Oiling the wheels of the New Zealand economy

New Zealand debt survey

PwC New Zealand treasury survey

Issue two

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Welcome to the second PwC New Zealand treasury survey

Our survey focused on the debt raising activities of entities with approximately $50 million to $500 million of outstanding debt.

The objective was to better understand how these organisations, often with limited treasury resource, make their decisions relating to debt management. For example, why they choose bank funding over debt capital markets funding or vice versa; do they see benefit in a credit rating; how do they determine which banks to use; what types of covenants are they exposed to; what treasury policies are they subject to; and how have they traded off attributes such as the cost of debt relative to term, or relative to the freedom from covenants.

Larger entities were excluded from the survey as these entities, in general, have little choice but to use both bank funding and the debt capital markets given the size of their funding requirements; they will generally (but not always) have a credit rating; they will use a large panel of banks for their funding requirements; they have, by necessity, well thought out and established treasury policies relating to debt funding matters; and, in general, have dedicated treasury teams to manage debt funding risk issues.

In summary, we focused on those entities that had significant choices around debt funding alternatives, but also had enough debt to make it a meaningful issue to manage.

We believe the survey results provide some valuable insights into what these entities are doing to manage their funding risk. It should also provide some interesting ideas for entities to consider and potentially adapt what they are doing to add further value for their businesses.

The survey was completed during the last four months of 2012 and was conducted through a series of interviews (the large majority of which were undertaken face to face with the remainder through telephone interviews). The survey was conducted in this manner to enable a deeper understanding of the responses. This approach allowed follow up questions to be asked to clarify some of the answers supplied by respondents and therefore further enhanced the understanding of funding issues facing entities of this size.

All the entities represented in our survey had full responsibility for their debt raising functions. While a small number of respondents had a majority owner (whether New Zealand or offshore), these entities operated independently and had full autonomy around funding decisions.

The survey results highlight that funding challenges and pressures, while not at the same intensity as they were during the height of the Global Financial Crisis (GFC), remain significant. As noted by the Reserve Bank of New Zealand in its most recent Financial Stability Report, "New Zealand's financial system continues to face a challenging international environment. Global economic activity is weak and this is affecting emerging market economies, including China. Conditions in the euro area remain fragile and the underlying fiscal and structural issues facing the region are substantial. Global growth could be further undermined by the prospect of a material tightening in US fiscal policy. This external environment poses significant risks for the New Zealand financial system[1]." Most respondents remember how difficult times were during the GFC and remain wary of a similar situation happening again. Many have taken steps (for example, pre-funding and diversification of their funding providers) to further reduce the risk in their funding activities and to mitigate the impact of any sudden deterioration in funding market conditions.

The survey results are broken down into four key themes: general funding issues; considerations relating to bank funding; considerations relating to debt capital markets funding; and treasury policy issues associated with debt and liquidity. Where relevant, the presentation of the findings have been separated out between the local government sector (ie. councils) from the remaining entities. In many instances, the approach the local government sector takes to funding decisions is completely different to those 'other' entities. This trend has become further exaggerated with the introduction of the Local Government Funding Agency (LGFA).

Lastly, thank you to all those respondents who kindly gave up their valuable time to participate in the survey. It was your openness and willingness to share your information and thoughts with us that has made this publication possible.

1. Reserve Bank of New Zealand's Financial Stability Report November 2012, Page 3.

Key findings

The following were the key findings in relation to the debt raising activities of entities with approximately $50 million to $500 million of outstanding debt.

- Entities (excluding councils) are heavily reliant on the bank sector and are unlikely to utilise the debt capital markets. 80% of debt funding for these entities is from banks.
- Funding pressures have generally eased since the GFC. However, most entities remain focused on debt raising issues and will often refinance debt well in advance of maturity to avoid showing debt as a current liability in their financial statements. Pre-funding, while it is rarely a requirement formalised in Treasury policies, is frequently undertaken on an informal basis.
- Entities place heavy emphasis on cost and term when raising debt. 65% rank cost as the most important consideration. They typically would desire a longer tenor but bank pricing beyond three years is often regarded as too expensive, or in some cases longer term funding is not available.
- Line fees and drawn margins for entities (excluding councils) rarely differ materially from a 50%/50% split.
- Often banking relationships around funding are historically based and an entity is unlikely to change if a bank has shown the ability to lend through cycles without major changes to pricing, availability and terms and conditions.
- Banks are excellent at understanding their clients' needs around funding and when to talk to them about funding requirements. 92% of entities view the contact as 'about right'.
- Cost is the main factor influencing councils to utilise the debt capital markets (including the LGFA). For non-council entities, diversification away from bank funding and the ability to achieve a longer tenor are more important than cost.
- Credit ratings are generally the domain of the local government sector and Standard & Poor's (S&P). 59% of councils have a credit rating, whilst 94% of entities that have a credit rating utilise S&P.
- The LGFA has and will continue to significantly change the local government sector's approach to funding. Reliance on banks in this sector will continue to reduce as the LGFA becomes a third source of funding for most.
- Treasury debt policies are often inappropriate or unworkable for entities of this size. Time buckets for spreading debt maturities and liquidity headroom are the most common core debt policies.

Contents

Breakdown of respondents

We had over 80 respondents to the survey – the substantial majority of the population of New Zealand entities with approximately $50 million to $500 million of outstanding debt.

Respondents included a wide range of publicly listed companies, local authorities and a large number of private entities. As a result of the high response rate, the results should be representative of entities with outstanding debt in this range.

We use the word 'approximately' $50 million to $500 million of debt as there were a number of respondents to the survey that experience a high degree of volatility in their outstanding debt due to the seasonal or cyclical nature of their underlying businesses. Hence, their debt may vary from less than $50 million to greater than $50 million at times during their financial year. At the other end of the spectrum, some respondents had debt ranging from less than $500 million to greater than $500 million during their annual cycle. We should also make it clear that these parameters were based on outstanding drawn debt, as opposed to overall debt facility size.

Ownership	%
Listed	38%
Private	23%
Council	26%
Government	13%
Total	100%

Industry sector	%
Consumer	17%
Councils	26%
Energy	6%
Healthcare	7%
Infrastructure	2%
Ports	8%
Primary	16%
Property	13%
Other	5%
Total	100%

In total, our respondents had

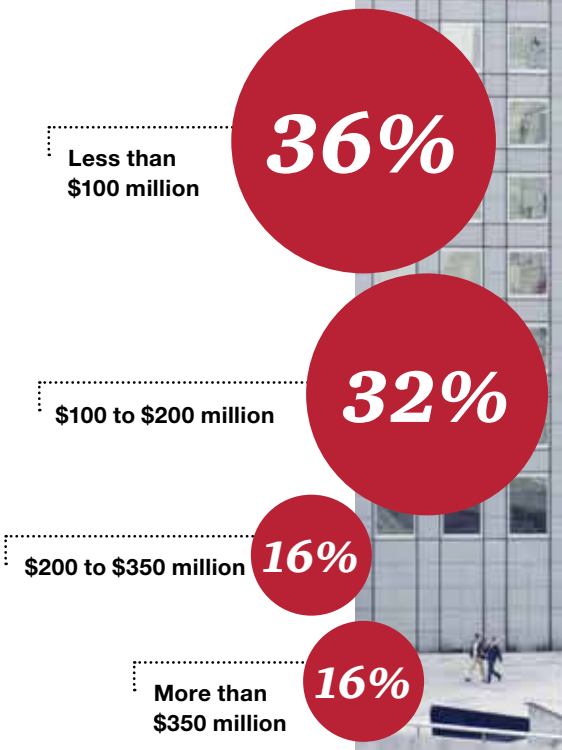
$16.6 billion

of outstanding drawn debt...

or an average per respondent of

$195 million

Total drawn debt



General funding issues

1 Use of a credit rating

The first issue we addressed with respondents was whether entities with debt ranging from $50 million to $500 million had an external credit rating or saw potential benefit from having an external credit rating.

In summary, only 20% of respondents had an external credit rating. The majority of entities that have a credit rating do so because they wanted to access the debt capital markets and saw a direct pricing benefit, along with increased demand from those wholesale investors that could only invest with rated entities.

Of the respondents that do not have a credit rating, 15% were contemplating obtaining a rating over the next two years. The most common reason given for looking to obtain a rating was expansion plans either through acquisitions or increased capital expenditure, which meant a capital markets issuance was being considered at some point in the future.

This is the first area where the responses from the local government sector were completely different from 'all other entities.' 59% of local government bodies had a credit rating, increasing to 82% if those councils in the process of obtaining a rating or seriously contemplating obtaining a rating are included. This contrasts with the remainder of entities where only 6% had a rating, increasing to just 14% if those entities which are seriously considering obtaining a rating are included. This clearly reflects a number of factors including the greater use of the debt capital markets by the local government sector; their relatively strong credit standing; their public ownership (and therefore greater focus on transparency); and the introduction of the LGFA, which gives a pricing benefit to those entities obtaining a credit rating.

Only 20%

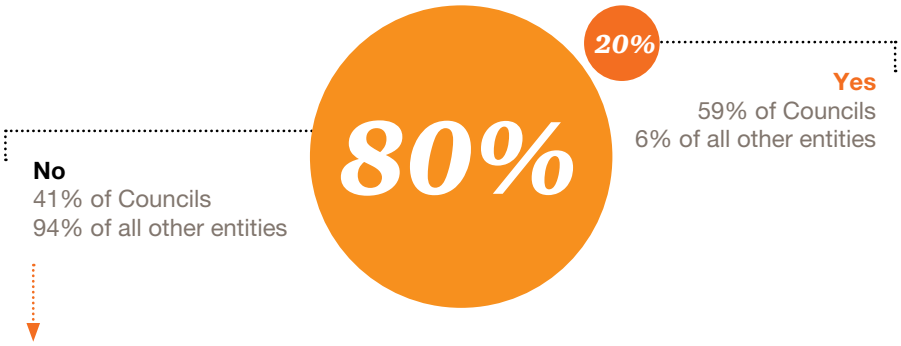
of respondents had an external credit rating

The breakdown by long term credit rating bands (utilising Standard & Poor's (S&P) terminology) and by credit rating agency used is outlined on the following page. With 94% utilising S&P, this agency clearly dominates. The main reasons for utilising S&P over other credit rating agencies are name recognition and a perception of a more user friendly fee structure.

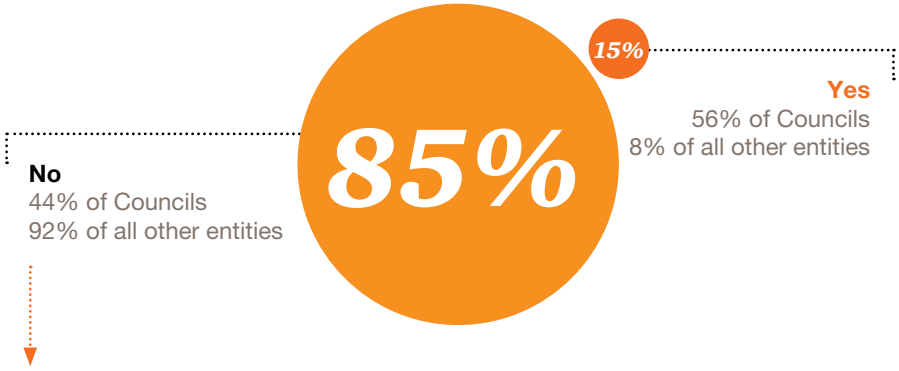
Of the entities which did not have a rating, and were not contemplating getting a credit rating, the primary reason given was that their debt requirements are, and were likely to remain, too small to justify a rating. Typically, a credit rating would only be obtained if an entity had debt requirements significant enough to economically access the debt capital markets (although a credit rating is not essential to access them).

