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## Research Update:

# Taupo District Council Ratings Affirmed At 'AA/A-1+'; Outlook Remains Stable

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## Research Update:

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## Overview

- Taupo's financial management and budgetary performance continue to support the ratings on the New Zealand-based district council.
- We expect Taupo's debt burden to decline relative to revenues as the council maintains its strong operating position.
- We are affirming our 'AA' long-term and 'A-1+' short-term issuer credit ratings on Taupo.
- The stable outlook reflects our expectation that the rating on the sovereign will continue to constrain the rating on Taupo, while we see only a low likelihood that the council's stand-alone credit profile (SACP) will deteriorate substantially.

## Rating Action

On May 22, 2017, S&P Global Ratings affirmed its 'AA' long-term foreign currency and local currency and 'A-1+' short-term issuer credit ratings on Taupo District Council (Taupo), a New Zealand local government. The outlook on the rating remains stable.

## Outlook

The stable outlook reflects our expectation that the rating on the sovereign will continue to constrain the rating on Taupo, while we see only a low likelihood that the council's stand-alone credit profile (SACP) will deteriorate substantially.

## Upside scenario

If we were to raise our rating on the sovereign, then we would likely raise our ratings on Taupo because the council's SACP is currently stronger than our foreign-currency rating on the sovereign.

## Downside scenario

With an SACP stronger than the foreign-currency rating on the sovereign, it would take a substantial deterioration in the council's credit profile to warrant a downgrade. We believe this is unlikely to occur within the next two years. However, it could happen if we perceive Taupo's financial management to

be deteriorating significantly, resulting in a substantial rise in council spending that leads to a rapid decline in the council's after-capital account balance, a sharp rise in its debt burden, and stress on its liquidity position.

## **Rationale**

We have updated and extended our forecasts for Taupo until 2019. Following this update, we still expect the council's financial management and budgetary performance to support its credit profile. We expect balances after capital accounts to remain broadly positive, due to the council's strong operating surpluses and relatively low capital expenditure, mainly on renewals.

### **Taupo's economic concentration in tourism offsets prudent financial management and supportive institutional framework**

We continue to cap our rating on Taupo at the level of our long-term foreign currency rating on New Zealand (AA/Stable/A-1+) because we believe the council could not withstand a default scenario better than the sovereign could, and that the council's credit metrics would deteriorate in line with those of the sovereign in the event of a distress scenario.

The institutional framework within which New Zealand councils operate is a key strength supporting Taupo'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. This system allows Taupo to support higher debt levels than some of its international peers can tolerate at the current rating.

In our opinion, Taupo's financial management is strong, similar to that of most New Zealand councils. The council has focused on fiscal consolidation following years of key infrastructure spending. Taupo 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. Debt and liquidity policies are prudent, with no issuance of foreign-currency and interest exposure being mostly hedged. Supporting our view is Taupo's policy of cash funding its depreciation.

Taupo's economy is supported by a large proportion of nonresidents that own holiday homes and a strong tourism sector, with GDP per capita income of about US\$37,600 on average over the past three years. Taupo's estimated per capita income partially overstates the actual income level of its economy as nonresidents do not form part of the district population. This also exposes Taupo's property market to New Zealand's broader economic conditions, which could weaken council revenue streams in the event of an economic downturn.

Also contributing to our view of Taupo's economy is the concentration risk in the tourism sector.

### **After-capital account surplus supports the council's fiscal position and debt continues to decline**

We expect Taupo's after-capital account to remain in surplus of about 6% of total revenues between 2017-2019, reflecting strong operating balances and low capital expenditure. The council's capital expenditure was 24% lower than our expectation in 2016, which contributed to a balance after-capital account surplus of almost 13% of total revenue. We forecast smaller surpluses in the medium term, reflecting no major infrastructure projects given the council's previous key infrastructure upgrades. We expect Taupo to spend between NZ\$16 million and NZ\$23 million on infrastructure, predominately renewals, which is around 22% of total expenditure. This is significantly lower than 2010 when capital expenditure was over 60% of total expenditure.

We expect the council's modifiable revenues to be about 91% of operating revenues (after S&P Global Ratings' adjustments) between 2015 and 2019, providing the council a high degree of budgetary flexibility. Modifiable income streams such as property rates and user charges are key sources of council income. Taupo's revenue flexibility is also supported by its above-average capability to generate revenues from asset sales such as the sale of property and land, term deposits, commercial paper, and other liquid assets held in its investment fund. Sale of these assets could generate additional council revenue, should that become necessary to support debt repayment.

