

CBA PERLS VI (CBAPC) : Looks attractive at the right margin though not quite a black PERL

Recommendation: Subscribe Prefer margin of at least 3.80%.

Overview

Commonwealth Bank (CBA) will raise \$750m via an ASX-listed hybrid issue, Perpetual Exchangeable Resaleable Securities VI (PERLS VI) (ASX Code: CBAPC). This is another mandatory converting hybrid. CBAPC are perpetual, exchangeable, unsecured, subordinated notes with a mandatory exchange date of 15 December 2020, subject to conditions unless they are redeemed or exchanged earlier following specific events (see key terms) or CBA exercising an option to call the security two years early. Face value is \$100. Fully franked dividends are discretionary and non-cumulative payable quarterly, based on the 90-day BBSW rate plus a margin. CBA has not provided an indicative margin range. This issue will fund the redemption of PERLS IV (CBAPB), which are approaching their mandatory conversion date of 31 October 2012.

Summary and Recommendation

We recommend investors subscribe. On an absolute basis the security is undervalued as we expect it to offer a margin comfortably above our fair margin of 3.15%. We point out however that similar securities (ANZ's ANZPC and Westpac's WBCPC) are currently trading at margins around 3.80% so we would prefer CBAPC to have a margin of 3.80% or more.

The security potentially offers attractive distributions backed by a business with strong competitive advantages. However, the additional terms such as the mandatory conversion trigger conditions make CBAPC the most equity-like of the major bank hybrids on issue and therefore the riskiest in that relatively low risk group. Investors need to be comfortable with this. We would have preferred CBA issue a higher ranking, pure debt security such as the subordinated note issues by the other major banks (ANZHA, NABHA,

WBCHA) though the margin on CBAPC will be higher to compensate for the higher risk.

We assign CBA a low business risk and are comfortable with an investment in CBA. As such CBAPC falls into the lower risk group of our income securities coverage universe but note that in terms of the major bank hybrids, it is more risky. Investors also need to appreciate CBAPC is an unsecured and subordinated investment, so in a wind-up scenario, investors could potentially lose all their investment. Put simply, it is riskier than a bank deposit. To be very clear though, we don't forecast financial distress for CBA. Investors are also exposed to the possibility of a fall in CBA's share price to below the minimum conversion price, in which case the security would not be converted and would roll over until the share price recovers. But we think this unlikely and have a fair value estimate of \$60.00 on CBA shares, which is above where they currently trade. There is also the risk investors could get less than \$100 worth of shares on conversion following specific trigger events. Compared to a recent share price for CBA of \$54, the price of CBA shares would have to fall to around \$10.80 for CBAPC securityholders to receive CBA ordinary shares worth less than \$100. We think this too is unlikely as that price is well below our \$44 bear-case fair value estimate for CBA ordinary shares.

We remind potential investors to weigh up alternative investment options, depending on their individual preferences: bank deposits, bank equity, or bank debt such as this security. Yields on major bank equities still look attractive though they carry more risk and prices are more volatile than hybrids. For example, Morningstar has a forecast FY13 gross yield of around 9.1% for CBA based on the recent share price of \$54 and 8.2% on our \$60.00 fair value estimate.

Valuation

While all the CBA hybrids have the same underlying exposure, being the CBA group, the terms of CBAPC are less attractive than CBAPA and CBAPB so we assign a higher fair margin of 3.15% versus 2.40% for CBAPA and CBAPB. The fair margin is calculated using a credit spread of 1.80%, an illiquidity cost of 0.10% and an additional 1.25% to account



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About Morningstar

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Major Bank Dividends Yields

ASX Code	Morningstar Gross FY13 Forecast Yield
ANZ	8.9%
CBA	9.1%
NAB	10.8%
WBC	9.9%

Source: Morningstar 20 August 2012

for non-cumulative distributions, the maximum number of shares on conversion conditions, Capital and Non-Viability Trigger events, subordinate dividend stopper conditions and risk of substantial share price movement.

CBAPC is a 'true' hybrid with debt and equity like characteristics as it can be converted into ordinary equity. It is of similar ilk to the most recent hybrid issues by ANZ and Westpac (WBC) (ANZPC and WBCPC), which have been issued under stricter rules imposed by the prudential regulator, Australian Prudential Regulation Authority (APRA). ANZPC and WBCPC are the closest listed major bank hybrids to CBAPC, however, the terms of CBAPC are less favourable than these two securities.

Our fair margin of 3.15% on CBAPC is higher than our 2.65% fair margin for ANZPC and WBCPC and 2.40% for CBAPA and CBAPB. ANZPC and WBCPC pay margins of 3.10% and 3.25% above the 180-Day BBSW rate. If we exclude notional accrued distributions, ANZPC and WBCPC were trading below face value as at 30 August 2012. Consequently they have been trading on market at higher margins, averaging around 3.8% recently.

On an absolute valuation basis, if the margin on CBAPC is set above our fair margin of 3.15% the security would look attractive. However for an investor with a dollar to invest, the choice is between the CBAPC offer or one of the securities currently on issue. Therefore on a relative valuation basis we prefer CBAPC to have a margin of 3.80% or above, which is where ANZPC and WBCPC currently trade. If the margin is set below the trading margins on ANZPC and WBCPC it is reasonable to expect CBAPC to trade on market below face value. So there may be a better entry point into CBAPC once it lists.

Security Risks

Similar to ANZPC and WBCPC, CBAPC has a Capital Trigger event clause which requires immediate conversion of some or all securities into ordinary equity if the bank's core capital ratio falls below 5.125%. In such a scenario CBAPC securityholders would receive ordinary shares worth less than \$100 if the CBA share price at the time was less than the relevant amount, due to a maximum number of shares on conversion condition.

CBA's Common Equity Tier 1 ratio on a Basel III basis ratio was 7.5% as at 30 June 2012. This provides a healthy buffer of around \$8b over the 5.125% minimum. This ratio is not likely to trickle down to 5.125%. Any fall below 5.125% would probably be sudden, through a major operational failure such as

rogue trader losses or a massive increase in bad debts. Put in context, such an event would have to erase around \$8bn of capital or slightly more than one year's profits - not impossible, but highly unlikely. If this ratio did fall below 5.125%, CBAPC holders would likely suffer a capital loss due to maximum conversion conditions, unlike holders of CBAPA, which doesn't have this condition. However in such a scenario the price of other CBA hybrids would likely trade like equity and be adversely impacted. So if CBAPA and CBAPC were trading at similar margins our preference would be CBAPA given its superior terms.

