Introduction

Another year draws to a close. Heading into to the new year, for infrastructure investors, the summer looks to be a particularly busy one with a range of deals (debt and equity) across the board.

Unless you've been actively participating in Bitcoin, this quarter had nothing particularly remarkable in it (a good thing!). Broadly in fixed income markets there's a more positive sentiment with indications of growth across OECD markets leading into 2018, although we're all no doubt watching the shape of the yield curve. Specific within infrastructure and energy markets – the Government announced the National Energy Guarantee. We haven't commented on the policy in this quarter's newsletter as there's very little concrete detail as to its structure and operation, and thus it's difficult to discern the implications for investors.

We're not really one for making predictions, but this quarter we have a piece on base rate predictions. We also have a short piece on private debt markets in Australia.

We'd like to take the opportunity to wish each of our readers a merry Christmas and a happy new year.

Markets update

Infra spreads v Itraxx

Infradebt bond index 3-6Y CGB spread

DS ITRAXX AU 5Y CONT SERIES - CDS PREM. MID

Bond Indicies (% change last 6 months)

ML HY — 2.60%

ML IG — 1.13%

Bloomberg Comp — 0.79%

AU Yield curve

22-Dec-17, 24-Nov-17, 27-Oct-17, 29-Sep-17, 1-Sep-17, 4-Aug-17

AU 3/10Y bond/swap rates

3-year bond rate, 10-year bond rate, 3-year swap rate, 10-year swap rate

New issuance and refinancing – public information

Date	Borrower	Instrument	Size (m)	Term (Yrs)	Curr.	Pricing/Notes
December	Transurban	Loan	550	5	AUD	West Gate Tunnel
December	Metro Tunnel	Loan	3,500	8	AUD	Construction
December	Sunshine Coast Airport	Loan	60	5	AUD	Loan
November	Hills Motorway	Loan	407	5	AUD	Refinance
November	Stockyard Hill Windfarm	Loan	750		AUD	Construction
November	Reliance Rail	Loan	1,800	5/7	AUD	Refinance
November	Loy Lang B	Loan	700		AUD	Acquisition
November	Lincoln Gap Wind Farm	Loan	150		AUD	Merchant
November	Royal Adelaide Hospital	Loan	2,600		AUD	Refinance
November	Western Roads Upgrade	Loan/USPP	800		AUD	Construction
November	Sydney Desalination	Loan	1,655		AUD	Refinance
November	Swan Hill Solar Farm	Loan	17		AUD	Merchant
October	Macquarie Atlas Roads	Loan	500	5	AUD	
October	Emerald Solar Farm	Loan	118	5	AUD	Telstra PPA
October	Victoria Desalination	Loan	727	15	AUD/USD	Refinance
December	Multinet Gas	Bond	265	7	AUD	3.64% fixed
December	Endeavour Energy	Bond	350	7	AUD	3.50% fixed, BBSW+127
October	Ausgrid	Bond	1,200	7	AUD	2.91% fixed, BBSW+1.22 %
December	Endeavour Energy	USPP	A$200/U$645	10/12/15	AUD/USD	Swap + 155-165
October	United Energy	Bond	170	7	AUD	3.85% fixed
December	Adani Abbot Point	Bond	500	5	USD	UST + 245

