Strategy and Finance Division
Investor Relations & DCM

OTP BANK
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Transcript

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Operator

Ladies and gentlemen, welcome to OTP Bank Quarter one 2019 conference call. I will now hand over to Mr Bencsik, CFO. Sir, please go ahead.

László Bencsik

Thank you very much. Welcome, everyone, good morning or good afternoon depending on where you are. Well, I'm glad you join us today to discuss comments and questions regarding OTP Bank's 2019 First Quarter Results. The interim report itself has been available since the early morning and the presentation itself, as usual, has been put up to the website also, so it's available there, and I follow the usual practice and walk you through a few pages. I promise I'll be shorter than usual, so we actually split the standard pack into two. We'll only focus on the first half and all the other pages may be used when you ask questions or just for you to read.

Starting the presentation on page two, the overall result. The accounting profits for the first quarter was HUF 72.6 billion. As usual, we had one-off items, quite sizable and material one in the first quarter, namely the Hungarian Bank tax being the largest of these. As always, this year, we also accounted for the entire expected bank tax in Hungary in the first quarter. The adjusted result was HUF 90.4 billion, and that actually means 14% year-on-year increase. Roughly half of this increase came from the new acquisition in Bulgaria, Expressbank, which already contributed HUF 5.2 billion to the consolidated results, so without this, we would have grown only 7%. I think it's important to mark that in the first quarter we have already had 50% of the earnings coming from non-Hungarian activities, which is in line with our strategy to further diversify our operations regionally.

On page three, see the ROE number, where the numbers talk for themselves, but what we can say is that this trajectory of relatively high level of returns on equity continues. If you look at the adjusted ROE, it is actually slightly higher than a year ago and it's perfectly in line with what we have seen before.

Page four, just some dry numbers, and some further information on the two adjustments. As I said, it's mainly the bank tax in Hungary, which resulted in this negative number, and then more interesting on page five, you see the contributions of the different group members to the first quarter result and also the year-on-year dynamics of these contributions. Hungary was relatively flat. Bulgaria increased a lot, but again, a large share of this increase actually came from the inclusion of the profit of Expressbank, the former SocGen subsidiary in Bulgaria, which we acquired in January this year, so it was fully consolidated in the first quarter results.

If you look at the year-on-year dynamics, I think, nominally, very important is Ukraine. The Ukrainian bank is doing extremely well and continues to do better and better each quarter, which is very good to see, so it's a remarkable performance. If you look at the underlying economics and trends in the business, actually, they look quite good and assuming a relatively stable environment, we assess them as fairly sustainable. Croatia did also well, and this is the first quarter where we actually can show you the merged bank because last year, for most of the year, we used to have two banks operating parallel. The technical merger happened at the end of November, so since then, we actually have one bank with one IT system, and you see the results. There will be a page describing in more detail the cost synergies we realized and the returns in Croatia. I think, it's an important benchmark and indicator of what to potentially expect in other situations where we are also engaged in similar merger activities.

On page six, you see the overall high level P&L break down, and I think, here you have to take into consideration that acquisitions do distort these numbers, so whenever you want to compare a period in this year to previous periods, you'd better look at the "without acquisitions" numbers because otherwise the numbers might be misleading. Therefore on this page on the right side, the two columns describe the “without acquisitions” developments and numbers, so basic operating profits without acquisitions increased 10% year-on-year, 11% income growth and 12% cost increase. I think that's a quite reasonable underlying organic dynamic, which has been pretty much driven by volume growth, especially taking place last year. Risk cost was basically in line with our expectations. We previously guided for similar risk cost rate as we had last year and indeed, it was almost exactly the same. I mean the risk cost rate in the first quarter was similar what we had during the whole last year.

Page seven describes the performing volume growth dynamics, and as we indicated during our previous conference call and during the previous presentation, we are changing or shifting the methodology from less than 90 days past due loans being the definition of performing into the more recent methodology, IFRS 9 compliance Stage 1 and Stage 2, so from now on, we are going to present the performing volumes at Stage 1 and Stage 2 as opposed to less than 90 days past due. Having said that, if you look at our analyst tables, which are also available on the website, you will find the previous numbers as well, so during the course of this year, we are going to show actually both sets of numbers in order you were able to compare to previous periods better. So, on this page you see that we had a consolidated loan growth of performing loans in one quarter of 1%, excluding the acquisitions, because obviously the first quarter numbers do include Expressbank Bulgaria and also in the balance sheet and in the client volumes numbers, it does include our Albanian acquisition, which was done at the end of the first quarter. And because it was done at the end of the first quarter, it only came through the balance sheet, not the P&L, so the P&L was not affected in the first quarter. The P&L effect will be there only starting from the second quarter.

Now if you don't adjust for the acquisitions, then actually the growth was 12%. After adjustment, it was 1%. Now this development requires some explanation. First of all, we already indicated when we talked about the expectation about this year that we expect slowdown in terms of volume growth. Last year the total performing volume growth was 15%, and in the first quarter it was only 1%. I also indicated that this slowdown is probably going to come from large corporate growth. As expected, large corporate loan growth has slowed down, and indeed, this is what we do see happening in the first quarter. If you look at the last row at the bottom, corporate volumes altogether grew 0%, and especially in Hungary and also in Bulgaria it was basically flat. We still have capital growing in some other markets.

There will be one slide actually at the very end of the presentation, and that actually shows that, for instance, in Hungary, this 0% growth came as the composition of actually negative growth in large corporate loans, minus 2%. Why? The micro and small companies loans continue to grow at pretty much the same pace as the last year, so at least so far during the first quarter what we see is that, indeed, large corporate and project finance, i.e. large ticket corporate lending is slowing down. This is basically due to pricing. The competitive environment in these markets developed into a stage where we have cases where, basically it was not particularly competitive with our credit. Potentially we might have a different view than our competitors on the risk-reward/return requirement, I don't know. But what we see and this was again not surprising or unexpected because, usually, at this stage of the cycle, this happens and that's perfectly fine with us, that we have less share in the large corporate volume growth, which tends to be very low, very thin in terms of margins, but capital requirements tends to be there as well, so overall, when you run the numbers, it's not obvious that you actually want to participate in the low-margin, large corporate lending, at least not from our point of view. Demand is there, so there's no stop or visible decline in demand at all, so this is not something which characterizes these markets. This is more specific to us.

