1. COMMENTARY ON OPERATIONS FOR THE QUARTER

On 3 October 2012 LGFA held its seventh bond tender. A total of $275 million was issued, bringing bond outstandings to $1.330 billion.

Table 1: Results of LGFA Bond Tender Number 7

Tender Date: 3 October 2012
Settlement Date: 8 October 2012

LGFA Bonds Offered:	**15 Dec 2017**	**15 Mar 2019**
Coupon Rate:	6.00%	5.00%
Amount Offered:	$95 million	$180 million
Total Bids Submitted:	$326 million	$596 million
Total Number of Bids Submitted:	26	30
Total Successful Bids:	$95 million	$180 million
Total Number of Successful Bids:	6	14
Successful Range:	3.56% - 3.60%	3.87% - 3.94%
Weighted Average Successful Yield:	3.58%	3.92%
Unsuccessful Range:	3.60% - 3.73%	3.94% - 4.02%
Weighted Average Unsuccessful Yield:	3.64%	3.97%

Highlights of LGFA's seventh bond tender were:

- A good bid cover ratio of 3.4 times ($922 million of bids received for $275 million of bonds offered). While this was below the average bid cover ratio of 4.2 times achieved by LGFA in our seven tenders to date, it was an impressive result given the size of the tender.
- Pricing levels that held up well; the margin on our March 2019 bond increased marginally to 93 bps over NZGBs (from 91 bps at the last tender), but the margin of 77 bps over NZGBs recorded for our December 2017 maturity was the best result ever achieved in an LGFA tender.
- Maintenance of the pricing improvement relative to council benchmarks generated by tender numbers 4 and 5. Our benchmark December 2017 bond (offered for the first time since tender number 4) priced at 55 bps over swap; again, the best margin to swap ever achieved in an LGFA tender. This margin remains around 50 bps below AA rated councils.
- Successful bid ranges of 4 bps (2017s) and 7 bps (2019s); a similar result to the previous tender. As noted previously, a 7 bps successful bid range compares favourably with the results achieved by NZDMO at a number of their recent tenders.
- Consistent with the larger size of this tender, the number of bids was well up on last tender (from 32 to 56 bids), while the number of counterparties bidding almost doubled from four to seven.

On 7 November 2012 LGFA held its eighth bond tender. A total of $130 million was issued, bringing bond outstandings to $1.460 billion.

Table 2: Results of LGFA Bond Tender Number 8

Tender Date: 7 November 2012
Settlement Date: 12 November 2012

LGFA Bonds Offered:	**15 Dec 2017**	**15 Mar 2019**
Coupon Rate:	6.00%	5.00%
Amount Offered:	$50 million	$80 million
Total Bids Submitted:	$270 million	$378 million
Total Number of Bids Submitted:	24	22
Total Successful Bids:	$50 million	$80 million
Total Number of Successful Bids:	1	3
Successful Range:	3.60% - 3.60%	3.98% - 3.99%
Weighted Average Successful Yield:	3.60%	3.98%
Unsuccessful Range:	3.67% - 3.83%	3.99% - 4.16%
Weighted Average Unsuccessful Yield:	3.72%	4.06%

Highlights of LGFA's eighth bond tender were:

- An excellent bid cover ratio of 5.0 times ($648 million of bids received for $130 million of bonds offered). This result exceeded the average bid cover ratio of 4.3 times achieved by LGFA in our eight tenders to date.

- Pricing levels that improved significantly; the margin of 69 bps over NZGBs recorded for our December 2017 maturity (down substantially from 77 bps at the last tender) was the best result ever achieved in an LGFA tender. Our March 2019 bond also performed well, with the margin over NZGBs falling from 93 bps at the last tender to a new low of 89 bps at this tender.

- Maintenance of the pricing improvement relative to council benchmarks generated by tender numbers 4 and 5. Our benchmark December 2017 bond priced at 44 bps over swap; again, the best margin to swap ever achieved in an LGFA tender.

- Successful bid ranges of 0 bps (2017s) and 1 bp (2019s); a marked improvement on the previous tender. In the case of the December 2017 bond, the total amount offered was taken out by a single bid that was fully 7 bps below the next lowest bid. This is the first time we have experienced such aggressive bidding in an LGFA tender.

- A surprisingly high number of bids for a relatively small tender. There were 46 bids received this time (down from 56 bids last time, but tender number 7 was more than double the size of this tender). The number of counterparties bidding remained unchanged from last tender at seven.

On 12 December 2012 LGFA held its ninth bond tender. A total of $75 million was issued, bringing bond outstandings to $1.535 billion. LGFA's debt program in 2012 has exceeded $1.5 billion; well above the $1 billion originally expected.

