MDM Bank - 1H 2008 Results Conference Call
Tuesday, 26th August 2008
14:00 Hrs UK time
Chaired by Andrey Ilyin

Andrey Ilyin

Good afternoon, ladies and gentlemen. Thank you for joining MDM Bank's interim results conference call. I am here to take you through the results, basically, and to give some indication on the outlook for the remainder of the year and, as usual, to answer any questions that you might have. I am hoping that some of you at least had a chance to take a look through the financials. If not, I will basically give you the highlights, so you can get a feel for what was going on in the first half.

Operator, if we could move to slide number three, please, of the presentation. Basically, talking about the first half results, we can say that the second quarter was certainly far more successful than the first quarter. The net profit for the second quarter amounted to about RUB 1.5 billion, which was basically a 16% increase on net profit recorded in the second quarter of last year. However, given to the poor first quarter results, the overall first half is down by 20%. So, net profit declined by 20% over the same period of 2007 to about RUB 2.2 billion. And I would remind you that the major three reasons for poor results in the first quarter were one specific provision against the corporate borrower, excess liquidity which was biting into the net interest margin and poor results on the trading side, driven mainly by the market volatility on the equities. In the second quarter we were able to recover the losses which, the market losses which were recorded on the equities book and also there were some positive developments... There were some positive developments as regards the corporate borrower. We have managed to obtain an additional collateral and we're not expecting to make any losses and any further provisions either. Overall the balance sheet increased in the first six months of the year by about 10% to RUB 350 billion, which is about $15 billion, and loans in the first six months grew by about 11%. Predominantly that was driven by the growth in customer deposits because, in fact, the share... As you will see later on, the share of international financing of our balance sheet has dropped in the first six months. Total equity grew by 6% and now exceeds RUB 41 billion, which is about $1.7 billion. Cost/income ratio increased relative to the first half of 2007 but it, there was still market improvement in the second quarter relative to the first quarter of this year. Again, as I've said before, strong deposit growth across all the business lines and the ratio that we monitor very carefully these days is deposits to loans ratio. Excluding deposits, customer deposits at the Latvian Trade Bank, that ratio has improved relative to the year-end of 2007 from 51.7% to over 56% and I believe that we would have this ratio at above 60% by the end of the year and around 70% towards the end of 2009. Provision coverage of non-performing loans was solid, over 130%, and the exposure to real estate and construction sectors, which we had at the end of 2007 at around 25% of gross loans, has dropped to about 18% and will continue to decline in the next, over the next 12 to 18 months.

Next slide, please. Just a brief update on the network development – why is this important? Network is a very key part of our retail strategy because the retail strategy that we're pursuing is centred around small business lending on the asset side and, on the liabilities side, retail deposit-taking and current accounts whereas in Russia current accounts basically are centred around payroll services. In order to provide those products, you actually need to have branches because alternative distribution channels do not really work very well for these product areas. Therefore the broad and effective branch network is pretty much very high on the agenda at MDM these days. We are targeting around 230 full-service points of sale by the year-end and with a medium term target in mind of about 500 to 600 points of sale and overall, as of today, we've got 180. So, big plans as regards the network, which actually is putting pressure on the cost side but, you know, we have to go through that investment phase anyway.

Next slide, please. We've got some charts here showing, basically, the evolution of the revenue and cost side and the profit-before-tax as well as return on equity and cost/income ratio. On the left-hand side you can see that in the second quarter the revenue, the revenues, quarterly revenues were back on the upward trend, following the dip in the first quarter caused by predominantly market losses on equities. And also the quarterly profit-before-tax has recovered. On the right-hand side chart you can see that the cost/income ratio is continued to, continuing to oscillate around the 50% mark, which is again... It will be hard to sustain over the next two years due to the intense investment cost pressure, driven partially by the branch network rollout but also to a significant extent by the IT upgrade that is happening. In terms of return on equity, you can see that it's been slightly disappointing over the past few quarters but we are hoping to get it back close to 20% next year.

Next slide, please. Here's a chart showing segmental revenues. We've got two main business segments, Corporate & Investment Banking and Retail Banking. Retail, just to remind you, includes both consumer financial services and small business banking as well. Revenues in the retail area grew by about, about 20% in the first half and CIB revenues increased by 10%. That basically was affected... CIB revenues were certainly affected by the volatility in the capital markets since Corporate & Investment Banking now incorporates sales and training as well. But overall the Retail revenues growth is progressing fairly well and now Retail contributes 25% to the overall revenue base of the Bank.

