MOODY'S
INVESTORS SERVICE

CREDIT OPINION
9 September 2019

Update

Rate this Research

Banco do Estado de Sergipe S.A.

Update following rating affirmation and change in outlook to negative

RATINGS

Banco do Estado de Sergipe S.A.

Domicile	Aracaju, Sergipe, Brazil
Long Term CRR	Ba1
Type	LT Counterparty Risk Rating - Fgn Curr
Outlook	Not Assigned
Long Term Debt	Not Assigned
Long Term Deposit	Ba3
Type	LT Bank Deposits - Fgn Curr
Outlook	Stable

Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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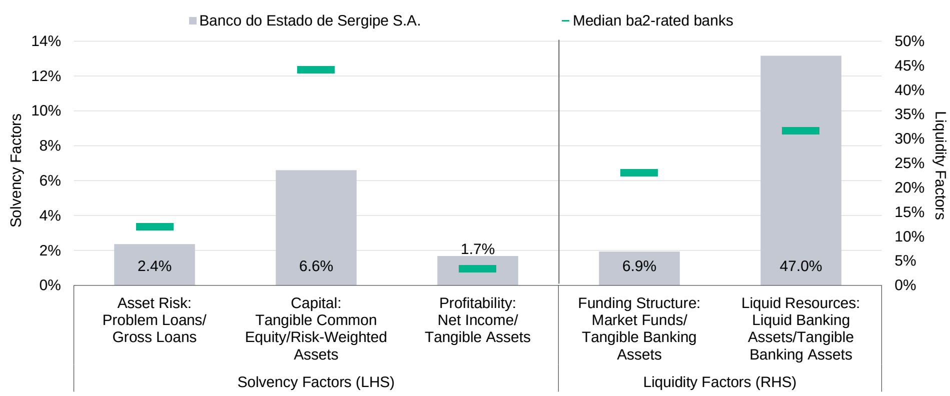
Summary

On 3 September 2019, we affirmed all the ratings and assessments assigned to Banco do Estado de Sergipe S.A. (Banese), and changed the outlook to negative from stable on its Ba2 local-currency deposit rating. Banese has a ba2 standalone Baseline Credit Assessment (BCA), reflecting its well-entrenched local franchise as the state-owned bank of the state of Sergipe. Although small, Banese's defensible position in the local market stems from its focus on providing banking services to the state's civil servants, as well as small and medium-sized enterprises, which are intrinsically connected with Sergipe's economy. The ba2 BCA also reflects our view that Banese's business potential is somewhat constrained because of its limited footprint.

Exhibit 1
Rating Scorecard - Key financial ratios



Source: Moody's Financial Metrics

Banese's loan book is primarily made up of secured payroll and personal credit to public servants, resulting in low effective loss over the past few years. Strong performance reported in the first six months of 2019 resulted from strong growth, lower funding and credit costs, as well as an improving fee income. The recent decline in capitalization, resulting from the material adjustment to equity caused by actuarial liabilities at the Banese-sponsored private pension fund Instituto Banese de Seguridade Social (Sergus), reduces the bank's loss-absorption capacity and limits its growth perspective and competitive strength in its regional market, where the bank holds a 41% loan market share.

Credit strengths

» Small retail franchise, with an entrenched footprint that supports a stable and granular core funding base

» High share of payroll loans, which reduces credit losses during market downturns

» Well-managed state-owned franchise and adequate governance guidelines, which reduce the risk of political interference

Credit challenges

» Capital buffer is an important component of Banese's financial profile because it supports the bank's competitive position in the local retail banking segment, in which competition is intensifying.

» Earnings will likely be challenged by growing competition from large retail banks and slow operational growth.

» Asset-risk profile could come under pressure as the bank expands its operations beyond its regional footprint to compensate for limited expansion prospects in its home market.

Rating outlook

While all the ratings were affirmed on 3 September 2019, the outlook on Banese's Ba2 long-term local-currency deposit rating was changed to negative outlook, from stable. The negative outlook reflects the recent decline in the bank's capitalization ratio, following a material negative adjustment to its equity caused by the need to account for the actuarial liabilities at the Banese-sponsored private pension fund Sergus, triggered by the decline in Brazil's basic interest rate. A lower capital position reduces the bank's loss-absorption capacity and limits its growth perspective and competitive strength in its regional market, where the bank holds a 41% loan market share.

The outlook on the Ba3 long-term foreign-currency deposit rating remains stable because this rating is constrained by Brazil's foreign-currency deposit ceiling of Ba3.

