NAB Subordinated Notes 2 (NABPE)

Analysts

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Fixed Income

Issue overview

Issuer	NAB
Issue ASX code	NABPE
Face value	$100
Estimated offer size	$750m
Bookbuild margin	2.20-2.30%
Franking	0%
Interest payments	Quarterly
First interest payment	20 Jun 2017
Minimum application	$5,000
First Optional Redemption	20 Sep 2023
Maturity Date	20 Sep 2028

Timeline

Lodgement of prospectus	8 Feb 2017
Bookbuild margin	15 Feb 2017
Offer opens	16 Feb 2017
Offer closes	
NABHB Reinvestment	10 Mar 2017
NAB Securityholder	10 Mar 2017
Broker Firm	17 Mar 2017
Issue date	20 Mar 2017
ASX listing (deferred settlement)	21 Mar 2017

Breaking the 3.5 year drought of subordinated debt issuance

The NAB Subordinated Notes 2 (NABPE) offer has been launched seeking to raise $750m to replace the $1,173m NAB Subordinated Notes (NABHB) ahead of the 18 June 2017 call date. NABPE represents a long overdue new ASX listed issue of Tier 2 subordinated debt, breaking a 3.5 year drought since WBCHB's launch in July 2013. Since 2014, banks have refinanced ASX listed debt issues via the wholesale market, while non financial issuers have tended to utilise undrawn bank debt facilities.

We expect strong support for NABPE given the lack of new debt issuance, and $1.6bn of WOWHC and ORGHA redemption money from late 2016 looking for a home. In addition, the amount available for new money bids is likely to be restricted with our anticipation of strong investor support for the NABHB Reinvestment offer.

Figure 1: ASX listed debt redemptions 2014-2017

ASX Code	Maturity / Call Date	Issue Size	Replacement Issue	ASX Code	Maturity / Call Date	Issue Size	Replacement Issue
BENHA	17 Mar 2014	$91m	No	AFIG	28 Feb 2017	$185m	No
TAHHA	1 May 2014	$284m	No	TAHHB	22 Mar 2017	$250m	No
LEPHC	20 Aug 2014	$165m	No	CNGHA	31 Mar 2017	$1,000m	
HBSHA	27 Oct 2014	$50m	No	NABHB	18 Jun 2017	$1,173m	NABPE
PRYHA	28 Sep 2015	$152m	No	ANZHA	20 Jun 2017	$1,509m	
CBAHA	24 Dec 2015	$570m	No	HBSHB	20 Jun 2017	$228m	
AYUHA	14 Apr 2016	$120m	AYUHB	WBCHA	23 Aug 2017	$1,676m	
PPCG	16 Jun 2016	$50m	PPCHA	CTXHA	15 Sep 2017	$550m	
WOWHC	24 Nov 2016	$700m	No	GMPPA	30 Sep 2017	$327m	
ORGHA	22 Dec 2016	$900m	No	Debt Redemptions Pending 2017		$6,897m	
Debt Redemptions 2014-2016		$3,083m					

SOURCE: COMPANY DATA, BELL POTTER

With NABPE having a first call date in Sep 2023 (6.5 years), the bookbuild margin of 2.20-2.30% appears to be priced fairly when compared with the 2.00% trading margin on NAB Tier 2 subordinated debt (Sep 2021 call) in wholesale market.

Figure 2: Trading margins on debt and equity securities

	Ranking (prior to exchange)	Security	Trading Margin over BBSW	Maturity / Mand Conv*	First Call
Higher Ranking	Senior debt	NAB (OTC) senior	100bp	Oct 2021	
	Subordinated debt	NAB (OTC) subordinated	200bp	Sep 2026	Sep 2021
		NABPE	**220-230bp**	**Sep 2028**	**Sep 2023#**
	Preferred equity	NABPD (Additional Tier 1)	380bp	Jul 2024*	Jul 2022#
Lower Ranking	Equity	Ordinary NAB Shares	~600bp	Perpetual	

WHERE NOT CONVERTED OR WRITTEN-OFF ON ACCOUNT OF A CAPITAL TRIGGER EVENT (NABPD) OR A NON VIABILITY TRIGGER EVENT (NABPD, NABPE). FIRST CALL DATE IS DISCRETIONARY.

SOURCE: YIELDBROKER, BELL POTTER

* MANDATORY CONVERSION IS SUBJECT TO SATISFYING THE MANDATORY CONVERSION CONDITIONS

NABPD IS PERPETUAL AND MAY NOT BE EXCHANGED.

