

**Sale and Purchase  
of Russian Banks in 2008  
(MARKET REVIEW)**



## Tendencies. Prices. >

This Review is based on the information from public sources, opinions of experts who have followed through the deals, polling of bank buyers and bankers, who were privy to these deals, and insider information.

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## Changing environment. Figures and facts. >

The world financial crisis and hypersensitivity to prices for energy resources have been and still are detrimental to the Russian economy.

The crisis came to Russia with a lag (the first strong impacts of crisis were felt in the USA in the spring of 2007). On September 15, 2008 the share market of the USA has experienced the first shock, which became the strongest after September, 11 of 2001; colossuses of its bank system lost balance.

Year 2008 has struck the whole world. Dow Jones Index came back to figures of 1997. Some states found themselves on the verge of default. The world has witnessed bankruptcies of big companies, and inability of the majority to find resources for lack of market credits. National governments have to spend enormous resources to support businesses at the time of devaluation of many national currencies.

Until mid May 2008 the Russian market continued to grow at the rates already customary and at the same time record ones. The Russian authorities even tried to show the country off as "the island of financial stability in a raging sea of world crisis". By the autumn of 2008

the situation has changed drastically. By no means minds of investors turned to more optimism with a new wave of military tension in the Caucasuses, the attitude of the Russian authorities towards shareholders of some public companies (Mechel, TNK-BP), who remembered well YUKOS story.

Instead of going down gradually, early in autumn indexes and quotations just collapsed. Large-scale capital flight from the Russian market (about 130 billion USD in 2008) has led to a slump of prices, oversold market and lack of liquidity. This is also proved by the fact that by the year end the market has ceased to react significantly to changes of the basic world indexes and to actions of the Russian financial authorities. The market remained adequately responsive to changes of oil prices, which price hike was the basic driver of economic growth in Russia in the 2000s.

Big market players with sufficient buying power stand by and don't buy because the situation may turn for the worse. The market has not yet seen 2008 reports of many companies, including banks. The risk of higher losses due to nonperforming assets and defaulted obligations is evident.

## Changes in the Russian banking system in figures >

By the end of 2008 in Russia there were 1108 registered credit organizations (CO), which was only 2.5% less (as on January 1, 2008 they numbered 1136). The number of Cos with foreign capital was 221.

The Bank of Russia revoked fewer licenses in 2008: 35 against 55 in 2007, and 62 — in 2006. Unlike in previous times, when most of the licenses were withdrawn for violation of money laundering laws, in 2008 banks lost their licenses for default on their obligations.

The procedure of registration of a new bank is still very complicated: in a year the Bank of Russia has registered 13 COs, including 6 foreign "daughters" (among them AIG Bank Rus, BMW Bank, Goldman Sachs Bank, Rabobank and others). In 2007 12 COs were registered. Slowdown in registrations of new COs is prone to inertia, and, in our opinion, this will be proved by statistics of 2009–2010 because the process of registration takes a long time, and many decisions to set up a new bank and to launch registration procedures date back to pre-crisis times.

In 2008 the number of 100% foreign-owned COs increased from 63 to 76 (compared to 2007 growth from 52 to 63). The aggregate share of foreigners in the capital of Russian banks, which crossed a

significant line of 25% early in 2008 (after Societe Generale increased its share in Rosbank to 50% + one share), has finished the size of the package in Rosbank to 50% + 1 action) amounted to 28.49%. Thus, the aggregate authorised capital stock of all COs in one year grew 20.4%.

Total assets in the bank sector have grown in one year by 7,897.2 billion roubles (more than 39 %) or 6.7% of GDP. Thus, on January 01, 2009 total bank assets were 67.5% of GDP, which is much below the level in a developed economy. Concentration of bank assets is still high: the first 200 largest banks of the country account for 90% of the total capital of the bank system and 92.5% of the assets, and the share of the last 400 banks is less than 1%.

