National Australia Bank


# 2016 YEAR IN REVIEW

## Capital Financing

This document was published on 15 December 2016.

## Steve Lambert, EGM Capital Financing

# A LOOK BACK OVER THE YEAR

2016 saw the theme of volatility and innovation continue, the importance of Asian investors and the growing power of self-managed superannuation for non-institutional investors in the domestic bond market.

Last year in our Year in Review 2015 overview I spoke about two common themes being innovation and volatility. Volatility saw markets closed at various times due to many factors, often global in nature. In respect to innovation there was a strong move in how people needed to find solutions to overcome this volatility and other challenges.

In some respect those two themes continued in 2016. The first few months of 2016 saw the low point of commodity prices and a lot of uncertainty over global growth generally and Chinese growth specifically. The market rebounded in March and we broadly saw a more friendly issuing environment through the remainder of the year. Markets became focused on elections and their aftermath domestically and the US as well as the Brexit vote. Geopolitical issues in the Middle East, China sea, North Korea and Russia all distracted and impacted markets during the year. At the end of 2015 we spoke of the types of geo-political risk we saw potentially being the back drop for 2016. Most of that played out, markets opened, they closed; they created opportunities and we saw all of this in 2016 and we have similar expectations in 2017.

Australian corporate borrowers were less active in 2016 than we saw in 2015. The syndicated loan markets were down approximately 20% in 2016 compared to 2015. The corporate bond market in 2016 broadly experienced a similar decline. Partly this decline is due to the transition of Australians economy post the mining boom; challenges in the construction industry and; the debate over foreign investment. Overall the bond markets produced similar volumes domestically year on year.

Two key themes we are seeing in the Australian domestic market is one; the continued rise of the importance of Asian investors and; two the rise of the power of self-managed superannuation with the growth of non-institutional investors in the domestic bond market.

Australia continues to run current account deficits; hence we need to borrow money overseas to create a capital account surplus. The importance of Asian investors in funding Australia has been consistent since the Global Financial Crisis, be it through loans and/or bonds. The importance of the offshore market cannot be underestimated. Every year the percentage of the domestic market that is purchased from Asian investors grows and the number and the variety of the investors from Asia are becoming more diverse both geographically and from the type of institution. We are also seeing more activity from the Asian offices of a number of European or US fund managers. I don't see this changing in 2017.

The other big theme is the power of self-managed superannuation and the power of the growth of non-institutional investors in the domestic bond market. Traditionally we saw this demand in the hybrid and convertible market but increasingly these investors are providing liquidity in the senior debt for all types. 2016 was the year where this went from a consistent, albeit small, bid for new issues, into being a more significant part of most book builds. A number of infrastructure related issuers saw strong bids in 10 year FRN's from this sector and I think this will be a continuing theme in 2017 as more self-managed superannuation move towards fixed income, a seriously underweight asset class.

Innovation is weaved into both of these themes. NAB is extremely proud to bring the first green bond from a commercial bank at the end of 2014. In 2015 we saw that transaction replicated by other banks both domestically and offshore. In 2016 the green bond market stepped up another level, in April we saw the first green certified securitisation transaction for Flexigroup, following we saw a tranche of that securitisation for green qualifying assets. In July we saw the first green bond from an Australian Government Authority, Treasury Corporation of Victoria. This market is certainly becoming more topical for Australia and a reflection on the growing investor appetite for assets that are socially responsible.

This market will continue to grow as investor's continue to have the desire for investments that are attractive in their own right and equally have purpose.

As we finish 2016 there is continuing discussion about Australia's sovereign rating, S&P have Australia on negative outlook since July. This has particular relevance for all financial institution borrowers and ultimately for other non-financial borrowers. I believe this discussion will get more attention during 2017. There will be lots of election discussions next year as well, so while the US election is out of the way, we will see elections in France, the Netherlands, Germany (both state and federal) as well as an interesting independence referendum (think Scotland) in Catalonia. It will be interesting this year to see how the new US administration deals with the ongoing foreign policy issues around the globe. This will create the usual propensity for markets to react, whether this is from instability in North Africa and the Middle East or one of a number of other spots around the world it is hard to say. The key is for issuers to expect volatility and be ready to issue in windows when the markets are open.

Thank you for allowing us to work with you during the year. We look forward to working with you in 2017.

# AUD CORPORATE BOND MARKET OVERVIEW

Australia's corporate bond market consolidates amid slow macro backdrop, ahead of an expected supply rebound in 2017.

**Brad Scott**

Australia's corporate bond market experienced a year of supply consolidation in 2016, during a period characterised by muted company demand for term debt, recurrent bouts of volatility and a continued investor bias towards longer tenors.

Calendar 2016 was ushered in with sharp rises in market volatility initially related to concerns regarding China's slowing economy. Markets were then further rocked by the negative flow-on effect to commodity prices, namely oil, and in turn to investor sentiment.

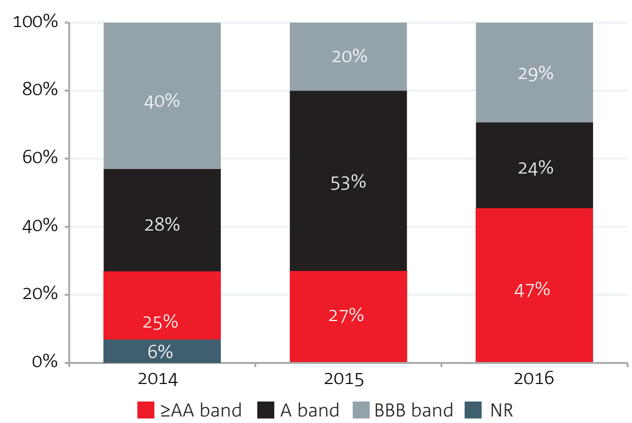
Combined with reporting season and a rise in credit rating downgrades, it would be easy to conclude that local issuers stood back and bided their time to issue in Q1.

In reality, local corporate debt markets were facing a supply drought based on the reality that many issuers had pre-funded in prior years, deleveraged or were perhaps targeting different markets such as USPP, Sterling and Euro markets for varying reasons – tenor, volume etc. This came as no surprise to NAB's DCM team as we saw a lack of a forward deal pipeline emerge at the tail end of 2015. This phenomenon, it should be said, impacted all debt markets universally and by the end of 2016 total corporate funding is around A$100 billion down from A$160 billion in 2015.

It is against this backdrop, and with fixed income market participants wondering when indeed an Australian corporate would issue, that May finally saw its first corporate issue when AirServices Australia (AAA) issued its first ever dual tranche transaction totalling A$400 million (7yr/10yr) with NAB acting as JLM. Prior to this the only single transaction had come from repeat Kangaroo issuer Korea National Oil Corporation in February. AirServices' excellent outcome, however, had its intended effect of reassuring issuers about the solid level of demand locally, and by months end, 3 more issuers had entered the market. These included two Kangaroo auto issuers and the first domestic BBB rated issuer of the year, Port of Brisbane, who issued an eye catching 7yr A$250 million at a very tight credit spread (NAB JLM).

Following that, the issuance was dominated in a volume sense by Kangaroo issuers including a return from Apple (A$1.425 billion/3 tranches) and an impressive debut issue from The Coca Cola Company (A$1 billion/2 tranches) which enhanced headline market volumes. Given these first half jumbo volumes, the first half of 2016 saw issuance of A$4.85 billion, up around 10% on the prior comparable period. In reality, deal count wise, transactions were down however, while the resultant skew towards 'AA' rated volumes, masked the underlying trend seen towards 7yr BBB demand driven by Australian and Asian investors.

**Recent A$ corp issuance by rating**




Source: NAB Corporate Debt Markets

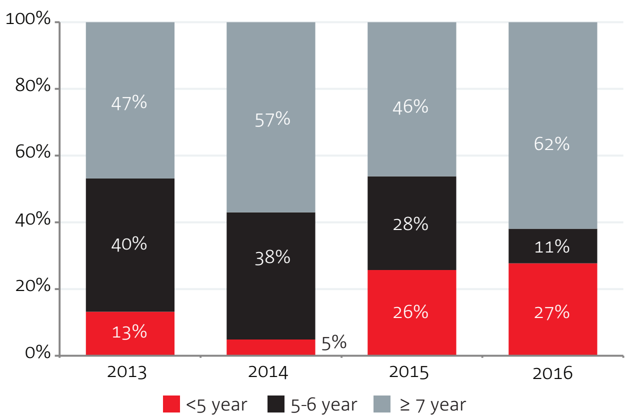
Pleasingly, the second half of the year saw a rise in activity with NAB busy across multiple corporate mandates including SGSP Australia Assets, Local Government. Funding Vehicle, Infrastructure play Westlink M7 (printing A$500 million in 2 tranches) and a debut Kangaroo issue from Toyota Motor Credit Corporation amongst many others. Until the emergence of both Brexit and the Australian Federal election, it is equally noteworthy to the extent that taps of A$30-$50 million became a more popular vehicle for corporate issuers in 2016, notably in the property sector.

**Key 2016 themes:**

The second half of 2016 saw some of the more traditional themes that have been prevalent in recent years namely:

- A rise in activity around the 7yr+ tenors, is a trend that indeed remains the sweet spot for the market and should remain so in 2017. 7yr+ deals accounted for 62 % of volumes in 2016, the highest on record.

**Historical A$MTN issuance by tenor**




Source: NAB Corporate Debt Markets

**10 year demand:**

- A step-up in 10yr investor demand, driven by largely Japanese-related mandates, while domestic investors showed encouraging signs of their willingness to participate. The most poignant illustration of this was shown by the strong response to GPT's A$150 million transaction (and subsequent NAB led tap), and Melbourne's Airport's A$200 million 10yr deal which saw orders of ~A$800 million.

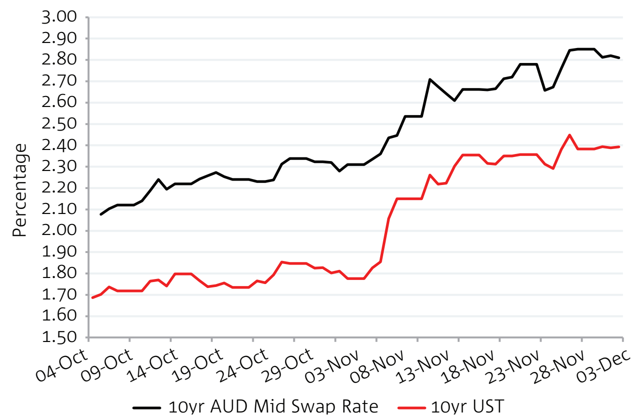
**Kangaroo Issuers:**

- Increased significance of Kangaroo issuers, who have not only underwritten about half the markets' reduced volume this year, but provided a welcome source of diversification for investors. This has ensured that average deal sizes have remained elevated in 2016 (A$350 million average vs A$223 million in 2013), but we do note the absence of benchmark A$500 million sized deals in 2015.

**Investor sensitivity to relative value**

- Investors limited to flat secondary performance on many of their portfolios over 2016, as credit spreads drifted sideways. For deals then that offered value or high spreads such as Qantas' successful two tranche A$425 million (7/10yr), investors have been willing buyers. Equally, yields rose sharply since Q3 in 2016 and the US Presidential outcome in November provided further headwinds for investors.

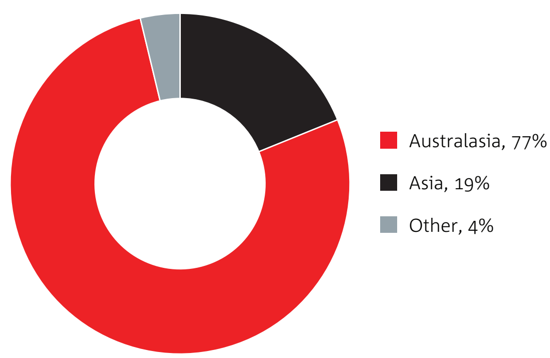
**Credit curves steepen post US presidential election outcome**




Source: Bloomberg

Role of Asia: Asia's significance to Australian corporate bond issues continued in 2016, with deals typically seeing around 25-30% participation from this continent. NAB has also seen some widening of this market (beyond funds), as Chinese banks hungry to lend to Australian corporates, have increased interest in bond deal participation.

**Asia is a key role in A$MTN distribution (2016)**




Source: NAB Corporate Debt Markets

## 2017 Corporate Bond Outlook

NAB sees corporate bond issuance rebounding in 2017 across A$/offshore, offsetting the slowness of 2016 where the corporate A$ MTN market saw A$9bn of supply. Based on growing pipeline visibility, we attribute this more constructive expectation to the alignment of market forces reflecting cyclical and structural factors. These include continued Kangaroo interest in developing A$ curves, a lift in M&A, privatisation-related bridge-to-bond activities, and the refinancing of around A$16bn equivalent of aggregate corporate bond maturities from multiple markets. Combined with higher yields on offer for investors and growing investor interest to see more corporate issuance in 2017, we think perhaps 2016 will be remembered then not as being subdued, but merely the calm before the storm.

# 2016 AUSTRALIAN LOAN MARKET OVERVIEW

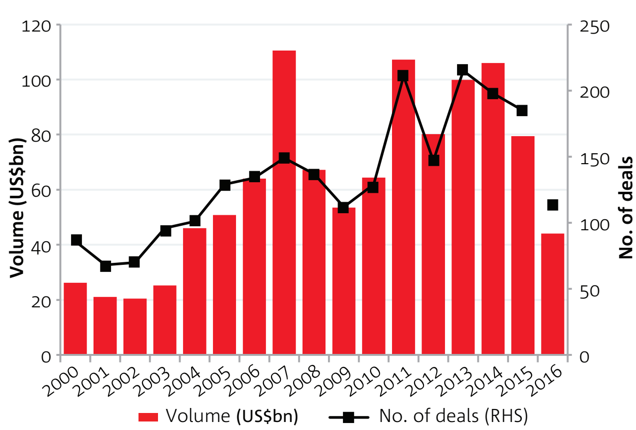
A tale of two halves for the Australian Loan Market in 2016.

**Stephen Boyd and Mark Bower**

The year commenced with limited activity, caused by increasing credit spreads following increases in bank cost of funds and Borrowers waiting for a lead to enter the market. Several key transactions during May and June opened up market volume with the last few months of 2016 seeing very strong activity and many transactions in market to satisfy bank demand for assets.

Looking at overall statistics year to date, the Australian loan market has been subdued versus previous years with YTD volume down over 25% YOY, which is a similar experience across the Asia Pacific region.

**New Loan Market Volume chart (as at 4/12/16) Vol. (US$bn)**




Source: Thomson Reuters , LPC Data

The decline has been due to a combination of factors principally:

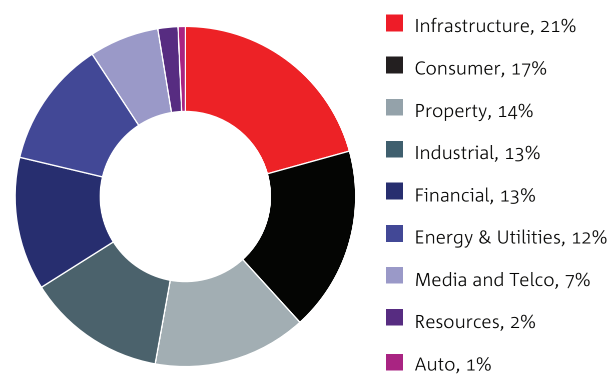
- Low credit growth resulting in a lack of demand by the corporate sector for credit;
- Reduced level of refinancing due to significant refinancing occurring over the last few years; and
- Increased loan pricing making it less conducive for borrowers to refinance early compared to previous years.

Although loan volume has been down 2016 YTD, the year has been active with an increase in new money deals that have been a combination of additional funding raised by corporates; M&A and privatisation. These transactions have been meaningful in volume with strong support by banks.

There is A$20 billion+ in transactions in market attempting to close before year end 2016 which, while still leaving volume short of previous years, will represent a significant increase on the current YTD trend.

Consistent with previous years, market liquidity has remained strong with all syndicated facilities coming to market oversubscribed. This year has been highlighted by more event driven transactions (acquisition and privatisation) than prior years and transactions have supported a wide variety of sectors which is a key feature of the loan market.

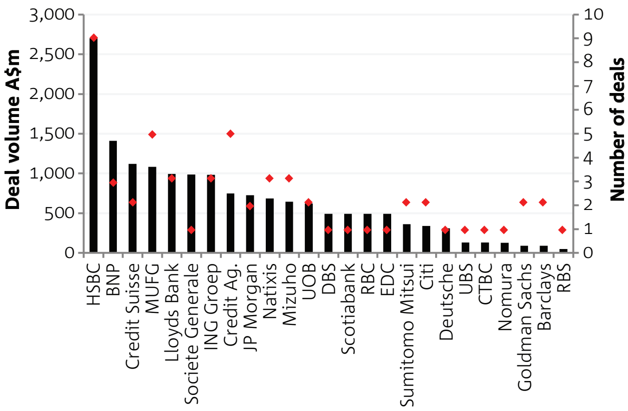
**2016 YTD loan deals by sector**




Source: Loan Connector

The loan market also experienced an increase in new banks establishing a branch in Australia improving local liquidity available to Australian borrowers. Most of the banks that established a presence were of Taiwanese origin. A few transactions have additionally been syndicated into the Asian region, which have also been well supported by banks in key regions of Singapore, Taiwan, Hong Kong/China and regional Japan.

**2016 YTD Australian loan participation from mandated lead arrangers**

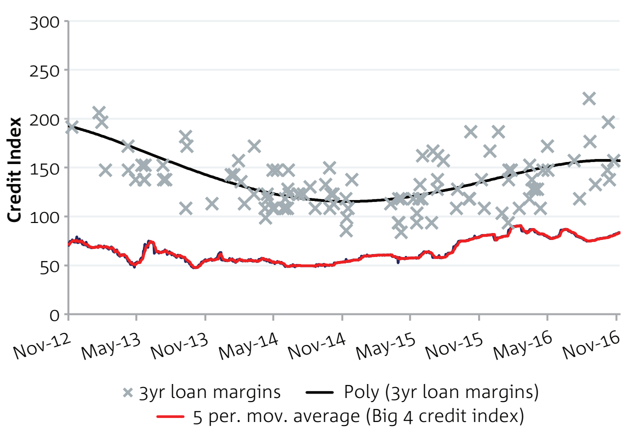



Source: Bloomberg, NAB Debt Markets Origination

## Drivers of change

Unlike previous credit cycles where an increase in loan pricing was associated with a tightening in market liquidity, the market experienced increased pricing without any noticeable contraction in credit availability. The catalyst for this was the market volatility experienced in Q4 2015 impacting on funding costs of banks globally resulting in loan pricing widening in the order of 20-30bps.

**Australian Loan Market pricing**



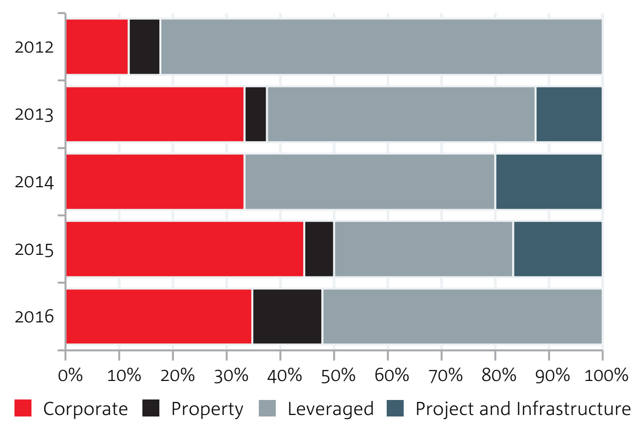

Source: Thomson Reuters , LPC Data

Banks have also been increasingly affected by the cost of additional capital raised to meet increased prudential requirements imposed by regulators.

The ability of banks to pass on increased costs has been limited due to continuing strong liquidity and subdued market volume. Banks have been increasingly balancing the level of commitment provided to borrowers with the overall relationship, given the increased cost of capital.

This is resulting in syndicate composition broadening, to include other banks or non-bank investors (institutions and funds) from across the region that are more passive. This approach allows for a more balanced lender group to support clients in meeting their funding and maturity needs.

**Breakdown of funds participation in loan transactions**




Source: Thomson Reuters, LPC

## Australian Loan Market Outlook for 2017

The loan market is expected to continue to exhibit surplus liquidity relative to demand for credit over the next 12 months. Foreign banks based in Australia and offshore will continue to show active interest to deploy capital as Australia remains a favoured destination particularly in regard to the infrastructure and utility sectors.

2017 will reveal more on how banks deal with regulatory change and increased prudential requirements with the consequent impact of increased funding and capital costs. Each bank will manage this in different ways through either:

- Being more selective of their target market and available capital to deploy;
- Reduced hold commitments and increased distribution of loan assets in primary or the secondary market; and
- Increased securitisation of loan assets.

The growing involvement of institutional investors and funds in the loan market will be complementary to both banks and borrowers.

Geopolitical risk will also remain a key focus through 2017, and how events impact sentiment and overall conditions across credit markets.

# 2016 DOMESTIC BANK AND KANGAROO FINANCIALS OVERVIEW

Financial supply drives volume for a record year in the A$ bond market

**Rahni Soliman**

2016 has been an interesting year for frequent issuers in the A$ bond market, accentuated by pockets of extreme volatility as a result of Brexit and the outcome of the US federal election. Despite this, year on year issuance volume is up on last year with a record total of A$125.5bn issued in 2016.

May represented the largest issuance month for Financials with ~A$10 billion in supply as issuers took advantage of strong investor demand ahead of the Brexit vote.

General investor cautiousness in the run in to Brexit resulted in very low issuance volume through June and July. However the market quickly rebounded as it became apparent that the road to Brexit would be long and drawn out. With plenty of cash to put to work, aided by heavy redemptions, investors once again showed strong support for A$ financials and credit spreads continued to grind tighter.

The second half of the year was similar to the first as markets nervously anticipated the outcome of the US Federal Election. Whilst a Donald Trump victory was widely expected to be negative for financial markets, the resulting volatility was short lived. Issuance quickly resumed as issuers completed their funding plans for the year. The long end of the curve has been of particular focus in Q4 as the selloff in rates triggered investor appetite in the 10 year bucket.

## New Issue Concession

While the first half of 2016 provided relatively stable market conditions issuers were required to pay double digit new issue concessions (NIC) in order to entice investors into primary market transactions. As the year progressed, the NIC's eroded and deals found strong support from both domestic and Asian investors.

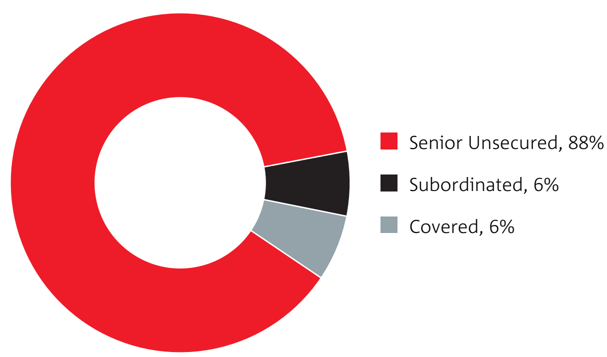
By September it was not uncommon to see transactions price flat or through issuers domestic curves, provided market conditions were conducive at the time.

The weighted average NIC for Senior Unsecured Financials in 2016 was 5.0bps

## Major Bank Issuance

The Australian major banks have been very active in the A$ market in 2016, issuing a total of A$36.6bn in Senior, Covered and T2 Capital formats versus A$21.4bn in 2015.

**Major bank product split BBG**




Source: Bloomberg

Larger transaction sizes were driven by a strong domestic and offshore bid for major bank paper as wider NIC's provided greater incentive for investors to participate in a new benchmark offering.

