

Debt Market Quarterly Update: Q2 2010

Key themes

- Four key criteria to fund growth and/or deliver improved earnings performance.
- All eyes remain on China as European credit concerns moderate.
- Positive results from recent stress testing of European banks prompt questions as to whether testing was tough enough?
- Improved Australian debt volumes signal appetite for new money lending for good quality credits.
- Domestic cash rate on hold for foreseeable future pending inflationary outlook.
- Increasing momentum in the property sector evidenced by alternative funding sources entering the market.
- SME sector still suffering from “poor cousin” syndrome, but alternative funds are looking to fill the hole.

As we move through the current reporting season, shareholder attention will be turning to the next phase of growth. For many CFOs, this creates the challenge of sourcing funding on economic terms that allows them to invest in growth projects – both organic and M&A driven.

Alternatively, where there are no obvious external growth opportunities, companies will also be considering whether they can optimise their capital structure or take advantage of improving market conditions to deliver enhanced earnings. This is likely to be particularly relevant for those forced into rebalancing their capital structure over the last 12-18 months at suboptimal levels.

In the current environment, where a large percentage of available liquidity has been allocated to refinancing – year to date (YTD) ~60 percent of Asia-Pacific loan volume was refinancing related – securing new money funding continues to remain a challenge for many borrowers.

Despite the challenges, in our experience, new money debt is generally available in most situations, provided CFOs can equip themselves with four key criteria: (i) having a good understanding of the current debt markets to better manage expectations; (ii) having more than one financing option or alternative to consider to create an element of competitive tension; (iii) having sufficient time to source, implement and execute solutions to enhance negotiating power; and finally (iv) having robust and sound financial forecasts to provide increased comfort to financiers.

Global perspective

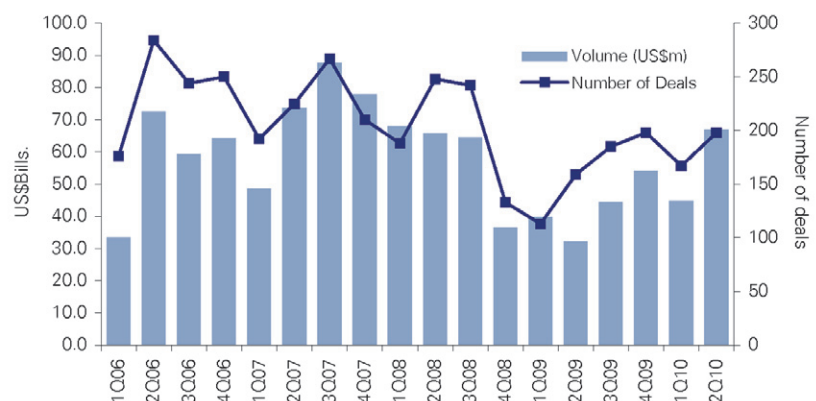
For the time being, market concerns surrounding the European sovereign debt crisis which overwhelmed the first calendar quarter of 2010 appear to have subsided. The market, at least in the short term, seems to have adjusted to this ‘new order’ with Ireland, Greece, Spain, Portugal and Italy all managing to gain traction with

recent debt raisings. However, the longer term impacts of the fiscal and economic situation are still to be played out. Ireland’s recent credit downgrade is an example of the position of a number of countries in the region and highlights the need to seriously consider tough, unpopular fiscal policies and austerity measures to reign in debt levels.

On a surprising note, the recent round of European bank stress testing delivered favourable results. It required only 8 percent (seven banks) to raise capital levels, whilst similar testing in the US last year required more than half the participants to raise their levels. Questions have been raised about whether this testing was tough enough when much of the European sovereign debt held by market participants was excluded, including Spanish and Greek bond issuance.

