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Research Update:

First Nations Finance Authority 'A-' Ratings Affirmed; Outlook Remains Stable

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Overview

- Not-for-profit lender First Nations Finance Authority (FNFA) has continued to expand its loan portfolio, supporting greater geographical and single-name loan diversification
- It also maintains profitability, structural mechanisms to protect asset quality, moderate leverage, and support from the federal government.
- We are affirming our 'A-' long-term issuer credit and senior unsecured debt ratings on the FNFA.
- The stable outlook reflects our expectation that the authority will sustain its solid competitive position in a niche market, which will promote further growth, while maintaining prudent lending policies.

Rating Action

On Aug. 15, 2017, S&P Global Ratings affirmed its 'A-' long-term issuer credit and senior unsecured debt ratings on not-for-profit lender First Nations Finance Authority (FNFA). The outlook is stable.

Rationale

The ratings on the FNFA reflect S&P Global Ratings' view of the authority's solid competitive position in a niche market as an important lender to First Nations. The ratings also reflect the FNFA's prudent structural mechanisms, including its intercept mechanism, which enhance asset quality; ongoing financial support for operations from the federal government; and moderate leverage. We believe that the authority's low profitability and the concentration of its loan portfolio somewhat offset these strengths, although the FNFA is improving its geographic diversity. We have assessed the authority's stand-alone credit profile (SACP) at 'bbb'.

The ratings further reflect our belief that the FNFA benefits from a moderately high likelihood of receiving extraordinary support from the federal government, resulting in a two-notch uplift from the SACP for the final 'A-' rating. We believe the authority has a strong link with the federal government, which the government's funding support for its operations demonstrates. We also believe the FNFA plays an important role for the government via its statutory mandate and public policy role to facilitate access to capital by First Nations. Also supporting our assessment of the authority's important role is the political visibility of First Nations' issues generally, and the considerable need for capital on First Nations'

land.

The FNFA is a financial intermediary that supports access to credit for First Nations. It borrows in the capital markets and on-lends the proceeds to its borrowers, who are exclusively First Nations. Borrowers use the loan proceeds for capital infrastructure on their lands, and secure the loan with a pledged revenue stream. The authority issued its inaugural bond in 2014, and has since reopened this bond twice. It now has C\$251 million outstanding as of June 30, 2017. Although it was created via federal legislation, the FNFA is not an agent of the Government of Canada. Nevertheless, we believe the authority benefits from a strong and supportive relationship with Canada.

We believe the FNFA has a solid competitive position in its niche market as a First Nations lender. Historically, access to capital has been a challenge for many First Nations. In recent years, access has improved, 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. By mandate, the FNFA is authorized to lend to councils for tax-supported debt requirements -- other lenders are not. Furthermore, some First Nations have capital needs (and debt repayment capacity) that exceed the ability or willingness of existing lenders to supply capital, in our opinion. Some have estimated that total capital needs for Canadian First Nations are more than C\$20 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 and we do not expect this to change. We also do not expect an influx of new lenders into this market, although existing ones might increase their presence.

We believe the FNFA benefits from good asset quality, owing to structural mechanisms. Those structural elements include rigorous qualification process required of all borrowing members, the authority's ability to intercept all eligible stable, ongoing and unencumbered revenue streams, prudent discounting of pledged revenues, and intervention powers. The FNFA ordinarily intercepts the eligible revenue streams of borrowers, maintains the debt service payments, and remits the balance to borrowers. The arrangement allows the authority to timely access of revenues, in our opinion.

The FNFA benefits from ongoing operational funding support from the federal government. The authority was created by the federal government, which expected it to need sustained financial support owing to its initial small loan portfolio and start-up costs. The government has provided operational grants since inception, which have increased as needed by the authority. We expect the government will continue to support the authority until it achieves self-sufficiency.

The FNFA's equity is primarily its credit enhancement fund, which reached C\$30 million as of June 30, 2017, and the federal government funds. While the authority's debt-to-equity has increased dramatically over the past several

years since it began lending operations, it dropped to 10x as of June 30, 2017, from 24x in March 2016, following recent capital injections provided by the federal government. Nevertheless, we expect debt to continue to rise, consistent with the FNFA's forecast, and equity to increase from additional capital injections and retained earnings. As the authority's loan growth rises, additional capital is critical in supporting creditworthiness.

We expect the FNFA to produce overall surpluses in 2018 and beyond because of continuing federal grants and increasing management fees and interest revenues. We believe that the authority will remain profitable as the loan portfolio continues expanding. Profitability has improved over the past two years, although it remains low. In fiscal 2017, the FNFA recorded its second year of surplus, reaching C\$878,035 from C\$580,895 a year earlier. Relative to average assets, however, the authority's net income stayed flat, at 0.3%; return on equity was 5.4%, compared with 5.5% a year earlier (all figures S&P Global Ratings-adjusted).

The FNFA faces 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. However, the financial strength and sound financial practices of Borrowing Members will mitigate this risk somewhat. Geographically, loans are concentrated in British Columbia, but this concentration has decreased as FNFA's loan book has grown. Loans to First Nations located within British Columbia fell to 33% of total loans as of July 2017 from 52% in fiscal 2016. We expect this concentration to continue to diminish over the next several years. Single-name concentration has also fallen as more Borrowing Members joined. The largest obligor represented 9.6% of total loans as of July 2017. We expect that geographical and single-name concentration will improve as more councils in other provinces become Borrowing Members.

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

Liquidity

We believe that the authority's liquidity is adequate. As of June 30, 2017, the FNFA had several sources of liquidity including cash and cash equivalents of C\$3.2 million, a credit enhancement fund of C\$30 million, and a debt reserve fund (DRF) of C\$16.8 million, which in total exceed the authority's upcoming debt service requirements of nearly C\$12 million. With the FNFA withholding 5% of each member's loan request in the DRF, the funding is growing faster annually than the authority's interest obligations at current interest rates. The principal on the bonds is not due until 2024, and the FNFA has established sinking funds for its debenture retirements. Sinking funds totaled C\$12.7 million as of June 30, 2017. Borrowing Members prepay their

loan obligations as pledged revenues that are owed to members into a trusteed account before debt service payments are made, which reduces the risk that liquidity might not be sufficient to meet debt service obligations. In addition, the authority has a revolving credit facility with a syndicated banking group for up to C\$175 million, which it uses for interim financing between bond offerings.

Outlook

The stable outlook reflects our expectation that the authority will continue to expand its loan portfolio, interest income, and fees, maintaining profitability in the next two years. We expect asset quality will remain good.

Deteriorating asset quality that suggests weak underwriting decisions and requires joint and several support from borrowers could lead us to lower the ratings. In addition, increased debt issuance without adequate capital support, leading to debt-to-equity ratios above 30x would put downward pressure on the rating. Also, we could downgrade the FNFA if we revised the likelihood of extraordinary support to moderate or low if the federal government's oversight of the authority lessened or the importance of its policy role diminished.

Sustained profitable operations, coupled with earnings retention, increasing portfolio diversification, and a stronger capital base could put upward pressure on the SACP. We could upgrade the authority if we were to revise the likelihood of extraordinary support to high or greater because of increased importance of the authority's public policy role or strong direction by the federal government in the FNFA's strategy development and day-to-day operations.

Related Criteria

- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Financial Institutions - Finance Companies: Rating Finance Companies, March 18, 2004

Ratings List

Ratings Affirmed

First Nations Finance Authority

Issuer credit rating	A-/Stable/--
Senior unsecured	A-

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at www.spcapitaliq.com. All ratings affected by this rating action can be found on the S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.

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