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## Research Update:

# Corporacion Financiera de Desarrollo S.A. 'BBB+/A-2' Ratings Affirmed, Outlook Remains Stable

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## Research Update:

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## Overview

- Peru-based development bank COFIDE has maintained its significant role in providing finance for domestic infrastructure projects and to small and medium enterprises (SMEs) in key sectors for the Peruvian government with ongoing capital support from the latter.
- Nevertheless, we see increasing credit risk due to the hold in construction of Peru's large infrastructure projects stemming from a corruption scandal involving construction firms, along with COFIDE's increasing risk concentration in the infrastructure lending segment, which could weaken its asset quality.
- We're affirming our 'BBB+/A-2' issuer credit ratings on COFIDE and lowering its stand-alone credit profile (SACP) to 'bbb-' from 'bbb'. As a result of the latter, we're lowering our subordinated debt rating to 'BB+' from 'BBB-'.
- The stable outlook reflects our view that the bank will maintain risk-adjusted capitalization levels slightly above 7% for the next two years and that lending should gradually rebound in the next year as the government seeks to uproot corruption and to boost infrastructure spending in order to address delays in Peru's infrastructure program.

## Rating Action

On April 10, 2017, S&P Global Ratings affirmed its 'BBB+/A-2' issuer credit ratings (ICRs) on Corporacion Financiera de Desarrollo S.A. (COFIDE). The outlook remains stable. At the same time, we lowered the bank's SACP to 'bbb-' from 'bbb' and, consequently, lowered our subordinated notes rating to 'BB+' from 'BBB-'. The rating on these notes is one notch lower than the bank's SACP, reflecting subordination risk.

## Rationale

Our SACP revision stems from COFIDE's increasing credit risk due to the interruption of large infrastructure projects given the corruption investigation related to several concessions granted to the Brazilian construction firm, Odebrecht. COFIDE holds considerable exposures in Gasoducto Sur Peruano gas pipeline (\$125 million) and Chaglla hydro power plant (\$100 million) that represented around 32% of the bank's total adjusted capital

(TAC) as of Sept. 30, 2016, which we deem as high. In our view, the default risk for the loans on these two projects has significantly increased, and we expect the bank's credit loss provisions to spike in the following years. COFIDE is exposed to some single-name concentration, given the size of the infrastructure projects it funds. The bank has expanded its exposures to infrastructure in the past five years, in line with public policy initiatives to speed up large projects in order to boost the country's economic growth. Nonetheless, the current risk concentration and our expectations for asset quality indicators are no longer in line with our previous risk position assessment for COFIDE. In this regard, although its asset quality indicators remain in line with those of the banking system, we expect nonperforming assets to deteriorate to in 2018, when the project loan payments are scheduled to start. Nevertheless, we expect the bank to maintain conservative coverage policies and to increase loan-loss reserves throughout the next two years.

The ICRs on COFIDE continue to reflect its historically satisfactory business stability mainly because of its unique role in providing long-term financing to infrastructure projects in Peru. Despite the bank's low internal capital generation in the past few years, COFIDE has maintained adequate capital levels thanks to the ongoing support from its shareholder and modest loan disbursements in 2016 amid a slowdown in the pace of the country's infrastructure investment program. On the other hand, we expect credit provisions to hit the bank's bottom-line results for the next two years. The ratings also reflect our expectations that the government would provide extraordinary and timely support to the bank in the event of a financial distress, which also results in a favorable debt profile, ample refinancing flexibility, and healthy liquidity.

Our view of a high likelihood of government support to COFIDE is based on the following factors:

- Its important role for the government given that the bank promotes and finances investments and public and private infrastructure projects in Peru, which has a significant infrastructure gap.
- The bank's very strong link with the government, which owns 99% of the bank through "El Fondo Nacional de Financiamiento de la Actividad Empresarial del Estado" (FONAFE), a fund created in 1999 to oversee the government's corporate activities and equity stakes. The Corporacion Andina de Fomento (CAF; AA-/Negative/A-1+) owns the remaining share of COFIDE through preferred shares. Several capital injections in recent years and COFIDE's close reputation with the government demonstrate the bank's close link with the latter.

Our bank criteria use our Banking Industry Country Risk Assessment (BICRA) economic risk and industry risk scores to determine a bank's anchor, the starting point in assigning an issuer credit rating. The anchor for banks operating in Peru is 'bbb-' (please see "Banking Industry Country Risk Assessment: Peru," published Sept. 2, 2016, on Global Credit Portal).

COFIDE's business position reflects its role in supporting Peru's considerable infrastructure needs as the only development bank in Peru and the

second-largest government-owned bank with around 3% of the market share in terms of loans and with a 29% market share among public banks. As of December 2016, the bank's long-term financing of infrastructure projects constituted about 85% of its lending exposures, while the remaining exposures are SME lending intermediated through other financial institutions (banks, municipal and rural institutions, credit unions, among others). We expect the lending mix to remain stable for the next two years. However, we expect COFIDE's bottom-line results to be pressured by lower net interest margins and increasing credit-loss provisions for the next two years. Moreover, we expect the bank's lending growth this year to be sluggish due to the halt in construction of large projects. However, lending growth should resume in the intermediate term given the government's commitment to expand and boost Peru's infrastructure and to increase public infrastructure spending.

