Thames Coromandel District Council – Funding and Interest Rate Strategy

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Interest rate strategy recommendation

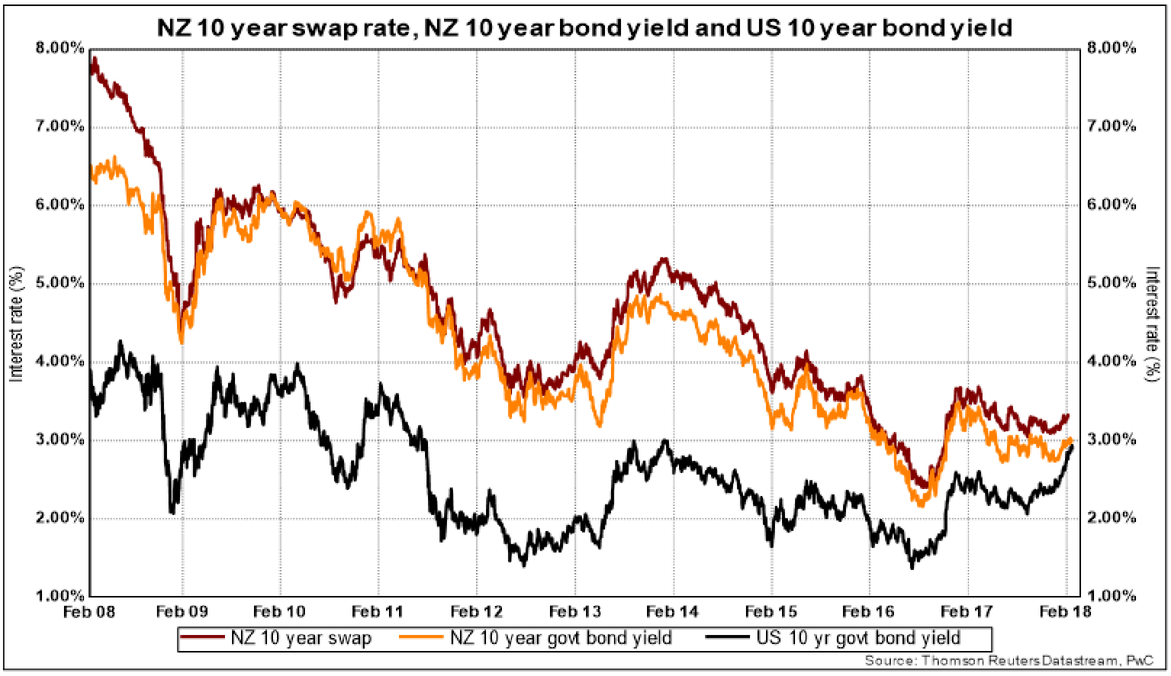
Market Overview

As discussed in our recent treasury meeting, please find below an interest rate strategy to ensure Thames Coromandel District Council ("Council') achieves compliance with Policy parameters and to extend the term of Council's fixed rate portfolio.

New Zealand long-term interest rates (e.g. 10-year New Zealand Government Bonds) typically move in lockstep with US 10-year Treasury bond yields.

