Issuer Name

Macquarie Bank Limited

Security Name

Macquarie Bank Capital Notes 3

Security Recommendation

Subscribe

Security Risk

Upper Medium

Issuer Outlook

Improving | **Stable** | Deteriorating

Key Characteristics

Product Type	Capital Note	**Issue Price**	$100.00
Issue Size*	$400,000,000	**Accrued**	$0.00
Par Value	$100.00	**Capital Price**	$100.00
Fixed/Floating	Floating	**Running Yield**	[2.92%-3.12%]
Payment Frequency	Quarterly	**Expected Yield to Maturity*** **	[3.87%-4.07%]
Current Distribution**	[2.92%-3.12%]	**Trading Margin**	[2.90%-3.10%]
Issue Margin / Coupon	[2.90%-3.10%]	**First Call Date**	7 September 2028
Franking Credits Incl.	Yes	**Scheduled Conversion Date**	8 September 2031
ASX Listed	Yes (ASX Code: MBLPD)	**Next Ex-Date**	[TBC]
Convertible	Yes	**Next Payment Date**	7 December 2021
GICS Sector	Banks	**Next Cash Distribution**	[TBC]

* With the ability to raise more or less. ** Based on issue margin plus 90-Day BBSW of 0.02%. *** Based on issue margin of [2.90%-3.10%]%, an interpolated swap to call rate of 0.97% and an expected call date of 7 September 2028.

Summary

On 3 August 2021, Macquarie Bank Limited (MBL) launched an offer for Macquarie Bank Capital Notes 3 (BCN3) to raise $400 million, with the ability to raise more or less. BCN3 are expected to be quoted on the Australian Stock Exchange (ASX) under the code MBLPD. BCN3 securities are perpetual, unsecured, convertible, non-cumulative and subordinated notes. The purpose of the transaction is to raise regulatory capital (Additional Tier 1) for MBL and the net proceeds of the Offer will be used for general corporate purposes. The margin is guided at [2.90%-3.10%] p.a. above 90-day BBSW and distributions are expected to be franked at the same rate (currently 40%) as Macquarie Group Limited (MGL) ordinary shares (ASX: MQG). Distributions are also floating rate, discretionary, non-cumulative, subject to Payment Conditions, and paid on a quarterly basis in arrears. The distribution rate has a floor of 0.00%, noting therefore that the floor for 90-day BBSW is effectively -[2.90%-3.10%][1].

This security has no fixed maturity date but is scheduled for mandatory conversion into MGL ordinary shares on 8 September 2031, or the next distribution payment date on which the exchange conditions are satisfied. At MBL's discretion, the BCN3 may be resold or exchanged, or subject to APRA approval redeemed on 7 September 2028, 7 March 2029, 7 September 2029 or if a Tax Event or Regulatory Event occurs, subject to conditions. The BCN3 will convert into MGL ordinary shares following an Acquisition Event, subject to conditions. As this security meets capital instrument eligibility criteria under Basel III, it also contains loss absorbing terms and conditions known in the documentation as a Common Equity Tier 1 Trigger Event and a Non-Viability Event. Upon the occurrence of either of these, this security will be exchanged for MGL ordinary shares without the protection of exchange conditions. If exchange cannot occur for any reason within five business days, the BCN3 will be written off and all holders' rights terminated.

Figure 1: Capital Structure[2]

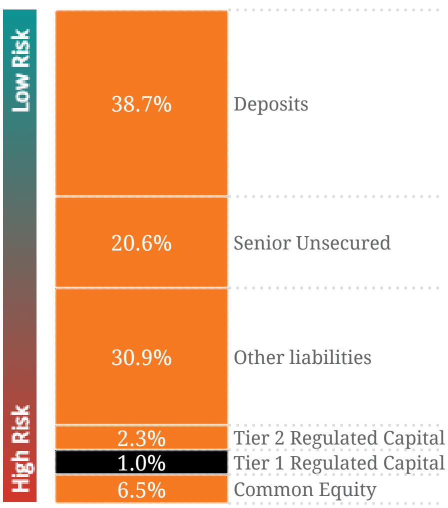
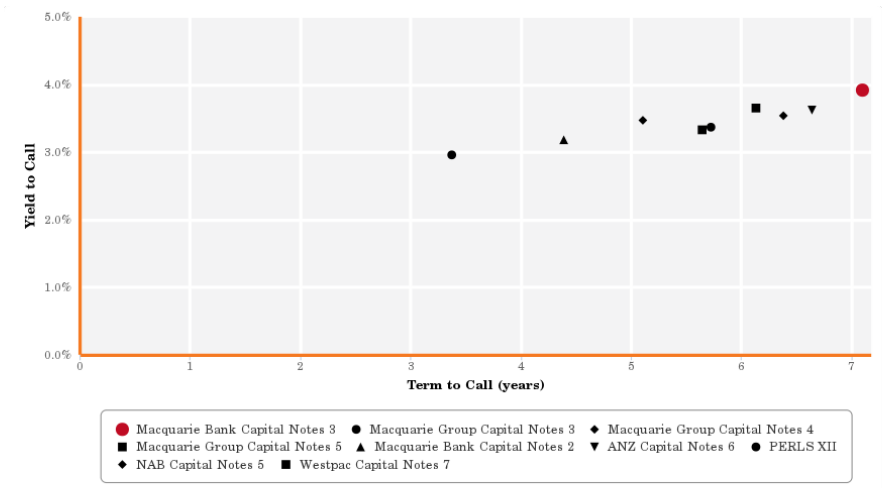


Figure 2: Relative Value



[1] If BBSW became negative, this negative amount would be taken into account in calculating the distribution. If the Distribution Rate was negative as a result, BCN3 Holders would not receive a Distribution and there would be no obligation on BCN3 Holders to pay MBL. [2] Pro-forma balance sheet as at 31 March 2021 assuming $400 million issuance of BCN3.

Security Recommendation - Subscribe *as at 3 August 2021*

We see fair value around the 275-280bps margin mark, at an offered margin of 290-310bps we recommend investors **Subscribe** due to the relative value premium and our fundamental credit comfort.

This is the third ASX-listed capital note offered by MBL, with the most recent being Macquarie Bank Capital Notes 2 (BCN2, ASX: MBLPC), which was issued in June 2020 raising $641 million at a 4.70% margin above 90-day BBSW with a 5.5 years term to first call (22 December 2025).

We are comfortable with the credit profile of the Issuer and our analysis indicates at the bottom of the indicative margin range, 2.90%, the security offer is attractively priced on a relative valuation basis. While we see continued tailwinds for AT1 hybrids, we note that trading margins are at all-time lows since Basel III implementation (2013), so the prices of AT1 securities would be adversely affected if credit spreads normalise.

Ideally a new security will incorporate a new issue premium to compensate for the pricing uncertainty between the launch and settlement. Especially in this case, given its long-dated tenor – BCN3 will be the longest dated (to first call) listed AT1 on issue. That said, we note buying in the primary market rather than the secondary has the advantage of accessing liquidity at a known price – a particular driver for institutional buyers.

Compared to the MBL/MGL issuer curve, at a margin of 2.90%, BCN3 offers a 12bps margin premium. While not perfectly comparable, it also screens cheap compared to the longest dated listed Big Four AT1 securities ANZ Capital Note 6 (ASX: ANZPI) and NAB Capital Notes 5 (ASX: NABPH) that last traded at respective margins of 2.67% and 2.62% (2 August 2021).

MBL is a key operating fully owned subsidiary of MGL. It is important to understand the structural differences between MGL and MBL. Securities issued by MGL, have similar credit and structural risks to certain securities issued by other Non-Operating Holding Companies (NOHCs) such as Challenger, Suncorp and AMP. This means the financial obligations of NOHCs rank behind those of their operating subsidiaries, including MBL. Furthermore, APRA can prevent the upstreaming of capital from the regulated operating subsidiaries to the NOHCs. Overall, we consider MBL is superior credit to MGL with the Bank having the additional support of the Group. This view is also reflected by the ratings agency which rate MBL a notch higher than MGL. (MBL: A [Fitch], A2 [Moody's] and A+ [S&P]) (MGL: A- [Fitch], A3 [Moody's] and BBB+ [S&P]).

The Bank Group is a large contributor of Group income, so MGL can rely to some extent on dividends (or APRA approved capital distributions) from its operating subsidiaries in order to service its obligations. Although this increases the risk to instruments issued from MGL, the converse holds true – MBL investors are afforded an additional level of comfort, through APRA supervision, above MGL's ability to manage its capital, liquidity and operating risks over and above the minimum requirements set out by APRA across its regulated operating subsidiaries.

We view the business and operational risk of MBL similar to MGL. The Group's diversified income stream and internal, group-level capital management systems make it difficult to analyse from a credit perspective. However, MGL has proven to be a consistent performer over the medium to long term and arguably better than the Big Four major banks. Furthermore, with bigger annuity style business units contributing to a robust earnings buffer, we are comfortable with management's ability to adapt to changing conditions.

As BCN3 contains loss-absorbing terms, risk events such as a Common Equity Tier 1 Trigger Event or a Non-Viability Event triggering exchange (or write-off) may happen, but we consider the probability of such an event for MBL to be remote. 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 loans or a failure of risk management within an operating subsidiary 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 first Optional Exchange Date (7 September 2028) and all distributions being made in a timely manner. If this security is not called on this date (extension risk), its price may drop significantly.

The BCN3 Offer comprises a Securityholder Offer for eligible MBL and MGL securityholders, Broker Firm Offer and Institutional Offer. The margin is expected to be announced on 6 August 2021 following completion of the bookbuild. All Offers are expected to open on 11 August 2021 with the expected closing date on 24 August 2021.

Positive / Negative Risk Factors

What factors would change the Recommendation UP

- Strong Capital Position. MGL is well capitalised with regulatory capital well above prudential minimum requirements, which provides a significant loss absorption buffer.

- Well-Funded with High Liquidity Levels. Funding and liquidity and metrics are comfortably above regulatory minimum requirements.

- Regulatory Oversight. APRA continues to implement disciplined controls over domestic banking operations. The Group is required to hold adequate regulatory capital to cover the risks of both the Bank and the Non-Bank Group. Benchmarks such as regulatory capital are often stricter than international regulators and APRA has also displayed a willingness to work with the industry during times of stress to ease any headwinds where possible. APRA continues to work with the industry to support improved transparency.

