KPMG
cutting through complexity

Debt Market Update
Q4 2014

Edition 22

Corporate Finance

KEY THEMES

- Australian debt market remained healthy throughout 2014, with 6 percent increase in volumes year on year
- Australia's first green bond issued
- Capital discipline and debt management in the spotlight for oil & gas companies
- Murray's examination results are out, financial system subject to changes
- Interest rate inversion – is it cheaper to borrow long term than short term?

AUSTRALIAN DOMESTIC DEBT MARKET

The final quarter of 2014 saw continued solid activity levels in the domestic debt market, where 12-month rolling volumes remained above the US$100 billion mark for the fifth consecutive quarter (see Figure 1).

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

Source: Thomson Reuters Loan Connector, KPMG Analysis

Despite a fall in rolling 12-month volumes, on a quarter-by-quarter basis, the market saw a 55 percent increase in syndicated loan volume in Q4 compared to Q3, with a total of US$34.8 billion raised across 54 transactions.

Average deal size continued its upwards trajectory, led by large transactions from Origin Energy, APA Group, Vodafone and Stella EWL Finance (the East West Link ("EWL") consortium of Lend Lease, Capella, Acciona and Bouyges), each delivering more than US$3 billion. Two of the four largest transactions in the quarter were "new-money" – APA Group's US$4.1 billion for the acquisition of the QCLNG pipeline from BG Group and Stella EWL Finance's US$3.1 billion for the financing of the EWL project. Of recent interest is the utility of Stella EWL Finance's debt facility, given that drawdowns have continued despite suspension of the EWL project by the new Labour state government.

2014 saw volumes in the domestic syndicated loan market grow to $US106 billion (up by 6 percent on 2013), further compression in bond yields, the rapid emergence of alternative lending markets and an increased market appetite for innovative financing structures.

Table 1: Notable transactions

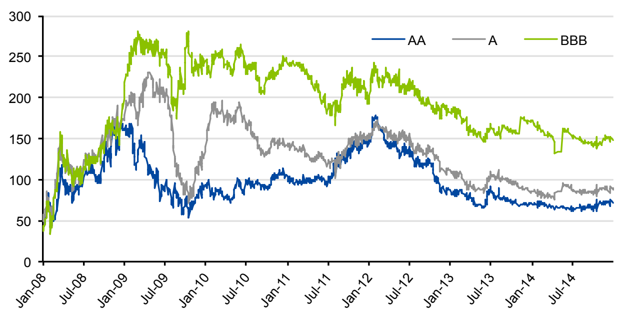
Borrower	Date	Tranche amount	Tenor	Margin
Origin Energy	Dec-14	A$ 2,838	4 yrs	125 bps
		A$ 2,902	5 yrs	140 bps
		A$ 800	4 yrs	125 bps
		A$ 550	4 yrs	125 bps
		US$ 113	4 yrs	125 bps
		US$ 113	5 yrs	140 bps
APA Group	Nov-14	US$ 4,100	2 yrs	ND
Vodafone Hutchison	Dec-14	US$ 1,750	3 yrs	ND
		US$ 1,750	3 yrs	ND
Stella EWL (East West Link)	Oct-14	A$ 3,384	7 yrs	200 bps
		A$ 135	5 yrs	ND

Source: Thomson Reuters Loan Connector, KPMG Analysis

Rolling 12-month issuance in the Australian corporate bond market fell circa 4 percent quarter-on-quarter. That said, high quality issuers issued on favourable terms, as demonstrated by QML's (BBB+) successful A$250 million 7 year fixed (160bps over swap) and A$200 million 10 year floating note (190bps over) in late November and early December respectively.

