Investment Strategy

1. Purpose and background

1.1 Introduction

Section 101A of the Local Government Act 2002 requires local authorities to prepare and adopt a financial strategy as part of its long-term plan (LTP).

The purpose of the financial strategy is to facilitate prudent financial management by providing a guide to consider proposals for funding and expenditure by making transparent the overall effects of those proposals on the local authority's services, rates, debt and investments.

Council's (i.e. HBRC and HBRIC) investments are an important aspect of its financial strategy, both as a mechanism for protecting and maintaining intergenerational equity, and as a funding source to reduce rates.

Council investments are managed as per the following guiding principles:

- Council is a custodian of its investments on ratepayers' behalf.
- By default, generally commercial investments will be considered by HBRIC whereas HBRC will operate as a passive investor.

1.2 Background

As a result of the August 2019 initial public offering of Napier Port on the NZX, in which HBRIC sold a 45% shareholding, Council has an increasingly diverse range of investments. This growth has meant Council's investment holdings are becoming an increasingly important enabler for Council to achieve its wider LTP objectives.

Both HBRC and HBRIC own and manage investments on Council's behalf. HBRC has a number of forestry, property and managed fund holdings which are held for a range of reasons (both commercial and non-commercial).

HBRIC (a CCTO) is responsible for owning and managing Council's direct commercial investments. For instance, Napier Port Holdings Limited (Council's largest direct investment) is held by HBRIC. In the future it is Council's intention for HBRIC to be the vehicle through which commercial investments are made.

HBRC benefits from HBRIC's investments through regular dividend payments which are used to meet wider Council objectives.

1.3 Purpose

The purpose of this Investment Strategy is to outline Council's approach to managing its investment assets. The Investment Strategy reflects the principles agreed upon with Councillors as part of the 2021-31 LTP process. It builds on this work by providing detail regarding the operational elements required to implement the Investment Strategy.

This Investment Strategy covers Council's investment assets. This includes:

- Council's shareholding in Napier Port Holdings Limited
- Council's forestry holdings
- Council's externally managed funds
- Council's Wellington property holdings.

Council's endowment leasehold land holdings have been excluded from this Investment Strategy. This is because the cash flow from this land was sold for 50 years to ACC in the financial year ending June 2014. There is also limited saleability associated with this holding given existing contractual arrangements. However, from time to time properties will be sold and profits over and above the amount owing to ACC will be transferred to the long term investment fund.

The rest of this Investment Strategy document provides an overview of the Investment Strategy along with the mechanisms required to implement it.

2. Hierarchy of documents

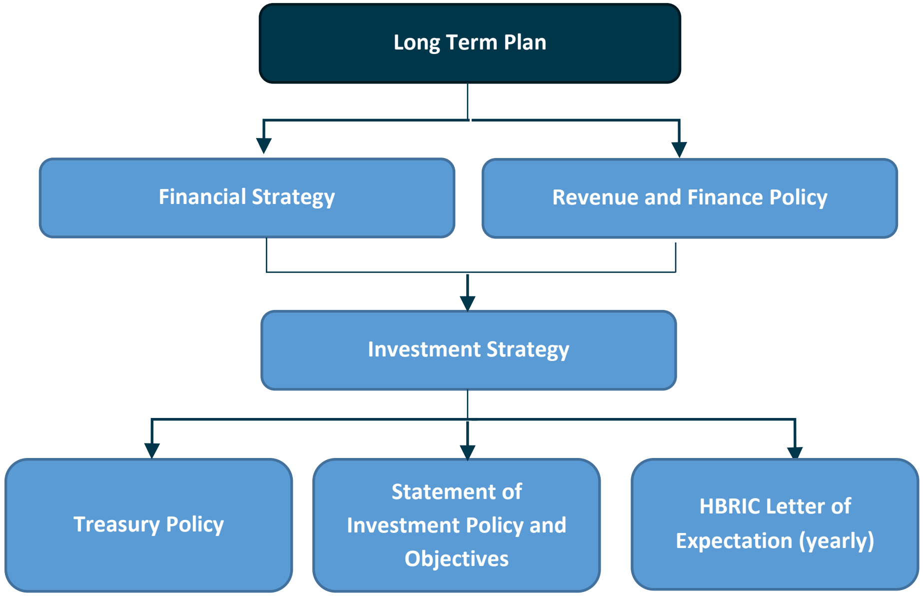
Council's Investment Strategy cannot be read in isolation and interacts with many other Council documents.

