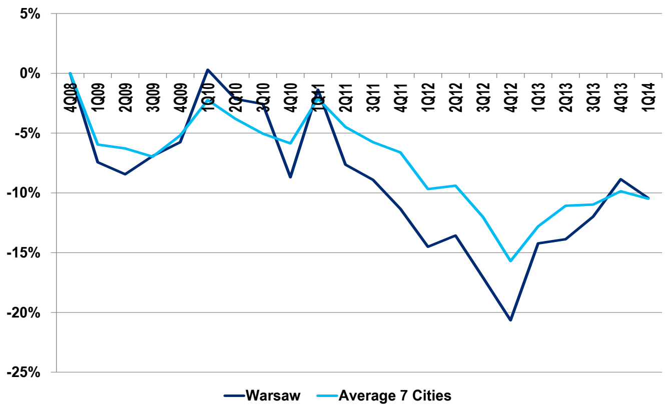
Source: NBP and Citi Research

Figure 123. Polish Banks – Average Loan-to-Value Ratio CHF Denominated Housing Loan by the Quarter of Origination (Percentage)



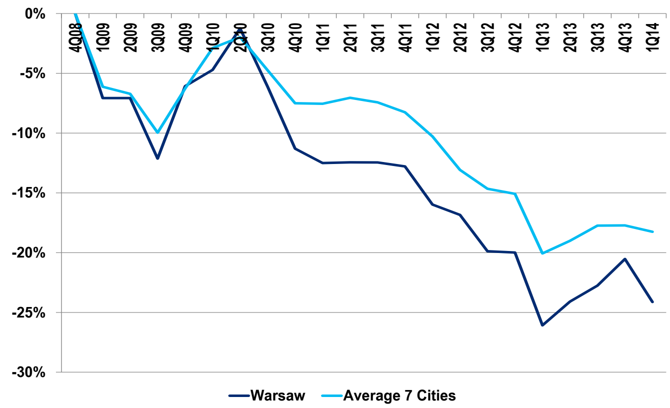
Source: NBP and Citi Research

Figure 124. Poland – Accumulated Decline in Flat Prices (Transaction Prices - Primary Market), 1Q08-1Q14 (Percentage)



Source: NBP and Citi Research

Figure 125. Poland – Accumulated Decline in Flat Prices (Transaction Prices - Secondary Market), 1Q08-1Q14 (Percentage)



Source: NBP and Citi Research

Negative equity on more than 213,000 mortgage loans is a key headwind for the Polish mortgage market

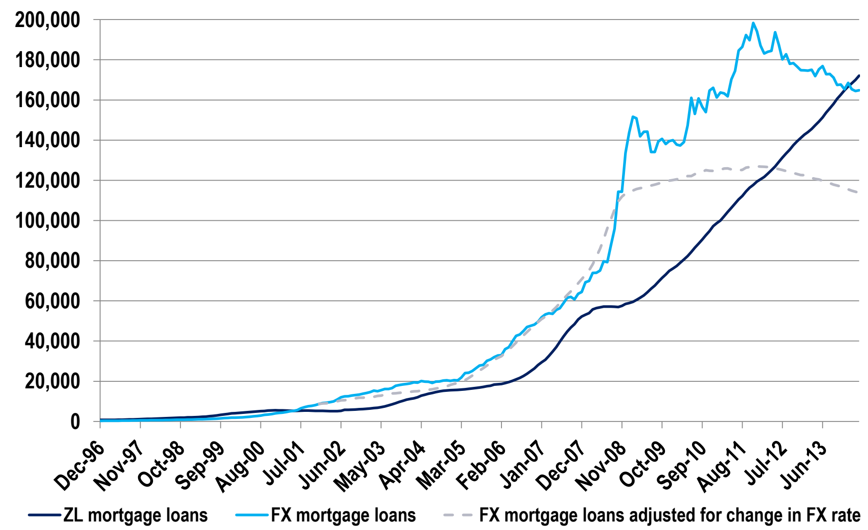
The average value of a FX loan with a LTV above 100% is about Zl 402k. This means that for households that have 10% negative equity will owe c Zl 40k more than the value of their house. In our opinion, many of households that are in such a situation cannot afford to pay that amount to move house. It means that even if such a household's financial situation could afford to make payments on a larger mortgage to buy a new bigger flat/house, they have to stay in the old flat/house because they cannot get rid of the old real estate investment with negative equity.

Even clients with a LTV below 100% may be reluctant to exchange their flat/house for a new one because the transaction would mean realising an FX loss on the FX mortgage taken to fund the purchase (we note that due to the lack of offers of new FX mortgages, clients are not able to roll-over their FX short position through taking a new FX loan). On average we estimate that clients looking to upgrade their housing would have to realise an FX loss of between Zl c30,000 (on loans granted in 2005) and c Zl150,000 (on loans granted in 2008); this may be difficult from a psychological perspective for many households (the average loss is about twice higher than the average savings per household).

Thus between 132,499 (the number of mortgage loans with a LTV above 110%) and 677,515 (the total number of FX loans) of households are effectively shut out of the mortgage market because they have negative equity and/or the necessity to realise losses on their FX debt.

