

## CREDIT OPINION

5 July 2016

Update

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### RATINGS

Corporacion Financiera de Desarrollo S.A.

|                  |                                |
|------------------|--------------------------------|
| Domicile         | Lima, Peru                     |
| Long Term Rating | Baa2                           |
| Type             | LT Issuer Rating - Fgn<br>Curr |
| Outlook          | Stable                         |

*Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.*

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# Corporacion Financiera de Desarrollo S.A.

## Semi-Annual Update

### Summary Rating Rationale

Moody's assigns a standalone baseline credit assessment (BCA) of b1 to Corporación Financiera de Desarrollo S.A. (COFIDE), 99% owned by the Republic of Peru via its holding company FONAFE, the National Fund for the Financing of State Entrepreneurial Activities. The standalone BCA reflects the moderate loss absorption capacity of COFIDE's capital, its large and increasing exposure to project finance risk, its increasing leverage, and modest earnings generation.

Capitalization is a key constraint to the standalone credit assessment, due to COFIDE's illiquid investment holdings, including the Peruvian government's shares in the Corporación Andina de Fomento (CAF, rated Aa3) that comprise one quarter of the balance sheet and reduce tangible equity. Internal capital generation is also limited by modest profitability, due to low margins and high operating costs relative to revenues. Nevertheless, total capital increased by 3% during the 1Q2016, comparing with YE2015. The tangible common equity to tangible assets ratio maintained flat at 17.5% in the same period.

The rating also captures the sizeable and increasing project risk taken on by COFIDE, as a significant portion of the lending book is devoted to infrastructure projects as part of its mandate. Although COFIDE lends to such projects through financial institutions, it retains the full project risk exposure equal to its funding participations. COFIDE's portfolio of infrastructure loans has grown significantly, as well as its leverage as the entity continues to raise funds to support loan growth.

Infrastructure finance will be an important growth driver in the banking sector in the coming quarters in the country. Although Peru's gross investment ratio is among the highest in the region, at 26% of GDP, the country infrastructure needs generate an opportunity for COFIDE, as the development bank plays an important role.

Moody's also assigns COFIDE Baa2 long-term local and foreign currency issuer ratings. The issuer ratings are based on the b1 standalone BCA that benefits from five notches of uplift to reflect our assumption of a very high probability of support from the Peruvian government. This assumption is based on its ownership and financial linkages as well as COFIDE's public policy mandate to help promote economic growth by financing targeted sectors such as infrastructure and SMEs. The positioning of COFIDE's issuer ratings below Moody's A3 country rating for Peru reflects the lack of an explicit guarantee by the government as well as COFIDE's relevance as a project and SME lender within the Peruvian economy.

## Credit Strengths

- » Capital has moderate loss absorption capacity
- » High probability of support from the government due to ownership, policy mandate, and financial linkages

## Credit Challenges

- » Large and increasing exposure to long term project finance
- » Increasing leverage and weak liquidity
- » Modest profitability pressured by low margins and high operating costs relative to earnings

## Rating Outlook

The outlook on all ratings is stable.

## Factors that Could Lead to an Upgrade

Upward movement in COFIDE's standalone BCA would hinge on significant improvement in tangible capital and maintenance of good asset quality. An upgrade of the issuer ratings would hinge on multi-notch upgrades of COFIDE's standalone rating.

## Factors that Could Lead to a Downgrade

Downward pressure on the standalone BCA could result from a significant decline in capitalization or asset quality. A downgrade of the issuer ratings would occur with a downgrade of the sovereign ratings.

