Transcript of Q3 2016 results conference of mBank

[edited version]

***Joanna Filipkowska, Vice-director of Investor Relations and Group Strategy*:** Good afternoon and welcome to this conference summarizing Q3 results of mBank Group. We have CEO, Cezary Stypułkowski, CFO Christoph Heins and chief economist Ernest Pytlarczyk. First, over to Mr. Stypułkowski.

***Cezary Stypułkowski, Chief Executive Officer*:** I don't how to begin. We just had this meeting with the press – it was 2-3 hours ago – and so of the top of my head I said instead of the presentation why don't we move on to Q&As and it turned out to be really productive. Rather than wasting time discussing things we think might be relevant but not necessarily the people we are talking to. But before you decide which format you'd rather have, let me tell my favorite joke: there was a bank, which worked quite fine, with an old CEO, whose desk was always clean – that's my dream, but forget it. Whenever there was a problem, his people came to his office and he was sitting there relaxed in a big arm chair behind this clean desk. They would ask him a question and he would ritually open the drawer with a key, pull it out, look inside, close it, and then he would reply. His reply would normally work. But as usually the case is with people who advance in age he just died one day and e verybody just went to see what in his desk, in his drawer. They broke the lock open, pulled out the drawer, and there was just a slip of paper, yellow, old crumpled piece of paper, which said the asset on the left. That's my joke. What would you rather have the regular routine or, since you are more skilled observers of our results and our balance sheet, would you rather cut to the chase and focus on what you are interest in? When our results are less good we will give you a presentation. The journalist were clear, they said outright they would rather have Q&As. Well, if you're silent, that means probably not all of you have done your homework. Ok, let's go through the routine presentation.

Let's start by saying that this was in general a good quarter. Some of you were close to the numbers that we produced. The key thing here is that mBank as well as probably other banks have performed very well with net interest income. There were two reasons. Inflow of clients' fund on the one hand and slowdown in lending. As a result the NIM rose. Our deposit volumes performed very well. Our market share in retail deposits increased by 1 percentage point within 18-24 months. High margin products are also growing dynamically. N&C income went back to our regular level, around 230M, which is much better than in Q2 which was a weak quarter, mostly because of the costs that we paid rather than the income that we earned. Cost to income ratio was 48.1% in a quarter with no one-offs – that seems really decent and well within our strategic goal. As a results of stronger deposits, especially the inflow of transactional cash, our loan to deposit ratio was 95.1%, which is probably better than the market average. But the weigh down from 134% in 2010 to the current level has been beyond our expectation. Our capital position is very strong. Our equity levels and total capital ratio – they bring us close to the capitalization of banks at the end of XIX century, when they had lots of equity on the balance sheet. In terms of volumes – I think under the circumstances we are growing at the good pace. I think there are no special remarks to be made here. The product volumes are growing quite decently. We've also approved a new strategy of the Bank, which will organize our initiatives by 2020. Of all the new developments, like the high, strong customer acquisition, both in retail and corporate banking and the relatively good adoption of mobile banking and BLIK, it's all well on track.

As for the financial results, this translates into a somewhat lower profit YoY, after the bank tax. So the net profit is significantly lower than in previous year, but a large part of that is attributable to bank tax. I've already mentioned the margin, which is in uptrend due to the two reasons I discussed before. In general terms when investors look at any institutions worldwide, our RoE is below the cost of capital, which may be considered disappointing, but the distortion by the bank tax impacts our figures. Balance sheet volumes – these are quite self-explanatory. All the arrows are in green. We had a slightly higher cost of credit, namely the additional LLPs we set up in Q3, somewhat higher than in Q2. I think the cost of risk was 69 points on average, but mainly due to corporate banking. We will go into detail if you have any specific questions. Client acquisition is going well. For the market shares, our corporate segment has remained at 6-8% of market share, depending on the balance sheet item. We've also been happy to note that we have made a step in the right direction, moving out of big tickets, big exposures to large Polish companies. Instead, we are focusing K2 SMEs where are position is strong and growing. In retail banking, net of growth of mortgages and the Swiss franc issue, all of our products have grown their market shares. Mortgages, that's a question mark. But there is no doubt that we will see some slowdown in the corporate segment. Investments, that's another question mark as you will hear from Ernest. Leasing has been growing quite well, although there was drop quarter on quarter. Now Christoph.

