

NEW ZEALAND INTEREST RATE STRATEGY LGFA INAUGURAL TENDER AND PRICING ANALYSIS

SUMMARY

We consider today's inaugural LGFA bond tender to have been a success, attracting solid bidding. We were also encouraged by the margin the DMO achieved in this first issue, which one would expect to have a sizeable "price discovery" premium. However, in the event, the margins achieved were generally better than a selection of comparable AAA rated peers.

BACKGROUND

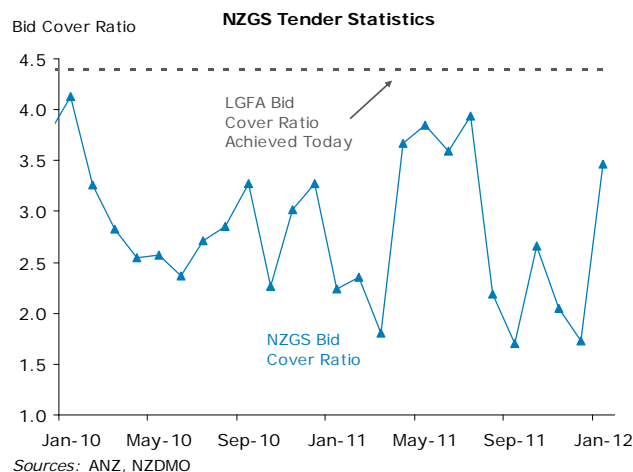
The Local Government Funding Agency (LGFA) was established in December 2011 for the purpose of raising funds for its shareholder members, being a collection of local authorities, including the major authorities in most (but not all) of New Zealand's major cities. Borrowings by the LGFA are jointly and severally guaranteed by its members. However, importantly, the LGFA is not guaranteed by the New Zealand government. Standard & Poor's (S&P) have rated the LGFA AA+ (local currency) and AA (foreign currency). It is expected that the LGFA will issue \$1bn of debt in 2012, via tenders conducted by the NZDMO. Today's tender is the first such tender.

TENDER RESULTS

The table below highlights how well today's tender went, with overall bid cover of 4.4 times. As the chart at top right of the page shows, this is well up on the post-2009 average bid cover ratio achieved in NZGS tenders, of 2.9 times. It is also well above the monthly average NZGS bid cover for any month since 2010.

Bond	Volume Offered \$m	Volume Bid \$m	Accepted Yield Range	Spread to NZGS*	Bid Cover Ratio
LGFA 4/15	50	216	3.65% - 3.69%	80	4.3
LGFA 12/17	250	1,104	4.33% - 4.66%	118	4.4
Total/Average	300	1,320	N/A	N/A	4.4

* Spread between NZGS at the time of bidding, and maximum accepted yield.



While it is impossible to directly compare price tension as we normally do without the presence of an existing market, analysis of the tails and ranges is telling, as the table below shows.

Bond	Tail Width*	Upper Range~	Non-Comp Spread^
LGFA 4/15	6bps	+2bps	+15bps
LGFA 12/17	34bps	+5bps	+19bps

* Span between lowest and highest successful yields.

~ Spread between weighted average successful yield and highest successful yield.

^ Spread between weighted average unsuccessful yield and weighted average successful yield.

Irrespective of one's view on an appropriate margin, if we look at the range of successful bids, it is immediately obvious that the tail for the 2017s looks wide at 34bps. However, this is clearly skewed to the downside, rather than the upside, and is thus indicative of strong bidding. Indeed, our "upper range" measure shows that bidding was well clustered, with few hopeful "fliers", hence the reasonably tight 6bp spread between the weighted average and maximum successful yield on the 2017s. The non-comp spreads are a touch wide, but we prefer to look through this in light of the pleasing state of other measures.

