nab

BRINGING IN THE BUY SIDE

Finding and executing genuinely innovative funding solutions has been a major focus for **National Australia Bank** (NAB) in recent years. To make this strategy work, the bank aims to shed light on a critical component of funding innovation: understanding investor preferences and connecting them with assets that may not be available elsewhere.

NAB has been at the forefront of understanding the changing role of banks in corporate funding for some years. With balance-sheet capacity at an increasing premium, NAB moved early to align its corporate-finance business with borrower priorities. Its aim has been to provide funding solutions based on a genuine understanding of borrower needs and goals, in doing so moving away from a product or balance-sheet focus.

"It used to be that banks would just use their balance sheets for corporate funding, but we can no longer do this to the same extent," says Mark Todd, Sydney-based head of portfolio solutions at NAB. "For us, this has led to a focus on thinking about how we bring customers to customers."

The starting point, Todd explains, is the fundamental change taking place in the banking sector. This has led NAB to reassess its relationship with buy-side clients, based on the idea that the bank's job is now to play a role between customers of all stripes. "In the past the bank worked more around how to sell particular products – whether they were mortgages or credit cards, or corporate bonds. Our business used to be product-focused, where now it is relationship-focused," Todd says.

Over the course of the past 18 months, deal flow has reflected this approach more than ever before – in the form of increased volume of more bespoke debt transactions for unrated issuers, and in enhanced visibility of less cookie-cutter transactions in general.

Perhaps the most significant facilitator of this proliferation has been the evolution of the Australian investor base. This has come in two forms, both of which have emerged gradually but with increasing visibility when it comes to being the catalyst for successful debt deals.

One is the growth in scale of the noninstitutional bid. The other is the willingness of institutional funds – even the largest, most traditionally mainstream funds – to engage with less liquid, more bespoke, often smaller and generally higher-yielding asset classes.

Noninstitutional demand in Australia is gradually developing from its traditional fixation with equity and property, supplemented by term deposits as the only significant fixed-income asset. An ageing population is seeking income certainty at a time of dawning post-crisis awareness of sequencing risk and the dangers of insufficient portfolio diversification. These self-managed investors are increasingly asking advisers for fixed-income direction (see box on p34).

The institutional-investor element appears to be more a case of the bespoke-transaction segment gaining critical mass than of investors having damascene conversions on their own

DISCUSSION CONTRIBUTORS

As the basis for this exploration of how the Australian buy side is engaging with diversity in fixed-income investment, in September National Australia Bank hosted a discussion among a group of its leading investor clients, to explore and share their insights into investment motivations when it comes to asset diversity. This discussion is quoted throughout this article.

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NONINSTITUTIONAL INTEREST *CONTINUES TO GROW*

The root cause of noninstitutional-investor interest in high-yield fixed income in Australia is this cohort's increasing appetite for fixed income overall. The search for consistent income, capital security and asset diversity is leading a growing segment of the self-managed sector to explore, and allocate to, debt product.

■ CRAIG What is causing noninstitutional investors to seek out high-yield fixed-income product?

JONES There are a few things happening. There has been a hunt for yield, which has bid up all asset prices. At the same time, increasingly our clients are aware they have to move away from traditional asset classes like equity and property to generate income flow. This is particularly relevant for the retirement cohort and, for our business, for income matching in the aged-care space. The bottom line is there is underlying demand for this asset class.

From an advisory-firm perspective, technology is also allowing us to start to access deal flow. A lot of independent financial advisers are now starting to run managed accounts, which effectively allow them to pool their clients' money and thus act like a family office.

With the buying power this creates they can now start to access deals they were locked out of in the past because they had retail clients that didn't satisfy the wholesale requirement. These platforms are now allowing us to hold assets and distribute them across the whole client base.

On the yield side, because asset prices have been bid up over the years our clients are starting to really assess whether they need liquidity – or at least whether liquidity needs to be the foremost component of their investment strategy.

They are starting to talk about trading liquidity for a consistent income stream, and therefore they are quite willing to sit in something for three or four years to maturity. This is a change, because liquidity was a big issue as we emerged from the financial crisis. At the time, illiquid assets were associated with leverage – but this is not the case with the high-yield debt market.

