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Bank of Georgia

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19 October 11 | **Initiation of coverage** | Financial Services

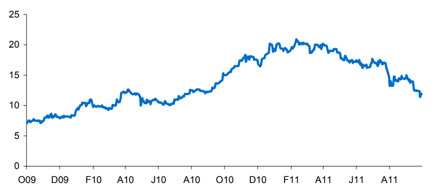
Bank of Georgia (LSE:BGEO)3

BUY

Share price	**$11.95**
Target price	$17.00
42% Upside	
Market cap ($m)	375
BIS Tier 1 ratio (%)	18%
Cash and reg reserves/total assets (%)	25%
No. of shares fully dil. (m)	31.4
Free float (%)	100.0
Average daily vol ('000, -3m)	58.6
Dividend yield (%)	1.4%
PER at Target price (Y1)	6.7x
Sector PER	7.9
Price/tangible book (2010A)	1.16
12 month high/low ($)	21/11.4

(%)	1m	3m	12m
Absolute	-13%	-27%	-22%
FTA relative	n/a	n/a	n/a

Price (-2yr)



Source: Datastream

Share price as at close: 17 October 2010

Next news

Q3 results

Business

Headquartered in Tbilisi, Bank of Georgia has 36% market share of its home market and is the largest bank in Georgia.

www.BOG.ge

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The lowest risk bank in the FTSE

With a liquidity ratio of 25% of total assets, a BIS tier 1 ratio of 18%, total capital ratio 27% H1 2011, and loans to deposit ratio of 1.17x, we believe Bank of Georgia has the lowest risk balance sheet of any bank in the FTSE. This low risk balance sheet is also reflected in the low level of indebtedness of the bank's customers. This provides a solid platform for strong structural growth. We initiate coverage with a BUY.

"An indestructible franchise" according to one competitor

Bank of Georgia is a leading Georgian universal bank, with a 34% market share of deposits, which is seeking a premium listing on the London Stock Exchange and FTSE Index inclusion, as announced on 5th September. Since November 2006, the bank has been listed on the LSE in the form of a GDR and the shareholder base is 95% Western investors. Return on Equity was 22% at H1 2011, the bank is not overly reliant on wholesale funding, less than 17% of wholesale funding (5% of total liabilities) matures in less than one year.

Risks

Georgia is an open economy, with exposure to trends in world trade both an opportunity and a threat. Longer term, rather than a re-opening of hostilities between Russia and Georgia, we perceive the main risk is that the country catches "the Irish disease." We are reassured by the presence of a strong Central Bank, with enhanced credibility following the financial crisis. Despite the London listing, the head office remains in Tbilisi, and Bank of Georgia is not subject to UK government ringfencing proposals. Indeed, Bank of Georgia's London listing should help George Osborne achieve his aim of making Britain a home of successful international banks that lend to families and businesses – without exposing British taxpayers to the massive costs of those banks failing.

Valuation

On the conservative assumptions that i) Georgian productivity (GDP per capita) and financial penetration (deposits/GDP) increases to a level somewhere between that of Lithuania and Slovenia ii) Bank of Georgia maintains 34% market share of deposits; we think Bank of Georgia could multiply in value by 10x. This is a case of when, not if, in our view; but may take up to two decades. To underline the conservativeness of our assumptions we value Bank of Georgia at 1.6x 2010A tangible book (or $17 per share). This compares to peak valuation of 6.1x historic tangible book ($44 per share) in July 2007. Our recommendation is BUY TP $17 per share.

A draft of this research has been shown to the company following which minor factual amendments have been made.

Year end May	Revenue ($m)	Surplus ($m)	PBT ($m)	Tax (%)	Adj. EPS (c)	PER (x)	P/TB (x)	Div yield (%)
2009A	191	82	-63	n/a	-1.9	-6.2	1.3	
2010A	193	83	55	15%	1.6	7.7	1.2	
2011E	216	107	87	15%	2.4	4.9	1.0	1.4%
2012E	248	122	92	15%	2.5	4.7	0.8	1.9%
2013E	283	138	102	15%	2.8	4.3	0.7	2.1%

Source: Seymour Pierce Ltd

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Picture of Freedom Square, Tbilisi, Georgia courtesy of F1 Online/Rex Features

Executive Summary

No taxpayer support over the crisis

Georgia is a small, independent, mountainous country on the periphery of Europe. It has a population of 4.4m, with an ancient cultural heritage of trade. At $5000 GDP (PPP) per capita is almost 6x lower than that of Slovenia. Around half the population is unbanked and mortgage indebtedness per capita is $200 relative to average annual salary of $3,900. Or put another way, mortgages are less than 4% of GDP, compared to over 50% for Slovenia and over 100% for the UK. Tbilisi, the capital, is on the same latitude as Barcelona and New York and is home to around one quarter of the country's population, and 80% of the banking system's loans. During the hostilities with Russia and the on-going global financial crisis no Georgian bank has received tax payer support or equity injections from the Government.

Shareholder friendly governance and incentives

Conservative risk management and reporting standards

Bank of Georgia is a leading Georgian universal bank (34% market share of deposits), which is seeking a premium listing on the London Stock Exchange and FTSE Index inclusion. Since November 2006, the bank has been listed on the LSE in the form of a GDR and the shareholder base is 95% Western investors. The intention of the London listing is neither regulatory arbitrage, nor an attempt to shop around for the stockmarket where banks trade on the most generous price to book multiple (obviously!) but instead is recognition of how much progress has been made since 2004. The bank reports under IFRS and is audited by Ernst & Young. Corporate Governance follows international best practice with a two tier structure of Non Executive Supervisory Board overseeing a capable and properly incentivised Management Board. The Management Board has a strong international pedigree and the Chief Executive has over 80% of his wealth in the shares of the bank. Bank of Georgia does not pay cash bonuses.

Extremely prudent NPL coverage ratios, impressive history of core deposit growth

As of H1 2011 the Bank reported Net Interest Margin of 7.1% in H1 (v 8.1% H1 2010), RoE of 22% (v 12% H1 2010), fully diluted eps growth of 2.2x to $1.40 for the half. Deposit growth was 40% year on year, almost double the rate of loan growth (23% year on year). The cost income ratio is 52% (v 60% H1 2010) and the bank has a BIS tier 1 capital ratio of 18%.

An "indestructible franchise"

The banking market in Georgia is highly concentrated, with the top 3 banks accounting for 79% of market share (H1 2011). There is no equivalent of HBOS or Northern Rock, using external securitisation funding to win market share, nor is there likely to be in the future. Indeed, one of Bank of Georgia's competitors suggested to us that it had "an indestructible franchise". The bank is not overly reliant on wholesale funding. Its loans/deposits ratio is 1.17x (H1 2011) and just 5% of total funding (ex customer deposits which have a short maturity, but behave as a stable funding source) matures within one year.

Strength of prudential regulation / Central Bank oversight

Rather than Russian hostilities recommencing, we believe the main risk is that either the bank, or country as a whole, catches "the Irish disease". That is, after a decade of strong GDP per capita growth, a small group of inter-connected politicians, bankers and property speculators, with a shared admiration for race horses, start to believe that the rules of gravity don't apply in their country. We are reassured by the presence of a strong Central Bank, with enhanced credibility following the financial crisis. However, we are also re-assured by the arms length relationship between bank management and property developers (see section on risk management). We note that the market capitalisation of the Irish banking sector peaked in Q1 2007 at $14 000 per capita (or $65bn in absolute terms), so the Georgian banking sector at $258 per capita (Bank of Georgia's market capitalisation grossed up by two thirds divided by 4.4m people) is a considerable distance from that problem at the moment.

Valuation

We think there is a decade or two of profitable structural growth ahead for Bank of Georgia. To underline the conservativeness of our assumptions, we value Bank of Georgia at 1.6x 2010A tangible book (or $17 per share). This compares to peak valuation of 6x historic tangible book ($44 per share) in July 2007. We think a 12 month target price misses the point, Bank of Georgia is, in our view, the only bank in the FTSE that has decades of profitable growth ahead.

Bank of Georgia Data Sheet

GEL (m)	2008A	2009A	2010A	2011E	2012E	2013E	2014E
Net Interest Income	219	197	210	236	278	324	370
Non-Interest Income	122	122	133	147	161	178	195
Total Income	341	319	344	383	439	501	566
Operating Expenses	-188	-183	-196	-194	-223	-256	-295
Surplus	153	136	148	189	216	245	271
Impairments	-133	-133	-45	-36	-54	-65	-78
Operating Profit	20	3	103	153	162	180	193
Non-Operating Items	-21	-109	-5	0	0	0	0
Pre-Tax Income	-1	-106	98	153	162	180	193
Net Income to sh/holders	1	-99	83	130	138	153	164
Growth							
Revenue	57%	-6%	8%	11%	15%	14%	13%
Expense	67%	-3%	8%	-1%	15%	15%	15%
Surplus	45%	-11%	8%	28%	14%	13%	11%
PBT	n/a	n/a	n/a	56%	6%	11%	7%
Tangible book		-4%	16%	21%	18%	17%	15%
Total Assets		-11%	37%	30%	23%	20%	20%
Balance Sheet	2008A	2009A	2010A	2011E	2012E	2013E	2014E
Total Assets	3,259	2,913	4,005	5,206	6,400	7,680	9,216
Average Interest Earnings Assets	2,136	2,175	2,596	3,374	4,148	4,977	5,973
Weighted Risk Assets	2,951	2,455	3,653	4,749	5,838	7,005	8,406
Total Gross Customer Loans	2,039	1,661	2,352	3,058	3,758	4,510	5,412
Total Customer Deposits	1,193	1,272	2,005	2,807	3,649	4,378	5,254
Tier 1 Capital	638	549	638	756	880	1,018	1,165
Tangible Equity	513	494	573	690	815	953	1,100
Common Shareholders' Equity	666	579	664	782	906	1,044	1,192
				0.246	0.223	0.218	0.209
Key Metrics							
Net Interest Margin	10.30%	9.10%	8.10%	7.00%	6.70%	6.50%	6.20%
Tier 1 Ratio (BIS)	21.6%	22.4%	17.5%	15.9%	15.1%	14.5%	13.9%
NBG Ratio	16.6%	19.7%	13.0%				
Tangible Equity / RWAs	17%	20%	16%	15%	14%	14%	13%
Loan / Assets Ratio	63%	57%	59%	59%	59%	59%	59%
Loan / Deposit Ratio	171%	131%	117%	109%	103%	103%	103%
Simple leverage ratio	6.4	5.9	7.0	7.5	7.9	8.1	8.4
NPL ratio	2.9%	7.7%	4.7%				
Impairments/customer loans	-6.5%	-7.2%	-2.2%	-1.3%	-1.6%	-1.6%	-1.6%
Cost income ratio	55.2%	57.2%	57.1%	50.6%	50.7%	51.2%	52.1%
Pre-Provision ROA	4.9%	4.4%	4.3%	4.1%	3.7%	3.5%	3.2%
ROA	0.0%	-3.2%	2.4%	2.8%	2.4%	2.2%	1.9%
Pre-Provision ROE	22.1%	5.5%	20.6%	23.0%	22.8%	22.3%	21.6%
ROE	0.1%	-15.9%	13.3%	18.0%	16.4%	15.7%	14.7%
RoTE	0.1%	-19.6%	15.5%	20.6%	18.4%	17.3%	16.0%
RoWRAs	0.0%	-3.7%	2.7%	3.1%	2.6%	2.4%	2.1%

Source: Seymour Pierce Ltd

Valuation

An overly simplistic Gordon Growth Model valuation for Bank of Georgia might look like the table below. 15% Through The Cycle RoE (RoE H1 2011 was 22%, but we view this as close to “peak” profitability), perpetual growth of 7% and a cost of equity of 12% might suggest a target price to tangible book of 1.6x or $17 per share.

Simplistic Valuation

	2010
TBPS ($)	10.3
RoE	15%
Growth	7%
CoE	12%
Target Price to book	1.6
Target price ($)	17

Source: Seymour Pierce Ltd

But we think assuming a 12% cost of equity is too high. Too high? When the bank itself offers Lari cash deposits paying a rate of 13% rate for 1 year and inflation is still above 10%?