Associated with this reason for not obtaining a credit rating was the cost and complexity of obtaining one and the fact that many entities could obtain all the debt they needed from the banking sector without having to rely on the debt capital markets.

Do you have a credit rating?



If you don't, are you considering one?



In essence, the upfront and ongoing costs, along with the administrative input, did not come close to exceeding the benefits (if there were any).

Other reasons not to obtain a credit rating included:

a. a belief that the credit rating agencies would not fully understand their business or did not fully understand the sector they were in;

b. the fact that competitors had not obtained one;

c. reliance on a guarantee (making a rating superfluous);

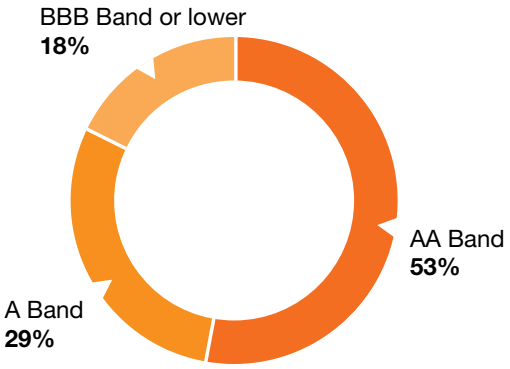
d. the fact that banks did not require one and did their own credit analysis;

e. the private nature of the entity and the desire to remain that way; and

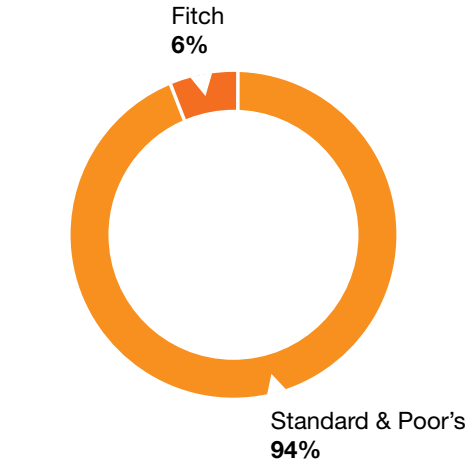
f. the ability to issue in the capital markets without a rating, especially if the entities 'name' was well recognised and had a good reputation.

Some companies had obtained shadow credit ratings for a variety of different reasons but decided not to proceed. Reasons for this included a belief that the rating agency had not rated the entity in line with its expectations (ie. a belief that they did not really understand their business or sector) and because banks were applying a higher internal rating to the entity than that which the rating agencies would apply.

What level of credit rating do you have?



Which agency do you use?



2 Where do entities fund from?

Respondents were asked where they accessed their debt funding from – the banks or the debt capital markets[2]. All respondents utilised bank funding, either as drawn funding or in the form of a back-up standby facility (or both). If those entities that solely used bank funding as a back-up standby facility are excluded, this number reduces to 87%. Overall, bank funding accounted for 67% or $11.1 billion of the total drawn debt covered in this survey.

35% of respondents accessed the capital markets for at least part of their funding requirements, comprising 33% or $5.5 billion of the total drawn debt covered in this survey.

Of the entities accessing the debt capital markets, 37% solely relied on this source, using bank funding only for pure back-up or standby facilities. Of those entities accessing the debt capital markets, 53% had a credit rating.

The debt maturity profile of the capital markets funding differed materially from the bank funding debt maturity profile. Shown in the table is the breakdown of drawn debt by time to maturity. It should be stressed that this shows current time remaining until maturity and not the original tenor when the debt was first put in place.

The greater relative percentage of short term debt held by councils reflects the use of CP and the greater relative percentage of debt beyond five years reflects the use of long term bonds (and the lack of bank appetite to lend for terms beyond five years).

2. Note, for the purposes of this analysis, we have included local government funding undertaken with the LGFA under capital markets funding, as that is its original source.

As can be seen, the capital markets funding tends to be made up of short term instruments (such as commercial paper ('CP')) or longer dated bond instruments. Note that many of the bonds showing a maturity of 1-3 or 3-5 years originally had a longer maturity. The high percentage of bank funding in the 1-3 year time horizon reflects that many entities do not want to report any debt as 'current' in their financial statements and that this timeframe often reflects the 'sweet-spot' for bank lending (ie. the optimum balance between cost, term and covenants).

Again the results differ materially between local government bodies and 'all other entities'. Councils raised 71% of their debt from the capital markets while 'all other entities' raised 80% of their debt directly from banks (refer table below). The percentage of debt that the councils raise from the capital markets is likely to increase further given the influence of the LGFA and its ability to provide councils with longer dated debt at attractive margins relative to bank funding.

Time to maturity

	Total ($m)	Total (%)	Bank (%)	Debt capital markets (%)
Overall				
0-1 year	3,143	19%	15%	26%
1-3 years	8,003	48%	59%	27%
3-5 years	4,067	24%	24%	27%
5-10 years	1,258	8%	2%	18%
10 years+	119	1%	0%	2%
Total	16,590	100%	100.0%	100%
% of funding			*67%*	*33%*
Councils				
0-1 year	1,169	27%	36%	22%
1-3 years	1,428	32%	40%	30%
3-5 years	968	22%	18%	24%
5-10 years	823	19%	6%	24%
10+	0	0%	0%	0%
Total	4,388	100%	100%	100%
% of funding			*29%*	*71%*
All other entities				
0-1 year	1,974	16%	12%	31%
1-3 years	6,575	54%	62%	23%
3-5 years	3,099	25%	24%	31%
5-10 years	435	4%	2%	10%
10+	119	1%	0%	5%
Total	12,202	100%	100%	100%
% of funding			*80%*	*20%*

3 Priorities when raising debt

Respondents were asked to rank six considerations, from most important (ranked 1) to least important (ranked 6) when they raised debt or put in place a new debt facility. The six considerations were: the cost of the debt; the term of the debt; ongoing compliance (such as regular reporting to lenders); ease of execution; diversity of funding sources; and lack of restrictions (such as the absence of covenants, credit rating triggers etc). Respondents were also given the opportunity to specify and rank 'other' criteria that they considered important but were not included in the six listed considerations.

When it came to the most important consideration (ie. what respondents ranked as number 1), not surprisingly 65% selected the cost of the debt. A meaningful 13% of respondents selected the ability to get term as their number one consideration and a further 7% of entities ranked the ability to raise debt on flexible terms and conditions (ie. lack of restrictions) as the most important. 'Other' considerations, (for example, the (long term) banking relationship/partnership, counterparty risk, type of banking facility) were the most important for a small number of respondents. It was notable that counterparty risk (ie. ensuring that the lender will be in existence and able to fund the entity when required) was ranked the most important issue for a small but vocal number of respondents. This issue is discussed again in the section on Treasury Policies relating to debt funding.

When it came to what respondents included in their top three considerations, the results again paint a clear picture. 99% of respondents included the cost of debt in their top three considerations, while 87% included term and 48% lack of restrictions. The responses under 'other' considerations were excluded from this analysis as not all respondents could vote for or rank these considerations.

A common theme that came through was the inevitable trade-off between these priorities when raising debt. For example, increased term only came with increased cost, and an easing of covenants or other restrictions was usually associated with increased cost.

Finally, the table shows the full ranking of considerations (again, for the reason previously outlined, excluding the 'other' category). With 21 points to be allocated (1 + 2 + 3 + 4 + 5 + 6) by each respondent across the six categories, 3.5 (21/6) represents an average score. The mean was then determined for the 80 plus responses in each category and ranked in order of importance.

As is clearly evident, cost is a very important consideration.

The local government sector again shows some important differences. Cost remains the most important consideration. Compared to 'all other entities', term and compliance are relatively more important considerations for councils. This is due to the long term nature of their assets and the greater level of public scrutiny and disclosure, which increases the focus on compliance with (published) internal policies. Lack of restrictions is the least important factor for local government entities as most are not subject to financial covenants.

For 'all other entities', cost, term and lack of restrictions were, in that order, the most important considerations.

Priorities when raising debt

	No. 1 consideration	Top 3 considerations	Mean score
Overall			
Cost	65%	99%	1.44
Term	13%	87%	2.46
Compliance	2%	22%	4.44
Ease of Execution	2%	15%	4.72
Diversity	4%	29%	4.33
Lack of Restrictions	7%	48%	3.61
Other	7%		
Total	100%		21.00
Councils			
Cost	58%	100%	1.59
Term	24%	91%	2.16
Compliance	6%	34%	4.05
Ease of Execution	2%	16%	4.56
Diversity	0%	39%	4.14
Lack of Restrictions	10%	20%	4.50
Other	0%		
Total	100%		21.00
All other entities			
Cost	68%	98%	1.39
Term	9%	86%	2.57
Compliance	0%	18%	4.58
Ease of Execution	2%	15%	4.77
Diversity	5%	25%	4.40
Lack of Restrictions	6%	58%	3.29
Other	10%		
Total	100%		21.00

4 Were respondents comfortable with their debt maturity profile?

Respondents were asked about their debt maturity profile – would they like a longer debt maturity profile and/or would they like their profile to be different.

When it came to a desire for a longer debt maturity profile, respondents were generally evenly split. 46% reported that they were comfortable with the current length of their debt maturity profile. Of the remaining 54%, around half of these were unequivocal that they would like a longer maturity profile, with the other half desiring a longer profile but only if the extra margin or cost was considered reasonable. In many cases, entities had examined longer debt maturity options but had concluded that the extra cost was not justifiable. The LGFA was seen as an important factor allowing councils to easily extend their maturity profile in a cost effective manner.

Responses were also mixed when it came to whether entities wanted a different debt maturity profile. The main reasons cited for being comfortable with their current profile included:

a. their current profile served the company well throughout the GFC and there was little reason to change;

b. their profile already had sufficient tranching built in and therefore refinancing risk was already adequately reduced;

c. there was ample bank appetite to meet refinancing needs and therefore the risk was considered low and manageable; and

d. overall debt levels were reducing or considered low and therefore debt management was not a major concern.

Those respondents who wanted a different debt maturity profile cited a number of reasons (apart from wanting a longer debt maturity profile to reduce refinancing risk). Main reasons included:

a. wanting a closer match to their asset profile;

b. wanting a greater mix of debt maturities (in the case of a single tranche, there was general discomfort at being exposed to having all their debt maturing at one time);

c. wanting current debt maturities to be spread further apart; and

d. wanting to reduce gaps in their current debt maturity profile.

A number of entities were not comfortable with their current profile but acknowledged there were specific business considerations that had led to their current profile being what it was and they were taking active steps to modify their profile.

Many entities recognised that with relatively low levels of debt, there was a trade-off between maintaining a number of different debt tranches to spread refinancing risk, and keeping things simple and practical.

5 How far in advance of needs do entities fund?

The funding difficulties that eventuated throughout the GFC have not been forgotten. Entities are looking to minimise the risk of being caught in a funding vacuum again. Most entities fund or extend facilities well in advance of needs and/or the maturity of existing debt with 39% targeting one year or longer. Planning or discussion around new funding or funding renewals will often occur over an even longer time frame. If local government councils are excluded from this analysis, the percentage funding one year or longer in advance increases to 48%.

