KPMG

Debt Market Update

Q1 2016

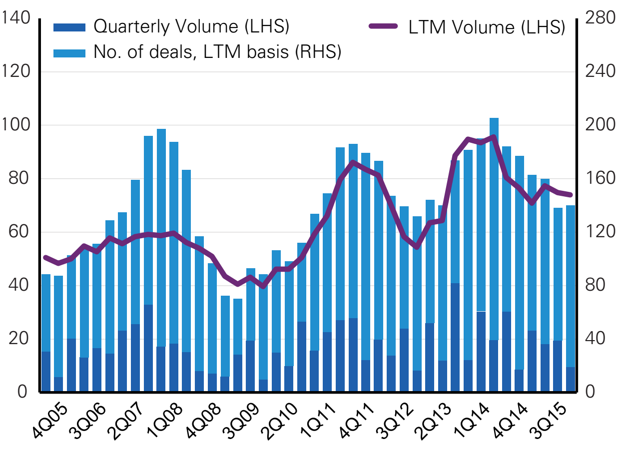
Key themes

- **Australian bank debt market** – typical slow start to the year, although local market holding up better than offshore
- **Australian bond market –** exceptionally low volumes driven by uncertainty and higher margins
- **US private placement market** – declines in aggregate volume through weaker issuance from lower-rated borrowers
- **Interest rates** – 'Lower for longer' from the US, with Australia decreasing rates post-quarter end by 25bps to an historic low of 1.75 percent

Australian domestic bank debt market

The first calendar quarter has experienced a decline from the previous year-end quarter every year since 2001, with 2016 no different – Q1 2016 volumes and transaction numbers were down over 50 percent on Q4 2015. The January holiday period and the extended effort from corporates and lenders to close transactions prior to Christmas and the December reporting period are cited as reasons for the annual decline. When assessed on a rolling 12 month basis, the volume has increased slightly on Q4 2015.

Figure 1: Australian syndicated loan volume



Source: Loan Connector (data extracted April 2016), KPMG Analysis

In comparison to the prior comparative period of Q1 2015, the Australian market first quarter was moderately up, pricing A$15.0 (US$10.9) billion of loans across 25 transactions (avg. A$600 (US$439) million) compared to A$12.5 (US$9.9) billion across 27 transaction (avg. A$463 (US$364) million). The increase can be attributed to two substantial transactions collectively delivering A$5.1 billion in volume – being the A$3.5 (US$2.5) billion acquisition financing for State Power Investment Corp's takeover of Pacific Hydro Pty Ltd, and A$1.5 billion for the project financing of the WestConnex motorway (see Table 1 for further details).

In addition to these larger deals, we highlight the Zeuss Childcare transaction, funding the acquisition of Guardian Early Learning Group (Guardian) by Partners Group on behalf of its clients – the first major Australian acquisition by the Swiss-headquartered private markets investment manager. KPMG Debt Advisory acted as financial advisor to Partners Group for this landmark transaction, achieving a successful outcome in the tight deal timeframe on a structure that provides Partners Group with the flexibility to undertake key growth initiatives for Guardian.

The Australian debt market quarterly performance was stronger than other markets in Asia which experienced downturns to both Q1 2015 as well as the prior yearly period with total lending the lowest in over four years. The major driver of this decrease was the significant decline in the Chinese markets with transaction volumes falling 78 percent from the prior year due to in-country and global volatility. This is anticipated to recover due to increasing appetite from Chinese companies in offshore M&A transactions.

