FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms New Zealand's LGFA at 'AA'/'AA+'; Outlook Positive/Stable

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Fitch Ratings - Sydney/Hong Kong - 03 Nov 2020: Fitch Ratings has affirmed New Zealand Local Government Funding Agency Limited's (LGFA) Long-Term Foreign-Currency Issuer Default Rating (IDR) at 'AA' with a Positive Outlook, and its Long-Term Local-Currency IDR at 'AA+' with a Stable Outlook. At the same time, Fitch has affirmed the senior unsecured local-currency rating at 'AA+' and the short-term domestic bond programme at 'F1+'.

Fitch has categorised LGFA as a government-related entity (GRE) under our Government-Related Entities Rating Criteria. This reflects LGFA's status as a council-controlled organisation (CCO) and its links to the New Zealand sovereign (AA/Positive, AA+/Stable, F1+). Our rating approach "looks through" the shareholder structure and control chain and links LGFA to the New Zealand sovereign as we expect extraordinary support to come from the central government. Our assessment of LGFA's 'Very Strong' status, ownership and control, 'Strong' support record, 'Strong' socio-political and 'Very Strong' financial implications of a default translates into an overall support score of 45. We have therefore equalised LGFA's ratings with that of the sovereign, which is a shareholder, liquidity provider and derivative counterparty to LGFA. The ratings are assigned without an assessment of a Standalone Credit Profile.

The affirmation also considers the strong underlying credit profiles and general asset quality of LGFA's council shareholders and borrowers, which operate within a stable institutional framework and provide full support for LGFA's debt obligations through joint and several liability guarantees (JSLG).

LGFA began operating as an optional borrowing vehicle for New Zealand's councils in February 2012, following the enactment of the Local Borrowing Act 2011. Its main objective is to optimise debt funding terms and conditions for participating local authorities (PLA). This includes reducing interest costs, offering flexible terms and allowing long-term borrowing.

LGFA had 18 foundation council shareholders on incorporation, of which nine were considered founding members, as well as the New Zealand government. The number of shareholders increased in 2012 by 12 to a total of 30 councils. Another 26 councils are borrowers and guarantors, while 12 are borrowers only. A total of 70 local authorities were eligible LGFA borrowers at 30 October 2020. PLAs represent around 90% of New Zealand's local government sector debt. LGFA aims to provide a minimum of 85% of the local government sector's aggregate long-term debt funding.

KEY RATING DRIVERS

'Very Strong' Status, Ownership and Control: LGFA is a CCO under the Local Government Act 2002, which is enabled by the Local Government Borrowing Act 2011 and incorporated under the Companies Act 1993. The sovereign's legal links to LGFA are demonstrated through supportive legislation and the central government's (Crown) 20% ownership of LGFA's shares alongside the local councils' 80% ownership. This assessment is supported by the strong institutional framework of New Zealand and Fitch's view of the likelihood of a liability transfer to the central government, if needed.

All council shareholders and borrowers with more than NZD20 million in loans are required to sign JSLGs, which are on demand and can be called without a board or court order. The JSLGs allow a security trustee to call on guarantors directly following a payment default by LGFA. Should a guaranteeing council not pay its share, the shortfall is recoverable from the other guarantors on a pro rata basis to rates revenue and supported by debenture security over each council's rates revenue.

The LGFA is not guaranteed by the Crown, but its special status is underpinned by a committed liquidity facility from an arm of the New Zealand Treasury and legislation that allows other forms of liquidity support if deemed in the public interest. LGFA is monitored by the Department of Internal Affairs, which also oversees local councils, and must comply with securities laws. It is not regulated by the Reserve Bank of New Zealand, but the issuance of LGFA securities to the public is compliant with the Financial Markets Conduct Act and regulated by the country's Financial Markets Authority.

'Strong' Support Track Record: LGFA received an initial equity contribution from the sovereign but does not require or receive subsidies and transfers to support its operations. LGFA is the only dedicated financing vehicle for New Zealand's local-government sector and, as of 30 October 2020, was guaranteed by 58 local councils covering the majority of the country's territorial authorities and population. This guarantee structure and the central role of LGFA in the national financial framework lead to our strong expectation that extraordinary support would be forthcoming in case of need.

