Presale Report: Challenger Capital Notes 2 (CGFPB) Suitable for Higher Risk Investors

Recommendation: Subscribe

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Executive Summary

Challenger Limited, or Challenger, will raise AUD 350 million - with the ability to raise more or less - via capital notes to be listed on the Australian Securities Exchange, or ASX, called Challenger Capital Notes 2 (ASX Code: CGFPB). Challenger will use the proceeds of CGFPB to fund a subscription for Additional Tier 1 Capital of Challenger Life Company, or CLC.

The Offer comprises an Institutional Offer made to certain Institutional Investors; a Broker Firm Offer made to Australian resident retail and high net worth clients of Syndicate Brokers; and a Securityholder Offer made to Eligible Securityholders.

CGFPB are subordinated, convertible, transferrable, perpetual, unsecured notes that may be redeemed or resold for cash or converted into ordinary shares of Challenger on 22 May 2023 (or on an earlier date in certain circumstances) subject to APRA's prior written approval. Otherwise, CGFPB will mandatorily convert into ordinary shares of Challenger on 22 May 2025 (subject to certain conditions being satisfied). If the conditions for mandatory conversion are not met on 22 May 2025, conversion will be deferred to a later date when the conditions are re-tested.

Distributions will be paid quarterly in arrears, based on the 90-day bank bill swap, or BBSW, rate plus a margin in the indicative range of 4.40% to 4.60% per annum. For example, using the current 90-day BBSW rate of 1.78%, this equates to a total estimated gross running yield range of 6.18% to 6.38% per annum.

Key Takeaways

- We believe a subscription to the Challenger Capital Notes 2 is appropriate for investors with a high-risk tolerance. If investors fall into this classification, we recommend they subscribe to the offer for CGFPB.
- We believe the indicative trading margin pricing range of 4.40% to 4.60% is attractive for higher risk hybrid investors looking to diversify their exposure away from the major banks - albeit higher up the risk curve.
- Investors should be aware that Morningstar considers Challenger a no moat rated issuer, with a standard stewardship rating.
- The near-term outlook for hybrid pricing should remain supported by technical factors including diminishing hybrid supply.
- Hybrid securities should not be viewed as traditional fixed-income products, nor should they be considered a substitute for low-risk investments such as term deposits.

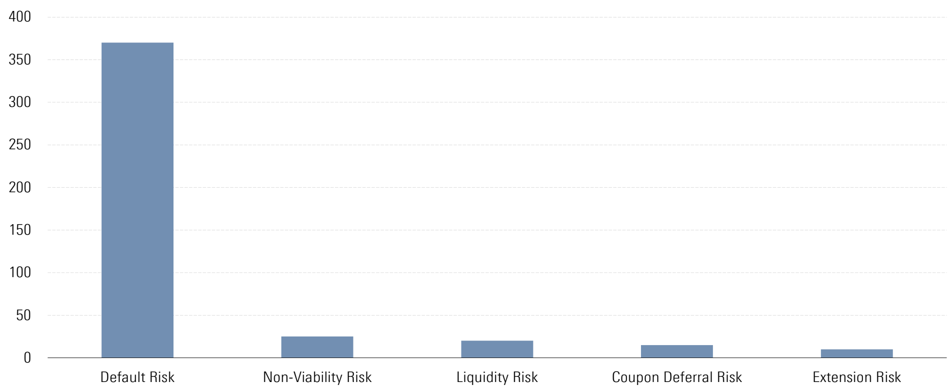
Recommendation

We recommend investors willing to take on a greater degree of risk subscribe to the offer for CGFPB at the indicative margin range of 4.40% to 4.60%.

We assign CGFPB a high investment risk rating. This is higher than the major bank and Insurance Australia Group hybrid securities in our coverage list, which we allocate a medium risk profile. The terms and conditions, such as non-viability triggers in this new breed of hybrid securities make them more equity-like, however, unlike the major bank Basel-III compliant Tier 1 securities; CGFPB does not have a capital trigger.

We believe CGFPB offers an attractive return from an absolute return perspective for investors with a high-risk tolerance. To arrive at this conclusion we have to examine whether the offered trading margin compensates investors for the requisite risks. These include default risk, non-viability risk, liquidity risk, coupon deferral risk, and extension risk. Each of these risks requires compensation in the form of yield pickup. Exhibit 1 highlights the contribution of these risk factors into our required hurdle rate of 4.40%. Not surprisingly, default risk is the major driver of the required rate of return.

Exhibit 1 CGFPB Meets Our Required Internal Absolute Value Hurdle Rate, (basis points).



