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Fixed Income Analysis

CREDITO REAL S.A.B. DE C.V, SOFOM

Barita Investments Limited
15 St. Lucia Way, Kingston
Tel #: 1-888-429-5333

Company Overview

Credito Real, S.A.B. de C.V., SOFOM is a leading Non-Bank Financial Institution (NBFI) in Mexico, with a focus on consumer lending. The Company has a diversified and scalable lending business platform in five main business lines: payroll loans, durable goods loans, small business loans, group loans and used car loans. Credito Real offers products mainly to the low- and middle-income segments of the population, which historically have been underserved by other financial institutions.

Executive Summary

Credito Real, S.A.B. de C.V., SOFOM, E.R. provides consumer financing services with an emphasis on personal loans, traditional credit, credit to suppliers and return on assets services. With the advent of the COVID-19 pandemic, the company has reported reduced gross and net interest income which is understandable in light of the macroeconomic backdrop which has deteriorated considerably across most nations, including Mexico. What we believe is peculiar, however, is that despite the pandemic and the shocks to the economy, the company's loan book has remained, for the most part, quite resilient. S&P notes that the company's main business line, payroll loans, is among the lowest risk interest income sources across the NBFI lending space. However, we note that despite the company's strong continued performing loans, interest income has fallen significantly which is peculiar since management notes they have not been lending at significantly reduced rates.

Simultaneously, we find that the company's cost of borrowing has declined much faster than we believe is appropriate when compared to interbank funding rates in Mexico. On balance, we believe Credito Real has underlying fundamental issues that increase the corporate's credit risk beyond what is reported by S&P.

Investment Positives

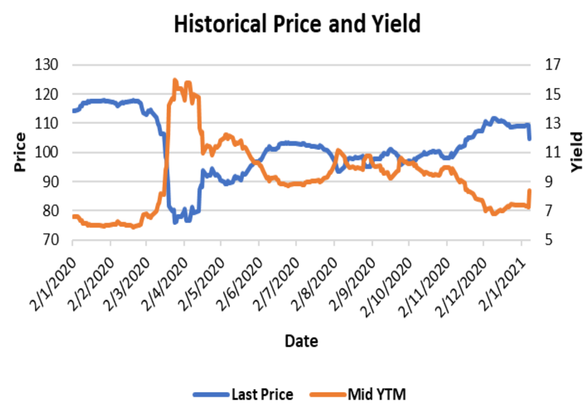
- **Payroll loans:** these loans are seen as a best-in-class segment of the lending space, particularly those associated with government agencies.
- **Company positioning:** Credito Real has a leading position in the non-bank payroll lending market.

Investment Negatives

- **Interest Income decline:** we believe the decline in interest income was too severe considering the robust performing loans on the company's balance sheet**.**
- **Interest Expense too low:** Despite a surge in debt, interest expense is unusually low, driven by funding costs which declined significantly faster than what we noted in the interbank funding rates.
- **Negative operating cash flows:** Even prior to the pandemic, the company was reporting negative operating cash flow for years which is unsustainable, especially in light of the decline in income.
- **Low cash:** Cash position is still very low which suggests the company may need to tap increase its leverage again.
- **Cyclicality:** The COVID-19 pandemic continues to pose a threat, despite the vaccines creating a more optimistic future. Therefore, the macro factors which guide the company's performance can deteriorate if there are unexpected spikes in new cases as financials tend to move in tandem with the economic backdrop.

Sector:	Financial Services
Bond Name	CREAL 9.50% 2026
Credit Rating/Outlook (S&P)	BB/Stable
Maturity	February 07, 2026
Issue Size	US$400Mn
Rank	Senior Unsecured
Current Price (January 12, 2021)	US$107.87 / US$107.88 (Bid/Ask)
Yield to Maturity	7.59% / 7.36% (Bid/Ask)
Yield to Worst	7.24%
Call Option (worst call date)	February 7, 2025
Recommendation	**Underweight**

