# NAB Convertible Preference Shares (NABPA): The First Tier 1 Security Since 1999.

## Recommendation: Subscribe at a margin of at least 3.20%

### Overview

National Australia Bank (NAB) is looking to raise at least AUD 750 million in new capital via the issuance of convertible preference shares (NAB CPS). These securities are to be listed on the Australian Stock Exchange (proposed ASX Code: NABPA) and are designed to provide tier 1 regulatory capital which complies with APRA's newly implemented capital adequacy standards (Basel III requirements).

NAB CPS are fully paid, non-cumulative, convertible, resalable, redeemable, subordinated, perpetual, unsecured preference shares. Although this security is legally a perpetual instrument it has embedded conversion mechanics which (subject to satisfying the conversion conditions) requires conversion into NAB common stock at the mandatory conversion date (22 March 2021). However, as part of the structure the issuer reserves the right to redeem (convert or resell) the security earlier subject to APRA approval (the optional conversion/ redemption/ resale date being 20 March 2019). This option is standard for an issuer as it provides them with additional flexibility in managing capital.

NABPA pays fully franked discretionary and non-cumulative distributions payable quarterly in arrears, based on the 90-day bank bill swap rate (BBSW) rate plus a margin. NAB has communicated that the indicative margin range is (3.20–3.40%).

### Summary and Recommendation

NABPA is the first tier 1 hybrid security issued by NAB since the National Income Securities in June 1999. NAB has historically issued tier 1 securities into the wholesale market but with the success of Commonwealth Bank's PERLS VI (CBAPC) and Westpac Capital Notes (WBCPD), NAB has decided to return to the retail market.

We recommend investors subscribe, so long as the margin over 90-day BBSW is 3.20% or more. This security is almost a carbon copy of previous Basel III compliant securities (with some minor exceptions) and hence we assess NABPA using a consistent analysis framework. Morningstar takes into account the current relative value and the long term fair value of the new issue. Our analytical process takes into account our fundamental issuer analysis and structural considerations before applying a quantitative method for assessing the fair value.

NABPA is suitable for investors looking for stable income with a stable to positive view on the credit profile of the issuer. This is not a defensive or growth asset and should be treated as such in the asset allocation process.

We consider NAB to have a low issuer risk. A component of this assessment is our medium business risk rating, which is in line with the other major banks. This view is consistent with wholesale market pricing whereby the implied probability of default is almost identical across the major banks. The probability of unscheduled conversion on NABPA is higher than the probability of default, but this risk is still low on a relative basis so NAB falls within the lower issuer risk group of our coverage universe.

Issuer risk does not take into account structural considerations which change the risk profile of the security itself. Features such as the common equity and non-viability triggers change the dynamics of the security to make it unsuitable for defensive/ conservative investors. Excluding systemic influences the performance of this security will be linked to the capital buffer and viability of the business (and inherently the banking industry). These securities are higher risk than senior debt securities from the same issuer and will act accordingly with changes to the level of systemic risk. We note that the slight difference between WBCPD and NABPA is that the former is a note and the latter is a preference share. This makes a marginal difference in recovery at the point of conversion and discussed further in structural considerations.

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**Table 1: Morningstar's key qualitative data points for Australian banks**

| | Issuer Risk | Business Risk | Economic Moat |
|---|---|---|---|
| National Australia Bank | Low | Medium | Narrow |
| Westpac Banking Corp | Low | Medium | Narrow |
| Commonwealth Bank | Low | Medium | Narrow |
| ANZ Bank | Low | Medium | Narrow |
| Bank of Queensland | Medium | Medium | None |
| Bendigo Bank | Medium | Medium | None |

On an absolute basis the security should offer a margin comfortably above our fair margin of 3.20%. From a relative value perspective similar Basel III compliant securities (CBAPC) rallied in the second half of 2012 but since late January have softened with trading margins currently around 3.40–3.50%. This softening is a function of new supply (Westpac's WBCPD security being an example) but given the rally in recent months we expect tier 1 spreads to stabilise between 3.15–3.30%. NABPA should offer a margin at least equal to current trading margins and therefore investors should expect a margin at the higher end of the range 3.20–3.40%.

**Valuation**

NAB CPS is the first Basel III compliant security for NAB. Other listed NAB securities have a distinct prospectus with terms that affect the performance of the security in different ways. Morningstar assesses long term quantitative fair value based on mapping our investment risk rating to the probability of conversion.

The structural terminology in NABPA makes the loss given conversion higher than loss given default in other debt instruments issued by NAB (this is primarily because of the loss abortion mechanics). We assign a fair margin of 3.20%, which is consistent with WBCPD and CBAPC, based on loss given conversion (not default) spread of 2.40%, an illiquidity cost of 0.10% and an additional 0.7% to account for discretionary distributions.

**Issuer Credit Perspective**

Morningstar's issuer credit perspective is our assessment of an issuer's ability to meet its legal obligations in a full and timely manner. Our process is based on four key pillars; Business Risk, Loss Absorbency, Bank Solvency and Probability of Default. This assessment is specific to the financial health of the issuer. We then consider the security's structural elements to formulate our investment risk rating for the security itself. It is important for investors to look at all elements of our analysis before participating in the issue.

*Business Risk*

Morningstar's business risk rating is our qualitative assessment of the presence of any sustainable competitive advantages (economic moat), the reliance on debt capital markets (domestic and foreign) and quality of management and sub-committee's (risk and capital). Consistent with other major domestic banks we assign NAB a low business risk.