If you look at other segments, consumer exposure continues to grow with the same pace it was growing last year, so group level 3%, despite the fact that the first quarter in Russia is always seasonally low, so we see typically zero or negative loan growth in Russia in the first quarter. As usual, it did happen this year as well, so you can see only 1% growth. But for instance, Bulgaria and Hungary kept growing 3 and 5% just in one quarter. If you compare this to 19% annual growth in

Hungary, then actually the 5% suggest even an acceleration in terms of volume growth dynamics compared to last year, and the 3% increase in Bulgaria without acquisition is okay.

The other segment, which seems to be more seasonal, at least in Hungary, is housing loans. Actually, housing loan growth in Hungary dropped, in our case to 1%. We don't think that this is going to be representative for the whole year, and already in the second quarter we expect acceleration of growth. The market was relatively dynamic, so we don't think that there are any intrinsic changes in the underlying dynamics of the market growth, which has had somewhat less share in that growth, basically due to pricing, but this has been fixed and we will continue to grow with the market, at least in housing loans in Hungary.

The rest of the Group: Bulgaria was strong, 3%, and other markets were reasonably strong as well in terms of mortgage growth in the first quarter, so overall, this 1% might not be kind of a tremendously high headline number, but if you look at the underlying dynamics and basically in ballpark figures, these underlying dynamics are in line with what we expected. Therefore, I think the original guidance is still there, so we guided for less growth than 15% last year. We guided for maybe around 10%, and we also said that large corporate was going to grow less and, indeed, that is what we see in the first quarter, so that's in line with expectations.

Page eight, deposits grew 1% in the first quarter. I don't think that so much additional information is needed here. Given our comfortable position, it's clearly not a strategic target to grow deposits. Nevertheless, we make money on them, and if anything, we have reduced the cost of funding, the interest rates on deposits. We had two countries, Croatia and Montenegro, where typically our clients have revenues from the tourism industry, because they have long coastlines in those countries, and therefore, they typically have revenues during the summer when there is a high season, so deposits tend to increase during the summer and decrease during the winter, so it's also seasonally related to the countries.

Page nine is about margins, margin dynamics. I think this is something positive. When we guided for expected margin development during this year, we said that we believe we were close to the bottom of the margin cycle and we expected no more than five basis points further decline on the group level without acquisitions, and what we actually saw in the first quarter was that, in fact, without acquisitions, it increased, and it was 4.33%. That means if you compare to the last year annual number, there was a three basis points increase. If we compare to the last quarter, then it's four, so at least, the ballpark trajectory seems to be aligned with what we expected, so without acquisitions, the margins bottoming out seems to be visible. Again, this number is going to be heavily distorted by the acquisitions, which will come through the consolidated numbers depending whether they are higher or lower margin than the rest of the group or the existing group.

On page 10 we have further details regarding the largest group members in terms of margins, and I think, a very welcome news in Hungary is that we do see some improvement compared to the last quarter of '18, so that's good. Having said that, we already talked about our vision of the expected reference rate in Hungary. During the course of the winter and even at the beginning of the year, we were expecting around 80, 90 basis points for the three months BUBOR interbank rates in Hungary. But then, given the communication coming from the Central Bank, we adjusted that back to maybe 35-45 basis points levels by the end of the year, but that would mean still an increase, right? We ended the first quarter at 18 bps. Now, this is going to be depending on inflationary developments and the good news is that the April inflation data was slightly better than expectations, so the headline inflation was 3.9, but the core inflation adjusted for tax was only 3.4%, and in fact, this already declined compared to March, so it improved and was by around 10 bps lower than in March, so that suggests we're actually at least from the data that we have seen, that the inflationary pressure is not going to be a lot further and not going to mount, and therefore subdued monetary policy measures are more likely. Having said that, there's obviously uncertainty and risk around this, but at least from what we have seen so far from data, this is our best estimate. Bulgaria, there's some noise in this data obviously because of the acquisition. The end of the period number already includes the new acquisition. The beginning of the quarter doesn't, so it's a kind of mixed bag, but the underlying NIM continued to decline, and if you take out the acquisition itself, the decline continued slightly, as it did in Russia. Croatia and Ukraine improved slightly.

A few words about the acquisitions and mergers. Our latest announcement regarding acquisitions was in Slovenia, so we announced that we agreed with Société Générale to acquire SKB Banka, their subsidiary in Slovenia, and as you can see on page 11, it's a bank with 8.5% market share, EUR 356 million equity. We're number four, and it's not on the page, but last year they made 15.9% return on equity, so in our assessment, it's a very decent, very well managed, efficient and profitable bank, so we believe that we are buying a very good asset in a country which is stable and provides us a new strategic opportunity.

The other event was actually closing the transaction in Albania at the end of March, therefore this new Albanian bank is already part of the consolidated numbers, in the same numbers what you see in the interim report. Now compared to the whole group, and also compared to our Slovenian acquisition, this is a rather small entity, but it's also coming from Société Générale, and it actually bears the marks of the Société Générale assets we have seen so far: a very well managed bank with a very decent client base, very efficiently run, so we believe that it creates an excellent footprint in Albania by acquiring this bank, which has only 6% market share in a relatively small market, albeit high potential market. It may not change the whole story of the group, but I believe it will marginally improve it into the right direction, so we actually have high expectations regarding this new entrance into Albania.

