Research note
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CE3 Banks Update

We Prefer Erste, Still Like High Dividend Payers

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- CE3 banks performed strongly year-to-date driven by a significant risk premium reduction, particularly in Austria (RBI, EBS) and Hungary (OTP); Polish banks underperformed given their already high valuations and high (though manageable) CHF loan exposure;

- Despite a strong rally in Erste's shares year-to-date, we believe the bank's shares could further re-rate this year as investors' focus should now shift from risk issues (being significantly reduced post ECB's AQR and Hungary's mitigation of controversial "crisis" policies) to ROE improvement. We think that the market does not fully reflect Erste's EPS recovery potential from normalising asset quality in CEE. We increase our target price for Erste to EUR 28.0 from EUR 24.0 on passage of time effects and higher weight assigned to ROTE in 2016 and beyond in our analysis. We maintain our “Buy” rating;

- Hunt for yields in current low interest rate environment remains supportive for high dividend payers. We would play dividends via Komercni (CZ) or Pekao (PL). Their shares trade with a premium to the sector on value metrics (even after adjusting for excess capital), which we believe is a structural premium as dividend yield is likely to beat other metrics in low growth/rate environment. Although the premium is likely to persist for longer, it should not widen much further, in our view. Since Komercni trades at 2.1x P/B, we lower our recommendation to “Hold” from “Accumulate”. As we now expect the bank to pay-out nearly 100% of its profits in coming years, we apply higher weight to dividend model in our valuation to arrive at a new target price of CZK 5,600 (up from CZK 5,200 previously).

- Among CE3 banks we retain our “underweight” recommendation for Polish banks due to ongoing political debate on solution for CHF mortgages and NIM pressure from recent policy rate cuts.

- We are also cautious on banks with high exposure to Russia/Ukraine, mainly OTP and RBI, as the earnings cycle in these countries has just begun and the depth and duration of recession is highly unpredictable. We think both banks may be prone to increased share price volatility following their latest strong outperformance.

CE3 BANKS OUTLOOK 2015

RISK PREMIUM FALLS, DIVIDENDS IN FOCUS, PLAY EPS MOMENTUM VIA ERSTE …

CE3 banks outperformed in Q1; OTP and Erste lead the rally; Polish banks lag

CE3 banks had its best quarter in at least 2 years driven by a significant risk premium reduction, further supported by ECB action. CECE Banking Index rose 14.7% in 1Q15, roughly in-line with broader CECE Index, but 1.2 ppt above STOXX 600 Europe banking index. OTP and Erste lead the rally as they saw their risk premiums to fall sharply helped by Hungary's mitigation of controversial "crisis" policies.

Polish banks are clear laggards given their already high valuations and high (though manageable) CHF loan exposure. Underperformance of Polish banks in 1Q15 wiped out their long lasting premium over Komercni, which currently trades at a 10% premium to Polish banks. As we explain later in the text, we believe Komercni's premium is warranted and could persist for longer.

We apply selective approach to CE3 banks

Individual CE3 banks are in different stages of earnings cycle and face market specific headwinds; we thus remain selective on CE3 banks. We would play EPS recovery through Erste Bank. For income investors searching for an attractive dividend yield, we still recommend Komercni or Bank Pekao, though we do not see much upside from current levels. We would avoid Poland for now and banks with Russia/Ukraine exposure.

Erste – EPS recovery as near term driver for stock appreciation

Decline in both sector and Erste's specific risk premium helped the stock outperform

Erste's recent strong share performance reflects its risk premium reduction, for which we called in our previous research notes on Erste. ECB's latest actions (including AQR) have played significant role in lowering the sector risk premium.

Additionally, Erste's idiosyncratic risk has also declined, particularly in Hungary. In our last report, issued on January 23 ("Erste Bank – Major risks largely contained, upgrade to Buy"), we expressed our concern on possible additional interventions in Hungarian banking sector from the local government.

