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PARTNER CONTENT

THE RISING DEMAND FOR ASIAN BONDS

The latest Asian Bond Investor Survey, sponsored by HSBC and S&P Global Ratings, shows a major desire among investors to add risk — and some surprising results in two areas that will drive the bond market over the coming years.

By **Matthew Thomas**

In 2016, Asian bond issuers faced a series of hurdles, each threatening to destabilise the market more than the last.

Slumping oil prices and fears about China hurt sentiment at the start of the year, but were soon eclipsed by the impact of the United Kingdom's vote to leave the European Union. The Brexit vote, in turn, was overlooked in November as investors struggled to work out what the election of US President Donald Trump meant for the world.

It is remarkable that, through all of this, primary issuance of G3 bonds in the region kept up almost unabated. There were certainly moments of volatility when issuers and investors could not agree on fair prices, but these were measured in days or weeks rather than months. By the end of one of the most surprising years in recent history, G3 issuers in Asia ex-Japan had sold $231.28 billion of bonds, comfortably beating the $220.49 billion record they set in 2015, according to Dealogic.

This year, they have started even stronger. By April 28, issuers in Asia ex-Japan had raised $139.6 billion from the G3 market — almost double the amount sold during the same period at the start of 2016.

To find out what is driving the expansion in Asia's credit markets — and to figure out where investors are focusing their energies now — FinanceAsia teamed up with HSBC and S&P Global Ratings to commission our third survey of the region's bond investor base. The poll, conducted by East & Partners between February and March, had responses from 177 global fixed income investors.

The news was undoubtedly positive. Some 81.4% of investors are planning to add exposure to Asian credit over the next 12 months, compared to 77% that were planning to do so six months ago, when the survey last took place.

China is, perhaps unsurprisingly, the market that generates the most excitement among the global investor base. Around 45.2% of investors said they were looking to increase their exposure to Chinese credits over the next 12 months, despite a steady rise in dollar issuance from the country and easier access to the domestic market for foreign investors.

But while the broader outlook remains strong, some bonds are more favoured than the others. On two of the hottest topics of the moment — infrastructure and green bonds — investors showed notably higher levels of appetite.

BRIDGE TO SOMEWHERE

Since Chinese leader Xi Jinping travelled to Central and Southeast Asia in late 2013, the region has been abuzz with excitement about infrastructure investment. It was on that trip that Xi outlined his 'Belt and Road' Initiative, a massive infrastructure plan that seeks to revive economic links forged thousands of years ago.

The move will transform economies

throughout South, Southeast and Central Asia. But it is not simply about China investing elsewhere; the country's government will also make sure that plenty of money continues to flow into domestic infrastructure projects.

"There has been massive investment in infrastructure in China — and it's not too much of a stretch to say part of that investment is a cornerstone of Belt and Road," said Thomas Jacquot, head of Asia-Pacific infrastructure ratings at S&P Global Ratings. "It is about connecting China to the world, but you also need that connection within China."

Xi's announcement led to a flurry of further developments, including the creation of the Asian Infrastructure Investment Bank and the New Development Bank, two multilateral institutions, and the Silk Road Fund, a Chinese state-owned investor. It has been followed by a renewed commitment to infrastructure spending from governments across the world, from the United States to the Philippines.

"There is a big focus on infrastructure development globally," said Alexi Chan, global co-head of debt capital markets at HSBC. "It is high on the political agenda, right across the Asia-Pacific region. The political impetus could not be stronger right now."

"Infrastructure is high on the political agenda, right across the Asia-Pacific region."

Alexi Chan, HSBC

This is good news for the bond market. It has raised the possibility of a flurry of infrastructure financings, potentially changing the face of Asia's debt markets. But although the excitement is palpable, the flow of deals remains limited. Bank lenders, the old enemy of bond specialists, remain a force to be reckoned with when it comes to project financing.

"Infrastructure financing in Asia is still a bank loan market, but the growth of the loan market has not kept pace with the growth of demand for infrastructure," said Ritesh Maheshwari, head of market and franchise development in Asia Pacific at S&P Global Ratings.

