29 May 2018

Housing New Zealand Limited (HNZL) – A New High Grade Issuer

- **Housing New Zealand Limited (HNZL) has announced its intention to syndicate a NZ$ 5 year and/or 7 year bond as soon as mid-this week.**
- **HNZL is a 100% Crown-owned entity, whose credit ratings are equalised with the NZ government (AA+). It does not have an explicit guarantee.**
- **In principle, we believe HNZL should trade inside of LGFA based on its closer link to the Crown. We observe that HNZL CP trades a few bps under LGFA bills.**
- **LGFA bonds will be more liquid than HNZL, but our analysis of the NZ SSA sector suggests the market does not put a high liquidity premium on smaller issuers.**
- **Our best guess is that HNZL comes 0bps to 10bps through the LGFA curve, although given this is the inaugural issue(s), there is high uncertainty around that range. We wouldn't rule out HNZL pricing above LGFA for this first deal to entice investors.**
- **We make some comparisons to the Australian and Canadian high-grade spread markets in the Annex.**

Housing New Zealand – a brief overview

Housing New Zealand Corporation (HNZC) is responsible for the provision of state housing in New Zealand.[1] It currently owns or manages 63,000 properties across the country.

Housing is a policy priority for the Labour Government. To that end, in the Budget two weeks ago, the Government announced its intention to increase the stock of state houses by 6,400 over the next four years. HNZC also intends to renew around 75% of its existing stock of state houses over the next 20 years. In order to fund this, Housing New Zealand plans to borrow around $1b by the end June 2019 and $2.9b cumulatively by the end of June 2022 via bond issuance. This is a break from the past; Housing New Zealand had previously borrowed from the NZDMO rather than issuing under its own name.[2]

A 100% Crown-owned entity, with a credit rating equalised to the NZ govt.

HNZC is 100% owned by the New Zealand government. HNZC in turn owns 100% of Housing New Zealand Limited (HNZL), which has 97% of the group's assets ($25b) and 79% of the group's debt ($1.5b), which to this point has been acquired from the NZDMO. HNZL will be the entity borrowing in the capital markets to fund the increase in state homes and renewal of existing housing stock.

Credit rating agency S&P assigns an AA+ local currency, long-term credit rating to both HNZC and HNZL. These ratings are equalised with those of the NZ Government. Although there is no explicit government guarantee on the debt, S&P's assessment is that there is an "almost certain" likelihood of extraordinary Government support in the event of financial distress ("almost certain" is the highest category on S&P's scale).

Table 1: HNZC and HNZL ratings equalized to the NZ govt.

Rating type - S&P	HNZL and HNZC		NZ Government	
	Rating	Outlook	Rating	Outlook
Local currency - long term	AA+	Stable	AA+	Stable
Local currency - short term	A-1+		A-1+	
Foreign currency - long term	AA	Stable	AA	Stable
Foreign currency - short term	A-1+		A-1+	

What are they planning to issue?

HNZL has announced its intention to issue a 5 year and/or 7 year bond as early as mid-this week via syndication. The bond(s) will be denominated in NZ dollars. We don't have any information as yet around the potential size of the issue(s) although we know its borrowing requirement by the end of June 2019 is around NZ$ 1b.

Comparing HNZL and LGFA

The natural domestic reference point for HNZL is the New Zealand Local Government Funding Authority (LGFA). LGFA's ratings are also equalised with those of the NZ Government by both S&P and Fitch.

[1] We refer readers to HNZ's website and the investor presentation for more information.
[2] The last time HNZ funded itself via bonds in the market was around 20 years ago.

Table 2: S&P assessment of HNZL and LGFA

Rating type - S&P	HNZL and HNZC		LGFA	
	Rating	Outlook	Rating	Outlook
Local currency - long term	AA+	Stable	AA+	Stable
Local currency - short term	A-1+		A-1+	
Foreign currency - long term	AA	Stable	AA	Stable
Foreign currency - short term	A-1+		A-1+	

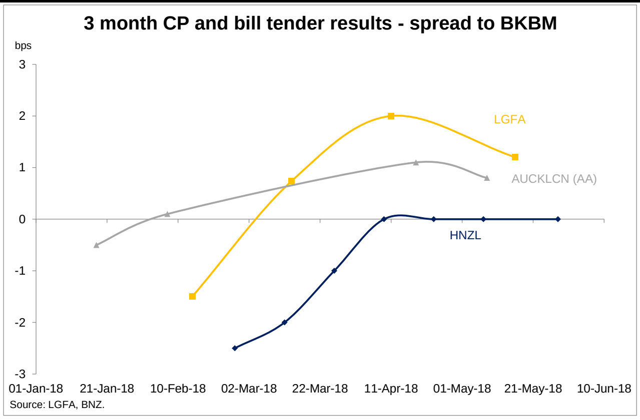
Additional information - S&P	HNZL and HNZC	LGFA
Standalone credit profile	aa	aa-
Likelihood of extraordinary Government support	"Almost certain"	"Extremely high"

While S&P assigns both entities the same credit ratings, it takes a slightly more favourable view on HNZL's likelihood of extraordinary government support ("almost certain" vs. "extremely high", the category below it) and HNZL's standalone credit profile ("aa" vs. "aa-").

