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CREDIT OPINION
25 February 2019

Update

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JSC Development Finance Institution Altum

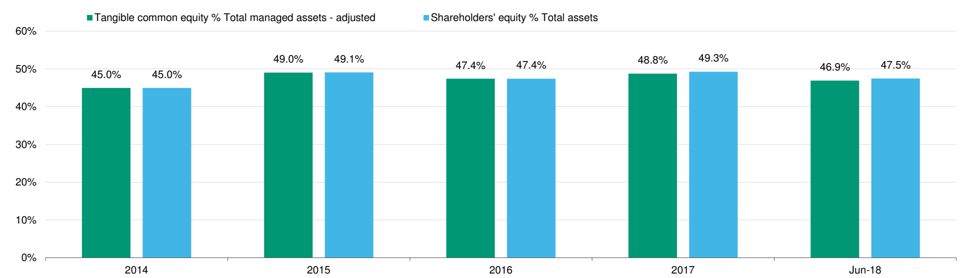
Update following change of outlook to review for upgrade

Summary

JSC Development Finance Institution Altum's (Altum) long-term issuer rating of Baa1 is under review for upgrade and the short-term rating is Prime-2, reflecting the combination of (1) a baseline credit assessment of ba2, which is also under review for upgrade, and (2) a very high probability of support from the Latvian government (A3 stable). The support assumption is based on the importance of Altum for the growth strategies of the Latvian government, as well as the government's strong track record of providing support to strategic companies.

Altum's stand-alone baseline credit assessment of ba2 reflects the institution's mandate as a development institution, with high capitalisation (see Exhibit 1), funding sourced from state and European Union (EU) government levels and including asset risk protection mechanisms. These strengths are balanced against a high level of problem loans and weak profitability.

Exhibit 1
Altum's capital metrics, as adjusted



Source: Altum's financial reports, Moody's investors Service

Credit strengths

» Very high probability of government support

» High capitalization

» Stable funding although state-backed funding is expected to decline in the long run

» Although weak, all profits are retained in the company

Credit challenges

» High volumes of problem loans, although coverage is very high

» Due to its mandate as a development organization, profitability is very low

Rating outlook

The review for upgrade reflects the potential for a higher overall assessment under the combined application of the updated Finance Companies methodology, released on December 10, 2018 (which determines the stand-alone assessment or BCA) and the Government Related Issuers methodology (which determines the rating uplift on the basis of support assumptions from the sovereign, Latvia). The updated methodology enables an enhanced ability to reflect the unique standing and funding conditions of Altum reflecting: 1) its position in the industry, and the scope of its policy mandate to provide a distribution channel for state and EU program funds to both end-customers and other financial institutions, and 2) the large share of loss coverage incorporated in the funding programmes and low refinancing risks.

Factors that could lead to an upgrade

The review for upgrade will consider the position of the company in the industry, both in terms of competition, industry stability and product risk, as well as the evaluation of key aspects of the company's financial strength. More specifically, the strengths of the issuer's market position within the scope of a quasi-public policy mandate in combination with the company's unique funding profile have the potential to lead to a higher BCA outcome. As a result, the uplift potential for the issuer rating from a likely higher BCA will also have to be re-assessed as part of the ratings review.

Factors that could lead to a downgrade

A downgrade is unlikely, given the current review for upgrade status of the rating. Altum's rating could experience downward pressure if the company's position in the industry deteriorates, for example through a state decision to alter the company's mandate with detrimental impact on its franchise and currently largely insulated competitive position, unwind programmes or funding, or sell parts of or the entire company.