MCNABB We're seeing similar developments. We have a lot of clients who think they need to allocate more into fixed income because of lifecycle issues. These are people who generally think they understand equity and property but know they don't understand fixed income.

These clients are starting to move from traditional asset classes – equity and property – into hybrids and fixed income. They come to us because they feel they need someone to invest for them. They also think there's a lack of transparency in our sector, so they need someone to 'hold their hand' in the process.

Getting back to high yield, we are a diversified fund and we can be 50 per cent allocated to unrated. We have been as much as 30 per cent in corporate high yield in the past. Actually, right now we're down to zero – but only because there's a parallel story in the asset-backed space where the banks are having to give up some of the assets on their balance sheets because of capital constraints. This creates an alternative fixed-income investment opportunity we are passing on to our investors.

"WE HAVE A LOT OF CLIENTS WHO THINK THEY NEED TO ALLOCATE MORE INTO FIXED INCOME BECAUSE OF LIFECYCLE ISSUES. THESE ARE PEOPLE WHO GENERALLY THINK THEY UNDERSTAND EQUITY AND PROPERTY BUT KNOW THEY DON'T UNDERSTAND FIXED INCOME."

JAMES MCNABB AQUASIA

account. Fund managers say they have always had appetite for high-yielding product, but today's banking environment is bringing more supply to their doors (see box on facing page).

What appears to be emerging is more consistent support for transactions that historically could not have reliably found substantial liquidity in the Australian dollar market. NAB has arranged or lead-managed two deals of A$300 million (US$238.3 million) or more from unrated issuers since September last year (see chart on p37), and the bank's Sydney-based director, debt markets, Andrew Gordon, says volume outcomes of this nature have alerted additional borrowers to the burgeoning domestic capital-markets offering.

"I have met companies that only took the meeting because A$300 million is a size that looks relevant to them – for the first time," Gordon reveals. "Equally, there is an education process as some unrated issuers are often new to the debt-markets space. But many issuers are highly engaged and interested in the bond solution."

The capital-markets history of one of these unrated borrowers – NEXTDC – gives an even clearer illustration of growing liquidity for this type of transaction and the virtues of persistence on the part of issuer and arranger. NEXTDC has issued three bond deals since 2014, increasing its ambitions going into the execution process and its final volume outcome

INSTITUTIONAL-INVESTOR *MOTIVATION*

Australian fund managers agree that the changing shape of the bank business model is supporting higher-yielding opportunities. Their own appetite for such product is also growing.

CRAIG What appetite do institutional investors have for unrated bonds?

MOAL The way Perpetual Investments has approached high yield – and why I was hired – was as a complement to existing strategies. I do not have a dedicated high-yield fund at the moment – instead there are a couple of funds into which I can put investments. Some have up to 10 per cent invested in high yield, one has up to 50 per cent.

The idea is to provide high-yield coupons, so I am looking for the more risky – or truly sub-investment-grade – bonds. I'm not really interested in 'investment-grade-like' unrated credit. This is more difficult because I'm competing with investment-grade return and, more to the point, liquidity.

I also want to have a mix of different assets. What I'm looking for is good risk-return. I like high yield, but I also believe in the capital backing the asset so that, if things go wrong, I'm looking to get back par.

These funds have different constraints regarding liquidity. They have the ability to invest in loans, but loans are very illiquid. The bond format is very valuable because it provides more liquidity and therefore allows me to do larger volume.

DAVID We have broad-based income-opportunity strategies that have always had the capacity to invest in unrated. The only change is that these funds have grown over the last few years. This has helped our appetite more than any broad mandate changes – of which there really haven't been any.

Our funds have the capacity to invest in the public high-yield market and emerging markets, so there is quite a bit of competition for their capital. In Australia, we will look at any company that fits the spectrum. We will do our credit work, see what an issuer comps to and think about liquidity.

Historically this last piece has been pretty easy as there hasn't really been liquidity. But perhaps we will need to think about it more nowadays – depending on the company. We will see how it compares to what we can get in the public markets.

I think the broad focus hasn't really changed. It's more that there has been an increased volume of opportunities in this space as banks have become more willing to let assets go.

The question we will always ask is how we find the sweet spot where the specific asset a bank is willing to let go is actually something we like.

KASE We've had a long-running interest in the high-yield space. It can provide diversification and additional yield. To some extent we would rather have the choice to lend directly to a corporate than lend to a bank which then lends to a corporate.