Several months of active withdrawal of deposits from banks left them in October-December with negative values of retail deposit growth, but for the whole year they grew 14.5 % (against 35.4% in 2007).

For the first time in a few years profitability of bank business has started to go down. The bank sector is still highly segmented, overregulated and is all the time reformed.

## Changes in the Russian banking system — observations.

The development potential of the Russian banking system remains high – in Russia the demand for bank services is hardly met 100%. Until mid 2008 growth rates in financial sector exceeded those of economic growth. The bank system developed rapidly and bore additional risks. When cheap long-term money became scarce, problems of the bank system became obvious.

Companies found it harder and harder to get credits, and consumer credits were practically not available.

Banks are ready to credit companies at high rates and for short terms, and that is unacceptable for businesses with low profit rates. At the same time the state has been filling the bank system with billions of roubles, which in part became "a pillow" of bank liquidity, were converted into hard-currency accounts, but have not reached the majority of the companies of the real sector, and that has caused indignation of financial authorities.

High dynamics of growing credit portfolios, lax lending standards, and outdated banking technologies have led to high credit delinquency. In existing circumstances losses due to retail credit defaults

cannot be covered by high profits of the portfolio. Frequently, when crediting on pledge (mortgage credits, car loans, etc.), banks assessed the value of the first pledge and only then — solvency of the borrower, which is basically wrong.

For a number of reasons banks prefer not to declare a default on credits. Banks "clean up" their balances, moving problem loans to affiliate companies, thus distorting official statistics of overdue credits. It is complicated to assess real volume of credit defaults, but the trend of their substantial growth is obvious. The boom of non-performing loans can provoke the second surge of the crisis.

The most likely on the Russian banking market is the risk of liquidity crisis. Thanks to relative immaturity and "young age" of the banking system the US scenario of the mortgage market default is not the menace here. Slowdown in rates of development has caused unemployment growth in the financial sector. There is no call now for employees of various levels, including foreign top managers, who were readily employed for the sake of introduction of Western technologies and simpler dialogue with Western creditors.



### State demand

After purchase by the State of the first banks, which have defaulted on their obligations, it became clear that the State will not allow sliding into panic and destroying the bank sector at all hazards. It is evident that the State will be one of the key players on the market of mergers and acquisitions.

In crisis loans on pledge of a company's business lead to consolidation of this business in the hands of banking structures, in the case of Russia — the State. There were three credit organisations which asserts grew at most rapid pace — the Sberbank, VTB and Gazprombank (besides the money from the State,

these banks received from the Bank of Russia a guarantee of indemnification of their losses incurred through their operations on the market of interbank lending). Growth of assets of the banking system was due to the inflow of Government funds.

We believe that the wave of redistribution of the banking system lies ahead, when small and medium-sized banks become unprotected dependants. The position of the regulator calling for

substantial reduction in the number of banks is one more proof of the above. Involvement of the State in these processes will grow.

The State and State Banks find no use in prolonged ownership and management of assets from insolvent businesses and their defaulted shareholders. Hence, search for new owners and property redistribution according to new rules is not too distant future.



## Attacking banks >

Long time ago the regulator set the course for reducing the number of banks. The constraints were a strong lobby and endurance of small banks. In the early 90s licences were issued to practically everybody. Financial crisis came to be the favourable environment for implanting plans by the regulator.

During last year some anti-recessionary legislation was enacted (some of it is aimed against the market players):

- Once again control over banks became stronger — now a representative of the Bank of Russia is appointed in every CO, which has received state loans or deposits from Federal funds, also for supervision over executed transactions; in their public statements representatives of the Bank of Russia declared that 200 "large" and "significant" banks will come under their intensive supervision. It is possible to draw a conclusion that in the near future the regulator will not interfere in the work of other COs. In addition, the State started to exercise more rigid control over use of "anti-recessionary" money, including hard-currency transactions.

