OTP Bank 4Q 2017 Results Conference Call — Friday, 02 March 2018

Anna Marshall

Hello from London, everyone. This is Anna Marshall from the senior bank team at JP Morgan, and I have the pleasure of introducing today's speaker, Mr László Bencsik, Chief Financial and Strategic Officer at OTP Bank. László, over to you, please.

László Bencsik

Thank you, Anna. Good afternoon, or good morning, depending on where you are, and thank you very much for joining us today on the fourth quarter conference call of OTP Group. As usual, we have the presentation uploaded to the website, so I hope you have been able to access it, and you have it in front of you. As usual, I'm going to go through the pack in the first part of this conf call, and in the second part you will have the opportunity to ask questions.

Starting on page two of the presentation, the accounting profit for the whole year was HUF 281.3 billion. The adjusted profit was 284.1 billion. Both of these numbers are historic record high results in the history of OTP Group.

This is higher than ever, even before the crisis, and this is even higher than what we booked in 2008, when we sold our insurance subsidiary, Garancia, and it had a one-off effect. This is really an outstanding performance, in this sense. As you can see, the adjustments were rather small.

We had the usual bank tax, and then we had the positive impact of the acquisition. Both of the Splitska acquisition, but more importantly, the Vojvodjanska acquisition, which was consolidated in December, just in the last quarter, created a positive P&L effect through booking a badwill.

On page three, you can see the guidance we made a year ago, and how we fared, compared to these promises or indications. The ROE, especially if we calculate it based on this 12.5% Common Equity Tier1 ratio, which we originally defined as the base for calculation, it was 22.4%, the accounting one was 18.5%, still much better than the 15% originally targeted. The loan growth was according to plan, at the very end of the scale: we defined a range of between 2016 growth, but still single digit. We just managed to hit the lowest double-digit number, 10%, so this is a very good performance.

Net interest margin declined by 16 basis points without the effect of acquisitions. Obviously, the previous number was also without acquisitions.

I'm just warning you that if you look at our numbers, and understand the year-on-year changes, you have to always bear in mind that the two acquisitions last year had a major impact on our P&L, and also, the balance sheet.

Therefore, the year-on-year comparison, without taking these effects into consideration, might be somewhat misleading. So, this NIM erosion, which we have here, 16 basis points, was without acquisitions. Including acquisitions, it was more: 26 basis points. I will speak a bit more about this later on.

We expected risk costs to decline, and they did, quite spectacularly; we had more than 50% less risk cost last year than in 2016.

Operating expenses, unfortunately, grew somewhat more than we originally expected, so the expectation FX adjusted, and without acquisitions was between 3% to 4%. We ended up growing by 4.6%, and this pressure was primarily coming from the labour market. Just to give you an indication, in Hungary, the real wages grew last year by 9.5%. This is almost 10% real wages growth. And the other countries where we operate are not very different from this. The labour markets are extremely tight, and at the same time, we are quite ambitious in terms of modernising and further developing the bank, and especially, the IT infrastructure and our services, going more into digital services. It is, obviously, costly in technology, but also, and even more in terms of people.

Acquisitions. We indicated that we were going to do further acquisitions, and indeed, we have closed down two, the Splitska and Vojvodjanska Bank.

Dividend, we are going to propose to the AGM 15% nominal increase in the dividend payment compared to the previous year, according to what was originally indicated, and in fact, put aside on a quarterly basis. There is no surprise there.

We assess this performance as being relatively good, compared to other somewhat comparable banking groups, who operate actively in the region. On page four, you see the ROEs, compared to these, and the CET1 ratios. Obviously, it is very difficult to compare ourselves to any institution, because we are quite unique in being only present in the CEE and CIS, and headquartered in CEE, namely in Hungary. All the other banks have a very large part of their operations and books outside the region, being in Western Europe. This is only of limited relevance, but this is the best we could do.

On page five, basically, this outstanding performance is driven by the very favourable operating environment that we had last year in all of the countries where we are present, but especially in Hungary. The Hungarian macro performance was really outstanding, and you have to go back really far in history to see a similar growth pattern in the Hungarian economy.

It's not just the growth itself, which was, indeed, quite broad based, as you can see on this chart. GDP growth 4%, household consumption growth 4.3%, investments grew more than 22%. And there is a remark we have to make there, this is partially explained by the fact that in 2016, the growth was actually negative; investments declined by 15%. This is partially due to the low base in '16, and this volatility is related to the EU funds. Export growth remains strong at 6.5%. So, a broad based well balanced growth. But at the same time, numbers that are not on this page are also very strong. The balance indicators are quite solid. Deficit below 2%, the current account surplus 4.7%, and public debt ratio 72% and declining. Inflation, 2.4%, unemployment, 4.2%, and real wages grew by above 9%, as I just indicated, which is very positive on the consumption side and the retail loan demand side, but not so positive on the personnel expenses side.

All in all, we operated in a very good, relatively fast growth and stable growth environment last year. That resulted in a very strong and accelerating long growth. As you can see on page six, the organic Group-level loan growth was 10%, and including acquisitions, it was 25% year-on-year.

In Hungary, we grew organically by 11%. The Hungarian organic growth was higher than the group average. And especially in Hungary, if you look at this timeline starting in 2009, there were a lot of negative rates, marking a long period of deleveraging in Hungary. Then loans started to grow in '16, and then we had this solid growth in '17. We are very much hopeful that this trend is going to continue, and growth is going to remain quite strong.

Also, on this slide you see the deposit growth, which remains equally strong. The net result of this is that the gap between deposit and net loans actually grew. Our liquidity surplus grew by more than HUF 400 billion. This gap is HUF 3.2 trillion, which is more than EUR 10 billion.

Most of it is in Hungary, so 2.7 trillion of this gap is in Hungary, where the loan to deposit ratio is still lower than 50%.

So, strong organic growth, both in loans and in deposits, and a very good year in terms of acquisitions, as you can see on page seven. Obviously, there is nothing new about this, but I think it's worth just remembering and reflecting on the importance of these two acquisitions, because as you can see, in both cases we managed to acquire much larger banks than we had in these markets. Therefore, our market position not just slightly improved, as in the case of some previous acquisitions we had been doing. In these cases our market position fundamentally changed and improved, and this is what we want to see, and what we would further like to do in some other markets, as well.