## Key Indicators

Exhibit 1

### Corporacion Financiera de Desarrollo S.A. (Consolidated Financials) [1]

|  | 3-16 <sup>2</sup> | 12-15 <sup>2</sup> | 12-14 <sup>2</sup> | 12-13 <sup>2</sup> | 12-12 <sup>2</sup> | Avg.                 |
|--|-------------------|--------------------|--------------------|--------------------|--------------------|----------------------|
| Total Assets (PEN million)                                       | 13505.1           | 13545.2            | 9714.8             | 8110.6             | 6863.7             | 18.4 <sup>3</sup>    |
| Total Assets (USD million)                                       | 4056.0            | 3970.5             | 3263.8             | 2900.1             | 2689.0             | 10.8 <sup>3</sup>    |
| Tangible Common Equity (PEN million)                             | 2362.1            | 2370.9             | 1890.0             | 1876.6             | 2258.6             | 1.1 <sup>3</sup>     |
| Tangible Common Equity (USD million)                             | 709.4             | 695.0              | 635.0              | 671.0              | 884.9              | -5.4 <sup>3</sup>    |
| Problem Loans / Gross Loans (%)                                  | 0.8               | 0.7                | 2.5                | 0.0                | 0.1                | 0.8 <sup>4</sup>     |
| Tangible Common Equity / Risk Weighted Assets (%)                | -                 | 20.0               | 117.3              | 27.8               | 43.6               | 52.2 <sup>5</sup>    |
| Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%) | 1.9               | 1.9                | 5.8                | 0.1                | 0.1                | 2.0 <sup>4</sup>     |
| Net Interest Margin (%)  | 1.2               | 1.7                | 1.9                | 2.5                | 2.3                | 1.9 <sup>4</sup>     |
| PPI / Average RWA (%)  | -                 | 1.8                | 1.6                | 1.8                | 2.2                | 1.9 <sup>5</sup>     |
| Net Income / Tangible Assets (%)                                 | 0.8               | 0.6                | 0.8                | 0.9                | 1.1                | 0.8 <sup>4</sup>     |
| Cost / Income Ratio (%)  | 33.6              | 35.1               | 48.2               | 36.3               | 38.1               | 38.2 <sup>4</sup>    |
| Market Funds / Tangible Banking Assets (%)                       | 67.3              | 68.9               | 62.2               | 65.2               | 60.4               | 64.8 <sup>4</sup>    |
| Liquid Banking Assets / Tangible Banking Assets (%)              | 50.9              | 45.1               | 45.5               | 41.2               | 15.1               | 39.5 <sup>4</sup>    |
| Gross loans / Due to customers (%)                               | 72695.2           | 3364.1             | 2704.6             | 7239.0             | 19780.9            | 21156.8 <sup>4</sup> |

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel II; LOCAL GAAP [3] Compound Annual Growth Rate based on LOCAL GAAP reporting periods [4] LOCAL GAAP reporting periods have been used for average calculation [5] Basel II & LOCAL GAAP reporting periods have been used for average calculation  
Source: Moody's Financial Metrics

## Detailed Rating Considerations

Detailed considerations on COFIDE's ratings are as follows:

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**CAPITAL HAS MODERATE LOSS ABSORPTION CAPACITY**

CAF shares held on COFIDE's balance sheet totaled \$703.3 million and absorbed most of tangible equity of \$817 million, thus limiting its loss absorption capacity for the loan and investment books. Partly offsetting this risk are loan loss reserves totaling \$193 million that are in excess of reported problem loans. This capital constraint is being progressively alleviated to a degree, given significant efforts by COFIDE's board of directors to increase capital. The Board approved the retention of 60% of the company's 2014 and 2015 earnings. More significantly, the 2015 Public Debt Law published in December 2014 provides for the capitalization of multilateral borrowings totaling PEN 425.3 million (\$142.27 million) effective in January 2015. Taking into account the capitalization of these liabilities and the company's net income, the CAF shares will be less of a constraint on tangible equity, but will still represent a high 85%.

Further, capital has been supported by periodic capital injections from the government to support loan growth. The latest materialized in June 2015 when COFIDE received PEN 31.2 million. COFIDE's BIS capital complies with Peruvian capital regulations. The capital ratio has decreased to 30.5% as of YE2015 from 44.1% at year-end 2014, which reflected the entity's loan expansion. During 2015 total lending expanded by 22.7%. However, during the 1Q2016 there was a contraction of 13.8% comparing with December 2015 largely due to loan pre-payments related to energy sector.

**LARGE AND INCREASING EXPOSURE TO LONG TERM PROJECT FINANCE**

COFIDE's asset quality metrics are solid, with nonperforming loans (NPLs) at 0.8% of total loans as of March 2016. Reserves covered 9.5% of total loans as of March 2016, higher than the 4.2% for commercial banks, indicative of the higher risk associated with long term project finance. Low non-performing loan levels reflect the view of COFIDE as a preferential creditor by its borrowers as well as its conservative risk management practices. Outstanding NPLs to date are legacy loans inherited from troubled financial institutions during the financial crisis of the late 1990s, which are being gradually repaid.

We nevertheless note the asset quality risks inherent in COFIDE's sizeable and growing portfolio of infrastructure loans, particularly as the company retains the credit risk of the projects it helps finance, although loans are made through other financial institutions. COFIDE assesses both the creditworthiness of the on-lending institution and the cash flows of the project. COFIDE also buys bonds and issues guarantees related to infrastructure projects.

As part of COFIDE's mandate, the company is responsible for channeling financing to infrastructure projects. The company's loan portfolio has grown significantly during the last years. The investment financing is largely focused on infrastructure related to energy and transportation. The largest infrastructure loans are to COSAC (urban transportation project, \$189 million), Chaglla and Cerro del Aguila (hydro power, \$175 million), IIRSA Sur Trazos 1 and 5 (highway construction, \$135 million), and Southern Gas Pipeline (\$125 million). These represent about half of COFIDE's total infrastructure portfolio.