It is established based on the principles in Council's LTP, Financial Strategy and Revenue and Financing Policy. These documents also outline Council's investment expectations.

The Investment Strategy provides the broad outline and general direction for how these expectations will be met. The Strategy is then implemented in the following documents that sit below it:

- Council's Statement of Investment Policies and Objectives (SIPO) details the approach to managing specific externally managed funds under the Investment Strategy.
- The HBRIC Letter of Expectation outlines Council's dividend expectations. The substance of this is then reflected in HBRIC's Statement of Intent.
- Finally, the Treasury Policy provides greater detail on items for which Council approval is required. This includes items relating to:
    - ethical/responsible investing
    - permitted delegations
    - counterparty risk
    - investment reporting.

Figure 1: Hierarchy of documents



3. Definitions

Cash return: The income received from Council's investments (e.g. Napier Port dividends, managed fund income and rental income) after fees and taxes.

Napier Port income: Dividends received from Napier Port Holdings Limited after taxes.

Gross return: The cash return received and unrealised capital gains from Council's investments after fees and taxes.

Investment income: Includes managed funds income, dividends and property income after fees and taxes.

Managed fund income: Dividend, interest payments and distributed realised capital gains received from Council's managed funds after fees and taxes.

Property income: Rental income received from Council's property investments.

Realised capital gains: Profit from the sale of some (or all) of Council's investment holdings.

Strategic asset: An asset Council owns which is considered to have particular importance to the community and/or Council's ability to promote outcomes within the community. The Significance and Engagement Policy must be applied to any Council consideration to change a strategic asset.

Target return: Council's gross return requirement.

Unrealised capital gains: Appreciation in the value of Council's investments that has not been realised. An example is an increase in the share price of HBRIC's holdings in Napier Port Holdings Limited.

4. Investment holdings

Both HBRC and HBRIC own portions of Council's investment assets. This is a legacy of previous decisions made by Council and due to commercial implications which have meant some of the proceeds from the Napier Port IPO have remained with HBRIC and been invested.

The following table details the investment assets covered by the Investment Strategy and whom they are owned by. It also indicates whether the investment holding is strategic or not. These distinctions are important because it has implications regarding return expectations and the realisation of capital gains (refer Section 6 of this Investment Strategy). Portions of some investment holdings are strategic whereas other portions are not; where this occurs two entries have been presented within the table.

Table 2: Investment assets covered by the Investment Strategy

Investment asset	Owner	Current manager	Strategic/non-strategic
Napier Port Holdings Ltd	HBRIC	HBRIC	Strategic
Future Investment Fund (Managed Fund)	HBRIC	Jarden/Mercer	Strategic
Future Investment Fund (Managed Fund)	HBRC	Jarden/Mercer	Strategic
Long Term Investment Fund (Managed Fund)	HBRC	Jarden/Mercer	Non-Strategic
Forestry	HBRC	HBRC	Non-Strategic
Wellington Leasehold Property	HBRC	HBRC	Non- Strategic

A description of each investment asset is provided below.

Napier Port Holdings Limited: Council has a 100% ownership of HBRIC and HBRIC has a 55% ownership stake in Napier Port Holdings Limited (NPHL). As Council's objective is to maintain an ownership proportion of no less than 51%, the majority of the stake is considered Strategic.