Financial Summary (Peso $)				
	2017	2018	2019	TTM
Net Interest Income	4.75 Bn	5.54 Bn	5.96 Bn	4.51 Bn
Non - Interest Income	1.07 Bn	708.06 Mn	798.55 Mn	948.60 Mn
Net Income	1.66 Bn	1.96 bn	1.98 Bn	1.06 Bn
Total Assets	41.91 Bn	49.56 Bn	61.59 Bn	73.95 Bn
Total Equity	14.77 Bn	15.94 Bn	16.06 Bn	17.78 Bn
Financial Ratios				
	2017	2018	2019	TTM
Net interest margin (%)	20.54	20.44	16.51	12.85
Non-Performing Loan (%)	1.35	1.70	2.10	1.80
Debt to Equity	1.60X	1.92X	2.58X	2.95X



Financial Performance - *All monetary values are in pesos unless otherwise stated*

Income

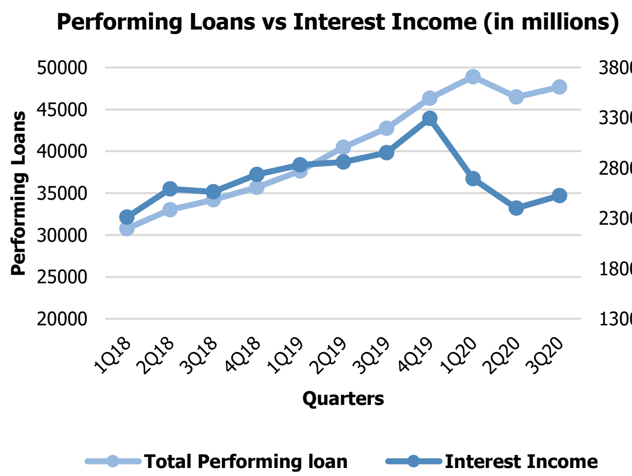
For the nine months ended September 30, 2020, Credito Real reported an interest income decline of -11.86% while reporting an interest expense increase of 0.26%. This decline in interest income matched against a slight increase in interest expense magnified net interest income decline, which fell sharply by -19.57%. For the quarter, the company reported a quarter over quarter growth in interest income (16.15%) and net interest income (11.89%), against an increase in interest expense of 24.73%. This indicates that on a quarter-by-quarter basis, the company's performance has improved but the increase in the cost of debt outpaces the increase in interest income.

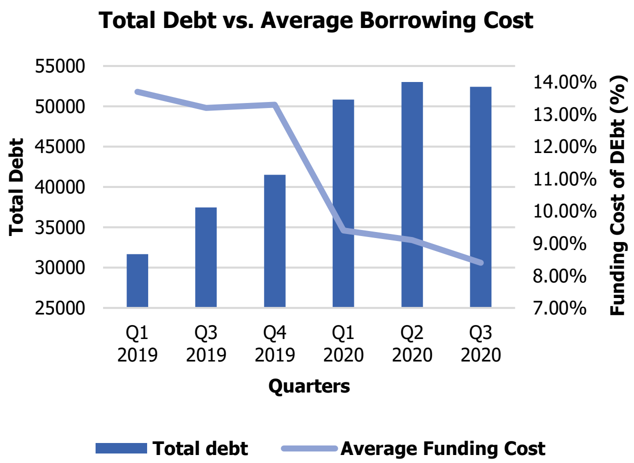
Despite the uptick, however, YoY results remain subdued with net interest income of just $911 million, presenting a YoY decline of -34.50%. Management has attributed this decline mainly to "softened economic dynamism" stemming from the COVID-19 pandemic.

On a net basis, other operating expenses totaled -2.02 billion for the 9 months relative to -$2.20 billion in the prior period last year, representing an improvement to the tune of -8.18%. Against the sharper decline in the company's core business, however, this improvement in cost was minor. Consequently, Operating profit for the period fell as much as -59.60%. This was further magnified by subsidiary related losses which resulted in net earnings declining YoY by -59.06%, moving from $1.55 billion to $635.70 million. On a quarter over quarter basis, the company reported improved net earnings of 198.90 million relative to 131.40 million in the prior year. Interestingly, however, despite the increase in net interest income, the company reported higher expenses which eroded operating profit (-7.97% QoQ). Consequently, improved net profit for the quarter was fostered by the company's associate companies which reported earnings of $32.30 million relative to a loss in the previous quarter of -$47.70 million.

