

Research Update:

# Kapiti Coast District Council Ratings Raised To 'AA/A-1+' On Improving Finances, Revised Criteria; Removed From UCO

July 26, 2019

## Overview

- On July 15, 2019, we published our revised methodology for rating local and regional governments and subsequently placed our ratings on Kapiti under criteria observation (UCO).
- Kapiti's financial position continues to improve with stronger after-capital account balance forecasts helping substantially reduce borrowing needs. The council's liquidity policies also ensure debt service coverage remains higher than in the past, offsetting weaknesses associated with its high debt levels.
- Following our review, we are raising our long-term and short-term ratings on Kapiti to 'AA' from 'A+', and 'A-1+' from 'A-1', respectfully.
- The outlook is stable.

## Rating Action

On July 26, 2019, S&P Global Ratings raised its long-term ratings on Kapiti Coast District Council (Kapiti) to 'AA' from 'A+'. We also raised the short-term rating to 'A-1+' from 'A-1'. The outlook is stable.

At the same time, we removed the "under criteria observation" (UCO) identifier from the ratings.

## Outlook

The stable outlook reflects our expectations that Kapiti's experienced financial management will ensure the council's financial position continues to strengthen, while maintaining conservative debt and liquidity policies resulting in high coverage ratios.

### PRIMARY CREDIT ANALYST

**Anthony Walker**  
Melbourne  
+ 61 3 9631 2019  
anthony.walker  
@spglobal.com

### SECONDARY CONTACTS

**Rebecca Hrvatin**  
Melbourne  
(61) 3-9631-2123  
rebecca.hrvatin  
@spglobal.com

**Jin Zhang**  
Melbourne  
+ 0396312041  
jin.zhang  
@spglobal.com

## Downside Scenario

Downward pressure could occur if there was a change in policy direction resulting in large, sustained deficits of more than 15% of total revenues. This scenario would likely increase debt levels substantially above our forecasts. Further, we could lower the rating if we believe financial management is weakening through a higher risk appetite such as riskier debt and liquidity policies. Alternatively, we would lower the rating if we lowered that 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 substantially below our forecasts, while the council maintained recent improvements in its budgetary performance and liquidity coverage.

## Rationale

The upgrade reflects Kapiti's continually improving credit profile. Stronger after-capital account balance forecasts over the next few years are helping reduce debt levels compared to our previous expectations. The council's liquidity policies, such as its prefunding strategies, also ensure debt service coverage remains higher than in the past, offsetting weaknesses associated with its high debt levels relative to peers.

The rating action also follows the recent publication of our revised "Methodology For Rating Local And Regional Governments Outside Of The U.S.," published on July 15, 2019.

## Strong financial outcomes and prefunding strategy improving rating; debt burden remains high

Kapiti's budgetary performance continues to improve as the council focuses on consolidating its financial position. We expect the council's operating surpluses will remain strong, averaging about 21% from 2018 to 2022. We also forecast the council's after-capital account balance will move into surplus in 2022 after averaging deficits of just 1% of total revenues between 2019 and 2021. This surplus will be Kapiti's first in more than a decade and will curtail borrowing needs compared to previous years. These outcomes are driven by lower capital expenditure, which we believe it will deliver 80% of, and higher operating revenues compared to the past.

Budgetary performance is stronger than we expected last year, when we expected deficits to average 3% of total revenues Kapiti's has incurred sizeable after-capital account deficits in the past. These peaked at 45% of total revenues in 2012 and 2013 resulting in much higher debt levels and the main factor that kept the council's rating lower than peers.

Kapiti's strong revenue and expenditure flexibility compared with domestic and international peers supports its budgetary performance. We believe the council could improve its financial position compared with our base-case forecasts, which incorporate general property rate increases of 4.8% in 2020. The council has a self-imposed rate increase limit of 5.5% a year, but can raise rates above this limit if needed simply by consulting with the public. Further, the council

could delay nonessential capital expenditure reducing its spending by more than the 20%, which we factor into our base case.

Kapiti's liquidity position supports its improved credit profile. Due to its prefunding strategy and access to the New Zealand Local Government Funding Agency (the LGFA), we consider its liquidity coverage to be exceptional. The council's internal cash and liquid assets cover about 120% of upcoming debt maturities and interest costs. This could weaken slightly next year as debt repayments increase. The council is prefunding long-term debt up to 18 months before it matures to reduce refinancing risks, and to take advantage of favorable market conditions resulting in positive cost of carry. This has resulted in higher cash holdings of about NZ\$59 million during the next 12 months, which more than covers upcoming debt of NZ\$45 million and interest of about NZ\$9 million in the next 12 months. Kapiti also has unutilized bank facilities of about NZ\$20 million.

Further, 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 high compared with peers although it is improving. We forecast the council's stronger budgetary performance and rising operating revenues will help reduce debt to about 226% of operating revenues in 2022 from 270% in 2019. Total tax-supported debt is currently amongst the highest in New Zealand and local governments that we rate globally. It peaked at 313% of operating revenues in 2017, however, Kapiti's prefunding strategy contributes about 20% of its current debt levels.

