BELL POTTER

May 2013

Analysts

Barry Ziegler 613 9235 1848

Damien Williamson 613 9235 1958

Authorisation

John Gleeson 612 9255 7220

Macquarie Group Capital Notes (MQGPA)

Fixed Interest

Issue overview

Issuer	Macquarie
Issue ASX code	MQGPA
Face value	$100
Estimated offer size	$400m
Book-build margin	4.00-4.20%
Franking	Partially
Dividend payments	Half yearly
First dividend payment	19 Dec 2013
Minimum application	$5,000
First Optional redemption	19 Jun 18
Mandatory Exchange	21 Jun 21

Timeline

Lodgement of prospectus	14 May 2013
Bookbuild margin	21 May 2013
Announcement of margin	22 May 2013
Offer opens	22May 2013
Offer closes	
Reinvestment& General	11 Jun 2013
Broker firm / Institutional	18 Jun 2013
Issue date	19 Jun 2013
ASX listing (deferred settlement)	20 Jun 2013

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This report is to be read in conjunction with the MQGPA prospectus.

No margin for error at +400bps

Macquarie Group has announced the issue of Macquarie Capital Notes (MQGPA) to replace the $600m Macquarie CPS (MQCPA) ahead of its 30 June 2013 Mandatory Conversion date.

Inline with credit margin contractions over the past six month, the market is in search of yield. Demand for debt securities has been strong, therefore, credit margins have contracted strongly. This has allowed the Macquarie Group to offer the new MQGPA series at a distribution margin of between +400bps and 420bps over BBSW180.

MQG is Australia's largest investment bank with a market cap. of over $15bn with a strong balance sheet. MQG has in excess of $12.948bn Eligible capital vs. the APRA Basel III Tier 1 capital requirement for MQG is $9.871bn, a considerable surplus to requirement, yet MQG is seeking an additional $400m Tier 1 capital.

In assessing fair value for this issue, we are of the view that MQGPA should trade at a premium of between +125bps and +150bps over the comparable Westpac CPS 111 series. WBCPC is currently trading at SWAP5Y+302bps. Similar Tier 1 capital of the regional domestic banks BENPD and BOQPD trading at +402bps and +420bps.

In our view, the fair margin for an investment bank operating in a subdued market with few corporate activities and depressed levels of trading, at best MQGPA should be in the range of +425bps to +450bps. This issue is being priced on the prospects of a vastly improved global outlook in economic activity. At +400bps there is very little room here for error.

Figure 1: Trading margins on debt and equity securities

	Ranking	Security	Trading Margin overSWAP	Maturity	First Call
Higher Ranking	Secured debt	SUN covered bond (OTC)	66bps	Nov 2017	
	Unsubordinated unsecured debt	SUN senior debt (OTC)	75bps	Apr 2015	
		BOQ senior debt (OTC)	135bps	Dec 2015	
	Subordinated unsecured debt	NABHB	186bps	Jun 2022	Jun 2017
		CNGHA (Colonial)	232bps	Mar 2037	Mar 2017
		SUNPD	257bps	Nov 2023	Nov 2018
	Preference securities	WBCPC	302bps	Mar 2020	Mar 2018
		BOQPD	420bps	Apr 2020	Apr 2018
		MQGPA Capital Note	**400-420bps**	**Jun 2021**	**Jun 2018**
Lower Ranking	Equity	Ordinary MQG shares	500bps	Perpetual	

SOURCE: YIELDBROKER, BELL POTTER as at 15 May 2013

Key features

- **Initial distribution 5.762%-5.593%p.a:** Floating rate based on 180BBSW of 2.75% plus 4.00-4.20% book-build margin and 40% franked
- **Option to redeem at year 5 with scheduled conversion at year 8:** MQG has the option to redeem / convert in June 2018, subject to APRA approval.
- **Ordinary dividend restrictions:** Applies on the non payment of MQCPB dividends

Macquarie Capital Notes MQGPA

MQCPA Reinvestment	Dates
Record Date	13 May 2013
Reinvestment offer opens	22 May 2013
Reinvestment offer closes	11 Jun 2013
Transfer to MCN	18 Jun 2013
Issue Date for MCN	19 Jun 2013
Cash payment of $5.1371	22 Jun 2013

