

## Research Update:

# Inversiones La Construcción Assigned 'BBB+' Credit And Debt Ratings, Outlook Negative On Chile's Higher Economic Risks

January 24, 2022

## Overview

- We've assigned a 'bbb+' group credit profile (GCP) to Inversiones La Construcción (ILC) group. It reflects its sound business and revenue diversification, as well as its likely adequate profitability and capitalization. The GCP also reflects still manageable economic risks in Chile, although they have been increasing due to the effects of the pandemic and mid-term uncertainties. On the other hand, the banking operations depend heavily on wholesale clients.
- Additionally, we believe the holding company (HoldCo) benefits from stable dividends from its several operating subsidiaries, that provide a comfortable buffer to meet its financial obligations. As result, we rate the HoldCo at the same level as the GCP. Thus, we're assigning our 'BBB+' long-term issuer credit rating to the Chile-based HoldCo, Inversiones La Construcción.
- The negative outlook on our rating on ILC reflects the negative trend in our economic risk in our assessment of Chile's financial sector due to persistent pressures amid the pandemic and mid-term uncertainties.
- ILC plans to issue senior unsecured notes for about \$400 million with a tenor of about 10 years. ILC will mainly use the proceeds to pay down its current debt. The rating on the proposed notes is the same as that on the issuing entity, ILC, because of the notes' seniority.

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## Rating Action

On Jan. 24, 2022, S&P Global Ratings assigned its 'BBB+' long-term issuer credit rating on ILC. The outlook is negative. In addition, we assigned our 'BBB+' issue-level rating to ILC's proposed senior unsecured notes.

## Rationale

The rating on ILC reflects its strong business position thanks to its wide business diversification and stability, leading market positions of its key operating subsidiaries, as well as favorable profitability prospects for 2022-2023. In addition, we expect ILC to maintain adequate capital base. We also observe risks mitigated by the group's wide array of businesses and adequate composition of the investment portfolios. We also base our assessment on our expectation that the group will continue growing conservatively in the business segments where it has expertise. On the other hand, ILC's banking operations are mainly funded by wholesale sources, mostly debt issuances, a disadvantage compared with other financial institutions in Chile. We view the group's liquidity as adequate. ILC benefits from stable earnings from the pension business; however, potential changes amid ongoing discussions in its structure could affect the group's credit fundamentals in the next few years.

We use our Banking Industry Country Risk Assessment (BICRA) economic and industry risk scores to determine the group's anchor, the starting point in assigning its GCP. Our anchor for financial institutions operating in Chile is 'bbb+'. See "Banking Industry Country Risk Assessment: Chile", published Aug. 27, 2021.

**ILC is one of the largest Chilean financial conglomerates.** The Chilean Chamber of Construction (CChC) is the ultimate shareholder of ILC, which provides brand recognition to the group. ILC underwrites insurance businesses in Chile through its operating subsidiaries, Confuturo, Consalud and Vida Camara; provides banking products and services through Banco Internacional, and healthcare services through RedSalud. ILC also generates a large portion of its revenue through its non-consolidated subsidiary, AFP Habitat, a large pension fund manager operating in Chile, Peru, and Colombia. As a result, ILC benefits from a wide range of business lines, which also contribute to the groups' earnings stability. Insurance and healthcare providers contribute about 30% of earnings, the bank 20%, and AFP Habitat about 50%. In addition, its insurance subsidiaries hold competitive advantages as the leading players in their markets and because their distribution model is based on controlled channels, which also provides business stability. AFP Habitat is the second-largest pension fund administrator in the Andean region after Sura, with a leading position in Chile (market share of 29% in terms of assets under management [AUM]), and increased presence in Peru and Colombia (10% and 13% of market shares, respectively).

Confuturo is one of the largest underwriters of pensions "rentas vitalicias" in Chile. The insurer aligned its distribution model in recent years to support a growth strategy through greater focus on profitability than on growth. Consalud and Vida Camara provide mandatory and complementary health insurance policies, which is the business line bearing the brunt of the pandemic since 2020, although its profitability should rebound starting in 2023. Banco Internacional is a small player in the Chilean banking system with focus on corporate lending, and it has consistently contributed to the group's earnings. ILC's has a stake in AFP Habitat through its joint venture agreement with Prudential Financial Inc., under which both shareholders have a co-controlling agreement. However, we expect ILC to continue receiving dividends from AFP Habitat on a constant basis thanks to its stable cash flows, geographic diversification, and the well-established shareholder agreement.

**ILC's profitability has been partly resilient to the effects of the pandemic thanks to its business diversification.** Profits were pressured until 2020 primarily due to higher health insurance claims and lower investment capital gains amid unstable capital markets, and because of the

higher insurance reserve requirements following the update of mortality tables in Chile. Therefore, ILC's return on equity (ROE) averaged 8.7% in 2018-2020. However, we estimate ROE has rebounded in 2021 to about 13%, and that it will reach 10%-13% in 2022-2023 mainly because new insurance reserves requirements have decreased, while Consalud will resume generating profits amid lower claims under the mandatory health insurance.