- Diversity and Relative Resilience of Revenue. The business has a healthy revenue mix in terms of type and geography.

What factors would change the Recommendation DOWN

- Regulatory Risk. MGL, and in particular the Bank, is highly regulated and changes to regulation could impact profitability and or require changes to the business model. This risk is mitigated by having a sizable Non-Bank business which gives MGL more scope to adapt to changes in regulation than a pure banking business.
- COVID-19. With around two thirds of income coming from offshore, the global economic impact of the pandemic has more significance for MGL than the domestic impact. However, the impact on the global economy has not been as bad as anticipated and conditions are improving. A large mix of annuity-style income is a plus and fiscal and monetary levers being pulled by governments and central banks has helped lessen these impacts.
- CET1 and Non-Viability Triggers. This security contains CET1 Event 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 unlikely, but possible in a worst-case scenario.
- Market Risks. Although MGL is well diversified it remains exposed to financial market shocks both in Australia and globally.

Issuer Outlook - Stable *as at 3 August 2021*

Macquarie Issuer Outlook

MBL is a key operating subsidiary and APRA regulated entity of MGL. Due to the interconnected and mutually dependent relationships with other segments of the broader group structure, the credit profile of the Bank is arguably dependent on the financial health of MGL. Principally for this reason, our Outlook for MBL covers the broader Group structure and results. The commentary below therefore relates to the Group.

First Quarter 2022 Trading Update

On 29 July 2021, MGL provided a strong 1Q22 trading update for the three months to 30 June 2021 that saw improved trading conditions lead to a significant increase in net profit contribution from operating groups versus 1Q21. The result was driven by markets facing businesses and moreover reflects favourably on its diversification and ability to adapt to changing conditions. Asset quality and the capital position remain robust and we retain our fundamental credit comfort.

Annuity-style business net profit contribution for 1Q22 was up slightly on the prior corresponding period (PCP). At FY21 annuity-style activities represented 54% of MGL's net profit contribution. The overall performance reflected growth across most lending portfolios along with lower loss provisions in Banking and Financial Services (BFS). This was partially offset by a net lower contribution from Macquarie Asset Management (MAM) as the absence of the gain on the rail leasing business sale in 1Q21 outweighed the Macquarie Infrastructure Corporation (MIC) disposition fee income earned in 1Q22.

Markets facing business net profit contribution for the June quarter was significantly up on PCP due to the sale of UK commercial and industrial smart meter businesses in Commodities and Global Markets (CGM), partially offset by the timing of some income recognition. Additionally, Macquarie Capital (MacCap) saw investment income growth and higher M&A fees, though equity capital markets income was lower.

The Group's capital position remains strong. Group surplus capital declined from $8.8 billion at 31 March 2021 to a still healthy $7.4 billion at 30 June 2021. This reflected the payment of the final dividend ($1.2 billion) and investment ($1.5 billion) to support growth across the business. The Bank's CET1 ratio was fell from 12.6% to a 12.1% but is well above regulatory requirements.

The MGL Board has lowered the target dividend payout range from 60%-80% to 50%-70% to allow more flexibility to support growth initiatives. This may not be well received by equity holders, but it is a positive from a credit perspective.

Bank Funding and liquidity metrics remain comfortably above regulatory benchmarks. The average Liquidity Coverage Ratio (LCR) was 171% while the Net Stable Funding Ratio (NSFR) stood at 122%, versus a 100% regulatory minimum for both ratios.

Overall, the 1Q22 update demonstrates MGL's ability to consistently deliver superior result versus peers over the medium to long term while prudently managing its balance sheet with a strong risk management framework. It is encouraging that despite the uncertain conditions, MGL continues to see a healthy pipeline of investment opportunities and is prepared to fund them. MGL has a good capital stewardship track record underpinned by maintaining strict risk/return hurdles for assessing investment opportunities.

MGL continues to maintain a conservative approach to capital, funding and liquidity. This supports our **Stable** view on MGL's credit outlook.

Outlook

Management did not provide FY22 profit guidance. They remain cautious on the near-term outlook given uncertainty about the pace of the global economic recovery from COVID-19, market volatility and geopolitical risks. In light of this, MGL is prudently maintaining conservative capital, funding and liquidity settings. Management was more optimistic on the medium-term outlook and believe the business is well placed to deliver strong performance.

Operating conditions are better than anticipated last year. The Australian economy has fared better than originally expected through the pandemic in 2020, however risks to the pace of the recovery persist from lockdowns. The overall global economic outlook is also better, underpinned by improving conditions in the US and strength in China. However, the economic recovery is uneven across other economies because of various factors such as lockdowns associated with the latest wave of COVID-19 hitting some regions and the pace of the vaccine rollout.

Over the medium to long term, MGL has demonstrated its ability deliver superior results relative to peers and to prudently manage its balance sheet by navigating changing conditions, maintaining a strong risk management framework and a strict capital allocation discipline. While MGL's credit profile is weaker than the Big Four banks given the nature of its business, it has arguably been better managed and delivered more consistent and stronger results. We maintain a **Stable** view on MGL's credit outlook.

FY21 Issuer Commentary

The following discussion is based on the most recent financial statements. All figures are in AUD unless otherwise indicated.

Earnings

MGL's FY21 result for the 12 months to 31 March 2021 came in at the top end of guidance with NPAT up 10% on the prior year to a record $3.02 billion driven by a strong performance from markets facing businesses. The second half performance was very strong, with NPAT soaring over 100% on the COVID-19 impacted 1H21 to $2.03 billion.

Return on equity was 20 basis points lower at a still impressive 14.3%. While annuity style business reported a comparatively weaker result for the year, management's focus on building this type of revenue stream helps lower earnings volatility, which was evident in the 1H21 result. All this combined with strong capital, funding and liquidity levels support MGL's Stable credit profile.

Net operating income rose 4% over the year to $12.77 billion reflecting higher net interest income, lower credit impairment charges, partially offset by lower fee and commission and net leasing income. The second half was 31% higher than 1H21 at $7.26 billion. Credit and other impairment expenses fell 50% over the year to $524 million from the partial credit provision unwind as a result of improved economic conditions and outlook. Operating expenses were flat at $8.87 billion year on year as higher staff and non-salary technology expenses were offset by lower brokerage, commission and trading-related fees. 2H21 expenses increased 8% over the first half to $4.60 billion but was outstripped by net income growth.

Net profit contribution from operating groups (profit before unallocated corporate costs, profit share and tax) rose 12% to $6.10 billion, while for 2H21 this was 68% higher than 1H21 at $3.83 billion.

Annuity style businesses net profit contribution declined 4% during the year to $3.31 billion and represented 54% of total net profit contribution. The year-on-year decline was the result of: (i) lower Macquarie AirFinance income and performance and commission fees, partially offset by a gain on the sale of Macquarie European Rail and the reversal of impairments in MAM; (ii) growth in deposits, loans and funds and lower credit impairments, offset by margin compression in BFS; and (iii) a decline in commodities lending and financing revenues, that was partly offset by growth in Specialised and Asset Finance revenues within CGM.

After a weak first half, markets facing businesses recovered strongly in the second half with net profit contribution climbing more than 200% to $2.11 billion driving the full year up 39% to $2.78 billion. Increased revenues across the market facing parts of CGM was the main driver of the turnaround, including the windfall in the North American gas business from extreme weather conditions in the US. MacCap was impacted by lower fees and commissions from weaker M&A and DCM activity and lower asset realisations - which were partially offset by higher ECM and investment income.

Capital

MGL is unique in the Australian landscape as it is comprised of a Bank Group and a Non-Bank Group. This presents challenges for investors assessing its capital position. Whilst MBL is regulated in the same way as other Australian Deposit-Taking Institutions (ADIs), the Non-Bank Group is regulated using an internal Economic Capital Adequacy Model (ECAM), which is approved by APRA. MGL is required to hold adequate regulatory capital to cover the risks of both Bank Group and the Non-Bank Group. Capital adequacy requirements set by APRA for all ADIs apply to the Bank Group, however, the Non-Bank capital presents transparency issues for external investors.

MGL's capital position remained strong as at 31 March 2021, with the Group's financial position comfortably exceeding APRA's Basel III regulatory requirements. MGL reported a capital surplus of $8.8 billion as at 31 March 2021, down from $9.4 billion at 30 September 2020. In April 2021 APRA imposed a $500 million operational capital overlay at Level 1 on MBL for breaches of prudential and reporting standards that would temporarily reduce investment capacity.

MBL's CET1 ratio is strong and well above regulatory requirements, increasing from a pro-forma 12.5% at 30 September to 12.6% at 31 March 2021.

Traditionally, Non-Bank assets represent a reasonably small proportion of overall group assets. Most of the risk is held within the Bank Group and is subject to APRA's risk-weighting standards for which MBL is accredited under the Foundation Internal Ratings Based Approach (FIRB) for credit risk, the Advanced Measurement Approach (AMA) for operational risk and the Internal Model Approach (IMA) for market risk and interest rate risk in the banking book. This broadly makes it one of the five domestic financial institutions to hold what is generally referred to as 'advanced accreditation'.

APRA is in the process of implementing changes to a number of regulatory standards. Based on current information it remains MGL's expectation that it will have sufficient capital to accommodate likely additional regulatory Tier 1 capital requirements as a result of the proposed changes.

A $3.35 per share final dividend franked at 40% was declared taking the FY21 dividend to $4.70. This equates to a 60% payout for the half and 56% for the full year versus MGL's 60%-80% target, *which was subsequently lowered to 50%-70% at the 1Q22 update.*

Funding and Liquidity

MGL is well funded and liquidity levels are high. As at 31 March 2021, the MBL's (APRA) leverage ratio was 5.5% (internationally harmonised 6.3%), down from 5.9% at 30 September 2020 and well above the 3% minimum. The average LCR was 174% and the NSFR was 115%, from 176% and 121% respectively as at 30 September 2020 and over the 100% regulatory minimum.

The balance sheet remains healthy, with the Group managing risk with a conservative approach. Term assets remain sufficiently covered by a mixture of term funding, stable deposits and equity with minimal reliance of short-term wholesale funding markets. MBL has utilised the RBA's Term Funding Facility, having drawn down $1.7 billion and has $1.3 billion in undrawn capacity remaining. Total customer deposits continue to grow, up 25% over the year to $84.0 billion, representing 48% of funding sources.

