Alfa-Bank JSC

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Alfa-Bank JSC

SACP	bb+	
Anchor	bb-	
Business Position	Strong	+1
Capital and Earnings	Adequate	0
Risk Position	Strong	+1
Funding	Average	0
Liquidity	Adequate	

+

Support	0
ALAC Support	0
GRE Support	0
Group Support	0
Sovereign Support	0

+

Additional Factors	0

Issuer Credit Rating
BB+/Stable/B

Major Rating Factors

Strengths:	Weaknesses:
• Leading commercial position among private-sector banks. • Efficient risk-management framework. • High systemic importance in Russia.	• Still challenging, although improving, operating environment in Russia. • Declining, but still-high, single-name concentration in the loan book. • High level of foreign currency lending, although historically well-managed foreign currency risk.

Outlook: Stable

The stable outlooks on nonoperating holding company (NOHC) ABH Financial Ltd. (ABHF) and its Russia-based main operating entity, Alfa-Bank JSC, reflect our view that Alfa-Bank will remain a core operating entity of the consolidated ABH group, maintaining sound operating performance and high risk-management standards over the next 12-18 months.

Downside scenario

The possibility of a negative rating action on Alfa-Bank is currently remote, because it would require significant deterioration in its creditworthiness, with our assessment of the bank's stand-alone credit profile (SACP) deteriorating by two notches or more.

If Alfa-Bank's SACP were to deteriorate by one notch, we would expect to include one notch of support for systemic importance. We could take a negative rating action on ABHF if, contrary to our base-case scenario, we thought the group would fail to successfully manage the risks associated with its expansion in the retail segment, with new loan loss provisions significantly exceeding market average metrics.

Upside scenario

A positive rating action on either entity is also remote at this stage, since it would require either significant improvement in the group's capitalization (with the risk-adjusted capital [RAC] ratio sustainably above 10%) or, generally, a more supportive operating environment for banks in Russia.

Rationale

Our analysis focuses on the consolidated accounts of ABHF, the NOHC of Alfa-Bank. We refer to ABHF as the Alfa banking group, or the group, in this report. Alfa-Bank houses ABHF's banking operations in Russia, which are by far the group's largest operations and its backbone. We therefore view Alfa-Bank as a core entity of ABHF.

The ratings on Alfa-Bank incorporate our 'bb-' anchor for banks operating predominantly in Russia, as well as our view of Alfa-Bank's longstanding leading competitive position among private-sector banks in Russia in terms of assets, product lines, and efficiency. We also take into account some recovery of margins due to decreasing funding costs and better profitability metrics than privately owned domestic peers'. We view positively the bank's efficient risk-management framework and absence of direct lending, as well as its very swift reaction to collateral foreclosure, which supports asset-quality management, even in downturns. Alfa-Bank benefits from a stable funding base and sufficient liquidity coverage, and has better access to capital markets than local peers. We consider Alfa-Bank to have high systemic importance in Russia and believe there is a moderately high likelihood that the Russian government would provide extraordinary support to Alfa-Bank if needed. However, it's neutral for rating on Alfa-Bank, since the difference between the sovereign's creditworthiness and that of Alfa-Bank is too low, in our view.

Anchor: 'bb-' for a commercial bank operating in Russia

Our bank criteria use our Banking Industry Country Risk Assessment (BICRA) economic and industry risk scores to determine a bank's anchor, the starting point in assigning an issuer credit rating. The anchor for a commercial bank operating only in Russia is 'bb-', based on an economic risk score of '8' and an industry risk score of '8'.

Economic risks are higher for Russian banks than for peers in large emerging markets such as China, Brazil, and India. Although we now expect Russian economic growth of 1.5% in 2019 and average growth of 1.8% in 2020-2022, we consider that the economic environment will remain challenging for Russian banks over the next two years. The economy still relies heavily on commodities and lacks the structural reforms that would improve the efficiency of its nonexport sectors.

We expect lending growth of 12%-15% in 2019, on the back of strong growth in retail lending averaging 18%-20% in 2019. In our opinion, the increased credit demand seen in 2018 was largely due to significant delayed lending demand from corporate and retail clients. We expect new lending growth will likely moderate in 2019. A pick-up in new lending will strengthen the banking sector's profitability, to some extent compensating for the burden of significant accumulated problem and restructured loans that continue to pressure the profitability and capitalization of many Russian banks.