Factors that could lead to an upgrade

Banese's rating outlook could return to stable if the bank is able to maintain loan growth and preserve its profitability in its regional market, restoring its capital position in less than 12 months and maintaining adequate asset-risk and liquidity metrics.

Factors that could lead to a downgrade

We could downgrade Banese's BCA and local-currency deposit ratings if the bank is unable to restore its capitalization to levels between 8% and 9% in the next 12-18 months, which would weaken its loss-absorption capacity. In addition, in case the bank materially increases its exposure to riskier loans, future recurring earnings could be hurt because of higher credit costs as new loans will season under a still-slow-growth economy in 2020.

Key indicators

Exhibit 2

Banco do Estado de Sergipe S.A. (Consolidated Financials) [1]

	06-19[2]	12-18[2]	12-17[2]	12-16[2]	12-15[2]	CAGR/Avg.[3]
Total Assets (BRL Billion)	5.8	5.5	5.1	4.4	4.0	11.1[4]
Total Assets (USD Billion)	1.5	1.4	1.5	1.3	1.0	12.1[4]
Tangible Common Equity (BRL Billion)	0.3	0.4	0.3	0.3	0.2	7.5[4]
Tangible Common Equity (USD Billion)	0.1	0.1	0.1	0.1	0.1	8.5[4]
Problem Loans / Gross Loans (%)	2.4	1.6	2.6	3.2	2.3	2.4[5]
Tangible Common Equity / Risk Weighted Assets (%)	6.6	9.6	8.8	9.3	7.2	8.3[6]
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	15.7	8.0	13.3	16.6	15.0	13.7[5]
Net Interest Margin (%)	8.7	8.6	9.6	9.1	7.6	8.7[5]
PPI / Average RWA (%)	5.6	6.0	7.5	7.9	6.2	6.7[6]
Net Income / Tangible Assets (%)	1.7	1.3	2.0	2.1	0.9	1.6[5]
Cost / Income Ratio (%)	66.7	66.1	62.4	63.3	72.9	66.3[5]
Market Funds / Tangible Banking Assets (%)	5.6	6.9	7.5	10.2	9.4	7.9[5]
Liquid Banking Assets / Tangible Banking Assets (%)	47.7	47.0	42.4	40.1	36.2	42.7[5]
Gross Loans / Due to Customers (%)	60.6	62.3	64.7	74.2	81.1	68.6[5]

[1] All figures and ratios are adjusted using Moody's standard adjustments. [2] Basel III - fully-loaded or transitional phase-in; LOCAL GAAP. [3] May include rounding differences due to scale of reported amounts. [4] Compound Annual Growth Rate (%) based on time period presented for the latest accounting regime. [5] Simple average of periods presented for the latest accounting regime. [6] Simple average of Basel III periods presented.

Sources: Moody's Investors Service, company filings

Profile

Founded in 1961, Banco do Estado de Sergipe S.A. (Banese) is owned by the state of Sergipe, which holds 89.8% of its total shares, and the remaining 10.2% are free float. The bank is part of the Banese conglomerate, which primarily comprises the bank and the credit card issuer and acquiring company Sergipe Administradora de Cartões e Serviços Ltda. Because Banese is a regional local government bank, its activities are restricted to the state of Sergipe through 63 branches.

Although small, Banese's defensible position in the local market stems from its focus on providing banking services to the state's civil servants, as well as small and medium-sized enterprises, which are intrinsically connected with Sergipe's economy. Most of the executives are career professionals or former employees who retired and decided to return to the bank, but directors are subject to changes in the local government every four years.

Detailed credit considerations

Historical asset-risk levels reflect Banese's focus on secured lending, but asset risks rise as the bank diversifies into unsecured lending products

Banese's asset quality has always been supported by its focus on core business of offering secured household loans to civil servants of the state of Sergipe. According to our calculation, the ratio of problem loans (total loans overdue between E and H) to gross loans increased to 2.4% in June 2019 from 1.62% as of year-end 2018, resulting from slow loan growth and reflecting some risk concentration particularly added by the wholesale book. This ratio stood just below the industry average of 2.9% for June 2019. Reserves for loan losses were maintained at 4.22% of total loans in June 2019, which is considered conservative given the low loss rate that remains at around 1% on its core product. The level of loan-loss charge-offs reduced to less than 1% of gross loans in June, and the volume of renegotiations also reduced by 30% from the same period in 2018, accounting for 1% of the loan book, with recoveries reducing as well. While the bank's focus is on lower-risk payroll loans, the level of unsecured consumer loans and wholesale credit has been increasing asset risk in times of slow growth.

