BELL POTTER

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IAG Convertible Preference Shares (IAGPC)

Fixed Interest

Issue overview

Issuer	IAG
Issue ASX code	IAGPC
Face value	$100
Estimated offer size	$350m
Bookbuild margin	4.00%
Franking	100%
Dividend payments	Half yearly
Minimum application	$5,000
First optional conversion	1 May 2017
Mandatory conversion	1 May 2019

Timeline

Lodgement of prospectus	19 Mar 2012
Bookbuild	26 Mar 2012
Announcement of margin	27 Mar 2012
Offer opens	27 Mar 2012
Offer closes:	
IAGPA Reinvestment	19 Apr 2012
General	19 Apr 2012
Broker Firm (non IAGPA)	30 Apr 2012
Issue date	1 May 2012
ASX listing (deferred settlement)	2 May 2012

At a 4.00% margin, the price is right

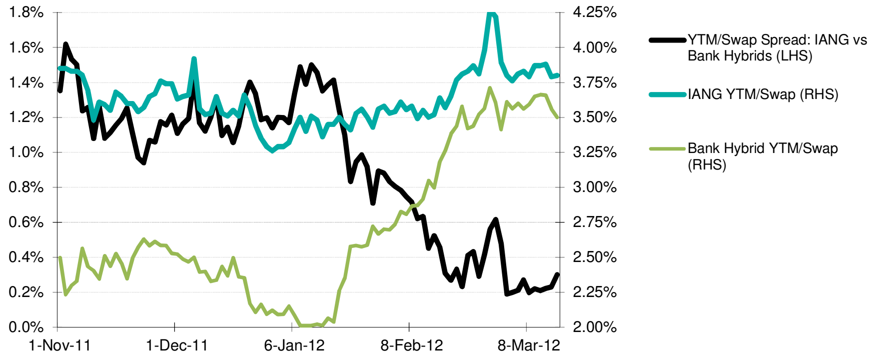
IAG has launched a new convertible preference share (CPS) issue primarily to fund the redemption of the $350m fixed rate IAG Reset Preference Shares (IAGPA) in June.

The security structure is similar to that adopted on the recent Westpac CPS (WBCPC) and ANZ CPS3 (ANZPC) issues. IAGPC has one new feature called a Non-Viability Trigger Event. This is a more subjective test whereby conversion of IAGPC into IAG shares is required if APRA determines that IAG would become non-viable in the absence of conversion, or a public sector injection of capital.

The most comparable security to IAGPC is the IAG Reset Exchangeable Security (IANG), both with issue margins of 4.00% (reflecting the grossed up value of franking). While the duration of IAGPC is up to 2.5 years shorter than IANG converted at the first optional exchange date, this benefit is neutralised through time value of money of paying half yearly dividends and the Non-Viability Trigger Event.

Overall we assess a fair value margin of 3.85% (same as IANG). This provides a 0.60% premium to the 3.25% WBCPC issue margin, reflecting the more volatile nature of insurance earnings.

Figure 1: Trading margin on IANG versus major bank hybrids



SOURCE: IRESS, BELL POTTER

Key features

- **Initial gross running yield of 8.47% (5.93% fully franked):** floating rate based on 180BBSW of 4.47% + 4.00% margin. First half yearly dividend to be paid 1 Nov. This provides an attractive rollover option for IAGPA investors who will receive a boost in fully franked income from the fixed rate of 5.63% fixed (8.04% grossed up).
- **Option to redeem at year 5 with mandatory conversion at year 7:** IAG has the option to convert in May 2017 or on any subsequent dividend payment date.
- **Ordinary dividend restrictions:** applies on the non payment of IAGPC dividends
- **Automatic conversion under a Non-Viability Trigger Event**

IAG Convertible Preference Shares

IAG overview

IAG is a leading general insurance group, with over 90% of group premium revenue generated in Australia and New Zealand. The revenue split is 46% motor insurance (including CTP) and 25% home insurance. The company has a market cap of $7bn and is one of the top 35 ASX listed companies.

IAG operates under five key operating:

Australia Direct: 1H12 Net Profit $230m. This is IAG's largest business with ~8m policies, focusing on direct personal lines insurance products such as compulsory third party (CTP), motor & home contents insurance, and a small business insurance.

