ING WHOLESALE BANKING

Russia

Dmitry Dudkin
Credit analyst
Moscow (7 495) 755 5480
dmitry.dudkin@ingbank.com

NFC

One large positive factor

Initiating coverage

Buy

Banks

S&P
B-/stable

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National Factoring Company (NFC) is offering the market its debut RBL1bn bond. This presents an opportunity to invest in the paper of the Russian factoring market leader, having the credit risk compensated by an attractive yield.

As a party related to the Uralsib group, NFC enjoys significant support from this large banking holding. The relatively small size of NFC should consequently be less of a concern to potential investors.

NFC should be viewed as an entity that was purposely separated from Uralsib to focus on providing factoring services. The company currently claims **a 45-50% share of the factoring market** in Russia and is rapidly expanding operations in the positive economic environment.

The bank is well capitalised with shareholders' equity amounting to 32.6% of its total assets. This ratio is destined to decrease with NFC raising more debt, but for the time being the capitalisation of NFC is one of the highest in the Russian banking system.

The truly **important asset of NFC is its core factoring team**, which has been in the market for seven years and previously worked at IBG NIKoil, which later served as the key part in the consolidation of Uralsib group.

The **two main issues relating to NFC** are: (1) the dependence on FC Uralsib for its funding; and (2) the high concentration of the loan portfolio. The first is gradually being solved by the attraction of new debt financing; the second is expected to deteriorate in the long run with further growth of the factoring portfolio.

Key figures (2005)

Assets (US$m)	
Cash	30.5
Consumer loans	0
Credit card loans	0
Factoring loans	158
Loan-loss reserves (LLR)	(5.8)
Net loans	152.2
Fixed and intangible assets	0.2
Liquid assets	40.5
Earning assets	162.1
Total assets	194.7
Average earning assets	148.3
Average assets	164.5
Liabilities & capital (US$m)	
Deposits	1.1
Debt securities	0
Wholesale funding	126
Equity	63.5
Income statement (US$m)	
Net Interest income	28.4
Loan-loss provision expense	(3)
NII after provisions	25.4
Fees & commissions income	0
Operating income	25.4
Operating expenses	(3)
PBT	17
Net profit	12.9
Ratios (%)	
Net interest margin	19.20
NI margin after provisions	17.20
Return on avg assets	7.90
Return on equity	20.40
Cost/income	0.12

One large positive factor

Proposed bond

National Factoring Company (NFC) is offering investors its debut rouble bond with the following terms:

- Size: RBL1bn.
- Term to maturity: Three years.
- Coupons: Fixed, paid quarterly.
- Put option: One year, at par.

Effectively, the new bond will probably be traded as a one-year instrument priced to its put option.

Issuer description

As a unit separated from FC Uralsib, NFC can concentrate on providing factoring services

NFC is a Russian bank entirely dedicated to providing factoring services.

Founded in 2003, NFC occupies the lead position in the Russian factoring market with a market share of 45-50%. This success is based on the past performance of the bank's team, which previously developed the factoring business at IBG NIKoil.

NFC is a member of two main professional factoring associations – International Factors Group (IFG), based in Brussels, and Factors Chain International (FCI), based in Amsterdam.

In 2005, NFC was ranked No.104 in the Russian banking system by assets and No.75 by net profit.

Ownership structure

NFC is fully controlled by Uralsib group – one of the largest banking conglomerates in Russia

NFC is split 50/50 between two legal entities: limited liability company Salerna and limited liability company Centrryboproduct. However, the ultimate beneficiary of the bank is Nikolai Tsvetkov, the founder of one of the largest Russian private banking groups Uralsib, as NFC was created in 2003 in a process of separation of the factoring business unit of IBG NIKoil – a Russian bank that later served as one of the key assets in consolidation of the Uralsib group.

The largest part of the Uralsib group is currently Financial Corporation Uralsib (FC Uralsib) – which is both a commercial and investment bank, and in 2005 entered the top five largest Russian banks by assets.

Geographical representation

The company's regional offices are located in 18 cities of Russia apart from Moscow

In order to have capacity for regional development of its activities, NFC has established a network of small branches in the most important cities of Russia.