Table 3: Results of LGFA Bond Tender Number 9

Tender Date: 12 December 2012
Settlement Date: 17 December 2012

LGFA Bonds Offered:	**15 Dec 2017**	**15 Mar 2019**
Coupon Rate:	6.00%	5.00%
Amount Offered:	$30 million	$45 million
Total Bids Submitted:	$148 million	$179 million
Total Number of Bids Submitted:	13	13
Total Successful Bids:	$30 million	$45 million
Total Number of Successful Bids:	1	1
Successful Range:	3.59% - 3.59%	3.95% - 3.95%
Weighted Average Successful Yield:	3.59%	3.95%
Unsuccessful Range:	3.59% - 3.68%	3.96% -4.03%
Weighted Average Unsuccessful Yield:	3.65%	4.00%

Highlights of LGFA's ninth bond tender were:

- An strong bid cover ratio of 4.4 times ($327 million of bids received for $75 million of bonds offered). This result marginally exceeded the average bid cover ratio of 4.3 times achieved by LGFA in our nine tenders to date.
- Pricing levels that improved significantly; the margin of 66 bps over NZGBs recorded for our December 2017 maturity (down from 69 bps at the last tender) was the best result ever achieved in an LGFA tender. Our March 2019 bond also performed very well, with the margin over NZGBs falling from 89 bps at the last tender to a new low of 83 bps at this tender.
- Maintenance of the pricing improvement relative to council benchmarks generated by tender numbers 4 and 5. Our benchmark December 2017 bond priced at 46 bps over swap; marginally above the best margin to swap ever achieved in an LGFA tender (44 bps).
- Successful bid ranges of 0 bps (2017s) and 0 bps (2019s); again, the best result for this tender metric ever achieved (and as good as it gets!). In the case of the December 2017 bond, the total amount offered was taken out by a single bid that was 2 bps below the next lowest bid. This was the second consecutive tender where bidding was more aggressive than normal.
- A reasonable number of bids for a small tender. There were 26 bids received this time (down from 46 bids last time, but tender number 8 was almost double the size of this tender). The number of counterparties bidding remained unchanged from last tender at seven.

2. PERFORMANCE AGAINST OBJECTIVES AND PERFORMANCE TARGETS

Primary Objective

LGFA will operate with the ***primary objective*** of optimising the debt funding terms and conditions for Participating Local Authorities. Among other things this includes:

- *Providing debt to Participating Local Authorities at the lowest possible interest rates commensurate with the relevant maturity*

  LGFA has met its primary objective by continuing to achieve significant improvement in the pricing of our benchmark 15 December 2017 bond. Most of this improvement was obtained in the June quarter, with further solid improvement of 9 bps achieved in the December quarter.

  The December 2017 maturity is regarded as our benchmark bond because it has the largest volume outstanding, the most liquidity and longest history of issuance.

  From the inaugural tender held on 15 February 2012 to date, there has been a substantial improvement of 43 basis points (bps) in the December 2017's margin to swap (as outlined in the table below):

Margins	**15 Feb 2012 (bps)**	**31 Dec 2012 (bps)**	**Pricing Improvement (bps)**
LGFA margin to NZGB	113	66	47
NZGB margin to swap	(24)	(20)	(4)
LGFA margin to swap	89	46	43

  Some of this pricing improvement has resulted from LGFA's ongoing marketing activities, including:

  - Speaking as part of a New Zealand presentation series (with NZDMO and RBNZ) at the fifth Annual Australasian Fixed Income Conference in Sydney, organised by CBA. This provided an opportunity to highlight LGFA's performance in 2012 to a group of approximately 50 investors from Australia, New Zealand, Asia, Europe and the United States.

  - Undertaking regular meetings with investors and intermediaries.

- *Making longer-term borrowings available to Participating Local Authorities*

  We continued to offer two maturities in excess of five years to participating councils:

  - 15 December 2017 bond (five years), first issued at the inaugural bond tender held on 15 February 2012; and

  - 15 March 2019 bond (just over six years), first issued at the fourth bond tender held on 6 June 2012.

  It is also interesting to note that council demand has been very strong for these longer-term maturities. During the 2012 calendar year, our December 2017 and March 2019 bonds accounted for 89% of total issuance.

- *Enhancing the certainty of access to debt markets for Participating Local Authorities, subject always to operating in accordance with sound business practice*

Access to debt markets has been enhanced by the consistently strong cover ratios achieved at all LGFA bond tenders held in 2012. Our cover ratio (ie ratio of total amount bid to total amount offered) for each tender has been:

LGFA Tender	Volume Bid ($m)	Volume Offered ($m)	Cover Ratio (times)
1	1,320	300	4.4
2	959	265	3.6
3	855	140	6.1
4	752	130	5.8
5	546	145	3.8
6	245	75	3.3
7	922	275	3.4
8	648	130	5.0
9	327	75	4.4

From the table, it is important to note that:

- Total bids received have amounted to $6.6 billion in the first nine tenders;
- The average cover ratio has been a very strong 4.3 times;
- Our lowest cover ratio to date is still a very respectable 3.3 times; and
- LGFA's average cover ratio compares favourably to the average of 3.4 times achieved by NZDMO over the past few months.