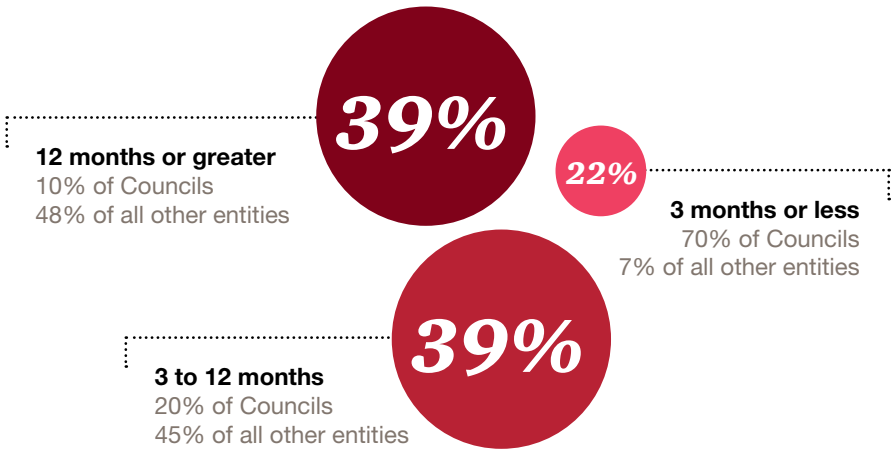
A common issue for many entities was the desire to avoid showing debt as 'current' (ie. as a current liability) in their financial statements. In fact 31% of respondents stressed this as a major factor driving their timing on refinancing. This consideration was most prevalent in (although not limited to) publicly listed companies with 61% of publicly listed respondents raising this as a major factor. Many thought that having debt showing as 'current' was irresponsible and sent the wrong signal to shareholders about debt management and its importance. Although this pre-funding often came at considerable cost, many thought the extra expense outweighed the potential negative consequences. This trend is a clear change from practices that existed before the GFC. Overall 47% of respondents did not have any debt classified as current. If the analysis is restricted to those entities solely relying on bank funding, this number increases to 65%.

The 22% of respondents leaving funding commitments to the very short term (ie. less than three months) is probably overstated and does not fairly reflect the debt risk culture within those organisations. Often those organisations which fund within three months of needs were utilising short term funding instruments (such as CP). However, this form of funding was supported by longer term (undrawn) standbys which are designed to provide back-up liquidity should an unforeseen event occur. As a result, given the importance of standbys, these were renewed or extended a considerable period of time before maturity. Most of these entities were councils. Of the 'non-councils' only 7% left locking in funding commitments to a period of three months or less.

Those entities pre-funding in the 3 to 12 month timeframe were generally very conscious of upcoming refinancing and the liquidity risk that it posed. However, they were also equally conscious of the extra cost imposed by refinancing earlier than needed. Many closely monitored market conditions and were prepared to act quickly to extend or renew facilities if they viewed market funding conditions as deteriorating.

There was also often a difference between the timing of funding new debt (maybe due to an acquisition) and the renewing of 'ongoing' facilities. Ongoing facilities were generally renewed a certain time in advance each year or period, whereby new facilities were often put together much more quickly out of necessity. Often, the event causing the requirement for new debt was made contingent on the entity being able to put in place the necessary debt facilities.

How far in advance of needs do entities fund?



6 How do funding risk management issues compare to two years ago?

Respondents were asked how they viewed funding risk management issues compared to two years ago – specifically, were they more important, less important or about the same.

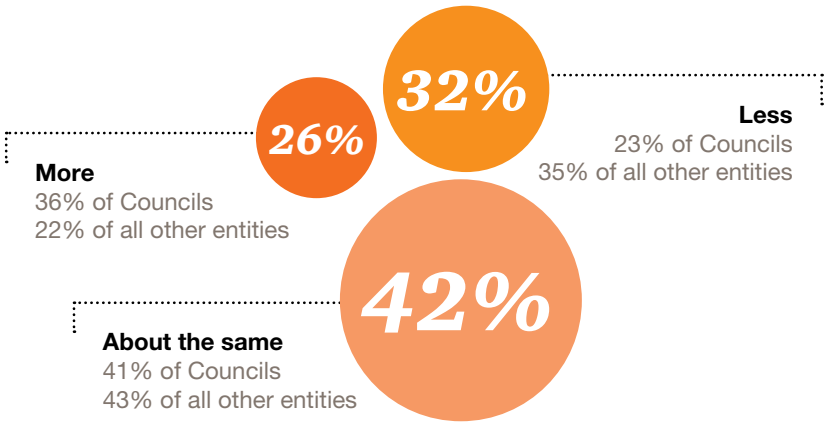
In general most respondents considered funding risk management issues as less important (32%) or about the same (42%) compared to two years ago.

Many of those who said they were less important stressed that they were only 'slightly less important'; or 'less important, but still important'; or only less important as the company had either 'reduced debt levels' or had 'secured longer term funding arrangements'. However, it was also clear in many cases that there was no shortage of banking appetite for some entities, with a common comment being along the lines that 'banks were falling over themselves to lend us money'.

For those entities that cited funding risk management issues to be more important (26%), most noted company specific factors as the main contributing factor such as a major acquisition or expansion plans increasing the need to secure longer term funding. A lesser number referred to market factors such as the ongoing problems in Europe and the possibility that this could lead to a deterioration of conditions in the funding markets.

Interestingly, 36% of local councils responded that funding issues were more important than two years ago. This is despite the high credit quality of the sector and the introduction of the LGFA. Reasons given were mainly council specific, often driven by an increasing need for higher infrastructure expenditure and therefore higher debt levels. For those respondents that at the time of the survey had not yet joined the LGFA, many noted that joining the LGFA will largely eliminate or reduce those funding pressures as it will provide an additional source of funding.

Funding issues more or less important



Bank funding

7 Introduction

All respondents utilised some form of bank funding. The majority had a banking facility (or a combination of banking facilities) which provided core funding (ie. that which was expected to remain in place for the foreseeable future); working capital or seasonal facilities; and a portion set aside for 'standby' funding (ie. headroom or available liquidity that could be called upon in emergencies or unplanned situations).

The proportions in which respondents utilised these types of bank funding differed markedly according to the nature of the organisation. For example, utilities tended to utilise bank funding largely to meet core debt demands, with little attributable to working capital needs. On the other hand, retailers, exporters and some primary producers had a much greater portion of their combined banking facilities targeted at their (volatile) working capital requirements. Some respondents, particularly councils that solely relied on the capital markets for their funding, utilised banking facilities only as pure 'standbys'.

Overall, our respondents in the survey had in place $17 billion of bank funding facilities, of which on average 65% were drawn. If those facilities used purely as standbys are excluded, then the average amount drawn increases to 67%. It is worth pointing out that due to the seasonal nature of some businesses, the disclosed level of drawdowns can differ significantly depending on what time of the year the information is reported. Further, a number of entities proactively managed the level of their seasonal facilities, changing the commitment level regularly throughout the year as their underlying needs change.

Overall, our respondents in the survey had in place

$17 billion

of bank funding facilities.

8 Number of banks used for funding

Respondents were asked how many banks they utilised for their bank debt facilities.

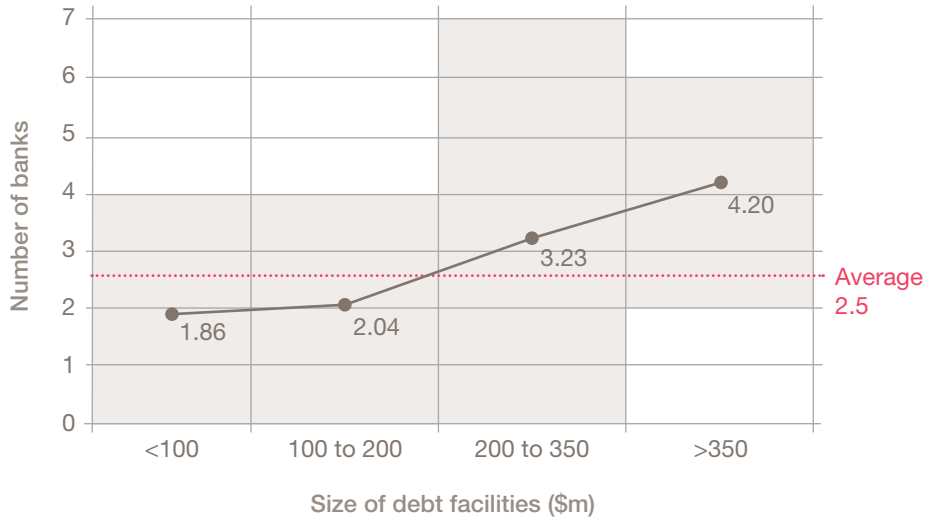
On average, an entity utilised 2.5 banks, – which given overall debt facilities of $17 billion, represents an average commitment of around $79 million per bank per entity. Given some of the smaller New Zealand banks and non-Australasian owned offshore banks offer smaller funding commitments, you would expect the average facility size of the large Australasian owned banks to be higher than this.

Averages in this area are only so useful. Quite clearly, a banks' funding commitment to any individual entity will, to a large extent, depend on the banks assessment of the entity's credit quality, as well as other factors such as the term of the facilities, ancillary business etc.

You would expect a strong correlation between the total dollar value of a debt facility and the number of banks utilised. In general this was found to be true, although wide variations existed. The chart opposite shows the average number of banks used broken down into total banking facility size (note, this refers to total banking facilities and not total drawn bank debt). The shading in each bucket shows the range of banks used by respondents in each bucket.

This was another area where the local government sector differed from 'all other entities'. On average, a council utilised 2.2 banks as opposed to 2.7 banks for 'all other entities'. This is largely driven by the fact that local government entities are more likely to rely on the capital markets for a large portion of their funding and some will only utilise banks as standby providers to support their CP issuance.

Number of banks used



Local government entities are more likely to rely on the capital markets for a large portion of their funding and some will only utilise banks as standby providers to support their CP issuance.

9 Do entities have too many banks or not enough?

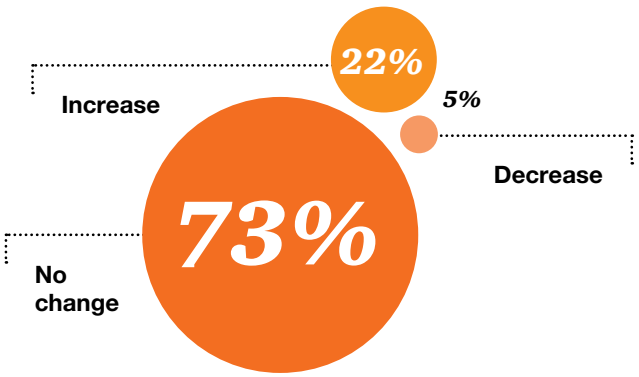
Respondents were asked whether they would like to increase or decrease the number of banks they had for funding, or remain with the status quo.

In general, 73% were comfortable with the number of banks they had for funding. Interestingly, of the 25% of entities which were sole banked, 57% of those remained comfortable with the status quo. The history to this type of arrangement was often a long standing (and obviously mutually beneficial) relationship. Commonly however, entities would benchmark their incumbent bank against other providers to ensure pricing and other covenants were 'at market'. It was clear though that a deep sense of loyalty prevailed with this group of respondents.

