Rating Report

Report Date:
January 11, 2016

Insight beyond the rating.

Kommunalkredit Austria AG

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The Company

Kommunalkredit Austria AG was demerged on 26 September 2015 as part of the partial sale process of Kommunalkredit (KA old) which was formed in 2009. The new Bank benefits from a profitable and self-funding legacy portfolio and its business model will focus on areas of expertise inherited from KA old, such as energy & environment, social infrastructure and transport.

Recent Action

September 30, 2015
DBRS Assigns BBB (low) Senior Ratings to Kommunalkredit Austria AG, Stable Trend

Ratings

Issuer	Debt Rated	Rating	Trend
Kommunalkredit Austria AG	Long Term Debt and Deposit	BBB (low)	Stable
Kommunalkredit Austria AG	Short-Term Debt and Deposit	R-2 (middle)	Stable

Rating Rationale

On September 30, 2015 DBRS assigned first-time ratings to Kommunalkredit Austria AG (KA or the Bank). These include a Long Term Debt and Deposit Rating of BBB (low) and a Short Term Debt and Deposit Rating of R-2 (middle). The Trend on both ratings is Stable. DBRS has also assigned an Intrinsic Assessment (IA) of BBB (low) and a Support Assessment (SA) of SA3.

The BBB (low) rating reflects the good quality, profitability and self-funding dynamic of the legacy portfolio demerged into KA in the course of the September 2015 partial sale process of Kommunalkredit old (KA old) which resulted from a previous demerger in 2009. This quality portfolio will allow the new Bank some cushion in terms of time, capital and earnings in order to fully establish KA's planned business model. However, the rating also takes into account the challenges faced by the Bank, including its narrow business model, lack of track record, and dependence on wholesale funding. (Continued on page 2)

Rating Considerations

Strengths

(1) Well recognized brand name with capable management team and banking platform – inheriting the operational infrastructure and management teams from KA old

(2) Good quality and self-funded loan portfolio which generates carry income to allow implementation of the proposed business plan

(3) Recognized expertise in infrastructure financing and advisory across the energy, social infrastructure and transport sectors

Challenges

(1) Following a two-year absence, KA will need to resurrect its ability to generate new business, but without the Bank's historical size

(2) Expand and/or re-establish relationships with investors from across the money management and insurance sectors

(3) Maintain credit strength, cash flow underwriting goals, and capital targets -- even if at the expense of growth

Financial Information

EUR Millions	01/01/2015
Total Assets	4,493
Equity	170
RWAs (Credit Risk)	665
Total Capital	235
Total Capital ratio	26.20%
Impaired Loans % Gross Loans	0.00%
Common Equity Tier 1 (As-reported)	19.00%

Notes:

- ***Financial statement information for KA is only available publicly as per 1 January 2015 (local GAAP – Austrian commercial code UGB).***
- ***Throughout this research, we refer to "KA" as the current entity following the September 2015 demerger; "KA old" for the prior entity established via the demerger of November 2009; and "former KA" to the historical entity up until November 2009.***

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Rating Rationale (Continued from page 1)

Once KA's business platform is fully-established over the medium term, there could be scope for rating improvement if the Bank is able to meet the targets it has set for profitability, credit quality, liquidity and capitalisation. However, near term upside for the ratings is limited. Any deterioration or variance from targeted levels of new business, profitability, capital and/or expected leverage, or the quality of assets or earnings from the legacy portfolio, would contribute towards negative rating pressure. These incorporate DBRS' expectation that, if necessary to maintain capital levels, planned dividends will not be distributed.

DBRS notes the Bank inherits a well-recognised banking platform and that the new entity will benefit from important project finance relationships established by its Kommunalkredit predecessors, in Austria, and to a lesser extent more widely in Europe. KA is controlled by Private Equity investors Interritus Limited and Trinity Investments (a legal vehicle managed by Attestor Capital LLP). Together, Interritus and Trinity jointly hold 99.78% of KA via Gesona Beteiligungsverwaltung GmbH (Gesona). The remaining 0.22% is held by the Austrian Association of Municipalities, which had also held a stake in KA old. The new bank benefits from a good quality, fully-funded loan portfolio which generates carry income which in part will fund the future business model. Focusing on recognised areas of expertise inherited from its predecessors, such as energy & environment, social infrastructure and transport, KA will generate new business based on project cash flows and plans to sell the major portion of future risk to market investors.