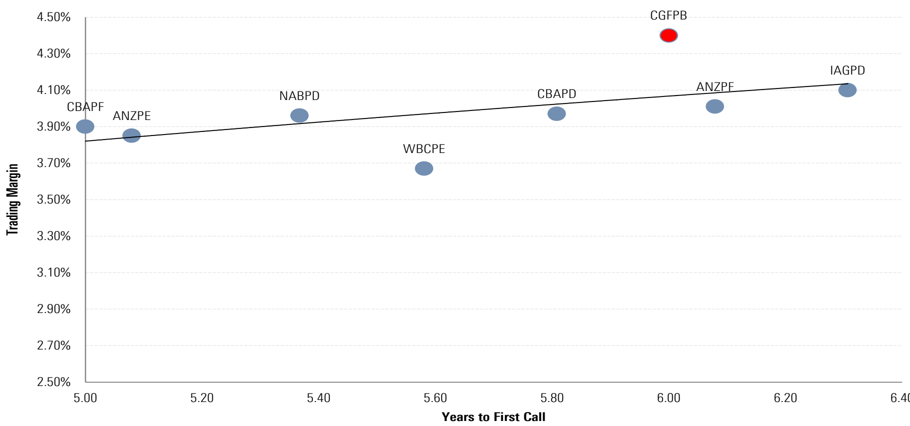
Source: Morningstar.

We also believe the yield premium earned over Challenger's ordinary share dividend yield is appealing. Morningstar forecasts a Challenger 2017 fiscal year dividend yield of 4.3% grossed up for franking, albeit with greater upside potential due to equity price appreciation, or vice versa. The lower end of the CGFPB indicative trading margin range provides a grossed up yield to call of 6.2%, about 190 basis points above the ordinary share dividend yield.

Undertaking a relative valuation on CGFPB isn't a straightforward exercise due to the lack of like-for-like comparable issuers. Nevertheless, we have identified a range of securities that we believe provide the closest comparable sample. These include the ANZ Capital Notes 2 (ANZPE), NAB Capital Notes 2 (NABPD), Westpac CPS (WBCPC), CBA PERLS VII (CBAPD), ANZ Capital Notes 3 (ANZPF), IAG Capital Notes (IAGPD), and the yet to list CBA PERLS IX (CBAPF). We only include securities with between five and seven-year terms to call.

Due to the lower creditworthiness of Challenger when compared to the major banks, we require a material new issue premium on our nominated fair value curve. Ordinarily with a new issue, we like to see a 10 to 20 basis point premium to the fair value curve. In this instance, we increase that to 30 to 40 basis points.

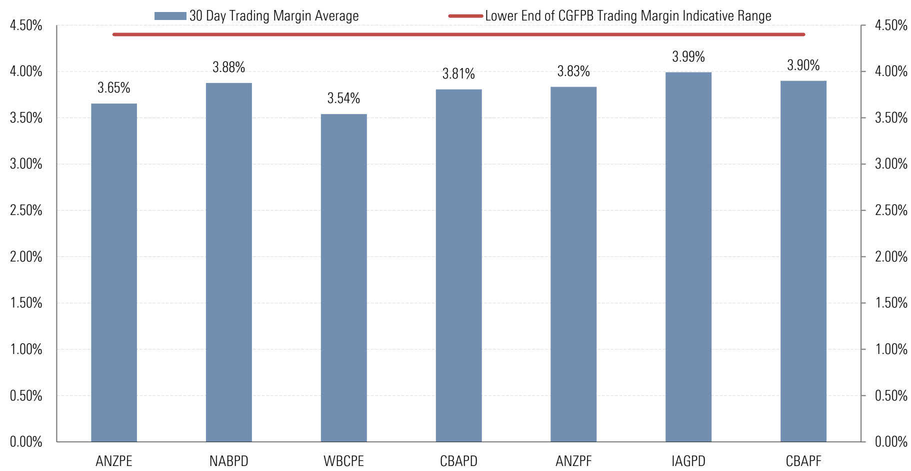
Exhibit 2 CGFPB Relative Value



Source: Morningstar.

CGFPB also offers an attractive new issue premium on both the most-recent closing prices of comparable securities and on the average trading margin of those securities during the last month. For example, the lower end of the proposed indicative trading margin of 4.40% offers a 10% premium to the 30 day average of the IAGPD trading margin, a security with a similar term to first call.

Exhibit 3 CGFPB margin attractive on current and recent pricing (%)

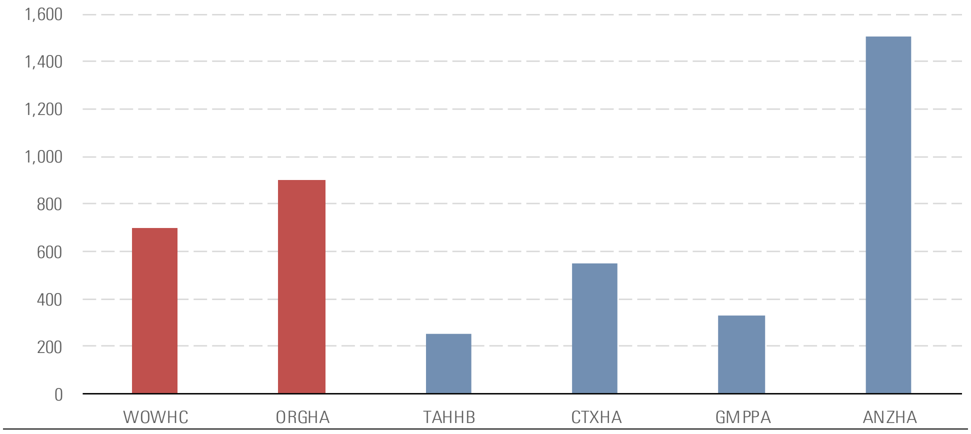


Source: Morningstar.