One of our concerns with Australian major banks has been their dependence on debt capital markets. This reliance has reduced somewhat with deposit funding becoming a larger piece in the funding pie but with limited domestic funding capacity Australian issuers are forced to international markets to meet their term funding requirements. Domestic treasurers typically have a funding limit which can be executed in the Australian market. When we take into account refinancing redemptions the net funding increase that can be absorbed domestically is a very small part of the overall size of a bank balance sheet. That said, we do not believe the major bank's ultimate survival depends on access to these markets. We could argue that they are of such domestic importance to the economy that if external funding was unavailable the government would provide a guarantee facility similar to what was made available during the global financial crisis.

*Economic Moat*

The economic moat concept is a cornerstone of Morningstar's investment philosophy and is used to distinguish high quality companies. An economic moat allows a firm to sustain excess returns over a long period of time. Without a moat, profits are more susceptible to competition. Companies with a narrow moat are likely to achieve normalised excess returns beyond ten years while wide moat companies are likely to sustain excess returns beyond 20 years.

We assign NAB a narrow moat rating. Banking in Australia is an effective oligopoly, with the four major banks controlling over 90% of the business and consumer lending markets, plus the vast majority of bank deposits. NAB is currently growing its home loan book at twice the rate of system growth, with its share of the Australian bank home loan market currently 16%, compared to market heavyweights Commonwealth Bank of Australia (CBA) at 28% and Westpac Banking Corporation (WBC) at 26%. Household deposit market shares are similar, with CBA leading at 30%, WBC at 23%, Australia & New Zealand Banking Group (ANZ) at 15% and NAB at 14%. Despite dominant market positions, competition is intense between the four major banks. Tight cost control and strong volume growth provide a solid

platform for consistent earnings growth well in excess of our cost-of-equity estimate. Importantly, we expect this to continue.

NAB is a diversified financial services business, benefiting from economies of scale and a sticky customer base. 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. NAB leverages its strong distribution network, large number of financial advisers and high-profile MLC investment platform to further expand into the wealth sector. Customer inertia is high, as most customers view the major banks as providing similar levels of service. Most major bank customers have multiple product relationships with their bank, ensuring limited switching due to cost and time pressures. NAB's focus on deeper customer relationships promotes customer loyalty, reduces switching and improves profitability.

Regulation and highly profitable customer lending reduces risk taking in non-lending asset classes, with NAB holding negligible exposures to dodgy European sovereign debt. The concentrated market ensures above-average risk-adjusted returns. Mortgage lending is consistently profitable and accounts for 54% of total loans and 35% of total assets at September 2012. Pricing is opaque as higher advertised rates are discounted for customers, and mortgage interest rate changes tend to be matched by competitors. Standard loans require mortgage lenders' insurance if loan/value ratios (LVRs) exceed 80%, limiting credit risk on a large portion of higher LVR loans. Low-doc mortgage loans above 60% LVR require lenders' mortgage insurance, so mortgages resemble a fee-based business with significant operating leverage, and NAB benefits from its growing market share. Mortgage insurance is paid by borrowers but benefits the bank in the event of a mortgagee-in-possession property sale below the outstanding loan amount.

NAB's Australian mortgage portfolio includes a lower proportion of first home buyers and low-doc loans compared to its two bigger retail focused peers, Commonwealth Bank of Australia and Westpac Banking Corporation. Mortgage insurers in Australia are regulated by APRA, with the two dominant insurers currently rated AA- by S&P. Both insurers regularly stress test their mortgage insurance portfolios and are capitalised to withstand loss severity rates significantly higher than the worst previous experiences. Mortgage insurance covers 100% of the insured loan amount for the loan life. The major provider of mortgage insurance is Genworth Financial, with about 60% of the Australian and New Zealand market. Importantly, Genworth Financial's Australian assets and capital are 'ring-fenced' from its U.S. parent.

Australian lenders are legally obligated to assess a borrower's financial capacity to meet loan repayment obligations. If a lender makes a loan to a borrower who cannot initially afford the loan, courts can extinguish the loan. All home loans in Australia are full recourse and banks have clear title to the mortgaged property and all other assets. Often home loans are cross-collateralised against other property, particularly common for homes purchased as an investment property and/or beach house type properties. These characteristics of the Australian mortgage industry support tight underwriting standards and reduce mortgage credit risk, thereby increasing the attractiveness of NAB's successful drive to increase home loan market share and boost return on equity.

*Management*

Cameron Clyne has been CEO since January 2009. He was CEO of NAB's New Zealand business, BNZ, and his previous background was weighted to management consulting rather than traditional banking. Clyne started during the worst of the global financial crisis, with Lehman Brothers collapsing in September 2008, international credit markets freezing and investment markets plunging. In Australia, the banks were dealing with corporate collapses, sharply higher funding costs, increasing bad debts and surfacing off-balance sheet exposures. Deteriorating global credit conditions caused NAB to recognise provisions on large portfolios of collateral debt obligations and structured asset facilities.

Clyne started restructuring in late 2008 overhauling and reinvigorating management. The CEO announced a new group strategy in March 2009, including a 25% cut in dividends, and confirmed the way forward was business banking, retail banking and wealth management in Australia and New Zealand. The CEO revelled in the period of intense uncertainty and change, making clear status quo was not an option. The CEO implemented necessary cultural change and a more effective risk management framework, and continues to establish much-needed credibility with investors and the market. Lost ground is being recovered, but some long-term doubters remain unconvinced the turnaround strategy will last.

There is ample proof of dramatic improvement in branch service levels and customer satisfaction, reflecting a significant change in staff culture at the grassroots level. The 'fair-go' strategy won considerable admirers and delivered strong growth in

customers and business. NAB has turned around, momentum kick-started, return on equity is improving and earnings quality is solid. Clyne's strengths are his cool head under pressure, a good grasp of changing customer and industry dynamics, and a disciplined approach to implementing his vision.

