CURRENT THEMES IN AUSTRALIAN CAPITAL MARKETS

INTRODUCTION

The recent past in Australian capital markets has been characterised by themes of volatility but also innovation. Volatility has seen markets closed at various times due to many factors, often global in nature. Innovation has been driven by both how to deal with this volatility but also due to changing investor preferences.

The first few months of 2016 saw the low point of commodity prices and a lot of uncertainty over global growth generally and Chinese growth specifically. The market rebounded in March and we broadly saw a more friendly issuing environment through the remainder of 2016 and that has continued in 2017 here in Australia but also the US. Markets have been focused significantly on elections and their aftermath. In Australia and the US in 2016 (July and November respectively), the Brexit vote (June 2016) and then a series of European elections in 2017.

Geopolitical issues in the Middle East, China sea, North Korea and Russia all distracted and impacted markets during the year. At the end of 2015 we thought about the types of geo-political risk we saw potentially being the back drop for 2016. Most of that played out, markets opened, they closed; they created opportunities and we saw all of this in 2016 and we have been similar expectations in 2017.

At the end of 2016 there was continuing discussion about Australia's sovereign rating, S&P have had Australia on negative outlook since July. This has particular relevance for all financial institution borrowers and ultimately for other non-financial borrowers. I believe this discussion will get more attention throughout 2017 and will create another instability element.

Australian corporate borrowers were less active in 2016 than we saw in 2015. The syndicated loan markets were down approximately 20% in 2016 compared to 2015. The corporate bond market in 2016 broadly experienced a similar decline. Partly this decline is due to the transition of Australians economy post the mining boom; challenges in the construction industry and; the debate over foreign investment. Overall the bond markets produced similar volumes domestically year on year.

There are three key themes we are seeing in the Australian domestic market. Firstly the continued rise of the importance of Asian investors and; secondly the rise of the power of self-managed superannuation with the growth of non- institutional investors in the domestic bond market. Both of these themes also impact on our third theme, increased innovation.

Australia continues to run current account deficits; hence we need to borrow money overseas to create a capital account surplus. The importance of Asian investors in funding Australia has been consistent since the Global Financial Crisis, be it through loans and/or bonds. The importance of the offshore market cannot be underestimated. Every year the percentage of the domestic market that is purchased from Asian investors grows and the number and the variety of the investors from Asia are becoming more diverse both geographically and from the type of institution. We are also seeing more activity from the Asian offices of a number of European or US fund managers. I don't see this changing anytime soon.

The other big theme is the power of self-managed superannuation and the power of the growth of non- institutional investors in the domestic bond market. Traditionally we saw this demand in the hybrid and convertible market but increasingly these investors are providing liquidity in the senior debt for all types. 2016 was the year where this went from a consistent, albeit small, bid for new issues, into being a more significant part of most book builds. A number of infrastructure related issuers saw strong bids in 10 year FRN's from this sector and I think this will be a continuing theme as more self-managed superannuation move towards fixed income, a seriously underweight asset class.

Innovation is weaved into both of these themes. NAB is extremely proud to bring the first green bond from a commercial bank at the end of 2014. In 2015 we saw that transaction replicated by other banks both domestically and offshore. In 2016 the green bond market stepped up another level, in April we saw the first green certified securitisation transaction for Flexigroup. In July we saw the first green bond from an Australian Government Authority, Treasury Corporation of Victoria. Subsequently in March 2017 we saw Queensland issue a green bond and NAB issue the first offshore green bond from an Australian issuer. This market is certainly becoming more topical for Australia and a reflection on the growing investor appetite for assets that are socially responsible.

In April 2017 NAB launched a world first, an AUD500mn Gender Equality Social Bond.

