Thursday, July 9, 2020 | special comment

Banks – PEO x ALR: Calculating Potential M&A Synergies

Pekao (PEO PW) | rating: buy | target price: PLN 68.90 | current price: PLN 54.68

Alior Bank (ALR PW) | rating: hold | target price: PLN 14.98 PLN | current price: PLN 16.75

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PZU, Poland's state-owned insurance giant and owner of controlling stakes in two listed banks, Pekao and Alior, in May said it wanted to reexamine its involvement in the banking assets, but stressed that divestments were not part of the review. In our view, one of the ways PZU could minimize risks and maximize returns on its bank investments would be by marrying the two institutions. What is more, a merger of Pekao and Alior would perfectly fit the agenda of Poland's State Assets Minister, Jacek Sasin, who would like to see Polish companies from the same or adjacent sectors consolidate and create national 'champions' capable of competing with major European rivals.

Our analysis shows that, by combining their assets, Pekao and Alior would merge into the largest bank in Poland. The loan portfolio of the 'New Pekao' would contain only a small share of high-risk CHF-denominated mortgages, and it would regain its rank as the #1 corporate bank capable of quickly growing EPS. As the acquiring party, Pekao can also look forward to recognizing sizable "badwill" on the takeover, enough to pay for what would be substantial costs of post-merger integration (judging by the example of the Moneta Money-Wustenrot deal). Ironically, together with Alior Pekao would also be getting back its former subsidiary, BPH, though in a streamlined condition.

All in all, a merger with Alior Bank in our view would create value for the shareholders of Pekao (through a big EPS boost) as well as the remaining shareholders of Alior (through an acquisition premium). The one big question is how PZU, which currently has a 31.91% stake in Alior, could approach the transaction so that it can avoid having to write off goodwill.

The theoretical M&A deal notwithstanding, we still consider Pekao an attractive buy opportunity at the current share price level.

How Would the Deal be Structured

The process of merging Pekao with Alior could prove a challenge due to PZU's current holdings in Alior (with a share of 31.91%) and its internal methods of valuation. **In the most likely scenario, Pekao would hold a tender offer for Alior's shares to reach a 66% stake, which PZU would not accept.**

We assume Pekao would offer a premium of 23% over Alior's market price (the same as recently paid by another state-owned company, the petroleum producer PKN Orlen, for shares in the state power utility Energa) **to make a total deal price of approximately PLN 1.76bn** – an amount close to Pekao's undistributed profit for FY2019 **and well below its current surplus of about PLN 9bn (PLN 7bn T1)**. With only 20% of the 2019 retained earnings included in the capital surplus, this would leave a generous reserve for a potential future dividend distribution.

The big question is how Pekao would handle the next phase of the transaction in such a way as to not have to mark-to-market the Alior stake. One solution would be to form a special-purpose vehicle, and another would be to swap Alior's shares for Pekao's. However before PZU can acquire more shares in Pekao over and above the current 20% stake, its co-shareholder in the bank, the state-run fund PFR, holding 12.80%, would have to sell a portion of its securities, most likely through an accelerated book building process, in order to avoid attaining a 33% joint investment and having to make the mandatory tender offer to reach 66% required under Polish law.

In summary, we believe Pekao can afford to buy Alior Bank even at a substantial premium over the current market value.

Estimated price and badwill on acquisition of Alior Bank by Pekao (PLN m)

Premium*	10%	23%	30%	40%
Price of a 100% stake	2,382	**2,663**	2,815	3,031
Price of a 66% stake	1,572	**1,758**	1,858	2,001
Implied P/B	0.35	**0.39**	0.41	0.44
Maximum Badwill	4,491	**4,210**	4,058	3,842

Source: mBank *Over per-share market value of PLN 16.75

Badwill – the Cherry on Top

The European Central Bank recently signaled that that it wants to make consolidation processes easier for banks, among others through more favorable treatment of badwill and its recognition as capital. In Poland, badwill has recently featured in the takeover of Deutsche Bank Poland by Santander, and in Alior's acquisition of BPH.