Key indicators

Exhibit 2

JSC Development Finance Institution Altum (Consolidated Financials) [1]

	6-18[2]	12-17[2]	12-16[2]	12-15[2]	12-14[2]	CAGR/Avg.[3]
Total managed assets (EUR thousand)	468,886	451,686	443,126	406,918	435,360	2.1[4]
Total managed assets (USD thousand)	547,451	542,383	467,388	442,033	526,809	1.1[4]
Pretax Preprovision profits / Average Managed Assets (%)	1.3	0.8	0.5	0.7	-0.1	0.7[5]
Net Income / Average Managed Assets (%)	1.1	0.8	0.0	0.2	-0.5	0.3[5]
ROE (%)	2.2	1.7	0.0	0.4	-1.1	0.7[5]
Tangible Common Equity (Finance) / Tangible Managed Assets (%)	46.9	48.8	47.4	49.0	45.0	47.4[5]
Effective Leverage (%)	104.2	94.8	99.9	91.4	111.8	100.4[5]
Problem Loans / Gross Loans (Finance) (%)	21.0	23.1	27.6	29.0	30.6	26.3[5]
Problem Loans / (Shareholders' Equity + Loan Loss Reserve) (Finance) (%)	18.1	20.1	26.6	29.2	33.4	25.5[5]
Net Charge-Offs / Gross Loans (%)	1.8	1.7	1.7	4.8	5.5	3.1[5]

[1] All figures and ratios are adjusted using Moody's standard adjustments. [2] IFRS. [3] May include rounding differences due to scale of reported amounts. [4] Compound Annual Growth Rate (%) based on time period presented for the latest accounting regime. [5] Simple average of periods presented for the latest accounting regime.

Source: Moody's Financial Metrics

Profile

Altum has a strong mandate by law to promote the advancement of the Latvian economy through the development, approval, implementation and monitoring of aid programmes. These programmes are currently funded through the state budget and through EU structural funding. Although not a systemically important institution by size, Altum is the main development institution in Latvia and is of considerable importance to the delivery of the government's economic policy and we expect that the probability of support from the Latvian government is very high. Altum's shareholders comprise the Ministry of Finance (40%), the Ministry of Economy (30%) and the Ministry of Agriculture (30%).

Altum's main areas of activity relate to providing loans, credit guarantees and insurance for business export deals, as well as investment to venture capital funds. It also offers non-financial support in the form of consultations, education, mentoring, etc. Currently, Altum's activity is restricted to so-called programmes (financial instruments or grants) which are developed and then monitored at the ministry level. Therefore, all the investments made by Altum comply with government-defined development programme criteria. Altum implements support programmes and offers financial instruments, providing service to customers directly, as well as in cooperation with financial intermediaries and commercial banks. Altum has five regional centers and 16 consulting offices in different parts of Latvia.

Altum's activities are regulated by special law, the Development Finance Institution Law, passed by the Latvian Parliament in October 2014 and in force since March 2015. Altum's creation was supported by the European Commission's decision "Latvia MLB development segment and creation of the Latvian Single Development Institution". The other laws applicable to the institution are the Law on Governance of Capital Shares of a Public Person and Capital Companies, the Commercial Law and other binding regulatory enactments. Altum was established in December 2013 as a merger of the following three enterprises:

» Latvian Development Finance Institution Altum SJSC, (previously the Mortgage and Land Bank of Latvia), specialised in credit activities;

» Latvian Guarantee Agency LLC (LGA), specialised in guarantees and investments in venture capital;

» Rural Development Fund SJSC (RDF), specialised in credit activities for farmers.

Altum is not a deposit-taking institution and does not have a banking license. While it is obliged to prepare annual audited accounts in accordance with IFRS, the entity is not required to comply with minimum capital requirements.

As of 30 September 2018, Altum reported a total consolidated asset base of EUR473.5 million ($549.3 million).

Detailed credit considerations

Strong capitalization

Altum has large capital buffers to withstand volatility in earnings, and to support future growth. The Moody's adjusted tangible common equity to tangible managed assets ratio stood at a very strong 46.9% as of end-June 2018, although down from 48.8% as of end-December 2017 due to a one-off increase of loan loss provisions in the amount of EUR1.65 million from the adoption of IFRS9 in January 2018. However, Altum's strategy to grow its guarantee portfolio increases its contingent liabilities.

