

# Sparbanken Rekarne AB

Rating Update

## LONG-TERM RATING

**A-**

## OUTLOOK

**Stable**

## SHORT-TERM RATING

**N-1+**

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## RATING RATIONALE

Our 'A-' long-term issuer rating on Sweden-based Sparbanken Rekarne (SpR) reflects the bank's regional market and its 50% ownership by Swedbank AB. SpR focuses on private customers and small and medium-sized enterprises (SMEs) in Eskilstuna and Strängnäs counties in central Sweden, with a local population nearing 145,000 inhabitants. As with other savings banks, SpR has an arrangement with Swedbank, under which Swedbank provides material diversification of product offerings, shared IT costs and the opportunity to finance mortgage loans via Swedbank Hypotek AB. We view SpR's cooperation with Swedbank as significant as it supports earnings, market position, product offering, funding and liquidity. We also view Swedbank's ownership as positive for the credit rating. In our view, the ownership and return requirements of Swedbank have contributed to SpR having a slimmer capital structure than its savings bank peers across the Nordic region. Earnings metrics are somewhat weaker than those of similar savings banks when adjusted for SpR's higher leverage, and the bank's strong record on loan losses and impairment is expected to continue given low interest rates, despite signs of a slowing economy.

## OUTLOOK

Our stable outlook for SpR reflects expectations of growth in the bank's primary market, despite downside risks to the manufacturing sector. We expect the bank to continue its relationship with Swedbank and for Swedbank's creditworthiness to remain strong despite potential fines associated with money laundering. We include a notch of ownership support in the rating but expect that improvements in the standalone credit assessment would reduce the upside from ownership.

### POTENTIAL POSITIVE RATING DRIVERS:

- A rating upgrade is unlikely at this time given the current capitalisation and ownership.

### POTENTIAL NEGATIVE RATING DRIVERS:

- Reduced ownership by Swedbank or decline in Swedbank's creditworthiness.
- Significant economic weakening in the region, leading to factory closures, reduced economic activity and high unemployment.
- Materially lower capitalisation and/or asset quality.

Figure 1. Sparbanken Rekarne key credit metrics, 2015–2021e

	2015	2016	2017	2018	2019e	2020e	2021e
Net interest margin (%)	1.54	1.36	1.37	1.42	1.44	1.50	1.50
Loan losses/gross loans (%)	0.03	0.01	0.03	0.00	0.04	0.04	0.04
Pre-provision income/REA (%)	3.2	3.0	3.2	3.0	2.1	2.3	2.3
Return on equity (%)	13.0	12.2	11.7	13.4	11.3	10.4	10.6
Loan growth (%)	13.0	9.4	6.0	18.5	16.0	11.0	8.0
CET1 ratio (%)	16.0	17.0	18.6	16.3	15.2	14.9	15.0

Based on NCR estimates and company data. e–estimate. REA–risk exposure amount. CET1–common equity Tier 1. All metrics are adjusted in line with NCR methodology.

## COMPANY PROFILE

SpR is a savings bank, with ownership evenly divided between Swedbank and the Sparbanken Rekarne foundation. The bank had total assets of SEK 14.6bn (SEK 23.2bn including loans transferred to Swedbank Hypotek) as of 30 Sep. 2019. Like most Swedish savings banks, the bank shares a history of cooperation with Swedbank AB, which provides material product diversification, shared costs on IT solutions and the opportunity to finance retail mortgages via Swedbank Hypotek AB, Sweden's largest issuer of covered bonds. However, Swedbank's 50% ownership distinguishes the bank from other savings banks by increasing its focus on achieving return targets set by Swedbank. Swedbank's recent issues related to money laundering at its Estonian branch are not expected to affect its commitment to SpR.

