Lonsec

Lonsec Income Investments
NAB Subordinated Notes 2 (NABPE)

Lonsec Research Pty Ltd ABN 11 151 658 561 AFSL 421 445

07-02-2017

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Approved

Risk rating categories

	LOW	MOD	HIGH	SPEC
FINANCIAL	●			
STRUCTURAL		●		
MATURITY		●		
LIQUIDITY	●			
INDUSTRY			●	
VOLATILITY	●			
RISK PROFILE		●		

Key details

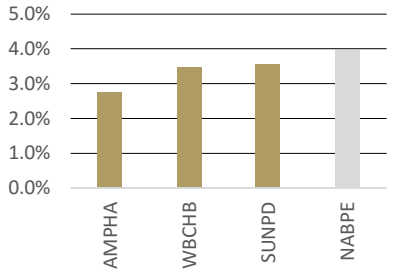
ISSUE NAME	NAB SUBORDINATED NOTES 2 (NABPE)
ISSUER	NATIONAL AUSTRALIA BANK
ISSUE FEATURES	SUBORDINATED UNSECURED DEBT, FULLY PAID, FLOATING RATE, CUMULATIVE, LOSS ABSORBING
CLASSIFICATION	TIER 2 CAPITAL
FACE VALUE	$100
ISSUE SIZE	$750M, WITH THE ABILITY TO RAISE MORE OR LESS
INTEREST RATE	INDICATIVE MARGIN[1] OF 2.20–2.30% P.A. OVER 90-DAY BANK BILL RATE. INITIAL CASH YIELD OF 3.97–4.07%[2] PA.
INTEREST FREQUENCY	QUARTERLY
FRANKING	UNFRANKED
OPTIONAL REDEMPTION DATE	20 SEPTEMBER 2023
MATURITY DATE	20 SEPTEMBER 2028
MINIMUM APPLICATION SIZE	$5,000 (BEING 50 NOTES)
PROSPECTUS	WWW.NAB.COM.AU/NSN2OFFER

1 Margin to be set at bookbuild on 15 February 2017
2 Based on 90 Day BBSW of 1.77%

Capital Ranking / Security Type

DEPOSITORS, SECURED DEBT	
SENIOR/UNSUBORDINATED DEBT	
SUBORDINATED DEBT	●
PERPETUAL CAPITAL NOTE	
ORDINARY EQUITY	

Yield to call for listed peers



Important Dates

BOOKBUILD DATE	15 FEB 2017
OPENING DATE	16 FEB 2017
CLOSING DATE	10 MAR 2017
COMMENCEMENT OF TRADING	21 MAR 2017
FIRST INTEREST PAYMENT DATE	20 JUN 2017

1. Subject to the Solvency Condition

Approved – Low to Moderate Risk

NAB intend to raise $750m via the offer of NAB Subordinated Notes 2 (NABPE). The offer proceeds will be used to satisfy regulatory capital requirements, which include replacement of NAB Subordinated Notes (NABHB) at its optional redemption date in June 2017. Accordingly, NABPE is structured as a Basel III compliant Tier 2 security with terms comparable to NABHB.

Lonsec regards NABPE as a reasonably low risk security with a clean cash maturity profile (expected 6.5-year term), limited equity conversion risk, non-deferrable interest payments[1] and an attractive floating rate cash yield (currently 4.0%), which will rise with any increase in short term rates. The low structural and maturity risks should support a reasonably low level of volatility, and we believe the short supply of ASX listed subordinated debt, noting seven scheduled maturities (with few anticipated listed replacements) within the next 12 months, will support strong demand for the Notes.

Lonsec have assigned NABPE an 'Approved' investment rating and a Low-to-Moderate risk assessment.

Financial risk – Low

Lonsec regards NAB as a high quality issuer with an investment grade credit rating, good regulatory capital position, strong market position, low impairments and a proven track record of earnings, dividend and book value growth. Earnings and capital levels are sensitive to general economic and financial market conditions, as well as regulatory change. Normalising loan impairments, moderate credit growth and margin pressure are shaping as headwinds to short term earnings growth, though at this stage credit quality remains sound and supported by low interest rates, while the higher capital requirements imposed by APRA have strengthened the group's ability to withstand economic shocks.

Structural risk – Low to Moderate

NABPE are subordinated and unsecured notes issued by NAB that qualify as Tier 2 regulatory capital. They are not deposit liabilities and are therefore not protected by the government guarantee, nor are they secured against any asset of NAB. The Notes rank for payment of interest and return of capital ahead of ordinary shares and preference shares, but behind unsubordinated creditors including deposit holders.

The key risk to this issue, and the primary point of difference to pre-Basel III Tier 2 securities, is the inclusion of the non-viability trigger. This clause means holders are likely to incur a loss (and possible write-off of their investment) should NAB experience extreme financial difficulty, such that APRA regards NAB as 'non-viable'. However, Lonsec regards this as a highly unlikely scenario in the term to maturity. Refer to page 6 for further information.

Interest payments are paid and reset quarterly, at a rate equal to the 90-day Bank Bill rate plus the issue margin. The 90-day bank bill rate is a floating rate, and therefore the level of interest rate payments will vary over time and may become more or less attractive. Interest payments are not discretionary or deferrable, and therefore must be paid so long as NAB is solvent at the time of, and immediately after, payment. In the event that NAB would become insolvent through the payment of interest or repayment of the face-value, NAB can defer payment without triggering a default. In such a circumstance missed payments are cumulative, and will be payable to the holder as soon as the solvency condition is satisfied.

Maturity risk – Low to Moderate

NABPE has a legal cash maturity date of 20 September 2028. However, NAB also has the option to redeem the Notes on 20 September 2023 or any interest payment date thereafter, or on the occurrence of a tax or regulatory event. Upon redemption, holders will receive $100/note face value. Failure to repay face value within seven days of its due date will constitute an event of default (subject to the solvency condition).

Holders have no right to request early redemption; however, investors seeking liquidity can sell on-market. Holders have limited risk of equity conversion, with conversion only possible in the event of non-viability.

Under Basel III prudential standards, NABPE's regulatory capital classification is required to amortise on a straight line basis over the final 5 years to maturity (i.e. 20% p.a.). This provides incentive for NAB to redeem and replace the Notes in September 2023, implying a 6.5-year term. We expect NAB to redeem the Notes at that time, and therefore assign a low-to-moderate maturity risk rating.

Liquidity risk – Low

NABPE is expected to have an issue size above $750m, which based on the liquidity of similar sized comparable securities, should support weekly turnover of $4-5m.

Industry risk – Moderate

Lonsec has assigned a Moderate industry risk rating in-part due to the industry's leveraged exposure to underlying macroeconomic and financial market conditions and a relatively high degree of regulation. Australian banks are still highly profitable with net interest margins around 2% and return on equity of ~14%. Whilst Australian banks remain exposed to the risk of higher impairments if the economy was to slow significantly, the higher capital requirements being imposed by the regulator enhance the industry's ability to withstand economic shocks. It is the intention of the regulator to have Australia's major banks rank comfortably within the top quartile of internationally active banks in terms of capital strength.