For a start, the cost of equity calculation ought to take into account the conservativeness of a bank’s balance sheet. That is the tier 1 capital, total asset leverage, liquidity ratio and funding ratio should all be taken into account in the investment case. Bank of Georgia has a tier 1 ratio of 18% total capital ratio of 27%, both well above UK banks. But it is the simple leverage ratio where the bank stands out, with tangible equity is just 6 times total assets v 35 times for Barclays. The liquidity ratio is harder to compare with UK banks, as there are different definitions of liquidity. Bank of Georgia liquidity ratio is 25% of total assets, of which 10% is either cash or held at their Central Bank as a mandatory reserve. In the UK the FSA has a definition of eligible assets that can be held as liquidity (UK Gilts, US Treasuries, Euro AAA government debt, unencumbered cash balances held at central banks) which we show for the UK banks.

Fortress balance sheet

Leverage comparisons

	Leverage*	Tier 1	Cash & Eligible Reserves/ Total Assets	Loans/Deposits
Bank of Georgia	6.3	18%	25%	1.17
Barclays	34.7	14%	9%	1.18
HSBC **	21.0	12%	6%	0.79
Lloyds	24.7	12%	10%	1.47
RBS	24.1	14%	11%	1.14
Stan Chtd **	16.9	14%	???	0.79

Source: Seymour Pierce Ltd

*Total Assets/Tangible Equity

**HSBC doesn’t split out FSA liquidity portfolio, we include only their cash plus UK, US Govt and Agencies, and HK Govt. Standard Chartered claims a liquidity ratio of 26%, but does not make clear how much of this is eligible liquidity under FSA rules

Banks are leveraged play on increasing customer prosperity

Secondly, the cost of equity calculation is rarely forward looking, and it should be. A general rule of thumb is that it is better to buy equity in a bank when inflation and interest rates are high, but falling (Lloyds circa 1980). It is normally a terrible idea to buy equity in a bank when long term interest rates are low, and staying low (Japanese banks, Lloyds circa 2010).

We also believe that a useful cost of equity calculation should take into account the level of indebtedness of a bank's customers and likely direction in customer disposable incomes. A bank operating in an environment of falling inflation, with low level of customer indebtedness and rising disposable incomes, ought to mean a bank's equity is safer than a bank with highly indebted customers and falling disposable incomes. Although a headline rate of 13% offered on one year deposits is attractive, going forward we would expect this rate to gradually fall, so the benefit to the deposit holder is eroded. Instead, the benefits of falling inflation and increasing customer prosperity accrue to the owner of a bank's equity.

Neither of these commonsense heuristics are captured in the (theoretically correct) standard cost of equity calculation.

Lithuania is 3x more productive, Slovenia is 6x more productive

To demonstrate our point, we have built a deposit franchise model. We assume that Georgian productivity per capita is a decent proxy for disposable income per capita, and can eventually reach that of either Lithuania or perhaps even Slovenia. We have chosen these two countries because of both of them have smaller population than Georgia, to demonstrate a large population is not necessary for growth. Like Georgia, both countries have a coastline, open economies and a history of trade with larger neighbours. Culturally both countries feel a curious mix of Germanic, Slavonic, Celtic and Mediterranean influences.[1] However Lithuanian GDP per capita is 3x greater than that of Georgia and Slovenia is almost 6x more productive on a PPP basis. Financial penetration (as measured by deposits to GDP) is 40% for Lithuania and 60% for Slovenia.

GDP per capita to grow at 8% through the cycle

Bank deposit growth to grow ahead of GDP growth

Over the last decade Georgia has achieved 8% CAGR in GDP per capita, and assuming this 8% CAGR can continue it would take 15 years to reach the current level of Lithuania and 23 years to reach the level of Slovenia. We assume financial penetration means bank deposits grow faster than per capita GDP, and our central assumption is that deposits per capita ought to grow at 14% CAGR (versus 40% year on year growth in deposits reported by Bank of Georgia H1 2011). We also assume Bank of Georgia can maintain market share of 1/3 of Georgian banking system deposits.

Terminal value 1.9x tangible book

Our final assumption is that after this level of deposit growth, Bank of Georgia will trade on an “ex growth multiple” of 1.9x tangible book. Not unreasonable for a deposit funded bank with a sustainable RoE of 15% in a mature, concentrated market. By coincidence it is the average price to tangible book Singaporean and Hong Kong banks have traded at over the last decade.

[1] Architecturally Tblisi, with its tree lined streets and ancient castles, looks “Mediterranean”, though the legal system is based on Germany, and the diplomat Sir Fitzroy Maclean suggested there was a “Celtic” feel to the culture.

Valuation

Alternate two stage model	Georgia 2010	Lithuania	Slovenia	*Notes*
GDP per capita	4,900	16,000	28,200	*Assume Georgian GDP per capita goes to Lithuania or Slovenian levels*
Assume growth of 8%		15 years	23 years	*At 8% CAGR this would take 15 yrs for Lit or 23 years for Slovenia*
Deposits/GDP	28%	40%	60%	*Assume continued financial penetration rising deposit/GDP ratio*
Deposits per capita ($)	1,372	6,400	16,920	
Deposits $m	3,287	28,800	76,140	*Absolute level of deposits assuming Lit or Slovenia data*
of which Bank of Georgia one third	1,133	9,504	25,126	*Assume Bank of Georgian maintains current mkt share of deposits*
Implied CAGR in deposits		14%	14%	
Tangible book $	573	1,901	5,025	*Assume ratio of tangible book/deposits ratio stays constant*
Implied growth in book		8%	10%	
Tangible book per share ($)	10.32	30.7	81.2	*Assume number of shares grows 1% CAGR*
Terminal value		1.9	1.9	*Average of HK / Singapore banks P/TB last 5 and 10 years*
Undiscounted Target Price ($)		58.4	154.3	*Target price in $*
Implied discount rate to get to current price		12%	12%	

Source: Seymour Pierce Ltd

On this basis, we believe Bank of Georgia has the potential to increase its share value by between 6 and 15 times over the next couple of decades. Absurdly bullish? We don't think so. If one discounts back a ten fold increase in shareprice at a 12% cost of equity over 20 years, this generates the current share price. To be clear, we think it is entirely reasonable, on some pretty conservative assumptions that Bank of Georgia multiplies in value by 10 times, over an extended period of time. However, applying a 12% discount rate to this opportunity doesn't make sense to us. CAPM has its uses, but valuing Bank of Georgia is not one of them, in our view.

We have tried to cross check our assumptions with bank market capitalisation per capita data. Unfortunately both Lithuania and Slovenia have a large proportion of their banking system owned by overseas banks. In our view, these countries sold off their banking system too early, and most of the upside will go to the parent companies with headquarters in Paris, Vienna or Stockholm.

Banking market cap to GDP in small, developed countries

Instead, we show the market capitalisation of the banking sector per capita of developed markets with similar population sizes (Ireland, Hong Kong ex HSBC and Singapore). At the risk of sounding like an over enthusiastic analyst during the internet boom, we show the potential if the Georgian Government succeeds in its stated strategy of creating a regional trade and financial hub. If everything goes right (and it probably won't) Bank of Georgia peak valuation could reach over $20bn, that is more than 50 times the current valuation.

Market cap per capita (USD)

Peak Mkt Cap per Capita	Average mkt cap US$bn last 10 yrs	Avg mkt cap per capita	Peak USD bn	When	Peak Mkt cap Per capita (USD)
Ireland	29.8	6,349	65	Q1 2007	13,912
Hong Kong*	58.9	8,290	103	Q2 2008	14,471
Singapore	46.6	9,916	85	Q3 2011	18,063
Average		8,185			15,482
Would imply for Georgian banking system	$bn				
Average (last 10 years)	37				
Peak valuation	70				
Would imply for Bank of Georgia **					
Average (last 10 years)	12				
Peak valuation	23				

Source: Seymour Pierce Ltd

*Hong Kong is ex HSBC

** Assumes Bank of Georgia maintains 34% market share of country deposits

Number of shares:

As of December 2010 the average number of shares outstanding was 30.04m. However, fully diluted this rises to 33.51m because there are 3.5m of potentially diluted shares underlying a convertible debt instrument arranged in January 2009 with the EBRD and the IFC, which is treated as dilutive. Conversion would reduce the bank's interest expense and increased 2010 attributable profit by GEL 8.1m (or 10%). We have used the fully diluted number of shares in our valuation, and assumed a further 1% dilution per annum going forward.

Georgia: country profile

Georgia is a small, independent, mountainous country on the periphery of Europe, with a population 4.4m, and an ancient cultural heritage of trade dating back millenia. At $5000, GDP (PPP) per capita is around half the level of Serbia, or almost 6x smaller than Slovenia[2].

Although still at a low level, the country is clearly moving in the right direction with Gross National Income (GNI) per capita compounding at an impressive rate over 5, 10 and 15 years. Still around half the population is unbanked and mortgage indebtedness per capita is $200 (354 Lari) relative to average monthly salary of $327 (557 Lari). Mortgages are less than 4% of GDP, compared to 52% for Poland and over 100% for the UK.

Historic growth in GNI per capita

Country	Current	Historic CAGR		
	US $	5 year	10 year	15 year
Georgia	4,960	6.3%	8.0%	9.0%
Estonia	19,510	4.2%	7.4%	7.8%
Latvia	16,350	4.9%	7.4%	7.7%
Lithuania	17,870	5.2%	7.8%	7.3%
Slovakia	23,120	8.3%	7.9%	7.1%
Poland	19,010	7.1%	6.1%	6.6%
Croatia	18,730	4.5%	5.8%	5.9%
Singapore	55,380	5.6%	5.3%	5.1%
Ukraine	6,560	3.5%	7.5%	5.1%
Slovenia	27,140	3.1%	4.5%	5.0%
Hong Kong	47,130	5.7%	5.9%	4.8%
Ireland	32,520	-0.3%	2.8%	4.8%

Source: World Bank

Tbilisi, the capital, is on the same latitude as Barcelona and New York and is home to around one quarter of the country's population. Currently, Tbilisi residents represent 80% of the banking system's loan book.

[2] GDP on a current exchange rate basis was $2600 for Georgia in 2010, versus $3000 for Serbia, $28 000 for Slovenia

Country comparisons

	GDP per Capita (PPP)	Domestic Debt per Capita (USD)	Domestic Debt/GDP	GDP Composition			Unemployment Rate	Stock of Domestic Credit (USD billions)
				Agriculture	Industry	Services		
	USD	USD	(%)					
Georgia	4,900	865	18	10%	29%	61%	16.4%	4
Serbia	10,900	2,876	26	12%	23%	65%	17.2%	21
Latvia	14,700	11,986	82	4%	22%	74%	18.4%	26
Lithuania	16,000	6,866	43	3%	28%	69%	17.8%	24
Poland	18,800	7,893	42	3%	33%	64%	12.1%	303
Estonia	19,100	15,016	79	3%	29%	68%	16.9%	19
Slovakia	22,000	12,517	57	4%	35%	62%	13.5%	68
Czech Rep.	25,600	11,606	45	2%	38%	60%	9.0%	127
Slovenia	28,200	25,745	91	2%	31%	66%	10.7%	51
UK	34,800	82,166	236	1%	22%	78%	7.8%	5151
Ireland	37,300	159,529	428	2%	29%	70%	13.6%	745
Hong Kong	45,900	62,595	136	0%	7%	93%	4.4%	446
Singapore	62,100	42,979	69	0%	28%	72%	2.2%	202

Source: CIA Factbook, World Bank

The population is primarily Christian but the country also has a tradition of diversity and religious tolerance of minority ethnic groups[3]. Life expectancy is 69 years for men and 76 for women.[4]

GDP fell 70% in the early 1990s

In the mid 1980s Georgia's per capita Gross National Income (GNI) was just over $5000, two thirds that of Ireland, and half the per capita level of Hong Kong and Singapore (versus 10% of those countries today), according to World Bank data. But the country was a particularly severe casualty of the collapse of the Soviet Union, and suffered a civil war. As a result between 1989 and 1993, the Georgian economy shrank by 70%, the worst performance of all the post-Soviet states, according to estimates from the Central bank.

More recently in 2008-9 real GDP growth showed greater resilience falling by only 4%, despite an economic blockade by Russia which saw the price of natural gas supplied by Russia sky rocket and a brief armed conflict in 2008. This compares to Estonia and Lithuania where GDP fell 14% in the same time period and Latvia where GDP fell 18%.

