Quarterly Report

Quarter 3: 2016 - 2017
Period ended: 31 March 2017

NEW ZEALAND
LOCAL GOVERNMENT
FUNDING AGENCY

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A. Quarter issuance and highlights summary

Quarter	Total	Bespoke	2017	2019	2020	2021	2023	2025	2027
Bonds issued $m	**160**	N/A	-	-	20	-	-	100	40
Loans to councils $m	**280**	153	-	7	2	-	5	83	30
Loans to councils – No.	**23**	12	-	2	2	-	1	4	2

Year to date	Total	Bespoke	2017	2019	2020	2021	2023	2025	2027
Bonds issued $m	**755**	N/A	-	20	90	30	45	425	145
Loans to councils $m	**834**	333	3	9	5	15	58	333	68
Loans to councils – No.	**58**	26	1	3	3	2	3	16	4

In addition to the above issuance, LGFA has issued $300 million of treasury stock to itself, comprising $50 million of each LGFA bond maturity (except the 2017s). The treasury stock holdings are used to facilitate stock lending to banks to assist with improving secondary market liquidity in LGFA bonds.

Key points and highlights for the March quarter:

- Bond yields reversed the previous quarters rise by declining over the quarter while the yield curve continued to steepen. The 2019 bond yield fell 33 bps (0.33%) while the 2027 bond yield fell 18 bps (0.18%). While bond yields reversed some of the previous quarters significant rise, the front end recovered more than the back end of the yield curve.
- LGFA issued $160 million of bonds during the quarter in only one tender held in February. The average term of issuance of 8.04 years was slightly longer than the 7.38 years for the previous quarter, reflecting the greater proportion of 2025s and 2027s being issued. Outstandings across the seven LGFA maturities now total $7.275 billion (including $300 million of treasury stock).
- LGFA margins to NZGB and swap continued the previous quarters improvement with spreads to NZGB narrowing up to 23 bps and spreads to swap narrowing by 15 bps over the quarter.
- On-lending to council borrowers was $280 million including $153 million of bespoke issuance (55% of total lending) during the quarter. Much of this borrowing activity related to council refinancing of the December 2017 loans. The average term of on-lending to councils during the quarter was 7.45 years which was slightly longer than the prior December quarter (7.21 years) but shorter than the average term of 8.08 years for the 2015-16 year.
- The short-term council borrowing product launched in November 2015 remains well supported by councils with loans outstanding of $255 million as at 31 March 2017. This was an increase of $14 million over the quarter.
- LGFA Net Operating Gain (unaudited) for the nine months to March 2017 was $8.654 million or $0.825 million above budget.
  - Net Interest Income of $13.092 million was $0.762 million above budget due to council refinancing of their December 2017 loans through additional borrowing from LGFA rather than the repayment of their existing loans. This provides a short term boost to net interest income due to higher lending than forecast.
  - Expenses of $4.438 million were $63k below budget due to a lower than forecast usage of the DMO facility offset by higher NZX fees than forecast.

B. LGFA bond tenders during quarter

Tender 44: 15 February 2017 $160 million

Tender 44 Tender date: 15 February 2017	**Apr-20**	**Apr-25**	**Apr-27**
Total amount offered $m	20	100	40
Total amount allocated $m	20	100	40
Total number bids received	18	55	22
Total amount of bids received $m	165	390	146
Total number of successful bids	1	9	4
Highest accepted yield %	2.980	4.000	4.195
Lowest yield accepted %	2.980	3.980	4.190
Highest yield rejected %	3.085	4.095	4.265
Lowest yield rejected %	2.985	4.000	4.195
Weighted average accepted yield %	2.980	3.995	4.190
Weighted average rejected yield %	3.01	4.028	4.209
Coverage ratio	8.25	3.90	3.65
NZGB spread at issue bps	**52.5**	**79.5**	**89.5**
Swap spread at issue bps	**32.0**	**59.9**	**64.3**
Swap spread: AA council bps	**42.5**	**67.3**	**77.5**
Swap spread: AA- council bps	**47.5**	**72.3**	**82.5**
Swap spread: A+ council bps	**52.5**	**77.3**	**87.5**
Swap spread: unrated council bps	**57.5**	**82.3**	**92.5**

Weighted average yields were 2 bps lower on the 2020s and the 2025s and 3 bps lower on the 2027s compared to the previous December 2016 tender.

Demand was very strong for all three maturities. There were 1 successful bid for the 2020s, 9 successful bids for the 2025s (understandable given the larger volume offered) and 4 successful bids for the 2027s. There were 95 bids in total compared to 70 bids in the previous tender.

