Research Update:

Development Bank of Southern Africa Ratings Affirmed; Outlook Stable

October 30, 2019

Overview

- In our view, there is an almost certain likelihood that the South African government would provide timely and sufficient extraordinary support to the Development Bank of Southern Africa Ltd. (DBSA) if needed.
- Consequently, we equalize our ratings on DBSA with those on South Africa.
- We are affirming our 'BB/B' foreign currency ratings and 'BB+/B' local currency ratings on DBSA.
- The stable outlook reflects the outlook on the Republic of South Africa, indicating that our ratings on DBSA will move in conjunction with those on the sovereign, provided we continue to assess the likelihood of government support as almost certain.

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Rating Action

On Oct. 30, 2019, S&P Global Ratings affirmed its 'BB/B' long- and short-term foreign currency issuer credit ratings and 'BB+/B' long- and short-term local currency issuer credit ratings on the Development Bank of Southern Africa Ltd. (DBSA). The outlook remains stable.

Rationale

We equalize our ratings on DBSA with those on South Africa (foreign currency BB/Stable/B, local currency BB+/Stable/B). This reflects our opinion that there is an almost-certain likelihood that the South African government would provide timely and sufficient extraordinary support to DBSA in the event of financial distress.

Consistent with our criteria for government-related entities (GREs), we base our rating approach on our view of DBSA's:

- Critical role as one of the South African government's primary vehicles for promoting infrastructure development in the country's public and private sectors.
- Integral link with the South African government, through 100% ownership, ongoing government

supervision, and capital injections when required.

Our assessment of the critical importance of DBSA's role to the government is based on our view that DBSA remains one of the government's key vehicles for delivering infrastructure development and meeting strategic policy goals. DBSA's mandate is to largely focus on infrastructure financing and development in municipalities, public institutions, and other projects in South Africa and the region.

Within South Africa, DBSA predominantly supports public sector projects in energy, transport, and in metropolitan municipalities where infrastructure projects aim to catalyze economic growth. The government has also recently set up an infrastructure fund, and the fund's implementation unit sits within DBSA with an aim to fast-track development projects.

DBSA also plans to increase lending to poorer under-resourced municipalities and the water sector to assist in closing infrastructure gaps. It is, however, limited by the availability and readiness of those entities to create viable financeable projects. Consequently, DBSA support to those municipalities often takes the form of technical assistance grants, capacity-building initiatives, and overall project support. DBSA's ongoing commitment in this respect aims to enhance its developmental role and help drive GDP growth in the country.

DBSA also has a mandate for the development of the Southern African Development Community (SADC), primarily infrastructure financing projects that aim to link the region economically. In 2015, DBSA received an even wider mandate to provide lending and support to the rest of Africa. Despite this wider mandate, DBSA's will remain mainly concentrated in South Africa, which will make up about 75% of the loan book. Outside South Africa, DBSA often faces competition from other development financial institutions that offer lending at concessional rates, are often owned by multiple governments, and also benefit from preferred creditor treatment as multilateral institutions. While trying to fulfil government policy initiatives, DBSA is also guided by commercial viability, as required by the South African government as sole shareholder, while simultaneously considering the benefits of regional integration.

Our assessment of the strength and durability of the link between DBSA and the government remains integral, based on 100% ownership and ongoing government supervision. Between 2012 and 2015, the government injected South African rand (ZAR) 7.9 billion into DBSA, reinforcing the shareholder (government) involvement in DBSA's mandate. We understand that the government views the capital injections in part as a way of strengthening DBSA's contribution to municipal lending and project-based funding to second-tier state-owned enterprises, and funding of core domestic and regional infrastructure projects and programs. DBSA maintains callable capital of ZAR20 billion to boost its capital base.

We assess the DBSA's stand-alone credit profile (SACP; not considering the likelihood of government support) at 'bb', with a 'bb+' anchor. We view the bank's capital and earnings as supportive of its SACP and the remaining factors as less supportive. We note the concentration within the loan portfolio and downside pressure that could emerge on the SACP should there be a deterioration of the loan portfolio. Our 'bb+' anchor for DBSA draws on our Banking Industry Country Risk Assessment (BICRA) methodology and our view of the economic risks facing DBSA's lending outside South Africa.

