

29 March 2018



## Interest Rate Strategy: LGFA 2022 Tender Preview

- **LGFA has announced that it will tender \$150m of a new April 2022 bond next Wednesday, 4<sup>th</sup> April.**
- **This will be the first LGFA bond that doesn't match an NZGB maturity.**
- **The LGFA has introduced a 'soft cap' on outstandings for its bonds of \$1.5b. With the 2021s and 2023s near to that cap, LGFA has decided to issue a new 4 year bond.**
- **We estimate 'fair value' on the 2022 bond between a range of +25bps to +30bps over mid swaps.**
- **LGFA spreads to NZGBs have widened over recent weeks and continue to offer a healthy yield pick-up to NZGBs. Notwithstanding some weakness in global credit markets of late, we think the tender should go well, given what appears to be robust investor appetite for 3-5 year bonds.**

### Background

The NZ Local Government Funding Agency ("LGFA") has announced that it will issue a new 2.75% coupon, 14 April 2022 maturity bond next Wednesday. The 2022 will be the first bond on the LGFA to have a maturity (or coupon) that doesn't match an NZGB.

The LGFA is introducing a 'soft cap' of \$1.5b on the amounts outstanding of its bonds. Table 1 below shows that the 2021 and 2023 maturity bonds are already close to this cap. The 2022 is being introduced to meet investor demand for short-to-intermediate bonds and to meet a gap in maturities with no NZGBs and only two Kauri issues in 2022.

Additionally, LGFA's lending mismatch has grown as Councils have borrowed in the 2022 maturity; the new bond will assist in managing that gap.

Table 1: Amounts Outstanding Per LGFA Bond

Bond	Amounts outstanding	Remaining capacity
2019	1,290	210
2020	1,030	470
2021	1,470	30
2023	1,479	21
2025	899	601
2027	1,076	424
2033	335	1,165

### Fair Value Estimates

LGFA intends to issue \$150m via tender of the new Apr-2022.<sup>1</sup> The 2.75% coupon on the Apr-2022 LGFA bond is much lower than the two surrounding bonds meaning its duration will be closer to the Apr-2023 than the May-2021.

We estimate a range on the LGFA Apr-2022 between +25bps and +30bps over mid-swaps. The Nelson Siegel Svensson (NSS) fair value model generates a yield estimate of 2.77% for the Apr-2022 LGFA bond, which equates to a spread of +25bps to mid-swaps. A linear interpolation of the LGFA I-spread curve (which, unlike the NSS method, does not take account of duration differences owing to coupon sizes) generates a similar estimate. Chart 2 shows the LGFA yield curve with the estimated Apr-2022 shown.

However, an interpolation of the LGFA yield curve based on modified duration, rather than maturity, generates a higher yield estimate for the new LGFA Apr-2022 of 2.82%, and a spread to mid-swaps of +30bps.

Table 2: Summary of 'Fair Value' Estimates for LGFA 2022

	Yield	Spread to mid-swaps
NSS fair value	2.77	25.5
Swap Model	2.77	25.5
MDur Interpolated	2.82	30.3

The LGFA-NZGB spread curve is shown in Chart 4, with an implied spread for the Apr-2022 LGFA bond of +60bps. If we back-out the LGFA yield based this spread and a 'theoretical' Apr-2022 NZGB reference point, we again get a range of 2.77% to 2.82%, depending on the method for estimating the underlying NZGB. Looking at the IBRD curve as a further sense check also generates a fair value estimate within that range (the Jan-2022 IBRD bond has an I-spread of +30bps).

On this occasion, we'd put a bit more weight on the higher modified duration measure as a sense of fair value for the new LGFA bond. Chart 3 shows the LGFA curve with modified duration on the x-axis, and shows a 'kink' at the 4 year point based on the NSS and swap model estimates.

<sup>1</sup> LGFA is tendering \$150m. As is standard for a new line, a further \$50m will be retained as Treasury stock by LGFA and used for stock lending. Post a successful tender, the amount on issue will be \$200m.

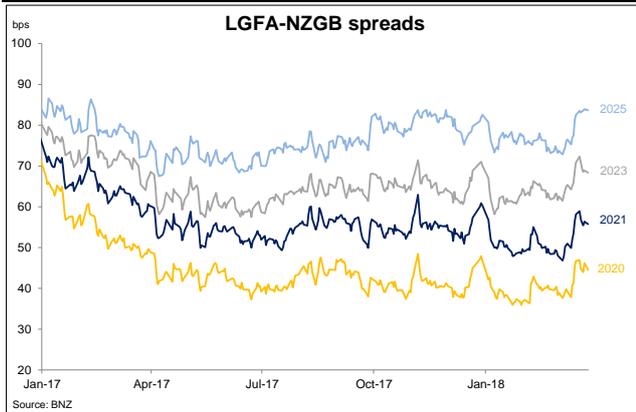
**Recent LGFA spread performance and demand**

LGFA-NZGB spreads have moved wider over recent weeks, driven by the widening in NZGB-swap spreads. LGFA-NZGB spreads on the 2021 and 2023 bonds are near to the widest levels over the past 12 months (see Chart 1).

