KBC Securities

Flash

OTP

24 September 2004

The "bank tax" story

Banks	Current price	HUF 4,302	Buy
Hungary	Target price	HUF 5,050	Unchanged

Performance over	1M	3M	12M
Absolute	-1%	+2%	+63%
Relative to BUX	-4%	-6%	+20%
12M Hi/Lo	HUF 4,570/2,505		

Reuters	OTPB.BU
Bloomberg	OTP HB
Market cap	EUR 4.9bn
Next corporate event	
3Q results on November 12, 2004	

FY/e 31.12	2003	2004E	2005E	2006E
NII (HUF bn)	176.1	243.2	249.9	253.7
Non-interest income	149.6	166.7	185.0	204.1
Total income	314.9	394.8	419.4	440.0
After-tax profit	85.4	124.5	128.7	134.6
EPS (HUF)	305	445	460	481
P/E	8.8	9.7	9.4	8.9
P/BV	2.4	3.0	2.5	2.1
DPS (HUF)	60	120	138	168
Yield (%)	2.2	2.8	3.2	3.9

Source: K&H Equities **Unadjusted figures*

After skirmishing all last week, representatives of Hungarian banks and the government reached an agreement yesterday on the "bank tax" issue. Banks will pay a HUF 30bn contribution to the budget, but only in 2005 and 2006. Prime Minister-designate Gyurcsány said the budget would not need the extra revenues from 2007 since Hungary is expected to receive a higher contribution from the EU's budget.

The news is slightly positive in our view, as the agreement justifies only a 1% decrease in OTP's share price versus the worst-case scenario of 10%, which assumed a permanently higher tax rate. Moreover, OTP's CEO said yesterday that the company would be able to offset a large part of the lost money via further rationalization.

Meanwhile, 2006 is election year in Hungary. According to recent polls the current opposition party, which also supports the "bank tax", may form the next government. Since they didn't take part in the negotiations and did not make any promises, we see a low but existing risk that the new system could remain in place for a longer period.

The story

Last Wednesday the FinMin announced that the 2004 public sector deficit would be HUF 110bn–120bn higher than originally targeted and would reach 5.1–5.3% of GDP, versus the originally targeted 4.6%. However, the ministry is sticking to a considerable 0.5–0.7pps reduction of the deficit-to-GDP ratio in the coming years. To achieve this goal, the government said it would propose that parliament raise the corporate income tax from 16% to 24% for financial institutions, which would mean HUF 30bn additional revenue for the budget. This sum equates to around 0.13% of 2005 GDP.

Consequent to these events, OTP published a determined announcement last Friday. The bank said it would partly shift the cost of the potential higher tax rate to clients through wider margins. Moreover, OTP said it would focus on developing its foreign subsidiaries, or even resettling its most profitable elements from Hungary to Slovakia (where the tax rates are lower), if the parliament approved the 24% corporate tax.

Although the government initially seemed adamant about the tax hike, the FinMin was eventually willing to discuss potential compromises. FinMin Draskovics said that his ministry would examine the possibility of any alternative, practicable solutions, while insisting on the additional HUF 30bn contribution from banks.

After several discussions throughout the past week the parties agreed yesterday that the banks would pay a HUF 30bn contribution to the budget, but only in 2005 and 2006. According to the government, the budget will not need these supplementary revenues from 2007, since Hungary expects to receive a higher contribution from the EU's budget after that date.

Yesterday evening there were two possibilities for deducting the money from banks:

1. Introduce a new tax on the banks' net interest income (6%, deductible from corporate tax)
2. Raise the corporate tax for financial institutions from 16% to 24%

The government eventually chose the first option. For OTP this version is slightly better, since it covers only around 37% of the total net interest income in Hungary, while in terms of pre-tax profit it accounts for almost 44% of the sector. With the first version OTP's effective tax rate could grow to 23.5% in 2005 and 23.2% in 2006.

What about the long-term future?

In Hungary the government announces the tax law for the subsequent year on November 15. Even if a new regulation is launched, we cannot be 100% sure how long it will be applied for.

Although the current government promised to abolish the "bank tax" from 2007, based on recent polls they are unlikely to be in office in autumn 2006, when the 2007 tax law will be formed[1]. The opposition parties that could be in power at that time also support the higher tax on banks, thus we see some minor, but very real, chance of the new system remaining in place after 2006. Nevertheless, in our model we calculate with the abrogation of the new system, as we believe this outcome to be more likely.

How is OTP affected?

