

**CREDIT OPINION**

1 November 2016

New Issue

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**RATINGS**
**Banco Regional de Desenv do Extremo Sul**

Domicile	Porto Alegre, Rio Grande do Sul, Brazil
Long Term Debt	Not Assigned
Type	Not Assigned
Outlook	Not Assigned
Long Term Deposit	Not Assigned
Type	Not Assigned
Outlook	Not Assigned

Please see the [ratings section](#) at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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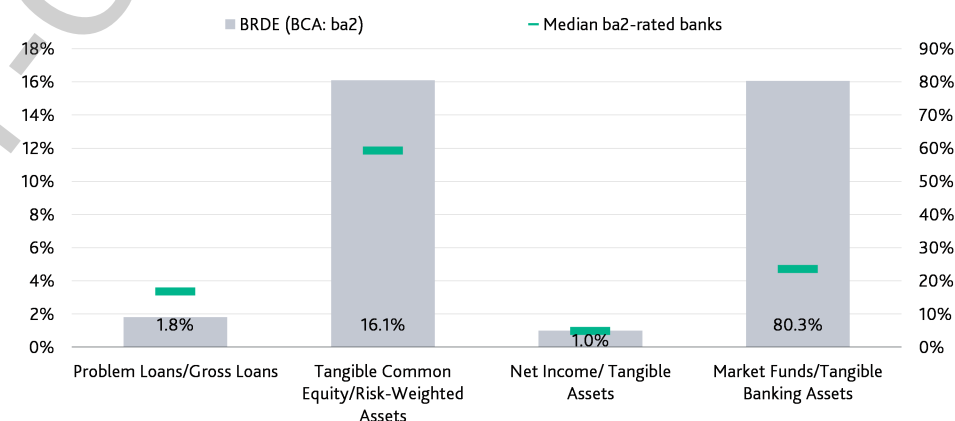
# Banco Regional de Desenv do Extremo Sul

## Semiannual Update

**Summary Rating Rationale**

Banco Regional de Desenvolvimento do Extremo Sul (BRDE) is a regional government development bank focusing on the relatively prosperous southern states of Brazil and is owned by the states of Santa Catarina (unrated), Rio Grande do Sul (unrated) and Parana (Ba3, negative). BRDE's Ba2 issuer rating is determined by its baseline credit assessment (BCA) of ba2, and an assessment of moderate affiliate support from its owners. The standalone BCA of ba2 reflects BRDE's established franchise as a development bank, deteriorating but still sound asset quality, as well as adequate capitalization and strong profitability. The bank's stable but highly concentrated funding structure comprised of funds predominantly sourced from Banco Nacional de Desenvolvimento Econômico e Social – BNDES (Ba2 negative) is a key factor in its ratings. Our assumption of moderate support is based on BRDE's development policy role, its importance for the supply of long-term financing in the region, and the demonstrated commitment of its shareholders. BRDE is classified as a government-related issuer, as defined in "Government-Related Issuers: Methodology Update" (published in October 2014).

Exhibit 1

**BRDE - Key Financial Ratios**


Source: Moody's Financial Metrics

### Credit Strengths

- » Established role as a regional development bank with steady loan growth, with a focus on the agricultural industry
- » Diminishing pressure on capitalization following shareholder injections
- » Limited susceptibility to political influence owing to three-state ownership

### Credit Challenges

- » Historically low delinquency ratios which will be pressured in the weakening operating environment
- » Concentrated funding structure with a high reliance on funds from BNDES
- » Downward profitability pressures in light of the deepening economic recession

### Rating Outlook

The outlook on BRDE's ratings is negative and reflects the continued challenges the bank will face in maintaining low delinquency and high profitability levels as **Brazil's recession continues**. The outlook also considers the risk that capitalization levels may be pressured further by continued rapid expansion of the bank's operations.

