ProCredit

Initiation of coverage

Impact-oriented SME lender in SEE and EE

Banks

ProCredit (PCB) has extensive experience in supporting small and medium-sized enterprises (SMEs) in emerging economies (coupled with a strong environmental, social and governance (ESG) profile), with a focus on Southeastern (SEE) and Eastern Europe (EE) and banking operations in Ecuador. Its in-depth, impact-oriented relationships with SME borrowers (93% of loan book at end-Q120), prudent credit risk management and solid capital base (CET-1 ratio of 14.0% at end-Q120) should help reduce the impact of macro headwinds. We forecast PCB's ROE to increase from c 7% in FY19 to 10% by FY24, driven by solid loan book growth after FY20e (c 9% pa), which can be achieved with the existing capital base. This should be assisted by limited growth in operating expenses due to a lean branch network and digital platform.

Year end	Net interest income (€m)	EPS* (€)	DPS (€)	P/BV (x)	P/E (x)	ROE (%)	Yield (%)
12/18	186.2	0.90	0.30	0.5	7.0	7.6	4.8
12/19	194.5	0.89	0.30	0.5	7.1	6.9	4.8
12/20e	199.9	0.54	0.18	0.5	11.7	4.0	2.8
12/21e	205.1	0.70	0.23	0.5	9.0	5.2	3.7

Source: ProCredit, Edison Investment Research. Note: * From total operations.

'Hausbank' for SMEs, direct bank for individuals

PCB has recently finalised streamlining its business, involving a digital direct bank strategy for private clients (leveraging its in-house tech company Quipu) while offering comprehensive services to SMEs. As a result, PCB has reduced its branch network (by c 8x) and headcount (by c 3–4x) over the last six years, and also sold banks in less promising markets in Latin America and Africa. This is gradually translating into a lower cost income ratio (CIR), at 64.6% in Q120 (although lower income in 2020 may temporarily push it back to c 70%). While recently PCB's return on equity has been below peers, we underline its relative stability throughout the cycle and believe that its mid-term ROE and CIR targets of 10% and below 60%, respectively, are achievable (close to our FY24 forecasts).

Pause in secular growth trend due to the pandemic

The SEE and EE region has benefited from secular GDP growth of 3–5% pa in the last five years, with SMEs being one of the main drivers. COVID-19 is expected to trigger a recession in 2020 (the IMF forecasts a decline of 4–5% in PCB's markets), with a rebound of c 5% forecast in 2021. In the longer run, PCB's business should be assisted by the low banking sector penetration in the region (with a loan book to GDP of 40–45% on average vs over 70% in Western Europe).

Valuation: Looking undemanding

We have valued PCB's shares using a P/BV-ROE approach and, based on a sustainable return on tangible equity (RoTE) of 10%, we arrive at a fair value of €7.50 per share (c 20% upside to the current share price). Factoring in an RoTE in line with PCB's five-year historical average of c 8% would translate into a fair value of €5.63. PCB trades on an FY20e P/BV multiple of 0.5x vs the peer average of 0.9x, which we believe is only partially justified by its lower ROE.

4 June 2020

Price	**€6.30**
Market cap	**€371m**
Total assets (€bn) at end-March 2020	6.6
Shares in issue	58.9m
Free float	35.7%
Code	PCZ
Primary exchange	Frankfurt Prime Standard
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	25.5	(6.8)	(27.5)
Rel (local)	9.2	(10.5)	(31.5)
52-week high/low		€8.6	€4.6

Business description

ProCredit is a Germany-based group operating regional banks across Southeastern and Eastern Europe, as well as in Ecuador. The banks focus on SMEs and private middle-income and high earners. At end-March 2020, the group's total assets stood at €6.6bn.

Next events

Q220 results	13 August 2020
Q320 results	12 November 2020

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Edison profile page

ProCredit is a research client of Edison Investment Research Limited

Investment summary

Company description: Specialist lender for SMEs

PCB is focused on providing impact-oriented financing primarily to SMEs (93% of the bank's loan book at end-March 2020) to support investment and working capital needs throughout their lifecycles, with individual loan volumes mostly in the range of €50k to €3m. Green loans represent a growing share of its loan book (16.7% at end-March 2020). Moreover, it is a direct bank for private clients with a proprietary digital platform and a lean branch network, targeting middle-income and high earners (including SME owners) in particular. Importantly, as ESG aspects stand high on PCB's priority list, it does not provide meaningful volumes of consumer loans. Its geographical footprint currently covers 10 countries in SEE and EE, as well as Ecuador plus its holding and minor banking operations in Germany (it operates under a German banking licence). PCB's major strategic shareholder since inception is Zeitinger Invest (17% stake). Prominent shareholders include KfW (a leading German development bank), holding a 13.2% stake, and International Finance Corporation (IFC, which is part of the World Bank), with a 10.0% stake. PCB's solid financial standing was confirmed by Fitch in April 2020 with a long-term rating of BBB and stable outlook for ProCredit Holding and its six subsidiary banks. The company's strong ESG profile is illustrated by its MSCI ESG rating of AA.

Valuation: Our base scenario indicates c 20% upside

Our P/BV-ROE valuation indicates a fair value of €7.50 per share, which is c 20% upside potential to the current share price. This is based on our assumed sustainable RoTE of 10%, in line with management's mid-term ambition and our FY24e forecast. Factoring in a sustainable RoTE of 8% (in line with PCB's five-year historical average) would translate into a fair value of €5.63 per share. As the valuation is based on our FY20 tangible book value forecast (€13.0 per share), it is dependent on the cost of credit risk we have pencilled in for FY20e (80bp at group level vs management guidance of 50–75bp), as well as net interest margin (NIM) (we assume the NIM declines by 12bp in FY20e), which this year may be affected by multiple factors, including rate cuts by central banks (potentially intensifying competition in the sector) and additional liquidity needs, eg due to deposit outflows (which might force PCB's banks to seek more expensive external funding or raise deposit rates). PCB's FY20e P/BV stands at c 0.5x (vs the peer average of c 0.9x), which we believe is not fully justified by its relatively lower return on equity (ROE).

Financials: Dependent on SME NPL ratios in the region

Although COVID-19 will weigh on PCB's profitability this year due to a higher level of loss allowances (provisions for credit losses) and muted growth in gross loan book (we assume 2.1% in FY20e), we believe the bank will remain profitable with an ROE of c 4.0% in FY20e. This is the function of a slight NIM decline on one hand, but modest growth in operating costs on the other hand following the efficiency measures introduced in the past (translating into a CIR of 68.8% in FY20e). For FY21e, we forecast an ROE of 5.2%, supported by a gradually declining cost of risk and rebounding lending volumes. The group's capital base should remain resilient as PCB remains profitable while loan book growth decelerates. This will be further assisted by the recent reduction in PCB's Supervisory Review and Evaluation Process (SREP) add-on, the European Banking Authority's equivalence acknowledgement of the Serbian banking regulatory framework, as well as the prospective introduction of Capital Requirements Regulation II (CRR II) from 2021 (extending the SME support factor to exposures above €1.5m). Consequently, we forecast PCB's CET-1 ratio will be 14.1% in FY20e and 14.3% in FY21e (vs 14.0% at end-March 2020), well above regulatory requirements. In line with management's mid-term targets, we assume that PCB's loan book growth will accelerate to c 10% pa in FY22–24e, assisting a stable decline in CIR (to 61% by FY24e) and improvement in profitability (ROE at c 10% in FY24e).

Sensitivities: Cost of risk and structural macro/political factors

As discussed above, PCB's near-term performance will be largely determined by the macro environment amid the COVID-19 outbreak, in particular the level of loan loss provisions and non-performing loans (NPLs). We estimate that every 10bp increase in FY20e cost of risk reduces our PCB valuation by €0.03 (or a mere 0.5%) per share. In this context, we note a number of factors supporting PCB, such as 1) high loan book quality and collateral requirements, 2) well-trained and experienced staff aligned with PCB's 'Hausbank' for SMEs approach, 3) a lean branch network and digital platform, 4) support from international financial institutions (as shareholders, debt holders and/or partners in SME funding schemes) and 5) solid liquidity with a liquidity coverage ratio (LCR) of 181% at end-March 2020. Beyond COVID-19, we have identified other important sensitivity factors for PCB, comprising foreign exchange risk (mostly affecting the value of PCB's equity stakes in regional banks), as well as macroeconomic and political risk in the region (discussed in detail later in the note).

Company description: Leading lender for leading SMEs

PCB specialises in financing SMEs in transition economies, including SEE, EE and South America (Ecuador). Its focus is on impact-oriented financing, which supports sustainable development, employment and social prosperity. In the past, the group offered mainly small-volume lending to micro and SMEs (MSMEs) but has changed its target customer group to growing, well-established SMEs, which foster innovation, local production and a transition to a green economy. PCB also offers banking services to private clients, predominantly to middle-income and high earners (SME owners in particular).

The company provides a full range of banking services. This includes lending to business clients in the form of investment and working capital loans (with a target amount of €50k to €3m) as well as liquidity management and trade finance. Moreover, it offers housing and investment loans as well as overdrafts to private clients. The company also provides current accounts, flexible savings and term deposit accounts.

History: From NGO consulting to own banking operations

Consulting projects in emerging markets

PCB has its origins in IPC, a consulting company founded in 1980 (now Zeitinger Invest, a major shareholder with a c 17% stake in PCB). Initially, the company ran advisory projects with government-owned development banks and credit-granting NGOs in Latin America aimed at providing access to the formal financial sector for MSMEs in emerging markets. In the 1990s, IPC expanded its activities to downscaling programmes in commercial banks in Latin America and the former Soviet Union, which were intended to improve financial services offered to MSMEs by commercial banks.

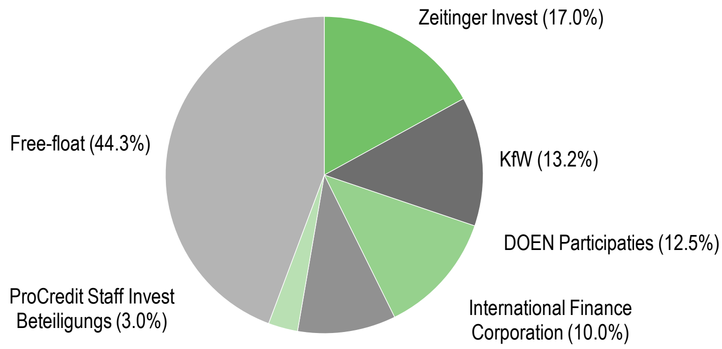
Starting to set up 'greenfield' banks

In 1997, the company established its first microfinance bank in Bosnia in the aftermath of the Bosnian War, which left the country highly disorganised while the economy remained strongly dependent on SMEs. The bank was set up together with international public sector development organisations, including KfW (a German development bank), IFC (a member of the World Bank Group), the European Bank for Reconstruction and Development (EBRD) and the Netherlands Development Finance Company (FMO). Notably, KfW and IFC are still PCB's major shareholders, with stakes of c 13% and 10%, respectively. At that time, IPC was also granted a management mandate in the Bosnian bank. To raiseaccess more capital, the company was founded in 1998 as Internationale Micro Investitionen (IMI). The initial shareholders were IPC and ipc-investment (now ProCredit Staff Invest) and new investors soon joined, eg PCB's current shareholder DOEN Foundation (a Dutch entity focused on supporting sustainable and socially inclusive entrepreneurs), and expanded the network of its banks to 17 entities.

