AUSTRALIAN CREDIT MARKET CONFIDENT ON ECONOMIC RECOVERY AND MARKET OUTLOOK

Australia's corporate debt market has performed well despite two years of pandemic-related disruption to businesses and – at times – market function. Participants at a **Fitch Ratings**-*KangaNews* roundtable at the end of 2021 discuss market evolution, the 2022 outlook and the prospect of further sustainability integration into fixed income.

PARTICIPANTS

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OPERATING CONDITIONS

Davison The past year has perhaps been less dramatic than 2020 but is arguably even more interesting from a credit perspective. How have business operating conditions fared over the last 12 months?

■ **RAHMAN** Late in 2020, despite Victoria being in lockdown, we hoped the pandemic was behind us. As we moved into winter in the northern hemisphere – where we also operate – it became clear this was not going to be the case as new virus strains emerged.

Ramsay Health Care has continued to support the public-sector community response to the rapidly changing demands of the COVID-19 environment, and our operational and financial metrics reflect this disruption. Results are improving as the business adapts to the unpredictable operating environment and we are well positioned to continue benefiting from pent-up demand for private and public healthcare services. Key to supporting this are vaccination rates and government funding.

■ **TRIGONA** The importance of the National Broadband Network to Australia was certainly highlighted in the last 18 months of the pandemic, which became the catalyst for widespread reliance on technology. As Australia went into lockdown, thanks to NBN Co everyone who was able to work from home could work from home, while students of all ages continued their education and Australians – pleasingly – continued shopping, were entertained and remained

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>
> **VICKY MELBOURNE** FITCH RATINGS

THE ROLE OF *THE DOMESTIC MARKET*

The Australian dollar bond market has quietly become more reliable for corporate issuers while also adding to its utility in range of tenors and liquidity. Sustainable-finance options have helped further. Issuers reflect on the value of local bond funding.

DAVISON How do borrowers view the domestic market nowadays, in light of its recent gains but also increased volatility? How much confidence do you have about its availability?

■ **TRIGONA** When we were embarking on debt capital market issuance, the feedback we received was that there was limited capacity to raise funds in the domestic market. But we have issued close to A$2.8 billion (US$2 billion) in Australia over the last 12 months and we are very positive going into the new calendar year.

We have issued twice in the US dollar market since April 2021, in five tranches. The strong support from offshore investors has grown our investor base significantly and we are seeing some of these accounts, including central banks, invest in our domestic issuance. The offshore bid should support our domestic issuance in future.

■ **RAHMAN** The domestic market has deeper foundations nowadays. Ramsay Health Care was exclusively funded by bank loans until recently, then we decided it was time to proceed with obtaining a credit rating in May this year. It is rare to do this unless there is an intention to access the bond market and it is time for us to diversify away from a purely bank-funded debt book to a combination of bank loans and bonds.

My view has always been that long-term assets should always be funded by long-term liabilities – such as bonds and even equity – while working capital should be funded with revolving bank loans or debt we know will be repaid soon, minimising liability-management costs.

We consider it important to have a bond programme that can accommodate the domestic market. It is a great market and always a good thing to be supported by and to support it.

It is a fact, however, that the Australian dollar market remains a bit more binomial in that it has a tendency to shut down unilaterally while others are open for business. Going to the US, in a worst-case scenario we might have to pay for a deal – but we would always come back with the money we needed.

It is therefore important to have a domestic bond programme that is rated and ready to go, so we can access it opportunistically when conditions are buoyant. I like to think the domestic market, which is our home turf, will be able to work with us in this regard.

It is a funding option we would be cautious and opportunistic about, though. We have a strong business in Europe so the euro market is also available to us. But it would be remiss not to be open to the Australian market, which is a great option.

■ **VANDELIGT** Other than in the most severe market deteriorations, we have a high level of confidence in the Australian market. Each deal I have been involved with has seen growth in ticket sizes and investor numbers.

