Research Update:

Kapiti Coast District Council Outlook Revised to Stable On Improved Economic Fundamentals; 'AA/A-1+' Ratings Affirmed

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Overview

- Economic growth prospects for Kapiti Coast District Council have improved, bolstered by its growing population and linkages with New Zealand's national capital--Wellington.
- As a result, Kapiti's capital expenditure is elevated, which will ensure the local government's after-capital deficits and debt levels remain relatively high compared with peers.
- The council's robust prefunding policy and financial management should ensure liquidity coverage remains strong, offsetting risks associated with high debt levels.
- We revised the outlook on Kapiti to stable from negative and affirmed our 'AA/A-1+' issuer credit ratings.

Rating Action

On July 25, 2022, S&P Global Ratings revised its long-term rating outlook on Kapiti Coast District Council, a New Zealand local government, to stable from negative. At the same time, we affirmed our 'AA/A-1+' issuer credit ratings on the council.

Outlook

The stable outlook reflects our view that Kapiti's financial management and liquidity policies will ensure liquidity coverage remains above 80% of debt service during a period of elevated capital spending.

Downside scenario

We could lower our ratings if capital spending by Kapiti exceeds our forecasts, or the council changes its pre-funding strategy, putting downward pressure on liquidity coverage or driving debt levels much higher than we anticipate. These scenarios could cause us to re-evaluate our view on Kapiti's financial management.

There could also be downward pressure on the rating if the New Zealand government's (the Crown) "Three Water" reforms, slated to commence on July 1, 2024, adversely affect the council's credit profile. This could occur if the reforms weaken budgetary performance or liquidity coverage, or increase debt levels relative to operating revenues.

Upside scenario

We could raise our ratings on Kapiti if the council were to significantly reduce after-capital deficits, leading to a declining debt burden while maintaining strong liquidity coverage.

There could be upward pressure on the rating if the Crown's "Three Water" reforms structurally improve budgetary performance without narrowing the council's liquidity, and structurally reduce debt levels relative to operating revenues.

Rationale

The council's credit profile is bolstered by Kapiti's improving economic growth prospects. The council is enjoying flow-on effects of widespread hybrid-working policies, relatively cheaper housing, and improved linkages to Wellington after the opening of the Transmission Gully motorway.

This growth is requiring the council to increase its capital expenditure (capex). Kapiti's relatively large capex plans are putting pressure on its financial position through persistent, large after-capital deficits and rising debt levels.

Strong financial management including Kapiti's liquidity policies, such as the debt prefunding strategy, should ensure that the council's debt-service coverage remains high. This strategy, as well as its access to the New Zealand Local Government Funding Agency (LGFA), partially offsets risks associated with Kapiti's very high debt levels relative to its peers.

Our base case excludes the potential effect of the Crown's proposed "Three Water" reforms. The reform program, as currently envisaged, could see responsibility for drinking water, wastewater, and stormwater assets taken away from councils and amalgamated into four new regional water service entities from mid-2024. The reforms are still under development.

Improving economic prospects, excellent institutional framework, and strong financial management underpin Kapiti's creditworthiness.

The council's local economy supports its credit profile. Kapiti's economy is benefiting from the widespread hybrid working arrangements across New Zealand, and better access to Wellington. The opening of the Transmission Gully Motorway in March 2022 reduces commute times to Wellington by about 10 minutes. This, along with the cost of housing, makes Kapiti a more attractive location for employees working in Wellington, including the capital's resilient and high paying public service sector. To cater for this growth, the council is investing in infrastructure to support an additional 32,000 residents and 15,000 dwellings over the next 30 years as part of its new Housing Strategy.

According to Infometrics (a New Zealand economic consultancy), Kapiti's economy grew by 7.4% in the year to March 31, 2022, reflecting strong construction activity and its growing population.

The economy has proven resilient during the Covid-19 pandemic. Kapiti's economy benefited from a higher proportion of residents employed as professionals or managers, when compared with the New Zealand average, and less exposure to tourism, agriculture and manufacturing than domestic peers.

Kapiti has a population of around 58,000 and is one of the six subregions in the Greater Wellington area. Prior to the pandemic, it was estimated that more than 10,000 of Kapiti's residents commute to Wellington for work each day. Official GDP per capita of NZ$25,000 in Kapiti is well below the national average of NZ$63,500, owing largely to the output of its residents being captured within Wellington's economic data. Another reason for its lower GDP is in part because of the district's relatively older population. The proportion of residents aged over 65 is 26.3%, compared with the national average of 16.0%. We don't believe the GDP per capita accurately reflects the wealth of the district because the average household income of Kapiti residents in 2019 was NZ$94,800, compared with the national average of NZ$106,600.

New Zealand's extremely strong and predictable institutional framework underpins Kapiti's credit profile. We believe the country's institutional framework is one of the strongest and most predictable globally. The New Zealand local government system also 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 level.

We consider Kapiti's management to be strong. We expect the strategic direction of the council to remain steady following the October 2022 local government elections. Likewise, we expect its experienced management team to deliver on the majority of its 2021-2041 long-term plan; although delivering its elevated capital budget will be difficult given capacity and supply constraints the sector its facing. The council prepares long-term plans every three years, annual plans in the intervening years, and audited end-of-year annual reports, in line with national requirements. This 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. We consider the council's debt and liquidity policies to be prudent. Preparing the prefunding strategy up to 18 months in advance of debt maturities minimizes refinancing risks. Kapiti doesn't use debt to fund operating expenses, has no issuance of foreign-currency debt, and mostly hedges its interest exposure.

Elevated capital spending driving large deficits and rising debt levels; prefunding strategy remains key strength to support liquidity.

