Research Update:

Bancolombia 'BBB-/A-3' Ratings Affirmed On Strong Business Position And Better Profitability; OutlookRemains Stable

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Overview

• Colombia-based universal bank, Bancolombia, continues to show a predominant market position in Colombia and has recently positioned itself as one of the largest financial groups in Central America.
• Despite improved profitability and internal capital generation, its risk-adjusted capitalization remains its main rating weakness.
• We are affirming our 'BBB-/A-3' issuer credit ratings on the bank and on its subsidiary, Panama-based Bancolombia Panama.
• We expect Bancolombia to gradually enhance its internal capital generation, but it will take more than 12-18 months before we see risk-adjusted capitalization improving above 5%.

Rating Action

On Sept. 25, 2014, 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 remains stable.

Rationale

The ICRs on Bancolombia reflect our "strong" assessment of its business position, stemming from its prominent and leading market shares in the Colombian financial system, our "weak" view of its capital and earnings—which continues to be its major rating weakness—and our opinion of its "adequate" risk position underpinned by low credit losses and sound reserve coverage. The ratings also consider our assessment of its "average" funding with "adequate" liquidity. The stand-alone credit profile (SACP) remains at 'bb+'.

The 'bbb-' anchor draws on our Banking Industry Country Risk Assessment (BICRA) methodology and our view of the weighted average economic risk in the countries in which Bancolombia, on a consolidated basis, has exposure through its loan book—Colombia (80%), Panama (15%), and El Salvador (5%). As a result, the weighted economic risk is about '6'. Our bank criteria use the BICRA economic and industry risk scores to determine a bank's anchor, the starting point in assigning an ICR.
Colombia's economic risk, where the bank holds its biggest exposure, 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' 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. 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.

Our opinion about Bancolombia's "strong" business position continues to be underpinned by its leading and prominent market position in the Colombian financial system, along with a strong franchise value and brand recognition. The recent acquisition of Banistmo (formerly HSBC Panama), coupled with its leading participation in El Salvador through its subsidiary, Banco Agricola S.A. (BB-/Negative/B), has made Bancolombia one of the largest financial groups in Central America. We believe that these acquisitions have further enhanced its regional presence and have increased its geographic and business diversification.

In our view, its business stability has remained sound based on Bancolombia's market position as the largest financial institution in the country. The bank has held an almost unchallenged market position, with a market share of 20.8% in terms of total loans and 18.0% in terms of total deposits as of June 2014. Bancolombia is practically the leading bank in all the business lines in which it participates. These market shares have been very stable for the past several years, and have resulted in both revenue stability and predictability. Its total loan portfolio has grown at a compound annual growth rate (CAGR) of 22.7% for the past three years, while its revenue base rose at a CAGR of 12.1%. Nationwide footprint supports business stability, servicing more than 7 million customers. Its customer base continues to exhibit long-standing relationships, as seen in its relationships with Colombia's largest corporations. As a result, the bank is less reliant in terms of pricing strategies to retain customers. Given its predominant market position and our forecasted growth for both Bancolombia and the Colombian banking system, we expect the bank's business stability to remain strong for the next two years.

In our view, Bancolombia's main rating weakness continues to be what we
consider "weak" capital and earnings. This mainly stems from our forecast risk-adjusted capital (RAC) ratio, which we estimate to be at about 4.5% by the end of 2015. As Bancolombia improved internal capital generation after finalizing the issuance of preferred shares and concluding the acquisitions in Guatemala and Panama, this forecast is 20 basis points higher than our previous one.

Our forecasted 4.5% RAC ratio is supported by the following base-case scenario assumptions:

- Colombia GDP expands at 4.0% in 2014 and 2015;
- Loan portfolio growth of 13% for 2014 and 2015;
- Dividend payout ratio similar to that of the past three years; and
- Our forecast does not contemplate any further acquisitions.

We consider that profitability metrics and earnings capacity have remained fairly stable, and we expect this to continue. The bank has maintained adequate profitability as a result of ongoing loan portfolio growth, and satisfactory efficiency and asset quality. The bank improved its earnings, profitability metrics, and consequently, its internal capital generation. These improvements have been better than we had expected due to better funding costs, more profitable earnings assets composition, and sound cost containment policies. We expect that the economies of scale and the benefits from current acquisitions will be more reflected in the intermediate term, improving profitability further.

We continue to view Bancolombia's risk position as "adequate" underpinned by adequate risk concentrations and credit losses that are similar than those of the Colombian banking system and other banks with same economic risk scores. Bancolombia continues to show satisfactory risk dispersion among several asset classes. As of second-quarter 2014, its loan portfolio was consisted of commercial/corporate loans (56.7%), consumer loans (17.7%), leases (13.8%), residential real estate mortgages (11.1%), and other loans and acceptances (0.7%). In addition, its top 20 largest exposures represented only 10.5% of its consolidated total loan portfolio and 64.6% its total consolidated reported equity as of June 2014. Risk exposure, from a geographic standpoint, is already reflected in our anchor through a consolidated economic risk with the exposure to El Salvador, Guatemala, and Panama.