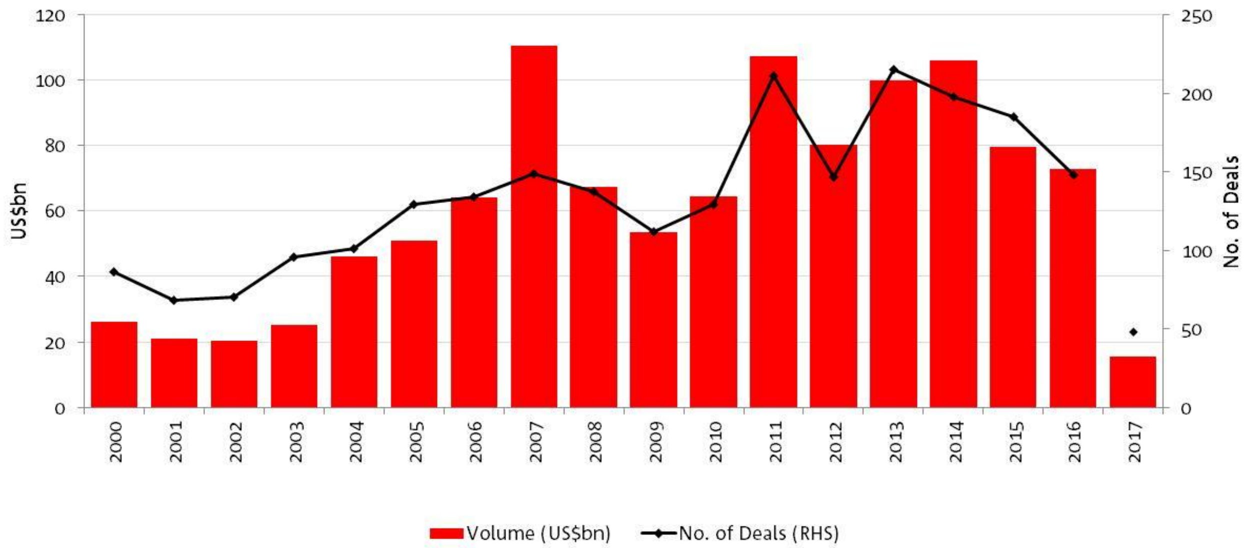
This market will continue to grow as investor's continue to have the desire for investments that are attractive in their own right and equally have purpose.

I will look briefly at domestic syndicated loan and bond markets before moving on to discuss a little about the complexity of a broader definition of AUD markets before looking at the three main themes.

LOAN MARKETS

Looking at overall statistics year to date, the Australian loan market has been subdued versus previous years with YTD volume down over 25% YOY, which is a similar experience across the Asia Pacific region.

New Loan Market Volume chart Vol. (US$bn)



Source: Thomson Reuters , LPC Data
Updated with 2017 YTD figures

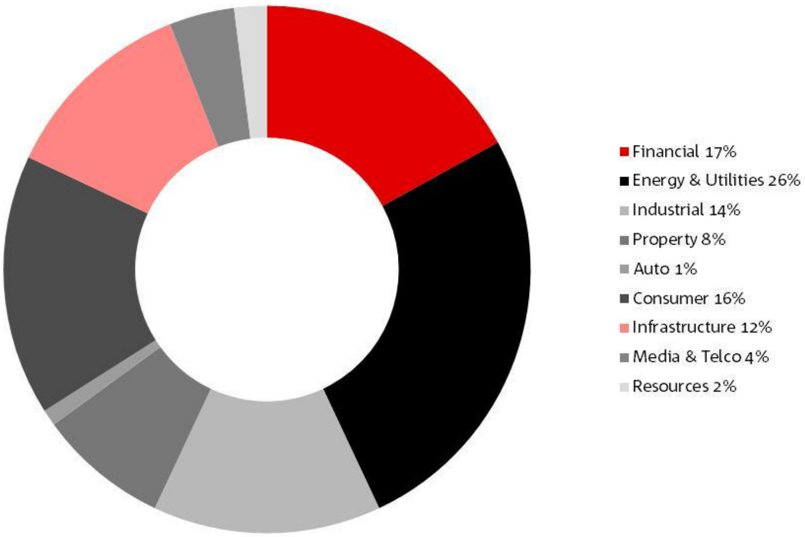
The decline has been due to a combination of factors principally:

- Low credit growth resulting in a lack of demand by the corporate sector for credit;
- Reduced level of refinancing due to significant refinancing occurring over the last few years; and
- Increased loan pricing making it less conducive for borrowers to refinance early compared to previous years

Although loan volume was down significantly, the year was active with an increase in new money deals that have been a combination of additional funding raised by corporates; M&A and privatisation. These transactions have been meaningful in volume with strong support by banks.

