OTP Bank Q3 Results Conference Call

Friday, 09 November 2018

Samuel Goodacre Good afternoon, ladies and gentlemen. My name is Sam Goodacre from J.P. Morgan's banks team, and we're delighted to welcome you today for the OTP Third Quarter '18 Results Call. Without further ado, I'll pass the floor to Laszlo Bencsik, OTP Group Chief Financial and Strategic Officer. Laszlo, over to you.

László Bencsik Thank you, Sam. Good morning, or good afternoon, depending on where you are. Welcome to OTP Group's 2018 Third Quarter Interim Report conference call. As usual, you have the presentation available on the website, so I hope you've been able to download it. We are following the usual procedure: I'm going to present the presentation in the next half an hour, and then we'll open the floor for questions.

If you'll allow me, I'll jump into the slides, starting on page two. We have closed another rather successful quarter. The adjusted profit was HUF 92.7 billion, that's a historic high and it meant a 2% increase compared to the previous quarter.

One important remark here is, as you can see, the contribution of foreign subsidiaries has grown in the overall result, which is even more visible on the third page, where you can see the entity by entity profit in the third quarter and the first nine months.

And as you can see, the Hungarian operation's contribution to overall profit went lower and, in itself it was 21% less in the third quarter than in the second quarter. But we have had a number of foreign subsidiaries where the performance was quite outstanding, for example in Croatia.

In Croatia, in the first nine months we booked HUF 20.9 billion profit, and this is a significant increase. Obviously, this includes Splitska banka results for the whole year, so this is the combined profit of the two entities which we still have. By the way, the technical and legal merger is going to be completed very soon, before the end of the year, so by then we should have one merged entity there.

Ukraine did extremely well, I would say, HUF 7 billion in one quarter and 18.2 billion in the first nine months. I think Romania as well made a very nice comeback and a decent nine-month performance, HUF 4.8 billion. And also, the rest of the group has done rather well in the course of the last nine months.

If we look at the P&L, line by line, starting on page four, you can see the one-off items. We had an unexpected one-off, it's a goodwill write-down. It's basically a service company in Hungary which is fully included into OTP Core, and since it basically stopped servicing entities outside the group, therefore on a group level we had to write off the goodwill which we had on this entity, because almost all the revenues are from the group to this entity. In itself, the valuation of this entity has not changed, so on a stand-alone basis there's no change in the value of this entity, therefore there's no tax impact. Obviously, it doesn't have any impact on our regulatory capital either, because it has already been deducted from that.

Then, we had a smaller amount, HUF 0.6 billion plus in Hungary, this is a write-back of provisions we previously made for fines regarding one case where we all the banking sector was basically found not compliant with competition regulations and, therefore, first we had to pay a fine and then it was paid back, because the courts decided that the fine was too high. And then, in the second round, a new fine was established, and we paid that new fine, but it was less than what we provisioned for, so there was a release.

And then, we have this recurring item linked to the acquisitions. We have a negative item which is related to the merger costs, the integration costs of the two ongoing integrations. One is very close to finishing, in Croatia, and the other one, where we are close to the middle of the process, is Serbia.

If we go to page five, we see the numbers without one-offs, so the consolidated adjusted profit after tax, and this was HUF 92.7 billion in the last quarter. On this slide, I think what is worth mentioning is the operating profit without one-offs line: if you look at the first nine months compared to last year, and you look at the middle two columns, which are without acquisitions, there you can see a 3% growth, year on year. We find it very positive.

Finally, even without the impact of new acquisitions, the operating profit is growing as a result of quite dynamic volume growth, as you will see later on in the presentation. Also, on a quarterly basis, we had 7% plus on this line, and I think this is also quite a strong performance.

On page six we have four miscellaneous items. The first one is the guidance, which is well-known, it was given on 20th September by the Chairman, but I think formally we have to note it here as well. And then, there is some recent development in the Hungarian environment in terms of regulation.

The first one is a very recent one. Basically, the subsidies for the building society scheme stop coming. Actually this is not the correct phrasing of the sentence. These types of contract are not any more available for sale, so we cannot sell this in the future, but all the existing contracts continue to exist and there will be subsidies coming to all the existing contracts, but new sales of this structure are discontinued.

Having said that, the government decided actually not to use the level of subsidies, but to redirect them to other schemes, and the scheme where they redirected the subsidies is the Housing Subsidy for Families scheme. So, they changed this facility, they extended it and they increased the amount which can be given under this other subsidy scheme.