Margins over NZGBs were 9.5 bps tighter on the 2020s, 6.5 bps tighter on the 2025s and 4.5 bps tighter on the 2027s compared to the previous tender.

Margins over swap (after DMO charges) were 9.5 bps tighter on the 2020s, 9 bps tighter on the 2025s and 10.75 bps tighter on the 2027s compared to the previous tender. Issuance spreads were 3 bps tighter than the prevailing secondary market levels at the time of the tender.

The average maturity of the LGFA bonds issued in the tender was 96.5 months (i.e. 8.04 years) and was a similar result to the December tender.

Coverage ratio of 4.4 times was the equal best coverage ratio since November 2013.

While we issued $160 million of LGFA bonds we on-lent $175 million to ten councils. $49 million of the lending was on a bespoke basis.

Total LGFA outstandings across the seven maturities (including Treasury Stock) following the tender was $7.275 billion.

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C. Key performance indicators

Measure		Prior full year to June 2016	Q1 30 Sep 16	Q2 31 Dec 16	Q3 31 Mar 17	Q4 30 Jun 17
Average cost of funds relative to NZ Government Stock and NZ Treasury Bills for issuance in the 12-month period to 30 June 2017	Target %		0.50%	0.50%	0.50%	0.50%
	Actual %	0.74%	0.646% (0.874% for bonds and 0.32% for bills)	0.743% (0.83% for bonds and 0.30% for bills)	0.553% (0.81% for bonds and 0.30% for bills)	-
Average base margin over cost of funds for short term and long term lending	Target %		0.10%	0.10%	0.10%	0.10%
	Average actual %	0.106%	0.10% (0.109% for long term and 0.082% for short term lending)	0.10% (0.1075% for long term and 0.082% for short term lending)	0.102% (0.109% for long term and 0.081% for short term lending)	-
Estimated interest cost savings %	Target %		Improvement on prior year	Improvement on prior year	Improvement on prior year	Improvement on prior year
	2019 actual %	17 bps	15 bps	15 bps	19 bps	-
	2021 actual %	27 bps	22 bps	21 bps	27 bps	-
	2025 actual %	33 bps	24 bps	20 bps	25bps	-
Issuance and operating expenses (excluding AIL) YTD	Target ($ m)		$1.10 m	$2.40 m	$3.60 m	$4.80 m
	Actual ($ m)	$5.98 m	$1.11 m	$2.33 m	$3.39 m	-
Lending (short and long term) to participating councils YTD	Target ($ b)		$6.516 b	$6.791 b	$7.066 b	$7.341 b
	Actual ($ b)	$6.241 b	$6.605 b	$7.016 b	$7.291b	-

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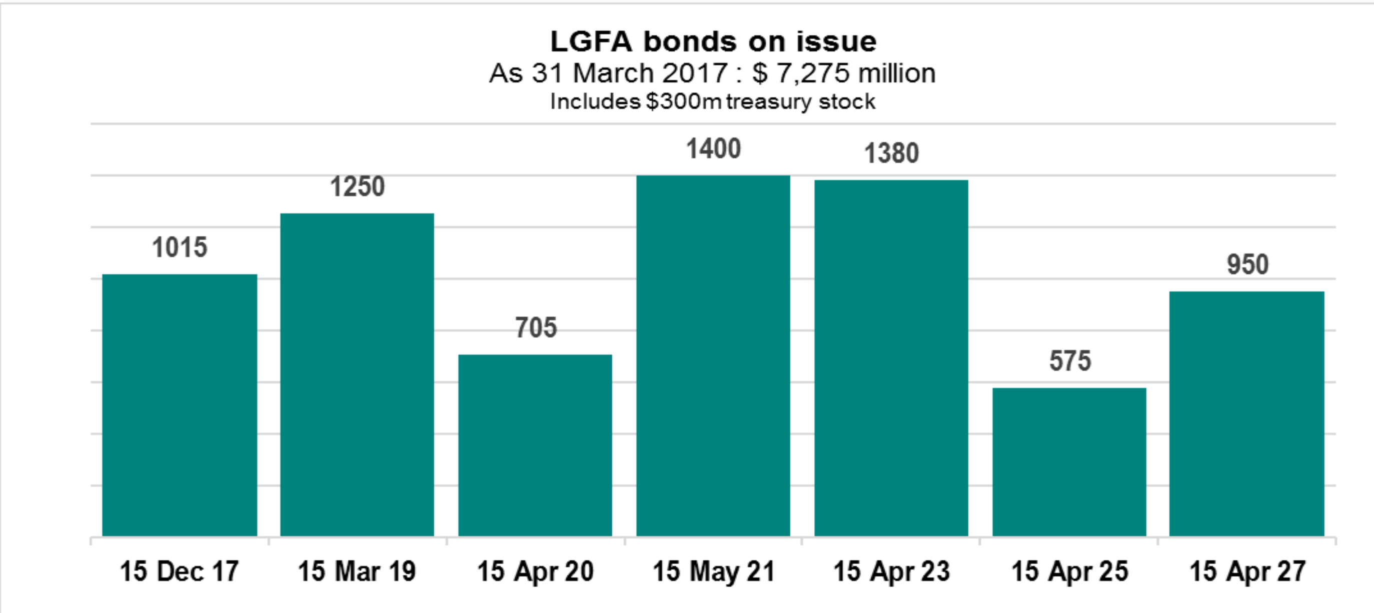
D. Summary financial information (provisional and unaudited)