PEER COMPARISON

From a pricing perspective, trying to find suitable comparable issuers is perhaps the biggest problem in terms of benchmarking. This is because the LGFA is unique – not so much in its structure (with joint and several guarantees and no

LGFA INAUGURAL TENDER AND PRICING ANALYSIS

government guarantee), but more so because of its age and its credit rating. As S&P noted in their credit rating of LGFA, comparable **global peers tend to be AAA rated, and have been in existence for much longer.**

Despite credit rating differences, we thought it would be useful to analyse how bonds issued by peers compare from a pricing perspective. As we contemplated this analysis, **our feeling was that it was reasonable to expect that longer-standing offshore institutions with higher credit ratings would set a lower limit in terms of margins LGFA may trade at. However, we are also mindful of unique domestic aspects** of the LGFA, and the universe of comparable local bonds. Indeed, as far as domestic investors are concerned, pricing on LGFA bonds may well simply be a resolution of 2 basic “tensions”. **The first is the apparent “expensiveness” of LGFA bonds given how far they are trading through comparable Auckland Council bonds. The second is the apparent “cheapness” of the bond when compared to NZGS, particularly given the matched credit rating, and what S&P call the LGFA’s “very important” role and “integral” link with the government, which suggests that there is an “extremely high likelihood of extraordinary government support”. Judging by the bidding at today’s tender, we suspect these 2 considerations have been influential in determining pricing.**

Turning again to our analysis of global peers – the results of which are shown in the table on page 3 – two things are immediately obvious. The first is that there is no real consistency in pricing, particularly when swapped back to a margin over NZGS. This is despite the fact that we tried to select issues with similar maturities to those offered by the LGFA, and where possible to find deals with market coupons, and in G10 currencies. Of note, not all 5yr issues trade at wider margins to same-issuer 3yr issues.

PRICING JUDGEMENTS

If we ignore the Municipality Finance AUD 3 year issue, which seems to trade at an unusually wide margin, the average margin for the other 2 issues is around +110bps to NZGS. By contrast, margins for the 5 year issues range from +115 to +158bps, with an average of around +130bps.

Although not directly comparable, it is also worth mentioning that the Australian QTC 2/18 bond trades at approximately +128 to ACGBs. This bond is not guaranteed by the Australian government, and is

instead issued by a single state government, with a credit rating one notch higher than the LGFA. At the moment, we estimate this bond would swap back to NZGS at a margin of close to +90bps.

On the basis of the limited analysis we did of the 6 agency issues, one could be tempted to conclude that +110 and +130 might be suitable margin benchmarks for 3yr and 5yr AAA rated sovereign agencies respectively. Remember though, that the LGFA is AA rated (foreign currency).

On top of that, we must acknowledge that any peer comparison is not an exact science – far from it in fact. For one, we didn’t examine all similar bonds, and as noted, even in our limited sample there were some glaring inconsistencies. **With so much variation in swap spreads, and basis swap spreads across the globe, let alone tax treatment, it would be dangerous to rely on a global comparison alone** – noting our earlier comment about bonds trading below the likes of Auckland Council, but above NZGS.

We also need to acknowledge that even if the selection of bonds we presented are alternatives to investment in the LGFA, they are substantially “fiddlier” in that a buyer would have to buy the bond and swap it back to NZD. By contrast, the LGFA issues are vanilla domestic bonds.

ASSESSMENT

Broadly speaking, we believe the **DMO has done well to have issued bonds with a maximum clearing margins of around 80 and 118** for 2015 and 2017 bonds respectively.

At these margins, **the LGFA has not come close to achieving its stated aim (from its Statement of Intent) of an average cost of funds of 50bps above NZGS.** However, given current market conditions, we consider today’s tender to have been a success.

Although success on the part of the issuer may perhaps imply the opposite for investors, there is a happy middle ground, and we think today’s margins are consistent with that. **The fact that bid cover was as high as it was is very encouraging, as it shows the issuer is on peoples’ radars.** Investors may have hoped for wider margins – but we only have to cast our minds back to the inaugural issue of the NZGS 5/21 in May 2009. That issue had an initial “tail” of successful bids of 51bps, and became a “dog” for months. Today’s tender couldn’t have been any more contrasting to that!

