



ASIA-PACIFIC *Debt Capital Markets* EVOLVING TO SUPPORT A REGION IN TRANSFORMATION

The massive and unprecedented transformation of the Asia-Pacific region, driven by demographics, growing wealth and technological innovation, and reshaping economies, society and infrastructure alike, means debt capital markets must evolve to match. This was the central theme that emerged from the recent **National Australia Bank (NAB) 2017 Asian Debt Capital Markets Conference**, attended by a wide range of experts, issuers and investors.

While delegates made it clear that more needs to be done to shape debt capital markets to support the region's rapidly growing needs, they also identified a number of promising trends. They were united on this being a time of clear potential: to enhance emerging connections between markets; to build infrastructure that both supports rising populations and contributes to sustainability targets; and to develop innovations in funding and service delivery that meet the goals of communities, issuers and investors. Asia-Pacific's dynamism, in other words, will continue to stand it in good stead.

Soaring infrastructure demand

Any examination of the region's capital requirements, whether by a government, issuer or investor, must begin with the acknowledgement that demographic and financial pressures mean countries can no longer 'go it alone.' As Steve Lambert, Executive General Manager, Corporate Finance at NAB, pointed out, as populations rise, grow older and cluster in urban areas, "governments can no longer fund the infrastructure advanced economies need due to financial constraints." Australia's population, for example, is set to grow by the equivalent of another Canberra-sized city each year, yet the country is also confronting a fiscal deficit, underlining the

need to attract private sector investment — including from overseas.

Conscious of these demands, the Australian government made infrastructure a major focus of its recent 2017-2018 budget, boosting planned infrastructure investment from 2013-2014 to 2020-2021 to A\$70 billion from the previous A\$50 billion.

Also notable is that the budget "includes an increasing diversity of funding mechanisms for (infrastructure) projects, including equity injections into government-owned companies and concessional loans in addition to conventional grants," said Peter Jolly, Global Head of Research, Fixed Income, Currencies and Commodities at NAB.

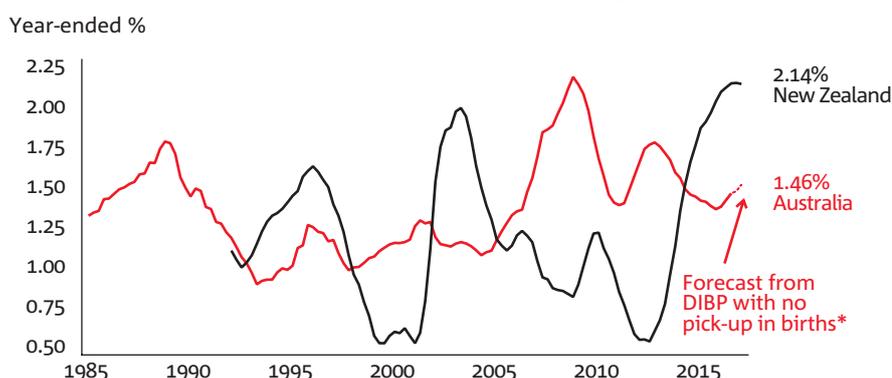
A similar pattern is evident throughout the region. Take Auckland, New Zealand's fastest-

growing city, where around 800 new residents arrive each week and some NZ\$2 billion in infrastructure investment is needed each year to keep pace with growth, according to Sue Tindal, Group Chief Financial Officer at Auckland Council. The limited size of the New Zealand debt capital market means Auckland Council needs to raise around one-third of its funding offshore, and the "Asian market is very important" for that purpose, she said.

Regional forces are also shaping the development of Australian and New Zealand infrastructure and contributing to the financial viability of this infrastructure going forward, further underlining the growing interdependency of Asia-Pacific economies. The recently privatised Port of Melbourne, for example, which attracted almost half of its debt capital from Asian lenders, has grown primarily on the back of Australia's booming trade with the rest of the region.

