

Debt Market Update

Q1 2015

Edition 23

Corporate Finance

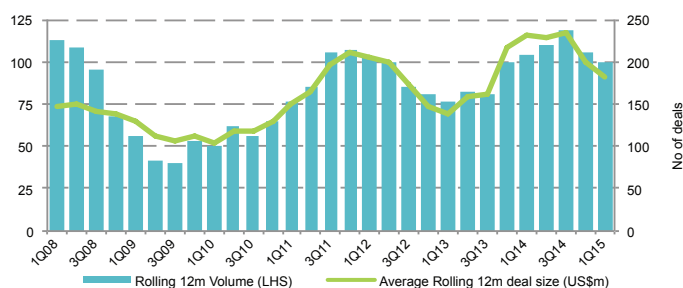
KEY THEMES

- Australian debt market issuance hiccups... but corporate issuance abroad increases
- Deal of the quarter – APA Group demonstrates how to successfully issue off-shore with US\$3.7 billion
- Australians issuing off-shore – lots of success but beware some finding pricing unresponsive
- ASIC's probe into BBSW setting practices coming to a head
- Australian interest rates – more downward trending and still significant yield curve inversion
- The ECB launches its quantitative easing programme
- More clarity in developing retail bond market disclosure obligations – a new potential source of liquidity

AUSTRALIAN DEBT MARKET

Q1 2015 saw a material drop in domestic syndicated loan volumes with issuance of US\$7.0 billion across 20 transactions, a 50 percent drop on Q1 2014 volumes and the fourth lowest quarter in the last 10 years. 12-month rolling average volumes decreased to US\$99 billion (see Figure 1).

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



Source: Thomson Reuters Loan Connector, KPMG Analysis

Three infrastructure transactions dominated – ConnectEast's \$1,035 million project financing, AMP's \$1,044 million acquisition financing for Royal North Shore Hospital and SDP Finco's \$1,656 million refinancing – and were the only ones above \$1 billion (see Table 1).

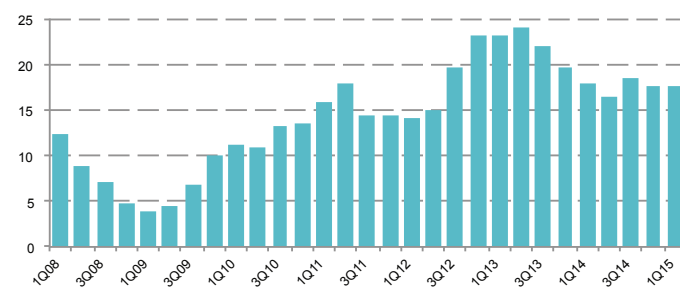
Table 1: Notable syndicated loan transactions

Borrower	Date	Tranche amount (m)	Tenor (years)	Margin (bps)
Laing O'Rourke	Mar-15	500	1	ND
Hills Motorway	Mar-15	405	3	ND
		350	5	ND
SDP Finco	Mar-15	40	1	ND
		416	3	
		600	5	
		600	7	
Chemaustralia	Feb-15	65	5	LIBOR + 475
		515	7	LIBOR + 625
ConnectEast	Feb-15	240	3	ND
		400	4	
		395	5	
Consolidated Press	Feb-15	255	4	ND
		500	5	
Royal North Shore Hospital	Feb-15	1,044	5	ND

Source: Thomson Reuters Loan Connector, KPMG Analysis

In contrast volumes in the AMTN market remain largely unchanged with issuance of \$3.0 billion only 4 percent down on Q1 2014 and the rolling 12-month average at \$17.6 billion close to the previous quarter (see Figure 2).

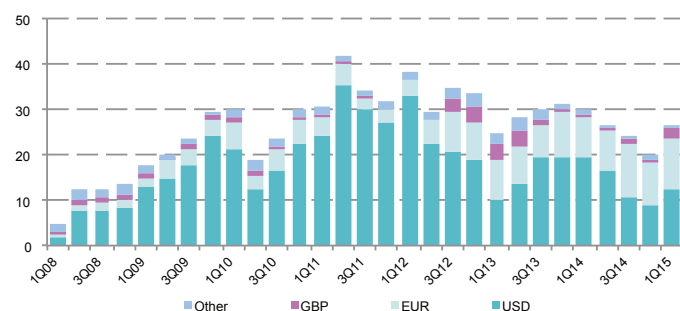
Figure 2: Rolling 12m A\$ corporate bond market (A\$b)



Source: Bloomberg, KPMG Analysis

Compensating for the reduction in these two markets' issuance by Australians off-shore was materially higher at over US\$9.0 billion or more than 3x issuance in Q1 2014 and a near 50 percent increase quarter-by-quarter (see Figure 3).

