Lonsec

Lonsec Income Investments

CommBank PERLS VIII Capital Notes (CBAPE)

16-02-2016 | Lonsec Research Pty Ltd ABN 11 151 658 561 AFSL 421 445

Lonsec Income Investments
CommBank PERLS VIII (CBAPE)

Approved

Risk rating categories

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

Key details

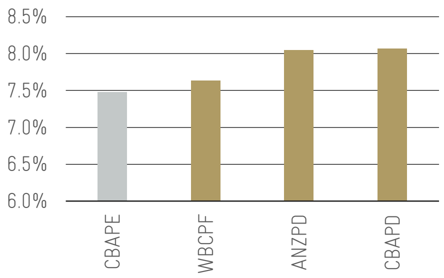
ISSUE NAME	COMMBANK PERLS VIII (CBAPE)
ISSUER	COMMONWEALTH BANK OF AUSTRALIA (CBA)
ISSUE FEATURES	FULLY PAID, CONVERTIBLE, NON-CUMULATIVE, PERPETUAL, UNSECURED & SUBORDINATED
FACE VALUE	$100
ISSUE SIZE	$1.25BN, WITH THE ABILITY TO RAISE MORE OR LESS
DISTRIBUTION RATE	INDICATIVE MARGIN[1] OF 5.20-5.35% P.A. OVER 90-DAY BANK BILL RATE. INITIAL CASH YIELD OF 5.24-5.34%[2] P.A. OR 7.49-7.64% P.A GROSSED-UP FOR FRANKING CREDITS
DISTRIBUTION FREQUENCY	QUARTERLY
FRANKING	CURRENTLY 100%
OPTIONAL CALL DATE	15 OCTOBER 2021
MANDATORY EXCHANGE DATE	15 OCTOBER 2023
MINIMUM APPLICATION SIZE	$5,000 (BEING 50 NOTES)

1 Margin to be set at bookbuild on 23 February 2016
2 Based on 90 Day BBSW of 2.285%

Capital Ranking / Security Type

DEPOSITORS, SECURED DEBT	
SENIOR/UNSUBORDINATED DEBT	
SUBORDINATED DEBT	
PERPETUAL PREFERENCE SHARES	●
ORDINARY EQUITY	

Gross yield to call for listed peers



Important Dates

BOOKBUILD DATE	23 FEB 2016
OPENING DATE	24 FEB 2016
CLOSING DATE	18 MAR 2016
COMMENCEMENT OF TRADING	31 MAR 2016
FIRST DISTRIBUTION DATE	15 JUN 2016

Approved – Moderate Risk

CommBank PERLS VIII Capital Notes (CBAPE) are convertible, subordinated and unsecured capital notes issued by Commonwealth Bank of Australia (CBA). The Notes are expected to pay quarterly, fully-franked distributions based on an issue margin of 5.20-5.35% over the 90-day floating Bank Bill Rate, implying an initial cash yield of 5.24-5.34% or 7.49-7.64% grossed-up for franking credits. CBAPE is technically perpetual, though Lonsec expects the Notes to be redeemed for face value on 15 October 2021, being an expected term of 5.5 years. Proceeds from the offer will be used to satisfy regulatory capital requirements, including the replacement of PERLS III (PCAPA) which have a 6 April 2016 call date. The Notes are being issued after a period of rising credit spreads, and will therefore have the highest issue margin of all major bank Additional Tier 1 (AT1) securities and a cash yield that is at least 60bps above peers. Whilst it is possible that credit spreads continue to rise in the short term, we view the heightened volatility as an opportunity for patient investors. We have assigned CBAPE an 'Approved' rating, meaning we expect the Notes to pay all distributions and for holders to receive face value on maturity.

Financial risk – Low

CBA is a high quality issuer with a strong regulatory capital position, low impairments, a stable investment grade credit rating and a proven track record of earnings and dividend growth. Customer deposits provide the majority of group funding, thus reliance on less stable wholesale funding has steadily reduced. The pro forma Common Equity Tier 1 capital ratio of 9.2% provides a comfortable buffer to the 8.0% regulatory requirements and CBAPE's 5.125% capital trigger. Asset quality metrics remain strong, though we suspect credit metrics have peaked. Rising impairments are shaping up as the key risk to earnings, however, this doesn't appear likely in the short term as asset quality is supported by low interest rates and low unemployment, while resources exposure is low. We were pleased with 1H16 earnings which increased 4% to $4.8bn, and whilst we suspect earnings growth will slow, we are comfortable with CBA's financial position & outlook and accordingly assign it a Low financial risk rating.

Structural risk – Moderate to High

CBAPE are low ranking capital notes issued by CBA, through its New Zealand branch, which are classified as AT1 capital. They are not deposit liabilities and are therefore not protected by the government guarantee, nor are they secured against any asset of CBA. The Notes rank for payment of distributions and return of capital in a winding-up of CBA ahead of ordinary shares and equally with other perpetual AT1 securities, but behind the claims of all senior ranking creditors. Distributions are discretionary, though are expected to be paid quarterly at an indicative margin of 5.20-5.35% over the floating 90-day Bank Bill Swap Rate. Distributions are also expected to be fully franked. Non-payment of a distribution will not be an event of default. Distributions that are not paid will not subsequently be paid, however, a dividend stopper applies, meaning if distributions are not paid on CBAPE, CBA cannot pay a dividend on ordinary shares or return any capital to shareholders, until a distribution is paid in full on a subsequent distribution payment date, or until CBAPE are exchanged or redeemed. Lonsec believes the probability of a missed distribution to be low, and expects for all distributions to be paid over the term to call date.
The Notes are structured with a capital and non-viability trigger which are designed to protect CBA's solvency during times of financial stress. The trigger clauses require for automatic exchange into ordinary equity (without regard for the mandatory exchange conditions) should CBA's Common Equity Tier 1 ratio fall to or below 5.125%, or APRA rule that exchange is necessary because without it CBA would become 'non-viable'. Because of the maximum exchange number, CBAPE investors would receive less than $101/share on conversion if CBA's share price is less than ~$15 (i.e. ~80% below the current share price) at the time of automatic exchange. If a capital trigger or non-viability trigger event occurs and conversion of CBAPE is not effective for any reason, the Notes will be terminated and holders will incur a principal loss. However, Lonsec regards this as an unlikely scenario within the term to call.

