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Debt Market Update
Q1 2014

Edition 19

Corporate Finance

KEY THEMES

- Traditionally quiet quarter, however positive outlook to follow
- Alternative financing remains firmly on the agenda of corporates
- Institutional lending on the rise and bond markets increasingly competing with traditional bank loans

DOMESTIC DEBT MARKET UPDATE

The debt markets got off to their usual measured start to the year in Q1 2014, with US$11.2 billion priced for the quarter. This represents an 18 percent increase on Q1 2013, and is in line with the first quarter historic average volumes since 2009 of US$11.0 billion.

First quarters tend to be quieter as borrowers rush to close deals at the end of the year. This was certainly the case in Q4 2013 with US$47 billion in financings closed, representing 47 percent of last year's total financings. This also reflected borrowers rushing to take advantage of materially reduced margins coupled with a number of mega deals to come through at the end of 2013. As such, the decrease in volume when compared to the prior quarter should not be interpreted as a decrease in market appetite. From our dealings with financiers, there continues to remain considerable appetite to provide additional funding for growth and acquisitions.

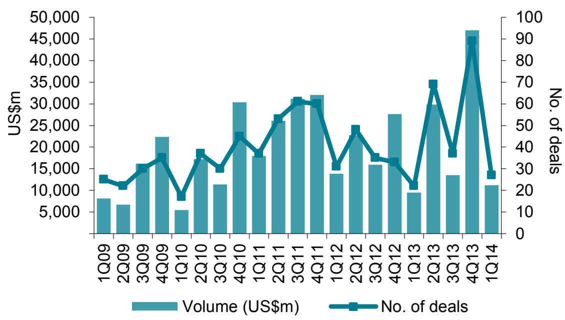
Refinancing continues to be the main driver of activity, accounting for 66 percent of total volume[1]. Significant deals to come to market in Q1 included Sonic Healthcare's A$1.3 billion refinancing and Asciano's A$1.3 billion (BBB-) refinancing. Transaction details are as follows:

Issuer	Tranche	Amount (m)	Tenor (yr)	Pricing
Sonic Healthcare	1	A$ 179	1	Undisclosed
	2	€ 186	1	
	3	€ 190	2	
	4	A$ 510	5	
Asciano Finance	1	A$ 650	3	BBSW+1.45%
	2	A$ 650	5	BBSW+1.75%

Source: Thomson Reuters Loan Connector

Further, over A$1 billion in new-money raisings contributed to total volume, with Quadrant Private Equity's takeover of Zip Industries (A$105 million facility), Seek Australia's acquisition of JobStreet Corp (A$770 million facility, including a portion of refinancing), and the dividend recapitalisation for SCA Hygiene (A$562 million). Whilst refinancings at typically reduced margins remain the predominant financing purpose, these new money transactions are encouraging for financiers seeking loan growth in a market that is largely devoid of new money opportunities.

Figure 1: Australian syndicated loan volume



Source: LoanConnector, KPMG analysis

It is anticipated that market activity for the remainder of the year will be driven by the improving business confidence and corporate activity leading to improving deal flow for the local market. This corporate activity, includes the continuation of firms engaging with the IPO markets, demerger activity, firms seeking inorganic growth (e.g. the recent mooted David Jones acquisition), private equity trade sales owing to the maturation of several funds, and infrastructure privatisations and PPPs. These will be fanned along by borrowers utilising the continued low interest rates for their corporate activities.

Supporting a strong pipeline for the remainder of the year, we note several mega-transactions may execute which will push significant deal flow into the market. These include the announced Westfield split, anticipated to come to market in Q2 2014, the Roy Hill project financing and the Queensland Motorways sale.

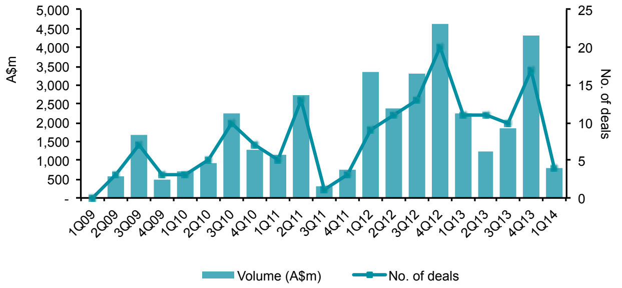
The derth of new-money transactions in the Australian bank market has driven increasing competition and resulted in a number of borrowers being able to command increasingly tight margins as illustrated by BBB rated borrowers being able to cut margins by up to 40-50bps compared to a year previously. In response to the

[1] http://www.loanconnector.com/loanconnector/LPC_LC2_Home.do

tightening of margins, banks are now making noises that they are approaching marginal levels of profitability on corporate lending alone based on estimated returns on equity and capital.