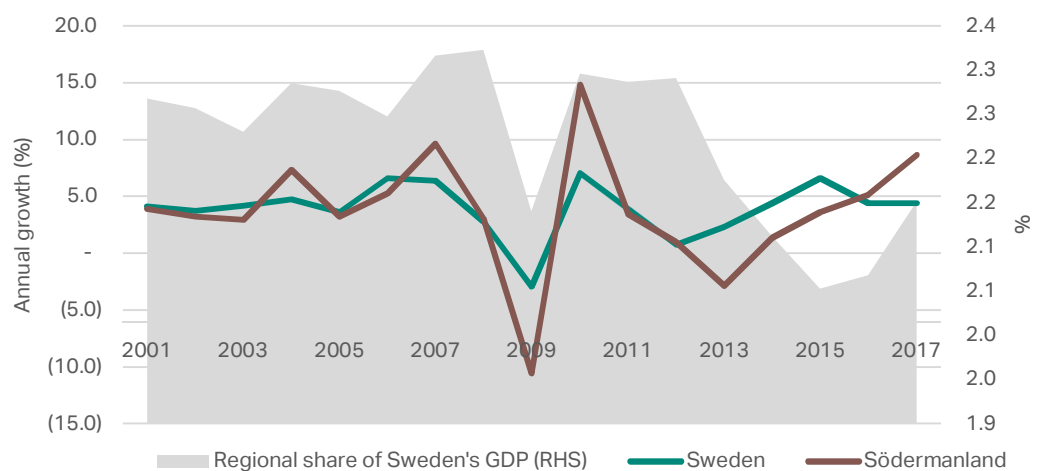
SpR is based in Eskilstuna, with branches in Strängnäs and Mariefred, in the county of Södermanland, on the south shore of Lake Mälaren. Södermanland county has nearly 300,000 inhabitants of which half live in communities with an SpR branch. The region has a strong manufacturing industry and the area is home to Mälardalen University, with 15,000 students. Eskilstuna's population is expected to increase by 15,000 by 2025 and the region has seen growth in the construction of residential housing and public transport to accommodate the expected population expansion and reduce travel time to Stockholm.

### STRONG MANUFACTURING REGION WITH IMPROVING RAIL ACCESS TO STOCKHOLM

Despite signs that the Swedish economy is slowing, NCR expects the domestic operating environment to be supportive for Swedish banks over the next two years. Loan losses and non-performing loans (NPLs) among Swedish banks are among the lowest in Europe and are expected to remain low over the next few years, even as the economy slows due to a reduction in capital investment and slower economic growth across Europe. Monetary policy remains expansionary and conducive to low credit losses while housing prices have rebalanced after adapting to new production and amortisation standards.

*Operating environment scores 'bbb+'*

Figure 2. Södermanland's annual growth and regional share of Sweden's GDP, 2001–2017



Source: Statistics Sweden

### *Regional factors*

Södermanland county and the neighbouring county of Västmanland are important for Sweden's manufacturing industry. The Södermanland economy has been more volatile than the Swedish economy historically, given cyclicity in demand for vehicles and heavy equipment. This was especially notable in 2009, when the global recession led to significant layoffs at local production plants and a severe contraction of the Södermanland economy (see Figure 2). Södermanland's annual economic growth has averaged 3.6% since 2000, below the national average of 3.9% over the same period and the region's share of the Swedish economy is just over 2%. Despite the significance of manufacturing, Eskilstuna and Strängnäs counties have diverse employment with 14–16% of workers employed in manufacturing, compared with 12% at national level, as well as a higher share of employment in education owing to the size of the local university.

Recent economic growth has been driven by real estate development in the region to accommodate increased housing needs and improvements in rail access to Stockholm. For this reason, construction is another important, yet cyclical, source of employment in the region. Södermanland's population growth reflects Sweden's, with 0.8% annual population growth since 2000 and similar shares of foreign-born and domestic population growth over the same period.

We consider the size of SpR's primary market, diverse employment and slower economic growth in our overall score of 'bbb+' for the bank's operating environment assessment. This compares with the national score of 'a-'.

### **CAPITAL SUPPORTED BY OWNERSHIP AND COLLATERALISED LOANS**

### *We assess risk appetite as 'bbb+'*

Although SpR is a savings bank, its risk profile is affected by its 50% ownership by Swedbank and Swedbank's expectations of a 15% return on equity. In our view, this is the primary reason for SpR having considerably higher leverage than other Swedish savings banks (see Figure 3). SpR has increased its loan book rapidly since 2018 by retaining a higher share of commercial and residential mortgage loans on its own balance sheet rather than transferring them to Swedbank.