This rapid growth is only possible because we are generating a substantial amount of capital, due to the high profitability. The 18.5% return on equity, which we had last year, generates a substantial amount of capital, which is available for organic and non-organic growth. Our liquidity position is outstanding, as well.

The second most important feature of last year, apart from the accelerating performing volume growth, was the low level of risk cost. And this is not just a phenomenon in the case of OTP, but this is what we see in other markets in other banks, and especially in Hungary, the recent data came out from the National Bank, regarding the performance of the all banking sector. The banking sector, if I remember rightly, had a positive 1% risk cost rate. This was not just true for us, but for the rest of the banks, as well. Having said that, the HUF 31 billion annual risk cost on a group level is certainly at the lower end of the cycle. And the risk cost ratio was 40 basis points only, which is a considerable decline, compared to 2016.

Not just the ratio, but if you look at the other indicators, for instance, the share of the more than 90 days past due loans dropped below 10%, now it is 9.2%, and there was a lot of decline during last year.

The coming pages are always there, so we included them, and please look at them, and you will see important information. But again, I have to warn you that these numbers, on a year-on-year comparison basis, have a somewhat limited relevance because they have not been adjusted with the new acquisitions, therefore, the numbers are not directly comparable. Later on, I will go into more detail, into the P&L lines, and explain the effect of the acquisitions as well.

I'm jumping to page 13, where you see certain miscellaneous items. The first one is the update on the M&A transactions. As you have seen in the financial statement, we consolidated the Serbian bank, Vojvodjanska Bank, to our group report. We closed the acquisition process on the 1st of December, and the balance sheet numbers are included in the year end group balance sheet, and we also included one month's P&L impact. So, the one month P&L result was included from Vojvodjanska, albeit this was rather small, but positive.

The third acquisition, which is in progress, is still in progress. We are still waiting for the decision of the Romanian National Bank. They have already obtained the approval of the competition authorities, but the Central Bank has not yet formulated its decision. This is expected to happen in the next couple of weeks.

As for the IFRS 9 impact, which we also indicated in the stock exchange report, we expect HUF 50 billion impact on retained earnings. This is after the deferred tax assets we created. The provision increase is expected to be HUF 58 billion when adopting the IFRS 9 standards.

We also intend to use the phasing in transition rules available for European banks, and therefore the actual Common Equity Tier1 impact in 2018 is expected to be only three basis points, very small. In the first year, only 5% of the total impact has to be included. Then it goes up, next year it will be 15% altogether, and in two years 30, and in four 50, and five 75%. In 2023 we will have to include the entire impact of this extra volume of provisions in the capital adequacy of the Group.

The third element is a recent development, which was announced by the Government Debt Management Agency, and unfortunately, this is negative for the Group. If you remember, a year ago, they started to cut the distribution fees for government bonds to the banks, and there was a further cut, which happened in February. We expect the impact of this to be HUF 3.5 billion negative on the fee income what we generate.

Now, I'm going to go more into detail into the P&L lines, starting on page 14. This is the total income, and here, you see the year-on-year and quarter-on-quarter changes, both nominally and in percentage terms. And where it's relevant, the nominal and the percentage changes are split, so you see a total change and you see another number, which indicates the change without acquisitions, as if no acquisitions happened.

For the Group the total income including acquisitions grew by 9% year-on-year; without acquisitions by 5%. I think here the 5% is the really interesting number. We managed to organically grow last year the total income by 5%.

If you look at the countries, in Hungary there was 3% growth. Unfortunately, in Bulgaria, we had minus 4%, and this is related to the still quite steep decline in the net interest margin in Bulgaria, which we have been witnessing for a long period of time, and which is likely to continue in the future. In Russia the FX adjusted growth, so excluding the change of the exchange rate of the rouble, was 6%. In Hungarian forint terms it was more because the rouble appreciated. Likewise, in Ukraine the FX adjusted change was minus 1%, so basically flat. Croatia improved, and there is the very substantial impact of the acquisition. In Serbia we had improvement, and the acquisition had an extra boost, even if it was just for one month.

Going one level deeper, into the net interest income line, where it is more visible what's going on. The NII on the group level remained flat without acquisitions. And I think this is a good result, given that the NIM declined by 16 basis points. The composition of this NIM decline, plus the 10% organic growth, resulted in more or less flattish NII.

Hungary was almost flat. The last quarter was quite strong, but here, we had a one-off accounting booking event, which was not related to fundamental business events, this improved the NII by HUF 1.3 billion, as you can see here. You can see here the magnitude of decline in Bulgaria: 14% decline year-on-year in the NII, which is due to the margin compression.

I think this is the only country where we see this strong impact coming from the margin decline, but also DSK is still much higher than, for instance, what we have in Hungary, and more on this later on. Russia, in rouble terms, stayed flat, and in the last quarter it improved. The quarterly growth is basically due to the very rapid volume growth what they had, and it's usually seasonal during the last quarter. Ukraine, some decline due to NIM compression, and Croatia and Serbia improving, and some decline in Romania, Slovakia, and Montenegro.

On page 16 starts a section which talks about volumes, starting with loan volumes. You can see the details of this 10% year-on-year organic growth, which has been quite strong across the board in these countries. Hungary grew by 11%, and for instance Russia 22%, and most of this growth came during the last quarter: 12% growth happened only during the last quarter, but this is the usual seasonality that we tend to see in Russia.

There is one number that is important here. It's a small number, but it's very important. It's the mortgage growth, 2% in Hungary. This is a turnaround year for mortgages, because this is the year when mortgage volume on a yearly basis started to grow. This is where we expect further acceleration. As for corporate growth in Hungary, we had a stellar growth of 18%. This might be somewhat lower this year, or it should be somewhat lower, because now we are concentrating the capital allocation to parts where we have higher returns, now that there is growth everywhere in the portfolio.

I think this is a number to watch during the course of this year, the mortgage volume growth in Hungary, and the expectation is that it's going to be higher and higher, as we go ahead in time.

