BondAdviser

Research Report

Report Created on 17 February 2020

Issuer Name

National Australia Bank Limited

Security Name

NAB Capital Notes 4

Security Recommendation

Subscribe

Security Risk

Upper Medium

Issuer Outlook

Improving	Stable	Deteriorating

Key Characteristics

Product Type	Capital Note	**Last Price**	$100.00
Issue Size*	$750,000,000.00	**Accrued**	$0.00
Par Value	$100.00	**Capital Price**	$100.00
Fixed/Floating	Floating	**Running Yield****	3.87 - 4.07%
Payment Frequency	Quarterly	**Yield to Maturity*****	3.97 - 4.17%
Current Distribution**	3.87 - 4.07%	**Trading Margin**	2.95 - 3.15%
Issue Margin / Coupon	2.95 - 3.15%	**Optional Call Date**	17 September 2027
Franking Credits Incl.	Yes	**Legal Final Maturity**	Perpetual
ASX Listed	Yes (ASX Code: NABPG)	**Next Ex-Date**	TBC
Convertible	Yes	**Next Payment Date**	17 June 2020
GICS Sector	Banks	**Next Cash Distribution**	TBC

*Subject to change, expected to be $750 million, with the ability to raise more or less. **Based on issue margin plus 90-Day BBSW of 0.9177%. ***Based on issue margin range of 2.95-3.15%, an interpolated swap rate to call of 1.0180% and an expected call date of 17 September 2027. All pricing as of close 14 February 2020.

Summary

On 17 February 2020, National Australia Bank Limited (ASX: NAB, the "Issuer") launched an offer for NAB Capital Notes 4 (Expected ASX Code: NABPG, the "Notes"), to raise $750 million, with the ability to raise more or less.

These securities are structured as perpetual, subordinated, unsecured, convertible notes. Distributions are expected to be discretionary, non-cumulative, floating rate, fully franked, and paid on a quarterly basis in arrears until converted or redeemed. The Notes will be issued on the 23 March 2020 and the purpose of this transaction is to partially refinance the existing $1.34 billion NAB Capital Notes (NABPC) and for general corporate purposes. The margin on the Notes is expected to be set between 2.95% and 3.15% p.a. above 90-Day BBSW.

This security has no fixed maturity date but is scheduled for conversion into NAB ordinary shares on 17 September 2029, or later when conversion conditions have been satisfied. At the Issuer's discretion, the Notes may be redeemed (subject to APRA approval), transferred or converted on 17 September 2027. As this security meets the new capital instrument eligibility criteria under Basel III, it also contains the loss-absorbing terms and conditions known in the documentation as Common Equity and Non-Viability Trigger Events. The security therefore qualifies as Additional Tier 1 capital for NAB. Upon the occurrence of either of these events, this security will be automatically converted into ordinary shares or written-off without the protection of conversion conditions. Conversion calculation ratios are set based on issue date VWAP and will be updated on issuance. If conversion cannot occur for any reason, the Notes will be written-off and all Noteholders' rights terminated.

Figure 1: Capital Structure[1]

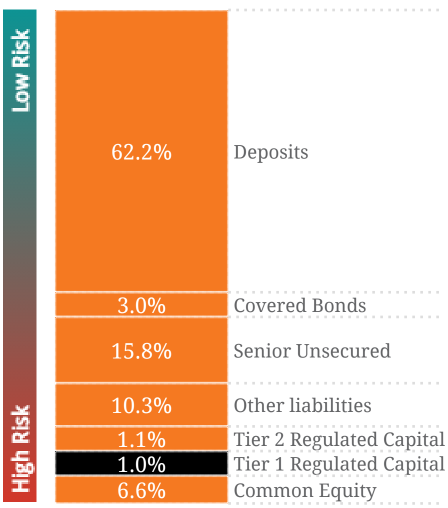


Figure 2: Relative Value

Security Recommendation - Subscribe *as at 16 February 2020*

BondAdviser recommends investors **Subscribe** to this security. This is the fifth ASX-listed security offered by NAB since 2013 which qualifies as Basel III compliant Additional Tier 1 Capital (the most recent being NAB Capital Notes 3 (NABPF), which were issued in March 2019). The Notes will be used to partially refinance the existing NAB Capital Notes (NABPC), which are scheduled to be called on 23 March 2020, as well as for general business purposes.

From a credit perspective, the recent increases in core equity capital, lending constraints and higher risk weights required by APRA are positive outcomes for holders of debt and hybrid instruments of the banks. While these may not be fully welcomed by shareholders, if the changes are conducted in an orderly manner over a reasonable period, price volatility for all instruments should be minimised.

Notwithstanding this possible volatility, in our view, these securities do offer a yield commensurate with their risk. Optically and when compared to recent other major banks' and NAB's own outstanding issues, the proposed 2.95 - 3.15% margin represents a thin new issue premium for a 7.5-year tenor but arguably slightly higher than other recent issuance offerings. Whilst yields and margins are generally trending tighter, it is also our opinion that the evolving bank regulations also mean the risks between Common Equity and Additional Tier 1 securities are diverging somewhat with an improving credit outlook but a deteriorating equity outlook.

In terms of relative value, the securities appear to be pricing with a thin new issue premium to recent similar securities such as the most recent CBA deal, CBA PERLS XII (CBAPI), which was issued in November 2019 for a then market-leading tenor of ~7.5 years (the same as NABPG) and also NABPF, which was issued in March 2019 at a tenor of ~7.25 years. These deals now have ~7.2 and ~6.3 years to their first call date respectively.

There was no other major bank AT1 issuance in 2019, nor is any more expected in 2020 bar the likely refinancing of NAB Convertible Shares 2 (NABPB) ahead of its December 2020 call date. This also is a relatively large deal ($1.7 billion) and will occur before a significant ~$5.5 billion of major maturities in 2021 and even larger ~$9.0 billion in 2022.

It is therefore important to acknowledge the currently very limited expectations in net supply of AT1 capital instruments on the ASX, which is a further supportive factor of the tighter margin environment. With no foreseeable catalyst for change, these conditions are expected to continue, and the valuation offered by this security is ultimately a function of this strong technical setting.

The issued margins of the aforementioned CBAPI and NABPF deals were both reflective of extant market conditions. The latter was (of refinancing necessity) launched during the early 2019 period where a Labor government was widely assumed and which would likely have seen the abolition of franking credits to most investors, which elevated the margin to 400 basis points. In late 2019, with this threat removed, CBAPI successfully priced a 7.5-year deal at a margin of 300 basis points. Both (with less than a year's tenor difference) are now pricing close to 280 basis points over 3-month BBSW.

We previously commented over late 2018 and early 2019 that there was a short-term oversupply risk in the local AT1 market. This did not eventuate to any material effect and following APRA's current loss aborbing capital proposals, we expect most major banks to increase their Tier 2 issuance rather than AT1. If this were to take listed form then there may be some supply-side widening in AT1 spreads but we view any increase to regulatory capital as a positive for all credit classes.

As the security contains loss-absorbing terms, risk events such as Common Equity or Non-Viability Trigger Events prompting exchange (or write-off) may happen but we consider the probability of such an event for NAB to be remote in the short to medium term. Investors should note these terms make the return profile asymmetric (material loss of capital but limited upside) and in all likelihood its performance will have a higher correlation to equities than a traditional fixed income instrument during a period of stress. The most likely scenario for a breach of these triggers would be either (or a combination of) a significant and sharp deterioration in the asset quality of NAB or a failure of risk management that would lead to significant losses. If these events are triggered, they are likely to cause a significant capital loss to the investor.

Our valuation assumptions for this security are based on it being redeemed (in full) on the optional redemption date (17 September 2027) and all interest payments being made in full in a timely manner. If this security is not called on this date (extension risk), the price of the security would likely fall.

Overall, our relative value analysis suggests this security is offered to investors at a margin considered fair and commensurate with comparable securities and which supports our **Subscribe** recommendation.

Positive / Negative Risk Factors

What factors would change the Recommendation UP

- The domestic regulator (APRA) continues to implement strict controls over domestic banks. The Liquidity Coverage Ratio (minimum 100%) became enforceable on 1 January 2015 and the Net Stable Funding ratio (minimum 100%) became effective on 1 January 2018. These ratios continue to significantly improve the transparency of risks, in addition to capital for investors.