Debt

Within the context of the pandemic, the company's revenue and earnings are justified. However, a closer analysis of the company's balance sheet raises questions about the legitimacy of its performance. As indicated in the chart below (performing loans vs interest income), interest income has fallen sharply since the start of FY2020 while "performing loans" continue to increase. Since gross interest income is driven by performing loans, we do not believe the interest income decline (which we believe is drastic) is justified. In fact, the decline is sharp and started as early as in the first quarter, at the initial stages of the pandemic. Consequently, interest income is now in line with the company's 2Q 2018 (more than 2 years ago) - at which point, performing loans were significantly lower. Management has indicated that they are not offering reduced rates on loans which creates some skepticism about the company's real income generation. By reducing its interest income, the company is able to report lower ECL which has a net positive effect. Additionally, the company's balance sheet grows which in turn gives the impression of stability which paints a "favorable" post-pandemic picture. This "positive" outturn is then further supported by a reduction in interest cost (reduces interest rates in general results in reduced interest income and interest expense).



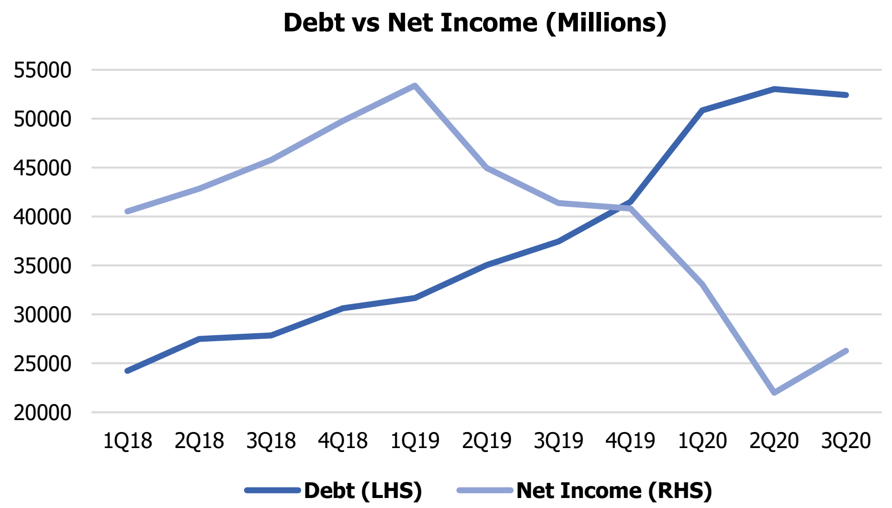


As it relates to our qualms about the decline in interest cost (average borrowing cost as indicates in the chart above), the company has reported consistent growth in its debt load, particularly in 2020 given the backdrop of the COVID-19 pandemic. Management notes that the company's significantly reduced cost of funding, which is now at 8.4% (-480 bps. YoY and -70 bps. Q/Q), is due to both the environment of lower interest rates and an adequate risk profile supported by the stability of its operations. However, the decline in funding is significantly greater than the decline in the interbank average funding rate as seen in the robust contraction of the spread since the beginning of 2020, as indicated in the table below. We have a particularly high concern about the rates charged between Q4 2019 and Q1 2020 considering the company reported a decrease in its average funding cost of -3.9%, which is a significant reduction over just a single quarter. Conversely, the interbank funding average only declined by -0.58% in that period. Consequently, interest expense has remained largely flat despite the considerable increase in the debt load (22.49% between Q1 2020 and Q4 2019) which leads us to believe the company's reported interest expense is less than it should be.