*Bank Solvency – Capital, Funding, Liquidity, and Asset Quality*

Morningstar assesses the financial health of an issuer using a purely objective assessment based on bank-specific accounting metrics. Our Solvency Score measures a bank's most recent performance in four key areas: capital adequacy, asset quality, earnings power and liquidity. These measures are scored against a fixed set of thresholds set by our global credit committee.

*Capital*

Morningstar considers NAB to have a satisfactory capital ratio relative to regulatory, security specific and internal requirements. NAB has a more complex asset base than its domestic peers primarily as a result of the Clydesdale Bank subsidiary and the orderly run off of the Specialised Group Asset (SGA) portfolio. That being said the capital structure is consistent with other major banks. In its most recent trading statement NAB announced the group Core Tier 1 ratio (on a Basel II basis) was 8.39% compared to 8.29% as at 30 September 2012. The Group's estimated Common Equity Tier 1 (CET1) ratio (on a Basel III basis) was 7.69% (this is primarily as a result of how dividends are treated under the new regulation).

As with other majors NAB has had a strong history of managing its capital buffer, but it has also had its fair share of failed expansions into foreign markets (i.e. Homeside and Clydesdale). During the height of the financial crisis (November 2008) NAB raised AUD 3.0 billion in equity capital (50% more than expected) followed by AUD 2.75 billion in July 2009. This was primarily to stabilise the balance sheet as a result of rising bad debts but this was more than sufficient and was arguably excessive. However, it proved NAB's capital committee can be overly conservative in a time of stress.

At the full year 2012 results NAB introduced a Basel III Common Equity Tier 1 ratio target of above 7.5% to apply from 1 January 2013, and will look to operate at an appropriate buffer to this target. The buffer is key for capital investors so Morningstar would expect NAB to pursue a buffer range of at least 0.5–1% above this target ratio. This is broadly in line with Westpac's objective and 2.875%–3.375% above the capital trigger minimum of 5.125% (the capital trigger is a term within the prospectus which is discussed further in the structural considerations section).

We are confident that NAB will maintain a capital buffer range consistent with the other major banks even with a slightly higher-risk balance sheet. This has been consistent across the industry, and it is arguable that RWA's will be able to grow while retaining a satisfactory capital buffer.

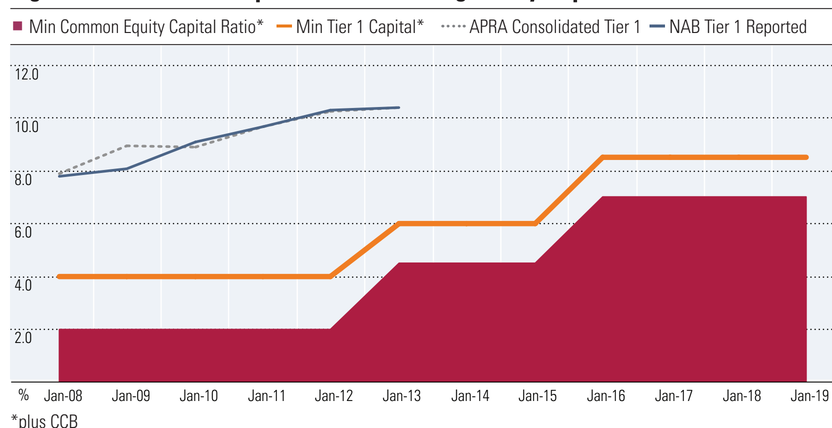
The estimated Basel III NAB common equity tier 1 ratio is 7.69%, well above the minimum requirement of 4.5% effective 1 January 2013. The estimated Basel III pro-forma total tier 1 ratio is 9.6% (NABPA adding minimum 0.21% to tier 1 capital) which is 3.6% over the minimum requirement but broadly in line with 2016 targets.

*Asset Quality*

Asset quality of NAB is satisfactory given the current market conditions with unemployment being the greatest driver of deteriorating asset quality. Household leverage remains high despite some improvement in recent years. Morningstar believes that a slight uptick in unemployment in 2013 will have a minimal impact on asset quality, but this may impact the risk weighting of household assets which would in turn change the capital requirement.

Residential mortgages represent approximately 23% of risk weighted assets and although this is lower than Westpac and Commonwealth it still represents the primary link to the financial health of the economy through NAB's collective provisioning policy. According to APRA statistics residential mortgages represent ~60% of Australian bank loan portfolios at 30 September 2012. However, based on empirical data the main risk of losses are more likely in the bank

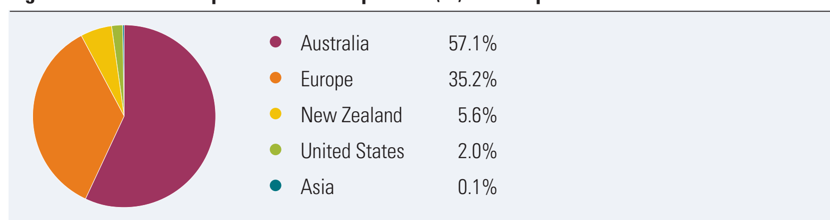
**Figure 1: NAB's tier 1 capital ratio versus regulatory requirements**




