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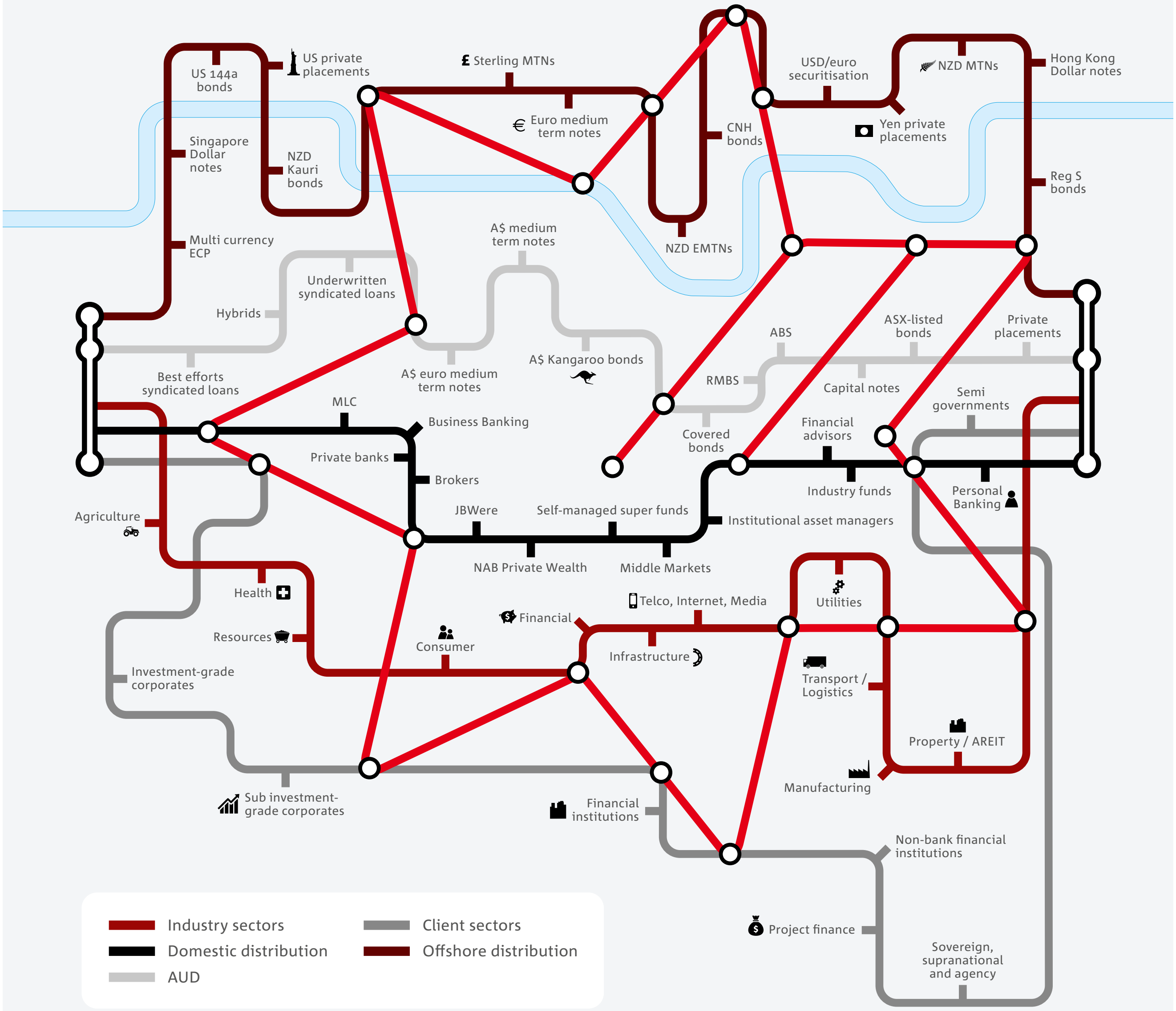
Sector Insights:

# Corporate Finance Insights

November 2014

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# Welcome

**Peter Stephens**
Head of Capital & Ratings Advisory, NAB Advisory

**Welcome to the November 2014 edition of NAB's Corporate Finance Insights. With more to talk about and more to think about, our Corporate Finance Insights publication focuses on themes that are topical and relevant to our clients. As with all publications, we include interviews and opinions from key market participants to provide you with insights that can help with your strategic business decisions.**

In this edition we are pleased to present a compilation of articles with the underlying theme on change.

We celebrate the successes of Western Australia-based GR Engineering Services a company that has developed a global reputation for its innovative approach to delivering fixed price engineering design and construction services to the resources and mineral processing industry.

We ask our Chief Financial Officer his view of the barriers and challenges for the Australian business landscape; he also shares his aspirations on the operating framework for Australian businesses with a call for greater transparency and support, while also sharing a little about his career and personal drivers.

Continuing on the theme of CHANGE we are seeing an increase in innovation in response to growth demand for fixed interest product. We talk about a growing theme in the Australian debt market for sub-investment corporates diverse funding through capital markets issuance through non-rated over the counter markets.

We hear from Kane Thornton, Deputy Chief Executive of the Clean Energy Council on the groundswell of consumer interest both from Australian households and businesses on solar power solutions to assist in the management of rising electricity costs. A drop in the cost of solar panel systems and new funding solutions is making solar power an increasingly attractive option and could potentially change the electricity landscape in Australia.

We trust that you enjoy the latest instalment of our Corporate Finance Insights series and we welcome any feedback.

Yours sincerely

Peter Stephens

## In this issue

# Business view from the CFO's office

**Craig Drummond**
Group Executive,
Finance and Strategy

**"The cost of doing business and the lack of investment in research and development are among the key concerns for Australian businesses," says Craig Drummond, NAB's Group Executive, Finance and Strategy. In this profile, Drummond shares his views on what's driving the Australian economy, key customer concerns, NAB's expansion and investment plans – and the joys of the surf and recharging through fitness.**

As Australia continues to evolve structurally and economically to compete on a global scale and generate domestic prosperity, there's an urgent imperative for Australia to remove barriers to corporate innovation. But there are some immediate hurdles to overcome.

Drummond notes that customers are expressing concern about the impact of costs. This is partly driven by the high value of the Australian dollar, red tape, compliance and tax issues that are pushing up costs, with corporate tax rates higher than many jurisdictions in the region.

"As a nation if we want to compete in a world that's been through tougher times than us and during that time have driven their costs down, we need to do a better job across our supply chain costs," he says.

Drummond also believes Australia's ability to compete globally will be compromised if we don't invest.

"We need more investment and research and development in sectors outside of mining; without this Australia will lose its reputation as an innovative nation," he says. "Australia has missed that long-term spending over the last five to 10 years; we tend to look at the financial results for the next six months, which is very shortsighted."

