Suncorp Group Subordinated Notes (SUNPD)

Recommendation: Subscribe at a minimum spread of 3.10%

Overview

Suncorp Group (ASX Code: SUN) is looking to raise at least AUD 500 million (more or less depending on demand) via Suncorp Subordinated Notes (Proposed ASX Code: SUNPD). This will be Suncorp's first ASX-listed Tier 2 security that includes the new non-viability event terminology. It is a different structure to the recently-issued Suncorp CPS II (ASX Code: SUNPC) and hence investors should read the terms before subscribing. Unlike the Tier 1 securities, these securities are issued with a legal final maturity in November 2023 with an optional redemption date in November 2018.

These securities pay interest quarterly in arrears (there is no franking and payments are not discretionary) based on the 90-day bank bill swap rate (BBSW) plus a margin. The indicative margin range is 2.85–3.10% over the benchmark and will be set via bookbuild. Funds raised will be used for general corporate, funding and regulatory capital purposes.

Summary and Recommendation

We assign Suncorp a medium issuer risk rating. It does not have sustainable competitive advantages (economic moat) but based on its highly regulated operating environment and stable outlook we assign a medium issuer risk. Our fundamental analysis suggests that Suncorp is a solid issuer but is still dealing with some legacy issues even if they are presently under control. We do not forecast financial distress in the near-term but are wary of insurance event risk and the potential effect this might have on holders of SUNPD.

We recommend investors subscribe at a minimum margin of 3.10% over 90-day BBSW. SUNPD is suitable for investors looking for stable income with a positive view on the credit profile of the issuer. This security is more defensive than Tier 1 securities due to the shorter term to maturity and non-discretionary payment of principal and interest, but it is not as defensive as Australian Government Bonds. The inclusion of a non-viability conversion trigger increases the expected loss upon conversion, but we believe this scenario is unlikely to happen over the duration of this security.

Morningstar's valuation takes into account the current relative value between securities and the long-term fair value of the new issue. On an absolute basis we believe the fair value margin is 3.10% above 90-day BBSW. On a relative value perspective, SUNPD looks cheap compared to the current trading margin on SUNPC (on a risk adjusted basis). However, inclusion of a non-viability trigger means investors share the same risk of conversion borne by investors in Tier 1 securities. Hence the spread between the Tier 1 and Tier 2 security should be tighter than historically evident.

Reinvestment Offer – Suncorp Convertible Preference Shares (SBKPB)

Suncorp is offering holders of Suncorp Convertible Preference Shares (SBKPB) the opportunity to reinvest their proceeds into the new Suncorp Subordinated Notes. All outstanding securities for SBKPB will be redeemed (through resale process) and cancelled on 14 June 2013.

This is not a like-for-like offering. We recommend investors look at the new security on its own merit. SBKPB is a Tier 1 security issued by the Suncorp Bank with arguably lower risk profile than the overall group. The new offer is a Tier 2 security which means it is higher in the capital structure and distributions are not discretionary.

Table 1: Risk Summary

Issuer Risk	Business Risk	Financial Risk	Debt Cushion	Distance to Default	Economic Moat	Industry Group	Sector
Medium	Medium	Fair	Fair	Good	None	Life and General Insurance	Financial Services

Source: Morningstar

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Table 2: Morningstar's key qualitative data points for Australian Life and General Insurance Sector

	Issuer Risk	Business Risk	Economic Moat
Suncorp Group	Medium	Medium	None
Insurance Australia Group	Medium	Medium	None
QBE	–	Medium	Narrow
AMP	–	Medium	Narrow

Source: Morningstar

Valuation

This is the first Basel III compliant listed Tier 2 security offered by a domestic issuer and hence there are no like-for-like relative pricing points. The best point of comparison is the Subordinated Notes issued by Australia & New Zealand Banking Group (ANZ), National Australia Bank (NAB) and Westpac (WBC) in 2012. We ascribe narrow economic moat ratings to each of the four major banks, but a no-moat rating to Suncorp. For this reason SUNPD should price at a premium to ANZHA, NABHB and WBCHA.

We assign a fair margin of 3.10% to SUNPD. The fair margin is calculated using a credit spread of 2.40%, an illiquidity cost of 0.10% and an additional 0.6% to account for the probability of loss given conversion. Our fair credit spread is wider than the bank subordinated notes primarily due to our view that general insurance is a higher-risk business, which is subject to event risk, and hence the probability of conversion is higher. We recognise that event risk is mitigated by an overcapitalised insurance division (on a pro-forma basis), but we remain conservative on our assumptions for insurance events and loss provisions of the 'bad bank' unit of the banking subsidiary.

