Research Update:

Kapiti Coast District Council Outlook Revised To Negative On Weakening Budgetary Metrics; 'AA/A-1+' Ratings Affirmed

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Overview

- Kapiti Coast District Council has weak budgetary metrics, given inflationary pressures on its operating budget while capital expenditure (capex) is at a record high.
- Wider deficits will weigh on the council's liquidity coverage, while pushing up its gross debt to 309% of operating revenues by fiscal 2026 (year-end June 30). This is higher than the level for all other 'AA'-rated peers globally.
- We revised the outlook on the long-term rating on Kapiti to negative from stable. At the same time, we affirmed our 'AA/A-1+' issuer credit ratings.
- The negative rating outlook reflects the possibility that Kapiti's budgetary metrics will not recover in line with our expectations over the next two years.

Rating Action

On July 21, 2023, S&P Global Ratings revised its long-term rating outlook on Kapiti, a New Zealand local government, to negative from stable. At the same time, we affirmed our 'AA/A-1+' issuer credit ratings on the council.

Outlook

The negative outlook reflects our view that Kapiti's budgetary metrics will remain weak over the next two years, potentially leading to higher debt and narrowing tolerances within the 'AA' rating.

Downside scenario

We could lower our long-term rating on Kapiti if its after-capital account deficit does not materially improve as we forecast. This could occur if the council is less willing and has less flexibility to adjust its budget than we currently believe.

Upside scenario

We could revise the outlook to stable if Kapiti reduces its after-capital account deficits materially. This would result in lower stabilizing debt, and potentially higher liquidity coverage, than our forecasts.

Rationale

Higher recurring costs could weaken Kapiti's credit metrics if the council fails to widen its revenue sources amid extended inflation over the next two years. The council's operating expenses have ballooned over the past year due to sharply higher operating and staff costs.

The challenges will remain, although Kapiti expects upside to revenues via new grants from the New Zealand central (Crown) government. Wider after-capital deficits could continue to drive the council's debt higher. The council has higher debt to operating revenue than all 'AA'-rated peers globally.

We expect rising interest costs and growing deficits to structurally weaken Kapiti's liquidity coverage. That said, the council's debt prefunding strategy will keep its liquidity afloat, and underpin its strong financial management. This strategy, as well as the council's access to the New Zealand Local Government Funding Agency (LGFA), partially offsets risks from very high debt levels relative to peers.

Our base case excludes the potential effects of the Crown's proposed water reforms. The reform program, as currently envisaged, could shift the responsibility for drinking water, wastewater, and stormwater assets from local government councils to 10 new regional water service entities from early 2025. The reforms are still under development.

Elevated operating expenses will contribute to larger after-capital account deficits and rising debt; prefunding strategy remains key to liquidity. We estimate Kapiti will run after-capital account deficits averaging 22% over fiscal years 2024-2026 as it moves forward with its large infrastructure program. Our new base case assumes wider deficits than before, mainly due to inflation in the council's operating budget. The council has managed to stay well-staffed in a tight and competitive labor market, allowing it to deliver a record amount of capital spending. Its after-capital account deficit weakened to more than 32% of total revenues in 2023.

Kapiti expects to deliver NZ$64 million in capital expenditure (capex) over fiscal 2023. We forecast declining capex year on year, averaging NZ$61 million over the next three years. This is about 2.5x higher than the capex delivered in fiscal years 2019-2021. The council's 2024 annual plan includes an ambitious infrastructure pipeline, consisting of upgrades to water infrastructure, roads, and coastal infrastructure.

Despite weak fiscal outcomes, we believe Kapiti has more budgetary flexibility than international peers. The council is able to freely adjust its own-source revenues to meet its spending needs. General property rates, fees, and user charges typically make up 80%-90% of its annual operating revenues.

Kapiti increased general rates by 7.8% in fiscal 2024 to partially offset higher inflation than it expected in its cost of delivering services. Furthermore, the council could defer or cancel non-essential capital plans to support budgetary outcomes.

Kapiti's large capital program and prefunding strategy continue to add to its debt. We forecast a ratio of total tax-supported debt to operating revenue of about 309% by 2026, up from 274% in 2022. Interest costs could average 11% of operating revenues over fiscal years 2023-2025, although the council remains well-hedged against interest rate movements.

Kapiti's internal liquidity, which includes interest costs and upcoming budgetary needs, has fallen versus our previous expectation. This is due to wider after-capital account deficits and rapidly rising interest rates. In our view, liquidity remains one of the council's key credit strengths, with support from its policy to prefund upcoming debt maturities up to 18 months in advance.

Kapiti's cash and liquid assets after budgetary needs will be sufficient to cover 93% of upcoming debt maturities, and interest costs, in our estimation. As of June 30, 2023, the council had about NZ$15 million of cash and term deposits and NZ$55 million in term deposits linked to upcoming debt maturities.

