

NATIONAL AUSTRALIA BANK LTD

FACT SHEET

FEBRUARY 2024

I A M
INCOME ASSET
MANAGEMENT

National Australia Bank Ltd

Issuer Outline

National Australia Bank Limited (NAB) provides banking financial solutions. The Company offers internet banking, accounts, insurance, credit cards, home loans, and personal loans. NAB serves customers in Australia.

Sector:	Financial
Sub-Sector:	Banks
Country:	AU
Ownership:	Public

IAM Credit View

NAB was resilient as it withstood market headwinds and heavier competition in FY23, delivering a YoY increase of 9% on net profits to \$7.7bn. Capital adequacy ratio (core CET1) saw a modest growth of 71bps (to 12.22%), accrediting the improvement to NAB's ongoing focus on maintaining a strong balance sheet while pursuing the top line.

In FY24, this ratio is likely to decline by ~50bps after adjusting for planned share buybacks but remains in excess of the target operating range of 11% to 11.5%. Proportion of deposits (most stable/cheap source of funding after cash) in its funding mix has also increased to 82%, reducing the reliance on more costly funding sources such as term funding from debt markets given elevated cash rates. On the revenue front, NAB has reaffirmed its desire to further extend its reach in deposits market which includes the target audience of savers under age 30. The bank is disciplined in executing its commercial/pricing strategy by de-prioritising mortgage lending (deterred by thinning margins) and instead play into its strength which is the Business and Private Banking division. This was evident by the acquisition of Citi's consumer banking business in FY23.

Key focus of purchase was cited to be for Citi's unsecured lending capability, whereby the seller had established itself as the fifth-largest credit card provider in Australia.

Issuer Credit Rating & Outlook

Agency	Rating	Outlook
S&P	AA-	STABLE
Moody's	Aa3	STABLE
Fitch	A+	STABLE

Key Financials (AUD m)

LTM (31 March)	2024
Net interest income	16,809
Non-interest income	3,839
NPAT	7,414
Gross loans	708,287
Total assets	1,059,083
Customer deposits	642,674
Short- and long-term debt	223,168
Non-performing loans (NPLs) to total loans (%)	0.18
CET 1 ratio (%)	14.19

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Since consolidation, NAB is the second-largest credit card provider domestically (after CBA) whilst continuing its lead in business banking (~22% of market share).

Citi's deep expertise and resourcing further equipped NAB with an additional ~800 employees alongside proprietary systems from Citi's in-house platforms (to be replicated on NAB's infrastructure), strongly supporting NAB's ambitions and ability to grow in this market. In parallel, non-core operations continue to be divested such as its wealth management and asset servicing divisions to simplify the bank's business portfolio.

These transactions further add on to the series of transitional work NAB already has in-flight, heightening operational pressures from execution and transitional risks. Given the sufficient cushioning in liquidity and capital buffers, any losses from unplanned project costs should be sufficiently absorbed if not mitigated from early on. All in all, NAB boosts a positive growth story as a corporate with strong fundamentals and sound management.

Relative value trade opportunities

NAB Wholesale Subordinated Notes 6 FRN stands out most compared to other Tier 2 Subordinated issues by NAB. The bond features a margin of 2.6% over 3-month BBSW with first call in 2027. The newer NAB Wholesale Subordinated Notes 7 FRN yields slightly lower at 2.2% over 3-month BBSW at a further first call of 2028, rendering its predecessor as more attractive.

Comparing the series of convertible notes issued by NAB, the NAB Capital Notes 3 priced most attractively at issue of 4.0% margin over 3-month BBSW while newer issues priced lower such as NAB Capital Notes 7 priced at 2.8% margin over 3-month BBSW. The former provides the higher ongoing cashflows, while the latter boosts higher yield-to-maturity at 7.02% (higher by 56bps).

Note: the aforementioned trade opportunities reflect a point-in-time perspective and require reassessment as market movements are linked to the credit cycle and/or idiosyncrasies.

Strengths of NAB

- **Strong capitalisation:** NAB is well-capitalised, with a core Common Equity Tier 1 (CET1) ratio of 12.2% at 30 September 2023. This is in excess of the target range of 11.0% to 11.5% to further protect NAB's financial position in anticipation of any adverse events from the economic and operating environment. The Australian Prudential Regulation Authority (APRA) requires authorised deposit-taking institutions (ADIs) to hold a minimum ratio of Tier 1 capital to risk-weighted assets of 11.75%, with at least 10.25% in the form of CET1 capital (based on minimum prudential requirement of 4.5% plus D-SIBs capital buffer of at least 5.75%).

