Transcript of Q1 2017 results conference of mBank

April 27, 2017

[edited version]

Joanna Filipkowska, Deputy Head of Investor Relations: Good afternoon ladies and gentlemen, to our conference presenting results for Q1 of mBank Group. The results will be covered by the Chairmen of the Board, Cezary Stypułkowski and the Vice-Chairman and CFO, Christoph Heins. Macroeconomic situation will be covered by Ernest Pytlarczyk, the Chief Economist of the Bank, and Director of Investor Relations and Group Strategy Department.

Cezary Stypułkowski, CEO: I think you've already met Ernest in his new role, and you know that he expanded his responsibilities onto Strategy and Investor Relations. So you already met him as for his other scope of responsibility – as of today he's your person too. And two; at my right we've got Andreas Boeger who will take over from Christoph Heins as of the first of July, but now he is with us informally and we want to introduce him to you. Now, speaking of substance; It's been a good quarter. In the basic business lines the Bank's results were close to Q4, even with a smaller count of working days (I think by two), but year on year I think the results are highly satisfactory to us. So no surprise here, beside one thing – as a matter of a principle Q1 has always been a bit weaker, but this time around there is really nothing bad to say about the Bank's income in the first quarter. Speaking of the costs, well, it's always been here, no restructuring, but we are always trying to manage costs in the right way. Below 50% of C/I ratio has always been a target, but of course you have to be aware that if there is banking tax, the short term adjustments capability is smaller, of you take away the effect of tax we are still at the level of 45%, so no reasons for concern here. Speaking of deposits; the Bank's deposit level has been satisfying, the loan to deposit ratio was about 90% or slightly more than that in Q1. At the same time (as you know) we also had money from the capital… we also drew money from the capital markets last October. It was 500 million and this time it was 200 million of Swiss francs. So the pressure on deposits was smaller. Speaking of term deposits; we are not really encouraging them very much, and current accounts have been subject to the steady growth. So in this area things have been good, too. On the capital side; speaking of nominal indices presented by banks, we are the best equipped one, I think. But we are operating under AIRB regime, so we are benefiting from that. Volume wise; no miracles her, I think. At the level of NML; we've been growing at the steady pace, slightly above the market. On the corporate side; maybe not in this quarter, but in general, we've abandoned higher exposures in large corporate sale. Now our market share is quite stable – between 6.2% and 6.5%. The question is about the rest of the year. Also, we are slowly going back to financing mortgages, but we are still stressing that mortgages are not very much a standard product for us. Margin has been growing steadily for the next quarter around, so it's positive. And the customers still like us. Retail ones and corporate ones, alike. And the retail part, I think it's the second quarter in a row, that we've launched the 3.0 application. Very much welcomed by the market, very fast switch-over process for customers, so we are really happy about it. The profit was slightly smaller, in some areas, that you could expect. And now over to Christopher, further part of the presentation, and I'll be ready to take you questions after the presentation.

Christopher Heins, CFO: I think in general the first quarter was really driven by the constant execution of our strategy, i.e. serving our clients. We can clearly see this with respect to the acquisition of new clients, on the retail clients especially. Coming together, transactional clients, basically, which means that with those clients we also were able to gain more balances on current accounts. That's the main driver for the development on the deposit side. As far as loan growth is concerned - you saw the numbers – record high non-mortgage loan sales, plus more mortgage loan sales in this quarter than in the previous quarters. However, still far below, I would say, historical levels (our CEO just explained why). The market is still regaining a little bit on the margins on the spread on those products, and plus, for us it's even more important to focus on the client centricity with respect to our strategic implementation here. Excluding the FX effects, you see that this, portfolio has grown by roughly 2% - again, mainly coming from the retail side. And on the corporate side we saw a little bit slower quarter, we had a very decent Q4 last year. With respect to the deposits (I've already mentioned this); this is really driven by the balances on the current accounts, mainly steaming also from the new clients. On the term deposits side, we continued to manage out-term deposits to some extent, including also some reprising events that took place, and also helped us on the margin side of the deposits. With respect to the core income; Q1 had two days left (or less) than Q4, and if I added back those numbers, Q1 clearly shows a similar high record lever with respect to the core income than Q4. Interest income - again two elements – we were able to further increase the margins on the interest income side, and we saw further decreases on the interest expense side, as I just explained, mainly steaming from the deposit side. So that's a very good continuation of our strategy. On the fee and commission income side - very solid result from our perspective, not that usual seasonal drop in Q1, of course in some of the elements (and you can see this in the appendix – on the details on the fee and commission income), some seasonality with respect to card payments of course, but on the other side very active equity brokerage business. Then on the other side again, no IPO activity in Q1. So it's a combination of different things, but in general a very very solid quarter. Then, on the net trading income - I was asked in the last quarter (when we disclosed the Q4 figures) I think this clearly shows the markets came back to the large extend and you see this in the trading income result. And by the way – we have also seen this on the OCI, the other comprehensive income, which is a part of the capital. With respect to the costs side, again: well managed cost base, that very small uptick on the personal expenses that you see here, is to the largest extent driven by the contribution to the social security fund. So nothing unusual for Q1. With respect to the regular costs, I would say the G&As, including also the amortization – slightly lower, or pretty much in line with our expectations So the largest driver on the cost side is apparently the BFG contribution – we have seen this across the sector, in the last days and we will continue to see this, I guess. I can confirm here, we did receive a letter from the BFG earlier this week, with an additional, sort of, amount or the amount exceeding our initial expectations – that's all embedded in this number. So with respect to the full year we would expect the BFG contribution in the ball park of roughly 180 million compared to the 160 that we paid last year (and please keep in mind that this 160 last year also included this one time additional 10 million for the coverage for the bankruptcy of one of the cooperative banks). C/I ratio, our CEO already mentioned this, we just highlighted here, the normalized level, i.e. if we were accruing the resolution fund component that we had to book upfront in full – 116 million – then the normalized level would have been 45.3% C/I ratio for the quarter.