Bond investors are ready to help. Some 53.1% of investors polled said they were planning to increase their exposure to the infrastructure sector in the next 12 months. When this poll was first conducted in March 2016, the percentage stood at just 41.7%.

Perhaps as importantly, 50% of investors said they would 'participate' in the Belt and Road Initiative, compared to just 11.7% who had no plans to do so. (The rest had not yet developed a view.)

PLAIN SAILING

Asia's infrastructure bond market tends to be more vanilla than investors in Europe or the United States may be used to. In those markets, infrastructure bonds are often issued by a special purpose vehicle, have limited or zero-recourse to the parent corporation, and make payments based on the cash flow generated by the project. In Asia, infrastructure bonds much more closely resemble conventional bond deals.

"What's the definition of an infrastructure bond?" asks Jacquot. "In Europe or the US, it needs to be a project bond but in Asia, it usually means a corporate bond issued by a company that operates in the infrastructure space."

That is no bad thing. Although a diversity of structures is a clear positive for investors, the major goal of the infrastructure bond market is simple — to finance infrastructure. Cut a man's journey to work in half and it is unlikely he will ask you about financing structures.

The relative simplicity of infrastructure

Alexi Chan, global co-head of debt capital markets at HSBC

SURVEY DEMOGRAPHICS

TOTAL FIXED INCOME ASSETS UNDER MANAGEMENT

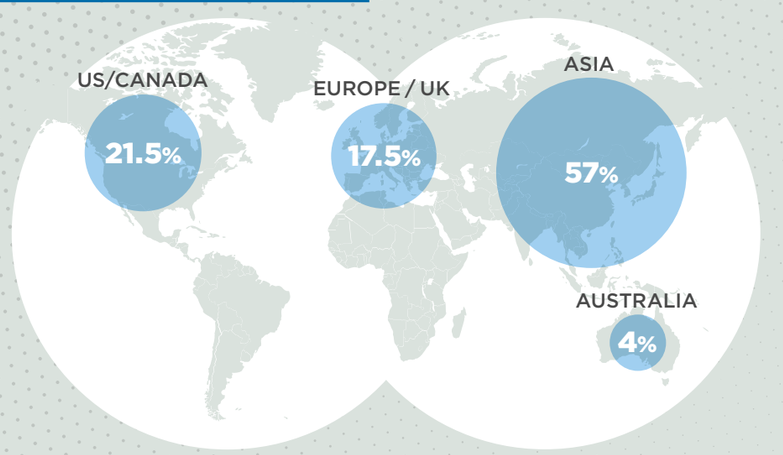
$3.86b
AVERAGE FI AUM

$1.33-6.10b
RANGE OF FI AUM

$0.43b
1ST STANDARD DEVIATION

$683.2b
TOTAL FIXED INCOME AUM AMONG INVESTORS POLLED

RESPONDENTS: GLOBAL DISTRIBUTION



INTERVIEWEE DISTRIBUTION

85.3%
CIO OF FIXED INCOME / HEAD OF FIXED INCOME / HEAD OF CREDIT / HEAD OF EMERGING MARKET DEBT

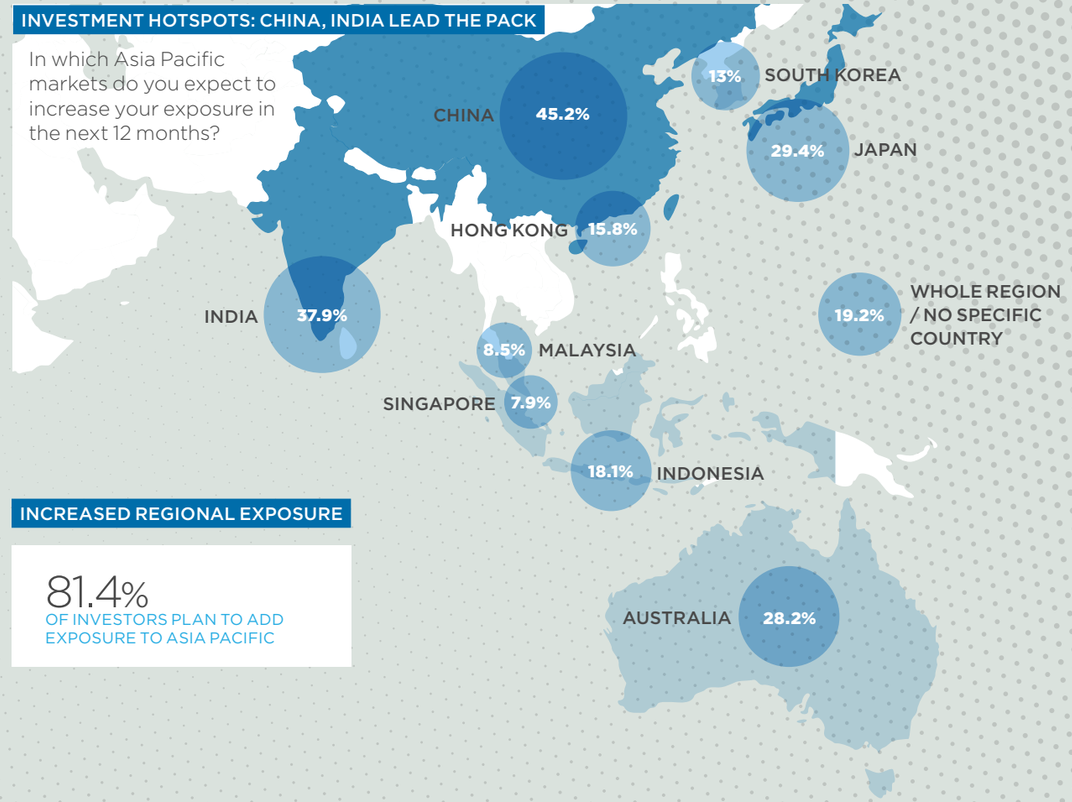
14.1%
SENIOR FIXED INCOME / PORTFOLIO HEAD

0.6%
OTHERS

SURVEY 1 / MARCH 7TH – MARCH 29TH, 2016 **SURVEY 2** / AUG 15TH – SEPT 5TH, 2016
SURVEY 3 / JAN 30TH – MARCH 3RD, 2017

INVESTMENT HOTSPOTS: CHINA, INDIA LEAD THE PACK

In which Asia Pacific markets do you expect to increase your exposure in the next 12 months?



INCREASED REGIONAL EXPOSURE

81.4%
OF INVESTORS PLAN TO ADD EXPOSURE TO ASIA PACIFIC

