

National Factoring Company

Credit Analysts

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CREDIT RATING

B-/Stable/C

Outstanding Rating(s)

Counterparty Credit B-/Stable/C

Credit Rating History

Dec. 21, 2005 B-/C

Sovereign Rating

Local
Currency BBB+/Stable/A-2

Foreign
Currency BBB/Stable/A-2

Russian Federation (The)

Related Entities

Bank URALSIB (OJSC)

Counterparty Credit B/Positive/C
Certificate of deposit B/C

Major

Strengths:

- Leading market position in Russia's factoring business;
- Focused strategy and committed, experienced management team;
- Adequate capitalization and profitability; and
- Benefits of membership in a large diversified financial group.

Weaknesses:

- Risky operating environment;
- Substantial, albeit gradually decreasing, reliance on related-party funding; and
- Fairly high single-name concentrations by international standards—though below the average for local financial institutions—highlighting still-limited customer diversification.

Rationale

The ratings on Russia-based National Factoring Company (NFC) reflect its limited customer diversification; relatively high concentration risks; heavy, albeit gradually

decreasing, funding dependence on related parties; and short operating history as a stand-alone entity. They also reflect the generally risky operating environment in Russia. The ratings benefit from NFC's leading market position in the domestic factoring sector, high capitalization and profitability, and membership in a large diversified financial group.

NFC is a specialized monoline factoring company with a strong position in the fast-growing factoring market in Russia. The company is a member of URALSIB Financial Corp. (URALSIB FC; not rated—formerly Financial Corp. NIKoil, until May 2004). NFC represented only about 2% of the URALSIB FC group's consolidated assets and profits in 2005. Although it operates independently, NFC relies on the group for funding and capital support. About 94% of NFC's liabilities at June 30, 2005, came from related parties, mainly the group's flagship entity, Bank URALSIB (OJSC) (B/Positive/C). Although the group and Bank URALSIB have been supportive of NFC, Standard & Poor's Ratings Services does not consider the company to be strategically important to the group.

NFC's high capitalization—with adjusted common equity to assets of 38% at Sept. 30, 2005—will decline rapidly in the medium term due to continued business expansion, but should remain adequate. The small absolute amount of capital (about \$60 million at Dec. 31, 2005) could limit expansion opportunities and leave the company exposed to major unexpected credit and operational shocks. NFC reports a relatively high level of single-name credit concentrations, albeit lower than that of most Russian financial institutions. Its credit risk profile is fairly high, as it deals mainly with small and midsize enterprises (SMEs). This credit risk is mitigated to some extent, however, because NFC's business is dominated by recourse factoring, which allows the company to reclaim its advance from the product supplier if the end buyer does not pay. Earnings are currently strong but concentrated by counterparties, and consequently potentially volatile. Pressure on profitability may also come from an interest margin that is likely to narrow rapidly in the near term.

Outlook

The stable outlook balances NFC's good commercial prospects against a weak funding profile and concentration risks. As the ratings already incorporate funding and customer diversification in the medium term, the potential for an upgrade depends on NFC's ability to strengthen its stand-alone credit profile and establish a track record for adequate capitalization and profitability.

If NFC is unable to grow and diversify its customer base or if its financial and credit profiles markedly deteriorate, the ratings could be lowered or the outlook could be revised to negative. The ratings or outlook could also come under pressure if macroeconomic conditions worsen, leading to a decline in core performance and an accumulation of risks in the factoring portfolio. Any negative credit developments at URALSIB FC would also affect the ratings on NFC, because of its funding dependence on related parties. This reliance, as well as that on other financial and strategic links with URALSIB FC, will likely lessen in the future, however.

Profile

NFC was founded in 2003, when a factoring department of Bank IBG NIKoil (merged into Bank URALSIB in September 2005) was carved out into a separate company. The transfer of the factoring business from Bank IBG NIKoil to NFC was completed only in the first half of 2005, however. Although NFC has operated as a stand-alone company for only about three years, its operational history has been tracked since February 1999, when a specialized factoring department was created in Bank IBG NIKoil. The bank pioneered factoring services in Russia in the late 1990s,

and NFC currently handles about 40% of all domestic factoring. The number of the company's factoring customers (suppliers of products) increased to about 550 in December 2005 from about 250 in 2002. In 2004, the volume of invoices financed amounted to about \$800 million and is projected to reach \$1.5 billion in 2005.

Mainly focused on plain-vanilla debt factoring, NFC has recently introduced three complementary products: debt receivables management, credit risk coverage, and debt collection. NFC mostly services local trade and production companies, but it also supplies outsourced factoring to domestic banks.

