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Haitong Bank in a report from December 11 (08:00) downgrades Alior Bank to SELL from Buy (FV PLN 24.9) and Millennium Bank to SELL from Neutral (FV PLN 5.0).

Valuation Methodology

- **Alior Bank**

Valuation – We use a Dividend Discount Model (DDM) with a 90% weighting and a Polish banks' peer multiples' analysis with a 10% weighting to value Alior. Our FV is based on the weighted average of these two methodologies.
Sensitivity – We provide two sensitivity analyses for our fair value estimate wherein we examine two sets of variables: (i) ROE and perpetuity growth rates; and (ii) equity risk premium and the risk-free rate.
CHF bill adjustment – We estimate a total PLN 30bn (1.5x higher compared to previous PLN 12bn) cumulative loss for the banking sector stemming from restructuring of the CHF portfolio. Taking into account the Polish Bank Association's (ZBP's) expected PLN 60bn loss on the portfolio of CHF mortgages to individuals, based on the assumption that the loan will be switch to PLN at the historical exchange rate and repaid at the CHF LIBOR rates, assuming 60% of clients will go to the court and 80% will win the court case. We are aware that given the large number of assumptions this calculation has a very high margin of error. Subsequently we apply a market share weighted portion of this loss per share to individual banks.
Main assumption changes – We apply a cost of equity of 10.5% (up from 9.5% previously), mainly on the back of a higher beta (higher risk for the bank). We assume a terminal ROE at 6.4% (vs 9.3% before). We use a risk-free rate of 3.5% (based on the long-term 10Y Polish Government Bond Yield assumption).
Forecast revisions: We have revised our forecast based on the following factors: 1) lower profitability of the consumer lending business, based on the implications of September's CJEU ruling concerning the return of the early repayment of consumer loan fees; 2) slower growth in operating expenses, following better than anticipated costs growth in 9M19 offset somewhat by higher BFG charges; 3) slightly lower net provisioning in 2020E-21E based on a 1% cut to loan growth (+6% YoY in 2019 and +4% YoY in 2020-21E) and expected change in the strategy towards more asset-based loans. Thus we have lowered our 2019E NI estimate by 29% to PLN 410m (-43% YoY), 2020E net income by 36% to PLN 446m (+9% YoY) and by 39% YoY to PLN 466m (+5% YoY).

- **Millennium Bank**

Valuation: We use a Dividend Discount Model (DDM) with a 30% weighting and a Polish banks' peer multiples' analysis with a 70% weighting to value Bank Millennium. Our FV is based on the weighted average of these two methodologies.
Sensitivity: We provide two sensitivity analyses for our fair value estimates wherein we examine two sets of variables: (i) ROEs and perpetuity growth rates; and (ii) equity risk premium and the risk-free rate.
CHF risk adjustment: We estimate a total PLN 30bn (almost 5x higher compared to the previous PLN 6bn) cumulative loss for the banking sector stemming from restructuring of the CHF portfolio. Taking into account the Polish Bank Association's (ZBP's) expected PLN 60bn loss on the portfolio of CHF mortgages to individuals, based on the assumption that the loan will be switch to PLN at the historical exchange rate and repaid at the CHF LIBOR rates, assuming 60% of clients will go to the court and 80% will win the court case. We are aware that given the large number of assumptions this calculation has a very high margin of error. Subsequently we apply a market share weighted portion of this loss per share to individual banks.
Main assumption changes: We apply a cost of equity of 10%, up from 9.5%. We assume a terminal ROE for MIL at 9.2% (vs 12.0% before). We use a risk-free rate of 3.5% (based on the long-term 10Y Polish Government Bond Yield assumption).
Forecast revisions: We have adjusted our 2019-2021E earnings for: 1) betterthan-expected 3Q19 results; 2) expected result of September's CJEU ruling concerning the return of the early repayment of consumer loan fees (annual negative impact of some PLN 80m on NII, fading over time); 3) higher BFG fees; 4) introduction of the gradual portfolio provisioning of FX loans following the less favourable court rulings (PLN 140m, i.e. 1% of the portfolio in 4Q19E and PLN 280m, i.e. 2% of the portfolio in the following years); 5) higher cost of risk on

the Eurobank portfolio. Our 2019E NI is down by 19% to PLN 621m (down 18% YoY). Our 2020E forecast drops by 39% to PLN 597m (+4% YoY) and by 29% YoY in 2021E to PLN 849m (+42% YoY).