- In October 2019, Standard & Poor's (S&P) updated its Economic Risk Assessment of Australia to '3' from '4'. This follows a revision to Australia's sovereign outlook to 'Stable' from Negative in September 2018. A direct consequence of this action is an increase in the stand-alone credit profiles (SACPs) of the big four banks from 'a-' to 'a'. A following consequence is the one-notch increase in the agency's ratings of subordinated debt issued by such banks to 'BBB+' and 'BBB-' for Tier 2 and Tier 1 instruments respectively. This should strongly support both debt classes but particularly the latter, which are now back within the agency's Investment Grade rating band.

- APRA's 2016 increase to average risk weights for residential mortgages from ~16% to at least 25% for advanced accredited banks was a success and positive for all holders of bank capital instruments as it increased the amount of core equity capital required to be held, thereby reducing systemic leverage. Any further increases in nominal capital will also increase the buffer against unexpected losses in mortgage portfolios and improves the financial stability of the system, the standalone credit profile of the banks and their individual securities.

- APRA's focus for the banks remains core equity capital, with the expectation that the major banks are compliant with its benchmark of "unquestionably strong" minimum Common Equity Tier 1 (CET1) ratio of 10.50% of risk-weighted assets (RWAs) by 2020. As a result, banks have a significant loss absorption cushion through earnings, capital and provisioning which are the primary defences against loan and security impairments. This is likely to increase through the introduction of the above capital adequacy requirements.

- Any further sector 'macroprudential' policies announced by regulators would be credit positives. We view the August 2018 powers to embed ASIC staff within the major banks (and AMP) positively in terms of stronger governance, compliance and transparency.

- The Royal Commission has increased scrutiny on the banks and led to greater regulatory oversight from both APRA and ASIC. Additionally, the banks have largely streamlined operations (i.e. have divested or are looking to divest life insurance and wealth management businesses) whilst also increasing spending on compliance and risk management. Although ultimate impacts from the Royal Commission remain unknown, we view this as a long-term positive for credit investors in the form of stronger governance, (likely) ongoing regulatory monitoring and higher compliance for the financial services sector as a whole.

- The original prohibition of mortgage broker trailing commissions (as recommended by the Royal Commission) would likely consolidate power to the banks to originate loans organically and we viewed this as a positive for the banks given broker distribution costs would be lower. This Government decided not to prohibit trail commissions on new loans but will review their operation in early 2022. An Australian Competition and Consumer Commission (ACCC) review will occur on this topic together with one on home loan pricing whose final report is due on 30 September 2020. We do not currently expect any materially adverse outcomes for credit investors and there could even be some mild positives.

- NAB reset its dividend payout per share in FY19, thereby acknowledging the need to generate and retain capital organically to meet regulatory requirements, which we view as a credit positive.

What factors would change the Recommendation DOWN

- Distributions on this security are discretionary and subject to payment conditions. Currently, the upper limit is 8.00% of CET1 but we note possible APRA revisions to this limit post the unquestionably strong target of 10.50% and amendments to the capital adequacy framework.

- This security includes Capital and Non-Viability Event trigger terminology. If breached, investors are at risk of substantial capital losses. A significant and sharp deterioration in the asset quality of residential mortgages (which would affect all banks) or a failure of risk management within a division could adversely affect the loss absorption cushion of the Group and result in an event whereby conversion (or write-down) is triggered. This is an unlikely, but possible event.

- ASIC continues to variably target hybrid securities (subordinated bonds and preferred equity securities) due to their perceived higher risk and complexity compared to other fixed income products. This focus presents a threat to the ongoing viability of the asset class rather than an issuer-specific risk. Whilst there are some structural mitigants to wholesale change, a regulatory crackdown would prove to be a significant credit negative.

- The return of the Coalition to the House of Representatives in Australia has removed any short-term threat to the abolition of franking credits which was proposed by the Opposition Labor party. This subsequently offered broad support to all instruments which include franked distributions (most equities and bank hybrids). In our opinion, there is a very low risk that this policy (or similar) will again become a political topic but should it do so, there is likely to be adverse price and margin movement on hybrid securities.

- The next 3-5 years could be characterised by slowing productivity growth, environmental constraints, rising general debt levels as well as targeted de-leveraging and uncertainty over the economy; all of which would adversely affect the banking sector as a whole.

- Downward pressures on the bank's credit rating - although unlikely given the outlook revision to 'Stable' from 'Negative' (September 2018), any future S&P downgrade of Australia's sovereign credit rating would lead to an immediate downgrade of major bank's senior credit rating (as the government would have less perceived financial scope to lend support). The implementation of a resolution regime would also likely prompt a downgrade to senior debt. Either scenario would probably leave subordinated ratings unchanged but we would anticipate adverse price pressures nonetheless.

- Highly variable interbank swap rates (BBSW) have not been proved to be a material negative to earnings with the majority of Australia's banks raising rates on lending products to combat rising funding costs. Should the banks' ability or capacity to substantially pass on higher funding costs decrease, we would view this as a mild credit negative.

Issuer Outlook - Stable *as at 16 February 2020*

The below Outlook relates to NAB's full year 2019 (FY19) results, however, we have provided an update below this to reflect the Group's 1Q20 update on 13 February 2019.

Earnings

The full year ended 30 September 2019 (FY19) was another difficult period for National Australia Bank (NAB), amid ongoing fallout from the Hayne Royal Commission and difficult operating conditions across most of its operations.

For FY19, statutory net profit decreased by 13.6% to $4.8 billion (from FY18) and cash earnings declined by 10.6% to $5.1 billion. The result was impacted by large notable items, which occurred in each half, and comprised significant customer-related remediation costs ($1.6 billion before tax), including customer compensation, costs for implementing remediation processes and costs for incorrect banking matters. A change to NAB's software capitalisation policy saw the threshold increase to $2 million from $0.5 million, which lowered cash earnings by $494 million before tax. Excluding large notable items, cash earnings were 0.8% higher at $6.6 billion compared to FY18.

Net operating income decreased 4.2% from the prior corresponding period (pcp) to $17.2 billion (FY18: $18.0 billion) whilst operating expenses excluding restructuring related costs and customer related remediation increased by just 0.4% to $8.2 billion (vs pcp), as continued investment in technology and associated amortisation charges and increased compliance costs drove increases in general expenses. These were partially offset by claimed benefits from the transformation program materialising. NAB's $1.5 billion investment spend via the program has now delivered total savings (since September 2017) of $800 million and is at the core of the Group's intent to simplify and rationalise operations. Broadly, the bank achieved its target of 'flat expenses' for the full year.

The Group's Net Interest Margin (NIM) fell by 7 basis points (bps) from FY18 to 1.78% because of a change in the housing lending product mix, particularly a transition from interest-only loans to principal and interest lending, competitive pressures combined with regulatory constraints and higher short-term wholesale funding costs. These factors were partially offset by growth in housing and business lending volumes and lower deposit costs. Excluding Markets and Treasury and customer-related remediation, NIMs declined by 4bps.

The divisional breakdown shows a mixed performance across the Group with ongoing strong results in the New Zealand Banking division again offset by poor performance in the Consumer Banking and Wealth arm. The former reported a cash earnings increase of $5.1% to $1,055 million driven by higher revenue from growth in lending, offset by increased investment spend and higher credit impairment charges. The Consumer Banking and Wealth division posted an 11.2% fall in cash earnings to $1,366 million with lower margins and competitive pressures in housing being the key drivers, but also reflecting margin repricing and lower average funds under management. The Business and Private Banking division reported a 2.4% decline to $2,840 million mostly due to higher credit impairment charges and higher operating expenses and investment spend. Positively for the future, revenues increased by 1% on SME business lending growth. The Corporate and Institutional Banking arm reported a 2.1% fall in cash earnings to $1,508 million, slightly worse than the flat outcome at the half year with higher impairment charges on a small number of larger exposures dragging down the overall performance. Revenues in this division also increased 1% despite lower Markets income as the unit focuses more on growth segments.

Capital

A very challenging and pervasive operating environment shaped by regulatory constraints, earnings volatility and further potential customer remediation prompted NAB to cut its dividend in the first half and it retained the absolute payout as it focusses on maintaining balance sheet strength. The Group's dividend reset has seen it cut by 16.2% (16 cps) to 83 cents per share and we suspect, at best, that this will be retained for some periods into the future. Additionally, NAB announced it would raise a net ~$1.6 billion in fresh capital via a partially underwritten dividend reinvestment plan and a 1.5% discount to the dividend reinvestment plan (DRP). The moves are part of a plan by the bank to position itself appropriately ahead of the challenges it faces in the near future. We previously suspected also, that similar prior actions were taken because the sale (and subsequent capital benefits) of NAB's MLC Wealth arm will not occur as quickly as the bank originally envisaged.