That said, accelerated shrinkage of FX mortgages stock (FX-adjusted FX mortgages declined -5.3% yoy in December 2013 vs. -3.4% yoy in December 2012) suggests that despite losses on FX, some creditors have started to pay back FX mortgages (given 25-30 years' maturity of mortgage loans, assuming no new production, the stock of loans should shrink by no more than 4% per annum). We think that due to increased housing needs (enlarged family, children growing up) on the one hand and declining prices of apartments and houses on the other hand, a rising number of FX debtors may decide to realise FX loan losses and replace their flats for bigger ones, taking a new mortgage in zloty.

Figure 126. Polish Banks – Mortgage Loans, Dec96-Apr14 (Polish Zloty in million)

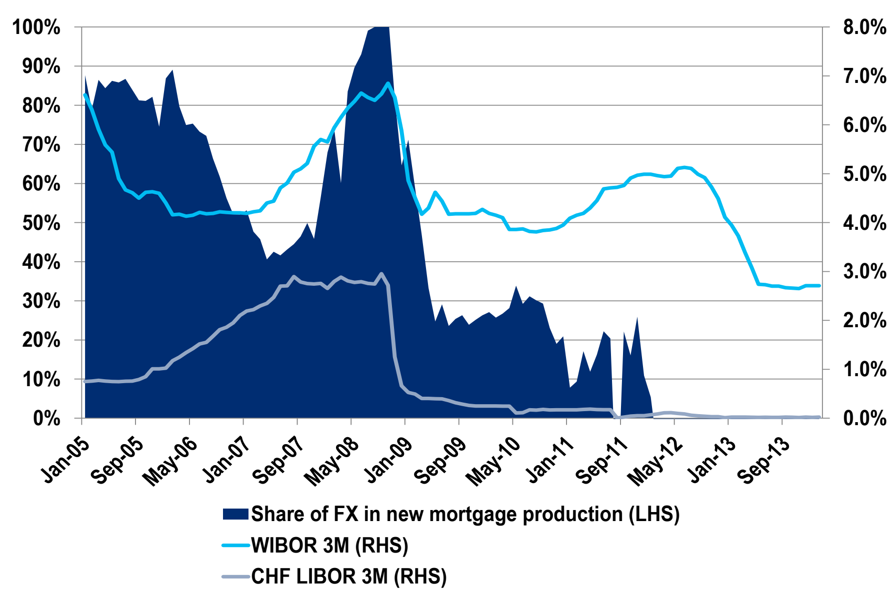


Source: NBP and Citi Research

We think that the key element in clients' decision process will be the CHF/PLN rate. Material CHF weakness vs. PLN might trigger FX loan re-payment while CHF appreciation (for example due to zloty weakness vs. other major currencies) may be a hurdle to the process.

Lower zloty rates encourage replacement of FX loans by zloty-denominated mortgages. We note that WIBOR 3M (2.71% currently) hasn't declined to as low level as 3M CHF LIBOR in 2005 (below 1%), when low Swiss interest rates triggered a boom in CHF mortgages in Poland, but it is as low as CHF LIBOR was at end of 2007, when the sale of mortgage loans peaked.

Figure 127. Polish Banks – WIBOR 3M, CHF LIBOR 3M vs. Currency Structure of New Mortgage Production, Jan05-Feb14 (Percentage)



Source: stooq.pl, NBP and Citi Research

We expect repayment of FX mortgages to accelerate in coming years, positively affecting banks' profitability as, given the increased cost of funding and a normalised level of credit risks, these loans look to be barely profitable for banks.

Litigation Risks Related to Legacy Assets

Clients negatively impacted by zloty weakness may blame banks for their problems and accuse banks for mis-selling.

We note a recent rise in litigation against banks for past selling of FX-denominated mortgages. The clients claim that they weren't properly informed about FX risks or claim that the interest rate or FX rate was illegally set by the banks (Polish Financial Weekly - Will Clients Sue Polish Banks for Unfair FX Rates?).

We think, paradoxically, that an improvement in the macro environment and the positive outlook on the wage bill and real estate prices, triggering an interest in changing flats/houses for bigger ones, may lead to an increased number of legal actions against banks started by clients that were able to pay (practically unchanged vs. 2008) monthly installments but find themselves unable to cover in cash the negative equity on their FX mortgages (the surplus of the loan value, increased due to zloty depreciation, over the flat/house value).

Given the upcoming three elections within 1.5 years in Poland, we cannot rule out the risk that the problems of FX borrowers become a political topic in the future. We note that one hearing in the Senat (the Upper House of Polish Parliament) fully focused on the issue of FX mortgages but we underline that as yet none of the strongest political parties has included that issue into its political agenda.

