LGFA Quarterly Report for period ended 30 June 2012

1. COMMENTARY ON OPERATIONS FOR THE QUARTER

On 2 May 2012 LGFA held its third bond tender. A total of $140 million was issued, bringing bond outstandings to $705 million.

Table 1: Results of LGFA Bond Tender Number 3 held on 2 May 2012

Tender Date: 2 May 2012
Settlement Date: 7 May 2012

LGFA Bonds Offered:	15 Apr 2015	15 Dec 2017
Coupon Rate:	6.00%	6.00%
Amount Offered:	$20 million	$120 million
Total Bids Submitted:	$57 million	$798 million
Total Number of Bids Submitted:	8	36
Total Successful Bids:	$20 million	$120 million
Total Number of Successful Bids:	6	10
Successful Range:	3.36% - 3.46%	4.22% - 4.24%
Weighted Average Successful Yield:	3.43%	4.23%
Unsuccessful Range:	3.46% - 3.56%	4.24% - 4.35%
Weighted Average Unsuccessful Yield:	3.50%	4.26%

Highlights of LGFA's third bond tender were:

- Record bid cover ratios of 6.7 times for the December 2017 maturity, and 6.1 times for the overall bond tender ($855 million of bids received for $140 million of bonds offered).
- Pricing at 101 bps over NZGBs for the December 2017 maturity (down from 113 bps at the inaugural tender) and 79 bps over NZGBs for the April 2015 maturity (virtually unchanged from the inaugural tender). The improvement in pricing of the longer dated bond was a very encouraging outcome.
- Solid pricing against Auckland Council, although estimating LGFA's margin to Auckland was difficult given volatility in the council's primary and secondary market pricing levels. We estimated LGFA to be trading in May somewhere between 35 bps (based on Auckland's $100 million tap of their March 2016 bond) and 45 bps (based on ANZ's month end bond pricing sheets) under Auckland Council.
- A record low successful bid range for the December 2017 maturity of just 2 bps (4.22% - 4.24%). This was an exceptionally strong outcome, given the fact that NZDMO's performance target for this tender metric was 5 bps.
- A total of 44 bids from six counterparties recorded for the tender. Bids ranged from $1 million up to $65 million, suggesting that larger wholesale bids for LGFA bonds are starting to emerge.

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On 6 June 2012 LGFA held its fourth bond tender. A total of $130 million was issued, bringing bond outstandings to $835 million. With over 80% of expected issuance for the calendar year now completed, it is likely that LGFA's debt program in 2012 will increase by around $500 million up to $1.5 billion.

Table 2: Results of LGFA Bond Tender Number 4 held on 6 June 2012

Tender Date: 6 June 2012
Settlement Date: 11 June 2012

LGFA Bonds Offered:	15 Dec 2017	15 Mar 2019
Coupon Rate:	6.00%	5.00%
Amount Offered:	$55 million	$75 million
Total Bids Submitted:	$334 million	$418 million
Total Number of Bids Submitted:	32	29
Total Successful Bids:	$55 million	$75 million
Total Number of Successful Bids:	1	1
Successful Range:	3.74% - 3.74%	4.08% - 4.08%
Weighted Average Successful Yield:	3.74%	4.08%
Unsuccessful Range:	3.78% - 4.00%	4.09% - 4.23%
Weighted Average Unsuccessful Yield:	3.86%	4.16%

Highlights of LGFA's fourth bond tender were:

- Another excellent bid cover ratio of 5.8 times for the overall bond tender ($752 million of bids received for $130 million of bonds offered). Two successive tenders with cover ratios in excess of five times is an outstanding result in difficult market conditions.
- Debut pricing at 113 bps over NZGBs for the inaugural issue of our new March 2019 maturity exceeded market expectations. Maintaining pricing at 101 bps over NZGBs for the December 2017 maturity was also a significant improvement on market indications immediately prior to the tender (around 112 bps).
- Improved pricing relative to council benchmarks. On average, LGFA is likely to have increased its margin below AA rated councils by around 10 bps at this tender.
- A record low successful bid range for both maturities of zero, with the 2017s and 2019s each taken out by a single bid (for $55 million and $75 million respectively).
- Significant bidding interest, with 61 bids from seven counterparties recorded for the tender. Bids ranged from $1 million up to $75 million, again suggesting that larger wholesale bids for LGFA bonds are becoming more prevalent.

2. PERFORMANCE AGAINST OBJECTIVES AND PERFORMANCE TARGETS

Primary Objective

LGFA will operate with the ***primary objective*** of optimising the debt funding terms and conditions for Participating Local Authorities. Among other things this includes:

- *Providing debt to Participating Local Authorities at the lowest possible interest rates commensurate with the relevant maturity*

  LGFA has met its primary objective by achieving a significant improvement in the pricing of the benchmark 15 December 2017 bond, particularly over the past quarter.

