Australia's ***high-grade market*** ramps it up

Government, semi-government, sovereign, supranational and agency (SSA) and major bank wholesale issuance continues to make up the staple diet for investors in Australia's bond market. Issuer and investor desire for diversity is being recognised, according to participants at KangaNews's annual DCM summit on March 25-26 in Sydney.

While they acknowledge that Basel III implementation continues to drive domestic bank balance sheets to be substantial holders of their paper, Australia's semi-government issuers see – and welcome – growing participation from offshore investors.

For instance, New South Wales Treasury Corporation (TCorp)'s Sydney-based chief executive, Stephen Knight, says around 45-50 per cent of holders of the semi-government issuer's outstanding paper are domiciled abroad – and takeup continues to grow. "We see a number of new central banks entering our space and this is now a core investor base for us," Knight reveals.

John Collins, chief executive at Western Australian Treasury Corporation (WATC) in Perth, also sees demand as a virtuous circle. "In our case offshore investment is around 20-25 per cent. With Basel III changes domestic bank balance sheets are purchasing around 35 per cent of all our portfolios. This provides a bid to the market and we're seeing growth coming from offshore and from a number of different types of asset managers."

Participants in other high-grade sectors also acknowledge the apparent step change in offshore appetite for AUD debt. "Five years ago all of ING Bank Australia's paper was bought by domestic investors. Nowadays up to 60 per cent goes offshore," comments Nigel Bradshaw, Sydney-based senior dealer, treasury at ING Bank Australia.

The re-emergence of Japanese retail investor interest in AUD assets has been noted by Australian fund managers. Anthony Kirkham, head of investments and Australia operations at Western Asset Management in Melbourne, explains: "This money has been flowing back into traditional monthly income funds and insurance companies' annuity products in particular. There is a need to match long-dated annuities with 10-year plus assets and this is where the recent demand for 10-year AUD product has come from."

"IF YOU THINK ABOUT THE COUNTRY'S MAJOR TRADE EXPOSURE TO ASIA – THE GROWTH PART OF THE GLOBAL ECONOMY – THE PROSPECTS FOR AUSTRALIA'S ECONOMIC PERFORMANCE IN THE MEDIUM- TO LONG-TERM LOOK SOLID."

ROB NICHOLL AUSTRALIAN OFFICE OF FINANCIAL MANAGEMENT

Solid fundamentals

The economic fundamentals for Australia remain strong despite concerns about China, says Rob Nicholl, Canberra-based chief executive at the Australian Office of Financial Management (AOFM). "If you think about the country's major trade exposure to Asia – the growth part of the global economy – the prospects for Australia's economic performance in the medium- to long-term look solid," he says.

Nicholl also suggests there are signs that previous unease over the ebb and flow of offshore investment with strengthening and weakening of the domestic currency has lapsed.

"Many of the reserve managers that have come into the AUD market in the last 3-4 years hold AOFM paper unhedged because they have elected to make portfolio allocations into AUD government bonds. The adjustment in the currency from time to time is actually a signal for them to top up their portfolio allocations," Nicholl explains.

In fact, sovereign and semi-government issuers say future challenges are more likely to arise from policy and political issues than economic fundamentals.

Even so, David Goode, ANZ's Melbourne-based head of debt investor relations, says Australia's major banks are keeping an eye on the macroeconomic environment in Australia as offshore investors focus increasingly on the economic outlook given the economic transition taking place. He asks: "What happens if China really does slow down? Do funding conditions get harder in the medium term?"

Changing profiles

While increasing global regulation makes the banking system safer, it also has an impact on how intermediaries are able to fulfil their more traditional roles, TCorp's Knight points out. He says: "We are used to banks being the dominant private-sector issuers in capital markets. But new capital rules mean there are likely to be certain aspects of financing where it will no longer be feasible for banks to continue to be significant lenders, particularly in terms of infrastructure requirements."

Australia's significant infrastructure task is where government policy and regulation intersect, Australia's state funders suggest. Required infrastructure funding – some of which is already under way – will need to come from a mix of government and private sectors in order that state governments are able to achieve budgetary consolidation targets. This brings superannuation and other non-traditional investors into play in the domestic capital markets.

The conundrum of Australia's low allocation to fixed income is well documented. But there are hopes that the ongoing financial system inquiry (FSI) might shine a guiding light. Among other issues, the inquiry is being asked to report on how the financial system can more efficiently allocate Australian-sourced capital to minimise its exposure to volatility in global capital markets.

is of utmost importance. Richard Jackson, Brisbane-based executive general manager, funding and markets at Queensland Treasury Corporation, says: "Fixed-rate Australian dollars remains our issuance product of choice and one we actively support. But we also want to be in a position to take advantage of opportunities when investor demand and the market environment suits. For this reason we will look at alternative methods of funding from time to time."