Equity and other news

- Glencore is considering a bid for the WICET coal terminal to rival a $4bn bid from a consortium comprising Aurizon, Macquarie Capital and Brookfield. Glencore is among the junior lenders and is the largest shipper within the WICET consortium.
- Melbourne Metro Tunnel - Transurban has secured the right to operate tolls in the tunnel until 2045 as well as extend the concession of its existing CityLink toll road by 10 years until 2045. The project consists of upgrading the existing West Gate Freeway and widening the M80 Ring Road interchange and Williamstown road, building twin tunnels to connect the West Gate Freeway to the Port of Melbourne precinct and a new bridge over the Maribyrnong River and over 14 kilometres of new and upgraded walking and cycling paths.
- US data centre group Equinix Inc on Monday said it was buying Australian data centre company Metronode from the Ontario Teachers Pension Plan in an all-cash deal worth A$1.035bn (US$791.15m). Metronode operates internet and communications infrastructure facilities throughout Australia for some of the country's largest corporations, government agencies, telecommunications and IT service providers. Metronode generated approximately A$60m of revenue in the 12 months ending September 30, 2017, Equinix said in a statement. The deal was expected to close in the first half of 2018, subject to some conditions including regulatory approval.
- The New South Wales state government has shortlisted three out of four bidding consortia for the Regional Rail public private partnership tender to replace the entire rolling stock of its regional train network. They are Bombardier Inc with Macquarie Capital as adviser, Spanish rolling stock manufacturer CAF's Momentum Trains consortium with Mitsubishi UFJ Financial Group as financial adviser and The Regional Futures consortium led by Downer EDI Ltd with Plenary Group advising. In addition to replacing the fleet of over 110 trains, the project includes the construction of a new maintenance facility. The total project cost is between A$750m (US$567m) and A$1bn. Final bids are due later in 2018 and the contract will be awarded in early 2019, with delivery of the first trains slated for sometime in early 2020.
- Industrial and Commercial Bank of China (ICBC) said on Sunday it did not intend to finance Indian conglomerate Adani Enterprises Ltd's controversial A$4bn (US$3bn) Carmichael coal mine in Australia. Adani is seeking A$2bn (US$1.54bn) in external financing for the proposed project in the state of Queensland. Australian and overseas banks are reluctant to provide any loans for the project which faces strong opposition from environmentalists over the size of the mine and the potential for damage to the Great Barrier Reef.
- Reliance Rail Pty Ltd, the sponsor of the New South Wales passenger train PPP, has completed a A$2bn (US$1.5bn) refinancing with new bank debt, bonds and a capital injection from shareholders AMP Capital and International Public Partnerships Ltd. The size of the bank debt portion was over A$1bn with a tenor of more than five years. The project company had A$1.9bn in senior and junior bonds as well as a A$357m 12-year loan with a tranche maturing in 2018. The senior bonds were guaranteed by Financial Guaranty Insurance and Syncora Guarantee.
- Singapore's Keppel Infrastructure Trust has stated that it is reviewing ownership of Basslink Pty Ltd, the underwater power cable linking Tasmania to mainland Australia, after receiving enquiries from parties interested in buying the project. The project resumed operations in June after a six-month outage. Keppel is in talks with Hydro Tasmania – Basslink's main customer – and its lenders regarding an ongoing default in the project loan. Due to the breakdown, Hydro Tasmania has not made full payments to Basslink resulting in a failure to meet the minimum debt service coverage ratio on the loan. The breach of the covenant has been waived by lenders on condition the loan is refinanced. The project was backed by a A$717m (then US$539m) five-year club loan with nine banks in November 2014 to refinance outstanding bonds.
- Renewable energy developer RES Australia reached financial close in October on the 68MW Emerald Solar Park in Queensland, the company said in a press release. National Australia Bank and Westpac Banking Corp are providing a A$118.49m (US$90m) five-year project financing to back the construction, according to

Thomson Reuters LPC data. The project is backed by a long-term offtake agreement from Telstra. The firm sold 100% of the equity to Australian specialist fund manager Lighthouse Infrastructure's Lighthouse Solar Fund as part of the project reaching financial close.

- Equis Energy, Asia's largest independent renewable energy firm, said it had agreed to be sold to Global Infrastructure Partners (GIP) and other investors including sovereign wealth fund China Investment Corp for US$3.7bn. The buyers are also taking on assumed liabilities of US$1.3bn. "The transaction is the largest renewable energy generation acquisition in history and positions GIP as a dominant renewable energy developer in the key OECD growth markets of Australia and Japan, as well as across India and South-East Asia," Equis Pte Ltd and GIP said in a statement.
- France's Engie SA has pressed for higher bids for its Loy Yang B coal-fired power plant in Australia following the release of a national energy security plan that encourages the use of coal, one of the bidders said on Monday. Delta Electricity, which submitted a final bid backed by private equity firm Apollo Global Management by an initial mid-September deadline, said on Monday that Engie had sought further bids this month, without saying how much the seller was looking for. Australia's conservative government announced a plan last week to impose a National Energy Guarantee (NEG), requiring energy retailers to tap power sources including coal-fired plants to ensure electricity supply remains stable.
- Palisade has entered into a 99 year lease to run Sunshine Coast Airport. Palisade will pay the Council $82 million for the lease including a $67 million upfront payment to be used for construction of a new runway. The Council will retain a 5% interest in the revenue of the airport. The deal is part of a $319 expansion project. Palisade will assume control of the airport and take care of all operations, future developments, terminal upgrade and route development.
- Westconnex – as at the date of writing process letters have been issued and thus due diligence will commence in earnest.

