KPMG
cutting through complexity

Debt Market Update
Q2 2015

Edition 24

Corporate Finance

KEY THEMES

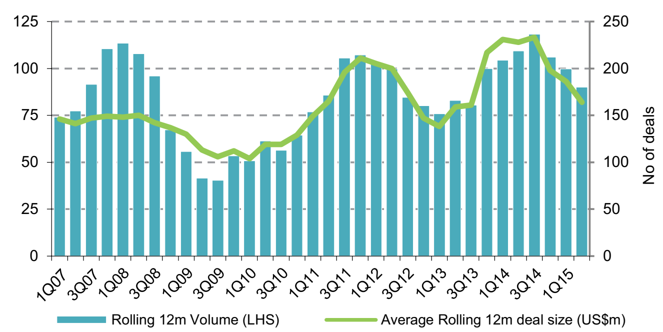
- Australian debt market – continued 'Aussie' activity in the public and private offshore debt markets
- Deal of the quarter – South32 debuts with a tremendous outcome
- New thin capitalisation rules – the first year in effect
- Bond markets – volatility amidst unprecedented liquidity
- Greece – A real tragedy of Greek proportions
- Fintech – the buzz about town with Stone and Chalk

AUSTRALIAN DEBT MARKET

The syndicated loan market was more robust in the quarter ended June 2015 than the first quarter, with loan volume coming in at over US$25 billion across 44 transactions. Average deal size for the quarter was also materially higher at US$573 million, supported by 15 deals over the $1.0 billion mark (in AUD terms). This concludes the 2015 first half tally at US$33 billion in loan volume amid a slowdown in the mining sector and continued economic uncertainties in Europe and China.

In comparison to the corresponding period last year, volumes in the first half of 2015 were down 33 percent. Accordingly, the downwards trend in the rolling 12 month syndicated loan volume continued since peaking in Q3 2014 (see Figure 1). This slowdown in domestic syndicated loan volumes is consistent with the key lending markets across Asia, with the exception of China, inferring that this is more of a regional trend rather than just a domestic development. Looking at a broader timeframe in Figure 1, we also observe that a 3 year average refinancing cycle since the GFC may be driving volume movements.

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



Source: Thomson Reuters Loan Connector, KPMG Analysis

Against this environment, the Australian market enjoyed an uptick in event driven transactions, with the largest being Federation Centres' $5.1 billion facility established to fund its merger with Novion Property Group. Other event driven transactions include Lend Lease's SG$2.0 billion loan secured for its new Singapore-based *Paya Lebar* project, TPG's $2.0 billion M&A facility to back its hotly contested iinet acquisition and BHP/South32 spin off deal which netted $1.9 billion from financiers.

For non-event driven transactions, borrowers have adopted an 'amend and extend' approach with the aim of securing more favourable pricing on their facilities. We have engaged on a number of these transactions for our clients in the first half, with significant improvements in pricing and terms evident.

Table 1: Notable syndicated loan transactions

Borrower	Date	Tranche amount (m)	Tenor (years)	Margin (bps)
Federation Centres	Jun-15	1800	1	ND
		960	2	
		840	3	
		800	4	
		700	5	
Lend Lease	Jun-15	SG$2,000	4	ND
Whitehaven Coal	Jun-15	800	4	250
		200	4	ND
		400	4	250
LS Newco	May-15	100	5	ND
		359	7	550
		US$350	7	450
South32	May-15	US$1,500	5	ND
TPG Telecom	Apr-15	2,000	3	260
NSW Ports	Apr-15	500	1	ND
		125	3	150
		400	3	150
		400	5	150

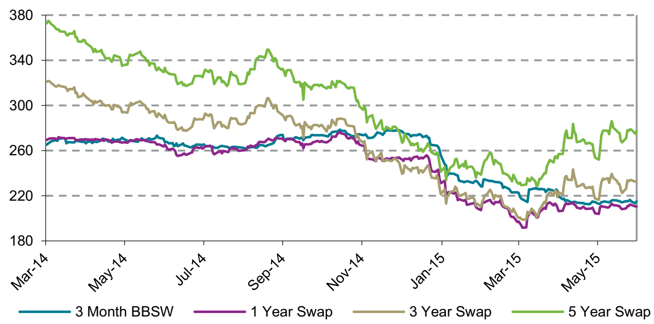
Source: Thomson Reuters Loan Connector, KPMG Analysis

Both AMTN and off-shore debt markets have been favoured by Australian corporates of late, with lenders reciprocating in the form of increased appetite and flexibility as the hunt for yield continues. The recent quarter has seen the first-ever A$ denominated $359 million 7-year TLB tranche done by LS Newco (a JV between Leightons and Apollo), a $200 million 5.5-year floating rate AMTN issue by Wesfarmers (floaters have predominantly stayed in the realm of financial institutions only) and the return of large long-term corporate A$ notes not seen since the peak of 2007 with Asciano's A$350 million 10-year deal.