The indicative margin range (2.85 –3.10%) on SUNPD looks attractive relative to the current trading margin on SUNPC (~3.80–3.90%) on a risk/reward basis. However, we would argue that the inclusion of a non-viability trigger means investors are subject to the same risk of conversion as Tier 1 securities and hence the spread between Tier 1 and Tier 2 securities should be tighter than historically evident. Over the last year, the spread between Tier 1 and Tier 2 securities for the banks has been ~90-120bps. Therefore it is reasonable to assume that the spread should be ~0.70–0.80% for Tier 1 and Tier 2 securities with a non-viability trigger from the same issuer. This spread prices in terms such as discretionary dividends and capital triggers. In our opinion priority ranking in the event of default (or work out) is irrelevant for investors due to the conversion mechanics.

Issuer Credit Perspective

Morningstar's issuer credit perspective is our assessment of an issuer's ability to meet its legal obligations in a full and timely manner. Our insurance methodology is based on four key pillars; Business Risk, Debt Cushion, Financial Risk and Distance to Default. These assessments are specific to the financial health of the issuer. We then consider the security's structural elements to formulate our investment risk rating for the security itself. It is important for investors to look at all elements of our analysis before participating in the issue.

Table 3: Business Risk

Size (Assets in AUD Mil)	92,910
Economic Moat Rating	None
Equity Uncertainty Rating	Medium
Management Grade	Standard
Underwriting Profitability % (Adjusted 7-Yr Average Modified Combined Ratio)	81.2%
Business Risk Score	Fair

Source: Morningstar

Morningstar's business risk score is our qualitative assessment of the presence of any sustainable competitive advantages (economic moat) and four insurance-specific considerations: regulatory environment, underwriting profitability, the volatility of underwriting profitability, and overall level of underwriting risk. The Life and General Life Insurance sector in Australia has distinct attributes which makes understanding its dynamics a fundamentally important consideration for investors.

Size

Suncorp's size has a neural impact on its business risk rating. We believe that size is relevant in assessing the credit quality of insurers. Large insurers generally have better access to capital markets, and they have more parties with stakes in their survival. While we understand that the majority of balance sheet assets are not held for the company's benefit, we believe that the larger the asset base, the more stakeholders involved in the survival of the issuer. Suncorp is one of Australia's largest two domestic general insurers and sixth-largest bank and also has a life insurance and niche wealth management business. The size of the domestic market means Australian insurers are capped at a moderately low level on a global scale.

Economic Moat

The economic moat concept is a cornerstone of Morningstar's investment philosophy and is used to distinguish high quality companies. An economic moat allows a firm to sustain excess returns over a long period of time. Without a moat, profits are more susceptible to competition. Companies with a narrow moat are likely to achieve normalised excess returns beyond ten years, while wide moat companies are likely to sustain excess returns beyond 20 years.

Suncorp does not have enough sustainable competitive advantages to have a narrow economic moat. As the only company with general insurance underwriting, banking and life insurance the group is unique. Suncorp contends that ownership of 'manufacturing´ capacity in these business lines means it should be able to cross-sell more products than other banks. So far the results are inconclusive, with divisional growth rates in line with their sectors. Suncorp has added less value for investors than a portfolio of shares in pure-play insurers and banks. It has a large regional banking franchise in Queensland but its interest margins and fees are affected by sector-wide competition.

The general insurance business faces national competitive pressures. In both the insurance and banking businesses brand equity is not as strong as at the major banks, which have a narrow moat. Suncorp's pricing power across its three sectors is not sufficient to stop rates of return on capital falling towards the cost of capital during sector downturns. The general insurance business grows with the economy and the number and value of insured assets, but is cyclical. The main downside risks are competitive pressures on premiums, deterioration in claims trends, and large insured events, or catastrophes, especially where the net claims are above-budget and lead to increased reinsurance costs.

The core banking business grows with the economy; the risks are slower asset and revenue growth from economic downturns, and higher bad and doubtful debts. The non-core bank is in runoff and its earnings will be volatile and unpredictable. Suncorp being medium sized in 2006, meant the the group was vulnerable to a takeover. The acquisition of Promina in March 2007 made the group a more difficult undertaking for any domestic acquirer and also bought scale in general insurance. The company´s fortunes now lie mainly with the domestic general insurance cycle: the flow of capital into and out of the industry, respectively pressuring and raising premiums, underlying claims trends and catastrophe claims, and the cost of reinsurance. The turnaround under CEO Patrick Snowball is proceeding very successfully with growth in the underlying insurance margin, runoff of the non-core bank, expansion in the core bank and good new business growth in the life insurer.