Asset Quality

Asset quality remains sound, having improved over 2H21. MGL is a global business with 68% of FY21 income coming from offshore, so is more vulnerable to global economic conditions than the Big Four major banks. The vast majority of customers coming out of temporary loan deferral arrangements have now resumed making payments. Meanwhile, improved economic conditions and outlook have resulted in a partial unwind of credit loss provisions. Group net impaired loan assets have fallen from $1.67 billion at 30 September to $1.54 billion. As a percentage of loan assets, the ratio declined from 1.78% to 1.47%.

Asset quality risks remain though, so credit loss provisions have been maintained at elevated levels at $1.60 billion at 31 March 2021 compared to $1.65 billion at 30 September 2020 and $914 million at 30 September 2019. The majority of provisions are concentrated within the Group's loan assets ($1.18 billion).

Figure 3: Credit Curve (Comparable Securities)

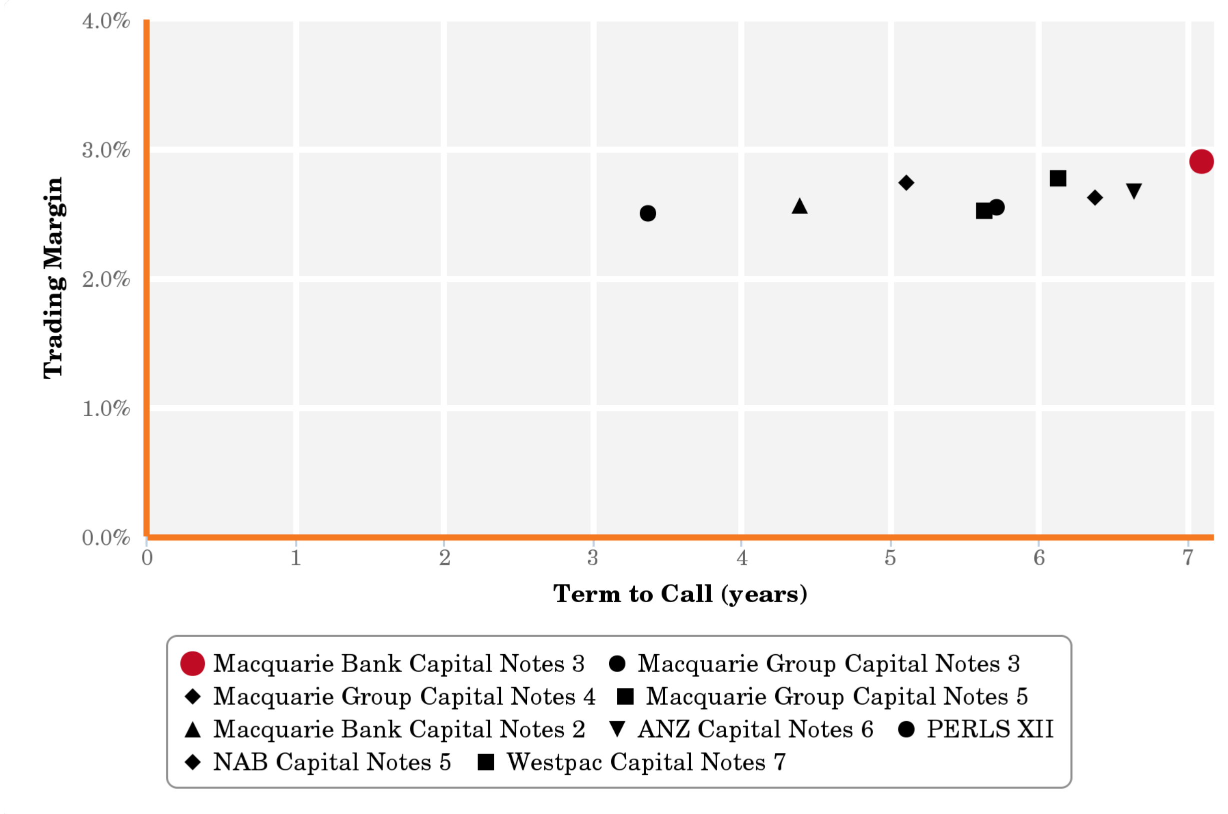
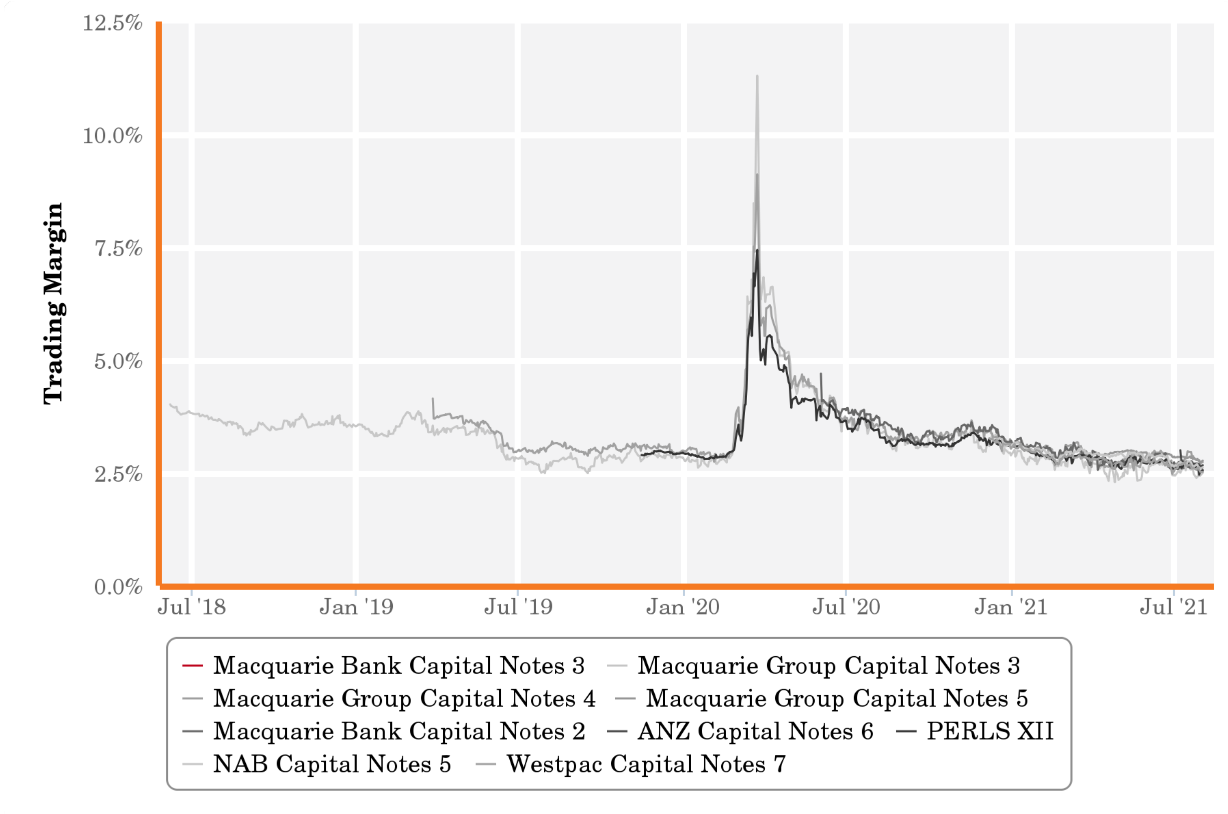


Figure 4: Historical Trading Margins of Comparable Securities



Source: BondAdviser

Hybrid Commentary

Issuer Overview

Macquarie Bank Limited (MBL) is a key wholly-owned operating subsidiary of Macquarie Group Limited (MGL, ASX code: MQG), which is a financial services holding company. MBL provides a range of products and services including deposits, loans, asset finance, risk and capital management solutions across debt, equity and commodities to retail, institutional and government clients. The Bank also provides shared services to the Group via the Corporate segment. The Non-Bank Group part of MGL includes asset management, investment banking and the activities and assets of Commodities and Global Markets that are not part of MBL.

Our research on MBL and MGL focusses more on the larger Group as the business and operational risks of MBL are largely reflected in the more transparent and more widely discussed Group results. The two are interconnected with mutually dependent relationships across the broader group structure, so the credit profile of the Bank is arguably dependent on the financial health of the whole Group.

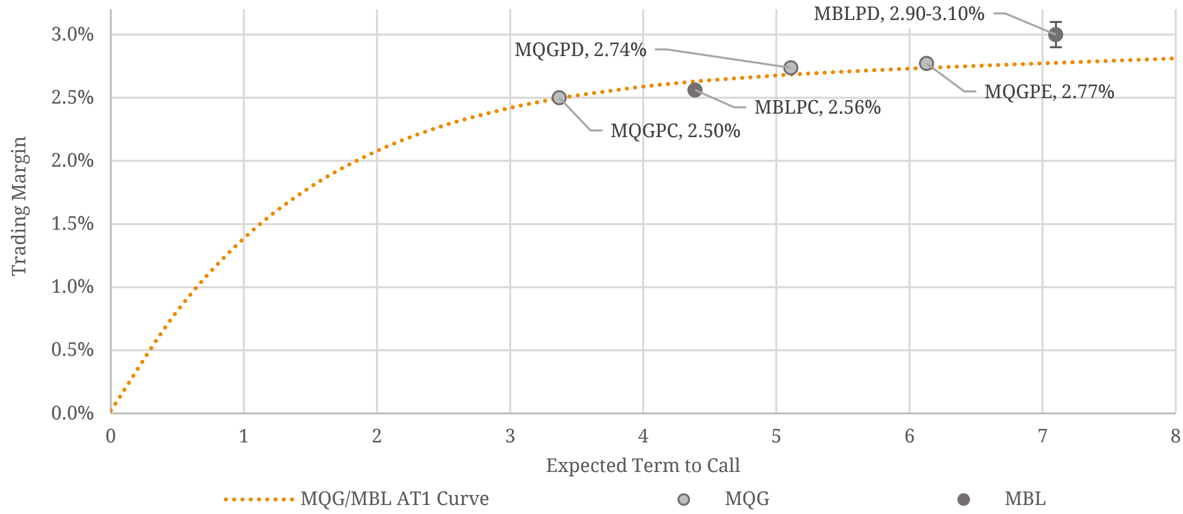
MBL is an APRA regulated ADI. MGL is regulated by APRA as a Non-Operating Holding Company (NOHC) of an ADI. MGL's capital adequacy framework requires it to maintain minimum regulatory capital requirements calculated as the sum of the Bank Group's minimum Tier 1 Capital requirement (prevailing APRA ADI prudential standards) and the Non-Bank Group's capital requirement (calculated using Macquarie Group's ECAM).