CBAPC has inferior dividend stopper conditions, similar to ANZPC and WBCPC. CBA could potentially keep paying distributions on CBAPA and PCAPA while not paying on CBAPC. This situation is unlikely but possible.

CBAPC is the first major bank hybrid with a Non-Viability Trigger, which is now required by the prudential regulator, APRA, as part of Basel III global financial industry reforms. The Non-Viability Trigger essentially gives APRA the discretion to require some or all of CBAPC to be converted into CBA ordinary shares. Similar to a conversion following a Capital Trigger event, holders could potentially receive ordinary shares worth less than \$100.

A Non-Viability Trigger Event occurs if APRA believes that CBA would become non-viable without an exchange of some or all of CBAPC or a public sector injection of capital or equivalent support. The use of this trigger event by APRA is at its discretion so may not be limited to its concerns about CBA's capital levels and could extend to concerns about the bank's funding and liquidity. CBA's metrics for capital funding and liquidity are strong. However, being a qualitative trigger, assessing the Non-Viability Trigger is more complex than a quantitative benchmark like the Capital Trigger. This makes CBAPC the most equity-like of the major bank hybrids on issue and therefore riskier. These terms are imposed by APRA and effectively make CBAPC subordinate to other CBA hybrids on issue. It must be remembered APRA is trying to protect policyholders and depositors. We consider securityholders' prospective interests in our analysis.

Other security risks include:

- ▶ CBAPC are an unsecured, subordinated investment, so in a wind-up scenario noteholders could potentially lose all of their investment.
- ▶ CBA could default on the payment of distributions. Missed distributions do not have to be made up.
- ▶ CBA could issue more equal or higher-ranking securities, which may reduce the ability of CBAPC

holders to recover their investment in a wind-up scenario. In such a scenario CBAPC holders will likely have been converted into CBA ordinary shares so the possibility of recovering any capital would be slim.

- ▶ The price of the security once listed may be impacted by changes in credit spreads, interest rates and the financial performance of CBA.
- ▶ These are floating rates securities that will reprice quarterly, so interest-rate changes will affect distributions.
- ▶ There is a risk that liquidity of the securities will be low, which will impact the bid/ask spread.

Key Differences between CBAPA, CBAPB and CBAPC

There are several similarities between these three CBA hybrids, but we note key differences which make CBAPC less attractive than CBAPA and CBAPB:

- ▶ Capital Trigger and Non-Viability Events. If either of these are triggered, CBAPC securityholders could potentially receive shares worth less than \$100, as a Maximum Conversion Number of shares would apply. This is not applicable to CBAPA and CBAPB. The stricter condition is required by APRA.
- ▶ Dividend Stopper: The dividend stopper conditions for CBAPC are not as favourable as they are for CBAPA and CBAPB holders. For CBAPA and CBAPB the dividend stopper applies to equal and junior ranking securities unless consecutive distributions are paid for 12 months or an optional distribution equal to 12 months of unpaid dividends is paid. For CBAPC, this restriction only applies to distributions on its ordinary shares. This means that CBA could keep paying distributions on CBAPA (we assume the CBAPB will be redeemed), while not paying CBAPC distributions. In effect, this is a quasi subordination of CBAPC to CBAPA. CBAPC are redeemable two years early by CBA and there is no step in margin if CBA does not redeem.

Comparison to PCAPA

PCAPA are not mandatory convertors, but have a step-up margin feature. On the step-up date, the margin increases 1% to 2.05% above 90-day BBSW if not redeemed. Like CBAPC, PCAPA has a maximum conversion number of shares condition. For PCAPA this condition applies if CBA's Tier 1 capital ratio falls below 5% or total capital ratio falls below 8%. PCAPA do have more favourable dividend stopper conditions similar to CBAPA and CBAPB.

Similar Bank Hybrids on Issue

ANZ and WBC have similar hybrids (ANZPC and

WBCPC) on issue to CBAPC, but they do not have a Non-Viability Trigger event condition. On the positive side CBAPC pays distributions quarterly rather than semi-annually as do ANZPC and WBCPC.

CBA Perls III (PCAPA). Although not a mandatory convertor, these hybrids have a maximum conversion number if CBA's Tier 1 capital ratio falls below 5% or total capital ratio falls below 8% and there are similar conditions which indicate that the bank is in distress.

Westpac TPS (WCTPA). Although not a mandatory convertor, these have a maximum conversion number if WBC's Tier 1 capital ratio falls below 5%.

About the Issuer

CBA is one of the four major Australian banks and the largest by market capitalisation (\$86bn). CBA offers a full suite of banking services in Australia and New Zealand, also operates in certain Pacific and Asian countries, and sells wealth management, life and general insurance in Australia. The bank reported total assets of \$718bn as at 30 June 2012, including \$532bn in gross loans, bills and receivable. Cash NPAT for FY12 was \$7.1bn, representing a ROE of 18.6% and EPS of 449.4cps.

Issuer Thesis

The financial crisis exposed some poor commercial lending decisions but in the long run CBA has consistently grown shareholder wealth in favourable economic times. The loan book's large weighting to home loans and the high proportion of customer deposits in funding reduce risk.

A narrow economic moat rating is justified by the bank's strong competitive position. Securitising non-bank financials and foreign banks previously provided fairly strong competition for CBA in home and business loans and business deposits but the bank's ROE has not fallen below the cost of equity for the last 10 years. Foreign banks are a lesser force now but even in their heyday they never mounted a serious assault on the retail franchises, market shares or branch networks of the major banks. The sunk costs and infrastructure were too great to replicate. Local regional banks tend to follow the majors on pricing and are not currently in a position to threaten CBA's economic returns. Bouts of apparently intense price competition between the four major banks have not threatened superior shareholder returns.

Many investors are concerned about a sharp downturn or crash in the Australian housing market. While Australian housing is expensive and debt-to-household income ratios are high, we remain comfortable for

several reasons. Tight underwriting standards, lender's mortgage insurance, low average loan-to-valuation ratios, a high incidence of loan pre-payment, full recourse lending, a high proportion of variable rate home loans and the scope for interest rate cuts by the Reserve Bank of Australia (RBA) combine to mitigate potential losses from mortgage lending. We cannot rule out falling home prices but investors who readily compare the Australian residential real estate market to that of the U.S. and other markets are ignoring fundamental differences.

CBA's Core Banking Modernisation (CBM) program is a major transformation project replacing antiquated, unreliable and inefficient 40 year-old IT systems. CBM should drive competitive advantage by enabling faster and targeted marketing campaigns, real-time banking and a smoother, more efficient customer experience.