Fig 1 Regional offices (2005)

Office	Number of employees
Moscow	**115**
Arkhangeslk	1
Voronezh	3
Ekaterinburg	8
Kazan	5
Krasnoyarsk	3
Murmansk	3
Nizhny Novgorod	6
Novosibirsk	5
Omsk	3
Perm	4
Rostov-on-Don	4
Samara	4
St Petersburg	10
Saratov	5
Tumen	5
Ufa	6
Chelyabinsk	7
Yaroslavl	3
Total	**200**
Foreign offices	
Kishinev (Moldova)	3
Yerevan (Armenia)	3

Source: Company data

Russian factoring market

Russian factoring market is in the early development stage

Clearly, factoring services in Russia are in an early development state. Not much information is available about this market, as in the majority of cases factoring loans are reported within the consolidated loan portfolios of Russian banks, so the true size of the market is hard to estimate.

Nevertheless, we believe the total factoring turnover (aggregate volume of financing provided within a year) can be estimated in 2005 at approximately US$4bn.

NFC claims a 45-50% market share

NFC estimates it holds a 45-50% market share.

The list of NFC's competitors in this market includes: NOMOS Bank, Petrocommerce, Probusinessbank, Promsvyazbank, Bank Soyuz, Srednevolzhskaya Factoring Company, Tatfondbank, TransCapitalBank, TransCreditBank, Bank CentroCredit, Zerich, Ami-Bank, VUZ-Bank, Dalkombank, Eurocommerce-Stroycredit, LKB-Finance, Sibirgazbank, Severnaya kazna.

This share is unsustainable in the long run due to expected competition increase

The high market share of NFC looks unsustainable in the long run. The low activity of competitors can be largely explained by the fact that the largest simply were not paying enough attention to the development of their factoring business, while NFC presented itself to clients as a professional dedicated institution backed by one of the largest banking groups in Russia. Expected market growth and, correspondingly, higher possible profits should stimulate competitors' efforts in capturing potential clients, which should lead to redistribution of market share away from NFC.

Financial state

Figure 2 summarises the key financials of NFC in recent years.

Fig 2 Key figures

	2003	2004	2005
Assets (US$m)			
Cash	10.3	0.4	30.5
Consumer loans		0.0	0.0
Credit card loans		0.0	0.0
Factoring loans		104.5	158.0
Loan loss reserves (LLR)		(2.9)	(5.8)
Net loans		101.6	152.2
Fixed and intangible assets	**0.0**	**0.1**	**0.2**
Liquid assets	15.6	32.5	40.5
Earning assets	5.3	134.5	162.1
Total assets	15.6	134.3	194.7
Average earning assets		69.9	148.3
Average assets		74.9	164.5
Liabilities & capital (US$m)			
Deposits	0.0	25.4	1.1
Debt securities	0.0	0.0	0.0
Wholesale funding	0.0	53.6	126.0
Equity	15.6	52.6	63.5
Income statement (US$m)			
Net interest income		4.9	28.4
Loan-loss provision expense (LLPE)		(2.8)	(3.0)
NII after provisions		2.1	25.4
Fees & commissions income		0.0	0.0
Operating income		2.1	25.4
Operating expenses		(0.6)	(3.0)
PBT		0.1	17.0
Net profit		0.1	12.9
Ratios			
Net interest margin (%)		7.0	19.2
NI margin after provisions (%)		3.0	17.2
Return on avg assets (%)		0.1	7.9
Return on equity (%)		0.1	20.4
Cost/income		0.30	0.12
Non-interest expense/avg assets (%)		0.8	1.8
Net loans/customer deposits		4.0	141.4
Net loans/total deposits		1.3	1.2
Liquid assets % total assets	100.0	24.2	20.8
LLR % gross loans		2.8	3.7
Equity % total assets	100.0	39.2	32.6

Source: Company data

Notes to the presented data:

- In 2003, NFC's balance sheet basically contained only US$10.3m in cash and US$5.3m in bank deposits, US$15.6m in total; 2004 was a true start-up year for the company; in 2005 the business activity acquired stable features.

NFC demonstrated factoring portfolio growth of 51% in 2005

- In 2005, the total assets of NFC increased by 45% having reached US$104.7m. This growth was mainly driven by a 51% increase in gross factoring loans, the portfolio of which expanded last year from US$104.5m to US$158m.

- The factoring loan portfolio constituted 97.4% of the total earning assets of NFC by the end of 2005 reflecting the fact that the factoring activity remains the only (and primary) business line of the company.

