MOODY'S INVESTORS SERVICE

Credit Opinion: OJSC Bank of Baku

Global Credit Research - 14 Dec 2011

Baku, Azerbaijan

Ratings

Category	**Moody's Rating**
Outlook	Stable
Bank Deposits	B2/NP
Bank Financial Strength	E+
Baseline Credit Assessment	(B2)
Adjusted Baseline Credit Assessment	(B2)

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Key Indicators

OJSC Bank of Baku (Consolidated Financials)[1]

	[2]**12-10**	[2]**12-09**	[2]**12-08**	[2]**12-07**	[2]**12-06**	**Avg.**
Total Assets (AZN million)	**239.9**	**182.8**	**180.0**	**152.0**	**71.2**	[3]**35.5**
Total Assets (USD million)	**300.0**	**227.5**	**224.0**	**179.2**	**81.4**	[3]**38.6**
Tangible Common Equity (AZN million)	**31.2**	**27.4**	**20.8**	**13.2**	**11.2**	[3]**29.2**
Tangible Common Equity (USD million)	**39.0**	**34.1**	**25.9**	**15.6**	**12.8**	[3]**32.2**
Net Interest Margin (%)	**11.6**	**10.5**	**12.8**	**9.4**	**8.7**	[4]**10.6**
PPI / Avg RWA (%)	**8.1**	**5.8**	**6.9**	**--**	**--**	[5]**6.9**
Net Income / Avg RWA (%)	**6.8**	**4.1**	**4.8**	**--**	**--**	[5]**5.2**
(Market Funds - Liquid Assets) / Total Assets (%)	**-4.1**	**5.9**	**15.0**	**29.0**	**-5.8**	[4]**8.0**
Core Deposits / Average Gross Loans (%)	**96.6**	**68.3**	**64.6**	**75.5**	**87.2**	[4]**78.4**
Tier 1 Ratio (%)	**10.3**	**14.8**	**8.3**	**9.2**	**20.1**	[5]**12.6**
Tangible Common Equity / RWA (%)	**15.7**	**19.0**	**13.3**	**--**	**--**	[5]**16.0**
Cost / Income Ratio (%)	**51.8**	**60.3**	**53.6**	**51.8**	**47.1**	[4]**52.9**
Problem Loans / Gross Loans (%)	**0.3**	**2.5**	**4.9**	**4.0**	**0.2**	[4]**2.4**
Problem Loans / (Equity + Loan Loss Reserves) (%)	**1.1**	**8.4**	**20.3**	**20.0**	**0.8**	[4]**10.1**

Source: Moody's

[1] All ratios are adjusted using Moody's standard adjustments [2] Basel I; IFRS [3] Compound Annual Growth Rate based on IFRS reporting periods [4] IFRS reporting periods have been used for average calculation [5] Basel I & IFRS reporting periods have been used for average calculation

Opinion

SUMMARY RATING RATIONALE

Moody's assigns a bank financial strength rating (BFSR) of E+ to Bank of Baku, which translates into a long term scale of B2. The rating reflects: (i) the bank's credit risk appetite, as demonstrated by the recent rapid lending growth and focus on the risky segments of the retail loan market (ii) the bank's growing business franchise and its good market position as the second-largest consumer lender in Azerbaijan; (iii)good profitability (iv) adequate capitalisation, (v) sufficient liquidity, and (vi) adequate asset quality.

Bank of Baku's B2/Not Prime long- and short-term global local currency (GLC) ratings do not factor in any probability of systemic support in the event of a stress situation.

The outlook on the BFSR and all long-term ratings is stable.

Rating Drivers

- Good market position as the second-largest consumer lender in Azerbaijan
- Strong profitability leads to ample internal capital generation capacity
- Capital and loan loss provisions provide a sufficient buffer against expected credit losses
- Rapid loan growth challenges asset quality and puts pressure on capitalisation and liquidity

Rating Outlook

All of the bank's long-term ratings carry a stable outlook.