Supply Side Technicals Should Support Pricing

Although this is a new issue, adding approximately AUD 350 million back into the domestic listed hybrid supply pool, we still expect hybrid supply dynamics to provide a tailwind to prices in 2017. Exhibit 4 is a collection of debt and hybrid securities that have either not been replaced recently or we do not expect to be replaced. These include the Woolworths Notes II (WOWHC) and Origin Energy Subordinated Notes (ORGHA), both of which were called and not replaced in late 2016. Going forward, we believe the Tabcorp Subordinated Notes (TAHHC), the Goodman PLUS II (GMPPA), and the Caltex Subordinated Notes (CTXHA) are more than likely to be called and not replaced. There is also the possibility that ANZ Bank opts to refinance their Tier-2 ANZ Subordinated Notes (ANZHA) in the wholesale market as opposed to the retail market. Nevertheless, if we exclude ANZHA, the other securities mentioned make up total potential withdrawn supply of approximately AUD 2.7 billion. If we include ANZHA, this amount blows out to AUD 4.2 billion. To put this into context, AUD 4.2 billion represents approximately 10% of total supply of Morningstar's hybrid coverage universe. We must keep in mind that CGFPB contains materially different terms and conditions to the hybrid securities highlighted in Exhibit 4.

Exhibit 4 Supply technical to provide hybrid tailwind in 2017 (AUD million)



Source: Morningstar. Red shading denotes securities that have already been called without a replacement transaction.

Hybrid Securities Are Materially Riskier Than Term Deposits and Traditional Fixed Income

It is important to reiterate that hybrid securities should not be viewed as traditional fixed-income products, nor should they be considered a substitute for low-risk investments such as term deposits. Therefore, they should offer a yield premium over these lower-risk products. Hybrid prices can become volatile in times of distress, similar to equity shares and unlike traditional senior bonds. Due to their complex terms and conditions, investors often confuse key differences between hybrid securities and other investments from the same issuer. Exhibit 5 outlines some of the key differences between the Challenger Capital Notes 2 and alternative Challenger investments and otherwise. Investors should consider these differences in light of their investment risk and return profile.

Exhibit 5 Differences Between CGFPB and Other Investments

Feature	Challenger Annuity	Term Deposit	Challanger Capital Notes 1	Challanger Capital Notes 2	Ordinary shares
Issuer	CLC	Bank, credit union or building society	Challenger	Challenger	Challenger
Legal Form	Policy (unsecured, unsubordinated debt obligation referable to a statutory fund under the Life Insurance Act)	Unsecured, unsubordinated debt	Unsecured, subordinated note	Unsecured, subordinated note	Ordinary share
Term	One year to lifetime	One month to five years	Perpetual (subject to mandatory conversion into ordinary shares)	Perpetual (subject to mandatory conversion into ordinary shares)	Perpetual
Ranking in Winding-Up	Rank higher than Notes and ordinary shares	Rank higher than Notes and ordinary shares	Rank lower than Senior Creditors, equally with the Notes, but higher than Ordinary Shares (1)	Rank lower than Senior Creditors, equally with Challenger Capital Notes 1, but higher than Ordinary Shares (1)	Rank lowest of all securities
Transferability	No	No	Yes - Notes quoted on ASX as CGFPA	Yes - Notes expected to be quoted on ASX as CGFPB	Yes - quoted as CGF
Protected Under Financial Claims Scheme	No	Yes (2)	No	No	No
Distribution Rate	Fixed or increasing by reference to the CPI or a fixed rate	Fixed (usually)	Floating (Bank Bill Rate + Margin of 3.40% p.a., adjusted for franking)	Floating (Bank Bill Rate + Margin (to be determined under the Bookbuild, and expected to be in the range of 4.40% to 4.60% p.a.), adjusted for franking)	Variable dividends
Distribution Payment Dates	Monthly, quarterly, semi-annually or annually	Monthly, quarterly, semi-annually or annually	Quarterly (distributions are discretionary)	Quarterly (distributions are discretionary)	Semi-annually (distributions are discretionary)
Distributions cumulative / non-cumulative	Cumulative	Cumulative	Non-cumulative	Non-cumulative	Non-cumulative
Dividend Stopper	No	No	Yes, until next Distribution Payment Date	Yes, until next Distribution Payment Date	No
Franking	No	No	Expected to be fully franked (3)	Expected to be fully franked	Expected to be fully franked
Optional Redemption (at Challenger's option)	No	No	Yes, on 25 May 2020 and following Regulatory or Tax Event	Yes, on 22 May 2023 and following Regulatory or Tax Event	No
Optional resale (obligation on Holder to sell instrument at Challenger's option)	No	No	Yes, on 25 May 2020 and following Regulatory or Tax Event	Yes, on 22 May 2023 and following Regulatory or Tax Event	No
Optional conversion to Ordinary Shares (Challenger's option)	No	No	Yes, on 25 May 2020 and following Regulatory or Tax Event	Yes, on 22 May 2023 and following Regulatory or Tax Event	No
Mandatory conversion	No	No	Yes, on 25 May 2020 and each Distribution Payment Date after this date, or at any time upon the occurrence of an Acquisition Event or Non-Viability Trigger Event	Yes, on 22 May 2023 and each Distribution Payment Date after this date, or at any time upon the occurrence of an Acquisition Event or Non-Viability Trigger Event	No
Voting rights	No	No	No right to vote at general meetings of holders of Ordinary Shares	No right to vote at general meetings of holders of Ordinary Shares	Yes - quoted as CGF
Treated by APRA as regulatory capital?	No	No	No, but used to fund subscription for Additional Tier 1 Capital of CLC	No, but used to fund subscription for Additional Tier 1 Capital of CLC (4)	Not currently (5)