[3] This long history of religious tolerance extended into Communist times. Even in the 1930s, Stalin was reluctant to persecute the Georgian Church as severely as the church in other parts of the Soviet Union, because the Generalissimo was concerned not to offend his devout mother, who had sent him, aged 16, to the Tbilisi Theological Seminary in the hope that he would become a priest.

[4] Source: UN. For reference life expectancy in Scotland is 76 for men, 85 for women

Georgia – plus separatist regions

Source: BBC

Politics

Following the "Rose Revolution" in 2003 the President Mikhel Saakashvili initiated reforms aimed at reducing red tape, corruption and liberalising the economy. According to the World Bank, Georgia ranks highest for the most reformed country in the last five years. The next election cycle is 2012-13, all the sources we spoke to suggested that the opposition parties would struggle, against the popular mandate for continuing liberalisation and anti-corruption reforms. In October 2010, parliament passed constitutional changes curbing the power of the presidency, and boosting those of the Prime Minister. Opposition parties have claimed President Saakashvili is planning to become PM once his second presidential term ends in 2013.

Most recently in October Bidzina Ivanishvili, who Forbes magazine estimated was worth $5.5bn in March this year has announced his desire to enter politics. Ivanishvili made his fortune in the 1980s Moscow importing computers and push button phones, then later owning Rossiky Kredit Bank in Russia. He also has an interest in Cartu Bank, the sixth largest bank in Georgia by assets. Up until the last month he has focused mainly on his business interests, collecting Picasso's and philanthropy. Ivanishvili shuns the limelight and has only ever given one interview, to the Russian newspaper Vedomosti in 2005. In October 2011 he wrote an open letter to the Georgian Government announcing his intention to go into politics saying "I believe that any business should be done with clean hands based on honest and open relationships with people." From an investors perspective we believe the institutions (Central Bank, Ministry of Finance) are strong enough to protect shareholders, whatever the politics.

The US has a major strategic interest in the country, having invested heavily in an oil pipeline that can deliver 1.2m barrels per day from Azerbaijan via Georgia to Turkey and then on to Western markets. Saakashvili has made NATO membership one of his main goals. The US military has trained Georgian troops and the country has sent troops to Iraq and Afganistan.

Conflict

Since the restoration of its independence in 1991, Georgia has had ongoing violent disputes with local separatists in Abkhazia and South Ossetia regions and with Russia. Unlike in the Baltic states, the populations of these regions are not ethnic Russians placed there after the last war, but instead are descendents of inhabitants who historically sided with Russia in their Caucasian excursions back to the time of Lermontov.

Five days of heavy fighting

In August 2008, the conflict with South Ossetia escalated as Georgian troops engaged with local separatist fighters and Russian forces that had crossed the border. In the days that followed the initial outbreak, Georgia declared a state of war as Russian forces launched bombing raids deep into Georgia, targeted and destroyed Georgian infrastructure, blockaded part of the Georgian coast, took control of Tskhinvali (the South Ossetian administrative centre) and the Abkhazia region and landed marines on the Abkhazia coast effectively using the region to open a second front with Georgia. After five days of heavy fighting, the Georgian forces were defeated, enabling the Russians to enter Georgia uncontested and occupy the cities of Poti, Gori, Senaki and Zugdidi. In August 2008, Georgia and Russia signed a French-brokered cease-fire.

Separatist regions

Following the armed conflict in 2008, Russia formally recognised separatist regions Abkhazia and South Ossetia. The perception among all the sources we have spoken to (Russians, Georgians, the EU Monitoring Mission and a Tbilisi based international journalist) is that "Russia got what she wanted" and therefore further conflict is unlikely. Russia did not target the Baku-Tbilisi pipeline and Moscow did not highlight energy as an issue in the conflict. Georgia is no longer reliant on gas supplied by Russia, with gas imported from Azerbaijan.

Indeed, Georgia has worked hard to achieve the goal of energy independence and exported 1 TWH of electricity in 2010 to four neighbouring countries, and the Government aims to double this to 2 TWH by 2013. Only 18% of the country's hydro power potential is currently being exploited, with 5 new HPP projects under construction annual exports of electricity should reach $300m by 2018.

Low and simple taxes, and business friendly environment

In 2005 Georgia enacted a new Tax Code that introduced lower, flat tax rates and significant procedural improvements. The number of taxes and total tax rates were further decreased in 2008. No new taxes or tax rate increases can occur without a nationwide referendum.

Tax regime

VAT	18%
Income Tax	20%
Corporate Tax	15%
Dividend and interest income	5%
No payroll or social insurance	
No separate CGT	
No stamp duty	

Source: Georgian Economic Overview, www.georgia.gov.ge

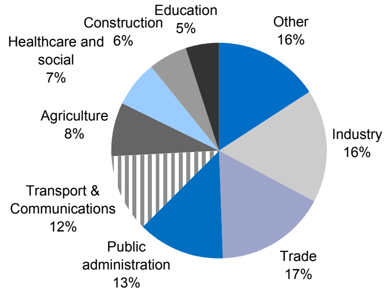
Following changes in the law, labour unions play no role, compared to union membership of 22% for the 10 new EU Member States, while the density in the 15 "old" EU Member states is 30%. Retirement age is 65 for men and 60 for women.

Bloated public sector has already been cut back

The IMF suggests that higher labour market flexibility boosts growth by increasing labour participation and better matching wage and productivity growth. In Georgia, there is no minimum wage, no restrictions on weekend working and probation period is up to six months (if employment is terminated within this period no severance pay is required). Severance pay is 1 month's salary (regardless of years served) once an employee has passed probation. The law does not require an employer to give advanced notice in terminating employment and the employer has no retraining or reassignment obligations. Saakashvili's government famously instituted wide-ranging reforms upon coming to power that involved firing a large chunk of its police and civil service force. So, unlike several Mediterranean countries, there is no problem with rigid labour laws protecting an unproductive public sector, and public administration is 13% of GDP, Education 5% and Health and Social Care 7%. .[5]

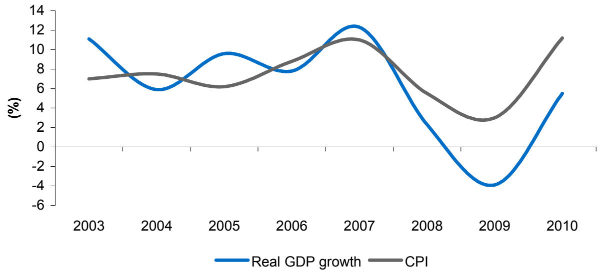
[5] *Labour Laws in Eastern Europe and Central Asian Countries: Minimum Norms and Practices* Arvo Kuddo, World Bank Nov 2009

GDP Breakdown



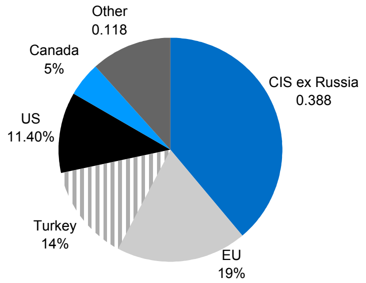
Source: Georgia.gov.ge

Real GDP growth and CPI



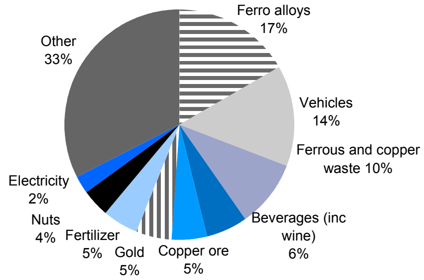
Source: Georgia.gov.ge

Trading partners (exports) FY 2010



Source: Georgia.gov.ge

Trading Goods (exports) FY 2010



Source: Georgia.gov.ge

There is also a diaspora of Georgians in Russia and Europe, generating remittances of around 7% of GDP. Gross remittances have grown from $1.1bn in 2008 to $1.6bn in 2010. Net remittances were just under $1bn in 2010.

As of September 2011 the Central Bank held $2.76bn of Gross International Reserves (equal to 4.5 months of imports). According to the IMF the level of reserves is considered to be sustainable if it is higher than 3x times.

Bank of Georgia

The bank was founded in 1902, but was then nationalised in the 1920's following Georgia's loss of independence to the Soviet Union. In 1994 the state bank was then privatised, with the EBRD a shareholder since 1998. The bank has been listed on the Georgian stock exchange since 2003, but it is only really in 2004 when a new management team took over and attracted institutional shareholder backing (Firebird, East Capital) with an aggressive turnaround plan. Since November 2006 the bank has been listed on the LSE in the form of a GDR and the shareholder base is 95% Western investors. The Management Board has a strong international pedigree and the Chief Executive has over 80% of his wealth is in the shares of the bank. Bank of Georgia does not pay cash bonuses.

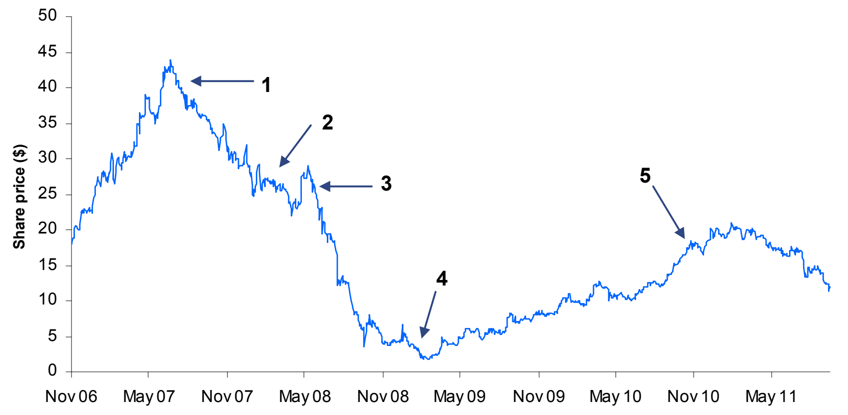
Management incentives in shares not cash bonuses

Between 2004 and 2007 several acquisitions followed, with Bank of Georgia book value per share growing at 82% and EPS growing at 61% CAGR. From 2007-2009 the bank was a victim of the financial crisis, with the share price falling steeply from peak valuation in July 2007. In 2008 the bank survived Russian hostilities, a system wide fall in banking deposits and a 16% overnight devaluation in the currency without receiving tax payer support. In 2009 the bank made a GEL105m and 3 GEL per share loss (US $61m or $1.76 per share loss). The bank sought a $200m loan from IFC and EBRD, though shareholder dilution was capped at 10%.

Since H1 2009 the bank has made a strong recovery. As of H1 2011 the Bank reported Net Interest Margin of 7.1% in H1 (v 8.1% H1 2010), RoE of 22% (v 12% H1 2010), fully diluted eps growth of 2.2x to $1.40 for the half. Deposit growth was 40% year on year, almost double the rate of loan growth (23% year on year). The cost income ratio is 52% (v 60% H1 2010) and the bank has a BIS tier 1 capital ratio of 18%.

BIS tier 1 ratio of 18%

Share price history



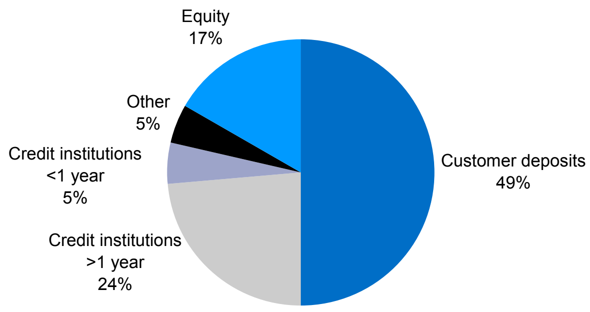
Source: Seymour Pierce Ltd

1. Peak valuation 6x tangible book, July 2007
2. Raises $100m at $25 per share (15% of share capital) February 2008
3. Russian hostilities with Georgia July August 2008
4. Currency devaluation by 16% Nov 2008, $52m subordinated convertible loan from IFC and EBRD, dilution capped at 10%
5. Record operating income of GEL 347m, beats announced net income target of GEL 72m by 15%, FY 2010

The bank enjoys 36% market share of total Georgian banking assets, and serves approximately one million retail and corporate clients through its network of 143 branches and 408 ATMs (the largest ATM network in Georgia), as well as through other delivery channels including the Internet, mobile banking and Georgia based call centre[6]. Given that Bank of Georgia represents around three quarters of the Georgian stock exchange it makes sense that the bank has a second listing. The head office remains in Tbilisi, and the bank continues to be regulated by the National Bank of Georgia so is not subject to UK ringfencing proposals.