What Could Change the Rating - Up

A sustained track record of satisfactory financial fundamentals could have positive rating implications in the medium term.

What Could Change the Rating - Down

Any mismanagement of the bank's growth strategy - resulting in material adverse changes in the bank's risk profile, particularly significant deterioration of asset quality and financial fundamentals, or loss of market franchise - could potentially negatively affect Bank of Baku's ratings.

Recent Results and Company Events

Bank of Baku's total assets increased by 16% during the first nine months of 2011, reaching AZN279 million (US$354million) at end-September 2011.

As of YE2010, Bank of Baku reported total assets of AZN240million (US$301 million), shareholders equity of AZN36.3million (US$45.5 million) and net income of AZN11.6million (US$14.5) million, according to its (audited) IFRS financial statements.

Bank Financial Strength Rating

Franchise Value

Headquartered in the city of Baku (capital of Azerbaijan), Bank of Baku is a medium-sized bank that ranked 12th among 46 Azeri banks by total assets, holding around 2.2% of system assets, 2.7% of loans and over 4.4% of customer deposits as of 30 September 2011. The bank has a clear retail focus, with 82% of its loan book composed mostly of consumer loans, car loans and credit cards at end September 2011. Although consumer lending is a relatively small market segment in Azerbaijan, Bank of Baku is the nevertheless the second-largest consumer lender in the country . To acquire clients, the bank is closely cooperating with over 800 partners in the market including major universities, medical centres and other organisations. The bank also has partnership arrangements with leading automobile dealers and retail stores. We note that Bank of Baku's car loans franchise has been largely based on the bank's established relationship with a related party car dealer - (a leading distributor of foreign-made cars in Azerbaijan), which is likely to provide greater stability for the franchise, enabling the bank to achieve relatively firm positions in this segment. Since 2001, Bank of Baku has been cooperating with a number of International Financial Institutions (IFI) which provided technical and financial assistance in developing SME, micro-financing and leasing business and helped to improve corporate governance and risk management standards. Bank of Baku's distribution network currently consists of 18 branches. During the first nine months in 2011 its loan portfolio increased by 30% exceeding that of system average. We expect Bank of Baku's franchise to continue improving in the medium to long term as we believe that the population in Azerbaijan remain largely underbanked and that retail banking has substantial growth potential.

Profitability

Bank of Baku reported strong and improving profitability in 2010-Q32011 which was supported by wide interest margins of 11.6% (10.52% in 2009 and 12.85% in 2008) as Bank of Baku focuses on high-yielding retail loans. In our opinion, profitability will remain strong in 2012 as a result of growing loan book while a significant increase in loan loss reserves and operating expenses is not expected.

Bank of Baku reported a net income of AZN19.8 million in Q32011, up from AZN10.7 million in Q32010, according to the bank's non-audited IFRS report.

Under its audited IFRS in 2010, the bank reported net income of AZN11.6 million, leading to a high Return on Average Assets of 5.5% (3.36% in 2009; 4.51% in 2008).

Asset Quality

Despite Bank of Baku's focus on the risky segments of consumer lending, the share of non-performing loans (defined as loans overdue by more than 90 days) remains relatively low. The reported level of loans overdue for more than 90 days stood at 3.7% of the gross loan portfolio as at 30 September 2011 (5% in 2009 and 3% in 2008). Provisioning coverage was maintained at 4.6% of gross loans, providing sufficient problem loans coverage. In light of the stabilising operating environment, we expect asset quality to remain stable; however, we note that asset quality ratios could be diluted if the bank maintains rapid loan-book growth, which could result in a higher level of delinquencies in a maturing loan portfolio.

Capital Adequacy

Bank of Baku's shareholder equity stood at AZN54.5 million at 30 September 2011 and funded 19% of the bank's assets providing a sufficient coverage for expected losses in the medium term. We note that Bank of Baku's good profitability leads to ample internal capital generation capacity and we expect that profit will remain the main source of capital increase in the near to medium term.

