

Sector Flash

Banking

Kazakhstan

20 February 2008

M&A activity to intensify in Kazakhstan

Takeaways from meetings with leading Kazakhstani banks

- During our meetings with leading Kazakhstani banks on a recent trip to Almaty we confirmed our understanding that the Kazakhstani banking crisis has not yet run its course. Many banks have virtually ceased lending and many construction companies have frozen some of their projects. Real estate prices have plunged 30%-40% and market participants expect them decline even further.
- Bankers do not expect international debt markets to open up to them in 1H08F and therefore plan to concentrate on collecting loans and attracting deposits rather than lending. The most optimistic scenario suggests 10%-15% growth for the industry's loan book in 2008F.
- A large part of Kazakhstani banks' outstanding \$12bn in debt is due in 1H08F. We believe that without state support many Kazakhstani financial institutions and construction companies will have difficulty redeeming debts and continuing operations. Most of the bankers we met believe they will be able to get through the crisis without government support. At the same time most of them rely heavily on government assistance.
- Government support comes at a cost and we think the government is likely to take advantage of the current situation to strengthen its power. We believe M&A activity and hostile takeovers are likely in the banking and construction industries, signs of which we have already seen including a reported deal between Kookmin and CenterCredit and the purchase of 10%-15% in KKB on the open market by a large Russian investment bank on behalf of a third party.
- We continue to view the Kazakhstani banking sector negatively given its lack of growth and likely asset quality deterioration. However, if the buyouts continue, stock prices might appreciate in the short term until buyers run out.
- Of the top ten banks, Alliance Bank seems the most likely acquisition target given its severe need for liquidity, underperformance and low multiples. Although there are questions over the bank's loan book quality, long-term ownership of the largest Kazakhstani consumer lender could be worth the risk, in our view.
- Foreign banks' Kazakhstani subsidiaries should take advantage of the current situation to win market share, as they are relatively free of funding woes compared to Kazakhstani banks. Top-tier Kazakhstani banks with good distribution networks and foreign ownership by powerful international banks would be well positioned to gain market share in the country.

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Crisis not over yet, but profits are possible

Our trip to Kazakhstan supported our view that the crisis is still underway. Although bankers initially expected the crisis to be over by end-2007, it appears it could persist throughout 2008. The most optimistic bankers expect 10%-15% industry growth this year vs. 96% in 2006 and 48% in 2007, while pessimists believe the industry will contract.

Many banks have almost stopped all lending by toughening underwriting requirements.

The lack of external funding and the extensive liabilities due in 2008 are the main reasons for the drop in industry growth. Most Kazakhstani banks are unable to raise external debt at reasonable rates. Kazakhstani bankers do not expect the international debt market to open to them before 4Q08 with the exception of Halyk Bank, which claims to have no fundraising difficulties whatsoever.

Kazakhstani banks are due to redeem \$12bn in debt this year according to the county's banking regulator.

The debt consists of syndicated loans, Eurobonds, bilateral loans, accrued interest and some borrowings presented as deposits. The NBK expects national GDP will stay flat in 2008 if the banks roll over none of the outstanding debt, which is possible in our view.

If Kazakhstani banks are unable to roll over their \$12bn in debt in 2008, local deposits would be the only source of funding for the banks. We estimate that for the total industry loans to expand 10% this year, the total deposit base would have to rise 36%, which we view as unlikely.

Fighting for deposits, Kazakhstani banks increased rates by about 200bp. Additionally, to keep their margins intact, the banks increased rates on newly issued loans, and loans outstanding. However, in some cases, outstanding retail loans were not affected as it is a tedious process to renegotiate conditions. Facing an increased financial burden, Kazakhstani businesses have held back on their operations, which has affected the troubled construction industry among other business, including SMEs. Those businesses are now forced to manage their cash more rigorously and keep as little in their accounts as possible. Thus, in our view, it is overly optimistic to expect high growth in the commercial deposit base.

Retail deposits, which currently represent around 22% of all deposits, are also unlikely to deliver strong growth in 2008F. Deposits from individuals are a function of personal disposable income. In 2008, we do not expect much income growth in the banking or construction industries, which generated around two-thirds of the county's total GDP growth in 2007. Therefore we do expect much income growth in Kazakhstan in 2008.

The government has stepped in to support the banking and construction industries by forming a \$4bn fund to finance pre-approved construction companies, SMEs and investments. The government has also promised to increase the amount to \$7bn-\$8bn if necessary. The money costs banks 9%, and they have to bear the risks of lending it to the short-listed companies. It is also possible that the government might place funds in certain banks as deposits.

However, everything comes at cost and the government might decide to take advantage of the current situation to strengthen its power. We believe M&A activity and hostile takeovers are likely in the banking and construction industries, signs of which we have already seen including a reported deal between Kookmin and CenterCredit and the purchase of 10%-15% in KKB on the open market by a large Russian investment bank on behalf of a third party.

