Update on new leasing standard and capital management/debt markets update

March 2019

Building a better working world

Contents

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Leasing Standard Update

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AASB 16

- Changes to accounting standards for leases
- Became mandatory on January 1st 2019
- Most companies to commence reporting from either 30th June or 31st December 2019*
- Effectively brings almost all operating leases onto the balance sheet of lessees

*depending on half-yearly or yearly requirements, listed or unlisted

Potential impact

- Corporates need to be prepared for the wide-spread impact

Income statement	Balance sheet	Cash flow statement	Financial metrics
↑ EBITDA	↑ Lease assets	↑ Cash flow from operating activities	↑ Debt / EBITDA
↑ Operating profit and finance costs	↑ Financial liabilities	↓ Cash flow from financing activities	↓ Interest cover
↔ Profit before tax	↓ Equity	↔ Total cash flow	↑ Debt / Assets

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Determining the balance sheet value

- The amount on the balance sheet is calculated by discounting the lease cash-flows
- The discount rate is that which is inherent in the lease
- If unable to calculate this, the Incremental Borrowing Rate ("IBR") can be determined

Incremental Borrowing Rate

Definition:

The rate of interest that a lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the right-of-use asset in a similar economic environment.

Incremental Borrowing Rate cont'd

Interest-rate

*The **rate of interest that a lessee would have to pay to borrow** over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the right-of-use asset in a similar economic environment.*

- Determining a debt interest-rate to borrow funds
- Assumes asset is 100% debt funded (?)
- Generally can use internal or external pricing benchmark

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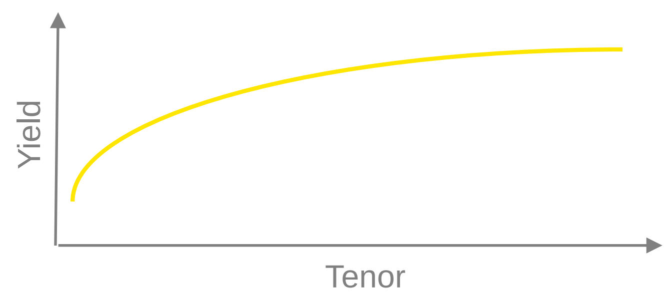
Incremental Borrowing Rate cont'd

The rate of interest that a lessee would have to pay to borrow over a ***similar term****, and with a similar security, the funds necessary to obtain an asset of a similar value to the right-of-use asset in a similar economic environment.*

Tenor

- We have seen some companies group all leases and take weighted average tenor
- Others have grouped by asset class and/or similar remaining tenors (i.e. 1-2, 3-4, 5-7 years, etc)

Typical yield curve (illustration)



Incremental Borrowing Rate cont'd

The rate of interest that a lessee would have to pay to borrow over a similar term, and with a ***similar security****, the funds necessary to obtain an asset of a similar value to the right-of-use asset in a similar economic environment.*

Security

- Pricing needs to be adjusted to reflect a secured lend over the asset in question
- We have seen a range of actions taken:
  - Do nothing (high credit rating)
  - Estimate
  - Calculate

Incremental Borrowing Rate cont'd

The rate of interest that a lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to ***the right-of-use asset*** *in a similar economic environment.*

