

## URSA Bank: A bear grip on the market

- **Background.** Novosibirsk-based URSA Bank<sup>[d]</sup> is the result of a merger between Sibacadembank and Uralvneshtorgbank which took place in Dec 2006. URSA is one of the leading regional players in Russia, with a formidable franchise in its Siberian and Urals home federal districts (SFD and UFD, respectively).
- **Ownership.** The bank is controlled by a group of Russian entrepreneurs, most of whom are career bankers, led by Igor Kim. Foreign shareholders (EBRD, DEG and Clariden) hold more than 28% of the bank. The relationship between the major foreign and local shareholders and the bank are governed by shareholder agreement.
- **Business model.** The bank is a full service financial institution with a primary focus on consumer and SME lending.
- **Market positioning.** The bank is the second-largest player after Sberbank in SFD. In UFD the bank is in the top five, but faces much stronger competition from local banks.
- **Capital adequacy.** In our view, the bank's capitalisation is marginally acceptable, given that a high proportion of its capital is in the form of hybrid instruments (preferred stock) and subordinated debt, while a large proportion of equity is tied up in goodwill.
- **Rapid growth accentuates asset quality risks.** The bank grew very rapidly both organically and through acquisitions by taking over UVTB. Such strategy exacerbates asset quality risks already inherent in the rapidly growing Russian banking sector.
- **Asset quality is mixed.** While the quality of the bank's corporate loan book is quite robust, its retail portfolio displays a much higher, but not critical, level of delinquencies. Having said that, we expect its portfolio to become somewhat less risky in the future, on the back of a shift to a larger share of lower-risk loans.
- **Portfolio is more granular than on average.** Its top-20 lending exposures accounted for 10.6% of the bank's loan portfolio at YE06. This level of concentration is markedly lower than for a typical Russian bank and stems from the bank's focus on SME and retail lending.
- **Performance.** URSA is quite profitable, on the back of healthy margins and improving efficiency. The bank's performance going forward will likely be negatively affected by the margin pressure but also underpinned by rising revenues from cross-selling and a stronger emphasis on efficiency.
- **Liquidity and funding.** The bank's growth over the past few years has been largely asset-driven. This growth could not have been funded solely by deposits and therefore the bank established access to (and increased its dependence on) various wholesale funding sources which could become expensive and volatile at inauspicious times.

	1Q07*	2006	2005
Total assets (as reported)	4,471	4,239	998
Net loans	3,019	2,560	693
Net income (as reported)	22	54	18
<b>Capital adequacy</b>			
Equity (as reported)	593	570	99
Equity (net of goodwill)	344	324	156
Tier I ratio	8.9%	10.1%	11.7%
<b>Asset quality</b>			
Overdue loans % Loans	5.8%	5.6%	3.0%
NPLs % Loans	3.8%	3.5%	n.a.
Provisions/Loans	4.1%	4.2%	1.6%
<b>Liquidity</b>			
Loans/Deposits	202.9%	184.7%	142.8%
Loans/Total assets	67.5%	60.4%	69.4%
Wholesale funding/liabilities	55.3%	44.5%	41.4%
<b>Profitability and efficiency</b>			
Net interest margin (adjusted)	8.7%	10.1%	9.5%
Costs/Average assets	5.6%	6.5%	4.7%
Efficiency ratio	54.2%	49.4%	61.8%
RoAA (adjusted)	2.3%	2.7%	2.8%
RoAE	26.4%	28.6%	30.8%

\*figures annualised where appropriate

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# Investment summary

## Credit profile

URSA Bank is one of the largest regional banks in Russia, which as of 1 Apr 2007, ranked 20<sup>th</sup> in terms of total assets (\$4.47bn under IFRS), according to *Interfax*.

URSA Bank was created on the basis of Sibacadembank (SAB), with a hub in Novosibirsk, which took over Yekaterinburg-headquartered Uralvneshtorgbank (UVTB) in Dec 2006. This merger went relatively smoothly, given the banks' strong similarity in corporate cultures, but a full business/operational merger has yet to be fully completed. URSA Bank is the second-largest bank (after Sberbank) in the Siberian Federal District and one of the largest banks in Urals. The UFD and SFD are home to 22 of Russia's regions, accounting for approximately 40.5% of Russia's physical territory and 33.4mn inhabitants as of 31 Mar 2007. URSA Bank had 21 regional headquarters and 239 branches, four representative offices, 360 ATMs and approximately 10,000 employees as of 31 Mar 2007. The bank's future strategy envisages the better utilisation and optimisation of the existing network.

Both SAB and UVTB had a significant shareholder in common: Igor Kim, a career banker, who in 2002-2004 served as chairman of the board and as a member and a chairman of the board of directors of Bank Caspian (Kazakhstan). We believe that Kim is a major mastermind and driving force behind the bank's transformation into one of the regional leaders. His business partners (Alexander Taranov, Andrey Bekarev and others) also have an excellent grasp of the banking business, which makes the company one of the most well-run regional (and national) banks in Russia. The bank's strategy is also steered by experienced foreign shareholders (EBRD, DEG and Clariden), which play a very active role on its board of directors. Although the bank is run by a professional management team, the presence of committed shareholders with a solid understanding of the banking business is a strong underpinning factor.

SAB's expansion over the last three years was strongly asset-driven, with its market share growing dramatically from a very low base. The company was actively extending unsecured consumer loans in most of the regions in which it maintained a presence. Such loans have very high yields but also carry much greater risks, which are reflected in a relatively-high NPL ratio in this portfolio segment. We think, however, that the risks inherent to the bank's retail portfolio will gradually come down in the future for the reasons outlined further on in this report. In addition, in our view, the bank holds adequate reserves for loan impairment, which cover identified problem loans.

The bank's exponential growth warrants periodic capital injections. In order not to create dilution, the bank is quite aggressive in issuing capital instruments without voting rights (such as preferred stock). Such instruments are hybrids and have features of both equity and debt. Their further excessive use could negatively alter the perception of the quality of the bank's capital, both by investors and by rating agencies. As a mitigating factor, the latest issue of preferred stock, which netted the bank more than \$400mn, carries a relatively low minimum dividend rate (about 3.86% per year vs 9% per year for the previous issue). Therefore focus on pure equity injections will increase in the future, which could prompt the bank's shareholders to consider an IPO or strategic sale in the not-too distant future.