**We believe that expertise of ILC and its subsidiaries' senior management will help the group cope with the hit to its profits due to the pandemic.** We also expect ILC to continue benefiting from increasing economies of scales and commercial synergies between its operating subsidiaries. All these factors, along with the group's leadership position, extensive customer base, and diversified revenue sources, will allow it to maintain a strong business position, in our opinion.

**ILC has capacity to boost capital due to its diversified and stable dividend sources, which gives the group higher financial flexibility.** In addition, we expect the group to keep an average risk-adjusted capital (RAC) ratio of 6.5% for 2022-2023. We expect the group to support its asset growth through prudent dividend policies during the next few years. Our base-case scenario also incorporates the following assumptions:

- Chile's real GDP growth of 11.4% in 2021, and averaging 2.5% in 2022-2023.
- Earnings diversification, with Habitat, Confuturo, and Banco Internacional contributing the bulk of it.
- Key subsidiaries to continue upstreaming dividends.
- Adequate profitability with ROE reaching 10%-13% in 2022-2023.
- Dividend payout ratios of about 50% in line with the practice in recent years.
- No significant M&A activity or rise in debt.

We believe ILC has good quality of capital because its equity consists of paid-in capital, reserves, and retained earnings. Moreover, the group benefits from strong earnings quality, reflected in its revenue structure that mainly consists of net interest and insurance income.

**We expect ILC to maintain a conservative growth strategy during the next few years with focus on its core business segments.** The bank has improved its underwriting practices and credit risk management in recent years. As a result, its nonperforming assets (NPAs) have significantly improved since 2019, although still remain slightly higher than industry average. Charge-offs have remained below the industry levels, because a large portion of the bank's loan portfolio is well-collateralized, which mitigate credit losses. The bank's credit portfolio is diversified by lending sectors and single names--20 principal obligors make up 14% of the portfolio, in line with the composition of other large players in the country. In addition, insurance subsidiaries benefit from risk diversification, given the retail nature of their business base, which mainly consists of pensions and health insurances. We also believe the group's investment portfolios are adequately diversified by single obligor, and most of securities have solid credit quality. Although the business mix is somewhat complex, we view the risk of unexpected losses arising from the pension business to be limited and continue decreasing because AFP Habitat is widening its diversification.

**The bank is mainly funded through wholesale funding, mostly debt issuances, which we view as less stable.** Funding structure compares unfavorably with those of domestic financial institutions that increase their lending through customer deposits. However, Banco Internacional has been diversifying its funding base recently by issuing multiple bonds in the domestic market with diversified maturity profiles.

**We believe ILC and its subsidiaries have adequate levels of liquidity to cover its short-term obligations.** The group's broad liquid assets to total short-term wholesale funding ratio has been around 1.1x since 2018. We believe the insurance subsidiaries have sound levels of liquidity and good earnings capacity to cover insurance-related liabilities and financial obligations.

**We rate ILC at the same level of the group's 'bbb+' GCP because it benefits from diversified and very stable sources of income in the form of dividends from a wide range of businesses.**

Therefore, we believe businesses are sufficiently diverse and independent, such that a hypothetical suspension of cash flows from any of ILC's operating entities wouldn't compromise its financial position and ability to honor its obligations. We expect the HoldCo to continue receiving more than sufficient cash inflows to meet its obligations because dividends from its subsidiaries would cover more than 5x of its interest expenses.

## Outlook

The negative outlook on ILC for the next 24 months reflects downside risks until Chile's economy fully recovers and prospects for the medium term become clearer amid potential amendment of the constitution, the polarized political landscape after presidential election, and/or other global developments.

## Upside scenario

We could revise the outlook on ILC to stable if the pressures on the financial system decrease, prompting us to revise the negative trend in the economic risk in Chile's BICRA to stable, while all other fundamentals remain unchanged.

## Downside scenario

We could downgrade ILC if we assign a higher economic risk score in Chile's BICRA. In addition, we could lower the rating if diversification of dividends sources narrows, or if ILC increases its debt or its subsidiaries upstream lower dividends, reducing HoldCo's debt service coverage below 4x.

## Ratings Score Snapshot

Issuer credit rating	BBB+/Negative/--
GCP	bbb+
Anchor	bbb+
Business position	Strong (+1)
Capital and earnings	Adequate (0)
Risk position	Adequate (0)

Funding and liquidity	Moderate and Adequate (-1)
Comparable rating analysis	0
Support	0
ALAC support	0
GRE support	0
Group support	0
Sovereign support	0

## Related Criteria

- Criteria | Financial Institutions | General: Financial Institutions Rating Methodology, Dec. 9, 2021
- Criteria | Financial Institutions | Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Dec. 9, 2021
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Financial Institutions | General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- Criteria | Insurance | General: Refined Methodology And Assumptions For Analyzing Insurer Capital Adequacy Using The Risk-Based Insurance Capital Model, June 7, 2010

## Ratings List

### New Rating

#### Inversiones La Construccion S.A.

Analytical Factors	bbb+
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#### Inversiones La Construccion S.A.

Senior Unsecured	BBB+
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### New Rating; CreditWatch/Outlook Action

#### Inversiones La Construccion S.A.

Issuer Credit Rating	BBB+/Negative/--
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