Credit Insights - by KPMG Cyprus Credit Institute

Bringing the Corporate and the Financial communities together

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Table of contents

Background

The first issue of Credit Insights tackled an issue which has been debilitating the Cypriot economy over the past few years: corporate distress and the need to rescue our companies.

This second issue of Credit Insights investigates what and to what extent stakeholders are doing to:

1. **Rescue our businesses, on the basis of NPL trends analysis**

2. **Avert similar distress traits in the future, on the basis of fresh lending data analysis.**

1 Corporate sector Non-Performing Loans: which way?

What is the current situation?

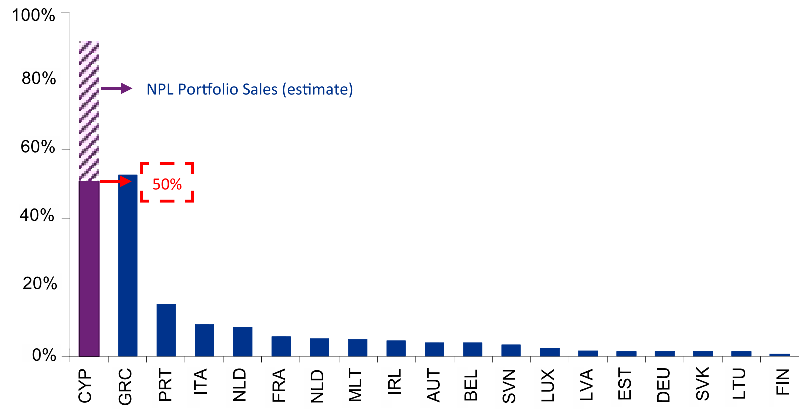
A top priority for the European Union (EU) is the completion of the Banking Union which will form an integral stepping stone for Europe's Economic and Monetary Union. One of the key areas which is essential to complete the Banking Union is the establishment of a comprehensive strategy to address the issue of Non-Performing Loans (NPLs). The prevailing average EU NPLs ratio, which currently floats at just over 3%, is considered by the EU to be excessively high and has to be reduced.

By comparison, the NPLs ratio in Cyprus is still over 30% and this even after a large chunk of loans has been driven out of the banking system due to loan portfolio sales/transfers and the dissolution of the Coop. If these loans were added back, the ratio would be in the mid-forties. What is of equal concern, is the disproportionately excessive level of NPLs, compared to the country's Gross Domestic Product (see diagram 1).

The private corporate sector is over-indebted (diagram 2) and small to medium enterprises (SMEs), which are indisputably the backbone of the Cypriot economy (more than 99% of all companies in Cyprus fall within this category), have an NPLs ratio of just under 40% (diagram 3). If we add back those loans which have been taken outside the banking system, but remain nevertheless in the real economy, the ratio would be closer to 50%, implying that, roughly, one in two SMEs have financial difficulties. Large corporates have demonstrated a significant improvement leading to a much lower NPL ratio of 18% (diagram 3), albeit this is still high compared to European norms.

Diagram 1

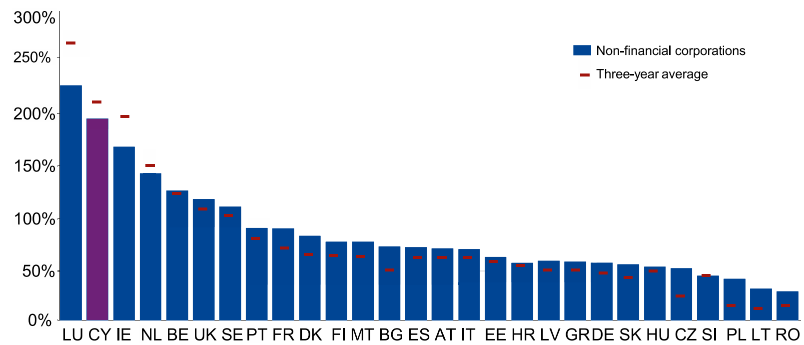
NPL to annual GDP ratio in EU Countries



Note: Data as at 2018Q4 for Cyprus and 2018Q2 for the other countries
Source: Central Bank of Cyprus, International Monetary Fund (Nov 2018), KPMG Analysis