Page 17 is interesting because this depicts the level of activity we have within the Group, because volume growth is not necessarily congruent with the actual amount of activity we do. This is how the new production grew last year, and as you can see, there are some very high numbers. For example, Bulgaria, which is a large bank, grew year-on-year by 50%, in terms of new mortgage production. In Hungary the new mortgage production grew by 30%. In Romania, 70% mortgage and almost 50% unsecured loan activity. It's a pretty strong development in new production.

On deposit growth, again, across the Group, it has been quite strong, resulting, overall, in 8% growth, and in Hungary 10%.

Page 19 talks a bit about the exciting topic of net interest margin (NIM), and how it has developed. The top line number declined by 26 basis points year-on-year. Obviously, Splitska, having a lower NIM than the rest of the Group, but being quite sizeable in terms of balance sheet, had an overall negative impact on the Group level NIM.

If you take this effect out, then if you compare the two years without the impact of the acquisition, then this decline was only 16 basis points.

We tried to provide some flavour on what happened during the last quarter. In the fourth quarter, there was a five basis points decline, and in the bottom of the chart on page 19, you see the components of this decline. Fundamentally, interest rates had an 11 basis points effect. Most of it came from Romania, which was an accounting revision, so to say, so there was a one-off accounting correction we made during the last quarter. The 6 basis points Romanian impact is really a one-off, and it's not going to continue to appear.

Fundamentally, what was there during the fourth quarter is the Russian three basis points and the DSK contribution of two basis points decline to the Group level NIM. On the other hand, Russia contributed in two other ways. One is that its size grew, because of the 12% growth in volume in Russia. Its overall share in the total NIM and total NII increased, and because Russia is still much, much higher in terms of NIM than the rest of the Group, so this composition effect was a positive one. And we also included Vojvodjanska, which technically improved the Group NIM by three basis points in the fourth quarter.

And then there's the FX impact. The rouble strengthened, and it had three basis points positive contribution through the exchange rate conversion to the NIM.

On page 20, you see the largest Group members' NIM development. In Hungary, in fact, we had a slight increase, but this was attributable to a one-off accounting booking, which is not recurring. Without this, we would have had a 3.09% NIM instead of 3.16%. Bulgaria, this decline is unfortunately something that is not going to end very soon, but will continue into 2018, the first and second quarter, and probably the third quarter, as well. This continuous erosion in the margin in Bulgaria is due to the repricing of the existing book, and also the front book being lower margin than the back book.

Russia, if you look at the year-on-year change in the NIM, then in fact, most of it can be explained by the fact that there are some intra Group funding transactions, which don't have a net value, but do inflate the balance sheet of our Russian book, and therefore, decrease the NIM. That's the factor behind most of the year-on-year decline in Russia. If you look at the decline in the last quarter, then this is fundamental, because especially during the last quarter, during the very high Christmas season, we saw very fierce price competition, especially in the POS segment in Russia. I would say even irrational levels of APRs appeared at some of our competitors, and obviously, selectively, in order to stay in the game and reap the marginal benefits, as long as they are there, we had to follow them. Hopefully, this is not going to last long, and hopefully, this was mostly related to the sale actions, which are usual before the Christmas period in December in Russia. But we don't know, and there seems to be continuous price pressure there, especially in POS loans.

Croatia, in the margin, as you can see, there was a step down from the second to the third quarter, but this is related to the Splitska inclusion to our numbers, and there was only a very slight change from the third to the fourth quarter.

In Romania, as I said, there was this negative one-off booking we had to make, in order to correct something which was not properly booked during the previous quarters of last year. This is not going to recur, and it was clearly a one-off, so hopefully the margin will jump back to close to previous levels.

In Ukraine somewhere in the second quarter, or in the third quarter we had a methodology change, which somewhat reduced the NII. Ukraine is one of the countries, together with Romania, where the rate environment started to move upwards, both in Ukraine and in Romania we have seen rate hikes, and they may continue.

We already have within the Group two countries where we see tightening of the monetary policy, which hopefully, especially in Romania, might manifest in somewhat more stable margins, or maybe even somewhat better margins.

This leads us to page 21, where we have explained a lot of what happened in net fee income. Net fee income performance last year was really very, very good. We grew 15% organically, and with acquisitions 19%, and the last quarter was quite strong with 9% increase. We're talking mostly about the year-on-year numbers. This 9% growth in Hungary was all fundamental as business activity increased; related to higher consumption, higher card usage, higher volume and number of transactions. This is intrinsic growth.

As well as in Bulgaria. In Russia, there was a reclassification of HUF 3 billion expense from net fee income to the NII, so it was negative HUF 3 billion to the NII, and this is positive three billion to the net fee income in Russia. Without this adjustment, the growth was nominally six billion, but this is still more than 30%. So, very strong growth, and this is related to fundamental business activity there. We are not surprised that we are growing in Croatia and Serbia due to the acquisitions, but in Ukraine we had close to a 20% growth in local currency in fees.

And the last row is the Hungarian fund management, which managed to grow 15% due to the very high success fee, which they received due to the very good performance of the funds they manage. And all this money came in during the last quarter, that's why you see this quite sizable number of HUF 5.3 billion quarter-on-quarter nominal growth in the fee income of the Hungarian fund management company.

Other non-interest income grew by 17%. A big chunk is from Hungary. Hungary did very well, especially the trading, treasury, and securities trading was a very lucrative business last year. DSK improved, but this is more the swaps and methodology changes between the Bulgarian bank and the Hungarian bank, so the net impact on the Group level is somewhat more moderate. Nothing tremendously exciting on that front. All in all, we can say that last year was really good for all the treasury activities we had within the Group.

This leads us to page 23, where we talk about the operating costs. At the very beginning I indicated that this is a line where we missed somewhat our target what we originally indicated at the beginning of the year. The FX-adjusted without acquisition operating cost growth was 4.6%. As you can see here, the growth was quite moderate in Hungary; only 2%. This is partially due to the fact that the social contributions we have to pay as employer after the wages decreased by five percentage points last year, so that, to a large extent, compensated the wage increases we had to make.

This is going to continue into this year, because there is another 2.5 percentage point decrease in the level of contributions. Not as strong impact as last year, but still material positive impact coming from that, which will partially balance the growth of the wages, which we have to keep up.

