

Research Update:

# Kapiti Coast District Council 'AA/A-1+' Ratings Affirmed; Outlook Stable

July 26, 2020

## Overview

- We forecast a large financial and economic shock in New Zealand during 2021 because of the COVID-19 pandemic. We expect Kapiti to incur moderate after-capital account deficits during the next few years because of revenue headwinds and higher capital expenditure.
- The council's liquidity policies ensure debt-service coverage remain exceptional, offsetting weaknesses associated with its very high debt levels. The council's experienced management and New Zealand institutional settings support the ratings while the district's economic profile tempers these strengths.
- We are affirming our 'AA' long-term and 'A-1+' short-term issuer credit ratings on Kapiti.
- The outlook is stable.

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## Rating Action

On July 27, 2020, S&P Global Ratings affirmed its 'AA' long-term local and foreign currency ratings and 'A-1+' short-term issuer credit ratings on Kapiti Coast District Council (Kapiti), a New Zealand local government. The outlook is stable.

## Outlook

The stable outlook reflects our view that Kapiti's financial outcomes will remain a key strength even though it will incur moderate deficits during and after the COVID-19 period. We also expect the council's experienced management to maintain conservative liquidity policies resulting in high coverage ratios.

## Downside scenario

Downward pressure could occur if there was a change in policy direction resulting in large, sustained deficits. This scenario would likely increase debt levels substantially above our

forecasts, and/or weaken its liquidity coverage.

Alternatively, we would lower our rating on Kapiti if we were to lower our rating on the New Zealand sovereign.

## **Upside scenario**

Any upward pressure on our ratings on Kapiti would be constrained by our foreign-currency sovereign rating on New Zealand. If we were to raise our rating on the New Zealand sovereign, then upward pressure on Kapiti could occur if its financial position improves relative to our forecasts. This could occur if debt levels and interest costs reduced sustainably below our forecasts, while maintaining strong liquidity coverage.

## **Rationale**

We have affirmed our ratings on Kapiti after reviewing its 2020-2021 annual plan and assessing the potential effect of the COVID-19 pandemic. Kapiti's financial outcomes remain a key strength even though we expect the council to incur moderate after-capital account deficits during 2020-2023 due to the effect of COVID-19 on its revenues and higher capital expenditure. We forecast the council's debt burden to be on a downward trajectory as the council continues to consolidate its financial position, and revenue growth picks up after 2021. The council's liquidity policies, such as its prefunding strategies, ensure debt-service coverage remain exceptional, offsetting weaknesses associated with its very high debt levels relative to peers.

Strong financial management, access to the New Zealand Local Government Funding Agency (LGFA) and New Zealand's excellent institutional settings continue to support the council's credit profile. The district's economic profile meanwhile tempers these strengths.

## **A supportive institutional framework and experienced financial management underpin Kapiti's creditworthiness**

The institutional framework within which New Zealand councils operate is a key strength supporting Kapiti's credit profile. The New Zealand local government system promotes a strong management culture, fiscal discipline, and high levels of financial disclosure among local councils. Additionally, the framework is supportive of councils' rate-collection abilities. This system allows Kapiti to support higher debt levels than some of its international peers can tolerate at the current rating.

We consider Kapiti's management to be strong. We expect its experienced management team to successfully execute its 2018-2038 long-term plan and manage its financial position within our forecast during the COVID-19 pandemic.

Kapiti prepares a long-term plan every three years, setting an important forward-looking approach to prudent financial management, which sets an important baseline for the council's operating and capital expenditure requirements, and its funding strategy. The council was on track to fully fund depreciation by 2022 before the COVID-19 pandemic, which has prolonged this goal until 2025. We consider the council's debt and liquidity policies to be prudent. The council "green-line strategy" aims to reduce the size of its capital programs and eventually enable the council to start paying down its debt. Further, the prefunding strategy up to 18 months in advance of debt maturities minimize refinancing risks. Kapiti doesn't use debt to fund operating expenses, has no issuance of foreign-currency debt, and mostly hedges its interest exposure.

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The district's economy is broadly supportive of the council's credit profile. Kapiti has a population of around 53,200 and is one of the six subregions in the Greater Wellington area. The economy has been growing after being stagnant for the decade to 2013 before the COVID-19 pandemic. However, like all domestic peers, it will still suffer in 2021 from the COVID-19 pandemic and subsequent government lockdown.