Figure 3: Rolling 12m Australian corporate off-shore bond issuance (US\$b)



Source: Bloomberg, KPMG Analysis

This nearly evened total issuance to US\$19.0 billion for the quarter compared to US\$19.5 billion in Q1 2014 (a drop of less than 2.5 percent). There were a number of large Australian corporate issues including APA's US\$3.7 billion into the US, Euro and Sterling markets in March – the biggest single issuance by an Australian BBB/Baa2-rated corporate off-shore to date (see Table 2).

Table 2: Notable off-shore bond transactions

Borrower	Credit Rating	Date	Tranche amount (m)	Currency	Tenor (years)	Margin (bps)*
APA	BBB	Mar-15	700	EUR	7	92
			600	EUR	12	130
			600	GBP	15	155
			1,100	USD	10	135
			300	USD	20	184
Scentre	A	Mar-15	400	GBP	7	110
Paladin**	NR	Mar-15	150	USD	5	ND
Telstra	A	Mar-15	1,000	USD	10	118
Woodside	BBB+	Feb-15	1,000	USD	10	165
SP Ausnet	A-	Feb-15	560	EUR	12	73

* Margins over respective off-shore benchmarks (not AUD swap)

** Convertible bond issue

Source: Thomson Reuters Loan Connector, Bloomberg, KPMG Analysis

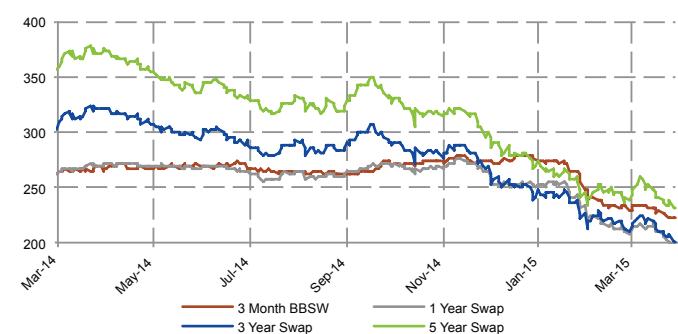
Largely unchanged corporate spreads seen in 2014 continued with little change in pricing over the quarter (see Figure 4). However a continued decrease in swap rates – 5 year BBSW which dropped 110bps during 2014 dropped a further 37bps in the quarter (see Figure 5) – resulted in continued tightening of all-in borrowing costs.

Figure 4: Australian corporate bond 5 year spread to swap (bps)



Source: Bloomberg, KPMG Analysis

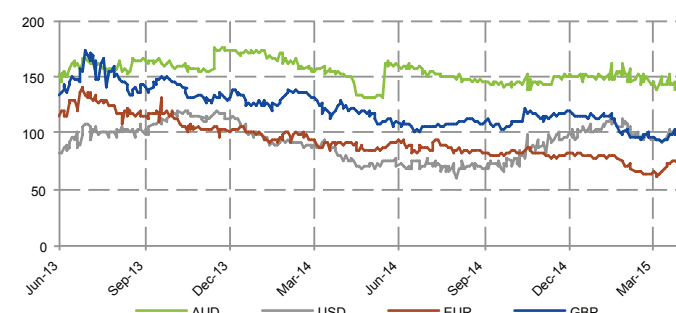
Figure 5: Australian interest rate swaps



Source: Bloomberg, KPMG Analysis

US corporate bond spreads continued to widen whilst Australian and Sterling remained largely flat. However EUR spreads slid materially lower (see commentary hereunder in “ECB LAUNCHES QUANTITATIVE EASING” and see Figure 6) producing a gap to other markets which may be the cause for some successful issuance by Australians into the EUR market in the quarter.

Figure 6: 5 year BBB corporate bond spreads to swap (bps)



Source: Bloomberg, KPMG Analysis

Back home, major challenges in the Australian credit markets have surfaced with the struggles of iron ore miners and related service providers in particular. Since the close of Q1 the expected RBA rate cut has not eventuated although fundamental structural issues in the iron ore sector are unlikely to be helped by rate cuts alone. The May meeting of the RBA committee will be closely watched with anticipation of further cuts expected.

DEAL OF THE QUARTER

In March, APA Group demonstrated how Australian corporates can access multiple global funding markets with the successful refinancing of its QCLNG acquisition loans.

On 16 March, APA Group issued three fixed rate note tranches under its EMTN programme in two foreign currencies: a €700 million 1.375% 7 year; €635 million 2.0% 12 year; and £600 million 3.5% 15 year priced at 92bps, 130bps and 155bps over mid-swaps respectively. All three notes were swapped into US\$. The following day APA Group issued into the US\$ market – a US\$1,100 million 4.2% 10 year and a US\$300 million 5.0% 20 year fixed rate note – 135bps and 184bps to mid-swaps respectively.

