

Credit spreads drop as rates rise

After a lull period in the middle of the year, there has been a marked pick-up in corporate bond issuance over recent months. A number of issuers are achieving all-up pricing below their bank debt pricing, and in some cases for longer tenors to boot! As credit spreads paid over swap have reduced due to stronger investor demand, underlying market interest rates have increased, resulting in the fixed interest offerings over the year being relatively consistent in the 7% to 8% region.

A summary of non-bank issues since March 2009 are as follows:-

Date	Issuer	Rating	\$m	Ten.	bps
Mar	Fonterra	A+	\$800	6	+340
	Auckland City Council	AA	\$100	5	+200
	Auckland Int. Airport	A	\$50	5	+265
	NZ Post Subordinated	AA-	\$150	5	+400
	Tower	N/R	\$100	5	+450
	Contact Energy	BBB	\$550	5	+400
	AMP Group Finance Sub.	A-	\$400	5+5	+450
May	Vector	BBB+	\$150	5 yrs	+275
	WaterCare Services	AA	\$160	5 & 7	+200
	Works Finance	BBB-	\$100	3	+500
Aug	Manukau City Council	N/R	\$28 \$97	4 6	+114 +142
	Auckland Int. Airport	A-	\$125	5	+120
	University of Canterbury	N/R	\$100	5+5	+175
	Waitakere City Council	A+	\$150	5	+120
	Nov	Christchurch City Council	AA+	\$50	3
	Goodman Property	BBB+	\$150	5 1/2	+225
	TrustPower	N/R	\$125	5 & 7	+210 +230
	Kiwi Income Property Trust Convert	N/R	\$100	5	+350
	Watercare Services	AA	\$50	5	+100

It is expected that further new corporate borrowing names will be attracted to issue fixed-rate bonds in the local market as pricing, funding risk and tenor are all starting to be superior to traditional bank debt financing. The Kiwi Income Property Trust Mandatory Convertible Note pricing is "interesting". Benchmark REIT's in the US who are BBB rated issue senior debt at 350 bps over swap. The KIPT Convertible Notes are subordinated and thus of inferior credit/security standing.

Reflections on a challenging and volatile year.....

APRM asked a diverse group of investment and financial market participants of how they viewed the year just about past:-

Mark Brighthouse, Brook Asset Management

"This year the pool of capital in New Zealand has started to look a lot like a paddling pool: you can't float much in it and it keeps getting gradually shallower."

Lloyd Cartwright, Westpac Institutional Bank

"The first half was dominated by the impact of the global financial crisis which exposed corporates and banks in particular to huge funding risks while financial markets reaped the benefits of extreme volatility and strong directional moves in currency and rates.....in contrast, the second half has seen debt consolidation and de-leveraging with less volatility and activity from a markets point of view."

Phil Combes, NZ Debt Management Office

"At the start of 2009 issuing \$250 million of government bonds each week looked like a truly challenging task! By year end, we have achieved that target thanks to tremendous support from domestic and international investors."

Luke Bunt, The Warehouse Limited

"If there was any one year that provided opportunity through volatility in financial markets 2009 was probably it, but it was also a stark reminder to focus on cash, maintain diversified debt portfolio's and take care in hedging your bets."

Phillip Lindberg, Deutsche Bank NZ

"Whilst the road ahead will no doubt be bumpy, the turnaround in both financial markets and most economies in 2009 has been something we could only have dreamed about at the start of this year."

Grant Hassell, AMP Capital Investors

"Two years of big interest rate adjustments have taught investors a valuable lesson about what income assets are supposed to do in your portfolio. Fixed income is the "shock absorber" in a balanced portfolio and we shall see a return of focus to interest rate risk management and less on credit risk which will be allocated back to equity markets."

Chris O'Neale, ANZ

"It was a year where the NZ debt capital market proved that it could punch above its weight - continuing to efficiently supply corporates and banks with term funding at a time when many other international markets were not."

Bruce MacDonald, SKYCITY Entertainment Group

"With an equity raising and then buyback of USPP debt, it has been an exciting year, but the personal highlight has been having the balance sheet set up so there was no need to refinance the bank facility – those historical margins sure look good now."