Key features

- **Initial floating coupon of 3.97-4.07% unfranked:** Based on 3 month bank bill of 1.77% + 2.20-2.30% bookbuild margin. Interest payments are cumulative not deferrable so long as the solvency condition is met.
- **NAB option to redeem at Sep 2023 call date, maturity at Sep 2028:** Subject to APRA approval, NAB may elect to redeem NABPE at the Sep 2023 call date, and on any subsequent interest payment date, provided certain conditions are met.
- **Potential for conversion under a Non-Viability Trigger Event:** If APRA views NAB would be non-viable in the absence of conversion of Basel III compliant Tier 1 or Tier 2 instruments or a public sector injection of capital, NABPE would only be converted after full conversion of lower ranking Tier 1 instruments such as NABPA ($1.5bn), NABPB ($1.7bn), NABPC ($1.3bn), and NABPD ($1.5bn).

NAB Subordinated Notes 2

NABHB Reinvestment	Dates
NABHB Ex Entitlement	2 Feb 2017
NABHB Record Date	3 Feb 2017
Reinvestment offer opens	16 Feb 2017
NABHB ex interest	9 Mar 2017
Reinvestment offer closes	10 Mar 2017
NABHB interest paid	20 Mar 2017
Issue date	20 Mar 2017
ASX listing (deferred settlement)	21 Mar 2017

NABHB Redemption	Dates
NABHB Ex Entitlement	2 Feb 2017
NABHB Record Date	3 Feb 2017
Reinvestment offer opens	16 Feb 2017
NABHB ex interest	9 Mar 2017
Reinvestment offer closes	10 Mar 2017
NABHB interest paid	20 Mar 2017
NABHB cease trading	8 Jun 2017
NABHB ex dividend	8 Jun 2017
NABHB redemption	19 Jun 2017
NABHB interest paid	19 Jun 2017

Reinvestment Offer for NABHB holders

As the NABPE offer is essentially a replacement issue for the NAB Subordinated Notes (NABHB), NAB is offering the opportunity to reinvest NABHB securities held at the 3 February 2017 record date into new NABPE securities (ex entitlement date 2 February 2017). NAB will also give priority to allocations under the Broker Firm Reinvestment Offer applicants over Broker Firm Applicants.

NABHB holders essentially have three options:

- **Option 1: Participate in Reinvestment Offer:** For NABHB holders that lodge their Reinvestment Offer Application Form by 10 March 2017, NABHB securities will be Reinvested into new NABPE securities on 20 March 2017. NABHB investors will also receive the scheduled quarterly interest payment of $1.1306 unfranked on 20 March (ex interest 9 March)
- **Option 2: Sell NABHB on market:** NABHB is expected to cease trading on 8 June 2017
- **Option 3: Do nothing and with $100 Cash Redemption pending:** APRA has provided approval for redemption, where NAB has the option of redeeming remaining NABHB securities on Monday 19 June 2017. Assuming NAB undertakes the highly likely scenario of redemption, NABHB investors will receive $100 cash redemption per NABHB security. Holders will also receive two quarterly interest payments of $1.1306 unfranked on 20 March and ~$1.11 unfranked (90 days) on 19 June.

Offers for Broker Firm and Securityholders

- **Broker Firm Offer:** This is available to Syndicate Brokers of the NABPE issue (Bell Potter is not a syndicate broker), subject to scaling back from the Reinvestment Offer demand. Broker firm bids will participate in the Bookbuild to be held on 15 February 2017.
- **Securityholder Offer:** Available to investors in NAB, National Income Securities (NABHA), NAB Subordinated Notes (NABHB), NAB Convertible Preference Shares (NABPA, NABPB), and NAB Capital Notes (NABPC, NABPD). Applications for investors holding these securities at the 3 February 2017 record date requires a HIN or SRN. The closing date for the Securityholder Offer is 10 March 2017.

There is no Customer Offer or General Offer.