bonds in Asia compared to Europe and the US should also help bring investors into the market more quickly. It will ensure that conventional bond investors do not need to hire whole new teams — or learn to price new sources of risk — before they can participate.

"The public debt markets will be increasingly important in all of infrastructure finance across Asia," said Matt Bosrock, global head of developing markets at S&P Global Ratings. "Banks are being forced to de-lever, whether due to government pressure or tighter capital adequacy requirements. Having more of that long-term debt provided by the public capital markets will be increasingly important."

Financing the infrastructure gap is going to require all available sources of private and public sector capital, said Chan. Major financings from new and established development banks, as well as continued growth of Asia's local currency bond markets, will be needed to help the region meet the $26 trillion infrastructure requirement it faces, according to Asian Development Bank estimates.

The ADB was behind one prominent recent deal. In the Philippines, a credit wrap from the lender allowed Aboitiz Power to sell an infrastructure bond that doubled as a climate bond, getting certification from the Climate Bond Initiative. The deal captured the two driving factors of change in Asia's bond markets, both offshore and domestic.

Infrastructure bond issuance is getting a lot of attention — but investors may be even more excited about green bonds.

Matt Bosrock, managing director, global head of developing markets at S&P Global Ratings

GREEN LIGHT

The potential for a green bond market in Asia ex-Japan has been talked about for some time. But almost overnight, it has become a reality.

There were $37.6 billion of green bonds sold in the region during the course of 2016, according to Dealogic data which includes both foreign and local currency transactions. That was a mind-boggling 2,230% growth on the previous year, despite the fact that 2015 was itself a break-out year for Asian green bonds. It is clear that this kind of percentage growth cannot continue. But there is ample room for many years of development in Asia's green bond market — and in many different directions. More issuers will be added to the market, from more countries, adopting more novel structures.