On the risk side – we continue to see very decent and solid behavior of our loan portfolio, both on the retail side as well as on the corporate side. Corporate LLPs – nothing unusual, it's always, you know, lower figures in the Q1 after you close the books for the full year. On the retail side, that small uptick – it's nothing of any concern to us, it comes simply from the fact of the continued growth of the non-mortgage loan portfolio, so more volume. Of course, non-mortgage loans come with a little bit higher risk factor than mortgage loans. I think we've clearly stated this already last year, we feel very comfortable with this loan portfolio, the ratios are unchanged, it's simply the LLPs, simple math, you have just higher volumes and that's kicking in on the GLLPs side. With respect to the cost of risk, obviously, when you look at the quarter in isolation, this is not the usual ball park number than we would expect, so for the full year, I would say, we are more expecting 55-60 bps in total as far as cost of risk is concerned.

Just quickly on the NPL ratio – continue to go down. As you may know, we sold NPL portfolio on the retail side in Q4, we will further look into opportunities to sell NPL portfolios, there is nothing on the agenda at the moment, however we will continuously look into this, whenever it makes sense from our perspective and also especially makes sense from the economic perspective. But the NPL ratio clearly shows and especially combined with the further improved coverage ratio now, the quality of our portfolio and especially when we also compare this to the sector.

Let me just highlight a couple of things on the funding side. We did issue another CHF 200 under our EMTN programme. We appreciated very much the upgrade from S&P in March on our long-term credit rating to BBB+ that you can see here. So we very much continue to believe in a well-diversified funding structure. For us it's important to have a prudent funding mix in place, we don't just simply rely on deposits. It does come of course with a drag on profitability, we've talked about this before, nothing has changed on that front. But it also will help us going forward from our perspective when it comes to the discussions about any sort of buffering around market risk events, funding risk and all these associated discussions around this. It does, however, apparently hurt us a little bit also on the resolution fund contribution, at least it's our interpretation at the moment. So we need to continue to look into this and see what the sector is doing and what the communication is from the BFG in the coming weeks but it looks like when you look at the methodology, how the resolution fund is calculated, that a bank like us with more capital funding outstanding out there, has some sort of disadvantages. That's definitely something that could be very interesting for the entire sector going forward and also from the regulatory perspective how this is being seen.

With respect to the capital ratios, we continue to improve them, not a big surprise after we decided not to pay any dividend for last year so this time we included all the retained earnings from 2016. That to a large extent drove the improvement on the capital ratios combined with a positive improvement on the RWA plus the change on the front of the methodology that we introduced already last year, the floor discussion, you remember that one.

At this stage I would hand over to Ernest and after that will be more than happy to take your questions. Thanks.