### *ESG summary*

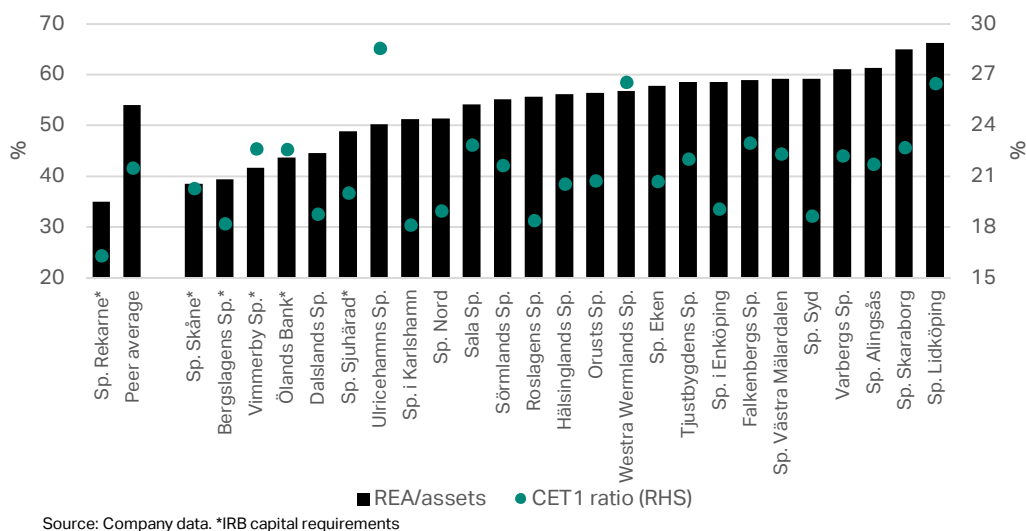
Despite having a greater commercial focus than many savings banks, SpR has maintained a commitment to sustainability and social responsibility in the communities it serves. The bank cooperates closely with Mälardalens University and sponsors local education, youth athletics and cultural projects via distributions to the Sparbanken Rekarne foundation. The bank also cooperates with the Stadsmission charity on a project called "Varmt om Hjärtat" (Close to the Heart) which encourages crowdfunding donations for local projects, for which the bank provides additional donations. SpR already limits loans to the worst environmental offenders and evaluates Environmental, Social and Governance (ESG) impacts for its largest customers. It plans to incorporate ESG analysis into all its credit decisions during 2020. SpR has developed risk management and governance solutions which have been sold to the Swedish Savings Banks Association for distribution among its peers. We view this risk leadership among the bank's peers as positive for its own risk governance.

### *Capital*

Despite its relatively small size, SpR is more similar to Swedbank than its savings bank peers in terms of capital structure. SpR is one of six savings banks using foundation internal ratings-based models in its calculation of regulatory REA. This has resulted in the lowest share of REA to assets among comparable savings banks in Sweden (see Figure 3). In our view, this makes the bank's CET1 capital ratio of 15.6% (as of 30 Sep. 2019) difficult to compare with those of its regional peers, which tend to have both higher capital ratios and standardised capital models. In addition, we note that SpR's leverage ratio is below 6%, a level typically associated with more diversified national or international banks.

To improve comparability with similar peers, we adjust REA when assessing SpR's capitalisation and earnings. We assume a standardised model for credit risk exposures, giving credit for highly collateralised loans. The adjustment results in an additional SEK 600m in REA for corporate loans based on 30 Sep. 2019 exposures which would reduce the bank's reported capital ratios by 160bps to 14.0%. In our projections we assume average on-balance-sheet loan growth of 9.5% for the next two years and a dividend payout ratio of 30%. In addition, we understand that SpR is considering alternatives to increasing its capital base to manage its internal capital buffer risk appetite, to allow for further growth and to prepare for future changes in capital requirements. As a result, we expect the bank to improve its overall capitalisation during 2020 to allow for continued growth in own balance sheet lending and continue to view the capital situation as in line with a 'bbb' assessment.

