

# MOODY'S

## INVESTORS SERVICE

### Credit Opinion: OJSC Bank of Baku

Global Credit Research - 17 Dec 2014

Baku, Azerbaijan

#### Ratings

| Category                            | Moody's Rating |
|-------------------------------------|----------------|
| Outlook                             | Stable         |
| Bank Deposits                       | B1/NP          |
| Bank Financial Strength             | E+             |
| Baseline Credit Assessment          | b1             |
| Adjusted Baseline Credit Assessment | b1             |

#### Contacts

| Analyst                | Phone           |
|------------------------|-----------------|
| Petr Paklin/Moscow     | 7.495.228.6060  |
| Maria Malyukova/Moscow |                 |
| Yves Lemay/London      | 44.20.7772.5454 |
| Anna Avdeeva/Moscow    | 7.495.228.6060  |

#### Key Indicators

##### OJSC Bank of Baku (Consolidated Financials)[1]

|   | [2]12-13 | [2]12-12 | [2]12-11 | [2]12-10 | [2]12-09 | Avg.    |
|---|----------|----------|----------|----------|----------|---------|
| Total Assets (AZN million)                        | 642.9    | 486.2    | 307.3    | 239.9    | 182.8    | [3]36.9 |
| Total Assets (USD million)                        | 820.7    | 620.1    | 391.1    | 300.0    | 227.5    | [3]37.8 |
| Tangible Common Equity (AZN million)              | 113.9    | 83.8     | 52.5     | 31.2     | 27.4     | [3]42.8 |
| Tangible Common Equity (USD million)              | 145.4    | 106.8    | 66.8     | 39.0     | 34.1     | [3]43.7 |
| Net Interest Margin (%)                           | 16.1     | 16.2     | 14.5     | 11.6     | 10.5     | [4]13.8 |
| PPI / Average RWA (%)                             | 12.7     | 12.4     | 10.4     | 7.2      | 5.5      | [5]9.7  |
| Net Income / Average RWA (%)                      | 8.8      | 8.8      | 10.1     | 6.1      | 3.9      | [5]7.5  |
| (Market Funds - Liquid Assets) / Total Assets (%) | 3.8      | 5.3      | 1.2      | -4.1     | 5.9      | [4]2.4  |
| Core Deposits / Average Gross Loans (%)           | 83.7     | 87.8     | 91.2     | 96.6     | 68.3     | [4]85.5 |
| Tier 1 Ratio (%)                                  | 11.4     | 11.8     | 9.1      | 9.2      | 13.5     | [5]11.0 |
| Tangible Common Equity / RWA (%)                  | 18.8     | 18.8     | 18.0     | 13.9     | 17.3     | [5]17.3 |
| Cost / Income Ratio (%)                           | 36.8     | 37.0     | 41.5     | 51.8     | 60.3     | [4]45.5 |
| Problem Loans / Gross Loans (%)                   | 3.2      | 5.6      | 3.3      | 5.0      | 5.1      | [4]4.5  |
| Problem Loans / (Equity + Loan Loss Reserves) (%) | 12.9     | 22.5     | 13.5     | 20.9     | 17.4     | [4]17.4 |

Source: Moody's

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel I; IFRS [3] Compound Annual Growth Rate based on IFRS reporting periods [4] IFRS reporting periods have been used for average calculation [5] Basel I & IFRS reporting periods have been used for average calculation

#### Opinion

##### SUMMARY RATING RATIONALE

We assign long-term global local- and foreign-currency deposit ratings of B1 to Bank of Baku, which is at the same level as the bank's baseline credit assessment (BCA) of b1. The rating reflects the bank's (1) good asset quality,

leading to lower credit costs compared with those of similarly rated peers; (2) healthy capital buffer, which, together with a robust pre-provision profitability, provides the bank with good loss-absorption capacity; and (3) stable liquidity profile supported by predictable cash flow from its granular loan portfolio.

Bank of Baku's B1/Not Prime long- and short-term global local currency (GLC) ratings do not factor in any probability of systemic support in the event of a stress situation.

The outlook on all long term ratings is stable.

The Bank reported total assets of AZN670.6 million, total equity of AZN112.6 million, and net income of AZN25.0 million as of 30 June 2014 under unaudited IFRS.

### **Rating Drivers**

- Good market position as the largest provider of consumer loans among private banks in Azerbaijan
- Strong profitability, albeit pressured by increasing credit costs following loan portfolio seasoning and steady market saturation
- Better than peers asset quality
- Liquidity profile will remain stable supported by slowing down lending growth

### **Rating Outlook**

All long term ratings carry a stable outlook

### **What Could Change the Rating - Up**

Material improvements in the bank's market franchise as well as maintenance of sound asset quality, profitability and capitalisation may have positive rating implications for the bank's ratings in the longer term.