In our model we calculate with HUF 215.2bn and HUF 213.1bn net interest income (NII) from OTP's Hungarian units in 2005 and 2006 respectively. These sums would equate to the payment of HUF 12.9bn and HUF 12.8bn extra tax into the budget. However, tax on NII is deductible from the corporate tax base, which provides a HUF 2.1bn and HUF 2.0bn tax shield for the two years in question.

On the bottom line the total amount of extra tax paid by OTP will be HUF 10.8bn and HUF 10.7bn in 2005 and 2006 respectively, which is basically in-line with the CEO's announcement yesterday, which suggested that OTP would contribute around HUF 10bn to the budget in the next two years.

The impact of the "bank tax" on OTP's earnings

(in HUF bn)	2003	2004E	2005E	2006E
NII (cons)	176,096	243,239	249,917	253,689
NII DSK*	4,820	23,853	28,496	33,432
NII OBS	4,672	5,384	6,204	7,149
NII in Hungary	166,604	214,002	215,217	213,108
Hungary / Cons.	*94.61%*	*87.98%*	*86.12%*	*84.00%*
Tax on NII (6%)			12,913	12,787
Tax shield (16%)			2,066	2,046
Extra tax paid			**10,847**	**10,741**

** In 2003 OTP consolidated only the 4Q of DSK*

Changes in estimates

In conjunction with the implementation of the new legislation into our model we have augmented our estimates for OTP. In our view, after the developments in recent weeks, the high rate environment will remain in place for longer

[1] Next parliamentary elections will be held in spring 2006

than originally expected. We now calculate with a slower decrease of yields in the coming quarters. A higher yield environment ensures a higher interest margin for OTP, which will help to offset the shortfall of the bank tax. Our new net interest margin estimates are 6.52%, 5.94% and 5.52% for the period 2004–2006, which represent increases of 3bps, 16bps and 12bps respectively.

The CEO also said yesterday that OTP would dismiss 1,000 employees, or 6% of the total workforce, by the end of 2005. This reduction was previously mentioned at the conference calls held after the 1Q and 2Q results. We have therefore already built the redundancies into our model and have left our personnel expenses estimates unchanged.

Changes in valuation, but HUF 5,050 target price remains

Bases on the above factors we have increased our EPS forecast for 2004 by 0.6% to HUF 445, but slashed the 2005 and 2006 projections by 4.0% and 4.6% to HUF 460 and HUF 481 respectively. For the subsequent years we abolished the supplementary tax payments from our model.
Altogether these amendments had only a minor impact of –0.4% on our fair value calculation, we therefore maintain our Buy recommendation and HUF 5,050 target price for the stock.

Chronology

September 15: government announces its plan to increase corporate tax on banks from 16% to 24% (OTP's shares fall 9% intra-day)

September 17: OTP responds, saying it will shift the cost to customers and will resettle its most profitable elements from Hungary to Slovakia if the tax is imposed

September 18-19: the government shows willingness to negotiate

September 20: the first meeting between banks' representatives and the government

September 20–23: speculation spreads on the market about the potential outcomes

September 23: compromise reached on the additional HUF 30bn contribution from banks

September 24: the exact method of tax deduction announced

September 27–29: the government will file its proposal on the tax law to parliament

November 15: latest date for the announcement of the 2005 tax law

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Financial data

INCOME STATEMENT (HUFbn)	2001	2002	2003	2004E	2005E	2006E
Interest income from loans	104.7	129.7	159.1	232.4	264.3	285.0
Other interest income	108.7	100.6	124.3	172.1	148.1	129.1
Total interest income	213.5	230.3	283.4	404.5	412.5	414.1
Interest expenses on deposits	91.9	85.4	81.4	131.2	131.9	134.1
Other interest expenses	8.1	10.6	25.9	30.1	30.7	26.2
Total interest expenses	100.0	96.0	107.3	161.3	162.6	160.4
Net interest income	**113.5**	**134.3**	**176.1**	**243.2**	**249.9**	**253.7**
Provisions	6.2	8.8	10.8	15.1	15.6	17.8
Net interest income after provisions	107.3	125.5	165.3	228.1	234.3	235.9
Net fee income	40.1	50.7	61.7	66.9	73.5	82.1
Insurance fee income	39.0	49.7	56.3	60.8	66.8	73.5
Other income	10.8	11.2	11.7	16.1	18.5	19.0
Non-interest income	**99.0**	**124.6**	**149.6**	**166.7**	**185.0**	**204.1**
Total income	**206.3**	**250.0**	**314.9**	**394.8**	**419.4**	**440.0**
Insurance costs	32.2	39.8	41.8	43.5	46.1	48.9
Personnel expenses	41.4	50.2	61.3	74.2	77.8	81.7
Depreciation and amortization	15.0	17.0	17.8	19.5	21.5	23.3
Goodwill amortization	0.0	0.0	2.0	8.6	0.0	0.0
Other non-interest costs	48.1	56.9	69.4	76.1	79.4	81.3
Non-interest expenses	145.8	176.9	210.2	244.8	251.0	264.7
Pre-tax profit	60.5	73.1	104.7	150.0	168.4	175.4
Income Taxes	11.6	14.0	19.3	25.5	39.6	40.7
After-tax profit	**49.0**	**59.2**	**85.4**	**124.5**	**128.7**	**134.6**

