



NZX/ASX Release

Fitch affirms long-term rating of Heartland

19 May 2020

Fitch Ratings (**Fitch**) has affirmed the Long-Term Issuer Default Ratings (**IDR**) of Heartland Group Holdings Limited (NZX/ASX: HGH) (**Heartland Group**) and Heartland Bank Limited (NZX: HBL) (**Heartland Bank**) at 'BBB' and the Long-Term IDR of Heartland Australia Group Pty Ltd (Heartland Australia) at 'BBB-'. The Outlooks remain Stable.

The affirmation reflects Fitch's view that the bank has solid buffers to withstand its base-case scenario and the stable outlook indicates the bank enters the economic downturn with sufficient headroom in its key financial metrics.

In its attached press release, Fitch noted that "the ratings of [Heartland Group] and [Heartland Bank] are driven by the group's consolidated risk profile, which reflect its stronger-than-peer profitability". A number of other New Zealand financial institutions have either had their rating downgraded, or their outlook revised from stable to negative, by Fitch. Heartland is pleased with this recognition which it attributes to its differentiated strategy, higher relative margin on resilient asset portfolios and strong cost management through delivery of products to its customers by lower cost digital platforms.

- Ends -

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18 May 2020 | Affirmation

Fitch Affirms Heartland at 'BBB'; Outlook Stable

Fitch Ratings-Sydney-18 May 2020:

Fitch Ratings has affirmed the Long-Term Issuer Default Ratings (IDR) of Heartland Group Holdings Limited (HGL) and Heartland Bank Limited (HBL) at 'BBB' and the Long-Term IDR of Heartland Australia Group Pty Ltd (HAG) at 'BBB-'. The Outlook is Stable.

The affirmation reflects our view that the bank has solid buffers to withstand our base-case scenario at its current rating level. The Stable Outlook indicates that the bank enters the economic downturn with sufficient headroom in its key financial metrics to remain broadly consistent with its Viability Ratings of 'bbb'.

Key Rating Drivers

IDRS, VIABILITY RATING AND SENIOR DEBT RATING FOR HGL AND HBL

The ratings of HGL and HBL are driven by the group's consolidated risk profile, which reflect its stronger-than-peer profitability and higher risk appetite. We expect the coronavirus pandemic to significantly damage New Zealand's economy and weaken the group's asset quality and profitability over the next two years.

As part of this rating action, Fitch has revised the outlook on the 'a' operating environment score for New Zealand banks to negative, from stable, to reflect the significant downside risk posed by the measures undertaken to slow the spread of the pandemic. We are likely to revise this outlook to stable if our base case of a recovery starting in 2H20 eventuates. However, an outcome that is significantly weaker than our base case would see a lowering of the score to 'a-'.

A sharp rise in the unemployment rate in New Zealand would be likely to substantially increase non-performing loans and cause material deterioration in the asset quality and profitability of HGL and HBL. As a result, Fitch has revised the factor outlook for asset quality (factor score of 'bbb+') and earnings and profitability (factor score of 'a-') to negative, from stable.

We expect asset quality to weaken in late 2020 or early 2021, once repayment holidays end, as there will be a portion of businesses and households that will be unable to resume repayments despite the high level of support from the government. The bank's exposure to business lending is

higher than that of peers, which could make it more vulnerable to the economic shock.

Profitability has been stronger than that of peers, benefiting from a higher margin and strong cost management. Nevertheless, we believe low interest rates and a significant rise in impairment charges will weigh on profitability over the next two years. Credit growth may remain above the system in the next two years, possibly driven by the bank's reverse mortgage portfolio. This could offset some of the profitability pressure, however, the negative factor outlook reflects the possibility of credit costs exceeding our expectation.

HBL's capital position should remain sound in the next two years, although buffers may contract due to the deterioration in profitability. We believe the Reserve Bank of New Zealand's requirement to suspend dividend payments could partly offset the pressure from deterioration in asset quality and internal capital generation. We expect HBL to maintain a common equity Tier 1 (CET1) ratio that is consistent with the current score of 'bbb+'.

HGL's funding profile is weaker than that of domestic peers of similar size, reflecting the group's higher reliance on wholesale funding, which we believe will continue. Strong support from the central bank has mitigated short-term liquidity pressure on the bank. We believe the bank has the ability to attract more deposits, if required, benefiting from its strong margin.

SUPPORT RATING AND SUPPORT RATING FLOOR FOR HBL

The Support Rating and Support Rating Floor of HBL reflect Fitch's view that, while support for the group from the New Zealand sovereign is possible, it cannot be relied on. We believe the group's small size and the existence of the open bank resolution scheme lowers the propensity of the sovereign to support its banks. The scheme allows for the imposition of losses on depositors and senior debt holders to recapitalise a failed institution.