### **What Could Change the Rating - Down**

Downward pressure could be exerted on Bank of Baku's ratings as a result of any material adverse changes in the bank's risk profile, particularly any significant impairment in the bank's asset-quality.

## **DETAILED RATING CONSIDERATIONS**

Unless noted otherwise, data in this report is sourced from company reports and Moody's Banking Financial Metrics.

### **GOOD MARKET POSITION AS THE LARGEST PROVIDER OF CONSUMER LOANS AMONG PRIVATE BANKS IN AZERBAIJAN**

Headquartered in the City of Baku (capital of Azerbaijan), Bank of Baku is the country's leading provider of consumer loans which has the largest retail loan portfolio among privately owned banks. Bank of Baku is a medium-sized bank ranked 8th by total assets among 43 commercial banks operating in Azerbaijan as of 1 November 2014, and holding 3.0% of banking system assets.

The bank has a clear focus on loans provided to individuals, with 96% of its loan book composed mostly of consumer loans, car loans and credit cards at 1H-2014. Over the first six months of 2014, Bank of Baku's loan portfolio increased by 8% only (2013: 35%; 2012: 58%). The slowdown followed the new measures introduced by the CBA in 2013-14 aiming to reduce potential risks of overheating in the consumer finance sector. We expect the bank's lending growth over the next 12-18 months will not exceed 15-20% yoy.

We, however, expect the bank's franchise to remain solid in the medium to long term, and that the bank will maintain its good market position mainly because the new measures will impose additional entry barriers for new players that recently increased or planed to increase their focus on this lucrative sector.

In order to acquire clients, the bank is closely cooperating with over 800 partners in the market including major universities, medical centers and other organisations. The bank also has partnership arrangements with leading automobile dealers and retail stores. We note that Bank of Baku's car loans franchise has been largely based on the bank's established relationship with a related-party car dealer (a leading distributor of foreign-made cars in

Azerbaijan), which is likely to provide greater stability for the franchise, enabling the bank to achieve relatively firm positions in this segment.

Since 2001, Bank of Baku has been cooperating with a number of International Financial Institutions (IFI) which provided technical and financial assistance in developing SME, micro-financing and leasing business and helped to improve corporate governance and risk management standards. Bank of Baku's distribution network currently consists of 25 branches. The bank has a relatively diversified shareholder structure, with no single party owning a controlling stake in the equity. The largest shareholder - NAB Holding (40% equity stake) - is a Turkey-based company which also has interests in a variety of businesses in Azerbaijan, including car dealerships, trade of consumer electronics and tourism.

#### **STRONG PROFITABILITY, ALBEIT PRESSURED BY INCREASING CREDIT COSTS FOLLOWING LOAN PORTFOLIO SEASONING AND STEADY MARKET SATURATION**

The bank's focus on high-margin consumer-lending business has provided it with robust core profitability. The bank reported strong annualized pre-provision income (PPI) at 14.4% of average assets in 1H-2014 (year-end 2013: 11.9%; year-end 2012: 11.6%). As a result of seasoning of its rapidly grown loan book in 2012-13 along with steady market saturation credit costs increased to 5.3% (annualized) of average gross loan book at 1H-2014 (year-end 2013: 1.7%; year-end 2012: 1.5%). Over the six months ended 30 June 2014 Bank of Baku recognised net income of AZN25.0 million under IFRS, translating into return on average assets of 7.6% and return on equity of 42.5% (year-end 2013: 8.2% and 43.0%, respectively).

We note that Bank of Baku's good profitability leads to ample internal capital generation capacity and we expect that profit will remain the main source of capital increase in the near to medium term. In our view with regulatory Total Capital Ratio (CAR) of 19.5% and Tier1 of 12.2% reported as at 30 September 2014, Bank of Baku's capital levels will be sufficient to absorb expected losses under our central and adverse scenario taking into account material regular dividend payouts (around 76% of net profit for 2013 and 50% for 2012).

We expect that Bank of Baku's core profitability will remain robust over the next 12-18 months, supported by strong net interest margin (18.9% in 1H-2014) and high operating efficiency (the cost-to-income ratio was 27.5% at 1H-2014), however, pressure from credit costs will persist following seasoning of the loan portfolio.

#### **BETTER THAN PEERS ASSET QUALITY**

We note that Bank of Baku's overall asset quality remains superior to that of similarly rated peers, with the level of loans overdue for more than 90 days at around 3.1% of the gross loan portfolio, as of 31 December 2013, which is below the market average (7% overdue). In addition, the bank provides sufficient coverage of problem loans, by maintaining loan loss reserves at 5.5% of gross loans at 1H-2014 and 3.2% of gross loans at year-end 2013. As the lending growth will be subdued over the next 12-18 months we expect problem loan ratio to deteriorate somewhat, while strong PPI generating capacity will allow to create adequate provisions.

