BondAdviser

Research Report

Report Created on 29 August 2021

Issuer Name

Suncorp Group Limited

Security Name

Suncorp Capital Notes 4

Security Recommendation

Subscribe

Security Risk

Upper Medium

Issuer Outlook

Improving	Stable	Deteriorating

Key Characteristics

Product Type	Capital Note	**Issue Price**	$100.00
Issue Size*	$350,000,000.00	**Accrued**	$0.00
Par Value	$100.00	**Capital Price**	$100.00
Fixed/Floating	Floating	**Running Yield**	[2.91%-3.11%]
Payment Frequency	Quarterly	**Expected Yield to Maturity*** **	[3.93%-4.13%]
Current Distribution**	[2.91%-3.11%]	**Trading Margin**	[2.90%-3.10%]
Issue Margin / Coupon	[2.90%-3.10%]	**First Call Date**	19 June 2028
Franking Credits Incl.	Yes	**Scheduled Conversion Date**	17 December 2030
ASX Listed	Yes (ASX Code: SUNPI)	**Next Ex-Date**	[TBC]
Convertible	Yes	**Next Payment Date**	17 December 2021
GICS Sector	Insurance	**Next Cash Distribution**	[TBC]

* With the ability to raise more or less. ** Based on issue margin of [2.90%-3.10%] plus 90-Day BBSW of 0.01%. *** Based on issue margin of [2.90%-3.10%], an interpolated swap to call rate of 1.03% and an expected call date of 19 June 2028 (deferred from 17 June 2028 due to the Business Day convention).

Summary

On 30 August 2021, Suncorp Group Limited (ASX: SUN) launched an Offer for Suncorp Capital Notes 4 (ASX: SUNPI), to raise $350 million, with the ability to raise more or less. The purpose of the transaction is to raise regulatory capital (Additional Tier 1) for SUN. These securities are structured as redeemable, perpetual, unsecured, convertible and subordinated notes. Distributions are expected to be discretionary, non-cumulative, floating rate, fully franked, and paid on a quarterly basis in arrears. The margin is guided at 2.90% to 3.10% p.a. above 90-day BBSW. There is no obligation on Holders to pay SUN if the distribution rate was to become negative.

This security has no fixed maturity date but is scheduled for mandatory conversion into SUN ordinary shares on 17 December 2030, or later, when conversion conditions have been satisfied. At SUN's discretion, the Notes can be redeemed, resold or converted into SUN ordinary shares on 19 June 2028, 18 September 2028 or 15 December 2028, or if a Tax or Regulatory Event occurs, subject to conditions and APRA approval. At SUN's discretion, conversion (but not redemption or resale) may also happen if a Potential Acquisition Event occurs, subject to conditions and APRA approval. The Notes will convert into SUN ordinary shares following an Acquisition Event, subject to conversion conditions.

As this security meets capital instrument eligibility criteria under Basel III, it also contains loss absorbing terms and conditions known as a Non-Viability Trigger Event. The security therefore qualifies as Additional Tier 1 capital. Upon the occurrence of a Non-Viability Trigger Event, this security will be automatically converted into SUN ordinary shares without the protection of conversion conditions. If conversion cannot occur for any reason within five business days of the Non-Viability Trigger Event, the Notes will be written off and all Holders' rights terminated.

Figure 1: Capital Structure[1]

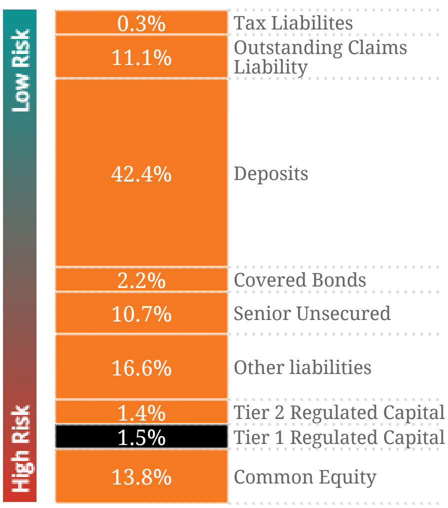
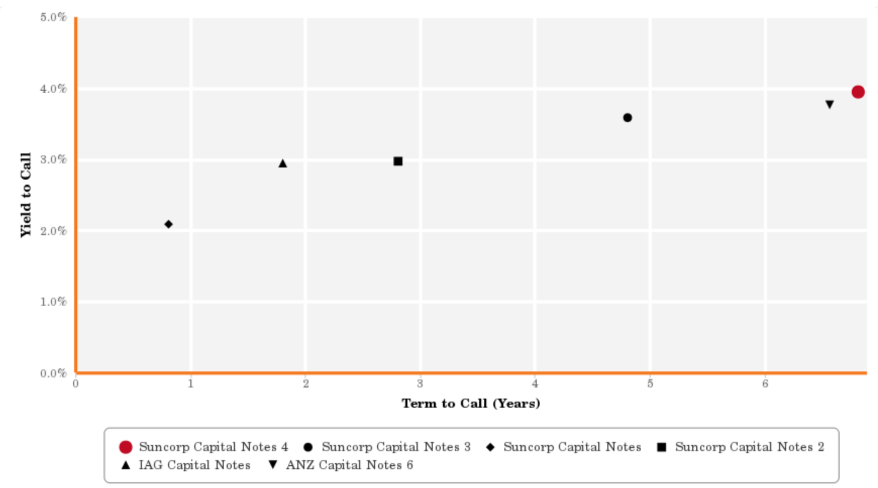


Figure 2: Relative Value



[1] Pro-forma balance sheet as at 30 June 2021 assuming a net $343m is raised from SUNPI after costs.

Security Recommendation - Subscribe *as at 29 August 2021*

We see fair value around the 285-290bps margin mark and at an offered margin of 290-310bps we recommend investors **Subscribe** due to our fundamental credit comfort.

This is the seventh ASX listed security offered by SUN which qualifies as Basel III compliant Additional Tier 1 Capital. The most recent issue was Suncorp Capital Notes 3 (SUNPH), which were issued in December 2019 and raised $389 million at a 300bps margin over 90-day BBSW with a 6.5 year term to first call (17 June 2026).

Our valuation assumptions for this security are based on it being redeemed in full on the first optional call date (19 June 2028) and all interest payments being made in a timely manner. If this security is not called on this date (extension risk) the price of the security may drop significantly.

Ideally a new security issue margin will include a new issue premium to compensate for the pricing uncertainty between the launch and settlement. That said, we acknowledge the advantage of buying in the primary market rather than the secondary given the availability of liquidity at a known price – a particular driver for institutional buyers.

We are comfortable with the credit profile of the SUN and our analysis indicates at the bottom of the indicative range, 290bps, the offered margin is fair on a relative valuation basis and incrementally cheap above that.