Time for Marathon Runners

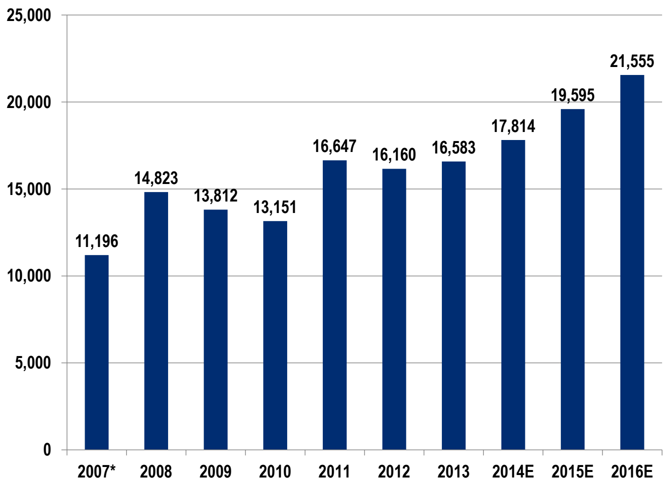
Summing up, in the coming years we expect a gradual improvement in sector profitability, driven by a gradual reduction of the stock of thin-margin FX mortgages and accelerated lending positively affected by improving sentiment and rebounding macro. Simultaneously, due to rising regulation and emerging litigation risk, some banks applying the most aggressive sale strategies may be forced to change their approach. In other words, we think the coming years should be very favourable to banks targeting long-term growth based on building relationships with clients over those looking to only maximise short-term profits.

Financial Forecasts

Balance Sheet

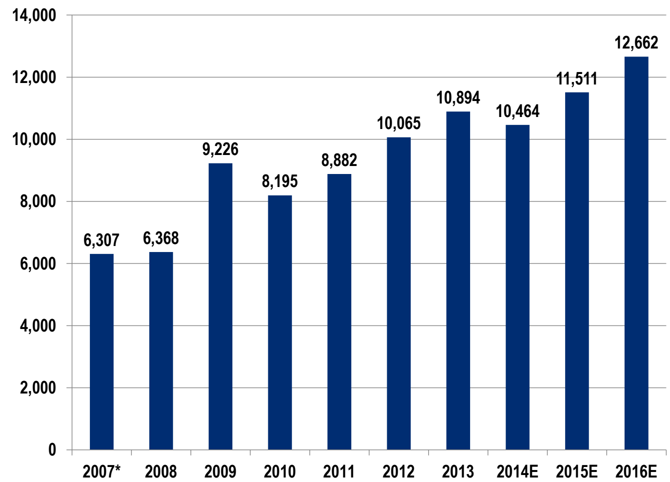
Loans and Deposits

Figure 128. BNPP Polska – Loan Growth, 2007-2016E
(Polish Zloty in million)



Source: Company data, Citi Research estimates

Figure 129. BNPP Polska – Deposit Growth, 2007-2016E
(Polish Zloty in million)



Source: Company data, Citi Research estimates

Shareholders' Equity

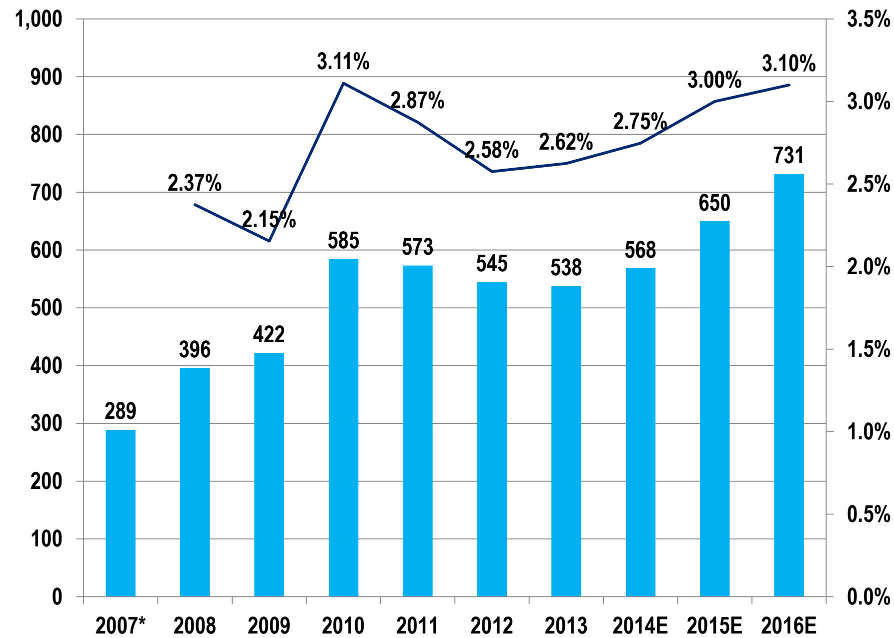
In July 2009 the bank was merged with Dominet Bank. BNPP Polska (then named Fortis Bank Polska) issued 5.2m new shares to Dominet SA, the Dominet Bank shareholder. The difference between Dominet Bank's net asset value (Zl 133m) and the nominal value of issued shares (Zl 157m), i.e. Zl -24m, was booked in the bank's equity.