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- **Healthy debt maturity profile supported by strong liquidity management:** NAB maintains a strong focus on stable deposits both from a growth and quality perspective and continues to utilise deposits as a key funding source for funded assets. A supplementary source for funding is via term funding programmes. The weighted average time of term funding is 4.3 years for the bank, meaning the risk of significant refinancing in a period of potential market dislocation is greatly mitigated. NAB also had an average liquidity coverage ratio (LCR) of 140% as of 30 September 2023 (+9% from 2022), well-above regulatory minimums (100%), as well as domestic peers. This implies that NAB is well-positioned to meet net cash outflows over a 30-day period during a severe liquidity stress scenario.
- **Sound macro environment and regulatory oversight:** Australian financials, benefit from operating in an economy characterised as having a very high degree of economic resilience with low susceptibility to event risk. The Australian economy rebounded strongly after COVID-19 related disruptions, and while the impacts of the pandemic are largely behind us, it remains that institutional and governance frameworks compare well with overseas jurisdictions, providing an additional level of security, against future uncertainty. D-SIBs like NAB are subjected to more intense supervisory oversight and stricter capital requirements to ensure greater capacity to absorb losses, to increase resiliency to failure.
- **Systematic importance to the Australian economy and financial system:** In the unlikely event of a failure, it is expected that the Australian government is more than likely to provide support for a workout solution as NAB is highly interconnected with Australia's financial sector including \$587 billion in deposits managed for retail and business customers, representing ~17% of the total Australian book.

Weaknesses of NAB

- **Near term debt repayment task:** NAB has imminent debt maturities of A\$19bn to address in FY24, bulk of which (\$18bn) is payable to the RBA Term Funding Facility (TFF). TFF was introduced to provide ultra-low cost funding (three-year fixed rate of 0.25%) to support the economy during the Covid-19 pandemic. Given this source of funding is rolling off, NAB will need to tap into the cash and/or debt markets for new funding to repay these maturities. This will likely incur higher funding costs considerably in light of elevated cash rates, dragging profitability of NAB due to higher interest spend. In the case that NAB is unable to source appropriate funding, it may resort to reducing business activities (e.g. lending) and/or operate with smaller liquidity buffers at the cost of heightening the risk of yet another regulatory breach.
- **Concentrated revenue stream from banking activities:** NAB continues to divest from non-core operations to focus on the banking business in ANZ. Playing to its strength, NAB's skew leaves its earnings more vulnerable to the pressures on lending markets, and households and businesses that are experiencing elevated cost burdens from higher interest rates and inflation. Over the recent years, WB has fully divested MLC Wealth and broker aggregation businesses. Diversity in revenue streams has proven to be an effective hedge, particularly in times of market volatility as Macquarie Bank has shown.

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Risks related to the NAB

- **Heightened operational and financial risks from recent movements in organisational structure:** NAB has undergone multiple acquisitions and divestments over the recent years in accordance with its current strategic goals. The most recent acquisition saw the purchase of Citi's consumer banking division with key rationale as leveraging the seller's presence and expertise in unsecured business (Citi was the fifth-largest issuer of credit cards in Australia) while also acquiring its residential mortgages and bank deposits portfolios. The transaction was completed in mid 2022 and is currently in transition phase for the development of technology infrastructure and services on NAB's platforms to support the Citi book. Concurrently, NAB is also facilitating the transition of its wealth management business to MLC after successfully completing the sale just the year before in mid 2021. Notwithstanding NAB's departure from its custody business which is also currently in transition to other providers with planned timeline of 3 years noting this is a relatively short timeframe considering the operational and transitional risks that could occur especially with multiple counterparties to coordinate with. Nevertheless, a more streamlined and focused business model will likely benefit NAB in terms of growing its market share but prior to that the transition includes a material amount of risks such as growing costs and uncertainty of the profitability of the new business units that could ultimately become a drag on NAB's overall financial position and performance.
- **Rating downgrades:** Ratings on both issuers and issues can be influenced by factors that do not necessarily reflect the financial strength or credit quality of a specific issuer, such as the Australian sovereign rating, the rating agencies' view on the economic prospects of the country or relative strengths of the regulatory framework. For example, in 2020 both S&P and Moody's placed the ratings on a number of Australian financial institutions on negative outlook due to concerns about the economic outlook for Australia. This will adversely impact NAB's ease of accessing cheaper funding, competitive position, and financial stability.
- **Weakness of the Australian Dollar:** NAB is sensitive to forex movements given its extensive business operations in foreign countries as well as a sizeable holding of foreign investments. Offshore operations hold liquid assets denominated in local currency to meet required regulations as imposed by each jurisdiction's regulator. Foreign revenue will likely be lower once converted back to Australian dollar as the currency appreciates, and reversely return a higher net income in Australia dollar terms if the Australian dollar depreciates against other foreign currencies.

