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Colonial Group Subordinated Notes (CNGHA)

Fixed Interest

Issue overview

Issuer	Colonial
Issue ASX code	CNGHA
Face value	$100
Estimated offer size	$500m
Bookbuild margin range	3.25-3.75%
Franking	0%
Interest payments	Quarterly
Minimum application	$5,000
Call date	31 Mar 2017
Step up	n/a
Maturity	31 Mar 2037

Timeline

Lodgement of prospectus	15 Feb 2012
Bookbuild margin	23 Feb 2012
Announcement of margin	24 Feb 2012
Offer opens	24 Feb 2012
Offer closes	21 Mar 2012
Issue date	29 Mar 2012
ASX listing (deferred settlement)	29 Mar 2012

Range looks attractive

The launch of the Colonial Group Subordinated Notes (CNGHA) offer provides investors with the opportunity to lock in a high issue margin from one of Australia's leading providers of wealth management and insurance services, which is a wholly owned subsidiary of Commonwealth Bank (CBA).

Based on the current 90 BBSW of 4.40% and the expected bookbuild margin of 3.25-3.75%, CNGHA offers an initial running yield of between 7.65-8.15%. This yield compares favourably with term deposit rates of typically less than 5.50% offered by the parent's banking operation.

In looking at benchmarking, the bookbuild margin provides a healthy premium to the 275-300bp margin on the new ANZ Subordinated Note (ANZHA) for taking on relatively low levels of incremental risk from CNGHA's equity like features.

We note the bottom end of the bookbuild range is currently comparable with the June 2016 National Wealth Management (NWM) subordinated debt security trading on the over-the-counter wholesale debt market. Similar to CBA's relationship with Colonial, NWM is the Wealth Management division of NAB, operating under brands such as MLC and JB Were. Overall we assess a fair margin on CNGHA of 3.20%.

Key features

- **Initial floating yield of at least 7.5%:** although the current 90 BBSW provides for a first coupon of at least 7.65%, CNGHA has a minimum first coupon rate of 7.50% which provides some protection if the RBA reduces the cash rate in March.
- **Quarterly unfranked interest:** first interest payment date 29 June 2012.
- **Interest protected:** while the issue terms allow for deferral of CNGHA interest payments at Colonial's discretion for up to 5 years on a cumulative and compounding basis, investors are protected by the dividend stopper requiring non payment of ordinary dividends to CBA. In FY11, Colonial paid $580m of dividends to CBA, the equivalent of 8.5% of CBA's $6.8bn cash net profit.
- **Redemption most likely in 5 years:** although CNGHA has a 25 year maturity date, we expect redemption at the year 5 call date. One important aspect of this structure is that it is expected that some of the ratings agencies will treat CNGHA as equity first 5 years. Noting the Australian Taxation Office (ATO) treats CNGHA as debt, once the equity credit falls to 0% at year 5, this will most likely become an expensive debt facility.

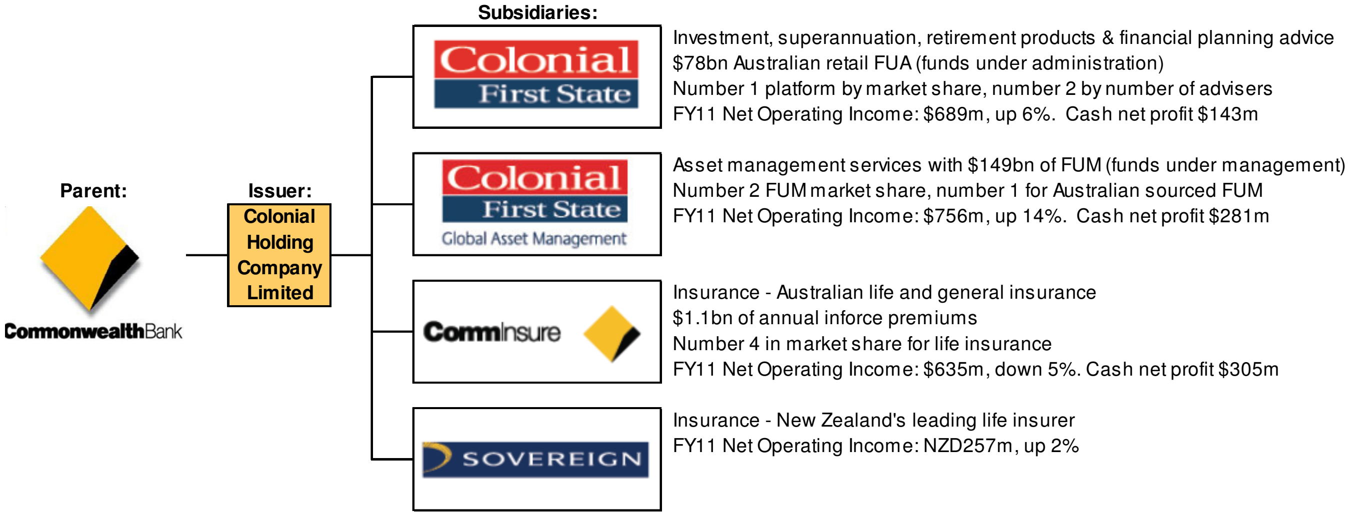
Additional Disclosure: Bell Potter Securities Limited is acting as Co-manager to the Colonial Group Subordinated Notes issue and will receive fees for this service.