In Bulgaria we have a major transformation project on-going. Basically, we have changed everything that can be changed in retail, and we are trying to develop every part of our retail activities in Bulgaria, which includes high operational expenses, higher IT development, lot of money to consultants and hiring new people, or replacing existing colleagues with new ones, which tend to be more expensive. This year was quite a strong growth, in terms of costs in Bulgaria, but we hope that the investments we make there into modernising our retail activities will pay off, and we will see the benefits in terms of better profits later on.

Russia, 8% growth due to the growth of the volumes and the new sales, and also the higher rate environment, and then inflation dropped, and wage inflation is quite strong in Russia. And then Ukraine, 5%. This is a country where we have 14.5% inflation level, so the 12% nominal growth in cost is lower than inflation level.

Croatia without acquisition 2%, Serbia 2%. And then we have Touch Bank, which is a large contributor to costs, an increasing contributor to costs, but it doesn't quite contribute to profits. We are working on fixing this issue, and developing strategies how to make its performance better.

At this point, I'm going to say a few words about some of the highlights of our Group members. For instance, on page 25 and 26, you see some information on our success stories in Hungary. In retail and corporate we have strong and usually improving market shares in cash flows, in household savings. Year-on-year, it didn't improve, but it was still quite strong in new mortgage origination.

I think these numbers are speaking for themselves, and we are quite happy with these levels of market shares. In corporate we are growing fast; our market share stabilised. But again, in corporate it's not a target anymore to further increase our market share. Rather we want to focus on a higher return business within corporate, and therefore not to continue to grow our market share anymore, so much.

Page 27, a page about Bulgaria. Quite strong return on equity of 20% despite declining margins, and what counterbalanced last year the declining margin was the lower risk cost rate. This is quite a low margin environment. Just to remind you, the National Bank of Bulgaria deposit rate is even lower than the European Central Bank deposit rate. It is minus 60 basis points, so this is an extremely low rate environment. Nothing lasts forever, at some point the euro rates will start to grow, and therefore the Bulgarian rates will follow, and then hopefully we'll get out from this long trend of negative NIM development.

Russia, overall, very good. Above 20% return on equity. Decent growth in POS, and very high growth in cash loans, which is our target product, or more supported product, in terms of profitability and growth momentum as well. The risk cost rate moderated, so this is a rather stable picture what we have there.

Ukraine, on page three, interestingly, if you look at the return on equity number, which we had last year in Ukraine, it's 47.1%, so a really stellar performance. We have seen a somewhat volatile past there, as you can see, and there were a number of years where we had negative equity as a whole group what we have in Ukraine.

Croatia, page 31. Here maybe the return on equity number is interesting. Just to remind you, this 9.3% includes 8 months of Splitska. This doesn't include Splitska for the entire year, and this is before any type of synergies. This is with the additional expenses of executing the merger, so at the moment we have extra costs due to the developments we have to make in order to create a joint IT platform, and to manage the whole merger. This is without the entire year contribution of Splitska, only eight months, and this is also before any synergies realised. It is quite the opposite, as I said, now we have extra costs at this period.

We have some slides about the further details of risk costs on the Group level, as usual. I'm sure you will find interesting data there.

Please allow me to jump to page 36 and 37, where I would like to give you some indication about expected performance for this year, for 2018. The most important one is the external environment, and we are quite optimistic in this regard. Here, you see our forecasts related to the GDP growth in these countries. Basically, in all of the countries where we operate we expect a very positive and supporting economic environment.

Hungary, we expect 4% growth in '18, similar to the growth rate last year. And we expect this growth to continue to be broad based, covering all parts of the economy. In all the other countries, I think these are quite healthy growth levels. On the right side of this page, you see our expectations for the market growth rates in retail and corporate for all these countries.

Finally, page 37. This is our carefully worded guidance for some of the most important levers of performance for 2018. As for the one-offs, for sure there will be the bank tax, we've already booked it in January, so this is there for sure. And we are hopeful that we will see other acquisitions coming through, and they will have potentially a one-off impact, but we don't know how much in what direction.

If we go more to the fundamental part of the business, I have to remind you that for each of these sentences or paragraphs, you have to also consider whether they are with or without acquisitions, because these numbers have different values and meanings, if you include or if you don't include acquisitions.

Organic long growth, starting from 2017 closing numbers which included Vojvodjanska and Splitska Bank, but not including any more acquisitions, we expect similar performing loan growth than we had last year. One extra comment, that maybe the composition of this loan growth will be different. We would like to see higher growth in retail volumes, and somewhat lower growth in corporate volumes. Therefore, hopefully the margin contribution of the performing volume growth should be higher than last year, because last year it was quite tilted towards corporate. The biggest driver of this change is expected to be the Hungarian mortgages, not surprisingly.

Net interest margin erosion. Similarly, this guidance includes the acquisitions we have completed, but doesn't include any further acquisitions. Therefore, we use the last quarter, the fourth quarter number, because this is the one that included both Splitska and not fully, but partially, Vojvodjanska. Compared to this level, we expect further 10-15 basis points decline on an annual basis, so if you compare the last quarter last year to the whole year 2018. Just one caviar on this: if all goes well we might be able to see the bottom of this NIM cycle during the year. As the Chairman said during the press conference, the last quarter might even already show some improvement.

Obviously, here the rate environment is interesting, how it's going to evolve. I want to pre-empt any questions like that. We don't expect any rate hikes in Hungary, certainly not during the course of this year, probably not even next year, but maybe next year, the reference rate can start to get higher.

All in all, the composition and other effects might lead to some positive changes at the end of the year. Factually this is our guidance, so 10-15 basis points decline compared to the last quarter.

Risk cost, overall, we expect somewhat higher risk cost in 2018 than in 2017. And here, we don't have any qualifying comments, so this is basically including last year's acquisitions, and again, not including new acquisitions, but last year, just to remind you again, Splitska was not included for the whole year, but just eight months, and Vojvodjanska for just one month. This is going to have, in itself, certain pressure for higher risk cost, because this year we will have another four months of risk cost from Splitska and the entire year risk cost from Vojvodjanska. This is just one part of the picture of why we expect somewhat higher risk cost this year than last year.

