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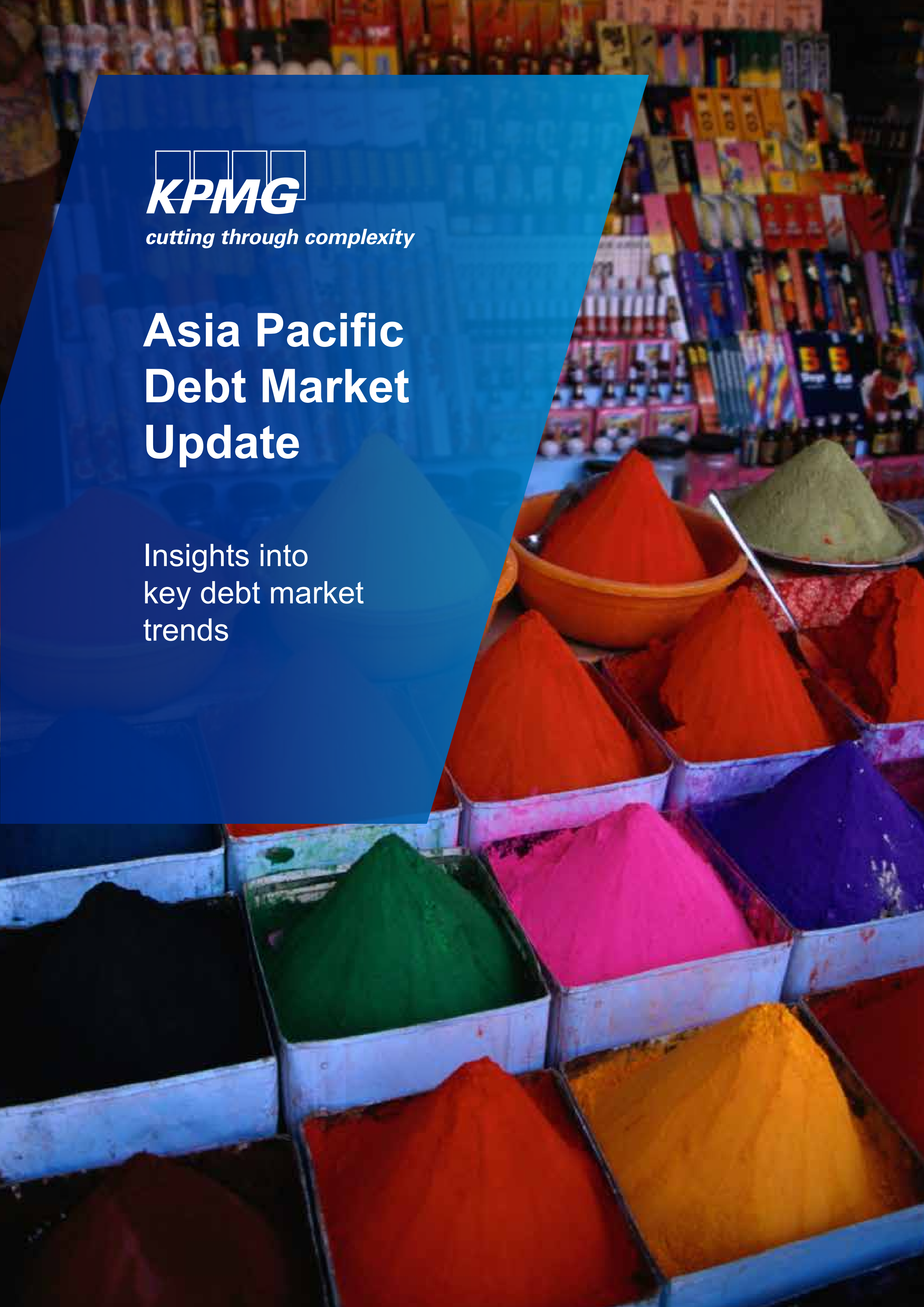
Asia Pacific Debt Market Update

Insights into key debt market trends



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Welcome to KPMG's inaugural Asia Pacific (ASPAC) Debt Market Update. This regular publication draws together insights into key debt market trends from member firms' Debt Advisory specialists across the ASPAC region.

Macro Trends

GDP growth (percentage change year-on-year)

	2010	2011	2012 forecast	2013 forecast
China	10.4	9.2	8.2	8.8
Australia	2.5	2.0	3.0	3.5
Japan	4.4	(0.7)	2.0	1.7
India	10.6	7.2	6.9	7.3
ASEAN-5[(a)]	7.0	4.5	5.4	6.2

Note: (a) Indonesia, Malaysia, Philippines, Thailand, Vietnam.
Source: IMF World Economic Outlook Database, April 2012.

