INTERNATIONAL GROUP OF RATING AGENCIES
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Research Report on Cyprus

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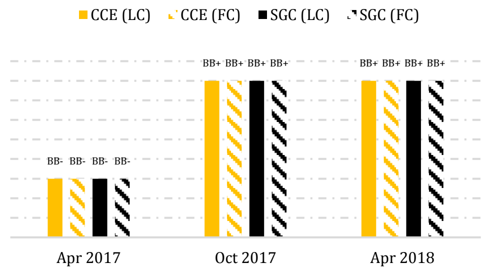
Ratings

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	2015	2016	2017
Gross gov. debt, EUR bn	19,0	19,3	18,7
Nominal GDP, EUR bn	17,6	17,9	18,7*
Real GDP growth, %	-1,6	2,8	3,8
Gross gov. debt/GDP, %	107,5	107,8	100
Deficit (surplus)/GDP, %	-1,4	-0,3	1,5
Inflation rate, %	-0,5	0,1	-0,4
Current Account Balance/GDP, %	-2,9	-5,2	-3,7*
External debt, USD bn	-	-	126**

Development indicators	2017
Inequality adj. HDI	0,762
GDP per capita, USD th	36,5

Default indicator	04.04.2018
7-Year Gov Bond Yield, %	1,5

Source: RAEX-Europe calculations based on data from the IMF, WB, Ministry of Finance, UN, Deutsche Boerse. *Forecast for 2017, ** Figure for 3Q 2017

Summary

The Agency's confirmation of the ratings of Cyprus at 'BB+' reflects the stabilization of GDP growth rates at a solid level, continuous positive development in public finances 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.

Despite the downward dynamics of government and private debt, the level of both metrics remains quite high and, combined with the still elevated degree of bad assets, represents the key threat to Cyprus' creditworthiness.

We could upgrade the rating in our next revision, if positive factors continue with the current trend and the negative variables improve further.

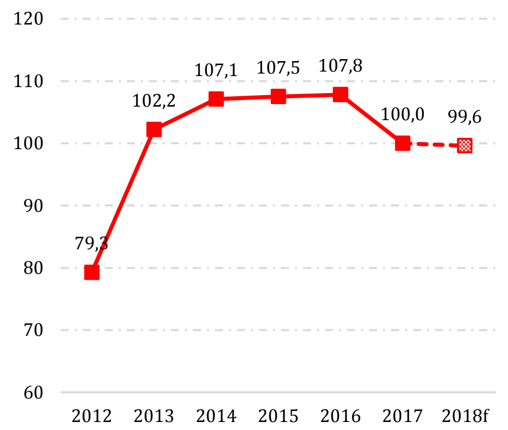
The government debt is still high but dynamics are favorable. The government debt level stood at around EUR 18,7 bn as of end-2017 which is the lowest level since 2014 in nominal terms. As % of GDP, it amounted to around 100% in the same period declining by 7p.p. as compared to a year before, due to robust GDP growth of 3,8% in real terms (see graph 1). We anticipate further reduction in the debt metrics in the future due to the implementation of structural reforms, and strong economic growth. However, despite our positive expectations, the debt load remains high.

The debt structure slightly improved in 2017 compared to the previous year. Short-term debt was as low as 1% of GDP and 2,7% of budget revenues and represented only 1% of the total debt as of end-2017. 64% of the debt is in the form of official loans and only 4% is issued in foreign currencies. However, the share of debt with floating interest rate is slightly high and accounted for 46% of the total debt load as of December 2017 (see graph 2).

Fiscal balance turned positive as of end-2017. As we expected in our previous revision[1], the fiscal stance improved in 2017 and marked a surplus of around 1,5% of GDP in 2017 compared to a deficit of 0,3% in 2016 according to the Ministry of Finance. The surplus is mostly driven

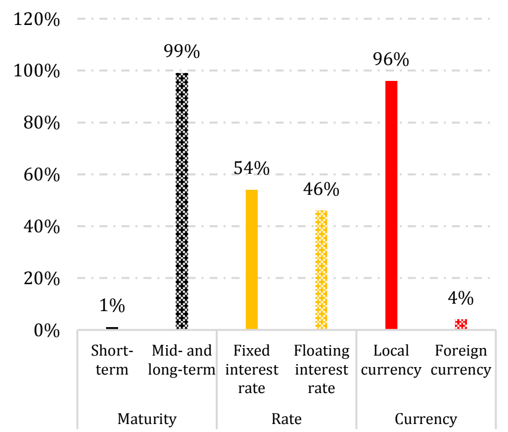
[1] Research report on Cyprus from 6 October 2017 (https://raexpert.eu/reports/Research_report_Cyprus_06.10.2017.pdf)

Graph 1: General government debt to GDP



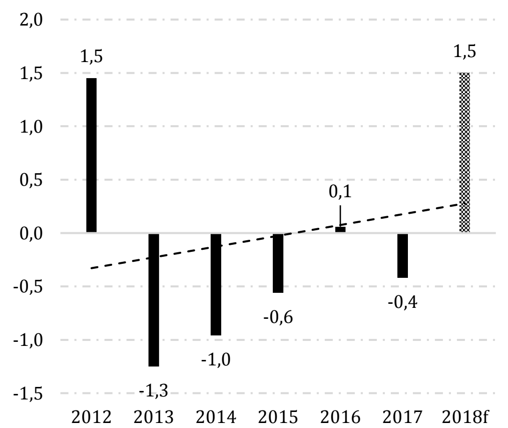
Source: RAEX-Europe calculations based on data from the IMF and European Commission

Graph 2: General government debt structure



Source: RAEX-Europe calculations based on data from Ministry of Finance

Graph 3: HICP, % y-o-y



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

by an increase in tax collection and social security contributions, while on the expenditure side the subsidies declined. The Agency expects the fiscal surpluses to continue in the following years, driven by the solid economic performance and responsible fiscal policy. However, the current delay in the implementation of structural reforms and privatization plans could impose a certain risk on the public finances. The government continues with the fiscal consolidation process, with the focus on productivity enhancing projects to improve long term growth. Therefore, we can expect public investment in the R&D sector and more favorable tax regime for innovative small and medium enterprises in order to improve the country's competitiveness and attract foreign investment. However, additional pressure on public finances might arise with the implementation of the health system reform and the termination of the agreement that limits public sector wage growth to the nominal GDP growth in 2018.