Consistent with previous years, market liquidity has remained strong with all syndicated facilities coming to market oversubscribed. This year has been highlighted by more event driven transactions (acquisition and privatisation) than prior years and transactions have supported a wide variety of sectors which is a key feature of the loan market.

2017 YTD loan deals by sector



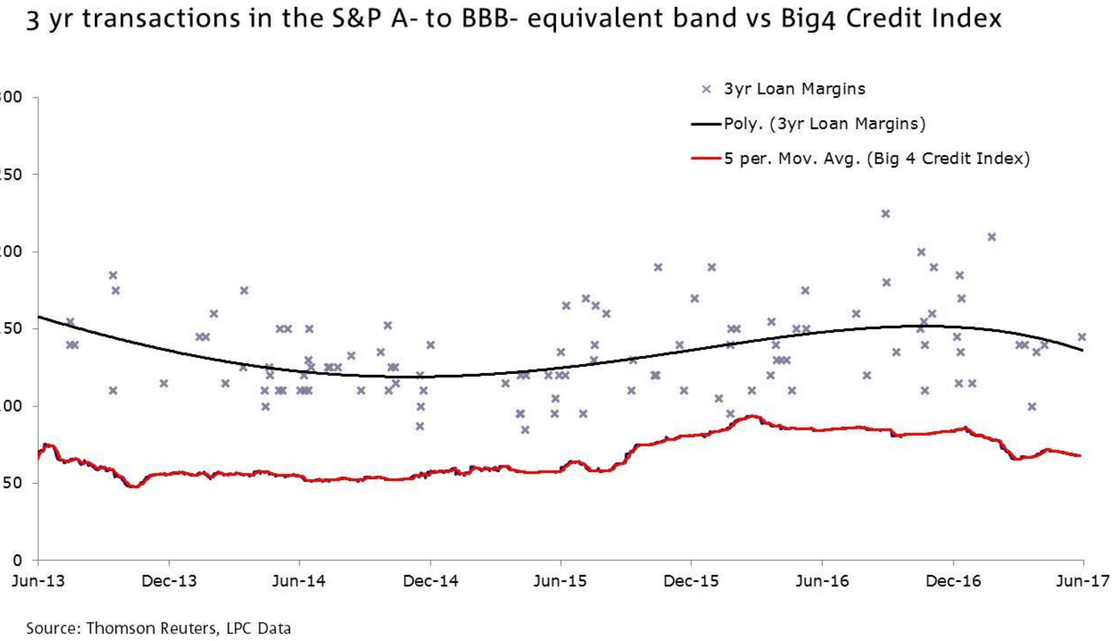
Source: Thomson Reuters , LPC Data

The loan market also experienced an increase in new banks establishing a branch in Australia improving local liquidity available to Australian borrowers. Most of the banks that established a presence were of Taiwanese origin. A few transactions have additionally been syndicated into the Asian region, which have also been well supported by banks in key regions of Singapore, Taiwan, Hong Kong/China and regional Japan.

Drivers of change

Unlike previous credit cycles where an increase in loan pricing was associated with a tightening in market liquidity, the market experienced increased pricing without any noticeable contraction in credit availability. The catalyst for this was the market volatility experienced in Q4 2015 impacting on funding costs of banks globally resulting in loan pricing widening in the order of 20- 30bps.

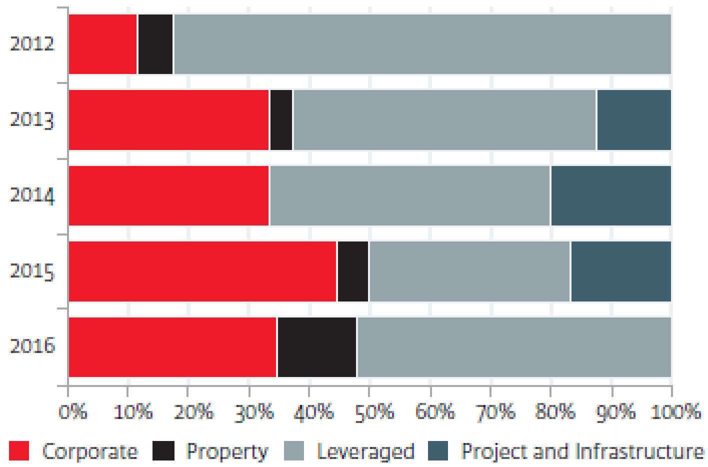
Australian Loan Market pricing



Banks have also been increasingly affected by the cost of additional capital raised to meet increased prudential requirements imposed by regulators.