With a 41% market share of total credit in the state of Sergipe, Banese's consolidated loan book increased 3% quarter over quarter in June 2019 and 12% in the 12 months, with individual loans representing roughly 75% of the total portfolio, including a small book of residential mortgage loans to households that accounted for less than 20% of all loans. Although the wholesale portfolio is made up of loans to small and medium-sized enterprises and accounted for only 12% of total loans in Q2 2019, it incorporates some degree of borrower concentration, which was responsible for the bank's asset risk and credit cost volatility in the past. The 10 largest borrowers accounted for 5.6% of total loans and 51% of the tangible common equity (TCE) in June 2019.

Overall, the ba2 Asset Risk score is two notches below the Macro-Adjusted score of baa3 and reflects the balance between the bank's various types of secured consumer loans, and the growing participation of unsecured loans, such as credit cards and personal loans. Additionally, the assessment incorporates the inherent business concentration in the state of Sergipe, which limits Banese's ability to diversify its risks geographically.

Material adjustment to capitalization deteriorates Banese's loss-absorption capacity, but it could be temporary

In June 2019, Banese's capitalization was materially hit by an equity adjustment related to actuarial losses incurred at its employees' pension fund (Sergus). This adjustment reduced capital by BRL71 million, net of tax credits, triggering its capital contingency plan. The different interpretation of accounting standards among the bank's independent auditors, the pension fund regulators (PREVIC), the local Securities Exchange Commission (Comissão de Valores Mobiliários) and the Central Bank of Brazil led to Banese being asked to account for the full actuarial obligation of the pension fund, instead of a partial adjustment relative to a proportional contribution according to its 39.25% sponsorship. Sergus largely comprises a defined benefit post-retirement plan, which has been closed to new members since 2017.

We historically viewed Banese's core capital levels as adequate, with recurrent internal earnings generation that has supported growth strategy in the past years. However, in June 2019, our TCE ratio deteriorated to 6.6% in June 2019 from 9.5% in March 2019, well below the 10% average maintained by the banks we rate in Brazil, and the 8.9% average presented by Banese in the past three years. From a regulatory perspective, the Common Equity Tier 1 capital ratio declined to 8.9% in Q2 2019 from 11.8% in the previous quarter, falling to the lowest historical level and remaining just slightly above the 8.5% minimum requirement.

This credit event triggered Banese's capital contingency plan, requiring the bank to reduce the private securities position held by its marketable securities portfolio and to issue Tier 2 local-currency subordinated notes to increase its total capital ratio for restoring capitalization to support growth. However, these measures will not help restore our TCE ratio, which takes into consideration government securities adjusted at 100% for risk-weighted assets' (RWA) calculation. By Moody's metric, capital recovery will primarily depend on Banese's internal capital generation and its ability to reduce future shareholders' dividend payout.

Historically, the high dividend distribution policy has been a burden on the bank's capital replenishment capacity. However, as part of its strategic approach to enhance its capital position, Banese will reduce its dividend policy to a 30% payout from the 55% payout in the past few years. Overall, we assigned a b2 Capital score, which reflects the potential reversal of the adjustment made in June 2019, currently under discussion with the Central Bank of Brazil.

According to Banese's management, the Central Bank of Brazil is currently analyzing a request made by the bank that aims to consider the contributive parity among the fund's participants, assisted individuals and the sponsor, which would result in a lower adjustment corresponding to 39.25% of the fund's actuarial deficit, from 100%, equal to its financial responsibility as the sponsor. The bank expects a final decision from regulatory authorities in Q3 2019. In such a scenario, the adjustment effect on its TCE/RWA would be a reduction of 180 basis points to levels above 8%. Based on its reported Q2 2019 earnings, it would take roughly two to three quarters for Banese's TCE/RWA to rise to 9% through internal earnings generation, therefore, reverting the pressure on its financial profile. In the Q2 2019, internal capital generation increased TCE by 25 basis points.

Margins and funding cost pressures will increase in the next 12 months

Over the past three years, Banese's performance has benefited from (1) higher-margin loans that resulted from the contraction of competitive pressure from other public banks in its local market (Sergipe); (2) its fee income activities, including the credit card businesses controlled by the bank; (3) a consistent decline in the cost of risk since 2017; and (4) low funding costs. The bank's bottom-line results for H1 2019 improved from the past year's results because of the expansion of the loan book, increased fee-income activities, mainly the credit-card-acquiring business and new bank accounts, and lower cost of credit and funding, resulting from the maturity of more expensive subordinated bank notes (letras financeiras subordinadas).