Figure 3. Sparbanken Rekarne CET1 and REA/asset ratios, 2018

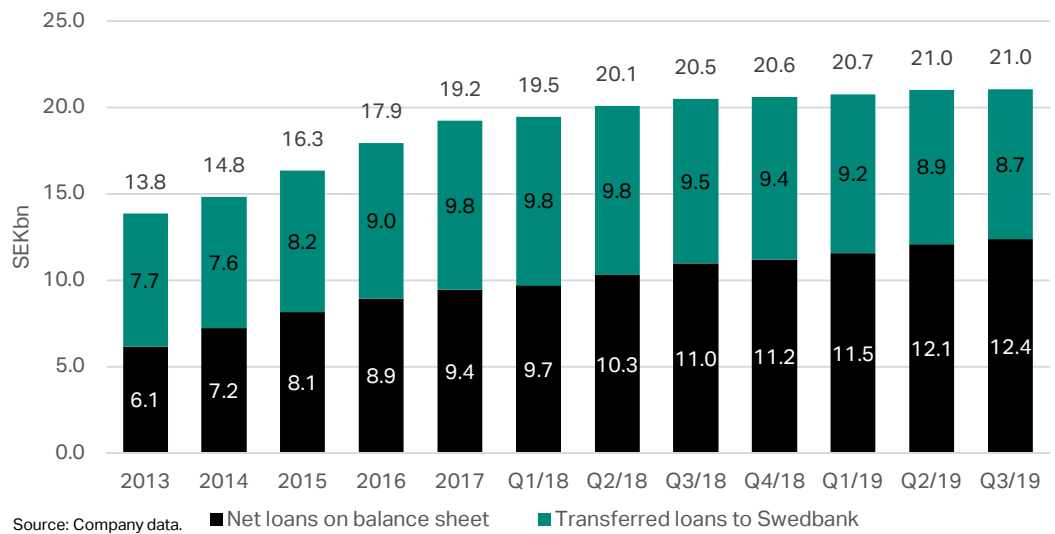


Given the high volume of SpR's loan growth coming from its existing customers' transferred loans, we perceive overall loan growth to be in line with the lending volume in Sweden (see Figure 4).

*Funding and liquidity*

To finance the growth in the loan book, SpR has issued SEK 1.85bn in senior unsecured debt since the first issue from a medium-term note program in April 2018. We anticipate that the bank will maintain a high share of well-diversified retail deposits in its funding profile, even as it grows. SpR has quite a different profile from most of the Swedish market, where banks tend to use covered bonds and senior unsecured debt for around two-thirds of their funding. However, its funding is similar to that of similar-sized Nordic savings banks with access to capital market funding.

**Figure 4. Sparbanken Rekarne net loans on own balance sheet and transferred to Swedbank, 2013-2019Q3**



SpR's cooperation with Swedbank allows the bank to transfer mortgage loans to Swedbank Hypotek AB in exchange for commission. As of the third quarter of 2019, SpR had transferred SEK 8.7bn to Swedbank, compared with nearly SEK 12.4bn of net loans on its own balance sheet (see Figure 4). The transfers include nearly SEK 2bn in commercial real estate loans. However, Swedbank has restricted new commercial mortgage transfers and reduced all savings banks' commissions on transferred commercial loans, incentivising banks to finance their own commercial mortgages.

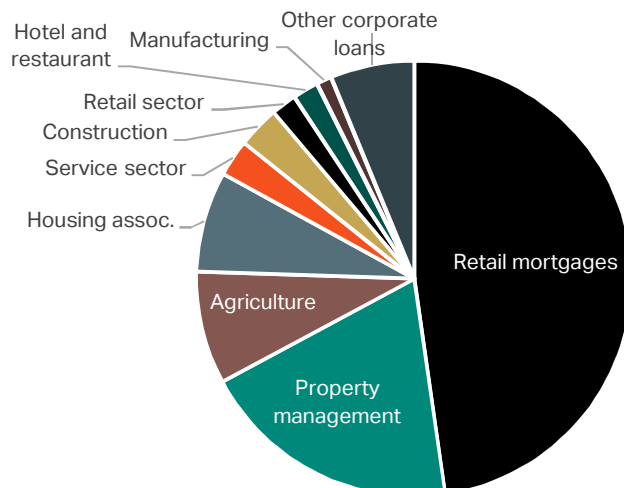
As of 30 Sep. 2019, SpR's net stable funding ratio (NSFR) was 133%, indicating stable financing over the coming 12 months, while the liquidity coverage ratio (LCR) was also high at 289%. SpR also has an SEK 400m credit facility from Swedbank. We expect the bank to maintain LCR and NSFR well above regulatory requirements, in line with its internal risk limits and targets. We anticipate that the bank will be able to refinance outstanding senior unsecured bonds which begin to mature in December 2020.