Of those respondents that remained happy with the status quo, many commented that if debt changed materially (increasing or decreasing), they would look to adjust (increasing or decreasing respectively) the number of banks they utilised.

Of those that wanted to increase the number of banks they utilised for funding (22%), the most common reasons were: increasing debt levels; to install (more) competition; to "keep the incumbent(s) honest"; or to "become less reliant and increase diversification". A significant portion had a strong view on which bank they would add to their panel (or not add) given the perceived strengths and weaknesses of the various banks. In some cases, the next bank to be added would be chosen based on their strengths in other areas (for example, foreign exchange or overseas transactional banking) and not just on their debt funding capabilities.

How do you want to change the number of banks used?



It is clear a deep sense of loyalty prevailed with this group of respondents.

Of those that wanted to decrease the number of banks they utilised for funding (5%), the most common reasons were decreasing debt levels and the time taken to manage different banking relationships.

It again became clear that in most instances, there were many willing banks keen to participate or increase their participation on accounts. In other words, most entities were spoilt for choice.

For local government entities, 77% were comfortable with the status quo and the remaining 23% were looking to increase the number of banks they utilised. The most commonly cited reason for looking to increase the number of banks was diversifying the risk. Despite the introduction of the LGFA, no councils were actively seeking to reduce their number of banks, although several mentioned they had recently done so or would look to reduce the size of their bank facilities (given large portions of their future financing would be taken care of through the LGFA).

Is one bank enough?

The question often asked is whether utilising one bank for your funding needs is enough?

So, what are the advantages and disadvantages?

The clear advantage when an entity is sole banked is that there will be a tendency to build a stronger partnership between the bank and entity concerned. The bank will tend to show more loyalty and will naturally develop a greater understanding of the entity's business as they have more 'skin in the game'. They also have more to lose if their performance fails to live up to expectations. The entity has the advantage that they spend less management time dealing with banking relationships.

The most obvious disadvantage for an entity is the lack of competition. How does the entity know they are getting the best possible pricing and terms and conditions? There is also the related disadvantage of being dependant on just one provider. The entity needs to consider what happens if for some reason the bank cannot or no longer wishes to fund the entity. Further, there is the potential for the bank to become full on limits, which could restrict the entity concerned.

Impact of the GFC

The GFC has obviously made entities consider in more depth the structure of their banking facilities.

A trend to emerge is for entities to have back-up in their banking facilities. For example, if they require a facility size of $100 million and they know that each bank is comfortable lending them $50 million, they will utilise three banks (each with a third of the facility), so that if one bank pulls out they can cover their requirements with the remaining two.

This approach has the added advantage that it creates a degree of competition within the banking syndicate, as each bank is aware that an entity can still adequately fund without them.

10 How often do banks talk to entities about their funding needs?

Respondents were asked how often the banks they used for funding, on average, discussed with them their funding needs. They were then asked was this too often, about right, or not enough.

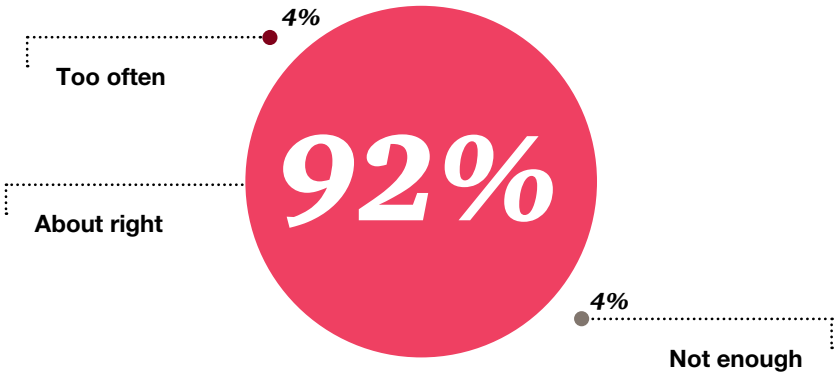
92% replied that the contact from the banks with regard to funding needs was 'about right'. This was despite the frequency of contact varying from 'about weekly' to 'once every couple of years' and many other timeframes in between. Just as importantly, a frequent comment made was along the lines of 'in normal times the contact would be too frequent, but we are going through a significant (acquisition, capital expenditure phase, etc) so the contact is appropriate for the circumstances'. This clearly shows that banks in general have a good understanding of their clients' funding needs and adapt their coverage as conditions or circumstances change.

Only 4% responded that the contact was 'not enough'. Sentiment expressed in the feedback was 'I think we have slipped below the institutional radar' or 'we have to initiate the contact with the bank on funding needs'.

Only 4% of respondents conclusively declared that contact on funding matters was too frequent (although several more were close, commenting that they wouldn't want more frequent contact).

It is also clear that banks differ in the amount of contact they have with their clients on funding matters. Multi-banked respondents sometimes tailored their responses in such a manner to indicate that some banks talk to them too much and others almost never, even though overall it may be 'about right'.

How often do you talk about funding needs?



11 Original tenor of bank funding

Respondents were asked what the maximum original tenor of their bank funding was, would they like this to be longer, and if in their opinion the tenor of bank funding available was likely to increase, decrease, or remain about the same.

On average, the maximum original tenor of bank funding was 4.1 years. Three years was the most common term (36%), with five years (28%) and four years (21%) also being relatively common. As expected, original bank funding beyond five years (8%) was uncommon. To a large extent this reflects the reluctance for most banks to lend beyond five years (to most entities) and also most entities' lack of willingness to pay the extra margin for terms longer than five years. Very few entities also had maximum original bank funding terms of less than three years (7%). In most cases this reflects the individual entities' desire to have a shorter original term, rather than any reluctance on the banks to lend for longer original periods.

In some cases, there were terms in the borrowing facility documentation which gave the ability, after a certain period of time (commonly yearly and usually on mutual agreement), to extend the term of the bank facility back to its original maturity. This has encouraged some entities to take shorter maximum original terms than may otherwise have been the case.

Not surprisingly, the average duration of bank funding for the local government sector was higher than the overall average (at 4.4 years). This reflects the generally higher credit standing of these counterparties and the longer term nature of their assets.

60% of respondents were comfortable with the term of their bank funding, with 40% desiring a longer original term. This is broadly consistent with the earlier results that roughly 54% of entities wanted a longer debt maturity profile. The difference can be put down to:

a. some entities (particularly councils) would look to the capital markets rather than bank funding to provide a longer tenor; and

b. the desire for a longer debt maturity profile may be driven by the current amount of time remaining until maturity, rather than the original tenor.

When respondents were asked if they thought the tenor of bank funding available was likely to increase, decrease or stay the same, most felt it was likely to increase (46%) or at least stay the same (45%). Few (9%) felt that the availability of tenor was likely to decrease. These results reflect that most respondents felt banking conditions had got easier since the GFC, and many entities reported increased appetite from banks to provide funding. The relatively recent focus of a prominent foreign bank in relation to certain sectors has also been an influential factor.

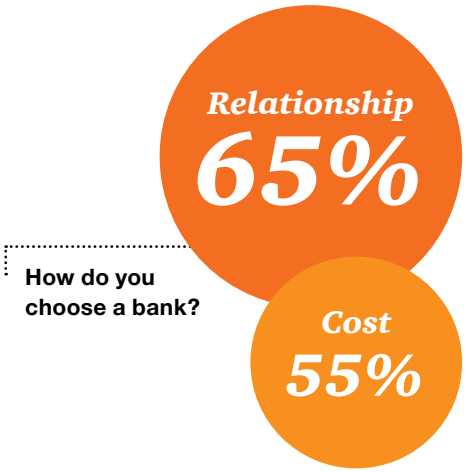
It will be interesting to see how banks respond in this regard, given funding costs for banks remain elevated in the longer part of the curve and many would see providing funding beyond five years being the predominant role of the debt capital markets rather than the banks.

Original tenor of bank funding	%
Less than 3 years	7%
3 years	36%
4 years	21%
5 years	28%
Greater than 5 years	8%

Availability of tenor	%
Increase	46%
Stay about the same	45%
Decrease	9%

12 How do entities choose which banks to involve in their funding?

Respondents were asked how they chose which banks they used for funding. That is, what were the key factors in their decision making?



How do you choose a bank?

Two key themes dominated the responses – well over half the respondents cited relationship with the bank (65%) and cost (55%) and often a combination of both as key factors.

In many cases, the relationship with a bank (or banks) went back many years and therefore the incumbent bank(s) were often inherited by the current CFO. Many entities expressed reluctance to replace an existing bank given the build up of understanding and knowledge about an entity and preferred to keep the status quo as long as the bank pricing (and associated covenants etc) were at or at least close to the competition.

The track record of a relationship bank was also particularly important, especially when it came to the period during the GFC. A banks proven ability to lend through cycles without major changes to pricing, availability of funding and terms or conditions was cited as a major factor in an entity keeping its existing relationships.

A significant minority (25%) referred to having undertaken a banking tender at some stage in the past, either as a way to select which banks they would use or to supplement their existing banking relationships. Cost was generally the major determinant for these entities.

Other common factors associated with choosing one bank over another included recognition of innovation, often around the structure of a facility; knowledge of an industry sector; flexibility (often around covenants or around speed of response and execution); and minimum credit rating requirements.

Interestingly, some respondent's chose their funding banks (or were looking to increase their funding banks) based on other (non-funding) treasury considerations. For example, if they wanted expertise in foreign exchange or overseas transactional banking, they would look to a bank with that perceived expertise to put into their bank funding group.

Another clearly held view was that there was an opportunity for the big four Australasian banks to expand their value adding activities outside of their core markets. Therefore, those entities with requirements in other markets (commonly foreign exchange and overseas transactional banking) were more focused on other banks with those capabilities.

Local government entities exhibited a slightly different decision making process. 36% reported undertaking a tender at some stage, with 77% citing cost and 41% bank relationship as key factors. The need for transparency and public accountability are obvious driving factors in this sector.

In many cases, the relationship with a bank went back many years and therefore the incumbent bank(s) were often inherited by the current CFO.

13 Bank facility features

Respondents were asked a number of questions relating to the attributes of their banking facilities. These concerned aspects such as the structure of their facilities, security requirements, financial covenants, other major restrictions and fee structures.

Syndicated v Bilateral

Entities were asked how they structured their banking facilities; whether as a syndicated facility or as a number of bilateral facilities. The majority (71%) utilised bilateral facilities, 25% used syndicated facilities and 4% utilised a combination (ie. some of their facilities were syndicated and others bilateral). A number of entities that had bilateral facilities commented that the terms and conditions of each bilateral were often identical apart from the pricing.

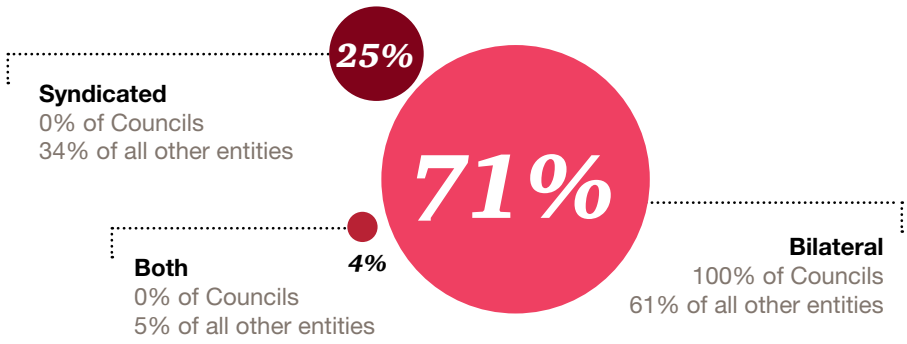
The advantage of bilateral facilities is that it is easier for an entity to negotiate and take advantage of differential pricing (ie. they can take advantage of individual bank pricing rather than being subjected to a collective pricing agreement). It also enables an entity to draw down on the facility they want to (presumably the most cost efficient), rather than equally across a panel of banks.

