

New Zealand Credit Analysis

Hamilton City Council

Ratings

Local Currency
Long-Term Secured Debt Rating AA-

Outlook

Local-Currency Long-Term Secured
Debt Rating Stable

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Related Research

- *International Rating Methodology for Local and Regional Governments (July 2008)*
- *Local Government General Obligation Rating Guidelines (March 2007)*

Rating Rationale

- Fitch Ratings assigned New Zealand's Hamilton City Council ("the Council") an 'AA-' Long-Term Local Currency Secured Debt Rating. The Council's debt is secured under an indenture trust deed by a continuing charge on rates for the full and timely payment of debt service. The Outlook is Stable.
- Hamilton is an important and growing service centre for the Waikato agricultural and manufacturing region, and one of New Zealand's largest cities.
- Council finances are dependent on property taxes, which have grown in recent years commensurately with population growth, new real estate development, and inflation-driven increases in the levy.
- With the current economic slowdown in New Zealand, there are signs that average home sale prices have started to decline from their peak in 2008, which could affect short-term tax base growth.
- The Council's finances benefit from annual operating surpluses, which fund capital reserves, act as internal liquidity, or pay for a large portion of capital expenditure.
- Debt levels are low now relative to many measures, including the Council's governmental role, but are expected to rise to a moderate level according to the Council's 10-year financial plan.
- Some budgetary exposure to rising debt service costs is likely, but the current economic climate is likely to moderate the pace of borrowing, and the impact of additional debt service on budgetary resources.
- Fitch's Negative Outlook on New Zealand's 'AA+' Long-Term Foreign Currency Issuer Default Rating (IDR) and on its 'AAA' Long-Term Local Currency IDR should have no direct credit implications for Hamilton. Indirectly, however, the prospects of higher cost of capital and for a more sluggish economic recovery could affect the Council's future financial flexibility and infrastructure development plans.
- Decentralisation is very advanced in New Zealand by international standards. The Local Government Act of 2002 provides a comprehensive and flexible legal platform on which Hamilton and other local governments can operate.

Key Rating Drivers

- An important credit consideration is the pace of debt accumulation with respect to the council's development plan.
- A secondary credit consideration is the extent of future reliance on development charges for meeting the council's debt servicing requirements.

Profile

The Council is a territorial local authority governed by the Local Government Act 2002. The Council is responsible for water distribution, wastewater treatment, solid waste management, public safety, roadway and local transport services, recreational and cultural services, land-use planning and economic development. Other governmental services are provided by the central government, including health, education, social security and welfare.

Organisational Profile

The city's elected officials include a mayor and 12 city councillors. The most recent local election was held in 2007, after which the number of councillors was reduced from 13 to 12 and the number of wards was reduced from three to two (East Ward and West Ward). The next council election is scheduled for 2010. Key administrative officials include the chief executive and five general managers; the latter manage standard municipal service areas.

Economic Profile

Hamilton is a large and important second-tier city by New Zealand standards. Its population of more than 130,000 is far smaller than the 405,000 population of Auckland City, which is the country's largest city and part of an eight-council area that could be amalgamated into a single territorial authority with a population of about 1.4 million (Auckland Council) in 2010. Hamilton is closer in size to Wellington, which is the country's capital city, with 180,000 people (See Appendix 1 for New Zealand local government economic comparables). The city serves as a regional service centre for Waikato, a large agricultural and food manufacturing region. It also benefits from relatively close proximity to the Auckland International Airport, which is 1.5 hours' drive away; however, Hamilton also has its own international airport.

Economic Factors

	2005	2006	2007	2008
Population	126,650	129,249	136,600	139,136
Capital value (NZDm)	12,590	13,013	21,049	21,170
Capital value/capita (NZD)	99,408	100,682	154,092	152,153
Average home sales price (NZD; March year end) ^a	237,600	289,000	319,500	332,000
Value real estate activity (NZDm; March year end)				
Non-residential consents	108	168	173	159
Residential consents	210	180	180	210

^a Home price only; does not reflect land sales price
Source: Fitch

Hamilton's economy has benefited from continued population (including from immigration) and tax base growth. The city's property base (capital value) per capita is below the median for New Zealand local governments (see Appendix 1: New Zealand Local Government Comparables), but this reflects the city's largely residential and institutional character. Property is revalued every three years, and the large increase in values in 2007 reflects the most recent revaluation.