Credito Real Debt Cost Profile vs Mexico interbank costs	Q3 2020	Q2 2020	Q1 2020	Q4 2019	Q3 2019	Q1 2019
Average Cost of Funds	**8.40%**	**9.10%**	**9.40%**	**13.30%**	**13.20%**	**13.70%**
Change	-0.70%	-0.30%	-3.90%	0.10%	-0.50%	
Mexico's interbank average funding rates	**4.76%**	**5.91%**	**7.10%**	**7.68%**	**8.17%**	**8.28%**
Change	-1.15%	-1.19%	-0.58%	-0.49%	-0.12%	
Spread	**3.64%**	**3.19%**	**2.30%**	**5.62%**	**5.03%**	**5.42%**
Increased Debt, Flat cost of Debt	**Q3 2020**	**Q2 2020**	**Q1 2020**	**Q4 2019**	**Q3 2019**	**Q1 2019**
Debt	**52,433.70**	**53,028.80**	**50,845.00**	**41,511.20**	**37,466.80**	**31,668.80**
Interest Expense	**1,107.90**	**1,181.20**	**1,079.90**	**1,311.00**	**1,195.00**	**1,065.90**

Simultaneously, the debt becomes less sustainable as it increases, and interest income remains subdued. We note in the chart below that debt has been trending upwards while income has, for the most part, been on a downward trend, even before the pandemic - starting as early as the first quarter of 2019. If we also look at the company's most recently released cash flow statements (not provided for quarterly data), operating cash flow has been negative for the last three financial years. This coupled with a declining income statement (while interest income and interest expense data that does not reflect the company's performing loans), the significant growth in debt and questionable decrease in the cost of debt when compared to Mexico's interbank average funding rates, leads us to believe the corporate has an operation not optimal to drive the growth necessary to effectively manage its debt.

Despite not submitting quarterly cash flow statements, we can infer from the increase in debt and the decline in income that operating cash flow remains negative. This is further supported by the company's cash position which has declined from $1.18 billion as at December 2019 to $399.60 million based on its Q3 balance sheet, notably despite debt injection. Considering these factors, we anticipate that the company may need to again tap the debt market which would further increase its leverage and reduce its debt servicing capabilities.



Industry Analysis/Country Analysis

Industry Analysis

The Non-Bank Financial Intermediaries (NBFI) industry over the period has suffered from increased asset quality deterioration on the heels of the pandemic. Going forward, the recovery of each company's balance sheet and income statement will significantly reflect its exposure by sector. Some sectors have been affected more than others by the pandemic and therefore present heightened risk.

Against that backdrop, Credito Real and AlphaHolding are best positioned as it relates to loan exposure, largely due to their high exposure to the "payroll to government employees" sector (see heat map table) which, according to the S&P, remains one of the lowest risk sectors within the NBFI industry as the government has opted not to discontinue payroll for public sector workers despite the ongoing pandemic.

Mexican NBFIs' Exposure By Sector

Commercial loan distribution	Unifin	Mexarrend	Engencap	Crédito Real	Operadora de Servicios Mega	AlphaHolding
Agro			1%		23%	
Clothing		3%		1%		
Commerce	10%	2%		2%		
Construction	6%	2%	4%	1%		
Energy		0%				
Financial institutions		6%		3%		
Food & Beverages		3%	10%	1%		
Industrials		2%	8%	1%	20%	
IT		4%			6%	
Manufacturing	32%		9%	1%		
Mining			3%			
Oil & Gas			2%			
Ports & railroads/transport	6%	10%	29%	2%	16%	
Public sector					20%	
Services/tourism	46%	19%	19%	7%	10%	
Steel & construction materials		13%	13%			
Payroll to government employees				62%		95%
Other		35%	1%	21%	5%	5%
High-risk exposure	**52%**	**45%**	**72%**	**10%**	**66%**	
Moderate-risk exposure	**48%**	**45%**	**18%**	**26%**	**28%**	**5%**
Low-risk exposure	**0%**	**10%**	**10%**	**64%**	**6%**	**95%**

Source: S&P Global Ratings.