# Strengths and weaknesses

## Credit strengths

- One of the strongest Russian regional banks, with a well-established franchise and a good chance to defend its position in its home markets
- Partial foreign ownership (over 28% held by EBRD, DEG and Clariden) brings on board valuable institutional investors expertise
- Strengthening corporate governance
- Increasing emphasis on lower-risk lending products may help to de-risk the portfolio, albeit at the expense of lower margins
- Higher-than-average portfolio granularity
- Sound profitability and satisfactory liquidity position

## Credit weaknesses

- Exponential growth causes concern over future asset quality once the portfolio seasons and credit cycle turns down
- New entrants into the bank's traditional markets (as well as regulators) could change the competitive landscape to the detriment of the interest margins and/or cause the bank to assume more risk
- The vulnerability, albeit limited, of the bank's asset quality and liquidity to external shocks at the national or regional level
- The relatively high level of delinquencies in the unsecured consumer lending book, which are, however, well provisioned
- Asset-driven growth increases the bank's reliance on confidence-sensitive wholesale funding sources
- Relatively tight capital adequacy with a rising share in the capital of hybrid instruments

# Peer group comparison

URSA Bank, as a strong player in two large federal districts, is unique in Russia: Most of the other large regional banks typically belong to a single republic or region. Hence there are almost no regional banks in Russia which could compare with URSA Bank in terms of geographical coverage. Keeping all these caveats in mind, we have selected Kazan-based Ak Bars, together with Moscow-based Rosbank and Uralsib as the bank's closest peers. Our peer-group comparison is summarised in Figure 1.

Figure 1: Peer group comparison

Bank/Indicator	URSA	Ak Bars	Uralsib	Rosbank
Rating (S&P/Moody's/Fitch)	nr/Ba3/B	nr/Ba2/BB-	B+/Ba3/B+	B+/Ba2/B+
Reporting date	YE2006	YE2006	YE2006	YE2006
Reporting standards	IFRS	IFRS	IFRS	IFRS
Total assets	4,239	3,865	11,606	11,159
Equity	570	886	1,742	1,066
Equity ratio	8.1%	22.9%	15.0%	9.6%
Tier 1 ratio	10.1%	16.9%	13.8%	12.1%
Problem loans/ Gross loans	5.6%*	1.04%**	na	3.2%
Net interest margin	10.1%	4.9%	5.0%	7.0%
RoAA	2.7%	1.8%	1.5%	1.5%
Costs/Avg. assets	6.5%	2.6%	4.9%	5.2%
Loans/Deposits	192.7%	139.6%	86.1%	78.8%

\* - includes all overdue loans (even if they are overdue for just one day) \*\* - as of 1H 06

Source: IFRS reports, Fitch Ratings, Renaissance Capital estimates

While we believe that URSA Bank's majority shareholders do not have very deep pockets<sup>1</sup>, the bank has succeeded in growing much faster than the market, quickly ascending to the Top 20. We think that URSA Bank exhibits a lot of attractive features vs Ak Bars, Uralsib and other larger regional banks. It is not as anchored to one region (as Ak Bars is) and could expand further geographically. It does not depend on regional authorities, as many other prominent regional banks do. In addition, it enjoys good recurring profitability which Uralsib, for example, is seriously lacking. All in all, we consider URSA Bank to be one of the most promising regional growth stories.

We note, however, that URSA Bank's rapid growth has somewhat stretched its resources. We believe that URSA Bank operates with the lowest level of core capital (a significant part of its capital is tied up in goodwill arising from the acquisition of UVTB) and has the weakest loans-to-deposits ratio among its peers, which is a sign of structural imbalance<sup>2</sup> that arise when substantial external borrowing is required to fund rapid growth. Nevertheless, the bank partially overcame the latter problem, creating a well-matched balance sheet in terms of maturities.

URSA Bank's disclosure of NPLs is the best, compared with its peer group. The bank made its reporting of NPLs more rigorous by switching from reporting based on an overdue portion of the loans to whole-balance reporting. The level of detail is also fairly high, and includes the age of overdue loans. While the NPL statistics are not comparable for all banks, we can still conclude that URSA Bank has the highest

<sup>1</sup> - Ak Bars is essentially controlled by the government of Tatarstan; Rosbank and Uralsib are controlled by wealthy Russian businessmen. We believe that URSA Bank's Russian shareholders have much more limited resources to support the bank's development.

<sup>2</sup> - We regard loans-to-deposits ratios not exceeding 100% to be at a much more comfortable level

level of NPLs stemming from the extent of its penetration into unsecured consumer lending, which does not preclude it from being the most profitable<sup>3</sup>.

The bank's reliance on wholesale funding is the highest among banks in its peer group. We believe that this situation won't improve dramatically in the foreseeable future, making the bank's liquidity situation more precarious under adverse scenarios.

On the other hand, URSA Bank demonstrated the widest net interest margins, driven by its share of high-yield loans to individuals (the largest among its peers). The bank's efficiency ratios have been improving, but still have significant room for improvement. We think improvement is possible, given the bank's increasing focus on cross-selling, automation and network optimisation.

Overall, we think that URSA Bank has good potential to remain among the market leaders, while continuing to demonstrate solid financial fundamentals.

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<sup>3</sup> - the expense of the higher risks it runs

# Background and ownership structure

Sibacadembank (renamed URSA Bank in Dec 2006) was established as a commercial bank and registered with the CBR in 1990. Russkiy Narodniy Bank (Russian People's Bank Ltd) and Kuzbass Transport Bank acceded to Sibacadembank in 1998 and 2001, respectively. In 2001, Sibacadembank acquired a controlling interest in OJSC Dalvneshtorgbank (now called OJSC Vostochny Express Bank, literally 'Orient Express Bank') in the Russian Far East, which it subsequently divested in 2004. In 2003, Sibacadembank acquired 100 new ATMs from Wincor Nixdorf International GMBH, Germany. In 2003, Sibacadembank also acquired a 57.8% stake in the Western Siberian Insurance Company, ZHASO for RUB33.8mn, which URSA Bank holds principally as a financial investment and with which URSA Bank has a non-exclusive business relationship. On 22 Dec 2006, URSA Bank acquired all of the outstanding shares of Uralvneshtorgbank via the conversion of Uralvneshtorgbank's shares into shares of Sibacadembank, and Sibacadembank subsequently changed its name to URSA Bank.

In addition to actively working with international commercial banks, URSA Bank has worked closely with certain large International Financial Institutions (IFIs) during the past four years. In 2003, the EBRD provided a \$3mn loan to Sibacadembank to use in microlending and SME lending. In 2004, the EBRD increased this loan to an aggregate of \$13mn, and provided a separate \$3mn trade finance facility to Sibacadembank. In 2004, Sibacadembank entered into a five-year, \$7mn loan agreement with the International Finance Corporation (IFC) and in Jan 2005 Kreditanstalt für Wiederaufbau (KfW) extended a seven-year, \$6.1mn credit facility to Sibacadembank for lending to SMEs. In 2005, the IFC extended a five-year, \$6mn subordinated loan to Sibacadembank for the purpose of increasing Sibacadembank's capitalisation.

DEG and Clariden became shareholders of Sibacadembank in Dec 2005 and EBRD increased its equity investment in Sibacadembank to 28.44%.