This replaced the need for APA Group to make any drawdowns on the acquisition bridge put in place at the end of 2014 and at US\$3.7 billion is the largest single issuance in any bond market by a Baa2/BBB-rated Australian issuer, let alone into and across three off-shore markets.

With good preparation and planning APA Group has demonstrated that Australian corporates can successfully tap global financial markets accessing low all-in costs, range and length of tenor and deep liquidity.

AUSTRALIANS OFF-SHORE – A MIXED BAG

Issuers into the off-shore bond markets are capitalising on a number of key benefits: pricing – including price tension in any process; tenors – longer than those available in the Australian syndicated loan and bond markets; and increased diversification of liquidity sources.

Despite the quarter delivering close to record volume in new issuance a number of key issues were also pulled, most notably Bradken’s Term Loan B and Fortescue Metals Group’s Term Loan B followed by a pulled high-yield bond issue. Both companies pulled their issues due largely to investors’ failure to meet pricing demands. In neither case was there a lack of investor appetite at a price – indeed Fortescue has since successfully raised US\$2,300 million in the high-yield market at a yield of 10.25% equivalent to approximately 175bps more than offered in March and for a smaller quantum due in part to reverse inquiry – nor any material credit concern. Nonetheless a pulled issue such as Bradken’s and Fortescue’s can have a reactionary and negative impact on equity values – best avoided.

ASIC PROBE LEADING TO AN ALTERNATIVE TO BBSW?

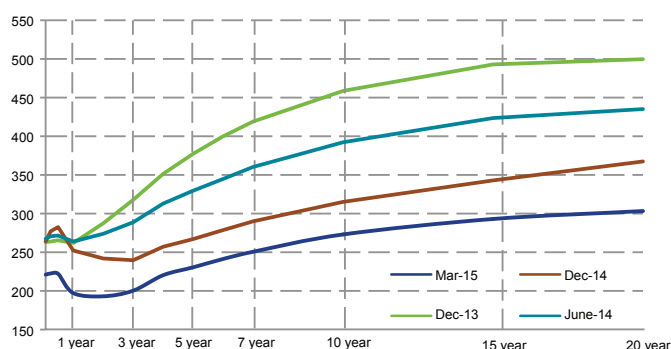
Two years since ASIC first investigated the possible manipulation of BBSW following the LIBOR scandal in the UK, it has yet to formalise a position on any of the four Australian banks part of the original 14 bank panel. In 2014 RBS, BNP and UBS were presented with enforceable undertakings while ANZ suspended seven traders in the wake of investigations. However proving any manipulation of BBSW has been very challenging. In March 2013 BBSW setting was changed from 14 banks submitting levels to a system of observable market trades aimed at making the setting process more robust. Concerns have emerged since around trading patterns between the minutes following 10 a.m. and before the official rate set at 10.07 a.m.

In March this year AFMA suggested using a new benchmark rate – the overnight index swap (OIS) – as an alternative to BBSW. This would reduce systemic risk in the benchmark rate setting process.

INTEREST RATES – THE MORE IT CHANGES...

The recent steep declines in the Australian interest rate yield curve has broken records. Finishing 2014 at record lows across much of the curve, it has continued to drop since the start of 2015 (see Figure 7). For borrowers, when combined with tight credit margins, these record low interest rates and swaps make the borrowing environment cheaper than ever before.

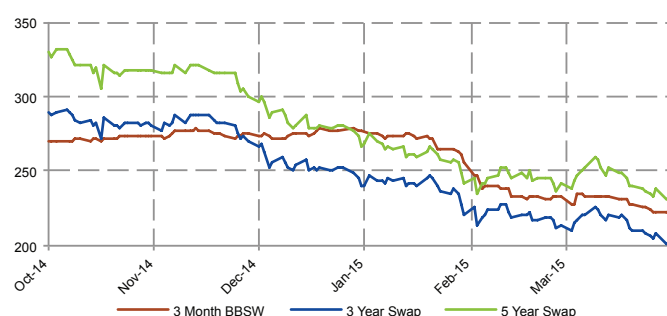
Figure 7: Australian yield curve, select dates 2013 - 2015



Source: Bloomberg, KPMG Analysis

Prior to the February RBA rate cut there was an inversion in rates going beyond 5 years, with the 3 month BBSW rate higher than both 3 year and 5 year swaps. This (correctly) suggested an expected cut to the RBA cash rate (as occurred in February). Since the rate cut, 3 month BBSW has pushed sharply lower and the inversion has come back from 5 years to somewhere between 3 years and 4 years (see Figure 8). Market participants had anticipated and priced in a cut in April (market commentary suggested that 80 percent of participants had predicted a cut in April) which did not occur with the RBA leaving rates on hold. Most participants have now shied away from predicting the precise timing of a cut although very few would view anything other than further cuts likely during the year – the market is rumoured to be 50:50 about a cut or a hold at the May meeting. Views will differ, but given the very low medium term swap rate environment it continues to suggest the time may be ripe to lock-in rates where appropriate.