At the same time, governments are increasingly being called upon to deliver infrastructure as a service — that is, with the end-user in mind, and rigorously measured in terms of customer satisfaction, financial and other key performance indicators. In markets like Australia and New Zealand, this concept is already "legally embedded," Ms. Tindal said. It is also taking root elsewhere in Asia as governments strive to meet the needs of an expanding middle class.

Chart 1: Australia and New Zealand population growth



* Incorporates net migration forecasts from the Department of Immigration and Border Protection
Source: ABS, National Australia Bank

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Asian investors and Australian infrastructure: Towards a future-proof partnership

Sustainability no longer optional

One of the biggest demands — from communities, regulators, investors and industry alike — is for infrastructure to be built in a more sustainable way. As noted by Sean Kidney, CEO and Co-Founder of the Climate Bonds Initiative (CBI), current climate change trajectories point to potentially devastating consequences for the planetary environment, and hence economies and investors, by the second half of this century.

This means future infrastructure has to be ‘built green’, taking into account the impact of climate change and the regulations that are likely to arise as governments move to stave off a crisis. Norway, for example, has already unveiled plans to phase out fossil-fuel-powered cars,¹ and countries like China and India look set to follow suit.

“If you’re investing in infrastructure for cars and you’re not thinking electric straight away, you’re missing a trick,” Mr. Kidney said.

“In every sector you can think of there is concerted public action to shift to green infrastructure. Place your bets now: do you want to bet on a company operating with 20th century infrastructure or a company that’s building 21st century infrastructure?”

This push is also coming from the investor side as more funds operate under sustainability mandates and commit to divest from fossil fuels or other sectors associated with negative environmental impacts, given concerns about climate change and future returns.

While sustainable investment may have traditionally been slower to catch on in Asia than the West, many delegates see encouraging signs of change. “It’s no secret that a growing pool of capital is seeking to invest with purpose as well as return,” remarked David Jenkins, Director, Corporate Finance at NAB. “On the investor side, Australia and New Zealand is the second-fastest-growing region globally, behind Japan, in terms of funds going into responsible investment capital.”

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¹ <http://elbil.no/english/norwegian-ev-policy/>

Green bond solutions taking off

Soaring demands for green infrastructure, and investments that are both sustainable and capable of generating solid returns, can be addressed through a single instrument: green bonds, or bonds used to fund projects that have a positive environmental impact. “It’s a marriage made in heaven,” Mr. Kidney said. “Investors worried about yield and climate risk on one side, and on the other a huge infrastructure pipeline financed or refinanced through green bonds.”

This convergence of interests has fuelled massive growth in the green bond market in recent years, though green bonds still represent only a sliver — 1.4% — of global debt capital market issuance, according to Moody’s.² The CBI estimates total green bond issuance could nearly double to US\$150 billion this year. Importantly, much of this growth will be rooted in Asia, presenting new opportunities for issuers and investors alike.

Though a relatively late entrant to the market, China has gone from “zero to hero” in green bond terms, Mr. Kidney said, issuing some US\$40 billion worth last year as the country gears up to meet its environmental targets.

CBI China project manager Ivy Lau noted the market would grow even further as the country’s authorities have made it clear the public sector will only account for a small portion of infrastructure investment and that infrastructure must ‘go green,’ pointing to “huge potential” for private investors. “Green bonds are an ideal tool for investors because they’re stable, rated and provide large liquidity,” she added.

