Introduction

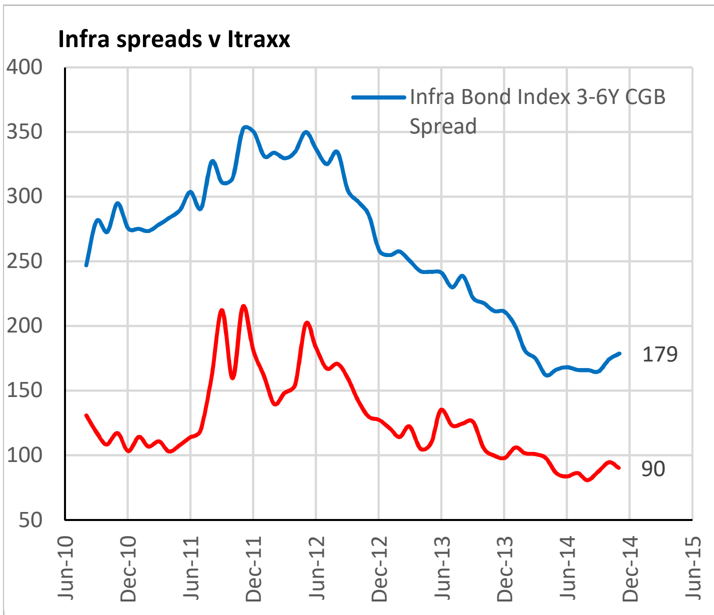
We expect that many people will be taking leave post Christmas, so we thought we would bring forward this quarter's newsletter. We'd like to take the opportunity to thank people for their interest in the publication, our readership continues to grow which is gratifying. We would also particularly like to thank people who've provided commentary, thoughts and requests for more information or suggestions for future articles – this is really important as we want to keep the newsletter relevant and contextual to the Australian infrastructure scene. If you've recently been added to the mailing list you can find back copies of the newsletter on our website.

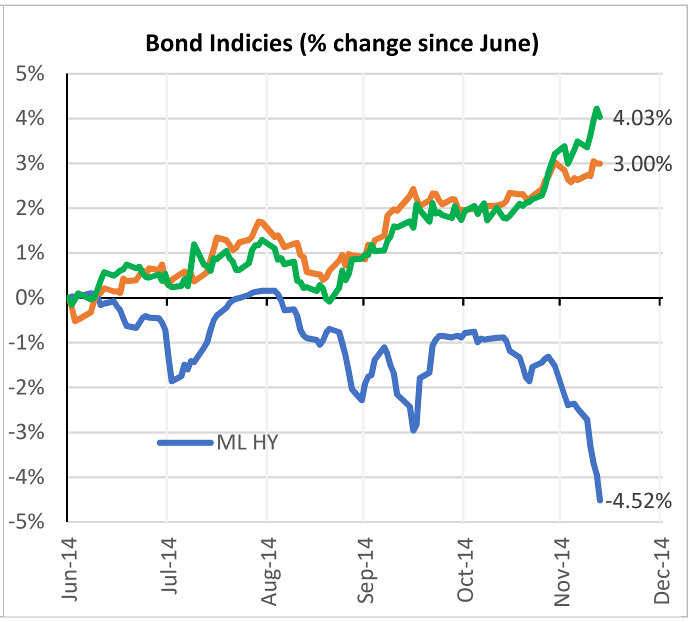
In this quarter's edition, we have two articles, the first relates to the fall in energy prices and the impact on high yield debt – questioning whether this issue is idiosyncratic to energy or if it will give rise to further issues more broadly across credit markets. Our second article looks at the Australian bond and loan universe – exploring various issues relating to infrastructure debt, in particular: its size, composition, structure and competitive dynamics, together with investment opportunities.

We'd like to wish everyone a merry Christmas and a happy new year. By all accounts 2015 is shaping up to being an exceptional year for Australian Infrastructure with many large asset sales, new greenfields projects coming on line, and a strong political focus on the sector – most likely next year will be a record for debt issuance. At the same time broader financial markets, most notably the low level of risk free rates, make the investment environment ever more challenging as we head into the new year.

Markets update

Spreads on infrastructure debt moved slightly wider at the end of the quarter. However, the more spectacular performance is for high yield, which has fallen sharply on the back of lower oil prices – see more in this quarter's feature article.





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New issuance and refinancing

The table below provides a list of publicly available deals.