On page 13, we try to summarize the story, what can be seen in terms of numbers, in Croatia. If I may remind you we actually did the acquisition back in 2017 second quarter, so that's when we closed the transaction and we acquired Splitska Banka from SocGen, and the merger process lasted until the end of November of last year. So, the first quarter of this year is the first period where you see an integrated entity as opposed to two separate banks running parallel, therefore, this is the first time we can have a glimpse on the potential synergies or cost savings coming from this merger. As you can see, if you compare the first quarter numbers to first quarter last year and we adjust that with inflation – basically, operational cost inflation of 0.6%, wage inflation for personnel expenses in the financial sector of 4%; plus, the FX adjustment, – then we come to adjusted 11.1 billion cost base, and if you compare it to the 9.6 billion actual number in the first quarter this year, then the nominal change is 13% of the two entities. Now, obviously, a slightly more refined gauge to what happened is if we compare this nominal cost saving to one of the banks' cost basis, and I think it makes sense to compare it to the smaller one. If we compare it to the nominal cost base of, OTP Bank of Croatia in the first quarter last year, then the actual cost saving was 31%.

As you can see, we already initiated the branch closures, so we closed down 46 branches, and I think now we are very close to the optimal coverage in the country, and I think the other metrics is the return on equity, which is interesting. When we started to talk about this acquisition, people were asking us what targets we had and how we wanted to create value, so hopefully this gives some indication that we are going in the right direction. The reported ROE of this integrated entity in the first quarter was 12.5%, but the leverage is very small. Because of the structure of this transaction, namely OTP Bank of Croatia acquired Splitska Banka and we increased capital in OTP Bank of Croatia to do so, there is excess capital at the moment in the bank, so the common equity Tier 1 ratio of this integrated entity in the first quarter was 19.2%, which is clearly well above the common equity Tier 1 or Tier 1 requirement. If you adjust that back to the group level midterm targets set at 15%, common equity Tier 1 and Tier 1, and we recalculate the ROE on this modified capital base, call it effective capital base, then the ROE would have been 15.8%, so already above the 15% threshold in Croatia in the first quarter.

Now, on page 14, you see the impact on our capital adequacy ratio of these three acquisitions, so the common equity Tier 1 went down to 14.9%, and we also included in the interim report itself the other acquisitions that we have so far announced, including the Slovenian one, thus the pro forma potential impact in terms of common equity Tier 1 ratio is about 2.7 percentage points negative, but that basically would assume that we had already acquired all these banks in the first quarter, and we had actually included them in our consolidated numbers. This obviously has not happened, and it's not going to happen in the second quarter either, so most likely, these acquisitions, I mean the remaining ones will be finalised somewhere in the second half or even closer to the end of the year. That means that we're going to accumulate capital on a quarterly basis, and we actually conduct quarterly reviews, and according to the E.U. regulations, if these reviews fulfil certain legal requirements, then actually the interim results can be included in our regulatory capital, and we did that for the first quarter, and we're going to continue to do that for the remaining quarters of the year, therefore I think it's a fair expectation that there will be an ongoing organic accumulation of regulatory capital over the course of this year.

On the following page, few words about loan portfolio quality, and this is another area where we are changing the metrics what we use to describe the situation. We are adopting the IFRS 9 language, and from now on, we're going to refer rather to the Stage 3 ratio, which is closer to the previous NPL definition, and it obviously includes the 90 days past due volumes. The ratio of Stage 3 volumes was 8.2% at the end of the first quarter. It keeps declining. You see the rate of decline, which is actually quite steep, and on the same page, you also see that out of this 8.2, 5.9% was the 90 days past due, which also kept declining. The other interesting number, and I'm sure you have already started to compare them between banks, is the own coverage of the different stage loans in different banks. The 2018 year-end, Stage 3 own coverage, i.e. provisions dedicated to Stage 3 loans divided by Stage 3 volumes was 66.8, which was also affected by the acquisitions, because when we do an acquisition, you can't net out according to the accounting rules. Typically, a large share of the provisions on Stage 3 net out, and then, typically, we continue after the acquisition to report only the net amount of the Stage 3 volumes, therefore, there's a distortive impact coming from new acquisitions. They reduced this ratio because some of those Stage 3 volumes appear as netted out with provisions, but without the acquisition and this netting out, it would have been 67.3%, so actually it would have increased compared to the end of last year. In comparison to some other banks, it seems to be a relatively high number and that is also in line with our long-term strategy to be as conservative as possible in provisioning.

Regarding our expectations for the rest of the year, on page 16, you see that from our perspective, the most important is clearly the GDP growth expectation in Hungary, and we are quite bullish and optimistic about that. We actually expect around 4.5% growth. Some kind of data which is already available about the first months of this year suggests that there actually is very little, if any, slowdown in the growth rate of the economy, so we are actually adjusting upwards our expectations regarding GDP growth in Hungary for this year. I think that's very good news for us and basically for the entire sector in Hungary, so if anything, we should expect higher volume growth and better portfolio quality than we originally did.

Regarding other countries, our expectations have not changed drastically. In general, in all of the markets where we operate, we expect reasonably stable and favourable supportive economic environments for our banking activities, so it continues to be a relatively supportive environment. Therefore, there is a good reason to believe that the performance of the previous levels can continue.

That leads us to the last two pages, which are the kind of very well thought out phrases, which we already included during the previous conference call and presentation about our expectations regarding this year. First of all, we know more today about the expected level of the Romanian banking tax and the Serbian Swiss franc mortgage fixing, i.e. the potential impact of these two lines which we already expected as one-offs. In Romania, the bank tax for us seems to be certainly not more than HUF 2 billion per year. If all goes very well, this can be actually very close to zero. If we deliver on our strategic goals and organic strategic growth targets in Romania, then I think we have good chances to achieve a much lower-level of bank tax. Under the current structure if a bank is growing over 8% and reduces its margin, then actually there are lower levels of bank tax to be achieved.