The ability of banks to pass on increased costs has been limited due to continuing strong liquidity and subdued market volume. Banks have been increasingly balancing the level of commitment provided to borrowers with the overall relationship, given the increased cost of capital.
This is resulting in syndicate composition broadening, to include other banks or non-bank investors (institutions and funds) from across the region that are more passive. This approach allows for a more balanced lender group to support clients in meeting their funding and maturity needs.

Breakdown of funds participating in loan transactions



Source: Thomson Reuters, LPC

The loan market is expected to continue to exhibit surplus liquidity relative to demand for credit over the next 12 months. Foreign banks based in Australia and offshore will continue to show active interest to deploy capital as Australia remains a favoured destination particularly in regard to the infrastructure and utility sectors.

2017 will reveal more on how banks deal with regulatory change and increased prudential requirements with the consequent impact of increased funding and capital costs. Each bank will manage this in different ways through either:

- Being more selective of their target market and available capital to deploy;
- Reduced hold commitments and increased distribution of loan assets in primary or the secondary market; and
- Increased securitisation of loan assets.

The growing involvement of institutional investors and funds in the loan market will be complementary to both banks and borrowers.

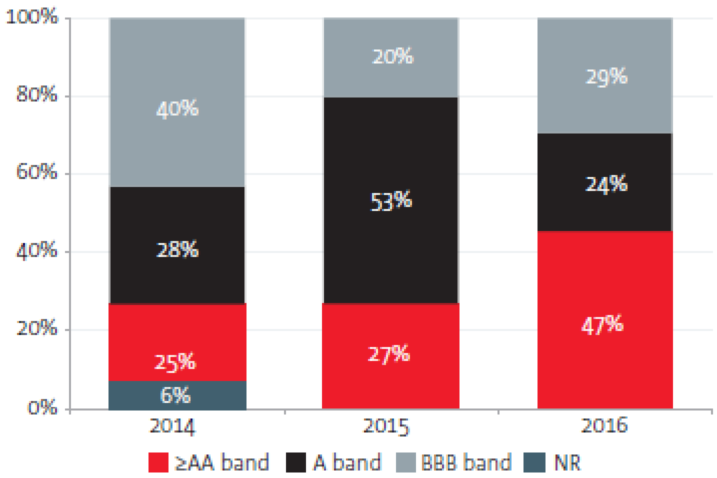
AUD CORPORATE BONDS

Australia's corporate bond market experienced a year of supply consolidation in 2016, during a period characterised by muted company demand for term debt, recurrent bouts of volatility and a continued investor bias towards longer tenors.

In reality, local corporate debt markets were facing a supply drought based on the reality that many issuers had pre-funded in prior years, deleveraged or were perhaps targeting different markets such as USPP, Sterling and Euro markets for varying reasons – tenor, volume etc. This phenomenon, it should be said, impacted all debt markets universally and by the end of 2016 total corporate funding came in at around A$100 billion down from A$160 billion in 2015.

It was a story of two halves domestically in 2016. The first half saw very little corporate issuance, literally same till April but picking up in the second quarter. Key issuance included names like Air Services Australia, Port of Brisbane, Apple, Coca Cola and while some of these were very large deals it mastered a bigger trend towards longer tenor (7 year) lower end of investment grade (BBB) from Australia and Asian investors.