Nevertheless, NAB's Common Equity Tier (CET) 1 ratio was 10.38% as at 30 September 2019, down 2 bps from 1H19 but up 18 bps from FY18 as the Group moves towards the APRA 'unquestionably strong' 10.50% minimum requirement by 1 January 2020. Driving the move was a net 44bps increase in organic capital generation (cash earnings, less the dividend and adding underlying RWA growth). The 1H19 DRP underwrite added 25bps whilst customer remediation (-29bps) was the largest detractor together with an operational risk overlay (-16 bps) and changes to the measurement of derivative counterparty risk (-18bps).

NAB expects a pro-forma CET1 ratio of 10.75% after the new DRP and partial underwrite occur.

The Reserve Bank of New Zealand (RBNZ) has proposed changes to its capital framework with final proposals expected in December. Currently, these imply NZ$4-5 billion increases to BNZ's Tier 1 capital or a decrease in its risk weighted assets (RWAs). NAB's management actions are expected to reduce the ultimate impact of the proposals.

Overall, despite the headline dividend cut, the decisions by management are, in our opinion, prudent given the difficult and uncertain environment ahead, indicating a priority for balance sheet strength. The moves give the bank flexibility to accommodate volatile conditions and position it well to safely exceed the APRA benchmark by January 2020. This assumes there are not any further material items impacting capital, which is far from certain given past experiences.

Funding and Liquidity

The global funding environment has been generally accommodative over the period however volatile credit spreads have complicated conditions somewhat. The Group has been able to maintain a sound funding and liquidity position whilst reporting mixed performance in key metrics. NAB's Liquidity Coverage Ratio (quarterly average) (LCR) fell 3% from FY18 to 129% driven by a $4 billion increase in net cash outflows, partially offset by a $1 billion increase in Total Liquid Assets. The Group's LCR remains well above the APRA minimum of 100%.

The Group's Net Stable Funding Ratio (NSFR) remained static at 113% over the course of the financial year. This is still comfortably above the APRA minimum requirement of 100%.

NAB raised a total of $26 billion of term funding over the period – well below the highs seen of over $35 billion in FY16 and FY17, but understandable given the credit (housing) slowdown. Secured funding remained constant at $5 billion and the largest declines were seen within senior and subordinated debt. This too is rational given APRA's loss absorbing capital (LAC) proposals which preferences Tier 2 debt to meet its new capital targets.

The Group maintains a well-diversified wholesale funding profile across issuance type, currency and tenor with the weighted average remaining maturity of the Group's term wholesale funding portfolio stable at 3.2 years. NAB also managed to grow its customer funding base with total customer deposits increasing by 3.8% to $425 billion in the year, however it (and peers) caution that future revenues are likely to be further impacted by any future interest rate cuts with $88 billion currently at or near floors.

Asset Quality

NAB's reported asset quality has again suffered from higher arrears for housing lending with most key metrics deteriorating over the period.

Outright credit impairment charges increased 18% to $919 million in FY19, and as a percentage of gross loans and acceptances increased 2 bps to 16 bps. Although the charges are mostly specific and reflect impairment of a small number of larger exposures, the increase remains concerning given the recent tightening of regulatory requirements. The increase was driven primarily by specific credit impairments within the Corporate and Institutional Banking division, as well as within New Zealand Banking, related to the dairy portfolio with a tripling of impairments in the second half to 6%. The Group appears confident this is structurally sound though and cited average LVR's of 86%.

The Group's collective provision to credit risk-weighted assets ratio increased 4 bps to 0.96% and continues a thematic trend.

90+ days past due (DPD) loans increased by $1.0 billion to $3.6 billion and also extends prior increases. In some sympathy to the outcome, this is similar to peers' experiences and partly reflects lengthening times to sell properties in the current (or recent) market environment.

In our view, despite modest deterioration in some of the Group's key asset quality metrics which are of concern, NAB's credit position remains sound as Australia progresses through its house-price correction. We expect stabilisation of credit metrics given the housing market appears to have righted itself in the latter part of 2019.

Outlook

The operating environment looks likely to remain quite hostile for banks through 2020 at least. Economic and retail growth is slowing, housing credit growth is at historical lows, regulatory burdens have increased and the Group continues to struggle with community and customer perception issues in the wake of the Hayne Royal Commission. Each of these will continue to drag on future loan and earnings growth. Furthermore, customer remediation and regulatory compliance investigations are continuing and are expected to bring further additional costs, although management believe they have adequately provided for currently foreseen costs.

However, NAB's transformation plan appears to be (positively) on track and beginning to reap material benefits. Despite the aforementioned cost challenges, the Group has succeeded in keeping underlying expenses broadly flat through FY18 and FY19. The productivity benefits generated by the plan will be critical to the Group's profit growth, as will eventually shedding most of the almost 1,000 additional staff it has engaged to remediate customers. Similarly, the Group remains focussed on its Business Bank to provide capability and innovation to support SME business lending growth. The Group's digital bank, UBank, also offers encouraging growth opportunities over the medium- and long-term.

We believe the bank's capital management decisions are prudent given the difficult and uncertain environment ahead and should position the Group well to maintain its sound balance sheet. It has not undertaken an equity capital raising, which would have been credit positive at this stage, but we place some faith in its trust that it will achieve its CET1 targets as well as a successful MLC separation.

If conditions deteriorate further, the Group's impairment charges will be of particular interest in analysing its capital position, with a natural skew to the downside.

First Quarter 2020 (1Q20) Trading Update (post FY19 Results)

On 13 February 2020, NAB announced its first quarter 2020 (1Q20) trading update and reported unaudited statutory net profit after tax (NPAT) of $1.70 billion and cash profit of $1.65 billion (up 1% from 2H19's quarterly average).

Management noted that revenue rose less than 1% mainly due to a slightly higher NIM from home loan repricing. Unfortunately, expenses rose 3% but that it continues to target broadly flat expenses for FY20.

The group's common equity tier 1 (CET1) ratio ended the quarter at 10.6%, 20 basis points higher than at the year-end and reflective of a 17 basis point gain from the underwritten DRP. The Group's Net Stable Funding Ratio (NSFR) was recorded as 112%, its quarterly average Liquidity Coverage Ratio (LCR) was 129% and the Leverage ratio 5.6%, all little changed from the year end.

NAB reported a decrease in credit impairment charges for the quarter, down 17% from 4Q19, to $185 million, its' lowest since 1Q18. This was mostly due to the non-recurrence of NZ dairy impairments previously taken and the impact of house price movements in the second half FY19.

Asset quality remained broadly stable with collective provisions to credit RWA flat at 96 basis points in the quarter. However, the 90+ day past due and gross impaired assets to gross loans and acceptances ratio increased to 0.94% from 0.72% a year ago and has slowly risen over the past year. With house price declines now unlikely to continue, we are hopeful that this ratio will stabilise in the near future.

NAB also provided an update on its planned exit of MLC Wealth. This had previously been delayed until FY20 and it appears possible this will probably be deferred beyond this date with NAB citing a challenging business environment currently. A public market exit is NAB's preferred mechanism but it will also explore alternative structures and options.

Lastly, NAB stated that it is considering an offer of a new ASX listed AT1 capital security alongside the potential repayment of NAB Capital Notes and subsequent conversion of up to $750 million into ordinary shares, which would add 18 basis points to CET1 levels.

Next Event: NAB is scheduled to release 1H20 results in May 2020.