While the indicative margin range sits between a -15bps and +5bps range below and above the SUN AT1 issuer curve, we note that SUN AT1 margins have been relatively volatile. The three-month average trading margin for SUNPH of 276bps possibly provides a better basis for comparison and places SUNPI 14-34bps above this – an identical concession is present against our fixed 6.75-year tenor trading margin of ASX-listed Big Four AT1 hybrids. In comparison to the Big Four AT1 curve and longer dated securities, SUNPI also screens fair to cheap. However, we note that while we see continued tailwinds for AT1 hybrids, trading margins are near all-time lows since Basel III implementation (2013), so the prices of AT1 securities would be adversely affected if credit spreads normalise.

This is an entirely new money transaction; however, we expect demand to be strong at both the institutional and eligible securityholder level. Whilst there may not be natural demand from the roll of an existing SUN AT1 security, we suspect that some SUNPF holders, which has its first call date in June 2022, will bid aggressively in order to ensure allocation – akin to a bird in the hand argument. Ultimately, given: (1) the relatively smaller size, compared to recent transactions, (2) the excess demand present at such transactions, (3) the ability to diversify outside the Big Four banks, and (4) the lower interest rate environment, we suspect the transaction will have no shortage of demand, despite not having a reinvestment offer.

Predominantly a general insurer, SUN operates in an industry which is subject to financial shocks directly linked to catastrophic events - albeit less so than life insurers. However, the defences of the Group are substantial including claims provisions and reinsurance in general insurance and loan loss provisions in the bank and common equity capital across the Group, so an event which triggers non-viability is unlikely. Nonetheless, catastrophe risk is somewhat unmanageable, and this security does warrant a trading margin premium to major bank Tier 1 capital instruments. We consider the probability of a Non-Viability Trigger Event to be reasonably remote, but if it was to occur it would likely cause a significant capital loss, so it is a risk investors' need to be aware of.

The Offer comprises a Securityholder Offer for eligible SUN securityholders, Broker Firm Offer and Institutional Offer. The margin is expected to be announced on or before 6 September 2021 following completion of the bookbuild. The Security Holder and Broker Firms offers are expected to open on 7 September 2021 with the expected closing date of 20 September 2021. Institutions bid during the bookbuild on or before 6 September 2021.

Positive / Negative Risk Factors

What factors would change the Recommendation UP

- Robust Capital Position. SUN has a strong excess capital position over and above its regulatory requirements. Provided the Group can maintain a reasonable claims ratio during a period of moderate catastrophe events, the market will maintain confidence in its underwriting ability.
- Reinsurance Cover. SUN has reinsurance cover to help reduce claims risk for its insurance business. It also has a quota share arrangements.
- Disciplined Regulatory Supervision. SUN is subject to oversight by prudential regulators (APRA in Australia and RBNZ in New Zealand), which monitor risks and financial conditions, conducts stress testing and detailed supervisory reviews and sets capital benchmarks.
- A supportive AAA rated Federal Government. As witnessed during the GFC and most recently the COVID-19 crisis, domestic banking benefits from a supportive government. A recent example includes the provision of a term funding facility for the industry to support lending to businesses. It is possible Australia may lose its AAA rating in the medium-term, whilst this is not expected to impact levels of government support, we may also see a downgrade of the stand-alone credit profile of banks and by extension a downgrade in AT1 hybrids.

What factors would change the Recommendation DOWN

- Regulatory Risk. Insurers and banks are highly regulated and changes to regulation could impact profitability and or require changes to the business model.
- Non-Viability Trigger Event. Distributions on this security are discretionary and not cumulative. A key risk here is that if SUN is unable to maintain the PCA ratio above the minimum requirements, distribution payments may not be able to be made. The other key risk is where APRA determines that a Non-Viability Trigger Event has occurred. If this were to occur, investors are at risk of substantial capital losses, with all the Notes written-off in a worst-case scenario.

- Competition. General insurance products are commoditised with price being the main differentiator. A competitive pricing impacts the rate of premium growth so we are cautious of slipping underwriting standards to maintain market share.
- COVID-19. Risk from the pandemic is like few others Australia has faced, and as such brings with it a great deal of uncertainty. The impact on the economy has been negative, but not as bad as anticipated and conditions are improving. However, risks from lockdowns persist. In insurance, the risk is reduced affordability of insurance, lower demand in some insurance categories, volatility in investment earnings and low interest rates impacting returns on investment portfolios. In banking, the risk is the potential for a sharp deterioration in asset quality.
- Subordination. This security is heavily subordinated on the issuer capital structure and its features reflect this. For example, distributions are discretionary and subject to payment conditions. Although we do not anticipate any failure on the part of the issuer to meet their distribution payments, it has precedent overseas and cannot be ruled out in a worst-case economic backdrop scenario.

Issuer Outlook - Stable *as at 29 August 2021*

Suncorp Issuer Outlook

No earnings FY22 guidance was provided at the FY21 result release in August, which is not a surprise given the uncertainty. Management noted the improvement in the operating environment but believe the outlook remains uncertain from the economic impacts of the pandemic, as risks from lockdowns persist. Importantly, SUN retains a conservative stance and is focused on ensuring key funding, liquidity and balance sheet metrics are at prudent levels to endure a range of economic scenarios. Concurrently, management continue to push ahead with its three-year strategic agenda aimed at driving growth and improving efficiencies.

For insurance, we assume natural perils will be at more normalised levels for FY22. Gross written premium (GWP) growth has held up very well and will support earnings, but risks remain from economic impacts of COVID-19 that could temper new business volumes and customer retention rates, while low interest rates and volatile investment markets may weigh on investment income.

The domestic finance industry was facing one of its greatest challenges in the form of COVID-19, but Australia has fared relatively well in managing the health and economic consequences of the pandemic. While Australia's economic performance has been better than expected last year, our view was the recovery was unlikely to be smooth. There is renewed uncertainty as the latest and more contagious variant of the virus spreads, resulting in lockdowns including an extended one in Australia largest city, Sydney. Vaccines continue to provide light at the end of the tunnel despite a much longer than anticipated rollout program, but risks of lockdowns will persist at least until vaccination rates in the community are much higher.

JobKeeper finished at the end of March 2021, but the reintroduction of government income support payments, to lockdown impacted workers; at comparative levels and loan repayment deferral arrangements by lenders, help mitigate risks to asset quality from lockdowns.

Overall, the domestic banking and insurance outlook remains challenging but operating conditions are better than they were in 2020 and certainly not as bad as originally anticipated. Importantly, the banking and insurance industry continues to benefit from strong regulatory and government support while maintaining healthy capital buffers and loan loss provisions above pre-pandemic levels.

On balance, we consider industry risks for banks and insurers are lower than in 2020 as the economy is performing better than anticipated. An improving earnings outlook, maintenance of high loan loss provisions, combined with healthy capital, funding and liquidity levels, put the sector in an improved position to manage the risk of higher loan impairments.

While risks to asset quality remain in SUN's banking business, the Group's much larger insurance business provides all important diversification, the capital position remains robust despite the buy-back, with high levels of reinsurance and loss provision coverage supporting the credit profile. We have a **Stable** view on SUN'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.

