Ukraine | Research
Fixed Income | Banks
Desk Note

August 9, 2012

Banking sector Eurobond issuers

2Q12: Barely profitable but broadly safe on liquidity

Banks are still struggling to return to decent profitability (the NPL surge in 2009-11 is still being felt), but their debt-servicing capacity is currently beyond concern. Steady deposit inflows (+10% yoy in June) against the backdrop of sluggish lending (+4% yoy) leaves banks with sufficient funds to make timely payments on liabilities. We remain positive on the liquidity and solvency of privately held FUIB and Privatbank, as well as state-owned Ukreximbank and Oschadbank. The latter two are deploying all new cash into government T-bills, but the money will certainly be returned should the banks need it for debt redemptions. We are wary of Finance & Credit Bank and VAB Bank Eurobonds as we believe the issuers need shareholder support for liquidity and solvency.

Sector highlights

Lending to remain feeble in 2H12

Lending remains weak: corporate loans increased a mere 2.0% in 1H12 (reaching a new historical high) while the retail portfolio shrank 5.7% (32% off its end-2008 peak). Any recovery will remain constrained by the banks' lack of long-term funding and the dearth of creditworthy borrowers.

Funding supported solely by deposits

Ukraine's banking sector is becoming increasingly reliant on deposits – the loan-to-deposits ratio stood at 157% at end-June, down from a peak of 229% in April 2009. Yet, most client funds are short-term – about 63% of retail deposits attracted in 1H12 have maturities of less than 6 months.

Liquidity tight on restrictive NBU monetary policy

The NBU continues to keep a tight handle on hryvnia liquidity to prevent FX speculation. The overnight lending rate stayed in double digits for most of June and July. That said, the high rates are not indicative of the situation at large banks – most are perfectly liquid and avoid the interbank market.

Sector turning profitable for first time since 2008

The sector's net interest income continues to decline mainly due to a narrowing interest spread. We project that combined pre-provision profits will decline by more than 10% yoy in 2012 but we still expect the sector to turn profitable for the first time since 2008 on a decrease in provisions.

Top Eurobond picks: FUIB, EXIMUK and OSCHAD

We recommend the Eurobonds of state-owned Ukreximbank (Apr'15, YTM 11.0%) and Oschadbank (Mar'16, YTM 12.5%). Although we think their financial health is far from perfect given extensive related-party lending, we are confident the government and NBU stand ready to support their liquidity. We clearly prefer FUIB (Dec'14, YTM 13.1%) over Privatbank (Sep'15, YTM 14.3%) given the former's outstanding transparency, stronger capital base, and measured lending policy. Also noteworthy, FUIB offers an attractive premium to yields on the debt of its sister companies DTEK (Apr'15, YTM 10.2%) and Metinvest (May'15, YTM 10.4%), and we believe SCM, the holding company, will ensure that all of its subsidiaries meet debt obligations on time and in full.

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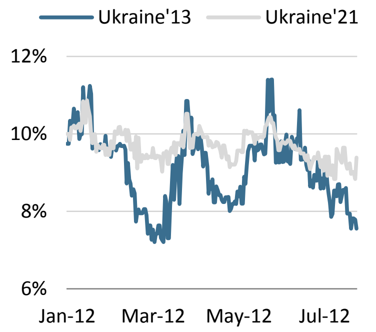
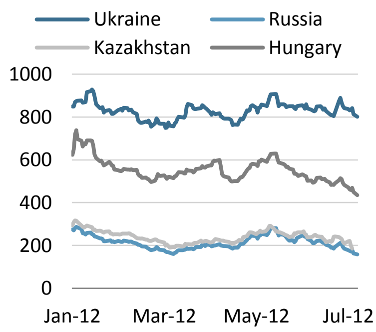
Ukraine Eurobond yield



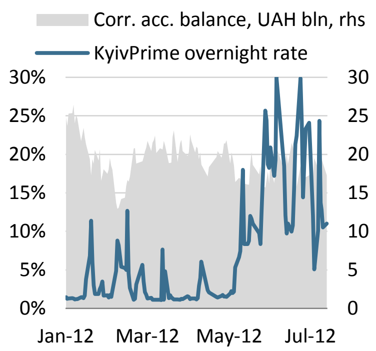
Source: Bloomberg

Ukraine 5-year CDS vs. peers



Source: Bloomberg

Banking sector liquidity indicators



Source: Bloomberg

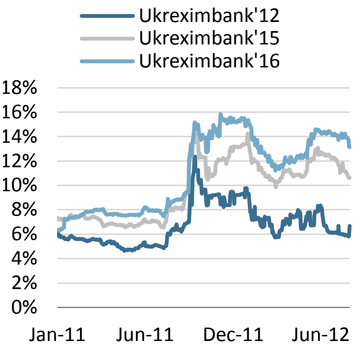
Ukreximbank (EXIMUK)