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. We consider Kapiti's contingent liabilities to be very small given the small likelihood of a natural disaster in the region and potential impact 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-ground and below-ground assets.

## **New Zealand's institutional framework and Kapiti's management support the council's credit profile**

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. 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 is seeking to fully fund depreciation by 2022 and it adopts a "green line strategy" that aims to reduce the size of its capital programs and eventually enable the council to start paying down its debt. The council has prudent liquidity policies in its prefunding strategy. We consider the council's debt policies to

be prudent, supported by the council's decision to not proceed with borrowing to establish investment funds, which we consider to be a higher-risk financial strategy. Kapiti uses debt to fund capital expenditure and refinance long-term borrowings, has no issuance of foreign-currency debt, and mostly hedges its interest exposure.

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. 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 to the national average of about 15%, which could pressure the council's ability to raise revenues over the longer term.

## Key Statistics

Table 1

### Kapiti Coast District Council--Financial Statistics

(mil. NZ\$)	--Year ended June 30--						
	2016	2017	2018	2019e	2020bc	2021bc	2022bc
<b>Selected Indicators</b>							
Operating revenues	66	67	76	78	82	86	90
Operating expenditures	56	55	63	60	66	67	68
Operating balance	10	13	13	17	16	19	22
Operating balance (% of operating revenues)	14.5	18.6	16.8	22.4	19.3	22.2	24.2
Capital revenues	2	7	8	6	4	8	4
Capital expenditures	18	24	23	23	20	30	21
Balance after capital accounts	(7)	(4)	(2)	(0)	(1)	(3)	4
Balance after capital accounts (% of total revenues)	(10.3)	(5.4)	(2.1)	(0.2)	(0.9)	(2.7)	4.6
Debt repaid	36	43	105	30	45	60	45
Gross borrowings	56	92	100	35	46	53	45
Balance after borrowings	13	45	(7)	5	(0)	(10)	4
Tax-supported debt (outstanding at year-end)	161	211	206	211	211	203	203
Tax-supported debt (% of consolidated operating revenues)	244.5	313.1	270.9	270.4	257.6	235.8	226.0
Interest (% of operating revenues)	12.7	13.6	12.8	12.1	11.5	10.5	10.1

Table 1

### Kapiti Coast District Council--Financial Statistics (cont.)

(mil. NZ\$)	--Year ended June 30--						
	2016	2017	2018	2019e	2020bc	2021bc	2022bc
National GDP per capita (single units)	55,202	57,429	59,465	61,082	63,139	65,307	67,745

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. dc--Downside case represents some but not all aspects of S&P Global Ratings' scenarios that could be consistent with a downgrade. uc--Upside case represents some but not all aspects of S&P Global Ratings' scenarios that could be consistent with an upgrade. N/A--Not applicable. N.A.--Not available. N.M.--Not meaningful.

## Ratings Score Snapshot

Table 2

### Kapiti Coast District Council--Ratings Score Snapshot

Key Rating Factors	Scores
Institutional framework	1
Economy	3
Financial management	2
Budgetary performance	1
Liquidity	1
Debt burden	5
Stand-alone credit profile	aa
Issuer credit rating	AA

S&P Global Ratings bases its ratings on non-U.S. local and regional governments (LRGs) on the six main rating factors in this table. In the "Methodology For Rating Local And Regional Governments Outside Of The U.S.," published on July 15, 2019, we explain the steps we follow to derive the global scale foreign currency rating on each LRG. The institutional framework is assessed on a six-point scale: 1 is the strongest and 6 the weakest score. Our assessments of economy, financial management, budgetary performance, liquidity, and debt burden are on a five-point scale, with 1 being the strongest score and 5 the weakest.

## 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**

- Guidance | Criteria | Governments | International Public Finance: Methodology For Rating Local And Regional Governments Outside Of The U.S., July 15, 2019
- Public Finance System Overview: New Zealand's Institutional Framework For Local And Regional Governments, Nov. 12, 2018
- New Zealand Councils Remain Highly Rated Even As Debt Expands, June 25, 2019
- New Zealand Outlook Revised To Positive On Improving Fiscal Position; 'AA+' LC And 'AA' FC Ratings Affirmed, Jan. 31, 2019
- Non-U.S. Local And Regional Government Had A Good Half, Ratings-Wise, July 16, 2019
- Ratings History List: Asia-Pacific Local And Regional Government Ratings Since 1975, March 8, 2019
- Local Government Debt 2019: Global Debt Stock, Outside The U.S., To Exceed US\$11 Trillion By 2020, Feb. 26, 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
- Default, Transition, And Recovery: 2017 Annual International Public Finance Default Study And Rating Transitions, June 11, 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

### Upgraded; CreditWatch/Outlook Action

	To	From
<b>Kapiti Coast District Council</b>		
Issuer Credit Rating	AA/Stable/A-1+	A+/Positive/A-1

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