Regulatory Environment

The Australian regulatory environment is complex, but is designed to protect policy holders from financial collapse of the issuer and the use of public funds to support the issuer in a time of stress. Suncorp Group is subject to APRA's Basel III requirements for its banking subsidiary and APRA's life and general insurance capital standards (LAGIC) for its Life and General Insurance subsidiaries. This security (SUNPD) is designed to provide fungible Tier 2 capital at the NOHC level which can be allocated to the subsidiaries if and when necessary.

On 1 January 2013 APRA introduced the new Capital Adequacy regimes for Life and General Insurance (LAGIC) and Banking (Basel III). We have discussed Basel III in depth in previous reports and hence we will focus on LAGIC requirements. This new framework was introduced with the aim of introducing more risk-sensitive capital measures and creating a standardised capital measure across APRA's regulated entities. Prior to 1 January 2013, insurers reported their actual capital ratios as a function of the minimum capital ratio (MCR). Going forward the minimum capital ratio is replaced with the Prudential Capital Requirement (PCR).

The PCR is defined as the Prescribed Capital Amount (PCA) and any Supervisory Adjustment. In a similar fashion to the current banking regulatory framework the PCA can be determined either using:

- Standard method (risk charges)
- Internal Model Method (IMM)
- Supervisory adjustment (Pillar 2): applied to reflect risks not otherwise captured in the PCA.

The composition of capital will also be consistent with Basel III whereby the eligible capital base will be made up of:

- Common Equity Tier 1
- Additional Tier 1 (i.e. Suncorp CPS II)
- And Tier 2 Capital (i.e. Suncorp Subordinated Notes)

The impact of LAGIC has not been significant with some actuaries estimating the final impact to be an increase of ~9% in the minimum prescribed capital. The overall effect for the investment portfolio is more punitive for equity investments, an increased focus on asset and liability duration (interest rate risk) matching and a concentration risk charge, which arguably has the greatest impact on domestic insurers.

Table 4: Financial Risk

Reserves / Capital	161%
Gross Written Premium/Capital	205%
Debt/Capital (Group)	42%
Investment Portfolio Loss Rate % - Sensitivity Analysis	7.9%
Capital Reduction % – Sensitivity Analysis	3.9%
Financial Risk Score	Fair

Source: Morningstar

The new LAGIC framework will require insurers to hold sufficient capital to absorb unexpected shocks or loses that arise over a one-year period with a 99.5% level of probability. In reality this is a highly complex calculation, and is subject to a number of assumptions, which does not give us full confidence that the 99.5% probability is achievable. Hence why the subjective non-viability trigger is included in regulated capital securities.

We have only provided a high level summary of the regulatory environment for more information please revert to the Prospectus.

Underwriting
In assessing the underwriting efficiency of the issuer we look at the average modified combined ratio through a typical cycle to remove the effect of any outlier years and adjust the measure accordingly for future expectations. On average Suncorp's underwriting is reasonably profitable but in the last few years has had a tendency to be volatile due to increasing claims. We expect a slight deterioration in the combined ratio in the next five years as claims remain elevated. Volatility in operating profitability is going to be the focus of new LAGIC framework and hence we expect Suncorp to pursue a more stable combined ratio going forward. Overall the underwriting capacity of the business is strong, but not without its challenges and hence we score the underwriting risk in the mid-range relative to global peers.

We regard the financial health of Suncorp as fair. We discuss our opinion on the general insurance subsidiary below and although the recent figures look strong, the underlying earnings volatility across the group remains. We are positive on the outlook for the group, but we remain conservative in our loss estimates while non-core banking book remains part of the group.

Suncorp Group has surplus capital which arguably will at some point be returned to shareholders. There are a number of reasons for this surplus (including overcapitalising the non-core banking book) but importantly we remain confident that Suncorp is adequately capitalised at the group level but may require some structural adjustments at the subsidiary level to meet the requirements under the new capital frameworks. As SUN falls under both our insurance and banking methodologies some of our risk measures can look distorted. For this reason we will assess the financial risk of the group using a blend.

As we have discussed before the Prescribed Capital Amount (PCA) is the new regulatory measure of capital for life and general insurance. It is very difficult to forecast the PCA due to its new dynamic nature, but we are confident that under the new framework SUN will focus on stable earnings in its insurance divisions in order to be confident of its future capital requirements.

Suncorp aims for a 90% probability of adequacy for claims in its general insurance subsidiaries.
The reserve to capital ratio measures the safety of capital holders beyond this 90% probability of adequacy. This ratio is 161% (according to proforma 31 December 2012 accounts and excluding excess capital held at NOHC level). We consider this to be a satisfactory level, but are wary of event risk possibilities in Australia, which could have a negative impact on the overall capital level.