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## Factors that Could Lead to an Upgrade

» At present, there is no upward pressure on the bank's ratings

## Factors that Could Lead to a Downgrade

- » A weakening of BRDE's financial fundamentals, particularly a deterioration in the quality of the loan book and lower capitalization levels, would have a negative effect on the bank's rating.
- » A downgrade in Brazil's sovereign rating would also lead to a downgrade in BRDE's ratings.

## Key Indicators

Exhibit 2

### BANCO REGIONAL DE DESENVOLVIMENTO DO EXTREMO SUL (Consolidated Financials) [1]

	6-16 <sup>2</sup>	12-15 <sup>2</sup>	12-14 <sup>2</sup>	12-13 <sup>2</sup>	12-12 <sup>3</sup>	Avg.
Total Assets (BRL billion)	15.5	15	13.4	11.5	9.4	13.5 <sup>4</sup>
Total Assets (USD billion)	4.9	3.8	5	4.9	4.6	1.5 <sup>4</sup>
Tangible Common Equity (BRL billion)	2.4	2.4	2.1	1.5	1.3	17.2 <sup>4</sup>
Tangible Common Equity (USD billion)	0.8	0.6	0.8	0.6	0.6	4.8 <sup>4</sup>
Problem Loans / Gross Loans (%)	1.8	1.8	1.6	0.7	1.3	1.4 <sup>5</sup>
Tangible Common Equity / Risk Weighted Assets (%)	16.1	16.8	18.5	15	15.2	16.6 <sup>6</sup>
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	8.1	8.3	7.4	3.9	6.5	6.9 <sup>5</sup>
Net Interest Margin (%)	5.1	4.8	5.3	5.3	4.7	5 <sup>5</sup>
PPI / Average RWA (%)	3.8	3.7	4.3	3.7	3.2	3.9 <sup>6</sup>
Net Income / Tangible Assets (%)	1	1.8	1.6	1.3	0.9	1.3 <sup>5</sup>
Cost / Income Ratio (%)	35.5	34.4	32.8	34.9	39.9	35.5 <sup>5</sup>
Market Funds / Tangible Banking Assets (%)	80.3	80.3	80	81.5	81.9	80.8 <sup>5</sup>
Liquid Banking Assets / Tangible Banking Assets (%)	16.6	16.2	15	14.8	13.6	15.2 <sup>5</sup>

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel III - fully-loaded or transitional phase-in; LOCAL GAAP [3] Basel II; LOCAL GAAP [4] Compound Annual Growth Rate based on LOCAL GAAP reporting periods [5] LOCAL GAAP reporting periods have been used for average calculation [6] Basel III - fully-loaded or transitional phase-in & LOCAL GAAP reporting periods have been used for average calculation

Source: Moody's Financial Metrics

## Detailed Rating Considerations

### FOCUS ON AGRICULTURAL INDUSTRY IN THE SOUTH OF BRAZIL

Founded in 1961, BRDE is owned by the States of Rio Grande do Sul (unrated), Santa Catarina (unrated) and Parana (Ba3 stable), which together contribute roughly 17% of Brazil's GDP. The bank lends directly to private-sector companies, largely agricultural producers, and to cooperatives, as well as to infrastructure projects.

Per its mandate to foster development in the south of Brazil, BRDE's operations are focused in three states: Parana, which accounted for 41% of the bank's loan book of BRL12.8 billion as of June 2016; Santa Catarina, which accounted for 30%; and Rio Grande do Sul, which accounted for 26%. From 2011-2015, loan operations have expanded at a compound annual growth rate of 15.2%, as the bank has acted as a conduit for growth in the agricultural industry in the region, and the bank reported year on year loan growth of 7.2% as of June 2016. This growth has been supported by BRDE's strong relationship with regional **credit** cooperatives that channel resources to smaller producers and provide strong loan guarantees.