Recent A$ corp issuance by rating



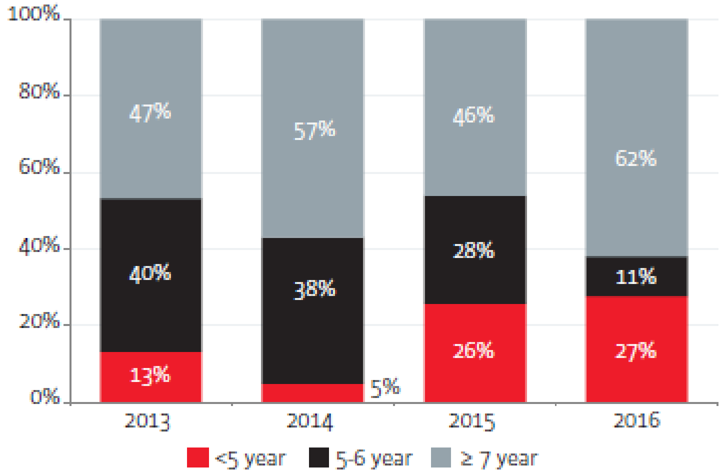
Source: NAB Corporate Debt Markets

Pleasingly, the second half of 2016 saw a rise in activity across multiple corporate mandates including SGSP Australia Assets, Local Government. Funding Vehicle, Infrastructure play Westlink M7 (printing A$500 million in 2 tranches) and a debut Kangaroo issue from Toyota Motor Credit Corporation amongst many others. Until the emergence of both Brexit and the Australian Federal election, it is equally noteworthy to the extent that taps of A$30-$50 million became a more popular vehicle for corporate issuers in 2016, notably in the property sector. I think this will possibly become a feature of the market some smaller size deals for specific names.

The second half of 2016 saw some of the more traditional themes that have been prevalent in recent years namely:

- A rise in activity around the 7yr+ tenors, is a trend that indeed remains the sweet spot for the market and has stayed so in 2017. 7yr+ deals accounted for 62% of volumes in 2016, the highest on record.

Historical A$MTN issuance by tenor

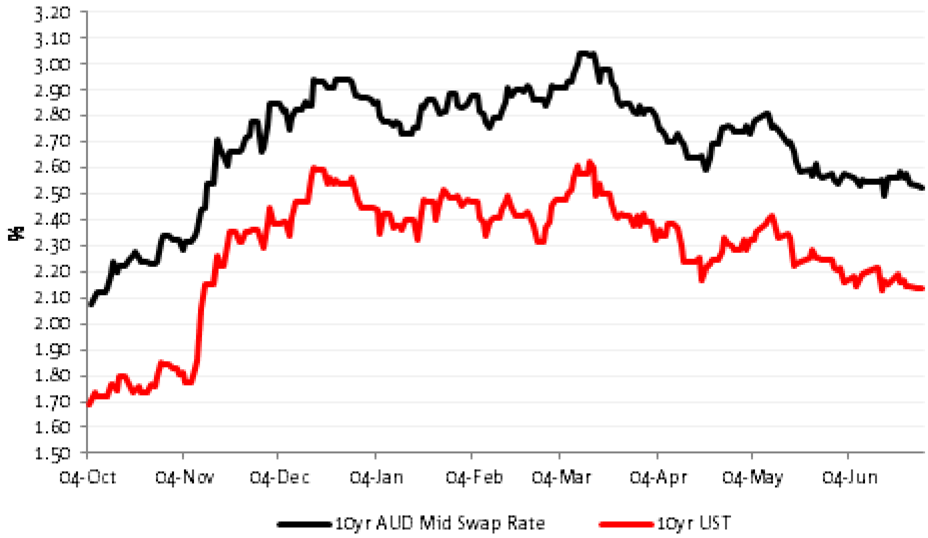


Source: NAB Corporate Debt Markets

- A step-up in 10yr investor demand, driven by largely Japanese-related mandates, while domestic investors showed encouraging signs of their willingness to participate.

- Increased significance of Kangaroo issuers, who have not only underwritten about half the markets' reduced volume over the last few years, but provided a welcome source of diversification for investors.
- Investors very sensitive to relative value in primary markets as secondary performance was at best flat.

