MOODY'S
INVESTORS SERVICE

Credit Opinion: Corporacion Financiera de Desarrollo S.A.

Global Credit Research - 05 Feb 2015

Lima, Peru

Ratings

Category	Moody's Rating
Outlook	Stable
Issuer Rating	Baa2

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Key Indicators

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

	[2]9-14	[2]12-13	[2]12-12	[2]12-11	[2]12-10	Avg.
Total Assets (PEN million)	9,456.0	8,110.6	6,863.7	5,406.6	5,160.1	[3]16.3
Total Assets (USD million)	3,268.6	2,900.1	2,689.0	2,005.0	1,838.6	[3]15.5
Tangible Common Equity (PEN million)	1,893.9	1,876.6	2,258.6	2,203.0	2,148.4	[3]-3.1
Tangible Common Equity (USD million)	654.7	671.0	884.9	817.0	765.5	[3]-3.8
Net Interest Margin (%)	2.1	1.9	2.3	2.7	2.9	[4]2.4
PPI / Average RWA (%)	1.7	1.8	2.2	2.6	2.8	[5]2.2
Net Income / Average RWA (%)	1.0	1.2	1.6	1.8	1.7	[5]1.5
(Market Funds - Liquid Assets) / Total Assets (%)	22.0	24.0	45.3	41.3	39.5	[4]34.4
Core Deposits / Average Gross Loans (%)	2.0	1.6	0.6	1.3	0.8	[4]1.3
Tier 1 Ratio (%)	26.6	26.9	34.6	42.6	47.0	[5]35.5
Tangible Common Equity / RWA (%)	27.5	27.8	43.6	52.9	57.1	[5]41.8
Cost / Income Ratio (%)	37.2	36.3	38.1	35.5	32.9	[4]36.0
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), 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. Capital growth is also limited by the corporation's dividend payout, although this has been significantly reduced through 2015, in addition to other significant efforts by the board of directors to increase capital.

Other key risk factors include the sizeable and increasing project risk taken on by COFIDE, as 75% 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 light of slower than expected economic growth in Peru. Leverage has also increased significantly 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 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 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.

What Could Change the Rating - Down

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.

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$809 million represented a quarter of the balance sheet as of September 2014 and more than absorbed tangible equity of $770 million, thus limiting its loss absorption capacity for the loan book. Partly offsetting this risk are loan loss reserves totaling $198 million that are in excess of reported problem loans. The corporation's dividend payout also limits internal capital generation, although this is offset by periodic capital injections from the government to support loan growth.

We expect this capital constraint to be alleviated to a degree in the coming year, given significant efforts by

COFIDE's board of directors to increase capital. During 2014, the board approved the retroactive capitalization of 50% of 2013 earnings effective May 2014. At the same time, the Board approved the retention of 60% of the company's 2014 and 2015 earnings. More significantly, in December 2014, the 2015 Public Debt Law published in December 2014 provides for the capitalization of multilateral borrowings totaling PEN 475.5 million (= US $168.9 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%.

That said, COFIDE's BIS capital more than complies with Peruvian capital regulations and increased to 45.2% as of September 2014 from 36% at year end 2013, largely reflecting its $300 million Tier 2 international debt issue of 2014.

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 10.8% of total loans as of September 2014, higher than the 4.1% 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.

The company's portfolio of infrastructure loans has grown significantly since 2011, doubling to US$ 1.4 billion, or 75% of total loans as of September 2014 from 50% as of year-end 2011. The largest infrastructure loans are to COSAC (urban transportation project, US$ 189 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 half of COFIDE's total infrastructure portfolio.

Loans to SMEs and microfinance entities comprise the remaining 25% 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 since 2010 to support loan growth, largely driven by debt issuances and bank borrowings, which also serve to diversify its funding. 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 more than doubled, mainly due to the $300 million issuance of 5-year senior bonds in 2014 as well as a $300 million issuance of 15-year subordinated bonds in the international market, and the $500 million issuance of 10-year global bonds during 2012.

Liabilities to shareholders' equity increased to 3.2x as of September 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 September 2014, 34% of total funding was composed of borrowings. Borrowings are sourced from commercial banks (34%), international capital markets (47%), multilaterals (10%), and local capital markets (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 September 2014 from 4.5 years in 2010. The average maturity of COFIDE's local currency liabilities has also increased to 13 years as of September 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 nine months of 2014, COFIDE reported a stable net income when compared to the same period 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 24% 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 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 US$3.3 billion, shareholders' equity of US$770 million and nine month net income of US$18.5 million as of 30 September 2014.