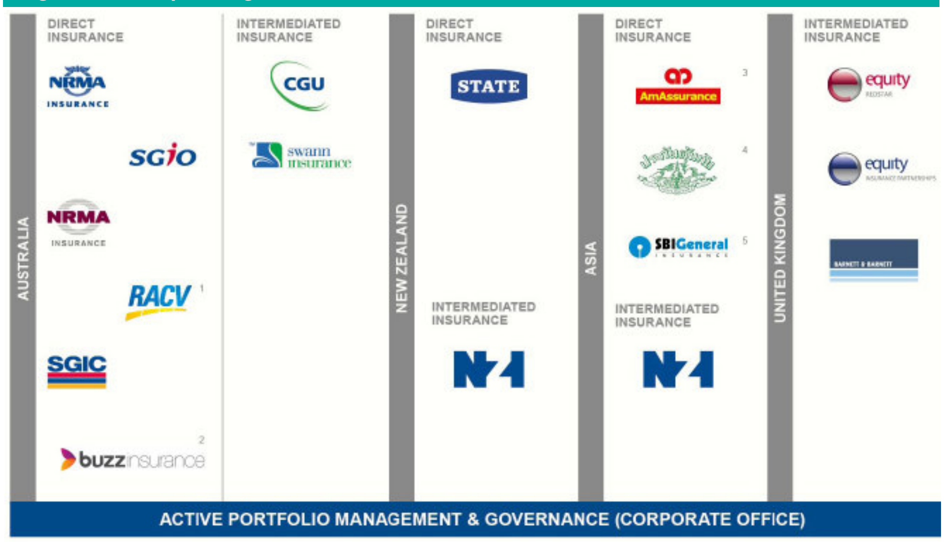
Australia Intermediated: 1H12 Net Profit $88m. CGU is one of Australia's largest intermediary based insurers, selling products through a network of more than 1,000 intermediaries such as brokers, agents, motor dealerships and financial institutions. Swann Insurance provides niche insurance products to over 750,000 customers.

New Zealand: 1H12 Net Profit $34m. State provides direct insurance services in New Zealand offering products such as car, home, contents and travel insurance to over 500,000 households. NZI is New Zealand's leading commercial insurer, which includes partnerships of more than 2,200 general insurance brokers.

UK: 1H12 Net Loss $7m. Operations include Equity Red Star as its specialist motor underwriting operation.

Asia: 1H12 Net Loss $68m (impacted by Thailand floods). Operations include a controlling economic interest in NZI and Safety Insurance in Thailand, 49% share of AmG Insurance Berhad general insurance joint venture in Malaysia, and a 26% interest in State Bank of India (SBI) General Insurance company joint venture in India.

Figure 2: IAG operating divisions and brands



Notes:

(1) RACV is via a distribution relationship and underwriting joint venture with Royal Automobile Club of Victoria (RACV) Limited.

(2) RACV has a 30% interest in Buzz Insurance.

(3) 49% ownership of the general insurance arm of AmBank Group, AmG Insurance Berhad, trading under the AmAssurance brand.

(4) 98.6% voting rights in Safety Insurance, based in Thailand.

(5) 26% ownership of SBI General Insurance Company, a joint venture with the State Bank of India.

