FINANCIAL ANALYSIS

A. Damu Entrepreneurship Development Fund

1. The government established Damu Entrepreneurship Development Fund (Damu) in 1997 to stimulate the development of small and medium-sized enterprises (SMEs). Until 2007, Damu’s main mission was to extend credit directly to SMEs, but now most of its financial programs are delivered through financial intermediaries (banks). Samruk-Kazyna National Wealth Fund is Damu’s sole shareholder.

2. Damu implemented several SME credit lines under the government’s recent economic stabilization program. The first tranche (2007) included T48.8 billion\(^1\) in 7-year loans to banks at interest rates of 9.2%–9.3%; the banks onlent the funds to SMEs at market rates averaging 17.21%. Under the second tranche (2008), Damu lent T54.7 billion to banks for 7 years at a fixed rate of 7.5%, and the banks onlent at a nominal rate of 12% and an effective rate of 13%–15%. Under the third tranche (2009), the government provided Damu with T117 billion. The results from these loans were mixed. Although the program provided anti-cyclical support and helped prevent the economy from free fall after the shock, some of the banks to which Damu provided loans became insolvent.\(^2\) Damu suffered a loss of T10.4 billion ($71.1 million) in 2009, compared to a profit of T785 million ($5.3 million) in 2008.\(^3\) At the end of 2009, Damu’s net worth decreased by 24% to T29.9 billion, and its ratio of liabilities to total assets was 88.5% compared to 70% a year earlier. Damu’s financial results for 2009 were negatively affected by a provision for loan impairment of T18.0 billion ($123.3 million), broken down as follows: (i) T13.7 billion on loans to banks (6% of the total amount disbursed), including the following banks under restructuring: Alliance Bank (ALB), Astana Finance, BTA Bank, and Temirbank; (ii) T1.2 billion on loans made directly to SMEs (16% of the total amount disbursed); (iii) T1.2 billion on loans to microfinance organizations; and (iv) T393.7 million on lease contracts.

3. As of year-end 2009, Damu’s total assets amounted to T260.9 billion, up 95% over the previous year. Loans to banks and financial institutions accounted for 87% of assets, amounting to T228 billion at the end of 2009, up 114% from the previous year. Direct loans to SMEs amounted to T7.6 billion at the end of 2009, or 2.9% of total assets, down 33%. In order to enable it to expand its lending portfolio, Damu has borrowed from Samruk-Kazyna National Wealth Fund. Liabilities from Samruk-Kazyna National Wealth Fund increased from T86.3 billion at the end of 2008 to T224.9 billion at the end of 2009. Due to the increased debt and losses incurred in 2009, Damu’s debt–equity ratio increased from 2.4 in 2008 to 7.7 in 2009.

4. In 2006, Damu formed a risk management department after it was forced to buy back its own bonds\(^4\) following a delisting request from the local stock exchange based on two consecutive years of poor results. In addition, in 2006, Damu suffered losses on trading transactions by its Treasury team, and in 2007 it incurred a loss of T195 million. A new chair of the management board was subsequently appointed. Damu’s risk management team currently consists of a director, two senior managers, and two managers. The department reports directly to the management board. Although Damu has its own risk management software, Samruk-Kazyna National Wealth Fund is developing common risk management software to be used by all of its member companies.

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\(^1\) $1 = T146.

\(^2\) While Damu has adopted good credit management policies, the government intervened in the selection of partner banks under the economic stabilization program.

\(^3\) Damu’s return on assets (ROA) declined from 0.2% in 2008 to –5.2% in 2009, while its return on equity (ROE) declined from 2.2% to –29.9% over the same period.

\(^4\) In 2005, Damu issued T3 billion ($20.5 million) in 5-year local currency bonds.
B. Participating Financial Institutions

1. Bank CenterCredit

5. Bank CenterCredit (BCC) was founded in 1988. In 2008, Kookmin Bank, the largest bank in the Republic of Korea, acquired 23% of BCC; it has gradually increased its ownership share to 41.9%. The International Finance Corporation purchased a 10% stake in BCC in 2010. Kookmin Bank provides various forms of technical assistance to BCC, including developing risk management systems, credit rating and scoring systems, and information technology. BCC is a leader in the retail and SME lending segments, although it is also active in corporate lending. At the end of the first quarter (Q1) of 2010, BCC was the fourth largest bank in Kazakhstan in terms of assets, with a 10.5% market share. It has 20 branches, 190 service points, and 566 automatic teller machines (ATMs). BCC is rated B by Fitch with a stable outlook and Ba3 by Moody's with a negative outlook.