Volatility risk – Low

Given the reasonably low structural, maturity and conversion risks, we expect volatility to be low in the period to maturity. However, the market price will fluctuate due to various factors including general movements in credit spreads, interest rates, economic conditions, investor sentiment, NAB's financial position and other events, which may cause NABPE to trade below par at some stage. As a result, we recommend investing with the intention of holding to maturity.

NAB Subordinated Notes 2 (NABPE)

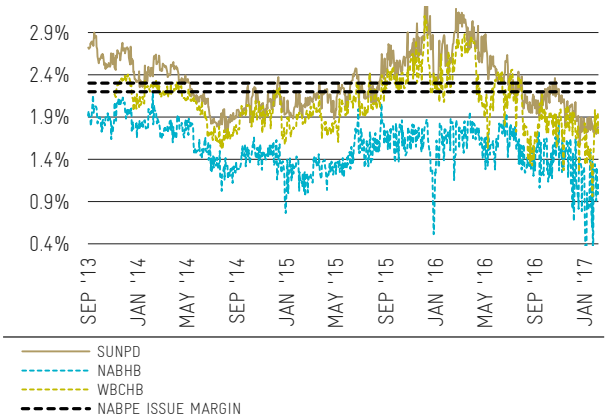
Relative Value

Comparable Listed Securities

Lonsec considers Westpac Subordinated Notes II (WBCHB), Suncorp Subordinated Notes (SUNPD) and NAB Subordinated Notes (NABHB) to be the closest comparable listed securities to NABPE:

- WBCHB is the only ASX listed major bank Basel III compliant Tier 2 security (i.e. structured with a non-viability trigger) and is therefore the most comparable security to NABPE. Since listing in August 2013, WBCHB has traded within a margin range of 96-310bps, at an average of 207bps. Over the past 5 trading days its margin has averaged 184bps.
- SUNPD, also Basel III compliant, has traded within a margin range of 157-340bps since August 2013, at an average of 232bps. We note SUN has a lower credit rating than NAB & WBC, and hence the higher average margin. Over the past 5 trading days SUNPD's margin has averaged 175bps.
- NABHB was issued pre-Basel III implementation, and therefore the absence of a non-viability trigger is the key point of difference to NABPE. NABHB has traded at an average 154bp margin since August 2013. Over the past 5 trading days its margin has averaged 112bps.

Chart 1. Trading margins for comparable securities



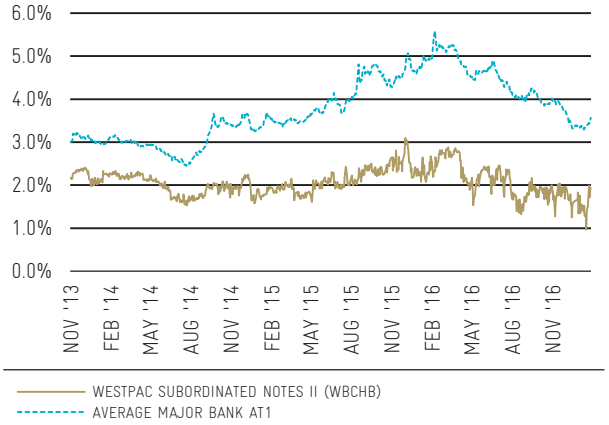
Source: Lonsec, Thomson Reuters

Lonsec View

Lonsec regards the indicative 220-230bps pricing range as attractive, acknowledging:

1. The margin midpoint reflects an 18bp premium to the average trading margin of WBCHB;
2. WBCHB has typically traded at a 171bp discount to Tier 1 securities (see chart 2). The indicative margin range for NABPE represents a 131bp discount to Tier 1 spreads; and
3. Limited supply of listed subordinated debt – Opportunities to allocate to the sector are diminishing, as seven subordinated debt securities are scheduled to mature within the next 12 months, and we anticipate few replacements. We remind investors Primary Bonds (September 2015), CBA Retail Bonds (December 2015), Woolworths Subordinated Notes (November 2016) and Origin Energy Subordinated Notes (December 2016) were all redeemed without a listed replacement. Colonial are unlikely to replace Colonial Group Subordinated Notes (March 2017) with a Tier 2, while TABCORP have notified holders of its intention to redeem (without replacement) its Subordinated Notes in March 2017.

Chart 2. Trading margins – Basel III Securities



Source: Lonsec, Thomson Reuters

Overall, we believe NABPE to be attractively priced for the current environment and its risk assessment. NABPE will provide an attractive floating rate cash yield (currently 4.0%), which will rise with any increase in short term rates, and importantly offers an opportunity lower portfolio concentration to the Tier 1 sector, which has dominated issuance in the past.

Table 1. Comparable Securities

	NABPE	WBCHB	SUNPD
SECURITY TYPE	SUBORDINATED NOTE	SUBORDINATED NOTE	SUBORDINATED NOTE
OPTIONAL REDEMPTION DATE	20 SEPTEMBER 2023	22 AUGUST 2018	22 NOVEMBER 2018
MATURITY DATE	20 SEPTEMBER 2028	22 AUGUST 2023	22 NOVEMBER 2023
CAPITAL TRIGGER	NO	NO	NO
NON-VIABILITY TRIGGER	YES	YES	YES
RESET TRADING MARGIN	2.20 – 2.30%	1.70%	1.78%
CASH RUNNING YIELD	3.97 – 4.07%	4.00%	4.50%
YIELD TO CALL	3.97 – 4.07%	3.47%	3.55%

Source: Lonsec, Thomson Reuters

NAB Subordinated Notes 2 (NABPE)

ISSUE DATE: 7-02-2017

Financial Risk — Low

Lonsec has considered a number of factors in assessing the financial risks associated with the issue and issuer. As part of our analysis we review the capital quality, liquidity, credit & asset quality, earnings growth forecasts, earnings sensitivities and operating efficiency in the overall assessment.

Lonsec regards NAB as a high quality issuer with an investment grade credit rating, good regulatory capital position, strong market position, low impairments and a proven track record of earnings, dividend and book value growth.

NAB have exited their underperforming US & UK assets (Great Western Bancorp in July 2015, CYBG in February 2016, and 80% of MLC Life in October 2016), leaving it as a simplified, stronger, and domestic focussed bank (97% of gross loans within Australia & NZ). Accordingly, NAB's CET1 capital ratio has strengthened to 9.5% and cash ROE has stabilised at ~14%.

It is well positioned in the domestic market, with a 25% business lending market share and 15% housing lending share. Earnings and capital levels are therefore sensitive to general economic and financial market conditions, such as credit growth, unemployment, funding markets and regulation. While offshore divestments should improve NAB's financial profile in the long term, normalising loan impairments, decelerating credit growth and margin pressure are shaping as key headwinds to earnings growth. Regulatory capital pressure is currently less of a threat following delays to finalised Basel IV standards, with implementation now unlikely until 2019.

Interestingly, NAB's direct resources sector exposure is the lowest of the majors, however it is overweight commercial real estate. Impairment levels have risen off a low base, and we do expect them to continue to normalise over the medium term (particularly if rates rise), though at this stage credit quality remains sound and supported by low interest rates and reasonable employment, while its improved capital levels enhance its ability to withstand economic shocks.

Asset growth also remains strong (+4.8% in FY16), though we are expecting credit demand to slow as a result of an already highly leveraged household sector, slowing nominal GDP growth and tightened lending standards.