The foundation of ProCredit

IMI became ProCredit in 2003, with core shareholders being IPC, DOEN, KfW, IFC and ProCredit Staff Invest, and continued consolidating ownership of the respective regional banks. Meanwhile, it expanded its geographical footprint in Latin America and Africa. In December 2011, ProCredit Bank in Germany obtained a banking licence from the German regulator (BaFin). ProCredit Group has been listed on the Prime Standard segment of the Frankfurt Stock Exchange since December 2016. PCB's shareholder structure has remained broadly stable, as illustrated in Exhibit 1.

Exhibit 1: PCB's current shareholder structure



Source: ProCredit. Note: These are based on the following latest notifications from the respective shareholders: Zeitinger Invest (8 October 2018), KfW (28 December 2016), DOEN (29 December 2016), IFC (27 February 2018) and TIAA (29 December 2016).

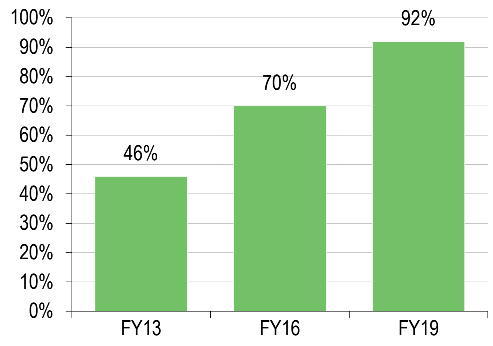
'Hausbank' for SMEs in SEE and EE

Focus shifting from microenterprise loans to well-established SMEs post 2008/09

While successfully withstanding market headwinds during the global financial crisis in 2008/09, PCB decided to alter its business focus. Lending practices in the microcap space were aggressive, leading to over indebtedness and little regard for social or environmental factors. At the same time, demand for SME lending was growing. Consequently, PCB moved away from being a product-oriented microfinance provider in 2008 to become a 'Hausbank' for SMEs, focused on maintaining long-term partnerships with its clients and providing them with a full range of financial services. PCB highlights that SMEs have a substantial impact on overall economic development in countries where it conducts operations, as they provide c 60–80% of total employment and generate at least half of the value add.

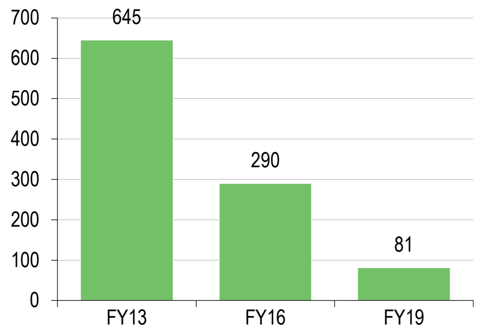
The strategic shift to larger-scale businesses is illustrated by an increase in PCB's initial loan size over recent years, with the share of loans over €50k at 92% at end-2019 vs 46% at end-2013 (see Exhibit 2). This was coupled with a significant reduction of the branch network (81 at end-2019 vs 645 at end-2013, see Exhibit 3) and staff (c 3k at end-2019 vs 11.5k at end-2013), which translated into an increase in loan book per employee to €1.6m at end-2019, compared with €0.4m at end-2013. SMEs currently account for c 50% of PCB's customer deposits and 60% of fee income (but 93% of its loan book).

Exhibit 2: Share of loans with a volume over €50k in PCB's loan book



Source: ProCredit

Exhibit 3: Reduction of PCB's branch and service point network over time



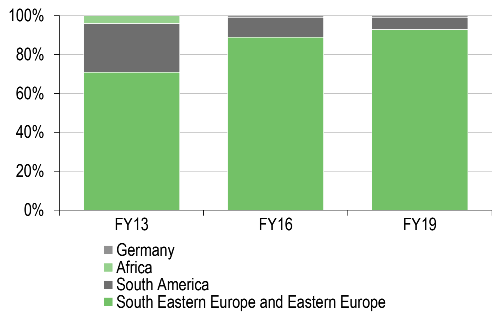
Source: ProCredit

Optimising its regional footprint

PCB decided to focus on SEE and EE and exit operations in less promising markets, such as Africa and Latin America (except for Ecuador), as well as Armenia. It finalised the consolidation and restructuring of the group in 2019. Finally, it acquired the remaining minority stake in ProCredit Bank Ukraine in January 2020 (and thus holds a 100% stake in each of its regional banks now). The company highlights that most of the disposals were motivated by the group's long-term strategic vision and it is worth noting that these loan books were not under/non-performing.

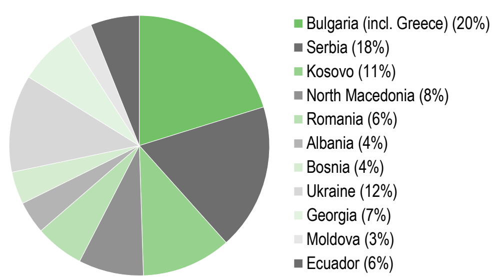
Consequently, at end-March 2020, PCB conducted its banking operations in 12 markets (13 if we include ProCredit Bulgaria's branch in Greece). SEE and EE represented 93% of its gross loan book, up from 46% at end-2013. The largest markets are Bulgaria (20% of gross loan book at end-March 2020), followed by Serbia (18%), Ukraine (12%) and Kosovo (11%), see Exhibit 5. PCB's banking business in Ecuador was c 6% of the gross loan book at end-March 2020. The company's German operations are largely focused on providing services to the group, such as efficient payment, liquidity and support functions. They include ProCredit, Quipu (the software subsidiary responsible for developing its digital platform), ProCredit Bank Germany (1% of the group's gross loan portfolio at end-March 2020) and ProCredit Academy in Fürth (which runs a training centre for the group's employees). The company has implemented German banking standards across its regional banks and is supervised by the German authorities (BaFin and Bundesbank).

Exhibit 4: PCB's regional loan book split between 2013 and 2019



Source: ProCredit

Exhibit 5: PCB's regional loan book exposure at end-March 2020



Source: ProCredit

Strategy

Sustainability and impact orientation as a top priority

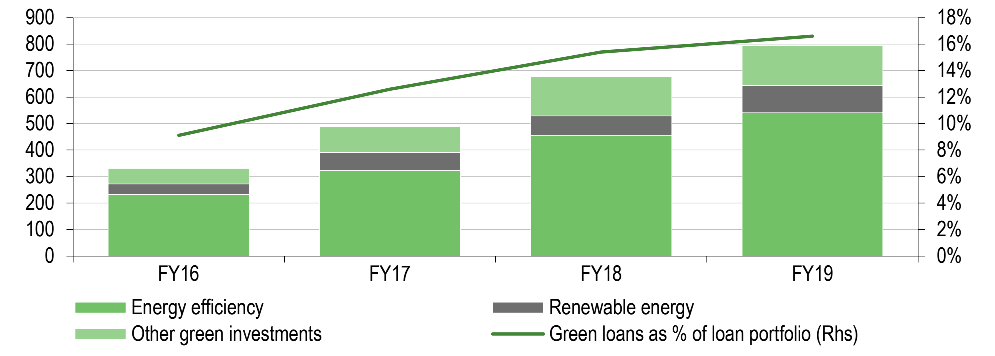
PCB's long-term mission is to contribute to an inclusive, stable and efficient financial system. It focuses on building and maintaining long-term relationships with its clients and employees, offers only simple and transparent products, promotes a savings-oriented culture and puts a strong emphasis on prudent credit as well as environmental and social risk management. This is enhanced by the group-wide code of conduct, which includes an exclusion list, specifying business activities that must not be financed by the group (in fact, no business activities will be established with clients engaged in any of these activities). Additionally, the company has set standards to minimise the environmental impact of its lending operations, supported by the Group Environmental Steering Committee at group level and Environmental Committees in the local banks. PCB's strategy is aligned with the UN's Sustainable Development Goals.

Moreover, it has been actively cooperating with European institutions to foster innovation and became one of the largest partners for the InnovFin programme run by the European Investment Fund (EIF). The latter doubled the available financing covered by guarantees provided to PCB through the InnovFin initiative to €1.62bn in July 2019, which extended PCB's capacity to grant loans to innovative companies. PCB has enabled access to this EU-backed funding to around 2,000 SMEs.

Green loan portfolio represents c 17% of PCB's total loan book

The company's sustainability orientation is illustrated by its growing book of green loans, which it started disbursing in 2006 and which represented 16.7% of its total loan book at end-March 2020 (or €807m) compared to 15.4% at end-2018 (see Exhibit 6). These include loans to fund energy efficiency projects that reduce energy consumption by at least 20% (these made up 68% of the green loan portfolio at end-2019) as well as renewable energy (13%) and other green investments (19%), including investments leading to the prevention of air, water and soil pollution, waste management, as well as organic agriculture and production. Interestingly, green loans accounted for c 30% of PCB's loan book growth in FY19 and Q120, with particularly strong momentum in renewable energy projects (characterised by stable income streams, which is especially important in the current environment). PCB's mid-term target is to increase the share of green loans in its total loan book to 20%.

Exhibit 6: PCB's green loan book (€m)



Source: ProCredit

High MSCI ESG rating of AA

The company is committed to reducing its direct environmental footprint and become carbon neutral in the medium term. In 2019, the group reduced its CO_2 emissions by 19% y-o-y, thanks to internal environmental measures in its premises, replacing fleet with electric and hybrid vehicles (c 65% of its car fleet currently), as well as progressive reduction and recycling of waste.

PCB's ESG performance, measured by the MSCI ESG rating, was AA at 12 May 2020, which places it in the top 15% of companies rated by MSCI in the banking sector worldwide.

Direct (digital) bank for private clients

Despite its traditional approach to banking, the company is committed to investing in the development of efficient and secure technology. Its app- and web-based functionalities are developed in-house by its software subsidiary Quipu, which PCB believes helps address IT challenges quickly. With respect to the development of PCB's direct (digital) banking, a major milestone was the introduction of 'ProCredit Direct' in 2017, a digital banking platform primarily for private clients. It complemented the existing approach of 'Hausbank' for SMEs and allowed it to initiate the digitalisation of financial services to private clients, fully completed in 2018. Since then, all transactions in the group's banks have been digital (ie PCB substantially abolished over-the-counter and cash transactions in its branches). Currently, PCB is focused on the digitalisation of non-financial transactions, including development of MyDIRECT, an online service that enables clients to confirm their identity digitally via remote video (which was introduced in its banks in Bulgaria and Georgia last year). The company underlines the innovative nature of its IT solutions in the markets it operates in, eg PCB's bank in Ecuador is the only fully digital and cash-free bank in the country. Interestingly, while the group has largely finalised the shift away from loans with a volume below €50k last year, it treats this market segment as an opportunity for more streamlined lending to private and small corporate clients using its digital platform.