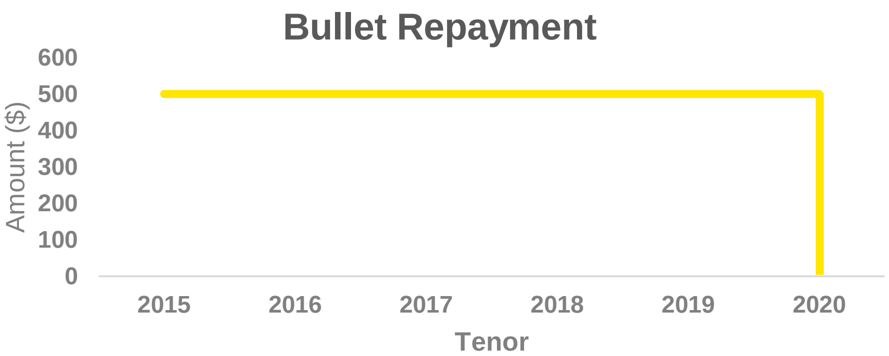
Asset

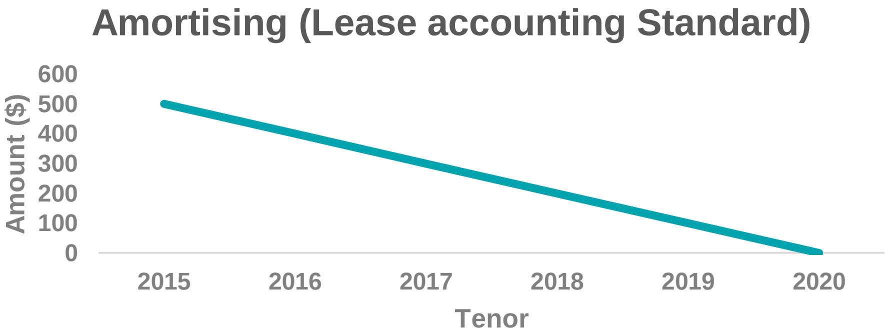
- Debate over whether we are measuring the asset or 'right-of-use-asset'
- Potential impacts:
  - Tenor – may need to use a fully amortised tenor consistent with accounting standards for leases
  - Amount – asset value (nominal or discounted lease cash-flows)

Incremental Borrowing Rate cont'd

Asset

The rate of interest that a lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to ***the right-of-use asset*** *in a similar economic environment.*





Incremental Borrowing Rate cont'd

The rate of interest that a lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the right-of-use asset in a ***similar economic environment****.*

Environment

- Currency of the lease should be consistent with the pricing benchmarks adopted
- Companies may have leases in multiple countries – noting pricing in particular countries may be higher than others (even after factoring cross-currency conversion)

Key issues in assessing the rate

- Generally can use <u>internal</u> or <u>external</u> pricing benchmarks

Internal	External
► Is the lessee and guarantor group the same? ► Will increased debt (from leases) alter credit rating, or interest-rate via movement on a pricing matrix? ► How do you get longer/shorter tenors? Different currencies?	► Can you calculate an accurate credit rating? ► From where to source the appropriate benchmark pricing? ► How does your approach compare to your peers?

Further considerations

- There is no “one size fits all” process - the best approach to take generally comes down to each company’s objectives:

1 Externally or internally calculated
- Resources and expertise?

2 Centralised vs decentralised control/calculation
- Clear methodology needed if not centralised

3 Accuracy versus time/cost
- Benefits of spending time and expense to calculate an accurate figure

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Capital Management Planning

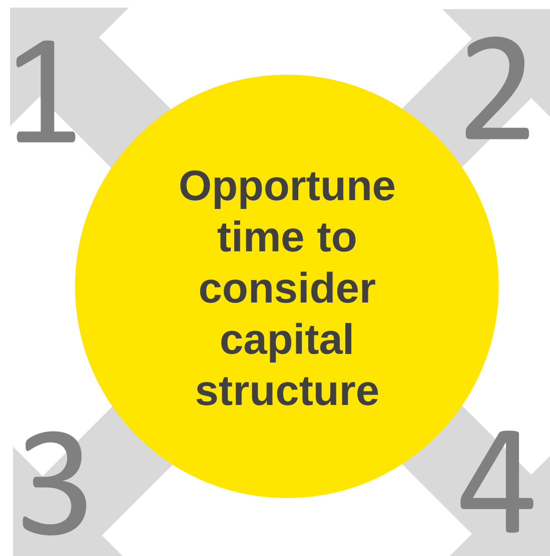
Is it time to address capital management?

New leasing accounting standards

- Impact on financial statements and financial covenants
- Banks not prepared for this accounting change, could impact appetite / higher pricing / covenants

Potential economic downturn

- General pull-back in lending appetite for some sectors / leveraged borrowers
- Impact to interest rates and FX exposures



Increase in alternative funding options

- Proliferation of alternate credit providers
- New debt markets and private placement options

Favourable terms and pricing

- Historical low debt pricing
- Non-banks can provide flexibility of terms, longer tenor

