5 October 2018

Rating-Agentur Expert RA upgraded from 'BB+' to 'BBB-' the ratings of Cyprus. The rating outlook is stable.

Rating-Agentur Expert RA upgraded the sovereign government credit rating (SGC) of Cyprus from 'BB+' (Sufficient level of creditworthiness of the government) to 'BBB-' (Moderately high level of creditworthiness of the government) in national currency and from 'BB+' (Sufficient level of creditworthiness of the government) to 'BBB-' (Moderately high level of creditworthiness of the government) in foreign currency. The rating outlook is stable which means that in the mid-term perspective there is a high probability of maintaining the rating score.

MAJOR FACTORS THAT INFLUENCED BOTH TYPES OF RATINGS:

Positive factors:

- The structure of debt remains favorable. According to the Public Debt Management Office, obligations due within one year stood at 4,5% of total debt in June 2018. Only 3% is issued in foreign currencies and 54% is in the form of official loans as of 1H 2018 (4% and 61% in 2017 respectively). The share of floating interest rate debt slightly dropped from 46% of the total debt load as of end-2017 down to 41% as of 1H 2018;
- Cyprus finished 2017 with a fiscal surplus of 1,8% of GDP compared to a surplus of 0,4% of GDP the year before. Favorable fiscal developments continued in 1H 2018 when the budget balance marked a surplus of 1,7% of GDP according to the Ministry of Finance. The surpluses have been driven by the revenue increase from taxes on production and imports as well as taxes on income and wealth due to the increase in the employment levels and in salaries which additionally boosted social contributions;
- The country's macro profile is improving as GDP per capita at PPP remained solid at USD 37 000 in 2017 and real GDP continued to grow by a robust 3,9% as of end-2017 (3,4% in 2016). Growth continued in 2018 driven by sectors such as retail trade, construction and manufacturing and stood at around 3,9% y-o-y as of 1Q 2018. We expect that Cypriot economy grows by around 4,0% in 2018;
- High level of institutional development as Cyprus ranked 53rd out of 190 countries in the Doing Business ranking (45th in the previous report). Additionally, it has a very high Human Development Index (adjusted for inequality) at 0,768 according to the newly publish Human Development Index for 2017;
- According to the World Bank's Worldwide Governance Indicators, Cyprus is ranked 74th out of 214 territories in the Rule of Law Index (improvement for one place compared to previous report) which indicates strong confidence in contract enforcement, property rights, the police and the courts as of September 2017;
- Net inflows of FDI in Cyprus amounted to 48% of GDP as of 2017 (12% in 2016) which is much higher compared to peer[1] countries (2% on average in 2017) showing the strong investment potential in the country.

Restricting factors:

- As we anticipated in our previous revision[2], the domestic credit to GDP dropped further in 2017 to 241% (266% by end-2016). All loan segments, including households (-6%),

[1] Cyprus peers include the "peripheral Eurozone" countries such as Portugal, Italy, Spain and Greece.
[2] Research report on Cyprus from 6 April 2018 (https://raexpert.eu/reports/Research_report_Cyprus_06.04.2018.pdf)

corporates (-9%) and financial institutions (-11%) followed a downward trend y-o-y. The banks' assets to GDP ratio plunged further to around 352% as of end-2017 (372% in 2016), and continued in a downward path as of 1Q 2018. Nonetheless, this ratio remains the highest among its euro peers;

- After peaking in 2014, the unemployment rate has been in a downward trend and reached a record low of 7,7% in 2Q 2018 (11% as of end-2017), driven mostly by seasonal employment, but still remaining below its peers' average. The jobless rate among youth was 17,9% by middle of 2018. We expect the overall unemployment figure to continue its gradual decline driven by sustained economic growth;
- Government guarantees stood at around 9,1% of GDP as of end-2016 compared to 15,4% in 2015, which slightly eases the pressure associated to contingent liabilities;
- As of end-2017, the Harmonized Index of Consumer Prices (HICP) turned negative and stood at -0,4%. Over 2018 it turned to positive territory and stood at 2,5% as of August 2018, mostly driven by increases in prices of utilities, food and beverages. We expect the HICP to grow by around 1,5% as of end-2018;
- The economy remains diversified but still highly focused in the services sector. As of 1Q 2018, the industry distribution in the three largest sectors was as follows: retail, accommodation and food services (21%), financial (9,8%) and real estate (8,3%);
- The economy is moderately competitive. Cyprus is ranked 64th out of 137 countries in the Global Competitiveness Index report (2017-2018) prepared by the World Economic Forum (83rd in previous ranking). Moreover, the trade balance widened to -4% of GDP in 2017 driven by higher imports of goods, mostly ships and aircrafts compared to -0,8 in 2016;
- Regardless of the fact that the privatization law has been annulled, resulting in the dismantling of the Privatization Unit, the Ministry of Finance continues with the privatization program; however, the overall process remains delayed with main challenges such as ports in Limassol and Larnaca, Telecom, National Lottery, Stock Exchange and Electricity Company.

Negative factors:

- By the end of 2017 the government debt dropped below 100% of GDP for the first time after 2012 down to 97,6% of GDP and 245,8% of budget revenues. Even though the debt level is likely to rise to around 106% in 2018 due to the restructuring of Cyprus Cooperative Bank (CCB), we expect this metric to decline in the following years driven by solid GDP growth and fiscal surpluses;
- Albeit improving, we still consider the banking sector as a key constraint to Cyprus' creditworthiness. Despite remaining substantially high, the share of NPLs as a percentage of total loans continued to decline further; as of May 2018 this ratio stood at 42,7%, a decline of around 3p.p. from January 2018. Going forward, we expect this metrics to reduce significantly in the short- and mid-term perspective due to the restructuring of CCB, where the government cleaned up the balance sheet of NPLs by moving them to the newly created entity. After ending 2017 in a negative note, ROA stood at 1% as of March 2018. Capitalization remains solid with capital to assets ratio at 8,8% and the overall solvency ratio at 16,2% as of December 2017 (15,5% in March 2018);
- The stock market remains underdeveloped with 69 listed companies as of July 2018 (80 in December 2017), while market capitalization stood at EUR 2,36 bn in July 2018 (12,5% of GDP as of end 2017).