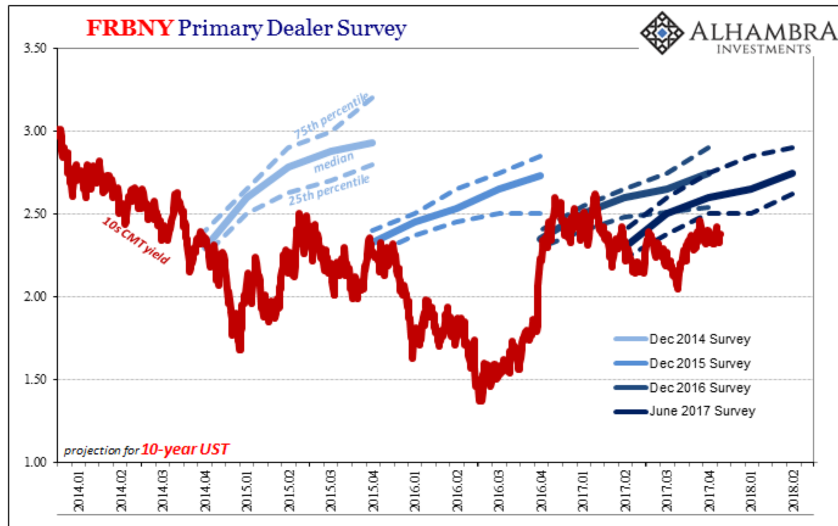
Will be 2018 be the year of higher interest rates?

You have to admire the consistency and conviction of economists – even if accuracy sometimes leaves something to be desired. Economists have consistently forecast for the past four years that the US Federal Reserve would soon increase interest rates and that this would lead to higher long-term bond rates in the US (and by extension, given the importance of US bond markets, for the rest of the world). Clearly with 10-year bond rates still at much the same level as 2014 – these past projections haven't been right – but will 2018 be the year that long-term bond rates move decisively higher?

This is a critical issue for all investors – as low long-term interest rates have been a key explanation for the elevated valuation multiples of public and private assets (that is, TINA, or There is No Alternative as an explanation of asset pricing).

Chart 1: Wall Street Economist Surveys of Interest rates

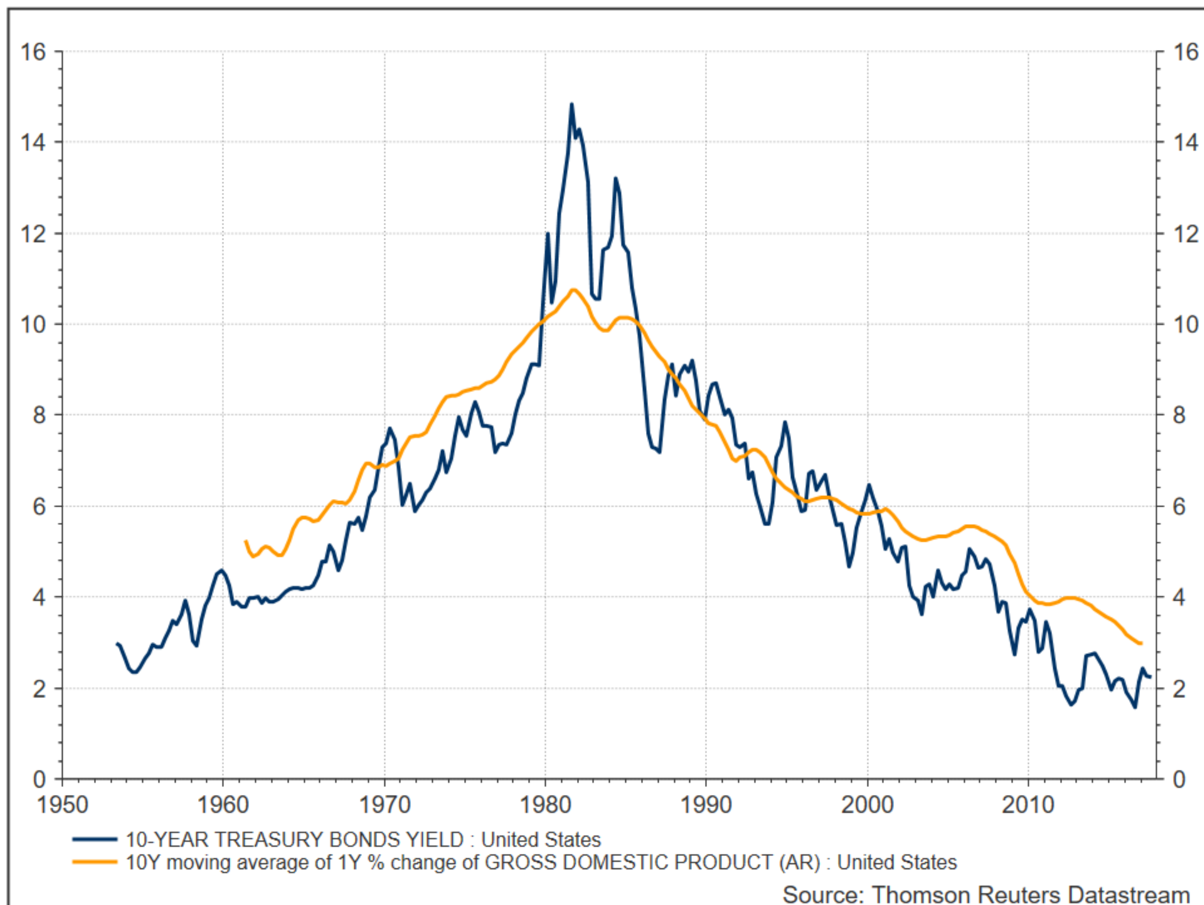
"Even a stopped clock is right twice a day"



