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Weekly Market Insight

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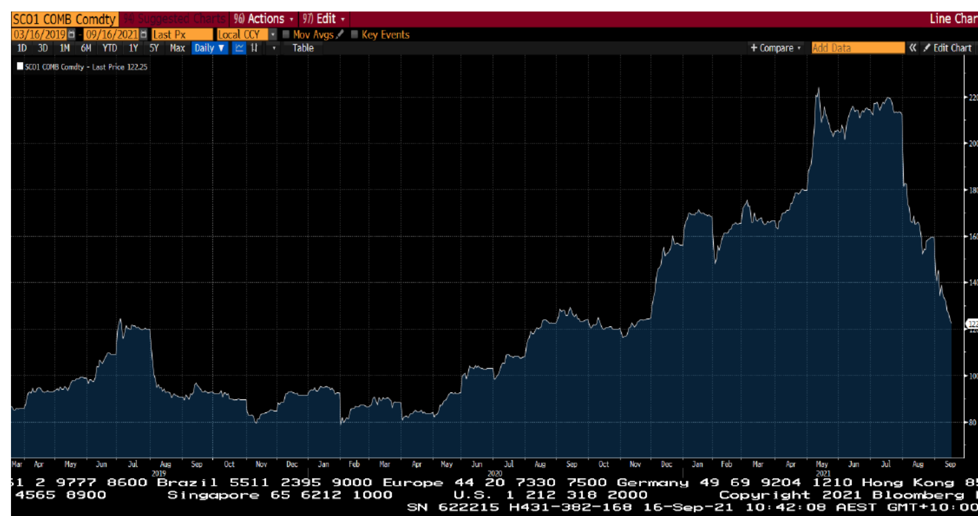
Chart of the Week: Iron Ore Prices (in USD) in Freefall



Source: Bloomberg

Weekly Insights

- Sydney Airport Inflation Linkers
- Strandline Operating Update
- Equity Bubble: Why it Makes Sense to be Wary of Duration Within Your Fixed Income Allocation
- Weekly "Most" Traded

Week in Review

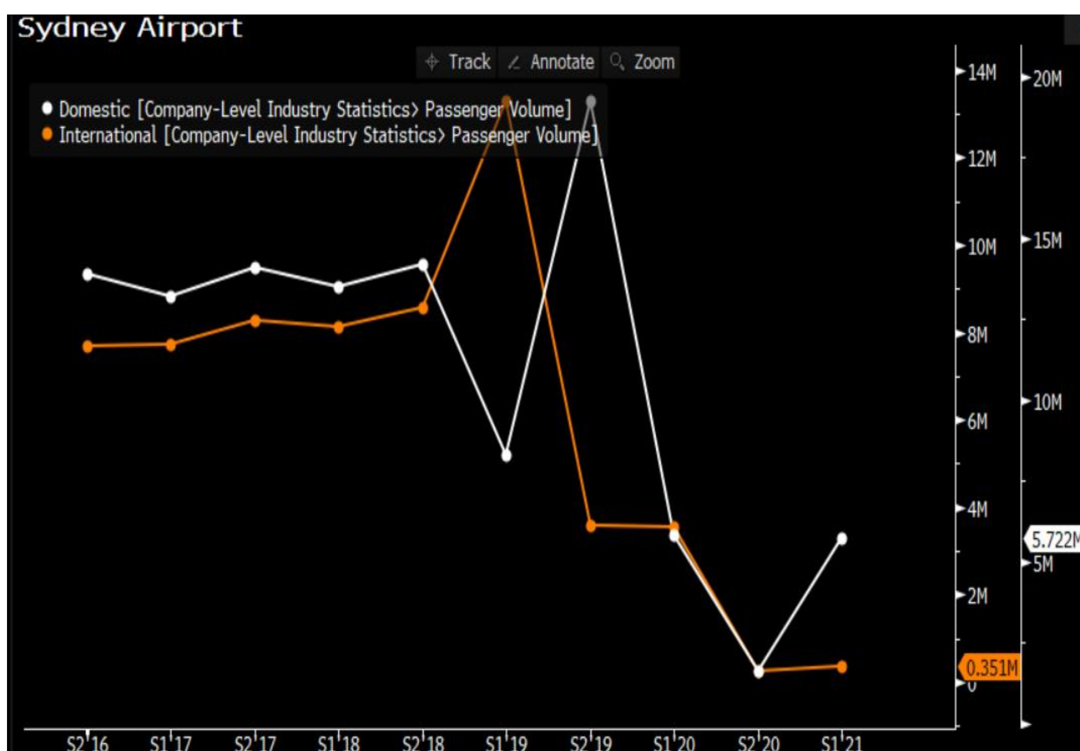
- The Reserve bank of Australia kept its key interest rate and three-year bond target unchanged at 0.10% and stuck to its tapering plan to buy AUD4bn of government securities a week, down from AUD5bn. The board however decided to extend the bond purchases until at least February 2022, which reflects the delay in the economic recovery and increased uncertainty around the Delta outbreak.
- South Australian electricity network manager, Electranet Pty Ltd came to market last week to raise AUD350m via a 7.25yr fixed coupon bond pricing at asset swap +132 basis points – equivalent to a coupon of 2.4737% paying semi-annually. The deal was extremely well received by the market with the final bookbuild more than 4.5 times oversubscribed at AUD1.6bn.