The **badwill generated by the Pekao-Alior transaction at the high end could be as much as PLN 4bn** (though it will probably be less than that) given Alior's current low valuation. However the actual final amount recognized by Pekao would have to be reduced by dissynergies and impairment of other intangible assets (e.g. brand names). Pekao could use the bargain acquisition gains to pay the costs of post-merger integration, which we estimate close to PLN 1bn, and to increase provisioning against Alior's credit-impaired portfolio to bring the current loan loss provision ratio of 49% up to match Pekao's 67% – a one-time charge of an estimated **PLN 1.6bn.**

IFRS 9 "Stage 3" loans and loan loss provisioning as of 31 March 2020 (PLN m)

	Stage 3 loans	Charge-offs	Provisions/ Stage 3 Loans
Alior	8,994	4,397	49%
Pekao	8,302	5,571	67%

Source: mBank

An EPS-boosting deal

Assuming no equity raise, by merging with Alior, Pekao stands to increase its 2021E EPS by 14% (based on our current forecasts which take into account the latest interest cuts and low cost of risk) and **by a further 18% in 2022**. In an extremely optimistic scenario where the merged bank can achieve half of the average **cost and revenue synergies** generated by recent bank M&A deals in 2021, and reach 100% of the average in 2022, the respective **annual EPS estimates would increase by 43% and 58%**. These estimates also assume Pekao would follow the example of Moneta Money Bank and pay for post-merger integration costs from badwill. **Even with lower cost synergies** (PLN 579m gross), the New Pekao's future **EPS would still grow at very impressive annual rates of 39% in 2021 and 53% in 2022.**

EPS estimate for merged Pekao

(PLN m)	2021E	2022E
Net interest income	7,305	7,988
Non-interest income	3,792	3,954
Total income	**11,096**	**11,942**
Costs	5,417	5,481
Operating income before provisioning	**5,680**	**6,462**
Provisioning	2,488	2,134
Pre-tax income	**3,191**	**4,328**
Tax	723	980
Minority interests	-2	-2
Net income	**2,466**	**3,346**
Bank tax	824	874
Net income	**1,642**	**2,472**
Synergies		
- Lower financing costs	123	246
- Operating costs	292	584
Net income after synergy	**2,057**	**3,302**
Current EPS of Pekao	5.5	8.0
EPS of Pekao + Alior	6.3	9.4
EPS incl. synergies	7.8	12.6
EPS growth post merger	**+14%**	**+18%**
Post-merger EPS incl. synergies	**+43%**	**+58%**

Source: mBank

How We Calculate Synergies

Estimated post-merger integration costs and synergies generated by recent Polish bank M&A deals*

	Integration Costs	Cost Synergy
BZ WBK + Kredyt Bank	-1.15%	0.83%
PKO BP + Nordea	-0.65%	0.70%
Alior Bank + BPH	-0.61%	1.18%
BZ WBK + Deutsche Bank	-1.72%	0.72%
BNP + Raiffaisen	-1.59%	0.88%
Millennium +Eurobank	-1.43%	1.34%
Average	**-1.19%**	**0.94%**
Pekao +Alior (PLN m)	**-911**	**721**

Source: mBank, *as a % of acquired assets

We use as our reference point the estimated **average integration costs** entailed in recent M&A deals between banks operating in Poland, which we put very **roughly at 1.19% of acquired assets.** When applied to the current assets of Alior, in zloty terms this percentage implies total **post-merger integration costs of about PLN 911m**.

When it comes to **synergies**, we would expect them to fall in the range of PLN **579-721m**, with the top end calculated in the same way as the integration costs, and the low end worked out assuming Alior lays off 40% of current staff, generating payroll savings on top of savings on space rentals, communications, training, etc., and the elimination of expenses on IT, marketing, and consulting.

Estimated cost synergies after 40% job cuts

(PLN m)	Savings
Payroll	316.4
Rentals	23.5
IT	112.2
Marketing	79.2
Consulting	30.0
Communications	11.6
Training	6.5
Total	**579**

Source: mBank

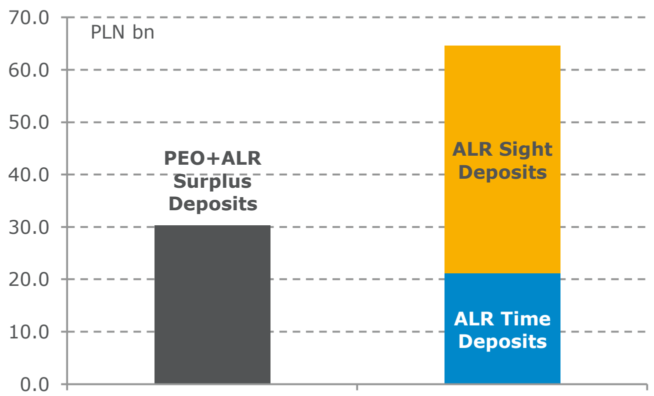
Additional Synergies Through Interest Income

There is a noticeable difference in the costs of funds of Pekao and Alior, defined as interest expenses divided by average interest-bearing liabilities. To Alior's credit, at **46bps** by Q1 2020 the gap had narrowed considerably compared to an average of 72bp registered over the past years. With the potential merger, if the **difference were reduced** by a half this would facilitate net savings in the amount of **PLN 123m**. Eventually, in a low interest environment the difference in funding costs could probably be eliminated.

