



CBA leads the pack

By Elizabeth Moran of FIIG Securities Limited

These last few weeks saw the Commonwealth Bank (CBA) hike mortgage rates over and above the RBA cash rate before any of its major competitors, but it also announced the issue of a \$500m retail bond, an exciting development for Australian investors. The CBA will become the first local bank to issue an unsecured senior bond to retail investors that will be listed on the ASX.

The retail bond opens up the bond market to all investors wanting to diversify their investment portfolios with a high quality, liquid asset.

In my \$1m fixed income portfolio, I have a \$50,000 term deposit with a credit union paying 5.7%. When this matures on 2 December 2010, I'll use the funds to buy CBA retail bonds. It wouldn't be worth incurring fees to break the term deposit, but I can register my interest in acquiring the bond in the primary market with a fixed income distributor now, then use the funds once the term deposit matures to acquire the bonds. The bond is an excellent addition to my portfolio, which I'll explain in this article.

Investor's Perspective

Commonwealth Bank Retail Bond Offer Details	
Issuer	CBA
Security Name	CommBank Retail Bonds Series 1
Maturity	24 December 2015
Margin	90 day BBSW + 1.00%-1.15%
Size	\$500m+
Minimum Parcel	\$5,000

Source: FIIG Securities Limited

CBA have stated that the coupon for the first three month interest period will be a minimum 6%.

The pricing on the deal also compares reasonably with similar wholesale senior ranking bonds issued by the major banks. A five year senior bond issued by the National Australia Bank is now trading at around 1.14% over BBSW bringing it in line with the top end of the indicative margin for the CBA retail bonds.

Another comparison is the level where major bank senior unsecured bonds were trading at prior to the global financial crisis. At the height of the market these securities traded at a margin of just 0.10% over BBSW, a far cry from the levels of current deals. While we don't expect to see these levels again, we would expect some contraction over time which would increase the value of the CBA retail bonds.

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In fixed income, like most markets, retail investors typically pay more than wholesale participants for the equivalent product. So it is great to see that retail investors in the CBA deal are set to receive a return similar to that available at the wholesale end of the market.

The issuance of a CBA security is a positive sign for the listed retail bond market. So far, there have been fewer deals in this sector than we would have expected and the presence of a top 10 Australian company should enhance the credibility of retail bonds. CBA will lead the way where we expect others to follow.

Advantages of CBA retail bonds

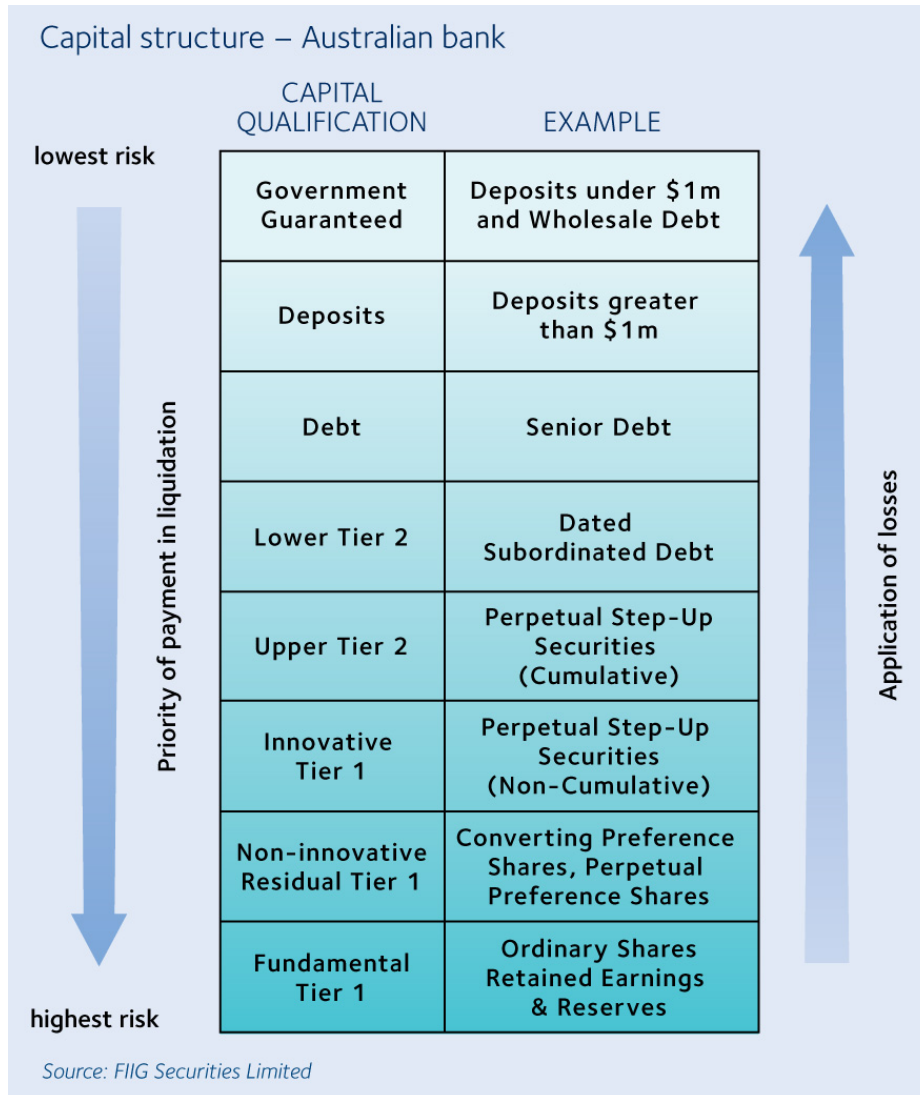
- ***Liquidity*** - I would expect CBA bonds to be very liquid. That is easily bought and sold without impacting the price of the security. This is the most significant advantage for investors. No need to bother with comparing at call accounts or qualifying for savings bonuses if you want ready access to your money. The high quality of the bond and its listing on the ASX will ensure you can access your funds quickly (T+3)
- ***Pays a floating coupon*** - tied to 90 day BBSW, so that if you have the view that interest rates will rise, you can take advantage of a rising interest rate environment by buying the CBA bond without locking into a longer fixed term deposit
- ***Coupon is paid quarterly*** - unlike many term deposits that only pay interest annually. Meaning investors can reinvest coupons earlier ultimately earning higher returns than five year term deposits
- ***Very high credit quality*** – CBA has a very low risk of default
- ***Potential for capital gain*** - if the bond price rises above its face value of \$100 and you sell them before maturity. If credit spreads continue to improve this is a likely outcome.
- ***A small charge for selling the securities*** - compared to much higher break fees if you need to redeem a term deposit early

