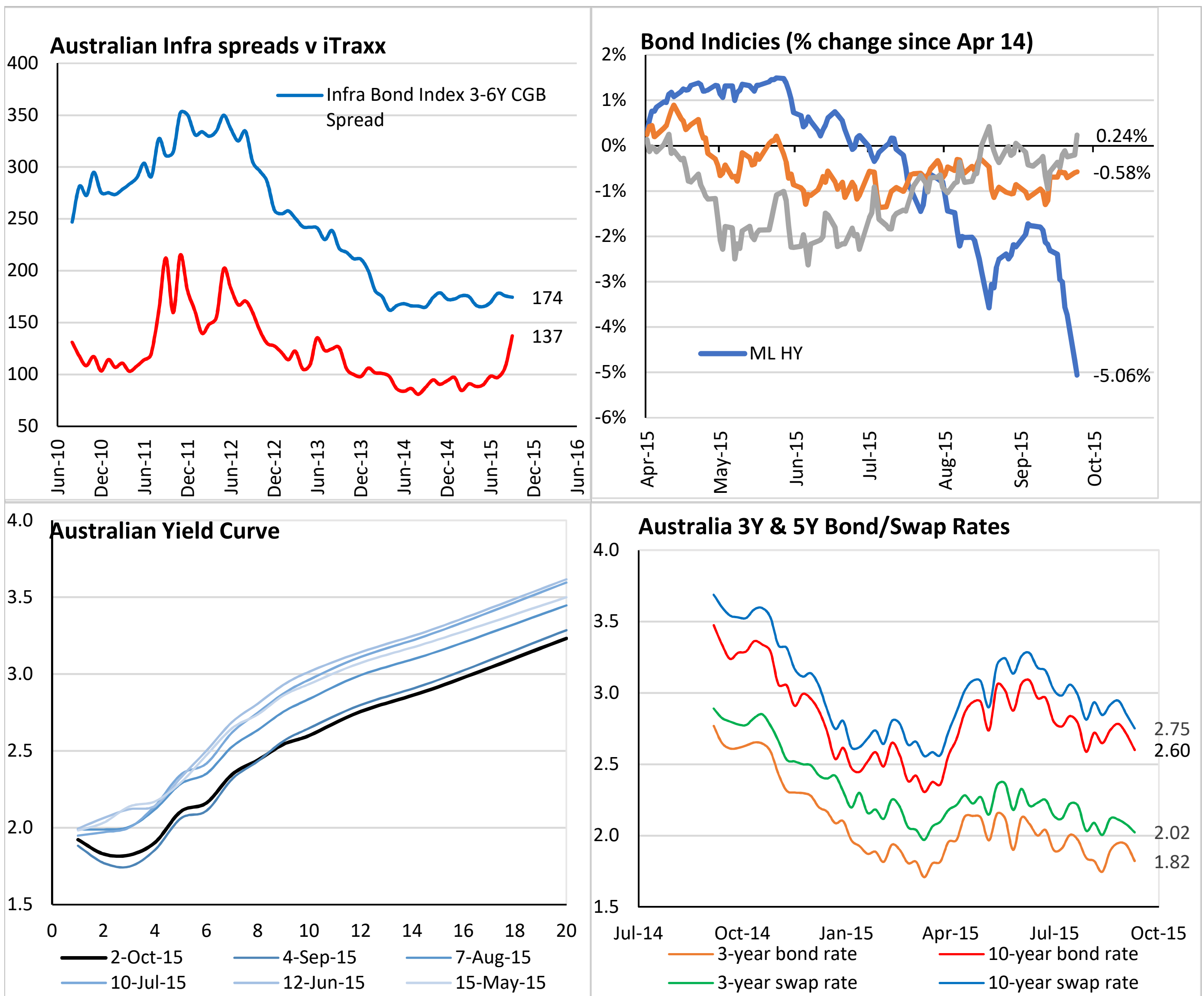
Introduction

The past three months have seen a sharp shift in credit market conditions – with spreads moving wider in most markets on concerns about the economic outlook. In addition, to our regular features on market conditions and infrastructure transactions – the articles in this quarter's newsletter looks at developments in the ports sector, the predictive capacity of credit spreads, and China's progress on rebalancing its economy.

Markets update

Market volatility has increased significantly over the past quarter. Deteriorating data releases from China have spooked markets. In credit, there have been significant moves in Credit Default Swap (CDS) indices, particularly high yield. In the last week of September, the European iTraxx Main CDS Index delivered four days of price movements in the range of 1.9-2.4 standard deviations, which resulted in the biggest one week movement in CDS pricing since May 2010.



New issuance and refinancing

The table below provides a list of publicly available deals.

Date	Borrower	Instrument	Size (m)	Term (Yrs)	Curr.	Pricing
September	Powerco	Bond	150	7	NZD	140
September	Melbourne airport	Bond	250	7	AUD	137
September	Brookfield	Loan	950/950	3/5	AUD	?/450
July	DBNGP	Bond	55	8	AUD	200
September	Sydney Convention Centre	Loan	1,200	7	AUD	From 260 to low 100s
August	Crown Castle	Loan	238/508	3/5	AUD	150/200
August	Macarthur Wind Farm	Loan		4/6	AUD	120/150
July	Transurban Queensland	USPP	155/ 230/ 256/A$70	10/12/ 15/15	USD/ AUD	175/185/ 200/210
September	Sunshine Coast University Hospital PPP	Loan	510	4	AUD	
August	Darling Harbour Live PPP	Loan	1386	5	AUD	120
September	Energy Developments	Loan	530	5	AUD	150
August	Toowoomba Second Range Crossing	Loan	400	5	AUD	
August	Hornsdale Wind Farm	Loan	195	20	AUD	
August	North Queensland Gas Pipeline	Loan	115	7	AUD	
July	Tasmanian Gas Pipeline	Loan	92	5	AUD	
July	APA	Loan	311/311/207	2/3/5	AUD	
July	Mundaring Water Treatment Plant PPP	Loan	265	5	AUD	160