Maturity risk – Moderate

CBA has the option to redeem (subject to APRA approval) or resell CBAPE for $100 cash on 15 October 2021, or at any time following the occurrence of a tax or regulatory event. If the Notes have not been exchanged beforehand, CBA must exchange CBAPE into $101 worth of ordinary shares on 15 October 2023, provided that the mandatory exchange conditions are satisfied (see pg. 7). If the exchange conditions are not satisfied on 15 October 2023 (which would require CBA ordinary shares to be trading 44% below the issue date VWAP, or below ~$42), conversion will be deferred until the next scheduled distribution payment date when the exchange conditions are satisfied, and as such the Notes are technically perpetual with no hard maturity date. Lonsec believes this is unlikely to occur and expects CBAPE to be redeemed for face value on 15 October 2021, subject to CBA's capital position and prevailing credit spreads. Holders cannot request redemption; however, investors seeking liquidity can sell on-market.

Liquidity risk – Low

CBAPE is expected to have a $1.25bn issue size, which should support weekly turnover of $3-5m.

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 reasonably profitable with net interest margins holding above 2% and return on equity of ~15%. 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 regulators enhance the industry's ability to withstand economic shocks. It is the intention of the regulator to have Australia's banks rank within the top quartile of internationally active banks in terms of capital strength.

Volatility risk – Moderate

Lonsec expects CBAPE to exhibit moderate volatility over the term of the issue. We attribute this to the Notes' low ranking capital status and capital / non-viability triggers, which may result in CBAPE being moderately positively correlated to CBA's equity price. The reasonably high issue margin should offer some protection from volatility, though CBAPE may still trade below the issue price at some stage, and may therefore not be suitable for short term investors.

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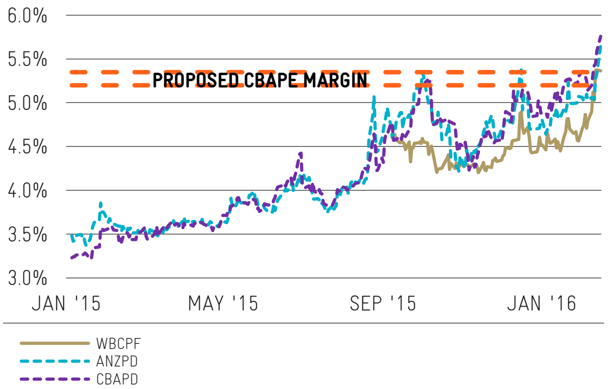
Relative Value

Lonsec considers Westpac Capital Notes 3 (WBCPF), ANZ Capital Notes (ANZPD) and CBA PERLS VII (CBAPD) to be the closest comparable securities to CBAPE.

- WBCPF has traded on a 5-day average trading margin of 5.25%.
- ANZPD has traded on a 5-day average trading margin of 5.27%.
- CBAPD has traded on a 5-day average trading margin of 5.51%.

The below chart plots the trading margin of CBAPE's closest peers against the indicative 5.20-5.35% issue margin.

Chart 1. Trading margins for comparable securities

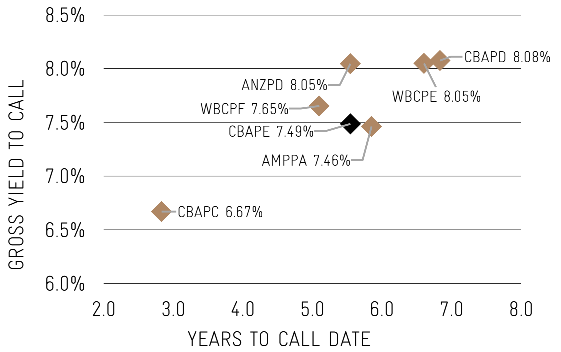


Source: Lonsec, Iress

Trading margins have increased significantly since late 2014, the margin on PERLS VII (CBAPD) having climbed 104% (from 2.80% to 5.71%) since issuance in September 2014. Wider spreads can be attributed to a number lingering concerns, notably slowing domestic and global economic growth, debt servicing worries for emerging economies, concern about a devaluation of the Chinese Yuan, tightening bank interest margins and worries about troubled resources/energy loan exposure. More specifically for the AT1 market, the prospect of further interest rate cuts (acknowledging that AT1 distributions are linked to a floating BBSW), increased issuance due to higher regulatory requirements and book growth, volatile wholesale credit markets, and selling pressure to fund bank equity entitlement offers have also had an influence. Accordingly, CBAPE is being issued with an issue margin range of 520-535bps, which as per the above chart, is in line with current trading margins.

To give this margin some historical perspective, PERLS VI (CBAPC) was CBA's first ever listed Basel III compliant AT1 security. It was listed in October 2012 at a margin of 3.80%, and since that time has traded at an average margin of 3.20%. Its current trading margin is 4.38%. PERLS III (PCAPA), which is being replaced with PERLS VIII (CBAPE), listed in April 2006 at a margin of 1.05% and has traded at an average margin of approximately 3.8%. From January 2008 to April 2009 PCAPA's average margin was 3.9%, however it reached a high of 11.9% in March 2009. We note though that comparing the two securities is imperfect given their structural and margin differences.