The general trend for ASPAC's economies in the first half of 2012 was one of slowing growth. In their recent World Economic Outlook July Update, the IMF attribute this partly to the weaker external environment, and also to decelerating domestic demand in response to capacity constraints and policy tightening, particularly in China and India. However, activity across the region was supported by a rebound in industrial production driven by reconstruction spending after the Tsunami in Japan and Thailand floods, together with strong domestic demand in Japan.

"The ongoing dislocation of the Euro sovereign borrowers continues to impact activity in the Asian markets. As investors remain tentative, liquidity continues to be limited and banks are seeking to protect themselves against further shocks. Confidence in Spain and Italy's economies is fundamental to Eurozone stability, both governments' bond markets have come under pressure in recent months."

"Eurostat, the European Union's statistics agency, revealed that the economies of both the Eurozone and the wider 27-country EU shrank by a quarterly rate of 0.2 percent in the second quarter of the year. In the first quarter, output for both regions was flat and we do not anticipate growth in the Eurozone during the remainder of 2012."

China's picture may not be so bleak, GDP growth slowed to 7.6 percent in the second quarter of 2012 – the slowest quarterly growth since 2009, according to China's National Bureau of Statistics. The latest data points to weaker domestic demand combined with declining export growth. A spokesman from the General Administration of Customs confirmed that demand from the European Union (which has now been replaced by the US as China's biggest export market) has decreased; a trend we expect to continue throughout the second half of 2012. There is also a risk that GDP growth will be negatively impacted by political uncertainty surrounding China's leadership transition.

Slowing growth in China is having a wider impact across the ASPAC region, particularly in Australia whose largest export market is China. Data released by the Australian Bureau of Statistics confirmed GDP growth shrank to 0.6 percent in Q2, from 1.4 per cent in the previous quarter. Key contributors to the decline were a sharp fall in the prices of resource exports, together with mining production and manufacturing output.

Similarly, Japan – another country that relies on China for the greatest share of its exports – also experienced a stabilization of industrial production and a flat manufacturing Purchasing Managers Index (PMI) in the second quarter, according to the Asian Development Bank (ADB) in its Asian Economic Integration Monitor (July 2012). However, strong domestic demand and reconstruction spending contributed to growth of 4.7 percent in the first quarter.

> ADB also reported South East Asia to have experienced a stronger first half, with GDP growth across the region of 4.3 percent in Q1, on account of Thailand's rapid recovery from flood damage, and strong growth in the Philippines. Singapore and Malaysia had a weaker first quarter.

Policy updates

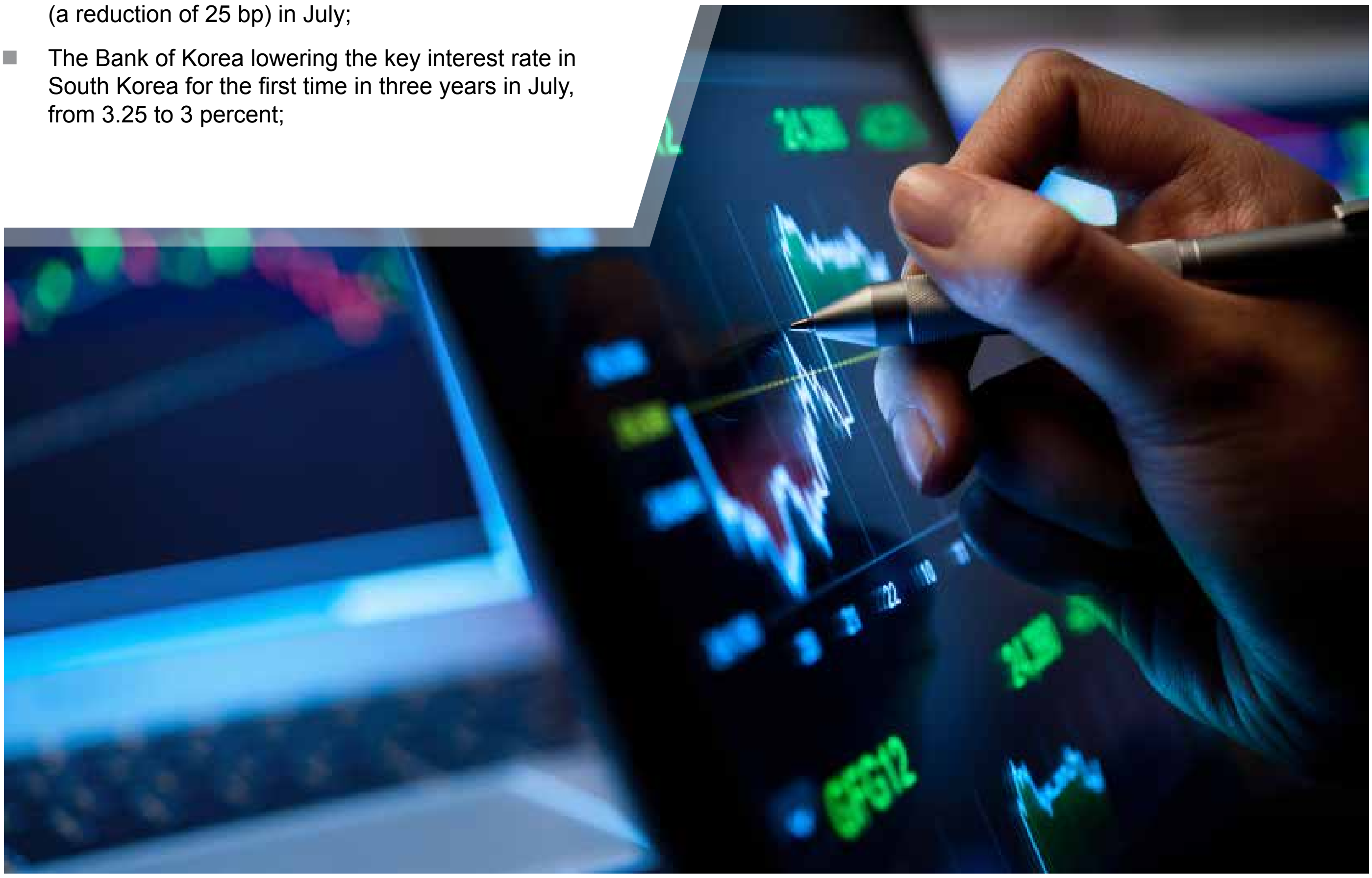
China's government continues to focus on policies that will steer the economy towards a soft landing. The focus is on containing inflation, while providing more support to small and mid-sized companies, and incentives to boost domestic consumption. Specific initiatives include:

- Easing regulations to allow high-yield bond issuance by smaller companies;
- The introduction of an RMB 15 billion SME development fund; and
- Reduction of the Reserve Requirement Ratio by 0.5 percent in both February and May, which now stands at 20 percent for the country's large financial institutions, releasing an estimated RMB 400 billion into the loan markets.

The year to date has seen central banks continue to attempt to stimulate growth using monetary policy tools. These moves include:

- The People's Bank of China reducing the one year lending rate to six percent (a reduction of 31 basis points (bp) and the deposit rate to three percent (a reduction of 25 bp) in July;
- The Bank of Korea lowering the key interest rate in South Korea for the first time in three years in July, from 3.25 to 3 percent;
- Australia cutting the benchmark cash interest rate by 50 bp in May, and by a further 25 bp in June and October to 3.25 percent;
- The benchmark rate in Europe also reaching a record low in July, after the ECB lowered the rate by 25 bp to 0.75 percent, and recently, the European Central Bank President Mario Draghi announced an unlimited sovereign bond purchase program in an attempt to regain control of interest rates in the Euro area;
- The US Federal Reserve extending 'Operation Twist', which aims to drive down long term interest rates by selling short term bonds and buying longer dated bonds, and;
- The Bank of England announcing an additional GBP 50 billion of government bond purchases in July, bringing total quantitative easing to over GBP 375 billion.

> China's government continues to focus on policies that will steer the economy towards a soft landing.

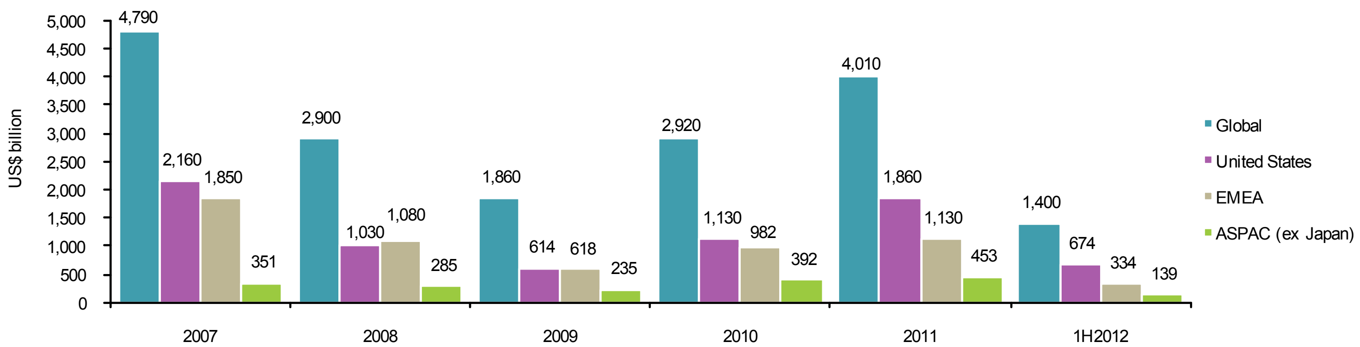


Loan issuance

New issuance volumes in the global loan markets slowed considerably in the first 6 months of 2012.