The bank is not overly reliant on wholesale funding, the loans/deposits ratio is 1.17x (H1 2011) and less than 17% of wholesale funding (5% of total liabilities) matures in less than one year. It is worth pointing out that even within this there is very little refinancing risk, as the bulk of these credit institutions are organisations such as International Finance Corporation (IFC) part of the World Bank, the EBRD, the Netherlands Development Financial Corporation and other development banks.

Liability structure 2010A



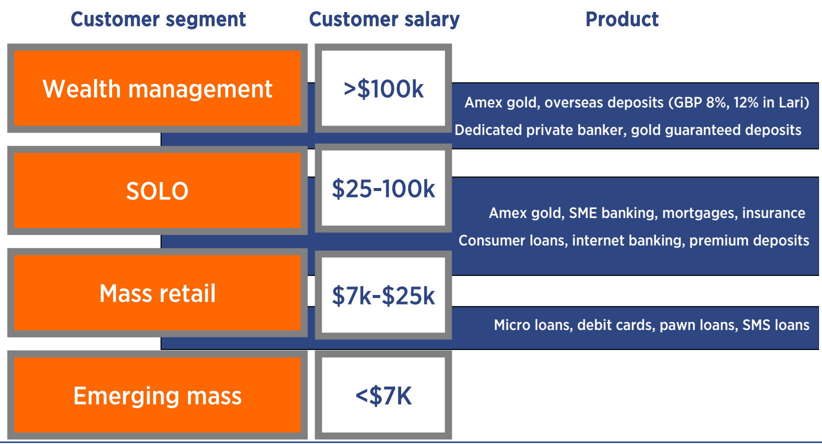
Source: Bank of Georgia, Seymour Pierce Ltd

The view of the customer

Bank of Georgia's customer segmentation reflects the unique nature of post Soviet countries, with many younger people, income affluent but asset poor, earning higher salaries than the older generation. With this segment in mind, Bank of Georgia has developed "SOLO" brand which is a cross over between the mass retail customer and wealth management.

The SOLO brand offers a personal banker with expertise in all the bank's products including insurance. SOLO customers are offered an Amex Gold card not available to mass retail customers, plus exclusive lifestyle and entertainment offers and discounts.

Bank of Georgia customer segmentation



Source: Seymour Pierce Ltd

[6] We got a Seymour Pierce intern to do a mystery shopping exercise on the call centre. The level of English spoken was good, although they did seem to have a bit of trouble with the name Rory Farquharson.

Retail Banking is 43% of both total income and the gross loan book and 44% of customer deposits. The bank offers basic banking accounts, though customers either pay for extras such as a debit or credit card or sign up for a packaged account.

Mass retail current account fees (GEL)

Retail Service	Individual Fee in Lari	Package in Lari
Universal Account	12	
Visa Classic/Mastercard	50	
Visa Electron/Cirrus/Maestro *	10	
Internet / telephone banking	18	
SMS banking	12	
Direct Debit	12	
Standing Order	12	
Package		37.5
Total	126	37.5

*requires funds to be available at the time of transfer; debit cards, by contrast allow transfers up to a certain limit
Source: Bank of Georgia, Seymour Pierce Ltd

Income grew 34% at the half year to GEL 94m, well ahead of costs which were up 10%. Retail Bank net income was GEL 50.7m versus 4.1m in H1 2010, driven in part by impairment provisions being written back from the previous year. Retail customers reached 862 000 up 9% year on year. The bank had 600 000 debit cards, and 78 000 American Express cards.

Analysis of income growth

GEL (m)	2006	2010	% of 2010 total income	CAGR	Absolute Change	Components of Growth
Retail	45.1	162.5	43%	38%	117	45%
Corporate	42.1	141.5	38%	35%	99	38%
Broking & AM	4.4	12.1	3%	29%	8	3%
Insurance	8.6	48.7	13%	54%	40	15%
Central	13.7	10.0	3%	-8%	-4	-1%
Total	113.8	374.8	100%	35%	261	100%

Source: Bank of Georgia, Seymour Pierce Ltd

Product offering

The bank offers consumer loans of up to GEL 50 000 ($30 000) for customers that are staff members of organisations registered in the main towns and cities at interest rates starting at 17%. Loans greater than GEL 10 000 require some form of hard collateral. In addition the bank also does pawn loans, secured against gold or silver up to $10 000, or loans for purchasing a car from abroad up to $20 000. Mortgages (branded hypo+) are aimed at borrowers with monthly income of above GEL 950 (ie $560) v Georgian average monthly salary of GEL 560. One innovation is the SMS loan scheme, where customers with good credit records are sent an SMS telling them they are pre-approved for small loans that they can then access through BOG's ATM network.

We think the opportunity for Bank of Georgia is not so much the increasing financial penetration of customers earning less than $7 000 a year. These customers can be expensive to serve, and can represent a poor credit risk. Instead, it is the growing demand for financial products among the "mass retail" customer base and SME client base, with the potential for some upward migration into the SOLO brand.

Retail bank per customer data

Number of customers	845,000
Per customer data (GEL)	Retail
Revenue	222
Cost	-107
Net income	120
Gross Loans	2,199
Deposits	1,063

Source: Bank of Georgia, Seymour Pierce Ltd

Historically, Retail has also included BG Bank Ukraine, which had been acquired as part of an international expansion strategy under the previous Chief Executive. Following the crisis, the expansion strategy was reversed and in 2009 the bank wrote off the goodwill associated with the acquisition (73m GEL). Then, in February 2011, the bank sold an 80% equity interest in this bank (valuing it at 0.8x book value). Bank of Georgia retains a 20% interest, and has may have minimal exposure through BG Capital which is being wound down. Bank of Georgia owns a 70% stake in a Belarussian bank (Belarusky Narodny Bank), book value is carried on the balance sheet at GEL 36m (5% of total shareholders equity).

The Belarussian bank and a number of other business subsidiaries (a vineyard, a hospital, gym company) acquired under previous management are considered non core, and we expect (with the possible exception of the banking subsidiary) to see progress made in disposing of these assets.

Real estate construction in Tbilisi – a case study in Risk Management

We believe Bank of Georgia's approach to risk management is best demonstrated by a case study. In July 2007, Sulkhan Gvalia, Deputy CEO responsible for Risk Management, analysed the commercial and development real estate market. The Bank of Georgia team identified a number of warning signs and red flags:

- Prices had risen rapidly, well ahead of rents and building costs.
- Developers were acting as if property prices were a one-way bet. For instance developers pre-sold property "off the plan" but, rather than use the proceeds to fund building development, they bought more development land.
- It appeared around 2/3 of the residential market was speculative (ie flipping, rather than buying to live).
- Deposit growth slowed markedly as people stopped saving and instead began speculating in real estate.
- Rapid growth was causing management problems for the developers.

Result: Bank of Georgia reduced exposure to the sector early and avoided many of the problems competitors saw in the development area. Through the crisis, Non Performing Loans (NPLs) increased 5 fold to GEL 140m. However, despite reaching 7.7% of gross loans, NPLs remained well covered by balance sheet provisions. The ratio of write offs to prior year impairments also gives comfort that the company was provisioning conservatively through the crisis.

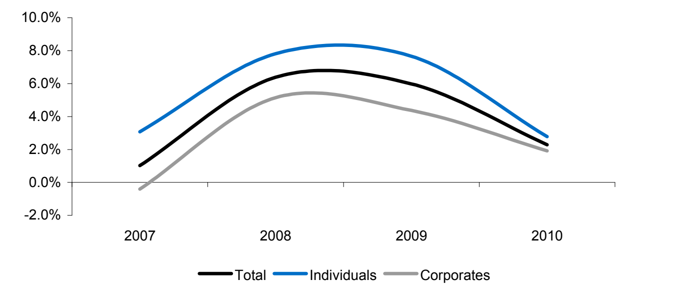
Loan book analysis

GEL (m)	2007	2008	2009	2010
Individuals	699	1080	862	1006
Trade & Services	648	668	549	859
Construction	157	159	151	275
Other commercial	200	239	266	387
Gross loans	1704	2145	1827	2527
B/S Provisions	28.9	106.6	166.5	175.5
Non Performing Loans	25.6	64.4	140.0	117.6
NPLS % of Gross loans	1.5%	3.0%	7.7%	4.7%
B/S provisions/NPLS	113%	166%	119%	149%

Source: Bank of Georgia Financial Reports, Seymour Pierce Ltd

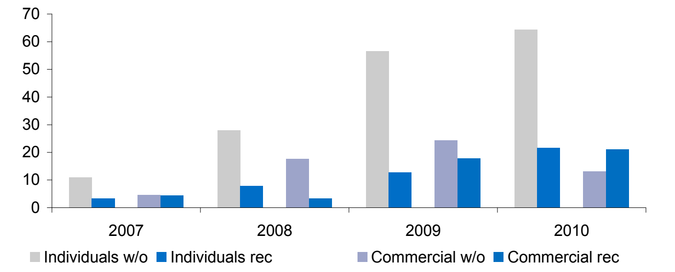
In addition, although Bank of Georgia loan book is highly collateralised, with 92% of gross loans secured against property, inventory or trade receivables, the bank does not do Asset Based Lending. The bank requires collateral security, but still insists on lending against cashflow rather than asset values in the bank's credit approval process.

Bank of Georgia Impairment Charge/Avg Gross Loans



Source: Bank of Georgia Financial Reports, Seymour Pierce Ltd

Write offs to recoveries absolute (GEL m)



Source: Bank of Georgia Financial Reports, Seymour Pierce Ltd

Impairments versus write offs

Between 2007 and 2010 the cumulative impairment charge for the group was GEL 309m, 40% higher than cumulative write offs. Interestingly there was a divergence between lending to individuals and commercial loans. Commercial loan write offs were half the cumulative provision, due to a high level of recoveries. In contrast, the ratio of write offs to individuals relative to recoveries for individuals is perhaps a little disappointing. Possibly this was the provisions charge the company took against individuals was more accurate because their performance was easier to model. However, Bank of Georgia also told us that the collections and recovery process for troubled individual loans was more challenging, because of the administrative difficulties of dealing with a large number of loans going wrong all at the same time. The appropriates systems are now in place though and we would expect the bank to be faster to respond when the credit cycle turns once again.

Movement in Bank of Georgia balance sheet provisions

Movement in Provisions		2007	2008	2009	2010		Cumulative
B/S Provisions	21	28.9	106.6	166.5	175.5		
Non Performing Loans		25.6	64.4	140.0	117.6		
Charge							
Individuals		21.5	69.5	74.4	26		191
Commercial loans		-4.1	53.3	44.4	23.9		118
Total		**17.4**	**122.8**	**118.8**	**49.9**	A	**309**
Recoveries							
Individuals		3.4	7.8	12.7	21.6		46
Commercial loans		4.5	3.3	17.8	21.1		47
Total		**7.9**	**11.1**	**30.5**	**42.7**	B	**92**
Write offs							
Individuals		-10.9	-28	-56.5	-64.4		-160
Commercial loans		-4.7	-17.7	-24.3	-13.1		-60
Total		**-15.6**	**-45.7**	**-80.8**	**-77.5**	C	**-220**
Other *		-1.8	-10.6	-8.7	-6.1	D	-27
Balance of provisions		28.9	106.5	166.4	175.5		154

Source: Bank of Georgia Annual Report, Seymour Pierce Ltd
* Other is interest on impaired loans and currency translation difference
Movement in Balance sheet provisions = Charge (A) plus recoveries (B) less write offs (C) and "other" (D)

Everything we observed and listened to about the Bank's credit process suggested high quality people and processes were involved in credit decisions. The bank has two credit committees one of which supervises and manages the Bank's credit risks in respect of retail loans and one which supervises and manages the Bank's credit risks in respect of corporate loans. Each Credit Committee approves individual loan transactions, and establishes credit risk categories and provisioning rates on such transactions. The Bank uses scorecards to help in the decision making process, and then conducts post event analysis (for instance the higher value GEL 200 000 mortgages turned out to have a worse recovery rate than smaller loans). This post event analysis is then updated and feeds back into the lending and risk assessment process.

