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Research Update:

New Zealand Local Government Funding Agency Outlook Revised To Positive After Action On Sovereign; Ratings Affirmed

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Research Update:

New Zealand Local Government Funding Agency Outlook Revised To Positive After Action On Sovereign; Ratings Affirmed

Overview

- We have revised our outlook on the long-term ratings on the New Zealand Local Government Funding Agency Ltd. (LGFA) to positive from stable, after similar action on the New Zealand sovereign.
- At the same time, we are affirming our 'AA+/A-1+' local-currency and 'AA/A-1+' foreign-currency ratings on LGFA.
- The ratings reflect our assessment that LGFA's strengths, which include its dominant market position as a source of funding for highly rated New Zealand local councils, continue to offset its relatively modest, albeit gradually improving, risk-adjusted capital ratio.
- The ratings also reflect our view of LGFA's very important role and integral link with the New Zealand sovereign.

Rating Action

On Feb. 4, 2019, S&P Global Ratings revised the outlook on its long-term ratings on the New Zealand Local Government Funding Agency Ltd. (LGFA), a public-sector funding agency, to positive from stable, after similar action on the New Zealand sovereign. At the same time, we affirmed our 'AA+/A-1+' long- and short-term local-currency and 'AA/A-1+' long- and short-term foreign-currency issuer credit ratings on LGFA.

Outlook

The positive outlook on LGFA reflects that on the New Zealand sovereign, and our view that the likelihood of LGFA receiving extraordinary support from the sovereign is unlikely to change in the next two years. In addition, we expect LGFA's standalone credit profile to remain stable at 'aa-' during the next two years. We would raise our ratings on LGFA if we were to raise our long-term ratings on New Zealand, all else being equal.

Downside scenario

We would revise the outlook on LGFA to stable if we were to take similar action on New Zealand. In addition, a weakening of LGFA's public policy role

or links to the New Zealand sovereign could cause us to lower our assessment of the likelihood of extraordinary support from the sovereign, which would result in downward pressure on the ratings.

Downward ratings pressure could also emerge if we consider LGFA's stand-alone credit profile to be weakening. This could occur, for instance, if we were to observe larger asset-liability mismatches without mitigating factors, if LGFA's dominant market position wanes, if access to funding markets or liquidity fall markedly, or if there is a significant decline in the underlying creditworthiness of LGFA's borrowers.

Rationale

Our ratings on LGFA reflect its standalone credit profile (SACP) of 'aa-', and our view that there would be an extremely high likelihood of extraordinary financial support for LGFA from the New Zealand government (the Crown) in a distress scenario.

The ratings on LGFA are underpinned by New Zealand's excellent institutional settings and wealthy economy, as well as LGFA's dominant market position and robust management and governance. We consider LGFA's borrowers to be highly creditworthy because those that we assign ratings to have an average long-term issuer credit rating of about 'AA-'. In addition, LGFA has access to a diverse set of domestic and overseas investors and a NZ\$1 billion standby facility with the New Zealand Debt Management Office (NZDMO), the debt management arm of the Crown. Partially offsetting these strengths, in our view, is LGFA's highly concentrated lending portfolio, which leads to a weaker capital adequacy assessment than many international peers.

LGFA was established in December 2011, following the enactment of the Local Government Borrowing Act 2011, to provide debt funding to New Zealand local and regional governments (i.e., councils). Its main objective is to raise debt on behalf of councils on terms more favorable than if they had raised that debt directly. LGFA is 20% owned by the Crown and 80% owned by 30 council shareholders. As of the time of writing, LGFA counts 61 of New Zealand's 78 councils as members. Together, these councils account for most of the local government debt within New Zealand.

Enterprise Risk Profile: Ratings underpinned by very strong management, dominant market position, and New Zealand's excellent institutional settings

- LGFA has a strong public policy mandate, high market share, and growing base of highly rated council borrowers.
- LGFA's borrowers benefit from New Zealand's excellent institutional settings and wealthy economy, though financial system risk and council debt levels are moderately high relative to peers.
- Risk management is robust, and bolstered by an experienced management and

governance team.