### HIGH EXPOSURE TO LOCAL PROPERTY MARKETS

SpR's regional profile creates geographic risk concentrations which are monitored by various limits within the bank's risk appetite framework and internal risk reporting. SpR's lending exposures are associated with retail and commercial mortgages on existing property, with 83% of on-balance-sheet loans associated with residential, commercial or agricultural properties (see Figure 5). Given that nearly 90% of the bank's customer base is within its core markets, there is a material concentration of real-estate collateral around Eskilstuna and Strängnäs. As the bank retains more loans, the share of residential and commercial mortgages has increased. SpR also finances less than SEK 1bn in residential development loans, most of which are guaranteed by the National Board of Housing, Building and Planning and are considered to have a 0% risk weighting given the government-related sponsor.

*We score credit risk 'bbb'*

Figure 5. Sparbanken Rekarne loans by segment, 30 Sep. 2019



Source: Company data

Aside from property-related lending, SpR's loan book has modest exposures to various corporate segments, and the bank has reduced its direct exposures to construction and manufacturing over the past four quarters. However, many of the bank's exposures would have secondary effects if there were significant layoffs at any of the region's largest manufacturers or a sudden change in the local or national economy.

SpR's transferred mortgage loans to Swedbank provide income via commission fees negotiated by the savings banks. SpR has a first-loss risk associated with the transferred loans that results in a reduction in paid commission when writedowns of transferred loans occur. This risk is capped at the commission payment for the loans, which was SEK 56m over the past four quarters and is falling due to transferred loans and lower commissions on commercial mortgages.

*Other risks and strategic ownership*

In our view, market risk is not a material risk factor for SpR, given the lack of a trading portfolio, low limits on interest rate risk and immaterial foreign currency exposure. The bank proactively transfers loans with longer maturities to Swedbank to reduce interest risk on its own books. There is some spread and counterparty risk associated with SpR's liquidity portfolio, but the vast majority of the exposure is to highly rated counterparties.

SpR has strategic ownership in Indecap Holding AB (jointly owned with other savings banks) and 33% of the shares in Portfolio Försäkra AB (held with Sparbanken Västra Mälardalen and Bergslagens Sparbank) and has two smaller ownership stakes. We note that the bank stopped consolidated financial reporting in 2019 given the immateriality of its subsidiaries.

**STRONG LOCAL POSITION BUT LIMITED REGIONAL MARKET SHARE**

*We score market position 'bbb'*

SpR has a strong position in its core markets and among local individuals and SMEs, with 77,000 private and 7,000 corporate customers in a market of 145,000 inhabitants. The bank faces local competition from all of Sweden's national banks, and the largest corporations in the region are typically served by the larger banks. New competitors in the mortgage market have received a lot of attention for their low mortgage rates, but thus far SpR has not experienced a material impact on its customer base and added competition has not affected its ability to increase volumes. At national level, the bank has about 0.4% of retail deposits and 0.5% of mortgage loans, including loans transferred to Swedbank.

*We assess performance indicators at 'a'*

*Earnings performance*

**EARNINGS AND LOSS PERFORMANCE IN LINE WITH PEERS'**

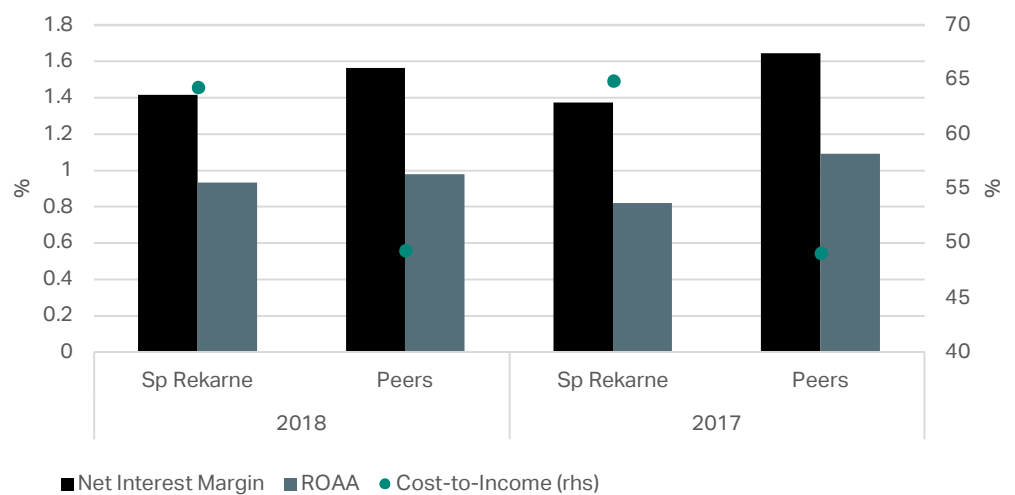
A reduction in commission payments and slower than expected rises in interest rates have resulted in a downward revision in our assessment of SpR's performance indicators to 'a' from 'a+'. In particular, we have reduced our earnings projections for SpR to reflect lower commissions from insurance and transferred loans. Although the bank continues to increase net interest income (NII), in large part by transferring loans from Swedbank, the bottom-line impact has been offset by reductions in associated commissions as well as changes in commission agreements with its insurance partner, Folksam. We do not expect any considerable deterioration in the bank's asset quality given low interest rates and the likelihood of continued economic development in the region.