Existing (MBLPC) and offered (MBLPD) MBL AT1 securities contain Common Equity Tier 1 capital trigger clauses, whereas MQL AT1 securities ('MCN') (MQGPC, MQGPD and MQGPE) do not. At the MBL security level, this adds an extra layer of risk but also some positive visibility to possible trigger events given the discretionary nature of non-viability triggers. Notably, there is offsetting risk for the MGL MCNs, which rely to some extent on dividends from MBL to fund distributions, thus they technically rank behind the holders of securities in the Bank. This is in part mitigated by other income from within the Non-Bank Group that is significant and less capital intensive. We note that there are many possible nuances arising from the Group structure and in a stress scenario, all securities are likely to suffer adverse price pressure.

Relative Value – Issuer / Group

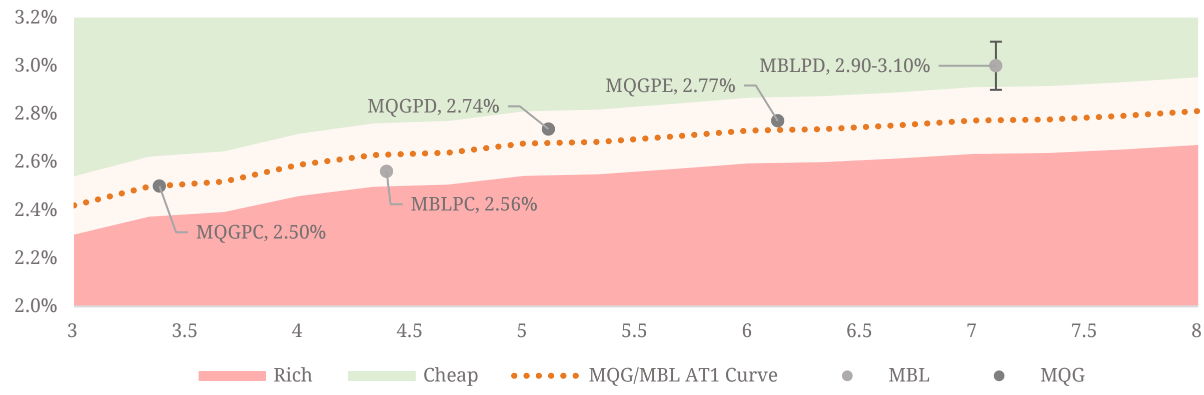
We view the Bank as having better credit fundamentals than the Group. This is consistent with public credit ratings. As illustrated in Figure 7, this is not reflected in outstanding market pricing of Bank and Group AT1 securities. Through this lens, our Issuer curve includes both Bank and Group AT1 securities. As seen in Figure 5, we view the premium offered as attractive, sitting 12-32bps over the Issuer curve. This is somewhat in contrast to MQGPE, which in February 2021, at an issue margin of 300bps, was offered at the fair value curve and subsequently repriced inwards 10bps.

Figure 5. MBL / MGL Curve – Trading Margin



Source: BondAdviser, ASX. As at 2 August 2021.

Figure 6. MBL/MGL Curve – Trading Margin – BondAdviser Valuation

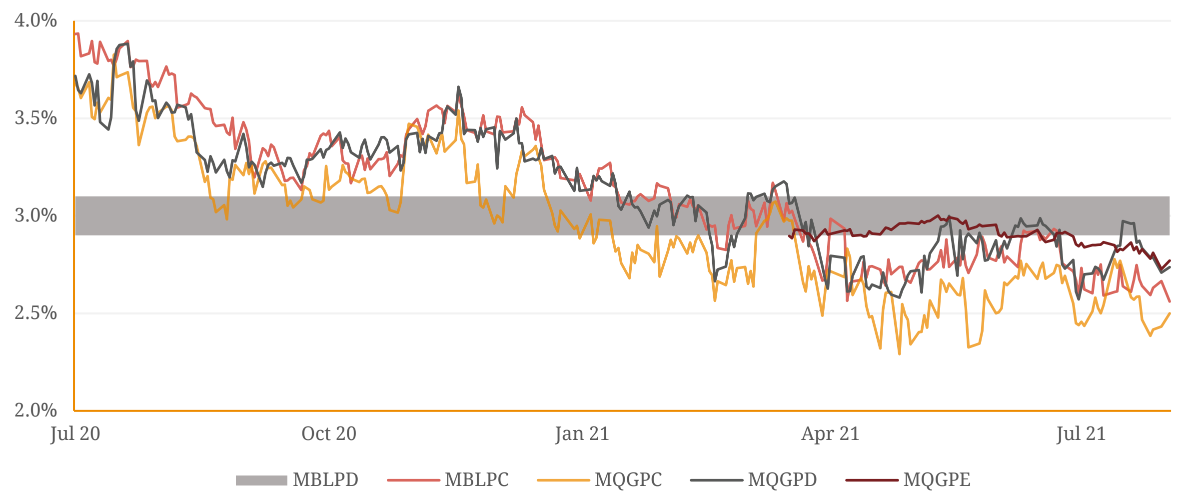


Source: BondAdviser, ASX. As at 2 August 2021 close.

In May 2020, MBLPC was priced at a robust 60bps premium to the Big Four AT1 curve and an even more so attractive 25bps premium to comparable MGL AT1 securities. This was the first AT1 security to be offered post the COVID-19 sell-off and we viewed the offer as being concessional to support a fragile market. From our perspective, this was one the best deals of the year for investors at primary but do not see similar concessions as being required or normative in the current market environment.

Whilst the optics are not *as* attractive for MBLPD, we still see the value being cheap (being synonymous with good value to investors in bond vernacular) at the lower-bound of the offered range and robustly cheap at the upper-bound. We firmly support the trade at 290bps, believing there is an appropriate 12bps premium to our fair-value MBL/MGL curve as illustrated in Figure 6. Whilst we would always prefer a larger premium, in the face of potentially excess demand, we could accept a clearing margin of 280bps, where a nominal 2bps premium to fair value would be offered.

Figure 7. Macquarie Group Existing NOHC ASX-Listed Hybrid Historical Trading Margins & MBLPC



Source: BondAdviser, ASX. As at 2 August 2021.

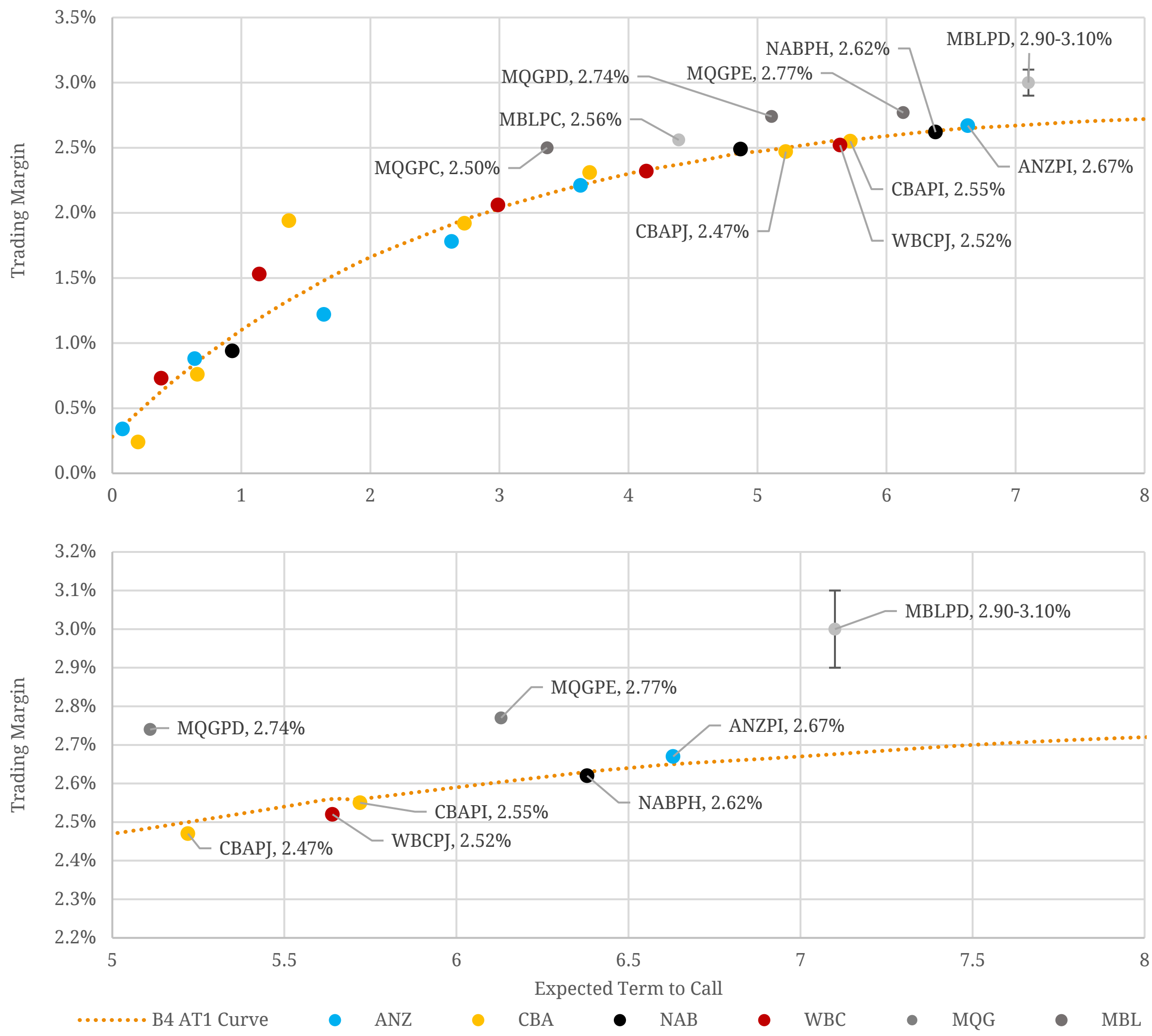
As we discussed earlier, there are structural features to consider when comparing MBL and MGL issuances. In theory, from a credit perspective, MBL securities should trade tighter than MGL on account of MBL's better credit rating, more transparent regulated status and implied support from the Group. In reality, the market does not generally price MBL's securities as such, most likely because both entities are viewed homogenously as well as the presence of CET1 Capital Triggers within the MBL AT1 hybrids, which are not contained in MGL's securities.