Further tightening will likely be contingent on business and consumer confidence, and any international geo-political shocks.

Figure 2: Australian corporate bond market volume

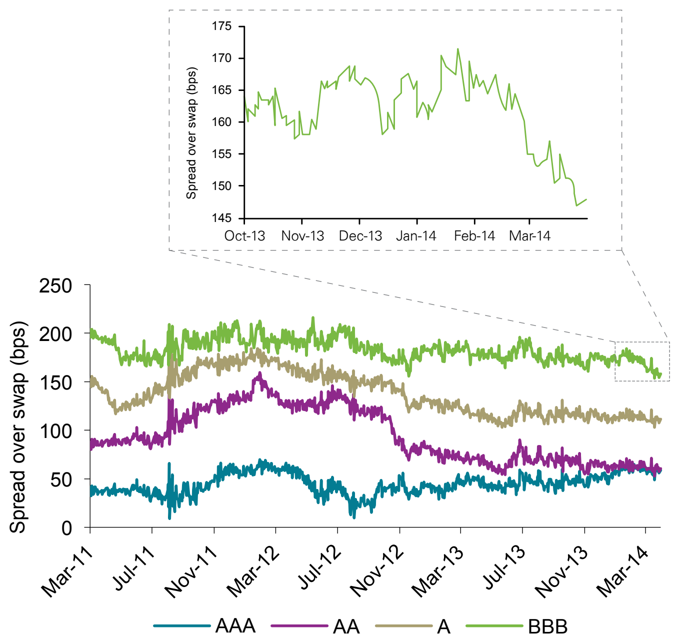


Source: KangaNews, KPMG analysis

In line with the bank market, the Australian bond market was quiet in Q1 2014 with only four deals brought to market, including Citipower's A$150 million (BBB+) and Fonterra's A$175 million (A+) issues. Further, only one deal was taken to the global markets, with SP AusNet pricing a €350 million transaction. These anaemic levels have not been evidenced since Q1 2009.

It will be interesting to see the extent to which deal flow returns in Q2 2014 particularly given the decreased supply in Q1 2014 is likely to positively impact market spreads. Potentially limiting Australian market deal flow are attractive market dynamics in foreign bond markets – particularly the European market and improved basis swap costs. Whether Australian issuers are drawn away from the local market will likely be determined by deal size constraints (Euro market typically requiring larger ticket sizes than the Australian market) hedging considerations, and all-in pricing analysis.

Figure 3: Three-year corporate bond pricing over swap



Source: Bloomberg, KPMG analysis

Spreads have been mostly flat for the AAA, AA and A credit profiles; however significant contraction has been experienced in the BBB range with contraction of 17bps in the quarter to 149bps over swap, the equal lowest margin for the last three years. Investors' appetite for BBB credits extends to 5 years, with spread also significantly contracting in the quarter – 24bps in Q1 2014 and 63bps over the past year to c.145 bps at the end of the quarter. If the market continues to exhibit a lack of deal flow, pricing is likely to come in further as financiers and investors bid for a smaller pool of opportunities.

More generally the overall debt market continues to build momentum into Q2, with several corporate transactions announced (Westfield, Arrium), the Roy Hill project financing (US$7.8 billion) and a number of infrastructure privatisation transactions expected to launch shortly[2]. All together, the pipeline for the remainder of the year appears healthy and likely to show strong improvements from the current quarter.

DEAL OF THE QUARTER

For Laureate International Universities, a leading international network of higher education, Australia is integral to its growth plans. In fact, with a network of over 75 institutions, Laureate has opened Australia's first private university in 20 years with Torrens University in South Australia.

To further capitalise on local opportunities, Laureate acquired 20 percent of Think Education Group (THINK) in August 2012 with an option to purchase the remainder at a later date. Since that initial purchase, THINK (with the support of Laureate) has gone through a period of re-investment and change management which has ultimately delivered materially improved business performance.

In light of the positive performance, Laureate reconfirmed that THINK was the right platform to achieve growth in Australia, and subsequently acquired the remaining 80 percent, to supplement its existing local network established by Torrens University.

As part of the acquisition, Laureate with the assistance of KPMG, secured a 5 year syndicated facility to fund its A$140 million acquisition of THINK. The deal was a multi option facility, including acquisition finance, capital expenditure and working capital tranches. Pricing and terms achieved were competitive and provided Laureate with a stable Australian funding platform.