Apart the merger with Dominet Bank, the bank's capital was increased by Zl 441m in 2009 (2.1m new shares issued at Zl 209) and by Zl 260m in 2012 (4.6m new shares issued at Zl 56.90).

P&L Forecasts

Net Interest Income

Figure 130. BNPP Polska – Net Interest Income and Net Interest Margin, 2007-2016E



Source: Company data, Citi Research estimates

We note that in 2012 and 2013 net interest income was positively affected by income on the settlement of a prepayment of some credit facilities from BNP Paribas Group (Zl 23.2m and Zl 19.1m, respectively). NII in 2013 also reflected:

- re-pricing of funding from BNP Paribas Group (Zl -18m);
- the material improvement in the spread on consumer loans (to a large extent due to lower rates as consumer loans have fixed interest rates), lower average subordinated loans and credit facilities from the parent group as well as the one-off income from Vistula Group restructuring (Zl 8.7m).

Non-Interest Income

Figure 131. BNPP Polska – Fee Estimates, 2007-2014E

Breakdown of fee income	2007	2008	2009	2010	2011	2012	2013	2014E
Custody and securities	3	2	3	2	1	2	1	0
Transfers	53	55	59	62	61	58	58	58
Guarantees	15	15	16	18	20	21	22	24
Lending fee	26	35	33	27	24	26	30	32
accrued	20	24	27	20	15	15	16	
booked up-front	6	11	6	7	8	12	14	
Derivatives	16	48	5	3				
Intermediary	11	4	2	2	2	1	3	2
Cards	12	12	18	21	21	23	24	21
Insurance		0	27	47	29	26	23	24
Asset management	2	8	4	5	4	3	3	4
Other	12	11	11	28	23	26	34	29
Total fee income	**150**	**191**	**178**	**215**	**184**	**186**	**198**	**194**
Custody and securities	-1	-1	0	0	0	0	0	0
Cards	-4	-8	-10	-13	-11	-11	-16	-15
Cash and transfers	-4	-1	-3	-2	-2	-2	-1	-1
Franchise branches		0	-9	-19	-10	-9	-10	-13
Insurance			-1	-2	-2	-2	-3	-2
Other	-1	-2	-5	-20	-18	-16	-19	-21
Total fee costs	**-10**	**-12**	**-29**	**-56**	**-43**	**-40**	**-49**	**-53**
Net fees	**140**	**178**	**149**	**159**	**140**	**146**	**150**	**142**

Source: Company data, Citi Research estimates

In 2013 the bank's net fees grew 2.6% yoy driven by higher lending and factoring fees as well as the release of some provisions related to card business. In contrast to many peers, the bank hasn't changed its bancassurance accounting in 2013. Insurance commissions from products with insurance premium paid in advance are booked in net interest income over the life of the product while commission from products with monthly paid fees is booked in fee income.

In 2008, the bank's results were affected by provisions on liabilities from FX options, including Zl 34.6m in retail (SMEs) and Zl 174m in corporate banking. In total provisions amounted to Zl 208.6m, out of which Zl 104.3m on overdue liability and Zl 104.3m due to credit risk. In 2009 the provisions related to FX options declined to Zl 26m.

In 2013 the other and financial income was positively affected by gains from sale of available for sale securities and the reimbursement of interest from tax office, related to VAT paid earlier on insurance of leased cars (Zl 4m).

Administrative Costs

The bank has implemented two cost savings programmes:

- The first programme was part of the recovery plan, in 2009, when the bank reduced headcount by 263 (due to that the bank created in 2009 a Zl 20m restructuring reserve)

"Triathlon" project targeted Zl 87m annual savings

- The second reorganisation and cost optimisation programme ("Triathlon" project) was initiated in 2Q12; its target was to reduce annual costs by Zl 87m; annually; in the first stage, mostly implemented in 2012, the focus was on the optimisation of back office and head office functions; in the second stage the reorganisation and simplification of functions related to direct contact with customers was addressed; within the restructuring program 303 FTEs were made redundant and 60 internally replaced.

In 2013 general costs dropped due to implemented savings while the yoy decline in staff costs was mainly caused by the high base

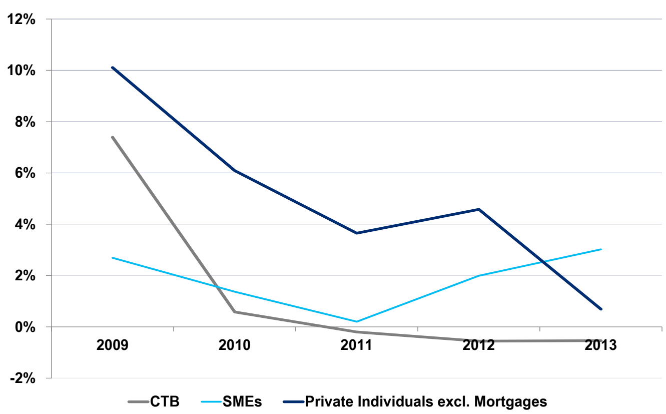
The implemented saving plan led to lower rent, IT and telecommunication costs and general costs declined -4% yoy while depreciation and amortization dropped 24% yoy in 2013. The decline in labour costs (-4.6% yoy) was caused mainly by a release of the provision for headcount restructuring (Zl +4.4m in 2013 vs. Zl -13m impact of provision created in 2012) and the underlying costs grew 1.3% yoy due to higher bonuses and full-year consolidation of BNP Paribas Factor.

