BACK IN BUSINESS

Credit supply – including nonfinancial corporate issuance – started to flicker in New Zealand in February, and picked up pace in March. There are signs that some of the problems which had faced local corporate issuance, specifically appealing pricing of alternative funding sources and bifurcated wholesale and retail demand, have eased. Supply remains the main challenge.

BY LUCY SYMONDS

As has been the case since 2013, Kauri issuance began before the domestic sector got into gear in New Zealand at the start of the new year. Bank of New Zealand was the first of the local big-four banks to enter the domestic market in 2016, pricing a NZ$300 million (US$207.2 million) covered bond on January 28, but this was the only domestic credit transaction until late February.

Three bank and three corporate deals priced between February 23 and the end of Q1, however, for total volume of NZ$1.7 billion (see chart on p24). In the corporate sector the New Zealand market leads its nearest neighbour, Australia – where no domestic corporate deals had priced by the end of March, although the local bank market remains relatively fertile.

Fonterra Co-operative Group (Fonterra) was the first corporate to return to domestic issuance in New Zealand, printing a NZ$150 million, seven-year deal on February 26. Meridian Energy (Meridian) and Genesis Energy priced NZ$150 million and NZ$100 million of seven- and six-year transactions, respectively, in early March.

David McCallum, director, investment banking at Deutsche Craigs in Tauranga, says domestic conditions are conducive for corporate issuance. "There are natural supply and demand factors at play," he tells *KangaNews*. "The supply side is helped by the fact that offshore markets are currently comparatively less attractive. This is paired with new simplified documentation requirements for existing issuers, which make for quick and simple execution and mean issuers are benefiting significantly from increased retail participation in the bookbuild process."

COMINGLING DEMAND POOLS

All three corporate transactions were issued in retail format. A challenge experienced by the New Zealand market in recent times has been a pricing gap between where retail investors will buy and the – typically wider – levels institutional investors demand for corporate paper.

However, some intermediaries believe the two liquidity pools have grown closer together. Chris O'Neale, Wellington-based director, debt capital markets at ANZ, says: "Of late we have seen widespread demand from both institutional and retail investors for local deals."

Mat Carter, director, debt capital markets and syndicate at Westpac Institutional Bank (Westpac) in Auckland, adds: "The bifurcation of demand has diluted, given wider credit spreads and the more constructive primary-issuance environment."

At the same time, New Zealand intermediaries say retail investors have reduced their pricing expectations as a consequence of two factors. One is a growing level of

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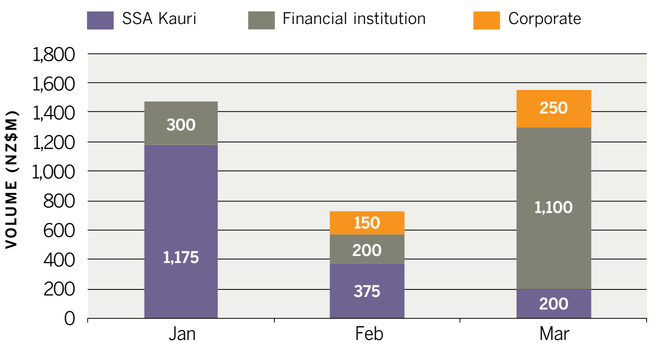

SOURCE: KANGANEWS APRIL 6 2016

sophistication in this sector – that investors are including bonds in more balanced portfolios and thus sticking with the asset class even when headline yields are less than impressive.

There is also an ongoing capitulation by retail investors to the idea that rates will be down at subdued levels for a while yet. "There is probably a view that rates are low, but they have been low for a while and they may not change," McCallum explains. "Waiting for rates to go up before investing hasn't been the right call for the last year or two. Who knows what rates are going to be like in a year or so from now? But if you have a balanced portfolio, and a laddered approach to fixed interest within it, you just have to accept where rates are and run with it. It's also worthwhile noting that for as long as inflation remains subdued the retail return is attractive despite the low outright rates."

One thing that certainly appears to be true is that the traditional preference for fixed income among retail investors remains in place – despite low yields. "Driven by the idiosyncrasies of the New Zealand market, we still see strong retail demand in spite of current low interest rates," says Stephen Hong, New Zealand fixed interest manager at BT Funds Management in Auckland. In fact, he says this may result in a greater proportion of refinancing being directed to the domestic market under retail documentation.

It is true that both institutional and retail liquidity continue to build. Fiona Doddrell, director, debt capital markets and syndicate at Westpac in Wellington, comments: "The retail bid remains strong due to the lack of supply and the ever-growing pool of retail cash. In addition, negative feedback from wholesale investors regarding relative value to offshore has dissipated to some extent, and we have seen institutional demand pick up across the retail and wholesale issuance landscape."

EASIER ACCESS

The mechanics of issuing to a combined retail and institutional investor base have been assisted by eased documentation requirements for retail-format deals – in particular by allowing retail deals to be brought to market more quickly. Hong says the same-class exemption rule helps corporates issue to the retail market in a "timelier and more cost-effective manner, and thus bring deals to market in the kinds of windows that help retain wholesale demand, too".

Meridian issued its March transaction – for NZ$150 million of seven-year paper – under the quoted financial-product exemption rules. Janine Crossley, group treasurer at Meridian in Wellington, says doing so "significantly reduced the documentation and time required to complete an issue", as well as providing access to retail investors to further expand the company's funding base.

