GCR RATINGS

Public credit rating report | South African Financial Institution | October 2020

Grindrod Bank Limited

Rated Entity	Rating class	Rating scale	Rating	Outlook/Watch
Grindrod Bank Limited	Long Term Issuer	National	A-(ZA)	Stable Outlook
	Short Term Issuer	National	A2(ZA)	--
	Long Term Issuer	International	B+	Stable Outlook

Strengths

- Strong risk position, with credit losses below peers.
- Stable funding structure with good liquidity.

Weaknesses

- Weak competitive position given the relatively small size and modest market share.

Rating rationale

The national scale long and short-term issuer ratings, as well as the international scale long term issuer rating of Grindrod Bank Limited ('Grindrod'; 'the bank') have been affirmed. This reflects the bank's historically superior cost of risk relative to peers, adequate capitalisation and sound funding structure and liquidity. This is balanced by the bank's weak competitive position.

Grindrod operates exclusively in South Africa, and its operating environment score has been reduced to a total of 14.5 from 15.5. This as a result of the South African Country risk score being reduced to 7.0 from 7.5, and the South African Financial Institutions Sector risk score being reduced to 7.5 from 8.0.

Grindrod's weak competitive position reflects the bank's relatively small size, with a modest market share of approximately 0.2% in an oligopolistic South African banking sector. It further reflects our expectation of increased revenue volatility, as a result of the reduction in the more stable historical fee income which was earned from the provision of bank accounts to South African Social Security Agents ("SASSA") grant beneficiaries. Positively the bank does have some product diversification, offering a broad range of products and services, albeit with a large portion of its lending activities skewed towards commercial real estate.

Capitalisation and earnings are a neutral ratings factor. In terms of the requirements of the Banks Act, the bank did not meet the minimum capital requirements for FY19. This was a technical breach caused by the consolidation of two trusts that source and sell to investors cumulative redeemable preference shares. The trusts were deemed to be controlled by the bank and were therefore consolidated, resulting in the capital adequacy breach. The breach was condoned by the Prudential Authority whilst a remediation process, which was completed by 1 September 2020, was undertaken. The breach was remedied through de-consolidation of the trusts. GCR expects the capital ratio to return to between 14%-15% and remain in the lower end of that range over the outlook horizon. This balancing the expected loan book growth with adequate returns. We forecast the bank to return approximately 0.8% to 1.0% of total assets over the next 12 months, balancing a restrained net interest margin of just over 1%, cost to income of approximately 55%, flat non-interest revenues and a low cost of risk.

The risk position is a positive ratings factor. This opinion balances the bank's very strong historical cost of risk, along with our expectation of a deterioration in asset quality as a result of Covid-19. Credit losses have averaged less than 0.3% of total loans over the past five years and are expected to remain below 0.5% in the next 12 months, even with the severely impacted operating environment. This expectation also factors in the bank's intention to increase its lending activities. The bank's loan book is somewhat concentrated in the commercial real estate sector; however, it holds good levels of collateral against it. Loan loss reserves are considered to be adequate, at around 101.6% of non-performing loans at 31 December 2019.

Funding and liquidity are a relative strength of the bank versus market peers. Despite some single name concentrations in the deposit book and higher cost of funds, we consider the funding structure to be stable and benefitting from the lack of concentrations with financial corporates. Furthermore, liquidity is considered to be good, with liquid assets covering a significant 52% of total deposits and multiples of the banks wholesale funding at 31 December 2019. The regulatory net stable funding and liquidity coverage ratios both compare well to market peers. GCR expects the liquidity position to remain good but decrease marginally over the next 2 – 3 years as the bank increases it lending activity.

Despite being an important and well supported entity within the wider Grindrod Group we have not factored in any support to the ratings on the bank. This largely reflects a conservative view on the capacity of the group to provide timely support, given publicly available information on the group.

Outlook statement

The outlook is stable, balancing the severely weakened operating environment with our opinions on stable risk, capital, and liquidity.