The disadvantage of bilateral facilities is that if the terms and conditions are different, it increases the administrative time involved in managing debt funding and makes compliance a more complex issue.

The most common form of syndicated facility is one where the pricing is uniform and drawdowns between participants are in accordance with their level of facility participation. A few entities reported having a syndicated facility but having differential pricing between participants (ie. a pricing side letter). A smaller minority also reported having the ability to draw down amongst participants on a disproportionate basis.

Interestingly, all local government entities included in the survey utilised bilateral facilities.

Syndicated vs bilateral

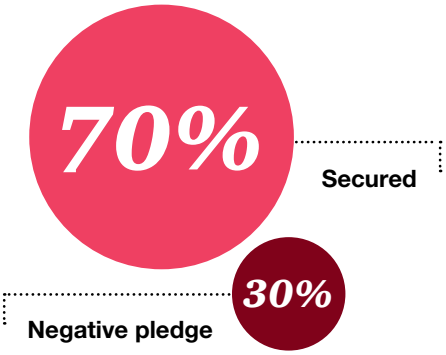


Bank Debt Security

Most facilities (70%) were secured, normally against assets, and less frequently against revenue streams. The remainder had a negative pledge type arrangement (an indenture stating that the entity will not pledge any of its assets if doing so gives the existing lenders less security). Commonly entities with a negative pledge arrangement had a guaranteeing group concept, whereby the substantial majority of the group's assets and/or earnings had to be part of the guaranteeing group.

Most local government entities, especially with the requirements of the LGFA, utilised a Debenture Trust Deed as part of their security arrangements.

Secured vs negative pledge



Financial Covenants

Apart from those entities in the local government sector, financial covenants were typically required. By far the most common financial covenants imposed are a form of interest coverage ratio (sometimes in the form of a fixed charge ratio if the entity had exposure to leases etc) and a form of gearing ratio. These were often expressed in slightly different forms depending on the entity and industry involved. Of those respondents that did have financial covenants, 94% had an interest coverage type ratio and 78% had a gearing type ratio.

The absolute numerical levels at which the various financial covenants were set differed between entities. This was not unexpected and reflects the different credit quality and industries of the entities involved. For this reason we have not reported on the 'averages' of various financial covenant ratios.

Other types of financial covenants that are less commonly imposed included an EBITDA/debt ratio (27%), essentially giving an idea of the time taken to pay off debt; minimum levels of equity (or similar) that must be maintained (13%); working capital covenants (9%); and restrictions around the level of dividend distributions that can be made (6%).

Type of covenant	%
Interest Coverage	94%
Gearing	78%
Debt/EBITDA	27%
Minimum Equity	13%
Working Capital	9%
Distribution	6%

Other Restrictions

Other restrictions imposed varied and were often specifically tailored to the entity or industry concerned. Common restrictions (in the form of prohibitions, requirement for prior approval etc) included limitations on asset disposals; prior approval for acquisitions and/or capital expenditure above a certain size; insurance requirements; restrictions on levels of underdeveloped assets; and continuity of ownership clauses. As expected, provision of information and reporting obligations were common requirements.

It was very uncommon for a council to have financial covenants of any kind. Requirements were normally limited to the provision of certain financial information and reporting obligations.

A factor for many entities when deciding which banks to use for funding was the form of covenants and other restrictions that were required. Entities were much more likely to utilise banks which provided more flexible or 'user friendly' covenants that they believed could be comfortably complied with and which suited their business model. This was both in the absolute numerical level an entity had to comply with and how the particular covenant was defined or worded. Innovation and understanding of an entities' business in this area were commonly rewarded. In some cases, the pricing of bank facilities also varied with the levels an entity achieved in key financial ratios.

For those entities with a credit rating, rating triggers were very uncommon with the exception that in several cases entities were exposed to margin step-ups if their credit rating was downgraded.

Fee Breakdown

Of significant interest was the fee breakdown, in particular between what entities paid in line fee (or commitment fee) compared to the drawn margin. Typically, when establishing a banking facility an entity will pay a one-off establishment fee, a line fee (for having the facility available) and a drawn margin when funds are actually drawn from the facility. For example, an entity may pay a 10 basis point establishment fee, a line fee of 60 basis points per annum and a further 50 basis points when funds are actually drawn from the facility. In this example, the split between line fee and drawn margin would be expressed as 45.5% line fee (50 divided by 110) and 55.5% drawn margin (60 divided by 110).

We have not reported an absolute average line and drawn margins as while it may be of some interest to compare an individual entity's fees against the average, there are some very obvious reasons why such a comparison would not serve any productive purpose. The most obvious reason is that the fee an entity pays is to a large extent linked to its perceived credit quality (ie. the higher the credit quality the lower the fee). Other reasons include factors such as differing tenors on the underlying facilities; different covenant and security packages; different dates that facilities were put in place; different types of facilities; and other ancillary business that may impact pricing.

On average, the percentage split in fees between line fee and drawn margin was 42.5% on line fee and 57.5% on drawn margin. Around half (45%) had a split between line fee and drawn margin of exactly 50/50. This is clearly the standard split in most situations. Only 5% of respondents had a split where the line fee was greater than the drawn margin; and a further 19% had a line fee which was between 40% and 50% of the total line fee and drawn margin. The remaining 31% had a line fee of less than 40% of the total line fee and drawn margin. Clearly, it is in the interest of entities to have the line fee being the smallest percentage possible relative to the drawn margin.

Before hitting up your bank(s) for a re-weighting of your line fee and drawn margin, most of the entities with a line fee percentage of less than 40% had special reasons for such a split. Many used their facilities as pure standbys and had a very low probability of actually drawing down. Therefore, the drawn margin was largely irrelevant to them and would not have been the subject of rigorous negotiation. Others had a very strong credit profile; a strong security offering; offered the opportunity for significant ancillary business; had a unique relationship with their (often sole) banking provider; or were priced in this manner largely for historical reasons.

This finding is confirmed if we look at the breakdown between councils and 'all other entities' on this matter. Clearly councils generally have a stronger credit profile and security offering than average and to a large extent utilise their bank facilities as pure standbys. On average, councils have a line fee/drawn margin split of 30/70% respectively, compared to 'all other entities' which have an average split of 47.5/52.5% respectively. Further, 90% of council entities had a line fee that was less than 40% of the total line fee and drawn margin. This compares with 8% of 'all other entities'. At the other end of the spectrum, only 5% of councils had a line fee that was 50% or greater of the total line fee and drawn margin, compared to 68% of 'all other entities'.

Facility fees (line fee as a percentage of line fee & drawn margin)

	%
Overall	
Line fee less than 40%	31%
Line fee 40% to less than 50%	19%
Line fee exactly 50%	45%
Line fee greater than 50%	5%
Total	100%
Councils	
Line fee less than 40%	90%
Line fee 40% to less than 50%	5%
Line fee exactly 50%	0%
Line fee greater than 50%	5%
Total	100%
All other entities	
Line fee less than 40%	7%
Line fee 40% to less than 50%	25%
Line fee exactly 50%	62%
Line fee greater than 50%	6%
Total	100%

Typically, when establishing a banking facility an entity will pay a one-off establishment fee, a line fee (for having the facility available) and a drawn margin when funds are actually drawn from the facility.

Debt capital markets funding

14 Introduction

35% of respondents to the survey utilised the debt capital markets for funding. 11% of respondents solely relied on the debt capital markets for their funding (albeit backed by a bank standby facility).

In total our respondents sourced 33%, or $5.5 billion of debt from the capital markets. Those entities active in the capital markets either utilised the market for short term funding (typically CP) because of the pricing advantage, or for long dated bond funding in excess of where the banks would normally provide funding. The approximate average *remaining* duration of the capital markets funding was around 3.3 years compared to 2.3 years for bank funding. This difference is despite the fact a sizeable portion of capital markets debt had a much longer *original* maturity.

Of those entities that were active in the capital markets, 53% had a credit rating. This illustrates that capital markets are to a large extent accessible without a credit rating for a large number of entities.

For the majority of respondents (65%) that did not access the debt capital markets (ie. relied solely on bank funding), most (69%) did not have any appetite for such issuance in the future. The predominant reason given was that they regarded their debt requirements (and forecast debt requirements) as too small to warrant issuing in the debt capital markets. Related to this reason was the extra cost and compliance associated with being active in that market. Many also saw the capital markets being relatively more expensive than available bank funding. Other common reasons cited for not accessing the debt capital markets included:

a. debt patterns being too seasonal or project based and therefore not suited to capital markets issuances;

b. banks comfortably providing the necessary funding;

c. private companies wanting to remain that way; and

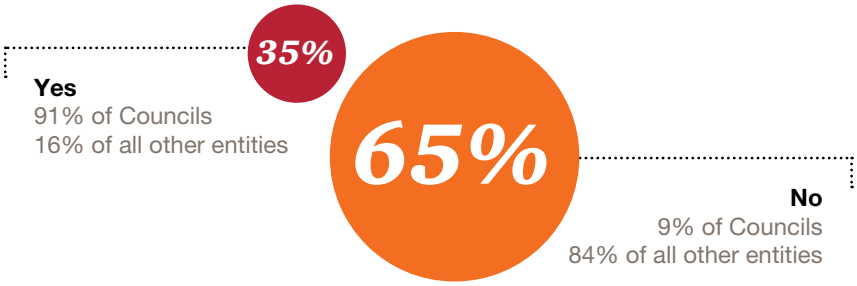
d. an overarching desire to keep things as simple as possible. While not frequently mentioned, the (essentially) free option to repay bank debt early (which is not available with vanilla debt capital markets issuances) is also a worthy consideration when assessing the relative merits of capital markets funding versus bank funding.

Of the 20% that said future issuance in the debt capital markets was possible, most referred to it being dependent on acquisitions or a growth profile giving them substantially higher debt levels, or on the relative cost (especially of retail funding) improving.

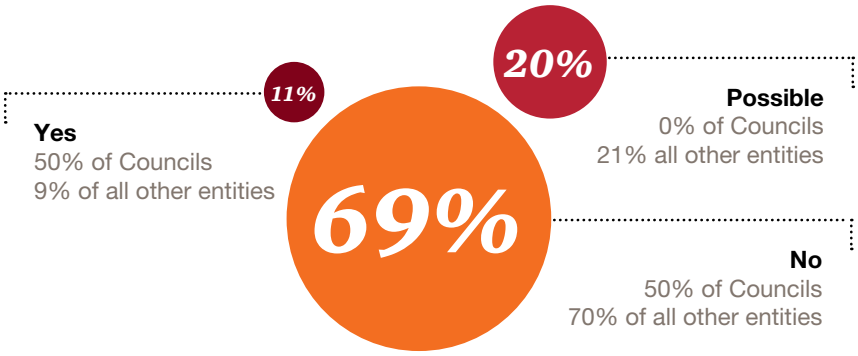
Of the 11% of respondents who have definite plans to access the debt capital markets in the future, most cited as their primary motivating factor growth plans that were relatively certain, along with a strong desire to increase the tenor of their funding and achieve diversification away from bank funding.

