AFRICA MERCHANT CAPITAL: INSIGHTS

LAND AND AGRICULTURAL BANK OF SOUTH AFRICA

AMC TRADE FINANCE LTD

AFRICA MERCHANT CAPITAL

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“Strategy without tactics is the slowest route to victory.

Tactics without strategy is the noise before defeat.”

– *Sun Tzu*

1. Background

1.1 Introduction

This research is focused on the Land and Agricultural Development Bank of South Africa (Land Bank). As a pivotal role player in the South African agri-cultural landscape, it is important for institutional investors, retail investors as well as the public to take note of this key institution, what their mandate is, the role they play and most importantly the significance of the recent developments that have raised concerns in the agricultural community pertaining to their status as a going concern. This paper starts by exploring the role of Development Finance Institutions (DFI's) in the economy and the critical role they play in Africa's development. Next, we dig deep into the fundamentals of the Land Bank and explore areas of concerns and its possible impacts. Lastly, this research piece proposes possible solutions to the Land Bank demise and investigates the roles of alternative funders and solutions for agri-focused businesses and stakeholders.

1.2 The role of DFI's in society

DFI's aim to have a developmental impact in the markets in which they invest, alongside the requirement for sustainable returns. Sustainable returns refer to the methodology of identifying and quantifying environmental, societal, and economic impacts of investment in projects and initiatives (APWA, 2017). DFI's are typically majority owned by national governments and source their capital from national and international development funds or benefit from government guarantees. This, by and large, guarantees their creditworthiness in theory, which should make it possible for them to raise significant amounts of money in international capital markets at low rates and provide financing at competitive terms relative to commercial banks (OECD, 2019).

Figure 1: DFI's key features



Finance provided by DFI's are also intended to act as a catalyst to attract and mobilise the involvement of other private investors into sectors that would not have otherwise been considered. What sets DFI's apart from commercial banks is their unconventional credit qualification criteria, encompassing factors such as job creation, gender equality and youth employment capability. DFI's essentially reduce the amount of risk associated with projects directed towards developmental goals (ODI, 2011).

1.3 DFI's role in Africa

Development finance plays a critical role in African markets and have disbursed around US$500 billion towards the African continent over the last decade. Some of the major international DFI's invested in Africa include the World Bank, European Investment Bank, African Development Bank and The New Development Bank. The World Bank Group alone has invested approximately US$116 billion in Sub-Saharan Africa in an assortment of grants, credits, loans and guarantees between 2011 and 2019; whereas the African Development Bank Group mobilised around US$115 billion in 2019 alone for investment into Africa (GIIN, 2019).

Figure 2: Key DFI's in Africa



1.4 DFI's in South Africa

There are four major domestic DFI's in South Africa. They are listed below, followed by a short description of each and the sectors in which they focus:

a) Industrial Development Corporation (IDC)
b) Development Bank of South Africa (DBSA)
c) National Empowerment Fund (NEF)
d) Land and Agricultural Development Bank of South Africa (LADBSA or Land Bank)

a) Industrial Development Corporation (IDC): The IDC funds 'high- impact and labour intensive' projects across the whole of Africa. Sectors include mining, manufacturing, and infrastructure. Funding is disbursed against a measurement scorecard tracking metrics such as environmental impact, rural impact, black ownership, female ownership, and youth ownership. They have also launched a special initiative to integrate small medium enterprises (SME's) into the supply chains of larger corporations.

b) Development Bank of South Africa (DBSA): The DBSA has a pan-SADC (Southern Africa Development Community) mandate to promote sustainable economic development in this region. They have a focus on social and economic infrastructure and has funded several major projects in the healthcare, energy, water, and education industry. The DBSA is increasingly broadening its reach across Southern Africa and has supported several infrastructure initiatives in regions such as Lesotho, Namibia, Zambia, and Mozambique.

c) National Empowerment Fund (NEF): The NEF funds a variety of businesses including early-stage start-ups, up to multimillion-dollar projects. They do however have a focus on early-stage funding and as a result include in their offering an in-house incubation and technical assistance program for aspiring entrepreneurs. Only black South Africans or South African businesses that are majority black owned are eligible for NEF funding and has also put in place special incentives to attract female entrepreneurs.

d) Land and Agricultural Development Bank of South Africa (LADBSA or Land Bank): The Land Bank was founded in 1912 and is the oldest financial institution in Africa. It is a specialist African agricultural bank offering financial solutions to farmers through a spectrum of funding lines in the form of short to long term loans. Funding is mainly used for the financing of land, equipment, asset finance, livestock, and crop finance. Although the Land Bank has a development focused mandate, through its deposit-taking and retail-banking service offering, the bank does not strictly fit the definition as a pure DFI. Nonetheless, it is one of the largest development financiers in Sub-Saharan Africa, having disbursed close to US$ 13 billion in loans over the last five years.

1.5 Land Bank vision, mission, and values

The Land Bank utilises funding raised from public and private sector partnerships, each differing in capital raising methodology. The Land Bank's' vision is to be a world-class agricultural development bank, one that stimulates growth, drives performance, and spurs innovation. The Land Bank's' mission is to collaborate with all stakeholders to build an adaptive and competitive agricultural sector; one that drives environmental, social, and economic development, ultimately contributing to food security on the African continent. Their core values as listed per their annual investor report is pro-activity, empowerment, accountability, meaningful contribution, and organisational synergy (LBIAR, 2019). The mandate of the Land Bank highlights the importance of the agricultural sector to South Africa's development and transformation agenda. Their main objectives as per the Land Bank Act, No. 15 of 2002 are summarised in the list below:

Figure 3: Land- Bank Act key features

1. •Food security and commercial agriculture
2. •Rural development, job creation and entrepreneurship
3. •Environmental sustainability and equitable ownership
4. •Growth of the agricultural sector and access to land
5. •Enhancing productivity, profitability, investment and innovation

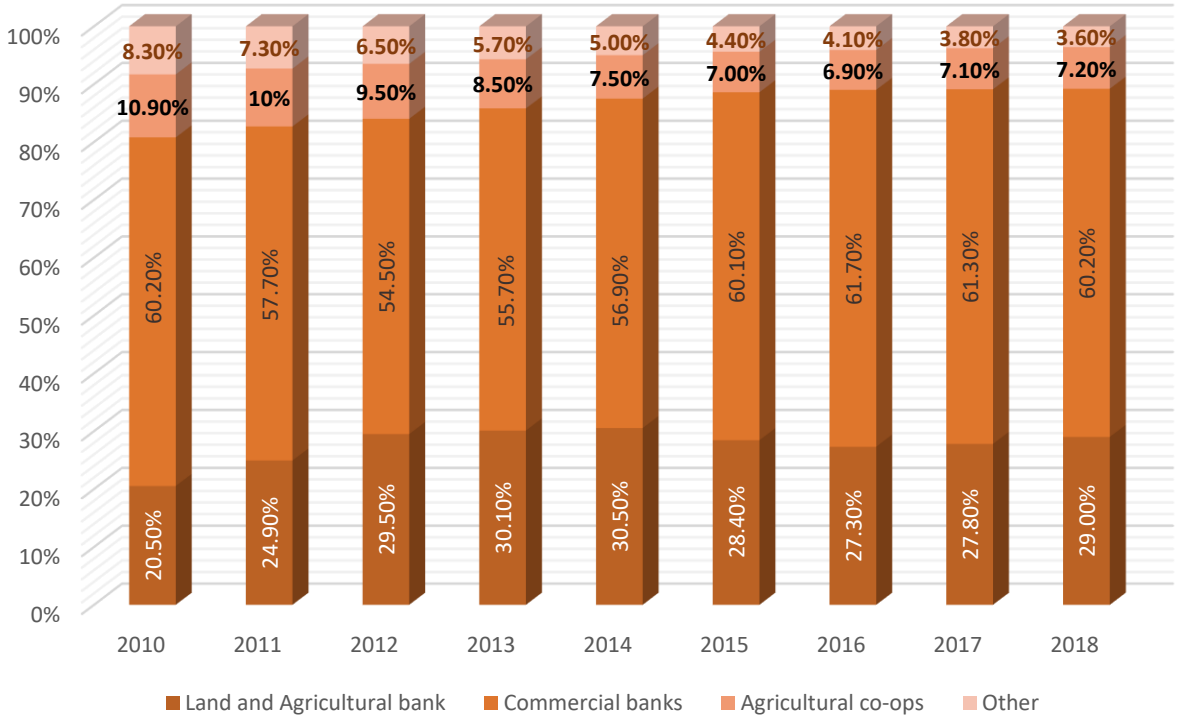
2. Setting the scene

2.1 Contribution to agricultural debt

Farming is a high-risk, high-cost business. Farmers require affordable funding for the purchase of equipment, crops, land, and a host of other input costs upfront, with profits from their farming endeavours only being realised once or twice per year at harvest season (DAFF, 2015). It is for this reason that multiple funding channels exist to support farmers financially, through commercial bank funding, agricultural co-ops, the Land Bank, and other means of funding (including private debt issuance or equity). The table below illustrates the breakdown of agri-finance debt market share in South-Africa from 2010-2018. The main contributors of debt in this sector are the commercial banks at around 60% of total agri debt, the Land Bank at 29% of total agri-debt, agricultural co-ops at 7%, and other private lenders at 3,6% (LBIAR, 2018).

The Land Bank contributes a significant portion of debt in the agricultural sector and plays an integral part of the SA agricultural economy. From all the funding channels in the last decade, the Land Bank is the only funder that has grown in agri-debt market share (41% growth) and has absorbed all the debt capital redemptions from private lenders and agricultural co-ops, who have reduced their market share by 56% and 34% respectfully. The commercial banks' market share has remained relatively consistent throughout (LBIAR, 2018). The reasons for the redemptions include risk-off sentiment from private investors into the agri-sector because of land reform uncertainty and the inability to compete with commercial and Land Bank cost of capital. These lines of funding have up until very recently been considerably less costly than private capital.