Diagram 2

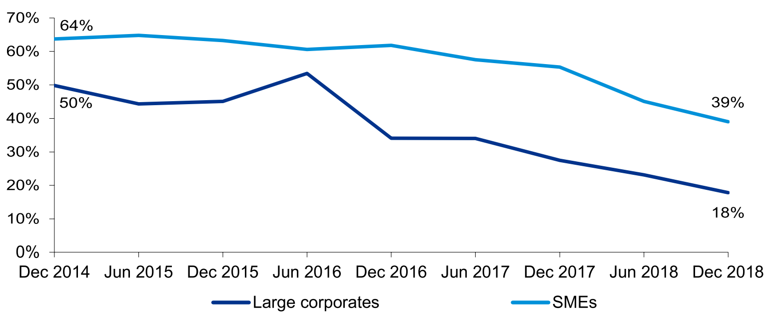
Total Debt of NFCs as a ratio of GDP



Note: Data as at 2018Q3
Source: European Central Bank, KPMG Analysis

Diagram 3

NPL ratio



Source: Central Bank of Cyprus, KPMG Analysis

What does the future hold?

It is apparent that the Cypriot economy, insofar as NPLs are concerned, still has a long way to converge to the EU targets. This convergence, which is required to achieve the EU's objective of completing the Economic and Monetary Union, will undoubtedly have profound implications and overwhelming pressures on the local financial and corporate sectors respectively, over the coming months and years.

Indicative of the expected trajectory of NPLs, is the target recently promulgated by the Minister of Finance, for a single digit NPLs ratio in the banking sector within the next 12 months. This target implies a reduction in NPLs of around €7 billion (or close to 33% of GDP) in the coming months.

As a result, in the current positive economic and financial context, whereby the Cypriot economy is visibly regaining strength, corporate Cyprus finds itself at another crossroads juncture as NPLs and the heavy private indebtedness continue to pose significant risks to economic growth and financial stability. Stakeholders should seize the momentum to drive NPLs and indebtedness to manageable levels:

- Company owners, directors and managers must seek ways to turn around their businesses, agree restructuring plans with creditors and other stakeholders, and start delivering results, primarily targeted at reducing debt and other liabilities; this should be their top priority.
- Lenders, credit acquirers and debt servicers ought to deal immediately with all those corporate entities (SMEs in particular) - and households – that they have not been able to find solutions with yet. Well-meaning, transparent, cooperative borrowers need an opportunity to be rescued and turn around.
- Structural impediments continue to hinder a faster decline in NPL stocks. State authorities must facilitate a well-functioning corporate rescue (for viable entities) and liquidation (for non-viable entities) framework, by introducing even more legislative and structural amendments to the corporate, insolvency and judicial regimes.

In light of the intense pressure which is, undeniably, expected to be exerted by the EU, and regulators, for further radical reductions in NPLs, stakeholders should bear in mind that the European Council has come up with a multi-disciplinary 'Action Plan to tackle NPLs in Europe', both in terms of reducing existing stocks and preventing a renewed future accumulation.

The implementation of the plan is instructive in understanding the far-reaching repercussions on local players. The 'minimum loss coverage for NPLs milestone' is indicative of what is to be expected. A common minimum provision coverage ('statutory prudential backstop') for newly originated loans (after the regulation comes in force) which subsequently become NPLs, will be introduced. This backstop will necessitate a 100% provision coverage within three years for unsecured exposures and within 9 years for secured, by immovable collateral, exposures.

This is but one of the many reasons that stakeholders (borrowers, lenders, the state) must do whatever is possible within their remit to facilitate and accommodate the radical transformation of the local corporate world's balance sheets, operational set-ups and governance modus operandi.

This can only be achieved via a quantum leap in our collective mind-set. A new, collaborative business rescue culture is a must.

2 Developments in lending conditions to the corporate sector

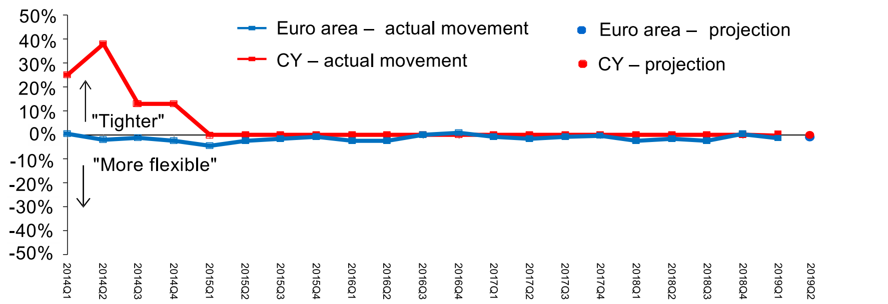
Supply – Demand – Pricing Conditions

Having significantly tightened credit standards for non-financial corporations ("NFCs") in the period 2012-2014, Cypriot banks have maintained a stable outlook since then. Over the same period, European banks have had a slight easing of credit standards (diagram 1).