Managed funds: There are two funds that collectively form Council's managed fund investments:

- **The Long Term Investment Fund** is held by HBRC and was established using money set aside for discontinued projects. Council investments in this fund are considered Non-Strategic.
- **The Future Investment Fund** is held by HBRC and HBRIC. It was formed using proceeds raised from the Napier Port IPO. These investments are Strategic Assets.

Forestry: HBRC owns a range of forestry assets that consist of forestry crop for logging and mānuka plantings for honey.

Wellington leasehold property: HBRC owns various residential and commercial leasehold properties in Wellington.

5. Investment requirements

5.1 Investment objectives

Council has three principal investment objectives. These are outlined as follows:

1. To increase the region's wealth and prosperity through the investment portfolio.
2. To increase asset values within the investment portfolio.
3. To protect asset values so future generations can also benefit from the investment portfolio.

Underneath these objectives sit a range of sub-objectives that ensure Council can achieve these outcomes. These sub-objectives are detailed below.

Objective 1: To increase the region's wealth and prosperity through the investment portfolio

- To generate a cash return from the investment portfolio to assist with the affordability of rates while maintaining the community's desired levels of service and to fund intergenerational or transformational projects.
- To enable HBRIC to use a portion of the cash return generated from its investment holdings to support and stimulate regional growth by making strategic commercial investments.
- To maintain a controlling stake in NPHL.

Objective 2: To increase asset values within the investment portfolio

- To receive a target return from HBRIC on an annual basis (as detailed in Council's Letter of Expectation) whilst otherwise allowing HBRIC to operate independently and actively investing directly within the region.
- To generate capital growth in the investment portfolio to maintain at least the real capital value and to benefit future ratepayer generations.
- To use a portion of the cash return generated from the investment holdings to build up an investment reserve to manage volatility of investment returns and distributions. Further details on this reserve are provided in Section 6 of this Investment Strategy.

Objective 3: To protect asset values so future generations can also benefit from the investment portfolio

- To realise capital gains when appropriate to ensure intergenerational equity is maintained.
- To ensure investments align with Council's responsible and ethical investment requirements as detailed within Council's Treasury Policy.
- To prudently manage the investment holdings as Council is a custodian of current and future ratepayers assets.
- To manage investment risks and optimise returns.
- To establish the controls needed to enable Council management to efficiently manage the investments.

5.2 Return targets

Investment assets held by both HBRC and HBRIC are currently expected to provide a cash return of 4% per annum and a gross return of 6% per annum. The higher gross return target reflects the need for the investment portfolio to maintain its real capital value to ensure intergenerational equity is maintained.

The return requirements will be computed into a numerical value at the start of each LTP period for each investment asset for the following three years. This ensures the cash expectation is understood and enables the effective management of the investment assets. Further, the setting of a numerical target based on a three year average rather than a percentage helps to normalise for volatility throughout the forecast period and provides clarity of requirements.

For some investment assets, the return expectations may be lower than required. For instance, Council's property holdings may only reasonably be able to provide a cash return of 2%. Where this occurs, it is expected the return requirement from Council's managed funds and other investments would adjust. This may require re-aligning the investments within the fund. Further detail is provided in Council's SIPO.

Return target example (illustrative only)

The following example indicates how the return targets will be set. As part of this example, we have illustrated how the managed fund return requirement would be expected to adjust to reflect a lower return elsewhere (i.e. in property).

Council Investment Assets: $560 million

Cash Return Required: $22.4 million (560 x 4%)

Gross Return Required: $33.6 million (560 x 6%)

Table 3: Return targets

Investment asset	Value ($m)	Cash return expectation p.a.	Gross return expectation p.a.	Cash return requirement ($m)	Gross return requirement ($m)
Napier Port	385	4%	6%	15.4[1]	23.1[1]
Property	18	2%	4%	0.4[2]	0.7[2]
Forestry	10	4%	6%	0.4[3]	0.6[3]
Managed Funds	147	4.2%[5]	6.3%[5]	6.2[4]	9.2[4]
Total	**560**	**4%**	**6%**	**22.4**	**33.6**

