Quarterly Report

Quarter 1: 2017 - 2018
Period ended: 30 September 2017

NEW ZEALAND
LOCAL GOVERNMENT
FUNDING AGENCY

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A. September quarter issuance and highlights summary

Quarter	Total	Bespoke	2017	2019	2020	2021	2023	2025	2027	2033
Bonds issued $m	255	N/A	-	-	80	30	39	40	36	30
Loans to councils $m	290.4	242.4	-	5	-	-	-	7	28	8
Loans to councils – No.	36	30	-	1	-	-	-	2	2	1

Year to date	Total	Bespoke	2017	2019	2020	2021	2023	2025	2027	2033
Bonds issued $m	255	N/A	-	-	80	30	39	40	36	30
Loans to councils $m	290.4	242.4	-	5	-	-	-	7	28	8
Loans to councils – No.	36	30	-	1	-	-	-	2	2	1

Key points and highlights for the September quarter:

- The bond curve steepened over the quarter with long dated yields rising and short dated yields falling. The 2019 bond yield fell 14 bps (0.14%) while the 2033 bond yield rose 11 bps (0.11%).
- LGFA issued a modest $255 million of bonds during the quarter across two tenders. The average term of issuance of 6.59 years was very short compared to the average term for the 2016-17 year of 8.87 years. LGFA bonds outstanding as at 30 September 2017 were $8.010 billion (including $350 million of treasury stock).
- LGFA margins to NZGB and swap reversed the narrowing trend of the previous four quarters with spreads to NZGB unchanged (2019s) to 13 bps wider (2025s) and spreads to swap widening by 1 bps (2019s) to 23 bps (2033s).
- On-lending to council borrowers was $290.4 million including $242.4 million of bespoke loans (83% of total lending) during the quarter. Much of this borrowing activity related to council refinancing of their December 2017 loans. The average term of on-lending to councils during the quarter was 7.36 years which was significantly shorter than the prior quarter (9.38 years) and the average term of 8.20 years for the 2016-17 year.
- LGFA achieved a historic milestone in providing 100% of all council borrowing in the quarter and on a rolling 12 month basis has undertaken 94.9% of total sector borrowing.
- The short-term council borrowing product remains well supported by councils with loans outstanding of $296 million as at 30 September 2017. This was an increase of $64 million over the quarter although the number of councils using this product increased by five to twenty-four.
- LGFA Net Operating Gain (unaudited) for the three months to September 2017 was $3.342 million or $0.143 million below budget. The contributors were
    - Net Interest Income of $4.736 million was $0.275 million below budget with the shortfall due in part to a $0.142 million negative variance from the valuation of some mismatch hedging swaps deemed to be ineffective for accounting purposes.
    - Total expenses of $0.707 million were $47k below budget due to a lower than forecast usage of the DMO facility and slightly lower personnel costs. AIL payments were in line with forecast.

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B. LGFA bond tenders during quarter

LGFA held two bond tenders over the quarter.
Tender 48: 19 July 2017 $145 million

Tender 48 Tender date: 19 July 2017	**Apr-20**	**Apr-25**	**Apr-27**	**Apr-33**
Total amount offered $m	50	40	25	30
Total amount allocated $m	50	40	25	30
Total number bids received	10	17	8	14
Total amount of bids received $m	106	64.864	38	43
Total number of successful bids	1	10	5	12
Highest accepted yield %	2.535	3.590	3.800	4.470
Lowest yield accepted %	2.535	3.550	3.770	4.350
Highest yield rejected %	2.600	3.625	3.850	4.580
Lowest yield rejected %	2.540	3.590	3.800	4.470
Weighted average accepted yield %	2.535	3.572	3.777	4.410
Weighted average rejected yield %	2.563	3.604	3.825	4.541
Coverage ratio	2.12	1.62	1.52	1.43
NZGB spread at issue bps	41.0	78.0	85.0	115.0
Swap spread at issue bps	15.0	44.7	48.5	81.7
Swap spread: AA council bps	**26.25**	**54.5**	**63.5**	**88.5**
Swap spread: AA- council bps	**31.25**	**59.5**	**68.5**	**93.5**
Swap spread: A+ council bps	**36.25**	**64.5**	**73.5**	**98.5**
Swap spread: unrated council bps	**41.25**	**69.5**	**78.5**	**103.5**

We tendered the same maturities as the previous three tenders. Weighted average yields were 4 bps higher on the 2020s, 21 bps higher on the 2025s and 2027s and 26 bps higher on the 2033s compared to the previous June 2017 tender reflecting a steeper yield curve and soft bidding for the longer dated bonds.

Demand was good for the 2020s with one successful bid at 1.5 bps below prevailing secondary market mid rates. The 2025s and 2027s were issued 3 bps above prevailing mid rates while the 2033s were issued 8 bps above prevailing mid rates. Despite the small tender size, demand remained soft for the 2033s with a 12 bps successful bid range with only $43 million of bids for the $30 million tendered.

