

Orient Express Bank

Foreign & local currency issue ratings	Moody's
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Senior unsecured	B3
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Outlook	Stable
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H1:07 results — keeping options open

- On October 3rd, Orient Express Bank (OEB, the Bank), released IFRS results for the six months ended June 30th 2007 (H1:07). The Bank's credit story has remained intact. Strong balance sheet growth, declining non-performing loan (NPL) levels, **rising cash balances and successful placements of senior and subordinated debt have reinforced financial flexibility.**
- OEB's **bottom line profitability has moderated**, with annualised return on equity (ROE) of 34.1% in H1:07, relative to 87.8% in 2006:
 - Net interest income before loan loss provision (LLP) grew by 155% in H1:07, and net interest margin expanded to 17.2%;
 - The ROE decline is mainly attributable to slower fee and commission income growth in H1:07, and lower levels of income related to the sale of loans to URSA Bank (URSA). OEB has the right to sell loan portfolios to URSA on pre-determined conditions (refer to our report dated May 24th 2007, titled "*Earning its stripes*", for further details on loans sales);
 - Cost growth was acceptable at 55%, and tax policy showed substantial conservatism.
- Funding flexibility has increased substantially since the end of 2006, and the H1:07 financial statements mention that new capital in the amount of \$65 – \$70m will be raised once regulatory approval is obtained. We note, however, that OEB's **planned asset level of \$1.5bn at the end of 2007 seems highly optimistic** in the current circumstances.
- Closure of the debt capital markets since July 2007 imply that placement of a Eurobond in H2:07 will not be possible. Fortunately, in addition to raising around \$250m in public market funding mid-year, OEB has an option to sell loans to URSA up to a limit of about \$320m in 2007 (it had only sold \$80m in loans by June 30th 2007).

OEB's credit story remains robust, although asset growth may slow. An acquisition of OEB by URSA appears to be on track, although it is unlikely that a final decision will be made before mid-2008, therefore this merger is not a given. Still, OEB's outstanding bonds are putable at par within 9 – 15 months if the merger does not take place, otherwise the Bank will be merged with URSA, a larger and more creditworthy bank. These bonds represent good value, considering that even if held to maturity, they mature in 22 months.

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Unless indicated otherwise, **all figures are presented in US dollars**, and growth rates and financial ratios are calculated based on US dollar-denominated underlying data.

1.1 Corporate activity and public market issuance

Although still a small niche bank, OEB's profile and reach continue to increase, as illustrated by a number of measures and events set out below:

- OEB was **ranked 8th by volume of unsecured consumer loans**, 23rd by volume of auto loans and 59th by volume of loans to small and medium-sized entities (SMEs) issued during H1:07. The Bank was ranked 60th by the number of plastic cards issued to June 30th 2007 (per RBC Rating), 111th by assets (per Interfax).
- On June 27th 2007, Orient Express Finance Limited (OEFL — an SPV which was created to issue debt instruments, the proceeds of which would be used to issue loans to the Bank) **attracted a \$43m subordinated loan** on behalf of the Bank. This subordinated loan, which bears interest at 11% for five years (whereafter there is a step-up rate for the remaining five years) qualifies as Tier 2 capital (refer to Section 1.2).
- In July 2007, OEFL **issued RUB5.4bn (\$210m) 9.875% rouble-denominated loan participation notes** (LPNs) due in July 2009. The terms of these senior unsecured notes include two put options:
 - If, within one year (i.e. by July 2008), there has been no positive Board decision that OEB will be acquired by URSA Bank, investors can put the bond at par; and
 - If, within 18 months (i.e. by January 2009), there has been a positive Board decision that OEB will be acquired by URSA Bank but the CBR does not grant approval for this purchase, investors can put the bond at par.

Per management, the process of planning the merger of OEB and URSA is moving forward, but no additional documentation in this regard has been signed. Management continues to expect that a positive Board decision regarding the merger will have been made by mid-2008.