*plus CCB

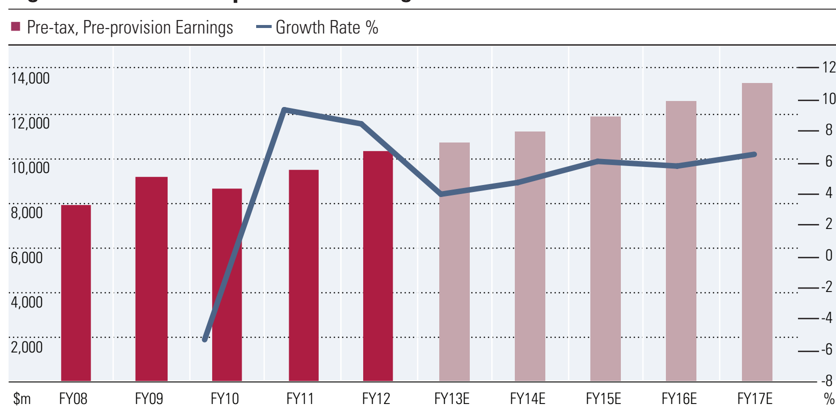
Source: Morningstar

**Figure 2: NAB: Gross Impaired Asset Composition (%) as at September 2012**



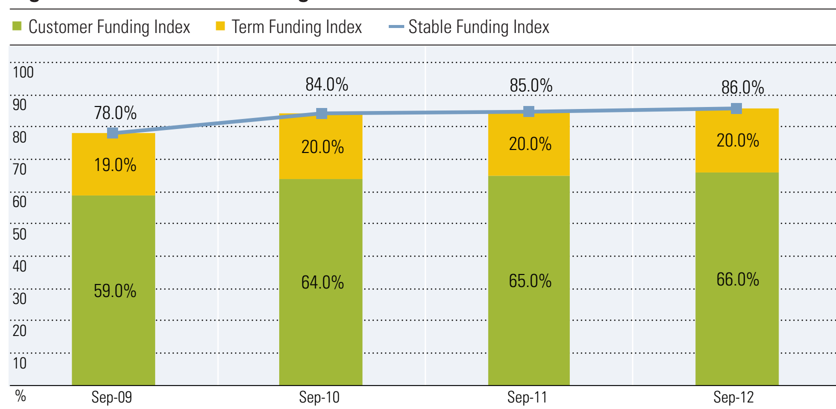

Source: Morningstar, National Australia Bank

**Figure 3: Pre-tax, Pre-provision Earnings Growth**




Source: Morningstar

**Figure 4: NAB Stable Funding Index**




Source: Morningstar, National Australia Bank

commercial loan books. This can be a concern for NAB through its specialist lending assets but we remain confident that any issues which have been evident in the past are now monitored closely.

In Morningstar's opinion NABs provisioning policy is conservative with provisioning as a proportion of risk weighted assets currently the highest among the four majors. This is also a reflection of their asset composition but again from a capital investors perspective this is a credit positive.

NAB announced a relatively clean first-quarter fiscal 2013 trading update, but limited detail makes it difficult to fully gauge underlying performance. As expected, asset quality was broadly stable and, importantly, bad debts of AUD 554 million for the quarter were in line with our full-year bad debt forecast of AUD 2.1 billion.

*Earnings Power*

The pre-tax, pre-provision earnings (PPE) are a bank's first line of defence against credit losses. As such, it receives the highest weighting in the Bank Solvency Score. The higher a bank's core earnings power, the more losses it is capable of absorbing without affecting its allowance for loan losses or common equity tier 1 capital balance.

While NAB's earnings power is not as high as WBC or CBA, its position within the oligopoly still allows for substantial earnings power. Morningstar's equity analysts project PPE to grow at an average of 6.0% per annum over the next five years giving investors comfort that the first level of defence against deteriorating asset quality has a solid outlook.

*Funding and Liquidity*

Stable funding is an important assessment of an issuer profile but it is not heavily weighted in our objective assessment. Reliance on capital markets funding is the main component of our business risk analysis and we take into account the funding composition in this analysis.

Funding and liquidity risk are defined by NAB as:

Funding risk is the risk which arises due to change in appetite and capacity of the market to provide adequate long-term and short-term funds to meet the group's strategic plans and objectives at an acceptable cost. This includes the risk of over-reliance on any source of funding to the extent that a lack of diversified funding sources jeopardises the Group's ability to raise funds at acceptable costs under adverse business conditions.

Liquidity risk is the risk of the Group being unable to meet its financial obligations as they fall due.

Funding and liquidity risk are measured and monitored on a daily basis, with any non-compliance escalated to the Group Asset and Liability Committee (GALCO) and Group Chief Risk officer.

NAB established its capital and funding sub-committee to delegate authority on behalf of the board in relation to the group's capital and funding activities. This committee introduced a range of monitoring metrics in order to manage liquidity and funding risk. The primary measure used to monitor funding and liquidity is the Stable Funding Index (SFI). This is a function of the

Customer Funding Index (CFI) and Term Funding Index (TFI). The CFI represents core assets which are funded by customer deposits whereas the TFI represents the proportion of the group's core assets that are funded by term wholesale funding with a remaining term to maturity of greater than one year. These indices are shown in Figure 4.

These calculations are similar to the proposed regulatory calculations and will act as a guide for the liquidity coverage ratio and net stable funding ratio which are to be implemented in the future as prudential requirements.

*Stress Test – Loss Absorption Cushions*

Morningstar's Bank Stress Test score evaluates a bank's capacity to handle additional losses in its loan and securities portfolios. This ability depends on the bank's initial capital position, provisioning and its 12 month forward pre-tax, pre-provision earnings (PPE). NAB comfortably passed all the stress test requirements set out under our methodology.

