Debt Market Update
Q3 2014

Edition 21

Corporate Finance

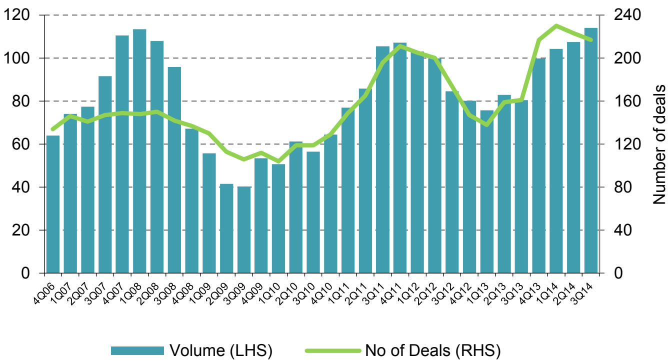
KEY THEMES

- Continuing increase in issuance volumes and ongoing margin tightening in Australian debt market
- Base interest rates remain at all-time lows but indications of potential hikes in some markets
- Australian securitisation market shows signs of resurgence
- Concerns of a credit bubble developing in US leveraged markets
- Debt capital structure planning key to IPO success

AUSTRALIAN DOMESTIC DEBT MARKET

Q3 2014 marked a significant milestone in Australian syndicated loans with rolling 12-month volume of US$114 billion exceeding the pre-GFC peak of US$113 billion in Q1 2008 (see Figure 1).

Figure 1: Rolling 12m Australian syndicated loan volume (US$bn)



Source: Thomson Reuters Loan Connector, KPMG Analysis

Q3 2014 saw US$20.1 billion in new issuance with 31 transactions in the period. This represents a 48 percent increase in volume from Q3 2013 although a drop from Q2 2014 as is traditionally the case.

Looking beyond the quarterly activity, rolling 12-month volumes have increased steadily by over 50 percent since Q1 2013 and are nearly three times their post-GFC nadir in Q3 2009.

Adding to this positive issuance volume environment is 12-month deal numbers running above 200 for the fourth consecutive quarter. Indeed data collected since 2001 by Bloomberg suggests that corporate issuance is at an all-time high supporting suggestions that market liquidity is incredibly favourable for corporate issuance.

Average deal size is not a key contributing factor to the high issuance volumes with the average deal size in the last four quarters coming in at $526 million compared to the noticeably larger average deal size of $767 million in the four quarters ended Q1 2008. A more favourable economic outlook (if any) is also not a major contributor as evidenced by the relatively small proportion of event driven transactions with only 23 percent of volume associated to 'new-money' deals. More likely we are seeing some evidence of cyclicality of refinancing given debt tenors have typically been restricted to 3 and 5 years since 2008.

Perhaps an important driver behind the record numbers, as reported in previous Debt Market Updates, is the pricing levels being achieved by corporates. Figure 2 illustrates a continuing downward trend in pricing for investment grade companies.

Our recent transaction experience confirms that borrowers are not only benefiting from cheaper pricing but also enjoying an improvement in general financing terms. To date there has been no sign this trend is reversing and we expect it to continue for the remainder of the year

Figure 2: Australian bond 5 year spread to swap

Source: Bloomberg; KPMG Analysis

Spreads have continued to compress during 3Q 2014 with pricing for Australian BBB credit tightening a further 15bps. This trend is reflected through the investment grade bond market and is being driven by investors' continued hunt for yield.

The loose monetary policies in major developed markets (think US Fed, Europe's ECB, UK's BoE & Japan's BoJ) continues to be a key contributor to this downward pricing pressure. Policy is leading to a noticeable increase in the number of non-Australian lenders seeking higher returns with exposure to the Australian domestic market. Approximately 41 percent of the syndicated loan volume over the past seven quarters has been provided by non-Australian lenders.

However factors such as debate over when the US Fed will start to hike the Fed fund rate (with its QE programme formally coming to an end in late October) may put a brake on this downward trend in coming periods.