Colonial Group Subordinated Notes

Exposure to one of Australia's largest wealth managers

Colonial Group Subordinated Notes (CNGHA) offer provides exposure to Australia's leading providers of wealth management, asset management and insurance. With operations spanning four key divisions of Colonial First State, Colonial First State Global Asset Management, CommInsure and Sovereign, Colonial generated net profit of $800m in FY11, equivalent to 11.7% of CBA's $6.8bn cash net profit.

Figure 1: Colonial divisional overview



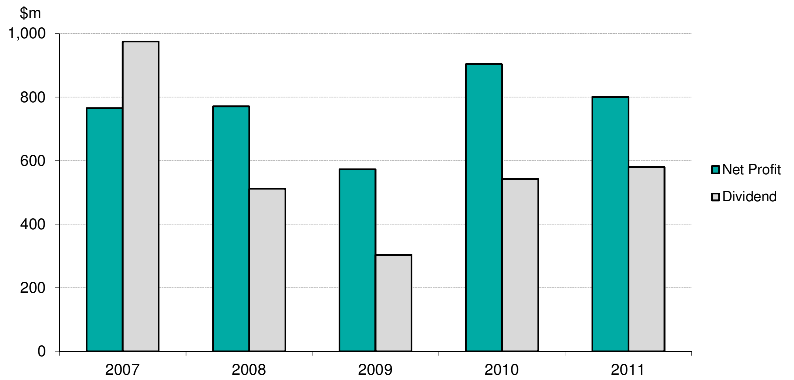
SOURCE: COMPANY DATA, BELL POTTER

Optional interest deferral unlikely given CBA dividends

While issue terms allows for the deferral of CNGHA interest payments at Colonial's discretion for up to 5 years on a cumulative and compounding basis, we see this event as highly unlikely. One key protection for CNGHA investors is that deferral of interest payments would be subject to stopping the payment of dividends on ordinary Colonial shares held by CBA.

CBA Group policy states that all subsidiaries should pay a dividend equal to their profit to the Bank each year, subject to retaining a certain amount of cash for working capital, regulatory and other requirements. Since FY08, Colonial's payout ratio has averaged 64%, while the FY11 payment of $580m was equivalent to 8.5% of CBA's net profit.

Figure 2: Colonial net profit and dividend payments



SOURCE: COMPANY DATA, BELL POTTER

Colonial Group Subordinated Notes

Sound issuer financials

Overall we are comfortable with Colonial's financial metrics at 30 June 2011. Gearing is moderate at 49% while interest cover is a strong 7.2 times.

Figure 3: Colonial Balance Sheet and Profit and Loss at 30 June 2011

	FY11 $m
Cash	1,160
Financial Assets	17,599
Intangibles	2,747
Other Assets	1,372
Total Assets	**22,878**
Borrowings	2,840
Other Liabilities	16,584
Total Liabilities	**19,424**
Total Equity	**3,454**
Net Debt / Equity	49%

	FY11 $m	FY10 $m	Change
Net Revenue	5,590	5,539	0.9%
EBIT	1,417	1,504	-5.8%
Interest	197	197	
Profit Before Tax	1,220	1,307	-6.7%
Tax	420	403	
Net Profit	**800**	**904**	**-11.5%**
Interest Cover	7.2x	7.6x	
Dividend Paid	580	542	7.0%
Payout Ratio	72.5%	60.0%	

SOURCE: COMPANY DATA, BELL POTTER

CNGHA ranks ahead of $4.4bn of CBA equity

Although CNGHA is subordinated to $2.3bn of debt, it ranks ahead of $4.4bn of CBA preferred and ordinary equity. Overall CNGHA diversifies Colonial's funding base.

Figure 4: Ranking of Colonial Group Subordinated Notes

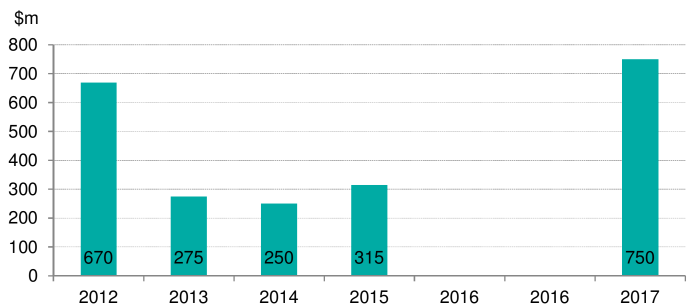
	Ranking	Obligations	Amount
Higher Ranking	Secured debt	None	$0m
	Liabilities preferred by law	Includes employee entitlements	$137m
	Unsubordinated unsecured debt	Borrowings	$2,310m
	Subordinated unsecured debt	**Colonial Group Subordinated Notes**	**$500m**
	Preference securities	Preference shares held by CBA	$276m
Lower Ranking	Equity	Ordinary shares held by CBA	$4,134m