July	Millmerran Power Station	Loan	230/230/230	3/5/7	AUD	
July	Perth Airport	Loan	100/450	4/5	AUD	
August	United Energy	USPP	100/74/A$42	7/10/10	USD/ AUD	145/150/160
August	Melbourne Train Station (Southern Cross)	USPP	202	17/11 w. avg	USD	120
August	West Australian Schools PPP	Loan	340	7	AUD	

Equity and other news

- AMP Capital and Infrastructure Capital Group have acquired the Port Hedland international airport 50-year lease for $205m. It provides for a $165m upfront payment and a $40m mandatory capital works program over the next five years.
- Brookfield Infrastructure is offering to buy Asciano for an enterprise value of circa $12b. The offer comprises $6.94 per share in cash and 0.0387 in BIP share units. Asciano is to pay a special dividend of up to 90c per share if the deal proceeds, and Brookfield will seek listing on the ASX. The deal has the unanimous support of the Asciano board. Shareholder approval will be sought at a meeting in mid-November along with ACCC approval.
- Qantas and Sydney Airport have reached agreement on the Terminal 3 lease, which reverted to Sydney Airport on 1 September 2015. Qantas received $535m and will recognise a gain on sale of $210m. Qantas will retain exclusive use of the terminal until 2019 and will now incur a per-passenger charge rather than make a fixed payment.
- BrisConnections lenders have agreed to start the sales process on the $1.3b+ AirportLinkM7 toll road. Indicative bids are expected to be received by early September, and completion is expected by early 2016. BrisConnections went into receivership in 2013 with $3.6b of debt due to traffic being significantly below pre-construction forecasts.
- Macquarie, UBS and Unisuper have acquired Crown Castle for $2b. Crown Castle Australia owns 1,700+ wireless towers backed by contracts with Australia's largest telecom companies (Singtel Optus, Telstra and Vodafone) to provide wireless communications coverage for the vast majority of mobile device users in the country.
- Transurban has acquired the remaining 25% interest in DRIVe from CP2 for $145m. DRIVe holds investments in 95 Express Lanes and 495 Express Lanes in Northern Virginia, United States.
- Bidders for Victoria's High Capacity Metro Train PPP project are waiting for the government to announce a shortlist ahead of the release of the request for proposals in November. The $1.3bn project encapsulates the finance, design, supply and maintenance of 37 new trains for Melbourne's Cranbourne-Pakenham line. It is expected that final bids will be due April 2016, financial close will be in November 2016, with expected first delivery in late 2018. The government has stipulated that at least 50% of the project must be constructed locally to boost Victoria's flagging manufacturing sector.
- The Macquarie consortium has been named preferred bidder in the $370m West Australian Schools PPP. The contract is expected to be signed by the end of September with construction to start in October. The consortium's other partners are Badge Constructions, Perkins and Spotless Facility Services. The project represents the first set of schools to be built under a PPP in Western Australia.
- AGL Energy Ltd has sold a 50% stake in the 420MW Macarthur project to H.R.L Morrison & Co for A$532m – equivalent to the book value of the asset. The acquisition is backed by stapled financing with four and six year

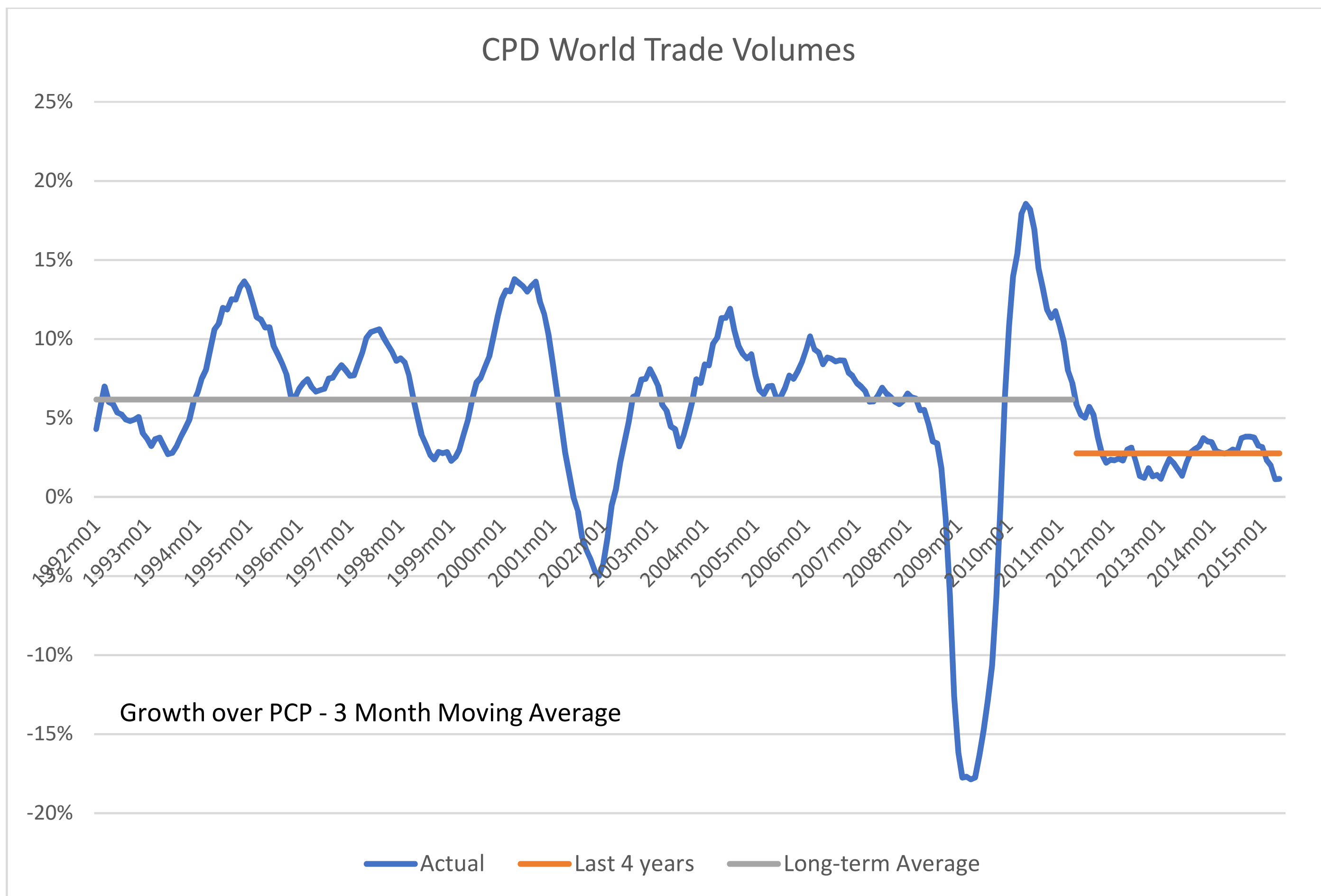
tenors. The other 50% stake in the wind farm is held by Malaysia's Malakoff International Ltd, which acquired the interest from New Zealand's Meridian Energy Ltd for A$650m in 2013. AGL will retain its role as operator and offtaker of the power and renewable energy certificates.