Support factors:

- Participation in a strong currency and political union. Cyprus is part of the European Economic and Monetary Union (EMU) since 2004 (moderately strong support factor);

- The country has a very strong and important reserve currency (EUR) (moderately weak support factor).

SENSITIVITY ASSESSMENT:

The following developments could lead to an upgrade:

- Continued and sustained reduction in government debt levels driven by fiscal surpluses and economic output with declining unemployment and consolidation of the current account;
- Further reduction of the NPLs ratio and further decline of the overall external debt metrics.

The following developments could lead to a downgrade:

- A steep reversal on the dynamics of public finances as a result of lower GDP growth;
- Further deterioration of the banking system stance.

"The upgrade of Cyprus' SGC ratings to 'BBB-' reflects the consistent and sustained improvement in fiscal metrics resulting in an improved budgetary position and lower government debt levels. Furthermore, economic output has been solid and stable, the unemployment level continues to constantly decline and the positive net FDI figures show the improved attractiveness of the Cypriot economy for foreign investors. Moreover, the asset quality of the banking system continues to improve as a result of the government's intervention in Cyprus Cooperative Bank (CCB). Finally, we consider that the dependence of Cyprus on foreign aid has been substantially reduced since they left the three-year economic adjustment program from the European Stability Mechanism (ESM) and the IMF; since then, public finances have remained fairly stable.

However, we still consider the banking sector risk as the key threat to Cyprus' creditworthiness. Moreover, despite improving, we continue to consider public and private leverage levels to remain substantially high." - Clarified Marko Denic, Rating Analyst of Rating-Agentur Expert RA GmbH.

Responsible expert: Marko Denic, Rating Analyst of Rating-Agentur Expert RA

Reviewer: Hector Alvarez, Rating Associate of Rating-Agentur Expert RA

Research report on Cyprus is available at:

https://raexpert.eu/reports/Research_report_Cyprus_05.10.2018.pdf

Next scheduled rating publication: TBD in December 2018.

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RATING HISTORY:

Date	Review reason	SGC		Outlook	
		National currency	Foreign currency	National currency	Foreign currency
06.04.2018	Scheduled review of both types of ratings for the country	BB+	BB+	NA	NA
06.10.2017	Scheduled review of both types of ratings for the country	BB+	BB+	NA	NA
07.04.2017	Scheduled review of both types of ratings for the country	BB	BB	NA	NA
14.10.2016	Scheduled review of both types of ratings for the country	BB	BB	NA	NA
22.04.2016	First assignment of both types of ratings for the country	BB-	BB-	NA	NA

Minute's summary

The rating committee for Cyprus was held on 4 October 2018. The quorum for the rating committee was present. After the responsible expert presented the factors, which influenced the rating assessment, the members of the committee expressed their opinions and suggestions within the framework of the Sovereign methodology. The chairman of the rating committee ensured that every member of the committee expressed his/her opinion before proceeding to the voting.

The following methodology was used for the rating assessment: Methodology for Assigning Sovereign Government Credit Ratings – Full Public Version (from May 2018) can be found under the following link: https://raexpert.eu/files/methodology/Methodology_Full_Sovereign_V3.pdf. Descriptions and definitions of all rating categories can be found under the following link: http://raexpert.eu/sovereign.php under the "Rating scale" section. The user of the rating shall read the methodology in order to have a full understanding of the rating procedure.

These ratings are unsolicited. The rated entity did not participate in the rating process.

Main sources of information: International Monetary Fund, World Bank, World Federation of Exchanges, World Economic Forum, Doing Business, United Nations, Central Bank of Cyprus, European Central Bank, Ministry of Finance of Cyprus, Cyprus Stock Exchange (CSE), German Stock Exchange.

Limits of the Credit Rating

During the rating assignment process, Rating-Agentur Expert RA GmbH (the Agency) used publicly available information that was considered to be reliable, complete and non-biased. The responsible expert performed the rating assessment of the country with information considered as the most reliable and up to date in accordance to the overall position of the country and the Agency's internal criteria for selecting data providers. The information and data used for this specific assessment can be considered as of sufficient quality.

Regulatory use

SGC ratings can be used for regulatory purposes according to the ESMA definition.

Conflict of interest

The responsible expert was neither influenced nor biased by third parties during the rating assessment. All employees involved in the rating assessment and revision of the rated entity have reported absence of conflicts of interests before initiation of the rating process.

Rating-Agentur Expert RA GmbH is completely independent from the activities of other agencies of the RAEX group.

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Office responsible for preparing the rating

The office responsible for the preparation and issuance of this credit rating is the office of Rating-Agentur Expert RA GmbH in Frankfurt am Main, Germany.

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The European Securities and Markets Authority (ESMA), the EU's direct supervisor of credit rating agencies (CRAs), has registered Rating-Agentur Expert RA GmbH as a CRA under Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies, with effect from 1 December 2015.

Rating-Agentur Expert RA GmbH applies the Code of Conduct Fundamentals for credit rating agencies issued by the International Organization of Securities Commissions (IOSCO Code) and includes the basic principles of IOSCO Code in its Code of Conduct.