Part of URALSIB FC, NFC represented only about 2% of the group's consolidated assets and profits in 2005. Bank URALSIB is the largest member of URALSIB FC, accounting for about 70% of its assets of over \$8 billion at midyear 2005. URALSIB FC's other two smaller business activities are insurance and financial services (investment, custody, and asset management companies), which together represent about 30% of its consolidated assets.

Since its foundation in 2003, NFC has prepared its financial statements according to IFRS. The gradual transfer of business to NFC from Bank IBG NIKoil between 2003 and midyear 2005 distorted the company's financials, however. NFC's unaudited accounts at Sept. 30, 2005, in the financial tables at the end of this report therefore represent the first full picture of the company's stand-alone performance after the completion of the transfer.

Ownership

Factoring companies are required to have a banking license in Russia, so NFC is registered as a bank and regulated and supervised by the Central Bank of Russia. Although this regulatory requirement might be abolished, NFC wants to keep its legal banking status, which provides better regulatory control. If the licensing requirement is eliminated, entrance barriers to new players in the Russian factoring business would decrease, consequently increasing competition.

Like all members of URALSIB FC, NFC is ultimately controlled by two of the company's beneficiary owners, one of whom is the president, Nikolay Tsvetkov, who holds a 49% stake. Mr. Tsvetkov actively participates in the management of URALSIB FC and its member companies and banks, while the second owner's operational involvement is very limited. The latter has interests in LUKoil OAO (BB/Positive/—), Russia's largest vertically integrated oil company.

Although the URALSIB FC group and Bank URALSIB are supportive of NFC, Standard & Poor's does not view the company as being strategically important for the group. Over the medium term, NFC could be sold without causing significant disruption to the group's development. In the second half of 2005, Bank URALSIB opened a new factoring department, largely assisted by NFC in the areas of IT and product development. In order to avoid any direct competition and cannibalization of the factoring business within the group, NFC will work with large and midsize customers, while Bank URALSIB's factoring department will target small companies.

Despite some limited commercial cooperation with other group members, NFC is operationally independent, with its own IT platform and operational systems. No functions, services, or premises are shared with other group members, including Bank URALSIB. Only one of NFC's 18 regional offices is based in the same building as a Bank URALSIB branch, but space is not shared. In early 2006, the company will move its Moscow headquarters away from its current location in the same office building as a Bank URALSIB branch. Aiming to differentiate itself from the group, NFC changed its name from NFC URALSIB-NIKoil in November 2005.

Strategy

The company's well-articulated and focused strategy to strengthen its factoring franchise distinguishes it from many other Russian financial institutions. With total factoring advances estimated at only \$3 billion in 2005 (although almost double those in 2004), the Russian factoring market is still rather limited, but is growing fast. With a strong foothold in this market and a committed and experienced management team, NFC is well positioned to benefit from sector growth and remain a major player, despite toughening competition.

In addition to competing with specialized factoring companies, NFC faces significant competition from local commercial banks, where customer knowledge of factoring and ability to differentiate between it and working capital lending are still low, albeit progressively improving. Consequently, NFC is making large investments in factoring popularization and customer education, major drivers of its business growth and client diversification. The company's decent regional network (18 offices in major Russian cities as of December 2005) also supports its growth and diversification prospects.

NFC is keen to develop good relations with the global financial community and enhance its name recognition outside Russia. It is a member of the world's oldest factoring association, International Factors Group (IFG), which elected NFC's chairman, Mikhail Treyvish, to its board in October 2004 (he is the first ever representative of an emerging country to that body). Mr. Treyvish also heads the Eastern European IFG Chapter. NFC is a member of two other international associations: Factors Chain International and East European Factoring Association. This should be helpful in developing its still-limited import- and export-related factoring services. NFC has majority stakes in joint-venture factoring companies in Moldova and Armenia, which, however, together represent less than 5% of the company's consolidated financials.

Asset Quality

NFC's asset risk mainly stems from its factoring business, as other investments, including securities and fixed assets, are limited. As in 2005, recourse factoring is expected to continue to represent the majority of the company's assets in the foreseeable future. NFC's off-balance-sheet exposures are minimal, as credit risk coverage products are still underdeveloped in Russia.

