CURRENT THEMES IN *Australian debt capital markets*

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This paper examines the three main themes that are expected to shape the future growth and development of domestic capital debt markets (including syndicated loan and bond markets). The first two themes are: the continued rise in the importance of Asian investors; and the growing appetite of self-managed superannuation funds and non-institutional investors for investing in the domestic bond market. These trends also have an impact on the third theme — increased innovation — both in terms of alternative international markets for raising funds and in the design of debt products. This paper was prepared for the Monash University and Australian Centre for Financial Studies' 22nd Melbourne Money and Finance Conference on 10–11 July 2017.

With Australia continuing to run current account deficits, capital inflow is required, such as through borrowing money (or raising equity) from overseas investors, to create a capital account surplus. Asian investors have continued to fund Australian debt issuance through loans, and/or bonds, since the global financial crisis (GFC).[1] The importance of the offshore market should not be underestimated. Every year the percentage of domestic market debt issuance that is purchased by Asian investors grows. The number and diversity of investors from Asia are increasing, both geographically and by type of institution. There is also increasing activity from the Asian offices of a number of European or US fund managers, which is likely to continue.

Another significant theme is the growing scale of self-managed superannuation funds (SMSFs) and non-institutional investors, along with their appetite for investing in the domestic bond market. Traditionally this demand was more focused on the hybrid and convertible market but increasingly these investors are providing liquidity in all types of senior debt.[2] During 2016, bidding for new debt issues by these investors grew from a consistent, albeit small, part of the domestic debt market to a fairly significant part of most book builds. A number of infrastructure-related issuers saw strong bids in 10-year floating rate notes (FRNs) from this sector. This trend may continue as more SMSFs move towards greater fixed income exposure, which has been an underweight asset class.

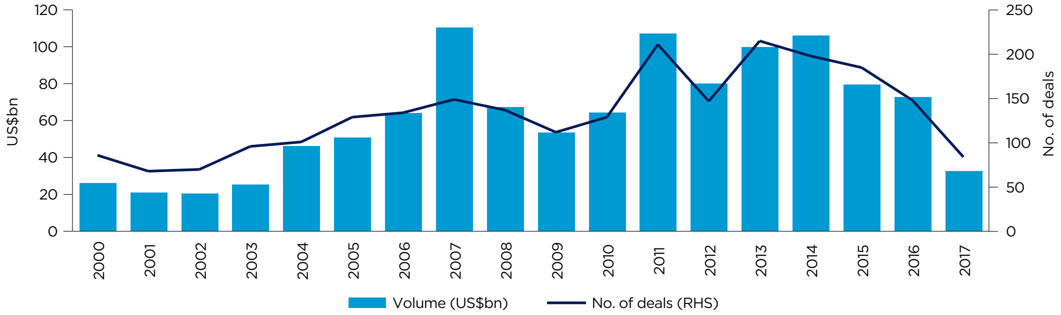
Innovation is also an important theme affecting the domestic debt market. One important development is the extent to which international debt markets provide alternative issuance opportunities to cater to international demand. A second is the emergence of debt products designed to cater to investor preferences for both financial and non-financial considerations. That latter development is illustrated by NAB issuing the first 'green' bond from a commercial bank globally at the end of 2014. In 2015 that transaction was replicated by other banks both domestically and offshore.

In 2016 the green bond market stepped up another level. In April, the first green certified securitisation transaction was undertaken by Flexigroup and, in July, the first green bond was issued by an Australian Government Authority, Treasury Corporation of Victoria. Subsequently, in March 2017, the Queensland Government issued a green bond and NAB issued the first offshore green bond from an Australian issuer. This market is becoming more topical in Australia and is a reflection of the growing investor appetite for assets that are socially responsible.[3] The market will continue to grow as investors continue to have the desire for investments that are both financially attractive in their own right and finance activities that have a desired social purpose.

Syndicated loan markets

In 2017, the Australian syndicated loan market has been relatively subdued (as shown in Figure 1), with year-to-date (YTD) volumes down over 25 per cent from the previous year, which has been a similar experience across the Asia Pacific region.

FIGURE 1: New loan market volume (US$bn)



Source: Thomson Reuters, LPC Data (updated with 2017 YTD figures).

