OTP Bank 2Q 2018 Conference Call

Friday, 10 August 2018

Sam Goodacre: Hello, ladies and gentlemen, and welcome to OTP's first half results conference call. I'm Sam Goodacre from J.P. Morgan's equity research team and I'm delighted to welcome Laszlo Bencsik, the CFO of OTP Group, who will present the group's results and host the question and answer session. Laszlo, over to you.

Laszlo Bencsik: Thank you, Sam. Thank you for the fine introduction. Good morning or good afternoon, depending where you are. Thank you for joining us today for OTP Group's 2018 second quarter and first half results presentation.

As usual, we are going to follow the procedure that the first slide starts with a presentation using the document which is available on the website. I hope you have been able to download it and you can follow it through with me. I'm going to process this document page by page and then when we are through this presentation, you'll have a chance to ask your questions.

Starting the document, page two, the results, a quite successful second quarter I would say in terms of profits. A 15% quarter-on-quarter improvement in the adjusted profit. As for the accounting profit, first half year-on-year 16% up, and adjusted profit 17% year-on-year up.

I'm happy to see that the contribution of the foreign subsidiaries is growing, in the first half of this year it was up to 39%. The second quarter didn't bring large adjustment items, so the difference between adjusted and accounting numbers is relatively small. On page three, in fact, you can see the details of the adjustments we made.

Altogether in the second quarter it was minus 1.4 and it's a combination of some positive tax savings due to goodwill and impairments charges write-off, and there was 1.8 billion negative cumulative effect of acquisition related extras, out of which HUF 1.2 billion equivalent was cost related, typically third party advisors costs related to the two mergers we are doing and also the other acquisitions that we are doing at the same time.

On page four you see the adjusted figures, the P&L lines, and in order to try to make it more comprehensible we actually separated out the impact of the newly acquired entities when we compare the first half of this year with the first half of last year, because Splitska banka and Vojvodjanska banka which were not there for the whole period of the first half of last year, were fully included in the numbers of this year and therefore this immediate comparison of these two numbers required some adjustment.

So, you see two columns, the first half adjusted number without M&A and the year-on-year growth rate without the impact of acquisitions. First of all, it's obvious that the acquisitions had a positive impact because the growth rate was obviously much higher if we include these acquisitions as well. But if you want to understand better the underlying business dynamics, it's probably better to look at these adjusted without acquisition growth rates.

As for the organic part of the business, we see 2% total income growth and 6% operational cost growth. There will be a lot more detail later on so I'm not dwelling too much on this and, most importantly, you see the quite significant decrease in risk cost compared to last year. This is probably one out of the three most important features of this year, that we have an even lower risk cost apparently than we had last year. Last year we thought we had a low level, so it's a positive surprise for us as well.

The quarter-on-quarter performance was strong in terms of revenues. All revenue lines did better. Unfortunately, costs increased as well, 7% in just one quarter, and the risk cost was slightly, but only slightly better than in the first quarter.

If we look at the individual business' contribution to the overall profits on page five, you see that in almost each case we see improvement. It's probably just Bulgaria where we don't see improvement comparing the first half of this year to last year, and in some cases the improvement is actually quite substantial.

Obviously in the case of Croatia and Serbia most of the improvement is coming from the new acquisitions. In Ukraine we organically improved profits by 94%, in Romania 59%, Russia 14% and in Hungary 6%. So, even the organic performance is quite strong and here you can see also the quarter-on-quarter results.

Before we deep-dive into other topics, just some general remarks or miscellaneous remarks. First of all, obviously you have probably heard that we have made two acquisitions, a bit more later on about this, and the second item on this page is that the macro prudential regulation is changing in Hungary.

The payment to income regulation which is actually regulated for retail customers, how much loans we can provide them is dependent on their income level, so the maximum loan payments are regulated depending on the income level of our clients.

What we see now is that they introduced two new categories. The currently existing rules continue to apply for those mortgages which are fixed at least for ten years, but for lesser years of fixation, so less than ten but more than five, or less than five the ratios will be lower, which is going to give further incentive for the banks and customers to take on fixed loans as opposed to variable loans.

You might remember that last year this was one of the goals of the central bank, what they communicated as an important goal to be achieved to increase the ratio of fixed loans within the newly issued mortgages and, in fact, we are not far from already fulfilling this goal, because if you look at, for instance, the latest figures, the June figures of non-subsidised housing loan applications, 90% of these applications to our bank were already fixed, and not variable.

Therefore we can infer that maybe the impact of these new regulatory changes will be somewhat limited on OTP, if at all, because we have already moved in this direction and we have heavily promoted fixed housing loans as opposed to variable. But for some of our competitors who have kept on selling more variable and less than five-year fixed loans this might actually cause some problems.

The third point in this table is a rather unfortunate mistake we made because in the actual report and in the analyst tables we sent out there is a mistake with one number. It's basically the Stage 3 ratio and the Stage 3 volumes. The Stage 3 ratio correctly at the end of the second quarter for the whole group was 11.1% as opposed to 10.6 which was in the report. By the way, we also published the individual ratios for the group members. Those individual ratios were correct, so only this aggregate number was not correctly presented. I apologise for that, but obviously even with this number we are seeing an improvement compared to the first quarter number, so the trend is similar to what you could observe in the previous figure.