The bank's capital and earnings is based on a projected risk-adjusted capital (RAC) ratio before diversification of 7.0%-7.5% for the next 12-18 months and financial losses given increasing credit loss provisions among some infrastructure loans. The bank's RAC ratio is weaker than the regulatory capital ratio (currently at 28.8% as of December 2016) mainly because of the bank's large equity exposure through its investments in CAF. We view this exposure as having higher risk weights under our capital methodology, in comparison with the regulator's methodology. Our base-case scenario incorporates the following assumptions:

- Peru's GDP growth of 3.5% for 2017 and 3.8% for 2018.
- Lending contraction of 1.5% for 2016, no growth in 2017, and 5% expansion in 2018.
- Net interest margins to continue dropping because of increasing pre-payments of project loans.
- Credit-loss provisions of around PEN710 million distributed between 2016 and 2018 results in order to cover 100% of the exposures to Gasoducto Sur Peruano and Chaglla hydro power plant. As a result, we expect the bank to post losses in 2017 and 2018.
- We also expect the government to continue providing capital to the bank through the purchase of its debt it owes to the multilateral lending entities.
- No dividend payments for the next two years, given the expected net losses.

However, we still consider that our RAC overestimates COFIDE's risks relative to those of its peers, supporting the bank's current risk position assessment. Although we believe that the bank's investments in CAF are an insufficient buffer against unexpected losses, we believe that the government would provide capital in exchange to cover potential gaps.

The bank's funding assessment reflects its stable funding ratio (SFR) of 104.7% as of December 2016 and averaging 102.8% for the past three years, similar to that of the majority of Peruvian banks. Our baseline expectation is that SFR will hover above 100% for the next two years due to low funding needs. Unlike private banks, COFIDE is not allowed to receive deposits. However, its financial flexibility benefits from the government's ongoing

support, allowing COFIDE to refinance its debt, as seen in strong demand for its issuances. Although the bank receives higher-than-average external funding, we believe it has an adequate funding profile, given the long-term nature of the funding required for its loans. We expect the bank to continue matching tenors and currencies on its balance sheet to mitigate risks. As of Dec. 31, 2016, its funding consisted mainly of debt issuances in international capital markets (64%), loans from Peruvian commercial banks (16%), loans from international commercial banks (6%), debt from local capital markets (10%), and credit lines from multilateral organizations (4%).

On the other hand, the bank continues to maintain adequate liquidity cushion to cope with unexpected cash outflows over the next 12 months. Its broad liquid assets covered 1.7x its short-term wholesale funding. This provides the bank sufficient time to manage its liquidity risk. Moreover, COFIDE has an investment of PEN2.3 billion in CAF, which we consider illiquid because this type of share is only government-owned. However, we expect the government of Peru to purchase these shares in case COFIDE requires support.

## **Outlook**

The stable outlook on COFIDE for the next 18-24 months reflects that on the sovereign and our expectation that the bank will maintain its RAC slightly above 7% for the next two years and relatively sound business stability amid challenging conditions in the country's infrastructure investment plan. Our stable outlook also reflects our view that the government would provide extraordinary and timely support to the bank in the event of financial distress.

### **Upside scenario**

An upgrade is significantly limited at this point because given the bank's SACP, it will only occur if we were to raise the sovereign local currency rating by three notches, which is extremely unlikely in the next two years, in our view. On the other hand, if COFIDE disposes its investments in CAF's shares that would bolster its capital position, we could raise the ratings on COFIDE's subordinated notes.

### **Downside scenario**

We could lower the ratings in the next 18-24 months if its RAC drops consistently below 7% or its business stability deteriorates further than we expect due to difficulties in accelerating the infrastructure projects in Peru. In addition, we could lower the ratings if there's a similar action on the sovereign ratings.

## Ratings Score Snapshot

Issuer Credit Rating	BBB+/Stable/A-2
SACP	bbb-
Anchor	bbb-
Business Position	Adequate (0)
Capital and Earnings	Adequate (0)
Risk Position	Adequate (0)
Funding and Liquidity	Average and Adequate (0)
Support	0
GRE Support	+2
Additional Factors	0

## Related Criteria

- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria - Financial Institutions - Banks: Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Financial Institutions - Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria - Financial Institutions - Banks: Revised Market Risk Charges For Banks In Our Risk-Adjusted Capital Framework, June 22, 2012
- Criteria - Financial Institutions - Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 09, 2011
- Criteria - Financial Institutions - Banks: Banks: Rating Methodology And Assumptions, Nov. 09, 2011
- Criteria - Financial Institutions - Banks: Bank Capital Methodology And Assumptions, Dec. 06, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Financial Institutions - Banks: Commercial Paper I: Banks, March 23, 2004

## Ratings List

### Downgraded

	To	From
Corporacion Financiera de Desarrollo S.A. Subordinated	BB+	BBB-

### Ratings Affirmed

Corporacion Financiera de Desarrollo S.A. Counterparty Credit Rating Senior Unsecured	BBB+/Stable/A-2 BBB+
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Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at [www.standardandpoors.com](http://www.standardandpoors.com) for further information. Complete ratings information is available to subscribers of RatingsDirect at [www.globalcreditportal.com](http://www.globalcreditportal.com) and at [www.spcapitaliq.com](http://www.spcapitaliq.com). All ratings affected by this rating action can be found on the S&P Global Ratings' public website at [www.standardandpoors.com](http://www.standardandpoors.com). Use the Ratings search box located in the left column.

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