The gross written premium to capital ratio is very strong at 205% (at 31 December 2012), but this is subject to significant volatility and under LAGIC it is unlikely that this level will be maintained. Under LAGIC, volatile profit levels require excess capital and hence the return on capital is difficult to forecast.

The final component of Suncorp's financial risk analysis is its investment income sensitivity. Under this measure we apply a one standard deviation loss rate to each asset class in Suncorp's investment portfolio. These loss rates are a form of portfolio stress test, which is expressed as a percentage of the capital base. Investment income is split between income of insurance funds and income on shareholder funds. Investment income was strong in the past 12-18 months as the yield curve shifted lower and credit spread contracted. That is unlikely to happen again at any time in the near future. The details of investment portfolios are not given for technical reserves so we assume the portfolio is matched against their given benchmark of 40% Investment Grade Credit, 20% Inflation Linked Bonds, 20% Commonwealth Government Bonds and 20% Semi-government Bonds. The sensitivity of Suncorp's investment income as a contributor to profit is likely to be the biggest drag on earnings in the short-term, but based on our assumed loss rates the current capital base is sufficient to withstand a sharp fall in the value of the portfolio.

Debt Cushion

Morningstar measures an insurer's ability to cover its debt maturities and future interest payments with its balance sheet surplus and future profitability. The analysis of Suncorp's Debt cushion is made simple by the fact that insurance subsidiary has negligible debt (a small amount of sub debt) as the majority of the groups funding is provided by Suncorp Metway ("the core bank"). This effectively renders any analysis of the debt cushion for the insurance division inadequate. For this reason it is reasonable to assess the funding and liquidity profile from the core bank as a substitute.

Funding and Liquidity

Suncorp's funding strategy is unique. Historically, banking division (Suncorp Metway Ltd) was not sufficiently strong enough to directly access term wholesale funding markets at a competitive price level. Hence, the group funds a proportionately higher amount of its loan book through deposits, short term wholesale markets and off-balance-sheet instruments rather than traditional wholesale term markets. However, the recent covered bond issuance has changed the funding landscape.

In 2009 the banking division took the strategic decision to create a "non-core" banking portfolio of AUD 18.5 billion (one-third of its total loans at the time), which was match-funded to its expected amortization with a series of term funding issues utilizing the Australian government guarantee available at the time. As at 30 June 2012 Suncorp had reduced its non-core corporate loans (reverting to its traditional focus on home loans and SMEs) to approximately $6bn and used the funds to repay wholesale borrowings. This has in turn reduced leverage and improved the overall funding profile of the banking group.

It is unlikely that the funding position of the group will change in the near future and asset growth will remain funded by the covered bond program, securitisation and retail deposits.

Suncorp manages the majority of its liquidity through the investment composition of its technical reserves and, to a lesser extent, its liquid banking assets. Suncorp's management has historically been conservative on its approach to technical reserves and their respective investment composition.

Morningstar considers the liquidity profile of the Suncorp group as sufficient to meet any short-term requirements, but is aware that short term mismatches may potentially occur in the circumstance where claims and reinsurance payments are not matched.

Distance to Default

The final measure in Morningstar's credit opinion is our distance to default. This measure provides us with a guide to the probability of an issuer meeting its obligations (without covenants). This does not have a large impact on our overall assessment but is designed as a quantitative measure of default probability.

Importantly our fundamental assessment suggests that our default probability estimate is high relative to market based assessments (i.e. implied default probability from credit default swaps) and hence we can assume our underwriting techniques are more conservative than the market.

Structural Considerations

Morningstar's credit opinion is a measure of strength of an issuer and the probability that it will meet all future obligations. Investors also need to assess the security's unique structural characteristics, before investing. Suncorp Subordinated Notes are less structurally complex than the recent Suncorp CPS II. Unlike Tier 1 securities, all regulated Tier 2 securities do not allow the issuer discretion when paying interest, which removes a significant amount of uncertainty. This security has a legal maturity at 10.5 years and because it has a five-year call option is eligible to be counted as regulatory capital only for a period of five years, after which it simply becomes expensive debt.

