Quarterly Report

Quarter 3: 2017 - 2018
Period ended: 31 March 2018

NEW ZEALAND LOCAL GOVERNMENT FUNDING AGENCY

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A. March quarter issuance and highlights summary

Quarter	Total	Bespoke Maturity	2017	2019	2020	2021	2023	2025	2027	2033
Bonds issued $m	**120**	N/A	-		45			45	30	
Term Loans to councils $m	**183**	126.5	-			-	18.5	25	13	
Term Loans to councils #.	**20**	13	-			-	4	2	1	

Year to date	Total	Bespoke Maturity	2017	2019	2020	2021	2023	2025	2027	2033
Bonds issued $m	**739**	N/A	-	40	225	70	79	189	66	70
Term Loans to councils $m	**701.4**	556.9	-	5	5	5	18.5	46	53	12
Term Loans to councils #	**77**	55	-	1	1	2	4	7	5	2

Key points and highlights for the March quarter:

- The bond curve was slightly steeper over the quarter with the 2033 bond yield rising 4 bps (0.04%) while the 2020 bond yield fell 5 bps (0.05%).
- LGFA issued only $120 million of bonds during the quarter in one tender. The March quarter is always the quietest quarter for issuance, averaging $184 million of issuance over the past six years. The average term of issuance of 5.79 years was much shorter than the average term for the 2016-17 year of 8.87 years but in line with the average term of 5.74 years for the current financial year. LGFA bonds outstanding as at 31 March 2018 were $7.579 billion (including $350 million of treasury stock).
- LGFA margins to swap were unchanged for the shorter LGFA bond maturities but widened in the back end of the curve on global credit market concerns e.g. the 2033 spread to swap widened by 14 bps (0.14%). LGFA Spreads to NZGB tightened by between 1 bps (2033s) and 6 bps (2021s).
- Long dated on-lending to council borrowers was $183 million including $126.5 million of bespoke maturity loans (69% of total lending) during the quarter. The average term of on-lending during the quarter was 7.45 years which lengthened from the average loan term of 5.62 years in the previous quarter.
- LGFA market share of 84.4% for the rolling 12-month period to March 2018 was unchanged from the 12-month period to December 2017.
- Short-term lending to councils remains well supported by councils with loans outstanding of $264.9 million as at 31 March 2018. This was a decline of $67 million over the quarter and the number of councils using this product declined by five to twenty. The decline was due to councils extending the term of their debt by borrowing on a longer dated basis and repaying the short-dated loans.
- LGFA Net Operating Gain (unaudited) for the nine-month period to March 2018 was $9.303 million or $0.594 million above budget.
- While there were no new council members during the quarter, we are expecting a number to be consulting in their Draft Long Term Plans on joining.

B. LGFA bond tenders during quarter

LGFA held only one bond tender over the quarter.

Tender 53: 14 February 2018 $120 million

Tender 50 Tender date: 4 Oct 2017	**Apr-20**	**Apr-25**	**Apr-27**
Total amount offered $m	45	45	30
Total amount allocated $m	45	45	30
Total number bids received	15	19	17
Total amount of bids received $m	185	172	110
Total number of successful bids	6	11	5
Highest accepted yield %	2.265	3.530	3.860
Lowest yield accepted %	2.250	3.480	3.845
Highest yield rejected %	2.305	3.720	4.065
Lowest yield rejected %	2.265	3.530	3.860
Weighted average accepted yield %	2.259	3.507	3.855
Weighted average rejected yield %	2.274	3.563	3.915
Coverage ratio	4.11	3.82	3.67
NZGB spread at issue bps	39	78	86
Swap spread at issue bps	7	49	62
Swap spread: AA council bps	17.5	57.75	80.0
Swap spread: AA- council bps	22.5	62.5	85.0
Swap spread: A+ council bps	27.5	67.5	90.0
Swap spread: unrated council bps	37.5	77.5	100.0

We tendered three tranches but with a shorter tenor than usual due to soft market conditions. Price support was mixed with successful yields for the 2020s (2 bps below mid-rate), good for the 2025s (at mid- rate) and average for the 2027s (3 bps above mid-rate).

Since the December 2017 tender, market expectations for the first RBNZ OCR rate hike has been pushed into 2019 and led to strong demand for short dated bonds by banks and investors. Long dated bond appetite was not as strong due to rising US interest rates, curves steepening and NZ yields being tight on a spread to US and Australia.

The spread to swap compared to the prior tender was 2 bps tighter on the 2020s and set a record low while the 2025s was 3.5 bps tighter. Spreads to NZGB were 1 bps to 2 bps wider than the prior tender and was due to the positive fiscal news implying reduced NZGB supply.

The average maturity of the LGFA bonds issued in tender of 5.79 years was in line with the current 2017-18 year average (5.74 years).

Coverage ratio of 3.89 times was very strong and followed the December 2017 tender coverage ratio of 3.94 times.

While we issued $120 million of LGFA bonds we on-lent $104.5 million to seven councils. The average term of lending was longer than normal at 8.4 years but we chose not to match fund the long-dated lending with long dated issuance due to the nervous state of the market and we had previously issued longer tenor bonds than on-lending.

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C. Key performance indicators

We have met only of the four KPIs as at the end of the March quarter. We have maintained issuance and operating expenses below budget but not met the other KPIs which are influenced by factors outside of our control e.g. amount of borrowing undertaken by councils and the term of borrowing.

Due to the reduction in short term lending over the quarter (and being replaced by increased longer dated lending) the average base margin widened by 0.005% to above 10 bps. We are struggling to improve our estimated interest cost savings due to secondary market spreads on our comparable group (Auckland and Dunedin councils) not widening in line with the LGFA spreads to swap. This is due to LGFA issuing bonds on a regular basis and a lack of issuance by the other councils. Our volume of council lending is currently below SOI forecast and this is due to the December 2017 loans rolling off, more subdued borrowing by councils relative to forecast and our largest borrower Auckland Council preferring to borrow in offshore markets.