Table 1: Notable syndicated loan transactions

Borrower	Date	Trache amount (A$m)	Tenor (Years)
WestConnex FinCo Pty Ltd	Mar-16	1,500	6.7
Asciano Finance Ltd	Feb-16	650	5.6
		650	3.7
AMP Group Finance Services Ltd	Mar-16	250	2.0
		250	4.0
		250	5.0
Southern Cross HoldTc Pty Ltd	Mar-16	371	5.0
Zeuss Childcare III Pty Ltd	Mar-16	31	5.0
		124	5.0
		80	5.0
		20	5.0

Source: Loan Connector (data extracted April 2016), KPMG Analysis

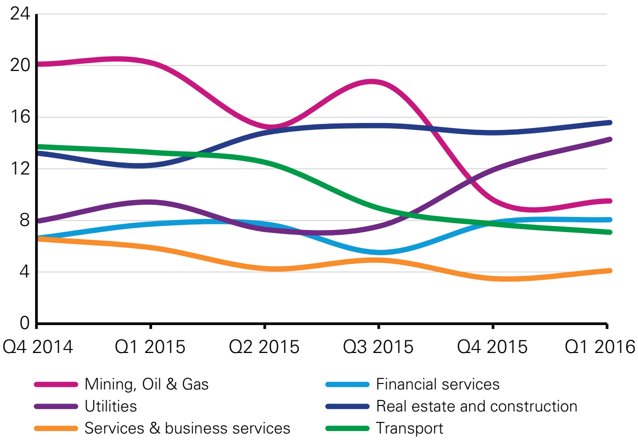
The reduced loan volumes in the Australian debt markets can be attributed to a couple of factors:

- decreased level of refinancing activity (falling from 88 percent to 55 percent of quarterly transaction volume over the past 12 months), as corporates have either previously locked in extended facilities or are not pursuing early refinancings due to the higher margins in the market at present.
- decrease in mining and energy sector transactions given the declines in the commodity markets in this period. The quarterly contribution of the mining, oil and gas sectors fell to 12 percent, one of the lowest in the past five years. These industries are now ranked third in sectoral performance – see Figure 2 below.

On a positive note, M&A market activity has steadily increased over the past 12 months (representing an increase from 10 percent to 25 percent of dollar volume) to provide increased activity. Further, project finance transactions are showing stronger volumes on the back of the WestConnex transaction.

In regards to positive sector performance, utilities have increased steadily from Q4 2015 on the back of the substantial deal volume from the NSW Government energy sector privatisations and the State Power acquisition of Pacific Hydro Pty Ltd. Real estate and construction continues to be a strong contributor, which now ranks as the largest sector by volume on a rolling 12 month basis – see Figure 2 below.

Figure 2: Australian syndicated loan volume, LTM by sector (US$b)



Source: Loan Connector (data extracted April 2016), KPMG Analysis

Pricing pressures within the Australian loan market are expected to continue in the coming quarters, with pressure coming from a combination of factors:

- increased cost of debt raisings by the banks evidenced by recent capital market issuance,
- requirements from the regulator (APRA) on regulatory capital being retained to cover unforeseen events and credit risk,
- increased loan loss provisions, particularly from exposures in certain industries (such as mining, oil and gas), and
- servicing recent significant equity capital raisings completed to meet regulatory capital requirements

The ability of the banks to pass on these pricing pressures is dependent on the borrower's credit as well as other relationship factors – recent transactions highlight both reductions as well as increases in margins for different borrowers:

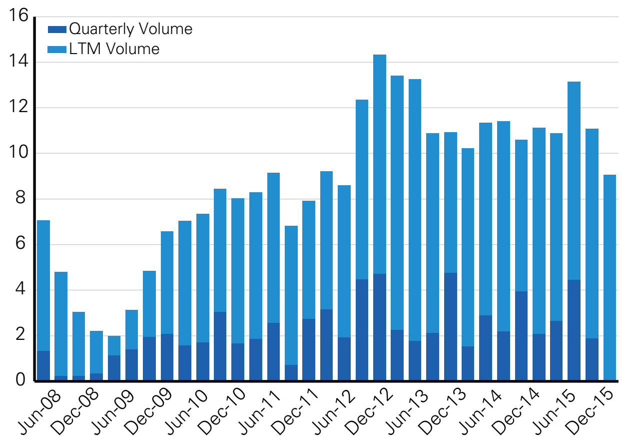
- Woolworths recent 5 year transaction was 50bps higher than their Oct-2014 financing (albeit at a 5.5 year tenor).
- Asciano's recent 3 year transaction was 10bps lower than their Feb-2014 transaction.