Mike Symonds, Bank of New Zealand

"A year of unprecedented volatility in Financial Markets, where effective risk management really came to the fore."

Dean Edgerton, ANZ

"What surprised me was how quickly the NZ investor community got back up off the floor after being king hit in the first quarter of the year. Both institutional and retail investors adapted quickly to the changed investment landscape by moving investment funds to the well rated corporate fixed interest rate market thereby providing New Zealand corporate borrowers with much-needed liquidity."

Lower bank credit spreads not feeding through to corporate borrowers

Global and domestic New Zealand credit margins peaked in March 2009. As a “bellwether” it is appropriate to compare where Australasian banks (all of whom are AA rated) have funded in the three-year maturity, as it clearly has wider significance for corporate borrowers given that this maturity sits well within most borrower’s liquidity and funding risk management requirements. In March 2009, the banks’ marginal cost of borrowing for three- year money (predominantly offshore wholesale issues swapped back to NZD) peaked at approximately 170 basis points over the NZD three-year swap rate. As at the end of November 2009, the Australasian banks funded three-year money domestically at approximately 90 basis points and from the offshore capital markets at approximately 75 basis points (after swapping back to NZD).

The big question then is “will corporate borrowers benefit from this reduction in the banks’ borrowing costs?” APRM does not think so for the following reasons.

In broad numbers, New Zealand Inc is debt financed to the tune of approximately \$310 billion, of which 40% is provided by foreign investors. What is very scary indeed is that approximately 90% of the total funding pool has an investment period of less than 12 months. The very short-term nature of the debt funding is the major reason why the RBNZ has pulled its regulatory stick out. Not only is New Zealand overly dependant on foreign investors, we borrow short term “hot” money from them. Over recent months the RBNZ has required the banks to fund longer (more expensive) and to fund a higher percentage from the domestic market. The result has been the recent domestic retail deposit war going on between the banks, where they are fighting for market-share and paying 90-110 basis points over the 90-day Bank Bill Rate for retail and some wholesale deposits.

Adding to this woe is the RBNZ’s recent announcement that they will not allow the banks to use other banks’ debt for liquidity purposes. The new requirement will hurt the banks as they have historically invested in each other’s debt for capital weighting purposes and in the knowledge they could REPO such debt with the RBNZ for instant liquidity. Accordingly, APRM do not see the Australasian banks’ marginal cost of borrowing decreasing for some time and instead believe the banks’ weighted-average cost of borrowing has remained static, notwithstanding the significant reduction in their wholesale market credit spreads. If it is assumed that the banks weighted-average cost of funds for three-year money stabilises at around 100 basis points, then their starting point in terms of lending three-year money has to be somewhere near to 120 basis points (generously allowing 20 basis points operating costs) before they are receiving any return on capital.

APRM currently observes the corporate lending world being divided loosely into three relationship categories by the local banks:-

- Local Authorities and corporate borrowers with credit ratings BBB and above – where the borrower will do better to access term debt through the debt capital markets, with banks focusing on transactional, derivative and working capital business requirements.
- Lowly-g geared corporates with modest borrowing requirements, however attractive full- service banking needs such as foreign exchange, transactional banking and interest rate derivatives. The corporates in this category are highly sought after and there is evidence of a return to contestability and credit margins closing-in to below the banks’ marginal borrowing costs.
- Highly-g geared corporate borrowers who use the banks for not much more than the straight debt provision i.e. marginal “value-add business” to the bank lenders. The borrowers in this category will pay full whack (no pun intended) and can expect credit margins to be between 200 and 350 basis points, depending upon their credit standing within the bank.

Some of the local banks have recently increased their “liquidity premium” margins on top of existing credit margins. The banks may blame the new RBNZ Core Funding Ratio for these increased funding costs, however the RBNZ have been forced to impose the regulations on banks to save the banks from themselves, in terms of being sucked-in again into poor funding risk practices of “borrowing short- lending long”. At the end of the day, corporate borrowers are the ones paying for the banks’ historically poor funding risk disciplines and the inevitable regulatory response.

