Heritage Bank Retail Bonds

Heritage Bank has just announced the launch of a new income offer: Heritage Bank Retail Bonds. The first round of access is through a broker firm allocation, prior to shareholder offer and listing in June.

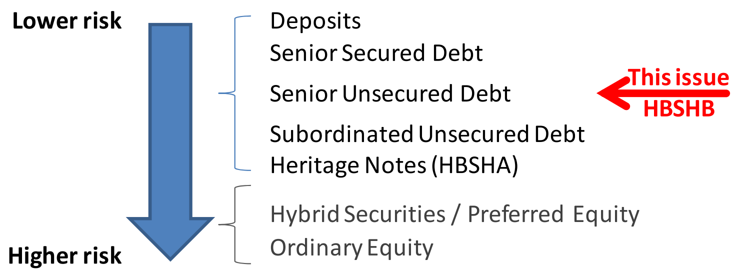
The Bonds will pay a quarterly coupon of 7.25%pa, maturing 20th June 2017 (5 years). The bond will be tradable on the ASX.

Heritage Bank Retail Bonds Offer Details	
Issuer	Heritage Bank
Security Name	Heritage Bank Retail Bonds
Maturity Date	20th June 2017 (5 years)
Margin	7.25%pa
Size	$125m+
Minimum Parcel	$5,000 (Wealth Focus minimum is $10,000)

Source: Heritage Bank Retail Bonds prospectus

This issue will be used for general funding purposes and refinance existing debt.

Investors concerned about hidden catches within some of the recent hybrid offers would do well to consider this offer. This is a clean vanilla Bond, offering a 5 year term to maturity, greater security than the existing listed issue (HBSHA), quarterly distributions and a fixed interest rate.

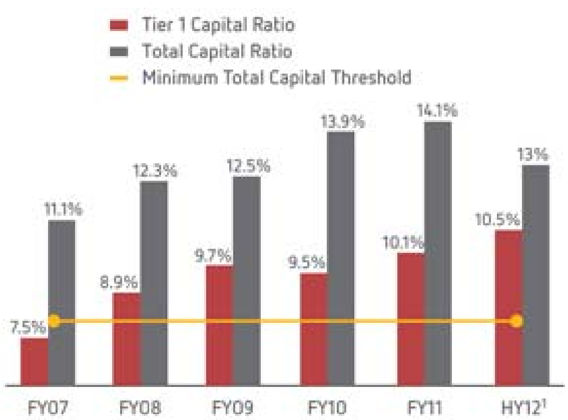


Background to Heritage

Heritage Bank Ltd is the largest customer-owned bank in Australia tracing its roots back to the Toowoomba Permanent Building Society in 1875 with over 300,000 members.

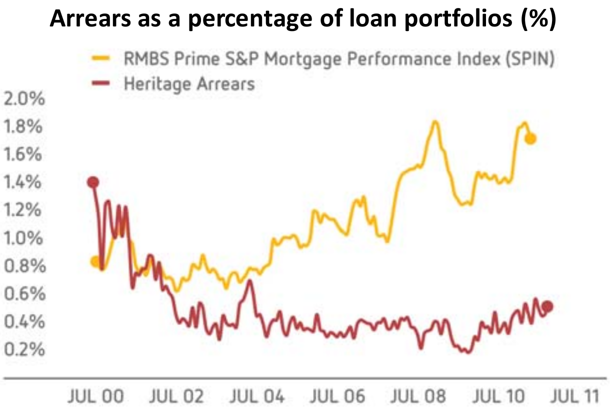
As a mutual, the bank does not pay dividends, rather its profits are either retained by the bank to provide financial strength or passed through to its members through low cost services.

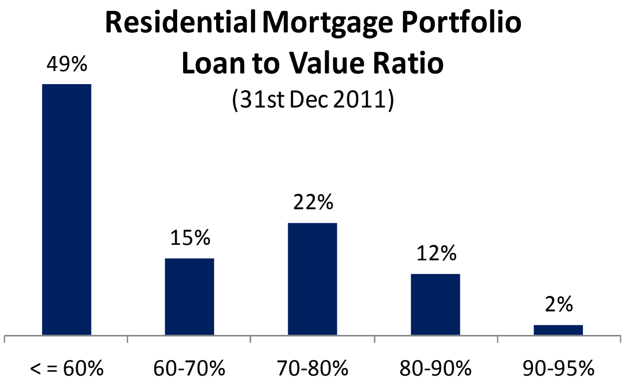
Being a mutual, the bank benefits by avoiding the constant drive for shareholder profits and increased leverage that we see in some of the more familiar bank names. However, this is a double edged sword, no shareholders means Heritage can't simply issue stock via a rights issue to raise capital and we feel the effects of this are reflected in Heritage holding higher levels of capital.



Focus on loan book

The main concerns with any bank post GFC always relate to lending practices and the Loan to Value Ratio (LVR) of their home loans. The concern is a weaker economy may lead to increased defaults.





Source: Heritage Bank Retail Bonds Prospectus

We note that Heritage's loan book appears relatively strong. As at December 2011, 95% of Heritage's lending was prime residential mortgages with an average LVR of 58% and an arrears performance that is materially better than the industry average.

Comparative Securities

This isn't the first issue Heritage has listed on market, Heritage raised $50 Million with their Heritage Notes (HBSHA) in 2009, paying a fixed coupon of 10%pa for 5 years.

	Heritage Bank Retail Bonds HBSHB	Heritage Notes HBSHA
Spot in capital structure	Deposits Senior secured debt Senior unsecured debt - HBSHB Subordinated unsecured Ordinary shares	Deposits Senior secured debt Senior unsecured debt Subordinated unsecured - HBSHA Ordinary shares
Maturity Date	20th June 2017 (5 years)	25th October 2019 (10 years)
Expected Call Date	14th June 2017	27th October 2014
Step-up	2.50% if not redeemed following a Change in Control	2.2175% in year 5
Common Equity Trigger Event	None	None
Distributions	Fixed rate (unfranked), paid quarterly	Fixed (unfranked), paid quarterly. *Floating from year 5*
Deferral of interest	None	Yes, if insolvent
Margin	***7.25%pa***	***10%pa (until year 5)***
Yield to first call date	7.25%pa	7.6%pa

HBSHA last traded at $106.70 (cum dividend of approximately $0.93). Assuming this is repaid at the first call date, the yield to maturity on this security is 7.6%pa.

However, it should be noted that HBSHA sits further down the debt structure (less secure) and could potentially convert to a floating rate Note if not repaid in October 2014 and we feel investors should expect to see a margin for this added risk of 0.5%-1.00%pa.

Our View

Heritage Bank Retail Bonds ticks all the right boxes;

- It's a small offering of $125 Million that is likely to be heavily oversubscribed. *We suspect this will be increased to around $200 Million.*
- Unlike other recent offers such as ANZHA, we feel it unlikely that Heritage will significantly increase this offer, providing investors with support in the aftermarket.
- Fixed rate products are likely to be very attractive to investors if interest rates continue to drop as anticipated.
- Heritage Bank's arrears rates have been materially lower than the industry and lower LVRs are likely to provide some protection in the event of falls in house prices.
- Pricing relative to Heritage Notes (HBSHA), indicates some upside for Heritage Retail Bonds.

We feel this issue has some upside on listing. Heritage Notes have been very tightly held since issue and we suspect this will follow suit.

Note: Heritage Bank Retail Bonds will be listed on the ASX and as such the price of the Bond's will be subject to market movements. Investor's selling on market may receive a price lower (or higher) than the issue price.