On 17 May 2006, a joint meeting of Uralvneshtorgbank's supervisory board and Sibacadembank's board of directors was held to discuss a potential combination between Uralvneshtorgbank and Sibacadembank. At the joint meeting, the supervisory board of Uralvneshtorgbank and the board of directors of Sibacadembank approved the concept of a combination and certain parameters regarding the proposed terms of the merger, including the relative values of the ordinary and preferred shares of Uralvneshtorgbank and Sibacadembank in connection with the combination.

In Sep 2006, the extraordinary general shareholders' meetings of both Sibacadembank and Uralvneshtorgbank approved the combination, together with the accession agreement and other relevant documentation necessary to formalise the combination.

On 22 Dec 2006, Sibacadembank completed its acquisition of all of the outstanding shares of Uralvneshtorgbank, pursuant to which the ordinary and preferred shares of Uralvneshtorgbank were converted into ordinary and preferred shares of Sibacadembank, respectively.

URSA Bank determined the cost for the acquisition of Uralvneshtorgbank by referring to the valuation of the Uralvneshtorgbank shares that were exchanged for the newly issued ordinary and preferred shares of URSA Bank. URSA Bank valued the Uralvneshtorgbank shares on the date of acquisition at RUB8,659.0mn. URSA

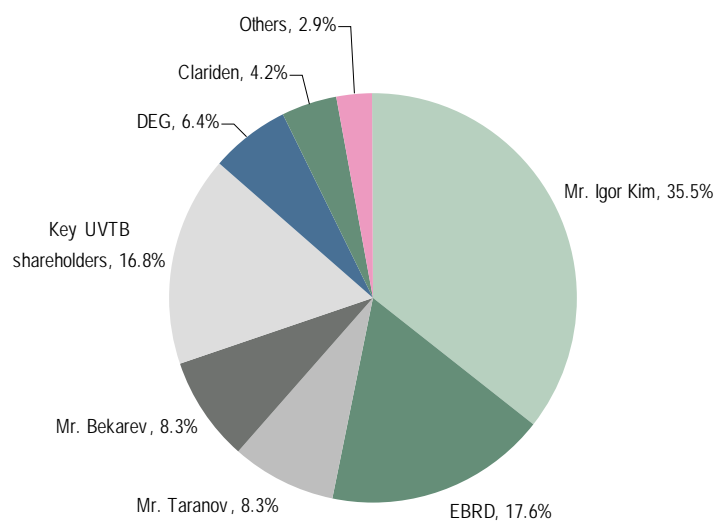
Bank recorded the fair value of Uralvneshtorgbank's net assets as of the date of acquisition at RUB2,164.7mn and recorded goodwill of RUB6,494.2mn.

Sibacadembank and Uralvneshtorgbank each had a large network of branches in different regions of the Russian Federation. Sibacadembank had a large branch network in the SFD and Uralvneshtorgbank had a large branch network in the UFD. The Sibacadembank and Uralvneshtorgbank networks were contiguous, but non-overlapping. This regional diversification is expected to provide the combined bank with a larger market for its corporate and retail banking products, synergies in the distribution and promotion of its products and greater insulation from economic downturns in any one region. In its core banking markets of the SFD and the UFD, URSA Bank is the second-largest bank in terms of total assets behind Sberbank. However, URSA Bank has overtaken Sberbank in its core Novosibirsk region, where it is the leading bank when measured by total assets.

Although the legal procedures relating to the combination of Sibacadembank and Uralvneshtorgbank were completed on 22 Dec 2006, there are a number of outstanding matters related to the merger that must be resolved during 2007, including the unification of product ranges and product terms, the implementation of consistent deposit taking and loan extension processes and requirements, uniform employment policies, the transition to a unified IT platform with a singular processing centre and database storage system for URSA Bank's network in the UFD and SFD and the completion of the rebranding campaign.

URSA Bank is controlled by a group of individuals (most of whom are long-standing business partners) along with institutional foreign investors (EBRD, DEG and Clariden) which jointly hold more than 28% of the bank's capital. The bank's voting power is distributed as shown in Figure 2.

Figure 2: URSA Bank: Distribution of voting power



Source: Company data

The bank's board of directors currently comprises 11 members, including three representatives of foreign shareholders and two independent directors. The bank has strategic, audit and compensation committees but does not currently have a risk committee. We believe that foreign shareholders are not just passive investors but are rather actively involved in the bank's strategic management, and provide other forms of support.

In our view, URSA Bank's ownership structure represents a fair mix of local and international interests, and is creditor-friendly. Although the bank's Russian shareholders hold a majority of shares, they do not have a supermajority on the bank's board, signifying that are receptive to the influence of their strategic partners and independent directors.

# Strategy

URSA Bank's strategy is to continue its development as a full-service, universal bank offering corporate and retail services in its core regions of the UFD, the SFD and the Russian Far East. URSA Bank plans to increase its share of both the corporate and retail market in order to maintain its position as the largest bank after Sberbank in its core regions and to become one of the 10 largest banks in Russia in the medium-term. We view these targets as achievable, even in the face of toughening competition.

The bank's future strategy consists of the following major elements:

**The cross-selling of retail products to existing customers.** URSA Bank's retail customer base, including current customers and customers who have used URSA Bank's services in the past, consists of 2.8mn people and is one of URSA Bank's main competitive advantages. While in previous years URSA Bank's retail strategy focused almost entirely on attracting new customers to URSA Bank, going forward URSA Bank is placing significant emphasis on selling new products to individuals with whom URSA Bank already has a relationship. Given URSA Bank's deeper understanding of these clients' potential needs and credit history, cross-selling to them is expected to result in better product targeting and loan portfolio quality improvement. In addition, URSA Bank plans to expand its retail business by cross-selling products to the employees of its corporate clients.

We believe that if the bank were to attain success in cross-selling, it will be able to realise economies of scope and increase revenue per customer. This could serve as an offset against falling margins in the lending business.

**The rebalancing of the retail loan portfolio towards lower-risk products.** Prior to 2006, the rapid growth of URSA Bank's retail loan portfolio was achieved mainly through the extension of consumer finance loans and, to a lesser extent, car loans. Starting in 2006, URSA Bank shifted its focus towards lower-risk retail credit products such as mortgages, car loans and credit card loans. This strategy has resulted in a significant change in the mix of URSA Bank's retail loan portfolio. For example, as a percentage of URSA Bank's overall retail loan portfolio, the share of consumer finance loans decreased from 85% as of 31 Dec 2005 to 75% as of 31 Dec 2006, while the share of mortgage loans has increased from 1.1% as of 31 Dec 2005 to 17.1% as of 31 Dec 2006. In developing its mortgage lending business, URSA Bank plans to continue to take advantage of its leading regional presence in the SFD, as URSA Bank is often the only bank offering mortgage loans in a particular region or locale.

We believe a shift towards lower-risk products could become a very welcome driver of portfolio de-risking. On the other hand, we believe it could become problematic to find borrowers with sufficient savings for a down payment. If the segment of potential borrowers with sufficient savings were to become saturated faster than expected, URSA Bank may have to drop down payment requirements for mortgage loans (typically 10-20%), thus lowering the quality of new originations.