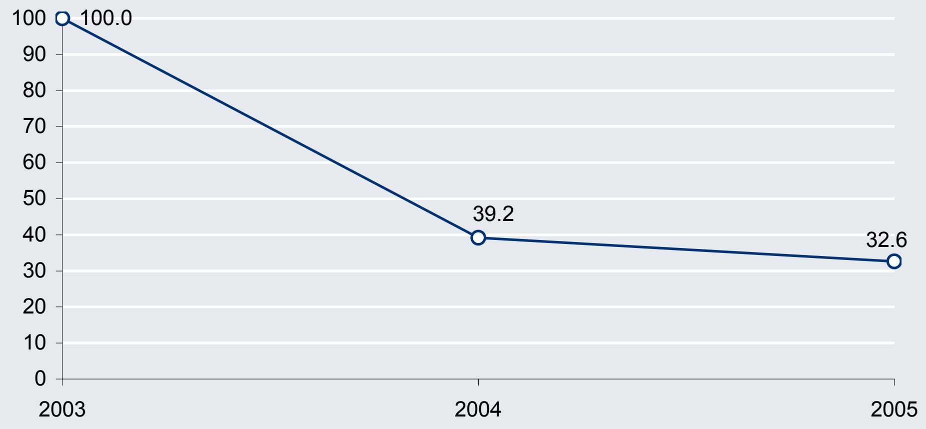
Net interest margin grew in 2005 from 7% to an impressive 19.2%

- The net interest margin of NFC reached 19.2% in 2005 compared to 7% in 2004.

Funding

Equity

Fig 3 Equity ratio (% total assets)



Source: Company data

The bank is well capitalised: equity comprises 32.6% of total assets

In 2005, shareholders' equity comprised 32.6% of the total assets of NFC, which makes it one of the best capitalised banks in the Russian banking system.

Such a situation is a natural result of the fact that the company was recently created from scratch, as in 2003 equity capital was all NFC had on its balance sheet.

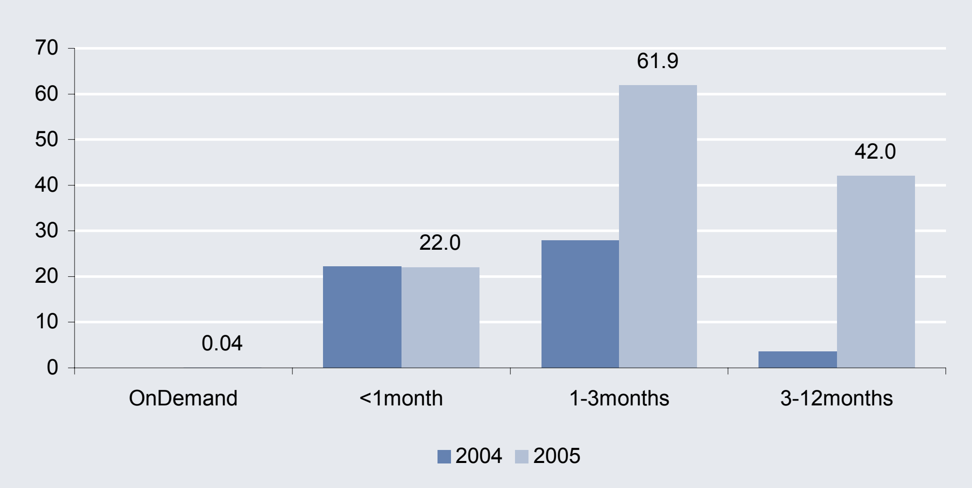
As a result, we expect the capitalisation to continue gradually falling in the coming years, but in its present state the bank is capable of raising more debt.

Debt

Debt raised by NFC is 99% bank loans

Amounts due to credit institutions currently comprise 99% of the funds raised by NFC to finance its operations apart from equity capital. In 2005, NFC's indebtedness to banks amounted to US$126m.

Fig 4 Term structure of debt (2004-05, US$m)