Measure		**Prior full year to June 2017**	**Q1 30 Sept 2017**	**Q2 31 Dec 2017**	**Q3 31 Mar 2018**	**Q4**
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 %	0.104%	0.094% (0.1086% for long term and 0.08% for short term) ✓	0.097% (0.1071% for long term and 0.09% for short term) ✓	0.102% (0.1080% for long term and 0.09% for short term) ✗	
Estimated interest cost savings %	Target %		Improvement on prior year	Improvement on prior year	Improvement on prior year	Improvement on prior year
	2019 maturity At quarter end	12 bps	11 bps ✗	10 bps ✗	10 bps ✗	
	2021 maturity At quarter end	20 bps	13 bps ✗	18 bps ✗	14 bps ✗	
	2025 maturity As at quarter end	17 bps	5 bps ✗	14 bps ✗	11 bps ✗	

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Issuance and operating expenses (excluding AIL) YTD	Target ($ m)		$1.33 m	$2.73 m	$4.02 m	$5.45 m
	Actual ($ m) Year to date	$4.67 m	$1.20 m ✓	$2.55 m ✓	$3.76 m ✓	
Lending (short and long term) to participating councils	Target ($ b)		$7.834 b	$7.932 b	$8.03 b	$8.128 b
	Actual ($ b) Year to date	$7.736 b	$8.101 b ✓	$7,481.5 b ✗	$7,594.8 b ✗	

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-17**	**31-Dec-17**	**31-Mar-18**	**30-June-18**
Interest income	88.68	178.15	259.14	
Interest expense	83.95	168.53	244.82	
Net interest revenue	**4.73**	**9.62**	**14.32**	
Issuance and On-lending costs	0.49	1.09	1.63	
Approved issuer levy	0.19	1.02	1.26	
Operating expenses	0.71	1.47	2.13	
Issuance and operating expenses	**1.39**	**3.58**	**5.02**	
Net Profit	**3.34**	**6.04**	**9.30**	

Financial position ($m)	**30-Sep-17**	**31-Dec-17**	**31-Mar-18**	**30-Jun-18**
Retained earnings + comprehensive income	30.83	33.52	33.52	
Total assets (nominal)	8,338.71	7,721.93	7,979.38	
Total LG loans (nominal)	8,101.05	7,488.52	7,594.67	
Total LGFA bills (nominal)	350.00	370.00	545.00	
Total LGFA bonds (nominal)	7,760.00	7,109.00	7,229.00	
Total borrower notes (nominal)	124.45	114.43	117.28	
Total equity	55.83	58.52	63.18	

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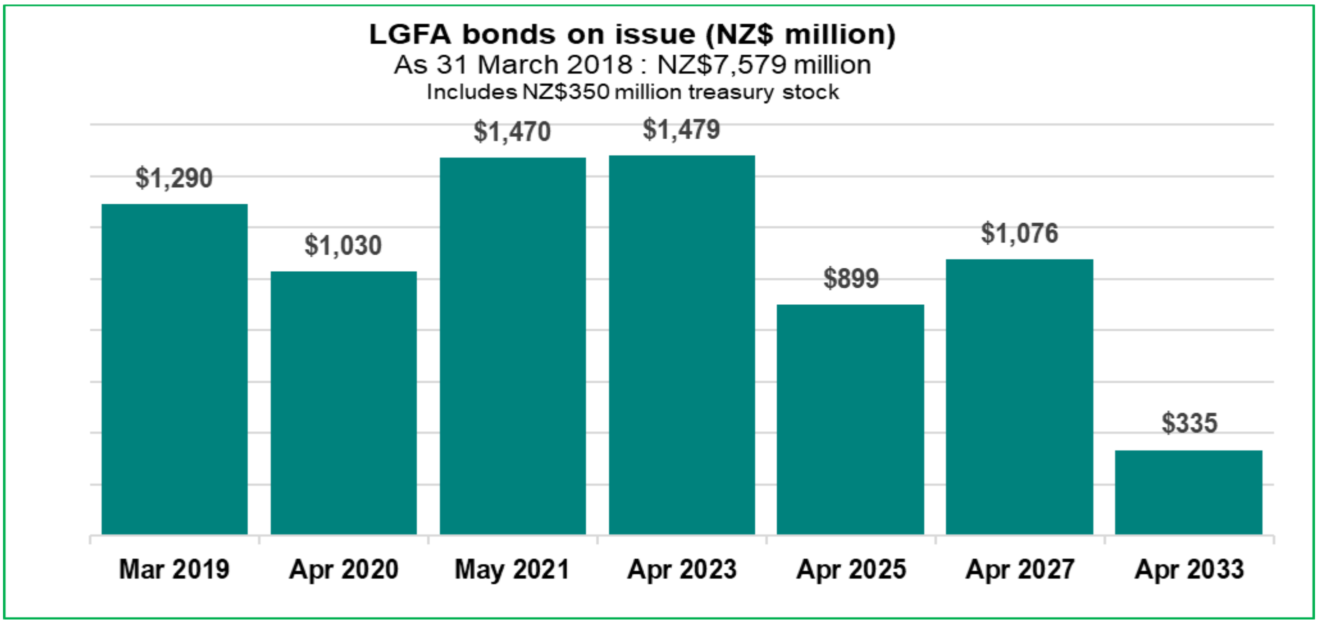

E. Quarterly compliance summary

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 $125m 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 on a relative basis to other sources of financing

The LGFA on-lending base margins are 9 bps (terms out to 2019s), 10 bps (2020s to 2022s) and 11 bps (2023s and longer). The actual average base lending margin paid by council borrowers will depend upon the term of council borrowing. The base margin charge covers our operating costs and provides for our capital to grow in line with the growth in our balance sheet to maintain a capital buffer.

Our estimated annual savings to councils based upon the secondary market levels at 31 March 2018 of LGFA bonds compared to bonds issued by Auckland and Dunedin councils is between 10 bps and 20 bps depending upon the term of borrowing. The amount of savings has reduced over the past quarter as LGFA borrowing spreads have widened slightly while Auckland and Dunedin borrowing margins have narrowed. The relative movement in secondary market margins is due to supply and demand e.g. Auckland Council has not issued in the domestic capital markets for over a year and Dunedin City Treasury last issued in October 2017 while LGFA has issued $1.27 billion of bonds in the past year.

March 2018	**Savings to AA rated councils (bps)**				
	Auckland 2019	Dunedin 2020	Dunedin 2021	Auckland 2022	Auckland 2025
AA rated councils margin to swap	26	38	42	48	73
Less LGFA margin to swap	-7	-8	-18	-25	-51
LGFA Gross Funding Advantage	19	30	24	23	22
Less LGFA Base Margin	-9	-10	-10	-10	-11
Total Saving	10	20	14	13	11

Note that from 30 June 2017 we have removed the implied "LGFA effect" of 10 bps of savings in borrowing costs from the analysis. The LGFA effect was the assessment of immediate savings to councils when LGFA first commenced lending to councils in February 2012.