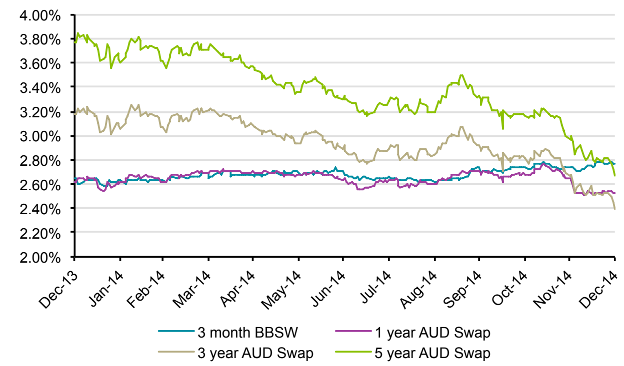
With regard to pricing trends in the broader market, despite a compression in spreads in the first 3 quarters of 2014, Q4 suffered a reversion of this trend leaving spreads largely unchanged over the year (see Figure 2). However a decrease in underlying swap benchmarks (as demonstrated by the 110bps drop in the 5 year swap rate over 2014, (see Figure 3) resulted in a material tightening of all-in corporate bond yields.

Figure 2: Australian corporate bond 5 year spread to swap (bps)



Source: Bloomberg; KPMG Analysis

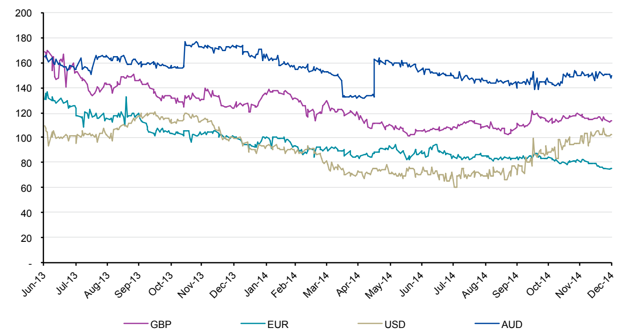
Figure 3: Australian interest rate swaps



Source: Bloomberg; KPMG Analysis

As reported in the previous Debt Market Update, the favourable interest rate environment is starting to unwind in some markets, particularly in the US, as evident through increasing spreads in the US bond market (see Figure 4). Possible factors that could have triggered this pick-up in US spread to swap include worsening of risk sentiment from plunging oil prices or a market correction as US Fed relieves its downwards monetary pressure on bond yields.

Figure 4: 5 year BBB corporate bond spreads to swap (bps)



Source: Bloomberg; KPMG Analysis

Looking forward to 2015, we believe the Australian debt market will focus on the strength of local economies (including the state of the resources sector given lower commodity prices), interest rate cuts by the RBA, the scale of government asset privatisations and the impact of the recently announced €1.1 trillion QE package from the ECB.

The upcoming asset privatisation announced by both Federal and State governments could require significant debt funding. Given the scale of assets on offer (estimated to be circa A$90 billion, excluding Queensland's assets) and that these were historically funded through the Federal and State treasuries, such a substantial transfer of debt to the private sector could place upwards pressure on debt pricing and market capacity. However, we believe, provided there is an orderly phased sale process and sensible debt structures are put in place, debt volumes should be absorbed and pricing maintained.

The RBA cash rate previously forecast by most market commentators to have reached its nadir at 2.50 percent in 2014 was cut to 2.25 percent in early February, with a further 25bps cut expected later in 2015 as a result of anticipated subdued growth and potential pressure from future commodity price reduction.

DEAL OF THE QUARTER

In October, Stockland came to market with Australia's first corporate green bond. This is an important milestone for the local market, paving the way for other Australian issuers to launch similar offerings that contributes towards corporate environmental goals with the added benefit of diversifying funding sources.

This innovative €300 million bond issuance was launched "certified in compliance with international climate bonds standards", where proceeds are ring-fenced for "green"purposes. For Stockland, this will assist in their investment in green-star rated shopping centres, retirement villages and residential projects with a minimum 4-star green rating.

Issued under their existing Eurobond programme and listed in Singapore, the notes allow for funding diversification within prevailing structures. Stockland was able to access new investors as part of the offering (particularly those with a "green" mandate). The notes priced at 82bps over EURIBOR swap, or 153bps over BBSW (when swapped back to AUD).