BALANCE SHEET (HUFbn)	2001	2002	2003	2004E	2005E	2006E
Non int.-bearing assets	174	212	273	307	329	347
Cash	382	355	277	349	371	355
Inter-bank placements	332	296	252	296	286	266
Securities held for trading	229	220	377	358	340	323
Loans	771	1,281	1,983	2,395	2,785	3,190
Securities held-to-maturity	402	353	300	300	300	301
Int.-bearing assets	2,115	2,505	3,188	3,699	4,083	4,435
Total Assets	**2,290**	**2,717**	**3,461**	**4,006**	**4,411**	**4,782**
Deposits from banks	37	79	126	159	189	196
Deposits from customers	1,892	2,151	2,690	3,055	3,306	3,551
Liabilities from issued securities	40	85	125	140	153	166
Subordinated bonds	17	16	15	16	17	18
Int.-bearing liabilities	1,986	2,331	2,957	3,371	3,666	3,931
Accrued interest payable	1	1	2	2	2	2
Other liabilities	124	149	176	216	235	252
Total liabilities	2,122	2,493	3,149	3,605	3,921	4,203
Shareholder equity	167	224	312	400	490	578
Total liabilities and equity	**2,290**	**2,717**	**3,461**	**4,006**	**4,411**	**4,782**

FINANCIAL RATIOS	2001	2002	2003	2004E	2005E	2006E
ROAE	32.6%	30.3%	31.9%	35.0%	28.9%	25.2%
ROAA	2.3%	2.4%	2.8%	3.3%	3.1%	2.9%
Net margin	5.23%	5.36%	5.70%	6.52%	5.94%	5.52%
Spread	5.36%	5.52%	5.90%	6.65%	5.98%	5.50%
Non-interest income / Total income	48.0%	49.8%	47.5%	42.2%	44.1%	46.4%
Cost / Income	68.6%	68.3%	64.5%	59.7%	57.7%	57.8%
Cost / Avg. assets	6.7%	7.1%	6.8%	6.6%	6.0%	5.8%
Personnel expenses / Avg. assets	1.9%	2.0%	2.0%	2.0%	1.8%	1.8%
Provisions / Net interest income	5.4%	6.6%	6.1%	6.2%	6.2%	7.0%
Provisions / Loans	0.9%	0.9%	0.7%	0.8%	0.7%	0.7%
NPL (2-5) coverage	48.6%	40.1%	36.9%	40.0%	42.0%	44.0%
Equity / Assets	7.3%	8.2%	9.0%	10.0%	11.1%	12.1%
Loans / Assets	33.7%	47.1%	49.6%	51.7%	54.0%	56.4%
Loans / Deposits	40.8%	59.5%	73.7%	78.4%	84.2%	89.8%
Capital adequacy ratio	14.1%	13.4%	10.5%	11.4%	11.6%	12.1%
Tier 1	12.7%	12.6%	9.4%	10.4%	10.6%	11.1%
Tier 2	1.4%	0.8%	1.1%	1.0%	1.0%	1.0%
Effective tax rate	19.1%	19.1%	18.5%	17.0%	23.5%	23.2%
BVPS (HUF)	597	799	1,114	1,430	1,751	2,064
P/BV	2.8	2.9	2.4	3.0	2.5	2.1
EPS (HUF)	175	211	305	445	460	481
P/E	9.4	10.9	8.8	9.7	9.4	8.9
DPS (HUF)	25	0	60	120	138	168
Dividend payout ratio	14.5%	0.0%	19.7%	27.0%	30.0%	35.0%
Dividend yield	1.5%	0.0%	2.2%	2.8%	3.2%	3.9%

Source: K&H Equities

*Historic valuation data are based on historic prices

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