The spread to swap compared to the June 2017 tender was 1 bps wider on the 2020s, 8 bps wider on the 2025s, 6 bps wider on the 2027s and 11 bps wider on the 2033s. Spreads to NZGB were unchanged on the 2020s, 6 bps wider on the 2027s and 8 bps wider on the 2025s and 2033s.

The average maturity of LGFA bonds issued at 8.02 years was the shortest since the November 2016 tender.

Coverage ratio of 1.7 times was the lowest for a year and followed the June 2017 tender ratio of 1.9 times.

We issued $145 million of LGFA bonds and on-lent $144 million to nine councils.

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Tender 49: 23 August 2017 $110 million

Tender 49 Tender date: 23 August 2017	Apr-20	May-21	Apr-23	Apr-27
Total amount offered $m	30	30	30	20
Total amount allocated $m	30	30	39	11
Total number bids received	14	13	12	11
Total amount of bids received $m	116	107	74	30
Total number of successful bids	4	2	5	6
Highest accepted yield %	2.485	2.765	3.160	3.780
Lowest yield accepted %	2.480	2.735	3.140	3.740
Highest yield rejected %	2.570	2.870	3.370	3.890
Lowest yield rejected %	2.570	2.765	3.160	3.790
Weighted average accepted yield %	2.481	2.740	3.145	3.766
Weighted average rejected yield %	2.510	2.803	3.233	3.826
Coverage ratio	3.87	3.57	2.47	1.50
NZGB spread at issue bps	43.00	54.00	65.00	86.00
Swap spread at issue bps	16.80	25.60	39.00	62.50
Swap spread: AA council bps	**28.0**	**39.75**	**55.75**	**77.8**
Swap spread: AA- council bps	**33.0**	**44.75**	**60.75**	**82.8**
Swap spread: A+ council bps	**38.0**	**49.75**	**65.75**	**87.8**
Swap spread: unrated council bps	**43.0**	**54.75**	**70.75**	**92.8**

Weak market sentiment continued with both large Kauri and LGFA issuance in the June quarter led to banks unwillingness to hold long dated LGFA bonds in a background of global bond market uncertainty and tight credit spreads.

We anticipated the weaker sentiment and tendered a smaller size ($110 million) and shorter duration. The 4.7 years weighted average term of issuance was the second shortest term of all forty-nine tenders.

The result was disappointing as we accepted $9 million less of the 2027s and over accepted the 2023s by $9 million due to poor bidding for the 2027s. Demand was soft for the 2027s with a 4 bps successful range for the $11 million accepted but yields were 6 bps above the prevailing market yield at the time. Demand was stronger for the 2020s, 2021s and 2023s with weighted average yields at prevailing mid rates on the 2020s and 2021s and 3.5 bps above on the 2023s.

The spread to swap compared to the July tender was 2 bps wider on the 2020s and 14 bps wider on the 2027s. Spreads to NZGB were 2 bps wider on the 2020s and 1bps wider on the 2027s.

Coverage ratio of 2.97 times was satisfactory but tender size was modest.

While we issued $110 million of LGFA bonds we on-lent $75 million to six councils. The additional issuance was to fund loans we have made to council since the July tender.

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C. Key performance indicators

Measure		Prior full year to June 2017	Q1 30 Sep 17	Q2 31 Dec 17	Q3 31 Mar 18	Q4 30 Jun 18
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 % Rolling 12 month	0.104%	0.094% (0.1086% for long term and 0.08% 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 maturity As at quarter end	12 bps	11 bps ✗			
	2021 maturity As at quarter end	20 bps	13 bps ✗			
	2025 maturity As at quarter end	17 bps	5 bps ✗			
Issuance and operating expenses (excluding AIL) YTD	Target ($ m)		$1.33 m	$2.73 m	$4.09 m	$5.45 m
	Actual ($ m) Year to date	$4.67 m	$1.20 m ✓			
Lending (short and long term) to participating councils	Target ($ b)		$7.834 b	$7.932 b	$8.03 b	$8.128 b
	Actual ($ b) Year to date	$7.736 b	$8.101 b ✓			

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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-17**	**31-Dec-17**	**31-Mar-18**	**30-June-18**
Interest income	88.68			
Interest expense	83.95			
Net interest revenue	**4.73**			
Issuance and On-lending costs	0.49			
Approved issuer levy	0.19			
Operating expenses	0.71			
Issuance and operating expenses	**1.39**			
Net Profit	**3.34**			

Financial position ($m)	30-Sep-17	31-Dec-17	31-Mar-18	30-Jun-18
Retained earnings + comprehensive income	30.83			
Total assets (nominal)	8,338.71			
Total LG loans (nominal)	8,101.05			
Total LGFA bills (nominal)	350.00			
Total LGFA bonds (nominal)	7,760.00			
Total borrower notes (nominal)	124.45			
Total equity	55.83			