Industry risks are also high. Access to external funding remains limited because of the economic sanctions imposed on several large banks and corporates. While deposit growth has slowed significantly, deposits remain the core funding source for the sector. Funding concentrations at small and midsize banks make them particularly vulnerable to deposit outflows. The dominance of state banks in the Russian banking sector has traditionally distorted competition and weighed on private-sector banks' creditworthiness. We expect state banks to further strengthen their market positions in 2019-2020. We consider that banking regulation and supervision remain reactive rather than proactive. However, the central bank's efforts to clean up the banking sector have been positive for the sector's stability.

The banking sector received significant government support in the form of capital, funding, and liquidity in the past. We anticipate that, over the coming years, government support will likely be available predominantly for large state-related banks and systemically important private banks.

Table 1

Alfa-Bank JSC Key Figures					
	--Year-ended Dec. 31--				
(Mil. $)	**2018**	**2017**	**2016**	**2015**	**2014**
Adjusted assets	47,049.0	44,568.0	38,079.0	31,377.0	43,452.0
Customer loans (gross)	29,626.0	27,889.0	23,243.0	20,996.0	26,997.0
Adjusted common equity	6,100.0	5,489.0	4,822.0	4,153.0	4,237.0
Operating revenues	3,132.0	2,334.0	1,979.0	2,263.0	2,554.0
Noninterest expenses	1,170.0	1,125.0	906.0	928.0	1,195.0
Core earnings	1,380.4	851.0	568.0	423.0	(19.0)

Business position: The largest privately owned bank in Russia, successfully competing with government banks

With total assets at $47.2 billion as of Dec. 31, 2018, Alfa-Bank JSC ranks No. 4 among Russian banks in terms of assets, and No. 1 among privately owned financial institutions in Russia. For many years, Alfa Bank has been successfully competing with larger government-owned banks, demonstrating consistently good revenue generation, a sustainable strategy, and balanced approach to risk management. The bank has 492 retail branches across the country, and it served more than 530,000 corporate customers and about 16.1 million retail clients as of end-2018.

The group's management and strategy are key strengths for the bank's overall business position. Alfa-Bank's rapid and successful recovery after the downturns of the past decade, notably the efficient workout of problem loans, demonstrates the bank's focused strategy and leads us to believe that it will continue to manage the risks arising from pressured macroeconomic conditions efficiently. The bank's ultimate owners, foremost among them Mikhail Fridman, have been with Alfa-Bank since the 1990s and we consider them committed to the banking activities in Russia.

The bank continues to focus mainly on corporate lending. However, it is also gradually increasing retail lending, in particular personal instalment loans, credit card loans and mortgages. Retail lending represented about 20% of the loan portfolio as of Dec. 31, 2018 (from 15% a year earlier) versus a target of 30% by 2021.

We consider Alfa-Bank's growth strategy feasible, based on our expectation that the bank will expand without significant deterioration in asset quality as it seeks good-quality clients. In our view, the bank's significantly lower funding costs than the average for its Russian peers (3.9% versus 4.6% for 2018) will further support growth. This is due to significantly large volumes of cheap and stable current accounts, mainly because of the bank's good infrastructure and client services.

Table 2

Alfa-Bank JSC Business Position					
	--Year-ended Dec. 31--				
(%)	2018	2017	2016	2015	2014
Loan market share in country of domicile	3.8	3.8	3.3	2.6	2.8
Deposit market share in country of domicile	4.0	3.4	3.3	2.7	2.5
Total revenues from business line (mil. $)	3,154.0	2,362.0	1,979.0	2,264.0	2,666.0
Commercial banking/total revenues from business line	47.2	59.2	58.2	53.5	42.6
Retail banking/total revenues from business line	38.3	44.3	44.0	43.6	59.2
Commercial & retail banking/total revenues from business line	85.5	103.5	102.2	97.1	101.7
Trading and sales income/total revenues from business line	(2.0)	(5.6)	(3.9)	N/A	N/A
Other revenues/total revenues from business line	16.5	2.2	1.7	2.9	(1.7)
Investment banking/total revenues from business line	(2.0)	(5.6)	(3.9)	N/A	N/A
Return on average common equity	22.4	15.0	11.3	8.8	0.7

N/A--Not applicable.