Capital management planning 101

Consider funding needs

Assess debt sustainability and target credit rating

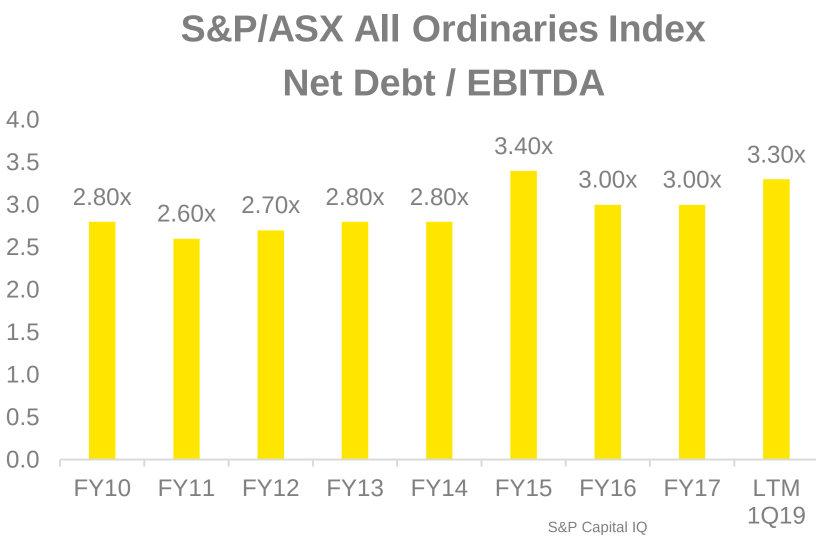
Assess capital requirements and conduct sensitivities

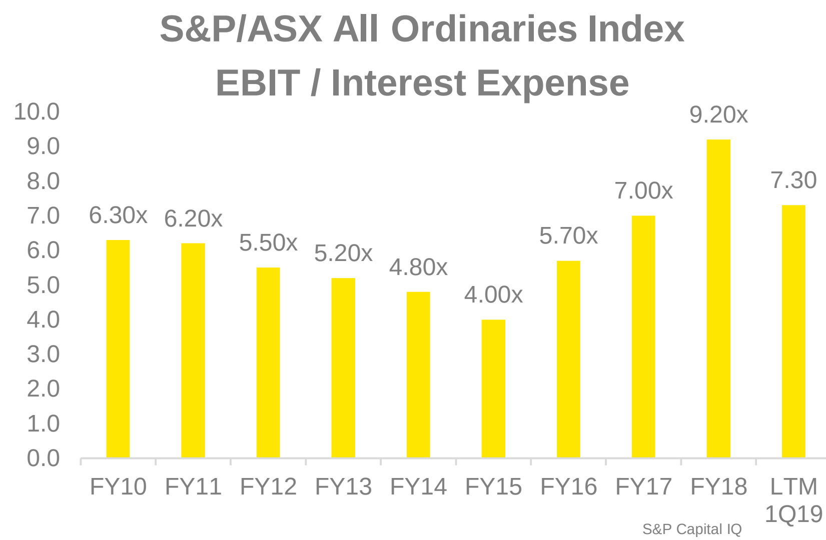
Assess advantages and disadvantages

The capital management plan and financial model should focus on

1. Funding certainty
2. Lowest WACC
3. Liquidity
4. Flexibility
5. Funding & maturity diversification
6. Financial risk management
7. Access to capital markets

Australian corporate gearing vs profitability





The above charts reflect the level of gearing and interest coverage for the 500 largest companies listed on the ASX by market capitalisation

There has been some fluctuation in Net Debt/EBITDA levels, which peaked above 3.4x in FY12-15 as a result of commodity price fluctuations, but has since fallen to a moderate level of 3.3x in FY19

Lower base rates and improving profitability across the ASX have brought down overall interest rates improving interest coverage

Market trends in capital management

1 Impact of the new leasing standard on debt structures

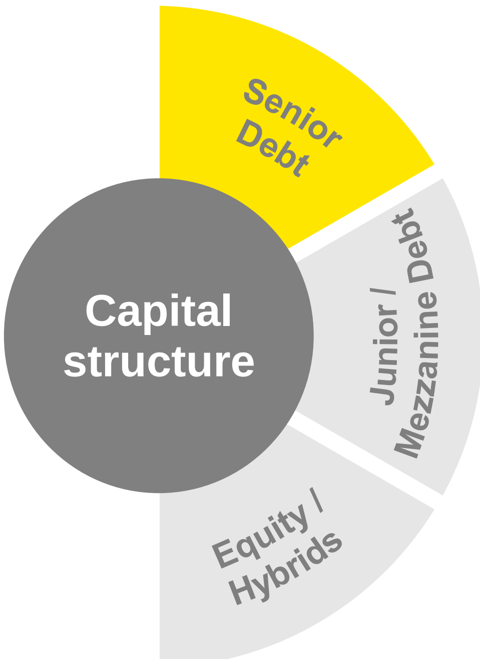
2 Uncertain economic environment and market outlook