The main current influence on earnings growth is weak credit growth, a product of household risk aversion and deleveraging, and delays to business plans for capital expenditure. Funding cost pressures are constraining interest margins.

Bad and doubtful debts expense peaked in first half fiscal 2009 and normalised by the end of fiscal 2011. Writebacks of the economic overlay, a general provision for higher bad debts in case the economy deteriorates sharply, are on hold during the current patchy economic conditions. Wealth management earnings will struggle while equity markets trend sideways or downwards. In addition cost control will be necessary for earnings growth in an environment of weak revenue growth.

CBA's narrow economic moat should enable it to grow profitably at the rate of system credit growth despite the headwinds. The four major banks have a powerful grip on lending markets and are also the first choice of depositors seeking capital security. CBA has one of the most recognised and trusted bank brands in Australia, the advertising and marketing budget, and customer fulfilment capacity (branches, systems, funding capacity) to increase this brand equity. CBA has proven it can increase cross-sell ratios and we expect further improvement as the CBM project rolls out. Excellent cost efficiency and room for further incremental improvement facilitate profitable growth even during periods of pricing pressure.

Business Risks

Issuer Risk

We assign CBA a low business risk. CBA is a leveraged financial group lending to all segments of the economy. It is therefore exposed to deteriorating

economic conditions. Higher interest rates, inflation and unemployment can reduce loan growth and increase bad and doubtful debts expense, while exchange rate volatility can affect certain sectors. In a severe recession CBA might not be adequately provisioned for the resulting bad debts. A substantial loss of market share in any major segment, coupled with contraction in net interest margins, would diminish net interest income. Wealth management earnings depend on the levels and direction of equity markets. Banks are tightly regulated and are thus exposed to adverse regulatory changes.

Some 20% of total funding is from offshore wholesale funding markets, exposing CBA to higher wholesale funding costs flowing from the European credit crisis. Since the 2008 global financial crisis CBA has mitigated this risk by increasing the maturity of its wholesale funding. The bank also retains the option to reprice the loan book, though this would be unpopular with customers.

Economic Moat

We assign a narrow moat rating to CBA, mainly due to sustainable structural characteristics of the Australian and New Zealand banking industries. The other three major banks also have narrow moat ratings.

Banking in Australia is largely an oligopoly, with the four major banks controlling over 90% of the business and consumer lending markets, plus the vast majority of bank deposits. Pricing is rational. New Zealand is similar. The concentrated industry benefits from high barriers to entry across most segments, making it hard for new entrants to gain any sort of foothold, particularly in retail and business banking. Foreign banks have not made a serious dent in the domestic majors' market share, while the smaller regional banks compete on service and local brand recognition but face higher wholesale funding costs than the majors and are unable to undercut on price. They tend to follow the majors in pricing.

Well-managed scale begets more scale. CBA leverages its large branch network to increase cross-sell, for example, of wealth management and insurance products. CBA's large scale generates substantial cost advantages over smaller banks and non-banks. This enables CBA to price competitively but still at levels which generate current ROEs.

In common with the other majors CBA has pricing power from brand strength, an intangible asset. Australians and New Zealanders have a cultural preference for large financial institutions with heritage brands due to perceived greater financial security.

This preference exists even when the customer is a borrower.

A combination of scale, for example CBA accounts of 25% of the banking system's loans, and years of relentless management attention to costs make CBA one of the most cost-efficient banks in its industry, with a cost/income ratio of 46% in fiscal 2012 (banking sector average 47.0%). This enables the bank to price competitively while maintaining superior shareholder returns.

Management

We rate management highly. CEO Ralph Norris retired in late 2011 after six exemplary years of shareholder capital stewardship, including steering CBA through the global financial crisis with relatively little damage to earnings. His tenure was marked by few operational, execution and strategic missteps and many successes, especially a resilient strategy which continues to this day.

New CEO Ian Narev is a talented executive who got the job because he demonstrated understanding of the rapidly changing world of banking. He does, however, have relatively little experience as a banker, having headed CBA's Business & Private Banking Division only from 2009 to 2011. Before 2009 he was Group Head of Strategy and led the acquisition of Bankwest in 2008, as well as the investment in Aussie Home Loans. Before joining CBA, Ian Narev was a partner of McKinsey & Company, the global consulting firm, and before then a lawyer specialising in mergers and acquisitions.

Banking is a specialised and risky business and we normally prefer experienced career bankers as CEOs. Ian Narev demonstrates potential as a farsighted leader in the changing world of banking but has relatively little experience at loan underwriting and is untested at the CEO level

Earnings

CBA delivered a record result with FY12 cash NPAT coming in at \$7.1bn, up 4% on FY11 in line with Morningstar's forecast. There were no major surprises and Morningstar retained its positive view on the narrow moat bank. The full year dividend was a record \$3.34ps fully franked representing a 75% pay out. Earnings were supported by moderate loan growth (up 5%), strong customer deposit growth (up 8%), better than expected bad debts (down 15%) and solid cost control (up 3%). Divisional composition was strong with all divisions except Wealth Management increasing earnings. Business Banking, Institutional Banking and Bankwest all delivered impressive results.

In terms of income mix, banking represented 85%, fund management 10% and insurance 5% of total operating income. Net interest income, the most stable revenue line accounted for a healthy 66% of total operating income. Other banking fee income represented just below 20% and trading income, one of the most volatile revenue components, contributed less than 3%. By region the majority of CBA's income is sourced from Australia (88.6% in FY12) with New Zealand making the next highest contribution of 7.9%

Capital

CBA has a strong capital position well above APRA and Board minimum requirements, even allowing for the soon to start tougher Basel III regulatory changes. The downside of increasing capital levels is pressure on ROE and we saw CBA's sector leading ROE suffer from a 90bp fall to 18.6%. High absolute profitability, moderate loan growth and DRP take-up combine to boost capital levels enabling an increase in the dividend payout from 73% to 75%.