Capital and earnings: Adequate capitalization, supported by sound earning buffers

We expect that Alfa-Bank and the group will continue to show positive results and that internal capital generation capacity will be sufficient to cover the growth in risk-weighted assets. Therefore, we expect the group's capitalization, measured by our RAC ratio, to stay almost flat at 8.5%-8.7% over the next 12-18 months (versus 8.7% at year-end 2018) based on the following assumptions for the group:

- Loan portfolio growth of 13% per year. We expect growth in the retail segment to be faster than in the corporate segment;
- A drop in the net interest margin to around 4.5% from 4.8% in 2018, in line with the sector trend, but at a slower pace, as the bank gradually increasing the share of retail loans in its loan book; and
- A cost of risk at about 1%, in line with our expectations for large banks in Russia.

The group's historical profitability metrics are better than privately owned domestic peers', gravitating toward those of government-owned banks and foreign subsidiaries. We note that consolidated net income of $1,325 million as of end-2018 compares favorably with other Russian banking groups. We expect that revenue generation capacity will remain at least at a similar level over the next two years, resulting in above 15% return on equity.

We understand that the shareholders are ready and capable to provide Tier 1 capital for the bank, if needed. However, in our base case, we do not include any additional capital injections for the next two years. This is because Alfa-Bank and the larger group have sufficient capital buffers, in our view, thanks to good internal capital generation capacity, and the $500 million in perpetual loan participation notes that the group raised in January 2018, which we include in our capital calculations as having intermediate equity content.

We expect the dividend payout ratio to remain at 5%-7% for the next two years. At the same time, we do not expect this will distort capitalization metrics, because, under our base-case scenario, earnings capacity should remain strong.

Table 3

Alfa-Bank JSC Capital And Earnings

	--Year-ended Dec. 31--				
(%)	**2018**	**2017**	**2016**	**2015**	**2014**
Tier 1 capital ratio*	17.3	15.7	16.2	16.8	12.8
S&P Global Ratings' RAC ratio before diversification	8.7	7.5	8.6	7.2	6.4
S&P Global Ratings' RAC ratio after diversification	7.9	6.7	7.5	7.6	6.7
Adjusted common equity/total adjusted capital	86.6	88.8	87.3	100.0	100.0
Net interest income/operating revenues	64.2	74.5	69.2	58.4	87.2
Fee income/operating revenues	31.2	36.2	32.0	25.9	32.3
Market-sensitive income/operating revenues	7.3	(9.5)	1.0	15.0	(20.5)
Noninterest expenses/operating revenues	37.4	48.2	45.8	41.0	46.8
Preprovision operating income/average assets	4.3	2.9	3.1	3.6	2.9
Core earnings/average managed assets	3.0	2.1	1.6	1.1	(0.0)

RAC--Risk-adjusted capital. *The tier 1 capital ratio for 2014-2016 is calculated based on Basel I and the ratio for 2017-2018 is baed on Basel III.

Table 4

Alfa-Bank JSC Risk-Adjusted Capital Framework Data

	Exposure*	S&P Global Ratings' RWA	Average S&P Global Ratings' RW (%)
(Mil. $)			
Credit risk			
Government & central banks	6,070	1,328	22
Institutions and CCPs	6,499	5,395	83
Corporate	28,831	53,679	186
Retail	6,131	10,623	173
Of which mortgage	513	474	92
Securitization§	0	0	0
Other assets†	1,869	4,107	220
Total credit risk	49,401	75,132	152
Credit valuation adjustment			
Total credit valuation adjustment	--	0	--
Market Risk			
Equity in the banking book	25	263	1,050
Trading book market risk	--	0	--
Total market risk	--	263	--
Operational risk			
Total operational risk	--	5,873	--
	Exposure	**S&P Global Ratings' RWA**	**% of S&P Global Ratings' RWA**
Diversification adjustments			
RWA before diversification	--	81,267	100
Total diversification/ concentration adjustments	--	7,525	9
RWA after diversification	--	88,793	109
		Total adjusted capital	**S&P Global RAC ratio (%)**
Capital ratio			
Capital ratio before adjustments		7,043	9
Capital ratio after adjustments‡		7,043	8

*Exposure at default. §Securitization exposure includes the securitization tranches deducted from capital in the regulatory framework. †Exposure and S&P Global Ratings' risk-weighted assets for equity in the banking book include minority equity holdings in financial institutions. ‡Adjustments to Tier 1 ratio are additional regulatory requirements (e.g. transitional floor or Pillar 2 add-ons). RWA--Risk-weighted assets. RW--Risk weight. RAC--Risk-adjusted capital. Sources: Company data as of Dec. 31 2018, S&P Global Ratings.