LGFA INAUGURAL TENDER AND PRICING ANALYSIS

Peer Comparison	Rating	Currency	Yield	Swap	Spread	Basis	Margin to NZD Swap	Swap Spread	Margin to NZGS
KBN Kommunalbanken Norway									
5/05/2015	AAA	USD	1.19	0.68	0.51	35	86	20	105
9/05/2017	AAA	JPY	0.58	0.45	0.14	120	133	25	158
Kommuninvest Sverige AB									
16/09/2015	NR	NZD	3.98	3.06	0.92	N/A	92	20	112
12/08/2017	AAA	SEK	2.56	2.07	0.50	49	99	25	124
Municipality Finance PLC									
17/04/2015	NR	AUD	5.66	4.26	1.40	10	150	20	170
7/02/2018	AAA	NZD	4.67	3.77	0.90	N/A	90	25	115

Source: ANZ estimates, Bloomberg

IMPORTANT NOTICE

NEW ZEALAND DISCLAIMER

This publication is for information purposes only. Its content is intended to be of general nature, does not take into account your financial situation or goals, and is not a personalised adviser service under the Financial Advisers Act 2008. It is recommended you seek advice from a financial adviser which takes into account your individual circumstances before you acquire a financial product. This publication does not constitute an offer to sell or solicitation to buy any security or other financial instrument. No part of this publication can be reproduced, altered, transmitted to, copied to or distributed to any other person without the prior express permission of ANZ National Bank Limited (the "Bank").

This publication is a necessarily brief and general summary of the subjects covered. The information contained in this publication is given in good faith, has been derived from sources perceived by it to be reliable and accurate and the Bank shall not be obliged to update any such information after the date of this publication. To the extent permitted by law, neither the Bank nor any other person involved in the preparation of this publication accepts any liability for the content of this publication (including the accuracy or completeness thereof) or for any consequences flowing from its use.

UNITED STATES DISCLAIMER

This publication is being distributed in the United States by ANZ Securities, Inc. (Member of FINRA [www.finra.org] and registered with the SEC) ("ANZ S") (an affiliated company of Australia and New Zealand Banking Group Limited ("ANZBG") and the Bank), which accepts responsibility for its content. Further information on any securities referred to herein may be obtained from ANZ S upon request. Any US person(s) receiving this publication and wishing to effect transactions in any fixed income securities referred to herein should contact ANZ S 277 Park Avenue, 31st Floor, New York, NY 10172 USA, Tel: 1-212-801-9160, Fax: 1-212-801-9163, not its affiliates.

This publication is issued on the basis that it is only for the information of the particular person to whom it is provided. This publication may not be reproduced, distributed or published by any recipient for any purpose. This publication does not take into account your personal needs and financial circumstances. Under no circumstances is this publication to be used or considered as an offer to sell, or a solicitation of an offer to buy.

In addition, from time to time ANZBG, the Bank, ANZ S, their affiliated companies, or their respective associates and employees may have an interest in any financial products (as defined by the Australian Corporations Act 2001), securities or other investments, directly or indirectly the subject of this publication (and may receive commissions or other remuneration in relation to the sale of such financial products, securities or other investments), or may perform services for, or solicit business from, any company the subject of this publication. If you have been referred to ANZBG, the Bank, ANZ S or their affiliated companies by any person, that person may receive a benefit in respect of any transactions effected on your behalf, details of which will be available upon request.

The information herein has been obtained from, and any opinions herein are based upon, sources believed reliable. The views expressed in this publication accurately reflect the author's personal views, including those about any and all of the securities and issuers referred to herein. The author however makes no representation as to its accuracy or completeness and the information should not be relied upon as such. All opinions and estimates herein reflect the author's judgement on the date of this publication and are subject to change without notice. No part of the author's compensation was, is or will be directly or indirectly related to specific recommendations or views expressed in this publication. ANZBG, the Bank, ANZ S, their affiliated companies, their respective directors, officers, and employees disclaim any responsibility, and shall not be liable, for any loss, damage, claim, liability, proceedings, cost or expense ("Liability") arising directly or indirectly (and whether in tort (including negligence), contract, equity or otherwise) out of or in connection with the contents of and/or any omissions from this communication except where a Liability is made non-excludable by legislation.

This document has been prepared by ANZ National Bank Limited. ANZ (part of ANZ National Bank Limited), Level 7, 1 Victoria Street, Wellington 6011, New Zealand Phone 64-4-802 2217 Fax 64-4-496 8639 <http://www.anz.co.nz> email nzeconomics@anz.com