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Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden N.V. (FMO)

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Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden N.V. (FMO)

Major Rating Factors

Issuer Credit Rating
AAA/Stable/A-1+

Strengths:
- Almost certain government support expected in the event of financial distress.
- The state's maintenance obligation and guarantee of FMO's financial commitments.
- Historically strong financial profile.

Weaknesses:
- Significant volatility in the income stream and high risk profile of its lending.

Rationale

The ratings on Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden N.V. (Netherlands Development Finance Co.; FMO) is based on an equalization with the ratings on the State of the Netherlands (AAA/Stable/A-1+), reflecting Standard & Poor's Ratings Services' opinion that there is an "almost certain" likelihood that the Dutch government would provide timely and sufficient extraordinary support to FMO in the event of financial distress.

In accordance with our criteria for government-related entities (GREs), our rating approach is based on our view of FMO's:

- "Critical" role as one of the government's vehicles for promoting private sector growth in developing countries, an important public policy goal in The Netherlands.
- "Integral" link between the government and the GRE. The ratings reflect strong sovereign support for the company, based on the operating maintenance obligation and the solvency commitment as well as a track record of support. FMO is a key instrument in the pursuit of the government's official policy of international cooperation.

Sovereign support was formally codified in the 1998 agreement between FMO and the state. Under Article 8 of the agreement, the state is legally required to enable FMO to meet its obligations on time. The duration of the agreement is indefinite and its termination requires 12 years' notice by either party. The Netherlands' long-term commitment to, and support of, FMO is also demonstrated by the sovereign's obligation in most circumstances to safeguard the company's solvency (Article 7 of the agreement).

FMO is a leading European development finance institution, with total assets of €3.7 billion in 2008. The company supports businesses and financial institutions in developing countries with capital and skills. It does so by arranging loans, equity investments, guarantees, and other investment promotion activities. It also manages several development funds on behalf and at the risk of the Dutch government.

Profitability in 2008 was significantly affected by high-value adjustments that reflected the risk in FMO's portfolio and net income as a percentage of total average assets decreased to 1.5% from 4.2% in 2007. The results from equity participations remained significant and somewhat offset the impact on profitability due to the value adjustments of FMO's financial investments. Given the nature of its business and the high level of equity and mezzanine financing, FMO's financial results are relatively volatile. However, FMO's experience of managing emerging market risks will support long-term profitability.

Outlook

The outlook on FMO mirrors that on The Netherlands and reflects our expectation that the 1998 agreement with the state will remain in force for the foreseeable future. Given that FMO already has a very strong capital base relative to its business, we do not expect the state to resume making capital contributions. The Dutch state, however, is in principle committed to future capital contributions if FMO's loan portfolio expansion requires it. FMO's prospects as a majority state-owned company with a strong public mandate and continued support from the state are considered secure.

Extraordinary Government Support: Almost Certain

We view the role of FMO as critical to meeting the official policy objectives of the State of The Netherlands. Further, we view the link between the government and FMO as integral and this is supported by the track record of credit support as well as by the state support of FMO's financial obligations and the state's commitment to continue funding FMO if necessary.

FMO was established in 1970 by the state, several Dutch companies, and trade unions as a joint-stock company under the "Law of May 1, 1970, on Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden N.V." Under FMO's Articles of Association, the company is mandated to promote the economic and social progress of developing countries by funding private sector investments, primarily through long-term loans and equity investments, in those countries in line with the Dutch government's policy goals on development cooperation. FMO also provides guarantees for third-party investments in developing economies and plays an active role in trade financing and syndicated loans. In addition, FMO manages several development funds and their associated risks on behalf of the government.

Until 1991, FMO was the government arm that financed investments in developing countries, mostly in the private sector. The agreement between the state and FMO signed in 1991 clearly defined FMO's more commercial approach and its focus on private sector operations, and conferred on the company a relatively large degree of management and operational independence. The agreement was last amended in 1998, mainly to reassert its validity in the longer term and to extend and comprehensively define the government's financial support of, and obligations to, FMO. The 1998 agreement has an indefinite term and its termination requires 12 years' notice from either party. Moreover, FMO's authorized share capital comprises 49% 'B' shares, which may be held by the private sector, and 51% 'A' shares, which may only be issued to, and owned by, the state. Neither the state nor the private sector shareholders have shown any interest in altering the ownership structure. The banking license that FMO obtained in March 2008 has no effect on the shareholder structure.