Accessing appropriate risk at the appropriate level and in an appropriate format has been a challenge in the past. It feels now, from discussions I'm hearing, that there has been a shift in incentives inside the banks – though this differs from bank to bank.

I think a number of domestic investors are ready and able to invest in the high-yield sector. We just need to get a bit more momentum going for the sector to stand on its own two feet economically. If we can get the price piece right, we will be at the beginning of something very interesting.

"I THINK A NUMBER OF DOMESTIC INVESTORS ARE READY AND ABLE TO INVEST IN THE HIGH-YIELD SECTOR. WE JUST NEED TO GET A BIT MORE MOMENTUM GOING FOR THE SECTOR TO STAND ON ITS OWN TWO FEET ECONOMICALLY. IF WE CAN GET THE PRICE PIECE RIGHT, WE WILL BE AT THE BEGINNING OF SOMETHING VERY INTERESTING."

MIHKEL KASE SCHRODER INVESTMENT MANAGEMENT

on each occasion (see chart on p37). In part, this reflects the rapid growth of the issuer – but it also speaks to emerging demand.

Gordon says the most notable feature of market evolution NEXTDC's 2017 transaction exposes is the growth in institutional demand for the right unrated product. The deal's book included 11 institutional investors – all of them what Gordon describes as "typically buyers of investment-grade, rated MTNs". He adds: "This is how we hoped the unrated market would develop – with a combination of institutional and noninstitutional buyers active in the same deals – and it is clear the institutional sector is starting to arrive in size."

THE RIGHT PRODUCT

Although NAB's strategy is product agnostic, Gordon says in the interests of maximising liquidity for less mainstream bond-market issuers it helps to offer the investor base a relatively familiar product format. He explains that the larger, public deals NAB has worked on are designed to be tradeable through Austraclear – and that these sit atop another set of smaller, privately placed and genuinely bespoke transactions.

In this way, the public high-yield market in Australia is about increasing the visibility of local liquidity pools by funding what is a relatively small group of corporate borrowers with suitable credit profiles and borrowing needs. Gordon reveals

LIQUIDITY: A FRANK AND REALISTIC APPROACH

Investors – both institutional and noninstitutional – say the best approach to managing their clients' liquidity expectations is to be clear about what the nature of realistic expectations should be. The hope is that doing so will help prevent irrational behaviour even under stressed market circumstances.

SWISS It is generally assumed that high-yield product is generically less liquid than investment-grade bonds. Is this a fair assessment, and if so how do different types of investors manage liquidity and discuss it with their clients?

MCNABB We are very careful to educate our clients on liquidity, especially the fact that a component of the returns we're generating come from buying things that aren't liquid. We're managing expectations in this respect.

I would sound a note of caution about the market, here, in the sense that we believe there are products on the street that are offering liquidity on underlying assets that really aren't liquid. I suspect at some point this will bite us all on the backside, unfortunately.

MOAL To operate a broad high-yield mandate you also have to tell your clients you're not giving them daily liquidity. If you have to offer them this, you have to leave substantial cash on the balance sheet and not be fully invested. Which means you won't achieve your objectives. We need to be fully invested, and our clients have to understand that the part of the capital structure we are investing in is less liquid.

JONES It comes down to the education piece at client level, and this takes time. We are an objectives-based investment firm, so it's easier to have a conversation about assets being illiquid and the benefit this brings. We can say to clients that the illiquid part of their portfolio is not accessible – and that's the trade-off.

It's a journey for clients to accept this. Once they understand this concept, the risk of them trying to liquidate assets or panicking because they can't liquidate them in the event of a downturn decreases. The education piece is a vital part of the investment process – if you don't do it you start to get into the kinds of problems experienced during the financial crisis.

MCNABB We say to our clients: 'If you as an investor want to liquidate for an idiosyncratic reason, you can at any given moment. But if you want to liquidate when everyone else is doing so, you're going to get stuck.' We also favour assets that self-liquidate rather than relying on the market, which is another reason we like asset-backed bonds at the moment.

KASE I agree that the problem comes when you buy something that's illiquid but convince yourself it's liquid and think you're just getting a large credit-risk premium. Whereas really what you're doing is getting some credit-risk premium and a lot of illiquidity premium. You can't really lay off the illiquidity risk.