The credit quality of councils in New Zealand is high, and on an improving trend. S&P Global Ratings currently assigns ratings to 23 councils in New Zealand, including most of LGFA's largest borrowers, all of which have long-term issuer credit ratings between 'AA' and 'A+' and an average rating of approximately 'AA-'.

The local government sector is supported by New Zealand's excellent institutional settings and wealthy and resilient economy, with GDP per capita of about US\$42,400 in 2018. The country's real economic growth has been solid during the past few years at more than 3% per annum, resulting in rising wealth levels. We expect growth to continue over the next few years. We view the domestic financial system as being moderately high risk, in part due to strong house price appreciation, particularly in the nation's largest city, Auckland. Risks stemming from rising property prices and household debt appear to have stabilized since 2017, though it will take some time for them to subside. We also note that leverage in the local government sector is relatively high compared with other jurisdictions, standing at about 140% of operating revenues.

LGFA has a solid record of accomplishment since 2011 in fulfilling its public policy mandate, despite being younger than most of its peers. It has a dominant market position in New Zealand, accounting for about 80.2% of all council long-term borrowing in the 12-month period to December 2018. Its customer base continues to grow, with two new council members joining LGFA in the December quarter, and with several prospective new members in the pipeline. New Zealand's largest council, Auckland Council, accounts for roughly 37% of the national economy and half of the local government sector's gross debt. LGFA limits its lending to Auckland Council to reduce concentration risk, which means that LGFA's share of aggregate local government debt is also limited to about two-thirds. Dunedin City Council is the only council of substantial size that does not borrow through LGFA.

LGFA is able to lend on terms that are more attractive than if councils opted to borrow in their own name or through the banking system, as evidenced by market spreads between LGFA bonds and New Zealand dollar bonds issued by Auckland Council, Dunedin City Council (via Dunedin City Treasury Ltd.), and the major banks. LGFA has also helped councils to lengthen the average tenor of their borrowings. We expect growth in LGFA's lending book to flatten during the next few years because it has now amassed the majority of council borrowers in New Zealand, and as high-growth councils turn to potential Crown sources of infrastructure finance, like the NZ\$1 billion Housing Infrastructure Fund. LGFA has recorded growing net interest income and positive profit levels in every year except its first (partial) year of operation. We expect LGFA's earnings to remain modest, reflecting its central objective of reducing funding costs for councils.

We consider LGFA's management and governance to be a key strength, and one that reduces potential risks. LGFA is governed by a six-member board, of which five members, including the chairperson, are independent directors. The board is responsible for the strategic direction and control of LGFA's activities. LGFA also has a shareholders council, made up of 5-10 appointees, that recommends appointments to the board and coordinates shareholders on governance decisions. LGFA's management team is highly qualified. Its senior executives bring many years of experience from previous roles in council treasury operations, debt management, and private financial markets.

Like many of its international peers, LGFA is not subject to banking regulations. However, its bonds are quoted on the NZX Debt Market and LGFA is therefore subject to continuous disclosure obligations. In addition, securities issued to retail investors are regulated under the Financial Markets Conduct Act 2013. LGFA produces annual financial statements that are audited by external auditors appointed by the Auditor-General of New Zealand.

Financial Risk Profile: Risks from borrower concentration are partly offset by sound access to capital markets and strong liquidity

- LGFA's two largest borrowers account for around 47% of its lending book, resulting in concentration risk, though we expect this to gradually decline.
- LGFA benefits from a joint and several guarantee from 48 council guarantors, and its lending is secured over property rates revenue.
- LGFA funds itself only in domestic capital markets. Liquidity is buttressed by a NZ\$1 billion standby facility from the Crown.