Christoph Heins, Vice-President of the Management Board, Chief Financial Officer: Thank you very much. I will try to be brief as well. So, I think on the back what our CEO has just pointed out, Q3 was a very strong quarter from our perspective. We had record high core revenues of 953M, so very strong interest income as well as net fee and commission income. Total revenues above and beyond 1B, which is also for us a very important benchmark here. No major one-offs in Q3, so this is sort of a true regular revenue stream that we have seen. Where does it come from – on the interest income side, it's twofold. The one is on the funding side. Although the volume of deposits is pretty much flat quarter over quarter, after very significant growth of deposits in Q2, we have changed the composition of the deposits slightly. So, we have managed some sort of higher priced, particularly corporate deposits, out and replaced them with more retail-driven deposits, mainly from transaction balances on current accounts. This comes also with the further increase in client base and new accounts that we have basically acquired in the last quarter. On the asset side it's also a process of repricing constantly loans. We have seen some further increase on the corporate side, especially also supported by our subsidiaries, mLeasing, mFaktoring, for example. So there was a very solid and decent move on that front. On the balances on the retail side, non-mortgage loans, again very positive results here after the record high Q2. 1.55B, again it's, I think, the second best result in the quarter that we have seen so far.

Costs went slightly up, not that much QoQ. This was mainly driven by investment into IT, some projects that usually don't come linear during the year, so whenever this projects are being initiated or being closed, then you book certain things. Plus, also some strategic investments and initiatives, some regulatory driven. So, there is nothing of any major concern or something like that. But when you think about IFRS9 projects, for example, these things are kicking in now. On the net fee & commission income, maybe one more comment. We have discussed this in Q2 a little bit. This was maybe a bit disappointing, we are now back to levels that we have seen in 2015 and previously, really driven by higher income on the fees across each and every product - credit-related fees, card-related fees and so on. So that's also a very solid base on that front. On the cost of risks, that's maybe something where you look at when you see the increase on the corporate side. Two comments on that. First of all corporate loan loss provisions are usually more volatile than retail LLP across different sectors and across different quarters. It's important to highlight that with the introduction earlier this year of the so called restricting law, the whole sector has probably seen now an uptick on cost of risks. This is also true for us. The issue is basically for the entire sector that we are forced to book loan loss provisions even if our facility with the particular client is not basically deteriorating. So just because of the fact that a corporate client might file for that protection under restructuring law, we are forced to run that process and review all of our cash flows. This is something that we have seen in the last quarter and I would personally also expect this to be seen going forward again across the entire sector. That does not mean, however, that we face any deterioration in credit quality or quality of our portfolio – that's very important to highlight. And when we also compare the figures YoY, LLPs didn't really go up, so it's quite the opposite, they are pretty flattish. It's just that we had earlier this year releases on the corporate side, so that's why it's pretty stable. So is the NPL ratio, it's flat pretty much YoY on the Group side.

Just a few words on the funding side and on the capital side. Funding, again, the percentage and the share of the deposits continue to play a very important role. You see this here, more than 17% of all funding base stems from the deposits. The second largest component is due to banks. Those loans, particularly the Swiss franc funding that we have received in the past from Commerzbank, as we have mentioned before, we continue to repay these loans. We will further repay this so this pocket becomes smaller and smaller and this will be replaced either by deposits and/or by the EMTN program, which went up by 1 percentage point here, compared to Q2. In Q3 we have very successfully issued another 500M benchmark issuance under our EMTN program. It was very successfully placed in the market, we had very high investors' demand, heavily oversubscribed, I would say, and pricing-wise very, very attractive for us.

With respect to capital ratios, you see here the buffers that we have comparing our actual ratios to the minimum requirements. What happened in October already, you have heard about this, KNF introduced the other systemic important institutions buffer to us, 50 basis points. That brings up the capital ratios. On the other side, we did receive the KNF letter with respect to the FX add-ons, so that's a reduction given that the swiss franc portfolio continues to come down. So, in a nutshell we have not received the final numbers from KNF yet on the Group level, this was just on the stand-alone level, however, based on internal calculations at the moment, we expect pretty much similar levels. So I would expect roughly TCR at the ballpark of 17%. So you see very decent buffers at the capital side as well, which provides us for the necessary room to further growth basically, which is our strategy. And as far as liquidity is concerned, again, we are well within each and every required level, so very solid liquidity on the funding basis on that front as well. Thank you.