DBRS views KA's new business model positively as the emphasis is on balance sheet-light generation of project risks which will then be largely targeted for sale. Market dynamics have led to a perceived deficit of project finance supply, which combined with insurance and pension investor interest for quality assets, is likely to support the planned business model. Nonetheless, KA will need to establish the Bank's new business generation following two years of European Commission imposed moratoriums. The Bank's ability to leverage its ongoing project finance consulting, management and advisory roles will be central for success, as will its ability to build on relationships with investors to establish ongoing distribution capability.

New business at KA is expected to grow slowly but is then planned to increase at a faster rate from 2017, once the new model is fully established. These earnings are planned to offset the expected decline in cash flow from the legacy portfolio as these assets mature. The planned improvement in earnings is expected to fund a future dividend stream. DBRS expects that these dividends are non-binding and that foregoing payment could provide a further cushion for establishing the Bank's strategy, if required.

KA targets a 13% common equity tier 1 (CET1) ratio over the long-term which DBRS understands should correspond to an improved leverage ratio approaching double digits by 2025. At inception the Bank had a CET1 ratio of 19% and a leverage ratio of 3.8%, reflecting the retroactive establishment of the Bank under Austrian UGB (GAAP) accountancy rules, to January 1, 2015. The initial capital ratio reflects the good quality of the Bank's legacy portfolio which in large part represents exposure to Austrian municipalities which enjoy low risk weightings. Although the ratios are solid, DBRS notes that the risk weighted assets (RWAs) amount to only 20% of assets. As a result the absolute levels of CET1, EUR 170 million under Austrian UGB (GAAP), are relatively low.

Rating Drivers

Factors with Positive Rating Implications
Near term upside for the ratings is limited. The current rating is based on the adequate quality, profitability and self-funding dynamic of the legacy portfolio which allows some cushion of time for the Bank to establish its new business model.

Factors with Negative Rating Implications
The current rating anticipates that the Bank management and its new owners will stick to the current business plan and targets. Any deterioration of planned earnings, asset quality or capital targets could contribute to negative rating pressure.

Historical Background

The former Kommunalkredit Austria (former KA which existed up until 2009) was first established in 1958 with the purpose of providing cost effective long-term financing to Austrian municipalities. The former KA began to cooperate with Dexia in 1992 and by 2001 the Franco-Belgian bank stake in former KA had been increased to 49%. The Bank faced financial difficulties during the financial crisis of 2007-2008 due to significant short-term funding gap, complicated by holdings of securities and CDS. The portfolio at the time was largely low margin and tender-offer based public finance business which had been the focus of its historical business model.

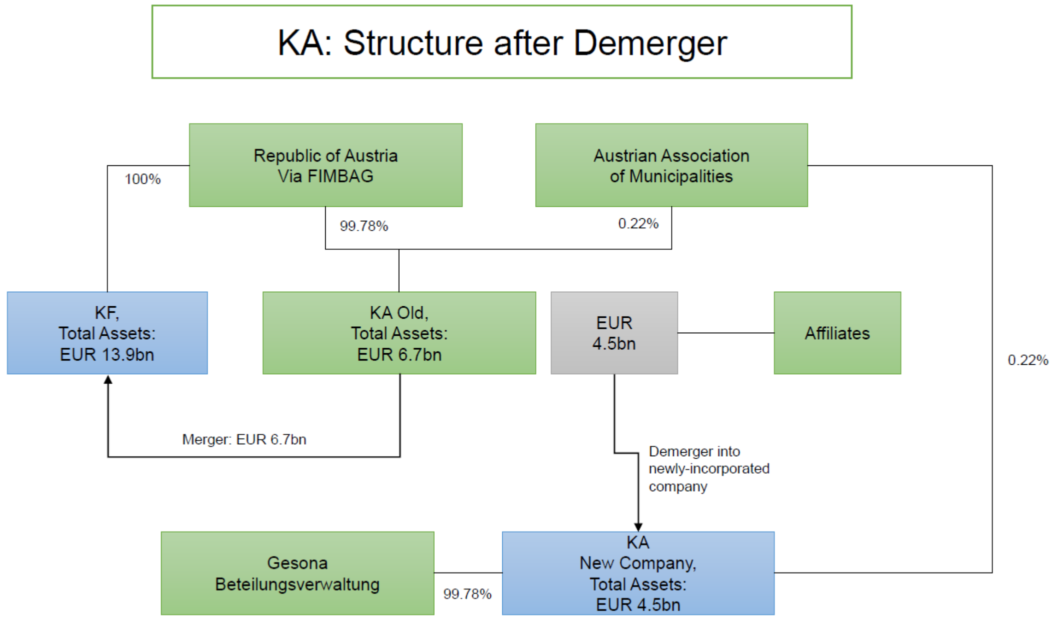
The former KA was forced to request support from the Austrian state in 2008. At the time, former KA was the 7th largest bank in Austria with total assets of EUR 37 billion and was owned 51% by Österreichische Volksbanken AG (ÖVAG) and 49% by Dexia. The former KA was sold for EUR 1 to the Austrian Government and ÖVAG and Dexia converted EUR 372.5 million of senior funding into capital participating instruments. In 2009, under an EC (European Commission) supervised restructuring programme, the Bank was split into Kommunalkredit Finanz (KF or KA Finanz), which included the non-strategic operations [including the CDS and securities portfolio], and a strategic entity Kommunalkredit old (KA old) which inherited the core portfolio of loans to local authorities and continued to operate under the Kommunalkredit name. As part of the sovereign support programme for the Bank, KA old received a capital injection of EUR 250 million. Concurrently, KF received impaired asset relief equivalent to EUR 441 million in aid, a capital injection of EUR 1 billion, as well as state funding guarantees for a maximum amount of EUR 10.6 billion.