Group Earnings

Suncorp Group (ASX: SUN) reported a strong FY21 result despite COVID-19 and adverse weather events, benefitting from robust GWP growth, stronger investment returns, net interest margin expansion and the unwind of COVID-related provisions. While the earnings performance was positive from a credit perspective, in addition to the large dividend payout ratio (79.3% of cash earnings), the announcement of a buy-back is negative as it will reduce the Group's surplus CET1 capital position, albeit from an elevated level. We retain a Stable view on the SUN's credit outlook with capital still in a healthy position, along with high levels of reinsurance coverage and loan loss provisioning remaining above pre-pandemic levels.

FY21 cash NPAT increased 42.1% on FY20 to $1.06 billion, driven by stronger performances in Insurance (Australia) and Banking, and partially offset by a weaker result in New Zealand. Statutory NPAT of $1.03 billion grew at a slower pace, 13.1%, primarily due to the prior year including a gain on the sale of the car parts and repair business. The net impact of COVID-19 was neutral with lower frequency of motor claims offset by higher claims provisions for the potential business interruption insurance claims.

A fully franked final dividend of 40 cents per share (2H20: 20 cps) was announced taking total dividends for the year to 66 cps (FY20: 36 cps). This equates to a 79% payout ratio, which is at the top of the 60-80% target. SUN also announced capital management initiatives comprising: (1) an 8 cps fully franked special dividend; and, (2) an on-market buy-back of up to $250 million of ordinary equity, expected to start in September 2021 and run for about 11 months.

Insurance (Australia)

Insurance (Australia) NPAT rose 42.4% to $547 million, reflecting a 5.5% increase in GWP with growth across all insurance portfolios, except compulsory third party, driven by positive price and volume, stronger investment returns from shareholder funds and increased prior period claims reserve releases. This was marginally offset by higher investment spend and natural hazard claims costs – we expect natural hazard claim costs to remain problematic for some time, perhaps permanently.

Underlying net claims costs, which excludes discount rate movements, rose by 5.0% a result of increased claims provisions for business interruption insurance and higher natural hazard costs, which was $34 million above the $898 million allowance for the year. The insurance margin widened from 6.8% in FY20 to 8.5% in FY21 with the second half coming in at 9.5%.

Banking and Wealth

Unsurprisingly to us, the release of COVID-19 provisions saw Banking and Wealth deliver a 69.0% lift in NPAT to $419 million. It was also positive to see an improvement in the net interest margin. Like most banks, it suffered from higher operating expenses and there was earmarked weakness in a moderately lower loan portfolio.

The net interest margin expanded 13 basis points over the year to 2.07%, reflecting improvements in the funding mix and lending spreads. The margin is expected to trend back to the 1.85-1.95% range over the next few years as a result of competitive pricing pressure and front to back book churn – i.e. think unwinding of the Term Funding Facility (TFF).

Customer deposits grew 3.9% with the deposit to loan funding mix increasing 320 basis points to 72.1% over the year. This is positive given the reliance on short-term money market funding. Gross loans and advances (GLAA) declined 0.8% on FY20, with the key home lending book 0.9% lower. There was a modest improvement in the second half, with home loan balances 0.8% higher and lodgements up 24% but higher levels of repayments and property sales weighed on portfolio growth.

Operating costs rose 3.7% due to higher investment spending, however the 4.1% growth in total income grew saw a 20 basis point contraction in the bank cost to income ratio to 57.1%.

Loan impairment expenses came in at a gain of $49 million compared to $171 million expense for FY20 as a result of a $60 million collective loan loss provisions release.

The underperforming Wealth segment reported a nil underlying profit result for FY21 compared to a $6 million loss in the prior year reflecting lower expenses following the sale of Suncorp Financial Advice in March 2020. SUN agreed to sell its wealth business Suncorp Portfolio Services in April 2021 for $45 million, with settlement expected in March 2022.

Suncorp New Zealand

Suncorp New Zealand reported a 17.0% decrease in NPAT to NZ$215 million largely due to the performance of general insurance.

New Zealand General Insurance business NPAT declined 19.2% to NZ$177 million. The 9.2% rise in GWP was underpinned by growth across all portfolios and flat operating costs were offset by higher reinsurance and natural hazard costs, normalistion of claims and lower investment income.

Claims costs climbed 17.7% as natural hazard claims soared NZ$45 million over the year to NZ$84 million and exceed the full year allowance by NZ$27 million. The reported insurance margin declined 450 basis points lower at 15.3%.

The New Zealand Life business NPAT was 5% lower at NZ$38 million as the benefit improved claims experience were offset by adverse interest rate movements.

Capital

SUN ended FY21 in a sound capital position with the Group maintaining regulatory capital metrics around the upper end of targets. However, the on-market buy for up to $250 million of ordinary equity will materially reduce the Group's excess CET1 capital position from elevated levels, to what will still be a sound level.

The Group excess CET1 capital versus the mid-point of the target stood at $773 million as at 30 June 2021 (post FY21 final and special dividends), but would fall to $523 million on a pro-forma basis if the full buy-back was completed. At the NOHC level the excess would be $387 million. This would put the Group excess below the level from a year ago, which was elevated because of COVID-19 risks ($823 million at 30 June 2020) but it would exceed the excess position of $448 million at 30 June 2018 and $377 million at 30 June 2017 (the excess balance at 30 June 2019 was abnormally high at $990 million following asset sales).

From a credit perspective we would prefer elevated excess capital retained, as it provides a greater loss absorption buffer for debt and hybrid investors. However, we had expected that over time excess capital levels to be handed back to shareholders depending upon the economic outlook. We note the buy-back is flexible as it can be tuned on and off depending upon conditions and the capital impacts are incremental as it undertaken progressively over an 11-month period.

The General Insurance business's CET1 position was 1.20x the prescribed capital amount (PCA) (adjusted for the FY21 final and special dividend) and near the top end of its 1.075-1.275x target. The Bank's CET1 ratio of 9.42% (post the FY21 final and special dividend) is at the upper end of its 9.0-9.5% range.

Funding and Liquidity

The Bank's funding and liquidity position remains sound, with metrics well above regulatory requirements.

The average liquidity coverage ratio (LCR) strengthened materially over the year to 30 June 2021; being a massive 159%. End-of-year LCR was 136%, compared to APRA's minimum requirement of 100%. Liquidity metrics are expected to normalise following the reduction in the RBA's Committed Lending Facility (CLF) and utilisation if the Term Funding Facility (TFF). SUN drew down $4.1 billion from the 3-year TFF, so it will have a relatively large refinancing task to manage in FY23/24 – this will be adverse to the net interest margin.

The net stable funding ratio (NSFR) was steady over the six months to 30 June 2021 at 131%, placing it comfortably above the APRA regulatory requirement of 100%. Customer deposit funding stood at 72.1%.