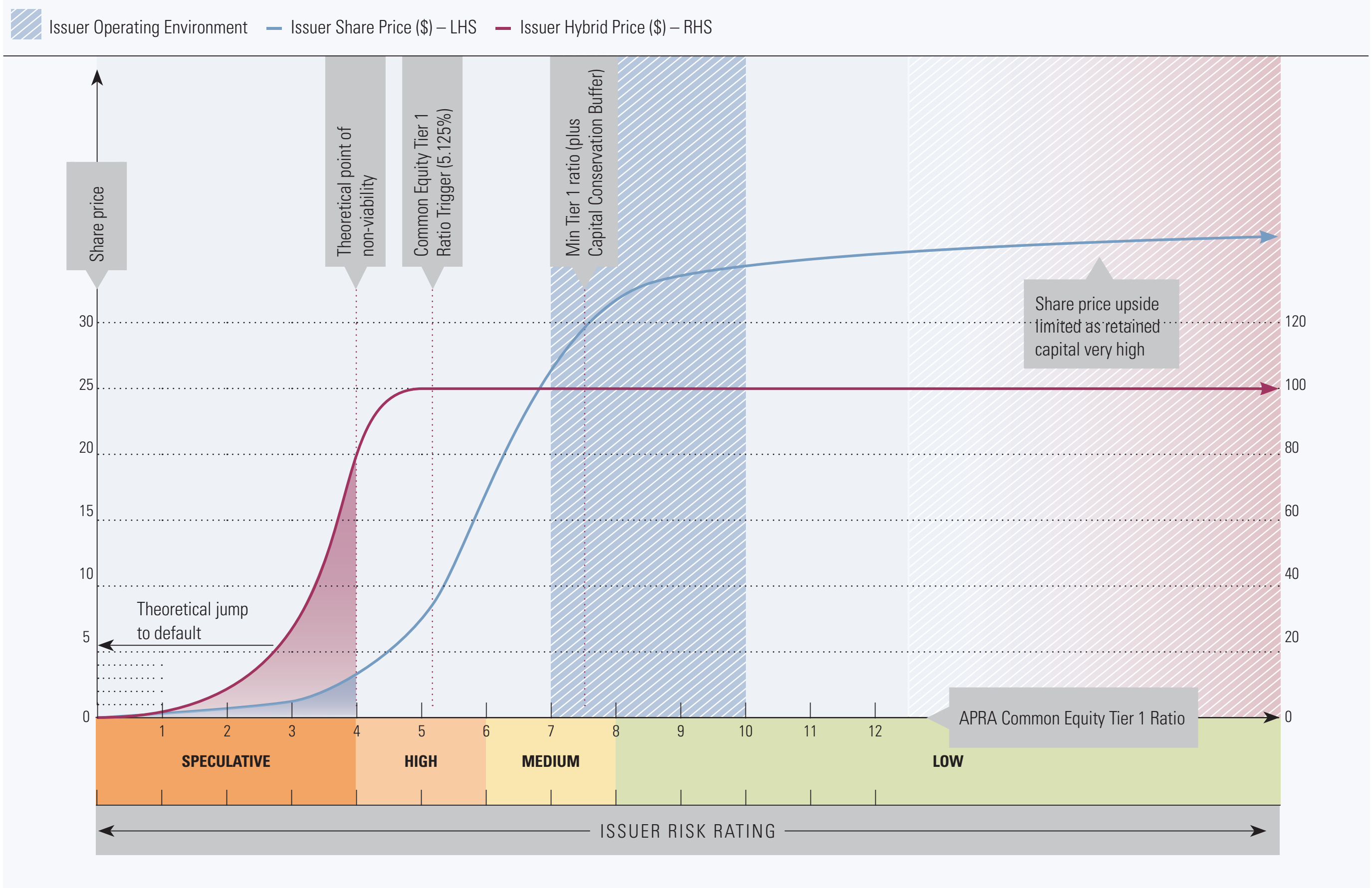
The other significant structural terms are the solvency condition and risk of unscheduled conversion (or write off) due to a non-viability trigger event.

The solvency condition is a condition precedent to all payments on the notes. This condition was included in previously issued ANZHA, NABHB and WBCHA. If this condition is not met then failure to make payment does not constitute and event of default.

As with other APRA-regulated instruments the largest risk to holders is unscheduled conversion due to a non-viability trigger event. Although we consider this an unlikely event, the implications for holders are substantial. Unscheduled conversion forced by the regulator will only happen in the case of a large downside event which would otherwise lead to insolvency. APRA has decided not to provide a clear and objective definition of non-viability to ensure they have full discretion to convert in a time of stress. Note that there are no conversion conditions for SUNPD.

As we have previously discussed Tier 2 securities rank senior to common equity and tier 1 securities. In a 'wind up' scenario losses will be allocated in a reverse sequential order. However, the point of non-viability

Figure 1: Theoretical Capital Risk Profile for Equity and Hybrid Instruments



Source: Morningstar

effectively renders a wind up scenario irrelevant as the security will have been converted well before this point. The definition of non-viability is consistent across all regulated capital securities, so we do question whether there any value in subordination under non-viability. If APRA deems Suncorp to be non-viable, it will enforce conversion of relevant capital securities. This could be only Tier 1, or it could be Tier 1 and Tier 2 securities. The terms of the prospectus state that it must convert all Tier 1 securities first. If Suncorp is at the point of non-viability, the required capital necessary to reinstate a minimum capital requirement means that it is highly probable that all relevant securities will be converted together. So in effect under non-viability Tier 1 and Tier 2 securities rank pari passu and will have the same recovery.

