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Australia forges tighter links with Asia - Issuers and investors gather in **Hong Kong** and Singapore to discuss opportunities in Australia's debt capital markets.

National Australia Bank (NAB) hosted two one-day conferences in **Hong Kong** and Singapore last month to selectively showcase a number of Australian corporates and financial institutions to key Asia-based fixed-income investors.

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The conferences were opened and chaired by NAB's Executive General Manager of Debt Markets, Steve Lambert, who talked about the important role Asia now plays in the health and development of Australia's debt markets. 'I like to think of Australia as becoming the southern part of the Asian capital markets and this is evidenced by the interlinkages between Asia and Australian capital markets which continue to grow,' said Lambert.Keynote speaker Eric Williamson, **Group** Treasurer at NAB, gave some insights into Australia's banking landscape. He looked back over the global financial crisis to report that Australia's banking sector had emerged in a strong position - being home to four of only 10 banks in the world with a double-A credit rating and a stable outlook from all three major ratings agencies. 'Australia has had 24 years of consecutive economic growth and government borrowings are low, that puts us in a very positive position,' said Williamson. 'The country's banks went into the crisis with quality asset portfolios, a diversified mix of businesses and strong balance sheets.'

Williamson said, over time, the country's banks have reduced their reliance on borrowing from the offshore markets to fund their balance sheet and have sought new sources of capital. 'We moved quickly to boost our deposit bases so that 70% of all bank funding now comes from deposits. We have also been active in extending the duration of our wholesale funding.'

National Australia Bank's own fundraising activities exemplify how the market is evolving, said Williamson. 'As a **Group**, we have Adollars 141 **billion** in outstanding term funding and each year we issue between Adollars 25 and dollars 30 **billion** into the markets with a weighted average maturity of five years.' He said NAB has seen an increase in the number of Asian investors participating in the bank's trades. 'In 2013, 12% of our term funding was raised from Asia ex-Japan, mainly in US dollars, and one of our top 10 global investors is based in the region I expect this proportion to reach 20% over time.'

Williamson said Asia is a natural funding source for Australian issuers. 'Our debt markets team under Steve Lambert has taken a practical role in forging links between the two markets by supporting education initiatives, simplifying documentation and spreading the word to different investors and issuers.'

Infrastructure focus

One sector likely to garner much interest from Asian investors is infrastructure.

'Infrastructure Australia puts the pipeline of developments at Adollars 139 **billion**,' said Sam Watson, Head of Origination in Asia for NAB, in a presentation to conference delegates. 'The agenda is being driven by the privatisation of existing government assets and new greenfield projects that are being funded with the help of the private sector.'

Watson said NSW and Queensland are currently leading the way with the most developed privatisation programme with transport and port assets flagged for **sale**, as well as electricity transmission and distribution once electoral mandates have been obtained.

Watson went on to say that recent announcements from Victoria and WA indicate some assets are likely to come up in those States. Meanwhile, greenfield projects will be in the form of public-private partnerships for social and economic infrastructure like schools, hospitals and transport. 'We see one or two PPPs come out of each of the key states each year,' said Watson. A third opportunity lies in trade sales. 'The asset cycle has run up and some financial sponsors in the market who bought assets a few years back are now getting ready to sell,' he said.

Watson said competition for infrastructure assets is high, and recent multiples achieved on port sales in New South Wales show how buoyant the market is. 'There is a lot of capital flowing into Australia with global and domestic pension funds, sovereign wealth funds and dedicated infrastructure funds looking to deploy capital in Australia.' For debt and fixed income investors, he said there are a number of features of the Australian project finance market that make it attractive to offshore lenders. 'The underlying structure of the projects is sound, execution risk is low relative to other regional markets, terms and conditions remain fairly robust, but spreads are starting to come in which is a trend we expect to continue.'

Talking to NAB's capabilities, Watson said the bank has deployed twice as much capital to the infrastructure market than any other bank in Australia. 'We are the number one debt arranger in the infrastructure sector over the past five years.'