One factor here is that it's unlikely that we can have as high level of recoveries from previously created provisions as we did last year. And also given the strong loan growth what we expect, and because IFRS 9 has somewhat higher provisions on Stage 1 then the IBNR in performing under the old regime, so a fast growing portfolio might result in somewhat higher provisions.

When we compare risk costs, we'll compare an IAS39 risk cost in 2017 to an IFRS 9 risk cost in 2018.

Operating expenses, unfortunately this is a line where we expect somewhat higher growth than last year. Last year, it was 4.6%; this year we expect 6%. This is FX adjusted, and this is without acquisitions. So, just trying to compare apples to apples.

You might notice that two items are missing here, or you might say they are missing. One is the ROE guidance. The ROE target has not changed. A few years ago we declared a mid-term, longer term target of being above 15% ROE, assuming 12.5% Common Equity Tier1 ratio. That still stays. Last year we by far over performed that target, and hopefully, this year we will also over perform that, so this is not a very precise indication of how we are going to perform.

The other one is the expected dividend payment after the year 2018. This is a topic on which the Chairman will share further guidance during the AGM, because this is something we should discuss with the shareholders. This is going to be more of a topic on the shareholders' meeting which will be on the 13th April.

With this slide, I'm finishing the formal presentation part, and I'd like to ask you to ask your questions. Please, operator, open the line for questions.

Operator

Ladies and gentlemen, if you would like to ask a question, please press star one of your telephone keypad now. If you change your mind and wish to withdraw your question, it's star two. And when preparing to ask your question, please ensure that your phone is unmuted.

Our first question is from Samuel Goodacre from Morgan Stanley. If you would like to go ahead, Sam.

Samuel Goodacre

Thank you very much, and thanks for the presentation, László. I've got three questions, and the first two are about capital and acquisitions. Earlier today, in some press comments, it was suggested that you may look to enter two new markets. Previously, your comments were more about focusing on improving subscale returns for some of your smaller businesses.

If you are indeed looking to enter into new markets, does that mark a shift in that strategy? And what sorts of market positions in new markets would you, this time around, be willing to acquire? And the second question related to acquisitions, in fact, it's more about divestments.

If you are left with countries where your market shares are smaller, you may not be able to benefit from economies of scale, and therefore, your returns could be lower than you would hope. Would you consider to exit such markets? Thank you.

László Bencsik

The Chairman has not specified what these two countries are, so I'm not going to. There was a very generous statement that he can also possibly imagine entering new countries, as well, but this doesn't change our core and fundamental strategy related to acquisitions.

The focus is on the current footprint, and on existing countries, and it's very, very unlikely that we do anything material outside of the current footprint. It's not impossible, but this is not the main focus. We don't have anything that would materially change the composition of the Group.

Exits, there's nothing on the table on that side, and we are not considering this short-term, definitely, and not even mid-term. All our efforts, at the moment, are concentrated on organic and also acquisition type growth. We are quite hopeful that we can use this window of opportunity to address these situations where we have not optimal size or not optimal type of presence.

At the moment, all of our efforts are concentrated on this. Later on, if these efforts are futile, and we don't go anywhere in some countries, we will, at some point, have to address that question. But at the moment, and in the foreseeable future, we believe that there is opportunity to acquire at a reasonable price, as we have done, and this is what we will concentrate on.

Opportunities can come from surprising angles and places, so we haven't given up on any of the countries where we are.

Samuel Goodacre

Thank you for that. My third question is about the cost inflation you're guiding for, and in particular, the digitalisation angle. So, when you're thinking about this type of IT investment, is it more to yield benefit on the revenue side? Because, of course, digital transformation would allow you to better engage with customers, better leverage data for CRM and marketing type purposes. Or is it, rather, on the cost side, and all about running a leaner and more streamlined organisation?

László Bencsik

First of all, despite our strong investment and a lot of effort in developing digital in Hungary, if you look back in 2017 the cost increase in Hungary was only 2%. It's not that we are spending astronomical amounts of money on this. The primary focus is on improving our current digital services, and introducing new ones. Primarily, it's revenue increase and customer retention. That's for Hungary.

In Bulgaria, for instance, we also do a lot of digital stuff, but it's a complete overhaul of what we do in retail: changing how the branches are set out, the branch processes, the products, and the branch footprint, the organisation of retail, inbound, outbound call centres, further development. We have a new integrated CRM and front end IT project. It is Bulgaria where we do a more fundamental overhaul of the retail operation, and the expectation is clearly to turn around. If you look at the previous trend of market share erosion, because if you look at market share in Bulgaria, it has not too visibly, but slightly, gradually, it has declined somewhat during the last five or six years.

This is a trend we want to turn around. In Bulgaria we expect revenue, and especially volume and market share impact coming from these changes. Cost savings and efficiency improvements will come later. This is something in the second phase, or second rollout, but for that, you have to change how you work. We have to change how we work together and how we organise ourselves, especially in the headquarters in each country. I don't want to use buzzwords like agile and things like that, but we are also developing on that front. We are trying to figure out how to operate internally much more efficiently by getting closer our business guys, and IT development guys, and all the other functions, and creating more unified units that are more efficient.

There are also developments on that front, but I can't promise you like in one year, we will have cut whatever per cent of the cost base out. We are not in that mode at the moment. Where we will see cost improvements is the acquisitions. When we do an acquisition, we have very high expectations of cost synergies, typically, and this is going to come. We should be able to see that. In the countries where we are buying sizeable assets, there should be cost synergies, but they take some time to manifest. This is going to come in the foreseeable future, in the two countries where we have already concluded these acquisitions, and further acquisitions in countries where we are present, as well, we will improve efficiency.

I think this was rather a long answer, but hopefully it depicts how we think about this problem.

Samuel Goodacre

It does, indeed. Thank you very much.

Operator

Our next question is from Andrew Keeley from Sberbank. If you'd like to go ahead.

Andrew Keeley

Good afternoon. I have a couple of questions on your Russian business. As you've commented in your presentation, it's the third year of losses you've had in a row at Touch Bank. The losses in 2017 seem to have shifted from being driven by the start-up costs that we saw in 2015, 2016, to provisioning and asset quality, and very, very high risk costs.