Asset Allocation

Insurance Australia's asset allocation is consistent with the Group's risk profile and the Board's approved investment strategy. The portfolio, which has grown over the half to $13.9 billion (1H21: $13.3 billion) and comprised 76% of insurance policyholder funds and 24% of shareholders' funds.

A modest amount of risk was added to the investment portfolio over the half with exposure to equities increased from 2% to 4%, but overall, it remains conservatively positioned with 94% of the total portfolio invested in cash and fixed income securities. Around 78% of investments were rated A or higher with the average credit rating for Insurance Australia's investment assets steady at AA.

Reinsurance

SUN maintains a robust reinsurance coverage to help mitigate claims costs from natural hazards such as storms, floods hail and bushfires. The FY22 reinsurance program is unchanged on FY21. The main program includes an upper limit of $6.5 billion and aggregate excess of loss reinsurance cover, which is in addition to the main catastrophe reinsurance program. SUN has raised its FY22 natural hazards allowance from $950 million in FY21 to $980 million.

Asset Quality

Asset quality was mixed but there were no signs of significant stress in 2H21. While gross impaired assets fell $5 million overt the half to $180 million, past due loans increased by $36 million to $550 million, attributable to some customers coming out of COVID relief arrangements, as well as seasonal factors related to customer spending habits over the Christmas holiday period. At 30 June 2021, 3.0% of loans accounts (~$200 million) under the temporary repayment deferral arrangements that ended on 31 March 2021, were past due and/or impaired with 5.6% (~$300 million) in hardship arrangements.

Importantly, the Bank is well provisioned with levels above pre-pandemic levels, despite some unwinding. Total loss provisions stood at $239 million at the end of June 2021 compared to $304 million at 31 December 2020 and $139 million at 31 December 2019. Total provisions and equity reserve for credit losses was 0.63% of GLAA (1H21: 0.72% and 1H20: 0.45%).

Figure 3: Credit Curve (Comparable Securities)

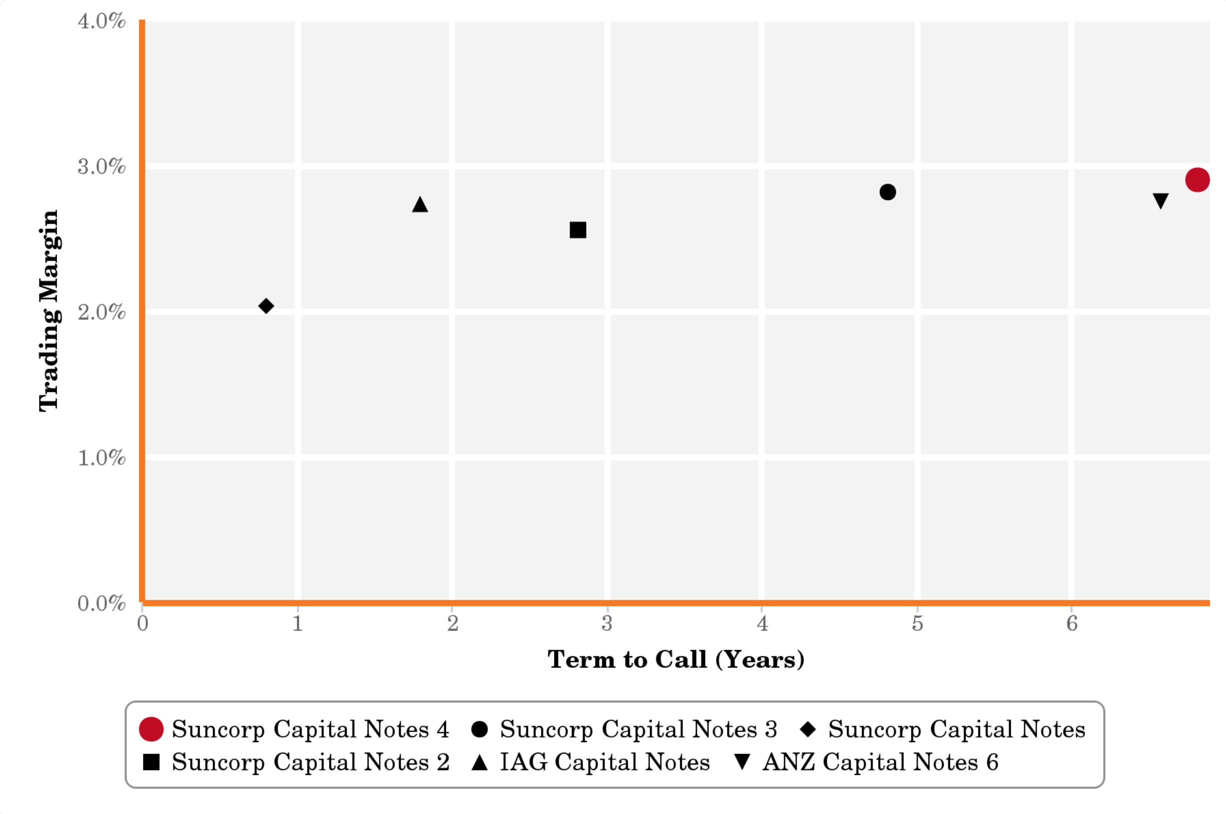
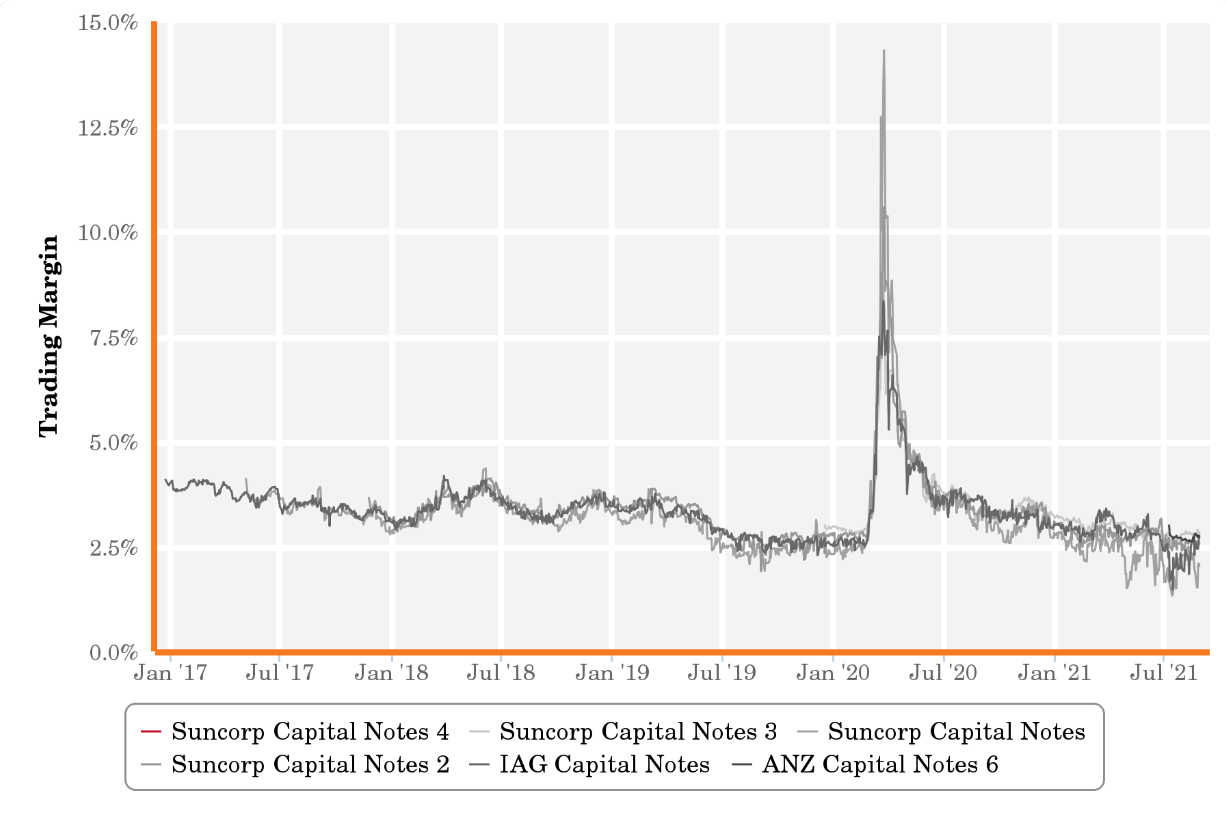