To our positive surprise, the opposite actually happened in Q1. In February, the government of Hungary and the European Bank for Reconstruction and Development (EBRD) sealed an agreement aimed at strengthening Hungary's financial sector. Under the agreement the government pledged to "promote a stable and predictable framework to support macroeconomic stability" and committed to "refrain from implementing new laws or measures that may have a negative impact on the profitability of the banking sector". The agreement also provides for concrete measures such as the substantial reduction of the banking tax for the period 2016-2019 (PM Orban announced that special banking tax will be cut next year by around HUF 60bn, a 40% drop on 2015). Based on this agreement Erste has invited the two parties to invest in Erste Bank Hungary by acquiring a minority stake of up to 15% each.

EPS momentum should drive Erste shares higher; we increase our TP to EUR 28.0

Despite a strong rally in Erste's shares in 1Q15 we believe the bank's shares could further re-rate this year as investors' focus should now shift from risk issues to ROE improvement. Therefore we now put more stress on P/E analysis than P/B analysis (more appropriate when risk issues dominated stock's movement) in our valuation.

Erste currently trades at 13.5x its expected 2015 earnings versus 15.0x and 12.6x of CE3 banks (measured by CECE Banking Index) and STOXX 600 Europe Banks, respectively. Unlike Polish or Czech banks, Erste Group's earnings should be boosted by a process of normalizing asset quality in markets such as Hungary or Romania. Therefore we adjust Erste's current earnings for a normalized level of risk costs. To do this, we take current pre-provision profit (PPP) of Erste and subtract a normalized level of risk costs from PPP to arrive at adjusted earnings. For the purpose of this analysis we assume a normalized level of the Group's risk costs at 80 bps over total exposure versus 179 bps seen last year. Using the adjusted earnings yield P/E of 11.2x, implying an even more appealing discount to its CE3 peers.

Hence, we think that the market does not fully reflect Erste's EPS recovery potential from normalising asset quality in CEE. We increase our target price for Erste to EUR 28.0 from EUR 24.0 on passage of time effects and higher weight assigned to earnings in 2016 and beyond in our forward looking ROTE/COE analysis and implied P/E methodology.

Komercni (CZ) and Pekao (PL) preferred for income investors

Dividend yield beats other typical valuation metrics in current low yield environment; We like Komercni and Pekao as high dividend payers but see limited room for further appreciation

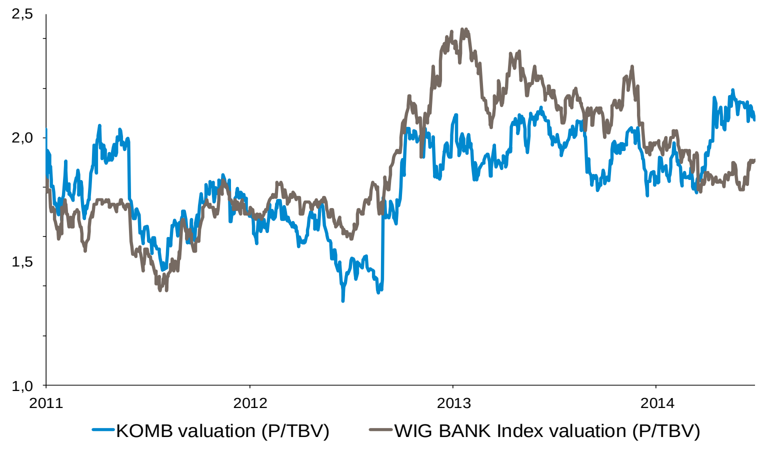
Hunt for yields in current low interest rate environment remains supportive for high dividend payers. We would play dividends via Komercni (CZ) or Pekao (PL) among CE3 banks. Komercni currently (already ex- CZK 310 dividend rights) trades at 16.3x its expected 2015 earnings, Pekao even at 20.4x compared to CE3 banks average of 15.0x. As both banks are overcapitalized (relative to its local regulator's criteria), we adjust the multiples for banks' excess capital to arrive at P/E of 15.6x and 16.4x for Komercni and Pekao, respectively, still slightly above CE3 banks average. Nevertheless, we believe this is a structural premium as dividend yield is likely to beat other metrics in low growth/rate environment. Although the premium is likely to persist for longer, it should not widen much further, in our view.

