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NAB Subordinated Notes (NABHB)



Issue overview

Issuer	NAB
Issue ASX code	NABHB
Face value	\$100
Estimated offer size	\$500m
Bookbuild margin range	2.75-2.85%
Franking	0%
Interest payments	Quarterly
Minimum application	\$5,000
First redemption date	18 Jun 2017
Maturity	18 Jun 2022

Timeline

Lodgement of prospectus	14 May 2012
Bookbuild margin	18 May 2012
Announcement of margin	21 May 2012
Offer opens	21 May 2012
Offer closes:	
Securityholder & General	8 Jun 2012
Broker Firm & Institutional	15 Jun 2012
Issue date	18 Jun 2012
ASX listing (deferred settlement)	19 Jun 2012

Additional Disclosure: Bell Potter Securities Limited is acting as Co-manager to the NAB Subordinated Notes issue and will receive fees for this service.

NAB's first new issue since 1999 - opportunity to diversify

NAB has launched the first ASX listed Tier 2 Capital security since the \$2bn National Income Securities (NABHA) in 1999, seeking to raise \$500m through the issue of NAB Subordinated Notes (NABHB).

NABHB is a vanilla subordinated debt security which will also provide attraction for participation from institutional investors seeking high yield. NABHB's debt like features also provides for greater investor protection than its perpetual income securities (NABHA), while the margin reflects the full cash amount of interest payments.

The expected bookbuild margin range of 2.75-2.85% is comparable with the 2.75% issue margin on the ANZ Subordinated Notes (ANZHA) and the ANZ subordinated debt security traded on the wholesale OTC (over-the-counter) market. NABHB also compares favourably 3.25% gross issue margin on the recently listed Westpac Convertible Preference Shares (WBCPC).

Noting ANZHA has been the best performing of the six new issues in 2012, we have a favourable view on NABHB given the issue margin is at least equivalent to the 2.75% margin on ANZHA.

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)	115bp	Jan 2017	
	Unsubordinated unsecured debt	NAB senior debt	160bp	Feb 2017	
	Subordinated unsecured debt	ANZHA	275bp	Jun 2022	Jun 2017
		NABHB	275bp	Jun 2022	Jun 2017
	Income securities	NABHA	310bp	Perpetual	
	Preference securities	WBCPC	350bp	Mar 2020	Mar 2018
Lower Ranking ↓	Equity	Ordinary NAB shares	600bp	Perpetual	

SOURCE: YIELDBROKER, BELL POTTER

Key features

- **Initial floating yield of 6.55-6.65%:** based on current 90 BBSW of 3.80% and bookbuild margin range of 2.75-2.85%. This provides investors the opportunity to lock in historically high issue margins. The yield is well above residential mortgage rates (~6.3%) and term deposit rates (up to 5.3%) available to NAB customers.
- **Quarterly unfranked interest:** first interest payment date is 18 Sep 2012. Interest payments are not deferrable so long as the solvency condition is met.
- **Redemption highly likely at year 5:** although NABHB has a 10 year maturity, we view it as highly likely that NAB 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 NABHB'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 NAB's capital levels are sufficient.

NAB Subordinated Notes

NABHB provides a healthy margin plus investor protection

NABHB 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 the recently listed ANZPC and WBCPC on the other hand have 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 the Common Equity Capital Ratio falls below 5.125%. In addition, payment of preference dividends are at the issuer's discretion on a non-cumulative basis, subject to dividend restrictions on ordinary shares.

NABHB also has the benefit of the time value of money with quarterly interest payments combined with the fact the NABHB margin reflects the full cash amount of the unfranked interest payments, while the recently issued mandatory convertible preference shares (ANZPC, IAGPC, WBCPC) reflect 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 NAB to redeem NABHB 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 NAB 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 NAB to redeem NABHB at year 5, it must obtain APRA's prior written consent. Factors that are considered in obtaining this consent include:

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

NAB Subordinated Notes

Benefits of NABHB

- Historically high issue margin of at least 275bp above 90 BBSW, for a minimum term of at least 5 years
- ASX listed debt in NAB
- Issue likely to be rated by Standard & Poor's, increasing institutional participation
- First ASX listed issue from NAB since 1999, allowing diversification into another of the major banks

Investment risks

Key investment risks include:

- NABHB is not a Government protected deposit liability of NAB
- NABHB ranks behind all NAB 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 NAB's operating and financial performance. This in turn could potentially lead to weakening of its capital adequacy and NAB's ability to redeem the securities
- Increased risk with NAB relative to the other major Australian banks due to its UK banking operations
- Adverse regulatory changes / Government policy
- Increasing competition
- Operational risks and trading errors
- Increasing competition.

Fixed Income

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