The majority of issuance has occurred in the 5 year tenor as the Australian banks remain focused on NSFR compliance ahead of 1 January 2018.

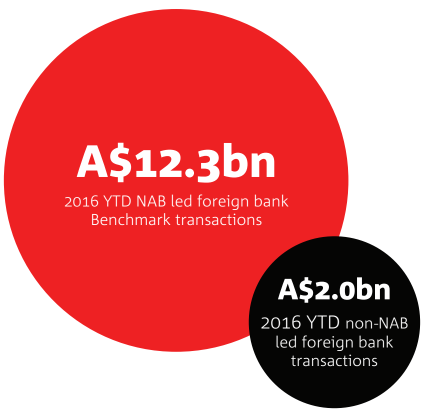
NAB issued the largest benchmark transaction of any financial institution in recent years, with a A$3.2bn dual tranche 5-year senior unsecured offering in May which priced at S/Q ASW +117 bps.

## Offshore Financials

The jurisdictional diversity of issuers from the sector also demonstrates the increasing appeal of the A$ market as a source of funding for global issuers.

Foreign banks (both Kangaroo and Foreign Branches) have been active this year and make up c.23% of total issuance from the FI sector. NAB, as a JLM and Bookrunner, continues to dominate this space having led A$12.3bn of supply from Foreign banks in 2016.

**NAB led Foreign Bank A$MTNs**




Source: Bloomberg

## Covered Bonds

The A$ Covered Bond market kicked back into gear in 2016.

The product appeals to issuers as it facilitates access to offshore markets and longer tenors, delivers the lowest headline wholesale funding cost and may continue to be a viable and functioning funding source during times of market volatility. Having a covered bond capability is considered to be a prudent and effective part of a diversified funding strategy.

NAB has acted as Joint Lead Manager on every non-major bank Covered bond in 2016 including the inaugural DBS Covered Bond, the first Asian bank to issue in this format in A$.

**2016 Australasian Bank Covered Bond League Table AUD (excluding self-led deals)**

| Bookrunner | Value (USD$m) | Number |
|---|---|---|
| NAB | 407 | 5 |
| ANZ | 299 | 4 |
| Deutsche Bank | 160 | 2 |
| UBS | 160 | 2 |
| Westpac | 108 | 1 |

Source: KangaNews

## Credit Spreads

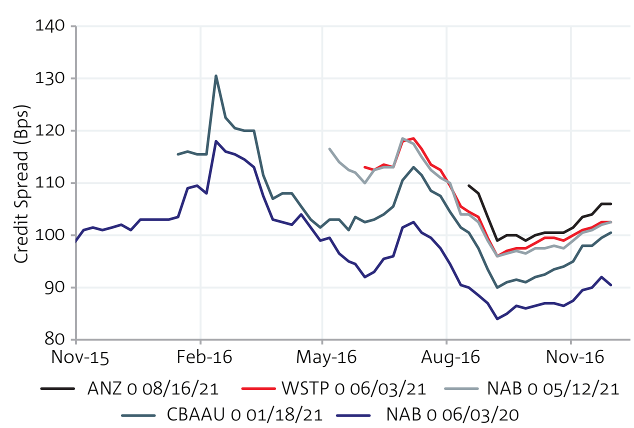
It has been a volatile year for credit spreads globally and the A$ market has not been immune to the impact of events occurring in other parts of the world. The initial move wider started in late July following Brexit.

However, in the weeks following, markets stabilised and credit spreads performed well throughout Q3 printing the tights for the year.

A softening in spreads occurred again following Trump's victory in the US election, but unlike the significant shifts in rates and equities the adjustment in credit markets was quite muted.

Headline risk remains on a number of fronts, and as Trump takes the reigns of the largest economy in the world, the probability of more volatility in global markets is somewhat likely.

**Major bank credit spreads**




Source: Yieldbroker

# SECURITISATION IN 2016

NAB's Securitisation team goes from strength-to-strength being the clear house of choice for customers and a thought leader in the market.

**Jacqueline Fox and Sarah Samson**

2016 has been NAB's strongest year in securitisation as measured by key indicators. The 2016 Peter Lee survey results demonstrate just how much the bank's securitisation capabilities and service proposition resonates with customers. This is evidenced by the number of customer deals the team is involved with and the sheer proportion that NAB performed the coveted role of Arranger.

**CY2016 key measures**

- Participation Rate of 89% (NAB has acted as a JLM on 23 out of 25 deals to market[1])
- Arranger Rate of 68% (NAB has Arranged 17 of those 23 deals[1])
- No. 1 on KangaNews League Tables

We are proud to be respected by our customers and recognised for the 5th consecutive year as Securitisation House of the Year (KangaNews).


**2016 AU Securitisation League Table (incl. AUD and Foreign Currency Tranches excluding self-led)**

| Bookrunner | Volume (A$m) | Number of deals | Market share (%) |
|---|---|---|---|
| National Australia Bank | 4101 | 25 | 29.2 |
| Westpac Institutional Bank | 2070 | 15 | 14.7 |
| ANZ | 1787 | 10 | 12.7 |
| Commonwealth Bank of Australia | 1747 | 14 | 12.4 |
| Macquarie Bank | 1278 | 8 | 9.1 |
| Citibank | 846 | 4 | 6 |
| Deutsche Bank | 625 | 4 | 4.5 |
| J.P. Morgan | 456 | 3 | 3.3 |
| HSBC | 396 | 2 | 2.8 |
| Credit Suisse | 266 | 2 | 1.9 |
| **Total** | **12004** | **74** | **90.5** |

Source: KangaNews

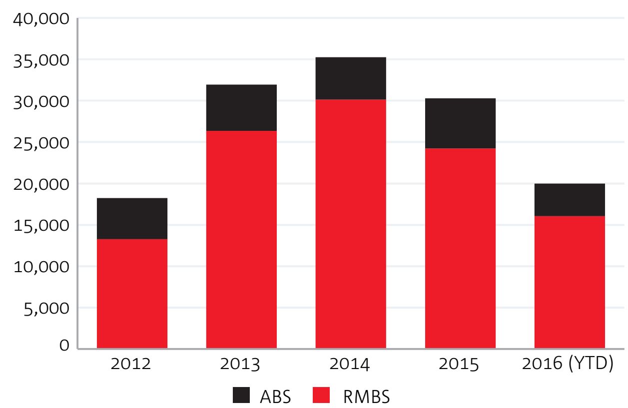
[1] Excluding Self-Led and Private Placements

## Lower volumes but increased investor participation

Like many other products, aggregate securitisation issuance volumes are down year-on-year: CY2016 $19.6 billion as at the end of October 2016 versus $30.3 billion for the same CY2015 period. The decrease in issuance volumes is attributable to a few things: overall credit growth; slowed investment lending due to macro-prudential tightening; use of alternate funding options such as covered bonds and senior unsecured plus spots of market volatility over the course of the year.

The rest of CY2016 is likely to see a few more deals print but our view is that the year will end still well short of 2015 volumes. The CY2017 Q1 pipeline is looking strong and indicates stronger issuance levels for CY2017 all things being equal.

**Total Australian RMBS and ABS issuance (A$m)**

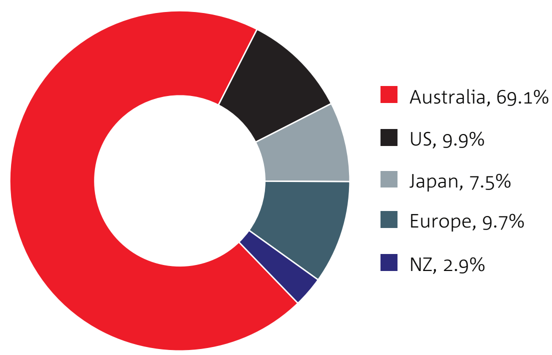



Source: NAB as at 18 November, 2016

Throughout the year, issuers have been well supported by domestic and offshore fixed income investors with the balance sheet bid continuing to be represented albeit to a lesser extent than for CY2016.

Offshore investor participation has grown for AU securitised product with the entry of new investors across regions. RMBS investor location is shown in the chart below, representing ~31%:

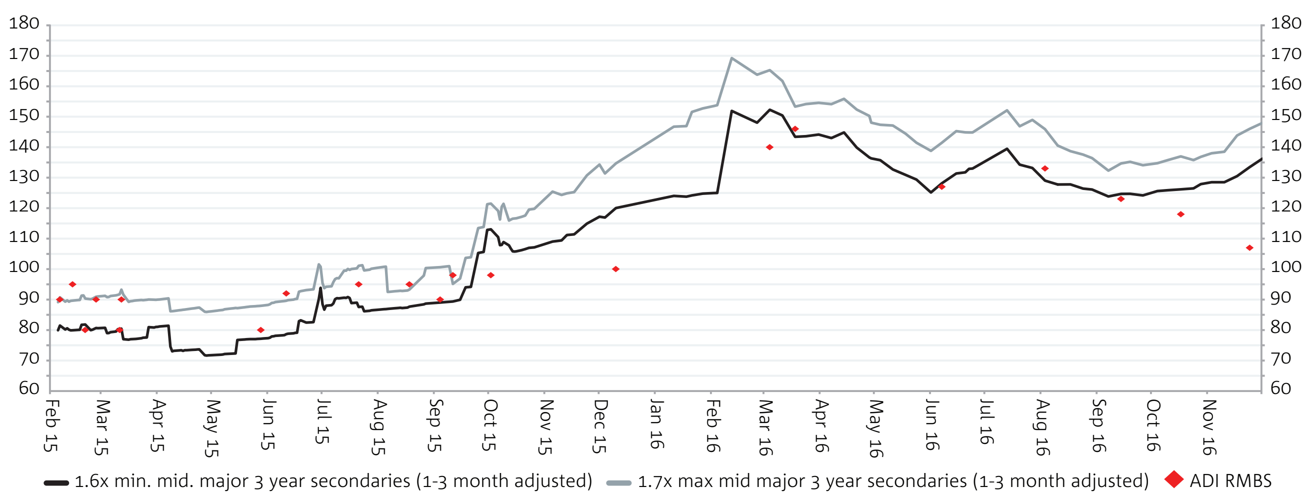
**CY2016 RMBS**




Source: NAB as at 18 November, 2016

Consistent with broader credit markets pricing for securitisation issues widened at the beginning of CY2016 given market volatility and contracted slowly during the course of the year with good value being offered from the primary market.

**Historical ADI RMBS pricing**




Source: NAB

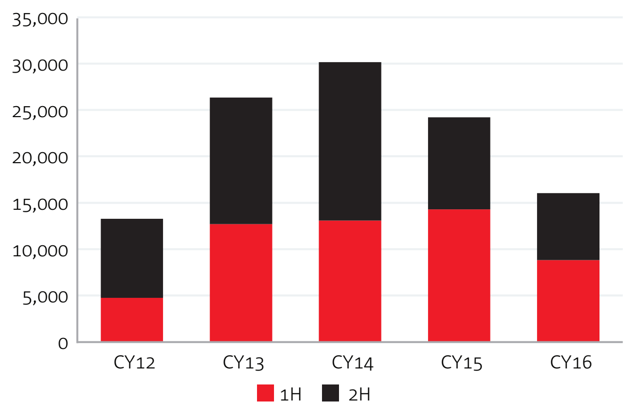
2016 M&A activity involving securitisation funding has also been quieter than in 2015 albeit with some activity in the equipment loan space and a few portfolio sales, reflecting some ADIs still looking to exit from non-core asset classes, as well as some consolidation in the non-bank sector.

## RMBS

RMBS continues to represent the bulk of the Australian securitisation market, with approximately A$15.7 billion (equivalent) in public issuance across a total of 28 deals as at the end of October.

We anticipate a strong pipeline moving into CY2017.

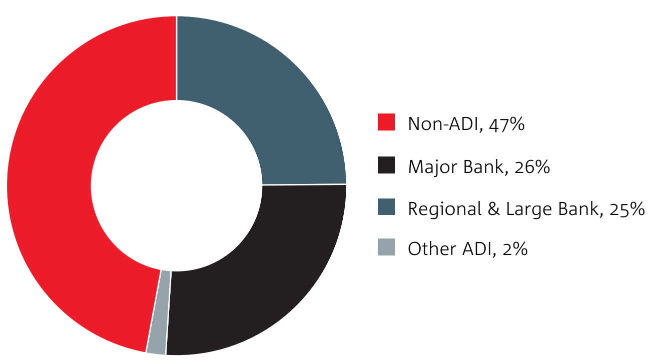
**Public RMBS issuance (A$m)**




Source: NAB as at 18 November, 2016

All RMBS issuer classifications were active during the course of the year and this is expected to continue in 2016. The chart above illustrates that 2015 first half issuance volumes were up on 2014, however, volatile market conditions during the second half slowed issuance with a number of issuers electing to stay on the sidelines for conditions to settle.

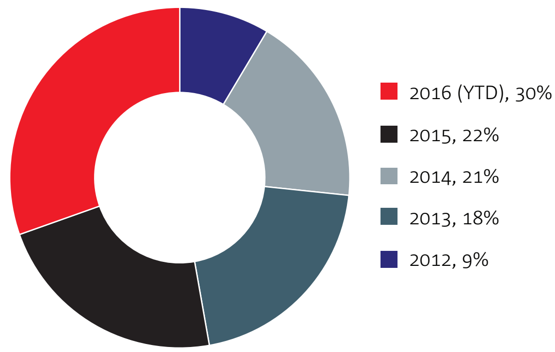
**YTD RMBS issuance volume by issuer type**




Source: NAB as at 18 November, 2016

The proportion of prime and nonconforming RMBS public issuance as at the end of October grew to approximately 9%, with outright volume at just over A$2 billion. Further nonconforming issuance is not expected until early 2017. Consistent with 2014 and 2015, non-ADI names continue to tap the US market with USD 144a format providing for greater diversification across their investor base. We expect a small group of issuers will continue to invest in diversification with opportunistic transactions during the course of 2017.

**Public nonconforming issuance**



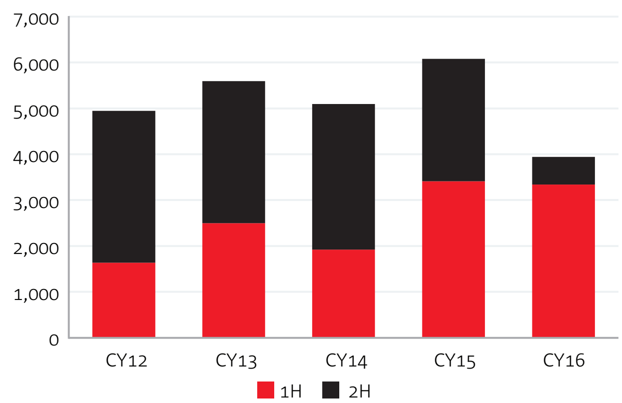

Source: NAB as at 18 November, 2016

## ABS

Total year to date issuance for Australian ABS, including offshore issuance, stands at just short of A$4 billion equivalent across 6 deals, shy of 2015 levels. Regular auto issuers Macquarie-SMART (x2) and Westpac-Crusade returned to the market, along with Driver and CNH. Consumer finance issuer Flexigroup-Certegy also came to market with an innovative 'green tranche, a first for the AU market.

ABS issues are typically well supported by investors given the diversification value and their shorter tenor to most RMBS issues.

**ABS Issuance (A$m)**




Source: NAB as at 18 November, 2016

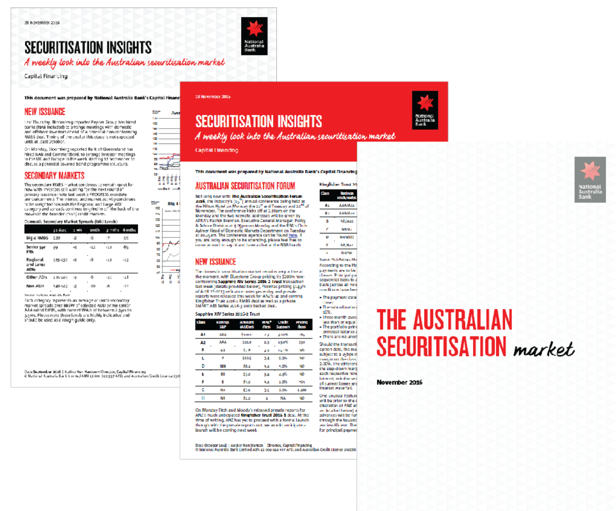
## Innovation and thought leadership

At NAB we pride ourselves on innovation and thought leadership. This year NAB arranged FlexiGroup's Certegy ABS issue which included a 'green' tranche, being the first in the AU market and significantly, the first Climate Standards approved green ABS in the world. NAB also sponsored a 'green' themed panel at this year's 2016 Australian Securitisation conference drawing a range of participants.

We view securitisation as a transparent funding tool for green assets and believe the AU market will evolve over time to include more ABS transactions carrying the 'green' label.

## Research

NAB provides a weekly research offering titled Securitisation Insights, semi-annual review and outlook publications and special articles to ensure our issuer and investor clients remain informed about the Australian Securitisation market.




## Regulatory impacts

On 10th November this year APRA released its final draft of APS120. Unsurprisingly to the industry, there was little movement on some of the core changes made in the discussion paper released in November 2015. The primary impacts relate to increased risk weights for financial intermediaries providing warehousing and/or investing to customers. Ultimately this is expected to flow through to increased pricing and a more limited environment for warehousing arrangements. The implementation date for the final standard is 1st January 2018.

# EVOLUTION OF THE AUSTRALIAN DOLLAR BOND MARKET

What is going on in the Australian dollar bond market?

**Mark Abrahams**

It's not a simple question to answer as the AUD bond market is not just one market. It is - at last count – at least six markets with their own features, documentation and target investors. Some investors can straddle a number of the formats while others are more constrained due to other factors like restricted mandates or regulatory drivers.

The main AUD bond formats are:

- **AUD Onshore Wholesale:** This comprises our domestic and Kangaroo borrowers, with bonds usually settled through Austraclear initially and subsequently bridged to Clearstream/Euroclear. Documentation is generally under Australian law however recently we have seen some offshore law creeping in.
- **AUD Onshore Retail:** These bonds are usually ASX listed and settled through CHESS, with subordinated bank hybrid deals dominating volumes. This is a well-established market with a very different execution process and targeted non-institutional investor base.
- **AUD EMTN (Reg S):** These bonds are usually documented under a European jurisdiction (predominantly under UK law) with the programme also listing in Europe. AUD Eurobonds started to proliferate once the AUD became a 'floating' currency in 1983, however, appetite has expanded beyond the original European retail arena with the emergence of Asian investors who buy AUD structured notes and vanilla private placements in this format. AUD EMTN subordinated (Tier 2) public deals have started to proliferate in recent years with issuers favouring this format over the Kangaroo which is more costly and takes longer to establish. The EMTN transactions are usually more modestly sized, often starting with just A$100 million as an initial volume target.
- **AUD SEC Registered Global:** As the name suggests, these bonds can be sold in most of the large markets including the US. The format has grown dramatically in recent years, partly as a result of increased regulation of the global systemically important banks ('G-SIBs'). This market is discussed in more detail below.
- **AUD Local market bonds** like Uridashi and Formosa bonds use the EMTN format as a base. Uridashi notes overlay a Japanese 'shelf' to enable distribution to Japanese retail investors. Technically, they are notes issued outside of Japan and are sold in secondary trade (one day or more later) to Japanese retail investors. Formosa bonds are issued by non-Taiwanese borrowers and are listed on the Taipei Exchange, thereby effectively becoming a 'domestic' issuer. This allows Taiwanese life companies to participate as investors without breaching holding restrictions on offshore names.
- **AUD denominated US Private Placement ('USPP') deals:** These bonds are occasionally added to a USD USPP if it does not suit an issuer to either receive US funding, or if they do not wish to swap USD note proceeds to AUD. Some USPP investors can accommodate this.

## What is so special about the AUD global?

**How has this market muscled in on the action over the last few years?**

The format has always been around for non-USD deals. However due to higher legal costs and more viable alternatives the Global format had only been occasionally used.  Five years ago, there was a flurry of AUD and NZD fixed rate US-bank names tapping this market and aiming directly at large US based funds. The deals received some demand from Asia, however as the target comprised US onshore investors, the deals were launched and priced in New York time. There was close to no participation from Australian accounts.

Then nothing much happened for three years.  As rates dropped globally, AUD yields followed, as a result, fixed rate bonds in AUD became less popular for financials. Just one AUD Global was printed by a US bank in each of the years 2013, 2014 and 2015.

However, a turning point seems to have occurred with the Citigroup trade in July 2015. Firstly, it wasn't driven by the attractiveness of a fixed rate issue. Rather, the focus was a floating rate note ('FRN'). The FRN tranche was ultimately four times larger than the fixed tranche. Secondly, the deal was launched and priced in the Asia-Pacific time zone rather than the US. In this case, the target for this trade was the pool of stickier AUD funds and commercial banks based in Asia rather than the US based funds previously targeted by the market. Demand onshore in Australia was considered to be a bonus, attracting a very healthy 37% from a small number of Australian buyers.

But why was the Global format chosen in the first place? The real driver links to one of our key identified trends around financial system change, that is, a trend of increased regulation (although the recent Trump triumph might question whether financial regulation will continue to increase). The proposed introduction of the total loss-absorbing capacity (TLAC) rules has removed the Kangaroo option for US based G-SIBs.

The Australian law governed Kangaroo bond does not have the US home market jurisdiction required to achieve the bail-in status required under TLAC. The proposed TLAC regulation has been constructed on the premise that US home market jurisdiction of the issuance will make it easier to enforce the bail-in laws.

Since that Citigroup trade, we have witnessed four bank deals in 2016 raising circa A$2.95 billion. Citigroup returned to the AUD Global market twice in 2016, raising A$1.30 billion in 5 and 10 year maturities. Wells Fargo (A$1.65 billion across three tranches) and Bank of America (A$750 million across two tranches) also printed very successful deals. What is pleasing is that the Australian domestic participation continued to broaden as the format became more familiar to investors.

Over the past 12 months, the Ford Motor Company has used its US Global documentation to print two AUD deals rather than setting up a Kangaroo alternative. The ongoing use of the format has increased familiarity of it with Australian based investors. Current outstanding AUD Global deals are listed below.

**Current outstanding AUD global deals**

| Name | Coupon | Announce | Currency | Issued amount (AUD) |
|---|---|---|---|---|
| Morgan Stanley | FIXED | 2/05/2012 | AUD | $1,000,000,000.00 |
| Morgan Stanley | FIXED | 24/09/2014 | AUD | $650,000,000.00 |
| Citigroup Inc | FRN | 28/07/2015 | AUD | $600,000,000.00 |
| Ford Motor Credit Co LLC | FIXED | 3/12/2015 | AUD | $500,000,000.00 |
| Citigroup Inc | FRN | 27/04/2016 | AUD | $600,000,000.00 |
| Citigroup Inc | FIXED | 27/04/2016 | AUD | $150,000,000.00 |
| Ford Motor Credit Co LLC | FIXED | 25/05/2016 | AUD | $450,000,000.00 |
| Wells Fargo & Co | FRN | 20/07/2016 | AUD | $900,000,000.00 |
| Wells Fargo & Co | FIXED | 20/07/2016 | AUD | $500,000,000.00 |
| Wells Fargo & Co | FIXED | 21/07/2016 | AUD | $250,000,000.00 |
| Bank of America Corp | FRN | 26/07/2016 | AUD | $550,000,000.00 |
| Bank of America Corp | FIXED | 26/07/2016 | AUD | $200,000,000.00 |
| Citigroup Inc | FRN | 20/10/2016 | AUD | $300,000,000.00 |
| Citigroup Inc | FIXED | 20/10/2016 | AUD | $250,000,000.00 |

Source: Bloomberg and NAB data

Whilst we don't expect the Global format will replace the broader appeal of the Kangaroo for offshore issuers, we believe this format is now a proven option for issuers who either cannot use the Kangaroo format for regulatory reasons and for those who prefer the simplicity of using one Global programme. NAB has been fortunate to be involved as Bookrunner on every US bank AUD Global in recent years.