A few words on equity on page seven. The Common Equity Tier 1 ratio increased to 16% including the first half results minus the anticipated dividend payments. So the pro forma number is 16%. It was 15.6% at the end of the first quarter, so we are accumulating excess capital as time goes by. The liquidity position hasn't changed really. We continue to have a net loan to deposit ratio close to 70% at the group level.

We also included, and it's available on the website too, pages with more details about the two banks where we signed agreements with SocGen and we are hopeful to include these deals very soon and consolidate them. Just a few highlights are included here on the following two pages. On page eight you see that in Bulgaria Expressbank, the bank in question of this acquisition, had 6.7% market share at the end of the first quarter, and if you combine that just pro forma with our current market share, then it's 19.4%, which could actually result in propelling us into the largest operation in Bulgaria, which is nice. Obviously it's not a goal in itself. The most important thing is the profitability and to have the maximum potential from the exact position, but it shows the magnitude of the deal and it's actually quite meaningful for our position in the country and hopefully for the profitability of our operations there.

If you look at the following page, you see that although it's a smaller bank, the profile of Expressbank is somewhat different from DSK. DSK is retail oriented, it has traditionally been a retail bank. SocGen Expressbank is actually quite the opposite; it has more strength in corporate. In fact, Expressbank's corporate loan and deposit volumes are higher than our Bulgarian bank's volumes.

Therefore the profiles seem to be quite complementary, which increases the attractiveness of this deal for us. It's quite a decent and profitable bank, as you can see from the 2017 numbers; close to 15% return on equity, 1.6% return on assets.

The other acquisition brings a new country into our group, Albania, as we agreed to buy a good size bank in this country, with 5.7% market share. In fact, it might surprise you that we did this but this is quite in line with what we try to achieve, namely focus on this region and find value creation opportunities, and we find the Albanian market actually quite promising.

It's obviously not very well developed, but therefore it provides great opportunity. It's a relatively sizeable country in the Balkans, close to three million inhabitants and, even more importantly, this is one of the few countries where the population is growing as opposed to some of the other countries where unfortunately we see quite fast population decline.

This is again an interesting bank. It's profitable. It seems to be well-managed and it gives us an entry point into a country with a good potential for growth, and there's good potential for profitable growth. By the way, this bank has also been profitable: the return on equity last year was close to 5%, less than the other target in Bulgaria, but obviously it's a much smaller bank in a less developed country.

Now let me turn to the cross-section, so going line by line of the P&L, and then look at the cross-section by countries, by operating entities. On page 11 we see the total income chapter starting and here to make more meaningful the numbers and more representative of the fundamental developments we made some adjustments, or somewhat extended the numeric presentation of these numbers.

Namely, where this is applicable, we have the with and without acquisition numbers. For OTP Group total income with acquisitions grew 8%, without acquisitions only 2% year-on-year first half, and likewise we have these adjusted numbers for Croatia and also for Serbia.

Then there are two countries where the exchange rate relative to the Hungarian Forint moved substantially and created quite a large difference between the dynamics of these numbers in local currency and the dynamics we can observe in Hungarian Forint. For instance, and these are Russia and Ukraine, while the total income in Roubles terms in Russia grew 9%, in HUF terms it actually declined by 4%. In Ukraine, total income in local currency grew 34% whereas in Hungarian Forint the growth is only 22%, so this is some additional information you might find useful.

Here on this slide I'm not going to go more into the details because the following three slides explain the components of the total income, namely net interest income and then other income and fee income.

Starting with the net interest income part on page 12, you see that again similar group level growth, year-on-year 8% in the first half, without acquisitions 1.4%. If we look at Hungarian Core where there are no acquisitions in the applicable timeframe, year-on-year we went up 3% and quarter-on-quarter 1%. This is a combination of accelerating volume growth and further declining margins.

A similar situation in Bulgaria. Unfortunately there the margin decline exceeded the positive impact of loan growth, so there we actually see a slight net interest income decline.

I'd like to warn you that in case of the quarter-on-quarter results, to understand that in the case of Bulgaria you have to take into account this note that we have on this page. There was a HUF 1.8 billion reclassification between the first and second quarters. We corrected numbers related to the IFRS 9 accounting between the two quarters and that had a negative impact on the second quarter. It should have been actually in the first quarter. That has some impact on the quarterly distribution of net interest results during the first half and also the net interest margin for the first and second quarter NIMs; obviously no impact on the first half numbers.

Russia did quite well, 6% overall local currency growth. You will see the magnitude of volume growth is quite substantial there. Croatia, quarter-on-quarter 4%, decent dynamics. Ukraine, fabulous results, this is really strong and also in terms of profitability by far our Ukrainian business has the highest return on equity. If we look at the first half return on equity number for our Ukrainian operation, then it's 60%. Finally it has turned out to be quite a profitable business after many years of seriously negative results.

Turning to the components of net interest income, namely volume growth in loans and deposits, and also later on talking about the margin evolvement, first maybe we start with the loans.

Quarter-on-quarter we have 5% performing loan volume growth FX adjusted, and this 5% is not annualised, so actually the nominal growth in one quarter was 5%.

In Hungary it was even higher, we had 6% volume growth just in one quarter, and then you see the similar numbers for the other countries. I'd like to pinpoint maybe Ukraine, Serbia and Montenegro where we also have actually quite strong double-digit growth rates just within one quarter.

The other important factor here, we separated within mortgage volume growth housing loans and home equity. We've been talking about this for the last two, three years that we started to see increasing levels of new production, and at the same time the stock volume growth somewhat lagged behind.