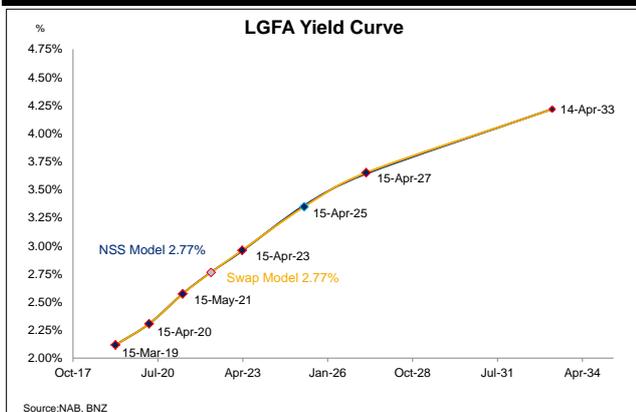
LGFA's decision to introduce a new bond at the 4 year point in part reflects a desire to meet investor demand for that sector. The short-to-intermediate sector of the curve appears to be the 'sweet spot' for investors, with attractive carry and roll to the NZGB curve and arguably better protection against any further global credit spread widening than the long-end. LGFA's ownership breakdown shows the intermediate sector of the curve (21s and 23s) also has a higher proportion of holdings among bank treasuries than other parts of the curve.

The \$150m of Apr-2022s to be tendered looks a manageable amount for the market to absorb. Notwithstanding some broader weakness in global credit markets of late, which may give investors some pause for thought, we expect the new bond to be well received by the market, especially in light of the recent spread widening to NZGBs.

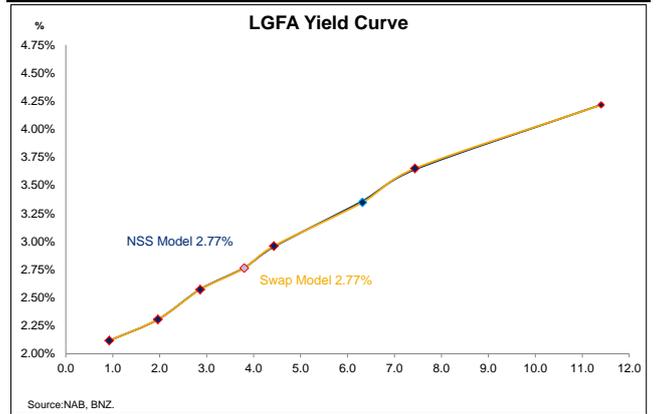
**Chart 1: LGFA-NZGB Spreads Have Widened Recently**



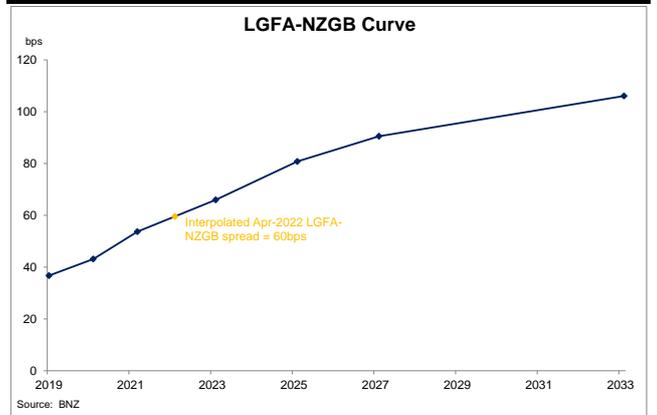
**Chart 2: LGFA Yield Curve**



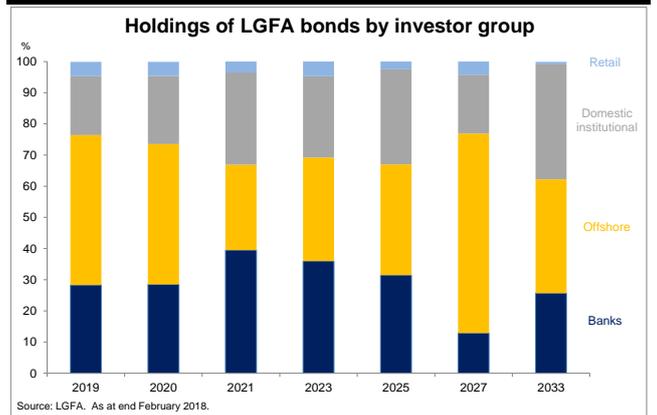
**Chart 3: LGFA Curve With Modified Duration Axis**



**Chart 4: LGFA-NZGB Spread Curve**



**Chart 5: Holdings of LGFA Bond by Investor Group**



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