- On September 7th, there was an extraordinary meeting of OEB's shareholders, at which an increase in the Bank's authorized share capital was approved. 1,680,000 shares with a nominal value of RUB100 each will be issued. Existing shareholders of the Bank have pre-emptive rights to purchase the shares in proportion to their existing holdings. If shares are issued at their nominal values, **the share capital increase should total between \$65m and \$70m**. The Bank's current shareholders are expected to participate.
- As we illustrated in our previous report on OEB dated May 24th 2007, one of the tools OEB uses to fund growth in its assets (in particular, loans) is the selected sale of portfolios of loans to URSA, from time to time. Based on the H1:07 financial statements, **OEB sold loans with a book value of around \$80m in H1:07**. This is relative to sales of loans totaling \$272m in 2006. We believe that during August 2007, OEB sold loans totaling about \$30m to URSA, in three separate transactions.

OEB's market-focussed activities in 2007 to date have involved strengthening and expanding the Bank's franchise and capital/funding structure, as well as continuing to implement key aspects of the Bank's strategy such as diversifying the Bank's products and loan portfolio, successfully tapping international capital markets, and proceeding along the path towards an acquisition by URSA.

1.2 H1:07 financial update

OEB's H1:07 IFRS results illustrate that the Bank has taken a somewhat more measured approach to growth than in 2005 and 2006, that the ROEs of 80% – 100% seen in these years may be giving way to more moderate and sustainable profitability. We note, however, that the favourable nature of OEB's loan sale agreements to URSA mean that the volume of loan sales in any given period has quite a substantial impact on the resulting ROE.



Total NPLs (which are defined very conservatively as loans where interest or principal is more than one day overdue) reached almost \$50m, and were 45% covered by LLP which was 4.9% (\$21.8m) of loans to customers vs. 6.0% on December 31st 2006. In spite of the fact that NPLs levels showed improvement, we believe it would be imprudent for OEB to reduce its NPL coverage levels below the current levels of 45%. Indeed, URSA's NPLs (which are defined in the same way as those of OEB) are 65% covered by provisions.

- **Other credit-relevant balance sheet measures were benign** — cash and cash equivalents (CaCE) in the balance sheet rose to 9.2% of assets at the end of H1:07, and interbank exposures were minimal. A portion of the cash balances noted at the end of June 2007 probably represent cash raised from the issue of subordinated debt.

Loan and deposit concentrations remained low. Deposit concentration (top 10 depositors as a proportion of total deposits) fell from 15.6% to 10.8% in H1:07.

Financial performance highlights include:

- **More moderate ROE and ROA.** OEB's (annualised) ROE fell from 87.8% in 2006 to 34.1% in H1:07. ROA declined from 15.4% to 4.5% (annualised). While the H1:07 ROE and ROA are still generous, and not out of line with Russian banks involved in primarily retail business, the reduction in these metrics deserves further analysis.
- **Net interest income** grew 155% to \$69.5m (before LLP); \$53.8m after LLP. At the same time assets grew only 98% in H1:07 and net interest margin (NIM) actually expanded from 15.7% in 2006 to 17.2% in H1:07. Therefore, interest income generation did not contribute to the decline in ROE/ROA.
- **Non-interest revenue (NIR)** fell by 35% in H1:07. OEB's NIR has two main components — net fee and commission income, and "other" NIR which is mainly net profit on loan sales to URSA. In H1:07, income from fees and commissions rose only 14% on an annualised basis and loan-sale related income was \$52.8m (assuming simple annualisation) relative to \$81.1m in 2006. Another way to look at relative volumes of loans sale income is to consider the amount of related party income relative to total income. This ratio was 47.2% in 2006 and 26.8% in H1:07. Thus, the proportion of income contributed from URSA-related loans sales has fallen by 43% (annualised) in H1:07. We see this as a positive business development, even though effects on ROE may be negative.

