Rating-Agentur Expert RA GmbH upgraded to 'BB+' the ratings of Cyprus

Rating-Agentur Expert RA GmbH upgraded the sovereign government credit rating (SGC) of Cyprus from 'BB' (Sufficient level of creditworthiness of the government) to 'BB+' (Sufficient level of creditworthiness of the government) in national currency and from 'BB' (Sufficient level of creditworthiness of the government) to 'BB+' (Sufficient level of creditworthiness of the government) in foreign currency.

Rating-Agentur Expert RA GmbH upgraded the country credit environment rating (CCE) of Cyprus from 'BB' (Sufficient quality of credit environment of the country) to 'BB+' (Sufficient quality of credit environment of the country) in national currency and from 'BB' (Sufficient quality of credit environment of the country) to 'BB+' (Sufficient quality of credit environment of the country) in foreign currency.

MAJOR FACTORS THAT INFLUENCED BOTH TYPES OF RATINGS:

Positive factors:

- As of the end-2016, short-term debt amounted to 3,3% of GDP and 8,6% of budget revenues and represented only 2% of the total debt as of June 2017. Additionally, only 5% is issued in foreign currencies and 66% is in the form of official loans. Nonetheless, the floating interest rate debt accounted for 45% of total debt load as of June 2017 (46% in June 2016);
- The fiscal deficit stood at 0,5% of GDP in 2016 (excluding the effect of the recapitalization of the cooperatives), narrowing by around 0,9p.p. from a year before. The continuous improvement of the fiscal stance is due to the strong economic growth as well as the government's efforts to keep up with the prudent fiscal policy. Going forward, we can expect this trend to persist, however, a possible departure from this path can be caused by the upcoming presidential elections in 2018 which could increase the public spending;
- The country's macro profile is encouraging as GDP per capita at PPP remained solid at USD 34 400 in 2016 and real GDP continued to grow by 3,5% as of 2Q 2017 (2,8% in 2016). The growth was mostly driven by sectors such as tourism, retail, construction and manufacturing. However, we do not expect these high growth rates to remain in the long term due to the deceleration in private consumption which is currently one of the growth drivers;
- The privatization plans have been overall delayed, but the privatization process of Troodos and the Lottery should be completed by 1H 2018. The government has shown strong determination to conclude this objective in order to further reduce the debt burden;
- High level of institutional development as Cyprus ranked as 45th out of 190 countries in the Doing Business ranking (improvement of two places compared to the previous ranking). Additionally, it has a very high Human Development Index (adjusted for inequality) at 0,762;
- According to the World Bank's Worldwide Governance Indicators, Cyprus is ranked as 75th out of 214 territories in the Rule of Law Index which indicates strong confidence in contract enforcement, property rights, the police and the courts;

- Net inflows of FDI in Cyprus amounted to 25% of GDP as of 2016 which is much higher compared to peer countries[1] (2,4% on average in 2016).

Restricting factors:

- Private credit to GDP stood at 269% by end-2016, despite loans to households and corporates still following a downward trend. Also, banks' assets to GDP stood at 376% in 2016, the highest among its euro peers;
- The unemployment rate followed a downward trend and reached 10,6% as of 2Q 2017 remaining below its peers average. We expect this figure to continue its gradual decline on the back of the positive prospects of the economy;
- Government guarantees stood at around 9,9% of GDP as of end-2016 due to the redemption of two government guaranteed bonds from the Bank of Cyprus, which slightly reduced the risks associated to contingent liabilities;
- The annual inflation rate turned positive in December 2016 and remained positive until July 2017, when it stood at -0,1%. We expect inflation to remain positive throughout 2017 driven by increase in prices of commodities, utilities and transportation as well as favorable dynamics in the tourism sector;
- The Cypriot economy remains diversified but focused in the retail, financial and real estate industries. However, the services sector leads with around 87% of the economy;
- The economy is moderately competitive. Cyprus is ranked as 64th out of 138 countries in the Global Competitiveness Index report (2017-2018) prepared by the World Economic Forum (83rd in previous ranking). After an almost negligible trade surplus in 2016, in line with IMF, we expect the trade balance to show a surplus of around 1% of GDP in 2017.