  From the inaugural tender held on 15 February 2012 to date, there has been a substantial improvement of 32 basis points (bps) in the December 2017's margin to swap (as outlined in the following table):

Margins	15 Feb 2012 (bps)	30 Jun 2012 (bps)	Pricing Improvement
LGFA margin to NZGB	113	90	23
NZGB margin to swap	(24)	(33)	9
LGFA margin to swap	89	57	32

  Some of this pricing improvement has resulted from LGFA's ongoing marketing activities:

  - Undertaking another significant investor roadshow (Auckland and Wellington) in late May 2012 to launch the new 15 March 2019 bond; and
  - Participating in major conferences (eg the INFINZ Finance and Capital Markets Forum) to continue promoting LGFA bonds to investors and intermediaries.

- *Making longer-term borrowings available to Participating Local Authorities*

  There are now two maturities in excess of five years that are available to participating councils:

  - 15 December 2017 bond (five years plus), first issued at the inaugural bond tender held on 15 February 2012; and
  - 15 March 2019 bond (just under seven years), first issued at the fourth bond tender held on 6 June 2012.

- *Enhancing the certainty of access to debt markets for Participating Local Authorities, subject always to operating in accordance with sound business practice*

  Access to debt markets has clearly been enhanced by the consistently strong cover ratios achieved at the first four LGFA bond tenders. Our cover ratio (ie ratio of total amount bid to total amount offered) for each tender has been:

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Tender	Volume Bid ($m)	Volume Offered ($m)	Cover Ratio (times)
1	1,320	300	4.4
2	959	265	3.6
3	855	140	6.1
4	752	130	5.8

From the table, it is important to note that:

- Total bids received have amounted to $3.9 billion in the first four tenders;
- The average cover ratio has been a very strong 4.5 times;
- Our lowest cover ratio to date is still a very respectable 3.6 times; and
- LGFA's average cover ratio compares favourably to the average of 3.0 times achieved by NZDMO over the past few years.

While access to debt markets is currently very strong, there is always a risk of insufficient bidding interest on the day with a tender method of issuance. To mitigate this risk, we have now commenced work with Russell McVeagh to update our Operating Rules and Guidelines, to allow LGFA bills to be issued.

Additional objectives

LGFA has a number of additional objectives which complement the primary objective. These objectives will be measurable and achievable and the performance of the company in achieving its objectives will be reported annually. These additional objectives are to:

- *Operate with a view to making a profit sufficient to pay a dividend in accordance with its stated Dividend Policy set out in section 6*

  Three key factors have contributed to LGFA performing well ahead of budget in the first six months of operations:

  - Bond issuance ($835 million) and on-lending activity ($819 million) were significantly higher than forecast;
  - Overheads have been well contained; and
  - GST refunds have provided additional funding to reduce the retained earnings deficit.

  As a result, LGFA is currently ahead of schedule to make its first dividend payment.

- *Become the primary source of debt funding for Participating Local Authorities*

  Councils have strongly supported LGFA to date. After our fourth bond tender in June, 14 (out of 18) participating councils had borrowed from us. In the July tender, South Taranaki District Council became the 15th borrower after just five tenders.

- *Operate in a manner to ensure LGFA is successful and sustainable in the long-term*

  The key to LGFA's long-term sustainability is to ensure that it can always fund councils at lower rates than they can fund themselves. To provide evidence of LGFA's performance against this objective, we have included the chart below (produced by Asia Pacific Risk Management). This chart compares LGFA's spread to swap against a number of other issuers for five year maturities.