Issue Date	Security	Issuer	Volume (mil)	Tenor (years)	Issue swap spread (bps)
1/10/2014	Loan	Port of Newcastle	875	3/5	150/180
3/10/2014	Loan	East West Link	3,300	7	200
9/10/2014	Bond	Melbourne Airport	EUR 350	10	75
30/10/2014	Loan	United Energy	77	5	
31/10/2014	Bond	AGL Energy	600	7	170
6/11/2014	Loan	ATCO Gas	450	5	
1/12/2014	Loan	Northern Beaches Hospital	725	3	200
3/12/2014	Bond	Australian Rail Track Corp	175	5	85
5/12/2014	Loan (Ext)	Origin Energy	6,600	3/5	125/140
Pending	USPP	Brisbane Airport	200	10/12/15	
Pending	Bond	Queensland Motorways	150	7	160

Equity and other news

- APA Group acquired the Queensland Curtis LNG (QCLNG) pipeline from BG Group for $6.02 billion. This represents a circa 12.5x EBITDA multiple.
- The ACT shortlisted two consortia for Supreme Court Redevelopment PPP (est. $100 million).
- Duet Group is undertaking a $400 million capital raising, the purpose of the funds will be to fund growth in its United Energy and Multinet Gas businesses and improve its credit outlook.
- Bids were recently submitted for the acquisition of Royal North Shore Hospital from RBS. The successful consortium is expected to be notified prior to 31 December 2014.
- Marketing for the Port Of Darwin has commenced with an expected sale value of circa $200 million.
- The newly elected Victorian Government has commenced negotiations to rescind contracts for East-West link.

Will the oil woes spread?

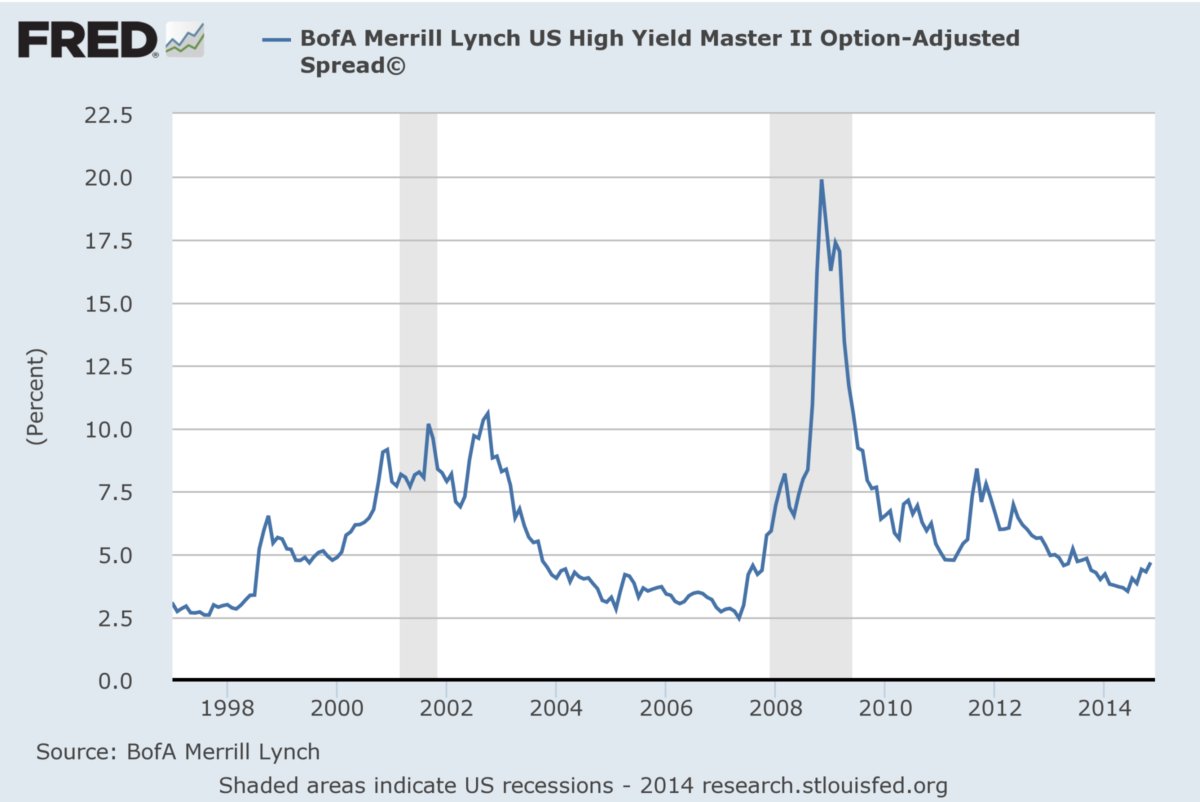
> *"At this juncture, however, the impact on the broader economy and financial markets of the problems in the subprime market seems likely to be contained." Ben Bernanke 28 March 2007*