Rating triggers

We could raise the rating if the earnings capacity and capitalisation of the bank improves from beyond current levels. We consider a lowering of the national scale to be unlikely over the outlook horizon, although a deterioration of asset quality would bring down the ratings.

Analytical contacts

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Related criteria and research

Criteria for the GCR Ratings Framework, May 2019
Criteria for Rating Financial Institutions, May 2019
GCR Ratings Scale, Symbols & Definitions, May 2019
GCR Country Risk Scores, May 2020
GCR Financial Institutions Sector Risk Score, June 2020

Ratings History

Grindrod Bank Limited					
Rating class	Review	Rating scale	Rating class	Outlook	Date
Long Term issuer	Initial	National	BBB+(ZA)	Stable	April 2016
	Last	National	A-(ZA)	Stable	October 2019
Long Term issuer	Initial	International	BB	Stable	April 2016
	Last	International	B+	Stable	October 2019
Short Term issuer	Initial	National	A2(ZA)	N/a	April 2016
	Last	National	A2(ZA)	N/a	October 2019

Analytical entity: Grindrod Bank Limited

The national scale issuer ratings on Grindrod reflect the strengths and weaknesses of Grindrod Bank Limited on a stand-alone basis. Grindrod Bank Limited is part of a wider group, Grindrod Limited, which is a JSE listed holding company focused on freight movement and related industries. Grindrod Bank Limited is a small part of the group, contributing c.8% to the group's revenue and is insulated from the rest of the group as a result of regulation and the investment holding company nature of the group.

Operating Environment

The operating environment assessment is anchored by Grindrod Bank Limited's 100% exposure in South Africa.

Country risk

The South Africa country risk score of '7.0' reflects GCR expectations that GDP per capita will range between US$6,000 and US$6,500 over the next 12-18months, balancing deeply negative economic growth in the short term due to COVID-19, with modest in the medium/ long term with stable population growth and continued pressure on the local currency. It also factors in institutional scores in the middle of the range, supported by voice & accountability and regulatory quality, macro-economic stability, infrastructure and the strengths of the financial system. Corruption and politics, innovation and health are the detracting elements of institutional strength for the country. GCR have made a small positive adjustment to the initial score, balancing the size and diversification of the South African economy versus regional peers and strong monetary policy flexibility against the deteriorating fiscal position of the government and high profile SOEs.

Sector risk

GCR has lowered the South African Financial Institution sector risk score to 7.5. The onset of the COVID-19 pandemic has compounded an already strained operating environment, with the South African Reserve Bank (SARB) projecting a 7% GDP contraction in 2020.

Given the early indicators from the banks, we expect credit losses will increase to between 1.5%-1.7% for the top tier banks, rising to over 2% for the sector has a whole; largely because the 2nd and 3rd tier unsecured and SME lenders will have a disproportionate impact on sector wide credit losses in comparison to their size.

South African households appear to be in a relatively good space to service debt, due to the reduction in household leverage over the past 10 years and the positive impact on affordability from lower interest rates. However, the reduction in employment and disposable income will bring up credit losses materially across most of the banks. Given the dynamics of the population, and the flat real estate industry over the past 5 years, we expect unsecured and semi-secured lending (over half of total household liabilities) to be the major source of credit losses. SME lending will also face a great deal of pressure, with credit losses climbing significantly. However, this book represents only about 7.5% of total banking sector loans. More positively, the overall corporate sector is expected to just about navigate through these challenging times, albeit with pockets of vulnerability, due to the modest levels of leverage. Going forward, GCR views the hospitality, tourism and discretionary retail sectors as the most at risk, due to enforced restrictions on population movement and social gatherings by the South African government caused by the COVID-19 pandemic. We estimate that these vulnerable sectors represent around 10% of the total loan books for the banking sector.

The return on equity and return on assets of the South African banking system moderated to 13.5% and 1.06% in March 2020 from 15.68% and 1.27% in March 2019 respectively, and we expect profitability to deteriorate further by the year end. This opinion reflects the lower interest rate environment, lower business transactions and higher cost of risk. Positively, the coverage of operating costs by relatively risk-free non-interest income underlines some stability for banks. With regard to capitalisation, we expect the tier one ratio to range between the 12.75% and 13.25% range by year end 2020 (13.6% as of year-end 2019.

