Research Update:

Bancolombia, S.A. y Companias Subordinadas 'BBB-/A-3' Ratings Affirmed On Strong Operating Performance; Outlook Stable

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Overview

- Its leading market position, sustained growth, and strong franchise value have allowed Colombia-based universal bank, Bancolombia to maintain its strong business position.
- Bancolombia's operating performance remains sound; nevertheless, its risk-adjusted capitalization remains its main rating weakness. It has recently been hampered by depreciation in the Colombian peso (COP), reflected in higher loan growth and an increase in goodwill.
- We are affirming our 'BBB-/A-3' issuer credit ratings on the bank and on its core subsidiary, Bancolombia Panama.
- The stable outlook on Bancolombia reflects our expectation that it will improve its risk-adjusted capitalization to around 4.3% by year-end 2016 as a result of good earnings generation. We also expect the bank to maintain its "strong" business position, and to benefit from the stability of its solid business franchise.

Rating Action

On Sept. 30, 2015, Standard & Poor's Ratings Services affirmed its 'BBB-' long-term and 'A-3' short-term issuer credit ratings (ICRs) on Bancolombia S.A. y Companias Subordinadas (Bancolombia). At the same time, we affirmed our 'BBB-/A-3' ratings on its core entity, Bancolombia Panama S.A. The outlook on both entities remains stable.

Rationale

Our ratings on Bancolombia reflect its "strong" business position (due to its leading market position in the Colombian banking system and strong business stability), its "weak" capital and earnings (with a projected RAC ratio of 4.3% for the next two years), its "adequate" risk position (underpinned by adequate risk diversification and healthy asset quality metrics), and its "average" funding and "adequate" liquidity. The stand-alone credit profile (SACP) remains 'bb+'.

We continue to view Bancolombia as having "high" systemic importance within the Colombian financial system, due to its leading market share in terms of deposits--19.3% as of June 2015--and its importance to the country's payment system. We also view the Colombian government as being "supportive" towards its financial system. This results in a "moderately high" likelihood of
extraordinary government support to Bancolombia. Considering the sovereign local currency rating of 'BBB+', Bancolombia's SACP receives one-notch of uplift.

Our bank criteria use our banking industry country risk assessment (BICRA) economic risk and industry risk scores to determine a bank's anchor, the starting point in assigning an issuer credit rating. Our anchor for Bancolombia is 'bbb-', reflecting the weighted average economic risk of '6', given the countries in which the bank has its major loan portfolio exposures--Colombia (74%), Panama (19%), and El Salvador (6%). The industry risk score for Colombian banks is '5', with a negative trend, reflecting our opinion of the financial system's potential funding vulnerability.

Colombia's economic risk, where the bank has its biggest exposure, reflects the country's low-income levels (which constrain its economic resilience) and 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 BICRA industry risk score of '5' for Colombia, where the bank is domiciled, 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. However, 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.

We maintain our assessment of Bancolombia's business position as "strong" due to its leading market position in the Colombian banking system, strong franchise value, and good business stability. The bank has maintained its leading market share in Colombia in terms of total loans and deposits--22.4% and 19.3%, respectively, as of June 2015. Its business line diversification, long-standing customer relationships, and nationwide presence also provide revenue stability; operating revenues have exhibited a 15% compound annual growth rate (CAGR) in the last four fiscal years. Bancolombia participates in nearly all business lines in Colombia, although commercial loans have historically represented the greatest share of its loan portfolio. As of the end of second quarter 2015, commercial loans represented 71% of the loan book (including acceptances), followed by consumer loans (15%), and residential real estate loans (13%). As Bancolombia's revenues are primarily from interest income (nearly 70% during the first half of 2015, and 64% on average for the last three fiscal years), its profitability metrics have also remained stable.
The bank has strong geographic diversification through its fully owned subsidiaries, Banistmo S.A. (BBB-/Stable/A-3) in Panama and Banco Agricola (B+/Stable/B) in El Salvador, and through its 40% stake in Grupo Agromercantil in Guatemala. We expect Bancolombia to maintain its leading market position in the next two years mainly through organic growth.