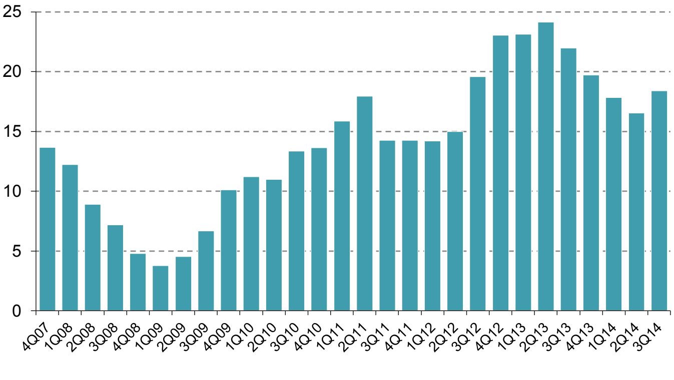
Nonetheless Australian corporates appear to be taking advantage of the current favourable pricing environment. A number of large transactions took place in Q3 2014 including Sun Group, Viva Energy, Telstra, AMEX, Healthscope, Charter Hall and WSO Finance (Westlink M7) each contributing more than A$1 billion to market volumes. Notable transactions are shown in Table 1 below.

Table 1: Notable transactions

Borrower	Date	Tranche amount	Tenor	Margin
Sun Group	Jul-14	A$ 750m	3 yrs	125 bps
		A$ 750m	5 yrs	150 bps
		A$ 375m	3 yrs	125 bps
		A$ 25m	3 yrs	ND
Sun Group	Jul-14	A$ 1,000m	2 yrs	ND
Viva Energy	Jul-14	US$ 1,300m	2 yrs	175 bps
		US$ 750m	5 yrs	270 bps
Telstra	Jul-14	A$ 1,500m	3 yrs	85 bps
AMEX	Jul-14	A$ 2,000m	3 yrs	110 bps
Healthscope	Jul-14	A$ 1,295m	3 yrs	130 bps
Charter Hall	Aug-14	A$ 300m	3 yrs	ND
		A$ 400m	4 yrs	ND
		A$ 500m	5 yrs	ND
Westlink M7	Aug-14	A$ 520m	3 yrs	125 bps
		A$ 525m	5 yrs	150 bps
		A$ 225m	7 yrs	170 bps

Source: Thomson Reuters Loan Connector, KPMG Analysis

Figure 3: Rolling 12m A$ corporate bond market (A$bn)



Source: Bloomberg, KPMG Analysis

The A$ corporate bond market also showed continued volume increase with 11 percent uplift in quarterly 12 month run rate (see Figure 3). Positive investor demands were consistent with reduced pricing. Supply is sustained at healthy levels over recent quarters and the volume in Q4 2014 will be of particular interest given the very strong quarter experience in 2013.

The overall increasing volumes in the past 4 years is a positive sign for borrowers seeking access to alternative funding sources.

Of particular interest, Glencore's debut 5 year BBB A$500 million issue closed at 140bps over swaps comparable to Incitec Pivot's 5½yr BBB A$200 million issue slightly over a year ago (Aug 13), which closed materially wider at 215 bps over swaps demonstrating the significant tightening in pricing. According to market speculation, Glencore's issue was A$200 million over-subscribed with over 90 investors participating. Glencore joins other prominent mining, oil and gas issuer such as BHP Billiton, Anglo American and BP issuing in the growing A$ bond market.

Other notable issuance includes SPI's A rated A$100 million 10 year issue and Scentre's A1 rated A$400 million 7 year issue.

This positive market data for the quarter reinforces our view that the market is supportive for quality borrowers seeking debt funding or looking to reduce funding costs via a competitive refinancing process.

DEAL OF THE QUARTER

Westfield spin-off, Scentre Group (ASX:SCG) issued a first time bond in July since listing on the ASX in June. SCG raised equivalent A$3 billion (€1.6 billion and £400 million) in the European market, representing the largest European issue by an Australian non-mining corporate. The issues were reported to be significantly oversubscribed. Other large Australian issuers in Europe include Telstra and Origin with issuance of between €750 million and €1 billion in recent years.

SCG was drawn offshore by a lack of liquidity and tenor domestically as well as execution speed and pricing. Together with its subsequent A$MTN in late August SCG, has refinanced a large portion of its A$5 billion facilities.