According to Article 8 of the 1998 agreement, "The state shall prevent situations arising in which FMO is unable to meet (its financial) commitments on time." The article comprehensively lists the types of obligations covered by this undertaking.

This obligation exists solely between the state and FMO. FMO's creditors do not have a direct claim against the state and Article 8 does not formally constitute a full, unconditional guarantee. Nevertheless, the pledge effectively ensures that FMO's obligations are fully supported by the state's credit standing. The Dutch central bank has allowed a 0% risk weighting to all the financial instruments and loans to FMO specified in Article 8. The robustness of the state's backing of FMO's obligations is further underpinned by the constitutionally binding nature of the 1998 agreement, which is an obligation for the state rather than the current government. Moreover, unlike other obligations that the state has toward FMO, Article 8 cannot be suspended under any circumstances while the agreement remains in force (Article 10).

Article 7 of the 1998 agreement also stipulates the state's "maintenance obligation" toward FMO, which, unlike the guarantee on the company's financial liabilities, can be suspended. Under this obligation, the state is committed to covering all FMO's losses from unforeseen and nonprovisioned operational risks that cannot be covered by the general reserve risk fund.

If FMO's financial situation were to deteriorate to the extent that it could be expected to invoke the state's obligations, the Ministry of Finance would be entitled to direct the company's financial and economic policies. Under such a scenario, FMO's failure to comply with the minister's directions could result in the suspension of the maintenance obligation, although the likelihood of such a suspension seems remote, as cooperation between the state and FMO has always been good. If FMO were liquidated, its capital reserves would fall due to the state after settlement of the contractual return to shareholders.

State support for FMO is also demonstrated by the funding the company has received in the past. From 1991 to 2005, FMO received annual average capital contributions of over €45 million from the Dutch government. Given that FMO now has a very strong capital base relative to its business, the state's capital contributions are not expected to resume in the next few years. The Dutch state, however, is in principle committed to future capital contributions if FMO's expansion of its loan portfolio requires it. FMO also benefits from advantageous bilateral tax treaties and de facto preferred credit status in certain of FMO's countries of operation.

Organization And Operations: Buffers Enable Portfolio Growth In 2008, But Asset Quality Suffers

While FMO's activities in 2006 and 2007 were significantly affected by the excess liquidity in global financial markets, in 2008 the liquidity dried up as commercial investors became less willing to invest in developing countries. In this environment, FMO's portfolio of loans, equity investments, and guarantees increased by 36% increase to €3.7 billion (excluding government funds). Portfolio growth was financed by an increase in both long- and short-term liabilities. There was a slight increase in the share of investment in low-income countries and also in the share of higher-risk equity and mezzanine products. The focus on the financial sector (comprising bank and nonbank financial institutions, housing finance, and capital markets), which makes up 55% of the portfolio, remains.

Since 2002, the benign economic climate and a continued focus on strong risk management had led to a sharp reduction in incremental negative value adjustments, and past value adjustments could often be released. In 2008, however, as financial market turbulence feeds through to the real economy FMO's clients across the globe have been feeling the impact, although to varying degrees. Consequently, value adjustments have increased. By year-end 2008, specific value adjustments and incurred but not reported provisions on loans to the private sector and at the risk of FMO amounted to 12% of gross disbursed loans, while gross non-performing loans (those provisioned or experiencing payment arrears for three months or more) increased significantly to 12% of FMO's outstanding loan portfolio, from 3% in 2007. Value adjustments for loans guaranteed by the state rose to 28% of gross disbursed loans with nonperforming loans significantly higher than among loans managed at the risk of FMO, reflecting the less commercial nature of this side of the business.

FMO's overall investment decisions must observe the principles stated in the Criteria Memorandum (an appendix to the 1998 agreement). In addition to promoting economic development in emerging economies, environmental and social factors are key for FMO when it considers investment projects. In addition to these investment criteria, FMO's management has established exposure limits by country, client, sector, and guarantor, in order to diversify risk.