Record Local Government debt issuance

New Zealand Local Authorities issued a record amount of debt in 2009. To date, \$1.620 billion has been issued in the form of fixed-rate bonds and Floating Rate Notes. The issuance figure excludes commercial paper and term bank debt. The total debt issuance this year is significantly higher than the annual issuance of recent years i.e. 2008 = \$550 million, 2007 = \$620 million, 2006 = \$980 million, 2005 = \$500 million.

Interestingly, issuance was high in the first half of 2007 prior to the onset of the global credit crisis; in fact \$550 million was issued in the first six months of 2007. A significant amount of “pre-funding” of debt transactions was executed in early 2007, leaving a number of Councils fully funded leading into the 2008 year.

Key statistics of interest for this debt sector in 2009 are:-

- The most popular maturity was 4-5years totalling, \$890 million (55% of total issuance).
- Fixed bond issues exceeded Floating Rate Notes for the first time, confirming investor interest for absolute yields.
- Retail issuance exceeded \$420 million.

Bank debt loan documentation – pricing and security clauses

The heady days of early 2007 enjoyed by New Zealand credit markets, immediately preceding the credit crisis, saw corporate loan documentation reach its most permissive stage (from a borrowers perspective). In the aftermath that followed, there has been a major tightening up of loan documentation and a significant change to the process of formal credit approval by bank lenders:-

- On average, the timeframe between indicative offers and formal credit approved offers increased from one week to three weeks and documentation now averages one month to complete. Gone are the days where a Local Authority could ask for a committed standby line and have the whole facility signed up in one week! **Response:** *Allow plenty of time to refinance debt and/or arrange new debt facilities.*
- A significant number of changes occurred where the banks could review pricing terms during the life of the loan commitment. New and amended review clauses found there way to different sections within the loan agreement making them difficult to isolate. The number of “events of review” increased significantly ranging from “market disruption”, “increased cost of capital (banks)” to quite simple “annual reviews”. APRM has also observed the odd “review on seven business days notice” finding its way into documents during the peak of the crisis, although this has now quietly disappeared. When challenging the banks about borrowers wanting to determine their “funding risk” and that pricing needed to have continuity for the commitment period, the response was often that the banks were providing a “liquidity commitment”, albeit at their price determination. **Current situation:** *Banks have started to consolidate the review clauses into one section and most of them are now falling into the area triggered by issues beyond the banks control (Regulatory, tax etc, rather than at the banks immediate discretion). Whilst funding margins have now become easier to lock-down for the commitment duration, the “liquidity premium” has now found its way into a number of banks documentation within the pricing section of the loan agreement. The liquidity premium is often reviewable on a seven days notice period and is not particularly transparent in its determination or calculation.*
- Commitment fees are now the key determinant of a bank’s “return on risk-adjusted capital” for standby or working capital debt facilities. Establishment fees and review/extension fees, which were effectively phased-out through competition leading up to the credit crisis, have now re-emerged with a vengeance. **Response:** *Not particularly negotiable if you are a simple balance sheet user in the eyes of the bank (i.e. offering no material value-add derivative business).*
- APRM has noticed a significant effort by many banks to revert some corporate clients back from negative pledge to general security agreements and greater emphasis on “belts and braces” security. **Response:** *APRM has, in its advice to borrowers, strenuously resisted any move back away from negative pledge arrangements as this hard won place at the top of the security evolution chain is often a key element to a company’s ability to contest banks (especially as some degree of normality returns to the markets). It is also a practically necessary requirement for those seriously considering credit ratings and capital market debt issuance.*
- Financial ratio covenants generally tightened in terms of gearing, interest rate coverage and cash flow. Market valuations became heavily scrutinised and financial market derivatives revaluations, whilst not often included within the ratios, became a more focused element of a bank’s credit threshold calculation. **Current Situation:** *The banks began to create and self perpetuate events of review/default with the combined impact of tighter covenants and significantly increased credit spreads. More recently we have seen a far more flexible attitude towards medium term sustainability in relation to such covenants, as some banks realised that they were making a rod for their own backs in terms of client maintenance.*

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