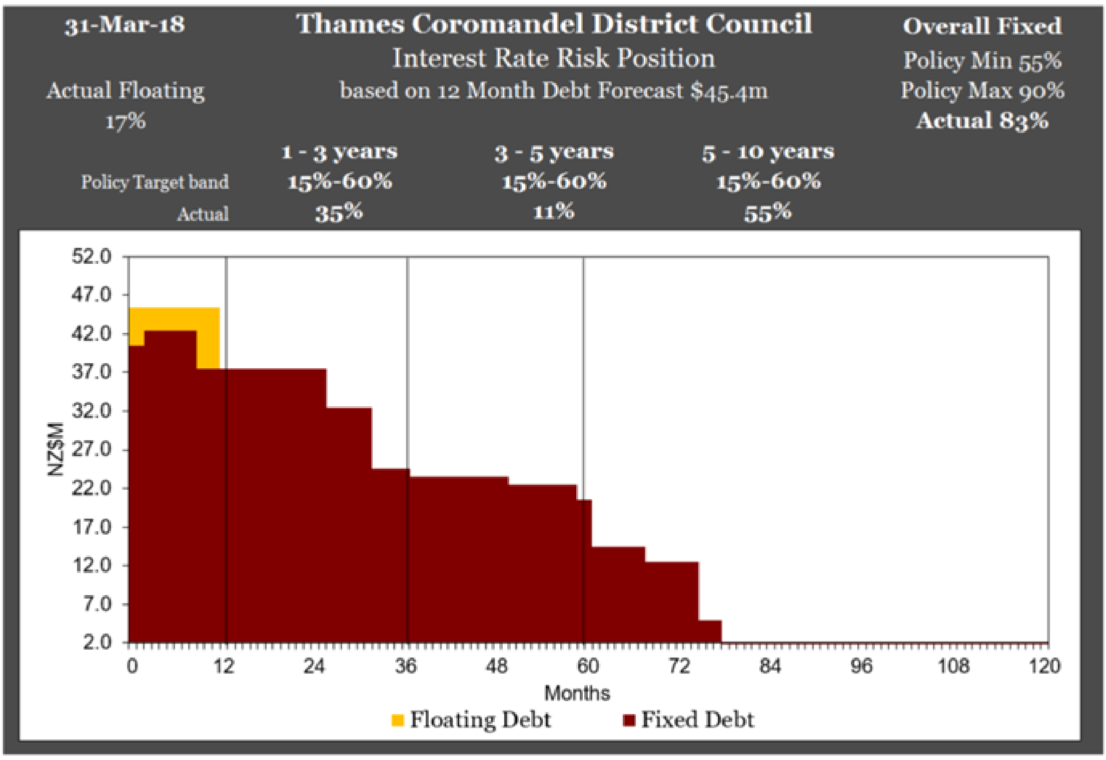
Over the last month we have observed the US 10-year Treasury bond yield break above key resistance levels (at 2.60%) to trade above 2.85% currently. We see further potential for the United States 10-year Treasury yield to increase. Financial markets are pricing in the expectation of the Federal Reserve delivering three (and possibly four) Fed Funds Rates increases this year, as inflation pressures mount and a neutral monetary policy position is sought.

Although New Zealand long-term rates have increased, the movement has been relatively slight compared with US interest rate movements (20 basis points v 50 basis points). With the spread between the New Zealand 10-year Government Bond and US 10-year Treasury at historical lows, we expect the New Zealand 10-year Government Bond yields (and the New Zealand 10-year swap rate) to follow its US counterpart. This movement would see the re-establishing of the historical relationship 'risk premium', resulting in New Zealand long-term interest rates higher over the next 12-months.



Recommended strategy

Council's projected interest rate risk position, as at 31 March 2018, based off the interest rate risk position data provided to us is as follows (including the 12-month debt forecast figure of $45.4 million):



Council are currently non-compliant to maturity sub-limits in the 3-5 year timeframe (11% v 15% minimum). PwC recommends the following linked forward starting quarterly/quarterly borrower swaps to both:

1. Ensure Council achieves Policy compliance, and
2. Extend the term of Council's fixed portfolio to further protect long-term borrowing costs

The below pricing is based on indicative wholesale market pricing, which is exclusive of any KVA pricing adjustments banks may make.

Notional (NZDm)	Start Date	Maturity Date	Indicative Swap Rate
3.00	29 May 2020	29 November 2025	3.39%
4.00	23 November 2020	23 November 2026	3.52%
7.50	10 June 2024	31 March 2028	3.83%

