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Financiera El Comercio

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Financiera El Comercio

Major Ratings Factors

Counterparty Credit Rating
B-/Positive/--

Strengths

- Largest financial company in terms of loans, deposits, and distribution network in Paraguay
- Larger proportion of fee-based revenues than peers
- Adequate asset quality indicators
- Strong profitability

Weaknesses

- High risks inherent to operating in Paraguay's financial system
- Highly competitive environment
- Still room to improve collection and disbursement systems
- Strain on asset quality and loan loss coverage if loan portfolio increases significantly

Rationale

The ratings on Paraguay-based nonbank financial institution Financiera El Comercio (El Comercio) reflect the country's high sovereign risk and the intrinsic risks in the Paraguayan financial system. The rating also incorporates our view that, given the company's rapid expansion in a highly competitive environment, El Comercio will have to further consolidate its already improving business and financial performance as it minimizes operational risks that could affect asset quality. The company's relatively strong market position among financial companies operating in Paraguay, its diversified loan portfolio and revenue structure, as well as its adequate asset quality and fairly strong profitability partially offset these negative rating factors.

Paraguay's rather small economy also exerts some pressure on El Comercio's operating performance. The country has limited fiscal flexibility, and its financial system is growing amid deficiencies in its institutional and legal frameworks.

Although it is a relatively small entity within the Paraguayan financial system, its status as the country's largest financial company with the widest branch network in the private financial sector (only behind the government owned Banco Nacional de Fomento) make El Comercio one of the system's more important players. Despite increasing its loan portfolio at an annual average rate of 42% over the past five years, it has maintained relatively sound asset quality, with a nonperforming loan (NPL) ratio of 3.1%, better than the industry-wide 6.7% (as of June 30, 2009). The company follows a conservative approach in provisioning, with a loan loss reserve-to-NPL ratio reaching a high 211%. The company maintains adequate liquidity levels and, given El Comercio's relative ample distribution network and strong market position, presents a relatively well-diversified funding profile. The company will have to continue improving its credit procedures in order to further increase its market penetration, even as it tries to maintain healthy asset quality indicators.

Although its capitalization has been trending a bit downward recently, given its high rate of growth, El Comercio has adequate capitalization to sustain this growth in its portfolio over the next several quarters, with an adjusted capital-to-assets ratio of 13.1% as of June 30, 2009. Because of its conservative profile and historical commitment to maintaining a capital base cushion commensurate to its risks, we expect El Comercio to maintain adequate capitalization by retaining a higher proportion of earnings and/or incorporating new shareholders. In this respect, the company incorporated Grupo ACP from Peru in July 2009 as a shareholder with 10% participation of the total equity. If we include this new capital contribution, capitalization would increase up to almost 16%.

Outlook

The positive outlook reflects our expectation that, despite Paraguay's still high operating and sovereign risks, El Comercio will continue to expand. We also anticipate that the bank will further strengthen its competitive position, while consolidating its recent changes in credit procedures as it preserves its asset quality and relatively strong capitalization levels. A major decline in Paraguay's economy or deterioration in El Comercio's asset quality, profitability, or capitalization could result in a downgrade.

Profile: Focus On Microfinance

Financiera El Comercio is a financial institution operating under the supervision of Paraguay's Central Bank. Although it is a relatively small entity within the Paraguayan financial system, its status as the country's largest financial company with the widest branch network in the private financial sector, behind only that of the government owned Banco Nacional de Fomento, makes El Comercio one of the system's more important players. With the opening of 10 new branches in 2008 the company had 48 branches--including headquarters and 22 services centers--as of year-end 2008, the second largest distribution network among banks and financial companies operating in Paraguay. El Comercio looks forward to expanding its network up to 50 locations, mainly in inner Paraguay as of the end of December 2009.

Even though its focus is on providing loans to microbusiness and entrepreneurs, El Comercio offers a wide range of services and products including consumer loans, dollar and local-currency savings accounts, credit cards, foreign exchange, local- and foreign-currency transfers, and payments for private and public services. Since July 2004, El Comercio has been an official agent of Western Union Financial Services Inc. in the business of transferring money. It services approximately 62% of Western Union's money transfers in Paraguay with 180 sub-agents across the country.

