

NZX/ASX release
8 October 2021

Heartland long-term rating affirmed, outlook remains stable

Fitch Rating (**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.

In its press release, attached, Fitch noted Heartland's favourable profitability comparative to other banks, stable asset quality, good risk management systems and control frameworks, and strong capital position as positive rating factors.

Heartland is pleased with this recognition, and attributes it to its strategy to deliver products that are the best or only of their kind, its consistently high net interest margin, stability in its asset quality, and strong cost management through the delivery of products to customers by way of digital platforms.

Fitch has also revised the operating environment factor outlook to stable, from negative, as part of the review, reflecting its belief that downside risks related to New Zealand's economic prospects have abated sufficiently.

Heartland Bank remains one of just two Australasian banks to have no reduction or adverse change to its ratings or outlook since January 2020, despite the economic impacts of COVID-19.

– ENDS –

For further information, please contact the person(s) who authorised this announcement:

Andrew Dixon
Chief Financial Officer
021 263 2666
andrew.dixon@heartland.co.nz
Level 3, Heartland House, 35 Teed Street, Newmarket, Auckland, New Zealand



RATING ACTION COMMENTARY

Fitch Affirms Heartland at 'BBB'; Outlook Stable

Tue 05 Oct, 2021 - 9:50 PM ET

Fitch Ratings - Sydney - 05 Oct 2021: 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.

KEY RATING DRIVERS

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

The ratings of HGL and HBL are driven by the group's consolidated financial profile, which is underpinned by its sound profitability. Heartland has a limited franchise and focuses on niche segments where it can achieve a market leading position. The bank appears to have higher risk appetite in commercial and non-residential mortgage consumer lending compared with peers, although it is mitigated by its good risk management systems and control frameworks.

We revised the operating environment factor outlook to stable, from negative, as part of the review. The revision reflects an improvement in New Zealand's economic prospects since mid-2020, although the current lockdowns may temporarily disrupt the economic recovery. We believe downside risks have abated sufficiently to revise the factor outlook. This action was consistent with the action taken on New Zealand's large banks during a June 2021 review and three of the New Zealand regional banks in July 2021.

Fitch expects HGL's asset quality to remain generally stable in the short term, although current lockdowns could lead to a modest weakening in the bank's asset quality.

Nonetheless, we believe the economy remains fundamentally robust and significant

asset-quality deterioration is unlikely without another major shock to the economy, which is not our base case. This has led to us revising Heartland's asset-quality factor outlook to stable, from negative. We believe HGL's stage 3 loans/gross loans ratio, Fitch's core asset quality metric, will remain consistent with its current score of 'bbb+' over the next two years.

We believe HGL's profitability will continue to compare favourably with other New Zealand regional banks, reflecting its stronger net interest margin. Further release of Covid-19 related loan-loss provisions is likely as the economy continues to recover. This should in turn provide some short-term support to HGL's profitability in the financial year ending June 2022 (FY22), but we do not expect the benefit to be as large as in FY21. We expect HBL's operating profit/risk-weighted assets ratio to remain consistent with its factor score of 'a-' and thus have revised the factor outlook to stable from negative.

Fitch expects HBL's common equity Tier 1 (CET1) ratio to continue increasing in the next two years. The bank's CET1 ratio of 13.9% at end-June 2021 is already close to the 14% minimum Tier 1 ratio requirement under the new regulatory capital rules that will be fully implemented in mid-2028. Management is likely to target a moderate buffer above the minimum requirement. We expect Heartland to meet this requirement mainly through CET1 capital, although the bank may issue some Additional Tier 1 instruments. Additionally, the bank still needs to meet the minimum total capital ratio requirement of 16% by 2028, with Tier 2 instruments used to meet the difference between this and the Tier 1 requirement.

HGL's core funding metric of loans/customer deposits ratio may continue to increase in the next two years, largely due to its growth in Australia, which is funded by wholesale debt. This could put downward pressure on the group's current funding score of 'bbb' if HAG continues to grow at a fast pace and its reliance on wholesale funding remains unchanged. Nonetheless, HGL's strong net interest margin means it has a stronger capacity to increase deposit funding than its peers, if required. This provides some support to HGL's funding profile.