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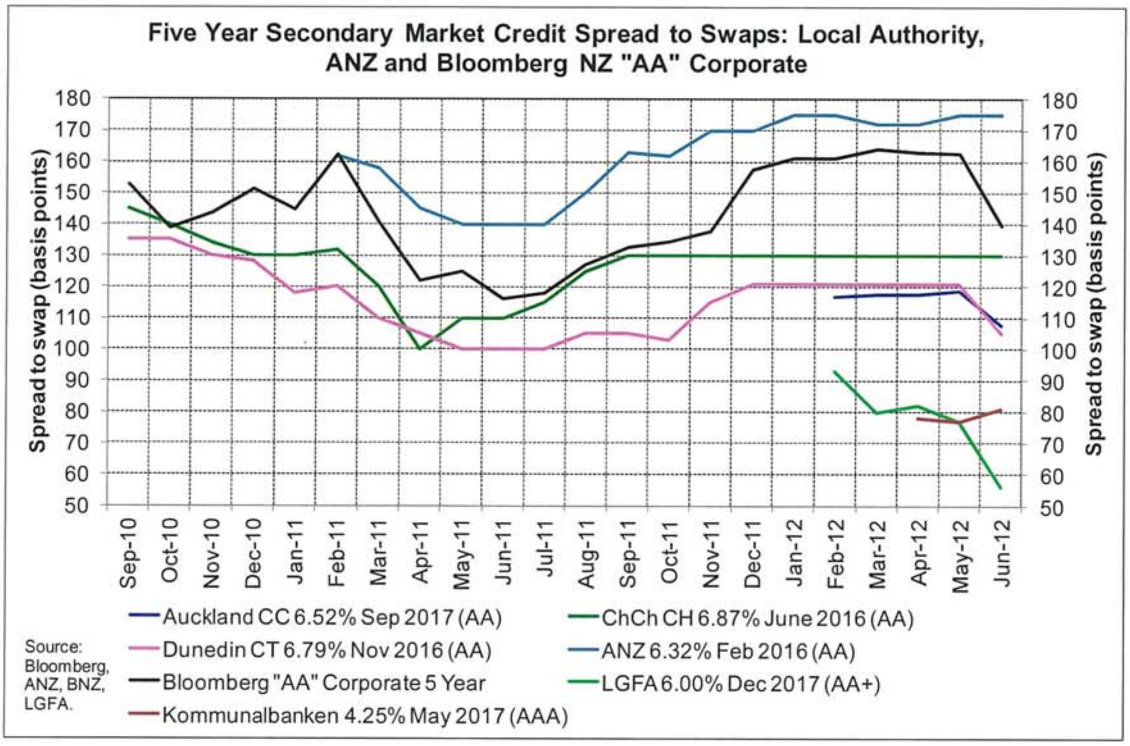

From the chart above, we estimate that by end June 2012 LGFA was saving AA rated councils approximately 30 bps in annual interest costs on a five year security.

The basis for this estimate is set out in the table below:

Margins on 15 December 2017 bond	**30 June 2012 (bps)**
AA rated councils margin to swap	107
LGFA margin to swap	57
LGFA Funding Advantage *Less Base Margin*	50 (30)
LGFA Net Funding Advantage "LGFA Effect" *	20 10
Total saving for AA rated councils	**30**

* Estimated reduction in AA rated councils margin to swap as a result of LGFA operations. This estimate is based on the fact that there was no movement between May and June 2012 in the swap spreads of benchmark issuers such as Kommunalbanken (AAA) and Fonterra (A+). We conclude that the swap spreads of AA rated councils were therefore pulled down by successful LGFA tenders.

Using similar analysis, we estimate that by end June 2012 LGFA was saving A rated councils approximately 35 bps and unrated councils around 40 bps in annual interest costs on a five year borrowing.

Educate and inform all Local Authorities (both participating and non-participating) on matters within the scope of LGFA's operations

During the quarter, LGFA:

- Discussed various issues (including monitoring arrangements, performance reporting, disclosure of borrower information and debt refinancing) at the May Shareholders' Council meeting;
- Wrote to all non-participating councils seeking information on their plans to join LGFA (as shareholder, guarantor or borrower), and their desired timing in relation to becoming new borrowers; and
- Arranged a New Borrowers Forum to be held in Wellington on 31 July for all non-participating councils (and their advisors) to learn about the process involved in becoming a new borrower from LGFA.

- *Become a leading participant in the New Zealand capital markets*

  Two more articles from leading industry publications are attached to this Report. They provide evidence of the considerable interest in LGFA's activities from both the domestic market and our international peer organisations. The two articles are:

  - KangaNews' coverage of a roundtable discussion between LGFA and its Scandanavian municipal agency peers in its April 2012 edition; and
  - INFINZ's feature article on the LGFA in its May 2012 Journal.

- *Provide excellent service to Participating Local Authorities*

  Further modifications to the LG security and Borrower Note term sheets were implemented for the fifth bond tender held on 11 July (in consultation with NZDMO and Computershare). After the initial difficulties experienced during our first settlement process, we have now completed the settlement of the last four tenders very smoothly and efficiently.

  LGFA has also provided greater flexibility to councils in setting the terms of their LG securities:

  - Two councils have borrowed on a fixed rate basis; and
  - One council has borrowed on an FRN basis but with bespoke rate reset dates that match their existing swap reset dates.