On a related note, according to our calculations the **merged Pekao would have a surplus of deposits over loans totaling PLN 30bn**, about **PLN 9bn more than the total term deposits of Alior**.

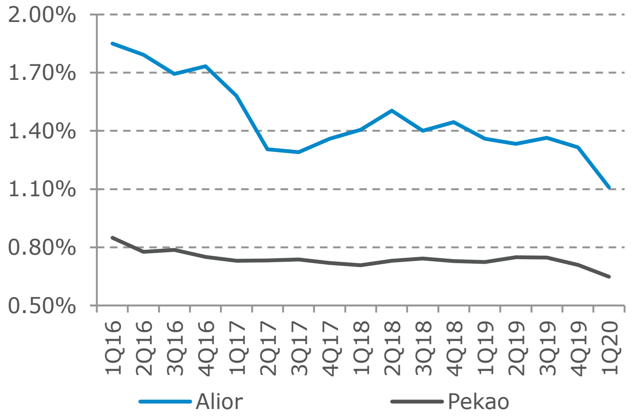
Another important factor when considering funding costs are future MREL debt issuances. Banks have to meet final MREL targets by 2024 by issuing billions in new debt. **If we compare the securities already issued by Pekao and Alior, we see that Alior is paying nearly twice the risk premiums of Pekao** (as reflected in their respective credit ratings). The merged bank could probably pay lower interest on MREL issuances.

New Pekao would have a surplus of deposits over loans totaling PLN 30bn, about PLN 9bn more than the total term deposits of Alior



Source: mBank

Funds costs, Alior vs. Pekao



Source: mBank

Coming Back as the No. 1 Corporate Bank

The New Pekao would have assets of PLN 294bn, loans of PLN 202bn, and deposits of PLN 232bn. **Compared to** Poland's current biggest bank by assets, **PKO BP**, the assets of the new Pekao would be **about PLN 28bn higher.**

Pekao's new loan portfolio would consist of PLN 74bn housing loans (33% of total), PLN 38bn other retail loans (17%), and PLN 107bn corporate loans (48%). This would give it loan market shares of 15% overall, of which 15% in corporate loans (#1), 16% in housing loans (#2), and 13% in other retail loans (#1). **A 15% market share does not look problematic form an antitrust standpoint**.

The merged Pekao would regain its position as the leader in corporate banking and in consumer banking.

Pekao's market share potential after Alior merger

	MMortgages	Retail NML	Corporate	Total
PKO	**25.4%**	10.4%	13.4%	**16.6%**
PEO + ALR	16.0%	**12.9%**	**14.9%**	15.0%
PEO	13.5%	5.2%	11.3%	10.8%
SPL	11.4%	10.0%	9.9%	10.4%
ING	10.6%	4.2%	9.0%	8.5%
MBK	9.0%	7.3%	7.0%	7.7%
BNP	4.3%	3.8%	6.8%	5.4%
MIL	8.3%	4.9%	2.7%	4.9%
ALR	2.5%	7.7%	3.6%	4.2%
BHW	0.4%	1.9%	2.0%	1.5%

Source: mBank

List of abbreviations and ratios contained in the report:
EV – net debt + market value (EV – economic value)
EBIT – Earnings Before Interest and Taxes
EBITDA – EBIT + Depreciation and Amortisation
PBA – Profit on Banking Activity
P/CE – price to earnings with amortisation
MC/S – market capitalisation to sales
EBIT/EV – operating profit to economic value
P/E – (Price/Earnings) – price divided by annual net profit per share
ROE – (Return on Equity) – annual net profit divided by average equity
P/BV – (Price/Book Value) – price divided by book value per share
Net debt – credits + debt papers + interest bearing loans – cash and cash equivalents
EBITDA margin – EBITDA/Sales

OVERWEIGHT (OW) – a rating which indicates that we expect a stock to outperform the broad market
NEUTRAL (N) – a rating which indicates that we expect the stock to perform in line with the broad market
UNDERWEIGHT (UW) – a rating which indicates that we expect the stock to underperform the broad market

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