As indicated earlier in the survey, the results on usage of the debt capital markets differ significantly between councils and 'all other entities'. 91% of councils access the debt capital markets as opposed to 16% of 'all other entities'. If we include those entities that indicated that future issuance was definite or possible, these numbers increase to 95% and 41% respectively.

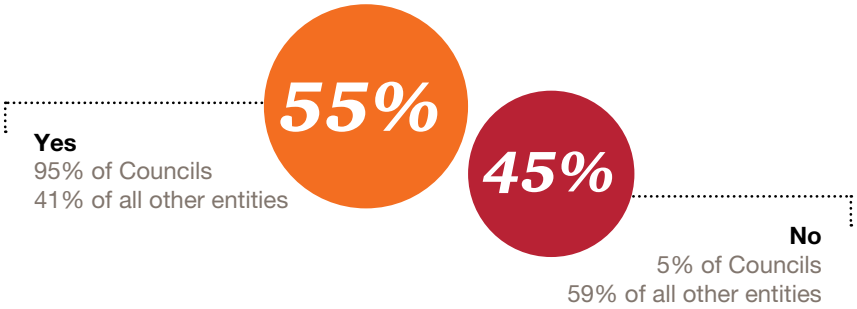
Entities using debt capital markets



Entities not using capital markets but may in the future



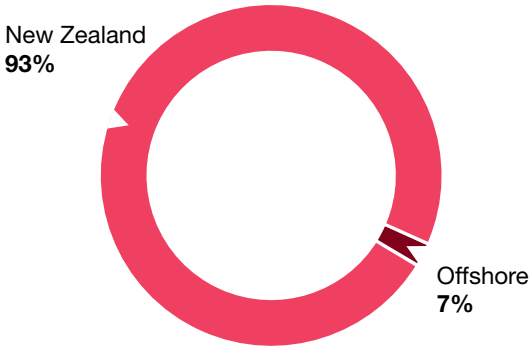
Entities using debt capital markets *OR* may in the future



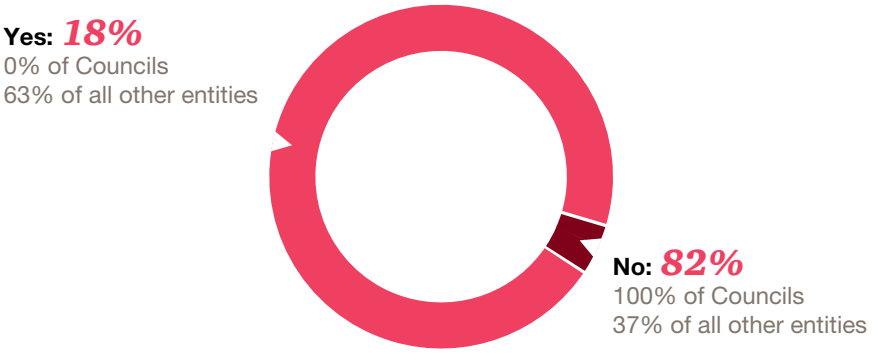
15 Debt capital markets utilised

Of the respondents that utilised the debt capital markets, most (93%) limited their issuance to the New Zealand capital markets[3]. A wide variety of debt instruments were utilised, the most common being CP, vanilla fixed rate bonds or notes, floating rate notes and the utilisation of the LGFA for some local government entities.

Debt capital markets utilised?



New Zealand debt capital market securities listed on the NZDX?



Overall, only 18% of entities utilising the New Zealand debt capital markets chose to list their debt instruments on the NZDX. However this is distorted by the fact that councils do not list their securities on the NZDX as they are all wholesale placements and/or through the LGFA. Of the 'all other entities', 63% listed their debt securities on the NZDX.

Of those entities which chose to list their debt instruments on the NZDX, many already had listed equity securities so extra compliance was not a factor.

Other benefits seen from listing debt securities were:

a. assisting volume;

b. making the issue more attractive (as retail investors could more easily trade their securities);

c. enhancing name and brand awareness; and

d. creating a pricing benchmark.

For those entities which did not list their securities, the most common reason was that securities were only placed with wholesale institutional or private investors and therefore listing was not a relevant issue.

Other reasons cited for not listing included:

a. extra compliance;

b. extra cost;

c. no pricing benefit;

d. no additional investor participation as the investor market was already known and well understood; and

e. a perception that issues listed on the NZDX did not trade in a meaningful volume.

3. Note, Councils, outside the LGFA and Auckland City, are currently prohibited from issuing in currencies outside NZDs.

16 How is an arranger chosen?

Respondents were asked to rank six considerations, from most important (ranked 1) to least important (ranked 6), regarding how they choose their arranger for a debt capital markets issue.

The six considerations were: arranger fees; relationship (with a bank); relationship (with an individual); pricing indication; rotation (ie. an entity took turns giving business to their relationship banks); and perceived capability in the market. Respondents were also given the opportunity to include, specify and rank 'other' criteria that they considered important but were not included in the six listed considerations.

For this analysis we have excluded the local government sector as a very large proportion of the debt capital markets instruments were either obtained via the LGFA or were essentially 'self-arranged'. By that we mean a council would have an established CP or bond programme whereby they would issue small amounts of debt via a tender by contacting their relationship banks for a quote and dealing on the basis of the most attractive issuance level.

	No. 1 consideration	Mean score
Perceived Capability	44%	1.75
Pricing Indication	6%	2.88
Relationship - Bank	19%	3.31
Relationship - Individual	19%	3.69
Arranger Fees	0%	4.31
Rotation	0%	5.06
Other	12%	
Total	100%	21.00

For 'all other entities', when it came to the most important consideration (ie. what respondents ranked as number 1), 44% selected perceived capability of the arranger in the market. A further 38% collectively selected relationships with a bank and/or a relationship with an individual within a bank as the most important consideration. The remainder selected pricing indication as the most important factor (often stating that capabilities of arrangers were very similar) or 'other' reasons, such as the bank providing services in addition to the standard arranger service, such as an underwrite.

The table shows the full ranking of considerations (note, responses under 'other' considerations were excluded from this analysis as not all respondents could vote for or rank these considerations). With 21 points to be allocated (1 + 2 + 3 + 4 + 5 + 6) by each respondent across the six categories, 3.5 (21/6) represented an average score. The mean was then determined for the responses in each category and ranked in order of importance.

What is apparent from these findings is that rotation between providers is not a consideration. This could be in part due to the fact that capital market issuances are infrequent occurrences for participants in this survey and they therefore do not have the volume of issuances to spread amongst relationship banks even if they wanted to.

Arranger fees were also not considered a significant factor. This may be partly due to these fees being fairly uniform amongst providers.

17 Rationale for debt capital markets over bank funding

Respondents were asked to rank five considerations, from most important (ranked 1) to least important (ranked 5), regarding why they chose debt capital markets funding over bank funding.

The five considerations were cost; diversification; the availability of longer tenor; the size of respondents funding requirements; and the marketability of the securities. Respondents were also given the opportunity to include, specify and rank 'other' criteria that they considered important but were not included in the five listed considerations.

When it came to the most important consideration (ie. what respondents ranked as number 1), 57% selected cost. Most of the respondents that selected cost were either utilising short term capital markets instruments and/or were local government bodies funding, at least in part, through the LGFA. A common method of funding for rated entities is the utilisation of short term CP on a rolling basis backed up by a longer term bank standby. This gives the entity the benefit of relatively low margins on the CP but the security of having the back-up of a long term bank standby should the funding markets become disrupted. The effective overall cost of this facility to the entity is the combination of the issuance margin of the CP plus the line fee on the standby[4].

20% each selected diversification or the availability of longer tenor as the most important consideration.

Again results differ significantly between the local government sector and 'all other entities'. For councils, 70% ranked cost as the most important consideration, followed by tenor (15%) and diversification (10%). For 'all other entities', 40% ranked diversification as number 1, with cost and tenor being selected by 30% each.

Finally, the table below shows the full ranking of considerations (note responses under 'other' considerations were excluded from this analysis, as not all respondents could vote for or rank these considerations). With 15 points to be allocated (1 + 2 + 3 + 4 + 5) by each respondent across the five categories, 3 (15/5) represents an average score. The mean was then determined for the responses in each category and ranked in order of importance.

We have broken down the table into local government and 'all other entities' to illustrate the difference in considerations. What is clear is that councils fund through the capital markets primarily because it is cheaper than bank funding, whereas diversification away from bank funding and the availability of longer dated tenors are in general more important for 'all other entities' than cost considerations. Size requirements and the marketability of the securities are unimportant factors with virtually all respondents.

Rationale for debt capital markets funding over bank debt

	No.1 consideration	Mean score
Overall		
Price	57%	1.75
Diversification	20%	2.36
Tenor	20%	2.41
Size	0%	4.09
Marketability	0%	4.39
Other	3%	
Total	100%	15.00
Councils		
Price	70%	1.26
Diversification	10%	2.74
Tenor	15%	2.53
Size	0%	4.05
Marketability	0%	4.42
Other	5%	
Total	100%	15.00
All other entities		
Price	30%	2.78
Diversification	40%	1.56
Tenor	30%	2.17
Size	0%	4.17
Marketability	0%	4.32
Other	0%	
Total	100%	15.00

4. As well as any establishment fees, etc to be amortised over the term of the underlying facilities.

Treasury policies relating to debt funding

18 Introduction

Respondents were asked in this section of the survey to outline their treasury policies (assuming they had a treasury policy) relating to matters concerning debt funding and liquidity management.

Questions were asked on the content of their formal policy – including did they have to pre-fund commitments a certain period in advance; did they have to hold a certain amount of headroom in their facilities; did they have to spread their debt maturities; who within their organisation could approve new debt issuance; and if they separated out their debt management decisions from their decisions relating to interest rate risk management. Overall, responses varied significantly – ranging from those that have very formal structured policies (dominated by explicit numbers and time frames) to those that have more subjective policies focusing on the intent of the policy; and finally those that have little if any documented policy but instead had an informally established process of reporting and planning that regularly addressed some of the debt risk management issues.

As will become apparent when the results are presented, local government entities tend to have more formal policies than 'all other entities', partly given their need for transparency and the overall scrutiny from the public, as well as because of the requirements imposed by the LGFA.

19 Pre-funding

Pre-funding policies, to a large extent, originated from the GFC and credit rating agencies looking for entities to fund well in advance of needs (including both new debt and the refinancing of maturing debt). The obvious purpose and benefit of this kind of policy is to reduce debt (re)financing risk. The obvious downside is the additional cost this imposes in terms of having funding facilities in place before they are required.

Only 14% of respondents had a formal pre-funding policy – normally along the lines of 'all debt requirements will be locked in place with a formal commitment at least x months before they are required'.

However, 59% of respondents, while not having a formal policy stipulated in their treasury policy, had informal arrangements (to differing degrees of formality), whereby in practice the entity would pre-fund a certain period in advance of needs. This demonstrates that pre-funding is an issue that entities are focused on. Often the time period was driven by the desire to avoid showing debt (or a material amount of debt) as current in the balance sheet. In some cases, these informal arrangements involved a two stage process: a longer time period where strategic decisions about refinancing had to be made by the Board and senior management; and a shorter time period by when the funding commitment had to be locked in.

