MOODY'S
INVESTORS SERVICE

Credit Opinion: Corporacion Financiera de Desarrollo S.A.

Global Credit Research - 08 Jul 2014

Lima, Peru

Ratings

Category	Moody's Rating
Outlook	Stable
Issuer Rating	Baa2

Contacts

Analyst	Phone
Jeanne Del Casino/New York City	1.212.553.1653
Georges Hatcherian/Mexico	52.55.1253.5700
M. Celina Vansetti/New York City	1.212.553.1653
Lauren Kleiman/Mexico	52.55.1253.5700

Key Indicators

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

	[2]3-14	[2]12-13	[2]12-12	[2]12-11	[2]12-10	Avg.
Total Assets (PEN million)	8,140.0	8,110.6	6,863.7	5,406.6	5,160.1	[3]12.1
Total Assets (USD million)	2,898.3	2,900.1	2,689.0	2,005.0	1,838.6	[3]12.1
Tangible Common Equity (PEN million)	1,796.3	1,778.5	1,791.4	1,774.2	1,768.2	[3]0.4
Tangible Common Equity (USD million)	639.6	635.9	701.8	658.0	630.0	[3]0.4
Net Interest Margin (%)	2.6	2.5	2.3	2.7	2.9	[4]2.6
PPI / Average RWA (%)	2.2	1.8	2.2	2.6	2.8	[5]2.3
Net Income / Average RWA (%)	1.3	1.2	1.6	1.8	1.7	[5]1.5
(Market Funds - Liquid Assets) / Total Assets (%)	51.2	52.8	45.3	41.3	39.5	[4]46.0
Core Deposits / Average Gross Loans (%)	2.2	1.6	0.6	1.3	0.8	[4]1.3
Tier 1 Ratio (%)	26.2	26.9	34.6	42.6	47.0	[5]35.5
Tangible Common Equity / RWA (%)	25.7	26.4	34.6	42.6	47.0	[5]35.2
Cost / Income Ratio (%)	32.4	36.3	38.1	35.5	32.9	[4]35.0
Problem Loans / Gross Loans (%)	0.0	0.0	0.1	0.5	0.3	[4]0.2
Problem Loans / (Equity + Loan Loss Reserves) (%)	0.1	0.1	0.1	0.5	0.3	[4]0.2

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), 98.98% 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 71% 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 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 specific 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$833 million represent one third of the balance sheet and more than absorb shareholders' equity totaling $774 million, thus limiting its loss absorption capacity for the loan book. Partly offsetting this risk are loan loss reserves totaling $216 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 April 2013 for around US$4 million to fund loan growth.

COFIDE's adjusted Tier 1 ratio was 26.2% as of March 2014 (adjusted for government securities), having steadily declined from 42.6% as of year-end 2011, due to strong growth of the credit portfolio, 27% 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 11.8% of total loans as of March 2014, 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, 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.

The company's portfolio of infrastructure loans has grown significantly since 2011, doubling to US$ 1.3 billion, or 71% of total loans as of March 2014 from 50% as of year-end 2011. The largest infrastructure loans are to COSAC (urban transportation project, US$ 200 million), Chaglla and Cerro del Aguila (hydro power, US$ 175 million), IIRSA Sur Tramos 1 and 5 (highway construction, US$ 135 million), and Fenix (thermoelectric plant, US$ 100 million). These represent about one half of COFIDE's total infrastructure portfolio.

Loans to SMEs and microfinance entities comprise the remaining 29% 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 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 also serve to diversify its funding. Leverage has almost doubled, mainly due to 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 $216 million (PEN 600 million). Liabilities to shareholders' equity increased to 2.7x as of March 2014 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 March 2014, 57% of total funding was composed of borrowings, down from 81% as of year-end 2010, while issued debt comprised 34%. Borrowings are sourced from commercial banks (49%), international capital markets (29%), multilaterals (14%), and local capital markets (12%). 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 March 2014 from 4.5 years in 2010. Moreover, the average maturity of COFIDE's local currency liabilities increased to 15 years as of March 2014, 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.

However, COFIDE's returns have been improving, as the corporation maintains control of operating costs particularly with respect to headcount. Operating expenses have grown by 12% on average since December 2010 in line with average growth of total assets. Hence, operating expenses remained below 1% of total assets, similar to the average posted by commercial banks. For the first three months of 2014, COFIDE reported a 30% increase in net income in sol terms of US$2 million (PEN 5 million), due primarily to strong net interest income. The net interest margin (NIM) rose to 2.6% as of March 2014, up from 2.4% as of March 2013, as interest revenues exceeded funding costs. Returns on average assets and equity therefore rose to 1.1% and 3.9%, respectively, versus 0.9% and 3.0% as of March 2013.

HIGH PROBABILITY OF SUPPORT FROM GOVERNMENT 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 in case of need, given its ownership, financial linkages, and principal 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 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.

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 98.98% 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$2.9 billion, shareholders' equity of US$774 million and three month net income of US$7.7 million, as of 31 March 2014.