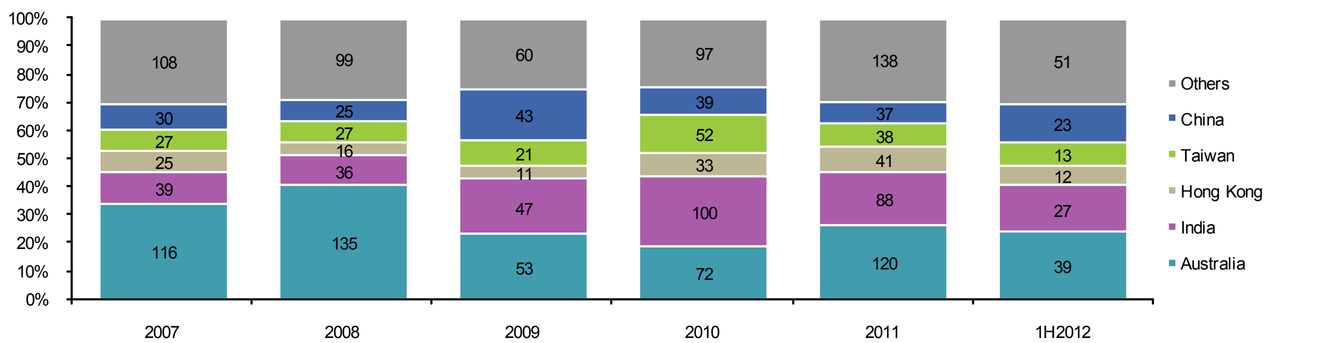
"Only US$ 1.4 trillion of debt was syndicated in the first half of the year, which compares to US$ 4 trillion issued throughout 2011. ASPAC (ex Japan) contributed US$ 139 billion, maintaining just over 10 percent of global loan market. Lending in Australia fell 20 percent in the first half (year-on-year), with Hong Kong and Singapore, traditionally Asia's most active markets, witnessing declines of 30 percent and 26 percent, respectively."

Figure 1: Global syndicated loan volume (2007 – 1H2012)



Source: Dealogic

Figure 2: ASPAC (ex Japan) syndicated loan volume (2007 – 1H2012)



Source: Dealogic

Bank lending in ASPAC continues to be impacted by both regional and global influences. We examine three key factors below.

Liquidity squeeze

European and US banks have continued their efforts to deleverage their balance sheets as they attempt to increase their capital bases ahead of the introduction of a range of regulations, particularly Basel III, and protect against further volatility in the Eurozone. Available capital is frequently being directed towards banks' home markets and key clients restricting the new business written in ASPAC. Some banks are even selling quality credit in the regional secondary markets.

The reduced bank liquidity has been exacerbated by increasing borrowing costs arising from further rating agency downgrades of a number of leading global financial institutions. Moody's cut the ratings of five US and 10 European banks in June (Goldman Sachs, Citigroup, JP Morgan, Morgan Stanley, UBS and Barclays were all downgraded by two notches, while Credit Suisse was downgraded by three notches).

Given the lower levels of activity by many international banks in the region, corporates have relied on an increased activity from regional banks. Regional banks have maintained their lending capacity and increased market share, as can be seen in the shift in the number of regional banks among the top mandated lead arrangers in the region between 2007 and 2012. Australian domestic banks have been able to hold consistent positions in the market, while local banks from China, India and Japan have increased their volume ranking and market share.

Table 1: Mandated lead arrangers, Asia Pacific (ex Japan)

	2007	2010	1H 2012
1	ANZ Investment Bank	State Bank of India	State Bank of India
2	Citigroup	Bank of China	ANZ Investment Bank
3	National Australia Bank	ANZ Investment Bank	Bank of China
4	Westpac	Bank of Taiwan	Westpac
5	Commonwealth Bank of Australia	HSBC	Commonwealth Bank of Australia
6	BNP Paribas	IDBI Bank	National Australia Bank
7	HSBC	Westpac	Sumitomo Mitsui Financial Group
8	Standard Chartered Bank	Standard Chartered Bank	HSBC
9	Bank of China	National Australia Bank	Mitsubishi UFJ Financial Group
10	Credit Suisse	Axis Bank	Mizuho

Source: Dealogic

The volume of cross-border funding has also been rising; in particular there is further appetite from Chinese, Japanese and Taiwanese banks to lend across ASPAC.

Japanese Banks have proved resilient to external shocks thanks to their relatively high deposit ratios and lower funding costs. We expect that borrowers will continue to utilise the large pool of Yen liquidity, with more Yen-denominated loans being issued in the coming months. This situation is also supporting the activity of Japanese companies and investors across the region.