Founded in 1976, El Comercio is the oldest nonbank financial institution in Paraguay. Although initially serving small and midsize enterprises (SMEs) and larger companies, in 1999, after a merger with EFISA Financiera, the microfinance institution (MFI) has somewhat reshaped its strategy and target markets for greater emphasis on microfinance, taking advantage of EFISA's knowledge.

The institution's social mission is to provide loans and services especially to the low-income market, helping reduce poverty in Paraguay. El Comercio has maintained close relations with other important players in the global microfinance sector. El Comercio has participated in the Programas Globales de Crédito para la Microempresa (Global Credit Programs for Microenterprises), financed by the Inter-American Development Bank. Also, in 2001, the company received its first FOMIN (Fondo Multilateral de Inversiones del BID), which was aimed at strengthening El Comercio to expand microenterprises in Paraguay.

Support And Ownership: A Committed Group Of Shareholders

Headquartered in Asunción, Paraguay, El Comercio is majority owned by Paraguayan shareholders, several of which constitute the company's top management. As of December 2008, Paraguayan shareholders held 83% of the total. Acción Gateway Fund, a multinational microfinance organization, is the major individual shareholder, with the remaining 17% of total stock. In July 2009, the company incorporated Grupo ACP from Peru as a shareholder with 10% participation of the total equity, diminishing Acción Gateway's participation to 15.3% and the Paraguayan shareholders to 74.7%.

With the inclusion of two new members from Grupo ACP (Peru) and Banco Sol (Bolivia), seven members, independent from management, comprise the board of directors, which monitors business performance, establishes corporate strategy, and reviews the company's business plan and policies. These two new members provide an external view of the business while contributing their experience from their own countries. The main institutional shareholder, Acción Gateway, does not take part in the operating decisions but does periodically evaluate its performance.

El Comercio has a minor participation (7.7%) in a credit card management company, Bancard S.A., and an 8.1% interest in an electronic collection entity, Pronet S.A. Another entity, Sistemas y Gestiones S.A., was created to handle payment collections and is 100% owned by El Comercio. El Comercio also holds a 95% participation in El Comercio Envíos al Paraguay S.R.L., a remittance company.

Strategy: Consolidating Its Market Position

El Comercio is pursuing both a defined social mission and financial viability. It focuses mainly on microclients, nearly 65% of its total portfolio, of which more than 75% are rural clients. Current major goals are consolidating its market position, mainly in the microclients segment; strengthening cross-selling to existing clients; and assuring profitability through productivity gains in organization and technology. El Comercio has been investing in the development of new products and marketing strategies, strengthening its network, and reorganizing its operating areas to serve a broader customer base. In this respect, the company made important gains during 2008 in achieving first place in terms of loans, deposits, and network size among financial companies in Paraguay as of end of June 2009.

Across El Comercio's more than 30 years in operation, management has adapted to new circumstances, reshaped its strategy to better fit client demands, and achieved financial viability. It operates in a relatively risky environment because of the country's high sovereign risk; however, we believe it can ride out economic cycles.

Even though its main focus is on microclients--defined as recipients of small loans, $1,500 on average--El Comercio retains its clients when they grow into small and midsize companies (see chart 1). In fact, credit to SMEs accounted for 18.5% of the total loan portfolio as of June 31, 2009. El Comercio also offers consumer loans and credit cards, which together represent 17% of total loans as of June 2009.

