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Haitong Bank in a report from October 9 (08:00) keeps PZU at NEUTRAL (FV PLN 28.4).

Valuation Methodology

We value PZU using a DDM and an excess return on capital method. We also use peer multiple valuations, but only for comparison purposes.

Our final fair value is an average of a DDM and excess return on capital method (each with a 50% weighting). Using a DDM, we derive a fair value of PLN 24.5 (down from PLN 29.7) while using the excess return on capital method we arrive at PLN 23.1 (down from PLN 26). On top of that, we add PZU's share in our fair value for both Alior Bank (PLN 0.6 down from PLN 2.5) and Bank Pekao (PLN 4 down from PLN 7.6). Our fair value for PZU is estimated at PLN 28.4 down from PLN 38.0, implying 10% potential to the current share price.

Main assumptions: Our cost of equity estimate is 9.5% (up from 8.5%) with an equity risk premium of 5%, beta of 1.5x (up from 1.0x) and a risk free rate of 3.0% (down from 3.5%, based on the 10Y Polish Government Bond Yield). We assume a terminal ROE for PZU at 15% (down from 20.0%).

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.

Peer comparison – valuation method: On a 2021E P/E of 7.5x PZU trades at a 11% premium to the Emerging market peers median of 6.8x but at an 18% discount to Developed markets peers median of 9.2x. The usual high premium to P/B 2021E at 1.1x has narrowed to 77%/36% respectively, despite the still superior ROE of 15.6% with a 74%/57% premium to Emerging/Developed markets.

Forecast revisions: Overall, we have revised 2020-22E NI by -53%/-12%/-13%. We have lowered our forecasts due to banking assets write-offs and adjusted expectations for the banking segment given lower interest rates, with NI down by -86% (adjusted for PLN 1.3bn impairment on intangible assets)/-37%/-27% in '20-22E. At the same time we have adjusted 20-22E insurance business results by +12%/-3%/-8% as claims and new sales were below expectations, and costs came above in 1H20.

Our GWP forecast differs by -2%/0%/+2% from consensus in '20-22E. Our net earnings expectations differ from consensus by -19%/+3%/-3% in '20-22E.

Risks to Fair Value

Macro related: Risks of a different macroeconomic scenario, especially in light of the highly unpredictable outcome of the COVID-19 outbreak, both in terms of magnitude and length, including: i) interest rates; ii) asset quality/cost of risk; iii) volume growth.

Pandemic related risks – Traffic limitations reduce the frequency of motor claims; the economy freezing may contribute to a higher loss ratio in contractual guarantees and financial insurance; risk involving business interruption linked solely to specific non-life losses (e.g. fire); additional costs of suspending / modifying business processes; compensatory actions for employees and agents; greater insurance awareness due to the pandemic could lead to increased demand for insurance products.

Interest rates volatility – may not only have an impact on the financial results of both insurance and banking operations but also on equity under the Solvency II regime. An increase/decline in interest rates would be

difficult/supportive in the short term (depresses/improves bond prices), but supportive/difficult in the longer term because it would restore/worsen yields and profitability.

Change in dividend prospects due to i.e. market regulations (potential further KNF ban on dividends), M&A activity, payout of excess capital (not included in our forecasts), etc;

Non-life segment – potential margin pressure from renewed price competition and/or claims increase/decline; lower/higher demand for new and imported cars, deceleration/acceleration of new sales of property insurance, especially in the motor business

Life segment – potential margin pressure from higher competition and adverse aging trends; higher unemployment level (not evident in 2Q20) may limit gross written premiums in group insurance;

Banking segment – Higher/lower earnings of the PZU group banks. Potential increase / decrease in market interest rates could lead to an improvement/deceleration in earnings; potential slowdown of GDP could lead to higher risk costs (incl. COVID-19 specific); potential higher / lower demand or/and competition could lead to higher / lower volume growth, capital market volatility could lead to lower/higher sales of investment funds;

- o Risk of further banking assets impairment – PZU has made a PLN 1.3bn total impairment on banking assets in 1H20. It is writing off the entire PLN 0.9bn Alior Bank goodwill and intangible assets (bought at average price of some PLN 65-69 per share). Bank Pekao's goodwill was partly reduced by PLN 555m to PLN 1,714m (-24%) in 1H20. PEO was bought @ PLN 123 per share vs the current price of PLN 54.16 i.e. 55% higher.

- o Changes in the banking assets strategy. According to the CFO comments following 2Q20 results, the strategy towards banking assets needs to be reconsidered due to a substantial drop in interest rates leading to declining profitability. According to an unconfirmed press report (Parkiet 26/05/2020), the merger of Alior Bank (31.9% owned) with Bank Pekao (20% owned) may be back on the agenda. However, this has been denied by 3 sides PZU/PEO/ALR. However, other options should not be ruled out.

Investment income – PZU group is exposed to a change in valuation of various asset classes (debt instruments, equities, derivatives, FX rates, etc). A change in capital market performance could put income under pressure / or boost it potentially; lower/higher interest rates lead to lower/higher banking segment interest income, which is included in the group's investment income.

Further potential cost savings initiatives (headcount and/or branch optimisation) are not included explicitly in our forecasts;

Regulatory risks - We do not incorporate material positive/negative regulations, among other PPE, regulations concerning claims for general damage for the pain caused by the vegetative state of a relative injured in an accident;

- o Risk of higher insurance guarantee fund (UFG) contribution – The current regulation sets the annual contribution to the UFG at 1.3% of GWP from MTP liability of motor vehicle owners and farmers' liability. The risk of a higher contribution due to higher compensation payments from the fund is not incorporated in our forecast.

Risks related to state-ownership - PZU is state controlled and thus we see a risk of non-market oriented decisions, i.e. changes to the management board.

M&A risks – Both in insurance, banking as well as the asset management segment, PZU could potentially face the risk of mispricing and/or M&A implementation risk in a potential transaction;

Risks embedded in the insurance business, i.e. catastrophic or extraordinary risks may have an adverse impact on earnings;

Strategic targets – risk of not delivering upon strategic targets.

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