Overall, we are comfortable with NAB's current financial position and outlook, acknowledging that we believe NAB (and the sector) are entering a period of low earnings growth. We expect NAB to be in a position to meet interest payments and repay NABPE holders their face value on maturity. Accordingly, we assign a Low financial risk rating.

Issuer Summary

NAB is Australia's fourth largest bank with $778bn in total assets and $82bn market capitalisation. It provides a broad range of banking & financial services and products to retail, small business, corporate and institutional clients through recognised brands including NAB, nabtrade, UBank, MLC, JBWere and Plum.

Operations primarily span Australia and New Zealand, though also encompass Europe, US and a number of countries in the Asia Pacific region. NAB is traditionally a business bank, and maintains an approximate 25% market share of the Business lending market and 15% market share of the Australian mortgage and household deposit market.

Profitability

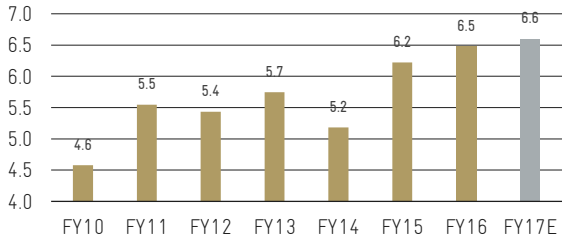
NAB reported a $1.6bn 1Q17 cash profit, down 1% on the pcp as higher staff and IT expenses more than offset substantially lower BD&D charges and stable NIM. In FY16, cash profit increased 4.2% to $6.5bn. Cash ROE reduced 50bps to 14.3%, mainly reflecting lower leverage and stronger capital position. Good cost control, strong CET1 capital position, stable dividend and only a small rise to impairments were the highlights, while slowing revenue growth and stretched payout ratio were key negatives. We expect NAB to rebase it dividend payout ratio (currently 81%) to target levels (70-75%) over the coming periods.

Asset growth was solid at 4.8%, reflecting 5.7% growth in housing lending and 3.1% growth in non-housing lending. Group net interest margin decreased 2bps to 1.88%, reflecting higher wholesale funding costs, and accordingly operating income growth slowed to 2.5%.

The loan impairment expense increased 7.0% to $800m, reflecting higher specific provision charges related to a downgrade of a number of large unnamed institutional facilities, which was partially offset by lower collective provision charges. The impairment expense as a percentage of gross loans remains very low at 15bps, suggesting asset quality remains sound, though we expect bad debt charges to normalise in future periods.

At 3 February 2017, analyst consensus is for NAB to report a FY17 cash profit of $6.6bn, up 1.8% on FY16. We expect low single digit earnings growth over the medium term.

Chart 3. Full Year Cash Earnings ($bn)

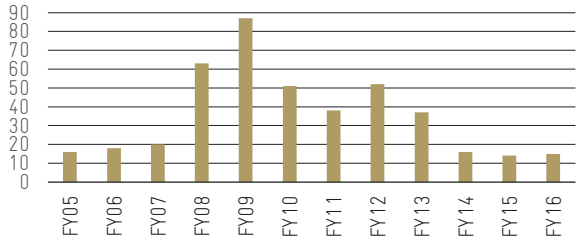


Source: NAB Annual Reports, Lonsec, Thomson Reuters

Asset quality

Commodity sector weakness and increased impairment of New Zealand dairy exposures caused the level of impaired assets and impairment expenses to rise in FY16, but overall asset quality is generally sound with low interest rates, reasonable employment, asset price growth and generally healthy business balance sheets helping to keep troublesome and impaired assets below historical averages. Impairment charges relative to gross loans have increased only marginally to 15bps, which remains well below NAB's estimated average of 46bps (see below).

Chart 4. NAB Bad & Doubtful charges to loans (bps)



Source: NAB Annual Reports, Lonsec, UBS

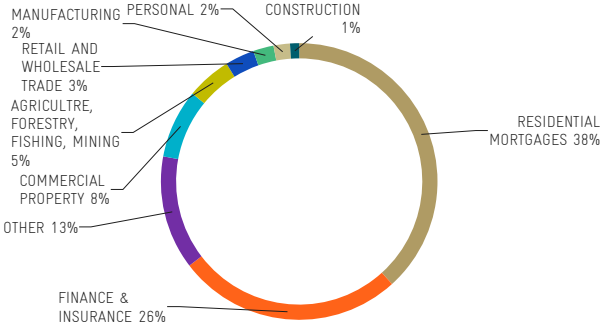
NAB Subordinated Notes 2 (NABPE)

ISSUE DATE: 7-02-2017

Credit Risk

NAB had total $960bn in gross credit exposures at 31 December 2016, which were concentrated to Australia (72%), NZ (10%) and UK (7%). Around 38% of gross exposures relate to residential mortgage lending, which is generally a higher proportion than US & UK banks, and in part reflects Australia's above average home-ownership desires, high household leverage and lenient tax treatment. We consider NAB's Australian mortgage lending portfolio to be relatively low risk, reflective of its very low 3bps long run loss rate. This can be attributable to a mortgage book weighted towards owner occupier loans (58% of the portfolio), full recourse lending, low dynamic LVR (45%) and lenders mortgage insurance on high LVR lending. We do note however 78% of loan balances are variable rate, and household balances sheets are currently geared at record levels (household debt to disposable income 187%). Loan serviceability has been supported by record low interest rates and reasonable employment, and therefore we regard higher interest rates as the biggest risk to loan serviceability, house prices, credit growth & impairments. The remaining loan book is diversified across industry, though NAB has a relatively high exposure to commercial real estate (8%) and agriculture, forestry and fishing (5%). Resources exposure is the lowest of majors at just 1% of total exposures. At this stage commercial real estate and agricultural impairments are low.

Chart 5. Credit Exposure by Industry



Source: NAB Pillar 3 Report, Lonsec

Funding and liquidity profile

NAB relies on customer deposits as well as wholesale debt to fund its business activities and as a source of liquidity. Deposit funding is generally perceived as more stable than short-term wholesale debt, with deposits considered to be 'sticky' and of generally longer term. Wholesale funding is also important as it helps to diversify the funding base, reduce liquidity risk and is typically cheaper than deposit funding. NAB's funding approach is focussed on attracting retail deposits, which accounts for 54% of its funding mix. The balance is comprised of various short and long term wholesale debt issuances (39%), and equity (7%).

Liquid assets total $118bn, providing for a liquidity coverage ratio of 124% at 31 December 2016, which is above the 100% minimum imposed by APRA.

Whilst Lonsec is comfortable with NAB's financial position, if market conditions deteriorate or there is a major systemic shock on the Australian, or other financial systems due to economic, financial, political or other reasons, there is a risk that NAB's funding activities may be adversely affected and its liquidity, funding and lending activities may be constrained. Lonsec notes that these events are unlikely and difficult to predict but would be likely to negatively impact NAB's business, financial performance and capital position.