Next slide, please. Just to give you a few highlights on the Corporate & Investment Banking, it still counts for the bulk of our revenues, 75%. In the first half we've had continuing fairly strong growth in corporate customers, particularly we would like to know the growth in customer deposits excluding Latvian Trade Bank because Latvian Trade Bank has got several customers with very sizeable periodic current account movements and in order to analyse the trends, we typically exclude Latvian Trade Bank from the picture. Overall there was a strong growth in assets, about 28%, and in financial markets we actually maintained our leading positions, in foreign exchange, bullion banknote trading, money markets. Trading results, as I've mentioned before, have recovered in the second quarter, practically covering the losses, market losses incurred in the first quarter. And, as we told you before, in the first quarter we had created a provision, specific provision against one corporate borrower. Basically, we've got now a significantly stronger position in the shape of collateral, which is a piece of prime real estate in one of the largest cities of Russia and therefore we're quite confident that no further provisions will be required going forward.

Next slide, please. A few words on Retail Banking. We have 20% revenue for the first half of 2008, added partially by 15 new full-service points which were opened and the continuing expansion of the ATM network as well. Retail and small business banking growth in deposits was perhaps a little bit constrained but the overall market was not growing very fast either. However, a targeted advertising campaign which we launched resulted in a big inflow of new clients and we show you here that we've got 9,000 new savings accounts in about a month, which is a very good result. The small business lending, which is a target strategic area... Small business loan portfolio grew by 31% in the first six months, which is, as we estimate, slightly ahead of the market, which we believe was about 25%. So, the small business banking portfolio is... This growth is seen as key to reshaping the balance sheet and key to the successful execution of the retail strategy as well.

Next slide, please. We have here the structure of the liabilities and assets. On the asset side very little has changed, in fact, relative to the year-end of 2007, just a slight increase in the share of loans, from basically 53% to 54% at the end of the first half. Given the fact that the consumer lending portfolio was not growing as rapidly, the overall retail portfolio, the share of the retail loan portfolio shrank but, in fact, that certainly masks the rapid growth of the small business loan portfolio. As you can see, the proportion of cash declined only marginally from the year-end, so we still remain very, very liquid, in fact, to a significant extent carrying a lot of excess liquidity, continuing to carry a lot of excess liquidity on the balance sheet. On the liabilities side, which is the right-hand side chart, you can see here a sharp rise in the share of customer deposits. However, a good five percentage points of that is due to an abnormal swing at Latvian Trade Bank around the end of the second quarter. So, essentially growth in customer deposits on the balance sheet is pronounced but it's probably not as pronounced as shown here. So, it's probably increased its share from about 39% to 45% or so.

Next slide, please. Net interest margin in the second quarter, in fact, has gone up, as we've expected. Basically, that is linked to the fact that basically new lending, essentially on strong growth in new lending which was done at higher rates. You can see from the right-hand side chart that growth in corporate loan portfolio has recovered to a significant extent and the small business banking loan portfolio, which is the blue line on the right-hand side chart, although it's a small but still continuously growing portion and that is a much higher margin lending than corporate or retail or consumer portfolios. In terms of the net interest income, we have recovered growth as well. Despite the fact that we still continue to carry a lot of excess liquidity, you can see that we've, we had a record net interest income, quarterly net interest income in the second quarter exceeding RUB 4 billion for the quarter.

Next slide, please. In terms of the concentration, we had some positive developments in the second quarter. The concentration on the asset side, the top 20 borrowers has dropped slightly to below 20% from about 21.7% at the end of the first quarter and the concentration of liabilities we believe is beginning to decline to the levels which are far more comfortable to ourselves as well, basically below 48%, the top 20 depositors, and we believe that that trend will continue throughout the future. In terms of the coverage of non-performing loans, you can see here a slight reduction. That is basically an... You know, I think it's an understandable situation. We are now probably entering a period where we are past, where we're certainly past the peak of the credit cycle. We have accumulated significant excess provisioning of non-performing loans which is now being gradually reduced but we're not expecting to see the provision coverage of non-performing loans to fall, certainly not below 100%, but we're also expecting it to stay at around this level of 130% towards the end of the year as well.