In recent years, growth has been supported by population growth, higher levels of investment in housing due to overflow from Wellington's housing market, and significant infrastructure investment by the New Zealand central government in the region. Growth has lagged the broader national average for a number of years resulting in lower local GDP per capita, incomes levels, and growth per capita compared to the national average. According to central government statistics, Kapiti's dependency ratio of residents aged under 15 years and over 65 years is much higher than the national average. About 27% of residents are aged 65 years or over compared with the national average of about 15%, which could pressure the council's ability to raise revenues over the longer term.

### **Financial outcomes and prefunding strategy remain key strengths of the ratings even as COVID-19 hits council revenues; debt burden remains very high**

We forecast the council's budgetary performance to be weaker compared with our previous expectations. This is because of the severe economic and fiscal shock caused by the COVID-19 pandemic, and the central government's and council's responses.

We expect the council's after-capital account deficits to be moderate for 2019-2023, averaging about 4.5% as COVID-19 hits revenues and the council increases its capital spending. We forecast the council will deliver about 80% of its capital program budgets during 2021-2023, with an average of about NZ\$29 million per year, which is higher than the NZ\$23 million delivered per year in 2019 and 2020 due to carryover from previous years being delivered. The council recorded an after-capital account surplus of 0.7% in 2019 after a decade of large deficits averaging 15.5% over 2009-2018.

The council's operating balance will remain strong, with a five-year average of 19.5% of operating revenue during 2019-2023. We are expecting to see the operating balance to fall to about 15% from 22% of operating revenue in 2020 and 2021 due to the effects of COVID-19 on council revenues. As the economy and revenues recover in 2022 we forecast margins to return to more than 20% of operating revenues.

Our forecasts exclude five "shovel-ready" infrastructure projects totaling NZ\$102 million that were shortlisted by the New Zealand government as part of its stimulus plans. The New Zealand government is seeking infrastructure projects that could help stimulate the economy as it recovers from the COVID-19 pandemic. The projects' effect on the council's financial outcomes, financial position, and credit rating will depend on their size, timing, and funding arrangements.

While the council's 2020 and 2021 budgets have been negatively affected by COVID-19, the council moved ahead with an average rates increase of 2.6%. This decision is supporting financial outcomes during this period of economic and financial uncertainty. This demonstrates the council's high level of flexibility within its budget to increase rates and user charges, or defer some nonessential capital expenditure to support financial outcomes and its credit profile.

Kapiti's exceptional liquidity coverage continues to support its credit profile. The council's liquidity position benefits from its prefunding of upcoming debt maturities up to 18 months in advance. The council's internal cash and liquid assets cover about 115% of upcoming debt maturities and

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interest costs. We estimate the council to have about NZ\$54.5 million in cash at the end of 2020 and NZ\$20 million in bank lines to cover NZ\$40 million term debt maturities, NZ\$8.3 million interest, and spending needs in 2021. The council has prefunded NZ\$35 million of the NZ\$40 million maturities in 2021 financial year and has started prefunding of the NZ\$20 million debt maturing in October 2021.

We consider access to the LGFA provides Kapiti, and other local New Zealand councils, with additional sources of external liquidity, particularly during periods of stress in financial markets. In our view, the LGFA benefits from an extremely high likelihood of central government support, and has helped Kapiti lengthen its maturity profile and reduce its interest costs.

Although its prefunding strategy reduces refinancing risks, it also adds to the council's debt burden. Kapiti's level of debt remains very high compared with its peers, though it is improving. We forecast the council will reduce debt to about 221% of operating revenues in 2023 from 270% in 2019. This is driven by a lower stock of debt, but also operating revenues rising after the COVID-19 outbreak. Total tax-supported debt is currently among the highest within local governments that we rate globally. It peaked at 313% of operating revenues in 2017. Kapiti's debt levels rose sharply from about 120% of operating revenues in 2011 following the council's decision to front-load its capital expenditure in the 2012-2022 long-term plan. It has risen further since due to the prefunding strategy.

We consider Kapiti's contingent liabilities to be very small, given the small likelihood of a natural disaster in the region and potential effect on the council. The council is part of the Outer Wellington shared services syndicate with four other councils in the region and is jointly insured to cover above- and below-ground assets.

