SRH CONSULTING

INDEPENDENT ADVISER

September 2022 Review of NRC Annual Report and Audit Process

The 2021/22 financial year was another extremely trying year for both the private and public sectors. The period witnessed a continuation of COVID lockdowns, a large increase in illness cases requiring isolation, continued supply chain constraints, unprecedented global financial market volatility resulting from the abrupt transition from a low inflation environment to significantly increased global inflation and further major geopolitical crises. The relentless rise in inflation to levels well exceeding the New Zealand Reserve Bank's benchmark ceiling of 3% resulted in interest rates and mortgage borrowing costs more than doubling and consequently New Zealand experienced a significant shift in household as well as business cash-flow contraction and confidence. The later part of the financial year saw a notable downward correction to most global asset valuations such as equities, bonds, and property. This was a year of significant change, not only to New Zealanders perception of wealth but also to spending habits.

Inflation also brought with it a disruptive influence on household and business economic planning and forecasting. Its' impact has been measurable in public benefit organisations with unbudgeted increases to operational and Capex costs, revenues, and delays to construction of infrastructure and buildings.

Against these trying conditions, NRC has shown remarkable financial risk management resilience in terms of weathering the multiple financial market storms prevalent in the 2021/22 year.

NRC has fared comparatively well to others in the local government sector. Council continued to exceed its balanced budget benchmark with revenue 106% of expenditure against a benchmark of 100%. Whilst down on previous years this was mainly the result of lower than anticipated gains from the externally managed fund and a timing difference on the sale of a investment property.

NRC's return of -2.50% on the externally managed fund portfolio of $76.2 million was disappointing, albeit not unexpected given the seismic impacts to global financial markets and was significantly better than the New Zealand funds management average return of – 7.8% for the June 2022 financial year. NRC's externally managed fund was clearly in the top performing quartile of New Zealand managed funds. The NZ Superfund, New Zealand's largest fund manager experienced a drop in value of $3.3 billion to $55.7 billion as at June 2022, down from the previous year's $59 billion (-5.4%).

NRC's externally managed fund generated an average annual return >7% over the past 5 years, even when considering the negative return for the June 2022 year.

The strategic/ oversight management of NRC's external funds, within the overriding SIPO limit controls, has been prudentially effective and sets NRC up well for the 2022/23 year.

Border closures, staff illness and a significant national skills shortage in auditors has caused major challenges to the local government sector. Nearly every regional and territorial council has had unprecedented delays to their statutory external audit timetable with most audits running 6-11 months behind normal schedule. By contrast, NRC has had a seamless audit process, conducted on time and completely to plan. NRC's outgoing lead engagement auditor Peter Gulliver of Deloitte conveyed to me that NRC & the NRC financial team are the model of a best practise audit client saying that the team is technically savvy, well prepared, and diligent. Deloitte, to their credit have maintained excellent continuity, notwithstanding auditor shortages impacting on all audit firms.

The audit results are, in my opinion, as good as it gets for NRC. There was only one raised finding requiring a management response concerning 6 Private Equity fund managers not providing audited internal control reports. This effects $3.3 million of investment exposure and was primarily with investments that were undertaken prior to the changes in NRC's SIPO in December 2021. Deloitte do recommend a full independent review of the investment SIPO parameters and risk appetite over the coming year.

When reviewing NRC's 2021/22 performance in relation to key financial measures it is heartening to see that council continues to be in a robust and healthy financial position.

Rates affordability crept up to 49% against a maximum quantified limit of 75%, and although higher than last years 36% reading, was primarily caused by the loss of income from the externally managed funds and can hopefully be considered "one-off".

Council has $13.96 million of external debt, no change to last year, and continues to have abundant debt capacity due to holding significant investments categorised as non-current assets that can be readily liquidated if required. Council has a net debt gearing constraint (cap) of net debt being no more than 175% of adjusted revenue. This currently allows Council to externally borrow up to $88 million in terms of net debt to adjusted revenue and provides for total debt headroom capacity of $162 million.

The current negative debt leverage (-147.3%) allows Council to perform well against debt servicing benchmarks. Net interest to total rates revenue remains close to 0% (0.4%) against a benchmark of <25% and net interest to total revenue is also close to 0% with a benchmark of <20%.

With such low net debt to revenue gearing, other important prudential benchmarks associated with debt servicing are well met with borrowing costs at 0.8% of revenue well below the benchmark limit of 10%. The current rise in New Zealand interest rates will not materially impact on councils' debt servicing forecasts.

Council has a high level of liquidity in that it can very easily meet its obligations from committed access to easily liquifiable financial assets. Councils' liquidity benchmark is that liquid assets and access to committed funding should exceed 110% of external debt. Council is currently at 448%.

From an ongoing sustainability perspective, NRC continues to outperform balanced budget benchmarks. NRC generates sustainable revenue in excess of council's core expenditure at 106% against a 100% benchmark. Net cashflows from operations continue to be strong with council comfortably exceeding planned net cashflows from operations.

It is pleasing to see that NRC's core and reoccurring revenues continue to exceed NRC core and reoccurring costs when one off realised and unrealised gains are conservatively stripped out. This is most importantly evidenced by Council's cash flows as well.

Council is financially well placed to support the Northland Region's four well beings – Social, Economic, Environmental and Cultural priorities.