The stress test score is based on a bank's expected capital position at the end of a two-year period of (hypothetical) elevated losses. Expected losses in various loan and security categories are applied to a bank's most recent asset composition (reported in APS 330). Losses are then subtracted from the bank's last reported core equity tier 1 capital position. Consistent with other major banks NAB performed very strongly against Morningstar's stressed scenario. This stress test is arguably not as severe as APRA's own hypothetical stress tests which are intended to test the boundaries of 'severe but plausible' macroeconomic deterioration.

APRA will stress the capital, liquidity and cashflow of an institution over a 3 year period (relative to Morningstar which is over two) using the below key macroeconomic parameters (assumed to be worst case):

- a sharp (5 per cent) contraction in real GDP in the first year;
- a rapid rise in the unemployment rate to a peak of 12 per cent;
- a peak-to-trough fall in house prices of 35 per cent; and
- a fall in commercial property prices of 40 per cent.

These stresses are extreme circumstances and more severe than our worst case scenario. However, the results were strong:

- none of the banks would have failed under the downturn macroecnomic scenario;
- none of the banks would have breached the four per cent minimum Tier 1 capital requirement of the Basel II Framework in any year of the stress test; and
- the weighted average reduction in Tier 1 capital ratios over the three-year stress period was 3.8 percentage points.

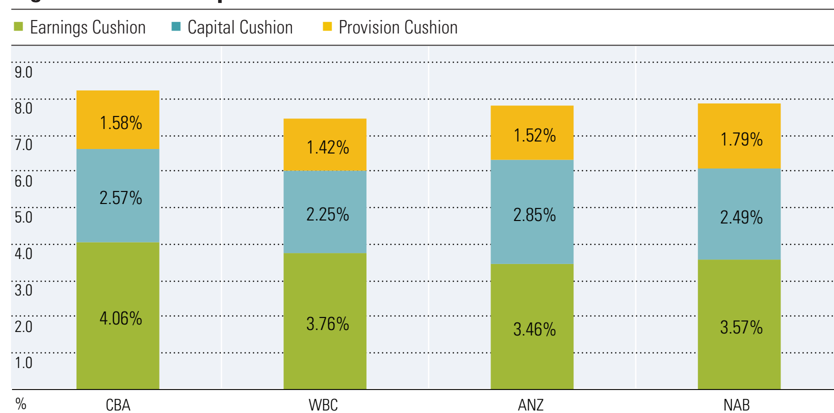
These results are clearly a positive for the market with the assumptions in a worst case scenario being extremely unfavourable. Although Morningstar stresses capital over a two year period we believe that the primary risk of default comes in a sharp deterioration over a one year period. Therefore, we monitor the loss absorption cushion as a % of risk weighted assets. As stress testing by the regulator is more severe than our own, it would be highly irregular for a bank to fail our stress test.

Importantly, this is a general measure of loss absorption. Losses are recognised differently in core equity capital depending on how they are provisioned (varies between institutions due to quality and asset composition). While we do not expect losses to be sufficiently high enough to breach the capital trigger, if losses are large (and over a short time horizon) the structural elements of NABPA will change how losses are attributed to different parts of the capital structure. This is discussed further in structural considerations.

*Distance to Default*

The final measure in Morningstar's credit opinion is our distance to default. This is an adjusted form of Morningstar's structural model of default. This measure provides us with a guide to the probability of an issuer meeting its obligations (without covenants). This does not have a large impact on our overall assessment but is designed as a quantitative measure of default probability.

**Figure 5: Loss Absorption Cushion as % of RWAs**




Source: Morningstar Estimates, APS 330 Disclosures

Importantly our fundamental assessment suggests that our default probability estimate is conservative (higher) than other market based assessments (i.e. implied default probability from credit default swaps).

**Structural Considerations**

Morningstar's credit opinion is a measure of strength of an issuer and the probability that it will meet all future obligations. It does not form a complete view on individual securities such as NABPA. The best way to think of our credit opinion in the context of NABPA is a probability of non-conversion. Importantly this is not probability of default, which has a lower probability (see Figure 6 for theoretical timing illustration).

Morningstar considers redemption or resale as positive outcomes for the investor but conversion is where risk increases. Conversion of NABPA will happen only in four scenarios (excluding an early redemption event):

- Optional conversion, subject to APRA approval and satisfying specific conversion conditions, on 20 March 2019 (this is different from WBCPD as it provides the issuer more flexibility);
- Mandatory conversion, subject to conversion conditions, at 1% discount to VWAP on mandatory conversion date (22 March 2021);
- Unscheduled conversion (which in this prospectus is called a Loss Absorption Event) due to :
  - Common Equity Trigger Event
  - Non-viability trigger

The mandatory conversion date is 22 March 2021 (for valuation purposes this is the date which Morningstar uses as the expected maturity date). On this date holders of NABPA will be converted into NAB common equity at a 1% discount ($101.01) to the volume weighted average price (VWAP) of NAB common equity during the 20 Business Days preceding the mandatory conversion date.

Mandatory conversion is subject to:

- First scheduled conversion condition – VWAP of NAB shares on the 25th business day preceding the scheduled conversion date is greater than 56% of the issue date VWAP
- Second scheduled conversion condition – VWAP of NAB shares during the preceding 20 business days before the scheduled conversion date is greater than 50.51% of the issue date VWAP.
- No delisting event applies

These conditions are designed to protect the security holder from short term volatility in the NAB share price which might unnecessarily effect the scheduled conversion calculation.

The most important conversion type to understand is unscheduled conversion. This is an unlikely, but severe, scenario which from a timing perspective is before default or insolvency. The threshold is clear for the common equity trigger (being 5.125% of common tier 1 capital) but non-viability has not been clearly defined. Both of these scenarios are the key to the risk profile of the security. The risk profile is asymmetric with a low probability that the security will be converted but loss given conversion can be high. These structural elements are described below and are designed to meet the loss absorption requirements set out by APRA.