6. BCC started SME lending with the assistance of the European Bank for Reconstruction and Development (EBRD), and it continues to apply the EBRD approach to credit analysis. BCC considers SMEs to be its most important segment. Borrowers are analyzed primarily based on cash flow analysis rather than collateral valuation or earnings reported for tax purposes. At the end of 2009, 42% of the bank's loan portfolio was to SMEs, 35% to individuals, and 23% to large corporations. Typical small loan maturities are 1–3 years, with a weighted average interest rate of 14.06%. Loans to medium-sized enterprises have maturities of 3–7 years and an average interest rate of 13.85%. The average size of small loans is T64.5 million, while the average size of medium loans is T762 million.

7. BCC’s financial statements are prepared in accordance with International Financial Reporting Standards (IFRS) and audited by Deloitte. Audit reports are unqualified. The internal audit department comprises nine people, including the manager. Internal auditors inspect 10 branches or departments per year. The quality of the bank’s financial disclosures and corporate governance is good.

8. The bank’s gross loan portfolio at the end of 2009 amounted to T726.9 billion. Loan portfolio growth has been slow at 3.4% in the first half of 2010, following 12% growth in 2009. The main sectors for business lending are trade (21% of total loans), followed by food (6%) and industrial construction and manufacturing (6%). BCC’s loan portfolio is of good quality, particularly when compared with other Kazakh banks. As of 31 December 2009, nonperforming loans (NPLs) accounted for 3.5% of gross loans outstanding and were adequately provisioned, with provisions for loan losses representing 9.3% of gross loans outstanding. However, about 40% of loans have been restructured. Related party loans account for 1% of total loans.

9. BCC has established four levels of credit approval, starting with branch credit committees, which have approval limits ranging from $30,000 to $2 million (T4.5-300 million), depending on the qualifications of the local staff. The small credit committee in the head office consists of 10 middle managers and can approve loans of up to $3 million (T450 million). The full credit committee consists of various senior and middle managers and has the authority to approve loans of up to $10 million (T1.5 billion). The management board can approve loans of up to 25% of the bank’s capital, while the board of directors approves larger loans.

5 NPLs are loans that are past due 90 days or more.
6 $1 = T150.
10. BCC has a capital adequacy ratio that significantly exceeds the regulatory minimum of 8%. BCC’s total capital adequacy ratio was 27.0% (Basel II method) in Q1 2010, up from 22.7% in 2009. Profitability has been weak in recent years. BCC had a return on assets (ROA) of only 0.3% in 2009, primarily as a result of a significant increase in provisions for loan losses. In the first half of 2010, annualized ROA was also 0.3%, hindered by a change in accounting policy that required the bank to deduct previously accrued interest on delinquent loans. The bank is highly liquid, as increasing deposits have not been matched by corresponding increases in the loan portfolio. On 1 April 2010, cash, correspondent accounts, and government securities represented 38% of total assets.

2. Kazkommertsbank

11. Kazkommertsbank (KKB) was established in 1990. EBRD acquired 15% of KKB’s capital in 2003. In May 2009, Samruk-Kazyna National Wealth Fund acquired 21.2% of the bank’s capital as part of the government’s economic stabilization program. In 2010, Samruk-Kazyna National Wealth Fund transferred a portion of its shares to the trust management of major shareholders, with the result that the Central Asian Investment Company (CAIC), EBRD, and the bank’s chairman, Mr. Nurzhan S. Subkhanberdin, maintain effective control of the bank. KKB is the largest bank in Kazakhstan, with total assets amounting to T2,646 billion in Q1 2010. It also has one of the largest branch networks, with 23 branches, 134 outlets, and 1,020 ATMs. In June 2010, Standard and Poor’s (S&P) confirmed KKB’s long-term B rating, with a negative outlook.