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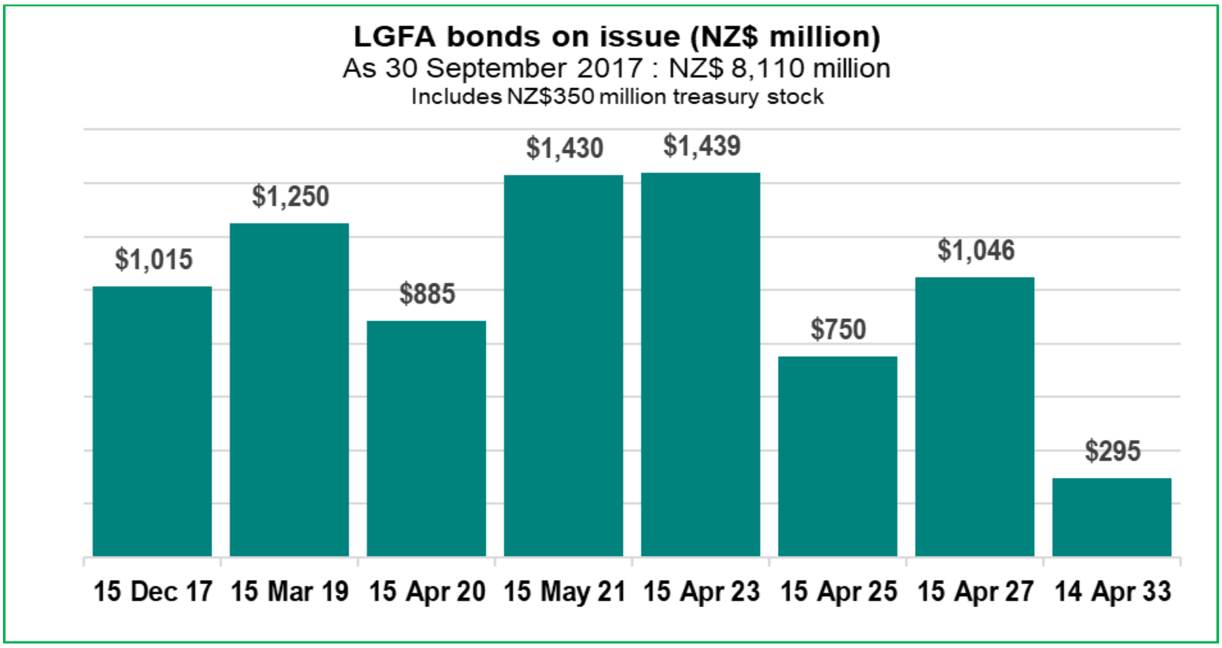


E. Quarterly compliance summary

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 $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

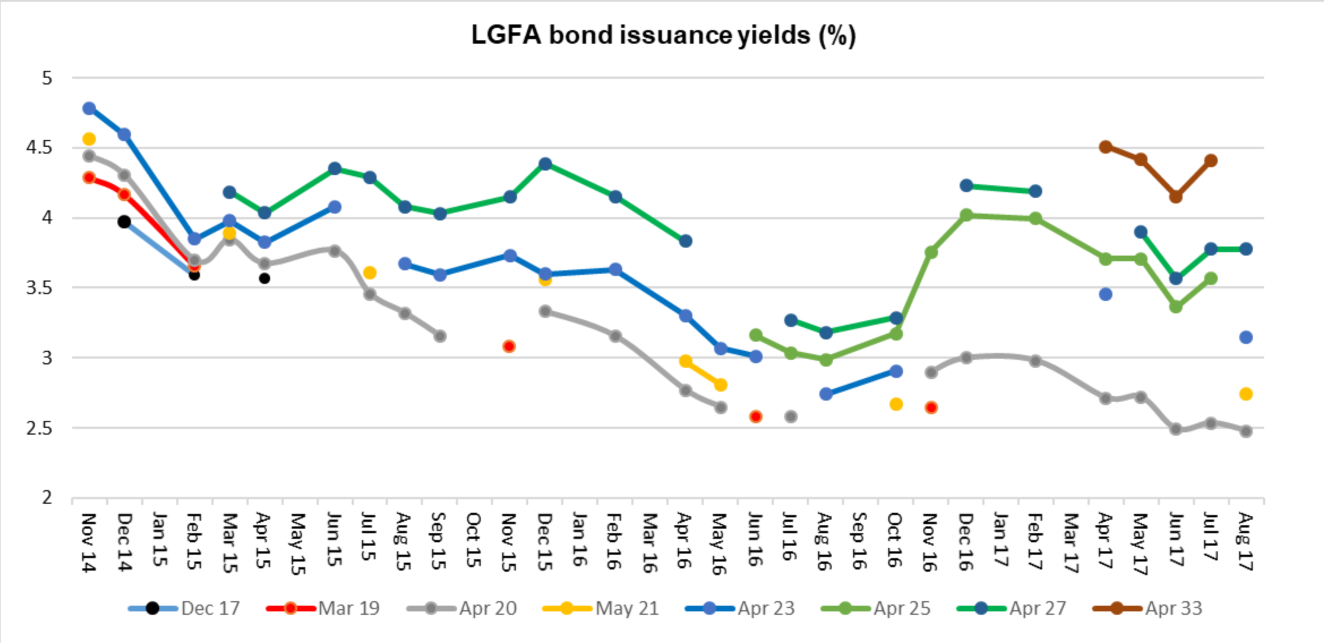
1. Providing savings in annual interest costs for all Participating Local Authorities

The LGFA on-lending base margins have been held constant since August 2015 at 9 bps (2017s and 2019s), 10 bps (2020s and 2021s) 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.