Economists expectations of higher bond rates are premised on:

1. Traditional relationships between long-term nominal GDP growth and long- bond rates. If US real GDP growth is expected to be 2-3% and inflation 1-2%, this would imply a 10 year bond rate of 4-5% - not 2-3%.

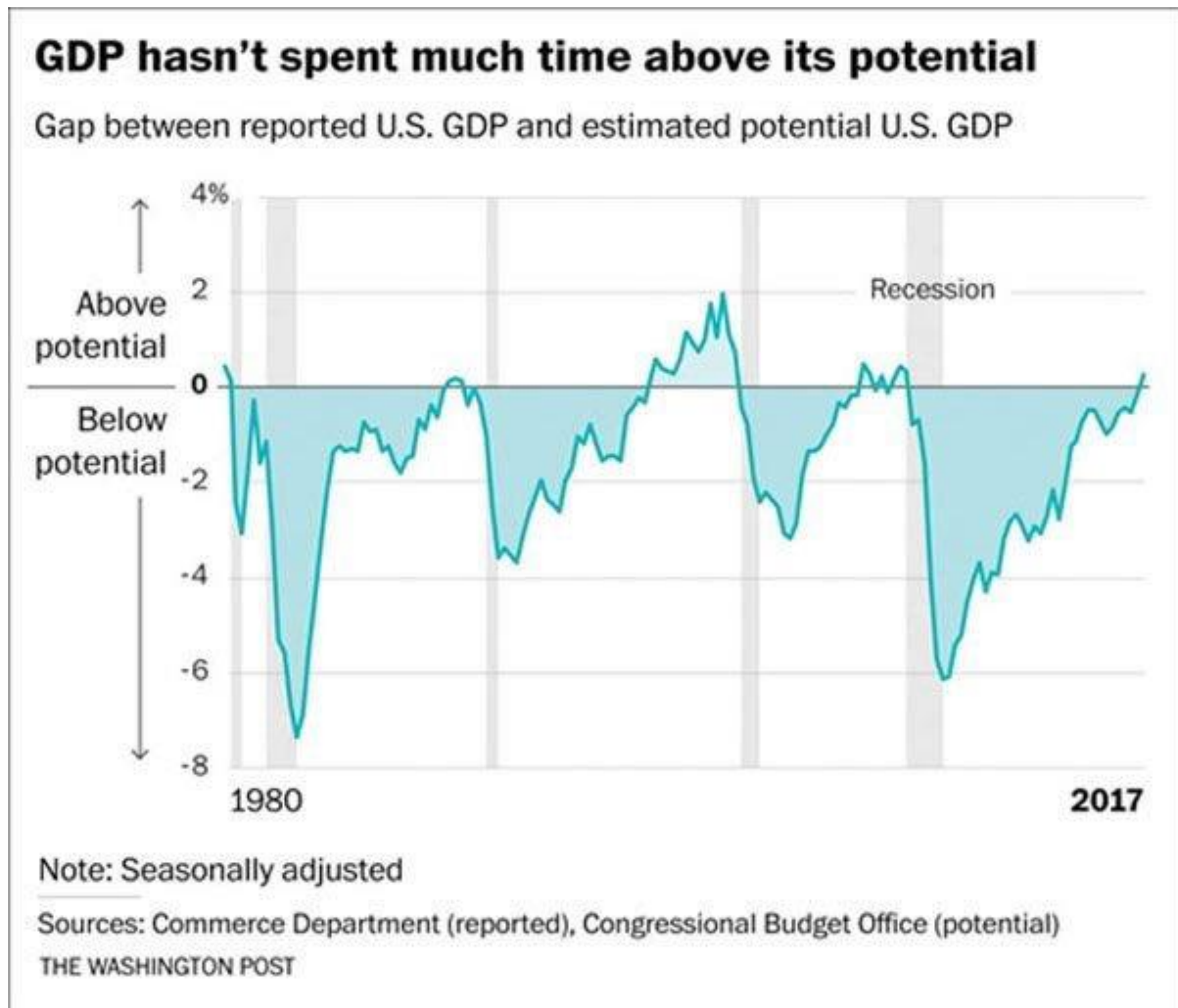
Chart 2: US Bond Yields vs Nominal GDP Growth