Altum's profit is not paid out in dividends. Instead it accumulates as reserves to ensure financial stability and sustainable operations, and to mitigate programme risks.

Weak asset risk mitigated by substantial risk coverage reserves

A high number of problem loans is credit negative but the risk is largely mitigated by a sizeable government- and EU-backed asset risk protection (reported as credit risk cover by public funding). Under this credit risk cover scheme, the sponsor (the state of Latvia or the EU) takes the first losses within the portfolios of loans, venture fund investments or guarantees (the percentage varies from one programme to another), providing meaningful protection against asset risk. Due to the nature of Altum's mandate and the risk cover, the institution has a larger risk appetite than would be the case for a commercial bank.

Altum's portfolio is diversified. Based on Altum's business development strategy, Moody's expects moderate growth in the entity's loan book and venture capital funds while the volume of guarantees should grow more rapidly.

As of end-September 2018, the Group's books and records held a portfolio of the financial instruments granted within the state aid programmes for the total value of EUR485.1 million (2017: EUR441.3 million), made up of 17,296 projects (2017: 14,402), including:

» loan portfolio of EUR214.4 million (2017: EUR207.6 million)

» investments in venture capital funds for the total value of EUR47.64 million (2017: EUR51.3 million)

» guarantee portfolio of EUR223.1 million (2017: EUR182.4 million).

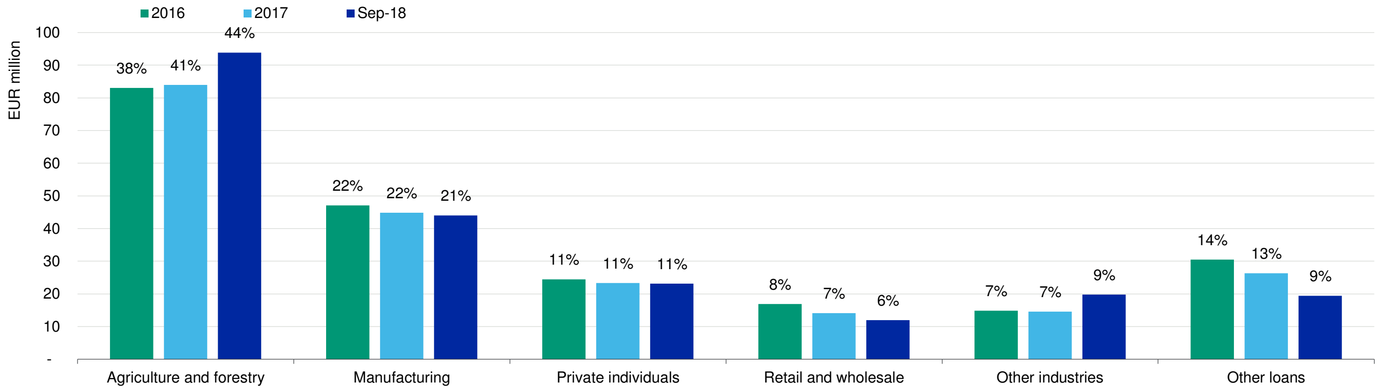
Altum expects a certain amount of loss on all its investments, depending on the programme structure and terms. The expected losses are estimated in advance and covered by the credit risk cover, a percentage of a programme's funding.

» Loans are given directly to companies and to a lesser degree, private individuals. The largest portion of loans are investment loans, aimed at helping smaller companies grow their businesses. Agriculture has traditionally been a large segment and constituted 44% of the loan portfolio at end-September 2018. Manufacturing and processing industry makes up 21% and private individuals 11% (see Exhibit 3).

» Funds aimed at venture capital/equity investments are managed by external funds, with partnership agreements and consultation committees in place to safeguard that programmes are followed. Fund managers typically also invest own money in these funds. The programmes aimed at equity investments have a large expected loss and therefore there are larger risk coverage reserves.

» Guarantees are given to banks to stimulate lending to borrowers who have viable business strategies but might lack enough own funds or enough collateral. Altum aims to grow primarily through guarantees going forward.