Chart 1

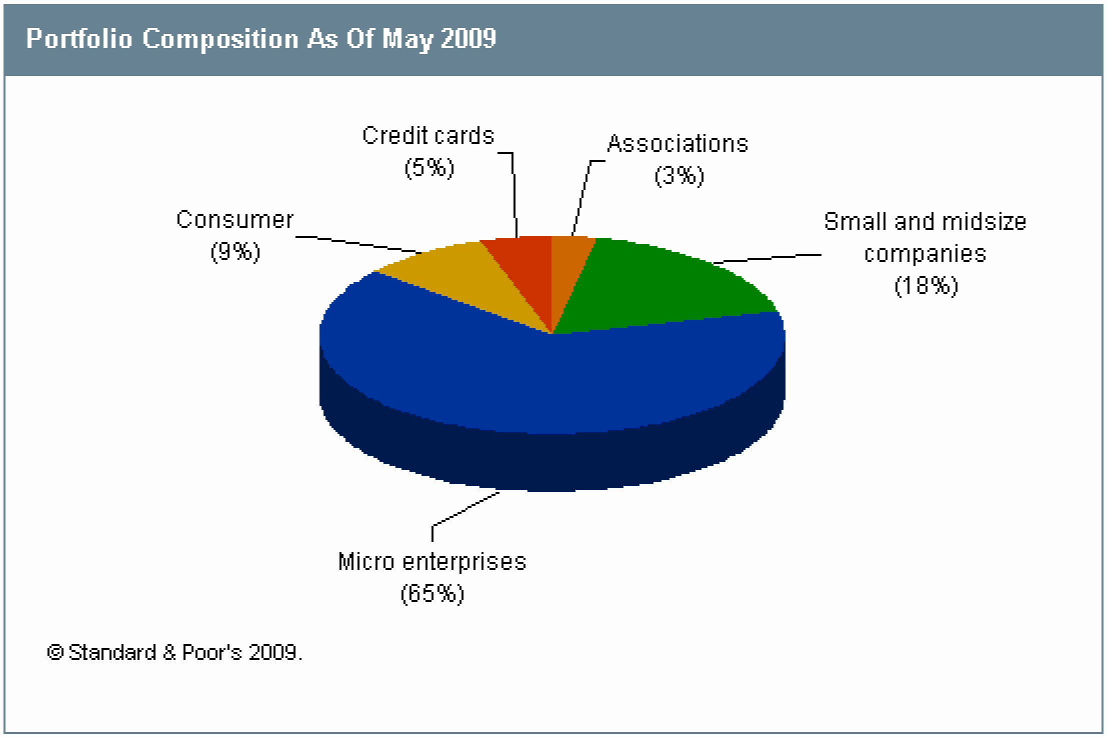
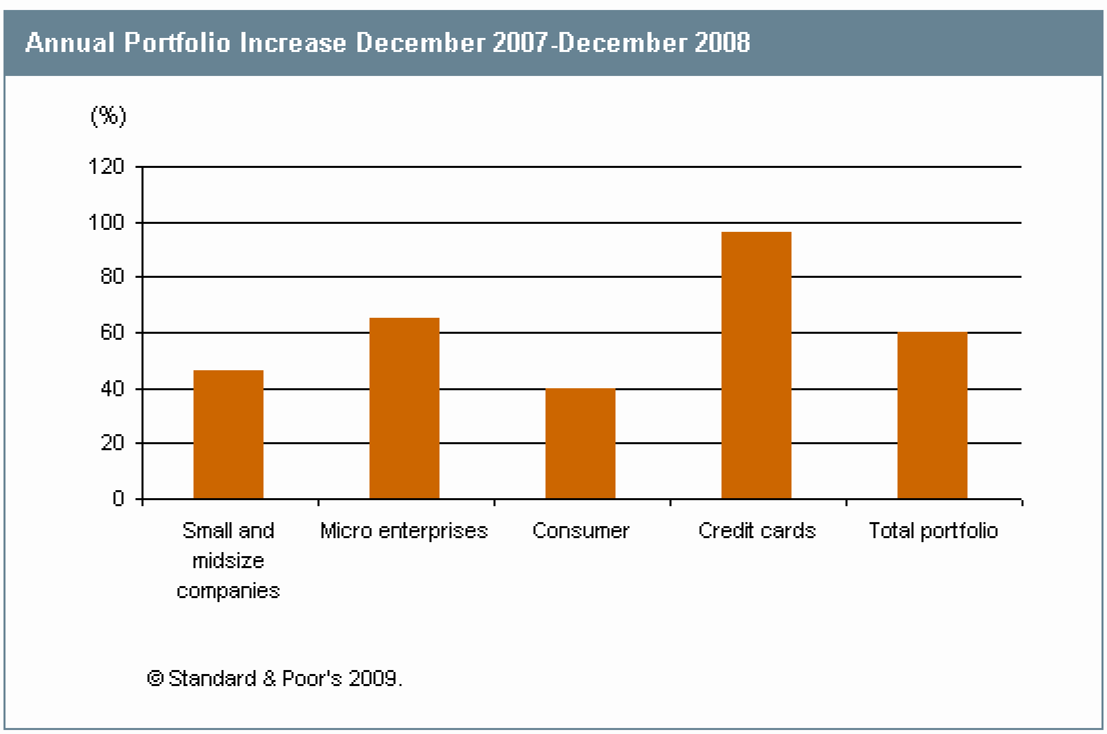