Management

We have met both the Supervisory Board and the Management Board (we spent 2 days seeing the company in Tbilisi in September 2011, see Appendix II for full list). Below is a brief outline of both boards. Due to its largely institutional shareholder base the Supervisory Board is market orientated and contains two representatives of minority shareholders (Firebird and East Capital).

Supervisory Board

Neil Janin, Chairman of the Supervisory Board: a Canadian national, Director of McKinsey in its Paris office, where he joined the Firm in 1982. David Morrison, Vice Chairman of the Supervisory Board: spent his legal career at the international law firm Sullivan & Cromwell LLP, where he was a managing partner of the firm's European offices.

Other members of the Supervisory Board include Ian Hague (Firebird Management LLC), Kaha Kiknavelidze (Rioni Capital, former Executive Director UBS) Hanna Loikkanen (East Capital, formerly FIM Group, Nordea), Allan J. Hirst (formerly Citibank for nearly 25 years, primarily leading Central and Eastern Europe business) Al Breach (former Head of Research UBS Russia).

Management Board

The management team consists of internationally trained bankers who returned to Georgia from 2004 onwards. The Chief Executive has over 80% of his wealth in Bank of Georgia shares, and Bank of Georgia does not pay cash bonuses to the management team.

Chief Executive Irakli Gilauri has served as the CEO of Bank of Georgia since May 2006, having previously served as Chief Financial Officer since September 2004. Before his employment with Bank of Georgia, Mr Gilauri was a banker at EBRD's Tbilisi and London offices for five years, where he worked on transactions involving debt and private equity investments in Georgian companies. Mr Gilauri received his undergraduate degree in Business Studies, Economics and Finance from the University of Limerick. He was later awarded the Chevening Scholarship, granted by the British Council, to study at the Cass Business School of City University, where he obtained his Master of Science Degree in Banking and International Finance

Deputy CEO SB Real Estate Irakli Burdiladze, previously served as the Chief Operating Officer of Bank of Georgia since March 2007 to June 2010. Prior to this appointment Mr. Burdiladze has served as the Chief Financial Officer of Bank of Georgia. Immediately prior to joining Bank of Georgia Mr. Burdiladze served as the Chief Financial Officer of GMT Group, a leading real estate developer and operator in Georgia. Mr. Burdiladze has received a graduate degree in International Economics and International Relations from the Johns Hopkins University School of Advanced International Studies in Washington D.C. and is a graduate of the Tbilisi State University with an undergraduate degree in International Relations.

Deputy CEO, Finance, Giorgi Chiladze previously served as General Director of BTA Bank (Georgia) since August 2005. Prior to joining JSC BTA Bank (Georgia), he was an executive member of the Supervisory Board of JSC Europace Insurance Company (2004-2005) and a founding partner of the management consulting firm, Altergroup Ltd. Mr Chiladze had previously worked in the United States at the Program Trading Desk at Bear Stearns in New York City, prior to returning to Georgia in 2003, Mr. Chiladze received a Ph.D. in physics from Johns Hopkins University in Baltimore, Maryland and an undergraduate degree in physics from Tbilisi State University.

Deputy CEO, Corporate Banking Archil Gachechiladze previously served as Deputy Director in charge of Corporate Recovery at TBC Bank, Georgia since August 2008.

Prior to returning to Georgia in 2008, Mr. Gachechiladze worked as an Associate at Lehman Brothers Private Equity (currently Trilantic Capital Partners) in London. From 1998 through 2004, Mr. Gachechiladze worked as Senior Associate at Salford Equity Partners, Senior Analyst at the EBRD in Tbilisi and London, Senior Financial Analyst at KPMG Barents in Tbilisi, and Team Leader for the World Bank's CERMA Project in Tbilisi. Mr. Gachechiladze is CFA Charterholder and member of the CFA Society of the UK. He received an MBA with Distinctions from Cornell University and undergraduate degrees in Economics and Law from Tbilisi State University

Deputy CEO, Retail Banking Mikheil Gomarteli has been appointed as Deputy Chief Executive Officer of Bank of Georgia in February 2009. Mr. Gomarteli has been with Bank of Georgia since December 1997. For the 12 years that he has worked for the Bank Mr. Gomarteli held various senior positions including Head of Banking Products and Marketing (2000-2002); Head of Branch Management and Marketing (2002-2003); Head of Branch Management and Sales Coordination (2003-2004); Head of Strategy and Planning (2004-2005); Head of Business Development (March 2005-July 2005) and Co-Head of Retail Banking (March 2007-February 2009). Mr. Gomarteli holds a Diploma in Economics from Tbilisi State University.

Deputy CEO, Risk Management Sulkhan Gvalia has served as Deputy CEO, Chief Risk Officer since January 2005. Since 1995 Mr. Gvalia served as the Deputy Chairman of the Management Board of TbilUniversalBank (TUB), acquired by Bank of Georgia in November 2004. During his tenure at TUB, Mr. Gvalia spearheaded several departments at TUB, including finance, accounting and strategy. Mr. Gvalia received his undergraduate degree in law from Tbilisi State University.

Deputy CEO Legal Affairs Avto Namicheishvili previously served as the Bank's General Counsel, a position he had held since March 2007. Before joining Bank of Georgia, Mr. Namicheishvili was a partner at Begiashvili & Co. Limited, a leading Georgian law firm, where he acted as the Bank's external legal advisor for three years. Mr. Namicheishvili continues to serve as an arbitrator at the European International Arbitration Court in Georgia. Mr. Namicheishvili received a graduate degree (LLM) in international business law from Central European University, Hungary and undergraduate degrees in law and international economic relations from Tbilisi State University.

Deputy Chief Executive Officer Investments and Strategic Projects Murtaz Kikoria since June 2011 has previously served as Acting CEO of of BG Bank and Deputy Chief Executive Officer of Bank of Georgia, in charge of Compliance. Prior to joining the Bank of Georgia, in August 2008, Mr. Kikoria served as the General Director of Zarapkhana Limited, Georgia's leading jewelry retailer. From 2005 to 2007, Mr. Kikoria served as a Senior Banker at the European Bank for Reconstruction and Development ("EBRD"). Before joining EBRD, Mr. Kikoria served as Head of Banking Supervision and Regulation at the National Bank of Georgia from 2001 to 2005. Prior to joining the National Bank of Georgia, Mr. Kikoria held various senior positions at United Georgian Bank (now VTB Bank (Georgia)) and SilkRoad Bank (now JSC BTA Bank (Georgia)). Murtaz Kikoria also served as the Chairman of Bank of Georgia's Audit Committee since February 2008. Mr. Kikoria received an undergraduate degree from Tbilisi State University in economics, specializing in finance and credit.

Deputy Chief Executive Officer Wealth Management Vasil Revishvili was appointed Head of Wealth Management Unit in December 2008. Mr Revishvili joined the Bank in August 2008 as Head of Structured Products. Prior to joining the Bank, Mr Revishvili worked for four years at Pictet Asset Management in London and Geneva as Head of the Investment Risk Unit and later as a Senior Investment Manager in the Balanced and Quantitative Investment Team. From 1995 to 2003, Mr Revishvili held various positions at EU-TACIS Counterparty Fund, Georgian Investment Centre and World Bank Tbilisi Water Project. Mr Revishvili received an undergraduate degree in applied mathematics and computer sciences from Tbilisi State University and a Masters Degree in Finance with distinction from the London Business School. Mr Revishvili is also a designated Financial Risk Manager by the Global Association of Risk Professionals.

The Banking Environment in Georgia

As of December 31, 2010, the Georgian banking system comprised 19 banks. The total assets of the banking system constituted 50.8% of GDP. The country is open to foreign ownership of banks, with non resident investors holding 84.4% of the equity in the Georgian banking system.

NPLs peaked at 6% (IMF methodology)

Following the financial crisis, Non Performing Loans (NPLs) peaked at 19% in June 2009 though the ratio has dropped rapidly to 12.5% Dec 2010. It should be noted however that the NBG standard of NPLs is considerably stricter than the IMF internationally comparable methodology. On the IMF methodology NPLs peaked at 6% [7] RoE for the banking system was 9.6% in 2010 and RoA was 1.7%. Around 80 percent in the total volume of commercial banks loans are made to Tbilisi based businesses and individuals.

The Georgian Banking System

GEL (mln) otherwise noted	YE 2004	YE 2005	YE 2006	YE 2007	YE 2008	YE 2009	YE 2010
GDP	9,994	11,582	13,639	17,162	18,864	18,028	20,714
Growth (nominal)		16%	18%	26%	10%	-4%	15%
Total Assets	1,699	2,548	4,228	7,208	8,866	8,293	10,564
Growth		50%	66%	70%	23%	-6%	27%
Gross Loans	965	1,730	2,681	4,589	5,993	5,185	6,261
Growth		79%	55%	71%	31%	-13%	21%
-of which consumer	180	296	527	1,135	753	656	827
Growth	#DIV/0!	64%	78%	115%	-34%	-13%	26%
Total Deposits	983	1,538	2,328	3,511	3,845	4,174	5,818
Growth		56%	51%	51%	10%	9%	39%
Retail Deposits	493	718	1,109	1,549	1,859	2,104	2,641
Growth		46%	54%	40%	20%	13%	26%
Banking sector ratios							
Asset/GDP	17%	22%	31%	42%	47%	46%	51%
Loans/GDP	10%	15%	20%	27%	32%	29%	30%
Deposits/GDP	10%	13%	17%	20%	20%	23%	28%
ROA, %	2.40%	3.10%	2.80%	1.90%	-2.60%	-0.80%	1.67%
ROE, %	10%	14.90%	15.30%	9.60%	-12.40%	-4.30%	9.60%
Loans/Assets, %	57%	68%	63%	64%	66%	63%	59%
Loans/Deposits, %	98%	113%	115%	131%	155%	124%	108%
Deposits/Liabilities, %	74%	74%	70%	61%	52%	61%	66%
Product Penetration							
Number of Debit Cards (m)	<100,000	-	1.14	1.89	3.01	3.49	2.58
Number of Credit Cards	0	0	7,632	161,352	549,328	470,484	474,630
Number of ATMs	<150	-	-	864	1,344	1,339	1,501
Number of POS Terminals	<750	-	-	5,255	7,623	7,494	9,398

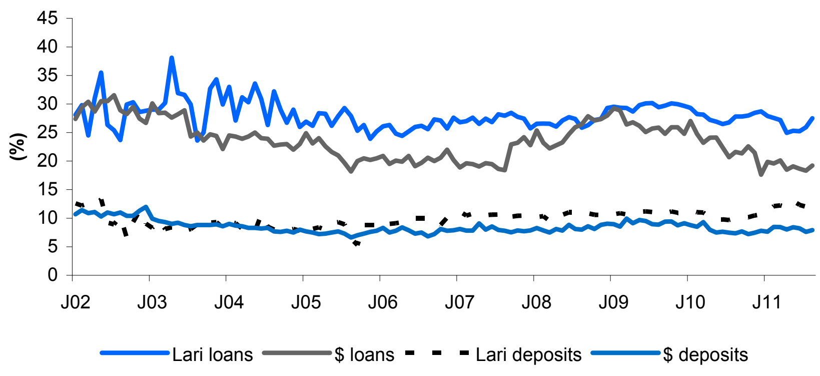
Source: National Bank of Georgia, Seymour Pierce Ltd

75% of banks balance sheets (assets and liabilities) are US dollar denominated

As of September 2011, inflation was 10.9% trending down from a peak of 13.6% earlier in the year. In line with the rest of the Georgian banking system, 75% of Bank of Georgia's loans is currently in dollars, though the Central Bank is keen to reduce the "dollarization" of the banking system, since most of the population earn income in Lari. One way of encouraging more Lari loans is the higher risk weighting (currently 175%) that the Central Bank sets on loans denominated in foreign currency. However, this in turn creates another problem given most customers' caution towards long term deposit saving in the Lari (unsurprising given the country's recent history), but also somewhat ironic given that since the Rose Revolution at the end of 2003, the Lari has appreciated by 50% relative to sterling.