'Strong' Socio-Political Implications of Default: LGFA's primary role is to provide more efficient costs and diversified funding sources for local authorities. It has been able to raise debt on behalf of local authorities on more favourable terms than if they were to raise the debt directly. Fitch believes that in an unforeseen default scenario, the local government sector would have the ability to access emergency financial support from the Crown and alternative funding from private-sector lenders. However, a default by LGFA would have significant socio-political implications as it would cause significant delays to public-sector projects and affect the provision of essential services by local authorities. Consequently, we believe a default would have significant economic and political implications due to the wider impact on New Zealand's citizens and economy.

'Very Strong' Financial Implications of Default: We regard LGFA as an important financing vehicle for New Zealand's local-government sector, which has increased capital-market liquidity and tenor while lowering funding costs. LGFA is the country's second-largest bond issuer after the sovereign; the 70 current participating local authorities, including the country's largest local councils, represent 90% of the local government sector and as at 30 June 2020 LGFA lending represented an estimated 86% of local government debt.

The Local Government Borrowing Act 2011 permits the Crown to lend money to LGFA to meet an exceptional and temporary liquidity shortfall if necessary or expedient in the public interest. This legislation, along with the JSLGs, ensures an LGFA default could realistically occur only in the event of the entity's insolvency and the inability of the Crown and other local-council shareholders to honour their obligations. In such a scenario, the ability of the central government, other GREs, and state-sector borrowers to source funding in a timely, cost-efficient manner is likely to be severely affected.

Meeting Operating Targets: LGFA has the primary objective of optimising its PLAs' debt funding terms and conditions while achieving its own shareholder-agreed objectives and performance targets. Although its mission is not to maximise its own profits, the entity reported consistent net operating profit over the last five years, which Fitch expects will be maintained via continued financial discipline and strong liquidity, supported by LGFA's links to the 'AA' rated sovereign. Liquidity remains strong with a significant increase in LGFA's liquid asset portfolio to over NZD1.7 billion in September 2020 from NZD594 million in December 2019, supported by the Crown via its NZD1.5 billion liquidity facility, in addition to the Reserve Bank of New Zealand adding LGFA bonds to its Large Scale Asset Purchase Programme in April 2020 to support LGFA's market liquidity.

Headwinds from the evolving coronavirus pandemic and a recent increase in LGFA's debt ceiling for a number of its government-sector borrowers could result in pressure on borrowers' credit profiles, although credit quality across New Zealand's local authorities remains sound with the vast majority of LGFA lending being to council borrowers rated by major rating agencies at 'AA-' or higher, supported by Fitch's view of New Zealand's robust institutional framework.

DERIVATION SUMMARY

Fitch classifies LGFA as an entity linked to the New Zealand sovereign under our GRE criteria and applies a top-down rating approach based on our assessment of the strength of its linkage with and the incentive to support by the New Zealand sovereign. LGFA's 45-point GRE support score reflects the combination of 'Very Strong' and 'Strong' key rating drivers.

The score also leads to LGFA's IDRs being equalised with those of the sovereign.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

Positive rating action for the New Zealand sovereign would be mirrored in LGFA's ratings.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

LGFA's Long-Term IDRs could be downgraded in the event of negative rating action for the New Zealand sovereign. A weaker assessment of the strength of linkage or incentive to support factors leading to a GRE support score of 42.5 or lower under our GRE criteria could also result in a downgrade.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit [https://www.fitchratings.com/site/re/10111579].

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

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

RATING ACTIONS

ENTITY/DEBT	RATING			PRIOR
New Zealand Local Government Funding Agency Limited (LGFA)	LT IDR	AA Rating Outlook Positive	Affirmed	AA Rating Outlook Positive
•	ST IDR	F1+	Affirmed	F1+
•	LC LT IDR	AA+ Rating Outlook Stable	Affirmed	AA+ Rating Outlook Stable
•	LC ST	F1+	Affirmed	F1+

VIEW ADDITIONAL RATING DETAILS

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Additional information is available on www.fitchratings.com

APPLICABLE CRITERIA

Government-Related Entities Rating Criteria (pub. 30 Sep 2020)

International Local and Regional Governments Rating Criteria (pub. 28 Oct 2020) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

New Zealand Local Government Funding Agency Limited (LGFA)	EU Endorsed

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New Zealand