Then, there's a one basis point decline in the bank tax, starting next year. Positive, but only marginally. Finally, another important measure which came out this week, the government extended the deadline or the timeline for the 5% preferential VAT rate for newly-built residential real estate.

I think this is important because that actually created quite a strain in the economy: the previous deadline was the end of next year; now, what they've done is extending this deadline but it's only applicable for those new buildings where the permit was issued before 1st November this year. So, no new permits will be subject to this regulation but houses with existing permits can be built and sold with the lower VAT.

That makes the whole market smoother and less noisy and less overheated, so this is clearly a positive measure for the entire economy, and also obviously for the construction sector and the housing sector in Hungary. We quite positively interpret this measure.

On the capital position, the CET1 ratio went up to 16.4%, including the interim profit less indicated dividend. The liquidity reserves remained quite stable, so there's nothing tremendously exciting on that front.

Next page, there was a lot of news about the results of the EBA stress test which recently came out. I think OTP did well. This is public information, so there's nothing new about this. We came, in the list of 48 banks, 16th in terms of the level of Common Equity Tier 1 ratio in 2020 under the adverse scenario. In terms of the level of drop we came number 9 out of the 48 banks. That, I think, confirms also the regulator's view on our capital adequacy and resilience to shock. It seems that they also find it rather positive and good.

Page nine, this is total income. Again, year on year, including acquisitions, it's 10%, but it's better to look at the numbers without-acquisitions, which was 5%. I think that's, in itself, quite a good result, plus quarter on quarter we have 4% growth. I'm going to go deeper, because I'm going to talk about also the NII and other income lines, thus it's better to explain to you the underlying dynamics in the subsequent pages than on this page.

Only one comment. The exchange rates are important; in the case of Russia and Ukraine, you also have to look to the numbers in the original currencies in order to fully understand the business developments, and we also have these numbers here on this slide, especially when we make the year-on-year comparison.

Starting on net interest income on page ten, a few remarks here for some important items. Obviously, loan growth across the board is a very important factor in shaping the NII development, but specifically Hungary, the third quarter improvement, which is quite sizeable, is also attributable to the increase in the reference rate, which was small but it had some positive impact.

Also, the roll-over of the securities portfolio somewhat improved the securities and the related swaps results. And also, the very liquid money market assets, which are also part of our liquidity reserves, went down to lower levels, so we had actually a lower amount kept at very low rates. These altogether resulted in quite high NII.

Bulgaria, in the second quarter there was this accounting correction, which makes less comparable the first, second and third quarters in a crude way, but I'm going to explain later when I talk about the NIM. If you compare the first nine months to last year, unfortunately there's still a decline, and this is the factor of the ongoing repricing of the book which is still there; as indicated before, it was going to continue, albeit at a lower rate. But it is still there and, as you can see, we have the results visible.

In Russia the business activity is strong, and NII was quite strong in the third quarter, year on year as well. I think Ukraine is particularly interesting because here, in local currency, year on year, we had 43% growth in the net interest income. Romania also did quite well, due to somewhat improving margins, because this is one of the countries where we have already seen some increase in the rate environment, and that has beneficial impact on the NIM there.

On page 11 you see the quarterly loan dynamics. Overall we had 4% growth. Hungary 6%, and Russia was quite dynamic as well. Ukraine, Serbia, but of course in all countries I think we were doing rather fine. What is quite remarkable here is the 4% housing loan growth, just in one quarter.

If we go to page 12, there you can see the year on year changes in volumes. The 14% without acquisition is a rather high number, and including acquisitions it was 18%. Again, Hungary 16% is quite strong, and it's strong across the different segments: consumer 19%, mortgage 6%. But again within mortgages, housing loan was growing 11% and home equity was actually negative. So, on a year on year basis repayments were still more than new origination. Corporate was quite strong as well.

As for the entire market, just to give you an example, the third quarter new housing loan production was a historic high, so we reached a new peak. It's even higher than what we had in 2008, before the crisis, on a quarterly basis.

Page 13. To put it into perspective, we put in this slide, because we find it interesting, the level of organic growth. This number here is non-FX adjusted and net loans. The previous slides were FX-adjusted for OTP, and performing volumes were there. Sorry for the fact that r four have still only six months data because they have not reported yet, but I think the reading on this chart on high level is basically that even compared to some of the banking groups in Europe, we seem to have quite dynamic organic growth momentum at the moment.

Household loans, page 14. This story, what I've talked about so far, was only the stock development, but if you look at the new production, then still the momentum seems to be stronger than just pure stock performance levels. In Hungary mortgage loan production, year on year, is actually 42% up compared to last year, and in Bulgaria, for instance, it's 61%, and also cash loans in Hungary 55% up, so in these core markets we had stronger growth in new production than in stock volumes.