The bank's business position is constrained by the bank's modest size and relatively narrow focus on infrastructure and public sector financing. We consider the profitability posted by the group and its unique position within South African market as supportive factors to its business position. The bank's operations are segmented into two main business lines: lending within South Africa (75% of total loans) and financing in the rest of Africa (25%). The energy sector remains the largest recipient of development finance (58% of total lending), with the balance disbursed among municipalities and the infrastructure subsectors of water and sanitation, as well as in transport in South Africa and across the SADC region.

We assess DBSA's capital and earnings as very strong. At year-end 2018, the risk-adjusted capital (RAC) ratio before adjustments was 19.2%, a reduction from 20.4% the year before amid a shift to exposure. We expect the RAC ratio to weaken to between 18%-19% in 2020, balancing modest loan growth and volatile capital generation. We consider DBSA's earnings to be volatile. At year-end 2018, earnings improved noticeably to ZAR3.1 billion from ZAR2.2 billion a year earlier. The increase is attributable to a swing in foreign exchange revaluation gains of ZAR744 million realized in 2018 (2017: loss of ZAR302 million). We expect return on equity (ROE) will remain in line with historic averages over the next 18-24 months, on the back of a broadly stable net interest margin.

We believe that DBSA's risk position is under pressure, in line with the pressures on the broader South African economy. Nonperforming loans have risen and in our opinion are likely to breach the 6% internal limit, albeit remain below the peak of 9% in 2013. We recognize the role of the development bank to act counter-cyclically along with the improved risk management in recent periods in terms of loan underwriting, surveillance, and recovery. Nevertheless, given the challenging macroeconomic environment both within South Africa and the surrounding SADC, we expect asset quality metrics will weaken in 2019. We expect the NPL ratio will exceed 7% in 2019 before falling toward the upper limit of 6% in 2020 and 2021. We expect NPL coverage will remain above 100% over the forecast period, which is well above the coverage ratios of South African commercial banks.

We consider single obligor concentrations to be high, given the bank's countercyclical and development mandate. Concentration increased in the last financial year, with the top 20 loans accounting for over 70% of total loans and around 160% of total adjusted capital as of March 31, 2019, above 2018's figures of 60% and 140%, respectively. Moreover, the largest loan, to Eskom, accounted for 22% of total loans and more than 50% of total adjusted capital at the same time. In August 2017, DBSA waived a "clean audit" clause in its debt agreement with Eskom and allowed the utility time to address its governance and accounting issues. We understand that the loans to Eskom are performing. Eskom's board has since been largely replaced and reforms are ongoing.

We consider funding to be a rating weakness given that DBSA is not a deposit-taking institution and relies on concentrated wholesale funds, with no direct access to central bank funds. That said, it does maintain sound liquidity ratios and a stable funding profile. Funding is largely made up of debt securities (70% of total funding) and lines of credit (30%). The main funding sources comprise funding from domestic capital markets, asset managers, local and international commercial banks, and development finance institutions.

The bank's relatively long-term funding structure attracts higher funding costs than other commercial banks, with its cost of funds slightly below 7.5% in March 2019 (2018: 7.5%), against a peer average of between 3%-4%. Nonetheless, the bank maintains good funding and liquidity metrics. As of March 2019, the long-term funding (LTF) ratio had declined to 75.0% (2018: 93%). We note some impact on the short-term liquidity ratios, amid the prefunding of the maturing DV22 bond. We expect the liquidity ratios to return to the long-run historical averages.

Outlook

The stable outlook on DBSA reflects the outlook on the Republic of South Africa, indicating that the ratings on DBSA will move in conjunction with those on the sovereign as long as we assess the likelihood of extraordinary support as almost certain. We expect that over the outlook horizon, which typically covers 12 months, DBSA will likely maintain its critical role and integral link with the South African government.

We could lower the ratings on DBSA if we downgraded South Africa. Pressure on the rating could also result from a weaker assessment of the almost certain link with the government, possibly tied to a significant extension of DBSA's activities to countries outside South Africa or to the private sector.

Upside rating potential for DBSA would be tied to an upgrade of the Republic of South Africa. We do not expect to rate DBSA higher than the sovereign.

Related Criteria

- Criteria | Financial Institutions | General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria | Financial Institutions | Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria | Financial Institutions | Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Criteria | Financial Institutions | Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- South Africa, May 24, 2019

Ratings List

Ratings Affirmed	
Development Bank of Southern Africa Ltd.	
Sovereign Credit Rating	
Foreign Currency	BB/Stable/B
Local Currency	BB+/Stable/B
Senior Unsecured	BB+

Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.