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Credit Opinion: Eurasian Bank

Global Credit Research - 22 Mar 2011

Almaty, Kazakhstan

Ratings

Category	Moody's Rating
Outlook	Negative(m)
Bank Deposits	B1/NP
Bank Financial Strength	E+
Senior Unsecured -Dom Curr	B1
Subordinate -Dom Curr	B2

Contacts

Analyst	Phone
Maxim Bogdashkin/Moscow	7.495.228.6060
Anna Shurshilina/Moscow	
Yves Lemay/London	44.20.7772.5454

Key Indicators

Eurasian Bank (Consolidated Financials)[1]

	[2]**12-08**	[2]**12-07**	[2]**12-06**	**Avg.**
Total Assets (KZT billion)	**285.7**	**210.6**	**152.3**	[3]**37.0**
Total Assets (USD billion)	**2.4**	**1.7**	**1.2**	[3]**40.3**
Tangible Common Equity (KZT billion)	**50.3**	**43.7**	**18.2**	[3]**66.3**
Tangible Common Equity (USD billion)	**0.4**	**0.4**	**0.1**	[3]**70.4**
(Market Funds - Liquid Assets) / Total Assets (%)	**-8.1**	**-7.8**	**-2.3**	[4]**-6.1**
Core Deposits / Average Gross Loans (%)	**109.8**	**83.4**	**84.9**	[4]**92.7**
Cost / Income Ratio (%)	**63.6**	**57.0**	**46.0**	[4]**55.6**
Problem Loans / Gross Loans (%)	**10.8**	**7.1**	**4.3**	[4]**7.4**
Problem Loans / (Equity + Loan Loss Reserves) (%)	**24.8**	**18.0**	**19.5**	[4]**20.7**

Source: Moody's

[1] All 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

Opinion

SUMMARY RATING RATIONALE

Moody's assigns a bank financial strength rating (BFSR) of E+ to Eurasian Bank, which translates into a Baseline Credit Assessment (BCA) of B1. The BFSR is constrained by significant concentrations in the bank's loan book, weak profitability and poor asset quality. However, the rating is supported by the bank's relatively strong capital adequacy and good liquidity cushion.

Moody's assigns a long-term global local currency (GLC) deposit rating of B1 to Eurasian Bank - at the same level as its B1 BCA.

Credit Challenges

- Significant borrower concentration in the loan book

- Weak profitability, although improvements materialised in 2010

- Further deterioration of the bank's asset quality is possible due to still tough credit conditions in Kazakhstan

Credit Strengths

- Good geographic diversification throughout Kazakhstan

- Robust capital adequacy

- Financially strong owners, which can support the bank's capital through regular capital injections

Rating Outlook

The bank's long-term ratings carry a negative outlook, which reflects pressure on the bank's credit profile from deteriorated asset quality and Kazakhstan's sustained tough credit conditions. The outlook on the BFSR is stable.

What Could Change the Rating - Up

Successful implementation of Eurasian Bank's strategy - to (i) reduce borrower concentration in its loan book; (ii) improve profitability via improving asset quality; and (iii) develop its retail franchise and business with SMEs - could exert upward pressure on the rating. However, a BFSR upgrade is unlikely in the medium term.

What Could Change the Rating - Down

Downward pressure could be exerted on the rating as a result of any one of the following: (i) a failure to maintain adequate capital ratios in the context of gradually deteriorating assets and weak efficiency; or (ii) an inability to decrease high borrower concentration in its loan book.

Recent Results and Developments

In March 2011, Eurasian Bank acquired a micro-credit company "ProstoKredit" from Societe Generale group in an effort to further diversify its own business. ProstoKredit specialised in retail segment (car and consumer loans). The total loan portfolio sold to Eurasian Bank comprised KZT12.9 billion (US$88 million) or about 5.7% of the bank's gross loan portfolio. Nevertheless, the deal is likely to be credit positive for Eurasian Bank because it might noticeably improve its retail lending franchise and overall presence on the Kazakhstani market.

Eurasian Bank reported total assets of KZT359 billion (US$2.4 billion) under unaudited Kazakh Accounting Standards as at YE2010 (11% growth compared to YE2009), shareholders' equity of KZT26 billion (US$173 million) as at YE2010. In 2010, the bank's net profit totalled KZT633 million (US$4.3 million) compared to a net loss of KZT13 billion the previous year.

DETAILED RATING CONSIDERATIONS

Detailed considerations for Eurasian Bank's currently assigned ratings are as follows.

Bank Financial Strength Rating

Qualitative Factors (70%)

Factor 1: Franchise Value

Trend: Neutral

Eurasian Bank is the seventh-largest bank in Kazakhstan by total assets, with a market share of around 3% in terms of total assets as of YE2010. Eurasian Bank's relatively extensive network of 68 branches and outlets is distributed between the largest Kazakh cities, enabling the bank to actively develop its retail and SME lending businesses, which account for about half of its gross loans.

