Research Report on Cyprus

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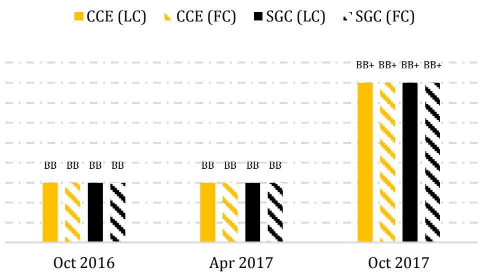
Ratings

Sovereign Government Credit (LC)	BB+
Sovereign Government Credit (FC)	BB+
Country Credit Environment (LC)	BB+
Country Credit Environment (FC)	BB+

* These ratings are unsolicited

Ratings dynamics



Main Economic Indicators of Cyprus

Macro indicators	2014	2015	2016
Gross gov. debt, EUR bn	18,8	19,0	19,3
Nominal GDP, EUR bn	17,4	17,4	17,9
Real GDP growth, %	-2,5	-1,5	2,8
Gross gov. debt/GDP, %	108,2	108,9	106,0
Deficit (surplus)/GDP, %	-0,2	-1,4	-0,5
Inflation rate, %	-0,9	-0,6	0,03
Current Account Balance/GDP, %	-4,3	-2,9	-5,3
External debt, USD bn	-	-	113,7

Development indicators	2016
Inequality adj. HDI	0,762
GDP per capita, USD th	34,4

Default indicator	06.10.2017
7Y Gov Bond Yield, %	1,58

Source: RAEX (Europe) calculations based on data from the IMF, WB, Ministry of Finance, UN, German Stock Exchange.

Summary

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.

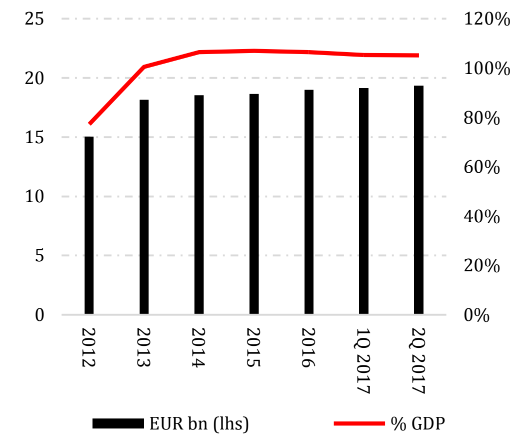
We concluded that the financial dependency on partner countries and international institutions has substantially declined on the back of the aforementioned positive developments combined with the fact that Cyprus has left the European Stability Mechanism (ESM) and the IMF adjustment program. Additionally, 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.

Government debt set to decline. Strong GDP growth continued to support the decline of government debt to GDP ratio which by end-2016 stood at around 106%. However, in June 2017 the issue of Eurobonds pushed the total debt load higher, reaching a record EUR 19,3 bn as of 2Q 2017 (see graph 1). Despite this increase, the Agency expects government debt to keep a downward trend going forward as a result of the aforementioned sustained economic growth and recurrent fiscal surpluses.

The debt structure by types of creditors remained unchanged since the last revision (see graph 2). Also, the maturity structure does not present a significant risk for the country as short-term debt represented as low as 2% of total debt in June 2017 and stood at 3,2% of GDP and 8,6% of budget revenues by end-2016. Additionally, only 5% of total debt is denominated in foreign currencies and 66% is in a form of official loans as of 2Q 2017. The share of debt with floating interest rate dropped to 45% as of June 2017 (46% in 2016); however, the level remains high.

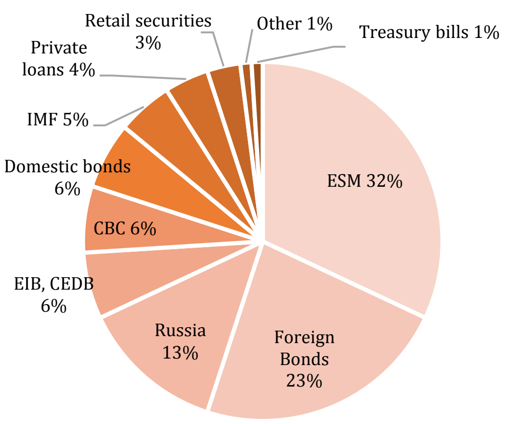
Fiscal balance likely to turn positive by end-2017. The fiscal deficit in 2016 stood at 0,5% of GDP (excluding the effect of the recapitalization of the cooperatives), narrowing around 0,9p.p. from a year before. Despite the abolishment of property tax, the Agency expects that the budgetary position will remain positive in the future driven by the strong economic growth and accountable fiscal policy of the government. The small budget