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FIONA TRIGONA NBN CO

connected to family and friends throughout Australia and across the world.

Last year, we connected more than 933,000 new customers via a multi-technology mix. We have 300,000 kilometres of fibre-optic cable, 2,200 fixed wireless towers and two satellites. Digitalisation is not only happening, but since the pandemic it is accelerating.

We expect this demand to continue. According to research from McKinsey, the pandemic has triggered changes to technology adoption over the last 12 months that would otherwise have taken 3-4 years to play out.

■ **MELBOURNE** Overall, corporate borrowers' performance has been a function of Australia's vaccination rate and pent-up demand. A lot of companies were able to withstand even the second lockdown. Government relief measures helped but having an annual vaccination programme will be the key to recovery.

The borrowers that were affected most across our portfolio were in discretionary retail, gaming, entertainment and tourism. A lot of these sectors will recover and benefit from the pent-up demand but there are a couple of pockets where we are seeing potential impacts from a structural perspective – gaming being the key sector, due to international VIPs staying away from the casinos.

The property sector will also be affected as companies determine what their future working models are – home or office. We will likely see a flight to quality and the premium assets will be protected.

Energy and utilities companies are typically stable credits, but the renewable transition is happening while national energy prices have fallen. This will reduce earnings for retailers and income for coal and gas generators.

Davison Supply-chain disruption is clearly the focus of a lot of attention in late 2021. How does this affect a company like Port of Melbourne (PoM) and the infrastructure sector as a whole?

■ **VANDELIGT** PoM is a stable infrastructure asset and the business has demonstrated as much over the period of the pandemic. We are the landlord of the port and therefore do not have any operations. But the stevedores have been able to continue their operations largely unaffected through COVID-19.

From a volume perspective, trade normally increases at the rate of roughly 2-3 per cent per annum but the port saw record growth of 14 per cent during financial-year 2021. The economy has been supported by government stimulus, which resulted in stronger purchasing of consumer goods. Many of these goods were imported through the port.

Supply-chain disruptions are largely the result of global issues rather than local port operational ones. We have recently seen a small increase in congestion due to COVID-19 cases in the port precinct and also due to an increase in industrial action. But the impact of the congestion is small in the context of global supply-chain issues.

The global issues are about excess demand in the system globally as a result of fiscal support from governments all over the world. The theme of consumers spending more on goods in Australia is consistent across the globe and has resulted in excess demand.

This has stressed the global supply chain, compounded by COVID-19 cases in the transport system, and insufficient vessels and availability of empty containers to move goods around the globe. This is resulting in slower transit times and choking the supply chain, which ultimately results in a slowing of the velocity of trade.

It should go back to normal once vaccination rates get to the required level offshore. But I am not sure how long it will take.

■ **HODGES** The extent and timing of lockdowns and travel restrictions drove the impact for toll roads. We saw severe impacts in the September quarter in Sydney and Melbourne across the sector.

Now vaccination rates are at a sufficient level to reopen, the recovery looks robust. We do not expect any further containment measures to be reimposed and forecast further recovery over the course of next year.

Nonetheless, some of the assets we look at are exposed to airport-related risk. There could be some lingering impact from international-border restrictions. These will gradually fall away, but business travel could take longer to recover than tourist and domestic travel.

STATE OF CORPORATE CREDIT

Davison This is a tricky juncture for credit investment as competing supply potentially changes spread dynamics while of course the market expectation is for rates to increase. At the same time the market is digesting the operational environment we have discussed. How are investors approaching corporate debt at present?

■ **KIRKHAM** The market has been relatively well behaved. The few sectors that were beaten up have performed on the reopening trade – such as the REITs, universities, airports and the like. This is partly because everyone got comfortable when we reopened previously and consumers rushed back to doing what they love, like hanging out in shopping centres.

The general theme has been high demand for credit: primary-market corporate deals have all been three, four or five times oversubscribed. Obviously, with super low base rates, the chase for yield has driven this.