Lower fees and commissions could be as a result of OEB changing its products in response to competition or as part of the strategic diversification of the business. Perhaps they are as a result of products being restructured to include a higher effective interest rate and lower fees/commissions (which would also explain expansion in NIM). Loan sale related income is highly unlikely to reach 2006 levels, given that OEB has other funding sources in 2007, and management also stated that the intention is to make more limited use of this refinancing mechanism in 2007 and beyond.

- **Cost control and tax management are on track.** OEB's cost-to-income (C/I) ratio has risen from 45.8% in 2006 to 62.8% in H1:07, mainly due to falling NIR. While the Bank is aggressively enhancing its operations (employee numbers rose by 744 people to a total of 3,868 in H1:07), costs are being contained. OEB's effective tax rate is slightly above the statutory 24%, and cash payment of the tax liability appear to be ahead of schedule, signally conservative tax management.

OEB's H1:07 results show good balance sheet growth, increased funding and capital flexibility, and apparently rising asset quality. ROA and ROE have declined substantially, mainly as a result of a lower volume of loans sales to URSA (which are on favourable terms and front-load profit into OEB's income statement). However, annualised ROE of just over 30% is still very attractive, and in H1:07 income of around \$11m (not annualised) has been added to the Bank's capital base.

1.3 Bond performance

The turmoil in global financial markets (which prompted a "flight to quality") and the ensuing liquidity crunch in the intermediation business has resulted in Russian bank bonds (and particularly those of small banks such as OEB) being particularly hard hit. OEB's small size and the illiquidity of its single senior unsecured issue have left bonds trading "somewhere" in the indicative price range of 90 – 92 (as at October 8th 2007).



OEB's current price range has been driven purely by market factors and the bond's illiquidity. As illustrated in this report, the Bank is fundamentally sound, growing and profitable. It raised around \$250m in debt and Tier 2 capital mid-year, and has an option to sell loan portfolios to URSA under existing terms and conditions (up to a limit of RUB8bn — about \$320m — in 2007).

Consequently, in addition to a favourable starting point (i.e. ahead of the start of credit market woes in July/August 2007), OEB is in the unique position that it can refinance loans to the value of around \$240m in the second half of 2007, having used only about \$80m of the total capacity in H1:07. Although the Bank did not wish to refinance such a large volume of loans with URSA in 2007, the ability to do so is key, since OEB planned to raise Eurobonds in H2:07, which will not be possible in the current market conditions. In short, when it comes to funding, OEB has more options than many other Russian banks.

OEB's credit story remains robust, although asset growth is likely to slow. There is very little chance that assets will be the planned \$1.5bn by the end of 2007. The outstanding bonds represent good value as either they will be putable at par within 9 – 15 months, or the Bank will be merged with URSA, a substantially larger and more creditworthy bank.



Appendix 1: Summary of financial indicators

OEB's original rouble-denominated income statements and balance sheets have been converted to US dollars at the respective period-end rates.

Table 1: Extracts from consolidated income statements

\$m	2005	2006	H1:07 ¹	05/06 % ch	06/H1:07 ¹ % ch
Interest income	4.4	43.4	109.3	884%	152%
Interest expense	(3.3)	(16.2)	(39.8)	394%	146%
Net interest income prior to loan loss provision (LLP)	1.1	27.2	69.5	2,300%	155%
Charge to LLP	(1.7)	(11.6)	(15.7)	565%	35%
Net interest income (NII)	(0.6)	15.6	53.8	n/a	246%
Net gains/(losses) from financial assets	0.0	0.0	0.7	0%	n/a
Net gains/(losses) from dealing in foreign currencies	0.2	0.5	-	105%	n/a
Net fee and commission income	6.9	28.7	32.7	318%	14%
Other non-interest revenue	17.4	51.9	19.4	198%	(63%)
Non-interest revenue (NIR)	24.5	81.1	52.8	231%	(35%)
Total operating income	23.9	96.7	106.6	305%	10%
Operating expenditure	(8.5)	(49.6)	(76.8)	485%	55%
Net operating income	15.4	47.1	29.8	206%	(37%)
Taxation	(4.2)	(12.5)	(7.9)	199%	(37%)
Net income	11.2	34.6	21.9	209%	(37%)

Sources: Financial statements, Standard Bank Group

Note 1: Income statement items have been annualised (by multiplying H1:07 income statement line items by 2).