Australia's major bank funding representatives also share the view that issuers should have a contingency plan. Matt Price, head of group capital management at National Australia Bank in Melbourne, says his bank has been working to build out its product base with more stable forms of wholesale funding. "Our structured-notes capacity has increased significantly and we have started to issue covered bonds," Price says. "We also have capacity to issue in other currencies like Turkish lira and renminbi."

environment, price is probably the last thing we worry about. Volume is always our main consideration – and having contingent funding sources so that we feel comfortable from a liquidity perspective."

This backdrop helps to dictate what the price for domestic diversity is going to be relative to offshore, Zuber adds. "But the domestic market is the most critical for us to get right and, as long as we continue to do this, it will continue to be a strong place for us to fund ourselves."

Domestic investors urge issuers to consider their home market first. "We prefer to see local issuers issue in AUD – particularly those companies that have purely Australian dollar cash flows," comments Tim van Klaveren, Sydney-based head of credit at UBS GAM. "If companies are borrowing offshore, and investors are buying these bonds and swapping them back, the main parties that benefit are intermediaries."

Bob Sahota, Sydney-based head of fixed interest at Challenger, agrees.

"THE DOMESTIC MARKET IS THE MOST CRITICAL FOR US TO GET RIGHT AND, AS LONG AS WE CONTINUE TO DO THIS, IT WILL CONTINUE TO BE A STRONG PLACE FOR US TO FUND OURSELVES."

CURT ZUBER WESTPAC BANKING CORPORATION

Anne Anderson, Sydney-based managing director and head of fixed income, Asia Pacific at UBS Global Asset Management (UBS GAM), says she – like her peers – is eagerly anticipating the FSI's conclusions.

"There is a lack of depth in our capital markets with regard to the gap between the traditional bank channels and the enormous pool of savings in our superannuation channels," Anderson comments. "One of the most critical challenges in Australia is around income for retirement on a 20-year horizon."

Resourcefulness required

Australia's domestic issuers suggest the need to be both nimble and flexible

Home bias

Since the beginning of 2014, Australia's bank and corporate issuers have noted a convergence in pricing between offshore and domestic markets – so much so that, in some circumstances, even the cost of swapping proceeds back to Australian dollars has not stopped the offshore option being the most economic.

"There have not been too many occasions when your domestic market hasn't been your most effective funding source," comments Curt Zuber, group treasurer at Westpac Banking Corporation in Sydney.

But cost is not always at the head of the checklist, Zuber continues. "Depending upon the dynamics and the

"If certain offshore markets are more competitive on a swapped-back basis and this is the correct economic decision for issuers to make, by all means explore these avenues," Sahota says. "But test out your target levels with domestic investors first."

Australia's asset managers welcome Kangaroo issuance, too – particularly from corporates. Rather than taking money off the table, they imply offshore issuers are filling a gap in the domestic market. For instance, Adrian David, associate director and senior credit analyst at Macquarie Investment Management in Sydney, explains: "Australia does not have an A-rated oil-and-gas major. This leaves space for names like BP Capital Markets to come in." •

Demand for AOFM syndication allows tight pricing and record volume

The Australian Office of Financial Management (AOFM) says healthy demand for its latest syndicated deal – predominantly from domestic accounts – drove record volume.

The AOFM priced a new A$7 billion (US$6.4 billion), 12-year syndicated issue on March 12 in a transaction which surpassed the Australian market's record deal volume set by a 20-year A$5.9 billion deal also placed by the AOFM, in November last year.

According to the AOFM, its latest deal saw around 39 per cent offshore distribution – mainly to Asia, at 30 per cent, and the remainder to Europe, the UK and Japan. This marks a notable change from the distribution profile of the 20-year syndication from 2013, which saw 60 per cent sold offshore.

By type, the new deal mainly comprised bank books and fund managers at 25 per cent and 23 per cent, respectively. Hedge funds, central banks, bank balance sheets and insurance made up the remainder. The book for the deal reached nearly A$10 billion in size, the AOFM says, enabling pricing at the tighter end of guidance at 24 basis points over EFP – initial price guidance for the issue was a spread of 23-26 basis points.

"PREVIOUS BOOKS MIGHT ALSO HAVE WARRANTED A LARGER ISSUE SIZE BUT THE BORROWER DID NOT WANT THE LARGER VOLUME. THIS TIME IT HAD THE QUALITY, SIZE OF BOOK AND CAPACITY TO DO THE LARGER SIZE."

PETER DALTON WESTPAC INSTITUTIONAL BANK

Robust demand

Rob Nicholl, chief executive officer at the AOFM in Canberra, tells *KangaNews* the borrower mandated the benchmark deal without any specific expectation on size or level of demand. "Our price guidance was fairly tight because we didn't think there should be a lot of conjecture around what is a mid-curve bond. The price guidance was devised such that if we did get a large volume we could price towards the tighter end, which is what we did," he explains.

Nicholl adds the transaction was set up in a way which provided flexibility to the AOFM but, even so, the level of demand it encountered required decisions to be made. "Once we got a book approaching A$10 billion we had to decide how much we should print and, of course, how to scale it back," he explains. "We realised that we couldn't only print A$3 billion as investors wouldn't be happy: it would have looked inconsistent with the level of response and the fact that the deal was launched as a key benchmark issue."

