Distressed Investing in Australia
2013 Market Update

Market update

The secondary debt market, consisting of distressed, impaired and non-core loan sales, has continued to experience a good level of activity in the past year.

Whilst activity might have been down on 2010 and 2011, as shown by the fall in visits to Australia by market participants, it does appear to have exceeded expectations. During certain parts of the year liquidity in the market was impacted by the European debt crisis.

In regard to transactions in the last 12 months, one of the largest was Nine Entertainment, where there was sufficient agreement to allow for a debt for equity swap to occur. A scheme of arrangement was used to implement the loan to own strategy, which given the potential contractual issues was a far more seamless process, compared to a formal insolvency process to restructure the group. Other recent restructurings that were implemented through schemes include Alinta, Redcape and Centro.

In terms of debt trading, BrisConnections was one of the largest groups whose debt has started to trade recently following a period of contractual debt "lock-up". It is the owner of AirportLinkM7 in Brisbane. The road opened in July with traffic well below forecast. It has $3+ billion of debt originally across 10 banks. Lenders were considering a debt standstill in February 2013, however opted for a formal insolvency process.

Other matters where debt has continued to trade in the last 12 months include Soul, Oracle, Fitness First, RiverCity, Top Ryde and Gunns. However, it does appear that there are less new syndicated names appearing as distressed.

The largest portfolio transaction in late 2012, was the BOSI commercial loan portfolio with what is believed to be approximately AUD$250 million in face value. Prior to this deal, BOSI also sold its distressed property loan portfolios in Australia and New Zealand, estimated at AUD$3.5 billion combined face value, in two separate transactions to consortiums including Blackstone and Morgan Stanley, and to Goldman Sachs and Brookfield Asset Management.

Based on the above, debt trading does now appear to be generally accepted by banks operating in Australia.

With respect to profiting in the Australian secondary debt market, the results to date appear to have been quite mixed with some participants having extremely good results and others not so. Similarly the prices that banks have sold the original debt have greatly varied on single transactions, particularly given changes in market liquidity, transaction outcomes and currency over recent years.

Going forward

To assess the level of distressed investing going forward and where it will occur, it is necessary to consider, firstly the level of lending and provisions in the Australian banking market and then the lending mix of the local banks.

For the level of loans and provisions, the all Banks Loan Analysis (Figure 1) shows that whilst provisions as a proportion of lending has recently decreased, the level of lending provisions remains relatively high. This is further illustrated in Figure 2.

For Foreign subsidiary banks, Figure 3 highlights the level of provisions against total loans in Australia. The level of provisions to June 2012 has remained high.

With regard to the split of business lending, the Reserve Bank of Australia ('the RBA') published the following table in September 2012.

Major Banks' Business Lending Exposures as at end March 2012

Sector	*Share of total per cent*
Property	25
Utilities, telecommunications and other	22
Wholesale and retail trade	13
Agriculture, forestry and fishing	10
Manufacturing	8
Transport and storage	7
Business services	5
Construction	4
Accommodation, cafes and restaurants	4
Mining	2

Source: RBA

Most interesting from the summary is the large exposure to commercial property and the relatively small exposure to mining, the latter sector tending to borrow from the offshore bond markets. For commercial property distress continues. According to the RBA's September 2012 Financial Stability Review, commercial property market lending (including developers of residential property) accounted for approximately 30% of business loans, but nearly half of businesses loan impairments.

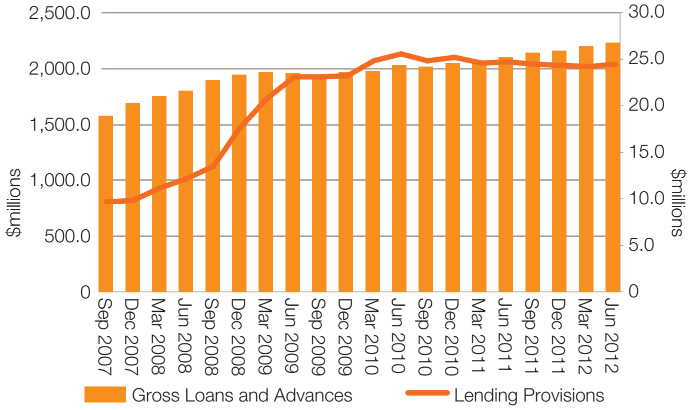
The distress in banks' commercial property exposure does appear to be a result of the longer term impacts of earlier growth as shown in Figure 4.

In summary, for distressed debt investing going forward in Australia, given the relatively high level of impaired debt, the current distressed entities whose debt continues to churn and the acceptance of debt trading by the major banks, it appears that the current level of activity will continue, with a reasonable proportion of distressed being business property loans. However, the largest impediment for future growth in the secondary distressed debt may be the apparent reluctance to expand from syndicated debt and property loan books into the trading of debt in bi-lateral exposures.

