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# Debt Market Update
## Q2 2014

**Edition 20**

## Corporate Finance

## KEY THEMES

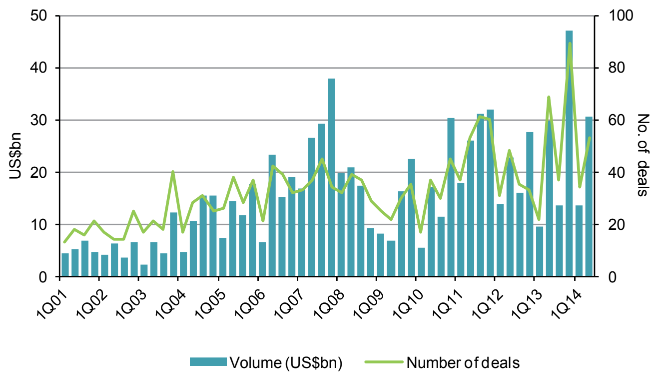
- The Australian debt market sees volumes double relative to previous quarter
- Loan and bond pricing continues to contract both globally and in Australia
- Commitment fees under pressure
- Batavia features increasing in popularity
- Disintermediation on the rise

## DOMESTIC DEBT MARKET UPDATE

2Q14 saw momentum surge back into the Australian debt market. With US$30.7 billion completed in 2Q14, the quarter represented a strong bounce back from the subdued 1Q14 in which only US$13.6 billion across 34 transactions closed. The total result for 1H14 represents a 13 percent increase from the same period last year.

Interestingly, 2Q14 is the fifth largest on record, and closes only the third sustained period where the 12 month market run-rate is above US$100 billion – the others being the lead up to the financial crisis, and the surge in borrowing in late 2011 through to early 2012, primarily as a result of significant project financing transactions.

**Figure 1: Australian syndicated loan volume**




Source: LoanConnector, KPMG analysis

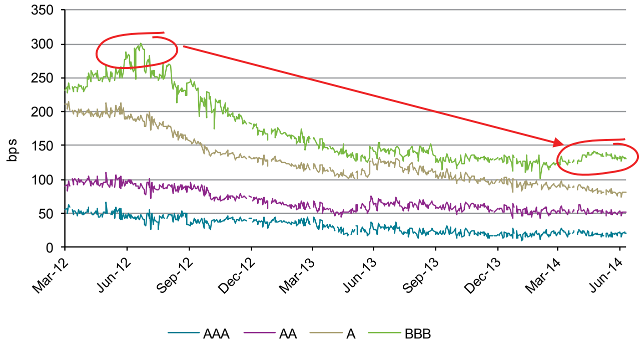
The strong volume in 2Q14 was led by a number of large 'new financings' including the significant US$7.8 billion Roy Hill project financing completed in April 2014, the Hastings led acquisition of Port of Newcastle and the purchase of QML by Transurban, ADIA and AusSuper. Other significant transactions for the quarter included:

| Borrower | Date | Tranche amount | Tenor | Margin |
|---|---|---|---|---|
| APT Pipeline *refinancing* | Jun-14 | A$ 400m | 2.25 yrs | 100 bps |
| | | A$ 425m | 3.25 yrs | 110 bps |
| | | A$ 425m | 5.25 yrs | 140 bps |
| NCIG *refinancing* | May-14 | US$ 550m | 3.00 yrs | 155 bps |
| | | US$ 400m | 5.00 yrs | 185 bps |
| | | US$ 250m | 7.00 yrs | 225 bps |
| CDPT Finance *refinancing* | May-14 | A$ 546m | 4.00 yrs | n/a |
| | | A$ 473m | 5.00 yrs | n/a |

Source: LoanConnector, KPMG analysis

Whilst 2Q14 showed strong volumes, most significant transactions were debt refinancings resulting in weak overall credit growth. This dynamic, as well as the increasing number and type of lenders seeking Australian credit exposure, has resulted in continued competition for credit, resulting in downward pricing pressure and improvement in terms, particularly for investment grade borrowers.