Nicholl says pricing was assisted by the volume of demand. With large volume in the new line from debut, liquidity should be available immediately – reducing or obviating any need for a primary market premium.

Joint lead managers on the deal agree it is unsurprising the AOFM received robust support. The final book was in line with the issuer's previous transactions – for example its A$5.9 billion 2033 syndicated issue, which priced in November 2013, was also well bid with an A$8.9 billion book – but greater supply-side flexibility allowed for a larger print on this occasion.

Peter Dalton, Sydney-based head of syndicate at Westpac Institutional Bank – a joint lead manager on the transaction with Citi, Deutsche Bank and UBS – tells *KangaNews*: "On this occasion the AOFM had capacity to issue larger volume. Previous books might also have warranted a bigger issue size but the borrower did not want the larger volume. This time it had the quality, size of book and capacity to do the bigger size."

James Arnold, director, debt capital markets at Citi in Sydney, agrees. "The AOFM is conscious of how it allocates its transactions and how it ensures they are placed into the right hands. As a syndicate there is confidence the borrower is not going to allocate a trade excessively off a book which wouldn't support it."

Syndicated pipeline

The AOFM timed the deal to be priced avoiding major data announcements or factors which could negatively influence its success. Nicholl says: "We were also conscious that we wanted to get this to a futures basket size before June, at which point bonds will enter the next December 10-year contract roll. We gave ourselves a bit of time in case we needed to build the new line to a reasonable size through tenders after the syndication."

With the completion of the syndication the AOFM had issued just over A$62 billion of its A$75 billion net issuance programme for 2013/14. And despite strong demand for its latest deal the debt management agency has no immediate plans for further issuance via syndication.

Nicholl tells *KangaNews*: "We will continue to turn to syndications for longer-end new maturities. The next 10-year basket bond to establish would be a 2028, which we wouldn't need to do for another 18-24 months." •

AOFM COMPLETES DIVESTMENT OF AB RMBS HOLDINGS

The Australian Office of Financial Management (AOFM) disclosed the sale of four more AB tranches of its residential mortgage-backed securities (RMBS) portfolio on March 13, confirming at the same time that its holdings of these mezzanine notes would reach zero by April 14.

Although the latest sale was for just A$49.2 million (US$44.8 million) of amortised face value, it came two weeks after a much larger AB note sale, totalling A$317.1 million. That volume accounted for roughly 80 per cent of the AOFM's AB-note holdings, according to its Canberra-based director, financial risk, Michael Bath.

The four tranches most recently sold were placed at margins ranging from 120 basis points over bank bills for notes with a sub-one year weighted-average life (WAL) to 180 basis points over bills for paper with a WAL of 5.7 years. This is in line with margins on the larger February 28 divestment, which had a range of 120-160 basis points over bills but a longest WAL of 4.4 years.

The sale of the AOFM's AB notes is in line with significant price tightening in this asset class in the weeks leading up to the transactions (see story on this page). Issuers and intermediaries on recent RMBS deals with placed subordinated and mezzanine tranches have also commented on the high level of demand for these notes.

For instance, Arkady Lippa, head of balance-sheet solutions at National Australia Bank in Melbourne, confirmed that the AB and B tranches on Bendigo and Adelaide Bank (BEN)'s A$500 million Torrens Series 2014-1 Trust transaction, which priced on February 25, were 2-3 times oversubscribed. They were thus able to be tightened from initial guidance "to price at arguably the lowest levels the market has seen for these types of securities – at least on a deal where pricing has been publicly disclosed."

The BEN AB notes priced at 160 basis points over bank bills and the B1 and B2 notes at 245 and 290 basis points over, respectively.

Following the AOFM's latest sale of RMBS notes, the last remaining AB holding in its portfolio was a single tranche of a 2008 Firstmac deal. The AOFM says this note was expected to be called in April, at which point the sovereign debt management agency will no longer have any mezzanine RMBS paper. •

Demand for lower-rated notes continues to support RMBS deal flow

Healthy investor demand for securitisation issuance saw two new deals, from AMP Bank (AMP) and Heritage Bank (Heritage), price in the first week of March.

Borrowers and joint lead managers agree the pipeline for further issuance is strong, supported by ongoing demand for lower-rated notes and bank balance sheet participation.

On March 6, Heritage priced HBS Trust 2014-1 – a three-tranche RMBS with a total volume of A$400 million (US$361.1 million) – via lead managers ANZ, National Australia Bank (NAB) and Westpac Institutional Bank. The triple-A rated class A tranche of the issue which had a 3.3-year weighted average life (WAL), priced at 95 basis points over bank bill swap rate (BBSW). The deal is the borrower's first RMBS transaction since 2011.