**Expansion of credit product range for corporate clients.** URSA Bank is continuing to develop new credit product lines, which are designed to attract new corporate customers and to increase revenues from existing corporate customers. In response to demand from its customers, in 2006 URSA Bank launched several new products such as project finance, leasing and mezzanine financing. URSA Bank believes it can achieve higher margins on these operations than from its traditional

banking products. The new product offerings are expected to facilitate the growth of its corporate loan portfolio and to enhance margins without compromising credit quality.

We believe that this is a very promising and potentially rewarding segment, but we hope that the riskier activities will be capped and their risks kept under control.

**Lending to SMEs.** URSA Bank has been actively lending to SMEs since 2003 and plans to continue to grow its SME lending business. SME lending is one of the fastest-growing segments of URSA Bank's corporate business, and it is an area where management believes URSA Bank's local presence and expertise provide it with a clear competitive advantage. Since launching its various SME programmes, URSA Bank has developed considerable expertise in SME lending and plans to take advantage of the relatively limited competition in this segment in its core regions. As of 31 Mar 2007, URSA Bank had a total of 12,000 SME borrowers and a total SME loan portfolio of RUB5,555.7mn (6.8% of the total portfolio).

We view SME lending as an important avenue for further portfolio diversification and yield enhancement without a disproportional rise in risks.

**Maintenance of a balanced and diversified funding base.** URSA Bank's funding strategy is to access and maintain sustainable and cost-effective sources of funding. URSA Bank aims to combine the stability and cost effectiveness of a large deposit base with the flexibility of capital markets-based financing. As part of this strategy, URSA Bank aims to continue to increase its customer deposit base, which accounted for 38.4% as of 31 Mar 2007 (37.8 % of total liabilities as of 31 Dec 2006). Specifically, URSA Bank sees growing opportunities to attract funds from new and existing corporate clients. Recognising that the principal source of corporate deposits in the Russian banking market are typically large, Moscow-based corporations, URSA Bank has established a branch in Moscow which is responsible for attracting deposits and other business from large corporate clients with surplus liquidity. At the same time, URSA Bank intends to capitalise on its past two years of successful fundraising activity in the domestic and international capital markets. This it plans to do by continuing to obtain: i) Short- and medium-term financing in the rouble bond market through the issuance of rouble bonds and promissory notes; and ii) medium-term senior and subordinated debt financing through its corresponding banking relationships, through international syndicated loan and debt capital market financing, and by refinancing portions of its mortgage and car loan portfolios through securitisation programmes in the international capital markets.

We think that the increased focus on the cost and diversity of funding, as well as on relationship issues with large depositors, will help to combat shrinking margins and supply the bank with more affordable and predictable resources.

**Measured expansion of the distribution network, with increased focus on efficiency.** URSA Bank's distribution network plays a critical role in expanding its customer base in the retail and SME segments, which are of particular strategic importance. In a rapid network expansion during 2006, URSA Bank opened 54 new branches, of which 28 were opened by Uralvneshtorgbank and 26 were opened by Sibacadembank. As of 31 Mar 2007, URSA Bank's distribution network comprised 239 branches and 360 ATMs. With an average retail loan balance per branch of RUB120.9mn as of 31 Dec 2006, URSA Bank's branch network is one of the most efficient among retail-oriented banks in Russia. While URSA Bank plans to continue

to expand its branch network in the future, it will also place more emphasis on improving the efficiency of its existing network, which is expected to lead to more selective branch openings and the closure of inefficient branches. As a result, URSA Bank expects more moderate growth in its branch network in 2007 than in previous years. URSA Bank also aims to outsource certain functions it currently carries out in-house (such as collections) with the goal of improving operating performance.

We believe that efficiency-enhancing measures will be indispensable in the face of growing competition and mounting pressure on the interest margins.

**Evaluation of growth opportunities through acquisitions.** We expect URSA Bank to continue to evaluate opportunities as they arise, to expand into new regions of Russia, and/or to enhance its positions in its existing markets through potential acquisitions, mergers or other forms of strategic alliances. Any contemplated acquisition will have to meet strict evaluation criteria in terms of shareholder value and strategic rationale.

We consider the merger of Vostochny Express Bank with URSA Bank to be one of the bank's most significant issues, and will help to strengthen the bank's positions in the Russian Far East. Since the bank's major shareholder (Kim) owns stakes in some other banks in the European part of Russia, we cannot rule out that URSA Bank may finally transcend its traditional home boundaries and become a national player. If this happens, its ultimate success will depend on the ability of management to do business in more over-banked Russian regions.

# Financial analysis

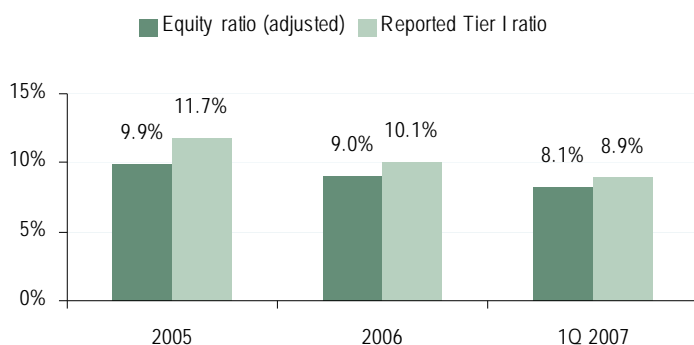
As we've already mentioned, on 22 Dec 2006, URSA Bank completed its acquisition of the outstanding shares of Uralvneshtorgbank (UVTB). For the purpose of the preparation of URSA Bank's IFRS financial statements as of and for the year ended 31 Dec 2006, the acquisition of UVTB has been accounted for using the purchase method of accounting, as of the date of acquisition.

While URSA Bank's YE06 balance sheet readily consolidates the assets and liabilities of UVTB, its consolidated income statements only reflect UVTB's financial results for the last week of the year. Therefore, unadjusted financial ratios would create certain distortions on the income statement and balance sheet figures. In particular, the net interest margin and return on average assets of the combined bank for 2006 will be understated. There are two major ways in which these ratios may be analytically adjusted. The first analytical approximation would be to combine the banks' balance sheets for the previous years while incorporating UVTB's standalone income statement into the financial results as if both banks existed as a single reporting entity before 22 Dec 2006. This method should produce results that are more or less comparable and consistent with the results going forward from the date of combination (and therefore would be superior). Another method is to strip off UVTB's 'new' Uralvneshtorgbank assets and liabilities from the YE06 consolidated balance sheet and to calculate ratios for former Sibacadembank only. We have calculated most of our profitability ratios by applying the first method, which involves some degree of subjectivity and analytical approximation.