On a Basel II basis CBA's Common Equity Tier 1 ratio was 7.82%. On a draft Basel III basis CBA's Common

Table 1: Major Bank Hybrids and Dividend Yields as at 30 August 2012

ASX Code	Issuer	Contract Style	Trading Margin	Gross Running Yield	Gross YTR	BBSW
ANZPA	ANZ	Mandatory Conversion	3.18%	6.96%	6.99%	90-day
ANZPB	ANZ	Mandatory Conversion	2.74%	6.33%	6.52%	90-day
ANZPC	ANZ	Mandatory Conversion	3.88%	7.10%	7.64%	180-day
ANZHA	ANZ	Note	2.67%	6.53%	6.46%	90-day
CBAPA	CBA	Mandatory Conversion	3.13%	7.21%	6.93%	90-day
PCAPA	CBA	Step-up	4.75%	5.44%	8.86%	90-day
WBCPA	WBC	Mandatory Conversion	3.21%	6.25%	7.17%	90-day
WBPCB	WBC	Mandatory Conversion	2.88%	7.52%	6.60%	90-day
WBPCP	WBC	Mandatory Conversion	3.74%	7.20%	7.57%	180-day
WCTPA	WBC	Step-up	4.93%	5.48%	9.06%	90-day
NABHB	NAB	Note	2.73%	6.56%	6.53%	90-day

Source: CBA

Table 2: Comparable Mandatory Converting Major Bank Hybrids

	CBAPC	CBAPB	CBAPA	ANZPC	WBCPC
Name	CBA PERLS VI	CBA PERLS IV	CBA PERLS V	ANZ CPS3	WBC CPS
Type	Mandatory Converting Hybrid	Mandatory Converting Hybrid	Mandatory Converting Hybrid	Mandatory Converting Hybrid	Mandatory Converting Hybrid
Issuer	CBA	CBA	CBA	ANZ	WBC
Issue Size	\$750m, but can raise more or less.	\$1.465bn	\$2.0bn	\$1.34bn	\$1.189bn
Face Value	\$100	\$200	\$200	\$100	\$100
Issue Date	17-Oct-2012	12-Jul-2007	14-Sep-2009	29-Sep-2011	23-Mar-2012
Margin above Base Rate	No Indicative range provided	1.05% p.a.	3.40% p.a.	3.10% p.a.	3.25% p.a.
Base Rate	90-Day BBSW	90-Day BBSW	90-Day BBSW	180-Day BBSW	180-Day BBSW
First Call / Exchange/ Redemption Date	15-Dec-2018	N/A	N/A	1-Sep-2017	31-Mar-2018
Mandatory Exchange Date	15-Dec-2020	31-Oct-2012	31-Oct-2014	1-Sep-2017	31-Mar-2020
Step-Up	None	None	None	None	None
Distributions	Discretionary, non-cumulative, fully franked distributions with a dividend stopper.	Discretionary, non-cumulative, fully franked distributions with a dividend stopper.	Discretionary, non-cumulative, fully franked distributions with a dividend stopper.	Discretionary, non-cumulative, fully franked distributions with a dividend stopper.	Discretionary, non-cumulative, fully franked distributions with a dividend stopper.
Capital Trigger Event	Yes, if Common Equity Tier 1 ratio is equal to or below 5.125%	No	No	Yes, if Core Tier 1 ratio is equal to or below 5.125%	Yes, if Common Equity ratio is equal to or below 5.125%
Non-Viability Trigger Event	Yes	No	No	No	No
Conversion into ordinary shares	Yes	Yes	Yes	Yes	Yes
Ranking	Above CBA ordinary shares.	Above CBA ordinary shares.	Above CBA ordinary shares.	Above ANZ ordinary shares.	Above WBC ordinary shares.

Source: ANZ/CBA/WBC/Morningstar

Equity ratio was 7.5% as at 30 June 2012, up from 7.3% as at 30 June 2011 and above the minimum requirement of 4.5% effective 1 January 2013. An additional buffer of 2.5% comes into effect on 1 January 2016, bringing the minimum requirement to 7.0%. APRA has not yet finalised the revised calculation but is proposing to adopt stricter rules than global standards. On a Basel III fully harmonised global basis, as at 30 June 2012 CBA estimates the ratio would have been 9.8%, above the CBA's Board target of greater than 9.0%. CBA is well positioned to meet the new requirements.

All deposit taking institutions such as CBA are regulated by APRA, the prudential regulator, and one of the requirements is to hold certain levels of regulatory capital to protect deposit holders from losses. The most equity like or most loss absorbing type of regulatory capital is Common Equity which includes ordinary equity, retained earnings and certain other items. The next layer of regulatory capital is Tier 1 capital, which is Common Equity plus certain other securities such as CBAPC. Total comprises Tier 1 capital plus certain other securities. Under Basel II principles, banks are required to hold a minimum amount of Tier 1 and Total capital, Under the tougher Basel III principles effective 1 January 2013

banks are also required to hold a minimum amount of Common Equity.

Assets

CBA is Australia's largest home lender. Home loans and total loans made up 52% and 79% of the balance sheet as at 30 June 2012. Trading securities and other fair value assets comprised 12%. Credit exposures by region is heavily skewed towards Australia. Australia represents 79.7% of gross credit exposures, with New Zealand accounting for 8.1%. The remaining exposures are small; Europe (5.2%), Americas (4.5%) and Asia (2.4%).

Asset quality is sound. CBA's bad debt expense to total loans is sector leading at a low 21bps with a \$1.1bn bad debt charge in FY12. The \$202m decline in the economic overlay provision assisted the bad debt performance and the remaining provision stands at \$847m at June 2012. Lower than expected home loan arrears dispel concerns of an impending blow-out in bad debts. CBA again demonstrated the strength of its \$350bn mortgage book and at this stage there are no material signs of mortgage stress for Australia's biggest mortgage lender. Mortgage quality indicators continue to improve.

Funding

The bank remains well funded despite the European sovereign debt crisis. The mix of customer deposit funding has been ticking up gradually and represented around 62% of total funding (excluding equity) as at 30 June 2012. Over the year to 30 June customer deposits grew by \$30bn to \$379bn. Volatile investment markets and weak investor confidence has seen strong deposits flows. Despite this competition for retail deposits is strong with rates above the RBA cash rates on offer in the market. CBA has also tapped into the covered bond market raising \$13bn during the second half of FY12 and has capacity to raise a total of \$35bn to \$40bn. The average maturity of long-term wholesale funding was 3.7 years.

Liquidity

CBA has a strong liquidity position. Over the year liquid assets increased 35% to \$135bn. This has been the trend across the sector since the GFC and better positions the banks to cope with the volatile credit markets.

Key Dates for CBAPC

- ▶ Bookbuild: 10 September 2012.
- ▶ Announcement of margin: 11 September 2012.
- ▶ Offer Opens: 12 September 2012.
- ▶ Closing Date for Offer: 5 October 2012.
- ▶ Issue Date: 17 October 2012.
- ▶ Commencement of Trading: 18 October 2012.
- ▶ First Distribution Payment Date: 17 December 2012.
- ▶ Call Date: 15 December 2018.
- ▶ Mandatory Exchange Date: 15 December 2020.