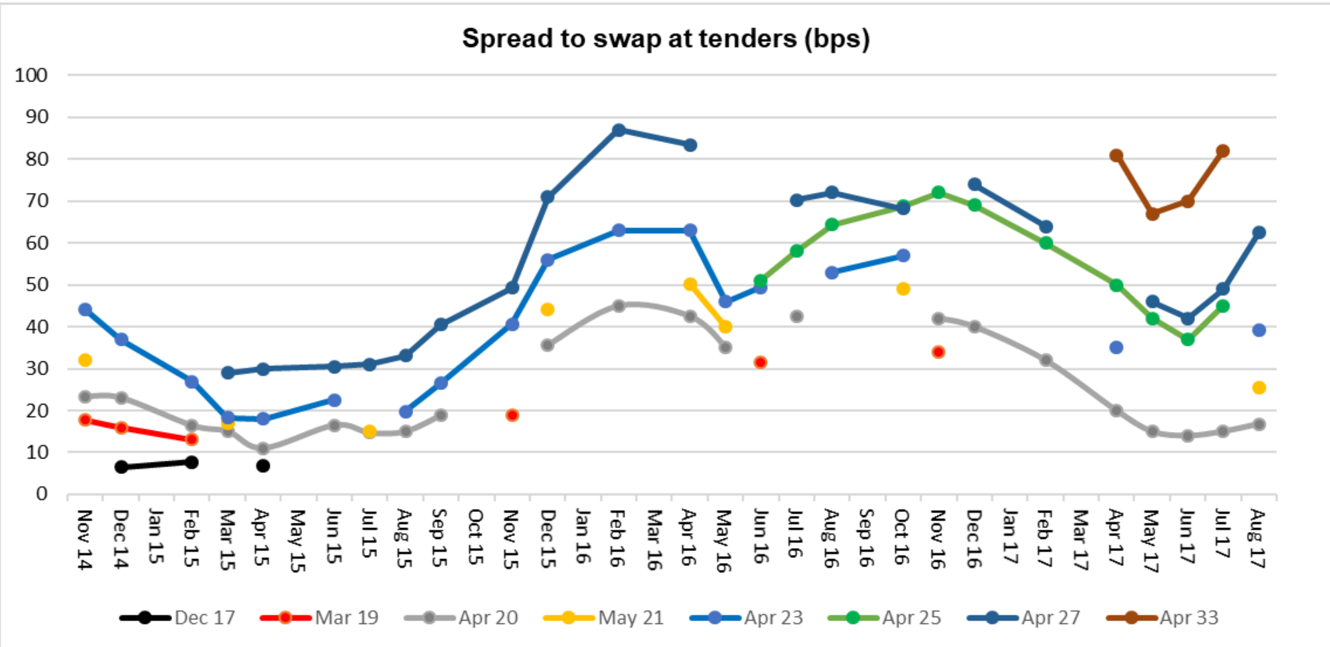
Our estimated annual savings to councils based upon the secondary market levels at 30 September 2017 of LGFA bonds compared to bonds issued by Auckland and Dunedin councils is between 5 bps and 18 bps depending upon the term of borrowing. The amount of savings has reduced in the past quarter as LGFA borrowing spreads have widened while Auckland and Dunedin borrowing margins are unchanged. Both councils have not issued in the domestic capital markets for some time while LGFA has held nine bond tenders of $1.35 billion in total over the past twelve months.

30-Sep-17	**Savings to AA rated councils (bps)**				
	Auckland 2019	Dunedin 2020	Dunedin 2021	Auckland 2022	Auckland 2025
AA rated councils margin to swap	33	46	51	53	74
Less LGFA margin to swap	-13	-18	-28	-34	-58
LGFA Gross Funding Advantage	20	28	23	19	16
Less LGFA Base Margin	-9	-10	-10	-10.5	-11
Total Saving	11	18	13	8.5	5

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.