SOURCE: COMPANY DATA, BELL POTTER

Funds raised to refinance 2012 debt maturities

Colonial has stated the net proceeds of the offer will be used to refinance existing Colonial debt facilities. Of note, Colonial has $114.6m of debt maturing in February 2012 with a further $555m maturing in May 2012.

Figure 5: Colonial debt maturity profile



SOURCE: COMPANY DATA, BELL POTTER

Colonial Group Subordinated Notes

Equity credit for some, debt for others

CNGHA is the fourth recent subordinated debt issue designed to attract Equity Credit for the issuer.

In order to obtain Equity Credit, the security must have equity like features such as deferral of interest payments and the provision for the issuer to extend redemption to the maturity date. It is expected that a component of all of these three issues will qualify for equity treatment by at least one of the ratings agencies for the first five years and providing ratings support to the issuer.

While the structure satisfies the ratings agencies equity requirements others view this as debt. As such CNGHA will be classified as debt by the ATO, allowing tax deductions on interest payments.

Structure closest to Woolworths Notes II

Overall the structure of CNGHA is the closest to the highly successful Woolworths Notes II (WOWHC) issue. Both have a 25 year maturity and the same low end bookbuild margin of 3.25% as well as the provision for optional deferral of interest with no requirement for the mandatory deferral of interest.

Figure 6: Comparison with Tabcorp Subordinated Notes, Origin Energy Notes and Woolworths Notes II

	Colonial Group Subordinated Notes (CNGHA)	**Tabcorp Subordinated Notes (TAHHB)**	**Origin Energy Notes (ORGHA)**	**Woolworths Notes II (WOWHC)**
Issue size	$500m	$200m	$900m	$700m
Margin: 90 BBSW +	3.25-3.75%	4.00-4.50%	4.00%	3.25%
Maturity	25 years	25 years	60 years	25 years
First call date	Year 5	Year 5	Year 5	Year 5
Step-up date	n/a	Year 5	Year 25	Year 5
Step-up margin	0.00%	0.25%	1.00%	1.00%
Optional interest deferral	Yes, subject to dividend stopper	No	Yes, subject to dividend stopper	Yes, subject to dividend stopper
Mandatory interest deferral	No	Yes, if Tabcorp's Leverage Ratio is above 3.5 times, or Interest Cover Ratio is below 3.0 times	Yes, if Origin's Leverage Ratio is above 4.0 times, or Interest Cover Ratio is below 3.5 times	No
Interest deferral	Interest can be deferred for up to 5 years on a cumulative and compounding basis	Interest can be deferred for up to 5 years on a cumulative and compounding basis	Interest can be deferred for up to 5 years on a cumulative and compounding basis	Interest can be deferred for up to 5 years on a cumulative and compounding basis
Assessed equity credit	At least 50% first 5 years, then 0%	100% first 5 years, then 0%	100% first 5 years, then 0%	50% first 5 years, then 0%
Ranking	Subordinated, ranks above prefs and ordinary shares held by Commonwealth Bank	Subordinated, ranks above ordinary equity	Subordinated, ranks equal with Euro Capital Securities and above ordinary equity	Subordinated, ranks above ordinary equity

SOURCE: COMPANY DATA, BELL POTTER

Colonial Group Subordinated Notes

Investment risks

Investors need to be aware that while Colonial Group is a wholly-owned subsidiary of CBA contributing over 10% of the bank's annual net profit, CNGHA and other obligations of the issuer are not guaranteed by CBA. In looking at other 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 Colonial's operating and financial performance which could potentially lead to the optional deferral of interest payments, extending redemption until the 2037 maturity date or insolvency of the group.

Key Business Risks of Colonial include:

- A material deterioration in global capital and equities markets and the Australian economy
- Adverse regulatory changes
- Operational risks and trading errors
- Increasing competition.

In addition, APRA is currently reviewing the application of capital standards to conglomerate groups such as CBA which hold banking, wealth management and insurance business.

Although APRA published a discussion paper on the proposed new standards in March 2010, it is not known at this time whether the discussion paper represents the final proposals or whether or not CNGHA will qualify as regulatory capital for the CBA Group under the new standards.

Noting that implementation of the new standards may apply as early as 2013, if CNGHA does not qualify, Colonial may:

- Keep CNGHA on issue without amendment
- Seek to amend the terms with the consent of holders
- Seek to redeem CNGHA at face value plus accrued interest plus a flat redemption premium of $1.50 per security.

Fixed Income

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