Policies governing lending decisions

FMO's main activity is to provide loans. Lending and guarantee operations include project finance, corporate loans, and lines of credit to financial institutions, which in turn onlend to local companies. In line with its mandate to operate commercially, the company provides funding on similar terms and conditions to those found in global financial markets.

FMO calculates what interest rate to charge by adding a spread over its own basic rate for fixed-rate loans, or over LIBOR, or over an equivalent benchmark for floating-rate loans. The spread generally varies between 200 basis points (bps) and 500 bps, reflecting borrower and country risks, the maturity of the loan, and the current situation in the financial markets. FMO also mobilizes funds from commercial banks through nonrecourse loan syndication. The company provides part of the funds for the loan and serves as the lender of record for the entire loan.

Policies governing equity investments

FMO's equity investments are growing each year as FMO works to diversify its product mix and meet the needs of its clients. FMO's equity investments comprise common and preference shares, subordinated loans with equity options and other quasi-equity instruments. FMO never takes more than a minority equity investment and is never the largest shareholder, although in some cases it is willing to take seats on company boards.

The bank's equity investments have an average duration of five years. In addition, exit arrangements, preferably through stock markets, are agreed at the outset. FMO also provides management support and participates in private equity funds, which in turn take stakes in local firms not listed on the stock exchange. FMO's equity investment policies were tightened in 2001. Investment criteria are now stricter, portfolio management is more important, and more attention is paid to generating cash flow, collaborating with partners, and improving the structure and completion of exits.

Local currency financing and new products

FMO is involved in local currency financing because foreign banks are often not in a position to offer local currency on longer tenors. Local currency products have always been available to clients through government funds, but more recently FMO has started introducing its own products. FMO hedges all currency risk for its own products through The Currency Exchange Fund (AA-/Watch Neg/A-1+), of which FMO is an important shareholder (see the full analysis on The Currency Exchange Fund, published Dec. 10, 2008, on RatingsDirect).

Policies governing provisions

A specific loan provisions policy was introduced in 2003, linking the provision ratio (15%-100%) to internal ratings and the duration of arrears. A new value-adjustment policy has introduced the concept of incurred but not reported (IBNR) provisions, in accordance with IFRS. IBNR provision relates to risks that are present but not yet identified, calculated with a model that depends on factors such as country ratings, portfolio breakdowns, default risks, and recovery rates.

Table 1

FMO Balance Sheet

(Mil. €)	2008	2007	2006	2005	2004	2003	2002	2001
Total assets	3,654.0	2,685.0	2,306.0	2,329.0	1,844.9	1,748.3	1,457.5	1,497.7
Loans (net)	1,723.1	1,276.0	1,098.5	991.8	885.3	847.9	829.1	961.6
Equity investment	456.1	337.5	215.9	127.9	93.4	81.9	79.2	103.5
Cash and interbank holdings	471.0	184.1	114.8	373.2	148.5	439.5	349.4	234.8
Marketable securities	564.1	585.6	633.9	626.5	569.4	147.8	115.5	132.2
Other assets	439.8	301.9	242.8	209.5	148.3	231.2	84.3	65.6
Total liabilities	2,425.4	1,502.9	1,222.8	1,378.8	1,060.5	1,015.4	782.2	864.3
Debt securities	1,295.2	1,117.9	1,004.0	1,139.4	895.2	913.7	647.9	777.2
Of which short-term	231.5	261.8	664.0	751.8	42.1	107.5	47.2	61.0
Banks	1,015.6	244.1	44.2	28.8	64.5	11.9	49.2	61.0
Customer deposits	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other liabilities	114.6	140.9	174.6	210.6	100.8	89.8	85.1	26.0
Capital	1,228.6	1,182.2	1,083.1	950.2	784.3	732.9	675.3	633.4
Of which share capital (paid-in)	9.1	9.1	9.1	9.1	9.1	9.1	9.1	9.1
Of which reserves	1,219.5	1,173.1	1,074.1	941.1	775.3	723.8	666.2	624.4

Profitability: Hit By High Value Adjustments

The volatility of the company's annual results remains a salient feature, especially as equity and mezzanine financing increases. FMO can, however, partially manage annual profits through the spreads it charges its customers for its financial products.