Also, earnings cycle is not supportive for Czech and Polish banks as they represent typical retail banks with high share of interest income on total revenues, thus facing headwinds from ultra-low interest rates. Furthermore, margin pressure is even more pronounced given the banks' high liquidity. As long as loan growth remains subdued in the region, banks will suffer from low reinvestment yield of excess cash. Also, risk costs are cyclically low, further putting cap on banks' profitability growth. Therefore we have NEUTRAL rating on both Komercni and Pekao. We see a strategy of "Buying the Dips" as appropriate for the moment.

Komercni trades at 10% premium to Polish banks which could persist for some time, we retain our "underweight" recommendation for Polish banks

In our latest report on Komercni, released January 19, 2015 ("KB - TP increased to CZK 5,200. Low risk & high dividend deserves a premium"), we noted that Komercni deserves premium over Polish banks due to lower risk profile (no CHF exposure, limited Russia/Ukraine exposure), better earnings and dividend prospects which proved to be right. Komercni currently trades at a 10% premium to Polish banks (see the chart below). Komercni's relative valuation looks stretched when compared to a 3-year average relative valuation over Polish banks (nearly 2 standard deviations above it), but not so much once compared to a 5-year average relative valuation (just 1.2 std. above it). We think this historical comparison is not relevant for the moment as Komercni now faces fewer earnings headwinds than its Polish peers and we believe this premium could persist for longer. Hence, we retain our "underweight" recommendation for Polish banks due to ongoing political debate on solution for CHF mortgages and earnings headwinds from recent policy rate cuts.

CH 1 – KOMERCNI GAINS PREMIUM OVER POLISH BANKS



Source: Patria, Bloomberg

We increase our target price for Komercni to CZK 5,600; rating lowered to HOLD

As we state above, Komercni's premium over CE3 banks is likely to be here for some time. Low risk profile and high dividend yield remains stock supportive. However, the premium should not widen much further, in our view. Komercni's high liquidity, perceived as one of the factors that contribute to bank's low risk profile, limits the bank's earnings growth potential. As we expect the loan growth to remain subdued in coming quarters, Komercni's net interest margin will be pressured from low reinvestment yield of its excess cash. Note, the bank reinvests its low-rate-sensitive liabilities (free funds) into the long end of the yield curve through interest rate swaps. The Czech 10 year interest rate swaps further weakened throughout Q1, hence potentially challenging the management' outlook for flat net interest income this year. Also, risk costs are cyclically low, further putting cap on bank's profitability growth.

We previously valued Komercni on a blended average of a forward looking ROE/COE analysis, implied P/E methodology and Gordon growth dividend model with 40% weight assigned to the former and 30% to the other two methods. Given Komercni's profile we simplify our valuation methodology and use only two approaches: implied P/E methodology and Gordon growth dividend model. As we now expect the bank to pay-out nearly 100% of its profits in coming years, we apply higher weight to dividend model (80%) in our valuation to arrive at a new target price of CZK 5,600 (up from CZK 5,200 previously). We lower our recommendation to "Hold" from "Accumulate".

We would avoid CE3 banks with high Russia/Ukraine exposure which could be source of increased volatility

We already mentioned that individual CE3 banks are in different stages of earnings cycle and face market specific headwinds. Our analysis of CE3 banks by geography suggests to underweight Poland in the CE3 region. We are also cautious on banks with high exposure to Russia/Ukraine, mainly OTP and RBI as the earnings cycle in these countries has just begun and the depth and duration of recession is highly unpredictable. We think both banks may be prone to increased share price volatility following their latest strong outperformance.

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