The decline in new issuance has been due to a combination of factors, principally:

> a lack of demand by the corporate sector for credit

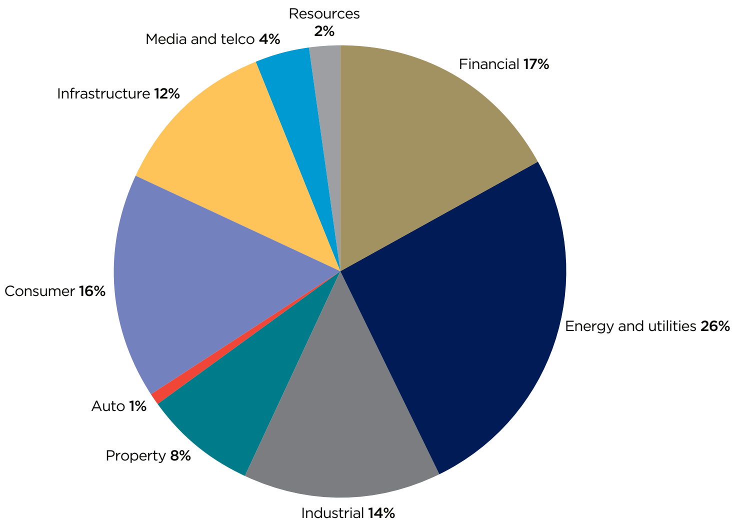
> a reduced level of refinancing due to significant refinancing occurring over the past few years

> increased loan pricing making it less conducive for borrowers to refinance early compared to previous years.

Although loan issuance volume was down significantly in fiscal year (FY) 2016–17, it was relatively active with an increase in new money deals (rather than refinancing of existing/maturing loans) that have been a combination of additional funding raised by corporates, mergers and acquisitions (M&A) and privatisation. These transactions have been meaningful in volume with strong support by banks.

Consistent with previous years, market liquidity has remained strong with all syndicated facilities coming to market oversubscribed. FY 2016–17 has seen more event-driven transactions (acquisition and privatisation) than in previous years and transactions have supported a wide variety of sectors (as shown in Figure 2), which has been a key feature of the domestic loan market.

FIGURE 2: 2017 YTD loan deals by sector



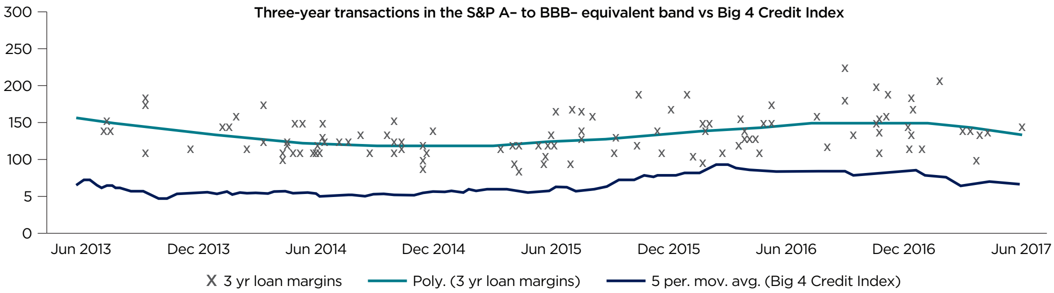
Source: Thomson Reuters, LPC Data.

The loan market also experienced an increase in the number of new banks establishing a branch in Australia, improving local liquidity available to Australian borrowers. Most of the banks that established a presence were of Taiwanese origin. In addition, several transactions were syndicated into the Asian region, which has also been well supported by banks in the key regions of Singapore, Taiwan, Hong Kong/China and regional Japan.

Drivers of change

Figure 3 shows the behaviour of credit spreads over the bank bill swap rate (BBSW) on new three-year loan syndications (and a polynomial trend of those spreads) as well as a measure of the behaviour of bank debt funding costs (using a five-month moving average of the credit spreads for the four major banks).

FIGURE 3: Australian loan market pricing



Source: Thomson Reuters, LPC Data.

Banks have also been increasingly affected by the cost of additional capital raised to meet increased prudential requirements imposed by regulators. The ability of banks to pass on increased costs has been limited due to continuing strong market liquidity and subdued market volume. Banks have been increasingly balancing the level of commitment provided to borrowers with the overall relationship, given the increased cost of capital. This is resulting in syndicate composition broadening to include other banks or non-bank investors (institutions and funds) from across the region.

There are several types of fund managers (corporate, property, leveraged, and project and infrastructure) involved in syndications. This approach allows for a more balanced lender group to support clients in meeting their funding and maturity needs.

One development likely to be a feature of the market in the future is that foreign banks based in Australia and offshore will continue to show active interest in participating in Australian syndication. Currently there is particular interest in the infrastructure and utility sectors. This, in combination with the increased role of fund managers as syndicate participants, raises the question of how the role of Australian banks may change, particularly given ongoing regulatory change and increased prudential requirements (and their subsequent effects in terms of increased funding and capital costs).