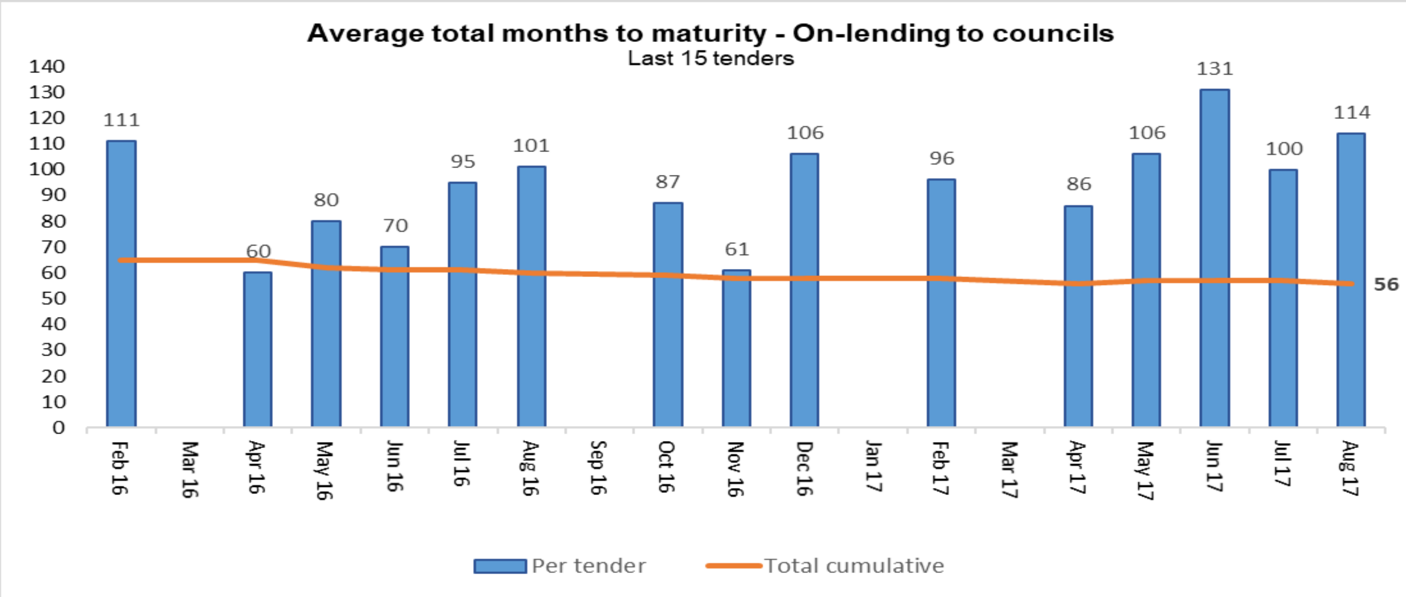
We held two tenders during the September quarter with total issuance of $255 million. This was lower than the previous quarters issuance ($530 million) and the average quarterly issuance of $352 million since LGFA commenced issuing in 2012. Despite the smaller issuance volume, credit spreads widened as credit market conditions softened and the market absorbed the large amount of long dated LGFA issuance in the previous quarter. Secondary market spreads to swap for LGFA bonds widened by between 1 bps (2017s) and 23 bps (2033s) over the quarter with the average spread to swap across all LGFA bonds widening by 13 bps to 41 bps. Of note, the spread to swap of 28 bps as at June 2017 was the two-year low and the spread widening to NZGB over the September quarter was a more modest 4 bps.



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

The average borrowing term (excluding short dated borrowing) for the September 2017 quarter by council members was 7.36 years and this was significantly shorter than the June 2017 quarter average of 9.38 years and the 8.20 years for the 2016-17 year. The shortening in term was due to councils in the quarter reacting to the recent widening of borrowing margins in the longer dated maturities. Also, the June quarter experienced a larger than normal amount of long dated council borrowing when the ability to borrow into maturities between 2027 and 2033 was first made possible.

With the debut issuance of a 2033 LGFA bond maturity in April 2017, councils can now borrow for terms from one year to sixteen years and to any in between maturity on a bespoke basis.