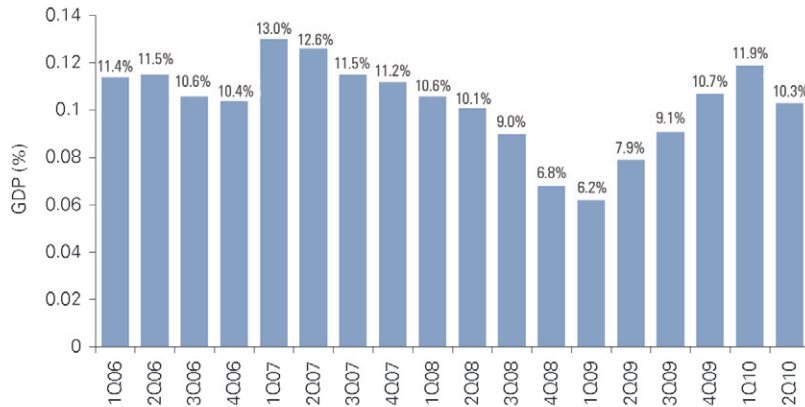
Closer to home, loan volumes throughout Asia-Pacific (ex. Japan) rose nearly 56 percent for the first half of 2010 (compared to 1H09), driven by more activity in the Hong Kong and Taiwan markets. Larger deal sizes and greater participation by foreign borrowers also contributed to the increased volume (refer Fig. 1).

Fig. 1 – Asia-Pacific offshore loan (Ex. Japan)



The Chinese growth story, which has sheltered Australia from the worst of the global downturn, continues to push ahead with China's June GDP numbers (refer Fig. 2) showing growth at 10.30 percent. This equates to an average GDP growth of 11.10 percent for the 2010 YTD. China's average GDP for 2009 was 8.48 percent and 9.13 percent in 2008. The downward trend for the most recent quarter is expected to continue into coming months as Chinese authorities use monetary and fiscal policy to slow the pace of growth to avoid the economy overheating.

Fig. 2 – Chinese GDP adjusted for inflation



Source: www.tradingeconomics.com

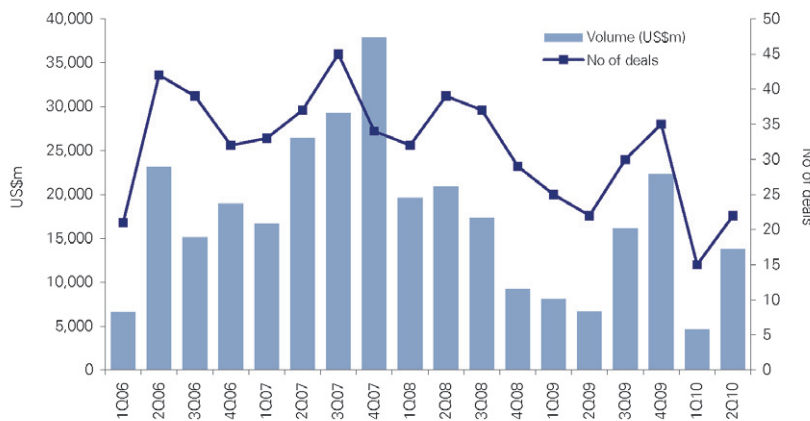
Australian debt market observations

Australian loan market volumes have increased in the second quarter of 2010, albeit off a very low base from the previous quarter. Total loan volume for Q2-10 was more consistent with the average quarterly loan volumes prevailing since the onset of the global financial crisis, but still well below pre-crisis levels (refer Fig. 3). Although it is worth noting that ~A\$10bn of this quarter's volume or ~60 percent was driven by four transactions – refer to 'Recent Significant Australian Transactions' section.

There have been multiple examples of debt raisings in Q2-10 being oversubscribed. This is a positive sign and shows that the market is improving for borrowers with strong credit profiles. We attribute this to stabilising market conditions, in conjunction with lenders continuing to be incentivised by regulatory authorities to invest in quality assets to replenish and grow their loan portfolios. This becomes particularly relevant as corporate debt levels have reduced somewhat following a spate of equity raisings over the last 18 months.

Evidence that banks have increasing appetite for large scale new money lending facilities was seen with the recent Healthscope transaction (see next column for details) further illustrating improving liquidity in the market. There are also signs of bank appetite returning for selected underwritten transactions, although volumes are well short of pre-GFC levels. Recent underwritten deals include Spark Infrastructure Ltd (\$250m & \$200m, 180bps, 3 & 4yr), and Study Group Holdings Ltd (PE Deal – LBO, \$330m, 3yr, 450-475 bps).

