Transcription for VOZROZHDENIE BANK

November 24th 2015

Corporate Participants

Elena Mironova
Vozrozhdenie Bank – Deputy Head of Investor Relations

Andrey Shalimov
Vozrozhdenie Bank – Deputy Chairman of the Management Board

Conference Call Participants

Jason Hurwitz
VTB Capital

Andrey Pavlov-Rusinov
Sberbank

Maria Semikhatova
Citibank

Andrew Keely
Sberbank

Olga Naydenova
BCS

Presentation

Operator
Ladies and gentlemen, welcome to Vozrozhdenie Bank Third Quarter 2015 Earnings conference call. I now hand over to your host, Elena Mironova, Deputy Head of IR. Madam, please go ahead.

Elena Mironova
Thank you and good day everyone, welcome to our webcast and conference call. As usual, detailed discussion of the results is in our press release and reporting at Investor Relations section of the website at vbank.ru. This time we've had an eventful quarter, so let me bring you through the financials and the key developments, and then Andrey Shalimov will join me on the Q&A to discuss your questions.

This was quite a challenging quarter for us; though we were pleased to see some first signs of recovery on the macro level, risks still remained elevated. The balance sheet squeezed, but the key for us here was to maintain its income generation capacity and ensure its reliable structure. We saw a surge in retail lending that helped us to protect and improve our net interest margin, though the corporate portfolio contracted. The key, of course, were high provisions on NPLs that led to a net loss of RUB 2 billion.

Let’s turn to the slide three, assets were down 6% quarter-over-quarter, driven by lower net loans and cash and equivalents. The latter declined due to cuts of interbank lending and overnight placements. We discussed during the previous call that we had applied this instrument to support margin and utilise excessive liquidity in Q2, so now there was no need in that. However, the share of liquid assets remained at a comfortable level of 21%. Another risk that we faced in Q3 was Rouble depreciation, though it didn’t affect us materially. We've cut our FX exposures and the share of FX in the balance sheet was stable at moderate 18% both in assets and liabilities. As you can see from the bottom left graph, we still have quite a significant portion of FX from customer accounts placed in cash and equivalents, and we aim at cutting this share. Loan-to-deposit ratio was up to 99% and that is now close to the targeted range.

Let’s turn to the slide four on the customer funds. 6% decline came primarily from the retail deposits. As the bottom left chart shows, it fell on August; several VIP clients withdrew their FX deposits. It was a kind of one-off, but these clients stayed with the bank. The core client base was not affected and that’s the most important for us. We mostly dwell on smaller-scale deposits and ordinary retail customers. Around 95% of the number and 70% of the total volume of deposits are covered by Deposit Insurance Agency guarantees, so they are less than RUB 1.4 billion. The share of VIP clients with deposits of more than RUB 100 million is less than 9%. Again, talking about those large outflows, they were mostly in FX and raised on quite expensive rates at the start of the year, so in general we benefited from that withdrawal, as we saw a lowering FX position in deposits, and made another rates cut this quarter. We saw an inflow of Rouble-denominated funds in October and that’s what we were aiming at in our rate policy.

Let’s turn to slide 5. Loan portfolio contracted 3% quarter-over-quarter due to quite a sharp decline in the large corporates. That change remained in line with our policy to improve diversification. This quarter, the first reason for a contraction was that a large client repaid its FX loan. Actually, it was a client we worked with for many years, but now he’s expanding his business and becoming really too large. In December, after sharp FX devaluation, we were in breach of N6 CBR norm because of him, and with that, he needed some additional funds for his activity, so we've started talks with him to cut exposure and in September he fully repaid his debt. Well, we lost a client, which is not quite good, but we got our cash back and now we’re replacing this volume step-by-step with some smaller-sized companies. In the large corporates, we have also sold problem exposures on more than RUB 4 billion and that’s another reason for such a slump. We were cautious on new lending to SMEs this quarter, but resorted to loans to administrations. They have almost tripled in size. These are regions with a good credit rating; our loans are packed against planned budgetary expenditures. By the way, across all over history there were no defaults on this segment. It’s kind of a safe haven for quite risky times.
In retail, we saw a 9% boost quarter-over-quarter on the back of lowering interest rates, 7.5% increase in mortgages both due to State-subsidised

programme and the bank's own products. Consumer loans were supported by targeted sales within the existing client base.