> "KPMG provided high value added services to Laureate including Corporate Finance, M&A Due Diligence and Integration and Tax services. We hope to be a repeat client as we continue to grow in Australia."
>
> *John Vermaaten*
> *CFO, Laureate Education, Asia*

DEFAULTS IN THE EAST

China experienced the first series of private corporate bond defaults during Q1 2014 with Shanghai Chaori Solar Energy Science and Technology and Xuzhou Zhongsen Tonghao New Board Co. missing their RMB89.8m[3] (c.US$15m) and RMB180m (c.US$29m)[4] coupon payments respectively.

Growing concerns of further defaults have led some market participants to suggest that there could be increasing market instability in China as panicked investors flee the market[5]. The added level of market risk highlights the importance for Australian corporates to consider and focus on counterparty credit.

In fact, China's premier Li Keqiang recently spoke out at China's yearly meeting of parliament, noting that defaults will be "hard to avoid"[6] as the government accelerates financial deregulation. Although these comments do not quell fears of market instability due to expected corporate bond defaults, it does highlight that investors need to appropriately price risk and not assume implied government support. In other words, as financial deregulation leads to more efficient capital markets in China, Australian corporates will eventually trade with more transparent and more accurately rated counterparties.

[2] Loanconnector and KPMG analysis

[3] Forbes, Another Chinese Default – But it's still note a Bear Stearns Moment for China, 13/3/2014
[4] Thomson Reuters, Second private Chinese firm defaults on bond, 1/4/2014
[5] Forbes, Another Chinese Default – But it's still not a Bear Stearns Moment for China, 13/3/2014
[6] Thomson Reuters, Comments from Chinese Premier Li Keqiang, 13/3/2014

EMERGENCE OF THE MARKET DISRUPTORS

The continued development of user-friendly technology has allowed the introduction of more services to borrowers and lenders alike. In doing so these new services are now competing with traditional sources of financing.

This trend together with a funding gap in the market, caused by the shrinking of banks' balance sheets due to regulatory requirements, has led to the emergence of peer-to-peer (P2P) lending.

P2P lending takes place online through various lending platforms and credit checking tools and involves the lending of money between unrelated individuals directly, without the need for a bank to facilitate the transaction. The online platform takes a fee for their role as facilitator and manager of the deal, which is usually significantly less than rates charged by banks. P2P lenders presently offer loans to both individuals and small businesses.

Australia has demonstrated growth in this market space recently, with:

- P2P lender Paid International is considering listing on the ASX to broaden its range of investors and borrowers[7]
- Venture capital fund, Reinventure Group investing in SocietyOne[8].

As this market continues to develop, we should hope to see more diverse fixed income asset classes for investors seeking yield.

ALTERNATIVE FINANCING ON THE AGENDA

The environment over the past 5 to 7 years has been one of low growth with equity investors across the globe continuing to focus on return on capital deployed and sustainability of the free cash flow. This focus on return on capital has resulted in an increased utilisation of existing assets and strategic decisions to postpone asset replacement to preserve cash and return metrics. A number of industries are now facing the challenging task of balancing the increasing need to replace these ageing assets, generate free cash flows and maximise return on capital.

In addition to traditional measures such as improved controls and utilisation, disposals and capex deferral, some industry players are adopting smarter ways to share the risk and reward associated with capex spend through the use of alternative solutions. These solutions take a number of forms.

The drivers for undertaking alternative forms of funding will vary depending on the corporate, although commonly include release of capital for redeployment within the business, increased covenant and impairment headroom, and meeting thin capitalisation requirements.

Before entering into these structures, there are a number of considerations for corporates, and having clearly defined requirements will assist in developing a structure that best meets strategic objectives. In particular, some of the accounting considerations include:

- types and characteristics of assets
- appetite for having leases on the balance sheet (operating vs. finance leases)
- control measures and appetite for shared control
- appetite for de-recognition of risk and rewards of ownership.

KPMG is currently assisting a number of clients to navigate these structures in order to meet their corporate objectives, whilst having regard to the proposed new IFRS standards in respect of operating leasing.

These structures are not for all businesses, however when done correctly can achieve significant strategic objectives. In addition, the strong liquidity in the current market is expanding the investor universe that has the mandate and capability to support these solutions.

INSTITUTIONAL LENDERS ON THE RISE

The funding requirement for corporate and project finance continues to be largely met through the bank market, with the big four dominating loan volumes (and in turn influencing terms) and international banks generally focusing on larger corporate transactions or project financings.