- Palisade has acquired 100% of the North Queensland Gas Pipeline from VFMC. The 391km pipeline transports gas from the Moranbah Gas Project in the Bowen Basin to power and industrial users in Townsville.
- DUET has acquired Energy Developments Group for $1.4bn which includes a cornerstone stake owned by Pacific Equity Partners.
- Infigen has sold its US wind portfolio for US$272.5M to reduce debt and pave the way for refinancing its core debt facility. US$186.3m from the sale will go towards repaying 25% of the outstanding loan, with the remainder used to close out interest rate swaps and pay for transaction costs.

Hard to port!

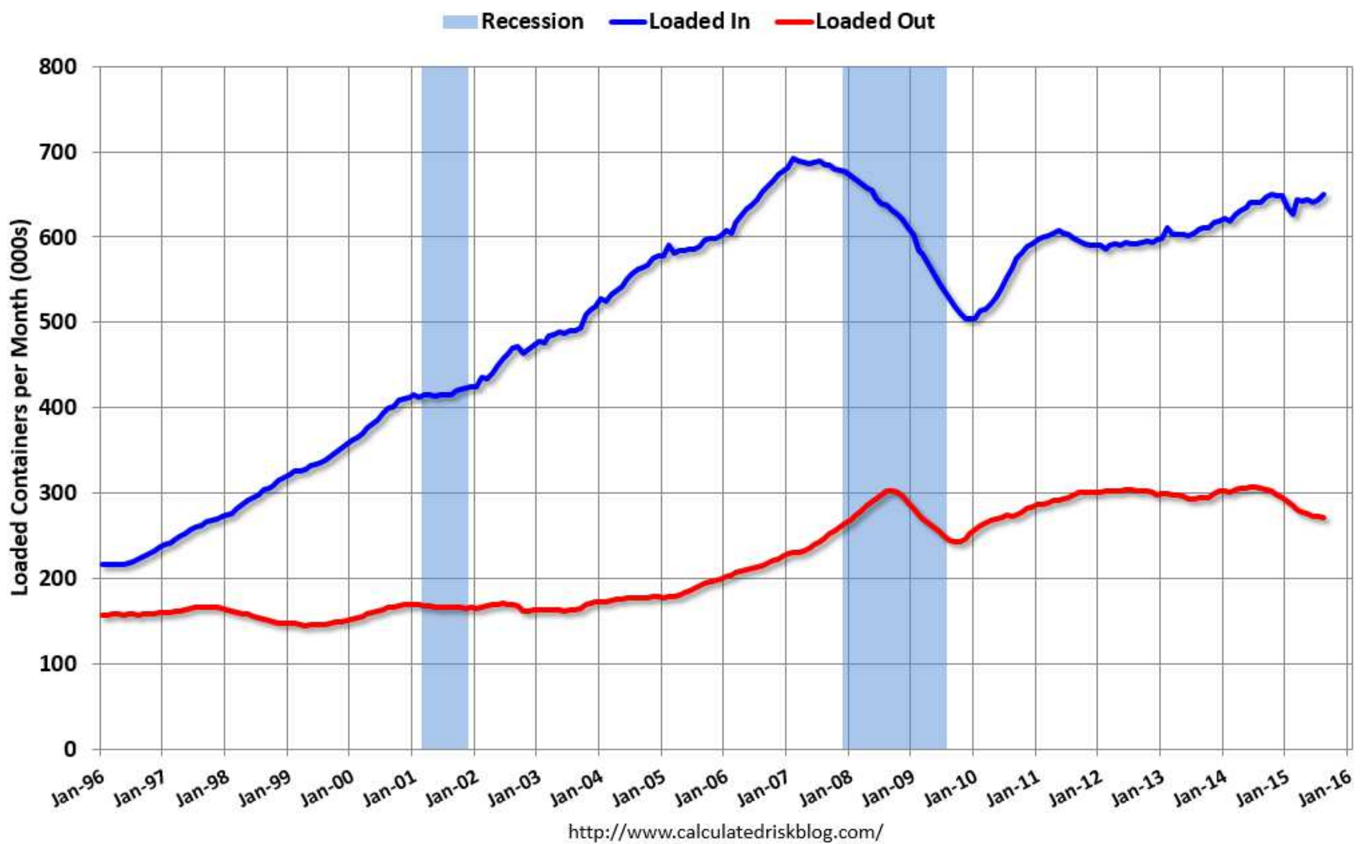
While much has been written about how the recovery from the GFC has been disappointing compared to past post-recession recoveries, one aspect that is worth considering is global trade growth and its impact on port assets. Australian ports are a topical infrastructure investment – both from the perspective of existing holdings of privatised assets (Port Botany, Port of Brisbane, Port Kembla and Flinders Ports) but also with the forthcoming privatisation of Port of Melbourne.

Ports are toll roads for sea freight. Operational cash flows are driven by growth in trade volume, changes in port charges and capital expenditure. The chart below shows the CPD index of the growth in global trade volumes since the early 1990s. The impact of past recessions is highly visible – with sharp falls in trade volumes. However, what is also clear, is that the recovery from the GFC has been unusually weak. Global trade has grown at less than 3% per annum over the last four years, compared with a more than 6% growth rate over the long-term.