Eurobond parameters

Amount, USD mln	250	750	125
Maturity	10/12	04/15	02/16
Coupon	6.8% S/A	8.38% S/A	5.79% S/A
S&P	na	na	na
Fitch	B	B	CCC
Moody's	B2	B2	B3

Source: Bloomberg

YTM



Source: Bloomberg

Key takeaways from 2Q12 financials

Net income of USD 3 mln; net interest income increased 11% yoy on a wider interest spread and despite a 4% yoy drop in net loans. Pre-impairment profit rose 12% yoy but the bank continued sending that nearly in full to loan loss reserves. Ukreximbank's net loan portfolio remained flat in 2Q12.

Ukreximbank's 2Q12 and 1H12 financials, UAS, USD mln

	1H12	yoy	2Q12	qoq	yoy
Net interest income	216	7%	105	-4%	11%
Net fees and commissions	30	0%	15	6%	-3%
Operating expenses	-72	27%	-39	18%	24%
Pre-impairment profit	207	5%	97	-12%	12%
Impairment charge for credit losses	-198	5%	-94	-11%	13%
Net income	6	19%	3	18%	21%
Cost/Income	25.9%	3.4pp	28.8%	2.0pp	5.7pp
Assets			9,452	4%	-6%
Gross corporate loans			6,287	-3%	-3%
Gross retail loans			112	-6%	-17%
Loan loss reserve			-1,095	-18%	-2%
Liabilities			7,234	5%	-8%
Corporate deposits			2,217	0%	-18%
Retail deposits			1,775	2%	4%
Equity			2,218	0%	0%

Source: Company data

Our view and outlook

As lending is unlikely to revive in the coming months and loan losses are still to be covered in full, the bank will likely stay only marginally profitable in 2H12. Our key concern is its evolving cooperation with Naftogaz (NAFTO) – the lender was involved in over USD 1.0 bln in T-bill repo deals with the monopoly in the past few months. Ukreximbank had previously refrained from doing business with Naftogaz.

Oschadbank (OSCHAD)

Eurobond parameters

Amount, USD mln	700
Maturity	03/16
Coupon	8.25%, S/A
S&P	na
Fitch	B
Moody's	B2

Source: Bloomberg

YTM

Source: Bloomberg

Key takeaways from 2Q12 financials

Marginally profitable with net income of just USD 6 mln. Net interest income up 12% yoy, but pre-impairment profit remained flat as operating expenses grew 27% yoy. Asset growth accelerated to 8% qoq in 2Q12, but the net loan portfolio grew just 3% qoq. The bank deployed liquidity into T-bills (holdings up 30% qoq to USD 2.5 bln), whose share in total assets reached 24%.

Oschadbank's 2Q12 and 1H12 financials, UAS, USD mln

	1H12	yoy	2Q12	qoq	yoy
Net interest income	297	15%	147	-3%	12%
Net fees and commissions	63	8%	31	-7%	8%
Operating expenses	-184	25%	-97	12%	27%
Pre-impairment profit	164	-16%	98	48%	0%
Impairment charge for credit losses	-129	-18%	-88	118%	13%
Net income	29	-8%	6	-72%	-59%
Cost/Income	53.0%	9.8pp	49.9%	6.0pp	-7.0pp
Assets			10,602	8%	17%
Gross corporate loans			6,951	4%	24%
Gross retail loans			550	0%	-7%
Loan loss reserve			-1,168	8%	38%
Liabilities			8,375	11%	21%
Corporate deposits			1,007	0%	-38%
Retail deposits			3,629	7%	22%
Equity			2,227	-1%	2%

Source: Company data

Our view and outlook

Growth in the bank's core earnings remains strong but increases in operating expenses and loan loss provisions in 2Q12 are a source of concern. We do not expect cost/income to improve, but provisions should decline in 2H12. The bank remains highly liquid given the high share of government T-bills on its balance sheet, which can be put up as collateral for refinancing loans from the NBU.