This is also due to this composition effect because where we really see strong growth is the housing loans. Home equity, i.e. mortgage loans which are taken not for the purpose of buying or building or refurbishing real estate, continued to decline.

Housing loans started to grow actually quite fast, in just one quarter the growth was 3%, while overall mortgage growth in just one quarter was 2%. This is the level of increase we saw for the whole last year. Finally we see the previous trend also show up in the overall stock numbers.

I think even more impressive are the numbers if you look at page 14 where we describe the year-on-year FX adjusted performing loan volume changes. The whole group grew 13% without the impact of acquisitions. Hungary, likewise 13%, and here the year-on-year loan growth in mortgages was actually 4%. The other two parts kept on growing quite fast as well: consumer lending 18% and corporate lending 22%.

Basically across the board you see quite dynamic volume growth and this is equally true for Bulgaria, it's very true for Russia and, as you can see, Croatia is doing well.

You have to remember that in Croatia during the last year we have been very busy merging these two banks. This organic growth is achieved while we are merging together the two banks. We are very far from losing market share or customers who are actually increasing the volumes which I think is a good performance, even if it's lower than in some other markets, given the fact that we are very busy and seriously engaged in concluding and completing the operational merger.

Ukraine, 24%, very strong, especially taking into consideration that we haven't been selling mortgages now for ten years, so mortgage volumes continue to decline, but we had such an outstanding performance in consumer loans and corporates that it was enough to reach 24% yearly growth.

Also Romania was strong. Serbia, even without the acquisition quite strong, 21% and, again, Serbia, just like in Croatia, we are extremely busy with the merger tasks. So, we are growing these two banks organically while our colleagues are working heavily on concluding the merger.

Where we are not so strong in terms of growth is Slovakia. Unfortunately in Slovakia we also struggle with the profitability, so it's not at all clear if additional volume growth brings much profit improvement for us in this country. Montenegro likewise grew quite strongly.

Just one more additional aspect into this loan growth story, and that's the new disbursements. New disbursements continued to grow much faster than actual volume growth, especially in mortgages and Hungarian cash loans. But in mortgages in Hungary and Bulgaria you see that the year-on-year new production growth is definitely much higher than the stock volume growth we have just discussed.

A short note on deposits on page 16. Quarterly growth was relatively moderate, 1%, but year-on-year we grew 12%, this is still strong. This is not a strategic target for us to achieve large deposit volume growth, but as long as we can collect deposits at low rates we are more than happy to take them on board, especially because they usually relate to more customer relationships, other transactions and so on, so they have other ways to impact revenues as well.

Turning to the margin picture, which is less bright I must admit, we experienced further margin erosion in the second quarter. As you can see, the consolidated net interest margin went down to 4.25% and the decline was 12 basis points in the second quarter.

At the bottom of the page we tried to segregate the different factors within this overall number, namely the impact of individual margin changes and the composition effect driven by the different growth rates of these volumes, and finally the foreign exchange rate impact.

The most important impact came from the Bulgarian bank, which we explain on the next page and also here in the footnote, that it was more technical than fundamental, and fundamentally it was actually much less than technically. Nevertheless the margin decline was there and also in Hungary it was there.

If you want to understand what happened exactly or a more detailed the reasoning behind these numbers, then you have to turn one page to page 18 where you can see the largest group members and their net interest margin developments on a quarterly basis.

As you can see, Hungary went below 3% and Bulgaria went to 3.27% but, again, due to this rebooking of certain revenues between the two quarters, if we adjust back to these numbers, then that's what you see in the grey rectangles, that then the overall decline is actually less. Obviously the first half number is basically the same, so the first quarter should have been somewhat less and the second quarter somewhat higher.

Going back to the Hungarian number, there are different forces in place here. The first one is related to how we deploy our liquid reserves, and in the second quarter we actually had higher volume of liquid reserves kept at very low levels of yields because of liquidity management reasons. We could not invest these into longer maturities, so that yielded very low results.

The other thing is that there's this ongoing replacement of maturing Hungarian government bonds with new Hungarian government bonds, at least it was so in the first and the second quarter. Typically these actually result in higher yields because we have fixed maturities, but we actually had more variable bond maturities or bonds previously swapped to variable rates. If we compare the combined yield of those which matured and the new investments, the newly bought sovereign bonds actually had a higher yield than the ones which matured, so this part was actually slightly positive.

Then we have the new book - back book problem, and this is more pronounced in mortgages where the new production started to be actually quite fast, and it's growing now the overall volume of mortgages, but obviously the new production has a somewhat lower yield than the average of the current stock.

Within the existing stock there's another thing going on, that the old subsidised mortgages get repriced at lower and lower levels as the benchmarks gradually decrease, and therefore there is a slight decline there as well.

Then finally we had this slight or quite marginal increase in our reference rates, the three-month and six-month interbank rates in Hungary. The average three-month rate went up seven basis points quarter-on-quarter, and the six-month nine basis points.

Obviously their effect has not materialised in the second quarter or they have not affected much the NII because repricing is not immediate for our variable loans, it will affect more the third quarter. This is actually positive from our perspective, but the actual financial impact on revenues did not really show yet in the second quarter.

DSK, again, I talked about this technical correction but the underlying trend has not changed, so we still have this gradual repricing of the old book, but at a lower rate than previously, so this margin erosion seems to continue there.