We project Taupo's debt metrics to improve through to 2019 due to after-capital account surpluses. We forecast the council's total tax-supported debt to be 158% of operating revenues in 2019, down from 190% in 2016. We expect interest expenses to remain inflated at 11.6% of operating revenue for 2016-2018, gradually declining in line with the council's lower debt burden, hedging position, and margins from its participation in the Local Government Funding Agency.

While debt remains high compared to peers, Taupo's contingent liabilities remain low. The council's insurance policies, disaster recovery fund and its investment fund limit its exposure to contingent liabilities that could arise from natural disasters. The district is susceptible to volcanic eruption and the flooding of Lake Taupo, which could cause some financial impact to the council with clean-up and landslides, as well as the loss of tourism.

We currently estimate that Taupo's liquidity sources - average free cash and liquid assets - to average about NZ\$88 million during the next 12 months, covering 157% of its debt service. When including unutilized bank facilities of NZ\$50 million, Taupo's debt-servicing ratio reaches 245%. The council recently refinanced its long-term bond valued at NZ\$25 million.

## Key Statistics

Table 1

Taupo District Council Key Statistics					
Years ending June 30 (MIL. NZ\$)	2015	2016	2017bc	2018bc	2019bc
<b>Selected Indicators</b>					
Operating revenues	77	78	76	78	85
Operating expenditures	57	58	57	59	61
Operating balance	21	20	19	19	24
Operating balance (% of operating revenues)	26.6	26.0	24.8	24.0	27.8
Capital revenues	4	7	5	3	2
Capital expenditures	12	16	19	23	16
Balance after capital accounts	13	11	6	(1)	10
Balance after capital accounts (% of total revenues)	15.7	13.2	6.9	(1.4)	11.5
Debt repaid	56	8	6	0	10
Gross borrowings	40	6	0	1	0
Balance after borrowings	(3)	9	(0)	0	(0)
Modifiable revenues (% of operating revenues)	88.6	90.3	93.5	92.2	92.2
Capital expenditures (% of total expenditures)	17.0	21.4	24.7	28.2	20.5
Tax-supported debt (outstanding at year-end)	150	149	143	144	134
Tax-supported debt (% of consolidated operating revenues)	194.4	189.8	188.6	184.2	158.4
Interest (% of operating revenues)	13.3	12.7	11.1	11.0	9.3
Local GDP per capita (single units)	51,208	50,829	0	0	0

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. Base case reflects S&P Global Ratings' expectations of the most likely scenario. Downside case represents some but not all aspects of S&P Global Ratings' scenarios that could be consistent with a downgrade. Upside case represents some but not all aspects of S&P Global Ratings' scenarios that could be consistent with an upgrade.

## Ratings Score Snapshot

Table 2

Ratings Score Snapshot	
<b>Key Rating Factors</b>	
Institutional Framework	Extremely predictable and supportive
Economy	Average
Financial Management	Very strong
Budgetary Flexibility	Very strong
Budgetary Performance	Very strong
Liquidity	Exceptional
Debt Burden	Very high
Contingent Liabilities	Low

\*S&P Global Ratings bases its ratings on local and regional governments on the eight main rating factors listed in the table above. Section A of S&P Global Ratings' "Methodology For Rating Non-U.S. Local And Regional Governments," published on June 30, 2014, summarizes how the eight factors are combined to derive the rating.

## Key Sovereign Statistics

Sovereign Risk Indicators, May 3, 2016. Interactive version available at <http://www.spratings.com/sri>

## Related Criteria

- 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
- Criteria - Governments - International Public Finance: Methodology For Rating Non-U.S. Local And Regional Governments, June 30, 2014
- Criteria - Governments - International Public Finance: Methodology And Assumptions For Analyzing The Liquidity Of Non-U.S. Local And Regional Governments And Related Entities And For Rating Their Commercial Paper Programs, Oct. 15, 2009
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

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

Taupo District Council Issuer Credit Rating	AA/Stable/A-1+
Taupo District Council Commercial Paper	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](http://www.standardandpoors.com) for further information. Complete ratings information is available to subscribers of RatingsDirect at [www.globalcreditportal.com](http://www.globalcreditportal.com) and at [www.spcapitaliq.com](http://www.spcapitaliq.com). All ratings affected by this rating action can be found on the S&P Global Ratings' public website at [www.standardandpoors.com](http://www.standardandpoors.com). Use the Ratings search box located in the left column.

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