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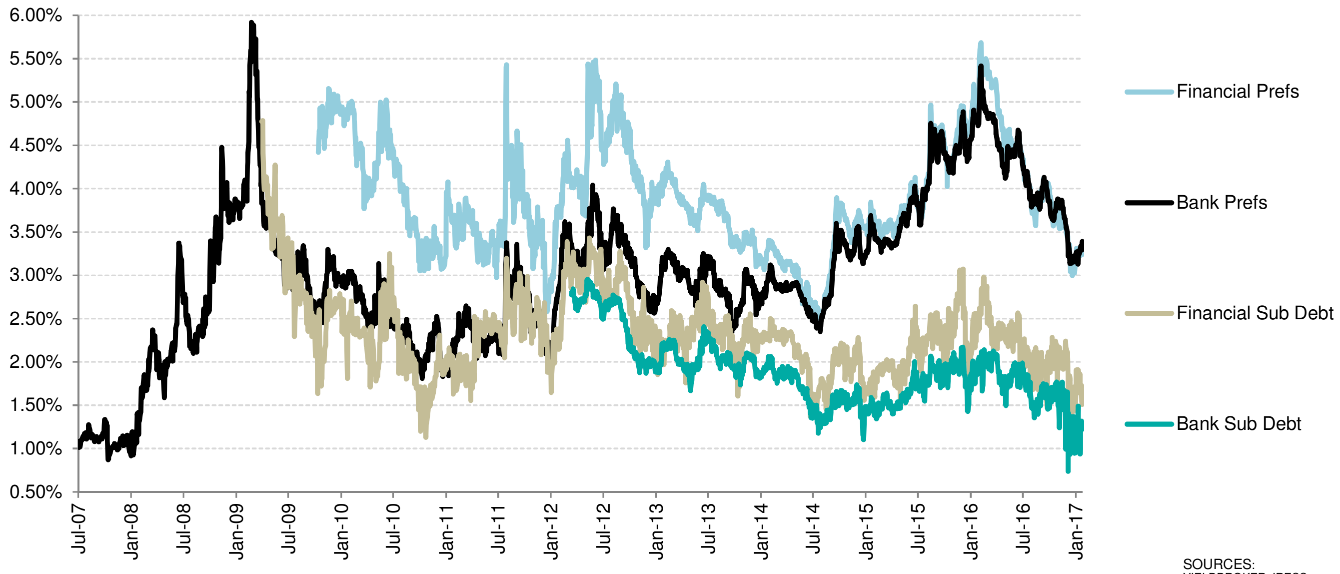
Bank subordinated debt margins firm as call dates loom

Figure 3 tracks the average trading margins split across 4 sectors:

* Financial Prefs
(AMPPA, BENPD, BENPE, BENPF, BOQPD, CGFPA, IAGPD, IANG, MBLPA, MBLPB, MQGPA, MQGPB, SUNPC, SUNPE)
* Bank Prefs
(ANZPC, ANZPD, ANZPE, ANZPF, ANZPG, CBAPC, CBAPD, CBAPE, NABPA, NABPB, NABPC, NABPD, WBCPC, WBCPD, WBCPE, WBCPF, WBCPG)
* Financial Subordinated Debt (AMPHA, SUNPD)
* Bank Subordinated Debt (ANZHA, NABHB, WBCHA, WBCHB).

Figure 3: Trading margins on ASX listed debt and hybrid sectors



SOURCES: YIELDBROKER, IRESS, BELL POTTER

Lower capital price volatility in subordinated debt

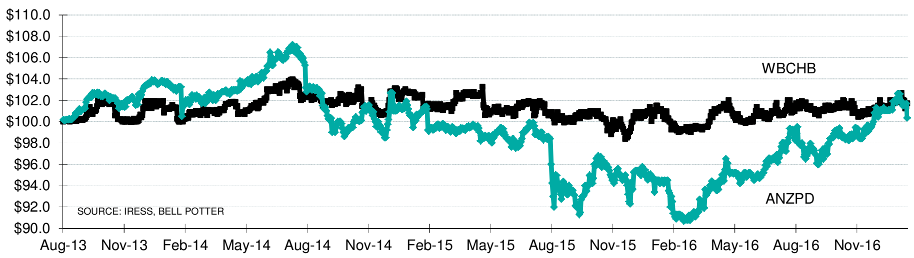
Figure 4 highlights the capital price volatility of ANZ Capital Notes (ANZPD) and Westpac Subordinated Notes II (WBCHB), which were both launched in July 2013 and listed in August 2013.

The trading range of Additional Tier 1 major bank hybrids have shown substantially more volatility over recent years, with ANZPD having a trading range between $90.60 and $107.60 since listing.

By contrast, WBCHB has tracked closer to its $100 par value, with a trading range between $98.06 and $104.10.

The lack of new ASX listed debt issuance has been a key factor supporting WBCHB. Ongoing hybrid issuance and the impact of $17.3bn of major bank rights issues in 2015 has contributed to the volatility in Additional Tier 1 hybrids such as ANZPD.

Figure 4: Capital price volatility ANZPD vs WBCHB



SOURCE: IRESS, BELL POTTER

NAB Subordinated Notes 2

Largest ASX listed debt issue since 2013

NABPE represents the first major bank Tier 2 subordinated debt issue since the $925m WBCHB offer in mid 2013. The next largest issue undertaken was the $630m CWNHB offer which listed in April 2015.