Types of informal policies included:

a. reviewing timing and quantum of funding requirements during an annual business planning process;

b. regular strategy reports to Board around timing and quantum of funding needs; and

c. a practice of extending banking facilities for a certain period (usually one year) every period (again, usually one year).

27% of respondents reported not having any sort of pre-funding policy (formal or informal). Reasons cited for not having a policy included:

a. the availability of surplus cash and/or standby facilities;

b. the low levels of debt and therefore its relative unimportance;

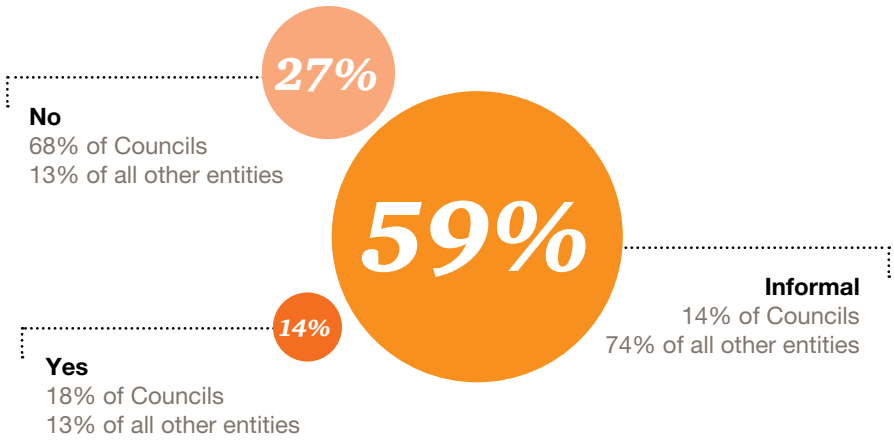
c. a high level of confidence in the availability of funding, especially given the entity's underlying credit; and

d. a belief that if their entity was subject to funding difficulties then 'it was all over anyway'!

The results again varied significantly between the local government sector and 'all other entities'. Interestingly, 18% of councils had a pre-funding policy, but they were generally expressed in the opposite manner to the above example. That is, a council 'could pre-fund up to x months in advance' if it so desired, but there was absolutely no requirement to do so. This reflects the credit quality of the council sector, the availability of standby bank lines and/or cash investments, and the desire to limit pre-funding line fees. The majority of councils (68%) had no policy (formal or informal) which is again a reflection of their strong credit characteristics and relative ease of funding and results in most councils not having a requirement for a policy of this type.

At the other end of the spectrum, while only 13% of 'other' entities have formal policies, 74% have informal policies illustrating the importance of this matter to most non-council organisations.

Do entities have a pre-funding policy?



20 Spreading of debt maturities

This question essentially asked respondents whether or not there were any restrictions on having all their debt (drawn and/or facilities) maturing in any one period, and if there was, how widely spread the policy required the debt maturities to be.

Responses differed from entity to entity, with common responses being:

a. No more than x%, (or in some cases a $ figure) of debt maturing in the next, or any, period (very commonly 12 months);

b. A certain minimum % maturing after a certain minimum timeframe;

c. Maximum (and often minimum) percentages of debt maturing across certain time buckets (most commonly 0-3 years; 3-5 years; and 5+ years);

d. A combination of ***(a)*** and/or ***(b)*** and/or ***(c)*** above;

e. A subjective policy indicating the intent to spread debt maturities, where practical, but no formal objective percentages, dollar figures or specific time periods;

f. No policy, but a general informal intent to spread debt maturities where practical; and

g. No policy at all.

Overall 55% of respondents had a formal policy (along the lines of ***(a)*** to ***(d)*** above) with the use of time buckets being the most common (64% of those respondents with a formal policy).

An interesting finding was that a significant number of respondents reported having a prescriptive policy (such as that described in (c) above), but being in breach of the policy due to the impracticalities (or excessive cost) of trying to spread debt maturities when the entity had a relatively small amount of total debt. A number of these respondents acknowledged that they were in the process of revising their policy.

This raises the consideration (for those companies with limited debt) of having a formal subjective policy without objective numbers – ie. a policy that spells out the clear intention to spread debt maturities where practical and includes regular reporting of debt maturities to the Board. The alternative, to take account of the impracticalities, is to have wide percentage bands or a very limited number of time buckets. However, this in effect provides little, if any, additional comfort or benefit than formally setting out a general intention and having regular Board oversight through ongoing reporting.

Of those entities without a formal policy (45%), 38% of these respondents had informal methods of managing the risk. The most common were:

a. regular discussion at the Board level, backed up by regular reporting of the debt position; and

b. statements in documents such as business plans to reduce refinancing risks or spread debt maturities as far as practical (or in the form of numerical targets).

For those respondents without a formal or informal policy, the main reasons given were:

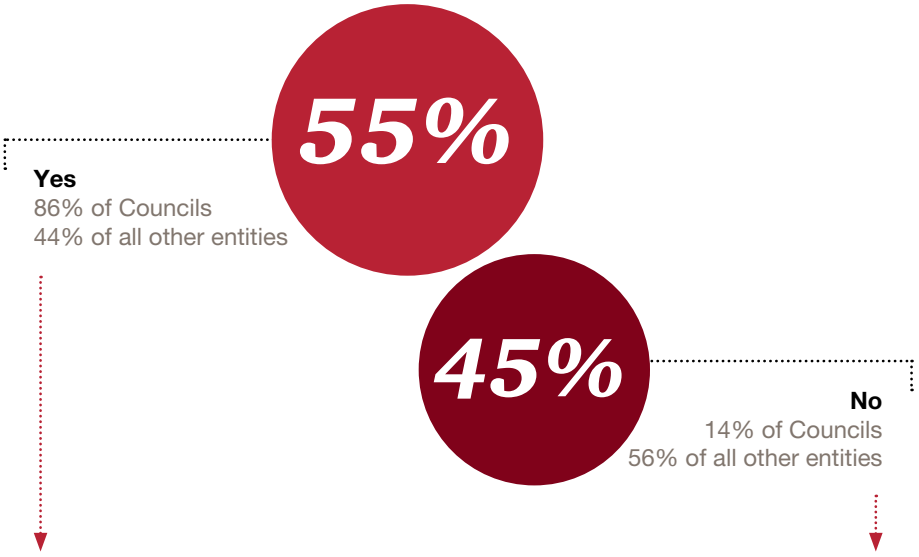
a. the size of their debt (or more correctly the lack of size);

b. previous policies had become impractical and unmanageable; and

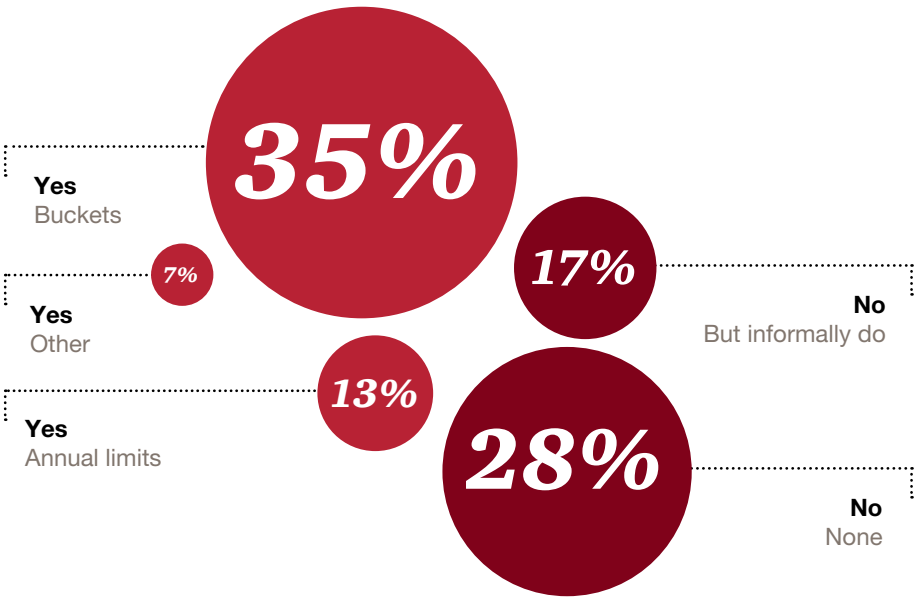
c. debt all being in one tranche (and a desire to keep things simple).

The results again varied significantly between the local government sector and 'all other entities'. 86% of councils had a formal policy dealing with the spreading of debt maturities, compared to just 44% of 'all other entities'.

Do entities have a policy that requires them to spread debt maturities?



Type of policy



21 Level of headroom or undrawn committed facilities

This question was designed to see what 'emergency funding' facilities entities had in place in case of unexpected events or other sources of funding drying up.

Around half of respondents (53%) had a formal treasury policy dealing with this issue. Most of the 47% of respondents that did not have a formal policy were monitoring headroom informally.

Common procedures included:

a. regular reporting on cash flow and debt levels (both actual and forecast) to their Boards; annual reviews of headroom during their business planning process or more frequently if requirements were seasonal;

b. ensuring credit rating agencies were comfortable with their liquidity position;

c. CFOs maintaining a certain $ figure in reserve; and

d. entities ensuring facilities were in place before capital commitments were made.

For those entities that did have a policy, the most common form of policy was one specifying undrawn committed facilities available (in the form of 'headroom') as a percentage of forecast estimated peak debt requirements over a certain period. By far the most common forecast period was 12 months. Some entities utilised current debt levels as the denominator rather than forecast debt levels.

The policy is often expressed in two equivalent ways – either having total available facilities of say 120% of forecast peak debt; or having facility headroom of say 20% over forecast peak debt.

Example:

An entity currently has $100 million of drawn debt. Over the next 12 months the company expects debt to peak at $120 million. A policy of having undrawn committed facilities available of 20% of forecast peak debt would mean that the entity, to comply with policy, would need $24 million of undrawn committed facilities available (ie. a total of $144 million of facilities in place). A policy of 5% of forecast peak debt would mean $6 million of undrawn committed facilities available (ie. a total of $126 million of facilities in place).

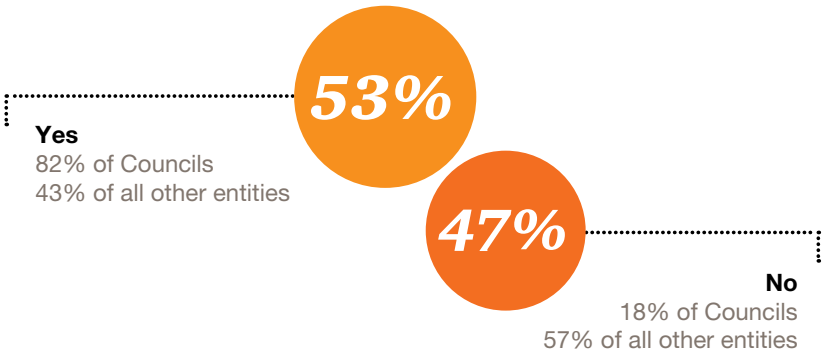
The percentage of available headroom ranged from 0% (no headroom) to 20%, with the average percentage headroom being 10.3%, with over half the respondents having a headroom policy buffer of exactly 10%.

While it is tempting for companies to compare their current policy (ie. its percentage headroom) with the survey average, there are many sound commercial reasons why this would sensibly differ between entities. Companies with sound predictable cash flows will need less headroom than more volatile seasonal companies, or those going through major acquisitions or capital expenditure phases.