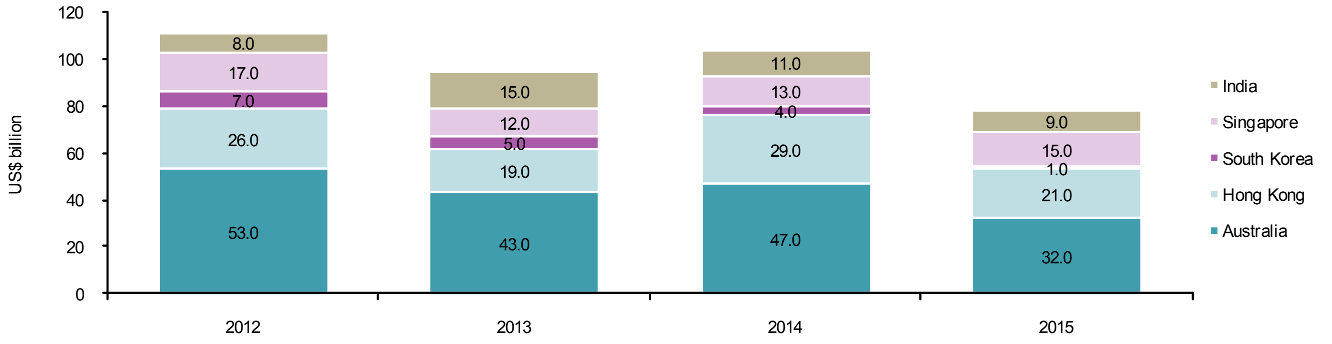
Taiwanese banks are also becoming more active, and are increasing lending in mainland China and Hong Kong. They often enjoy lower funding costs than the European banks, and often require lower returns than many of their Asian peers.

Chinese Policy Banks, Export Credit Agencies and the Big 4 commercial banks continue to be aggressive in cross-border financing, particularly where they can assist Chinese firms undertaking projects and supporting the Government's "going abroad" policies and objectives.

Refinancing

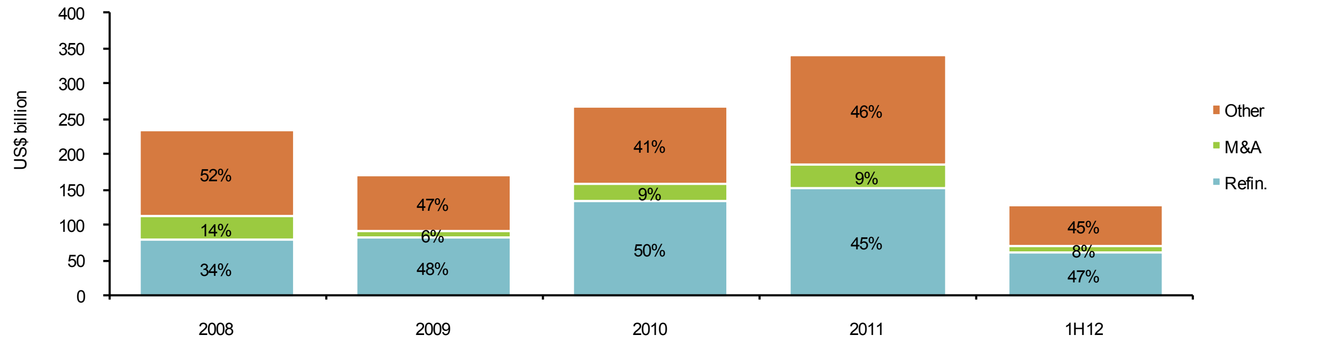
Refinancing continues to be a key driver of bank lending in the region, accounting for 47% of total bank loans issued in the first half of the year. There is a significant volume of bank debt to be refinanced over the next three years, which, when combined with the scarcity of capital, is likely to make it difficult for certain corporates to secure bank funding for new opportunities.

Figure 3: ASPAC refinancing needs 2012-2015



Source: LoanConnector

Figure 4: Refinancing largest generator of Asia Pacific loan volume



Source: LoanConnector

Cost of funds

> **While borrowers have successfully refinanced their loans, this has come at a price. Margins have been increasing as a result of tighter liquidity conditions and the rising cost of funds. As shown in the table below, a top-tier borrower such as the IFC offered a significantly higher all-in price of 176 bps for a three year deal to refinance part of its HK$ 17.3 billion facility maturing in March.**

Despite tighter liquidity and higher costs, capacity for M&A activity is still available, and we expect lending for this purpose to pick up in the second half. Several large transactions have recently been completed, including loans for Hong Kong Exchanges & Clearing Co Ltd's purchase of the London Metal Exchange in June (US$ 843 million one year financing agreed as a club deal with Deutsche Bank, HSBC and UBS, and a US$ 1.8 billion three year bilateral loan provided by China Development Bank), and facilities agreed by China's Bright Food Group Co Ltd to fund their acquisition of Weetabix (completion expected 2H). The market also reports that China National Offshore Oil Company will tap the international loan markets for their proposed C$15.1 billion bid for Calgary's Nexen Inc.