We believe new measures introduced by the CBA in 2013-14 (aiming to reduce potential risks of overheating in the consumer finance sector) will result in slower lending growth and more conservative underwriting practices which will support bank's asset quality in the next 12-18 months. On top of that, quality of retail loans will be supported by increased budgetary spending and economic growth in Azerbaijan (Baa3 stable), which positively affects labour market conditions and personal income.

#### **LIQUIDITY PROFILE WILL BE SUPPORTED BY SLOWING DOWN LENDING GROWTH**

We expect Bank of Baku's liquidity profile to remain stable over the next 12-18 months, however, we view the level of liquidity buffer the bank has maintained in recent years - mainly represented by cash, nostro accounts and due from banks - as relatively low at 9.6% of assets at 1H-2014 under IFRS and 8.1% of assets at 3Q-2014 under local GAAP. At the same time we note that the bank's liquidity profile remains supported by stable and predictable cash flow from its granular loan portfolio especially considering slowing down lending growth since the beginning of 2014 .

#### **Global Local Currency Deposit Rating (Joint Default Analysis)**

Moody's assigns a long-term GLC deposit rating of B1 to Bank of Baku. The rating is supported by the bank's BCA of b1.

#### **Foreign Currency Deposit Rating**

Moody's assigns B1/Not Prime foreign currency deposit ratings to Bank of Baku, at the same level as the bank's GLC deposit ratings.

## ABOUT MOODY'S BANK RATINGS

### Bank Financial Strength Rating

Moody's Bank Financial Strength Ratings (BFSRs) represent Moody's opinion of a bank's intrinsic safety and soundness and, as such, exclude certain external credit risks and credit support elements that are addressed by Moody's Bank Deposit Ratings. BFSRs do not take into account the probability that the bank will receive such external support, nor do they address risks arising from sovereign actions that may interfere with a bank's ability to honor its domestic or foreign currency obligations. Factors considered in the assignment of BFSRs include bank-specific elements such as financial fundamentals, franchise value, and business and asset diversification. Although BFSRs exclude the external factors specified above, they do take into account other risk factors in the bank's operating environment, including the strength and prospective performance of the economy, as well as the structure and relative fragility of the financial system, and the quality of banking regulation and supervision.

### Global Local Currency Deposit Rating

A deposit rating, as an opinion of relative credit risk, incorporates the BFSR as well as Moody's opinion of any external support. Specifically, Moody's Bank Deposit Ratings are opinions of a bank's ability to repay punctually its deposit obligations. As such, they are intended to incorporate those aspects of credit risk relevant to the prospective payment performance of rated banks with respect to deposit obligations, which includes: intrinsic financial strength, sovereign transfer risk (in the case of foreign currency deposit ratings), and both implicit and explicit external support elements. Moody's Bank Deposit Ratings do not take into account the benefit of deposit insurance schemes which make payments to depositors, but they do recognize the potential support from schemes that may provide assistance to banks directly.

According to Moody's joint default analysis (JDA) methodology, the global local currency deposit rating of a bank is determined by the incorporation of external elements of support into the bank's Baseline Credit Assessment. In calculating the Global Local Currency Deposit rating for a bank, the JDA methodology also factors in the rating of the support provider, in the form of the local currency deposit ceiling for a country, Moody's assessment of the probability of systemic support for the bank in the event of a stress situation and the degree of dependence between the issuer rating and the Local Currency Deposit Ceiling.

### Foreign Currency Deposit Rating

Moody's ratings on foreign currency bank obligations derive from the bank's local currency rating for the same class of obligation. The implementation of JDA for banks can lead to high local currency ratings for certain banks, which could also produce high foreign currency ratings. Nevertheless, it should be noted that foreign currency deposit ratings are in all cases constrained by the country ceiling for foreign currency bank deposits. This may result in the assignment of a different, and typically lower, rating for the foreign currency deposits relative to the bank's rating for local currency obligations.

