

CEE banking credit update: OTP Bank's Q3 2011 results – all eyes on tail risks (buy/overweight)

Ample operating liquidity covered the FX repayments due until 2016 2.7X. OTP's operating liquidity reached EUR 4.8 bn which compares favourably with EUR 1.73 worth of its FX repayments due until 2016. The loans to deposits ratio increased to 105.0% (+3.4% qoq) largely due to the inflated FX loans balance related to the weaker forint.

Decent capitalisation by sector standards remained the bank's key strength. The tier 1 ratio reached 14.1% (-1.1% qoq) and the total capital ratio edged down to 17.5% (-0.6% qoq).

Recurring operating profitability remained high with the key catalyst being POS lending in Russia. On the group level the net interest margin improved to 6.44% as of Q3 2011 from 6.25% as of Q2 2011 and 6.07% as of Q3 2010. The figure for 9M 2011 reached 6.32% (+2bp yoy). The net interest margin for the core Hungarian operations without the influence of one-off items reached 5.06% as of Q3 2011 (+28bp qoq) due mainly to the repricing of corporate deposits and payment of previously unpaid interest on delinquent loans. In Russia the net interest margin reached 18.44% as of Q3 2011 (+0.32% qoq, +4.31% yoy) which was mainly due to the fast pace growth in the new consumer lending.

One-off items were the major drag on the bank's bottom line results. OTP booked three large one-offs: a) revaluation result of FX swaps worth of HUF 3.53 bn; b) gain on repurchase of UT2 and LT2 capital instruments worth of HUF 1.45 bn and c) gain on Croatian government bonds worth of HUF 4.3 bn. Same as in the previous quarter the bank booked a banking levy worth of HUF 7.2 bn. In addition, the loss on early repayment of FX mortgages in Hungary reached HUF 1.9 bn.

Cost control loosened somewhat due to high growth in Russia. The ratio of operating costs to average assets deteriorated to 3.74% as of Q3 2011 (+13bp qoq) while the cost to income ratio improved thanks to the higher pre-provision income to 43.2% as of Q3 2011 (-1.7% qoq). However the C/I ratio for 9M 2011 surged by 1.9% yoy to 44.0%.

Asset quality picture failed to impress. The new NPL formation edged higher qoq with NPL up to 16.0% (+0.6% qoq) while the coverage improved to 75.1% (+1.8% qoq). The core Hungarian business saw a rise of NPLs to 12.3% (+0.8% qoq, +2.3% yoy) while the Russian subsidiary reported a qoq decline to 13.0% (-0.3% qoq, -3.1% yoy) thanks mainly to a decent rise in new lending. In terms of other larger subsidiaries, Ukraine's NPLs reached 30.8% (-1.7% qoq, +2.0% yoy) while those of Bulgaria surged to 15.0% (+0.9% qoq, +4.3% yoy).

All eyes on tail risks. With both liquidity and loss absorption capacity at high levels the key risks relate to asset quality and sovereign agenda. That said we expect a) a further deterioration in NPL ratios driven by the weak growth prospects of CEE economies and the bank's high exposure to FX lending and b) high risks stemming from the controversial policy mix of the Hungarian government featuring bank levies and the forced losses on remortgaging/repayment of FX loans. Moreover, we think that the stakes are high that Hungary does not avoid a downgrade by a major rating agency despite initiating the IMF's precautionary loan programme. Bearing in mind all the related risks we think that the valuations of the bank's LT2 bonds look attractive - being widely a function of EURHUF exchange rate. We also find the impact of a downgrade to junk as having only a limited impact on the sub-bonds which are themselves rated by Moody's at Ba1. **That said we stick to our buy/overweight recommendation on the OTPHB 5.27% 09/16 LT2 bonds.**

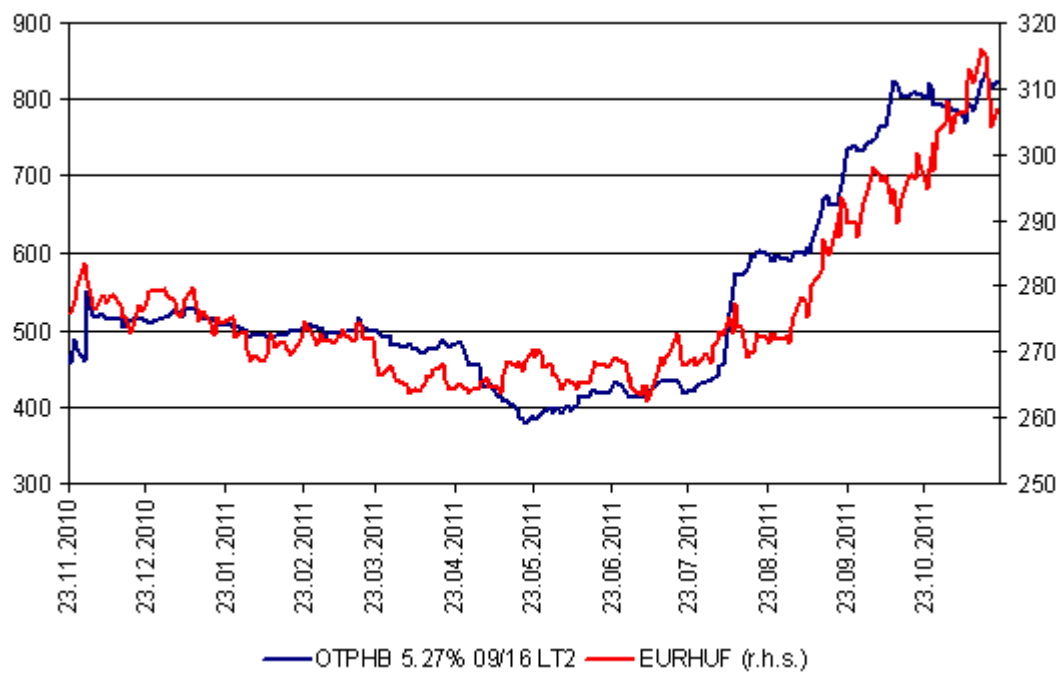
Key financials

	Q2 2011	Q3 2011
NPLs (Group)	15.4%	16.0%
Provisions (Group)	11.3%	12.0%
Provision coverage (Group)	73.3%	75.1%
NPLs (Hungary)	11.5%	12.3%
Provisions (Hungary)	8.9%	9.6%
Provision coverage (Hungary)	77.3%	78.2%
NPLs (Russia)	13.3%	13.0%
Provisions (Russia)	11.2%	11.5%
Provision coverage (Russia)	84.1%	88.8%

	Q2 2011	Q3 2011	9M 2010	9M 2011
Return on Equity	13.6%	12.3%	13.8%	12.9%
Return on Assets	1.84%	1.72%	1.76%	1.78%
Operating income margin	4.44%	4.92%	4.82%	4.58%
Operating income margin without one-offs	4.43%	4.54%	4.44%	4.45%
Net Interest Margin	6.25%	6.58%	6.30%	6.32%
Net Interest Margin without one-offs	6.25%	6.44%	6.05%	6.28%
Operating costs / Average assets	3.62%	3.74%	3.50%	3.61%
Cost / Income	44.9%	43.2%	42.1%	44.0%
Net loans / (Deposits + Retail bonds)	101.6%	105.0%	105.8%	105.0%
CAR	18.1%	17.5%	18.0%	17.5%
Tier1 ratio	15.2%	14.1%	14.1%	14.1%
Core Tier1 ratio	13.6%	12.7%	12.6%	12.7%

Source: company data

Asset swap spread



Source: Bloomberg, Raiffeisen RESEARCH