■ **GARLAND** Relative calmness in credit spreads has been a key feature of the market in 2021. Particularly in contrast to the volatility in rates, and to a lesser extent equity, the credit environment has been relatively benign. This has provided opportunity for investors to generate stable excess return predominately from carry and roll.

We have seen ongoing economic growth support the market as the global economy came back from COVID-19. Accommodative monetary policy supported a reach-for-yield environment. Even central-bank programmes, such as the RBA [Reserve Bank of Australia] term funding facility (TFF), removed a large amount of financial supply from the market

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>
> **ASRAR RAHMAN** RAMSAY HEALTH CARE

and left credit investors with excess cash to spend on corporate issuance and other credit assets.

Another support for markets is fortress-like corporate balance sheets. Strong and improving credit fundamentals combined with elevated balance-sheet liquidity led to a benign outlook for defaults.

■ **STRANO** The economic backdrop remains robust. Despite US inflation, we are expecting solid growth there – and the same applies here in Australia. Off the back of this, we expect credit investors will continue to seek margin over risk-free rates as they have this year.

Regarding the extreme volatility in bonds this year, we have seen credit margins hanging in there the whole way through. This provides a lot of confidence. As for valuations, investment-grade corporates are still in the fair range. Banks have underperformed but we expected this coming out of the TFF and it is good that this distortion is now over.

Overall, we are reasonably positive we can continue to earn income while the economic backdrop remains as robust as it is now. That said, we have gone from a situation where we were basically limit-long on pretty much everything credit in the second half of 2020 to being far more selective in the second half of this year.

We are embracing a lot more curve risk in our floating-rate portfolios and adding spread duration in selective names offering attractive returns – such as Melbourne Airport, which recently issued at 3.8 per cent yield. This kind of flexibility is advantageous in a more selective market.

Davison Richard Garland mentioned the comfort investors take in conservatively positioned corporate balance sheets. But are issuers easing their own liquidity positions as the economy recovers?

■ **RAHMAN** When the pandemic hit, no-one knew how severe it was going to be, so everybody stockpiled liquidity – and we did the same. We issued A$1.5 billion (US$1.1 billion) of equity in 2020 and paid down a lot of debt – but the cash has not all been spent. Our income was a little down due to the nature and mix of our earnings profile but it was not as severe as we expected. Fortunately, the bulk of the A$1.5 billion was not required.

We do not typically have leverage this low and ultimately it is not the most efficient for all stakeholders. There is a range of options for what we may do with the liquidity and, most importantly, no-one in the corporate world regrets doing what they did. It was better to find oneself in surplus than to discover liquidity reserves were insufficient.

■ **VANDELIGT** Our business operates with a high EBITDA margin, of about 90 per cent, which means it generates cash quickly and can strengthen its liquidity buffer rapidly. Even so, as we moved into the pandemic – and with the support of shareholders – we bolstered the balance sheet by withholding income distributions.

After it became clear that volume was not materially affected, the excess liquidity was unwound and the withheld income distributions were paid to shareholders.

■ **HODGES** We saw withholding of equity distributions, some deferral of capital expenditure and new liquidity facilities put in place across the infrastructure sector as a whole. We saw a lot of balance-sheet management and strengthening of liquidity positions at the start of the pandemic.

■ **TRIGONA** Our circumstances are different. At the start of the pandemic, NBN Co was completing the build phase so liquidity was provided by the Commonwealth government. The build was complete in June 2020 and we began the task of refinancing a A$19.5 billion Commonwealth loan.

The refinancing was initially funded by bank facilities before we issued our inaugural transaction in the debt capital market, in November 2020. Since then, we have completed 18 transactions totalling A$9.5 billion – so we are well positioned going into the new year.

ESG DEVELOPMENTS

Davison A watchword of today's market is the need to integrate environmental, social, and governance [ESG] principles into the credit process. How has the market evolved in 2021?