## Key Statistics

Table 1

### Key Statistics

(mil. NZ\$)	--Year ended June 30--				
	2019	2020bc	2021bc	2022bc	2023bc
<b>Selected Indicators</b>					
Operating revenues	78	80	79	88	91
Operating expenditures	61	68	68	68	70
Operating balance	17	12	12	19	21
Operating balance (% of operating revenues)	22.2	15.2	14.6	21.8	23.4
Capital revenues	6	6	11	4	4
Capital expenditures	23	23	30	28	28
Balance after capital accounts	1	(5)	(7)	(5)	(3)
Balance after capital accounts (% of total revenues)	0.7	(6.2)	(8.0)	(5.8)	(3.2)
Debt repaid	65	45	40	45	40
Gross borrowings	70	44	32	40	45
Balance after borrowings	6	(6)	(15)	(10)	2
Tax-supported debt (outstanding at year-end)	211	210	202	197	202

Table 1

### Key Statistics (cont.)

(mil. NZ\$)	--Year ended June 30--				
	2019	2020bc	2021bc	2022bc	2023bc
Tax-supported debt (% of consolidated operating revenues)	270.0	263.9	255.0	224.7	221.2
Interest (% of operating revenues)	12.2	11.1	10.5	9.3	9.1
National GDP per capita (single units)	62,023	62,615	62,175	66,305	68,886

The data and ratios above result in part from S&P Global Ratings' own calculations, drawing on national as well as international sources, reflecting S&P Global Ratings' independent view on the timeliness, coverage, accuracy, credibility, and usability of available information. The main sources are the financial statements and budgets, as provided by the issuer. bc--Base case reflects S&P Global Ratings' expectations of the most likely scenario. N/A--Not applicable. N.A.--Not available. N.M.--Not meaningful.

## Ratings Score Snapshot

Table 2

### Ratings Score Snapshot

#### Key Rating Factors

Institutional framework	1
Economy	3
Financial management	2
Budgetary performance	1
Liquidity	1
Debt burden	5
Standalone credit profile	aa
Issuer credit rating	AA

S&P Global Ratings bases its ratings on local and regional governments on the eight main rating factors listed in the table above. Section A of S&P Global Ratings' "Methodology For Rating Non-U.S. Local And Regional Governments," published on June 30, 2014, summarizes how the eight factors are combined to derive the foreign currency rating on the government.

## Key Sovereign Statistics

Sovereign Risk Indicators. Interactive version available at <http://www.spratings.com/sri>.

### Related Criteria

- Criteria | Governments | International Public Finance: Methodology For Rating Local And Regional Governments Outside Of The U.S., July 15, 2019
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria | Governments | International Public Finance: Methodology: Rating Non-U.S. Local And Regional Governments Higher Than The Sovereign, Dec. 15, 2014
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

## Related Research

- Default, Transition, and Recovery: 2018 Annual International Public Finance Default And Rating Transition Study, Aug. 19, 2019
- Global Ratings List: Local And Regional Governments 2019, Aug. 3, 2019
- Non-U.S. Local And Regional Government Had A Good Half, Ratings-Wise, July 16, 2019
- New Zealand Councils Remain Highly Rated Even As Debt Expands, June 25, 2019
- Local Government Debt 2019: Global Debt Stock, Outside The U.S., To Exceed US\$11 Trillion By 2020, Feb. 26, 2019
- New Zealand Outlook Revised To Positive On Improving Fiscal Position; 'AA+'LC And 'AA'FC Ratings Affirmed, Jan. 31, 2019
- 2019 Outlook: Prospects For Non-U.S. Local And Regional Governments Remain Sound, Although A Few Risks Loom For Some Entities, Dec. 11, 2018
- Public Finance System Overview: New Zealand's Institutional Framework For Local And Regional Governments, Nov. 12, 2018

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision.

After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee's assessment of the key rating factors is reflected in the Ratings Score Snapshot above.

The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria and Research').

## Ratings List

### Ratings Affirmed

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#### Kapiti Coast District Council

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Issuer Credit Rating AA/Stable/A-1+

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Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at [www.standardandpoors.com](http://www.standardandpoors.com) for further information. Complete ratings

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information is available to subscribers of RatingsDirect at [www.capitaliq.com](http://www.capitaliq.com). All ratings affected by this rating action can be found on S&P Global Ratings' public website at [www.standardandpoors.com](http://www.standardandpoors.com). Use the Ratings search box located in the left column.

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