

NZ Funds credit checklist

Focus on flexibility.

Executive summary

- As the crisis moves from a medical one to an economic one, the focus of financial markets shifts from systemic risks to the performance of individual businesses.
- This requires a strong company research process and it is a key point of differentiation for NZ Funds.
- NZ Funds has developed an eight-point credit checklist which covers areas such as financial flexibility, company risk and management quality.
- The credit checklist can lead us to form different views from rating agencies and this can be a return opportunity.

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Wellington Airport and Infratil 2024 Bonds - yield history



Source: Bloomberg.

Lockdowns and social distancing appear to be working as they are flattening the curve and reducing pressure on hospitals around the globe. This action has come at an economic cost and as a result, the crisis is being transformed from a medical one into an economic one. In a similar manner, the focus of financial markets shifts from systemic risks to the performance of individual businesses and their ability to respond to the crisis.

At this point, having a strong company research process is critical and it will be a key differentiation point between active investment managers with inhouse expertise and those who rely on other peoples' opinions such as rating agencies.

At NZ Funds we have a two-step process for credit research. Step one is the process we use for shares – we look at a company as if we owned 100% of the business and research how the company has performed in good times and in bad and how it has been valued by the market at each point.

As a debt investor you need to be focused on the downside, as unlike a shareholder you do not typically benefit from a good outcome but will be penalised for a bad one. To help assess this risk, NZ Funds has developed an eight-point credit checklist. This checklist considers issues such as financial flexibility, company risks, management quality and debt coverage. This helps us to understand the options management have in times of strife.

One of the outcomes of this approach is that we may form a very different view than the rating agencies, and this can be a return opportunity. One such example is Wellington Airport which is rated BBB+ by Standard & Poor's. In the Income Portfolios we do not hold Wellington Airport but instead have explicitly chosen to own the unrated bonds issued by Infratil, its 50% owner. Why?

The bonds issued by Infratil are disliked by many professional investors for two reasons. Firstly, as an investment holding company Infratil invests equity

into its subsidiary businesses such as Trustpower, Vodafone, Tilt Energy and Wellington Airport. Equity investments are subordinate to any debt in those businesses – if times are bad you are at the back of the line. Secondly, Infratil itself has debt (bonds and bank debt) so the total level of debt across the combined businesses is relatively high.

So why then do we prefer Infratil bonds over Wellington Airport bonds?

Our credit checklist highlights that the two companies face very different levels of flexibility.

Wellington airport is a single business and its revenue is reliant on airline flight numbers. There are no alternative revenue sources and in addition, the airport is essentially a single asset so they do not have the ability to sell off secondary assets.

Wellington airport is a private company jointly owned by Infratil and Wellington City Council. This significantly limits the ability to raise new capital if needed as either party may be unwilling or unable to contribute new funds.

In summary, this means that the management of Wellington Airport have very limited options at this difficult time. In contrast, Infratil has numerous options.

Infratil's revenue is diversified across a variety of sectors including utility like industries. So even though Wellington Airport has been severely impacted by COVID-19, businesses such as Vodafone, Trustpower and Tilt Renewables continue to perform well. Indeed, Tilt Renewables last week completed a A\$260m return of capital of which Infratil's share was A\$169m.

The diversity of Infratil's investments also provides management with the option to raise cash by selling individual investments through either a trade sale or the sale of shares in the listed entities.

Lastly, Infratil itself is a listed company. One of the key themes in the NZ Funds Income Portfolio is that we have a strong preference for listed companies. A share market listing increases transparency and provides an avenue to raise additional capital during challenging periods. Today, Infratil does not require additional capital, however it is an option management have.

Having a defined credit investment process makes it clear to us that despite being a leveraged business, Infratil is well equipped to navigate this downturn. This allows NZ Funds' clients to benefit from the higher yield that the Infratil bonds offer.



Mark Brooks
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Mark is responsible for management of the Income portion of clients' portfolios at NZ Funds. This encompasses both New Zealand and Global fixed-income securities.

After beginning his career with NZ Funds, Mark spent five years during the early 2000s in London managing a portfolio for a European credit hedge fund.

Since re-joining NZ Funds in 2007, he has built a strong track record of performance for clients across both local and global income.

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