We only held one tender during the March quarter with total issuance of $120 million. This was significantly lower volume than the prior quarter issuance ($364 million) and the average quarterly issuance of $347 million since LGFA commenced issuing in 2012. Credit market sentiment turned negative over the quarter with long dated spreads widening as yields rose and global concerns towards risk assets increased. High grade corporate bond supply was very strong with $3.8 billion of Kauri bonds issued in the quarter (compared to $2.6 billion for the entire 2017 calendar year) and the NZDMO issuing $2 billion of the new 2029 NZGB. Secondary market spreads to swap for LGFA bonds were unchanged for 2019 through 2021 maturities but 14 bps wider for the 2033 bond maturity.

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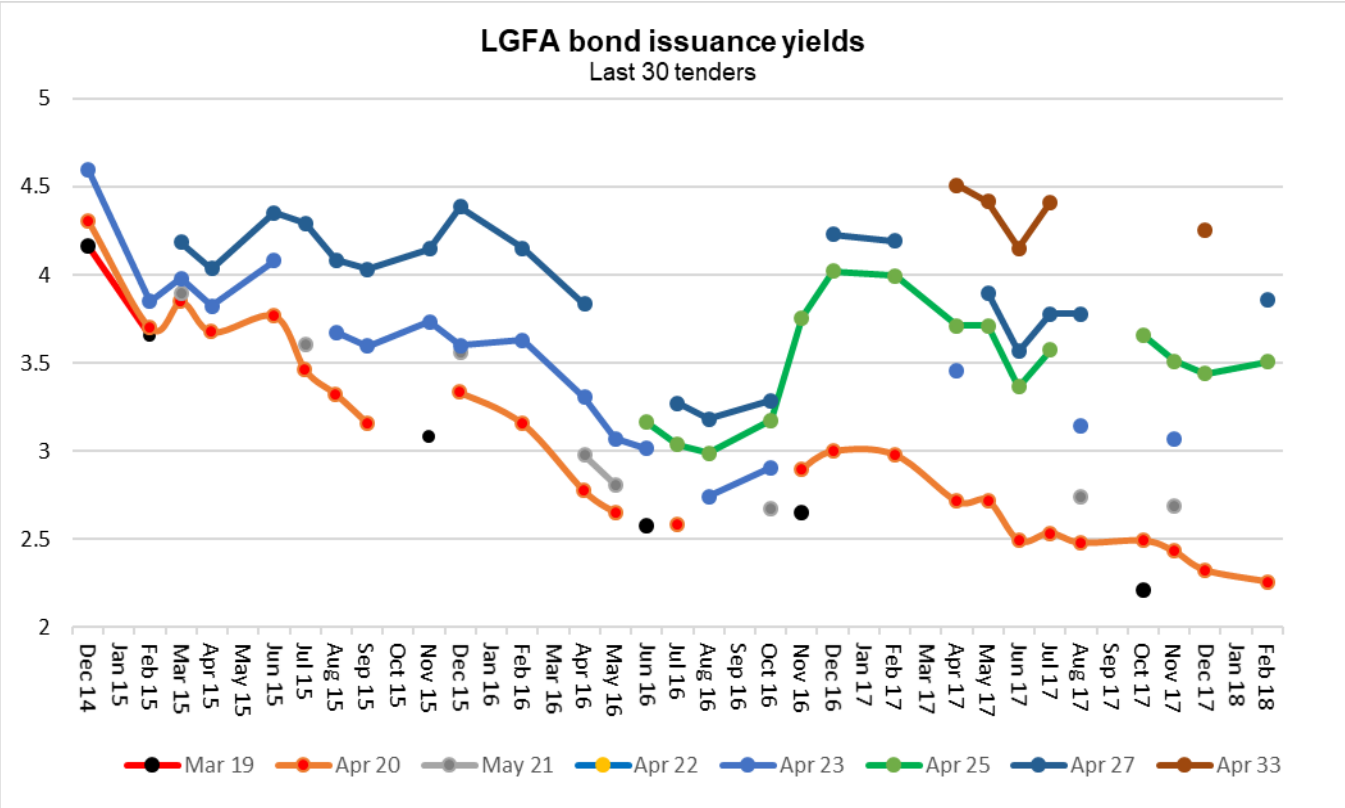
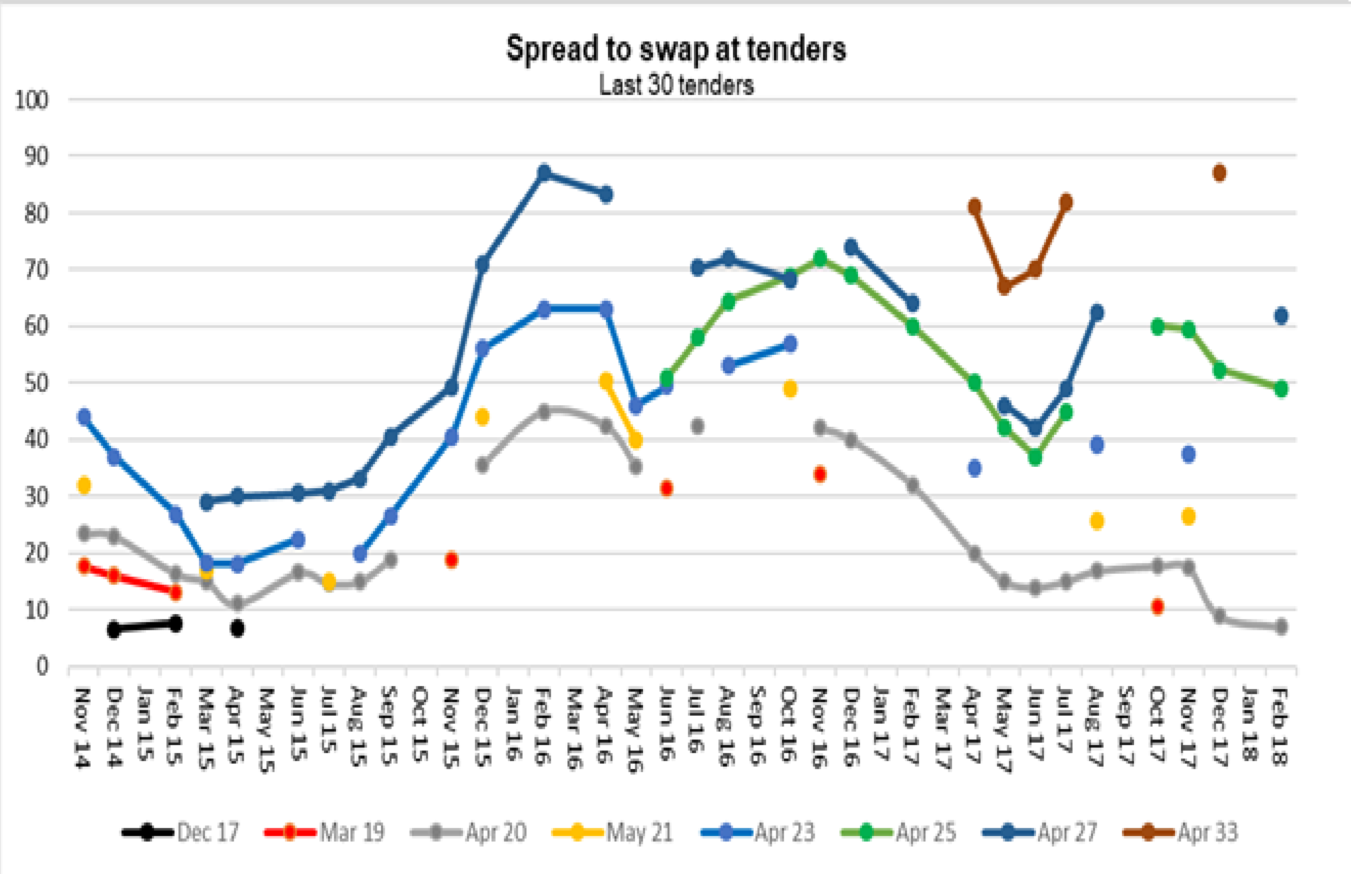
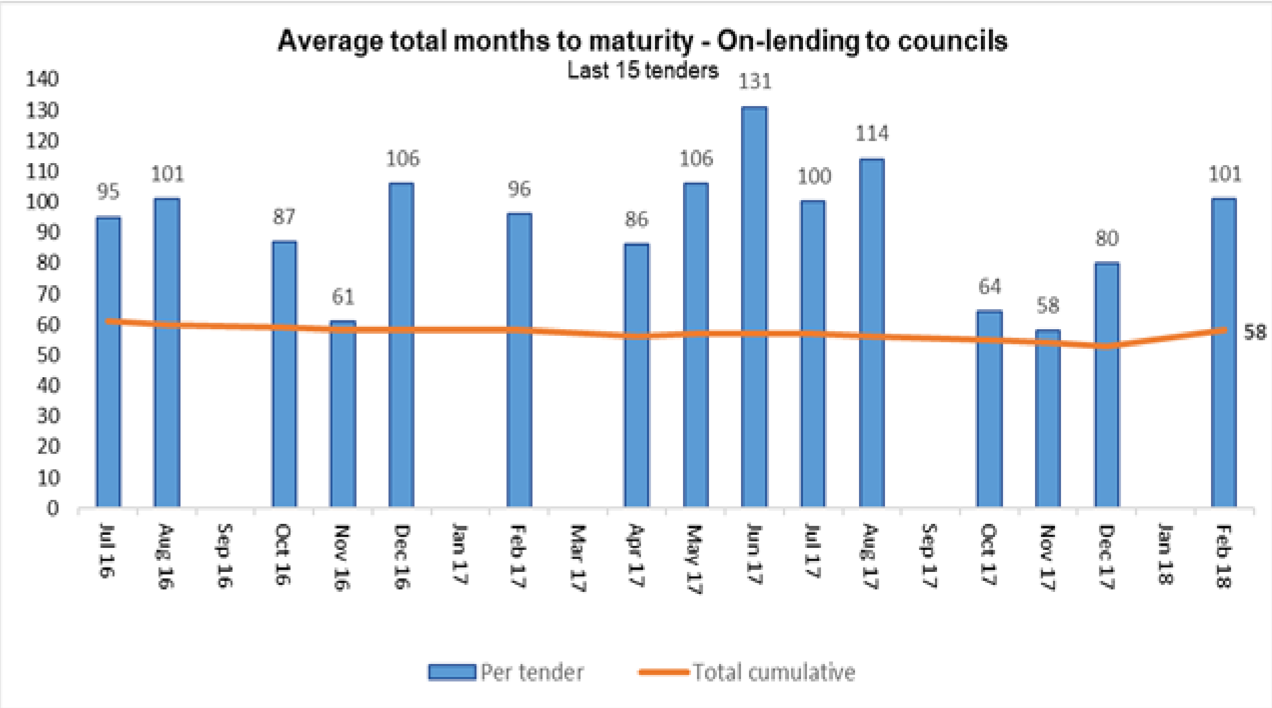