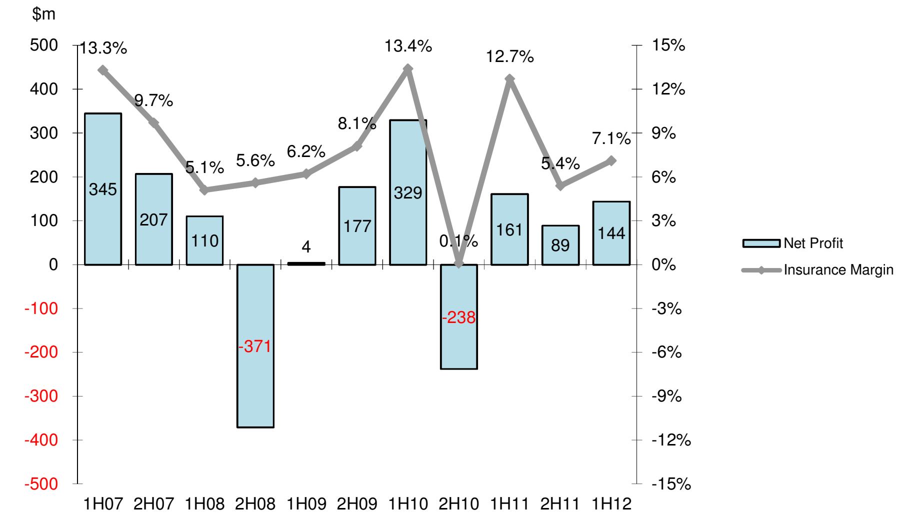
SOURCE: COMPANY

IAG Convertible Preference Shares

Volatile earnings

One of the major factors generating earnings volatility for IAG is the difficulty in forecasting the financial impact and timing of natural disasters. This is generally associated with a detrimental impact on the insurance margin.

Figure 3: IAG operating profit and insurance margin



SOURCE: COMPANY DATA, BELL POTTER

IAG is also exposed to a significant degree of volatility in its investment income. At 31 December 2011, 89% of its $12.7bn portfolio was invested in cash and fixed interest with only 5% of the portfolio exposed to Australian equities. Almost 100% of the technical reserves portfolio is invested in cash and fixed interest, while 35% of shareholder funds was invested in growth assets including Australian equities.

With regards to capital levels, a string of major disasters and associated releases of reserves has seen IAG's Minimum Capital Requirement (MCR) fall from a recent peak of 2.03x at December 2009 to 1.69x at December 2011. Despite this, IAG retains a reasonable buffer above its internal benchmark of 1.45-1.50x.

Figure 4: IAG summary of financial metrics

Financial Metrics	1H07	2H07	FY07	1H08	2H08	FY08	1H09	2H09	FY09	1H10	2H10	FY10	1H11	2H11	FY11	1H12
	$m	$m	$m	$m	$m	$m	$m	$m	$m	$m	$m	$m	$m	$m	$m	$m
Gross Written Premium	3,324	4,057	7,381	3,851	3,942	7,793	3,922	3,920	7,842	3,863	3,919	7,782	3,936	4,114	8,050	4,318
Net Earned Premium	3,155	3,588	6,743	3,709	3,586	7,295	3,683	3,550	7,233	3,643	3,422	7,065	3,710	3,528	7,238	3,839
Underwriting Profit	244	163	407	-7	23	16	-505	240	-265	278	-339	-61	321	-150	171	-240
Investment Income																
Technical Reserves	176	184	360	224	208	432	732	48	780	210	344	554	149	340	489	475
Shareholder Funds	166	135	301	76	-52	24	-72	33	-39	91	5	96	147	66	213	-30
Total Investment Income	342	319	661	300	156	456	660	81	741	301	349	650	296	406	702	445
Net Profit	**345**	**207**	**552**	**110**	**-371**	**-261**	**4**	**177**	**181**	**329**	**-238**	**91**	**161**	**89**	**250**	**144**
Insurance Margin	13.3%	9.7%	11.4%	5.1%	5.6%	5.4%	6.2%	8.1%	7.1%	13.4%	0.1%	7.0%	12.7%	5.4%	9.1%	7.1%
Minimum Capital Requirement	2.39x	1.67x	1.67x	1.87x	1.62x	1.62x	1.51x	1.79x	1.79x	2.03x	1.92x	1.92x	1.81x	1.58x	1.58x	1.69x

SOURCE: COMPANY DATA, BELL POTTER

IAG Convertible Preference Shares

IAGPA reinvestment offer

In response to the upcoming 15 June 2012 reset date for $350m IAGPA (IAG reset preference shares) issue, IAG has launched IAGPC as a replacement issue to fund the cash buy back of IAGPA at its face value of $100 per security.

As a result, IAGPA holders have the option to reinvest some or all of their IAGPA holdings registered on 16 March 2012 into the new IAGPC offer, or apply to be bought back early on 1 May 2012. Current IAGPA holders can also apply for additional securities under the offer and will receive a priority allocation ahead of general applicants. Closing date for the reinvestment offer is 19 April 2012.

Holders who reinvest or elect to be bought back early will receive a pro-rata dividend of $2.1286 fully franked on 1 May 2012, while investors who elect to hold to the 15 June 2012 reset date will receive the full final dividend of $2.8227 fully franked.