Sydney Airport Inflation Linkers

Sydney Airport is currently in the midst of a potential takeover from IFM, Global Infrastructure Partners, AustralianSuper, and QSuper. This investor base tends to run assets to achieve at least a BBB or higher rating. Thus, holders of Sydney Airport bonds can be confident there is no downside risk (only upside potential).

Passenger traffic is a key revenue driver for the airport both through direct landing charges and indirect retail and car parking streams. In the absence of international passenger recover, Sydney Airport has sufficient liquidity till at least until the end of calendar year 2022, via cash and undrawn facilities. This gives them plenty of buffer if international passenger growth doesn't ramp up as expected.

Chart 1. Sydney Airport Passenger Volumes (in Millions)



Source: Bloomberg

International travel restrictions are likely to be lifted in a gradual process once at least 80% of the eligible population is vaccinated. In our view, even if there are small hiccups by the Federal Government, the credit is safe and can absorb any small delays.

We expect international travel to begin Q4 2021 and to ramp up over Q1 2022 and Q2 2022.Both the State and Federal Governments are incentivised to get Sydney Airport back to an essential part of our transport network. Sydney Airport makes a significant contribution to the state and federal economies, generating AUD38bn in economic activity a year. This contribution is equivalent to 6.8% of the NSW economy and translates into more than 338,500 for the people of Sydney.

The real inflation adjusted yield on these securities can often be higher than the yield offered by equivalent rated nominal BBB corporate bonds. For example, if one used a long-run normalised inflation 'year on year' CPI of 2%, that would be a yield of 3% per annum.

Chart 2. Sydney Airport Linkers Details

Issuer:	Sydney Airport Finance
ISIN:	AU3AB0000085
Security Name:	SYDAU 3.12 11/20/30
Payment Rank:	1st lien
Rating (S&P, Fitch, Moody's):	BBB+, WD, Baa1
Sector:	Industrial
Coupon Type:	Fixed
Coupon:	3.120%
Current Coupon:	3.120%
Next Coupon Date:	20-Nov-2021
Maturity Date:	20-Nov-2030
Duration:	4.0390
Yield:	CPI+1% pa
Running Yield:	2.6442%
Capital Price:	164.049

Source: IAM Capital Markets

Strandline Operating Update

Strandline provided an upbeat construction update on its Coburn Project.

What has changed since last review?

- All major construction contracts are now awarded, which represents over 90% of the construction scope (in terms of value). The latest being construction of a permanent accommodation village, supply of HDPE field piping, and overhead powerlines.
- Civil bulk earthworks construction by Macmahon continues to be the primary focus on site; peak civil workforce reached with the following substantive progress.
- Pioneer workers camp completed and construction of a 270-person accommodation village is progressing rapidly, with first occupancy expected later this month.
- Hybrid power station, dozer mining units, and processing plant EPC works all advancing on-time, with all major mechanical equipment ordered and design reviews and fabrication underway.
- First production of heavy mineral concentrate (HMC) on track for December quarter, 2022.

