Research Update:
Bancolombia, S.A. y Companias Subordinadas 'BBB-/A-3' Ratings Affirmed; Outlook Remains Negative

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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

• Colombia-based universal lender Bancolombia continues to have a leading position in the Colombian financial system, with strong participation in other Central American markets. It has maintained good business diversification, a strong franchise, and sound business stability.
• Bancolombia's capital remains weak, although it's improved over the past two years, primarily based on our projected risk-adjusted capital (RAC) ratio of 4%, on average, for next 24 months.
• The bank's asset quality metrics slightly deteriorated as a result of its exposure to the Ruta Del Sol project and Electricaribe; however, we still consider the metrics manageable and in line with the rest of the Colombian banking system.
• We are affirming our 'BBB-/A-3' issuer credit ratings on the bank and on its core subsidiary, Bancolombia Panama.
• The negative outlook on Bancolombia continues to reflect that on the sovereign. The bank's rating incorporates one notch of government support, given the bank's high systemic importance and our view that the Colombian government is supportive towards its financial system.

Rating Action

On July 25, 2017, S&P Global Ratings 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 negative.

Rationale

The ICRs on Bancolombia reflect its predominant business position due to its leading market position in the Colombian banking system, with good business stability. The ratings also reflect our view of the bank's capital and earnings through our projected RAC ratio of 4%, on average, for the next 24 months, and the bank's risk position, which is supported by adequate risk diversification and good asset quality metrics. Bancolombia's large and stable deposit base continues to support its funding profile, with no significant liquidity needs in the near future. Its stand-alone credit profile (SACP) remains at 'bb+'.

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The bank's SACP receives one notch of uplift, given that we believe Bancolombia has high systemic importance within the Colombian financial system, due to its prominent market share and its importance to the country's payment system. This is coupled with our view that the Colombian government is supportive towards its financial system. This combination of factors results in a moderately high likelihood of government support to Bancolombia. The combination of its SACP (bb+) and the sovereign local currency rating (BBB+) results in a 'BBB-' long-term ICR.

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 Bancolombia is 'bb+', reflecting the weighted average economic risk of '7' given the countries in which the bank has its major loan portfolio exposures as of December 2016: Colombia (66%), Panama (21%), El Salvador (6%), and Guatemala (6%). The industry risk score for Colombian banks is '5' with a stable trend (see "Banking Industry Country Risk Assessment: Colombia," published Aug. 31, 2016).

Bancolombia's leading market position in the Colombian financial system drives its business position assessment, along with a strong franchise value, a stable base of recurring clients, and brand recognition not only in Colombia but also across Central America through its subsidiaries' brands. The bank's business stability has remained sound and is growing, mainly due to its position as the largest bank in Colombia. Its market position has remained stable in the last few years, with a market share of around 25% and 20% in terms of loans and total deposits, respectively, as of Dec. 31, 2016. The second and third largest banks in the country have a market share of 14.5% and 13.3%, respectively. Therefore, we consider it unlikely that Bancolombia will lose its leading position in the next two years.

Bancolombia's business diversification also provides revenue stability. The bank continues to participate in almost all business lines, although commercial loans have historically represented the highest share of its loan portfolio. As part of the management's strategy as of March 31, 2017, we saw a slight shift from the commercial and leasing segments to the consumer and mortgage sectors. Commercial loans—including financial leases—decreased to 70.5% from 72.0%, while consumer loans increased to 16.8% from 15.0% and residential real estate mortgages increased to 12.7% from 12.5%. The remaining 0.5% remained stable, comprised of other loans. Additionally, Bancolombia's revenue is comprised mainly of interest income (around 72% as of March 31, 2017, with a three-year average of 68%), which we believe helps stabilize the bank's profitability ratios.

The bank's presence in Central America through its fully-owned subsidiaries Banistmo S.A. (BBB-/Negative/A-3) in Panama and Banco Agricola S.A (B-/Negative/B) in El Salvador, as well as its 60% stake in Banco Agromercantil de Guatemala S.A. (BB/Negative/B) in Guatemala through Grupo Agromercantil, makes Bancolombia one of the largest financial groups in
Central America and provides strong geographic diversification. We expect growth on a consolidated basis that will enable Bancolombia to maintain its important market position in all the regions where it operates, and thus, we don't envision any changes to its business position assessment in the next few years.

Our assessment of Bancolombia's capital remains primarily based on our projected RAC ratio of 4%, on average, for next 24 months. The assessment also incorporates a low quality of capital (due to the hybrid issuances and a relatively important goodwill in its capital base) and an adequate quality of earnings and earnings capacity. We also consider the bank's strategy and efforts to strengthen their capital base by retaining more earnings in order to have a more comfortable capital structure when Basel III is adopted and implemented in Colombia. Additionally, the Colombian peso (COP) foreign exchange rate will remain relatively stable, so the bank's goodwill—which is dollar-denominated—won't impact its total adjusted capital (TAC) levels.