Chart 2. Grossed-up yield to call date



Source: Lonsec, Iress

As per Chart 2 above, slightly superior gross returns are obtainable by purchasing an already listed security that is trading below par, such as CBAPD or ANZPD. However, there is a capital component to that return which may be received over time or at some point in the future, whereas CBAPE provides investors a more attractive and upfront cash return now. In other words, CBAPE's cash yield is 107bps above CBAPD and 83bps above ANZPD, though gross YTC is similar. Similar high issue margins have benefited recent IPO's AMP Capital Notes (5.10% issue margin, last price $100.90) and Macquarie Capital Notes 2 (5.15% issue margin, last price $97.98), which have outperformed the broader sector since their listing. Overall, we believe CBAPE to be appropriately priced for the current environment and its risk assessment. We acknowledge it is possible that CBAPE will trade below par should credit spreads continue to widen, but also believe current spreads are providing attractive yield opportunities for patient long term investors.
We have assigned CBAPE an 'Approved' rating, meaning we expect the Notes to pay all distributions in the term to call and for holders to receive face value on maturity.

Table 1. Comparable Securities

	CBAPE	CBAPD	WBCPF
SECURITY TYPE	CAPITAL NOTE	CAPITAL NOTE	CAPITAL NOTE
ISSUE MARGIN	5.20 – 5.35%	2.80%	4.00%
OPTIONAL EXCHANGE DATE	OCTOBER 2021	DECEMBER 2022	MARCH 2021
SCHEDULED CONVERSION DATE	OCTOBER 2023	DECEMBER 2024	MARCH 2023
CAPITAL TRIGGER	5.125% CET1	5.125% CET1	5.125% CET1
NON-VIABILITY TRIGGER	YES	YES	YES
RESET TRADING MARGIN	5.20 – 5.35%	5.79%	5.37%
CASH RUNNING YIELD	5.24 – 5.34%	4.17%	4.63%
GROSS YIELD TO CALL	7.49 – 7.64%	8.08%	7.65%

Source: Lonsec, Iress at 15 February 2016

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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 CBA as a high quality issuer with a stable investment grade credit rating & outlook, a good regulatory capital position, strong market position, low impairments and a proven track record of earnings and dividend growth. It is the leading major Australian bank in terms of profitability, and Lonsec's preferred banking exposure. Earnings and capital levels are sensitive to general macroeconomic and financial market conditions, as well as regulatory change. Key earnings risks for CBA (and banks in general) include increased bad debts and higher funding costs, which would likely stem from a domestic economic slowdown, lower asset prices and/or systematic deterioration. While we believe impairments will inevitably revert higher, which will slow future earnings growth, this doesn't appear likely in the short term as asset quality is supported by low interest rates and low unemployment, and low resources exposure.

Overall, we are comfortable with CBA's financial position and outlook and accordingly we assign it a Low financial risk rating.

Issuer Summary

CBA is Australia's largest major bank and Australia's largest company by market capitalisation. It provides a range of banking & financial services and products to retail, small business, corporate and institutional clients. Principal activities include lending, deposit taking, superannuation and funds management, insurance, foreign exchange services, financial advisory and margin lending which are delivered through recognised brands including CBA, Colonial First State, CommSec and Bankwest. Operations primarily span Australia and New Zealand, which generate ~95% of group income, and also UK, US, Japan and Singapore a number of countries in the Asia Pacific region. CBA services approximately 16m customers, and holds a leading 25% market share of the Australian mortgage market and 29% market share of the Australian deposits market.

The products and services provided by the Group are grouped into seven key business divisions, being:

Retail Banking Services (45% of group earnings) offers residential mortgages, deposits, transaction banking etc. to meet the banking needs of personal and small business customers.

Business and Private Banking (17% of group earnings) services CBA's small-medium enterprise customers, as well as personal and institutional online trading customers.

Institutional Banking and Markets (13% of group earnings) provides a range of capital raising, transactional and risk management products and services for corporate, government and institutional clients.

New Zealand (9% of group earnings) includes banking, funds management and insurance businesses operating in NZ.

Wealth Management (8% of group earnings) includes global asset management, platform administration, life and general insurance businesses.

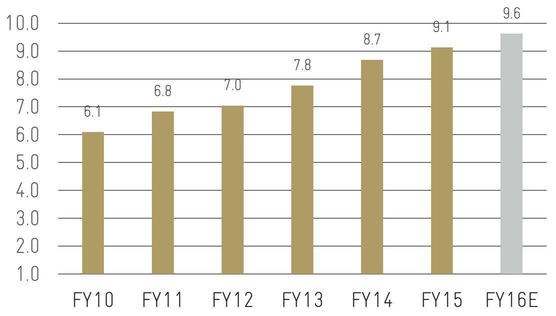
Bankwest (8% of group earnings) is a full service banking division.

International Financial Services (0% of group earnings) incorporates CBA's Asian retail and small-medium enterprise banking operations.

Profitability

CBA reported 1H16 cash profit of $4.8bn, up 4% and ~1% above consensus estimates. Net interest income increased 6%, reflecting 9% growth in interest earning assets that was partially offset by a 5bps contraction to NIM to 2.06%. The 6% increase in operating expenses, mainly on higher staff and IT spend, was disappointing and saw cost-to-income stable at 42.2%. Loan impairment expenses increased 3% on 2H15, with higher loan losses experienced in WA & QLD (driven by deteriorating mining towns) while institutional banking and NZ dairy provisions were increased. However, as a percentage of total loans impairments remain benign at 17bps which is well below long term averages. EPS growth (+1%) trailed profit growth (+4%), and ROE contracted 140bps to 17.2% due to the increased equity base following September's $5.1bn capital raising. 1H DPS of $1.98 is unchanged and represents a payout ratio of 71%. Overall, this was a pleasing result and CBA continues to deliver moderate earnings growth despite numerous sector headwinds. Analyst consensus is for CBA to report a FY16 cash profit of $9.6bn, up 5.2% on FY15. Earnings have grown at a compounded annual rate of 8.4% since FY10, though we suspect earnings growth over the medium term will be slower with headwinds coming from more onerous capital requirements, normalization of impairment charges and NIM pressure.