"All key aspects of Coburn are proceeding in line with our development plan, putting Strandline well on track to capitalise on the buoyant mineral sands market, which is benefiting from strong global demand and ongoing supply challenges." –Strandline MD Luke Graham

Since last review, binding offtakes have been secured for 100% of Coburn's initial production with top-tier customers. As mentioned previously, around 72% of revenue for the first five years of production had been secured through offtake agreements. In our view, the CBRNRS 12 03/20/26 USD bonds offer compelling relative value for investors as part of a diversified portfolio.

From a credit analyst perspective with consideration for what could go wrong, in our view there are two key risks which are appropriately mitigated:

1. *Cost inflation*: This is a very low risk development on the cost side, with 75% of contracts secured on a fixed price basis for the development. Thus, construction risk has been largely transferred to the builder here.
2. *Time delay*: A reason for delay would be a COVID-19 industry pandemic situation in Western Australia related to personnel and travel. Currently, personnel are at their highest level, so this risk would appear quite low.

These two risks are largely mitigated by the fact the covenants are forward-looking and the terms are very strong, i.e., they benefit from a robust security package: first ranking security over the mine plus listed parent STA, cash sweep, DSCR, and a forward-looking Loan-Life Coverage Ratio.

Nonetheless, if bondholders (for any reason) did need to accelerate, recovery on this asset style lend would be close to 100%.

- The current market cap of Strandline Resources implies a group LTV of 52%.
- The definitive feasibility study values Coburn at AUD463m (post-tax NPV), which implies an LTV of 35% for the Issuer.
- On top of this, it has two assets with combined NPV assessed to be AUD223m combined (implying an LTV of 29% for the group).

Chart 3. Coburn Financial Evaluation Case

Category	Updated DFS – Final Product Case (Jun-20)	Scoping Study Extension Case integrated with updated DFS (Jun-20)
Mine Life	22.5yrs	37.5yrs
Tonnes Mined	523Mt	876.8Mt
Throughput	23.4Mtpa	23.4Mtpa
Capital Expenditure (Pre-production)	A$260M	A$260M
Revenue	A$4.37B	A$7.94B
Total Opex (C1)	A$1.80B	A$3.00B
Total All-in Sustaining Costs (AISC)	A$2.08B	A$3.50B
Revenue-to-operating cost (C1) ratio (RC)	2.4	2.6
NPV (pre-tax, real, no debt, 8% discount Rate)	A$705M	A$825M
EBITDA	A$2.35B	A$4.54B
Avg. annual EBITDA	A$104M	A$121M

Source: Coburn Investor Presentation

Equity Bubble: Why it Makes Sense to be Wary of Duration Within Your Fixed Income Allocation

Almost one and half years have gone by since COVID-19 first hit, and markets have gone along in a merry way. Central banks around the world have managed to keep asset prices buoyant through exorbitant quantitative easing (QE) strategies. US Federal Reserve chairman Jerome Powell recently reassured global markets that although tapering is on the precipice, interest rate rises are still some way off. Global markets enjoyed the dovish tone from the US Federal Reserve chairman with equities rallying. However, bonds rallied (yields fell) as well, which begs the question of whether bond markets have correctly priced in or are understating tapering risk? Finally, the events in the Middle East are a good reminder that geopolitical risk can poke its head out when you least expect it.

The aggregated balance sheets of the US Federal Reserve, European Central Bank, and the Bank of Japan have now increased from around USD2trn in 2000 to over USD25trn. A huge twelve and a half times increase over a twenty-year period. Low interest rates globally have encouraged aggressive risk taking to achieve above-average returns – including the use of leverage or derivative-based strategies. Many institutional managers will have allowed risk management standards to slip to achieve set alpha targets. It is arguable if any institutional managers have really generated alpha, or it is a direct result of the liquidity injection from central banks which has helped all managers respectively. In previous cycles, this hasn't boded well for risk assets, and we could be about to see this play out again.

One problem has been that central banks around the world have been overly accommodative as opposed to overly restrictive in their interest rate and monetary policy stance. As a result, investors have latched onto this dynamic like bees to a honeypot – and benefitted from the liquidity pumped into the global system. However, this liquidity has caused correlations and volatility (risk) relationships between the equity and bond markets to breakdown. With equity markets around the world at all-time highs and aggressive risk-taking occurring simultaneously, it is hard to not get cautious about risk assets once again.