[7] see National Bank of Georgia Annual Report 2009, page 54

Interest rate on loans and deposits (Lari and $)



Source: National Bank of Georgia

Dollarization H1 2010

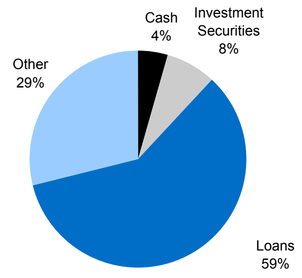
	Balances outstanding	Flows (Q2 2010)
loans	75%	56%
deposits	70%	40%
-term deposits	94%	
-current/demand deposits	48%	

Source: National Bank of Georgia

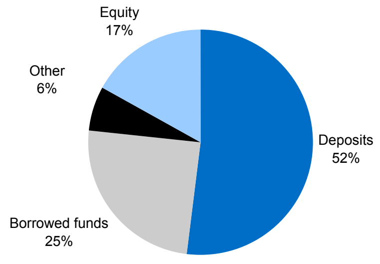
Banks earn interest of 7.5% on Central Bank required reserves

Flows into Lari denominated savings are increasing, again explained by policy from Central Bank. At the start of 2011 the Central Bank increased reserve requirements on foreign currency liabilities from 5% to 15%, but has subsequently reduced the reserve requirements on international borrowings with maturities of more than two years down to zero. The Central bank also raised the reserve requirement on lari denominated funds from 5% to 10% however the impact on net interest margins is mitigated by the fact that banks earn the Central Bank policy rate (currently 7.5%) on these reserves that they are required to hold.

Banking sector assets



Banking sector liabilities



Source: Seymour Pierce Ltd

As of December 2010, the volume of external borrowings in the banking system totalled GEL 1,492 million, or only 7.2% of GDP. International financial institutions and parent companies account for 69% of external borrowings, while the remaining 31% is due to other private sources.

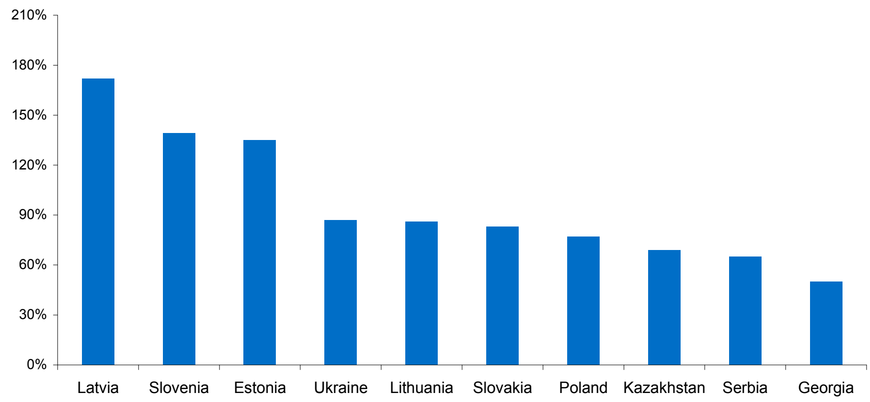
Georgian Banking System Balance Sheet

GEL (m)	Dec-06	Dec-10	CAGR
Cash	204	458	22%
Investment Securities	327	802	25%
Loans	2,673	6,256	24%
Other	1,024	3,048	31%
Total Assets	4,228	10,564	26%
Deposits	2,097	5,489	27%
-demand deposits	1,109	2,524	23%
-enterprises	172	729	44%
-individuals	778	2,074	28%
Borrowed funds	854	2,623	32%
Other	378	665	15%
Equity	898	1,788	19%
Total Liabilities	4,228	10,564	26%
Loans/Deposits	1.27	1.14	
Cash/Total Assets	4.8%	4.3%	
Non deposit financing	29%	31%	

Source: Seymour Pierce Ltd

At 50% bank asset/GDP, financialisation remains low, even compared with other post Soviet countries. Notoriously the UK bank asset/GDP ratio is 500%. But even on a deposit/GDP ratio though Georgia is below 30%, three times lower than UK deposits of 90% of GDP[8].

Comparisons bank assets/GDP



Source: World Bank

Ignoring Western Europe, financial penetration looks low in Georgia compared to countries like Turkey (38% deposits/GDP 48% loans GDP) Lithuania (40% deposits/GDP, 60% loans/GDP) or Estonia (65% deposits GDP/ 100% loans/GDP).

[8] Between 1964 and 1984 UK deposits oscillated between 45% and 60% of GDP (source Adair Turner *What do banks do?)*

Strong Central Bank

All Georgian banks have had their balance sheets well and truly stress tested in the last five years. The loans to deposit ratio for the banking system was 1.56x in 2008 (Bank of Georgia loans/deposits was 1.7x in 2008). Through the financial crisis, rolling over external finance was not exactly helped by the Russian invasion. As we argue above, we think the latter is unlikely to recur - but it is still worth considering how the system and particularly Bank of Georgia coped with these tribulations.

The answer, as the table below shows, is simple: cash. Despite the liberalisation and de-regulation agenda, the National Bank of Georgia (the Central Bank) kept a firm grip on regulation, with stability the key goal at the early growth phase of the banking sector. Before the crisis the Central Bank required an "obligatory reserve requirement" of 13% cash, which it subsequently loosened to 5% in October 2008 at the height of the crisis.

Comparison of balance sheet resilience

	BOG	BOG			
Ratios	2008	H1 2011	Hong Kong	Singapore	Ireland
Cash (inc NBG reserves)/Assets	15.2%	25.3%	8.9%	7.2%	1.0%
Loans/Assets	62.6%	59.2%	43.0%	49.7%	70.0%
Loans/Deposits	1.71	1.17	0.59	0.81	1.46
Deposits + tangible equity/Total liabilities	0.54	0.68	0.79	0.68	0.52
Revenue/Deposits	28.2%	18.5%	3.6%	4.1%	5.2%
Revenue/Total Liabilities	10.3%	9.3%	2.6%	2.5%	2.5%

Source: Seymour Pierce Ltd

Hong Kong banks are Hang Seng, Wing Han and Bank of China (HK)

Singapore banks are DBS, OSBC, UOB

Irish Banks are Bank of Ireland, Allied Irish, Anglo Irish

The Central Bank also has a distinct capital adequacy calculation methodology, which requires loans made in foreign currency to be risk weighted at 175% (200% before the crisis). On this NBG methodology Bank of Georgia's tier 1 was 13.2% in 2007 rising to 16.6% in 2008 (following a $100m or 15% capital raise of new ordinary shares in February 2008). This translates to a "normal" Basel I ratio of over 25% in 2008. The NBG requires a 12% minimum total capital ratio on their methodology.

Capital Ratios, National Bank of Georgia v Basel

	2007	2008	2009	2010
NBG methodology				
Core	369	573	535	494
Supplementary	163	162	270	423
Less: Deductions	-166	-269	-347	-367
Total	366	466	458	550
RWA	2,796	3,458	2,717	3,800
NBG weighting foreign currency denominated loans	200%	175%	150%	175%
Core	**13.2%**	**16.6%**	**19.7%**	**13.0%**
Total capital	**13.1%**	**13.5%**	**16.8%**	**14.5%**
Basel Capital Ratios				
Tier 1	465	638	549	638
Tier 2	160	273	370	405
Less: Deductions	-215	-134	-67	-71
Total	409.8	777	851	972
RWA	1,859	2,951	2,454	3,653
Tier 1	**25.0%**	**21.6%**	**22.4%**	**17.5%**
Total capital	**22.0%**	**26.3%**	**34.7%**	**26.6%**
NBG / Basel				
Tier 1	0.8	0.9	1.0	0.8
Total	0.9	0.6	0.5	0.6
RWA	1.5	1.2	1.1	1.0

The Central Bank is also responsible for consumer protection. Recent competition for a relatively small pool of mortgage customers from Societe General's subsidiary, has led to downward pressure on net interest margins. One response was for banks to make switching costly, by raising pre-payment penalties. The NBG has now limited pre payment penalties to not more than 2%.

We asked the Central Bank how they think about the trade off between competitiveness and financial stability. The response was that both are something they watch, for signs of trouble. Despite the highly concentrated market, we got the impression that banks are not viewed as earning excess profits currently. The Central Bank is not keen to intervene directly, but instead would call banks representatives round for a chat to "show banks the consequences of being too aggressive with their lending".

Central Bank responsible for both financial stability and consumer protection

There is a wish to make sure consumers' have enough information to make informed decisions (the NBG published *Regulation on Provision of Necessary Information to Consumers of Banking Services*). The NBG has also set up a separate unit for protecting consumers' rights (website http://nbg.gov.ge/cp).

A credit bureau exists where data is shared (both positive and negative information) among banks has been in existence since 2005. The environment is very "lender friendly". There is a debtor register agency, with information shared among banks and the police. If a loan secured on a car is in default, the police have the ability to pull a driver over and confiscate the vehicle. In addition the collections process has been streamlined, with the onus of proof on the borrower to prove to appeal against a notary's decision.

Competition

We detail below the main competitive environment. HSBC made an attempt to enter the market around 5 years ago, but has since retreated. The decision was a result of the 5-filter portfolio review initiated by the new Chief Executive. It was mainly because the bank was seen as subscale (2010 the HSBC Georgia had less than $10m of revenue and less than $2m of profit). A full withdrawal is planned for early 2012.

Meanwhile, Bank Republic, a Societe Generale subsidiary has not fared much better. The bank has achieved the dubious achievement of recording 4 consecutive years of negative RoE, meanwhile also losing market share in both loans and deposits.

Soc Gen

Negative RoE and falling market share

Republic (Soc Gen)		2008	2009	2010	2011
RoE	(%)	-7.3	-4	-42	-26
RoA	(%)	-1	-0.5	-4.3	-3.5
Market share					
Loans	(%)		10.1	6.4	5.9
Deposits	(%)		11.3	8.5	6.5

Source: Bank Republic website, Seymour Pierce Ltd

VTB, the Moscow based corporate bank, is following a niche strategy, focusing on large corporate (eg mining companies) transactions, settlements and cross sales of investment banking products. By 2013, the bank is aiming at 15% RoE across the group.

All this suggests that Georgia is a competitive market, but that it is hard for even well run international banks like HSBC[9] to compete effectively. Investors familiar with concentrated banking markets should feel reassured that none of the smaller market share banks are attempting to "do a Northern Rock" focussing on a volume growth and market share led strategy.

Competition

Bank	Branches	Retail customers	Customer per Branch	Deposits	Deposit Marketshare	Deposit growth H1 11 v H1 10	Loans/ Deposits
Bank of Georgia	143	793,275	5,547	2,004	35%	54%	1.17
TBC	45	500,000	11,111	1,365	27%	38%	1.00
ProCredit	58	436,898	7,533	454	7.80%	57%	1.24
Republic (Soc Gen)	37			431	7.40%	-14%	1.00
Liberty Bank	193	1,300,000	6,736	480	8.50%	25%	0.39
VTB	15			169	2.90%		

Source: Annual Reports, Seymour Pierce Ltd

[9] we hesitate to describing Soc Gen as "well run"

TBC Bank

With 45 Branches and less than 500 000 clients TBC is the second largest bank in Georgia, primarily focussed on large corporates (59% of net profit) and SME (24% of net profits). Currently retail banking is 17% of net profit. As many of the retail banking customers come through the SME banking relationship, the retail clients tend to be higher net worth individuals. TBC has 27% market share of total deposits, and 25% market share of net loans, the bank is active in trade finance.

TBC bank

TBC Highlights	GEL (m)	Growth
	FY 2010	y-o-y
Revenue	193	8%
PBT	59.6	945%
Loans	1548	40%
Deposits	1365	38%
Total Assets	2268	30%
Cost / income	55%	
RoE	14%	
Tier 1	21.8%	

Source: Seymour Pierce Ltd

Management

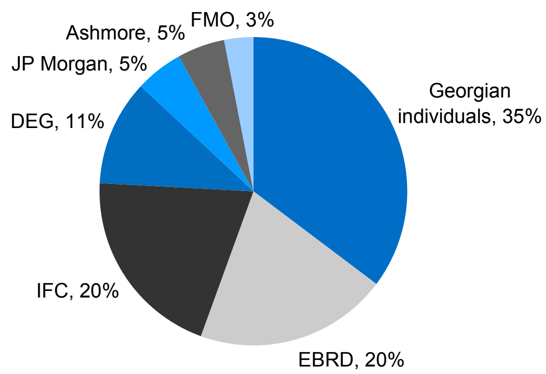
Chair: Mamuka Khazaradze - Mamuka is the founder and Chairman of Lisi Lake Developments, prior to that he was president and founder of Borjomi Beverages and the Georgian Reconstruction Company. He has been chairman since TBC was established in 1992.