	2007	2012
Borrower	IFC Development Ltd	IFC Development Ltd
Loan amount	HK$ 17.35 billion	HK$ 10.0 billion
Price (all-in)	43 bps	176 bps
Tenor	5 years	3 years
Number of banks	33 banks	12 banks

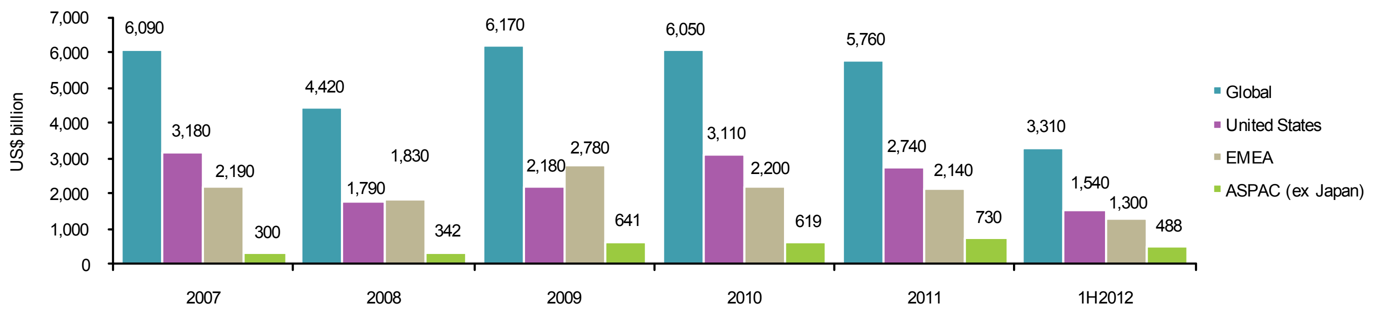
Source: Basis point

Bond markets

Global debt capital market volumes reached US$ 3.3 trillion equivalent in the first half of 2012; a four percent decrease compared to the same period in the previous year. The first half of 2011 accounted for 60 percent of the total issuance (US$ 3.44 trillion), while second half volumes dropped to US$ 2.31 trillion, the lowest half-year volume since the financial crisis in 2008.

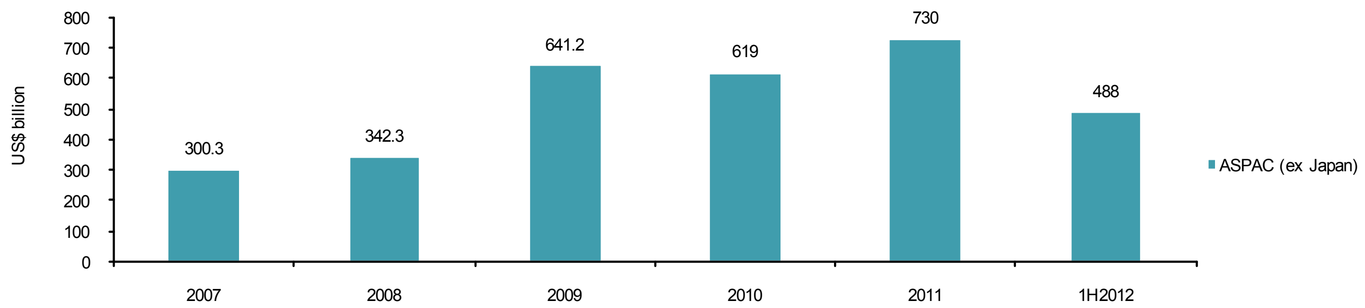
Having reached a record US$ 730 billion for the full year in 2011, ASPAC (ex Japan) Debt Capital Market (DCM) issuance was already at US$ 488 billion by the end of June 2012.

Figure 5: Global DCM volume (2007 to 1H2012)



Source: Dealogic

Figure 6: Asia Pacific (ex Japan) DCM new issuance volume (2007 to 1H2012)



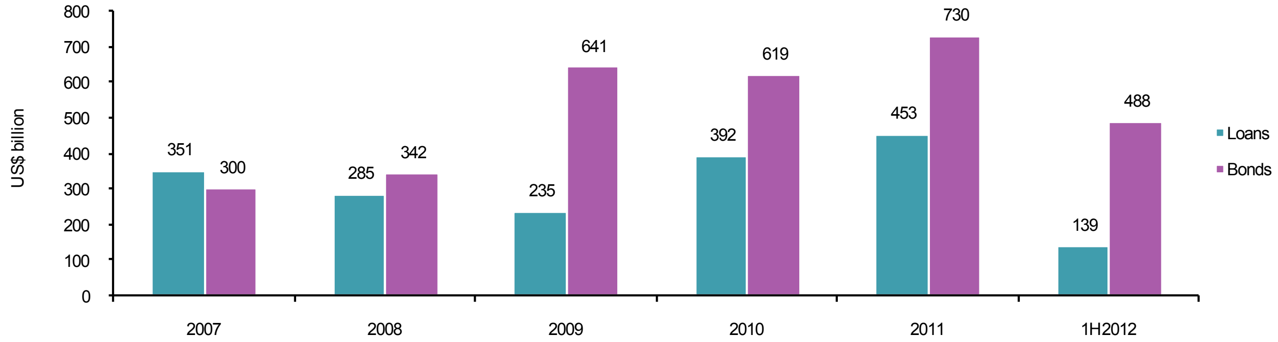
Source: Dealogic

Structural shift

Traditionally Asian corporates have relied on bank loans as their primary source of debt funding and access to the bond markets has been largely limited to governments and state-owned corporations.