In Russia we had a spike in the margin in the first quarter and then it adjusted back in the second quarter as the cheap funding in form of lower rate deposits phased out. Croatia increased a little bit. Romania slightly increased, and in Ukraine we actually see more improvement which is due to the rapidly increasing rate environment there in local currency. Our business activity is actually quite heavily tilted towards local currency lending, so that actually shows up positively in the margin there, and our funding cost hasn't really changed much. We are seeing widening of the net interest margin in Ukraine, which obviously contributed very positively to the profitability of our Ukrainian business.

The next page is about the fee income which shows quite healthy dynamics, 2% growth without acquisitions year-on-year in the first half, and 14% improvement quarter-on-quarter. That quarter-on-quarter improvement is typically seasonal, we usually have this from the first to the second quarter, especially in Hungary where we always explain this Compensation Fund cost kicking in the first quarter and the related tax deductions in the second.

The quarterly improvement is partially technical and we also have usually the booking of the financial transaction tax for cards in the first quarter, so there you have these recurrent technical items which appear in the first quarter, but the reverse is appearing in the second quarter. Besides these technical items we see improving transactional activity in Hungary, so the fundamental drivers of net fee income also improve and that is basically true across the Group.

As you can see, we have improvement in Bulgaria, Russia, especially in local currency. In Croatia we improved quarter on quarter, year-on-year there's a small decline. Ukraine is doing well, and basically all the other subsidiaries as well; Slovakia is an exception where the year-on-year number is negative.

As for other income, not much on the actual business fundamentals level. There are two technical changes here which have had an impact on our Hungarian and Montenegrin results on this line. And we had other directional impacts on other lines, and we tried to explain them here as much as we could.

We can turn to the cost development story on page 21. This is, I would say, the least bright side of the picture. Namely the level of growth that we have in operating cost throughout the group, the first half numbers compared to last year showed 5.6% growth without acquisitions, but if we look at the numbers with FX adjustment, so without the impact of exchange rate changes, then it was actually 7.5% on an annual basis without the impact of acquisitions.

We tried to explain country by country what were the reasons for this apparently high cost growth, and if you look at those, actually we have recurring items, so the picture is actually quite similar across all countries. What do we have here?

First of all, we have fast growing business volumes and sales activity, especially in Hungary and Bulgaria. Sales activity was growing much faster than the volume growth, therefore it should have an impact and actually it does have on variable cost. For instance, in Hungary we started to increase the headcount in the branches in order to keep up with the service level, while we are having so much more sales activity in the branches. This is true for most of the countries where we operate.

Then the second problem is wage inflation. Salaries, real and most importantly nominal wages increased quite drastically in the region. This is good news if you look at loan demand and the business activity of our clients because disposable income is growing, consumption is growing, loan demand is growing, and at the same time the loan quality is very good.

But this money is coming from somewhere; it's coming from corporates, banks and so on who have to pay higher and higher wages in order to retain the talented workforce. We try to remain competitive in wages and this is actually not easy, but inevitable.

Then we also invest in renewing our services and IT infrastructure, primarily focusing on hiring more people who can do more and better IT development. This is also an ongoing effort which is reflected in the numbers you see here.

Where we should expect cost efficiency improvements is primarily short-term, the impact of the acquisitions. Once we finish the merger in Croatia and in Serbia and once we finalise the new acquisition in Bulgaria and then later on when we complete the merger, we should see tangible cost efficiency improvement in these countries.

These are the short-term primary expected improvements in terms of cost efficiency. In the other countries we believe that this is the right time to actually benefit from the growth potential of these markets, and we definitely want to grow as much as it makes sense in terms of volumes. But that means increasing business activity, higher marketing and other variable costs, and that means more need for people and, due to increasing inflation, more expensive people.

Going to a more positive chapter of the story is the risk cost, the credit quality which is more on the positive side of these overall developments and changes in the market. This is the bright side of the coin. As you can see here, we hardly had any risk costs in the first half of this year and the portfolio worsening, taking out every adjustment, was actually quite small.

The 90-day past due ratio has gone down to 8.1% and the risk cost rate was practically zero. On page 23 you see the deterioration levels by country and, as you can see, the entire deterioration was driven by our Russian business which is a business as usual level. So, a very optimistic and positive story on the portfolio quality and risk cost side continues.

Finally, three more pages on the Hungarian activity. The first one is the P&L and we have basically talked about each line in the previous part of the presentation. I'm not going to repeat that. On pages 25 and 26 there are some further data on our retail banking and also corporate banking activities in Hungary.

As you can see, our market share has continued to improve. In new mortgage generation we are at 29.4%, getting close to 30% and growing. Cash loans, 38%, getting close to 40% and growing. Household saving, 31.6% market share and growing, so these are very good numbers.

Just to give you a flavour, this is a very active and dynamically growing market. In this growing overall market we managed to gain further market share, and we are actually quite happy with our retail performance in Hungary and likewise we're quite happy with our corporate performance.

Sales activity continues to be very strong in the corporate segment and this is true for all sub segments of corporate: this is true for large, midsize and small corporates as well, as you can see on this page. As a result, our market share started to increase again. During this first half year we went up to 14.7% market share in Hungarian corporate loans, which is quite a promising result.

Finally, I'm sure you will have questions related to our guidance: how we see the yearly numbers potentially shaping up. We're just trying to pre-empt these questions, so a few words on how we see the situation today. I'm going to refer to the guidance which our Chairman - CEO gave at the annual general meeting in April this year where he described the expectations of the management for 2018.