Two days later, AMP priced Progress 2014-Trust – a four-tranche RMBS with a total volume of A$1 billion – matching the issuer's largest-ever Australian dollar securitisation. AMP's triple-A rated class A tranche also has a 3.3-year WAL and priced at 95 basis points over BBSW. The deal was led by ANZ, Deutsche Bank, Morgan Stanley and NAB.

Deal breakdown

Joint lead managers say the book for HBS Trust 2014-1 was oversubscribed with final participation from 21 accounts. In total, approximately 70 per cent of the deal was bought by bank balance sheets with the remainder taken by real-money investors. By location, 82 per cent of the deal was sold domestically.

The class A bonds were 1.5 times oversubscribed, while the AB notes were more than 2.5 times oversubscribed. The class A bonds priced at the tighter end of the 95-100 basis point guidance and the class AB bonds came in 5 basis points tighter than the guidance price at 165 basis points over BBSW.

Similarly, robust demand saw AMP's Progress 2014-1 Trust RMBS deal upsized from a launch volume of A$500 million. In total, leads say 24 accounts participated. Involvement from institutional investors was greater: more than 65 per cent of the deal was bought by real-money investors, with the remainder going to bank balance sheets. By location, 86 per cent was sold domestically.

Paul Williams, chief treasury and business strategy officer at Heritage in Brisbane, tells *KangaNews* previous strong securitisation deals – particularly Bendigo-Adelaide's A$500 million RMBS in early March – gave Heritage the confidence to return to the market with its first RMBS since 2011.

AMP, meanwhile, was drawn to issue by similar fundamentals. Jason Bounassif, head of markets, group treasury at AMP in Sydney, says the fact that investors were receptive to a potential RMBS trade combined with the borrower's funding and capital requirements for the year to prompt the latest deal. Bounassif adds: "It is always difficult to get an accurate gauge on market appetite. However, investor demand for high-quality RMBS is typically strong. We expected to have more than A$1 billion in demand."

"IT IS ALWAYS DIFFICULT TO GET AN ACCURATE GAUGE ON MARKET APPETITE. HOWEVER, INVESTOR DEMAND FOR HIGH-QUALITY RMBS IS TYPICALLY STRONG. WE EXPECTED TO HAVE OVER A$1 BILLION IN DEMAND."

JASON BOUNASSIF AMP

Structure demand

While good demand came in across both RMBS deals, joint-lead managers flag the level of oversubscription in particular for the mezzanine and sub notes in both deals. Bounassif suggests demand across the whole structure will continue to grow as real-money investors regain confidence in Australian collateral and banks continue to use the RMBS asset class for their liquidity books.

Demand is particularly robust for AB notes, says Gary Sly, Sydney-based executive director, structured capital markets at ANZ. "This is an ideal spot for investors looking for yield – it is still rated triple-A with pricing 60-70 basis points back from the senior triple-As. The B-note space is also well supported with a substantial jump in the number of participants bidding for these bonds. Overall the market is in great shape."

Craig Stevens, Melbourne-based associate director at NAB, tells *KangaNews*: "There is a lot of demand for the mezzanine and junior notes because there seems to be a deficiency of yield alternatives in the market at the moment. The seniors are also strongly subscribed."

Demand down the deal structure remains vital for some RMBS issuers. Heritage's Williams says a key objective for the borrower's transaction was obtaining prudential capital relief.

He explains: "We had a great underlying pool, like most issuers from the mutual sector, so had a solid level of interest early on. We pre-placed the B notes then looked to build a book across the top two tranches. We had a great response from investors and were happy with the advice we received."

Bank book weighting

AMP's solid support from real money is also highlighted by leads. Lionel Koe, director, securitisation at NAB in Melbourne, explains: "While balance sheets accounts typically comprise the lion's share of books, it was great to see strong participation from real-money accounts. The level of support across all tranches facilitated the upsize and tightened pricing across the mezzanine and subordinated notes."

A higher proportion of demand for RMBS deals is still coming from bank balance sheets, however. "Real-money investors are very engaged but bank balance sheets are generally bidding for bigger tickets," Sly says. "There is still some caution with many investors being prescriptive as to spread levels. This indicates the market may be in a transition phase towards tightening margins."

Australian USD issuers

Robust demand for securitisation is not just restricted to Australian dollar deals but is also starting to be evident in Australian securitisation in foreign currencies. Australian issuers also priced 2014's first forays into US dollar securitisation in the first week of March with two transactions pricing – one of asset-backed securities (ABS) and one RMBS.

Resimac remarketed the short-duration US dollar tranche of its Resimac Premier Series 2013-1 deal on March 4. The new A-2B US$260 million tranche priced at 30 basis points over US dollar Libor. According to *KangaNews* data, the original US dollar A1-A note had volume at issue of US$300 million and priced last year at 35 basis points over US dollar Libor.

Subsequently, on March 5, Macquarie Leasing priced SMART ABS Series 2014-1US Trust. The nine-tranche structure has its top four tranches – all denominated in US dollars for a volume of US$500 million – sitting on top of five tranches of Australian dollar subordinated debt which totals A$76.13 million.