Our revised earnings assessment to 'bbb+' from 'a' reflects that SpR's earnings metrics are somewhat weaker than those of its Nordic savings bank peers. It also considers that expected improvement in net interest margins from more normal interest rates are unlikely to materialise to the degree we expected a year ago. Along with higher-than-anticipated growth in risk-weighted assets over the last few quarters, the bank's core earnings have not covered its growth in capital requirements.

SpR has averaged a return on equity of just under 13% over the past five years, even as interest rates have fallen. This exceeds the levels achieved by most Nordic savings banks given the bank's low share of equity compared with those of its peers. Our analysis of risk-adjusted earnings therefore makes a similar adjustment for the bank's REA as described in the capital section above. This results in a pre-provision return on REA of about 2% through the first three quarters of 2019 (2.2% unadjusted), which is just below the bank's 2018 peer average of 2.3%.

SpR's cost-to-income ratio of 66%, after adjusting for one-off gains from divestments, is well above that of most of its peers and the net interest margin of 1.4% has been impacted by low market rates. We expect the bank to be able to increase its net interest margin slightly in 2020 and to focus on cost efficiency to improve bottom line earnings while interest rates remain low.

**Figure 6. Sparbanken Rekarne earnings vs Nordic savings bank peers', 2017–2018**

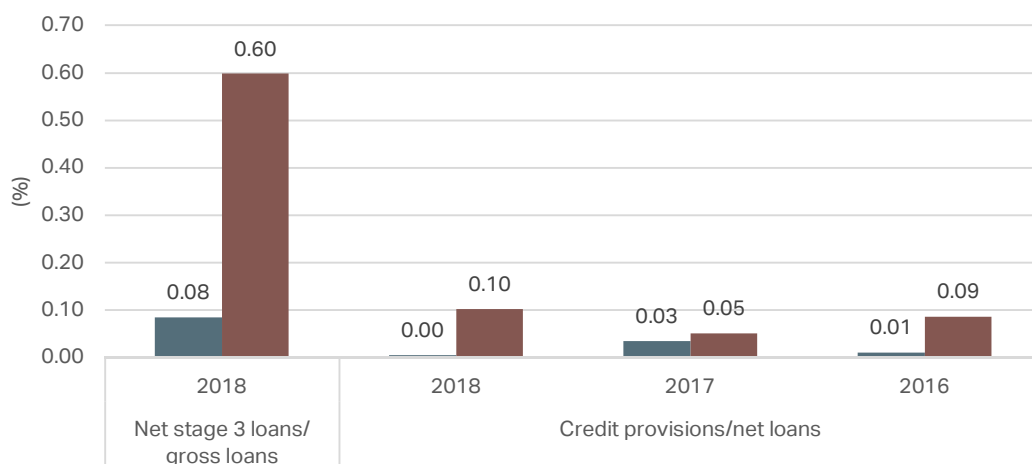


Source: Company data. Peers include 45 similar-sized savings banks in Norway and Sweden.

Loss performance

SpR's loss performance has been outstanding in recent years and net stage 3 NPLs stood at a very low 14bps of gross lending as of 30 Sep. 2019. We project loan losses at a manageable 4bps in our forecast, given a growing regional economy and continued low interest rates.

Figure 7. Sparbanken Rekarne asset quality vs Nordic savings bank peers', 2016–2018



Source: Company data. Peers include 24 similar-sized savings banks in Norway and Sweden.

ADJUSTMENT FACTORS

PEER COMPARISON

We believe that the bank's relative strengths and weaknesses are well reflected in our 'bbb+' initial credit assessment. NCR has confidential credit assessments (not full credit ratings) on nearly 300 Nordic banks. The average assessment is 'bbb+', reflecting a high level of savings banks in the sample. See [Has Nordic bank creditworthiness reached its peak?](#), published 17 Jun. 2019.