Although fairly high by international standards, single-name concentrations in the company's factoring advances are below the domestic market average. The twenty largest suppliers of products represented almost 45% of NFC's total factoring advances (or almost 110% of its adjusted common equity) at Sept. 30, 2005. At the same date, the twenty largest debtors (buyers of delivered goods) accounted for almost 25% of its total factoring advances (or almost 60% of its adjusted common equity). Despite expected rapid growth in the company's factoring business and decline in capitalization ratios in the next three years, single-name credit concentrations as a share of equity are likely to remain limited, due to increasing customer diversification, especially among midsize companies. The industry breakdown by supplier in NFC's factoring advances demonstrates moderate concentrations, with the food and beverage sector representing 29% of total advances and computers and consumer electronics representing 24% at June 30, 2005.

Problem factoring advances (past due for more than 90 days and exposures to suppliers or debtors having financial or operational difficulties) accounted for a fairly low 1.2% of total factoring advances and were more than 100% covered by provisions at Sept. 30, 2005. These ratios could deteriorate rapidly, however, given substantial single-party credit concentrations and generally high economic and political risks in Russia. The legal framework for the factoring business in Russia, namely in the areas of invoice sales and the transfer of claim rights, is adequate.

Nevertheless, the local court system is still inefficient and often arbitrary, which makes problem debt workouts for NFC and other Russian financial institutions challenging.

NFC's risk management is adequate, with recently enhanced systems and procedures to process growing business volumes. Almost a quarter of the approximately 200 company employees are involved in credit monitoring. Credit approval systems and guidelines are fairly prudent, with decisions based on internal rating models and committee reviews of both suppliers and debtors. Individual factoring advances typically represent 80%-90% of approved invoices. Currently 95% of all factoring advances relate to recourse factoring, with nonrecourse factoring likely to grow gradually. This will require adaptation of credit risk management techniques and a greater attention to operational risk.

Profitability

Because of reporting deficiencies in the past three years and a limited track record during positive macroeconomic conditions in Russia, NFC's profitability indicators reported in the past three years are barely reflective of future performance. Although NFC's profitability is likely to remain good in 2006, supported by growing business volumes and the expected positive macroeconomic situation in Russia, the company's substantial revenue and credit concentrations and risky operating environment might lead to performance volatility. Continued customer diversification and expansion should gradually smooth potential volatility, however.

With over 60% of its revenues deriving from net interest income, the company is vulnerable to continually shrinking interest margins, which are adversely affected by fierce competition and the company's growing funding costs. Due to substantial—albeit progressively declining—client concentrations, NFC's profitability is also exposed to potential client departures, consequently limiting the company's pricing power. The 25 major clients-suppliers accounted for over 40% of total revenues in the first nine months of 2005. Factoring origination and service fees, representing about 35% of the company's total revenues in 2005, are also subject to volatility and competitive pressures.

The average size of large credit exposures at the company is substantial compared with its net operating income before loan loss provisions, representing 25% in the first nine months of 2005. If one of the company's largest exposures becomes nonperforming, NFC's credit costs would increase sharply, negatively affecting its profitability. In light of pressured margins, profitability prospects will be dependent on increased volumes and resulting economies of scale, as well as sustained fee generation.

Asset-Liability Management

NFC's weak funding diversification and niche market position restrict its financial flexibility. These negatives are offset to some extent by the predominantly short-term nature of its business—which is favorable for its liquidity management—and by the company's membership in a diversified financial group. NFC's currently low balance sheet liquidity is somewhat mitigated by its access to funding from group members. As of June 30, 2005, related-party funding, mainly from Bank URALSIB, covered 94% of the company's liabilities. This figure fell below 70% in the second half of 2005 due to a growing volume of nonrelated bank borrowings. We expect that gradually weakening links with the group, specifically in the area of funding support, will drive the need for a higher balance sheet liquidity reserve and consequently will reduce the share of factoring advances in total assets.

NFC wants to further diversify funding away from related parties by issuing Russian ruble bonds and by raising debt from domestic and international banks. This development of new funding sources is also important for strengthening its longer term liabilities. Although individual factoring advances have contractual maturities of two months on average, the real duration of some counterparty credit exposures may be longer term because of a continuous flow of transactions. As a non-deposit-taking entity, NFC will continue to be entirely wholesale funded, consequently implying a lumpiness of the liabilities profile and rollover risk.

Capital

The currently abnormally high capitalization ratios—with a ratio of adjusted common equity to assets of 38% at Sept. 30, 2005—will be driven down quickly in the next three years by continued business expansion, but should remain adequate at above 10%. The small absolute capital amount (about \$60 million at year-end 2005), however, could limit expansion opportunities and leaves the bank exposed to potential credit and operational shocks. The dividend policy is fairly conservative, calling for at least 50% of the company's profits to be retained. No dividend payouts have been made in the past three years, however. In the next couple of years, capital growth is expected to come primarily from earnings retention.