- The Bank of Russia managed to legislate the requirement of a CO capital increase to 90 million roubles from January 01, 2010 and 180 million roubles from January 01, 2012. Otherwise, the bank license is to be withdrawn.

- The procedure of a merger and consolidation, involving a CO, has changed, this includes a twice shorter term for the regulator to approve the documents: from 4 to 2 months.

- Payment to Reserve Fund requirements have been lowered.

- The state injected money into the banking system through unsecured auctions, against the security of ready assets from specially expanded pawn list, against non-marketable securities, through placement of Federal funds on deposits. Practically In reality, because of a number of formal requirements to a bank, quality of security and other subtleties, only a small number of banks could get an access to these resources. In-haste approved decisions and procedures have appeared to foment corruption.

## Crisis as the basic driver of the market

In 2008 a number of big banks lost their financial stability and were bought or made viable by the players, ready to perform their obligations. The first purchases were made quickly, without possibility of a detailed analysis of the acquired target, and with no participation of Deposit Insurance Agency (DIA). The price paid in such purchases with "symbolical" face value has nothing to do with market multipliers and was equal to the volume of obligations of the target bank and its bad debts; therefore majority of buyers does not know its exact value until today.

KIT-FINANS fell the first victim of the crisis and was sold in October to a group of the companies led by ALROSA and Russian Railways Company; Gasenergoprombank bought Sobinbank and Solidarity (Samara); Vnesheconombank bought Sviaz-Bank; the National Reserve Bank (NRB) got a controlling interest in AKB Russian Capital; Promsviazbank got control over Yarsotsbank and Nizhni Novgorod Bank. Alpha Bank got a controlling interest in Severnaya Kazna (from the

Urals); Solidarity Bank bought Potential; Bank 24.ru and Gazenergobank (Kaluga) were sold to Probusinessbank; BINBANK got a controlling stock of Bashinvestbank.

DIA, which was not involved in the process of bank acquisitions from the very start, could not find investors for sanitation of all problematic banks: VEFK, Gubernski Bank Tarhany and Electronika (the first bank, which became the testing ground for the legislated procedure of sanitation) became them. The purchasers, which participated in making problem banks viable before the relevant law was adopted, found themselves in a difficult situation.

It is important to note that the above purchases were made mostly with the money from the State, which did not help shareholders of "sinking" banks, and followed the way of crediting acquired targets and nationalising their majority in one way or another.

## The Last of the Mohicans

Despite the crisis and conventional wisdom that the market has died, 2008 saw transactions, which are worth of attention. Some of them were conceived or started in 2007 (the approximate prices of transactions are shown below):

- The British Barclays Bank purchased Expobank for 745 million USD.
- Bank of Cyprus bought 80% of shares of Yuniastrium Bank for 576 million USD.
- Marfin Popular Bank of Cyprus has completed the end-of-2007 transaction, buying a controlling interest (about 50.4%) of Rosprombank for 83 million Euro.
- Starr Russia Investments III and JCF FPK investment companies bought 40% of Investtorgbank shares for 5 billion roubles.
- ONEKSIM Group bought 100% of APR-BANK shares for 50 million USD.
- Pavel Boiko (former Chairman of sold Investsberbank) and partners bought 75.17% of Kubanbank shares (price information is not available).

In 2008 the following banks changed hands completely or in part: Tatecobank, Tatinvestbank, the First Republican Bank, Sovietski Bank, Attachebank, Slavprombank, Slamek-Bank and many others. The total amount of transactions in 2008 was no more than 1.7 billion USD, which is slightly below that of 2007 (over 2 billion USD). With prices determined for transactions on the market

in 2008 (many transactions started in 2007), the capital multipliers are no more than 4.2.

Because of high latency it is difficult to give an exact figure of the total volume of the market of purchase and sale of banks and bank businesses, taking into account average and small banks. Our estimate is about 50 transactions, which started in 2008.