The bond markets have now become a significant source of debt capital for investment grade companies across the ASPAC markets, where longer term financing can be achieved at more attractive rates than in the loan market. Bond markets are increasingly being viewed as a more reliable source of funding as liquidity problems, regulatory changes, and higher funding costs contribute to the volatility of bank lending. Figure 7 demonstrates the growing significance of bonds in the ASPAC debt new issuance markets.

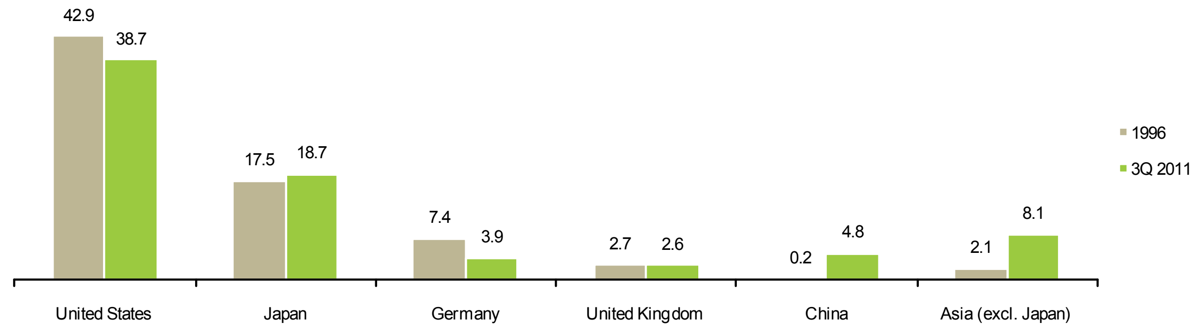
Figure 7: Volume of bank loans and bond new issuance in ASPAC



Source: Dealogic, Bloomberg

"Asia's share of global bond issuance has risen dramatically since the Asian debt crisis, reaching over 8 percent of total issuance at the end of the third quarter of 2011."

Figure 8: Share of all local currency bonds outstanding (%)



Source: Asia Bond Monitor

A growing number of entities have been tapping the "dim sum" bond market – RMB-denominated bonds issued outside China. Total issuance of dim sum bonds increased by 52% year-on-year in the first half of 2012, to RMB 67.2 billion[(1)]. Although Chinese policy banks and state-owned enterprises account for much of this volume, many international companies have also issued bonds to diversify their funding sources and meet growing demand for investments and trade settlements made in RMB.

This market has slowed in recent months as expectations for an appreciation of the RMB against the US dollar recede. This is likely to signal a temporary decrease in investor appetite for dim sum bonds. As yields continue to rise, issuers are increasingly finding cheaper debt funding alternatives in US dollars. Chinese government dim sum bonds are being sold at significantly higher yields. China's Ministry of Finance sold three-year bonds with a coupon of 1.85 percent in July, compared with 0.6 percent for a similar issuance in August last year.

Source: (1) Hong Kong Monetary Authority

Demand for Yen-denominated "samurai bonds" continues to hold with foreign companies raising JPY 1.22 trillion by the beginning of June – already the highest level in four years. With long-term interest rates below one percent, and yields the lowest for nine years, multinationals consider Japan as a stable place to raise funds. Korean companies are driving much of this growth having raised a record amount this quarter.

Conclusion

One result of the tight credit environment has been a steady growth in diversification of the sources of funding as participants explore non-traditional sources of debt and investors aggressively seek new opportunities in the credit markets. We believe that this is a trend that will continue in the medium term and activity will increase in a number of markets, particularly:

Local currency bond markets

As already mentioned, the regional bond markets are becoming a significant source of debt across the region. Investor appetite is generally limited to high quality, medium to large issuers, requiring a high credit rating (i.e. better than BBB+). Much of this development has been for government or quasi government issuers; however the growth in private corporate and financial institutional borrowers is strong and we expect this to be a dominant trend in the medium term.

“Alternative” credit market

There has been an increasing trend of the establishment or expansion of fixed income focused funds. Private equity houses are paying increasing attention to non-traditional transactions as they face pressure to allocate capital raised in recent years. As spreads in the credit markets have widened the lending capacity in the non-bank market continues to increase with funds seeking diversification and absolute yield.