The other element which was not yet clear last time was the Serbian Swiss franc mortgages fixing scheme, which is an optional structure. We have to provide our customers the opportunity to convert and then they decide. So, that also involves a reduction of this principal and also interest amount, and the total negative impact we expect is to be around HUF 2 billion. Again, this is the very maximum, assuming that all customers take up the structure, which usually doesn't happen.

Our other guidance for this year, the volume growth, which I already talked about, is around 10%. It's still something, which looks feasible. In terms of margins, we actually seem to be in a better position in the first quarter than we were, so instead of declining, we saw a slight increase in the group margins, so I think that's a rather good news. In terms of credit portfolio quality and risk cost, basically the first quarter risk cost rate was pretty much similar to last year’s average. There was only one basis point difference, so I think, again, the first quarter result was in line with what we expected, and the last line, obviously is by far the biggest challenge for us, to contain cost growth, operational cost growth. If you just compare the first quarter of this year to last year without acquisitions and FX adjusted, then actually the growth rate was 11%, which is well above the 4% which we indicated as a very aggressive target for this year. Having said that, if you look at the last year cost development, it was not evenly shaping at all: the last quarter was really very high, so obviously, if we can avoid that this year, then we can actually get lower than this 11% and get closer to 4%. So, I think under an extremely good scenario, we can even reach 4%, but I must admit this is a very challenging task to achieve, but this is what we are aiming for. The first quarter result, however was not tremendously supportive in our belief that this can be done. Nevertheless, we try to do our best to achieve this 4% growth.

On page 18, you have a very kind of elaborate description about the potential expectations about the dividends, because apparently the number which we included in financial statements as potential dividend is a result of a calculation which is based on an E.U. regulation. This was really important for us in the first quarter because we wanted to include the first quarter results into the regulatory capital, and therefore, we did the auditor review for the first quarter, but obviously there was a question, what to account for as dividends when we do that. After careful considerations with our supervisor in Hungary, we followed the word-by-word requirements of the E.U. regulations related to this situation, i.e. if an entity does not have a clear dividend policy and how to calculate in that case these dividends, it's actually fairly complicated. It has to be done on the basis of stand-alone OTP Bank and then use that number for the group, which obviously doesn't reflect much economic substance. Therefore, please regard it as a technical number. We still keep what we said during the previous presentations that we would like to retain the right to make our final dividend proposal at the beginning of next year in the first quarter once the acquisition wave is over and we know exactly where we stand in terms of capital position.

So that was all, that was the formal presentation that I intended to share with you, and in the rest of the pack, you see the familiar pages at least for those of you have been following us for the last couple of years, so we are showing the quarterly developments and the year-on-year developments of the different P&L lines, and you also see some explanation plus there are some further slides on risk cost and portfolio quality in Hungary in retail and corporate, but I'm not going to talk about it formally now. This was what I intended to present, and now I'd like to open the floor for questions, so please, operator, help us do the question-and-answer section of this conference call.

QUESTION AND ANSWER SESSION

Operator

Our first question comes from Anna Marshall, Goldman Sachs. Please go ahead.

Anna Marshall

A couple of questions for me please. The first one is on your expansion strategy, so firstly, on Slovenia, could you please provide a little bit more background behind your decision to enter the country, and perhaps a bit more details in terms of where you plan to take the unit? What is the strategy for it going forward in terms of growth, etc.? My second question is on the cost. Specifically, could you please give more colour on the year-on-year growth in Hungary that was recorded in Q1, and could you please provide kind of the rationale in terms of increase in staff? Can you grow in terms of volumes into that cost base, and another question on the cost also is, are these the full scale of cost synergies in Croatia or they're going to increase going forward?

László Bencsik

Slovenia, after careful consideration, we decided that this is a market which might be long-term strategically interesting for us, and we found a very good bank at a reasonable price, which in our expectations ended up kind of creating value. Therefore, we decided to enter and doing so I think, we created a very good platform for our presence in Slovenia. Slovenia is a fairly developed economy, I mean, rather on the smaller end of the Eurozone, but we see it as certainly a stable one after the big deleveraging of the owner and the difficulties that the country and its banking sector had. Now it does seem to be a very clean and transparent banking environment and the bank we acquired seems to be of very good quality.

In terms of growth rates, if we compare to other countries, for instance, as for loan growth, our expectation in Slovenia for this year… I have to check. The GDP growth is 3.3%, for this year. Last year, it was 4.5%, so it's a growing market. I'm going to check the volumes for different segments. And importantly, its proximity is interesting for us, because this country is in the region where we believe we can add value, because of our knowledge of these markets and because of our regional proximity, so therefore it was kind of a natural consideration for us to think about Slovenia.

This bank did more than 15% ROE last year. Obviously, the situation is somewhat similar to, for instance, our Hungarian operation in a sense that the risk cost is actually positive. You could argue that this may not be sustainable forever at this level unless other actions are taken, but it's a well-managed and well run and quite profitable bank, and we believe that the pricing was fair. It was also part of the story with SocGen, it has fallen into this chain of transactions, which we've conducted on an exclusive basis.

Hungarian cost development, I think, this is a very pertinent question, and I think, it's one of the biggest headaches for us. On a year-on-year basis, FX adjusted basis, it was 17%, in Hungary, went up by 17%. You can see on page 24 of the presentation. We also tried to include some explanations. Basically, we had 5% increase in the head count and we also had 5% base salary hike last year, so this added to the cost. We have steeply increasing IT expense and expenses. That is related to our efforts to modernize and substantially transform our IT infrastructure in Hungary. Due to historical reasons, potentially, we have the oldest system in the group in Hungary, because the Hungarian system environment was the first one which was modernized back in the mid-'90s, and we still live with those core elements of the IT infrastructure, and this is, obviously, not an easy task and it takes time and it's actually quite costly. The problem is that we also increased somewhat the headcount partially related to sales activities, due to the very substantial growth in new production. But we also have been hiring a lot of IT personnel. The number is around hundreds, right? Compared to our size, this is a substantial volume of people we hired in order to develop internal capabilities and skills for this core or strategic competency of IT developments in the bank in Hungary, plus to modernize the IT environment. We are working hard and trying to contain this growth, and I very much hope that this year will not be as high in terms of growth rate. It shouldn't not be, but I can't also promise that we are, in the immediate future will carry out cut costs in the Hungarian operation, because this is really a major transformation what we started in Hungarian IT.