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 10% 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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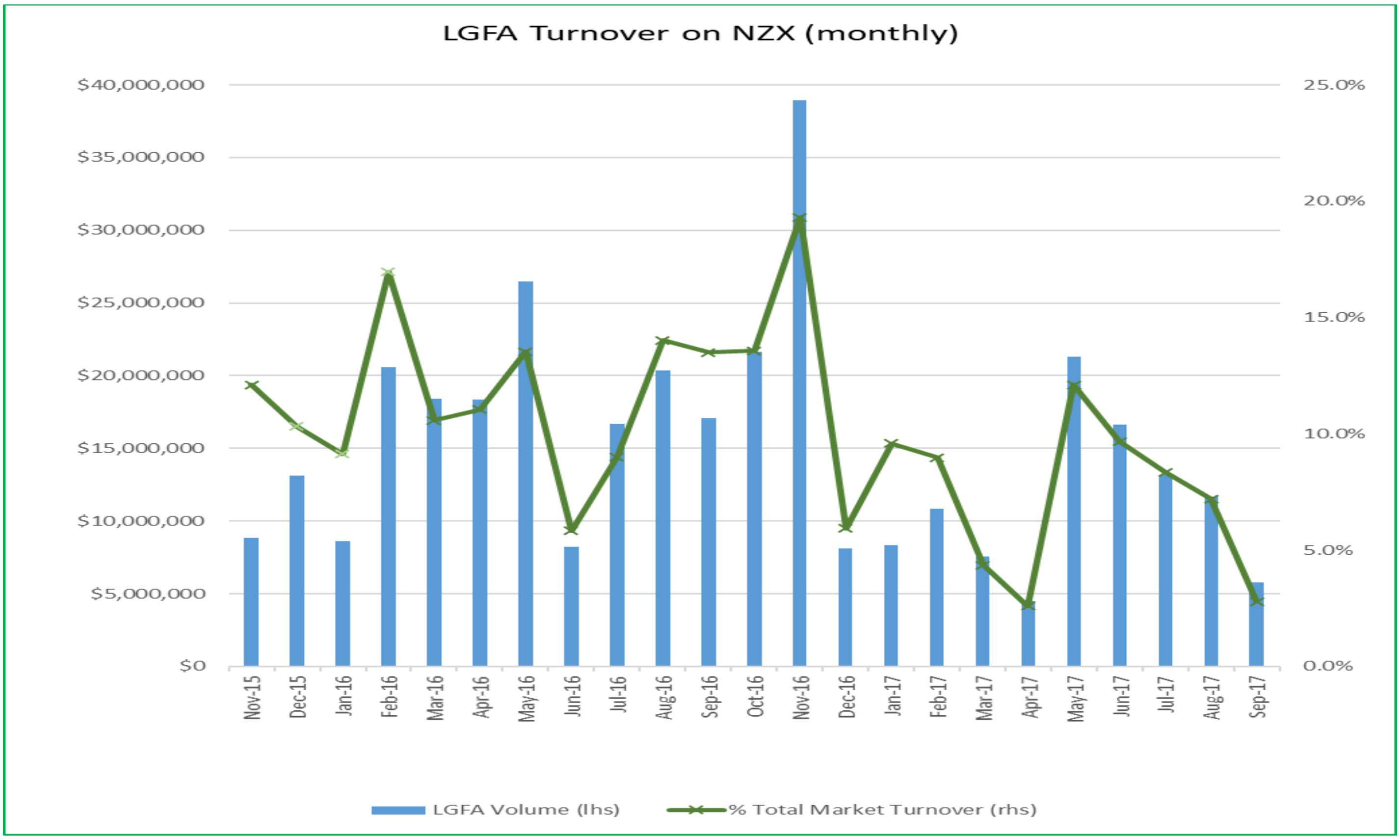
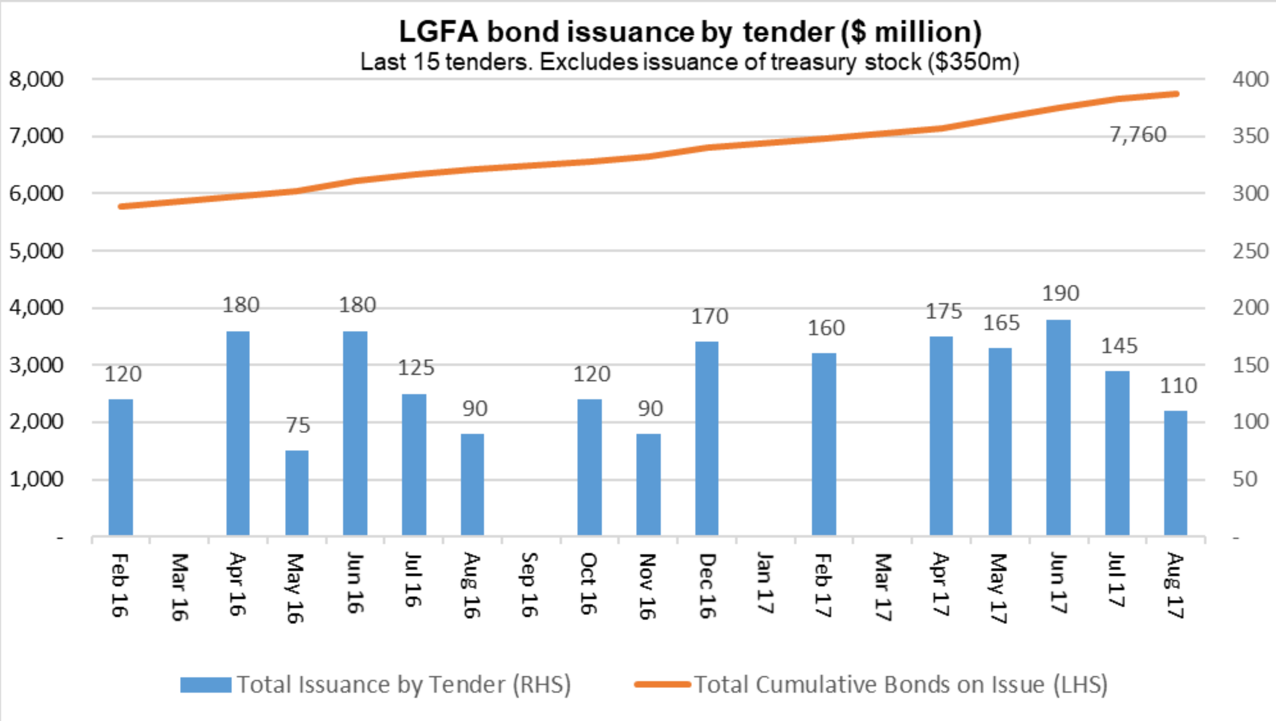
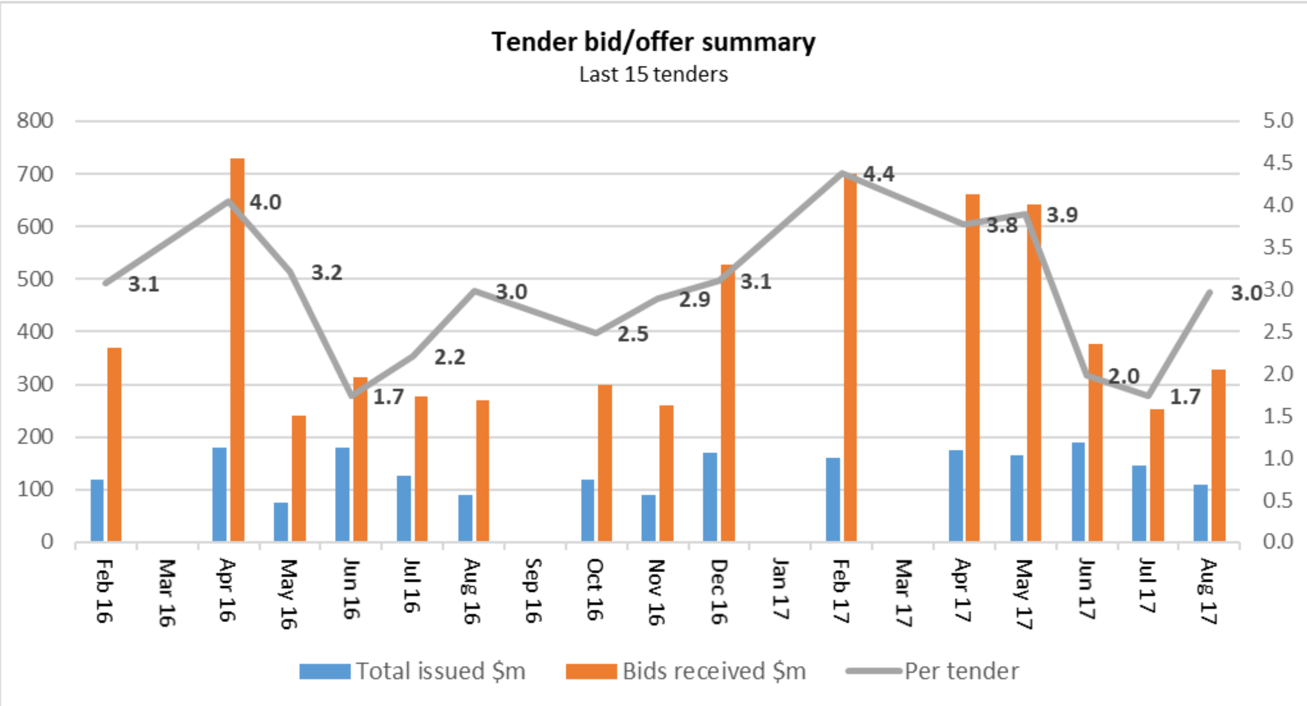