Table 1: SA Agri-debt market share

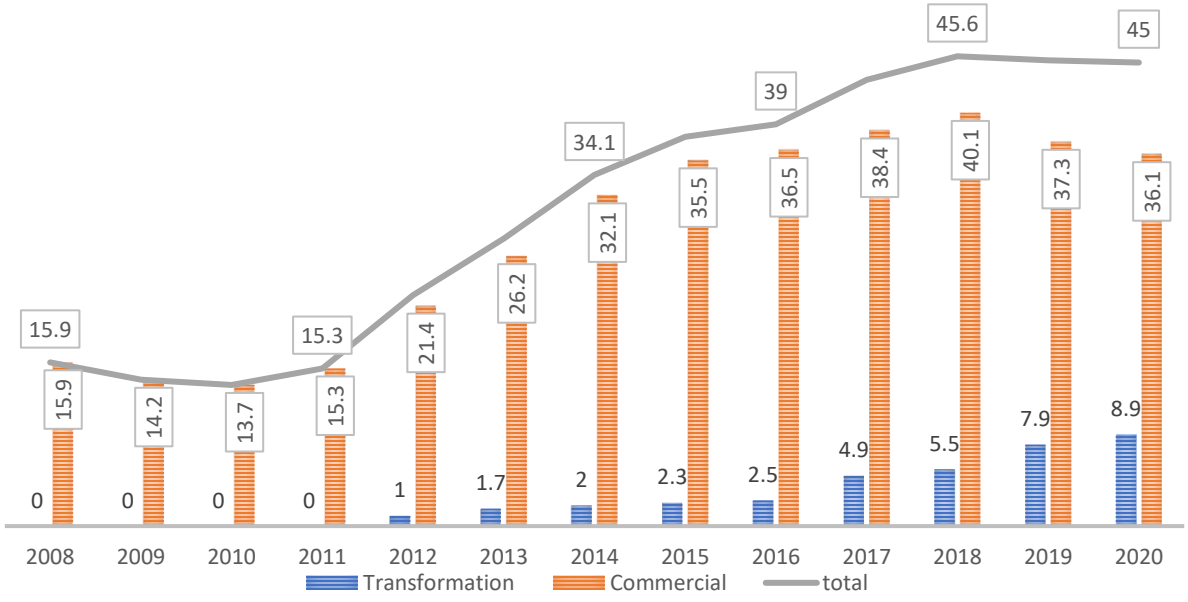


2.2 Land Bank funding model

The Land Bank's' funding model is twofold, ensuring delivery on the banks' mandate. The first line of funding is raised in the debt and capital markets which are commercially backed, acting similar to a commercial loan. Typical investors are commercial banks and institutional investors such as fund managers. The typical instruments used to raise capital for these types of loans are by way of promissory notes, T-bills, and bond issuance. Commercial terms and conditions apply to this funding channel and is mostly allocated towards commercial farming (LBIAR, 2019).

The second line of funding is allocated towards development/transformation and is backed by DFI capital. DFI's contributing to the Land Bank development book include the African Development Bank, World Bank and the KfW (Kreditanstalt für Wiederaufbau Bankengruppe). This line of funding is often referred to as 'patient money' and have long tenors, in excess of 10 years. Loans granted in this category have to meet strict utilisation and reporting criteria and are geared towards qualifying development projects focused on qualities such as job creation, uplifting of communities and access to land. The bank broadly defines 'development' as loans to commercial corporate operations where black ownership is greater than 50% and/or are Broad Based Black Economic Empowerment (BBBEE) level 1-4 contributors. At present, the development book is a considerable component of the banks' total loan book valued at R8.9 Billion (20% of total loan book).The table below shows the total Land Bank loan book size (Rands) from 2008-2020 as well as the transformation loan-book relative to the commercial loan book size.

Table 2: Land-Bank Loan book (Rbn)

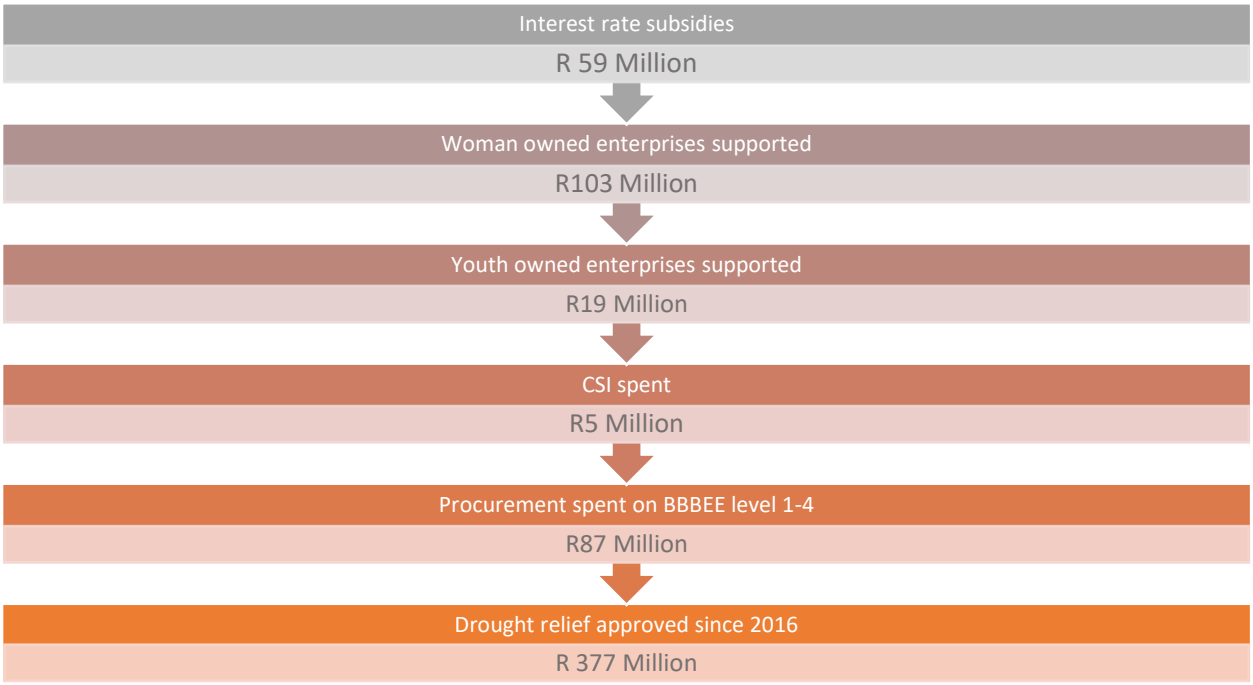


The loan book size remained relatively stable from 2008-2011 in the wake of the global financial crisis, with zero Rand being allocated to transformation loans in that period (100% of funding went to commercial loans). The period from 2012- 2015, the total loan book grew by 19% CAGR, with commercial lending taking up 94% of the total loan-book and transformational/development facilities starting to form part of the book. From 2016 - 2020, the loan book peaked in terms of percentage allocation to transformational loans relative to commercial loans as well as total loan book size (2018 peak: R40,1 Billion). Since 2019 leading to 2020 - 2021, the loan book size started to contract. The bank has stated that they want to continue growing the transformation book as a percentage of the total loan book to about 30% over the next 3-5 years. Over the last 5 years, there has been a significant effort made to grow the development and transformational loan book, in line with their mandate.

2.2.1 Development impact scorecard

The Land Bank has invested R8.9 Billion in development loans since 2012. They have invested R103 million to enterprises wholly owned by woman, R59 million into interest rate subsidies (where cost of capital is largely absorbed by the bank) and R19 million into enterprises owned by individuals younger than 21 years of age. Corporate social investment (CSI) encompasses projects that uplift communities of which the Land Bank has invested R5 million to date. In terms of supporting BBBEE companies, the bank has supported these businesses with R87 million in funding and to relieve farmers from drought related costs, R377 million has been provisioned.

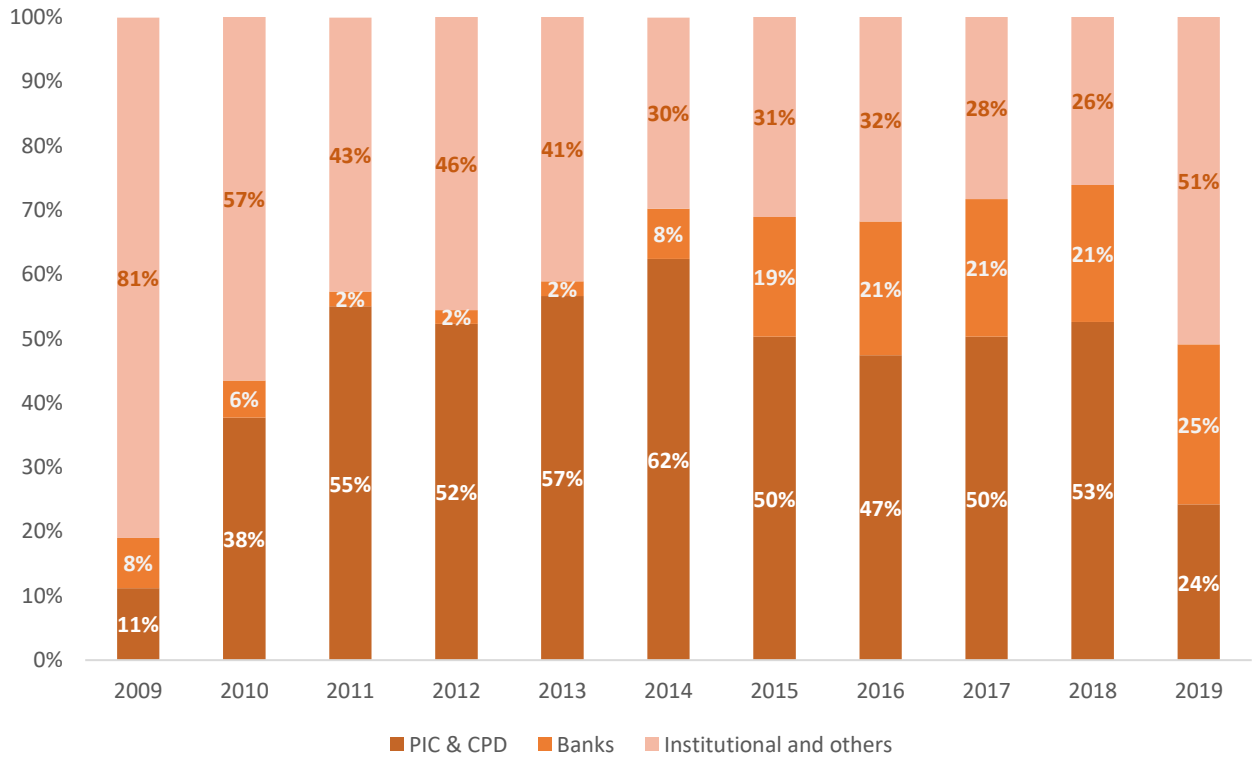
Figure 4: Land-Bank Development Scorecard