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

Source: Bloomberg, KPMG Analysis

Figure 3: Australian interest rate swaps (bps)



Source: Bloomberg, KPMG Analysis

On an aggregate level, the bond market experienced a sell-off late in the quarter, driving corporate bond spreads higher as shown in Figure 2, where BBB corporate bond spreads increased by 20bps in the quarter. At the same time, a significant increase in longer-term base rates was observed (see 3-year and 5-year A$ swap rates in Figure 3) while shorter dated rates remained relatively unchanged on the back of announcements made by the RBA and the Fed over the period.

Whether or not this signals that the bottom of the market is behind us (at least in terms of pricing) remains to be seen. Based on recent KPMG lead transactions and from market intelligence, there remains room for further tightening in pricing and relaxing of terms in the borrower's favour. A number of large transactions confirm the continued compression of margins, albeit lately in a more selective manner, as evidenced by South32's 5-year US$1.5 billion deal and Woodside's 3-year US$500 million tranche both being completed at 90bps (i.e. sub-100 points).

For the second half of 2015, we turn our attention to NSW's privatisation of its poles and wires assets, as well as closely observing how some of the major macro-economic events influence the local debt market (think Greece debt crisis, China's stock market bubble, the Fed interest rate hikes, plunging commodity prices and RBA's continued jawboning of the Australian dollar).

DEAL OF THE QUARTER – SOUTH32

In May, the newly listed South32 (BBB+) successfully established a US$1.5 billion syndicated facility to support its spin-out from BHP Billiton. The 5-year multi-currency revolver was priced at a margin of just 0.90 percent over LIBOR with an up-front fee of 0.25 percent. The transaction was also heavily oversubscribed with lenders scaled back to US$100 million commitments.

The transaction pricing surpassed other notable deals during the quarter including Woodside Petroleum (BBB+) which successfully refinanced a US$800 million facility with a 3-year tranche (0.90 percent margin + 0.30 percent upfront) and a 5-year tranche (1.15 percent margin + 0.50 percent upfront).

Undoubtedly the South32 deal was a tremendous success given the pricing achieved and the credit appetite shown by the banks in what remains a challenging period for commodity prices. The question remains, is this as good as it gets for debt markets? It's a call we were almost ready to make, however, recent activity has swayed us from doing so just yet.

NEW THIN CAPITALISATION RULES – FIRST YEAR IN AFFECT

With the recent financial year end, FY15 marks the first tax year where foreign entities in Australia could be impacted by the ATO's new thin capitalisation rules regarding shareholder loans. From July 1 2014, the safe harbour limit for non-bank financial entities was reduced from 75 percent to 60 percent on a debt to total asset basis.

In effect, this could mean that many borrowers who had previously relied on the higher safe harbour threshold will now need to consider whether an Arms-Length-Debt-Test (ALDT) could allow the same level of debt above the new lower threshold.

The ALDT is required by the ATO to establish whether the amount of debt could reasonably be expected to have been borrowed in that industry by the borrower and that a commercial lender could reasonably be expected to lend up to those debt levels.

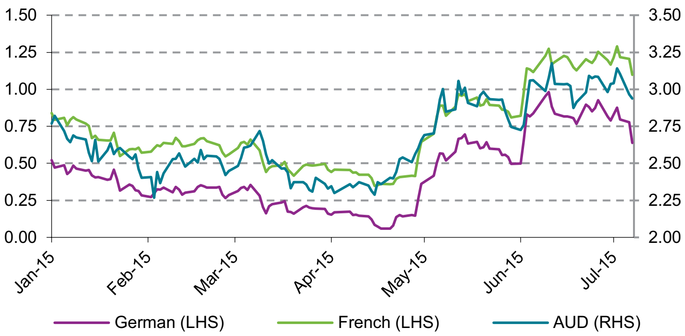
The failure to comply with the applicable safe harbour limit results in the disallowance of tax deductions for that part of the borrower's debt expenses. This potentially represents a material tax impact for borrowers with shareholder loans.

VOLATILITY AMIDST UNPRECEDENTED LIQUIDITY

An unintended consequence of the various market manipulations made over the past 5 years following the financial crisis has been exposed in recent months with significant volatility returning to markets, in particular bond markets. Amidst unprecedented levels of macro liquidity in the global markets, markets globally (in particular fixed income) have experienced micro illiquidity resulting in heightened volatility as investors all rush for the exit simultaneously.

As noted by European Central Bank president Mario Draghi, "At very low levels of interest rates, asset prices tend to show higher volatility". And he wasn't joking – the German bond market experienced its largest 2-day spike since the late '90s in May, moving from near zero to over 98bps in a 6-week period. The Australian market didn't escape punishment, experiencing its longest stretch of losses for over 15 years.

Figure 4: 10-year government bond yield analysis (%)



Source: Bloomberg, KPMG Analysis

In addition to the ultra-low interest rate environment, there are a number of factors that all contribute to the increased volatility in these markets (with thanks to Nouriel Roubini and his insightful article published June, 2015).