Chart 3. CBA Full Year Cash Earnings ($bn)



Source: CBA, Lonsec

Asset quality

Asset quality is strong with low interest rates, asset price growth, generally healthy business balance sheets and more conservative lending practices helping to keep troublesome and impaired assets low. The loan impairment expense did rise in 1H16, mainly due to higher provisioning in Institutional Banking and Markets and an increase in home loan arrears and losses in WA & QLD, though as a percentage of gross loans and acceptances impairments remains very low at just 17bps. By way of reference, the loan impairment expense ratio was 73bps in FY09. Similarly, gross impaired assets as a percentage of gross loans is low at 0.41%, and loans 90+ days past due but not impaired as a percentage of gross loans fell 4bps to 0.30%. Given the quality of the loan book, collective provisioning has lowered to 0.84%.

Credit Risk

As at 31 December 2015, CBA had total gross credit risk exposures of $956bn, with a bias towards residential mortgage lending. Australian residential mortgages account for 48% of CBA's total credit exposures, which is

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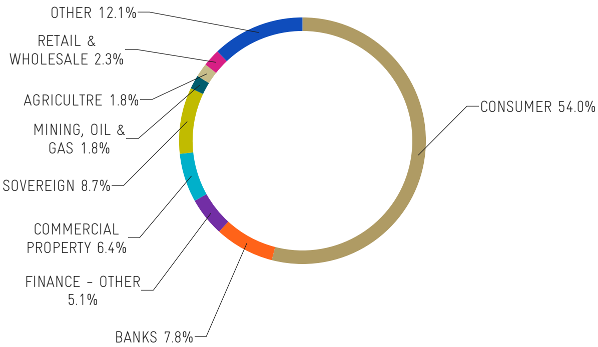
generally higher than US & UK banks, and in part reflects Australia's above average home-ownership desires and increase in household leverage. We consider CBA's Australian mortgage portfolio to be relatively low risk, given the low portfolio dynamic LVR of 50% and bias towards owner occupied lending, which is 62% of the portfolio. The low average LVR provides a buffer should the domestic housing market deteriorate. Approximately 78% of Australian mortgage customers are ahead of scheduled repayments, and mortgage delinquencies are low having been supported by low mortgage rates and reasonable employment. The majority of mortgages are variable rate loans, and CBA applies a 2.25% serviceability buffer for new variable rate lending. This means mortgage customers should be able to service higher interest rates should interest rates return to normal levels, however higher interest rates is still likely to lead to higher delinquencies. Investment property loans represent 33% of the Australian mortgage portfolio.
In terms of corporate lending, exposure to the mining, oil and gas sector is low at 1.3% of total committed exposures, though we expect conditions to remain challenging in the near term. Finance, commercial property and governments are the other major sector exposures.

Chart 4. Credit Exposure by Industry



Source: CBA, Lonsec

Funding and liquidity profile

CBA 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. CBA's funding approach is focussed on attracting retail deposits, which at 31 December 2015 accounted for 64% of total funding composition. The remaining 36% of total funding is comprised of various wholesale debt issuances, the weighted average maturity of outstanding long term wholesale debt being 3.9 years.

Liquid assets total $139.7bn, which according to CBA, is sufficient to cover all short term liabilities, including repaying deposits, when they fall due. The liquidity coverage ratio was 123% at 31 December 2015, up from 116% on the pcp, and above the 100% minimum imposed by APRA.

Whilst Lonsec is comfortable with CBA'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 CBA'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 CBA's business, financial performance and capital position.

Capital position

CBA is regulated by APRA and other regulatory bodies which require CBA 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 CBA and the major banks, the intention being to set capital standards such that Australian Authorised Deposit Taking Institutions are 'unquestionably strong' and within the top quartile of internationally active banks. Accordingly, from 1 January 2016 APRA requires the major banks to maintain a Common Equity Tier 1 Capital Ratio equal to 8.0% of risk-weighted assets, and from 1 January 2018 a minimum leverage ratio requirement will be introduced. Whilst regulatory reforms are ongoing, CBA raised $5.1bn of equity capital in September 2015 to satisfy current and future requirements, which helped increase its CET1 capital ratio to 10.2% as at 31 December 2015. Pro-forma APRA's changes to risk-weighted asset weights, which become effective 1 July 2016, CBA's CET1 capital ratio is 9.2%. This level of capital is in line with management targets, comfortably above 8.0% regulatory minimums and the 5.125% CBAPE Capital Trigger level. In dollar terms, as at 31 December 2015 CBA has $8.8bn of capital above current regulatory requirements, and $20.1bn of capital above CBAPE's Capital Trigger level. Should these levels be threatened in the future, CBA's ability to pay distributions and dividends will be restricted, and we would expect management to take to take steps to restore its capital position.

We stress that whilst higher capital requirements are creating headwinds for EPS growth (negative for equity holders), they are a positive for the credit profile of CBA the banking sector, and therefore debt (and hybrid) holders. 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, CBA is likely to target a higher capital level in the future, which if implemented, will add further stability to CBA and lower the probability of a Common Equity Capital Trigger Event occurring.

Conclusion

Lonsec considers CBA to be a good quality issuer with a good regulatory capital position, strong market position, low impairments and a proven track record of earnings and dividend growth.

CBA is exposed to the risk of higher impairments if the global economy (and in particular the Australian economy) were to slow significantly, however we note the higher capital requirements imposed under the Basel III reforms and FSI recommendations enhance the group's ability to withstand economic shocks.