For us it's a broader portfolio-construction question around how much illiquidity risk we take, how much we get paid for it and also where we allocate it from a risk perspective. We are aware, of course, that illiquid products will have different characteristics. But the idea that everything we own needs to be highly liquid is somewhat nonsensical.

JONES Part of the issue with liquidity is the way investors are focused on short-term performance. We are asked to give quarterly, semi-annual and annual updates. The education process is around trying to explain to clients that they really need to be looking at performance over a three-year window. They need to forget what the equity index did over 12 months or what the bond-market index did over six months. We say to clients, 'Let's look at the three-year strategy we have in play and measure it on a three-yearly basis.'

We just want to see whether the assets are producing what they were forecast to and whether we're on target to meet our clients' goals. If you change the conversation away from the day-to-day performance issue it makes it a lot easier for clients to accept some illiquidity in their portfolio positions.

“TO OPERATE A BROAD HIGH-YIELD MANDATE YOU ALSO HAVE TO TELL YOUR CLIENTS YOU'RE NOT GIVING THEM DAILY LIQUIDITY. IF YOU HAVE TO OFFER THEM THIS, YOU HAVE TO LEAVE SUBSTANTIAL CASH ON THE BALANCE SHEET AND NOT BE FULLY INVESTED. WHICH MEANS YOU WON'T ACHIEVE YOUR OBJECTIVES.”

ANNE MOAL PERPETUAL INVESTMENTS

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>
> **MARK TODD** NATIONAL AUSTRALIA BANK

that the most likely source of high-yield issuance in Australia is companies with growth ambitions in the top 300 listed names – but in all likelihood outside the top 100.

“What we are trying to do is bring transactions in a bond format that can be traded,” Gordon says. “In this context we’re not even talking about institutional loans, which are less liquid still than unrated bonds and cannot access broader investor channels.”

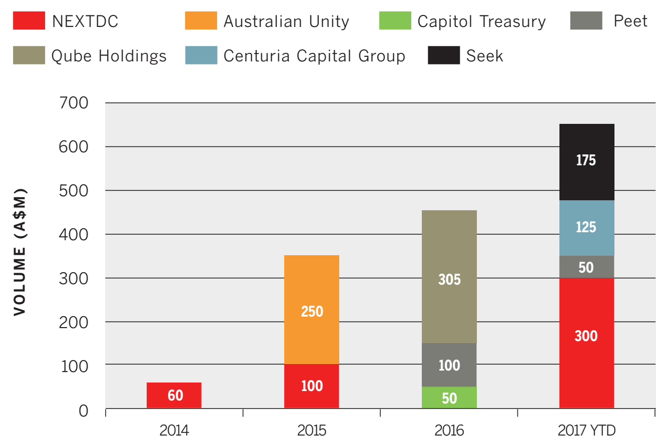
The signs are that investors are meeting half way on the liquidity issue. They report that they are getting on the front foot when it comes to conversations with their clients about the nature of liquidity and the value of illiquidity premia (see box on facing page). When these conversations have positive outcomes, investors can more comfortably allocate to product they expect not to offer reliable liquidity.

The emergence of consistent deal flow in 2016 and 2017 is the product of significant background work. The real heavy lifting, market participants acknowledge, has come over the past three or four years. Todd says NAB has been having in-depth conversations with selected local institutional investors over this period, to work on mutually acceptable formats for documentation and deal execution.

“We started talking to institutional fund managers, and from that engagement they started asking how to be involved with this market on an ongoing basis,” Todd reveals. “We have taken institutional investors along for the ride – we took their views and preferences to issuers, and also focused on establishing the credibility of the names we planned to bring to market.”