> *"There's never just one cockroach in the kitchen". Warren Buffet. 1989 shareholder letter.*

The US high yield market probably doesn't garner that much attention amongst Australian superannuation trustees. While many funds will have an indirect exposure to this market through the opportunistic portions of their overseas fixed income portfolios, it isn't a market that looms large in the monthly/quarterly trustee discussions on asset allocation.

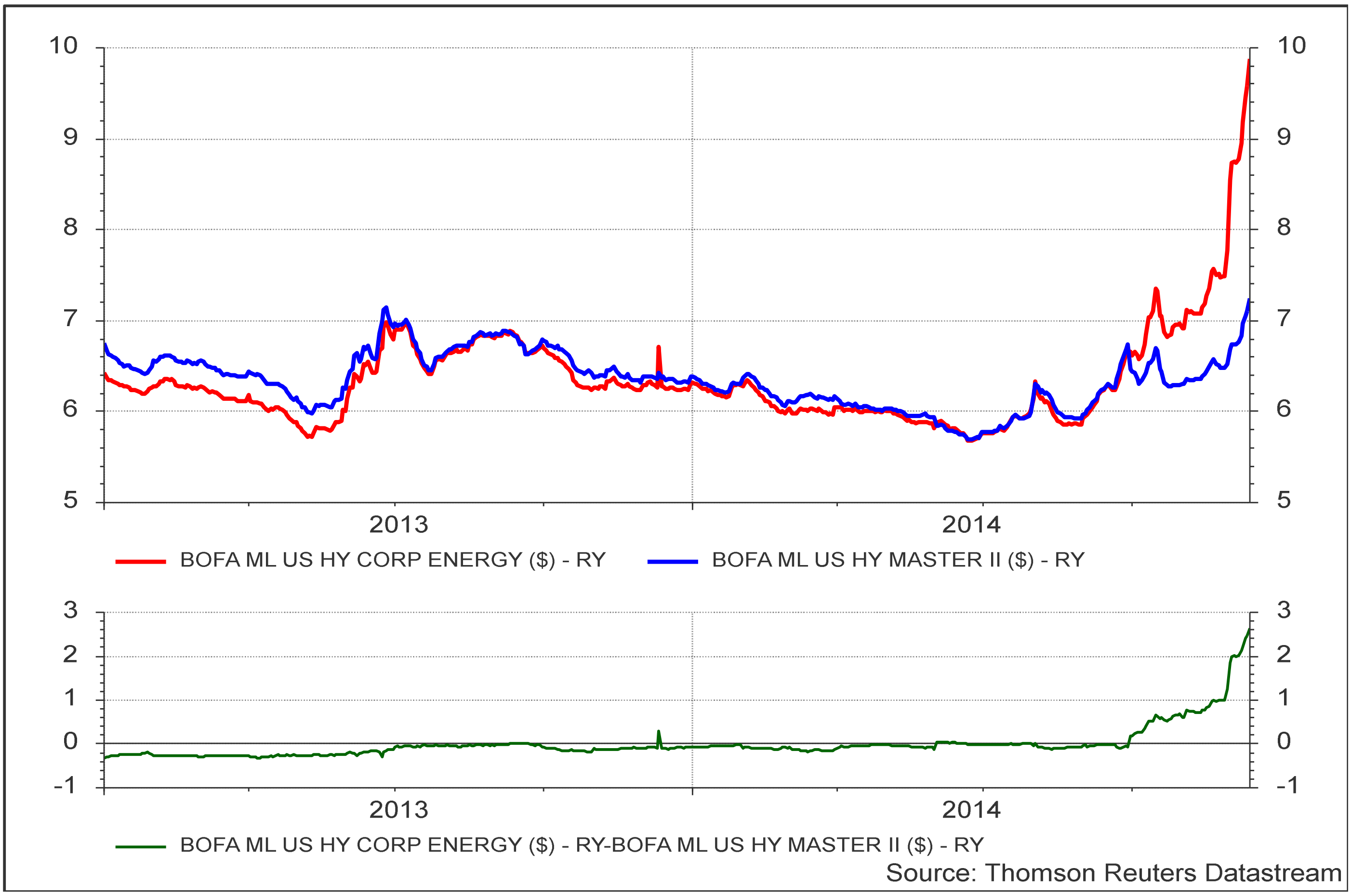
The US high yield market provides debt capital for US companies (and some foreign companies that choose to borrow in USD) rated below investment grade (that is, CCC to BB+). It is a large market with US$1.3 trillion outstanding and thousands of individual issuers making for a highly competitive and efficient market for reasonably riskier borrowers. It is this market that is the primary source of debt capital for the private equity industry.