After a number of years of high returns on assets and equity, profitability decreased in 2008. The high level of value adjustments in 2008 due to increased risk in the portfolio offset the still strong results on equity participations that have been significant drivers of profitability. Return on average assets was 1.5% in 2008, a notable decline compared to 2007, while ROE was at 4% in 2008 from about 9.3% in 2007.

Total income increased in 2008, with a significant result from the sale of equity participations as in 2006 and 2007. Divestment of or exit from equity participations amounted to €78 million in 2008.

FMO's main source of income is still the net interest on its loan portfolio, which represented 51% of total revenues in 2008 on the back of growth in the portfolio as well as an increase in interest revenues of the treasury portfolio. Remuneration for services rendered in managing programs on behalf of the state was stable at €25 million.

Typically, FMO's biggest expense is its provisioning (including equity value adjustments). In 2008, this has certainly been the case. Provisions were 60% of revenues compared to 18% in 2007 and positive value adjustments in 2005-2006. This level of provisioning is similar to that during the 1998-2003 periods when average provisions over revenues were 63%.

According to the 1998 agreement, FMO's net profits must first be allocated to cover any losses incurred in previous years, after which the company makes the required transfer to the contractual reserve. The management and the supervisory board then decide how to appropriate the remaining net profit. The distributable profit component in 2008 was €2.4 million and a cash dividend of €3.01 per share was proposed, with the remaining €1.2 million to be added to other reserves.

Table 2

FMO Profit and Loss Account

(Mil. €)	2008	2007	2006	2005	2004	2003	2002	2001
Income	209.6	199.0	202.1	134.1	126.5	104.6	94.6	91.9
Net interest income	106.2	102.4	91.5	79.5	80.0	75.6	76.1	76.5
Income on equity investments	78.4	72.5	73.9	9.4	13.7	6.6	2.6	2.0
Remuneration for services rendered*	25.2	23.5	23.3	22.7	19.1	18.6	14.1	10.8
Other income	(11.1)	(8.5)	4.6	20.0	11.1	3.8	1.7	2.6
Expenses	179.9	86.7	41.1	33.2	71.2	75.4	84.9	93.9
Operating expenses	55.5	51.2	47.3	41.1	36.0	33.2	30.5	25.4
Value adjustments	124.3	35.4	(6.2)	(7.9)	35.3	42.2	54.4	68.5
Of which to loans	96.4	26.2	(8.7)	(13.0)	32.9	20.3	27.4	61.7
Of which to equity	27.9	9.2	2.4	5.0	2.4	2.8	8.3	20.4
Of which general value adjustment	0.0	0.0	0.0	0.0	0.0	19.1	18.8	(13.6)
Profit before tax	37.4	116.3	164.6	101.0	55.4	29.3	9.1	(2.0)
Taxes	(10.7)	11.3	30.6	27.6	18.0	8.7	4.6	(6.2)
Net profit	48.1	105.0	134.1	73.4	37.3	20.6	4.6	4.3

*Mostly services rendered to the state plus syndication fees.

Funding And Liquidity: Benefits From Good Market Access

FMO's principal source of funds is domestic and international financial markets, to which the company has good access. Access to domestic markets has been facilitated by the 0% risk weighting of FMO's obligations in the balance sheet of Dutch financial institutions. FMO's global MTN program was increased to €3 billion in May 2008.

FMO also has a €1.5 billion ECP program in place, although it has not issued under this program as of publishing. We rate the program 'A-1+' on the back of the strong sovereign support, including the operating maintenance obligation and the solvency commitment of the State of The Netherlands. Additionally, given FMO's bank status, it has access to funding at the European Central Bank (AAA/Stable/A-1+). Over 90% of its securities are repo eligible at the ECB.

About 13% of FMO's assets are held as cash-on-hand and deposits. Including marketable securities, liquid assets increase to 28% of total assets, which further increases the liquidity buffer available to FMO.