We wouldn't overplay the extent of the difference in credit risk between the two entities (they are rated the same after all), but at least directionally S&P appears to see HNZL as a slightly stronger credit. Additionally, HNZL is central government risk as opposed to local government risk in the case of LGFA. Both these factors mean that we would expect HNZL to trade somewhat inside of LGFA on the basis of credit risk alone.

We observe that HNZL has consistently issued CP at rates a few bps inside of LGFA since the inception of its programme in February. The domestic CP market can be a bit idiosyncratic (Auckland Council, which is rated AA, has printed inside of LGFA on two occasions recently), but it would be tentative evidence that the market sees HNZL as a slightly stronger credit than LGFA.

Chart 1: 3 month CP and bill tenders – spread to BKBM



Estimating liquidity risk

Of course, LGFA is an established issuer in the domestic bond market and has been in operation since 2012. LGFA has almost $8b of bonds outstanding. LGFA bonds are reasonably actively traded and there is a functioning repo market, which enables dealers to 'short' bonds and facilitates two-way liquidity.

HNZL will have only around $1b outstanding by the end of June 2019 and $2.9b by the end of June 2022. It will take time before liquidity in HNZL bonds picks up. Is there any way to put a value on what LGFA's superior liquidity is worth?

One approach to estimating liquidity premium in the domestic market is to look at spreads between various SSA issuers in the five year space. Most SSAs are AAA rated, and investors typically see minimal difference in credit risk between the entities. The differences in spreads in the 5 year sector therefore should provide a barometer of liquidity premia.

IBRD is the largest SSA issuer in the NZ market with around $7.5b outstanding. EIB in contrast has only one Kauri bond (its $200m 5y bond from earlier this year) and less than $1b outstanding – it has a much less liquid curve. The spread between the 5 year asset swap on EIB and IBRD is around 7bps, which incidentally is the same as the equivalent spread in AUD (IBRD is typically seen as the strongest credit within the SSA sector). The spread between 5y EIB and RENTEN, which has more than $3b outstanding, is around 1bp. On the basis of this simple "control experiment", it seems to suggest the market does not demand much of a liquidity premium for those issuers with a smaller amount of bonds outstanding.

Table 3: Comparison of 5 year ASW vs. bonds outstanding

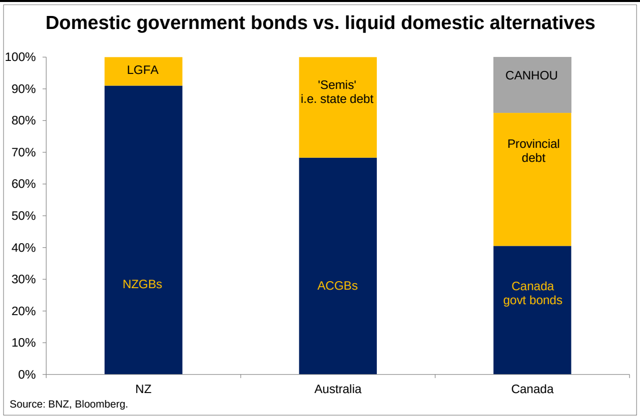
Issuer	Total NZD bonds outstanding (NZ$m)	o/w Kauri bonds outstanding (NZ$m)	5 year bond ASW
LGFA	7,819	7,819	34.9
IBRD	7,551	7,425	33.7
ASIA	3,434	2,650	34.6
RENTEN	3,115	3,025	39.5
NIB	2,750	2,750	34.6
KFW	2,425	1,700	36.8
EIB	975	200	40.7

The international evidence on the presence of liquidity premia is mixed. In the Annex we show some examples of government related issuers in Australia and Canada. Australia's small government guaranteed and government-owned issuers trade wider than NSWTC, a AAA-rated semi-government issuer, indicative of liquidity premia. In Canada, EDC (which enjoys the full faith and credit of the Canadian government) has only one CAD bond outstanding, but trades inside of both the Canada Housing Trust (CANHOU, another government guaranteed issuer with $240b outstanding) and British Colombia, a AAA-rated province. The Canada example suggests that there can be instances where investors place a premium on "scarcity value."