Each bank can be expected to manage this in different ways, such as:

> being more selective of their target market (borrowers and sectors to support) and the amount of available capital used to support this type of lending

> reduced commitments to the share of each issue and long-term holding of loans, with increased distribution of loan assets in the primary or the secondary market

> increased securitisation of loan assets.

The growing involvement of institutional investors and funds in the loan market will be complementary to both banks (as originators and distributors of loan participations) and borrowers.

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Australian dollar-denominated corporate bonds

Australia's corporate bond market experienced a period of consolidation in supply in 2016, reflecting muted company demand for term debt, recurrent bouts of volatility and a continued investor bias towards longer tenors.

In reality, local corporate debt markets were facing a supply drought due to the fact that many issuers had pre-funded in previous years, deleveraged or were perhaps targeting different markets such as the US private placement market (USPP), sterling and euro markets for varying reasons such as tenor and volume. This phenomenon affected all debt markets globally and, by the end of 2016, total corporate funding (including financials) fell to around AUD 100 billion from AUD 160 billion as at end-2015.

Key issuers included Air Services Australia, Port of Brisbane, Apple and Coca Cola and, while some of these were very large deals, it masked a bigger trend towards interest by Australian and Asian investors in longer tenor (seven years) and the lower end of investment grade (BBB). The composition of issuance varies between rating categories.

The second half of 2016 saw a rise in activity across multiple corporate mandates including SGSP Australia Assets, Local Government Funding Vehicle, Infrastructure play Westlink M7 (printing AUD 500 million in two tranches) and a debut Kangaroo issue from Toyota Motor Credit Corporation among many others. Prior to both Brexit and the Australian federal election, it is equally noteworthy that taps issuance of AUD 30 million to AUD 50 million became a more popular vehicle for SMSF and non-institutional investors.

The second half of 2016 and first half 2017 saw a continuation of the more traditional themes prevalent in recent years, namely:

> a rise in activity around the seven-year+ tenors, a trend that remains the sweet spot for the market. Seven-year+ deals accounted for 62 per cent of volumes in 2016, the highest on record

> a step-up in 10-year investor demand, driven by largely Japanese-related mandates, while domestic investors showed encouraging signs of their willingness to participate

> increased significance of Kangaroo issuers (i.e. non-Australian firms issuing foreign bonds denominated in Australian dollars in the Australian market), who have not only underwritten about half the market's reduced volume over the past few years, but have also provided a source of diversification for investors

> investors very sensitive to relative value in primary markets as secondary performance was at best flat.

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Alternative markets for Australian debt issuers

The AUD bond market is not just one market. Effectively, it is at least six markets with their own features, documentation and target investors. Some investors can straddle a number of the formats while others are more constrained due to factors such as restricted mandates or regulatory drivers. These different formats provide alternative mechanisms to the domestic AUD bond market for linking investors and borrowers; this has been particularly relevant given the increasing Asian interest in Australian debt issues.

The main AUD bond formats are:

> *AUD onshore wholesale:* This comprises domestic and Kangaroo borrowers, with bonds usually settled through Austraclear initially and subsequently bridged to Clearstream/Euroclear. Documentation is generally provided under Australian law, however, recently some legal requirements from offshore jurisdictions have also been creeping in.

> *AUD onshore retail:* These bonds are usually ASX listed and settled through CHESS, with subordinated bank hybrid deals dominating volumes. This is a well-established market with a very different execution process and targeted non-institutional investor base.

> *AUD European MTN (Reg S):* These bonds are usually documented under a European jurisdiction (predominantly under UK law) with the program also being listing in Europe. AUD eurobonds started to proliferate once the AUD became a 'floating' currency in 1983, however, appetite for these instruments has expanded beyond the original European retail arena with the emergence of Asian investors who buy AUD structured notes and vanilla private placements in this format. AUD EMTN-subordinated (Tier 2) public deals have started to proliferate in recent years with issuers favouring this format over the Kangaroo, which is more costly and takes longer to establish. The EMTN transactions are usually more modest in size, often starting with just AUD 100 million as an initial volume target.

> *AUD SEC-registered global:* As the name suggests, these bonds can be sold in most of the large markets including the US. The format has grown dramatically in recent years, partly as a result of increased regulation of the global systemically important banks ('G-SIBs').

> *AUD Local market bonds* like Uridashi and Formosa bonds use the EMTN format as a base. Uridashi notes overlay a Japanese 'shelf' to enable distribution to Japanese retail investors. Technically, they are notes issued outside of Japan and are sold in secondary trades (one day or more later) to Japanese retail investors. Formosa bonds are issued by non-Taiwanese borrowers and are listed on the Taipei Exchange, thereby effectively becoming a 'domestic' issuer. This allows Taiwanese life companies to participate as investors without breaching holding restrictions on offshore names.