Risks related to the Instruments (Tier 2) and Additional Tier 1 (AT1)

- **Optional call dependent on regulatory approval:** Tier 2 notes include an early call feature where the face value of the notes may be repaid early in cash from a given date stated in the terms and conditions of the instrument. The optional redemption requires regulatory approval, which may not be provided. In general, regulators are unlikely to provide approval for a Tier 2 instrument to be called if it results in a reduction in the issuer's capitalisation; regulators are unlikely to provide approval for a redemption or resale unless the issuer has, or is expected to, issue an instrument of similar size to replace the instrument subject to that call. To the extent the

optional call was expected not to be exercised, it is likely that the price of the notes will be negatively affected, with this negative price movement being potentially material.

- **Conversion or write-down following a Non-Viability Trigger Event:** A Non-Viability Trigger Event occurs when APRA determines conversion to ordinary shares (or write-off) of some or all of an issuer's contingent capital securities (Tier 2 and AT1) is necessary to prevent that financial institution becoming non-viable. Whether a non-viability trigger event will occur is solely at the discretion of APRA. APRA does not define what constitutes a non-viability event and there are currently no precedents under Basel III to determine non-viability. If such event occurs, the issuer may be required to convert some or all of its Tier 2 notes into ordinary shares. In a more severe scenario, the issuer may be required to write-off the value of these notes. We note that it is expected that the conversion / write-off would be expected to be applied first to AT1 hybrids and only then to the Tier 2 if the AT1 conversion / write-off was not sufficient to restore the issuer to a viable position.
- **Capped equity conversion:** Conversion of Tier 2 notes following a non-viability trigger event is subject to a maximum number of shares being issued. As such, if the notes are converted into ordinary shares, the value of ordinary shares an investor receives may be significantly less than the face value of their notes.
- **Subordination:** Tier 2 and AT1 notes are deeply subordinated, and rank ahead only of ordinary shares. AT1 was used recently when international banks (such as Credit Suisse and Silicon Valley Bank) collapsed rather than providing capital support earlier in the crisis.

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Summary Bond Details

ISIN	Issue Amount	Ranking	Coupon	Coupon Frequency	First Call ¹	Maturity Date	Issue Rating (S&P/Moody's/Fitch)
AU3CB0291284	AUD1000m	Subordinated Unsecured Tier 2	6.322% ²	Semi-annual	3 August 2027	3 August 2032	BBB+ / Baa1 / -
AU3CB0297554	AUD950m	Subordinated Unsecured Tier 2	6.163% ³	Semi-annual	9 March 2028	9 March 2033	BBB+ / Baa1 / A-
AU3FN0048195	AUD1000m	Subordinated Unsecured Tier 2	3mBBSW + 2.15%	Quarterly	17 May 2024	17 May 2029	BBB+ / Baa1 / A-
AU3FN0070199	AUD250m	Subordinated Unsecured Tier 2	3mBBSW + 2.80%	Quarterly	3 August 2027	3 August 2032	BBB+ / Baa1 / -
AU0000293813	AUD1.25bn	Jr Subordinated Additional Tier 1	3mBBSW + 2.80%	Quarterly	17 June 2033	Perpetual	- / - / -
AU0000226961	AUD2.0bn	Jr Subordinated Additional Tier 1	3mBBSW + 3.15%	Quarterly	17 December 2029	Perpetual	BBB- / - / -
AU0000124042	AUD2.39bn	Jr Subordinated Additional Tier 1	3mBBSW + 3.50%	Quarterly	17 December 2027	Perpetual	BBB- / - / -

¹ Excludes potential terms that would allow the issuer to redeem prior to the maturity date through a make-whole call.

² Resets on 3 August 2027 at a rate equal to the 3 month BBSW + 2.80%.

³ Resets on 9 March 2028 at a rate equal to the 3 month BBSW + 2.17%.

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Tier 2 Structure

Interest Deferral/Cancellation	Interest is deferrable and cumulative if, prior to the payment of interest, the issuer is not solvent or would not be solvent after payment.
Non-Viability Trigger	Yes, standard Basel III compliant non-viability trigger. If APRA determines the issuer is at risk of becoming non-viable, the terms of the notes indicate that the primary method of loss absorption will be via conversion of the subordinated notes into equity, in-part or in full.

Perpetual Tier 1 (AT1) Structure

Interest Deferral/Cancellation	Interest is deferrable and non-cumulative. Interest payment is optional and, if unpaid, the issuer has no obligation to pay any deferred amounts later. A cancellation of interest does not constitute a default under the Notes for any purpose.
Common Equity Tier 1 Trigger	If a bank determines, or APRA notifies a bank in writing, that the bank's Common Equity Tier 1 ratio is less than or equal to 5.125%, the bank may be required to write-off some or all the face value of the notes or convert some or all of the notes into ordinary shares.
Non-Viability Trigger	If APRA determines that an issuer requires capital support to prevent it from becoming non-viable (a 'non-viability event'), the bank may be required to write-off some or all the face value of the notes or convert some or all of the notes into ordinary shares.
Maturity	The notes do not have a maturity date. This means that the issuer does not have an obligation to repay the principal, although if it elects to do so, it will require APRA approval.

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Disclosure

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