Many of the headlines regarding the junk bond market in 2014 focused on the very low level of junk bond spreads. This has led some observers – for example Carl Icahn - to label junk bonds as a 'bubble'. Spreads hit a low of 3.3% in June this year but have moved up since, particularly in the last couple of months.



What does this widening of spreads mean? Is it a portent of a broader weakening of credit markets?

A substantial driver of the widening of high yield spreads has been the collapse in the oil price and its consequent impact on US energy companies. The energy sector is one of the biggest industry sectors in the high yield market (circa 18% of the overall market). It is a sector dominated by oil service companies as well as the US shale oil/gas sector. Both sectors have been extremely hard hit by the recent decline in oil prices. Shale oil companies are particularly vulnerable as they are often highly levered and rely on cash flow from current wells to fund the capital expenditure of new drilling (and wells have a short half-life). The chart below focuses on the energy sector and shows the blowout in yields in the US high yield market over the past couple of months.



Deutsche Bank have analysed the cash flows and gearing of individual issuers within the sector. They have predicted that a sustained oil price of below $60 a barrel (essentially today's pricing) would see a 15% default rate amongst high yield energy issuers and, from this sector alone, a 2.5% contribution to high yield default rates. That is roughly doubling overall high yield default rates from current levels.

This highlights that while lower oil prices will reduce input costs and free up household and corporate budgets around the world – not everybody is a winner. The fall in prices will hurt both companies and countries dependent on oil (and competing sources of energy) revenue. These losers have the potential to inflict significant credit losses on the financial system/investors.

The question for investors is whether this new found risk aversion and fear will be contained to the specific dynamics of the energy sector, or whether it will spread more broadly. If it does, it will reinforce the role of high yield (and credit markets more generally) as the 'canary in the coal mine' of financial markets.

Australian infrastructure debt universe – bonds versus loans

Infrastructure markets have experienced intense competition for high quality assets over the past few years, resulting in what appears to be rich valuations. The present situation creates a challenge for Australian superannuation funds seeking to 'get set' in infrastructure. For example, IFM's Brett Himbury said in March "for the supply of dollars that the Australian superannuation fund system has, there has not been enough deals to invest in."

Given the apparent 'cost of capital shoot-out' for the equity piece of the capital structure, what does the debt piece look like? Focusing on Australian dollar denominated senior debt, there are two main types of debt finance:

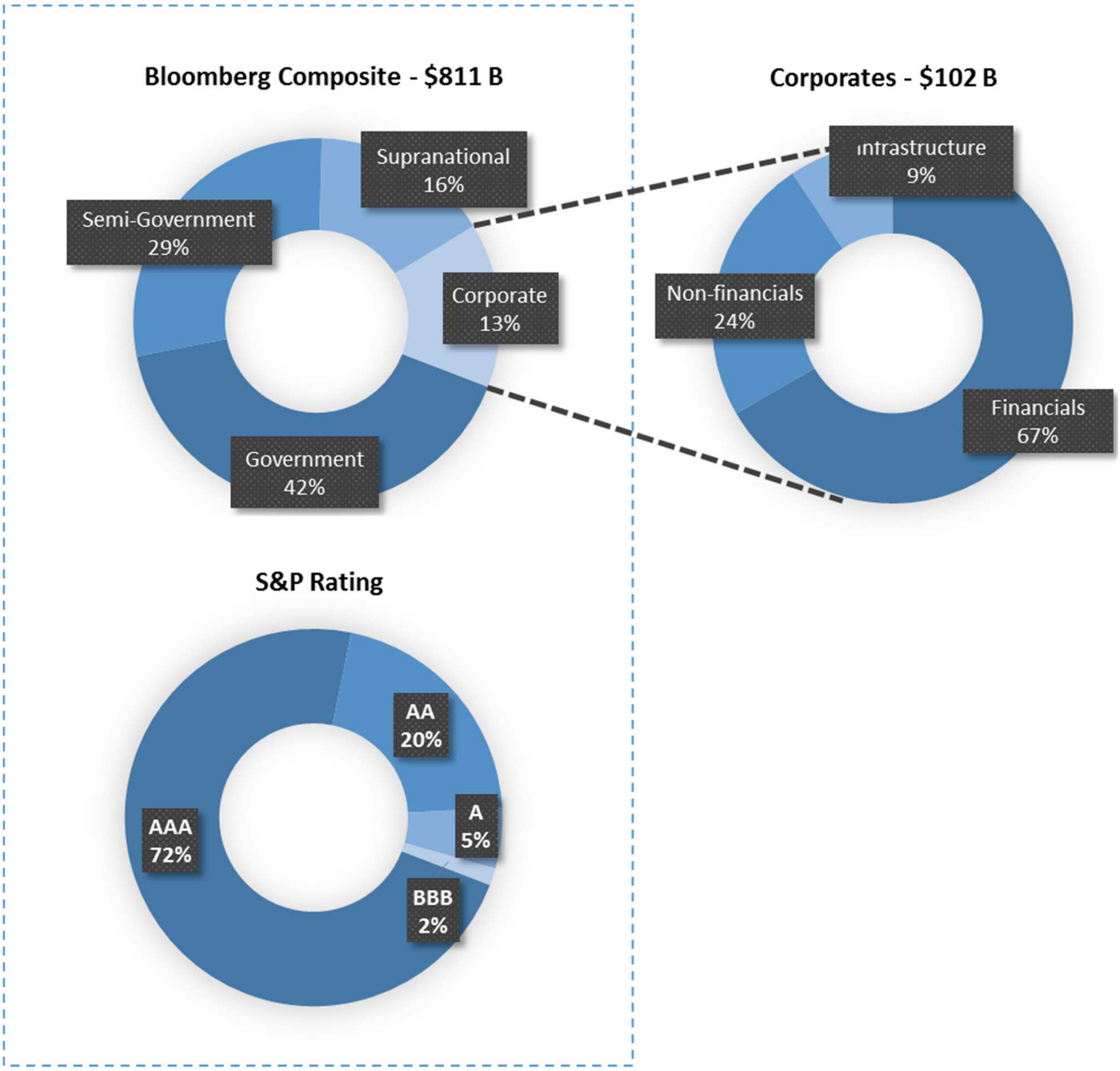
- Bonds: marketable debt securities being fixed rate, floating rate or inflation linked. They tend to only be issued by the larger infrastructure borrowers who have a formal credit rating. Being publicly traded instruments, from an investor's perspective, one of the attractions of bonds is the prospect of liquidity.

- Loans: private debt instruments that have traditionally been created by banks lending to infrastructure assets. They are typically floating rate and may, or may not, have a formal credit rating. As this market has developed, documentation has become increasingly standardised with established procedures for the sale and transfer of loan interests. A key driver for standardisation has been the advent of larger bank groups funding individual transactions — for example, the purchase of Port Botany by the IFM consortium was funded by a loan from a group of ten banks.

The Infrastructure Bond Market

One way to consider the size and composition of the infrastructure bond market is to look at infrastructure issuers within the Bloomberg AusBond Composite Bond Index. This is the typical benchmark superannuation funds adopt for Australian fixed income.