Our assessment of Bancolombia's capital and earnings remains "weak," reflecting our projected RAC ratio of about 4.3% in 2016. This level still reflects the high amount of goodwill generated after the acquisition of Banistmo and the high portion of preferred shares in the bank's capital structure. We expect good earnings generation coupled with more-moderate loan portfolio growth to help maintain the RAC above 4% in 2016. The bank's risk-adjusted capitalization levels lingered below 4% before 2015, and failed to meet our expectations. In 2013, when the bank acquired Banistmo, the goodwill generated was higher than we had anticipated, consequently weakening the bank's risk-adjusted capitalization; in 2014 external factors, such as the significant Colombian peso depreciation, similarly hurt the bank's RAC ratio.

Our forecast reflects our base-case scenario, which includes the following assumptions:

- Colombia's GDP growth of 2.5% in 2015 and 3.0% in 2016
- Loan portfolio growth of 16% in 2015 and 11% in 2016 and a 3% increase in other earning assets for each year
- Net interest margin (NIM) around 5.5%
- Goodwill increase of 28% in 2015 arising from Colombian peso depreciation and 9% in 2016
- Tax rate of 30%
- Dividend policy unchanged from previous years
- Efficiency ratio of around 52% for the next two years, as the bank continues to explore efficiencies and cost controls
- NPAs around 3.2%, with 1.2x reserve coverage, and net charge-offs around 1%
- Core earnings to adjusted assets of around 1.4%

We will analyze the impact of the acquisition of an additional 20% stake in Grupo Agromercantil Holding S.A. (not rated) once Bancolombia receives all necessary authorizations and discloses the purchase price.

We consider Bancolombia's quality of capital moderate (according to our criteria), based on its reliance on hybrid issuances to support regulatory capital ratios. The bank has maintained adequate profitability as a result of loan portfolio growth, improvement of its net interest margins (NIMs) and better efficiencies, despite the higher tax burden in Colombia. Its revenues are comprised mainly of interest income (nearly 70% in the first half of 2015, and 64% on average for the last three fiscal years), providing stability to its profitability ratios. We currently forecast core earnings to adjusted assets to be about 1.4% for the next 18 months, as the bank continues to make its balance sheet more profitable (without major increases in its securities portfolio), and to control costs. Also, income from fees should remain...
positive, given the bank's efforts to promote the use of credit cards and the distribution of insurance policies.

Bancolombia's conservative origination practices, adequate risk diversification, good asset quality metrics, and low credit losses underpin our "adequate" assessment of its risk position. The bank does not exhibit significant credit risk concentrations in terms of sector or single-name exposures. In addition, its top 20 largest exposures represented a low 7.8% of its consolidated total loan portfolio and 51.1% of its total consolidated reported equity as of June 2015. There are no currency mismatches in Bancolombia's balance sheet; dollar-denominated loans represented 36% of the total loan book as of June 2015, and were matched with deposits in the same currency.

During 2015, the bank has been focusing on less risky products, such as commercial and mortgage loans, to maintain healthy asset quality metrics. Nonperforming assets (NPAs, with nonperforming loans more than 30 days as per Colombian regulation) stood at 3.1% as of June 2015, in line with the 3.0% of June 2014, and maintained strong reserve coverage of 1.2x. NPAs more than 90 days past due have also remained stable--1.8% as of June 2015, comparing favorably with the average of other banking systems in the region. Despite the more-challenging economic environment, Bancolombia has maintained low credit losses; with charge-offs of 0.9% as of June 2015 and a three-year average of 0.8%. We expect NPAs to remain between 3.0% and 3.2% during the next two years and reserve coverage to remain at current levels, while net charge-offs should approach 1%.

