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Research Report on Cyprus

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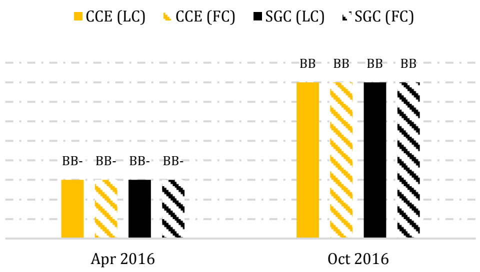
Ratings

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	2013	2014	2015
Gross gov. debt, EUR bn	18,5	18,8	19,0
Nominal GDP, EUR bn	18,1	17,4	17,4
Real GDP growth, %	-6,0	-2,5	1,5
Gross gov. debt/GDP, %	102,5	108,2	108,9
Deficit (surplus)/GDP, %	-4,4	-0,2	-1,4
Inflation rate, %	-1,1	-0,9	-0,5
Current Account Balance/GDP, %	-4,5	-4,6	-3,6
External debt, USD bn	-	-	111,6

Development indicators	2015
Inequality adj. HDI	0,76
GDP per capita, USD th	31,2

Default indicator	14.10.2016
10Y Gov Bond Yield, %	3,4

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

Summary

The upgrade of Cyprus ratings from “BB-“ to “BB” mainly reflects positive dynamics in the factors which we stated in our previous sensitivity assessment as triggers for an upgrade; namely a stabilization in banking system metrics, current and expected improvement of public finances and consistent economic growth. Furthermore, a decrease in contingent liabilities, reduction in price volatility and constant increase of the inflation rate towards positive territory, also influenced our decision to upgrade the ratings.

Despite the upgrade, there are still factors restraining the score. Government debt, despite declining, remains high, NPLs have also declined in absolute terms but the ratio to total loans remains elevated and the external risks, in the form of high debt, negative NIIP and current account deficits, continue to be present.

Government debt expected to remain in a downward trend and contingent liabilities were trimmed. As noted in our previous review for Cyprus[1], government debt levels have peaked at around 108% of GDP and 279% of budget revenues in 2015. Despite both figures remaining quite elevated, they remain below the average of its euro peers[2] (see table 1). We expect these metrics to start a downward trend due to an improvement in the fiscal metrics as a result of prudent fiscal policies and accelerating economic growth (see graph 1).

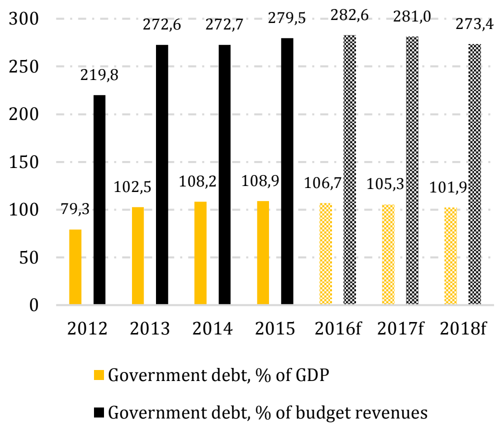
Table 1: Peer comparison for 2015

Key Financial Ratios	Cyprus	Greece	Italy	Portugal	Spain
GDP growth (%)	1,5%	-0,2%	0,8%	1,5%	3,2%
Inflation rate (%)	-0,5%	0,4%	0,1%	0,3%	0,0%
Fiscal balance/GDP	-1,4%	-3,1%	-2,6%	-4,4%*	-5,1%
Current account/GDP	-3,6%	0,0%	2,2%	0,4%	1,4%*
Government debt/GDP	108,9%	176,9%	132,7%	128,8%*	99,0%*
Unemployment rate	14,9%	25,0%	11,9%*	12,4%*	22,1%
Private credit/GDP	314,1%	135,4%	171,4%	167,0%	193,6%
FX reserves/GDP	4,6%	3,2%	7,9%	9,9%	4,2%

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

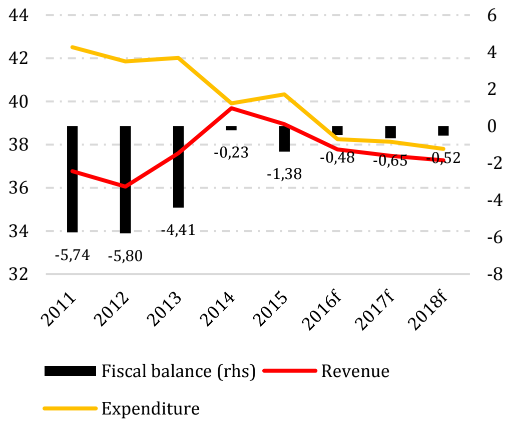
[1] Research report on Cyprus from 22 April 2016 (http://raexpert.eu/reports/Research_report_Cyprus_22.04.2016.pdf).
[2] Cyprus peers include the “peripheral Eurozone” countries such as Portugal, Italy, Spain and Greece.

