FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Kommunalkredit Austria at 'BBB-'; Outlook Stable

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Fitch Ratings - Frankfurt am Main - 21 Feb 2023: Fitch Ratings has affirmed Kommunalkredit Austria AG's (KA) Long-Term Issuer Default Rating (IDR) at 'BBB-' with a Stable Outlook and Viability Rating (VR) at 'bbb-'.

KEY RATING DRIVERS

Business Model Constrains Ratings: KA's VR reflects its established niche franchise in infrastructure and energy (I&E) finance, experienced management team, improving profitability and strong asset quality record. It is underpinned by a robust risk-management framework and adequate funding and liquidity. The bank's VR is constrained by our assessment of its business profile given its small equity base relative to concentration risks in its I&E portfolio.

Well-Executed Business: The bank's concentrated but robust business model concentrates on its niche finance in European I&E financing and on municipal finance (mainly in Austria). KA's highly experienced management team has a successful, albeit short, record in operating these businesses with above- average returns while maintaining strong asset-quality metrics. We believe that the expected change in KA's ownership - agreed in February and likely to be closed in 3Q23 - will not result in a fundamental change of its strategy.

Uneven Risk Profile: Our assessment of the bank's risk profile incorporates its appetite for sub-investment grade-rated, opportunistic infrastructure and project-finance transactions and declining low-risk municipal financing as a share of its total loans. KA's underwriting standards and risk-control framework have so far mitigated inherent project risks in infrastructure assets as demonstrated by a lack of loan defaults since end-2015.

Strong Asset-Quality Metrics: KA's asset quality benefits from its low-risk public sector portfolio. To date the bank has not reported any non-performing loans (NPLs), despite higher-risk exposures in its I&E segment. However, given its concentrated loan book, single NPLs could sharply inflate its impaired loans ratio as its infrastructure loan book seasons. This is however mitigated by above-average historical recovery rates in the I&E segment and low correlation between the financed asset classes.

Above-Average Profitability: KA's profitability is a rating strength and rising due to the expansion of its new business volume in combination with limited credit losses and a competitive cost base. Our assessment also reflects concentration of revenue in the I&E segment. We believe KA can maintain healthy profitability above peers' in 2023 and 2024, but the bank's concentrated credit exposures mean that loan losses on a small number of counterparties would affect earnings materially.

Small Capital Base: KA maintains capital ratios with adequate buffers over its minimum capital requirements, and the bank has a targeted capital increase of EUR100 million from its new owner in 2023. Despite the planned injection and internal capital generation, the size of its equity base is still small relative to the concentration and business risks inherent in its I&E portfolio.

Stable Funding and Sound Liquidity: The bank's funding profile is stable, which we expect to remain intact in a rising-rate environment given KA's recourse to retail and wholesale deposits. This is supplemented by KA's capital-market activities including covered bond and senior debt issuance. KA's liquidity is sound, prudently managed and underpinned by the bank's solid liquidity buffers.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to negative rating action/downgrade:

We could downgrade the ratings if the bank incurs multiple sizeable defaults in its project-finance portfolio, leading to weaker capitalisation or if it relaxes its limits and underwriting standards to enable further opportunistic lending to higher-risk projects, more aggressive project-financing structures or junior financing.

We could also downgrade the ratings if aggressive risk-weighted assets (RWA) growth without matching capital increases results in an increasing use of KA's large exposure limit. A downgrade could also result from significant deterioration in the bank's ability to syndicate its lending commitments to a sizeable pool of external investors.

Factors that could, individually or collectively, lead to positive rating action/upgrade:

An upgrade of the IDR and the VR would require a materially larger and more diversified franchise and a major reduction in single-name concentration, in combination with further and material strengthening of its capital base, beyond the planned capital injection from its owners in 2023.

OTHER DEBT AND ISSUER RATINGS: KEY RATING DRIVERS

Its 'F3' Short-Term IDR is the only option mapping to a 'BBB-' Long-Term IDR.

KA's long-term senior preferred (SP) debt rating is aligned with the bank's Long-Term IDR. This reflects Fitch's expectation that KA will not be subject to a minimum requirement for own funds and eligible liabilities, and that the bank will not build and maintain buffers of junior and senior non-preferred debt sustainably in excess of 10% of its RWAs.

KA's 'no support' Government Support Rating (GSR) reflects our view that the EU's resolution framework is likely to require senior creditors participating in losses, if necessary, instead or ahead of a bank receiving sovereign support. The IDRs also do not factor in any support from KA's owners because Fitch generally considers that support from financial investors, while possible, cannot be relied upon.

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OTHER DEBT AND ISSUER RATINGS: RATING SENSITIVITIES

The SP notes' rating is sensitive to KA's Long-Term IDR.

KA's GSR is at the bottom of Fitch's rating scale and therefore cannot be downgraded. An upgrade of the GSR would require a higher propensity of sovereign support. While not impossible, the Bank Recovery and Resolution Directive makes this highly unlikely.

VR ADJUSTMENTS

The operating environment score of 'a+' is below the 'aa' category implied score due to the following adjustment reason: international operations (negative).

The business profile score of 'bbb-' is above the 'bb' category implied score due to the following adjustment reason: strategy and execution (positive)

The asset quality score of 'bbb' is below the 'aa' category implied score due to the following adjustment reason: concentrations (negative)

The earnings and profitability score of 'bbb' is below the 'a' category implied score due to the following adjustment reason: revenue diversification (negative)

The capitalisation and leverage score of 'bb+' is below the 'a' category implied score due to the following adjustment reason: size (negative); internal capital generation and growth (negative)

The funding and liquidity score of 'bbb-' is above the 'bb' category implied score due to the following adjustment reason: non-deposit funding (positive)

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Financial Institutions and Covered Bond issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com.

RATING ACTIONS

ENTITY / DEBT	RATING	PRIOR

Kommunalkredit Austria AG	LT IDR	BBB- Rating Outlook Stable Affirmed		BBB- Rating Outlook Stable
	ST IDR	F3	Affirmed	F3
	Viability	bbb-	Affirmed	bbb-
	Government Support	ns	Affirmed	ns
Senior preferred	LT	BBB-	Affirmed	BBB-

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Bank Rating Criteria (pub. 07 Sep 2022) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Kommunalkredit Austria AG	EU Issued, UK Endorsed

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