LGFA began issuing 3-month and 6-month LGFA Bills and commenced short dated (less than 1 year) lending to councils in late 2015. LGFA has short term loans to twenty-three councils of $297 million outstanding as at 30 September 2017.

LGFA is currently documenting an Australian Medium-Term Notes Programme 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.

Despite the soft July and August tenders, we believe that LGFA bond tenders continued to be supported by the market with the coverage ratios across the two tenders averaging 2.27 times. This is in line with the long-term average over the forty-eight tenders held to date. 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. We have also offered slight shorter LGFA bond maturities in the tenders to offset the slight weaker prevailing market conditions.





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

$1.435 billion in bespoke transactions. During the September 2017 quarter, we lent $242.4 million on a bespoke basis to seventeen councils. This comprised 83% 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 $297 million of loans outstanding as at 30 September 2017.

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 twelve councils over the September 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.

The LGFA board met with the Local Government Commission and the board received management papers on council depreciation policies and an assessment of group vs parent reporting.

LGFA management met representatives from Treasury and MBIE to discuss the Housing Infrastructure Fund and Crown Infrastructure Partners.

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 $3.342 million for the September quarter was in line with the management forecast of $3.485 million. The average cost of funds for the first quarter of the 2017-18 financial year was 2.53%. 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 than 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 September 2017 quarter. LGFA market share of total sector borrowing for the September 2017 quarter was 100% and for the year to September 2017 was 94.9%. 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 September quarter was 100% and for the year to

September 2017 was 94.3%. 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.

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 first quarter on an unaudited basis are $1.394 million which is $132k below budget. This variance is the consequence of:

- Issuance and on-lending costs (excluding AIL) at $0.491 million were $81k below budget. There were lower fees than budgeted relating to the NZDMO facility offset by higher registry costs than forecast.
- Operating costs at $0.707 million were $47k below budget and reflected lower overheads and personnel costs than forecast.
- Approved Issuer Levy payments of $195k were in line with our forecast of $200k but the larger coupon (and AIL payment) month is October.