Automatic conversion under a Non-Viability Trigger Event

The release of the APRA discussion paper on 6 September 2011 entitled "Implementing Basel III capital reforms in Australia" outlined its proposals to implement a package of reforms to strengthen the capital framework for financial institutions in order to prevent some of the issues caused by the GFC.

One major concern of the GFC is that a number of Tier 2 capital instruments (mainly subordinated debt) and in some cases Additional Tier 1 instruments did not absorb losses incurred by financial institutions, which would have ultimately failed without public sector support.

In response, the Basel III reforms require that all regulatory capital instruments (including Additional Tier 1 and Tier 2 instruments) must be capable of absorbing losses in the event the financial institution is unable to support itself in the market place.

Under the non-viability requirements, APRA is proposing that all Additional Tier 1 and Tier 2 instrument will be written off or converted into listed equity if it views that the financial institution would be non-viable in the absence of conversion or a public sector injection of capital.

While APRA has not prescribed any precise metrics, this measure would most likely be associated with a combination of a material decline in capital levels (potentially below a Minimum Capital Requirement of below 1.00x), significant operating losses, a number of severe natural disasters, and IAG not having the ability to access equity markets to boost its capital position.

APRA proposes that these requirements must be incorporated in the contractual terms and conditions of each instrument to be eligible as regulatory capital from 1 January 2013. This date also marks the proposed amendment to the reduction of the Maximum Conversion Number under the Non-Viability Trigger Event from 50% to 20% of the issue date VWAP, which will result in investors receiving less than face value if the IAG's share price falls by more than 80% to below $0.68.

Assuming an Issue Date VWAP of $3.40, the Maximum Conversion Number will become 147.06 IAG shares per IAG - i.e. ($100 / (20% x $3.40)) = 147.06. If automatic conversion is done at say $0.50 (including 1% conversion discount), IAGPC holders will only receive $73.53 of IAG shares (i.e. 147.06 x $0.50).

IAG Convertible Preference Shares

Mandatory Conversion Conditions

In order for Convertible Preference Shares (CPS) to qualify for Additional Tier 1 capital, APRA has imposed a maximum conversion number in order to limit the dilution of ordinary shares upon conversion.

This maximum conversion number represents the hybrid face value divided by 50% of the volume weighted average price (VWAP) of the issuer on the 20 business days preceding the issue date (Issue Date VWAP). For example, if IAG's 20 day VWAP was $4.00 before the issue date, the maximum conversion number is 50.00 (i.e. $100 / (50% x $4.00)).

To protect holders from receiving less than face value at mandatory conversion, there are Mandatory Conversion Conditions (MCC) which investors need to be aware of:

- First: VWAP of ordinary shares on the 25th business day before a possible Mandatory Conversion Date must be above a certain threshold (57.5% of the Issue Date VWAP for IAGPC)
- Second: VWAP of ordinary shares during the 20 business days immediately preceding a possible Mandatory Conversion Date must be greater than 50.51% of the IAGPC Issue Date VWAP
- Third: continuous trading (i.e. no delisting event or suspension of ordinary shares) prior to a possible Mandatory Conversion Date - to provide protection should investors wish to sell the ordinary shares they receive upon Conversion.

If any of the MCCs are not satisfied, mandatory conversion will not occur. The issuer does however have the option of applying to APRA for cash redemption. In the event mandatory conversion does not occur, the security will remain on issue and continue to pay dividends at the same margin. Mandatory Conversion Conditions will be tested on each subsequent future dividend.

It is worth noting Issue Date VWAPs under the first and second MCCs is based on a relevant fraction of 0.5, under new APRA proposals the relevant fraction could be reduced to 0.2. If the proposals are implemented on 1 January 2013, the Issue Date VWAP requirement under the First MCC would reduce from 57.5% to 23% and from 50.51% to 20.202% on the Second MCC.

