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URALSIB Bank – 2007 IFRS results

On June 5, URALSIB Bank's management met analysts to discuss the bank's 2007 performance and IFRS report. On the whole, the bank's performance was in line with management's forecasts, outlined in March when it presented the bank's 2007 RAS statement) (see our note http://www.sovlink.ru/files/080311_USBN_SOVL_rus.pdf). Net profit fell dramatically – by 47% to the bank's 2006 level of RUR 2.2 bn – however, it slightly exceeded management's estimates (RUR 1.2 bn according to RAS + unconsolidated RAS profit of its leasing company (RUR 700 mn). Due to the abrupt fall in net income, the bank's ROE fell from 9.5% to 4.7%, and ROA dropped from 1.5% to 0.6%.

However, it is useful to analyze the bank's 2007 results by looking at 1H07 and 2H07 separately. At the beginning of 2007, in the background of increasing turmoil on global financial markets, the bank decided to modify its asset structure radically (by reducing the share of its securities portfolio and increasing the share of its loan portfolio). Management's aim was to increase the share of sustainable banking income (interest, fee & commission income) instead of depending upon the bank's traditionally high share of volatile trading gains. As a result, the bank substantially reduced the weight of stocks in its asset structure – from 12.3% at the beginning of 2007 to 3.4% by the end of the year. At the same time, the share of the bank's loan book increased from 54.9% to 66.5% of assets. The bank liquidated its stock portfolio in an unfavorable market environment, which resulted in a loss for the bank. However, it had to pay large amounts of profit taxes on this operation due to the use of the cash accounting method in Russian taxation (profit is estimated from the historical cost of the shares, not their current market value). Moreover, in 1H07 the bank's operating expenses (including payroll expenses) rose sharply. All these factors resulted in a RR2.9 bn loss for the bank in 1H07.

Nevertheless, in 2H07 the bank's net profit (RUR 5.1 bn) exceeded the annual profit of 2006 (RUR 4.2 bn) due to the restructuring of its assets (from stocks to its credit portfolio). In 2007, the bank's loan portfolio grew by 45% whilst retail loans increased by 74%. Together retail loans and SME loans (the highest yielding loans segment on the Russian market) account for 65.5% of URALSIB's loan portfolio. As a result, the bank managed to increase its net interest margin from 3.0% in 2006 to 4.1%, while net interest income increased by 46%. In addition, the bank changed its loans provision policy by reducing its provisions/NPLs ratio from 127% to 102%, which contributed in the sharp increase (119%) in interest income after loan impairment provisions. We note that the NPL/loan portfolio ratio for URALSIB Bank (4.2% versus 4.6% in 2006) seems to be fairly high for a TOP-10 Russian bank – Rosbank is the closest peer bank with similar credit quality. At the same time, URALSIB's target Provisions/NPLs ratio (at least 100%) is lower than the ratio applicable to Sberbank, VTB, Vozrozhdenie Bank, and BSPb.

Another significant factor in the improvement of the bank's performance in 2H07 is related to the cost control program implemented by the bank's holding structure - these measures will be continued in 2008-09.

In conclusion, the restructuring undertaken by the bank in 2007 has substantially boosted the bank's sustainable banking income. The bank's sustainable income / operating expenses ratio increased from 82.6% in 2006 to 120.1%.

RUR mn	2007	2006	2007/06, %
PBT	3,616	5,705	-36.6%
Net income	2,197	4,180	-47.4%
Assets	374,714	306,645	22.2%
Shareholder's equity	47,799	45,988	3.9%
ROA	0.6%	1.5%	
ROE	4.7%	9.5%	
Net interest margin	4.1%	3.0%	
Cost/Income	78.3%	57.1%	

Source: Company data



RUR mn	2007	2006	2007/06, %
Net interest income	16,680	11,416	46%
Net interest income after provisions for loan impairment	15,549	7,116	119%
Net fee & commission income	4,992	3,888	28%
Gains less losses from securities trading, FX operations and metals' trading	(1,015)	7,119	
Operating income	20,716	19,025	9%
Operating expenses	(17,100)	(13,320)	28%
Sustainable banking income / operating expenses	120%	83%	

Source: Company data

Plans for 2008 and interim results

In March, management gave the following guidance for the bank's 2008 results:

Net income (RAS)	RUR 9 bn (vs RUR 1.2 bn in 2007). Management did not forecast the bank's IFRS results, which were implicitly assumed to be close to its RAS forecast.
Asset growth	40-50%
Loan portfolio growth	50%
Corporate loans	about 50%
Retail loans	80%
ROE	18%
ROA	2%
Cost/Income	60%
Cost/Assets	Similar to 2007 (4.7%)

For 5 months 2008 the bank's net income (RAS) amounted to RUR 3.4 bn, and management expects about RUR 4 bn in 1H08. Our estimates for the bank's 1H08 results (RAS) compared to 1H07 (RAS) imply impressive income growth with costs remaining at the same level.

RUR mn	1H08E	1H07	1H08E/1H07
Net interest income	9,482	5,110	86%
Net fee & commission income	3,418	2,467	39%
Operating income	14,295	8,036	78%
Operating expenses	-8,066	-7,565	7%
PBT	6,229	472	1220%
Income tax expenses	-2,288	-4,055	-44%
Net income	3,941	-3,583	

Source: Company data, SOVLINK estimates



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YOUR FIRST CALL – FOR THE SECOND TIER

June 06, 2008

Currently, management has confirmed annual forecasts for the bank's net income, revenues and ROE. It expects the bank's net interest margin to increase from 4.1% to 4.5%, and plans to continue cost optimization measures. In the near future, management will present a proposal for issuing Eurobonds (\$250-300 mn) and Ruble bonds (RUR 5-10 bn) in 2H08 to the Board of Directors. In May, the bank began syndication of a 1-year loan (\$150 mn, LIBOR+1%). At the same time, since the beginning of the year, the bank has paid off syndicated debt amounting to \$600 mn and a further \$300 mn is to be paid off in the near future.

However, due to the substantial slowdown in the growth rate of funding sources and the stricter monetary policy of the Russian Central Bank, management plans to reduce its annual forecasts of the bank's assets and loan portfolio growth (to an increase of about 25% regarding assets, and 30-35% regarding the loan portfolio) which appears to be fairly realistic. The key challenges facing the bank are its high cost level (the holding's restructuring plan and improvements in efficiency will take some time to take effect) and its ability to replace trading profit by core banking income in an environment, where growth in the global banking sector has slowed down.

We positively view the bank's strategy aimed at increasing sustainable banking income, boosting growth of its retail loans portfolio, reducing costs and enhancing transparency (e.g. implementation of quarterly IFRS reporting since 9M07). Compared to other Russian banks, URALSIB Bank is, currently, the most expensive Russian public bank on a P/E07 basis (39) (due to its low net income); while, it is one of the cheapest banks on a P/BV07 basis (1.7). However, if the bank succeeds in its plans to increase its 2008 net income by nearly 4 times (to RUR 9 bn), its P/E valuation ratio would become quite attractive (P/E-08E of 8.7, P/BV-08E of 1.4). At the same time, currently, we consider the risk of investing in the bank to be fairly high – taking into account both the uncertainty in the bank's ability to reach its target earnings and its very low free float (low liquidity level).



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STRONG BUY:	Upside over 25%; confidence level – high / upside over 100%; confidence level - low
BUY:	Upside between 15 and 25%; confidence level – high / upside between 25% and 100%; confidence level – low
HOLD:	Upside of less than 15%; confidence level – high / upside of less than 25%; confidence level – low
SELL:	Target price at or below current price levels

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