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ANZ Subordinated Notes (ANZHA)

Fixed Interest

Issue overview

Issuer	ANZ
Issue ASX code	ANZHA
Face value	$100
Estimated offer size	$500m
Bookbuild margin range	2.75-3.00%
Franking	0%
Interest payments	Quarterly
Minimum application	$5,000
First redemption date	14 Jun 2017
Maturity	14 Jun 2022

Timeline

Lodgement of prospectus	14 Feb 2012
Bookbuild margin	20 Feb 2012
Announcement of margin	21 Feb 2012
Offer opens	21 Feb 2012
Offer closes:	
General	13 Mar 2012
Broker Firm & Institutional	19 Mar 2012
Issue date	20 Mar 2012
ASX listing (deferred settlement)	21 Mar 2012

Higher ranking with a high cash margin

ANZ has launched the first ASX listed Tier 2 Capital security since 2009, seeking to raise $500m through the issue of ANZ Subordinated Notes (ANZHA).

The expected bookbuild margin range of 2.75-3.00% compares favourably with 3.10% issue margin on the August 2011 ANZ CPS3 (Convertible Preference Share) offer (ANZPC). ANZHA's debt like features also provides for greater investor protection.

We also note the ANZHA margin reflects the full cash amount of the interest payments, while the ANZPC margin reflects the grossed up value of franking credits.

The minimum bookbuild margin of 2.75% appears more than fair when benchmarked against comparable debt securities traded on the wholesale OTC (over-the-counter) market, as well as lower ranking equity instruments. In particular the 90bp premium in margin appropriately reflects the extra 4.5 years of duration when compared with the ANZ subordinated debt with a January 2013 call date.

Figure 1: Trading margins on debt and equity securities

	Ranking	Security	Trading Margin over BBSW	Maturity	First Call
Higher Ranking	Secured debt	CBA covered bond (issue margin 175bp)	137bp	Jan 2017	
	Unsubordinated unsecured debt	ANZ senior debt	160bp	May 2016	
	Subordinated unsecured debt	ANZ subordinated debt	185bp	Jan 2018	Jan 2013
		ANZHA	**275bp**	**Jun 2022**	**Jun 2017**
	Preference securities	ANZPC (issue margin 310bp)	320bp	Sep 2019	Sep 2017
Lower Ranking	Equity	Ordinary ANZ shares	480bp	n/a	

SOURCE: YIELDBROKER, BELL POTTER

Key features

- **Initial floating yield of 7.10-7.35%:** based on current 90 BBSW of 4.35% and bookbuild margin range of 2.75-3.00%. This provides investors the opportunity to lock in historically high issue margins. The yield is well above residential mortgage rates (~6.6%) and term deposit rates (~5.5%) available to ANZ Bank customers.
- **Quarterly unfranked interest**: first interest payment date is 14 June 2012. Interest payments are not deferrable so long as the solvency condition is met.
- **Redemption highly likely at year 5:** although ANZHA has a 10 year maturity, we view it as highly likely that ANZ will redeem at the first redemption date in June 2017. Major incentives for redemption in June 2017 include the potential for reputational damage, and a reduction of ANZHA's Tier 2 capital weighting by 20% at the beginning of each of the last 5 years to maturity. Redemption at year 5 does however require APRA's written approval on being satisfied that ANZ's capital levels are sufficient.

ANZ Subordinated Notes

ANZHA provides a healthy margin plus investor protection

ANZHA has the benefit of providing investors protection of the more debt like features such as cash redemption, mandatory payment of interest and more senior ranking in the unlikely event of a wind up.

A preference share such as ANZPC on the other hand has more equity like features. These include satisfying the share price requirements of the Mandatory Conversion Conditions, conversion risk into ordinary shares at maturity, and automatic conversion if ANZ's Common Equity Capital Ratio falls below 5.125% (currently 8.5%). In addition, payment of ANZPC dividends is at ANZ's discretion on a non-cumulative basis, subject to dividend restrictions on ordinary shares.

ANZHA also has the benefit of the time value of money with quarterly interest payments combined with the fact the ANZHA margin reflects the full cash amount of the unfranked interest payments, while the ANZPC margin reflects the grossed up value of franking credits on half yearly payments.

Loss of Tier 2 capital status an incentive to redeem at year 5

It appears the biggest financial incentive for ANZ to redeem ANZHA at year 5 is the staged reduction Tier 2 capital classification. One key requirement for subordinated debt to classify as Tier 2 capital is it must have a weighted average maturity of at least 5 years. If the security has less than 5 years to maturity, the amount of the security included as Tier 2 is reduced by 20% at the beginning of each year.

Another key consideration is the potential reputational damage to ANZ as a frequent issuer in capital markets. The non redemption at call dates or the step up of securities is typically associated with an issuer facing a degree of difficulty in accessing capital markets.

We note the new Basel III requirements do not allow for a step-up provision on this security. By contrast, the ASX listed Tier 2 note issues undertaken by AMP (AQNHA) and Heritage Building Society (HBSHA) in 2009 had the provision for a 50% step-up in margin if these securities are not redeemed at the 5 year call date.

In order for ANZ to redeem ANZHA at year 5, it must obtain APRA's prior written consent. Factors that are considered in obtaining this consent include:

- ANZHA is replaced concurrently or beforehand with Tier 2 Capital of at least the same quality; or
- APRA is satisfied that ANZ's capital position will be well above its minimum capital requirements after ANZHA redemption.

ANZ Subordinated Notes

Investment risks

Key investment risks include:

- ANZHA is not a Government protected deposit liability of ANZ Bank
- ANZHA ranks behind all ANZ Bank deposits and senior debt obligations
- New issues may offer more attractive issue terms and margins, placing downward pressure on the security price
- A dislocation of credit markets may result in an increase in credit spreads, placing downward pressure on the security price
- A material deterioration in global capital markets and the Australian economy could result in an adverse change in ANZ's operating and financial performance. This in turn could potentially lead to weakening of its capital adequacy and ANZ's ability to redeem the securities
- Adverse regulatory changes / Government policy
- Increasing competition
- Adverse regulatory changes
- Operational risks and trading errors
- Increasing competition.

Fixed Income

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