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Research Update:

First Nations Finance Authority Assigned 'A-' Rating; Outlook Stable

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Research Update:

First Nations Finance Authority Assigned 'A-' Rating; Outlook Stable

Overview

- We are assigning our 'A-' long-term issuer credit rating to not-for-profit lender First Nations Finance Authority.
- The rating reflects our view of the authority's solid competitive position in a niche market of providing long-term fixed-rate financing, good asset quality that prudent structural mechanisms enhance, support for operations from the federal government, and low leverage.
- The stable outlook reflects our expectation that, in the next two years, the federal government will continue to support the authority and that it will continue to build its loan book while maintaining its solid competitive market position.

Rating Action

On Dec. 18, 2014, Standard & Poor's Ratings Services assigned its 'A-' long-term issuer credit rating to not-for-profit lender First Nations Finance Authority (FNFA). The outlook is stable.

Rationale

The rating reflects our view of the authority's solid competitive position in a niche market, good asset quality that prudent structural mechanisms enhance, support for operations from the federal government, and low leverage. We believe that the current low profitability and concentration of the loan portfolio in a relatively small number of borrowing members somewhat offset these strengths.

We believe that the FNFA has a solid competitive position in a niche market because of its ability to provide loans of longer duration. Historically, access to long-term fixed-rate capital has been a challenge for many First Nations. Access has improved in recent years, but some impediments to lenders remain, such as security or lenders' mandates. By statute, land or buildings on First Nations territories cannot be pledged as collateral. The authority is mandated to lend to councils, which other lenders are not. Furthermore, some First Nations have capital needs (and debt repayment capacity) that exceeds lenders' ability or willingness to supply capital. Total capital needs from 634 Canadian First Nations are estimated to easily exceed C\$5 billion. Those needs are typical of all Canadian communities: infrastructure (water and roads), community-owned housing, equipment, and economic development. Because of these favorable demand and supply conditions, we believe that the authority

does not and will not face pricing pressures. We also do not expect an influx of new lenders into this part of the loan market.

Prudent structural mechanisms protect asset quality, in our opinion. Those structural elements include a rigorous qualification process for all borrowing members, revenue interception, prudent discounting of pledged revenues, and the authority's intervention powers. For example, on intervention powers, the First Nations Fiscal Management Act authorizes the authority, where loan repayment is in question, to replace the chief and council, thereby assuming full treasury and budgetary powers over that community. As well, the credit quality of the pledged revenue streams is good, in our view, because the majority consists currently of provincial revenue-sharing agreements, land lease contracts, and federal right-of-way agreements.

The FNFA was created by federal statute and the government has supported it since its inception. Owing to its small loan portfolio size and start-up costs, the authority has produced operating deficits in the past two fiscal years. Grants from the federal government have covered the deficits, and we expect the government will continue to do so until the loan portfolio grows to achieve self-sufficiency.

Leverage metrics are what we view as favorable. At the end of fiscal 2014, the FNFA's capital base was about C\$10.7 million, consisting of equity of C\$300,000 and reserves of C\$10.4 million. Borrowing, at that time, stood at C\$54.4 million or 5.2x the capital base. The authority's leverage metrics are more favorable than those of other non-profit peers. We expect its leverage levels will increase as its loan portfolio grows. We do not expect any significant sustained increase in reserves until the loan portfolio reaches self-sufficiency. As well, we believe a substantial increase in equity is unlikely during our two-year outlook horizon.

Owing to the size of its loan portfolio, the FNFA's profitability is weak, in our opinion. The revenues from administrative charges on loans to members are not large enough to support operations. For the 2014 fiscal year, the authority incurred a deficit of C\$659,411, up from the previous fiscal year's deficit of C\$469,409. Net interest income, however, was positive in 2014 and double that of the previous fiscal year. For fiscal 2014, net income was negative 1.3% of average assets, which was an improvement from the negative 2.6% the previous fiscal year. As well, the FNFA has been incurring one-time start-up expenses. We expect that profitability measures, however, will improve as the loan portfolio expands. For fiscal years 2015 and 2016, we expect the authority to balance its operations.

The FNFA does face concentration risk. With a mandate to lend to First Nations, the authority's loan book is and will be very concentrated by type of borrower, namely First Nations' councils. Borrowing members' financial strength and sound financial practices mitigate this risk somewhat, in our view. Geographically, loans are concentrated in British Columbia because the majority of members are in the province. We expect that geographical concentration will improve in the future as more councils in other provinces

become members. Currently, 147 First Nations across Canada have become scheduled to the FNFA Act, of which 84 are in British Columbia.

In accordance with our government-related entity criteria, we view the likelihood of the FNFA receiving extraordinary government support as "moderately high" based on our assessment of the "strong" link with the federal government, which the government's funding support demonstrates. We believe that the FNFA plays an "important" role because of the need for First Nations' access to capital by to fund infrastructure renewal, the authority's statutory mandate to lend to approved First Nations, and the political importance of First Nations issues, including natural resource development.

We have also used our "Principles Of Credit Ratings" in conjunction with Financial Institutions' "Rating Finance Companies" and "Rating Government-Related Entities: Methodology And Assumptions" as our criteria foundation for our analysis of FNFA's creditworthiness. We believe the Rating Finance Companies criteria cover all the fundamental aspects of the authority's credit profile because the criteria's rating factors line up well with the FNFA's key credit characteristics.

Liquidity

We believe that authority's liquidity is more than adequate. At fiscal year-end 2014, the FNFA's credit enhancement fund stood at C\$10 million and its debt reserve fund was C\$2.7 million. Both funds are held in cash or cash equivalents. Borrowing members prepay their loan obligations as pledged revenues that are owed to members are paid into a trusteed account before debt service payments are made, limiting the need for liquidity. In addition, FNFA has a revolving credit facility with a major Canadian bank totaling C\$100 million, of which C\$45 million is unused.

Outlook

The stable outlook reflects our expectation that the FNFA will continue to build its loan book in the next two years, which will add fee revenues and ultimately eliminate its operating losses; and that it will maintain its solid competitive market position. We also expect that the federal government will continue to support the authority. We could downgrade the FNFA if we were to downgrade Canada, or if the likelihood of extraordinary support changed to "moderate" or "low," material credit losses happen, or increased competition eroded the authority's market position. We could raise the rating if the likelihood of extraordinary support changed to "high" or greater or the FNFA profitability improved such that it was able to retain earnings and increase its capital.

Related Criteria And Research

Related Criteria

- Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010
- Rating Finance Companies, March 18, 2004

Ratings List

Rating Assigned

First Nations Finance Authority

Issuer credit rating

A-/Stable/--

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