Financial Year ($m)	YTD as at Q1	YTD as at Q2	YTD as at Q3	YTD as at Q4
Comprehensive income	**30-Sep-16**	**31-Dec-16**	**31-Mar-17**	**30-Jun-17**
Interest income	76.54	155.71	236.43	-
Interest expense	72.35	147.20	223.34	-
Net interest revenue	**4.19**	**8.51**	**13.09**	-
Issuance and On-lending costs	0.45	0.90	1.33	-
Approved issuer levy	0.18	0.87	1.05	-
Operating expenses	0.66	1.43	2.06	-
Issuance and operating expenses	**1.29**	**3.20**	**4.44**	-
Net Profit	**2.89**	**5.31**	**8.65**	-

Financial position ($m)	30-Sep-16	31-Dec-16	31-Mar-17	30-Jun-17
Retained earnings + comprehensive income	19.22	23.143	26.486	-
Total assets (nominal)	6,835.90	7,228.55	7,528.69	-
Total LG loans (nominal)	6,605.23	7,014.90	7,293.97	-
Total LGFA bills (nominal)	225.00	225.00	350.00	-
Total LGFA bonds (nominal)	6,435.00	7,115.00	7,275.00	-
Total borrower notes (nominal)	102.80	108.40	112.76	-
Total equity	47.12	48.14	51.49	-



E. Quarterly compliance summary

Policy	Limit	Policy page ref	Continuous Compliance
One-month Liquidity Monitor	>120%	S1-1.1	Yes
Three Month Liquidity Monitor	>110%	S1-1.2	Yes
Twelve Month Liquidity Monitor	>110%	S1-1.3	Yes
Council Exposure (any 12-month period)	<10% of Balance Sheet	S1-1.5	Yes
Liquidity Buffer	>110%	S1-1.4	Yes
Partial Differential Hedge (PDH Interest Rate Gap Report	$40,000	S3-4.1	Yes
Value at Risk (VaR)	$250,000	S3-4.2	Yes
Council Maturity (any 12-month period)	$100m or 33% of LGFA borrowing	S1-1.6	Yes
Funding Largest Council Exposure	>100%	S1-1.7	Yes
Foreign Exchange Exposure	Nil	S7-3.1	Yes
NZDMO Facility Utilisation	Report monthly	S8-8.5	Yes
Counterparty Credit Limits	80% of Portfolio $75m Counterparty (category 3)	S4	Yes
Auckland Council Exposure (proportion of total Council exposure)	<40%	S1-1.8	Yes
Balance Sheet Maturity Mismatch	<15% of Balance Sheet	S2-2.1	Yes
Financial Covenants	Various (as set out on p13)	S9	Yes
Authorising Treasury transactions	Two approvers, one signature	S8-8.4	Yes

Details for compliance breaches over quarter.

There were no breaches over the quarter.

