

CBA PERLS 5

28 August 2009

Executive Summary

- PERLS 5 is the new hybrid issued by the Commonwealth Bank offering a margin of 3.40% over the 90 day bank bill swap rate (BBSW). The issue is for approximately \$900m and is structured as a five year mandatory converting preference share – the standard format for new bank hybrids.
- The PERLS 5 offer good relative value when compared with other major bank converting preference shares and other fixed income products in the Commonwealth Bank capital structure.
- In a challenging market environment and slowing economic conditions the Commonwealth Bank's operating performance has been solid. Operating income growth has been strong, up 14% on the prior year and net profit was down just 7% on 2008 to \$4,415m.
- The bank has a strong Tier 1 capital position of 8.07%. This will increase to approximately 8.37% subsequent to the issuance of the PERLS 5.

PERLS 5

PERLS 5 are an A+ rated security (S&P) and are the fifth in the series of hybrid securities offered by the Commonwealth Bank. They are to be issued at the relatively high margin of 3.40% over BBSW.

The PERLS 5 will mandatorily convert to Commonwealth Bank ordinary shares on 31 October 2014 if the four standard conversion conditions are satisfied. They are:

- The volume weighted average price (VWAP) on the 25th business day before the possible conversion date (or if trading in bank ordinary shares did not occur on that date, the last business day prior to that date on which trading in bank ordinary shares occurred) is greater than 56% of the issue date VWAP;
- The VWAP during the period of 20 business days on which trading in bank ordinary shares took place immediately preceding, but not including, the possible conversion date is greater than 50.51% of the issue date VWAP;
- No delisting event applies in respect of the conversion date; and
- The bank has not elected to resell all PERLS 5.

Current Ratings

	CBA (i.e. Bank)				Outlook
	CBA	PERLS 5	PERLS 4	PERLS 3	
S&P	AA	A+	A+	A+	Stable
Moody's	Aa1	NR	NR	A1	Negative
Fitch	AA	NR	NR	NR	Stable

Key Terms

Issuer	Commonwealth Bank
Security	Converting Preference Share
Offer Size	\$900m
Initial Margin over Benchmark	3.40%
Maturity Date	Perpetual (See below for call date)
Issue Price	\$200.00
Benchmark	90 Day BBSW
Minimum Parcel	\$5,000
Franking	Yes 100%
ASX Code	CBAPA

Key Dates

Prospectus Lodgement	Friday, 28 August 2009
Book build	Friday, 4 September 2009
Opening Date	Monday, 7 September 2009
Closing Date	Friday, 2 October 2009
Issue Date	Wednesday, 14 October 2009
Deferred Trading	Thursday, 15 October 2009
Holding Statements	Monday, 19 October 2009
Normal Trading	Tuesday, 20 October 2009
First Interest Payment	Monday, 1 February 2010
Initial Conversion Date	Friday, 31 October 2014

Updated Capital Ratios 30 June 2009

Tier 1 Capital Ratio	8.07%
Pro forma Tier 1 Capital Ratio	8.37%
Total Capital Ratio	10.42%
Pro forma Total Capital Ratio	10.72%

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The most relevant conversion condition is the first one. If it is met then investors will either receive \$202.02 (a 1% discount) worth of Commonwealth Bank ordinary shares (the default option), or \$200.00 cash if the bank elects and receives APRA approval.

Essentially, the ordinary shares have to be approximately 56% of the current Commonwealth Bank share price on the issue date of PERLS 5. Based on the today's pricing, that would mean the Commonwealth Bank ordinary share price would have to be above \$25.19 for this condition to be met. It's likely that the Commonwealth Bank ordinary share price will be above this figure and in the unlikely event that it isn't these conditions are tested on each quarterly payment date thereafter. Generally the conversion conditions are standard clauses and the risk that the PERLS 5 won't be converted at the first opportunity is low.

The risks and relative value associated with the PERLS 5 is discussed in sections below.

Company Background

Commonwealth Bank is one of Australia's big four banks. The bank recently purchased BankWest from troubled United Kingdom bank HBOS for \$2.1bn. Commonwealth Bank has extensive operations in Australia but also owns the ASB Bank in New Zealand and one of Australia's largest wealth managers – Colonial First State. Commonwealth Bank has a credit rating of AA from S&P making it one of the highest rated banks globally.