2. Making longer-term borrowings available to Participating Local Authorities

The average borrowing term (excluding short dated borrowing) for the March 2018 quarter by council members was 7.45 years and while this was longer than the December 2017 quarter average of 5.62 years, it was still shorter than the 8.10 year average term for the prior year. The shortening in term compared to the prior year was due to councils responding to the recent widening of borrowing margins in the longer dated maturities. Also, many councils had taken advantage of the tighter margins in early 2017, using the opportunity to extend longer when the 2033 maturities were first made available in April 2017.



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 $15 million per month or 9.5% 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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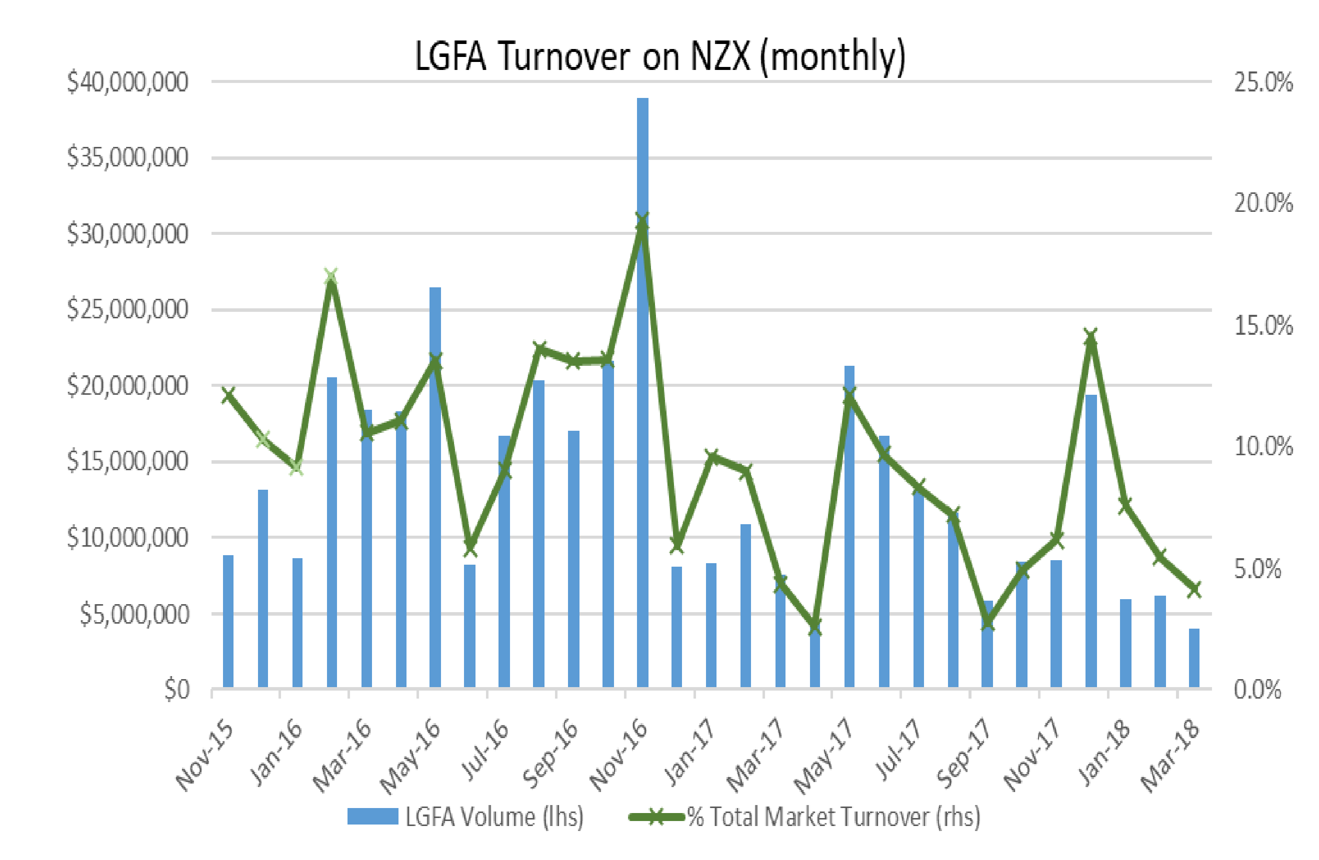

LGFA began issuing 3-month and 6-month LGFA Bills and commenced short dated (less than 1 year) lending to councils in late 2015. LGFA has short term loans to twenty councils of $265 million outstanding as at 31 March 2018.

LGFA documented an Australian Medium-Term Notes Programme in November 2017 to provide the ability to issue in currencies other than NZD. It is not our intention to use this programme but to have it established to provide some flexibility in case of the unlikely scenario of a significant market disrupting event in the future.

The LGFA bond tender held in February was supported by the market with a healthy coverage ratio of 3.89 times which was similar to that achieved in the December 2017 tender. We continue to offer three or four LGFA maturities at each tender and try to maintain the volume offered within the $130 million to $170 million range to ensure ongoing price tension and reduce the risk of a tender failure.