Exhibit 3
Loan book breakdown by industry

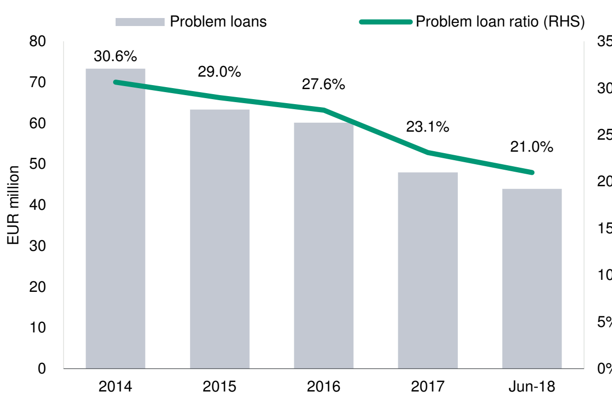


Percentages show the share of the total loans for each period.
Source: Altum's financial reports, Moody's Investors Service

The problem loan[1]-to-gross loan ratio stood at 21.0% at end-June 2018, falling from 23.1% at end-December 2017, which is commensurate with the entity's business model as it is targeting borrowers with weaker risk profiles (see Exhibit 4).

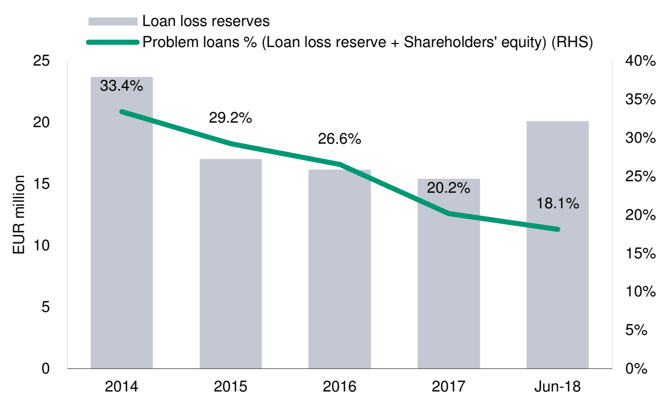
The loan loss reserves-to-problem loans ratio stood at a low 46% at end-June 2018 (end-2017: 32%). However, when including the programmes' credit risk cover for loans, coverage is high at 155% at end-June 2018 (end-2017: 125%).

Exhibit 4
Problem loans ratio



Source: Altum's financial reports, Moody's Investors Service

Exhibit 5
Problem loans coverage indicators



Source: Altum's financial reports, Moody's Investors Service

Altum-issued guarantees benefit from government backing

According to the Law on Development Finance Institution, the state is responsible for the guarantees issued by Altum (in case of Altum's failure to pay) to the amount specified in the Law On the State Budget for the Current Year. As of end-September 2018, a portfolio of outstanding guarantees (EUR223 million) is oversecured by state funding to amount of EUR250 million according to the Law on State Budget 2018 (2017: EUR182 million). Although this does not affect the standalone credit profile of Altum, it contributes to our view that the state is committed to Altum and its mandate.

Strong liquidity profile, with funding coming from Latvian state and European institutions