1. Any return in a winding-up may be adversely affected if APRA determines that a Non-Viability Trigger Event has occurred. Following Conversion,Holders will hold Ordinary Shares and rank equally with other holders of Ordinary Shares in a winding-up of Challenger. If Conversion on account of a Non-Viability Trigger Event foes not occur for any reason within five Business Days of the Non-Viability Conversion Date, Notes will be Written-Off.
2. The protection for all protected accounts that an account holder has with an Australian deposit taking institution is limited to $250,000.
3. Initially, Challenger Capital Notes 1 were partially franked but distributions are expected to be fully franked going forward.
4. APRA has advised that it does not object to Challenger using the proceeds of Notes to fund a subscription for Additional Tier 1 Capital of CLC.
5. Under the capital related prudential standards for conglomerate groups, Challenger Limited, as a non-operating holding company, is expected to be prudentially regulated and its ordinary shares will be treated as regulatory capital.

Source: Morningstar, Challenger Capital Notes 2 Prospectus

Don't Expect Any Change In The Event of a Challenger Winding-Up Scenario

In the event of a winding-up of Challenger, which we consider highly unlikely, if CFGHB have not been converted or written-off on account of a non-viability trigger event, the notes will rank ahead of ordinary shares, equal with all other Relevant Perpetual Subordinated Instruments (including Challenger Capital Notes 1), but behind any securities or instruments that rank in priority to CFGHB and all other creditors of Challenger, as shown below. The Relevant Perpetual Subordinated Instruments currently only include the Challenger Capital Notes 1 issued in October 2014. CGFPB will be considered a Relevant Perpetual Subordinated Instrument if and when issued.

Exhibit 6 Ranking of CGFPB In the Event of a Winding-Up Scenario

	Type	Illustrative examples[1]
HIGHER RANKING		
	Preferred and secured debt	Liabilities preferred by law including employee entitlements and secured creditors
	Unsubordinated and unsecured debt	Bonds and notes, trade and general creditors
	Subordinated and unsecured debt	Subordinated notes and other subordinated and unsecured debt obligations
	Relevant Perpetual Subordinated Instruments	Notes, and any other securities expressed to rank equally with Notes (including Challenger Capital Notes 1)
	Ordinary Shares	Ordinary Shares
LOWER RANKING		

1 These examples note the order of ranking in the context of Challenger. Challenger is a non-operating holding company of companies in the Challenger Group and most of the claims Challenger has on these companies rank behind the relevant company's creditors, and in the case of CLC, also rank behind policyholders, in a winding-up of those companies.

Source: Morningstar, Challenger Capital Notes 2 Prospectus.

The Offer

The Offer comprises:

- an Institutional Offer made to certain Institutional Investors;
- a Broker Firm Offer made to Australian resident retail and high net worth clients of Syndicate Brokers; and
- a Securityholder Offer made to Eligible Securityholders.

The Institutional Offer is available to Institutional Investors (provided that such investors may not be in the United States) who are invited by the Joint Lead Managers to bid for Notes in the Bookbuild expected to be conducted on 7 March 2017.

The Broker Firm Offer is available to Australian resident retail or high net worth clients of Syndicate Brokers invited to participate through the Broker Firm Offer. If you are applying under the Broker Firm Offer, you should contact your Syndicate Broker for information about how and when to lodge your Application and accompanying Application Payment. Generally, you will lodge your Application with your Syndicate Broker. Applications under the Broker Firm Offer (whether lodged through a Syndicate Broker or as otherwise directed) must be received by the Registry by 10.00am (Sydney time) on 6 April 2017.