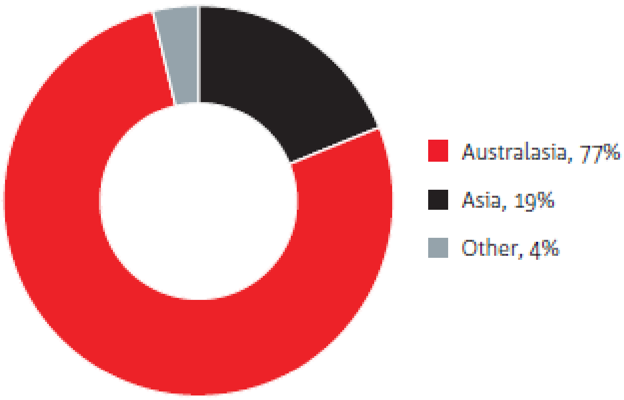
Credit curves steepen post US presidential election outcome



Source: Bloomberg

Role of Asia: Asia's significance to Australian corporate bond issues continued in 2016, with deals typically seeing around 25-30% participation from this continent. NAB has also seen some widening of this market (beyond funds), as Chinese banks hungry to lend to Australian corporates, have increased interest in bond deal participation.

Asia is a key role in A$MTN distribution (2016)



Source: NAB Corporate Debt Markets

WHAT IS AN AUSTRALIAN DOLLAR BOND?

It's not a simple question to answer as the AUD bond market is not just one market. It is - at last count – at least six markets with their own features, documentation and target investors. Some investors can straddle a number of the formats while others are more constrained due to other factors like restricted mandates or regulatory drivers.

The main AUD bond formats are:

- **AUD Onshore Wholesale**: This comprises our domestic and Kangaroo borrowers, with bonds usually settled through Austraclear initially and subsequently bridged to Clearstream/Euroclear. Documentation is generally under Australian law however recently we have seen some offshore law creeping in.
- **AUD Onshore Retail**: These bonds are usually ASX listed and settled through CHESS, with subordinated bank hybrid deals dominating volumes. This is a well- established market with a very different execution process and targeted non-institutional investor base.
- **AUD EMTN (Reg S)**: These bonds are usually documented under a European jurisdiction (predominantly under UK law) with the programme also listing in Europe. AUD Eurobonds started to proliferate once the AUD became a 'floating' currency in 1983, however, appetite has expanded beyond the original European retail arena with the emergence of Asian investors who buy AUD structured notes and vanilla private placements in this format. AUD EMTN subordinated (Tier 2) public deals have started to proliferate in recent years with issuers favouring this format over the Kangaroo which is more costly and takes longer to establish. The EMTN transactions are usually more modestly sized, often starting with just A$100 million as an initial volume target.
- **AUD SEC Registered Global**: As the name suggests, these bonds can be sold in most of the large markets including the US. The format has grown dramatically in recent years, partly as a result of increased regulation of the global systemically important banks ('G-SIBs'). This market is discussed in more detail below.
- **AUD Local market bonds** like Uridashi and Formosa bonds use the EMTN format as a base. Uridashi notes overlay a Japanese 'shelf' to enable distribution to Japanese retail investors. Technically, they are notes issued outside of Japan and are sold in secondary trade (one day or more later) to Japanese retail investors. Formosa bonds are issued by non-Taiwanese borrowers and are listed on the Taipei Exchange, thereby effectively becoming a 'domestic' issuer. This allows Taiwanese life companies to participate as investors without breaching holding restrictions on offshore names.

- **AUD denominated US Private Placement ('USPP') deals**: These bonds are occasionally added to a USD USPP if it does not suit an issuer to either receive US funding, or if they do not wish to swap USD note proceeds to AUD. Some USPP investors can accommodate this.

ASIAN INTEREST IN AUSTRALIAN CAPITAL

As we have just discussed Asia buyers of Australian debt have options beyond what we would normally consider in the Australian Capital Markets. They can participate in bilateral loans (if they have an Australian branch) and the syndicated loan markets as well as participating in a number of the AUD offshore bond markets. That is on top of any USD or local currency issuance by Australia borrowers.

Because of this optionality, looking at Asian buyers in any one market, such as the domestic loan market, will typically understate the overall influence of Asia buyers.

At around the time of the GFC Asia demand for Australia debt was primarily driven by Asia based commercial banks or the Australian branches of Asia based commercial banks. This is still the most important segment of Asia debt demand for non-government debt. But its importance is changing, as is its shape. Since the GFC more Asia based banks have created branches in Australia and those that had been here for some time have grown their assets significantly. This has been especially true of the three Japanese mega-banks, but also the Chinese, Taiwanese and Singaporean banks with branches in Australia.