Figure 5: Mandatory Conversion Conditions

	IAGPC	IAGPC#	ANZPA	ANZPB	ANZPC	CBAPA	CBAPB	MQCPA	SBKPB	WBCPA	WBCPB	WBCPC
Date of Hybrid Issue	1-May-12	1-May-12	18-Dec-09	1-Oct-08	29-Sep-11	13-Oct-09	11-Jul-07	8-Jul-08	13-Jun-08	29-Jul-08	30-Mar-09	23-Mar-12
Mandatory Conversion Date	1-May-19	1-May-19	15-Dec-16	16-Jun-14	1-Sep-19	15-Oct-14	31-Oct-12	30-Jun-13	14-Jun-13	26-Sep-13	30-Sep-14	30-Mar-20
Conversion Discount	1.0%	1.0%	1.0%	2.5%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%
Issue Date VWAP	$3.37	$3.37	$21.80	$17.35	$19.53	$50.49	$55.08	$48.79	$14.38	$20.09	$17.51	$20.92
50% Dilution Cap	$1.69	$0.67	$10.90	$8.68	$9.77	$25.25	$27.54	$24.40	$7.19	$10.05	$8.76	$10.46
Max Conversion No (Face Value/Dilution Cap)	59.35	148.37	9.17	11.53	10.24	7.92	7.26	4.10	13.91	9.95	11.42	9.56
Conversion Test 1 - % Issue Date VWAP	57.50%	23.00%	56.00%	56.00%	56.00%	56.00%	60.00%	55.56%	55.56%	55.56%	55.56%	55.56%
Conversion Test 1 Security Price	$1.94	$0.78	$12.21	$9.72	$10.94	$28.28	$33.05	$27.11	$7.99	$11.16	$9.73	$11.62
Conversion Test 2 - % Issue Date VWAP	50.51%	20.20%	50.51%	51.28%	51.28%	50.51%	50.51%	50.51%	50.51%	50.51%	50.51%	50.51%
Conversion Test 2 Security Price	$1.70	$0.68	$11.01	$8.90	$10.01	$25.50	$27.82	$24.64	$7.26	$10.15	$8.84	$10.57
Conversion Test 3 - Continuous Trading	Yes	Yes	Yes	Yes	Yes	n/a	n/a	Yes	Yes	n/a	n/a	n/a
Parent Share Price - 15 March 2012	$3.37	$3.37	$22.28	$22.28	$22.28	$48.98	$48.98	$27.38	$8.32	$20.92	$20.92	$20.92
Prem/Disc to Dilution Cap	100.0%	400.0%	104.4%	156.8%	128.2%	94.0%	77.9%	12.2%	15.7%	108.2%	138.9%	100.0%
Prem/Disc to Conversion Test 1	73.9%	334.8%	82.5%	129.3%	103.7%	73.2%	48.2%	1.0%	4.1%	87.4%	115.0%	80.0%

Under APRA's latest discussion paper on the implementation of Aust Basel III Rules applying to general insurance groups, APRA proposals would reduce the Relevant Fraction of the Issue Date VWAP to 0.2.