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.

The Kaikoura earthquake in November impacted on Wellington CBD buildings. As result, staff are currently working from the Local Government New Zealand offices but are expected to return to the LGFA offices in the coming 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 have been held in 2017 with both agencies and S&P affirmed the long-term rating of LGFA at AA+ (stable outlook) on 25 September 2017. Fitch have yet to publish their rating and last affirmed the rating at AA+ (stable outlook) on 15 November 2016.

11. Achieve the financial forecasts

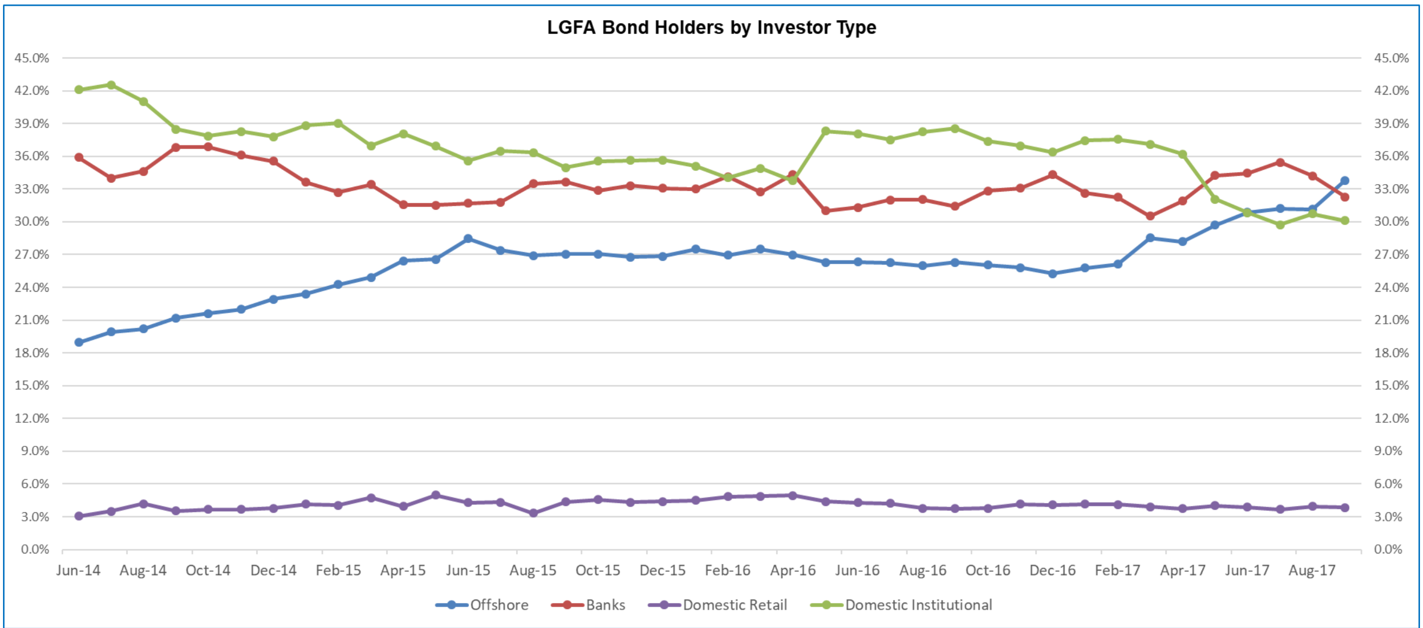
As at the end of first quarter, Net Interest Income was estimated by management on an unaudited basis to be $275k below budget while expenses are $132k below budget. Net Operating Gain of $3.342 million was $143k below budget but 16% above the Net Operating Gain for the equivalent period in the prior 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 us in our tenders. Our focus is on growing and diversifying the offshore investor group as these investors have the most 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 September quarter while bank holdings declined

- Offshore investors increased their holdings by $307 million over the September quarter and by $634 million over the past six months. They are estimated to hold $2.62 billion (33.8% of outstandings) compared to $1.69 billion (26.3% of outstandings) as at 30 September 2016. The 33.8% of outstandings held by offshore investors is a record high and for the first time they have surpassed both domestic banks and institutional investors as our single largest investor group.
- Domestic institutional and retail investors increased their holdings by $29 million over the September quarter and were estimated to hold $2.63 billion (33.9% of outstandings) compared to $2.72 billion (42.2% of outstandings) as at 30 September 2016. A small number of larger domestic investors have reduced their holdings over the past twelve months following the outperformance of LGFA bonds relative to swap, NZGBs and Kauri issues.
- Domestic banks reduced their holdings by $81 million over the September quarter compared to the $459 million increase over the June quarter. This reduction was a natural consequence of the other two investor groups increasing their holdings beyond the total tender issuance over the quarter. Bank secondary market trading books provided the inventory for investors to increase their holdings over the quarter. Bank holdings of $2.51 billion (32.3% of outstandings) compared to $2.02 billion (31.4% of outstandings) as at 30 September 2016.



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H. Key trends