Relative Value – Comparables

Given the credit quality of the Bank, our comparable analysis solely focuses on Big Four AT1 securities. Whilst we do not view this as like-for-like, it is a more accurate reflection of value compared to the more volatile non-Major Bank comparable dataset. The closest term equivalent is ANZPI, with a 6.6-year term to expected call offering a 267bps trading margin. Thereafter, NABPH, with a 6.4-year term to expected call offers a 262bps trading margin.

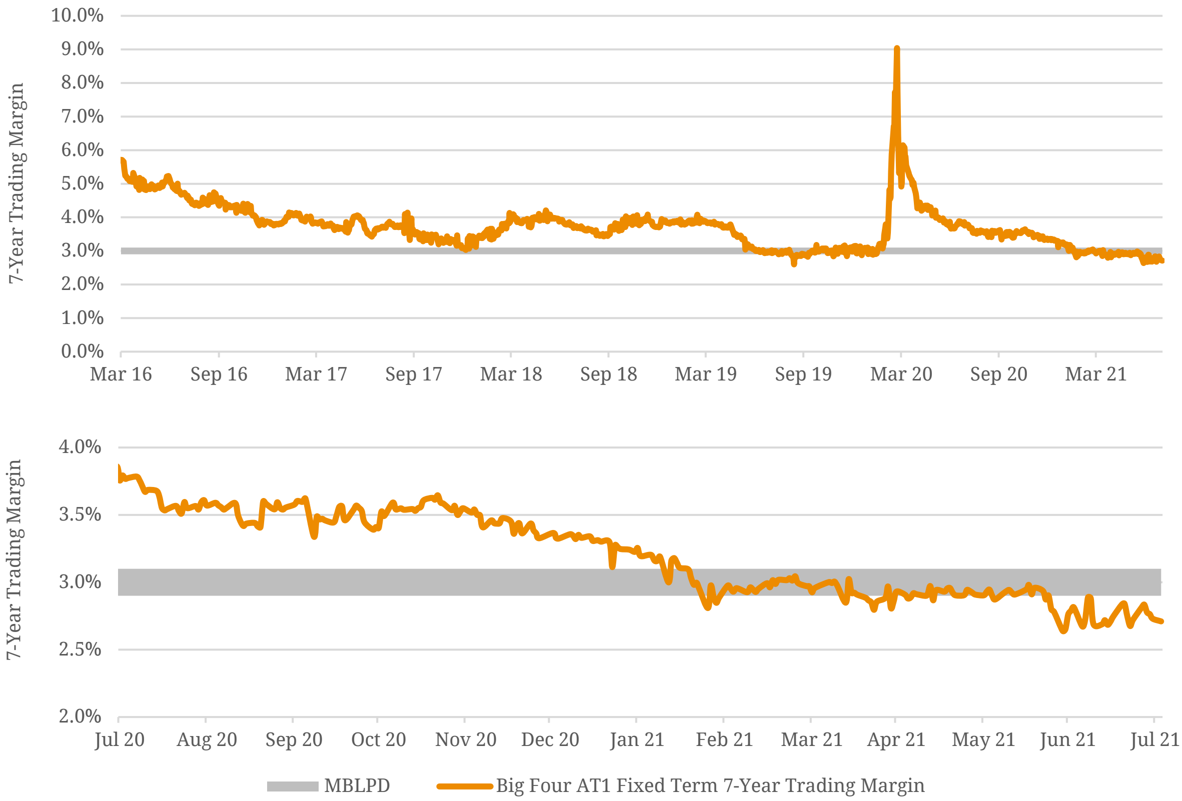
At a 290-310bps offer range, both the comparable curve and the longer-dated securities screen MBLPD as attractive from a relative valuation perspective. We cautiously note this is in the context of close to all time tights in trading margins post Basel III (2013). Whilst we see continued tailwinds in the AT1 sub-asset class, we recognise there may be some normalisation of credit spreads in the longer term, which would be adverse to the price of BCN3.

Figure 8. Big Four Curve – Trading Margin



Source: BondAdviser, ASX. As at 2 August 2021.

Figure 9. MBLPD Historical Spread to Big Four AT1 Fixed Term 7-Year Trading Margin

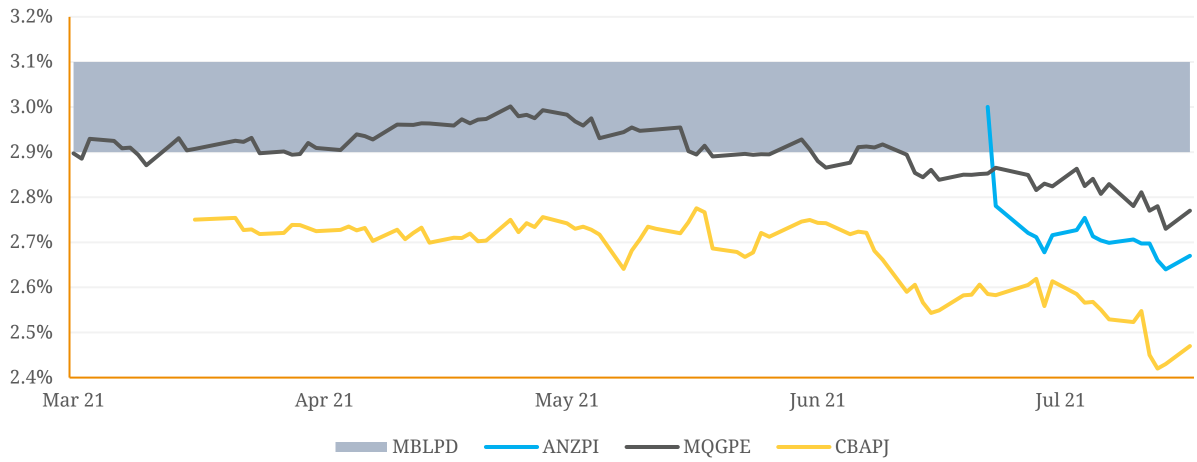


Source: BondAdviser, ASX. As at 2 August 2021.

As illustrated in Figure 9, at the 7-year tenor, over the past year, the credit and term spread has fallen for listed Big Four AT1 securities. Our calculations place the lower bound at the end of June 2021 at 265bps and subsequently this has been largely rangebound at ~270-280bps. As at 2 August 2021, this 7-year trading margin was 267bps, which makes the 23bps premium at lower bound of the guided margin range (290bps) appear on the cheap side of fair from a comparable valuation perspective. The upper bound range (310bps) with a 43bps delta looks notably attractive.

Recent Big 5 AT1 issuances has generally traded well with margins compressing below issue margins (see Figure 10). As at 2 August 2021, ANZ Capital Notes 6 (ASX: ANZPI) had narrowed 33 basis point to 2.67%; CBA PERLS XIII (ASX: CBAPJ) 28 basis points to 2.47%; and Macquarie Group Capital Notes 5 (ASX: MQGPE) 13 basis points to 2.77%. MQGPE has not performed as well as the other two securities as, in our opinion, it was priced tight to the fair value curve, with the issue margin of 2.90% coming in below the 3.00-3.20% indicative range.

Figure 10. Recent New Issue Trading Margins & MBLPD

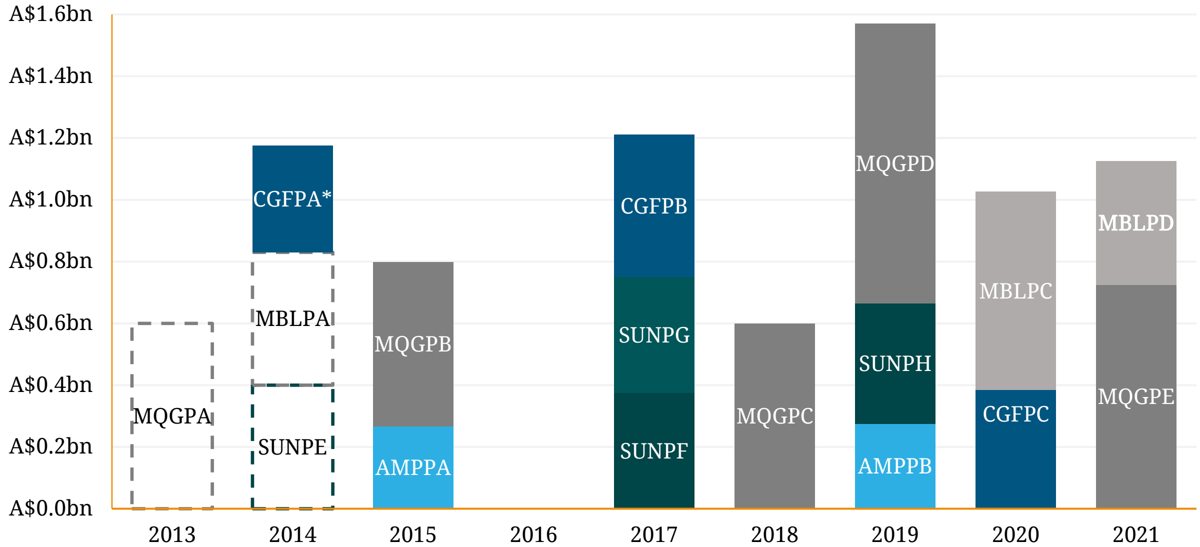


Source: BondAdviser, ASX. As at 2 August 2021.