LGFA's lending portfolio is concentrated compared with most of its peers, and this constrains its capital adequacy assessment. We estimate LGFA's risk-adjusted capital (RAC) ratio to be 19.2% before diversification and 1.8% after adjustments for single-name concentration, as of June 30, 2018. LGFA's two largest borrowers, Auckland Council and Christchurch City Council, represented 47% of its loan book as at June 30, 2018, while its 20 largest borrowers accounted for around 85%. LGFA's capital structure includes NZ\$25 million of paid-in shareholder capital, about NZ\$39 million in retained earnings, and about NZ\$135 million in borrower notes, which we view as equity-like, inclusive of accrued interest. LGFA also has NZ\$20 million of uncalled shareholder capital, which we exclude from our calculations but note could be called to support LGFA's financial position in a stress scenario. We expect LGFA's capitalization to slowly improve as retained earnings grow and borrower concentration gradually declines, particularly as Auckland Council accesses alternative sources of funding.

We consider LGFA's financial risk management to be excellent, which helps to mitigate its lending concentration risk. LGFA's investments are restricted to approved financial instruments, such as term deposits and highly rated bonds,

as specified in a board-approved treasury policy. LGFA fully hedges any foreign-currency exposures back to New Zealand dollars. Credit risk on derivative contracts is minimized by the use of NZDMO as the counterparty to all such contracts. Similar to many of its international peers, LGFA's credit quality is exceptional, reflecting the fact that it has not experienced any arrears on payments or loan impairments since inception. Council borrowers must comply with various financial covenants relating to their net debt, interest expenses, and liquidity. To minimize concentration risk, LGFA requires that no more than the greater of NZ\$100 million or 33% of a council's borrowings mature in any 12-month period, and Auckland Council is limited to a maximum of 40% of LGFA's total lending book.

Supporting its financial profile is the fact that all of LGFA's borrowers must provide debenture security by way of a charge over council property rates and rates revenues. We view this security as being extremely strong because rates revenue is the largest and most stable source of income for New Zealand councils, and because rate collection ranks ahead of all other claimants, including mortgages and New Zealand's Inland Revenue Department. At present, LGFA can only provide debt funding to New Zealand councils, and not any council-controlled organization, joint venture, or partially owned entity.

In addition, our assessment of LGFA is strengthened by the joint and several guarantee of LGFA's obligations. Other than the New Zealand government, each of LGFA's shareholders must be a guarantor, and, if the principal amount of a council's borrowing exceeds NZ\$20 million, that council must also become party to a deed of guarantee. LGFA currently has 48 council guarantors.

We believe that LGFA has sound access to domestic capital markets. LGFA's bonds are issued domestically in New Zealand dollars and, since 2015, have been listed on the NZX Debt Market, allowing participation by retail investors. Bonds are spread across eight maturities, largely matching those of benchmark New Zealand government bonds. They have mostly been in tranches of NZ\$1 billion or greater in order to promote liquidity and cater to investor demand. Tenders are spread throughout the year to ensure consistency of supply. Demand for LGFA's bonds is supported by their repo-eligibility with the Reserve Bank of New Zealand with a low haircut. According to LGFA's surveys, about 39% of its debt is held by offshore investors. Since 2015, LGFA has also issued short-dated bills via tender and private placement. In November 2017, LGFA established an Australian-dollar medium-term notes program, which it has not yet opted to utilize.

We consider LGFA's liquidity to be strong, reflecting its portfolio of liquid financial assets and access to a NZ\$1 billion standby facility with the NZDMO. We believe that LGFA would generally be able to meet its short-term obligations even in an extreme stress scenario in which all maturing council loans must be rolled over while LGFA's own access to market funding is cut off. We also believe that, in practice, New Zealand councils would be able to reduce their borrowing requirements in such an environment. All rated New Zealand councils post strong operating surpluses and use debt only to fund capital expenditure, which would likely be postponed in such a scenario.