Figure 3: Credit Curve (Comparable Securities)

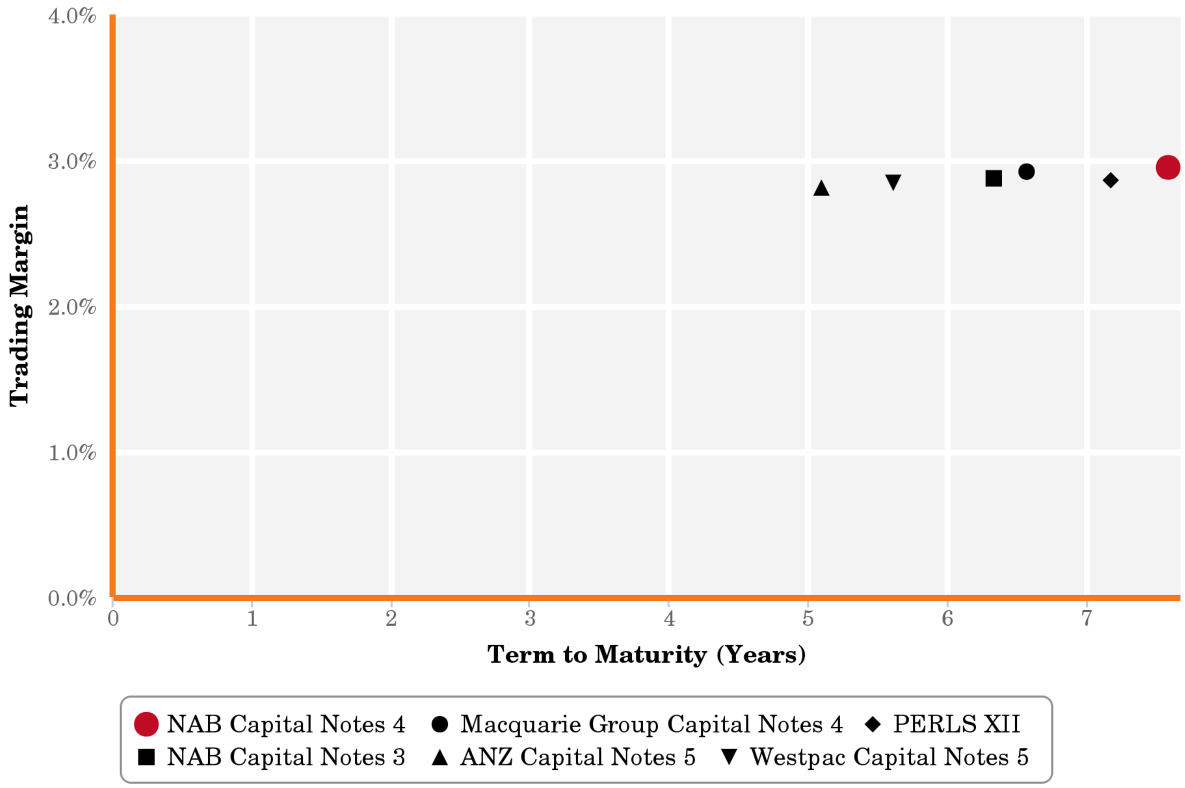
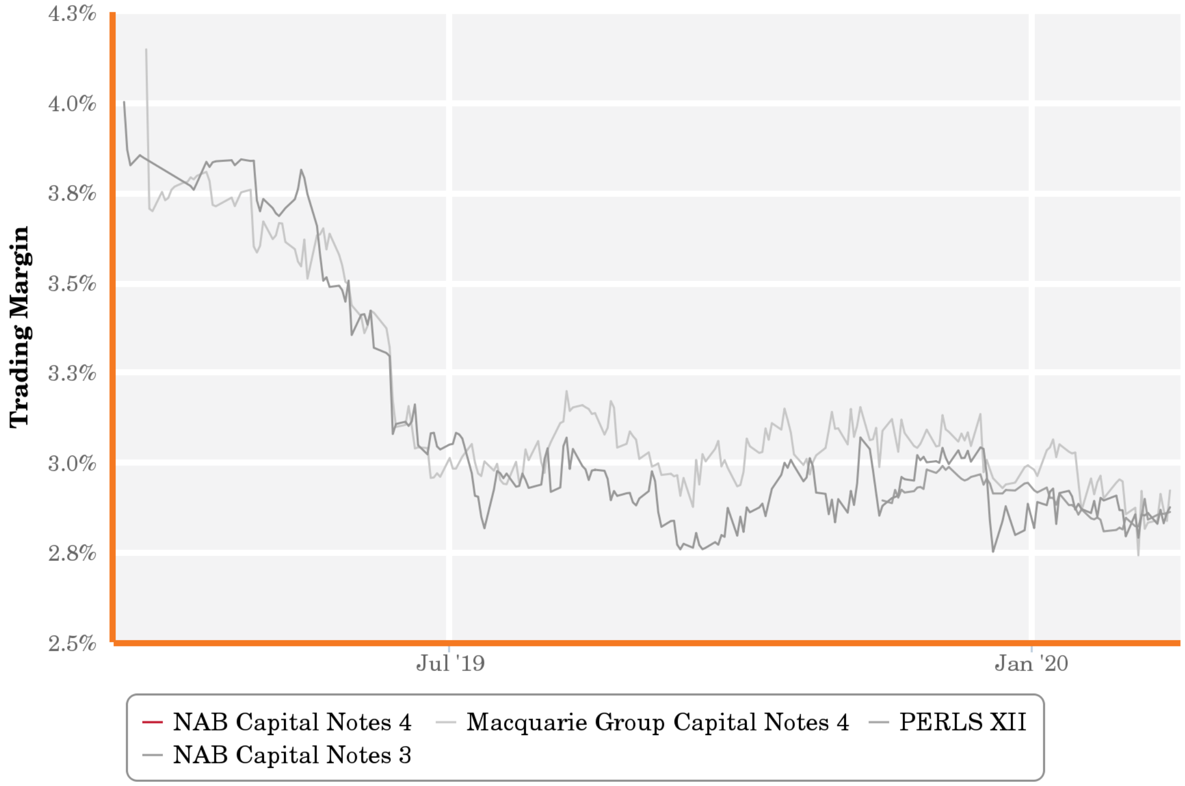


Figure 4: Historical Trading Margins of Comparable Securities



[1] The balance sheet structure diagram represents a measure of liabilities and capital in order of seniority of the overall cash balance sheet.

Source: BondAdviser

Hybrid Commentary

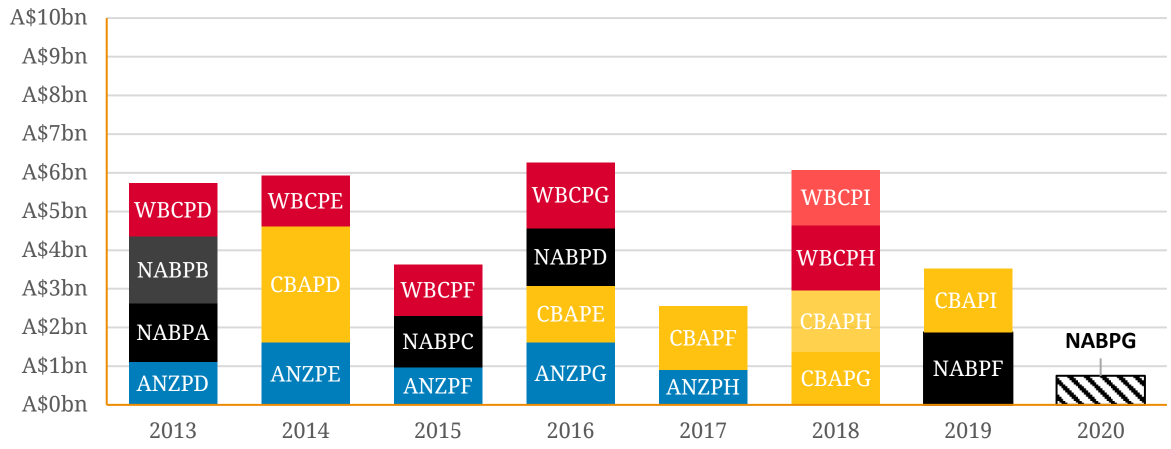
Since 2012, and in line with the regulatory framework that governs the Australian banking system, the major banks have significantly increased their Additional Tier 1 (AT1) or "hybrid" issuance. NAB has had five large domestic issuances over this period, including two in 2013 followed by one in each of 2015 and 2016 and its last was the large issuance of NABPF in March 2019 (Figure 5).

The NAB Capital Notes 4 (expected ASX code: NABPG) issue will be used for general corporate purposes and will also aid the refinancing of the $1.34 billion of NAB Capital Notes (ASX Code: NABPC) at its first optional call date (23 March 2020).

We note that in addition to the NABPC redemption, NAB has a further $1.7 billion of AT1 securities which are likely to be called in 2020. This other line is NAB's Convertible Preference Shares 2 (ASX Code: NABPB, which were issued in December 2013 for a then long-tenor of 7-years and which have an Optional Call Date of 17 December 2020.