Sarah Samson, Melbourne-based director at NAB – a joint-lead manager on Resimac's deal – tells *KangaNews* the book was oversubscribed, suggesting demand remains solid.

She explains that while there is robust demand for longer tenor, the challenge remains structuring a transaction so it is efficient for issuers, particularly around the swap. "The basis seems to be moving in our favour, particularly in euros, so we might see something in that space," Samson says.

"I think issuers will continue to market themselves in the US and elsewhere offshore to build a good reputation. As long as the swap works we should continue to see foreign-currency issuance," she adds. •

Institutional *tier-two* dialogue continues as *Westpac* prints A$1 billion

Westpac Banking Corporation (Westpac) says its first Basel III-compliant tier-two transaction issued without retail documentation further developed the institutional participation seen in Australia's first wholesale new-style tier-two bank debt earlier this year.

But while institutional investors are broadly becoming more comfortable with new-style tier two – in particular how to value non-viability – some say they still find better value elsewhere.

On March 7, Westpac became the first of Australia's big four banks to price a purely wholesale tier-two deal which qualifies as tier-two capital under Basel III rules. The A$1 billion (US$909.7 million), 10-year floating-rate note (FRN) transaction – with a non-call-five structure – priced at 205 basis points over bank bills.

In July last year, Westpac became the first of Australia's big four banks to launch a tier-two capital deal under new Basel III rules, in a transaction available to and targeted at retail investors. That A$850 million issue priced at 230 basis points over bank bills.

Westpac's wholesale tier two follows a similar transaction at the start of the year from Bendigo and Adelaide Bank (BEN) – the first such deal in Australia. BEN priced A$300 million of 10-year non-call-five FRN paper at 280 basis points over bank bills on January 21. The transaction's issuer and lead managers said at the time that increased investor comfort around the new-style securities supported a significant oversubscription – of two-and-a-half times – and price tightening.

Guy Volpicella, head of structured funding and capital, group treasury at Westpac in Sydney, tells *KangaNews* that Westpac's interest in a Basel III-compliant tier-two deal was piqued by the solid investor bid for new-style tier two which became apparent around BEN's recent wholesale deal.

"Our current capital management strategy is to replace our capital trades as they roll off or are due to roll off over time," Volpicella says. "In addition, we were aware of strong appetite for new-style tier-two issuance from domestic institutional investors, particularly after the recent BEN trade."

Institutional target

While no formal roadshow preceded Westpac's self-led transaction, the bank says it started conducting discussions around the format and pricing of new-style tier two with domestic institutional investors even before its retail transaction came to market last year. "It has been an ongoing process of education rather than a rush to the finish line," Volpicella comments.

According to Allan O'Sullivan, Sydney-based director, retail syndicate at Westpac Institutional Bank (WIB), the support the deal attracted reflects the change in the attitude of fund managers to non-viability structures. "Many institutional investors have now completed their risk-management and due-diligence assessments and are comfortable with how to value the non-viability aspect of tier two," he says.

Westpac says it achieved broad domestic institutional investor participation in its debut Basel III tier-two transaction, with the majority of the deal's 70 buyers coming from the Australian fund-manager community. "By far the majority of participating accounts were domestic, demonstrating the depth of understanding of the product," Volpicella comments. "The number of investors participating shows that the 12-18 months of work involved in bringing investors up to speed with the Basel III requirements has paid off in assisting their understanding of the product."

According to lead-manager data, over 80 per cent of the final book was allocated to asset managers and insurers. Private banks and middle-market investors combined for around 10 per cent of the final allocation. By geography, 85 per cent of the paper was absorbed by domestic accounts while Asia was the most significant of the international jurisdictions participating in the deal – with some interest also noted out of Europe and New Zealand.

"THE NUMBER OF INVESTORS PARTICIPATING IN OUR TRANSACTION SHOWS THAT THE 12-18 MONTHS OF WORK INVOLVED IN BRINGING INVESTORS UP TO SPEED WITH THE BASEL III REQUIREMENTS HAS PAID OFF IN ASSISTING THEIR UNDERSTANDING OF THE PRODUCT."

GUY VOLPICELLA WESTPAC BANKING CORPORATION

Middle-market connection

Westpac saw its institutional investor participation grow compared with Australia's first wholesale-only issue of tier-two bank debt. Multiple banking sources confirm that BEN saw middle-market participation at a higher level – around one-third of deal volume – but this was based on quite a different marketing timetable.

O'Sullivan explains: "The Westpac tier-two deal was built on having cornerstone institutional-investor appetite which gave the borrower the ability to launch and close the transaction very quickly. This challenged some middle-market accounts from a timing perspective. Other deals might be able to benefit from middle-market liquidity, where there is greater appetite to targeted middle-market investors and where books are left open for a longer period than was the case for Westpac."

Nonetheless, the burgeoning middle-market investor base remains on the radar for issuers. For example, while Volpicella points out that Westpac's primary focus was to market to institutional investors he notes that the transaction still received a sizeable amount of middle-market investor take-up.