I'm just wondering whether you can add a little bit more colour as to what's gone wrong there. What are the loan products that you're issuing? How you're looking to change that. And a bigger picture is how much longer can your patience last for this business? Do you expect another loss making year this year? For example, do you think that you've put the changes in place now to turn that around?

László Bencsik

A pertinent question, indeed. Some of our patience ran out, and therefore we changed the management. Originally it was set up as legally part of the bank what we have in Russia, but fully independent operationally and management wise, as well.

This is what we changed, the gentleman who managed the unit independently left us in December, and it's now under the management of the bank itself. We have a very talented management team, so now it operates, more or less, as a profit centre of the bank.

That allows us to have better synergies with the bank, and more resources, potentially, devoted to these operations, especially in terms of management attention. Also it opens up the previously existing areas to share information, and share experience related to the market.

If you look at what Touch Bank does, it came up with quite an innovative product when it started, which is a product with one card, which contains everything. This card that can operate as debit card, as a credit card, or as an amortising cash loan, and the customer can self-select the different features he or she wants to use, and change the functionality of this one product. The new management team has some new ideas on how to introduce other products, and how to improve the value proposition.

The fundamental problem is that customer acquisition cost is too high, and the retention cost is too high compared to the margin we make. Being very honest, we haven't figured out how to profitably sell banking products digitally, which seems as a different industry. We operate as a multichannel universal banking group, in all the countries where we operate we have such banks, with the exception of this Touch Bank.

We are used to serving multichannel customers and providing better and better digital services to, typically, our existing customers. Improving the service they get, doing cross-selling, and improving the retention and reducing churn. This is a very different business from going out to the digital world, without any physical presence, without existing customers, and trying to acquire new customers purely through digital channels and means.

Honestly, we haven't figured out how to do that. I don't know whether it's possible at this stage in Russia to do it, because it's not just us who haven't been extremely successful in building up new digital banks in Russia. Tinkoff is a star, and they started more than ten years ago. They reaped early the market. Sberbank is so developed in all of these digital services that they put the scale quite high. We have a fairly sophisticated and developed digital banking environment driven by Sberbank and Tinkoff, both of them being extremely successful, and with the other experiments or trials, which have, so far, not proved to be very successful, including us. That's where we stand.

What I can say that we are assessing the situation on a quarterly basis. I don't have a very clear answer. One of these assessments is just coming. Then with the new management team, and the new organisational set-up, we have a fresh view on what we are doing, and a lot of new ideas, and then synergies with the bank, and so on, and so on. There are a lot of new ideas on what to do.

How long our patience will last, it will not last forever, but at the moment, we have a long list of very exciting ideas by the management team of the Russian Bank, which can be implemented, and hopefully, could result in a much better performance. So, in a nutshell, that's the answer.

Andrew Keeley

That's very comprehensive, thank you very much. And staying on your Russian business, I noticed that there was pretty strong growth in your corporate lending last year. I'm just wondering if you could tell us what segments of the corporate market this is mainly serving?

I notice, in your loan growth guidance, you have a much slower growth in this corporate business than for this year. I'm just wondering why you expect the big slowdown.

László Bencsik

Percentage wise, it's big, but nominally, it's not, because we are starting from a very low base. Despite the fact that the loan book is very much dominated by unsecured retail loans, if you look at the deposit side, this is basically a universal bank, serving corporate clients, a lot of micro small companies, that is a big part of our deposit base, but also, mid-caps.

Obviously, we are not active in the Russian large corporate sector. Our size would not allow that. But micro small, especially in transactional banking and in deposits and mid-caps, transactions, deposits, and loans. It's basically mid-caps centred in the two regions where we are stronger regionally, around Moscow and Omsk.

If you go back to the tradition of the bank what we acquired there, it used to be put together from three entities before we acquired it in 2006. One regional bank in Russia, one regional bank in Omsk, and the POS franchise with agents. Based on these historic roots, we do serve corporate clients, and this was a part of our strategy to try to strengthen our corporate lending as well, not just in transactional banking and deposit gathering, just in order to diversify somewhat the loan portfolio, and also, to provide fuller and better services to our existing customer base. It is typically our existing customer base that we are serving with some new customer acquisitions, but it doesn't mean that we are opening up a new business line. This has always been there. If you look back, ten years ago the corporate loan volumes were higher than today. This is nothing new. We are just continuing what we used to have. We didn't emphasise it so much for some years, but now we try to put more emphasis on corporate. But nominally, on a Group level, this is clearly not a high growth. In terms of the ratio, it's high.

My remark on potentially having less corporate growth and more retail growth, it's more related to Hungary. If you look at our Core growth in 2017, for instance, in mortgages we only had 2% growth, whereas corporate was growing 18%. This is what we expect to change during this year, so potentially more mortgage growth and less corporate growth, primarily in Hungary.

Operator

Our next question is from Gabor Kemeny from Autonomous Research. If you'd like to go ahead.

Gabor Kemeny

Hi. Gabor from Autonomous. My first question is on your guidance. You're targeting quite significant organic growth, and also, acquisitions. How do you think about capital generation, and especially RWA growth from here? Because if I just take the consensus profit and dividend assumptions, and I assume a 10% growth, which you are targeting in the case of the performing loans, I think your growth would consume most of the organic earnings generation.

My second question is on Hungary and asset quality. Earlier, you mentioned that you would expect further write backs in Hungary, until your NPL ratio drops to, I think, 4% or 5%. You are not very far from there now, so how do you think about the Hungarian provisioning outlook from here? Do you expect write-backs in 2018?

László Bencsik

There will be further write-backs in Hungary, but as you have rightly identified, we now have a lower non-performing ratio in Hungary, and therefore, the potential for that is somewhat less. But this year, if all goes well, then we will probably see further write-backs.

As for equity and capital adequacy, we described this range between 12% and 18%. We are quite happy to move within this range. At the moment, we are at 15.3%. I don't know how you calculated that the organic growth will consume the entire capital generation; we certainly have different numbers.

