

# Ukrainian Eurobonds: Banking sector

Banking securities remain the most promising among Ukrainian Eurobonds

Artem Kost, [kost@ufc-capital.com](mailto:kost@ufc-capital.com)

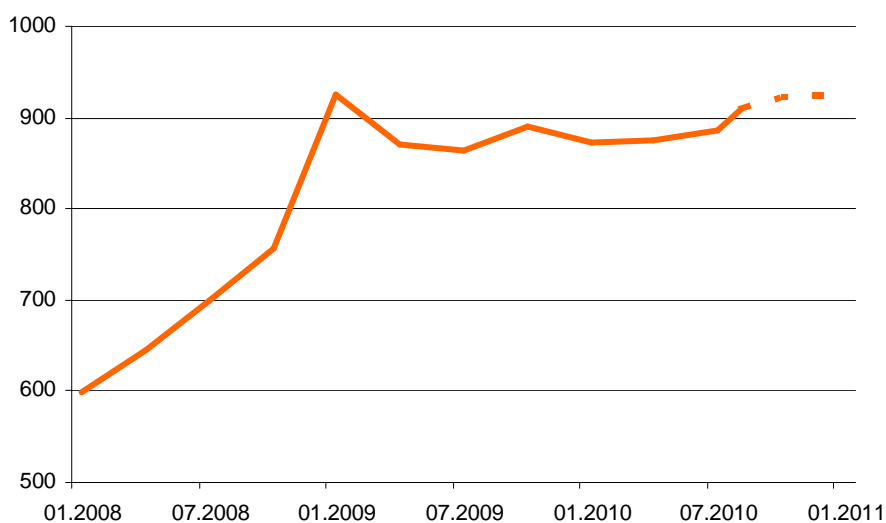
Vladimir Landa, [landa@ufc-capital.com](mailto:landa@ufc-capital.com)

August 16, 2010  
Eurobonds

Ukraine's banking system is coming back to life. This is confirmed both by the banks' financial performance and the overall rise in the level of confidence in the sector. The consequence was the growth of quotations of financial institutions' Eurobonds, backed by the general thaw in the debt market on a global level, as well as in Ukraine.

The volume of bank assets, growth of which resumed in 2H2009, is creeping close to a record high. According to NBU data, bank assets as of August 1, 2010 reached UAH 907 bln, which is only 2% below the highest pre-crisis value.

## Assets of the Ukrainian banking system of in 2008-2010

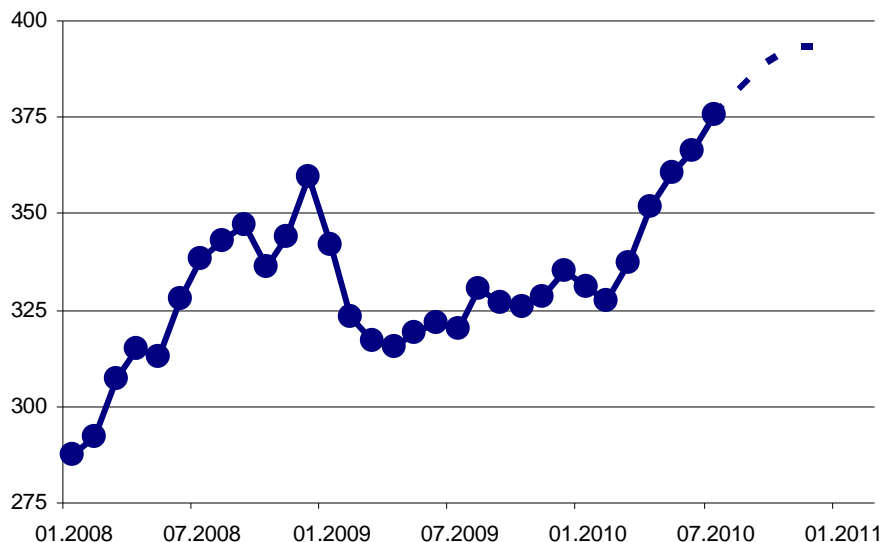


Sources: NBU, UFC Capital forecast.

According to our expectations, the coming months will see continued growth in Ukrainian bank assets, but the pace of growth will not match that of July 2010.