State support for former KA was conditional on a number of commitments including the downsizing of the Bank's balance sheet by 60% from its size in 2008, and thereafter limiting total asset growth to 2% per annum with a focus on traditional public finance and project finance. There was also a call to cease future securities or derivatives activities other than asset liability management (ALM). In addition, the Austrian Government committed to sell KA old by December 31, 2012. Yet the Austrian government later requested an extension, and in March 2013 communicated its intention to the EC to place KA old in run-off, following the discontinuation of the privatization process which had been launched in May 2013. This decision was approved by the EC in July 2013 and largely restricted KA old's new business generation to consulting and advisory services, as well as securities business for ALM purposes. The approval also allowed the Austrian government to sell a portion of KA old in future, with the size limitation of not more than 50% of assets.

This set the foundation for the de-merger process of the current KA which was completed in September 2015. In August 2014, FIMBAG [the Financial Market Holding Company of the Republic of Austria] published a public tender offer for the de-merger and sale of just under 50% of KA old assets, with the balance of any assets to be transferred to KF (the run-off bank established in 2009). Following a bidding process, FIMBAG signed a binding sale offer with a consortium of investors in March 2015. This consortium was led by private equity firm Interritus and London based investment firm Trinity Investments/Attestor Capital.

Franchise Strength – Description of Operations

KA was established in late September 2015 with total assets of EUR 4.5 billion under Austrian UGB (local GAAP), in line with EC requirements at roughly half the asset size of KA old. KA operates under the banking license transferred from KA old. Likewise, its initial assets and liabilities comprised only those demerged from KA old. The new owners, Interritus and Attestor, aim to continue KA's historical expertise in the sectors of energy, social infrastructure and transport and to expand and/or re-establish the franchise centered on the generation and distribution of infrastructure finance.



Beginning in July 2013, EU restructuring conditions prohibited KA old from generating any new financing projects. However, since that time, KA old maintained its industry expertise via the completion and management of existing deals, as well as ongoing consulting, advisory and service contracts which should benefit KA going forward. Concurrently, some of KA's historical competitors in Austria and Germany have to some extent also withdrawn from infrastructure project finance origination. DBRS notes the decrease in supply defined by KA and the Bank's still strong ties in Austria and more broadly in some European markets. This should place KA in a competitive position for re-entering project finance origination. KA is targeting slow but steady growth with the aim of establishing an "originate to distribute" model for infrastructure project finance assets – working closely with project sponsors and institutional investors in order to structure attractive long term investments. Ultimately, KA targets to place up to 80% of risk for each transaction following the completion of each project's construction phase.