Hiring/HR policy

PCB highlights that it can fulfil the needs of SMEs better than its competitors, thanks to its well-trained and long-serving staff, with 75% of the team having more than five years of experience in the group, while managers in local banks have worked for PCB for over 12 years on average. PCB remains focused on targeted recruitment and staff development, which it supports with comprehensive training programmes provided by ProCredit Academy in Fürth, Germany. PCB's spending on employee training rose from €6.8m to €7.2m in FY19. Notably, the company's renumeration policy is aligned to its long-term oriented business objectives and does not include any short-term, performance-related bonuses. PCB promotes gender diversity, as exhibited by the composition of the management boards in the group's banks, with women representing 53% of the headcount. The bank's response to COVID-19, and in particular the health and safety of employees, has benefited from a focus on digital banking, which has enabled staff to work from home and continue to engage with clients.

Management

ProCredit's business is managed by ProCredit General Partner (the personally liable managing partner of ProCredit AG & Co KGaA), which has a management board consisting of two members:

- **Dr Gabriel Schor** has worked for the consulting company IPC (discussed above) since 1983. He was appointed a member of PCB's management board in 2004 and is responsible for reporting and controlling, supervisory reporting and capital planning, accounting and taxes, group treasury and group funding. In September 2019, he also took over investor relations, group communications, administration and translation.
- **Sandrine Massiani** joined PCB in 2007 and initially worked as regional coordinator in Africa. She became a coordinator of the group's human resources in 2011, and a manager of human resources and IT in 2015. She was appointed to the management board in 2017

and has overseen human resources, internal audit, risk management, IT, business support and compliance. Since September 2019, she has also been responsible for credit risk, group environmental management, legal, group anti-money laundering and fraud prevention. Before Sandrine Massiani joined PCB, she worked at BNP Paribas and Development Finance International (an international advisory firm focused on emerging markets) and was a project coordinator and short-term expert at IPC.

A notable change to the management board took place in September 2019, when Borislav Kostadinov (who had been responsible for credit risk management, environmental management and impact reporting) resigned from his function for personal reasons. **Dr Gian Marco Felice** will join the management board in June 2020 once all formal procedures with BaFin have been completed. He has held various managerial positions within the group since 2001 and is now an authorised representative of the company ('prokurist'), responsible for business support, environmental management and impact reporting.

PCB's key management personnel also includes **Christian Dagrosa**, who is a prokurist and manager responsible for investor relations, as well as reporting and controlling. However, he is not a member of the management board of ProCredit General Partner.

Overview of operations by country

We have summarised PCB's operations by country in Exhibit 7. We note that EE displays higher profitability (annualised return on average equity (ROAE) of 15.2% in Q120 vs 7.1% in SEE), driven by a higher NIM (4.5% vs 2.5% in SEE and 3.1% at group level) and lower CIR (39.7% vs 65.7% in SEE and 64.6% at group level). At the same time, the share of NPLs remains low across regions.

Exhibit 7: Summary of PCB's operations by region and country

	Gross book at end-Q120 (€m)	Gross loan book y-o-y	NPL ratio (end-Q120)	Cost income ratio (Q120)	Cost income ratio (FY19)	Profit after tax in FY19 (€m)	ROE (FY19)
Southeastern Europe	**3,414**	**9.9%**	**2.2%**	**65.7%**	**72.0%**	**38.4**	**7.8%**
Bulgaria	956	12.7%	N/A	N/A	N/A	18.5	N/A
Serbia	854	12.2%	N/A	N/A	N/A	5.9	N/A
Kosovo	512	0.8%	N/A	N/A	N/A	21.5	N/A
North Macedonia	376	13.3%	N/A	N/A	N/A	4.2	N/A
Romania	307	17.8%	N/A	N/A	N/A	-4.1	N/A
Bosnia & Herzegovina	205	8.5%	N/A	N/A	N/A	-0.8	N/A
Albania	205	-1.2%	N/A	N/A	N/A	-6.6	N/A
Eastern Europe	**1,064**	**10.5%**	**3.2%**	**39.7%**	**42.3%**	**37.7**	**17.4%**
Ukraine	607	16.4%	N/A	N/A	N/A	24.2	N/A
Georgia	319	-0.7%	N/A	N/A	N/A	9.0	N/A
Moldova	138	16.5%	N/A	N/A	N/A	4.5	N/A
Ecuador	**307**	**26.7%**	**2.6%**	**90.8%**	**102.5%**	**-1.3**	**-2.3%**
Germany	**54**	**-26.2%**	**N/M**	**N/M**	**N/M**	**1.6**	**N/M**
TOTAL	**4,839**	**9.2%**	**2.4%**	**64.6%**	**70.5%**	**54.3**	**6.9%**

Source: ProCredit

SEE: Strong loan book momentum and quality, but muted margins

PCB's loan book growth across countries (except for Kosovo and Albania) has been strong overall in recent years at 10%+ pa, supported by the comparatively low level of loan book to GDP at c 30–55% compared to 70%+ in major Western European economies (see Exhibit 8). In Kosovo, PCB has a leading position in a rather saturated market and thus focuses on retaining its high market share.

PCB's NPL ratio (2.2%) is below local sector levels as banks continue to deal with legacy assets. It is below the ratio reported by Raiffeisen in SEE (3.3% at end-March 2020), as well as its two listed Romanian peers (BRD at 3.3% and Banca Transilvania at 2.83% at end-March 2020), although it is also worth highlighting that these peers had a significantly higher ratio a few years back (at c 10–15%). PCB's NIM in the region stood at 2.5% in Q120 (annualised), below the c 3.3–3.5% for some of its listed peers, with the lack of meaningful consumer lending being likely one of the key reasons. PCB faces competition from European banking groups in the region, which means margins are likely to remain moderate.

Overall, profitability in SEE was dampened by PCB's bank in Romania, which posted a €4.1m loss in FY19 amid high financing costs as the bank is still in the process of building critical mass. On the positive side, we note that the bank tax announced in Romania in 2019 was abolished at the beginning of 2020. Moreover, Albania recognised a loss of €6.6m in FY19, resulting from restructuring costs as well as the earthquake in November 2019. Key positive earnings contributors in SEE were Bulgaria (profit after tax of €18.5m in FY19) as well as Kosovo (€21.5m).

EE: Solid growth and margins, with NPL ratio well under control

The EE region's performance in recent years was characterised by a gradual recovery in corporate funding in Ukraine (57% of PCB's loan book in EE at end-March 2020) from the ongoing conflict with Russia, which started in 2014 and triggered a wave of bank closures (with their number down from c 180 in 2014 to 76 in June 2019, according to the German Advisory Group Ukraine). Similarly, Moldova has been recovering from the 2014 banking crisis induced by the collapse of three local commercial banks (Banca de Economii, Unibank and Banca Socială). Like SEE, loan book momentum was further supported by low banking sector penetration (see Exhibit 8).

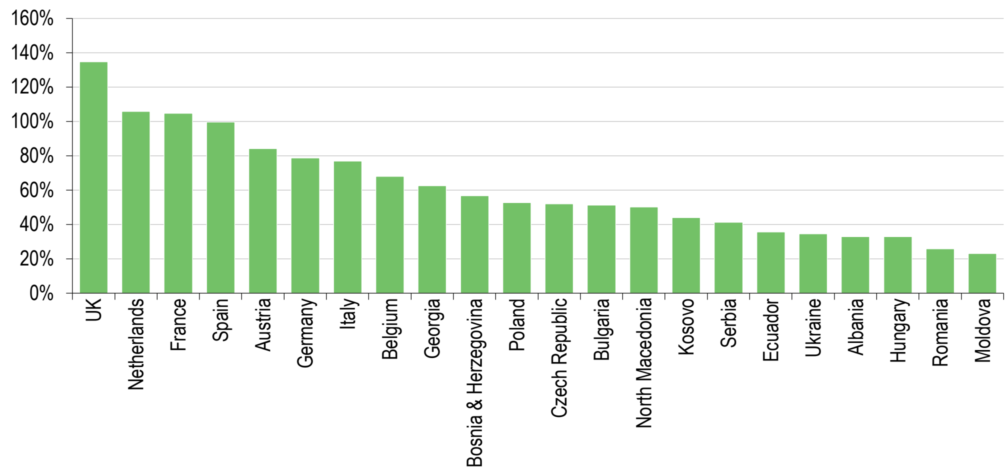
With respect to competition in the region, it seems to be somewhat weaker compared to SEE due to the more limited presence of international banking groups and thus higher market share of local/regional players. For instance, the two largest banks in Georgia (TBC Bank and Bank of Georgia) have a combined market share of c 70% by total assets. While the presence of international (non-Russian) banks is slightly higher in Ukraine, all local banks (in particular state-owned) hold c 70% of the market. Consequently, PCB's interest rates on loans, and hence NIM and profitability, remain solid in the region. The company's NIM in Q120 stood at an annualised 4.5%.

It is worth highlighting that the NPL ratio in the Ukrainian banking sector was 48.4% at end-2019 according to the IMF (vs ProCredit Bank Ukraine at 3.7% at end-2019). The NPL ratio in Georgia at end-September 2019 stood at around 4.4% based on local central bank data (vs PCB at around 3.0% at end-2019), whereas in Moldova it was c 8.5% at end-2019 according to the IMF (vs PCB at 3.1%).

Ecuador: Healthy margins, but a particularly weak macro environment

Ecuador is PCB's only exposure to Latin America (c 6% of its total loan book). While the NIM in the region has been favourable for PCB at 5.2% in Q120, the local economy has experienced a 'perfect storm' in recent years with headwinds from 1) political instability and social unrest triggered by, among other things, the fuel subsidy cut, 2) the impact from Fed rate hikes up to end-2018 (as the US dollar is its official currency), 3) a significant drop in oil prices lately (Ecuador is a major regional exporter) and 4) COVID-19. Consequently, the country recently defaulted on its bonds and requested IMF funding. Competition in the banking sector is predominantly from local market participants. While PCB's operations in Ecuador have been profitable in the past, they are yet to return to break-even since realignment of the business model.

Exhibit 8: Domestic credit to private sector by banks as percentage of GDP in 2018



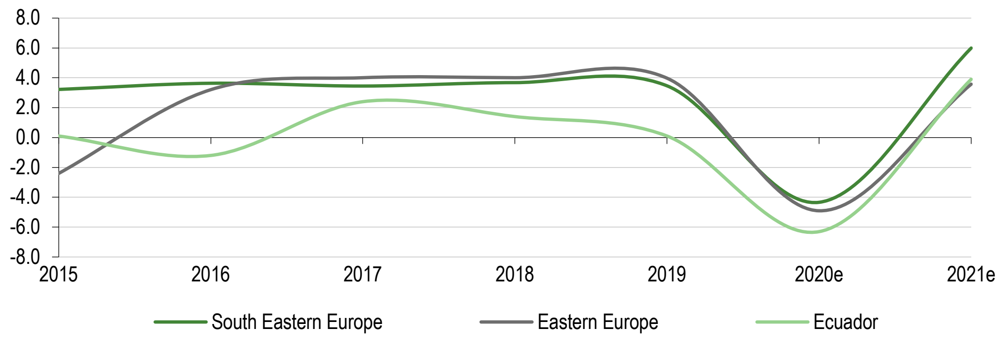
Source: World Bank

Market outlook

Pandemic has led to revised macro projections for the region

SEE and EE experienced relatively benign economic conditions after the global financial crisis (GFC), posting continuous, stable, low- to mid-single digit growth (as measured by real GDP) over the last five years and around 3–5% in 2019 alone (see Exhibit 9). However, the pandemic led to a significant downward forecast revision by the IMF in April 2020 (see Exhibit 10). Although these projections assume a visible rebound in economic activity in 2021 (in line with the base case scenario in our PCB forecasts), they are subject to a high level of uncertainty.