Corporate bond activity rises

The evolution and renaissance of Australian-dollar corporate **bonds** was discussed in the next presentation by Brad Scott, Head of Corporate Bond Origination, for NAB. 'The Australian medium-term note market has been around for about 15 years, and its relevance as a reliable alternative debt funding source for corporates has only accelerated post the global financial crisis,' said Scott, adding that the market now accounts for one in every three dollars raised by Australian corporates in global bond markets. 'We have about 50 issues a year on average which is a reflection of the big shift towards corporates moving to diversify their debt funding sources.'

NAB has been a **lead** manager for a growing number of Australian-dollar MTNs for key corporates, including Perth Airport, CitiPower, Mitsubishi Corporation, Telstra Corporation, Mirvac, University of Sydney, Wesfarmers, Lend Lease, Anglo American, Transurban and the Port of Brisbane.

Aside from a rise in infrastructure issuers - which made up a quarter of all deals in the past six months - Scott says the market has also been willing to invest further down the credit curve and there has been a clear trend towards tenor extension. 'Investor appetite has extended out from an average of five to seven years and there are encouraging signs about seeing the market develop further in the ten year maturity bucket, often viewed as being more a sweet spot for offshore investors.'

Scott says many of NAB's clients continue to talk to the bank about gaining greater access to Asian investors to diversify their investor base. 'Over the years, Asian participation in Adollars corporate **bonds** has grown significantly with interest coming from asset managers, banks and private banks. Sometimes Asian orders account for more than half of all orders, though the current average is about 20 to 30%.'

As new investors continue to be attracted to investing in corporate **bonds**, Scott expects oversubscription rates on new deals to continue to hover around 2 to 3 times. 'There is more demand from investors than there is supply and this trend will continue to prevail over the remainder of 2014.'

In a further review of trends in specific instruments, Arkady Lippa, Director, Frequent Issuer Coverage at NAB, gave delegates an update on the securitisation market - which has made a steady recovery since the global financial crisis - and spoke about the growth in covered **bonds**.

'Covered **bonds** have been an important part of the European capital markets for many years, but in Australia they only came about in 2011 when legislation was passed to allow them to be issued,' said Lippa, adding there was an immediate rush to market by the country's financial institutions in 2012. 'Since then issuance has settled and covered **bonds** now form part of the secured funding mix,' he said.

Lippa said, in 2013, about half of all covered bond deals were issued in US dollars, with another 31% in euro.

'AUD issuance over the last 12 months has been in the 10yr part of the curve.'

In order to increase the size of the issuer pool, Lippa is hopeful that Australia might adopt new conditional pass-through structures that were introduced in Europe last year. These covered **bonds**, if not redeemed at maturity as a result of the issuer-bank default, convert to a pass-through which allows the ongoing testing of the market for the right time to sell.

'This removes the chance of a fire sale, thereby improving the stability of the banking system if an issuer defaults and reducing the risk that investors will lose money in such scenario albeit giving rise to some extension risk.' Lippa said adopting these pass-through structures would make covered bonds more viable for single-A/triple-B rated financial institutions. 'Watch this space,' he said.

Macro picture

Painting a macro backdrop for delegates, Terry Fanous, Associate Managing Director at Moody's Investors Service spoke about corporate rating trends, indicating that most investment-grade companies in Australia have solid balance sheets and sufficient head room in their ratings. Moody's expects continued overall Ebitda growth in 2015 with the sector's leverage expected to stay under 3 times.

'Since the global financial crisis, companies have done well to strengthen their funding and liquidity positions, broaden debt sources and refinance well ahead of maturities,' said Fanous. 'We expect demand for debt capital to grow substantially in the next few years, driven by the Australian government's focus on privatisation and infrastructure development.'

Conference delegates were given a further feel for general market conditions by NAB's Global Head of Research, Peter Jolly, who gave an overview of Australia's economic outlook. 'With its large export sector and links to the commodity cycle, Australia is basically a beta play on where the world is going,' said Jolly, who calculates that in the 20 years to 2015 Australia will have recorded an average GDP growth rate of 3.5% against 2.6% for the US and 1.5% for the eurozone.