MQCPA-non-reinvestment	Dates
Cease Quotation	13 Jun 2013
Record date final payment	20 Jun 2013
Resale Date	1 Jul 2013
Final distribution	1 Jul 2013

Reinvestment Offer for MQCPA holders

The MCN (MQGPA) offer is essentially a replacement issue for Macquarie CPS (MQGPA), MQG if offering the opportunity to reinvest securities held at the 13 May 2013 record date into new MQGPA securities. MQG will give priority allocations under the Reinvestment Offer over applications received under the Security holder Offer, Customer Offer and General Offer.

MQCPA holders essentially have three options:

- **Option 1: Participate in Reinvestment Offer:**

  Holders can elect to roll-over into the new issue and if the roll-over has been accepted holders will receive 1 new MCN and a payment of $5.1371 per MQCPA.

- **Option 2: Sell MQCPA on market:**

  MQCPA ceases trading on 13 Jun 2013.

- **Option 3: Do nothing and receive $100 Cash Redemption:**

  In addition to receiving $100 cash redemption per MQCPA security on 1 July 2013 plus the final distribution of $5.5931 per security.

Offers for Broker Firm, Securityholder, [Customer& General]

- **Broker Firm Offer:** This is available to clients of Bell Potter. Broker firm bids will participate in the Bookbuild to be held between 14 May and 21 May 2013. Broker firm offer closes 18 Jun 2013.
- **Security holder Offer and General Offer:** The offers opens on 22 May 2013 and closes 11 Jun 2013

Redemption Features

Macquarie Capital Notes are a perpetual security therefore do not have a maturity date.

However, the issuer does have the ability, *at its option*, to elect to exchange or resell (redeem) the issue at $100 on the following call dates subject to prior written APRA approval

- 19 June 2018
- 19 December 2018 or
- 19 June 2019

Under the revised Conglomerates Rules from APRA, the MQGPA series will only receive transitional treatment until the first call date being 19-June-2018. Although this is an incentive to redeem, MQG will likely assess its capital position, credit spreads and general market conditions at the time before electing whether to redeem.

Holders have no redemption rights

Macquarie Capital Notes-MQGPA

Mandatory Conversion Conditions

In order for Convertible Preference Shares (CPS) to qualify as 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 face value of the preference share divided by 50% of the volume weighted average price (VWAP) of the issuer on the 8 business days preceding the issue date (Issue Date VWAP). For example, if MQG's 8day VWAP was $45.00 before the issue date, the maximum conversion number would be 4.44 MQG shares per MQGPA security (i.e. $100 / (50% x $45.00)).

To protect MQGPA holders from receiving less than face value at scheduled conversion, there are a number of Conversion Conditions which investors need to be aware of:

- First: VWAP of ordinary shares on the 25th business day before a possible Mandatory Conversion Date 21 June 2021 must be above 56% of the Issue Date VWAP. Using the MQG price on 10 May 2013 of $45.00 x 56%= $25.20.
- Second: VWAP of ordinary shares during the 20th business days immediately preceding a possible Scheduled Conversion Date 21 June 2021 must be greater than 50.505% of the MQGPA Issue Date VWAP (i.e. $22.73).
- Third: Continuous trading (i.e. No Delisting Event) prior to a possible Mandatory Conversion Date - to provide protection should investors wish to sell the ordinary shares they receive upon conversion. A Delisting Event occurs when MQG is delisted or suspended, or there is an Inability Event.

If the Mandatory Conversion Conditions are not satisfied, Conversion on the Mandatory Conversion Date will not occur. Under this scenario, the security will remain on issue and continue to pay dividends at the same margin. The Mandatory Conversion Conditions will be tested on each subsequent future half yearly dividend date.