Key Dates for CBAPB

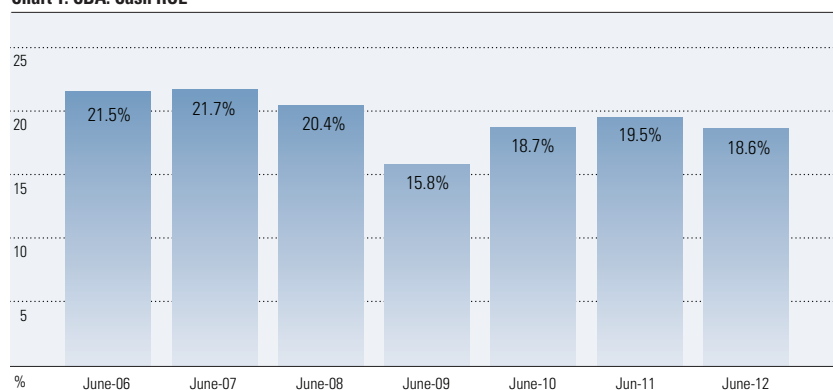
- ▶ Record Date for Reinvestment Offer: 7 September 2012.
- ▶ Reinvestment Offer Opens: 12 September 2012.
- ▶ Closing Date for Reinvestment Offer: 5 October 2012.
- ▶ On-market buy-back of CBAPB: 12 October 2012.

- ▶ Record date for final distribution on CBAPB: 16 October 2012.
- ▶ Payment date for final distribution on CBAPB: 23 October 2012.
- ▶ Last date of trading for CBAPB: 24 October 2012.
- ▶ Resale Date for CBAPB holders not participating in the reinvestment offer: 31 October 2012.

Key Terms

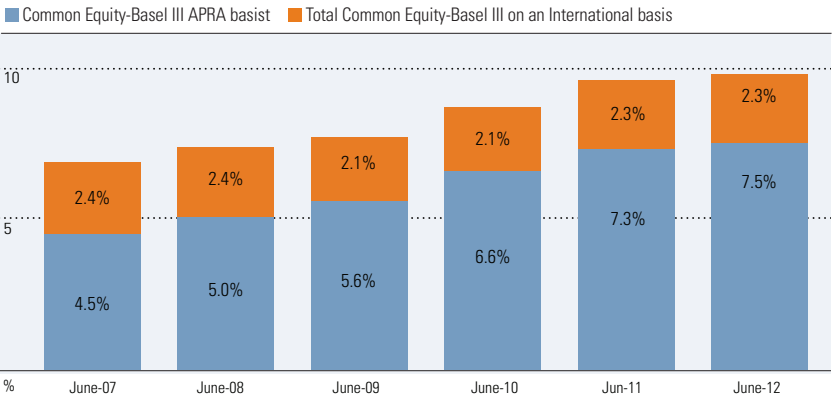
- ▶ ASX code is expected to be CBAPC.
- ▶ Face Value: \$100 per security.
- ▶ Minimum Subscription Amount: \$5,000 (50 units). This is not applicable to the reinvestment offer for eligible CBAPB holders.
- ▶ Amount to be raised: CBA plans to raise \$750m via the issue of 7.5m securities but has the ability to raise more or less.
- ▶ Distribution Rate: (90-day BBSW rate + Margin%) x (1-Corporate Tax Rate).
- ▶ Margin: CBA has not provided an indicative margin range. The margin will be set via a bookbuild process.
- ▶ Frequency of Distributions: Quarterly on 15th of March, June, September and December.
- ▶ Franking: Fully Franked. If the distribution is not franked or partially franked, a gross-up amount would be payable by CBA.
- ▶ Distributions: Distributions are discretionary and not cumulative. They are also subject to a payment test the most material being: CBA having sufficient distributable profits; the payment will not breach CBA's capital requirements; the payment will not cause CBA to become insolvent; and APRA not objecting. Dividends and gross-up amounts are not cumulative, so CBA does not have to make up for missed distributions.
- ▶ Dividend Stopper: If a CBAPC distribution is not paid then dividend and capital restrictions will apply to CBA ordinary shares from that distribution payment date until a distribution is paid in full on a subsequent distribution payment date. Subject to some exceptions CBA cannot:
 - ▶ Declare, determine, or pay a dividend or distribution on CBA ordinary shares.
 - ▶ Return any capital or undertake buy-backs or repurchases in relation to CBA ordinary shares.
- ▶ Capital Classification: Tier 1 Capital.
- ▶ Term: Perpetual. However:
 - ▶ CBA must exchange on the Mandatory Exchange date 15 December 2020 subject to conditions;
 - ▶ CBA may redeem on the Call Date of 15 December 2018; or
 - ▶ CBA may redeem or exchange earlier following the occurrence of specific events.