# AGENCY & TRUSTEE SERVICES

Evolving to anticipate and exceed our customers' expectations.

**Melisha Hughes**

2016 has been a busy year for the wider NAB Corporate Services business with continued growth in traditional agency services roles as well as corporate services activity. On the Agency front, we were proud to receive the results of the Peter Lee Associates Large Corporate Relationship Banking Survey for 2016, placing us #1 for both market position[1] and high quality of service[2].

Customers have come to expect a highly competent and pro-active approach to the management of debt transactions and consistent endeavours to expand service offerings, including US Private Placement Agency services and Escrow Agency services. Customers also expect this to be integrated with a wider offering including issuer and SPV trustees, trust managers, fund administration, transactional banking, active cash management solutions to minimise negative carry, to reduce operational risk.

In 2016 we closed project finance transactions where our role commenced pre financial close, involving advice on maximising operational efficiency of transactional documents in our capacity as agent; security trustee and account bank; management of equity moneys; construction drawdowns (including relationships with expert third parties); all the way through to completion and issuance of capital markets take-outs; as well as providing operational cash management solutions post completion.

In addition, through its licenced trustee and trust manager businesses, NAB was able to provide ancillary services to a structured pooled borrowing vehicle, acting as note trustee, trust manager, security trustee and account bank for the transaction. Overall, there is an expectation that we use our experience to place an operational risk mitigation lens on everything we do.

In terms of flow, syndicated loan volumes in the Australian Loan Market were down from 2015; however we have seen growth in self-arranged transactions, particularly from the institutional investor sector, as well as infrastructure and structured asset finance segments, with a number of these transactions being on behalf of offshore names. Early engagement with Stakeholders particular has yielded additional opportunities to assist consortiums with managing equity funds via escrow or project accounts.

There has been a significant amount of activity in the renewables sector with both local and foreign sponsors looking to diversify their energy portfolios by investing in green assets. In this space, our independence and 'Agency for Hire' approach has proven invaluable for solely foreign lender syndicates. Similarly, the Agency portfolio was expanded by a number of new Corporates taking advantage of foreign lender appetite to establish non-Australian syndicates in support of offshore operations and expansion opportunities.

Looking forward, we expect continued momentum in the financial institutions, infrastructure and renewable energy sectors with a number of pipeline opportunities awaiting determination over the next few months.

Investor profile across our Agency portfolio shows continued support for Australian transactions from the major Australian banks, foreign lenders based in Australia and ongoing, if not increasing appetite from Asian lenders. There has also been a steady increase in the level of interest in loan transactions from institutional investors, including superannuation and investment funds. Of the secondary trades that have taken place across the Agency portfolio year to date, 45% have been conducted with Asian lenders, 26% with institutional investors and funds and the remainder with European and US lenders. Based on our discussions with market participants over the course of 2016, we fully expect accelerated growth from the institutional investor segment in both primary and secondary syndication over the next few years.

[1] #1 for Market Position for Agent for Syndicated Loans (Peter Lee Associates Large Corporate Relationship Banking Survey 2016. Ranking against all banks).
[2] #1 for Overall Service Quality for Agent Services (Peter Lee Associates Large Corporate Relationship Banking Survey 2016. Ranking against the four major domestic banks).

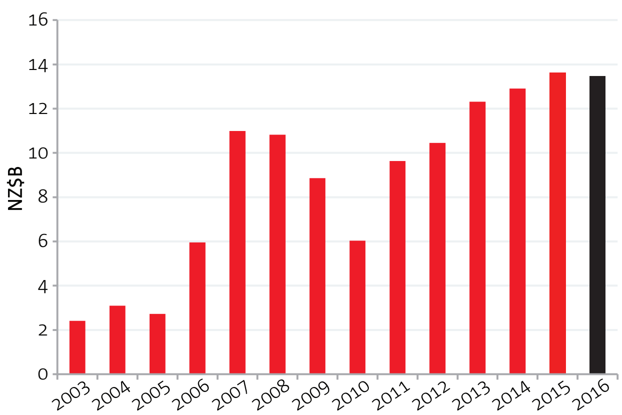
# SPOTLIGHT ON NEW ZEALAND

A year of capital, unrated issues, and new entrants into the Kauri market.

**Mike Faville**

2016 YTD has seen NZ$13.4 billion priced across 74 transactions, from a diverse range of corporate, bank, local authority and supranational and sovereign agency borrowers. This volume is on track to exceed the NZ$13.6 billion priced in 2015, and is already beyond the NZ$12.9 billion priced in 2014.

**Annual total market bond issuance**




Source: BNZ Markets

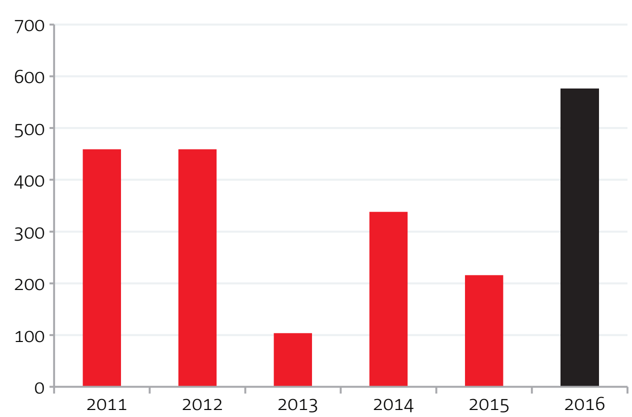
## Regulatory capital deals keep coming

The New Zealand bond market has a long history of appetite for subordinated and convertible issues, and this last 12 months has seen a strong flow of regulatory capital issues from banks and an insurance company. Three major banks, one local bank and one insurance company have issued Tier 2 capital (in date order, BNZ NZ$550 million, The Co-Operative Bank NZ$15 million, IAG NZ$350 million, Westpac NZ$400 million and NZ$350 millon). BNZ had a syndicate role on every one of these except the Co-Operative Bank Issuance. Two things are notable from these transactions – Issuers continue to have a need to raise hybrid capital, and the market does not have limitless capacity to absorb these instruments, as seen by the declining deal sizes over time. As markets do, we expect a balance point of sustainable issuance volume will be found. What's also interesting is that as retail investors may be feeling a little full on subordinated debt, domestic institutions continue to grow more comfortable with these structures and comprise ever greater proportions of books.

## Strong supply of unrated credit

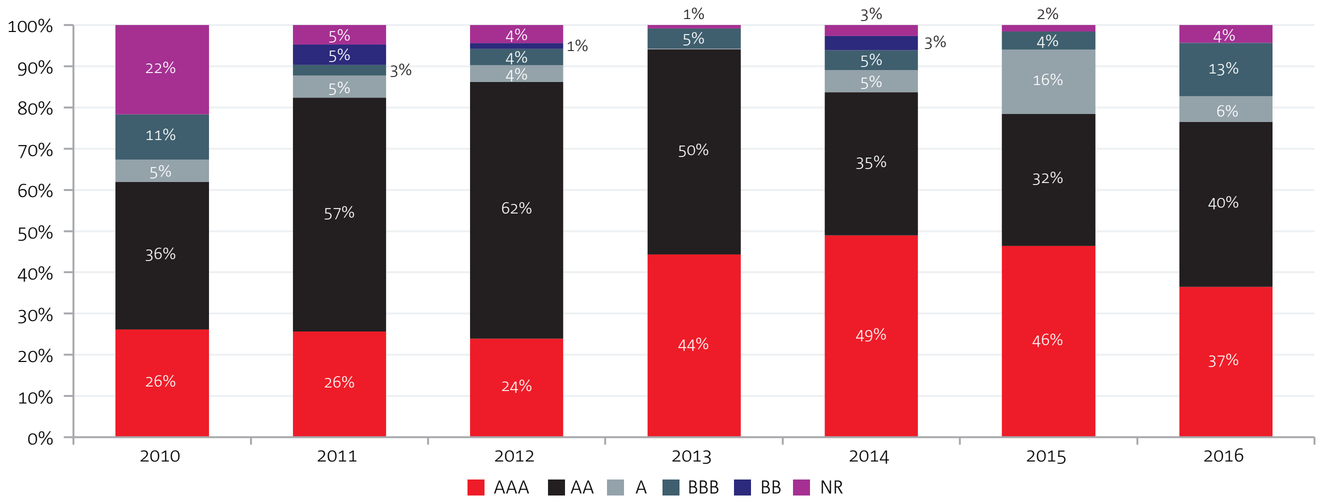
2016 already has been a record year for unrated issuance, with NZ$576 million issued year to date across 5 transactions. In contrast, NZ$216 million of unrated credit was issued in 2015. Kiwi Property Group, Trustpower, Z Energy, Air New Zealand and Infratil all accessed the market with unrated issues. BNZ had a syndicate role on every deal except Infratil. Demand for these issues was initially strong, however signs of investor fatigue were evident in some trades in mid to late 2016. An interesting side note on the Air New Zealand issue – the issuer is rated Baa2 by Moody's, but chose not to get an issue rating on the bonds. So even though the issue is senior unsecured, many investors viewed the deal as unrated. It would be very interesting to see unrated issuers from other jurisdictions come into the NZ market. We think the right names would get a warm reception.

**Annual total unrated bond issuance**




Source: BNZ Markets

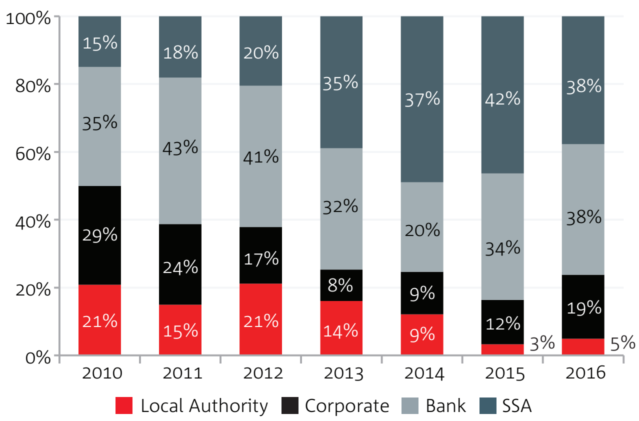
**Historical issuance by rating**




Source: BNZ Markets

On the back of increased supply in unrated issuance, 'BBB' band and below issuance is up from 6% in 2015 to 17% this year.

**Historical issuance by sector**




Source: BNZ Markets

## Corporate supply up

Like many markets around the world, supply rather than demand continues to be the limiting factor in corporate bond issuance volumes. NZ had an uplift in total supply this year, but corporates still only mustered a total market share of 19% across 17 transactions totalling NZ$2.161 billion (2015's numbers were 15 and NZ$1.791 billion respectively). Notable transactions included: Fonterra NZ$150 million; Chorus NZ$400 million, Meridian Energy NZ$150 million, Kiwi Property Group NZ$125 million, Spark NZ$150 million and Auckland International Airport NZ$225 million. We think the market would love to see a high quality name issue a hybrid capital transaction, with retail investors, and a growing proportion of institutions keen for the elevated yields these issues offer.

## Another solid year of Kauri issuance

It has been a slightly slower year for Kauri issuance in 2016 with NZ$5.4 billion of issuance, marginally down from 2015 with total Kauri issuance of NZ$6.325 billion. The overall theme in 2016 has been smaller print sizes, but with some notable exceptions World Bank (NZ$875 million), International Finance Corp (NZ$325 million), World Bank (NZ$600 million), KEXIM (NZ$350 million) and World Bank (NZ$550 million).

SSA Kauri issuance has accounted for 38% of total NZ dollar issuance so far this year, down from 42% in 2015.

An interesting development in a market that has stuck to similar crop of names for many years, were Kauri debut issues by Korea Development Bank (NZ$200 million 3y FRN) and KEXIM (NZ$350 million 5y). These issues were very well received, strongly oversubscribed and attracted new offshore investors into the Kauri market. A pleasing development is that those same new investors have continued to buy Kauri product from other names, so this is a strong positive for the market.

## Transition to a new regulatory framework

Over the last two years NZ has been moving to a new regulatory framework under the Financial Markets Conduct Act 2013, replacing the old Securities Act from 1978. The transition is now complete, and the new rules have simplified issuance procedures for some issuers.

# ASIA IN FOCUS

It was a volatile year for Asian debt capital markets, characterised by global uncertainty and unprecedented headline-driven event risk.

**Lorna Greene, Joshua Sife and Michelle Wong**

A slowing Chinese economy, RMB volatility and a long delayed (but much anticipated) US interest rate hike have weighed on investor confidence this year. Global risk markets were disrupted by significant risk events such as Brexit and the US election which saw markets shut for prolonged periods. Despite this, overall Asian risk sentiment this year has been supportive as investors continue to seek for yield and paper.

## Spotlight on US$ Reg S in Asia

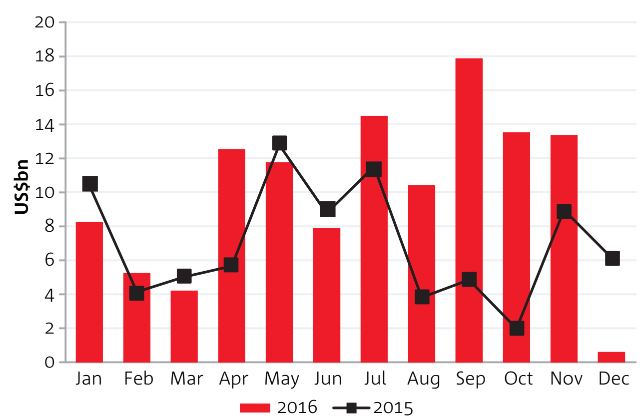
This year saw Asian investor focus intensify on the US dollar market as one of the only major currency markets still offering yield. Global volatility and uncertainty, coupled with negative interest rates and quantitative easing measures in key developed economies in Europe and Japan, have significantly impacted issuance in other G3 currencies.

As a result, 2016 has been a record year for Australasian US$ Reg S issuance. Year to date issuance volume stands at circa US$119 billion compared to circa US$86 billion in 2015[1], despite a reduction in net supply from Chinese borrowers.

Increased cash holdings and the lack of new CNH investment opportunities in the Dim Sum market saw the US and Australian dollar markets emerge as key beneficiaries. This, coupled with increased difficulty in sourcing paper in the secondary market and undersupply seen in the US$ Reg S market for periods of this year has further contributed to the strong demand and attractive pricing outcomes for issuers. This shift in demand has seen Asian investors increasingly act as the main drivers of US dollar public benchmark transactions, typically accounting for 80% or more of unallocated orderbook demand this year.

Issuers are acknowledging this shift, with many choosing to tap the US$ Reg S only market for the first time in 2016, as well as announcing US dollar denominated transactions in the Asian time zone to meet changing investor needs. This year has also seen Asian investor demand grow for US dollar denominated assets in maturities of 10 years or longer as investors, particularly insurers, move further out the curve rather than taking increased credit risk, in the hunt for yield. The above factors have combined to produce record pricing outcomes and orderbook volumes in US$ Reg S only format for issuers across all sectors and tenors this year.

**Asia US$ Reg S issuance: monthly activity**




Source: Dealogic; NAB Debt Syndicate and Origination

## China market update

China remains the largest source of debt issuance in Asia, with mainland borrowers accounting for 47% of G3 bond issuance in Asia (ex. Japan) in 2016.[2] However, cheaper onshore funding has seen a net reduction in offshore Chinese debt issuance year on year, with Chinese issuers opting for domestic issuance in the onshore bond market.

The Asian high yield market saw a revival mid-year as markets closed for the summer in August and borrowers took advantage of clear issuance windows and a lack of

[1] Bloomberg LLP, 2016.
[2] Bloomberg LLP, 2016.

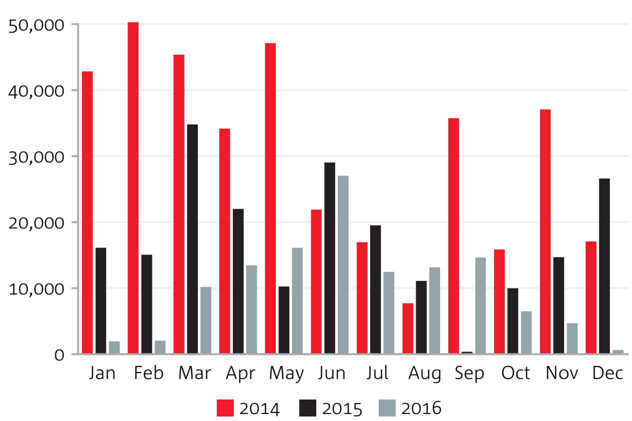
supply. Asian high yield issuance remains dominated by Chinese real estate names, with many borrowers opting for buybacks or exchanges to manage balance sheet risk in volatile markets.

Chinese Local Government Financing Vehicles (LGFV) were prominent issuers this year via direct issuance and offshore entities/keepwell structures as Chinese authorities continued to restrict approvals allowing domestic refinance of offshore debt in a bid to encourage Chinese borrowers to diversify their funding into international markets to reduce reliance on domestic markets.

Furthermore, despite more cost effective funding available onshore, the offshore market remains attractive to many Chinese issuers due to the optionality of different currencies and tenors available. This is particularly relevant for infrastructure companies as it provides more flexibility to finance their often multi-year development plans. However, in the case of LGFVs, the number of borrowers and scale of total offshore funding required will likely put pressure on offshore funding costs in the future.

With the speculative bid gone from the CNH market, overall RMB currency volatility and Chinese economic weakness saw Dim Sum issuance plummet to record lows this year (-41% yoy volume)[3], with a much talked about market revival following the Republic of Hungary issue not materialising as the cost of issuance remains relatively high compared to onshore funding. In addition, investor appetite has shifted away from the Dim Sum market as investors struggle to replace maturing assets.

**Dim Sum issuance volume (CNH m)**




Source: Dealogic; NAB Debt Syndicate and Origination

### How to grow a giant Panda

Borrowers are increasingly turning their attentions to the Panda market. The onshore RMB market is now seen as more favourable for both foreign and domestic issuers compared to the larger Dim Sum market due to the large pool of domestic Chinese savers looking for yield. Although market development remains slow, and regulations unclear, an increasing number of foreign borrowers are considering the Panda bond market as a more viable long term option which also meets their strategic goals of closer ties with China. With the People's Bank of China ('PBoC') strategic focus turned towards growing the Panda market, issuers have found some flexibility around issuance requirements making the market more attractive for international names. As a result, there was a year on year increase in issuance volumes of +150%[4], with debut issues from National Bank of Canada, Veolia, The Republic of Poland and the Province of British Columbia in the format.

### RMB Internationalisation paces along

RMB internationalisation hit a new milestone in October with the inclusion of the RMB in the International Monetary Fund's Special Drawing Rights ('SDR') basket. The fanfare associated with this was unfortunately overshadowed by RMB volatility likely caused by PBoC intervention in an effort to contain bearish speculation on the CNH and ensure currency stability by limiting capital outflows.

This year also saw the first SDR denominated issuance or 'Mulan bond' from The World Bank in September, followed by Standard Chartered in October as the first commercial bank to issue in the format. The long term development of the Mulan market remains unclear as investor demand for the synthetic currency continues to be limited.

### Going green in China

Since the introduction of the PBoC's Green Financial Bond Rules last year, China has fast become the largest market for green debt in the world. Chinese borrowers have raised 39.6% of the US$59.2 billion in issuance this year, from only 3.6% in 2015.[5] Green certification has not yet resulted in a pricing advantage with new issues typically pricing in line with the borrower's senior outstandings as the bulk of demand continues to come from non- Environmental, Social and Governance ('ESG') focused investors, although participation from dedicated Green Funds continues to increase. This year saw a number of debut Asian green bond issuances, as well as landmark transactions including

[3] Dealogic, 2016.
[4] Bloomberg LLP, 2016.
[5] Dealogic, 2016.

Asia's largest green bond and China's first green covered bond, both from Bank of China.

## Focus on Formosa

Since its inception in July 2014, Taiwan's Formosa bond market has become one of the fastest growing Asian debt markets and an excellent source of new funding for international issuers, including a number of high-profile, blue chip corporates such as Apple, Verizon, Anheuser-Busch Inbev and Électricité de France tapping the market this year. 2016 also saw the largest-ever issuance volume, with the market being on track to pricing circa US$50 billion in Formosa bonds, compared to US$34 billion for the 2015 full year.

Formosa bonds are listed on the Taipei Exchange ('TPEx') and qualify as domestic issuance which means they may be included in the domestic portfolios of Taiwanese insurers, allowing for further investment in offshore credits (capped at 45%) and taking pressure off international bond portfolios.

A large part of issuance in the latter half of this year has been from refinance trades that have been called in the record low interest rate environment. Growth continues to be strong, and dominated by US dollar denominated issuance; however 2016 also saw Formosa issuance in AUD, CNH, NZD and ZAR, as well as the debut Tier 2 Formosa from ABN Amro and the debut Total Loss Absorbing Capacity-eligible issue ('TLAC') from HSBC.

## Rise of Asia-targeted capital issuance

As regulators continue to increase global bank and insurance capital requirements, this year saw an increase in Asia-targeted capital issuance as borrowers respond to strong demand from yield-hungry Asian investors. Asian investors are opting to take more subordination risk for familiar credits, rather than credit risk in volatile global markets with US$58 billion in issuance seen this year in US$ Reg S only capital issuance (vs US$45 billion in 2015[6]).

## Record new issuance in Singaporean and Hong Kong Dollar

Record deal volumes have been achieved in the Singapore dollar market from international borrowers this year, driven by local investors keen to diversify their portfolios following the Swiber default, the first-ever from a Singaporean company. This will likely see increased scrutiny on the Singapore dollar market which is characterised by unrated credits and covenant light structures as investors become more selective. In a further effort to provide better market disclosure, local regulators are also reviewing the sales concessions on debt issuance paid to private banks on fears of a conflict of interest.

Record new issuance has also been seen this year in the Hong Kong dollar market (HKD 3.04 trillion vs. 2.16 trillion yoy[7]) fuelled by stronger investor demand as investors move away from CNH denominated assets. 2016 also saw the first HKD Tier 2 issues from National Australia Bank, DBS Group Holdings and United Overseas Bank as the typically conservative HKD investor base also searched for yield in environment where rates remained at depressed levels throughout the year.

## Conclusion

The key trends observed in 2016 are set to continue into 2017 as uncertainty remains around the impact of future moves from global central banks, as well as the path to Brexit, a Trump presidency and ongoing global geopolitical risks, which will continue to drive demand for US dollar assets. Asian investors will continue to increase their importance in global debt markets as capital flows continue to shift from West to East and the growing middle class in emerging Asia have more cash to invest, providing borrowers with more opportunities for cost effective funding.

6 Dealogic, 2016.
7 Bloomberg LLP, 2016.

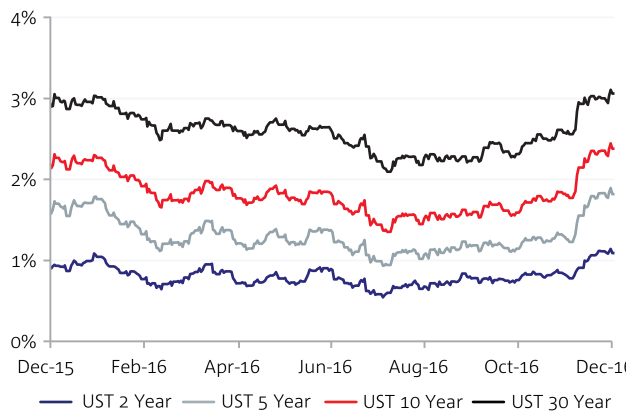
# SPOTLIGHT ON NORTH AMERICA

The US Debt Capital Markets remained a reliable source of funding for issuers in 2016 despite periods of global market volatility.