Figure 8: Australian historical interest rates



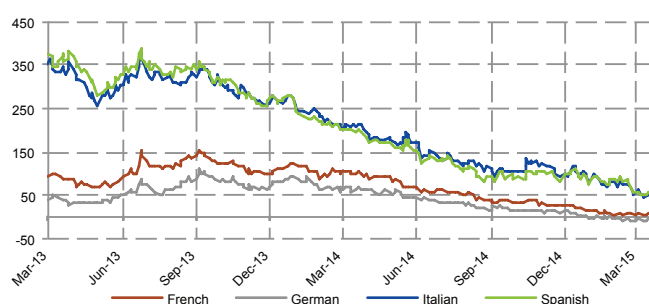
Source: Bloomberg, KPMG Analysis

THE ECB LAUNCHES QUANTITATIVE EASING

In January the ECB announced a structured quantitative easing (QE) programme following continuing failure to stimulate the Eurozone economy. In March the ECB started bond repurchases of €60 billion per month set to continue for 17 months – totalling in excess of €1.1 trillion. The quantum is not set in stone and the programme remains open-ended with closure contingent on achieving a “sustained adjustment” in inflation rates towards 2 percent. Market commentators expect 70 percent of purchases will be sovereign bonds, 12 percent covered bonds, 10 percent agency debt and 4 percent asset backed securities.

Success is reliant on execution by all 19 individual central banks and willing subscription to a risk sharing mechanism around each country’s capital such that total asset risk is distributed based on a country’s economic and demographic weight in the Euro area. The QE program has caused excessive distortion to the Euro bond markets, with German bond yields falling to record lows but with a large gap to other sovereign bond yields (see Figure 9) demonstrating the perceived challenges with the QE programme’s execution.

Figure 9: European 5 year sovereign bond yields



Source: Bloomberg, KPMG Analysis

This QE could benefit Australians issuing in the Euro market. Euro corporate bond spreads have fallen sharply (see Figure 6) making the Euro market cheaper compared to other corporate markets.

RETAIL CORPORATE BONDS – A NEW SOURCE OF LIQUIDITY ON THE HORIZON

The Financial Systems Inquiry is, *inter alia*, investigating recommendations for a reduction in disclosure requirements for retail corporate bonds to permit the issuance of ‘simple’ bonds and encourage the industry into developing standard terms for such ‘simple’ bonds. At present issuing bonds to retail investors is fraught with impediments and amongst them disclosure requirements. There is evidence of strong demand from both corporate issuers and retail investors (high net worth individuals and self-managed superannuation funds) for a type of simplified retail product.

In recent periods simplified term structures have been developed by a limited number of ‘brokers’ – namely FIIG Securities and NAB – for sub-investment grade issuance based in part on the terms available in the US high-yield market – over \$900 million since 2012 across 19 transactions with average tenors of 5 years and margins in excess of 400bps.

KPMG submitted responses to the FSI’s proposals and sees the development of simplified retail bond issuance as a welcomed development provided it is not to the detriment of the investor. The investors should have ready access to market information (i.e. swap prices) in order to avoid any mispricing and further consideration should be given to required market makers to ensure liquidity, external credit ratings and appropriate structuring avoiding elements such as complicated inter-creditor arrangements.

WELCOME TO THE TEAM



We are pleased to welcome Paul Hodsman to KPMG's Debt Advisory Team in Melbourne. Paul is a CFA with 10 years' experience across both debt and equity markets. Paul comes from CBA's institutional equities division where he was an equity research analyst for the past 5 years. Prior to CBA, Paul worked for 5 years in ANZ's Institutional Banking and Leverage Finance teams across various sectors. Previous experience includes:

- \$500 million acquisition facility for Archer Capital's acquisition of Ausfuel (fuel retail & distribution)
- ANZ Terminals' (port infrastructure) \$200 million capex expansion facility
- Cotton-On's (clothing retailer) \$130 million debt facility
- AWB's \$400 million syndicated loan facility and \$200 million Harvest Finance inventory finance facility

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Contact us



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



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



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: conradhall@kpmg.com.au

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