This point has not been clearly defined and it will remain subjective for APRAs purpose (which is ultimately to protect the public from having to support a failing banking institution). It is Morningstar's opinion that the point of non-viability is before default or insolvency (but probably after the capital trigger for the securities that have this structural characteristic) because it is in the interest of APRA to maintain solvency in domestic banking institutions.

The non-viability trigger ultimately gives APRA discretion to convert SUNPD into equity when it deems it appropriate. The use of this trigger event may not be limited to its concerns about Suncorp's capital levels and could extend to concerns about the bank's funding and liquidity.

Conversion will occur using a consistent predefined calculation (as per other Basel III compliant capital securities) with the number of shares received being a function of a calculation known as the conversion number. This conversion number has a maximum limit (known as the maximum conversion number), which will automatically write down the value of your investment depending on the common equity share price over the preceding 5 days. As non-viability conversion is forced Morningstar assumes 0% recovery.

Inability Event

If for some reason Suncorp is unable to convert SUNPD within five days of a non-viability trigger event then holders rights under SUNPD would be written off. The rights of holders of SUNPD following an inability event are equivalent to shareholder rights, but they will not be able to trade their rights on the ASX. In Morningstar's opinion the recovery difference would be so small it makes little impact to the valuation.

Table 1: Comparable Converting Major Bank Capital Securities

	SUNPD	WBCHA	NABHB	ANZHA
Name	Suncorp Subordinated Notes	Westpac Subordinated Notes	NAB Subordinated Notes	ANZ Subordinated Notes
Type	Notes	Notes	Notes	Notes
Issuer	SUN	WBC	NAB	ANZ
Issue Size	Min $500m	Min $1.680bn	$1.17bn	$1.5bn
Face Value	$100	$100	$100	$100
Issue Date	22 May 2013			
Margin above Base Rate	[2.85 – 3.10%]	2.75%	2.75%	2.75%
Trading Margin	–	1.93%	1.92%	2.05%
Base Rate	90-Day BBSW	90-Day BBSW	90-Day BBSW	90-Day BBSW
First Call Date	22 Nov 2018	23 Aug 2017	17 Mar 2017	20 Jun 2017
Final Maturity Date	22 Nov 2023	23 Aug 2022	17 March 2022	20 Jun 2022
Step-Up	None	None	None	None
Distributions	Non discretionary, gross pay (no franking credits), missed payment constitutes EOD	Non discretionary, gross pay (no franking credits), missed payment constitutes EOD.	Non discretionary, gross pay (no franking credits), missed payment constitutes EOD.	Non discretionary, gross pay (no franking credits), missed payment constitutes EOD.
Capital Trigger Event	No	No	No	No
Non-Viability Trigger Event	Yes	No	No	No
Conversion into ordinary shares	Yes	No	No	No
Solvency Condition	Yes	Yes	Yes	Yes
Ranking	Above SUN ordinary shares and Tier 1 securities.	Above WBC ordinary shares and Tier 1 securities.	Above NAB ordinary shares and Tier 1 securities.	Above ANZ ordinary shares and Tier 1 securities.

Event of Default

As payments of principal and interest are non-discretionary for SUNPD, missing these timely payments will constitute an event of default (except in circumstance of breach of solvency condition or non-viability trigger event). The note trustee (Australian Executor Trustees) will act of behalf of holder to remedy unpaid principal and interest.

Tax and Regulatory Events

Subject to prior approval of APRA, Suncorp may redeem the notes early in the scenario where a Tax or Regulatory Event has occurred. More information can be found in section 4.2, 4.4 and 4.7 of the prospectus.

Other Risks:

Excluding the risks described above SUNPD are subject to a number of other risks which investors should be aware of:

Market Risk

SUNPD has embedded equity risk (through the conversion process) which means it is exposed to market risk as a consequence of its trading activities and/or the management of its financial position. Therefore it is reasonable to suggest it is exposed to adverse movements in levels and volatility of interest rates, foreign exchange rates, commodity prices, credit prices and equity prices.

Interest Rate Risk

SUNPD resets on a quarterly basis. Technically this is defined as short duration and therefore changes in benchmark interest rates will have a minimal impact on the capital performance of the security.

Systemic Credit Risk

Although idiosyncratic credit risk has been assessed in this document, systemic effects can have an impact on the performance of the security. This risk is difficult to quantify but Morningstar mitigates this risk by incorporating a systemic risk premium in its fair value assessment.