[1]Cash return = 385 x 4% = 15.4; Gross return = 385 x 6% = 23.1
[2]Cash return = 18 x 2% = 0.4; Gross return = 18x 4% = 0.7
[3]Cash return = 10 x 4% =0.4; Gross return = 10 x 6% = 0.6
[4]Cash return = 22.4 – 15.4 – 0.4 – 0.4 = 6.2; Gross return = 33.6 – 23.1 – 0.7 – 0.6= 9.2
[5]Cash return expectation = 6.2 / 147 = 4.2%; Gross return= 9.2 / 147 = 6.3%

5.3 Reviewing return targets

The return targets will be evaluated every three years in-line with the LTP process. To determine these targets, Council will consider its numerical cash return requirement (by dollar amount) over the following three years. This will then be converted into a percentage-based annual return target as a sense check.

This approach is preferable as it ensures the targets align with Council's funding and investment reserve requirements and has been 'normalised' to reflect changes in asset values. It also ensures a robust forecast process, allowing performance Key Performance Indicators (KPI's) to be set. These targets will form part of the LTP process and align with plans on significant assumptions.

The capital gain target (i.e. to inform the gross return) will be set with reference to inflation expectations to ensure the real value of the portfolio is maintained.

5.4 Use of investment proceeds

A cash return will be provided to Council typically on a semi-annual basis (i.e. in two lump sums) or otherwise when received. This income received will be used for a range of purposes including:

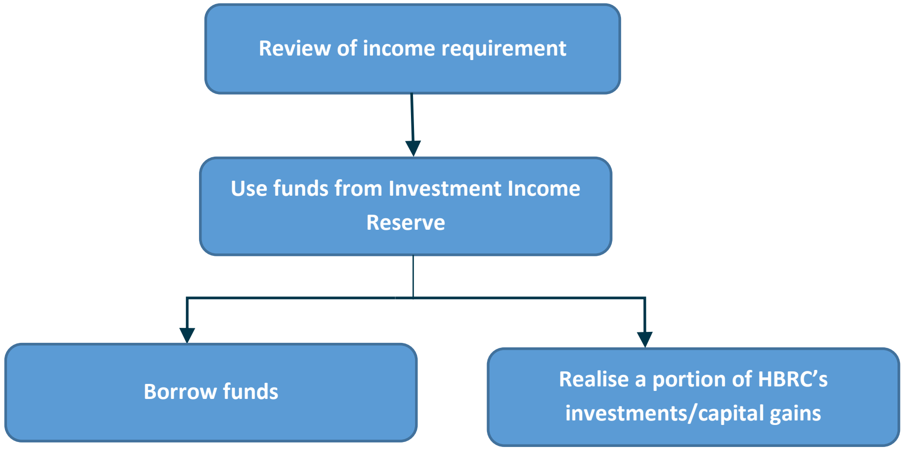
- to subsidise general rates
- to grow an investment reserve
- to fund regional growth initiatives.

Of these items, Council will first ensure the cash return received is sufficient to meet its rates subsidisation objectives. After this the remaining proceeds will be applied towards the other items outlined.

5.5 Lower cash returns than anticipated

On occasion Council may receive lower cash returns than anticipated. The protocols for dealing with these if the lower returns come from HBRIC are detailed within HBRIC's Investment Strategy. However, if these lower returns come from the HBRC portion of Council's investment portfolio, then the process detailed below should be undertaken to determine the response required (if any).

Figure 4: Process waterfall when cash returns are lower than anticipated



As per the above diagram, Council should first review its income requirement before taking any action. Accessing any available funds in the investment income reserve would then occur prior to selling a portion of HBRC's investment holdings or increasing Council borrowing.

5.6 Realising a portion of HBRC's assets when cash returns are lower than anticipated

When realising investment assets, only returns in excess of the net capital gains target (i.e. 2% after transaction costs has been met) can be realised. This ensures the real capital value objectives are achieved and intergenerational equity is maintained.