Additional objectives

LGFA has a number of additional objectives which complement the primary objective. These objectives will be measurable and achievable and the performance of the company in achieving its objectives will be reported annually. These additional objectives are to:

- *Operate with a view to making a profit sufficient to pay a dividend in accordance with its stated Dividend Policy set out in section 6*

Two key factors have contributed to LGFA performing ahead of budget in the first six months of 2012/13:

- Bond issuance ($1.535 billion) and on-lending activity ($1.530 billion) were significantly higher than forecast; and
- Overheads have been well contained.

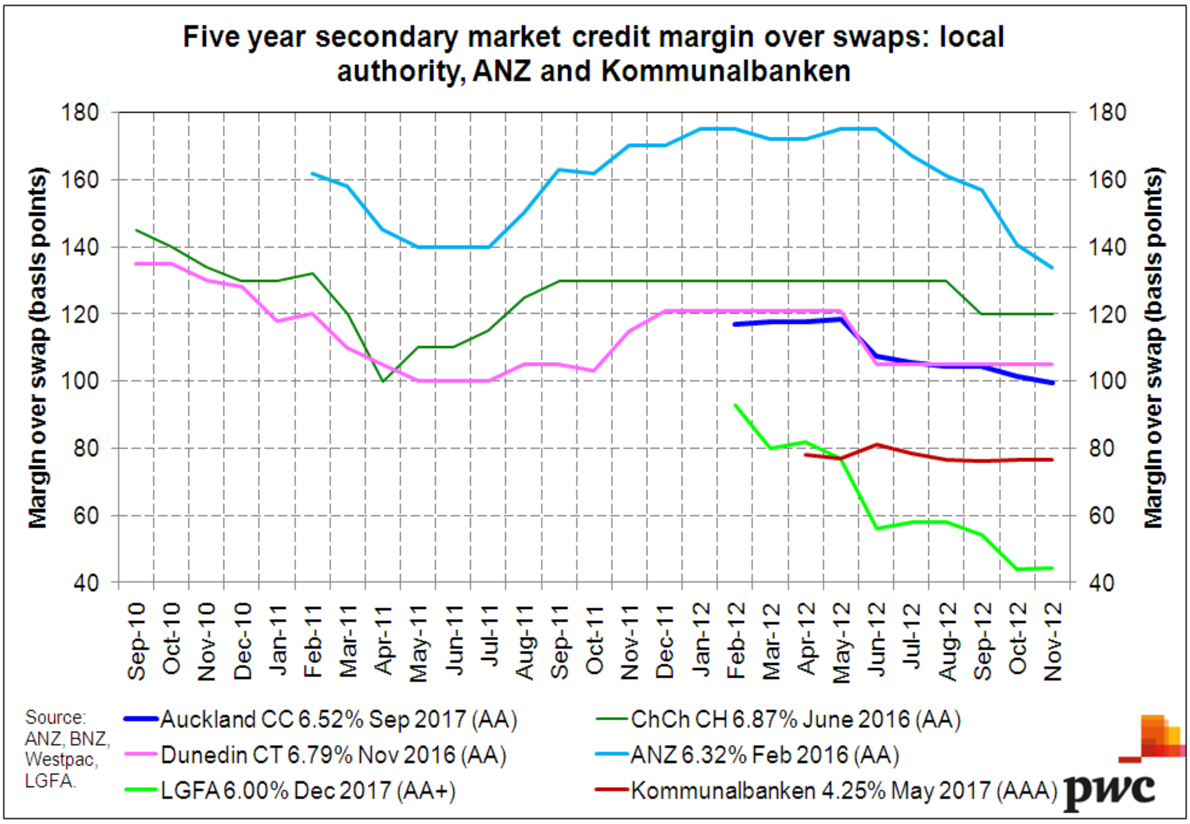
As a result, LGFA anticipates being in a position to make a larger first dividend payment than forecast in the SOI.

- *Become the primary source of debt funding for Participating Local Authorities*

  Councils have strongly supported LGFA to date. During 2012, 16 (out of 18) inaugural participating councils borrowed from us. Following the Second Opening on 30 November 2012, we finished the calendar year with a further eight of the twelve new shareholders borrowing from us. In all, 24 out of 30 participating councils had borrowed from LGFA by year-end.

- *Operate in a manner to ensure LGFA is successful and sustainable in the long-term*

  The key to LGFA's long-term sustainability is to ensure that it can always fund councils at lower rates than they can fund themselves. To provide evidence of LGFA's performance against this objective, we have included the chart below (produced by PricewaterhouseCoopers). This chart compares LGFA's spread to swap against a number of other issuers for five year maturities.



From the chart above, we estimate that as at 31 December 2012 LGFA was saving AA rated councils approximately 34 bps in annual interest costs on a five year security.