BNPP Polska participates in the group's global saving program "Simple & Efficient" and intends to achieve around Zl 26m of annual cost savings through the end of 2015.

According to the bank's medium-term financial plan administrative costs should grow less than inflation. Given the bank's continuous focus on cost efficiency, as demonstrated by the launch of the saving program, we forecast broadly flat yoy costs in the next three years.

Net Provisioning

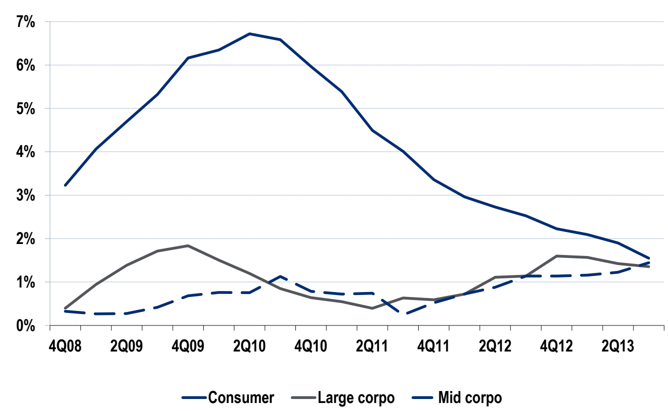
Figure 132. BNPP Polska – Cost of Risk*, 2009-2013 (Percentage)



*unconsolidated data

Source: Citi Research

Figure 133. Polish Banks – Cost of Risk, 4Q08-3Q13 (Percentage)



Source: NBP and Citi Research

Figure 134. BNPP Polska – Cost of Risk Estimates (Percentage)

	Assumed cost of risk by product				Implied cost of risk
	Mortgage loans	Other retail loans	Corporate loans	Micro & SMEs	
Sector (2009-9M13)*	0.21%	4.16%	0.95%	NA	
BNPP Polska (2009-2013)**	**0.23%**	**5.02%**	**1.35%**	**1.85%**	
BNPP Polska (assumption of sustainable cost of risk)	**0.20%**	**2.50%**	**0.30%**	**1.50%**	**0.85%**
Estimated share (2016)	30%	17%	36%	17%	

Note: * Sector mortgage cost of risk excluding GNB. ** Unconsolidated

Source: Company reports, NBP and Citi Research estimates

In 2010-2013, BNPP Polska's cost of risk in mortgages was slightly above the sector average, while in other retail loans and corporate loans it was significantly higher, due to aggressive sales practices in the former Dominet Bank and Fortis Bank Polska on the one hand and conservative provisions (especially on corporate loans) on the other hand.

In the future we expect the bank will keep its cost of risk in mortgages in line with the sector (20bp), while in corporate lending, due to the focus on higher-quality clients, we expect it to report cost of risk below the sector average (30bp in CTB and 150bp in SME loans vs. 80bp expected in the sector).

Given significant fluctuations in consumer loan cost of risk at the bank and in the sector, it is difficult to forecast the future cost of the risk. We note that:

- the sector's cross-the-cycle 2009-9M13 average 406bp was materially impacted by banks specialized in consumer lending, which, similarly to BNPP Polska, suffered from the burst of the cash loan bubble in 2009 – given the improvement in risk management, we think the sector cost of risk in the next cycle will be lower;

- we assume lower consumer cost of risk in banks offering consumer loans mainly to their own transactional clients (mBank, ING BSK and Millennium) and higher consumer cost of risk in more aggressive consumer lenders.

Taking into account sector trends, we forecast the bank's normalized cost of risk in consumer lending to be c250bp and we estimate the normalized total group cost of risk at c85bp. We note that, according to the bank's representatives, BNPP Polska's normalised cost of risk is about 70bp, or significantly lower than our estimate.

Net profit

The improvement in the bank's ROE to 5.8% in 2013 from 2% in 2012 was driven by lower administrative costs (-6% yoy) and lower net provisioning (-24% yoy despite Zl 20m provisions for legal risk arising from client litigation related to derivative products sold before 2009).

The bank's profitability in 2013 was affected by:

- gains from Vistula Group restructuring, including Zl 8.7m booked in net interest income, Zl 4.5m in financial income and undisclosed impact of released provisions booked in cost risk (Zl c20m, according to our estimates);

- one-off income on prepayment of loan to the parent group (Zl 19m booked in net interest income line);

- the creation of Zl 20m provisions for legal risk related to FX options sold to business clients before 2009;

- the release of a provision for cost of headcount restructuring (Zl 4m);

- the reimbursement of interest from tax office, related to VAT paid earlier on insurance of leased cars (Zl 4m)

The underlying net profit, adjusted for these one-off items, would be Zl 70m and the underlying ROE c4%.