**Maeve McLaughlin**

Both the US Private Placement Market and US Investment Grade Primary market saw very strong investor demand throughout the year, with order books that were frequently multiple times oversubscribed and pricing tightening from initial guidance. In the US Private Placement Market, the strong demand was largely attributable to the lack of supply, whereas in the US Investment Grade Market, supply remained robust; however, there was increased global investor participation. In addition, issuance yields were at all-time lows with both US Treasuries and credit spreads grinding tighter since the beginning of the year. This low coupon environment, coupled with increased investor demand, led to very favorable issuance dynamics for companies looking to raise capital in the US Debt Capital Markets in 2016.

**US Treasury Yields**




Source: Bloomberg

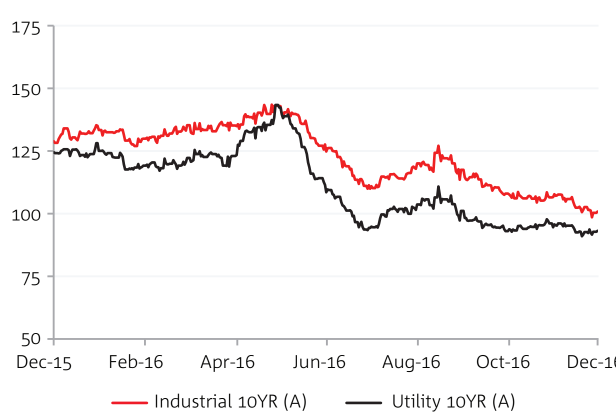
## US Treasury Yields

US Treasury yields reached historic lows this year, despite the improved economic outlook in the US. Global concerns around China, declining commodity prices and Brexit led investors to the safe haven of Treasuries rather than other riskier investments. The 10 year US Treasury yield started the year above 2.00%, however it quickly dipped below that level in February and remained sub 2.00% up until November. The day following the US election the 10 year US Treasury yield increased 20bps and reached over 2.40% (as of 1 Dec 2016). The yield curve also flattened over the course of the year, making longer term financing increasingly attractive to fixed rate USD issuers. As a result of these positive market dynamics, a number of issuers took this opportunity to raise long term debt: 50% of US Corporate Investment Grade Market issuance had tenors of 10+ years and 51% of issuance in the US Private Placement market had tenors for over 10 years.

## US Credit Spreads

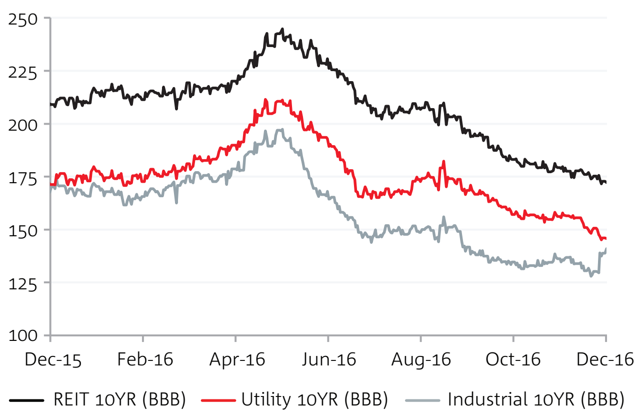
Despite falling Treasury yields, credit spreads continued to compress throughout the year and low coupon levels became the new normal. The average 10 year A industrial credit spread reached a high of 143bps in February, however, it declined over 50bps over the course of the year. Similarly, the BBB 10 year industrial index declined over 60bps after reaching a high of 197bps in February.

**10 Year US Spreads (A)**




Source: Bloomberg

### 10 Year US Spreads (BBB)




Source: Bloomberg

### 2016 market statistics (as at 1 December 2016)[1]

| | |
|---|---|
| **Volume** | US$1.26 trillion |
| **Deals** | 804 |
| **Tranches** | 1,191 |
| **Sector breakdown** | 37% Industrial<br>22% Financials<br>5% Utility |
| **Regional breakdown** | 67% U.S./33% Yankee |

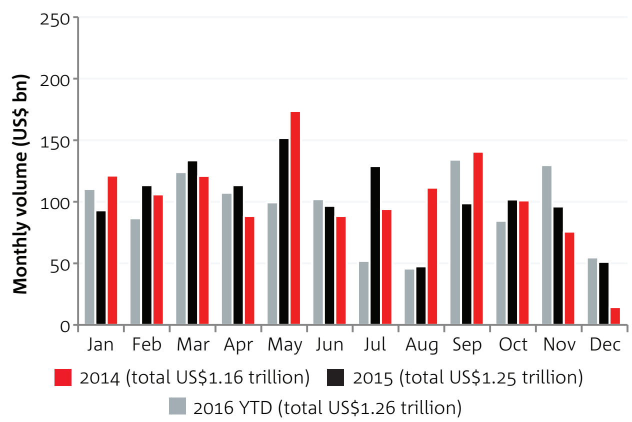
Source: Informal Global Markets

## US Investment Grade Market

2016 year-to-date volume continues to surpass last year's record pace with US$1.26 trillion priced across 804 transactions/1430 tranches (ex-SSA), up 4% year-over-year (figures as of 1 December 2016). Despite the US Investment Grade primary market having several 'zero issue' days this year, every time issuance resumed, confidence was restored and investor demand was unscathed. Issuance remained strong throughout the year, with quarterly investment grade new issue volume topping US$350 billion for three straight quarters for the first time in history. October and November continued this pace as new issue volume blew through market expectations, leading to record breaking issuance volumes in 2016.

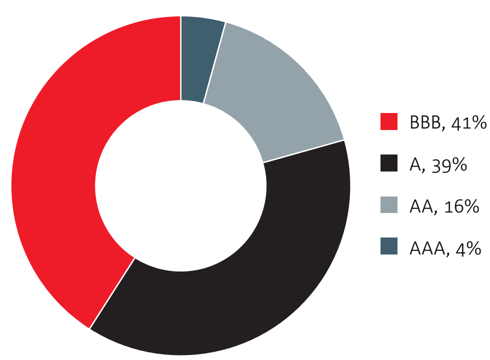
The majority of issuance in 2016 was from domestic issuers; however, there was a strong resurgence of offshore issuance with Yankee volumes up 33% from a year ago. Despite this, corporate issuance out of Australia was down 40% with US$3.45 billion priced across six transactions. This was not specific to the US Investment Grade primary market as issuance out of the region was down across almost all other debt capital markets. Australian companies continue to be attracted to the depth of the US market and their ability to raise a significant amount of capital without the need for financial covenants. Notable Australian transactions in 2016 included two inaugural issuances from Amcor (US$600m; April 2016) and Goodman Australia Industrial Partnership (US$600m; September 2016). Both of these issuers have previously accessed the US Private Placement market.

### US investment grade issuance




Source: Bloomberg

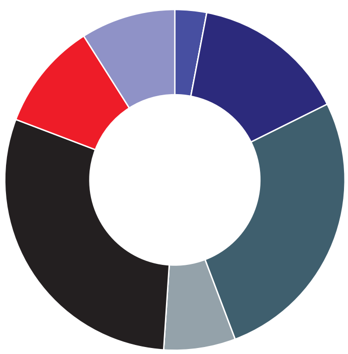
### Issuance by rating (BBB Band)




Source: Bloomberg

[1] Informa Global Markets.

### Issuance by tenor (10 year, 31%)




Source: Bloomberg

## US Private Placement Market

The US Private Placement market had yet another solid year despite a fall off in supply. Year-to-date, US$50 billion has priced across 199 transactions, with volume down approximately 7% from the same time last year. Despite volumes being down, the supply/demand imbalance bode well for issuers that accessed the market. Throughout the year, transactions were multiple times oversubscribed and priced with single digit new issue concessions, if there was any at all.

### 2016 market statistics (as at 1 December 2016)

| | |
|---|---|
| **Volume** | US$50 billion |
| **Deals** | 199 |
| **Sector breakdown** | 23% Utility<br>16% Property<br>11% Consumer<br>10 % Industrial<br>9% Infrastructure |
| **Regional breakdown** | 57% U.S./43% Cross-border |

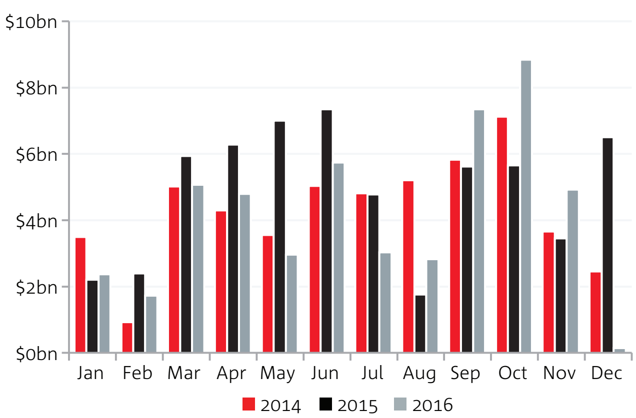
Source: Private Placement Monitor, NAB

One of the most attractive aspects of the US Private Placement market is that it is always open. Despite all of the noise around Brexit in late June, the US Private Placement market powered through and continued to price transactions unlike many other capital markets that shut temporarily. Notably, NAB's US Private Placement team priced a US$400 million transaction for Mirvac the week of the Brexit announcement and also a US$520 million transaction for Victoria Power Networks completed in the beginning of July - neither pricing nor volume was impacted by Brexit.

The US continues to be the leading region for issuance representing 57% of volume in 2016 YTD. The U.K. and Australia were the top two countries for cross border issuance, representing 16% and 11% of total volume, respectively. NAB executed several notable transactions from these regions including a £500 million (equivalent) transaction for SSE plc in March and a US$520 million transaction for SA Power Networks in May.

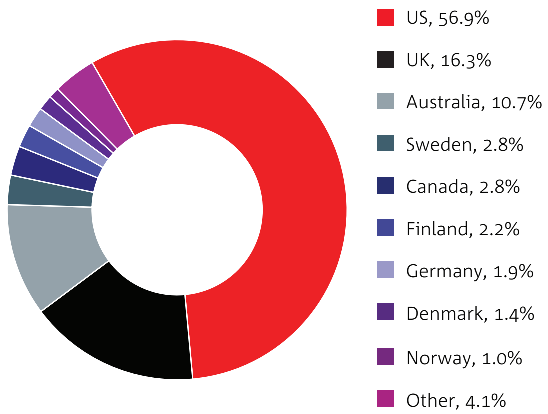
An increasing trend in the US Private Placement Market is the availability of foreign currency funding. Over 20% of new issue volume in 2016 has been funded in currencies other than USD. Sterling was the top currency for investors, accounting for 60% of total foreign currency volume. Investors are increasingly willing to provide foreign currency and there are over 20 investors who can do so. In addition, there are a number of investors who are now able to provide foreign currency without swap breakage protection. These investors either have a natural need for the currency or they are willing to waive their requirement for swap breakage if the notes are non-callable. NAB executed A$250 million transaction for Coca-Cola Amatil in August, which was 100% funded in direct A$ with US investors.

### Monthly historical US Private Placement volume (US$)



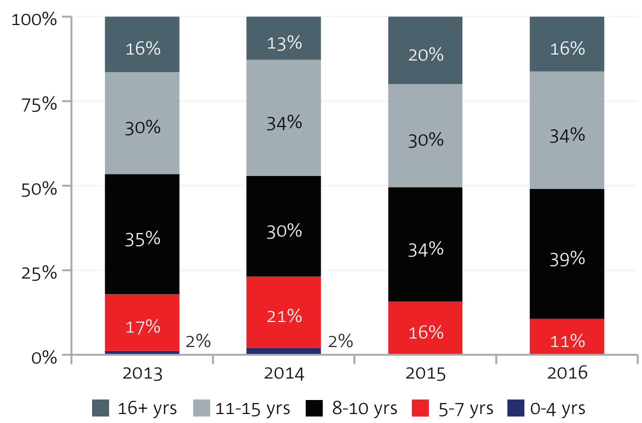

Source: Private Placement Monitor, NAB

## Issuance by country



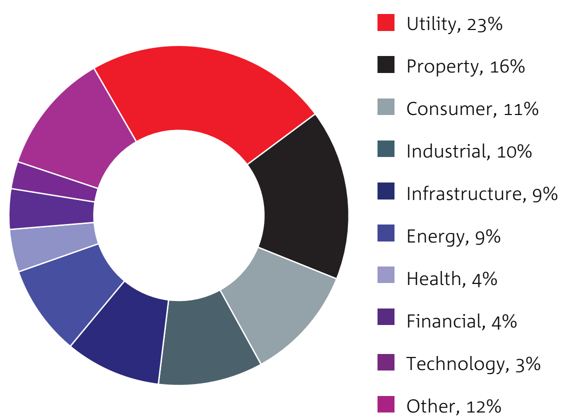

Source: Private Placement Monitor, NAB

## Issuance by tenor



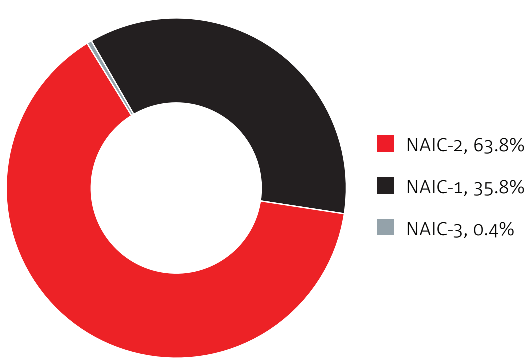

Source: Private Placement Monitor, NAB

## Issuance by sector




Source: Private Placement Monitor, NAB

## Issuance by rating




Source: Private Placement Monitor, NAB

# SPOTLIGHT ON UK AND EUROPE

Central Bank money keeps markets stable and open.

**Andrew Santone**

From Spanish elections, migrants, Turkey, Brexit and the upcoming Italian referendum the year has been one of continuous shocks to the system which threatened to derail the capital markets at any and all points. However, with the aid of what seems like a never-ending central bank stimulus the market demonstrated a remarkable amount of resilience and continued to offer issuers extremely attractive pricing and opportunities throughout the year.

The ECB's corporate sector Purchase Programme ('CSPP') was put in place in May and the central bank has adopted a real 'shock and awe' tactic with its presence in the market. At the start of October the central bank held nigh on €32 billion of corporate bonds, having bought at a reasonably consistent pace since its inception. The program is scheduled to run until March with a number of market commentators expecting it to be extended albeit at a slower purchasing pace. The central bank has indicated in several announcements of late that it is acutely aware of the distortion this program is having on the market but, it maintains its desire to 'get Europe growing' through decreased borrowing costs.

Meanwhile in the UK following the 'Brexit' referendum Bank of England ('BoE') Governor Carney put in place a number of stimulus initiatives. The core one being a scheme similar to that implemented by the ECB with the one difference being the corporate bond purchasing program would take place in secondary markets only and not, Primary. The program kicked off on the 27th of September and in its first 2 weeks had purchased £1.042 billion or just over 10% of the total £10 billion that was announced as the target for the 18 month Program.

Total volumes issued for the year (1 Oct through 30 Sept) in the Euro market were €1 Trillion with 1246 transactions being priced. This is up 5% on last year's €950 million and a small increase in the number of transactions which were 1216 last year. For the Sterling market volumes are essentially unchanged year on year with 2016 volumes at £112 billion from 196 trades compared to £110 billion from 210 trades in 2015. The real story in the Sterling market is the volume of issuance post the Bank of England QE announcement where we have seen over £30 billion issued bringing life back into the market from what was looking like a very poor year.

**Key transactions from Australian and New Zealand issuers for the year in the Euro and Sterling markets**

| Issuer | Amount | Coupon | Benchmark | Spread | Maturity |
|---|---|---|---|---|---|
| Aurizon Network | €500m | 3.125% | Mid Swaps | 265 bps | 1 Jun 2026 |
| Telstra Corporation | €750m | 1.125% | Mid Swaps | 70 bps | 14 Apr 2026 |
| Vicinity Centres | £350m | 3.375% | Gilts | 197 bps | 7 Apr 2026 |
| Scentre Group Trust | €500m | 1.375% | Mid Swaps | 117 bps | 22 Mar 2023 |
| BHP Billiton | €600m | 6.500% | Mid Swaps | 482 bps | 22 Oct 2077 |
| BHP Billiton | €1,250m | 4.750% | Mid Swaps | 436 bps | 22 Apr 2076 |
| BHP Billiton | €750m | 5.625% | Mid Swaps | 480 bps | 22 Oct 2079 |

Source: Informa GM

As in previous years we continued to assist our customers in navigating the market with Antipodean issuers continuing to enjoy a very positive reception with the European and Sterling investor base. With these issuers not being eligible for the ECB nor BoE corporate bond purchasing programs the trades generally come at a wider spread to equivalent European and Sterling domestic names albeit, very attractive levels on a swapped back A$/NZ$ basis. Also, enticing the investors is their increased likelihood of a strong allocation as the issues do not suffer from the 'crowding out' of deal books by central bank buying that they are suffering from when participating in CSPP eligible issues.

In respect to financial issuance, all of the major banks from Australia/New Zealand took advantage of the constructive market to issue several transactions in the market. The covered bond market was the most popular with each major bank and Macquarie Bank taking advantage of the unprecedented pricing outcomes and investor demand for such issues.

This demand from investors is driven by the same elements that we touched on above;

- increased spread available on non-central bank eligible bonds,
- ability to receive a meaningful allocation i.e. not be crowded out by central bank buying,
- the diversification that issues from the Australasian region bring to their portfolio

In market developments the Institutional Term Loan market continues to offer up alternative and more bespoke funding alternatives to clients with the infrastructure entities typically using this market and to great effect. This market is particularly useful for those entities that are subject to regulatory reset WACC charges as the customisation of cashflows, delayed drawdowns and other features allows the issuer to achieve the most effective spread for this portion of their debt.

# BIG CHANGES AND BIG NUMBERS: INFRASTRUCTURE IN EUROPE

Hiding behind the headlines is a rapid sophistication of the European infrastructure markets.

**David Horsfall and Nick Woolfitt**

While 2016 will principally be remembered in Europe for the surprise, and surprising immediate consequences, of the UK public's vote to leave the European Union, some astute historians may pick up an odd development. For a rare moment, infrastructure has moved out of the shadows to grab second billing, with a troika of 'H' projects (Hinckley Point, Heathrow's third runway and HS2) provoking the media to give some attention to our often ignored sector. Big numbers - in the cases of these projects some £93 billion - turn heads.

The link between the Brexit vote and the focus on infrastructure is clear. The new May government is advocating a return to global, rather than regional, mercantilism and in this regard stoking inward investment, enabling trade flows and boosting productivity are crucial. Indeed they chime with many of the megatrends Capital Financing has identified as driving our future world. Infrastructure is central to all of these, and it has the added benefit of providing a fiscal stimulus to address market jitters.

While it's great for the sector to get a fleeting bit of exposure, these UK mega projects mask some of the tremendous, and probably more important, developments throughout the continent. Some are familiar themes, others are really quite surprising. All are a reflection of the quite odd times that we live in.

## The role of infrastructure in a low inflation, low growth environment

Starting with the familiar, we continue to live in a low inflation, low interest rate, low growth world. Liquidity - in all parts of the capital structure - remains extreme, and the supply/demand equation is as heavily skewed towards supply as ever. A look at the huge fundraisings by third party funds – on track to exceed US$50 billion for the fourth consecutive year - shows how much dry powder is ready to be deployed by these investors, let alone the stacks of cash weighing heavily in the pockets of the pension, insurance and sovereign wealth funds. And with the European Central Bank (among other central banks) effectively charging for the privilege of not spending that money, there is quite some urgency to put it to work. Does this mean we're in an asset price bubble? Possibly, but there's still no better real asset class for those with inflation-linked liabilities to mitigate that risk. High quality assets will always be well bid, and while some investors buying in 2016 may have some regrets, others will have made very canny investments - just like in the last supposed bubble, 10 years ago.

The growing sophistication of European investors - across both debt and equity markets - has continued and even accelerated this year, with an increasing number of pension and insurance funds buying assets directly. While this is novel in Europe, it's consistent with the Australian model which recognises the natural affinity between long-term assets and long-term investors. European investors are learning very quickly. As a business whose role it is to match borrowers' needs with investors' desires, Capital Financing welcomes the growth of the European institutional market. It makes us proud too to see the key role played by our customers - both borrowers and investors - in driving this very rapid sophistication.

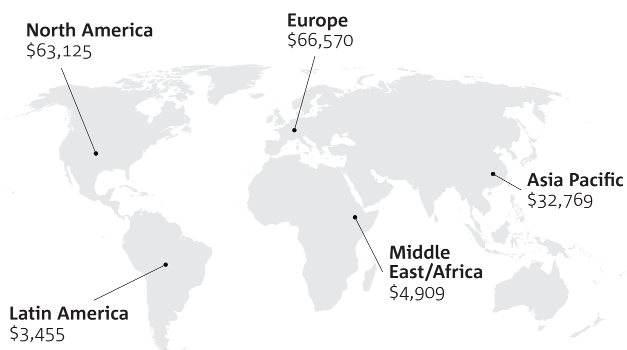
Europe remains the key focus of the largest infrastructure investors globally, with the top 50 infrastructure funds devoting more capital to the region than anywhere else:

## Infrastructure and the ageing society

There are signs too of governments growing up. For some time European governments have ignored demographic changes that are now looming large. The ageing population in Europe is becoming a declining population and governments will be predominantly left to pick up the pension and healthcare tabs. This will require changes in mindset, particularly in the relatively high sovereign debt, low growth and low inflation environment prevailing across much of the continent.

A shift from austerity to growth will be required at some point. Funding that growth will be a difficult question given the strained nature of government finances, but here real progress is now being made. Nice Airport was flagged for privatisation a decade ago; that has now happened. We are seeing investment starting to ramp up significantly in the Nordics, in Benelux, in Germany and in France. We are very excited that, maybe belatedly, the role of boosting growth and mending balance sheets through shifting productive assets off government balance sheets is gaining momentum – something that has been very successful in other countries including Australia for some 25 years. In recognition of this, we are seeing more of the major investors targeting Europe, which is now the most desired investment destination for the top 50 third party funds.

**II 50 fundraising by geographic focus ($m)**




Source: Infrastructure Investor

While releasing long-term assets from government hands to those life insurers and pension funds that have matching liabilities is one side of managing the ageing of the population, providing services to that population is also crucial. In this regard, Europe is doing somewhat better. Europe retains many of the world's great innovators, and this is certainly apparent in the infrastructure and energy sectors.

## Innovation and technological change

Europe's leadership in facing up to climate change is well documented, and continues apace. The increasing global deployment of offshore wind and solar owes a great debt to the incubation of those technologies in Europe, with the recent remarkably low price payable in relation to the Borssele wind farms showing the increasing maturity of the former sector.

Renewable technologies are just the tip of the iceberg. Developments this year in smart grids and metering, fast reactive energy production and frequency management through battery storage, the continuing and growing dialogue around smart cities and the internet of things, not to mention the constantly developing communications and data infrastructure sectors, confirm that Europe is at the front of rising to the challenges of the future. The deep industrial knowledge base and relentless focus on research and development across the continent will contribute heavily to the deployment and, ultimately, normalisation of these new developments.

## 2017 in prospect – what will Brexit mean for infrastructure?

There is little doubt that we are living in a time of great uncertainty and change, with the Brexit referendum leading to uncertainty in both politics and economics that will have impacts – both positive and negative – on infrastructure both in the United Kingdom and in the rest of Europe.