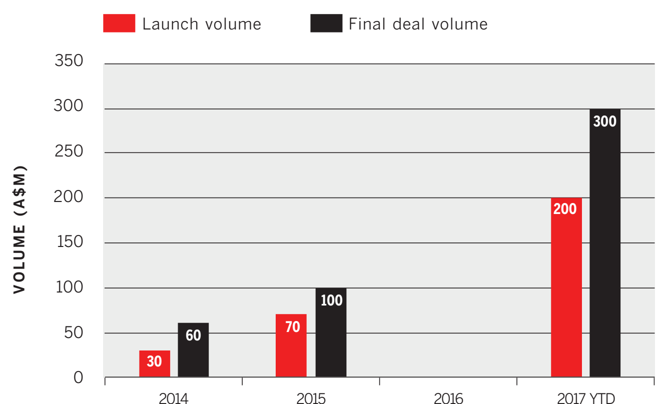
Anne Moal, senior high-yield analyst at Perpetual Investments in Sydney, says her re-entry to the high-yield market three years ago coincided with a new level of energy in the sector. “It was really exciting to come back at that stage because it was the first time – after being in Australia for

NAB-ARRANGED UNRATED AUSTRALIAN DOLLAR BOND DEALS



SOURCE: KANGANEWS 30 SEPTEMBER 2017

NEXTDC BOND DEAL LAUNCH AND FINAL VOLUMES



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> “We are naturally self-selecting the issuers to bring by volume – we want more A$100 million-plus issues so everyone can be rewarded for the time they have to invest in doing the credit work to participate in these transactions.”
>
> **ANDREW GORDON** NATIONAL AUSTRALIA BANK

INSIDE THE HIGH-YIELD *CREDIT PROCESS*

Investors, both institutional and noninstitutional, say a close understanding of high-yield borrowers' corporate strategies is critical in this market sector. Leveraging wider credit-analysis resources and applying shadow ratings to facilitate the deepest possible understanding tends to be a speciality of the institutional space.

■ CRAIG When considering unrated issuance, are investors looking for debt with an investment-grade profile even if it is from an issuer that for whatever reason has chosen not to seek a formal rating?

DAVID We have looked at companies from a low triple-B down to, say, a single-B type profile. Our appetite is based on this profile, so we need to maintain a shadow rating of what we think the rating profile is.

The dilemma we have from a resourcing perspective is that the amount of time it takes us to look at a triple-B company is far less than we need to look at a single-B company. At the same time, our outright volume appetite for single-B is probably going to be less. Sometimes the process is around balancing these dynamics.

We want any security to contribute to the portfolio. If we're looking at a company like Seek, which did a A$175 million (US$139 million) deal, there is enough debt out there for investors to buy. But if we're looking at a A$30-40 million transaction our ability to participate and have a genuine impact on our portfolio is quite a bit harder.

The questions we will have for National Australia Bank (NAB) if it is talking to us about company are: what does it do, what are the balance-sheet metrics and how much is it looking to raise?

When we have the answers to these three very simple questions we'll know whether we will be prepared to do the credit work. The answers to these three questions might be sufficient for us to say "this is probably not for us".

KASE We also shadow rate internally. There is a certain amount of work we have to do to get comfortable with a deal and make sure it stacks up. Ultimately, though, we want to achieve a more diversified portfolio.

If we are looking at companies going through a growth phase we know if we do the work now the issuer is likely to come back to market in the future. This promotes the longevity of the process and ensures the credit work isn't just a one off. If we get the sense a company is only ever going to do one three-year deal at A$50 million we'd probably look for something else.

■ SWISS Do noninstitutional investors use shadow ratings?

MCNABB We don't explicitly shadow rate. As we are looking at a credit we will have an idea where it fits in our spectrum. This is a little like a shadow rating but we don't explicitly call it this. But when we think about where pricing should be and what the terms are like we will compare with other deals.

One thing we have come up against – and it's a function of how the market works – is that an unrated credit needs to pay its way in the portfolio, because we are 50 per cent investment grade. It is actually difficult for us to buy an unrated credit with an investment-grade profile if it's priced like an investment-grade credit.

We find ourselves passing on unrated opportunities that stack up from a risk-return perspective but we can't find a home for them currently.

■ SWISS At what point does price come in to the credit process?

DAVID It's a bit circular, as you have to know the credit profile before you can know what the price should be. A good banker will steer you towards what they think the price should be, so it's possible to get a sense of this up front. But whenever we are assessing what price

"FOCUS ON MANAGEMENT PROBABLY BECOMES MORE HEIGHTENED IN THE UNRATED SPACE. WE WILL EITHER LOOK TO LEVERAGE THE RESOURCES OF THE LEAD BANKS OR OUR OWN INTERNAL EQUITY TEAMS TO ENSURE WE ARE ON THE SAME PAGE AS THE CHIEF EXECUTIVE."