'There is a lot of talk about Australia being a one-trick pony and the country's fortunes will drop in line with commodity prices, but we have a fairly good outlook for the economy despite the fact that commodity prices will continue to edge down.'

Jolly said conditions reached a low point in the second quarter of 2013 and have largely rebounded on the back of a strong recovery in residential construction. 'The low interest rate environment is working - house prices are up and new building approvals are on the increase,'

he said. 'Consumer and business confidence is better, and retailers have had a good six months.'

On the negative side, Jolly pointed to a slump in mining investment to 3.5% of GDP over the next two years - a significant decrease on the previous five-year period. He also said the Australian dollar remained too high for the country's manufacturers and that a looming drought triggered by El Nino weather patterns would likely affect agricultural output. 'Non-mining business investment is yet to pick up and house prices have probably reached a peak.'

To conclude, Jolly spoke about a recent survey measuring business conditions across various sectors. 'There are plenty of surveys that track confidence, but this survey measures actual conditions.' In other words, it measures sales trends to determine whether companies are expanding or contracting. 'The services sector is doing particularly well at the moment,' said Jolly. 'In general, conditions are good and trending up.'

CAPITAL ISSUANCE TRENDS

Investors based in Asia will be an important consideration for Australian bank and insurer issuers over the coming years, said Nick Chaplin, Head of Hybrids & Structured Capital Origination at NAB. Leading a panel discussion on capital issuance trends, Chaplin predicted that Tier 1 issues from Australian banks would remain Australian dollar focused, for now, and targeted at the domestic retail market.

Future Tier 2 capital issues, however, would be marketed to all investors including those outside Australia.

The following panel discussion included: Tim Ledingham, Treasurer at Bank of Queensland; John Caelli, General Manager Markets, ME Bank; Arthur Lau, Head of APAC Fixed Income at Pinebridge Asia; and Matt Price, Head of Group Capital Management, NAB Treasury.

Q: Is there a preference from Asian investors for unlisted Austraclear tradeable bonds versus ASX-listed issues, and is liquidity an important consideration when buying Adollars issues?

A: Arthur Lau: I can only speak on behalf of Pinebridge but listed or unlisted is not a material concern for us. We are more concerned about whether the deal is rated or not. We also like liquid deals, though a portion of our portfolio is buy-and-hold. Of course, our main considerations are price and yield.

Q: Can the issuers at the table please outline intentions around issuance of Tier 1 and Tier 2 capital instruments?

A: Matt Price: We will have an appetite for Tier 1 and 2 issuance over the coming years and want to hold an adequate amount of both. Our Basel II compliant standing stock of Tier 2 capital is subject to transition, which will amortise at 10% per annum over the next few years and we will look to refinance about Adollars 1 billion to Adollars 2 billion worth of non-equity capital issued into the domestic and offshore markets.

John Caelli: ME bank is a privately owned bank so we don't have a specific requirement for issuing Tier 1 capital, but we are having conversations with the regulator, APRA, regarding potential Tier 2 structures. At some stage in the next 6 to 12 months we would like to issue a Tier 2 deal and we would consider marketing to both Asian and domestic investors.

Tim Ledingham: Back in March 2012 we underwent a recapitalisation exercise and since then we have had strong core equity Tier 1 capital levels. Management is committed to maintaining the Bank's single-A minus rating, strong core equity tier 1 is key to that. The maturity profile of our Tier 2 holdings means that we won't need to refinance until 2016 when we will need to issue about Adollars 200 million. In the Tier 1 space we issued a Adollars 300 million CPS at the end of November.

Q: To the issuers, would there be any value in issuing Tier 1 outside of Australia in order to achieve investor diversity for instance?

A: Price: The amount of value an offshore investor gets from these issues is limited because of the tax treatment in Australia. And since we are a strong household name in Australia there is plenty of demand for our paper. However, investor diversity is a big driver for us and we are always looking for new investor bases.

Ledingham: The majority of the Bank's income is generated in Australia, we therefore produce franking credits and being able to issue Tier 1 deals in Australia means we use these credits to issue net pay securities. The Bank's immediate requirements for Tier 1 capital are relative minor and the Australian market is deep enough to meet our needs at present.