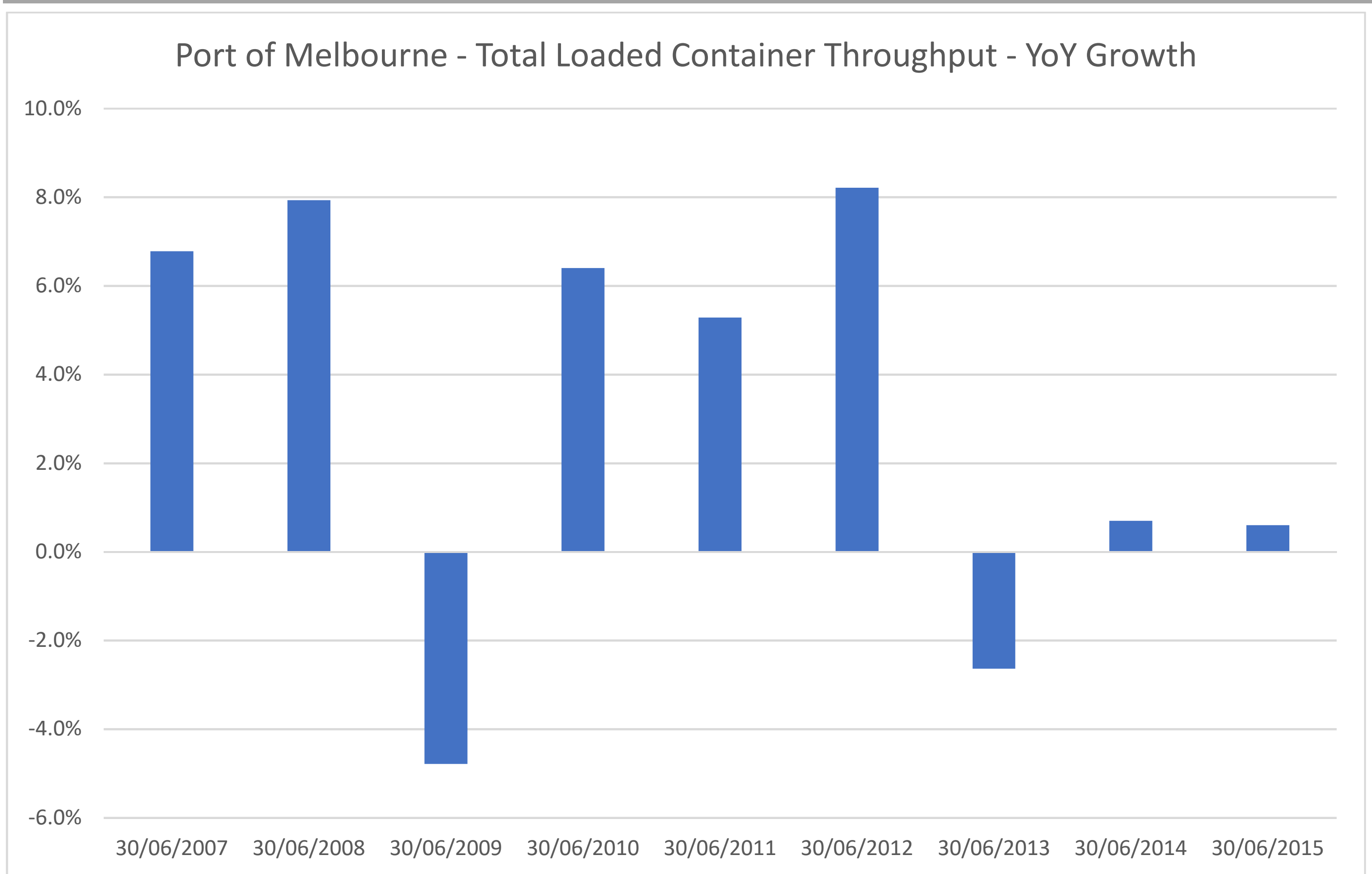


The CPD index focuses on global trade, that is, the average across developed and developing economies. However, the experience of individual ports around this central, albeit pretty anaemic, trend will be driven by port specific factors. Two of these factors are import/export shares and exchange rate trends. For ports dominated by imports, growth in imports will tend to pick up when the exchange rate is strong (as a strong exchange rate makes imports cheaper) and conversely when the exchange rate is weak.

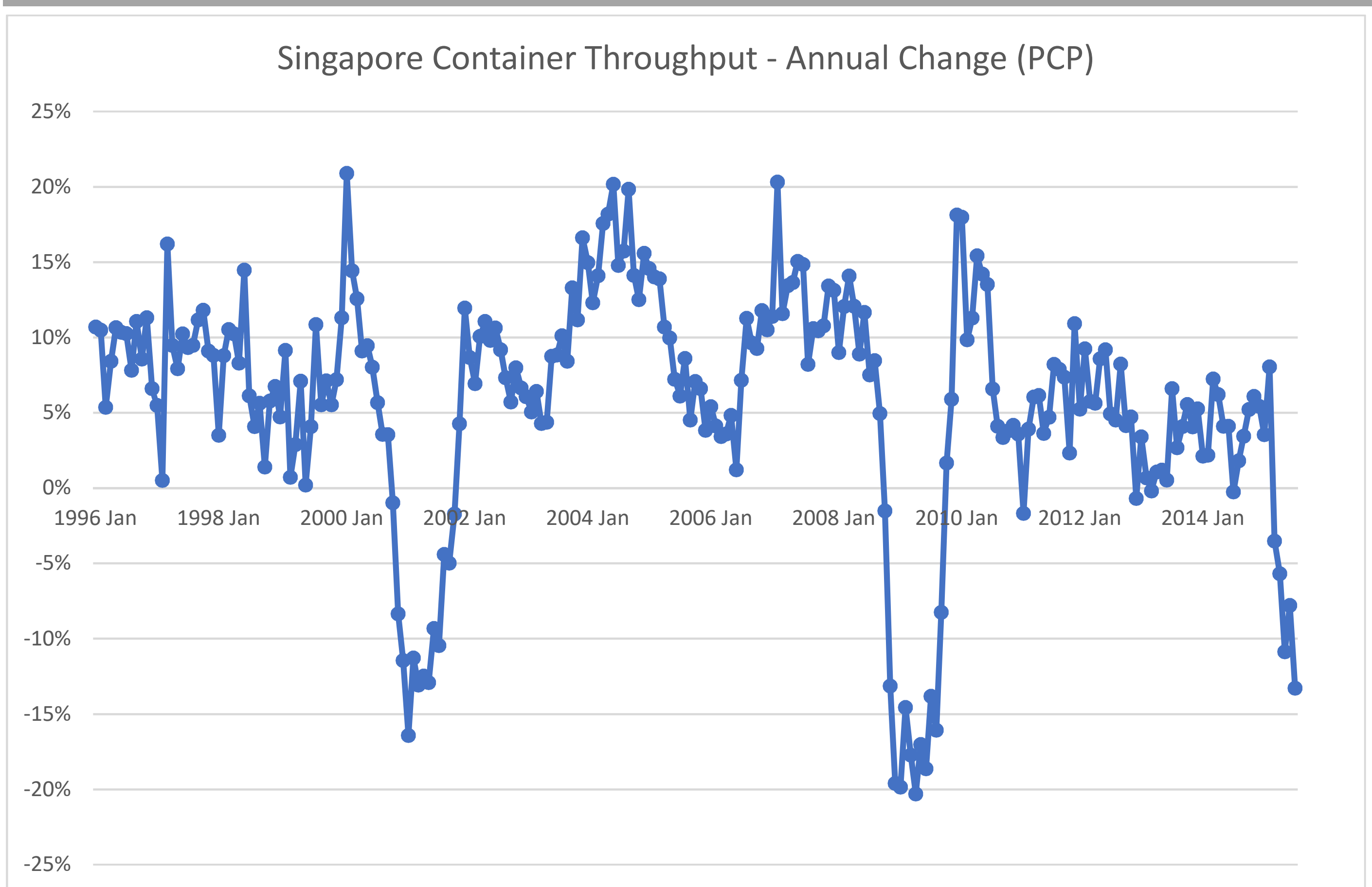
As an example of this, the chart below shows container volumes through Los Angeles and Longbeach ports. The US dollar has been strong over the past year and that is translating into increased import volumes. Given that imported full containers are roughly double exported full containers for Los Angeles and Longbeach – this means these ports are net winners from the strength of the US dollar.