2. Declining unemployment in the US or equivalent estimates of a reduced output gap. That is, growth since the GFC has now absorbed excess capacity and further growth would be expected to result in higher inflation (and short-term interest rates as central banks react to the emergence of inflation threats).

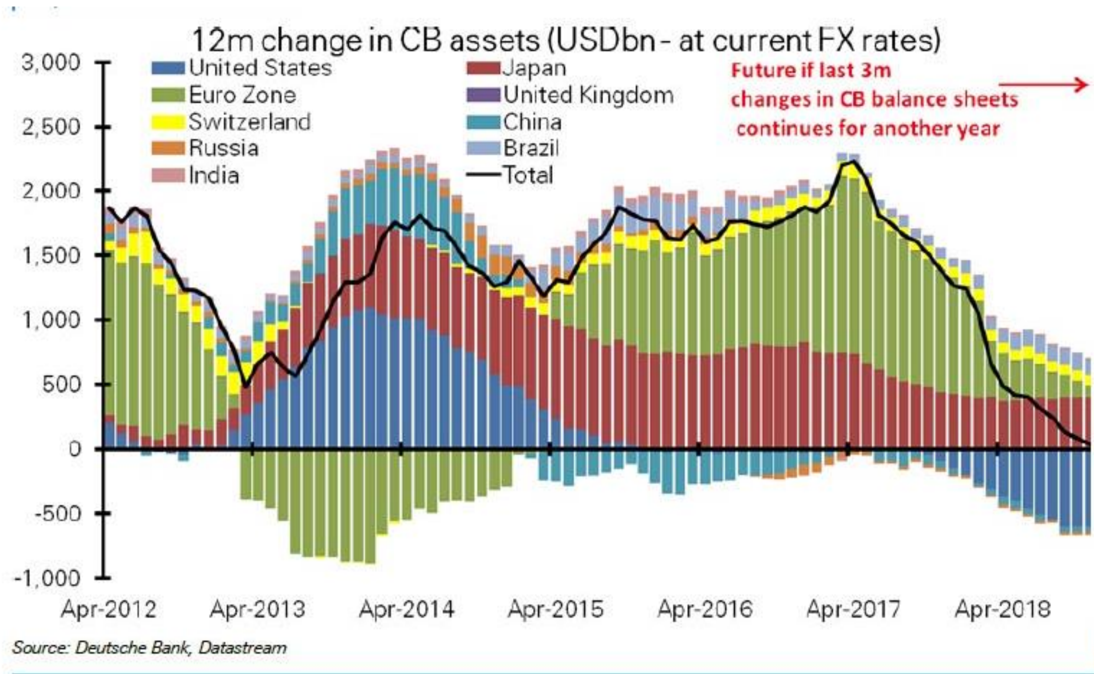
Chart 3: US Civilian Unemployment Rate

Chart 4: US Output Gap



3. Central bank balance sheets are forecast to have peaked in 2017 (assuming the ECB does taper in 2018) and with reduced liquidity from central banks rates will move higher.