Now on credit quality, as we discussed on the previous call, the coverage of 80% for 1 day+ NPLs was not quite comfortable for us. We have worked out NPLs quite actively. This time, we have sold exposures on RUB 4.1 billion in large corporates and RUB 185 million in retail. Most of them were more than one year overdue and we saw that further legal procedures could be quite expensive and challenging for us, so we decided that it would be better to find good buyers. We wrote off NPLs in SMEs on RUB 0.5 billion. What is positive about all the dynamics now is that the pace of new NPL formation has slowed down, so we hope that the peak is behind us. We have no new significant NPLs detected in Q3, but we have kept making charges on the problems detected in Q4'2014 and the first half of 2015. Those overdues are now moving to the lower category and requiring additional provisions. The cost of risk was 8.4% in the third quarter, a record for the last years and hopefully it will remain so. Around RUB 1.6 billion were made for large corporates and RUB 1.8 billion for SMEs. Again, we hope that we won't see any new large stories, though we expect that NPL formation will continue for some time.

On the retail side, on the bottom right chart, you can see that there was some pickup in total NPLs in retail, but that was driven by the technical overdue. For a more general definition, 90 days+ share of NPLs was down from 2.8% to 2%, and by the way, already by the end of October, we saw that out of RUB 1.4 billion of new NPLs less than 90 days overdue, RUB 1 billion was fully repaid, so it's really a technical issue.

The key for us this quarter was to improve the coverage and now for 1 day+, it's up by almost 8pps to 89%, and for 90 days+, it added up 11pps to 126%.

If we look at the static picture of the credit quality on the next slide, you will see that we have quite a moderate share of 90 days+ overdue. It's around 7.1%. Another characteristic of the credit quality is rescheduled loans and they have increased by 2.2 percentage points to 10.8%. Some of them are doing well. To some of them we have questions in terms of their cash flows and the quarterly performance. All of them are on tight monitoring and we hope that we have caught all the possible signs of worsening and detected all the potential problems in these two categories.

Now, on the P'n'L, year-over-year dynamics were overall positive. Net interest income was up, slightly lower fees were fully offset by strong trading revenues resulted from the volatile environment. Q3 was also good on the operating level. Net interest income was flat, fees on the rise for the second quarter in a raw and just some minor decline in operating income was driven by lower trading revenues in Q3 versus Q2.

A little bit more detail on the net interest margin dynamics. We maintain four consecutive quarters of net interest margin and spread expansion on the contrary to most Russian players. That was due to a quite quick and overall re-pricing of the corporate book starting from the end of last year. As you can see from the bottom left chart, retail loan yields were also on the rise and the share of retail was expanding, that supported net interest margin. That also offset mounting retail deposit costs together with some contraction in the cost of corporate deposits; as we do not compete aggressively in this market. The total cost of funds went down to 7.2% in the third quarter also due to expensive deposit withdrawals. Spread expansion was also supported by an increase of share of interest earning assets by 3 percentage points to 79%. Our target on NIM was 4.5% and now it's doing much better. It's close to 5%. We do not expect that this level can be sustained for a longer-term and we expect some pressure on NIM in the coming quarters, but again it's much better than we initially planned.

On the operating revenues, again, as I said, we saw a positive quarterly trend in net fees. They were up 1% quarter-over-quarter on high fees from settlements due to some new products introduced and FX operations. Year-over-year growth is constrained by lower business activity and credit demand that were important drivers last year. Costs were almost flat quarter-over-quarter and personnel expenses even slightly down on lower staff number. Year-over-year growth of 5.3% is below inflation. It's mostly driven by the severance payments and high contributions to the State Deposit Insurance Agency, but slightly weaker operating income was the reason for a slight pickup in the cost-to-income ratio.

On the bottom line, high provisions, as we discussed, resulted in RUB2 billion loss for the second quarter. ROEs are in the negative territory, but on the pre-provision level we see that it will continue to deliver quite healthy returns.