■ **CHIKE-OBI** Data for January-October 2021 show there has been about US$1 trillion in total sustainable-bond issuance, including the use-of-proceeds (UOP) structure and sustainability-linked bonds (SLBs).

The SLB as a funding instrument was created in 2019 but ICMA [International Capital Market Association] only published formal principles for the structure in June 2020. We are talking about an extremely young market with a huge amount of growth.

"The range-bound trading conditions we have seen over the last year are likely to persist for the medium term. Rates volatility has not really changed our view on credit per se. But we are seeing the front end of the Australian credit market looking very attractive in an all-in yield sense."

RICHARD GARLAND QIC

Comparing 2020 with 2021, the share of UOP green bonds has been stable at around 50 per cent of the total sustainable-bond market. There has been a shift away from social bonds in 2021, however. They made up 31 per cent of the market in 2020 but account for only about 20 per cent of the market this year.

A big reason for this is a lot of the social-bond issuance in 2020 was pandemic-related relief bonds – and there has been a big drop in those. There was an increase in social-bond issuance globally from Q3 2020 into Q1 2021 but this has fallen away significantly.

UOP sustainability bonds, with combined green and social activities, and SLBs are starting to fill this gap. SLB deals are making up about 12 per cent of the total market compared with only 3 per cent in 2020.

Several events in 2020 increased pressure on companies' social metrics, specifically to do with diversity and inclusion. A lot more companies that may have issued a green bond or would have chosen to do so in the past are now issuing sustainability bonds with four or five KPIs.

These typically include one social activity related to, for example, increased training programmes for people from underrepresented backgrounds, and engaging women or minority-owned suppliers as part of their supply chain.

On the sustainability-linked side, the main constraint is that issuers must have targets and metrics they can track in order to have sustainability-performance targets under the structure. The companies most ahead of the game, as far as having sustainability programmes and policies, are able to issue SLBs because they already have the data they need.

Within Asia, a lot of activity is from Chinese commercial banks issuing out of Singapore, Hong Kong, Macau and Europe. They are doing large transactions to create sustainable-loan books for Chinese corporates – which involves the use of interesting labels and structures. Bank of China did a really interesting SLB structure this year, where the KPI is the performance of its portfolio of sustainability-linked loans (SLLs). If a certain percentage of the SLLs fails to meet their targets the ratchet for the bond the bank issued is triggered. This is the first structure of its kind in the market.

Issuers are being quite creative, which presents challenges for investors because they really have to do their due diligence to find out if these bonds – whatever the label – meet international best practice. There are some questions about divergence in standards especially because Europe is so aggressive. It is introducing regulation on the funds-management side and on corporate mandatory disclosures, which are going to significantly increase from 2023.

Overall, the sustainable-bond market is still very small. It is about US$1 trillion this year while total bond-market issuance was US$27 trillion in 2020. But it is growing. Sustainability also seems to be getting more integrated into general business activity – it is something companies will mention even if they are not announcing a sustainable-financing structure.

Davison How does Australia's progress compare on a global basis?

■ **CHIKE-OBI** Australia represents a very small share of the global market, but this is understandable because Australia is a relatively small market. Its share of global issuance is about 1 per cent and the rest of Asia Pacific is 17 per cent. Europe is the leader with 58 per cent of issuance.

The trend has strengthened because Europe has so much regulation encouraging sustainable-finance activity and therefore many entities ready to get into the market.

The question will be how issuers that are not based or operating in Europe will be able to keep up with what seems to be a European-led drive to ESG reporting standards and disclosures. For instance, Australia does not have any mandatory disclosure for ESG.

Within Asia Pacific, this year the Hong Kong Exchange introduced mandatory disclosures for all listed companies, Japan introduced disclosures for all listed companies related to carbon and gender diversity, and China has announced there is going to be some mandatory environmental disclosure for companies.

