Opportunities in the Australian bond market

Paul Umbrazunas of Deutsche Bank look at the decline of traditional fixed-interest securities and ask what it means for Australian dollar bond portfolios.

Much has been made of the continued supply/demand dynamics in the AUD bond markets and what this will mean for the growth of spread product in AUD bond portfolios. The broad analysis revolves around the decreasing supply of the more 'traditional' forms of fixed-interest securities, such as commonwealth government securities (CGS) and semi-government bonds, due to asset sales and general fiscal controls, while inflow of cash to fund managers continues to rise due to compulsory superannuation legislation. A necessary corollary to this is the demise of traditional fixed-interest securities as a significant proportion of total bond portfolios and what forms of instruments will replace them.

There is little doubt that fundamental shifts in investment philosophy are happening. Our forecast, set out in *Figure 1*, assumes only modest growth in the total market (5%) of wholesale funds allocated to fixed-interest product. However, we would not be surprised to see growth of 7.5–10%. The issue thus becomes to what extent the newer forms of investments (such as kangaroo and corporate bonds) complement and replace core holdings of CGS and semi-government bonds.

Overall, investors will have to maintain a core holding of liquid 'gilt-edged' bonds as part of their total allocation process and, to a lesser extent, allow for duration plays (for domestic investors) and currency plays (for international investors). Further portfolio enhancements are then likely to be sought through the purchase of a range of higher creditworthy borrowers with the ability to issue in large volumes, allowing the process to continue, and obtaining a straight yield pick-up for the additional credit and liquidity risks from a 'typical' corporate bond issue.

The diversity of issuer will be a key factor in mitigating credit risks for a portfolio. It is unlikely that domestic Australian corporate issuance alone will be sufficient to provide either the outright level or diversity of debt product required. As a result, we see significant opportunities for offshore borrowers to provide the balance of any shortfall.

FIGURE 1

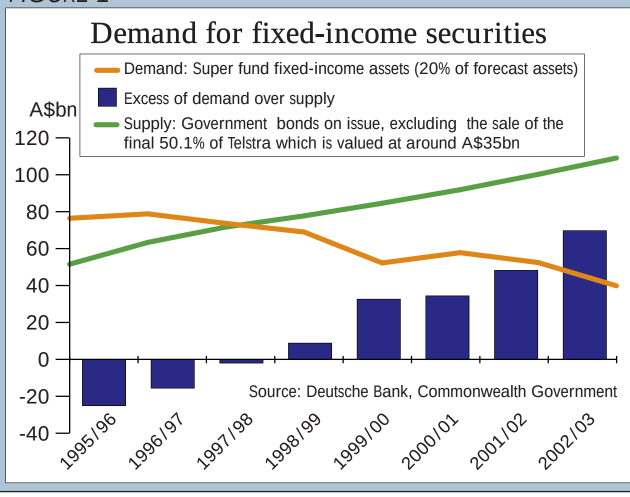

Figure 2 estimates the overall re-weighting process for fixed-interest portfolios towards corporate and non-Australian issuers. (*Other includes domestically issued corporate and kangaroo bonds and international bonds.)

The degree to which the AUD credit market has grown is given in *Figure 3*. Excluding private placements and asset-backed securities, issuance in spread product totalled AUD 5bn in 1998; and just under AUD 13bn for the first six months of 1999.

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Issuer composition

The other significant factor is the acceptance of a wider variety of credits.

Figure 4 shows the composition of issuers by type and by rating in the AUD market from 1 January to 31 July 1999. The current average weighting of fixed-interest portfolios to credit product in Australia is slightly below 14%. At present, the majority of investors have a rating 'floor' of A-. However, investors have recently been moving further down the credit curve with a number of 'BBB' type issues launched this year. Furthermore, investors are pursuing amendments to trust deeds to allow greater flexibility in the purchase of a wider range of fixed-interest assets.

The AUD interest rate and cross-currency swaps market is very liquid for maturities out to 10 years. This is significant to issuers who do not have AUD assets to fund and have another base currency. The bid/offer spread is three basis points and one can usually transact $300m–400m either side of this spread.

Regulatory/compliance framework

The overall regulatory and compliance framework in Australia is a very straightforward procedure. The principal legal

