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Research Update:

Banco Davivienda S.A. 'BBB-/A-3' Ratings Affirmed; Outlook Remains Stable

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Overview

- Colombia-based bank Davivienda maintains its strong presence in Colombia while it boosts participation in Central America.
- The ratings on the bank are still limited by moderate risk-adjusted capitalization (RAC).
- We are affirming our long-term 'BBB-' and short-term 'A-3' issuer credit ratings on the bank.
- The stable outlook reflects our expectation that, despite weaker credit conditions in Latin America for 2015, the bank's well-diversified business--by activities and geography--and prudent underwriting standards will continue to support its business and risk profiles.

Rating Action

On April 29, 2015, Standard & Poor's Ratings Services affirmed its long-term 'BBB-' and short-term 'A-3' issuer credit ratings on Banco Davivienda S.A. (Davivienda). At the same time, we are affirming our 'BBB-' issue-level rating on Davivienda's senior unsecured debt. The outlook remains stable.

Rationale

The issuer credit ratings (ICR) on Davivienda continue to reflect its "strong" business position, "moderate" capital and earnings, "adequate" risk position, "average" funding and "adequate" liquidity, as our criteria define these terms. The stand-alone credit profile (SACP) remains at 'bbb-'.

Our bank criteria use our Banking Industry Country Risk Assessment (BICRA) economic and industry risk scores to determine a bank's anchor, the starting point in assigning an issuer credit rating. Our anchor for Davivienda is 'bbb-', reflecting our view of the weighted-average economic risk in the countries to which the bank is exposed through its total loans--Colombia (representing around 80% of total loans) and El Salvador, Costa Rica, Panama, and Honduras representing the remainder. We score BICRAs on a scale of '1' to '10', ranging from the lowest-risk banking systems (group '1') to the highest-risk (group '10').

Our weighted economic risk score for these countries is '6.2'. Given that the majority of Davivienda's exposure is and will remain in Colombia, the bank's anchor is based on the country's economic risk score of '6' and an industry risk score of '5'. Colombia's economic risk reflects the country's low-income levels, which constrain its economic resilience, and reflect our "high risk" assessment for credit risk in the economy, as households have lower capacity to take out credit lines and are more vulnerable to economic downturns. On the other hand, Colombia has low inflation, moderate fiscal and current account deficits, a floating exchange rate, and a strong political consensus on key economic policies. These factors should maintain policy stability and economic resilience in the coming years. Colombia still has manageable economic imbalances--in our view, relatively fast credit expansion and rising housing prices pose an "intermediate risk" for the financial system. Still, the country's banking sector has sound asset quality and good underwriting standards, especially in the mortgage market.

Our industry risk score of '5' reflects no significant distortions in the financial system, banking industry's stability, and a satisfactory deposit base that has remained fairly stable even during periods of market turmoil. On the other hand, we believe there is room for improvement in Colombia's regulatory framework and track record, in particular with regard to capitalization rules. On the positive side, transparency in the financial system is very good and compares favorably with many of its peers in the region.

Davivienda's business position remains "strong." This assessment is supported by the bank's significant presence in the Colombian banking system--13% market share in terms of loans and 12% by deposits, as of Dec. 31, 2014--and because it is expanding its reach in Central America. Davivienda's diversification by business activities and geography, which provide stability to the bank's operating revenues, also supports our assessment. We expect these factors will allow the bank's performance to remain stable despite weaker credit conditions in Latin America for 2015 due to continued weak commodity prices and volatile currency performance in the face of a strong U.S. dollar.

Commercial loans accounted for 52% of consolidated total loans in Davivienda's loan portfolio, as of Dec. 31, 2014. Consumer loans and mortgages represented 27% and 22% of consolidated total loans, respectively. We expect this business diversification will remain relatively stable during the next two years. The bank's loan portfolio booked in Central America has a higher orientation toward commercial loans, which represent 59% of total loans. The bank's total loans booked outside Colombia represent 20% of Davivienda's consolidated loan portfolio. El Salvador holds 37% of Davivienda's international business by total loans, followed by Costa Rica (26%), Panama (21%), and Honduras with the remaining 17%. Looking forward, we believe that the participation of Colombia within Davivienda's total loans will remain stable at around 80%. In 2014, 22% of Davivienda's net income came from the subsidiaries based abroad, including dividend payments. In addition to the bank's international business, we believe that the brokerage services--provided by Corredores Davivienda--will add revenue diversification in the form of fee income.

