

Research Update:

Corporacion Financiera de Desarrollo S.A. Outlook Revised To Stable From Negative As Credit Metrics Stop Worsening

August 13, 2019

Overview

- Over the last two years, the credit fundamentals of Peruvian bank, COFIDE, were significantly affected by a massive corruption probe in Brazil, known as Lava Jato, that spread to Peru and hurt the country's infrastructure and construction sectors.
- After a sharp financial deterioration during 2017-2018, the bank was able to write-off most of its problematic credit portfolio, revamp credit provision deficiencies, and maintain satisfactory solvency levels thanks to timely government capital injections.
- Still, we expect COFIDE's credit exposure to remain single-name and sector concentrated and for the bank to have volatile asset quality metrics given its riskier nature, although supported by sound coverage levels.
- As a result, we're revising the outlook to stable from negative and affirming the 'BBB/A-2' ratings on the bank. We're also affirming our rating on the bank's subordinated debt at 'BBB-'.
- The stable outlook reflects our view that COFIDE's asset quality has stopped deteriorating and our expectation of somewhat lower downside risk in Peru's infrastructure and construction sector for the next 12-24 months.

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Rating Action

On Aug. 13, 2019, S&P Global Ratings affirmed its long-term issuer credit rating (ICR) on Corporacion Financiera de Desarrollo S.A. (COFIDE) at 'BBB'. We revised the outlook to stable. We also affirmed our 'A-2' short-term ICR and our subordinated notes rating at 'BBB-'. The rating on these notes is one notch lower than the bank's ICR, reflecting subordination risk. At the same time, we affirmed the bank's stand-alone credit profile (SACP) at 'bb-'.

Outlook

Our revision of the outlook to stable from negative indicates our view that the bank's asset quality deterioration has stopped and our expectation of somewhat lower downside risk in the country's infrastructure and construction sector for the next 12-24 months. Moreover, we don't expect changes in the bank's credit fundamentals in the intermediate term, because it will remain an important financing tool for the government to revive Peru's infrastructure project pipeline. We expect COFIDE's credit exposure to remain single-name and sector concentrated and for it to have volatile asset quality metrics given its riskier nature, although supported by sound coverage levels.

Downside scenario

We could lower the ratings in the next 12-24 months if its provision requirements or business stability worsen more than we expect due to difficulties in restarting infrastructure projects in Peru after the impact from corruption scandals related to Lava Jato. Higher risk could stem from faster-than-expected asset quality erosion or delays in infrastructure investments because of ongoing corruption investigations. We could also lower the rating if we see setbacks on the measures taken to address aggressive risk tolerances and poor internal controls.

Upside scenario

We don't expect relevant changes in the bank's credit fundamentals in the next year or so. A rating change would have to combine better prospects for the industry sector and strategic shifts in the bank's risk management that would lead to a more diversified and less vulnerable credit portfolio. In addition, we could upgrade the bank if it's able to consistently maintain a risk-adjusted capital (RAC) ratio above 7%, which we only expect to be sustainable if its profitability improve or if the entity is able to sell part of its shares in Corporacion Andina de Fomento (CAF).

Rationale

Over the last two years, COFIDE's credit fundamentals have been hampered by the Lava Jato corruption probe in Brazil, which spread to Peru and impaired the country's infrastructure and construction sectors. In response, the government passed a decree in early 2017 with the objective of sanctioning construction companies operating in Peru that admitted, or were found guilty of, corruption. However, the decree has caused financial difficulties among construction companies because they had trouble accessing financing for their projects. As a result, infrastructure construction in Peru has ground to a halt, hurting the country's economy. To get these projects restarted, Congress passed legislation last year to replace the mentioned decree.

In this sense, COFIDE's weakening credit profile in the last few years stems from souring loans to construction companies and affected projects with nonperforming loans (NPLs) peaking to 28.7% last year. COFIDE has a high concentration risk, with its 20 largest exposures--mostly from the infrastructure sector--representing about half of its credit portfolio and 1.5x of its common equity. The bank has increased its lending to the infrastructure sector in the past five years, mainly for energy and transportation projects. In our view, higher credit exposure to and concentration in complex corporate and legal structures have impaired its financial and operating performance, and we continue to incorporate this risk into our analysis.

Despite management's measures to address aggressive risk tolerances and poor internal

controls, we believe that the controlling ownership may still negatively influence strategic decisions made because of COFIDE's role in promoting infrastructure investments in the country amid increasing structural rigidities and private investment scrutiny.

COFIDE ended the first half of the year with NPLs at 7.6% of its credit portfolio, stable in nominal terms compared to 2018 year-end figures. The improvement in asset quality is explained by the charge-off of troubled projects: Gasoducto Sur Peruano (\$140 million), Líneas de Transmisión Peruanas (\$63 million), and Generadora Eléctrica Molloco (\$30 million). In addition, the rest of the drop in NPLs reflects the ongoing negotiation over the loan to Consorcio Corredores Segregados de Buses de Alta Capacidad (COSAC). However, we still see challenges stemming from ongoing negotiations over problematic loans and sluggish recovery of Peru's infrastructure and construction sectors, which could make asset quality metrics volatile.

In line with its role to promote infrastructure in Peru, COFIDE usually finances more complex projects than the market is willing to invest in, which may carry construction risk and greater cash flow sensitivity. Our base-case scenario considers that NPLs could rise up to nominal levels of PEN950 million, considering existing problematic loans (mainly the loans to COSAC and Minera IRL). Although we currently don't foresee its other loans for projects to run into difficulties, we deem the bank's concentration in infrastructure lending as high, which could potentially further weaken the asset quality indicators. Nonetheless, these risks are mitigated by our expectation that the government would provide capital in exchange for the bank's shares in Corporacion Andina de Fomento (CAF). We still believe that our RAC ratio overestimates COFIDE's risks relative to those of its peers, supporting the bank's current risk position assessment.

COFIDE's credit losses and capitalization levels performed in line with our last forecast, thanks to the government's financial support: it injected about \$170 million into COFIDE in the last two years. The bank's management has presented a capital enhancement plan to address rising provision needs, which has allowed the bank to keep its RAC ratio above 5%, while addressing corporate governance issues. We now forecast the RAC ratio to be close to 6% in the next two years. Healthier financial conditions should allow the bank to gradually resume credit origination, although this would also rely on stronger recovery of Peru's new projects pipeline and private investments.

Ratings Score Snapshot

Issuer credit rating BBB/Stable/A-2

SACP bb-

Anchor bbb-

Business position Moderate (-1)

Capital and earnings Moderate (-1)

Risk position Moderate (-1)

Funding and liquidity Average and Adequate (0)

Support 0

GRE support +4

Additional factors 0

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Financial Institutions | General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria | Financial Institutions | Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria | Financial Institutions | Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Criteria | Financial Institutions | Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Ratings Affirmed

Corporacion Financiera de Desarrollo S.A.

Senior Unsecured	BBB
Subordinated	BBB-

Ratings Affirmed; Outlook Action

	To	From
Corporacion Financiera de Desarrollo S.A.		
Issuer Credit Rating	BBB/Stable/A-2	BBB/Negative/A-2

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