2.3 Investor base over time

The graph below illustrates a high-level overview of the investor base of the Land Bank over time, which has seen monumental shifts over the last decade. In 2009 most of the capital (over 80%) came from Institutional and multilateral investors. The PIC had second largest exposure at 11% and the commercial and foreign banks had third largest exposure at 8%. Fast forward a decade later and the investor base has diversified substantially. Firstly, the intuitional and multi-lateral investors have decreased their exposure over time and stabilised at 51% in 2019. Secondly, the PIC has increased their exposure dramatically over time and stabilised at 24%. Lastly, the commercial and foreign banks' exposure has increased dramatically since 2014 and has stabilised at 25% as of 2019. Lenders are exposed to the Land Bank's debt through its domestic medium-term note (DMTN) programmes, one launched in 2010 and another in 2017. The DMTN programmes are publicly listed debt instruments with set maturity dates. Important to note is that most of the existing loans to the Land Bank are not government guaranteed. A guarantee is an agreement between lenders and the government (or the South African taxpayer) that the latter would pay any shortfall if a state-owned enterprise defaults on debt repayments. The government will only step in for debt that is guaranteed.

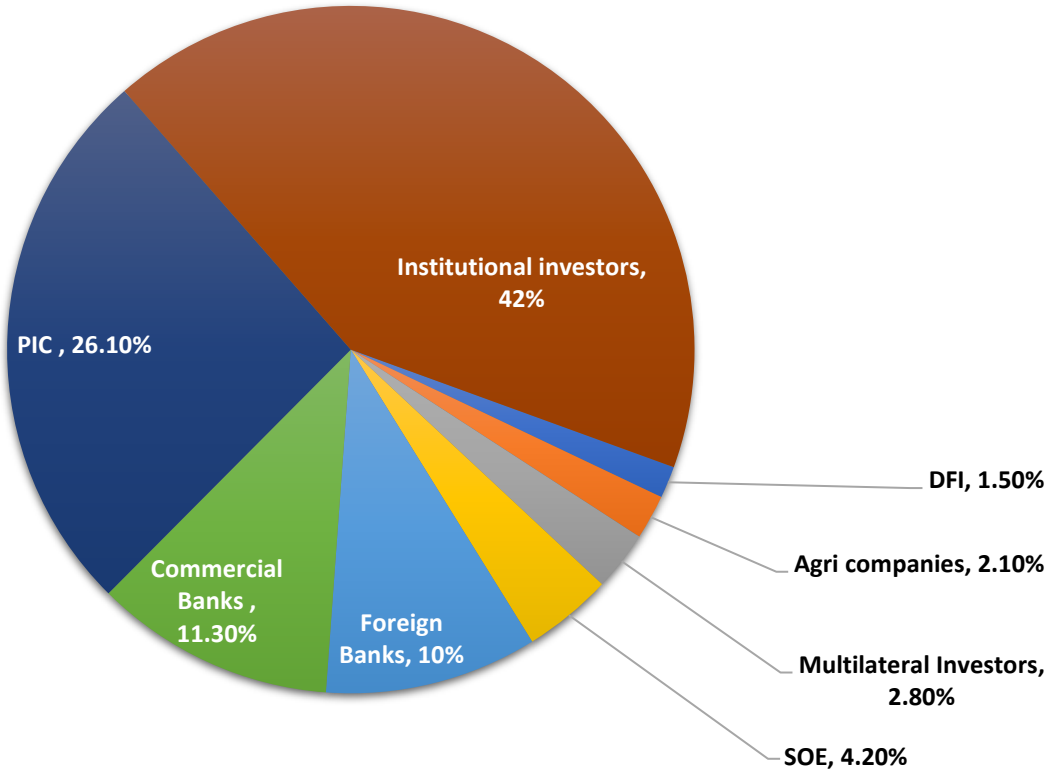
Table 3: Investor diversification base



Investor base over time (continued)

The graph below illustrates a more detailed breakdown of the Land Bank investor base as of 2019. The greatest contributor to Land Bank funding are institutional investors at 42%. These include pension funds, mutual funds, insurance companies, endowment funds and fund managers. A large investor included in this category is Futuregrowth Asset Management (the Old Mutual owned fixed income specialists in South Africa). Second largest contributors are the Public Investment Corporation of South Africa (PIC),they are a state-owned entity and is Africa's largest asset manager (approx. R2 Trillion in assets under management). The third largest investors are domestic commercial banks including ABSA, FirstRand, Nedbank and Standard Chartered. The fourth largest contributor are foreign banks (non-South African banks). The smallest contributors now include other state-owned entities (SOE's), agri-companies, DFI's and multilateral investors. Collectively, these smaller contributors make up approximately 10.6% of Land Bank's investor base (LBIAR, 2019).

Figure 5: Land-Bank investor base 2019



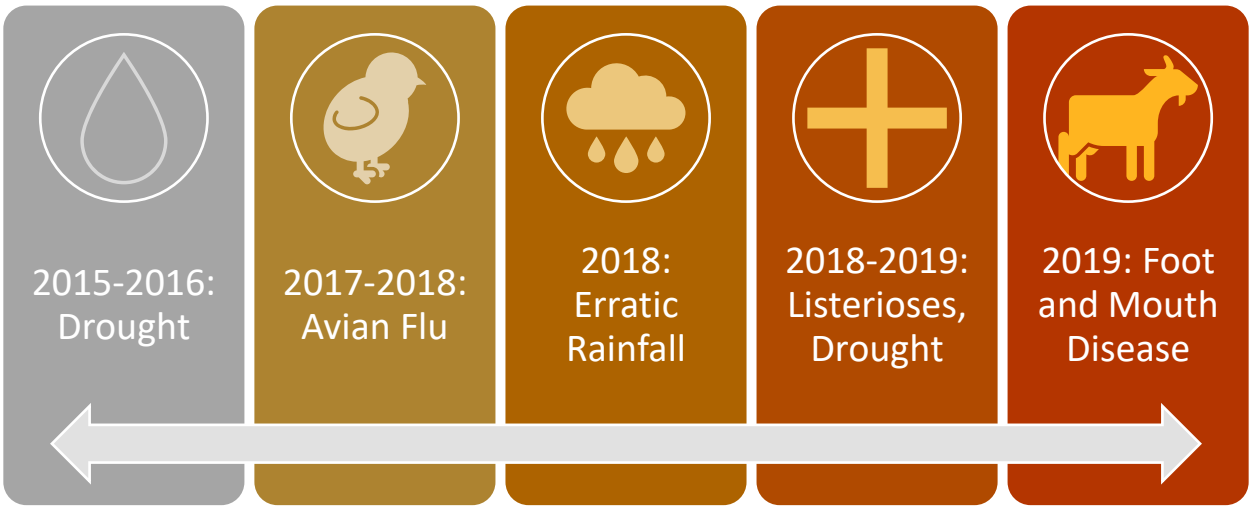
3. Dissecting the problems

The following section is dedicated to understanding the drivers of the Land Bank's demise. We investigate the macro-economic factors as well as the fundamentals including financial health markers, internal controls, sovereign ratings, and risk management.

3.1 Macro-economic factors: Agricultural sector volatility

The agricultural sector in South Africa has had a volatile stint during the last 5 years. These include very dry seasons in certain parts of the country, the outbreak of Avian flu, foot and mouth disease, erratic rainfalls, and the onslaught of the COVID-19 pandemic. All these factors have had an impact on farming stakeholders, including the Land Bank as a result. Later than anticipated planting, an increase in non-performing loans and impairments ultimately contributed to lower operating profits for the bank (LBIAR, 2020).

Figure 6: Key events 2015-2020



3.1.1 Droughts/erratic rainfall (2015-2016, 2018)

During the 2015-2016 agricultural season, El Niño weather patterns resulted in a late start to planting and low and erratic rainfall throughout Southern Africa. This resulted in higher-than normal temperatures and longer drought season experienced during the past 35 years across Angola, Botswana, Lesotho, Malawi, Madagascar, Mozambique, Namibia, South Africa, Swaziland, Zambia, and Zimbabwe. The pathway by which droughts effects agricultural activities include unfavourable crop growing conditions, reduced yields, crop failures and declines in local food and agricultural production (Ainembabazi, 2018).

3.1.2 Avian Flu (2017- 2018)

Also known as bird-flu, the outbreak of this highly pathogenic influenza in South Africa had a notable effect on the poultry industry – one of South Africa's largest agricultural subsectors. The poultry industry in South Africa is an important one, with local demand greater than supply. Over the last decade, poultry supply increased by 8.4 %, whilst demand increased by 21.2 %. It is for this reason that South Africa relies on chicken imports to satisfy demand. The primary driver of this increased consumption is the affordability of poultry over other meat products. With the outbreak of the Avian flu in SA in 2017, there was a 15% growth in chicken imports, increasingly displacing the domestic produce, negatively effecting local chicken farmers and stakeholders (OIE, 2017).