Ernest Pytlarczyk, Chief Economist at mBank Group: Concerning the macro projections in the next two or three quarters we will see a slowdown of economic growth. This is a soft patch as we like to call it in economics. 3% is an important threshold, I think Q3 data will be below 3%, Q4 as well. The nature of this slowdown is exogenous, in that it's to do with the EU funding, low absorption of EU funding. The government is late with the implementation of the waste water directives, local governments with the budget restrictions and the elections are very slow to invest and the EU component also affects private investments, because many companies use EU funding to invest in production lines. We don't know when this will pick up, I think that the determination to step up the absorption of EU funds should help the situation early next year, so according to expectations GDP will slow down and then pick up again, especially that the Eurozone projections have been downgraded, but that's the end of it. So, now growth is driven by fiscal stimulation based on 500+ and consumption, which should grow by more than 4%. The other drivers are close to null. As for inflation, we are moving out of deflation, but deflation has been record high in a core prices, so there was no inflation pressure in the economy. The impact of Ukrainian workers is underestimated, but they probably keep the prices under control. It's about 2 million people and the statistical office cannot really put a finger on the actual impact of that workforce on the labor market. Now the real economy has it's reflection on the monetary aggregates. We can see much lower growth rates of corporate lending. Although the structure is quite good, if you dig into it, there is quite a lot of investment lending, but the financial results of companies are very good, and the aspiration to invest is very low. Households, we expect some recovery, as a result of improved financial standings and it seems that the growth rate of mortgage loans should improve, albeit slowly. What is also important for the sector is that the banks will continue to be flooded by the deposits of households and corporates in the coming months. So historically speaking there was a shortage of domestic funding but now it's over, it's the other way around now, the prices of deposits will be going down. Briefly on the financial markets. Bonds, I think the risk premium is quite significant and high, and I don't think it's very likely to drop anytime soon, but there is no reason for concern, because what concerned investors was mostly the revenue of the public budget. Tax collection has improved, and next year's budget looks quite stable. As for the Polish zloty, the problem goes back to the response of global central banks and the Fed, I don't think that the policy of the European Central Bank is likely to support the zloty in the coming months or quarters. Thank you.

***Joanna Filipkowska*:** Right, time for the questions.

Kamil Stolarski, Haitong Bank: A question about the outlook of the net interest margin, especially the asset yield; are you expecting this to be 1.3 bps in the coming quarters, is it comparable quarter after quarter? So the outlook of the net interest margin. You said that the net interest margin could improve by 1.3 bps quarter after quarter, is it in line with your expectations, or is it different for mBank?

***Cezary Stypułkowski*:** Well, we will both address this question; In general, yeah, on the one hand you are asking about, wait, which side of the balance sheet (looking in my drawer), because in general the net interest margin…we are quite certain that the it will improve in the coming months. In our context, on the one hand, we are actively selling retail products, which are high margin products, it's our mantra; we are not looking for more clients to buy consumer loans, clients from outside of our transactional consumer base. We acquired clients who are transactional clients, lower risk…and so that's our mantra. But naturally these are higher margin products than our historical mortgage portfolio, so in retail, the growth of these balance sheet line is quite significant. As for corporate banking clients are not killing themselves to get a loan, but we have had this shift from the top Tier, from the big tickets, to SMEs, so it should work as well. As for deposits, well, it's quite obvious, it was different when our loan to deposit ratio was above 100%, now our current account balances have grown by 20% in retail banking, but also in corporates - I had a meeting with Mr. Gdański today, who was telling me off, because he said: we also have reported high increases in the current account balances, but their current account balances were somewhat different. Anyway, all these factors suggest that when it comes to the net interest margin in the next two quarters, I think, it's gonna be just the way up. How much? Well, there is no doubt, and Ernest has just said that, if the trend continues and we continue to get more funding client deposits, not just at mBank, I think people will be more keen to look closely at the quality of banks they work with, their transactionality, so we should benefit from that trend.

Kamil Stolarski: I have two other questions if I may. I think that fees paid to intermediaries selling loans, the fees paid by the bank, are the highest ever: that's 35 million only last quarter. Was there one-off there? Or did you start using third party intermediaries more than before?