Real estate activity has been brisk in recent years, but slumped with the country's economic slowdown and higher interest rates. City officials report that the values of both residential and non-residential building consents were levelling off in March 2008 compared with March 2007, and December to December new consent values declined. The average home sale price peaked in February 2008 at NZD342,327, and had reportedly declined by 2% by February 2009.

Regional employment and sales activity are dominated by retail and wholesale trade, by dairy farming, and processing. Although dairy sales have been increasing, dairy-related employment shrank from 12,000 full-time equivalent (FTEs) in 2001 to fewer than 6,000 FTEs by 2006. Regional employment is growing in retail and wholesale trade, education, tourism, and to a lesser extent hospitals, all of which favour and explain Hamilton's economic growth. Regional unemployment is still low but is expected to rise; the most recent unemployment figure for Hamilton was 4.9%, which was recorded in December 2008.

Financial Profile

The Council's finances are dependent on property taxes, which have grown in recent years commensurately with population growth, new real estate development,

and inflation-driven increases in the tax levy. The Council is responsible for water distribution, wastewater treatment, solid waste management, public safety, roadway and local transport services, recreational and cultural services, land-use planning, and economic development. Other governmental services are provided by the central government, including health, education, social security and welfare. Hamilton receives a small amount of intergovernmental transfers, which are mainly used for capital expenditure.

Hamilton's finances benefit from significant annual operating surpluses, averaging 15%-29% of operating revenue since 2004. In its calculation of operating surplus, Fitch includes development charges as revenue. Council policy dedicates the collection of development charges to meeting infrastructure and related reserve requirements, but it also describes a portion of debt that it expects to be supported by these charges. Nevertheless, these charges are not legally pledged nor restricted to the payment of debt service or capital expenditure. Fitch also counts principal and interest on debt as part of operating expenditure, as all debt is legally supported by the tax levy.

The operating surpluses, which account for most of the Council's internal liquidity (as cash balances are low), represent available cash flow for capital expenditure or capital reserves. Dedicated intergovernmental grants and asset sales also round out resources available for capital expenditure. The Council's forecast for its balance sheet indicates a tightening of cash and investments (supplemented only by external bank lines), which could be problematic in the future, as operating surpluses could become more dependent on development contributions. Nevertheless, Fitch notes flexibility within the Council's finances to manage operating surpluses, re-evaluate the pace of infrastructure investments, and refinance existing debt.

Rates and user fees, the two largest revenue items, have remained fairly stable in recent years, relative to total operating revenue. Less stable, and more subject to real estate development cycles, are development contributions. The Council does not maintain separate accounts for debt service or for capital expenditures. Fee-based cost recovery for water, sewer and solid waste services is low, but this is characteristic of New Zealand municipalities, which rely on property taxes for operating revenue.

Growth in employee expenses, which has been faster than growth in operating revenue, is a longer-term concern. Nevertheless, employee expenses in the 2009 Annual Plan are equal to a third of operating revenue, which is lower than for local governments in other countries, and partly results from the Council's mix of services, which includes the non-personnel operating and capital costs of its enterprise and local roadway activities. Debt service is also growing as a claim on revenue as the Council's debt accumulates. Its moderate claim on operating revenue reflects not only rising interest costs, but also the fairly rapid amortisation of tax-supported debt in New Zealand. The development of long-term debt instruments in New Zealand would increase budgetary flexibility.

Annual capital expenditure levels fluctuate, but have generally been increasing as the city develops. Net borrowing activity, which is the amount of debt issuance required for capital expenditure after deducting the operating surplus, intergovernmental capital grants, and property sales, varies by year, but with greater capital expenditure, net borrowing activity is expected to remain high for the next few years.

In addition to its operating activities, the Council has various economic development-related projects, which presently do not represent a significant contingent budgetary exposure. These include 100% ownership of Hamilton Properties Ltd., 50% ownership of Waikato Regional Airport Ltd., and 41% ownership of Hamilton Riverview Hotel Ltd. Additional debt issuance or financial support for these projects could detract from Council plans for needed infrastructure investments.