Source: Company data

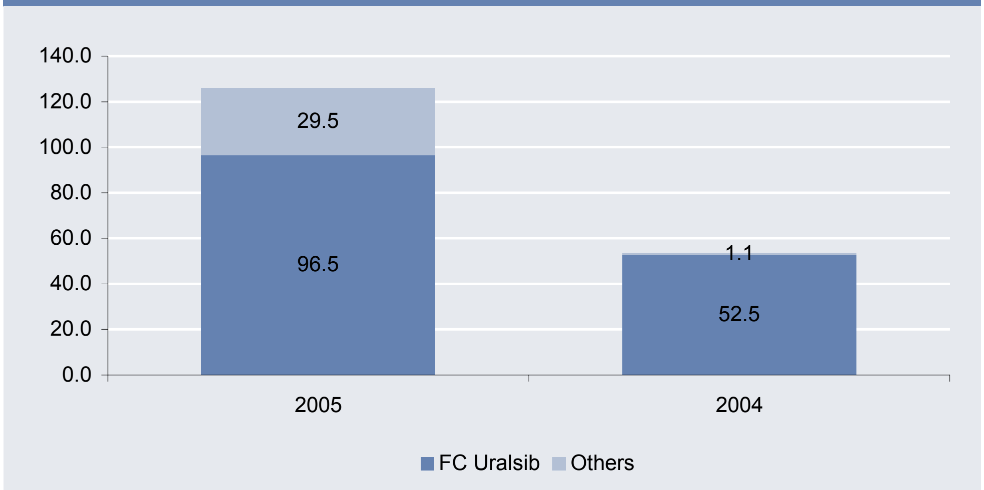
As can be seen, all the debt in both 2004 and 2005 was short term in nature with the maximum amount in the one-/three-month maturity range.

Related parties

76.5% of the provided loans were received by NFC from its related party FC Uralsib

Out of the total amount of debt raised by NFC by the end of 2005 (US$126m), US$96.5m or 76.5% was provided by a related party – FC Uralsib.

Fig 5 Debt distribution by source (US$m)



Source: Company data

On the other hand, in 2004 Uralsib's share in NFC's funding was close to 100%, so 2005 demonstrates a desire of NFC to diversify its funding sources.

The rest of the loans came from Standard Bank and Raiffeisen

The remaining part of the debt provided by parties other than Uralsib was raised from Standard Bank and Raiffeisen Bank in the form of rouble credit lines.

Furthermore, the plans of NFC to issue public rouble debt will also diminish the dependence of NFC on Uralsib in terms of financing.

Cost of funds too low

NFC borrowing rate was 3.75% in 2005, which is below risk-free market level

In 2005, the interest expense on NFC's bank loans totalled RBL69.6m, while average amount outstanding of these loans in 2005 was RBL2.55bn. Simply dividing the first figure by the second, we get 2.7% as a rough estimate of the average cost of NFC's funding. NFC's own data indicates that the average interest rate it paid on interbank loans was 3.75% – ie, a bit higher than our estimate. Nevertheless, both levels are inconsistent with NFC's own credit quality and general market conditions, as the risk-free NDF implied yields for 3-12 months (most popular terms for NFC's borrowings) fluctuated in 2005 in the range of 4-6%.

This means that NFC has been enjoying artificially good funding conditions on the side of Uralsib

This, in turn, means that Uralsib is charging NFC artificially low interest on its loans. On one hand, this is a positive factor providing NFC with additional profits. On the other hand, these unnaturally good conditions theoretically may cease to exist anytime and will disappear in the long run, at which moment NFC will be subjected to much tougher market funding conditions, which would significantly reduce its net interest margin.

We can roughly estimate that NFC's NI margin would have been at least 2.5-3.0% lower if it had funded its operations using market interest rates in 2005. Basically, this is the estimated direct benefit of having Uralsib as a related party.

Assets

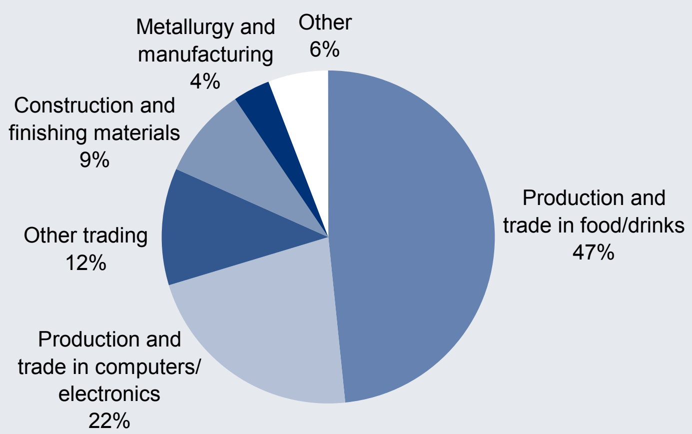
Being a dedicated factoring institution, NFC fully uses its funds providing factoring advances

The main part of NFC's assets is a book of short-term factoring loans (factoring advances), which in 2005 reached US$158m.

99% of the factoring loans in 2005 were provided by NFC with recourse to the client (ie, if the client's debtor does not pay an amount receivable assigned to NFC, NFC has the right to demand the remaining sum from the client after a certain period of time).

Average implied interest rate on factoring loans was in 2005 close to 21%.

