Research Update:
Bancolombia, S. A. y Companías Subordinadas 'BB+/B' Issuer Credit Ratings Affirmed; Outlook Remains Stable

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Table Of Contents

Overview
Rating Action
Rationale
Outlook
Ratings Score Snapshot
Related Criteria
Ratings List
Research Update:

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Overview

• Bancolombia's capital remains weak; however, its capital base has strengthened due to the recognition of its preferred shares as common equity, given that it hasn't redeemed them, and its capacity to absorb losses.

• The bank's asset quality metrics remain high, although they reflect some exposure to deteriorated projects such as Electricaribe and Ruta del Sol; still, we consider the metrics to be in line with the rest of the Colombian banking system.

• Bancolombia continues to have a leading position in the domestic financial system, with sound participation in other Central American markets. It's maintained good business diversification, a strong franchise, and sound business stability.

• We're affirming our 'BB+/B' issuer credit ratings on the bank and on its core subsidiary, Bancolombia Panama.

• The stable outlook on Bancolombia continues to reflect its improved forecast RAC ratio and its prominent market position in the Colombian and Central American markets.

Rating Action

On July 18, 2018, S&P Global Ratings affirmed its 'BB+' long-term and 'B' short-term issuer credit ratings (ICRs) on Bancolombia S.A. y Companias Subordinadas (Bancolombia). At the same time, we affirmed our 'BB+/B' ratings on its core entity, Bancolombia Panama S.A. The outlook on both entities is stable.

Rationale

The issuer credit ratings (ICR) on Bancolombia reflect its leading market position in the Colombian banking system; with sound business stability, a risk position supported by adequate diversification, and still manageable asset quality metrics, although they've recently worsened. The bank's capital position remains weak, although capital indicators have improved, with a projected risk-adjusted capital (RAC) ratio of 4.8% for the next 12 months. Bancolombia's total adjusted capital (TAC) incorporates the preferred shares.
issued between 1995 and 2012 as common equity, which strengthened our RAC ratio to 4.8% at the end of 2017 from 3.2% at year-end 2016. Despite this improvement, our assessment of the bank's capital and earnings remains unchanged. In addition, the ratings consider that Bancolombia's large and stable deposit base continues to support its funding profile, with no significant liquidity needs in the near future. The stand-alone credit profile (SACP) remains at 'bb+'.

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 ICR. Our anchor for Bancolombia is 'bb+', reflecting the weighted average economic risk of '7' given the countries where the bank has its major loan portfolio exposures as of December 2017: Colombia (70%), Panama (18%), El Salvador (6%), and Guatemala (6%). The industry risk score for Colombian banks is '5', with a positive trend (see "Banking Industry Country Risk Assessment Industry Risk Trend For Colombia Revised To Positive," published July 10, 2018).

Bancolombia's business position assessment remains supported by its predominant market position, not only in the Colombian financial system, but also across Central America. Our assessment also incorporates the bank's strong franchise value, good business diversification, and stable base of recurring clients.

The bank's business stability has remained sound primarily because of its position as the largest bank in Colombia. This market position has remained stable in the last few years, with a market share of around 25.5% and 23.4% in terms of loans and total deposits, respectively, as of March 31, 2018. The second and third largest banks still lag behind Bancolombia with market shares of 14.8% and 13.0%, respectively. Thus, we consider it unlikely that Bancolombia would lose its leading position in upcoming years.

The bank's business diversification also provides it with revenue stability. Bancolombia continues to participate in nearly all business lines, even though commercial loans have historically represented the highest share of its loan portfolio. As of March 31, 2018, these loans represented 69.3% of the loan book (includes financial leases), followed by consumer loans (17.2%), and residential real estate loans (12.9%). The remaining 0.6% remained stable is made up of other loans.