FIGURE 2

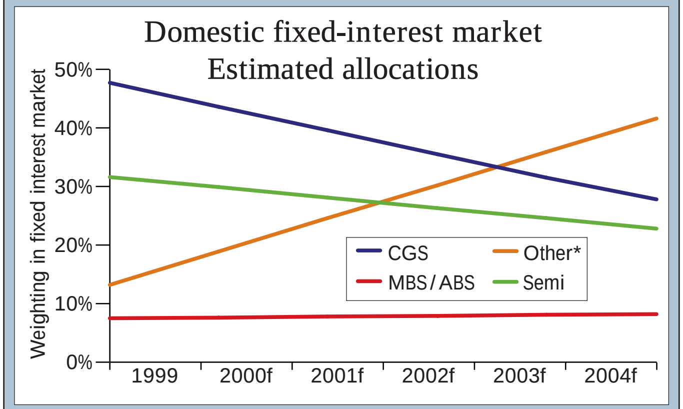
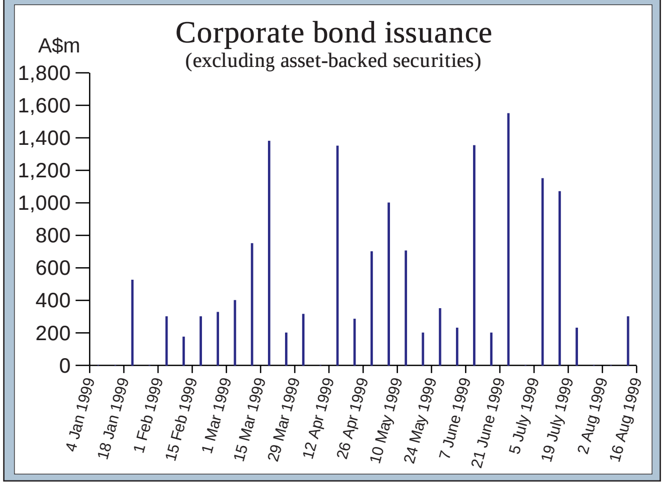


FIGURE 3



issues revolve around aspects of the following areas:

- securities law;
- tax;
- stamp duty; and
- disclosure (trade practices).

Overall, issues of securities are regulated by the Corporations Law. Generally, issuers will undertake an 'excluded issue' one category of which requires that securities are bought and sold for a minimum of AUD 500,000. As a result of compliance with this provision the issuer will not be required to lodge and register a full prospectus with the Australian Securities and Investments Commission.

The applicability of withholding tax and interest deductibility (or otherwise) will depend on the status of the issuer and if it has a 'permanent establishment' in Australia. Securities must be registered, so issues of withholding tax (from jurisdiction of the borrower) to ensure interest payments are received gross to Australia, must also be addressed. Stamp duty considerations can be resolved via appropriate (standard) structuring of issue documentation.

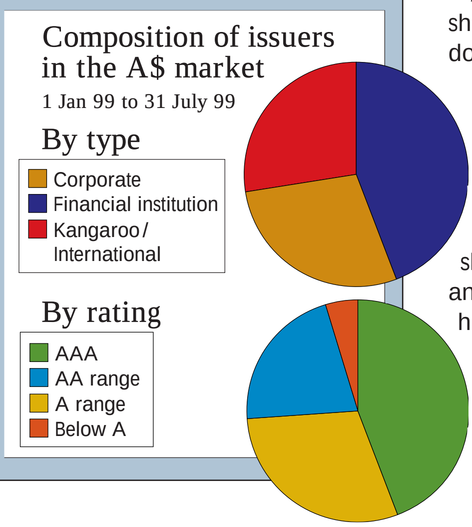
Disclosure requirements revolve around elements of the Corporations Law and Trade Practices provisions. As a general rule, the level of disclosure undertaken for public issues in the eurobond market will suffice. The information memorandum must confirm that the information is not misleading and that any material aspects of the issuer and its financial position have not been omitted.

The package of documentation will again reflect those of international capital markets and will comprise:

- note deed poll;
- offering circular/ information memorandum;
- subscription agreement; and
- registry services agreement.

A timetable of five to seven weeks should be allowed for completion of documentation.

FIGURE 4



Approaching the market

How important is it to undertake a roadshow in Australia? In general it is strongly advisable to meet the investment community in Australia should time allow. The growing need and use of credit product in portfolios has led to a greater use of credit analysis and greater input from analysts into the overall investment decision. By using a roadshow, investors will participate directly in their own due diligence process and establish lines of credit for the borrower in question. Thus, when an issue is launched, the question becomes one of pricing and relative value, rather than of the credit process itself. A relative value analysis of the issuer involves a comparison with outstanding AUD bonds of a borrower's peer group and an evaluation of where the borrower's bonds trade in other currencies and markets relative to the proposed issue.

The way forward

The re-weighting of fixed-interest portfolios and the excess liquidity of funds under management will create opportunities for borrowers to diversify their investor base into Australia. We see this expansion as comprising of two groups as follows:

1. those highly rated borrowers that can issue larger, more liquid volumes to act as a surrogate for the reduction in more traditional investments; and
2. investment-grade corporates that will allow a greater degree of diversification to reduce credit volatilities.

Investors will thus have at their disposal a greater number of liquid asset classes and a wider universe from which to implement portfolio strategies. The increased willingness of AUD investors to re-weight portfolios should thus provide a more stable platform from which international borrowers can achieve an alternative source of funds at levels comparable to other international capital markets. ■

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