Loans to SMEs and microfinance entities comprise 20% of the loan book and are also made through financial institutions. COFIDE's direct risk is to the financial institution and not to the SME or microfinance borrower. If the financial institution defaults, however, the right to collect on the loans transfers automatically to COFIDE. In this case, COFIDE assesses the creditworthiness of on-lending institutions and relies on them to assess the credit risk of the SME and microfinance borrowers.

COFIDE has a dedicated Chief Risk Officer (CRO) who reports to the general manager. A risk committee of eight members meets twice a month, and includes the deputy chairman, the CEO, and the CRO.

**INCREASING LEVERAGE AND WEAK LIQUIDITY**

COFIDE's leverage has been rising over the last 4 years to support loan growth, largely driven by debt issuances in the international market and bank borrowings, which also serve to diversify its funding. The leverage increase derives from several bond issuances (\$800 million senior bonds issued in 2015, \$300 million issuance of 5-year senior bonds in 2014, \$300 million issuance of 15-year subordinated bonds in the international market, and the \$500 million issuance of 10-year global bonds during 2012).

Market funds to tangible banking assets has been increasing steadily to 67.3% as of March 2016 from 62.2% in December 2014, and is expected to increase further as COFIDE continues to raise term funds to support its pipeline of infrastructure projects.

Larger borrowings are those related to senior bonds and long term borrowings (55%), other financial institutions (30%) and the subordinated debt (9%). Most borrowings coming from multilateral entities and government agencies are granted or guaranteed by the Republic of Peru.

Efforts to extend maturities have improved tenor matches with COFIDE's long and medium term infrastructure and SME credit portfolios that have tenors averaging eight and five years, respectively. Maturities of US dollar liabilities have been extended to an average of 8 years as of December 2015 from 4.5 years in 2010, while the average maturity of the local currency liabilities has also increased to 15 years from 6 years as of year-end 2010. COFIDE has placed bonds in the domestic market with up to 30 year maturities.

The improvement in tenor matches alleviates COFIDE's otherwise weak liquidity metrics particularly its low liquid asset ratio. COFIDE has also maintained adequate coverage of short term liabilities through solid asset and liability management. The entity maintains a positive cumulative tenor gap for up to one year, and has improved its coverage particularly in the very short term (less than one month).

#### MODEST PROFITABILITY PRESSURED BY LOW MARGINS AND HIGH OPERATING COSTS RELATIVE TO EARNINGS

COFIDE's earnings generation capacity is limited by low margins relative to operating costs despite robust loan growth. Overall profitability is also deterred by the large holding of CAF shares that do not generate dividends for COFIDE. Almost 72% of COFIDE's financial income derives from investment financing, largely focused on infrastructure, mainly energy and transportation, and the remaining income is driven by financial intermediation.

However, COFIDE's returns have been improving, as the corporation maintains control of operating costs particularly with respect to headcount. Operating expenses have contracted by 6.2% as of YE2015. Hence, operating expenses remained below 1% of total assets, similar to the average posted by commercial banks. For 2015, COFIDE reported a net income of \$24.1 million, 6.8% higher than last year.

#### HIGH PROBABILITY OF GOVERNMENT SUPPORT DUE TO OWNERSHIP, POLICY MANDATE, AND FINANCIAL LINKAGES

COFIDE'S Baa2 issuer ratings benefit from five notches of uplift from the b1 standalone BCA, based on our assumption of a very high probability of support from the Peruvian government, given its ownership, financial linkages, and mandate to promote economic growth. About half of COFIDE's loans are funded directly by the government through capital (equal to 27% of total assets) or through guaranteed funding (20% of total assets). In addition, COFIDE's management and board of directors are appointed by FONAFE.

The positioning of the issuer ratings at two notches below Moody's A3 country rating for Peru reflects the lack of an explicit guarantee from the government as well as COFIDE's relevance as a project and SME lender within the Peruvian economy. It is also indicative of the Peruvian government's self-prescribed limited participation in the financial system.

### Notching Considerations

COFIDE's issuer rating is based on the b1 standalone BCA that benefits from five notches of uplift to reflect our assumption of a very high probability of support from the Peruvian government, given its ownership, financial linkages and COFIDE's public policy mandate to help promote economic growth.

### Ratings

Exhibit 2

| Category   | Moody's Rating |
|--|----------------|
| <b>CORPORACION FINANCIERA DE DESARROLLO S.A.</b> |                |
| Outlook  | Stable         |
| Issuer Rating                                    | Baa2           |

Source: Moody's Investors Service

### Profile

COFIDE was established in 1971 by Decree-Law #18.807 as a public entity within the Ministry of Finance. In 1992, it was converted to a development bank by Decree-Law #25.694. The entity is 99% owned by the Republic of Peru via its holding company, FONAFE, with the 1% remaining stake owned by CAF. COFIDE reported total assets of \$4,06 billion, shareholders' equity of \$816 million and net income of almost \$8 million as of March 2016.

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