Whilst noting the above, it is our expectation that banks will seek to push through their higher funding costs to borrowers.

Australian domestic bond market

The relative positivity of volumes in the Australian corporate loan market was not experienced in the local corporate bond market, which had the lowest quarterly volume since at least 2008 as corporates remained on the sidelines and waited for market volatility to subside.

Figure 3: A$ corporate bond market (A$b)

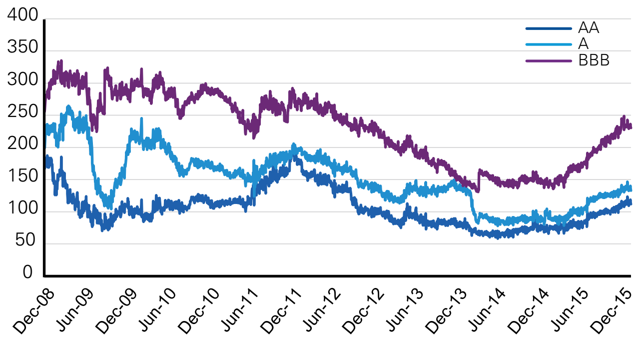


Source: Bloomberg (data extracted April 2016), KPMG Analysis

Corporate transactions priced during the quarter included only two issuances into the unrated wholesale bond market. This market, led to date by FIIG and NAB, provides corporates that do not have a credit rating with an alternative bond market, achieving funder diversity and typically a longer tenor profile than available from the banks. The transactions for the quarter include CML Group pricing an A$25 million, 8.00 percent coupon note for 6 years, and Impact Group pricing an A$45 million, 8.50 percent coupon note for 5 years.

The key driver for the decrease in volumes is the heightened margins in the Australian market, driven by global volatility and uncertainty around growth. Figure 4 over the page, details the continual ramp up in the 5 year margins since mid to late 2015 – the effect of which is evident in the consistently decreasing volumes in Q4 2015 and Q1 2016.

Figure 4: A$ bond market 5 year spread to swap (bps)



Note: The above graph portrays the spread between the yield on A$ 5 year bonds (rated by Standard & Poor's at AA, A and BBB) to the A$ 5 year swap rate

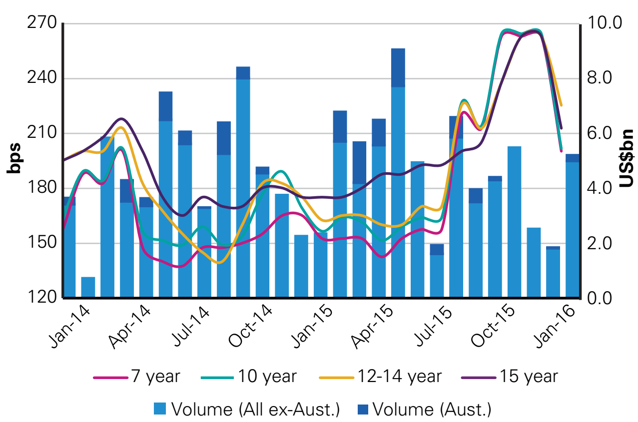
Source: Bloomberg (data extracted April 2016), KPMG Analysis

US private placement market

The US Private Placement (USPP) market had a moderate first quarter pricing US$10.0 billion across 32 issuers. This is down on 2015 volumes by 13 percent which saw US$11.4 billion priced across 66 issuers. The decrease in volume is most pronounced at the lower credit rating levels, with a $0.8 billion decrease in NAIC-3 rated transactions (equivalent to sub-investment grade) in the first quarter compared to the prior year – contributing nearly half of the total decrease in volume.