On a positive note, the sector risk score compares favourably to regional peers, given the sound risk management of the top tier banks (which account for just over 90% of total industry assets) and will continue to underpin the sectors stability. The strong regulatory framework (through early adoption of international risk management practices) has also allowed for a build-up of good capital and liquidity buffers over the years, and while profitability will weaken, capital preservation will be aided by dividend suspensions and possibly lower credit growth that will keep leverage under control. The absence of any build-up in foreign currency mismatches due to regulatory exchange controls has meant that the depreciation and volatility of the South African rand during this period has not had a material impact on the sector. Furthermore, the reserve bank has stepped in to inject liquidity into the system and relax regulatory guidelines in order to provide some stability to the system and ensure banks can continue to fulfil their primary objectives of providing credit to the economy. This has stabilised liquidity in the system, at least in the short term, but medium term risks remain given the uncertain course of the pandemic and implications thereof.

Business Profile

Competitive position

Weak competitive profile, with a relatively small size, modest market share and no geographic diversification.

Competitive positioning is a negative factor for the ratings. Grindrod's weak competitive position reflects the bank's relatively small size, with a modest market share of approximately 0.2% in an oligopolistic South African banking sector. The bank has some product diversification, offering a broad range of products and services, albeit with a large portion of its lending activities skewed towards commercial real estate. The exposure to commercial real estate is largely industrial, which has proven to be resilient even with the economic impact of COVID-19, with some retail exposure which we expect to continue to come under pressure. Grindrod's geographic diversification is weak, operating exclusively in South Africa, and further only having a presence in South Africa's four biggest cities.

Revenue stability has weakened with the contribution of more stable non-interest income to operating revenues declining from c.74% in FY18 to c.67% in FY19. This is a result of the reduction in the fee income which was earned from the provision of bank accounts to SASSA grant beneficiaries. Further, at 30 June 2020 c.41% of the bank's financial assets were exposed to cash and negotiable instruments, the returns of which can be impacted both positively or negatively (materially negative most recently) by interest rate movements which can be material and hard to predict during times of economic uncertainty.

Management and governance

Management and governance is considered neutral to the ratings.

Financial Profile

Capital and Leverage

Adequate capitalisation, expected to be sustained

Capitalisation and earnings are a neutral ratings factor. In terms of the requirements of the Banks Act, the bank did not meet the minimum capital requirements for FY19. However, we believe that this technical breach caused by the consolidation of two trusts that source and sell to investors cumulative redeemable preference shares, did not truly reflect the capital position of the bank at the time. In the opinion of the auditor/ regulator the trusts were deemed to be controlled by the bank and were therefore consolidated, resulting in the capital adequacy breach. The breach was condoned by the Prudential Authority, and has officially been remedied through relinquishing control and management of the trusts, which have been de-consolidated, while the bank still earns a similar level of income from the preference share activities.

Grindrod's capital ratio returned to 15.28% at HY20 after remedying the technical capital breach. GCR expects the capital ratio to migrate marginally lower to within the 14% - 15% range over the outlook horizon. This follows GCR's expectation of moderate loan growth as the bank looks to support its earnings (high proportion of financial assets are currently low yielding cash and negotiable securities), as well as the need for higher provisioning because of negative risk migration, resulting in risk weighted asset growth marginally outpacing internal capital generation. We forecast the bank to return approximately 0.8% to 1.0% of total assets over the next 12 months, balancing a restrained net interest margin of just over 1%, cost to income of approximately 58% (higher than historical levels even with slowing operating expenses as a result of lower operating income), flat non-interest revenues and a low cost of risk in the 0.4% - 0.6% range.