CEO: Vakhtang Butskhrikidze - Appointed in 1995, Vakhtang is also on the board of the Association of Banks of Georgia and the Georgian Stock Exchange and the Business Association of Georgia. TBC has been winning market share in deposits (24% H1 2011 up from 211% year end 2009) and loans (25% H1 2011 v 22% year end 2009).

Owners

The largest single owner are two development banks: the EBRD and International Finance Corporation (IFC) who both own 20%, but Georgian individual shareholders in aggregate own 35%.

Shareholder structure



Source: Seymour Pierce Ltd

Procredit Bank

ProCredit Georgia is development orientated bank, 100% owned by a holding company based in Frankfurt am Main, Germany. The holding company was founded in 1998 as Internationale Micro Investitionen AG, ProCredit group consists of 19 banks operating in transition economies and developing countries in Africa, Latin America and Eastern Europe. The shareholders of the holding company are Dutch DOEN Foundation, TIAA CREF, KfW (the German development bank,) IFC (the private sector arm of the World Bank).

Their core business is the provision of formal credit to micro and small enterprises. Rather than profit maximisation ProCredit promotes responsible banking and sustainable returns. The bank undertakes to contribute to overall financial literacy and foster a culture of savings. The bank's minimum loan amount is currently $2000, and encourages borrowers to use the money for investment rather than consumption.

Procredit Highlights

ProCredit	GEL (m)	Growth
	FY 2010	y-o-y
Revenue	82	5.3%
PBT	24.4	4%
Loans	594	11%
Deposits	480	25%
Total Assets	863	20%
Cost / income	68%	
RoE	19%	
Tier 1	20.0%	

Source: Seymour Pierce Ltd

The bank has 58 branches across Georgia and 1,640 employees. In total the bank has 49 thousand loans outstanding (average loan size is $6,700) and 436 000 deposit scounts. The bank has around 7% market share, and loans to deposit ratio of 1.24x. ProCredit is the only bank that deals with individual farmers and holds 50% of the country's lending to the agricultural sector – an area that is tricky to assess for credit-worthiness because of the small size of plots, the seasonality of crops and changes in agricultural cycles. The sector's growth has also been stymied by a lack of production and storage facilities.

CEO: Maya Meredova – Appointed in 2010, Maya has had a variety of roles with ProCredit in a number of countries. Before joining the Georgia team, she worked in ProCredit Bank Serbia and in ProCredit Bank Moldova. She had previously worked as a bank adviser in EBRD's Micro and Small Enterprise Facility in Kyrgyzstan and for the World Bank as a consultant specializing in private and financial sector development in Europe and Central Asia regions.

Liberty Bank

Liberty Bank is the fourth largest bank in Georgia (by total assets) with chequered history but a new management team with an accomplished track record now in place. The bank is the successor to the state-owned "AgroMretsvBank" which was privatised in 1995, renamed the "People's Bank of Georgia" in 2002. In 2008-9 aggregate losses amounted to 86% of equity and People's Bank needed rescuing. Previous management were removed and Liberty Capital acquired 91% and injected capital, plus the National Bank of Georgia gave new management a waiver on capital requirements (Basel I total capital ratio was minus 7.4% in September 2009, recovering to 13.6% June 2011). No Georgian bank received tax payer support or equity injections.

The bank was re-named Liberty Bank in 2010. The bank has 1.3m retail clients and 193 branches. Loans/Deposit ratio is 49% and liquidity ratio is 37%. The retail franchise is based around being the sole distributor of pension and welfare payments for the Government. However this franchise expires in 2012, and management have sought to ensure that the bank is not overly reliant on this income stream, expanding into the corporate and private banking space. The bank is also number 2 player in the payroll market and has 40% market share of Georgian remittances from overseas. Liberty Bank sees the firm's strongest growth in the retail sector, where it has implemented a slew of innovative products including a gift card that can be redeemed at dozens of participating retailers to capitalise on the country's gift-giving culture.

Liberty Bank

Liberty	GEL (m)	Growth
	FY 2010	y-o-y
Revenue	63	53%
PBT	4.7	n/a
Loans	157	94%
Deposits	357	76%
Total Assets	531	65%
Cost / income	73%	
RoE	22%	
Tier 1	5%	

Source: Seymour Pierce Ltd

Chief Executive of Liberty Bank

Lado Gurgenidze is the Chief Executive of Liberty Bank. Previously he served as Executive Chairman and CEO, at Bank of Georgia between 2004 and end 2006. At that time Bank of Georgia saw rapid expansion including in companies outside the financial sector and overseas acquisitions. After departing from Bank of Georgia, in 2007-2008, Lado served as Prime Minister of Georgia overseeing tax cuts, financial services sector reform as well as aggressive privatisation and liberalisation policies. Since stepping down as Prime Minister, Lado has been a frequent public speaker on issues of economic liberty and free-market reforms in developing countries. In August 2009, he was invited to join, as Chairman of the supervisory board of Bank of Kigali, the largest bank in Rwanda. Then in September 2009 he established, together with Dinu Patriciu, Liberty Investments, and announced the acquisition of a controlling equity interest in the former People's Bank, changing the name to Liberty Bank.

Valuation comparisons

The table below shows a sample of Kazakh, Russian, Turkish and Eastern European banks. We are somewhat sceptical on comparisons based on geography: very few would suggest that Austrian, Swiss and Italian banks are comparable. Similarly Singapore, Malaysian and Indonesian banks are very different beasts – we include the table more for the sake of completeness than to suggest Bank of Georgia should trade in line with the group.

Comparisons

		P/E			P/Book			RoE		
	Price	2011F	2012F	2013F	2011F	2012F	2013F	2011	2012	2013
Halyk	230	6.4	4.6	n/a	1.04	0.87		16	19	NA
Kazkommertsbank	260	6.5	3.7		0.53	0.50		6	9	13
Kazakh Banks		**6.5**	**4.1**		**0.8**	**0.7**		**10.6**	**13.8**	
VTB GDR	4.14	6.6	6.0	4.7	1.02	0.89	0.79	15	16	18
Sberbank	2.18	4.6	4.4	4.0	1.13	0.93	0.81	27	23	22
Russian		**5.6**	**5.2**	**4.3**	**1.1**	**0.9**	**0.8**	**20.9**	**19.5**	**19.8**
Garanti	7.24	9.6	9.1	8.5	1.66	1.45	1.29	18	17	17
Akbank	7.34	10.9	10.2	9.1	1.55	1.41	1.27	15	15	15
Turkish		**10.3**	**9.6**	**8.8**	**1.6**	**1.4**	**1.3**	**16.6**	**15.9**	**16.2**
PKO	32.9	10.2	8.8	8.0	1.76	1.58	1.44	18	19	19
OTP	3248	5.8	4.6	4.0	0.63	0.56	0.52	11	13	14
Hungary/Poland		**8.0**	**6.7**	**6.0**				**14.6**	**15.8**	**16.4**

Source: Seymour Pierce Ltd

Primarily the investment case on any bank should rest on the economic prospects (not the same thing as an endowment of resources or a large population) of the country, but we also show balance sheet ratio comparisons because even within the same country, banks can have a very different balance sheet structure. Kazakh banks, despite having similar tier 1 ratios, clearly have a very different balance sheet structure, in terms of cash/ total assets and loans/deposit ratio.

Other Balance sheet metrics

	Tier 1	Cash/Total assets	Loans/Deposits	Revenue/Deposits
Halyk	17.3%	18.7%	0.77	8.1%
Kazkommertsbank	16.2%	2.3%	1.44	4.3%
VTB GDR	14.7%	6.4%	1.26	7.6%
Sberbank	11.9%	8.3%	0.83	10.0%
Garanti	14.2%	6.1%	0.89	10.4%
Akbank		5.4%	0.80	9.1%
PKO		3.6%	0.98	7.4%
OTP	14.6%	5.2%	1.16	4.2%

Source: Seymour Pierce Ltd

And we also show the valuation relative to UK banking peers – again not because we think the stock is similar, but because as an investment case it should be compared to other opportunities that UK fund managers can invest in.

Valuation versus UK peers

(p) unless otherwise stated				PER			P/TB		
	Price		Target Price	2010	2011	2012	2010	2011	2012
Bank of Georgia	$12	BUY	$17	7.74	4.95	4.45	1.17	0.97	0.83
Barclays	179	HOLD	290	6.6	5.8	5.4	0.54	0.50	0.48
HSBC	524	BUY	800	11.7	9.6	8.1	1.36	1.27	1.19
Lloyds	36	HOLD	50.4	-15.6	19.8	10.1	0.61	0.65	0.57
RBS	26	Reduce	40	4.1	5.7	5.8	0.51	0.50	0.48
Stan Chtd	1411	BUY	2020	11.6	10.6	9.6	1.87	1.67	1.36

Source: Seymour Pierce Ltd

The table below shows that Bank of Georgia has the lowest risk balance sheet in the FTSE. Although Loans/Deposit ratio is higher than that of Standard Chartered and HSBC, the liquidity ratio plus tier 1 ratio show how resilient the balance sheet is.

Ratio comparison

	NIM	Tier 1	Liquidity	Loans/Deposits	Loans/ Total Assets	Revenue/ Deposits
Bank of Georgia	7.30%	18%	25%	1.17	59.2%	18%
Barclays	n/a	14%	9%	1.18	29.6%	8%
HSBC	2.54	12%	6%	0.79	38.6%	5%
Lloyds	2.07%	12%	10%	1.47	60.0%	5%
RBS	1.97%	14%	11%	1.14	33.9%	7%
Stan Chtd**	2.30%	14%	???	0.79	46.2%	3%

Source: Seymour Pierce Ltd

*Cash and eligible Central Bank reserves, STAN claims a 26% liquidity ratio, though we are not sure if this under the FSA definition

The liquidity ratio is harder to compare with UK banks, as there are different definitions of liquidity. Bank of Georgia liquidity ratio is 25% of total assets, of which 10% is either cash or held at their Central Bank as a mandatory reserve. In the UK the FSA has a definition of eligible assets that can be held as liquidity (UK Gilts, US Treasuries, Euro AAA government debt, unencumbered cash balances held at central banks) which we show for the UK banks.

Appendix I

Who we met

Bank of Georgia Management

Irakli Gilauri - CEO of Bank of Georgia

Giorgi Chiladze - Deputy CEO Finance

Thea Jokhadze - Head of Funding

Archil Gachechiladze - Deputy CEO in charge of Corporate Banking

Teona Mikadze - Head of SOLO (Personal Banking)

Sulkhan Gvalia - Deputy CEO in Charge of Risk Management

Irakli Burdiladze - Deputy CEO in charge of real estate

Vasil Revishvili - Deputy CEO in charge of Wealth Management

Nick Gamkrelidze - CEO Aldagi BCI (insurance subsidiary)

Avto Namicheishvili - Deputy CEO Legal Affairs

Other meetings in Tbilisi

Mr. Dimitri Ghvindadze - Minister of Finance

Archil Mestvirishvili - Vice President of NBG

Vakhtang Burtskhrikidze - CEO, TBC Bank

Lado Gurgenidze - Liberty Bank

Archil Kontselidze - CEO, VTB Bank

Zaza Bibilashvili and Lasha Gogiberidze - (BCI Lawyers)

Edward Gardner - IMF Representative

Matt Whatley - EU Monitoring Mission

Monica Ellena (former Bloomberg journalist, now working freelance in Tbilisi. She has written on Georgian and Armenian banks for The Banker).

