Debt Market Update
Q3 2015

Edition 25

Corporate Finance

KEY THEMES

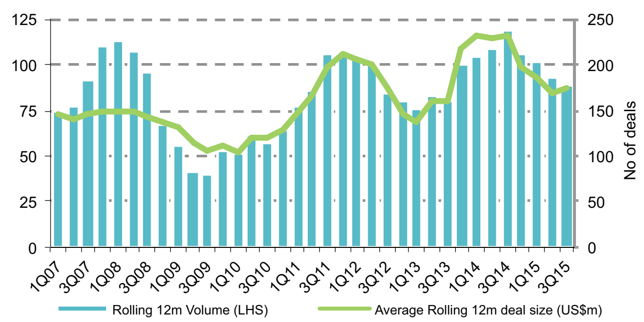
- Australian debt market – volumes decreasing and bond spreads widening
- Deal of the quarter – SICEEP achieves outstanding pricing reduction in a refinance whilst still under construction
- Bank funding costs – have we seen the bottom of the market?
- Lack of long dated bank tenor – a funding cycle mismatch
- Selecting a bank group – more than just pricing

AUSTRALIAN DOMESTIC DEBT MARKET

The syndicated loan market softened in the quarter ended September 2015 compared to the more robust June 2015 quarter, with quarterly loan volume falling circa 15 percent to US$19.0 billion across 46 transactions. Average deal size was US$413 million supported by 10 deals over the $1.0 billion market (in A$ terms).

On a rolling 12 month basis, the downward trend continued in the September quarter representing the fourth consecutive quarter of volume reduction since the peaking at US$118.2 billion in Q3 2014. The slowdown is consistent with the benign domestic growth conditions and also the slowdown in Asian GDP growth leading to lower growth in global trade volumes and industrial production.

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



Source: Thomson Reuters Loan Connector, KPMG Analysis

Refinancings continue to dominate the domestic syndicated loan market, as existing borrowers continue to seek to extend on existing terms while improving pricing. Although improved pricing on refinancing has been a consistent observation in the syndicated bank market over recent years, we are witnessing early signs that the banks are moderating lending if return hurdles cannot be achieved. While the cost of funding for the banks has increased, strong liquidity from offshore lenders has continued to apply pressure on local lenders to remain price competitive. Whilst bank debt margins have yet to tick up materially, an upward movement in pricing going forward would not be unexpected.

From a business confidence perspective, we saw a number of major M&A deals hitting the market, supplying much needed event-driven transactions into the syndicated debt market. Quadrant Energy, Evolution Mining, M2 Group, Programmed, Independence Group and Nexus Infrastructure (Toowoomba Second Range Crossing PPP) all make it to the list of headline M&A/project finance transactions for the quarter, netting a total of circa A$4.4 billion from financiers in the three month period.

Table 1 lists details of notable transactions in the third quarter of 2015.

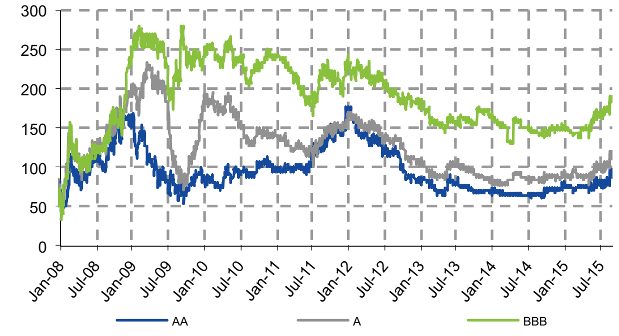
Table 1: Notable syndicated loan transactions

Borrower	Date	Tranche amount (A$m)	Tenor (years)	Margin (bps)
Coates Group Pty Ltd	Jul-15	1880	4	350 (opening)
Stella DHL Finance Pty Ltd (Sydney Convention Centre PPP)	Aug-15	1,331	5	120
		55	5	120
Quadrant Energy Pty Ltd	Aug-15	US$ 266	1	187
		US$ 267	3	187
		US$ 125	5	187
		US$ 267	5	187
		US$ 15	5	ND
Evolution Mining Ltd	Aug-15	155	3	250
		300	3	250
		400	5	250
APT Pipeline Ltd	Jul-15	311	2	85
		311	3	95
		208	5	125

Source: Thomson Reuters Loan Connector, KPMG Analysis

Meanwhile on the local corporate bond market, bond spreads continue to widen for Australian's investment grade borrowers in the recent quarter (see Figure 2).

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



Source: Thompson Reuters, Bloomberg, KPMG Analysis

A landmark event on the A$ bond market was Apple's A$2.25 billion bond issue (rated AA+ by S&P, one notch higher than Aussie "Big Four" banks) as part of the company's capital return initiative. The size of Apple's debut A$ deal easily dwarfs all other previous corporate bond issues in the AMTN market, with the next largest being BHP's A$1 billion 5yr issue at 87bps in March 2015. Apple's issue was split into two 4yr tranches and a 7yr tranche, priced at 65 bps and 110 bps respectively at issue date.