Trading Update (For the year ended 30 June 2009)

On 12 August 2009 the Commonwealth Bank announced its profit for the full year ended 30 June 2009. The result was broadly in line with expectations after the bank had already announced that its bad debt provisions would be up when it conducted its capital raising in December 2008.

Key financial highlights for the year included:

- Cash net profit after tax (including BankWest) was \$4,415m, down by 7% from the previous year due to increased impairment expenses.
- Funds under administration were \$175.3bn.
- Cash earnings per share of \$3.05 was down by 14% from the previous year.
- Delivered cash return on equity of 15.8%, down by 4.6% from the previous year.
- Solid operating performance with operating income up 14%.
- Net interest income growth of 21% on the prior year reflecting solid lending and deposit growth.
- Tier 1 capital remained strong at 8.07%.
- BankWest and St Andrews were acquired at a substantial discount to value which created a one off book gain of \$612m after tax.
- Net profit of the BankWest subsidiary was \$113m.

The main positive from the result was the top line profit growth for the bank due to the decreased competition which allowed the bank to increase margins over the six months. Also, the equity raising conducted at the end of 2008 significantly strengthened the balance sheet and the bank's Tier 1 capital ratio now stands at 8.07% with the Group electing to retain high levels of liquidity - \$80bn as at 30 June 2009. If \$900m of PERLS 5 are issued, the bank's Tier 1 capital ratio will increase to approximately 8.37%.

The main negative from the result was the substantial increase in bad debts during the period with total provisions to risk weighted assets rising to 1.92% at 30 June 2009. Also, with the economy stagnating, the bank flagged that bad debts will remain high for the next two years. Recent results from the ANZ and National Australia Bank have highlighted that the bad debts situation is deteriorating especially in the commercial property sector. While bad debts will continue to rise we view Commonwealth Bank along with Westpac as being the two institutions best placed to withstand the current difficult economic conditions.

Strengths - CBA

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- Commonwealth Bank is one of a few banks worldwide that has maintained the high credit rating of AA from S&P. This allows the Commonwealth Bank to raise and lend money at a lower cost to other institutions. CBA was recently ranked by Global Finance magazine as one of the top fifteen safest banks in the world.
- The bank showed strong sales and volume growth in key product lines for the year ended 30 June 2009 led by its retail banking division.
- Commonwealth Bank is in a solid position with ample capital and liquidity to drive future lending growth and development throughout 2010.

Risks - CBA

- The banking operations have an increasing exposure to bad debts which was the main driver behind the decrease in profits. The Commonwealth Bank is highly exposed to the residential property market due to its high proportion of mortgages on its loan book.
- Overall credit growth in Australia is expected to slow through 2010 and economic conditions are likely to remain challenging for the bank.
- Funding conditions for banks worldwide remain difficult and while the Commonwealth Bank with its AA rating from S&P is better placed than most, it remains a concern. Markets do however appear to be returning to normality.

Strengths – PERLS 5

- The PERLS 5 will offer a high cash coupon relative to most bank hybrids. This means that the total return to investors over the life of the security will be taken as income rather than a significant portion as a capital gain as is the case with the existing bank hybrids that are trading at a discount to face value.
- Since the PERLS 5 is structured as a mandatory converting preference share this eliminates the uncertainty associated with conversion on the maturity date. As long as the conversion conditions are met, (which is considered likely), investors will either receive \$202.02 worth of Commonwealth Bank ordinary shares on 31 October 2014, or \$200.00 cash.
- As will be discussed in a following section, the PERLS 5 offers good relative value when compared with both other Commonwealth Bank fixed income products and other major bank converting preference shares.