Let's see how the recent developments affected the capital position. The total capital under IFRS was down to 21 billion rubles, though our capital adequacy ratio stood well above the minimum required level. Total capital adequacy stood at 11.7% and for Tier-1 it was 10%, which is twice higher than the minimum required level. We were also among 27 banks selected by the Deposit Insurance Agency to provide capital support via OFZ bonds. In October we received RUB 6.6 billion under this programme. They won't be recorded in the IFRS, those bonds are held off balance, but they will be included into total adequacy ratio calculations starting from December 1th.

So to sum up, the key for this quarter was to maintain efficiency of the balance sheet. We have ensured net interest margin growth, less risky retail book was expanding while we remained conservative on corporate lending. It looks like now we are at the peak of provisions and, of course, such a high level can't be sustained in the longer-term, but we hope that due to some capital cushion, we will go smoothly into this loss-making period, and finally resume growth as the economy recovers.

That's on the financial results and now just a small update on our recent changes in the shareholding structure and where we stand now on that. As we spoke at our call in August, Promsvyazcapital, controlled by Dmitry and Alexey Ananiev, announced their intention to consolidate the controling share in the bank. That was followed by a series of deals with the major shareholders and that's how our shareholding structure looks as of 18 November. Promsvyazcapital is expected to consolidate more than 70% of the bank's shares. Now, they're waiting for the official permission of the Bank of Russia to finalise the deal to become the major shareholder and go into all the necessary corporate procedures, including mandatory offer to the minorities. At the same time, we have some changes on the management level. On Friday, we're holding the Extraordinary General Meeting of shareholders to elect the new board of directors and already, starting from 10 November, Konstantin Basmanov joined our team as a new CEO. He was deputy chairman of the Management Board at Promsvyazbank and he has really invaluable expertise in SME business and branch network optimisation, which he was in charge at Promsvyaz, that perfectly fits V.Bank's current focus.

That's all with the presentation and now let me turn the call over to Andrey Shalimov for the Q&A.

Question and Answer Session

Operator

[Operator instructions]

We have a question from Andrew Keely, Sberbank.

Andrew Keely
Hello, good afternoon. My first question is maybe, Andrey, you can just give us a little bit of an update in terms of the timing, the expected timing, now on these ownership changes and the kind of subsequent timing of any buyout offer to minorities. Thank you.

Andrey Shalimov
That's one of the key questions in the situation. We have a delay in this approval and the reasoning was provided by Promsvyazcapital. We expect this process to be finalised this week, so the best possible thing is to have this approval in place before the shareholders meeting. Then, of course, there is more probability but it exists that there could be some delay. Nonetheless we expect to receive it this week. Then, of course, Promsvyazcapital as a prospect key shareholder needs some time to make calculations and to issue this offer in due time. I suppose it should be a matter of a number of weeks for people to receive this offer.

Andrew Keely
Okay. Okay, that's fine, thank you. Just on your asset quality, I'm just trying to understand, I mean, obviously, the cost of risk has been going up enormously in the last couple of quarters and at the same time you've had NPLs or overdue loans had been coming down, there's been some increase in restructured loans, but I mean basically there'd been a fairly kind of steady trend, I suppose, of declining coverage ratio and then all of a sudden in the second quarter and the third quarter there's been a massive jump in the coverage ratio and very high provision charges. Can you explain why there's been this change in approach and is it related at all to the on-going change in ownership?

Andrey Shalimov
I can't trace direct ties between the two, but of course we were pretty much conservative in the policy. Last year, this was justified by the gyration in the general economic situation, and this year, you are partly right, these changes, of course, have kept management on alert, especially on recognition of credit risk and appropriate provisioning. But, nonetheless, the core of the process was the same. As we discussed, we managed to spot more of the problems at the beginning of the year, but there are some required terms to recognise, say, 90 days+ etc. So we register all the problems in the books still as non-overdue but impaired and then move down to this ledger. The origination of the problems by time was in the first and the second quarter. Our view in the spring was that the summer and, especially, the third quarter could be a period of heavy provisioning. We appeared more or less right in this approach to the timing and, actually, most of the provisions were made across the third quarter, so this was a period of rising NPLs in the first half of the year and then a rising provisioning to balance the coverage ratio in the third quarter.