The first point was about the return on equity target which has not changed now for a couple of years and it's reaching above 15%, assuming 12.5% Common Equity Tier 1 ratio. We agreed that it's very likely, even when we started to talk about this, that we were going to over-exceed this target, which we indeed did in the first half.

Our accounting result based return on equity number for the first half of this year was 19.1% and if you adjust back to this 12.5% Common Equity Tier 1 ratio, on which basis we originally made this forecast, then the ROE number would have been 23%. It's pretty clear that we should do much better in terms of ROE than this baseline suggestion originally stated.

The second forecast was related to the volume growth, organic volume growth without acquisitions. We said in April that it was going to be close to last year, maybe around 10%. Looking at the first half results it seems very, very likely that we will over-exceed this and performing volume growth in 2018 will be materially higher than 10%. Today the year-on-year growth rate is 13% and it's actually accelerating, so it seems that we will be comfortably above 10% in terms of the annual growth rate in 2018.

Then we have another target related to the net interest margin on a group level, and we suggested that it may be 10-15 basis points lower than the one which we reported in the fourth quarter last year, namely 4.38%. Now, this is the guidance we uphold. We seem to believe that this is still the right forecast and it's likely that the margin compression will be roughly at this magnitude.

The other item where we should be much more optimistic than the original guidance is the risk cost. Originally we guided for a higher overall nominal risk cost this year than last year, including acquisitions. Now, it's very likely that it's actually going to be lower than last year, and certainly the first half was meaningfully lower than last year.

Finally, the last one was related to the OPEX growth and we guided for FX adjusted OPEX growth of 6%. Now, this is the number where we are not doing very well compared to the original one since we just presented that the FX adjusted OPEX growth in the first half compared to last year was actually 7.5%, so here we need to work harder to get to the 6% target.

We haven't given up on that target and we are still working to achieve that, not to have more than 6% growth. It's possible, but it's going to be tight and there's a lot of work needed on our side to get there.

We will do everything sensible to make it happen, but obviously the first priority is growth, so if the variable cost increase requires more, then we will not sacrifice that just to remain in this original target. To our best knowledge this still seems a difficult but achievable target.

That's pretty much what I intended to share with you as far as this more formal presentation and now I'd like to give back the floor to the operator and ask you, the participants, to pose your questions.

Operator: If you'd like to ask a question, please press star followed by one on your telephone keypad now. If you change your mind and wish to withdraw your question, please press star followed by two. When asking your question, do make sure that your line is not muted locally. Today's first question comes from Mate Nemes from UBS. Mate, please go ahead.

Mate Nemes: Yes, good afternoon, and thank you for the presentation. I have a couple of questions. Firstly on guidance, still sticking with guidance, I think you mentioned at the beginning of the year that you would expect a bit more growth in retail and less growth in the corporate segment in Hungary.

If I look at the second quarter, both year-on-year and quarter-on-quarter changes, what I see is that corporate remains the key driver of volume growth. Could you perhaps shed some light on why this pronounced growth rate is still there and whether in the second half of the year this could change at all or not?

Then on operating expenses, you mentioned you're maintaining your 6% year-on-year FX adjusted OPEX guidance. Where could the reduction come from in the second half compared to H1 to hit this target?

Thirdly, on NIIs, given some rise in the BUBOR recently and then perhaps some rate hikes coming up next year in some of the operating countries, could you perhaps share the sensitivity of NII to, let's say, a 100 basis point rate hike? Thank you.

Laszlo Bencsik: Yes. Indeed, regarding this retail versus corporate growth rate in Hungary, the initial expectation was somewhat less corporate and somewhat more retail growth. Now, on the "more" side I think we are okay because retail is growing faster than it did last year, both consumer but, most importantly, mortgages grew much faster than last year. That part of the story is there and it continues to be there. I believe that especially mortgage growth will continue to accelerate.

As for the corporate segment, indeed the first half was quite strong. We don't expect the second half of this year to be equally strong, but it will still be pronounced. Technically we make decisions on an individual loan basis and we look at the expected profitability of each deal and if the expected profitability on a net present value basis is positive, then we take the deal. We are very liquid and we are generating sufficient amounts of capital.

The market opportunities were better in the first half in the corporate segment than personally I or the management expected. The market is growing fast as well. The market is growing 15% year-on-year, so when you look at that 22%, it's strong, but the overall market was 15%.

But that's a fair observation that indeed I made this remark and so far corporates remained very strong, but, again, the first part of the original guidance is there. Retail is accelerating as well which, from my point of view, is the important thing. To sum it up, retail started to accelerate and corporate remains strong.

Now, on the OPEX, in order to get to the overall 6% growth, it's not that we have to cut back expenses because the growth rate is 7.5%, rather than 6%. Costs will continue to grow in the second quarter, but maybe the growth rate overall year-on-year will be less than 7.5% what we saw in the first half, and this is partially related to seasonality and so on. But if your question was more like, are we initiating large cost-cutting exercises, laying off people, or scaling back business lines, or closing a large number of branches – my answer is that we are not doing that.

Typically these types of activities are happening when we are engaged in mergers, and that's why I said that once we conclude the technical mergers there will be cost efficiencies. This is probably something you might actually expect to see already in the last quarter this year, and some of the early signs of the actual cost synergies could materialise because we plan to finish the technical merger by the end of the third quarter in Croatia.