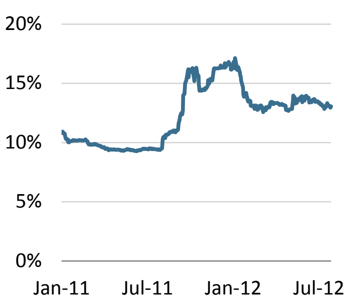
FUIB: First Ukrainian International Bank (PUMBUZ)

Eurobond parameters

Amount, USD mln	252
Maturity	12/14
Coupon	11.0%,Q
S&P	na
Fitch	NR
Moody's	B2

Source: Bloomberg

YTM



Source: Bloomberg

Key takeaways from 2Q12 financials

Strong growth in key revenues: net income added 9% yoy and net fees and commissions increased 15% yoy. Growth in operating expenses slowed to 15% yoy in 2Q12 from 95% yoy in 1Q12. The spike in costs is likely related to business restructuring following the merger with Dongorbank in mid-2011. Provisions declined 23% yoy in 2Q12 and the NPL coverage ratio reached 97%.

FUIB's 2Q12 and 1H12 financials, UAS, USD mln

	1H12	yoy	2Q12	qoq	yoy
Net interest income	97	13%	50	6%	9%
Net fees and commissions	21	14%	11	13%	15%
Operating expenses	-73	51%	-29	-32%	15%
Pre-impairment profit	47	-25%	29	57%	-16%
Impairment charge for credit losses	-26	-42%	-14	21%	-23%
Net income	16	24%	11	130%	-4%
Cost/Income	60.6%	17.2pp	50.5%	7.7pp	-19.7pp
Assets			3,936	-1%	na
Gross corporate loans			1,849	2%	na
Gross retail loans			609	-10%	na
Loan loss reserve			-436	-17%	na
Liabilities			3,424	-1%	na
Corporate deposits			890	1%	na
Retail deposits			1,193	5%	na
Equity			512	0%	na

Source: Company data

Our view and outlook

The bank clearly showed its ability to contain merger-related growth in operating expenses. With NPLs provisioned almost in full, the bank should continue cutting loan impairment charges. FUIB's liquidity cushion is thick enough (cash equivalents and T-bills combined account for 21% of total assets) and its solvency is strong with an NBU CAR of 15.5% (vs. a 10% minimum).

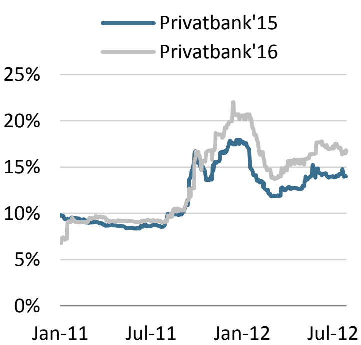
Privatbank (PRBANK)

Eurobond parameters

Amount, USD mln	200	150
Maturity	09/15	02/16
Coupon	9.38% S/A	5.80% S/A
S&P	na	na
Fitch	B	na
Moody's	B1	B2

Source: Bloomberg

YTM



Source: Bloomberg

Key takeaways from 2Q12 financials

Revenues declined 1.7% yoy on flat net interest income and weaker non-core earnings. Cost of risk surged to 4.6% in 1H12 from 3.4% in 1H11, which dented net income. Assets added 5.2% qoq and the net loan book grew 2% qoq. Liquidity remains high as cash and equivalents account for 17% of total assets.

Privatbank's 2Q12 and 1H12 financials, UAS, USD mln

	1H12	yoy	2Q12	qoq	yoy
Net interest income	453	19%	224	-2%	-1%
Net fees and commissions	252	13%	133	11%	7%
Operating expenses	-315	11%	-164	9%	12%
Pre-impairment profit	471	27%	208	-21%	-10%
Impairment charge for credit losses	-382	41%	-160	-28%	-12%
Net income	74	-25%	40	21%	-7%
Cost/Income	40.1%	-3.2pp	44.2%	5.4pp	7.7pp
Assets			20,236	5%	19%
Gross corporate loans			13,182	3%	12%
Gross retail loans			3,303	1%	11%
Loan loss reserve			-2,923	5%	24%
Liabilities			18,077	6%	17%
Corporate deposits			3,011	1%	8%
Retail deposits			9,803	3%	16%
Equity			2,160	1%	36%