The basis for this estimate is set out in the table below:

Margins on 15 December 2017 bond	31 December 2012 (bps)
AA rated councils margin to swap	100
Less LGFA margin to swap	(46)
LGFA Funding Advantage *Less LGFA Base Margin*	54 (30)
LGFA Net Funding Advantage Add “LGFA Effect” *	24 10
Total saving for AA rated councils	**34**

* *The ‘LGFA effect’ represents the estimated conservative reduction in AA rated councils margin to swap as a result of LGFA operations. From May to June 2012, the margin to swap for AA rated councils fell by 10 bps, with no corresponding move in swap spreads for other borrowers. This suggests that potential access to cost effective LGFA funding has enabled these councils to reduce their borrowing margin by around 10 bps.*

Using similar analysis, we estimate that as at end December 2012 LGFA was saving A rated councils approximately 39 bps and unrated councils around 44 bps in annual interest costs on a five year borrowing.

Educate and inform all Local Authorities (both participating and non-participating) on matters within the scope of LGFA's operations

During the quarter ended 31 December, LGFA:

- Issued a press release (13 December) to inform all local authorities that 12 new shareholders had joined LGFA (with eight of them borrowing at the December bond tender), and that LGFA won New Zealand Domestic Issuer of the Year at the KangaNews Awards 2012.

- Participated in a Fiscal Thresholds Working Party convened by LGNZ, as part of the Better Local Government reform programme.

- Supported the work of the recently established Local Government Infrastructure Expert Advisory Group (with one of our Directors also appointed as a member of the Advisory Group).

• *Become a leading participant in the New Zealand capital markets*

Two more articles from KangaNews are attached to this Report. They provide evidence of the considerable interest in LGFA’s activities from both the domestic and international investor base. The two articles are:

- A New Zealand update featuring NZDMO and LGFA, published in the December 2012 Supplement edition of KangaNews; and

- Write-ups on the winners of the KangaNews Awards 2012, featuring LGFA as the New Zealand Domestic Issuer of the Year (and Mark Butcher, from Auckland Council, as the New Zealand Treasurer of the Year). These were published in the December 2012/January 2013 edition of KangaNews.

- *Provide excellent service to Participating Local Authorities*

  Following completion of the Second Opening on 30 November, eight of the twelve new shareholders chose to participate in the bond tender held on 12 December. Seven of these eight councils were borrowing from LGFA for the first time. In all, a record nine councils participated in the last bond tender of the year. Our operational processes have been fine-tuned throughout 2012, to the point where no issues were reported during settlement on 17 December.

  Prior to the ninth bond tender, LGFA also provided additional information to all participating councils. For the first time, detailed pricing results from the previous tender (in terms of LGFA margins to NZGBs and mid-swap, and swap pricing from NZDMO) were included in our tender notification email to all borrowing councils. This enabled participating councils to make informed choices about whether to borrow from LGFA on a fixed or floating rate basis.

- *Ensure excellent communication exists and be professional in its dealings with all its stakeholders*

  During the quarter ended 31 December, LGFA:

  - Held its inaugural Annual General Meeting on 13 November 2012. At the meeting shareholders approved an amendment to the Shareholders' Agreement to reduce the utilisation commitment period for new shareholders (joining at the Second Opening) to approximately two years (from three years). Useful feedback on LGFA's dividend and margin policies was also received from shareholders;

  - Successfully completed the Second Opening on 30 November 2012. At the end of this process, $1.3 million of LGFA shares were transferred from twelve existing 'sell-down' shareholders to twelve new shareholders, with all transactions settled smoothly; and

  - Conducted regular media interviews (eg interest.co.nz, Bloomberg News) and contributed to KangaNews articles to ensure that markets (both domestically and internationally) are well informed about LGFA's activities and operations.

- *Ensure its products and services are delivered in a cost-effective manner*

  During the quarter ended 31 December, LGFA:

  - Charged a "base" margin to councils that averaged 0.30%, well below the maximum permitted of 0.40%; and

  - Restricted operating costs (for the six month period ended 31 December 2012) to approximately $250,000 per month, marginally below the monthly target of around $267,000.

- *Consult with Shareholders regarding the potential requirement for LGFA Borrowers to obtain comprehensive insurance cover*

  Following settlement of the ninth bond tender on 17 December 2012, LGFA has now on-lent $1.530 billion to councils. To date, there has been no requirement for borrowers to obtain or retain comprehensive insurance cover.

- LGFA's current credit assessment approach is to consider insurance cover along with various business interruption risks (including risks to physical assets) as part of an overall credit risk assessment of individual councils. In this regard, LGFA is aware that self-insurance arrangements eg. via the accumulation of financial assets, may be as effective as external insurance cover.

- LGFA will undertake future consultation with shareholders on the appropriate level of insurance cover for borrowers.

- *Review the appropriateness of LGFA's "broker" business model*

  The success of the "broker" business model is evident from three key factors:

  - Overall profitability (ie the retained earnings position) has significantly exceeded budget in the first year of operations;

  - Profitability has been achieved without the need for LGFA to take on significant interest rate risk eg. Value-at-Risk[1] is currently running at only 15% of policy limits; and

  - Significant improvement in the pricing of LGFA bonds has generated corresponding savings for AA rated council borrowers of around 34 bps in annual interest costs.

