

Strong market conditions assisting corporate borrower outcomes



The Australian Financial Review DealBook's respected journalist, Paulina Duran, recently sought out a detailed Q&A session with the leaders of PwC's Debt & Capital Advisory practice within Deals, the content of which is provided below. The resultant article was published on 22 April 2011.

Improving capital market conditions

The DCA team is constantly involved in providing strategic guidance to chief financial officers and Boards of large companies including the top ASX50 to ASX200 companies in relation to their capital management strategies and accessing funds both here and offshore. What are the opportunities in the current debt markets a CFO can't overlook?

DCA: Since the onset of the GFC, CFOs and Boards have been concerned by and focussed on "right sizing" their capital structure to meet both the general trading conditions and the prevailing challenges in the debt markets.

Over the last 18-24 months, borrowers and lenders have been concerned about the looming "refinancing bubble" that is to arise in 2011 and 2012, much of which arose through the restricted lending conditions and loan tenors made available during this challenging period.

This year presents a more optimistic outlook for both these issues. Firstly, trading outcomes for much of the market have been broadly resilient and improving, thereby meaning that capital structures (and debt levels) have met their intended needs and now provide a strong basis for ongoing improvement and enhancement for many. Additionally, domestic and international lenders and capital markets more generally have recognised both the absolute and

relative resilience of the performance of Australian borrowers and have a strong demonstrated appetite to provide credit to them.

The market now presents highly compelling reasons to seek to refinance expensive or onerous borrowing arrangements. Strong credit borrowers, particularly those with investment grade ratings or characteristics, are able to look to an ever widening range of markets to provide competition to terms (including longer tenors) and to pricing.

For example, the US private placement (USPP) debt market is proving to be a very attractive market for many, not just borrowers with natural USD borrowing needs. Investors are increasingly becoming capable and comfortable in providing AUD-denominated facilities, thereby making this offering more directly comparable with conventional loans, as there is no cross-currency swap required of the borrower (although differing early termination or prepayment issues arise).

This market has shown a great and disproportionate interest in quality Australian borrowers, with around a dozen issuances into this market already in 2011. During 2010, Australian borrowers accounted for around 11% of all USPP issuance – hardly in line with the aggregate borrowing needs across the globe. Other international and domestic bond markets are also legitimate and material sources of liquidity to strong investment grade borrowers.

Whilst changes in the global regulatory environment have changed the banking landscape to some extent, both domestic and foreign bank lenders have shown strong and increasing credit appetite for corporate and institutional loan exposure – particularly as many of the existing larger corporate borrowers of the major domestic banks have refinanced into other markets. Foreign lenders, whether based locally or offshore, are increasingly seeking out and participating in loans to strong Australian credits, allowing borrowers to widen and diversify their banking group without becoming unmanageable.

There are clear opportunities now to seek to unwind legacy GFC based financing structures, terms and pricing, and move back to a more balanced outcome between borrower and lenders.

Strong cashflow generation by many companies also means that capital management initiatives are now back in consideration. Cash accumulation has been a means to provide buffers to balance sheets and/or a war chest for opportunistic acquisitions. In both these regards, the improvements to the debt markets – both appetite and reduced challenges to access – means that CFOs and Boards can once again consider what the ongoing “right sizing” of their capital structure should be for the future and thereby their core debt sizing requirements. While to date this has primarily occurred at the “big end of town” (eg Rio Tinto, BHP, CSL, etc), the opportunity to carry out sensible capital management initiatives is available for consideration by boards across the ASX 200.

The changing roles and balance in the debt markets

As head of the debt & capital advisory practice for one of the world leading advisory firms, what is your forecast for the role of banks and intermediation of the lending function in Australia? Will companies continue to steer away from banks?

DCA: The role of banks across the globe has been changing to reflect both market opportunities and regulatory market requirements. We are currently going through a marked change in both such that we see a further divergence in the way in which various banks will respond in due course. It is also important to recognise that the opportunities and challenges differ greatly between “blue chip” borrowers and smaller or non-investment grade companies.