A high portion of customer deposits, a stable deposit franchise, and an adequate stable funding ratio (SFR) underlie our assessment of Bancolombia's "average" funding. Customer deposits represented 74.1% of its total funding base as of June 2015, and this portion has remained fairly stable over the last few years. The remaining percentage of the bank's funding base is made up of debt issuances, interbank loans, and repurchase agreements. The bank's SFR was 100.2% as of June 2015, which we consider adequate, although it is lower than the 106.3% average of the last three fiscal years. This reflects both the decrease in its available stable funding sources (due to higher goodwill) and an increase in its stable funding needs (due to the effects of Colombian peso depreciation on the total loan portfolio). We don't expect significant changes in the bank's funding in the near term, as it will continue to leverage its nationwide branch network to grow its deposit base.

In our opinion, Bancolombia's liquidity remains "adequate." Its broad liquid assets to short-term wholesale funding ratio was 1.8x as of the end of June 2015, with a three-year average of 2.7x. The bank's liquidity position--mainly made up of cash and government securities--and its stable base of wholesale clients also support our liquidity assessment. The bank has manageable refinancing risk with satisfactory maturities; the majority of its debt issuances will begin to mature after 2017, providing it with an adequate liquidity cushion. We expect the bank to maintain its satisfactory liquidity management through the next few quarters.
The ratings on Bancolombia Panama S.A. reflect its "core" status to the group. Bancolombia Panama consolidates the group's operations in El Salvador and the 40% minority equity investment in Guatemala-based Grupo Financiero Agromercantil (GFA; not rated) which, in our opinion, enhances Bancolombia's presence in Central America and its geographic and business diversification. Bancolombia Panama operates in lines of business integral to the overall group strategy and is fully integrated with the group. The subsidiary is highly linked to the group's reputation, and risk management.

**Outlook**

The stable outlook on Bancolombia reflects our expectation that it will improve its RAC to around 4.3% by year-end 2016 as a result of good earnings generation. We also expect the bank to maintain its "strong" business position, solid franchise in Central America, and "high" systemic importance in the Colombian banking system.

**Downside scenario**

We could downgrade the bank in the next 12 to 18 months if its RAC ratio consistently falls below 4% due to a higher amount of intangibles, leveraged acquisitions, or higher-than-expected organic growth that is not offset by internal capital generation. We could also downgrade the bank in the event of a sustained decline in asset quality metrics to below the industry average.

**Upside scenario**

We could upgrade the bank if we raise our local currency rating on Colombia and if Bancolombia's SACP improves. However, we view this scenario as unlikely to occur in the next 18 to 24 months.

We also expect Bancolombia Panama to maintain its "core" group status; therefore, its ratings will move in tandem with those on Bancolombia.

**Ratings Score Snapshot**

<table>
<thead>
<tr>
<th>Rating</th>
<th>Description</th>
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<tbody>
<tr>
<td>Issuer Credit Rating</td>
<td>BBB-/Stable/A-3</td>
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<tr>
<td>SACP</td>
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<td>Anchor</td>
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<tr>
<td>BICRA economic risk score</td>
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<tr>
<td>BICRA industry risk score</td>
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<tr>
<td>Business Position</td>
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<tr>
<td>Capital and Earnings</td>
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<tr>
<td>Risk Position</td>
<td>Adequate (0)</td>
</tr>
<tr>
<td>Funding</td>
<td>Average (0)</td>
</tr>
<tr>
<td>Liquidity</td>
<td>Adequate</td>
</tr>
</tbody>
</table>
Support +1
GRE Support 0
Group Support 0
Sovereign Support +1
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
• Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
• Banks: Rating Methodology And Assumptions, Nov. 9, 2011
• Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
• Bank Capital Methodology and Assumptions, Dec. 6, 2010

Related Research

• BICRA On Colombia Remains At Group '5', Various Rating Actions Taken On Five Colombian Financial Institutions, Sep. 15, 2015
• Supplementary Analysis: Republic of Colombia, July 31, 2015
• Credit Conditions: Latin America Navigates Choppy Waters Through 2015, July 14, 2015
• Economic Slump Will Largely Bypass Large Latin American Banks But May Take A Toll On Their Smaller Peers, July 9, 2015

Ratings List

Ratings Affirmed

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

Counterparty Credit Rating BBB-/Stable/A-3

Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at www.spcapitaliq.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column.
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