The other geography where we might see actually a cost reduction is Russia and it's related to Touch Bank. We started to merge Touch Bank which used to be an operationally independent unit. Legally it wasn't, but operationally it used to be independent. We are merging this entity back to the bank and by merging it back we're actually saving a lot of costs.

This is another part of the group where the second half of this year will be much better than the second half of last year, so there will be actually tangible visible improvements because of this operational merge we started somewhere in May in Russia.

Basically these are the two situations where actually nominal cost savings can appear during the later part of this year.

The NII sensitivity to Hungarian benchmarks is such that if the Hungarian interbank rate, the BUBOR, the three and six months reference rate increases by ten basis points, then NII on an annual basis should go up by HUF 2.1 billion.

If you want to have this number translated to net interest margin, then a ten basis point benchmark increase would result in roughly three basis points net interest margin increase at OTP Core in Hungary, and on a consolidated level it's less; approximately 1.5-2 basis points.

Mate Nemes: Okay, thank you. That was very clear.

Laszlo Bencsik: Thank you.

Operator: The next question comes from Gabor Kemeny from Autonomous Research. Gabor, please go ahead.

Gabor Kemeny: Hi, I have a couple of questions, one on Hungary and the other one on the Bulgaria deal. On Hungary, how do you think about the operating profit dynamics going from here? Obviously the Hungarian business has been performing very well, mostly on the basis of improving asset quality while the operating profit actually came down a little bit in the last few quarters. You mentioned you prioritised growth. At this level, do you think that a combination of income growth and cost inflation could mean similar operating profit dynamics or not significant growth in operating profit, or could this potentially change?

The second one on Bulgaria, can you share with us the rough timeline on receiving regulatory approvals for the Expressbank deal? The other one is, how do you think about the synergies related to Expressbank? As you mentioned, both of these banks are quite profitable. DSK and Expressbank are quite profitable on their own and these are quite complementary businesses with a bit different business profile. I wondered, how much room do you see to extract synergies here?

Laszlo Bencsik: Regarding operating profit dynamics, obviously the target is to achieve improving operating profit in Hungary and what separates us today from that, if we just look at the first half of this year, is that actually costs grew more than total income, but both of these lines were growing. More importantly, total income started to grow in Hungary which for many years decreased. This is basically the result of loan volume growth which finally appeared in Hungary.

The pace of volume growth accelerates and therefore I think it's fair to expect an acceleration in volume growth and hopefully next year there won't be further margin declines, and if the margin is not declining further and volume growth is there, then revenue growth actually will be stronger. That's one thing.

The other thing is that typically the loans in Hungary are not short-term, so it's not like in Russia where we have to sell almost the whole portfolio each year and therefore the variable cost content is quite big. Basically the fact that new production growth is high, it means that volumes grow and volumes generate NII, and the NII generated from the existing stock usually relates to a lower level of OPEX, because once you sold a mortgage the cost associated with servicing mortgages is much lower than selling mortgages, for instance. Hopefully as we build up the book and the volumes, the revenue impact will be bigger than the cost impact.

Certainly what we are working for is to have a growing operating profit line in Hungary. When we can achieve it, it mostly depends on the NIM developments in Hungary. The NIM development is primarily driven by the base rate environment and the base rate environment is in the hands of the National Bank, so this is something we cannot influence and honestly I don't have more information than you have on how it could develop in the future.

As for Bulgaria, regulatory approval according to the most optimistic timeframe is that we can close the deal by the end of the year. If none of the regulatory bodies exceed the expected timeline for their decision, then this is the most aggressive target to close everything before the end of the year. But if things go more normal, it's probably January, so by the end of January we should get there.

Synergies, because of the complementarity of these two businesses the synergies will be less as opposed to not being complementary businesses, that's clear. We are not going to announce the synergy targets as such. There will be some synergies, but your comment is actually quite right that these are actually complementary businesses.

Gabor Kemeny: Thank you. Just a small clarification on the NIM, I think you mentioned that in 2019 you wouldn't expect more NIM decline in Hungary. Does this assume any changes in the interbank rate, or is this more…?

Laszlo Bencsik: Yes.

Gabor Kemeny: So you assume the BUBOR would go up?

Laszlo Bencsik: That assumes that next year the Euro rate starts to move and that triggers a more material increase in the Hungarian reference rate environment.

Gabor Kemeny: Can you give us a sense how much increase you budget or you would expect in the BUBOR roughly next year?

Laszlo Bencsik: The detailed budgeting we haven't started for next year yet, so I don't even have the details, the final budget numbers yet. This is just speculation, so this is the least reliable part of what I can comment on because, again, this is subject to many factors.

In a base case scenario I think it's fair to assume that, especially if the situation continues to escalate in Turkey, it might actually put more pressure on some regional spreads as well which could also point to the direction of a somewhat higher rate environment. But, honestly, I don't know. In order for the NIM compression to stop in Hungary we need to have a reference rate increase.

Gabor Kemeny: Yes, that's fair. Thanks very much.

Laszlo Bencsik: Thank you.

Operator: We have a question from Andrzej Nowaczek from HSBC. Andrzej, please go ahead.

Andrzej Nowaczek: Thank you. My question was in part answered but I will follow up nevertheless. This is with regards to OPEX, your comment on OPEX. I have something more specific on headcount in Hungary; this increased by 4% since the beginning of the year and I understand you need to hire IT staff, but presumably this is to make the bank more automated. Should we expect the headcount in Hungary to eventually decline, or are you saying there won't be any branch optimisation and cuts in staff because you need the network to support volume growth?