DOMESTIC BOND PRICING

An issue for New Zealand credit issuance which came to the fore in 2015 was the ability of, in particular, corporate issuers to secure favourable pricing either from their banks or in international bond markets – specifically US private placements (USPPs). The latter market, in particular, received a boost to its already competitive pricing conditions by a conducive basis swap.

Pricing dynamics have clearly shifted in favour of the local option. Diana Gordon, fixed-interest portfolio manager at Gareth Morgan Investments in Wellington, tells *KangaNews* that local spreads have widened sufficiently in recent months to make New Zealand pricing more accurately reflect what is happening globally – with a consequent positive impact on demand.

"Institutional money has now become more interested in the New Zealand domestic market," Gordon explains. "This same sentiment would not have been true as recently as early January, as institutional investors still felt they weren't getting appropriately compensated for risk at the time."

While McCallum says pricing relativities vary by deal, he adds: "The domestic market is definitely pricing inside offshore markets, and that's driving some of the deal flow. On some of the recent deals it could be argued that bank funding might have been a bit tighter than where bond deals are landing. But I think there's an expectation that bank pricing will widen and that now is an opportune time to lock in longer-tenor domestic funding."

The proof of the pudding is in deal flow, and the fact that three corporates elected to use domestic capital markets between late February and the end of the first quarter appears to back the claims about relative pricing. Crossley confirms that the local option was the "most competitively priced for the volume and tenor required" by Meridian in its March transaction.

The company looked at the USPP and Australian dollar options before concluding that a New Zealand dollar deal would be "significantly more competitive", Crossley adds. As for the potential to fund in the bank market, she says the company was specifically seeking seven-year tenor, or longer than many banks are comfortable lending at. And she suggests domestic bond pricing is competitive with loans even in shorter tenors.

Meridian's successful outcome was aided by retail demand, which accounted for half the final book according to the issuer. But domestic pricing stacks up even for major-bank issuers, which traditionally offer too little yield – at least at senior level – to arouse retail interest.

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DAVID MCCALLUM DEUTSCHE CRAIGS

ASB Bank (ASB) priced a NZ$475 million, three-year deal at the start of March. Nigel Annett, general manager, treasury at ASB in Auckland, tells *KangaNews*: “Overall, I would describe the local market tone as constructive, with especially strong demand from our institutional and fund-management investor base in our most recent transaction.”

Conditions were sufficiently conducive to make ASB confident that a senior-unsecured transaction would work domestically, and that the issuer would not need to use its covered-bond capacity on this occasion.

Although Annett says ASB considered doing an offshore deal instead of a domestic, strong demand and lower execution risk meant the local market was far more attractive. “We were looking at the three-year part of the curve, which led us to the sterling market as a potential option. However, the UK was beginning to feel the impact from the ‘Brexit’ movement and investors were clearly nervous. Weighing up the risks compared with the domestic market made the decision for us.”

SUPPLY PROSPECTS

While the indicators are broadly positive on the demand side, New Zealand’s age-old problem with domestic supply shows little sign of abating. Investment funds continue to grow, but in the absence of substantial capex or credit growth a significant proportion of the nation’s savings will continue to be invested offshore.

There is little sign of significantly enhanced appetite for credit on the issuer side. “Major underperformance of the global or domestic economies will have an obvious effect on capex and general growth-driven debt levels. This is clearly a supply-side negative,” Doddrell confirms.

Shaun Roberts, director, investment banking at Forsyth Barr in Wellington, acknowledges that “supply has generally been the more difficult side of the equation”. But he adds that if higher bank funding costs flow through to the corporate lending market, this may further enhance the attractiveness of the capital markets to borrowers and keep the pipeline flowing.

The current year is not a standout for maturities in New Zealand. According to KangaNews data, NZ$1.4 billion of corporate issuance will mature in 2016 out of a total of NZ$5.2 billion of domestic credit redemptions. The equivalent totals for 2015 and 2017 are NZ$5.9 billion and NZ$5.1 billion, respectively.

As such, it appears that refinancing alone will not drive a step-up of supply in 2016 – unless borrowers refinance a proportion of offshore and bank debt maturing this year in the local bond market. And New Zealand market participants do have a degree of confidence that robust domestic demand will attract a bigger slice of the pie this year.

Deidre Copley, Tauranga-based head of fixed income at Craigs Investment Partners, says: “The additional volume of bonds brought to the market in Q4 last year and to date in 2016 has been very welcome – although some of the corporate bond offer sizes have been small, resulting in significant scaling. There are some proposed larger issues – more than NZ$250 million – which should increase the opportunity for demand, from both retail and institutional investors, to be satisfied.”

Meanwhile, Sara Double, director, debt capital markets and institutional lending at Commonwealth Bank of Australia in Auckland, says: “After a slow start to the year there is some good supply coming through with both bank and corporate deals coming to market. This is a good sign for the year.”

Sarah Minhinnick, director, debt capital markets at BNZ in Auckland, anticipates a solid pipeline. She comments:“The market saw a period of spread widening from November 2015 to March 2016, which appears to be stabilising. Demand remains strong, with recent transactions being well oversubscribed. Retail investors in particular are demonstrating good appetite for bonds, even at lower coupon levels.”

One upside of increased global volatility may be an enhanced marginal preference on the part of issuers for the comfort of home markets. Minhinnick comments: “We expect New Zealand issuers with a natural demand for New Zealand dollars to continue to fund in their home market, provided pricing remains competitive versus funding options from offshore fixed-income markets and so long as those issuers do not have bespoke tenor, volume or diversification objectives.” •

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FIONA DODDRELL WESTPAC INSTITUTIONAL BANK