Risks to Fair Value

- **Alior Bank**

Macro related: risk of different macroeconomic scenario including: i) interest rates; ii) assets quality/cost of risk; iii) volume growth in Poland.
Dividend: faster than expected return to dividend payment.
Volume growth significantly below/above our expectations.
Acquisition related: Lately the market speculates that the bank may be involved in the potential acquisition of mBank (Rzeczpospolita daily, 18/10/2019).
Regulatory risk – any new regulatory requirements concerning minimum adequacy ratios.

- Potential liquidity squeeze in the banking sector (commercial / cooperative segment) and financial institutions (SKOK segment) may lead to a larger contribution to the BFG fund.
- The most recent ruling of the Court of Justice of the EU that banks and other financial institutions should return a portion of all costs linked to a consumer loan to clients in the event of an early repayment. We see an upside risk to the current estimate of a PLN 320m negative annual impact if ALR management decides to change the approach to the capital used weighted calculation of fee return to clients, which seems to be consensus approach currently.
- ALR has been granting cash loans with one of the largest values (up to 200k, for up to 12 years) and specialises in high ticket consolidation loans. Large ticket loans have lately been on the radar of the supervisory bodies.

Asset quality – relatively higher risk appetite reflected in its higher–than-average cost of risk and NPLs. High exposure to the SME segment may cause higher than anticipated provisions at the bottom of the cycle.
Ownership related: ALR is indirectly state-controlled (via PZU and PFR - 32% stake), thus we see a risk of non-market oriented decisions.

- Risk of ongoing changes to the management board (3rd CEO since acquisition)
- Risk of ownership changes

Capital needs: any significant increase in appetite for loan growth could trigger a capital increase given its most modest margin in relation to the minimum requirements.
Valuation:

- Higher Risk Free Rate (lowers valuation)
- Change in market-wise sentiment towards dividend stocks.

- **Millennium Bank**

Macro related: Risk of different macroeconomic scenario including: i) interest rates; ii) assets quality/cost of risk; iii) volume growth in Poland.
NIM expansion: faster NIM expansion due to potentially higher assets spreads could lead to higher earnings;
Funding costs: Competitive rise in deposit rates could lead to NIM narrowing;
Better assets quality: could lead to a lower cost of risk, which would have a positive impact on earnings;
Regulatory risk: CHF mortgages

- The restructuring of foreign currency housing loans a different way to our base scenario or/and additional costs, i.e. spread bill. We estimate the maximum cost of a CHF bill that MIL could bear for it to still be able to report a CET1 above the minimum required by the KNF of 11.75% to be PLN 2.9bn, which implies a 21% cut in its CHF portfolio;
- Any new regulatory requirements concerning minimum adequacy ratios and/or dividends;
- Increase in LGD ratios for banks using the IRB methodology, rising min. requirements, in line with the Financial Stability Committee Recommendation of 13 January 2017;

FX rate: Relatively high exposure to FX risk of its CHF mortgage portfolio (some 22% of loan book). CHF depreciation helps the bank's liquidity position, while CHF appreciation shorts the bank's liquidity position;
Dividend:

- Slower or faster than expected return to dividend payments, as we expect first dividends to be paid from 2021 net profit;

Merger related:

- Given the recent acquisition of Eurobank assets (1.2x P/B), we see a risk of delivery of strategy costs and synergies.

Regulatory risk: Potential liquidity squeeze in the banking sector (commercial / cooperative segment) and financial institutions (SKOK segment) may lead to a larger contribution to the BFG fund.

Volume growth: significantly below/above our expectations

Valuation:

- Higher Risk Free Rate (lowers valuation).
- Change in the market-wise sentiment to 'risk on', with dividend stocks preferred.

IMPORTANT DISCLOSURES