Table 2: SCG bond issuances

Date	Quantum	Tenor	Margin
8 Jul 14	€ 400m	4 yrs	65 bps^
8 Jul 14	€ 600m	6 yrs	70 bps
8 Jul 14	€ 600m	10 yrs	83 bps
8 Jul 14	£ 400m	12 yrs	97 bps
28 Aug 14	A$ 400m	7 yrs	107 bps

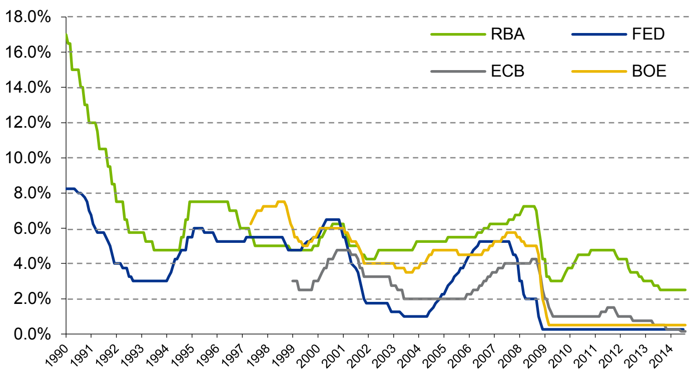
^ Floating

Source: ASX, KPMG Analysis

TIME TO LOCK-IN UNPRECEDENTED LOW INTEREST RATES?

In Australia and globally, government interest rates are at all-time historical lows.

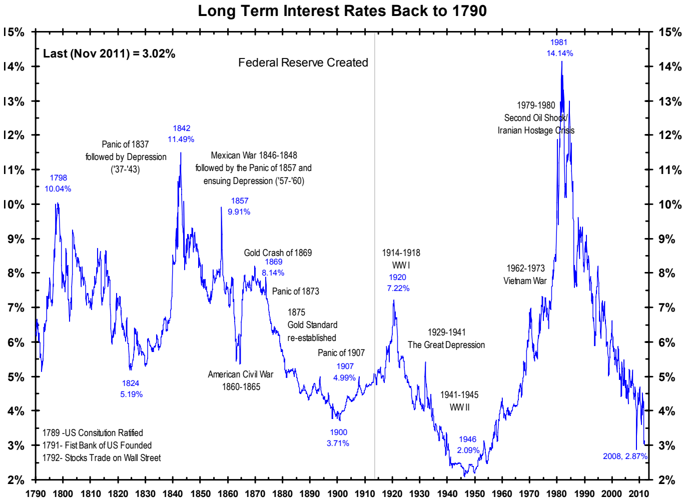
Figure 4: Government Interest Rates



Source: Bloomberg, RBA, KPMG Analysis

Data back to the 1790s suggests that rates in the US have never been as low as currently with the previous historic low of 2 percent immediately post WWII.

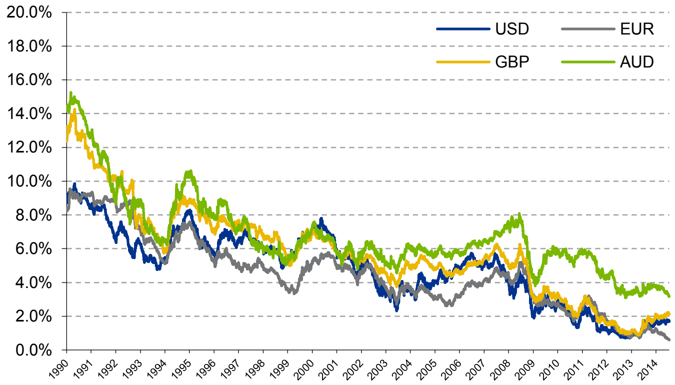
Figure 5: Long-term US interest rates



Source: Chicago CFA Handout by Bianco Research LLC, 'What Drives the Bond Market', 18 January 2011

Unsurprisingly, interest rate swap rates have tracked this downward trend and 5 year swap rates across these markets remain close to their lowest since 1990.