Fig. 3 – Australian loan market volume



Source: LoanConnector

Recent Significant Australian Transactions

TPG Capital and The Carlyle Group's acquisition of Healthscope is a signal to the market that large private equity transactions are not over. The A\$2.7bn takeover is the largest leveraged buyout since CVC Asia Pacific acquired nursing home company DCA in 2006. The transaction was financed by a A\$1.2bn 5-year facility which includes commitments from 17 banks. Pricing was reflective of the leveraged nature of the transaction with reported establishment fees of 400bps and margins of 450bps over BBSY.

Vodafone Hutchison Australia (VHA) reportedly successfully completed the largest syndicated loan deal for 2010 with an A\$3.0bn facility. The funds will be used to refinance existing shareholder loans and assist with VHA's growth plans. There were reportedly 12 lead arrangers in the 3-year transaction with margins reported to be circa 235bps over BBSY.

Origin Energy (rated BBB+ by S&P) reportedly received oversubscription when they approached the markets in early April and subsequently upsized from A\$2.0bn-equivalent to A\$2.5bn-equivalent on the back of strong support from Asian domiciled banks. The purpose of the loan was to refinance existing debt and support Origin's LNG ventures.

Santos Ltd (rated BBB+ by S&P) sourced A\$2.0bn in bilateral banking facilities from nine lenders. Santos was also reportedly oversubscribed, originally having 13 bank commitments to the value of A\$2.9bn. The funds will be used to refinance and extend the maturity of existing debt and fund future LNG projects.

Debt pricing and interest rates

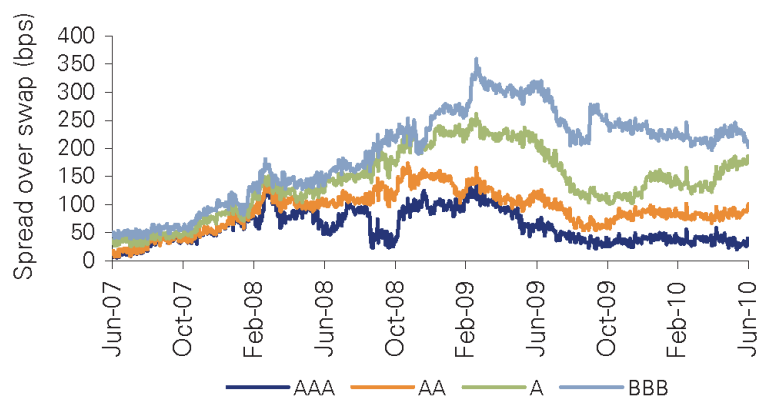
The reduction in credit spreads observed in previous quarters appears to have reached a level of resistance, with further pricing reduction likely to be harder to achieve and only possible on an exception basis.

Credit spreads across most rating categories have remained fairly stable over the last quarter, with 3-year 'BBB' pricing remaining in the 200-250bps range.

A degree of volatility remains in the 'A' pricing as the chart (refer Fig. 4 over page) indicates it has increased somewhat over the last quarter, moving towards the BBB curve, which has also seen marginal increases. This movement in 'A' and 'BBB' pricing continues the trend from last quarter's update.

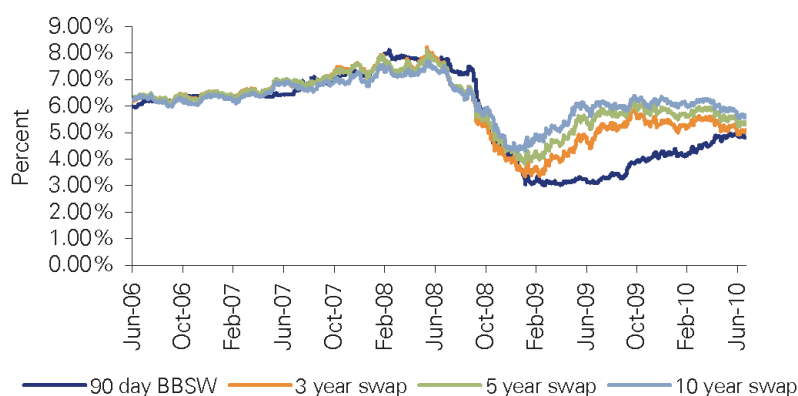
Whilst the 90 day BBSW remains below 3, 5 and 10-year swap rates, the gap has narrowed over the last quarter, (refer Fig. 5 over page). This largely reflects the six increases in the official cash rate since October 2009 (a cumulative increase of 1.5 percent) and a slight drop in medium to longer term interest rate expectations.

