MOODY'S
INVESTORS SERVICE

Credit Opinion: Corporacion Financiera de Desarrollo S.A.

Global Credit Research - 17 Jan 2014

Lima, Peru

Ratings

Category	Moody's Rating
Outlook	Stable
Issuer Rating	Baa3

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Key Indicators

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

	[2]**9-13**	[2]**12-12**	[2]**12-11**	[2]**12-10**	[2]**12-09**	**Avg.**
Total Assets (PEN million)	**7,856.7**	**6,863.7**	**5,406.6**	**5,160.1**	**4,851.3**	[3]**12.8**
Total Assets (USD million)	**2,825.4**	**2,689.0**	**2,005.0**	**1,838.6**	**1,679.2**	[3]**13.9**
Tangible Common Equity (PEN million)	**1,778.5**	**1,791.4**	**1,774.2**	**1,768.2**	**1,472.8**	[3]**4.8**
Tangible Common Equity (USD million)	**639.6**	**701.8**	**658.0**	**630.0**	**509.8**	[3]**5.8**
Net Interest Margin (%)	**2.6**	**2.3**	**2.7**	**2.9**	**1.9**	[4]**2.5**
PPI / Average RWA (%)	**1.7**	**5.1**	**6.1**	**2.8**	**1.8**	[5]**3.5**
Net Income / Average RWA (%)	**1.1**	**3.6**	**4.3**	**1.7**	**1.6**	[5]**2.5**
(Market Funds - Liquid Assets) / Total Assets (%)	**53.0**	**45.3**	**41.3**	**39.5**	**38.1**	[4]**43.4**
Core Deposits / Average Gross Loans (%)	**0.5**	**0.6**	**1.3**	**0.8**	**4.2**	[4]**1.5**
Tier 1 Ratio (%)	**25.9**	**34.6**	**42.6**	**47.0**	**43.6**	[5]**38.7**
Tangible Common Equity / RWA (%)	**25.5**	**34.6**	**42.6**	**47.0**	**43.6**	[5]**38.7**
Cost / Income Ratio (%)	**36.9**	**38.1**	**35.5**	**32.9**	**41.6**	[4]**37.0**
Problem Loans / Gross Loans (%)	**0.1**	**0.1**	**0.5**	**0.3**	**0.5**	[4]**0.3**
Problem Loans / (Equity + Loan Loss Reserves) (%)	**0.1**	**0.1**	**0.5**	**0.3**	**0.4**	[4]**0.3**

Source: Moody's

[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

Opinion

SUMMARY RATING RATIONALE

Moody's assigns a standalone baseline credit assessment (BCA) of b1 to Corporacion Financiera de Desarrollo S.A. (COFIDE), 98.96% 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 of the Corporación Andina de Fomento (CAF, rated Aa3) that comprise one third of the balance sheet and reduce tangible equity under our stress scenarios. Internal capital generation is also limited by modest profitability, due to low margins and high operating costs relative to revenues, as well as a high dividend payout, although the latter is largely offset by periodic capital contributions from the government.

Other key risk factors include the sizeable and increasing project risk taken on by COFIDE, as 70% of its loans are devoted to infrastructure projects. 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 doubled since 2011, pointing to increasing credit risk of the loan portfolio, particularly in the event of an economic downturn. Leverage has also increased significantly since 2010 and is expected to increase further as COFIDE continues to raise funds to support loan growth.

Moody's also assigns COFIDE Baa3 long-term local and foreign currency issuer ratings. The issuer ratings are based on the b1 standalone BCA that receives four notches of uplift to reflect our assumption of a 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 promote economic growth by financing targeted sectors such as infrastructure and SMEs. The positioning of COFIDE's issuer ratings at one notch below Moody's Baa2 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.

Rating Drivers

Capital has moderate loss absorption capacity

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

High probability of support from the government due to ownership, policy mandate, and financial linkages

Rating Outlook

The outlook on all ratings is stable.

What Could Change the Rating - Up

Upward movement in COFIDE's standalone ratings would hinge on sustained improvement in tangible capital and core earnings, and maintenance of good asset quality. An upgrade of the issuer ratings would hinge on multi-notch upgrades of both COFIDE's standalone and the Peruvian sovereign's ratings.

What Could Change the Rating - Down

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

DETAILED RATING CONSIDERATIONS

Detailed considerations on COFIDE's ratings are as follows:

CAPITAL HAS MODERATE LOSS ABSORPTION CAPACITY

CAF shares held on COFIDE's balance sheet totaling US$900 million represent one third of the balance sheet and more than absorb shareholders' equity totaling $778 million, thus limiting its loss absorption capacity for the loan book. Partly offsetting this risk are loan loss reserves totaling $200 million that are in excess of reported problem loans.