- *Maintain LGFA's credit rating equal to the New Zealand Government sovereign rating where both entities are rated by the same Rating Agency*

  - On 30 November 2012, Fitch affirmed LGFA's local currency credit rating at AA+ and foreign currency credit rating at AA. The outlook on both ratings is stable.

  - On 20 December 2012, Standard & Poor's affirmed LGFA's local currency credit rating at AA+ and foreign currency credit rating at AA. The outlook on both ratings is stable.

  - LGFA's credit ratings from both Fitch and Standard & Poor's are the same as the New Zealand sovereign ratings.

- *Achieve the Financial Forecasts set out in section 4*

  LGFA's actual financial results (for key items set out in Section 4 of the SOI), for the six month period ended 31 December 2012 are compared with forecast in the table below. For completeness, we have also included the full year forecast for 2012/13.

	$m 31 Dec 2012 Actual	**$m 31 Dec 2012 SOI Forecast**	**$m 30 Jun 2013 SOI Forecast**
Total Net Income	2.64	1.76	3.9
Overheads	(1.51)	(1.32)	(2.7)
Net Profit	1.13	0.44	1.2
Borrower Notes Interest	(0.34)	(0.20)	(0.5)
Surplus*	0.79	0.24	0.7

**before dividend payment*

[1] Value-at-Risk (VaR) is a statistical market risk management tool which seeks to determine the largest dollar loss likely to be suffered by LGFA over a 1 day period with a 95% confidence level.

- *Achieve the Dividend Policy set out in section 6*

  Refer to our earlier comments on this issue.

Performance Targets

Six performance targets are specified for LGFA in the SOI. Progress against each of these targets is discussed below, including an explanation of any material variances.

	Performance Measure	Target	Result	Outcome (Target met?)
1	Average cost of funds relative to NZGS	<0.50%	0.84%	x
2	Average margin above LGFA's cost of funds	<0.40%	0.30%	√
3	Annualised operating overheads	<$3.2 million	$3.0 million	√
4	Lending to participating councils	>$900 million	$1,530 million	√
5	Number of council shareholders	≥30	30	√
6	Number of eligible borrowers	≥40	30	x

There are two key reasons for LGFA's relative cost of funds averaging 34 bps over the target level of 50bps:

- The European debt crisis has increased the margins of all other issuers above sovereign borrowers, particularly in countries like New Zealand where the sovereign is highly rated.

- Only longer dated bonds (December 2017s and March 2019s) were issued at the three tenders held during the December quarter. While this reflected council demand for funding, longer dated bonds price at a relatively higher margin above NZGS than shorter dated bonds.

It is also worth noting that LGFA's relative cost of funds steadily improved as the quarter progressed. At the December bond tender, LGFA's weighted average cost of funds had fallen to 0.76% over NZGS; the best result achieved to date.

There are seven councils wishing to participate in the February bond tender as approved LGFA borrowers. These councils are:

Far North District Council
Matamata-Piako District Council
Nelson City Council
Queenstown Lakes District Council
Rotorua District Council
Timaru District Council
Waikato District Council

A further five councils have indicated a firm intention to join LGFA as borrowers in the next few months.

Consequently, we are very confident that LGFA will have at least 40 eligible borrowers by the end of the first quarter in 2013.

3. DETAILS OF EVENTS OF REVIEW

There have been no events of review in respect of any Participating Local Authority.

Consolidation top of the agenda in *New Zealand*

New Zealand's path back to surplus is a longer one than Australia's, and is made harder by the cost of rebuilding after the Christchurch earthquakes of 2010 and 2011. But as with its nearest neighbour, New Zealand's high-grade borrowers find themselves in sufficiently comfortable positions to be implementing strategic portfolio management initiatives.

According to New Zealand Debt Management Office (NZDMO) projections, New Zealand sovereign bond issuance is forecast to fall significantly over the coming years and should return to pre-crisis levels by 2016 (see chart on facing page).

Brendon Doyle, the NZDMO's Wellington-based treasurer, says the declining issuance path is not merely the happy product of an improving economy. "The minister of finance is absolutely committed to controlling net debt. His target is to return the net debt to GDP ratio to 20 per cent by 2020," Doyle explains. "At present, the means to achieving this is running a tight fiscal ship. But in time and as the budget reaches surplus the strategy will move towards other priorities, which may include debt reduction, New Zealand superannuation and Earthquake Commission contributions."

However, while the long-term fiscal path is improving in the next few years Doyle does not expect reduction in the outstanding volume of New Zealand government bonds (NZGBs), which has grown to around NZ$70 billion (US$56.9 billion) from around NZ$20 billion prior to the financial crisis, to be on the agenda.

Even as the national budget position improves – towards a projected return to surplus in the 2014/15 fiscal year – Doyle says reducing the level of outstanding debt is likely to remain a second-order priority until consistent budget surplus is established. "The government's first priority is to build up the buffers in its balance sheet rather than to retire debt," he confirms.