Based on current market expectations of mid-single digit earnings growth, we are comfortable in the company's ability to pay distributions over the term of the issue, and expect CBA to be in a position to repay CBAPE holders their face value on maturity.

Accordingly, we assign a Low financial risk rating.

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Structural Risk — Moderate to High

CBAPE are fully paid, subordinated, unsecured, non-cumulative, convertible, redeemable, perpetual capital notes issued by Commonwealth Bank of Australia (CBA), through its New Zealand branch, which qualify as Additional Tier 1 equity capital for the purposes of CBA's regulatory capital requirements. The Notes are not deposit liabilities and are therefore not protected by the government guarantee, nor are they secured against any asset of CBA.

Capital Ranking

CBAPE rank senior to common equity, equally with other Additional Tier 1 securities and below senior creditors and deposit holders. However, the ranking of holders in a winding of CBA will be adversely affected as it is likely that a Non-Viability or Capital Trigger event will have occurred, in which case the Notes will be exchanged into ordinary equity, and holders will rank for payment equally with other CBA shareholders.

Table 2: Capital Structure

RANKING	CAPITAL TYPE	DESCRIPTION
HIGHER RANKING	PREFERRED AND SECURED DEBT	DEPOSITS, EMPLOYEE ENTITLEMENTS, LIABILITIES PREFERRED BY LAW
	UNSUBORDINATED & UNSECURED DEBT	BONDS AND NOTES, TRADE AND GENERAL CREDITORS
	SUBORDINATED & UNSECURED DEBT	FIXED TERM SUBORDINATED DEBT
	ADDITIONAL TIER 1 CAPITAL SECURITIES	PERPETUAL CAPITAL NOTES & PREFERENCE SHARES E.G. CBAPE
LOWER RANKING	CBA SHARES	ORDINARY EQUITY

Source: CBA, Lonsec

Distributions

Distributions are scheduled to be paid quarterly based on a margin of 520-535bps over the 90-day floating rate Bank Bill Swap Rate. Distribution payments are expected to be 100% franked, though the franking rate may vary over time. To the extent a distribution is not fully franked, CBA will pay an additional amount in cash to compensate the Holder for the unfranked component. Therefore, a lower than 100% franking rate will result in a larger cash distribution with a smaller franking credit attached to the distribution.

The distribution rate is determined quarterly as the sum of the 90 day Bank Bill Rate per annum plus the issue margin, together multiplied by the franking adjustment factor (being 0.70 for a 100% franked distribution).

Distributions are not mandatory and are subject to the absolute discretion of CBA as well as the following payment conditions:

1. Payment will not result in a breach of CBA's regulatory capital requirements;
2. Payment will not result in CBA becoming insolvent; and
3. APRA does not object to the payment.

Non-payment of a distribution will not be an event of default and CBA will have no liability to holders in respect of the unpaid distribution. Distributions that are not paid do not accrue and will not subsequently be paid, however a dividend stopper applies, which prevents CBA from declaring a dividend on ordinary shares, returning any capital or undertaking a buyback of ordinary shares, until a CBAPE distribution is paid in full on a subsequent distribution payment date or until all CBAPE units are exchanged or redeemed. Given CBA's strong financial profile, market position and long history of paying dividends, Lonsec believes the probability of a missed distribution to be low, and expects for all distributions to be paid over the term to call date.

Loss absorption events

APRA's regulatory capital prudential standards aim to ensure banks maintain adequate capital levels to support the risks associated with their activities and can withstand unexpected losses. To that extent, since 1 January 2013 APRA has required capital securities be structured with Capital and Non-Viability Trigger Event terms. The inclusion of such terms is intended to protect CBA's solvency and reduce any future reliance on government bail-outs in times of significant financial difficulties. We note that whilst these features increase the risks to the holder, the risk is somewhat mitigated by the additional capital requirements being introduced by the regulator.

- **A Capital Trigger event** occurs when CBA or APRA determines that CBA's Common Equity Tier 1 Capital Ratio is equal to or less than 5.125%. The Common Equity Tier 1 capital ratio is the ratio of CBA's Common Equity Tier 1 Capital, which includes ordinary equity and retained earnings, to risk-weighted assets. As at 31 December 2015, CBA's Common Equity Tier 1 Capital ratio was 10.2%, which equates to a surplus of approximately $20.1bn above the 5.125% Capital Trigger Event level.
- **A Non-Viability Event** occurs when APRA notifies CBA in writing that it believes conversion of all or some CBAPE (or conversion or write down of other similar instruments) or a public injection of capital (or equivalent support) is necessary because, without it, CBA would become non-viable. Whether or not a Non-Viability Trigger Event will occur is at the discretion of APRA and there are currently no precedents to this. The circumstances in which APRA may exercise its discretion could be expected to include serious impairment of CBA's financial position, insolvency, concern about funding and liquidity levels and inability to raise money in the public or private market.

The occurrence of either event would see CBAPE convert to ordinary shares of CBA without regard to the exchange conditions. Because of the maximum exchange number, CBAPE holders could receive less than $101/note on automatic exchange if CBA's ordinary equity is trading below approximately $15 (being 20% of issue date VWAP). If exchange of the Notes is not effective for any reason within five business days of a Trigger event occurring, all rights in relation to the Notes, including to distributions, will be terminated and Holders will lose all of the value of their investment. However, Lonsec regards this as an unlikely scenario, and expects CBA to pursue other capital management initiatives (such as asset disposals, reduced payout ratio, equity raisings) to protect its regulatory capital position prior to the occurrence of a Trigger event.