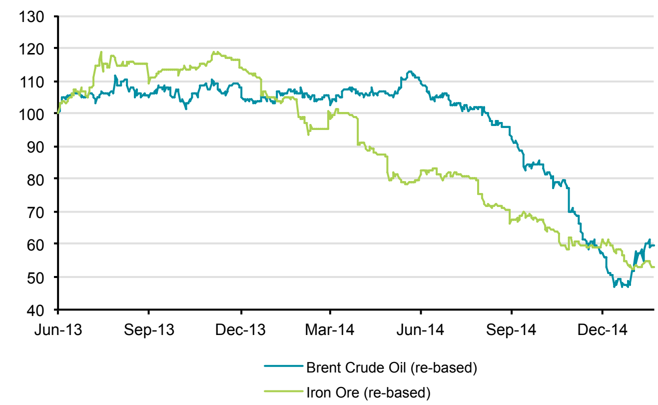
The market for this infant product has accelerated in recent months. The World Bank issued an AUD green bond in April 2014, however the Stockland note is the first time a domestic issuer has issued in this developing market. Given the high level of demand for the Stockland note, there has been further green bonds issued in the quarter – NAB issued an A$300 million green bond in December 2014 (the first AUD green bond by an Australian issuer).

KPMG's Climate Change & Sustainability team was involved in the development of this note, and would be pleased to discuss the green bond market and structures with other borrowers.

Please contact Adrian King in our Climate Change & Sustainability team on 03 9288 5738 if you would like further information.

CAN SOMEONE PLUG THE OIL SINK?

Figure 5: Historical iron ore and oil prices



Source: S&P Capital IQ, KPMG Analysis

The financial viability of most Australian oil and gas producers were thrown into the spotlight following a 40 percent plunge in Brent crude oil prices in the 3 months to December 2014. In fact, oil prices continued to fall in January 2015, touching a low of US$47 per barrel, after OPEC reaffirmed its stand to maintain production levels. Although oil prices rebounded in February, prices have yet to stabilise and uncertainty continues to loom. The LNG market is set to follow oil prices with a lag.

The plummeting oil prices would invariably exert an adverse impact on cash flows and profitability of established producers like Woodside, Santos, Origin and Oil Search. Other higher cost and/or highly leveraged producers will also feel the pinch and would be at odds to turn a profit under such depressed prices.

Consequently, covenants of existing debt facilities set on cash flows, oil reserves and enterprise value will be stretched, and any write down in asset valuations could significantly weaken credit metrics.

Two examples of market reaction on current fundamentals are Santos (BBB, downgraded from BBB+ last December) and Origin (Baa2), who both suffered a significant hit to their share prices and were placed under negative outlook by S&P and Moody's respectively.

Key takeaway? Capital expenditure and debt management will be essential for oil producers in 2015. Companies with deteriorating credit metrics may see the cost of capital increase, and likely to face hurdles when refinancing. For those who risk becoming prime takeover candidates, capital management may be an effective takeover defence tool.

FINANCIAL SYSTEM – RELEASE OF EXAMINATION RESULTS

On 7 December 2014, the Murray Financial System Inquiry (FSI) released its final report, outlining 44 recommendations to improve the efficiency and resilience of the Australian financial system. Whilst it remains to be seen which, if any, of the 44 recommendations will be adopted, the two that stand out include the proposed strengthening of the capital adequacy levels of Australian banks to be "unquestionably strong" and regulatory and disclosure reforms to streamline the process for Australian borrowers to issue in the domestic retail bond market.

The proposed strengthening of the capital adequacy of Australian banks to be "unquestionably strong" and move in line with the top quartile internationally will require an increase in capital levels (likely Common Equity Tier 1 Capital) to above 12.2 percent, up from between 10.0 to 11.6 percent currently. Although it is expected that this will increase the funding costs for the banks, the impact would mostly be felt by small-to-mid sized corporates as competition for new deals is likely to offset any margin pressure for large corporates.