Figure 5: New ASX listed debt issuance since July 2013

Date of Listing	Issuer	ASX Code	Size	Description	Margin over BBSW
23-Aug-13	Westpac	WBCHB	$925m	Subordinated Notes II (Tier 2)	2.30%
19-Dec-13	AMP	AMPHA	$325m	Subordinated Notes 2 (Tier 2)	2.65%
30-Apr-14	IMF	IMFHA	$50m	Bonds	4.20%
24-Dec-14	Contango	CTNG	$27m	Convertible Notes	5.5% Fixed
24-Apr-15	Crown	CWNHB	$630m	Subordinated Notes II	4.00%
16-Dec-15	Aust Unity	AYUHB	$250m	Bonds	2.80%
8-Jun-16	Peet	PPCHA	$100m	Bonds	7.5% Fixed
6-Oct-16	Qube	QUBHA	$305m	Subordinated Notes	3.90%
21-Mar-17	**NAB**	**NABPE**	**$750m**	**Subordinated Notes 2 (Tier 2)**	**2.20-2.30%**
Total			$3,362m		

SOURCE: COMPANY DATA, BELL POTTER

2017 looming as a year of net hybrid redemptions

With $6.9bn of pending ASX listed debt redemptions and $2.5bn of ASX listed hybrid issue redemptions pending in 2017, it appears that hybrid redemptions could exceed hybrid issuance for the first year since 2010.

Figure 6: 2017 redemptions pending

ASX Code	Security	Maturity / Call Date	Issue Size	ASX Listed Replacement Issue
AFIG	AFIC Notes	28 Feb 2017	$185m	No
TAHHB	Tabcorp Subordinated Notes	22 Mar 2017	$250m	No
CNGHA	Colonial Group Subordinated Notes	31 Mar 2017	$1,000m	
NABHB	NAB Subordinated Notes	18 Jun 2017	$1,173m	NABPE
ANZHA	ANZ Subordinated Notes	20 Jun 2017	$1,509m	
HBSHB	Heritage Bank Retail Bonds	20 Jun 2017	$228m	
WBCHA	Westpac Subordinated Notes	23 Aug 2017	$1,676m	
CTXHA	Caltex Subordinated Notes	15 Sep 2017	$550m	
GMPPA	Goodman PLUS II	30 Sep 2017	$327m	
ASX Listed Debt Redemptions Pending			$6,897m	
IAGPC	IAG Convertible Preference Shares	1 May 2017	$377m	IAGPD
ANZPC	ANZ Convertible Preference Shares 3	1 Sep 2017	$1,340m	
BENPD	BEN Convertible Preference Shares	13 Dec 2017	$269m	
SUNPD	Suncorp Convertible Preference Shares	17 Dec 2017	$560m	
ASX Listed Hybrid Redemptions Pending			$2,546m	
			$9,443m	

SOURCE: COMPANY DATA, BELL POTTER

The lack of debt issuance since 2014 and ongoing redemptions should continue to provide support to ASX listed debt securities such as NABPE.

Figure 7: New issuance 2010-2016

Issuance ($bn)	2010	2011	2012	2013	2014	2015	2016	Cumulative
Hybrid Issuance	0.92	3.42	13.16	8.66	7.46	5.60	7.03	46.25
Hybrid Redemptions	1.10	1.68	3.09	2.42	5.88	0.90	5.67	20.74
Net Hybrid Issuance	-0.17	1.75	10.07	6.24	1.58	4.70	1.36	25.51
IPOs	7.98	1.56	1.27	9.69	18.65	7.00	8.32	54.47
Major Bank Raisings	0.00	0.00	0.00	0.00	0.00	17.30	0.00	17.30
Net Hybrid & Equity Issuance	**7.81**	**3.31**	**11.34**	**15.93**	**20.23**	**29.00**	**9.68**	**97.28**
Bank Pref Avg Trading Margin (31 Dec)	1.92%	2.14%	2.76%	2.72%	3.13%	4.48%	3.22%	
Bank Pref Avg Duration (years) (31 Dec)	3.6	3.0	3.2	3.9	5.1	4.4	4.1	
CBA CET1 (30 June)	6.6%	7.3%	7.5%	8.2%	9.3%	9.1%	9.6%	

SOURCES: ASX, AFR, BLOOMBERG, COMPANY DATA, BELL POTTER

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Early Conversion Event: Non-Viability Trigger Event

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.