Fig. 4 – Three year corporate spread over swap



Source: Bloomberg, KPMG analysis

Fig. 5 – Base rates



Source: Bloomberg

With the variation between short and long term funding rates narrowing, we anticipate that more businesses will look to consider fixing their interest rate exposures in this environment.

More recently, as reported in previous updates the aggressive rate rises expected by the market 6 months ago have tempered given developments in Europe and the RBA remains cautious about the flow on impacts this may have on Australia's economy. Nevertheless, underlying inflation remains the key driver of future movements in the official cash rate and the RBA has indicated it will have no reservations in raising interest rates around an election campaign if it feels such an increase is warranted. The official cash rate has remained unchanged since May's rate rise at 4.5 percent.

Table 1

Australian USPP issuance in June 2010 quarter					
Issuer	Date	Amount US\$m	Tenor	Margin (bps)	Rating
AGL	In Market	200	10, 12 & 15 yrs		BBB
Goodman Fielder	Jun-10	300	7 & 10 yrs	200	NR
Energy gas partnership	Jun-10	185	5 yrs	220	BBB
Leightons	May-10	350	5, 7 & 10 yrs	225	BBB
United Energy distribution	Apr-10	435	4 & 7 yrs	180	BBB
Electranet	Apr-10	350	4 & 6 yrs	150	BBB

Source: Private Placement Letter, Company Announcements

Wholesale and Bond markets

On the wholesale funding front, it is estimated that the major Australian banks have somewhere in the vicinity of A\$140bn of their own funding due for refinance over the next 12 months. Westpac was one of the first domestic banks to tap the offshore market post the 3 notch downgrade in Greece, with a ~US\$2.0bn US Bond issuance (5-year, 137bps over US Treasuries). If sustained, the recent increases in cross-currency basis swap rates may lead to higher bank funding costs, which will most likely be passed directly on to corporate borrowers.¹

There is growing support from banks for the development of a covered bond market in Australia. Covered bonds are securities with full recourse to the issuer (bank), backed by a specific asset pool held on bank balance sheets (e.g. residential mortgages). Development of a covered bond market is currently restricted under APRA standards, but could be a key source of funding for banks to meet their refinancing requirements and fill the gap left by the withdrawal of the government guarantee.

Return of longer tenor?

Whilst overall bond issuance volumes from Australian corporates remain low, recent issues have been priced relatively competitively (refer examples below). Longer bond tenors have also been evidenced, up to 10 years in some instances. Despite continuing improvement, we expect strong appetite is only likely to be evident for leading borrowers, with volumes and tenor likely to remain modest for some time.

Telstra (rated A) sold A\$150m in 7.75 percent 10-year notes which was equivalent to 200 bps over the 10-year swap rate.

APA (rated BBB) recently launched an A\$300m 10-year senior unsecured MTN with indicative pricing at a margin of 240bps.

USPP market

The USPP market continues to be a viable source of alternate funding. In the June 2010 quarter, the deals contained in Table 1 were completed or still in market.

The USPP market has maintained its appetite with investors complaining of 'too many dollars chasing too few deals'². As a result 'oversubscription has become the order of the day'³. An example of the strong existing appetite is the Goodman Fielder placement which was reportedly five times oversubscribed.

Strong investor appetite is clearly favourable for borrowers who have benefited from the competitive pricing and longer tenors available in the USPP market.