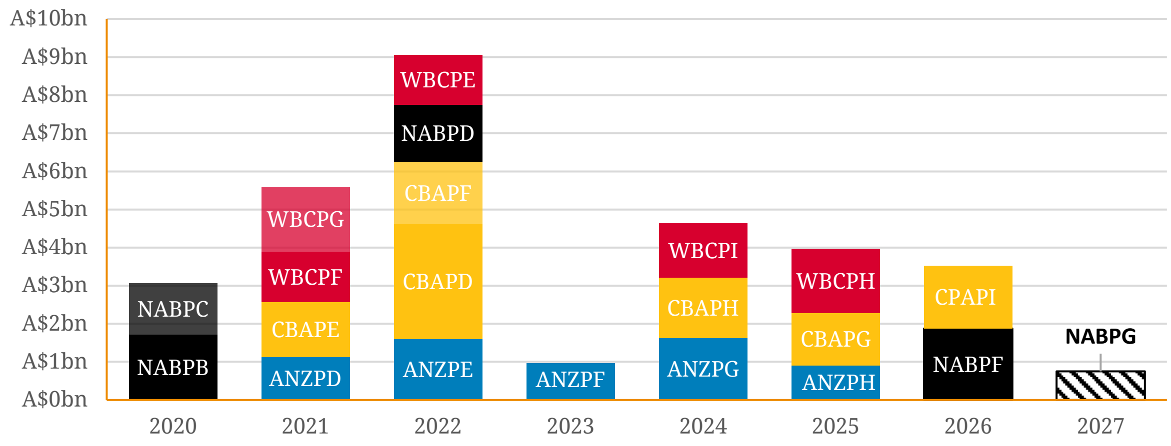
As can be seen in Figure 6, the NABPC and NABPB deals are the only (scheduled and expected) major bank AT1 maturities which will likely be refinanced in 2020. In late 2019, the Commonwealth Bank of Australia (CBA) issued an atypical deal (ASX Code: CBAPI, or PERLS XII) which was not to directly refinance a maturing instrument, but which took advantage of the lean supply factors and the significant trading margin rally exhibited by all hybrids through 2019 after the Coalition was returned to government, coupled with an increasingly negative interest rate outlook. For varied reasons, we do not expect any repeat of this unilateral action by peer banks in 2020 but it does remain a possibility.

Figure 5. Major Bank ASX-Listed Hybrid Issuance



Source: BondAdviser

Figure 6. Major Bank ASX-Listed Hybrid Maturity Profile



Source: BondAdviser

After the current calendar year (2020) has ended, 2021 and 2022 are each currently expected to see significant refinancing efforts, with ~$5.5 billion of likely calls in 2021 and ~$9 billion in 2022. Except for arguably CBA in 2022, no single major bank is expected to struggle materially in its forthcoming refinancing task(s). We note that CBA has ~$4.5 billion due in 2022 via CBAPD and CBAPF but after the unexpected and outsized issuance of CBAPI in late 2019, it has likely reduced this refinancing risk somewhat.

Figures 5 and 6 (together with Figure 11 below) help demonstrate that the Australian AT1 / listed market has matured over recent years, with issues between $750 million and $1.5 billion becoming more commonplace and this is a key reason behind the issuance of NABPG. It will also help optimise the bank's funding profile by staggering future maturities (Figure 6) and reducing short-term refinancing risks.

Whilst it is not certain that NAB will refinance NABPB later in 2020, it is highly likely that it will choose to do so. A more appropriate question could be for what tenor length would NAB issue a refinancing . Except for CBA's and Westpac's tactical CBAPH and WBCPI deals in late 2018 (which were between 5- and 6-years duration), the clear trend for major bank AT1 issuance since 2017 has been to issue deals for longer (7-years plus).

NAB may indeed choose to repeat this trend with a 7- to 8-year deal which would likely place a NABPB refinancing issue on a path for a 2028 call date. In the current low and flat yield environment this probably makes more sense to NAB's Treasury team through securing longer-term AT1 financing for not a lot of additional yield to pay (noting a large element is franked, lowering cash outflows). However, a more tactical 5-year deal, a year or so ahead of the NABPF redemption in 2026 would not overly surprise us.

2019 also saw a new loss absorbing capital (LAC) proposal from APRA (effective from 1 January 2024) and which saw prompt, large and long-dated Tier 2 debt issuances (wholesale) issued by all major banks. Although the final capital position is not certain, final, we expect more Tier 2 issuance by the major banks. Should this encourage a return of this instrument to the local listed (retail) market, it is possible that AT1 spreads may widen in a supply sympathetic response. We would and do view any increase to capital as positive for all classes of credit holders.

We continue to expect NAB's future capital accumulation to come more from retained earnings rather than new net issuance of capital instruments, which adds weight to the assumption of a limited supply of ASX-listed hybrids in the near-term. However, with the issuance of NABPF in March 2019, NAB took a reasonably unusual step in Australian hybrid markets by converting $750 million of the redeemed Convertible Preference Shares (NABPA) into ordinary shares, boosting its common equity Tier 1 (CET1) ratio by approximately 19 basis points. As part of its first quarter 2020 (1Q20) announcement in mid-February 2020, NAB indicated that it may take this course of action again with the forthcoming NABPC redemption. We would stress that this has no direct impact on AT1 instrument holders but is arguably a negative to equity holders, which see a minor dilution. Indirectly, AT1 investors do benefit from higher CET1 ratios, taking them further away from the Common Equity Trigger Level.

In October 2019 NAB established its debut *Wholesale* Capital Notes program to enable the bank to offer a platform to (presumably) repeatedly issue AT1 securities to professional or sophisticated investors. This was the first of its kind for Australian major banks as distinct from the more typical and frequent retail issues. It also supplements the existing Domestic Issuance Programme which NAB uses to issue in Tier 2 format. In December 2019, NAB successfully completed its first AT1 issue in this format – a 10-year (to call) fixed rate note at a franked distribution rate of 4.95%. The size of this was small compared to retail deals - $500 million but the Group expected smaller and more frequent transactions to occur from this platform. The consequence of this program to retail AT1 investors is that as NAB increasingly issues from it, the volume of AT1 capital sourced in this manner rises and which would likely concurrently lower the Group's need and demand for retail AT1 capital. Our base case though is that we broadly expect outstanding AT1 retail volume to remain flat or to grow more slowly rather than to actually decrease.

Also of some topical relevance, there is a current market focus on the long-standing National Income Securities (ASX Code: NABHA). These securities were issued in 1999 by NAB and fully lose their AT1 regulatory value at the end of 2021. We have separately discussed and repeatedly published research on these specific securities over the past few years. For this (NABPG) research note, we will not repeat our comments save for a generic point that should they actually be refinanced (different to repurchased and cancelled) in the near (1- to 2- year) future, this action would add almost $2 billion to the already large supply expected to come to market and which would likely pressure spreads wider at this point.

Figure 7. NAB ASX-Listed AT1 Hybrid Historical Average Trading Margin* **

* NAB Income Securities (NABHA) excluded from average margin calculation

** NABPC margin excluded from April 2019 onwards (i.e. term to optional call date < 1.0 years)

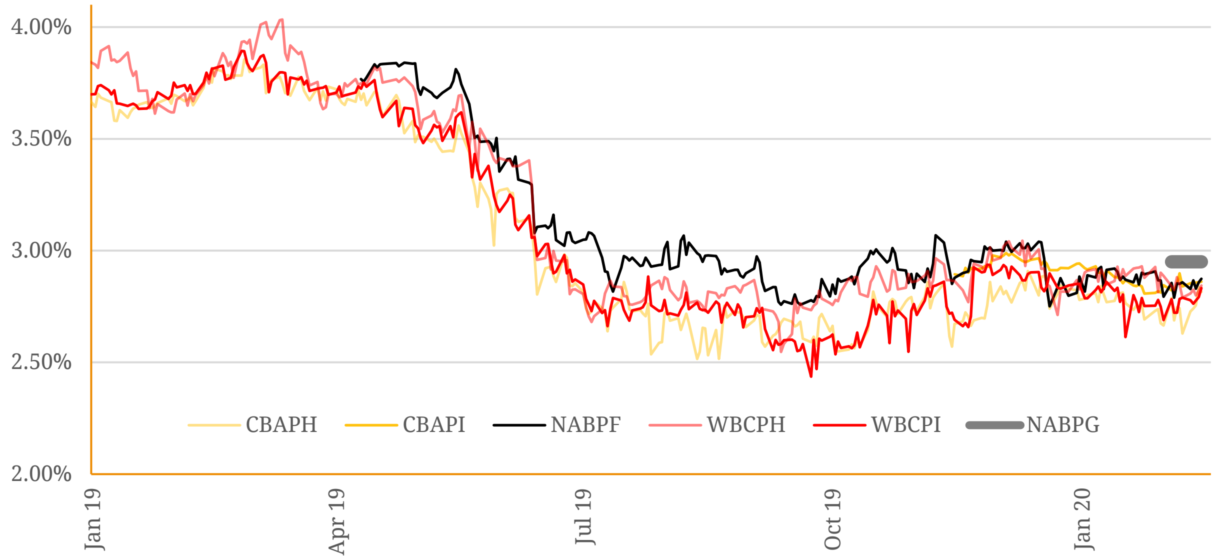
Source: BondAdviser (pricing as at 14 February 2020 close)

As figure 7 above shows, over the past six years or so, NAB's average hybrid trading margin has been broadly range-bound and has traded between 2.00% and 6.00% since late 2013.