Capital position

NAB is regulated by APRA and other regulatory bodies which require NAB to hold an adequate level of capital and liquidity to cover the risks of its operations and protect its solvency. Regulatory capital requirements have generally been increasing for NAB and the major banks, the intention being to set capital standards such that Australian Authorised Deposit Taking Institutions are 'unquestionably strong' and comfortably positioned within the top quartile of internationally active banks. Accordingly, from 1 January 2016 the major banks were required to maintain a Common Equity Tier 1 Capital Ratio (CET1) above 8.0%, and from 1 January 2018 a minimum leverage ratio requirement will be introduced. Whilst regulatory reforms are ongoing, NAB raised $5.5bn of equity capital in May 2015 to satisfy current and future requirements, and the 80% sale of MLC Life further improved its capital position. As at 31 December 2016, NAB's leverage ratio (Tier 1 capital to total exposures) was 5.4%, which is above the 3-5% range recommended by the Financial System Inquiry. Similarly, NAB's Common Equity Tier 1 Capital ratio of 9.5% is comfortably above current regulatory requirements and internal targets. As such, NAB has around $47bn of Common Equity and Additional Tier 1 capital which sit junior to NABPE on NAB's balance sheet.

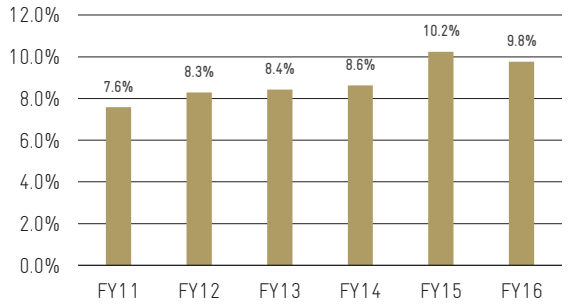
Should NAB's capital levels be threatened in the future, NAB's ability to pay dividends and distributions on lower ranking securities will be restricted, and we would therefore expect management to take to take steps to restore its capital position.

Whilst NAB estimates its capital ratios to be within the top quartile of the largest internationally active banks, APRA have indicated that "capital accumulation remains the appropriate course of action for most ADI's". We therefore expect NAB to target higher capital levels in the future, likely to be achieved via a reduction to the dividend payout ratio, operation of the dividend reinvestment plan and increased issuance of loss absorbing capital (i.e. equity and convertible securities).

We highlight that whilst higher capital requirements are creating headwinds for EPS growth (negative for equity holders), they are positive for the NAB's credit profile. Standard & Poor's have expressed that should all capital initiatives be implemented as expected, it expects to lift the stand-alone credit profiles of some or all of the banks by one notch, which should translate into "higher ratings on the hybrid and subordinated debt instruments issued by these banks".

Overall, we are comfortable with NAB's capital position and outlook, and expect it to continue to strengthen its credit profile over the medium term.

Chart 6. Common Equity Tier 1 Capital Ratio



Source: NAB, Lonsec

NAB Subordinated Notes 2 (NABPE)

Structural Risk – Low to Moderate

NABPE are fully paid, subordinated and unsecured term debt issued by National Australia Bank Limited (NAB). The Notes will qualify as Tier 2 capital for the purposes of NAB's regulatory capital requirements, and accordingly NABPE is structured to comply with Basel III standards. NABPE are not deposit liabilities and are therefore not protected by the government guarantee, nor are they secured against any asset of NAB. In a winding up of NAB, and assuming NABPE have not been redeemed, converted or written off before hand, investors will be entitled to claim for the face value and any unpaid interest after payment of all claims ranking senior to NABPE. Accordingly, if there is a shortfall of funds on a winding up of NAB, holders will suffer loss.

Lonsec regards the key risk to this issue to be the inclusion of the non-viability trigger. However, we are comfortable with NAB's financial position and regard non-viability or insolvency as an unlikely scenario within the period to maturity. We expect NAB to pursue a range of capital management initiatives, including asset disposals, reduced payout ratio or equity raisings, to protect its solvency and regulatory capital position prior to the occurrence of insolvency or non-viability, and note NAB has around $6bn worth of relevant Additional Tier 1 securities that will be converted or written off before any NABPE are converted or written off. We also acknowledge the loss absorption characteristics of Tier 2 capital are more limited than that applicable to Tier 1 capital. Accordingly, we assign NABPE a low-to-moderate structural risk assessment.

Capital Ranking

NABPE rank for payment of interest and return of capital ahead of common equity and preference shares, equally with other term subordinated unsecured debt issued after 1 Jan 2013, and below senior creditors and deposit holders. However, the ranking of holders in a winding up of NAB will be adversely affected as it is likely that a Non-Viability Trigger event will have occurred prior to wind up, in which case the Notes will be converted into ordinary equity, and holders will rank for payment equally with other NAB shareholders. If, for any reason, Notes that are required to be converted are not converted within five business days they will be written off and all holder rights in relation to the Notes, including to payment of interest and face value, will be terminated.

Table 2: Capital Structure

RANKING	CAPITAL TYPE	EXAMPLE
HIGHER RANKING	PREFERRED AND SECURED DEBT	DEPOSITS, EMPLOYEE ENTITLEMENTS, SECURED CREDITORS
	UNSUBORDINATED UNSECURED DEBT	TRADE AND GENERAL CREDITORS, BONDS, NOTES, DEBENTURES
	SUBORDINATED & UNSECURED DEBT	**NAB SUBORDINATED NOTES 2 (NABPE)**
	PREFERENCE SHARES	NAB CPS (NABPA), NAB CPS II (NABPB), NAB CAPITAL NOTES (NABPC), NAB CAPITAL NOTES 2 (NABPD)
LOWER RANKING	NAB SHARES	ORDINARY EQUITY

Source: NAB, Lonsec

Non-Viability Trigger

Since 1 January 2013, APRA has required Tier 2 capital securities be structured with a Non-Viability Trigger. The inclusion of this term is intended to protect NAB's solvency and reduce any future reliance on government bail-outs in times of significant financial difficulties.

A Non-Viability Event occurs when APRA notifies NAB in writing that it believes conversion of all or some NABPE (or conversion or write down of other similar instruments) or a public injection of capital (or equivalent support) is necessary because, without it, NAB would become non-viable. Whether or not a Non-Viability Trigger Event will occur is at the discretion of APRA. While APRA has provided little guidance on the parameters used to determine non-viability, it is expected to include serious impairment of NAB's financial position or insolvency. The value of ordinary shares received on conversion will depend on the market price of ordinary shares at the relevant time. As a non-viability trigger event will only occur during times of significant financial stress, conversion is likely to occur at a time when NAB's share price is low. Because of the maximum conversion number, holders will receive significantly less than $101/share on conversion if NAB's share price is below ~$6 (i.e. 80% below the current price) at the time of conversion. If for any reason a non-viability trigger event occurs and conversion of NABPE is not effected within five business days, the Notes will be written off, and all rights in relation to the Notes, including to payment of interest and face value, will be terminated. Holders will therefore lose all of the value of their investment.