- *Ensure excellent communication exists and be professional in its dealings with all its stakeholders*

  During the quarter, LGFA:

  - Continued to work with councils, NZDMO and Computershare on streamlining our settlement processes.
  - Maintained regular communication with intermediaries and investors to review and revise its debt issuance strategies; and
  - Conducted regular media interviews and contributed to INFINZ and Kommuninvest Dialog articles to ensure that markets (both domestically and internationally) are well informed about LGFA's activities and operations.

- *Ensure its products and services are delivered in a cost-effective manner*

  During the quarter, LGFA:

  - Charged a "base" margin to councils that averaged 0.30%, well below the maximum permitted of 0.40%; and

- Restricted operating costs (excluding establishment costs) to less than $200,000 per month, well below the monthly target of $250,000.

- *Consult with Shareholders regarding the potential requirement for LGFA Borrowers to obtain comprehensive insurance cover*

  Following settlement of the fifth bond tender on 16 July 2012, LGFA has now on-lent $969 million to councils. To date, there has been no requirement for borrowers to obtain or retain comprehensive insurance cover.

  On this basis, we have formed a preliminary view that:

  - Various business interruption risks (including risks to physical assets) should be considered as part of an overall credit risk assessment of individual councils; and
  - External insurance arrangements are not, a priori, preferred to self-insurance cover (eg via the accumulation of financial assets).

- *Review the appropriateness of LGFA's "broker" business model*

  The success of the "broker" business model is evident from three key factors:

  - Overall profitability (ie the retained earnings position) has significantly exceeded budget in the first six months of operations;
  - This profitability has been achieved at very low levels of interest rate risk (eg Value at Risk is currently running at just over 10% of policy limits); and
  - Significant improvement in the pricing of LGFA bonds has generated corresponding savings for council borrowers of around 30 bps in annual interest costs.

- *Maintain LGFA's credit rating equal to the New Zealand Government sovereign rating where both entities are rated by the same Rating Agency*

  This has been achieved to date.

- *Achieve the Financial Forecasts set out in section 4*

  LGFA's estimated financial results for key items set out in Section 4 of the SOI, for the periods ended 31 March and 30 June 2012 are:

	$m 31 Mar 2012 Estimated	**$m 30 Jun 2012 Estimated**	**$m 30 Jun 2012 Budget**
Total Net Income	0.3	1.1	1.5
Overheads			
- Operating Costs	(0.5)	(1.0)	(1.4)
- Establishment Costs	-	(0.2)	-
- Total	(0.5)	(1.2)	(1.4)
Pre-Establishment Costs	(4.0)	(4.0)	(4.6)
Borrower Notes Interest	-	(0.1)	(0.1)
Retained Deficit	(4.2)	(4.2)	(4.6)

  Note that establishment costs cover implementation fees paid to NZDMO that have been invoiced since incorporation. These costs were originally budgeted as pre-establishment costs.

- *Achieve the Dividend Policy set out in section 6*

  Refer to our earlier comments on this issue.

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Performance Targets

Six performance targets are specified for LGFA in the SOI. Progress against each of these targets is discussed below, including an explanation of any material variances.

	Performance Measure	Target	Result	Outcome (Target met?)
1	Average cost of funds relative to NZGS	<0.50%	1.03%	x
2	Average margin above LGFA's cost of funds	<0.40%	0.30%	√
3	Annualised operating overheads	<$3.0 million	$2.0 million	√
4	Lending to participating councils	>$500 million	$819 million	√
5	Number of council shareholders	>30	18	Target date 30 Nov 2012
6	Number of eligible borrowers	>40	19	Target date 30 Nov 2012

There are three key reasons for LGFA's relative cost of funds averaging just over twice the target level of 50bps:

- The European debt crisis has increased the margins of all other issuers above sovereign borrowers, particularly in countries like New Zealand where the sovereign is highly rated.
- A very high proportion (81%) of five and seven year bonds have been issued in the first four bond tenders. While this reflected council demand for funding, longer dated bonds price at a relatively higher margin above NZGS than shorter dated bonds.
- Higher costs are incurred when bonds are initially issued, due to market uncertainty about pricing and the relative illiquidity of new bond maturities.

An ongoing push to sign up new council shareholders and borrowers is planned for the September quarter.

Key elements of the work program include:

- Organising a New Borrowers Forum to be held at Wellington Airport on 31 July for all councils wishing to become new borrowers from LGFA in the next few months.
- Working through the credit assessments and documentation required to enable new councils to commence borrowing from LGFA from August.
- Progressing a variety of issues with existing shareholders and new councils wishing to become shareholders and/or guarantors to facilitate the Second Opening by November 2012.

Based on the interest expressed to date from councils, we expect to achieve our council shareholders and borrowers targets by 30 November 2012.

3. DETAILS OF EVENTS OF REVIEW

There have been no events of review in respect of any Participating Local Authority.