Graph 1: General government debt dynamics



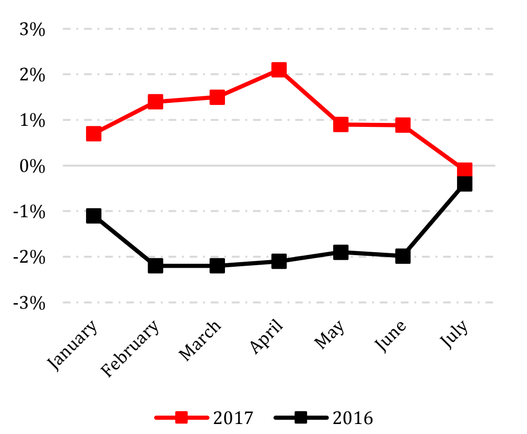
Source: RAEX (Europe) calculations based on data from the IMF and Ministry of Finance

Graph 2: General government debt structure



Source: RAEX (Europe) calculations based on data from the Ministry of Finance

Graph 3: Harmonized CPI, y-o-y



Source: RAEX (Europe) calculations based on data from the Ministry of Finance

surpluses will also cause general government debt to decline in absolute terms. A possible departure from this path could be caused by the upcoming presidential elections in 2018 which may cause some fiscal lapses. However, the government has shown efforts to keep up with the prudent fiscal policy and we can expect this trend to continue in the future.

Macroeconomic position improved further. Real GDP continued to grow by 3,5% as of 2Q 2017 (2,8% in 2016), mainly driven by the sectors such as tourism, retail, construction and manufacturing. We do not expect these high growth rates in the long term, however, the level of around 2% growth appears realistic taking into account that the Cypriot economy has picked up strongly. GDP per capita at PPP remained solid at USD 34 400 in 2016.

Cyprus left the three-year ESM/IMF economic adjustment program two months before scheduled. Furthermore, last year by the decision of European Council, Cyprus exited the excessive deficit procedure which was in place since 2010. As a result the Agency considers that Cyprus' dependence on financial assistance from partner countries reduced.

The unemployment rate continued on a decreasing trend and reached 10,6% as of 2Q 2017 remaining below its euro peers[1]' average (see table 1), while youth unemployment dropped to 25,3% from 29,1% a year before. These figures are record low since the 2013 crisis and we expect this figure to continue its gradual decline given the positive prospect of the economy.

Table 1: Peer comparison for 2016

Key Financial Ratios	Cyprus	Greece	Italy	Portugal	Spain
GDP growth (%)	2,8%	0,6%*	0,75%*	1%*	3%*
Inflation rate (%)	0,1%	-0,11%*	-0,56%*	2,3%*	0,6%*
Fiscal balance/GDP	-0,5%	-3,3%*	-2,4%*	-2,9%*	-4,4%*
Current account/GDP	-1%*	-0,03%*	2,17%*	0,02%*	1,9%*
Government debt/GDP	106,7%	183,4%*	133,2%*	127,9%*	99,0%*
Unemployment rate	12,9%	22,3%*	11,4%*	11,1%*	19,4%*
FDI, net inflows/GDP	25,1%	1,6%	1,5%	4,1%	2,5

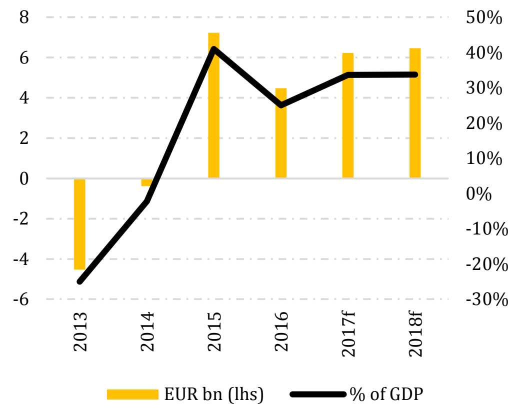
Source: RAEX (Europe) calculations based on data from the IMF and WB.
* IMF projections for 2016

Inflation (y-o-y % change) turned positive in December 2016 and remained positive until July 2017 when the harmonized consumer price index stood at -0,1% (see graph 3). Inflation picked up due to the price increase in sectors such as housing, utilities, gas and transport, while in the summer period tourism contributed considerably. We can expect inflation to remain positive by the end of 2017.