For the United Kingdom, the flavours of some of the impacts are apparent even if the specifics are far from clear. A weak pound will increase the costs of projects that rely on imported goods but aid those export-focussed industries, and the infrastructure that they use. It will also likely stoke some inflation, which may not only hurt the domestic consumer but also affect assets with inflation-linked revenue streams and investors with inflation-linked liabilities. We would expect to see cashed up tourists hitting the shops and restaurants of London and using the UK's airports, ports and railways to get here. Some businesses will win; and some will lose.

Financing certain projects will require more thought with the potential exit or scaling back of the European Investment Bank's (EIB) operations. Again, this could prove a mixed blessing as the benefits to long-term investors of freeing up long term investment opportunities weigh against the detriment of uncertainty in the commissioning of projects which may not otherwise be viable without the significant support the EIB has provided.

In Europe, the shockwaves of the Brexit vote may have significant political implications, most notably in France and Germany (and, possibly, Italy) where taming the increasingly disgruntled electorates will be key to the major parties retaining their power. Given the lacklustre economic growth in Europe, some form of fiscal stimulus and move away from austerity may be on the cards, with infrastructure investment being among the most politically acceptable means of delivering this.

We expect the UK and Europe to continue to remain a very attractive infrastructure investment market on account of the affluent societies, established regulatory and legal frameworks, and the deep access to capital.

NAB's London branch was established over 150 years ago, and our infrastructure business in the UK and Europe is nearing its 20th birthday. Through wars, recessions, political and economic instability NAB has supported our customers in the UK and Europe and we will be prepared for whatever surprises 2017 brings.

# FIXED INCOME BEYOND THE INSTITUTIONAL SECTOR

The power of education.

**Stefan Visser**

In July 2016, NAB, in conjunction with KangaNews the inaugural 'Fixed Income Beyond the Institutional Sector' Summit. Already considered a market leader in bringing together issuers, investors and funding opportunities outside the traditional institutional sector, NAB's emphasis on education in the fixed income market was showcased by both the quality of speakers involved, as well as the overwhelming response by delegates to attend the event from all parts of Australia.

Motivated by their desire to broaden and deepen their understanding of the fixed-income asset class and its role in portfolios, a variety of delegates from the middle-market, advisory and high net worth segments were in attendance. The event was at full capacity with delegate registrations totalling well in excess of 350 individuals.

With the platform provided by NAB and KangaNews, issuers and investors alike seized the opportunity to connect with each other and in the process gained a better understanding of what is required from both sides going forward, as well as how significant the prospect for the domestic fixed income market truly is.

Some of the key themes that brought together this diverse group of investors included:

- Demographic change and the role of fixed income in securing retirement income.
- Market access and developing a broader Australian fixed income sector.
- Asset class focus including Hybrid securities, capital and regulation.

The summit included a variety of panel discussions, interactive Q&A and case studies. Experts in the field used the opportunity to question the current state of play and what is required for the asset class to reach its potential in Australia.

Steve Lambert (EGM, Capital Financing – NAB) set the tone for the day with opening remarks emphasising the challenges facing Australia as demographic change reshapes the landscape and as the potential for the Australian bond market to play an important role in providing investors with appropriate alternatives for their retirement savings. The estimates in the recent Intergenerational Report (published in 2015) are that Australians born today can expect to live into their 90's, whilst the number of Australians aged over 65 is expected to double in the next three decades.

As Steve Lambert pointed out:

*"There are no 'demographic-change sceptics' out there – it is a real phenomenon that we as a nation have to deal with. But we have to ask how well agreement around how population demographics will change has translated into action. Have we done enough, knowing what the shape of age distribution is going to look like?"* [1]

Participants of the summit agreed that more and smarter savings will be required and this will include a greater level of engagement with the bond market. The estimated A$600-700 billion of Self Managed Super Funds' 1% allocation to fixed income, compares starkly with the institutional sector's approximate 20% (refer to Figure 1). The opportunity for both the fixed income market and the non-institutional investor base is obvious; however roadblocks still exist, including:

- broad base access to the asset class remaining more complex than required, whilst
- tax/regulatory incentives and a well established knowledge base for the other three asset classes (cash, property and equities) continuing to influence investor behaviour.

[1] KangaNews, Volume 11, Issue 96 - August/September 2016.

**Figure 1: The asset class gap between a professionally managed super fund and a typical SMSF.**

**Professionally managed super fund**


Source: APRA as at June 2015

**SMSF**


Source: ATO as at June 2015

As noted in the afternoon's Hybrid Capital Debate by Christopher Joye from Smarter Money Investments:

*"Non-institutional investors are long in both cash deposits and equities. These are the polar ends of the risk spectrum, so we absolutely should be encouraging them to 'fill the gap' with a continuum of covered bonds, senior and sub debt, and hybrids – to help bridge this barbell."* [2]

The table above indicates that there an 'asset gap' - an under representation of fixed income assets in self-managed superannuation fund portfolios (SMSF). Assisting market participants to understand this gap (and the associated risks and opportunities) drives the team at NAB to seek avenues to provide information, both on a potential issuer and investor front, and the Summit (hosted in conjunction with KangaNews) is an example of this process starting to come together.

NAB has reached thousands of interested parties with fixed income information and education through the continued use of digital media, investor roadshows and Sky Business during 2016. Speakers at the Summit echoed the importance of education, including Oliver Harvey from the Australian Securities and Investments Commission:

*"In the corporate bond space, there is clear appetite for a greater level of retail access. So I'd say, to some extent, most ideas on the table from the regulatory perspective are in terms of how to achieve this access. There is no question that education and third-party perspectives are critical ingredients."* [2]

He also noted that ASIC is focusing on two key strategies to encourage retail fixed income investment:

- Supporting government efforts to stimulate issuance in retail format; and
- Assist in providing education on, and familiarity with, this asset class.

Specific initiatives included the simple corporate bonds regime and the project to list Australian government bonds on the ASX.

The education initiatives have significantly increased interest in this asset class; however it has also served as a stark reminder that access for retail investors has remained limited. Shannon Finch from King & Wood Mallesons notes:

*"It has been a very long and winding path to get even some degree of direct access to some types of fixed income for listed – market and retail investors. We are aware that legal and regulatory impediments are far from the only factors at play, but they are at least ones we can do and are doing something about."* [2]

Even in this context, the non-institutional investor base has started to find its voice in the context of the local bond market. A variety of participants at the summit presented evidence of an upsurge of demand for fixed income assets, despite the headwinds of low yields. As an example, Nathan Walsh, General Manager, Self Directed Wealth at NAB, noted that nabtrade's listed fixed income exposures grew by 43% in the 12 months leading up to the conference.

[2] KangaNews, Volume 11, Issue 96 - August/September 2016.

Further proof of the non-institutional investor base flexing its muscles, can be found in the demand that NAB has been able to bring into transactions in the last 12 months in the deals specifically targeted at these investors or in the books of mainstream issuance, for example:

**NAB-arranged unrated deal distribution profile**

| Issuer | Deal volume (A$m) | Non-institutional distribution | Institutional distribution |
|---|---|---|---|
| **NEXTDC** | 100 | 68% | 32% |
| **Australian Unity** | 250 | 66% | 34% |
| **Peet** | 100 | 81% | 19% |
| **Qube** | 300 | 91% | 9% |

These outcomes have clearly left an impression with issuers, with Dom Scafetta, Group Company Secretary for Peet noting on the day:

*"We felt the domestic retail bond market would give us access to the greatest pool of investors. The simple corporate bond process was relatively straightforward and the base prospectus we put together affords Peet the ability to tap the market as many times as we want over a three year period with only a simple update required".* [3]

The 'Fixed Income Beyond the Institutional Sector' Summit for 2016 allowed for a space where this diverse non-institutional investor base could share its views on the way forward with both issuers and institutional investors alike and no doubt it will prove to be only the first of many more to come.

The quantity and size of deals targeted at the non-institutional investor base are building and as the demographic changes faced by Australia continue to lead more participants to join this investor pool in years to come, their voice will continue to grow even louder, their influence on individual deals more considerable and their demand for bonds more substantial.

[3] KangaNews, Volume 11, Issue 96 - August/September 2016.

# WELCOME TO THE DIGITAL SOLUTION

Embracing the challenge of delivering a digital solution to our investor base.

**Mark Todd and Nathan Doake**

The challenge for the bond market has been to provide an efficient 'equity like access' experience for existing and potential bond investors. In 2016, NAB responded to the challenge by collaborating with our online investor platform nabtrade, to provide customers with access to ASX listed and unlisted fixed income, global and local equities and the ability to provide portfolio flexibility through NAB Equity Lending. nabtrade is now the first digital platform in Australia to provide this depth and breadth of access.

The future is here.

## NAB fixed income customers continued to grow in 2016

The investor component of the NIIS business is now supported by approximately 1260 customers. Our client set is an evolving segment of non-institutional investors.

We have investment managers and advisers providing unique access to fixed income on behalf of their customers, advisers have been active in listed and Over the Counter (OTC) fixed income and the self-directed investor is now the fastest growing segment of our investor base.

Growth in custodial accounts increased by 63% and turnover grew by 25%. Customers are now accustomed to trading in secondary markets for fixed income, the turnover of which increased by 20%.

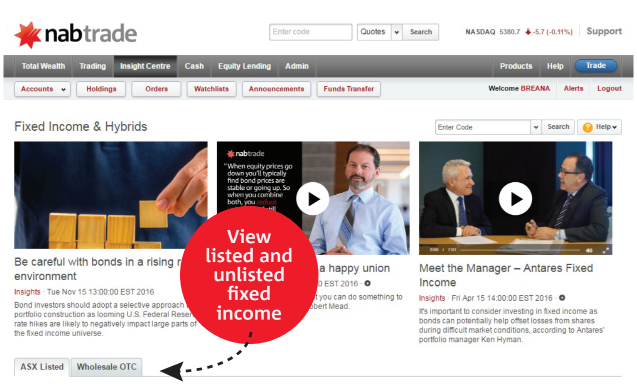
As customer engagement grew so did our understanding of their needs. Customers are time poor and have a preference for a singular platform that provides access to multiple products.

## Welcome to NAB Portfolio Access - the first wave in the digital revolution

NAB Portfolio Access (NPA) is a digital solution delivered via nabtrade enabling customers to view and transact local and global equities, listed and unlisted fixed income, managed funds (via the mFund Settlement Service) and fund these transactions via a NAB equity loan. Furthermore, NPA also enables customers to view their NAB bank accounts in a single view.

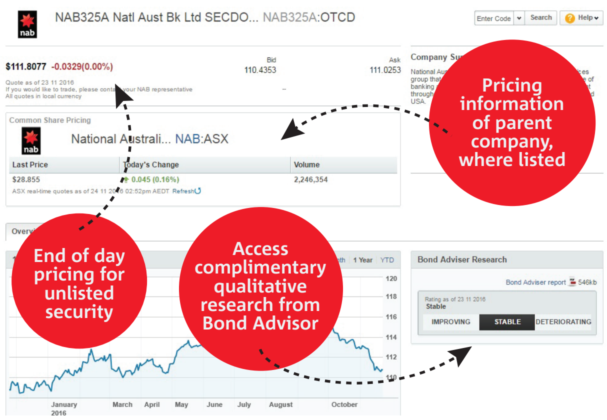
NPA is an exciting market first, as it enables Australian investors to truly take control of their wealth by viewing all their investments on one platform. Wealth consolidation is key and is supported by integrated research on listed assets as well as unlisted fixed income. No other digital platform seamlessly delivers institutional grade pricing and research in the unlisted fixed income space direct to customers like NPA does through nabtrade.

### Fixed income new on nabtrade




Sales support is provided through the nabtrade, NAB Income & Investment Solutions (NIIS) and NAB Equity Lending teams. Insights and research is delivered by Bond Adviser, an independent credit research house. Pricing and credit information on over 160 unlisted fixed income instruments is provided by Markit and research is now available on over 80 bonds.

**Expanding fixed income education**




## Did it work and what does it mean for markets?

Since launching NPA, over $570 million of securities has been transferred from competitor platforms by the NIIS team and there are now 14 new issues on the platform.

In just 6 months 250 customers have adopted the new service whose holdings are on average 3.25x larger than the average nabtrade customer; all benefiting from an easier way to manage their wealth with no initial or ongoing FUM based platform fees.

To date, the roll out has been concentrated in the NAB Private and Wealth channels. Throughout 2016 - 2017 the offering will expand into NAB's Business, Agribusiness, Education, Government and Health segments.

With the overwhelming success of NPA, we turn now to delivering the next phase which is to build further functionality through technology improvements and continue to build education and insights for our customers.

## The education wave

NAB has been at the forefront of advocating non-institutional investor education. Through the work with the Australian Centre for Financial Studies (ACFS), we have explored the impact of sequencing risk on the aging demographic. The ACFS are advocates for smoother portfolio returns as investors move through the lifecycle.

In July, NAB in conjunction with KangaNews news launched the 'Fixed Income: Beyond the institutional Sector' summit (further detail in article Fixed Income Beyond the Institutional Sector). The event garnered over 300 attendees and feedback was extremely positive.

The overarching response was that customers want more information, not less. They have made it clear they want more content that is original.

A benefit of the KangaNews conference for investors was that there was a realisation that numerous types of investors were looking for conservative options. A benefit to the issuers who attended was the fact that there is now a possibility of having an expanded investor base that are able, willing and appropriately educated to buy new and secondary issues across both OTC Markets and ASX listed markets. NPA is bringing NAB customers to the issuers preferred issuance platform.

## Where to from here?

There are critics of the bond market, citing what they see as the inevitable end of the 'lower for longer' thematic. There is a possibility of higher rates in the US and these critics advise customers to avoid the bond 'bubble'.

What we have seen from customers is not a desire to avoid bonds but rather a desire to avoid volatile markets. Many investors have been demanding conservative investments in line with the desire to preserve capital and generate income on a risk adjusted basis.

The goal for 2017 will be to deliver fixed income solutions on a digital platform that meet the needs of our customers. We will create reporting capability and eventually customers will be able to transact listed and unlisted fixed income electronically at a very low cost which will benefit investors and issuers. By combining ease of access with quality research via nabtrade, the platform is set to become the premier portal for our growing investor base.

The portal will enable customers to build portfolio models with interactive tools that can align investments to liabilities. Issuers will be able to tap investor demand so that execution risk is diminished and investor diversity is expanded.

After a stellar 2016, we are well positioned to improve and enhance our offering. Our goal is to continue our trajectory and develop our investor base to support the funding of Australia's future growth.

It is the right thing to do.

# HYBRID & STRUCTURED CAPITAL

Hybrids, Subordinated debt, Simple Corporate Bonds, Listed Investment Companies and High Yield Bonds – NAB continues to deliver opportunities for investors to diversify their portfolios.

**Nick Chaplin**

## Investor portfolios benefit from diversified offerings

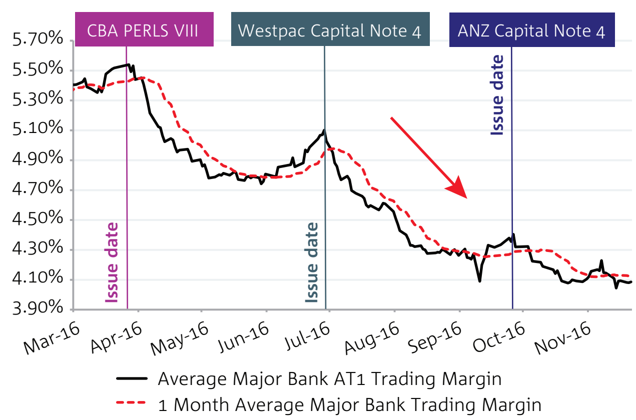
Hybrids and Subordinated Bonds provide valuable asset diversity for investor portfolios, not to mention the opportunity to enhance yields. 2016 saw the continuation of a good diverse product pipeline in the markets and a number of 'firsts' again enabling choice for investors.

2016 was a prolific year for Bank listed Tier 1 offerings with three of the four major Australian banks all requiring to rollover 'Additional Tier 1' capital issues. However, unlike the year before where margins had been rising throughout most of 2015 as investors grappled with a perception of higher supply, the opposite has occurred in 2016 with banks more reserved in their volume requirements for hybrid Tier 1 issues and a unique ATO amendment enhancing the capacity to issue offshore.

The year began with investors looking back at over A$18 billion of ordinary equity issues by the four major banks and Macquarie Bank through 2015. This was the direct result of the Financial System Inquiry (Murray Report) which required the banks to be 'unquestionably strong'. APRA supported these findings with a requirement for more 'Common Equity Tier 1 Capital' (CET1). The effect of these requirements was a material widening in Hybrid Tier 1 secondary margins as investors readied for more issuance. However, this was tempered when the market acknowledged that CET1 is ordinary share capital and not hybrid capital. Adding to the improved sentiment was issuing banks tempering their volume aspirations with A$1.2 to A$1.4 billion being the average issue volume rather than A$1.6 to A$2 billion.

Secondary margins for bank Tier 1 issues have tightened materially throughout 2016 with the hybrid asset class outperforming most other asset classes over the year. Each new issue has benefitted from the performance seen in the previous issue.

**Issue margins peaked with the CBA PERLS VIII issue**




Source: NAB Hybrid & Structured Capital Origination

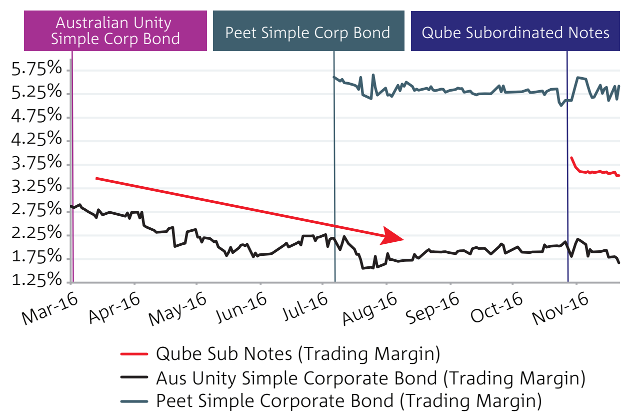
## Simple Corporate Bonds – NAB arranges the first two transactions

In the senior listed space, we saw a continuation of interest from growing companies for access to the Simple Corporate Bond (SCB) process. The SCB legislation enables listed companies (or companies with listed bonds) to issue a base prospectus that remains usable, much like a bond programme for three years. A second issue can occur with a short update document saving the issuer valuable costs of issuing bonds. It is ideal for companies that see more regular issuance of senior finance in the ASX-listed market. Importantly, the issues come with reduced civil liability for directors of the issuer, better reflecting normal corporate delegation processes while maintaining accountability.

In the 2015/16 financial year, both Australian Unity and Peet Group took advantage of the availability of SCB's to issue A$250 million and A$100 million respectively. Both of these companies are charting course for growth and the flexibility of the SCB is a highly suitable, low covenant option for multiple issues in the capital markets over the three year term of the base prospectus.

Investors were delighted with both transactions, buying into the rare listed senior bond market and taking advantage of strong yielding issues and the benefits of senior ranking. Performance can be seen below in Figure 2, combined with the solid secondary performance for Qube Holdings' subordinated note issue.

**Investors have gained access at various margin points across the curve**




Source: NAB Hybrid & Structured Capital Origination

## Listed investment companies – diversifying portfolios

NAB was Arranger and Joint Lead Manager on its first Listed Investment Company (LIC) issue in September 2016 for the Antipodes Global Investment Company, a specialist manager of global equities. A core premise of NAB's involvement was the consideration of appropriate asset allocation for investors being enhanced through exposure to a high-quality manager of global equities, an asset class that has rarely been a material proportion of Australian investor portfolios.

Antipodes provides an expert investment manager of global equities and related foreign currency management and has an exemplary record of investment returns for global equities. Take-up from NAB investors was exuberant in acknowledging the need for portfolio diversification away from typical large holdings of Australian equities and cash.

We expect to examine further opportunities for our investors from other potential LIC issuers with issues needing to show expertise in their chosen field of investment, a strong record of returns, and a unique asset class that provides diversity for investment portfolios.

## New offerings from NextDC and Capital Health lift the A$ high yield market as Qube Holdings delivers in the corporate subordinated bond market

NAB has been the clear market leader in the AUD high yield bond market for ASX listed companies, having been the lead arranger on over 90% of all new AUD raisings over A$50 million in size.

NAB's market leading distribution capabilities are also continuing to gain recognition beyond the domestic market with NAB jointly managing the most recent transaction from TFS Corporation in the USD s.144a high-yield market, sourcing bids from a number of Australian and Asian institutional investors to participate alongside US investors.

Unrated issuers continued to access the capital markets in the 2015/16 financial year with NAB arranging two particularly differentiating issuers. Australia's leading Data Centre provider, NextDC issued their second bond in two years with a new A$100 million issue and Capitol Health, issued A$50 million of unsecured 4 year notes that added valuable diversity to its funding sources.

The NextDC bond was the largest wholesale unrated bond in Australian history being supported by both domestic and Asian institutional investors, as well as seeing broad support from the sophisticated sub-institutional investor market which NAB has developed over numerous years.

The transactions that NAB has led in 2016 in this space have proven that the domestic high yield corporate bond market is a competitive and viable option for Australian issuers looking for local currency. On the other side of each transaction and considering the extended low-rate environment, investors are looking further down the credit curve, searching for yield and NAB's well-established domestic investor reach. This has enabled a range of issuers to access flexible funding sources, while protecting bank loan headroom, and avoiding expensive EPS dilution of equity support.

Other than the high yield offerings, subordinated issuance in recent years has almost been solely left to financial issuers with banks dominating hybrid capital markets. This year, however, Qube Holdings was welcomed with open arms to the listed subordinated bond market with a highly successful A$305 million issue to support their development of the Moorebank Intermodal terminal in Sydney. A smart move that protected their bank loan headroom and ensured no EPS dilution associated with equity issues, the bond has performed very well (see Figure 2 above) since listing and has given access to a vital company in the Australian infrastructure development space.

## Broadening the investor market to grow the Corporate Bond Market

NAB has not become the market leader in AUD denominated corporate debt capital market issuance by accident. It has been a deliberate process of investment and dedication to our investors and issuing customers. The growth that has come from this focus has led to broad penetration across institutional and non-institutional investors and provides issuers with the largest addressable market for optimal execution.

Through its incessant drive to support its investor and issuer customers, NAB is recognised as leading the charge towards the development of diverse liquidity pools in the Australian corporate bond market.

The growth of the non-institutional investor and the nurturing of this immense and vital investor base have provided NAB the ability to demonstrate the scale of demand for less mainstream fixed-income product in Australia. This in turn has enabled the bank to open more doors for borrowers.

The real breakthrough has been the growth for mingled institutional and non-institutional demand for Australian dollar transactions. It allows for some issuers, particularly in the high-yield space, to execute where no deal would previously have been possible.

## What's in store for 2017?

Compared to this year, 2017 will see a very different approach by the major banks to regulatory capital requirements as we see all four majors with listed Tier 2 deals coming up to call dates. The decision to stay in the listed market will be an interesting one, and worth consideration given the lack of any Tier 1 rollovers until later in the year.

We expect to see more interest from corporate issuers following the Qube Holdings issue and continuing interest from potential high yield bond issuers.

The LIC market is alive and well following the very successful Antipodes IPO with investors keenly seeking an understanding of some rarer asset classes as the search for portfolio diversity continues. We expect more to come in size over the next 12 months.

# REGULATORY CHANGE: THE IMPACT AND OPPORTUNITIES

Developments in regulation will continue to affect Australian ADI capital, and banks' strategic direction.