It is unquestioned that the major trading banks in Australia will continue to provide a very core, important and significant lending function to corporate Australia. It is important to recognise that banks in providing “credit lines” to borrowers, provide these by way of funding lines as well as other credit-related but non-funding products, such as interest rate and FX hedging instruments, performance bonds, letters of credit.

Banks seek to apply their increasingly scarce capital in a manner that best addresses core and value adding activities. With a scarce capital base, banks will seek to find ways of maintaining and supporting borrower relationships whilst, possibly, seeking ways to reduce the funding participation through acting as an intermediary rather than direct lender. Where choices arise, borrowers are expected to focus their banking relationships on higher value adding activity for them. These would include M&A and acquisition style financings where there are short time frames in which to secure funding, flexibility needs are prominent and confidentiality is paramount. As the economy continues to improve, these services are likely to become more material and important in the market.

Prior to the GFC the domestic and international securitisation markets provided a widespread opportunity for participation of institutional investors into direct lending or credit exposure transactions – a major form of lending disintermediation in the market. Whilst the securitisation market has since experienced challenges and issues over recent years – some clearly justified and some not – other non-traditional lender relationships are starting to emerge, particularly with institutional investors.

We have seen a number of domestic institutional investors directly participate in loan arrangements alongside traditional bank lenders. This is an area of opportunity being considered by both banks and institutions alike, as the growing pool of superannuation and other investment seeks to be effectively and efficiently deployed across markets.

Australian superannuation and other similar funds have a materially lesser asset weighting to the debt market sector generally than their peers in other parts of the world. As the Australian fixed income market is an essentially investment grade driven market, there is great pool of borrower at the corporate and institutional level that are supported exclusively or principally by bank lenders in meeting their funding needs. However, institutional investors are not naturally set up to look at and manage credit and funding exposures in the same manner as banks, so there are clearly some significant challenges to be overcome in unlocking this pool of potential liquidity.

When it comes to lending, which clients are favourites amongst banks and why? Which sectors are out of favour and what are their options?

DCA: The banks remain attracted to strong credit worthy borrowers that provide strong product “cross-sell” opportunities other than just simple loan funding needs. Having said that, it is this sector of the market that has been refinancing into other markets, and not necessarily using these historical core lender relationships.

Relationship is an increasingly important factor for both banks and borrowers. Banks will often seek to maintain a higher exposure to a particular client in order to reduce the likelihood of an unwanted lender stepping in and adding unwanted competition to the pool of ‘cross-sell’ opportunities, such as bond issuance, transaction banking, hedging, etc.

Banks have to date sought to maintain higher portfolio weightings to non-cyclical industry sectors and players, such as healthcare, infrastructure, utilities and other consistent demand businesses, but even these sectors have demonstrated challenges over recent times.

Credit fundamentals are important, as well as strong experienced management teams with demonstrated capability and integrity.

The property sector is clearly the most prominent sector that is still generally struggling for access to liquidity. This market sector continues to stratify with the strong investment grade REITs increasingly accessing highly cost effective funding from both domestic and international capital markets, reducing the need for and reliance on banking funding lines in their ownership and investment activities. Relationships are very important in this sector.

Other smaller participants are seeking a range of solutions, but importantly focussing on preserving the liquidity lines they currently have.

Fees in the debt markets

Financing in the debt markets is not the straightforward process it was five years ago. How have arranger fees in the loan and bond markets changed to reflect this? Is increased competition having an impact?

DCA: Accessing debt market financing is, in our opinion, migrating back to the more “normal” (not boom) market conditions that prevailed well prior to the onset of the GFC. There are still many complexities to be considered, and lender dynamics and attitude are no longer just merely price and opportunity driven as was the case during the pre-GFC boom period.