AT1 Issuance and Maturity Profile

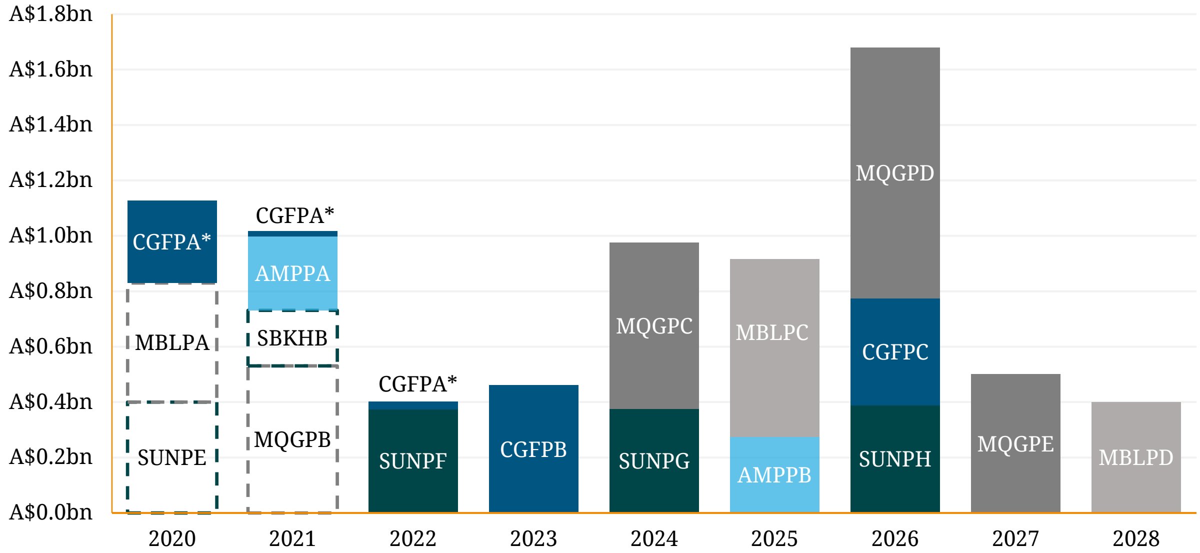
MBL is a relatively infrequent issuer of new-style Basel 3 hybrid instruments but has a long history of capital security issuance dating back to 1999. MBLPD is the third ASX-listed Capital Note offered by MBL, with the most recent being Macquarie Bank Capital Notes 2 (BCN2, ASX: MBLPC), which was issued in June 2020 raising $641 million at a 4.70% margin above 90-day BBSW with a 5.5-year term to first call (22 December 2025). Macquarie Bank Capital Notes (BCN, ASX code: MBLPA) were issued in October 2014 at a margin of 3.30% over 180-day BBSW, raising almost $430 million and were repaid in March 2020. Previous to these transactions, the Bank issued $400 million of Macquarie Income Securities (MIS, ASX code: MBLHA) in November 1999 at a 1.70% margin above the 90-day BBBSW. MIS were repaid in April 2020.

Figure 11. NOHC ASX-Listed Hybrid Issuance Profile (plus MBL)



*Source: BondAdviser. * CGFPA: ~$27.7m remaining on issue after $238m was reinvested into CGFPC and $60m repurchased in Nov-20 and $20m in May-21. Dotted line with no fill indicates redeemed Notes. Assumes $400 million issuance of MBLPD.*

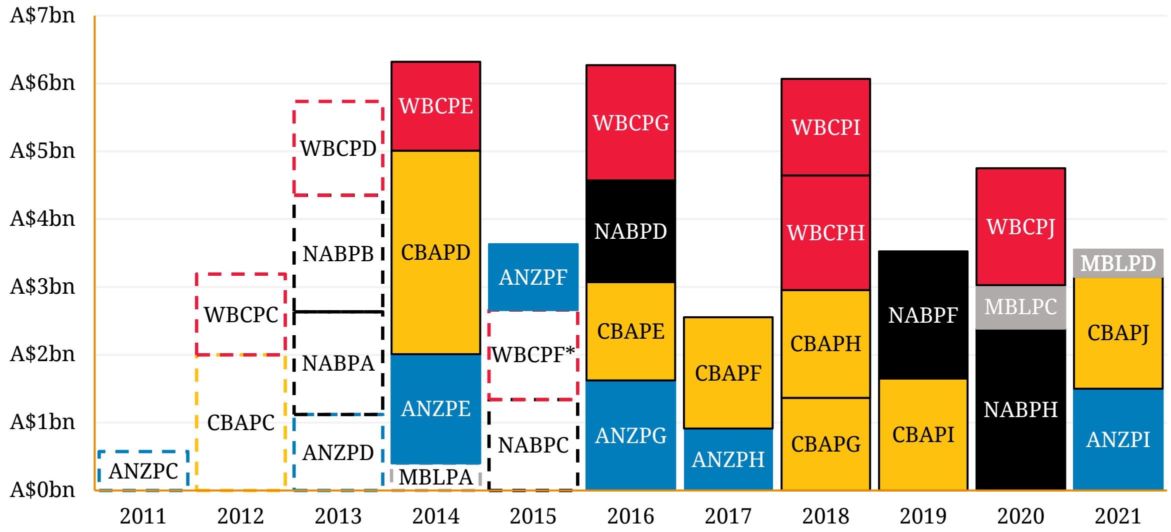
Figure 12. NOHC ASX-Listed Hybrid Maturity Profile (plus MBL)



*Source: BondAdviser. * CGFPA: ~$27.7m remaining on issue after $238m was reinvested into CGFPC and $60m repurchased in Nov-20 and $20m in May-21. Dotted line with no fill indicates redeemed Notes. Assumes $400 million issuance of MBLPD.*

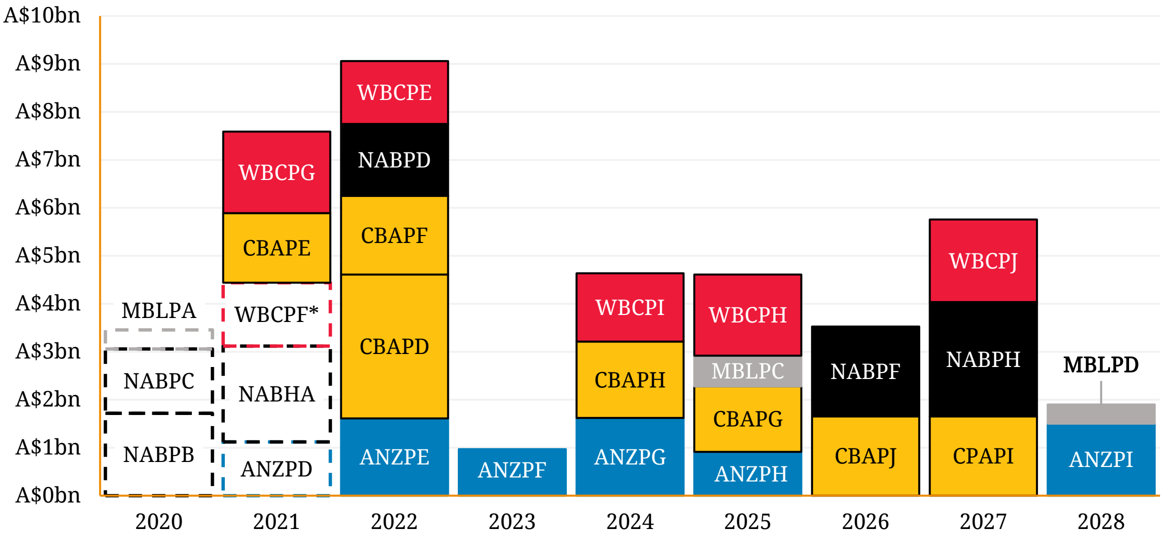
2021 has been relatively light on hybrid issuances (see Figures 11 and 13): Commonwealth Bank (ASX: CBA) issued CBAPJ in April 2021 raising $1.18 billion at a 2.75% margin over 90-day BBSW, first call October 2026; MGL issued MQGPE in March 2021 at 2.90% margin above 90-day BBSW, first call September 2027; and ANZ Bank issued ANZ Capital Notes 6 (ASX: ANZPI) in July 2021 at a 3.00% margin over 90-day BBSW, first call March 2028.

Figure 13. Major Bank & MBL ASX-Listed Hybrid Issuance



*Source: BondAdviser. * WBCPF ~$866m resold/reinvested into WBCPJ in Dec-20. The balance of $454m resold on Mar-21. Dotted line with no fill indicates redeemed Notes. Assumes $400 million issuance of MBLPD.*

Figure 14. Major Bank & MBL ASX-Listed Hybrid Maturity Profile

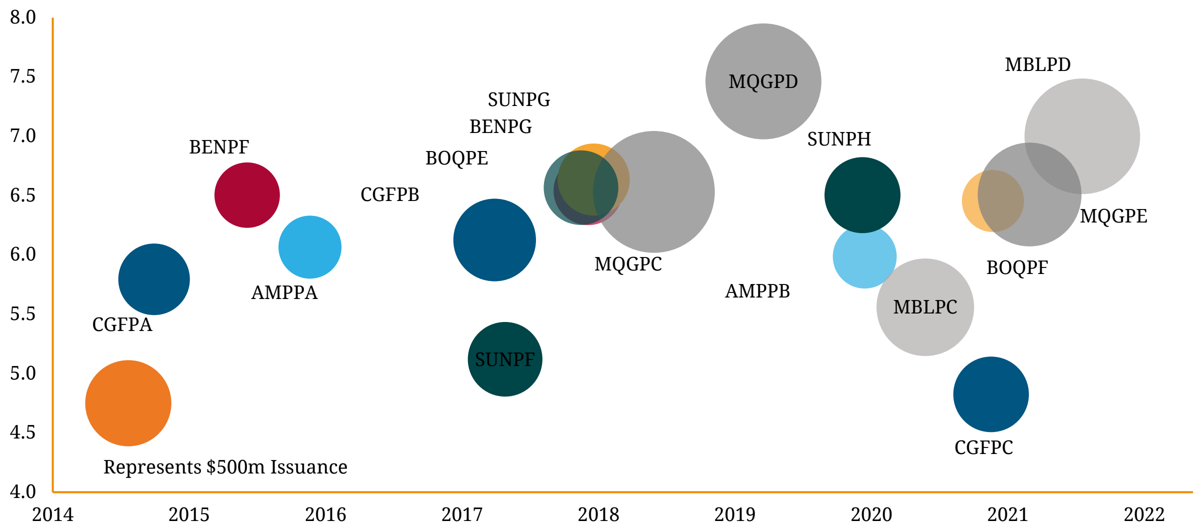


*Source: BondAdviser, * WBCPF ~$866m resold/reinvested into WBCPJ in Dec-20. The balance of $454m resold on Mar-21. Dotted line with no fill indicates redeemed Notes. Assumes $400 million issuance of MBLPD.*

Refinancing of existing securities tends to be the main driver of new supply. ANZPI and MQGPE were rollover transactions of ANZ Capital Notes (ASX: ANZPD) and Macquarie Group Capital Notes 2 (ASX: MQGPB), respectively). CBAPJ was an all-new monies deal.