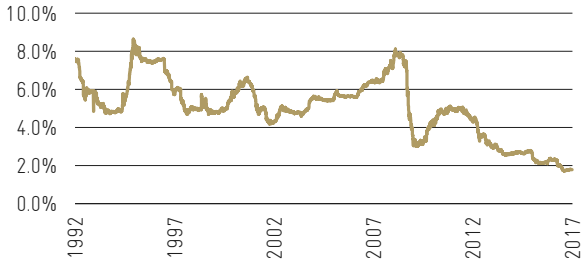
Interest Payments

Interest payments are scheduled to be paid quarterly until the Notes are redeemed, converted or written off. The interest rate payable is determined quarterly as the sum of the 90-day Bank Bill rate, plus the issue margin, which has been guided to be 220-230bps. The final margin will be determined under the Bookbuild and communicated to the market on 15 February 2017. Interest payments are deductible to NAB and not paid out of company profits, and will therefore not be franked.

The 90-day Bank Bill Swap Rate is the rate at which major Australian financial institutions lend short term cash to each other over a 90-day period. This rate is influenced by a number of factors and varies over time. As a result of movements in the underlying bank bill swap rate, the level of interest rate payments will vary over time and may become more or less attractive (see below chart).

Interest payments are not discretionary or deferrable, and therefore must be paid so long as NAB is solvent at the time of, and immediately after, payment. However, in the event that NAB would become insolvent through the payment of interest or repayment of the face-value, then NAB can defer the payment without triggering a default (known as the solvency condition). In such a circumstance missed payments are cumulative, and will be payable to the holder as soon as the solvency condition is satisfied. Should a non-viability trigger event occur, NAB's obligations to make payments in respect to the Notes will cease and holders will have no right to recover any unpaid amounts.

Chart 7. 90-Day Bank Bill Swap Rate



Source: Lonsec, Thomson Reuters

NAB Subordinated Notes 2 (NABPE)

Maturity Risk — Low to Moderate

NABPE has a legal cash maturity date of 20 September 2028. However, NAB also has the option to redeem the Notes on 20 September 2023 or any interest payment date thereafter, or on the occurrence of a tax or regulatory event (subject to APRA approval).

Upon redemption, holders will receive $100/note face value plus any accrued and unpaid interest up to the maturity date. Failure to repay face value within seven days of its due date will constitute an event of default (subject to the solvency condition).

Holders have no right to request early redemption; however, investors seeking liquidity can sell on-market. Holders have limited risk of equity conversion, with conversion only possible in the event of non-viability (see page 6 for further information on non-viability).

Under Basel III prudential standards, NABPE's regulatory capital classification is required to amortise on a straight line basis over the final 5 years to maturity (i.e. 20% p.a.). NAB is therefore incentivised, subject to its capital position, APRA approval and prevailing credit spreads, to redeem and replace the Notes in September 2023. Lonsec expects NAB to redeem the Notes at that time, implying a 6.5-year term. We note that while there can be no certainty NAB will exercise its call option in September 2023, or that APRA will approve of it, the legal cash maturity in September 2028 warrants a Low-to-Moderate maturity risk rating.

The table below sets out the maturity scenarios for NABPE.

EVENT	WHEN?	IS APRA APPROVAL REQUIRED?	DO CONDITIONS APPLY?	WHAT VALUE WILL A HOLDER RECEIVE?	IN WHAT FORM WILL THAT VALUE BE PROVIDED TO HOLDERS?
OPTIONAL REDEMPTION	20 SEPTEMBER 2023 AND ON ANY INTEREST PAYMENT DATE THEREAFTER	YES	YES	$100	CASH
REDEMPTION ON THE MATURITY DATE CONVERSION	20 SEPTEMBER 2028	NO	YES	$100	CASH
REDEMPTION IN OTHER CIRCUMSTANCES	IF A TAX[1] OR REGULATORY[2] EVENT OCCURS	YES	YES	$100	CASH
AUTOMATIC CONVERSION INTO SHARES	IMMEDIATELY FOLLOWING THE OCCURRENCE OF A NON-VIABILITY TRIGGER EVENT	NO	NO	DEPENDING ON THE MARKET PRICE OF NAB ORDINARY SHARES AT THE TIME, HOLDERS ARE LIKELY TO RECEIVE SIGNIFICANTLY LESS THAN $101. IF CONVERSION IS NOT POSSIBLE WITHIN 5 BUSINESS DAYS, THE NOTES WILL BE WRITTEN OFF	VARIABLE NUMBER OF ORDINARY SHARES

Source: NAB, Lonsec

1. A tax event will occur if NAB is obliged to pay additional amounts, is exposed to a significant increase in taxes or other costs in relation to NABPE or interest payable in respect to NABPE may longer be deductible for income tax purposes.

2. A regulatory event will occur where an unexpected change of laws or APRA's prudential standards prevent NAB from treating all of NABPE as Tier 2 regulatory capital, or where additional requirements will be imposed on NAB in relation to NABPE.

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Liquidity Risk — Low

A number of factors will influence NABPE's liquidity including; the size of the issue, free float, issue margin, credit spreads and the underlying market conditions. We assess liquidity risk with reference to the average weekly turnover relative to the size of the issue.

NAB has announced the initial offer size will be $750m, with the ability to raise more or less. The issue size should support a good level of liquidity for retail investors. Based on similar sized securities we expect average weekly turnover of around $4-5m. We note liquidity is less of a concern for small investors or those intending to hold to maturity.

Industry Risk — Moderate

The Australian banking system is in a relatively strong condition with each of the banks holding strong global credit ratings and top quartile capital levels.

The four major banks dominate market share in Australia and New Zealand. Since the GFC, the major banks have improved their funding, liquidity and capital positions, although there is still a major reliance on wholesale funding which represents about 40% of their total assets. Net interest margins remain around 2% and return on equity at around 14%. Impaired assets as a percentage of gross loans is low at around 0.5%, which is low relative to other developed economies.

The exposure of Australian banks to Europe remains minimal, although European problems do indirectly affect the cost and access to wholesale funding in global markets.

Rising spreads, higher funding costs and the state of the Australian housing and commercial property market can be regarded as some of the key risk factors that could adversely impact the banks financial position and profitability. House prices have gained strongly over the prior 12 months, helped by low borrowing rates and investor demand. In addition, accommodative monetary policy and Australia's reasonably strong economy (in comparison to global peers), should support a relatively low level of delinquencies and residential impairments moving forward, however the slowdown in the resources sector has seen impairments begin to rise in WA and QLD, and provisions are being increased for institutional banking and markets divisions. We expect impairments will continue to rise in the short term, and therefore suspect the sector is entering a period of low earnings growth.

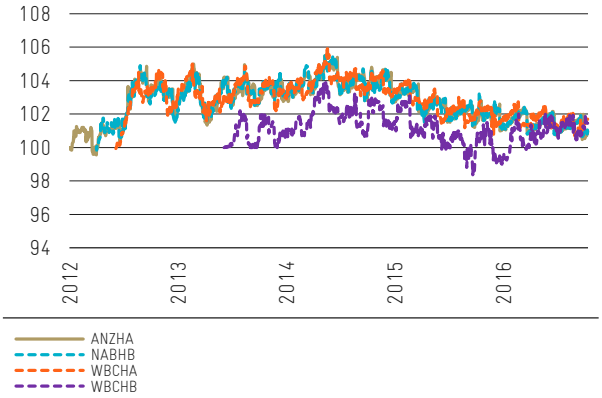
Overall, given the ongoing risk of further regulatory change, funding requirements and the industry's leveraged exposure to the underlying macroeconomic conditions and financial markets we assign a Moderate Industry risk assessment.