It's not a criticism to yours, but we see it differently. We believe that on top of where we are today, we will generate more earnings than needed for the risk weighted asset growth. And how much risk weighted asset growth? I think around 10% performing loan volume growth should be enough indication to be able to size the magnitude of the risk weighted asset growth, as well.

Gabor Kemeny

So, you mean by that you would be fine with dropping towards 12%, if you saw attractive acquisition opportunities, in terms of your CET1 ratio?

László Bencsik

It's more than that. We made a written statement in our previous stock exchange report, which described the new target, and we defined this range. It's very explicit, and we did that during the previous interim report, after the third quarter, and we identified this between the 12% and 18% range.

Operator

Our next question is from Simon Nellis from Citibank. If you'd like to go ahead, Simon.

Simon Nellis

Hi. It's Simon Nellis from Citibank. Thanks for the presentation. I have a question first on fee income. I see that the underlying fee growth of 15% was above loan growth. Do you expect to be able to maintain fee growth above loan growth going forward? That would be my first question.

László Bencsik

That would be unlikely, I would say. One of the miscellaneous items I described was the reduction of the distribution fees of retail bonds in Hungary by the Hungarian Debt Management Agency. In itself, this action reduces our fee income by 3.5 billion for one year. I would be quite positively surprised to repeat the same kind of percentage wise growth in fees that we had last year.

Having said that, most of our fee income is related to transactional revenues, card transactions, and other transaction revenues. Transactions keep growing, because this is related to the fundamental economic activity in the country, which in each of these countries where we operate, is growing.

Plus, the other part of the fee income is related to new loan originations, typically, cross-sell insurance products, and so on, and they generate free income. This is what you see for instance in Russia, a big part of the fee income growth we had last year was coming from this insurance selling and the commissions related to that.

The underlying factors will remain to be there, basically increasing number of transactions in these economies, and improving new sales. Therefore, there will be growth, but to have a similar level to what we had last year, I think it's unlikely, in terms of percentage.

Simon Nellis

That's very clear. And on the margins, specifically in Russia and Romania, I think there were some accounting issues in Romania, some reclassification of income in Russia. What's the actual underlying margin trend in those two markets, in your view? In Romania, market rates have been going up. Does that help your margin, adjusted for these one-offs?

László Bencsik

It should. It definitely should. Unfortunately, in Romania, if you look at the composition of deposits, the share of current accounts within total deposits is the lowest in Romania, out of all the countries what we have in the Group. This means that probably we will not be the ones where most of the benefits of the rate environment increase will manifest.

Certainly, the pressure, at least, is over, and now the external environment should drive in the direction of better margins. This is very recent, so we will have to see. There is one question, obviously, how the markets reacts, and to what extent. The existing book, the variable book is obviously repriced, and that helps.

The other question is how the higher margin environment translates into new lending rates. And this is up to the competition, whether the competitive factors result in higher new lending rate APRs, or just banks take the hit of the new production margin. I don't have an answer yet.

The baseline expectation is that in an increasing margin environment we should have better and improving margins. What happened in Q4 last year is not representative of the expectations of what we should see in the first quarter. They should go back, pretty much, margin wise.

Russia, I tried to explain during the presentation that during the last quarter, we had quite a fierce price competition, in terms of POS APRs. This was on the edge of some of our competitors, who, I think, stated to do some irrational behaviour, or irrational pricing, and I'm sure they're losing a lot of money, and it usually self-corrects. We have seen this before, especially in Russia in POS lending, that some competitors start crazy pricing, and they got burnt, and they have losses on those vintages, and they reprice and go back to normal. This is what I hope to happen in Russia, as well, after the fourth quarter. But we don't know, honestly, there can be further pressure on the APRs of the POS loans.

Operator

Our next question is from Olga Veselova from Bank of America Merrill Lynch. If you'd like to go ahead.

Olga Veselova

Thank you. I have several questions. They are about margin. Could you share with us impact on your margin from the maturity of the Hungarian sovereign bond portfolio this year? And remind us if the average yield on that sovereign portfolio is still just under 5%. This will be my first question.

My second question is about loan to deposit ratio in Hungary, which, for us, is a potential to improve margin going forward, but we don't see it happening. What needs to happen for you to start turning incoming deposit inflow into maybe investment product purchases for households? What needs to happen for you to improve this loan to deposit ratio this and next year?

And my third question is; what do you hear about potential new state initiatives on mortgages? And in particular, is there any debate about possible lowering of cap on customer friendly mortgages? Thank you.

László Bencsik

I'll start from the end, because I remember them better. So, customer friendly mortgages cap reduction or removal?

Olga Veselova

Reduction.

László Bencsik

No. We haven't heard about that.

Loan to deposit ratios in Hungary. This is somewhat related to the amount of monetary base in the country, and the loose monetary policies of the Central Bank, there is a lot of liquidity out in Hungarian forint. This applies less, obviously, to retail. The fundamental question is when and to what extent the retail clients will start to consume more and invest more? The good news is that they already started to consume more and invest more, and there's a lot of room, because savings even increased, in spite of that. I think we should, in the future, see strong consumption and retail household investment numbers in Hungary.

To what extent it's going to improve the loan to deposit ratio, that's still questionable, but the underlying trend should be positive. Having said that, we are still earning money on this, the excess deposits still earn NII for us. Obviously, the margin on this is lower than if we had mortgages, but it's still positive. We don't pay anything for it, the deposit rates are down to zero. Typically, we have transactional revenues related, because usually people use their account, to some extent. This is customer loyalty, and so on, and at the end, we do make money on these. We have a positive margin when we invest these. The current situation is not fundamentally bad at all. It's a very convenient situation, and certainly, there's a huge potential in it. There is a lot of room for households to spend more and invest more. The potential is there, I would put it this way. But even the current situation is okay, because we are earning money on these deposits.

In terms of the sovereign portfolio maturity, let me only give you one number. This is the most important, the fixed sovereign maturities this year amount to HUF 82 billion. The current yield of this portfolio is 4.25%. We have other maturities, but they are variable, so they are the ones that we have originally swapped to variable, their yield is much, much lower than that.

Operator

We have a question from Alan Webborn from Société Générale. If you'd like to go ahead.