Laszlo Bencsik: If you look at this headcount increase, half of it was related to increase the staff in the network. The other half was in the headquarters and most of it was IT and also call centre staff. The call centre and the network headcount increase is variable, so that's related to the increasing sales activities and especially the increasing mortgage sales activities because there's a lot of digitalisation and transactions migrate fast into digital channels which don't require the manual work.

New loan origination continues to be, especially in the case of mortgages, primarily branch based and, by the way, this gives us leverage because our market share. If you look at our market share, it increased on all fronts. In new mortgage origination we have close to 30% market share and growing. In 2007 we had around 16-17% market share, so we believe that part of this share increase from new production is related to the fact that our market share from physical infrastructure actually increased.

I don't know how long mortgage lending will continue to be branch based but today it is, and as long as it is I want to fully benefit from having this branch network in Hungary. Clearly this is not the year when we are closing down branches. It doesn't mean that we are not working on making these products digitally available and also simplifying the branch based process a lot by digitally making available a lot of information and actually streamlining the process.

In order to do the digital transformation our experience is that you actually need more people, especially if you do it in-house. Obviously if you outsource the whole thing and you buy software and you buy software development capacity from outside, then it goes to CAPEX more and less to OPEX, but eventually it hits your expenditure line. I think eventually these developments will manifest in cost reduction and in headcount reduction, but we are not in that phase.

We are actually quite keen on capturing all the market growth potential and also at the same time spend as much on innovation as possible. We just started an agile transformation, for instance, in Hungary involving actually a sizeable part of our headquarter organisation. Short-term, again, this is not going to reduce headcount.

In the very short-term it actually requires more people because in order to work in a different setup, different culture, you need typically different people. So, this is short-term, it is what we do, it doesn't result in headcount reduction, it's quite the opposite. On the other hand, long-term you are right, eventually we should reach a stage when digitalisation actually turns into less headcount. We are not there yet.

Andrzej Nowaczek: Okay, thank you very much.

Laszlo Bencsik: Thank you.

Operator: Next up we have Olga Veselova from Bank of America Merrill Lynch. Olga, please go ahead.

Olga Veselova: Thank you. I have several questions. My first question is about new regulation in Hungary, the PTI limits. What part of your mortgage borrowers fall under the category which is below the new lower thresholds?

If these borrowers were to migrate to a product with a fixation of over ten year periods, could you compare for us interest rates on mortgages with more than ten years fixation versus interest rates on mortgages with less than ten years fixation and floating rates?

Lastly on this regulation, this increase in household income threshold, does it matter at all or it's just basically indexation because there is wage inflation in Hungary so it almost doesn't matter for your borrowers? So this is the first question.

My second question is a follow-up about the acquisition of the two banks which you want to complete. Do you mind commenting on the price? I'm not asking of course the hard number, but maybe you can share with us if it's close to book, more materially above book, just above book?

You mentioned the ability to reduce costs or extract synergies from this M&A. Which other EPS accretion opportunities do you see there? Maybe improvement in margin in Bulgaria, and I see that the margin in your business in Bulgaria versus SocGen business in Bulgaria is quite reasonably different.

The last one is, you deliver very strong loan growth in Ukraine, even FX adjusted; could you share with us your aspiration, your willingness to grow there in the next years? So not this year, but in 2019 and 2020. What would be your long-term loan growth outlook for this region? Thank you.

Laszlo Bencsik: Regarding the PTI, I think I mentioned that if you look at the June new housing loans applications, only 10% was variable or less than five years fixed. We don't have a three-year product. I think OTP is almost there. We have 90% of the new loan requests coming in being five or more years fixed and I think this is going to further increase this number and push it more towards the ten years rather than the five years.

This is something we like. We believe that we have a structural advantage in long-term Hungarian Forint funding as opposed to our competitors having a much larger volume of retail current accounts. Retail current accounts are fixed, so we feel quite comfortable selling longer maturity fixed mortgages.

Obviously if this continues, we are going to buy less fixed sovereign bonds, so the ALM structure will move towards more fixed mortgages as opposed to longer maturity sovereign bonds which is, by the way, also going to result in our loan to deposit ratio in Hungary hopefully increasing and therefore having less liquid reserves and more volume growth.

Therefore the expectation of our business colleagues is that the new PTI limits are not going to have a meaningful negative impact on mortgage development or mortgage growth, on the contrary, it will further increase the share of the ten-year fixed mortgages.

Obviously the nominal interest rates on ten years are much higher than five years. The difference is the difference in the benchmarks. Basically the spreads are similar so the difference is there due to the benchmarks, the difference between the three months BUBOR as opposed to the five-year or the ten-year benchmark. So that's roughly how you can gage the interest rate differences between these loans.

Acquisition price, no, I'm very sorry but we are not in the position to disclose the purchase price. This is part of our agreement with the seller that we are not disclosing it.

Synergies, there will be synergies obviously because these are two banks and there are a lot of activities in banks which are duplicated if you merge two banks together. The fact that they are more corporate than retail means that in the network or in the salesforce there will be fewer synergies because typically in corporate you have relationship managers and they are linked to clients.

There is overlap between our client base as well but less so and therefore in those areas there won't be much more synergies. But in other areas, like functional areas, support areas obviously there will be cost synergies. So, cost synergies remain a material source of potential synergies.