He suggests following the example set by the US, which continued to invest in technology and innovation even during the toughest times of the Global Financial Crisis (GFC).

### Investment and expansion

Ramping up investment would augment the positive elements of the Australian economy, such as a stable government, strong population growth and the fact that it's located closer to the growth markets in Asia than many of its competitors and in a similar time zone.

"In spite of the challenges we face, opportunities abound in specific sectors", says Drummond. He predicts tourism and education will continue to be drivers of economic growth for Australia internationally, along with the mining sector, which has now transitioned to the export phase from the investment phase.

He sees potential to expand the agriculture sector but argues that there needs to be greater investment in distribution, transport and logistics infrastructure. For example, the investments made by New Zealand in the agriculture sector over the past three to four years have made New Zealand an even more significant competitor in agribusiness.

Drummond also sees significant privatisation opportunities coming out of the state and federal governments after a lull over the past decade. These are particularly around infrastructure assets handled by government including building hospitals, roads, electricity, ports and property assets.

"These are areas where the bank has deep expertise and we have plenty of capital for the right opportunities and the right customers," he says. "If it's a great customer of the bank, a good industry segment and a sensible investment case then we are very much open for business."

Further afield, NAB continues to move ahead with its deeply specialised approach to Asia. With so much discussion about the potential of the region, Drummond believes it's important to pinpoint key opportunities and focus resources accordingly. He says NAB – which has a significant share of the business banking market in Australia – will continue to play a key role for its customers wanting to engage with Asia.

"We're not focused so much on lending in the Asian market to Asian clients, but on Australian and New Zealand clients in Asia and the large Asian clients looking for opportunities into Australia," he says. "You can't be everything to everybody in our business and therefore we're focused in the areas where we have significant advantage."

He nominates healthcare, agriculture and infrastructure as three sectors where NAB enjoys significant market share and competitive advantage regionally.

## Banking is about people

"Banking is about people" is the firm belief of Craig Drummond whose financial career started in 1982 when he joined KPMG after graduating from the University of Melbourne with a Bachelor of Commerce.

He qualified as a Chartered Accountant but has spent most of his banking career as an investment banker. In 1986 he joined the Melbourne based JBWere as a banking analyst, and worked there for the next 23 years, eventually becoming Chief Operating Officer and then Chief Executive Officer. A highlight was overseeing the merger with Goldman Sachs to become Goldman Sachs JBWere. From there he served as Chief Executive and Country Head of Bank of America Merrill Lynch Australia before joining NAB in November 2013.

It was at Goldman Sachs JBWere that Drummond met the person who's had the most fundamental impact on his career. George Parsons, Chief Learning Officer for Goldman Sachs, coached Drummond for five years, primarily on the importance of building self-awareness and emotional intelligence.

"It was about understanding what motivates people and how to drive individuals," he says. "George studied theology and has had a fundamental impact on how I think about people."

Drummond also completed a six-week Advanced Management Program at Wharton University in the US. When it comes to mentoring others his advice is simple: "don't take yourself too seriously."

"Being serious at the right time is important, but you've got to have a perspective on life as well. This includes having responsibilities, obligations and balance outside of your work life. In these sorts of roles it's very hard to keep balance."

Drummond, who grew up in rural Victoria, maintains balance in several ways. He sits on the board of Geelong Football Club and is treasurer at the Florey Institute of Neuroscience and Mental Health. He's also passionate about golf and body surfing. He body surfs most weekends from December until April when the water temperature in Victoria drops below 17 degrees. When he lived in Sydney he would body surf 10 months of the year, going out with a group of friends most weekends.

"These sorts of things are about staying yourself," he says. "Because if you don't have that sort of release, along with family, and keeping perspective, you're a far lesser executive and you are far less prepared to deal with the issues that come along, particularly people issues."

He sees the biggest issue facing Chief Financial Officers today as understanding what's important and prioritising. Another issue is balancing the traditional CFO duties with working on the longer-term strategic direction.

"I've got 30 or 40 important issues on my agenda but what's critical? It's through experience and understanding your mistakes that you understand this," says Drummond. "I prioritise around understanding what could have a fundamental impact on the reputation and the balance sheet of the organisation, not the loudest voice."

*"Being serious at the right time is important, but you've got to have a perspective on life as well."*

### Encouraging growth

Growing the economy remains a concern for customers; in recent years, the economy has been running off 1% gross national expenditure.

"It's been fairly flat, so one of the big themes we're hearing from businesses is how we increase momentum in the domestic economy and how we ramp up productivity – which has been quite flat," says Drummond.

With non-mining investment running at very low levels compared to the past 20 years and consumers acting cautious, he believes we may need a paradigm shift to improve confidence until investment levels recover.

"Let's not be too critical – annual GDP growth is running at about 3% and we've had an extended period of export led economic growth," he says.

### Greater transparency and support

Drummond is also hearing calls from customers for greater transparency and consistency of support. NAB learnt an invaluable lesson during the GFC, providing consistent backing to clients at a time when other financial providers were pulling back.

"In those really tough times we were there for customers," he says. "Customers have also asked us to be fair and we've responded with a fair value agenda across the organisation. This means that when we see the benefits of lower funding costs we are prepared to pass them on."

There's also flexibility for the right customer and the right deal, which is all part of building genuine relationships.

"You win business by providing significant value to your customers. Great relationship bankers provide really outstanding insight and service and are there for their customers in the good and the bad times," says Drummond.

### The future of banking

Drummond believes the big four will remain the dominant players in the Australian banking landscape over the next decade. However, he predicts there will remain a domestically-skewed banking system, with a handful of truly global banks along with some more challenger brands, particularly when it comes to online offerings. He also expects more acceptance of end-to-end online banking products, something that hasn't taken off yet globally because people still value face-to-face interactions.

He's seen this close to home. His children – who are in their mid-twenties – still want to go into a bank branch to finish the transaction when they are deciding on a mortgage.

"They might use an aggregator online to work out where to go for a mortgage, but they still want to use a bank branch because it is the most important transaction of their life," he says. "They want to have someone to go to if something goes wrong or if they want to ask questions. It's not a given that everything goes online."

## Five minutes with **Craig Drummond**

**Where were you born?**
Leongatha, Victoria.

**Where did you go to school?**
Finished year eight at Leongatha High School and then went to Scotch College in Melbourne.

**What university did you attend?**
University of Melbourne.

**What did you study?**
Bachelor of Commerce.

**What motivates you?**
Winning, but winning the right way.

**What are your interests?**
Family, golf, body surfing and football.

**What is an interesting fact about you?**
My first car was a purple Mitsubishi Gallant.

**What is your key achievement?**
Becoming CFO of National Australia Bank.

**When did you join NAB?**
November 2013.

**What did you want to be when you grew up?**
I wanted to be involved in the stockmarket.

**Who would you be for one day?**
Gary Ablett Junior.

**What instrument did you play or want to play?**
I desperately want to learn the piano. That's on the bucket list. I've been to a number of Elton John concerts over the years and I loved him in the early years.