Table 2: Extracts from consolidated balance sheets

\$m	2005	2006	H1:07	05/06 % ch	06/H1:07 % ch
Cash and cash equivalents (CaCE)	13.5	27.8	55.7	106%	101%
Loans and advances to banks (net)	0.0	40.2	24.5	n/a	(39%)
Loans to customers (gross)	48.3	228.0	446.9	372%	96%
Less: LLP	(1.9)	(13.7)	(21.8)	636%	59%
Loans to customers (net)	46.4	214.3	425.1	362%	98%
Total assets	85.5	362.7	608.6	324%	68%
Due to other banks	16.0	32.8	61.5	105%	88%
Deposits and current accounts	34.7	217.9	315.0	527%	45%
Debt securities in issue	3.2	29.3	91.1	811%	211%
Subordinated debt	-	-	42.3	n/a	n/a
Total liabilities	64.4	305.0	538.8	374%	77%
Total equity	21.1	57.7	69.8	173%	21%

Sources: Financial statements, Standard Bank Group



Table 3: Selected financial ratios

%	2005	2006	H1:07 ¹	05/06 % ch	06/H1:07 % ch
<i>Asset quality</i>					
NPLs/gross loans to customers ²	3.2%	12.8%	11.0%	300%	(14%)
LLP/gross loans to customers	3.8%	6.0%	4.9%	56%	(19%)
LLP/total assets	2.2%	3.8%	3.6%	74%	(5%)
Charge to LLP/average gross loans to customers	6.1%	8.4%	4.6%	39%	(45%)
<i>Profitability and efficiency</i>					
Return on average equity (ROE)	98.9%	87.8%	34.1%	(11%)	(61%)
Return on average assets (ROA)	22.6%	15.4%	4.5%	(32%)	(71%)
Net interest margin (NIM) – on average earning assets	3.1%	15.7%	17.2%	400%	10%
NIR to total income	95.6%	74.9%	43.2%	(22%)	(42%)
Cost-to-income (C/I)	33.1%	45.8%	62.8%	38%	37%
Effective tax rate	27.2%	26.5%	26.5%	(2%)	-
<i>Funding and liquidity</i>					
CaCE/total liabilities	20.9%	9.1%	10.3%	(57%)	14%
Loans and advances/deposits	95.2%	107.0%	125.1%	12%	17%
Deposits/total assets	59.4%	69.1%	61.9%	16%	(10%)
<i>Capital adequacy</i>					
Tier 1 qualifying capital/RWA	27.1%	18.9%	13.0%	(30%)	31%
Total qualifying capital/RWA	27.1%	18.9%	20.9%	(30%)	(11%)
Equity/assets	24.7%	15.9%	11.5%	(36%)	(28%)
<i>Related parties & concentrations</i>					
Related party to total assets	4.7%	1.3%	0.6%	(73%)	(56%)
Related party to gross loans	1.3%	1.4%	0.7%	9%	(49%)
Related party to total liabilities	18.3%	4.5%	8.3%	(75%)	84%
Related party to total income	61.5%	47.2%	26.8%	(23%)	(43%)
Concentration risk (top 10 as a % of total deposits)	18.8%	15.6%	10.8%	(17%)	(31%)
Concentration risk (top 10 as a % of gross loans)	5.9%	1.9%	2.3%	(68%)	12%

Sources: Financial statements, Management accounts, Management, Standard Bank Group

Notes:

1. Income statement items have been annualised (by multiplying H1:07 income statement line items by 2). Ratios have been calculated using underlying rouble-denominated data.
2. NPLs are defined as all outstanding payments and related loans, which are more than one day overdue.



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