Our forecast factors in the following over the next 12-18 months:

- Loan growth of around 5% over the next two years;
- Core earnings to adjusted assets in the range of 0.8% to 1% over the rating horizon, from an average of 1.2%, reflecting a reduction in fee and commission income;
- Cost of risk is expected to peak at around 0.8% and moderate to the 0.4% - 0.6% range over the next 12-18 months.

Table 1: Capitalisation (%)

	2021(f)	2020 (e)	2019	2018	2017
GCR total capital to RWA	15.00	14.48	9.31	14.3	14.02
Core earnings to adjusted assets	0.54	0.52	0.54	1.46	1.12

f: Based on GCR forecasts. e: GCR expectations.

Risk

Good risk position with credit losses below peers and well collateralised loan book.

The risk position is a positive ratings factor. This opinion balances the bank's very strong historical cost of risk, along with our expectation of a deterioration in asset quality as a result of Covid-19. Credit losses have averaged less than 0.3% of total loans over the past five years and peaked at 0.84% at HY20 as a result of Covid-19. GCR expects credit losses to stabilise within the 0.4% - 0.6% range in the next 12 months, even with the severely impacted operating environment. This expectation factors in the bank's intention to carefully increase its lending activities, while remaining cautious as a result of an already deteriorating operating environment being exacerbated by the economic impact of Covid-19.

The bank's loan book is somewhat concentrated in the commercial real estate sector; largely in industrial commercial property which has proven to be resilient for the bank, and to a lesser extent in retail commercial property, which GCR expects to continue to come under pressure. Positively, Grindrod has no exposure to unsecured lending and holds good levels of collateral against its loan book. Loan loss reserves are considered to be adequate, at around 101.6% of non-performing loans.

Table 2: Risk (%)	2021(f)	2020 (e)	2019	2018	2017
New loan loss provisions to average customer loans	0.4	0.5	0.3	0.3	0.1
Loan loss reserves to non-performing loans	149.5	117.3	101.6	79.0	40.4
Gross non-performing loans to average customer loans	1.4	1.5	1.2	1.0	1.3

f: GCR forecast.

Funding and Liquidity

Solid funding structure and good liquidity.

Funding and liquidity are a relative strength of the bank versus market peers. Despite some single name concentrations in the deposit book and higher cost of funds, we consider the funding structure to be stable and benefitting from the lack of concentrations with financial corporates. At FY19, the bank had a core deposits to total funding base ratio of 93.4%, as well as a long-term funding ratio of 112.5%, both of which GCR views positively. This is in line with both historical levels, and our expectations going forward.

Furthermore, liquidity is considered to be good, with liquid assets covering a significant 52% of total deposits at FY19 and multiples of the banks wholesale funding. The regulatory net stable funding and liquidity coverage ratios both compare well to market peers. GCR expects the liquidity position to remain good but decrease marginally over the next 2 – 3 years as the bank increases it lending activity.

Table 3: Funding and Liquidity (%)	2021(f)	2020 (e)	2019	2018	2017
Long term funding ratio	104.8	104.4	112.5	111.2	107.3
GCR Stable funds ratio	138.9	139.2	92.0	113.7	130.5
GCR liquid assets/ customer deposits	53.3	53.8	52.2	46.2	62.8

f: GCR forecast. e: GCR expectations.

Comparative Profile

The comparative profile is neutral to the ratings.

Peer analysis

The peer analysis is neutral to the ratings.

Group support

Despite being an important and well supported entity within the wider Grindrod Group we have not factored in any support to the ratings on the bank. This largely reflects a conservative view on the capacity of the group to provide timely support, given publicly available information on the group.

Rating Adjustment Factors

Structural adjustments

No structural adjustments have been made to the ACE in arriving at the final ratings.

Instrument ratings

No instrument rating adjustments.