Then obviously pricing, especially deposit pricing offers upside: our market position in the retail savings in Bulgaria is very strong and we certainly are in a much better deposit pricing position than any other banks, especially compared to Expressbank, so this is clearly a pricing revenue synergy on the deposit base.

Then we believe, for instance, they have a very sophisticated and very successful leasing business, which we also have but it hasn't been so successful, so we expect quite a substantial revenue boost in certain segments where we haven't been so active like, for instance, leasing. So it's more of a mix there in terms of potential revenue synergies and cost synergies.

Regarding expectations for loan growth in Ukraine and other countries for 2019-20, I'm sorry but I have to refrain from giving guidance for next year and for two years, especially specific numeric guidance. What we see today is that generally there is a positive economic environment in basically all of the countries we operate.

Having said that, specifically Ukraine, the volatility of Ukrainian environment is certainly much bigger than in any of the countries we operate and things can develop into different avenues there. Certainly there are scenarios where we might not have any volume growth in Ukraine at all. I hope this won't happen and certainly this is not the expected or likely scenario we count on, but even those scenarios have meaningful probabilities.

Probably the most difficult to forecast is the Ukrainian growth because it is entirely dependent on the economic environment there and the Ukrainian economic environment is extremely volatile as we have seen during the last decade, or two decades, so unfortunately I won't be able to do that.

Olga Veselova: Thank you.

Laszlo Bencsik: Thank you.

Operator: Next we have Stefan Maxian from RCB. Stefan, your line is now open.

Stefan Maxian: Hello, thank you. Just a few questions remaining. One on Romania. You were flagging last time some potential change in your strategy concerning organic growth in Romania as the regulator turned down your acquisition attempt. Do you have an update on that?

Then with regard to Russia, you said that cheap funding from deposits phased out and you said you might consider funding using the excess liquidity in Hungary, so would you use that right now to fund further loan growth in Russia? Then could you give us an update on further M&A appetite you might have after the two recent acquisitions that you've announced?

Laszlo Bencsik: Romania, indeed, this is in progress. We are revisiting the organic growth opportunities in Romania and we are trying to identify new opportunities and potential, but this process has not finished yet, so we don't have a new organic growth strategy for Romania yet. The intention is clearly to keep it in high focus, but there's nothing I could report on today.

Russia funding, indeed this is a dilemma. It's actually not a question today because even the second and third quarter volume growth is there, but it's not very strong. The question will be the last quarter, the fourth quarter and the level of volume growth in new lending compared to the marginal cost of new deposit gathering in Russia and then we have to compare that to the group cost of funds and we will optimise it.

We don't want to switch into a modus operandi where we are funding any of the foreign subsidiaries from Hungary in a big way, we want all of our banks in the Group to be whole banks with full operations, being able to collect funding and deposits, and having deposits and transaction clients. Strategically we want to have a universal bank in Russia, that's the strategic direction.

However, short-term if we can optimise and the short-term optimisation is basically more related to profitability, if there are short-term optimisation opportunities, then we are ready to somewhat increase our funding temporarily to Russia, so that's also a possibility. But this will depend on the exact situation in the fourth quarter, how much volume growth will be there, how much demand will be there for consumer loans, and what marginal cost of deposits will be in Russia.

Our deposit market share in Russia is tiny. From our perspective, the Russian deposit market is very liquid and it's a continuous price elasticity curve, so if we price somewhat higher deposits, then we have more deposits. Given our very small size to the overall market, we can have as much liquidity as we want. It's just a question of pricing and in this sense we are going to optimise as much as we can.

M&A, we continue with our strategy. We continue to look for further opportunities and in this sense nothing has changed, so it's not that we stop here. We continue to look for further opportunities in line with the strategy we have outlined before.

Stefan Maxian: Okay, thank you.

Laszlo Bencsik: Thank you.

Operator: As a reminder for those still connected and if you'd like to ask any further questions, it's star one on your telephone keypad now. We have a question from Conrad Scheurkogel from Artha Capital. Conrad, please go ahead.

Conrad Scheurkogel: Thank you. Congratulations with a good set of results. Just on M&A, I just want to follow up. The deal that you announced, it was the same seller, so the Albania part of the M&A, was that mutually exclusive or inclusive? Do you find the country in particular interesting and that's why you decided to enter, and does this mean that you may look at a few more countries for further M&A activity?

Laszlo Bencsik: Yes, we have found this country attractive and we don't exclude entering new countries, but these should be in the region where we operate, but this is not the prime focus. The prime focus is on existing countries and out of these two, obviously the much bigger one happened in a country where we have already been present and this much smaller one happened in a country which is new for us.

Conrad Scheurkogel: Okay, thank you.

Laszlo Bencsik: Thank you.

Operator: As a final reminder, it's star one for any further questions on the phone. We do not have any further questions.

Laszlo Bencsik: Okay. Well, then thank you very much. Thank you for listening to the presentation. Thank you for participating on this conference call, and thank you for the very good questions you asked. I hope you will join us when we discuss the third quarter results on the 9th November, so that's the target date, I hope you join us.

In the meantime, I wish you all the best and if you have your vacation and holidays before you, then enjoy it and hopefully see you back or hear you back when we have the next conference call on the third quarter results. Again, thank you very much and goodbye.

Note: unabridged transcript with minor English stylistic corrections.