The strategy of balance sheet improvement is helped by the fact that New Zealand's net debt position, even given the ramp-up in issuance following the financial crisis and the earthquakes, remains impressive in global terms. Net outstanding New Zealand government debt as a proportion of GDP is set to peak at around 30 per cent of GDP.

"BECAUSE WE DON'T HAVE RETIRING DEBT AS A FIRST-ORDER PRIORITY WE ARE ABLE TO FOCUS, ALL THINGS BEING EQUAL, ON EXTENDING OUR MATURITY PROFILE TO REFLECT A MORE CONSTANT LEVEL OF DEBT OVER THE NEXT 10 YEARS."

BRENDON DOYLE NEW ZEALAND DEBT MANAGEMENT OFFICE

Issuance avenues

One benefit for the NZDMO – as well as declining NZGB yields – is the fact that a contained issuance programme should allow it to pursue optimal portfolio management strategies.

"Because we don't have retiring debt as a first-order priority we are able to focus, all things being equal, on extending our maturity profile to reflect a more constant level of debt over the next 10 years," Doyle reveals. "There are also good capital markets reasons to extend the yield curve, including forecast infrastructure requirements over the next 10-20 years. Unless our capital markets can support the financing of these projects it may be very difficult for them to be delivered."

Two key measures instituted as means towards this aim are the NZDMO's decision to reduce its stock of outstanding, short-term Treasury bills (T-bills) and to return to the inflation-linked bond market. The NZDMO placed its first linker for over a decade in October 2012, selling NZ$2.5 billion of bonds over a NZ$4 billion-plus book. Meanwhile, by October 2012 T-bill stocks had been reduced to NZ$7 billion from NZ$10 billion at the start of the current fiscal year.

Doyle highlights two main reasons why the return to inflation-linked issuance made sense for the NZDMO. "The first is that about half the NZ$250 billion balance sheet is made up of social assets – housing stock, schools, roads, hospitals and the like – which are long-dated in nature and also tend to be real assets. From a fiscal perspective, a lesson learned from the financial crisis is that it is valuable to have debt that is pro-cyclical to economic conditions, and from our perspective it is good to be able to issue something that is linked to economic growth."

Over time, Doyle says the NZDMO aims to have 10-20 per cent of its outstanding stock – which would amount to roughly NZ$7-15 billion at the current portfolio volume – in linker format. If the cost of this type of issuance is close to the nominal curve, he adds, the expectation would be of a figure closer to the top of the expected range.

New Zealand's other high-grade public sector issuer, the Local Government Funding Agency (LGFA), is focusing on improving the cost of funding for its local council owner-members, having debuted as a bond issuer in the first quarter of 2012. Aggregating local government borrowing under a unitary agency with ratings equivalenct to the New Zealand sovereign has already seen significant strides made on this front, according to Philip Combes, the LGFA's Wellington-based chief executive.

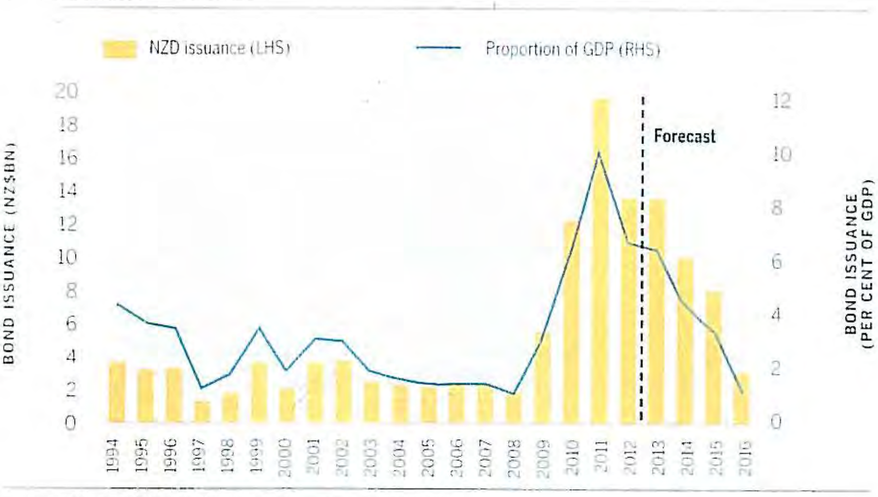
"Our claim is that we are saving double-A rated councils in New Zealand about 30 basis points within our first seven or eight months of operation," Combes says. "For unrated councils the savings are even greater – even though we charge them what is effectively a margin for credit, they still achieve an effective saving of 40 basis points over their own-name borrowing."

So far the LGFA has attracted around 66 per cent of New Zealand's local government sector to come under its banner, including almost all the major population centres. This figure will soon rise to 80 per cent when a clutch of new memberships is finalised.

As the LGFA becomes a more frequent issuer with a larger outstanding curve – and as more councils borrow through it – Combes anticipates economies of scale that could cut the margin the agency charges councils as a cost of issuance to as little as 10 basis points, from the current 30 basis points.