There has already been some work done in bringing more countries into the fold. In 2016, issuers from China, Hong Kong, India, Australia and South Korea sold stand-alone green bonds, either at home or abroad.

But the bulk of issuance so far has come from China, often domestic.

After the election of Donald Trump, China's leader Xi Jinping has been transformed into the loudest — and certainly the most important — voice pushing for climate change policy. Bond market regulators and local issuers had already started to move in that direction.

> **"Public debt markets will be important in all of infrastructure finance across Asia"**
>
> Matt Bosrock, S&P

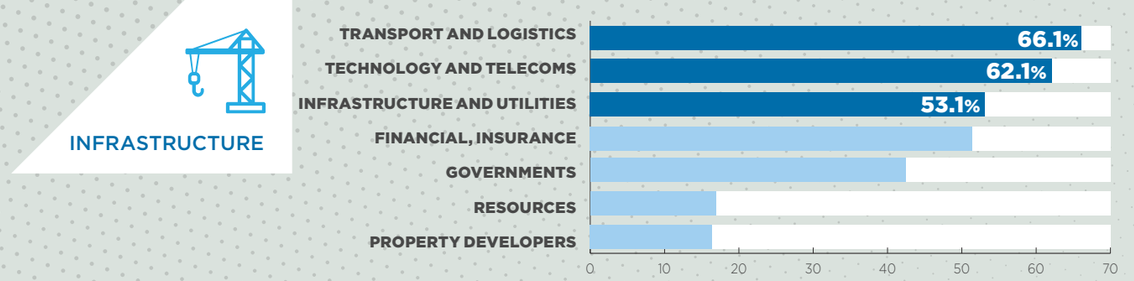
"China is now at the head of the pack when it comes to sustainable finance, and a global leader in the growth of the green bond market" said HSBC's Chan. "We can expect further interesting developments in the green space as China's capital markets continue to open up."

The bulk of these deals are being sold to domestic investors, despite the gradual opening up of China's bond market to foreign fund managers. But a few novel deals have married the onshore and offshore markets.

Bank of China provided one such

SECTORS TO WATCH

Which sectors within Asian fixed income do you think will be the most attractive in 2017?



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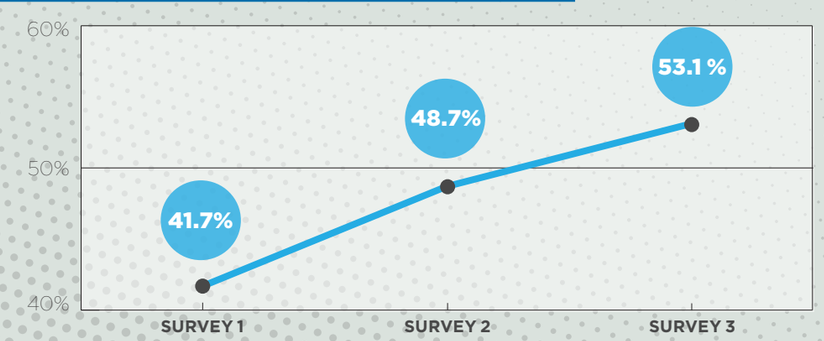
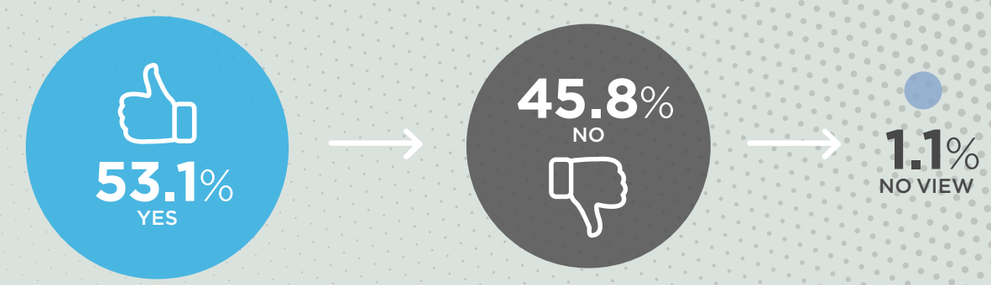
INVESTORS INCREASINGLY BULLISH ON INFRASTRUCTURE BONDS