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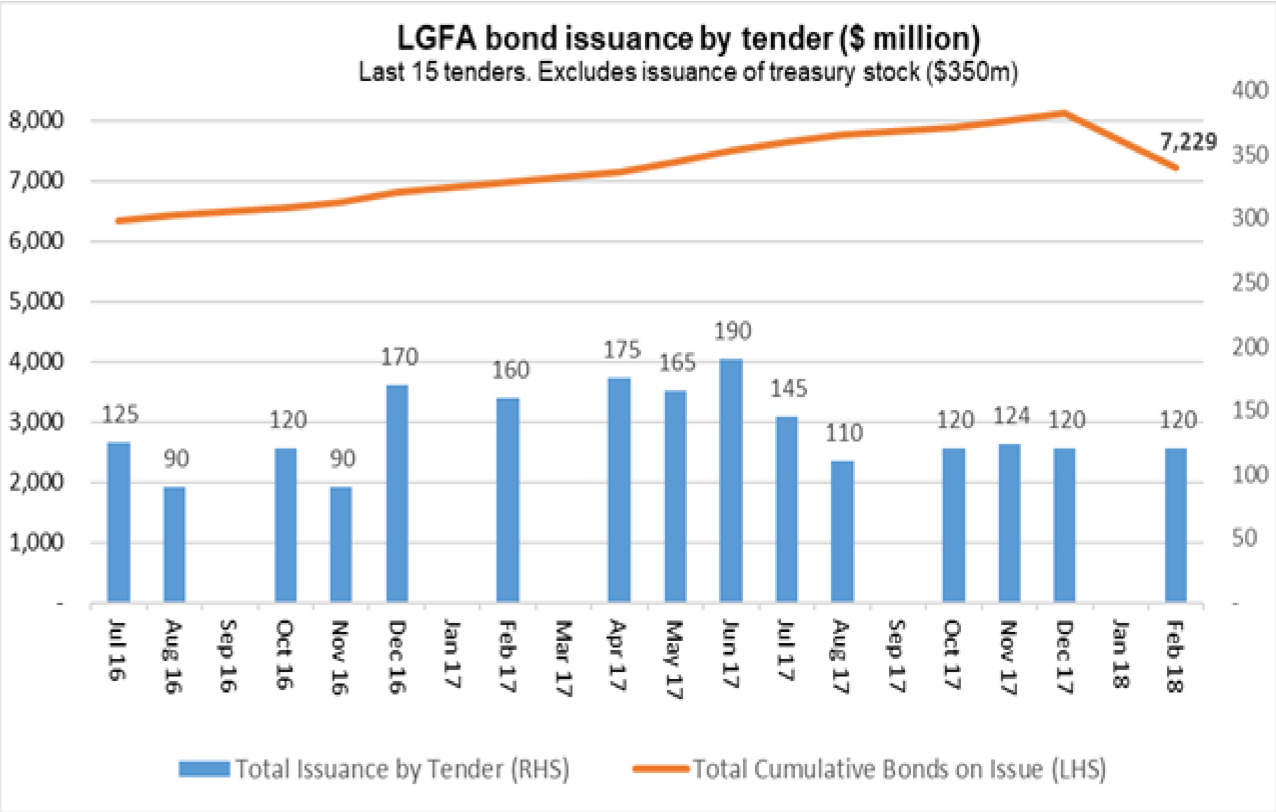
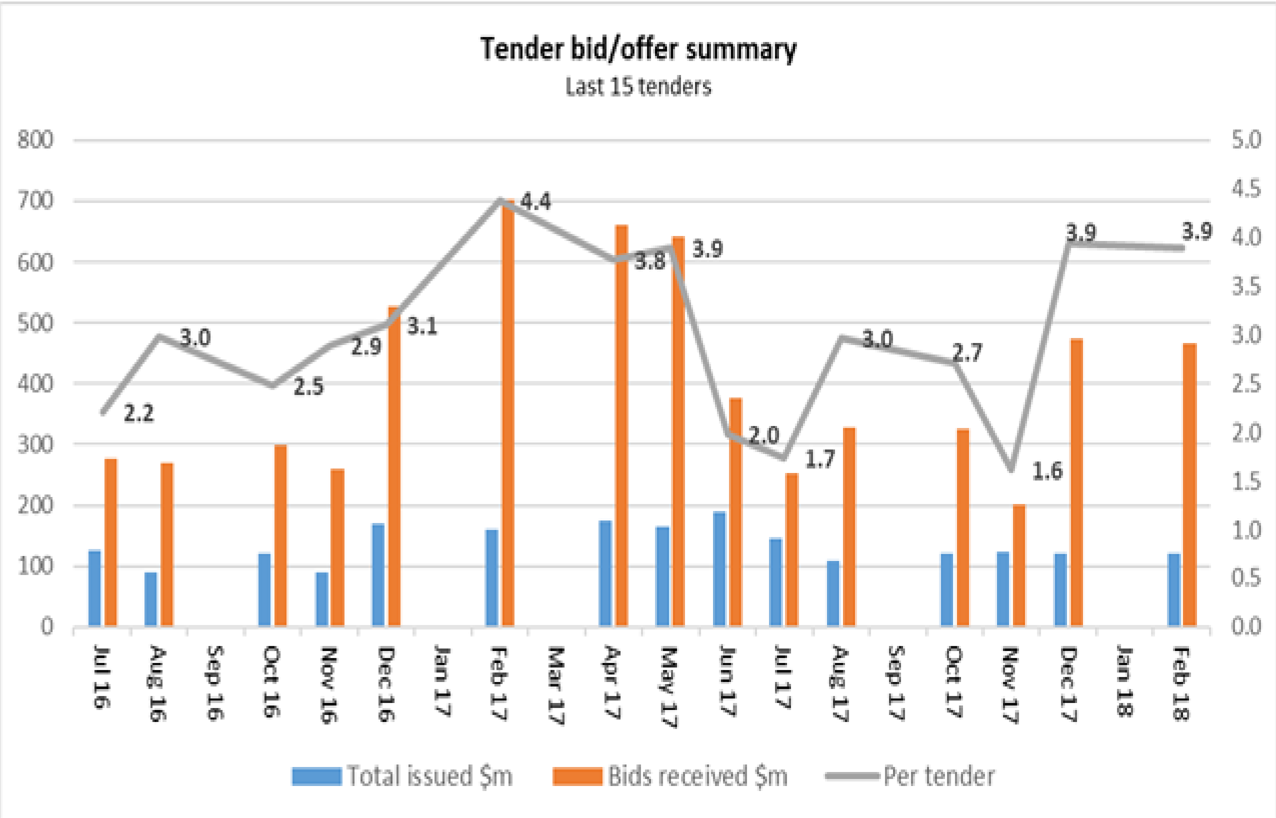




4. Offering more flexible lending terms to Participating Local Authorities

Bespoke lending continues to be a popular borrowing option for council members. During the quarter we lent $126.5 million on a bespoke basis to eleven councils. This comprised 69% of total term lending by LGFA to its members during the quarter.

Short term borrowing by councils has been well received with loan terms to date of between 3 months and 12 months on $265 million of loans outstanding as at 31 March 2018.

5. LGFA will monitor the quality of the asset book so that it remains of a high standard by ensuring it understands each Participating Local Authority's financial position and the general issues confronting the Local Government sector.

LGFA had meetings with nine councils during the March quarter to discuss their financial performance and any developments with the underlying council operations. LGFA reviews council agendas and management reports on an ongoing basis for those councils on the LGFA borrower watch-list.

LGFA has commenced work on credit default assessment analysis of its member councils in preparation for adopting IFRS9 for accounting purposes.

LGFA management met representatives from Fitch, Moody's and MBIE to discuss the local government sector. We have also been assisting an offshore agency who is considering whether to establish a similar vehicle to LGFA.

LGFA presented at the LGNZ Quarterly media briefing on the sector financial position and provided an LGFA update.

Additional objectives

6. 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 management account basis of $9.303 million for the nine-month period to 31 March 2018 exceeded the management forecast of $8.709 million. The average cost of funds for the first nine months of the 2017-18 financial year is 3.06%. This is lower than the 3.56% for the 2016-17 financial year due to the lower level of interest rates and much shorter term of LGFA bond issuance compared to the previous financial year. The LGFA Board has the sole discretion to set the dividend.

7. 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 March 2018 quarter. LGFA market share of total sector borrowing for the March 2018 quarter was 100% and for the year to March 2018 was 84.4%. Our market share remains strong compared to our global peers but will be influenced by the amount of borrowing undertaken by Auckland Council and Dunedin City Councils in their own name.

There are fifty-four participating local authority members of LGFA which is unchanged over the quarter. We are aware of at least six councils who are currently consulting through their LTP on their intention to join.