Apple's notable issue was thought to ignite the A$ corporate bond market, but only two other domestic issuers have since raised money in the A$MTN market (to the end of the September quarter) according to KangaNews. The two transactions are Melbourne Airport's A$250 million 7yr deal at 137bps and Telstra's return with a A$500 million 7yr transaction priced at 130 bps.

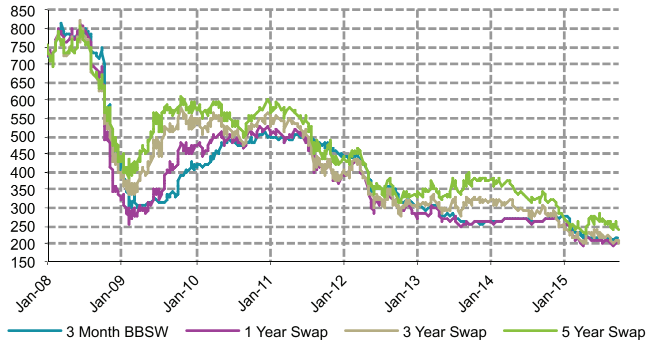
Any near term downwards movement in credit spreads or a rebound in A$ corporate issuance volumes is not readily expected by market participants, forcing corporate borrowers to take comfort in the domestic bank market and the USPP market for relative stability and dependability.

The USPP market continues to be in favour with corporate treasurers, with CSL, Goodman Trust, Civic Nexus Finance, United Energy Distributions and Vicinity Centres (ex. Federation Centres) collectively raising circa US$1.4b in the most recent quarter. An interesting issue was CSL's swiss franc USPP tranche (CHF400 million), deviating away from the typical US$ and A$ denominated deals for Aussie issuers in this market.

For the final quarter of the year, we are focusing on the continued progression of NSW's poles and wires privatisation initiative (focus is now on Ausgrid after Transgrid's A$10.3 billion sale to a Hastings-led consortium) and look out for further M&A activity / asset divestments by corporates as they look to reposition their respective balance sheets.

Needless to say we are also watching the RBA's interest rates moves very closely, to see if the rate setters decide to pull the trigger on lowering rates below the current all-time low of 2.00 percent. Figure 3 neatly summarises the journey of A$ base rates since the heights of the pre-GFC period to today.

Figure 3: Australian interest rate swaps



Source: Bloomberg, KPMG Analysis

DEAL OF THE QUARTER

The Sydney International Convention Exhibition and Entertainment Precinct (SICEEP) PPP refinancing took the top spot as our deal of the quarter. The SICEEP refinance in September saw its margins come down from 260bps to a low 120bps. The noteworthy point on this transaction is that the refinance (and price savings) were achieved while the project was still in its construction phase, a first of its kind for Australia's PPP market.

Two new banks entered the 8-bank A$1.3 billion syndicate, which was initially formed in December 2013. Led by the project's sponsors, the consortium managed to lock in a 140bps margin saving without materially reducing project risk exposures, as construction remained on schedule to finish in early 2017. The SICEEP consortium was supported by continued financier appetite (both new and existing banks) and high liquidity in the market.

We noted at least 3 other PPP facilities being refinanced in the quarter, amongst other new PPP projects coming on-stream plus the well-publicised State government asset privatisations. To support this pipeline, other international lenders have shown their willingness to re-enter the market and traditional fund investors have also taken roles in direct lending into infrastructure assets provided risk-returns are justified.

BOTTOM OF THE MARKET?

Banks' funding and lending rates have moved in close unison in recent years, with reductions in overall funding costs generally passing through to declines in lending rates. The 2013-2014 period saw declining wholesale funding costs as banks rolled off expensive crisis level funding which, combined with low deposit rates, flowed through to tighter pricing (credit spreads) on corporate lending. However, according to the RBA, competition in lending markets throughout 2014 resulted in the overall outstanding lending rate falling further than funding costs, with the spread between the two narrowing by around 10 bps.

More recently however, wholesale funding costs for the banks have begun to rise, refer to Table 2 on recent wholesale raising by NAB and Westpac.

Table 2: NAB and Westpac's benchmark 5-year issues

Banks	Date	Amount (A$'m)	Tenor (years)	Margin (bps)	Delta (bps)
NAB	Nov-15	2,100	5	108	**28**
NAB	Jun-15	1,900	5	80	
Westpac	Oct-15	2,100	5	108	**18**
Westpac	Jul-15	2,700	5	90	

Whilst rates are still significantly cheaper than the crisis level funding of 2009-2010, the marginal impact of this cheaper wholesale funding on the banks' overall cost of funding is reducing relative to a year ago. There is also concern that wholesale funding costs could increase further as banks look to lengthen their maturity profiles and further reduce their reliance on cheaper offshore short-term funding under pressure from APRA to meet regulatory funding ratio targets.