Note: For illustrative purposes we are using a price of $45.00.The issue date price will be determined on 19 June 2013

Macquarie Capital Notes MQGPA

Early Conversion under Loss Absorption Events

The fallout from the Global Financial Crisis has seen the Basel Committee on Banking Supervision establish new capital reforms to be phased in between 1 January 2013 and 1 January 2019. The key objective of these new reforms is to ensure banks are adequately capitalised in the event of future crises. On 28 September 2012, APRA published its final Basel III prudential standards which include a number of changes to the eligibility criteria for capital instruments, including stricter criteria for instruments to qualify as Additional Tier 1 Capital.

These requirements include Non-Viability Trigger Event, where securities such as MQGPA must be converted into ordinary equity if the financial position of MQG requires an immediate injection of capital. These prudential standards also require Australian banks to hold a minimum Common Equity Tier 1 Capital Ratio of 4.5% on 1 January 2013, increasing by the 2.5% capital conservation buffer to 7.0% on 1 January 2016.

Eligible Capital

APRA allows for a mix of capital to meet MQG's capital requirements, including shareholders' equity and certain hybrid instruments, with minimum requirements as described in the NOHC Authority. This is referred to as "Eligible Capital".

- APRA is currently reviewing its capital standards for non-operating holding companies of banks, such as MQG ("Conglomerates Rules"). Macquarie Group has assessed MCN will be eligible for inclusion as Eligible Capital under Its NOHC Authority.
- APRA has confirmed that MCN will be eligible for transitional relief under the revised

Conglomerates Rules expected to apply from 1 January 2014 until 19 June 2018.

Non-Viability Trigger Event

In addition, MQGPA will be Converted if APRA determines that MQG would be non-viable in the absence of an exchange or a public sector injection of capital. We note there are currently no precedents for a Non-Viability Trigger Event. The types of situations in which APRA may become concerned about non-viability include significant capital losses, prolonged difficulties in raising funding or maintaining sufficient liquidity.

Potential for Loss under Trigger Event if MQG is under $9.00

Conversion resulting from a Capital Trigger Event or a Non-Viability Trigger Event will be done at the VWAP of MQG shares traded on the 5 Business Days immediately preceding the Conversion Date. While this is not subject to the Scheduled Conversion Conditions, it is still subject to the Maximum Conversion Number, which represents the face value of the preference share dividend by 20% of the issue date VWAP. If MQG's 20 issue date VWAP was $45.00, the maximum conversion number would be 11.1111 MQG shares per MQGPA security (i.e. $100 / (20% x $45.00)). As such, MQGPA investors may exposed to receiving less than face value if MQGPA is converted at less than $9.00. In practice this will only occur in the unlikely scenario that the issuer suffers severe impairment losses and does not raise equity to absorb those losses.

As it is likely that conversion under one of these Trigger Events would occur prior to a company Wind Up, MQGPA holders will hold ordinary shares and rank equally with other holders of ordinary shares (i.e. lose priority ranking).

Macquarie Capital Notes MQGPA

Distribution Rate-partially franked

The Distribution for the Macquarie Capital Notes are discretionary, floating rate paid semi-annually in arrears and at this stage partially franked. The expected distribution will be BBSW180 plus a margin of +400bps to 420bps subject to the book-build discounted by the franking adjustment rate.

Figure 2: Distribution Rate –franking assessment ding margins on debt and equity securities

	Unfranked Distribution	Partially franked Distribution	Fully franked Distribution
(1) Reference Rate	2.7500% p.a.	2.7500% p.a.	2.7500% p.a.
(2) Margin	4.0000% p.a.	4.0000% p.a.	4.0000% p.a.
(3) = (1) + (2)	6.7500% p.a.	6.7500% p.a.	6.7500% p.a.
(4) Tax Rate	30%	30%	30%
(5) Franking Rate	0%	40%	100%
(6) Franking Adjustment Factor (per formula above)	100.0000%	85.3659%	70.0000%
(7) Distribution Rate = (3) × (6)	6.7500% p.a.	5.7622% p.a.	4.7250% p.a.

Source: Macquarie MQC prospectus dated 14 May 2013

Comparative yields and trading margins

Figure 3, lists the existing Mandatory Convertible Securities that are available to investors illustrating the yield to first call and trading margins of the issues. Before considering investment in the Macquarie Capital Notes, investors should consider comparing existing securities that could possibly better suit your needs in relation to the security of the issuer and yield offered.