**What sort of music do you like to listen to?**
A strong female vocalist, such as Mariah Carey.

**Where is your favourite holiday destination?**
Portsea, for the surf.

**How do you unwind after a hectic day?**
I go to the gym.

# Mining for innovation

**Joe Totaro**
Chief Financial Officer & Company Secretary

**Western Australia-based GR Engineering Services has developed a global reputation for its innovative approach to delivering fixed price engineering design and construction services to the mineral processing industry.**

The year 2013 was an important one for GR Engineering Services (GR Engineering). The company won its biggest project to date when Wolf Minerals (UK) Limited awarded it the engineering, procurement and construction contract (EPC Contract) for the Hemerdon Tungsten and Tin Project near Plymouth in the UK. The total EPC Contract is valued at approximately £76 million (A$125 million), with GR Engineering's remit encompassing the design, construction and commissioning of a 3Mtpa tungsten and tin mineral processing plant, plus associated infrastructure.

The awarding of the contract was preceded by GR Engineering working closely with Wolf Minerals over several years to deliver specialised studies and advice, while demonstrating the engineering and construction capabilities that are pivotal to the successful delivery of the project.

Joe Totaro, Chief Financial Officer at GR Engineering, explains that the company's expertise developed from working on Western Australian (WA) mining projects. This expertise, and the company's strong reputation as a specialist EPC Contractor contributed to the win. He says: "We offer fixed price contracts with limited warranties as to plant performance, completion times and other elements. The fact that we could guarantee a price was of comfort not only to Wolf Minerals but to its lenders on the project."

## Complex logistics

Running over two years, with a completion date of August 2015, one of the biggest challenges is managing the logistics involved in such a large-scale operation.

"The plant is a complex structure, involving many components such as valves, pumps, crushing gear, milling gear and electrical equipment – these things are sourced from all over the world, just as they would be if the project was here in Australia," says Totaro. "Furthermore, it's a different environment with its own work practices which, as managers, we need to be mindful of."

In Western Australia, GR Engineering has a team of engineers and draftspeople working on the engineering, drafting and design of the project and an additional team of about seven has been relocated to the UK. This includes project engineers, construction engineers and supervisors who'll oversee contract teams in the UK throughout the construction process.

## Cradle to grave solutions

Founded in 2006, GR Engineering has worked on projects in Australia, Africa, Indonesia and the UK. In 2013 the company was appointed by MZI Resources as the preferred contractor for the Keysbrook Minerals and Project in WA. The project will be completed on an EPC basis with a contract value of approximately $55 million.

The company traces its origins back to 1986 when the current management team founded a business called JR Engineering. This business was sold in 2001 and the same management team came together again to found GR Engineering in October 2006. Listed on the Australian Stock Exchange in 2011, it employs 160 professional support staff plus direct construction workforce and contractors.

At the cornerstone of its approach is a 'cradle to the grave' solution. The team prefers to become involved with a project at the feasibility study stage. At the moment there are 15 feasibility studies in play, relating to a broad mix of commodities, including gold, iron ore, copper and nickel. While there's usually a lull between the completion of a feasibility study and the arrangement of finance, they serve as a good bellwether of upcoming opportunities.

## Workforce management and risk mitigation

"Whenever possible we will engineer and design to our own feasibility study and construct to our own engineering and design, with our own directly employed workforce if it's in Australia, so that it's a completely seamless process which minimises risk," says Totaro. "It's a fairly unique product offering and one of the reasons for our success in winning work and mitigating risk in the business we're in."

*"For the first time we have moved, not from our engineering discipline, but from the sector in which we operate."*

Because GR Engineering guarantees projects will be delivered within a certain time and liquidated damages charged if they don't, delays can be costly. "Time is money – you want to be able to employ your workforce as efficiently as you can on as many projects as you can," says Totaro. "We stick to well established technologies, but every ore body is different. Sometimes there's geo-technical risk involved, sometimes there's logistical risk; we have executed projects on a fixed price basis on tops of hills in the jungles in the Solomon Islands so you can imagine the risks involved. But as a group we have been in the business for nearly 30 years so we are able to foresee where the risks are and head them off at the pass."

While GR Engineering specialises in fixed price contracts, on some projects it's not feasible, so they structure the contract differently. For example, in 2011 the company was engaged by Resolute Mining to conduct the feasibility study for the Syama Expansion Project in Mali, West Africa. The study included all aspects of the open pit expansion as well as the design and construction of a parallel oxide ore circuit. From that the company was appointed to the design and construction of the plant upgrade, something it is undertaking on a schedule of rates basis.

"In cases like this we are happy to manage the project on behalf of the client but we cannot accept risks that are associated with getting people and materials in remote locations, across poor infrastructure or with projects involving political risk," says Totaro. "But if it's a project in a location we are happy to do on an EPC basis, for example, the UK, Ghana or the Solomon Islands, we will do so."

*"The plant is a complex structure, involving many components such as valves, pumps, crushing gear, milling gear and electrical equipment – these things are sourced from all over the world, just as they would be if the project was here in Australia."*

## Innovation + process = growth

This approach is delivering solid results in a difficult trading environment for GR Engineering's sector. In the half year ending 31 December 2013, GR Engineering reported an NPAT of $7.3 million. Totaro explains that with EPC Contracting the entire capital value of a project flows through its profit and loss statement. This means for example that if the company wins a $100 million job that entire value flows through as revenue which can lead to wide revenue fluctuations from year to year.

Totaro attributes the growth to the innovative approach GR Engineering takes, coupled with its reputation in the industry.

This is reflected in the processes the company has in place to deliver projects on time and to budget while maintaining strong safety and quality performance. "We are prepared to provide bank guarantees and insurance bonds to secure certain elements of contract performance," he says. "Many of our processes have been well established for many years. While GR Engineering was incorporated in 2006, the team of people behind it worked together for many years at JR Engineering and this group still had a lot of industry recognition when they decided to re-launch in 2006."

Totaro also believes the company's international expansion has benefited from Australia's reputation as being at the forefront of the mining industry. "Australian miners obviously have quite some pedigree," he says. "As trading conditions in Australia became more difficult, many miners moved offshore looking for opportunities. In some cases we had already worked with them in Australia, so in a sense we followed them overseas."

Looking forward, there are enough opportunities and contracted revenue to give Totaro confidence about the company's prospects in 2015. He makes note of the company's $5.75 million acquisition of Upstream Production Solutions, marking its entry into the oil and gas services sector.