Chart 1: CBA: Cash ROE



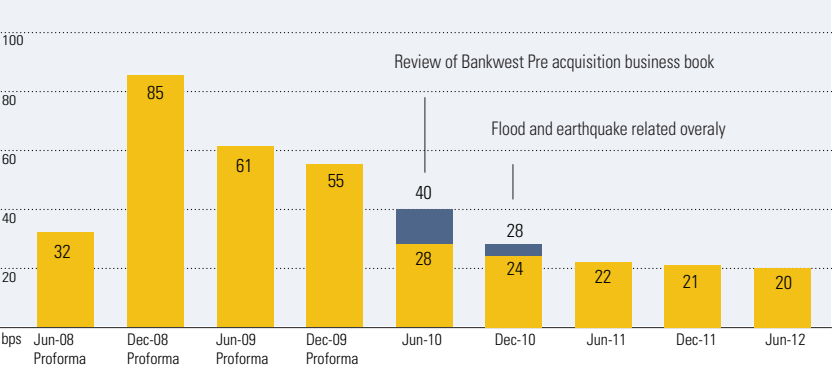
Source: CBA

Chart 2: CBA: Basel III Common Equity Capital Ratio



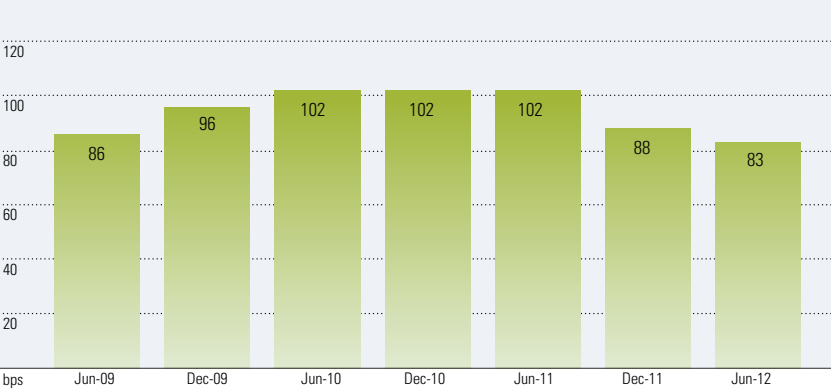
Source: CBA

Chart 3: CBA: Impairment Expense to Gross Loans



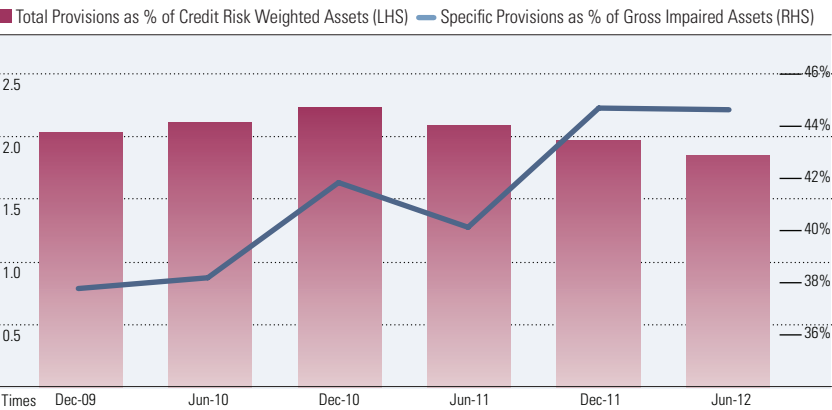
Source: CBA

Chart 4: CBA: Gross Impaireds to Gross Loans



Source: CBA

Chart 5: CBA: Provision Coverage



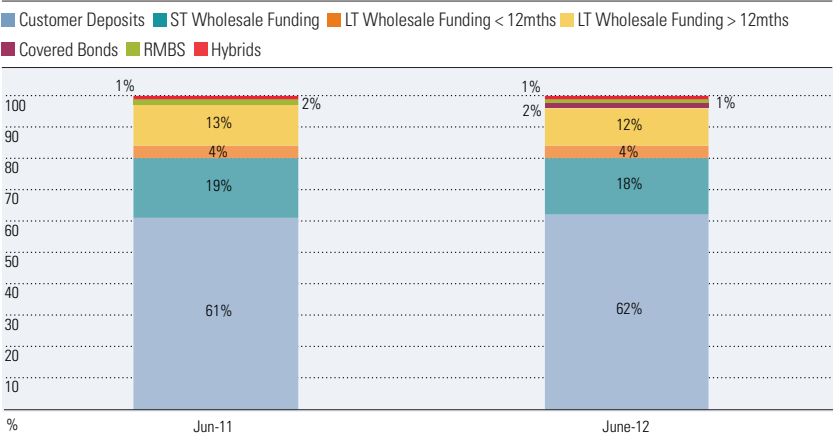
Source: CBA

- Mandatory Exchange: On 15 December 2020, CBAPC will be:
 - Exchanged into a variable number of CBA ordinary shares worth approximately \$101.01 at a 1% discount to the VWAP of CBA ordinary shares 20 business days before the Mandatory Exchange Date. This is subject to conversion conditions or unless they are exchanged or redeemed earlier due to various specific trigger events or redeemed at the Call Date. If the conditions are not satisfied, then exchange will be deferred until the next distribution payment date after 15 December 2020 that the conditions are met. There is no resale or redemption for cash on the Mandatory Exchange Date.
- The Mandatory Exchange Conditions are:
 - First Condition: The VWAP of CBA ordinary shares on the 25th business day before (but not including) the Mandatory Exchange Date (15 December 2020) is equal to or greater than 56% of the Issue Date VWAP of CBA ordinary shares.
 - Second Condition: The VWAP of CBA ordinary shares during the 20 business days before (but not including) a possible Mandatory Exchange Date is equal to or greater than 50.51% of the Issue Date VWAP of CBA ordinary shares.
 - Third Condition: CBA ordinary shares are listed or admitted to trade on the ASX.

The intent of these conditions is to protect CBAPC holders from the maximum number of shares on exchange condition i.e. protect them from receiving CBA ordinary shares worth less than \$101.01.

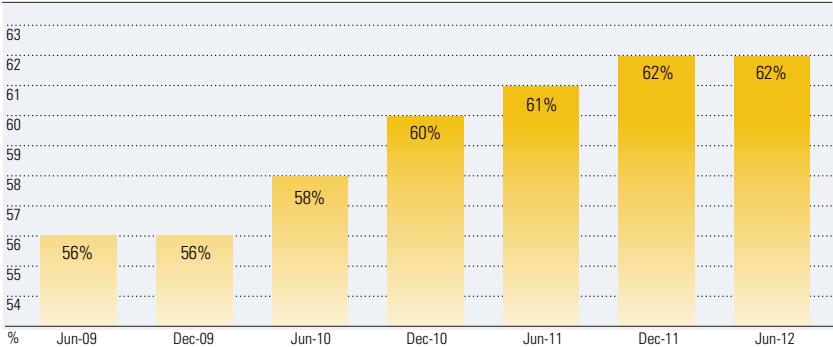
- Early Exchange following trigger events: CBA must exchange CBAPC into CBA ordinary shares following the occurrence of a Capital Trigger Event, Non-Viability Trigger Event or Change of Control Event.
 - A Capital Trigger Event occurs if CBA determines or APRA notifies CBA that either or both CBA's Level 1 Common Equity Tier 1 Capital Ratio or Level 2 Common Equity Tier 1 Capital Ratio is equal to or less than 5.125%, then CBA is required to immediately exchange such number of CBAPC securities that is sufficient to return the Common Equity Tier 1 ratio to above 5.125%. Exchange following this event is not subject to Mandatory Exchange conditions being satisfied. Therefore, a Maximum Exchange Number of