The report also suggests that current regulatory settings, notably tax policy and onerous disclosure requirements, distort the "efficient market allocation of financial resources" and have limited the development of the domestic bond market, particularly the retail market (where disclosure requirements are more onerous). The report recommends a reduction in the disclosure requirements for the ASX top 150 companies (by market cap) to issue "simple" bonds in the retail market with standardised terms and conditions. If the "simple" bond structure proves to be effective, it could then be extended to smaller listed corporates.

Promoting simplified industry standard terms and conditions, with disclosure levels (and therefore issuance costs) similar to those for domestic wholesale issuance, should assist in the development of the retail corporate bond market.

UNITRANCHE – RAPID HIGH FINANCE

A unitranche is a simplified financing structure that has gained prevalence in the US and some European markets over recent years. Our recent interactions with Australian corporates indicate increased interest for unitranche structures as a viable option for time critical leveraged acquisitions or sub-investment grade borrowers seeking leverage.

Table 2: Key features and benefits

Key structural feature	Benefit
Hybrid tranche	• Maximise leverage that could be attained through a purely senior facility
Single financing agreement, Single security agreement	• Accelerate deal execution speed • Decreased legal fees • Decreased administrative burden – one set of covenants and reporting requirements
Inter-creditor Agreement Amongst Lenders	• Accelerate deal execution speed – only need to deal with initial 1 to 2 lenders • Borrowers need not execute an inter-creditor agreement with lenders (this is managed by the lenders separately), thus decreasing execution risk
Single rate of interest	• Administratively simple. Lenders responsibility to negotiate seniority of the funding provided within the loan and associated interest within the inter-creditor agreement amongst lenders
No or minimal amortisation	• Increased operational flexibility to use excess cash within the business at own discretion (i.e. refinance or prepay debt)
Prepayment	• Decreased interest costs over the period of the loan – Prepayment applied over entire tranche, as opposed to on the cheaper senior portion
Covenants	• Flexible covenants with greater headroom typical of mezzanine covenants vs. senior covenants

The structure combines both senior and subordinated debt into one tranche, serviced by a single rate of interest, supported by a single set of financing documents. Whilst unitranches are not yet common in Australia and terms and conditions are highly tailored to the individual deal, Table 2 outlines some key features exhibited thus far by previous issuances.

It should be noted that due to interest from non-bank lenders / investors, fixed coupons may be preferred, carrying with them prepayment restrictions and penalties or a make-whole like provisions.

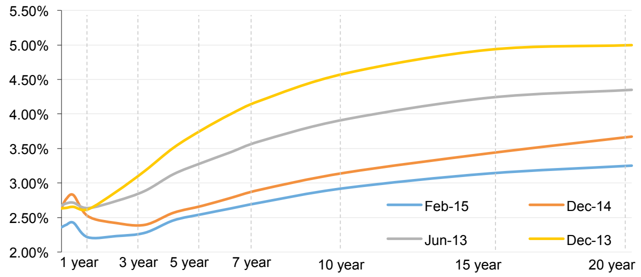
With increased interest in the structure, we have considered and structured unitranche deals on behalf of clients in Australia and in Europe (although we are yet to see one to fruition domestically).

With over 110 Debt Advisory professionals across the globe, KPMG is well placed to assist in determining whether a unitranche should form part of a funding strategy.

INTEREST RATE INVERSION

The recent steep declines in Australian interest rate yield curve has broken records, finishing 2014 at record lows across much of the curve. The drop in the curve has continued in early 2015. For borrowers, record low swap curves, and lower margins mean that the borrowing environment has rarely been cheaper.