SUPPORT ANALYSIS

SpR's ownership is split 50/50 between Swedbank and the Sparbanken Rekarne foundation. We view the benefit of Swedbank's ownership as important to the rating and reflected in the bank's capital structure. We therefore apply an additional notch in our assessment given the ability of Swedbank to provide valuable additional support. This notching also reflects the fact that our credit assessment of Swedbank is higher than our standalone assessment of SpR. In addition, we believe that the foundation could provide some additional capital from its liquid assets but note that a large majority of its assets are invested in shares in Swedbank and SpR.

ISSUE RATINGS

Our rating on SpR's unsecured senior debt is in line with the issuer rating, i.e. 'A-'. We also rate the existing programme 'A-', an indication of our ratings on future issuance from the programme. We do not rate the bank's outstanding Tier 2 instrument.

Figure 8. Sparbanken Rekarne issue rating indications

Issue rating indications	Starting point	Issue rating
Senior unsecured	Issuer credit rating	A-



**Figure 9. Sparbanken Rekarne rating scorecard**

Subfactors	Impact	Score
National factors	10.0%	a-
Regional, cross border, sector	10.0%	bbb
<b>Operating environment</b>	<b>20.0%</b>	<b>bbb+</b>
Capital	17.5%	bbb
Funding & liquidity	15.0%	a
Risk governance	5.0%	a-
Credit risk	10.0%	bbb
Market risk	0.0%	N/A
Other risks	2.5%	a
<b>Risk appetite</b>	<b>50.0%</b>	<b>bbb+</b>
Market position	15.0%	bbb
Earnings	7.5%	bbb+
Loss performance	7.5%	aa-
<b>Performance indicators</b>	<b>15.0%</b>	<b>a</b>
<b>Indicative credit assessment</b>		<b>bbb+</b>
Peer comparisons		0
Transitions		0
Borderline assessments		0
<b>Adjustment factors</b>		<b>0</b>
<b>Standalone credit assessment</b>		<b>bbb+</b>
Ownership		+1
Material credit enhancement		0
Rating caps		0
<b>Support</b>		<b>+1</b>
<b>Issuer rating</b>		<b>A-</b>
<b>Short-term rating</b>		<b>N-1+</b>

**Figure 10. Sparbanken Rekarne key credit metrics and financials**

Key credit metrics (%)	2014	2015	2016	2017	2018	2019Q3 YTD
<b>Income composition</b>						
Net interest income/op. revenue	53.6	48.4	43.5	42.3	46.0	58.2
Net fee income/op. revenue	44.8	52.7	52.9	53.8	48.1	38.0
Net trading income/op. revenue	0.8	(1.8)	3.0	3.3	4.1	1.7
Net other income/op. revenue	0.7	0.6	0.6	0.6	1.8	2.1
<b>Earnings</b>						
Net interest margin	2.0	1.5	1.4	1.4	1.4	1.4
Pre-provision income/REA	3.5	3.2	3.0	3.2	3.0	2.2
Return on ordinary equity	15.1	13.0	12.2	11.7	13.4	12.6
Return on assets	1.0	0.9	0.8	0.8	0.9	0.8
Cost-to-income ratio	63.1	63.0	64.7	64.9	64.3	64.8
Cost-to-income ratio, ex. trading	63.6	62.0	66.7	67.1	67.0	65.9
<b>Capital</b>						
CET1 ratio	16.3	16.0	17.0	18.6	16.3	15.6
Tier 1 ratio	16.3	16.0	17.0	18.6	16.3	15.6
Capital ratio	16.3	19.2	20.1	21.6	18.7	17.7
REA/assets	36.8	36.0	35.0	33.2	35.0	38.9
Dividend payout ratio	23.1	35.0	33.0	30.8	30.0	-
Leverage ratio	6.1	5.8	6.0	5.9	5.5	5.8
<b>Growth</b>						
Asset growth	10.4	18.7	5.6	6.7	17.1	11.7
Loan growth	17.5	13.0	9.4	6.0	18.5	12.6
Deposit growth	5.9	17.8	7.4	6.1	4.2	1.8
<b>Loss performance</b>						
Credit provisions to net loans	1.3	2.7	1.0	3.5	0.5	3.9
Impaired loans to gross loans	0.2	0.2	0.1	0.2	0.1	0.2
Net impaired loans to gross loans	0.0	0.0	0.0	0.1	(0.0)	0.1
Net problem loans to equity	0.4	0.4	0.4	0.7	(0.1)	0.8
NPL coverage ratio	83.5	78.6	71.1	64.6	106.4	70.3
Stage 3 loans/gross loans	-	-	-	-	0.1	0.2
Net stage 3 loans/gross loans	-	-	-	-	0.1	0.1
<b>Funding &amp; liquidity</b>						
Loan/deposit ratio	92.7	88.9	90.5	90.4	102.9	110.9
Net stable funding ratio	-	-	-	125.0	141.0	133.0
Liquidity coverage ratio	-	-	262.0	329.0	269.0	289.2