F. Performance against SOI objectives and performance targets

Primary objectives

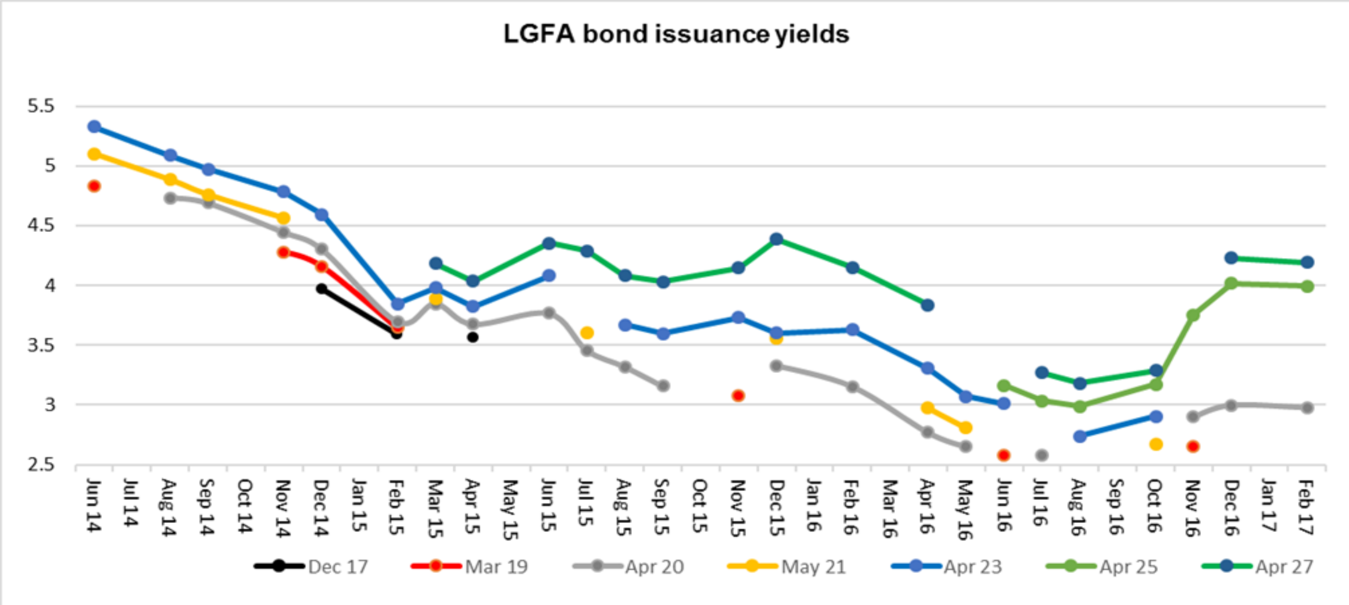
1. Providing savings in annual interest costs for all Participating Local Authorities

Our base on-lending margins have been held at a constant level since August 2015 of 9 bps (2017s and 2019s), 10 bps (2020s and 2021s) and 11 bps (2023s and 2027s). Our average base lending margin offered to council borrowers across all LGFA maturities is now 10 bps. The base margin charge covers our operating costs and provides for capital to grow in line with the balance sheet to maintain a capital buffer.

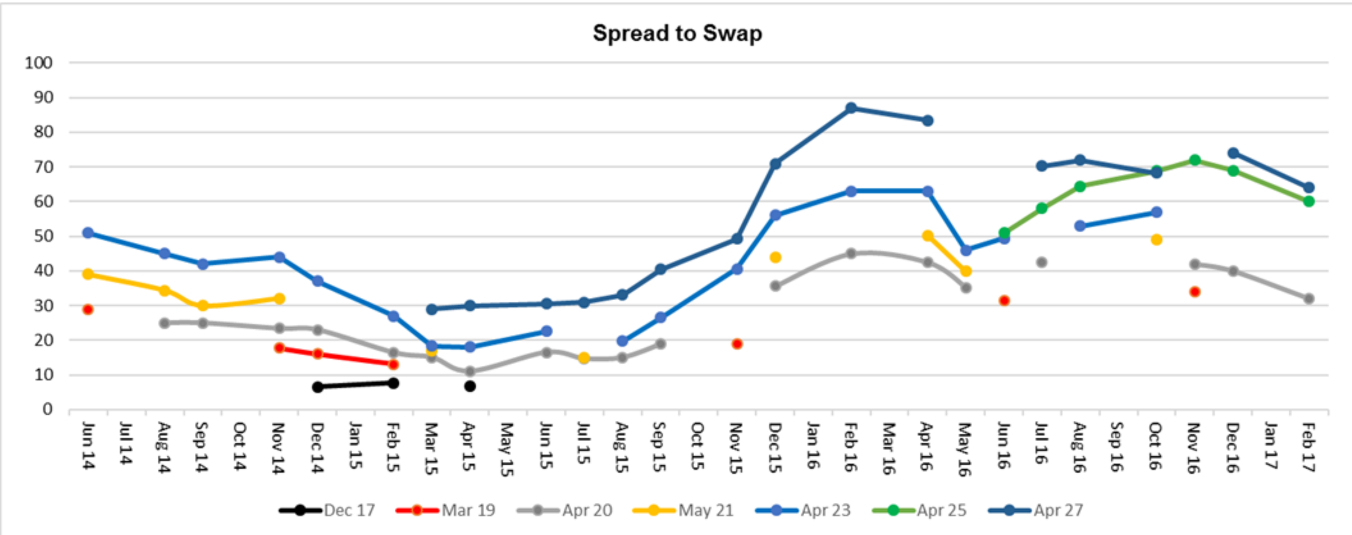
Our estimated annual savings to councils based upon the secondary market levels at 31 March 2017 of LGFA bonds compared to bonds issued by Auckland and Dunedin councils is between 19 bps and 27 bps depending upon the term of borrowing. There has been a small favourable change to these estimated savings over the past quarter.