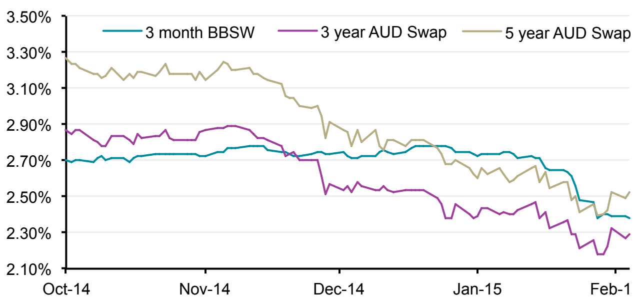
Figure 6: Australian yield curve, select dates 2013 - 2015



Source: Bloomberg, KPMG Analysis

Prior to the February interest rate cut by the RBA, there was an inversion in rates going beyond 3 years, where 3 month BBSW rate was higher than both 3 year and 5 year swaps. This (correctly) suggested the market expected interest rate cuts to the RBA cash rate. The effect of the recent interest rate cut has pushed the 3 month BBSW sharply lower to be in line with the 5 year swap rate (but still above the 3 year swap). The longer term impact of the rate cut on swap rates will depend on participants' views on further rate cuts, a return to stability or rate hikes. Views will differ, but given the very low medium term swap rate environment it may be a good time to lock-in the current available rates where it makes sense for a business and given an appropriate capital structure.

Figure 7: Australian historical interest rates



Source: Bloomberg, KPMG Analysis

In addition it may be possible to assume some benefit from the ongoing inversion through various structured solutions tailored to a borrower's capital structure and business profile.

KPMG's Financial Risk Management professionals provide expert advice to corporates in managing interest rate, currency and commodity risk and can assist in this analysis.

Paul Travers, a Director in KPMG's Financial Risk Management team can be contacted at 02 9335 8442.

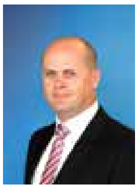
WELCOME TO THE TEAM

We are pleased to welcome Conrad Hall to KPMG's Debt Advisory Team, who has 20 years of experience in financial organisations. He has had recent exposure to Infrastructure financing (PPPs) and M&A Advisory, leading work for the Queensland Government.

Prior to joining KPMG, Conrad's experience came in the form of a 9 year stint with ABN AMRO and Merrill Lynch in London, where he worked on:

- some of the largest syndicated loan facilities ever structured (US$55-70 billion for BHP's intended acquisition of Rio Tinto)
- numerous cross border acquisition financings (US$12 billion for Xstrata's acquisition of Falconbridge);
- post IPO financings (Yell's GBP1.2 billion to support PE exit – Euroweek deal of the year)
- leveraged and infrastructure financings (closed life fund vehicle GBP905 million recapitalisation), and
- bridge financings, hybrid, mezzanine and equity capital raisings.

Contact us



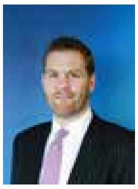
David Heathcote
Partner and National Head
Debt Advisory – Sydney
T: +61 2 9335 7193
E: dheathcote@kpmg.com.au

Raj Bhat
Partner
Debt Advisory – Sydney
T: +61 2 9335 8419
E: rbhat@kpmg.com.au

Greg Eldridge
Director
Debt Advisory – Melbourne
T: +61 3 9288 5759
E: geldridge@kpmg.com.au

Paul Travers
Director
Financial Risk Management – Sydney
T: +61 2 9335 8442
E: ptravers@kpmg.com.au

Scott Mesley
Partner
Debt Advisory – Melbourne
T: +61 3 9288 6748
E: smesley@kpmg.com.au



Jack Newall
Director
Debt Advisory – Perth
T: +61 8 9263 7491
E: jnewall@kpmg.com.au

Conrad Hall
Director
Debt Advisory – Brisbane
T: +61 7 3434 9105
E: chall6@kpmg.com.au

Adrian King
Global and Australian Head
Climate Change & Sustainability Services – Melbourne
T: +61 3 9288 5738
E: avking@kpmg.com.au

kpmg.com/au/corporatefinance