Volatility Risk — Low

The price and trading margin of NABPE may fluctuate due to various factors including; changes to general market conditions, investor sentiment, interest rates, credit spreads, economic outlook, NAB's financial position and credit rating, movements in the market price of NAB ordinary shares or senior or subordinated debt, the perception of or likely occurrence of a Non Viability Trigger Event or insolvency.

Investors can look to NAB Subordinated Notes (NABHB) and other comparable Tier 2 ASX listed securities (ANZHA, WBCHA & WBCHB) to guide volatility expectations, with NABHB trading within a range of $99.51 — $105.70 since listing in June 2012 (chart 6).

Chart 8. Listed Tier 2 Security Price Histories



Source: Lonsec, Thomson Reuters

Volatility can be expected to rise during times of stress or uncertainty, which may cause NABPE to trade below par at some stage. As a result, we recommend investing with the intention of holding to maturity.

Overall, given the reasonably low structural, maturity and conversion risks, we expect volatility to be relatively low in the period to maturity.

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Summary of Key Investment Risks identified in the prospectus

Investment in NABPE is an investment in NAB and may be affected by the ongoing performance, financial position and solvency of NAB. NABPE are not guaranteed by any Australian government, government agency or compensation scheme of Australia or any other jurisdiction.

Fluctuating interest payments

The interest rate is calculated for each distribution period by reference to the 90-day Bank Bill Swap Rate, which is the rate at which major Australian financial institutions lend short term cash to each other over a 90-day period. This rate is influenced by a number of factors and varies over time. As a result of movements in the underlying bank bill swap rate, the level of interest rate payments will vary over time and may become less attractive. If the bank bill rate becomes negative, the negative amount will be taken into account in calculating the interest rate, but under no circumstance will holders have an obligation to make payments in respect of interest to NAB on account of a negative bank bill rate.

Interest payments may not be paid

NAB is not required to make an interest payment should it fail to satisfy the solvency condition. In this situation, a missed payment does not constitute an event of default, however any unpaid interest remains a debt payable to the holder by NAB and will be payable on the first date on which the solvency condition is satisfied.

Additionally, NAB's obligations to make payments in respect to the Notes will cease and holders will have no right to recover any unpaid amounts in the event of non-viability.

Liquidity

The market for NABPE may not be liquid and may be less liquid than that of equity. If liquidity is low, there is a risk that, if investors wish to sell NABPE, they may not be able to do so at an acceptable price or at all.

Volatility

The market price of NABPE may fluctuate due to various factors including; changes to general market and economic conditions, investor sentiment, interest rates, credit spreads, NAB's financial position and credit rating, movements in the market price of NAB ordinary shares or senior or subordinated debt, the perception of or likely occurrence of a Non Viability Trigger Event. The Notes may trade below par at some stage, and accordingly, may not be suitable for short term investors.

Uncertain maturity date

NAB may elect to (subject to APRA approval) redeem the Notes on 20 September 2023 and on any interest payment date thereafter, or following the occurrence of a tax or regulatory event. Redemption may occur on dates not previously contemplated by holders.

Conversion following a non-viability trigger event

NAB must immediately convert all or some NABPE into ordinary shares if a non-viability trigger event occurs. As a result of the maximum conversion number, if a non-viability trigger event occurs NABPE holders may receive less than $101/note if NAB ordinary shares are trading below 20% of the issue date VWAP. Furthermore, NABPE holders would subsequently rank equally with ordinary equity in a winding-up. If a conversion is not effected within five business days, then holder's rights will be terminated and the Notes will be written off.

Ranking of NABPE in a winding-up

NABPE are subordinated and unsecured capital securities. If, after the claims of holders of senior ranking obligations, creditors preferred by law and secured creditors are satisfied there are insufficient assets to pay all amounts owing on NABPE, there is a risk that investors may lose some or all of the money invested in NABPE. Upon conversion (if converted), holders will become holders of ordinary shares of NAB and rank equally with other holders of ordinary shares.

Regulatory classification

APRA has confirmed that NABPE, once issued, will qualify as Tier 2 capital under Basel III prudential standards. However, if APRA subsequently determines that all or some of the Notes are not or will not be treated as Tier 2 Capital as a result of a change in law or a change in APRA's prudential standards, NAB may decide a Regulatory Event has occurred, which will allow NAB to redeem the Notes at NAB's discretion (subject to APRA approval).

Tax consequences

If there is a change in tax laws and that has a materially adverse tax consequence for NAB in relation to NABPE, then NAB may redeem NABPE earlier than expected by investors (subject to APRA approval).

Changes in control of NAB

The terms do not contain any provisions to protect the position of holders in the event of a change in control. There is therefore a risk that NABPE holders may be affected by merger and acquisition activity affecting NAB. By contrast, some other securities provide for mandatory conversion of notes into ordinary shares if there is a takeover of the issuing company.

NAB may issue further securities

NAB may raise more debt and issue further securities which rank equally or ahead of NABPE, which may affect a holder's ability to be repaid on a winding up of NAB.

Property exposure

Residential and commercial property lending constitute important businesses to NAB. A decrease in property valuations in Australia or other markets could materially and adversely impact the group's financial condition

Systemic Credit Risk

Although credit risk has been assessed by Lonsec it does not encompass systemic effects such as the global financial crisis. Instability in debt markets would pressure financing costs and increase refinancing risk.

Investors should refer to Section 7 of the Prospectus for further details of the risks associated with NABPE.

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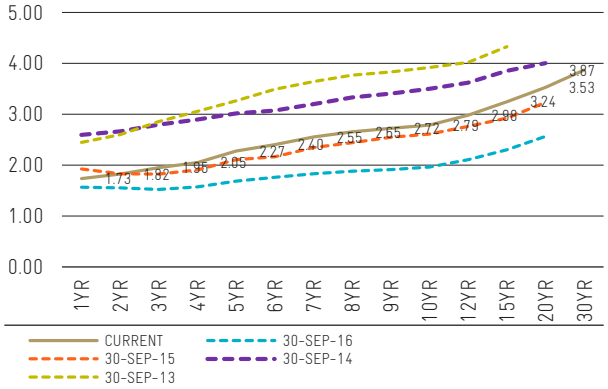
Yield Curve and Market Outlook

Chart 9. Yield curve



Source: Lonsec, Thomson Reuters

Cash Rate

The RBA maintained the cash rate at a record low of 1.50% in its December meeting, with slow economic growth and low inflation the primary catalysts. Monetary policy remains accommodative both locally and globally, although policy is beginning to tighten in some developed economies.

After gaining momentum in early 2016, the Australian economy unexpectedly contracted 0.5% in 3Q16 - its first negative growth since 1Q11 and the fastest fall since 4Q08 – dragged down by lower investment and net trade. Whilst the economy may have gained some momentum in the fourth quarter, growth on the year was probably closer to 2% than the 2.75% pace that is seen as the potential growth rate. Accordingly, employment growth has slowed and subdued wage growth suggests inflationary pressures will continue to remain low, and below the RBA's 2-3% target, for some time. Whilst improved terms of trade provide a tailwind into 2017, we see downside risks to economic growth coming from an earlier than expected housing downturn, the Government's focus on austerity and maintenance of its AAA rating, rising US and China tensions, and rising USD, which will pressure Australia's dependence on foreign capital.