Exhibit 9: Average GDP growth by region of PCB's operations (%)



Source: IMF. Note: Includes only countries where PCB has its regional banks.

Exhibit 10: IMF real GDP growth forecasts for PCB's countries of operation (%)

	2019	2020e	2021e
Bulgaria	3.4	4.0	6.0
Serbia	4.2	-3.0	7.5
Kosovo	4.0	N/A	N/A
North Macedonia	3.6	-4.0	7.0
Romania	4.1	-5.0	3.9
Albania	2.2	-5.0	8,0
Bosnia	2.7	-5.0	3.5
Ukraine	3.2	-7.7	3.6
Georgia	5.1	-4.0	3.0
Moldova	3.6	-3.0	4.1
Ecuador	0.1	-6.3	3.9

Source: IMF Economic Outlook April 2020

Government response broadly in line with Western Europe

SEE has been affected by the COVID-19 outbreak with a slight lag, with the first cases in most countries reported in early March. While the number of reported cases and deaths compared to the overall population has been lower in these countries than in Western Europe, it may be at least partially due to a lower number of COVID-19 tests being conducted. The local government responses in the region were broadly in line with the measures introduced in Western Europe. As the number of new cases began to slow, local governments gradually started to ease restrictions and unfreeze the economy in late April and early May (potentially providing some relief to GDP growth and unemployment).

Economies in the region assisted both locally and from abroad

Although the scope of financial support measures in the region was more limited than in developed Europe, it has been considerable in relative terms for some of the smaller economies (eg Serbia where they amount to more than 11% of GDP, according to Raiffeisen). At this stage, it is difficult to assess how quickly some of these initiatives (especially the fiscal packages) will provide relief, as they may be hampered by bureaucracy. We list some of the measures introduced for individuals and companies (in particular SMEs) below:

- **interest rate cuts**, with the exception of Kosovo where the official currency is the euro (despite the country not being a member of the eurozone);
- **credit moratoria**, ie suspension of loan repayments in all countries of PCB's operations, mostly with a duration of three to six months, as well as a freeze on credit ratings. Interestingly, the three-month moratorium in Serbia is obligatory unless the borrower decides to opt out;
- **reduced interest rates on loans to SMEs**, in particular in selected areas like tourism;
- **support to and easing of liquidity and capital requirements for banks**, eg the National Bank of Serbia provided liquidity to banks through an additional three-month EUR/RSD swap auction and repo purchase auctions of dinar government securities;
- **extended deadlines** to file and pay tax liabilities and pension contributions;
- **dedicated COVID-19 fiscal packages**, including contributions to monthly employee salaries for microenterprises and SMEs; and
- **rent suspensions** on office and other business space.

On top of local measures, the SEE/EE region (as well as Ecuador) has experienced assistance from international institutions. In April, the **European Commission** proposed €750m in support to the Western Balkans (Albania, Bosnia and Herzegovina, Kosovo, Montenegro and North Macedonia) through macro-financial assistance (MFA). A further €2.25bn will be allocated to Tunisia (€600m), Jordan (€200m), Moldova (€100m), Georgia (€150m) and Ukraine (€1.2bn).

The International Monetary Fund recently approved financial support through the Rapid Credit Facility (RCF) and Rapid Financing Instrument (RFI) to a number of countries in the region, including Bosnia and Herzegovina (US$361m), North Macedonia (US$191.8m), Albania (US$190.5m), Moldova (US$156.7m) and Kosovo (US$56.5m). Furthermore, it has provided US$375.6m in support to Georgia through an augmentation of its Extended Fund Facility. Ecuador also received considerable support through the RFI of US$643m, with the country being hit severely by both COVID-19 and the sharp drop in oil prices. We underline that Ecuador defaulted on its bond payment in April, postponing the repayment of US$800m until August.

Finally, what is particularly important from PCB's perspective is that the **European Investment Bank** (EIB) has embarked on mobilising up to €40bn funding for SMEs and mid-caps in Europe. This includes: 1) up to €20bn financing from dedicated guarantee schemes to banks, 2) liquidity lines to banks to facilitate additional capital support for SMEs and mid-caps of €10bn, and 3) asset-backed securities purchasing programmes allowing banks to transfer risk SME loan portfolios worth another €10bn. Specifically, the EIF (part of EIB Group) announced additional COVID-19 measures in the COSME and InnovFin programmes involving new guarantee capacity to unlock €8.0bn in working capital loans for SMEs to mitigate their liquidity constraints. The new measures in the InnovFin programme (in which PCB is participating) comprise, among others, a higher guarantee rate for working capital loans (80% vs 50% previously), reduced financial intermediary risk retention (10 vs 20% earlier), more flexible guarantee terms (including innovation eligibility criteria) and extended coverage of accrued or capitalised interest.

Sensitivities

We have identified several sensitivities influencing PCB's business. These include:

- **COVID-19:** we discuss the potential impact of the pandemic on PCB's cost of risk, as well as customer loan and deposit growth throughout the note in detail. We would like to emphasise that PCB's performance should be supported by a number of factors, including: 1) a lean branch network and digital platform (powered by Quipu) with all clients already on-boarded, 2) the high loan book quality and collateral requirements, 3) well-trained and experienced staff (most of the managers worked at PCB during the 2008/09 crisis), 4) emphasis on a long-term, in-depth and individual approach to SMEs throughout their lifecycle, with every business client advisor (BCA) responsible for only 40–50 loan clients, 5) support from international financial institutions (as shareholders, debt holders and/or partners in SME funding schemes) and 6) solid liquidity with a LCR of 181% at end-March 2020 vs the regulatory requirement of 100%. Overall, we estimate that every increase in cost of risk by 10bp in FY20e would reduce our PCB valuation by c €0.03 per share (or 0.5% vs the current level).
- **Foreign exchange risk:** PCB is exposed to foreign currency exchange rate volatility due to its international operations. At group level, currency risk primarily arises from the changing value of the parent company's equity investments in regional banks, which are denominated in the respective domestic currencies. This is being reflected directly in PCB's equity in the changes to its translation reserve. However, the impact on PCB's CET-1 capital is normally largely offset by a corresponding downward FX impact on its risk-weighted assets. We also note that 56% of the group's loan portfolio was denominated in euros at end-March 2020, followed by the US dollar (11%) and local currencies (33%). However, PCB aims to reduce credit risk for clients and the group's banks by typically disbursing foreign currency loans only to customers who generate revenues in this currency. Finally, depreciation of domestic currencies could lead to the reduction of regulatory capital ratios in local banks, but PCB mitigates this risk by matching the foreign

currency exposures of its assets and liabilities. The use of hedging instruments is thus limited at PCB.

Some countries where PCB is present have pegged their domestic currencies to the euro, which inherently reduces their volatility vs the euro (the group's reporting currency). This includes Bulgaria and Bosnia and Herzegovina ('hard' pegs) as well as Serbia and North Macedonia ('soft' pegs), which together represented 50% of PCB's loan book at end-March 2020. In addition, the euro is the official currency in Kosovo (11% of loan book at end-March 2020). At the same time, however, we acknowledge that currency pegs may be broken and consequently do not ensure the stability of exchange rates at all times (a good example here is Ukraine back in 2015).

- **Political risk** is elevated in several SEE/EE countries, as illustrated by military conflicts (Ukraine, Georgia), territorial disputes (Kosovo-Serbia) and internal political deadlocks (eg North Macedonia back in 2015–17). As global populism has intensified in recent years, the Western Balkans face the potential risk of conflicts between parties appealing to major ethnic groups. Moreover, the region is one of the playgrounds for political competition between the West and Russia.

  Having said that, we note that two countries where PCB operates – Bulgaria and Romania – are EU members, while Albania, North Macedonia and Serbia are EU member candidates. Several countries are also NATO members (Albania, Bulgaria, North Macedonia and Romania). Finally, we note that PCB has extensive experience in operating in these countries and navigating through times of political and military unrest.
- **Macroeconomic risk** remains higher in PCB's countries of operation compared to Western Europe and the CEE countries given the earlier stage of economic development and several challenges/risks these economies face, including:
  - higher share of foreign currency-denominated loans in the banking sector in several countries (eg Serbia, Albania and across EE);
  - susceptibility to global supply chain disruptions;
  - high reliance on remittances (eg Kosovo, Albania, Moldova);
  - high tourism contribution to GDP (eg Georgia, Albania); and
  - Ecuador's high sensitivity to oil prices.
- **Weather and natural disaster risk,** as illustrated by the 6.4 magnitude earthquake in Albania in November 2019, which contributed to PCB's NPL ratio in this country of 6.1% at end-2019 (above group average). Moreover, we understand that PCB's loan book could be affected in the event of a regionwide drought (which seems to be unfolding currently, with a particular impact on Ukraine and Romania) given its c 20% exposure to the agricultural sector.
- **Fintech competition:** a number of innovative companies (both balance sheet lenders and operators of digital marketplaces) such as Ferratum, Kapilendo, Creditshelf and Funding Circle seek to address the SME funding gap in Europe. These constitute potential new competition for PCB, given that they target a similar segment (eg Kapilendo focuses on loan volumes between €250k and €5m). Having said that, we believe that PCB's 'Hausbank' approach, coupled with strong experience in the markets in which it operates, represents a significant competitive advantage. Furthermore, fintech expansion in these markets is likely to occur later than in Western Europe or CEE.

Financials

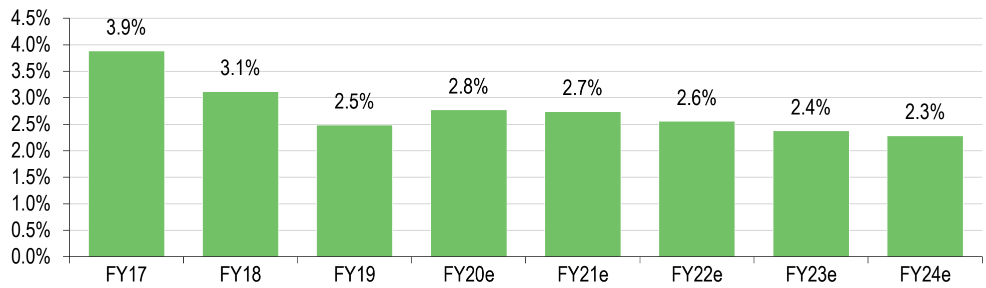
Prudent credit risk management and good loan book quality

Sustained low NPL ratio historically

The current downturn is likely to cause a deterioration of corporate asset quality, with SMEs and micro-companies being normally most vulnerable to this kind of shock given their more limited capacity to absorb a drop in revenue and withstand a liquidity crunch (even if this is somewhat mitigated by initiatives similar to the EIB's described earlier). Having said that, we note that PCB has shied away from aggressive lending and continuously focused on deep, long-term relationships with high-quality SMEs. Moreover, as a reminder, PCB does not offer any meaningful volumes of consumer loans, with 93% of its portfolio in SME lending and 6% in housing loans to private customers.