Table 1

National Factoring Company Balance Sheet Statistics								
(Mil. RUR)	—Year ended Dec. 31—				Breakdown as a % of assets (adj.)			
	2005*	2005(Q2)	2004	2003	2005*	2005(Q2)	2004	2003
<i>ASSETS</i>								
Cash and money market instruments	523	571	900	456	11.79	14.09	24.17	100.00
Securities	21	0	0	0	0.46	0.00	0.00	0.00
Trading securities (marked to market)	21	0	0	0	0.46	0.00	0.00	0.00
Customer loans (gross)	4,092	3,657	2,888	0	92.24	90.19	77.56	0.00
All other loans	4,092	3,657	2,888	0	92.24	90.19	77.56	0.00
Loan loss reserves	235	195	82	0	5.30	4.82	2.20	0.00
Customer loans (net)	3,856	3,462	2,807	0	86.94	85.37	75.37	0.00
Earning assets	4,254	3,657	3,721	156	95.90	90.19	99.91	34.20
Fixed assets	3	3	2	N.A.	0.06	0.07	0.05	N.A.
All other assets	33	19	16	0	0.75	0.47	0.42	0.00
Total reported assets	4,436	4,055	3,724	456	100.00	100.00	100.00	100.00
Adjusted assets	4,436	4,055	3,724	456	100.00	100.00	100.00	100.00
Breakdown as a % of liabilities + equity								
	2005*	2005(Q2)	2004	2003	2005*	2005(Q2)	2004	2003
<i>LIABILITIES</i>								
Total deposits	2,695	2,394	2,194	0	60.76	59.04	58.91	0.00
Noncore deposits	2,649	2,348	2,194	0	59.71	57.89	58.91	0.00
Core/customer deposits	47	47	0	0	1.05	1.15	0.00	0.00
Other liabilities	74	98	72	0	1.67	2.40	1.93	0.01
Total liabilities	2,770	2,492	2,266	0	62.43	61.44	60.84	0.01
Total shareholders' equity	1,666	1,564	1,458	456	37.57	38.56	39.16	99.99

Table 2

National Factoring Company Profit And Loss Statement Statistics (cont.'d)							
(Mil. RUR)	—Year ended Dec. 31—				Adj. avg. assets (%)		
	2005*	2005(Q2)	2004	2003	2005*	2005(Q2)	2004 2003
Nonperforming assets	50	32	11	0			
Nonaccrual loans	50	32	11	N.A.			
<i>AVERAGE BALANCE SHEET</i>							
Average customer loans	3,332	3,134	N.A.	N.A.			
Average earning assets	3,987	3,689	1,938	N.A.			
Average assets	4,080	3,890	2,090	N.A.			
Average total deposits	2,445	2,294	N.A.	N.A.			
Average interest-bearing liabilities	2,445	2,294	1,097	N.A.			
Average common equity	1,562	1,511	957	N.A.			
Average adjusted assets	4,080	3,890	2,090	N.A.			
<i>OTHER DATA</i>							
Number of employees (end of period, actual)	195	211	85	2			
Number of branches	17	17	0	0			

*Data as of Sept. 30, 2005, IFRS management accounts. Ratios annualized where appropriate. Year-end and midyear financial statements are audited, consolidated, and prepared according to IFRS. N.A.—Not available. RUR—Russian ruble.

Table 3

National Factoring Company Ratio Analysis					
	—Year ended Dec. 31—				
	2005*	2005(Q2)	2004	2003	
<i>ANNUAL GROWTH (%)</i>					
Customer loans (gross)	55.41	53.25	N.M.	N.A.	
Loss reserves	249.69	277.82	N.M.	N.A.	
Adjusted assets	25.43	17.80	716.41	N.A.	
Tangible common equity	18.99	14.44	219.74	N.A.	
Total equity	18.99	14.44	219.74	N.A.	
Operating revenues	438.82	396.44	79003.35	N.A.	
Noninterest expense	262.32	257.23	125493.33	N.A.	
Net operating income before provisions	556.07	488.92	63391.04	N.A.	
Loan loss provisions	151.13	169.36	N.M.	N.A.	
Net operating income after provisions	10475.27	8316.78	2390.30	N.A.	
Pretax profit	10475.27	8316.78	2390.30	N.A.	
Net income	12400.32	9408.80	2137.37	N.A.	
	2005*	2005(Q2)	2004	2003	
<i>PROFITABILITY (%)</i>					
<i>Interest margin analysis</i>					
Net interest income (taxable equiv.)/avg. earning assets	12.08	19.08	7.31	N.A.	
Net interest spread	11.15	18.14	6.96	N.A.	
Interest income (taxable equiv.)/avg. earning assets	13.57	20.63	7.75	N.A.	
Interest expense/avg. interest-bearing liabilities	2.42	2.49	0.79	N.A.	
<i>Revenue analysis</i>					