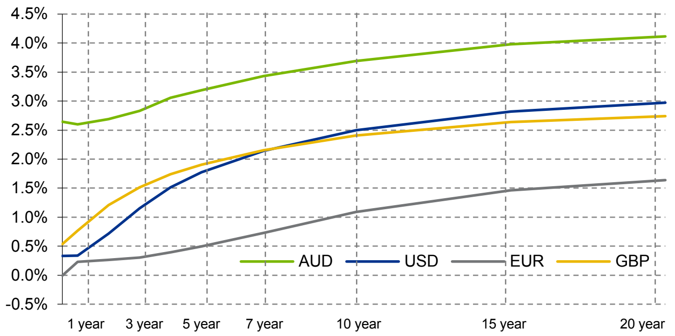
Figure 6: 5 year swap rates



Source: Bloomberg, Reuters, KPMG Analysis

Furthermore, yield curves are relatively flat giving borrowers the ability to lock-in longer-term at similarly low rates.

Figure 7: Swap yield curves



Source: Bloomberg, KPMG Analysis

However, macro-economic conditions are gradually seeing positive momentum in certain economies – namely the US and the UK – and with the winding back of QE measures in force over the last few years, this could suggest that interest rates could soon tick upwards reflected in recently increased rate swaps in those economies.

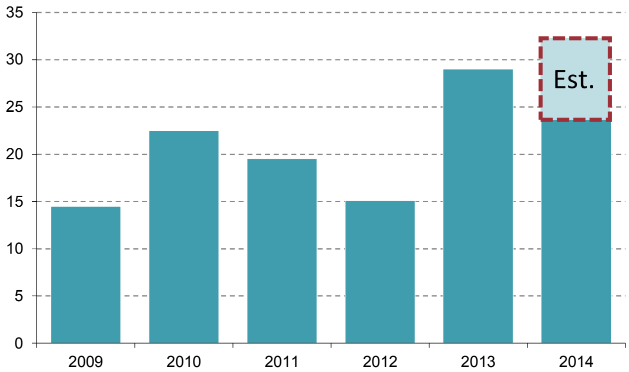
If the interest rate environment is about to turn, could now be an opportune time for borrowers to reconsider fixing interest rates for the medium-term at or near all-time lows?

[1,2] Standard and Poor's, Australian Securitization News, 6 Oct 2014

SECURITISATION MARKET RESURGENCE

New issue volumes in the Australian securitisation market has been at its highest since the GFC and the demise of the credit wrappers with 2014 set to beat record volumes again for a second year. Residential Mortgage Backed Securities (RMBS) saw new issue volumes of A\$29 billion[1] in 2013 and A\$24 billion[2] thus far in 2014 – A\$32 billion on an annualised basis.

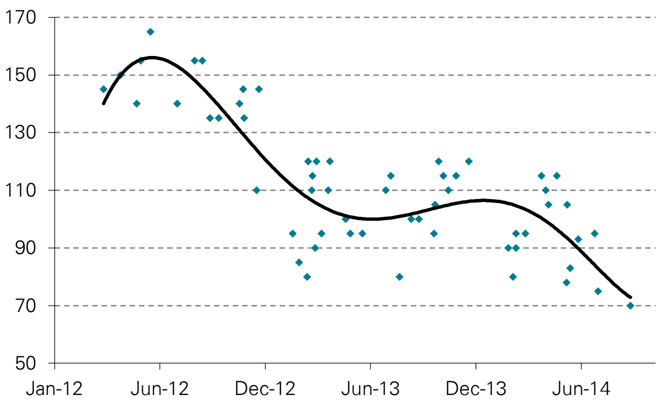
Figure 8: Australian RMBS volume (A\$bn)



Source: Standard and Poor's, KPMG Analysis

Strong investor demand for RMBS paper has been supported by the stability of the Australian economy and the underlying housing market. This strong demand can also be seen in the tightening pricing of recent issues. Notably recent AAA tranches pricing as low as 70bps compared to over 150bps in 2012.

Figure 9: Australian RMBS AAA-note spread to swaps (bps)



Source: KangaNews, Moody's Investor Services, KPMG Analysis

Investor demand is set to continue in the short-term as performance of post-GFC securitisation has been above average and as noted by Standard & Poor's in September: "[RMBS] have maintained a track record of solid performance with arrears and loss levels among the lowest in the major securitization markets."[3]

CREDIT BUBBLE FORMING AS LEVERAGE INCREASES & CREDIT TERMS LOOSEN?