Event Risk

Event risks arise as a result of unforeseen or unexpected events such as natural disasters, political reforms, mergers and acquisitions.

Key Terms

- Bookbuild: 17 April 2013
- Announcement of margin: 18 April 2013
- Offer Opens: 18 April 2013
- Closing Date for Offer: 20 May 2013 (Broker Firm Offer)
- Issue Date: 22 May 2013
- Commencement of Trading: 23 May 2013
- First Dividend Payment Date: 22 August 2013
- Optional Redemption Date: 22 Nov 2018

- Maturity Date: 22 Nov 2023
- ASX code is expected to be SUNPD
- Face Value: $100 per security.
- Minimum Subscription Amount: $5,000 (50 units).
- Amount to be raised: Min $500m with the ability to raise more or less.
- Distribution Rate: (90-day BBSW rate + Margin%) x (1-Corporate Tax Rate).
- Margin: SUN has provided an indicative range of 2.85–-3.10%
- Frequency of Distributions: Quarterly on 22nd of Feb, May, August and November.
- Franking: No Franking
- Distributions: Distributions are at the sole discretionary of NAB and subject to payment conditions outlined above. Distributions are not cumulative meaning that NAB does not have to make up for missed distributions.
- Capital Classification: Additional Tier 2 Capital.
- Term: 10.5 years subject to issuer call option at 5.5 years.
  - Unscheduled conversion as a result of a non-viablity trigger event;

We have only presented a summary of the material terms. Investors should examine the prospectus in detail.

Disclosure and Research Methodology

Limited Financial Services Guide

Morningstar Australasia Pty Limited ('Morningstar') ABN: 95 090 665 544, AFSL: 240 892 (a subsidiary of Morningstar, Inc.) of Level 36 Australia Square, 264 George Street Sydney NSW 2000 is the provider of the general advice ('the service') provided in this report. The service is provided through research including the profiling and rating of companies and the securities they issue. Morningstar does not receive commissions for the service and does not charge companies to be rated. Morningstar is remunerated for the service by subscribers paying a subscription fee. This fee is variable depending on the individual subscriber's specific requirements. Morningstar has no debt or equity relationship with any issuers of any securities. Morningstar may provide a licence for the use and distribution of the service to issuers of securities which are the subject of a research report. Morningstar representatives are remunerated by salary and do not directly receive any commissions or fees. They may be eligible for an annual performance payment which is discretionary and based on reaching agreed performance levels. Please refer to our Financial Services Guide (FSG) for more information www.morningstar.com.au/fsg.asp.

Listed corporate income securities

Morningstar covers around 30 listed income securities. Our methodology is forward looking, based on our expectations of future cash flows. Analysis is carried out by our income securities team, which is a subset of the equities research team and thereby utilising the equity analysts' expert knowledge and cash flow models of the underlying businesses.

The focus of Morningstar's analysis is to assess the degree to which the underlying business is capable of supporting the commitments required by the securities. We analyse the following factors to place the security in one of the security risk categories of: Excellent, Investment Grade, Speculative or Distressed:

- Business Risk – comprising an assessment of whether there is an economic moat (presence of sustainable competitive advantages), the strength of management and how uncertain future cash flows are; and
- Financial Risk – based on testing the company under a series of leverage and cash low ratios.

We then calculate the yield that is justified by the risk of the security based on a transition model which identifies a range of credit spreads, primarily based on historic default rates. We add a spread to account for transaction costs associated with illiquidity, and small additional spreads to represent the inconvenience or risks associated with non-cumulative dividends or the security being a perpetual.

Listed Income Securities coverage criteria

Coverage of around 30 listed income securities is based on client demand, determined on a set of guidelines, which include issue size being at least AUD 200 million, the underlying corporate or its listed parent being covered by Morningstar's equity research team, Morningstar's judgement of the investment merit of the security and the strength of existing and likely demand from our retail investor, broker, financial adviser, and institutional clients.

Timing and frequency of income security research reports

- Pre-IPO research reports on securities that meet the coverage criteria are published in the first week after the launch of the issue.
- Ongoing research reports are updated at least six monthly or sooner in the case of a major event.
- Income Securities Monthly reports provide a roundup of current pricing and recommendations and an outlook for the market.
- An archive of income securities research reports is available on Morningstar's Adviser Research Centre platform and Morningstar's retail investor website.