It will be interesting to see how Australian corporates respond. They are good at sustainability reporting, despite the lack of regulation, so maybe a mandatory regime is not necessary. It may be that Australian companies are just more naturally sustainability-focused and the market does not need to force them. The divergence between Australian policy priorities and what companies are doing to raise financing to reduce their carbon footprints is something to keep in mind.

There have been a few Australian SLBs. Wesfarmers and Woolworths focused on carbon emissions with no social- or governance-related targets. This might be a benchmark for what other issuers do in future. There is a lot of nuance and there are

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PHIL STRANO YARRA CAPITAL MANAGEMENT

INFLATION *OUTLOOK*

Perhaps the biggest market debate of 2021 has been whether inflation is transitory or is increasingly being baked into the economic outlook. Credit investors are still not certain but say market conditions should be manageable either way.

DAVISON What is investors' level of confidence about the temporary nature of supply-chain disruption and how this input feeds through into the all-important inflation outlook?

■ **GARLAND** It is a fascinating time for markets, where the uncertainty about inflation and how central banks remove themselves from their extraordinary policies is being questioned.

There is a big debate about whether inflation is transitory or more structural. The uncertainty will linger for some time to come and no-one knows the answer at this point. What has been interesting is the prevalence of the word 'bottlenecks' in central-bank speeches.

■ **STRANO** We have come off a 30-year period of relatively low inflation, low wages and elevated risk assets, which have trended higher as rates have fallen. This feels like an inflection point. What has been the case for the last 30 years is probably not going to be the case for the next 30 years.

We may not go back to 1970s-style inflation, but the potential for higher-risk assets and low wages to drive growth is not going to work as well for many everyday Australians.

In time they may feel they are not getting ahead, and if the value of their houses stops rising they may seek higher wages instead. We have become used to low inflation but we may need to prepare ourselves for a bit more of it going forward.

■ **KIRKHAM** The word 'temporary' has been used a lot about global inflation, but it has gone on a little too long already. Australia eased monetary policy to a record low and the central bank says it will leave cash rates there until 2024 – though the market does not agree. At the same time, the government has also been pumping money into the economy.

We have not seen this combination for a long time. It is happening in an economy that was not in a typical recession. It was shocked into one; it did not fall into it.

There are a lot of unknowns, which means we cannot look back at a playbook as a guide to what is going to occur. This is why markets are getting a little jumpy.

DAVISON Are borrowers or Fitch Ratings analysts seeing serious, sustained wage or price pressure in the economy? Is low unemployment flowing through to wage cost, for instance?

■ **MELBOURNE** We are seeing this, with a contribution from low net migration and population growth. The mining sector is very dependent on migration and this is where we are noting most of the labour-cost pressure – alongside hospitality and business services.

■ **VANDELIGT** We are seeing pressure on construction cost. There is such a huge infrastructure spend at the moment it is resulting in a skills shortage and placing pressure on labour costs.

regional differences, but Australia has the benefit of watching what some regional neighbours do.

■ **VANDELIGT** I have been listening to this update with real interest because PoM's shareholders and management are highly supportive of issuing into the sustainability-linked market. PoM has established a board safety and sustainability subcommittee to focus on this. It also recently employed a new head of sustainability, with whom the treasury team has been working closely in order to prepare for a transaction in this market.

The key issue we are working through is obtaining historical baseline data in order to develop a meaningful target for a transaction. We could issue now, but the targets might not be meaningful to investors because we do not have the underlying data.

We are conscious that investors want to see meaningful targets in deal structures so the baselining data issue needs to be worked through before we can bring a transaction to market and ensure clean execution.

Davison Do investors raise their eyebrows nowadays when a corporate issuer comes to market with a deal that is not ESG-linked?

■ **VANDELIGT** Not particularly. Coming to market in ESG format could translate into a bigger book and therefore potentially better pricing. But demand remains strong for non-ESG transactions.

Ultimately, when issuers come to market investors are trying to assess whether or not the business is sustainable. Investors can form this view from the disclosure materials – and if their view is the business is not sustainable, they do not invest. PoM can easily demonstrate the sustainability credentials of the business so we are not receiving any negative feedback for borrowing in a non-ESG format.