"For the first time we have moved, not from our engineering discipline, but from the sector in which we operate," says Totaro. "The acquisition of Upstream Production Solutions has been our first departure from our 'core' business. It was only a small acquisition, but there are 125 highly qualified and experienced people in the organisation and it has a good base load of work and opportunities. We are looking forward to giving this business the financial and management resources it needs over coming years to help broaden our growth base."

# Here comes the sun

**Robert White**
Associate Director, Environmental Finance Solutions

**Ashley Robertson**
Associate Director, Environmental Finance Solutions

**Kane Thornton**
Deputy Chief Executive, Clean Energy Council

**Australian households – and businesses – are increasingly turning to solar to help manage their power bills. Kane Thornton, Deputy Chief Executive of the Clean Energy Council, reveals the challenges and opportunities in the emerging solar market.**

Rising electricity costs, coupled with a drop in the cost of solar photovoltaic (PV) systems and a groundswell of consumer interest, are making solar power an increasingly attractive option for Australian households and businesses, according to Kane Thornton, Deputy Chief Executive of the Clean Energy Council (CEC).

Solar power is a smart investment especially when combined with the modest incentive offered by the Federal Renewable Energy Target scheme.

Solar PV systems generate power by converting the energy in sunlight to clean electricity. This conversion takes place within modules of specially fabricated materials that make up the solar panels.

## Hedging your bets

Thornton sees an inevitability about the importance that solar power will play in Australia, because it makes sense on a number of grounds.

"The general public wants more renewable energy and intuitively understands that burning coal or using expensive gas to generate electricity just doesn't make sense when Australia is so blessed with solar, wind and other resources," says Thornton. "Over two million households have some form of solar on the roof of their homes and polling shows that more than 75% of Australians want more renewable energy."

Solar power also helps hedge your bets against future price rises in electricity and gas. Power prices have risen substantially over the past three to four years, something that's predominantly been driven by increasing costs from the networks – the poles and wires component of electricity bills.

The repeal of the carbon pricing scheme in July will result in only a small drop in electricity prices. A report by the Australian Energy Market Commission found that the carbon price accounted for about 9% of electricity prices, while the cost of networks (poles and wires) accounted for more than half. National average electricity prices for households increased by 30% between 2000 and 2005, and by another 50% between 2005 and 2010.

Retail gas prices increased 151% from 2000 to 2012, according to AIG, which predicts the price of gas to triple, something manufacturers and energy-intensive businesses are particularly concerned about.

## Global shifts

The shift to solar in Australia follows global trends towards renewable energy. According to the Climate Council, global PV capacity has been growing, on average, over 40% per year since 2000. Germany leads the way with 32% share of the global PV capacity in 2012, followed by Italy and the US (16%), China (7%), Japan (6%), Spain (5.1%), France (4%) and Belgium (2.6%).

Australia, which has one of the highest levels of sunshine on earth, comes in at ninth place, representing 2.4% of the global PV capacity in 2012. Thornton believes Australia holds up well when you compare the percentage of households taking up solar.

He says: "We regularly talk to some of our colleagues around the world and the general gist of those discussions is they are shaking their heads and saying, 'imagine what we could do if only we had the sunshine that Australia has?' Countries around the world, like Japan and China , are looking to push hard into solar because they know it's an important part of the future energy mix but they aren't nearly as blessed as Australia is when it comes to the amount of sunshine we have."

In Australia, solar installation is led by South Australia where 25% of dwellings have solar PV installed, followed by Queensland (22%) and Western Australia (18%). NSW, ACT and Victoria have 10% of dwellings with solar PV, while Tasmania has 9%.

## Cost, investment and leasing

The upfront cost of installing solar panels is one of the biggest pain points when it comes to the mainstream adaptation of solar. The Renewable Energy Target scheme, designed to ensure that 20% of Australia's electricity comes from renewable sources by 2020, has helped reduce this up-front cost, but is currently under review.

The CEC estimates removing the target puts at risk $14.5 billion of new investment in Australian renewable energy projects by 2020, 18,400 additional jobs, and $1.4 billion annual savings on electricity bills beyond 2020, across all Australian households.

Financing is another way of managing the upfront costs. In California, one of the world's hot spots for solar power, third-party solar energy system leases account for nearly three-quarters (74%) of California's residential solar market, according to a report by solar power service provider Sunrun and solar energy industry market data provider PV Solar. Solar leasing is estimated to have added more than $1 billion to California's economy since being introduced in 2007.

Leases have been gaining momentum in Australia since 2012 when the first Australian solar providers started offering pay-as-you-go solar options enabling homeowners to go solar with no upfront cost, paying back the panels and systems over 20 years.

Solar leases are also an attractive option for businesses, along with solar power purchase agreements (PPA). While the two terms are often used interchangeably, the key difference is that with a solar lease you lease the equipment and with a PPA you're paying for the energy the panels produce.

Terms vary between providers, but leases are generally five to 15 years with monthly payments. During the lease term the supplier is responsible for monitoring and maintenance of the system and at the end of the contract, ownership of the system may be transferred to the business but this depends on the agreement.

Whether you opt for a lease or a PPA comes down to understanding the electricity consumption patterns for your particular business and industry, the electricity tariffs you pay and other accounting and taxation issues particular to your industry, says Thornton. In fact, depending on how you negotiate some of those arrangements, there can be very little difference between a PPA and a leasing arrangement.

"What we're seeing is solar companies really working with businesses and offering both," he says. "It's too early to say which ones will be more popular. There are plenty of businesses looking at leasing, but the PPA arrangements are being actively considered and taken up as well. It's a matter of the business coming to terms and understanding the difference between the two and understanding which option will work better with their particular businesses and their particular financial position."

*"The networks and the grid businesses are realising there's an inevitability about solar and they need to change how they do business and help businesses get solar onto the electricity grid."*

## Payback and uptake

Payback for small businesses investing in solar will vary and depend on various things, according to Thornton, including:

- Location of the business
- How much energy the business consumes (generally the larger the consumption the lower the existing power tariff) when it's consumed; daytime or nightime; five days a week or seven
- The structure of the existing electricity tariff and what any electricity tariff structure looks like for the residual grid power requirements when the solar system is not generating or not able to meet the demand on site.

"While the uptake of solar is creating opportunities for the traditional energy businesses, particularly the retail businesses, which are now offering their customers solar systems, it's a different story for businesses that aren't adapting," says Thornton.

"Solar is a disruptive technology and that essentially means the more new technology you put in the more it disrupts the traditional business models in the traditional energy sector," he says.

"We are certainly seeing that in the household rooftops space and we are seeing that in the business space as more businesses take up solar."

Apart from the upfront costs, the other big challenge in the take-up of solar is the traditional electricity grid, which presents challenges in terms of the time it takes for the solar companies to connect PV systems and the associated costs.