Council may realise either its Strategic or Non-Strategic assets. Consultation will however be required if realising strategic assets.

Prior to making a decision on whether to sell investment assets, Council should consider the underlying liquidity and divisibility of its assets. For instance, this could mean realising externally managed funds before Wellington Leasehold Property.

Before proceeding with the sale of any investment assets when cash returns are lower than anticipated, Councillors must first agree to the proposed transaction.

6. Capital Gains Policy

Council must ensure both current and future ratepayers benefit from the investment portfolio. This means consideration must be given to whether it is appropriate to realise capital gains.

6.1 Eligible assets

Council's Capital Gains Policy applies to both its Strategic and Non-Strategic assets. Selling strategic assets will require consultation.

6.2 Evaluation

The most appropriate time to complete the capital gains evaluation is following the end of each financial year. At this date, Council will review the performance of its investment portfolio and each specific investment asset. If the total gross return for both has on average exceeded 10% over the previous three years, then Council will proceed with its evaluation of whether to realise some of its capital gains. When realising capital gains Council must ensure its return targets are still met after the transaction (i.e. it still achieves a 6% gross return).

In evaluating whether to realise capital gains, Council's Investment Strategy should consider the following:

- The use of the proceeds raised and whether this aligns with Council's objective of maintaining current and future intergenerational equity.

- The importance of the item for which proceeds raised would be applied to and the impact on Council from alternative funding solutions (i.e. if capital gains aren't realised).
- The size of the net proceeds realised.
- Transaction costs.
- The investment outlook generally and for the asset class.
- Any relevant environmental, social and governance impacts.
- The impact on Council's wider investment holdings and asset allocation.
- Any investment reserve requirements.

Ahead of making a final decision, an assessment of these considerations will be provided to Council and discussed. Once evaluated a final capital gains decision would then be made.

6.3 Process

Council management will be responsible for realising any capital gains (following Councillors' approval). The process for realising capital gains will vary by asset class.

Council management will be expected to engage with relevant counterparties to ensure the funds are received in the quarter after the Councillors' decision is made. This will provide management with sufficient time to ensure they are minimising any transaction costs and to avoid any short-term market risk.

Once the transaction has occurred, management will be required to present proof to Councillors along with proof the funds have been applied towards the relevant Council activity. In the absence of a specific requirement agreed with Councillors, any funds raised will be put in to HBRC's LTIF until a decision is made regarding future use. This is because the LTIF is a readily existing vehicle to earn immediate returns on any funds until any investment is made.

6.4 Unsolicited offers

On occasion Council may receive unsolicited offers to purchase some of its investment holdings. In these instances, the following process is to be undertaken:

1. An office assessment of how the asset fits into the overall strategic objectives of the total (HBRC and HBRIC) portfolio asset allocation and risk appetite.
2. An assessment of the offer – with an up-to-date valuation.

Once this has been undertaken, Council management is then required to take the offer along with the completed assessment to Councillors who will decide how to proceed.

7. Reserving

An investment income reserve will be established to help smooth volatility in Council's investment portfolio. This means Council will not need to raise funding from other sources (such as rates) should investment returns be lower than required. This will ensure continuity of investment income and increases capital protection within the investment portfolio.

As per Section 5.4 of this Investment Strategy the investment income reserve will be created using proceeds received from Council's investment assets. The establishment of an investment income reserve still means Council's other reserves are required.

7.1 Requirement

Proceeds received that are used to establish the investment income reserve may vary over time. The intention should however be to grow the investment income reserve such that it can replace 6 to 12 months of cash return. As capital growth in the portfolio is expected, ongoing contributions to the investment income reserve will be required.

The funds received would be invested in low-risk treasury investments such as bank, call and term deposits to ensure the funds are available when they were needed. The reserve has been sized to reflect the opportunity cost associated with these investments (i.e. lower expected returns compared to the investment portfolio).