In light of the aforementioned and the largely high-risk exposure of the industry on a whole, we believe Credito Real and AlphaHolding are best positioned within this industry. Notwithstanding, the company's financial results, as previously highlighted, hold significantly more weight in our recommendation given that industry trends result from a macro view of companies and do not fully capture the specifics of each company's operations within the context of the industry.

Country Analysis

As of August 31, 2020, S&P Global Ratings affirmed its March 26, 2020 downgrade of Mexico from a BBB+ to a BBB credit rating with a negative outlook. The negative outlook reflects the possibility of the sovereign being downgraded within the next 12 to 24 months as a result of ineffective policy execution, a potential weakening of public finances and the likelihood of increased off-budget contingent liabilities. The effects of the deteriorating economic backdrop have been magnified by increased oil price shocks which have resulted in a narrowed non-oil tax base coupled with insufficient accumulated savings in the sovereign's oil stabilization fund (should be used to fund fiscal needs during periods of reduced oil cash inflow).

The downgrade reflects the expectation that the sovereign will register real GDP per capital below peers within a similar economic development band. This view is underpinned by subdued business confidence despite the current administration's outlining of an infrastructure investment initiative in November 2019. As the sovereign continues to rely on oil, the infrastructure developments mentioned by the administration, continue to have a weak potential given current oil prices have remained subdued on a YTD basis. This increases the difficulty in securing the necessary investments in refineries and pipelines. Given the aforementioned, S&P anticipates a widened public deficit coupled with an increased debt load and a weaker peso over the forecasted period through to 2023. These expectations remain at the fore but on a positive note, the sovereign has some cushioning in the form of a floating currency that buttresses external financing constraints coupled with a slim net external debt which averages approximately 30% of current account inflows. Furthermore, since the sovereign is a net oil importer, a decline in oil prices does benefit Mexico's current and trade accounts.

Company Credit Assessment - *S&P*

In its latest rating dated March 27, 2020, S&P Global Ratings downgraded the Local Currency Long Term credit from "BB+" to "BB" with a stable outlook. This rating guide reflects the company’s leading position in Mexico's non-bank payroll-lending market, a recurrent internal capital generation that supports capitalization levels and seemingly stable collection metrics despite the pandemic.

Weaknesses noted include the following:

- Pressured net interest margin and low payroll loan originations during the last few quarters
- Significant economic challenges due to the COVID-19 pandemic, especially to expand the small to mid-size enterprise (SME) lending segment without weakening asset quality metrics and
- Transactional and operational risks of operating with government entities.

The stable outlook assigned to Credito Real, S.A.B. de C.V., SOFOM, E.N.R. reflects S&P's expectation that the company will remain the largest non-bank financial institution in the Mexican payroll lending space as well as its increasing penetration of the US and Costa Rica, though they remain a small part of the company's business.

Risk

Default Risk: Despite the company's strong industry positioning, Credito Real's financials display tightened economic conditions across the board and in our view, the risks are more elevated than what appears to be the case, given our analysis of the company's interest income and interest expense mismatch when considered relative to the company's balance sheet, specifically, the growth seen in the company's performing loans.

Relative Valuation

As at January 8, 2021, Credito Real traded with a spread over the risk-free rate (G-Spread) of 666bps relative to its listed peers, as defined by Bloomberg, with an average G-Spread of 528bps which indicates that Credito Real is providing a higher yield relative to the risk-free rate compared to its closest listed peers. As indicated in the chart below, the spreads have declined considerably since peaking in the March to April period. At present, we believe the company's financial position, however, poses several red flags that must be addressed before we can recommend this bond to clients.

Recommendation - *Underweight*

We recommend that investors do not purchase this bond at this time. Our recommendation is underpinned by the company's deteriorating earnings, consistently negative operating cash flow and net interest income generation we believe to be questionable. The main positive for the credit is its industry positioning, specifically the company's exposure to less risky sectors as indicated by S&P. Nonetheless, the macro-environment remains fickle because of the pandemic and can deteriorate further which may create additional headwinds for loan portfolio growth and consequently, interest income growth. On balance, we believe the risk in owning this bond is too elevated to recommend.