A key risk that has also poked its head out is geopolitical risk. The current instability in the Middle East should be a concern for investors with the Delta-variant situation in the United States and generally weaker September/October period for markets. The lack of market volatility following the exit of US troops from Afghanistan also suggests markets have priced in zero downside here.

In our view, while many investors are worried about inflation being higher for longer, we believe the US Federal Reserve narrative around tapering has the potential to disrupt global markets in the near term. The famous taper tantrum in 2013 – when the US Federal Reserve threatened to remove stimulus and caused equities and bonds to both sell off (yields rose) – lives long in the memories of many investors. In fact, the positive approach by the market in response to chairman Powell's recent speech seems to suggest many investors want to believe the story that interest rate rises are still some way off and that inflation will only be temporarily higher. Again, this will not bode well for risk markets if the playbook runs a different course.

In our view, the dwindling benefit investors have received through global liquidity being pumped into the system as well as the inflation story potentially becoming a higher-for-longer paradigm present a new dynamic. For these reasons, there is valid risk interest rate rise expectations are not being correctly priced or understated by the market.

We would be looking to hedge out duration exposure by increasing portfolio allocation to floating rate exposure, especially bank hybrids and corporate floaters. It would be advisable to increase portfolio allocations to inflation-linked bonds, where the coupon is linked to inflation. Finally, moving down the curve to shorter duration fixed rate bonds and increasing credit risk to offset the reduction in yield make sense.

Be mindful, we are not advising investors to completely sell all their fixed rate bonds. However, turning the clock back almost one and half years, we saw, at the time, that those with cash on the sidelines were able to jump at attractive opportunities once they arose. The experience of early 2020 showed us that it was useful to have some ammunition left in the tank. Selling some fixed rate bonds which are trading above par and keeping them in shorter duration fixed rate bonds could prove a fruitful strategy.

Weekly Most Traded

The table below outlines our most frequently traded issues over the past week.

CCY	Issuer	Structure	Rating (Fitch, S&P, Moody's)	Cpn Type	Cpn	Call/Maturity	Yield
AUD	Latitude Group Holdings Ltd	Jr Subordinated	NR, N/A, N/A	Floating	3m BBSW +4.750%	27-Oct-26	4.750%
USD	Aust & NZ Banking Group	Jr Subordinated	N/A, N/A, Baa1	Floating	6m USLIBOR +0.150%	30-Oct-21	10.425%
AUD	Sydney Airport Finance	1st lien	BBB+, WD, Baa1	Fixed	3.120%	20-Nov-30	1.000%
USD	Westpac Banking Corp	Jr Subordinated	N/A, N/A, Baa1	Floating	6m USLIBOR +0.150%	30-Sep-21	11.960%
AUD	National Australia Bank	Jr Subordinated	BBB-, BBB, N/A	Floating	3m BBSW +4.000%	17-Jul-25	3.143%
USD	Coburn Resources Pty Ltd	Secured	N/A, N/A, N/A	Fixed	12.000%	20-Dec-23	10.245%
USD	Barclays Plc	Jr Subordinated	B+, BBB-, Ba2	Fixed	7.750%	15-Sep-23	4.510%
AUD	Pioneer Credit Ltd	Secured	N/A, N/A, N/A	Floating	3m BBSW +7.250%	22-Dec-21	13.500%
AUD	Members Equity Bank	Jr Subordinated	N/A, N/A, N/A	Floating	3mBBSW +5.000%	05-Dec-23	3.864%
AUD	Omni Bridgeway Ltd	Secured	N/A, N/A, N/A	Floating	3m BBSW +4.200%	08-Jan-22	5.820%
AUD	Pacific National Finance	Sr Unsecured	BBB-, BBB-, N/A	Fixed	3.800%	10-Jun-31	3.650%
USD	Infrabuild Australia Pty	1st lien	N/A, BB-*, B2	Fixed	12.000%	14-Oct-21	9.785%
USD	Citigroup Capital XIII	Jr Subordinated	BB+, BBB-, Baa3	Floating	3m USLIBOR +6.370%	14-Oct-21	5.347%

*Priced to the IAM Capital Markets assumption of repayment.

CONTACT US

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