Research report content

Income securities research reports contain detailed issuer analysis and an investment recommendation on the security. Reports contain the following content:

- Recommendations – Subscribe/Don't Subscribe for IPO reports. Buy, Accumulate, Hold, Reduce, Sell or Avoid once security is trading.
- Investment Rating – overview of the risk and investment appeal of the security
- Analyst Note – analysis of a key event and implications on the investment appeal of the security
- Thesis – analysis of the business risk and financial risk of the underlying business
- Contract Summary – description of the specific characteristics of the security
- Security Valuation – key inputs to the valuation of the security
- Risks – analysis of potential risks to the underlying business and security
- Investment Perspective of underlying business – Investment Rating, Risk, Growth, Profitability and Financial Health of the underlying company
- Forecasts and key ratios of the underlying business
- Note: Morningstar Australasia does not provide credit ratings.

Morningstar's income securities analysis builds on the modelling expertise of the equities research team, including:

- At least five years of detailed pro-forma financial statements
- Extensive analysis of free cashflow and return on invested capital
- Uncertainty and scenario analysis, including upside and downside cases
- Forecasts of leverage, coverage and liquidity ratios
- Estimates of off-balance sheet liabilities

Economic Moats

Just as moats protected castles from invaders in medieval times, businesses with economic moats have strong defences against their profits being competed away. We ascribe a moat rating to each stock researched: Wide, Narrow or None. The moat is the competitive advantage that one company has over other companies in the same industry. Moat firms have unique skills or assets, allowing them to stay ahead of the competition and earn above-average profits for many years. Returns on their invested capital will exceed the cost of that capital. Without a moat, highly profitable firms can have their profits competed away as other companies see how attractive the market is and try to move in to reap some of the rewards themselves.

Across our research, we have discovered five economic moat sources: Intangible assets, switching costs, network effects, cost advantage and efficient scale. Intangible assets include strong brands which encourage repeat sales and support price rises over time. Intellectual property rights like patents, trademarks, copyrights and government approvals are other intangible assets that can lead to moats. Switching costs make it too expensive or time-consuming to shift to an alternative supplier. The network effect is a virtuous cycle allowing strong companies to get even stronger. It occurs when the value of a particular good or service grows as the number of users grows. Cost advantage can derive from increased scale and efficiency, allowing the company to increase margins. Efficient scale occurs when a limited market is effectively served by existing players and the profit opportunity does not justify entry by others.

Business Risk

Business risk captures the fundamental uncertainty around a firm's business operations and the cash flow generated by those operations. The following factors are key to determining business risk:

- diversity of revenue sources – a company with diverse revenue stream should have more reliable revenues as weakness in one area may be offset by strength in others.
- cyclicality of revenues – for example revenues of a housing products supplier will be tied to cyclical property demand cycles and will be more volatile than a supermarket retailer which should have more ongoing demand.
- the firm's fixed-cost structure – companies with high levels of fixed costs will have greater swings in earnings as revenues move up and down.
- financial leverage – companies with excessive debt levels may run in to troubles should conditions deteriorate, potentially causing unwanted asset sales, dilutive equities issues or even bankruptcy.
- contingent events – examples include outstanding litigation, risk of aggressive acquisitions at high prices, asbestos liabilities etc.

Declaration

Declaration of personal shareholdings, disclosure list. These positions can change at any time and are not additional recommendations

AAO,ABC,ACG,ACL,ACR,AFI,AGK,AGS,AGX,AKF,ALL,ALS,AMP,ANO,ANP,ANZ,APA,APN,ARD,ARG,ASB,ASZ,ATI,AVX,BEN,BFG,BHP,BKI,BKN,BLY,BND,BNO,BOL,BOQ,BSL,BTU,BWP,BXB,CAB,CBA,CCL,CDD,CGS,CIF,CND,COF,COH,CPA,CRK,CRZ,CSL,CSS,CTN,DOW,DTE,DUE,EGP,EPX,EQT,ERA,ESV,EVZ,FMG,FXJ,GBG,GFF,GMG,GPT,GWA,HIL,HSN,IAG,IFL,IGR,IIN,ILU,IPD,JMB,KAR,KCN,KEY,KMD,LEG,LEI,LLC,MBN,MCR,MFF,MIO,MPO,MQG,MSB,MTS,MUN,MYR,NAB,NEU,NHC,NMS,NUF,NUP,NVT,NWS,OSH,PBG,PBT,PGM,PMV,PNR,PPT,PRG,PRY,PTS,QBE,QFX,QUB,RCR,REX,RFE,RHC,RHG,RIO,RKN,RQL,SAKHA,SEK,SFW,SGP,SGT,SHV,SMX,SOL,SRH,SRX,STS,SUN,SVW,SWM,TAH,TCL,TEN,TLS,TOL,TPM,TRF,TRS,TSE,UGL,UXC,WAL,WAM,WBB,WBC,WCB,WDC,WES,WHC,WHG,WOW,WPL,ZGL,