Page 15 shows the relevant figures for deposit growth on a quarterly and annual basis. 3% for the total group quarterly, 9% on annual basis without acquisitions. Volume-wise this is still quite substantial because, just to remind you, our net loan to deposit ratio is 72% for the whole group, so albeit deposit growth goes with a lower rate, nominally, especially on a yearly basis, this is just as strong as loans are growing, so our liquidity position remains nominally more or less stable in this sense.

Looking at margins, I think this is another interesting feature of this quarter, this very long trend of margin erosion seems to at least have slowed down considerably. In this quarter, we actually had a higher number than in the second quarter, but here we have this remark in the footnote, which we also mentioned in the second quarter. There was an accounting adjustment made in Bulgaria which had a negative impact, because we reported higher numbers in the first quarter and lower in the second compared to the underlying business performance.

If we adjust for these, then actually the first quarter NIM, as you can read in the footnote, would have been 435, second quarter 438 and third quarter 430 basis points. What this shows is that it seems that we are close or reaching the bottom of the NIM cycle.

I'm not saying that from this point it's going to go up, but at least the strong downward trend seems to stop, and it's likely to hover around this level or slightly lower than this level until, finally, the rate hikes start in the Eurozone, and also in Hungary. We expect the latter one to happen somewhere in the second half of next year, and from then on, as we have already indicated, we expect some improvement in the margins in Hungary.

On page 17, you see the NIM developments on the six markets which are the most important from the point of view of contribution to overall NII. Again, in Hungary, as I already said, we had some improvement due to the changes in the reference rate and the securities portfolio yields, but obviously the underlying loan dynamics was important, too.

At DSK Bulgaria we had to make these adjustments, therefore you see the adjusted numbers here on this slide. In Bulgaria, unfortunately the declining trend has not stopped, it actually continues, so we continue to experience this margin erosion, due to the continuous repricing of these portfolios.

In Russia we see further decline in the margin. This is coming from market pressure. New production rates are getting lower and it hits our margin. Croatia, somewhat lower rates due to excess liquidity and corporate lending. Ukraine actually started to improve and Romania started to improve. Again, these are the two countries where the rate environment is actually increasing or has already started to increase.

Fee revenues, you see the growth rates for the first nine months and for the third quarter, and again some remarks on this slide. In Hungary, in the third quarter there was a one-off item, there was a one-off payment for which we'd provisioned already in the second quarter.

More importantly, and that's more underlying and we have already talked about this, the distribution fees for government securities to retail clients in Hungary were cut in two rounds, the first round was in February this year, the second one during last summer, and therefore we realise less fee revenues on distributing Hungarian government papers to retail clients, and that is visible in our net fee income numbers.

Bulgaria, again growth due to underlying business activity, but also there was a HUF 0.3 billion equivalent one-off items, and then in Montenegro we had a reclassification of deposit insurance fees, so that creates this kind of noise in the numbers. The other results are more or less related to underlying business dynamics.

Other income, the second quarter was quite strong. Our treasury colleagues made quite a gain there, and therefore the third quarter quarter-on-quarter numbers looked less good in Hungary, but if we have the comparison to last year, the first nine months, you see that it's going up. Also, in Croatia, there's a seasonality in the third quarter related to the FX conversions in the tourism industry.

Then, obviously costs are the downside of the equation. On one hand, we are very happy that real wages and nominal wages grow quite fast and economic activity is very strong in almost all the economies where we operate, therefore we experience high loan demand and that manifests in quite strong growth in terms of our portfolios, but the downside of this equation is that we have to spend more on personnel.

Personnel expenses are growing fast for two reasons. One is that we actually have to hire new people because we have a much stronger economic activity. I've already showed you the slide which actually describes how much the new production of retails loans grew.

The second phenomena is that wages are growing and it has obviously an impact on the financial sector wages as well, and we have to accommodate, we have to follow that trend to some extent in order to retain the best talent in the market, which we need in order to be successful. You see a few remarks on this slide on the right side, but this is pretty much the underlying environment, so this remark is basically true for almost all the countries where we operate.

Credit quality, again this is one of the positives of this environment, it's not just that loan growth is accelerating, but also portfolio quality is quite benign and good. We have low risk cost and we have very low levels of portfolio deterioration. Also as a result of loan growth, the NPL ratio, the over 90 days past due ratio, keeps decreasing.