Alan Webborn

Hi. Thanks for the call. You've already had a few quite serious rates rises in Ukraine in the last couple of months. How should we see that, in terms of the impact on your business, and the impact on your margin? That would be the first point.

Secondly, does the comment that NIM for the Group, maybe bottoming out at some point during 2018, includes Bulgaria? Or is that likely to continue some attrition, whilst, perhaps, if reference rates pick up elsewhere, that could be a two-way street. That would also be interesting.

Thirdly, why didn't your deposit margin in Russia come down? I think I saw that it was stable, and there was asset pressure, you've explained that. But I did wonder why the deposit costs didn't come down. Is that because you're growing more, and you've got to pay up to get your share?

And where, amongst your competitors, do you think that the POS competition is coming from? Clearly, the large state banks have an advantage in funding costs. Is it coming from them? Or is it just coming from a slightly kamikaze view of your specialist competitors? That would also be interesting, thank you.

László Bencsik

Our POS competitors are the specialists. The biggest one is Home Credit, we are number two, and then Russian Standard and the likes. These are typically not the large state owned banks, which have cheap deposits.

Deposit rates. The average deposit rate is 5.1%, it is the total stock deposit rate in Russia. It's still below the base rate. I consider it as a good and relatively cheap deposit base. I know that the state owned banks, for example Sberbank has a much lower rate, but it would be unfair to compare ourselves to Sberbank, given a lot of things. We are quite happy with this deposit rate, and as the base rate continues to go lower, it might be somewhat lower. It's one of the historic lowest, if I think back to the last twelve years, since we have owned this bank. That's about the Russian deposit cost.

In Bulgaria the turnaround would come if the euro rate started to grow. Because in Bulgaria we have the currency board, so the exchange rate is pegged to the euro, and therefore the base rate moves together with the euro rate. When the ECB starts to hike their rates, this will be the time for the Bulgarian operation to turn around, in terms of margins. That means that most probably during the course of this year, there will continue to be margin erosion in Bulgaria. Obviously, the rate of this margin erosion should be less and less, given that higher and higher share of the back book has been repriced. There's less and less in terms of volumes which can be repriced. The speed of decline should slow down, but fundamentally it's going to stay there during the course of this year, and the turnaround can only be truly expected in Bulgaria when the ECB starts hiking rates.

Ukrainian rate hikes, and the impact. In principle, an increasing rate environment should result in better margins. Ultimately, this is what we expect. Obviously, Ukraine is somewhat special, because there's a shortage of local currency, so there's a somewhat uneven distribution of liquidity in local currency between the banks. That can have an impact on the UAH local currency deposit pricing. But fundamentally, this should be positive. This is the rule of thumb. When rates go up, margins improve, and when rates go down, margins decline. Having said that, Ukraine has its own features and peculiarities, but the fundamental direction where it should go due to this, is higher.

Alan Webborn

On the basis that the rate hikes seem to be as a response to inflation getting slightly out of control again, are you more concerned or less concerned about the business that you are doing? Not in inflation terms, but you're still looking to increase your exposure in nominal terms there.

I just wondered what you think is behind what's going on at the moment. Do you think it's a positive step that will sort things out? Or do you think there's an air of desperation? Just your view on that.

László Bencsik

Certainly, we don't read this as a sign of desperation. The expectation for the Ukraine in GDP growth for this year is 3.2%. And it also grew last year, so it's not starting from an exceptionally low basis. We are relatively optimistic about the environment in Ukraine, and we don't expect any major crisis to come in the foreseeable future.

The bank we had there is a fraction, in terms of size, that we used to have. And we don't have any group funding left, or very minimal outstanding. A big problem in Ukraine used to be the huge intra-group funding in dollars to our activities in Ukraine, and these dollar funds were used for dollar lending, especially dollar mortgages.

This was a disaster. If we had dollar mortgages today, I would be rather concerned, but we don't. This portfolio we have written off and converted. In the last five years, we have really concentrated on local currency lending, but only to the level of what the local currency funding allowed, what they could gather as deposits. That's the business model today.

Inflation is typically not a problem. If you do lending in local currency, unless there's hyperinflation when everything goes out of control If there's high inflation in a controlled environment, and the GDP is growing, then inflation is helping those companies who took a loan in local currency.

These levels, 100, 150, 200, 300 basis points rate hikes in Ukraine is very much in the range of normal business, so there's nothing we are alerted about.

Alan Webborn

Maybe just one last question. The exceptional costs that you referred to in Touch Bank, is that paying the new management, or paying off the old management?

László Bencsik

The old management.

Operator

Our next question is from Stefan Maxian from RCB. If you'd like to go ahead, Stefan.

Stefan Maxian

Thank you. Two questions from my side. First, on the net interest margin. You gave quite a helpful split on the NIM development for 2017. It was a split of interest rate effect composition and FX effect. Could you give, potentially, also some hint with regard to your guidance for 2018, how much of that would be composition effect and interest rate effect?

And the second, just overall, on your subsidiaries, maybe apart from Touch Bank, do you believe that all subsidiaries would be positive in 2018? Thank you.

László Bencsik

The answer to the second, yes, I hope they will.

The answer to the first, I'm sorry, but no. We have to leave some room for further conference calls and discussions during the course of this year. I think when we look at the first quarter result, then we can see how the NIM develops, and we might be able to draw further conclusions on the potential composition of the NIM developments throughout the year. today, I know that it would be more exciting if we shared more information on how we view the future, but please accept the fact that this is the amount of information we decided to disclose at this stage, regarding our expectations - obviously, we don't know the future, but once we see the first quarter results, we will all know better and more about how these trends unfold and develop, and then we can probably have a more detailed discussion about the components of the NIM development in the future.

Operator

We have no further questions on the phone lines, so I'll hand the presentation back to you.

László Bencsik

Thank you very much. Thank you for joining us today. And thank you very much for your very good questions. I wish you all the best, and I hope you will join us on our next interim report conference call, which will be on the 11th of May. In the meantime, we will have an AGM on the 13th of April, and I hope most of our investors will be present or represented there, as well.

Again, thank you for your participation and for listening, and I hope you join us next time. I wish you all the best and goodbye.

Note: unabridged transcript with minor English stylistic corrections.