The Short-Term IDR of 'F3' is at the lower of the two options available at a Long-Term IDR of 'BBB' as the funding and liquidity score of 'bbb' is not sufficiently high enough to support the higher option. Senior debt ratings are aligned with the Long-Term IDR, consistent with Fitch's Bank Rating Criteria, published 28 February 2020.

SUPPORT RATING AND SUPPORT RATING FLOOR

HBL's Support Rating and Support Rating Floor reflect Fitch's view that, while support for the group from the New Zealand sovereign (Long-Term Foreign-Currency IDR:

AA/Positive) 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 and Support Rating are driven by our expectation that there is a high probability of 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, 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.

GUARANTEED DEBT RATING FOR HAG

HAG's guaranteed notes are rated one notch below parent HGL Long-Term IDR, in line with Fitch's Non-Bank Financial Institutions Rating Criteria. Please see "Fitch Rates Heartland Australia Group's AUD75 Million Guaranteed Medium-Term Notes 'BBB-'" at <https://www.fitchratings.com/site/pr/10150240> for more details.

RATING SENSITIVITIES

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

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

The IDRs of HBL and HGL, and the Viability Rating and long-term senior debt ratings of 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. A combination of the following would likely result in a downgrade:

- 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 CET1 ratio of HBL declining below 10.5% without a credible plan to replenish regulatory capital buffers.

A downgrade of HBL's Short-Term IDR and short-term senior debt ratings seems unlikely as it would require HBL's Long-Term IDR to be downgraded by at least two notches.

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

An upgrade is possible if there is a sustained improvement in the HGL's risk appetite and funding profile while maintaining its other financial metrics.

The Short-Term IDRs may be upgraded to 'F2' if we revised our funding factor score to '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

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.

GUARANTEED DEBT RATING FOR HAG

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

The senior debt ratings of HAG's guaranteed debt instruments would be downgraded if HGL's IDR is downgraded.

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

The senior debt ratings of HAG's guaranteed debt instruments would be upgraded if HGL's IDR is upgraded.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Financial Institutions and Covered Bond 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.

ESG CONSIDERATIONS

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

RATING ACTIONS

ENTITY/DEBT	RATING		PRIOR	
Heartland Australia Group Pty Ltd	LT IDR	BBB- Rating Outlook Stable	Affirmed	BBB- Rating Outlook Stable
	ST IDR	F3	Affirmed	F3
	Support	2	Affirmed	2
● guaranteed	LT	BBB-	Affirmed	BBB-
Heartland Group Holdings Limited	LT IDR	BBB Rating Outlook Stable	Affirmed	BBB Rating Outlook Stable

[VIEW ADDITIONAL RATING DETAILS](#)

FITCH RATINGS ANALYSTS

George Hong

Director

Primary Rating Analyst

+61 2 8256 0345

george.hong@fitchratings.com

Fitch Australia Pty Ltd

Suite 15.01, Level 15 135 King Street Sydney 2000

Tim Roche

Senior Director

Secondary Rating Analyst

+61 2 8256 0310

tim.roche@fitchratings.com

Tania Gold

Senior Director

Committee Chairperson

+65 6796 7224

tania.gold@fitchratings.com

MEDIA CONTACTS

Peter Hoflich

Singapore

+65 6796 7229

peter.hoflich@thefitchgroup.com

Additional information is available on www.fitchratings.com

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APPLICABLE CRITERIA

[Non-Bank Financial Institutions Rating Criteria \(pub. 29 Feb 2020\) \(including rating assumption sensitivity\)](#)

[Bank Rating Criteria \(pub. 29 Feb 2020\) \(including rating assumption sensitivity\)](#)

ADDITIONAL DISCLOSURES

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

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ENDORSEMENT STATUS

Heartland Australia Group Pty Ltd

EU Endorsed, UK Endorsed

Heartland Bank Limited

EU Endorsed, UK Endorsed

Heartland Group Holdings Limited

EU Endorsed, UK Endorsed

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Banks Asia-Pacific New Zealand
