FitchRatings

RATING ACTION COMMENTARY

Fitch Revises Kommunalkredit Austria's Outlook to Positive; Affirms IDR at 'BBB-'

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Fitch Ratings - Frankfurt am Main - 08 Feb 2024: Fitch Ratings has revised Kommunalkredit Austria AG's (KA) Outlook to Positive from Stable while affirming its Long-Term Issuer Default Rating (IDR) at 'BBB-'. A full list of rating actions is below.

The Positive Outlook reflects continuing improvements in KA's financial profile. This includes in particular a substantial strengthening of the bank's capital base, which together with improved internal capital generation, increases the bank's capacity to absorb unexpected credit losses from its concentrated loan book.

KEY RATING DRIVERS

Business Model Constrains Ratings: KA's IDRs and Viability Rating (VR) reflect its established niche franchise in infrastructure and energy (I&E) finance, an experienced management team, profitability well above peers' and a strong asset-quality record. The ratings are underpinned by a robust risk-management framework and adequate funding and liquidity.

The bank's VR is constrained by Fitch's assessment of its business profile given its small, albeit growing, equity base relative to concentration risks in its I&E portfolio.

Successful Record; Experienced Management: KA's concentrated but robust business model focuses on its niche franchise in European I&E financing and on municipal finance (mainly in Austria). KA's highly experienced management team has a successful record in these businesses, with above-average returns while maintaining strong asset-quality metrics.

Fitch believes that the expected change in KA's ownership - agreed in February 2023 and likely to be completed in 1H24 - supports KA long-term focus and growth trajectory.

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, supplemented by low-risk municipal financing, although the latter is gradually declining 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 an impaired loan ratio significantly below that of peers with concentrated loan books.

Strong Asset-Quality Metrics: KA's asset quality benefits from its low-risk public sector portfolio. However, higher-risk exposures in its concentrated and growing I&E segment increase the risk of further loan impairments in the medium term as its loan book seasons. We estimate a moderate deterioration in KA's asset quality at end-2023, which we expect to extend into the next two years. However, we expect asset quality to remain significantly better than peers', mitigated by above-average historical recovery rates and low correlation between its financed asset classes.

Above-Average Profitability: KA's profitability is a rating strength and well above peers'. We estimate strong profitability in 2023 to have been driven by the expansion of its loan book in combination with strong margins, limited credit losses and an efficient cost base. Our assessment also reflects concentration of revenues in the I&E segment. We believe KA can maintain healthy profitability above peers' in 2024 and 2025, but the bank's concentrated credit exposures mean that loan losses on a small number of counterparties would affect earnings materially.

Small but Growing Capital Base: KA maintains capital ratios with adequate buffers over their regulatory minimum capital requirements despite the small size of its equity base. KA has a targeted capital increase of EUR100 million from its new owner once the acquisition is approved by the respective authorities, FMA and ECB, likely in 1H24.

Fitch expects KA's new owners to follow a supportive dividend strategy, which will allow KA to further increase its capital base via strengthened internal capital generation over the medium term. This underpins our positive outlook on the capitalisation score.

Stable Funding; Sound Liquidity: The bank's funding profile is stable, which we expect to continue in the current rate environment. KA's broadening access to retail and wholesale deposits, albeit confidence-sensitive, supports a further decline in KA's loan-to deposit ratio. KA's funding profile is supplemented by capital-market activities including covered bond and senior unsecured 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

A downgrade of the IDRs and VR is unlikely in the short term as indicated by the Positive Outlook. However, inability to continue growing KA's capital base in line with current management projections could result in an Outlook revision to Stable.

Pressure on the ratings could arise 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 RWA growth without matching capital increases results in 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

KA's Long-Term IDR and VR could be upgraded if the bank strengthens and increases its capital base on a sustained basis, beyond the expected capital injection from its new owners in 2024, leading to a reduction in concentration risks.

An upgrade of KA's Long-Term IDR and VR would be contingent on extending its record of business- model stability and earnings and profitability remaining resilient over the medium term, with an operating profit above 3% of RWAs. An upgrade would also require an impaired loan ratio being sustained at below 3% and evidence that the bank will not relax its current risk appetite.

OTHER DEBT AND ISSUER RATINGS: KEY RATING DRIVERS

KA's '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 that KA is not subject to a minimum requirement for own funds and eligible liabilities for the time being, and that the bank will not build and maintain buffers of junior and senior non-preferred debt in excess of 10% of its RWAs on a sustained basis.

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, ahead of a bank receiving sovereign support. The IDRs also do not factor in any support from KA's owners because Fitch generally views that support from financial investors, while possible, cannot be relied on.

OTHER DEBT AND ISSUER RATINGS: RATING SENSITIVITIES

An upgrade of the Short-Term IDRs would require an upward revision of the funding and liquidity score to 'bbb+', in conjunction with an upgrade of the Long-Term IDR.

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

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 reasons: size (negative); risk profile and business model (negative)

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

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

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' 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. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit https://www.fitchratings.com/topics/esg/products#esg-relevance-scores.

RATING ACTIONS

ENTITY / DEBT	RATING			PRIOR
Kommunalkredit Austria AG	LT IDR	BBB- Rating Outlook Positive	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

FITCH RATINGS ANALYSTS

Roger Schneider
Director
Primary Rating Analyst
+49 69 768076 242
roger.schneider@fitchratings.com
Fitch Ratings – a branch of Fitch Ratings Ireland Limited
Neue Mainzer Strasse 46 - 50 Frankfurt am Main D-60311

Patrick Rioual
Senior Director
Secondary Rating Analyst

+33 1 44 29 91 21
patrick.rioual@fitchratings.com

Christian Kuendig
Managing Director
Committee Chairperson
+44 20 3530 1399
christian.kuendig@fitchratings.com

MEDIA CONTACTS

Peter Fitzpatrick
London
+44 20 3530 1103
peter.fitzpatrick@thefitchgroup.com

Additional information is available on www.fitchratings.com

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APPLICABLE CRITERIA

Bank Rating Criteria (pub. 01 Sep 2023) (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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