Risks – PERLS 5

- As with all hybrid securities there is the risk of coupon non-payment. If a payment is missed then it is non-cumulative, however there is the provision for it be made up via an optional payment (subject to APRA's approval). We view the likelihood of coupon non-payment as low (no Australian major bank has ever missed a coupon to our knowledge) as this would enforce a dividend stopper on the bank's ordinary shares, an unpalatable event for the company and its management. The bank would then either have to pay the optional payment or make four consecutive PERLS 5 distributions before it can resume payment of dividends on its ordinary shares.
- The PERLS 5 are a preference share meaning they are technically perpetual securities. Also to meet the requirements of being a non-innovative Tier 1 capital instrument, the Commonwealth Bank is unable to pay a step up on the securities if they aren't exchanged or redeemed at the first opportunity on 31 October 2014. However, given the likelihood of the Commonwealth Bank's share price exceeding the threshold amount (approximately \$25.19) on that date, and the other conversion conditions being met, we view this risk as low. Also, in the event that conversion doesn't occur on this date, the mandatory conditions will be tested on each quarterly payment date thereafter.
- There is credit risk associated with the Commonwealth Bank. As a hybrid security the PERLS 5 will rank below all other bank depositors and creditors in the event of liquidation. However, investors in this

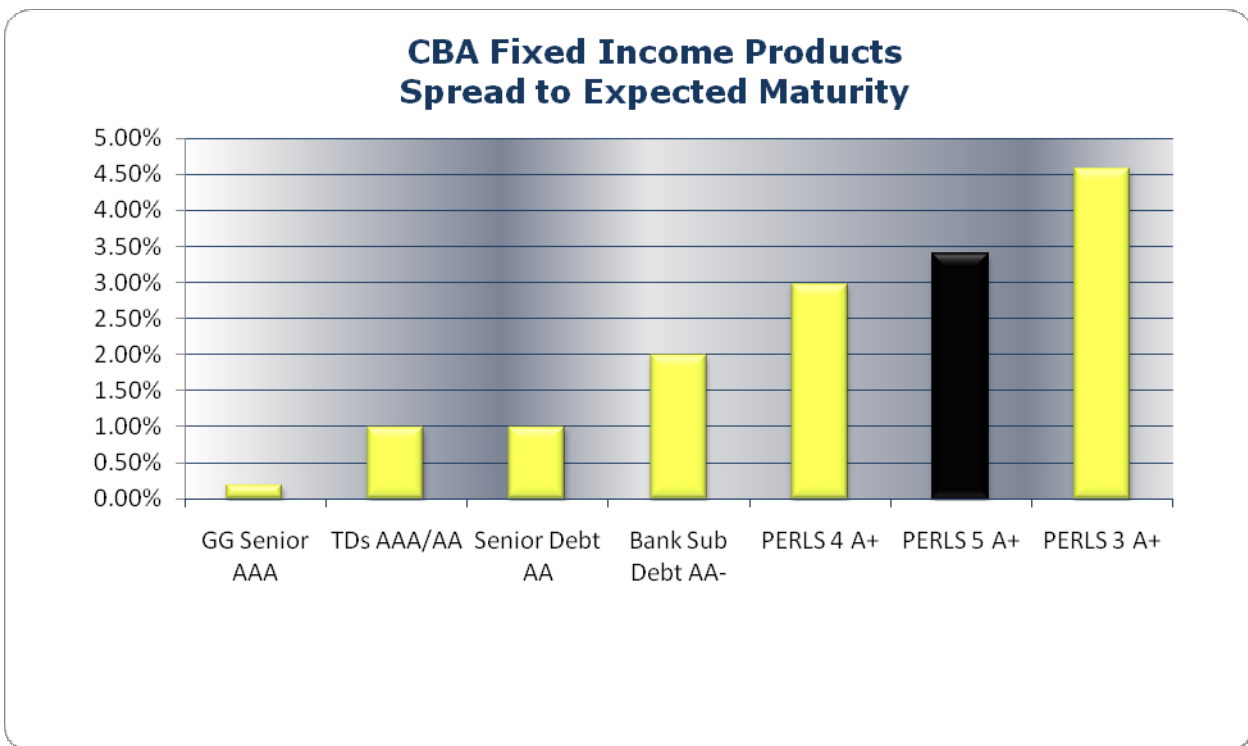
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security will rank above equity holders and investors in the PERLS 3 – who will be converted to ordinary shareholders in the event of a winding up. As a AA rated bank, the likelihood of insolvency is considered remote.

Value

The following chart highlights the returns on the various products in the Commonwealth Bank capital structure. The PERLS 5 offers good relative value compared with most products. Importantly, it offers a higher spread than the similarly structured PERLS 4 hybrid. Also, it offers better value than the traditional fixed income products, most notably the bank’s subordinated debt which is currently yielding only approximately 2.00%. The 1.40% additional spread available on the PERLS 5 more than compensates for the additional risk of being placed lower down the capital structure than subordinated debt investors.