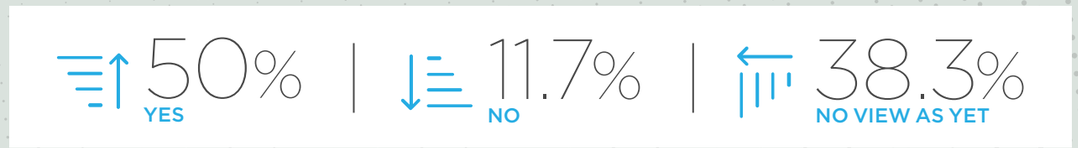
INFRASTRUCTURE GETS A BIG THUMBS UP

Do you expect to increase your fixed income exposure to the infrastructure sector in the next 12 months?



THE IMPORTANCE OF BELT AND ROAD

For those investors who answered 'Yes' to the above question, we asked: Are you likely to participate in the 'Belt and Road' agenda?



example last November, selling a $500 million bond that combined green bond status with covered bond technology. The deal was backed by a portfolio of 11 different onshore renminbi covered bonds, bridging the gap between onshore issuers and overseas investors.

One of the most hotly-debated subjects among green bond bankers is when the format will start to offer Asian issuers a meaningful funding cost saving. There is some anecdotal evidence of cheaper pricing in the European market, but so far Asian issuers do not appear to have achieved an economic benefit from their green bond issuance. Several market participants interviewed by FinanceAsia drew a comparison with the sukuk market. In both markets, a specialist investor base — Islamic investors and green bond funds — are crucial to ensuring a pricing advantage over conventional issues. But these investor bases need to achieve a critical mass before this becomes the case.

In the Islamic bond market, that has already happened, at least in some countries. In the green bond market, it is something for issuers to look forward to in the future. But there is little debate that, as the green bond investor base grows, the economic argument will grow with them.

"China is now at the head of the pack in sustainable finance"

Alexi Chan, HSBC

Just how much do investors want to increase their allocations to Asia's green bond market? The poll results paint a complex picture. Some 50.8% of investors said they were planning to boost their holdings of green bonds, up from 47.4% in the last round.

The percentage of investors that held green bonds actually fell to 13.6% in the latest round, down from 14.5% in round two and 14.6% in round one. Given the huge increase in green bond issuance in the region, this is likely down to an increase in the sample towards more non-Asian investors. But there is still plenty of work left to be done.

"We continue to work hard to raise awareness of this topic amongst the broader Asian investor base," said Chan.

HSBC

S&P Global Ratings

"The survey confirms that the broader drivers for bespoke portfolios dedicated to this asset class in Asia are still at an early stage – implying significant upside potential."

The education process is something that is going to require the collective effort of issuers, bookrunners, lawyers and analysts.

This can happen in part through the choice of well-known issuers. MTR Corp, the Hong Kong underground public transport operator, had the name recognition to make investors pay attention when it launched its own $600 million 10-year green bond in October 2016. By bringing more such deals from well-known credits, banks can convince investors that green bonds deserve a consistent allocation — not just of capital, but also of time and people.

But it also needs to happen on a more granular level, including by allowing investors to truly understand quite how green an issuer really is. With this in mind, S&P Global Ratings has launched its Green Evaluation service, an asset-level credential service that combines existing frameworks of governance and transparency — for example, the Green Bond Principles — with two additional pillars for climate resilience and environmental impact.

"Green Evaluation, which aims to provide investors with a more comprehensive picture of the green impact and climate risk attributes of their portfolios, can be applied to any type of financing, in part or in full," said Maheshwari.