Of more relevance over the past few years though is the tighter range of between 2.00% and 3.25% since mid-2017 and within this is the post-election tightening of NAB's (and all) hybrid trading margins from around 3.00% to levels averaging closer to the lower bound and which is currently ~2.25%.

The proposed margin of 2.95 - 3.15% sits comfortably within NAB's historical average valuation / margin range and towards the upper end of the most recent bounds. Investors should be aware though that this is only an average of all of the Issuer's Basel III AT1 deals and the average tenor of this subset is much shorter than the 7.5-years of NABPG, even when excluding securities which have less than 1 year to expected maturity.

Figure 8. Most Recent Major Bank Hybrid AT1 Trading Margins



Source: BondAdviser (pricing as at 14 February 2020 close)

Figure 8 (previous page) compares NABPG with the most recent hybrids listed by peer major banks. The only two issued in 2019 (NABPF and CBAPI) were of 7.25 and 7.5-year tenors and respectively have 6.3-years and 7.2-years remaining to their first call date. Both securities are currently trading between 2.85 and 2.90%, offering a thin new issue premium of between 5 and 10 basis points for, at most, a year's extra tenor. This is similar to the the lack of premia offered for the most recent major bank deals, namely NABPF, CBAPI, CBAPH and WBCPI.

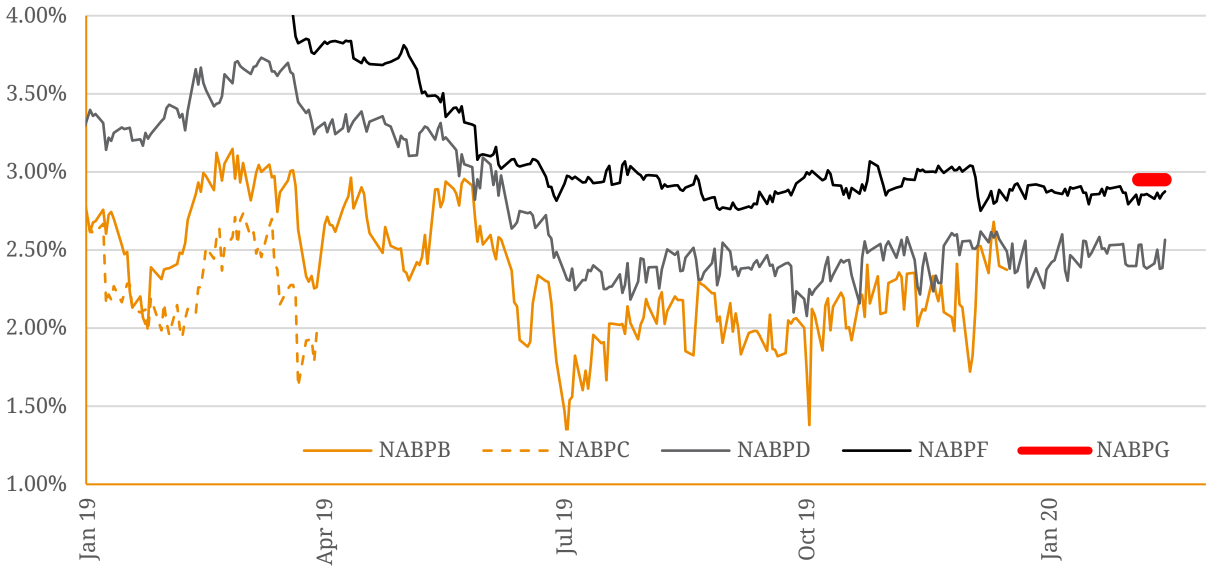
Of important note was the very high demand from investors to both of the above issues and that scale backs were applied to the NABPF Securityholder and Broker Firm/Institutional Offers (but not the Reinvestment Offer).

We stress that even in a supply constrained environment, it is unlikely that the significant tightening in margins seen following the Coalition's election victory will recur. This is most apparent in the case of NABPF, which was issued at a margin of 4.00% and within months (mostly after May 2019) was trading below 3.00%.

Absent supportive credit factors, in our view, the only realistic way margins would trade significantly tighter would be if interest rate levels and expectations were reduced further than their currently low settings. This would increase the *relative* attractiveness of hybrids against likely zero or negative deposit products.

Additionally, as Figure 9 below shows, when compared against NAB's own credit curve across the term structure, the proposed pricing offers a very marginal new issue premium given the limited expected supply. We earlier noted that versus the security closest in tenor to NABPG, NABPF, the new issue offers less than a 10 basis point pickup for an additional 1.2 years of exposure. NABPD (~2.60%, 2.4 years to call) offers ~40 basis point less for a significant ~5.1 years less risk of tenor.

Figure 9. Trading Margin Histories of Recent NAB Tier-1 Issuances * **



* NABPC margin excluded from April 2019 onwards (i.e. term to optional call date < 1.0 years)

** NABPB margin excluded from mid-December 2020 onwards (i.e. term to optional call date < 1.0 years)

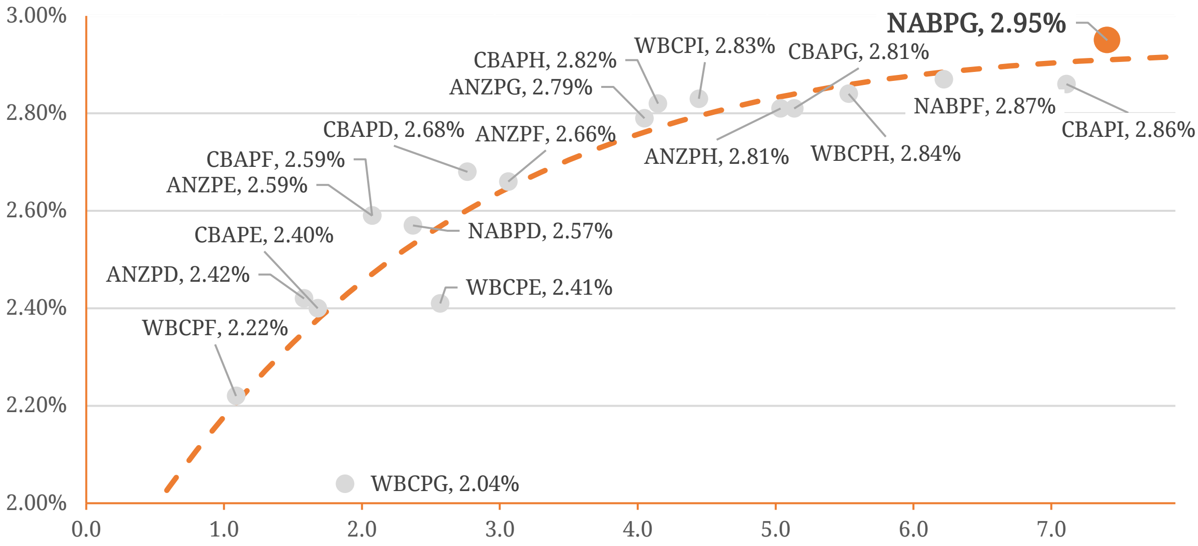
Source: BondAdviser (pricing as at 14 January 2020 close)

If we consider the broader major bank AT1 hybrid market (Figure 10, overleaf), NABPG (at an assumed margin of 2.95%) appears to be pricing slightly above the curve with the continuation of the theme of minimal new issue premium being offered to investors.

We previously believed that the CBAPI issue from late 2019 represented a floor in margins of 3.00% however NAB's slightly aggressive NABPG deal has broken through this assumption.

We do however fully expect market demand to validate this pricing point in the coming weeks as NABPG progresses to its issuance date and beyond.