## Capitalisation

Rapid asset growth over the past few years has put the bank's capital ratios under significant strain. However, the bank has managed to maintain capital adequacy ratios that are compliant with regulation and its debt covenants, thanks to capital contributions – mainly from preferred stock (we view it as a hybrid capital which combines the features of equity and debt), as well as by raising subordinated debt which qualifies as Tier II capital.

Figure 3: URSA Bank: Capital ratios<sup>4</sup>



Source: IFRS reports, Renaissance Capital estimates

<sup>4</sup> - The bank's equity ratio was adjusted as follows. First of all, goodwill was taken out of both equity and total assets. Second, we adjusted the bank's total assets for a currency swap, accounted for on the balance sheet.

The takeover of UVTB was a stock-only transaction. UVTB has been valued using a number of assumptions and the goodwill on this business combination amounted to about \$250mn or 42% of the bank's equity as of 31 Mar 2007, which considerably reduces the bank's core capital and hence its financial flexibility. We know that the bank has resorted to further preferred stock issuances in 2Q07 to augment its capital base in a manner which does not dilute ownership. As a result, the bank raised \$400mn and the minimum dividend was set at a rate of approximately 3.86% of the issuance price, which makes it more closely resemble a common stock when compared with the previous issue, which featured a 9% minimum dividend requirement. Still, we believe the bank's combination of the heavy use of hybrid instruments in its capital base with its high immobilisation of capital (in goodwill and fixed assets) results in a marginal capitalisation as one of the bank's main areas of weakness.

Figure 4: URSA Bank: Uses of shareholders' equity



Source: IFRS reports, Renaissance Capital estimates

### Asset quality and portfolio diversification

The bank's asset base grew very rapidly over the last few years across all major parts of the portfolio. Therefore, asset quality is one of the focal points of our analysis.

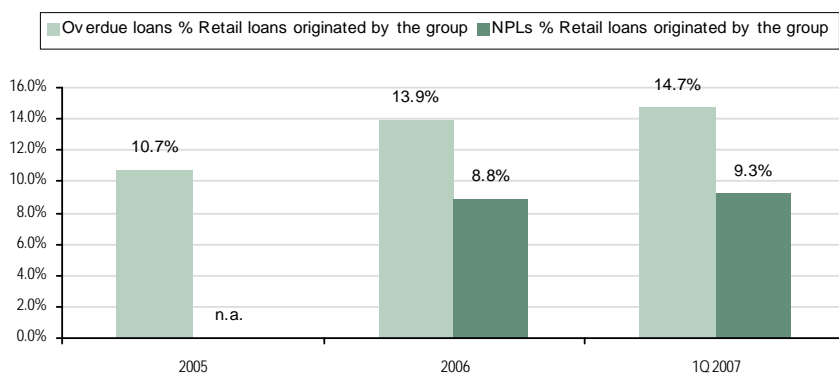
The bank's portfolio is almost equally divided between corporate loans (including project financing, loans to SMEs and financial leases) and loans to individuals (commonly referred to as retail loans). The bank views this mix as an optimal one which does not overexpose it to any one particular segment.

Retail lending could be further split into loans originated by the bank and loans acquired from other banks (mostly the bank's affiliate, Vostochny Express Bank). Such loans continue to be serviced by originators, which pass on interest payments to URSA Bank but keep monthly commissions. The quality of purchased portfolios is impressive on the back of limited recourse (in the form of guarantees with a topping-up feature) to the originating banks, which provides a good layer of defence.

The definition and way of measuring non-performing loans (NPLs) underwent certain changes recently. Until the 2006 interim financials, Sibacadembank (URSA's predecessor) had been disclosing as overdue only missed instalments as opposed to the whole loan balances, which created a notable difference – especially in the case of amortising loans, where instalments are widely spread out over time (such as consumer loans). Since 2006, the bank has switched to disclosing the whole balance as overdue, even though only one instalment may have been actually missed. The aggregate number of such loans became a proxy for NPLs, regardless of the delinquency stage. Since 31 Mar 2007, the bank has fine-tuned its approach and started reporting the ageing of overdue loans with only the portion overdue for more than 90 days considered as non-performing.

Our analysis indicates that unsecured consumer loans originated by the bank are a major driving force behind and contributor to the growth in bank's NPLs. We think that the portfolio will start to become less risky gradually, as the bank proceeds with increasing its share of lower risk products (such as mortgages).

Figure 5: URSA Bank: Quality of retail loans originated by the bank



Source : IFRs reports, Renaissance Capital estimates

The level of NPLs is high, but we believe that it is not materially out of line with the delinquency expectations of a portfolio with a hefty component of riskier unsecured products. So far, these losses have been fairly well provisioned for, with provisions generously covered by the bank's combined net interest stream.

The situation in the portfolio of purchased loans is more benign, with a negligible level of NPLs, which we think is due to the fact that originating banks (mainly Vostochny Express) are doing their job pretty well, clearing delinquencies in accordance with guarantee arrangements.

The bank's corporate lending book, which comprises loans to SMEs, larger corporate loans, trade and project finance as well as leasing transactions, is much cleaner, with a level of impaired loans of about 1.3% (NPLs stood at 0.5%). Should the bank's corporate NPLs rise in the future due to portfolio seasoning, changes in the portfolio mix and underwriting standards, or less favourable economic conditions, we expect them to subsequently remain at a reasonable level.

We believe that the following factors will negatively affect the quality of the bank's loan portfolio going forward:

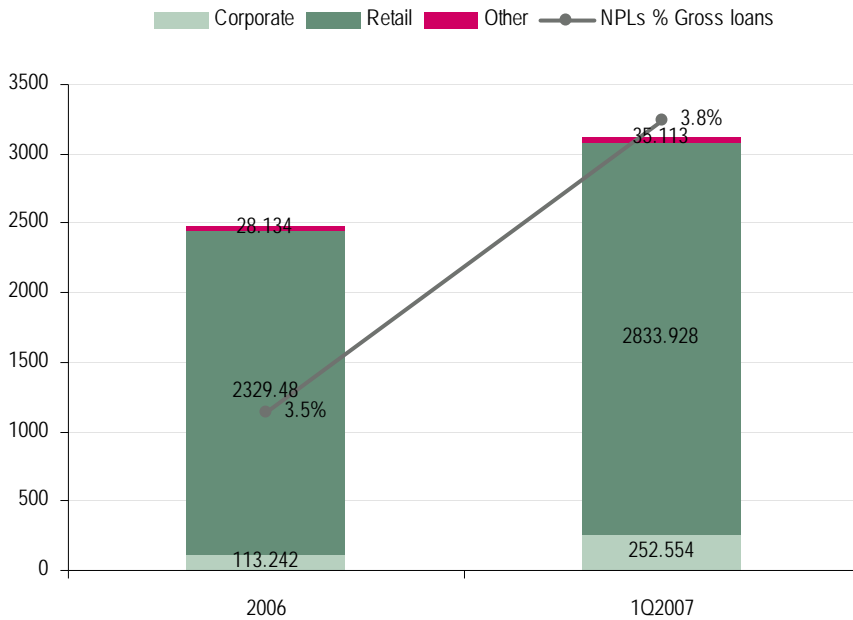
- Rapid growth will remain a key risk factor as it could negatively affect the quality of originations. Accordingly, such growth, if it were not properly managed, could lead to a meltdown in the bank's asset quality. We believe that the likelihood of such a scenario is very low since the bank has sufficient control mechanisms in place.
- Consumers will become more sophisticated and rising competition may result in the relaxation of underwriting standards and higher consumer indebtedness. Changes in legislation that dictate the introduction of personal bankruptcy procedures could increase individuals' propensity to default on their debts.
- The bank's portfolio of longer-term loans will go through a natural seasoning process with upward pressure on NPL levels.