The Securityholder Offer is available to Eligible Securityholders. To be an Eligible Securityholder, you must:

- be a registered holder of Ordinary shares or a registered holder of Challenger Capital Notes 1 at 7.00pm (Sydney time) on 23 February 2017;
- be shown on the applicable register as having an address in Australia; and
- not be in the United States or acting as a nominee for a person in the United States.

If you are an Eligible Securityholder, you may apply for Notes under the Securityholder Offer by either:

- applying online at www.challengercapitalnotes2.com.au, providing your SRN and HIN, and following the instructions in relation to your Application Payment. When applying online, you will be required to pay for Notes using Bpay (you will not be required to submit a paper Application Form if applying online); or
- completing the personalised paper Application Form accompanying the CGFPB Prospectus and lodging the personalised paper Application Form and accompanying Application Payment (made by cheque or money order) with the Registry.

Further information about the offer can be found in Section 6 of the Prospectus.

Security Risks

Non-Viability Risk

CGFPB has a non-viability trigger, which is required by the prudential regulator, APRA. The non-viability trigger gives APRA the discretion to require some, or all, of CGFPB to be converted into Challenger ordinary shares, making CGFPB more equity-like. In a non-viability scenario, holders are likely to receive ordinary shares worth significantly less than face value. A non-viability trigger event occurs if APRA determines Challenger would become non-viable without a conversion to Ordinary Shares, or write-off, of some, or all, of CGFPB; or that a public-sector injection of capital into, or equivalent capital support with respect to, Challenger is necessary because, without it, APRA considers that Challenger would become non-viable. It should be noted that whether a non-viability trigger event will occur is at the discretion of APRA and currently there are no precedents for this. APRA may exercise this discretion should it have a concern regarding Challenger's capital, liquidity or funding levels.

Write-Off Risk

If Challenger is required to convert some or all CGFPB to ordinary shares on account of a non-viability trigger event, but conversion does not occur for any reason within five business days of APRA's determination, those CGFPB units will be written-off. If written-off, the relevant holders' rights under the CGFPBs (including to receive distributions, payment of face value, or potential conversion to ordinary shares) will be immediately terminated with effect on and from the date of the non-viability trigger event, and holders will lose the entire amount of their investment in CGFPB.

Mandatory Exchange Risk

A fall in Challenger's share price to below pre-determined levels relative to the issue date volume weighted average price, or VWAP, required under the terms of mandatory exchange, would result in CGFPB not being exchanged on the mandatory exchange date and remaining on issue until the next distribution payment date when the exchange conditions are retested to determine if they are satisfied.

Credit/Default Risk

This is the risk of loss arising from Challenger defaulting on its payments, whether in the form of distribution payments or principal repayment (in accordance with the terms of CGFPBs). Nevertheless, investors should be aware CGFPB is an unsecured, subordinated investment, so in a wind-up scenario, investors could potentially lose all of their investment.

Subordination Risk

As subordinated obligations issued by Challenger, CGFPB will rank only ahead of Challenger ordinary shares. If Challenger issues more equal or higher-ranking securities in the capital structure, CGFPB may become further subordinated.

Market Price Risk

The market price of CGFPB could decrease below face value, depending on various market-related factors, such as credit spreads, interest rates or Challenger's underlying share price performance.

Distributions May Not Be Paid

There is a risk that distributions may not be paid. The terms do not oblige Challenger to pay distributions, and Challenger has absolute discretion not to pay any distribution. In addition, a distribution will not be paid if on a Distribution Payment Date:

- the consolidated retained earnings of the Challenger Group are negative (or would become negative on payment of the distribution); or
- the payment of the distribution would result in Challenger becoming, or being likely to become, insolvent; or
- APRA objects to the payment.

Challenger may also be prevented from paying distributions by the terms of securities issued, or which may be issued in future, by other members of the Challenger Group if a dividend, distribution or other payment has not been paid on those securities.

Distributions May Not Be Fully Franked, or May Not Be Franked At All

Challenger expects distributions, if paid, to be fully franked. However, there is no guarantee that Challenger will have sufficient franking credits in the future to fully frank distributions, or to frank them at all.

Liquidity Risk

Hybrids are generally less liquid than the shares in the same company. Low levels of liquidity can make it difficult to buy or sell a security, raising the risk of buying at an inflated price or selling at a capital loss. This is particularly the case with smaller issues such as CGFPB.

Extension Risk

If CGFPB is not Redeemed, Resold or Converted on the Optional Exchange Date (22 May 2023), it may trade like a perpetual security.

We encourage investors to refer to Section 5 of the Prospectus for further detail on the risks associated with investing in CGFPB.