**Dennis Craig**

## Introduction

In the view of the Basel Committee on Banking Supervision (BCBS), the Global Financial Crisis (GFC) highlighted five core weaknesses in the pre-GFC financial system:

- too much leverage,
- excessive credit growth,
- a high degree of systemic risk,
- inadequate capital buffers,
- insufficient liquidity buffers,
- excessive exposure to liquidity risk

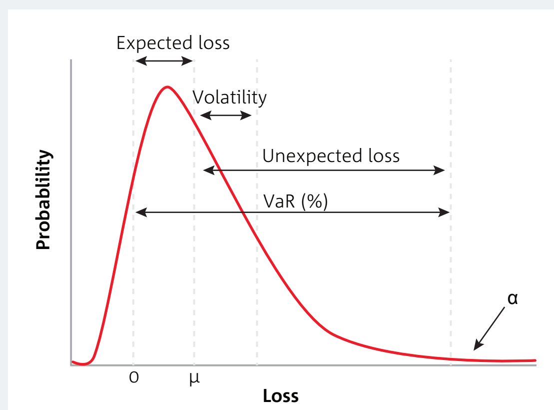
As the market lost confidence in the solvency and liquidity positions of the banking sector, these fault lines widened and were transmitted to the real economy, resulting in a significant negative impact on economic activity. In response, the BCBS, in conjunction with local regulators, launched a raft of regulatory reforms designed to address the key weaknesses set out above and 'provide the foundation for a resilient banking system that supports the real economy'.

The initial Basel 3 Framework (issued by the BCBS in 2010) represents the central element of financial reforms since the GFC. However, there were minor changes to the Basel 2 Securitisation Framework, Basel 2.5, that predated Basel 3 and various elements of the Basel 3 reforms are yet to be implemented (or implemented fully) in Australia. Meanwhile, the BCBS has continued its reform agenda, introducing additional core elements to the initial Basel 3 framework.

As 2016 draws to a close, it is timely to take stock of the current status of prudential regulatory reform in Australia, summarise the key focus areas for Australian ADIs and explore the opportunities that these may create for investors.

## Bank provisioning and capital

The risk of losses emerging on loans originated by a bank is uncertain as to both timing and quantum. To manage this uncertainty, the regulatory regime requires banks to separate losses into expected and unexpected losses. Provisions are made by the bank to cover expected losses and unexpected losses are covered by the capital held by the bank.



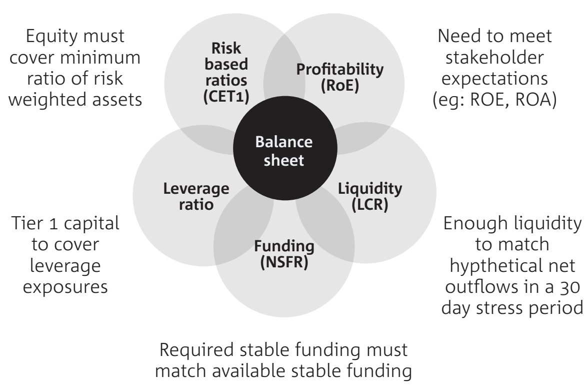

The bank can build the costs of expected losses into the price of its products. However, it must hold sufficient capital to cushion it from the impact of statistically unexpected losses. The amount of capital that a bank requires can be viewed through two different lenses (1) economic capital is the amount of capital that the bank itself determines that it requires to cushion itself from the risk of asset losses resulting in its insolvency, and (2) regulatory capital is the amount of capital that the bank's regulator requires the bank to maintain. The two measures of capital do not necessarily align.

Not all capital is equal. The less likely the bank would be required to repay the capital liability in a time of stress, the better the quality of the capital. Basel 3 bifurcates capital into Tier 1 (common equity, retained earnings and certain types of hybrids) and Tier 2 capital (less permanent types of long-dated subordinated and hybrid instruments). The three key drivers of a bank's capital requirements are its levels of credit risk, operational risk and market risk. The global regulatory change agenda since the GFC has made significant modifications to the rules relating to each of these core risks.

## Regulatory change is not all about capital

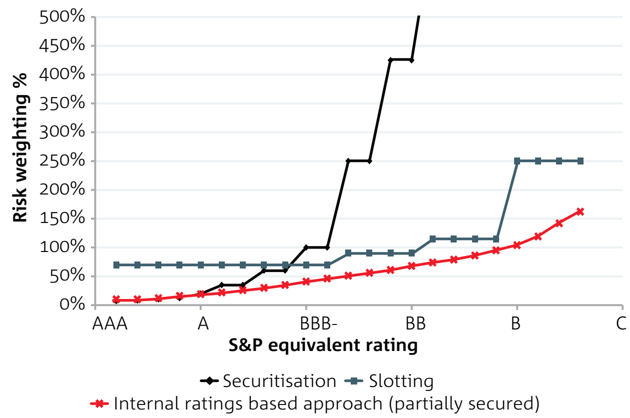
While capital remains a critical focus of the BCBS and APRA, the overall theme has been to regulate banks' entire businesses more heavily and more conservatively. Five key metrics have emerged that banks will increasingly need to manage:

- Capital
- Leverage
- Total Loss Absorbing Capital (TLAC)
- Net Stable Funding Ratio (NSFR)
- Liquidity Coverage Ratio (LCR)



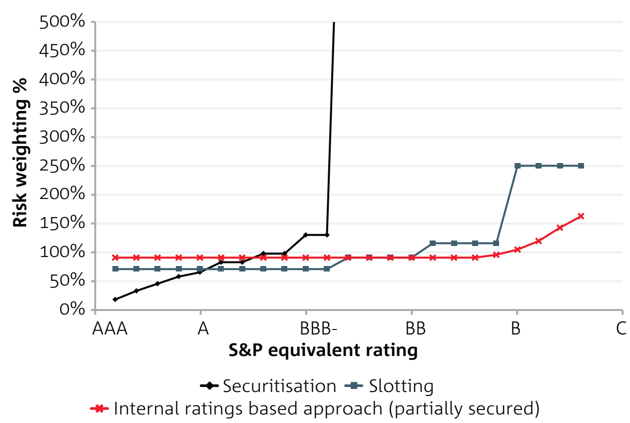

However, it is the proposed use of risk-weighted capital floors based on standardised approaches (capital) that arguably pose the greatest potential challenge for lending departments (as well as further changes to the Securitisation Framework for securitisation businesses):

### Current risk weightings by methodology and rating




Source: Basel Committee on Banking Supervision (BCBS) and National Australia Bank

### Proposed risk weightings by methodology and rating




Source: Basel Committee on Banking Supervision (BCBS) and National Australia Bank

These changes are not yet finalised by the BCBS and will then be implemented by APRA. However, it is clear that the overall picture is increased capital requirements for balance sheet usage by banks.

## Conclusion

Meeting these increased capital requirements depends on the size and shape of each individual bank's balance sheet. We have already seen the four major Australian banks raise A$32 billion of capital in 2015, with potential for more going forward. It is also likely that we will see increased efforts by banks to reduce Risk Weighted Assets (RWA) through asset sales and other capital relief trades, such as securitisation. This theme will provide opportunities for sophisticated credit investors, and for banks that are ahead of the curve in planning for the impact of the continuing waves of regulation.

# ASSET FINANCE & LEASING MARKET OVERVIEW

New aircraft demand to remain strong as more and more people take to the skies.

**Alistair Monk and Jackson Flint**

Transportation has long been identified by NAB as as a sector which will gain increasing prominence through both changing trade and capital flow trends as well as the demographic shift of growing global middle classes Therefore, the steady and selective expansion of Asset Finance & Leasing's ('AF&L') activities in the aircraft finance sector has been a logical progression for NAB.

Following the expansion of AF&L's presence into Singapore and London in 2015, NAB opened its New York AF&L office in 2016, completing the build-out of the business' global footprint and bringing NAB closer to many key global transportation clients.

2016 proved to be a successful year for NAB in the aircraft finance market where the team successfully closed over US$1.0 billion of new, senior secured debt facilities, adding several new clients in new geographic markets, whilst continuing to deepen our existing relationships in the aviation sector.

AF&L's increasing profile in the market place saw the team awarded a number of Mandated Lead Arranger roles during the year as we continued to focus on growing through partnering with the world's leading aircraft operating lessors or major airlines.

Fundamental to the continued success of AF&L's aircraft finance business is continued demand for new generation aircraft, which depends, in part, on continued growth in passenger and air cargo traffic.

## Air travel growth to continue

A generally accepted rule of thumb is that airline passenger traffic grows at roughly twice the rate of underlying GDP growth, with a slightly higher growth multiple applying in emerging markets.

Boeing, a commercial aircraft manufacturer, expects global GDP to grow at 2.9 percent annually over the next 20 years. During the same period, passenger traffic is predicted to grow by 4.8 percent per annum and air cargo traffic by 4.2 percent per annum. In line with this traffic growth, over the next 20 years Boeing sees a need for

**Global Aviation Funding requirements by region**

| Region | Narrow-body or regional jet | Wide-body | Total | % of total deliveries | Funding requirement (US$bn) | % of total funding |
|---|---|---|---|---|---|---|
| Asia | 11,450 | 3,680 | 15,130 | 38% | 1,147 | 40% |
| North America | 6,960 | 1,370 | 8,330 | 21% | 503 | 17% |
| Europe | 6,010 | 1,560 | 7,570 | 19% | 547 | 19% |
| Middle East | 1,580 | 1,730 | 3,310 | 8% | 376 | 13% |
| Latin America | 2,670 | 290 | 2,960 | 7% | 171 | 6% |
| C.I.S. | 1,000 | 170 | 1,170 | 3% | 68 | 2% |
| Africa | 850 | 300 | 1150 | 3% | 83 | 3% |
| World | 30,520 | 9,100 | 39,620 | 100% | 2,894 | 100% |

Source: Boeing Commercial Airplanes

39,620 new jet-engined aircraft. Flightglobal, an aviation consultancy, estimates that the total funding requirement for new aircraft delivered over this period is US$2.9 trillion. Roughly 75% of this funding requirement is expected to be in the form of debt, provided by export credit agencies, commercial banks and increasingly by capital markets.

Air travel demand dynamics shift as a country progresses through the different stages of economic development. In 1995, airlines in Europe and North America carried more than 64 percent of all air traffic. By 2035, that share is expected to shrink to 37 percent, with airlines in Asia Pacific and the Middle East becoming more prominent in global aviation. Reflecting this changing air travel dynamic, demand for new aircraft continues to become more diverse geographically.

Boeing expects that 38 percent of all new aircraft delivered over the next 20 years will be to airlines in Asia, which amounts to roughly 760 new aircraft each year for the next 20 years. Growth in Asia, a region which already boasts some of the world's largest and well-known airlines and aircraft leasing companies, is underpinned by liberal policy reforms that are ushering in new airlines, most importantly low-cost carriers, and the increasing spending power of the region's growing middle class and subsequent demand for business and leisure travel. Within Asia, China is expected to become the world's largest air traffic market during the next 20 years, overtaking North America.

In Europe and North America, where developed economies dominate, growth in air travel is expected to be slower than in Asia and the Middle East, however these two regions are expected to remain a key source of demand for new aircraft. Although the North American market will surrender its leadership role in aviation during the next 20 years, the region is expected to take delivery of 8,330 new aircraft, or 420 per annum for the next 20 years. For its part, Europe is expected to take delivery of a 7,570 new aircraft, or 380 per annum. Many regular travellers in Europe and North America will be familiar with these regions' aging aircraft fleets and will be relieved to know that airlines in these regions are responding to growing competition from low-cost carriers and increasingly stringent environmental regulations by replacing their older, less fuel-efficient aircraft with new and more economical aircraft that boast greener credentials. The large installed aircraft fleets in these regions generate a need for a considerable number of replacement aircraft, despite the forecast slower growth in air traffic.

The Middle East, a region that has rapidly increased its presence in aviation in recent years, is expected to continue growing strongly. Middle Eastern airlines are expected to take delivery of 3,310 new aircraft over the next 20 years. Airlines in this region are blessed with a fortuitous geographic location that allows them to connect almost any two points on the planet with a single connection (many regular long-haul travellers may be familiar with transiting through airports in Abu Dhabi, Doha or Dubai - three transit points that barely existed a decade ago). Interestingly, while the Middle Eastern airlines will take delivery of significantly less aircraft than their rivals in Europe, North America or Asia, Middle Eastern airlines are expected to account for a disproportionately large share of new aircraft financing. This is because these airlines will continue to favour acquiring pricey wide-body aircraft, such as Boeing's 777x and 787 and Airbus' A350 and A380, which have the capability to operate their long-haul services and offer premium cabins for business travellers.

## AF&L's future

Asset Finance & Leasing seeks to remain abreast of these changes, aiming to ensure NAB remains the aircraft financing house-of-choice for our existing aircraft lessor and airline customers with product suite matched to the needs of the market. Also, as new opportunities emerge in this dynamic environment, AF&L is selectively supporting new aircraft lessors and airlines with a view to on-boarding those we believe have a sustainable competitive position.

# ASSET FINANCE & LEASING TRENDS IN 2016

## The growth of the liquefied natural gas market.

**Geir Bakkelund**

Over the past 30 years, natural gas has become a key energy source representing 24% of global energy production[1]. Natural gas is a cleaner form of energy, omitting up to 50% less carbon dioxide when burnt as compared to coal As a result its share of the global energy mix is forecast to continue to grow. IEA estimate natural gas consumption to increase by 57% from 2012 to 2040. Large investments in Australia and US, in particular, have been made to cater for this growth in demand.

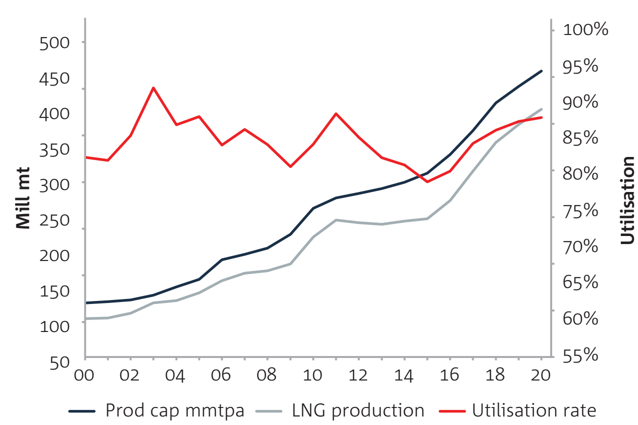
Seaborne LNG today represents about 10% of total global natural gas consumption, but the trade has seen a rapid increase from about 100m tonnes in 2000 to 250m tonnes last year.[2]

Why is this significant for Australia? Australia has now bypassed Malaysia becoming the second largest LNG exporter in the world, representing 12% of global seaborne trade[2] (many of these projects are financed by NAB). The distance between major consumers (Asia) and key producers (Qatar, Australia and US) is also increasing resulting in a greater need to transport LNG by sea. Asia consumes more than 70% of seaborne LNG with Japan being the largest single importer followed by Korea.[2] China and India remain in their infancy, but are forecasted to significantly increase their consumption over the next decade with the rise of the middle class.

So what is LNG? LNG stands for liquefied natural gas and involves cooling of natural gas to minus 163C thereby compressing its volume some 600 times. This makes its transportation economically feasible. Liquefaction takes place on-shore before the cargo is loaded. A typical modern LNG carrier has a volume intake of 174,000 cbm. To put that into energy perspective, one LNG tanker can supply approximately 330 Australian households' energy demand for one year.

In tandem with increasing natural gas consumption, the global LNG fleet has grown from some 100 vessels in 2000 to a current fleet of more than 400 tankers. With growing gas demand and investments, Clarksons Platou LNG estimate capacity to grow from 250m tonnes per annum currently to approximately 400m tonnes by 2020 (only incorporating facilities under constructions). Australia alone will add almost 30m tonnes of capacity over the next year.

**Liquefication capacity, production and utilisation from 2000 - 2020**




Source: Clarksons Platou LNG

How many new vessels will be required to accommodate extra supply and demand is a difficult question depending on where the cargo will be shipped, but using today's ratio of trade-to-vessel ratio the world will need more than 200 new LNG tankers by 2020.

Asset Finance and Leasing has been particularly active in the LNG space having part financed 30 LNG tankers over the last two years. LNG tankers tend to be on long term contracts with oil and gas majors which provide financiers with cash flow security in addition to the asset collateral.

The team is well placed to continue to support the growing industry with increasing export from Australia fuelling a cleaner world.

1 BP Statistics.
2 Clarksons Research.

# ASSETS: THE CURRENCY OF THE FUTURE

Governments are increasingly moving away from asset ownership.

**Bevan White and Angele Jalkh**

Australians have had a long-held belief that asset ownership is crucial. This might be about owning a home, a car, or even a boat. This is especially true for the Australian government which has historically owned key mobile assets. Today, a tight government budget must be allocated in the most efficient way possible. Asset Finance & Leasing (AF&L) is seeing a move away from direct asset ownership, towards a 'pay for use' approach to procuring mobile assets and services.

Given the increasing competition for government budget allocation, fully funded capital intensive projects are proving to be an inefficient use of scarce financial budgetary resources. As an example, under a 'Government Owned Government Operated' structure, the Commonwealth acquires high value, long life assets and pays 100% of the costs up front.

AF&L has seen an increasing propensity for the government to access assets and related services via leasing or private sector funding. Instead of the government using its scarce capital to purchase assets, the assets are purchased by the private sector and then provided to the government via a lease or an all-in services contract/charge. These payments are a small fraction of the total capital cost of the assets and accordingly, utilise far less of the Commonwealth's budget.

Alternative funding structures help to alleviate budget constraints without requiring the government to sacrifice the assets quality, capability or specification. Overall, the government is able to use these structures to free up expenditure for other projects and results in a more efficient allocation of funds.

## How does this work in reality?

In FY16, AF&L assisted the Royal Australian Navy with the financing of a number of support vessels and patrol boats. In these transactions, NAB purchases and finances the construction of the vessels and enters into a long term lease ('charter') with the Commonwealth or third party.

These transactions provide a predictable charter payment schedule where the costs of the assets are spread out over the asset life (c.20-30 years).

Whilst each transaction differs slightly, the common theme is that as long as the Commonwealth has rights to control the asset(s), it does not need to own them. As such, AF&L is seeing a move away from 'Government Owned Government Operated' models and towards pay for use based models or other 'Contractor Owned, Contractor Operated' structures.

These structures provide the Commonwealth with flexibility to contract private organisations to perform fleet management, fleet maintenance, operations and other non-core defence functions.

## AF&L's future

Current forecasts suggest that government revenue will continue to fall short of government expenditure requirements. By 2055, net debt is expected to represent 57% of national GDP and as a result, there will continue to be budget pressure.

This budgetary pressure should underpin an increasing movement towards pay for use models. This model has application across both federal and state government assets and can be tailored to any physical asset requirement.

The team's proven success in the government sphere has provided AF&L with a deep understanding of the government asset finance sector. AF&L is well placed to assist government with innovative capital financing solutions that balance the competing demands of a constrained budget with the need to supply critical services to the public.

# THE GROWING INSTITUTIONAL TERM LOAN MARKET

Continuing to build connections between borrowers and investors developments in the Institutional Term Loan market.

**Hamish Nicol**

We work with many mid cap clients, helping develop their funding plans to optimise their existing funding needs and to source funding for growth.

This sector of the market is traditionally heavily weighted towards bank loan funding. Generally the borrowing request is too small to make the US Private Placement market economical, and without a credit rating to access the Medium Term Note market (MTN), borrowers opt for 3-5 year bank debt. This allows them to maintain a simple debt funding platform, but results in tenors being capped at five years. It also limits funding diversification.

Issuers in this sector are often growing faster than larger corporates, meaning they require additional flexibility in their capital structure compared to a mature business.

Mid cap issuers seek a funding instrument which provides them with tenor beyond the bank market, without the need for a formal credit rating, using existing loan credit terms and without requiring drafting of bond documentation.

## What's the solution?

The Institutional Term Loan (ITL) market satisfies each of these needs, providing mid-cap issuers with capital structure and funding diversity previously only available to larger, rated entities.

An ITL is an 8-12+ year loan provided by institutional investors using the issuer's existing loan documentation. Funds invest pari passu with existing bank lenders, the only difference being the longer tenor of their commitment and the inclusion of a non-call period. In substance, this effectively gives the issuer the benefits of bond market funding, but in a form that uses the issuer's existing loan documentation terms.

Aside from the benefits to the issuer of this structure, it also benefits the investor, as it provides them with a longer tenor fixed income investment with partial management of prepayment risk. It also opens up the investment universe beyond those issuers with a credit rating who issue in the MTN market.

## Who are the investors?

The investors are domestic funds, US life companies, asset managers, and UK and European institutional investors. These investors are seeking longer tenor fixed income exposures. ITL investment provides them with an alternative form of fixed income.

The ITL market is largely driven by Australia's compulsory superannuation legislation, which provides a steady stream of additional funds under management, some of which is allocated into fixed income buckets. A portion of this funding can be invested in unrated fixed income exposures such as ITLs.

## National Storage REIT - A$100 million eight and ten year ITL

NAB recently closed an ITL transaction for National Storage REIT (NSR). NSR is an ASX 200 company providing storage solutions to individuals and businesses in Australia and New Zealand. The company has a market cap of A$694 million (as at 11 November). NSR recently acquired 100% of the Southern Cross portfolio of storage centres.

Using our investor relationships in Australia and the US, we tested investor appetite for an 8-10 year deal for the company. We placed A$100 million with a single domestic investor split A$50 million in eight years and A$50 million in ten years.

Whilst we have placed ITL's for infrastructure issuers and 'infra like' issuers in the past, this is the first ITL issuance by a mid-cap corporate. The deal extended NSR's weighted average time to maturity to 5.9 years and gave the company debt funding beyond the bank market.

## Who is suited to the ITL market?

There is investor appetite for issuers with long term assets (such as stable property portfolios or long dated revenue agreements) or corporates in sectors with defensible cash flows and strong core businesses.

In addition to providing mid-cap corporates with otherwise unavailable tenor, the ITL market can also provide rated corporates with an additional form of long tenor funding to complement public markets issuance (such as MTNs) and offshore issuance (such as USPP).

ITL's can also be used by project finance borrowers to complement short dated bank debt funding.

For some entities, the ITL market will provide funding to assist their capital structure in evolving the gap between bank loans and bond issuance. As ITL's have only a limited non-call period (for example, a ten year final maturity, with the ability to call after six years) an issuer has the ability to pre-pay the ITL after six years if their funding mix preferences change and they would instead like to issue in the rated bond markets and refinance the existing funding platform.

# LOCAL GOVERNMENT - AN UNTAPPED INFRASTRUCTURE FINANCING MARKET

Given the success of PPPs and privatisations at the Federal and State Government levels, why are Local Governments not in the spotlight?

**Campbell Webster**

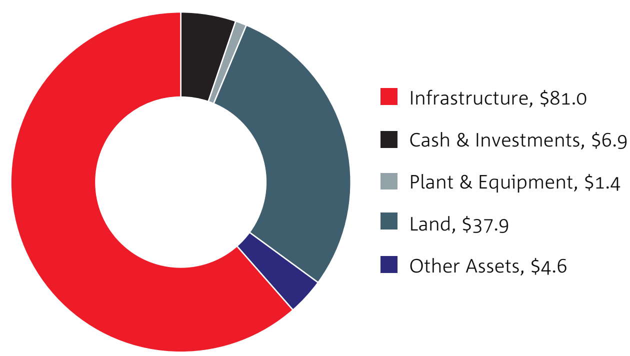
Public Private Partnerships ('PPPs') have had such success at the State and Federal Government levels as a form of procuring infrastructure, yet Local Councils have rarely used this structure to develop greenfield infrastructure for their residents.

NSW Premier Mike Baird has undertaken a 'Fit for the Future' review of all Council's in NSW and many did not meet the criteria. Amalgamation of some Councils has resulted, with NSW forming 20 new Councils in May 2016. This has reduced the number of Councils in NSW from 152 to 115. A further 6 mergers are currently subject to court rulings. The NSW government's reasoning is desire for 'stronger and more efficient Councils, which will free up money for important projects such as local roads, parks, playgrounds and footpaths'. The NSW State Government wants Local Councils to be more self-sufficient and wants to alleviate Councils of red tape, duplication and hopefully attract experienced and innovative managers to drive the future of Councils for their residents.