In contrast to the rather moderate dynamics of assets, indicating a smooth fundamental reconstruction, the deposit portfolio of Ukrainian banks is growing much more rapidly, pointing to a speedy growth in confidence in financial institutions.

## Total amount of deposits of the Ukrainian banking system in 2008-2010



Sources: NBU, UFC Capital forecast.

It is worth noting that the pre-conditions for further strengthening of the banking system in the medium term are in place. Of the dozens of once-troubled banks previously under NBU temporary administration, only four remain: Nadra, Rodovid, Inprombank and Sintez. The expected increase in Ukraine's sovereign ratings from leading rating agencies will facilitate the banks' access to international borrowing, carried out, in part, through the issue of new Eurobonds. Until that happens, investors will have to be satisfied with the limited number of existing bonds. According to UFC Capital estimates, this scenario will lead to a narrowing of spreads between the yields of certain undervalued banking sector bonds and the sovereign curve to about 200 basis points.

One should note that our recommendation to look at banking sector bonds as an investment idea is based, among other things, upon the continuing global trend of declining bond yields. If investor fear increases, regarding the sovereign obligations of developing countries, the growth potential for the value of bank Eurobonds might be reviewed. Although there are few grounds for such a pessimistic outlook in the short term, we feel we must warn our clients about the possibility of the aforementioned scenarios.

The rally seen over the past few months in the Ukrainian market for sovereign and corporate Eurobonds had virtually no effect upon Alfa-Bank (Ukraine) bonds. In 2009, the bank carried out large-scale debt re-structuring, as a result of which a new issue, maturing in 2012, was prepared. In our opinion, this very re-structuring is the key factor in the wariness of investors to buy the bank's bonds. *However, we see a second re-structuring, or default by the bank before 2012, being of very low probability.* Considering the notable positive trends in Ukraine's banking sector and the situation in Alfa-Bank itself, *we propose the bank's Eurobonds as one of the main investment ideas in this segment.*

- The bank is part of Russia's large Alfa finance and industry group, the banking business of which carries a lot of weight in the Eastern European region. *We believe that the parent entity and the Russian Alfa-Bank will actively support their Ukrainian subsidiary over the next two years, maintaining its liquidity via additional share issues and the allocation of credit lines.*
- The Ukrainian banking market is a priority for the parent of Alfa-Bank and *we expect that Alfa-Bank (Ukraine) will significantly revitalize itself in 2010-2012*, a process which will be facilitated by restored confidence in the sector, as well as the aim of Russian capital to occupy a more advantageous position in Ukraine.
- *We anticipate that the main purpose for the Alfa-Bank (Ukraine) in the coming years will be corporate lending.* The bank had previously been active in retail, which was its main problem over the last two years, as it was precisely in the Ukraine's consumer lending segment that percentages of bad loans and write-offs hit their high. Since 2007, however, the bank has steadily increased the share of loans to legal entities in its loan portfolio (2007 - 70%, 2008 - 71%, 2009 - 78%, first half of 2010 - 79%). *We see this as a positive trend, as corporate borrowers is a great deal more reliable, increasing the predictability of the bank's future cash flows.*
- In 2010, Alfa-Bank (Ukraine) began to show the profitability, following a disappointing 2009. Despite the fact that reporting for the July 2009 - June 2010 period shows the bank as still running at a loss, *we expect to see the bank will already be showing a positive margin by the end of 2010.*
- The dynamics of the structure of the bank's balance sheet over the past six months are also encouraging. On the background of stabilization of the Ukrainian banking system, Alfa-Bank (Ukraine) has - over 6 months in 2010 - been actively increasing its volume of deposits (with those of individuals growing by 54%), which became the basis for the increase in cash in the institution's asset structure (+52% for 1H2010). *To date, the bank has no problems with liquidity, suggesting a high likelihood that the bank will meet its financial obligations.*