However, Thornton is confident progress has been made in overcoming these challenges, which are consistent with the barriers being experienced around the world as traditional energy systems deal with more solar coming onto the system.

"The networks and the grid businesses are realising there's an inevitability about solar and they need to change how they do business and help businesses get solar onto the electricity grid." he says.

The CEC's *Guide to Installing Solar PV for Business and Industry* provides a breakdown of costs for grid-connected solar PV systems in Australia's capital cities. Such costs currently result in a solar PV system giving an IRR of at least 14% for those businesses with daytime tariffs at a minimum of 17 cents per kWh.

# Alternative capital

Tom Mazzaferro and Khoa Vu from NAB discuss the challenges Australian corporates face with sourcing debt financing and some key developments in the Australian and global debt markets.

**Tom Mazzaferro**
Head of Non Rated & Specialised Origination

**Khoa Vu**
Associate Director
NAB Advisory

## Outside of traditional bank debt, what other sources of debt capital are available for Australian corporates?

Depending on the industry, the size of the financing requirement and the nature of the asset and cash flows, banks have traditionally structured a financing package to suit most borrowers. The skill inherent with credit, debt structuring and portfolio management, coupled with the ability to forge long-term relationships with corporate borrowers, has up until now, kept the Australian corporate debt market almost exclusively the domain of banks.

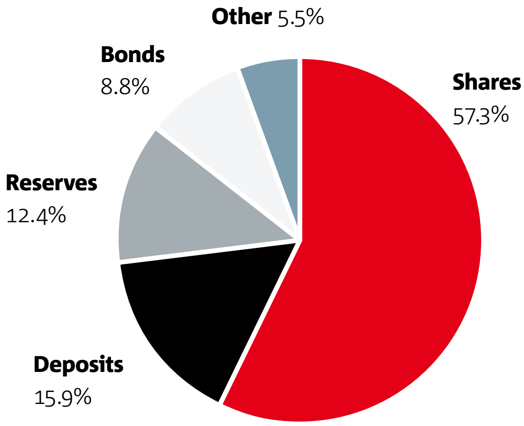
However, from a borrower's perspective, as most businesses follow their growth journey, there will be a greater need for funding flexibility, liquidity, tenor, and diversity. With the absence of a well-developed bond market in Australia, where there currently exist significant barriers to entry and only a select few corporates have access, most corporate borrowers will remain reliant on bank debt as their primary source of debt capital.

In offshore debt markets, the story is very different. In particular, the US and European markets have demonstrated an evolution towards market efficiency. Matching demand and supply through the forces of changing investor and borrower preferences, there exists a deep market in both public and private debt. Investment grade, private placement and high yield bond markets are open to most corporates seeking tenor and diversity. Additionally, the emergence of specialist debt funds investing in corporate, infrastructure and leveraged debt offer borrowers an alternative to bank and bond markets. Not only that, structured products are available for the right name, varying from senior and mezzanine debt to quasi equity product.

The Global Financial Crisis (GFC) showed that a lack of access to committed funding lines can become a real threat to the stability and growth of corporates, with this threat being exacerbated by the short-medium term tenors of bank debt, which requires borrowers to frequently return to the debt markets to refinance. This created an emphasis at boardroom level for corporates to not become over-reliant on bank balance sheet funding.

Changes to Basel III regulations require banks to hold larger amounts of capital and maintain a larger funding buffer (with less reliance on wholesale and short-term funding) than prior to the GFC. As domestic credit growth improves, this will place pressure on banks attempting to grow the provision of credit at the same rate as system growth. Additionally, foreign banks (mainly European banks) have reduced their market share in Australia and are lending much less than prior to the crisis, creating an additional gap in the supply of funding. The gap has been partially filled by Asian lenders.

### Superfund Asset Allocation




## What does this mean from the perspective of the investor?

Australia's superannuation market is the fourth largest global pension market in the world with about $1.6 trillion in assets. With an ageing population, baby boomers would typically prefer periodic annuity income streams over capital appreciation. Yet, fixed income allocation in Australia is only 8.8%, the lowest in the OECD compared to Europe and US where bonds traditionally outweigh equities. This is because fixed income products in the Australian market have been dominated by financial and sovereign debt issuers with only a handful of active corporate issuers. Australian investors have never had the opportunity to gain exposure to the corporate loan market.

The evidence from both sides of the equation (issuer and investor) seems compelling; and all but suggests that some kind of reform, change and/or innovation is imminent within the Australian debt market landscape.

**What is the future for debt funding in Australia?**

In response to the changes in the financial landscape, there has been an increased flow of funds from non-bank investors into private debt markets (that had previously been considered illiquid) seeking exposure to non rated credit.

A growing theme in the Australian market in recent years has been for corporates to increasingly diversify their funding through capital markets. For non-rated clients to achieve this diversity, the corporate bond market has had to develop to accommodate non-rated issuance. This has been provided through the non rated over the counter (OTC) market.

The Australian institutional fixed income (bond) market is only open for investment grade rated issuers with formal credit ratings of BBB-/Baa3 or better. This limits many Australian corporates from accessing the bond market as a funding alternative, whereas the sub institutional OTC market provides a capital markets funding alternative for non-rated corporates, particularly smaller companies with strong credit metrics who due to their size are unlikely meet the rating agency's requirements for an investment grade rating.

2013 saw the emergence of a non rated wholesale OTC market, with over $300 million raised by six separate issuers. The emerging market provides capital markets access to issuers who historically have been unable to raise funding in the institutional fixed income market in Australia without an external credit rating.

*"A growing theme in the Australian market in recent years has been for corporates to increasingly diversify their funding through capital markets."*

**The key differences and characteristics of the institutional wholesale market versus the sub institutional market**

| | Institutional | Sub institutional |
|---|---|---|
| **Investors** | Australian fund managers<br>Australian super funds<br>Insurance companies<br>Offshore funds<br>Credit hedge funds<br>Private banks | Self-managed super funds<br>Family offices<br>Boutique fund managers<br>Sophisticated investors<br>Private wealth firms<br>Asia private banks<br>Specialised debt funds |
| **Market Requirements** | An investment grade credit rating<br>Program documentation | No credit rating<br>Information memorandum |
| **Time to market** | Six weeks | Six weeks |
| **Execution window** | Two days | Seven days |
| **Indicative volume** | A$250m | Minimum A$30m to a maximum of A$100m |
| **Estimated number of investors** | 25 to 35 | 300 to 1000 |
| **Average investment size** | A$20m | A$250,000 |

The following article on debt markets and product innovation expands on this initial discussion to provide an overview of alternative capital markets available to Australian non-rated and sub investment grade corporates.