Financial statements are prepared using historical cost, with rates revenue (property tax) recognised in the levy year, and utility revenue and interest income recognised on accrual. Operating revenue also includes a number of non-cash provisions for such items as the recognition of newly vested assets and contributions to development contribution reserves. Other provisions, including depreciation, are built into the accounting of expenditures. Fitch has modified the Council's cash flow statements in its analysis of financial performance in order to separately view operating and capital activities. The largest cash items, rates revenue and employee expenses, are very close to the accrual-based presentation (See Appendix 2: Operating Statement and Balance Sheet for the Fitch financial reconciliation). This reconciliation permits an analysis of the sustainability of the operating surplus, the ability of these surpluses to support capital expenditures, and the extent to which capital activity deficits result in debt issuance.

Planning efforts, budgeting, audits, community discourse and transparency are superb by international standards. It is rare for a community of this size to produce such comprehensive annual and long-term plans. The Annual Plan acts as a check on the long-term plan, allowing the Council to speed up or slow down capital and service investments according to the pace of development and the Council's own budgetary performance.

Debt Profile

The Council's debt load is low per capita and relative to the size of the tax base (capital value); relative to the size of operating revenue, however, it is more moderate. The low level of debt is surprising given the nature of the Council's services, which have a heavy municipal utility and local roadway focus, both of which are capital intensive. Nevertheless, it is characteristic of other New Zealand councils, which as a group seem to be debt adverse. Debt levels across New Zealand's city councils are likely to increase as community plans respond to deferred infrastructure requirements arising from past population growth, infrastructure requirements from infill growth, and the effects of infrastructure investment on future economic development.

The 2009-2019 long-term plan shows a significant increase in tax-supported debt; however, its economic growth assumptions appear more robust than current national economic forecasts, and therefore the plan appears more like a balancing act between planning and forecasting. Fitch believes that flexibility to speed up or slow down capital expenditure and borrowing in response to actual growth can be achieved through the annual plan. This ability to adjust the pace and direction of capital expenditure is a key rating consideration given the likelihood of a weaker revenue environment in the short term.

The Council maintains a number of debt and debt-service limits relative to income and assets. By these internal policy measures, it has additional flexibility to issue and support debt. Debt is classified as council debt, internal debt and development contribution debt. Internal debt includes amounts borrowed from dedicated internal reserves. Internal borrowing varies, but at 30 June 2009 it represented 5% of outstanding debt. Council debt, which is secured from levy revenue, but for which development contributions are also dedicated, is borrowed externally through bonds or bank lines. The Council maintains a bank liquidity facility.

Debenture Trust Deed Provisions

The Council is able to issue secured debt through a master indenture, creating a lien on municipal revenue and accounts. Key provisions include a continuing covenant to pay according to the terms of the debt, a trustee role for the life of the debt, and investor/lender recourse, as long as it does not prevent the provision of services. To date, the Council has only issued debt supported by a continuing charge on rates revenue (property tax levy). All debentures are secured *pari passu*,

although the Council expects a large proportion of its debt actually to be supported by development charges. These local government debt security provisions are advanced and unknown throughout most of Asia Pacific, and are similar to the tax supported debt provisions of the US municipal debt market.

Local Government Act 2002

Decentralisation is very advanced in New Zealand by international standards. The Local Government Act of 2002 provides a comprehensive and flexible legal platform on which Hamilton and other local governments can operate. The legal authority of local governments in New Zealand to hold local elections, generate local revenue, and to issue and secure debt through a master indenture is also advanced by international standards. Complementary provisions of the Local Government (Rating) Act 2002 provide an adequate procedure for councils to pursue the recovery of unpaid rates, including the potential sale of affected properties or the interruption of affected water services.

Fitch recognises the Ministerial oversight of local government affairs as a credit strength for municipalities, especially the provisions that allow for a receivership role by the central government to ensure full recovery on debt obligations when a local government fails to meet its obligations under the Act.

Provisions within the Local Government Act that call for a balanced budget, community consultation, an annual audited financial report, the development of long-term community development plans, and investment and liability management plans, and that prohibit the issuance of foreign-currency debt should bode well for the integrity and development of municipal finance in New Zealand.