Of course, green bond markets are only part of a wider movement. The

Ritesh Maheshwari, managing director, head of market and franchise development, Asia-Pacific at S&P Global Ratings

GREEN BONDS

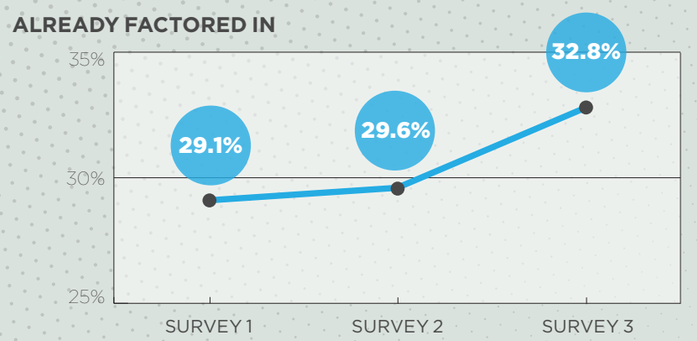
INVESTORS PLAN TO BOOST THEIR ALLOCATION TO GREEN BONDS

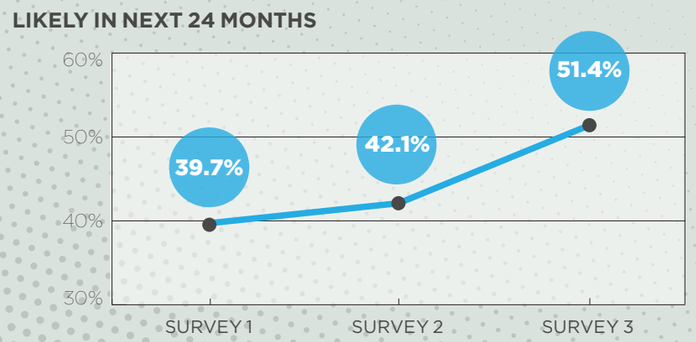
50.8%

UP FROM 47.4% IN THE LAST ROUND

IN THE MARKET FOR GOOD

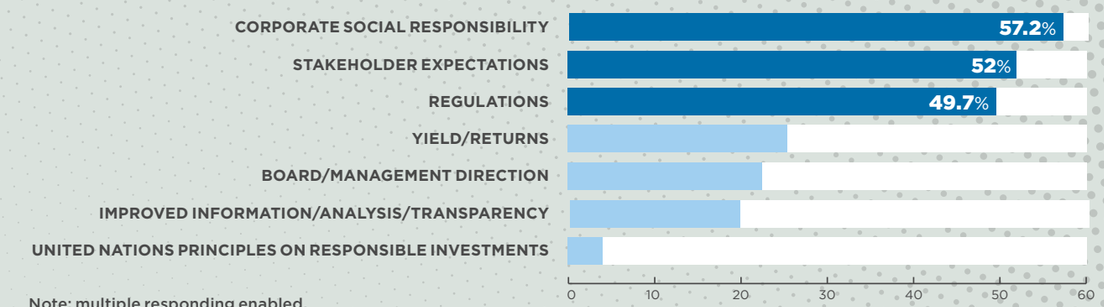
How strongly are environmental, social and governance factors (ESG) impacting your future credit investment decisions?





THE DRIVERS OF RESPONSIBLE INVESTMENT

If you already factor in ESG — or are likely to — what is driving this move?



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GOING GREEN

Are you invested in green bonds?

YES, OR 'FAMILIAR WITH GREEN BONDS BUT NOT YET INVESTED'

SURVEY 1	SURVEY 2	SURVEY 3
80.2%	81.6%	83.7%

HSBC

S&P Global Ratings

environmental, social and governance (ESG) segment of the bond market allows issuers a broader scope to address different causes — gender equality or wildlife conservation, for example — while still appealing to socially conscious investors.

Some 32.8% of investors responding to our poll said they had already factored ESG issues into their decision-making criteria, and another 20.3% expected to do so within the next 12 months. Only 2.3% of investors said they were not likely to consider ESG factors at any point.

There are clues in the data as to what will drive investment in green bonds. Some 57.2% of respondents said that increasing emphasis on corporate social responsibility was pushing them towards greater consideration of ESG — and 52% said the move was being driven in least in part by stakeholder expectations. Few things can drive a change in a fund's strategy more than the wishes of their own investors.

It is clear that the ESG market is here to stay. "Eighteen months ago, ESG came up in about one in every three meetings I had — and even then, it was the names you would expect," said Bosrock. "Now, it comes up in every single meeting."

CREDIT WHERE IT'S DUE

Green bonds and infrastructure finance were just two of the many topics investors were asked about in FinanceAsia's latest survey. Among the other questions put to investors were several on just how investors made their decisions — and in particular, how much weight they put on credit ratings.