12. KKB’s financial statements are prepared in accordance with IFRS and externally audited by Deloitte. Audit reports are unqualified. The board of directors has three independent board members, who chair the audit, risk, and nomination and remuneration committees. KKB hired White & Case and JP Morgan to advise on corporate governance and internal compliance to bring them up to international standards. Since 2007, KKB has improved its liquidity management and imposed stricter cost controls. The bank was deeply affected by the recent financial crisis. The quality of the bank’s loan portfolio suffered, with an NPL ratio of 19.5% at the end of 2009. KKB set aside large provisions for loan losses in both 2008 (T150.7 billion) and 2009 (T193.1 billion). Additionally, 24.9% of the bank’s loan portfolio was restructured in Q1 2010. KKB believes that its current level of provisioning more than sufficiently covers potential credit losses, and that its NPL ratio is higher than its expected recoveries. Thus, it expects a lower rate of additions to loan–loss reserves in 2010 and its NPL coverage ratio to come down from the 150%–200% levels seen in 2007–2008 to below 100%.

13. In Q1 2010, KKB’s gross portfolio amounted to T2,688 billion. The bank’s industry concentration is high, with loans to the construction and real estate sectors accounting for 38% of gross loans. 40.2% of KKB’s loans are local currency denominated, while related party loans comprise 0.04%. At the end of 2009, the bank had five loans, totaling T322.7 billion (12% of gross loans outstanding), which exceeded 10% of the bank’s equity.

14. By virtue of its extensive network in rural areas, KKB is in a good position to expand lending to SMEs. However, credit to SMEs decreased from 2.6% of total loans at the end of 2008 to 1.6% in Q1 2010. The average SME loan amount in 2009 was $27,720 (around T4 million) and trade is the dominant sector. 29% of the loans had tenors of 1–3 years, while 27% had tenors exceeding 7 years. At the end of 2009, 63% of loans were for investment purposes, 17% were for working capital, and 19% for refinancing, with the percentage of refinancing loans up substantially from 1.8% at the end of 2008. Despite a strong management interest in

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7 CAIC is a holding company through which the management of the bank owns 23.7% of the shares of the bank.
diversifying its loan portfolio, KKB remains a corporate-focused bank. The SME sector will become an increasingly important part of KKB’s strategy as it seeks to diversify risk.

15. To survive the current crisis, KKB has adopted a strategy of retrenchment that focuses on (i) asset quality, (ii) liquidity management, and (iii) cost controls. To improve asset quality, the bank has adopted a conservative approach to lending, with a modest 5% increase in the loan portfolio budgeted for 2010. The bank has centralized all credit decisions in the head office, even for SME loans. Although liquidity management is one of the bank’s priorities, cash and cash equivalents and other liquid assets represented only 9% of total assets in Q1 2010. However, the bank’s decreased dependence on foreign borrowings has improved its liquidity profile in 2010. Customer deposits increased from 43% of total liabilities at the end of 2008 to 56% in Q1 2010.

16. The decline in KKB’s net income over the last 3 years is a result of its high loan loss charges. However, the bank’s bottom line has been supported by a strong net interest margin (8.4% by the end of 2009), lower operating expenses, and a gain from the repurchase of its own debt. Operating expenses decreased by 9.9% compared to 2008, and the bank’s operating cost ratio improved from 16.9% in 2008 to 12.1% in 2009. The bank’s profits are not expected to increase over the long term until asset quality improves.

3. Alliance Bank

17. Alliance Bank resulted from the merger in 1999 of IrtyshBusinessBank with Semipalatinsk Municipal Bank. Alliance was controlled by Seimar Investment Group from 2001 until February 2009, when serious liquidity issues along with the deteriorated quality of the loan book forced the government—through Samruk-Kazyna National Wealth Fund—to take control of the bank. In April 2009, Alliance defaulted on its creditors. As a result of the bank’s debt restructuring, concluded in March 2010, Samruk-Kazyna National Wealth Fund remains the majority shareholder (67%). International creditors received an ownership stake of 33%, including 2.2% allocated to ADB. Completion of the debt restructuring and the government’s commitment to continue supporting Alliance until it is back on its feet, and until a strategic investor replaces Samruk-Kazyna National Wealth Fund as the key shareholder, have persuaded all three major international rating agencies to upgrade the bank’s rating to B–/stable/C, kzBB- kzBB- (Standard & Poor’s, 9 June 2010), B3/evolving/NP (Moody’s, 2 July 2010) and B–/stable/B (Fitch, 19 July 2010). Alliance was the seventh largest bank in the country in 2009.