Fig 6 Distribution of clients by industry (2005)

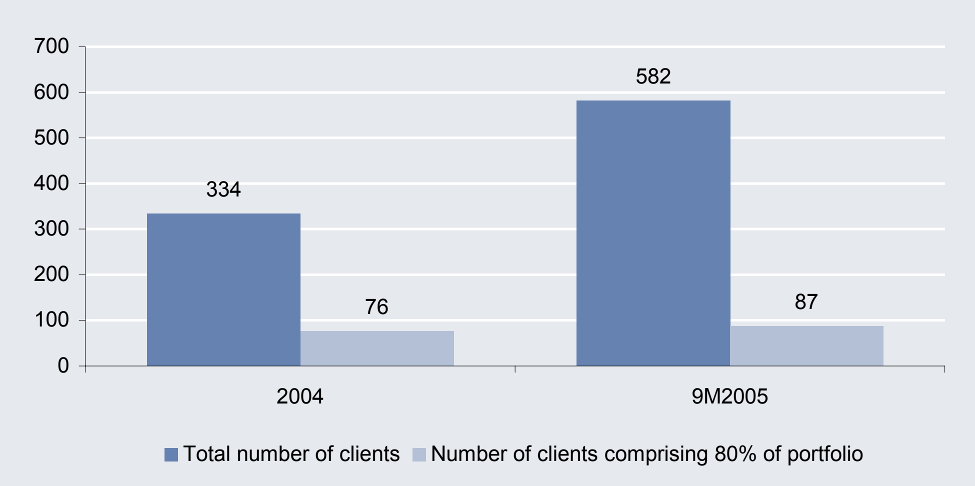


Source: Company data

The concentration of the factoring portfolio is high and is not diminishing

At the end of 2004, the amount of factoring advances to the ten largest borrowers comprised 30% of NFC's gross factoring portfolio. At the end of 2005, this percentage marginally declined to 29%. This fact reflects high concentration of NFC's factoring portfolio around top clients.

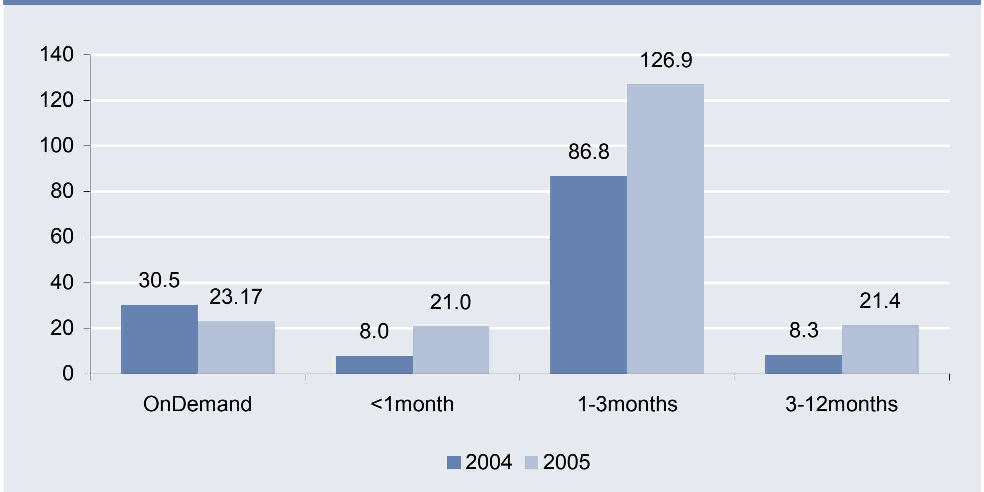
Fig 7 Number of clients



Source: Company data

Figure 7 shows that only 15% of the total number of clients comprised 80% of NFC's factoring portfolio in 2005. In 9M05, the total number of clients increased by 74%, while the number of top 80% clients grew only 14%, which also supports our thesis of the increased dependence of NFC on its top borrowers.

Fig 8 Term structure of assets (US$m)



Source: Company data

The majority of factoring advances are in the term range of 1-3 months

Figure 8 shows that the peak of NFC's assets in the term structure is also located in the one-/three-month range, matching the similar structure of NFC's liabilities.

Asset quality

In 2005, approximately 0.4% of the factoring portfolio was considered non-performing by NFC. None of the debt was considered bad and written off the balance sheet.

NFC reports 0.4% of its factoring loans as non-performing; none have been written off so far

Clearly, debt collection has not been the main concern of the bank, but in accordance with the Russian laws NFC maintains appropriate loan-loss reserve, which in 2005 amounted to 3.7% of the gross loan book.