31-Mar-17	Savings to AA rated councils (bps)				
	Auckland 2019	Dunedin 2020	Dunedin 2021	Auckland 2022	Auckland 2025
AA rated councils margin to swap	37	47	57	60	78
Less LGFA margin to swap	-19	-25	-30	-34	-52
LGFA Gross Funding Advantage	18	22	27	26	26
Less LGFA Base Margin	-9	-10	-10	-10.5	-11
LGFA Net Funding Advantage	9	12	17	15.5	15
Add 'LGFA Effect'	10	10	10	10	10
Total Saving	19	22	27	25.5	25

LGFA remains close to delivering on the 30 bps savings target for councils as outlined in the original business case for LGFA and continues to provide councils with access to long dated tenors (out to ten years). The popularity of the short term borrowing product also suggests councils are receiving reduced borrowing costs for short dated tenors.



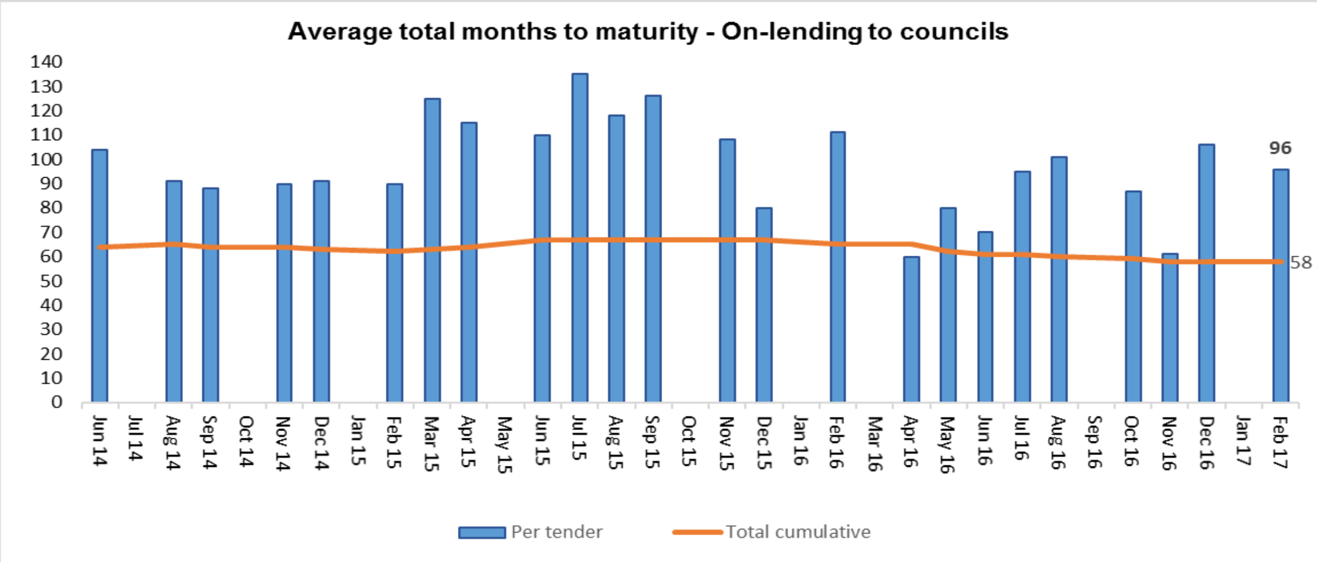
We only held one tender during the quarter with total issuance of $160 million. Credit market conditions were strong over the quarter with little issuance by high grade borrowers and good demand for credit from investors. Secondary market spreads to swap for LGFA bonds narrowed by between 4 bps (2017s) and 15 bps (2021s) over the quarter with the average across all LGFA bonds improving 13 bps to an eighteen-month low of 34 bps.