18. The adoption of improved business processes and procedures and the setting up of effective internal controls have been priorities for the new management team brought in by Samruk-Kazyna National Wealth Fund. Corporate governance, risk management, and transparency meet ADB requirements. The 10-person Internal Audit Department reports to the board of directors. Two sets of financial statements are prepared—one in accordance with Kazakhstan Accounting Standards (KAS) and the other compliant with IFRS. The latter is externally audited in accordance with international auditing standards. Deloitte was replaced as external auditor by KPMG in 2009. Both the 2008 and 2009 audit reports were qualified for reasons attributable to the former management team. The head of the Risk Division reports directly to the chair of the management board and the board of directors. The Risk Management Department has four units with a total staff of 44.

19. Every corporate and SME loan is now approved by a two-thirds majority of a credit committee that includes at least one risk management specialist. A credit rating system is scheduled to be implemented by the end of 2010. Real estate collateral is appraised by
independent external professionals and verified by internal experts. Prior to disbursal of any new corporate or SME loan, a risk management specialist has to confirm compliance with all credit policy requirements and the loan terms approved by the credit committee.

20. In March 2010, large (above $1.4 million [T200 million]) loans to legal entities represented 51.7% of Alliance’s gross loan portfolio, smaller loans to legal entities—8.9%, and loans to individuals—39.4%. Alliance’s strategy is to build up a diversified portfolio evenly split among corporate, SME, and retail lending. The main challenge is to develop the SME segment, in which the bank has historically been less active. Alliance’s main competitive advantages are its extensive national distribution network (19 branches, 115 cash desks, and 956 ATMs) and its unique relationship with some state bodies as a member of the Samruk-Kazyna National Wealth Fund Group. The bank’s growth strategy includes strengthening its already active role in state-funded finance programs and rebuilding its customer deposit base.

21. Alliance’s Q2 2010 capital adequacy ratios according to KAS (5.1% K1-1, 6.0% K1-2, and 11.7% K2) comply with the regulatory minimums. Its gross loan portfolio decreased from $7.2 billion at the end of 2007 to $3.6 billion in June 2010. From April 2009 to March 2010, few corporate loans were approved and the only new SME loans were funded by Damu programs. At the end of 2008 (before Samruk-Kazyna National Wealth Fund took over the bank), exposure to related parties amounted to 32.1% of total assets. The NPL ratio at the end of 2009 was 80.3% (IFRS) and the loan–loss–reserve NPL coverage ratio was 81.1%. Substantial additional reserves were created after due diligence of the loan book and off-balance sheet exposure was carried out in 2009. The loan portfolio has been segregated into a “Good Bank” (which consists of new loans and mostly current pre-restructuring loans) and a “Bad Bank” whose loans are managed by a workout unit with 116 dedicated specialists. As of 30 June 2010, 74.9% of the gross loan book is managed by the Bad Bank. The Bad Bank is scheduled to be closed by the end of 2011 after maximizing collections, writing off NPLs with no prospect of recovery, and restructuring and transferring the remaining loans to the Good Bank. The Good Bank’s Q2 2010 NPL ratio (KAS) was 4.7%, while the SME segment had a higher ratio of 13.7%.

22. Customer deposits decreased by 36.4% from the end of 2007 to the end of 2009 because of mistrust among depositors as soon as news spread about the bank’s problems. Deposits compose 36.3% of total funding (Q1 2010), while the new securities issued as part of the debt restructuring represent 63.7%. The ratio of gross loans to customer deposits was 434% in March 2010. After daunting losses in 2008–2009, Alliance posted a $2.3 billion profit in Q1 2010 (IFRS), mostly because of the debt restructuring. However, its KAS Q2 2010 net result was a $29.1 million loss.