¹ Stephen Aldred, Euro zone crisis to boost Asian loan pricing, LoanConnector, 28 May 2010
² Gayatri Iyer, 'Notes from the Buy Side', Private Placement Letter, 1 February 2010
³ ibid

With a thin supply of deals and tightening margins on investment grade placements, some have suggested the return of riskier NAIC-3 (equivalent to BBB-) credits may not be far away⁴. However, evidence of such a return remains to be seen.

As described above, the recent increased cost of basis swaps is reducing some of the cost of funds benefit of borrowing in offshore markets and should therefore be taken into consideration when comparing pricing in different markets.

Real Estate

Despite the stabilising macro conditions, the real estate sector is still facing a number of issues – mainly the ability to address their upcoming refinancing requirements (in both the listed and unlisted real estate trust market) and the ability to profitably fund property acquisitions where the capitalisation rate barely covers the cost of debt (consequently requiring equity to fund the transaction and take a view on the future growth potential). The construction sector is also being impacted by the increasing cost and lower availability of bonding and bank guarantee lines, which both chew up bank exposure limits and make new construction projects more expensive to fund.

Leading on from our discussion in last quarter's update, superannuation funds may be able to help address some of these issues. A major Australian superannuation fund (\$32 billion under management) recently communicated a mandate for commercial property to diversify its current asset mix. This was further evidenced via the announcement of appetite for up to an initial \$200 million investment in a financial services group to deploy into a managed unlisted property debt portfolio. This development testifies to the fact that further expansion in the commercial property space is being considered at the senior lending level.

Whilst we do not expect superannuation funds alone will replace the role of banks, they do serve as a viable alternative funding option in certain situations. With many borrowers in the property sector looking for longer term funding options diversification of funding across investors remains a priority.

SME update

Despite recent press reports around aggressive pricing amongst the domestic banks, SMEs are still facing difficulty across the sector in sourcing sufficient and appropriately structured debt solutions. Compounding this situation is the aggressive direction of funds toward mortgage growth rather than SMEs⁵. A concentration of market share towards the major domestic banks and lower participation from non-bank-lenders and foreign players has reduced the diversity of funding options available to SMEs⁶.

Whilst the impact on competitive pressure is obvious, it is important to note that money is still available for SMEs, but it is generally restricted to those borrowers who can demonstrate their credit worthiness both now, and importantly, going forward. Time will tell whether the performance of the sector (correlated with the macro conditions) and the lower risk appetite of those currently dominating this market will tempt other investors back into the SME market. In the interim, we are seeing increasing interest from mezzanine and subordinated debt investors (both locally and offshore), who have appetite for risk but are also looking for higher yields.

Securitisation

Green shoots are finally being evidenced in the asset backed securitisation (ABS) market, as local and offshore investors dip their toes into well structured transactions with strong investment grade tranches and a healthy level of credit enhancement.

The highlight in the ABS segment for the quarter was Macquarie Leasing's \$642m cross currency (USD & AUD) auto receivables backed securitisation (pricing: 90-150bps, WAL 1.1-3.3yr)⁷. This represents a show of strength for the domestic market with US investor appetite strong for the oversubscribed issuance. We anticipate competitive pricing and healthy market volume to continue for the coming quarter.

Outlook

With local and global equity markets continuing to remain volatile, the attention of both debt and equity investors will be firmly focused on the reporting period. Should the results surprise on the upside, this may provide a positive marker in a prolonged recovery which in turn will support increased liquidity beyond the strong investment grade end.

We suspect however that the financial year end reporting season will see a mixed bag of results which will provide further bifurcation to the two tier economy. In turn, this is likely to see banks continuing to support the top tier investment grade end of town at the expense of the SME sector and problematic sectors.

Fortunately we are seeing increasing appetite from alternative/non-traditional lenders which are expressing strong appetite for non-investment grade credits and sectors which have recently experienced an element of stress.

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4 Gayatri Iyer, "The Conundrum of the NAIC-3s" Private Placement Letter, 3 February 2010
5 Joseph Healy – NAB Group Executive Business Banking, Banks, Business Lending & the Economy II, 15 July 2010
6 Dun & Bradstreet
7 Moodys, Structured Thinking: Asia Pacific, 19 July 2010

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August 2010. VICN06321ADV.