Press Release

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Insight beyond the rating.

DBRS Confirms Kommunalkredit Austria AG at BBB (low), Trend Changed to Negative

Industry: Fin.Svc.--Banks & Trusts

DBRS Ratings Limited (DBRS) has today confirmed the Long-Term Debt & Deposit rating of Kommunalkredit Austria AG (KA or the Bank) at BBB (low) and the Bank's Short-Term Debt and Deposit rating at R-2 (middle). The trend on both ratings has been changed to Negative. KA's intrinsic assessment (IA) remains BBB (low) and the Support Assessment (SA) remains unchanged at SA3.

The BBB (low) long-term ratings continue to reflect the good quality and self-funding dynamic of the legacy portfolio which provides the Bank with some cushion in terms of time, capital and earnings in order to fully establish KA's planned business model. DBRS notes additionally KA's strong liquidity profile with approximately EUR 800 million of liquid assets that can be used for repos under ECB collateral rules. However, the rating also takes into account the challenges faced by the Bank, including its narrow and new business model, lack of track record, and dependence on wholesale funding.

The change in the trend to Negative, from Stable, reflects the Bank's relative lack of progress towards meeting the targets it has set for profitability and new business volumes within its business plan following regulatory delays in the approval of the demerger. The Bank has a challenging timeframe to meet to build up its new project finance activities in a conservative manner, at the same time that the legacy portfolio runs off.

Since the demerger from KA old (the good bank part of the former Kommunalkredit Austria) in September 2015, the Bank's 1H16 financial performance in terms of operating profit has been weak. The Bank is lagging behind its projected targets due to the later regulatory approval for the demerger and the subsequent related delay in business generation, but also due to the competitive environment and ultra-low interest rates in the Eurozone. The results of the Bank, under both IFRS and the local GAAP, were boosted by extraordinary gains on the buy-back of own bonds (mainly outstanding covered bonds) and the unwinding of related interest hedging derivatives. This was recorded as income of EUR 47 million under Austrian GAAP and EUR 31.9 million of positive valuation result under IFRS. Under Austrian local GAAP the operating result for 1H16 totalled EUR 4 million while net income amounted to EUR 29.7 million. The Bank also charged EUR 25.0 million as additions into its capital reserve account (silent reserves under local GAAP). Together with the existing capital reserves of EUR 15.0 million (fund for general banking risks), this contributed to a further strengthening of its capital. At the same time, however, DBRS notes that part of the extraordinary income was paid to shareholders through a dividend payment. DBRS will continue to closely monitor future shareholder payments.

KA still needs to successfully establish the Bank's new business generation. New business at KA was expected to grow slowly but is then planned to increase at a faster rate from 2017, once the new model is fully established. Earnings from the new business are planned to more than offset the expected decline in cash flow from the legacy portfolio as these assets mature.

DBRS understands that KA's planned business model emphasises a balance sheet-light generation of project risks. Focusing on areas of expertise such as energy & environment, social infrastructure and transport, KA aims to generate new business based on project cash flows and plans to sell the major portion of future risk to market investors. The Bank plans to pursue an active syndication strategy to long-term investors (e.g. insurance and pension funds) which is planned to be stepped up after 2018 as new business volumes are planned to increase. Meanwhile the Bank is pursuing a wide array of syndication channels (funds, insurance companies, pension funds, family offices) and is in the process of establishing its own distribution platform in the form of an alternative investment fund structure. DBRS also notes that the Bank will need to manage its syndication risk in a conservative manner to ensure it is appropriately positioned at times of market stress.

DBRS notes that during the portfolio build-up phase of KA, there are increased risks due to the early stage that many projects will be in (e.g. construction risk). In addition, many projects generate positive cash flows only after many years and the initial phase of an infrastructure project is typically subject to high cash flow uncertainties. Additionally, the uniqueness of infrastructure projects (e.g. road bridges, schools, etc.) makes infrastructure investments less liquid. The high initial construction risks, tail loaded cash flow profiles and illiquidity of the financed assets require that the lender is able to command a sizable risk premium, in terms of realised loan gross margins, for the financed transactions. This is becoming increasingly difficult in the current low yield environment which is additionally impacted by high competition. These risks are somewhat balanced by KA's good technical expertise, the application of a cash flow based lending methodology and the existence of state regulated price schemes for some projects.

KA currently reports approximately CHF 1.4 billion of FX-denominated liabilities (mainly covered bonds). The position is hedged through short-term FX derivatives, and is as such exposed not only to counterparty but also roll-over risk, although DBRS notes that this risk is expected to come down substantially (to be reduced by half) in late 2016 and early 2017, as a large amount of outstanding coverd bond issuances are maturing.

While KA has a strong CET1 ratio of 27.9% under Basel III transitional rules, DBRS notes that KA's risk-weighted asset (RWA) density is extremely low (risk weighted assets amount to only 18% of assets). As a result, the absolute level of CET1 capital is, in DBRS' view, comparatively low. The low RWA density mainly reflects the good quality of the Bank's legacy portfolio which is mostly exposed to Austrian municipalities and therefore result in a low level of RWAs. The low level of nominal capital however highlights the importance of managing concentration risk and the ability of the Bank to syndicate exposures. KA is targeting 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. Maintaining both strong capital levels and ratios will be important to balance the risks arising from credit risk concentrations inherent to the business model, the cash flow uncertainty of some infrastructure projects, as well as the illiquidity of the financed assets. Additionally, a prudent dividend distribution policy going forward remains an important rating factor.

RATING DRIVERS
Any further deterioration or variance in the Bank's progress in achieving its targeted levels of new business, profitability, capital and/or expected leverage, or a deterioration in the quality of assets or earnings from new business or the legacy portfolio, or excessive risk taking would exert negative rating pressure. Additional pressure could arise if planned dividends were distributed at a time when support for the Bank's capital levels was needed.While, near term upside for the ratings is limited by the Bank's monoline business model, a sustained positive track record of growth with well contained risks over the longer term and good capitalisation levels would be credit positive for the Bank.

Notes:
All figures are in EUR unless otherwise noted.

The principal applicable methodology is the Global Methodology for Rating Banks and Banking Organisations (July 2016). Other applicable methodologies include the DBRS Criteria – Support Assessments for Banks and Banking Organisations (March 2016) and DBRS Criteria: Rating Bank Capital Securities – Subordinated, Hybrid, Preferred & Contingent Capital Securities (February 2016). These can be found can be found at: http://www.dbrs.com/about/methodologies

The sources of information used for this rating include SNL Financial and company reports. DBRS considers the information available to it for the purposes of providing this rating to be of satisfactory quality.

DBRS does not audit the information it receives in connection with the rating process, and it does not and cannot independently verify that information in every instance.

Generally, the conditions that lead to the assignment of a Negative or Positive Trend are resolved within a twelve month period. DBRS's outlooks and ratings are under regular surveillance

For further information on DBRS historical default rates published by the European Securities and Markets Authority ("ESMA") in a central repository, see:
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Ratings assigned by DBRS Ratings Limited are subject to EU regulations only.

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Issuer	Debt Rated	Rating Action	Rating	Trend	Latest Event
Kommunalkredit Austria AG	Long Term Debt and Deposit	Trend Change	BBB (low)	Neg	Oct 11, 2016
Kommunalkredit Austria AG	Short-Term Debt and Deposit	Trend Change	R-2 (middle)	Neg	Oct 11, 2016

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