### About Moody's Bank Financial Strength Scorecard

Moody's bank financial strength model (see scorecard below) is a strategic input in the assessment of the financial strength of a bank, used as a key tool by Moody's analysts to ensure consistency of approach across banks and regions. The model output and the individual scores are discussed in rating committees

## Rating Factors

### OJSC Bank of Baku

| Rating Factors [1]              | A | B | C | D | E | Total Score | Trend     |
|---------------------------------|---|---|---|---|---|-------------|-----------|
| Qualitative Factors (70%)       |   |   |   |   |   | E+          |           |
| Factor: Franchise Value         |   |   |   |   |   | C-          | Improving |
| Market share and sustainability |   |   | x |   |   |             |           |
| Geographical diversification    |   |   |   |   | x |             |           |

|  |        |        |       |   |  |                |                |
|--|--------|--------|-------|---|--|----------------|----------------|
| Earnings stability                                 |        | x      |       |   |  |                |                |
| Earnings Diversification [2]                       |        |        |       |   |  |                |                |
| <b>Factor: Risk Positioning</b>                    |        |        |       |   |  | <b>E</b>       | <b>Neutral</b> |
| <b>Corporate Governance [2]</b>                    |        |        |       | x |  |                |                |
| - Ownership and Organizational Complexity          |        |        |       | x |  |                |                |
| - Key Man Risk                                     |        |        |       |   |  |                |                |
| - Insider and Related-Party Risks                  |        |        |       |   |  |                |                |
| <b>Controls and Risk Management</b>                |        |        |       |   |  | x              |                |
| - Risk Management                                  |        |        |       |   |  | x              |                |
| - Controls   |        |        |       |   |  | x              |                |
| <b>Financial Reporting Transparency</b>            |        |        | x     |   |  |                |                |
| - Global Comparability                             | x      |        |       |   |  |                |                |
| - Frequency and Timeliness                         |        |        |       |   |  | x              |                |
| - Quality of Financial Information                 |        |        |       | x |  |                |                |
| <b>Credit Risk Concentration</b>                   | x      |        |       |   |  |                |                |
| - Borrower Concentration                           | x      |        |       |   |  |                |                |
| - Industry Concentration                           | x      |        |       |   |  |                |                |
| <b>Liquidity Management</b>                        |        |        |       | x |  |                |                |
| <b>Market Risk Appetite</b>                        |        |        | x     |   |  |                |                |
| <b>Factor: Operating Environment</b>               |        |        |       |   |  | <b>E+</b>      | <b>Neutral</b> |
| <b>Economic Stability</b>                          |        |        |       |   |  | x              |                |
| <b>Integrity and Corruption</b>                    |        |        |       |   |  | x              |                |
| <b>Legal System</b>                                |        |        |       | x |  |                |                |
| <b>Financial Factors (30%)</b>                     |        |        |       |   |  | <b>B-</b>      |                |
| <b>Factor: Profitability</b>                       |        |        |       |   |  | <b>A</b>       | <b>Neutral</b> |
| PPI % Average RWA (Basel I)                        | 10.04% |        |       |   |  |                |                |
| Net Income % Average RWA (Basel I)                 | 8.32%  |        |       |   |  |                |                |
| <b>Factor: Liquidity</b>                           |        |        |       |   |  | <b>D+</b>      | <b>Neutral</b> |
| (Market Funds - Liquid Assets) % Total Assets      |        |        | 0.79% |   |  |                |                |
| <b>Liquidity Management</b>                        |        |        |       | x |  |                |                |
| <b>Factor: Capital Adequacy</b>                    |        |        |       |   |  | <b>A</b>       | <b>Neutral</b> |
| Tier 1 Ratio (%) (Basel I)                         | 10.02% |        |       |   |  |                |                |
| Tangible Common Equity % RWA (Basel I)             | 16.88% |        |       |   |  |                |                |
| <b>Factor: Efficiency</b>                          |        |        |       |   |  | <b>A</b>       | <b>Neutral</b> |
| Cost / Income Ratio                                | 43.43% |        |       |   |  |                |                |
| <b>Factor: Asset Quality</b>                       |        |        |       |   |  | <b>C+</b>      | <b>Neutral</b> |
| Problem Loans % Gross Loans                        |        |        | 3.61% |   |  |                |                |
| Problem Loans % (Equity + LLR)                     |        | 14.81% |       |   |  |                |                |
| <b>Lowest Combined Financial Factor Score (9%)</b> |        |        |       |   |  | <b>D+</b>      |                |
| <b>Economic Insolvency Override</b>                |        |        |       |   |  | <b>Neutral</b> |                |
| <b>Aggregate BFSR Score</b>                        |        |        |       |   |  | <b>D</b>       |                |
| <b>Aggregate BCA Score</b>                         |        |        |       |   |  | <b>ba2</b>     |                |
| <b>Assigned BFSR</b>                               |        |        |       |   |  | <b>E+</b>      |                |
| <b>Assigned BCA</b>                                |        |        |       |   |  | <b>b1</b>      |                |

[1] - Where dashes are shown for a particular factor (or sub-factor), the score is based on non-public information.

[2] - A blank score under Earnings Diversification or Corporate Governance indicates the risk is neutral.

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