Well, the environment is also quite tough if you look at the labour market in Hungary: wage inflation during the last two years was around 10%, so very high. The labour market is extremely tight or has been extremely tight for the last two years, so there are pressures, which make it actually quite difficult to contain the cost base in Hungary, but this is something we are very closely monitoring and trying to work out solutions to actually stop this or mitigate this growth. In the meantime, I got the loan growth expectations in Slovenia, so it's around 4% all in all, retail and corporate together for '19, and it's accelerating because last year it was 2.6%, so they are on the growing trajectory.

The third question was regarding Croatia and whether the cost synergies may continue. I was secretly hoping that you would like these numbers, because, I think it's actually quite promising that the first quarter after the merge, we could already show these numbers, tangible benefits, and I think what I can say is that the bulk of the savings has been done already in the first quarter. Obviously, there are some other effects, but then also, this should be a growing business, and if you look at the growth rate of our Croatian Bank last year, it was not tremendously high, because actually a large amount of their focus was on the merger, but we want to change that, so from now on, they will have to excel also in terms of growth, so being very honest, I was hopeful that you would appreciate already the level of cost savings we had been able to manifest in the first quarter.

Operator

Our next question comes from Sam Goodacre from JP Morgan. Please go ahead.

Samuel Goodacre

I've got a follow-up actually on that Croatia point, and then a couple of additional questions, but on Croatia, so you have outlined that the cost saving as a percentage of the smaller banks' cost base is about 30%. Can we see that as a benchmark for the acquisitions that you have made altogether? Is that the sort of level we ought to be thinking about, and moreover, synergies to date, we've spoken mainly about costs, is there anything across any of the acquires in terms of any potential revenue benefit? That's my first question.

László Bencsik

Okay. Well, put it this way, I would be happy to see this level of cost saving in other situations, but each situation is different, right? I don't think we can generalize to that extent, but I think it actually creates a good measurement. I would be reluctant to promise that we are going to achieve more or exactly the same of this. It might be somewhat less, but I think… and that definitely depends on the revenue situation, or on the level of overlap between the networks, level of complementarity of the different banks, the levels of efficiency of the different entities on a stand-alone basis and so on. I don't think we can have just one figure and say that this is it and then we are going to deliver exactly this in each case. It also depends on the scale. I mean, there's a scale difference: if we acquire a smaller bank than in this case, the ratio can be even higher or it can be also lower. So I wouldn't say that this is a hard benchmark you can use; each situation will be different, but I think this indicates that we seem to be capable of realizing cost synergies, which are material and meaningful. And this was the first, right? I think it's good that at the first try we managed to manifest the savings we were trying to achieve, so we take it as a very good result and a very promising augur for the future in terms of our intrinsic ability to deliver cost synergies, which, in my knowledge, is not always the case, right? Not all mergers actually result in cost savings if you look at the global markets and the expected savings. So again, don't take it as a numeric benchmark, but I think it can be taken as an indicator showing that we seem to be capable of delivering cost synergies quite soon and also, in a material and meaningful manner.

Samuel Goodacre

Okay, and actually, the second part of that question was related to revenue synergies and, in particular…

László Bencsik

Oh yes, I forgot sorry. It can happen, yes. The most immediate one is on the funding side, on deposit pricing, and that can happen if one of the two entities has a stronger retail deposit base and therefore a better funding cost structure, then that can actually be extended to the other entity, and to some extent, this is what we expect, for instance, in Bulgaria. So indeed, that can happen and that's the very obvious one, which actually happens quite soon if there is an opportunity for that. This effect was not there in Croatia, because we have two similarly structured banks in similar regions of the same country, but in other cases, this can actually happen. When one entity has a lower deposit rate due to potentially larger retail current accounts and so on and so on, then that entity continues as the brand of the lowest funding cost entity and then that can be clearly a positive revenue synergy.

The other positive revenue synergy can come from cross-selling and basically sharing best practices in terms of sales, and that is also there, but it takes more time and it may not be as immediately obvious. But if you have one entity, which is better in terms of its practices and their sales and customer service, and if that is extended to another bank, then it can also be positive, so yes, the answer is yes. It does exist, but I don't think it's as generally visible and not as large; short-term, definitely has a potential cost saving, so when we do the pricing and modelling of these acquisitions and situations, we tend to be very conservative on the revenue synergies. We tend to actually not count any revenue synergies in our models, but that doesn't mean that it doesn't happen. It's just less obvious to happen.

Samuel Goodacre

Okay, and actually, the second question, two different countries, but I'll bundle them together. The first is just some additional colour on Slovenia, particularly related to news flow on Abanka and the bid that you put in there. You obviously want to have a bigger presence than purely the SKB entity you have acquired. Could you update us on Abanka and also, any potential other target for you in Slovenia, and then the bolt-on to that is another country, but in the neighbourhood, Serbia, and the fact that you have said in your report that you would look to divest that entity. Is there any update on that?

László Bencsik

I'm surprised that you read somewhere that we want to divest Serbia. That's clearly no, so the answer to the second question is that in Serbia, we are actually growing, so we just finished the merger of Vojvodjanska Banka with our existing bank there, which happened in April, actually, I forgot to say that. There was another very important milestone we have reached in our merger processes, namely we finished the merger in Serbia very successfully, and now we are facing the next acquisition. Now that we finished the merger of Vojvodjanska Banka, we hope to pursue the transaction with SocGen and continue to acquire, so in Serbia, we're clearly growing and being very strategic, and actually, if this happens, we are going to be number two lender in the country by the end of the year, which I think is a great story.