Negative factors:

- The government debt load has slightly increased in absolute terms along 2017 mostly driven by the issue of a 7Y bond in June 2017 for EUR 850 m. However, mainly driven by the sustained GDP growth recorded in that period, the debt to GDP ratio declined to 106% in 2Q 2017 from 108% as of end-2016 and still stands below the average level of debt among its euro peer countries. Moreover, we expect a continued decline on this metric in the following years;
- The banking system, albeit remaining the main risk for the country's creditworthiness, continued its recovery through the first half of 2017. NPLs have slightly declined further as a share of total loans (46% as of May 2017 compared to 47% by end-2016), but remain substantially high (see graph 2a and 2c). ROA was once again negative at -0,34% by end-2016, but turned positive as of March 2017. Nevertheless, the banking sector is still well capitalized with capital to assets ratio at almost 10% and capital adequacy ratio at 16,5% as of March 2017;
- FX reserves continued to decline in absolute terms and stood at around 4% of gross government debt and covered only half a month of imports in December 2016;
- The stock market remains underdeveloped with 76 listed companies as of June 2017 (81 in December 2015). Furthermore, market capitalization stood at 13,4% of GDP by December 2016 and has dropped along 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).

[1] Cyprus peers include the "peripheral Eurozone" countries such as Portugal, Italy, Spain and Greece.

Stress factors:

- Dependence on partner-countries and international institutions for provision of financial support in crisis situations has decreased since Cyprus left the three-year economic adjustment program European Stability Mechanism (ESM) and the International Monetary Fund (IMF) earlier this year (weak stress factor).

ADDITIONAL FACTORS THAT INFLUENCED CCE RATINGS:

Positive factors:

- Narrow spread between interest rates on loans and deposits at 2,85% as of July 2017 (3,12% in 2016 and 3,52% in 2015).

Restricting factors:

- The Cyprus Stock Exchange General Index (CYSMMAPA) was stable in 2016 starting the year at 67 points in January and standing at 76,2 points as of July 2017.

Negative factors:

- Marginal quality and quantity of instruments offered in the financial market of the country;
- Private sector debt (domestic and external), despite declining over the years, remains extremely high at 734,5% of GDP in 2016. Moreover, as of 1Q 2017 it stood at around 750% of GDP, driven mostly by the increase of external debt.

SENSITIVITY ASSESSMENT:

The following developments could lead to an upgrade:

- Continued strong GDP growth with declining unemployment which in addition could reflect an improvement in the debt levels and fiscal balance;
- Additional decline of NPLs ratio and further deleveraging and stabilization of the banking sector.

The following developments could lead to a downgrade:

- Lower than expected GDP growth combined with deteriorating fiscal metrics resulting in an increased debt level;
- Significant escalation of NPLs level followed by worsening of the overall banking sector metrics, especially profitability and capital adequacy.

"The Agency is upgrading the ratings of Cyprus by one notch to BB+ mainly on the back of the country's improved economic performance similar to that observed before the 2013 crisis. This, combined with the stabilization of the government debt load, drove the reduction of the debt to GDP ratio. Moreover, despite the banking sector remaining the key risk for the economy, it has shown improvement, especially in the reduction of NPLs.

We concluded that the financial dependency on partner countries has substantially declined on the back of the aforementioned positive developments combined with the fact that Cyprus has left the European Stability Mechanism (ESM) and the IMF adjustment program. Additionally, the fiscal position improved further supported by increased revenues and the inflation rate turned into positive territory in 2016 and remained so during 2017. Finally, the level of unemployment is at a record low since the 2013 crisis." - Clarified Marko Denic, Rating Analyst of Rating-Agentur Expert RA GmbH.

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

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

Research report on Cyprus is available at:

https://raexpert.eu/reports/Research_report_Cyprus_06.10.2017.pdf

Next scheduled rating publication: TBD in December 2017.

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RATING HISTORY:

Date	Review reason	SGC		CCE	
		National currency	**Foreign currency**	**National currency**	**Foreign currency**
07.04.2017	Scheduled review of both types of ratings for the country	BB	BB	BB	BB
14.10.2016	Scheduled review of both types of ratings for the country	BB	BB	BB	BB
22.04.2016	First assignment of both types of ratings for the country	BB-	BB-	BB-	BB-

Minute's summary

The rating committee for Cyprus was held on 4 October 2017. 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 and Country Credit Environment Ratings – Short Public Version (from April 2017) can be found under the following link: http://raexpert.eu/files/methodology/Methodology_Short_Sovereign_v2.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

Only SGC ratings can be used for regulatory purposes according to the ESMA definition. CCE ratings are not considered as credit ratings within the framework of Regulation (EC) No 1060/2009.

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.

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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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