However, it is clear the RBA is in no rush to ease policy given its concerns over the current high levels of household debt, house prices and focus on financial stability. The return of double-digit house price growth (CoreLogic RP Data reported annualised 10.9% growth in December) and strong household credit are the key challenges to lower rates from here.

Overall, the RBA is attempting to "balance the benefits of lower rates in supporting growth and achieving inflation target with the potential risks to household balance sheets". Reluctance to further fuel the housing market will likely see the cash rate on hold in 1H17, although additional 'out-of-cycle' rate rises from banks may necessitate a lower cash rate simply to maintain the status quo.

Yield Curve

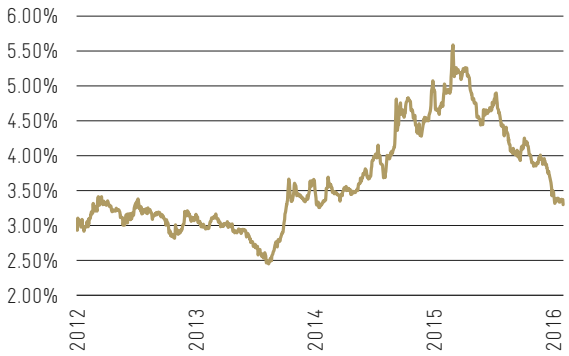
The global economy finished 2016 on a relatively upbeat note with all major regions experiencing a recovery in activity and a modest lift in inflation. The new US administration under Donald Trump is expected to implement a number of pro-growth fiscal policies, including tax cuts, infrastructure spend and reduced regulation, despite the US economy already operating at near full employment, near target core inflation, accommodative monetary policy and near record Government debt/GDP levels. Accordingly, the Federal Reserve raised the federal funds target rate by 25bps in December 2016, and has guided for three 25bps increases over each of the next three years, to reach a sustainable rate of around 3% in 2019. Whilst there are risks to these forecasts, and it is possible President Trump's proposed policies are 'watered down' and subject to lengthy delays, it is prudent to expect both short and long term rates to rise in the US, and lead to an increasing interest rate environment globally.

Growth has also recovered in Europe, with German GDP estimated to have expanded 1.9% in 2016 — the best annual rate of growth since 2011. Growth in the UK surpassed expectations, while the lower yen is supporting growth and inflation expectations in Japan.

Accordingly, global yields are rising and rotation away from traditional 'defensive' sectors has seen fixed rate bonds and yield sensitive equities underperform. Whilst the prospect of increased US protectionism, an escalation in tensions between the US and China and the rise of populist parties across Europe could introduce more volatility into markets and uncertainty over growth prospects, it is prudent to expect a gradually rising yield curve.

Credit Spreads

Chart 10. Major Bank AT1 Credit Spreads



Source: Lonsec, Thomson Reuters

Major bank Tier 1 (AT1) credit spreads tightened 127bps in calendar year 2016, helping the sector to generate a strong 9.5% return (ex-franking) in the calendar year. The strong returns can be attributable to generally improved risk sentiment, delays to Basel IV implementation (lower supply outlook), Trump led fiscal stimulus upgrades to global inflation and growth prospects (therefore improving bank margins) and corresponding rotation from traditional fixed interest into equities and floating rate debt that will generally perform strongly in the initial phases of a rate rise cycle.

Lonsec continues to expect the yield curve to normalise in 2017, but are conscious short term rates in Australia will remain low. Tier 1 credit spreads are now ~0.5 standard deviations below their 4-year average, suggesting valuations are becoming stretched. It is possible credit spreads will widen in the coming quarter, with February reporting season, rising USD and US & China tensions shaping as potential sources of volatility. Nevertheless, the floating rate structure of the hybrid market (low duration), should lead to outperformance vs traditional fixed income securities as the yield curve normalises.

Unlike 2016, the issuance outlook for 2017 appears scarce, with only one major bank AT1 (ANZPC) scheduled for call in September, while Challenger Limited (CGF) have

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previously announced their intention to raise AT1 capital prior to the end of the financial year. It is possible ANZ will consider bringing forward the ANZPC refinancing into 1H17, particularly if spreads remain low. A number of transitional Tier 2 instruments and industrial subordinated notes are scheduled to be called, though recent trends have seen these security types redeemed and replaced in the unlisted market. Basel IV finalisation and expected implementation in 2019, the potential implementation of Total Loss Absorbing Capacity requirements and a greater number of maturities in 2018 suggests primary issuance will accelerate in calendar 2018.

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Appendix: Lonsec's Listed Income Research Methodology

Lonsec's listed income research follows a structured framework to derive an investment rating and risk assessment. The investment rating is, much a like a credit rating, a long term assessment which remains relatively static, though will be upgraded or downgraded should our 'investment grade' view change. The risk assessment is more dynamic, and may vary more frequently throughout the term of the issue. In forming our investment rating we have assumed that positions are held to maturity and therefore will continue investment coverage through to maturity.

Investment Rating

Each listed income investment under coverage is assigned either an 'Approved' or 'Not Approved' rating:

Approved

The 'Approved' rating indicates that Lonsec believes the security is of 'Investment Grade' quality, meaning we believe the security will pay all distributions in the term to call and holders will receive face value on maturity, such that the income potential outweighs the potential risks.

Not Approved

The 'Not-Approved' rating indicates that Lonsec believes the security is not of 'Investment Grade' quality, meaning we believe the potential risks outweigh the long term income potential of the security.

These ratings are made with reference to the Lonsec risk assessment, which is discussed below, and with consideration to the relative attractiveness of the expected return. The potential return refers to the interest margin on offer over the relevant benchmark rate and any other investment return which may include conversion discounts, in-built call options, entitlements to IPOs and future step-ups in the margin.

Risk Assessment

The six risk categories identified and assessed (in order of importance) are

Financial

The financial strength of the issuer is examined according to the sector in which the company operates. This is primarily designed to ensure the analysis represents a true reflection of the issuer's financial strength and to take account of the fact that banks and insurance companies have very different financial structures than traditional industrial companies. Specifically, the key indicators analysed include balance sheet strength, wholesale credit rating, capital adequacy ratios, interest cover, asset quality, liquidity, net tangible assets, gearing and earnings quality.

Structure

The risks inherent in any listed income security can vary significantly based on the security structure. To assess structure risk, Lonsec examines subordination/capital classification, distribution payment tests, distribution restriction conditions and conversion conditions.

Maturity

The risks associated with the maturity structure of the issue are examined in detail and a relevant risk rating assigned. One of the key factors in the market's pricing of a listed income security is the maturity terms and conditions, as these determine the 'how' and 'when' the invested capital is returned to the investor. Lonsec forms a view on the expected maturity date of each security, having considered the maturity and/or conversion terms, the financial capacity of the issuer, the ascribed equity credit and the significance of the size of the issue to the issuer.

Liquidity

Liquidity risk is the risk that an investment may not be easily converted into cash with little or no discount to the last traded market value, and at minimum delay. A liquidity premium should be required by investors to compensate for lack of liquidity. Low liquidity can also result in higher than desired volatility. Key attributes analysed to rate liquidity include issue size and average weekly turnover.