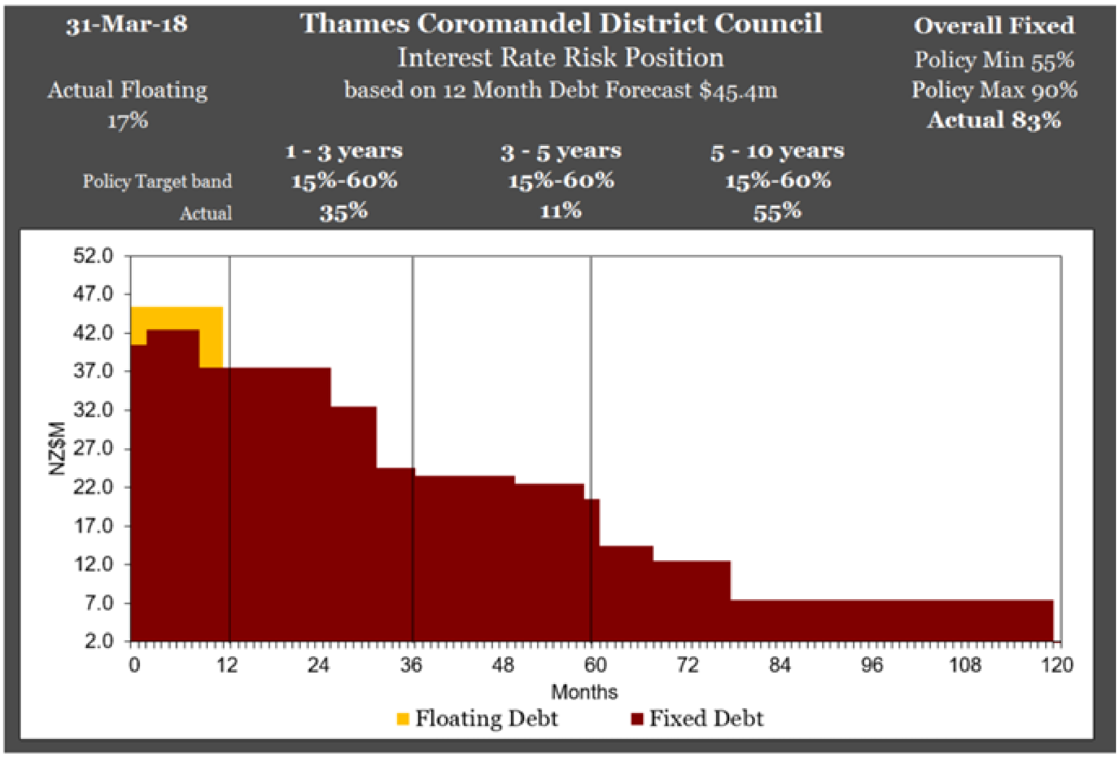
Note that the start dates of the forward starting borrower swaps coincide with the maturity dates of existing borrower swaps, thus the overall fixed rate percentage of the fixed portfolio (83%) does not increase. Council will continue to pay the fixed rates on the existing borrower swaps until the expiry date. The new forward starting borrower swaps do not impact Councils' current borrowing costs.

Following implementation of the aforementioned forward starting borrower swaps, Council will increase the term of its fixed portfolio from 4.0 years to 5.51 years.