But what about Australia? In Australia, where the main container ports are also import dominated, the currency effect will run the other way. The decline in the Australian dollar makes imports more expensive and we would expect this to reduce import growth (or even lead to declines). The chart below shows volumes through Port of Melbourne on a financial year basis.



Container volumes at the Port of Brisbane are similar – with full container throughput up only 1.4% for the 2015 financial year. More concerning is the short term – with the month of July showing an 8.5% fall relative to the previous year. Finally, if you want to scare yourself, see the chart below of volumes through Singapore – the pre-eminent hub for container trade in our region!



Credit – canary in the coal mine?

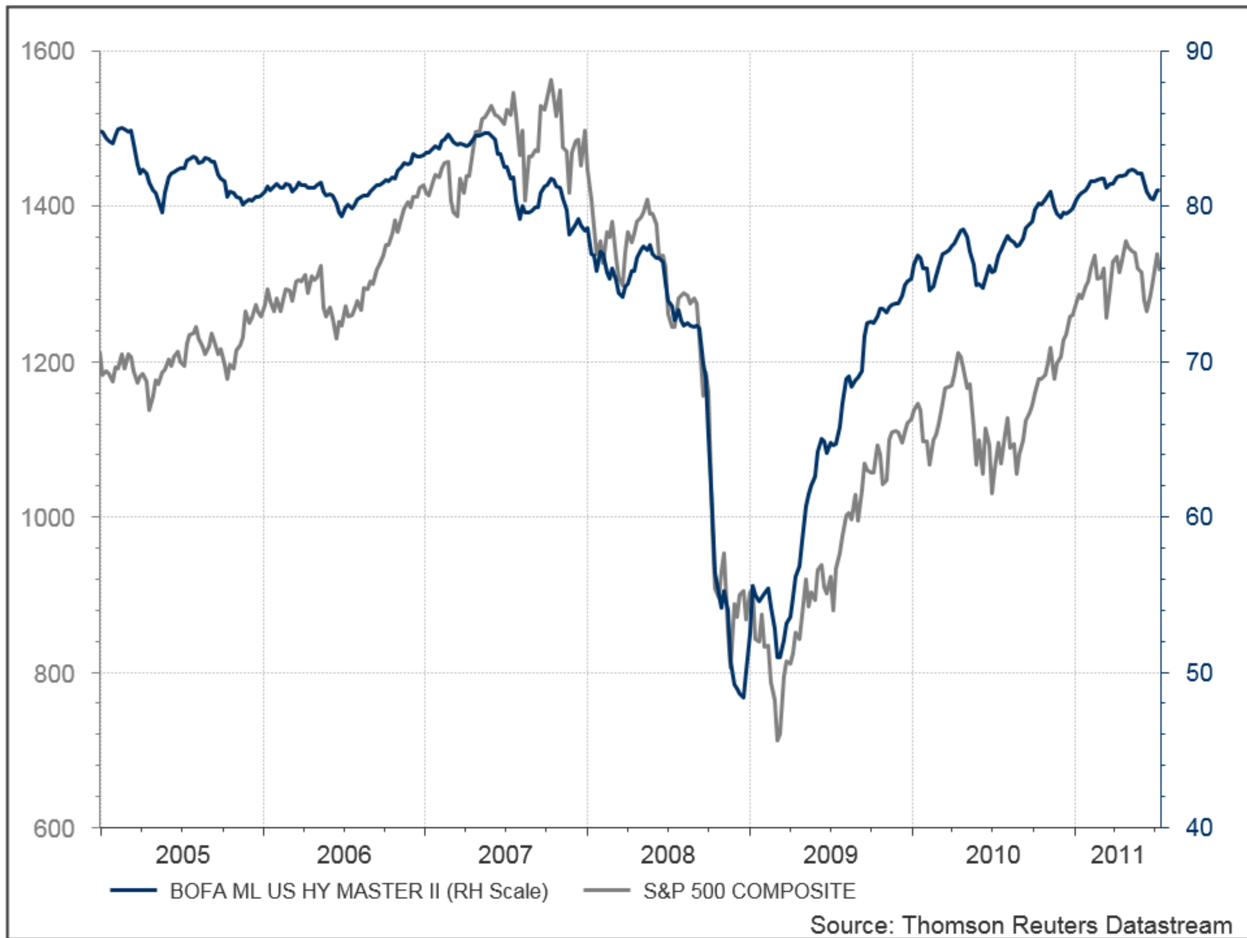
As an infrastructure debt fund manager (and former infrastructure equity fund manager) we like to think, on average, that credit investors are smarter than equity investors. While some of this is pure self-interest, credit markets do have a track record of moving before broader equity market downturns. Perhaps this is due to the focus on downside risk of credit investors.