# Debt markets and product innovation

**Andrew Ting**
Director, Non Rated & Specialised Origination

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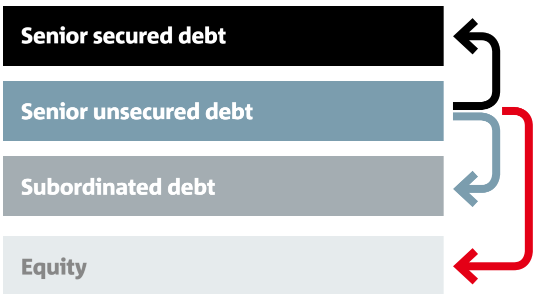
**Andrew Ting, Mark Bower and Hamish Nicol from NAB's Debt Markets team provide a brief overview of some of the alternative capital markets available to Australian non rated and sub investment grade rated corporates.**

**The private debt market in Australia, although in its infancy, is evolving and new products continue to emerge to support both the borrower's demand to diversify funding as well as investor's appetite to gain exposure to unrated corporates.**

The Australian OTC bond market is a prime example of new product innovation in response to growing demand. Following are some of the other options available.

### AUD senior unsecured notes




The structure of AUD senior unsecured notes is based on US high yield market standard documentation with investors benefiting from protections formed in this market over many decades.

Notes are generally structured so that:

- They are legally required to be repaid on maturity and cannot be converted into another type of security
- Interest cannot be deferred, capitalised or decreased over the term of the bond. It is an Event of Default if interest is not paid
- There is a fixed maturity date that cannot be extended and only called early in certain specified situations.

Although the Australian senior unsecured market is an emerging market, the past two years have seen stable growth as large pools of capital flow into this new market in search of yield with current cash rates at historical lows.

Additionally, investors in this market are willing to provide longer tenors than the bank market, and greater structural flexibility than the USPP market. Consequently, there has been an increase in issuance volume since 2012.

**NextDC – first unlisted and unrated, senior unsecured transaction by an Australian bank.**

NEXTDC Limited (NEXTDC) is a non rated S&P/ASX300 company founded in May 2010 and listed in December 2010 with a current market capitalisation of approximately A$380million. NextDC has grown to become Australia's largest vendor-neutral outsource data centre operator with sites in Sydney, Melbourne, Brisbane, Canberra and Perth. NextDC's data centre facilities services include physical housing, power, cooling & IT infrastructure support with a high-quality base of client names such as Australia Post, Telstra, Optus and AAPT.

On 2 June, 2014, NextDC launched the company's first unlisted senior unsecured bond targeting a minimum raising of $30 million. The offer obtained significant demand with books growing to around $50 million by the end of the first day, enabling NextDC to double the transaction to $60 million. This result demonstrated the strong appetite in the market for unrated debt from non bank investors and the good prospects for strong secondary market performance.

**Senior unsecured market - issuance activity**

| Issuer | Date | Amount |
|---|---|---|
| Coffey Corporate | Sep -14 | A$40m |
| 360 Capital Investments | Sep-14 | A$75m |
| Plenary | Jun-14 | A$35m |
| NEXTDC | Jun-14 | A$60m |
| Money3 | Apr-14 | A$30m |
| CBL Corporation | Apr-14 | A$55m |
| G8 Education | Feb-14 | A$50m |
| Payce Consolidated | Dec-13 | A$50m |
| PMP | Oct-13 | A$50m |
| Cash Converters | Sep-13 | A$60m |
| G8 Education | Aug-13 | A$70m |
| Mackay Sugar | Apr-13 | A$50m |
| Silver Chef | Sep-12 | A$30m |

The senior unsecured notes will have a term of five years, and pay a cash coupon of 8% with a cumulative 1% make-whole payable on redemption. The proceeds of this issue will be used for general corporate purposes, including the capital expenditure associated with fitting out additional capacity within existing data centres.

Investors came from a broad base including clients from NAB Private Wealth, NAB Business Bank, wealth managers, JBWere, high net worth sophisticated individuals and professional institutions. NAB was the sole arranger and book runner for this transaction, making this raising by NextDC the first unrated and unlisted OTC corporate bond to be arranged by an Australian bank.

### US term loan B

The US term loan B (TLB) product is a high yield loan issued into the institutional USD loan market. TLBs provides sub-investment grade borrowers with an attractive funding alternative to Australian issuers by allowing them to access the deep and liquid US leveraged capital market.

Key features of this market include:

- **Relatively large issue size:** Typically for funding greater than US$250million. Although not common, deals of around US$150million are possible
- **Available currency:** USD. TLBs are a natural hedge for USD revenues; otherwise, a USD/AUD cross currency swap will be required
- **Medium tenor:** The TLB is medium tenor, with maturities typically between five-seven years
- **Floating rate coupon:** It is a floating rate spread to the US LIBOR, payable semi-annually
- **Senior security:** Predominantly senior secured market
- **Covenant-lite available:** TLBs possess less restrictive covenants compared to bank debt. Despite some TLBs still having quarterly maintenance covenants, there is a current trend towards covenant-lite TLBs that have "bond-like" incurrence-only covenants
- **Two ratings preferred:** Investors prefer two credit ratings prior to issue from Moody's, S&P or Fitch
- **Active secondary TLB market:** There is no mandatory reporting of secondary TLB trades unlike bonds, and the market is liquid
- **Mandatory prepayments:** Typically 1% p.a. amortisation and annual free cash flow sweep
- **Voluntary prepayability:** TLBs can be prepaid at par by the issuer
- **Market flex:** Arrangers are allowed to increase or decrease margins based on investor demand.
- **Recapitalisations:** TLB dividend recap transactions are common in this market
- **Re-pricings possible:** In the event that market fundamentals indicate favourability towards re-pricing, investors are protected by a 101 soft call protection for the first six-twelve months
- **101 soft call protection:** In the event a re-pricing occurs, a 1% premium will be payable by the issuer to investors; this soft call protection is usually applied for the first six-twelve months.

Investors in the TLB market typically are insurance companies, pension funds, mutual funds, CLOs and hedge funds. There is ample demand for Australian borrowers across a number of sectors.

US investors are interested because:

- Australia offers a mature legal market that offers indirect exposure to China and other emerging BRIC economies
- Investing in Australian resource companies provides a hedge to inflation through commodities exposure
- Australian debt provides geographic diversification for debt investor portfolios.

The recent increasing preference of TLBs as an alternative capital source for leveraged issuers can be attributed predominately to more flexible covenants packages, strong investor appetite, lower or no amortisation and longer debt tenor features.