Combes says the LGFA hopes to be a flexible borrower in time, though as a new market entrant its eyes are at present fixed on the near horizon. "We are open to foreign currency issuance, though our focus is on building up New Zealand dollar lines to develop liquidity and market depth," he comments. "At the moment it is cheaper for us to issue in New Zealand dollars. But should this change we would certainly look at other options."

NZDMO BOND ISSUANCE



SOURCE: NEW ZEALAND DEBT MANAGEMENT OFFICE OCTOBER 2012

"WE ARE OPEN TO FOREIGN CURRENCY ISSUANCE, THOUGH OUR FOCUS IS ON BUILDING UP NEW ZEALAND DOLLAR LINES TO DEVELOP LIQUIDITY AND MARKET DEPTH."

PHILIP COMBES LOCAL GOVERNMENT FUNDING AGENCY

Earthquake impact

The biggest impetus in the New Zealand economy continues to be the post-earthquake rebuild. Estimates suggest the natural disasters of 2010-11 will entail a NZ$25 billion total cost – half of which will likely be met by the public purse. After a period of delays to the rebuild caused by natural phenomena, Doyle says the process has started to swing into stimulus.

"It is hard to over-state the impact of the Christchurch earthquakes, both on a personal level and on a fiscal and economic one," Doyle points out. "The Christchurch rebuild will provide a substantial impetus to the New Zealand economy, estimated over the next five years to be a 1-1.25 per cent contribution to GDP annually."

Combes also points out that the scale of the earthquakes' economic consequences has also played a role in masking, at least in part, New Zealand's economic resilience in the face of global woes. "New Zealand's fiscal strength is even more remarkable than the headline figures suggest, because the Canterbury earthquakes have cost the country around 10-15 per cent of GDP," he suggests. "Without this impact, New Zealand's fiscal position would be very close to that of Australia." •

KANGANEWS AWARDS 2012

NEW ZEALAND DOMESTIC ISSUER OF THE YEAR

Local Government Funding Agency

In terms of issuance volume and market impact, the Local Government Funding Agency (LGFA) has been the biggest development in the New Zealand bond market since the high-grade Kauri market debuted in 2007. From a standing start in mid-February 2012, the LGFA had issued nearly NZ$1.5 billion (US$1.2 billion) into three new bond lines by mid-December. In addition, on November 30 2012 the agency finalised the memberships of 12 new New Zealand local authorities, taking its shareholder base to 30 individual councils representing around 80 per cent of aggregate debt in the sector.

The LGFA has also been largely successful in winning over local investors, some of whom had feared before the new agency's introduction that a unitary funding authority would suck yet more supply out of the domestic institutional market. In fact, during 2012 the biggest fund managers in New Zealand told *KangaNews* they now welcome the LGFA's relatively liquid curve.

The LGFA has experienced early improvements in the pricing of that curve. For instance, the agency has seen the weighted average yield on its December 2017 maturity tenders fall by more than a full percentage point since it introduced the bond in February, to 3.6 per cent by the November tender.

And Philip Combes, chief executive at the LGFA in Wellington, says the agency is already delivering on its goal of providing cheaper debt financing to member councils. By late October, Combes says the LGFA was offering double-A rated councils a 30 basis point saving on their own-name debt issuance and a 40 basis point saving for unrated authorities – despite a higher on-lending cost to these borrowers from the LGFA itself.

In 2013 the LGFA is developing an internal and external drive to continue its cost savings for members. "Plans for the year include starting the process of international marketing in earnest, including investor meetings in both Europe and Asia, as one of the first steps towards building an offshore presence to further reduce our issuance margins," Combes tells *KangaNews*.

Working towards the LGFA's target of bringing down the issuance margin it charges to members – to as little as 10 basis points from 30 in 2012 – is another area of focus. Combes adds: "On the home front, because of the relatively quick scaling up of the LGFA operation, we believe there is scope to reduce our administration margin and therefore to reduce the cost we pass on to member councils." •

KANGANEWS AWARDS 2012

KAURI BOND HOUSE OF THE YEAR

ANZ

The Kauri market enjoyed a significant rebound in 2012 after a run of relatively lean years. By December 31 total issuance for the year stood at NZ$2.3 billion (US$1.9 billion), giving 2012 the third-highest annual aggregate ever, nearly NZ$600 million more than the 2011 total and the highest since 2008.

As a lead manager ANZ was credited with just under NZ$1 billion of total issuance for a market share of over 40 per cent, or more than double its nearest competitor.

Issuance volume was undoubtedly supported by a substantial maturity flow in 2012: nearly NZ$2.4 billion of Kauri paper rolled off during the year, compared with NZ$1.2 billion in 2011 and NZ$1.3 billion due in 2013. Glen Sorensen, director, syndicate at ANZ in Wellington, says: "It was a certainly big year for Kauri maturities. Redemptions are significantly less in 2013 but they will be large again in 2014, so this factor will have its peaks and troughs. The level of maturities in any given year undoubtedly influences issuance volumes and it did so positively in 2012."