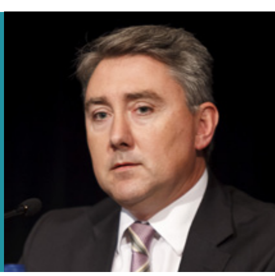
"The amount invested by middle-market accounts ended up being similar to the dollar amount this segment invested in the recent BEN transaction," Volpicella says.

Cautious approach

Despite the success of the deal, a number of institutional investors tell *KangaNews* that they still believe the risk-versus-reward equation in new tier-two issuance is blurred. For example, John Manning, Sydney-based senior investment manager at Aberdeen Asset Management (Aberdeen), says: "New-style tier two introduces a whole new risk paradigm for investors. They are taking deeper subordination at the tier-two level. This is a BBB+ risk profile compared with an A-risk profile in old-style tier two, and there are pricing differentials."

Manning, who says Aberdeen remains constructive on the remaining old-style lower-tier-two bonds on issue, also believes that there are relative-value considerations arising out of the new risk-return profile which remain difficult to assess.

"Investors are required to concede control in the context of convertibility into equity at the discretion of the regulator," he explains. "It is not simply a case of saying that the old-style tier two is at 150 basis points over bills so I should buy the new-style bonds at 205 basis points over. There are many different risk factors at play."



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JOHN MANNING ABERDEEN ASSET MANAGEMENT

Helen Pericleous, Sydney-based senior portfolio manager, credit markets at AMP Capital, also sees better relative value in the old-style lower-tier-two paper. "We would price non-viability at wider levels than where the new-style tier-two Westpac issue was fixed. Even at the broad sounding of 210 basis points over bills we had no interest. The old-style lower-tier-two deals continue to provide better relative value," she says.

WIB says the margin on Westpac's retail-targeted, new-style tier-two transaction from last year had traded in to around 210 basis points over bank bills – the same level at which the issuer launched its wholesale tier-two offer on March 6. This indicative launch spread was used as a hook to engage potential investors before the level was revised.

Final books of A$1.2 billion for the latest issue provided an opportunity, O'Sullivan explains. "The strength of the book gave us the chance to test a level of 205 basis points over bills with our cornerstone investors," he says. "The majority of the book was still there at this level, enabling the borrower to print a benchmark-sized transaction at the new level."

This indicative margin level was reached by taking several different valuation metrics into consideration, O'Sullivan adds. These included five-year senior-unsecured spreads and the trading levels of the transitional tier-two bonds encompassing an adjustment for non-viability.

"Based on the trading we see on major bank old-style tier-two and after considering additional tenor the accepted premium for point of non-viability is circa 25 basis points," O'Sullivan comments.

Westpac's transitional tier-two was trading at around 150-155 basis points over bank bills shortly before the new wholesale deal came to market, sources involved in the latest transaction confirm. They add that adjusting for the tenor of the new deal and adding 25 basis points in a premium for the inclusion of point of non-viability langauage implies a margin pickup to a spread level for new-style issuance of around 210 basis points over bills.

Spread compression appears to have continued – with the newly issued line seeing some performance post-pricing, market participants say. Bonds were indicated at around 197 basis points over bills on March 10. •

Tier-two spotlight switches to insurers as institutions continue to engage

The Basel III-compliant tier-two space has grown significantly since the beginning of the year with solidly supported transactions from Bendigo and Adelaide Bank (BEN) and Westpac Banking Corporation (Westpac). However, the successful completion of Australia's first new-style tier-two transaction from an insurance company is the most innovative yet, bankers say.

On March 13, Insurance Australia Group (IAG) became the region's first insurer to price a new-style tier-two transaction without retail documentation.

The issuer priced A$350 million (US$318.4 million) of tier-two paper at 280 basis points over bank bill swap rate (BBSW), the tight end of initial price guidance of 280-300 basis points. The transaction, led by ANZ and J.P. Morgan, has a 26-year final maturity and a five-year first call date.

As well as being structured to ensure the securities qualify as tier-two capital under the Australian Prudential Regulation Authority (APRA)'s capital-adequacy framework, IAG's deal is the first to be designed to receive intermediate equity credit treatment from Standard & Poor's Rating Services (S&P).

One of S&P's requirements is that a transaction must have a minimum 20-year residual tenor from the call date to final maturity, which the IAG notes offer. The securities are also convertible into ordinary IAG shares at the option of holders from year eight.

Alan Cazalet, IAG's Sydney-based group treasurer, explains to *KangaNews* that it is important for the issuer to be able to achieve not only regulatory approval but also S&P's capital treatment. "The longer maturity structure is quite common for insurance capital in overseas markets but is unusual here in Australia. However, bondholders have been provided with a conversion option from the eighth year onwards, which allows some certainty of liquidity of their investments."

Acquisition financing

The borrower confirms that proceeds from the transaction will be used to partly fund the acquisition of Wesfarmers' insurance underwriting business that IAG announced in December last year. Despite going out with a minimum issue size of A$200 million, Cazalet reveals that there was the capacity to upsize the deal from initial size intentions due to solid investor demand.