The KKB buyout was the main reason for the 73% three-month stock appreciation. We think that the current price of \$20 is excessive and believe it will ultimately fall once the buyer is done. However, if the buyout continues the stock could continue to rise in the short term.

We believe that Alliance Bank might be the next takeover target given its severe need for liquidity and relative undervaluation. Halyk Bank has a strong funding and shareholder base and is unlikely to be taken over. BTA shares are relatively illiquid and difficult to acquire.

Our view that construction industry exposure is of a greater risk to Kazakhstani banks than consumer lending is shared by many bankers. Consumer loans are more diversified than construction loans and have shorter terms. Moreover, government support for the construction industry is limited and might not be enough to bail out all the major players. According to market participants, there are around 25,000 unfinished apartments in Astana alone. The government agreed to buy 8,000 of those apartments at cost, leaving the fate of the remaining 17,000 with the construction companies.

● **Kazkommertsbank (Sell, 12-month target price of \$11.5)**

- Sticking to its expansion strategy of increasing its distribution network to 240 branches by 2010 from the current 191; opened around 80 branches in 2007.
- Facing around \$3.2bn in external debt in 2008F including syndicated loans (\$450mn in February and \$600mn in September), accrued interest payments, deposits, repo agreements and bilateral loans.
- Increased interest rates on corporate loans by 200bp and has a minimum corporate rate of 16%.
- Minimum retail deposit rates are 9% in dollars and 11% in tenge.
- Expects some loan book quality deterioration.
- Does not expect the external funding situation to improve before end-2008F.
- Plans to report its 2007 IFRS results in mid-March and does not provide any guidance before then.

● **Halyk Bank (Sell, 12-month target price of \$14.5)**

- Expects to grow 30% y-o-y in 2008F in loans, deposits and net income. Forecasts loan growth for the industry at 15%.
- Facing around \$470mn in external debt in 2008F including a \$200mn syndicated loan due in October 2008.
- Toughened loan underwriting requirements by decreasing the LTV ratio for mortgages from 70% to 50% to cope with increasing credit risks. Also strengthened collateral registration: it now takes around 2-3 weeks vs. three days previously.
- Increased interest rates on newly issued loans by around 300bp. Charges around 15% on short-term salary backed loans, 24% on consumer loans and 16% on mortgages, which makes its average rate about 17%.
- Raised deposit retail rates to 6%-7% and rates for corporate customers to 9%-10%. The bank's retail rates seem to be the lowest in the industry as its affluent customers can negotiate better conditions.
- Seeing an inflow of corporate accounts.
- Thinks real credit quality might be disguised due to government support and high oil prices.

● Alliance Bank (N.R.)

- Has changed its business model. The bank's previous model was similar to Russian Standard Bank's. However, now the bank plans to concentrate on credit card lending, like Capital One
 - Ceased lending cash for consumer spending
 - Plans to issue loans to credit card holders only. The process is at the very beginning. The bank has issued 140,000 cards and only about 12% are active
- Is to concentrate on loan collection in 2008, which it sees as its main challenge for the year.
- Expects its loan book to decline in 2008.
- Is reducing its headcount by around 20%.
- Expects total external payments of \$1,022mn in 2008.
- Thinks the quality of its loan portfolio might deteriorate this year. Currently has 3.8% NPL for its whole book with around 6% (\$120mn) for consumer loans.
- Increased loan and deposit rates. Pays up to 15% for 3-year deposits.
- Plans to publish results at the end of February. Expects net income to exceed \$309mn for the year and gave guidance net income of around \$280mn in 2008F.

● Bank TuranAlem (N.R.)

- Intends to proceed with international expansion. The bank sees more growth potential outside of Kazakhstan.
- Plans to consolidate the group's assets under an internationally registered company; the assets are currently consolidated under Bank TuranAlem.
- Will possibly hold an IPO in 2009.
- Confirmed its plan to divest Temir Bank; plans to use the proceeds to beef up its international subsidiary's capital.
- Around 30% of the bank's loans currently come from outside of Kazakhstan and it plans to increase the number to 70%.
- Restructuring business to focus on deposits gathering rather than lending in Kazakhstan. Thinks its local credit department is too big.
- Raised interest rates on corporate loans by 200-300bp and on retail loans by 200bp-400bp. The effective rate is around 18%.
- Accepts deposits at 9% in dollars and 11%-12% tenge.
- Has an optimistic growth forecast for 2008F of 15%-20%; pessimistic – negative growth.
- Facing around \$1,200mn in external payments in 2008.F

● Bank CenterCredit (N.R.)

- Reports circulate of a stake being sold to Kookmin, a Korean bank.
- Sees construction industry as the most risky for Kazakhstani banks.
- Pessimistic scenario envisages loan book to decline of \$700-\$1,000mn; the optimistic scenario would bring growth of 10%-15%.
- Facing around \$400mn in external payments in 2008.F

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