SOURCE: COMPANY DATA, BELL POTTER

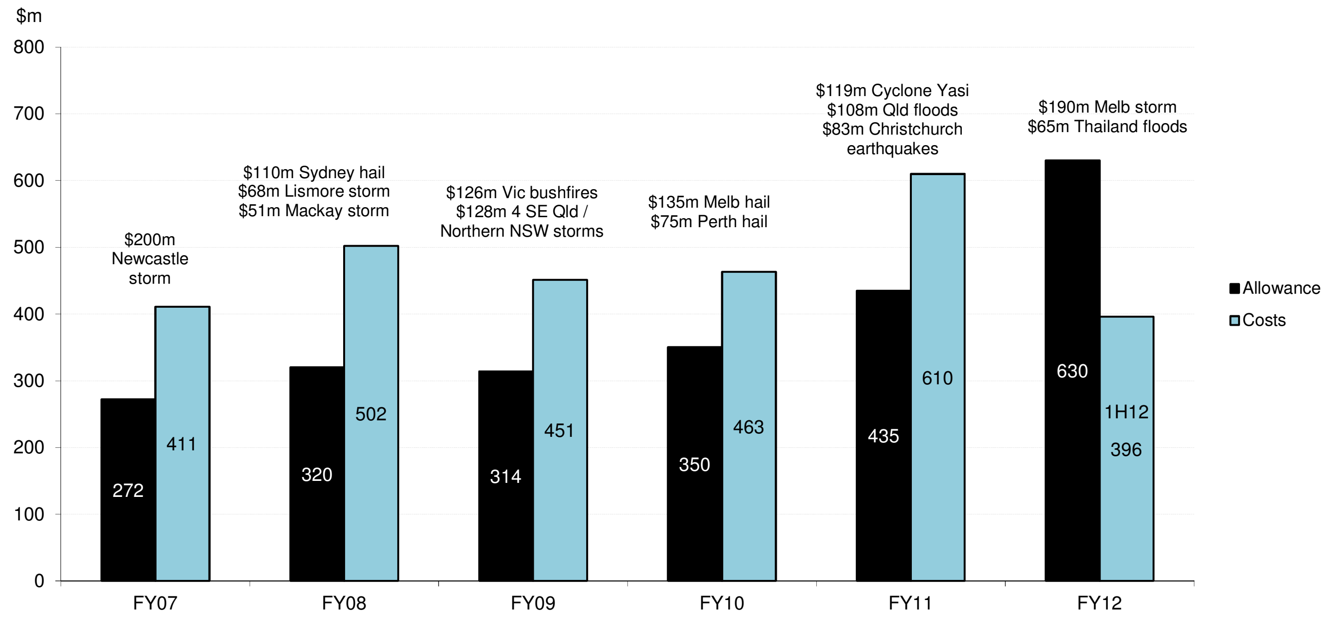
IAG Convertible Preference Shares

Investment risks

Key Business Risks of IAG include:

- The impact of the group of major natural disasters, including storms and cyclones, floods, earthquakes and bushfires. The incidence of major natural disasters has increased in recent years, exceeding IAG's allowance for natural peril claims in every year since FY07.

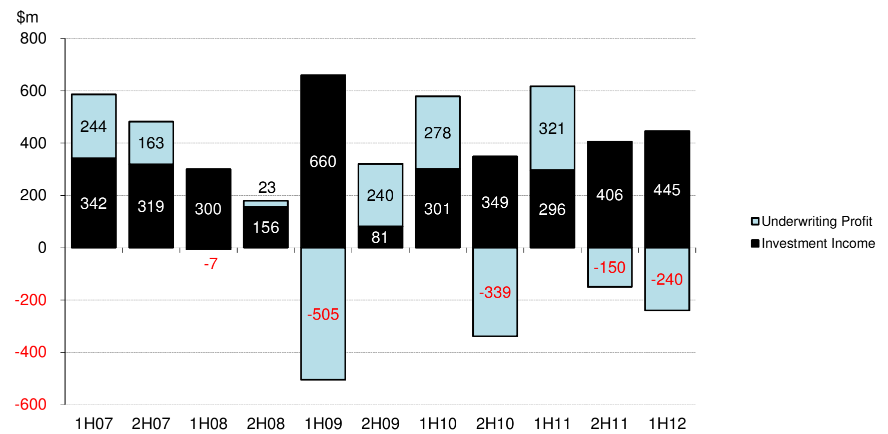
Figure 6: IAG allowance for natural peril claims versus actual outcome



SOURCE: COMPANY DATA, BELL POTTER

- Increasing reinsurance costs
- Increasing competition
- Volatile earnings
- Poor investment performance on technical reserves and shareholder funds

Figure 7: IAG's net profit and insurance margin



SOURCE: COMPANY DATA, BELL POTTER

IAG Convertible Preference Shares

Investment risks

Key Security Risks include:

- Adverse movement in credit spreads as a result of a tightening in the availability and cost of credit
- New issues may offer more attractive issue terms and margins, placing downward pressure on the security price
- Adverse change in IAG's and financial performance which combined with a major series of natural disasters and poor investment performance could place pressure on the levels of IAG regulatory capital levels (including the Minimum Capital Requirement).
- IAG's share price at the time of mandatory conversion may be below the thresholds set out in the mandatory conversion conditions
- Dividend Payment Test: One key condition for paying IAGPC dividends is IAG must satisfy the requirement of the Dividend Payment Tests. These include:
    - The dividend payment does not exceed IAG's distributable profits (unless APRA approves in writing after taking into consideration issues such as the level of surplus regulatory capital held)
    - The dividend wound not result in IAG's minimum capital requirements breaching APRA's capital adequacy guidelines
    - The dividend payment would not likely result in IAG becoming insolvent.

  It is worth noting in FY08, IAG reported a loss of $261m, following a $350m impairment charge taken against its UK insurance operations. In response, IAG made two share issues to fund dividend payments, namely a $287m fully underwritten DRP for the 2008 interim dividend and $92m DRP raising for the 2007 final dividend.

Fixed Income

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