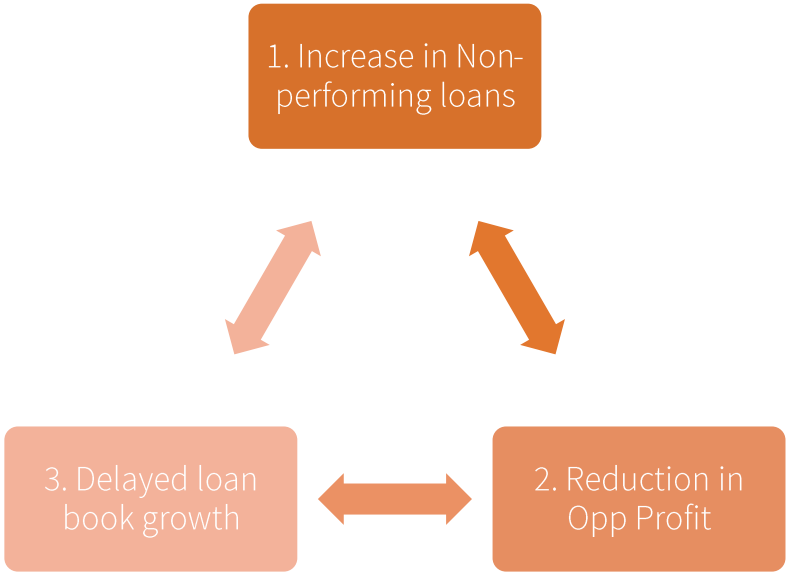
3.1.3 Foot and mouth disease (2019)

Foot and mouth disease (FMD) is a highly contagious viral disease which affects cloven hoofed animals including cattle, pigs, sheep, and goats. Although the disease does not affect humans and is safe for consumption, countries that are flagged with FMD lose their FMD-free status from the World Organization for Animal Health (OIE), and as a result South African meat producers could not export any meat products to certain countries, through fear of spreading the disease. This directly affected frozen meat exports from South Africa and hit local farmers with another blow (OIE, 2019).

4. Impact

The key impact of the volatile agri-landscape on the Land Bank is summarised in the diagram below. With non-favourable weather conditions experienced across the country over the past 5 years, an increase in non-performing loans (NPL) followed suite. Adverse weather conditions were not the sole contributing factor to the increased NPL but do seem to have played a considerable role (LBIAR, 2020). The knock-on effect of increased NPL were reduced operating profits for the bank which also led to a delay in further growth of the loan book.

Figure 7: Key impacts on Land-Bank



4.1 Deteriorating financials

This section focuses on the deteriorating financial position of the Land Bank. Starting with a look at key performance drivers including the loan book, operating profits, and net margins, moving into the loan book segmentation, debt maturity profiles, liquidity metrics, increased cost of capital, lack of internal controls, rise of non-performing loans, and sovereign rating downgrades. The graphic below summarises the key talking points:

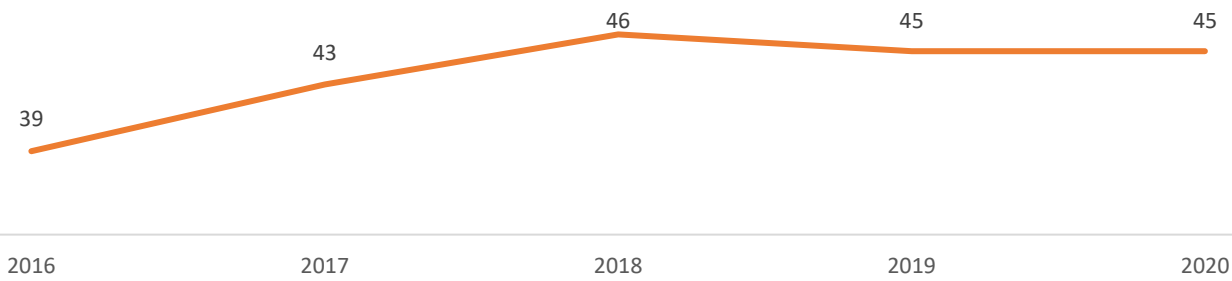
Figure 8: Key talking points

1. Loan Book size	• Inability to service new clients
2. Net interest margin	• Deteriorating margins
3. Operating Profits	• Deteriorating margins
4. Cost to income	• Increased cost to income
5.Liquidity	• Deteriorating metrics

4.1.1 Loan book growth plateau

The Land Bank has hit a loan book growth plateau over the last 3 years. The bank's loan book is worth about R45-billion as of 2021, with roughly R35-billion being from the commercial book. The Land Bank's financial woes has resulted in them not being able to further extend new loans to farmers, and only pay current lenders their interest portion without the principle amounts owed. It is anticipated that there will be a considerable reduction in the loan book size as borrowers are moving to alternative lenders that offer similar loan rates with additional services. As it stands, the bank cannot service their debts in their current form and funders will only recommit facilities on the back of state guarantees. The bank is not able to raise additional funding from the capital and debt markets either until a restructuring plan is presented to lenders, a commitment that has not been met at the time of writing.

Figure 9: Loan book size (Rbn)



4.1.2 Slipping net interest and profit margins

In April 2020, the Land Bank defaulted on certain repayments due to lenders, triggering credit downgrades and fears of a cross default on the debt of other state-owned firms. Since this event, the bank has been downgraded by Moodies credit ratings to a Ba3 rating, increasing their cost of raising capital and in turn increasing their cost of funding across the board. Its ability to attract funding is also compromised. Investors require a particular credit rating to be able to advance money to an organisation and given the bank's posture, it is not able to do this. The Land Bank's operational performance continued to deteriorate as its financial losses grew by 211% to R2.8bn for the year 2020, compared to a loss of R902m in 2019. Net interest margins have deteriorated 22% since 2016 and has played a large part in the banks' current financial situation. The cost-to-income ratio is a key financial measure in valuing a financial institution and reflects the ratio of operating costs relative to operating income. A lower ratio indicates a more efficiently run, profitable entity. Looking at table 4, the banks' cost to income ratio has deteriorated (increased) by a staggering 35% since 2016 and is on its way to unsustainable territory.

Figure 10: Operating profits(Rm)

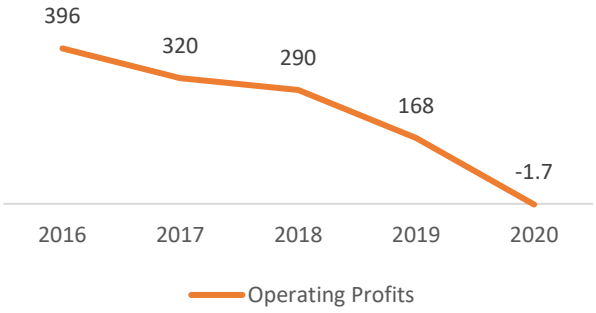


Figure 11: Net margins (lending)

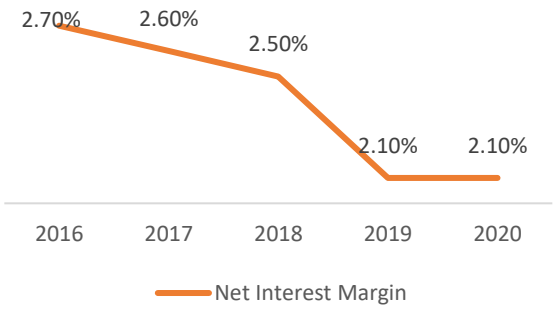
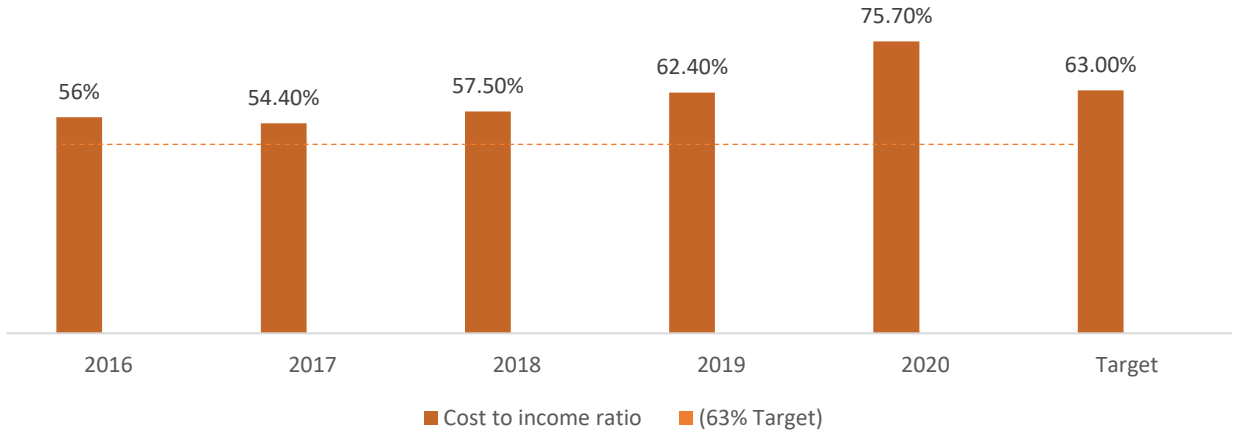