Local Councils are administered under the Local Government Act 1993. Councils have responsibilities to their residents to deliver local services such as community development programs, assessing development applications, collecting rubbish and recycling and processing rates, fees and other charges, running community facilities, including libraries, seniors centres and swimming pools.

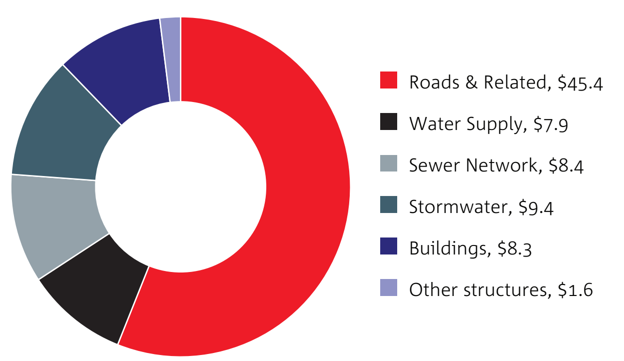
In many cases, Councils have large landbanks and large balance sheets with 'lazy assets'. That is, assets that are underutilised and undervalued and thus not delivering the best financial outcome for that Council. The Local Government Infrastructure Audit in June 2013 undertaken by the NSW Department of Local Government ('DLG') uncovered that Councils have some A$131 billion of assets in NSW alone, for which infrastructure comprises A$81 billion. Infrastructure assets are the systems and networks that provide services to communities such as roads, buildings, water supply, sewer networks and stormwater drainage. There is also a backlog in NSW of some $8 billion of required infrastructure (as at June 2012). It is noted that many Councils are underspending on asset management and maintenance.

**Total value of NSW council assets 2012 value (A$bn)**




Source: NSW Premier & Cabinet Local Government Infrastructure Audit (June 2013).

**Breakdown of total NSW infrastructure assets 2012 (A$bn)**




Source: NSW Premier & Cabinet Local Government Infrastructure Audit (June 2013).

The report highlighted that Councils could use borrowings to reduce the backlog, as one option. NSW Treasury also offered interest subsidies through three rounds of the Local Infrastructure Renewal Scheme which was used to fund $818 million of infrastructure projects across 96 Councils for 166 individual projects. It was fully utilised and now closed. Schemes such as this are useful, but they aren't enduring sources of funding ongoing infrastructure needs.

In some cases, Councils in NSW had been poorly managed, almost mismanaged and not with their residents as the priority. Liverpool City Council procured infrastructure projects which were the basis for the Liverpool City Council Inquiry in 2003, especially in relation to the Woodward Park precinct ('Oasis' project). The Council was sacked over its handling of the A$800 million project and the systemic financial management issues within. The NSW Government requires all Local Councils to have asset management planning in place that is integrated with the long term financial planning and strategic direction of the Council.

Many Councils still rely heavily on s94 developer contributions as a core source of revenue (nearly 50% in some cases). This might seem sustainable during a property and construction boom like that seen in NSW at present, but may not be sustainable longer term. In the meantime, the Council has sold their valuable assets (land) and in many cases used the funds to pay expenses.

NAB is actively meeting Councils with an initiative to better structure their infrastructure needs through the PPP methodology used at the State and Federal level. PPPs will give Councils a robust structure in which to procure infrastructure projects that they may otherwise delay or be unable to raise private sector financing for. A PPP with a 25 or 30 year concession allows the private sector to bring innovation and design, cost rigour and bid competitiveness to the process with no upfront payments required from Council. The asset is then managed under a contracted performance regime which the private sector must meet, otherwise the concession may be abated. The asset is then handed back to the Council at the end of the concession in an agreed handover condition, having been maintained adequately over the concession. The long concession period would allow the Council to raise a levy over this period to meet the service payments, rather than having to seek a once off upfront capital injection which they are often under pressure to repay within a short period. Cost overruns during construction and pricing of maintenance during operations are risks borne by the private sector.

The PPP model is enduring, remains active and has funded some of the largest infrastructure projects in Australia, including during the Global Financial Crisis (such as Victorian Desalination Plant PPP). Whilst State Treasuries may be able to provide a cheaper cost of capital, projects procured on balance sheet miss many of the risk transfer benefits brought by PPPs. The NSW Government has been clear they want Local Councils to be more self-sufficient.

The Act defines a PPP as an 'arrangement between a council and a private person for the purposes of: (a) providing public infrastructure or facilities (being infrastructure or facilities in respect of which the council has an interest, liability or responsibility under the arrangement), or (b) delivering services in accordance with the arrangement, or both'.

The guidelines for seeking approval from the DLG are not onerous and follow well established practices for PPPs at State level.

Some Councils have been using the guidelines to develop waste and water projects. Some examples of past and present PPPs and other projects include:

- **Rivers Regional Council.** Procurement of waste processing facility for WA.
- **Kimbriki Resource Recovery Project.** Northern Beaches and Mosman Councils on the Kimbriki Alternative Waste Technology Project. This is being procured as a PPP.
- **Eastern Metropolitan Regional Council.** The construction, operation and maintenance of a waste processing facility in WA.
- **Sunshine Coast Council.** Currently undergoing a process for a long-term lease of the airport to private sector investors.
- **Port Hedland Council.** Long-term lease of Port Hedland International Airport to private sector investors.

NAB is meeting with Councils and stakeholders in all Australian States to procure PPP and other project finance transactions across a broader spectrum of asset classes.

This development is linked to our identified trend of evolving government, where new and innovative models of funding and procurement are employed to deliver outcomes, or, in this case, where established models of funding and procurement are adapted to a new context.

# GREEN BONDS - MOBILISING INVESTMENT INTO THE LOW CARBON ECONOMY

## Green Bonds - the year that was

**David Jenkins**

2016 has been a watershed year in the world of 'Green Finance' especially for green bonds, with rapid growth and development in this evolving market. Decarbonisation of the global economy has accelerated as the impacts of climate change are increasingly recognised as critical environmental, social, economic and political issues globally. The December 2015 UNCOP21 Paris Climate Change Agreement has been ratified and is now in effect, whilst significant policy progress has been made in the world of Green Finance.

This policy progress has been matched by significant initiatives and commitments by governments, banks, investors and insurers in the rapidly growing green bond market. As the UNEP FI has highlighted, the challenge now is to transform the financial system from a focus on green finance to truly 'green institutions' which requires the practice of leading institutions in terms of climate related disclosure, natural capital accounting and green bonds to become standard practice. This requires more stakeholders to consider not only the risks, but to understand and develop the opportunities this transition to a sustainable, low-carbon economy offers.[1]

NAB recognises this and is committed to playing an active role in this transition to a low-carbon economy through our operations and financing activities. In November 2015 NAB committed to 5 climate change actions, including a commitment to undertake environmental financing activities of $18billion by 2022. As at September 2016, NAB had undertaken $7.3billion towards this target, including arranging another two landmark green bond transactions.[2]

NAB was also recognised this year as a 'Green Bond Pioneer' by the London Stock Exchange and Climate Bonds Initiative for our work developing the Australian green bond market.

### Why Green Bonds?

Green bonds are debt instruments labelled as green, with proceeds earmarked to finance green projects or assets that deliver environmental benefits. A green bond is differentiated from a regular bond by its commitment to use the funds raised to finance or re-finance green projects, assets or business activities

Green Bonds include 'Use of Proceeds' bonds (investors exposed to the credit risk of the issuing entity), 'Project Bonds' (investors exposed to the specific assets/project(s) being funded) and 'Securitised Bonds' (investors exposed to pool of loans used to finance green assets/projects).

**Key characteristics of Green Bonds**

| | |
|---|---|
| **Use of proceeds** | Proceeds should be used to fund investment in eligible 'green' projects/assets that provide clear environmental benefits. |
| **Selection of eligible projects and assets** | Issuers should outline their selection process and eligibility criteria for green projects, together with their environmental sustainability objectives |
| **Management of proceeds** | Issuers should have a defined process to track and report on the allocation of proceeds to eligible green projects during the life of the bond. |
| **Reporting** | Issuers should report annually on use of proceeds including allocation towards eligible green projects, and where available expected and achieved impact of these investments. |
| **External review** | Issuer's should obtain an external review of their green bonds and of their Green Bond Framework. |

Source: NAB, ICMA Green Bond Principles

[1] Environmental Finance (24 October 2016) 'Green Finance – at a tipping point?'.
[2] NAB Full Year Results 2016 (Investor Presentation).

An estimated USD 6 - 7 trillion in annual investment is required over the next 15 years to facilitate the global transition to an environmentally sustainable and low-carbon economy.[3] Private sector capital must be mobilised to enable this scale of investment. Traditionally most green debt financing has been provided via bank debt, whilst the public bond markets have played a comparatively minor role. This however is changing rapidly.

The Green Bond market is rapidly expanding in terms of issuance volume, issuers, investors and types/structures fuelled by the continuing global growth of socially responsible and impact investors seeking to decarbonise their portfolios, participate in the transition to a low carbon economy and/or invest with purpose. 2016 saw this growth continue with a flurry of commitments and pledges to invest in green bonds from institutional investors since the November 2015 UNCOP21 Paris Climate Change Agreement, matched by continuing oversubscriptions for new green bond issues. NAB has witnessed this firsthand, with significant levels of reverse enquiry from both mainstream and new investors seeking green bonds. With OECD estimates of less than 1% of global bond issuance being labelled green bonds, the potential for scaling-up the green bond market is enormous.

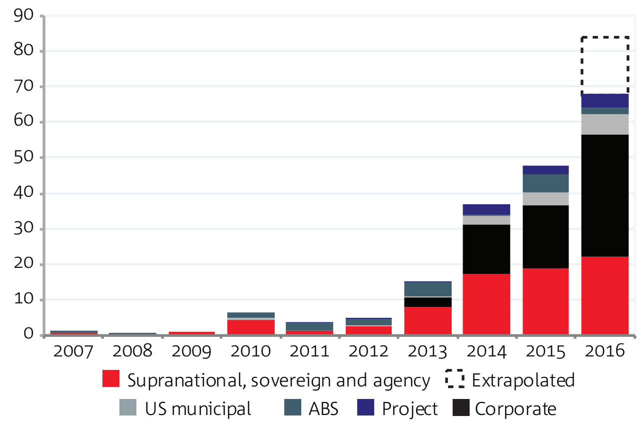
Green bonds offer several important benefits for both borrowers and investors including;

- Accessing an additional source of green financing to address the immense global need;
- Unlocking more long-term green financing to address bank's tenor and capital constraints;
- Enhancing green bond issuers' reputations and profiles;
- Offering potential cost advantages and mitigating execution risk given the deep investor base;
- Encouraging the 'greening' of traditionally brown sectors; and
- Offering new green investment opportunities for SRI, impact and long-term investors.

## 2016 Green Bond market update

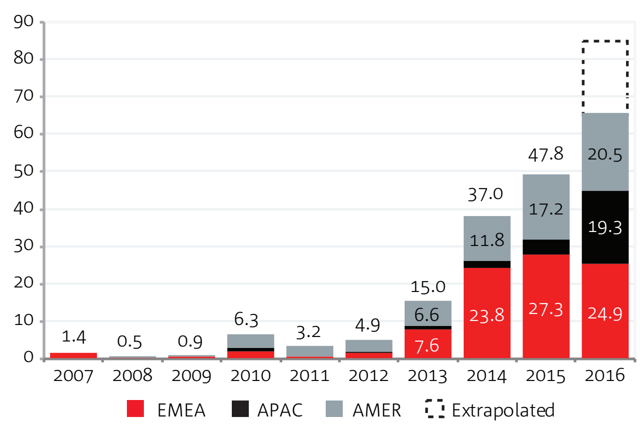
The green bond market continued to expand in 2016 in terms of volumes, issuer types, geographies and sectors financed. After global issuance of US$42bn in 2015, expectations for 2016 green bond issuance range from US$84bn by Bloomberg New Energy Finance ('BNEF') to US$100bn by the Climate Bonds Initiative ('CBI'). Corporate issuance has dominated 2016 so far, led by large European issues such as EDF's third green bond, a EUR1.75bn issue to finance its renewable energy investments.

**Annual Green Bond issuance by issuer type (US$bn)**




Source: Bloomberg New Energy Finance (Green Bonds Monthly October 2016)

**Annual Green Bond issuance by region (US$bn)**



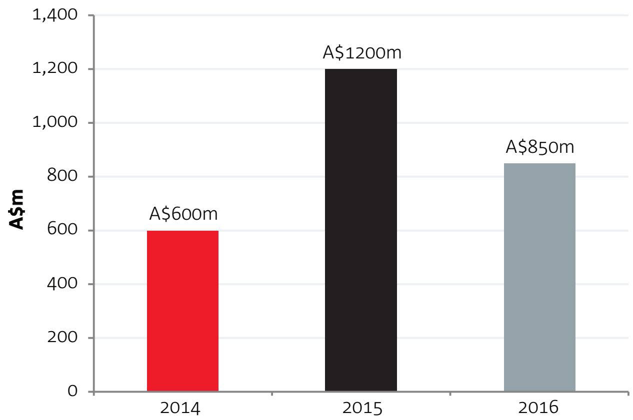

Source: Bloomberg New Energy Finance (Green Bonds Monthly October 2016)

2016 was also significant for the emergence of Chinese green bond issuance. Chinese issuers accounted for over 42% of global issuance of labelled green bonds in the first 7 months of 2016 according to the CBI, following the People's Bank of China ('PBoC') release of green bond guidelines in December 2015. Market participants expect this to continue with China to emerge as the leading regional issuer of green bonds.

Since 2014, A$2.65billion in green bonds have been issued into the Australian market across 7 transactions, all of which have attracted new and SRI investors. 5 of these green bonds have been certified under the Climate Bond Standards, with the remaining 2 SSA issuers electing to align their green bonds with the Green Bond Principles.

[3] OECD Report 2016 - 'Green Bonds: Country Experiences, Barriers and Options'

### Australian Green Bond issuance




Source: NAB

Australia has seen several market first green bond transactions in 2016 which financed a range of assets including;

- The NAB arranged TCV Green Bond – the first green bond issued by an Australian government issued authority and the world's first Climate Bond Standards certified, government issued green bond;
- The NAB arranged Flexi ABS Trust 2016-1 Class A2-G green ABS note – Australia's first green ABS offering and the world's first Climate Bond Standards certified, securitised green bond; and
- Westpac's Green Bond – a Climate Bond Standards certified green bond tranche issued alongside a standard bond tranche, for refinancing existing loans for renewable energy and low carbon buildings.

### Who is issung Australian Green Bonds?

**2016**
**TCV:** A$300m, 5 years (July 2016)*✓
**FlexiGroup ABS Trust:** A$50m, 5 years (April 2016)*✓
**Westpac:** A$500m, 5 years (June 2016)✓

**2015**
**Hallet Hill No. 2:** A$76m/US$99m, 12 years (May 2015)*
**ANZ:** A$600m, 5 years (May 2015)✓
**KFW:** A$600m, 5 years (April 2015)

**2014**
**NAB:** A$300m, 7 years (December 2014)*✓
**Stockland:** EUR300m, 7 years (October 2014)
**World Bank (IBRD):** A$300m, 5 years (April 2014)

Red indicates NAB acted as green bond structuring agent and arranger.
* NAB acted as joint arranger
✓Compliance with Climate Bond Standards

Source: NAB

2016 has witnessed several themes evolving in the green bond market. These include;

- Continuing harmonization of green bond guidelines, standards and reporting
- Continuing global growth of green bond investors
- Pricing tension
- Broader ranges of issuer types
- Growth of emerging market issuance
- Growth of green securitization
- Continuing emergence of semi and sovereign green bond issuance
- Broader deployment of green bond proceeds across more sectors
- Emergence of new green bond structures
- Green loans
- Social and Sustainability themed bonds
- Emergence of green mortgages and the growth of green RMBS

2017 is shaping up to be an even more active year for green bond issuance in Australia with significant reverse enquiry from issuers and investors, and a growing number of transactions in the pipeline for 2017 and beyond. These green bonds are expected to fund an even broader mix of assets via a range of green bond structures.

## Green bonds – standards, guidelines, shades of green and greenwashing.

Despite the rapid growth of the green bond market, no universally harmonised standard or definition of green bonds has been adopted to assist with analysis of the 'green' or environmental credentials of green bonds. This is vital to building investor confidence and a credible global green bond market. It will help address 'greenwashing', where bonds or projects are labelled as green, with little independent verification or unsubstantiated claims around their environmental benefits.

There are several emerging definitions, verification/certification schemes and instruments by which to assess green bonds. These include the Climate Bond Standards, the Green Bond Principles, national guidelines and definitions (such as the PBOC endorsed catalogue in China), second opinions, green bond ratings and assessment schemes, plus several green bond indices.

## What's next for Green Bonds?

The green bond market continues to be an investor led market, with investor appetite continually outstripping supply and continued oversubscription of new green bonds globally. The growth of responsible and impact investors globally, together with investors looking to decarbonise their investment portfolios and participate in financing the transition to a low carbon economy is providing a deep and diversified pool of investors seeking to deploy capital into this rapidly growing asset class which should only aid further development.

# CLEAN ENERGY A GLOBAL PERSPECTIVE

NAB's continuing to lead the renewables markets.

**Adam Coxhead, Ally Bonakdar and Andrew Smith**

## Renewables on the international stage

**COP21 and away!**

The 21st Conference of Parties (COP21) held in December 2015 triggered unprecedented support for the transition to a low-carbon economy. 195 countries including Australia and New Zealand adopted what is known as the Paris Agreement which aims to limit global warming to 2°C above pre-industrial levels, while recognising the need to pursue efforts to limit it to 1.5 degrees. The Paris Agreement came into force on 4 November 2016.

**Global Renewables investment of US$288 billion**

The International Energy Agency (IEA) estimated global investment in renewables was US$288 billion[1] (2.5x fossil fuel generation investment) in 2015. The IEA predicts that over the period to 2021, investment in renewables will total US$1.45 trillion increasing renewable capacity by 42% and its share of generation from 23% to 28%.

**Rapid cost decline**

Rapid cost decline continues to be a feature of the industry. Whilst the global level of investment in 2015 was broadly the same as that made in 2011, capacity additions grew by 40% and electricity output is expected to increase by over one-third.

The IEA estimates that globally the weighted average unit investment cost of onshore wind fell by 20% between 2010 and 2015, while that of utility-scale solar which has witnessed steeper cost curve declines dropped by more than 60%. An example of the level of cost decline was the Jinko Solar and Marubeni consortium bid of US$24 MWh for a 350MW solar photovoltaic project located in Abu Dhabi which set a record low.

## NAB's continuing the lead the renewables markets

Clean energy is a strategically important sector for NAB as demonstrated by our 5 climate change commitments, one of which is an organisational commitment to undertake financing activities of A$18 billion over seven years (to September 2022) to help address climate change and support the orderly transition to a low-carbon economy. NAB is proud to announce that it is well on target in achieving this objective as it has also already committed A$7.3 billion since 2015. NAB has provided $5.4 billion in project finance for renewable energy projects since 2003. We continue to be the leading arranger (by market share) of project finance to the Australian renewable energy sector.[2]

Recently, we accelerated and broadened our activity, including a number of industry-leading initiatives such as launching the first Australian bank-issued Climate Bond Standards certified Climate Bond and arranging green bond issuances for others, and arranging the first renewable transaction to feature in the USPP market.

This long-standing commitment to action on climate change is reflected within our own business. NAB was the first Australian bank to achieve National Carbon Offset Standard carbon neutral certification. More recently, we committed to source 10% of NAB's Australian electricity from new and additional renewable energy projects by 2018 – to stimulate growth in the renewable energy sector. NAB has also set a science-based greenhouse gas emission reduction for our operations; supporting the internationally agreed objective of limiting global warming to less than two degrees Celsius above pre-industrial levels.

[1] IEA Renewable Energy Medium-Term Market Report 2016.
[2] Project Finance International 2006-2016 Asia Pacific Initial Mandated Lead Arrangers League Tables – MidYear 2016 US$ Project Allocation, NAB analysis ranking against 4 major Australian banks – cumulative volume as at 30 June 2016.

In 2016, NAB became the first Australian bank to become a corporate member of the Clean Energy Council, Australia's peak body for the clean energy sector. During the year, NAB became the first major bank to sign up to the Victorian Government's Take2 Pledge and support the State-wide 2020-2025 emissions target.

## An Australian perspective

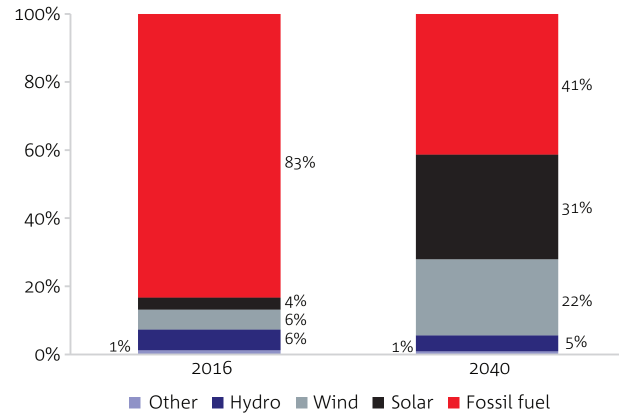
### RET and beyond – the only way is up!

As we approach COP22 later this year in Morocco, the Renewable Energy Target (RET) will remain an important pillar of Australia's emissions reduction policy, projected to deliver around 200 million tonnes of emissions reductions over the period from 2015 to 2030 (Climate Change Authority, August 2016).

With the RET legislation fully bedded down and the revised 33,000 Gigawatt-hour (GWh) target for large-scale renewable projects accepted by both mainstream political parties, the future for renewables is looking increasingly positive in Australia. To deliver on this target, approximately 6,000MW of new renewable generation capacity is required, creating more than A$10 billion of investment and approximately 6,500 new jobs in the process (Clean Energy Council, Briefing Paper, May 2015). This task is now well under way, with the market buzzing with optimism and Australia receiving renewed attention from international investors. We are seeing European and Asian equity investors focusing their attention on the Australian market again – as evidenced by IFM Investors divestment of Pacific Hydro to State Power Investment Corporation (SPIC), who will be a dominant renewables player in the market moving forward.

Australia's current and projected composition (2020) of generation mix is outlined below. Solar and wind will increasingly play a more substantial part in the future. This will become more pronounced with the advent and greater integration of battery storage, providing greater support to the energy network, when the cost efficiencies associated with batteries are realised.

**Current installed generation by fuel source**




Source: Bloomberg New Energy Finance

### States leading the charge with a focus on jobs and innovation

In 2016, the ACT Government concluded its successful reverse auction scheme, which over the last few years has seen approximately 650MW of renewable feed in tariff (FiT) contract of difference contract (CfDs) awarded to various projects to meet its legislated target of 100% electricity by 2020. The Next Generation Renewables Auction for 200MW concluded this year with a new benchmark price set for renewable energy in Australia with A$73/MWh for the Hornsdale wind farm, fixed for 20 years (with the Crookwell wind farm also winning with a FiT price of A$86.60/MWh for 20 years).