"After receiving overwhelming investor support we sought to balance this demand with the needs of the business. For the purpose of the Wesfarmers transaction IAG required funds totalling A$300 million. But we were able to take a little more than this, eventually capping the transaction at A$350 million."

According to lead-manager data, books exceeded A$650 million from 67 accounts. In total, 82 per cent of the transaction was bought by domestic investors. By type, asset managers bought 70 per cent, middle-market investors took 22 per cent and private banks purchased the remainder.

Structural recognition

Leads also say a degree of investor education was required prior to the IAG issue, given that it was the first deal carried out in the Australian wholesale market for a general insurer under Basel III. In fact, preparation has been progressively carried out for last 12 months, according to Peter Block, director, debt capital markets at ANZ in Sydney.

> "IT IS NO EASIER TO DEFINE POINT OF NON-VIABILITY FOR AN INSURER THAN IT IS FOR A BANK. AS FURTHER PRIMARY AND SECONDARY MARKET DATA POINTS ARE MADE AVAILABLE, IT WILL BE EASIER FOR ISSUERS AND INVESTORS ALIKE TO BE ABLE TO ASSESS THE LEVEL AT WHICH A NEW TRANSACTION SHOULD PRICE."
>
> **DUNCAN BEATTIE** J.P. MORGAN

"This isn't a straightforward product. It takes time to understand and you need to educate investors, especially around the new standards and the reasons for their inclusion for Basel III compliance. Many investors have formed views regarding the inclusion of point of non-viability [PoNV] language but we have seen increasing acceptance of these clauses in the recent deals from BEN, Westpac and now, very pleasingly, for IAG," Block says.

The requirement for insurance companies to include loss-absorbency features under Basel III tier-two rules – just as banks and regulated entities must – is unique to Australia. APRA itself confirms its expectation that PoNV is less likely to occur in an insurance company than a bank.

In a review of the capital standards regime applicable to general insurers and life insurers published in December 2011, the Australian regulator disclosed: "A decision by APRA that it is necessary to trigger write-off or conversion in circumstances where an insurer would otherwise become non-viable is expected to be less likely for insurers than may be expected to be the case for authorised deposit-taking institutions. This reflects the different nature of the circumstances that may lead to an insurer becoming non-viable and the options available to APRA and the insurer to address such situations."

Even so, bankers say there is no fundamental difference between the education processes around non-viability for an insurer and those undertaken for bank issuance.

For instance, Duncan Beattie, managing director, debt capital markets at J.P. Morgan in Sydney, says: "It is no easier to define point of non-viability for an insurer than it is for a bank. But more and more investors are becoming comfortable with the structure and, as further transactions come to market and primary and secondary market data points are made available, it will be easier for issuers and investors alike to be able to assess the level at which a new transaction should price."

Block agrees, suggesting that intermediaries' tasks around selling tier-two structures are gradually becoming easier. "IAG is a rare issuer, particularly in wholesale format where it hasn't issued since 2002. This scarcity value – along with the fact that this issuer is one of the top general insurers in the Australian market, is highly rated and is offering a security that is compliant with the new regime – demonstrates to us that investors are becoming increasingly accepting of the structure that we need to sell for Basel III compliance."

Long-awaited return

KangaNews data confirm that the latest IAG transaction is the first insurance company capital notes issue launched into the wholesale AUD market since Swiss Re brought a A$750 million dual-tranche hybrid transaction in April 2007. The Swiss Re deal was also a Kangaroo. IAG itself brought a tier-one transaction to Australian retail investors in 2012 but it has been out of the wholesale market for more than a decade.

"We have been absent from the wholesale market for a number of years," Cazalet confirms. "We elected to approach the institutional market on this occasion in order to diversify our investor base. We were very pleased with the response, not only from the institutional investor market but also the middle-market and indeed offshore investors."

The issuer's long absence from the wholesale market led IAG to decide it was prudent to meet with potential investors prior to the deal launching on March 11. Beattie tells *KangaNews* that the company carried out a roadshow visiting Melbourne, Sydney, Hong Kong and Singapore before green-lighting the transaction.

"There has been less insurance issuance in the AUD market and banks are better-understood credits than insurers. We also needed to reintroduce institutional investors to IAG given its previously long period of absence from wholesale markets," Beattie adds.

Pricing discussion

Block explains that initial price whispers on IAG – in the area of 300 basis points over BBSW – circulated towards the end of the roadshow were based on an analysis of various price points, including where major bank Basel III-compliant tier-two subordinated debt would price and other recent issuance in this space. Westpac's recent tier-two transaction, which hit the screens during the IAG marketing period, provided a further data point in this regard (see story on p7).

"We saw the recent BEN Basel III-compliant tier-two transaction trading in the area of mid-250s basis points over BBSW. Although IAG is a higher-rated issuer, its deal offered a more complex structure and was the first insurance capital trade to come to the market under the new regime. We adjusted our thinking to include premia for these elements," Block confirms.