Global debt markets are experiencing some of their most favourable issuer conditions since the GFC with borrowers able to achieve higher leverage and reduced covenants. The US leverage loan markets reached volume records in 2013 and are expected to record a similar total again in 2014 at an estimated US\$1.2 trillion or 40 percent higher than 2007. Furthermore leverage has increased materially with 57 percent of US LBO deals this year with leverage >6.0x – levels not seen since 2007 – and the resurgence of second lien lending where volumes in Q3 are up 70 percent on the same quarter last year.

[3] Standard and Poor's, Industry Economic and Ratings Outlook: Australian RMBS Fundamentals Reflect a Stable Economic Environment, 30 Sep 2014.

Soaking up this new leveraged loan volume in the US is a strong CLO market with new issuance already nearing the 2013 record.

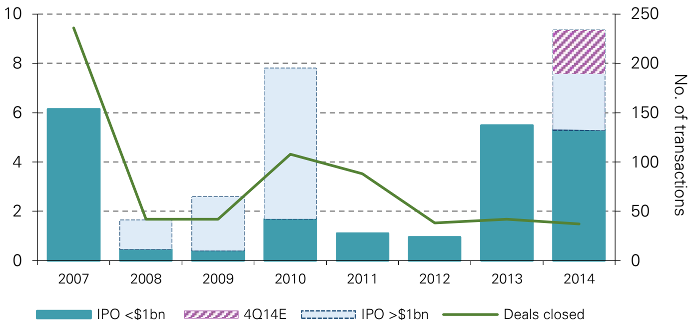
In parallel, concerns over the development of a credit bubble have forced US regulators to increase their oversight. The Federal Reserve and the Office of the Comptroller of the Currency are increasing their bank book surveillance and new regulatory guidelines require greater reserves which may result in fines for leveraged deals where leverage exceeds 6.0x. In addition, from next year regulation for any new CLO will force the issuer to hold more 'skin-in-the-game' in an attempt to prevent the unrestricted flow of high risk transactions into the shadow banking market.

More recently,we note that there has been volatility in the US and European leveraged loan markets through October which has caused a widening of pricing for high-yield transactions to induce investors into the transactions, or borrowers pulling the transaction entirely; a significant change from prior quarters. Perhaps this is a sign that thresholds are being reached and better risk return measures are being deployed.

PRACTICE NOTE – GEARING UP FOR AN IPO?

An IPO marks a defining moment in any company's history. A significant and sustained increase in IPO volumes has been evidenced in 2013 and 2014 (see Figure 10).

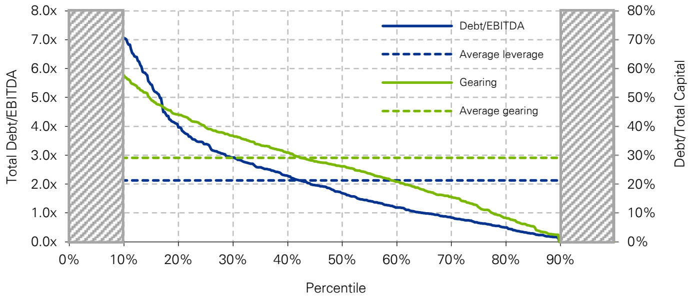
Figure 10: Australian IPO volumes (A$bn)



Source: S&P Capital IQ, KPMG Analysis

Capital structures and leverage levels differ vastly between private and listed ownership and a well considered funding strategy is key to a successful IPO. Leverage and gearing levels across all ASX listed companies show average leverage (Debt / EBITDA) of 2.1x and Gearing of 29 percent (see Figure 11).

Figure 11: ASX leverage and gearing



Source: S&P Capital IQ, KPMG Analysis

Capital structures post IPO are often 'sticky', as they can be more difficult, costly and time consuming to change. Management should reconsider their capital structure prior to an IPO as it can provide confidence to equity investors by demonstrating renewed debt investor appetite and open access to new and multiple funding channels.

Looking beyond the optimal debt-to-equity mix, the structure of your debt needs to ensure flexibility and capacity to pursue growth. Key considerations include: selection of the most appropriate debt product and market; cash headroom; tenors, conditions and pricing.

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