Note that conversion conditions do not apply during unscheduled conversion.

*Common Equity Trigger Event*

A common equity trigger event (also known as capital trigger event) is defined as when the issuers' common equity tier 1 capital ratio reaches 5.125%. This level was decided upon by the Basel Committee on Banking Supervision and implemented by APRA. Investors can monitor this trigger level on a quarterly basis as it is disclosed by the issuer in what is known as NAB's Pillar 3 report.

Importantly investors should understand that at 5.125% of core equity capital NAB still has significant enterprise value (this is different from market capitalisation) and hence investors will be converted when the company still has capital available to cover losses. To reach this capital level we expect the macroeconomic environment would have to deteriorate substantially with loan losses exceeding our worst case scenario. In the event that this scenario did eventuate NABPA would be converted (conversion conditions to not apply at this point) into common equity to a point where the common equity tier 1 ratio is restored above the 5.125% level.

Unscheduled conversion will occur using a predefined calculation with the number of shares received by investors being a function of a calculation known as the conversion number. This conversion number has a maximum limit (known as the maximum conversion number) which will automatically write down the value of your investment depending on the common equity share price over the preceding 5 days (% days VWAP).

This trigger event is not new and has been embedded in a number of securities to date (WBCPD, ANZPC, WBCPC and CBAPC). The timing of conversion for a capital trigger event is significant because theoretically it should be before the point of non-viability and

default/ insolvency. If NABPA is forced into unscheduled conversion it is likely that the issuer will require further equity capital injection and any recovery would be significantly diluted by new common equity capital. For this reason Morningstar conservatively assumes 0% recovery on unscheduled conversion.

Figure 6 shows a theoretical example of how the capital value of the preference share would work relative to its share price. We can see from the chart that the share price of an issuer will retreat significantly quicker as the level of capital reduces (this can be due to losses exceeding provisions) but the preference share price will only begin to reduce once it approaches the unscheduled conversion triggers. Ultimately if the issuer defaults (which is a highly unlikely event) the value of both securities would be nil. Hence, we conservatively assume nil recovery. Note that this chart is designed to display the theoretical price whereas in reality market prices are much more volatile.

*Non-viability trigger event*

The point of non-viability is the second line of defence before a public injection of funds if necessary to support the issuer. This point has not been clearly defined and it will remain subjective for APRAs purpose (which is ultimately to protect the public from having to support a failing banking institution). It is Morningstar's opinion that the point of non-viability is before default or insolvency (but probably after the capital trigger) because it is in the interest of APRA to maintain solvency in domestic banking institutions.

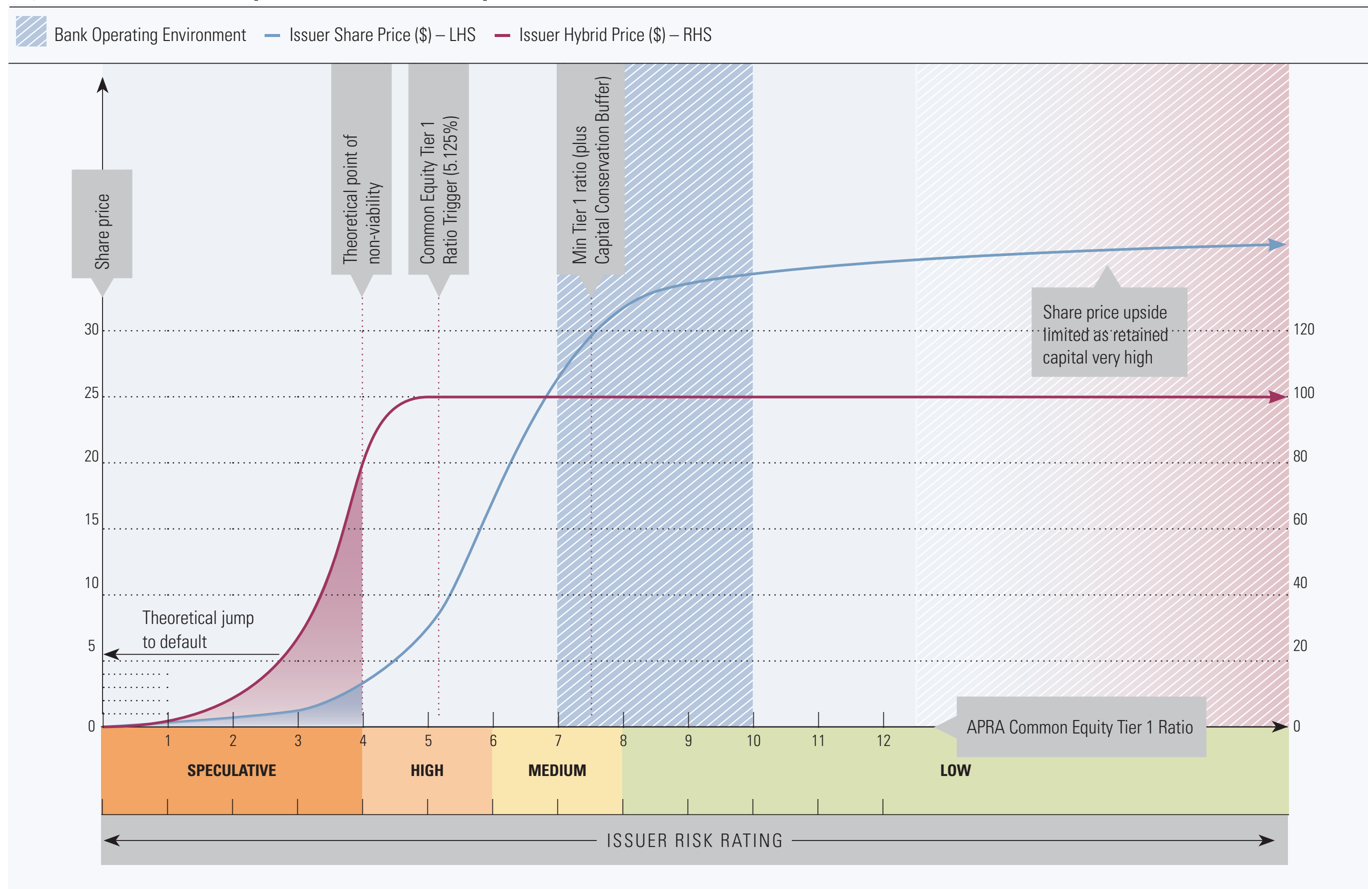
A Non-Viability Trigger Event has been defined as when APRA notifies NAB in writing that it believes:

- Conversion or write-off of some or all preference shares is necessary because, without it, NAB would become non-viable; or
- public sector injection of capital, or equivalent support, is necessary because, without it, NAB would become non-viable.

The non-viability trigger ultimately gives APRA discretion to convert NABPA into equity when it deems it appropriate. The use of this trigger event may not be limited to its concerns about NAB's capital levels and could extend to concerns about the bank's funding and liquidity.

Importantly the time distinction between the capital trigger event and non-viability trigger event would, in all likelihood, be small. A slow deterioration in capital

**Figure 6: Theoretical Capital Risk Profile for Equity and Hybrid Instruments**




Source: Morningstar

would be captured by the capital trigger but a sharp deterioration where asset write-offs are very large would be captured by non-viability.

As with the capital trigger event conversion will occur using the same predefined calculation with the number of shares received being a function of a calculation known as the conversion number. This conversion number has a maximum limit (known as the maximum conversion number) which will automatically write down the value of your investment depending on the common equity share price over the preceding 5 days (% days VWAP). As non-viability conversion is forced Morningstar assumes 0% recovery.

*Inability Event*
If for some reason NAB is unable to convert NABPA within 5 days of a loss absorption event (could be some court order restriction on issuing shares) then NABPA would be written off instead of converted. The rights of holders of NABPA following an inability event are equivalent to shareholder rights but they will not be able to trade their rights on the ASX. This is different to WBCPD which post an inability event holding give up all rights. In Morningstar's opinion the recovery difference would be so small it makes little impact to the valuation.

*Capital Note versus Preference Share*
NABPA is a standard structure which is comparable with BOQPD and BENPD but slightly different to WBCPD. This is not obviously to the naked eye but the difference lies in the workout process (or recovery) when and if conditions deteriorate. WBCPD was a note whereas NABPA is a preference share. If a loss absorption event occurs a noteholder automatically waives all their rights if they cannot be converted whereas a preference share holder still maintains some rights. This is another small difference in the recovery process which in the scheme of things has little impact on the current valuation.

*Dividend Restrictions*
As part of the APRA prudential requirements dividends on NABPA are at the director's discretion and subject to payment conditions (see exact conditions in appendix of prospectus). Morningstar incorporates a risk premium into our fair value to account for the small probability that dividends are not paid.

NABPA also includes terminology which restricts payments of dividends on common equity (dividend and capital stopper) if distributions on NABPA have not been paid. These restrictions are not as strong as dividend stopper conditions from older hybrid securities but will be the standard for Basel III compliant securities.

*Early Redemption Event*
NAB has the option of early conversion / redemption / resale of NABPA on 20 March 2019. NAB also has the option to convert/redeem/resell NABPA at face value on any payment date if it deems a Tax or Regulatory Event has occurred. This option is subject to APRA approval and holder should not expect that APRA will give this approval. Hence, Morningstar uses the mandatory conversion date for pricing purposes..

We note that conversion in this circumstance is subject to some but not all the conversion conditions. More information can be found in the prospectus appendix under section 6.

*Acquisition Event*
In the event that NAB receives an unconditional takeover bid (or scheme of arrangement) an acquisition event will have occurred (provided it is not deemed an NOHC event) and NABPA must automatically convert in common equity. Conversion will occur using the same calculations as conversion on the schedule conversion date. More information can be found in prospectus appendix under section 5.7 Automatic Conversion upon the occurrence of an Acquisition event.

A potential acquisition event relates to the same event type but is before a regulatory or court approval of the acquisition. The remedies for such an event are consistent.

**Other Risks**
Excluding the risks described above NABPA are subject to a number of other risks which investors should be aware of:
*Market Risk*
NABPA has embedded equity risk (through the conversion process) which means it is exposed to market risk as a consequence of its trading activities and/or the management of its financial position. Therefore it is reasonable to suggest it is exposed to adverse movements in levels and volatility of interest rates, foreign exchange rates, commodity prices, credit prices and equity prices.

*Interest Rate Risk*
NABPA resets on a quarterly basis. Technically this is defined as short duration and therefore changes in benchmark interest rates will have a minimal impact on the capital performance of the security.

*Systemic Credit Risk*
Although idiosyncratic credit risk has been assessed in this document, systemic effects can have an impact on the performance of the security. This risk is difficult to quantify but Morningstar mitigates this risk by incorporating a systemic risk premium in its fair value assessment.