3 Diversification of funding and wider range of liquidity pools for unrated issuers

4 Capital flexibility to take advantage of opportunistic acquisitions

Funding Sources 3

Capital structure – senior debt



Money market

- Bank bills, commercial papers, overdrafts, certificate of deposits

Bank debt (A$836b+ market)

- Lending volume is plateauing due to increased regulation / capital requirements, decreased risk appetite in some sectors and weakening demand
- Growth areas in Health, Energy and Infrastructure and shift to Asian lenders

Corporate bonds/MTNs (A$60b+ market, excluding USPPs, ABS and offshore raisings)

- Good investor demand and pricing conditions for investment grade issuers
- Developing ESG/Green/Municipal/HY bond markets with new investors emerging
- Strong appetite in US private Placement market in FY18 and expected to continue
- Asset backed securities market is A$124b – RMBS, CMBS, ABS

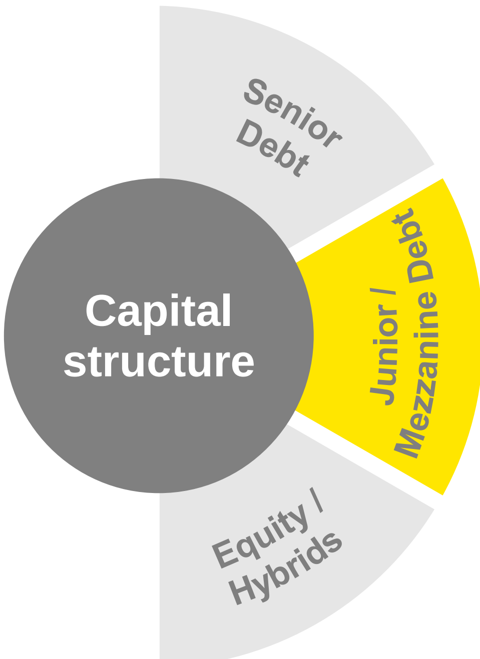
Unrated bonds – wholesale/retail listed (A$2b+ market)

- Offers more flexible issuance structures and capital for unrated corporate issuers
- Simple Corporate Bonds allows a new simplified regime for listed issuers to raise retail bonds

Alternative credit (A$80b+ market)

- Alternative credit investor market grew strongly in 2018 and is emerging as a new lender class
- Institutional term debt market for long term capital now operating and reached $1.7bn
- Other areas of strong activity include Infrastructure, Real Estate and PE/TLBs

Capital structure – junior / mezzanine debt



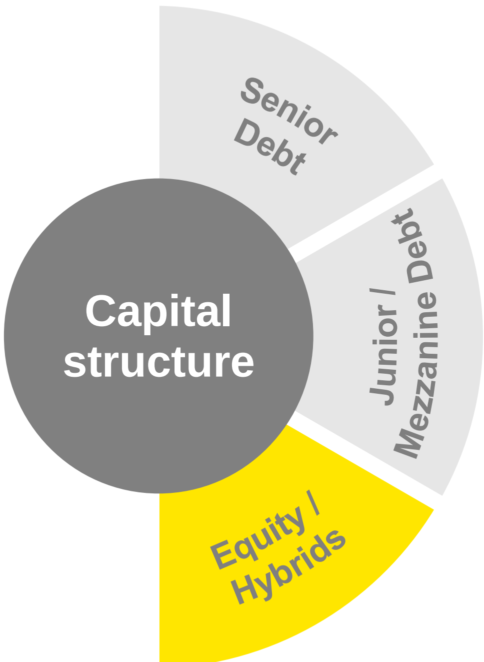
Globally, a growing market with a range of credit/special situations funds seeing 50+ of them now in Australia

- More expensive than senior debt due to lower guarantor/security ranking
- Primarily used to increase debt levels above senior debt capacity (i.e. PE owned) or supplement other forms of debt (i.e. major bank issues of subordinated bonds)
- Growing pool of institutional, private and family office investors
- Provides a more flexible approach towards risk and terms
  - Increase in uni-tranche/junior debt solutions
  - Minimum returns in high single digits and up to low to mid teens

Increasingly used by companies to support fast growth, provide more flexibility, fund real estate development and fill the refinance gap left by major banks retreating from certain sectors (i.e. retail, mining services). Lenders to this class of debt include:

- **Super funds** – appetite for property and infrastructure – low teens cost
- **High-yield funds** – seek higher returns across all sectors – mid teens cost
- **Uni-tranche funds** – blended return across senior, mezzanine and sometimes equity
- **Special situation funds** – opportunistic deals with high return hurdles; and
- **Distressed debt funds** – seek returns in the mid to high teens

Capital structure – equity



Reflects shareholder investment in the business, with significant dry powder in private equity/capital

Typically used by companies in the following areas:

- Start-up phase (i.e. tech company in development phase or resource company in exploration phase); or
- Mature companies where there is a transaction event or debt is not available due to struggling financial performance and/or very high gearing

Can be in the form of

- **Equity shareholding** (public and private)
- Some forms of **hybrids/convertibles** with mandatory conversion

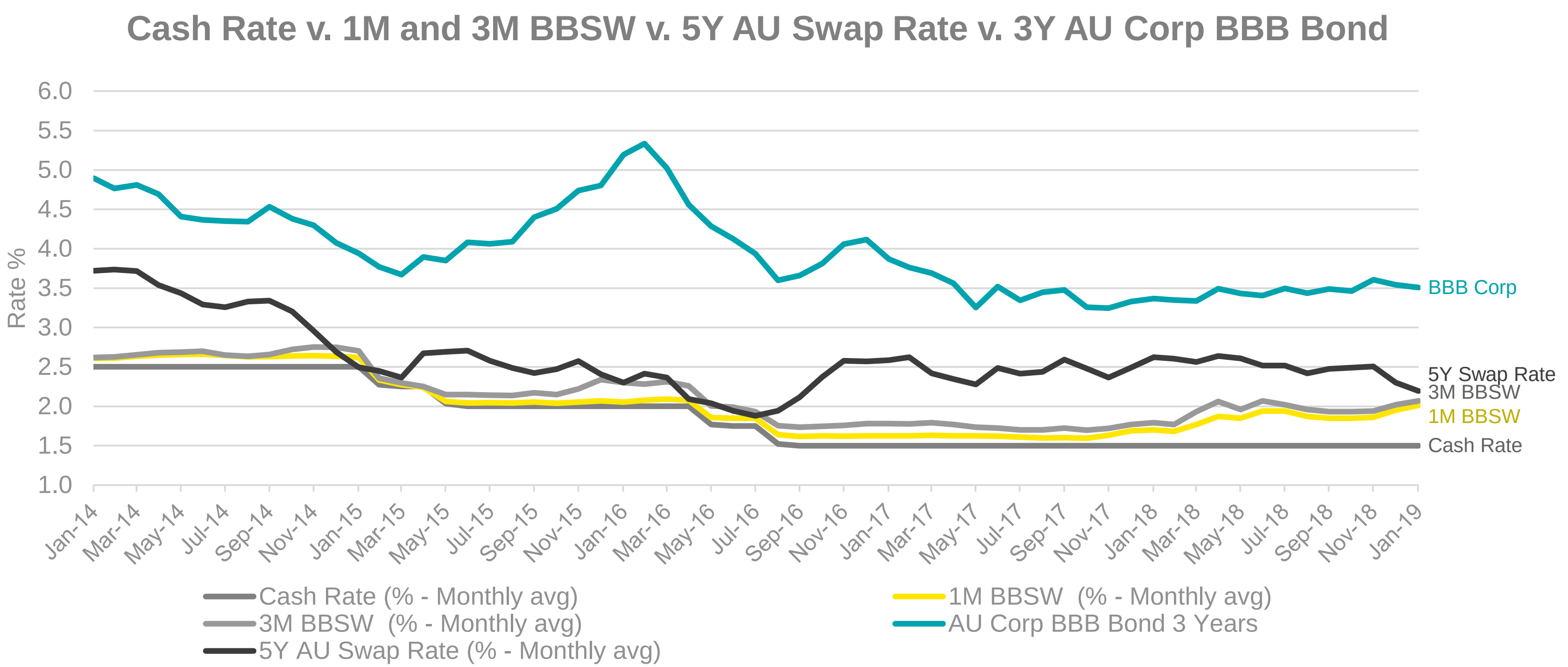
Institutional providers other than superfunds/fund managers can include:

- Venture capital – emerging source of capital for tech sector
- Hedge funds – increased appetite for opportunities in Australia
- Private equity – significant dry powder available for public to private trades
- Family offices – increasingly active in private equity and debt investing