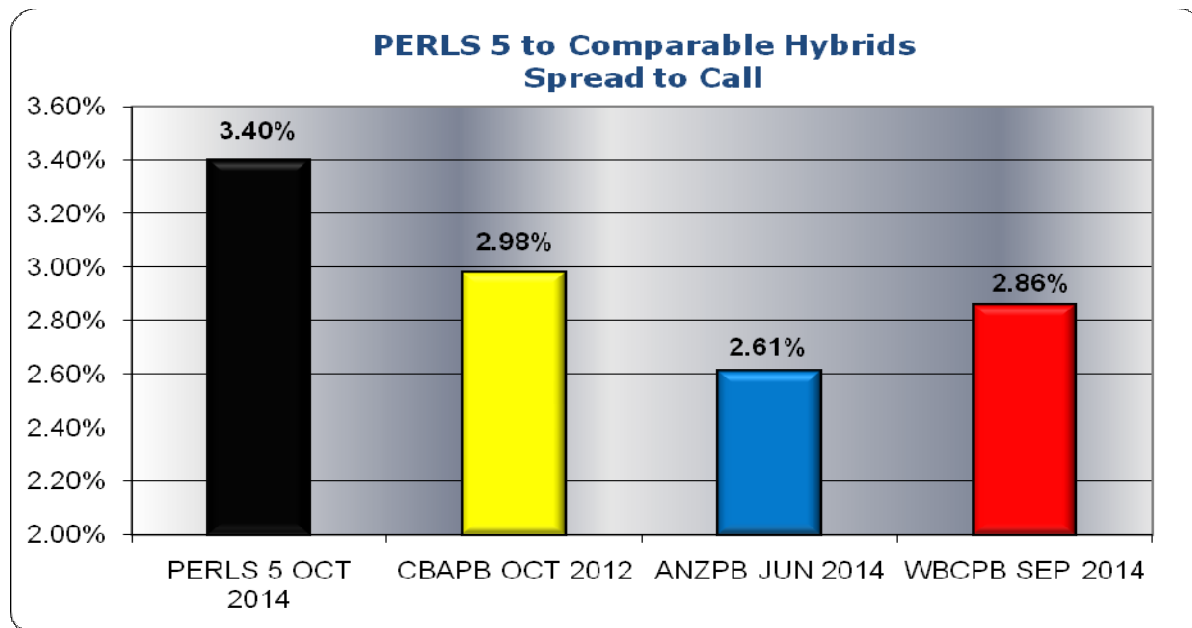
The only fixed income product in the Commonwealth Bank capital structure offering a higher return is the PERLS 3 which is currently trading on a spread of 4.58%. However, the PERLS 3 is ranked lower down the capital structure than PERLS 5 and is a longer dated security (7 years). Also, as a step-up preference share there is more uncertainty in relation to conversion at call for this security than there is for the PERLS 5 which is a mandatory converting instrument.



Source: FIIG Securities & CBA PERLS 5 Presentation

The following chart illustrates the spread over various relevant benchmarks to the reset date of the other major bank mandatory converting hybrids on offer. As can be seen, the PERLS 5 offers the highest spread of the comparable securities by a considerable margin.

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Source: CBA PERLS 5 Presentation

Summary

Commonwealth Bank is a well capitalised profitable bank and the PERLS 5 offers investors a high cash coupon relative to other bank hybrids. Overall PERLS 5 appears to be good value when compared to both other fixed income products within the Commonwealth Bank capital structure and also against major bank converting preference shares.

Brad Newcombe
Senior Research Analyst

FIIG Securities Limited

D +61 (0)7 3004 0300
F +61 (0)7 3229 0026

justinm@fiig.com.au
elizabethm@fiig.com.au
bradn@fiig.com.au
henrys@fiig.com.au

Level 10
Emirates House
167 Eagle Street, Brisbane
Queensland 4000, Australia

www.fiig.com.au
www.termdeposit.com.au
www.fixedincome.com.au

GPO Box 1186
Brisbane
Queensland 4001
Australia

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