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DBRS Confirms Kommunalkredit Austria AG at BBB (low), Trend Revised to Stable

Industry: Fin.Svc.--Banks & Trusts

DBRS Ratings Limited (DBRS) has confirmed the ratings of Kommunalkredit Austria AG (KA or the Bank), including its Long-Term Issuer Rating at BBB (low) and Short-Term Issuer Rating at R-2 (middle). The trend for all ratings has been revised to Stable, from Negative. The Intrinsic Assessment (IA) for the Bank is BBB (low), while its Support Assessment remains at SA3.

KEY RATING CONSIDERATIONS

The change in the trend on KA's ratings, to Stable, from Negative, reflects the progress that the Bank has made in developing its franchise in infrastructure lending, the improved core profitability, the ongoing very strong asset quality of both the legacy portfolio and the newly originated portfolio, and the continued robust liquidity profile. The BBB (low) IA incorporates the establishment of an "originate to distribute" model for infrastructure project finance assets, working closely with project sponsors and institutional investors to structure long term investments. The Bank has a challenging timeframe to build up its new project finance activities, as the legacy public sector portfolio runs off over the coming years. In DBRS's view the Bank has made good progress in 2017 and 1H18 in developing its franchise as evidenced by newly originated volumes of over EUR 530 million in 1H18. The Bank continues to have no non-performing loans reflecting the high quality of the public sector portfolio, although DBRS will continue to monitor asset quality closely given the lumpy nature of the infrastructure lending. Liquidity remains robust, however DBRS notes that, although capital ratios are high the nominal capital base is small.

RATING DRIVERS

Further positive rating pressure would require (i) a sustained positive track record of growth in infrastructure debt lending with well contained risks over the longer term, reflecting a successful transformation and execution of the new business model, (ii) maintenance of good capitalisation levels during the period of business growth, and (iii) further improvement in core profitability resulting from the new business activity.

Downward pressure on the ratings would be likely in the event of (i) any deterioration or variance in the Bank's progress in achieving its targeted levels of new business, profitability and/or capital levels, (ii) deterioration in asset quality or earnings from new business or the legacy portfolio, or (iii) if

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dividends were distributed at a time when support for the Bank's capital levels was needed.

RATING RATIONALE

The Bank reported pre-tax profit of EUR 11.5 million in 1H18, up from EUR 10.8 million in the same period of 2017, due to improved new business and controlled operating expenses, and the Bank's operating result improved to EUR 13.8 million during 1H18 (from EUR 4.6 million in 1H17). DBRS does however note that due to the implementation of IFRS 9 accounting rules in 2018, previous years' figures are of limited comparability. KA is slowly transforming its income sources from the legacy portfolio towards infrastructure debt lending and in 1H18, for the first time, the share of net interest income (NII) from new business exceeded NII generated by the legacy portfolio. DBRS expects this trend to continue as the legacy portfolio is expected to reduce by approximately 40% by 2021, however the legacy portfolio will continue to provide a crucial contribution to KA's earnings generation.

KA's asset quality continues to benefit from the high-quality public sector legacy portfolio which accounts for EUR 1.5 billion or around 60% of the total EUR 2.5 billion portfolio. This portfolio is primarily investment grade and contains no non-performing exposures. As a result of the legacy portfolio, around two thirds of the total loan portfolio remains within the domestic market with a large concentration to Austrian municipalities. DBRS notes that the Bank's total loan portfolio has high credit concentrations with the top 20 exposures representing 4.1 times the absolute level of CET1 capital. This is however substantially mitigated by the high quality of the assets, which mostly relate to provinces or public entities and many additionally benefit from guarantees. Although KA continues to have zero impaired loans as of 1H18, DBRS notes the unseasoned nature of KA's newly originated loan book and the greater risks during the portfolio build-up phase. DBRS also notes that the Bank will need to manage the syndication of risk in a conservative manner to ensure it is appropriately positioned at times of market stress.

KA has a diversified funding base comprising covered bonds, debt issuance and a growing deposit base. Debt securities remain the largest funding source for Kommunalkredit and this includes both covered bonds and senior debt. Customer deposits continue to grow, reaching EUR 910 million in 1H18, more than doubling since 1H17. As of 1H18, customer deposits represent 30% of the Bank's total funding. The growth in the deposit base reflects the ability of KA to raise deposits through Kommunalkredit Invest (an online retail platform) and Kommunalkredit Direkt, the Bank's deposit platform for local authorities and public-sector-related enterprises where KA raises corporate online deposits from municipalities. DBRS considers this funding source as relatively stable given the term of these deposits. The legacy portfolio is fully funded until maturity, with the bulk of financing provided by senior unsecured and covered bonds, however the legacy funding will decline in tandem



with the run-off and maturity of the assets they finance. The Bank currently funds its new business through existing liquidity, new deposits, as well as private placements raised under its Debt Issuance Programme. Liquidity is also strong with a free liquidity reserve of EUR 201 million at 1H18, well in excess of total debt maturities to the end of 2019.

The Bank's fully loaded Basel III Common Equity Tier 1 (CET1) ratio was at a high level of 21.3% at 1H18, although this was down by 220 bps from end-2017, driven by the development of new business which has higher risk weightings. As of 1H18, the Bank reported a total capital ratio of 26.9% and a leverage ratio of 6.7%. While KA maintains a strong CET1 ratio, DBRS notes that KA's risk-weighted asset (RWA) density is low, with RWAs amounting to 28.2% (vs. 27.1% at end-2017) of total IFRS balance sheet assets. The low RWA density reflects the good quality of the Bank's legacy portfolio, which is mostly exposed to Austrian municipalities. The low level of nominal capital (EUR 293.7 million), however, highlights the importance of managing concentration risk and the ability of the Bank to syndicate exposures. KA is targeting to maintain a CET1 ratio exceeding 15% over the long term, as the new business increases and higher risk weightings for future new business impact the capital ratios. DBRS views the Bank's internal capital generation ability as improving. In 1H18, KA reported under IFRS, cash dividend payments of EUR 11.5 million related to FY 2017 result. DBRS notes that with the plan to grow RWAs, a prudent dividend distribution policy will remain an important rating factor.

The Grid Summary Grades for Kommunalkredit Austria AG are as follows: Franchise Strength – Moderate; Earnings – Moderate; Risk Profile – Good/Moderate; Funding & Liquidity – Good; Capitalisation – Moderate.

Notes:

All figures are in Euro unless otherwise noted.

The principal applicable methodology is the Global Methodology for Rating Banks and Banking Organisations (July 2018). This can be found can be found at:
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Issuer	Debt Rated	Rating Action	Rating	Trend	Latest Event
Kommunalkredit Austria AG	Long-Term Issuer Rating	Trend Change	BBB (low)	Stb	Oct 8, 2018
Kommunalkredit Austria AG	Long-Term Senior Debt	Trend Change	BBB (low)	Stb	Oct 8, 2018
Kommunalkredit Austria AG	Long-Term Deposits	Trend Change	BBB (low)	Stb	Oct 8, 2018
Kommunalkredit Austria AG	Short-Term Issuer Rating	Trend Change	R-2 (middle)	Stb	Oct 8, 2018



Issuer	Debt Rated	Rating Action	Rating	Trend	Latest Event
Kommunalkredit Austria AG	Short-Term Debt	Trend Change	R-2 (middle)	Stb	Oct 8, 2018
Kommunalkredit Austria AG	Short-Term Deposits	Trend Change	R-2 (middle)	Stb	Oct 8, 2018

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