Australian domestic equity market (Jul-18)

- Total Market Cap **$1.95b** across 1,000 companies (S&P Capital IQ)
- Weighted Average ROE across 1,000 companies in FY18 **11.9%** (S&P Capital IQ)

General debt pricing trends



Source: RBA, EY Analysis

- Interest rates are at historical lows, all-in yields are increasingly attractive for well-positioned issuers to consider strategic long term financing and diversification options
- Increase in corporate spreads in late 2015 for commodities downturn and reduction in long term swap rates due to instability in late 2018 due to global market volatility

Recent market transactions

Borrower	Issue Date	Type	Purpose	Rating	Tenor	Amount	Price/Yield
New Century Resources	Feb-19	Term Loan	For general corporate purposes / refinancing	NR	3 yrs 2 yrs	A$40m A$60m	c. 1000bps c. 800bps
Virgin australia	Feb-19	Bond	For general corporate purposes / refinancing	B+	5 yrs	N/A	c. 8.125%
Newcastle Permanent Building Society Ltd	Feb-19	FRN	For general corporate purposes / acquisition / refinance	NR	2 yrs	A$165m	BBSW + 110bps
vodafone	Dec-18	Term Loan	For general corporate purposes / acquisition / refinance	NR	5 yrs 3 yrs	A$2000m A$2000m	BBSY + 130 bps BBSY + 110 bps
PMP Limited	Nov-18	Bond	For refinancing existing notes	NR	4 yrs	A$40m	c. 8.25%
Civmec	Nov-18	Bond	Refinance / Capex	NR	4 yrs	A$60m	7.00 - 7.25%
lendlease	Nov-18	Bond	For general corporate purposes	BBB-	5.5 yrs 10 yrs	A$500m	BBSY + 200 bps BBSY + 250 bps
Centuria	Oct-18	Bond	For general corporate purposes	NR	4.5 yrs	A$75m	BBSY + 425 bps 6.5% Fixed
Treasury Wine Estates	Sep-18	Term Loan	For general corporate purposes / refinance	NR	5 yrs 7 yrs	US$120m US$230m	LIBOR + 130 bps LIBOR + 165 bps
Junior Adventures Group	Aug-18	Unitranche	Leveraged buyout	NR	6 yrs	A$150m	BBSY + 550 bps

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Presenters

Jason Lowe
Partner, Melbourne
Capital and Debt Advisory

Jason is a Partner and Joint national head of Ernst & Young's Capital and Debt Advisory group. Jason has 20 years corporate financing and debt experience, including seven years at the ANZ Bank, four years at HSBC and seven years within the Debt Advisory field.

Jason spent a number of years within its Global Structured Finance division focusing on project financing assets, followed by relationship management roles within ANZ's Institutional Bank including two years in Hong Kong structuring and arranging debt facilities and capital markets instruments across Asia. Whilst at HSBC, Jason led the Large Corporates team in Sydney, and was banker to many of Australia's large listed entities.

Sebastian Paphitis
Partner, Sydney
Capital & Debt Advisory

Sebastian is a Partner and Joint national head of EY's Capital & Debt Advisory group. He has 20 years corporate financing, capital structuring and debt experience, including with Westpac and NAB, and eight years within the Debt Advisory field

He has deep experience in advising clients on their capital management, credit ratings profiles and global funding options strategies, on refinancing & raising of new debt facilities, working on structured financings, interest rate and FX hedging, debt capital markets issues and in dealing with local & offshore institutional, credit fund, pension fund and special situations investors

Mark Miller
Director, Melbourne
Capital & Debt Advisory

Mark is a Director in Ernst & Young's Capital and Debt Advisory group. He has ~16 years of banking and debt advisory experience, including 6 years at EY and 10 years working for ANZ in Sydney and Melbourne across corporate debt financings, acquisitions, project financings and LBOs/MBOs. Mark brings varied and deep experience in the origination, structuring and distribution of debt facilities.

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Phillipe Fontaine
Director, Sydney
Capital & Debt Advisory

Philippe is a Director of Ernst & Young's Capital and Debt Advisory group with over 20 years specialist banking, treasury, hedging, debt markets and debt advisory experience. Prior to joining Ernst & Young, Philippe worked at ANZ and Deutsche Bank in their Capital Advisory teams where he provided capital structuring advice to clients in support of their strategic agenda (acquisition, IPO, de-merger, buyback)

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