We think the bank will be able to increase ROE to around 9% in 2016 due to increased net interest margin, positively affected by growth in consumer and corporate lending and a decline in low-margin FX mortgages as well as by higher interest rates (we assume 3.1% NIM in 2016 vs. 2.6% in 2013 and 3.1% in 2010), gradually accelerating net fees (driven by rising number of clients) and broadly flat costs. We assume normalized cost of risk of 85bp vs. the bank's guidance of 70bp.

Figure 135. BNPP Polska – Profit and Loss, 2008-2016E (Polish Zloty in million)

GROUP	2008	2009	chg (%)	2010	chg (%)	2011	chg (%)	2012	chg (%)	2013	chg (%)	2014E	chg (%)	2015E	chg (%)	2016E	chg (%)
Net Interest Income	396	422	6.6%	585	38.6%	573	-1.9%	545	-5.0%	538	-1.3%	568	5.7%	650	14.3%	731	12.5%
Net Fee & Commission Income	178	149	-16.5%	159	6.7%	140	-11.7%	146	3.8%	150	2.6%	142	-5.2%	146	3.0%	155	6.0%
Financial Income	-58	-28	-51.1%	76	na	67	-12.3%	126	89.0%	128	1.2%	108	-15.8%	116	7.7%	122	5.0%
Other Income	15	27	80.9%	29	7.3%	0	-98.3%	-2	na	8	na	4	-53.9%	4	5.0%	4	na
Total Revenue	**532**	**570**	**7.2%**	**849**	**49.0%**	**781**	**-8.0%**	**814**	**4.3%**	**823**	**1.1%**	**822**	**-0.2%**	**916**	**11.5%**	**1,012**	**10.5%**
Labour Costs	-182	-227	24.6%	-234	3.2%	-268	14.5%	-292	9.1%	-279	-4.6%	-288	3.4%	-285	-0.9%	-285	0.0%
General Costs	-146	-230	57.7%	-289	25.8%	-266	-8.0%	-256	-3.8%	-246	-4.0%	-244	-0.8%	-244	0.0%	-244	0.0%
Depreciation	-38	-58	51.7%	-76	30.2%	-65	-14.1%	-59	-9.3%	-45	-24.0%	-42	-6.6%	-42	0.0%	-42	0.0%
Operating Expenses	**-366**	**-515**	**40.6%**	**-599**	**16.3%**	**-599**	**0.0%**	**-607**	**1.4%**	**-569**	**-6.2%**	**-574**	**0.8%**	**-571**	**-0.5%**	**-571**	**0.0%**
Operating Profit	**166**	**55**	**-66.7%**	**250**	**353.7%**	**182**	**-27.2%**	**207**	**13.8%**	**254**	**22.5%**	**248**	**-2.4%**	**345**	**39.1%**	**441**	**28.0%**
Provision Charge	-63	-576	818%	-193	-66.6%	-109	-43.4%	-154	41.0%	-116	-24.3%	-113	-2.6%	-140	23.8%	-175	24.7%
Associate Income	0	0	na	0	na	0	na	0	na	0	na	0	na	0	na	0	na
Profit Before Tax	**103**	**-521**	**na**	**57**	**na**	**73**	**27.2%**	**54**	**-26.7%**	**138**	**156.8%**	**134**	**-2.3%**	**204**	**52.0%**	**266**	**30.2%**
Minorities	0	0	na	0	na	0	na	0	na	0	na	0	na	0	na	0	na
Tax	-24	91	na	-16	na	-34	111.8%	-23	-32.5%	-35	55.1%	-34	-3.6%	-41	20.3%	-53	30.2%
Other	0	0	na	0	na	0	na	0	na	0	na	0	na	0	na	0	na
Net Profit	**78**	**-430**	**na**	**42**	**na**	**39**	**-5.1%**	**31**	**-21.8%**	**102**	**231.6%**	**100**	**-1.9%**	**163**	**62.8%**	**213**	**30.2%**

Source: Company data, Citi Research estimates

Figure 136. BNPP Polska – Balance Sheet, 2008-2016E (Polish Zloty in million)