**Figure 2: Australian bond 3 year margin over swap**



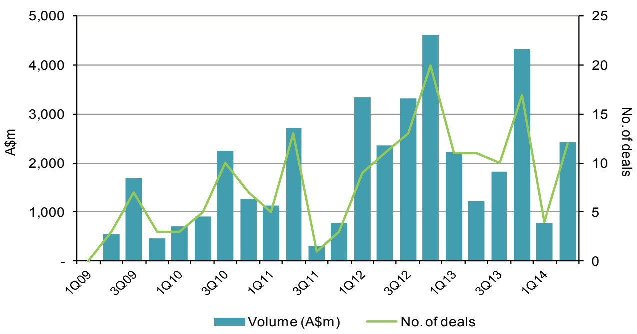

Source: Reuters, KPMG analysis

In particular, BBB issuance has seen significant contraction in pricing over the past 24 months driven by competition and the search for yield, with bond margins falling from 300 bps in June 2012 to below 150 bps today. We note that this pricing reflects bond market conditions; however, the above margins present a strong reference point for discussions with financiers. **It is likely that borrowers who financed over 18 months ago or earlier will be able to secure materially improved terms should they look to refinance in the current market**.

Supporting decreased pricing, the Australian banks themselves have experienced a contraction in cost of funds, evidenced by the decline in the AA curve above, along with low deposit rates and a contraction in covered bonds and RMBS pricing.

Australian bond pricing decreases have somewhat moderated in the past quarter despite continued downward trends in other global markets and continuing improvement in borrower terms for new transactions.

**Figure 3: Australian corporate bond market volume**




Source: KangaNews, KPMG analysis

The Australian bond market experienced a much stronger quarter compared to 1Q14 with a bounce back in corporate transactions. Competitive pricing was a key feature in the local market, as evidenced by the Port of Brisbane's 7 year note pricing at 145 bps over swap compared to 190 bps for a similar transaction a year ago. Qantas was in the market twice during the quarter, becoming the first sub-investment grade borrower to tap the institutional bond market in Australia. Other notable transactions were the return of Australian universities to the bond market, with both the University of Sydney and University of Melbourne pricing seven year transactions.

The market is continuing to grow into a strong alternative to the Australian bank market, providing extended tenor – of the 13 transactions identified for the quarter, the average tenor was slightly over six years.

Outside the traditional bank and bond markets, we are observing growth in Peer-to-Peer (P2P) lending, evidenced by the emergence of providers such as SocietyOne, backed by investors including Westpac's venture capital arm, institutional private placements and the pseudo high-yield private bond market. Whilst P2P lending only represents a small portion of the market at present, the growth in this space is expected to be strong based on the penetration of P2P lending internationally – in the UK, nearly £400 million in transactions have been lent over the past three years.

## DEAL OF THE QUARTER

In June, Port of Brisbane (PoB) returned to the domestic bond market with a bang, issuing a $200 million, 7 year note at record pricing for a BBB corporate.

The deal initially launched at $100 million with pricing at 150 bps over swap, already 40 bps inside the spread on their debut $300 million 7 year note issued this time last year (priced at 190 bps).[1]

After receiving considerable interest – being oversubscribed six times – the issue was upsized to $200 million and spread tightened a further 5 bps to 145 bps over swaps. This represents a 20 bps contraction from the lowest 7 year BBB deals this year (Perth Airport and SGSP Australia Assets both issued at 165 bps in March) and 45 bps inside the spread of PoB's debut issue last year. The transaction highlights the latent demand from investors for transactions in the local market.

PoB has now tapped both the USPP and A$ MTN markets twice, with the most recent USPP closing only a few weeks prior to the June A$ MTN.