Plummeting demand for banks in 2008 will cause substantial decrease in the market volume in 2009 and 2010: in our estimate, a decline of 50 % and more. This is proved by a number of refusals in 2008 of buyers to conclude transactions, if it was possible.

Despite signing in July the documents confirming its intention to get 75% of SDM-BANK shares, Israeli Bank Hapoalim cancelled this deal early in 2009. The bank's value was estimated approximately at 150 million USD. This case was not unique — the same Israeli bank refused to buy the Ukrainian Innovation Bank of about the same value.

Bank of Communications from China, which aimed to buy Rosevrobank for over 800 million USD, backed out.

Many large foreign and Russian players have refused purchases in Russia. Even those who had planned acquisition of rather inexpensive licence (shell only) without the business for independent development, have reconsidered their plans because of high country risks and uncertainty about when their investments in development may pay back.

## The Market Structure

In 2008 the market structure did not change. The Banks Bank still subdivides it into three segments:

1. A segment of bank licenses (core&shell). A substantial (up to 100%) part of assets/liabilities of such COs is usually affiliated with the seller and is withdrawn/replaced in the course of or immediately after the transaction.

2. A segment of medium-sized banks with developed infrastructure, well-running business processes, highly qualified management team and client base (over 10 000 clients). In this segment we find the majority of banks, many of which have several points of sale or even a small network. Frequently over 50% of their assets are in the hands of 20 to 30 % of the bank clients. Undercapitalisation results often in tied credits.

3. A segment of big banking business. The biggest non-State banks, which fall into this segment, do not need any introduction, but nevertheless they suffer from the drawbacks specific to medium-sized banks. The level of their corporate culture is often far below or simply incompatible with the approach of foreign buyers. In this segment there is a niche of banks, which shares circulate on organised markets and can be bought by private investors.

It is noteworthy that (mostly) in the second and third segments in 2008 we have found and may find in future the banks which are in pre-default stage. They do not make up a separate segment of the market, but need to be mentioned since methods and structuring of their acquisition (sanitation) differ from classical M&A. Here the risk of hostile takeover is imminent.

## Demand in 2008

In our estimate, demand for bank licences has decreased 30-40 %. Buyers are not in a hurry for a transaction. The time to sell assets passed a long time ago, and to buy, if the price does matter, is too early yet. When taking a decision on entry in the market almost all players face a dilemma — to buy or to register. Purchase of a bank is in most cases takes less time than registration, but is more expensive and also requires a check-up by the buyer of existing liabilities of the target bank and its assets' quality (first of all, the credit portfolio), which in the present situation is next to impossible, and thus is fraught with high risk.

Bankers express regularly their concern that under the veil of crisis companies refuse to repay credits in time even if they are solvent, as they realise their impunity. Thus, off-balance obligations and well-hidden drawbacks of a target bank cannot be excluded.

The main advantages of having a new bank registered in Russia are: no risk of accepting obligations of others and facing image problems, as well as relatively small costs. To make use of these advantages you have to bear with waiting for almost a year and run a risk of refusal to register at any stage. A new bank can be licensed to deal with private individuals only in two years from the date of registration, or from the very start, but this latter opportunity costs high — the capital of such bank shall be over 100 million Euro (the amendment to the law in force was passed on December 4, 2007, but was never used in 2008).

Among the arguments to 'vote' in favour of a purchase, besides saving time for building infrastructure, network and the team, which were so

costly back in 2007, there appear two more — attractive prices and accommodating sellers.

The number of POS is a crucial point. Many had to face a situation when it was very easy to open a credit with a bank, but then you had to queue to repay it - the network did not cope, and client loyalty was vanishing.