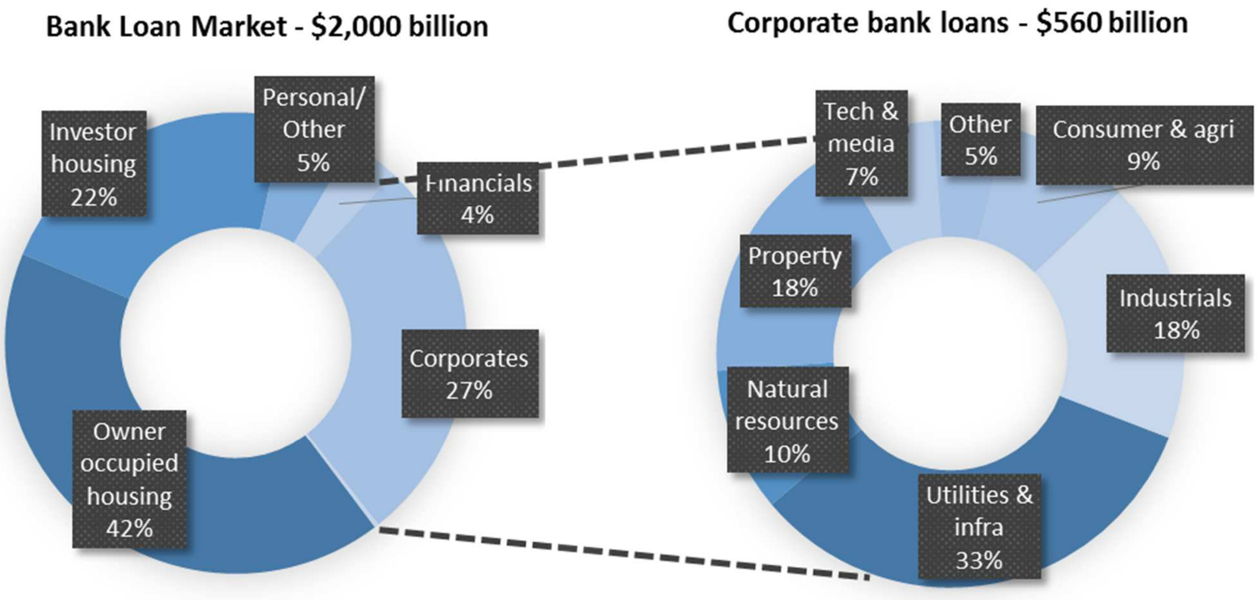
As demonstrated in the charts below, the AusBond Composite is dominated by government and semi-government bonds with a yield to maturity of 2.8% (as at 16 December 2014). Corporates comprise a mere 13% of the total index — down from roughly one third prior to the GFC. What's more, roughly two thirds of the index represents the debt of financials (which in turn is dominated by the big four banks). Non-financial corporates comprise less than 5% of the overall bond market ($38.6 billion).



Within corporates, only 9% of bonds are from infrastructure issuers (approximately 1.2% of the total bond index or $9.5 billion). Therefore, a typical balanced option with 10% in Australian fixed income is likely to have less than **12 basis points** of exposure to infrastructure debt through the corporate bond market.

Infrastructure Loans

Given that loans are not publicly traded, tracking down information on the composition of the loan market is more difficult. However, APRA does release data on the loan assets held on the balance sheets of Australian authorised deposit taking institutions (i.e. banks). There are approximately $2 trillion of loans on bank balance sheets, being roughly **three times the size of the bond market** (including all Commonwealth and State Government debt). As shown in the chart below, 64% of loans relate to owner occupied and investor housing loans, with non-financial corporate loans comprising 27% ($560 billion) of the market or 14.5 times the size of the non-financial corporate bond market. APRA does not release official data on the industry/sector split, but it is possible to interpolate this information from data released from the banks themselves. On this basis, lending to utilities and infrastructure comprise 33% of corporate loans or $185 billion . This means the infrastructure loan universe outnumbers the bond universe by 18:1.



It should be noted that the above analysis excludes subordinated or mezzanine debt, Australian banks typically seek senior lending rights with strong covenants, and don't usually invest in subordinated debt.

Most superannuation funds would have no direct exposure to this sector, which has remained the preserve of the banks. For many superannuation funds this presents an opportunity to lend to a sector they know and understand, further broaden/diversify their credit exposure and harness the additional return pickup through direct lending. The status quo sees funds lend the banks capital (via term deposits and their bond portfolios) which is then on leant to infrastructure assets at a healthy margin. Given the disintermediation that is happening in other parts of the financial system, as well as the natural fit between the long investment horizon of superannuation funds and the capital requirements of infrastructure assets, it is hard to see a reason why the status quo should continue – especially when seen in the context of the size of the Australian superannuation sector, let alone individual funds who are significant financial institutions in their own right.

Contact Us

We're always happy to chat (and learn new things!) if you want to know more, contribute more on a particular topic, or wish to discuss any of the above topics in greater detail feel free to drop us a line. Also, please don't hesitate to send us ideas for future articles.