Disadvantages

- The bonds are not government guaranteed, where deposits still qualify for the government guarantee until October 2011
- The bonds are lower in the bank's capital structure than term deposits, meaning they are higher risk and in the event that the CBA defaults (highly unlikely in my view) all term deposit holders will be repaid before bondholders. See the bank capital structure diagram below
- As the coupon is floating, if interest rates decline, the coupon will also reduce. However, even though the coupon is floating investors may recoup some of this decline through a higher bond price if they decide to sell the bond before maturity
- There is the potential for capital loss if you sell your bonds before maturity, although I would expect this to be minimal

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Capital structure – Australian bank



Evaluating the numbers

From a valuation perspective, the security looks reasonably attractive on a number of measures. Five year CBA term deposits are currently 6.40% but interest on these securities are only paid annually, not quarterly like the retail bonds. This inflates the return of the former.

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Currently BBSW is only around 5.05% meaning the initial coupon on the retail bond will be between 6.05% and 6.20%. However, this figure doesn't factor in future interest rate movements. With rates expected to increase over the coming years, this understates the return investors should expect to receive on security.

The relevant reference rate to look at when comparing against a fixed rate term deposit is the five year swap rate. This figure effectively swaps the floating rate return of the retail bond into a fixed return similar to a term. Currently, this rate is approximately 5.73% meaning the expected return on the retail bond is between 6.73% and 6.88%. This works out to be a premium of 0.33% to 0.48% more than what a five year term deposit is offering.

CBA's Perspective

The CBA needed to raise roughly \$40bn this year to support its loan book and growth and has found its cost of capital increasing as older, cheaper debt matures and must be replaced with more expensive new debt. Issuing retail bonds gives the CBA another avenue to raise funds. Being the first of the major banks to issue in the market and its competitive pricing should ensure CBA easily raises its \$500m target.

CBA at a glance

CBA is Australia's largest financial services provider, offering banking, insurance, investment and superannuation services. Moreover, it continues to grow its international footprint, undertaking banking or insurance operations in New Zealand, Indonesia and China to complement its Australian activities.

Its brands include Colonial First State, CommSec, Auckland Savings Bank (ASB), BankWest and FirstChoice.

CBA has over 1,000 branches throughout Australia and almost 3,800 Australia Post Agencies and employs 38,000 people.

Key results for the financial year ended 30 June 2010 include:

- Net profit after tax (NPAT) on a statutory basis was \$5.7bn, up 20% from 2009. NPAT on a cash basis was \$6.1bn, up 38% from 2009
- Total assets of \$646.3bn, up 4% from 2009. Of this, 50% is made up of home loans
- The Bank's Tier 1 capital ratio at 30 June 2010 was 9.2%, equivalent to 12.8% under FSA regulations. The total capital ratio was 11.5% (14.9% FSA)
- Deposits make up 60% of liabilities, of which 78% are stable Australian household deposits
- 2010 final dividend of \$1.70 per share, up 48% on the prior year. The total dividend for the year was \$2.90 reflecting a dividend payout ratio for the year of 73.9%

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- NPAT for the retail banking division was \$2.5bn, up 17% from the prior year. This increase was driven by a 38% increase in home loan income and an 8% increase in consumer finance income although tempered by a 9% decrease in deposit income
- NPAT for the business and private banking divisions was \$893m, up 21% from the prior year. All segments of this division delivered double digit income growth, while operating expenses only increased by 3%
- NPAT for the institutional banking and markets division was \$1.2bn, up from a \$166m profit in the previous year thanks to a 7% increase in operating income and an 85% decrease in loan impairment
- NPAT for the wealth management division was \$718m, up from a profit of \$289m the previous year
- NPAT for the New Zealand division (incorporating ASB Bank and Sovereign) was down 14% to NZ\$461m. This result was largely driven by increased funding costs due to tightening credit markets and a recession in New Zealand
- BankWest had NPAT of \$60m, up from a \$3m profit in the prior year. This was driven by growing banking income by 25% (with both higher volume and margins), and decreasing operating expenses by 3%, reducing the expense to income ratio from 66% to 51%.

How to be involved

You'll need to register your interest with a fixed income distributor by mid December. There is no cost to purchase the primary market (first time they are offered to investors) bonds (distributors receive a 50 basis point fee from CBA.)”.

The lead arrangers will then confirm allocations of the bonds with probable commencement date just before Christmas. For more information, please call your financial advisor.

It's important to note that if you don't get an allocation in the primary market, you can then buy the bonds through the ASX once they start trading, probably late December, although you'll then need to pay trading fees. Coupons will be paid late March, June September and December.

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