



*Insight beyond the rating.*

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## **DBRS Confirms Kommunalkredit Austria AG at BBB (low) with Negative Trend**

**Industry: Fin.Svc.--Banks & Trusts**

DBRS Ratings Limited (DBRS) confirmed 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 on all ratings remains Negative. KA's intrinsic assessment (IA) remains BBB (low) and the Support Assessment (SA) remains unchanged at SA3.

The BBB (low) long-term ratings reflect the good quality and self-funding dynamic of the Bank's legacy portfolio, which provides a cushion in terms of time, capital and earnings in order for KA to fully establish its planned business model. DBRS notes additionally KA's strong liquidity profile with approximately EUR 561 million of liquid assets, of which EUR 248 million unencumbered, which can be used for repos under ECB collateral rules. However, the rating also takes into account the challenges faced by the Bank, including the successful roll-out of its narrow and new business model alongside with challenges related to organisational transformation, the necessity for the Bank to build a track record in underwriting, syndicating and managing the risks from infrastructure finance projects, as well as its high proportion of wholesale funding.

The Negative Trend reflects the fact that the Bank still needs to demonstrate it can meet its targets for underlying profitability and new business volumes within its business plan, after a difficult start in 2016 caused mainly by regulatory delays. It also reflects DBRS's view that KA needs to demonstrate it can retain sufficient future profits and generate sufficient capital to ensure the Bank is able to remain at all times well capitalised while transforming its business model into a more RWA intensive one.

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. DBRS notes, however, the recent significant progress the Bank has made in new business generation in 1H17, which is likely to affect FY2017 results positively, mostly in terms of increased income from fees and commissions. The Bank's guidance for the FY2017 result is a more normalised profit level of around EUR 20 million under local GAAP compared to EUR 37.5 million in FY2016, which was driven by certain extraordinary items.

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New business at KA has grown slowly in 2016 but DBRS expects it to increase at a faster rate throughout 2017 and onwards. The recent significant progress in KA's origination and syndication efforts as of August 2017 resulted in new business generation of 17 projects in the areas of Transport, Energy & Environment, as well as Social Infrastructure with a total volume of EUR 454 million. According to KA's planning, the share of net interest income (NII) from the new business in the Bank's overall NII, which is projected to amount around 20% for year-end 2017, is set to exceed 60% by 2021, aiming to counterbalance the expected decline in cash flow from the legacy portfolio. The legacy portfolio stood at EUR 2.680 billion as of year-end 2016 and is expected to decrease by EUR 524 million to EUR 2.156 billion by year-end 2017 and reduce by approximately half by 2021 (based on contractual asset maturities). As the Bank is currently in a transformation phase, DBRS expects the new business model to have gained firmer traction by 2021.

DBRS notes that KA's planned business model emphasises a balance sheet-light generation of project risks. Net fee and commission income, which stands at EUR 8.7 million (as of 1H17), represented 28% of underlying operating income in 1H17 (adjusted by one-off trading gains) compared with a share of 25% or EUR 7.9 million in 1H16. The Bank's management aims to increase this share substantially by 2021 mainly on the back of origination fees from syndication and fees from consulting activities. Focusing on areas of expertise such as transport, natural resources, energy & environment and social infrastructure, 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 is pursuing an active syndication strategy to long-term investors. KA has originated new business volume of EUR 454 million as of August 2017 (in 17 transactions) and has already syndicated EUR 306 million, of which 127 million (in 8 transactions) in relation to new business and EUR 179 million in relation to the legacy portfolio, utilising a wide array of syndication channels (funds, insurance companies, pension funds, family offices). KA also aims to establish its own institutional distribution platform. DBRS 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 understands that as KA's business model moves from its currently low-margin, low-risk public finance business (municipal lending) towards the focus on infrastructure lending, this also necessitates substantial cultural and organisational changes involving processes, procedures, (IT) infrastructure, resource re-allocation, staffing, etc. DBRS understands that many important steps are already under-way but aims to follow-up closely on the implementation of such changes, cautioning about potential execution risk along the way.

KA currently reports approximately EUR 0.98 billion Covered Bonds of which EUR 0.47bn are denominated in CHF. The FX-mismatch is hedged through FX derivatives on an ongoing basis, and is

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as such exposed not only to counterparty but also roll-over risk, although DBRS notes that this risk has come down substantially (from CHF 1.4 billion in 1H16), as a large amount of outstanding covered bond issuances matured. In addition, the counterparty risk is mitigated by standard daily margining arrangements under ISDA/CSA agreements.

The IFRS pre-tax profit for 1H17 totalled EUR 10.9 million (EUR 34.5 million in 1H16) while net income amounted to EUR 13.9 million (EUR 27.5 million in 1H16), which was impacted by a positive one-off tax benefit from tax loss carry forwards of EUR 3.1 million. KA reported cash dividend payments in 1H17 attributable to the owners of the parent in the amount of EUR 32 million, which related to FY 2016 results. DBRS will continue to follow up closely on future shareholder payments to its private owners while also noting the shareholders' approval of authorised capital of EUR 79.7 million in 2017 paving the way for potential future capital increases.

The Bank's fully loaded Basel III Common Equity Tier 1 (CET1) ratio decreased to 26.9% at end-June 2017, down by 600 bps from end-2016, driven by the development of new business and consequently higher RWAs. According to regulatory requirements, KA needs to maintain a minimum CET 1 ratio of at least 5.75% and a total capital ratio of at least 9.25%. As of 1H17, the Bank reported a total capital ratio of 34.4%. KA's leverage ratio was 7.5% as of 1H17 (vs. 7.19% in FY2016).

While KA has a strong reported CET1 ratio at the current time, DBRS notes that KA's risk-weighted asset (RWA) density is very low, with RWAs amounting to only 25.1% (vs. 18% in 1H16) 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 and results 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 15% 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.

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.

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## RATING DRIVERS

Any 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, reflecting a successful transformation and execution of the new business model 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 (May 2017). This can be found can be found at:

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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

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Issuer	Debt Rated	Rating Action	Rating	Trend	Latest Event
Kommunalkredit Austria AG	Long-Term Issuer Rating	Confirmed	BBB (low)	Neg	Oct 10, 2017
Kommunalkredit Austria AG	Short-Term Issuer Rating	Confirmed	R-2 (middle)	Neg	Oct 10, 2017
Kommunalkredit Austria AG	Long-Term Senior Debt	Confirmed	BBB (low)	Neg	Oct 10, 2017
Kommunalkredit Austria AG	Short-Term Debt	Confirmed	R-2 (middle)	Neg	Oct 10, 2017
Kommunalkredit Austria AG	Long-Term Deposits	Confirmed	BBB (low)	Neg	Oct 10, 2017
Kommunalkredit Austria AG	Short-Term Deposits	Confirmed	R-2 (middle)	Neg	Oct 10, 2017

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