Chart 2



In the remittance business, the company offers domestic and international money transfers. El Comercio is an authorized agent of Western Union, with subagents around the country. In the remittance business, it is presently working on a project--together with Banco interamericano de Desarrollo, (BID) and Fondo Internacional de Desarrollo Agrícola (FIDA)-to increase the financial intermediation of clients receiving money transfers.

To keep consolidating and strengthening its competitive position, management is implementing some changes mainly in technology and processes. In 2008 the company created a new division of organization and process which is in charge of reviewing and developing the origination area process, among others. Improvements were also made in organization and technology, allowing increases in productivity and diminishing administrative costs.

Risk Management: Adequate, But Room For Improvement Still Exists

Standard & Poor's believes that El Comercio's risk management is adequate, supported by a satisfactory infrastructure and an independent and well-prepared management team. Nevertheless, it is still improving its collection and disbursement systems.

Operational risk is in line with most Paraguayan entities. El Comercio has not yet quantified this risk. Nevertheless, its policies and procedures are sufficiently comprehensive to cover daily operations. Each branch is subject annually to regulators' audits, both internal and external.

Credit risk

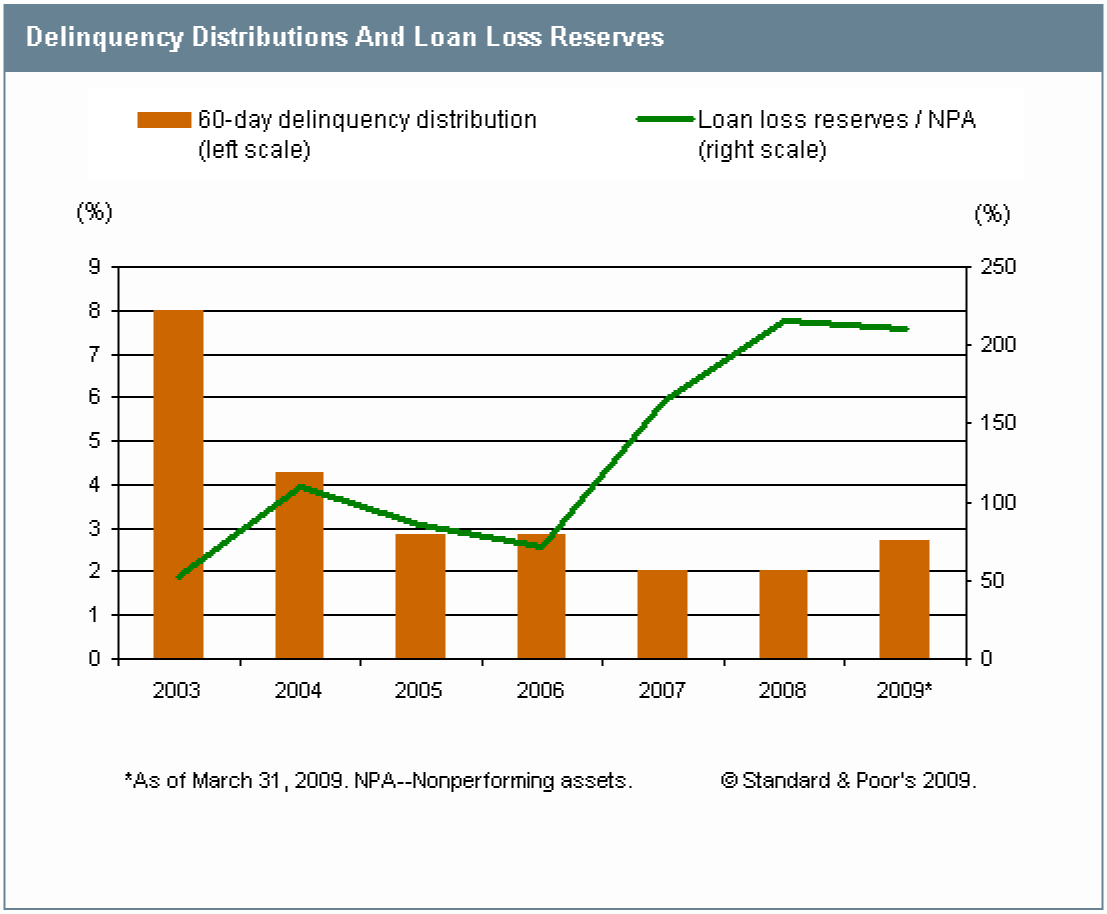
El Comercio is exposed to the risks the Paraguayan system poses to asset quality. Over the past five years, its portfolio has grown an average of 42% per year, significantly above the Paraguayan average, and has increased its market share and positioned itself as the largest financial company as of the end of June 2009. Despite this high growth, El Comercio has maintained strong asset quality, with better nonperforming asset ratios than the industry as a whole--3.1%, compared with an industry-wide 6.7% as of June 30, 2009. However, El Comercio will face the challenge of increasing its market penetration further while maintaining healthy asset quality in a highly competitive environment.