Our RAC forecast reflects our base-case assumptions, which include:

- Colombian GDP growth of 1.7% for 2017 and 2.2% for 2018 (please see "Credit Conditions: Political Uncertainty Hinders Improving Credit Conditions In Latin America," published on June 30, 2017);
- Lower foreign exchange volatility in the next two years: COP3,000 and COP2,900 per $1 for 2017 and 2018, respectively;
- A 6% goodwill increase for 2017 and a decrease of 0.8% for 2018, driven by stabler COP foreign exchange rates and no additional inorganic growth;
- Consolidated loan portfolio growing at an average of about 8% in 2017 and 10% in 2018;
- A net interest margin (NIM) of 5.85% on average for the next two years;
- Profitability at adequate levels, with core earnings to adjusted assets and efficiency levels around 1.45% and 51.1%, respectively, for the next two years;
- Average payout ratio of 22% for the next 24 months;
- Nonperforming assets (NPAs) and credit losses (NCOs) at about 2.7% and 0.9%, respectively, with a full reserve NPAs coverage; and;
- No additional inorganic growth for 2017 and 2018.

In our view, the bank's quality of capital and earnings remains unchanged as it still relies on hybrid issuances to support regulatory capital ratios, and the relatively important goodwill in its capital base supports our assessment of the low quality of capital. Bancolombia's profitability metrics and earnings capacity have remained fairly stable and we expect them to remain so. The bank posted 1.33% core earnings to adjusted assets at the end of the first quarter of 2017, slightly higher compared with 1.29% in the same period of 2016 and in line with its three-year average of 1.3%. This is the result of loan portfolio growth, improvement of the NIM (to 6.17% as of March 31, 2017, from 5.82% in Dec. 31, 2016), and better efficiency metrics. Over the next 24 months, we forecast core earnings to adjusted assets to be at about 1.45%, as a result of the bank's focus on increasing the profitability of its balance sheet without major increases in its securities portfolio, and its sustained efforts for cost controls. Moreover, fee income should maintain its positive
trend, given the bank's efforts to promote the use of credit cards, their trusts business, and the distribution of insurance policies.

Since our last review, Bancolombia's risk position has deteriorated, mainly because of external factors that have affected the entire Colombian banking system. The bank had collection issues with its infrastructure project Ruta del Sol, with the energy company Electricaribe, and with its small and medium-sized enterprises (SMEs) business unit due to transport segment exposures. Despite these recent changes, we still think that Bancolombia's risk position assessment compares adequately with those of its Colombian peers and other banks with similar economic risks. Bancolombia still shows satisfactory risk dispersion among several asset classes. Furthermore, even if the bank is concentrated in the commercial loans sector, its top 20 largest exposures represented a low 8.2% of its consolidated total loan portfolio and 1.0x of its TAC as of Dec. 31, 2016. These metrics are in line with those of its closest peers.

Despite the complex economic environment of 2016, Bancolombia's asset quality metrics are still manageable and similar to those of its rated peers in Colombia and Latin America. However, NPAs are higher than those of previous years, mainly due to the credit exposures the bank has with Ruta del Sol, Electricaribe, and in its SMEs segment. As of March 31, 2017, our NPAs ratio was 2.47% and our NCOs were at 0.81%, which were still in line with the rest of the Colombian banking system. Overall reserve coverage also remains strong, at 186.5% as of March 31, 2017, following the bank's expectations of further increases in its NPAs ratio and NCOs. For the next 24 months, we expect NPAs to remain around 2.7% with exceeding reserve coverage above 100%, while net charge-offs should be near 0.95%.

Our funding assessment of Bancolombia is driven by a stable and high proportion of customer deposits coupled with an adequate stable funding ratio (SFR). As of the first quarter of 2017, customer deposits represented around 76% of the total funding base, while the rest was comprised of debt issuances, interbank loans, and to a minor degree, repurchase agreements. The bank's stable funding ratio was 99.9% as of March 2017, which we consider as adequate, although it's slightly lower than the 102.8% average of the past three fiscal years and lower than the 114% of the Colombian banking industry. This ratio reflects both the decrease in the bank's available stable funding sources (due to a decrease in their interbank loans) and that there were essentially no changes in its stable funding needs. For the next 24 months, we don't expect changes in the bank's funding structure, because we expect that customer deposits will continue to grow as the bank leverages on its region-wide branch network.

Bancolombia's adequate liquidity is supported by the bank's broad liquid assets that covered short-term wholesale funding 1.5 times(x) as of March 2017, with a three-year average of 1.86x. This ratio has decreased mainly due to a 17.4% increase in the bank's short-term wholesale funding, because of more repurchase agreements and interbank deposits. Our liquidity assessment is also supported by the bank's manageable refinancing risk with a satisfactory
maturity profile, and by the bank's liquidity of mainly cash and government securities.

Outlook

The negative outlook on Bancolombia reflects that on Colombia. Currently, the bank's rating incorporates one notch of government support, given the bank's high systemic importance and our view that the Colombian government is supportive towards its financial system. We expect the bank to maintain its leading business position in Colombia and its solid franchise throughout Central America, while maintaining a conservative approach towards risk and liquidity management.

Downside scenario

If we were to downgrade the sovereign ratings in the next 24 months and the bank's SACP remains at 'bb+', the ratings on Bancolombia and its core entities would move in tandem with those of the sovereign.

Upside scenario

If in the next 24 months we revise the outlook on the sovereign back to stable and the bank's SACP is unchanged, we will take a similar action on Bancolombia and its core entities.

Ratings Score Snapshot

| Issuer Credit Rating:                | BBB-/Negative/A-3 |
| 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 +1

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
- 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 BBB-/Negative/A-3