The supply of new lending to NFCs has been steadily rising since 2015 in Cyprus (diagram 2), reversing the previous declining trajectory, mainly as a reflection of more favourable economic conditions, on the back of rising demand from NFCs (diagram 3) and declining interest rates, although these are still significantly higher than EU averages (diagrams 4, 5). What emerges from diagram 2, however, is that new funds have been channelled mostly to larger (> €1 million) loans compared to smaller loans, possibly indicating a prevalence of more corporate lending compared to micro, small and medium enterprise loans.

Diagram 1

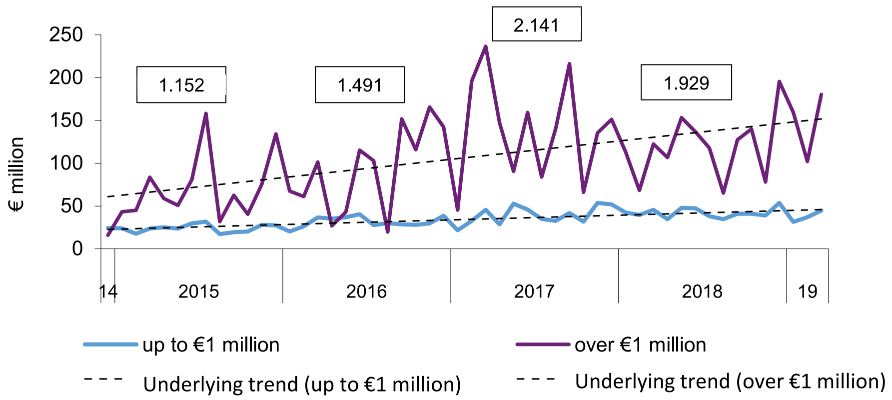
Lending criteria for NFCs



Source: Central Bank of Cyprus, European Central Bank

Diagram 2

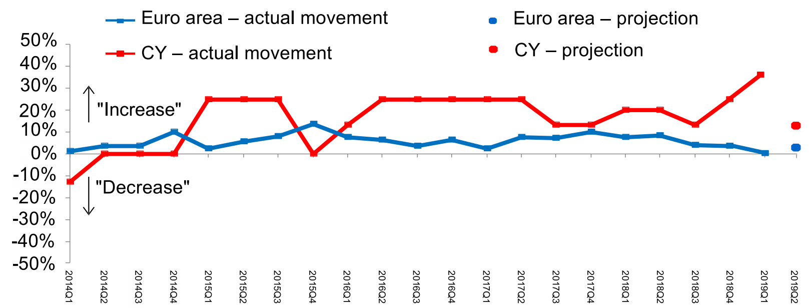
Pure new loans to NFCs



Source: Central Bank of Cyprus, KPMG Analysis

Diagram 3

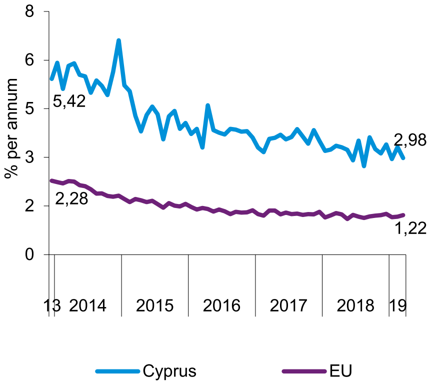
Demand for loans from NFCs



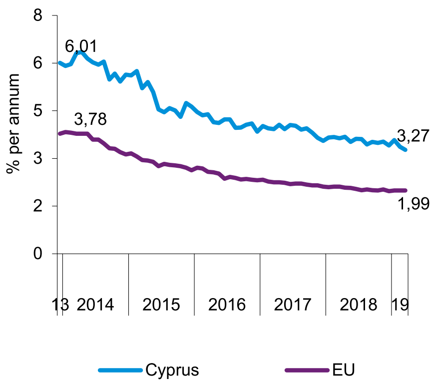
Source: Central Bank of Cyprus, European Central Bank