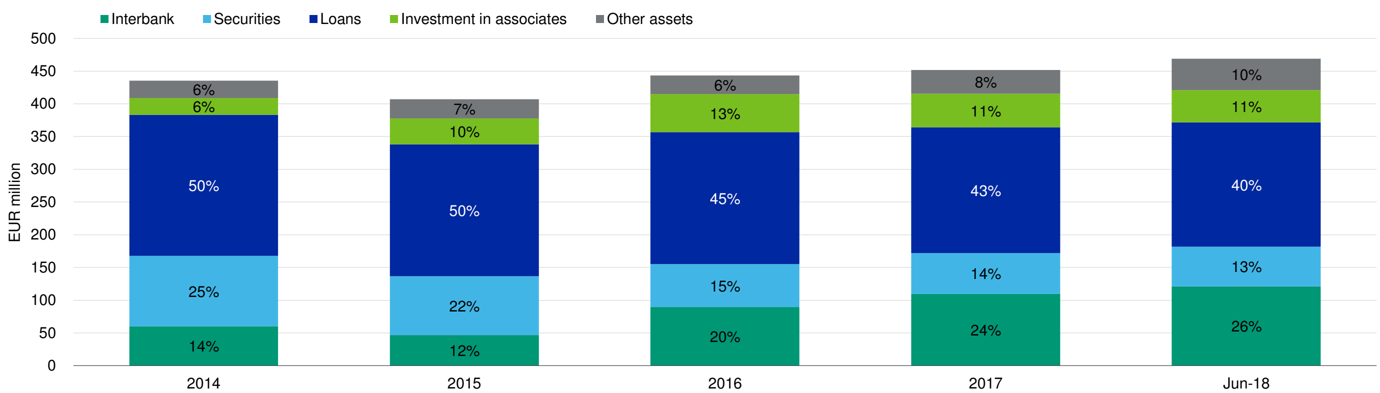
Most aid programmes, which are used to fund the institution, are replaced with new ones at maturity and thus funds are in practice not repaid. However, funds from operations is weak, constraining the liquidity score.

Altum is funded by borrowings from Latvian state, the European institutions and bond issuances. As of end-December 2017, around half of Altum's liabilities comes from support programme funding and state aid, the amounts and maturity of which are defined by the Cabinet of Ministers before the implementation of each programme. The other 50% of liabilities are divided between loans from the European Investment Bank, Rural Support Service and Latvian Treasury. The bonds are included in the year-end financial results, at which time it funded around 5% of Altum's assets. However, past 2020, some of the EU structural funds might gradually decrease while Altum plans on gradually increasing its funding with additional market funding.

Altum has a comfortable maturity profile, with 83% of funding (liabilities against credit institutions, general governments and support programme funding and state aid) having a maturity of more than one year, as of end-June 2018. Even though the support programme funding appears to have a given maturity, in reality it is transferred into a new programme after termination of the old one, so in practice these funds do not get repaid.

As of end-June 2018, Altum has a comfortable liquid resources cushion consisting mainly of demand deposits in other credit institutions and Latvian Treasury (EUR121 million), as well as Latvian government bonds (around EUR60 million). Over the longer term, we expect the increasing share of market funding might increase funding risks, as there will be a higher dependency on confidence-sensitive investors and higher refinancing risks.

Exhibit 6
Altum's assets breakdown



Note: The data labels refer to the percentages with respect to total assets.
Source: Altum's financial statements

Funds from operations were low at EUR10 million in 2017, whereas the outstanding senior debt was EUR20 million. With further issuances planned in the future, the funds generated by the operations might not be enough to repay upcoming maturities. This is largely mitigated by the large stock of liquid assets.

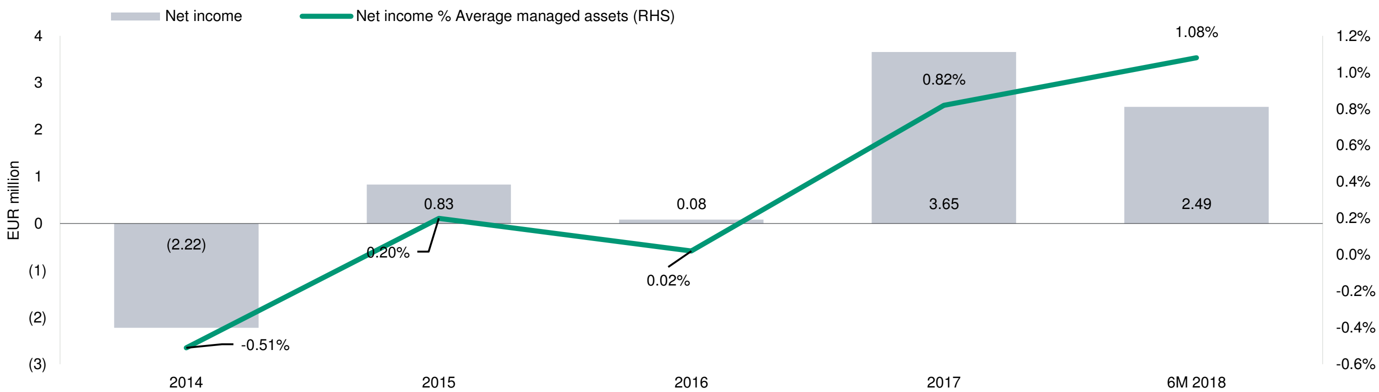
Weak profitability as profit maximization is not a priority