Our assessment on Davivienda's capital and earnings remains "moderate." This reflects our projected RAC ratio, which we expect to be about 6% for the next two years. As of Dec. 31, 2014, The RAC ratio was 5.9% before adjustments.

Davivienda's goodwill continues to represent a significant portion of its total adjusted capital (TAC), at around 30% as of Dec. 31, 2014. This ratio has gradually declined, and we expect goodwill will continue to limit the RAC ratio for the next two years.

Our financial forecasts incorporate our base-case scenario assumptions, which include:

- Colombian GDP growth slowing to 3.5% in 2015--from 4.8% in 2014--and recovering to 4.0% in 2015;
- Loan portfolio growth of about 15% in 2015 and 2016, on average, down from 24% in 2014 based on economic prospects;
- Relatively stable goodwill, as we don't expect additional acquisitions for the next two years;
- Profitability to remain adequate with the bank's return on assets (ROA) at 1.4% on average for the next two years but lower with respect to previous years'. This will reflect a lower net interest margin--due to the increasing participation of time deposits in the bank's funding base and higher market interest rates--and significantly higher effective tax rate due to Colombia's tax-reform;
- However, we believe that there are mitigating factors that would keep supporting Davivienda's profitability levels, such as its stringent cost-containment policy--reflected in stable and below-average non-interest expenses to operating revenues estimated at 46% for 2015 and 2016)--and its conservative underwriting standards that are resulting in a lower participation of credit loss provisions to operating revenues. This ratio will be below 30% in the next two years compared with the 37% average in the past four years;
- Nonperforming assets (NPAs = nonperforming loans plus repossessed assets) to total loans ratio at about 2% in the next two years, fully covered, and gross charge-offs to total loans about 1.5%; and
- Dividend payout ratio of about 35% in 2015 and 2016.

Davivienda's TAC fully incorporates its preferred shares (Colombian peso [COP] 1.14 trillion, representing 19% of its TAC as of Dec. 31, 2014), which classify as 'intermediate equity content' instruments. We still view the bank's quality of earnings as adequate due to its adequate profitability metrics, and because of its low participation of trading revenues within the bank's operating revenues. In our opinion, Davivienda has the ability to absorb credit losses through its adequate internal capital and earnings generation.

We still assess Davivienda's risk position as "adequate." The bank's adequate risk diversification--by individual debtors and by economic sectors--and low credit losses with respect to total assets support our assessment. In 2014, Davivienda took advantage of the good economic prospects in Colombia and continued to expand its loan portfolio. Loan growth was 23.8% in 2014 with a three-year average of 23.4%. For 2015, we believe Davivienda and most banks in Colombia will slow down their credit expansion due to likely slower economic growth. However, Davivienda's growth will continue to surpass the average pace in the system reaching about 15% on average, during 2015 and 2016 compared with the system's likely 13%-13.5%. We believe Davivienda's commercial loans will continue to drive future growth while the Fourth Generation (4G) Concession Plan might boost the bank's credit growth in its commercial loan portfolio by 2016.

We believe Davivienda's risk diversification remains adequate and supports its risk position. The bank's top 20 customers represented 8.4% of total loans and 79% of its TAC, as of Dec. 31, 2014. These levels are better than the bank's regional peers' that have higher concentrations. We also believe the bank's loan portfolio is well-diversified by economic sectors. With the exception of consumer loans and mortgages, we don't identify any sector representing more than 9% of the loan portfolio. In our view, entities related to the oil sector will have a tough year; however, Davivienda's exposure to this sector is limited and represents 1% of the bank's total loans. Construction, which is another sector that suffers under slowing economic conditions, represents 8.7% of Davivienda's loan portfolio.

Despite Davivienda's aggressive loan growth rates, we believe the bank's asset quality metrics will remain manageable, with NPAs bank's performance in its consumer and mortgage portfolios will be pressured during 2015 by the slowing economy in Colombia. However, the bank's conservative underwriting practices should avoid significant deterioration on NPAs. Payroll loans within the consumer portfolio represent 38.6%, excluding mortgages. And the bank implements conservative loan-to-value policies, which, by regulation, cannot exceed 70% of the price of a home and 80% for subsidized housing for low-income families. Net charge-offs represented a moderate participation of average total loans, 0.1%, as of Dec. 31, 2014. This ratio reflects the bank's high rate of recoveries. Without recoveries, gross charge-offs were 1.6% of average total loans at year-end 2014. We believe net charge-offs will remain low during the next two years, and we expect consumer loans to continue to represent of the lion's share of the bank's credit losses (86% as of Dec. 31, 2014).