Figure 3: Existing Mandatory Convertible Preference Shares

Issuer	ASX Code	ASX Price	First Call Date	Coupon Rate	Freq	F/f	Initial Margin	SWAP	Trade Margin	Running Yield	Yield to First Call	Issue Size $m
Mandatory Convertible Preference Shares												
ANZ Bank CPS2	ANZPA	$ 102.25	15-Dec-16	4.36%	Q	100%	3.10%	3.15%	2.72%	6.15%	5.87%	1969
ANZ Bank CPS	ANZPB	$ 101.18	16-Jun-14	3.94%	Q	100%	2.50%	2.72%	2.25%	5.61%	4.97%	1081
ANZ Bank CPS3	ANZPC	$ 101.16	1-Sep-17	4.23%	S	100%	3.10%	3.23%	3.12%	6.05%	6.34%	1340
Bendigo CPS3	BENPD	$ 107.16	13-Dec-17	5.68%	S	100%	5.00%	3.31%	4.02%	7.83%	7.32%	269
Bank of Queensland CPS	BOQPD	$ 104.30	15-Apr-18	5.70%	S	100%	5.10%	3.31%	4.20%	7.85%	7.51%	300
CBA PERLS V	CBAPA	$ 202.95	31-Oct-14	4.42%	Q	100%	3.40%	2.72%	2.53%	6.23%	5.25%	2000
CBA PERLS VI	CBAPC	$ 104.80	15-Dec-18	4.85%	Q	100%	3.80%	3.45%	3.02%	6.69%	6.46%	2000
IAG CPS	IAGPC	$ 102.50	1-May-17	4.79%	S	100%	4.00%	3.23%	3.35%	6.69%	6.57%	377
Macquarie CPS	MQCPA	$ 104.45	30-Jun-13	11.10%	S			2.76%	5.53%	10.63%	8.29%	600
National Bank CPS	NABPA	$ 101.18	20-Mar-19	4.37%	Q	100%	3.20%	3.45%	3.05%	6.20%	6.50%	1514
Suncorp Metway RPS	SBKPB	$ 100.52	14-Jun-13	4.38%	S	100%	3.20%	2.76%	9.68%	6.28%	12.44%	735
Suncorp Group CPS	SUNPC	$ 105.70	17-Dec-17	5.38%	Q	100%	4.65%	3.31%	3.51%	7.35%	6.81%	500
Westpac SPS	WBCPA	$ 100.64	30-Sep-13	3.82%	Q	100%	2.40%	2.81%	2.49%	5.45%	5.29%	1036
Westpac SPS II	WBCPB	$ 102.00	30-Sep-14	4.80%	Q	100%	3.80%	2.72%	2.92%	6.77%	5.64%	908
Westpac CPS III	WBCPC	$ 101.72	31-Mar-18	4.44%	S	100%	3.25%	3.31%	3.02%	6.29%	6.33%	1189
Westpac Capital Notes	WBCPD	$ 101.47	8-Mar-19	4.35%	Q	100%	3.20%	3.45%	3.01%	6.16%	6.46%	1250

SOURCE: COMPANY DATA

Inability Event

One additional risk is an Inability Event if MQG is not able to issue ordinary shares from Conversion under a Loss Absorption Event (i.e. Non-Viability Trigger Event). Scenarios under which this may occur include MQG being prevented from issuing ordinary shares by circumstances outside of its control, including an applicable law or order of any court, or action of any Government authority from issuing shares.

Under an Inability Event, the rights attached to MQGPA on and from the sixth day after the Loss Absorption Event Conversion Date will be an economic interest will be effectively limited to the dividends payable on the number of ordinary shares MQGPA holders would have receive on conversion. The capital value under of MQGPA under an Inability Event will most likely be significantly reduced as MQGPA will become an investment which may not be able to be sold on the ASX. In the event of a winding up, MQGPA holders claim relates to the surplus available to ordinary shareholders on the basis that MQGPA was converted into ordinary shares (i.e. proportionate claim to the enlarged ordinary equity base).