For example, the high yield market peaked in the second half of 1998 and deteriorated steadily through 1999, well ahead of the dot com market peak in March 2000.

Technology bubble (2000)

Ahead of the GFC, credit markets suffered significant deterioration in the second quarter of 2007 (starting with ABS and then spreading to broader credit markets). This was ahead of the peak in equities in October 2007, and certainly well ahead of the worst of the equity market falls in 2008.

GFC (2009)



More recently – high yield bond markets clearly peaked at the end of 2014 – coincident with the collapse in oil prices and its implications for the energy sector (which accounted for 20% of the market at the time). Credit markets have continued to deteriorate over the course of 2015 – with both high yield and investment grade spreads moving steadily wider.

2015 Black Monday

Are credit markets trying to tell us something about the current cycle? Asset prices have benefitted from unprecedented central bank stimulus with valuations at the high end compared to history. The underlying economic growth that has been generated post the 2009 financial has been relatively weak. In this context, the devaluation of the RMB by China is a potentially critical development, as a signal that its capacity to drive global growth has reached an inflection point.

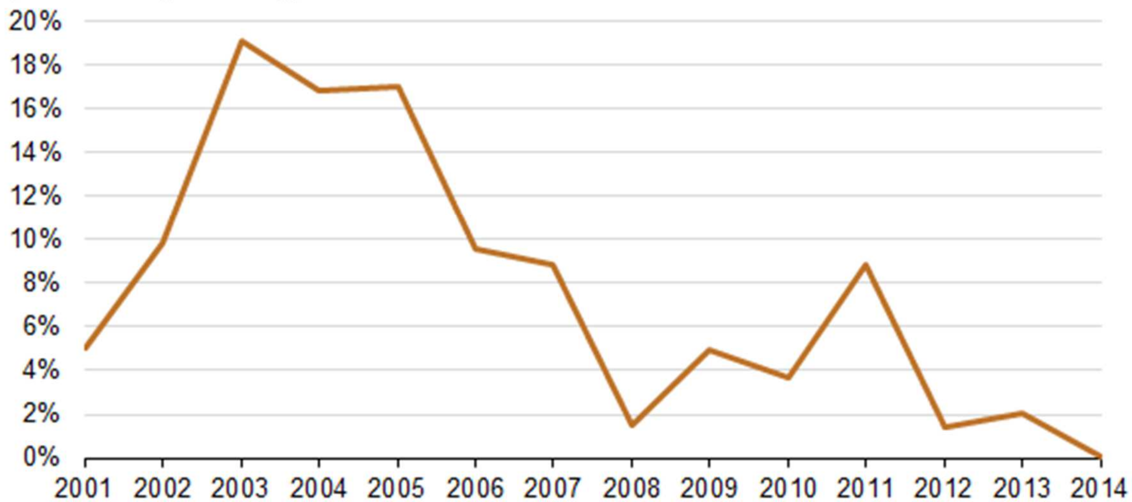
We believe investors should be keeping a close eye on credit market indicators along with the traditional equity metrics. Time will tell whether the most recent equity market ructions are a short-term correction or something more serious, but Infradebt has been, and continues to be, defensively positioned.

China rebalancing?

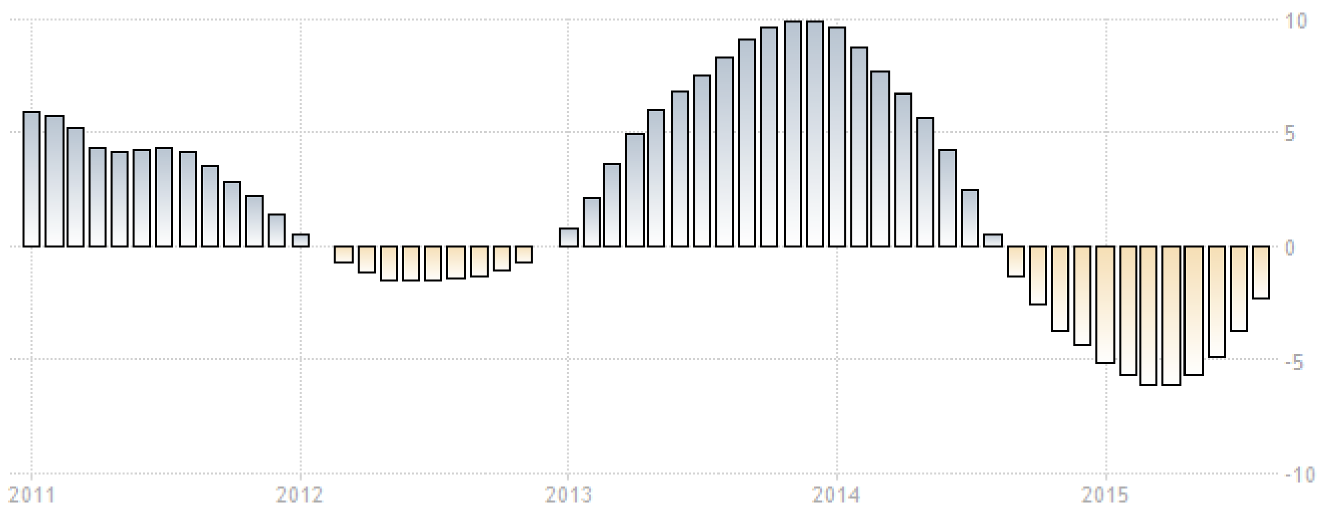
China has stated ambitions of moving away from an investment and export driven growth model to one driven by consumption and the services sector. The data suggests that industrial and construction activity is falling at a moderate pace. Key industrial commodities of coal, aluminium and steel are now trading at multi year lows. Industrial profits also remain under significant pressure.