Industry

Structural and operational risks associated with the industry in which the company operates can impact the financial position and prospects of the issuer, and hence the performance of the listed income security. Industry analysis involves consideration of the following factors: current and forecast industry conditions, domestic and global economic outlook and its expected impact on the industry, regulatory risks, the company's positioning and pricing power within its industry, the power of suppliers and buyers, as well as the life cycle stage of the industry.

Volatility

Volatility measures how much the market value of an issue fluctuates with respect to its face value over the life of the issue. Volatility is often viewed negatively in that it represents uncertainty, however, it can also provide the potential for higher returns. Both capital and income will contain some degree of volatility depending on the nature of the underlying investment. Our assessment of expected volatility takes into consideration a number of metrics including issuer strength, economic and credit market conditions, investor sentiment, equity market conditions, the perception of or likely occurrence of distribution deferral or a conversion trigger, capital ranking/structure, liquidity, conversion terms, maturity risk and the volatility of listed peers.

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Following an assessment of the risks and metrics described above, a risk assessment score is assigned to each of the six risk categories. The risk scores are assessed on a scale of 1 to 5, with 1 implying low risk and 5 high risk. Adding the scores of each category derives a total assessment score out of 80, which represents the overall risk assessment for the security. Out of the six risk categories, Financial risk is the heaviest weighted category and accounts for 43.75% of the total risk score. Structural risk follows with a weighting of 25.00% and Maturity risk at 12.50%. Liquidity, Industry and Volatility risks are the lowest weighted categories at 6.25% each.

The risk rating categories range from Low to Speculative, and are described below:

Low

A low risk assessment indicates that a majority of the risks are rated as low and the overall risk score is below 34 which indicates strong credit quality.

Moderate

A moderate risk assessment indicates that a majority of the risks are rated as moderate and the overall risk score is between 35 and 50 which indicates good credit quality.

High

A high risk assessment indicates that a majority of the risks are rated as high and the overall risk score is between 51 and 69 which indicates low credit quality.

Speculative

A speculative risk assessment indicates that a majority of the risks are rated very high and that the overall risk score is between 70 and 80 which indicates the issue is below investment grade and has speculative qualities.

Risk rating categories (example only)

	LOW	MODERATE	HIGH	SPECULATIVE
FINANCIAL		●		
MATURITY			●	
STRUCTURE	●			
LIQUIDITY		●		
INDUSTRY	●			
VOLATILITY			●	
RISK PROFILE		●		

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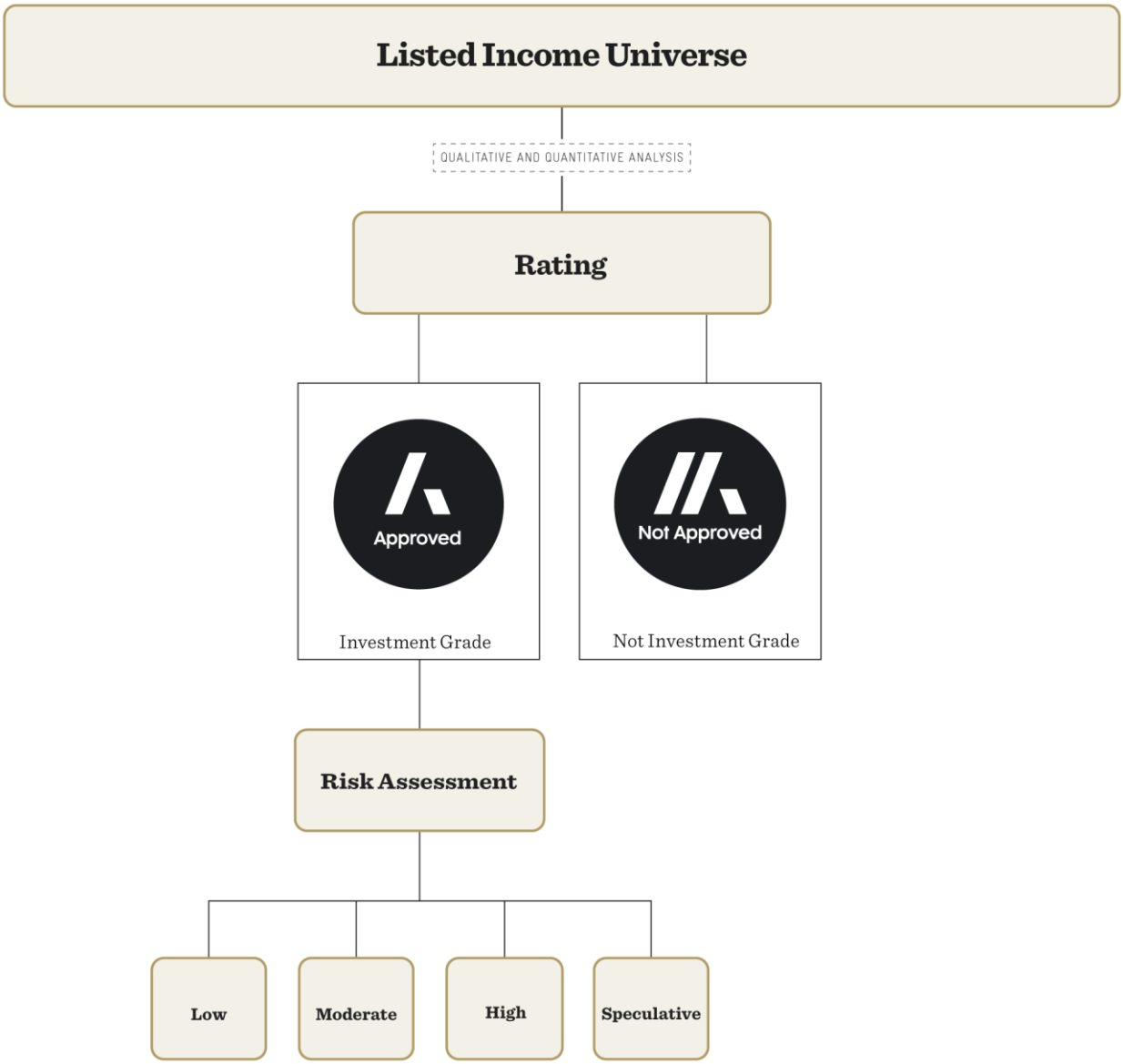

For further information on Lonsec listed income research, see the Lonsec Listed Income Investment Journal.

Lonsec

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Important Notice

The following relate to material presented in this document published by Lonsec Research Pty Ltd ABN 11 151 658 561 ("Lonsec") and should be read before making any investment decision.

Date prepared

Tuesday, 7 February 2017

Analyst

Matthew Asquith

Release authorised by

William Keenan

Lonsec listed income risk rating spread

	NUMBER	%
LOW RISK	5	9%
LOW-MODERATE RISK	1	2%
MODERATE RISK	29	54%
MODERATE-HIGH RISK	12	22%
HIGH RISK	7	13%
HIGH-SPECULATIVE RISK	0	0%
SPECULATIVE RISK	0	0%
TOTAL	54	100%

Lonsec listed income recommendation spread

	NUMBER	%
APPROVED	50	93%
NOT APPROVED	4	7%
TOTAL	54	100%

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