4.3.4 DFAP

Background and valuation

- The DFAP is a portfolio of investments in global shares and bonds. The DFAP has the following two goals:
  - Provide a portfolio of assets held in reserve to meet any unforeseen liquidity or funding events
  - Maintain the real capital value of the portfolio after making distributions
- Responsibility for the DFAP has recently transferred from ACIL to AC Treasury (the AC Treasuy management arrangement mirrors the earlier ACIL arrangement, and any difference in return is due to market performance only)

Indicative Market Valuation

- The portfolio is continually marked-to-market and comprises liquid stocks and bonds
- It is managed to maintain a constant market value of $328 million. This is achieved by passing through any yield income to AC and to the extent the portfolio ex yield increases above $328 million, liquidating the excess
- Accordingly a value of $328 million is a reliable estimate of realisable value
- AC targets a long-term return of 7% p.a. on the portfolio. Given recent equity capital market performance, recent years have seen stronger returns than this

Strategic Imperative for ownership / control

- The DFAP is a pure investment comprising minor positions in a wide range of public securities – no control rights of the underlying companies exist for Council. Accordingly, there is no ownership / control imperative
- However, the DFAP is maintained as part of the liquidity support for AC's treasury function – i.e. AC maintains ready access to liquid assets in the event a market event prevents AC from refinancing facilities as they come due
- The overall level of liquidity support held by AC Treasury (and the optimal form of it) would need to be considered if the DFAP was to be liquidated. We note that AC has an $800 million standby facility for the same purpose that could presumably be extended
- We note it is unusual for an organisation with the purposes of AC to hold such an asset

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Divestment funding impacts

- The table below sets out the indicative impact on AC funding from divesting the DFAP. We assume a value for the whole DFAP of $328 million. We make the following assumptions:
  - Return 7% p.a. paid out in full each year (as per LTP)
  - Interest rates of 6% (as per LTP)
- Two scenarios are shown:

  Scenario 1: Debt Reduction – sale proceeds are used to reduce debt

  Scenario 2: Non-income generating asset investment – sale proceeds are used to fund capex of a non-income generating asset

DFAP ($ millions)	Sale	FY16	FY17	FY18	FY19	FY20	FY21	FY22	FY23	FY24	FY25
Scenario 1: Debt Reduction											
Sale Proceeds	328	-	-	-	-	-	-	-	-	-	-
Debt Reduced	(328)	-	-	-	-	-	-	-	-	-	-
Interest cost savings	-	20	20	20	20	20	20	20	20	20	20
Estimated yield foregone	-	(23)	(23)	(23)	(23)	(23)	(23)	(23)	(23)	(23)	(23)
Net funding impact	-	(3)	(3)	(3)	(3)	(3)	(3)	(3)	(3)	(3)	(3)
Scenario 2: Asset Investment (Non-Income Generating)											
Sale Proceeds	328	-	-	-	-	-	-	-	-	-	-
Asset Investment	(328)	-	-	-	-	-	-	-	-	-	-
Estimated yield foregone	-	(23)	(23)	(23)	(23)	(23)	(23)	(23)	(23)	(23)	(23)
Net funding impact	-	(23)	(23)	(23)	(23)	(23)	(23)	(23)	(23)	(23)	(23)

Source: Auckland Council

- If the sale proceeds are used to repay debt, the sale results in a near-zero change to future cash flows (because the cash dividend yield approximates AC's borrowing rate)
- If the funds are reinvested in a non-income generating asset, a funding gap equal to the net surplus foregone is created

Option 2ai and 2aii: Other commercial assets not part of core council functions

Other commercial assets exist which also do not directly support core Council functions. Additional strategic priorities could be achieved if capital in these assets was released.

Auckland Council Example – Diversified Financial Asset Portfolio

Auckland Council holds a portfolio of equity assets held in reserve to meet any unforeseen liquidity or funding events. This is a legacy asset. In FY2014 this fund, the Diversified Financial Asset Portfolio (DFAP) has produced a gross return of 12.1% and now represents a $345m asset as at Feb 2015.

The DFAP was transferred from ACIL to Auckland Council's Treasury function in early 2015. We note that the approach taken by Auckland Council Treasury team largely mirrors the approach taken by ACIL. It is managed under an Investment Policy and has a Long term target return of 4% pa above the consumer price index[29]. We note that Auckland Council has currently invested over two thirds of this fund in growth assets - which has a higher risk : return ratio.

The DFAP indirectly meets the role of local government. The main arguments for retaining the fund include:

- This fund is generating a good return - why would we sell a cash generator? Markets are cyclical and so there will always be peaks and troughs in earnings profiles. Selling assets at the top of the cycle intuitively feels like a better use of capital than at the bottom of the cycle (i.e. when it is generating low returns). The question must also be asked, if it is generating such good returns, why doesn't the Council borrow substantially to invest more in the fund? The answer to this question lies in the risk attached to the reward. The role of Council is not to take on significant amounts of risk. We would not expect ratepayers to accept this; and
- The fund is a "rainy day" fund. If a "rainy day" did occur it is likely that the shock has occurred in the global economy (for example the aftermath of the GFC). This global shock would place downward pressure on the value of the DFAP and Auckland Council would effectively be selling towards the bottom of a cycle. The Auckland Council Treasury function must minimise the risks associated with its investments to avoid placing the capital value of the investment at risk. No unnecessary or speculative investment activity should be undertaken as noted in the Investment Policy. The fund investments can be liquidated through a readily available secondary market so retrieving capital can be easily done. It also should be noted that currently Auckland Council has a number of other financial tools available, for example short term credit facilities.

The rationale for holding the DFAP look even weaker than the rationale for holding AIAL shares. Auckland Council could divest its interest in this fund and reinvest the proceeds in paying down debt, reducing rates or accelerating infrastructure investment to better achieve the Auckland Vision.

Next steps – option 2ai

If Auckland Council decides to modify its stake in DFAP, it could:

- *Determine the optimal strategic holding;*
- *Undertake consultation with appropriate stakeholders;*
- *Commission robust financial analysis on impact of sale, including appropriate WACC; and*
- *Determine the appropriate share value, sale strategy, and application of proceeds to maximise value and return.*

[29] As per the Diversified Financial Asset Portfolio statement of investment policy and objectives