Next slide, please. Continuing on the subject of asset quality, we're showing here several charts. Probably the good one to start with is the non-performing loans ratio chart on the right-hand side. You can see here that the headline number, NPL number, which is the black line, has increased from 2.4% to 2.7% but, in fact, in July we have executed a successful profitable sale of a significant part of our retail non-performing loans to a collection agency and, following that sale, the Retail NPL ratio falls from 6.5% to 5.1% and the overall NPL ratio falls from 2.7% to 2.4%. The up trend in NPL ratio, the grey line, on the corporate, in the corporate loan portfolio is due for the time being just to one borrower, the situation to which we have been referring so far and, as I said, we are quite comfortable that we have now collateral which would allow us to avoid further provisioning and further losses. On the small business side, the NPL ratio has been trending up. It is this portfolio that is quite new to Russian banks in general. I think nobody knows for sure where exactly the NPLs will stabilise. However, we believe that the measures we're taking on the process side and on the underwriting criteria and on collateral and collection as well will actually see this ratio stabilise at below 4%. Certainly we would want it to see, stabilising at around 3.5%. On the cost of risk side, which relates provisioning expense to average loan portfolio, you can see the black bar going up in the first half of 2008 from 1.1% to 1.4%. That is pretty much the impact of this one-off corporate provisioning plus provisioning in the leasing portfolio which also was required in the first half. But overall we think the trend in asset quality is now beginning to basically diverge slightly. The measures... The internal measures we have taken on the retail side are beginning to see positive results in terms of the asset quality in consumer loans and we're hoping to see the same result in small business banking as well because it takes time. However, given the fact that the economy is actually slowing and the international markets are remaining difficult, I think it will certainly be unwise to believe that there will be no deterioration in asset quality on the corporate side. So, we're seeing some of that and that actually makes us change a little bit our industrial exposure. As I've mentioned before, we've reduced the real estate exposure from 25% to 18% and will, it will continue to drop, and also revised some of the collateral policies. Basically in the future the share of uncollateralised lending will drop significantly going forward.

Next slide, please. Here's an update on liquidity. Liquidity remains very, very robust. However, I think the overall cumulative liquidity gap for up to one month we're certainly not having as high positive gap as before because otherwise it would be impossible for us to make any money. However, we are very conscious of the difficulties with, in the international markets and we are quite conscious of the fact that the markets will probably stay difficult for a variety of reasons but the dynamics, the very positive dynamics on corporate and retail and private banking deposits that we have recorded so far, in fact, make us optimistic and we think that we can grow pretty much by 25%-30% just on deposits and gradually being able to run down the share of international funding in the balance sheet as a matter of strategic priority.

Next slide, please. Actually, having said that on the international funding, we certainly will be opportunistic and will take any opportunity to borrow, if it presents itself, but it doesn't have to happen. In fact, this year I think we're comfortably financed. Next year we've got just the syndication to refinance and we're quite comfortable that that will be possible. So... In fact, next year is not very intensive in terms of the burden, refinancing burden. A few words on the outlook. We think that we can grow our assets by about 25% this year, which is down but not massively down the 2007 number of 32%. Net interest margin, we believe that will stay stable at around 5%, close to what it, where it was in 2007 because there are... Well, essentially assets are re-pricing. Liabilities are re-pricing as well but not as dramatically and not as fast. But the additional downward pressure on the margin obviously comes from the fact that we're continuously keeping excess liquidity on the balance sheet which doesn't earn anything, which is the next bullet point; we believe that we'll have to be abnormally liquid throughout the year. On asset quality, as I said, we're seeing some improvements in Retail, driven by our internal efforts because those efforts actually take time to feed into the results and these efforts concern products, processes and controls. However, as I've mentioned before, it would be unwise to, not to expect any deterioration on the corporate loans side, given the fact that the economy is naturally slowing and the international markets remain difficult. So, essentially this is what makes, probably makes it quite difficult in 2008 to repeat the 2007 net profit result, given the state of the capital markets. And the capital markets are actually affecting us in several ways; trading losses and the absence of trading gains on the one hand and also a lot of commission deals are being postponed or pulled and, on the other hand, higher provisioning costs which are required in the circumstances. The revenues are growing, however revenue, the growth in revenues is being eaten up by these two factors. However, we are quite optimistic that we can continue growing and essentially our capital base is very, very solid and would allow us to continue growing for the next two to three years without resorting to any capital increases.

That actually concludes my presentation and, operator, I think at this stage we're ready to take questions, if there are any.

Questions and Answers

Viacheslav Shilin, UBS London

Good afternoon, everyone, it's Viacheslav Shilin from UBS in London. I have two questions. First is on the slide 12 where you talked about the sale of NPL portfolio. Could you please elaborate and tell us actually how much did you sell? I mean, what was the size of the portfolio you sold, what loans were in those, in that portfolio, meaning overdue by how many days, and also what was the recovery ratio for you from that sale? Thank you.