Beattie adds that while BEN provided a reference point for the first insurance-company tier-two issue in the Australian dollar market, the bank issue was not a direct comparable. There are structural differences between the two securities, including the fact that the IAG transaction carries an A- rating – it was launched via the Insurance Australia Limited operating subsidiary which is rated a notch higher than IAG.

Despite having roughly the same duration to first call date as BEN's tier-two offering, the IAG transaction contains more structural features, too. Even so, Beattie tells *KangaNews*: "Net-net we thought BEN was quite a reasonable comp. Retail trades from Suncorp Group, Westpac and AMP provided some relevance, too, although clearly institutions will use these less as a marker." •

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> **ALAN CAZALET** INSURANCE AUSTRALIA GROUP

MIDDLE EAST ON THE AUD INVESTOR RADAR AS FIRST GULF BANK DEBUTS

Australian intermediaries say the Kangaroo debut of First Gulf Bank could be another sign of a growing trend whereby Middle East-origin issuers seek to tap the Australian investor base.

The bank became the third from the region – and the second this year – to tap the Kangaroo market when it priced its inaugural issue on March 25.

First Gulf Bank's A$250 million (US$227.4 million), five-year transaction priced at a reoffer spread of 155 basis points over swap via lead managers ANZ, HSBC and Nomura. The deal's execution came just behind National Bank of Abu Dhabi (NBAD), which, after debuting in the Kangaroo market in February last year, refreshed its curve with a new deal on March 12.

NBAD priced A$400 million of new five-year bonds at 125 basis points over swap, a level that is 50 basis points inside the launch spread of its debut, A$300 million-sized transaction a year earlier.

Market participants say the close timing of the two recent Middle East-origin deals is more than coincidental. They believe the Australian market could prove fertile ground for issuers from the Middle East going forward. Not only is the arbitrage currently favourable but domestic investors are clamouring to find new assets, which is materially driving pricing down.

"There is ongoing appetite on the part of investors for new credits from strong, global jurisdictions," says Andrew Koczanowski, head of AUD syndicate at HSBC in Sydney. "We are beginning to see the same gradual progression to Kangaroo issuance from Middle East-origin borrowers that we saw with Canada, Scandinavia and Korea."

Meanwhile, Oliver Holt, head of AUD syndicate at Nomura in Hong Kong, explains that Kangaroo economics have potentially been working for borrowers from the region for some time, with some names starting to pay much closer attention to the AUD option since NBAD's 2013 debut. "The Kangaroo market used to be more expensive than the other global bond markets – now it is at least in line and, at best, a bit better for the borrower," Holt says.

DOMESTIC ANCHOR

First Gulf Bank's key target for its Kangaroo debut was Australian domestic investors. The desire to ensure the deal was well anchored kept volume at the final A$250 million size even though books reached nearly A$400 million, Holt explains. In fact, there was a marginal upsize from the issuer's A$200 million launch target in order to accommodate some of the surplus demand.

Distribution was in line with the issuer's objectives for the inaugural Kangaroo, says Apoorva Tandon, director, syndicate at ANZ in Sydney. "Distribution was split 41 per cent onshore, 31 per cent Asia and 28 per cent Europe," he reveals. "It featured strong support across funds, bank and private-bank investors. The final book contained over 75 accounts."

Final pricing was eventually fixed in line with guidance at 155 basis points over swap – or 30 basis points wide of NBAD's final reoffer spread. But the decision was taken not to push too hard on price despite the transaction being significantly oversubscribed.

The book would have supported a spread tightening had the lead managers chosen to allocate it differently, Holt reveals. "We could have printed A$250 million inside final guidance given the offshore momentum, but we took a view that we would have risked losing the key domestic anchor accounts at which this transaction was predominantly targeted."

Although the NBAD transaction provided a recent marker for Middle-Eastern issuance in the Australian market, the leads also say it is not really a direct comp because it tightened quickly in the secondary market. NBAD's latest Kangaroo was bid at around 118 basis points over swap shortly after the First Gulf Bank deal priced.

Even so, NBAD proved to be a useful reference point in pricing the First Gulf Bank deal. "Until the NBAD transaction was priced we were largely looking at the First Gulf Bank US dollar bond and using the basis swap to gauge potential pricing levels. In my eyes the primary issuance level offers a clearer marker because this is where the Australian domestic investors bought it. These investors wouldn't necessarily have bought it 10 basis points tighter," Holt says.

FUTURE TRENDS

Looking ahead, growing appetite from Australian dollar investors for new credits and jurisdictions should continue to attract inaugural issuers into the Australian dollar market, Tandon says.

He explains: "This trend is encouraging for future issuance across the credit spectrum. That said, it is our expectation that issuance from lower-rated credits will see a stronger skew in distribution into the offshore investor base, with increasing participation from onshore buyers over time – especially for issuers committed to developing a curve in AUD." •