Export credit agencies (ECA)

ECA financing has become an important source of liquidity for corporates; a trend that we expect to continue to gain pace throughout 2012 and beyond. Businesses with high capital intensity or new technology have been increasingly focused on raising funds through this route. The region has a number of the most active export credit agencies; China Export & Credit Insurance Corp, Export Import Bank of China, Korean Eximbank and Japan Bank for International Corporation (JBIC) and Nippon Export and Investment Insurance (NEXI) in Japan are all increasing their activities in the market and offering more and more market driven products.

Multilateral agencies and Development Banks

Multilateral agencies such as the International Finance Corporation, the Asian Development Bank, Korean Development Bank and the China Development Bank (CDB) have been participating in deals in developing markets and/or member countries to encourage or facilitate other banks (local and international) to join transactions. Multilateral agencies have traditionally tended to prefer funding discrete projects, but have recently been active participants in more general corporate financing, and the CDB has already pledged US$ 5 billion to seven ASPAC loans outside China this year.

Vendor financing

We have seen some small to medium-sized Asian corporates looking to raise expansion and/or working capital funding from their existing international vendors. This is as a result of the reduced lending capacity in the traditional loan markets, coupled with specific business development strategies of both parties.

In conclusion, we expect syndicated lending to remain subdued throughout the remainder of 2012 and into the first quarter of 2013 due to restrictions on bank liquidity, a refinancing bottleneck, and increased costs of funds. We do not anticipate a sudden change to these three fundamentals in the short to medium term, principally as a result of global economic uncertainty and the ongoing introduction of broad regulatory changes in the bank market.

Moreover, as we have outlined here, ASPAC corporates are already discovering new approaches to funding their growth and can take heart from the increasing depth of the region’s bond markets as well the potential options provided by alternative investment sources such as private equity, credit funds, and export credit agencies. If and when the conditions for more traditional syndicated lending eventually rebound, they will do so in a different, and in some ways much more dynamic lending environment.

Appendix 1:

Comparative loan pricing across ASPAC

Hong Kong – BBB-rated property developer (China State owned)		
Date	Oct 2007	Jun 2012
Loan amount	HK$3,000m (US$387m)	HK$3,000m (US$387m)
Price	HIBOR+34bps	HIBOR+210bps
Tenor (years)	5	3

Malaysia – State-owned investment holding company		
Date	Mar 2009	Mar 2012
Loan amount	US$500m	US$400m
Price	All-in 200bps	All-in 125bps
Tenor (years)	3	3

Singapore – Hotel business of property development firm		
Date	Sep 2007	Jan 2012
Loan amount	S$270m (US$179m)	S$180m (US$139m)
Price	All-in 85bps	All-in 150bps
Tenor (years)	2.5	3.25

Philippines – BBB-rated telecoms operator		
Date	Jan 2008	Mar 2012
Loan amount	US$100m	US$150m
Price	LIBOR+42bps	LIBOR+200bps
Tenor (years)	5	5

Australia – listed infrastructure services company			
Date	Jul 2007	Dec 2010	Feb 2012
Loan amount	A$250m (US$215m)	A$150m (US$149m)	A$250m (US$258m)
Price	BBSY+70bps	BBSY+230bps	BBSY+270bps
Tenor (years)	3	2	4

Taiwan – listed automobile parts manufacturer and distributor			
Date	Apr 2007	Nov 2009	Mar 2012
Loan amount	NT$350 (US$11m)	NT$1,650 (US$51m)	NT$1,250 (US$43m)
Price	All-in 120bps	All-in 210bps	All-in 185bps
Tenor (years)	5	5	5

Japan – BBB-rated listed conglomerate		
Date	Mar 2008	Feb 2012
Loan amount	US$500m	US$515m
Price	¥Libor+35bps	¥Libor+50bps
Tenor (years)	1	1

South Korea – BBB+-rated major consumer finance company		
Date	Apr 2008	Feb 2012
Loan amount	US$155m	US$100m
Price	LIBOR+130bps	LIBOR+170bps
Tenor (years)	3	3

Indonesia – listed coal mining group		
Date	Jul 2008	Apr 2012
Loan amount	US$150m	US$600m
Price	LIBOR+230bps	LIBOR+385bps
Tenor (years)	5	5

New Zealand – BBB-rated forestry products company		
Date	Dec 2006	Sep 2011
Loan amount	NZ$200m	NZ$405m
Price	All-in 200bps	All-in 400bps
Tenor (years)	5	5

Australia – listed manufacturing services company			
Date	Oct 2007	Jul 2011	Jun 2012
Loan amount	US$165m	US$315m	US$200m
Price	LIBOR+70bps	LIBOR+185bps	LIBOR+285bps
Tenor (years)	3	3	3

Source: LoanConnector

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