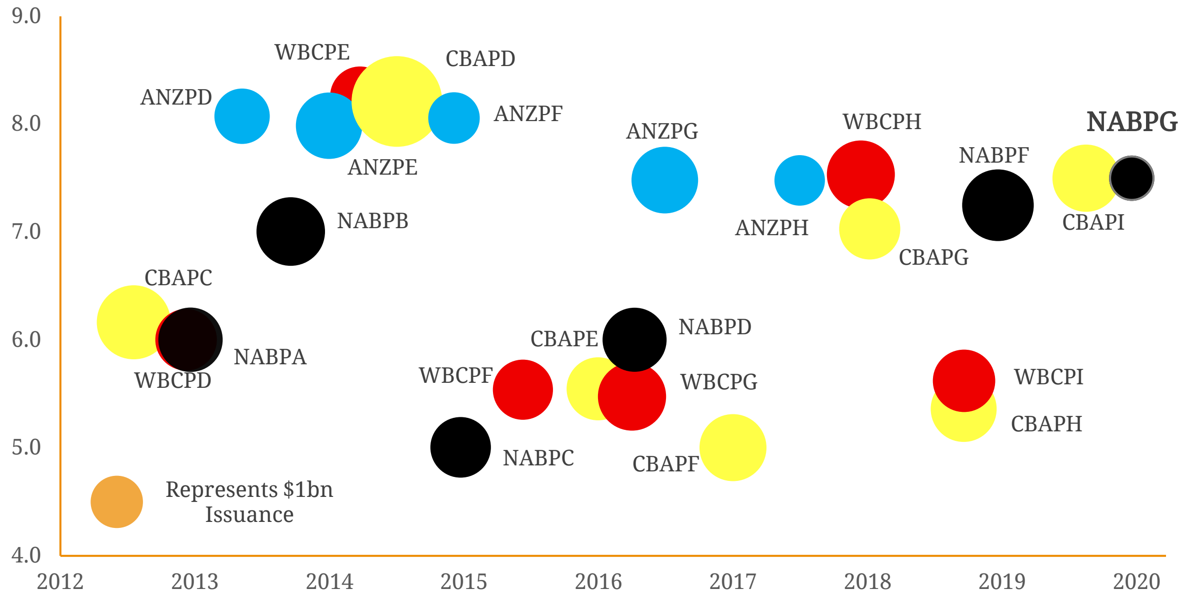
Figure 10. Major Bank Hybrid AT1 Trading Margins



Source: BondAdviser (pricing as at 14 February 2019 close, assumed issue margin of 2.95%)

Figure 11 below highlights the continuation of the trend for major banks to issue in 7-8 year tenors.

Figure 11. Major Bank AT1 Tenor (to Call) by Issuance Year



Source: BondAdviser

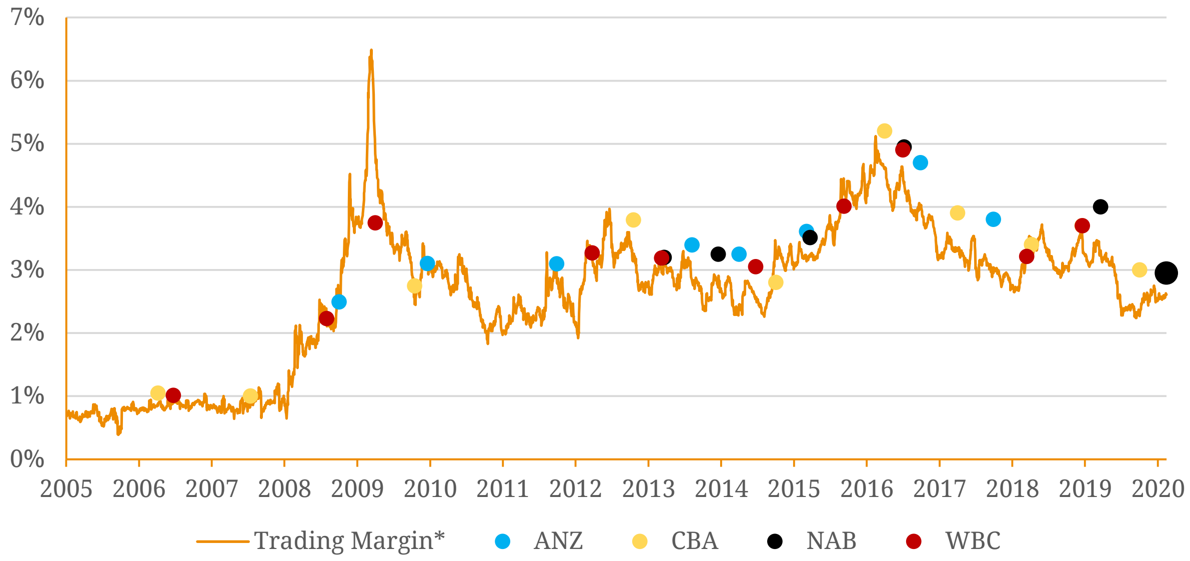
In conclusion, we would caution investors that current market trading margins (and by derivation, issue margins) are very thin but that we mostly believe this to be a reflection of currently low interest rate settings, which are forecast to remain such for the foreseeable future. In addition to this are the prudent and proactive steps that APRA is taking to bolster capital ratios of regulated entities. This should further improve already good ratios and the credit worthiness of local issuers.

Should interest rate and or inflation expectations rebound and increase then the trading margin on this security is likely to trend higher. That said, so too would the referenced (BBSW) margin meaning that the overall income to investors would increase.

The NABPG issue should see very strong refinancing demand from existing holders of NABPC and we expect the issue to raise more than the targeted $750 million, perhaps surpassing the $1.34 billion currently held. As such we would recommend all investors **Subscribe** to NABPG but non-NABPC holders should be prepared for a possible scale back to their requested allocation.

Appendix 1. Historical Comparison

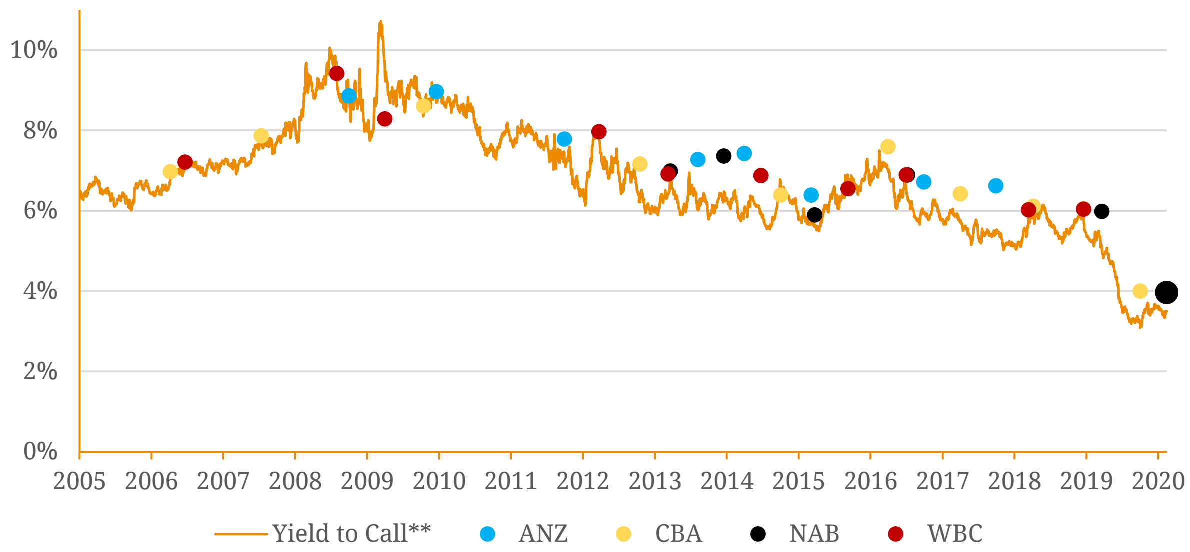
Figure 1. Major Bank AT1 Primary & Weighted Average Secondary Trading Margin*



	Last	1m	3m	YTD	1y	3y	5y	Inception^
Trading Margin	2.61%	2.55%	2.44%	2.51%	3.46%	3.55%	3.27%	0.28%
%Δ		2.35%	6.97%	3.98%	-24.57%	-26.48%	-20.18%	832.14%

Source: BondAdviser Index Platform: BANMAT1DFTR
** Weighted average based on market capitalisation. BANMAT1DFTR is a franked, total return index that is rebalanced on a daily basis.*
^Inception of BANMAT1DFTR is 16/5/2007.

Figure 2. Major Bank AT1 Primary & Weighted Average Secondary Yield to Call**



	Last	1m	3m	YTD	1y	3y	5y	Inception^
Yield to Call	3.50%	3.53%	3.45%	3.61%	5.48%	5.96%	5.70%	6.10%
%Δ		-0.85%	1.45%	-3.05%	-36.13%	-41.28%	-38.60%	-42.62%

Source: BondAdviser Index Platform: BANMAT1DFTR
*** Weighted average based on market capitalisation. BANMAT1DFTR is a franked, total return index that is rebalanced on a daily basis. Yield to call based on BondAdviser estimates.*
^Inception of BANMAT1DFTR is 16/5/2007.