The ratio of net income to tangible assets increased in Q2 2019 to 1.7% from 1.6% in March 2019 and 1.1% as of year-end 2018, despite the low interest rate environment. Banese has also been working to enhance the culture of technological innovation to maintain its competitive positioning in retail banking in its regional markets. In addition, the bank demonstrated strong control with the acceleration in technology investments and the digitization processing increasing administrative expenses, while personal cost grows in line with inflation.

The small size of the local economy and the limited expansion in Banese's franchise is an intrinsic constraint to its profitability, as banks resume growth and the competition from large universal banks that have more pricing power increases. In addition, while the reduction in market-based funding in the past two quarters helped the bank offset the pressures arising from lower-margin new loan originations, funding costs will likely increase the pressure on bottom-line results as Banese issues subordinated debt obligations to increase its regulatory capital position.

Stable and granular core funding is a key strength for Banese

The combined score of ba1 for Liquidity recognizes that Banese has a strong regional identity and defensible presence in its regional market, with one-third of the local market's time deposits. Banese has a low dependence on market-based funding because it benefits from its local identity that facilitates its access to a granular deposit base in its core region, with proven stability in times of stress. In June 2019, 65.9% of Banese's funding comprised demand, savings and judicial deposits, primarily from individuals and local companies, which are core resources that are sticky, granular and low cost, while an additional 26.3% constituted time deposits and letras de credito imobiliarias, which are bank notes linked to real estate loans, mainly sold to individual investors.

Government-related resources, including the cash positions of the state government and the municipalities, accounted for 9.4% of total funding in June 2019, and long-term funds provided by federal banks Banco Nac. Desenv. Economico e Social - BNDES (Ba2 stable, ba2) and Banco do Nordeste do Brasil S.A. (Ba2 stable, b1) accounted for only 1.5%. Core resources from individuals accounted for 45.3% of total funding, while judicial deposits accounted for another 21.9%, which ensures cheap and very stable funding for the bank.

In its efforts to enhance funding diversification and regulatory capital improvement, Banese plans to access the local capital markets through the issuance of bank notes (letras financeiras), taking advantage of the strong domestic liquidity. This strategy also supports the bank's capitalization because the subordinated bank notes will likely qualify as tier 2 instruments. In June 2019, the outstanding senior bank notes totaled BRL49.2 million, about 1% of total funding, with a short-term maturity profile between June 2020 and January 2021, while the outstanding subordinated bank notes totaled BRL93 million, all maturing in July 2023.

Banese maintains adequate cash, with a high portion held in government securities. The liquidity ratio, measured as liquid banking assets as a percentage of tangible banking assets, reached 47.72% in June 2019, mostly comprising government securities, which accounted for 86% of the portfolio. The remaining 14% of securities were largely invested in investment funds and certificates of deposits issued by tier 2 banks in Brazil, which will be shortened in the next few months, as part of the bank's capital plan, to reduce regulatory RWA calculation.

Banese's scores are influenced by Brazil's Moderate- Macro Profile

The Macro Profile of Brazil reflects (1) the large size and diversified nature of the country's economy, (2) the nation's more credible monetary policy, (3) its increasing commitment to addressing corruption, (4) the improving overall government effectiveness, and (5) its very low susceptibility to external shocks. However, Brazil's economic rebound has been weaker than expected, reflecting a degree of uncertainty surrounding the policy continuity in 2019.

Although public-sector banks continue to account for a substantial portion of total credit, they have been contracting since 2015, reducing market distortions created by their previous aggressive lending policies. The continued economic recovery expected in 2019 will support modest lending growth over the next 12 months, but it will be higher than the 5.5% recorded in 2018. However, banks will not face pressure on their funding needs, given the high levels of liquidity (largely domestic), while sustained low interest rates and low inflation will support borrowers' repayment capacity, leading to a stabilization in asset quality.

Support and structural considerations

In the absence of a bail-in resolution regime framework in Brazil, the ratings of subordinated debt, bank hybrids and contingent capital securities follow the additional notching guidelines, in accordance with our Banks rating methodology. In these cases, the approach takes into account other features specific to debt classes, resulting in additional notching from the Adjusted BCA of the issuer.