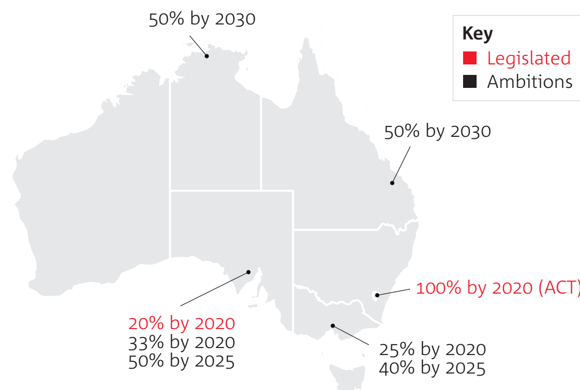
In addition, the ACT Government is rolling out household batteries, with the Government awarding grants to install subsidised battery storage in 200,000 Canberra homes and businesses. In view of the growing role of decentralised generation and storage, the Australian Energy Market Commission (AEMC) was recently tasked by the Council of Australian Governments (COAG) to monitor and report on whether the current economic framework continues to deliver on the national electricity objective centred on price, quality, safety, reliability, and security of supply.

The ACT Government has inspired other States into action, with the following State initiatives launched in 2016:

- **(QLD – Solar 120)** Queensland Government supported solar projects located in Queensland and tendering for the Australian Renewable Energy Agency (ARENA) and Clean Energy Finance Corporation (CEFC) utility-scale solar PV program by offering 20 year CfD contracts. ARENA has announced A$92 million in funding to support 12 different projects totalling 480MW; this is envisaged to create over 2,300 new jobs and spur more than A$1 billion investment in renewable infrastructure.
- **(QLD – Ergon Energy)** Queensland will receive its first large scale wind farm after the regional electricity utility, Ergon Energy, negotiated a long term power purchase agreement for the 189MW Mount Emerald wind farm. NAB is proud to be a lead mandated arranger of the Mount Emerald wind farm, to be developed and owned by Ratch Australia Corporation

  The Queensland Government has set a target of 50 per cent renewable energy by 2030 with a committee set up to determine the best way to achieve this target.
- **(VIC LGCs)** The Victorian Government successfully launched and concluded its Victorian LGCs tender, with each of Kiata and Mt Gellibrand wind farms being the successful tenderers in that process. NAB is proud to be the sole debt and ECA arranger in relation to the Kiata wind farm, which is jointly owned by John Laing and Windlabs. It is expected that these new windfarms will generate enough electricity to power 80,000 homes, totalling approximately 100MW of capacity.
- **(VIC Reverse FiT Auction)** The Victorian Government announced the 'VRET' Reverse Auction Scheme, which is designed to deliver on the State's renewables target of 25% by 2020 and up to 40% by 2025. This equates to approximately 5,400MW of new large-scale renewable capacity to be built in Victoria. The Victorian Government ran a consultation process on the auction scheme design and NAB provided its submission as part of that process. NAB recommended that the Government keep certainty in regulatory matters and the pipeline of opportunities at front of mind when designing the scheme. A simple framework with well-defined risk allocation will ensure the most efficient outcome for the State - and importantly – the end Customer.
- **(SA 100% Target)** The Labour SA Government announced its aspiration for 50% renewables energy by 2025. The State currently has approximately 40% of renewable generation and, in view of the recent SA blackout, further substantial increases may require greater focus on network support and energy storage. The AEMC is currently undertaking a review of the wholesale energy market framework to consider whether changes are required to accommodate the increasing volume of renewables whilst maintaining power system security.

### NEM renewable energy targets

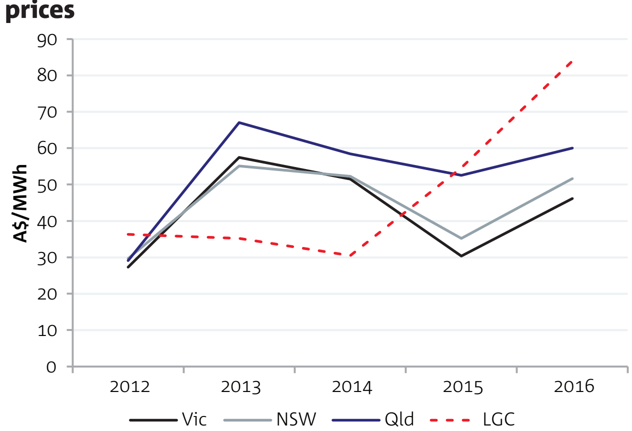



Source: Bloomberg New Energy Finance

### State of the energy market

In terms of the state of the energy market, renewable developers and independent power producers are enjoying high spot energy and large-scale generation certificate (LGC) prices, in particular, LGCs are trading at all-time highs:

### Yearly average historical Black and Green energy prices




Source: LGC prices – Bloomberg New Energy Finance; Black prices – AEMO Average prices

On the thermal front, Engie & Mitsui recently announced the proposed decommissioning of the 1,600MW Hazelwood coal fired power station, located in Victoria's Latrobe Valley, in the first half of next year, the plant currently supplies up to 25% of Victoria's base load electricity demand.

On the renewables front, 2016 has been full of activities. It witnessed the creation of a new dominant renewable energy player, Tilt Renewables, which recently demerged from New Zealand's Trustpower, to focus solely on renewables and take the opportunities presented in the Australian market. NAB was co-lead structuring and lead arranger in relation to the demerged entity. AGL announced the creation of the Powering Australian Renewables Fund (PARF), partnering up with QIC, on behalf of the Future Fund and its other investors. PARF is targeting 1,000MW of renewable generation, with a total investment of A$2-3 billion. NAB is proud to be a mandated lead arranger to the Nyngan and Broken Hill solar farms. Palisade also launched the Palisade Renewable Energy Fund (PREF), targeting approximately A$1 billion of total investment (A$100 million of equity from CEFC) in renewables projects for the investment period to 2020. NAB and another financier are committed to work with Palisade to provide debt financing for these renewable energy projects. Origin is running a sale process for its Stockyard Hill wind farm, with strong interest from domestic and international equity investors. All in all, it has been a big year for renewables in the Australian market.

## A UK and European perspective

**Europe and the UK are mature leading markets for Clean Energy and continue to drive cost reduction and innovation in technologies.**

In the UK, 2015 was the first year where renewable energy provided more than 25% of the UK's electricity needs. With approximately 12GW of solar PV capacity installed in the UK, there was something of a paradigm shift over summer 2016: May 2016 saw the first time that the UK has generated no electricity from coal since completion of the UK's first coal plant in 1882[3] and more electricity was generated from solar than from coal over the summer months in 2016. In November 2016 the Department for Business Energy & Industrial Strategy announced a consultation on the closure of all unabated coal fired power plants in the UK by 2025, alongside a further CfD subsidy auction for less established technologies, including offshore wind, wave and tidal power.

In Europe, 27.5GW of new renewable capacity was added in 2015, down from peaks of approximately 38GW in 2011-12, however still a very substantial level of investment. Renewable electricity generation reached 1,227 TWh, a 6% increase on 2014, and accounted for approximately 35% of total power output.[4] Renewable power support measures in Europe continue to trend away from FiTs and green certificates towards premium feed-in premiums and auction mechanisms. Renewable energy generation is expected to increase by 24% over 2015-21, with annual capacity additions expected to remain between 18 GW and 21.5 GW.

**Key themes are continued cost reduction, technological innovation and sector consolidation.**

Costs continue to be driven down across different sectors, most notably in offshore wind in Europe. Recent offshore wind auctions are particularly notable for low strike prices, with clearing prices at €73/MWh for the 700MW Borselle I and II projects in the Netherlands, then even lower for a 350MW near shore Danish project at €53/MWh and €50/MWh for the latest Danish 600MW Kriegers Flak project (58% below the strike price cap). Such ongoing cost reductions point to a future where renewable technologies can stand alone without subsidies, which we are starting to see early signs of in the UK where some developers are pursuing subsidy free onshore wind farm projects in Scotland following the closure of the existing subsidy regime to that technology. Ultimately such projects need to secure an attractive offtake arrangement and many developers and investors are hoping that a growing market for corporate Power Purchase Agreements could help to facilitate bankable projects, although the growth in demand for such arrangements is inherently linked to the outlook for power prices.

Innovation in technology continues apace, with 96MW of floating offshore wind projects being awarded in France during 2016, and the emergence of utility scale battery storage in the provision of ancillary frequency response services to grid operators.

Energy storage in particular has generated a lot of interest, with National Grid's recent 200MW tender for Enhanced Frequency Response services (sub 1 second response) in the UK demonstrating the value for money that providing more investment certainty can bring (through extended 4 year contracts and indications of an 800MW tender programme).Ultimately the £7-12/MWh price range of the successful tenderers was significantly lower than the £20+ price the grid operator had been paying historically for the Firm Frequency Response services (10-30 second

3 According to Argus Media and Carbon Brief
4 IEA Renewable Energy Medium-Term Market Report 2016

response). Energy storage business models continue to be refined and it seems will be reliant on owners ability to ‘stack’ revenues, which may require some redesign of revenue streams (such as ancillary services) with investors and consumers in mind in order to achieve this.

One of the key investment themes continues to be increasing levels of Merger and Acquisition (M&A) activity in Europe, driven by: 1) sector consolidation as developers and early stage investors realise investments, selling to lower cost of capital investors who are aggregating large portfolios; and 2) recycling of capital by utility developers into new projects, particularly in the offshore wind sector. A number of our pension fund clients are increasingly active investors, either directly, through portfolio platform companies or through fund managers. Investment from Asia, particularly Japanese conglomerates and Chinese state owned companies, is also becoming increasingly prevalent in many European markets.

**Politics continues to influence the outlook for renewables investment.**

The Brexit vote in the UK brought forward the traditional summer lull, however everyone picked up where they left off when they returned from holidays in September and our experience is that activity has been strong since then.

The potential impact of Brexit on the renewable energy sector is primarily felt in two areas that ultimately both influence investment appetite: 1) regulation and policy; and 2) power prices.

In respect of regulation and policy, if/when Britain leaves the union, the EU’s Renewable Energy directive, which sets a target for the UK of 15% of primary energy and 30% of electricity from renewable sources by 2020, would no longer apply. However, the UK’s climate change goals established at a national level through the Climate Change Act, which requires an 80% reduction in GHG emissions by 2050. This goal is progressed by 5 yearly carbon budgets and will remain legally binding. Equally, the UK has signalled its ongoing commitment to climate change goals via the Paris Agreement at last year’s COP21 and the new government has signalled they will seek to ratify that commitment by the end of 2016. Industry participants are anticipating firmer energy policy guidance from the new government in the upcoming autumn statement.

With respect to power prices, there are a number of Brexit-impacted factors that could have both positive and negative impact on future power prices: less integration with European markets; delayed investment decisions; foreign currency import costs; and lower economic growth. Initial evidence has been that the strongest effect in the near medium term has been the lower currency, which has raised input costs for gas and coal fired generation, with near-medium term power prices rising meaningfully and market advisor forecasts rising in response.

Initially delayed in the aftermath of Brexit and formation of a new government, the proposed £18 billion Hinkley Point C Nuclear Power plant was given the go-ahead in mid-September by new Prime Minister Theresa May with the clear message that the UK is open for business. With a CfD strike price of £92.50/MWh indexed for 35 years, the cost of the project is substantial but proponents argue it will provide essential baseload capacity to ensure security of supply as Britain’s ageing fleet of nuclear and coal fired generators shut down.

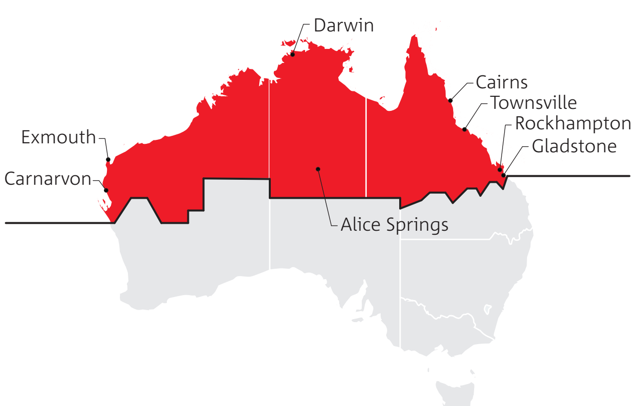
# SPOTLIGHT ON NORTHERN AUSTRALIA

The Federal Government is pushing for accelerated economic infrastructure investment in Northern Australia and is offering concessional loans to bring accelerate this investment forward.

**Phillip Mak and Con Michaelidis**

In 2016, the Northern Australia Infrastructure Facility became available for project proponents to support infrastructure developments in Northern Australia. The Federal Government (Government) has been a strong supporter of infrastructure development in Northern Australia and in June 2015 released a White Paper titled 'Our North, Our Future' setting out a plan to unlock Northern Australia's economic potential. Included in the initiatives outlined in the White Paper, the Government announced the implementation of a A$5 billion Northern Australia Infrastructure Facility (NAIF). The NAIF will provide concessional loans to major economic infrastructure to support the development of Northern Australia.

**Northern Australia defined**




Source: NAB 2016.

Northern Australia captures the Northern Territory and parts of Western Australia and Queensland above the Tropic of Capricorn. This area covers 40% of Australia's land mass, contributes to 11% of Australia's GDP and holds only 4% of Australia's population.

Australia's north is uniquely geographically positioned to take advantage of:

- its proximity to growing South East Asian economies which are within 3-5 hours flying time from Darwin.
- growing Asian middle class which by 2030 will represent around 2/3 of the global middle class population
- similar time zones to the most dynamic economies in Asia, which is advantageous for service industries.
- recently concluded Trans-Pacific Partnership (TPP) and Free Trade Agreements (FTA) between Australia and Japan, South Korea and China. In addition to ongoing negotiations with India, Indonesia and on regional FTAs such as the Regional Comprehensive Economic Partnership (RCEP) and the Pacific Agreement for Closer Economic Relations (PACER) Plus.

## NAB in Northern Australia

Over the past five years NAB has been an active supporter of infrastructure, energy, and resources projects in Northern Australia with leading roles in the financing of airports, LNG projects, port terminals, iron ore mines, wind farms, gas pipelines and even a prison. In addition NAB has been a strong supporter of agriculture in the region and holds the enviable title as Australia's largest agricultural bank with 30% market share.

## Infrastructure gaps in Northern Australia

In early 2015 Infrastructure Australia published their Northern Australia Audit which identified infrastructure gaps requiring investment in order to meet the Government's population and economic growth projections. Gaps were identified across the transport (airport, port, rail, road), energy (electricity, gas pipeline), water, and telecommunications sectors. These sectors all represent 'enabling infrastructure' and drive economic growth outside the projects themselves.

The Government will facilitate the development of Northern Australia by creating successful business environments in which businesses can thrive.

This will be achieved through:

- economic policies,
- enabling infrastructure to get things moving,
- regulation that minimises costs on business,
- a workforce with the right skills, and
- basic research to assist business to identify opportunities.

## Northern Australia Infrastructure Facility

Headquartered in Cairns, the NAIF was opened for business on 1 July 2016. The A$5 billion of funding is available to deploy into Northern Australian projects over the next five years.

Loans provided by the NAIF offer exceptional benefits to borrowers including:

- **Lower interest rate** – calculated with reference to the Commonwealth Bond rate for similar tenors in addition to an admin fee
- **Longer loan teno**r – up to maturity of the longest Commonwealth Bond term (currently 2046)
- **Different repayment schedule** – longer interest-only periods with NAIF loan repaid following amortisation of commercial bank debt
- **Capitalised interest during construction**
- **Capital structure flexibility** – NAIF loans may form any part of the capital structure including senior or subordinated

To be eligible for NAIF funding, proponents must demonstrate that the project involves a construction element (either greenfield or capital expansions) and is economic infrastructure capable of serving multiple users. In addition NAIF must co-lend alongside commercial lenders with NAIF providing no more than 50% of the total debt funding. As such the involvement of NAB in your NAIF application process is important as we can assist in optimising commercial outcomes from NAIF negotiations.

NAB is well positioned to assist our customers throughout their NAIF application process given our strong working engagement with the NAIF, robust understanding of deal structuring and appetite for funding infrastructure projects.

## Conclusion

The NAIF presents NAB's customers with an excellent opportunity to accelerate proposed investment in Northern Australian projects and promises to be an impressive example of the public and private sector coming together to support Australia's continued prosperity.

NAB has the leading capability to arrange and structure NAIF facilities and can provide co-funding alongside NAIF.

Please reach out to your NAB relationship banker should you wish to discuss opportunities to fund your Northern Australia capital expenditures and to take advantage of the Northern Australia Infrastructure Facility.

# WHEN TRADITIONAL APPROACHES ARE NOT SOLVING FOR SOCIETY

When civil society demands a new approach to solve a wicked social problem.

**James Waddell**

When traditional approaches are not solving society's most pressing social issues a new approach is called for.

A consequence of one of our identified trends of budget constrained governments is the public sectors quest to develop innovative models of service delivery.

Social impact investment is an example of this quest in action. It enables innovation in the delivery of social and financial outcomes across the community. A spectrum of products associated with social impact investment exists, from outcomes-focused grants and payment-by-results contracts, to equity and debt instruments, social impact bonds and more.

NAB is active in exploring ways that it can assist Governments to innovate in the way that social services are financed and delivered. The new model of financing services, called social impact investment, offers an innovative way of bringing together capital and expertise from the public, private and social sectors to deliver better outcomes for Australians.

In an Australian first, NAB has supported a social impact investment that will be used to support parolees with the aim of reducing the rate of reoffending and re-incarceration. Our investment will enable On Tracc (Transition Reintegration and Community Connection) to contribute to the NSW Government's commitment to reduce reoffending by 5 per cent by 2019.

On Tracc will work with up to 3,900 parolees over five years, and will be jointly delivered by not-for-profit groups Australian Community Support Organisation (ACSO) and arbias. ACSO and arbias are experienced in providing community support services and delivering early intervention programs to people in the criminal justice system.

The NAB investment will provide working capital for On Tracc and is jointly provided by the NAB and ACSO. Returns to NAB and ACSO are dependent on the performance of On Tracc.

The On Tracc program commenced on 1 September 2016. The program provides intensive, individual post release support to parolees to help them reintegrate into the community, particularly in the first 16 weeks after release.

The client group comprises adult parolees with a medium to high risk of reoffending, released to supervision in selected Sydney metropolitan areas. Client groups will be referred to On Tracc over 12 month periods for up to five years. Reoffending outcomes will be measured across each group. The performance of the program will be measured by the rate of re-incarceration for each group of clients in the 12 months following their release from custody.

For all but the first group of clients, the reduction in re-incarceration will be measured by comparison to a live randomised control group. For the first group, the reduction will be in relation to a fixed rate of re-incarceration based on historical data. The program will be evaluated by the NSW Bureau of Crime Statistics and Research.

Unlike the two previous social impact investments, where social benefit bonds were sold to the market and for which terms were required to be disclosed, there are only two investors involved in On Tracc on commercial terms that were collaboratively developed on a confidential basis. This approach ensures changes to the program can be dealt with expeditiously.

This is the third social impact investment in NSW, following the Newpin and The Benevolent Society social benefit bonds implemented in 2013. Another nine transactions are in various stages of development across Australia.

Governments across Australia are seeking to collaborate across the private, non-government and financial sectors in delivering solutions to their most pressing social problems and we expect this nascent impact investment industry to continue on its growth trajectory.

# ISLAMIC FINANCE IN AUSTRALIA

*"NAB has designed a funding tool using an agency-based contract known as wakala, the first such dedicated funding platform in the country."* (Reuters, 2016)

**Dr Imran Lum**

Over the past decade, Islamic finance grew at double-digit rates and Reuters estimate that Islamic finance assets currently range in the vicinity of over US$2 trillion.[1] The industry continues to grow. For example there was a 16 per cent growth in Islamic retail and commercial banking assets in 2014-2015,[2] and Moody's estimate that the long term market for Islamic financial services is in the tune of US$5 trillion.[3] Part of this growth is attributed to an overarching story of demographic shifts, with rapid income growth in Asia building an expanding middle class. It is also part of a broader story of changing global trade and capital flows, with the 'economic centre of gravity' shifting from North to South and East to West.[4]

The Islamic finance sector continues to be dominated by Malaysia, and the Gulf Cooperation Council (GCC) who have set up Islamic ecosystems to ensure that the industry continues to grow. Investors from these two regions are increasing their presence in Australia and more and more Australian businesses are engaging, transacting and partnering with these investors. Australia is increasingly being seen as an attractive investment destination to diversify their asset portfolios. Foreign investment has been essential to the development of Australia's economy for over 200 years, evolving from investment from the United Kingdom into the wool industry in the 19th century to the broader international sources of capital we see today.[5] Having said that, Australia as an investment destination for Islamic money faces tough competition from financial centres such as London, Singapore, Hong Kong, Luxembourg and even other non-Muslim majority countries such as South Africa because they have taken the extra step to amend tax laws to facilitate Islamic investment. All of those countries have also issued Sukuk bonds to benefit from Islamic capital flows.

## NAB's involvement in Islamic Finance

Shariah compliant financing in Australia can be complex and involves parallel consideration of various structuring, legal and taxation issues to produce an outcome that is not only viable, but which is commercially and legally robust. NAB's Capital Financing division houses the only Islamic finance business among the four major banks in Australia and has managed to capitalise on this growing industry. To date, NAB has financed over A$160 million for Islamic clients seeking a Shariah compliant solution for their financing needs. NAB's Islamic offering covers a range of different areas ranging from microfinance, a Sukuk bond trading book, Islamic FX forwards and Shariah compliant financing solutions for Islamic investors seeking property acquisition financing or development financing.

NAB has completed some landmark transactions in this space including a ~A$30 million Shariah compliant property deal for a large Saudi Arabian fund, which was their first foray into the Australian market. NAB also completed a Shariah compliant property deal for AEPim to purchase an iconic A$160 million CBD Property in Brisbane. AEPim was established in 2008 by Yusof Wahid and the Sulaiman Al Rajhi family, the principals behind the Al Rajhi Group which is one of the largest privately owned enterprises in the Middle East. As part of that transaction, NAB structured the first Shariah compliant FX Forward transaction (wa'd and a bay' al-sarf) ever in Australia. This helped AEPim hedge the FX risk associated with their purchase of the Brisbane property.

Branching out of NAB's Corporate and Institutional Bank, NAB has structured transactions for the Business Bank including an $11m transaction for Piety Investments a local property development company. This illustrates the broadening of NAB's capability in this space. This market leading product offering allows NAB to innovate for new to bank Islamic investors from the Gulf Cooperation

[1] State of the Global Islamic Economy, Reuters, 2016.
[2] E&Y World Islamic Banking Competitiveness Report 2016.
[3] Moody's, 2014.
[4] CSIRO Futures.
[5] DFAT.

Countries and SE Asia and also local investors who require a Shariah compliant solution for their financing needs.

## Recent Federal Government Budget mentions ‘Asset-backed’ financing

In 2010, the Board of Taxation (the ‘Board’) released a discussion paper titled ‘Review of the Taxation of Islamic finance’ to explore barriers related to Islamic finance. The Board completed its review and submitted its report to the Government in June 2011. The Government released the Board’s long awaited final discussion paper to the public on 13 May 2016 following the announcement of the proposed changes to the tax treatment of ‘asset-backed’ financing arrangements in the 2016/17 Federal Budget.

The Board’s recommendations are intended to ensure that Islamic finance products are treated at parity with conventional products having regard to their economic substance. The measures are intended to remove tax impediments to the provision of Islamic finance products and therefore, encourage greater utilisation of Islamic finance in Australia. The release of the final discussion paper is a positive step to encourage growth of the Islamic finance industry. It is also recognition by the Government that it is important for Australia as a net capital importer to have access to alternative and evolving sources of foreign capital such as Islamic finance to fund capital projects in Australia.

NAB has an extensive network in South East Asia and the Gulf Cooperation Council (GCC) region and the pipeline of Shariah compliant deals for 2017 looks strong. Regardless of whether the proposed tax changes take place, NAB is well placed to capture this growing market and provide financing for real estate investment and construction in Australia where the owner, equity investor and/or developer has a preference for a Shariah compliant solution.

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# NOTES

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