As of June 30, 2009, El Comercio's net loan portfolio amounted to Paraguayan guaranís (PYG) 310.7 billion ($62 million). This represented a 46% year-over-year increase, well above the industry's 27% average for the same period.

Total net loans represent about 75% of total assets, and given the portfolio structure of the company, with more than 60% of total loans allocated to microfinance, individual risk concentrations are very low, with the top 50 clients representing 5% of total loans as of June 30, 2009. The company has a well distributed loan portfolio by sector with no one sector representing more than 25% of total loans. El Comercio takes very little collateral for lending operations, but some loans are supported by guarantors. Additionally, nearly 80% of the lending is in local currency.

Past-due loans have been decreasing since 2002, when they reached a high of 15%. In line with the improving macroeconomic environment, the nonperforming loans-to-total loans ratio has improved since 2002, reducing loans 60 days overdue to a low 2% of the total loan portfolio as of Dec. 31, 2008 (see chart 3). However, the NPL ratio increased up to 3.1% as of end of June 2009, fuelled by a worsening in the economic context and partly explained by a seasonal factor. In this sense, the company has already taken some measures in order to minimize the impact on asset quality (systems, technological tools, strengthening on policies and procedures, training, and incentives to officers, among others).

Chart 3



The loan loss reserve has also increased significantly during the past years, particularly since 2006, on a more conservative provisioning policy that exceeded regulatory requirements. As of June 30, 2009, loan loss reserves-to-NPLs reached a high 211% from 72.2% as of Dec. 31, 2006. El Comercio significantly exceeds the average loan loss reserves for financial companies in Paraguay (211% versus 83%).

We consider the loan portfolio underwriting and management procedures to be adequate. The average term of the loans is 12 months, but this is generally adapted to the borrower's cash flow to facilitate its payment. The process of disbursing and collecting loans is quite detailed, though it presents certain risks, especially fraud and human error. However, El Comercio has been investing and improving its systems and capabilities to minimize these types of risks.