Chart 6: CBA: Funding Mix



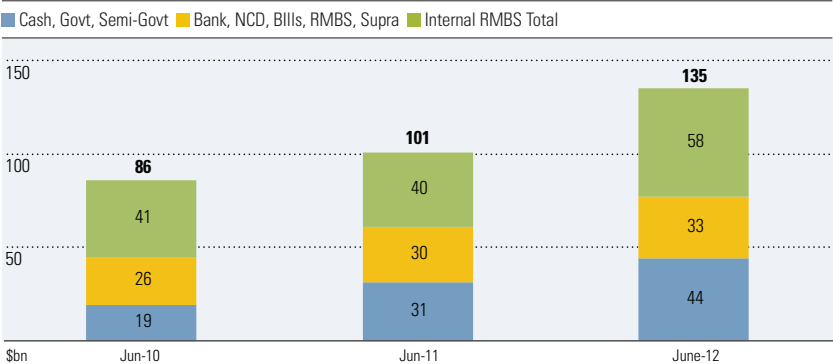
Source: CBA

Chart 7: CBA: Deposit Funding Mix



Source: CBA

Chart 8: CBA: Liquid Assets



Source: CBA

Table 3: Morningstar Forecasts

	Actual	Morningstar Analyst Forecasts				
	FY10	FY11	FY12	FY13F	FY14F	FY15F
Net Profit after Tax (\$M)	6,656	6,793	7,071	7,415	7,923	8,426
EPS Growth %	5.2	0.7	2.4	3.0	4.8	4.3
DPS Growth %	27.2	10.3	4.4	2.7	4.7	4.2
Net Interest Margin %	2.13	2.12	2.09	2.11	2.14	2.15
Return on Equity %	20.6	19.0	18.3	17.5	17.6	18.0
Return on Assets %	1.1	1.0	1.0	1.0	1.0	1.0
Cost to Income Ratio %	45.1	45.2	45.6	44.5	43.5	43.0
Equity/Assets %	5.4	5.5	5.7	5.7	5.7	5.7
Dividend Payout Ratio %	66.5	72.9	74.3	74.1	74.0	73.9
Loan growth %	5.8	1.2	4.9	4.6	6.0	6.7
Net Loans and Leases / Deposits %	127.6	119.9	114.3	110.8	110.3	111.0
Tier 1 Ratio %	9.1	10.0	10.0	10.0	10.0	10.0
Bad Debt Expense to Average Loans (bps)	42.6	25.4	20.9	22.5	25.2	24.1
Pre-Tax Pre-Provision Earnings Growth %	15.5	3.0	1.7	8.6	8.0	5.7

Source: CBA

shares on exchange will apply i.e. calculated using 20% of the Issue Date VWAP. For example, if the Issue date VWAP of CBA ordinary shares was \$54.00, the Maximum Exchange Number of Shares will equal 9.25926 ($\frac{\$100}{(\$54.00 \times 20\%)}$). So, if the CBA share price on conversion was \$5.00, then CBAPC securityholders would receive CBA shares worth approximately \$46.30 ($9.25926 \times \5.00) for each security. This means CBAPC securityholders could potentially receive CBA ordinary shares worth less than \$100. In this example the CBA share price on conversion would need to be less than \$10.80 for CBAPC securityholders to receive CBA ordinary shares worth less than \$100.

► A Non-Viability Trigger Event occurs if APRA notifies CBA that it believes: that exchange of some or all CBAPC (or some action in relation to other CBA capital instruments) is required because without it CBA would become non-viable; or a public sector injection of capital is required because without it CBA would become non-viable. Following such an event CBA must immediately exchange such number of CBAPC securities that is specified by APRA or necessary to satisfy APRA that CBA will no longer be non-viable. Exchange following this event is not subject to Mandatory Exchange conditions being satisfied. Similar to exchange following a Capital Trigger Event, CBAPC securityholders could potentially receive CBA ordinary shares worth less than \$100.

► Non-viability is a relatively new type of trigger event and occurs at the discretion of APRA.

The prospectus states that circumstances where APRA may exercise its discretion may not be limited to its concerns about the bank's capital levels, but could extend to concerns about the bank's funding and liquidity.

- ▶ A Change of Control Event occurs if a takeover bid for CBA ordinary shares is made and certain conditions are satisfied or a scheme of arrangement is proposed and certain conditions are satisfied. Exchange following this event is subject to the second and third Mandatory Exchange Conditions being satisfied. This means CBAPC securityholders are protected from receiving CBA ordinary shares worth less than \$101.01 (which represents \$100 face value converted at 1% discount).
- ▶ Early Redemption: CBA can redeem CBAPC early for cash at face value for tax or regulatory reasons subject to approval by APRA.
 - ▶ A tax reason occurs if as a result of a change in law or change in application or interpretation of law CBA is unable to fully frank distributions on CBAPC; or if CBA receives opinion that there is a material risk that it would face a material adverse tax consequence in relation to CBAPC. These exclude changes or consequences already expected by CBA at the issue date.
 - ▶ A regulatory reason occurs if CBAPC no longer qualifies as Tier 1 capital other than as a result of a change already expected by CBA at the issue date.
- ▶ Call Date: On the Call date (15 December 2018) CBA can exercise its call and redeem PERLS VI for cash (subject to APRA approval) or elect that resale occur such that a third party purchases the PERLS VI for cash.
- ▶ Ranking in wind-up: CBAPC rank ahead of junior ranking securities (such as CBA ordinary shares), equally with equal ranking capital securities (such as PERLS V (CBAPA), behind senior ranking obligations (such as CBA Retail Bonds (CBAHA) and deposits), liabilities preferred by law (such as employee entitlements and secured debt (covered bonds).
- ▶ CBAPC holders have no right to request early exchange or redemption.

We have only presented a summary of the material terms. Investors should examine the prospectus in detail.

Options available for CBAPB securityholders

What are the options available to CBAPB securityholders?

1. Participate in the Reinvestment Offer. Via this offer CBAPB holders can sell all or part of their holdings through the on-market buy-back facility for face value (\$200) and automatically reinvest in CBAPC. This offer is only available to CBAPB holders who are registered holders on the record date of 7 September 2012 with a registered address in Australia. Applications received under this offer will be given priority allocation.
2. Sell on market. CBAPB holders can sell on market for cash by the last trading date which is expected to be 24 October 2012.
3. Hold on for resale. This is effectively a redemption for cash at face value (\$200) with all remaining CBAPB securities being automatically acquired by the resale broker.

Final Distribution for CBAPB securityholders

1. For CBAPB holders participating in the reinvestment offer, the final distribution will be paid on 23 October 2012, for period up to and including 16 October 2012.
2. For CBAPB holders that don't participate in the reinvestment offer and don't sell on market after the ex-distribution date, the final distribution will be paid on 23 October 2012, for relevant period up to and including 16 October 2012. If they continue to hold CBAPB until 31 October 2012, they will be paid a distribution for the relevant period up to and including 30 October 2012.

Disclosure and Research Methodology

Limited Financial Services Guide

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Listed corporate income securities

Morningstar covers around 30 listed income securities. Our methodology is forward looking, based on our expectations of future cash flows. Analysis is carried out by our income securities team, which is a subset of the equities research team and thereby utilising the equity analysts' expert knowledge and cash flow models of the underlying businesses.