The high dividend payout of around 75% also limits internal capital generation, although this is largely offset by periodic capital injections from the government. While COFIDE has paid about $65 million in dividends since 2010, it has received about $104 million in capital infusions to support loan growth. In January 2010, the government capitalized COFIDE with $100 million to enable it to participate in a new $460 million Infrastructure Investment Fund together with local AFPs ($220 million), Brookfield Asset Management ($100 million), and CAF ($40 million). The last capital injection was in September 2012 for around US$4 million to fund loan growth.

COFIDE's Tier 1 ratio was 33.14% as of September 2013 according to our estimates, having steadily declined from the 44.5% posted as of year-end 2011, due to strong growth of the credit portfolio, 31% for the past 12 months.

LARGE AND INCREASING EXPOSURE TO LONG TERM PROJECT FINANCE

COFIDE's asset quality metrics are solid, with nonperforming loans (NPLs) remaining below 1% of total loans for the past several years. Reserves covered 12.3% of total loans as of September 2013, higher than the 4.1% average for commercial banks, indicative of the higher risk associated with long term project finance. Low non-performing loan levels reflecting 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 equal to its participations, although loans are made via other financial institutions. Besides loans, COFIDE also buys bonds and issues guarantees related to infrastructure projects. COFIDE therefore assesses both the creditworthiness of the on-lending institution and the cash flows of the project.

The company's portfolio of infrastructure loans has grown significantly since 2011, doubling to US$ 1 billion, or about 70% of total loans as of September 2013 from 50% as of year-end 2011. The largest infrastructure loans are to COSAC (urban transportation project, US$ 200 million), IIRSA Sur Tramos 1 and 5 (highway construction, US$ 135 million), Chaglla (hydro power, US$ 100 million), and Buenos Aires-Canchaque (highway construction, US$ 35 million). These represent about one half of COFIDE's total infrastructure portfolio.

Loans to SMEs and microfinance entities comprise the remaining 30% 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, therefore, 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 chairman of the board, but has no veto power. 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 since 2010 to support loan growth, largely driven by debt issuances and bank borrowings, which have also served to diversify its funding. Leverage has almost doubled since 2010, mainly due the $500 million issuance of 10-year global bonds during 2012. COFIDE has also issued term debt in the domestic market for the US dollar equivalent of $133 million (PEN 340 million) in 2012 up from $70 million (PEN 175 million) in 2011. Liabilities to shareholders' equity increased to 2.6x as of September 2013 from 2.1x as of year end 2012 and 1.5x in 2011, and is expected to increase further as COFIDE continues to raise term funds to support its pipeline of infrastructure projects.

As of September 2013, 51% of total funding was composed of borrowings, down from 77% as of year-end 2010, while issued debt comprised 37%. Borrowings were sourced from commercial banks (29% of funding), multilaterals (10%), government agencies (7%), and insurance companies (5%). 70% of 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 8.5 years as of September 2013 from 4.5 years in 2010. Moreover, the average maturity of COFIDE's local currency liabilities increased to 11 years as of September 2013, 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 due to 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. However, COFIDE has maintained control of operating cost growth particularly with respect to headcount, with operating expenses growing by 12% on average since December 2010 in line with the average growth of total assets. Hence, operating expenses remained below 1% of total assets, as compared with the 3.6% posted by the banking system. Overall profitability is also deterred by the large holding of CAF shares that do not generate any dividends for COFIDE.

For the first nine months of 2013, COFIDE reported a 12% increase in net income in sol terms of US$20.4 million (PEN 54.5 million), due primarily to strong net interest income. The net interest margin (NIM) rose to 2.6% as of September 2013, up from 2.2% as of September 2012, as interest revenue growth exceeded funding costs. Returns on average assets and equity were relatively stable at around 1% and 3.33%, respectively, versus 1% and 3.04% the year before.

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

COFIDE'S Baa3 issuer ratings incorporate four notches of uplift from the b1 standalone BCA, based on our assumption of a high probability of support from the Peruvian government in case of need, given the Peruvian government's 98.96% ownership of COFIDE, its financial linkages and its primary mandate to promote economic growth. Around one half of COFIDE's assets are funded directly by the government through capital (equal to 30% of total assets) or through guaranteed funding (20% of total assets). In addition, COFIDE's management and board of directors are entirely appointed by FONAFE.

The positioning of the issuer ratings at one notch below Moody's Baa2 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.

BUSINESS 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 98.96% owned by the Republic of Peru via its holding company, FONAFE, with the 1.04% remaining stake owned by CAF. COFIDE reported total assets of US$2.8 billion (PEN 7.8 billion), shareholders' equity of US$778.4 million and nine month net income of US$20.4 million, as of September 30, 2013.

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