- Greater extent of high-frequency trading creating enhanced herd behaviour of investors
- Changes to regulation, forcing banks to hold greater capital charges against their fixed income inventories – incentivising banks to exit their role as market makers in otherwise illiquid instruments
- Greater holdings in open-ended funds, permitting investors to sell out almost overnight – forcing the fund to sell even if it doesn't consider the trade to be in its best interests

Roubini notes the ironic situation we now face – excessive macro liquidity matched with micro market illiquidity. He sees this as a time bomb as central bank induced liquidity creates asset price bubbles that create risks of an eventual trigger and market crash (food for thought).

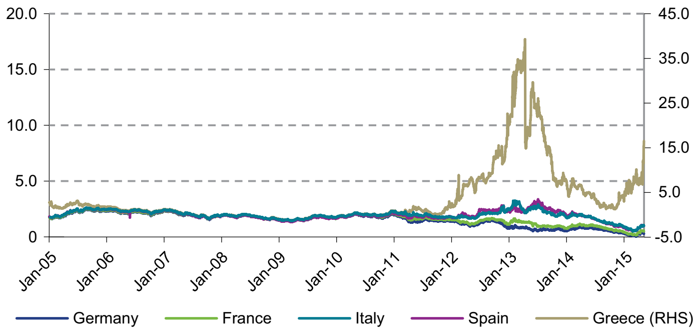
A REAL TRAGEDY OF GREEK PROPORTIONS

It would be remiss of us not to discuss the situation in Greece, as on 30 June it became the first developed economy to miss a payment to the IMF, and appeared to be on the brink of default and insolvency, had it not been for the significant compromises agreed to in negotiating the debt restructure.

Markets reacted as expected for Greece, with limited impact on the bond yields of other European nations – in particular the other PIIGS nations. This is in contrast to the 2011/2012 experience when the original Greek/PIIGS issues surfaced.

Reasons for this mostly focus on the transition of Greece's debt to public agencies (IMF, Euro group etc.) rather than private banks and investors as in 2011/2012 and therefore the lower (although not insignificant) risk of contagion to other countries.

Figure 5: 10-year treasury bond yields (%)



Source: Thomson Reuters, KPMG Analysis

With the ongoing uncertainty in the banking market, deposits have been increasingly fleeing the Greek banks – private sector bank deposits are at an 11-year low. This trend has increased the banks reliance on the emergency liquidity assistance funds – with widespread coverage of long ATM queues, a €60 withdrawal limit, closed bank branches and mass protests outside the Greek parliament. This has driven a number of market participants (even ones who were first highly optimistic of a united Euro solution) to accept a Greek exit or simply "Grexit" as the likely base case scenario, noting that there has never been a comparable exit since its formation.

Since then, the market enjoyed a much more palatable set of circumstances with both the Eurozone leaders and the Greek parliament finally approving the terms of a second bailout package, providing Greece with temporary relief and a 2 notch S&P credit rating upgrade to CCC+. This permitted the reopening of the country's banking system and the repayment of the IMF loan, thereby officially avoiding a formal default. The ability for Greece to adhere to the bailout terms and meet the now extended debt maturity schedule will be of continued interest for the near future.

FINTECH – STONE & CHALK ARRIVES

"Some things are set in stone… and everything else is written in chalk" is the meaning and ethos behind the name at the new fintech hub in Sydney.

The Stone & Chalk hub is an independent, not-for-profit entity created to foster and accelerate the development of world leading financial technology start-ups.

Stone & Chalk provides a physical location for collaboration between start-ups, financial institutions, technology companies, leading academics, government and regulators. The objective is to provide low cost services, expertise and mentoring, as well as access to capital for start-ups. The hub will also provide a pipeline of opportunities for financial institutions, venture capital funds and investors.

Digital disruption is transforming the financial sector and there is enormous upside potential across the banking and insurance landscape. Technologies including electronic and mobile payments, peer-to-peer and crowd-funding, automated advice, capital markets and crypto-currencies are all rapidly redefining how financial services are delivered and the customer experience. The Stone & Chalk hub will certainly be a space to watch for debt market developments in the near future.

WELCOME TO THE TEAM – KEITH HEGARTY

We are pleased to welcome Keith Hegarty to KPMG's Debt Advisory team in Sydney. Keith joins us from ANZ Structured Capital Markets (SCM) and brings in excess of 13 years structured finance and securitisation experience to the team. Prior to ANZ, Keith worked for nearly 8 years at Anglo Irish Bank and the Bank of Ireland in their portfolio management and corporate banking teams.

In his role at ANZ, Keith worked with a suite of product offerings, including ABS, RMBS, Covered Bonds and other structured finance derivatives. As Associate Director in SCM middle office, Keith was responsible for developing the reporting framework and delivering regulatory and internal reporting on their c. $10 billion portfolio.

Our Global Debt Advisory offices

KPMG's global Debt Advisory Services of 110 professionals helps our clients achieve optimal financing outcomes across the entire spectrum of debt products.

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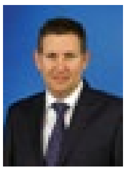

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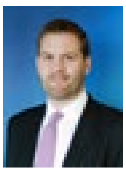

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