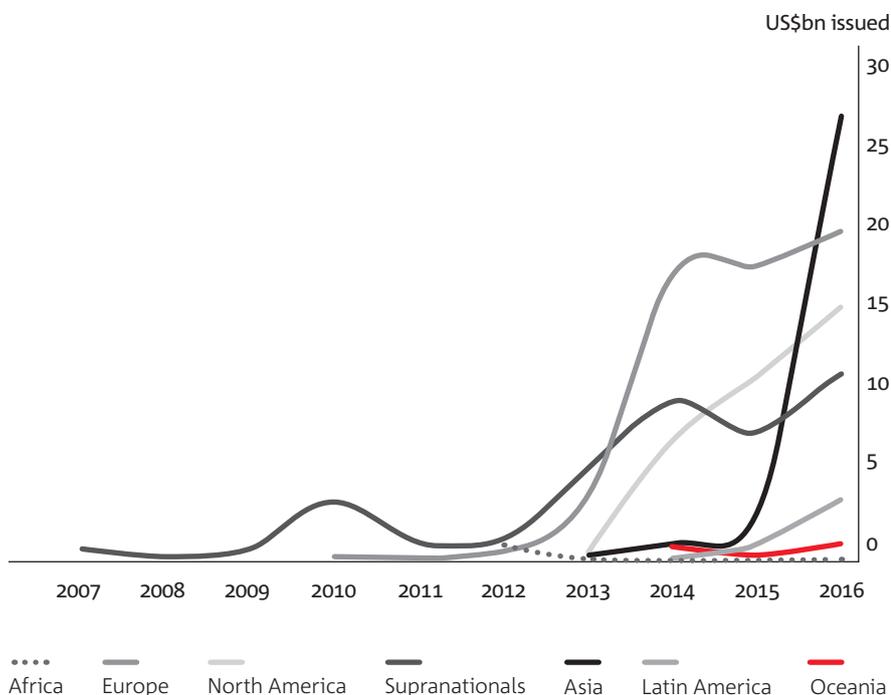
The People’s Bank of China is also moving to support green bonds by enhancing the regulatory framework and encouraging third-party verification of issuances, Ms. Lau said.

Similar moves are afoot elsewhere in the region, such as Singapore, where the Monetary Authority of Singapore (MAS) is introducing a grant scheme to help companies absorb green bond issuance costs. “That’s a tremendous step in the right direction to reduce the burden on the issuer of the additional cost to issue a green bond — which is minimal, but there is a cost,” said Trisha Taneja, Green Bonds Advisor at Sustainalytics, an independent global provider of environmental, social and governance (ESG) research, ratings and analysis.

As with service-oriented infrastructure, there is clear potential for Australia to serve as a green financing model for the rest of the region. “To engage with the investor base any green bond needs to be credible,” said NAB’s Mr. Jenkins. “Australia is leading in this respect, and our market has developed with investor requirements for high levels of transparency and credibility for green bonds at the forefront.”

NAB, for example, has embedded a robust framework in its green bond platform, Mr. Jenkins added, developed in accordance with the original Climate Bonds Standard. “We will see more repeat issuers, more opportunities in terms of structure, issuer types, sectors financed and a collaborative investor-led process. There has to be transparency in terms of what the impact is; credibility is key, setting the benchmark as high as possible.”

Chart 2: Green bond issuance by region



Source: Climate Bonds Initiative (January 2017), National Australia Bank

² <http://www.reuters.com/article/bonds-greenfinance-idUSL4N1F91C0>

Social bonds on the rise

Another aspect of the growing role of sustainability in regional debt markets is the social bond, the proceeds from which fund projects that deliver positive social benefits such as workplace gender equality, essential services or affordable housing. Social bonds are an even more nascent asset class than green bonds, but “have come to prominence in the last couple of years,” said NAB’s Mr. Jenkins.

“NAB has developed a social bond framework as we did with green bonds,” he added. “They align with the infrastructure theme because they can extend across so many essential services, such as healthcare, education and affordable housing. And again investors are focused on credibility, exactly where the proceeds are being deployed.”

The market was given a major boost recently by the launch of a social bond program by the International Finance Corporation (IFC), which kicked off in March 2017 with a US\$500 million global benchmark issue.³

The proceeds “will go towards two types of loans, financing women entrepreneurs and also services that go to the ‘base of the pyramid,’ people who earn US\$8 or less a day and don’t have access to basic goods,” said Flora Chao, Senior Financial Officer at the IFC. “It was 1.4 times over-subscribed, but what was amazing was that 20 percent of the investors were brand new. We’ve been around for a long time, and that’s quite telling for issuers — they can know they’ll benefit from investor diversification.”