## IS YOUR BANK GIVING YOU THE COMMITMENT YOU DESERVE?

Commitment fees are levied on the undrawn balance of debt facilities, and are typically priced as a percentage of facility margins. Prior to the financial crisis, it was possible to achieve minimal commitment fees (for example, 25 percent of margin achieved by Infigen Energy in June 2008).[2] However, the GFC and the changing regulatory environment increased the market-standard to a 50-60 percent level.

Recent examples suggest a renewed trend towards a reduction in commitment fees to below 50 percent. Decreases have been achieved by Telstra (40 percent, July 2014) and Asciano (45 percent, February 2014). Further, we are aware of a number of private transactions that have achieved below the historical market standard of 50 percent.

The banks have rightly pointed to the increased cost of capital as part of the new regulatory regimes as evidence of the need for higher commitment fees and banks have been quick to point out that the Telstra commitment fee was achieved due to its 'premium A-rated' credit rating.

However, in a market where fewer deals are being done leaving banks to compete strongly for the available transactions, there may be scope for you to review commitment fees and potentially reduce this holding cost.

## BATAVIA AND EVERGREEN FEATURES INCREASING IN POPULARITY

With continued borrower friendly market conditions, the domestic bank market is providing further flexibility and options to borrowers. Such structures include the return of the Evergreen and the newly developed Batavia structure.

An Evergreen facility puts the borrower in the driver's seat by essentially providing a free option. The facility agreement has a defined tenor, however the maturity of the facility can be pushed out by 12 months at the borrowers request. Each year the facility will be automatically extended by a year or the borrower can renegotiate terms and conditions with financiers. If these new terms are not accepted, the facility will run out the term of the loan. Key advantages of its structure include:

- reduces refinancing risk;
- provides certainty of funds; and
- increases ability to take advantage of changing market conditions and associated pricing impacts.

A Batavia facility sits between a Common Terms Deed and syndicate arrangement. This structure is documented under a single Syndicated Facility Agreement (SFA), therefore allowing titles to be allocated to banks. However, the Batavia facility permits additional tranches on common terms (excluding pricing and tenor) by financiers not necessarily involved in the initial SFA. Key advantages of its structure include:

- lack of pricing transparency between financiers of different tranches provides competitive tension to drive pricing down;

[1] KangaNews, KPMG Analysis.

[2] LoanConnector, KPMG analysis.

- allocations do not need to be based on a pro rata basis;
- flexibility to prepay existing tranches and replace with lower pricing or more cooperative financiers; and
- an event of default driven by an individual lender of a tranche is less likely to occur, given a majority of financiers would still be required for the agent to enforce it.

## DISINTERMEDIATION ON THE RISE

Disintermediation is the structural shift away from traditional bank financing, with borrowers increasingly obtaining funding from alternative sources outside of the bank market. Driving this shift is the increase in debt funding requirements of corporates as economic activity picks up, coupled with ongoing regulatory reform restricting banks' capacity to lend (particularly longer term) and increasing competition from non-bank lenders and markets.

In a recent article, S&P published statistics predicting that Australia will see an increase in disintermediation of 11 percent through 2018.[3] Whilst banks will still dominate the lending landscape (76 percent in 2018), the 11 percent increase in disintermediation represents an expected US$166 billion to be sourced from alternative non-bank funding providers.

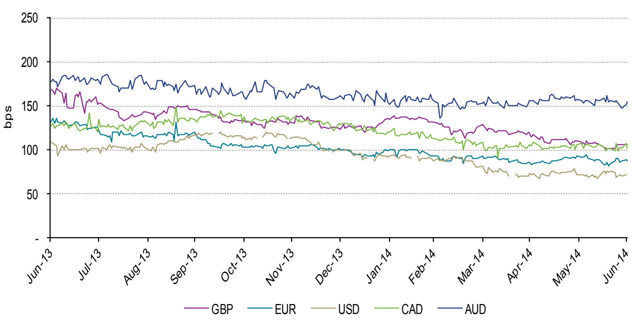
Increasing competition from alternative debt markets is likely to see banks competing fiercely to maintain their share of business lending. Larger, stronger credits should be in a position to take advantage of any pricing arbitrage opportunities between these competing debt markets. With demand for funds forecast to increase significantly and global disintermediation on the rise, corporate borrowers need to consider the increasing number of funding options available to them and how they are placed to execute these.