Figure 4: Historical Trading Margins of Comparable Securities



Source: BondAdviser

Hybrid Commentary

Issuer Overview

Suncorp Group (ASX: SUN) is a listed financial services company, which provides general insurance and banking products and services via its operating subsidiaries. The company is headquartered in Queensland and provides its full suite of products across Australia and general insurance and life products in New Zealand.

General insurance is the largest part of the Group representing 61% of Group NPAT in FY21 and is one of the largest domestic general insurers in Australia by GWP. Banking comprised 36% of FY21 Group NPAT with this division more akin to regional banks Bendigo and Adelaide Bank (ASX: BEN) and Bank of Queensland (ASX: BOQ) in terms of size. Life and wealth operations represent a very small part of the total business.

SUN operates under a Non-Operating Holding Company (NOHC) structure and is regulated as such in Australia by APRA requiring it to meet Level 3 Prudential Capital Requirements for Eligible Capital. The general insurance, banking and life subsidiaries also have to meet prudential requirements pertinent to their respective sectors. Other domestic companies operating under a similar NOHC structure include AMP Group (ASX: AMP), Challenger (ASX: CGF) and Macquarie Group (ASX: MQG).

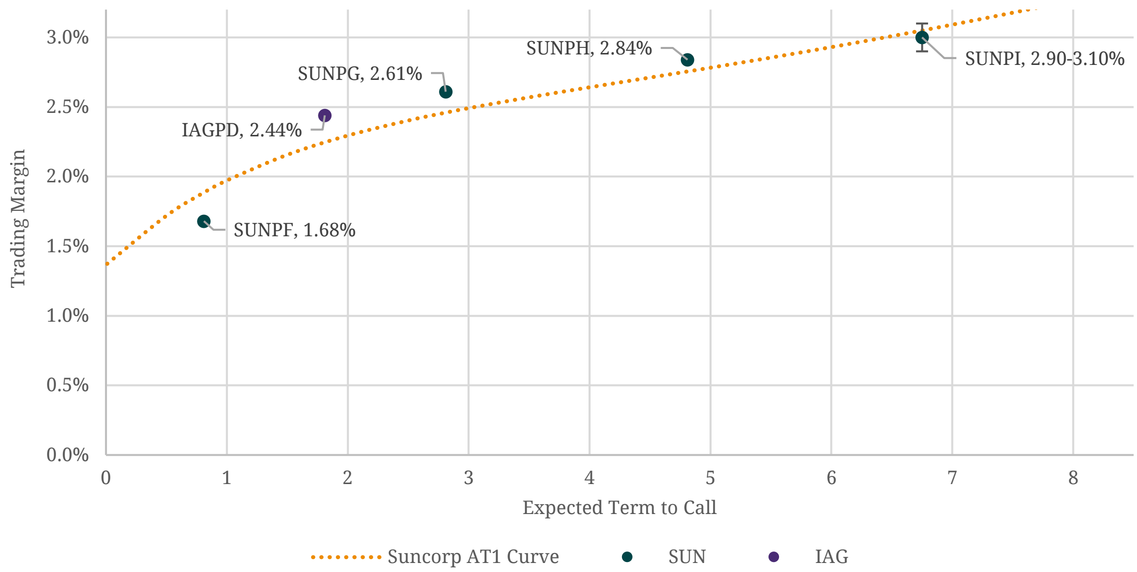
Like other large financial institutions, SUN has a long history of capital instrument issuance. This AT1 capital instrument is being issued by the NOHC, as are all the other SUN AT1 capital instruments currently outstanding. Therefore, the distributions on these securities ultimately rely on dividends from SUN's operating subsidiaries. APRA has the power to limit the upstreaming of such dividends, however this risk is mitigated by the substantial amount of excess capital held at the Group level. Additionally, we saw that when APRA placed restrictions on discretionary capital distributions by authorised deposit taking institutions and insurers, as result of COVID-19 in 2020, hybrid security distributions were not impacted and only dividends on ordinary equity were reduced.

Relative Value – Issuer / Group / Insurance

As illustrated in Figures 5, 6 and 7, we analyse the relative value of the offering in comparison with the Group's secondary traded AT1 securities. As seen in Figure 5, on first glance, the issuance margin offered appears on the richer side of fair. There are several reasons why we see such partial analysis as misleading and instead are of the opinion that the Notes are fairly valued and actually offer a nominal concession.