Owing to its importance in southern Brazil, the agricultural sector represents over 50% of BRDE's loans and is split among cattle breeding, protein production, multiple crops, warehouse services and transformation companies. Among the main credit lines offered by the bank are loans to finance machinery acquisition, investments to improve production plants or to construct new ones, and some working capital financing. For the most part, BRDE provides long-term loans, with an average maturity longer than five years and also lends to infrastructure projects, mostly in the energy industry.

Like other regional development banks, BRDE is also involved in managing funds for state governments. Alongside BNDES, the bank is an agent of the FSA (Fundo Setorial do Audiovisual) fund, which supports film-making and small-scale television industries. BRDE also manages a development fund that channels loans to municipalities in Santa Catarina (FUNDAM). The bank is responsible for the origination of these loans and for monitoring credit allocation, but it does not share credit risk with public funds, and receives roughly 3% as management fees of disbursements. **Between 2013 and June 2016, approximately BRL600 million investments were made through the FSA fund and BRL500 million had been lent to municipalities through FUNDAM.**

#### LOW DELINQUENCY RATES ARE SET TO RISE AS OPERATING ENVIRONMENT WEAKENS FURTHER

As of June 2016, BRDE's non-performing loan (NPL) ratio was 1.8%, in line with the ratio reported of December 2015, although up by 20 basis points from the ratio of 1.6% versus June 2015. Even with modest loan growth of 10.6% in 2015 and the bank's policy of guarantee coverage of 130% of loan value, the volume of non-performing loans went up reflecting the weak performance of economic activity in Brazil. Still, the volume of 90-day past due loans remains low, significantly below those of the retail-oriented government-owned banks and in line with BRDE's development bank peers. Although BRDE has traditionally maintained high reserve coverage, its levels have fallen in the last three years with the bank reporting coverage of 436% in 2013, 192% in 2014 and 149% in 2015. As of June 2016, coverage was 167%.

Importantly, the NPL ratios reported by the bank understate asset risk as they don't account for restructured loans, which averaged BRL262 million annually between 2012 and 2015, amounting to 2.3% and 1.7% of BRDE's loan book in 2014 and 2015. As of June 2016, restructured loans were 0.9%. The restructured loans are associated with the bank's portfolio of agricultural loans, which are often originated by government-sponsored credit renegotiation programs. BRDE does not report the stock of its restructured loans and only gives the flow during an annual or semiannual period.

BRDE's loan book also shows credit risk associated with relatively high geographic and sector concentration as well as by borrower type. The focus on the southern states, despite their stronger economic growth compared to other states, constrains the origination of operations to a single region, which also results in a less diversified revenue structure than that of peers with nationwide coverage. Similarly, the bank's loan book also features a high concentration in the agriculture segment, leading to higher credit risk than in operations that cover a variety of segments, such as BNDES's. Although the exposure to agriculture has been positive for BRDE in light of the sector's recent good performance, particularly the devaluation of the Brazilian real against the US dollar, which has benefited exporters, Brazil's deepening recession will inevitably affect this industry as well. **BRDE is also exposed to the challenges faced by smaller scale producers in Brazil's recession given its focus on lending to them both directly and through agricultural cooperatives.**

For 2016, we expect upward pressure on delinquencies owing to the challenging operating environment and the prospects for another severe contraction in economic growth, particularly given BRDE's exposure to smaller companies and to rural producers that are more susceptible to an economic downturn.

#### CAPITALIZATION TO REMAIN ADEQUATE FOLLOWING PREVIOUS DIPS

As measured by Moody's ratio of Tangible Common Equity to Risk Weighted Assets, BRDE's capital ratio was of 15.6% as of June 2016, down from 16.5% in December 2015. This fall was driven by a 7.7% rise in the bank's RWAs in light of its loan growth and the bank increasing the risk-weighting for loans already approved but still to be disbursed within a one-year period, a procedure in line with regulatory requirements.