Further details are shown on page 22, where you see the same on a country basis. As you can see, pretty much the only country where we still have some loan deterioration is Russia, where this is the normal course of business. As the volume growth is quite high there, we also have somewhat higher levels of deterioration, despite the fact that the risk cost rate is actually quite stable and quite okay. Just to remind you: in Russia the consumer loan volume in one year grew 34%, and obviously it's not surprising that the non-performing volumes are growing as the normal course of business there.

On page 23, we have three slides concluding this short presentation with the Hungarian results. In Hungary, also similar to the group, I think what is important to note is the operating profit without one-off items, and this is +1% on a year on year basis, if you look at the first nine months. I think this is an important development in Hungary: finally, after long years of negative development, we see again increasing operating results.

One slide about our retail performance in Hungary. Our market shares are increasing. In terms of newly contracted mortgage loans amounts we are at around 30% market share in the first nine months. In terms of new cash loan disbursements our market share is 38.1%, and also our market share in household savings continues to increase.

Plus, on page 25, you'll see the corporate business line, and, as you can see, corporate dynamics are even stronger than retail, year to date. And these are not annualised numbers, this is the actual year to date growth – we had 22% in mid and large corporate and 20% in small corporate. We continue to grow faster in corporate than the market, therefore our market share has somewhat increased in the course of this year, and we are getting again close to 15%.

This is what I intended to say as the general introductory presentation. I'm sure you have many questions to ask, so I'd like to ask the operator to please open the floor for questions.

Operator Thank you. Our first question comes from Mate Nemes of UBS. Mate, your line is now open, please, go ahead.

Mate Nemes Thank you very much for the presentation and good afternoon. I have two questions, please. Firstly, on operating expenses, it is clear that year on year strong wage inflation, is this in fact affecting operating expenses, but I was a bit surprised that on a quarter-on-quarter basis, while revenues were up 4%; costs remained flat. Could you talk about the driver and mechanics behind this?

And then, specifically on Russian costs, I noticed that there is a 7% drop there in OPEX in Russia, is this headcount reduction or is this a savings on costs related to the integration of Touch Bank?

Secondly, on net interest margins, I think you were clear that you wouldn't expect material further decline going on from here, but if you could be a little bit more specific, would you actually expect expansion in the next two to three quarters here? Then, specifically in Hungary, do you actually need the rate hikes, inter-bank rates going higher, in order to see a better NIM trajectory? Thank you.

László Bencsik OPEX on a quarterly basis, the salary increases are not gradual, it's typically done at the beginning of the year, so on a quarter-on-quarter basis it doesn't necessarily manifest. There's nothing tremendously specific. Obviously, it's also marketing and consulting fees and so on, there are some expenses which are not evenly distributed over the year, and this has one impact. Then, related to personnel expenses, it's basically the fact that the increase was not at the end of the second quarter.

You are right that the Russian decrease is related to Touch Bank in two ways. One way is that in the second quarter we had, write-offs of software which we discontinue in Touch Bank, they had some bespoke system which we are not using in the bank because we basically migrate the customers to the bank's environment and we've written off certain immaterial assets in the second quarter as a one-off cost, and this was not material in the third quarter.

Also, the overall Touch Bank costs, which are now within the Russian bank, get less and less, that's the other part here. So, this is behind the Russian decrease in OPEX. Both of these items are related to Touch Bank.

The NIM, I don't think we are going to see increasing NIM from now on. This is unlikely. I think that in the next three quarters we will still have some pressure on the NIM, especially coming from Bulgaria, and also from Russia where we see strong price competition. On the other hand, we have Ukraine where NIM has started to increase, we have Romania where it has increased, too, so there are different dynamics in different countries.

Specifically in Hungary I don't expect improvement until the reference rate starts further increasing. The rate should slightly decrease and hover around this level, depending on various factors, but this is not going to be a new trend. A new trend will be established when the reference rate environment starts growing, and we expect this to happen in the second half of next year.

According to the National Bank's communication, this is the likely period when we are going to see material further increase in the reference rate. Until then I don't expect an increase in the NIM in Hungary.

Mate Nemes That was very clear, thank you.

Operator Another question comes from Stefan Maxian of RCB. Stefan, your line is now open, please, go ahead.

Stefan Maxian Thanks a lot for the presentation. I have four questions, if I may. One relates to the pricing trends on Hungarian mortgages. I think we've seen margins actually deteriorating at the beginning of the year, as ten-year swaps went up, if you can comment on that? How do you see the current pricing environment, or have you started to reprice mortgages?

Secondly, on your OPEX trend, in your last conference call you flagged also an increase in headcount to cope with the loan growth, especially in Hungary. If you could comment if this trend is continuing?