Consequently, PCB was able to report a low NPL ratio (reflecting Stage 3 loans under IFRS) historically, which stood at 2.4% in Q120 and 2.5% at end-2019 (compared to 3.1% in FY18 and 3.9% in FY17, see Exhibit 11). Previously, PCB reported the ratio of loans over 30 days late (vs 90 days for NPLs currently), which stood at a relatively low level between 3.7% and 4.9% in 2010–16. It is also worth noting that PCB's green loan portfolio is characterised by even better quality, with its NPL rate at end-2019 of just 0.6%. We forecast NPL ratios at group level of 2.8% in FY20e and 2.7% in FY21e.

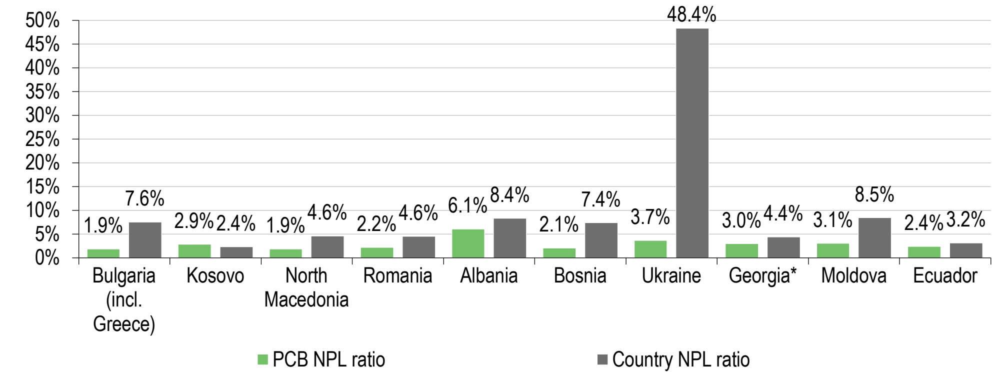
Exhibit 11: PCB's historical and forecast NPL ratio at group level



Source: ProCredit, Edison Investment Research

In this context, we note that PCB has never sold NPL portfolios, which means that its historical NPL ratio development may be largely considered organic (and supported by low net write-offs through the cycle), except for the business disposals in South and Central America as well as Africa. However, the NPL ratios for these businesses (except for Africa, which was slightly higher) did not differ materially from its current portfolio and their disposals were based on the evaluation of their long-term prospects rather than due to inferior loan book quality. PCB highlights that its focus on SMEs with strong payment capacity through economic cycles is reflected in its outperformance against local markets in terms of NPLs (see Exhibit 12). The bank considers its low NPL ratio one of the key long-term profitability drivers in the current low interest margin environment, particularly given that (as discussed earlier) it does not intend to enter the higher-margin consumer lending market.

Exhibit 12: PCB's NPL ratios (FY19) vs local banking sector NPLs



Source: IMF Financial Soundness Indicators, ProCredit. Note: Country ratios are last available (at end-Q219, Q319 or Q419). *NPL ratio for Georgia based on local central bank's methodology. Based on IMF data, this would be 2.7%.

Strict loan collateral policy and NPL coverage ratio comfortably at c 95%

PCB has consistently emphasised strict, formalised collateral requirements compared to many other local players that were relaxed about their requirements to fuel growth until February 2020. PCB's total loan collateral at end-March 2020 was €3.7bn and included commercial and residential mortgages (66%), financial guarantees (12%) and other (22%). Financial guarantees are largely provided by the EIF through ProCredit's regional banks to SMEs as part of the InnovFin programme, which in the case of PCB was increased from €800m to €1,620m as announced in July 2019 (making PCB one of the largest programme participants). These guarantees normally cover 50% of potential credit losses, translating into a lower loss allowance requirement for PCB (although loss allowances would not be much higher without the guarantees according to management). It is worth highlighting that the InnovFin SME Guarantee COVID-19 measures recently announced by the EIF, which include an increased 80% cover of credit losses for new working capital facilities (as discussed above), should help PCB grow its loan portfolio while allowing it to maintain its collateral standards. Despite the solid collateral for PCB's loan book, the group retained a robust NPL coverage ratio, which in Q120 was 95.5% (vs 89.1% at end-2019 and 90.8% at end-2018).

No elevated risk from sector exposure

It is also important to note that PCB has relatively limited exposure to sectors most affected by COVID-19, such as hotels and travel (c 4% of loan book) or transport and logistics (5%). Furthermore, PCB has an insignificant exposure to automotive production and supply, as well as the oil & gas sector (although it still has exposure to the broader manufacturing sector at 23%). In total, the most affected sectors (horeca, transportation, construction, as well as arts and entertainment) made up c 15% of PCB's loan book at end-March 2020, according to the company.

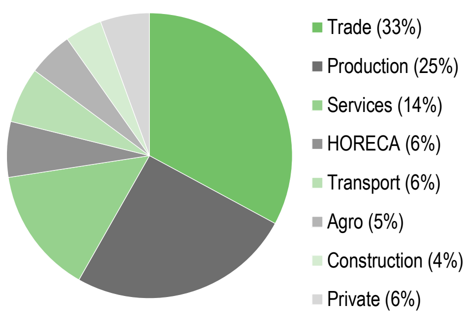
At the same time, one of its top sector exposures is agriculture, forestry and fishing (20%), which is likely to prove more resilient in the current overall adverse market conditions (although this may change if the drought unfolding in the region turns out to have a significant impact). Together with other relatively defensive sectors (food and drinks, waste management and health services), this represents around 40% of PCB's portfolio. This also includes PCB's renewable energy loans portfolio (c 2% of the group's loan book at end-2019, according to our estimates). Finally, it is worth noting that PCB states its single largest client exposure represents just 1.5% of the group's CET-1 capital.

Cost of risk likely to increase

Management has guided to a cost of risk (defined as loss allowances to average gross loan book) of 50–75bp in FY20, which is broadly in line with recent management guidance at Raiffeisen Bank International (75bp) and Erste Group (50–80bp based on a V-shaped recovery assumption). This will come from loans moving to Stage 2 (significantly increased credit risk) and Stage 3 (non-performing). Hence, although the cost of risk has already increased in Q120, this was not accompanied by a spike in NPL ratio. The latter should be largely back-end loaded (Q420 in particular) as defaults should materialise with a lag because: loans are considered non-performing if they are 90 days past due; credit moratoria of three to six months have been a common response across PCB's countries of operations (as per ESMA guidelines, moratoria do not increase credit risk); and some distressed loans will go through a restructuring process in H220 first. Importantly, in a statement released on 27 April, management highlighted that it has not experienced strong pressure on loan quality to date. We have factored in cost of risk at 80bp in FY20e, followed by 62bp in FY21e as we still assume elevated default rates in early 2021.

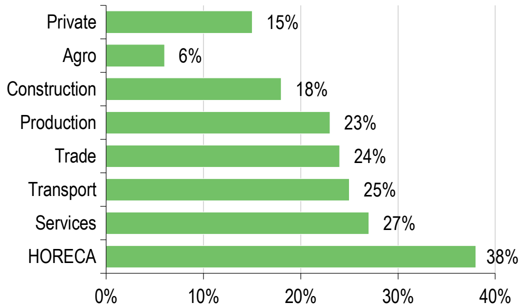
At end-March 2020, the share of PCB's loan book under moratorium was c 30%. However, this is distorted because (as mentioned earlier) Serbia has introduced moratoria in an opt-out setup (ie borrowers have to apply to not be subject to a moratorium). Excluding Serbia, 20% of PCB's loan book (or €0.8bn) is under moratorium, with the breakdown presented in Exhibit 13. The company has also disclosed the share of portfolio in moratorium by sector, with hotel, retail and catering (horeca) unsurprisingly at the top of the list (see Exhibit 14). We note that PCB (in line with standard sector practice) continues accruing interest income on its P&L from these loans despite the fact that actual cash inflow is being postponed.

Exhibit 13: Breakdown of PCB's loan portfolio under moratorium by sector



Source: ProCredit. Note: Excludes Serbia.

Exhibit 14: Share of portfolio in moratorium by sector

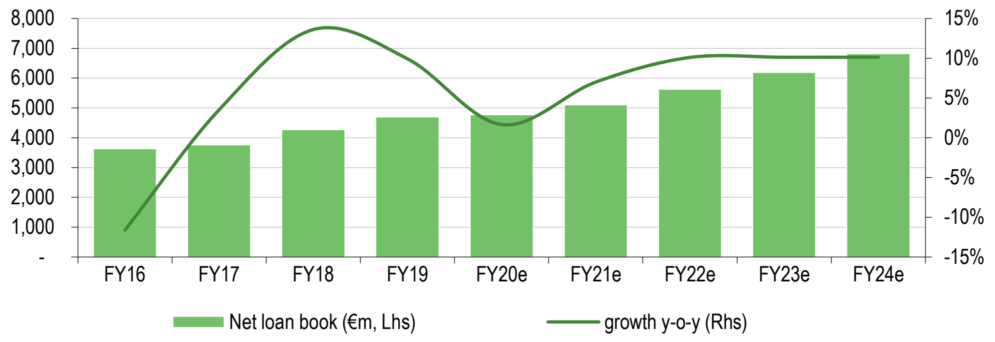


Source: ProCredit. Note: Excludes Serbia.

Prospective loan book growth muted as SMEs curb investments

The adverse macro environment will limit SME investments significantly but may also increase demand for bridge/working capital funding. Consequently, while the current environment is characterised by elevated risk, it may also prove an opportunity for PCB to expand its business. Nevertheless, risks seem to significantly outweigh opportunities at this stage. Moreover, predictions in the current environment are obviously subject to significant uncertainty. Still, our base case scenario assumes that, while a recessionary environment is likely to persist into early 2021, we may see some gradual recovery in the second half of next year (and technically also in Q221 given the low base effect). Consequently, we forecast PCB's net loan book growth at c 2% in FY20e and 7% in FY21e (see Exhibit 15). The FY20e assumption is broadly in line with company guidance of low single-digit growth in loan book. Management's mid-term target is to grow the loan portfolio by around 10% pa and our FY22e assumption is in line with this.