Okay, going back to Slovenia. I have not ever and I will never comment on some specific deals and potential deals either positively or negatively, so I'm afraid I cannot answer your question and there's nothing we can say specifically on this. What I can say is that, obviously we wanted to enter Slovenia, that's why we agreed to buy SocGen's subsidiary there, and that suggests that we consider Slovenia strategic and we want to be stronger long-term, and I think that's all that I can say at this stage.

Operator

Our next question comes from Andrzej Nowaczek, HSBC. Please go ahead.

Andrzej Nowaczek

Around three, four years ago, you talked about special dividends and/or buybacks in absence of M&A. If 12.5% is still what you see as an optimal CET1 ratio, and you're more or less done with acquisitions, will you consider increasing capital distribution to shareholders?

László Bencsik

We do consider, yes, so that consideration is there. Now this 12.5%, …actually, at the end of '17 we updated our capital strategy, if you remember, and we said that long-term we were targeting 15% Tier 1 and common equity Tier 1 ratio, and we also said that we are quite happy to move within a range, which is between 12% and 18%. The very reason we defined that range was that we wanted to capture this opportunity of doing value-creating acquisitions in this very positive economic environment where does seem to be not so much competition for banking assets in this part of world, and therefore, we had to define this broad range between 12 and 18 in order to be able to accumulate and expand and then further accumulate. So it's a long-term target, 15% and that communication was at the end of '17.

Again, we will come back to it whether 15% is the right target or not and maybe less is enough. This is partially a calibration compared to our competitors and what they target and where they are, because our primary rationale here is to be perceived as well capitalized, so that's important for us, for the markets and analysts and rating agencies' perception of us being well capitalized. So this kind of long-term target really depends on expectations and what other players do and target, and actually, less on the exact requirements from the regulator, which is actually much lower than this 15%, obviously, because otherwise, we could not go down to 12%. So while I'm saying that 15% is not carved into stone, this was our best estimate at the end of 2017 when we updated on our capital strategy, and we have not yet updated this, and we may do so somewhere at the end of this year when we see the end of this acquisition wave exactly and the exact level of capital we have.

Look, as our chairman said during the AGM, we are close to seeing the end of acquisitions, and after this phase, we expect to move into… he described it as a digestive period. A rumination so to say. The number of acquisitions we are doing in such a short period, and compared to our size, is really substantial. We will need time for sure to adjust and to reach a new efficiency optimum for this very different shape and size of group that we have, so what I'm trying to say is that the strategic intention is to very considerably slow down with new acquisitions, plus we don't see so much assets for sale either. We were quite lucky that SocGen strategically reviewed its investment in the region and decided to divest banks, which are actually represent very good quality. Honestly, I haven't heard about other players doing the same exercise.

So I think, one thing is clear that after the end of the acquisition, we will slow down and we will spend time on digesting these new acquisitions, and that means that there will be a period where we are going to accumulate capital, and you are very right to say that the question which you have asked a few years ago, whether we would do extra dividends or buybacks, this is going to come back. Probably, a year from now, this is going to be a very interesting and valid topic to talk about, and then I think we will also address and maybe revisit this long-term target of 15%, depending on where our competitors are and how the market sentiment looks at that future point of time in terms of requirements for these ratios.

So I know this was a rather long answer to a very specific short question, but this is the framework what we are thinking about, so today, at the moment, there's nothing I can tell you in terms of content other than what I have told, and when we come back to the dividend volume itself at the beginning of next year, I think this is going to be representative of the future strategy regarding how we look at capital and excess capital.

Andrzej Nowaczek

And maybe a quick follow-up on costs. Is 4% still the FX adjusted organic cost growth guidance?

László Bencsik

That's the target. That's what we target, but it's a stretched target, I admit.

Operator

Our next question comes from Gabor Kemeny, Autonomous Research. Please go ahead.

Gabor Kemeny

I have a question on JAWS. Revenues increased at a quite similar pace to costs in the first quarter, on an organic basis, both at plus 11%, and actually, if you look at the core revenue growth, that was a little bit slower than the cost inflation, so what do you think would need to happen to achieve positive JAWS over 2019? So meaning quicker revenue growth than cost inflation, and would you expect to get to positive JAWS as a base case?

László Bencsik

Well, the margin improvement would help us tremendously. Last year, was still a year of dwindling margins, and this is really the first quarter this year it started to increase. If the reference rate increases… even if only by 30 bps, that will have a positive impact in Hungary, and if that continues, then certainly that would help us tremendously because margin increase doesn't require additional cost. More volumes typically do, because that requires higher sales activity, but the easier solution to this is higher margins. I'm not suggesting that this is happening for sure or anything like that, but at least we see positive signs. So we might be at the beginning of a different margin trend than we have seen during the last six years in Hungary, so that's one thing.

The other thing which can be good for revenues is volume growth and especially, volume growth of less large cooperates and more consumer growth. And this is what we saw in the first quarter, so if you look at our Hungarian loan growth, it was really consumer loans which grew and by far, they have the largest in content, so the composition of new volumes changed positively. It's not so much the headline volume growth, because if the bulk of the volume growth comes from large corporate, then actually, the marginal revenue growth can be actually quite small. It's not the case with consumer loans, so consumer loan growth tends to be good for revenues and margins as well.

The other one which could help is the easing of the labour market. Now, this is not there, and honestly I don’t know how long this cycle is going to last, but the labour market doesn't show any sign of easing. It's actually the opposite. I think the only miracle which could happen here if Hungarians leaving the country during the last 10 years would come back, I think that would be a huge boost for the economy and would tremendously improve the labour market, but these miracles usually don't happen, at least not from one day to another. And the last one is, if finally our efforts come to fruition and we actually get through this IT transformation and as opposed to spending a lot more on changing IT systems, we can benefit from more efficient IT systems, which require less maintenance in terms of OpEx, CapEx, and personnel expenses. As a result we will actually provide better services to our clients. Now that is also not going to happen from one quarter to another, so not even from this year to next year. Because that seems to be a longer process.