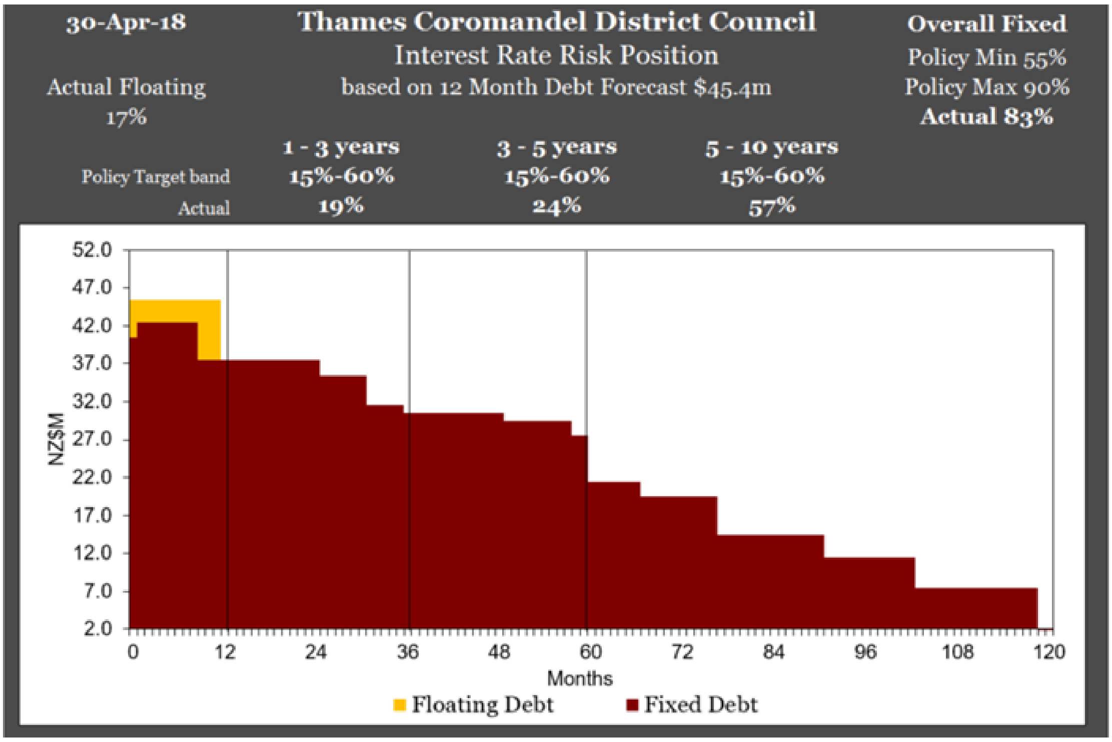
In order to ensure that Council's non-compliance with Policy limits is not immediately exacerbated by the transaction of the above swaps, implementation of the strategy is recommended to be completed in stages.

Specifically, the $7.5 million swap maturing 31 March 2028 is recommended to be transacted presently, however, the remaining two swaps must be implemented post 20 April 2018 in order to not cause a further breach of Policy maturity sub-limits. The interest rate profiles following this staged implementation process are shown below.

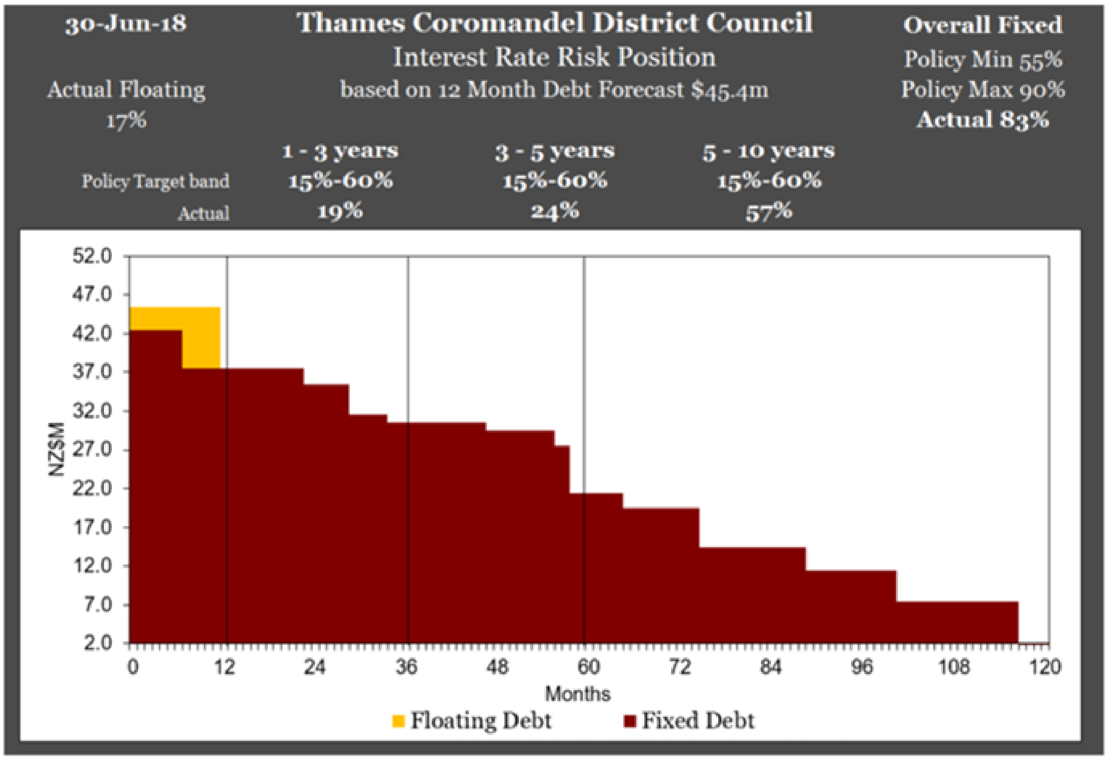
As at 31 March 2018; transaction of $7.5 million swap maturing 31 March 2028:



As at 30 April 2018; transaction of remaining two swaps recommended:



As at 30 June 2018, Council's projected interest rate risk position will be:



PwC recommends requesting pricing from your panel of banks, as we have recently observed differences in pricing between banks as a result of KVA margin adjustments.

When requesting pricing please ensure to ask what right-to-break clauses the banks are requiring, along with a breakdown of the wholesale and KVA components.

We can provide email narrative to send to the banks for pricing should you require.

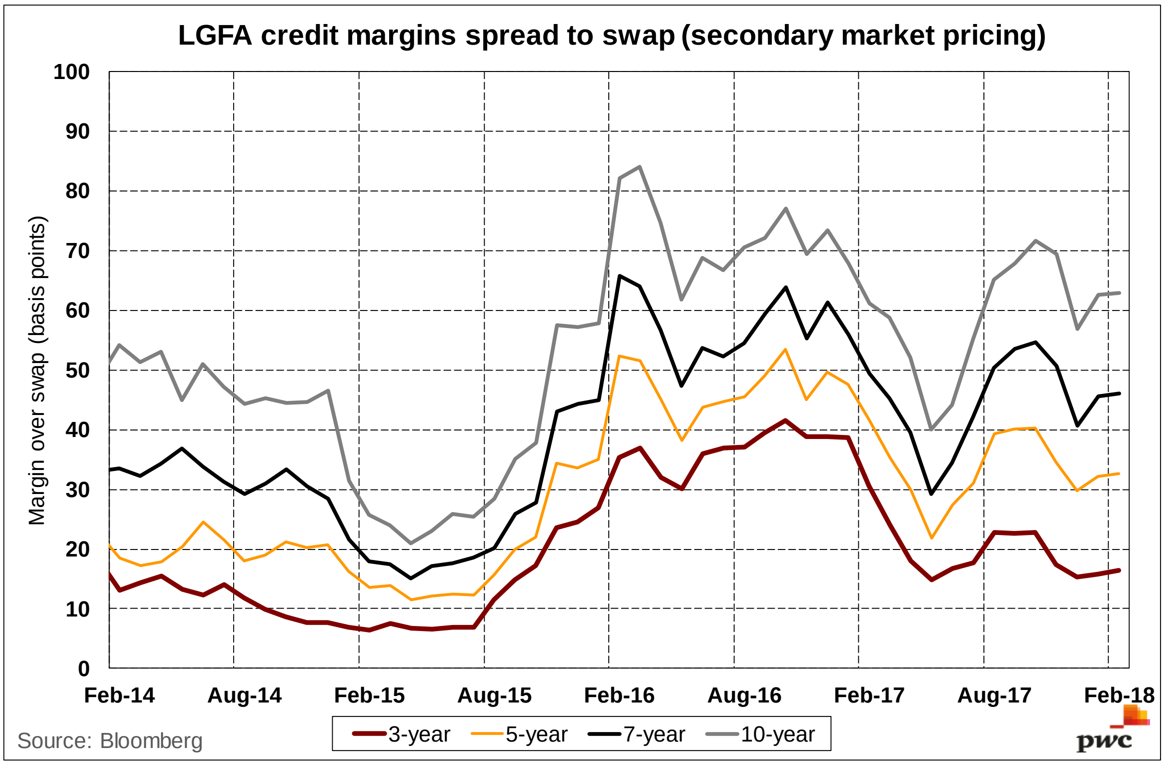
Funding strategy recommendation

Market Overview

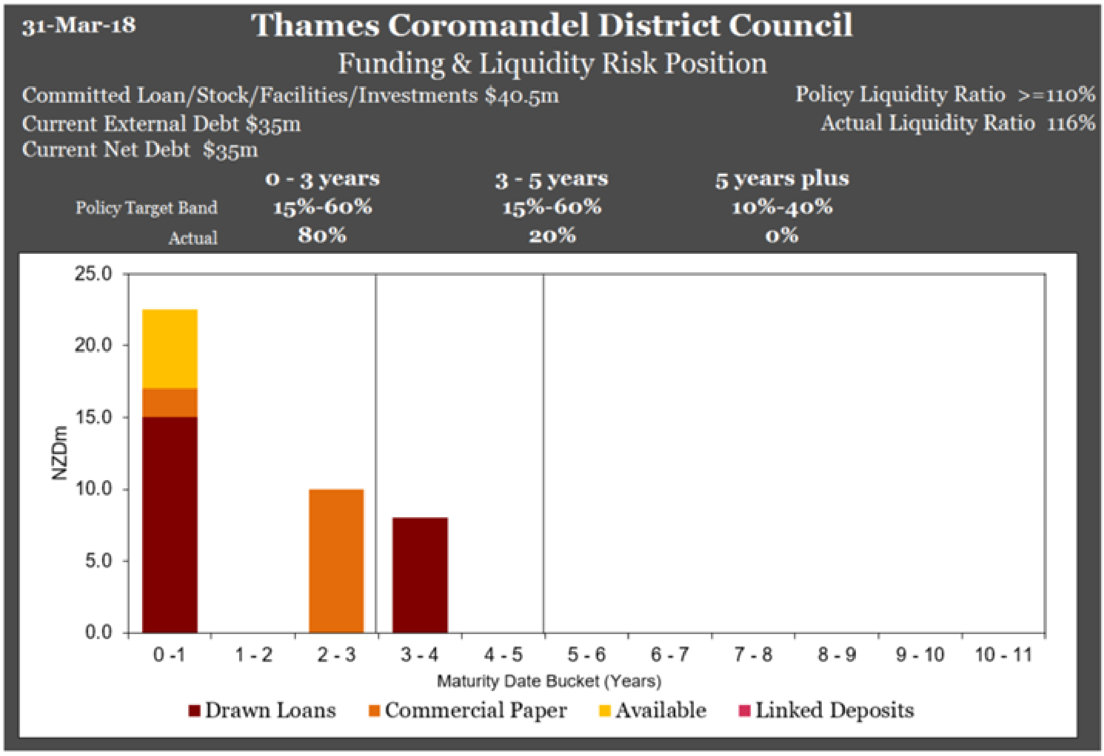
Further to our interest rate hedging recommendation and as discussed in our recent treasury meeting, PwC have outlined a recommended funding strategy that manages Council's Policy non-compliance risk position.

The current funding market environment appears poised for a widening in credit margins as investor appetite for longer dated investment maturities wanes. Recent evidence has suggested that investors are reducing the duration of their fixed interest investment portfolios as US wholesale interest rates increase. The implication being that credit margins for longer dated borrowing tenors are biased to increase over coming months.

This outlook is supported as seen in recent LGFA tenders where the longer dated tenors have not been actively sought.



We recommend the following funding strategy to manage Council's non-compliance to Policy parameters within the projected risk position as at 31 March 2018 (see below):



As shown above, Council is non-compliant within the 0-3 and 5 years plus maturity limits.

We recommend the following actions are taken to ensure Council achieves compliance with Policy parameters as at 31 March 2018. We have assumed that the total term debt and bank facility amounts remain unchanged, and that existing debt is considered long-term intergenerational debt.