While these factors will positively affect the quality of the bank's loan portfolio going forward:

- Consumer financing growth was to a large extent driven by the abnormally high level of margins, which were expected to generously cover NPLs. We think that going forward, most Russian banks, including URSA Bank, will become more risk-averse in light of declining margins.
- Retail loan book will see some de-risking on the back of the rising share of secured lending products. Even though this shift will be accompanied by an inevitable margin squeeze, it would also entail lower asset quality volatility.
- URSA Bank is in the process of completing the implementation of an automated credit risk scoring system from Experian-Scorex for unsecured retail loans. We think that this more formalised approach will facilitate the decision-making process within the bank and help to reduce delinquency levels in the future.
- The bank is going through a steep learning curve, and is gaining a better understanding of the behaviour of its customers. This process could help the bank develop the ability to identify customers with deteriorating creditworthiness.
- All in all, we see the general relaxation of underwriting standards in the market and the highly unfavourable changes in risk-reward ratios for loans as well as an abrupt and adverse change in the economic environment to represent the largest threats to URSA, as well as other Russian banks. Other than that, we expect URSA's asset quality to stabilise in the future.

Combined NPLs stood at 3.8% of the bank's total portfolio, slightly up from 3.5% at YE06. We realise that point-in-time NPL ratios are not very useful measures of the quality of rapidly growing and evolving loan portfolios. We, however, are not particularly concerned with the current, obtrusively high level of NPLs, as risk is only one part of the equation, and the bank's provisions so far appear high enough to absorb them. Having said that, while the bank's current interest margins leave certain room for error, this wouldn't necessarily be the case in a less benign operating environment.

Figure 6: URSA Bank: NPLs in separate parts of loan books and combined NPLs

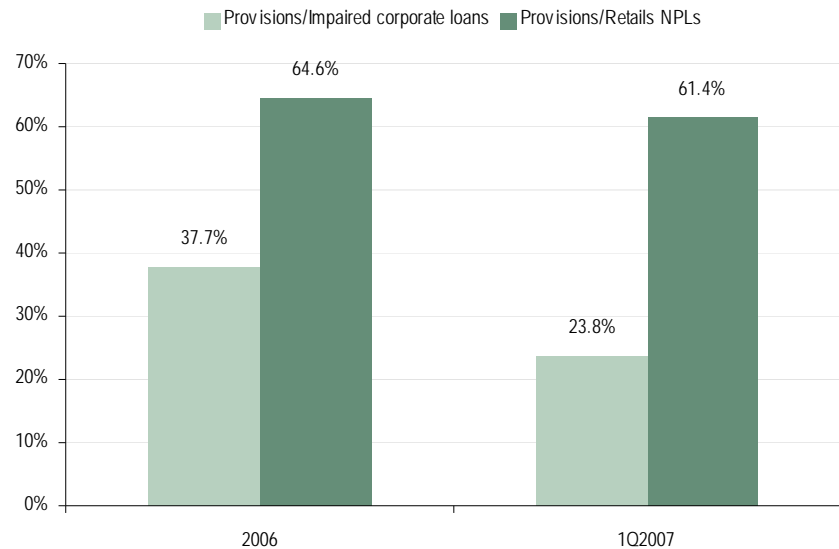


Source: Company data

Finally, we need to examine how conservatively the bank provisions for impaired loans.

The bank's aggregate provisions appear to adequately cover the bank's non-performing retail loans. Impaired corporate loans look to be more thinly covered; however, only slightly more than half of the company's impaired loans have been overdue for more than 90 days. Coupled with the availability of collateral for at least some loans, this implies greater recovery prospects than for delinquent loans to individuals, and hence a lower level of required provisions.

Figure 7: URSA Bank: Coverage of problem loans by provisions

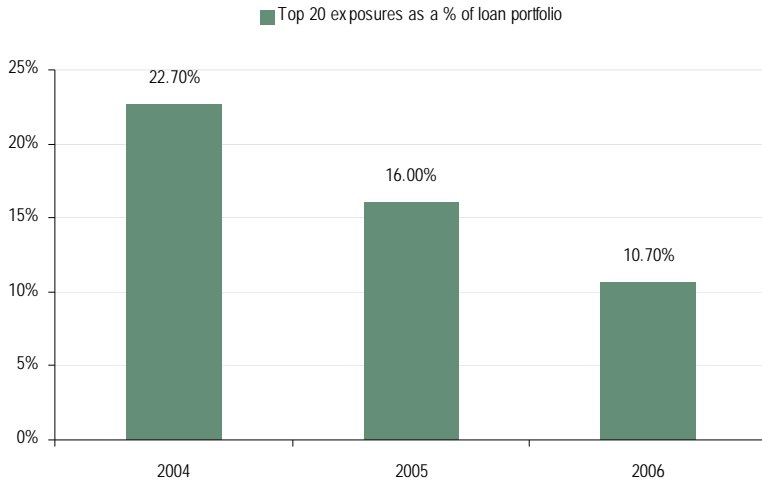


Source: IFRS reports, Renaissance Capital estimates

The bank's loan portfolio displays a very moderate level of single-party concentrations compared to most of its peers. We believe that the more granular portfolio is associated with the bank's focus on mid-market companies, SMEs and consumers.