2. Making longer-term borrowings available to Participating Local Authorities

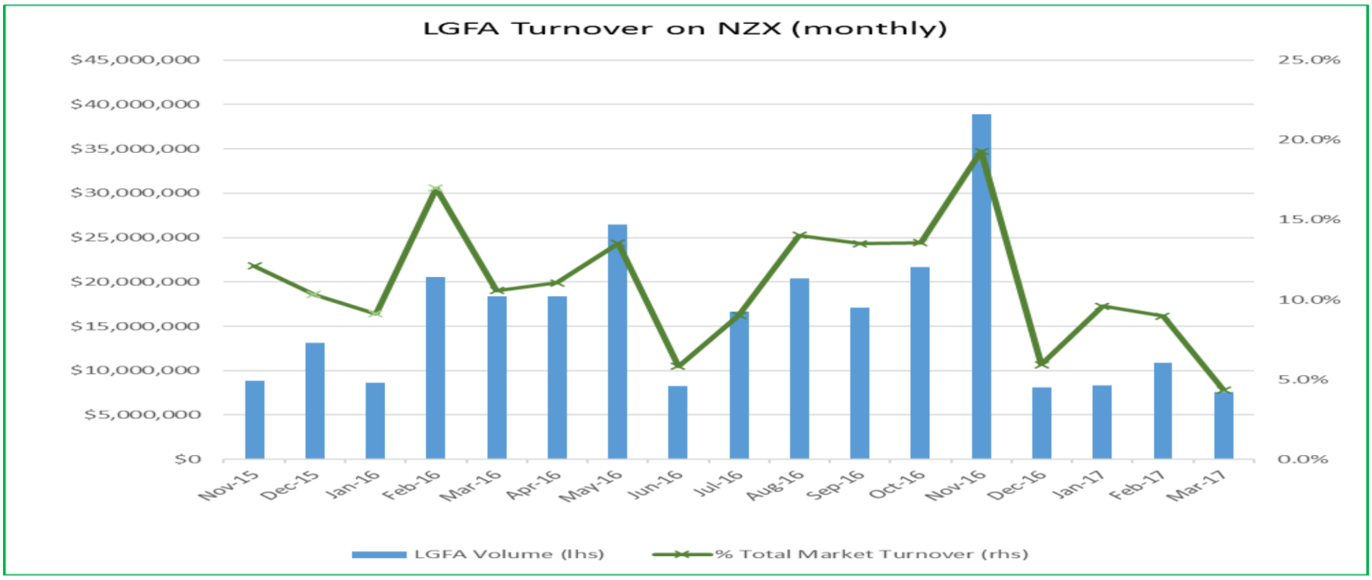
The average borrowing term (excluding short dated borrowing) for the March 2017 quarter by council members was 7.45 years and this was slightly longer than the previous quarter of 7.2 years but shorter than the 8.08 years for the 2015-16 year. The average issuance term of LGFA bonds during the quarter was 8.04 years compared to 7.5 years for the prior quarter and 8.10 years for the 2015-16 year.

LGFA last issued a new 2025 bond in June 2016 and will issue a 2033 maturity in the coming quarter.



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

The listing of LGFA bonds on the NZX Debt Market in November 2015 has led to greater investor awareness of LGFA bonds. Average turnover on the NZX Debt market since listing has been $16 million per month or 11% of the total turnover of the NZX Debt Market. Turnover has reduced in recent months as retail investors are more attracted to high term deposit rates.