Key financials (SEKm)	2014	2015	2016	2017	2018	2019Q3 YTD
<b>Balance sheet</b>						
Total assets	8,925	10,595	11,190	11,945	13,988	14,590
Total tangible assets	8,884	10,560	11,147	11,911	13,966	14,590
Total financial assets	8,785	10,413	10,979	11,273	12,580	14,275
Net loans and advances to customers	7,209	8,143	8,912	9,443	11,190	12,357
Total securities	1,063	1,235	1,173	1,182	1,226	1,331
Customer deposits	7,780	9,163	9,843	10,442	10,876	11,139
Issued securities	-	120	120	120	1,470	1,970
of which senior	-	-	-	-	1,350	1,850
of which subordinated	-	120	120	120	120	120
Total equity	609	714	774	839	924	980
Total ordinary equity	609	714	774	839	924	980
<b>Capital</b>						
CET1	534	612	667	737	797	884
Tier 1	534	612	667	737	797	884
Total capital	534	732	787	857	917	1,004
REA	3,281	3,818	3,918	3,969	4,891	5,677
<b>Income statement</b>						
Operating revenues	308	305	334	361	367	253
Pre-provision operating profit	114	113	118	127	131	89
Impairments	1	2	1	4	1	3
Net income	87	86	91	95	118	90

Based on NCR estimates and company data. All metrics are adjusted in line with NCR methodology.

Type of credit rating:	Long-term issuer credit rating Short-term issuer credit rating Issue credit rating
Publication date:	The rating was first published on 04 Dec. 2018.
Office responsible for the credit rating:	Nordic Credit Rating AS (NCR), Oslo, Norway. NCR is a registered credit rating agency under Regulation (EC) No 1060/2009.
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Methodology used when determining the credit rating:	<a href="#">Nordic Credit Rating - Financial Institutions Rating Methodology published 14 Aug. 2018</a> <a href="#">Nordic Credit Rating - Rating Principles published 16 Sep. 2019</a> The methodology and principles documents provide analytical guidance to NCR's rating activities including but not limited to, assumptions, parameters, cash flow analysis, and stress-testing. NCR's methodologies and principles can be found on our website <a href="http://nordiccreditrating.com/governance/policies">nordiccreditrating.com/governance/policies</a> . The historical default rates of entities and securities rated by NCR will be viewed on <a href="#">the central platform (CEREP) of the European Securities and Markets Authority (ESMA)</a> .
Materials used when determining the credit rating:	Annual- and quarterly reports of the rated entity, Bond prospectuses, Company presentations, Data provided by external data providers, Meetings with management of the rated entity, Non-public information, Press reports/public information, Website of rated entity
Conflicts of interest:	The rating is NCR's independent opinion of the rated entity's relative creditworthiness. The rating is solicited, i.e. it is prepared for a fee paid by the rated entity. At the time of analysis and publication neither NCR nor any of the analysts or persons involved in the rating process held any interest, ownership interest or securities in the rated entity.
Additional information:	Prior to publication, the rating was disclosed to the rated entity. The issuer was given 24 hours (of which 8 business hours) to remark on factual errors and/or the inadvertent inclusion of confidential information, if applicable. The rating was not amended after the review by the issuer. No stress test or cash flow forecasting was performed. NCR's rating is an opinion regarding the relative creditworthiness of an entity or an instrument. It is not a prediction, guarantee or recommendation to buy, hold or sell securities. NCR assigns outlooks to issuer ratings to indicate where they could move in the near term, normally 12–18 months. Further information on the rating process, rating definitions and limitations is available on our website: <a href="http://nordiccreditrating.com/governance/policies">nordiccreditrating.com/governance/policies</a> .
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