So I think, short-term, what can help is basically the rate environments increase, that would help margins to improve and the composition of our new lending activity shifting much more to retail and within retail to consumer loans as opposed to large corporate, and both of these, I think, are fairly reasonable expectations to happen.

Gabor Kemeny

A quick follow-up. Can you give us an approximate sense of the budget for this IT transformation and on the timeline that you are expecting to incur these costs?

László Bencsik

I think the timeline is easier to share with you. It will take probably two… rather three more years, and the level is pretty much the level what we expect this year, so what is likely is to have the same level of spending for another two, maximum three years. The actual number, we have not talked about, we just have a discussion with our legal colleagues today regarding to how much we can benchmark with other banks these IT costs and then they discouraged us, that there's very little legal room to share this data with other banks. It’s not hidden, you can find this in our costs and in our CapEx which is basically the increase in the fixed assets in Hungary, so you can get these numbers from what we have there. We don't expect this to be much higher also, so it's at a relatively high level already, which is going to stay there for a while.

Gabor Kemeny

Okay, and just a final follow-up on the drivers you mentioned on cost and revenues. Given that you don't expect much easing in the labour market and I think you are expecting fewer base rate increases in Hungary than you did earlier, is it fair to say that positive JAWS would have to come from consumer loans growing much more quickly than the rest of the book?

László Bencsik

No. Actually, the margins are higher… the first quarter net interest margin in Hungary was better than what we expected, than in the budget without a rate increase, so I see we might get to the original expectations, what we had for this year even without the reference rate going up to 80, 90 bps, so even if it increase only to 40-ish, I think we will be able to deliver what we plan for this year.

Operator

Our next question comes from Robert Brzoza, PKO. Please go ahead.

Robert Brzoza

Could you please elaborate more on the developments in the… on NPL level in the Russia unit? I see that a level of 90 days past due loans has jumped from HUF 82 billion to almost HUF 96 billion, whereas the amount shown in the presentation's quarterly generation of NPL was more or less stable quarter-to-quarter, and the question is what was due to smaller NPL sales in the first quarter or there are other reasons behind this behaviour?

László Bencsik

I think it's mostly the exchange rate.

Robert Brzoza

Exchange rate, okay.

László Bencsik

If you look at our numbers in HUF terms, right, and the rouble strengthened. Indeed, I think that the best proxy is the formation slide, the new formation, which is on page 25 of this presentation what we used today. So the first quarter formation was HUF 12 billion equivalent. The actual nominal value here doesn't make a lot of sense because this is on an exchange rate which has been stable, I don't know, for eight years or something, but the relative numbers are important. So compared to the third and the fourth quarter of last year, it went up by 20%, but this is actually less than the volume growth was during the second half of last year, so we had a very dynamically growing loan portfolio in Russia last year, in all, consumer loans grew more than 30% in volumes, and most of this growth came in the second half, and it takes 90 days to get to the 90 days past due. This 20% percent increase is less than the volume growth compared to last year this time, so there's no underlying worsening of portfolio quality or something funny happening there. It's basically business as usual more or less.

Operator

Our next question comes from Alan Webborn, Société Générale. Please go ahead.

Alan Webborn

A couple of questions, if I may. Even though when you look at the loan growth that you're achieving in core Hungary, for example, on consumer lending, you wouldn't suggest it, but is the state of your IT system and the need to have this sort of multiyear investment program, is it a handicap to your ability to deliver retail banking products in the way consumers in the region increasingly want to get them in terms of times online sign-ups and so on? I mean where do you think you are in that process? Is it currently a handicap that you need to address, or is there something that's much more related to back office, middle office? That would be an interesting point, and given the fact that you're talking about multiyear investments in Hungary on the basis that your systems are old, where in the other 50% of the business that is OTP do you have a state-of-the-art system, and where and how much of the others are in need of similar repair and similar investment as we go forward?

You've bought a lot of banks on board in different countries, in new countries. Presumably, the IT infrastructure is now a lot more complex than it was a couple of years ago, so can you give us an idea of where you are? And I guess, the question after that is, when do you get to a point where you can actually start putting some of these core systems together, benefiting from maybe expertise in one area in others? Are we three years, five years away from that? That would be a… if you can give a brief view of how you feel we are, that would be helpful, and the second question was simply clearly, at the moment in Ukraine, you're making massive returns and you're achieving some quite decent growth. When does that start to normalize? Or, for the moment, are you telling us that you still think a 6% or 7% loan growth and a 50% ROE is sustainable over the next couple of years?

László Bencsik

Okay. Well, these are the complex bunch of questions. As for service quality, the answer is very easy. We believe and it's not just an unfounded belief, this is based on empirical evidence, this is based on independent surveys and based on customer satisfaction data and customer usage data that our retail service quality in Hungary, I can only say is the best and it's actually much better than our competitors. Customers don't see anything from the complexity if issues you touched upon. In fact, if you look at the services we provide in terms of digital, I think it's state-of-the-art, and we have some very forward-looking developments, and this is not at all a hindrance on the side of our ability to sell more or service our customers better. The problem is the cost of doing that, because what we have stopped in Hungary is, based on these kind of old system elements and large kind of spaghetti environments where we always had very high expectations in terms of the services we provide, without changing the underlying core systems, then that actually led to a very huge robust environment. Providing a very high level of service and to be able to develop it with the speed we require the development to be is actually very expensive.

So, we want to modernize not, because we believe that we are not providing the service that is needed to be number one in Hungary; we are doing these developments in order to do it much cheaper and much more efficiently. Other markets… well, typically, our other banks have lower level of sophistication of services I have to admit, so I think they don't have a similar problem in any of the other banks. Typically, the IT environments are much more clear and have much less systems, and usually, we can substantially improve the services provided to customers by just changing the front-end or putting a CRM system there and so on, which we do. We tend to have much less problem actually, with the core applications in the subsidiaries than in Hungary.