Ernest Pytlarczyk, Chief Economist, Head of IR and Group Strategy: That's a fairly good beginning of the year. Q3 was the weakest quarter and it will only go to better, improvement of the economic situation in Q1. We have the forecast of GDP growth of 4% annually and we think that, number 1 are up for this forecast, specifically after the good beginning of the year. We also think that consensus will move towards our side. Where we differ is that we think that there will be some acceleration in the quarters to come, however the consensus is on the poorer second half of the year. The cyclical and structural ratios and features impact labour market. Shortage of employees, 5% remuneration growth witnessed already and will be even faster at the end of the year, the propagation of shocks: the programme 500+ which will become the permanent part of people's income, good exports, good situation in the Western Europe, 2% growth there already, the forecasts are on the continuous increase plus the inflation impact as well. And something that was lacking in our case, the EU funds absorption which is now improving v. previous year which is, with the impact of the policy of the Polish government, shift of attention to that side, so various investments are going to occur in the carting, there will be the consumption demand on the market clearly visible thanks to the 500+ programme but not only. The EU impact for private investments as well. Inflation and interest rates. The growing inflation trends, especially as regards the core inflation – the demand gaps will be covered, the demand on the labour market. Headline inflation should reach 2.5%, then it will decline, then rise again, but definitely there is an inflation trend. How will the Monetary Policy Council react? They are really reluctant to changing the interest rates, we are skeptical here, we think that if we view it from the global context, we are probably heading towards some nornalisation in Europe, there are some increases in interest rates in the US, it will come to Europe and then in Poland that will happen as an obvious solution we think. I think the Monetary Policy Council wouldn't be too stubborn on that, there will be some normalization on the Polish market, too. We also need to take into account the loans and deposits, there will be some speed up here from these moderate and low levels in the second half of last year, corporate loans on the increase we think, the slowing down dynamist of household deposits and the improvement of dynamist in consumer loans as well as in housing loans. It is related with the fact that all the wellness ratios, consumption ratios, the fears of losing jobs, they are at their historical minimum [or maximum] levels. So there should be decisions made on purchasing of flats and houses. We still pay out the risk premium, however that will come to a change, the spread against the German bonds has been narrowed recently. Are we the target for purchasing? Well, all depends on the global trends, we thenk that the interest rates globally will be higher and that will have an impact on an interest shown in our bonds. PLN, the exchange rate 4.2 v. EUR we think at the end of the year. Thank you.

Joanna Filipkowska: And now your questions, ladies and gentlemen. Please feel free to ask questions.

Dariusz Górski, DM BZWBK: Am I right that your adjusted earnings were approximately PLN 300 million? I mean, if you add back the three quarters of the BFG, we would probably be around that. I am kind of surprised why you keep on talking about 1 bn earnings target this year, because seems very conservative.

Cezary Stypułkowski: Whenever you don't know, be conservative, that's the natural advice. And since a lot of things can happen, I in principle I am very much with you. I think, what Ernest has said, and what I strongly believe, this will be a good year, for the bank and for the industry and for the economy itself. We are towards 1 billion PLN.

Dariusz Górski: This is the discussion we are having every quarter.

Cezary Stypułkowski: Other banks are less precise in describing their targets.

Dariusz Górski: That is true. Without this question, the presentation would not be complete. Touching upon your growth outlook, the origination has been quite strong across most of the sectors and my question is – this dip in corporates – was it intentional? Because I have an intention from other banks, that the corporate business is really starting to gain momentum. Can you confirm that and should we expect stronger origination further out in the year because it looks like momentum is really building.

***Cezary Stypułkowski*:** I was purposely in the discussion with head of our Head of Corporate and Investment Banking since I was expecting this question, and I can even read what he has responded since he is travelling. This is very much in line with I have responded to your first question. But to be fair, I very much share your views, I believe that the market is opening. And my feeling is that specifically the second part of the year should be stronger. This resonates also to what has been said by Ernest. I'm of the opinion that people have been late to open the investment drive due to instability on the political scene. Whether this is enough in the situation when the consumption is booming and exports are growing and the capacities of individual companies are very much under the pressure and labour market does not help, so I have to say investments is the only way really to respond. But still, I would say, my perception is that these are the last weeks of the stand and still of the private corporate sector side. So I'm more positive, I believe the second half of the year should be stronger, the 6% which we have exercised in terms of the lending book growing year on year is very much in line with the market. Whether we will be stronger? I think there is one phenomenon in our book, which I don't think is fully followed by yourself: I think over the years we limited our exposure to the big, titanium type of companies in the Polish market and we strengthen our position in a, let's say, upper middle market, with obviously smaller tickets. I would say, the nominal figure does not tell you everything, with a positive impact on margin and more diversification of our loan book. All in, we are keeping the market share somewhere between 6.2 and 6.5, depending on a quarter. Whether in a long run we will be more than 6.5? I would say, I would not exclude.