7.2 Ownership and management

HBRC will be responsible for owning and managing the investment reserve.

8. Investment opportunities

From time to time Council may be presented with new investment opportunities. These may be either Non-Strategic or Strategic assets (provided they generate a commercial return).

All new commercial investments will be considered by default by HBRIC. The investment evaluation criteria for these opportunities is reflected in HBRIC's Investment Strategy. Should HBRIC not wish to proceed with an investment, HBRC retains the option to invest directly.

As HBRC will generally be a passive owner of commercial investments, only managed fund investments are likely to be evaluated by HBRC in the future.

It is expected HBRC may also evaluate investments which are held for non-commercial reasons (e.g. forestry) but these are excluded from this Investment Strategy.

8.1 Evaluation process

Prior to making any investment decision, HBRC must undertake or receive a robust evaluation of the proposed investment.

Where the proposed transaction exceeds $5 million this evaluation must be presented to Councillors who will be responsible for approving the final investment decision. It is expected the investment evaluation will be presented to Council in the form of a scoping report.

The investment scoping report will need to justify why the investment is suitable and should be added to the long term investment portfolio. Amongst other items, the investment scoping report must cover the following items:

- How the investment opportunity arose.
- Historical investment returns and volatility.
- Examples of other peer Councils with such an investment.
- Expected returns (over a 5 year period).
- How the investment aligns with Council's risk profile.
- Any impacts on the wider investment portfolio from making the investment.
- Any impacts on Council's overall returns from making the investment.
- How the investment will be made and how the funds will be raised.
- The investments liquidity.
- How the investment aligns with Council's objectives.
- Key investment risks and mitigations.
- The proposed approach to performance and return monitoring.
- Upfront and ongoing costs from making the investment.

9. Role of HBRIC

9.1 Background

HBRIC Limited is a council-controlled organisation and is a wholly owned subsidiary of HBRC. It was established in 2012 to manage and own various Council assets. This remit has changed over time as its investment holdings have.

9.2 Scope

The 2021-31 Long Term Plan defined HBRIC's role in Council's Investment Strategy as being an enabler of regional growth and environmental outcomes. This means HBRIC will invest in the region as a commercial investor. The return target for these investments will reflect their risk profile. These investments are to be made using the excess returns generated by HBRIC's investment holdings. Excess returns are those exceeding the return HBRIC is required to provide to HBRC.

HBRIC's investment controls and procedures are outlined in its Treasury Policy and Letter of Expectation. HBRIC is expected to manage its investment holdings in accordance with these documents and report to Council on its compliance. Provided this occurs, HBRIC can manage its investment portfolio and determine how it meets Council's return requirements. This may include the use of borrowings (which HBRIC is permitted to do).

9.3 Dividends to Council

HBRIC is expected to provide Council with its contribution towards the overall return target. This will be provided to Council through regular dividend payments.

The annual numeric dividend expectation will be outlined to HBRIC in the Letter of Expectation. It will be calculated based on HBRIC's proportionate holding of the overall investment assets.

To the extent HBRIC's investment assets do not meet their cash return target, HBRIC has the capacity to borrow. This would supplement the cash return received and ensure the overall target is met.

10. Use of borrowings

Any proposed borrowings by HBRC that are linked to the investment portfolio will require the approval of Councillors.

However, in fulfilling its mandate, HBRIC may borrow. This aligns with its wider objectives related to increasing the size of its in-region investments. When borrowing there will be a range of parameters and debt limits which HBRIC must comply with. These will be outlined in HBRIC's Treasury Policy. This will ensure the level of leverage is appropriate and doesn't put various Council assets (such as the shareholding in NPHL) at risk.

11. Asset benchmarks

Asset class performance will be benchmarked against appropriate industry benchmarks with support provided from our advisors.

12. Review of Investment Strategy

Council's Investment Strategy will be reviewed no less than every three years. Reviews should coincide with the setting of Council's long term plan.