Diagrams 4, 5

Interest rates for new loans over €1,0 mln to NFCs



Interest rates for new loans up to €1,0 mln to NFCs



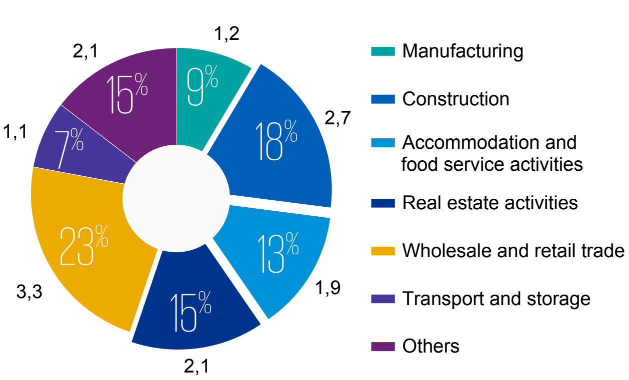
Source: Central Bank of Cyprus, European Central Bank, KPMG Analysis

Sectoral Breakdown

Despite significant de-leverage of the sector, construction and real estate-related activities (including hotels) continue to dominate the sectoral break-down of total NFC loans, with a combined ratio of almost 50% (diagram 6). The same sectors contribute more than 40% of the country's Gross Value Added (diagram 7).

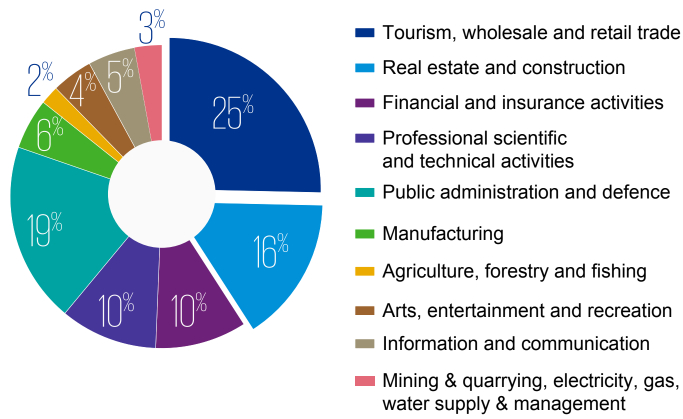
Diagrams 6, 7

Bank loans to NFCs by sector as at December 2018 (billion)



Source: Central Bank of Cyprus, KPMG Analysis

Cyprus Gross Value Added (GVA) by sector (2018)



Source: CyStat, KPMG Analysis

Lending benchmarks for real estate-related activities

As per KPMG's Property Lending Barometer 2018 survey, regarding real estate-related corporate lending activities, local banks demonstrate a marked preference in lending to the hotels sector, followed by the offices sector. On a ranking basis from 1 (lowest preference) to 5 (highest preference), local banks' average scores are shown in diagram 8.

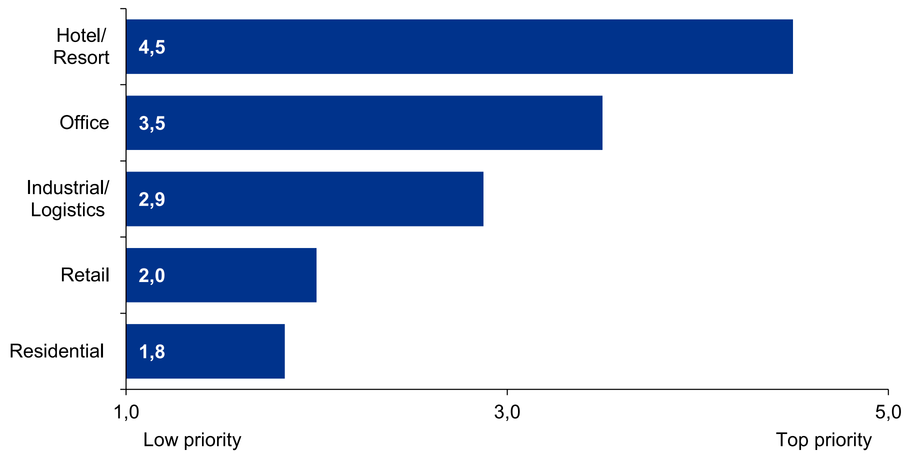
Coming out from the same survey, the following comparisons (diagrams 9 to 11), provide valuable insights into the criteria and benchmarks used by local banks in their lending activities to the real estate-related sector, compared to their European counterparties.