Investment risks

Key Business Risks of MQG include:

- A material deterioration in global capital markets and the Australian economy.
- Adverse regulatory changes.
- Operational risks and trading errors.
- Increasing competition.
- Credit rating downgrades.
- Losses associated with counterparty exposures.
- Poor performance of acquired businesses.

Investment risks (continued)

Key Security Risks include:

- MQG is not a bank deposit protected by the Government guarantee scheme
- As preferred equity, MQGPA ranks behind deposits, senior debt and subordinated debt in MQG.
- MQGPA dividends are at MQG's discretion and are non-cumulative.
- Unless APRA provides approval, MQGPA dividend payments are subject to satisfaction of the Dividend Payment Conditions. Any payment must not result in a breach of NAB's capital requirements under APRA's prudential standards, or result in MQG becoming insolvent.
- 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 MQG's and financial performance which combined with a major bad debt event could lead to the Automatic conversion, insisted by APRA, as required under a Non-Viability Trigger Event.
- Under an Inability Event, MQCPA will lose most of its value if MQG is not able to convert MQGPA into ordinary shares under a Loss Absorption Event.
- Conversion of MQGPA at the June 2021 Mandatory Conversion Date requires MQG's share price at the time of Mandatory Conversion to be above certain thresholds. If these thresholds are not met in June 2021 or at future half yearly dividend payment dates, MQGPA may remain on issue indefinitely.

Refer Section 5 from page 47 of the prospectus for further information on risks.

Additional investment risk:

ASIC "Be wary of the risks" warning: Money Smart website

The ASIC publication should be used as guidance which may be relevant to your consideration of MQCPB – namely, information for retail investors who are considering investing in hybrid securities.

Copies of the ASIC Guidance can be obtained from ASIC's website at:

www.moneysmart.gov.au/investing/complex-investments/hybrid-securities-and-notes

Basically, hybrid securities (including subordinated notes and convertible preference shares) may be from well-known companies but they are very different from 'normal' corporate bonds.

Some hybrid securities make investors take on 'equity-like' risks. Some also have terms and conditions that allow the issuer to exit the deal or suspend interest payments when they choose. Some are very long-term investments (for example, more than 20 years).

Hybrid securities may be unsuitable for you if you need steady returns or capital security typically from a bank term deposit style of investment.

Fixed Income

Bell Potter Securities Limited
ACN 25 006 390 772
Level 38, Aurora Place
88 Phillip Street, Sydney 2000
Telephone +61 2 9255 7200
www.bellpotter.com.au

Research Team

Staff Member	Title/Sector	Phone	@bellpotter.com.au
John Gleeson	Research Manager	612 9255 7220	jgleeson
Industrials			
Sam Haddad	Emerging Growth	612 8224 2819	shaddad
John O'Shea	Emerging Growth	613 9235 1633	joshea
Jonathan Snape	Emerging Growth	613 9235 1601	jsnape
Sam Byrnes	Emerging Growth Associate	612 8224 2886	sbyrnes
Bryson Calwell	Emerging Growth Associate	612 8224 2879	bcalwell
Stuart Roberts	Healthcare/Biotech	612 8224 2871	sroberts
Tanushree Jain	Healthcare/Biotech Associate	612 8224 2849	tnjain
Jonathan Kriska	Industrials	612 8224 2820	jkriska
Financials			
TS Lim	Banks/Regionals	612 8224 2810	tslim
Lafitani Sotiriou	Diversified	613 9235 1668	lsotiriou
Resources			
Stuart Howe	Bulks & Copper	613 9235 1782	showe
Fred Truong	Bulks & Copper	613 9235 1629	ftruong
Johan Hedstrom	Energy	612 8224 2859	jhedstrom
Stephen Thomas	Gold & Nickel	618 9326 7647	Sthomas
Bernard Lai	Gold	613 9235 1731	blai
Quantitative			
Janice Tai	Quantitative & System	612 8224 2833	jtai
Fixed Income			
Damien Williamson	Fixed Income	613 9235 1958	dwilliamson
Barry Ziegler	Fixed Income	613 9235 1848	Bziegler