Risk position: Asset quality is stronger than the system average, although single-name concentrations remain significant in an international context

In recent years, the group proved to be more resilient than peers' to the ongoing economic problems besetting the Russian economy. We acknowledge the group's track record in navigating financial crises and consider its risk position to be strong and better than most peers'. Alfa-Bank's cost of risk is below the system average, despite recent fast growth in the risky retail segment. Its average cost of risk over the past five years stands at 2% versus an estimated

2.9% for the system.

We also acknowledge the group's progress in reducing single-name concentrations, with top-10 loans dropping to 21.7% of total loans as of Dec. 31, 2018 from 27.4% as of year-end 2017. At the same time, we think that single-name concentrations will remain high in an international context, reflecting the concentrated structure of the Russian economy and the group's market position as one of the leading lenders to large Russian corporates. That said, the top-10 loans are to blue-chip Russian companies with higher-than-average credit quality.

The group currently aims to increase the share of retail loans in its loan book to 30% by 2021 from 20% as of Dec. 31, 2018. We expect the single-name portfolio concentrations to decrease slowly over the next two years, but still remain high in an international context. We believe that the bank would be able to expand retail lending without a significant increase in cost of risk, mostly because we believe that the management team's experience and market knowledge would facilitate cautious and sustainable expansion in the segment.

We also note the Alfa banking group's efficient risk-management framework and absence of direct lending, as well as its very swift and proactive reaction to collateral foreclosure, which supports asset-quality management, even in downturns. While some new problems may appear on the back of the higher growth rate we anticipate, we do not expect any material problem loans will arise, and expect that the level of nonperforming loans will remain at about 3.5%, with the majority of problem loans well provisioned.

We note that about 30% of the group's loans are in foreign currencies, mostly U.S. dollars, leaving the bank exposed to currency risk. However, these are matched by a 32% share of customer deposits denominated in foreign currencies. The group holds its net position in foreign currency close to zero, while foreign currency loans are extended mostly to exporting companies with foreign currency revenue and good operating performance.

Table 5

Alfa-Bank JSC Risk Position

	--Year-ended Dec. 31--				
(%)	**2018**	**2017**	**2016**	**2015**	**2014**
Growth in customer loans	6.2	20.0	10.7	(22.2)	(15.8)
Total diversification adjustment/S&P Global Ratings' RWA before diversification	9.3	12.2	14.0	(4.5)	(4.7)
Total managed assets/adjusted common equity (x)	7.7	8.1	7.9	7.6	10.3
New loan loss provisions/average customer loans	0.9	0.2	1.2	3.0	4.7
Net charge-offs/average customer loans	0.9	1.5	3.2	2.9	1.3
Gross nonperforming assets/customer loans + other real estate owned*	3.5	2.6	4.4	7.1	2.8
Loan loss reserves/gross nonperforming assets	86.6	114.2	110.5	94.3	214.1

RWA--Risk-weighted assets. *The 2018 data refers to Stage 3 loans under the IFRS9 definition. The data for 2017 and prior periods refers to loans past due more than 90 days.

Funding and liquidity: The group benefits from lower funding costs than its peers

We assess funding as average and liquidity as adequate. The group has successfully increased its deposit base over 2018 without increasing the cost of funds.

In our view, the group benefits from Alfa-Bank's strong and stable retail deposit franchise in Russia. It is the third-largest Russian bank by retail deposits, with a 10% market share, after Sberbank and VTB Bank JSC. Concentration of corporate deposits was fairly stable over 2018, with the 20 largest customers accounting for about 18% of core deposits on Dec. 31, 2018 (same as on Dec. 31, 2017).

We note that Alfa-Bank benefits from large volumes of cheap and stable current accounts, mainly because of its good infrastructure and client services. The bank's ratio of interest expense to average funding is 3.9%, one of the lowest among its peers, and it is one of the few banks in Russia that historically enjoyed relatively regular access to both domestic and international bond markets. The share of wholesale funding reduced to 19.7% as of end-2018 from 22% in 2017, due to a decrease in deposits due to banks and redemption of subordinated debt. We also positively note that Alfa is the largest bank issuers on the market that is not under sectoral sanctions and consequently benefits from access to international markets.

As of end-2018, the group had about 32% of its assets in liquid assets and securities eligible for repurchase transactions. Broad liquid assets amply cover short-term wholesale funding at all times. The debt redemption schedule appears smooth. There are limited refinancing needs over the next year, with more than 80% of outstanding debt maturing after end-2019, which we consider positive. The owners have a track record of providing liquidity to the group in times of need.