## ALFA-BANK (Ukraine), 2012

**BUY**

Current effective yield: **12.1%**

Fair effective yield: **8.5%**

### Information about bonds issue

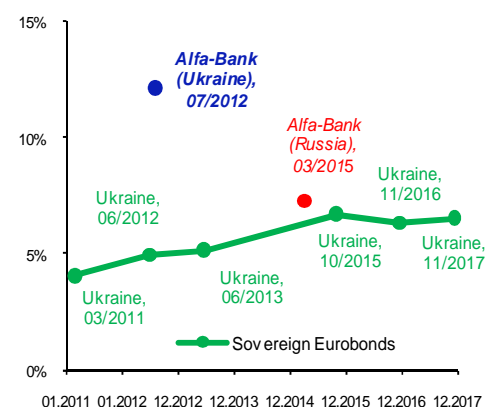
Bloomberg ticker	ALFAUA 13 07/30/12
ISIN	XS0441089926
Currency	USD
Par value	1 000
Volume	840 633 000
Coupon	13.0%
Coupon payment	4 times per year
Call / Put option	-
Bond type	amortizing
Maturity	30.07.2012

### Agency Rating

Agency	Rating
Standard & Poor's	CCC +
Moody's	-
Fitch	-

### Core ratios

Loans to individuals / loans to entities	0.27
Individuals' deposits / Total liabilities	0.17
ROA	neg.
ROE	neg.



*We believe that the spread between Alfa-Bank's Ukrainian and Russian Eurobonds of almost 500 b.p. is overstated, since the credit risks of these two structures are comparable, due to their single parent structure. In addition, Alfa-Bank (Ukraine) bonds YTM maintain an unexplained - in comparison to other Ukrainian banks - spread of 700 b.p. over the sovereign curve.*

## Alfa-Bank (Ukraine): Financials

Balance sheet, \$ mln	31.12.2008	31.12.2009	30.06.2010
Cash	121.4	424.7	648.4
Cash with other banks	524.4	197.5	105.6
Securities	49.1	53.8	97.3
Loans issued, including to:	3 641.2	3 170.2	3 015.4
legal entities	2 572.6	2 482.6	2 383.5
individuals	1 068.6	687.6	631.9
Loans provisions	287.9	538.0	717.5
Fixed and intangible assets	52.1	47.7	44.4
Other assets	95.8	237.4	242.2
<b>Balance</b>	<b>4 196.1</b>	<b>3 593.4</b>	<b>3 435.8</b>
Cash due to banks	1 057.8	945.6	623.1
Cash due to legal entities	2 220.4	599.2	562.2
Cash due to individuals	266.4	330.1	511.1
Other liabilities	222.0	1 358.1	1 343.5
<b>Total liabilities</b>	<b>3 766.5</b>	<b>3 233.0</b>	<b>3 040.0</b>
Charter capital	386.6	372.8	470.0
Provisions	22.5	31.3	42.0
Retained profit	20.6	-43.6	-116.2
<b>Total equity</b>	<b>429.6</b>	<b>360.4</b>	<b>395.8</b>
<b>Balance</b>	<b>4 196.1</b>	<b>3 593.4</b>	<b>3 435.8</b>

Income statement, \$ mln	2008	2009	01.07.2009- 30.06.2010
Interest income	574.4	705.5	645.5
Commission income	118.0	56.5	40.2
Trade income	142.1	83.5	18.1
Financial and other income	28.6	17.4	3.5
<b>Total income</b>	<b>863.1</b>	<b>862.9</b>	<b>707.3</b>
Interest expense	334.7	395.2	334.3
Commission expense	10.2	16.6	10.1
Administrative and other expenses	175.7	200.1	188.1
<b>Total expenses</b>	<b>520.7</b>	<b>612.0</b>	<b>532.6</b>
<b>Operating profit</b>	<b>342.4</b>	<b>250.9</b>	<b>174.8</b>
Net expenses for provisioning	304.1	286.8	201.1
Profit/loss from assets available-for-sale	0.0	-5.2	9.7
<b>Pre-tax profit</b>	<b>38.3</b>	<b>-41.1</b>	<b>-16.6</b>
Income tax	8.3	3.6	3.6
<b>Net profit</b>	<b>30.0</b>	<b>-44.7</b>	<b>-20.2</b>

Margins	2008	2009	01.07.2009- 30.06.2010
Return on assets	0.71%	neg.	neg.
Return on equity	6.98%	neg.	neg.