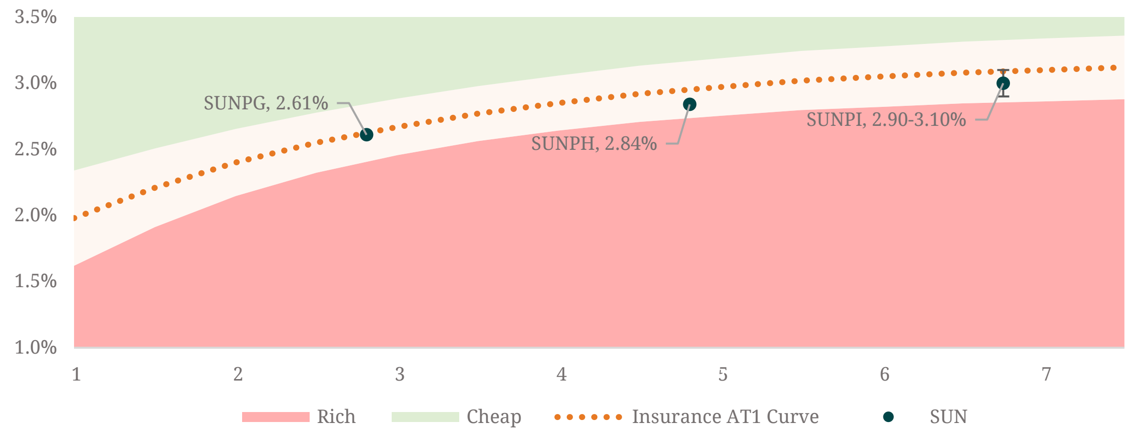
Firstly, we note than SUNPI's offer range of 290-310bps sits between a range of -15bps and +5bps below and above the respective Issuer curve. This is not unusual for Suncorp, given SUNPH, in November 2019, at an issue margin of 300bps, was offered 2bps inside the fair value curve. Similarly, in October 2017, SUNPG at an issue margin of 365bps, was offered without any concession present, 13bps inside the issuer curve. The smaller issuance sizes of Suncorp, alongside the diversity it offers compared to Big Four banks, means that investor demand has been robust in recent transactions – indicative of the lack of concession required. In the current low yield environment, this effect is only amplified.

Figure 5. SUN Curve – Trading Margin



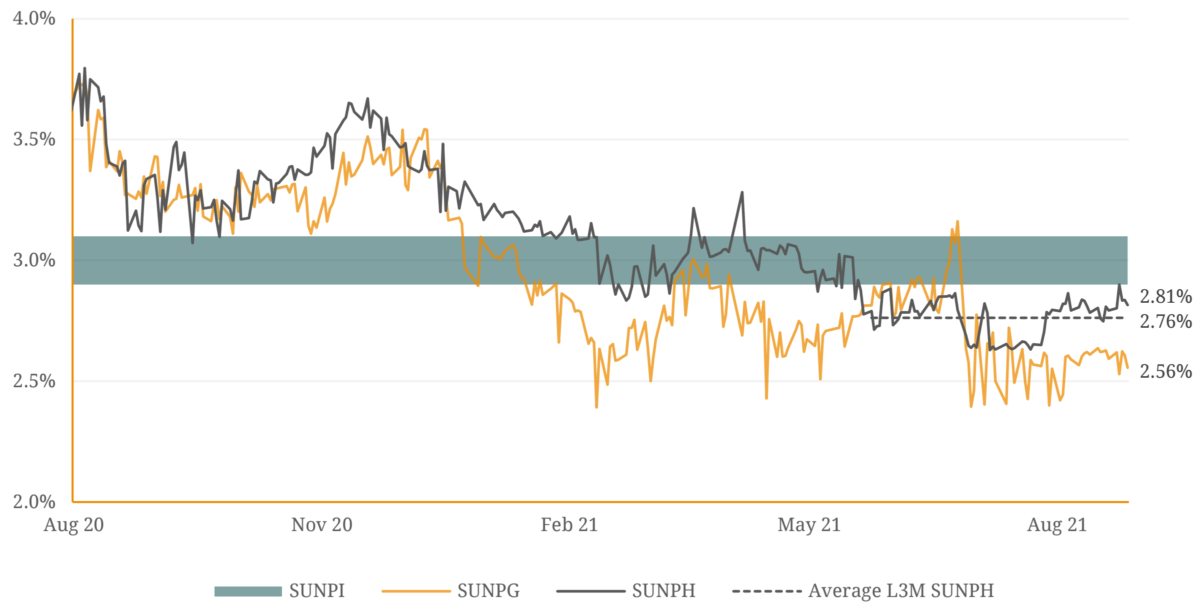
Source: BondAdviser, ASX. As at 27 August 2021. IAGPD included for reference, not included in curve derivation.

Figure 6. Insurance Curve – Trading Margin – BondAdviser Valuation



Source: BondAdviser, ASX. As at 27 August 2021 close. Rich/cheap banding defined by ±1σ 90-day realised volatility.

Figure 7. Suncorp Existing NOHC ASX-Listed Hybrid Historical Trading Margins



Source: BondAdviser, ASX. As at 27 August 2021.

Secondly, Suncorp's AT1 trading in secondary markets is volatile, more so than Big Four equivalents. We characterise some of this trading as inefficient – astute readers will have recognised that there have been times (December 2020, June 2021) where SUNPG, despite having a shorter term to maturity, has traded with a higher trading margin. These mispricings are indicative of such volatility that we attempt to look-through in determining value at primary issuance. One such way of smoothing volatility is by using an average. The 90-day average trading margin for SUNPH has been 2.76%. For an additional ~2 years of tenor, the 14-34bps pick-up to this average, on the offered range of SUNPI, appears fair at the lower-bound and cheap (this is synonymous with good value to investors in bond vernacular) above that marker.

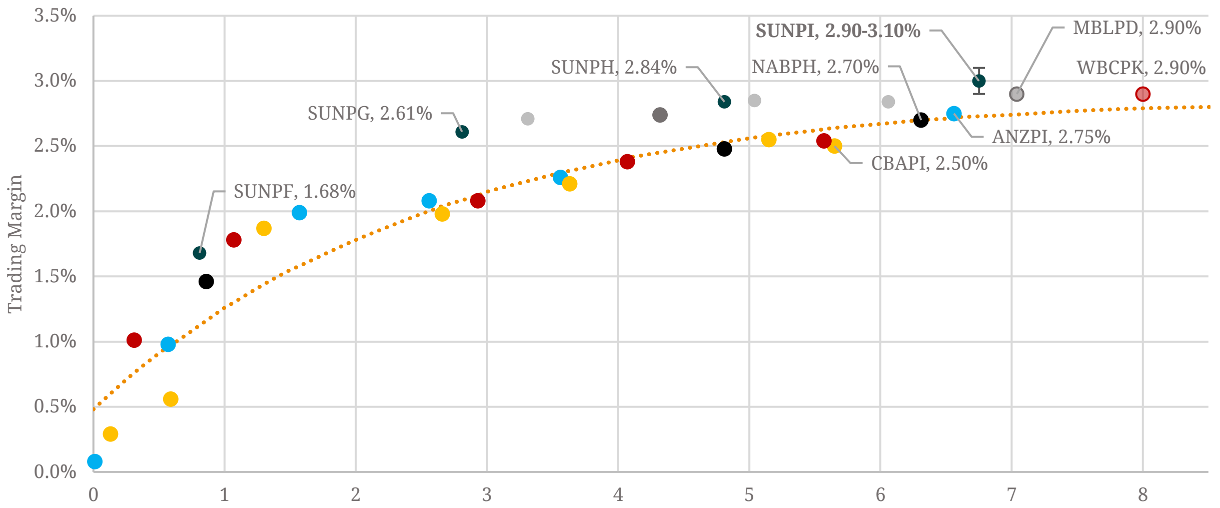
We expect demand to be very strong and hence support the trade at 290bps, believing it is fairly valued, relative to (1) prior Suncorp issuance, (2) the 90-day average trading margin of SUNPH and (3) the AT1 insurance curve. Given the longer-tenor and convexity to credit spread (price sensitivity to changes in the trading margin), we see the margin appropriately compensating for any potential downside volatility (given spreads are near historic tights) between trading and final margin settlement. Additionally, we note the advantage of buying at known price with the availability of liquidity in the primary market.