Cezary Stypułkowski**:** Well, in general, we are growing our sales, so the fees and commissions we are paying and the fees and commissions we are getting are not spread evenly over time, and there was a problem in the previous quarters, but it wasn't the problem with income, but rather the timing of costs. I think we've taken note of that I'm expecting this line to be more flattish, but there will continue to be growth.

Kamil Stolarski: Operating costs; you mentioned that you have invested in IT, but this quarter you have invested 41 million in IT, another record high figure, and also consulting spending, there was another quarter when spending on consulting was higher, so these lines, these are record high, would you like to share any details, what are these products or projects?

Christoph Heins**:** I think, again, I have already mentioned a couple of things, right, so; yes, consulting, and that's related to certain projects, again, some are projects that will help us to become more efficient, also as part of our third strategic pillar – efficiency. Some others are related to regulatory requirements, so again I'm just putting out IFRS 9 for example as a very, very large project for the entire sector, for the entire industry. When it comes to costs, well, IT is giving mBank's DNA and mBank's nature, about the apps, the applications and technology, there is a constant investment into that. Consulting is a little bit different and you see some quarters with higher and some quarters with lower costs, because you do not have projects usually fully, let's say, spreaded evenly across the quarters. So that's why I think that at the end of the day the year to date numbers are probably better ones to look at these elements. In general about costs; when you look at the cost to income ratio, when you take out the Visa one-off on the revenue side in Q2, then the cost to income ratio year to date compared, and also for the previous years, looks pretty good. We do manage costs and we do manage basically the cost to income ratio, so I think it's the nature of the business, that whenever you have some room to maneuver, you do this. That's why we call this managed costs. So it's not anything happening by mistake.

Katarzyna Czuba, BZW WBK: Question about your exposure to wind farms - the value and the quality of loans to wind farms, in the context of the amendment of the renewable energy sources law in Poland.

Cezary Stypułkowski**:** I cannot give you a very precise answer. That's not something that will keep me up at night. Before I joined the bank, I think that was one of the lines that was growing rather fast, but I think we… 162 million, 162. So it's not a major exposure. Thank you.

Christoph Heins**:** You pointed out that renewable and the wind farm sector, which is obviously very prominent at the moment especially, but again, as I stressed out already when talking about the cost of risks; mBank has not been, maybe it's just luck, but I don't think it's luck, we have not been exposed to any of those sectors that have been more troublesome in the past, right, so wind power and renewables is also one of those sectors that we are not particularly exposed to.

Cezary Stypułkowski**:** I can even tell you that we are quite lucky in that our majority shareholder, Commerzbank, had a portfolio and that there were some problems concerning the settlement issue, so that sensitized us to this matter.

Kamil Stolarski: And maybe could you please quantify the impact of the new restructuring law had on your cost of risk in this quarter?

***Christoph Heins*:** I wish I could at the moment, unfortunately I don't have the details on this one, but it's a trend that we see, and obviously this is something that, we can follow up on that I guess offline, but that's something that we need to see going forward as well. We do have seen some sort of facilities in this area, where we and our credit facility is not affected if you so want, with respect to repayments and interest payments, however we are affected because we have to run this impairment test, and the law specifically states, and the accounting rules are pretty strict, that once you do this, you have to book something, but just in expectation of the protection of the borrower basically. I do not have the details particularly for this quarter, I think this is something that we will probably, you know, do join the Q4 for the whole year 2016 disclosure.

***Łukasz Jończyk, Ipopema Securities*:** I have a question about your capital ratios; the new buffer for systemically significant institutions that will come on top of the minimum requirements, right – do you know if it will be added to the 50% and 100% threshold for the dividend buffer as well?

***Christoph Heins*:** I don't. I mean, at the end of the day I have to assume, right. At the end of the day the dividend buffer that's a different story, that's what we will then receive, whatever, by year end, or something like that from the regulators. What we do know is that this 50% buffer have been effective since October 4th, so it's in there, if you saw, and that's why I highlighted, you know those are the Q3 figures, that's why I highlighted, so the Total Capital Ratio has already gone up to 17.47%, but then simultaneously it's been reduced due to the reduction of the FX buffer. But then again, still, at the moment known for the stand-alone basis, assumption is in a ballpark of that area of 47 basis points let's say, probably 46 basis points on the Group level.

***Cezary Stypułkowski*:** From the perspective of dividend this will probably stay with us, you know, as long as we are systemically significant. I would be surprised if the regulator considered this element from the different angle.