Rating-Agentur Expert RA GmbH confirmed at 'BB+' the ratings of Cyprus

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

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

MAJOR FACTORS THAT INFLUENCED BOTH TYPES OF RATINGS:

Positive factors:

- The debt structure improved further in 2017. Short-term debt amounted to 1% of GDP and 2,7% of budget revenues and represented only 1% of the total debt as of end-2017. Additionally, only 4% is issued in foreign currencies and 64% is in the form of official loans. However, the floating interest rate debt is slightly high and accounted for 46% of the total debt load by the end of 2017;
- The fiscal stance improved in 2017 posting a surplus of 1,5% of GDP according to the Ministry of Finance. This surplus is mostly driven by an increase in tax collection and social security contributions, while on the expenditure side the subsidies declined. We expect further improvement of the fiscal stance driven by strong economic growth as well as the government's commitment to a tight fiscal policy;
- The country's macro profile is encouraging as GDP per capita at PPP is projected to have remained solid at USD 36 600 and real GDP continued to grow by a robust 3,8% as of year-end 2017 (2,8% in 2016). The positive output dynamics remained driven by tourism, retail, construction and manufacturing;
- 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 0,762;
- According to the World Bank's Worldwide Governance Indicators, Cyprus is ranked 75th out of 214 territories in the Rule of Law Index which indicates a moderately 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 its peer countries[1] (2,4% on average in 2016).

Restricting factors:

- We expect private credit to GDP to have dropped further in 2017 to around 240% of GDP, compared to 266% by end-2016. All loan segments, including households, corporates and financial institutions followed a downward trend. Also, the banks' assets to GDP ratio was estimated at around 360% in 2017 compared to 376% in 2016, but still remains the highest among its euro peers;
- The unemployment rate continued to decline and reached 11% as of end-2017 remaining below its peers' average. We expect this figure to continue its gradual decline driven by economic growth, particularly by the increase in private consumption;

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

- Government guarantees stood at around 9,1% of GDP as of end-2016 compared to 15,4% in 2015, which slightly reduced the risks associated to contingent liabilities;
- The annual y-o-y inflation turned to negative ground in 2017 and stood at -0,4%. In line with the IMF, we still expect inflation to turn to positive territory over 2018 mostly driven by increases in prices of commodities, food, transportation and the tourism sector;
- The Cypriot economy remains diversified but still highly focused in the services sector. As of 2017, the industry distribution in the three largest sectors was as follows: retail (21%), financial (10%) and real estate (9%);
- 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 the previous ranking). Moreover, the trade balance widened to -2% of GDP in 2017 compared to -0,8 in 2016;
- Despite government efforts to continue with the privatization program, the overall process remains delayed, shown by the recent parliament initiative to pass the law for scrapping the privatization unit within the Ministry of Finance. However, the government is still determined to go forward with privatization plans in order to further reduce the debt burden.

Negative factors:

- The government debt level improved better than we anticipated in our previous revision. As of end-2017, it stood at around EUR 18,7 bn, the lowest level since 2014. Additionally, supported by a robust GDP growth of 3,8% in 2017, the debt to GDP ratio declined to around 100% as of end-2017 compared to 106% in 2Q 2017 and still stands below the average level of debt among its euro peer countries. Even though we expect a continued decline of this metric in the following years boosted by GDP growth and fiscal surpluses, the still high level of government indebtedness remains a key negative factor;
- The banking system continued its recovery through 2017. NPLs declined further as a share of total loans and stood at 43,7% as of November 2017 compared to 47% by end-2016, but remain substantially high. The profitability worsened as compared to 2016, with ROA standing at -1,3% by September 2017. Nevertheless, the banking sector is still well capitalized with capital to assets ratio at 9% and overall solvency ratio at 16,2% as reported by the Central Bank of Cyprus as of September 2017;
- FX reserves continued to decline in absolute terms and stood at around 3,3% of gross government debt as of December 2017 and covered only half a month of imports in December 2016. Nonetheless, we do not expect this to affect the economy in case of a currency shock since most of their trade is done within the EU;
- The stock market remains underdeveloped with 80 listed companies as of December 2017 (74 in January 2017). Furthermore, market capitalization stood at EUR 2,3bn (12,5% of GDP).

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).

Stress factors:

- Dependence on partner-countries 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) last year (weak stress factor).

ADDITIONAL FACTORS THAT INFLUENCED CCE RATINGS:

Positive factors:

- Narrow spread between interest rates on loans and deposits at 2,8% as of December 2017 (3,12% in 2016 and 3,52% in 2015).

Restricting factors:

- The Cyprus Stock Exchange General Index (CYSMMAPA) was stable in 2017 starting the year at 68,4 points in January and standing at 69,5 points as of December 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 around 706% of GDP in 3Q 2017 (734,5% in 2016).

SENSITIVITY ASSESSMENT:

The following developments could lead to an upgrade:

- Further improvement of the debt metrics driven by fiscal surpluses and solid GDP growth with declining unemployment and consolidation of the current account;
- Reduction of NPLs ratio and further decline of private and external debt metrics.

The following developments could lead to a downgrade:

- GDP growth lower than anticipated which will result in higher debt levels and widening the current account deficit;
- A rebound trend of NPLs dynamics followed by deterioration of the banking sector metrics.

"The Agency's confirmation of the ratings of Cyprus at BB+ reflects better than anticipated GDP growth, a positive fiscal balance and, despite remaining the key risk for the economy, a slight improvement of the banking system metrics. Additionally, the government debt level declined further and we expect it to continue in a downward trend in the following years driven by GDP growth and expected fiscal surpluses. Finally, the level of unemployment is at new record low since the 2013 crisis. We could upgrade the rating in our next revision, if positive factors continue with the current trend and the negative variables improve further." - 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_06.04.2018.pdf

Next scheduled rating publication: 5 October 2018. The full sovereign rating calendar can be found at http://raexpert.eu/sovereign/#conf-tab-5

For further information contact:

Rating-Agentur Expert RA GmbH
Walter-Kolb-Strasse 9-11,
60594 Frankfurt am Main, Germany
+49 (69) 3085-45-00
E-mail: info@raexpert.eu
www.raexpert.eu

RATING HISTORY:

Date	Review reason	SGC		CCE	
		National currency	Foreign currency	National currency	Foreign currency
06.10.2017	Scheduled review of both types of ratings for the country	BB+	BB+	BB+	BB+
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 5 April 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.

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

Risk warning

The Agency disclaims all liability in connection with any consequences, interpretations, conclusions, recommendations and other actions directly or indirectly related to the conclusions and opinions contained in the Agency's press-release and research report.

This press-release represents the opinion of Rating-Agentur Expert RA GmbH and is not a recommendation to buy, hold or sell any securities or assets, or to make investment decisions.

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.

Rating-Agentur Expert RA GmbH is a credit rating agency established in Germany and therefore shall comply with all applicable regulations currently in force in the European Union.

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.