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Maturity Risk — Moderate

CBA has the option, subject to certain conditions and APRA prior written approval, to redeem or resell all of the Notes for $100 cash on 15 October 2021, or at any time following the occurrence of a tax event or regulatory event. If the Notes have not been exchanged, resold or redeemed beforehand, CBA must exchange CBAPE into $101 worth of ordinary shares on 15 October 2023, provided that the mandatory exchange conditions are satisfied. CBA is also required to exchange the Notes on the occurrence of a Change of Control Event.

Holders of CBAPE cannot request redemption; however, investors seeking liquidity can sell on-market

Mandatory Exchange Conditions

1. The VWAP of CBA ordinary shares on the 25th business day before (but not including) a potential mandatory exchange date is greater than 56% of the Issue Date VWAP, which is expected to be around $42/share, and
2. The VWAP of CBA ordinary shares during the period of 20 business days before (but not including) a potential mandatory exchange date is greater than 50.51% of the issue date VWAP, which is expected to be around $38/share, and
3. CBA shares are listed or admitted to trading on the ASX as at the Mandatory Exchange Date.

Investors should note that if the mandatory exchange conditions are not satisfied on 15 October 2023 (i.e. CBA ordinary shares are trading below ~$42), CBAPE will not be exchanged until the next scheduled distribution payment date when the mandatory exchange conditions are satisfied, and as such the Notes are technically considered to be perpetual. However, Lonsec believes this is unlikely to occur and expects CBAPE to be exchanged for face value on 15 October 2021, subject to CBA's capital position and prevailing credit spreads.

The table below sets out the maturity scenarios for CBAPE.

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 EARLY REDEMPTION BY CBA	15 OCTOBER 2021	YES	YES	$100	CASH
OPTIONAL RESALE	15 OCTOBER 2021	NO	NO	$100	CASH
EARLY REDEMPTION BY CBA FOR TAX OR REGULATORY REASONS	AT ANY TIME IF CBA IS UNABLE TO FRANK DISTRIBUTIONS, OR WHERE A CHANGE OF LAWS OR APRA'S PRUDENTIAL STANDARDS PREVENT CBA FROM TREATING CBAPE AS TIER 1 REGUALATORY CAPITAL, OR FOR OTHER TAX OR REGULATORY REASONS	YES	YES	$100	CASH
MANDATORY EXCHANGE	15 OCTOBER 2023 (IF THE MANDATORY EXCHANGE CONDITIONS ARE SATISFIED) OR THE FIRST DISTRIBUTION PAYMENT DATE AFTER THAT DATE ON WHICH THE MANDATORY EXCHANGE CONDITIONS ARE SATISFIED	NO	YES	$101	VARIABLE NUMBER OF ORDINARY SHARES
AUTOMATIC EXCHANGE	IMMEDIATELY IF A CAPITAL TRIGGER EVENT OR NON-VIABILITY TRIGGER EVENT OCCURS	NO	NO	DEPENDING ON THE PRICE OF CBA ORDINARY SHARES AT THE TIME, HOLDERS MAY RECEIVE SIGNIFICANTLY LESS THAN THE FACE VALUE	VARIABLE NUMBER OF ORDINARY SHARES, UP TO THE MAXIMUM EXCHANGE NUMBER
	IF A CHANGE OF CONTROL EVENT OCCURS	NO	YES	$101	VARIABLE NUMBER OF ORDINARY SHARES
WRITE-OFF FOLLOWING A NON-VIABILITY OR CAPITAL TRIGGER EVENT	WITHIN FIVE BUSINESS DAYS AFTER THE OCCURRENCE OF A TRIGGER EVENT, IF WITHIN THOSE FIVE DAYS CONVERSION OF CBAPE IS NOT EFFECTIVE FOR ANY REASON	NO	YES	$0	N/A

Source: CBA, Lonsec

CommBank PERLS VIII (CBAPE)

Liquidity Risk — Low

A number of factors will influence CBAPE' 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.

CBA has announced the initial offer size will be $1.25bn, with the ability to raise more or less, which should support a good level of liquidity for retail investors. Based on similar issues we expect average weekly turnover of around $3-5m. 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. Impaired assets represent less than 1% of total assets while the charge for bad and doubtful debts is less than 0.5% of total assets — both are 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. Lonsec notes that 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. 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 — Moderate

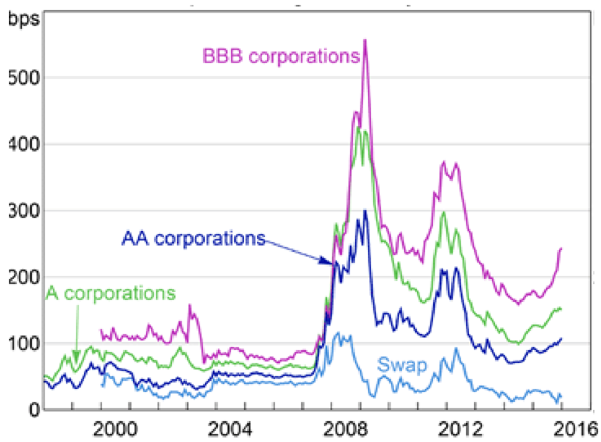
The price and trading margin of CBAPE may fluctuate due to various factors including; credit spreads, economic and credit market conditions, CBA's earnings and cash flow volatility, credit rating changes, interest rates, distribution deferral, movements in the market price of CBA ordinary shares or senior or subordinated debt, the perception of or likely occurrence of a non-viability event and investor sentiment.

We expect CBAPE to exhibit moderate volatility over the term of the issue, attributable to the Notes low ranking capital status and Non-Viability and Capital Trigger exchange mechanisms, which may result in CBAPE being moderately positively correlated to CBA's equity price. The reasonably high issue margin should offer some protection from volatility, though CBAPE may still trade below the issue price at some stage, and may therefore not be suitable for short term investors.