National Australia Bank Limited: Financial Summary

National Australia Bank Limited: Financial Summary | **Recommendation Summary** | **Subscribe**

17 February 2020

Profit and loss	2019	2018	2017	2016
Net Interest Income ($m)	13,614.0	13,467.0	13,166.0	12,930.0
Fee Income ($m)	2,153.0	2,185.0	2,131.0	2,093.0
Trading Income ($m)	1,450.0	1,266.0	1,240.0	945.0
Wealth Management ($m)	0.0	843.0	817.0	801.0
Other Income ($m)	4.0	2,183.0	670.0	1,353.0
Total Revenue ($m)	17,221.0	19,101.0	18,024.0	18,122.0
Growth (%)	-9.8	6.0	-0.5	-1.7
Total Expenses ($m)	-9,827.0	-9,910.0	-8,539.0	-8,331.0
Growth (%)	-0.8	16.0	2.4	1.7
Pre-Provision Profit ($m)	8,104.0	9,191.0	9,485.0	9,791.0
Growth (%)	-11.9	-3.1	-3.1	-4.5
Provisioning Expense ($m)	-927.0	-791.0	-824.0	-813.0
Taxation ($m)	-2,087.0	-2,455.0	-2,480.0	-2,553.0
Minority Interest and Pref	-3.0	-3.0	-3.0	-5.0
Adjustments ($m)	0.0	388.0	-893.0	-6,068.0
Group Statutory Earnings ($m)	5,087.0	5,554.0	6,178.0	6,425.0

Capital Adequecy	2019	2018	2017	2016
Core Equity Tier 1 (%)	10.38	10.20	10.06	9.77
Tier 1 Capital (%)	12.36	12.38	12.41	12.19
Tier 2 Capital (%)	2.32	1.74	2.17	2.00
Total Risk Weighted Capital	14.68	14.12	14.58	14.14
Credit ($m)	351,646.0	331,381.0	325,969.0	331,510.0
Market ($m)	10,023.0	9,460.0	7,766.0	7,299.0
Operational ($m)	47,698.0	37,500.0	37,575.0	37,500.0
IRRBB ($m)	6,404.0	11,343.0	10,804.0	12,136.0
Total Risk Weighted Assets	415,771.0	389,684.0	382,114.0	388,445.0
Dividend Payout Ratio (%)	91.10	94.10	79.40	80.80

Balance Sheet	2019	2018	2017	2016
Loans ($m)	587,749.0	567,981.0	540,125.0	555,281.0
Liquids ($m)	55,457.0	50,188.0	43,826.0	30,630.0
Goodwill ($m)	5,576.0	5,787.0	5,601.0	5,302.0
Trading Assets ($m)	96,828.0	78,228.0	80,091.0	89,102.0
Other ($m)	101,514.0	104,326.0	118,682.0	97,307.0
Total Assets ($m)	847,124.0	806,510.0	788,325.0	777,622.0
Deposits ($m)	522,085.0	503,145.0	500,604.0	436,497.0
Wholesale Debt ($m)	143,258.0	140,222.0	124,871.0	127,942.0
Other ($m)	126,177.0	110,431.0	111,533.0	161,868.0
Total Liabilities ($m)	791,520.0	753,798.0	737,008.0	726,307.0

Asset Quality & Provisions	2019	2018	2017	2016
Annual Provision Charge/Gross Loans				
Individually Assessed (Specific) (%)	0.11	0.08	0.12	0.13
Collective (%)	0.04	0.05	0.50	0.52
Total Charge (%)	0.15	0.13	0.62	0.65
Gross Non-Accruals ($m)	1,972.0	1,521.0	1,724.0	2,642.0
Loans Past 90 Days Due ($m)	3,603.0	2,648.0	2,245.0	1,975.0
Annualised Provisional Charge/Risk				
Individually Assessed (%)	0.19	0.13	0.07	0.18
Collective (%)	0.07	0.07	0.04	0.72
Total Charge (%)	0.26	0.20	0.11	0.91
Provisioning Coverage				
Specific Provision/Net Impaired Assets	65.70	79.60	66.90	38.30
Collective Provision/Credit Risk	0.96	0.92	0.86	0.85

Funding & Liquidity	2019	2018	2017	2016
Stable Funding Index (%)	93.00	93.00	93.00	91.00
Customer Funding Index (%)	70.00	69.00	70.00	69.00
Term Funding Index (%)	23.00	24.00	23.00	22.00
Liquid Assets incl contingent liquidity	129.6	110.5	107.9	118.0

Source: Company data, BondAdviser estimates.

Research Methodology

Every research report prepared by BondAdviser includes a clear recommendation on the security. This recommendation framework is designed to help investors navigate different investment opportunities by identifying the market price, yield, term to maturity, liquidity, volatility and risk.

The guide below may help you understand our research opinions. For further information on our research approach, you can refer to our RG79 statement by **clicking here**.

Research Opinions key

- **Buy** - Over the next 12 months, the analyst expects the security to outperform the current yield due to credit spread tightening or favourable movements in the underlying yield curve.
- **Hold** - Over the next 12 months, the analyst expects the security to provide stable returns broadly in line with the current yield but with little credit spread tightening.
- **Sell** - Over the next 12 months, the analyst expects the security to underperform the current yield due to credit spread widening or adverse movements in the underlying yield curve.
- **Suspended** - The recommendation has been suspended temporarily due to the disclosure of new information or market events that may have a significant impact on our recommendation. This also includes situations where we have been given non-public information and we need to temporarily suspend our coverage in order to comply with applicable regulations and/or internal policies.
- **Not Rated** - A security that has not been assigned a formal recommendation.
- **Ceased Coverage** - The recommendation has ceased due to issuers failure to disclosure necessary information or coverage is subjectively removed in accordance with our Research Governance Statement.

About BondAdviser

BondAdviser is Australia's only specialist independent fixed income research platform providing valuable information and clear investment recommendations for all ASX-listed interest rate securities and a broad range of over-the-counter corporate bonds.

We are the first choice for financial advisers, stockbrokers, private banks; and wealth management firms that need access to the highest quality, most timely and independent fixed income insights and useful analytical tools.

Clients use BondAdviser to meet their risk, governance and compliance requirements. Partnering with us gives them confidence they have a transparent audit trail when making recommendations about fixed income securities. This ensures they can demonstrate they have always acted in their clients' best interests.

Offering a one-stop-shop for pre-trade analytics, compliance and post trade support in Australian fixed income securities, we provide independent research recommendations updated daily.

The company is not aligned to any financial services organisation and the executive team brings over 75 years' combined experience in the fixed income sector.

Learn more

To learn more about the fixed income market visit our website **www.bondadviser.com.au**

Important Information

The web application, the Content and the Reports are not intended to provide financial product advice and must not be relied upon or construed as such. The statements and/or recommendations on this web application, the Content and/or the Reports are our opinions only. We do not express any opinion on the future or expected value of any Security and do not explicitly or implicitly recommend or suggest an investment strategy of any kind.

The Content and the Reports provided at this web application have been prepared based on available data to which we have access. Neither the accuracy of that data nor the research methodology used to produce the Content and Reports can be guaranteed or warranted. Some of the research used to create the Content and the Reports is based on past performance. Past performance is not an indicator of future performance. We have taken all reasonable steps to ensure that any opinion or recommendation in the Content or the Reports is based on reasonable grounds. The data generated by the research in the Content or the Reports is based on research methodology that has limitations; and some of the information in the Content or the Reports is based on information from third parties.

We do not therefore guarantee the currency of the Content or the Reports. If you would like to assess the currency, you should compare the Content or the Reports with more recent characteristics and performance of the assets mentioned within it. You acknowledge that investment can give rise to substantial risk and a product mentioned in the Content or the Reports may not be suitable to you.

You should obtain independent advice specific to your particular circumstances, make your own enquiries and satisfy yourself before you make any investment decisions or use the Content or the Reports for any purpose. This web application and the Content and the Reports provide general information only. There has been no regard whatsoever to your own personal or business needs, your individual circumstances, your own financial position or investment objectives in preparing the Content and Reports available at this web application.

We do not accept responsibility for any loss or damage, however caused (including through negligence), which you may directly or indirectly suffer in connection with your use of this web application or the Content or the Reports, nor do so we accept any responsibility for any such loss arising out of your use of, or reliance on, information contained on or accessed through this web application, the Content or the Reports.