Chart 5: Central Bank Balance Sheet Growth



While these are good reasons, at least in the case of the first two – they have been true for some time – and even the potential slowdown in growth in central bank balance sheets has been well flagged (and, hence, if it were going to have an immediate effect on bond rates it perhaps should have started to happen by now).

Against these arguments, part of the reason that rates have remained low are:

- Wage growth across the developed world remains anaemic – which is in stark contrast to the measured unemployment rate or output gap. In the absence of wage inflation, central banks will not rush to increase interest rates. That said, wage inflation (like many employment indicators) is notoriously lagging. If there is a wage breakout it would likely signal that the US Fed was well behind the curve.
- Debt is high. One of the core causes of the GFC was a build-up of excessive debt. While on a sectoral basis there has been some deleveraging (for example, US households) in aggregate there is more debt today. Delevering in some sectors has been more than offset by increased government and corporate leverage. In Australia, the housing boom has seen Australian household debt rise to global leadership levels. In our view, this excessive debt will place a fundamental ceiling on the extent of interest rates rises.

Without wanting to sound like an economist myself, this could be the year that economists are right, but our expectation is that a rise in rates will be modest – as high debt levels limit increases and, hence, rates remain low relative to history for some time to come.

Superannuation fund investment in private debt

The last month has seen a flurry of newspaper coverage regarding the potential for superannuation funds to invest in private debt. That is, direct loans to businesses/projects. This discussion was started by a roundtable organised by Anthony Pratt, Gina Rinehart and Lindsay Fox. The newspaper coverage was perplexing because:

1. superannuation funds are already participating in the private debt market and have been for some time (my first direct infrastructure debt investment for my clients was in 2000); and
2. most of the coverage focused on the benefits to borrowers (that is, the billionaires) of broader participation in lending markets – rather than the benefits to superannuation funds (that is the lenders).

There are strong demographic trends supporting superannuation fund participation in private debt markets. As fund memberships age (particularly on a balance weighted basis) an increasing proportion of assets are held by older members. These members want low-risk reliable income – that is, more debt-like returns and less equity-like returns. The shift to life cycle investment options is reinforcing this trend. The net result is that there is more capital in defensive allocations than previously, and this will only grow over time. This creates a strong demand for lower risk investments.

On top of this demographic trend, low base rates mean traditional highly liquid defensive assets like government bonds or cash have negative post inflation and tax and fee returns. They certainly don't deliver the CPI + 2% after tax and fees that is the typical return target of a lower risk retirement focused investment choice.

This situation should be encouraging funds to distinguish between liquidity characteristics and defensive characteristics. Just as not all growth assets need to be fully liquid (there is room in properly structured portfolios for allocations to private equity, property and infrastructure) not all defensive assets need to be fully liquid. This creates room for allocations to sectors such as senior loans – where there are substantial liquidity premiums available to investors.

The loan market also provides a much wider range of potential borrowers/projects than the bond market. Australia's bond market is quite narrow – with a focus on highly rated borrowers (such as the big 4 Australian banks and large offshore companies). Within infrastructure, it tends only to be the very large projects/borrowers who issue bonds (i.e. the Transurban's, Sydney Airport's), while a much broader universe of borrowers principally raise debt through the loan market.

Mrs Rinehart was quoted as being keen for superannuation funds to provide "low-interest, long-term money". While every borrower wants cheap debt – the converse applies to every lender. No one wants to be the provider of cheap money, and it is naïve of borrowers if they think that is the role that superannuation funds see for themselves.

Australian superannuation funds have grown to be large players in Australian and international capital markets. They have been active investors in infrastructure for 30+ years. They don't face the same constraints as banks. However, the real opportunity for funds, is to provide finance in ways that better meets the long-term needs of projects and, in doing so, generate attractive returns aligned to member outcomes (recognising the changing demographic profile).

In this sense, projects should see the opportunity for with superannuation funds as a chance to obtain finance that better meets their needs (tenor, amortisation, flexibility), rather than to pay the same or slightly less for something they otherwise would have got from the banks (ie 3-5 year floating rate debt + swap).

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.

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