Whilst wholesale funding costs are edging higher, the cost of deposits tends to have a greater impact on margins given they make up over 50 percent of banks' funding composition (Source: RBA). With APRA's renewed focus on liquidity (through the introduction of the Liquidity Coverage Ratio), banks will likely be forced to lift the level of term deposits (in place of "at call" deposits) to meet new liquidity requirements.

In the same light, the increasing capital requirements of the big banks is likely to edge funding costs higher. Over A$15 billion in equity capital has been raised by the big Australian banks since May this year following the release of the financial system inquiry's recommendations. However, with the approach of Basel IV whilst at the same time the big banks' global peers continue to grow capital at circa 40bps per annum, APRA has suggested there is potentially more to be done signalling further capital increases may be on the horizon for Australian banks given relatively poorer leverage ratio.

As the banks look to strengthen their balance sheets with further equity, returns on equity will continue to come under pressure with some re-pricing required to offset the dilutive impact. According to UBS, this re-pricing is expected to initially focus on investment property and owner-occupied mortgages, with some widening of business and corporate spreads likely to follow.

So what does all this mean? Whilst we are continuing to observe some corporates improve on pricing and terms, the number of these coming to market continues to taper and it is difficult to see further tightening of credit spreads extending into next year when we consider the banks' rising cost of funding and the impact of incremental capital and regulatory requirements. There has already been a slight reversal on bond credit spreads observed over the last 3 to 6 months (refer to Figure 2) and whilst this is likely driven in part by a level of uncertainty coming out of the potential impacts of a US rate increase, a weaker China and revised growth prospects of the Australian economy, it may be indicative of an end to the period of tightening credit spreads.

TRUE COST OF LONG DATED BANK TENOR

The domestic funding requirement for corporate and project finance continues to be met largely through the big four domestic banks which dominate total loan volumes. Achieving tenor beyond five years is challenging due to the nature of banks internal short term funding and Basel reforms. This dominance has resulted in a funding mismatch for corporates with long asset and project lifecycles.

Australian dollar capital markets provide issuers with a domestic alternative to bank debt, however this is predominantly limited to rated investment grade issuers, and tenor generally caps out at 5 to 7 years. Given the short term nature of these funding sources and requirement for shorter refinancing cycles, borrowers are facing a premium for longer dated debt.

This mismatch has forced many Australian corporates offshore to lock in longer term financing, competitive pricing and in some cases, better terms. US bond offerings are becoming an increasingly popular source of debt for Australian borrowers who are seeking to match their debt tenor and project / asset lifecycle.

Investment grade borrowers are looking primarily to the US Private Placement and 144a bond offerings. Whereas, sub-investment grade borrowers are generally restricted to the banks, or US Term Loan B market. The pricing of these alternative longer tenor funding sources (approx. 10 to 15 years) generally compares favourably to bank debt and helps mitigate refinancing risk for borrowers. Notwithstanding, these borrowers are subjected to exchange rate volatility and limited by the term of available currency hedges.

Given the short term nature of the financier cross-section domestically, there is a substantial volume of large scale refinancing due over the next 3 years, and an opportunity for institutional funds and other tailored financing solutions to provide large scale, long term funding in the corporate / project finance space. In the next phase of growth in Australia, these alternative funding sources will become increasingly important in filling the tenor gap

FORMING A PREFERRED BANK GROUP

We have seen a large number of new entrants into the domestic banking market post-GFC. Whilst this level of increased competition has resulted in favourable movements in pricing and terms and conditions, borrowers need to give careful consideration to the composition of their bank group.

There are many important factors to consider when selecting a bank group. Whilst overall pricing and terms and conditions are generally the most heavily weighted, there are several questions to ask yourself when selecting a finance group, including:

- What is their long term commitment to the local market? If they are a relatively new entrant to the market, can you be assured that they will be around in 3 to 5 years when it is time to refinance? The GFC demonstrated that banks, credit investors and alternative financiers come and go from the Australian market. As a more recently example, we have seen the sale of GE Capital Australia to offshore investors.
- Will they support me during difficult times? When times become tougher, the support of all financiers is critical in taking the necessary steps to correct business performance. If all financiers are on board early in the turnaround process, this can allow management to focus more energy on the improvement of the business rather than managing the financier group.
- What additional products and services can they offer? This is not only limited to the usual cross sell products like transactional banking, foreign exchange and interest rate risk management but services like trade finance, equipment finance and leasing, equity capital markets and structured finance and debt capital markets.
- What is their geographic coverage? If a borrower is considering expansion into a new region, it makes sense to have a financier with capability in that region to provide the support on the ground required to execute on the growth strategy.
- Have they got credit appetite to support additional funding commitments to support both organic growth and through acquisition? Do they have sufficient resources to arrange this in a timely manner so it does not become a distraction?

When selecting the members of a bank group, it is important to weight the above factors in coming to a final decision on the participants. A long term relationship with the right financiers is a critical aspect to continued success.

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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