

Rating Action: Moody's affirms ratings of Banese, negative outlook

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New York, July 10, 2020 -- Moody's Investors Service, ("Moody's") has today affirmed all ratings of Banco do Estado de Sergipe S.A. (Banese). Banese has a Ba2/Not Prime for local currency, long- and short-term deposit ratings, and Aa3.br/BR-1 for long and short-term Brazilian national scale deposit ratings. Banese's has a ba2 baseline credit assessments (BCA), which was also affirmed. The outlook on Banese's Ba2 local currency deposit rating remains negative and is stable on the Ba3 long-term foreign currency deposit rating.

A full list of the affected ratings and assessments of Banco do Estado de Sergipe S.A. is provided at the end of this press release.

RATINGS RATIONALE

In affirming Banese's ratings, we acknowledge the bank's entrenched retail franchise in its regional market, which is supported by a stable market share of core deposits in excess of 30%, largely sourced from the state government's civil servants. Banese's ratings and assessments incorporate strong liquidity metrics as well as recurring earnings generation, which ensures the replenishment of its capital. The negative outlook on the ratings is maintained to reflect the challenges to Banese's asset quality and profitability deriving from rapid loan growth and exposure to business segments that are more vulnerable to the downturn.

The coronavirus outbreak will cause a sharp contraction in the Brazilian economy in 2020 and deterioration in asset quality and profitability of banks, including Banese. Banese's loan delinquency has gradually increased from a 2.5% average ratio reported between 2014-2018, to 3.5% in December 2019 and March 2020, the highest ratio in the bank's 10-year financial history. Because of its recent rapid growth and despite the 35% share of low-risk payroll loans in its portfolio, Banese's loans will season under more adverse credit condition, causing non-performing loans (NPL) to increase, including its SME loan book, which is already experiencing punctual delinquencies. In addition, Banese has deferred payments on 7% of its loan book to accommodate borrowers' repayment capacity during the pandemic. While this measure may defer credit losses, a prolonged economic disruption will likely weaken asset quality further with direct effect on profitability and capital, in the event Banese has to raise loan loss provisions materially.

At the same time, Banese's Moody's adjusted tangible common equity to risk weighted assets returned to the 9% level by 4Q2019, after declining to 6.6% following material negative adjustments on equity made in June 2019, and which triggered Moody's negative outlook on the ratings. The adjustments reflected actuarial liabilities at Banese-sponsored private pension fund, Instituto Banese de Seguridade Social -- Sergus. Besides halving the amount of those negative adjustments, the bank's capital position was further reinforced by earnings retention in the period. Payout ratio in 2019 was only 24% in 2019, against 40% in 2018.

In 1Q20, the bank's net income dropped 13% over one year prior, due to higher credit costs and modest business growth. Results in 2019 were also affected by certain non-recurring gains related to insurance fees and recoveries. The 65% increase in credit costs resulted from a specific SME default, and any recovery on the loan will be used to increase provisions for credit losses that are expected to rise from the pandemic.

A key credit strength of the bank's ratings and assessments refers to its granular funding base with low dependence on market funds and strong liquidity ratio, historically above 35% of tangible banking assets.

Banese's Ba2 global local-currency deposit rating is aligned to a ba2 baseline credit assessment, and therefore, does not incorporate any support assessment from its shareholder, the State Government of Sergipe, nor does it benefit from systemic support, given its small size.

Moody's regards the coronavirus pandemic as a social risk under its ESG framework, given the substantial implications for public health and safety. Moody's does not apply any corporate behavior adjustment to Banese, as concerns about risk management and corporate governance are included in the financial scores. Corporate governance, however, remains a key credit consideration at Banese and requires ongoing monitoring. Please see Moody's Environmental risks and Social risks heatmaps for further information.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

Banese's rating outlook could return to stable if the bank is able to preserve its profitability in its regional market, maintaining adequate capital and improving asset-risk metrics.

The BCA and ratings could be downgraded if the bank's asset quality weakens materially at the same time that profitability declines because of higher provisioning needs as new loans will season under a more difficult economic scenario.

METHODOLOGY USED

The principal methodology used in these ratings was Banks Methodology published in November 2019 and available at https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1147865. Alternatively, please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

Banco do Estado de Sergipe S.A. is headquartered in Aracaju, Brasil. As of March 2020, Banese had total assets of BRL 6.3 billion (USD 1.2 billion) and shareholders' equity of BRL 491 million (USD 95 million).

LISTED OF AFFECTED RATINGS AND ASSESSMENTS

The following ratings and assessments of Banco do Estado de Sergipe S.A. were affirmed:

- .. Long-term local currency bank deposit rating affirmed Ba2, outlook negative
- .. Short-term local currency bank deposit rating affirmed at Not Prime
- .. Long-term foreign currency bank deposit rating affirmed at Ba3, outlook stable
- .. Short-term foreign currency bank deposit rating affirmed at Not Prime
- .. Brazilian long-term local currency bank deposit rating affirmed at Aa3.br
- .. Brazilian short-term local currency bank deposit rating affirmed at BR-1
- .. Long-term local currency counterparty risk rating affirmed at Ba1
- .. Short-term local currency counterparty risk rating affirmed at Not Prime
- .. Long-term foreign currency counterparty risk rating affirmed at Ba1
- .. Short-term foreign currency counterparty risk rating affirmed at Not Prime
- .. Brazilian long-term local currency counterparty risk rating affirmed at Aaa.br
- .. Brazilian short-term local currency counterparty risk rating affirmed at BR-1
- .. Long-term counterparty risk assessment affirmed at Ba1(cr)
- .. Short-term counterparty risk assessment affirmed at Not Prime(cr)
- .. Baseline Credit Assessment affirmed at ba2
- .. Adjusted Baseline Credit Assessment affirmed at ba2
- Outlook negative (m)

Moody's National Scale Credit Ratings (NSRs) are intended as relative measures of creditworthiness among debt issues and issuers within a country, enabling market participants to better differentiate relative risks. NSRs differ from Moody's global scale credit ratings in that they are not globally comparable with the full universe of Moody's rated entities, but only with NSRs for other rated debt issues and issuers within the same country. NSRs are designated by a ".nn" country modifier signifying the relevant country, as in ".za" for South Africa. For further information on Moody's approach to national scale credit ratings, please refer to Moody's Credit rating Methodology published in May 2016 entitled "Mapping National Scale Ratings from Global Scale Ratings". While NSRs have no inherent absolute meaning in terms of default risk or expected loss, a historical probability of default consistent with a given NSR can be inferred from the GSR to which it maps back at that

particular point in time. For information on the historical default rates associated with different global scale rating categories over different investment horizons, please see

https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1216309 .

REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found at: https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_79004.

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Regulatory disclosures contained in this press release apply to the credit rating and, if applicable, the related rating outlook or rating review.

Moody's general principles for assessing environmental, social and governance (ESG) risks in our credit analysis can be found at https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1133569 .

At least one ESG consideration was material to the credit rating action(s) announced and described above.

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