Recommended strategy

1. **Refinance the upcoming 15 March 2018 maturity of $12 million Commercial Paper (CP) through Floating Rate Notes (FRN) with the LGFA**

In December, Council issued CP through the LGFA to meet short term funding requirements and also allow time to confirm its core borrowing requirements through the LTP process. With LTP debt forecasts largely confirmed, we understand that it is appropriate to refinance the CP into longer dated term debt to support Council's on-going term debt funding requirements. The following FRNs are recommended to be issued through the LGFA:

Amount (NZDm)	Maturity Date	Indicative Secondary Market Pricing
6.00	15 April 2022	58 bps
6.00	15 April 2023	67 bps

The term of the recommended FRNs provides a lengthening of Council's debt funding maturity profile and more certainty over borrowing costs.

2. Pre-fund $10 million of the upcoming LGFA 15 March 2019 maturity of Floating Rate Notes (FRN)

Council have $15 million of FRNs maturing on 15 March 2019 with the LGFA. In order to achieve compliance with funding risk control limits, $10 million of these FRNs are recommended to be pre-funded into new FRNs with longer dated borrowing tenors. The following FRNs are recommended to be issued through the LGFA:

Amount (NZDm)	Maturity Date	Indicative Secondary Market Pricing
5.00	15 April 2024	76 bps
5.00	15 April 2025	85 bps

Please note that no pre-funding can be completed unless within 12 months to maturity of the above FRNs (i.e. no pre-funding activity can be completed before 15 March 2018).

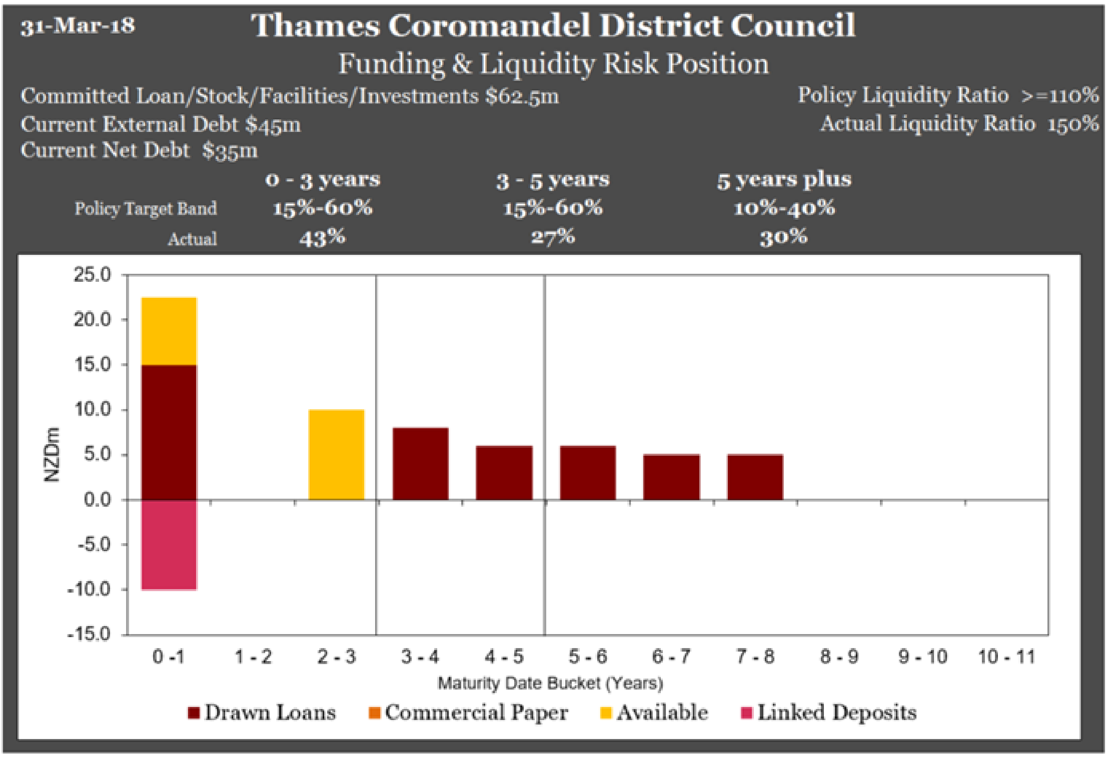
3. Council place the proceeds of the above $10 million of FRNs on bank term deposit