Exhibit 15: PCB's historical and forecast net loan book evolution



Source: ProCredit, Edison Investment Research

Maintaining a diversified range of funding sources

High emphasis on growing the customer deposit base

Last year, management put strong emphasis on customer deposits base expansion to diversify its funding sources and reduce average funding costs. This is important given that PCB's ratio of customer deposits to loans stands at a moderate 88% (at end-March 2020) compared to c 113% for Erste Bank, 102% in case of Raiffeisen Bank and 125% for OTP Bank. This translated into solid deposit growth in FY19 of 14.2% y-o-y (vs 7.1% and 2.8% in FY18 and FY17, respectively), assisted by both private and SME customers. This has been achieved despite PCB's continued execution of the 'ProCredit Direct' strategy in its private customer business (involving, among other things, abolishing cash transactions and migrating customers to its digital platform), which resulted in the departure of non-core clients with low account balances (which led to lower fees from account maintenance), particularly in Kosovo.

For this year, we assume the company may face some deposits outflow amid the liquidity crunch triggered by the COVID-19 lockdown. We understand the deposit outflow may be more pronounced in economies that rely on cash payments and where remittances from diaspora (which are likely to diminish) represent a large part of GDP, including many SEE/EE countries such as for instance Kosovo (remittances represent c 15% of GDP according to the OECD). That said, this should be partially offset by PCB's focus on digital banking for middle-income and high earners in the private customers segment, as well as the high level of client confidence its regional banks enjoy, which is underpinned by the German reputation and PCB's track record (eg it remained one of the last banks to stay open in several countries during the global financial crisis in 2008/09 as well as the military conflict in Georgia, according to the company). Although we understand that c 55% of PCB's deposit base consists of sight and savings (FlexSave) accounts (with limited or no withdrawal restrictions), the remaining 45% represent term deposits, which predominantly have a maturity longer than 12 months.

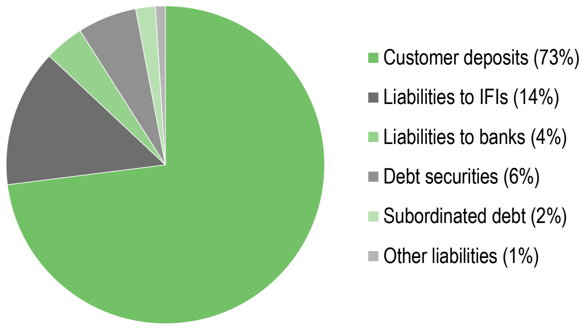
Based on all the above, we have conservatively assumed a 2% decline year-on-year in customer deposits in FY20e, followed by a 5% rebound in FY21e. Nevertheless, we acknowledge that (as per the company's statement dated 27 April) apart from some usual seasonal drop, PCB's deposit base has remained resilient so far (and was down c 2% in Q120 vs end-2019).

Other funding sources: Backed by international financial institutions

PCB's remaining external funding is a combination of financing provided by international financial institutions to the regional ProCredit banks (€838.5m at end-March 2020), as well as debt securities issued at holding level (€446.7m), including subordinated debt (€89.3m). Liabilities to international financial institutions comprise funding from development banks and funds such as, among others, the EIB, Council of Europe Development Bank, EBRD, Black Sea Trade & Development Bank, the Global Climate Partnership Fund, European Fund for Southeast Europe and responsAbility (a Swiss-based asset manager focused on development investments).

A noticeable part of PCB's debt securities at holding level is the US$90m green bond issued in May 2019 in a private placement with IFC, which as mentioned earlier is part of the World Bank Group and one of PCB's major shareholders. The proceeds will be used to further fuel growth in PCB's green loan book. The issue was followed by a number of smaller placements amounting to €50m with commercial investors (bringing the total proceeds to c €130m).

Exhibit 16: PCB's funding sources at end-March 2020



Source: ProCredit

Capital ratios well above regulatory requirements

PCB's regulatory capital structure is relatively simple, with no additional Tier-1 capital, meaning that its €742.3m CET-1 capital at end-2019 also represented all of its Tier-1 capital. This is supplemented by Tier-2 capital in the form of subordinated debt (€83.7m at end-2019 after early repayment of c €56m during 2019).

The bank's risk-weighted assets (RWA) of c €5.1bn at end-March 2020 were largely related to credit risk (€4.1bn), with its market risk (€565m) predominantly associated with currency risks arising from the value of its equity stakes in regional banks (with their changes reflected directly in equity). Furthermore, its operational risk stood at €436m at end-March 2020 and has been visibly reduced (from €800.7m at end-2015). The credit valuation adjustment risk was a minor €2m given the low value of derivatives on PCB's balance sheet.

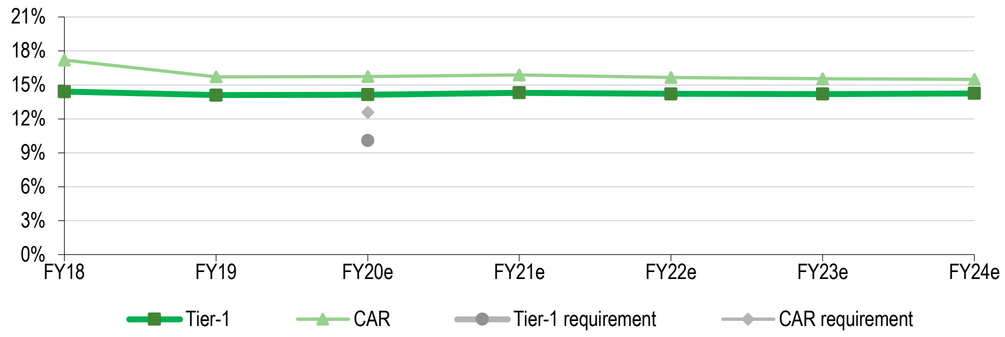
The company's CET-1 ratio (fully loaded) at end-March 2020 stood at 14.0%, well ahead of the regulatory requirement at 8.2%. Similarly, its Tier-1 and total capital adequacy ratio (CAR) stood at 14.0% and 15.6% versus the company's minimum regulatory levels of 10.1% and 12.6%, respectively. These ratios are broadly comparable with its three closest international peers – Raiffeisen, Erste Group and OTP Bank – which at end-March 2020 reported CET-1 ratios at 13.0%, 13.1% and 13.9%, respectively (slightly below PCB) and CAR at 16.8%,17.7% and 16.2% (somewhat ahead of PCB), respectively.

There are a number of factors that will provide relief to PCB's capital requirements in 2020 and 2021 through lower regulatory capital ratios as well as reduced RWA. Firstly, the group's CAR requirement in 2020 already declined on the back of a reduction in the SREP add-on from 2.5% to 2.0% announced by BaFin (the German regulator) in February 2020. Secondly, PCB is benefiting from the European Banking Authority's equivalence acknowledgement of Serbian banking regulation (alongside South Korea) in January 2020. As a result, the company's cash holdings in the Serbian Central Bank are assigned a 0% weight for the purpose of calculating its RWA, which led to a €120m reduction, according to management.

Finally, the introduction of CRR II in 2021 brings an extension of the SME support factor (SME SF) to exposures above €1.5m at 0.85. This should reduce PCB's RWA (and thus support its capital ratios) given that 30% of its loan book at end-March 2020 represented loans with a volume above €1.5m. That said, we acknowledge that credit exposures up to €1.5m for these loans were already previously subject to an SME SF of 0.7612 and SME loans disbursed by PCB rarely exceed €5.0m. The recently introduced higher guarantee cover for working capital needs as part of the InnovFin SMEG COVID-19 measures (80% vs 50% previously) is only applicable to new loan disbursements and should thus have a limited positive impact on PCB's RWA.

In conjunction with the short-term slowdown in loan book growth (as discussed above), we estimate the above factors will translate into CET-1 ratios of 14.1% in FY20e and 14.3% in FY21e (see Exhibit 17). Management has guided that CET-1 will be above 13% in FY20. We expect PCB's total CAR to reach 15.8% in FY20e and FY21e. We estimate that PCB's capital ratios at end-FY20 can support loan book growth of 15% pa until FY24 (excluding any retained earnings or translation reserve impact) compared to our current loan book growth forecast of 9% pa.

Exhibit 17: PCB's historical and prospective capital ratios vs regulatory requirements



Source: ProCredit, Edison Investment Research. Note: As PCB's Tier-1 ratio is in line with CET-1 ratio, we have excluded CET-1 capital from the chart.

Profitability below peers but likely to be resilient

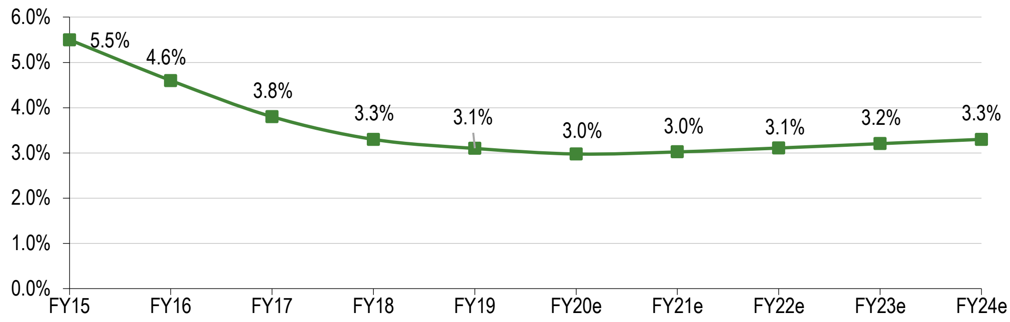
NIM compressing in recent years

PCB's NIM has been under pressure in recent years, mostly due to its repositioning from higher-risk (but also higher-margin) microloans to the segment for SME loans with a higher volume and to some extent also because of the competitive environment amid low interest rates. As a result, its NIM declined to 3.1% at end-March 2020 compared to 5.5% in FY15. As discussed above, this reflects a higher margin in EE (4.5%) and Ecuador (5.2%) compared to SEE (2.5%).

Before the COVID-19 outbreak, management highlighted that these margin pressures had abated and were not expected to continue. While management's working assumption is still for stable margins in FY20, the company also flagged a high level of uncertainty around margins in the near term. We note that PCB may seek additional external funding to secure incremental liquidity and/or raise the interest rate on customer deposits (thus increasing its cost of funding) due to reduced cash inflow from its loan book (due to the credit moratoria) and potentially also deposits outflows (in case these materialise). However, we note that the group's LCR is 181%, which is visibly above the regulatory requirement of 100%.

We also note potential pressures on margins resulting from central bank interest rate cuts. As a result, we have pencilled in a slight NIM decline to 3.0% in FY20e, followed by a stable margin year-on-year in FY21e and a gradual rebound in subsequent years (see Exhibit 18). This should be assisted by recovering customer deposits growth (as mentioned above).