Additionally, Kapiti had NZ$10 million in undrawn bank lines. Upcoming debt service requirements for the next 12 months include NZ$55 million of term debt maturities and NZ$13 million of interest costs, by our estimate. The council has prefunded all upcoming maturities for the next 12 months.

Access to 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, 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, mainly reflecting its exposure to natural disasters such as floods and earthquakes. The council is part of the Outer Wellington shared services syndicate with four other councils in the region and is jointly insured for above- and below-ground assets.

An 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 widespread hybrid working arrangements across New Zealand, and improved access to the Wellington central business district. The opening of the Transmission Gully Motorway in early 2022 and more affordable housing than Wellington make Kapiti an attractive location for Wellington-based workers.

Kapiti will be upgrading its 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 2.7% in the year to March 31, 2023. This reflected strong consumer spending and construction activity. The local economy has a higher proportion of residents employed as professionals or managers than the New Zealand average, and is less exposed to tourism, agriculture, and manufacturing than domestic peers.

The Kapiti Coast district had about 57,600 residents as of June 30, 2022. Prior to the pandemic, more than 10,000 of the residents commuted to Wellington for work each day.

According to the Ministry for Business, Innovation and Employment, Kapiti's GDP per capita is less than half of the national average. This is largely because the output of its residents is captured within Wellington's economic data. Another reason is the district's relatively older population. The district has about 26.6% of residents aged over 65, compared with the national average of 16.4%. Average household income in Kapiti was about 20% lower than the national average in 2022, according to Infometrics.

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 promotes a strong management culture, fiscal discipline, and high levels of financial disclosure among local councils.

Additionally, the framework supports the rate-collection ability of the councils. The system allows Kapiti to support higher debt than some of its international peers at the current rating level.

We consider Kapiti's management to be strong. The district elected a new mayor, Janet Holborow, in October 2022. Ms. Holborow had served as deputy mayor for the last two council terms. The council also appointed Darren Edwards as chief executive in October 2022.

Kapiti 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 sets an important baseline for the council's operating and capex requirements, and funding strategy.

In our view, Kapiti has prudent liquidity policies. Preparing its prefunding strategy up to 18 months in advance of debt maturities minimizes refinancing risks. The council does not use debt to fund operating expenses, does not issue foreign-currency debt, and mostly hedges its interest exposure.

Key Statistics

Key Statistics

(mil. NZ$)	Year ended June 30				
	2022	2023e	2024bc	2025bc	2026bc
Selected Indicators					
Operating revenues	94	105	116	117	122
Operating expenditures	73	91	97	96	100
Operating balance	20	15	19	21	22
Operating balance (% of operating revenues)	21.5	13.8	16.3	17.8	18.0
Capital revenues	15	11	11	13	12
Capital expenditures	45	64	65	60	59
Balance after capital accounts	(10)	(38)	(35)	(26)	(24)
Balance after capital accounts (% of total revenues)	(9.7)	(32.4)	(27.4)	(20.0)	(18.3)
Debt repaid	45	45	55	60	60
Gross borrowings	70	65	95	90	90
Balance after borrowings	15	(18)	5	4	6
Tax-supported debt (outstanding at year-end)	256	276	316	346	376
Tax-supported debt (% of consolidated operating revenues)	273.6	262.2	272.5	295.5	308.7
Interest (% of operating revenues)	8.8	10.1	11.0	11.9	12.5

Key Statistics

(mil. NZ$)	Year ended June 30				
	2022	2023e	2024bc	2025bc	2026bc
Selected Indicators					
National GDP per capita (single units)	70,956	75,662	76,757	79,640	82,902

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

Institutional framework	1
Economy	2
Financial management	2
Budgetary performance	3
Liquidity	2
Debt Burden	5
Stand-alone credit profile	aa
Issuer credit rating	AA

Key Sovereign Statistics

- Sovereign Risk Indicators. An interactive version is available at http://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

- Economic Outlook Asia-Pacific Q3 2023: Domestic Demand, Inflation Relief Support Asia's Outlook, June 26, 2023
- Default, Transition, and Recovery: 2022 Annual International Public Finance Default And Rating Transition Study, May 24, 2023

- Institutional Framework Assessment: New Zealand Local Governments, May 17, 2023
- New Zealand Local Government Funding Agency, March 1, 2023
- Pipedream Or Panacea: New Zealand's "Three Waters" Reforms Pt.1, Feb. 27, 2023
- Pipedream Or Panacea: New Zealand's "Three Waters" Reforms Pt.2, Feb. 27, 2023
- Global Ratings List: International Public Finance Entities 2023, Jan. 9, 2023
- Local And Regional Governments Outlook 2023: Rougher Seas Ahead, Nov. 29, 2022
- Credit FAQ: Lifting The Lid On New Zealand's "Three Waters" Reforms, Oct. 12, 2022
- Comparative Statistics: Local And Regional Government Risk Indicators: Asia-Pacific LRGs' Post-Pandemic Appetite For Capital Spending Is Strong, Sept. 22, 2022

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/Negative/A-1+	AA/Stable/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.