> *AUD-denominated US private placement (USPP) deals:* These bonds are occasionally added to a USD USPP if it does not suit an issuer to either receive US funding, or if they do not wish to swap USD note proceeds to AUD. Some USPP investors can accommodate this.

Asian interest in Australian capital

As indicated above, Asian buyers of Australian debt have options beyond what we would normally consider in the Australian capital markets. They can participate in bilateral loans (if they have an Australian branch) and the syndicated loan markets, as well as participating in a number of the AUD offshore bond markets. This is in addition to any USD or local currency issuance by Australia borrowers. Because of this flexibility, simply identifying the number of Asian buyers in any one market, such as the domestic loan market, will typically understate the overall influence of Asia buyers.

At around the time of the GFC, Asian demand for Australian debt was primarily driven by Asian-based commercial banks or the Australian branches of Asian-based commercial banks. This is still the most important segment of Asian debt demand for non-government debt. But its importance is changing, as is its shape. Since the GFC, more Asian-based banks have opened branches in Australia and those that had been here for some time have grown their assets significantly. This has been especially true for the three Japanese mega-banks, but also for the Chinese, Taiwanese and Singaporean banks with branches in Australia.

The non-bank demand has come primarily from either insurance companies from Asia, Asian fund managers and from US/European fund managers, mainly based in Asia, managing both global and regional debt mandates.

Non-bank demand has been growing strongly over the past three to four years and while it is still not as significant as the bank-led demand it can be the largest component of certain deals. We have seen this in two main areas — demand for financial issuers and also in longer dated (>seven-year) tenors.

With homegrown options subdued in some North Asia Markets, we expect to see a continued strong bid from the region for Australian paper in many forms. This will also be underpinned by more Asian banks establishing branches in Australia.

Growth in the non-institutional fixed income market

One of the fastest growing and influential parts of the domestic market over the post GFC period, but particularly since 2014, has been the increased bidding from non-institutional investors. This is a very broad group and includes SMSFs, the traditional 'middle market' accompanying faith-based groups, councils, and family offices, as well as financial advisers and other private wealth outside of superannuation.

There have been a number of reasons why this broad group has become significant.
First, the total size of the investor pool is huge: including the AUD 700bn held by SMSFs, non-institutional investors have over AUD 1 trillion in total investments.

Second, demographic change, specifically the agency of the population, has increased awareness of sequencing risk and the need for greater asset diversification.

Third, there has been increased supply of borrowers into the market, beyond the usual hybrid issuance and this has helped awareness of the fixed income market.

Finally, there has been a great deal of focus, from both regulators and from market participants on educating the market about fixed income products. It appears that this is starting to have a positive effect.

One of the interesting features of this market is the gap between professionally managed and SMSF exposures to fixed income. We have seen increased SMSF demand in recent years, from a very low base, and this has been the main driver of the recent spate of higher yield, non-rated issuance from institutions such as NextDC, Centuria Fund Management and Peet Limited.

The positive feature about the growth of non-institutional bidding is that we are finally seeing some real investor differentiation domestically. This is good for the market. It increases liquidity and it helps to remove some of the market volatility. While individual bids may be small, the combination of many such bids, along with the consistency of the bidding mean that the issuer benefits from having more diversified investors.

It is widely expected that this market will continue to grow over to next three to five years, driven by both the inflow of money to the SMSF sector and by a rebalancing of asset allocation.

Conclusion

Over the next few years, the three key themes highlighted in this paper are likely to continue to influence Australian capital markets. Further strong interest from Asian bank and non-bank institutional investors seems certain as Australian market fundamentals continue to support investment here. As SMSF volume approaches AUD 700bn there is increased awareness of the need to diversify investment classes which will support more fixed income origination. Finally, the market has seen some very interesting examples of innovation over the past few years. These transactions have performed well and this has sparked increased activity from both issuers and investors.

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Notes

1. Discussion of the role of foreign investors in Australian government debt markets and equity markets, while important, is beyond the scope of this paper.
2. These groups have also been significant investors in the hybrid 'bail-in' securities issued by Australian banks to help meet their regulatory capital requirements. While that market has grown substantially since the first issues in 2011, and competes with debt issuance for investor funds, further discussion is beyond the scope of this paper.
3. As a further illustration, in April 2017 NAB launched a world first, an AUD 500mn Gender Equality Social Bond.