Looking forward, whilst some of the large public and leveraged deals have been concluded, activity is expected in the following areas:

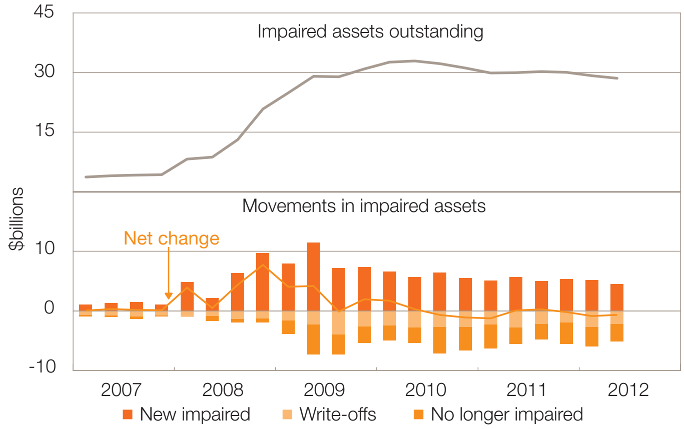
- Mining services
- Retail
- Energy
- Property
- Agribusiness.

Figure 1. All Banks Loan Analysis



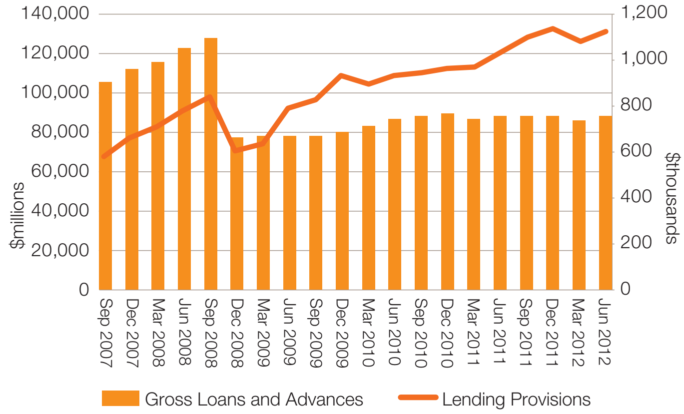
Source: Australian Prudential Regulation Authority (APRA)'s Quarterly Bank Performance Publication (June 2012)

Figure 2. Banks' Impaired Assets – Consolidated global operations



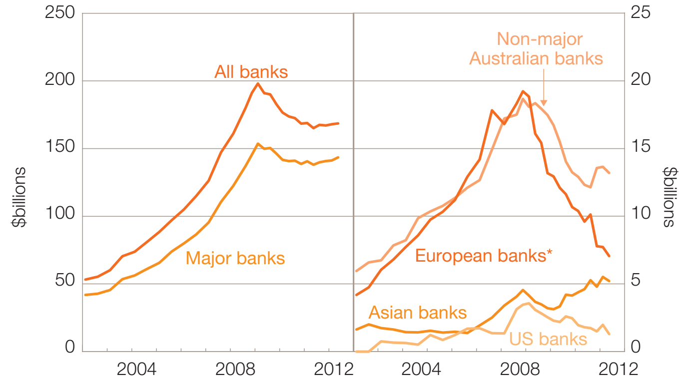
Source: APRA; RBA

Figure 3. Foreign Subsidiary Banks' Loan Analysis



Source: Australian Prudential Regulation Authority (APRA)'s Quarterly Bank Performance Publication (June 2012)

Figure 4. Banks' Commercial Property Exposures – Consolidated Australian operations



** Includes UK and continental European banks*

Source: APRA; RBA

Legal update

There were no new significant reform or legislative developments affecting the secondary market this last year.

Of more interest however, were two decisions of Australian courts which confirm the effectiveness and flexibility of creditors' schemes of arrangements to effect loan to own strategies for senior lenders.

In the decision of *Centro Properties Ltd [2011] NSWSC 1465*, Barrett J approved the scheme notwithstanding objection that the scheme –

- was contrary to public policy because it was inconsistent with winding up priorities and paid money to "out of the money" stakeholders including contingent creditors; and
- amounted to a breach of trust and an unlawful return of capital to shareholders.

His Honor found that the funds being paid were in effect secured creditor funds (rather than company funds) and they were entitled to apply those funds to effect an overall compromise with stakeholders if they wished to do so.

In the decision of *Nine Entertainment Group Limited [2012] FAC 1464*, Jacobson J convened meetings of creditors to consider a creditors' scheme of arrangement notwithstanding objection from minority secured lenders on the grounds that:

- they did not consent to being converted to equity; and
- that the board control rights given to certain senior lenders were class creating.

His Honor found that it was permissible under Australian law to convert senior debt to equity notwithstanding the objections of a senior lender to receiving equity. His Honor also declined to convene separate classes of creditors.

These decisions are very supportive of the secondary market and represent helpful precedents which confirm that the Australian restructuring market can produce similar outcomes to those achievable in the Commonwealth and other common law jurisdictions.

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