Davivienda's funding remains "average" within the Colombian banking system and our liquidity assessment is "adequate." The bank's funding structure is mainly composed of core customer deposits, which represented 75% of its funding base as of Dec. 31, 2014. Demand and saving deposits represent around 63% of total deposits. Retail depositors represent a smaller share in Davivienda's deposit base compared with that of other large banks in Latin America. However, this is a common characteristic in the Colombian banking system. On the other hand, the bank's Central American subsidiaries rely heavily on retail deposits.

The bank has been issuing debt in the local and foreign markets to better match its balance sheet. Bonds represented 9% of Davivienda's funding base while subordinated debt represented 4% as of Dec. 31, 2014. Only 15% of the bank's market debt matures within one year. Interbank loans complement Davivienda's funding sources, representing around 10% of its funding base. We believe Davivienda's funding structure will remain relatively stable in the next two years. The stable funding ratio--measured by available stable funding sources to stable funding needs--was 109% at year-end 2014 with an 111% three-year average. These levels support our "adequate" assessment of the bank's funding.

In our view, Davivienda's liquidity is "adequate." The bank's broad liquid assets represented 26% of total deposits, as of Dec. 31, 2014. And this ratio has averaged 29% in the past four years. In addition, the bank's broad liquid assets to short-term wholesale funding was 2.9x at year-end 2014 while the average of the past four years was 3.5x.

Davivienda has a "moderately high" likelihood of extraordinary government support; however, the issuer credit ratings don't reflect notches of government support. If we were to lower Davivienda's 'bbb-'stand-alone credit profile by one notch, the issuer credit rating would remain at 'BBB-' reflecting one notch of government support.

Outlook

The stable outlook reflects our expectations that the bank will maintain its important presence in Colombia while strengthening its market position in Central America. We believe that, despite weaker credit conditions in Latin America for 2015, the bank's asset quality metrics will remain adequate with NPAs to total loans around 2% fully covered by reserves, while gross charge-offs remain around 1.5%, supported by the bank's well-diversified business and prudent underwriting standards. The RAC will remain moderate, as we expect the RAC ratio to be about 6% in the next two years.

Downside scenario

If we were to revise Davivienda's SACP downward by two notches we could downgrade the bank. We believe this is highly unlikely in the next 12-18 months given the bank's resilience in terms of business stability and diversification of business activities while maintaining its current 35% dividend payout ratio. In addition, we do not expect the bank's risk position to weaken significantly in the next 12-18 months.

Upside scenario

If Davivienda strengthens the RAC ratio to above 7% we could upgrade the bank. Despite Davivienda's "moderately high" likelihood of government support--which reflects the bank's "high systemic" importance and the Colombia government's tendency to support private-sector commercial banks--we don't include any notch of support to the ICR. If we raise the local currency long-term rating on Colombia, we would raise the ratings on Davivienda, reflecting one notch of government support, if the bank's SACP remains unchanged.

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Ratings Score Snapshot

Issuer Credit Rating	BBB-/Stable/A-3
SACP	bbb-
Anchor	bbb-
Business Position	Strong (+1)
Capital and Earnings	Moderate (-1)
Risk Position	Adequate (0)
Funding and liquidity	Average and Adequate (0)
Support	0
GRE Support	0
Group Support	0
Government Support	0
Additional Factors	0

Related Criteria And Research

Related Criteria

- Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
- Group Rating Methodology, Nov. 19, 2013
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Bank Capital Methodology and Assumptions, Dec. 6, 2010

Related Research

- Credit Conditions: Weakness Ahead For Latin America As Brazil Falls Into Recession, April 2, 2015
- Latin American Banking Risks Won't Recede In 2015, Dec. 8, 2014
- Top Colombian Banks, Oct. 28, 2014
- Banking Industry Country Risk Assessment: Colombia, Aug. 6, 2014
- For Banks Globally, Higher Capital Requirements And Moderate Returns On Equity Will Constrain Lending Growth, June 11, 2014
- Sluggish Economic Activity Is Weighing On Latin American Banks' Performance, June 5, 2014

Ratings List

Ratings Affirmed

Banco Davivienda S.A.	
Counterparty Credit Rating	BBB-/Stable/A-3
Senior Unsecured	BBB-

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