Capital structure and solvency	31.12.2008	31.12.2009	30.06.2010
Loans to individuals / loans to legal entities	0.42	0.28	0.27
Deposits of individuals / Total liabilities	0.07	0.10	0.17

Sources: Company data, UFC Capital estimate

Privatbank is the giant of the Ukrainian banking system, the total assets of which exceeded \$12 bln by the end of 1H2010. The bank has a positive credit history, meeting its financial obligations to creditors in a timely manner and in full. Despite this, however, the bank's Eurobonds are traded at a higher yield than a number of bonds from other Ukrainian financial institutions. *The reason for this, in our opinion, lies in the fact that neither major international banks, nor the state are represented in Privatbank's ownership structure. Nevertheless, we believe that this is not a factor of great importance in determining the reliability of the bonds, since Privatbank's reputation is one of its key assets, which the current owners would never risk, before the bank's possible sale to foreign investors.*

- The Privat finance and industrial group, which controls Privatbank, has one of Ukraine's most diversified investment portfolios. This factor, as well as the group's successful exit from the steel business in 2008, made Privat one of the finance and industrial groups best prepared for the global crisis. This allowed Privatbank to survive the crises in the Ukrainian banking sector relatively painlessly; the parent company periodically re-capitalized the bank, in order to maintain its liquidity at the required level. *We expect that the bank's current shareholders will continue to increase the size of its equity, in accordance with asset growth.*
- The bank's financial results over the past few years have been among the best in the sector. For the first half of the year, Privatbank showed a return on equity of 5.8% and a return on assets of 0.65%, which was the second-best result among the group of Ukraine's largest banks. *We anticipate that, based upon the results of 2010, and on the background of stabilization in the Ukrainian banking sector, Privatbank will substantially improve its profit margins.*
- In 2010, Privatbank actively studied the possibility of entering the Eurobond market with a new series, but suspended the new issue. In July 2010, Fitch upgraded Privatbank's rating from B- to B, which gave a strong buying signal for its two existing bond series, but the bank again delayed the new issue. *We believe that current yields of Ukrainian Eurobonds are optimal for new placements, so we can expect Privatbank to step up its activities in organizing its Eurobond issue.*
- The improvement of the macroeconomic environment in the Ukrainian economy for the first 7 months of 2010 creates the grounds for possible improvements in sovereign ratings. *We believe that if Ukraine's ratings are upgraded, the ratings of Privatbank - as the leader of the banking sector - are very likely to be upgraded simultaneously.*

### Information about bonds issue

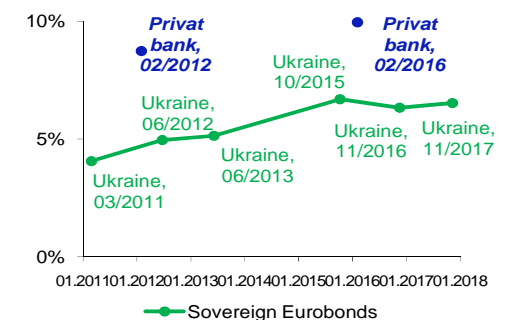
Bloomberg ticker	PRBANK 12
ISIN	XS0285182266
Currency	USD
Par value	1 000
Volume, mln	500 000 000
Coupon	8.0%
Coupon payment	2 times a year
Call / Put option	-
Bond type	bullet
Maturity	06.02.2012

### Agency Rating

Agency	Rating
Standard & Poor's	-
Moody's	B3
Fitch	B

### Core ratios

Loans to individuals / loans to entities	0.28
Individuals' deposits / Total liabilities	0.52
ROA	1.32%
ROE	11.82%



*Privatbank's bonds have increased in value significantly since the beginning of 2010, narrowing yield spreads over the sovereign curve to 370-380 b. p. Nevertheless, we believe that the spread in yields between Privatbank's Eurobonds and the Eurobonds of other leading Ukrainian banks will decline in the future, due to Privatbank's stronger financial results. However, in our opinion, their potential is already largely realized.*