Dariusz Górski: Your cost of fees - this was one of the reasons why your fees were flat and they seem to be jumpy, there some quarters when they are 170 and in some 150. So why are they so volatile? And the second question which again is technical: when I look at your loan yield, it's not showing signs of improvement. Why?

Christoph Heins: On the second part: I am not sure where you really get from that it's not showing improvement. I mean, at the end of the day, when you look at the portfolio size, taking into consideration the Swiss franc portfolio which again makes up for more roughly 24% of our all overall gross portfolio, which is stuck as far as margins are concerned, with a negative profitability as we all know so that's a drag. On the corporate side it really depends on couple of different elements - competition, which kind of sector you are serving, in which quarter and so on and so forth. We all know that the gigantic, largest corporates it's a thinnest margin business and the big question is at the end of the day – are we only looking at the interest income or are we looking at the broader side, i.e. combining interest income with fee income. And the fee income is the potential game changer in the industry, let's be very honest. And combining this, I think we are well positioned also going forward and it is volatile because when you remember what I said when we disclosed the Q4: we had some very active markets following the Trump trade in the markets, highly volatile markets. But those markets showed all of a sudden activity in the secondary market, issuing debt for corporate clients, IPOs even, so those are the more sophisticated businesses that we can serve our clients with. With that comes the fee income. Then you have a quarter like the first quarter this year that had some sort of lesser activity on that front. Now we compensate it with the retail side which is maybe from your perspective more boring because it's slower growing business on that front and it has some seasonalities. That's driving towards the first part of your question: the volatility. When you look at the details there are two elements in there: one is seasonality in card payments. Q1 is always lesser strong, let's put it this way, than Q4, of course, the holiday season is over. Then you have, on the corporate side, we didn't have any IPOs., so that's the other part. Then we had, and that's true when you look at the slide number 30 for example, that shows the fee and commission income, so grossing it up, we have also in the income side some movements. I'd like to highlight one component, the activity and securities issue, that's the red bar there. -32% QoQ and +26% YoY. There is a technical element in this: we incorporated our equity brokerage house last year into mBank. With that now and given some accounting changes, we had to net the way how we show the securities commission fee so in the past we grossed it up and we had the expenses also grossed up. Now we net it. So that's why on the income side it's lesser but on the expenses… The expenses in total went down by over 11% QoQ. So that's maybe some volatility. On the other side I can only repeat what we've said before. Remember, we do not maintain for example the cash machines like other banks, the ATMs, we buy services from others. So the more of our customers are using the cash machines, the more expenses we have. The less they do it, using for example their smartphones via BLIK, the lesser expenses we have. So to some extent the volatility doesn't concern me. We are more looking into the different buckets and quality of the earnings on that front. And I think when I look at the trend here and especially on the fees that are related to the more sophisticated products that we're offering our clients and again putting the client in the middle of our strategy – client-centricity is a key element here – then we strongly believe that we are well positioned to this. Can I rule out that it will continue to be volatile? No, not in those categories that I just mentioned. Seasonality and also to some extent client-driven. But that's ok – as long as we can serve the clients with best products and we have repeated business with the clients. That will help us going forward to largest extent.

Kamil Stolarski, Haitong Bank: If I just may, on the sales of your non-mortgage loans. Comparing what you are selling today to what you have been selling, let's say, two years ago, it seems that the loans to entrepreneurs... excuse me. I was asking about loans to entrepreneurs, they basically doubled from what you have been selling two years ago. Could you show us what is the profile of this client? Are they very little enterprises? You have the positive outlook for the market, so, would you consider increasing your risk appetite somehow further from what it's now?

Cezary Stypułkowski: I will answer in Polish, it will be clearer to you most probably. Mortgage loans. Our policy was not too consistent, because couple of years ago we assumed that we would finance our mortgage activity with covered bonds, which seems to be a reasonable solution in the long term perspective, because it's a more stable funding source. But it happened at the time where we didn't expect such a strengthening of our position on the deposit and liquidity side. So, we shifted large portion of our activities to the mortgage bank. When the banking tax was added, all these elements start to be too complicated, too complex. We also had this policy of having mortgage loans like not a stand-alone product, but somehow incorporated into the bunch of products for customers. So, depending on the speed of pushing mortgages away to covered bonds, our dynamics was poorer than the market. Our ambition is not to be the champion there, because we need to remember that interest rates are going to increase. What consequences it may have on customer is difficult to forecast. But, the extra component appeared - funding mortgages for small entrepreneurs. That was an element in our structure in the past and it plays a certain role right now as well. So, we may say that our mortgage loans, in the quarters to come, will come back to the bank. It should be more dynamic. Is it attractive to us? Well, it's a core product. It's product anchoring the customer with us. So, for entrepreneurs, it's also attractive from the main margin standpoint.