However, BRDE's current capital is now high and on a regulatory basis the bank reported a BIS capital ratio of 14.5% in June 2016, all of it in the form of common equity, well above regulatory minimum. The bank's capitalization was bolstered in 2015 by a transfer of BRL203 million from its profit reserves into its paid in capital account. This followed capital injections of BRL600 million in 2014 that became necessary following the introduction of Basel III rules in Brazil, particularly as a result of specific regulation that limited the amount of reserves in the calculation of common equity to 200%. Because BRDE's paid-in capital was relatively low, with most of its common equity in the form of profit reserves, the bank's BIS capital ratio plunged to 2.58% in 2013 owing to the new rule and placing the ratio well below the regulatory minimum of 11%.

We expect BRDE to maintain its capital above regulatory minimum levels particularly in light of the creation of a new resolution in 2015 through which the bank will transfer profits into its capital reserves semiannually. Moreover, BRDE's by-laws require the totality of earnings be retained and incorporated into the bank's capital reserves.

#### CONCENTRATED FUNDING BASE

Because of its policy role as a development bank, BRDE is not allowed to take deposits from individuals and companies. As a result, almost all of the bank's total funding of BRL12.5 billion (as of June 2016) was composed of resources received from BNDES. In 2013 and 2014, the bank was the single largest disburser of BNDES's credit lines to the agricultural industry in Brazil. **The rest of BRDE's funding base is comprised of resources from Banco do Brasil S.A. (Ba2/Ba2 Negative, ba2) and the Federal Government, including FINEP, FCO AND FGTS.**

The high concentration of funding weighs negatively on BRDE's creditworthiness, given the bank's strong reliance on BNDES for funding and access to the funds is tied to the availability of credit lines from BNDES. However, the long-term resources provided by BNDES do allow BRDE to match the average tenors of assets and liabilities.

#### STRONG PROFITABILITY – FOR A DEVELOPMENT BANK – WILL BE PRESSURED BY THE DEEPENING RECESSION

In the first half of 2016, BRDE reported net income of BRL78 million, 22% lower than in the first half of 2015. The bank's results were significantly affected by a 56% rise in its provisioning expenses, a direct result of the economic environment in Brazil, and despite the fact that Interest income from credit operations and invested assets was up by 9.4%. BRDE also benefited from fee-based revenues in the first six months of 2016 of BRL21 million, 40% higher than a year earlier. These fee based revenues come from BRDE's management of the FUNDAM fund, which focuses on municipal lending in Santa Catarina.

Although BRDE's mandate is not focused on profitability but on increasing lending with the objective of development to ensure economic prosperity and job creation in the south of Brazil, the bank's recurring earnings generation is significantly higher than that of other regional developing banks in Brazil.

In 2016, the bank's profitability will be pressured by the weakened operating environment in Brazil, which will lead to further increases in provisioning expenses that will affect BRDE's bottom line. This could also be exacerbated by higher funding costs if the bank starts tapping into the local capital markets by issuing debt (letras financeiras) or receiving loans from multilateral agencies.

#### Global Local Currency Issuer Rating

Under the Government Related Issuers methodology, BRDE's issuer rating derives from 1) the bank's baseline credit assessment (BCA) of ba2, and 2) our assumption of the likelihood of moderate affiliate support from the bank's owner states. However, BRDE's issuer rating does not benefit from any uplift, because its BCA of ba2 is one notch above the Ba3 global local currency issuer rating of the state of Paraná, which is the only one of the three owners rated by Moody's.

#### National Scale Rating

BRDE is rated Aa3.br and BR-1 by Moody's on Brazil's National Scale, mapped from Moody's global rating scale.

#### Ratings

Exhibit 3

Category	Moody's Rating
<b>BANCO REGIONAL DE DESENV DO EXTREMO SUL</b>	
Outlook	Negative
Baseline Credit Assessment	ba2
Issuer Rating -Dom Curr	Ba2
NSR Issuer Rating	Aa3.br
ST Issuer Rating -Dom Curr	NP
NSR ST Issuer Rating	BR-1

Source: Moody's Investors Service

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