Credit spreads widened significantly in 2015, and numerous macro-economic concerns and expectations of new issuance has caused spreads to widen to multi-year highs in 2016. Should this trend continue, the market price, liquidity and performance of CBAPE and other listed income securities is expected to be adversely affected, and could result in CBAPE trading below face value. There is a risk that investors who wish to liquidate prior to maturity will realise a capital loss, and therefore CBAPE may not be suitable for short term investors. Conversely, tightening of credit spreads is likely to result in CBAPE trading above face value.

Overall, Lonsec expects CBAPE to display moderate volatility.

Chart 5. Australian bond spreads



Source: RBA Chart Pack 3 February 2016

CommBank PERLS VIII (CBAPE)

Summary of Key Investment Risks identified in the prospectus

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

Perpetual

CBAPE is a perpetual, convertible and redeemable capital note with no fixed maturity date, but is scheduled to be exchanged for CBA ordinary shares in October 2023 (subject to certain conditions being satisfied).

There is a risk that exchange will not occur if the mandatory exchange conditions are not satisfied, and as such the Notes are technically perpetual. Regardless, Lonsec expects CBAPE to be redeemed or transferred for $100 cash at the optional call date.

Liquidity

The market for CBAPE 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 CBAPE, they may not be able to do so at an acceptable price or at all.

Volatility

The price & trading margin of CBAPE may fluctuate due to various factors including; credit spreads, economic and credit market conditions, CBA's earnings and cash flow volatility, credit rating changes, distribution deferral, movements in the market price of CBA shares or senior/subordinated debt, the perception of or likely occurrence of a capital trigger event or non-viability event and investor sentiment.

Distributions may not be paid

Distributions are not mandatory and can be deferred at the discretion of CBA. Non-payment of a distribution will not be an event of default and the holder has no claim in respect of such non-payment. No interest accrues on any unpaid distributions.

The payment of distributions are subject to payment conditions, namely that payment will not result in a breach of APRA's capital adequacy requirements, payment would not result in insolvency or likely insolvency, or APRA objecting to the payment

Ranking of CBAPE in a winding-up

CBAPE 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 CBAPE, there is a risk that investors may lose some or all of the money invested in CBAPE. Upon exchange (if exchange), holders will become holders of ordinary shares of CBA and rank equally with other holders of ordinary shares. If exchange is not effective for any reason within five business days, all holder rights in relation to CBAPE will be terminated and investors will incur a principal loss.

Property exposure

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

Floating rate distributions

The distribution 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 distributions will vary over time and may become less attractive.

Chart 6. Historical 90-Day bank bill swap rate

Source: Lonsec, Iress

A Capital or Non-Viability Trigger Event may occur

The occurrence of a Trigger event would see CBAPE convert to ordinary equity of CBA without regard to the exchange conditions. As a result of the maximum exchange number, if a Trigger event occurs CBAPE holders may receive less than $101/note if CBA ordinary shares are trading below 20% of the issue date VWAP. Furthermore, CBAPE holders would subsequently rank equally with ordinary equity in a winding-up. If a capital or non-viability trigger event occurs and exchange is not possible within five business days, then holder's rights will be terminated and the Notes will be written off.

Regulatory classification

APRA has confirmed that CBAPE, once issued, will constitute Additional Tier 1 capital. However, if APRA subsequently determines that all or some of the notes are not or will not be treated as Additional Tier 1 Capital as a result of a change in law or a change in APRA's prudential standards, CBA may decide a Regulatory Event has occurred, which will allow CBA to convert or redeem (subject to APRA approval) all of the Notes issue at the option of CBA.

Tax consequences

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

CBA may issue further securities

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

Conversion Price

The ordinary share price used to calculate the conversion number of ordinary shares may be different to the market price at the time of conversion. As a result, the market value of shares received upon conversion may be lesser or greater than $101 per note.

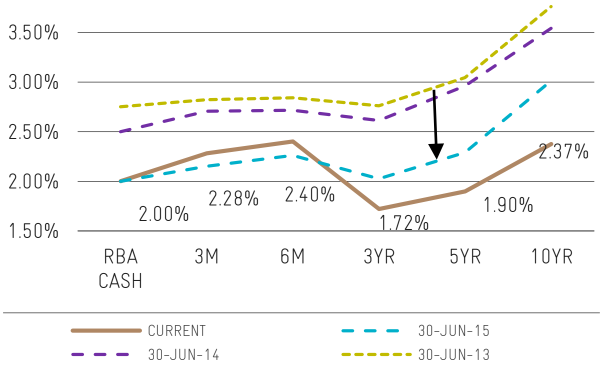
Systemic Credit Risk

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 5 of the Prospectus for further details of the risks associated with CBAPE.

CommBank PERLS VIII (CBAPE)

Yield Curve and Market Outlook

Chart 7. Yield curve



Source: Lonsec, Iress

Cash Rate

The RBA held the cash rate steady at 2.0% in February, where it has been since May's 25bps reduction. Economic growth improved to 2.5% p.a., as low interest rates lifted household consumption and the lower Australian dollar supported net export growth. This has translated into strong employment growth (though there are doubts to the reliability of the data), and RBA optimism that the economy will strengthen as the drag from falling mining investment gradually diminishes. Accordingly, the RBA has adopted a more neutral stance, though it has noted the low inflation outlook may afford it some scope to lower rates further if necessary.

We have adopted a more bearish outlook, seeing a number of risks to RBA forecasts. These include international stresses such as the continued slowdown and rebalancing of economic activity in China, US dollar strength which is weighing on manufacturing activity in the US and causing instability in emerging economies, lower commodity prices and more generally, a subdued global growth and inflation outlook. Domestically, the housing market has played a key role in leading Australia's economic transition from resources-led growth, though this source of growth is softening in line with the actions of policy makers, which should provide scope for the RBA to lower rates without fear of overheating the housing market.