The only near term hope for these sectors, dominated by excess capacity and fading demand, is the US$1.1 trillion "silk road" project – which could provide material government funded stimulus.

Coal consumption growth appears to have peaked in China. Given the significant social unease around air quality and pollution in China's cities, the Government is pushing for a transition to renewable energy. For those watching China, there appears to be an improvement in Beijing air quality over the past year.

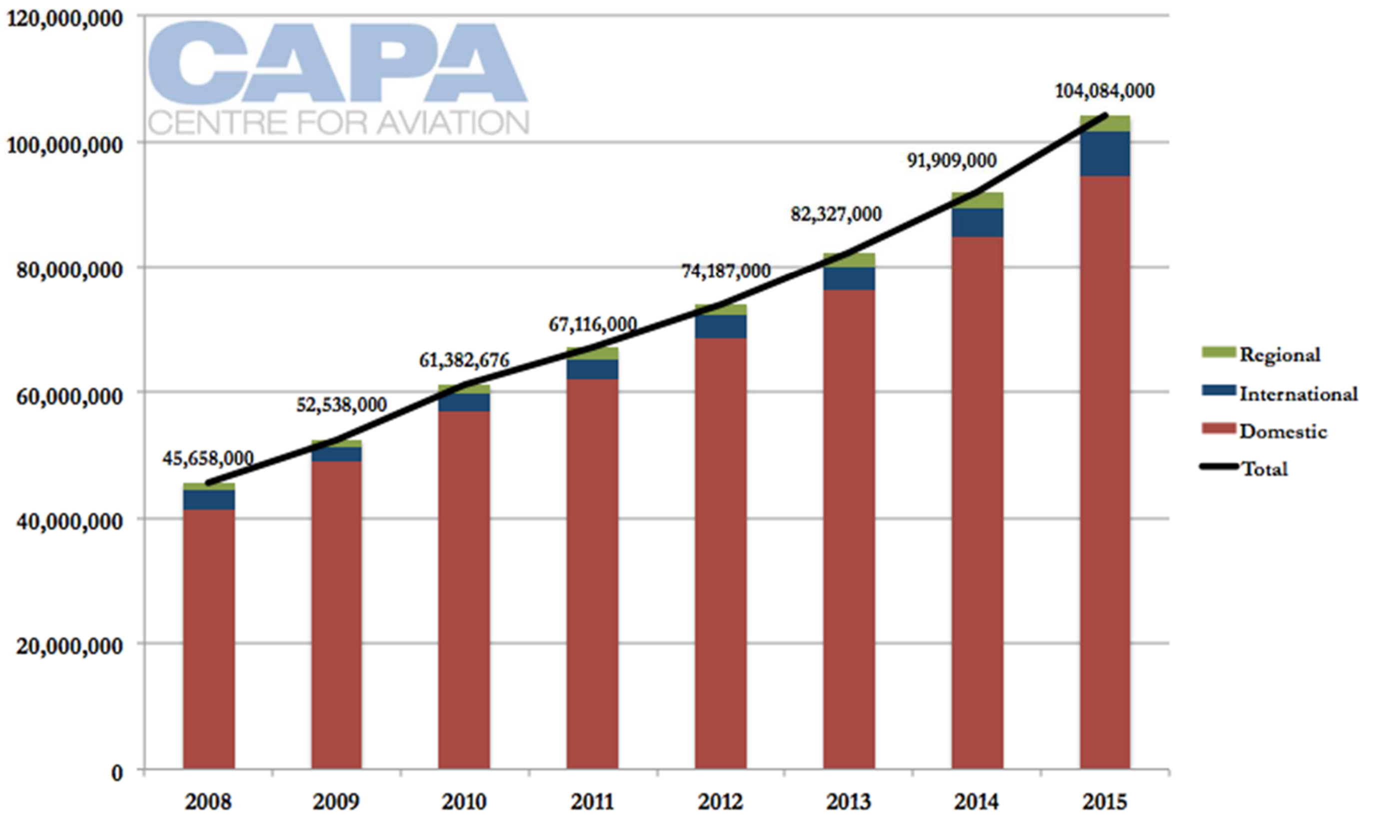


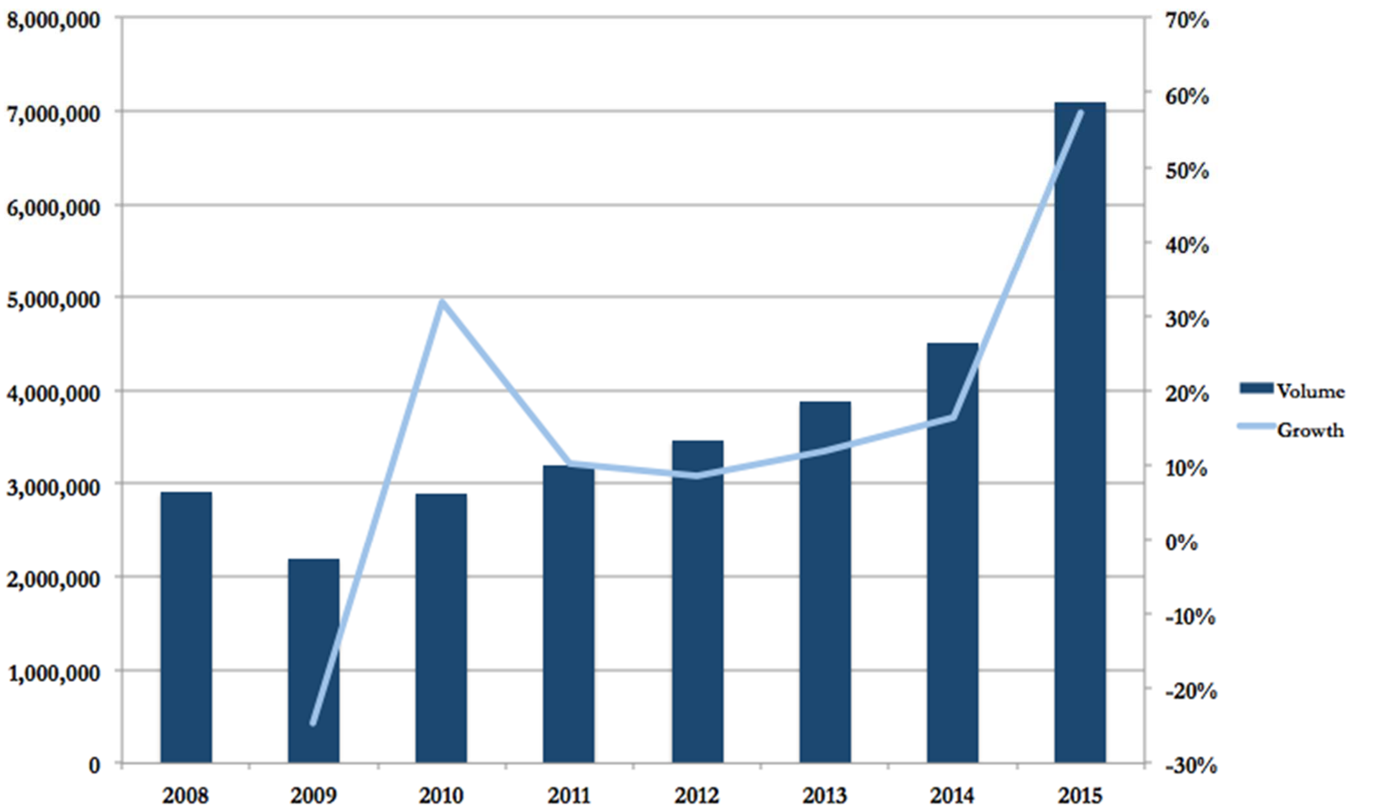
The housing bear market that started mid 2014 also appears to be slowing.