■ **TRIGONA** Investors ask whether we will issue a green or social bond, especially given NBN Co's purpose is about lifting the digital capability of Australia and bridging the digital divide. Investors are very interested in digital inclusion. They would like us to think about who our target population is and the underrepresented areas within Australia that we can help.

We are mindful of our responsibility to protect the environment in which we operate. We have strong internal engagement at senior management level, where there is an executive-led sustainability-governance committee.

We are also working on addressing climate risks and we have commenced a company-wide climate-risk assessment.

This is focused on the resilience of the network, especially regarding extreme weather conditions. This is a priority irrespective of whether we go to market with a green or sustainability bond.

Our treasury is working closely with NBN Co's sustainability function to establish a sustainability-bond framework and programme, which will allow us to go to market hopefully next year. We are looking at the assets we need to incorporate in this programme and we would like to issue UOP bonds rather than SLBs.

Given the size of the network and our future investments over the next few years, there should be sufficient assets to issue a UOP bond. But reporting is key.

We have been meeting with some offshore investors to get an indication of their reporting requirements. Given our funding programme, we need to access domestic and offshore markets. We need a programme that is robust enough to meet the needs of offshore investors, so we are looking at TCFD [Task Force on Climate-Related Financial Disclosures] reporting, the EU taxonomy and science-based targets.

We are publishing our second sustainability report, which will be released in December. As sustainability is embedded throughout NBN Co, we are looking at moving toward integrated reporting with our annual report. We are in the early stages of this process, but it is a very big focus.

■ **CHIKE-OBI** As I mentioned, what we should be keeping an eye on, given the lack of reporting standards in Australia, is whether companies try to meet global best practice of their own volition. The US and China do not have a comprehensive mandatory reporting framework for ESG, so it can be done – but I suspect it will be very dependent on the willingness and interest of each company.

This is a decision the Australian government and its financial regulators have to make. Do they want to create an environment where everybody must meet a certain minimum standard? Otherwise, European investors in particular will start questioning the inconsistent level of detail they will get from Australian companies.

ESG FUNDING OPTIONS

Davison So far, the market seems to have room for both UOP bonds and SLBs. But will this remain the case in future?

■ **CHIKE-OBI** Sustainability-linked is going to become a very big part of the market. We have seen social UOP shrink as a share and most of this proportion of issuance has gone to SLBs and sustainability UOP. This trend will continue.

There is a clear reason for SLB issuance to grow: because it is a commitment device. It forces borrowers to integrate sustainability into their operations, which is even more significant than a step-up in the structure. The issuer is on record as a company that says sustainability is integral to its operations. This is what the market and consumers want, and even what employees want.

I see increasing sustainability-linked integration, but the question is how much of this will go into fixed income and whether it will get to the point of completely displacing UOP bonds. I am not sure, because in the wake of COP26 it is clear there is a significant amount of financing needed for the low-carbon transition. This is likely more suited to UOP structures, especially in the green space.

In the short term, I could not say what the share will be. But I think the sustainability-linked market will be more than 12 per cent next year and SLLs will become a standard product for any sizable company in the future.

Davison Why did Ramsay choose an SLL rather than a UOP social or sustainability bond? As a healthcare provider, presumably the company has suitable UOP assets – but what were the considerations in deciding which format to use?

■ **RAHMAN** We have social elements in our SLL. There are five KPIs and two of them are social. One is training in mental health for employees, linked to the healthcare aspect of the organisation. The other is from the supplier point of view: our suppliers need to be independently accredited by EcoVadis as socially responsible, as defined by universally accepted criteria. The other KPIs focus on emission reduction and solar-panel installation.

Syndicated bank loans are strong contenders for ESG alignment. We went to great lengths to put our first formal targets in place and we have always had an impact statement. But it was when we considered an SLL that we made it prescriptive and accountable, and defined the targets for the organisation.