*"Although the Australian senior unsecured market is an emerging market, the past two years have seen stable growth as large pools of capital flow into this new market in search of yield with current cash rates at historical lows."*

| | Term loan B | Australian bank loan |
|---|---|---|
| **Currency** | USD. Otherwise a USD/AUD cross currency swap is required | AUD/USD available |
| **Tenor** | Five-seven years | Corporate lending typically three-five years |
| **Covenants** | Incurrence only if covenant-lite.<br>Maintenance covenants testing quarterly if not covenant-lite | Maintenance and incurrence<br>Ongoing financial covenants |
| **Lien/Security Covenants** | Additional debt can be incurred pursuant to either a leverage or fixed charge cover ratio, in addition to "Permitted Indebtedness" exceptions | Highly limited subject to "Permitted Security" exceptions |
| **Divestments/Investments** | Allowed as long as secured equally and rateably, in addition to "Permitted Liens" | Highly limited other than typically operational "Permitted Distributions" |
| **Credit Ratings** | Two ratings preferred | Not required |
| **Investors/Liquidity** | Minimum US$200m, no maximum US$606bn of new issuance in 2013 Active secondary market | No minimum size - max $1bn<br>Domestic banks, some IBs and international banks and loan funds<br>Generally no secondary market |
| **Interest payment** | Floating spread to US LIBOR, usually with LIBOR floor, payable semi-annually | Spread to BBSY or US/EUR/GDP LIBOR, usually paid quarterly |
| **Security** | Traditionally secured market, can be first/second lien | Secured |
| **PE dividend re-caps** | Common | Rare in the AUD loan market |
| **Change of control** | Investor put at 101 | Typically affirmative control of defined sponsors |
| **Reporting** | Annual/quarterly financial statements | Annual/quarterly financial statements, business plans, budgets and management presentations |
| **Prepayability** | One year 101 soft call | Generally prepayable at any time |
| **Upfront Fee** | Approximately 100-150bps | 350-425bps depending on the borrower, deal size and tenor |

**There are three broad types of Australian leveraged issuers active in the TLB market:**

**Natural resources**

TLBs provide an attractive alternative to corporate bank loans due to the shorter execution timeframe and more flexible terms than project financing funding. TLBs also provide a natural currency hedge if the issuer has USD revenues. Issuance by borrowers in the Resources & Mining segment during 2012-2014 YTD has made up 74% of total Australian TLB issuance, due to the size of the recent Fortescue Metals Group (FMG) issue.

**Private equity**

TLBs are a good alternative for a private equity issuer's initial acquisition purchase as the market offers flexibility around prepayability, including IPO events. The capability for the TLB to allow potential dividend recapitalisation trades on existing investments is attractive in returning equity to investors. Private equity issuers made up 18% of total Australian TLB issuance during 2012-2014 YTD.

**Other leveraged corporates**

TLBs allows sub-investment grade issuers to raise offshore funds away from expensive or covenant-heavy bank loan markets.

**Recent Australian TLB Issuances:**

| Issue Date | Issuer | Ratings | Issue Amount (USDm) | Spread | LIBOR Floor | Price | Yield | Tenor | Maturity |
|---|---|---|---|---|---|---|---|---|---|
| Nov-13 | Fortescue Metals Group | Ba1/BBB- | 4950 | 325 | 1.00% | 99.75 | 4.37% | 5.5 | Jun-19 |
| Sep-13 | Spotless | B3/CCC+ | 235 | 775 | 1.00% | 99.00 | 9.29% | 5.5 | Mar-19 |
| Sep-13 | Nine Entertainment | Ba2/BB | 185 | 300 | 0.75% | 99.75 | 3.85% | 6.4 | Feb-20 |
| Sep-13 | Spotless | B1/B | 845 | 400 | 1.00% | 99.50 | 5.22% | 5 | Oct-18 |
| Aug-13 | Alinta Energy | B1/B+ | 1070 | 537.5 | 1.00% | 95.00 | 7.66% | 6 | Aug-19 |
| Jun-13 | Nine Entertainment | Ba2/BB | 96 | 275 | 0.75% | 99.75 | 3.59% | 6.8 | Feb-20 |
| May-13 | Pact Group | Ba3/B+ | 885 | 275 | 1.00% | 99.50 | 3.89% | 7 | Jun-20 |
| May-13 | Hoyts | B3/B- | 100 | 725 | 1.00% | 99.00 | 8.70% | 7.5 | Dec-20 |
| May-13 | Hoyts | B1/BB- | 310 | 300 | 1.00% | 99.50 | 4.15% | 7 | Jun-20 |
| Feb-13 | Nine Entertainment | Ba2/BB | 700 | 275 | 0.75% | 99.88 | 3.57% | 7 | Feb-20 |
| Dec-12 | Atlas Iron | B2/B+ | 275 | 750 | 1.25% | 96.00 | 10.60% | 5 | Dec-17 |
| Oct-12 | Fortescue Metals Group | Ba1/BB+ | 5000 | 425 | 1.00% | 99.00 | 5.60% | 5 | Oct-17 |

## Institutional Term Loans

Institutional term loans (ITLs) are becoming an important part of corporate funding packages. We have been seeing an increasing desire from institutional investors to participate in the term loan market, with funding accessible in AUD STG, EUR and USD. Australia is becoming one of the most advanced countries in terms of non-bank participation in the loan market. Basel III regulatory framework impacts banks' capacity to provide longer tenor loans (> five years), creating an opportunity for funds to provide capital.

Term loan investors are seeking an exposure to achieve a return rather than trying to sell ancillary products. They can dialogue and form relationships with clients, however, only in relation to the term loan product.

In light of current market trends, there is a heightened demand from institutional fund investors for the term loan product. Investors are less focused on liquidity and more focused on putting money to work and overall returns. Investors include on shore funds as well as those from the UK, Europe and the US.

**Advantages of ITLs versus bank debt**

- Longer term, callable debt like bank funding, only subject to call protection for part of the life of the transaction
- An alternate source of capital that allows issuers to free capacity with banks for other opportunities. Banks provide shorter dated revolving funding, with funds providing longer dated term funding
- Will provide seven to ten year bullet funding on pari-passu terms with banks in a term loan format
- No ancillary business is required by investors, allowing borrowers to provide ancillary only to banks, which will potentially allow sharper pricing available from banks.

**Disadvantages of ITLs versus bank debt**

- Potentially more expensive compared to shorter tenor bank debt as investors have minimum return hurdles (however longer tenor is achieved)
- Will require pari-passu status with banks giving rights on waivers and covenants

*"In light of the current market trends, there is a heightened demand from institutional fund investors for the term loan product."*

| Overview of fund appetite by category | |
|---|---|
| **Infrastructure** | • Funds are attracted by asset life and cash flow stability<br>• Deal sizes often necessitate wide syndication<br>• ITL can be used to provide 7-10 year tenors, with bank debt providing tenors to 5 years |
| **Leverage** | • Funds attracted by yield on offer<br>• Opening margin 350bp+<br>• Funds taking advantage of borrower desire for tenor without need to tap a rated bond market |
| **Property** | • Commercial bank appetite for property is selective<br>• Some fund appetite to fill liquidity gap |
| **Mezzanine** | • Majority of deal flow is in the sponsored (private equity) space<br>• Players are often offshore funds<br>• Seek total return of circa 12-15% from cash and payment-in-kind (PIK) |
| **Infrastructure subordinated debt** | • Limited market in Australia<br>• Funds in this space are attracted by yield<br>• Australian funds invested in Europe |

## Recent transaction case study

CEU is an Australian corporation responsible for the finance, design, construction and operation of Melbourne's EastLink tollway project. In June 2012, an institutional term loan facility of A$1,271 million was closed for ConnectEast.

