

DBRS Morningstar Upgrades Kommunalkredit Austria AG to BBB, Trend Stable

BANKING ORGANIZATIONS

DBRS Morningstar upgraded the ratings of Kommunalkredit Austria AG (KA or the Bank), including the Long-Term Issuer Rating to BBB, from BBB (low), and the Short-Term Issuer Rating to R-2 (high), from R-2 (middle). The trend on the ratings is now Stable. The Intrinsic Assessment (IA) for the Bank was also upgraded to BBB from BBB (low), while the Support Assessment remains at SA3.

KEY RATING CONSIDERATIONS

The upgrade of the Long-Term Issuer Rating reflects the continued progress the Bank has made in developing its franchise in infrastructure lending, and the further improvement in core profitability, while maintaining solid capital levels. The upgrade also reflects the resilience of KA's business model despite the current challenging environment as a result of the COVID-19 pandemic.

The BBB IA incorporates KA's growing franchise in Infrastructure and Energy (I&E) finance as well as a solid business in public finance. KA has developed an "originate to collaborate" model for I&E finance assets, whereby the Bank works closely with project sponsors and institutional investors to structure longer term investments, which are then retained on balance sheet, or are syndicated to institutional investors and to KA's infrastructure fund, Fidelio, which was launched in 2018. In 2019 and H1 2020, KA has continued to build its franchise across a diverse range of deals. New business volume in H1 2020 was close to prior year numbers despite the severe economic downturn. The Bank continues to have zero non-performing loans reflecting the high quality of the public sector portfolio, and the good quality of the more newly originated I&E lending. DBRS Morningstar generally considers infrastructure assets as more resilient during time of crises, but we will continue to monitor credit performance closely given the lumpy nature of some of the I&E lending before syndication and KA's still relatively unseasoned portfolio. Syndication risk remains a key risk for the Bank but continues to be well managed. Funding continues to be well balanced between the growing deposit base and other wholesale sources while liquidity and capital ratios remained robust.

RATING DRIVERS

Given the narrow business focus and the concentration risk inherent in its business model, positive pressure on KA's ratings is unlikely in the medium term. However, further significant expansion of the franchise, together with longer term sustainable improvements in profitability and maintenance of solid asset quality, liquidity and capital could lead to an upgrade.

Evidence of the Bank facing significant challenges in syndicating risk, or originating new business could result in a rating downgrade. A marked deterioration in asset quality, especially in relation to larger exposures, resulting in a weakening of capital ratios could also lead to a downgrade.

RATING RATIONALE

KA has established an "originate to collaborate" model for I&E finance assets, whereby the Bank places strong emphasis on its

distribution capabilities, and works closely with project sponsors and institutional investors in order to structure long term investments. The originate to collaborate model is based on sourcing, underwriting and then syndicating I&E assets.

In 2019 and H1 2020, the Bank continued to perform well, despite the economic disruptions from COVID-19. In H1 2020, volumes of new I&E lending were at similar levels to H1 2019, with margins on new business remaining resilient. In H1 2020, KA reported a net profit (IFRS) of EUR 12.0 million, up from EUR 11.3 million in H1 2019, with operating income also improving. The improvements were driven by increases in net interest income as well as fee income, while costs were tightly managed. For the full year 2019, KA reported operating income of EUR 33.2 million, up from EUR 23.9 million in 2018, driven by both solid increases in net interest income and fees and commissions. Cost efficiency has also continued to improve with the DBRS Morningstar calculated cost-to-income ratio improving to 62% in H1 2020. Excluding more volatile and one-off items the adjusted cost-income ratio was 60% in H1 2020.

KA's asset quality remained strong with zero impaired loans as of H1 2020, reflecting the high quality of KA's public sector portfolio and the good performance of the more newly originated I&E lending. DBRS Morningstar notes, however, that the Bank's loan portfolio has high credit concentrations. These concentrations are substantially mitigated by the high quality of the assets, especially in the public sector loan portfolio. DBRS Morningstar generally considers infrastructure assets more resilient during times of crises, but notes that the portfolio is still relatively unseasoned. Given the still relatively short track record and the lumpy nature of some of the assets before syndication, DBRS Morningstar will continue to closely monitor both the credit performance of the I&E lending book and the ability of the Bank to continue to syndicate the risk.