Ratings appear increasingly important. Some 89.3% of respondents to the latest survey said they were either 'very important' or 'important' for bond issuers. That was around 8.5 percentage points higher than those who said the same during our first survey.

This does not mean there is no demand for unrated bonds. Prolonged low rates have ensured bond investors are both flush with liquidity and desperate for yield. As a result, some 47.5% of investors are also planning to increase their exposure to unrated deals.

A problem to consider is that when new issuers come to the market, it may be easier for them to make do without a rating. Their bankers can point to rated industry rivals when trying to coax investors into the 'correct' credit assumption. Secondary prices for their sector or country can provide a benchmark for pricing.

This would go some way to explaining why investors are both stressing the value of ratings while also proving willing to take on more unrated exposure. But the real surprise comes when you consider expectations on rates of default. Around 34.5% of investors expect rising defaults over the next 12 months — and more than 10% of investors polled expect a 'significant' increase in defaults.

Why, then, are they so eager to increase their exposure to unrated bonds?

A major factor was yield. The chase for yield was a driver for 91.7% of respondents to our poll, well above the 35.7% who were using unrated deals to get access to alternative asset classes. But investors will need to strike a balance between hitting their yield targets and unwittingly taking on too much risk.

"To lower risk in their portfolio, investors can demand that more issuers obtain credit ratings," said Maheshwari. "As reflected in the survey, transparency is becoming increasingly important in today's volatile environment."

> **"Transparency is becoming increasingly important in today's volatile environment."**
>
> Ritesh Maheshwari, S&P

There is reason to be optimistic. Rising interest rates in the United States are likely to remove some of the desperation among yield-hungry investors — and an increasingly diverse issuer base is going to help spread the risks that investors do take on with unrated deals.

Asia's bond market has been growing at a breakneck pace for the better part of a decade. But the major opportunities for the market — from green bonds to infrastructure and beyond — are still around the corner. Investors rightly have disparate views of sectors, spreads, and specific issuers.

But most of those investors polled share one thing in common. They're hungry for more. **FA**

THE RISING IMPORTANCE OF RATINGS

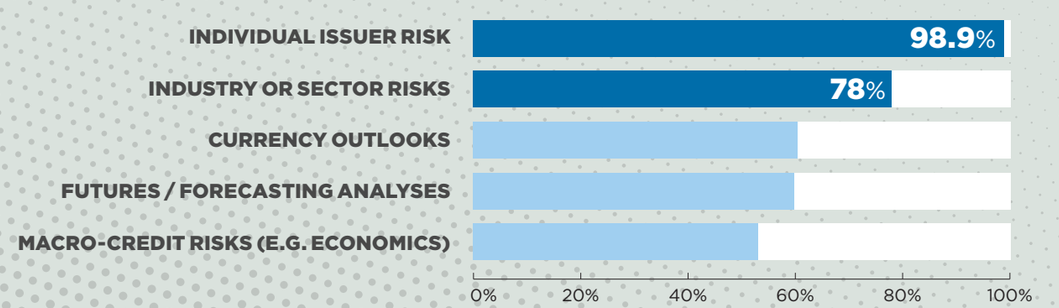
How important is it for an issuer and/or a bond to have a public credit rating?

RATINGS & RESEARCH

SURVEY 1	SURVEY 2	SURVEY 3
80.8% TOTAL	83.6% TOTAL	89.3% TOTAL

FOCUS: THE KEY TO VALUABLE RESEARCH

How would you prioritise the following in terms of research that can be provided to help you make more informed investment decisions?



THE DEFAULT OPTION

Do you expect default rates to increase in Asian fixed income markets in the next 12 months?

OUTLOOK

SURVEY 1	SURVEY 2	SURVEY 3
27.8%	30.9%	34.5%

UNRATED, BUT NOT UNLOVED

In the next 12 months how will your exposure to public unrated bonds in Asia-Pacific change?

INCREASED SIGNIFICANTLY OR SLIGHTY

SURVEY 1	SURVEY 2	SURVEY 3
42.3%	44.1%	47.5%

CHINA RISING

Are you currently invested in China's onshore bond market?