Key Dates for the Offer

- Record date for determining Eligible Securityholders: 23 February 2017
- Lodgement of the Prospectus with ASIC: 28 February 2017
- Bookbuild to determine the Margin: 7 March 2017
- Announcement of the Margin: 8 March 2017
- Lodgement of the replacement Prospectus with ASIC: 8 March 2017
- Opening Date: 8 March 2017
- Closing Date for the Securityholder Offer: 31 March 2017
- Closing Date for the Broker Firm Offer: 6 April 2017
- Issue Date: 7 April 2017
- Notes commence trading on ASX (deferred settlement basis): 10 April 2017
- Holding Statements dispatched by: 12 April 2017
- Notes commence trading on ASX (normal settlement basis): 13 April 2017

Key dates for Notes Date

- First Distribution Payment Date: 22 August 2017
- Optional Exchange Date: 22 May 2023
- Scheduled Mandatory Conversion Date: 22 May 2025

Key Terms

- Face value: AUD 100 per security.
- Minimum subscription amount: AUD 5,000 (50 units). Additional amounts can be bought in increments of AUD 1,000 (10 units).
- Amount to be raised: Challenger plans to raise AUD 350 million via the issue of 3.5 million securities with the ability to raise more or less.
- Cash distribution rate: (90-day BBSW rate + margin) x (1 − corporate tax rate). This assumes the CGFPB distribution is fully franked.
- Margin: The indicative margin range is 4.40% to 4.60% per annum.
- Term: CGFPBs are perpetual securities with no maturity date. They may never be repaid, and may never be converted into ordinary shares.
- Frequency of distributions: Quarterly on 22 February, 22 May, 22 August and 22 November.
- Franking: Distributions are expected to be fully franked. However, franking is not guaranteed.
- Distributions: Notes are expected to pay quarterly, floating rate distributions in arrears unless and until converted, redeemed, or written-off. Payment of distributions is subject to the discretion of Challenger and subject to payment conditions. These include that APRA does not object to a distribution being paid. Distributions are non-cumulative, meaning if a distribution has not been paid on a Distribution Payment Date then Challenger has no obligation to pay the distribution at any later date. Holders will not have any right to compensation if Challenger does not pay distributions. Failure to pay a distribution when scheduled will not constitute an event of default.
- Dividend stopper: If a distribution is not paid in full on a Distribution Payment Date, Challenger must not, without the approval of holders by a special resolution, declare, determine to pay or pay a dividend on its ordinary shares, or buy back or reduce capital on any of its ordinary shares, until and including the next Distribution Payment Date. This restriction won't apply if the relevant distribution is paid in full within three business days of the relevant Distribution Payment Date.

- Capital classification: CGFPB will not constitute Additional Tier 1 Capital or any other form of regulatory capital of Challenger. Rather, Challenger intends to use the CGFPB proceeds to fund a subscription for Additional Tier 1 Capital of CLC, the registered life company of the Challenger Group. CGFPB and Challenger's equity capital help to protect creditors of the Challenger Group by providing a loss-absorbing capital buffer that may support losses incurred by the Challenger Group. The contribution of Additional Tier 1 Capital to CLC will assist with funding the regulatory capital requirements of CLC resulting from annuity sales growth and will similarly help protect CLC's creditors and policyholders.
- Mandatory exchange date: CGFPB must be converted to ordinary shares on the Scheduled Mandatory Conversion Date (22 May 2025) or upon the occurrence of an Acquisition Event; however, conversion cannot occur unless the Mandatory Conversion Conditions (or the equivalent tests for an Acquisition Event) are satisfied. Where these are not satisfied, conversion will be deferred until the next Distribution Payment Date where they are retested to determine if they are satisfied. Each CGFPB unit which is the subject of a conversion under these circumstances will be converted to ordinary shares with a value of approximately $101 based on the VWAP at the time of conversion.
- The Mandatory Conversion Conditions are:
  - First condition: The VWAP of Challenger ordinary shares on the 25th business day before (but not including) a potential mandatory exchange date is greater than 55% of the Issue Date VWAP;
  - Second condition: The VWAP of Challenger ordinary shares during the 20 business days on which trading in ordinary shares took place immediately preceding (but not including) a possible Mandatory Conversion Date is greater than 50.51% of the Issue Date VWAP; and
  - Third Condition: no Delisting Event applies in respect of a Mandatory Conversion Date. A Delisting Event occurs when Challenger is delisted, or its ordinary shares have ceased to be quoted on the ASX or have been suspended from trading for five consecutive business days prior to that date and suspension is continuing on the possible Mandatory Conversion Date, or it is prevented by any applicable law or order of any court or action of any government authority or any other reason from converting CGFPB.
  - For example, if the issue date VWAP is AUD 10.00, the relevant VWAP for the first mandatory conversion condition to be satisfied would need to be greater than AUD 5.50, and for the second mandatory conversion condition would need to be greater than AUD 5.05.
- A non-viability trigger event occurs if APRA determines that conversion of some, or all, CGFPB (or conversion or write-off in relation to other Challenger capital instruments) is required, because without it, Challenger would become non-viable; or a public-sector injection of capital is required because without it, Challenger would become non-viable. Following such an event, Challenger must immediately convert such number of CGFPB securities specified by APRA or necessary to satisfy APRA that Challenger will no longer be non-viable. Conversion following a non-viability trigger event is not subject to mandatory conversion conditions being satisfied. The consequence is CGFPB holders could potentially receive Challenger ordinary shares worth less than face value.

