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Research Update:

Corporacion Financiera de Desarrollo Long-Term Rating Cut To 'BBB' From 'BBB+' And Removed From UCO, Outlook Negative

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Overview

- Peru-based development bank COFIDE has been experiencing faster-than-expected asset quality deterioration due to weakening infrastructure sector loans. Despite mitigating measures announced by the bank and explicit government support to buy up to 20% of Corporación Andina de Fomento (CAF) shares, we don't expect these measures to fully compensate for the provision requirements for the next two years affecting the bank's current capital levels. We also see increasing credit risk in its loans portfolio that could result in further asset quality deterioration.
- On the other hand, we're revising our expectations of extraordinary government support based on stronger evidence of government commitment to support the bank if financial stress persists.
- We're lowering our long-term issuer credit ratings (ICR) on COFIDE to 'BBB' from 'BBB+' and lowering its SACP to 'bb-' from 'bbb-'. We're affirming our 'A-2' short-term ICR on COFIDE. We're also raising our subordinated debt rating to 'BBB-' from 'BB+'.
- Additionally, we're removing the under criteria observation (UCO) designation previously assigned following the application of our new risk-adjusted capital framework methodology.
- The negative outlook reflects our view that COFIDE's risk-adjusted capital (RAC) ratio could weaken below 5% in the next 12 months if expected government capitalizations into the bank don't counterbalance increasing provision expenses. Although we expect a gradual inflow of capital based on the bank's proposed mitigating measures and the stated intention of the government to do so, the government can spread it over time given the bank's still comfortable regulatory capital levels.

Rating Action

On Aug. 17, 2017, S&P Global Ratings lowered its long-term ICR on Corporacion Financiera de Desarrollo S.A. (COFIDE) to 'BBB' from 'BBB+'. The outlook was revised to negative. We also affirmed our 'A-2' short-term ICR on the bank. At the same time, we lowered the bank's stand-alone credit profile (SACP) to 'bb-' from 'bbb-'. On the other hand, we raised our subordinated notes rating to 'BBB-' from 'BB+'. The rating on these notes is one notch lower than the bank's ICR, reflecting subordination risk.

Rationale

The downgrade of COFIDE and SACP review reflect COFIDE's worsening asset quality and weakening RAC levels. COFIDE's nonperforming loans (NPLs) indicators spiked in the second quarter of 2017 to 9.1% from 2.6% in the first quarter of the year and 0.3% in December 2016. Infrastructure loans continue to contribute to asset quality deterioration, which we account to the further increase of provision requirements in the second half of the year and to projected pressured capitalization levels throughout 2018. Moreover, the new management that took over the bank's office in September 2016 identified misapplication of regulatory provisioning, which will require additional write-downs of current loan loss reserves. Thus, we estimate an additional \$250 million in credit loss provisions for this year to adjust loan loss reserves to recent portfolio deterioration, and to fully cover the bank's exposure to Gasoducto Sur Peruano (GSP; a gas pipeline project in Peru), although this project's first repayment isn't due until June 2018. In light of this deterioration, COFIDE announced measures to support the bank's liquidity and capital profile:

- On April 29, 2017, a supreme decree (113-2017-EF) established new risk parameters to the bank, limiting its participation to up to 25% of total financing for each project. Exceptionally, project financing could reach up to 50% pending the Fondo Nacional de Financiamiento de La Actividad Empresarial del Estado's (FONAFE) board of directors' approval.
- On May 23, 2017, the government released a comfort letter confirming its commitment to buy up to 20% of CAF shares. The sale proceeds would amount around \$210 million, with before-tax profits of roughly \$75 million. The commitment has a term of four years.
- On July 4, 2017, FONAFE approved the retention of 2016-2018 net income.
- Other countermeasures could be taken if asset quality further jeopardizes the bank's capitalization.

Despite these measures, we view COFIDE's capital and earnings as weaker given that we don't expect the measures to fully cover the expected increase in credit loss provisions for the next 18 to 24 months. In addition, under the new capital framework methodology, our calculation of COFIDE's 2016 RAC ratio is about 30 basis points lower than before, mostly because we increased risk-weights charges to the bank's CAF shares. This change reflects our view of the higher average risk profile of unlisted stocks due to their generally higher leverage and their illiquidity. We forecast the RAC ratio to average 5.0%-5.5% over the next two years. However, we continue to believe that the government will provide capital in exchange for the CAF shares to cover unexpected losses, which could boost capitalization metrics if financial difficulties persist.