Profitability is a credit weakness for Altum, with expected low internal capital generation. Although profit maximization is not Altum's goal due to its specific business model, according to the Law the entity should operate with profit in the long-term, preserving the capital invested by the state. A positive return on equity is incorporated into the business strategy.

Altum's top-line revenues mostly consist of net interest income, which makes up to 78% of total revenues in the first six months of 2018. Fees and commission income accounted for around 4% of total revenues in the first six months of 2018.

After reporting a net loss of EUR2.2 million in 2014, Altum showed a positive bottom-line result over the next two years, although it was very close to break-even in 2016. After adjusting for non-recurring items, its net profit stood at EUR2.5 million in the first six months of 2018 up from EUR2.1 million over the same period in 2017, which translate into net income to average managed assets ratios of 1.1% and 1.0% respectively. Reported net profit stood at EUR2.5 million in the first six months of 2018 and EUR5.4 million in the same period in 2017.

Exhibit 7
Profitability levels



Source: Altum's financial statements; Moody's Investors Service

Over time, Moody's expects a slight improvement in profitability, with efficiency gains coming from increased business volumes on one side and reduced operating expenses on the other, mostly due to reorganization efforts, and implementation of new IT systems.

Operating environment

The updated methodology incorporates an operating environment score. At the conclusion of the review period, an operating environment score for Altum will be assigned, which will be a weighted combination of the Latvian macro level indicators and the industry risk score.

Industry risk indicators

The industry risk score for Altum will be assigned at the conclusion of the review period. It will reflect Altum's position in the industry as a development institution with a specific government mandate and within that scope, its ability to channel EU and State funding into the real economy.

Support and structural considerations

Very high probability of government support

The Latvian government has a track record of providing support to strategic companies, including the electricity, postal services, airlines, railways, and telecom sectors, as well as development institutions. The Latvian government has previously supported its development institutions by means of recapitalisation, liquidity support and guarantees. Due to the importance of Altum for planning and implementing growth strategies in the national economy, we assess that the probability of government support is very high.

Altum has a very high dependence on the Latvian state.

The very high default dependence reflects the strong probability that, in the event of a sovereign credit default, the risk of a potential financial crisis affecting Altum would be quite high, given (1) clear operational linkages to the government, whereby Altum has an explicit and well-recognised mandate to implement specific government policies; (2) the geographic focus of Altum's activities in Latvia; and (3) its high dependence on state funding.

Methodology

The principal methodology we use in rating JSC Development Finance Institution Altum is our Finance Companies rating methodology published in December 2018.

Ratings

Exhibit 8

Category	Moody's Rating
JSC DEVELOPMENT FINANCE INSTITUTION ALTUM	
Outlook	Rating(s) Under Review
Issuer Rating -Dom Curr	Baa1[1]
ST Issuer Rating -Dom Curr	P-2

[1] Placed under review for possible upgrade on December 12 2018
Source: Moody's Investors Service

Endnotes

1 Problem loans in 2018 consist of Stage 3 loans as per the IFRS9 reporting standards (introduced in January 2018), while for previous periods problem loans consist of the reported impaired loans and past due but not impaired loans.

REPORT NUMBER 1147558

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