Demand expected to be strong

The NZ market does not have many domestic issuers at the high quality end of the credit spectrum. LGFA has over $7.5b outstanding, which is around 10% of the size of the NZGB market. In contrast, the semis in Australia account for more than 40% of the ACGB market. And in Canada, the provinces and government-guaranteed Canada Housing Trust (CANHOU) combined have more bonds outstanding than does the Canadian government (see chart below).

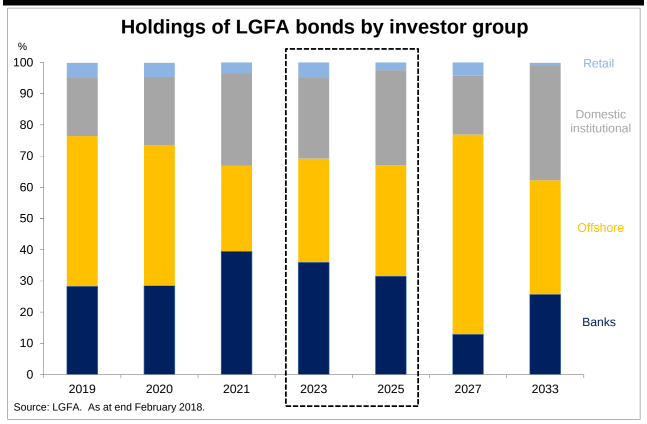
Chart 2: Breakdown of domestic bond markets



Source: BNZ, Bloomberg.

Given the relative scarcity of high quality domestic issuers in NZ and what is likely to be a healthy spread pick-up to the NZGB curve, we expect demand to be strong. In particular, there should be strong demand from domestic balance sheets, especially in the five year sector. Using LGFA holdings as a guide, banks are the largest holders of the 3 and 5 year bonds and still meaningful holders of the 7 year. The breakdown of LGFA holdings (as at the end of February) is shown in Chart 3 below. Offshore participation in HNZL may take some time to build up (foreign holdings in LGFA have been rising steadily over recent years). Domestic investors will likely value the name diversification and spread pick-up to the NZGB curve that HNZL offers.

Chart 3: Breakdown of LGFA holdings by investor group



Source: LGFA. As at end February 2018.

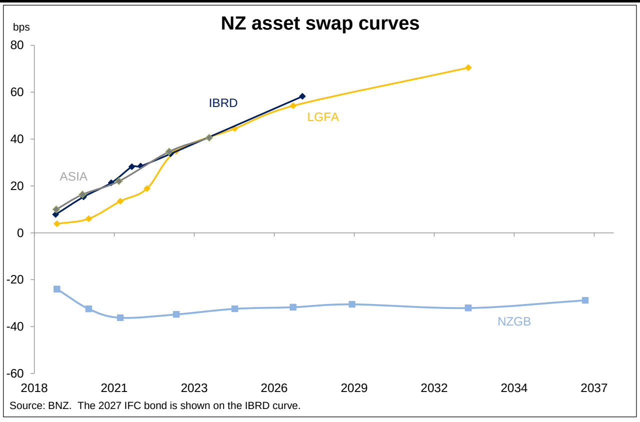
Pricing uncertain but likely to come modestly inside of LGFA

As this is the inaugural HNZL bond deal(s) there is considerable uncertainty around where it might price. The factors we consider are:

- HNZL appears a slightly stronger credit according to S&P (despite having the same credit rating);
- HNZL CP has been trading consistently inside of LGFA bills (tentative evidence the market sees it as a stronger credit);
- Some investors may place a premium on investing in a Crown entity rather than a local government entity, and HNZL is a unique issuer in the NZ context;
- HNZL is less liquid than LGFA, but the market does not appear to place a significant value on issuers with greater bonds outstanding;
- This is the first HNZL deal and there may be some new issue premia offered to entice investors and ensure the deal performs;

Adding all this up, our central case is that HNZL will price slightly inside of the LGFA curve (say between 0 to 10bps), although the range of possible outcomes is wide. Our presumption is that HNZL won't want to risk the deal performing poorly, given its funding requirement over the coming few years, and that should mean it doesn't price too far inside the LGFA curve. We wouldn't rule out the bond(s) pricing slightly back of LGFA for this first deal to entice investors, although it's not our base case.

Chart 4: Asset swap curves for select high grade issuers



Source: BNZ. The 2027 IFC bond is shown on the IBRD curve.

We estimate a new 'on market' 5 year LGFA would come around mid-swaps +31bps (interpolating the I-spread curve and using the NSS curve estimation procedure). We estimate a new 7 year LGFA would come between +45bps and +47bps over mid-swaps.

Our best guess at a range for a potential HNZL 5 year would be +20bps to +30bps over mid-swaps. Our best guess for the 7 year would be +35bps to +45bps over mid-swaps, although as discussed previously, we wouldn't rule out the deal(s) coming outside of these ranges. Changes in market rates will also affect our estimated ranges.