Asset quality has remained adequate and is in line with those of other rated banks in Colombia and Latin America, and those with same economic risk score. Nonperforming assets (NPAs, with nonperforming loans of more than 30 days, as per Colombian regulation) and credit losses have remained in line with the system's average. As of June 2014, NPAs were 3.0% with a three-year average of 2.6%. Also, NPAs of more than 90 days have been quite stable, at 1.5% for the past three years, and are better than the average for other Latin American banking systems and similar to the Colombian banking system's. Credit losses--measured as net charge offs--were 0.9%, with a three-year average of 1%, without significant changes from previous quarters. Moreover, reserve coverage has been strong with NPAs covered on average of 1.8x. As of June 2014, this indicator was 1.4x, and we expect it to remain at that level for
the next 12-18 months, better than its most immediate national peers. We are currently forecasting NPAs and credit losses to be about 3% and 1%, respectively, levels that we consider manageable and in line with those of its large peers in Colombia.

High shares of customer deposits, coupled with adequate stable funding ratios (SFR), are the main drivers behind our "average" assessment of Bancolombia's funding. Of its total funding base, as of June 2014, 77.4% were customer deposits. In addition, its SFR was 102.8% for the same period, with a three-year average of 107.2%, which we view as adequate. We consider that the funding structure, SFR, and liquidity ratios continue to be in line with the industry norm and with those of the bank's peers with the same industry risk score. We currently do not expect changes in its funding structure, based on our expectation that customer deposits will continue to rise. We also based this expectation on the bank's ample branching network in which it leverages its deposit growth. The share of deposits has remained fairly stable over the past several years.

In our opinion Bancolombia's liquidity remains "adequate." This view is underpinned by broad liquid assets that covered short-term wholesale funding 2.1x as of June 2014, with a three-year average of 2.7x. Our liquidity assessment is also supported by manageable refinancing risk with a satisfactory maturity profile. The majority of its debt issuances start maturing after 2017, providing also adequate liquidity cushion. We expect the bank to maintain its adequate liquidity management.

We continue to view Bancolombia as having high systemic importance within the Colombian financial system. This view stems from its leading market share in terms of deposits, 18% at June 2014, and its importance in the country's payment system. In addition, its 13% market penetration in the Colombian retail segment makes it a significant player. Furthermore, we view the Colombian government as being "supportive" towards its financial system. Consequently, we believe there is a "moderately high" likelihood of extraordinary government support to Bancolombia. As a result, its SACP receives one-notch uplift.

The ratings on Bancolombia Panama continue to reflect its core status to the group. Bancolombia considers Panama as a strategic growth market in the coming years, as the bank further enhances its presence in Central America. The core status of Bancolombia Panama also reflects our opinion that it is an integral part of Bancolombia's consolidated group strategy. The Panamanian unit primarily acts as an offshore vehicle to service Bancolombia customers' credit needs in foreign currency and offers Colombian customers access to markets in Central America. The branding and reputation of the Panamanian operation mirror that of its parent. Also, 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.
Outlook

The stable outlook on Bancolombia primarily reflects our expectation that it will remain as the largest financial institution in Colombia and one of the largest financial groups in Central America. It also incorporates our view that it will keep its high systemic importance.

We could downgrade the bank over the next 18-24 months if the RAC ratio consistently falls below 4%—due to leveraged acquisitions, higher-than-expected organic growth (13% for the next two years), lower internal capital generation stemming from asset quality deterioration, and higher provisions. This could occur if the bank penetrates riskier sectors of the economy, relaxing its underwriting policies.

We could upgrade the bank if we raise our local currency rating on Colombia and if there are improvements in Bancolombia's SACP. However, we view this scenario less likely to occur in the next 18-24 months.

As we expect no changes to Bancolombia Panama's core status to the group, the ratings on it will move in tandem with those on Bancolombia.

Ratings Score Snapshot

<table>
<thead>
<tr>
<th>Issuer Credit Rating</th>
<th>BBB-/Stable/A-3</th>
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<tbody>
<tr>
<td>SACP</td>
<td>bb+</td>
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<tr>
<td>Anchor</td>
<td>bbb-</td>
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<tr>
<td>Business Position</td>
<td>Strong (+1)</td>
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<td>Capital and Earnings</td>
<td>Weak (-2)</td>
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<tr>
<td>Risk Position</td>
<td>Adequate (0)</td>
</tr>
<tr>
<td>Funding and Liquidity</td>
<td>Average and Adequate (0)</td>
</tr>
</tbody>
</table>

Support +1
GRE Support 0
Group Support 0
Government Support +1

Additional Factors 0

Related Criteria And Research

Related Criteria
• Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Sept. 18, 2014
• Group Rating Methodology, Nov. 19, 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
• Credit Conditions: Latin America's Credit Quality Remains Stable, But Slowing Economy And Financial Volatility Increase Risks, Sept. 22, 2014
• Colombian Banks' Regional Expansion Has So Far Come At The Expense Of Capitalization, July 7, 2014
• Colombian Banks' Limited Capital Could Constrain Credit Expansion, July 7, 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
• Despite Market Uncertainties, Latin American Banks Have Generally Been Able To Maintain Satisfactory Performance, Jan. 16, 2014
• Latin American Banks Lean On Adequate Funding And Liquidity Amid Market Uncertainties, Oct. 16, 2013

Ratings List

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.