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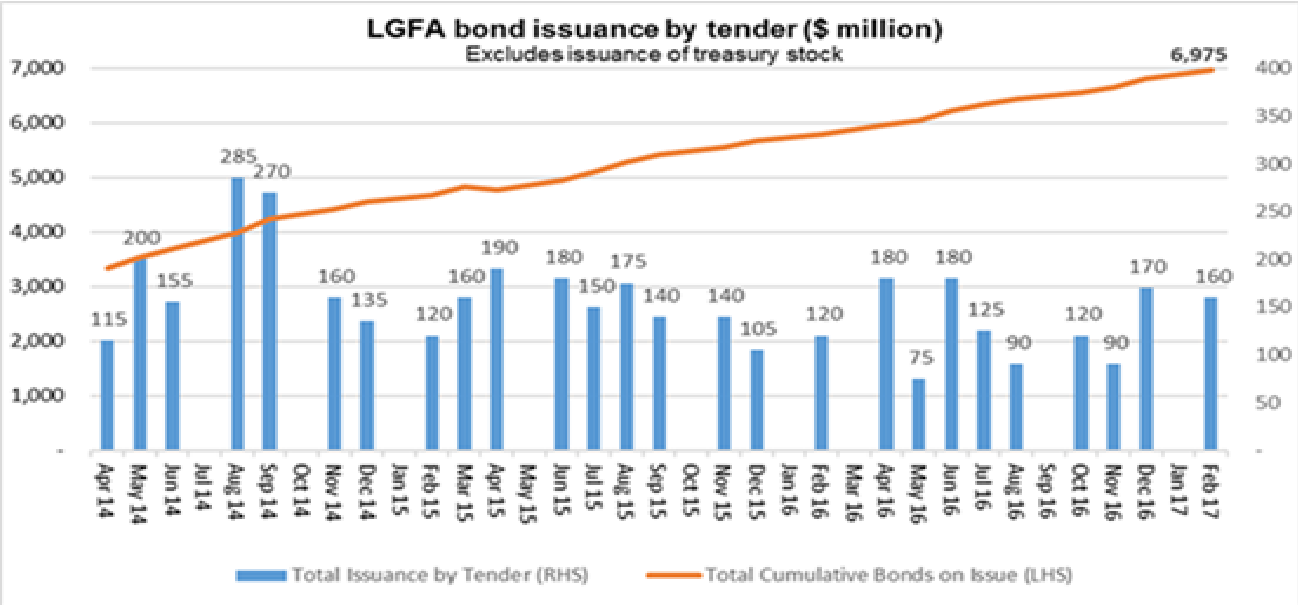
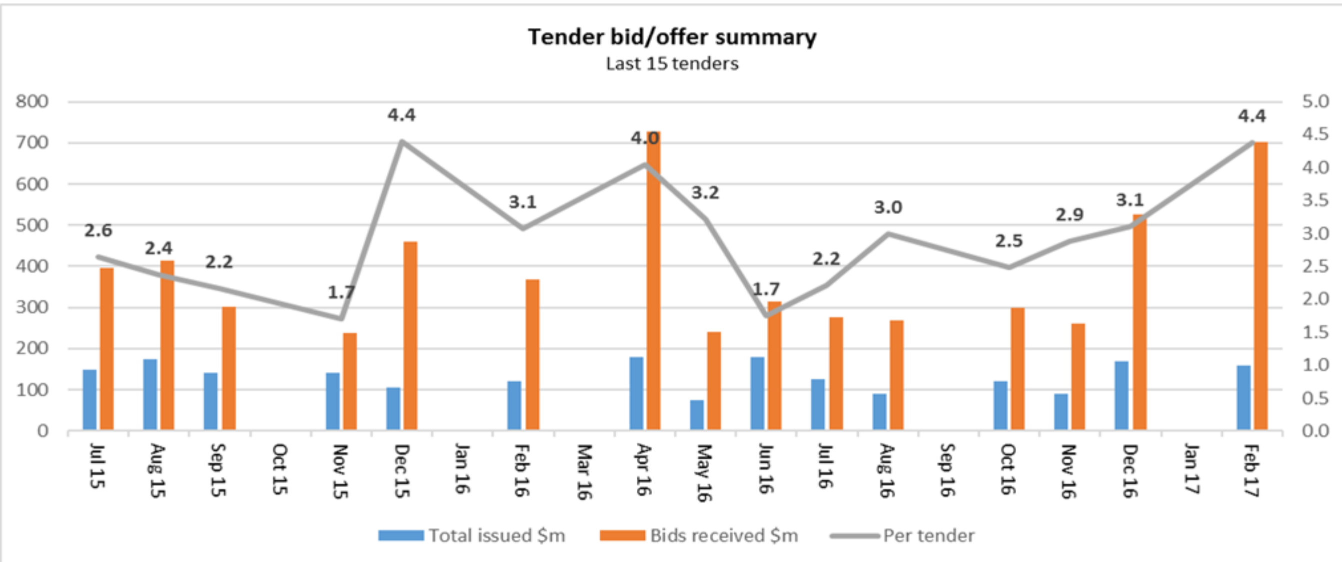
LGFA began issuing 3-month and 6-month LGFA Bills and commenced short dated (less than 1 year) lending to councils in late 2015. LGFA has short term loans to seventeen councils of $255 million outstanding as at 31 March 2017. We continue to receive enquiry from councils as to this product and would expect the number of participating councils and volume to grow over the next six months.

LGFA bond tenders continued to be supported by the market with the February tender attracting a 3.2 times coverage ratio. This is in line with the long-term average over the forty-four tenders held to date. Price tension remains strong as we issue between 1 bps and 3 bps tighter than secondary market levels at the time of each tender. We continue to offer three or four LGFA maturities at each tender and try to maintain the volume offered within the $100 million to $150 million range to ensure ongoing price tension.





4. Offering more flexible lending terms to Participating Local Authorities

Bespoke lending continues to be a popular borrowing option for council members. Since we introduced the ability for councils to choose their preferred maturity and date of drawdown in February 2015 we have lent $829 million in bespoke transactions. During the March 2017 quarter, we lent $153 million on a bespoke basis to eight councils. This comprised 55% of total term lending by LGFA to its members.