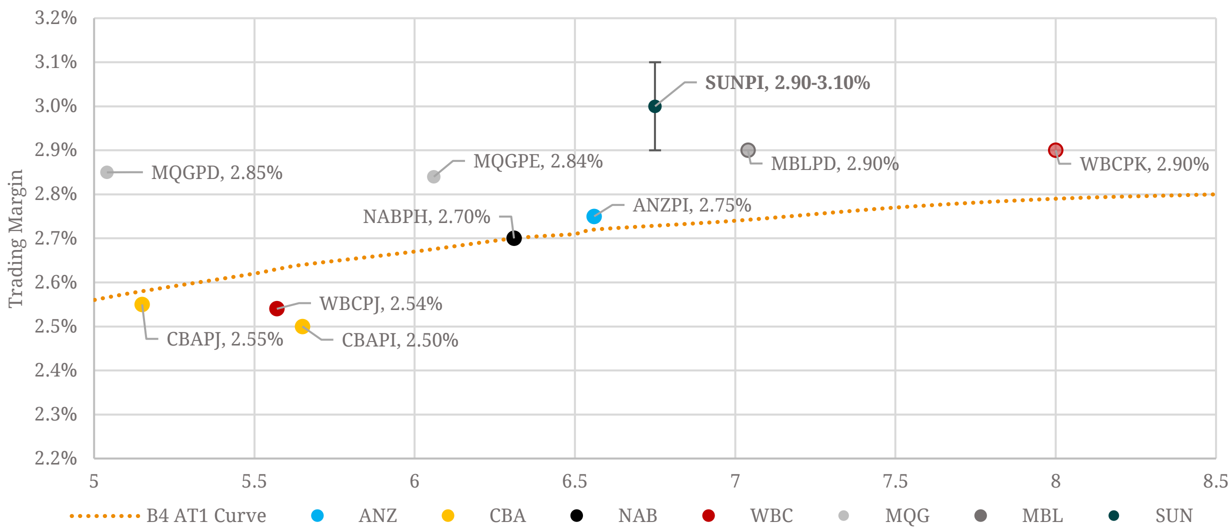
Relative Value – Comparables

Given the credit quality of the Insurer/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 AT1 comparable dataset. Two months ago, there were few issuances with such a long tenor for comparable purposes. Since then, Macquarie Bank Capital Notes 3 (ASX: MBLPD) and Westpac Capital Notes 8 (ASX: WBCPK) have both been issued/offered at margins of 290bps with respective tenors of 7 and 8 years. From an actively traded perspective, the closest ASX-listed term equivalent is ANZ Capital Notes 6 (ASX: ANZPI), with a 6.6-year term to expected call offering a 275bps trading margin at 27 August 2021. Thereafter, NAB Capital Notes 5 (ASX: NABPH), with a 6.3-year term to expected call, offers a 270bps trading margin.

At a 290-310bps indicative offer range, both the comparable curve and the longer-dated securities screen SUNPI 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 SUNPI and other longer term to call AT1 securities.

Figure 8. Big Four Curve – Trading Margin

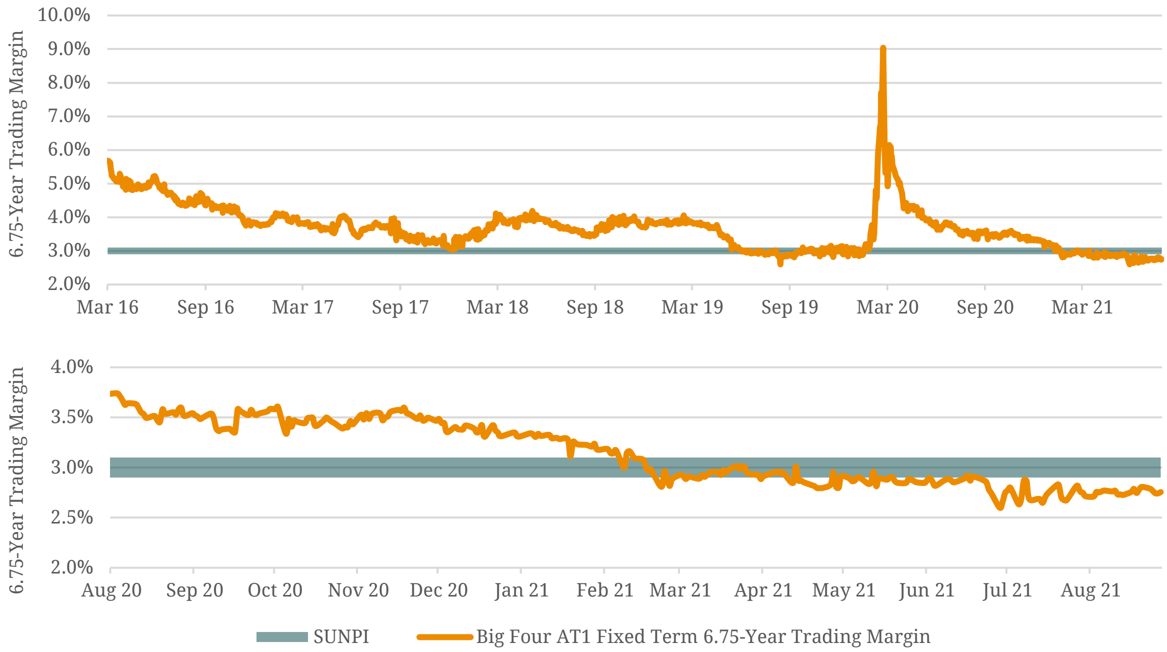




Source: BondAdviser, ASX. As at 27 August 2021.

As illustrated in Figure 9, at the fixed 6.75-year tenor, over the past year the credit and term spread has compressed for listed Big Four AT1 securities. Our analysis places the lower bound at the end of June 2021 at 260bps and subsequently this has been largely rangebound at ~265-280bps. As at 27 August 2021, this 6.75-year trading margin was 276bps, which makes the 14bps premium at lower bound of the guided margin range (290bps) for SUNPI appear on the cheap side of fair from a comparable valuation perspective. The optics on the upper bound range (310bps), with a 34bps delta, looks particularly attractive.