He adds: "However, I think other factors are more important when considering sustainable growth. Key among these is the relative attractiveness of New Zealand dollar yields. I see the fact that New Zealand dollar swap rates have been closing the gap to Australian yields since early 2011 as a significant positive for the support of future Kauri issuance. More generally, the relative safety of New Zealand as an investment destination in the global landscape is also key."

Sorensen tells *KangaNews* the percentage of international versus domestic participation in Kauri transactions has grown in recent years, and within the international Kauri investor base ANZ has seen participants diversify in name and geography.

One feature of the Kauri market that has not deviated in recent times has been its focus on supranational, sovereign and agency (SSA) borrowers. Since 2007 virtually all the Kauri flow has come from SSAs, and while Sorensen says he is hopeful about non-SSA prospects there are hurdles to overcome.

"The Kauri market works by bringing together offshore and domestic investors," Sorensen comments. "Generally speaking the domestic investor base has mandates and appetites that are relatively conservative and are largely NZ credit-centric. The SSA issuers appeal due to their high credit quality, diversification from domestic bank paper, pick-up over NZ government bonds and the benefit of repo eligibility." •

KANGANEWS AWARDS 2012

NEW ZEALAND
TREASURER OF THE YEAR

Mark Butcher
AUCKLAND COUNCIL

Mark Butcher, treasurer at Auckland Council, has now won KangaNews's New Zealand Treasurer of the Year award in two consecutive years. Market participants applaud Butcher's engagement with the market, as well as his close involvement with New Zealand's newest major borrower, the Local Government Funding Agency (LGFA). Butcher speaks to *KangaNews* about being involved with two of New Zealand's most prominent debt issuers.

Auckland Council has a lot of actual or potential investor stakeholders to take care of. How do you manage the occasionally competing demands of local institutional and retail, as well as international, investors?

Both the council and I as treasurer are very fortunate to have a great team of treasury staff. Since formation in late 2010 they have spent considerable time and effort establishing various funding programmes, focusing really hard on investor relations and looking for continuous improvement with the help of our banking partners.

From the outset we had a strategy to treat all investors equally in terms of communicating the Auckland Council story and providing updates as to our funding intentions and expected pricing levels. We do not differentiate between our domestic retail and institutional investors, as the banks and institutional investors are also keen supporters of our exchange-listed issues. This was one of the reasons behind launching a retail bond programme and our desire to do as much future domestic issuance as possible under this structure.

The past year saw the arrival of the LGFA. How has its presence affected your role and the way Auckland Council manages its debt programme?

The LGFA has added another funding source that we use on a regular basis and which provides the cheapest cost of funds to us. The emergence of the LGFA has helped our efforts to tighten our credit margin in the face of an increased overall borrowing requirement. A year ago we only had a domestic wholesale programme, but now the LGFA, offshore and domestic retail channels are available as well.

We were fully supportive of the need for the LGFA right from the start. Like all other participants we want to continue championing the cause. It has been pleasing to see the cooperative spirit and large take up from nearly all the sector.

Auckland Council's plans to return to the retail bond market were put on hold by an event risk situation in 2012. How did you manage the investor relations task around that issue, and what are the plans for retail issuance in 2013?

It was unfortunate and frustrating midway through what was to be a successful issue to have to withdraw the offer, but these things happen. Our investors and lead managers were very supportive, as we acted in the best interests of investors by pulling the offer and communicating the reasons for doing so. We also used it as an opportunity to provide an update and educate investors about the wider "Weathertightness" liability issue given that almost all intending investors in the new issue had existing holdings of Auckland Council debt.

The retail deal has subsequently been issued. Our preference is to undertake as much domestic issuance as possible in 2013 under the retail bond programme so as to increase our investor base and improve liquidity.

What conclusions have you drawn about the potential responsiveness of foreign currency markets to the Auckland Council name? Is Australia your most likely offshore market?

We spent time and effort with various offshore markets in 2012 explaining the Auckland Council story. This is because we are a new issuer in the offshore markets, we have an interesting story that needs to be communicated, and we have a funding requirement for each of the next six years that cannot be sourced solely from the domestic market.

Our strategy over the past year has been to issue under our EMTN programme – balancing the need for diversification, tenor and opening up new markets while being careful not to pay a substantial premium for this.

It is logical to look to the Australian domestic market in the coming years, subject to our tenor and pricing targets being achieved. It has been pleasing to watch from the sidelines the very large positive step forward by the Australian domestic market in 2012 and we would like to be part of the future development of that market.

Will you be able to continue offering a domestic wholesale bond curve to institutional investors in the coming years?

Yes, although hopefully we will be issuing our domestic debt under our retail bond programme structure. Our approximately 15,000 domestic retail and institutional investors have been very supportive of us as an issuer historically and we intend to continue growing that support where possible. •