Table 4: Cost to Income

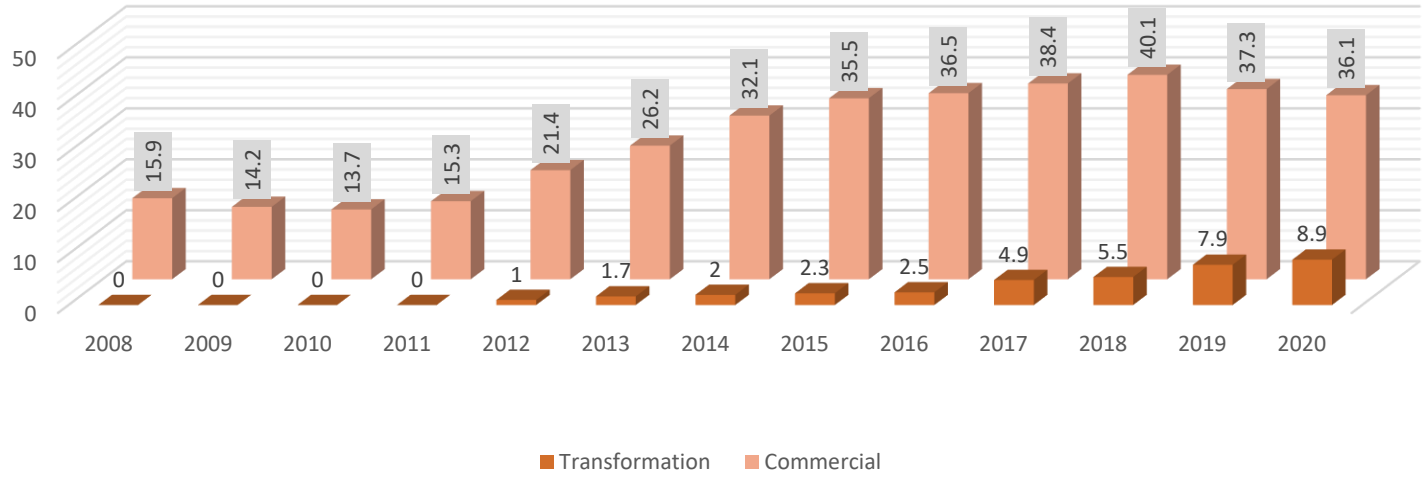


4.2 Loan book segmentation

To better understand how the bank came to where it currently is, it is worth taking a step back and reflect on the past. During the last 8 years, the bank had made significant efforts to grow the development and transformational loan book, with a compounded annual growth rate (CAGR) of 26% since 2012 to 2020. The transformation book now represents almost 20% of the banks' total loan book, valued at R8.9 Bn, consisting of R3.4 Bn worth of development loans and R5.5 Bn worth of transformational loans. Development clients refers to smallholder farmers who are new entrants into the sector with turnover between R50k-R1m. This also includes medium scale commercial producers with an annual turnover ranging between R1m – R10m (LBIAR, 2019).

Transformation clients on the other hand refers to agri-businesses with annual turnovers above R10m and who are wholly blacked owned, majority black owned with 51% black ownership and/or substantially black owned (30%-50% black owned and BBBEE level 1 – 4). The loans to these farmers have be below commercial lending rates for these farmers to afford the cost of debt. At the banks' current average cost of funding (9.3% in 2020), the bank cannot afford the cost of delivering development funding to these farmers if they want to be a profitable going concern. This is even more concerning because of the banks' goal of increasing the development book even more over time. Another issue with these development loans is that they are low quality lenders with higher probability of default.

Table 5: Loan book segmentation (Rbn)

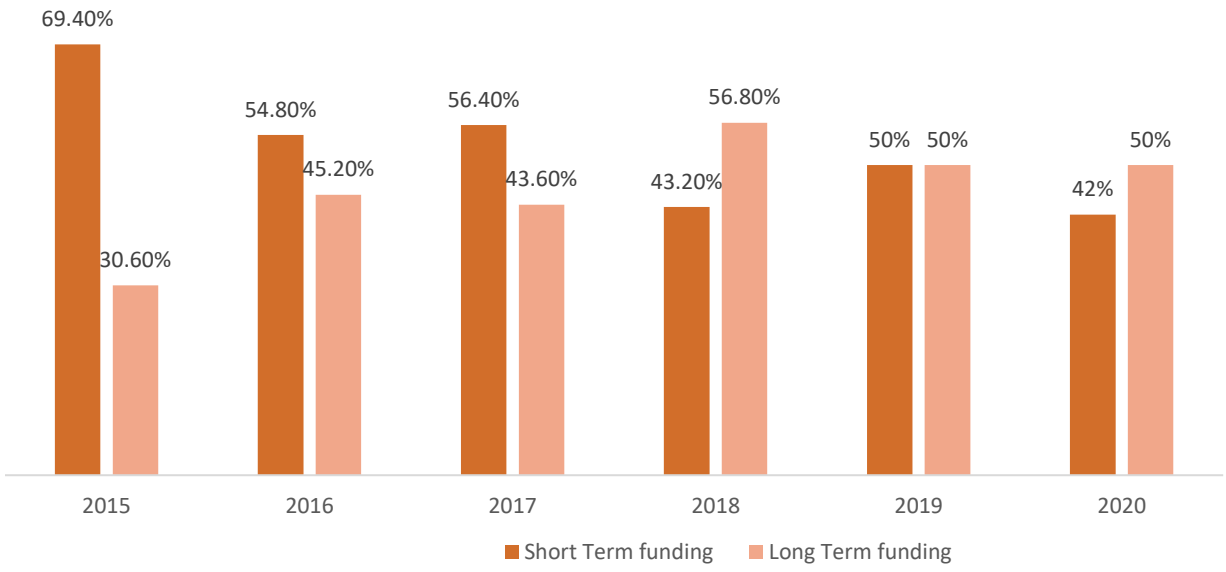


4.2.1 Debt maturity profiles (rebalancing of liability portfolio)

Another contributing factor to their financial instability is their shift in loan book maturity profiles. The Land Bank set out an objective to decrease the proportion of short term (ST) to long term (LT) loan tenors across their loan book. Where ST funding is defined as loans with maturities of less than 12 months and LT tenors with maturities greater than 12 months. Looking at the graph below, it is evident that the bank had an overweight reliance on ST vs LT loans in 2015 with a 70/30 split, respectively. Fast forward to 2020 and one can see how the bank has drastically changed the proportions with their loan book currently representing a ST-LT split of 42/50, respectively.

Having a more balanced split between maturities is a prudent risk management principle and not a problem per se. In the Land Bank's' case this is a disaster scenario, because of their cost of funding which has increased during the same time (from 6.3% in 2016 to 9.1% in 2020). The Bank was supposed to re-price their loan book to effectively match this increase in cost of funding, in order not to decrease their net margins, which the bank failed to accomplish (from 3% net margin in 2016 to 2 % in 2012). This has put tremendous strain on operating profits and poses a challenge for the bank.

Table 6: Debt maturity profiles

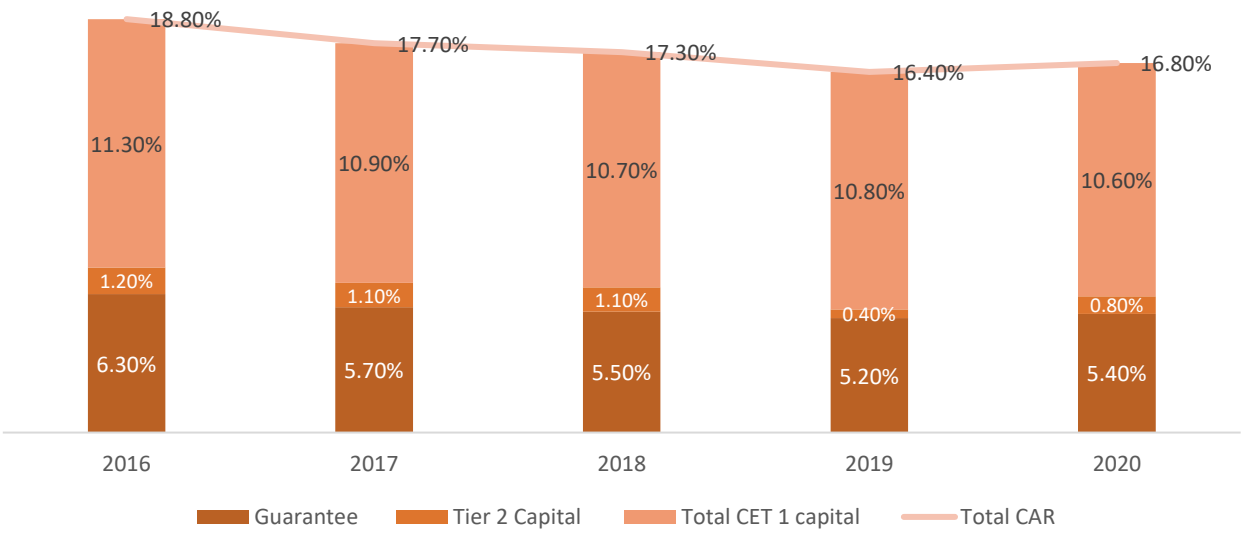


4.2.2 Deteriorating Liquidity metrics

Since 2016, the bank has voluntarily agreed to implement Basel I, II and III risk parameters, to align with international best practices for the banking industry. The metrics the bank started to track includes the capital adequacy ratio (CAR), liquidity coverage ratio (LCR) and net stable funding (NSFR) ratio (BIS, 2021). These measures shine further light on their status as a going concern.