KA aims to leverage its experience and extensive contacts among public sector borrowers, agencies, contractors and investors. These include municipalities, utilities, contractors and government agencies and programs which KA has continued to work with on a consulting, advisory and distributor basis following the 2013 moratorium on new business. KA highlights that its contacts are particularly strong in Austria, but also extend into Germany, as well as some niche EU and EEA markets. The targeted originate-to-distribute model is to be balance sheet-light and is aimed to produce value added returns for sourcing, underwriting and then syndicating project risk. KA intends to benefit from the changes in regulatory and market dynamics driven by 1) pressure on public finance, 2) pressure on banks' balance sheets through Basel 3 and 3) institutional investors' needs for long term assets.

As part of the demerger transaction, KA has retained the subsidiaries and affiliates which had been included within KA old. The most important of these is Kommunalkredit Public consulting (KPC), a consulting company which distributes and manages public grant funding from Austria to promote environmental projects. Indeed, KPC's role to act on the part of Austrian government agencies is written into grant legislation. In 2014, KPC granted a total of EUR 618.4 million to roughly 65,000 commercial and private projects. Its interaction across the project funding, construction and implementation chain (with both private and public counterparties) provides KA with a value added "view" of the overall market. Although specific details of KPC's projects are not public information, its teams are able to provide sector and industry expertise with the KA business teams. The contributions of other KA subsidiaries such as Kommunalleasing (in run-down), Kommunalnet E-Government Solutions and TrendMind IT Dienstleistung are similar in nature but smaller in scope. These provide know-how for data-base management platforms and IT services which are broadly recognized or used by Austrian municipalities.

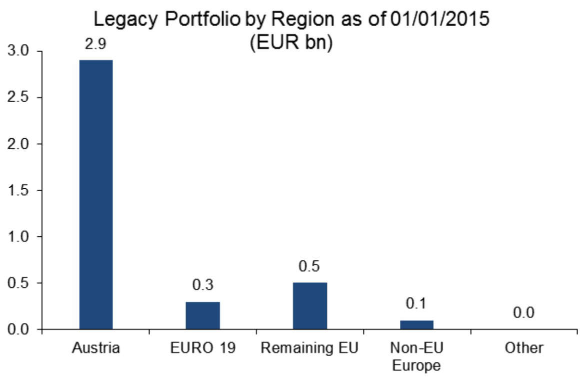
Earnings Power

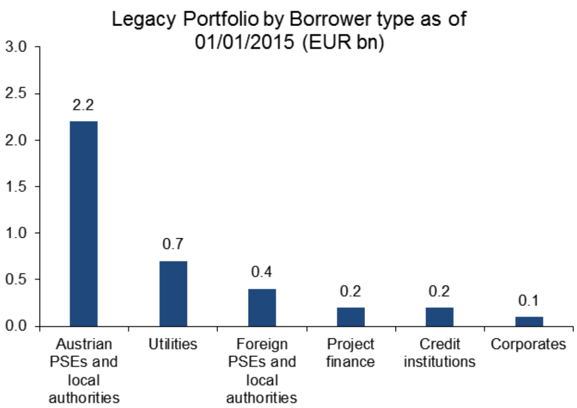
The historical earnings profile of KA old was characterized by low profitability. This largely reflected the “buy and hold” and tender offer platform which had dominated public finance generation. Going forward, KA’s initial earnings are largely tied to its EUR 3.8 billion of legacy assets acquired in the de-merger. These are expected to generate annual NII in the range of 1% of portfolio assets. The portfolio is fully funded and will decline in size as the portfolio matures. Initial earnings will also include fee income linked to services provided by KA to KF under a service level agreement. By 2020, the Bank aims to achieve a more balanced revenue and earnings profile which is majority generated by NII and fee and commission income from new business. KA anticipates more lucrative earnings from future business generation, yet this will need to be established in conjunction with successful roll-out of the new strategy.

DBRS notes that there is a high level of uncertainty regarding the Bank’s future earnings profile from new business, given the transformation taking place in the business model. However, initial earnings are primarily generated by the legacy portfolio and this provides KA a window of time during which to build up its new franchise. The current ratings are based on an expectation of dependable NII from existing de-merged assets, complemented by increasing fee income linked to the new originate to distribute model. Although failure to achieve forecast goals could result in downward pressure on the current rating, non-public interim results thus far support management’s plans.