Appendix II

National Bank of Georgia RWA methodology

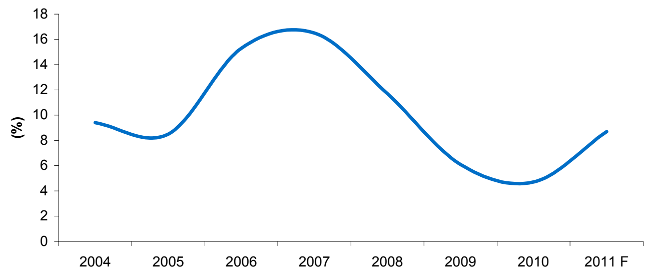
National Bank of Georgia	Basel I
According to the Georgian legislation, capital adequacy ratios (Tier I and Total Capital) must be not lower than 8 and 12 percent.	According to the Basel I Capital Accord, minimum capital adequacy ratios (Tier 1 and Total Capital) not lower than 4 and 8 percent.
Revaluation reserves of bank premises (component of the shareholders equity) are not allowed to participate in regulatory capital.	Revaluation reserves of bank premises, at the discretion of the super-vision, may be included in Tier II capital.
Credit risk weight for assets like claims guaranteed by treasury bills issued by the Ministry of Finance would be 20%.	These types of assets are risk weighted at 0%.
Credit risk weight for Claims directly and unconditionally guaranteed by the Ministry of Finance (or any other state agency considered under the legislation) is 50%.	These types of assets are risk weighted at 0%.
Claims directly and unconditionally guaranteed by the local government of Georgia and the OECD countries and claims guaranteed with debt securities issued by local governments (municipalities) of Georgia and OECD countries are risk weighted at 50%.	These types of assets are risk weighted at 10 and 20 percent respectfully.
Total loans are risk weighted at 100%.	Loans fully secured by mortgage on residential property that is rented or is (or is intended to be) occupied by the borrower will be recognized by the application of a 50% risk weight.
Banks' loans, accounts receivables and accrued interest receivables dominated in foreign currency (except, repayment source for which is documented foreign currency receivables from exports and/or which are secured by pledged foreign currency deposits in the same bank) are subject to FX risk weighting. **FX risk weighted assets correspond to additional 75% risk category – that is 175% risk weighted.**	No additional requirement for FX risk weighting.
Since only specific reserves are excluded from RWA, even if loan is loss and provisioning is 100%, till the loan stays on balance sheet it is still subject to FX weight.	No additional requirement for FX risk weighting.
CAR by NBG standard: 19% - December 2009 16% - December 2007	CAR by Basel I standard: 26% - December 2009 30% - December 2007

Appendix III

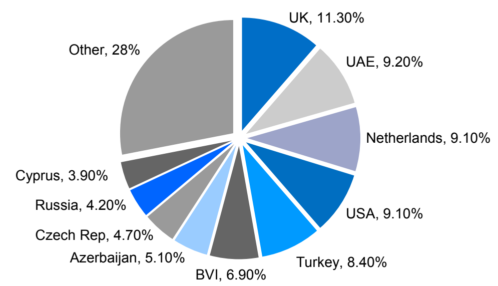
Healthy Government finances and FDI

Despite the low tax rates, tax revenue is 23% of GDP, and Government expenditures (capital and current) are 34% of GDP. Government current expenditure is capped at 30% of GDP and the budget deficit is capped at 3% of GDP. Government debt is currently 46% of GDP and is capped at 60% of GDP by law. Following the 2008 conflict, donors such as the World Bank, EBRD, Asia Development Bank pledged $4.5bn of support. This "Brussels Pledge" money has now been received, with just under half being spent on urban, energy and transport infrastructure. Absorption of these funds into the economy will continue for the next few years, boosting economic activity and generating jobs.

FDI as % of GDP



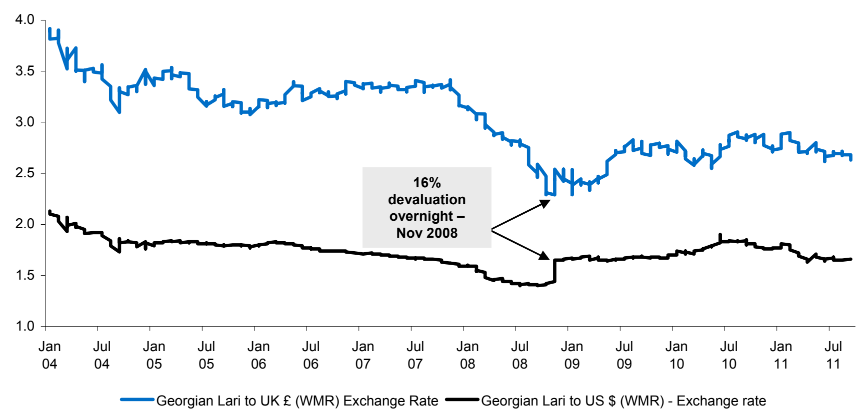
FDI breakdown by country



Source: Georgia Government

Fiscal discipline and market orientated reform has been recognised by the rating agencies, with Standard & Poor, Fitch rating both foreign and local currency government debt B+, Moody's rating the country Ba3. Cumulative Foreign Direct Investment between 2004-2010 has reached $6.9bn. These reforms have also been reflected in the currency, which has strengthened against both the USD and GBP since 2004.

Lari exchange rate (USD and GBP)



Source: Datastream

Just 3% of Georgians admitted to having paid a bribe in the last 12 months

Georgia currently ranks 68th, one place below Italy and above Brazil, India, China and Russia in Transparency International's Corruption Perception Index. According to Transparency International just 3% of Georgians admitted to having paid a bribe in the last 12 months (compared to 4% in Canada, 5% in the US and 13% in Italy).

Georgia ranks well ahead of neighbours and other countries in the region, which have the blessing (curse?) of being resource rich. If Georgia can develop strong institutions and political stability to be the regional hub in the region, this is likely to benefit the financial system.

World Bank - Ease of doing business ranking

Georgia	12
Armenia	48
Azerbaijan	54
Turkey	65
Russia	123
Iran	129
Ukraine	145

Source: World Bank

League tables only tell you so much. The dramatic progress made since the Rose Revolution has been politically driven, but we believe there is also a cultural element, with corruption and rent seeking being associated with the discredited past ideologies of communism and Russia, while fair dealing is associated with economic progress, the West and the future. The intention of the London listing is neither regulatory arbitrage, nor an attempt to shop around for the stockmarket where banks trade on the most generous price to book multiple (obviously!) but instead is recognition of how much progress has been made since 2004.

And although we would not want to overplay the Georgian cultural tradition of trade, we think it is appropriate to quote Sir Fitzroy Maclean, who visited the country a dozen times, and observed in 1976:

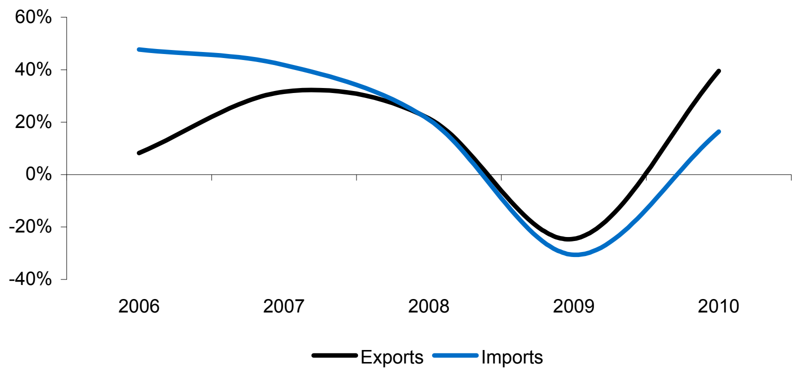
Georgians are tremendously unlike Russians

> *The Georgians are tremendously unlike the Russians and their language which they speak at a great rate is as different from Russian is as Chinese is from English. This, and much else besides, the Russians are inclined to find bewildering. One is always being told, in awed tones, terrifying tales of Georgian business acumen. The story, for example, of the operator who, by simply booking a plane to fly masses of mimosa from the Black Sea to Moscow, selling it an enormous profit to the flower-starved Muscovites and then flying back with a cargo of Dresden China from East Germany for sale at an equally large profit in Tbilisi.* [10]

[10] Sir Fitzroy Maclean *To Caucasus 1976*

The structure of Georgian trade

Import/Export Growth



Source: Seymour Pierce Ltd

Trade has recovered strongly since the Russian conflict and the collapse of Lehmans. Georgia imported $6.2bn of goods and services in 2010 and exported $3.8bn. The current account deficit (which traditionally was determined by the trade deficit) in 2010 was 9.6% of GDP the lowest since 2005.

Net exporter of electricity

Traditionally the main export of Georgia is ferroalloys (eg manganese ore) with their exports doubling from the previous year to equal USD 263.9 million in 2010. This was caused by both physical volumes increasing and a rise in prices of ferroalloys, as the export price grew 43.6%. The re-export of motor cars followed in the list. The annual growth rate of metal scrap export grew 72%, totalling USD 109.4 million. Pleasingly in 2010 the export of electricity significantly increased due to hydro power plants' reconstruction, posting an 82.1% annual growth.

Trade with EU growing at 36% per annum

Georgian largest trading partner by imports is Turkey, with which it has a Free Trade Agreement. According to the most recent data from the National Statistics Office of Georgia, in January-August, 2011, Georgian foreign trade turnover with EU countries increased by 36% and amounted to $1.5bn (26% of total trade turnover).

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Rating	Definition
Buy	Absolute return expected to be more than 10%
Add	Absolute return expected to be between 5% and 10%
Hold	Absolute return expected to be between -5% and +5%
Reduce	Absolute return expected to be between -5% and -10%
Sell	Absolute return expected to be less than -10%

As from 25 October 2010 the nomenclature of our recommendation was changed. Prior to that time Add recommendations were described as Outperform and Reduce recommendations were described as Underperform.

As at 30 September 2011 the distribution of all our published recommendations is as follows:

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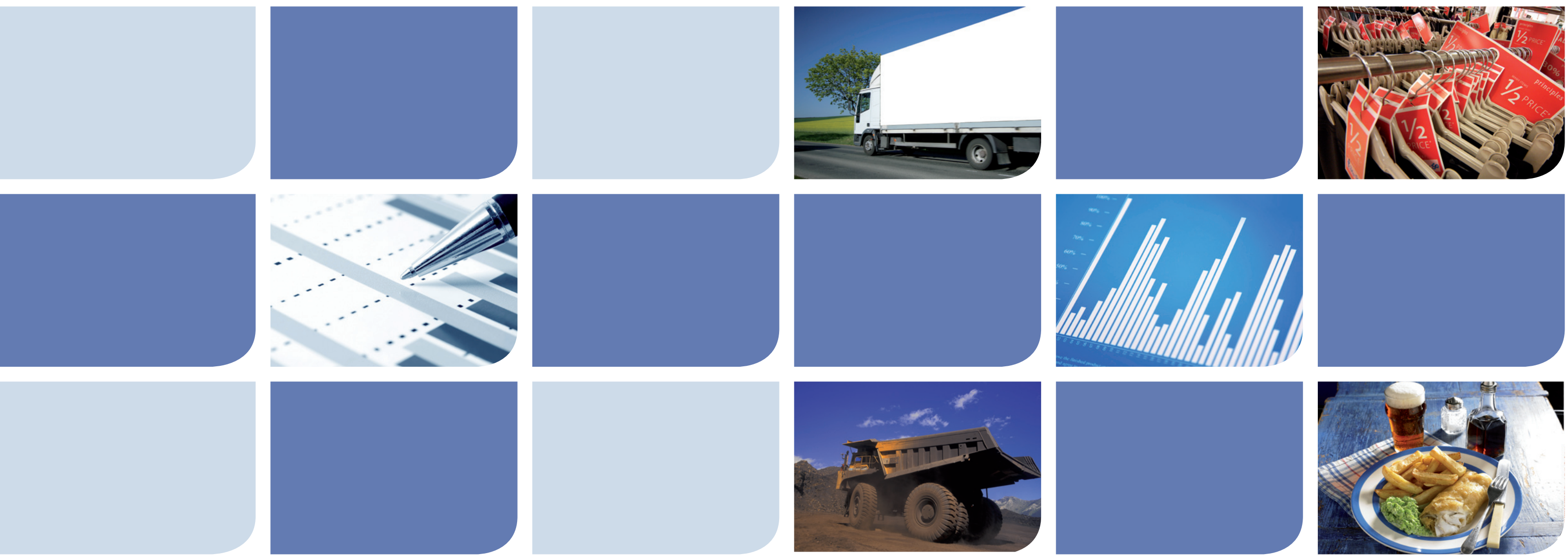

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