Eurasian Bank is ultimately controlled by three entrepreneurs, who also own around 44% of Eurasian Natural Resources Corporation (ENRC) - one of the world largest natural resources groups, with most of its industrial assets in Kazakhstan. ENRC's annual sales exceeded US$3.8 billion in 2009 and its operations accounted for around 3% of Kazakhstan's GDP. In addition, Eurasian Bank has a strong business relationship with ENRC and its subsidiary companies, and serves its numerous employees (around 65,000).

Over the past two years, Eurasian Bank attracted some corporate and individual customers from the two defaulted Kazakh banks - BTA Bank and Alliance Bank - which had contributed to the largest share of growth of its customer base.

The acquisition of ProstoKredit will help to boost Eurasian Bank's retail business as it provides the bank with technology, personnel and the widespread distribution channels of more than 500 points of sale located in retail store chains, in show rooms of car dealerships and in offices of local pension funds.

However, despite adequate geographic diversification of its assets throughout Kazakhstan and its improved retail franchise, Eurasian Bank's business concentration in a mid-sized country (based on GDP) acts as a constraint on Moody's assessment of its franchise value.

The bank scores D- for franchise value.

Factor 2: Risk Positioning

Trend: Neutral

The bank's major activities are in retail, corporate and SME lending, which together account for 57% of total assets as of YE2010. Its trading book mainly comprises government bonds and debt with quasi-sovereign risk. Therefore, we assess its market risk appetite as low.

Eurasian Bank's loan portfolio is highly concentrated on large borrowers. The 20 largest exposures accounted for more than 400% of Tier 1 capital (or around 274% of total capital) in 2010, which is higher than average for those peers with the same rating, and which therefore exerts downward pressure on the bank's prospective credit strength. Although several large borrowers are partially backed by bank deposits, borrower concentration remains very high.

The bank's total exposure to the construction and real-estate sectors stood at 55% of total capital (or 84% of Tier 1), which we view as moderate. However, the performance of these loans can still exert negative pressure on the bank's asset quality because these sectors remain under significant pressure and their recovery is not expected to be rapid. Moreover, mortgage defaults by individuals have been abnormally high in Kazakhstan and can also affect the bank's asset quality.

The exposure of Eurasian Bank to related-party transactions is insignificant.

Although the bank's risk management is gradually improving, it remains at the early stages of development.

Eurasian Bank scores E for risk positioning.

Factor 3: Regulatory Environment

For a detailed discussion of the country's regulatory environment, refer to Moody's Banking System Outlook on Kazakhstan, published in July 2010.

Factor 4: Operating Environment

Trend: Neutral

This factor is common to all Kazakhstan banks. Moody's assigns an E+ score for the overall operating environment in Kazakhstan. For a discussion of the operating environment, refer to Moody's Banking System Outlook on Kazakhstan, published in July 2010.

Quantitative Factors (30%)

Factor 5: Profitability

Trend: Improving

According to local GAAP, in 2010, the bank showed some profit (KZT633 million or US$4.3 million) compared with losses (KZT13 billion or US$88 million) in 2009. The improvement of the bank's performance in 2010 was mainly driven by contraction in loan loss charges and better efficiency.

The large liquidity cushion maintained by the bank continues to detract from its profitability. Given that adverse selection risks are still high in Kazakhstan, we view the bank's weaker profitability more favourably than its aggressive credit growth and consequent asset quality deterioration.

Going forward, we expect gradual improvements in profitability as the bank is seeking to balance risks by rewards via concentrating on more creditworthy borrowers and intensifying its retail lending.

In order to reflect our expectations regarding Eurasian Bank's future profitability, we have adjusted its D score for profitability to E+, with an improving trend.

Factor 6: Liquidity

Trend: Neutral

In the course of the current global financial crisis, Eurasian Bank maintained a large cushion of liquid assets (33% of total assets as at YE2010) by slowing its lending activity and widening its customer base. Although this strategy has affected its profitability and efficiency, the bank's liquidity is adequate given the current operating environment. This strategy also enabled the bank to activate its lending in 2010, with the gross loan portfolio growing by 21%.

The bank scores C+ for liquidity.

Factor 7: Capital Adequacy

Trend: Neutral

For the past few years, Eurasian Bank has exhibited steady capital adequacy and its shareholders have shown a strong commitment to support it to a sufficient level (with a Tier 1 ratio of 9.4% and capital adequacy ratio (CAR) of 14.2% as of YE2010, under local accounting standards). Nonetheless, the high borrower concentrations and high level of restructured loans in the bank's loan book render its capital vulnerable to possible further asset quality deterioration, especially while pre-provision profitability remains low.

In light of the above-mentioned issues, Eurasian Bank scores A for capital adequacy, which we have adjusted to C+ (with a neutral trend), reflecting its plans for further growth and high credit risks in the loan portfolio.

Factor 8: Efficiency

Trend: Neutral

The revised customer policy and significant cost-cutting measures implemented by the bank's management in 2009 and 2010 have already resulted in some improvements in Eurasian Bank's efficiency. The cost-to-income ratio reduced to 63% at YE2010, compared with 106% as at YE2009.

We expect some further improvement of the bank's efficiency in 2011, due to slightly better expectations towards the bank's revenue growth.

