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Eurocommerz (B2): 2007 IFRS results generate mixed impressions

We have analyzed the audited 2007 IFRS results of Eurocommerz, Russia's largest factoring company. They were released rather late for a relatively simply structured local financial institution. According to Eurocommerz, this is because the auditors didn't have enough experience in looking at Russian factoring companies without banking licenses.

At the first glance the results look strong; however, a closer look leaves mixed impressions and here are three reasons why.

1. Extremely high growth rates. As of the end of 2007, the company's factoring portfolio increased more than 4X (RUB27.8 bn), while total assets grew nearly 5.5X. As we understand, in 1H08 the company continued growing rapidly and actually almost doubled its assets. On one hand, high growth suggests a larger market share, an efficient business model, economies of scale and better diversification. On the other hand, however, the company may face problems concerning the quality of its assets. We don't know how successfully Eurocommerz manages this growth from a risk management perspective, and whether the rapid build-up in its factoring portfolio is not a result of relaxed risk criteria. The true quality of the book can hardly be assessed by looking at the provisioning ratio (1.9%), as it is always deflated during periods of strong growth. In that regard we would have been more comfortable if the company was regulated by the Central Bank vs. its current unregulated status. Finalizing the discussions about growth and asset quality, we also point out at surprisingly high level of concentration in the factoring portfolio: top-10 clients account for 15% of factoring/loan portfolio.

2. Equity capital appears large, but one layer above the operating company. In 2007, Eurocommerz's shareholders invested a solid amount in the capital of the company. Together with retained earnings it increased the company's equity by more than 8X (Equity/Assets ratio, 23%). However, it's quite uncomfortable from a credit perspective that most of the equity is located at the Cyprus-based parent company (Eurokommerz Holding Limited), not at the Russia-based operating company (bond issuer). The parent company is, by the way, not part of the ruble bond structure (no guarantees).

3. Significant reliance on capital markets. Eurocommerz is evidently too dependent on the capital markets. Given its lack of banking license, the company cannot offset that by developing a deposit base. At the end of 2007, Eurocommerz became the first company in Russia to securitize its factoring portfolio. The transaction totaled RUB12.5 bn. We believe it makes sense from the business perspective, but note that too much of securitization would put the unsecured bondholders in an unfavorable subordinated position.

Our analysis would be unfair without mentioning the unquestionably strong points of the company's credit profile. First of all, it has a short-term structure of assets, which ensures a high level of liquidity. Second, Eurokommerz has high interest margins (see below table).

Overall we have become somewhat less excited about Eurocommerz bonds than we were prior to analyzing the 2007 IFRS results (Eurokommerz was one of our top picks). Key reason is the extremely high growth rate with low visibility of the asset quality. So we are now neutral on the bonds (YTW approx. 16.5%). Eurocommerz's current growth levels suggest that the company will continue to be a very regular issuer of debt.

It would be also interesting to see what Moody's has to say with regard to the released financials. If the agency finds them solid and upgrades Eurocommerz ratings, we may see bonds in Lombard list. The latter

would of course give a boost to bond prices. However we don't view this as a base case scenario for the abovementioned reasons.

Key financial figures of Eurocommerz, IFRS		
Million RUB	2006	2007
Income from factoring	274	4 829
Interest income	-	164
Interest expense	138	1 814
Net income from factoring	136	3 178
Operating expenses	100	818
Net income	47	1 582
Equity	829	7 986
Factoring portfolio	5 759	27 820
Assets	6 170	34 682
Main figures		
NIM	3.2%	18.9%
ROAE	8.5%	35.9%
ROAA	1.0%	7.7%
Provision ratio	1.2%	1.9%
Equity/Assets	0.13	0.23

Source: Eurocommerz, MDM estimates

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