The focus of Morningstar's analysis is to assess the degree to which the underlying business is capable of supporting the commitments required by the securities. We analyse the following factors to place the security in one of the security risk categories of: Excellent, Investment Grade, Speculative or Distressed:

- Business Risk – comprising an assessment of whether there is an economic moat (presence of sustainable competitive advantages), the strength of management and how uncertain future cash flows are; and
- Financial Risk – based on testing the company under a series of leverage and cash low ratios.

We then calculate the yield that is justified by the risk of the security based on a transition model which identifies a range of credit spreads, primarily based on historic default rates. We add a spread to account for transaction costs associated with illiquidity, and small additional spreads to represent the inconvenience or risks associated with non-cumulative dividends or the security being a perpetual.

Listed Income Securities coverage criteria

Coverage of around 30 listed income securities is based on client demand, determined on a set of guidelines, which include issue size being at least AUD 200 million, the underlying corporate or its listed parent being covered by Morningstar's equity research team, Morningstar's judgement of the investment merit of the security and the strength of existing and likely demand from our retail investor, broker, financial adviser, and institutional clients.

Timing and frequency of income security research reports

- Pre-IPO research reports on securities that meet the coverage criteria are published in the first week after the launch of the issue.
- Ongoing research reports are updated at least six monthly or sooner in the case of a major event.
- Income Securities Monthly reports provide a roundup of current pricing and recommendations and an outlook for the market.
- An archive of income securities research reports is available on Morningstar's Adviser Research Centre platform and Morningstar's retail investor website.

Research report content

Income securities research reports contain detailed issuer analysis and an investment recommendation on the security. Reports contain the following content:

- Recommendations – Subscribe/Don't Subscribe for IPO reports. Buy, Accumulate, Hold, Reduce, Sell or Avoid once security is trading.
- Investment Rating – overview of the risk and investment appeal of the security
- Analyst Note – analysis of a key event and implications on the investment appeal of the security
- Thesis – analysis of the business risk and financial risk of the underlying business
- Contract Summary – description of the specific characteristics of the security
- Security Valuation – key inputs to the valuation of the security
- Risks – analysis of potential risks to the underlying business and security
- Investment Perspective of underlying business – Investment Rating, Risk, Growth, Profitability and Financial Health of the underlying company
- Forecasts and key ratios of the underlying business
- Note: Morningstar Australasia does not provide credit ratings.

Morningstar's income securities analysis builds on the modelling expertise of the equities research team, including:

- At least five years of detailed pro-forma financial statements
- Extensive analysis of free cashflow and return on invested capital
- Uncertainty and scenario analysis, including upside and downside cases
- Forecasts of leverage, coverage and liquidity ratios
- Estimates of off-balance sheet liabilities

Economic Moats

Just as moats protected castles from invaders in medieval times, businesses with economic moats have strong defences against their profits being competed away. We ascribe a moat rating to each stock researched: Wide, Narrow or None. The moat is the competitive advantage that one company has over other companies in the same industry. Moat firms have unique skills or assets, allowing them to stay ahead of the competition and earn above-average profits for many years. Returns on their invested capital will exceed the cost of that capital. Without a moat, highly profitable firms can have their profits competed away as

other companies see how attractive the market is and try to move in to reap some of the rewards themselves.

Across our research, we have discovered five economic moat sources: Intangible assets, switching costs, network effects, cost advantage and efficient scale. Intangible assets include strong brands which encourage repeat sales and support price rises over time. Intellectual property rights like patents, trademarks, copyrights and government approvals are other intangible assets that can lead to moats. Switching costs make it too expensive or time-consuming to shift to an alternative supplier. The network effect is a virtuous cycle allowing strong companies to get even stronger. It occurs when the value of a particular good or service grows as the number of users grows. Cost advantage can derive from increased scale and efficiency, allowing the company to increase margins. Efficient scale occurs when a limited market is effectively served by existing players and the profit opportunity does not justify entry by others.

Business Risk

Business risk captures the fundamental uncertainty around a firm's business operations and the cash flow generated by those operations. The following factors are key to determining business risk:

- diversity of revenue sources – a company with diverse revenue stream should have more reliable revenues as weakness in one area may be offset by strength in others.
- cyclicalities of revenues – for example revenues of a housing products supplier will be tied to cyclical property demand cycles and will be more volatile than a supermarket retailer which should have more ongoing demand.
- the firm's fixed-cost structure – companies with high levels of fixed costs will have greater swings in earnings as revenues move up and down.
- financial leverage – companies with excessive debt levels may run in to troubles should conditions deteriorate, potentially causing unwanted asset sales, dilutive equities issues or even bankruptcy.
- contingent events – examples include outstanding litigation, risk of aggressive acquisitions at high prices, asbestos liabilities etc.

Declaration

Declaration of personal shareholdings, disclosure list. These positions can change at any time and are not additional recommendations

AAO,ABC,ACG,ACL,ACR,AFI,AGK,AGS,AGX,AKF,ALL,ALS,AMP,ANO,ANP,ANZ,APA,APN,ARD,ARG,ASB,ASZ,ATI,AVX,BEN,BFG,BHP,BKI,BKN,BLY,BND,BNO,BOL,BOQ,BSL,BTU,BWP,BXB,CAB,CBA,CCL,CDD,CGS,CIF,CND,COF,COH,CPA,CRK,CRZ,CSL,CSS,CTN,DOW,DTE,DUE,EGP,EPX,EQT,ERA,ESV,EVZ,FMG,FX,J,GBG,GFF,GMG,GPT,GWA,HIL,HSN,IAG,IFL,IGR,IIN,ILU,IPD,J,MB,KAR,KCN,KEY,KMD,LEG,LEI,LLC,MBN,MCR,MFF,MIO,MP,O,MOG,MSB,MTS,MUN,MYR,NAB,NEU,NHC,NMS,NUF,NUP,NVT,NWS,OSH,PBG,PBT,PGM,PMV,PNR,PPT,PRG,PRY,PTS,Q,BE,QFX,QUB,RCR,REX,RFE,RHC,RHG,RIO,RKN,RQL,SAKHA,SEK,SPW,SGP,SGT,SHV,SMX,SOL,SRH,SRX,STS,SUN,SVW,SWM,TAH,TCL,TEN,TLS,TOL,TPM,TRF,TRS,TSE,UGL,UXC,WAL,WAM,WBB,WBC,WCB,WDC,WES,WHC,WHG,WOW,WPL,ZGL,