Australian transactions into the USPP market have similarly been muted, with only two transactions priced for a collective issuance volume of US$425 million. These included Charter Hall REIT returning to the market for a US$125 million, 10 year note, whilst Healthscope debuted in the USPP market with a US$300 million, 10 year note. It is understood both transactions were priced in the early 200 basis points margin range – an attractive rate for long term funding. At the same time in 2015, Australian corporates had priced US$1.2 billion across four transactions – this represents a substantial 63 percent pull back by Australian issuers.

Figure 5: USPP monthly issuance volumes (LHS, US$b) and NAIC-2 pricing (RHS, bps)



Source: Private Placement Monitor (April 2016), KPMG analysis

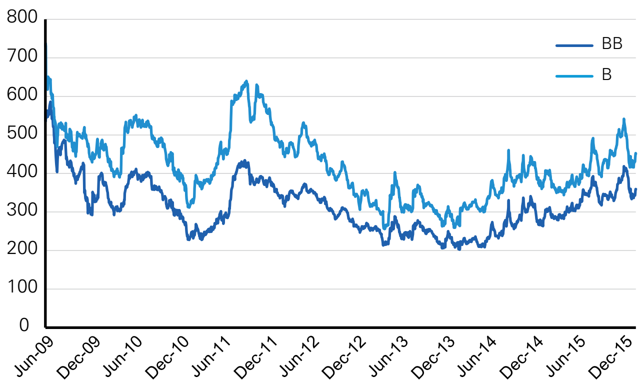
As is evidenced in Figure 5 above, the decline in volumes can be attributed to the substantial increase in margins experienced in the past six months. The jump, which has been experienced across all credit rating ranges, reflects global volatility given the commodity price plunge, the increase in defaults in the high yield market, and global growth concerns emanating from China.

US high yield bond market

Heightened volatility and uncertainty continue to plague the US high yield bond markets – margins remain elevated and have not yet broken through any material resistance levels to retrace back to lower levels. The concerns for the key corporates in these markets – in particular within the energy and mining sector – remain with lower commodity prices impacting profitability and coverage ratios. An example of this is Peabody Energy, once a market leader in US capital markets and the largest US coal miner, filed for Chapter 11 bankruptcy protection in April 2016.

It is unclear at this stage whether the margins can retrace without material improvement in the credit worthiness of these major energy and mining corporates (driven principally by higher commodity prices). Further, there is concern that the elevated pricing in the market, originally driven by energy and mining corporates, is beginning to impact other sectors who are forced to refinance in the present higher margin environment, reinforcing the elevated market situation.

Figure 6: US$ high yield bond market 5 year spread to swap (bps)



Note: The above graph portrays the spread between the yield on US$ 5 year bonds (rated by Standard & Poor's at AA, A and BBB) to the US$ 5 year swap rate

Source: Bloomberg (data extracted April 2016), KPMG Analysis

The flow-on effect of both the higher margins in the debt markets as well as general volatility and uncertainty within the board rooms is evident in monthly US M&A activity which has plummeted to US$96.9 billion in March 2016 from over US$400 billion at the end of 2015.

Interest rates

After holding the cash rate unchanged throughout the first quarter (and for the prior 12 months), the RBA surprised the market with a rate cut to 1.75 percent at the May board meeting. The trigger for the 25bps decrease was a weak inflation reading for Q1 2016 which saw a fall of 0.2 percent for the quarter, and a decrease in the annual rate to 1.5 percent.

Following these inflation results, the market was pricing in a 54 percent chance of a May rate cut – however, the substantial movements in the interest rate and FX markets subsequent to the cut highlights the market was surprised by the decision. After being mostly steady for the quarter, the interest rates have moved materially in the week since the rate cut – see Figure 7b.