During the GFC, arranger and upfront fees rose dramatically, as did loan and issuance margins. Some of these fee increases were due to changes in regulatory treatment and costs (for banks), others were a reflection of the increased challenges and complexities that arose in seeking to obtain financing outcomes, while in some instances they were simply a result of opportunism as the balance of power had shifted in favour of the lender. Consequently, we do not expect a full retracement to pre-GFC levels in the short term.

Competition is generally re-emerging, but challenges and complexities still exist in securing many refinancing outcomes. It is these factors that are

likely to maintain higher levels than were prevalent immediately pre-GFC.

However, like all fees, it is important that the borrower or issuer sees value in them and that there is a clear alignment between the respective interests of the arranger and the borrower. Many sophisticated borrowers have typically narrowed the role required of “arrangers” and thereby reduced the fees incurred to reflect the more streamlined value adding component of that role. Greater preparation and awareness by these parties provide them with this opportunity, without diminishing the core and real role that the financing counterparties play in securing funding for borrowers.

This ability to be prepared is not restricted to these more sophisticated borrowers, but it is less common in others as knowledge and information about the market for these other borrowers is less transparent.

How will carbon policy changes impact the market?

What impact is carbon pricing policy likely to have in the capital markets? What are lenders doing to mitigate the risk? What other challenges do utility borrowers face in meeting their large refinancing requirements?

DCA: Carbon policy continues to cause uncertainty in the capital markets, particularly where associated with energy-intensive businesses as well as the energy sector itself. Without a clear and unequivocal line of sight and timeframe, many lenders and borrowers are aware of the potential risks but are unclear as to what will happen and thereby how best to address the anticipated outcomes. Carbon policy outcomes may have both profitability and liquidity timing (ie changes in working capital) outcomes to borrowers that will require careful consideration when determining an effective response by all stakeholders.

Lenders and borrowers within the coal-fired generation sector have been managing this risk for. At least, the last 2 to 3 years but still with no increased level of certainty than perhaps was anticipated in 2009. Within this period a number of lenders have withdrawn from the market but, despite this, refinancing of these assets has been achieved under terms that are reflective of the market recognising the strategic and essential nature of these assets. More significantly, uncertain market conditions have resulted in restricted access to investment capital leading to a potential under investment in the long term maintenance of these currently essential infrastructure assets. This also challenges the deployment of new capital to meet increased and replacement capacity demand and needs – a risk that is gaining increasing attention across State and Federal governments.

The renewable energy sector has also struggled to access financing. Uncertainty resulting from carbon policy, other green energy initiatives and associated policy changes has resulted in market conditions that have not supported the expected investment performance of this developing market segment. Power purchase agreements with energy users have remained critical to development of new projects and, to a lesser extent, mitigating the merchant pricing risks of even major base load power generators.

This situation has highlighted the risks inherent in government policy formulation processes. Even regulated utilities (eg power transmission and distribution, and water utilities) have been subject to changes in government policy, and also the response by the independent pricing regulators. Whereas government policy risk had been considered a lower risk variable by credit rating agencies for regulated utilities, this is not necessarily the case now. This change impacts the determination of efficient and optimal capital structures for many borrowers in this sector.

Financing developments in the resources sector

Mining companies have been active issuers in the high yield market this year. Are markets becoming too complacent with that sector? What are the main safety checks, precautions and risks that financiers need to be taking into account when lending to these issuers?

DCA: Strong resources prices and outlooks have widely assisted existing and new resource projects to consider a widening range of financing options, including the high yield market. 2011 has seen the highest number of material issuances into the high yield market by the resource sector for some time. High yield markets are typically a USD denominated market, and with base US interest rates being at historical lows, even with the high margins payable the all-in price offered by these markets present very attractive opportunities for these borrowers to match fund their anticipated USD revenue base from these businesses at a low overall cost of capital.