We sought buy-in from the chief executives of all our businesses, then the executive committee and the board.

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>
> **JAMES HODGES** FITCH RATINGS

"The public nature of bonds makes it more difficult for issuers to take as many risks when it comes to their sustainability targets. The potential reputational risk associated with failing to meet targets is much bigger in the bond market, in other words – because everybody will know about it."

NNEKA CHIKE-OBI FITCH RATINGS

This is the level it went to before we formally made ourselves accountable via a loan facility.

When we went to market this year our view was that, while we could comfortably have closed a successful transaction without ESG, it would soon be inevitable that access to lenders would be increasingly more difficult without it. Lenders' and investors' mandates contain requirements to allocate to borrowers that are not only committed to ESG but hold themselves accountable to their statements by linking them to their financing arrangements. This will soon be the norm.

When we launched our syndicated SLL, we learned about one-third of the attendees at our presentation would not have been present had the loan not been ESG-linked. Another third commented that their approval processes were accelerated as a result.

The loan market has worked as the first place borrowers have adopted the working solution of a margin-linked format, rather than UOP as with green bonds. This has made it highly conducive for borrowers to link activities to ESG financing even when they do not have a particular green project to spend the money on.

The bond market has moved in this direction but remains less user friendly than the loan market at this point. The number of sustainability-performance indicators used in SLB criteria is less than half of what the loan market is willing to entertain. On pricing, where the loan market has a carrot-and-stick approach in the form of margin adjustments, with achievement or otherwise, the bond markets only have a stick. It is early days and there is no such thing as a standard, either.

Let me emphasise 'at this point', though. I have a strong sense that the bond market will eventually, if slowly, merge toward the loan market as it continues to seek socially responsible assets and allocate capital. I am sure we will see more issuers of ESG-linked bonds.

■ **CHIKE-OBI** Loans and bonds are different. More borrowers can take on a syndicated-loan facility than feel comfortable issuing bonds in the international market.

Other challenges for investors with a thematic focus lie in whether the SLB is green or social, and what happens if its targets are not met. Is the investor then holding an asset that no longer meets the standards they thought it did? This is a very difficult issue.

The difference between sustainability-linked loans and bonds is that loans are privately negotiated, meaning the terms are normally private as well. Companies may feel more comfortable having a wider range of performance targets in a loan structure.

This certainly seems to be the case from the research I have done: loans typically have 3-5 performance targets whereas bonds have one or two at most. This may be due to the public and market-focused nature of a bond when compared with a loan.

The public nature of bonds makes it more difficult for issuers to take as many risks when it comes to their sustainability targets. The potential reputational risk associated with failing to meet targets is much bigger in the bond market, in other words – because everybody will know about it. I am not sure how much we will ever learn about loans that have failed to perform in the sense of not meeting sustainability standards.

■ **GARLAND** We see merit in the current structures but we can also foresee a time where SLBs, and green bonds for that matter, cease to exist and instead vanilla bonds have covenants covering sustainability. This could be a way to circumvent some of these issues. It is not impossible, given the way so many bond issuers and investors have embraced sustainability and companies are setting sustainability goals for their businesses anyway.

■ **STRANO** We have been in furious agreement until now, but I would like to respectfully disagree with Richard Garland regarding covenants! Investors have generally always wanted covenants in bond documents – especially in investment grade – but not got them, in stark contrast with banks, which generally have. The argument has always been that covenants make it more problematic to negotiate with a disparate group of bondholders compared with banks.

I suspect ESG and documentation covering sustainability will come to resemble what we currently have: banks getting covenants and investors not getting them. Therefore, specific sustainability undertakings through labelled bonds may well persist as features in this part of the market.

■ **KIRKHAM** Each issuer is going to come at these types of bonds differently. What they put on the table regarding targets is key. We want to see meaningful issues dealt with and issuers not being too cute with regard to the target levels they put up.

