

HEARTLAND

New Zealand Limited

NZX Release

S&P revises credit rating outlook on Heartland Bank to “Developing”

30 October 2013

Heartland New Zealand Limited (NZX: HNZ) advises that Standard & Poor’s (**S&P**) has revised its credit rating outlook on HNZ subsidiary Heartland Bank Limited (**Heartland**) to “Developing” from “Negative”, reflecting a trend of strengthening business position for Heartland amid concerns relating to New Zealand’s macro-economic vulnerabilities. S&P’s full report is attached.

The “Developing” outlook reflects the prospect that Heartland’s rating could be raised or lowered within the next two years, depending on different but similarly probable scenarios. The S&P report states that:

- Heartland’s rating could be raised if Heartland successfully further developed its business position in the next 6-12 months, and New Zealand’s macro-economic vulnerabilities do not worsen.
- Heartland’s rating could be lowered if credit concerns relating to New Zealand’s macro-economic vulnerabilities escalated before any upward revision of Heartland’s business position.

Heartland is pleased with the change in outlook, and in particular with S&P’s acknowledgement of a trend of strengthening business position for Heartland.

- Ends -

For further information please contact:

Jeff Greenslade
Chief Executive Officer
Heartland New Zealand Limited
DDI 09 927 9149

RatingsDirect®

Research Update:

Outlook On Heartland Bank Revised To Developing, On Strengthening Business Profile Trend Amid Economic Risk Concerns

Primary Credit Analyst:

Nico N DeLange, Sydney (61) 2-9255-9887; nico.delange@standardandpoors.com

Secondary Contact:

Peter Sikora, Melbourne (61) 3-9631-2094; peter.sikora@standardandpoors.com

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Overview

- Following a review of Heartland Bank Ltd. (Heartland), we are revising our outlook on the bank to developing from negative, and affirming the 'BBB-/A-3' ratings.
- The developing outlook reflects the prospect that rating could be raised or lowered under different but similarly probable scenarios within the next two years.
- The rating could be raised if Heartland were to successfully further develop its business position in the next six-to-twelve months and economic vulnerabilities do not worsen. In that scenario, we expect we would raise the rating and revise the outlook to negative, to reflect current credit concerns relating to New Zealand's economic vulnerabilities.
- The rating could be lowered if credit concerns relating to New Zealand's economic vulnerabilities (including its material dependence on external borrowings, persistent current account deficits, and recent strong growth in house prices), which underpinned our outlook revision on May 16, 2013, escalated before any upward revision of our business position assessment on the bank. In this scenario, we expect we would lower the rating and revise the outlook to positive, reflecting the trend of Heartland's strengthening business profile.

Rating Action

On Oct 29, 2013, Standard & Poor's Ratings Services revised its outlook on Heartland Bank Ltd. (Heartland) to developing from negative. At the same time, we affirmed our issuer credit ratings on Heartland at 'BBB-/A-3'.

The outlook on MARAC Insurance Ltd. (MIL) is also revised to developing. Under our group-rating methodology, we have assessed MIL as a "strategically important" subsidiary of listed financial services group Heartland New Zealand Ltd. The long-term rating on MIL has been affirmed at 'BB+'.

Rationale

The developing outlook reflects our view of credit concerns relating to New Zealand's economic vulnerabilities (including its material dependence on external borrowings, persistent current account deficits, and recent strong growth in house prices), which underpinned our outlook revision on May 16,

2013, plus a trend of strengthening business position for Heartland. Specifically, Heartland is gaining momentum in the process of implementing business strategies to build its business position in distinct markets such as livestock finance, motor vehicle finance, and invoice financing, which are subject to less direct competition and lower contestability than are traditional banking market segments.

Our ratings on Heartland reflect the anchor stand-alone credit profile (SACP) for a bank operating only in New Zealand; plus Heartland's "weak" business position, "very strong" capital and earnings, "moderate" risk position, "below average" funding, and "adequate" liquidity.

Our bank criteria use our Banking Industry Country Risk Assessment economic and industry risk scores to determine a bank's SACP, the starting point in assigning an issuer credit rating. Our anchor SACP for a bank operating only in New Zealand is 'bbb+', based on an economic risk score of '3' and an industry risk score of '4'.

We view New Zealand as an open, resilient, and well-developed economy benefitting from flexible labor and product markets. We believe that a weakening in the country's macroeconomic factors could heighten the risk of a sharp correction in property prices in the country, which would likely trigger increased credit losses for the banks. We believe that this risk is heightened by New Zealand's material dependence on external borrowings and persistent current account deficits, against the backdrop of an uncertain short-to-medium term outlook for global economic recovery, and recent growth in house prices in some of the larger cities. We consider private sector debt as being high, although supported by high income levels, conservative underwriting, and a creditor-friendly legal framework. Our assessment of industry risk in the New Zealand banking sector is underpinned by the country's conservative regulation and the sector's restrained risk appetite, which are partly offset by limited funding support from customer deposits and a material dependence on net external borrowings.

The SACP for Heartland is 'bbb-'.

We assess Heartland's business position as "weak." We consider Heartland as having a small market share in terms of total assets (0.6% of total banking system assets), similar to a number of domestic peers we assess similarly. We also believe, however, that Heartland's business position has shown a strengthening trend. We are of the view that Heartland's strategy and chosen target market are distinctly different from its peers', resulting in less direct competition and lower contestability compared to the traditional markets. We believe that Heartland's market penetration into its chosen niches (consumer finance lending, livestock financing, and invoice financing) is gaining momentum, and that these exposures are more diversified than those within other, smaller banks. We hold the view that Heartland's future business position should also benefit from the progress made to exit the non-core property loans sector when market conditions are right.