Real GDP growth was robust in 2017. After a growth of 2,8% in 2016, the Cypriot economy grew by a strong 3,8% in 2017 mainly due to increased private consumption and a substantial growth in service exports, especially in the tourism sector. Almost all sectors grew in this period compared to the previous year, with construction (25%) mining and quarrying (8,8%) and accommodation and food service activities (9%) having the strongest increase, while the financial sector contributed negatively contracting by -1,5%.

As expected, the unemployment rate continued to decline and reached 11% as of end-2017, the lowest level since 2012, remaining below the average value of its euro peers[2] (see table 1). Moreover, youth unemployment continued to drop reaching a level of 24% in 2017, 5 p.p. less than a year before. The employment is mostly driven by the sectors such as commodities and real estate.

Table 1: Peer comparison for 2017, %

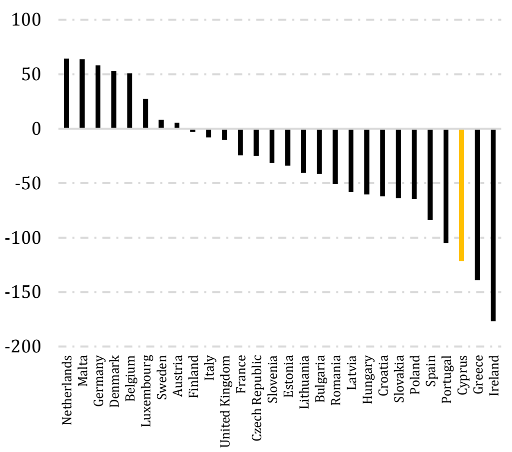
Key Financial Ratios	Cyprus	Greece	Italy	Portugal	Spain
GDP growth	3,8	1,7*	1,5*	2,4*	3*
Inflation rate	-0,4	0,9*	0,8*	2,3*	1,1*
Fiscal balance/GDP	1,5	0,1*	-1,4*	-1,3*	-2,6*
Current account/GDP	-3,7*	-0,2*	2,7*	0,4*	1,8*
Government debt/GDP	105,5*	180,1*	133*	125,7*	98,6*
Unemployment rate	11	22,2*	11,3*	9,7*	17,1*
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 2017, ** Actual values from WB for 2016

The inflation (as measured by the Harmonized Index of Consumer Prices) was negative in 2017 standing at -0,4% (see graph 3) mainly driven by

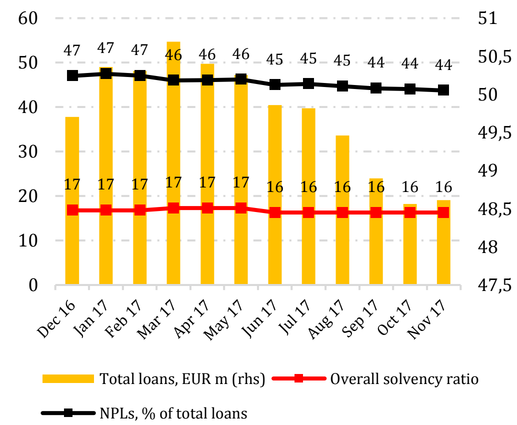
[2] Cyprus peers include the "peripheral Eurozone" countries such as Portugal, Italy, Spain and Greece.

Graph 4: Cyprus' NIIP as of 3Q 2017, % of GDP



Source: RAEX-Europe calculations based on data from Eurostat

Graph 5: Banking system dynamics



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

food and industrial goods' prices. In spite of this, we expect inflation to turn to once again in 2018 as a result of higher commodities' prices and higher wages.

External risk exposure remains worrisome. Gross external debt increased to EUR 126,6 bn as of 3Q 2017 and 676% of GDP, compared to end-2016 when it stood at 631%.

According to the recently published data from the Central Bank, the trade balance worsened as of end-2017 and stood at -2% of GDP compared to -0,8% in 2016. The current account had a similar trend in 2017, as the deficit widened to EUR 1,3 bn (around 6,9% of GDP) compared to 2016 when it stood at EUR 888 m (4,9 % of GDP).

We expect foreign direct investment (FDI) inflow to remain high in the following years as Cyprus is an attractive investment destination due to a favorable tax regime. However, a large share of the FDIs belongs to financial special purpose enterprises (SPEs) which are mostly an intermediary and not the actual investor.

Cyprus remains at the bottom of the EU net investment list. The net international investment position (NIIP) of the country slightly improved as of Q3 2017 when it stood at -121% of GDP compared to the end-2016 (-125% of GDP) (see graph 4).

The banking system continues to stabilize but NPLs still represent a key risk. Capitalization and liquidity remain solid 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. The profitability worsened compared to 2016, with ROA standing at -1,3% by September 2017. The overall system continues to deleverage, with banks' assets to GDP ratio estimated at around 360% in 2017, compared to 376% in 2016. However, despite NPLs ratio declining further down to 43,7% as of November 2017, they remain substantially high and impose a severe risk to the banking system (see graph 5). 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.

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_06.04.2018.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.