Standards and rules will be critical. If we can be involved in setting the targets rather than issuers coming up with them after a chat with their bankers that would also be positive.

> "It is certainly tricky for all businesses when it comes to new staff training and culture. Both are very difficult to manage if everyone is sitting in a home office. Therefore, we are not sure home working is a long-term phenomenon and hence we are not concerned about the REITs we invest in."
>
> **ANTHONY KIRKHAM** WESTERN ASSET MANAGEMENT

Ultimately we all want it to be consistent with the Principles for Responsible Investment.

CREDIT OUTLOOK

Davison How are investors positioning their portfolios for how they are expecting markets to behave in 2022?

■ **GARLAND** Rates are still close to a record low, corporate balance sheets are strong and companies are still acting quite conservatively. There are supply and demand tailwinds, and these things are not going away quickly.

Therefore, investors will continue to see credit as an important part of their portfolios, despite valuations being on the expensive side of fair. Looking ahead, there is likely more volatility ahead than we have seen in the rear-view mirror.

Some risks we are cognisant of include policy error – or rampant inflation leading to a taper-tantrum outcome – margin pressure from persistent supply-chain bottlenecks leading to significantly lower earnings expectations, a larger-than-expected M&A cycle and geopolitical risks that can rise at any point in time.

Even so, the range-bound trading conditions we have seen over the last year are likely to persist for the medium term. Rates volatility has not really changed our view on credit per se. But we view the front end of the Australian credit market as very attractive in an all-in yield sense.

We believe this is a good opportunity. We think market pricing for RBA rate hikes is too aggressive and our expectation is still that most central banks will be slow to exit loose monetary policy.

Finally, we are keeping an eye on real yields that have fallen to record low levels. This indicates just how easy financial conditions are here – and this is something we will be keeping a close eye on moving forward.

■ **KIRKHAM** With any investment, we want to make sure we are getting paid for the risk. Issuers are in a good place, and we want to ensure they stay fundamentally sound and maintain strong balance sheets. It is fine if they do not – but we want to be paid for the change.

On the technical side, there is still a lot of cash sitting around looking for a home and this is something we need to continue to monitor around flows and where money is going. It is fair to say this is going to be the case for some time thanks to extremely easy monetary policy and the abundance of cash in the system. This will not disappear overnight.

The services sector has experienced a greater impact from the pandemic, as have activity-based assets like toll roads and airports. But we believe they will all benefit from the reopening trade and have the right ownership structures to support them. We are also happy to gravitate to banks because they are still doing rather well from an asset-quality standpoint and will continue to be supported by central banks.

Davison Do investors have any macro concerns about how flexible working might affect the economy in the longer term, in particular sectors like property? Are you concerned about specific issuers?

■ **KIRKHAM** It is a real challenge for business owners but it very much depends on the type of business they are in. Things are not changing much in our industry and I have heard many others are the same. But some businesses and roles will allow employees to continue to work from home.

However, it is certainly tricky for all businesses when it comes to new staff training and culture. Both are very difficult to manage if everyone is sitting in a home office. Therefore, we are not sure home working is a long-term phenomenon and hence we are not concerned about the REITs we invest in. They are also typically premium sites that will always be in demand due to quality, status and location benefits.

■ **STRANO** The REITs we invest in are geared in the 20-30 per cent range. Any adjustments from a valuation perspective will be entirely worn by equity holders. When we invest, we do so with a high level of security and comfort that any necessary adjustments will be borne by equity holders.

■ **MELBOURNE** It is on a case-by-case basis but we are starting to see some people coming back into the office. Fitch itself is implementing a hybrid model, which is another thing to consider.

Even so, of the 45 of us that could be here today, we have three – and this is the most since we started coming back about a month ago. But we are still leasing the whole space, which changes the dynamics a little for the REITs involved.

There will be less demand for space, but there are also businesses that might be looking to take up some of the properties. E-commerce is growing, for instance, and it could pick up some of the office space. •