Table 6

Alfa-Bank JSC Funding And Liquidity

	--Year-ended Dec. 31--				
(%)	**2018**	**2017**	**2016**	**2015**	**2014**
Core deposits/funding base	82.7	79.9	71.0	69.1	56.2
Customer loans (net)/customer deposits	89.5	91.6	101.8	110.3	126.4
Long-term funding ratio	94.4	92.5	84.6	89.7	74.5
Stable funding ratio	131.4	127.5	119.8	120.5	103.4
Short-term wholesale funding/funding base	6.7	8.7	18.2	12.0	28.5
Broad liquid assets/short-term wholesale funding (x)	5.3	4.0	2.2	2.7	1.2
Net broad liquid assets/short-term customer deposits	61.2	58.4	54.4	46.3	15.1
Short-term wholesale funding/total wholesale funding	33.8	39.7	58.2	39.0	65.0
Narrow liquid assets/3-month wholesale funding (x)	12.8	7.6	4.1	6.4	3.4

Support: High systemic importance

We consider Alfa-Bank to have high systemic importance in Russia. We believe there is a moderately high likelihood that the Russian government would provide extraordinary support to Alfa-Bank if needed. However, we no longer incorporate additional notch of support from the Russian government into the ratings on Alfa-Bank, since we believe that, as the bank's stand-alone creditworthiness has strengthened to 'bb+', the gap between the creditworthiness of the bank and the sovereign is now too narrow for the government to provide for substantial extraordinary support that would translate into additional rating notches.

Additional rating factors: We base our analysis on the consolidated financial reports of the holding company

Alfa-Bank and its affiliated companies are owned by ABHF, a limited liability NOHC registered in Cyprus.

We consider Alfa-Bank to be a core entity of ABHF, as it represents more than 90% of ABHF's assets and liabilities and remains the driving force of the group's creditworthiness. Our unsupported group rating profile (UGCP) therefore largely reflects the strength of Alfa-Bank's operations.

The long-term rating on NOHC ABHF is two notches lower than the UGCP. The rating differential is mainly due to ABHF's status and reliance on dividends and other distributions from Alfa-Bank to meet its obligations.

Related Criteria

- Criteria | Financial Institutions | General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria | Financial Institutions | Banks: Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria | Financial Institutions | Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria | Financial Institutions | Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Criteria | Financial Institutions | Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria | Financial Institutions | Banks: Commercial Paper I: Banks, March 23, 2004

Anchor Matrix

Industry Risk	Economic Risk									
	1	2	3	4	5	6	7	**8**	9	10
1	a	a	a-	bbb+	bbb+	bbb	-	-	-	-
2	a	a-	a-	bbb+	bbb	bbb	bbb-	-	-	-
3	a-	a-	bbb+	bbb+	bbb	bbb-	bbb-	bb+	-	-
4	bbb+	bbb+	bbb+	bbb	bbb	bbb-	bb+	bb	bb	-
5	bbb+	bbb	bbb	bbb	bbb-	bbb-	bb+	bb	bb-	b+
6	bbb	bbb	bbb-	bbb-	bbb-	bb+	bb	bb	bb-	b+
7	-	bbb-	bbb-	bb+	bb+	bb	bb	bb-	b+	b+
8	-	-	bb+	bb	bb	bb	bb-	**bb-**	b+	b
9	-	-	-	bb	bb-	bb-	b+	b+	b+	b
10	-	-	-	-	b+	b+	b+	b	b	b-

Ratings Detail (As Of June 7, 2019)*

Alfa-Bank JSC	
Issuer Credit Rating	BB+/Stable/B

Ratings Detail (As Of June 7, 2019)*(cont.)		
Russia National Scale		NR/--/--
Subordinated		B+
Issuer Credit Ratings History		
27-Feb-2018		BB+/Stable/B
20-Feb-2017		BB/Positive/B
01-Jun-2016		BB/Stable/B
04-Feb-2015		BB/Negative/B
30-Dec-2014		BB+/Watch Neg/B
02-Jun-2017	*Russia National Scale*	NR/--/--
04-Feb-2015		ruAA/--/--
30-Dec-2014		ruAA+/Watch Neg/--
Sovereign Rating		
Russia		
Foreign Currency		BBB-/Stable/A-3
Local Currency		BBB/Stable/A-2
Related Entities		
ABH Financial Ltd.		
Issuer Credit Rating		BB-/Stable/B
Senior Unsecured		BB-
Alfa Bond Issuance PLC		
Subordinated		B+
Alfa Holding Issuance PLC		
Senior Unsecured		BB-

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.