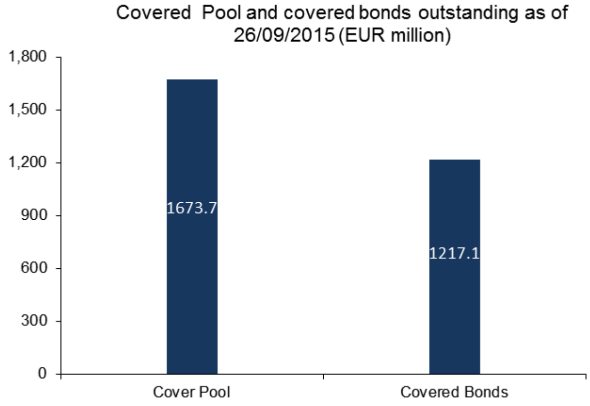
Risk Profile

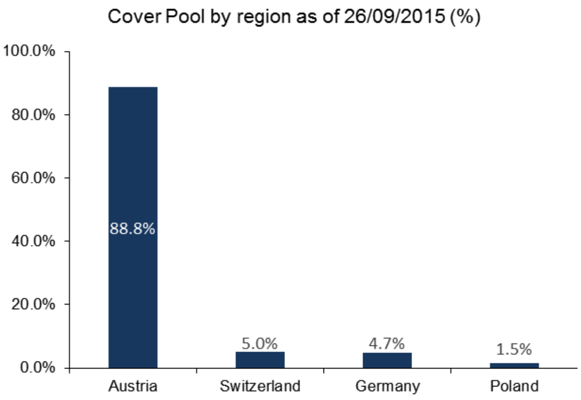
KA’s portfolio is primarily investment grade and at initiation contained no non-performing exposures. The bulk of the risk is Austrian with a large concentration to Austrian municipalities. The portfolio has some concentration with the top 20 exposures exceeding the absolute level of CET 1 capital. Yet this is partially mitigated by quality of exposure to most provinces, public entities and/or the additional guarantees which are in place.





KA’s portfolio incorporates an asset base which effectively serves to support EUR 1.2 billion in legacy covered bond funding. The cover pool, including over-collateralisation of 37% totals EUR 1.6 billion. The cover pool is highly rated and is largely linked to Austrian assets.



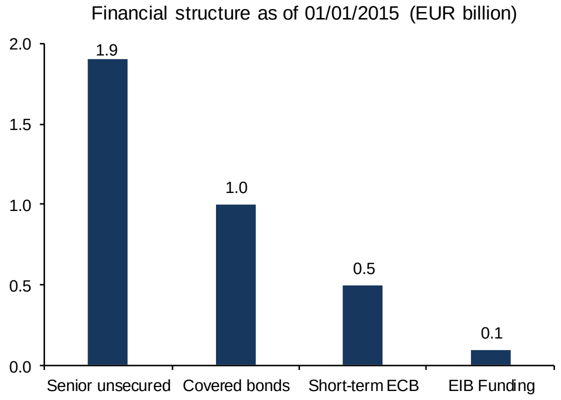


In order to ensure that the future quality of exposure remains strong, KA has established strict parameters for new business generation. The Bank will only finance new projects for which cash flows can be clearly defined as fully viable and sufficient to cover the entire credit period and which are not reliant on linked collateral and guarantees. Following the demerger in September 2015, KA is again authorized to engage in new business and new financing which will ramp up over several years as the business model is established.

The principal change in KA's risk profile will be related to the credit risk of new business. By 2020, newly generated business is expected to contribute up to 50% of the Bank's portfolio. Yet it will constitute a much larger share of overall risk weighted assets at the Bank as new business is targeted for industry and private exposure, rather that the public sector focused legacy portfolio. As noted above, the new business will be focused in Austria, as well as more broadly across core EU markets and will be concentrated in KA's key areas of competence -- Energy & Environment, Social Infrastructure and Transport.