Okay. The amount of loans sold, the nominal value of the loans sold was around $23 million. We sold them roughly for 7% of par value and that allowed us to make a profit on the transaction, accounting profit obviously, because those loans have been provisioned mostly 100%. They have been mostly overdue for... I should say all of them were overdue for more than 60 days pretty much but the bulk of them was in the NPL category which is 90 days plus. And these loans were predominantly classic car loans and express car loans.

So, they were actually then overdue by more than 90 days, not 60 days.

Well, all of them were more than 60 days but the bulk of them was 90 plus, yeah.

Okay. All right. And does your NPL classification still stand the same then, as overdue more than 90 days?

Yes, correct. Plus the obvious fraud because, you know, if the borrower misses, you know, doesn't make the first payment or stops after the first payment, that is an indication of fraud. That also falls into the NPL category.

And I guess the fact that they were almost all provision of, by 100%, we can assume that there was a relief in provision by $23 million.

That's not exactly how it works. We've made a small profit on the transaction because we bought it, sorry, we sold it for 7% of the par value, so we made about $2 million of profit. That profit will be booked in the third quarter.

And... Thank you. And my second question is on your future growth strategy. Do you consider growing through, first of all, outside of Russia and meaning outside of your current markets of operation, your further expansion to CIS or outside of CIS and what are you considering in domestic or international acquisitions in this respect?.

For the time being our strategy is actually confined to Russia. Russia is a very big market, obviously, and we've got just 1.5% of that market. So, there's plenty of room to grow. For the time being no plans to expand outside Russia.

Okay. Thank you very much.

No problem.

David Lewis, Merrill Lynch London

Hi, it's David Lewis from Merrill Lynch. I just had a couple of questions on, firstly on the SME book. What's the average maturity of that book?

The average maturity would be around two years.

Okay. And then given that delinquencies have moved up quite sharply there, I mean, have you been through any, you know, actual situations of seizing collateral and trying to work through recoveries in that book recently? Can you just give us a little bit of colour on how that aspect? Is it maybe working for you, if, you know, any recovery rates on loans you may have had to foreclose on in the SME book?

Sure. I can't give you any recovery rates from the top of my head but...

Yeah.

...but certainly there have been instances where we were required to step in and take collateral. In many instances the collateral that we take, in fact, is some piece of real estate which makes it a little bit easier to realise. So, in those situations we've been successful. When we take stock and trade, there is basically a far more modest recovery rate of maybe about 15% to 20%.

In terms of the timing and, I guess, you know, ease of actually executing these foreclosures, is that something that you've been able to get resolved through the courts etc. for, you know, in a space of a few months or is it, you know, is it something that takes a longer time?

It’s in very few situations we actually have to go to court because in many cases we just, you know, settle out of court and it, we repossess collateral. It doesn’t... The court procedure doesn’t really hamper us because there is no objection by the borrower. There are no active... There is no active objection by the borrower against our actions. In terms of the overall quality of the portfolio, I think we are seeing pretty much the same dynamics as we did in the retail. We started with a very low NPL ratio in consumer book, in auto loans. Then it suddenly started to rise and it took us six months probably to analyse the data, get rid of products that don’t really work, improve the collateral situation, tighten some of the guidelines basically and after about six months following those decisions, we started to see the actual results. So, it’s pretty much as in any new area of lending that we should probably see this pattern and I wouldn’t be, you know, paranoid if the NPL ratio was to exceed 4% for some time maybe by the end of the year. It doesn’t mean that... You know, it doesn’t mean that... We’re just learning, essentially. We started in this business in 2006, so it’s been essentially just over two years for us.

Okay. That’s very helpful. The other question I had was just on the trading performance so far in Q3. I mean, pretty steep fall for the Russian equity market, so I was just wondering if you had any comment on how you have faired through that and whether that is, you know, painting a difficult picture or not for your Q3 results.

Well, obviously it’s not very pretty. It’s not as awful as the first quarter but for the time being we’re not making money. I mean, obviously we have a loss on equities. However, the portfolio is much smaller than we had. I mean, we never had a big equities portfolio. We’ve entered the third quarter with a much smaller portfolio, so it’s not... I mean, it’s painful but it’s not as dramatic as Q1. So, that’s probably what I can say at this stage but otherwise, you know, the revenues from, on trading side have been actually quite healthy. That, actually, also helps.

Okay. Could you say what roughly the net Russian equity exposure is either now or maybe at the start of Q3?

The start of Q3 maybe 45 million and now we have about 35.