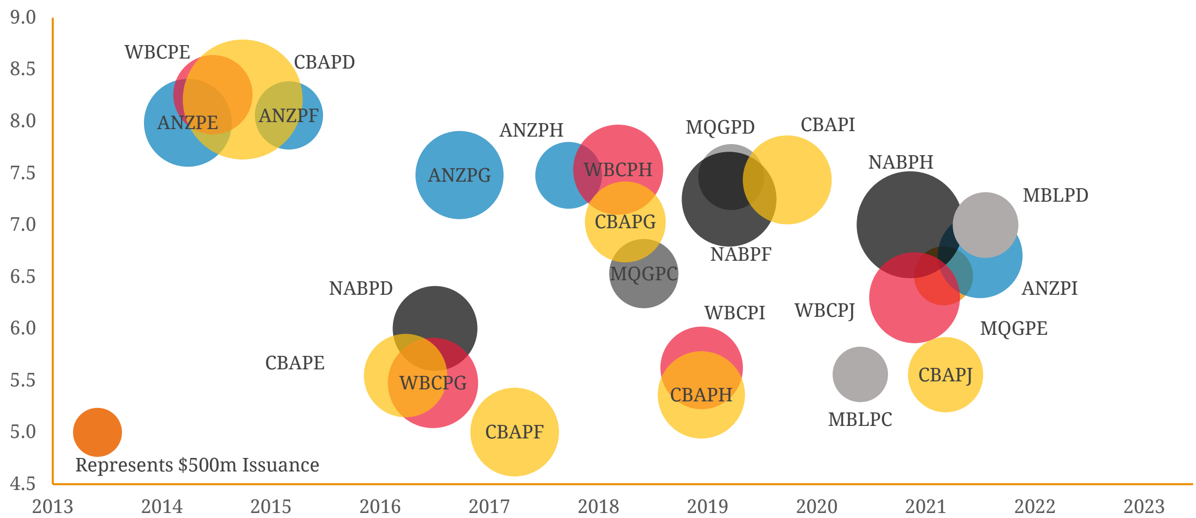
MBLPD is a new money issue and we expect it to be well supported given all-time low interest rates and the current relative lack of new supply from upcoming maturities in 2021. As can been seen in Figures 12 and 14 there are only three AT1 hybrids remaining on issue with call dates in 2021 (AMPPA, CBAPE and WBCPG). While not shown in these charts, there are also no regional bank hybrids due to be called over the remainder of this year. The most recent AT1 deal, launched in June this year, ANZPI, was very well supported. ANZ raised $1.5 billion, which was well above the initial $1.0 billion sought, with about half coming from rollovers of ANZPD and the remaining balance from new money.

Figure 15. Non-Major Bank Hybrid AT1 Tenor (to Call) by Issuance Year



Source: BondAdviser. Assumes $400 million issuance of MBLPD.

Figure 16. Major Bank Hybrid AT1 Tenor (to Call) by Issuance Year

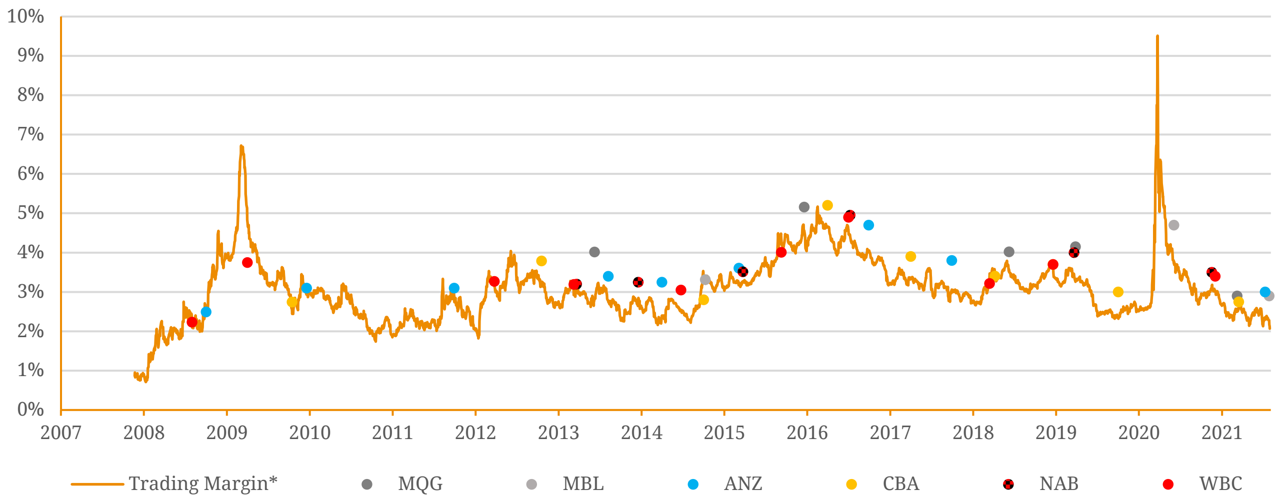


Source: BondAdviser. Assumes $400 million issuance of MBLPD.

Figures 15 and 16 highlight trends in issuance over the past few years. Understandably, when the market is risk adverse, as seen in 2020, tenors fall as issue margins increase. The reverse is seemingly true now, a risk seeking market is able to digest larger sizes at longer tenors with lower issue margins. The logic here applies at the issuer level also, when it is expensive funding, issue less, with shorter maturities. When it is cheap funding, issue more, with a longer maturity. In 2021, there has been a shift towards issuance of securities with longer tenors (time to call) and larger issue sizes. This would not be possible if the demand was not there. Declining interest rates have been supporting demand as investors go further up the risk curve for real yield.

Appendix 1. Historical Comparison

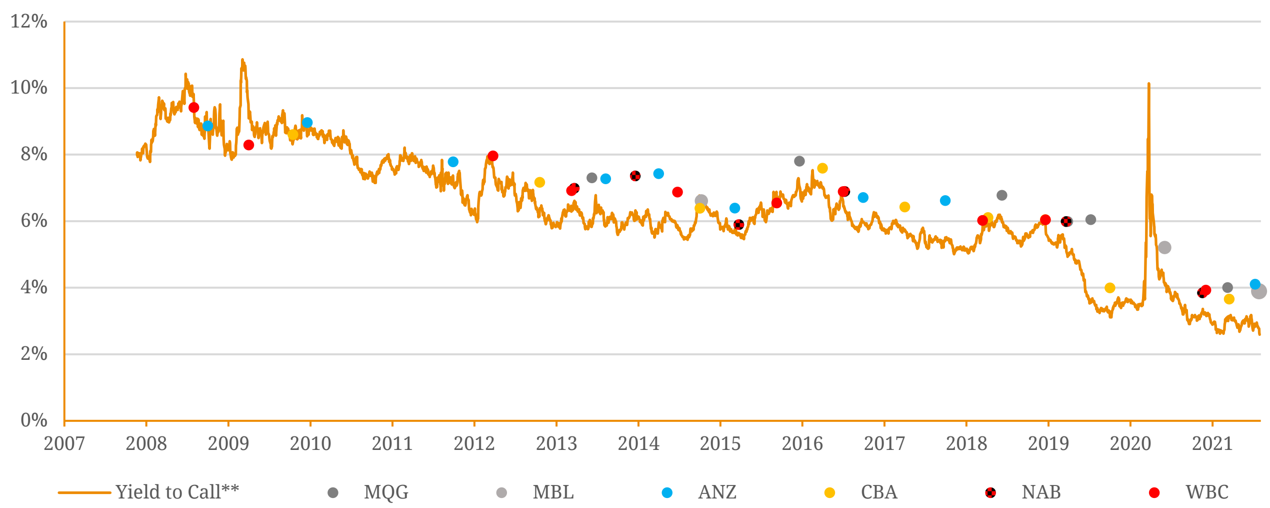
Figure 17. Big Four Weighted Average Trading Margin, B4+MGL & MBL AT1 Primary Issuance Margin*



	Last	1m	3m	YTD	1y	3y	5y	Inception^
Trading Margin	2.07%	2.13%	2.14%	2.65%	3.38%	3.11%	4.25%	0.28%
%Δ		-2.82%	-3.27%	-21.89%	-38.76%	-33.44%	-51.29%	639.29%

Source: BondAdviser Index Platform: BAB4AT1DFTR. As at 2 August 2021.
** Weighted average based on market capitalisation. BAB4AT1DFTR is a franked, total return index that is rebalanced on a daily basis.*
^Inception of BAB4AT1DFTR is 5/7/2004.