Then, briefly on Croatia, we have seen loan volume actually coming down, quarter on quarter, is that a seasonal phenomenon or is that somehow increased amortisation of the back book?

Finally, if you could give us an update on your M&A ambitions, in terms of countries, especially the ones you're looking at, and if we can still expect a new formulation of your dividend policy with full-year numbers or at the beginning of next year? Thank you.

László Bencsik As for the Hungarian mortgage rates, indeed we see quite strong price competition. New production in the third quarter carried around 3% spread, which is lower than what we had last year, so there's clearly some compression in that sense.

Loan growth and headcount in Hungary, we expect loan growth to continue, especially in the stock level. We haven't finished the budget for next year, so we don't have yet the headcount budget for the region or the network, so that would be too early to say exactly what the size of the sales force or the network is going to be next year.

Croatia, the negative development came from corporate as you can see on page 11 on the presentation, the decline was in corporate, related to some larger exposures going out of the portfolio.

M&A, there's nothing I can talk about now. We are in the process of closing the two deals which were announced during the summer, in Bulgarian and Albania. The only thing I can say is that we are also working on other potential deals but there's nothing I can report today on these.

Stefan Maxian Can we still expect a new formulation of your dividend policy next year?

László Bencsik Sorry, yes. There's no update on the dividend policy. We promise to do that when we see the whole-year result and before the AGM. No updates on the dividend policy yet.

Stefan Maxian Thank you.

Operator Our next question comes from Gabor Kemeny of Autonomous Research. Gabor, your line is now open, please, go ahead.

Gabor Kemeny A couple of things on margins, please. Firstly, when you guide for stable margins, does this assume a shift in the business mix towards more retail? Because I recall that you were hopeful, or you expected actually, that the retail loans would grow their share within the total loan book, yet we still see corporate loans growing a bit more quickly than the retail loans. Secondly, just a clarification, does the stable margin guidance refer to Hungarian margins or the group's margins?

László Bencsik Indeed, previously we expected lower growth rates in corporate, and we actually did better than what we budgeted or originally expected for this year. I think that's clear, and it is also clear after the end of the second quarter.

Looking at the rate of growth in corporate, year on year we had 27%. Looking at this number, I would be inclined to say that this rate should slow down in the future, so that's clearly an expectation.

Consumer business is going quite fast, the Hungarian consumer loan growth was 19%, and mortgages 6%, year on year, these are also quite strong numbers. Both retail and corporate grew faster this year than our original expectations at the beginning of the year, but corporate was growing even faster than retail.

I think what we should expect is similar to what I said a year ago, i.e. looking forward we should have much lower corporate growth rate and still stronger retail volume growth. Having said that, I was wrong when I said it a year ago, so it's up to you how much credit you give to me on this. But this is the rational expectation.

The margins, I'm trying to be very careful here because I'm not saying that we are going to have exactly the same margin from now every quarter; what I'm pretty sure about is that NIM is not going to expand much during the next two, three quarters. For visible expansion, we need rate-environment increase, that's clear.

Margins can be around this level, but can continue to go lower by a few basis points. There's still some pressure on margins because of the new production in Russia, in Bulgaria and in Hungary, especially in these three countries there's lower margin than the back book.

This continues to be there and it might result in somewhat lower margins from one quarter to another, this can happen, but these steps will be much smaller than they used to be. We are getting closer to a point in time when the rate environment starts improving from our perspective, and then the new trend should be established. But the new trend is not there yet and I'm not suggesting that it's going to be flat-line from now until then. There might be some further decline on a quarterly basis, but that decline should not be very large, and we are certainly going to stay in the range which we indicated as this year's expected level. And this is primarily driven by Hungary, Russia and Bulgaria.

Gabor Kemeny Thanks. Finally, on M&A, conceptually, when we discussed your M&A plans a couple of quarters ago, you mentioned that you would focus on the existing geographies and you would only enter into new markets if those were part of a broader package up for sale, and this now, indeed, happened with SodGen's Albanian business, so is this still the case in terms of your M&A preference, or are you now a bit more open to look at other markets, potentially?

László Bencsik The strategy hasn't changed. I also have said that the only country that we might consider in its own right is Slovenia.

Gabor Kemeny Okay, thank you.

Operator With no further questions on the line, I'll back to you for any further remarks.

László Bencsik Thank you very much for your questions and thank you very much for joining us today. I wish you a very nice day and weekend and hope you'll join us when we present the annual results, somewhere early March. Until then, I wish you all the best. Thank you and goodbye.

Note: unabridged transcript with minor English stylistic corrections.