Graph 1: Government debt dynamics



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

Graph 2: Public finance dynamics, % of GDP



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

The structure of the government debt remains favorable. As of 2Q 2016 short-term debt was as low as 3% of GDP and 7,7% of budget revenues and represented only 2% of the total debt. Furthermore, 95% is issued in EUR and 65% of total debt comes from official loans. Despite floating interest rate debt being 46% of total debt, the Agency does not see a risk in this type of debt due to the current QE program from the ECB and the low financing cost environment in the Eurozone.

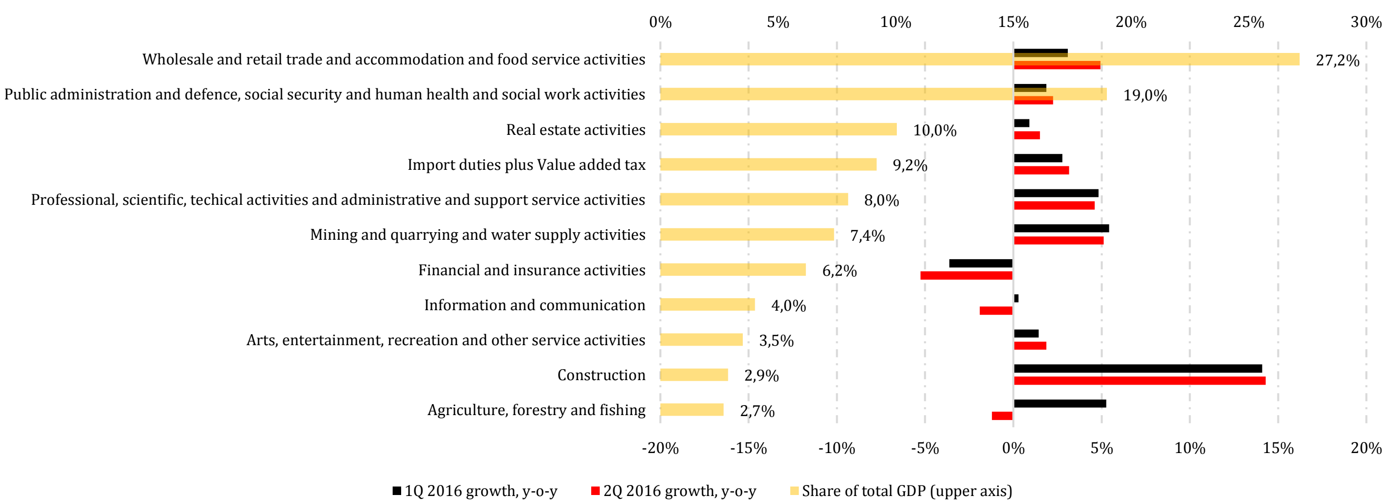
Moreover, contingent liabilities declined substantially in 2016. As a result of the cancellation of government guaranteed bonds by the Bank of Cyprus, the amount of government guarantees went from 15% of GDP to around 9% of GDP, a figure close to the EU average.

The fiscal budget has stabilized and continues to narrow. The government budget balance stood at -1,4% in 2015 without considering the one-off effect of recapitalization of the cooperatives. Even though government revenues have struggled to pick up consistently in the current year, expenditures have been maintained consistently low and the balance for year-end is expected to be narrower supported by increasing economic growth, mainly from touristic activities (see graph 2).

Despite the fiscal improvements, structural reforms and privatization plans have not yet materialized as expected.

We anticipate real GDP growth to accelerate and maintain a constant pace in the following years. Real output growth in Cyprus was 1,5% in 2015 propelled by tourism and private consumption caused by a decline in the overall price level. By 1H 2016, real GDP growth has remained positive and the economy has shown broad-based growth, except for the financial services sector which shrunk by 5,3% (see graph 3).

Graph 3: Structure and growth of the economy



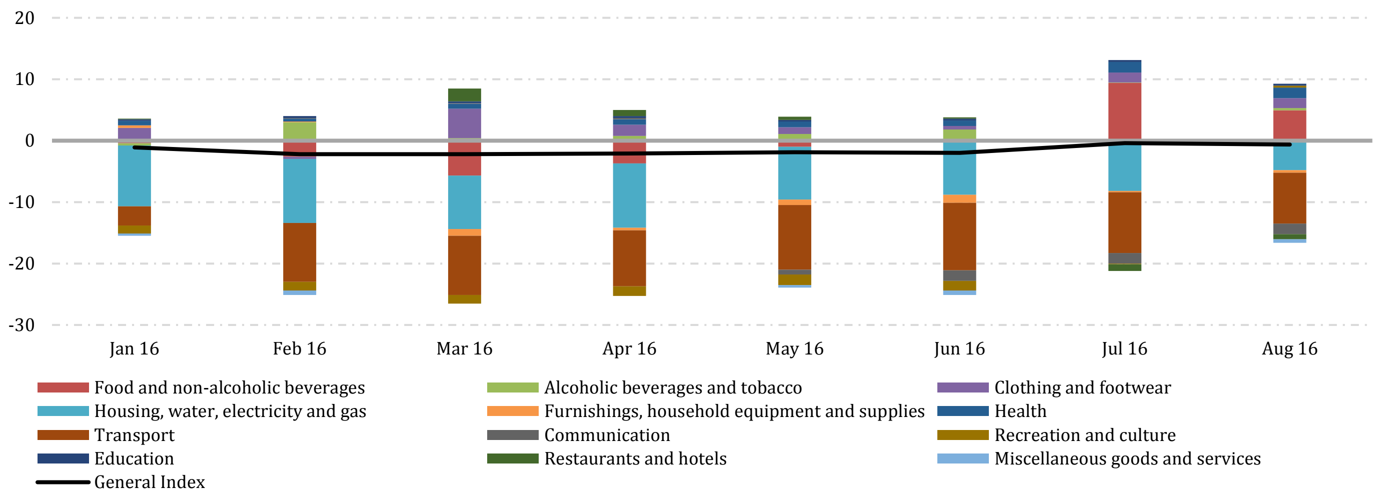
Source: RAEX (Europe) calculations based on data from Cystat