ADRIAN DAVID MACQUARIE INVESTMENT MANAGEMENT

more than a decade – that I could see banks had an incentive to develop different products, because of the capital costs of keeping their corporate clients," she comments. "Meanwhile, the financial crisis showed to corporates that funding solely via banks wasn't always a good thing. There were incentives for everyone to consider the unrated market more seriously."

Where high-yield product differs from more mainstream Australian debt offerings is the nature of the credit process investors go through to develop comfort with assets' creditworthiness and pricing (see box on this page). What may be starting to develop is an Australian equivalent of the US private placement market – at least in the sense that institutional investors expect to be much closer to their borrowers on an ongoing basis in the high-yield realm. Credit analysis in this sector is weighted much more to understanding a company's vision than is the case for investment grade.

should be it will always come down to what we think the credit profile is.

CRAIG What else comes into consideration for investors when looking specifically at high-yield or unrated debt? Are there institutional advantages?

KASE There is another element, depending on how your organisation is structured. Where we already have internal equity coverage we can leverage off that knowledge. This can be of benefit when a new issuer comes to market as we can quickly form an early view on which credits we want to be involved with.

DAVID Focus on management probably becomes more heightened in the unrated space. We will either look to leverage the resources of the lead banks or our own internal equity teams to ensure we are on the same page as the chief executive. This engagement becomes very important.

MCNABB We take the view that if we are buying a piece of high-yield debt we are in a partnership with the company. We want to know what its strategy is. Our process takes a bit of time – we like to have at least a few days to look at a credit.

It's also a tough process. We almost always say no and we need to get universal consent from our investment committee. This usually involves us understanding company strategy. We don't view this just as a credit – it's more of a corporate story as well.

SWISS It sounds like institutional investors have a wealth of access to management and disclosure. What do noninstitutional clients have access to and where could this be improved?

JONES It's a lot harder, because we don't have the teams to draw upon. We tend to use other information in our network: this might be other managers that we work closely with, or through NAB. Certainly it's easier if we already deal with the company on the equity side – for example with NEXTDC and Centuria Capital Group we were able to carry out our own assessments. For smaller issues we would likely partner with a manager with expertise in the relevant area.

As direct credit becomes more prevalent in the independent financial adviser (IFA) market there will be an opportunity for specialist credit-research houses that sit outside the traditional credit-rating agencies to provide services to IFAs in this space.

TODD Keith Jones will still be able to see a chief executive, though – from this perspective access is the same. We ask management to see all customers – this could be a fund manager or indeed anyone who is interested in being an investor. We are agnostic to the name behind the investor – we think the issuer needs to make the case regardless. NAB doesn't have some relationships that are stronger than others: it has relationships.

GORDON Through Mark Todd's work, for those investors that can't make a roadshow or group meetings we will make the same information available via websites and the like.

JONES We certainly want to know about strategic vision on an issuer's part, just as Adrian David says. We'd want to understand, to start with, whether we would invest in the equity piece. But we don't apply a shadow rating to the asset as such. Even if there was one we couldn't really show it to our client base.

"WE CERTAINLY WANT TO KNOW ABOUT STRATEGIC VISION ON AN ISSUER'S PART. WE'D WANT TO UNDERSTAND, TO START WITH, WHETHER WE WOULD INVEST IN THE EQUITY PIECE. BUT WE DON'T AS SUCH APPLY A SHADOW RATING TO THE ASSET."

KEITH JONES AFFINITY WEALTH SERVICES

Gordon is keen to encourage this sort of issuer-investor engagement, in line with NAB's view of itself as a facilitator. He explains: "We take comfort that institutional investors do their work ahead of deciding to invest at a certain price. At least 30 per cent, give or take, of our high-yield books goes to institutional investors and we're happy to see that we're not just pushing a price out there. There are sophisticated analysts crunching the numbers on a shadow-rating basis."

This type of evolution in the institutional investor base supports the kind of wider market development NAB is championing. "We don't actively pursue sub-A$50 million transactions," Gordon explains. "This means we are naturally self-selecting the issuers to bring by volume – we want more A$100 million-plus issues so everyone can be rewarded for the time they have to invest in doing the credit work to participate in these transactions." •