There are some fantastic success stories in this sector. Nonetheless, there are lessons to be learnt from history when other high yield offerings from the resources sector did not result in such a rewarding experience for investors. The high yield market is a market where such risks are evident, and it is up to the investors to seek to understand the risks and drivers that will mitigate these risks and, in particular, put them into relative comparison with other projects both in Australia and globally.

The resource market is a global market, with demand being heavily driven out of China and North Asia generally. Australia is also not the only provider of these resources, so increased supply and/or a risk of

collapse in demand are material variables that did not exist in this market 5 to 10 years ago. This means that investors need to now look more deeply into how individual borrowers and project seek to secure their production and revenues in this changed market context.

High yield markets generally provide more flexible financing terms than typically available from bank project finance lenders. This is because project finance lenders typically seek to lock down all sorts of risks to revenue and costs to best ensure that the loan is able to be serviced and repaid. Often these lenders require terms that project sponsors would prefer not to lock away, such as commodity price, where many project sponsors will attest that this is a core value requirement to the equity stakeholders.

With less uncertainties tied down in a high yield offering, it is up to the investors to better understand the risks involved in the project, including management and the broader competitive market. A more detailed assessment of financial capacity and management strategy to address unexpected risk is required, as the loan instruments themselves do not provide the strict protection to investors offered in bank project financing arrangements. This means that the capital structure requirements and approach between comparable projects in the same market using these differing approaches may materially impact on the possible outcomes to both equity and debt stakeholders even though they operate in the same prevailing market conditions over time.

Development in the Asian lending market

We have seen an increased level of Asian investors participating in Australian debt deals (both loans and bonds). Is this trend evidence that the Australian market is now integrated into the larger Asia-Pacific region? Or is Asian participation still driven by particular interests and circumstances?

DCA: As in many global debt markets, Australian borrowers are seen as increasingly attractive. Asian investors, particularly Asian banks, have also been active participants in meeting the debt financing needs of our stronger borrowers, and some other select market opportunities and sectors. Since the GFC, this market has evolved further. Unlike Australian banks, the vast majority of funding for Asian banks has been by way of their deposit base – they typically do not rely on international wholesale funding to provide lending capacity. As a result, they have become yield and value driven lenders, but still with a strong relationship bent as this deposit base is also recognised to be scarce and finite.

In the past two years, Australian borrowers have actively sought to target Asian lenders in their own market through Asian syndicated debt offerings. This

is in contrast to earlier times when the more common approach was to seek some Asian bank participation in Australian domestic loan syndications.

Both Australian tax laws and the increased number of interested Asian banks have made the Asian syndication market an attractive and cost-effective stand alone funding market for borrowers.

Within the Asian market there is a limited pool of highly credit worthy corporate borrowers. This limited pool have generally been able to command tighter pricing outcomes from this market competition when compared within comparable borrowers in other markets. In contrast, Australian borrowers typically offer either better credit quality and/or improved pricing outcomes to Asian lenders when compared to their local borrowers. This market generally commands a slight premium over domestic only transactions, but as it has developed into essentially a new stand alone market, the diversification value is considered to be well priced.

It is still important to look at the Asian market and the attitude and response of lenders separately by geography. Whilst Chinese banks still generally require some form of Chinese influence to support the provision of credit, the manner in which the influence or interest may evidence itself appears to provide greater scope for consideration in the more structured end of the loan market (eg project specific).

Taiwanese banks, which have historically only taken small participations in well-priced deals, are now demonstrating materially greater appetite but still with a value rather than relationship or cross-sell based driver. Korean banks are by and large supporting transactions that have a Korean link, but not exclusively. Japanese banks are materially increasing their lending activity, but the 3 major banks primarily undertake this through their Australian business, but see lead syndication roles into the Asian market as valuable cross-sell or core proposition opportunity.

A copy of the published article in the Australian Financial Review can be found at:

http://afr.com.au/p/markets/dealbook/opportunities_abound_for_cheaper_7pOKBNa0MPOUxVBBFHLkoM?hl

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