HAG

HAG's IDRs are driven by institutional support from its parent, HGL, which fully owns HAG. We believe HAG, which holds the group's Australia business, is a strategically important part of HGL and has strong management synergies with the parent and benefits from being part of the wider group.

HAG's IDR is notched down once from the parent's IDR to reflect our view that, while HAG is important to the group, its small size means that it is not a key and integral part of the business. HAG's Support Rating reflects Fitch's view that there is high probability of support from HGL, if required.

RATING SENSITIVITIES

IDRS, VIABILITY RATING AND SENIOR DEBT RATING FOR HGL AND HBL

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade:

The IDRs, Viability Rating and senior debt ratings of HGL and HBL could be downgraded should the bank substantially increase its risk appetite, possibly in an effort to improve the franchise, resulting in significant deterioration of its financial profile during an economic downturn, including:

- Stage 3 loans/gross loans of HGL increasing above 4% for a sustained period;
- operating profit/risk-weighted assets of HBL falling below 1% for a sustained period; or
- the common equity Tier 1 ratio of HBL declining below 10.5% without a credible plan to replenish regulatory capital buffers.

A downgrade of the operating environment score to 'a-' is unlikely to be sufficient by itself to result in a downgrade of the ratings.

The Short-Term IDRs would only be downgraded if the Viability Rating were to be downgraded by at least two notches.

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade:

Positive rating action is unlikely in the short-term given the challenges from the economic recession as a result of the coronavirus. It would also require a substantial improvement in the bank's franchise, an improved funding profile and no compromise in risk appetite.

The Short-Term IDRs may be upgraded to 'F2' if we revised our funding factor score to 'bbb+', from the current 'bbb'. This would require that HGL consistently maintain a loan/deposit ratio of less than 110%.

Fitch expects HGL's ratings to remain equalised with those of HBL in the short to medium term. However, bottom-up analysis of the group will be required for HGL's ratings should HAG become a more material part of the group.

SUPPORT RATING AND SUPPORT RATING FLOOR FOR HBL

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade:

The Support Rating and Support Rating Floor are already at the lowest level on Fitch's rating scale and cannot be downgraded further.

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade:

The Support Rating and Support Rating Floor are sensitive to any change in assumptions around the propensity or ability of the New Zealand government to provide timely support. An increased propensity to support would be required for an upgrade, but appears unlikely given the resolution framework in place.

HAG

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade:

Weakening in the propensity or ability of HGL to provide support to HAG is likely to result in lowering of HAG's IDRs and Support Rating.

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade:

An upgrade of HGL's IDR could be reflected in the rating of HAG.

Best/Worst Case Rating Scenario

International scale credit ratings of Financial Institutions issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit <https://www.fitchratings.com/site/re/10111579>.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

Public Ratings with Credit Linkage to other ratings

The ratings of HAG are linked to the ratings of HGL.

ESG Considerations

The highest level of ESG credit relevance, if present, is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity(ies), either due to their nature or to the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

Heartland Australia Group Pty Ltd; Long Term Issuer Default Rating; Affirmed; BBB-; RO:Sta
; Short Term Issuer Default Rating; Affirmed; F3
; Support Rating; Affirmed; 2

Heartland Group Holdings Limited; Long Term Issuer Default Rating; Affirmed; BBB; RO:Sta
; Short Term Issuer Default Rating; Affirmed; F3
; Local Currency Long Term Issuer Default Rating; Affirmed; BBB; RO:Sta
; Local Currency Short Term Issuer Default Rating; Affirmed; F3
; Viability Rating; Affirmed; bbb

Heartland Bank Limited; Long Term Issuer Default Rating; Affirmed; BBB; RO:Sta
; Short Term Issuer Default Rating; Affirmed; F3
; Local Currency Long Term Issuer Default Rating; Affirmed; BBB; RO:Sta
; Local Currency Short Term Issuer Default Rating; Affirmed; F3
; Viability Rating; Affirmed; bbb
; Support Rating; Affirmed; 5
; Support Rating Floor; Affirmed; NF

----senior unsecured; Long Term Rating; Affirmed; BBB

----senior unsecured; Short Term Rating; Affirmed; F3

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Additional information is available on www.fitchratings.com

Applicable Criteria

[Bank Rating Criteria \(pub. 28 Feb 2020\) \(including rating assumption sensitivity\)](#)

[Non-Bank Financial Institutions Rating Criteria \(pub. 28 Feb 2020\) \(including rating assumption sensitivity\)](#)

Additional Disclosures

[Dodd-Frank Rating Information Disclosure Form](#)

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