Risk Positioning

Bank of Baku has a relatively diversified shareholders structure, with no single party owning a controlling stake in the bank's equity. The largest shareholder - NAB Holding (40% equity stake) - is a Turkey-based company which also has interests in a variety of businesses in Azerbaijan, including car dealerships, trade of consumer electronics and tourism.

Bank of Baku's risk positioning is supported by a good granularity of the loan book and funding base as the bank mainly services retail clients. Nonetheless, we are of the opinion that Bank of Baku has a relatively high appetite for credit risk, reflected by the bank's recent rapid growth of its loan book (around 30% during the first nine months in 2011) and its focus on the risky segment of the retail loan market, the so-called "express loans".

Bank of Baku's credit risk management benefits from its focus on borrowers with a positive credit history within the bank . Risk management tools include a credit-scoring system and a database of retail credit histories.

Liquidity management is typical for a bank of this size and business profile. Tools applied include mainly cash-flow projections and stress-testing. Bank of Baku has no exposure to market risk.

Liquidity

We note that Bank of Baku's liquidity buffer has decreased during the first nine months in 2011 as the bank used its low- yielding liquid assets to meet an increasing demand for consumer loans. As a result ,the level of liquid assets declined to around 12% from 19% at YE2010. Historically Bank of Baku's liquidity position has been supported by its growing granular retail deposit base and its stable and predictable cash flows from the granular loan book. Bank of Baku's funding base mainly consists of retail deposits which increased by 83% in 2010 and by another 22% during the first nine months 2011, accounting for 70% of the bank's total liabilities (63% in 2010). The remaining portion of funding is represented by corporate deposits, interbank loans, term-funding provided by foreign development institutions and government funds.

Efficiency

Given its low size and retail focus, Bank of Baku has historically displayed comparatively moderate efficiency indicators with the cost-to-income ratio to 52% at YE2010 from 68.3% in 2009 as a result of the increased revenues.

Regulatory Environment

Azerbaijan has an evolving regulatory environment. Refer to Moody's Banking System Outlook on Azerbaijan, published in August 2011, for information on this factor.

Operating Environment

This factor is common to all Azerbaijani banks. Moody's assigns an E+ score for the overall operating environment in Azerbaijani. Refer to Moody's Banking System Outlook on Azerbaijan, published in August 2011, to obtain a detailed discussion on the operating environment.

Global Local Currency Deposit Rating (Joint Default Analysis)

Moody's assigns a long-term GLC deposit rating of B2 to Bank of Baku. The rating is supported by the bank's BCA of B2.

Foreign Currency Deposit Rating

Moody's assigns B2/Not Prime foreign currency deposit ratings to Bank of Baku, at the same level as the bank's GLC deposit ratings.

ABOUT MOODY'S BANK RATINGS

Bank Financial Strength Rating

Moody's Bank Financial Strength Ratings (BFSRs) represent Moody's opinion of a bank's intrinsic safety and soundness and, as such, exclude certain external credit risks and credit support elements that are addressed by Moody's Bank Deposit Ratings. BFSRs do not take into account the probability that the bank will receive such external support, nor do they address risks arising from sovereign actions that may interfere with a bank's ability to honor its domestic or foreign currency obligations. Factors considered in the assignment of BFSRs include bank-specific elements such as financial fundamentals, franchise value, and business and asset diversification. Although BFSRs exclude the external factors specified above, they do take into account other risk factors in the bank's operating environment, including the strength and prospective performance of the economy, as well as the structure and relative fragility of the financial system, and the quality of banking regulation and supervision.

Global Local Currency Deposit Rating

A deposit rating, as an opinion of relative credit risk, incorporates the BFSR as well as Moody's opinion of any external support.