Market risk

El Comercio has a well-defined structure and relatively powerful tools to monitor and manage market risk adequately. Even though the company is not required to comply with any regulatory limits, it sets internal guidelines on interest rates, liquidity, and foreign currency in line with more conservative policies. The company uses value-at-risk methodologies to monitor market risk, complemented by other nonstatistical tools such as sensitivity analysis.

Even though most of the credit portfolio is denominated in local currency, to avoid any currency mismatch, El

Comercio accounts for medium-term lines in foreign currency.

Liquidity and funding risk

El Comercio has relatively ample liquidity. Management has also adopted a cautious approach to liquidity. As of June 30, 2009, 19% of total assets were liquid instruments (mainly cash, deposits in Paraguay's Central Bank and in other financial institutions and investment in Paraguay Central Bank's short-term notes in local currency). Liquid assets cover approximately 35% of total deposits and 182% of sight deposits.

As a consequence of the company's relative strong market position--representing the largest distribution network among financial companies--El Comercio has a relatively well-diversified funding profile. Customer deposits represent the most important funding source, at nearly 64% of total liabilities as of end-June 2009. Deposits have been increasing at annual rates higher than those of the industry, allowing El Comercio to gain the largest market position with 21% of the industry's total deposits.

As of June 30, 2009, third-party funding was made up of 77% deposits and 23% credit lines from financial institutions, mostly multilateral agencies and other development concerns. As in the credit portfolio, most of the deposits are denominated in local currency, more than 80% as of end of June 2009. Deposits increased 49% annually in the first semester of 2009, faster than the system's deposit growth of 31%. Sight deposits represented less than 20% of total deposits as of June 30, 2009. Concentration risk was relatively moderate: the top 10 depositors represented 16.6% of total deposits as of end-June 2008.

Accounting: Conservative Principles Typical Of Microfinancials

Local regulations don't fully reflect the best practices under international standards, especially for microenterprises. Nevertheless, El Comercio also follows its own stricter rules, in line with its conservative approach. These rules are similar to those followed by microfinance institutions in other countries, such as Peru. For example, they set a maximum 30-day delinquency ratio, even though the regulator requires only a 60-day ratio.

Profitability: Relatively Well-Diversified Revenue Structure

El Comercio reports above-market profits explained by its ability to generate good interest margins and above-average fee income. Operating expenses are a relevant factor in the company's profitability given the small loan nature of the business. Although we believe competition will probably pressure the good results achieved in past years, the company's efforts to continue increasing its market penetration and cross selling should let El Comercio achieve an adequate risk control and will continue to sustain medium-term profitability.

El Comercio has continued to improve its earnings fundamentals in 2008. Return on average assets (ROA) rose to 7.5% in 2008, being the most profitable financial company in terms of ROA among Paraguay's 12 financial companies. However, during 2009's first semester, results were affected by higher provisioning efforts, decreasing its ROA to a still high 4%. Total income after taxes reached PYG22.2 billion ($4.5 million) during 2008, a 57% increase. The net financial margin remained practically unchanged during 2008 at a high 16.4% thanks to El Comercio's market niche and relatively low funding cost.

Because of El Comercio's ample offering of products and services, it has been continuously increasing its service-related revenues, both nominally and as proportion of total revenues, providing greater financial flexibility.

Fee revenues over total revenues reached 12.3% in 2008 according to Standard & Poor's methodology, which compares favorably with other Latin American peers.

Operating expenses are a relevant factor in El Comercio's profitability because of the small-loan nature of the business. The entity has a higher operating cost ratio than financial institutions operating in other segments: the noninterest expense-to-revenue ratio reached 69.1% in 2008, higher than the 59.9% posted in 2007.

In the medium term, and as long as the environment does not significantly deteriorate, Standard & Poor's believes that the company will continue to present good profitability. Nevertheless, the company will be challenged to continue increasing its scale in high-yielding segments while improving its efficiency and managing risk adequately, without harming its traditionally healthy asset quality.