Capital Levels Are High

Because of its activities in high-risk countries, FMO has a much higher risk profile than commercial banks. On average, FMO's level of risk weighting assets is two to three times higher than that of commercial banks. Even so, FMO is well capitalized relative to the high-risk profile of its operations. The standardized BIS ratio is approximately 30%.

At year-end 2008, total shareholder equity was €1.2 billion. The reserve allocation policy followed by the company has historically ensured that adjusted common equity to total assets has been maintained at above 40%, even at times of below-average performance. In 2008, the figure declined to 34%.

The company's authorized share capital doubled to €45 million in December 2000. Paid-in capital, which amounted to €9.1 million at year-end 2007, has remained unchanged since 1995, and there are no short-term plans to increase it.

The company's equity also includes the share premium reserve, the development fund, the contractual reserve, and other reserves. The share premium reserve contains funds that were transferred by the government during FMO's financial restructuring in 1991. The development fund includes the annual budgetary allocations made by the state. The annual contributions, which ended in 2005, increased the balance of the fund to €658 million. The contractual reserve includes the share of the annual profit that FMO is obliged to allocate under the terms of the 1998 agreement. The remainder of FMO's net profit, after deductions for the proposed dividend, is added to other reserves.

Table 3

FMO Financial Ratios

	2008	2007	2006	2005	2004	2003	2002	2001
Profitability (%)								
Revenues/average assets	6.6	8.0	8.7	6.4	7.0	6.5	6.4	6.3
Net interest income/average assets	3.3	4.1	3.9	3.8	4.5	4.7	5.2	5.3
Non-interest expense/average assets	1.8	2.1	2.0	2.0	2.0	2.1	2.1	1.7
Pretax profits/average assets	1.2	4.7	7.1	4.8	3.1	1.8	0.6	(0.1)
Net profit/average assets (ROA)	1.5	4.2	5.8	3.5	2.1	1.3	0.3	0.3
Return on equity (ROE)	4.0	9.3	13.2	8.5	4.9	2.9	0.7	0.7
Net interest income/revenues	50.6	51.4	45.3	59.3	63.2	72.3	80.5	83.2
Non-interest expense/revenues	26.5	25.7	23.4	30.7	28.4	31.7	32.3	27.6
Provisions/revenues	59.3	17.8	(3.1)	(5.9)	27.9	40.3	57.6	74.6
Pretax profits/revenues	17.9	58.5	81.4	75.3	43.7	28.0	9.6	(2.2)
Revenue/employee (000 €)*	841.8	843.3	902.4	660.6	642.3	533.7	492.6	560.4
Net profit/employee (000 €)*	193.2	445.1	598.6	361.5	189.6	105.1	23.8	26.0
Liquidity (% of assets)								
Cash and deposits	12.9	6.9	5.0	16.0	8.1	25.1	24.0	15.7
Net loans	47.2	47.5	47.6	42.6	48.0	48.5	56.9	64.2
Capital (%)								
Capital/assets	33.6	44.0	47.0	40.8	42.5	41.9	46.3	42.3

Table 3

FMO Financial Ratios (cont.)								
Capital/loans	71.3	92.6	98.6	95.8	88.6	86.4	81.4	65.9
Dividend payout ratio	4.6	2.1	1.0	0.3	0.6	1.1	5.0	5.4
Asset quality (%)								
Loan write-offs/average loans	0.4	0.0	0.9	1.4	3.6	3.4	2.7	0.4
Provisioning for loans/average loans (gross)	6.1	2.0	(0.7)	(1.2)	3.1	1.9	2.3	5.1
Provisioning for equity/average equity investments	7.0	3.3	1.4	4.5	2.8	3.5	9.1	19.3
General provisioning/average assets	0.0	0.0	0.0	0.0	0.0	1.2	1.3	(0.9)
Employees	249	236	224	203	197	196	192	164

*Assuming constant headcount throughout years.

Ratings Detail (As Of October 1, 2009)*	
Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden N.V.	
Issuer Credit Rating	AAA/Stable/A-1+
Senior Unsecured (122 Issues)	AAA
Issuer Credit Ratings History	
18-Jul-2000	AAA/Stable/A-1+
Default History	
None	

*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.

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