**Table 1: Comparable Converting Major Bank Capital Securities**

| | NABPA | WBCPD | CBAPC | WBCPC | ANZPC |
|---|---|---|---|---|---|
| Name | NAB CPS | Westpac Capital Notes | CBA PERLS VI | WBC CPS | ANZ CPS3 |
| Type | Mandatory Conversion | Scheduled Conversion | Mandatory Converting | Scheduled Conversion | Mandatory Converting |
| Issuer | NAB | WBC | CBA | WBC | ANZ |
| Issue Size | Min $750m | Min $500m | $2.0bn | $1.189bn | $1.34bn |
| Face Value | $100 | $100 | $100 | $100 | $100 |
| Issue Date | 8 March 2013 | 8 March 2013 | 17-Oct-2012 | 23-Mar-2012 | 29-Sep-2011 |
| Margin above Base Rate | [3.20 – 3.40%] | 3.20% | 3.80% | 3.25% | 3.10% |
| Base Rate | 90-Day BBSW | 90-Day BBSW | 90-Day BBSW | 180-Day BBSW | 180-Day BBSW |
| First Call / Exchange/ Redemption Date | 20-Mar-2019 | 8-Mar-2019 | 15-Dec-2018 | 31-Mar-2018 | 1-Sep-2017 |
| Mandatory Exchange / Scheduled Conversion Date | 22-Mar-2021 | 8-Mar-2021 | 15-Dec-2020 | 31-Mar-2020 | 1-Sep-2017 |
| 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% | Yes, if Common Equity Tier 1 ratio is equal to or below 5.125% | Yes, if Common Equity Tier 1 ratio is equal to or below 5.125% | Yes, if Common Equity Tier 1 ratio is equal to or below 5.125% | Yes, if Common Equity Tier 1 is equal to or below 5.125% |
| Non-Viability Trigger Event | Yes | Yes | Yes | No | No |
| Conversion into ordinary shares | Yes | Yes | Yes | Yes | Yes |
| Ranking | Above NAB ordinary shares. | Above WBC ordinary shares. | Above CBA ordinary shares. | Above WBC ordinary shares. | Above ANZ ordinary shares. |

Source: Morningstar

*Event Risk*

Event risks arise as a result of unforeseen or unexpected events such as natural disasters, political reforms, mergers and acquisitions.

**Key Terms**

- Bookbuild: 20 February 2013
- Announcement of margin: 21 February 2013
- Offer Opens: 21 February 2013
- Closing Date for Offer: 19 March 2013 (Broker Firm Offer)
- Issue Date: 20 March 2013
- Commencement of Trading: 26 March 2013
- First Dividend Payment Date: 20 June 2013
- Optional Conversion/Redemption/Resale Date: 20 March 2019
- Mandatory Conversion Date: 22 March 2021
- ASX code is expected to be NABPA
- Face Value: $100 per security.
- Minimum Subscription Amount: $5,000 (50 units).
- Amount to be raised: Min $500m with the ability to raise more or less.
- Distribution Rate: (90-day BBSW rate + Margin%) x (1-Corporate Tax Rate).
- Margin: NAB has provided an indicative range of 3.20–3.40%
- Frequency of Distributions: Quarterly on 20th of March, June, September and December.
- Franking: Expected to be Fully Franked.
- Distributions: are at the sole discretionary of NAB and subject to payment conditions outlined above. Distributions are not cumulative meaning that NAB does not have to make up for missed distributions.
- Dividend Stopper: If a NABPA dividend is not paid then dividend and capital restrictions will apply to NAB ordinary shares from that distribution payment date until a distribution is paid in full on a subsequent distribution payment date. Subject to conditions.
- Capital Classification: Additional Tier 1 Capital.
- Term: Perpetual. Subject to:
    - Optional conversion/redemption/resale (for the issuer and subject to specific conditions and APRA approval) on the optional 20 March 2019; or
    - Mandatory conversion on the mandatory conversion date (22 March 2021) subject to conversion conditions;
    - Unscheduled conversion as a result of a common equity trigger event or non-viablity trigger event;
    - NAB may convert/redeem or resell earlier following the occurrence of tax or regulatory events (subject to APRA approval);
    - NAB must convert all NABPA following the occurrence on an acquisition event;

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

# Limited Financial Services Guide and Research Methodology

**Limited Financial Services Guide**
Morningstar Australasia Pty Limited ('Morningstar') ABN: 95 090 665 544, AFSL: 240 892 (a subsidiary of Morningstar, Inc.) of Level 36 Australia Square, 264 George Street Sydney NSW 2000 is the provider of the general advice ('the service') provided in this report. The service is provided through research including the profiling and rating of companies and the securities they issue. Morningstar does not receive commissions for the service and does not charge companies to be rated. Morningstar is remunerated for the service by subscribers paying a subscription fee. This fee is variable depending on the individual subscriber's specific requirements. Morningstar has no debt or equity relationship with any issuers of any securities. Morningstar may provide a licence for the use and distribution of the service to issuers of securities which are the subject of a research report. Morningstar representatives are remunerated by salary and do not directly receive any commissions or fees. They may be eligible for an annual performance payment which is discretionary and based on reaching agreed performance levels. Please refer to our Financial Services Guide (FSG) for more information www.morningstar.com.au/fsg.asp.

**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**
Morningstar covers approximately 30 listed income securities. We operate an independent non-issuer paid model in all of our Australasia research, and therefore determine coverage of securities based on investor demand and our assessment of a security's attractiveness for investors. We use the following guidelines to determine income securities coverage in particular: (1) the underlying corporate or its listed parent are covered by Morningstar's equity research team, allowing us to leverage our depth of knowledge, (2) Morningstar's judgement of the investment merit of the security, such as non-esoteric structure, and (3) 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.
- cyclicality 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.