

Global Credit Research - 20 Mar 2015

Baku, Azerbaijan

Ratings

Category	Moody's Rating
Outlook	Stable
Bank Deposits	B1/NP
Baseline Credit Assessment	b1
Adjusted Baseline Credit Assessment	b1

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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
Problem Loans / Gross Loans (%)	3.2	3.1	3.3	5.0	5.1	[4]3.9
Tangible Common Equity / Risk Weighted Assets (%)	19.0	19.2	18.5	-	-	[5]18.9
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	13.6	13.7	14.6	23.5	20.2	[4]17.1
Net Interest Margin (%)	16.1	16.2	14.5	11.6	10.5	[4]13.8
PPI / Average RWA (%)	12.9	12.7	9.5	-	-	[5]11.7
Net Income / Tangible Assets (%)	7.2	6.7	8.5	4.8	3.3	[4]6.1
Cost / Income Ratio (%)	36.8	37.0	41.5	51.8	60.3	[4]45.5
Market Funds / Tangible Banking Assets (%)	14.4	17.0	12.4	16.5	28.3	[4]17.7
Liquid Banking Assets / Tangible Banking Assets (%)	11.0	12.3	12.1	21.8	24.0	[4]16.2
Gross Loans / Total Deposits (%)	122.0	119.4	117.6	108.3	122.3	[4]117.9

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 OJSC Bank of Baku (Bank of Baku), which is at the same level as the bank's baseline credit assessment (BCA) of b1. 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 ratings reflect the bank's (1) better than peers asset quality; (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. At the same time, the ratings remain constrained by the expected pressure on the bank's asset quality and profitability following the seasoning of the loan portfolio amid market saturation.

BANK OF BAKU'S RATING IS CONSTRAINED BY ITS MACRO PROFILE OF WEAK-

Azerbaijan's economy is reliant on hydrocarbon production, making it vulnerable to the recent sharp decline in oil prices. However, the government has been targeting economic diversification, and growth in non-oil sectors has supported growth in the banking system. Country's external vulnerabilities are mitigated by a sizable pool of accumulated foreign assets that serve as a buffer against potential shocks. Our assessment of very low institutional strength includes obstacles to the implementation of deep reforms to improve weaknesses such as corruption.

Azerbaijani banks benefit from continued demand for loan products given that banking penetration is still moderate. Constraining factors for Azeri banks include structural weaknesses such as lack of economic diversification despite gradual progress in this area, material single-name borrower concentrations, high foreign-currency exposure and limited access to long-term funding sources.

Rating Drivers

- Better than peers asset quality
- Strong profitability, albeit pressured by increasing credit costs following loan portfolio seasoning and steady market saturation
- Healthy capital buffer sufficient to absorb expected credit losses
- Liquidity profile remains 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

BETTER THAN PEERS ASSET QUALITY

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 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.

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. 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 the seasoning of the loan portfolio.

HEALTHY CAPITAL BUFFER SUFFICIENT TO ABSORB EXPECTED CREDIT LOSSES

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.

Bank of Baku's capital adequacy remains robust underpinned by strong profitability. The bank's Tier 1 and Total capital adequacy ratio (CAR) under the Basel framework virtually remained flat at 11.4% and 20.2%, respectively as at year-end 2013 (year-end 2012: 11.8% and 20.9%, respectively). In our view with regulatory Total Capital Ratio (CAR) of 20.55% and Tier 1 ratio of 11.93% reported as of year-end 2014 (year-end 2013: 20.3% and 11.1%, respectively), 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).

LIQUIDITY PROFILE REMAINS STABLE 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.

Notching Considerations

Global Local Currency Deposit Rating (Joint Default Analysis)

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.

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.

NOTE ON DATA

Unless noted otherwise, all figures shown in this report are sourced from the bank's latest annual and interim financial reports and additional information from the bank. In addition, where indicated through the document we use reference to Moody's Banking Financial Metrics which are based on our own chart of account, and are adjusted for analytical purposes. Please refer to the documents entitled "Financial Statement Adjustments in the Analysis of Financial Institutions" published on 19 December 2013.

About Moody's Bank Scorecard

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Rating Factors

OJSC Bank of Baku

Macro Factors	
Weighted Macro Profile	Weak -

Financial Profile						
Factor	Historic Ratio	Macro Adjusted Score	Credit Trend	Assigned Score	Key driver #1	Key driver #2
Solvency						
Asset Risk						
<i>Problem Loans / Gross Loans</i>	3.2%	b2	↓	b2	Expected trend	Unseasoned risk
Capital						
<i>TCE / RWA</i>	19.0%	ba1	← →	ba1	Expected trend	
Profitability						
<i>Net Income / Tangible Assets</i>	7.2%	baa3	← →	baa3	Expected trend	
Combined Solvency Score		ba2		ba2		
Liquidity						
Funding Structure						
<i>Market Funds / Tangible Banking Assets</i>	14.4%	b1	← →	b1		
Liquid Resources						
<i>Liquid Banking Assets / Tangible Banking Assets</i>	11.0%	b3	← →	b3		
Combined Liquidity Score		b2		b2		

Financial Profile

ba3

Qualitative Adjustments
Business Diversification
Opacity and Complexity
Corporate Behavior
Total Qualitative

Adjustment
-1
0
0
-1

Adjustments	
Sovereign or Affiliate constraint	Baa3
Scorecard Calculated BCA range	ba3 - b2
Assigned BCA	b1
Affiliate Support notching	0
Adjusted BCA	b1

Instrument Class	Loss Given Failure notching	Additional notching	Preliminary Rating Assessment	Government Support notching	Local Currency rating	Foreign Currency rating
Deposits	0	0	b1	0	B1	B1

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