Extremely strong likelihood of support from the New Zealand government in a stress scenario

We view the likelihood that the New Zealand government would provide timely and sufficient extraordinary support to LGFA in the event of financial distress to be extremely high. This assessment is based on our view of LGFA's:

- Very important role in meeting the New Zealand government's objectives. LGFA is the primary source of capital funding for the New Zealand local government sector. LGFA helps to deepen New Zealand's capital markets, and offers cost savings and access to longer-term borrowings to participating councils. A default by LGFA would likely lead to substantial delays or cancelations of local investment projects, thereby having a major impact on New Zealand's economy.
- Integral link with the New Zealand government. LGFA's enabling legislation allows the Crown to lend it money if it is in the public interest to do so, or to meet a temporary shortfall in a timely manner. In addition, we believe LGFA enjoys a special public status in New Zealand, as evidenced by its NZ\$1 billion committed liquidity facility with the NZDMO.

Key Statistics

Table 1

Selected indicators (mil. NZ\$)	--Year ended June 30--				
	2018A	2017A	2016A	2015A	2014A
Business position					
Total adjusted assets	8,835	8,491	7,257	5,412	3,918
Customer loans (gross)	7,976	7,784	6,451	5,032	3,742
Growth in loans (%)	2	21	28	34	49
Net interest revenues	19	18	16	14	10
Noninterest expenses	7	6	6	5	3
Capital and risk position					
Total liabilities	8,635	8,306	7,105	5,290	3,827
Total adjusted capital	199	185	153	121	91
Assets/capital	44	46	48	45	43
RAC ratio before diversification (%)	19.2	19.0	N.A.	N.A.	N.A.
RAC ratio after diversification (%)	1.8	1.5	N.A.	N.A.	N.A.
Gross nonperforming assets/gross loans	0	0	0	0	0
Funding and liquidity					
Liquidity ratio with loan disbursement (one year)	0.89	N.A.	N.A.	N.A.	N.A.
Liquidity ratio without loan disbursement (one year)	1.61	N.A.	N.A.	N.A.	N.A.
Funding ratio (one year)	1.65	N.A.	N.A.	N.A.	N.A.

N.A.--Not available. E--Estimate. A--Actual.

Ratings Score Snapshot

Issuer Credit Rating	
Local Currency	AA+/Positive/A-1+
Foreign Currency	AA/Positive/A-1+
SACP	aa-
Enterprise Risk Profile	Strong (2)
PICRA	Strong (2)
Business Position	Strong (2)
Management & Governance	Very Strong (1)
Financial Risk Profile	Adequate (3)
Capital Adequacy	Moderate (4)
Funding	Neutral
And Liquidity	Strong (2)
Support	+2
GRE Support	+2
Group Support	0
Additional Factors	0

Related Criteria

- Criteria - Governments - International Public Finance: Public-Sector Funding Agencies: Methodology And Assumptions, May 22, 2018
- 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
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- New Zealand Outlook Revised To Positive On Improving Fiscal Position; 'AA+' LC And 'AA' FC Ratings Affirmed, Jan. 31, 2019
- Assumptions For Liquidity Gap Analysis Under "Public-Sector Funding Agencies: Methodology And Assumptions", May 22, 2018

- Credit FAQ: A Closer Look At The New Public-Sector Funding Agencies Criteria, May 22, 2018
- 10 Public-Sector Funding Agencies Placed Under Criteria Observation On Publication Of New Criteria, May 22, 2018

Ratings List

Ratings Affirmed

New Zealand Local Government Funding Agency Ltd.

Analytical Factors

Local Currency aa-

New Zealand Local Government Funding Agency Ltd.

Senior Unsecured AA+

Short-Term Debt A-1+

Ratings Affirmed; CreditWatch/Outlook Action

To From

New Zealand Local Government Funding Agency Ltd.

Issuer Credit Rating

Foreign Currency AA/Positive/A-1+ AA/Stable/A-1+

Local Currency AA+/Positive/A-1+ AA+/Stable/A-1+

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