External debt continues to increase. Cyprus' gross external debt reached a new record high as of 1Q 2017 and stood at EUR 108,3 bn,

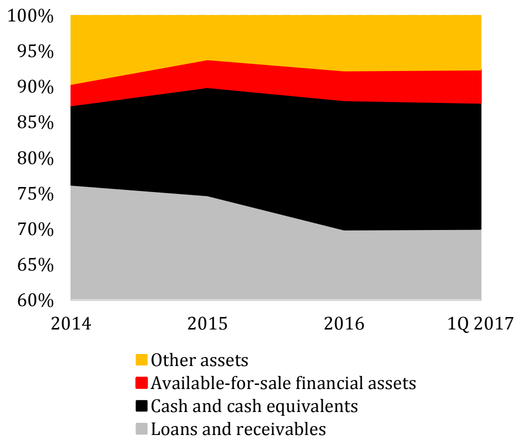
[1] Cyprus peers include the "peripheral Eurozone" countries such as Portugal, Italy, Spain and Greece.

Graph 4: Net Foreign direct investment inflow



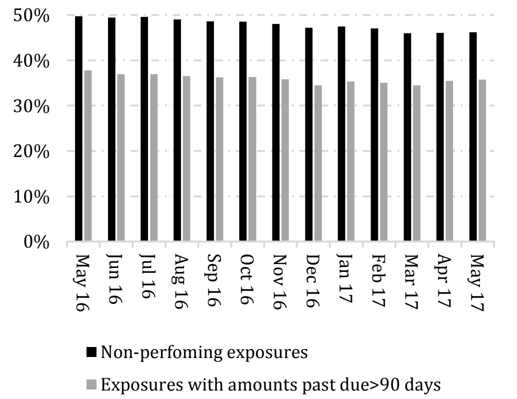
Source: RAEX (Europe) calculations based on data from the IMF

Graph 5: Assets distribution, % of total assets



Source: RAEX (Europe) calculations based on data from the CBC

Graph 6: NPLs, % of total loans



Source: RAEX (Europe) calculations based on data from the CBC

surpassing the level of end-2016 when it amounted EUR 106 bn. However, as % of GDP it declined and stood at 680%.

After a very narrow trade surplus in 2016, in line with IMF, we expect the trade balance to show a surplus of around 1% of GDP in 2017. Moreover, the net international investment position (NIIP) of Cyprus remains challenging. As of 1Q 2017 the NIIP as % of GDP stood at 127% which makes Cyprus second worse (after Greece) among EU countries. However, on the y-o-y base the ratio is improving. As of 4Q 2016 NIIP was 125% of GDP, compared to the same period 2015 when it was 130%.

Foreign direct investment inflow remains positive and high and well above its peers (see table 1). As of end-2016 net inflows as % of GDP stood at 20%, compared to 40% a year before (see graph 4). However, the high investment inflow is partly related to the special purpose entities (SPEs) with insignificant economic contribution to the Cypriot economy. Additionally, the surge in investment has been driven by the real estate sector and tourism attracted by the citizenship-by-investment scheme. Announced offshore exploration of natural gas could represent a significant investment potential for the Cypriot economy in the future as well as the possible reunification of the island.

Banking sector recovery continues with a slow pace. Private credit to GDP stood at 269% by end-2016, despite loans to households and corporates still following a downward trend (see graph 5). However, the banks' assets-to-GDP ratio stood at around 376% in 2016, and despite the increase as of 1Q 2017 (up to EUR 68,2 bn), the asset level shows a slow downward trend in the long run. Looking at the assets' structure, the declining share of loans has been compensated by the increasing cash levels on the banks' balance sheet. Still, the assets-to-GDP ratio remains the highest among its euro peers, but slow deleveraging can be anticipated through re-restructuring, write-off, assets swaps and repayments. As we already pointed out in the last Research report[2], the level of private external debt continued to increase reaching a record high as of 1Q 2017 of around 520% of GDP.

The level of NPLs has declined further as a share of total loans to 46% as of May 2017 compared to 47% by end-2016 and still remains substantially high. A narrower measurement of NPLs (past due>90 days), shows a slightly sharper decline in the level of NPLs, to 35,7% in May 2017 from 37,8% in the same month 2016 (see graph 6). ROA was once again negative at -0,34% by end-2016, but turned positive as of March 2017, while the capitalization remains solid with capital to assets ratio of almost 10% and capital adequacy ratio of 16,5% as of March 2017.

[2] https://raexpert.eu/reports/Research_report_Cyprus_07.04.2017.pdf

Important note for sovereign ratings

This Research Report shall be treated as a supplementary part of the published Press Release included in the following link:

https://raexpert.eu/reports/Press_release_Cyprus_06.10.2017.pdf

Both documents shall be treated as essential parts of each other.

For further information on the factors, their weights, methodologies, risks and limitations of these ratings, and other regulatory disclosures, please refer to the Press Release and the website of the Agency.