Risk Score Summary

Rating Components & Factors	Risk scores
Operating environment	**14.50**
Country risk score	7.00
Sector risk score	7.50
Business profile	**(3.50)**
Competitive position	(3.50)
Management and governance	0.00
Financial profile	**1.00**
Capital and Leverage	0.00
Risk	0.50
Funding and Liquidity	0.50
Comparative profile	**0.00**
Group support	0.00
Government support	0.00
Peer analysis	0.00
Total Score	**12.00**

Glossary

Balance Sheet	Also known as Statement of Financial Position. A statement of a company's assets and liabilities provided for the benefit of shareholders and regulators. It gives a snapshot at a specific point in time of the assets the company holds and how they have been financed.
Capital	The sum of money that is invested to generate proceeds.
Cash Flow	The inflow and outflow of cash and cash equivalents. Such flows arise from operating, investing and financing activities.
Cash	Funds that can be readily spent or used to meet current obligations.
Covenant	A provision that is indicative of performance. Covenants are either positive or negative. Positive covenants are activities that the borrower commits to, typically in its normal course of business. Negative covenants are certain limits and restrictions on the borrowers' activities.
Debt	An obligation to repay a sum of money. More specifically, it is funds passed from a creditor to a debtor in exchange for interest and a commitment to repay the principal in full on a specified date or over a specified period.
Diversification	Spreading risk by constructing a portfolio that contains different exposures whose returns are relatively uncorrelated. The term also refers to companies which move into markets or products that bear little relation to ones they already operate in.
Exposure	Exposure is the amount of risk the holder of an asset or security is faced with as a consequence of holding the security or asset. For a company, its exposure may relate to a particular product class or customer grouping. Exposure may also arise from an overreliance on one source of funding. In insurance, it refers to an individual or company's vulnerability to various risks
Income	Money received, especially on a regular basis, for work or through investments.
Interest Cover	Interest cover is a measure of a company's interest payments relative to its profits. It is calculated by dividing a company's operating profit by its interest payments for a given period.
Interest	Scheduled payments made to a creditor in return for the use of borrowed money. The size of the payments will be determined by the interest rate, the amount borrowed or principal and the duration of the loan.
Issuer	The party indebted or the person making repayments for its borrowings.
Leverage	With regard to corporate analysis, leverage (or gearing) refers to the extent to which a company is funded by debt.
Liquidity	The speed at which assets can be converted to cash. It can also refer to the ability of a company to service its debt obligations due to the presence of liquid assets such as cash and its equivalents. Market liquidity refers to the ease with which a security can be bought or sold quickly and in large volumes without substantially affecting the market price.
Long Term Rating	See GCR Rating Scales, Symbols and Definitions.
Margin	A term whose meaning depends on the context. In the widest sense, it means the difference between two values.
Market	An assessment of the property value, with the value being compared to similar properties in the area.
Maturity	The length of time between the issue of a bond or other security and the date on which it becomes payable in full.
Operating Cash Flow	A company's net cash position over a given period, i.e. money received from customers minus payments to suppliers and staff, administration expenses, interest payments and taxes.
Rating Outlook	See GCR Rating Scales, Symbols and Definitions.
Risk	The chance of future uncertainty (i.e. deviation from expected earnings or an expected outcome) that will have an impact on objectives.
Short Term Rating	See GCR Rating Scales, Symbols and Definitions.
Short Term	Current; ordinarily less than one year.

Salient Points of Accorded Ratings

GCR affirms that a.) no part of the ratings was influenced by any other business activities of the credit rating agency; b.) the ratings were based solely on the merits of the rated entity, security or financial instrument being rated; and c.) such ratings were an independent evaluation of the risks and merits of the rated entity, security or financial instrument.

The credit rating has been disclosed to Grindrod Bank Limited. The ratings above were solicited by, or on behalf of, the rated entity, and therefore, GCR has been compensated for the provision of the ratings.

Grindrod Bank Limited participated in the rating process via teleconference management meetings, and other written correspondence. Furthermore, the quality of information received was considered adequate and has been independently verified where possible. The information received from the entities and other reliable third parties to accord the credit ratings included:

- Audited financial results as at 31 December 2019;
- Analysis of Financial Results for the period ended June 2020;
- Opinion on De-consolidation of Preference Share Trusts;
- Other publicly available information and
- Industry comparative data.