The power of diversification

Diversification was another key regional theme raised by delegates at the NAB conferences — in terms of issuers, investors and types of issuance alike.

“Greater Asian participation in terms of both issuers and investors is bringing more depth and diversity to the market,” noted Melissa Gribble, Head of Frequent Issuer Coverage at NAB. “It also enhances Australia’s reputation as a market where global issuers can access both Australian and Asian investors.”

As well as changing demographics, Asian participation is being fuelled by the hunt for yield at a time when returns on traditional investments are low. And when Asian investors do widen their search for opportunities, Australia and New Zealand are natural first ports of call.

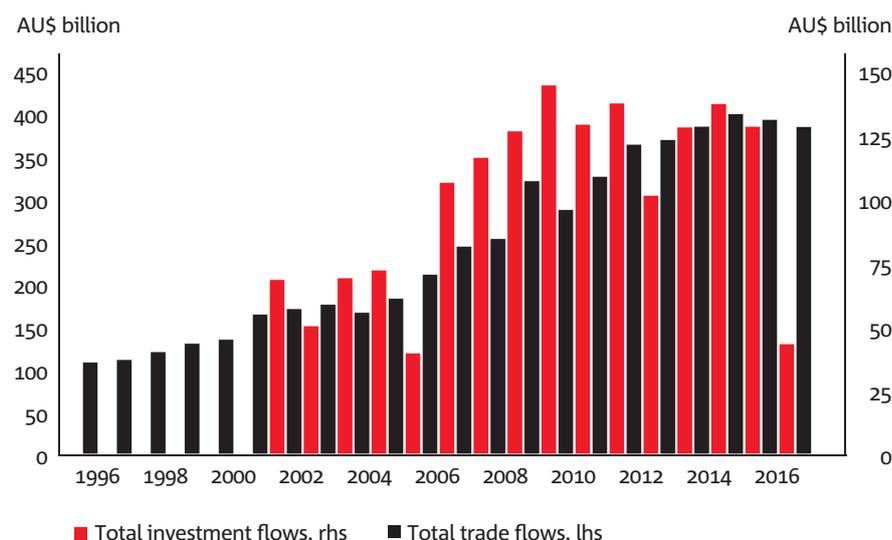
“There’s a low yield environment globally; Australia and New Zealand offer a reasonable

pickup in that yield in an environment that’s stable from a regulatory and legal perspective,” said Matthew Hall, Principal at QIC Global Infrastructure. “There’s a lot of transparency both into the regime and also the pipeline of opportunities that will come.”

Many see the potential for this dynamic to develop even further, not least due to geography, social factors and the simple facts on the ground. “Education is Australia’s largest and fastest-growing service sector, so many people in this region know Australia in multiple ways,” said NAB’s Mr. Lambert. “The linkages into this region are so great now.”

Australia’s largest trading partners are in Asia and the country “is getting more and more deeply integrated into the regional supply chain,” he added. “Capital flows have changed significantly in the past 20 years; Australia is now the third or fourth largest pool of investible funds. The Australian economy has grown strongly and the share of money going offshore has grown even greater. And this is a two-way story.”

Chart 3: Foreign flows between Australia and APEC



Source: Bloomberg, Macrobond, National Australia Bank

³ <http://www.mondovisione.com/media-and-resources/news/ifc-launches-innovative-social-bond-program-raising-500-million-through-benchm/>

New targets in the hunt for yield

The growth in yield-hungry Asian investors is being matched by the emergence of more firms in Australia and New Zealand that may be primarily domestically focused, but are keen to tap into an international investor base.