### What fuels demand and preconditions growth potential?

- The number of "core&shell" arrangements is limited and going down all the time: sellers strive to enter the medium-sized segment or sell the bank as a license.
- Registration of a new bank for a small or medium-sized Russian buyer is practically impossible. There is an opinion that for this country the sufficient number will be five banks really competing among themselves and present on a large scale in the regions. They will have an advantage of technologies and a variety of products. However, in practice this can hardly be implemented in the immediate future. Even without taking into account captive and highly specialised banks, for working with small businesses and "well-off" local clients, which are not likely to have this status in big banks, small banks will remain in demand for a long time.
- In the second half of 2009 we predict growth of demand for banks of the shell category ("the bare licence") because a large number of banks will not be able to bring their capitals to the legislated minimum, and banks in the medium-sized segment become more and more inconvenient for acquisition because it is really difficult to evaluate their credit portfolio, even in case of borrowers servicing their debts in due time.

### Today the demand comes from several groups of buyers:

- Russian banks buy banks to get the business of the target bank and then sell/give back its license. Sometimes the purpose of the buyer is to conduct transactions, which the bank-buyer would not like to carry out in its own name for various reasons.
- In 2008 the category, which disappeared in early 2000s, came back to the market. This category includes buying companies (holding companies) from various spheres of the business, which are ready to incur costs and bear risks of ownership of their bank in exchange for a guarantee of safety of own money and uninterrupted flow of payments. This is a natural phenomenon. Economic instability and mutual confidence crisis are fuelling processes of vertical integration: each holding prefers to have its own available assets required for functioning of its business (mostly non-core assets), rather than to source them on a contractual basis.
- Payment collectors, large retailers, car manufacturers and others highly specialised businesses, requiring special technologies and control. For example, already operating banks of Toyota Motor, Daimler AG and BMW. For a similar purpose Major-Auto bought Slamek-Bank (changed its name to Avtotorgbank). The plans to have their own banks were announced by Volkswagen and the Dutch Rabobank, which specialises in loans for agroindustrial sector and opened an affiliated bank in the Russian Federation in 2008.
- Funds with a focus on investments in crisis. We find no more on the market any non-core investors and

investment funds aimed at easy money through purchase of a CO and rather fast growth of its cost, which is due to the use of Western technologies, fiercely criticised after the onset of the technology crisis.

- Top managers, who have succeeded in developing and selling the bank they managed (but not owned) to a big buyer. In previous years a team of managers "broke away" with a big piece of the business, making it possible for them to buy a small bank and make sure it brings profit, but now that does not make any sense: the market can only accept more civilised forms and does not favour disloyalty of the management towards the owners. They are no longer working in the sold bank, are well informed on market trends, have unique experience and are keen to tell their "success story" again in more complicated situation. A good example of the above is a project by Pavel Boiko and partners who intend to set up a mortgage mono-bank on the foundation of Kubanbank, which they purchased.
- Russian private banks and financial companies, interested to buy banks, which got into difficulties, using also the money from the State in various forms: "daughters" of foreign banks announce they are ready to be involved in making problem banks viable, though there were no transactions of this kind on the market yet. There are also other buyers, for which any grouping seems to be impractical.

Most other big foreign banks have not yet come to the Russian market. It is reasonable to assume that the crisis has postponed their activity on this market for a number of years.

## Supply in 2008 >

Despite financial crisis and aggressive (towards small banks) policy of the authorities, banks were not offered for sale on a large scale at below cost prices. At the same time bank sellers became more flexible in pricing, providing guarantees and structuring transactions. For the first time over the last 10 years it is the buyer's market now.

Among the main factors driving Russian shareholders to sell their bank are stronger competition, increasing demand for better services, lower profitability, emergence of big foreign players and rapid development of existing ones, as well as higher risks

from the regulator, toughened supervision and risk of losing business. In these circumstances the majority of small and medium-sized players realise the need to look for a strategic investor or to sell their bank.

Simplified procedures of mergers in the bank sector have not yet triggered off a wave of friendly mergers of more or less strong banks since the laws are still difficult to abide by, practically the evaluation of quality and cost of assets of each merging entity is required, and disagreements here lead to longer terms of transactions and lower chances of their success.