Under Basel III, APRA requires Australian banks to hold a minimum Common Equity Tier 1 Capital Ratio of 4.5% on 1 January 2013. This increased to 8.0% on 1 January 2016 after inclusion of the 2.5% Capital Conservation Buffer and a further 1.0% D-SIB (Domestically Systemically Important Banks) Capital Buffer.

Post 1 January 2013, APRA's Basel III requirements for the issue of Tier 2 securities include a Non-Viability Trigger Event. This is intended to provide an advanced framework to replenish NAB's Common Equity Tier 1 Capital if NAB experiences significant financial difficulties. If APRA views that NAB would be non-viable in the absence of conversion Additional Tier 1 (NABPA, NABPB, NABPC and NABPD) or Tier 2 (NAB) instruments or a public sector injection of capital, NABPE would only be converted if full conversion of the $1.5bn NABPA issue, and $1.7bn NABPB issue, $1.3bn NABPC issue, and $1.5bn NABPD issue was first required.

We note there are currently no precedents for a Non-Viability Trigger Event. NAB believes the types of situations in which APRA may become concerned about non-viability include serious impairment of NAB's financial position, concerns about its capital funding or liquidity levels and/or insolvency.

The Non Viability Trigger Event provides the potential for NABPE holder to receive less than face if the conversion price is 80% below the Issue Date VWAP. Using the NAB share price on 7 February 2017 of $30.43, there is the potential for losses if NABPE is converted at below $6.09 (i.e. $30.43 x 0.2 = $6.09). In practice this event will only occur in the unlikely scenario that NAB suffers severe impairment losses and does not raise ordinary equity to absorb those losses.

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 NABPE – 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.

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Inability Event

One additional risk is an Inability Event where NABPE will be written off if NAB is not able to issue ordinary shares from Conversion within five Business Days of the Non Viability Trigger Event Conversion Date. Scenarios under which this may occur include NAB 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, NABPE holder's rights (including to distributions and face value) are immediately and irrevocably terminated, resulting in NABPE losing its value and investors will not receive any compensation.

Investment risks

Key investment risks include:

- NABPE is not a Government protected deposit liability of NAB.
- NABPE rank 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.
- As NAB relies on credit and capital markets to provide a source a of liquidity and funding for lending activities, there is the risk that access to these markets may be severely restricted in the event of a major systemic shock to the Australian, New Zealand or other financial systems. These shocks may result from economic, financial or political issues.
- A dislocation of credit markets may also 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.
- Adverse regulatory changes / Government policy.
- Operational risks and trading risks of NAB.
- Increasing competition in financial services.
- Holders have no redemption rights before the maturity date in September 2028.
- Redemption at the First Optional Redemption date in September 2023 and subsequent interest payment dates is subject to APRA approval, contingent upon APRA being satisfied with NAB's capital position. This may require that NAB replace NABPE with regulatory capital of the same or better quality, as a means to protect NAB depositors.
- The market price of NABPE will fluctuate as a security listed on the ASX for various reasons including liquidity, interest rate changes, credit margins, the financial performance of NAB and general economic conditions. The price of NABPE can fluctuate above or below par.

Refer page 61 (Section 7) of the prospectus dated 8 February 2017 for further information on risks.

Fixed Income

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Additional risks of hybrid securities

Hybrid securities are perpetual and do not constitute a deposit liability of the Issuer. They may be exchanged at the Issuer's discretion at the Optional Exchange Date (first call date) and then at the Mandatory Conversion Date if certain conditions have been satisfied. Hybrid securities pay discretionary dividends which are not cumulative if unpaid. Hybrid securities have complex terms of issue and each investment will differ in terms of conditions, time frame and interest rates. They often involve heightened risk and may not be suitable for all investors.

There are additional risks associated with this kind of investment as compared to a term deposit with the same issuer. These risks include:

- A 'trigger event' occurring leading to a deferral of interest payments or the Issuer repaying the hybrid early or much later than expected;
- Credit spreads widening making the return from the investment less attractive in comparison to other products;
- Additional new issuance at a higher margin;
- Market price volatility;
- Liquidity risk for hybrids is generally greater than shares in the Issuer company;
- Subordinated ranking;
- Distributions are at the discretion of the issuer;
- These products may be perpetual and can only be redeemed or exchanged for either cash or equity at the Issuer's option;
- Early repayment is at the Issuer's discretion

You should acquaint yourself with the specific returns, features, benefits and risks unique to any hybrid security before investing in them. If you do not understand, or have any concerns about a particular product you should talk to your Adviser. ASIC has published guidance, which may be relevant to your consideration of an investment of this kind, called "Hybrid securities and notes", under the heading 'Complex investments' at **www.moneysmart.gov.au/investing**