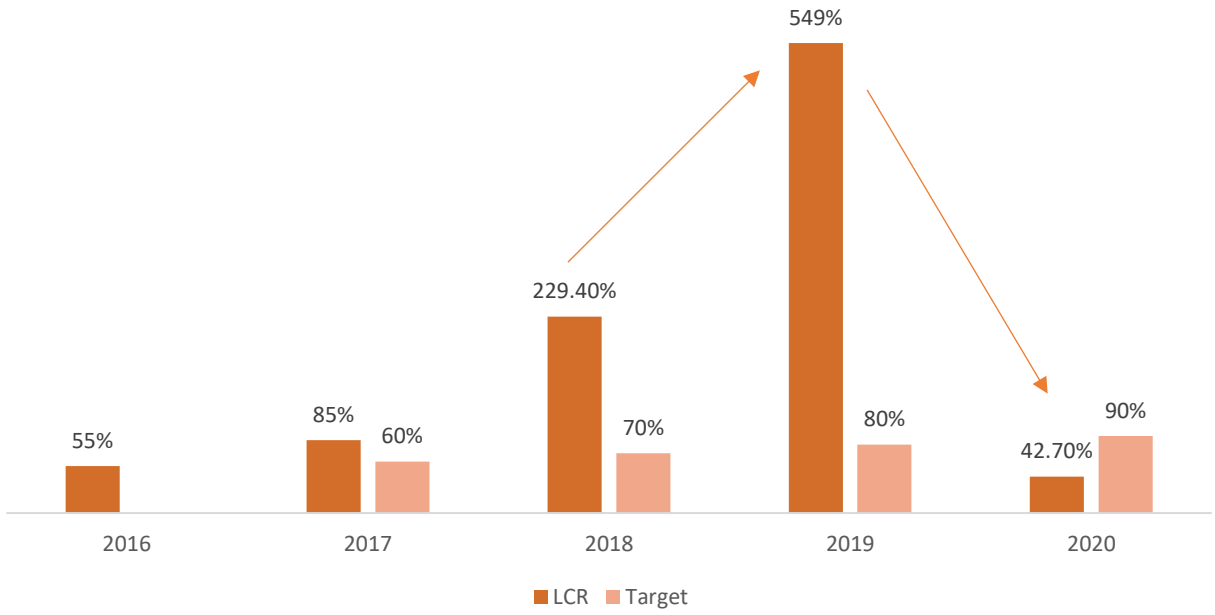
a) CAR measures a bank's ability to pay liabilities and respond to credit risks and operational risks. A bank that has sufficient CAR has enough capital to absorb potential losses and has less risk of becoming insolvent and losing depositors' money. The minimum CAR recommended under Basel II and III is 8% and 10.5% respectively. Looking at the table below, the Land bank has deteriorated their CAR by about 12% during the last 5 years. Although they are still well above Basel II and III guidelines, the trajectory is negative with no clear indication of improvements. Tier 1 (T1) capital consists of shareholders' equity and retained earnings and is a bank's core capital used to function on a regular basis. Tier 2 (T2) capital includes revaluation reserves, hybrid capital instruments and subordinated term debt, general loan-loss reserves, and undisclosed reserves which is a bank's supplementary capital. Tier 2 capital is considered less reliable than Tier 1 capital because it is more difficult to accurately calculate and more difficult to liquidate.T1, T2 and guarantees have declined over the last 5 years due to the growth in risk weighted assets over and above the growth in profitability, guarantee redemptions and lower non- performing loan coverage. Key to note is that the Land Bank includes government guarantees in their CAR calculation and artificially increases their CAR.

Table 7: Capital adequacy ratios (CAR)



b) The LCR refers to the proportion of highly liquid assets held by financial institutions, to ensure their ongoing ability to meet short-term obligations. This ratio is essentially a generic stress test that aims to anticipate market-wide shocks and make sure that financial institutions possess suitable capital preservation, to ride out any short-term liquidity disruptions that may plague the market. It is calculated by dividing the banks high quality liquid assets by its total net cash flows, over a 30-day stress period. High quality liquid assets only include those which has a high potential to be converted easily and quickly into cash. Under Basel III requirements, banks are required to hold high quality assets that are enough to fund cash outflows for 30 days (a 100% ratio).

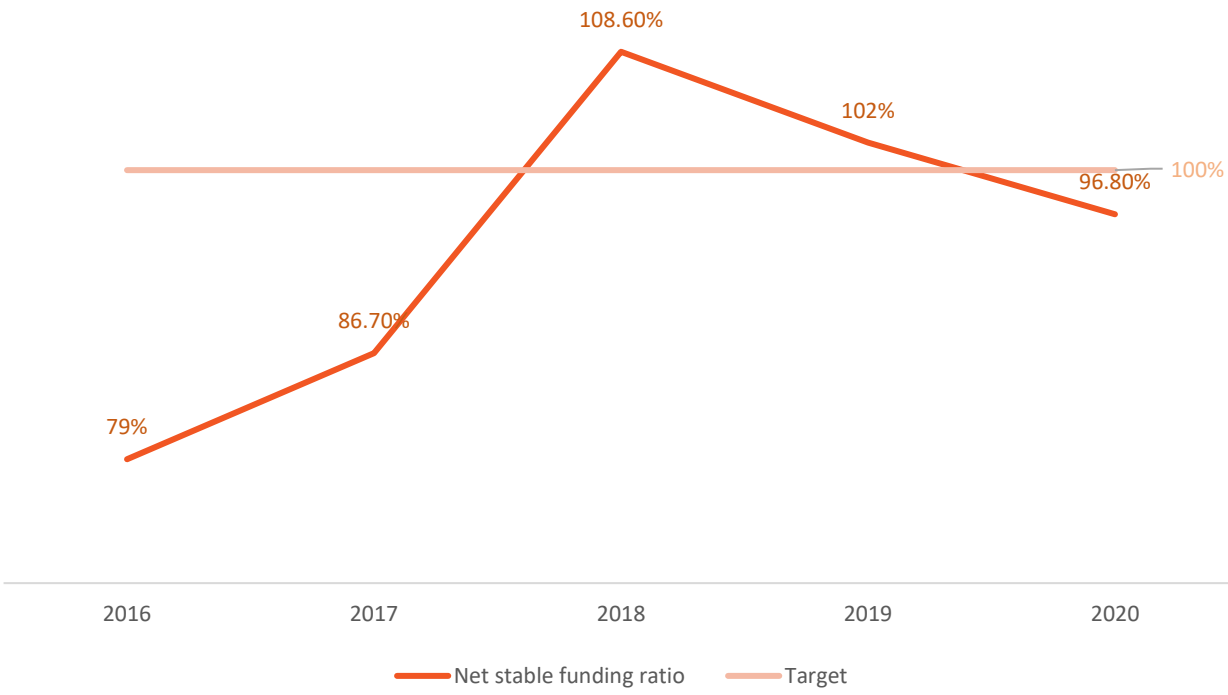
Table 8: Liquidity coverage ratio (LCR)



A 100% ratio means that the bank has just enough liquid assets to cover its monthly cash outflows. The liquidity coverage ratio applies to all banking institutions that have more than $250 billion in total consolidated assets or more than $10 billion in on-balance sheet foreign exposure. Because the Land Bank does not meet this criteria, they do not strictly have to comply to these requirements. The large spike in 2019 was due to the bank having access cash reserves to the tune of R1bn because of their slower than anticipated loan book growth and funds not being disbursed. Nonetheless, since 2019, the bank has deteriorated their LCR ratio by 506 % and undershot their target ratio by 47%. As it stands, the bank does not have enough highly liquid assets to even cover 30 days- worth of cash flows.

c) The NSFR presents the proportion of long-term assets funded by stable funding and is calculated as the amount of Available Stable Funding (ASF) divided by the amount of Required Stable Funding (RSF) over a one-year horizon. This ratio must equal or exceed 100% as recommended by Basel III. The banks' NSFR ratio has deteriorated since 2018 and is on a downwards trajectory, decreasing by 11% over a 2-year period. This is mainly due to the banks' increased proportion of loans with tenors greater than 12 months.

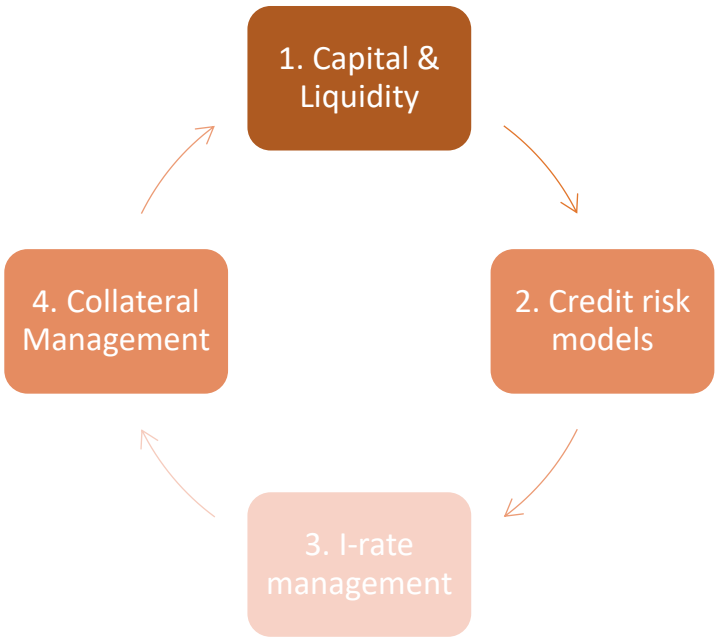
Figure 12: Net stable funding



4.3 Lack of Internal controls

Another contributor to the Land Bank's' woes is the lack of solid internal and management control. The Bank was very late in adopting industry standard metrics to measure and control credit, liquidity, and capital risk. The graph below gives an oversight of the internal controls which will be discussed.

Figure 13: Key internal control points



4.3.1 Capital and liquidity management

Management at Land Bank had no quantitative capital or liquidity management tools in place prior to 2017. Since 2018, the bank has developed 'Basel-like' risk management metrics measuring CAR, LCR and NSFR. This effectively means that risk management did not play a major role at the bank and they are in the very early stages of risk management implementation.

4.3.2 Credit risk models

The bank had no credit risk models in place prior to 2017. These models are designed to adjust interest rate pricing relative to certain risk characteristics. At the start of 2018, the bank started implementing an Internal Ratings-based (IRB) approach for pricing risk and are in very early stages of implementation.