# Price fluctuations

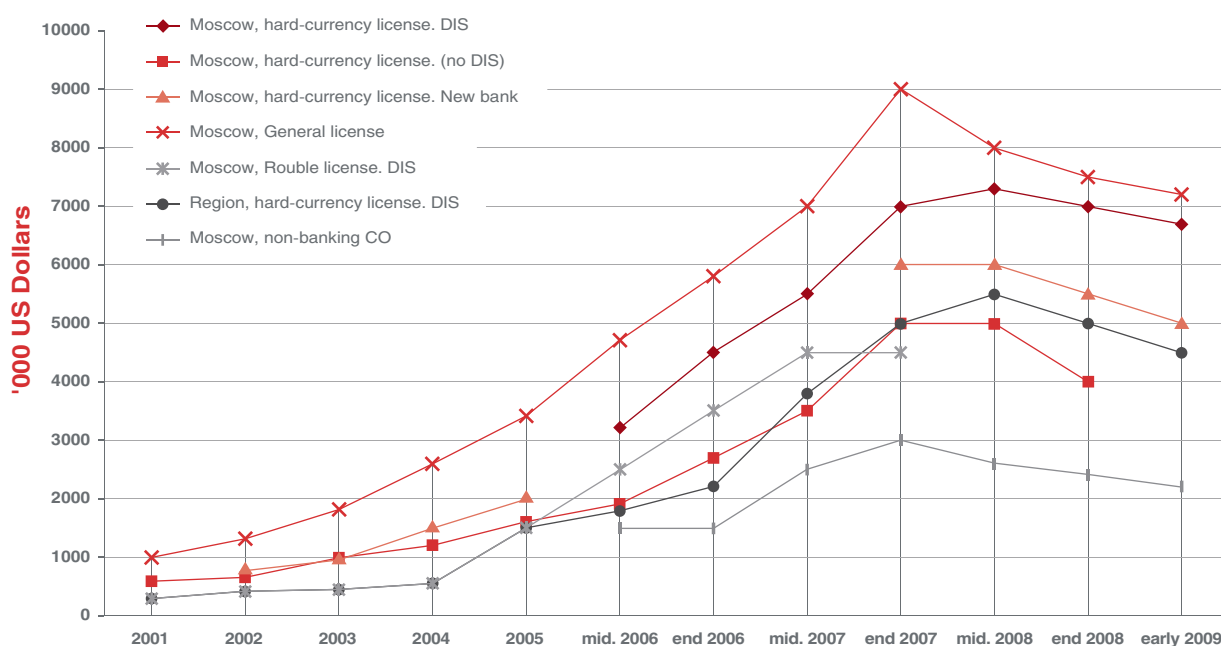
## Approaches to evaluation

1. For small banks in the segment of bank licenses we apply a comparative method of evaluation. Here the cost of a transaction is made up of the "license price" and compensation for the bank net assets. The license price depends on such factors, as location, available licenses, bank membership in DIS, record of violations (if any) by this bank of the banking legislation and instructions of the Central Bank, sale of 100 % of the shares and many other factors.

For the first time in 10 years of only upward movement, year 2008 saw a decrease in license prices. For the reasons outlined above prices did not slump. It is likely that they will grow slightly early in 2010, if smaller banks (they account for 99% of sold licenses) are not able to raise capital and lose their licenses, and there will be fewer offers on the market.

Below you will find the chart showing dynamics of prices for bank licenses in the past years.

**License Price Dynamics, 2001–2009**



They were almost no transactions in the segment of medium-sized banks, which was due to complexity of adequate evaluation of the business and risks.

At the first stage of the bank cost evaluation we proceed from the bank license cost, then the figure is subject to increase/decrease depending on certain parameters of this bank, such as, for example: the license to trade in precious metals, SWIFT, correspondent accounts in foreign banks, level of automation, quality of management (and other intangible assets), clean legal history. This is where the first stage of valuation is finished.