- Optional exchange: Challenger has the option, but not the obligation, with APRA's prior written approval, to (i) Redeem, Resell, or Convert to Ordinary Shares some or all CGFPB on the Optional Exchange Date (22 May 2023), or on the occurrence of a Tax Event or a Regulatory Event; and (ii) Convert all CGFPB to ordinary shares on the occurrence of a Potential Acquisition Event. In each case Challenger is restricted from exercising its option to convert if the Optional Conversion Restrictions apply. Each CGFPB security which is the subject of a Conversion under these circumstances will be converted to ordinary shares with a value of approximately $101 based on the VWAP at the time of conversion.
- Acquisition Event: Challenger is required to convert notes into ordinary shares where Challenger is acquired by way of a takeover bid or scheme of arrangement which meets certain requirements (refer to Section 2.5 of the Prospectus). There are conditions to conversion in these circumstances, which are designed to ensure that holders receive ordinary shares with a value of approximately $101 for each CGFPB unit they hold, and that the ordinary shares received may be sold on ASX. These conditions may never be satisfied and accordingly CGFPB may never convert into ordinary shares.
- CGFPB holders have no right to request exchange.

We have presented a summary of the key terms. Investors should examine the CGFPB Prospectus in detail if they intend to invest in CGFPB.

Issuer Details

Investment Thesis

Challenger is an asset and fund manager, with a business strategy of providing retirement income through its Australian Prudential Regulation Authority regulated niche life business. Challenger is the clear leader in the Australian retail annuity market and is well placed to benefit from strong long-term growth from the ageing population. Strong retail annuity sales growth during recent years was helped by ageing investors seeking stability during a period of equity market volatility, combined with product innovation, effective marketing, and a strong brand. Life assets under management of AUD 14.6 billion as at 31 December 2016 provide some scale advantages, at least until other major participants re-enter the sector. Life assets generate high gross investment yields, raising ongoing questions on the earnings risks inherent in the investment portfolio. Volatile investment markets and mismanaged risks are potential threats.

Despite a large distribution network, a low cost base, and strong long-term industry growth prospects, we do not think the firm has sufficient sustainable competitive advantages to justify an economic moat. A mild competitive disadvantage is that the distribution network is nonaligned, but this is offset by the strong brand and marketing campaign. Improving earnings quality and a strengthened balance sheet are opening up opportunities for more sustainable dividend growth.

Challenger is a clear leader in the Australian retail annuity market, holding a dominant market share and quickly establishing strong brand recognition and broad distribution through financial advisers. The business is well placed to benefit from strong long-term growth for annuities as increasing numbers of superannuation investors seek lifetime and secure retirement incomes.

Australia's compulsory superannuation system underpins long-term growth in superannuation assets, with industry experts predicting the pool of retirement assets to expand to more than AUD 4 trillion in the next 10 years.

Annuities will be increasingly attractive to the retiree sector, worried about market volatility and longevity risk. Australia's superannuation industry is still overwhelmingly focused on the preretirement ("accumulation") phase. Challenger expects an estimated AUD 73 billion is moving from the accumulation to retirement stage in fiscal 2017, with system growth expected to exceed 10% each year. The Henry and Cooper reviews encourage more use of annuities or similar products, but a structural shift in demand for annuities will need more government support.

The funds management business (comprising Fidante Partners and Challenger Investment Partners) manages over AUD 62 billion as at 31 December 2016 and is based on a stable of numerous boutique managers. The modest funds management group is growing strongly and increasing group profitability.

Challenger is far and away the market leader in conventional annuities, and the government's reactivation of deferred lifetime annuities after a long hibernation further strengthens our positive investment view. We see a strong long-term boost to annuity sales from revamped DLAs, as the insurance-like product provides income to retirees living beyond "average" life expectancy. The retirement income sector is expanding rapidly and we expect Challenger will face increased competition from the wealth-management industry heavyweights--the four major banks and AMP.
Challenger is delivering sustainable earnings growth. It is now a simpler business model, following major restructuring over the course of several years. The open register, strong balance sheet and attractive long-term industry dynamics also provide corporate appeal. We share CEO Brian Benari's upbeat outlook for the annuities business and the superannuation industry. The outlook remains positive, with strong long-term fundamental support for annuities as the population ages.