4.3.3 Interest rate risk management

Interest rate risk is the exposure of a bank's financial condition to adverse movements in interest rates. Excessive interest rate risk can pose a significant threat to a bank's earnings and capital base. Changes in interest rates affect a bank's earnings by changing its net interest income and the level of other interest sensitive income and operating expenses. Changes in interest rates also affect the underlying value of the

bank's assets, liabilities, and off-balance sheet instruments because the present value of future cash flows. It is apparent that the Land Bank had no interest rate risk management policies in place prior to 2017 and only started implementing a form of risk management in 2018 using interest rate swaps. Only 6.7% of the book was hedged in 2018 (R2.8 Billion).

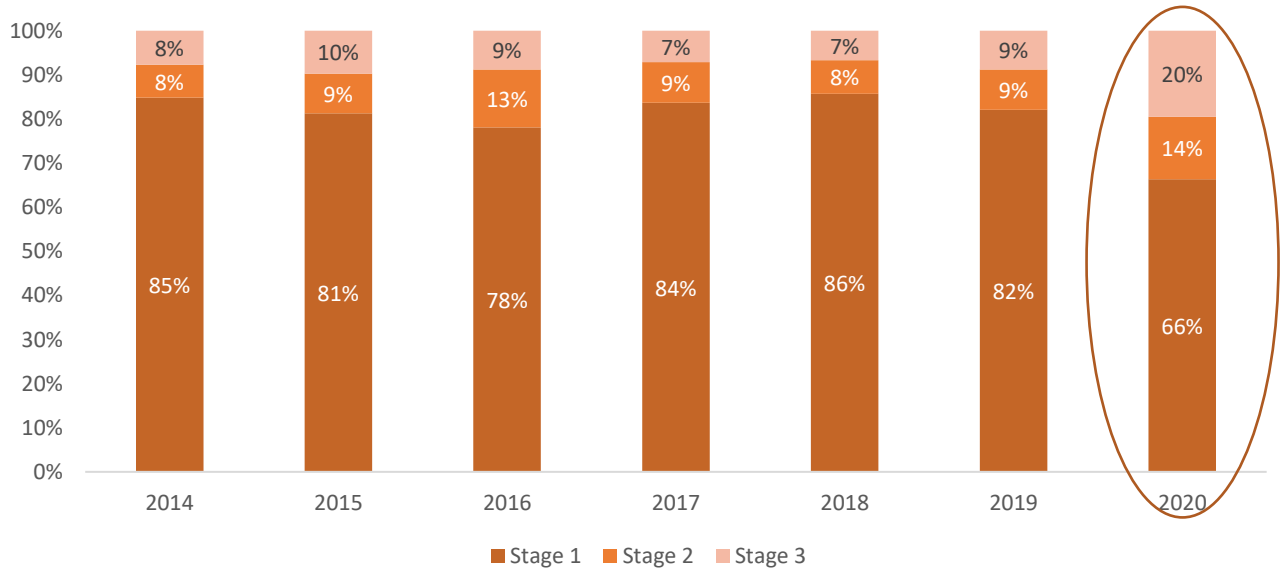
4.3.4 Collateral management

Like any other bank, the Land Bank takes some form of collateral as security before granting credit. Because of their development mandate and the growth of their development book over time, the quality of the collateral taken for credit granted has deteriorated. The bank has stated that they strive to issue new development credit in a more 'risk responsible' and prudent manner. The way this will be done is yet to be disclosed in detail and shines some light on the way development credit should be issued.

4.4 Non-Performing Loans on the rise

The bank classifies loans of various performance in stages. Stage 1 loans are performing loans, in other words exposures that are up to date with repayments. Stage 2 loans are under-performing and are in arrears due 30-90 days. Stage 3 loans are non- performing loans and are 90 days plus in arrears or in liquidation phase. Looking at data from the past 7 years, the bank had consistent under performing and non-performing loans as a percentage of the total loan book. In 2019 non-performing loans jumped by 29% and underperforming loans by 13%. In 2020 non-performing loans jumped by 122% and underperforming loans by 56%. The marked increase in non-performing assets is due to farmers struggling to repay their debts on time due in part to adverse weather conditions that caused late planting and harvesting as well as a general decrease in the quality of lenders that loans are disbursed to.

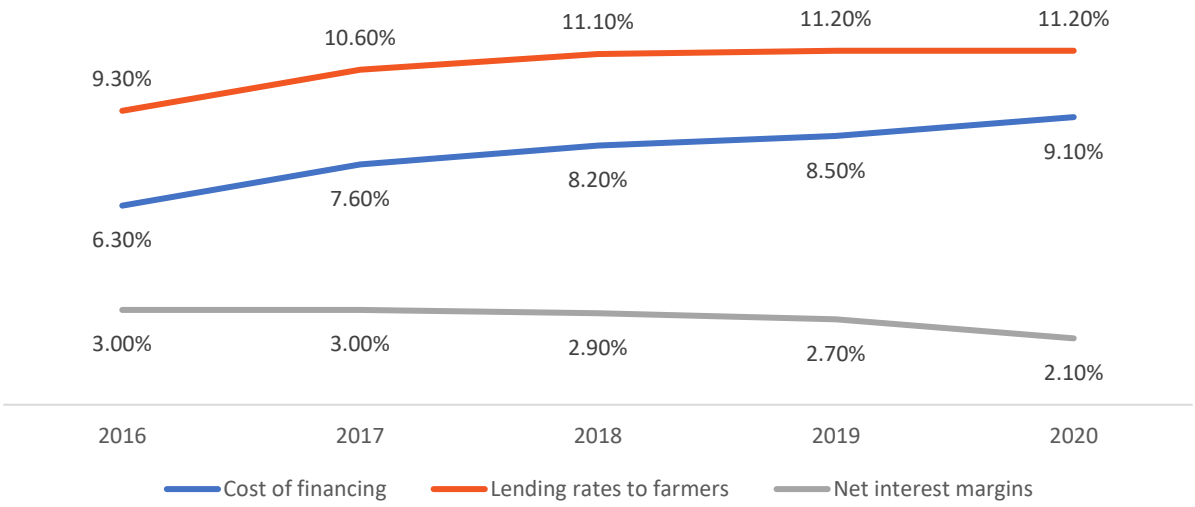
Table 9: Loan book performance



4.5 Unsustainable cost of capital

As mentioned earlier, the bank has shifted its loan maturity profile from majority of the loan book consisting of short-term tenor loans (70% in 2015) to less than 50 % in 2020, making the split between short term funding and longer-term funding more equal. From a risk management perspective, it is a prudent move and in line with the Banks' commitment to reduce reliance on shorter term funding and extend the maturity profile, thereby reducing refinancing risk and improving general liquidity levels of the bank.

Figure 14: Change in margins



The caveat to this transition is that while this maturity shift happened, the cost of funding had increased from 6,3% In 2019 to 9,1% in Feb 2020.The bank did not concomitantly re-price its loan book to effectively match the increase in cost of funding and as a result net interest margins had been significantly reduced. In other words, the bank did not adapt their lending rates in line with the increase in cost of funding to ensure they maintain a healthy NP margin.

The squeeze on margin because of increased cost of funding poses challenges for the bank. The first is that from a developmental mandate, they really cannot pass this increased lending rate on to the farmer as they are already in a marginalized position. Secondly, if they cannot bring down cost of funding internally, the bank will simply lose current clients and the loan-book will shrink. Taking the knock for the increase in cost of funding is not a financially viable option and in the long run will pose more harm than simply trying its best efforts to get its ratings back to investment grade.

4.6 Sovereign ratings downgrades

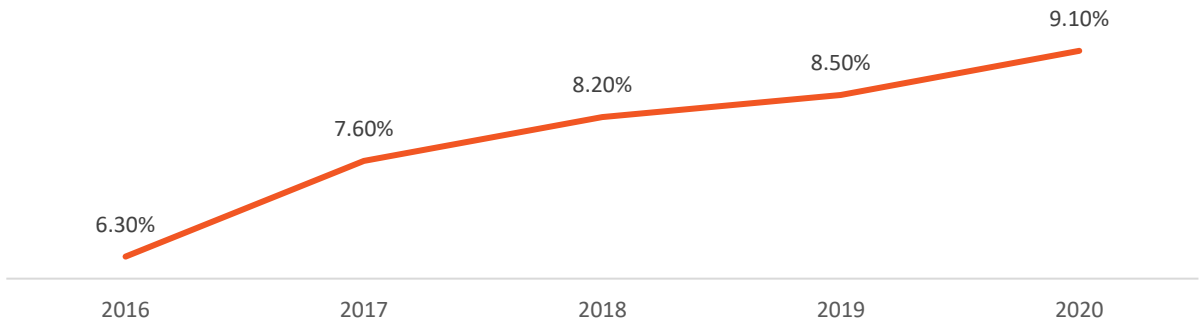
Moody's Investors Service provides investors with credit ratings, risk analysis, and research for stocks, bonds, and government entities. Through its rating system, Moody's assigns grades to bonds and stocks based on the risk associated with the investment. In 2019, the ratings agency flagged a Land Bank downgrade because of the increase in non-performing loans from persistent droughts and higher risk development loan disbursements.

Figure 15: Key Moodies events



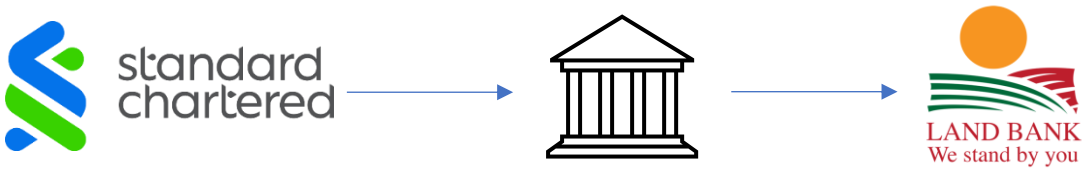
In January 2020, the Land Bank was downgraded from a Baa3 rating, which is considered investment grade, to a Ba1 rating (non-investment grade). Obligations rated Ba are judged to have speculative elements and are subject to substantial credit risk. This downgrade reflected Moodies' view in light of rising solvency pressures at the bank due to elevated credit risk (including high environmental risks relating to sustained droughts and increased frequency of disease outbursts). Part of the rating agencies' concerns were the delayed appointment of suitable leadership at the bank, which raised concerns about governance within the bank. These ratings matter from a cost of funding point of view. Corporates and governments which have lower credit ratings often have increased interest/fees/yields for borrowed debt from lenders to reflect the increased risk the lenders are taking. In effect they want to be compensated more for taking on additional risk, and this was indeed reflected in studying the graph below. More recently, Moodies has withdrawn all ratings services as of 2021, citing "its own business reasons" for the move. This places a spotlight on the independence and integrity of the bank going forward.