Figure 7a: Australian interest rate swaps – 2008 to May 2016 %

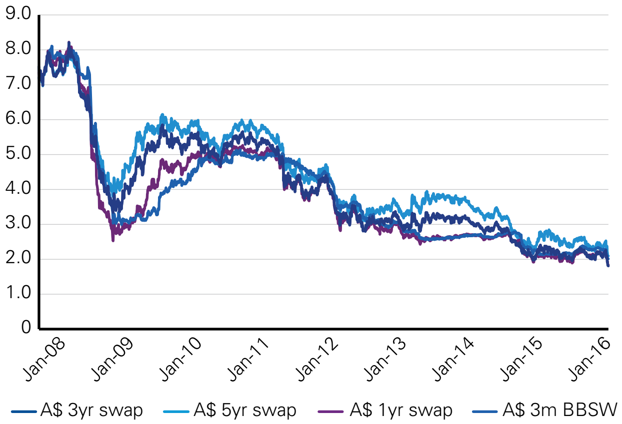


Figure 7b: Australian interest rate swaps – Jan 2016 to May 2016 %

Source: Bloomberg (data extracted April 2016), KPMG Analysis

Continuing to impact the Australian interest rate environment is the US Federal Reserve's interest rate decisions – to this end, the recent dovish commentary from Janet Yellen appears to indicate a patient approach to rate rises following the historic (albeit minor) increase in December 2015. The futures markets have interpreted the Fed's commentary as decreasing the likelihood to a rate rise in June 2016 (as previously expected), with only an 18 percent chance now factored into the markets (as at early April-16).

Following the Fed's dovish commentary, the US 10 year bond yields fell to 1.75 percent - down from 2.27 percent at the end of 2015 when market expectations were for multiple rate rises in 2016.

The 'lower for longer' message from the Fed further supported the RBA in their decision to lower the cash rate in May 2016, given the strength of the AUD in the lead up to the decision – which had risen to 78.01c in April prior to the rate cut but fell to the 73c range in the weeks following.

The US, Europe and Japan continue their ultra-accommodative monetary policies, leading to the position where over a third of developed market sovereign debt now have negative yields (based on Bloomberg indices). Inflation expectations globally are at 5 year lows, suggesting a low probability of higher interest rates in the near term across the developed world.

Finally, whilst its precise impact on global interest rates is unclear at present, we note the recent increasing support for a 'Brexit', or Britain's possible exit from the European Union, and highlight this as a significant risk for the global economy and interest rate settings in the event the vote succeeds. Scheduled for 23 June, the Pound has already begun to weaken in response.

Outlook

Little appears on the horizon that is likely to significantly abate the current pricing trend in markets and ongoing volatility. As such, we anticipate relationship bankers to be under increasing pressure to reprice their book at any opportunity (i.e. maturing facilities, upsizing, covenant reset, etc.). In such an environment, prudent borrowers will be well prepared in understanding their options and alternative structuring techniques that can mitigate the impact and allow them to 'push back' on pricing pressure from banks.

Further, we expect to see an increasing range of borrowers that find accessing liquidity from traditional sources difficult, particular across the mid market and mining, oil and gas services sector. This will no doubt drive the role of alternative debt market in meeting the funding requirement of many of these borrowers into the future.

Welcome to the team

We are pleased to welcome Brad Duff as an Associate Director in our Sydney team. Brad joins us from a diverse background which includes over 12 years of combined experience in Debt, Restructuring, Advisory Services, Credit Decisioning and Formal Insolvency. Before joining KPMG, at CBA and NAB he led and delivered on numerous corporate restructuring, portfolio management and debt sale projects in a wide range of matters in a variety of industries including Property, Healthcare, Financial Services, Mining and Mining Services, Retail, Agriculture, Manufacturing and Hospitality.

We are also pleased to welcome Priyanka Dean as an Analyst in our Brisbane team. Priyanka will be supporting Conrad Hall, our Queensland based Director, on Queensland and South Pacific transactions.

Our Global Debt Advisory offices

The KPMG Debt Advisory Services global team of 110 professionals help our clients achieve optimal financing outcomes across the entire spectrum of debt products and financing solutions.

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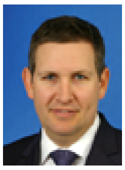

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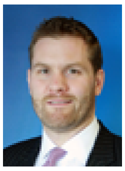

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May 2016. NSW N14052ADV