## Privatbank: Financials

Balance sheet, \$ mln	31.12.2008	31.12.2009	30.06.2010
Cash	412.4	1 158.6	1 986.0
Cash with other banks	983.5	649.4	649.6
Securities	126.7	67.2	103.1
Loans issued, including to:	9 453.1	9 391.6	10 805.2
legal entities	6 104.3	6 845.6	8 361.1
individuals	3 348.8	2 546.0	2 354.8
Loans provisions	1 086.8	1 675.2	1 897.3
Fixed and intangible assets	190.4	164.4	186.9
Other assets	331.8	1 022.6	493.4
<b>Balance</b>	<b>10 411.1</b>	<b>10 778.5</b>	<b>12 326.9</b>
Cash due to banks	1 269.9	1 425.1	1 883.6
Cash due to legal entities	3 069.0	1 943.2	2 121.3
Cash due to individuals	4 345.1	4 298.0	5 704.4
Other liabilities	662.7	1 826.0	1 240.2
<b>Total liabilities</b>	<b>9 346.7</b>	<b>9 492.2</b>	<b>10 949.6</b>
Charter capital	738.3	978.2	1 120.6
Provisions	84.1	164.9	170.6
Retained profit	242.0	143.1	86.1
<b>Total equity</b>	<b>1 064.4</b>	<b>1 286.3</b>	<b>1 377.3</b>
<b>Balance</b>	<b>10 411.1</b>	<b>10 778.5</b>	<b>12 326.9</b>

Income statement, \$ mln	2008	2009	01.07.2009-30.06.2010
Interest income	1 716.4	1 837.4	1 737.2
Commission income	1 101.1	404.9	395.0
Trade income	62.4	-30.6	56.4
Financial and other income	30.0	53.2	65.5
<b>Total income</b>	<b>2 909.8</b>	<b>2 264.9</b>	<b>2 254.0</b>
Interest expense	959.9	892.0	999.7
Commission expense	84.7	82.4	63.7
Administrative and other expenses	850.1	546.2	456.3
<b>Total expenses</b>	<b>1 894.7</b>	<b>1 520.6</b>	<b>1 519.6</b>
<b>Operating profit</b>	<b>1 015.1</b>	<b>744.4</b>	<b>734.4</b>
Net expenses for provisioning	658.0	597.2	559.1
Profit/loss from assets available-for-sale	0.0	-0.1	1.3
<b>Pre-tax profit</b>	<b>357.1</b>	<b>147.0</b>	<b>176.6</b>
Income tax	112.4	12.2	13.8
<b>Net profit</b>	<b>244.7</b>	<b>134.7</b>	<b>162.8</b>

Margins	2008	2009	01.07.2009-30.06.2010
Return on assets	2.35%	1.25%	1.32%
Return on shareholders' equity	22.99%	10.48%	11.82%

Capital structure and solvency	31.12.2008	31.12.2009	30.06.2010
Loans to individuals / loans to legal entities	0.55	0.37	0.28
Deposits of individuals / Total liabilities	0.46	0.45	0.52

Sources: Company data, UFC Capital estimate

**UFC Capital**  
47, Volodymyrska St., office 1 Kyiv, 01034, Ukraine  
Tel.: +380 (44) 391-37-78 fax: +380 (44) 391-37-79  
<http://www.ufc-capital.com>

**Mikhail Dorfman**  
Managing Partner  
*dorfman@ufc-capital.com*

**Vladimir Landa**  
Head of Research  
*landa@ufc-capital.com*

**Vitaly Gorovoy**  
Director of Strategic Development  
*gorovoy@ufc-capital.com*

**Artem Kost**  
Head of Fixed Income Research  
*kost@ufc-capital.com*

**Sergei Sharov**  
Analyst  
*sharov@ufc-capital.com*

**Blair Sheridan**  
Translator  
*blair.sheridan @ ufc-capital.com*

© 2010 UFC Capital. All rights reserved.

Opinions stated in the document are expressed taking into account the situation as of the date of the release. This document is intended solely for informational purposes; neither the information nor any opinion expressed herein constitutes an offer, or an invitation to make an offer, to buy or sell any securities or any options. While the information and opinions contained herein are based on materials believed to be reliable, we make no representation as to the accuracy or completeness of such information or opinions. Taking into consideration the above-mentioned, it is not advised to rely solely on the contents of this document to the detriment of conducting an independent research. The company's research department and its affiliates accept no liability in relation to the use of this information. Investing in Ukrainian economy and its securities involves a great deal of risk and investors should perform their own due diligence in checking the financial performance of the issuers before taking an investment decision. Any unauthorized copying, distribution as well as publishing of this document for any use is prohibited.