Overall, economic growth has been supported by low interest rates and a low currency but is complicated by low global growth, lower commodity prices and emerging market vulnerabilities. We expect growth to remain below trend in the short to medium term, with downside risks to growth requiring an accommodative policy stance. As such, we expect the RBA to maintain its easing bias and continue to lower the cash rate in 2016.

Yield Curve

Short term rates remain anchored and longer term interest rates have continued to fall, causing a flattening of the yield curve. This is an indication that growth and/or inflation expectations remain low. Persistently low yields continue to buoy high quality fixed interest returns, with the Bloomberg AusBond Composite index outperforming Australian equities on the rolling year. This aberration seems to be caused by two key events:

- Low domestic and global economic growth and inflation expectations; and
- US, European and Japanese central bank liquidity.

The US Federal Reserve lifted the federal funds rate by 25bps in December 2015, which is the first interest rate increase since 2006. Economic conditions have generally improved in the US, though monetary conditions are expected to remain very accommodative, as inflation remains below target and USD strength is weighing on manufacturing activity.

The slowdown in China and emerging economics more generally, has been the source of global growth downgrades. As mentioned above, we remain sceptical about the prospect of global growth and inflation recovering rapidly from here and therefore continue to expect long term rates to remain relatively low over the medium term, and rate rises from the Fed to be implemented slowly. Accordingly, the yield curve has flattened which may be signalling an imminent cut to short term rates.

Credit Spreads

The general rise in credit spreads suggests that investors have become more discerning about risk, with specific areas of concern coming from:

1. The prospect of further interest rate cuts, acknowledging the majority of the hybrid market are floating rate securities;
2. Increased supply (new issuance) – the banking sector is the predominant issuer of hybrid capital, and the implementation of higher regulatory capital requirements ensured a steady flow of hybrid issuance in 2015. Three of the four major banks have hybrid refinancing's due in 2016, and it is possible that additional capital will be required prior to the introduction of Basel IV standards and other changes to risk weightings;
3. Weakness in bank share prices, acknowledging that Additional Tier 1 securities can display positive correlation to the equity price of the issuer. The outlook for the banking sector has deteriorated somewhat in recent months, with higher capital requirements, tighter lending standards, volatile wholesale funding markets and the prospect of higher impairments creating medium term headwinds. Bank lending to the resources sector remains small (at 2-3% of total exposures), though provisioning levels are being questioned, and concerns about bank property loan portfolios (both residential and commercial) and international exposures have increased. Accordingly, consensus EPS & DPS forecasts are being downgraded; and
4. The likely selling of bank hybrids to fund participation in bank equity entitlement offers.

Ironically, bank credit profiles have arguably improved as capital levels have been increased, lending practices strengthened, and low interest rates and an improving employment situation has kept loan impairments at historically low levels.

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.

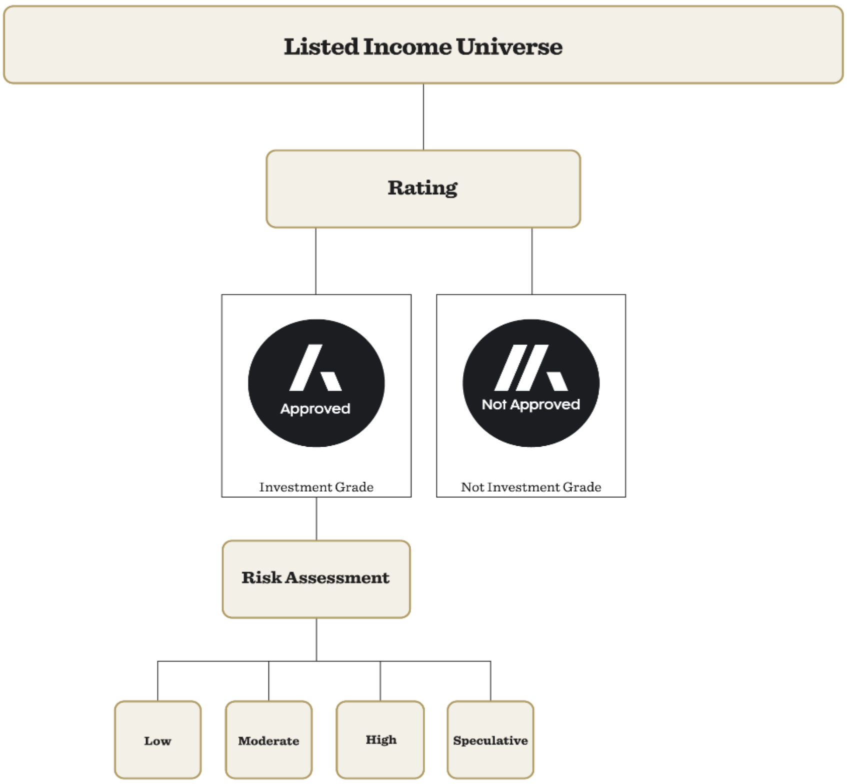
Speculative

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		●		

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



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Important Notice

The following relate to material presented in this document published by Lonsec Limited ABN 56 061 751 102 ("Lonsec") and should be read before making any investment decision.

Date prepared

Tuesday, 16 February 2016

Analyst

Matthew Asquith

Release authorised by

William Keenan

Lonsec listed income risk rating spread

	NUMBER	%
LOW RISK	4	8%
LOW-MODERATE RISK	3	6%
MODERATE RISK	25	48%
MODERATE-HIGH RISK	12	23%
HIGH RISK	8	15%
HIGH-SPECULATIVE RISK	0	0%
SPECULATIVE RISK	0	0%
TOTAL	52	100%

Lonsec listed income recommendation spread

	NUMBER	%
APPROVED	48	92%
NOT APPROVED	4	8%
TOTAL	52	100%