Capital: Adequate Though Slightly Declining, Supporting Portfolio Growth

El Comercio's capitalization is adequate to sustain portfolio growth in the medium term, despite recent high growth and the company's active payout policy of about half of total earnings. Nonetheless, with prospects of strong portfolio growth, capitalization depends on the company's ability to retain earnings. In this sense, the entity has diminished its payout policy to around 20% of total earnings and is looking forward to incorporating new strategic shareholders. In this respect, the company has incorporated Grupo ACP from Peru in July 2009 as a shareholder with 10% participation of the total stake. If we include this new capital contribution capitalization would increase up to almost 16%.

The management is committed to maintaining capitalization levels, mainly through internal capital generation given its historical high profitability levels which have been enough to support its expansion strategy. Because of its conservative profile and historical commitment to maintaining a capital base adequate for a cushion commensurate with risk, we expect El Comercio to maintain adequate capitalization.

The company's capitalization has been decreasing somewhat since 2004 because of high growth in the portfolio. As of June 30, 2009, and according to Standard & Poor's methodology, the adjusted capital-to-assets ratio fell to 13.1% from 17.1% at December 2007.

ACCION Internacional, an international organization dedicated to the development of microfinance, through Acción Gateway, is the major individual shareholder of El Comercio, bringing corporate governance experience from a well-known industry player.