Exhibit 18: PCB's historical and forecast NIM at group level



Source: ProCredit, Edison Investment Research

CIR likely to remain close to 70% this year

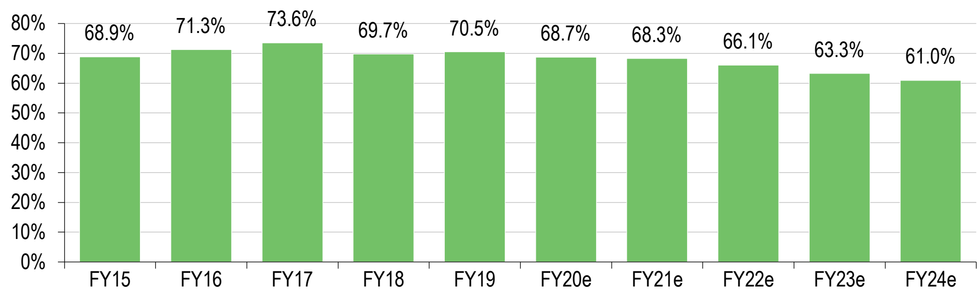
Although the company's business streamlining process, involving branch network and headcount reductions and the disposal of selected businesses in South America and Africa, was largely completed in FY19, this has not been reflected in PCB's CIR at end-2019. The ratio at group level stood at 70.5% in FY19 compared with 69.7% in FY18 and management's initial intension to reduce it below 70% in FY19.

This was the result of certain one-time charges associated with the business restructuring, including: €2.0m goodwill write-down in Romania booked in Q419; c €0.7m loss from sale of fixed assets coupled with a €2.1m write-down of head office in Albania; and a €1.9m write-down of the head office in Kosovo in Q419. We estimate that after adjusting for these one-offs, PCB's CIR would have been around 68.2%.

Recurring operating expense last year was driven by increased marketing spending to promote PCB's direct banking offer, as well as some growth in headcount. In Q120, marketing expenses declined, while personnel costs continued to grow together with the number of staff. In conjunction with the absence of non-recurring items described above, this translated into an improved CIR at 64.6% in Q120.

This year, the bank intends to further increase headcount to attract new SME customers who appreciate PCB's long-term approach to customer relationships, especially in the current tough market environment. While the lockdown is likely to result in reduced travel expenses (which were normally c €5m pa), we understand the company has largely exhausted the cost-optimisation potential following the completion of its cost-cutting measures last year. Consequently, management expects a broadly stable cost base in FY20 and guided to a stable CIR at around 70% in FY20, while still committing to the mid-term target of below 60% (we have conservatively assumed c 61% for FY24 driven by growing interest and fee income, see Exhibit 19).

Exhibit 19: PCB's CIR at group level

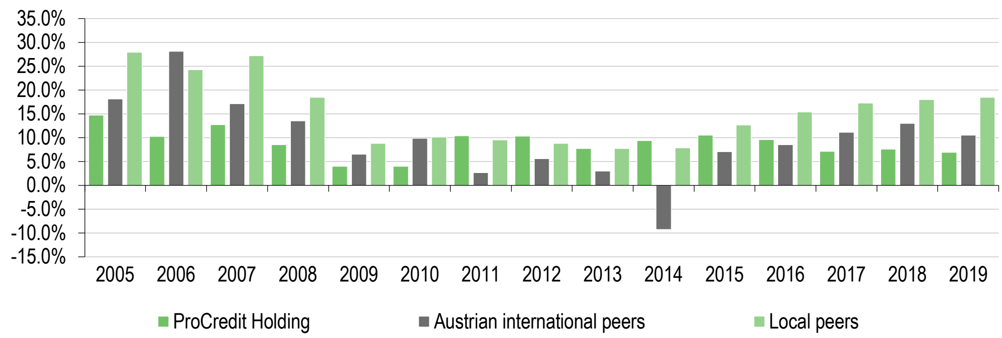


Source: ProCredit, Edison Investment Research

Return on equity: Affected by cost of risk but should still be positive in FY20

PCB's return on equity was somewhat below its local peers at c 7–8% over the last three years compared to its Austrian peers (Raiffeisen Bank International and Erste Group) at c 10–13% and local peers at c 15–25% (although this is in local currencies and is therefore subject to FX risk for international investors). However, it is important to highlight PCB's very stable returns, with the company remaining profitable in each year since 2005 (even during the GFC in 2008/09 at c 4%, see Exhibit 20) with an average ROE around 9%. In particular, the company's ROE remained ahead of the peer average over 2011–14, when the regional banking sectors faced high-risk provisions and NPL ratios. Nevertheless, PCB's ROE has lagged its peers during the expansionary phase of regional economies (and throughout the whole cycle). However, we note that the last seven years have been a period of business realignment (as outlined earlier).

Exhibit 20: PCB's historical ROE vs peers



Source: Company accounts, Refinitiv. Note: Local peers include BRD, Banca Transilvania, TBC Bank, Bank of Georgia, OTP Bank, Bulgarian American Credit Bank, Komerčnl Bank and Moneta Bank. Austrian international peers include Erste Group and Raiffeisen Bank International.

Management's intension is to improve PCB's ROAE to c 10% in the medium term. This compares with earlier targets of above 12% (communicated back in 2013) and 10–12% (shared in 2014). We have examined the main factors behind PCB's lower ROE by looking at its key performance indicators versus Raiffeisen Bank International, Erste Group and OTP Bank (due to a somewhat similar regional footprint) reported for FY19 (see Exhibit 21).

Based on the exhibit below, we conclude that that PCB's profitability versus the three banking groups may be lower due to 1) higher RWA as a percentage of total assets (78% vs c 50% for Austrian peers and 69% for OTP Bank), which we understand may be due to a higher risk weight of mortgages on commercial versus residential real estate, higher risk weight of corporate vs retail loans, as well as the lack of EBA equivalence acknowledgement for some of PCB's countries of operation (which means that most of PCB's liquid assets have a 100% weighting, as opposed to some of its peers), 2) a higher CIR at 70% vs c 60% for peers (although we note PCB's Q120 ratio was 64.6%) and 3) a higher customer loans to deposits ratio (although we note that PCB's NIM is higher).

Still, we forecast that PCB will be able to reach the 10% ROE target by growing its portfolio by c 9% pa over multiple years and expanding its customer deposit base at a mid- to high-single digit rate while keeping growth in operating costs at a limited level (following the efficiency measures introduced in recent years).

Exhibit 21: KPI comparison – PCB vs closest international peers

FY19	ProCredit	Raiffeisen	Erste Group	OTP Bank
Net interest margin	3.1%	2.4%	2.2%	4.1%
Net fee and commission income as % of total assets	0.8%	1.2%	0.8%	1.7%
Cost Income ratio	70%	57%	59%	58%
Effective tax rate	20%	23%	18%	11%
Customer loans as % of total assets	70%*	60%	65%	59%**
Cash (incl. with central banks) as % of total assets	16%	16%	4%	9%
Customer deposits as % of total liabilities	74%	70%	77%	85%
Equity to total assets	12%	9%	8%	11%
Customer loans to deposits	111%	95%	92%	78%
RWA to total assets	78%	51%	48%	69%
CET-1 ratio	14.1%	13.9%	13.7%	13.9%
ROE	**6.9%**	**11.0%**	**10.0%**	**20.6%**
Total assets (€m)	6,698	152,200	245,693	60,616

Source: Company accounts, Edison Investment Research calculations. Note: *68.2% when adjusted for one-off items; **52.7% on an adjusted basis.

For FY20e, management guides to an ROAE below FY19 (affected particularly by a higher cost of risks as discussed earlier in the note), though still positive. We estimate it at 4.0% in FY20e (broadly in line with the GFC level) and 5.2% in FY21e.

Dividend policy: Targeting a payout ratio of 33%

PCB's general dividend policy is to pay out one-third of its profits to shareholders, which translated into a board proposal to pay €0.30 per share from FY19 earnings. However, in response to the COVID-19 outbreak, the European Central Bank and BaFin have released a recommendation to banks to withhold any dividend payout and share buybacks at least until 1 October 2020. Consequently, PCB's management (after a discussion with the supervisory board) decided to postpone the decision with respect to dividend payments until Q420. In our forecasts, we assume that PCB will pay the above dividend in Q420.

Valuation

We have valued ProCredit using the implied price to tangible book value method based on our assessment of the bank's sustainable ROE and cost of equity derived from a capital asset pricing model. This is a common valuation method for banks, which allowed us to reflect PCB's specific profitability as well as risk profile. To arrive at the book value of PCB's tangible equity, we have subtracted the balance sheet value of intangibles from our shareholders' equity forecast. Subsequently, we have calculated the RoTE using net profit after taxes.

We have assumed a sustainable RoTE of 10.0%. We believe the bank is well positioned to reach its mid-term ROAE target at 10%, even if this may be achieved later than the management initially planned due to the COVID-19 outbreak and the resulting recession. We forecast that PCB should be able to reach this level in FY24e. Importantly, it should be able to do so based exclusively on the current regulatory capital and prospective retained earnings, with our forecasted CET-1 and CAR in

FY24 at 14.2% and 15.5%, respectively. Although PCB's capital ratios should by then still be ahead of regulatory requirements (currently at 8.2% and 12.6%), we are conservatively not adjusting our valuation for any remaining excess capital to retain a certain buffer in forecasts.

We have also factored in a cost of equity of 14.7%. For the purpose of estimating it, we have used country-level market risk premiums as calculated by Aswath Damoradan (professor of finance at the Stern School of Business at New York University) based on default spreads estimated from Moody's local currency sovereign ratings or sovereign credit default swaps. We have then weighted these market risk premiums according to PCB's gross loan book split by country at end-2019. Given the euro area yield curve is negative for maturities up to 28 years, we have assumed a 1% risk free rate, which is close to the average 10-year German bond yield over the last 10 years.

We have applied a beta of 1.0x, given the banking sector's performance tends to mirror conditions in the broader economy. We believe this is a conservative assumption given the risk profile of PCB's loan book (as illustrated by the net write-offs and share of defaulted loans) is below local banking sectors (as discussed above) and the fact that PCB operates under German regulations and supervision. We have also used a long-term growth rate of 2.0% in the P/BV-ROE valuation. Based on these assumptions, we have arrived at a fair value per PCB share of €7.50 (see Exhibit 22), which represents c 20% upside potential to the current share price.

Exhibit 22: PCB's P/BV-ROE valuation

€'000s unless otherwise stated	FY19	FY20e	FY21e	FY22e	FY23e	FY24e
Shareholder's equity	792,552	784,678	816,000	866,390	928,892	1,001,805
Intangibles	20,345	20,775	20,775	20,775	20,775	20,775
Tangible equity	772,207	763,903	795,225	845,615	908,117	981,030
Net attributable profit	61,522	31,652	41,339	64,169	83,891	100,877
RoTE	**8.3%**	**4.1%**	**5.3%**	**7.8%**	**9.6%**	**10.7%**
Tangible equity per share (€)	**13.1**	**13.0**	**13.5**	**14.4**	**15.4**	**16.7**
Tangible equity per share (FY20e, €)	13.0					
Sustainable RoTE	10.0%					
Growth rate	2.0%					
Cost of equity	14.7%					
Fair value multiple	**0.6x**					
Fair value per share (end-2020, €)	8.15					
discount factor	*0.92*					
Fair value per share (€)	**7.50**					
Current share price (€)	6.30					
upside / downside	*20%*					

Source: ProCredit, Edison Investment Research

Below we show a valuation sensitivity analysis based on cost of equity and sustainable RoTE. We note that when we assume an RoTE in line with PCB's five-year historical average of 8% (rather than the mid-term target of 10% assumed above) we arrive at a value at €5.63 per share (see Exhibit 23).