Many sellers viewed the events of the second half of 2008 as "a wake-up call", panic buying in the lower price segment stopped, and the time passed for multimillion transactions and multipliers in higher-prices segment. In 2008 sellers often agreed upon the bank cost at the first stages of negotiations,

but the second stage of the bank evaluation put on hold the majority of transactions.

The second stage — evaluation of bank assets (including net assets subject to indemnification), and it was this stage that during 2008 became an obstacle to further negotiations. Even if the parties agreed on the price, the buyer had to face liquidity risk in case of failure of the credit portfolio issued towards obligations of the bank in high-cost money situation. On the market of today it is extremely difficult to estimate the chances of default by a "good" (at the moment of analysis) borrower. The losses in that case are far above the bank cost.

2. Potential of growth of a price for a big bank.

The crisis has not affected the approach of investors to its evaluation. It was the probability of a successful transaction and the price that have changed. The most

widely used techniques is the price/book value ratio — P/BV (for banks — the capital), return on equity — ROE, and some others.

Investors consider it risky to invest in bank shares and continue to associate the largest banks with the US bank crisis. Multipliers of public banks have a negative impact on players: early in 2008 Sberbank was quoted at 3.4; Vozrozhdenie Bank — at 2.9, and VTB — at 1.9.

By the year end all the above banks traded at rates below 1. ("Public" offering by VTB at 13.6 copecks per share in May 2007 degraded to 2.6 copecks by March

10, 2009). Nevertheless, fundamental indices of the largest State Banks remain brilliant. In 2008 nobody from the first 10 by capital and assets has left. Big banks lost their profits, and rating agencies lowered their ratings.

Low P/BV ratio is a sign of the potential for growth. Investments of private individuals, whose strategy is "buy&hold", into securities of the state banks are attractive. Portfolio investors and large players do not hurry to purchase in connection with their internal difficulties and because the situation on the Russian market is unpredictable.

## Conclusions. Forecast.

The times of easy money on the credit market have passed. The liquidity crisis makes the bank sector consolidate. The demand for banks is not strong any more. According to the majority of experts, the economic environment will deteriorate further. The future change of the situation on the developing Russian market and return of large players will not bring in any case immediate results since the latter prefer to avoid abrupt entry and unavoidably skyrocketing quotations.

The events of 2008 have further strengthened the role of the State in economy.

Setting up of the state corporation "Russian Financial Agency", which can bring under one roof regulatory and managing functions, can be the peak of the State intervention in the financial sector of economy.

Stabilisation of economy and concentration by the State of a large quantity of assets can entail another wave of privatisation.

Overall consolidation of the sector did not happen for a number of reasons, including lack of well-running legal procedures, complexity of adequate evaluation of bank assets and risks, fears of bank owners from their experience in the previous crises.

Actions of the regulator which has gone a long way to cut the number of banks, were not a success in 2008 and have not collapsed the market of bank licences (as we had predicted in our review of 2007). Correction of prices late in 2008 – early in 2009 can be followed by their rise early in 2010. The wave of mergers and acquisitions in the next two or three years is inevitable.



## Invitation to the presentation >

### “Purchase & sale of a Russian bank”

We are pleased to invite you to come to our office or we can offer our services at your premises to your Board of Directors (or another governing body): to arrange this presentation (also in the format of a video conference), and/or to give legal advice, answer your questions.

The presentation is free of charge.

### Topics (subject to change on request):

- The structure of demand: what banks they buy and why?
- Price structure. How to find out the fair price for a bank?
- Aims of buyers: who and why buys banks?
- Possibilities to enter the market. Specifics of entering the Russian banking market for a foreign buyer.
- Who is more exposed to risk — the seller or the buyer? How to avoid ‘skeletons in the cupboard’ of the purchased bank? Average transaction prices in 2008.
- Price dynamics in 2001— 2009.

**To arrange for this presentation/consultation, please get in touch with Vladimir Kravchenko:**

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