The bank scores D for this factor, which we have adjusted to C.

Factor 9: Asset Quality

Trend: Neutral

Although asset quality challenges are currently common for all banks in Kazakhstan, Eurasian Bank's performance was better than the banking system average. The share of non-performing loans (loans 90+ days overdue) stood at 7.6% as of YE2010, while restructured loans decreased by two times in relative terms over 2010 - to around 14% of total loans. We estimate that most of the bank's restructured portfolio comprises loans, which are performing to date. Therefore, although part of restructured portfolio may transit to default at some stage, the amount of these loans is not expected to exert stress on Eurasian Bank's financial fundamentals. Moreover, the bank's loan-loss reserves relatively adequately cover its expected losses from the loan portfolio.

ProstoKredit's loan portfolio has been transferred to Eurasian Bank's balance sheet and this portfolio is expected to be of good quality - potential revenues exceed both cost of risks and administrative expenses for managing ProstoKredit.

The bank scores D for asset quality, although we have adjusted this downward, with a neutral trend.

Global Local Currency Deposit Rating (Joint Default Analysis)

Moody's assigns a long-term GLC deposit rating of B1 to Eurasian Bank. Although support from the bank's shareholders cannot be ruled out, the extent and timeliness of such support is uncertain. We do not consider that there is any probability of systemic support in the event of a stress situation. Consequently, the bank's GLC deposit rating is at the same level as its B1 BCA.

Foreign Currency Deposit Rating

Moody's assigns a B1 foreign currency deposit rating to Eurasian Bank. The rating is not constrained by the country foreign currency deposit ceiling for Kazakhstan.

Local Currency Debt Rating

Eurasian Bank's local currency senior unsecured debt is rated B1 on the global scale.

Notching Considerations

The bank's subordinated local currency debt is rated at B2, which is one notch below the bank's global local currency deposit rating reflecting the extent of the debts' subordination to senior classes of debt.

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 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 systemic support provider.

National Scale Rating

National scale ratings are intended primarily for use by domestic investors and are not comparable to Moody's globally applicable ratings; rather they address relative credit risk within a given country. A Aaa rating on Moody's National Scale indicates an issuer or issue with the strongest creditworthiness and the lowest likelihood of credit loss relative to other domestic issuers. National Scale Ratings, therefore, rank domestic issuers relative to each other and not relative to absolute default risks. National ratings isolate systemic risks; they do not address loss expectation associated with systemic events that could affect all issuers, even those that receive the highest ratings on the National Scale.

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.

Foreign Currency Debt Rating

Foreign currency debt ratings are derived from the bank's local currency debt rating. In a similar way to foreign currency deposit ratings, foreign currency debt ratings may also be constrained by the country ceiling for foreign currency bonds and notes; however, in some cases the ratings on foreign currency debt obligations may be allowed to pierce the foreign currency ceiling. A particular mix of rating factors are taken into consideration in order to assess whether a foreign currency bond rating pierces the country ceiling. They include the issuer's global local currency rating, the foreign currency government bond rating, the country ceiling for bonds and the debt's eligibility to pierce that ceiling.

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 and may be adjusted up or down to reflect conditions specific to each rated entity.

Rating Factors

Eurasian Bank

Rating Factors [1]	A	B	C	D	E	Total Score	Trend
Qualitative Factors (70%)						E+	
Factor: Franchise Value						D-	Neutral
Market Share and Sustainability				x			
Geographical Diversification					x		
Earnings Stability				x			
Earnings Diversification [2]							
Factor: Risk Positioning						E	Neutral
Corporate Governance [2]					x		
- Ownership and Organizational Complexity				x			
- Key Man Risk				x			
- Insider and Related-Party Risks					x		
Controls and Risk Management					x		
- Risk Management					x		
- Controls					x		
Financial Reporting Transparency				x			
- Global Comparability			x				
- Frequency and Timeliness				x			
- Quality of Financial Information					x		
Credit Risk Concentration					x		
- Borrower Concentration					x		
- Industry Concentration		x					
Liquidity Management				x			
Market Risk Appetite				x			
Factor: Operating Environment						E+	Neutral
Economic Stability					x		
Integrity and Corruption					x		
Legal System				x			
Financial Factors (30%)						C-	
Factor: Profitability						D	Improving
PPI / Average RWA - Basel I			1.61%				
Net Income / Average RWA - Basel I					-0.84%		
Factor: Liquidity						C+	Neutral
(Mkt funds-Liquid Assets) / Total Assets	-10.70%						
Liquidity Management				x			
Factor: Capital Adequacy						A	Neutral
Tier 1 Ratio - Basel I	12.70%						
Tangible Common Equity / RWA - Basel I	12.70%						
Factor: Efficiency						D	Neutral
Cost / Income Ratio				76.78%			
Factor: Asset Quality						D	Neutral
Problem Loans / Gross Loans				10.01%			
Problem Loans / (Equity + LLR)				42.10%			
Lowest Combined Score (9%)						D	
Economic Insolvency Override						Neutral	
Aggregate Score						D-	
Assigned BFSR						E+	

[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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