Kamil Stolarski: The sales of non-mortgage loans to entrepreneurs was at 514 million in this quarter - it's like two times more than it was two years ago. This is the new level, because last few quarters was around 400 million. Do you expect this to be at this level and does this reflect being more open to take risk?

Cezary Stypułkowski: SME expansion on a retail side is the fastest growing part of our business right now. As you may know, a few years ago bank has changed its strategy in this respect. Mr Kość, who used to be Head of our Strategy has been allocated with the responsibility and portfolio and he has done a fabulous job. We are currently in a situation where, as I said, mostly with the more sophisticated SME, internet-based clients, we see big success. Obviously, we cannot compete with the mainstream banks with the vast network of the branches, but the new model which we have introduced is working, let's say for the time being. Those effectively with a very low cost base and a strong expansion and a growth rates in this segment of the business is fastest growing.

Kamil Stolarski: Short question on cost of risk in corporate segment, because it was very little – was there some positive one-off or it's just the reflection of strong economy today?

Christoph Heins: Again, the one is Q1 is always less than Q4, because we continue to say Q4 is a longer quarter because until you really close your books for the year-end, whatever pops up that is part of the previous year. We did see some net releases on the corporate side, but especially one of the other aspects were we saw some repayment on already defaulted loans. So, more provisioned loans and then we saw the recovery on those.

Dariusz Górski: The regular question is obviously Swiss franc, our Swiss franc mortgages. It's no secret that the Polish Banking Association is coordinating banks' proposal on voluntary conversion. What would your take on that be?

Cezary Stypułkowski: I think the stance of the banking community and represented by the Association is pretty consistent from the very beginning. The message was that it should be individualized approach, not mandatory; that the best way is really to assist customers in need and this is being done by the banks on the individual basis, plus the fund has been created and obviously utilization is not that strong. As you know, we are under the pressure from the official sector with variety of, I can easily say, strange initiatives, which have been introduced over last two years. I think that there is more and more understanding of our stance and our approach. Something what is on the horizon, which is being seen like additional capital buffers, which should push the banks to convert into zloty portion of their portfolios on voluntary basis - well, we are, and it's not only our bank, serving some of our clients who meet the criteria, which are more or less agreed between the banks. The response, I have to admit, is not that strong. Plus, I have to admit, and this is my personal view, this scheme which will allow, even with some contribution from the banks, to convert due to the expectation that the capital burden will be eased still has come caveats. One of them is that since we are of the opinion that the interest rates will be going up - the question is whether it will be end of the next year, as Ernest has mentioned, or... but I think there is no doubt at this audience that we are on this trajectory. Then, we will be in a position, that even if we would transform the current loan into the zloty loan, then the customer will be exposed to the interest rate hike, and was a result of his monthly payments going up. I think that one of the concerns, at least I have, is that we will be blamed by the group of customers that, you know, they've been offered the Swiss francs, they have been encouraged to convert into zloty and know they are again penalized by the banks – banks should know that interest rates will go up, and I know that they will go up. Am I prepared really to take that type of the risk? In a situation where I don't think that the banks really violated any laws, that the banks effectively helped the clients to build up their apartments and they are servicing these loans in a very disciplined manner? And the concentration of the problems, let's be fair, this is the statistics which I have seen, the concentration is very much... you know... big amounts or bigger number of loans taken by the clients. So the concentration of people who do not pay are above 1 million zlotys and the number of loans taken. What does it mean? These were the clients with relatively strong financial position, the banks accepted their contributions, accepted the level of risk, and my assumption is that, you know, most of these cases have been more like buying semi-financial assets than serving housing needs. There is some kind of disconnect that people who have financed the bigger apartment or bigger number of apartment obviously they didn't reach their expectations. Some people didn't reach their expectations investing into stock market. Should we assist these people? That's the dilemma. I have to say that the solutions which are being offered by the banking sector focused on building up stronger buffers to support clients in need I think is a better solution than any other. And I am very much in favor of continuation of contributions to the fund. Obviously we will be following the discussion within the banking association and we will check with our clients whether there is an appetite, but I have to say this needs to be very selective, it cannot be… I don't want to expose the bank to another round of accusations that helping the clients, for whatever reason we deteriorated their positon.

Joanna Filipkowska: Do you have any other questions, ladies and gentleman? If there are no more questions, feel invited for refreshments. Thank you.