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

Expenses for the nine-month period on an unaudited basis are $5.017 million which is $230k below budget. This variance is the consequence of:

- Issuance and on-lending costs (excluding AIL) at $1.633 million were $90k under budget. There were lower fees than budgeted relating to the NZDMO facility offset by higher registry costs and legal costs than forecast. The larger amount of short term lending and establishment of an AUD bond programme has increased legal costs.

- Operating costs at $2.128 million were $171k below budget due to lower personnel costs than forecast but offset by additional legal costs relating to LGFA input into the HIF.

- Approved Issuer Levy payments of $1.26 million were slightly above our forecast of $1.23 million.

9. 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.

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

LGFA has credit ratings from Standard and Poor's ("S&P") and Fitch Ratings ("Fitch") and meets with both agencies in September and October each year. Meetings were held in 2017 with both agencies and S&P affirmed the long-term rating of LGFA at AA+ (stable outlook) on 25 September 2017 and Fitch affirmed the rating at AA+ (stable outlook) on 10 November 2017.

11. Achieve the financial forecasts

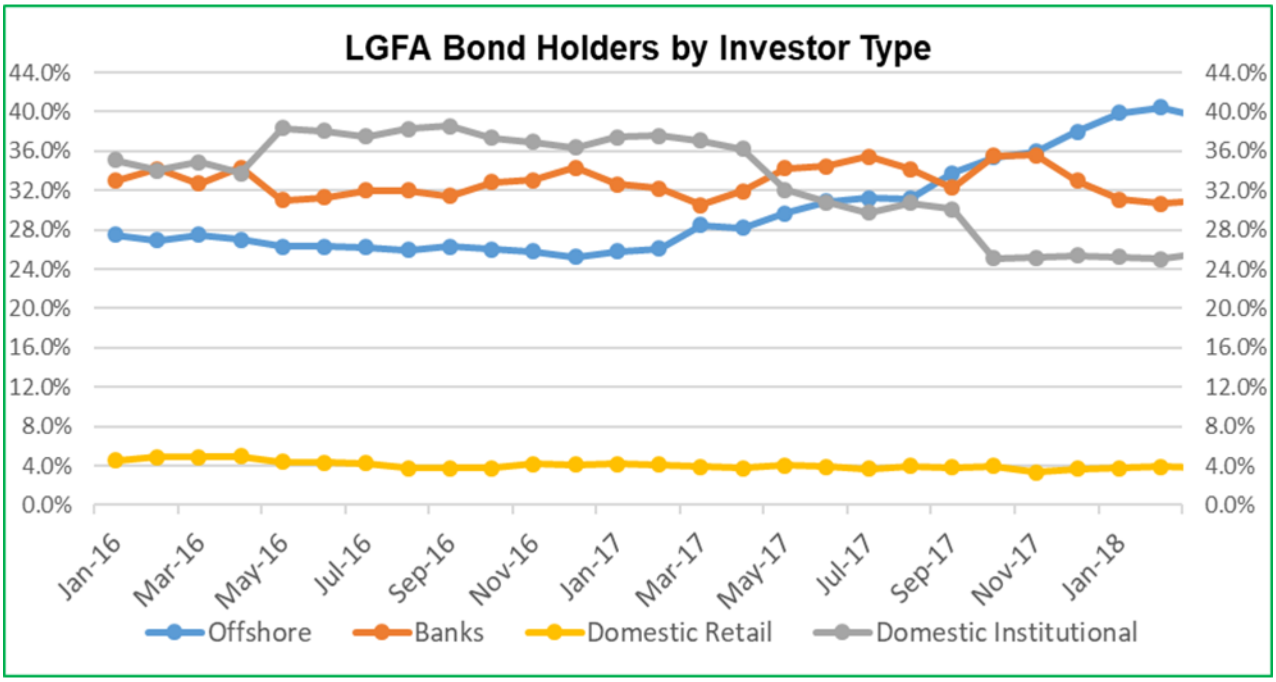
As at the end of third quarter, Net Interest Income was estimated by management on an unaudited basis to be $365k above budget while expenses are $230k below budget. Net Operating Gain of $9.303 million was $594k above budget and 7.5% above the Net Operating Gain for the equivalent period in the prior year.

G. Investor relations / outlook

Managing relations with our investor base is very important as the amount of LGFA bonds on issue has yet to peak and we require investors and banks to support our tender issuance. Our focus is on growing and diversifying the offshore investor group as these investors have the most growth potential given that we already receive strong support from the domestic banks and institutional investors.

Offshore investors and domestic investors increased their holdings of LGFA bonds during the March quarter while bank holdings declined.

- Offshore investors increased their holdings by $157 million over the March quarter and by $541 million since June 2017. They are estimated to hold $2.9 billion (39.5% of outstandings) compared to $2.3 billion (30.9% of outstandings) a year ago. Offshore investor holdings are at a record high and they have become our largest investor group.
- Domestic institutional and retail investors increased their holdings by $72 million over the quarter and were estimated to hold $2.1 billion (29.5% of outstandings) compared to $2.8 billion (41.0% of outstandings) a year ago. The decline over the past year has been due to the maturing of December 2017 LGFA bonds held in money market funds and a small number of domestic investors have reduced their holdings as they are less optimistic on the credit market outlook.
- Domestic banks reduced their holdings by $101 million over the quarter and by $341 million since June 2017. This reduction was due to the maturing December 2017 bond which was mainly held by banks in their liquidity portfolios and the increase in offshore investor holdings who buy from bank secondary market trading books. Bank holdings of $2.2 billion (31% of outstandings) compared to $2.1 billion (30.5% of outstandings) a year ago.