Bancolombia's presence in Central America, through its fully-owned subsidiaries Banistmo S.A. (BB+/Stable/B) in Panama and Banco Agricola S.A. (B-/Stable/B) in El Salvador, as well as its 60% stake in Grupo Agromercantil (not rated) in Guatemala, make Bancolombia one of the largest financial groups in Central America, with strong geographic diversification. For the next 12 months, we expect the bank to grow by about 7.6% on a consolidated basis, enabling Bancolombia to maintain its important market position in all the regions where it operates. Therefore, we don't foresee any changes to its business position assessment.
Our projected RAC ratio of 4.8% for the next 12 months underpins the bank's capital and earnings assessment. Based on the historical information of Bancolombia's preferred shares, and considering the bank hasn't redeemed these shares since its first issuance in 1995; we recognize that those instruments have behaved as common equity, absorbing losses when needed through dividend deferrals. For instance, we saw this in 1999-2000 when the bank didn't distribute dividends because of their losses due to the Colombian financial crisis. Moreover, preferred shares have the same tax treatment as common shares.

Bancolombia's total adjusted capital (TAC) incorporates the preferred shares that were issued between 1995 and 2012 as common equity, which strengthens our RAC ratio to 4.8% at the end of 2017 versus 3.2% at the end of 2016. Despite this improvement, we continue to assess the bank's capital and earnings as weak. Furthermore, based on our economic and financial expectations for Bancolombia during 2018-2019, we expect our RAC ratio to be around 4.8% for the next 12 months.

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

- Colombia's GDP to grow 2.5% in 2018 and 2.6% in 2019 (according to our last Credit Conditions article, "Domestic Politics And Increasing U.S. Protectionism Undermine Favorable Conditions," published on June 28, 2018).
- Foreign exchange volatility in the next two years: COP2,950 and COP3,000 per $1 for 2018 and 2019, respectively;
- Consolidated loan portfolio growing at about 7.6% in 2018 and 7.8% in 2019;
- Net interest margins (NIMs) of 5.85% for 2018;
- Adequate profitability, with core earnings to adjusted assets and efficiency levels around 1.14% and 49.3%, respectively, for the next 12 months;
- Payout ratio averaging 22% for the next year;
- Non-performing assets (NPAs) and credit losses (NCOs) at about 3.35% and 1.21%, respectively, fully covered by reserves; and
- No additional external growth for 2018 and 2019.

Although that our projected RAC ratio is within the 25 basis points (bps) threshold, we consider that Bancolombia's quality of capital is not high because of the relatively important amount of goodwill in its capital base. Since this intangible is dollarized, the bank faces the risk of the U.S. dollar appreciating, adding volatility to its TAC. The latter had negatively affected our ratio in 2015, when we saw the Colombian peso significantly depreciate, increasing the amount of its goodwill valuation by 47%.

Bancolombia's profitability metrics and earning capacity have remained fairly stable, and we expect them to remain so. The bank posted core earnings to
adjusted assets of 1.12% at the end of March 2018, slightly lower than the 1.33% in the same period last year, and in line with its three-year average of 1.22%. This has resulted from loan portfolio growth and a slight drop in its NIMs (to 5.61% as of March 2018 from 6.00% in December 2017), as well as improved efficiency metrics. The bank's total revenues are mainly composed of interest income—around 74% as of March 2018 with a three-year average of 70%—which, in our view, stabilizes its profitability metrics. Over the next 12 months, we forecast core earnings to adjusted assets of about 1.14% because of the bank's focus on making its balance sheet more profitable, without major increases in its securities portfolio, and sustained efforts to control costs. Moreover, fee income should keep increasing, given the bank's efforts to promote the use of credit cards, its trusts business, and the distribution of insurance policies.

Bancolombia's asset quality metrics have been worsening since 2016 due to large corporate clients that caused a general deterioration in the Colombian banking system. The bank has had problems with Ruta del Sol, a road infrastructure project; Electricaribe; and with its small to midsize (SMEs) business unit because of transport segment exposures. Despite these issues, we still believe that Bancolombia's risk position assessment compares adequately with its Colombian peers and with other banks with similar economic risks. Bancolombia continues to have satisfactory risk distribution among several asset classes. Furthermore, even if the bank is concentrated in the commercial loans sector, its top 20 largest exposures only represented 7.7% of its consolidated total loan portfolio and 0.7x of its TAC as of December 2017. These metrics are in line with those of its closest peers.