“The search for yield is prompting investors to think more broadly,” said Phil Swan, Treasurer at Newcastle Permanent Building Society, a mortgage-focused lender based in New South Wales that has become a regular issuer. “(More) investors are prepared to consider our name and get more acquainted with us as an organisation. Once they get past that hurdle, they look at a BBB+ entity like us and see the risk-reward tradeoff is attractive. They realise it’s a no-brainer, and wonder why it took so long.”

“We saw the opportunity to get our name out in the market and to start to diversify our funding sources,” agreed Paul Logan, CFO of Airservices Australia. As a government-owned firm with a monopoly on Australia’s air traffic control and rescue services, the company is an attractive prospect, but, according to Mr. Logan, has

still had to work to structure products for the region’s various investment appetites.

“It’s quite difficult to position issues to satisfy everyone,” he said. “Japan is looking for longer tenors; Hong Kong is more focused on yield; Singapore sits in the middle. The challenge for us as a small issuer is getting that balance right.” For Airservices Australia, one answer has been dual-tranche bonds.

Toyota Finance Australia, which provides financing for Toyota’s Australia customer and dealerships, is also conscious of the “need to diversify” and is “actively establishing [itself] with Asian investors,” said Carol Lydford, the company’s treasurer. As well as a domestic note programme, the firm’s issues span Euro medium-term notes, private placements and Uridashi bonds targeting Japanese retail investors.

Bank of New Zealand (BNZ) has also been building its US dollar and European exposure and has seen Asia emerge as a major force in US dollar issuances from Australia and New Zealand, according to BNZ Group Treasurer Neil Bradley. “It’s a big change over the last few years — Asian investors are putting their names down with confidence on every offer.”

BBB+



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An era of opportunity

Importantly, many delegates noted these debt capital market trends are taking shape against a backdrop of increasingly favourable economic and market conditions.

In Australia, there are clear signs the worst of the downturn that hit the country's resources sector may be over. As Michael Bush, Head of Fixed Income Credit Research at NAB, pointed out, earnings expectations are improving and "there has been a recovery in the assessed credit quality of Australian corporates pretty much across the board." Corporate bad debt is hovering at record lows and domestic banks are also in a strong capital position.

There are also more opportunities emerging in Asia, as evidenced by MAS's moves to grow the market for green and other forms of debt in Singapore; efforts to expand issuances in India; and most notably the opening of the China Interbank Bond Market (CIBM) in 2016 to foreign investors.

"Chinese authorities' strategic goals of renminbi (RMB) internationalisation, and developing and deepening the domestic capital markets dovetail in the opening up of the CIBM," said Christy Tan, Head of Markets Strategy and Research, Asia at NAB. "Increased foreign participation will help diversify ownership and reduce market volatility. It will also create even more reasons for investors to hold RMB assets and raise the share of these assets in global portfolios."

"Investor demand for Asian credit is strong in the context of the low yield environment," said Lorna Greene, Director, Origination and Debt Syndication Asia, Corporate Finance at NAB. "The driving growth of the dollar debt market is USD issuance targeted at Asia and Europe. In the past it was a smaller market, but the depth of demand is now so

strong that US\$1 billion-plus transactions 2-3 times oversubscribed are achievable. The shift in wealth from west to east, the changing demographics, mean there's a lot more cash to be put to work here."

As well as diversity and dynamism, the regional debt market is increasingly characterised by innovation, in everything from the structuring of transactions to the green and social bond spaces. Australia's early lead in these fields will ensure it plays a growing role not only as an investment destination, but as an exporter of innovation and expertise to the rest of the region, particularly in areas such as green bonds and infrastructure finance.

The end result will be regional debt markets that are in many ways more self-taught and self-sustaining, and that balance financial with environmental and social returns. As Jacqueline Fox, General Manager, Capital Markets & Advisory, Corporate Finance at NAB, noted, "the lightbulbs are going off": the immensity of the opportunities now available to issuers and investors — governments, corporates, consumers and regional financial institutions — is becoming clearer to all.

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