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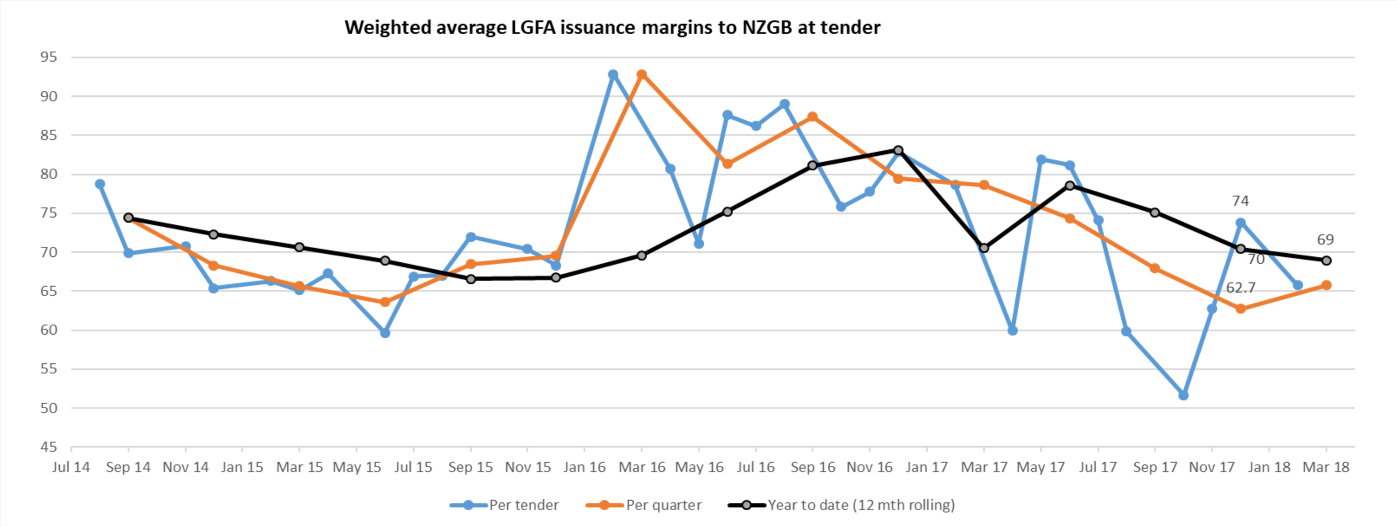
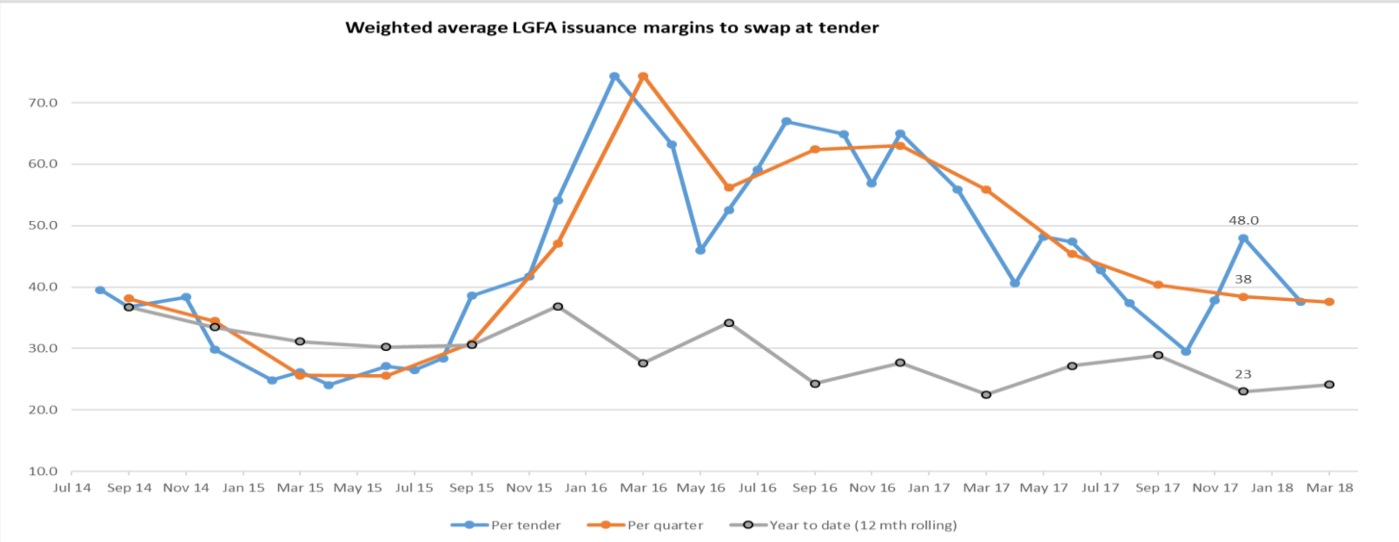
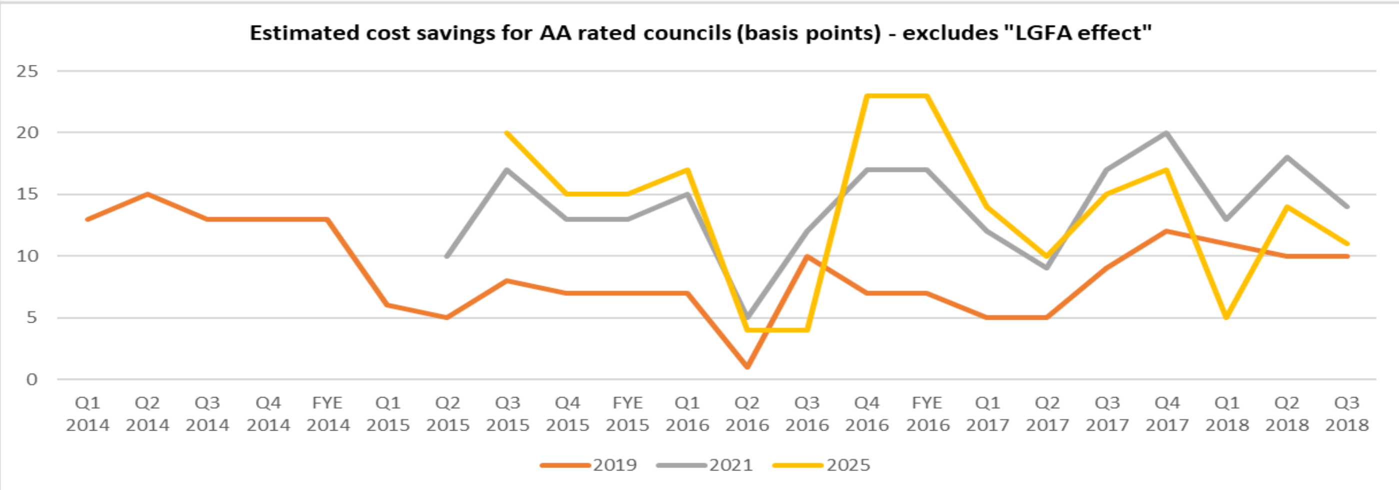
H. Key trends







Note: Weighted average margins are a function of the term of issuance at each tender as the longer the borrowing term, the wider the margin (assuming everything else remains constant).