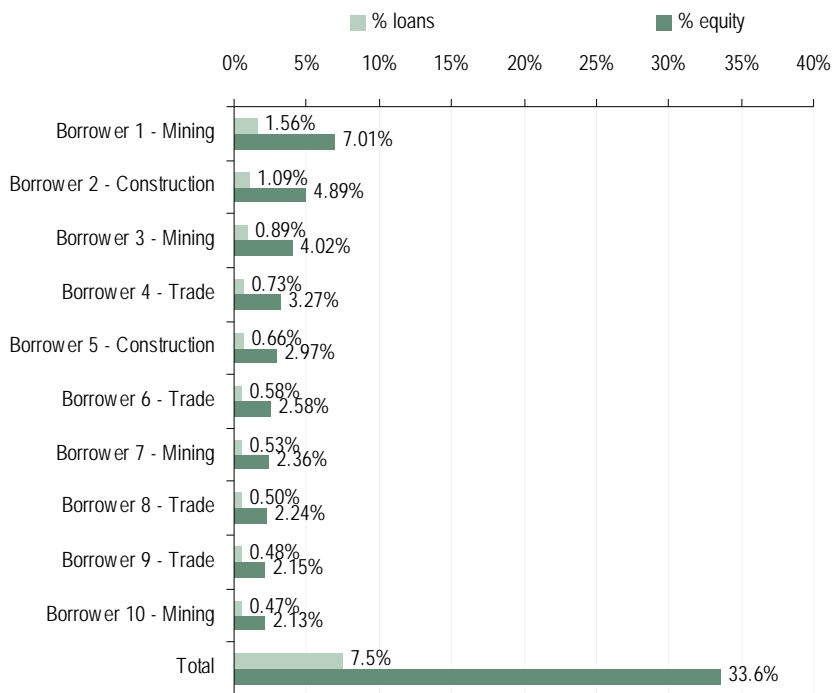
We note, however, that the largest exposures exclude a number of loans to finance (ie leasing) companies. The bank considers that its risks rest with pools of underlying assets which are financed and could be retrieved by the bank. Should these companies be included in the analysis, the level of concentration would go up, albeit not significantly.

Figure 8: URSA Bank – Single party concentrations (excluding loans to a number of finance companies) – Below average and on a downward trend



Source: Company data

Figure 9: URSA Bank – Breakdown of Top10 lending exposures (excluding loans to a number of finance companies – see above)

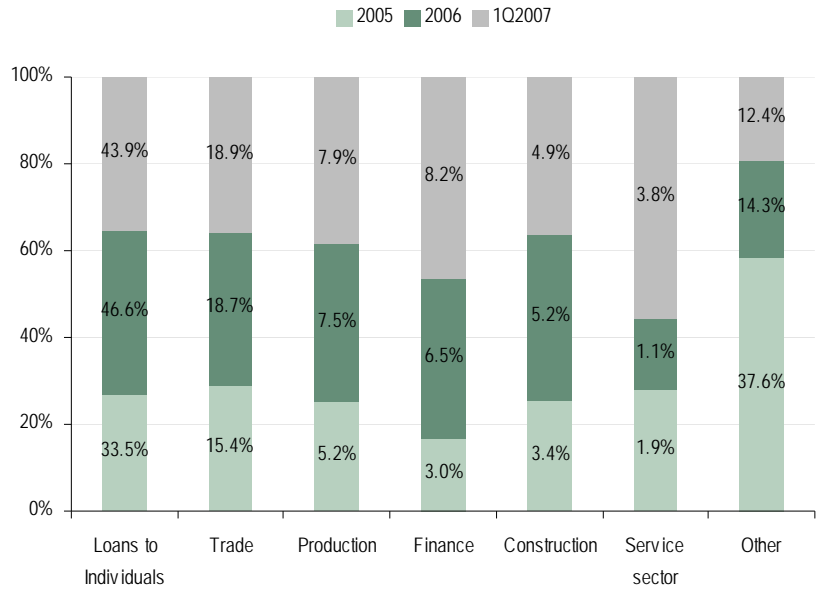


Source : Company data, Renaissance Capital estimates

On another upbeat note, URSA's portfolio is biased in favour of loans to individuals and trading companies. This renders the bank less vulnerable to the health of more cyclical sectors such as construction, and portfolio cash flows somewhat more predictable. The bank retains its regional concentration (although now, the scope of

its activities has expanded dramatically). Therefore, the quality of the bank's portfolio will be pretty much correlated to the health of the local economies.

Figure 10: URSA Bank: Portfolio by sector

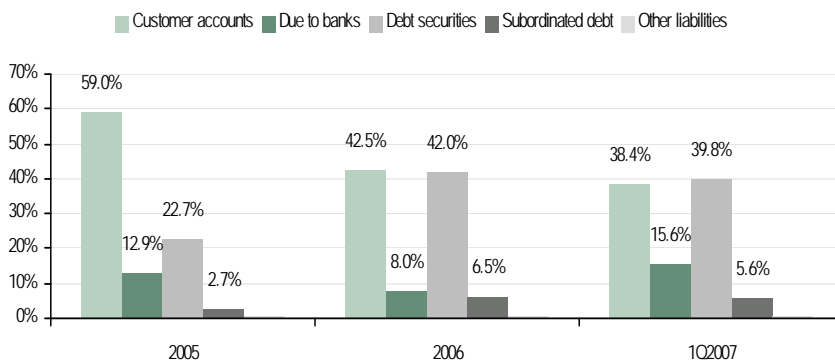


Source: Company data

## Liquidity and funding

URSA Bank's ferocious growth over the past few years has primarily been asset-driven. Core deposit growth lagged behind loan growth, which increased the bank's reliance on funds borrowed locally and, increasingly, internationally. Importantly enough, the bank has attained fairly good progress in getting an access to and diversifying its funding sources.

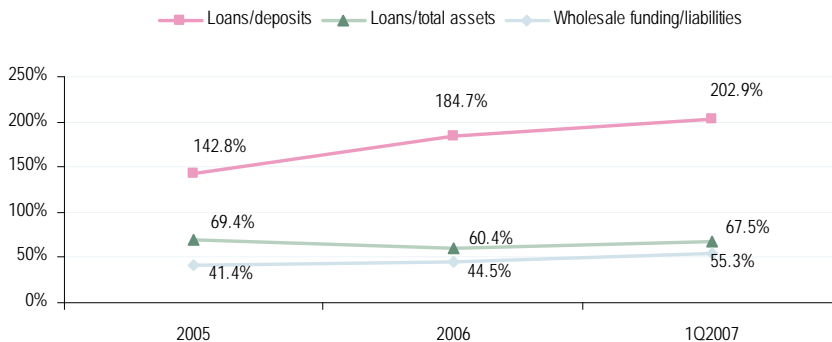
Figure 11: URSA Bank – Funding is well diversified by source



Source: IFRS reports, Renaissance Capital estimates

The bank's increasing reliance on wholesale funding reflected in a sharp growth in loans-to-deposits ratio.

Figure 12: URSA Bank: Increasing reliance on wholesale funding



Source: IFRS reports, Renaissance Capital estimates

We think that the gap between loans and core deposits will diminish as the market gets more mature. In the meantime, the bank would have to rely extensively on borrowed funds which will render its vulnerable to changing market conditions and investor sentiment.

Retail deposits accounted for the large chunk of funds on the customer accounts therefore the bank's customer funding is quite granular. Going forward, URSA Bank will put more emphasis on attracting funds from existing and new corporate clients to further diversify its funding sources and to manage its cost.