Now, in fact, the current setup is an advantage, because it will be pretty much impossible to manage so many mergers and acquisitions in parallel if we had a uniform IT platform, because then, where we should have one centralized resources to do development and that would be pretty much impossible to do so much parallel activities in so many different countries at the same time. With our current decentralized model, actually we can easily have very intensive IT developments in many of the countries and group members we have across the region, including Hungary and including parallel merger processes in different countries, because they don't consume the same IT development resource, because the systems are actually different and because, typically, they use local pools and skills to develop the systems that we have across the group.

When are we going to integrate the entire group into a uniform IT platform? I wouldn't dare to put a date on that. I'm also not 100% convinced that an entire uniform environment is the right one. It may be actually too expensive to have, because very soon we are going to have 12 countries, in the region, and some of them are potentially quite small. Some of them are big, and there are big differences in what we do and how we do and then the history of these banks, so I'm not 100% sure that is the most efficient solution, and then, in some cases, actually, there's a huge difference between our units in terms of how much we have to spend on IT in order to have the same level of service. Sometimes a local solution is much cheaper and much more flexible than a uniform platform.

Nevertheless, I think there are very strong reasons for a uniform platform especially in some areas, so for instance, the digital front-end, there's no reason why that should be different or the call centre or CRM or database management or the basic IT infrastructure and so on, but I can easily imagine a very efficient and flexible setup where the core systems are not exactly the same in each country. But nevertheless, it's only going to happen in the distant future, and short-term, this is not what we do. Short-term, we want to optimize first, we want to transform the Hungarian environment and we want to optimize each and every country and, actually, unify the systems where it makes the most sense, where we have a good solution for a new group level and where the business case is clear for implementing it, we want to do that, so there's no question about that.

Ukraine, it's how sustainable? Actually, if you looked at the revenue margin, it increases. Cost efficiency is very good and it improves. ROE has decreased, because the leverage decreased, since they have not yet paid dividends, but it is going to come and so the local equity increased a lot because they are very profitable. But even the ROE could be higher if we had an efficient capital locally. Obviously, nothing lasts forever, and Ukraine, the whole country has been volatile, and I think it's going to remain volatile. I think this period is going to happen when we have another very negative macroeconomic adjustment in Ukraine.

When is it going to happen? I don't know. It can be induced by or kindled by different factors. It can be an external or kind of global recession or it could be kindled by another geopolitical conflict or internal domestic political upheaval, so there are potential threats, but I don't think that the likelihood of these potential negative events is very high at all, so I don't think it will be higher now than a year ago. It has always been a volatile environment, but the last couple of years, it's been relatively stable, at least stable enough to provide these levels of return, and honestly, I don't see reasons why this should change, but that also doesn't mean that it will not change. At some point, it will, but I just don't know when, and up until that happens, we are quite happy with what we do, and we do it in a way that we keep in mind that anything can happen in Ukraine any time. So the type of lending we do is very different from what we did 12 years ago in Ukraine. We don't do any FX retail lending. In fact, we don't sell any mortgages. In corporates, we are much more selective. We typically focus on local currency lending. Dollar lending, we typically do, and leasing is getting actually a much bigger share of our lending activity there and we consider leasing to be less risky and this is inducing lending, so we also believe that the structure what we have there today is much more resilient than what we used to have 10 years ago.

Operator

Our next question comes from Máté Nemes from UBS. Please go ahead.

Máté Nemes

I have two follow-up questions, please. Firstly, on the net interest margin. Can you just confirm that the 4.25% floor for 2019 is without the effect of Expressbank, or you would also expect NIM to not go below 4.25% with it, Expressbank, included? And related to that, I think you mentioned that you expect 35, 45 basis point BUBOR by year-end. Can you perhaps talk about the expectations if the BUBOR stays where it is, how the NIM would develop? So that's the first question, and secondly, on operating expenses. Can you discuss that what measures, what steps you can take in order to converge towards the 4% underlying year-on-year target? Shall we expect actually more operating leverage will later come through in the remaining three quarters, perhaps more skewed to the second half of the year? Is this, let's say, base effect in, for example, Q4, is it the cut in the social contribution of two percentage point? Is there any incremental contribution from cost savings in Croatia, and I don't mean to suggest I'm not appreciative of the numbers there.

László Bencsik

The NIM guidance was without any acquisition, so it was without Expressbank and it was without any other acquisition, which is going to come during the course of this year, and without Expressbank, in first quarter it was markedly better than this 4.25%. Actually, the trajectory was different. It increased as opposed to decrease.

The Hungarian NIM slightly increased even without BUBOR increasing much, so if you are optimistic, from this point of evidence, you could say that maybe with the current composition of new sales, it could be possible to at least maintain the NIM in Hungary without even further increase in BUBOR. I think it can only happen if the composition of the new volumes remains really favourable and tilted towards consumer loans as opposed to large corporates, which happened in the first quarter by the way.

To get to the year-on-year forecast… when we look at the budget, actually, the first quarter, we were within the budget in terms of cost growth. What we need to do is to avoid the excessive seasonal increase in spending in the last quarter, so if we can avoid that, then we can actually get very close to 4%. The key is Hungary, and the key is to be able to contain the Hungarian costs and that depends on also the headcount development and on how we approach the general wage increase problem. But in broad terms, if we can avoid the hike in the fourth quarter, then we can actually can get close to this 4%.

[No further questions]

László Bencsik

Thank you very much. Thank you for being present on this conference call and thank you for your very good questions. I wish you all the best, a nice weekend, and I hope you join us when we have the next conference call presenting the second quarter numbers on 9th August, this summer, so up until then, all the best to all of you. Thank you very much again.

Note: unabridged transcript with minor English stylistic corrections.