We view the corporate governance structures in place as being adequate for

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Heartland, given the nature and scale of the bank's business activities. In our view, Heartland's strategy is well articulated and understood throughout the organization, and adapted to the environment that it operates in. We maintain our view that the executive management team is competent in managing the bank.

We assess Heartland's capital and earnings as "very strong," reflecting our expectation that the pre-diversification risk-adjusted capital (RAC) ratio will be broadly stable within the 16%-17% range over the next 12-18 months.

We've adjusted our RAC ratio forecast range downward by 50 basis points (bps) from our previous forecast, largely given Heartland's revised strategy for its non-core property asset portfolio, which results in fee write-off and write-down of assets amounting to NZ\$24 million.

Our forecast reflects our expectation that risk-weighted asset growth would be driven by the business, rural, and consumer divisions, offset by a reduction in residential mortgage and non-core property lending. We expect the rebalancing of the advances portfolio to increase risk-weighted assets relative to actual loan growth (primarily because of the higher risk weights for business rural and consumer loans, with lower risk weights for residential mortgage loans). In addition, we also believe that interest margins will improve as the rebalancing takes effect. Our expectations are that the size of dividend payments would only be determined after regulatory and rating agency capital-adequacy requirements had been considered.

We note that Heartland's RAC ratio could potentially fall to below 15% if our economic risk score and banking industry country risk assessment score on New Zealand's banking system worsened to "4". We are of the view that in addition to internal capital generation potentially moderating the impact of a downward adjustment to Heartland's capital and earnings assessment are capital-management initiatives to restore the RAC ratio to above 15%. In this regard, we believe that Heartland's management has the capacity and willingness to defend the bank's RAC ratio above 15%.

From a regulatory capital perspective, Heartland maintains capital ratios well in excess of the regulatory minimums, with Core Equity Tier 1, Tier 1, and Total Capital ratios of 13.76% in excess of the statutory minima of 10% (CET1) and 12% (Tier 1 and Total Capital adequacy), respectively.

Our risk-position assessment for Heartland is "moderate." In line with our expectations, Heartland continued to post high growth in its identified target markets, namely asset finance (motor vehicle finance), rural loans (livestock finance), and business loans (invoice finance). This growth was offset by a reduction in the bank's exposures to the residential mortgage market and its non-core lending portfolio, in line with its core strategy. Combined, the overall loan growth in finance receivables reduced by about 3.3%. In our view, the high growth in core assets and rebalancing of the loan portfolio still expose the bank to additional risks compared to peer banks in a more stable operating environment. Notwithstanding the afore-mentioned, we believe that

credit-underwriting standards are maintained.

We note that excluding Heartland's new strategy for non-core legacy properties, the overall trend in non-performing loans is improving. We believe that successful resolution of the non-core property portfolio over the medium term would alleviate some concentration risk concerns we still hold concerning the non-core property asset portfolio. In our view, the successful merger and bank registration has mitigated some operational risks during the transition period.

We assess Heartland's funding as "below average". We are of the view that Heartland's funding metrics improved in 2013, reflecting Heartland's improved loan-to-deposit ratio of 109%, from 128%, and a net stable funding ratio that improved to 101%, from 92%. These improvements largely reflect an increase in Heartland's retail deposits in the form of savings and term deposits. That said, we consider Heartland's core deposit funding base (which accounts for about 88% of its total funding base) as remaining vulnerable to competitive pressure from the major banks (who are reliant on offshore wholesale funding) should they compete more aggressively for domestic retail deposits.

We assess Heartland's liquidity assessment as "adequate". Liquidity management focuses on both overall balance-sheet structure and control of risk (within prudent limits) arising from the mismatch of maturities across the balance sheet, and exposure to undrawn commitments and other contingent obligations. Heartland also makes use of various scenarios to manage its liquidity risk profile. We note that Heartland's broad liquid assets are 1.25x total short-term funding.

Outlook

The outlook assigned to Heartland's rating is developing. The developing outlook reflects our view that Heartland's rating could be raised or lowered due to two different but similarly probable scenarios within the next two years.

The rating could be raised if Heartland were to successfully further develop its business position in the next six-to-twelve months and economic vulnerabilities were not to worsen. In this scenario, we expect to raise the rating and the outlook would likely be revised to negative to reflect current credit concerns relating to New Zealand's economic vulnerabilities.

The rating could be lowered if credit concerns relating to New Zealand's economic vulnerabilities (including its material dependence on external borrowings, persistent current account deficits, and recent strong growth in house prices), which underpinned our outlook revision on May 16, 2013, escalated before any upward revision of our business position assessment. In that scenario, we expect to lower the rating and revise the rating outlook to positive, reflecting the trend of Heartland's strengthening business profile.

Lastly, the potential also exists for the business position assessment of

Heartland and economic risk score assessment of New Zealand being revised simultaneously. If this were to occur the rating of Heartland would be affirmed.

Related Criteria And Research

- Group Rating Methodology, May 7, 2013
- Banks: Revised Market Risk Charges For Banks In Our Risk-Adjusted Capital Framework, June 22, 2012
- Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Banks: Bank Hybrid Capital Methodology And Assumptions, Nov. 1, 2011
- Banks: Bank Capital Methodology And Assumptions, Dec. 6, 2010

Ratings List

Ratings Affirmed

	To	From
Heartland Bank Ltd. Counterparty Credit Rating	BBB-/Developing/A-3	BBB-/Negative/A-3
MARAC Insurance Ltd. Counterparty Credit Rating Local Currency	BB+/Developing/--	BB+/Negative/--
Financial Strength Rating Local Currency	BB+/Developing/--	BB+/Negative/--

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