Government support

We believe there is a limited likelihood that Banese will receive support from the federal government for its rated wholesale deposits and senior unsecured debt, given the nonmaterial share of deposits in Brazil. However, because of the importance of Banese to the state of Sergipe, the bank's high integration with public policies and its significant deposit market share in the region, we believe that the bank would be supported by its shareholder, the Government of Sergipe, if necessary. However, the state of Sergipe is not rated and, thus, the deposit rating assigned to Banese incorporates no uplift from regional support.

Counterparty Risk (CR) Assessment

CR Assessments are opinions of how counterparty obligations are likely to be treated if a bank fails and are distinct from debt and deposit ratings in that they (1) consider only the risk of default rather than both the likelihood of default and the expected financial loss, and (2) apply to counterparty obligations and contractual commitments rather than debt or deposit instruments. The CR Assessment is an opinion of the counterparty risk related to a bank's covered bonds, contractual performance obligations (servicing), derivatives (for example, swaps), letters of credit, guarantees and liquidity facilities.

Banese's CR Assessment is positioned at Ba1(cr)/Not Prime(cr)

The CR Assessment of Ba1(cr) is one notch above the Adjusted BCA of ba2, based on our view that senior obligations represented by the CR Assessment will be more likely preserved than senior unsecured debt to minimize losses, avoid disruption of critical functions and limit contagion. This CR Assessment reflects an issuer's probability of defaulting on certain operating liabilities and other contractual commitments that are less likely to be subject to the application of a resolution tool to ensure the continuity of operations.

Methodology and scorecard

About Moody's Bank Scorecard

Our scorecard is designed to capture, express and explain in summary form our Rating Committee's judgment. When read in conjunction with our research, a fulsome presentation of our judgment is expressed. As a result, the output of our scorecard may materially differ from that suggested by raw data alone (though it has been calibrated to avoid the frequent need for strong divergence). The scorecard output and the individual scores are discussed in rating committees and may be adjusted up or down to reflect conditions specific to each rated entity.

Rating methodology and scorecard factors

Exhibit 3

Banco do Estado de Sergipe S.A.

Macro Factors		
Weighted Macro Profile	**Moderate -**	**100%**

Factor	**Historic Ratio**	**Initial Score**	**Expected Trend**	**Assigned Score**	**Key driver #1**	**Key driver #2**
Solvency						
Asset Risk						
Problem Loans / Gross Loans	2.4%	baa3	←→	ba2		
Capital						
Tangible Common Equity / Risk Weighted Assets (Basel III - transitional phase-in)	6.6%	caa1	←→	b2		
Profitability						
Net Income / Tangible Assets	1.7%	baa3	←→	ba2		
Combined Solvency Score		ba3		ba3		
Liquidity						
Funding Structure						
Market Funds / Tangible Banking Assets	6.9%	baa2	←→	ba1		
Liquid Resources						
Liquid Banking Assets / Tangible Banking Assets	47.0%	baa2	←→	baa2		
Combined Liquidity Score		baa2		baa3		
Financial Profile				ba2		
Qualitative Adjustments				Adjustment		
Business Diversification				0		
Opacity and Complexity				0		
Corporate Behavior				0		
Total Qualitative Adjustments				0		
Sovereign or Affiliate constraint				Ba2		
Scorecard Calculated BCA range				ba1 - ba3		
Assigned BCA				ba2		
Affiliate Support notching				0		
Adjusted BCA				ba2		

Instrument Class	**Loss Given Failure notching**	**Additional notching**	**Preliminary Rating Assessment**	**Government Support notching**	**Local Currency Rating**	**Foreign Currency Rating**
Counterparty Risk Rating	1	0	ba1	0	Ba1	Ba1
Counterparty Risk Assessment	1	0	ba1 (cr)	0	Ba1(cr)	
Deposits	0	0	ba2	0	Ba2	Ba3

[1] Where dashes are shown for a particular factor (or sub-factor), the score is based on non-public information.
Source: Moody's Investors Service

Ratings

Exhibit 4

Category	**Moody's Rating**
BANCO DO ESTADO DE SERGIPE S.A.	
Outlook	Negative(m)
Counterparty Risk Rating	Ba1/NP
Bank Deposits -Fgn Curr	Ba3/NP
Bank Deposits -Dom Curr	Ba2/NP
NSR Bank Deposits	Aa3.br/BR-1
Baseline Credit Assessment	ba2
Adjusted Baseline Credit Assessment	ba2
Counterparty Risk Assessment	Ba1(cr)/NP(cr)

Source: Moody's Investors Service

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