The non-bank demand has come primarily from either demand from insurance companies from Asia fund managers and from US / European fund managers, mainly based in Asia, managing both global and regional debt mandates.

Non-bank demand has been growing strongly the last 3-4 years and while it is still not as significant as the bank led demand it can be the largest component of certain deals. We have seen this in two main areas – demand for financial issuers and also in longer dated (>7 years) tenors.

With domestic grown options subdued in some North Asia Markets, we expect to see a continued strong bid from the region for Australian paper in many forms. This will also be underpinned by more Asian banks establishing branches in Australia.

GROWTH IN THE NON-INSTITUTIONAL FIXED INCOME MARKET

One of the fastest growing and influential parts of the domestic market over the past GFC period, but particularly relevant since 2014, has been the increased bid from non-institutional investors. This is a very broad group and includes SMSF's, the traditional "middle market" companying faith based groups, councils, and family offices, as well as financial advisors and other private wealth outside of superannuation.

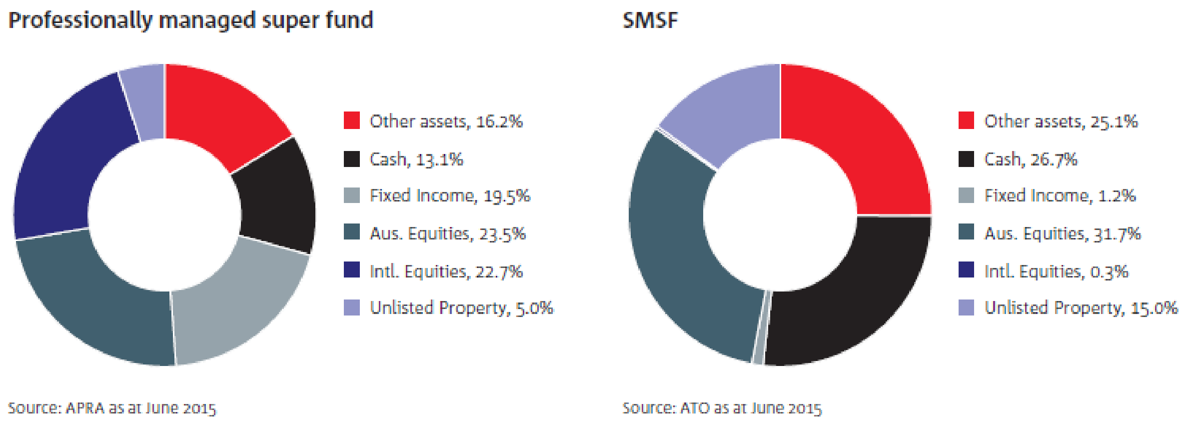
There have been a number of reasons why this broad group has become significant. Firstly, the total size of the investor pool is huge. Including the 700bn in SMSF, than this group would have over AUD 1 trillion in total investments.

Secondly demographic change, specifically the agency of the population, has increased awareness of sequencing risk and the need for greater asset diversification.

Thirdly there has been increased supply of borrowers into the market, beyond the usual hybrid issuance and this has helped awareness of the fixed income.

Lastly there has been a great deal of focus, from both regulators and from market participants to educate the market about fixed income. It appears that this is starting to have a positive affect.

Figure 1: The asset class gap between a professionally managed superfund and a typical SMSF.



One of the interesting features of this market is the gap between professionally managed and self managed super fund exposure to fixed income. We have seen increased demand, from a very low base, and this has been the main driver of the recent spate of higher yield, non-rated issuance from names such as NextDC, Centuria Fund Management and Peet Limited.

The great positive about the non-institutional bid growing is that we are finally seeing some real investor differentiation domestically. This is good for the market. It embraces liquidity and it helps to remove some of the market volatility. While individual bids may be small, the combination of many such bids, along with the consistency of the bid does mean that the issuer gets a more diversified investor buyer.

We expect that this market will continue to grow over to next 3-5 years, driven by both the insight of money moving into the sector and by a rebalancing of asset allocation. We believe that the key factor driving markets in the next few years will come from the supply sale – not the demand side of the market.