## AUSTRALIA LAGGING THE PACK

Whilst the Australian market has improved significantly over the past 12 to 24 months, providing a borrower friendly environment for debt issuance, it is interesting to consider the Australian funding landscape against international peers.

The 5 year BBB spread over swap for various currencies clearly highlights the disparity between what Australian issuers are able to secure in their transactions compared to their international peers.

**Figure 4: Australian 5 year BBB margin over swap**




Source: Bloomberg, Reuters, KPMG analysis

The reason for these significant differences will always remain debatable. However, it is pertinent to note that in contrast to the Australian fixed income market, the major international debt markets (*in particular the USD, EUR and GBP markets*) are highly liquid and comprise a diverse group of fixed income investors. These investors are often seeking investment opportunities in their respective domestic currency and appear to be willing to accept lower spreads in a competitive environment.

With a smaller domestic income investor base, an Australian domiciled borrower has limited competitive tension vis-à-vis their international peers to drive down the spreads for Australian dollar bonds. This lack of competition along with the cost of foreign currency swaps for those who can access international debt markets, are in our view the two key contributors to the disparity in credit margins highlighted above.

As the Australian superannuation funds continue to grow and invest further funds in the Australian dollar bond market along with the advent of a new crop of "wholesale investors", it is our view that the spread disparity will compress in the medium term.

## EYE ON THE PRIVATE BOND MARKET

There were a number of private bonds issued in the quarter, with NAB joining FIIG as a placement agent in this growing field.

Of note for the quarter were a number of transaction 'firsts':

- First private bond with a payment-in-kind structure – NextDC A$60 million, 5 year bond with a 1 percent compounding interest feature;
- First rated private bond (and largest private bond to date) – Adani Abbott Point A$100 million, 6 year bond;
- First Kangaroo private bond (foreign borrower issuing in AUD) – CBL Corporation A$55 million, 5 year bond.

The private bond market is not for all borrowers but may be worth exploring as part of a review of funding options. The market is typically focused on sub-investment grade, unrated borrowers seeking to gain additional tenor or increased volume than is traditionally available in the bank market – however pricing and fees may be elevated compared to bank transactions. Further, total volume is presently constrained at approx. A$80 million – A$100 million, however appetite for the product is growing.

## HEATING UP IN THE US MARKET

With the continuing ultra low interest rates on offer and continuing quantitative easing in the US markets, it is not surprising that the US debt markets remain highly competitive. Borrowers are enjoying some of the strongest issuance conditions on record as investors seek yield and relax borrower restrictions. Investors are increasing their exposure to 'covenant-lite' loans, and the level of deals financed at 6x leverage has returned to pre 2007 levels.

Could this be the high point of the cycle or are we heading back to the days of cheap debt and flexible structures? What we do know is, outflows from high-yield bond funds have accelerated and look to continue, whilst banks continue to feel the pressure of higher regulations over leveraged and non-investment grade lending. All of this in the context of the pull back in quantitative easing by the US Fed and fears of increasing interest rates in the nearer future than previously anticipated.

Australian firms continue to reach out to the US market – with AGL Energy transacting in July, and Aristocrat understood to be in process to raise funding for their recent US acquisition. However, in what may be a telling sign for the potential beginning of a pull back from the US market, a Term Loan B for Quick Service Restaurants was pulled recently in favour of a domestic market transaction.

The extent to which we are at a turning point for the market, or whether there is still room to run with the bulls in the US bond market will become clearer over the coming months.

[3] Standard & Poor's, *Global Bank Disintermediation Continues as Corporate Borrowing Needs Outpace Banks' Capacity*, 11 June 2014.

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