Price: Prior to 2009 we were very active in issuing Tier 1 into the offshore markets. Issuing into the institutional market is comparatively quick to execute, compared to the domestic retail market which takes about six weeks from launch to settlement. The legal documentation is also relatively hassle free.

Q: To Arthur again, would you have any interest in gross pay Tier 1 issues from Australian issuers?

A: Lau: I encourage Australian banks to look to the offshore market because we have a sizable exposure to bank capital paper and as this paper matures and is called, we need to find new issues to invest in. We look at some ASX-listed paper, but buying local currency paper adds an additional currency risk and swap cost. At the moment it is challenging because the yield spread isn't enough for us to justify the cost of the swap. In recent months, currency volatility has meant we have passed on a few trades.

Q: To the issuers, would you consider offering Tier 2 issues to the Asian investor market and what would be the key drivers behind this decision?

A: Price: We would certainly encourage Asian participation in our deals. The Asian private bank market was one of the first to embrace the new style of capital securities and interest from private banks in the region has been very resilient.

Ledingham: For Tier2 issuance Bank of Queensland is more focused on the domestic market, but we would encourage Asian investors to participate in our larger transactions. Our capital requirement are quite small and the local market has proved adequate enough.

Caelli: We strongly encourage Asian participation in our Tier 2 deals and would like to actively market our transactions in the region. We recognise the success of recent transactions that have attracted strong demand from Asia and we would like to be part of this.

Q: Would you consider doing roadshows to the region?

A: Caelli: Absolutely. It is very important for us to grow our profile in Asia. It is always beneficial to have one-on-one meetings with investors because it is more personal and gives you a better opportunity to sell your story and gauge what investors are interested in.

Q: Do investors have a preference for any particular tenor or structure with Tier 2 capital issues? Is preference yield driven?

A: Lau: Assuming the credit is solid, we don't have a preference between 10-year bullets and 10-year non-call-5 structures. But since some of our mandates have a specific maturity date, we tend to price an issue to the call date and prefer bonds that are highly likely to be called. We look at the quality of the company and the strength of the management which is why it is important to have the one-on-one relationship.

Q: Would investors be comfortable buying issues with longer tenors - for example a 12-year non-call-7? Would a 7-year call date be reasonable?

A: Lau: I think it is feasible. We invest in perpetuals for example, so whether an issue is callable in 5 years or 7 years is only a matter of pricing.

Q: What is the view from issuers on longer tenor Tier 2 bonds?

A: Caelli: Sometimes it depends how the rating agencies treat the capital and it is important for us to maintain appropriate capital ratios.

We would look at what the investor base wants and at the moment the sweet spot for investors is 10-year non-call-5. Having said that, if we can extend the tenor and get reasonable treatment from the agencies, it would be beneficial.

Issuer snapshot: Port of Brisbane

Covering 1,845 hectares and handling 2,700 shipping calls a year, the Port of Brisbane is the largest diversified cargo sea port on the upper east coast of Australia. The business was privatised in 2010 under 99-year lease agreements and is now owned by a group of institutional investors including local and international superannuation funds and a sovereign wealth fund from Abu Dhabi.

The Port of Brisbane is a landlord infrastructure asset, meaning it owns the land and wharves and earns income by renting these facilities to a variety of tenants. This gives it a diversified revenue profile underpinned by long property leases, said Ben Nolan, the company's Manager of Treasury and Commerce. 'Our growth is tied to Queensland's growth and at the moment we handle 94% of all container movements in the state,' said Nolan. 'Even so, we are only operating at around 30 - 40% capacity which means we can grow by two to three times without the need to build more infrastructure.'

Nolan said the company's container movements had grown on a CAGR basis by 6.5% over the last 10 years compared to the Queensland economy which had grown at 4.7%. The port's two largest exports are agricultural commodities and minerals, mainly coal. '60% of our imports come from Asia and over 80% of our exports go to Asia,' he said.