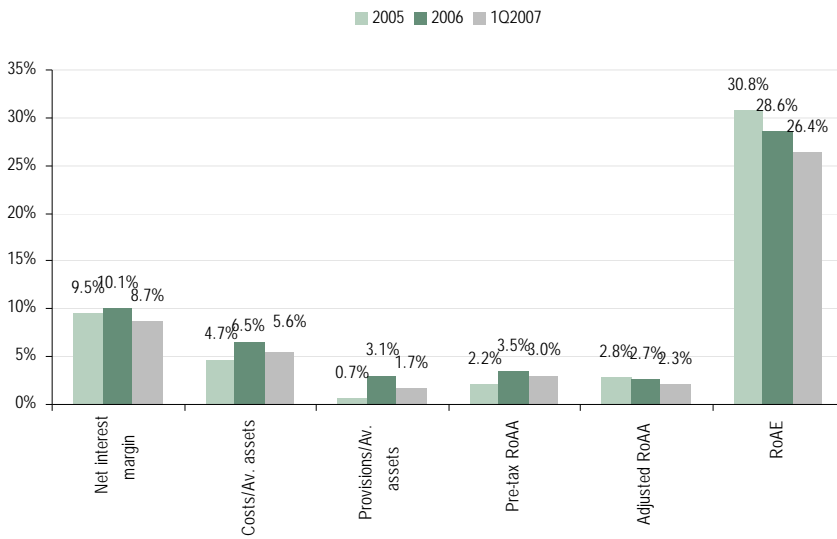
As of 31 Mar 2007, URSA had almost \$1.2bn in outstanding eurobonds, one of its largest funding sources. The bank has borrowed in dollars, euros and even more exotic currencies such as HUF. At YE06, it had an outstanding deposit swap transaction with Raiffeisenbank (the bank swapped €300mn into dollars). Since this deal was accounted for on the balance sheet at YE06, we have adjusted some ratios to correct them for the distorting effect of this swap. In 1Q07 it was replaced with off-balance-sheet derivative transactions involving rouble purchases of euros. As the bank is primarily lending to customers in roubles, its balance sheet is consistently short in dollars and euros with this mismatch being hedged using FX derivative contracts, mostly on a short-term rolling basis. We believe that this imperfect hedge is not a cause of concern, given our positive outlook on the strength of the Russian rouble.

The bank's assets and liabilities appear to be fairly well-matched, based on contractual maturities, which gives us an additional comfort that the bank is quite cautious about managing its liquidity profile.

**Profitability**

URSA Bank remains quite profitable in spite of the market-wide downward pressure on interest margins. Nevertheless, URSA delivered financial performance which is among the strongest in the market. Its success is largely attributable to the bank's initial focus on higher-yield loan products (such as unsecured consumer loans and a gradual shift to credit cards) which allowed the bank to skim the cream off.

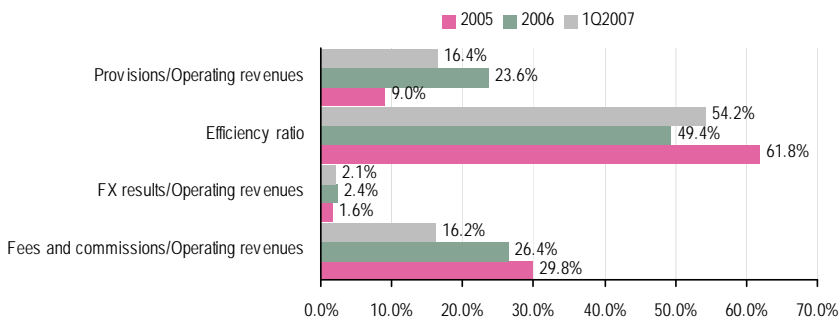
Figure 13: URSA Bank: Robust financial performance



Source: IFRS reports, Renaissance Capital estimates

The bank is clearly not a cost leader. We believe that with such an expansive business model, the bank had the luxury of not having very strict control over its operating costs, including credit losses. We believe that the situation will change in the next few years as the bank starts paying significantly more attention to containing and optimising its costs. While we have witnessed considerable efficiency improvements, we believe that a lot more could be attained on this front.

Figure 14: URSA Bank: Improving efficiency, provisions under control



Source: IFRS reports, Renaissance Capital estimates

All-in-all, we believe that despite the recent downward trend, URSA Bank's financial performance will remain above the level typical for banks with a similar business mix, barring an unexpected surge in credit costs and other operating expenses.

# Appendix

Figure 15: Balance sheet

	2005 \$ mn	2006 \$ mn	1Q2007 \$ mn
<b>ASSETS</b>			
Cash and cash equivalents	109	299	104
Mandatory cash balances with the Central Bank of the Russian Federation	11	42	44
Due from other banks	33	508	238
Loans to customers	693	2,560	3,019
Financial instruments at fair value through profit or loss	105	467	679
Investments available-for-sale	-	-	5
Goodwill	-	247	250
Other assets	8	24	34
Property and equipment	38	86	96
Deferred tax asset	1	6	2
<b>Total Assets</b>	<b>998</b>	<b>4,239</b>	<b>4,471</b>
<b>Liabilities and equity</b>			
Financial instruments at fair value through profit or loss	1	20	7
Due to other banks	109	666	603
Customer accounts	485	1,386	1,488
Debt securities issued	263	1,372	1,542
Subordinated debt	38	211	215
Other liabilities	3	13	21
<b>Total liabilities</b>	<b>899</b>	<b>3,668</b>	<b>3,877</b>
<b>Equity</b>			
Share capital	33	54	55
Share premium	43	437	442
Revaluation reserve for premises and equipment	-	-	-
Retained earnings	22	79	96
<b>Total equity</b>	<b>99</b>	<b>570</b>	<b>593</b>
<b>Total Liabilities and Partners' funds</b>	<b>998</b>	<b>4,239</b>	<b>4,471</b>

Source: Company data

Figure 16: Income statement

	2005 \$ mn	2006 \$ mn	1Q 2007 \$ mn
Interest income	91	279	152
Interest expense	(43)	(131)	(74)
<b>Net interest income</b>	<b>48</b>	<b>149</b>	<b>78</b>
Provision for loan impairment	(7)	(49)	(16)
<b>Net interest income after provision for loans impairment</b>	<b>41</b>	<b>100</b>	<b>62</b>
Fee and commission income	25	79	18
Fee and commission expense	(1)	(5)	(2)
<b>Net fee and commission income</b>	<b>23</b>	<b>73</b>	<b>16</b>
Net (loss)/income on securities trading	4	(0)	-
Net foreign exchange income	1	5	2
Recovery of impairment on credit related commitments	0	0	-
Other operating income	1	4	3
<b>Operating income</b>	<b>70</b>	<b>182</b>	<b>84</b>
Operating expenses	(26)	(56)	(20)
Staff costs	(22)	(56)	(35)
<b>Income before taxation</b>	<b>23</b>	<b>70</b>	<b>29</b>
Income tax expense	(5)	(17)	(7)
Dividends	-	-	(1)
<b>Net income</b>	<b>18</b>	<b>54</b>	<b>22</b>

Source: Company data

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