Our base-case scenario assumes:

- Peru's GDP growth of 2.8% for 2017 and 3.5% for 2018.
- Net customer loans to contract about 16% in 2017 and 3% in 2018 due to increasing loan loss reserves.
- Net interest margins (NIM) to remain weak, around 0.7%, as the bank faces

poor interest collection given increasing delinquency levels.

- We estimate that credit loss provisions could add up to \$350 million, taking into account the annual financial results for 2017-2018. Such levels could decrease depending on renegotiations, new biddings, asset sales and pre-payments.
- We're incorporating a CAF shares sale of \$50 million to the government this year that should generate an \$18 million profit.
- In 2018, we expect the government to buy the transferred \$104 million of sovereign-guaranteed debt booked to the bank.
- We consider the recapitalization of dividends paid in 2017 (referring to 2016's net income) and we expect retention of 100% of net income in the next two years.

Our view of COFIDE's business position has also worsened, reflecting its weak risk and financial management controls compared to the industry average. COFIDE has increased its participation in investment financing over the last five years to support the country's infrastructure needs, mainly in energy and transportation projects. In our view, higher credit exposure and concentration to complex corporate and legal structures have contributed to the recent financial and operational performance deterioration. Despite senior management's measures to address aggressive risk tolerances and poor internal controls, we believe that the controlling ownership may still negatively influence strategic decisions driven by COFIDE's role to promote infrastructure investments in the country amid increasing structural rigidities and private investment scrutiny.

However, we're increasing our expectation of the likelihood of extraordinary government support to very high from high, stemming from the increasing role COFIDE has in meeting government's key economic objectives, and greater evidence of government support. Infrastructure is one of the main government priorities to boost economic growth and productivity for the next few years, and COFIDE is an important tool in restarting the new projects pipeline and restoring private investments in the country. The government's explicit commitment to support the bank corroborates our review of this assessment.

We're raising COFIDE's subordinated debt notes to 'BBB-' from 'BB+', reflecting increasing government support towards the entity. We now believe such support would also extend to the bank's subordinated notes, preventing the bank from any regulatory intervention or surveillance that could potentially trigger the use of these instruments to absorb losses. Thus, the rating on the notes is one notch lower than the bank's ICR, reflecting contractual subordination risk.

Outlook

The negative outlook reflects our view that credit risks remain high for the next 12 to 24 months. Faster-than-expected asset quality deterioration and higher-than-expected credit loss provisions could translate into lower capital levels if they're not offset by additional capital injections. We believe that

restarting the infrastructure projects agenda and recovery of Peru's long-term investments are key to the bank resuming revenue generation going forward.

Downside scenario

We could lower the ratings in the next 12 to 24 months if COFIDE's RAC ratio drops consistently below 5% or its business stability deteriorates more than we expect due to difficulties in accelerating infrastructure projects in Peru. Higher risk could stem from faster-than-expected asset quality deterioration or increasing structural rigidities on infrastructure investments because of ongoing corruption investigations.

Upside scenario

An upgrade is limited at this point: it will only occur if we were to raise COFIDE's SACP by two notches, which we deem very unlikely in the next 12 to 24 months.

Ratings Score Snapshot

	To	From
Issuer Credit Rating	BBB/Negative/A-2	BBB+/Stable/A-2
SACP	bb-	bbb-
Anchor	bbb-	bbb-
Business Position	Moderate (-1)	Adequate (0)
Capital and Earnings	Moderate (-1)	Adequate (0)
Risk Position	Moderate (-1)	Adequate (0)
Funding and Liquidity	Average and Adequate (0)	Average and Adequate (0)
Support	0	0
GRE Support	+4	+2
Additional Factors	0	0

Related Criteria

- 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: 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: 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

Downgraded; CreditWatch/Outlook Action; Ratings Affirmed

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

Downgraded

	To	From
Corporacion Financiera de Desarrollo S.A. Senior Unsecured	BBB	BBB+

Upgraded

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

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