Despite some economic issues during 2017, Bancolombia's asset quality metrics have remained manageable and similar to those of rated peers in Colombia and Latin America. Although we consider them manageable, non-performing assets (NPAs) are higher than those of previous years. This is mainly explained by the consolidated impact of its credit exposures with Ruta del Sol; Electricaribe; and Consorcio Express, a transport company. As of March 31, 2018, the bank's NPA ratio was 3.2% and net charge-off ratio (NCHOs) was 1.4%; still in line with the rest of the Colombian banking system. Moreover, reserve coverage remained strong, with NPA coverage levels at 176%. For the next year, we project NPAs to be about 3.35%; also in line with our forecast for the Colombian banking system (3.32%).

Bancolombia's funding assessment is driven by a high and stable proportion of customer deposits coupled with a stable funding ratio (SFR) above 100%. As of March 31, 2018, its funding base hasn't changed significantly: customer deposits were around 79% of the total funding base. The rest is made up of debt issuances, interbank loans, and a small amount of repurchase agreements. The bank's SFR was 100.32% at the first quarter of 2018, which we consider in line with its funding assessment, even though it's slightly lower than the 101.77% average of the past three fiscal years, and lower than that of the Colombian banking industry (105.30%). For the next 12 months, we don't expect the bank's funding structure to notably change, based on our expectation that customer deposits will continue to be its main funding source, as the bank
uses its region-wide branch network.

Bancolombia's liquidity levels are underpinned by its broad liquid assets that covered short-term wholesale funding 2.0x as of March 31, 2018, with a three-year average of 1.9x. Furthermore, our liquidity assessment reflects the bank's manageable refinancing risk with a satisfactory maturity profile and its liquidity position, which is mainly comprised of cash and government securities.

We continue to view Bancolombia as having high systemic importance within the Colombian financial system, because of its leading market share in terms of deposits and its importance to the country's payment system and our belief that the government is supportive towards its financial system. The latter results in a moderately high likelihood of extraordinary government support to the bank. Nevertheless, we're don't currently incorporate any additional notches of support to our ratings on Bancolombia, considering the sovereign local currency long-term rating ('BBB'). Therefore, the ratings reflect the bank's SACP.

Bancolombia is a subsidiary of the investment holding company (IHC) Grupo de Inversiones Suramericana S.A. (BBB-/Stable/--). The group credit profile for Bancolombia includes our view of it as a moderately strategic subsidiary, which, according to our criteria, grants one notch of support to the company's SACP. However, this is subject to a cap of one notch below the GCP, which is our case. Therefore, we don't apply a notch.

**Outlook**

The stable outlook on Bancolombia for the next year reflects our expectation that the bank will maintain its leading business position in Colombia and its solid franchise throughout Central America while sustaining a RAC ratio of 4.8%. Additionally, our stable outlook incorporates our expectation of the bank's measured approach to its risk operations and conservative liquidity management.

**Downside scenario**

A downgrade of the bank without a downgrade of the sovereign is unlikely over the next year because if the bank's credit fundamentals worsened, leading to a revision of its SACP downward, we could reflect one notch of support from the sovereign.

**Upside scenario**

If our RAC ratio is comfortably above 5%, we could upgrade Bancolombia. This could happen if its internal capital generation is above our expectations due to improved operating revenues, coupled with manageable asset quality indicators.
**Ratings Score Snapshot**

- **Issuer Credit Rating:** BB+/Stable/B
- **SACP:** bb+
- **Anchor:** bb+
- **Business Position:** Strong (+1)
- **Capital and Earnings:** Weak (-1)
- **Risk Position:** Adequate (0)
- **Funding:** Average (0)
- **Liquidity:** Adequate

- **Support:** 0
- **GRE Support:** 0
- **Group Support:** 0
- **Sovereign Support:** 0

- **Additional Factors:** 0

**Related Criteria**

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria - Financial Institutions - Banks: Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Financial Institutions - Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Criteria - Financial Institutions - Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

**Ratings List**

**Ratings Affirmed**

- **Bancolombia, S. A. y Companias Subordinadas**
- **Bancolombia Panama S.A.**

    **Counterparty Credit Rating**  BB+/Stable/B
Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.