Local banks maintain tighter debt service cover requirements and, at the same time, require higher interest rate margins on their real-estate related corporate lending, compared to European benchmarks.

Local banks have a much lower loan duration threshold, compared to European benchmarks.

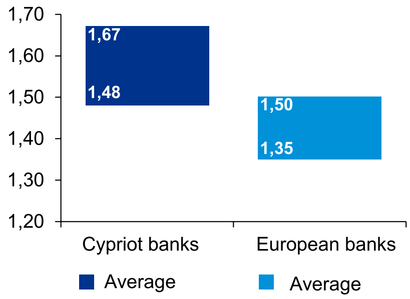
Diagram 8

Cypriot banks' lending priorities



Diagrams 9, 10

Ranges of Debt Service Coverage Ratio



Ranges of Loan interest margin

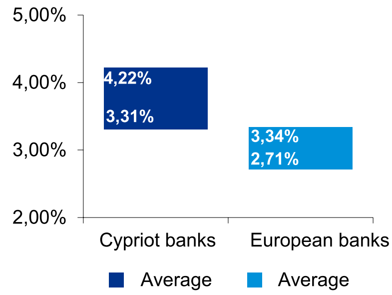
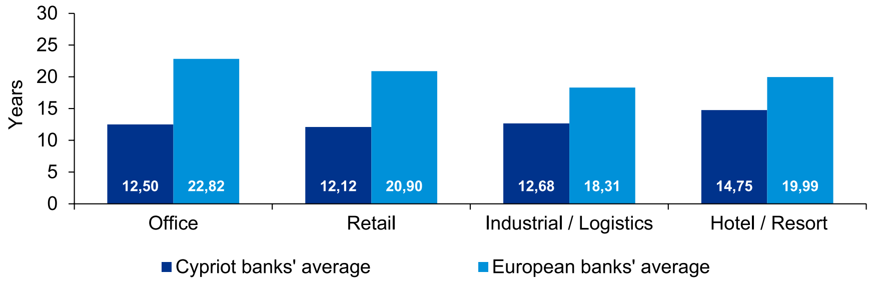


Diagram 11

Maximum average amortisation period (years)



Source: KPMG's Property Lending Barometer 2018, KPMG Analysis

Financial debt restructuring and refinancing

The recent positive trajectory of the economy, the return of confidence to the business world, and a steadily increasing appetite, at least by some banks, to refinance existing debt, provide an excellent opportunity to companies to clean up their balance sheets.

A well thought-out debt management strategy and balance sheet capital–liabilities restructuring/refinancing will facilitate debt serviceability, will enhance sustainability and long-term viability, and will add much needed resilience to face future challenges.

A word of caution

Although published data and the above survey results suggest that lending criteria remain tight, a word of caution is warranted. In a world of surplus and costly banking liquidity, substantial levels of NPLs, excessive private indebtedness, limited lending opportunities and intense price competition among banks, it is all too easy to relax standards and chase opportunistic lending propositions.

Prudent pragmatism and a disciplined know-your-customer (KYC), 'stick to the basics, no-frills' borrowing/lending attitude, should be seating high on the agendas of business leaders and banking executives respectively. Given that history has a tendency of repeating itself, lessons of the past should be well assimilated in our new borrowing-lending paradigm.

KPMG Debt Advisory and Debt Management services

01 New project financing

- Feasibility studies
- Investment appraisals
- Business and asset valuations
- Business plan reviews and assistance
- Financial forecast reviews
- Model review and assistance

02 Borrower and lender financial restructuring assistance

- Independent Business Reviews
- Financial restructuring plans (liabilities rationalisation)
- Refinancing assistance
- Stakeholders negotiation assistance
- Restructuring options identification, assessment and monetisation

03 Crisis Management & Turnaround

- Cash crisis management and cash flow stabilisation
- Operational restructurings (assets, profit and loss and cash flow optimisation)
- Corporate turnaround assistance
- Turnaround executive/chief restructuring officer appointments

04 Asset and Debt management services

- End-to-end Debt for asset transaction implementation (strategy, negotiation, execution)
- Real estate asset due diligence (financial, technical, zoning, tax)
- Valuations reviews
- Asset management planning, portfolio optimisation and exit strategies
- Loans servicing insourcing and outsourcing
- End-to-end foreclosure procedure insourcing and outsourcing

05 Corporate Recoveries

- Receiver/Manager appointments
- Liquidation appointments
- Act as Court appointed officers
- Independent expert reports
- Insolvency expert witness reports

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