This included:

- Refinancing of existing debt
- Two-five year funding provided by banks
- Seven year institutional tranche
- A$160million commitments from funds.

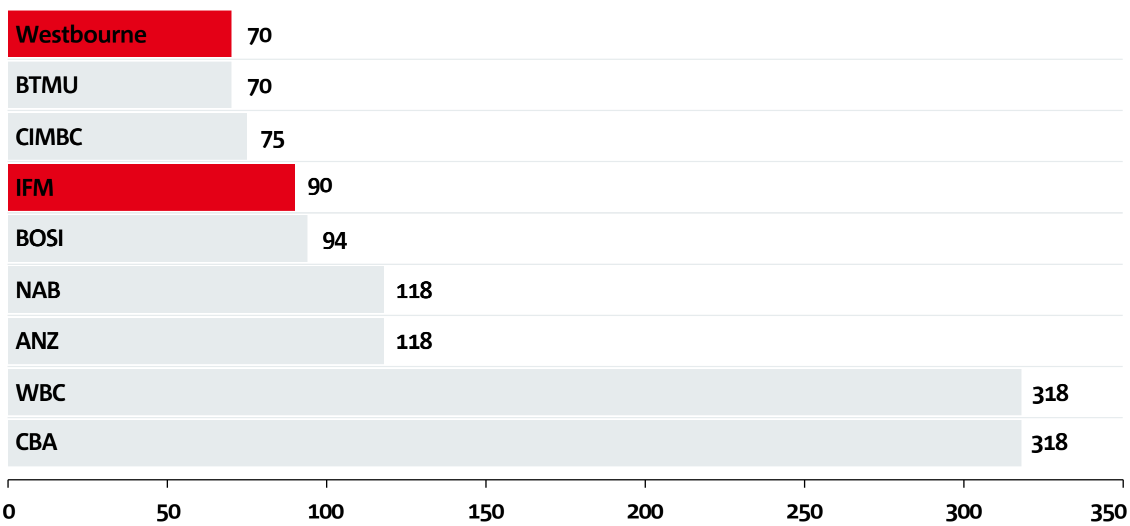
## Unitranche financing

Unitranche facilities have become an increasingly prevalent funding alternative in the US and Europe in recent years, particularly in the middle market segment. Unitranche financing involves the merger of typically separate, first and second lien credit facilities, or senior and mezzanine credit facilities, into a single credit facility.

Their increasing prevalence in acquisitions, dividend recapitalisations or refinancings, is a result of the many benefits that the unitranche structure provides to lenders and borrowers.

Given the facility is provided under one credit document, the borrower will only have one set of covenants.

**Syndication Outcome – ConnectEast**
Final Hold Amounts



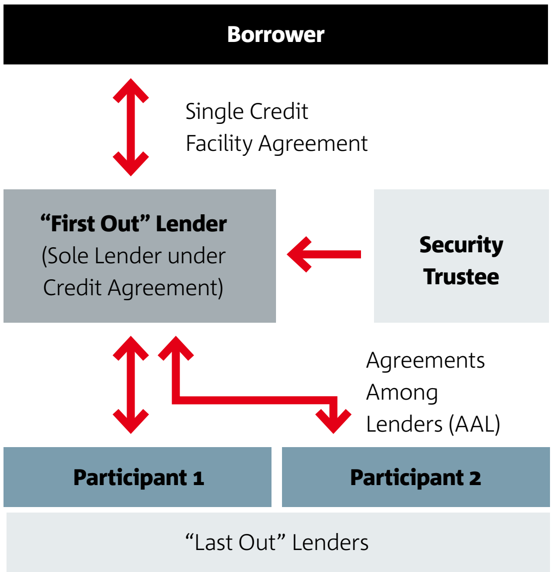
Key features of this product include:

- The merger of typically separate facilities into a single credit facility aims to accomplish the same goals as traditional first lien/second lien or senior/mezzanine debt, but with a more efficient and streamlined process for the borrower
- A unitranche facility is provided under a single set of credit documents, and administered by a single agent
- Instead of an intercreditor agreement, an AAL is entered into between the sole bank entering into the facility agreement, and one or more other participants
- Agreement Among Lenders (AAL) covers key intercreditor provisions including cash flow waterfall, voting, exercise of remedies, buy-out rights, assignments and bankruptcy
- The sole bank entering into the facility agreement is typically the "first out" senior lender, and the participant is the "last out" junior lender
- The credit agreement usually provides one blended pricing to the borrower and the AAL provides a price skim of the first-out lender's pricing in favour of the last-out lenders who bear "first loss" risk and is contractually subordinated to the first out lender.

**Advantages of unitranches**

- **Consolidated documentation and due diligence:** The ability for the borrower to negotiate with one lead lender instead of two (or more) separate lenders allows for a timelier and less costly execution due to the existence of single loan documentation and a single due diligence process
- **No syndication delays:** Unitranching does not have delays associated with syndication, and they are not accompanied by the baggage of flex rights and other syndication provisions

*"Unitranche facilities have become an increasingly prevalent funding alternative in the US and Europe in recent years, particularly in the middle market segment."*




- **Single set of covenants:** The existence of a single set of loan documentation means there is only one set of covenants for the borrower to negotiate and monitor; and additionally, the borrower has only one interest and amortisation payment schedule
- **Lower cost of capital for the borrower:** Unitranches may provide borrowers with cheaper funding because in most circumstances, all of the debt amortises over time in contrast to multi-tranche debt where the more senior lien amortises but the second lien does not
- **Flexibility of the AAL:** The AAL is precedent-driven and as such, is relatively easy to negotiate if lenders agree on the precedent.

**Disadvantages of unitranches**

- **Uncertainty of insolvency treatment:** Unitranches have not yet been tested in an insolvency administration so there is a lack of precedents on how unitranche facilities might be treated
- **Lack of a secondary market:** Unitranches are seen to be relatively illiquid; there is no secondary market for most unitranche debt.

In conclusion, the products and markets mentioned above are by no means exhaustive but provide an indication that alternative debt markets are in fact open and continue to evolve for sub investment grade and non-rated Australian corporates. For further information on these or any other debt market products, please feel free to contact the authors of this article.

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