Chart 4

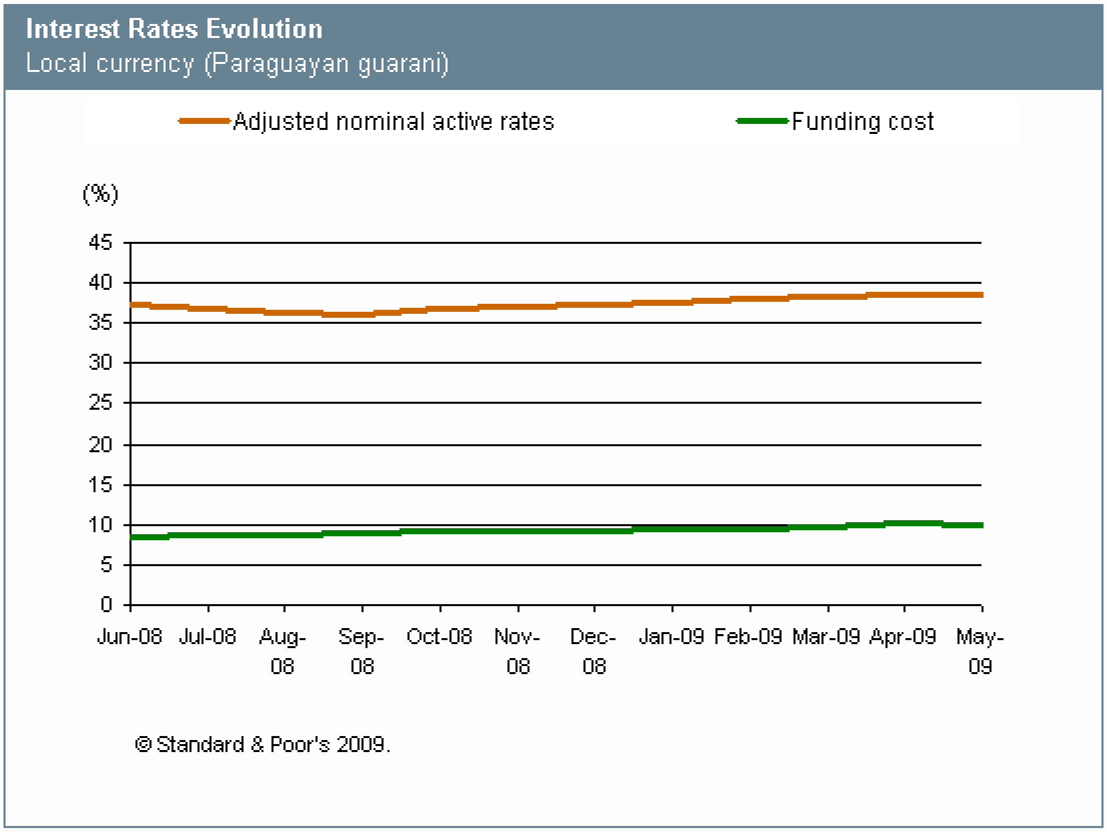

Interest Rates Evolution
Local currency (Paraguayan guarani)
Adjusted nominal active rates
Funding cost
(%)
45
40
35
30
25
20
15
10
5
0
Jun-08
Jul-08
Aug-08
Sep-08
Oct-08
Nov-08
Dec-08
Jan-09
Feb-09
Mar-09
Apr-09
May-09
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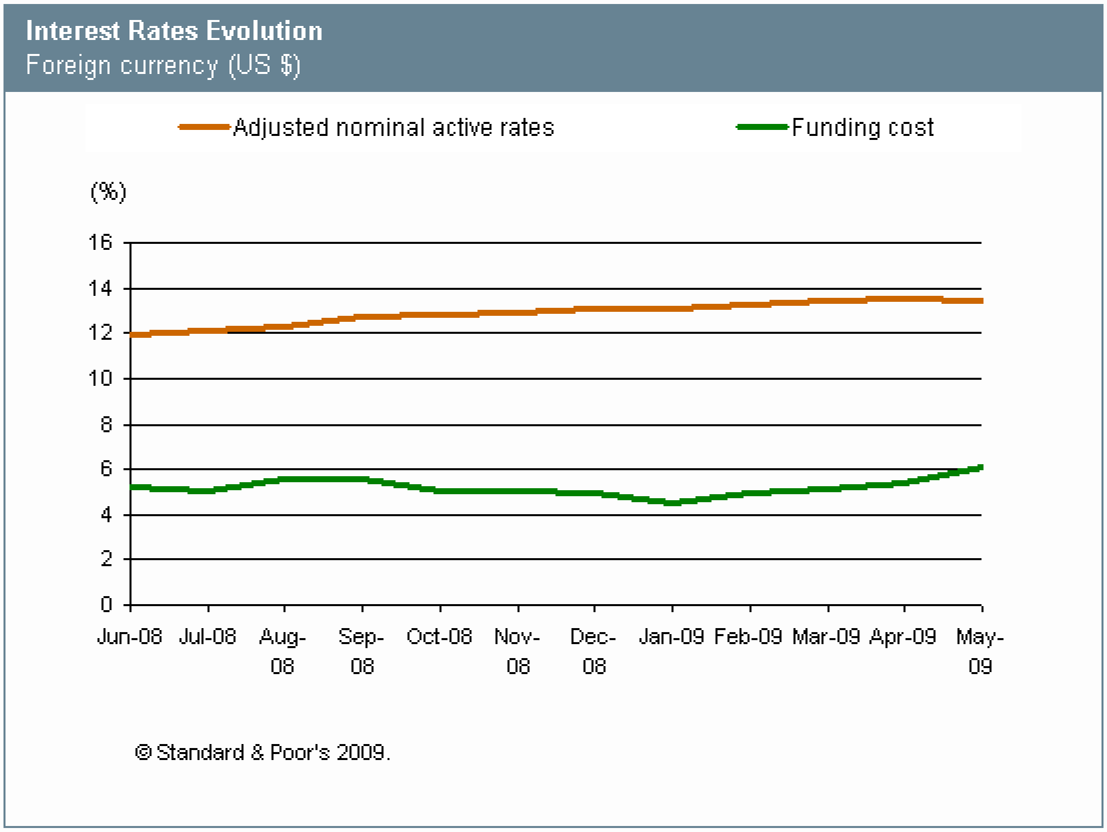
Chart 5



Ratings Detail (As Of August 19, 2009)*	
Financiera El Comercio	
Counterparty Credit Rating	B-/Positive/--
Counterparty Credit Ratings History	
30-Jul-2009	B-/Positive/--
30-Sep-2008	B-/Stable/--
Sovereign Rating	
Paraguay (Republic of)	B/Stable/B

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.