Kapiti outlined an ambitious capital program in its 2021-2041 long-term plan, focusing on investments in water, roading and coastal infrastructure to cater to its growing population. We estimate the council will run persistent after-capital deficits exceeding 15% until capital spending starts to wind down. The council underspent significantly on capex in 2022, reflecting challenging operating conditions, and capacity and supply constraints inhibiting the construction sector since the start of the pandemic. We forecast NZ$43 million of capex in 2022, compared with NZ$73 million in the council's long-term plan, with the shortfall to be carried over to subsequent years. Our capex forecasts rise to about NZ$60 million a year from 2023 onward; well-below those budgeted by the council.

Despite these weak fiscal outcomes, we believe Kapiti has a high level of flexibility within its budget to increase property rates and user charges, as demonstrated in its long-term plan. The council is increasing property rate by about 8% per year between 2022-2024 to contribute to higher capital spending, before moderating from 2025. Further, given its elevated capital plans, the council could easily defer a number of projects to ease pressure on its budget.

Kapiti's large capital program and its prefunding debt strategy continue to add to its debt level. The council has a high level of debt compared with its peers. We forecast the ratio of total tax-supported debt to operating revenues will reach about 303% in 2025, up from 250% in 2022. The council's total tax-supported debt is currently among the highest in the local governments that we rate globally. Kapiti's debt peaked at 313% of operating revenues in 2017, rising sharply from about 120% of operating revenues in 2011, following the council's decision to front-load capex in its 2012-2022 long-term plan as well as its prefunding debt strategy. This strategy accounts for about 20% of its outstanding debt--without it, debt would be closer to 240% of operating revenues.

Kapiti's prefunding debt strategy results in exceptional liquidity coverage. The council prefunds debt maturities 12-18 months in advance. Its internal cash and liquid assets cover about 115% of upcoming debt maturities, interest costs, and budget needs. At the end of 2022, we estimate the council will have about NZ$11 million of cash, NZ$60 million in term deposits (from its prefunding strategy), and NZ$10 million in undrawn bank lines to fund NZ$45 million of debt maturities in 2023 and the council's capital spending needs in 2023. In addition, 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.

We consider Kapiti's contingent liabilities to be small, given the low 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. The council altered its insurance policy. It no longer insures noncritical infrastructure and will instead direct savings into a self-insurance fund.

Key Statistics

Key Statistics

(mil NZ$)	--Year ended June 30---				
Selected indicators	**2021**	**2022e**	**2023bc**	**2024bc**	**2025bc**
Operating revenues	89	95	104	110	115
Operating expenditures	62	78	79	83	86
Operating balance	26	17	25	27	29
Operating balance (% of operating revenues)	29.5	18.0	24.5	24.7	25.1
Capital revenues	11.5	9.3	15.9	7.9	6.7
Capital expenditures	32.8	43.0	59.9	58.5	56.7
Balance after capital accounts	4.9	(16.7)	(18.5)	(23.3)	(21.0)
Balance after capital accounts (% of total revenues)	4.9	(16.1)	(15.4)	(19.7)	(17.3)
Debt repaid	40.0	45.0	45.0	55.0	65.0
Gross borrowings	60.0	70.0	70.0	90.4	95.8
Balance after borrowings	24.9	8.3	6.5	12.1	9.8

Key Statistics (cont.)

(mil NZ$)	--Year ended June 30---				
Selected indicators	**2021**	**2022e**	**2023bc**	**2024bc**	**2025bc**
Direct debt (outstanding at year-end)	232	257	282	317	348
Direct debt (% of operating revenues)	261.5	270.9	270.8	287.6	302.7
Tax-supported debt (outstanding at year-end)	232	257	282	317	348
Tax-supported debt (% of consolidated operating revenues)	261.5	270.9	270.8	287.6	302.7
Interest (% of operating revenues)	9.5	8.6	8.6	10.0	10.5
National GDP per capita (single units)	67,091	70,335	75,475	78,248	81,014

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. e--Estimate. bc--Base case reflects S&P Global Ratings' expectations of the most likely scenario.

Ratings Score Snapshot

Kapiti Coast District Council - Ratings Score Snapshot

Key rating factors	Score
Institutional framework	1
Economy	2
Financial management	2
Budgetary performance	3
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. An interactive version is available at https://www.spratings.com/sri.

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- 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
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Credit Implications of New Zealand's Proposed "Three Water" Reforms, May 10, 2022
- Institutional Framework Assessment: New Zealand Local Governments, April 28, 2022
- Local Government Debt 2022: Rising Risks Keep Global Borrowing High, April 13, 2022
- Institutional Framework Assessments For International Local And Regional Governments, April 12, 2022
- Credit Conditions Asia-Pacific Q2 2022: A Divide Takes Shape, March 29, 2022
- New Zealand Local Government Funding Agency Ltd., March 3, 2022
- Local And Regional Governments Outlook 2022: Long-Term Challenges Resurface As The Pandemic Eases, Feb. 3, 2022
- 25 Ratings In 25 Years: New Zealand Councils Prove Their Staying Power, Feb. 2, 2022
- Global Ratings List: International Public Finance Entities 2021, Oct. 13, 2021
- Default, Transition, and Recovery: 2020 Annual International Public Finance Default And Rating Transition Study, Sept. 14, 2021
- Comparative Statistics: Asia-Pacific Local And Regional Government Risk Indicators, Sept. 1, 2021
- Ratings History List: Asia-Pacific Local And Regional Government Ratings Since 1975, May 29, 2020

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; CreditWatch/Outlook Action

	To	From
Kapiti Coast District Council		
Issuer Credit Rating	AA/Stable/A-1+	AA/Negative/A-1+

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