Short term borrowing by councils has been well received with loan terms to date of between 3 months and 12 months on $258 million of loans.

Additional objectives

5. Operate with a view to making a profit sufficient to pay a dividend in accordance with its stated Dividend Policy

LGFA's Net Operating Gain on an unaudited basis was $8.654 million for the nine-month period compared to the management forecast of $7.829 million. The LGFA board declared a dividend for the 2015-16 year of 5.57% on 20 September 2016. Our 2016-17 year to date cost of funds is 3.51% which would imply a modestly lower projected dividend rate of 5.51% for the coming year.

6. Provide at least 50% of aggregate long-term debt funding for Participating Local Authorities

LGFA estimates market share from the PwC Local Government Quarterly Debt Report and the most recent report is for the December 2016 quarter. LGFA market share of total sector borrowing for the December 2016 quarter was 88.1% and for the year to December 2016 was 60.7%. Adjusting both estimates for Auckland Council borrowing in its own name (as Auckland Council is restricted in the amount that it can borrow through LGFA) then LGFA market share for the December quarter was 83.1% and for the year to December 2016 was 72.4%. Our market share remains strong compared to our global peers but will be influenced by the amount of borrowing undertaken by Auckland Council in its own name.

7. Ensure its products and services are delivered at a cost that does not exceed the forecast for issuance and operating expenses

Expenses on a year to date unaudited basis are $4.438 million which is $63k below budget. This variance is the consequence of:

- Issuance and on-lending costs (excluding AIL) at $1,328k were $23k below budget due to lower fees relating to the NZDMO facility and credit rating agencies offset by higher NZX costs from the additional bond issuance associated with the introduction of the bond lending facility.

- Operating costs at $2.063 million were $33k below budget and reflected lower overheads and travel costs than forecast offset by higher personnel and systems costs.

8. Take appropriate steps to ensure compliance with the Health and Safety at Work Act 2015

LGFA has a Health and Safety staff committee and reporting on Health and Safety issues are made to the LGFA board on a regular basis by the Risk and Compliance Manager. There were no Health and Safety incidents during the quarter.

The Kaikoura earthquake in November impacted on Wellington CBD buildings. As result, staff are currently working from the Local Government New Zealand offices until it is safe to return to the LGFA offices.

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

LGFA met with both S&P and Fitch rating agencies in September 2016 as part of their annual review process. S&P subsequently affirmed the long-term rating of LGFA at AA+ (stable outlook) on 20 October 2016 and Fitch affirmed the AA+ (stable outlook) on 15 November 2016.

10. Achieve the financial forecasts

As at the end of third quarter, Net Interest Income was $762k above budget while expenses are $63k below budget. Net Operating Gain of $8.654 million was $825k above budget and is 13.1% above the Net Operating Gain for the comparable prior year period.

We expect to achieve the SOI financial forecasts on a full year basis. There are three bond tenders scheduled for the June 2017 quarter and councils are refinancing their December 2017 loans in line with expectations.

G. Investor relations / outlook

Managing relations with our investor base is very important as we have yet to reach peak debt. Our projections for funding for each of the next three years is approximately $1.1 billion p.a. so we require both existing investors to increase their holdings and to also find new investors. Our focus is on growing the offshore investor and domestic retail investor base as these groups have the most potential given that we already received strong support from the domestic banks and institutional investors.

Over the past twelve months we have met with nearly all our forty largest holders across Japan, Hong Kong, Middle East, North America, Australia, UK, Europe and New Zealand.

Offshore investors, banks and domestic investors all increased their holdings of LGFA bonds during the quarter by a similar amount

- Domestic banks reduced their holdings by $268 million over the March quarter and were estimated to hold $2.128 billion (30.5% of outstandings) compared to $1.894 billion (34.2% of outstandings) as at 31 March 2016. Secondary market trading books reduced their inventory during the quarter as both domestic and offshore investors purchased LGFA bonds in the secondary market.
- Domestic institutional and retail investors increased their holdings by $102 million over the March quarter and were estimated to hold $2.859 billion (41.0% of outstandings) compared to $2.300 billion (39.8% of outstandings) as at 31 March 2016. LGFA bonds are being purchased for inclusion in Kiwisaver funds by institutional investment managers.
- Offshore investors increased their holdings by $267.6 million over the March quarter and were estimated to hold $1.988 billion (28.5% of outstandings) compared to $1.591 billion (27.0% of outstandings) as at 31 March 2016. The 28.5% of outstandings is a record high.

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H. Key trends