Source: Company data

Our view and outlook

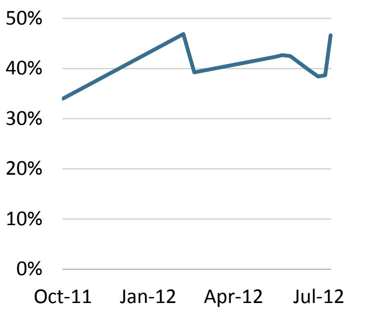
The decline in 2Q revenues should reverse and we expect more than 15% full-year growth on active lending. We are concerned about the rapid expansion of the loan book amid the dearth of creditworthy borrowers and do not rule out the involvement of related-party lending. We are also concerned with the fact that the bank has not deployed idle cash into interest-earning assets, which could be preventing an improvement in profitability.

VAB Bank (VABANK)

Eurobond parameters	
Amount, USD mln	112
Maturity	06/14
Coupon	10.5%, Q
S&P	na
Fitch	WD
Moody's	Caa1

Source: Bloomberg

YTM



Source: Bloomberg

Key takeaways from 2Q12 financials

10x yoy surge in impairment charges yielded a USD 46 mln net loss. Net interest income rose 62% yoy to USD 38 mln and net fees and commissions added 52% yoy to USD 8 mln. The pace of lending remained strong as the net loan book increased 9% yoy to USD 843 mln. The growth was well-funded with deposit inflows: corporate facilities rose 58% qoq while retail facilities were up 11%.

VAB Bank's 2Q12 and 1H12 financials, UAS, USD mln

	1H12	yoy	2Q12	qoq	yoy
Net interest income	6	-36%	5	903%	-9%
Net fees and commissions	16	81%	8	6%	52%
Operating expenses	-25	-23%	-12	1%	-30%
Pre-impairment profit	-1	-89%	2	nm	nm
Impairment charge for credit losses	-59	277%	-56	1888%	824%
Net income	-48	nm	-46	nm	nm
Cost/Income	104.8%	-41.4pp	88.4%	-63.5pp	-40.4pp
Assets			1,657	17%	71%
Gross corporate loans			875	20%	52%
Gross retail loans			215	-7%	-3%
Loan loss reserve			-246	33%	45%
Liabilities			1,526	17%	72%
Corporate deposits			322	58%	87%
Retail deposits			730	11%	58%
Equity			131	15%	56%

Source: Company data

Our view and outlook

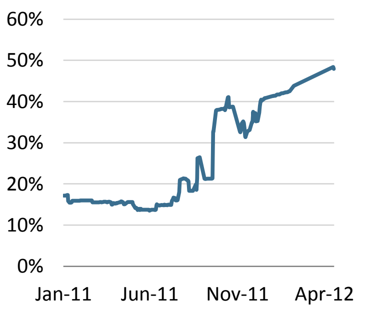
The extremely high pace of corporate loan portfolio growth may imply the bank is heavily involved in related party lending, while retail deposits remain the most significant funding source. We expect profitability to continue being negatively affected by loan impairment charges even though growth in core earnings should remain strong.

Finance and Credit Bank (FICBUA)

Eurobond parameters	
Amount, USD mln	95
Maturity	01/14
Coupon	10.5%, S/A
S&P	na
Fitch	na
Moody's	Caa1

Source: Bloomberg

YTM



Source: Bloomberg

Key takeaways from 2Q12 financials

Weak set of results: net interest income down 7% yoy in 2Q12 and pre-impairment profit dropped 83% yoy to less than USD 1 mln. Cost/income surged 14ppts yoy to an alarming 97% in 2Q12. Loan loss reserves remained at an extremely low 8.7% of gross loans.