I can't say that we should change this stance within the year. Maybe it makes sense to still keep up with this cautious approach across the whole 2015 to duly spot and provision all potential risks in the balance sheet. Actually, with capital support from this programme, it is quite achievable and those provisions make sense this year. Nonetheless, now, we are becoming a part of the larger group which could shore up capital if we need. The general proposition to this stance, the situation on our core capital, is that even suffering some losses due to those provisioning and with additional Tier-2 capital from the State, we are maybe in the trough of the process and there could be an upward trend both in the profits and capital. Balance sheet growth could be the best possible way. Then all those ratios could go down, naturally, simply due to increase in the size.

Since now, of course, the complication is the decline in size of the book, especially the corporate book. But nonetheless, provisioning of 100% for 1 day + overdue and closer to 140% for 90 days + overdues, they are still in the policy and if we change something in this aspect, I suppose it should be aired separately.

Andrew Keely
Okay, thank you, that is very helpful. Just briefly, I guess given everything that is going on, you may not have really much in the way of a kind of clear business plan for next year. What are your thoughts in terms of, generally, how you would – all else equal kind of thing – how you would expect to see growth in corporate lending and retail lending for next year.

Andrey Shalimov
It is decisive time now, I suppose, especially, in the external markets. We saw some change to the attitude to Russia, even inflow of capital. In recent days, it was a very welcomed turn of the attitude. Unfortunately, today's events could make it harder. The resolution in the market sentiment toward Russia, but let's see. Since this turn and then stabilisation in the Basel system, you can see that in Rouble terms, Basel System doing well. So budget almost balanced, so no detriment to Rouble-denominated welfare system, and maybe bottom out in some number of industries, they could make a ground for development. We don't expect a fast rebound next year, but nonetheless, there should be good reasons for some revival in the industry.

From that point of view, we are still keen to expand in retail, both in mortgages and to a less extent in non-collateralised loans, we still keep our core focus and provided no serious changes, of course, SME is a prime focus within the legal entities universe.

In corporate, I suppose we should be more selective, since we need to replenish capital base first to be more in a position to deal with bigger tickets and still the policy not to encase concentration, I suppose it should be helpful for the bank short-term. We don't see natural limitations in our core missions for 2016, due to our market share, which has not seen a limitation itself, and some improvements in a number of industries. But, of course, a lot depends on the strategy consideration, which is prime concern of new Board of Directors and that could redefine, I suppose, maybe not the core niches and the core target segments, but maybe the growth ratios, which shareholders hold us for, but it should be clean in the near future. Of course, next year business plan and financial plan should include all those strategic considerations.

Andrew Keely
Okay, all right, thank you very much.

Andrey Shalimov
Thank you.

Operator
[Operator instructions]

We have a question from Maria Semikhatova, Citibank. Please go ahead.

Maria Semikhatova
Hello, can you hear me right now.

Andrey Shalimov
Yes, sure.

Maria Semikhatova
A couple of questions, first on margins. You mentioned that you expect pressure going forward, so just want to hear your views, first of all, at what levels you think you should be able to maintain your margins, and if you already started to revise your loan yield to downwards or if you expect this to happen in the near future. That would be my first question.

Andrey Shalimov
Sorry, Maria, could you repeat the second part of your question?

Maria Semikhatova
Yes, if you have started to lower lending rates for your borrowers, so you see pressure or some competitors doing this (lowering lending rates) for clients.

Andrey Shalimov
Thank you, got you. Talking about the margin, I suppose it was a process of a rate normalisation, but, again, the policy of biggest banks influence heavily the situation. What we saw across the summer was the muted interest of biggest banks, biggest state banks to expand in corporate and SME segment, so they were pretty selective and in some customers it was quite a tough rate competition. But nonetheless, a lot of people didn't receive hefty offers from state banks, and that was easier to preserve their current level of interest rates, so that was one of their reasons for maintaining and expanding the margin. Of course, the second one was very fast liabilities repricing, and then in that case, of course, this withdrawal of some VIP

individual depositor funds was very helpful to reduce interest expenses. But nonetheless, most out of, say, relatively expensive funding, it expired by August, early September. That was, of course, a very welcome development.