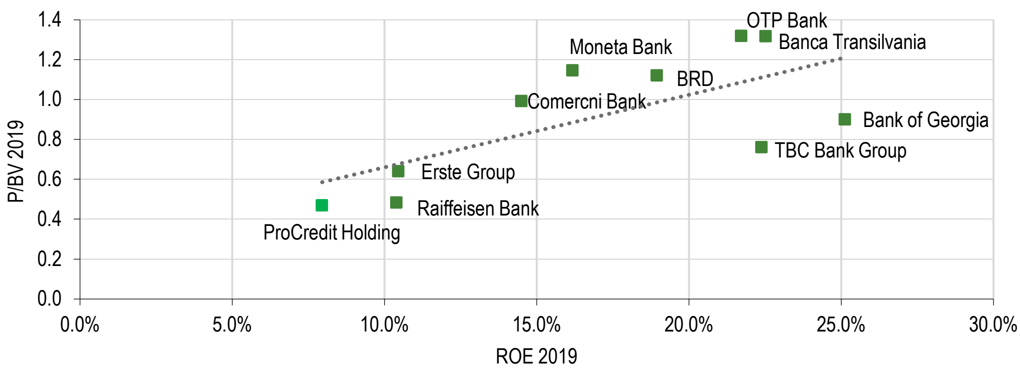
Exhibit 23: PCB's valuation sensitivity analysis (€/share)

		Sustainable RoTE						
		7.0%	**8.0%**	**9.0%**	**10.0%**	**11.0%**	**12.0%**	**13.0%**
Cost of equity	**13.2%**	5.32	6.39	7.45	8.51	9.58	10.64	11.71
	13.7%	5.10	6.11	7.13	8.15	9.17	10.19	11.21
	14.2%	4.89	5.86	6.84	7.82	8.80	9.77	10.75
	14.7%	4.69	5.63	6.57	**7.50**	8.45	9.39	10.33
	15.2%	4.52	5.42	6.32	7.23	8.13	9.04	9.94
	15.7%	4.35	5.22	6.09	6.96	7.84	8.71	9.58
	16.2%	4.20	5.04	5.88	6.72	7.56	8.40	9.24

Source: Edison Investment Research

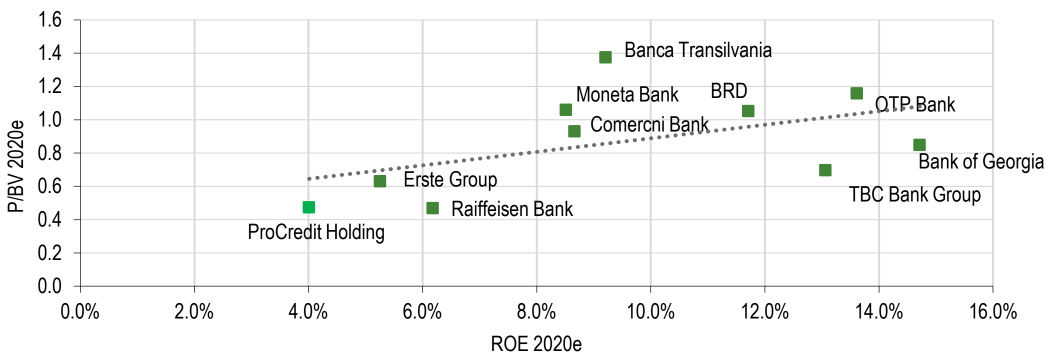
In Exhibits 24 and 25, we present how PCB fares versus its local peers on a P/BV-ROE scatter plot based on FY19 actuals as well as FY20e estimates (Edison forecasts for PCB and Refinitiv consensus estimates for peers). Although PCB has one of the lowest FY19 ROEs in the group (at c 8% based on continuing operations), it is also trading at one of the lowest P/BV ratios (0.5x) and as a result is positioned below the regression line, suggesting a certain degree of undervaluation. This is also the case on FY20e estimates, although we note that at this stage not all peer consensus figures may reflect the impact of macro factors (including COVID-19). It is worth keeping in mind that the group is quite scattered across the P/BV-ROE map (eg Georgian banks are traded at quite low P/BV compared to their ROE) making the regression line somewhat less reliable. We believe this may be due to a number of non-financial factors, such as the political risk perceived by investors.

Exhibit 24: P/BV vs ROE – ProCredit and its peers (2019 actuals)



Source: ProCredit, Refinitiv data

Exhibit 25: P/BV vs ROE – ProCredit and its peers (2020e)



Source: ProCredit, Edison Investment Research forecasts for PCB, Refinitiv consensus at 4 June 2020 for peers

Exhibit 26: Financial summary

Year ending December, €000s	FY17	FY18	FY19	FY20e	FY21e	FY22e	FY23e	FY24e
INCOME STATEMENT								
Net interest income	204,664	186,235	194,533	199,939	205,138	222,520	250,225	279,635
Net fee and commission income	45,834	52,172	51,972	51,085	54,065	56,655	59,367	62,209
Loss allowances (-)	4,819	(4,714)	(3,327)	39,055	31,210	17,199	13,458	13,930
Operating income	248,414	245,394	252,603	214,578	231,301	266,719	302,678	336,429
Operating expenses	186,265	167,866	175,737	174,297	179,233	187,598	200,094	213,587
PBT	62,150	77,528	76,866	40,281	52,068	79,122	102,585	122,843
Net profit after tax	**48,102**	**54,479**	**54,305**	**31,652**	**41,339**	**64,169**	**83,891**	**100,877**
Reported EPS (€)	0.86	0.90	0.89	0.54	0.70	1.09	1.42	1.71
DPS (€)	0.27	0.30	0.30	0.18	0.23	0.36	0.47	0.57
BALANCE SHEET								
Cash and balances at Central Banks	932,744	963,714	1,081,723	1,175,767	1,084,739	1,113,955	1,148,957	1,187,622
Loans and advances to banks	195,552	211,592	320,737	201,329	205,356	205,356	205,356	205,356
Investment securities	353,568	297,308	378,281	333,414	340,082	340,082	340,082	340,082
Loans and advances to customers	3,756,776	4,267,829	4,690,961	4,768,364	5,102,363	5,617,455	6,185,658	6,811,405
Property, plant and equipment and investment properties	142,347	130,153	138,407	134,170	134,170	134,170	134,170	134,170
Intangible assets	21,153	22,191	20,345	20,775	20,775	20,775	20,775	20,775
Other assets	79,659	73,396	67,106	67,996	67,996	67,996	67,996	67,996
Total assets	**5,481,799**	**5,966,184**	**6,697,560**	**6,701,815**	**6,955,481**	**7,499,788**	**8,102,993**	**8,767,405**
Liabilities to banks	359,477	200,813	226,819	235,543	240,254	254,669	269,950	286,146
Liabilities to customers	3,571,237	3,825,938	4,333,436	4,239,438	4,438,211	4,860,004	5,324,256	5,834,715
Liabilities to international financial institutions	549,598	813,369	852,452	942,961	961,820	1,019,529	1,080,701	1,145,543
Debt securities	183,145	206,212	343,727	357,375	357,375	357,375	357,375	357,375
Subordinated debt	140,788	143,140	87,198	89,320	89,320	89,320	89,320	89,320
Other liabilities	37,714	33,076	50,436	52,501	52,501	52,501	52,501	52,501
Total liabilities	**4,841,961**	**5,222,549**	**5,894,068**	**5,917,138**	**6,139,481**	**6,633,399**	**7,174,103**	**7,765,601**
Total shareholders' equity	639,839	743,634	803,492	784,677	815,999	866,389	928,891	1,001,804
BVPS (€)	11.8	12.5	13.5	13.3	13.9	14.7	15.8	17.0
TNAV per share (€)	11.4	12.1	13.1	13.0	13.5	14.4	15.4	16.7
RATIOS								
NIM	3.80%	3.30%	3.10%	2.98%	3.00%	3.08%	3.21%	3.32%
Costs/Income	73.6%	69.7%	70.5%	68.7%	68.3%	66.1%	63.3%	61.0%
ROAE	7.1%	7.6%	6.9%	4.0%	5.2%	7.6%	9.3%	10.4%
CET1 Ratio	13.7%	14.4%	14.1%	14.1%	14.3%	14.2%	14.2%	14.2%
Tier 1 ratio	13.7%	14.4%	14.1%	14.1%	14.3%	14.2%	14.2%	14.2%
Capital adequacy ratio	16.7%	17.2%	15.7%	15.8%	15.9%	15.7%	15.6%	15.5%
Payout ratio (%)	31.4%	33.3%	33.7%	33.3%	33.3%	33.3%	33.3%	33.3%
Customer loans/Total assets	71.3%	73.6%	71.6%	73.1%	75.3%	76.7%	78.0%	79.3%
Loans/Deposits	109.5%	114.8%	110.7%	115.5%	118.0%	118.3%	118.7%	119.1%

Source: ProCredit accounts, Edison Investment Research

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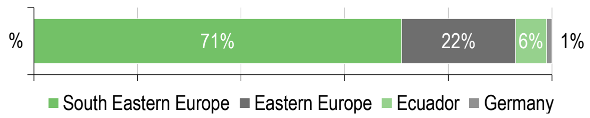
Gross loan book by geography



Management team

Board member: Dr Gabriel Schor

Gabriel has been part of the company since the beginning. He worked for the consulting company IPC since 1983 (IPC was consulting company founded in 1980; now Zeitinger Invest, a major PCB's shareholder). He was appointed a member of PCB's management board in 2004 and has been responsible for reporting and controlling, supervisory reporting and capital planning, accounting and taxes, group treasury and group funding. In September 2019, he also took over investor relations, group communications, administration and translation. He is the personally liable managing partner of ProCredit AG & Co KGaA.

Board member: Sandrine Massiani

Sandrine joined PCB in 2007 and initially worked as regional coordinator in Africa. She became a coordinator of the group human resources in 2011 and a manager of human resources and IT in 2015. She was appointed to the management board in 2017 and has overseen human resources, internal audit, risk management, IT, business support and compliance. Since September 2019, she has also been responsible for credit risk, group environmental management, legal, group anti-money laundering and fraud prevention. Before Sandrine Massiani joined PCB, she worked at BNP Paribas and Development Finance International (an international advisory firm focused on emerging markets) and was a project coordinator and short-term expert at IPC.

Principal shareholders	(%)
Zeitinger Invest	17.0
KfW	13.2
DOEN Paticipaties	12.5
International Finance Corporation	10.0
TIAA	8.6
ProCredit Staff Invest Beteiligungs	3.0
Free float	35.7

Companies named in this report

BNP Paribas, BRD, Banca Transilvania, Bulgarian American Credit Bank, TBC Bank, Bank of Georgia, Ferratum, Kapilendo, Creditshelf, Funding Circle, Erste Group, Moneta Bank, OTP Bank.

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