Disclaimer

The unemployment rate in Cyprus remains high at 14,9%, as mentioned in our previous report. Despite this, it is still below the average of its euro peers (see table 1).

Inflation was negative in 2015 and has remained so along 2016 (-0,6% by August 2016). In spite of this, prices are less volatile and inflation is starting to pick up; we expect it to return to positive territory in 2017 driven by an increase in food, clothing and health prices (see graph 4).

Graph 4: CPI growth per item, y-o-y % growth

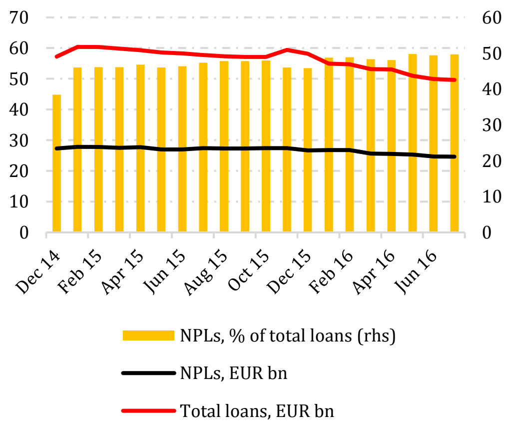


Source: RAEX (Europe) calculations based on data from Cystat

The country still has a substantial external risk exposure. Gross external debt of the country stood at around EUR 96,5 bn in 2Q 2016 and was as high as 640% of GDP in 2015; it is the highest among its euro peers. Nevertheless, it has declined by about 11% since 1Q 2015 when it was EUR 106,9 bn.

As stated in our previous report, the net international investment position (NIIP) is the lowest in the EU. The current account balance was -3,6% of GDP in 2015 and it is expected to remain negative propelled by the substantially wide deficit in goods trading. Despite this, we anticipate it to remain stable after posting deficits lower than 10% of GDP five years ago.

Graph 5: NPLs dynamics

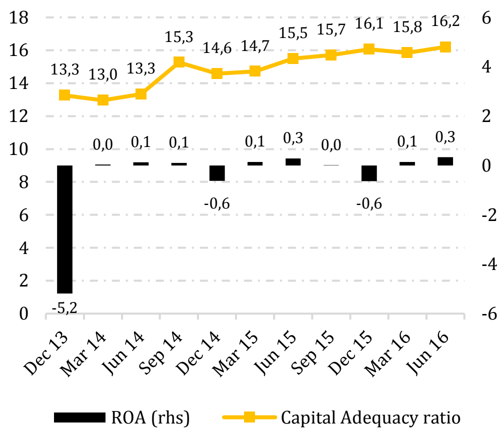


Source: RAEX (Europe) calculations based on data from the Central Bank of Cyprus

Banking metrics continue to show improvements, but NPLs ratios have not eased. Even though banking metrics have generally improved and stabilized, the system remains susceptible to further risks given the persistent high level of NPLs to total loans. NPLs have declined in absolute terms, however total outstanding loans have declined at a faster pace, causing an increase in the NPLs to total loans ratio which, by July 2016, stood at 49,6% (see graph 5).

While the deleveraging and NPL restructuring in Cyprus continues in order to reduce exposure to these types of risks, the amount of domestic

Graph 6: Banking system metrics, %



Source: RAEX (Europe) calculations based on data from the Central Bank of Cyprus

private credit was 314% in 2015, the highest figure among its euro peers (see table 1). Furthermore, banks' assets were also high at 420% of GDP in the same period.

Despite the lingering risk regarding bad loans and high levels of private debt, the capital to assets ratio has remained stable above 10% and the capital adequacy over 16%. Even though ROA was 0,34% in 1H 2016, it has followed the same trend as in 2014 and 2015 indicating a possible negative ratio at year-end (see graph 6).

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:

http://raexpert.eu/reports/Press_release_Cyprus_14.10.2016.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.