To calculate available headroom that an individual entity must have, some respondents used an absolute dollar figure as opposed to a percentage figure. While this is usually not the preferred option (because if a company's forecast debt materially increases or decreases, the relative safety net reduces or increases respectively), it can make sense in some specific instances (and is arguably easier to administer). For example, a stable utility with predictable cash flows (and therefore having debt levels which do not change materially) could easily express the policy headroom in absolute dollar terms. Furthermore, a company whose major risk is a quantifiable event costing a set estimated absolute dollar figure could be better off having policy headroom expressed in this manner, rather than in percentage terms (as the event will still cost x dollars if the underlying debt level is say $100 million or $200 million).

The results again varied significantly between the local government sector and 'all other entities'. 82% of councils had a formal policy dealing with the level of headroom or undrawn committed facilities, compared to just 43% of 'all other entities'.

Do entities have a policy that requires them to have a level of headroom in their facilities?



22 Approval of long term debt issuance

Respondents were asked who within their organisation could approve new long term debt issuance, including the renewal or extension of existing facilities.

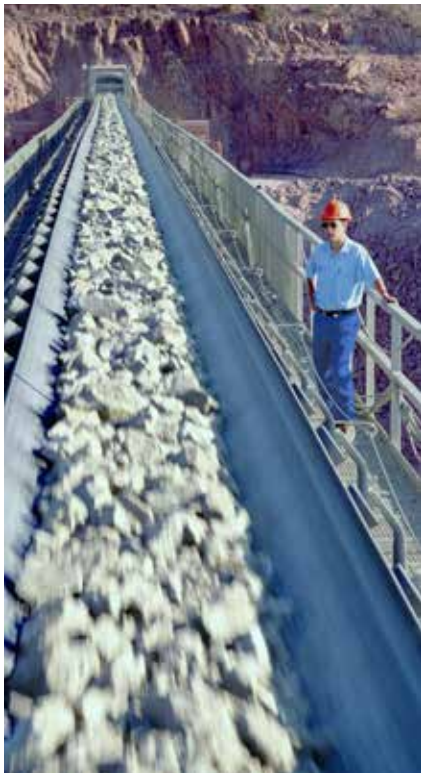
In almost all cases, for those non-council entities, the Board had to approve such issuance. For councils, to the extent that the new issuance was consistent with the council approved annual plan, the responsibility for approval of long term debt issuance generally lay with the CEO or CFO (or both acting together). Issuance outside the council approved annual plan had to go back to the council for approval.

In most cases, recommendations on funding decisions were made to the Board by the Treasurer, CEO, CFO or Board sub-committee (such as a Finance or Audit Committee). More routine matters, such as drawdowns under existing facilities or roll-overs of short term debt, were delegated to the likes of the Treasurer, CFO or CEO (or a combination acting together).

The fact that Boards generally approve all new long term debt issuances is a reflection of how important funding decisions are to organisations. While it was not a question that was formally asked, it would be interesting to see how the results for this question differ from the situation before the GFC. Anecdotally, it would appear that the GFC has resulted in decisions regarding debt funding moving further up the organisational structure.

23 Separation of debt and interest rate risk management

Respondents were asked whether they separated out interest rate risk management decisions from their debt management decisions. By this we mean, do entities lock in their interest rate exposure for the same period as their underlying debt maturities.



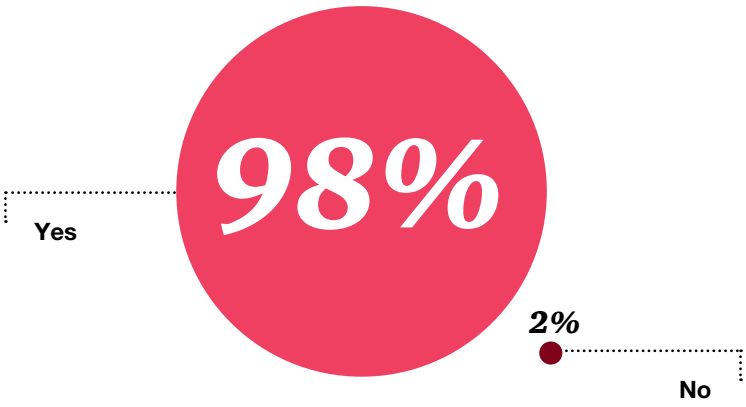
Example:

An entity draws down $100 million on its five year $100 million bank facility for five years at the floating rate plus a margin of 1%. The entity then locks in its interest rate exposure for those five years by entering into a five year pay fixed interest rate swap. In this case the entity is not separating out its interest rate risk management from its debt management. Alternatively, if the company leaves the interest at floating rates, or locks in the interest rate exposure for say three years (by entering into a three year pay fixed interest rate swap), the entity is separating out its interest rate risk management from its debt management.

The very large majority (98%) of respondents separated out interest rate risk management from debt management – many taking advantage of the current low floating rates and others fixing for long periods (often beyond the term of their underlying debt facilities)[5] through long term interest rate swaps at levels close to historic lows.

Results were consistent between the local government sector and 'all other entities'.

Do entities separate out interest rate risk management from debt management?



5. Hedging beyond the term of underlying bank facilities is often undertaken on those parts of the debt portfolio considered core – ie. likely to remain in place for the foreseeable future.

24 Hedge accounting

Respondents were asked whether they utilised hedge accounting in relation to the derivatives on their debt portfolio. The results were mixed, 58% hedge accounted, and 42% did not.

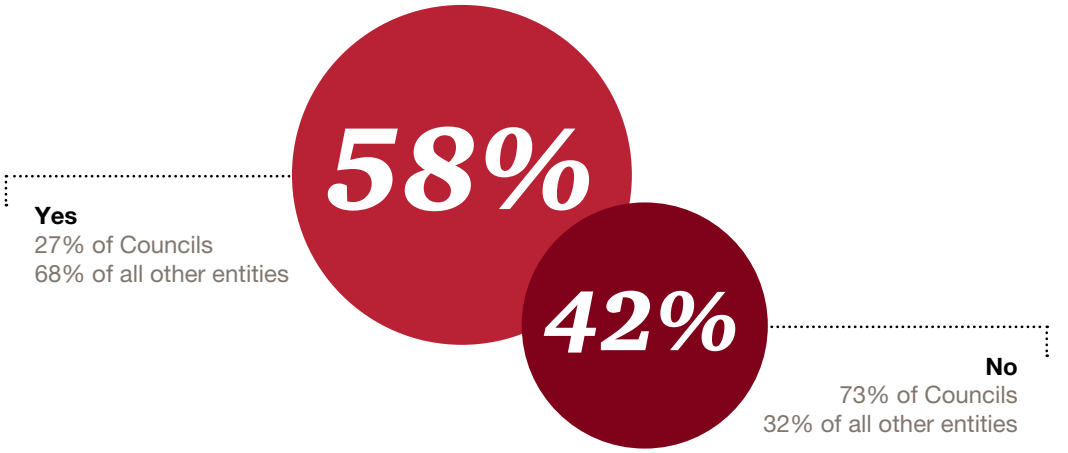
For those that did hedge account, many found the administration burdensome and were frustrated by the restrictions it imposed on economic decision making. For those that did not hedge account, many had issues explaining current mark-to-market losses to their Boards. All in all, a thumbs down to the hedge accounting standard!

However, things should improve once the proposed IFRS-9 *Financial Instruments* accounting standard relating to hedge accounting is adopted. The new standard should provide a more rational framework for Treasurers and CFOs to comply with.

For example, IFRS 9 will allow for the inclusion of derivatives as part of the hedged item. This is important for those who manage different components of risk separately, with many New Zealand companies that issue debt in foreign currency having separate hedging strategies and derivatives to manage the foreign currency risk and the New Zealand dollar interest rate risk.

Results differed significantly between the local government sector and 'other' entities. Only 27% of councils adopted hedge accounting, compared to 68% of 'all other entities' (increasing to 74% if only listed companies are included).

Do entities utilise hedge accounting in relation to the derivatives on their debt portfolio?



25 Other policies in relation to debt management

Respondents were asked to outline what other policies, if any, they had relating to debt management. Common examples relating to debt management, either directly or indirectly, included policies on:

a. interest rate hedging of the debt portfolio (most commonly broken down into time buckets);

b. maximum gearing levels or gearing targets;

c. maximum term of debt;

d. meeting rating agency requirements relating to debt metrics; and

e. restrictions on having debt in currencies other than NZD.

In addition, councils also had other policies dealing with such matters as maximum levels of net interest to revenue; maximum levels of net debt to revenue; and maximum levels of net interest to rates income. These policies help ensure compliance with LGFA covenants (where relevant).

One important debt policy risk, which was only brought up by a minority of respondents, was bank counterparty risk. What we are referring to here is not bank counterparty risk associated with derivative transactions or investments entities may have with a banking institution, but the contingent risk that an entity has undrawn facilities with a bank and cannot draw down on those funds when required because the banking counterparty is now insolvent.

Example:

An entity has a sole banking relationship with Bank A. It has a five year $100 million facility in place, of which $50 million is drawn down. $40 million of the remaining facility is earmarked for a capital expenditure commitment with the draw down scheduled in 12 months. The entity has the risk that Bank A goes insolvent in the period before these funds are due to be drawn down and the entity cannot arrange alternative funding in time to meet its capital expenditure commitment.

Respondents clearly fell into two camps here – those passionate about this risk and those who ignored it. It is obviously not an issue if the facility is fully drawn down (as in this case, the bank has all the counterparty risk on the entity it has lent to).

Respondents which were concerned about the issue had two main ways of managing (or minimising) this contingent counterparty risk. Firstly, by only dealing with banks above a certain credit rating threshold. Secondly, by limiting the contingent exposure the entity has to any one bank counterparty (eg. if undrawn committed facilities of $100 million were required, the policy may specify that no bank could hold more than 40% of the commitment).

While most entities do not actively manage this specific risk through their treasury policy, we should stress that this is a remote risk given the general strength of the Australasian banking sector (which to a large extent represents the banks which are providing respondents in this survey with the majority of their undrawn committed lines). If we look at the main four banks in New Zealand (or their Australasian parent), they are all rated in the AA band and in a recent survey conducted by *Global Finance Magazine*[6] of the world's 50 safest banks, they were rated 18th, 19th, 20th and 21st safest in the world (with Kiwibank ranked 22nd). Therefore, we do not want to magnify this issue into something bigger than it is. However, it is something entities should be aware of and is an argument in support of at least some diversity in bank funding relationships.

5. Global Finance Magazine rating as at July 30 2012, published August 16 2012.

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Get in touch

Roger Kerr
Partner
T: +64 9 355 8181
E: roger.j.kerr@nz.pwc.com

Stuart Henderson
Partner
T: +64 9 425 0158
E: stuart.r.henderson@nz.pwc.com

Brett Johanson
Partner
T: +64 4 462 7234
E: brett.a.johanson@nz.pwc.com

David Corbett
Partner
T: +64 9 355 8809
E: david.r.corbett@nz.pwc.com

Paul Skillender
Partner
T: +64 9 355 8004
E: paul.skillender@nz.pwc.com

John Bishop
Director
T: +64 9 355 8596
E: john.b.bishop@nz.pwc.com

Callum Dixon
Director
T: +64 9 355 8796
E: callum.j.dixon@nz.pwc.com

Chris Hedley
Director
T: +64 9 355 8183
E: chris.m.hedley@nz.pwc.com

Andrew Cosham
Director
T: +64 9 355 8638
E: andrew.p.cosham@nz.pwc.com

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