The Port of Brisbane's growth strategy is to capture more customers from the Queensland hinterland. 'Road access is already very good and we are now talking to the government about building a dedicated rail line into the port. We don't plan to fund this project and it would ultimately be delivered by a third party.' Nolan said only 5% of containers are currently distributed using rail and the company would like to increase this mode share.

Touching on its debt profile, Nolan said Port of Brisbane has a gearing ratio of 35% and an interest coverage ratio of greater than three. Over the past three years, the company has been moving away from its reliance on bank funding. 'About 50% of our debt now comes from the US private placement market, and more recently we issued an MTN in Australia that was well received and had very good interest from Asia.'

'Looking ahead we expect to fund our capex through the banks, and then term it out into the capital markets,' said Nolan.

Issuer snapshot: ME Bank

ME Bank started life in 1994 as Super Members Home Loans before becoming a licenced bank in 2001. The Bank is owned by 30 industry superannuation funds which together manage approximately Adollars 200 billion in retirement savings for Australian workers. 'One of our strategies is to bring banking to industry fund members through kiosks at the workplace' said John Caelli, General Manager of Markets at ME Bank.

The bank has grown its asset base to Adollars 21 billion, with Adollars 16.7 billion on balance sheet and Adollars 4.3 billion off balance sheet. '95% of our assets are residential mortgages,' said Caelli. 'And while our average loan balance is smaller than some of the larger banks, we have a broad geographic footprint. Our arrears performance is very good.'

ME Bank wants to be the bank of choice for industry super fund members and union members - a market estimated at between 5 and 6 million customers. 'We currently have just over 300,000 customers, so there is a real chance to grow our market share within the segment,' said Caelli.

Murray Davis, Treasury Manager at ME Bank, said there has been fundamental shift in the bank's funding focus over the past five years. Prior to the financial crisis, the bank was a prolific issuer of securitised **bonds**. 'Since 1995 we have issued over dollars 41 **billion** of RMBS across 44 **transactions** through two vehicles, making us the second largest issuer in Australia by number of deals,' said Davis. 'When securitisation markets froze during the financial crisis we had to rethink our strategy and we decided to seek a rating and issue in unsecured **bonds**.'

Securitisation now only represents 21% of the bank's funding mix (versus 95% six years ago), while its deposit base has grown from zero to Adollars 3.6 **billion** as at 31 March 2014. 'We also recently issued two senior MTN deals - one with a three-year tenor and another at four-years. This is a great success for a bank of our size,' said Davis. Issuer snapshot: Bank of Queensland

Bank of Queensland (BoQ) has spent the past two years refocusing its business and adjusting its risk appetite by building a better quality loan book with geographic diversification, relying less on Queensland-sourced income and boosting business banking volumes.

The bank's Treasurer, Tim Ledingham, said the switch in strategy came after the bank reported a loss in 2012. The management team moved quickly to restructure the balance sheet and reinvest in the business. The Bank has reported improved earnings over the last three halves and at our last half-yearly update we announced cash earnings of Adollars 140.2 **million**. The Bank has also reduced our impairment levels and we have been upgraded by S&P and Moody's.'

BoQ has dollars 42.5 **billion** in assets under management and 254 branches -it runs an interesting model where 179 of these branches are operated by owner-managers, which are franchised. 'This creates a really unique service model because the owners have skin in the game and are driven to write profitable business for us.The Bank's strategy has evolved to rely less on a single distribution channel with more focus on broadening to a multi channel distribution approach.' said Ledingham.

In the past 18 months, the bank has orchestrated two exciting acquisitions - acquiring the Virgin Money business in Australia and brand for 40 years, and the **purchase** of most of Investec's Australian business. The acquisitions give BoQ an iconic brand and increased capabilities in lending, leasing, credit cards and insurance.

James Shaw, Head of Funding at BoQ, said the bank remains well capitalised versus its peers. 'Our wholesale funding is a mix long-term **bonds**, securitisation, short term debt and a very small amount of subordinated debt,' said Shaw. 'We are now looking at building out our senior unsecured curve with the possibility of issuing a four-year unsecured trade in the coming months. We have a very clean maturity profile with no significant maturity towers.'

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