Specifically, Moody's Bank Deposit Ratings are opinions of a bank's ability to repay punctually its deposit obligations. As such, they are intended to incorporate those aspects of credit risk relevant to the prospective payment performance of rated banks with respect to deposit obligations, which includes: intrinsic financial strength, sovereign transfer risk (in the case of foreign currency deposit ratings), and both implicit and explicit external support elements. Moody's Bank Deposit Ratings do not take into account the benefit of deposit insurance schemes which make payments to depositors, but they do recognize the potential support from schemes that may provide assistance to banks directly.

According to Moody's joint default analysis (JDA) methodology, the global local currency deposit rating of a bank is determined by the incorporation of external elements of support into the bank's Baseline Credit Assessment. In calculating the Global Local Currency Deposit rating for a bank, the JDA methodology also factors in the rating of the support provider, in the form of the local currency deposit ceiling for a country, Moody's assessment of the probability of systemic support for the bank in the event of a stress situation and the degree of dependence between the issuer rating and the Local Currency Deposit Ceiling.

Foreign Currency Deposit Rating

Moody's ratings on foreign currency bank obligations derive from the bank's local currency rating for the same class of obligation. The implementation of JDA for banks can lead to high local currency ratings for certain banks, which could also produce high foreign currency ratings. Nevertheless, it should be noted that foreign currency deposit ratings are in all cases constrained by the country ceiling for foreign currency bank deposits. This may result in the assignment of a different, and typically lower, rating for the foreign currency deposits relative to the bank's rating for local currency obligations.

About Moody's Bank Financial Strength Scorecard

Moody's bank financial strength model (see scorecard below) is a strategic input in the assessment of the financial strength of a bank, used as a key tool by Moody's analysts to ensure consistency of approach across banks and regions. The model output and the individual scores are discussed in rating committees

Rating Factors

OJSC Bank of Baku

Rating Factors [1]	**A**	**B**	**C**	**D**	**E**	**Total Score**	**Trend**
Qualitative Factors (70%)						**E+**	
Factor: Franchise Value						**D+**	**Improving**
Market Share and Sustainability				**x**			
Geographical Diversification					**x**		
Earnings Stability		**x**					
Earnings Diversification [2]							
Factor: Risk Positioning						**E**	**Neutral**
Corporate Governance [2]				**x**			
- Ownership and Organizational Complexity				x			
- Key Man Risk							
- Insider and Related-Party Risks				x			
Controls and Risk Management					**x**		
- Risk Management					x		
- Controls					x		
Financial Reporting Transparency			**x**				
- Global Comparability	x						
- Frequency and Timeliness					x		
- Quality of Financial Information				x			
Credit Risk Concentration		**x**					
- Borrower Concentration		x					
- Industry Concentration	x						
Liquidity Management				**x**			
Market Risk Appetite			**x**				
Factor: Operating Environment						**E+**	**Neutral**
Economic Stability					**x**		
Integrity and Corruption					**x**		
Legal System				**x**			
Financial Factors (30%)						**B-**	
Factor: Profitability						**A**	**Improving**
PPI / Average RWA - Basel I	6.92%						

Net Income / Average RWA - Basel I	5.20%						
Factor: Liquidity						**D+**	**Neutral**
(Mkt funds-Liquid Assets) / Total Assets			5.63%				
Liquidity Management				x			
Factor: Capital Adequacy						**A**	**Neutral**
Tier 1 Ratio - Basel I	11.16%						
Tangible Common Equity / RWA - Basel I	16.01%						
Factor: Efficiency						**C**	**Neutral**
Cost / Income Ratio			55.25%				
Factor: Asset Quality						**B**	**Neutral**
Problem Loans / Gross Loans			2.53%				
Problem Loans / (Equity + LLR)	9.97%						
Lowest Combined Score (9%)						**D+**	
Economic Insolvency Override						**Neutral**	
Aggregate Score						**D**	
Assigned BFSR						**E+**	

[1] - Where dashes are shown for a particular factor (or sub-factor), the score is based on non public information [2] - A blank score under Earnings diversification or Corporate Governance indicates the risk is neutral