Table 4: Estimated LGFA 5 year and 7 year market bonds

	5 year		7 year	
LFGA	Yield	Spread to mid-swaps	Yield	Spread to mid-swaps
NSS fair value	2.95	31.4	3.32	45.0
Swap Model	2.95	31.1	3.34	47.2

Assumes a 2.75% coupon on the 5 year bond and a 3.25% coupon on the 7 year bond

Annex: Some offshore comparisons

Another way to think about the relative value between HNZL and LGFA is to look at the spread between government-guaranteed issuers and local governments offshore.

Australia:

In Australia, the benchmark for high-quality alternatives to government bonds is the state government sector (or 'semis'). The AAA semis (such as NSWTC and TCV) are in some ways analogous to LGFA, in that they are local government issuers with the same credit ratings as the government. NSWTC has over $50b outstanding, around 10% of the total stock of ACGBs; similarly LGFA has over $7b outstanding which is around 10% of the stock of NZGBs.

Semis' high liquidity and favourable regulatory treatment (they are classed as a "tier 1" asset by APRA for domestic banks' prudential holdings) means they trade relatively tight to Australian government bonds. Indeed, NSWTC and TCV trade inside of both EFIC (Export Finance and Insurance Corporation) which is explicitly guaranteed by the Australian government and Airservices Australia which is 100% government-owned.[3]

EFIC is an infrequent issuer in the AUD bond market with a modest ~$A1b outstanding. It launched its first new AUD line in over 5 years last month. Indicatively, the 2026 EFIC is currently trading around 44bps over the government curve, which is around 17bps wider than a similar maturity NSWTC.[4] The vast gulf in the amounts outstanding (~$1b v $50b+) between the two issuers as well as NSWTC's broader investor base and more frequent issuance activity explain why the government guaranteed entity trades wider than the state bond.

Table 5: Australia comparison

Country: Australia	Government guaranteed issuer	Local govt issuer
Issuer	AUSTC (EFIC)	NSWTC
Maturity	12-Feb-26	20-May-26
Spread to ACGB curve	44bps	27bps
Bonds outstanding in AUD	$1b	$53b

Country: Australia	Government owned issuer	Local govt issuer
Issuer	AIRSER	NSWTC
Maturity	19-Nov-20	1-May-20
Spread to ACGB curve	53bps	8bps
Bonds outstanding in AUD	$0.7b	$53b

Source: Yieldbroker

As it relates to NZ, we suspect the market won't demand as large a liquidity premium on HNZL as the Australian quasi-government issuers. HNZL and LGFA have similar gross issuance requirements by the end of June 2019 ($1.25b and $1b respectively) and there will be less divergence in the amounts outstanding between the two issuers.

Canada:

In Canada, provincial governments are large and regular issuers in the domestic bond market. British Colombia (BRCOL) is rated AAA, on par with the Canadian government. The province has a bit less than C$50b in domestic bonds outstanding, close to 10% of the stock of Canadian government bonds (similar to NSWTC and LGFA).

Export Development Canada (EDC) and the Canada Housing Trust (CANHOU) are both explicitly government guaranteed issuers in Canada, rated AAA.[5] EDC has only the one bond outstanding in CAD (a $500m Sep-22 issue). This EDC bond trades around 20bps above the Canadian government curve according to Bloomberg, which is around 10bps tighter than a similar maturity BRCOL bond (33bps over the CAN curve). The CANHOU bond in the 5 year sector also trades around 10bps tighter to the CAN curve than does BRCOL.

The fact EDC trades inside of both CANHOU and BRCOL despite having just the one bond outstanding in CAD suggests that sometimes a "scarcity premium" can be a bigger influence on pricing than an illiquidity premium.

Table 6: Canada comparison

Country: Canada	Government guaranteed issuer	Local govt issuer
Issuer	EDC	BRCOL
Maturity	1-Sep-22	18-Dec-22
Spread to CAN curve	21bps	33bps
Bonds outstanding in CAD	$0.5b	$46b

Country: Canada	Government guaranteed issuer	Local govt issuer
Issuer	CANHOU	BRCOL
Maturity	15-Jun-23	18-Dec-23
Spread to CAN curve	30bps	40bps
Bonds outstanding in CAD	$240b	$46b

Source: Bloomberg

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[3] We would cast aside the comparison with Airservices Australia given it only has one $A275m bullet bond and that was issued almost five years ago.

[4] AIRSER and AUSTC (EFIC) are not actively traded, so the spreads quoted in the table should be seen as indicative only.

[5] Technically, EDC enjoys the full faith and credit of the Canadian Sovereign. That is, EDC is consolidated on the government balance sheet. This is seen as an even stronger form of protection than an explicit government guarantee.

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