Figure 16: Cost of funding



4.7 Recent developments: The default significance

A loan default occurs when a borrower fails to pay back a debt according to the initial arrangement. On April 2020, the Land Bank issued a Stock Exchange News Service (SENS) announcement advising noteholders that the bank will not be able to repay some of its debt due in the coming week, triggering a default. The default affected bond holder investors in the 2010 R20bn note programme, as well as investors in the R30bn 2017 note programme. The most prominent among these investors are Standard Chartered Bank. They took a rogue approach to the default event and subsequently took the Land Bank to the High Court, demanding repayment.

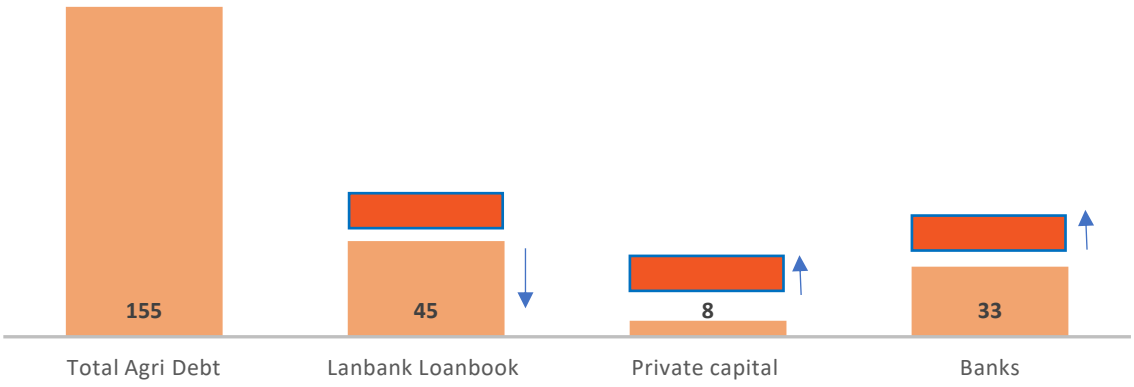


On 2 December 2020, Standard Chartered successfully won the High Court order to force the Land Bank to repay more than R400-million that it owes Standard Chartered, including interest accrued. The court suspended the repayment for 17 months or until 30 April 2022, on the condition that a debt restructuring agreement must be concluded by 31 March 2021. This date has since passed, and the Land Bank failed to present a revised restructuring plan to the courts. By law, Standard Chartered can legally begin a process to have the bank wound up — selling its assets to recover monies owed.

5. The impact of a fall

With the Land Bank facing structural issues, they are likely to size down their loan-book in the near future. The total estimated agricultural debt market in South Africa is valued at R155 Billion (DAFF, 2019). At 29% of agriculture debt market share, the Land Bank owns a substantial portion of market share. Should their loan-book decrease even marginally, it will leave a substantial funding gap in the market, unlikely to be filled by the banking sector because of their significant existing exposure. This gap will either be filled by further institutional funding or create an opportunity for private capital to participate in. This could be in the form of private equity fund participation, private banks, agricultural co-op banking or private loans from high-net-worth individuals., With a meagre 5% participation of private capital currently, this can dramatically increase in the future. The only caveat to this is that the cost of capital for these private lenders are substantially higher than commercial bank funding.

Table 10: Funding gap (Rbn)



A potential counter argument for the funding gap is that government liquidity injections from Treasury could solve the problem (better known as a 'bail-out'). The finance minister of South Africa had announced in his February 2021 budget speech that the Land Bank would receive R7 Billion emergency funding from the state. Continually throwing public money at an institution that has fundamental internal issues is not a solution, but not surprising looking at similar methodology applied across other SOE's. The bail-out money will also not be used to grow the loan-book, rather to service their current debt and avoid defaulting on their obligations.

6. The Solution

Agricultural groups have suggested the part-privatisation of the Land Bank to ensure that farmers have a reliable financing source. The proposals for a restructure or an alternative to the Land Bank comes on the back of the issues addressed in this report. Several solutions have been pondered in agri-cultural circles including the raising of capital from foreign investors and making a buyout offer to the Land Bank. The next solution proposed is establishing a farmer-owned co-operative bank. This would typically be a partnership between foreign investors, local farmers, and agribusinesses such as co-operatives and international insurance or agricultural businesses. There is big interest in private equity markets for investing in the agricultural sector in South African and Africa in general, which should also be considered.

The Land Banks' sweet spot was that it offered farmers seasonal facilities as it has a statutory pledge over agricultural stock in terms of the Land Bank Act. This meant that processors could pay their suppliers advances and settle payment once they get paid by their debtors, worth gold to these farmers. With the current status of the bank, this no longer seems viable, at least in the short to medium term until the bank restructures itself. Financing advances to farmers remains a funding gap in the market. A partial solution for exporters of agri commodities might be in the form of hard currency foreign loans. Typically, these loans are in the form of trade finance facilities where a third party (like Africa Merchant Capital) can step-in and unlock working capital tied in invoices and debtors, a market which has substantially grown particularly in the SME space. Time is not in favour of farmers at this stage, and they frankly cannot afford to wait for a Land Bank restructuring.

Figure 17: Solutions



7. Concluding remarks

Sun- Tzu wrote in his classic military treatise, 'The Art of War', that a well thought out strategy, without the accompanying tactics is a slow route to victory. But having tactics without a strategy is guaranteed to end in a lost battle. In the case of the Land Bank, the well-thought-out strategy for a sustainable development mandate cannot be achieved without applying accommodative tactics to make the probability of success the highest it can be. A favourable outcome requires favourable circumstances. Some circumstances such as climate change and macroeconomics are external and can only be managed to an extent, but internal battles need to be won first, including:

- re-evaluating their development mandate – The bank has to focus on either building their commercial book prudently or focus solely on development.
- establishing what is sustainable and practical – Running a development mandate has to be sustainable. Sustainability is coupled with profitability and the bank has no choice to better apply prudent risk management criteria to their lenders and reduce or at least manage non-performing loans.
- improve sovereign credit ratings - In order for the bank to provide loans at affordable rates, they have no choice but to improve their credit ratings and in turn lower their cost of funding to give DFI's and market participants confidence in the banks' ability to manage its loan-book.

If these battles are not won internally, farmers will not be able to obtain their funding required to produce our much-needed crops and the agricultural funding gap poses a direct risk to South-Africa and Africa's food security. Alternative funding solutions are expensive alternatives and should not be a replacement to a well-run DFI, albeit their benefits such as additional services can justify its premium. The alternative funding market allows access to capital and the time is rife for the alternative funding market to step in and participate in Sub-Saharan Africa agri- focused businesses. Africa Merchant Capital is well positioned to assist traders and exporters in agricultural commodities to unlock working capital through our bespoke financing solutions.

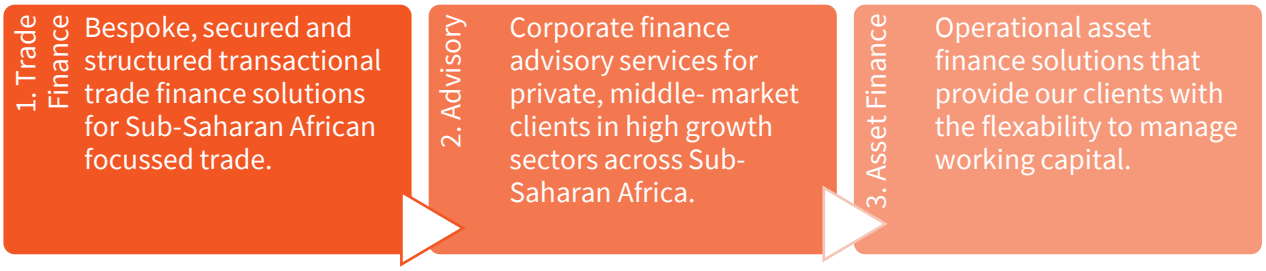
Figure 18: Key findings



8. Introduction to Africa Merchant Capital

Africa Merchant Capital (AMC) is the holding company of AMC Trade Finance (AMCTF) and Africa Merchant Capital Advisory. AMC is a London based privately owned boutique merchant bank, providing corporate finance advisory, bespoke structured trade finance and asset finance solutions for businesses active in the high growth markets of Sub-Saharan Africa.

Figure 19: Introduction to AMC



- AMC is led by finance professionals with extensive experience in the Sub-Saharan African capital markets.
- Specialist business units providing finance solutions to SMEs in the African mid-market of transaction sizes of USD 2 – 10 million.
- AMC Trade Finance finances hard currency denominated import and export transactions as lender of record.
- AMCTF has assembled a very strong team of over 150 years of combined African Structured Trade and Commodity Finance (STCF) experience.
- AMCTF has built a strong track record over the last 5 years, disbursing over 200 approved loans valued at c. USD 130 Million.

AMCTF is unique in the sense that the credit process and finance product is not balance sheet driven and focus more on the underlying commodity as security. This can add value in the trade cycle by shortening a trader or farmer's working capital cycle by unlocking value trapped in stock and debtors. The finance solutions are bespoke, structured, and secured and uniquely positioned to assist the borrowing trading business to reach new growth potential.

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