With Council not having an immediate requirement for the proceeds of this pre-funding (i.e. the two $5 million FRNs above), the proceeds can be placed on bank term deposit to a term matching the LGFA maturity which is being pre-funded (i.e. 15 March 2019) or a few days prior, to ensure funds are available for repayment as indiciated below.

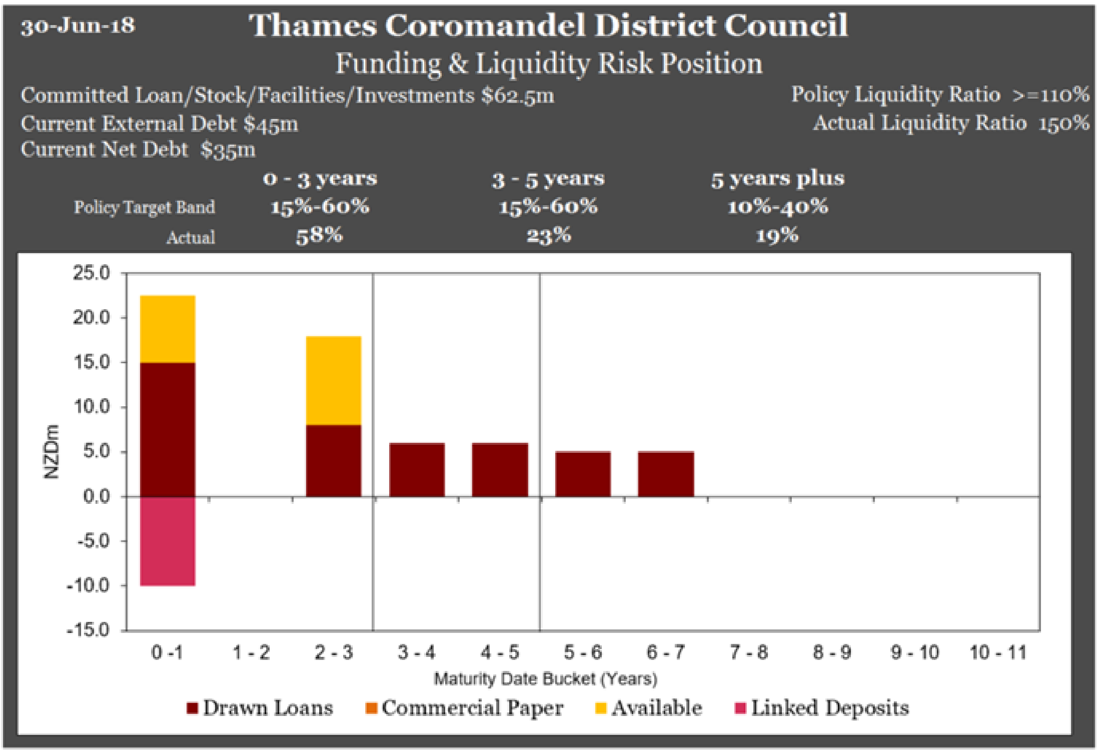
A new $10 million bank term deposit maturing 12 March 2019 would likely be around 3.45% (153 basis points above current BKBM at 1.92%).

However, this action will result in Council's balance sheet being 'grossed-up' over balance date and the term of the investment. Furthermore, any borrowing resolution impact should also be considered before strategy execution.

Following the implementation of the strategy, Councils funding and risk position as at 31 March 2018 will be as follows:



As at 30 June 2018, Council's projected funding and risk position will be as follows:



Following the implementation of this funding strategy, Council will achieve compliance across all Policy parameters as well as extending the term of funding maturities to further support borrowing cost certainty..

If you have any questions, please feel free to contact us.

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