Okay. That’s all my questions. Thank you very much.

No problem.

Dmitry Poliakov, Barclays Capital London

Yes, good afternoon, Andrey, it’s Dmitry Poliakov from Barclays Capital.

How are you?

Yes. I have a question regarding... We were talking a bit, a little bit about the direct exposure in your trading book. Do you have also some indirect exposure, like loans collateralised by Russian equities, maybe not publicly traded but in some private companies, for example, or also some worth repo book as well?

We have some repo exposure, obviously, but so far we have had no problem obtaining additional collateral when that was required by the margin calls. We don’t... We...

Sometimes we do take and, in fact, in many cases we... As a matter of obtaining leverage over the borrower, we would take equities, equity in the business as collateral, shares in the business as collateral, but certainly we don't base our lending decision on collateral. So, therefore I don't... I don't really see any other indirect exposure apart from the repo, which is secured by a very volatile, sorry, by very, very liquid, and volatile these days, shares, Russian shares.

Okay. So, the bank is not engaged in any acquisition finance or something like that.

We have some loans but the acquisition finance exposure has been very, very moderate and it's been in the regions and that's pretty much outside the sort of, you know, the prime capital markets.

Okay. And also a question on deposits. You mentioned that Latvian Trade Bank have experienced a quite healthy flow of deposits but you, for some reason you didn't count them as a sustainable, as a maybe core deposit base. I just wanted to ask why and also what currently are the main drivers behind the deposit growth because you were talking about 60% ratio for deposits to loan. How that would be achieved?

The... Yeah, the reason why we don't incorporate Latvian Trade Bank deposits, because it's not... Those deposits are fluctuating very widely. We've got maybe 10 to 15 corporate current accounts in Latvia which is servicing large Russian international, already international conglomerates, and those companies are very large and the swings in their current accounts can be very, very wild and it... Sometimes it actually masks the real trend in deposits. That's why we, we kind of, we separate the two things and that inflow that occurred towards the end of the second quarter in Latvian Trade Bank was basically for three or four days. So, in fact, it doesn't actually tell you anything about the core deposit growth. That's why we exclude it from the ratio. And in terms of the core deposit growth that is happening in the Russian market, there's been a lot of... We've seen quite healthy growth from mid-size corporates, some larger corporates, some of the state-owned companies as well that are placing their liquidity, parking their liquidity in commercial banks, those who are allowed to do that. Plus we've seen a nice trend in private banking deposits which are basically wealthy individuals that are not prepared to, you know, take exposure to very volatile equity markets or fixed income markets and prefer maybe to park their money, for the time being, in something more stable such as a bank deposit. And retail deposits are growing as well. That is driven pretty much by the new openings of points of sale plus by the fact that we're paying a slight premium to the market which actually may not necessarily be true in September but it certainly was true in Q2.

Thank you very much, Andrey. Very useful.

No problem.

Natalya Lyzanets, Deutsche Bank London

Yes, hi, Natalya Lyzanets here from Deutsche Bank. I have a question regarding your base costs and as you are now expanding into the SME and retail sectors, I was just wondering how you're expecting to restrict the costs.

Well, in fact, restricting costs will be very difficult, precisely because of the expansion which is basically every branch that we're opening immediately produces cost but the revenue base obviously takes... It takes time for that point of sale to get to, you know, full capacity in terms of selling. I have mentioned maybe on several occasions in the past that it will be very difficult for us over the next 18 months to two years to see the cost/income ratio dropping significantly below 50% because of those cost pressures. However, we have to go through that intensive investment period. We have a target of about 500 to 600 points of sale... Because we think that overall our sort of market share targets can only be achieved if we have network as wide as that but... So, as far as those costs are concerned, the costs relating to new openings, those will be very difficult to contain. However, what certainly will be contained is the central office cost which still accounts for quite a significant of our cost base. Plus there are some cost initiatives that will be taken and will get resolved... We'll see some results from that probably beginning, from the beginning, second half of next year which is basically taking some of the call centres that we have to locations outside Moscow and basically centralising our operations in those operating centres into locations in various time zones in Russia, taking those from the expensive areas such as Moscow. That is just one initiative that we have and we're hoping to see the benefit from that towards the end of 2009.

Thank you very much.

My pleasure.

Closing Comments

Okay, ladies and gentlemen. So, at this stage I think I'll just wrap up the conference call. Thanks very much for participating. I hope that was useful and, as usual, we are here to answer any further questions that you might think of in the future. Thanks a lot and bye bye.