Funding and Liquidity

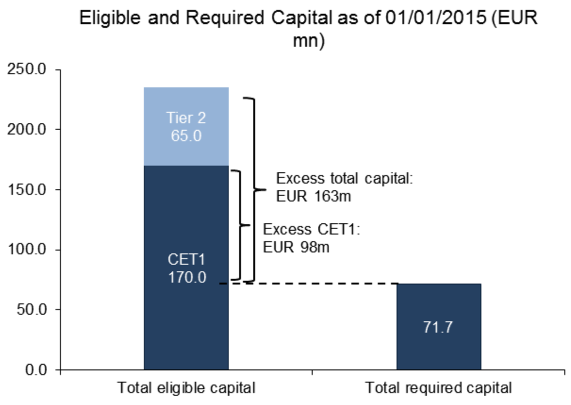
KA's funding profile largely reflects the funding of the legacy portfolio. This is outlined in the breakdown below. Apart from the legacy funding itself, the Bank benefits from a large surplus pool of ECB-eligible assets. KA also raises small levels of corporate deposits from municipalities through a web platform named KA Direkt. Although the EU had placed a moratorium on KA old taking on new deposit clients in 2013, existing clients have remained with the Bank and KA anticipates scope for some deposit expansion going forward. Clients are likely to remain focused on municipalities and regional corporates linked to KA associated projects.

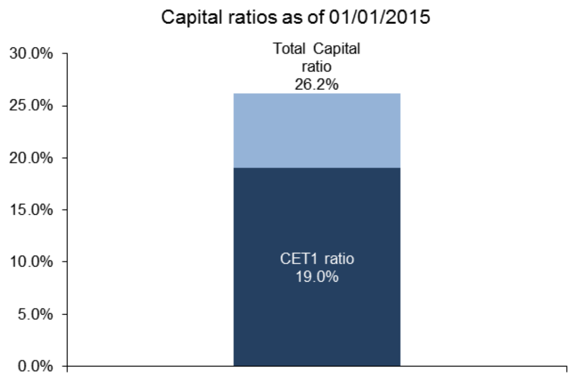


The legacy portfolio is fully funded until maturity, with the bulk of financing provided by senior unsecured and covered bonds. KA emphasizes that the structure ensures compliance with Basel III LCR and NSFR requirements. Going forward, the legacy funding will decline in tandem with the run-off and maturity of the assets they finance. KA expects that up to half of the legacy assets will have been run-off by 2020. KA plans to initially fund its new business through operating earnings, as well as the re-entry into wholesale funding markets.

Capitalization: Structure and Adequacy

KA has strong capital ratios with a CET1 of 19% and a total capital ratio of 26% retroactive to January 1, 2015. This reflects the good quality of the Bank's legacy portfolio which is mostly exposed to Austrian municipalities and therefore result in a low levels of RWAs. In absolute terms the Banks has CET1 of EUR 170 million under Austrian UGB (GAAP) for which all assets are valued at book. DBRS understands that available capital is materially higher under IFRS. KA targets a 13% CET1 ratio over the long term while maintaining a higher capital ratio as the new business ramps up and higher risk weightings for future new business erode some of the current strength.





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EUR Millions	01/01/2015 EUR Local GAAP	
Balance Sheet		
Cash and balances with central banks	267	5.94%
Public-Sector debt instruments eligible as collateral for Central bank funding	165	3.68%
Loans and advances to banks	533	11.86%
Loans and advances to customers	3,192	71.04%
Bonds and other fixed-income securities	155	3.44%
Participations	1	0.02%
Investments in associates	6	0.14%
Intangible non-current assets	0	0.01%
Property, plant and equipment	2	0.04%
Other assets	149	3.32%
Accruals	22	0.50%
Total assets	**4,493**	**100.00%**
Amounts owed to banks	1,234	27.46%
Amounts owed to customers	390	8.69%
Securitised liabilities	2,445	54.42%
Other liabilities	149	3.33%
Accruals	24	0.54%
Provisions	12	0.28%
Supplementary capital pursuant to Part 2 Titel 1 Chapter 4 CRR	68	1.50%
Equity	170	3.78%
- Subscribed capital	159	3.55%
- Capital reserves	0	0.00%
- Revenue reserves	1	0.01%
- Statutory reserve pursuant to § 23(6) Austrian Banking Act	10	0.22%
- Net loss / profit	0	0.00%
Total liabilities and equity funds	**4,493**	**100.00%**

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Ratings History

Issuer	Debt Rated	Current
Kommunalkredit Austria AG	Long Term Debt and Deposit	BBB (low)
Kommunalkredit Austria AG	Short-Term Debt and Deposit	R-2 (middle)

Notes:
All figures are in EUR unless otherwise noted.

For the definition of Issuer Rating, please refer to Rating Definitions under Rating Policy on www.dbrs.com.

Issuer ratings apply to all general senior unsecured obligations of the issuer in question.

Ratings assigned by DBRS Ratings Limited are subject to EU regulation only.