Financial Health

Challenger is in sound financial health. We like the strong cash flow conversion rate and the fact Challenger carries no recourse debt. Challenger is generating strong profits, and we expect dividends to increase to at least match earnings per share growth. Fiscal 2015 dividend growth was higher as the dividend payout ratio increased. Transition to new Australian Prudential Regulation Authority capital standards for general and life insurers is less onerous than originally anticipated. As at Dec. 31, 2016, Challenger's prescribed capital amount sat at 1.39 times. Challenger had AUD 853 million in excess regulatory capital and group cash. If the proposed AUD 350 million capital note issue proceeds this ratio would increase to 1.56 times on a proforma basis (assuming no change in prescribed capital amount upon receipt of funds by CLC).

Economic Moat

We do not ascribe an economic moat to Challenger, mainly reflecting insufficient entry barriers to stop existing competitors and potential new entrants from eroding the firm's dominant position in the annuity sector. We believe Challenger’s dominant market share is being driven by proactive marketing campaigns and offering more attractive returns than competitors.

Investor returns are limited by competition from alternative retirement-income products (such as bank term deposits), a lack of pricing power, regulatory capital requirements, and reliance on product distribution via nonaligned advisers. Challenger must take on investment risk to provide clients with a margin above the bond rate, as well as make an acceptable return for the firm. Miscalculating this risk, or severe economic shocks, could result in capital destruction. Further supporting our view the firm lacks pricing power, normalised cash operating margin (which includes normalised capital growth, returns on client funds after paying interest and distributions to annuity holders, and returns on shareholder funds) has fallen to 4.5% from 5.1% in fiscal 2011.

Earnings growth is solid in our five-year forecast period, and the business model is well placed to benefit from a growing pool of retirement savings; however, over time, we expect increased competition from large players, such as the four major banks and AMP. The operating environment is supported by ongoing equity market volatility, increasing growth in the retirement population, fear of outliving savings, uncertainty surrounding government's capacity to support the growing pension burden, increased marketing, and an expanding distribution footprint. Large and well-funded competitors could re-enter the annuities market, particularly if regulatory and taxation reform make the products more attractive and profitable for issuers. However, at this stage, the major banks and AMP are not keen because of their lower appetite for investment risk and because annuities are a capital-intensive business. We expect long-term growth in demand for retirement-income products, and we can see the major banks, AMP, or a major international life company moving more actively into the retirement-income product sector. The major banks and AMP already have strong brands and distribution channels (via planners and platforms) which provide a strong platform to grow from.

We consider Challenger's moat trend to be stable. Challenger continues to strengthen its brand with customers and advisers, via mainstream marketing campaigns, increasing business development managers and making annuities accessible on investment platforms. Challenger is increasingly becoming the brand synonymous with annuities among consumers and advisers. According to market research provided by Challenger, brand awareness among consumers which was almost non-existent in 2010 is now around 60% among consumers and over 90% among advisers.

As Challenger builds scale, its pricing power will also improve. In addition to making returns on client and shareholder funds, there are ongoing personal and business expenses to cover which are relatively fixed. Growing the annuity book over this cost base gives Challenger the opportunity to lower product fees, making it more difficult for new entrants to compete, while Challenger maintains bottom line earnings margins.

While these attributes help Challenger strengthen competitive advantages, both intangibles and cost advantages, at the moment, we do not see barriers to entry as formidable enough to thwart competition as the market grows. We also remain cautious on the ability to deliver an adequate client return to investors in a low-yield environment without taking excessive risks.

Management & Stewardship

In our view, Challenger has a Standard capital stewardship. We rate CEO Brian Benari highly, as he has been an impressive performer during his tenure at Challenger. He was promoted to CEO in February 2012, and the transition was smooth and uneventful. Benari joined Challenger in 2003 and prior to his promotion to CEO held the role of CFO and COO for three years. Previous CEO Dominic Stevens started the major restructure of the underperforming, diversified, and complex group in 2009. The balance sheet is strengthened, operating costs are tightly managed, and return on capital is maximised. We are confident that the growth strategy is on track, and that senior management will strive for improved shareholder returns. The Challenger board comprises eight board members, all of whom are independent except CEO Brian Benari. Chairman Peter Polson is a professional director, having previously worked in banking for many years. Board members have broad industry experience, including banking, finance, wealth management, insurance, and property.

Senior management continues to develop and increase the firm's annuities management business. Challenger is conservatively managed and will likely grow in line with strong long-term industry growth forecasts. Challenger's strong market position and brand strength will capture broad long-term growth in the retirement income space. We agree with the strategy to strengthen its position in this long-term growth industry while balancing cost control and protection of capital and liquidity.

We support the focus on selling more profitable, long-term annuities at the expense of short-term products. Concerns surrounding annuity margins and capital are overdone, but the two risks could increase in prominence in the future. Despite risks, we are reasonably confident management controls and governance are sufficient to limit potential damage to the businesses.

Research Report Disclosure Document

Currency

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