Figure 18. Big Four Weighted Average Yield to Call, B4+MGL & MBL AT1 Primary Issuance Yield to Call**

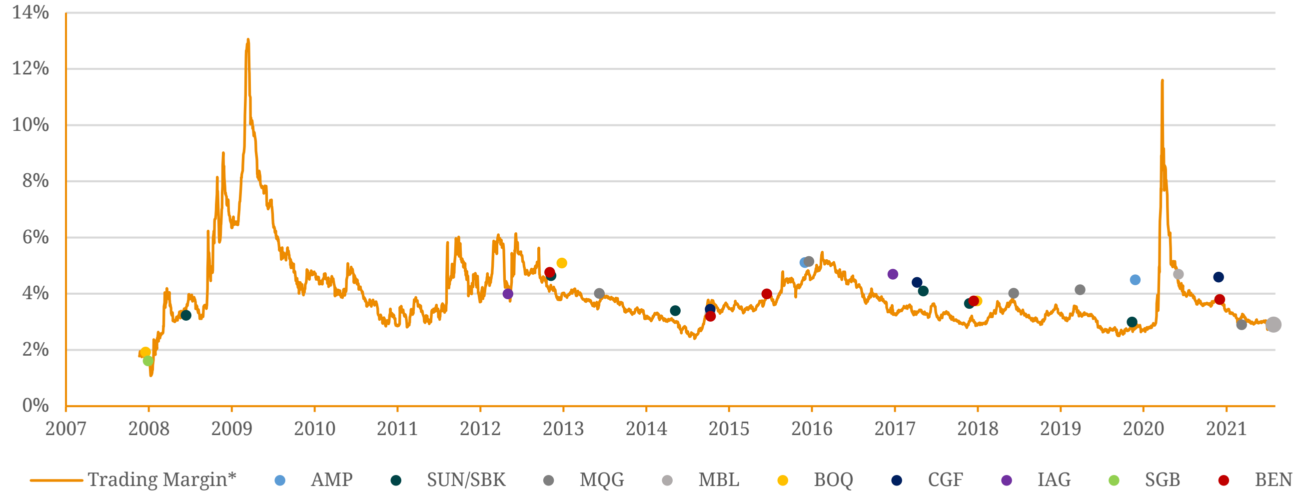


	Last	1m	3m	YTD	1y	3y	5y	Inception^
Yield to Call	2.54%	2.71%	2.68%	2.89%	3.67%	5.51%	6.15%	6.10%
%Δ		-6.27%	-5.22%	-12.11%	-30.79%	-53.90%	-58.70%	-58.36%

Source: BondAdviser Index Platform: BAB4AT1DFTR. As at 2 August 2021.
*** Weighted average based on market capitalisation. BAB4AT1DFTR is a franked, total return index that is rebalanced on a daily basis. Yield to call based on BondAdviser estimates.*
^Inception of BAB4AT1DFTR is 5/7/2004.

Appendix 2. Historical Comparison

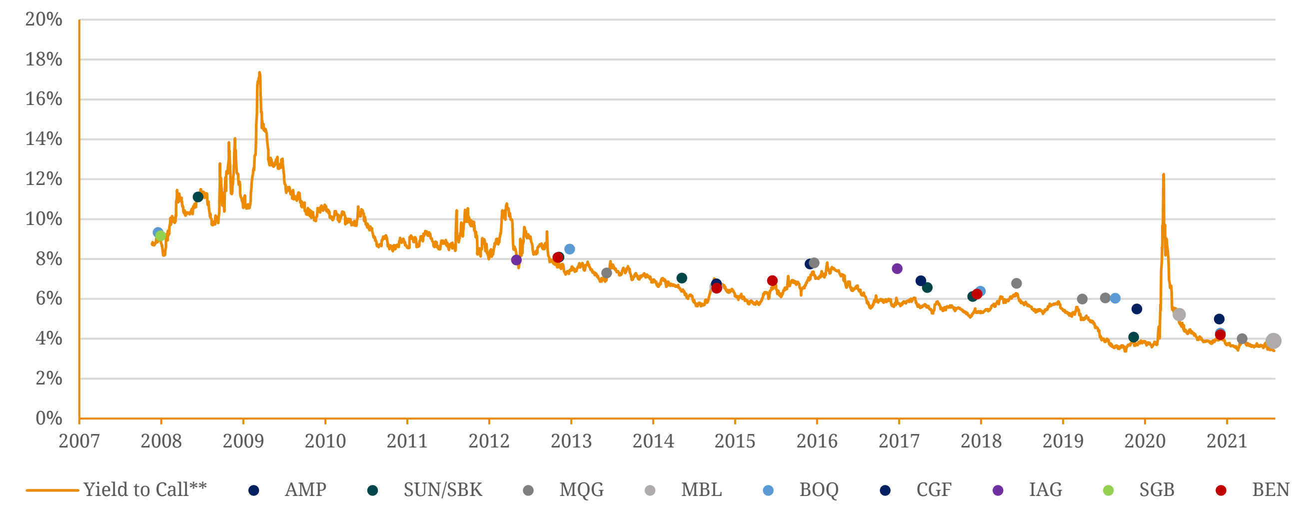
Figure 19. Non-Major AT1 Weighted Average Trading Margin, Non-Major AT1 Primary Issuance Margin*



	Last	1m	3m	YTD	1y	3y	5y	Inception^
Trading Margin	2.81%	2.72%	2.91%	3.37%	3.94%	3.27%	4.24%	0.89%
%Δ		3.31%	-3.44%	-16.62%	-28.68%	-14.07%	-33.73%	215.73%

Source: BondAdviser Index Platform: BANMAT1DFTR. As at 2 August 2021.
** 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 20. NM AT1 Weighted Average Yield to Call, Non-Major AT1 Primary Issuance Yield to Call**



	Last	1m	3m	YTD	1y	3y	5y	Inception^
Yield to Call	3.37%	3.46%	3.58%	3.69%	4.27%	5.68%	6.15%	7.36%
%Δ		-2.60%	-5.87%	-8.67%	-21.08%	-40.67%	-45.20%	-54.21%

Source: BondAdviser Index Platform: BANMAT1DFTR. As at 2 August 2021.
*** 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.

Macquarie Bank Limited: Financial Summary

Macquarie Bank Limited: Financial Summary

Recommendation Summary **Subscribe**

3 August 2021

Profit and Loss	2021	2020	2019	2018	2017
Net Int. Income ($m)	2,089.0	2,040.0	1,978.0	1,483.0	1,786.0
Fee & Comm. Inc. ($m)	1,326.0	1,185.0	1,231.0	503.0	414.0
Trading Income ($m)	3,315.0	2,615.0	2,526.0	1,192.0	773.0
Other Income ($m)	265.0	332.0	176.0	2,059.0	809.0
Total Revenue ($m)	6,995.0	6,172.0	5,911.0	5,237.0	3,782.0
Growth (%)	13.3	4.4	12.9	38.5	-39.0
Total Expenses ($m)	-4,697.0	-4,277.0	-4,432.0	-2,967.0	-3,061.0
Growth (%)	9.8	-3.5	49.4	3.1	5.4
Pre-Tax Earnings ($m)	2,298.0	1,895.0	1,479.0	2,270.0	721.0
Taxation ($m)	-622.0	-586.0	-394.0	-251.0	-73.0
Discontinued Ops. ($m)	0.0	164.0	956.0	0.0	0.0
NPAT ($m)	1,676.0	1,473.0	2,041.0	2,019.0	648.0
Growth (%)	13.8	-27.8	1.1	211.6	-82.3

Capital Adequacy Ratios	2021	2020	2019	2018	2017
CET1 Ratio (%)	12.60	12.20	11.40	11.00	11.10
Tier 1 Capital Ratio (%)	14.30	13.60	13.50	12.80	13.30
Total Capital Ratio (%)	18.10	15.20	15.60	14.60	154.00

Capital Base	2021	2020	2019	2018	2017
CET1 ($m)	11,840.0	11,653.0	8,839.0	10,128.0	10,024.0
Additional Tier 1 ($m)	1,628.0	1,315.0	1,626.0	1,592.0	1,970.0
Total Tier 1 ($m)	13,468.0	12,968.0	10,465.0	11,720.0	11,994.0
Total Tier 2 ($m)	4,223.0	1,592.0	1,598.0	1,697.0	1,889.0
Total Capital Base	17,691.0	14,560.0	12,063.0	13,417.0	13,883.0

Risk Weighted	2021	2020	2019	2018	2017
Credit ($m)	77,589.0	80,350.0	62,024.0	77,714.0	75,997.0
Market ($m)	5,660.0	3,971.0	5,382.0	3,303.0	3,958.0
Operational ($m)	10,337.0	10,655.0	10,111.0	9,960.0	9,979.0
Total RWA ($m)	93,959.0	96,976.0	77,517.0	91,730.0	90,016.0

Balance Sheet	2021	2020	2019	2018	2017
Liquids ($m)	50,521.0	45,555.0	36,841.0	35,085.0	23,907.0
Trading Assets	21,212.0	16,251.0	17,502.0	11,823.0	20,609.0
Deriv. Assets ($m)	20,552.0	44,845.0	14,090.0	10,668.0	10,788.0
Avail. for Sale ($m)	7,999.0	7,484.0	5,470.0	5,158.0	4,801.0
Loans ($m)	98,992.0	87,719.0	73,821.0	54,542.0	52,680.0
Intang. Assets ($m)	146.0	185.0	177.0	91.0	104.0
Other ($m)	17,426.0	24,097.0	21,521.0	44,866.0	48,650.0
Total Assets ($m)	216,848.0	226,136.0	169,422.0	161,633.0	161,539.0
Trade Liabs. ($m)	6,134.0	5,363.0	7,757.0	8,286.0	5,143.0
Deriv. Liabs. ($m)	17,475.0	37,823.0	12,523.0	10,043.0	10,280.0
Deposits ($m)	84,140.0	67,253.0	56,120.0	57,919.0	56,298.0
Payables ($m)	16,251.0	19,052.0	17,901.0	9,011.0	11,212.0
Debt ($m)	44,668.0	46,922.0	33,587.0	30,674.0	29,691.0
Loan Capital ($m)	6,804.0	4,997.0	4,550.0	4,256.0	4,615.0
Other ($m)	27,302.0	30,499.0	25,744.0	30,044.0	33,707.0
Total Liabs. ($m)	202,774.0	211,909.0	158,182.0	150,233.0	150,946.0
Total Equity ($m)	14,074.0	14,227.0	11,240.0	11,400.0	10,593.0

Funding & Liquidity	2021	2020	2019	2018	2017
Deposits as % of GLAs	84.40	76.70	76.00	72.00	74.20
Liquid Assets ($bn, Pillar 3)	36.1	29.4	24.0	23.6	29.5
LCR (%)	174.00	174.00	154.00	162.00	168.00
NSFR (%)	115.00	118.00	113.00		

Asset Quality & Provisions	2021	2020	2019	2018	2017
Gross Impaired Loans/GLA (%)	1.21	1.49	1.16	0.99	1.74
Provisions/Impaired Loans (%)	78.60	62.90	61.50	48.10	58.90
Provisions/GLA (%)	0.95	0.94	0.71	0.48	1.02

Source: Company data, BondAdviser estimates.

Research Methodology

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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.

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