GROUP	2008	2009	chg (%)	2010	chg (%)	2011	chg (%)	2012	chg (%)	2013	chg (%)	2014E	chg (%)	2015E	chg (%)	2016E	chg (%)
Cash and NBP Balances	1,495	833	-44.3%	1,173	40.8%	1,116	-4.8%	1,981	77.4%	1,290	-34.9%	1,548	20.0%	1,781	15.0%	2,048	15.0%
Interbank placements	606	1,573	159.5%	159	-89.9%	359	125.9%	208	-42.1%	79	-61.9%	95	20.0%	109	15.0%	126	15.0%
Financial Assets & Securities	2,573	3,450	34.1%	3,443	-0.2%	3,835	11.4%	1,971	-48.6%	2,678	35.9%	1,286	-52.0%	1,098	-14.6%	875	-20.4%
Net client lending	14,823	13,812	-6.8%	13,151	-4.8%	16,647	26.6%	16,160	-2.9%	16,583	2.6%	17,814	7.4%	19,595	10.0%	21,555	10.0%
Fixed assets	113	188	66.3%	158	-16.1%	149	-5.7%	124	-17.0%	126	1.7%	151	20.0%	174	15.0%	200	15.0%
Other assets	258	438	69.7%	456	3.9%	373	-18.1%	388	3.9%	361	-6.8%	696	92.6%	749	7.5%	805	7.5%
Total Assets	**19,869**	**20,294**	**2.1%**	**18,539**	**-8.6%**	**22,479**	**21.3%**	**20,831**	**-7.3%**	**21,117**	**1.4%**	**21,590**	**2.2%**	**23,506**	**8.9%**	**25,607**	**8.9%**
Interbank borrowing	10,475	8,572	-18.2%	7,909	-7.7%	11,071	40.0%	7,972	-28.0%	7,475	-6.2%	7,101	-5.0%	7,528	6.0%	7,979	6.0%
Client deposits	6,368	9,226	44.9%	8,195	-11.2%	8,882	8.4%	10,065	13.3%	10,894	8.2%	10,464	-3.9%	11,511	10.0%	12,662	10.0%
Other liabilities	1,807	1,127	-37.6%	1,100	-2.4%	1,122	2.0%	1,063	-5.3%	943	-11.3%	1,894	100.8%	2,173	14.7%	2,459	13.2%
Minorities	0	0	na	0	na	0	na	0	na	0	na	0	na	0	na	0	na
Equity (ex Minorities)	**1,218**	**1,369**	**12.4%**	**1,334**	**-2.5%**	**1,404**	**5.2%**	**1,731**	**23.3%**	**1,805**	**4.3%**	**2,131**	**18.1%**	**2,294**	**7.7%**	**2,507**	**9.3%**
Total liabilities & Equity	**19,869**	**20,294**	**2.1%**	**18,539**	**-8.6%**	**22,479**	**21.3%**	**20,831**	**-7.3%**	**21,117**	**1.4%**	**21,590**	**2.2%**	**23,506**	**8.9%**	**25,607**	**8.9%**
Interest Earning Assets	19,497	19,668	0.9%	17,926	-8.9%	21,975	22.6%	20,331	-7.5%	20,639	1.5%	20,743	0.5%	22,583	8.9%	24,603	8.9%

Source: Company data, Citi Research estimates

Figure 137. BNPP Polska – Key Ratios, 2008-2016E (Percentage)

GROUP	2008*	2009	2010	2011	2012	2013	2014E	2015E	2016E
NIM on AIEA	**2.37%**	**2.15%**	**3.11%**	**2.87%**	**2.58%**	**2.62%**	**2.75%**	**3.00%**	**3.10%**
NIM on Total Ave. Assets	1.99%	2.10%	3.01%	2.80%	2.52%	2.56%	2.66%	2.88%	2.98%
Net Fee & Commission Income/Total Income	33.6%	26.2%	18.7%	18.0%	17.9%	18.2%	17.3%	16.0%	15.3%
Net Fee & Commission Income/Deposits	2.8%	1.6%	1.9%	1.6%	1.4%	1.4%	1.4%	1.3%	1.2%
Cost/Income	**68.8%**	**90.3%**	**70.5%**	**76.7%**	**74.6%**	**69.2%**	**69.9%**	**62.4%**	**56.4%**
Cost/Avg. Assets	1.8%	2.6%	3.1%	2.9%	2.8%	2.7%	2.7%	2.5%	2.3%
Effective tax rate	23.8%	17.5%	27.7%	46.0%	42.4%	25.6%	25.3%	20.0%	20.0%
Dividend Payout Ratio	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Provisions/Avg Net Loans	0.42%	4.03%	1.43%	0.73%	0.94%	0.71%	0.66%	0.75%	0.85%
Equity/Assets	6.1%	6.7%	7.2%	6.2%	8.3%	8.5%	9.9%	9.8%	9.8%
Loans/Deposits	232.8%	149.7%	160.5%	187.4%	160.6%	152.2%	170.2%	170.2%	170.2%
Loans/Total Assets	74.6%	68.1%	70.9%	74.1%	77.6%	78.5%	82.5%	83.4%	84.2%
ROE	**6.6%**	**-33.2%**	**3.1%**	**2.9%**	**2.0%**	**5.8%**	**5.1%**	**7.4%**	**8.9%**
ROA	0.46%	-2.14%	0.21%	0.19%	0.14%	0.49%	0.47%	0.72%	0.87%
NPLs/Total Loans	3.12%	13.97%	15.55%	12.48%	11.19%	8.37%	7.90%	7.50%	7.00%
Provision Coverage of NPLs	55.2%	49.0%	55.2%	59.7%	61.9%	73.6%	72.9%	70.2%	68.7%
RWA/Total Assets	81.5%	70.2%	72.6%	74.2%	82.6%	83.3%	83.3%	83.3%	83.3%
Tier I Ratio (%)	**7.3%**	**9.3%**	**9.4%**	**7.9%**	**9.5%**	**9.7%**	**10.8%**	**10.4%**	**10.3%**
CAR	9.9%	13.4%	13.6%	11.5%	13.8%	12.4%	13.3%	12.7%	12.4%
Group Employees	1,785	2,680	2,832	2,769	2,815	2,794	2,798	2,742	2,687

Note:*2008 ratios calculated on the base of the end of the year data.