Finance and Credit Bank's 2Q12 and 1H12 financials, UAS, USD mln

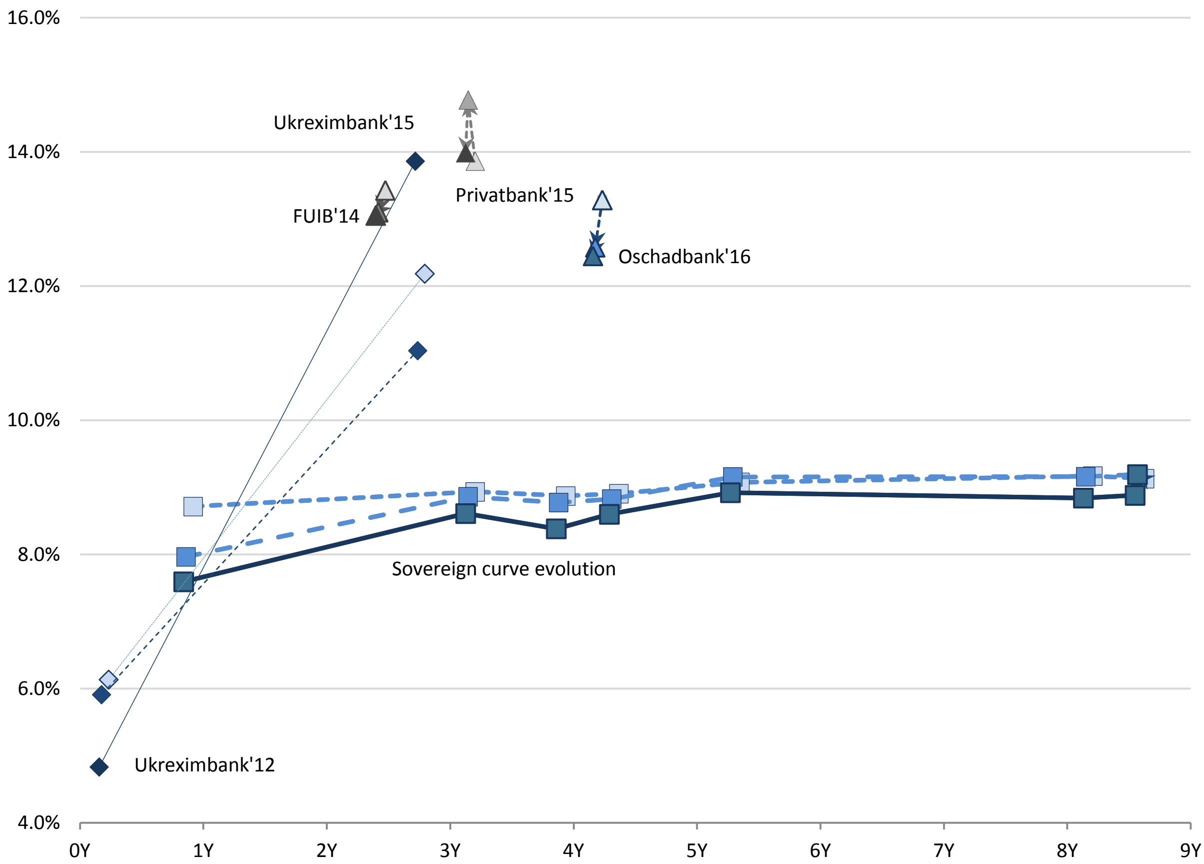
	1H12	yoy	2Q12	qoq	yoy
Net interest income	24	-7%	14	30%	-7%
Net fees and commissions	20	15%	10	-6%	9%
Operating expenses	-45	0%	-22	-2%	-2%
Pre-impairment profit	2	-80%	1	-16%	-83%
Impairment charge for credit losses	-2	-81%	-1	-29%	-95%
Net income	0	-65%	0	nm	nm
Cost/Income	96.4%	12.2pp	96.7%	13.4pp	0.5pp
Assets			2,776	-4%	-9%
Gross corporate loans			2,030	3%	3%
Gross retail loans			467	-1%	-7%
Loan loss reserve			-217	0%	9%
Liabilities			2,553	-4%	-10%
Corporate deposits			391	-7%	-35%
Retail deposits			1,022	0%	14%
Equity			223	0%	-5%

Source: Company data

Our view and outlook

The bank is still heavily under-provisioned and continues to allocate substantial amounts to loan loss reserves. CAR of 10.3% is only marginally above the NBU's floor of 10%. The bank announced plans for a 15% share capital increase, but the probability of success is low – the bank planned a 7.5% capital increase in March 2012 but failed to complete it, later offering no statement on the event.

Eurobond yield map evolution: 1 week, 4 weeks*



Source: Bloomberg, Concorde Capital

** The lightest markers indicate 4-week-old data, the darkest ones represent the most recent (August 08, 2012) data*
Note: Eurobonds of VAB Bank and Finance & Credit Bank are not on the chart as quotations are unavailable due to low liquidity of papers; subordinated Eurobonds Privatbank'16 and Ukreximbank'16 are not on the chart.
Source: Bloomberg, Concorde Capital

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