Appendix 1

New Zealand Local Government Comparables

City council ^a	Population	Capital value/capita (NZD)	Assessed value/capita (NZD)	Operating income/capita (NZD)	Operating expenditure/capita (NZD)	Total debt/capital value (%)	Total debt/capita (NZD)	Debt/operating income (%)
Largest New Zealand local governments								
Auckland City	404,658	329,784	16,489	1,370	1,273	0.10	329	24.1
Christchurch City	348,435	221,485	11,074	1,044	1,015	0.11	252	24.1
Hamilton City	129,249	178,705	8,935	978	1,091	0.56	994	101.6
Manukau City	328,968	199,686	9,984	772	830	0.02	43	5.6
North Shore City	205,608	291,774	14,589	1,091	1,086	0.30	869	79.6
Waitakere City	186,444	183,702	9,185	946	1,032	0.84	1,540	162.8
Wellington City	179,466	276,759	13,838	1,915	1,762	0.46	1,278	66.7
All New Zealand local governments								
Average	55,930	286,520	14,326	1,380	1,319	0.42	927	65.7
Median	32,859	267,476	13,374	1,284	1,290	0.19	518	37.3

^a Local authority financial statistics by council (Statistics New Zealand dataset for FY07); Fitch calculations from dataset for average, median and per capita values
Source: Fitch

Appendix 2

Operating Statement and Balance Sheet

(NZD 000)	2005	2006	2007	2008	Annual plan 2009
Cash flow operating statement (council level)					
Operating revenue					
Rates revenue	73,787	78,132	85,327	91,550	97,604
User fees and charges	34,443	39,414	36,569	41,454	41,295
Government operating grants	2,930	2,598	3,344	2,251	3,428
Interest/dividends	489	751	372	194	285
Council capital contributions	7,119	10,902	15,108	12,774	20,440
Total operating revenue	118,768	131,797	140,720	148,223	163,052
Operating expenditures					
Employee expenses	33,928	37,696	42,617	48,090	54,563
Services and supplies	43,470	51,009	48,125	54,918	46,834
Interest expense	6,991	8,521	9,802	12,537	21,828
Debt repayments			11,457	8,905	
Net GST	220	285	1,765	1,161	
Total operating expenditure	84,609	97,511	113,766	125,611	123,225
Operating surplus (deficit)	34,159	34,286	26,954	22,612	39,827
Non-operating activity					
Government capital grants	5,043	3,241	2,654	7,120	4,343
Purchase of property, plant and equipment	47,500	67,998	53,944	80,558	115,186
Capital surplus (deficit)	-42,457	-64,757	-51,290	-73,438	-110,843
Sales of property/investments	1,166	1,005	10,964	3,288	1,632
Budgetary surplus (deficit)	-7,132	-29,466	-13,372	-47,538	-69,384
Net borrowing activity ^a	10,483	30,569	6,766	47,568	69,384
Balance sheet data (council level)					
Cash and cash equivalents	107	290	558	1,289	0
Dedicated sinking funds	5,536	6,375	1,690	1,581	
Receivables	9,176	9,188	12,387	17,620	10,640
Property, plant and equipment	1,626,903	2,067,067	2,788,835	3,078,403	3,083,841
Payables	18,673	16,541	22,800	37,954	21,280
External council debt ^a	51,067	69,149	79,030	108,934	155,572
Internal council debt	34,318	29,910	43,526	37,109	40,000
Lease liabilities	2,031	2,097	2,137	2,000	
Development and financial contribution debt	49,824	61,882	64,916	82,965	134,728
Total indebtedness	137,240	163,038	189,609	231,008	330,300
Net debt (net of sinking funds)	131,704	156,663	187,919	229,427	330,300

^a Borrowing for budgetary deficit - debt repayments
Source: Fitch

Appendix 3

Financial and Debt Ratios

	2005	2006	2007	2008	Annual plan 2009
Financial ratios					
As a % of operating revenue					
Rates revenue	62.1	59.3	60.6	61.8	59.9
User fees	29.0	29.9	26.0	28.0	25.3
Council capital contributions	6.0	8.3	10.7	8.6	12.5
Employee expenses	28.6	28.6	30.3	32.4	33.5
Interest expense	5.9	6.5	7.0	8.5	13.4
Debt service	5.9	6.5	15.1	14.5	13.4
Total operating expenditure	71.2	74.0	80.8	84.7	75.6
Operating surplus (deficit)	28.8	26.0	19.2	15.3	24.4
Cash & cash equivalents	0.1	0.2	0.4	0.9	0.0
Per capita ratios					
Operating revenue	938	1,020	1,030	1,065	1,160
Operating expenditures	668	754	833	903	877
Capital expenditures	375	526	395	579	820
Net debt	1,040	1,212	1,376	1,649	2,350
Debt ratios					
Net debt/capital value (%)	1.0	1.2	0.9	1.1	1.5
Net debt/operating revenue (x)	1.1	1.2	1.3	1.5	2.0

Source: Fitch

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