Table 3

National Factoring Company Ratio Analysis (cont.'d)

	—Year ended Dec. 31—			
	2005*	2005(Q2)	2004	2003
Net interest income/revenues	63.15	100.13	100.00	100.00
Fee income/revenues	(0.00)	(0.06)	0.00	0.00
Market-sensitive income/revenues	0.11	(0.11)	0.00	0.00
Noninterest income/revenues	36.85	(0.13)	0.00	0.00
Personnel expense/revenues	17.07	16.88	27.06	17.88
Noninterest expense/revenues	26.84	28.72	39.91	25.14
Noninterest expense/revenues less investment gains	26.84	28.69	39.91	25.14
Expense less amortization of intangibles/revenues	26.84	28.72	39.91	25.14
Expense less all amortizations/revenues	26.84	28.62	39.91	25.14
Net operating income before provision/revenues	73.16	71.28	60.09	74.86
Net operating income after provisions/revenues	46.25	39.96	2.36	74.86
New loan loss provisions/revenues	26.91	31.32	57.73	0.00
Pretax profit/revenues	46.25	39.96	2.36	74.86
Net income/revenues	36.29	29.96	1.56	55.31
Tax/pretax profit	21.54	25.01	33.62	26.12
	2005*	2005(Q2)	2004	2003
<i>Other returns</i>				
Net income before minority interest/avg. adjusted assets (%)	6.79	5.41	0.11	N.M.
Net income/avg. assets + securitized assets (%)	6.79	5.41	0.11	N.A.
Net income/employee (RUR)	1,977,729	1,253,690	49,222	N.A.
Personnel expense/employee (RUR)	930,069	706,333	851,533	N.A.
Personnel expense/branch (mil. RUR)	15.32	13.96	N.A.	N.A.
Noninterest expense/branch (mil. RUR)	24.09	23.75	N.A.	N.A.
Cash earnings/avg. tang. common equity (ROE) (%)	17.72	13.99	0.23	N.A.
Core earnings/avg. tang. common equity (ROE) (%)	17.72	13.94	0.23	N.A.
	2005*	2005(Q2)	2004	2003
<i>FUNDING AND LIQUIDITY (%)</i>				
Customer deposits/funding base	1.73	1.95	0.00	N.M.
Total loans/customer deposits	8792.73	7851.90	N.M.	N.M.
Total loans/customer deposits + long-term funds	238.86	227.14	198.06	0.00
Customer loans (net)/assets (adj.)	86.94	85.37	75.37	0.00
	2005*	2005(Q2)	2004	2003
<i>CAPITALIZATION (%)</i>				
Adjusted common equity/adjusted assets	37.57	38.56	39.16	99.99
Adjusted common equity/customer loans (net)	43.21	45.16	51.96	N.M.
Internal capital generation/prior year's equity	18.99	14.44	0.49	N.A.
Regulatory total capital ratio	39.30	41.50	45.60	N.A.
Adjusted total equity/adjusted assets	37.57	38.56	39.16	99.99
Adjusted total equity plus LLR (specific)/customer loans (gross)	46.48	48.09	53.32	N.M.
	2005*	2005(Q2)	2004	2003
<i>ASSET QUALITY (%)</i>				

Table 3

National Factoring Company Ratio Analysis (cont.'d)

	—Year ended Dec. 31—			
	2005*	2005(Q2)	2004	2003
New loan loss provisions/avg. customer loans (net)	6.16	7.02	N.A.	N.A.
Loan loss reserves/customer loans (gross)	5.75	5.34	2.83	N.M.
Nonperforming assets (NPA)/customer loans + ORE	1.22	0.88	0.39	N.M.
Net NPA/customer loans (net) + ORE	(4.80)	(4.71)	(2.51)	N.M.
Loan loss reserves/NPA (gross)	470.48	604.37	718.54	N.M.

*Data as of Sept. 30, 2005, IFRS management accounts. Ratios annualized where appropriate. Year-end and midyear financial statements are audited, consolidated, and prepared according to IFRS. N.A.—Not available. N.M.—Not meaningful. RUR—Russian ruble.

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