Are Chinese consumers picking up the slack?

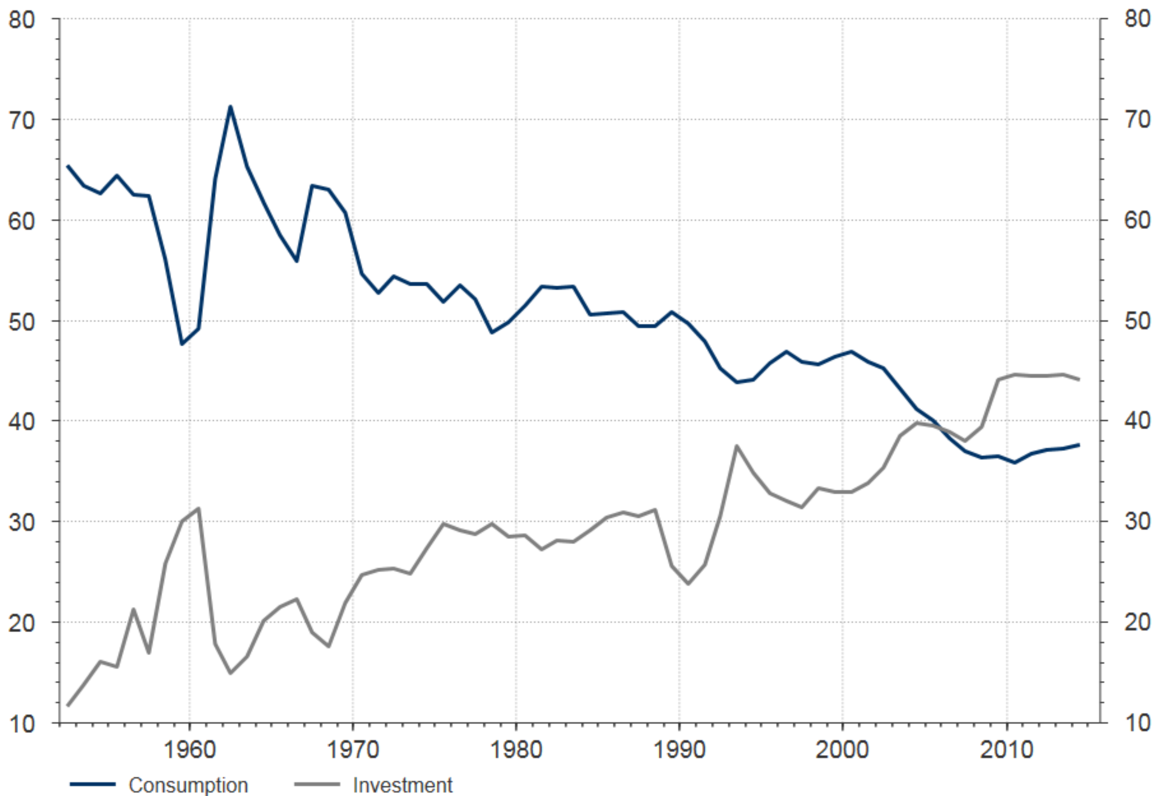
Chinese air traffic continues to grow at 10%+ growth rates in 2015. International flights are a small component of sales for Chinese airlines, rising from 4.5% from 2009 to 7% of in 2015. The chart below shows passenger numbers for Q1 2015. In the first quarter of 2015 there was a 57% increase in international passenger travel to 7.1 million passengers. That is the equivalent of 64 more A380 flights per day in Q1 2015!





On the other hand, the official data suggests retail sales are growing at a slowing rate and decreasing as a share of GDP. Not a good sign if consumption is meant to pick up the baton of economic growth.

China retail sales
Twelve-month percentage change
25
20
15
10
5
0
2000
2002
2004
2006
2008
2010
2012
2014
Consumer goods
Source: Thomson Reuters Datastream


China nominal consumption and investment
Per cent of nominal GDP
80
70
60
50
40
30
20
10
1960
1970
1980
1990
2000
2010
Consumption
Investment
Source: Thomson Reuters Datastream

What does this all mean? The transition in China is happening. Growth in industrial and investment dominated sectors, which have been the destination of much of Australia's commodity exports, is slowing. Whether consumption and services will pick up the slack remains to be seen. There are some positive signs – but history suggests that these great shifts in growth are rarely smooth.

Contact Us

We're always happy to chat (and learn new things!) if you want to know more, contribute more on a particular topic, or wish to discuss any of the above topics in greater detail feel free to drop us a line. Also, please don't hesitate to send us ideas for future articles.