The Australian capital markets provide issuers an alternative to bank debt, but this is typically limited to investment grade rated issuers. Restricted by a lack of depth and liquidity in this market, most corporate debt issuance is limited to tenors of between 5 and 7 years. Issuers seeking longer dated tenor have traditionally looked to overseas capital markets.

However, borrowers are increasingly using private placements to fulfil part of their funding requirements as an alternative funding source to bank and bond markets. These private placements are a natural funding alignment, particularly within the infrastructure and real estate sectors, matching long-dated asset life with the investor's own return obligations (e.g. pension, insurance and super funds) and providing opportunities to bridge the tenor gap in the domestic market where borrowers are being capped through bank and bond investor limitations.

A number of institutional funds have emerged that offer both traditional lending into 'bank club financing' structures or bespoke financing solutions. Lower yields from government bonds, coupled with investors seeking to reallocate portfolios away from a traditionally heavy reliance on equities, has pushed investors towards alternative investments that can meet both diversification requirements and mandated return and risk characteristics.

The emergence of more institutional lenders is likely to support corporate Australia, as these lenders are not subject to the same capital adequacy and liquidity rules which are constraining the ability of banks to lend[9].

WELCOME TO THE TEAM

We are pleased to welcome a new team member to KPMG's Debt Advisory Team. Jack Newall was previously a Managing Director in the Macquarie Funds Group and Macquarie Capital and brings over 15 years of corporate finance and debt advisory experience.

Jack's focus is on the infrastructure and natural resources sectors. Previously based in London, Jack's experience spans across the European market. Jack has led a large number of previous transactions successfully for many clients including:

- €950 million bond, loan and private placements for APRR, French toll road operator
- US$250 million refinancing for copper and gold miner GeoPromMining
- £165 million refinancing for commercial and retail real estate operator Warwick Square
- £400 million senior bank and £170 million high-yield refinancing for motorway services Moto owner & operator
- €285 million acquisition finance for CRa, Czech broadcast infrastructure owner and operator.

7 AFR, Payday and P2P lender considers float, 24 Mar 2014
8 AFR, Westpac buys into first peer-to-peer lender, 6 Mar 2014

9 AFR, Low-risk loan funds take off, 13 Feb 2013

RATING AGENCIES' POSITIVE OUTLOOK FOR 2014

2013 proved to be a turbulent year for global corporates and sovereigns in the view of credit rating agencies. S&P downgraded 568 issuers and upgraded 388 in 2013 with the resulting downgrade ratio of 54 percent being the lowest in 4 years[10]. Additionally, Fitch Ratings noted negative outlooks exceeded positive ones by more than three to one in line with the previous year, and further noted that most downgrades occurred in developed markets, particularly the Eurozone and the UK[11].

However, despite the negative activity experienced in the last couple of years, the rating agencies indicate that 2014 outlook appears stable. In particular, greater rating stability is expected in the Eurozone, reflecting "gradual economic recovery, small fiscal deficits and lower borrowing needs and costs."[12]. This stable outlook could prompt local corporates who may have previously hesitated approaching these off-shore developed markets, fearing the instability in the past (e.g. Euro debt crisis), to now consider entering those markets.

OUTLOOK

- Expected ramp up in loan activity.
- Increased corporate issuance in the Australian bond market as well as international and institutional markets.
- Renewed appetite towards lower rated borrowers by the Australian banks in search of better return on capital and equity.

YOUR THOUGHTS

We are keen to ensure that our Debt Market Quarterly Update is a topical and relevant publication for our readers. If you have any feedback on the content, format or would like to see articles on topics not covered in previous editions, we would be pleased to hear from you.

[10] S&P, Global Corporate and Sovereign rating actions and outlook: 2014 outlook is stable despite downgrades outpacing upgrades in 2013, 22 January 2014

[11] Fitch Ratings, Fitch Ratings Sovereign 2013 transition and default study, 14 Mar 2014

[12] Fitch Ratings, Fitch Ratings Sovereign 2013 transition and default study, 14 Mar 2014

Contact us

Contact KPMG's experienced Debt Advisory Services professionals for more information about our services.

David Heathcote
Head of Debt Advisory Services
Partner, Sydney
+61 2 9335 7193
dheathcote@kpmg.com.au

Scott Mesley
Partner, Melbourne
+61 3 9288 6748
smesley@kpmg.com.au

Raj Bhat
Director, Sydney
+61 2 9335 8419
rbhat@kpmg.com.au

Greg Eldridge
Director, Melbourne
+61 3 9288 5759
geldridge@kpmg.com.au

Jack Newall
Director, Perth
+61 8 9263 7491
jnewall@kpmg.com.au

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