Source: Company data, Citi Research estimates

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 rate BNPP Polska Neutral. 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.9% in 2016. 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 purchase/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 (45% weight) and post-merger (55%) valuations.

Valuation

Our Economic Value Added Valuation of Zl 64.6 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 Zl 51.6 per share is based upon the formula: Price / Book value = (Sustainable RoE - growth) / (Cost of equity - growth). In the “no merger” scenario we assume a sustainable ROE of 8.9% 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 9.1% ROTE and arrive at a fair value of Zl 52.6. In the “post-merger” scenario we assume ROE of 11.0% and ROTE of 12.5% and arrive at fair value estimates of Zl 72.7 and Zl 78.9, 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 Zl 67.1 as the weighted average of the post-merger valuation (55% weight) and the stand-alone valuation (45% 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.

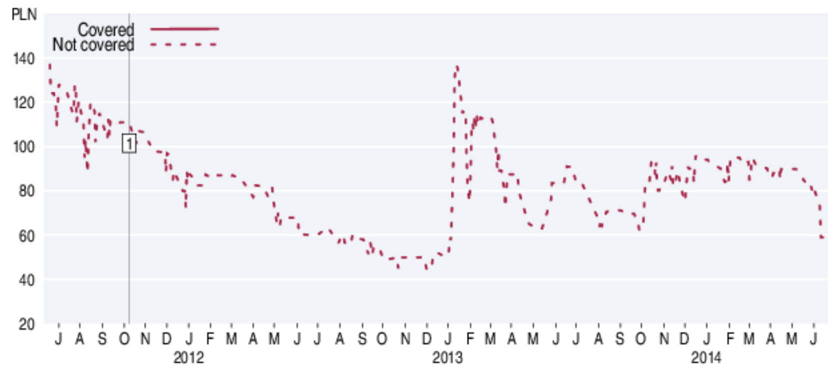
Appendix A-1

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



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

* Indicates change

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)

* 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 31st March 2014 is as follows: Buy (1) representing 23% of the DMBH coverage 0% of which are IB clients, Hold (2) representing 35% of the DMBH coverage 0% of which are IB clients, Sell (3) representing 42% 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 31st March 2014 is as follows: Buy (1) representing 23% of the DMBH coverage 0% of which are IB clients, Hold (2) representing 35% of the DMBH coverage 0% of which are IB clients, Sell (3) representing 42% 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 31st March 2014 is as follows: Buy (1) representing 23% of the DMBH coverage 0% of which are IB clients, Hold (2) representing 35% of the DMBH coverage 0% of which are IB clients, Sell (3) representing 42% 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 31st March 2014 is as follows: Buy (1) representing 23% of the DMBH coverage 0% of which are IB clients, Hold (2) representing 35% of the DMBH coverage 0% of which are IB clients, Sell (3) representing 42% of the DMBH coverage 0% of which are IB clients DMBH acts as a dealer and regularly trades in the securities of Alior Bank.

DMBH is a market maker in the publicly traded equity securities of PZU. DMBH rating distribution versus Investment Banking service provision in the past 12 months as at 31st March 2014 is as follows: Buy (1) representing 23% of the DMBH coverage 0% of which are IB clients, Hold (2) representing 35% of the DMBH coverage 0% of which are IB clients, Sell (3) representing 42% 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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	12 Month Rating			*Relative Rating*		
Data current as of 31 Mar 2014	**Buy**	**Hold**	**Sell**	**Buy**	**Hold**	**Sell**
Citi Research Global Fundamental Coverage	49%	40%	12%	1%	98%	1%
% of companies in each rating category that are investment banking clients	55%	53%	45%	58%	53%	42%

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Relative three-month ratings: Citi Research may also assign a three-month relative call (or rating) to a stock to highlight expected out-performance (most preferred) or under-performance (least preferred) versus the geographic and industry sector over a 3 month period. The relative call may highlight a specific near-term catalyst or event impacting the company or the market that is anticipated to have a short-term price impact on the equity securities of the company. Absent any specific catalyst the analyst(s) will indicate the most and least preferred stocks in the universe of stocks under consideration, explaining the basis for this short-term view. This three-month view may be different from and does not affect a stock's fundamental equity rating, which reflects a longer-term total absolute return expectation. For purposes of NASD/NYSE ratings-distribution-disclosure rules, most preferred calls correspond to a buy recommendation and least preferred calls correspond to a sell recommendation. Any stock not assigned to a most preferred or least preferred call is considered non-relative-rated (NRR). For purposes of NASD/NYSE ratings-distribution-disclosure rules we correspond NRR to Hold in our ratings distribution table for our 3-month relative rating system. However, we reiterate that we do not consider NRR to be a recommendation.

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