What we see now in the markets, it is a relative scarcity of cash and still some banks bidding very high in the market and, on the other hand, the Central Bank reducing gradually the amounts of Roubles they offer via collateralised facilities. That is an additional factor to keep the general level of rates closer to the upper boundary of what people expect. In this situation, and in anticipation of low refinancing rates in nearest future, of course, you should be careful, simply not to accumulate too much expensive liabilities, maintaining margin. From interest rates point of view, that is pretty favourable conditions now.

More heat starts to be felt in mortgage market with more expensive programmes from state banks, but nonetheless, the segment is still very profitable too.

Maria Semikhatova
I see, thank you. The second question would be on renegotiated loans, this increase in the third quarter, were there any specific sectors that were driving this? Can you maybe summarise what problems those were or faced?

Andrey Shalimov
I can't say that there are some deviations in the portfolios, NPLs and renegotiated loans from what we discussed before. Those number of sectors which suffered from slowdown in economy, they are more or less the same, so we didn’t spot any new unusual participants.

Maria Semikhatova
I see, and if I maybe rephrase a bit my question about renegotiated book, you mentioned that you might provision also heavily in the fourth quarter to improve coverage. How do you feel about amount of accumulated provisions on the renegotiated portfolio? Do you think you need to create more charges there as well?

Andrey Shalimov
No, we are much more comfortable with provisioning level than a quarter before, and we suspect that it could be too tight approach to stick to our average targets of 100 and 140%, but for changing the attitude, of course, we need to be sure that there is a turn in the economy path and that most of the borrowers, they have sound plans and could left their problems

behind. There are some signs of a resolution in many restructured borrowers, but it is a bit premature to say it firmly, so the general stance, we could add provisions in the fourth quarter, but on the other hand, some people could resume their normal functioning, being totally adopted to new operational environment of lower real incomes etc. From that point of view, we could expect some improvements.

Of course, some routine work to renegotiate terms to get additional collateral, we started down to spring, it started bringing fruits, so some complicated cases in which, of course, changes to the management team were not a very harmful factor and there were some delays because, of course, customers don't like change of the faces on the bank side. Now, they are very close to accomplishment and that should be additional positive factor.

Maria Semikhatova
I see, thank you.

Andrey Shalimov
Thank you.

Operator
[Operator instructions]

We have a question from Olga Naydenova, BCS. Please go ahead.

Olga Naydenova
Hello, Andrey, just a small follow-up question. Any possibility for improvement in your fee-based products, anything new where we can expect some growth in these lines?

Andrey Shalimov
We could expect broadening for the product line due to two factors: one internal, the development of mobile banking was pretty rapid within Vozrozhdenie. The change of some approaches for packages for the customers for cross-sale. Simultaneously, the available combination of Vozrozhdenie products and the products of Promsvyaz Group. Of course, it is very viable opportunity to expand this product line and, actually, to stress even more the focus of the bank on transactional business and the fee income. That is a matter of special consideration. Of course, now, that is a period of very thorough gap analysis in both banks' product lines and, of course, we expect both quick wins and some potential plausible ideas how to expand the fee products.

Olga Naydenova
We start to expect resumption of fee growth, at least in line with balance sheet for next year or not yet.

Andrey Shalimov
Yes, we expect rejuvenation of fee income growth. There were some subjective factors raising concerns about the future relations with the bank. Now those factors are removed, at least partly, and I suppose the clarification of the strategy and the status of the bank should remove them totally, so that is a very important thing. If you could stop here for most of the products and you maintain your relations, of course, that is a very good base.

On the other hand, we see that some competitive decrease of tariffs/fees etc, it is running out of steam in many markets, since most easy wins are already achieved and most of the banks they paid more attention to their transactional business. From that point of view, we suspect to see some floors in fee levels, and on the other hand, rejuvenation of the current customer base and maybe even possibility of some cross-sales of the products. That is one of the key ideas in business plan according to the general strategic consideration and, of course, that is one of the strengths of the bank spotted by new owners.

Olga Naydenova
Okay, thank you.

Operator
[Operator instructions]

Elena Mironova
Well, if we have no further questions coming through, let's conclude the call. Thank you all for taking your time to listen to us and feel free to contact the Investor Relations team for any more detailed questions that you may have. We will keep you posted on all our recent developments and otherwise, see you in March on disclosure of our full year results.

Thank you.