Ratings

NFC was recently rated B-/stable by S&P

NFC was assigned rating B-/stable by S&P in December 2005. Below is an excerpt from the agency's release on the company.

> "The ratings on NFC reflect its limited customer diversification; relatively high concentration risks; heavy, albeit gradually decreasing, funding dependence on related parties; short operating history as a standalone entity, and the generally risky operating environment in Russia…
>
> The ratings benefit from NFC's leading market position in the domestic factoring sector, high capitalisation and profitability, and membership in a large diversified financial group, URALSIB Financial Corp.
>
> The stable outlook balances NFC's good commercial prospects against a weak funding profile and concentration risks.
>
> As the ratings already incorporate funding and customer diversification in the medium term, the potential for an upgrade depends on NFC's ability to strengthen its standalone credit profile and establish a track record for adequate capitalisation and profitability…
>
> If NFC is unable to grow and diversify its customer base or if its financial and credit profile markedly deteriorates, the ratings could be lowered or the outlook could be revised to negative.
>
> The ratings or outlook could also come under pressure if macroeconomic conditions worsen, leading to deterioration in core performance and an accumulation of risks in the factoring portfolio. Any negative credit developments at URALSIB FC would also pressure the ratings on NFC, because of its funding dependence on related parties. Reliance on related-party funding, as well as on other financial and strategic links with URALSIB FC, will likely decline in the future, however."

Company's goals for the future

NFC formulates its targets until 2008 in the following way:

- Achieve gross interest income of US$95m (now US$31m) and profit before tax of US$43m (now US$17m).
- Increase the number of clients to 1,300.
- At the same time, maintain the high return on assets on the background of mitigated risks.
- Become the largest factoring agent in the Central and Eastern Europe and remain the undisputable leader of the factoring market in Russia.

SWOT analysis

Fig 9 SWOT analysis

Strengths	Weaknesses
Support from a large related party (Uralsib group)	Dependence on financing from FC Uralsib (related party)
Successful team, present on the market already for seven years	High factoring portfolio concentration
Leading market position	Small scale as a standalone bank
High capitalisation	
Opportunities	**Threats/Risks**
The market for factoring services is expected to rapidly expand, linked to the quick development of Russian retail trade and the solid growth of the economy as a whole	Increasing competition is likely to reduce NFC's market share in the long run
Diversification of funding sources (including the new bond) will make dependence on related party financing less critical	Possible loss of parent support if future results do not meet expectations: NFC is not the core business of Uralsib group
Attraction of new clients is expected to lower the factoring portfolio concentration	Distantly possible deterioration of general economic conditions in Russia (significant GDP growth slowdown, etc)

Source: ING

New issue pricing

We believe the November 2005 Impex-3 issue is the best benchmark for NFC

On 10 November 2005, Impexbank placed its third RBL1.3bn bond Impex-3 with a yield 9.46% to put in 1.5 years.

We believe the primary placement of Impex-3 is the best benchmark for NFC for the following reasons:

- Impexbank was at the time a standalone commercial bank, as the announcement of its acquisition by Raiffeisen came several months later.
- Impexbank was (and still is) rated B-/B1/B- by S&P/Moody's/Fitch – ie, its credit rating is very close to that of NFC.
- The bank was (and is) expanding its retail financing business, which is not exactly, but still close, to what NFC is doing.

We believe that Impex-3's YTP of 9.46% for 1.5 years corresponds to approximately 9.15% for one year taking into account the slope of the yield curve between the two terms.

Since November 2005, one-year rates have shifted up 40bp

At the moment of Impex-3's placement, the one-year NDF yield was approximately 5.3%. Currently, the one-year NFD is 5.7% (+40bp). This means that if Impex-3 were to place now, it would be sold at roughly a YTP of 9.5% for one year.

In our opinion, NFC should trade at a premium to Impexbank because:

- NFC is significantly smaller than Impex.
- NFC's new bond is a debut one, so the bank will have to pay for the entry to the market.
- NFC is a relatively new entity, while Impexbank has long been well-known in the banking community.

We estimate the fair premium of NFC over Impexbank (in its November 2005 state) at 50-75bp.

We estimate the fair range of NFC's one-year YTP as 10.00-10.25%

As a result, we can conclude that fair range for the credit of NFC in the current market conditions is 10.00-10.25% for one year.

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Outperform: expected 1-year total return that modestly exceeds the 1-year expected total return of the relevant market.

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