KA has a diversified funding base comprising a significant and growing deposit base, covered bonds, debt issuance and central bank funding. Public sector covered bonds remain a significant funding source for KA, funding most of the public finance portfolio. The customer deposit base continues to grow, and DBRS Morningstar notes that the bulk of these are term deposits. KA has a robust liquidity profile with a free liquidity reserve of EUR 291 million at end-H1 2020, including EUR 284 million of high quality liquid assets (HQLA), and additionally EUR 635 million of cash, cash equivalents and balances with central, well in excess of total debt maturities to end 2021. At H1 2020, the Bank's Liquidity Coverage Ratio (LCR) was very high at 526% and the Net Stable Funding Ratio (NSFR) was also solid at 116%.

KA reported a Basel III Common Equity Tier 1 (CET1) ratio of 18.4% at end-H1 2020, up from 17.5% a year earlier. However, DBRS Morningstar notes that KA's CET 1 capital ratio can fluctuate due to its syndication activities and is likely to decrease over the medium term as risk-weighted assets (RWAs) increase. KA also reported a leverage ratio of 7.9% and a total capital ratio of 21.4%. The capital ratios are well above the Bank's minimum regulatory capital requirements. KA is targeting to maintain a CET1 ratio exceeding 15% over the long term. In DBRS Morningstar's view, maintaining solid capital ratios will be important to balance the credit risk concentrations and syndication risk as well as the relative illiquidity of the financed assets. DBRS Morningstar views the Bank's internal capital generation ability as improving. DBRS Morningstar also notes that in the past, KA's parent has foregone dividend pay-outs, injected capital and authorised additional capital (currently EUR 86 million or about one quarter of CET1 capital) if needed.

ESG CONSIDERATIONS

A description of how DBRS Morningstar considers ESG factors within the DBRS Morningstar analytical framework and its methodologies can be found at: <https://www.dbrsmorningstar.com/research/357792>.

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

Notes:

All figures are in EUR unless otherwise noted.

The principal methodology is the Global Methodology for Rating Banks and Banking Organisations (8 June 2020) <https://www.dbrsmorningstar.com/research/362170/global-methodology-for-rating-banks-and-banking-organisations>

For more information regarding rating methodologies and Coronavirus Disease (COVID-19), please see the following DBRS Morningstar press release: <https://www.dbrsmorningstar.com/research/357883>

The sources of information used for this rating include Company Documents, Annual Reports 2017- 2019, Interim Reports 2019 – 2020 H1 and S&P Global Market Intelligence. DBRS Morningstar considers the information available to it for the purposes of providing this rating to be of satisfactory quality.

DBRS Morningstar 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 12-month period. DBRS Morningstar's outlooks and ratings are under regular surveillance.

For further information on DBRS Morningstar historical default rates published by the European Securities and Markets Authority (ESMA) in a central repository, see: <http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml>.

The sensitivity analysis of the relevant key rating assumptions can be found at: <https://www.dbrsmorningstar.com/research/367783>

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Ratings

Kommunalkredit Austria AG

Date Issued	Debt Rated	Action	Rating	Trend	Issued
02-Oct-20	Long-Term Issuer Rating	Upgraded	BBB	Stb	

Date Issued	Debt Rated	Action	Rating	Trend	Issued
02-Oct-20	Short-Term Issuer Rating	Upgraded	R-2 (high)	Stb	EU
02-Oct-20	Long-Term Senior Debt	Upgraded	BBB	Stb	EU
02-Oct-20	Short-Term Debt	Upgraded	R-2 (high)	Stb	EU
02-Oct-20	Short-Term Deposits	Upgraded	R-2 (high)	Stb	EU
02-Oct-20	Long-Term Deposits	Upgraded	BBB	Stb	EU

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