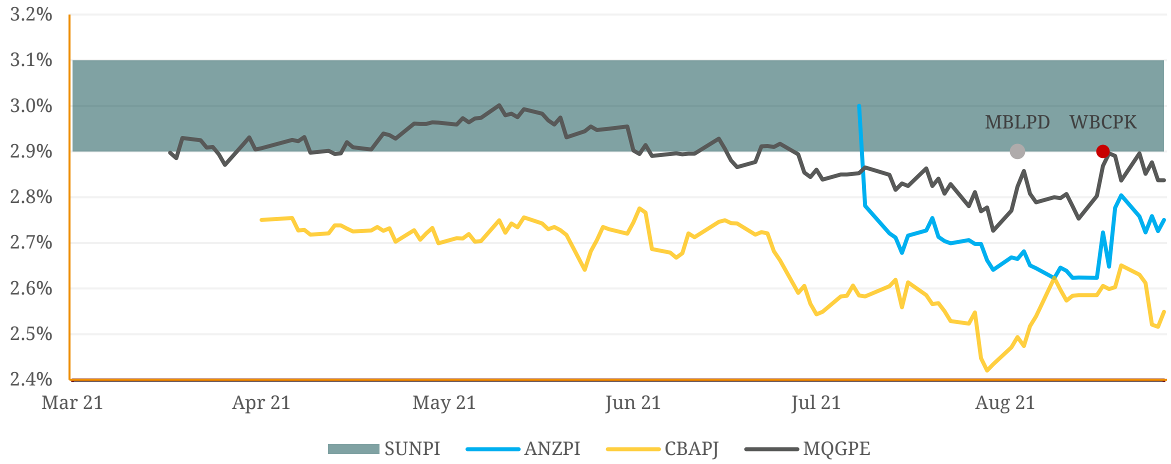
Figure 9. SUNPI Historical Spread to Big Four AT1 Fixed Term 6.75-Year Trading Margin



Source: BondAdviser, ASX. As at 27 August 2021.

Recent Big 5 AT1 issuances (includes MGQ/MBL) have generally traded well with margins compressing below issue margins (see Figure 10). As at 27 August 2021, ANZPI had narrowed 25 basis point to 2.75%; CBA PERLS XIII (ASX: CBAPJ) 20 basis points to 2.55%; and Macquarie Group Capital Notes 5 (ASX: MQGPE) 6 basis points to 2.84%. MQGPE has not performed as well as the other two securities as, in our opinion, it was priced tightly 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 & SUNPI

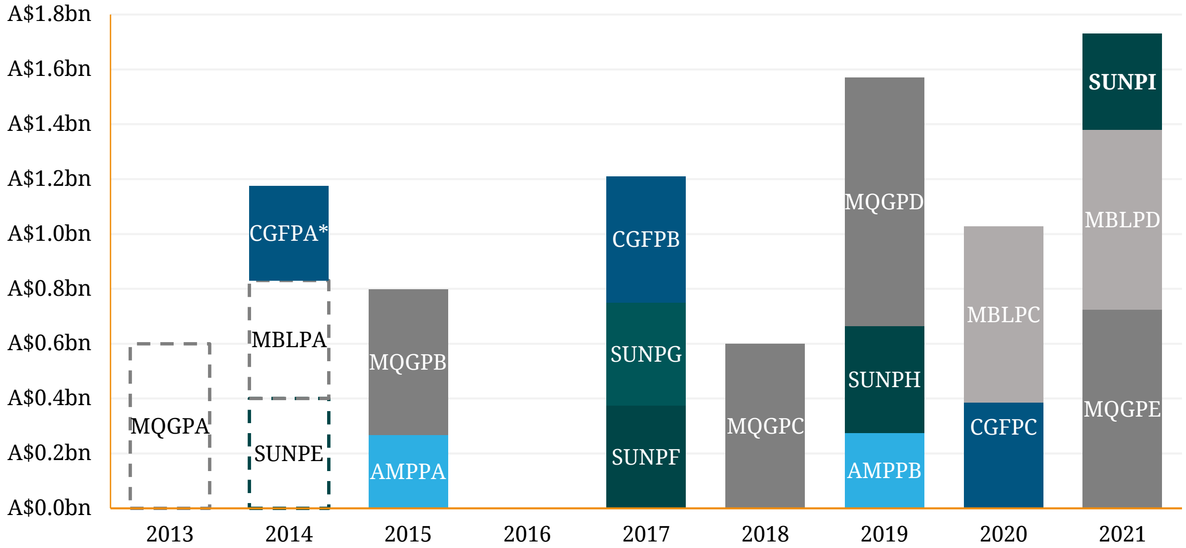


Source: BondAdviser, ASX. As at 27 August 2021.

AT1 Issuance and Maturity Profile

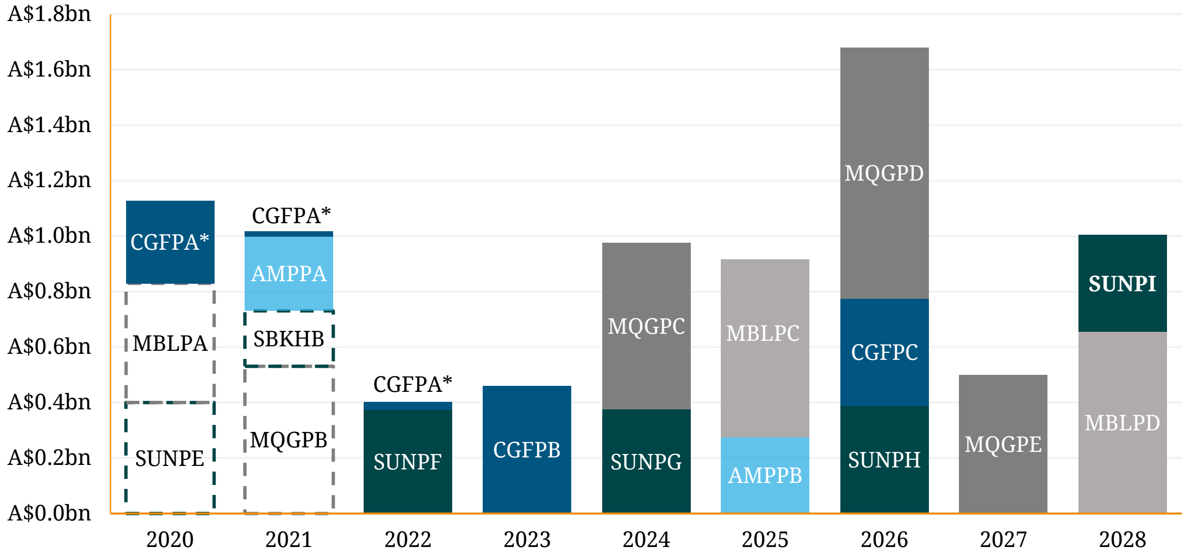
SUN is a relatively infrequent issuer of Basel III hybrid instruments compared to the major banks but has a long history of capital security issuance. SUNPI is the seventh Basel III compliant ASX-listed Capital Note offered by SUN, with the most recent being SUNPH, which was issued in December 2019 raising $389 million at a 3.00% margin above 90-day BBSW with a 6.5-year term to first call (17 June 2026).

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 $350 million issuance of SUNPI.*

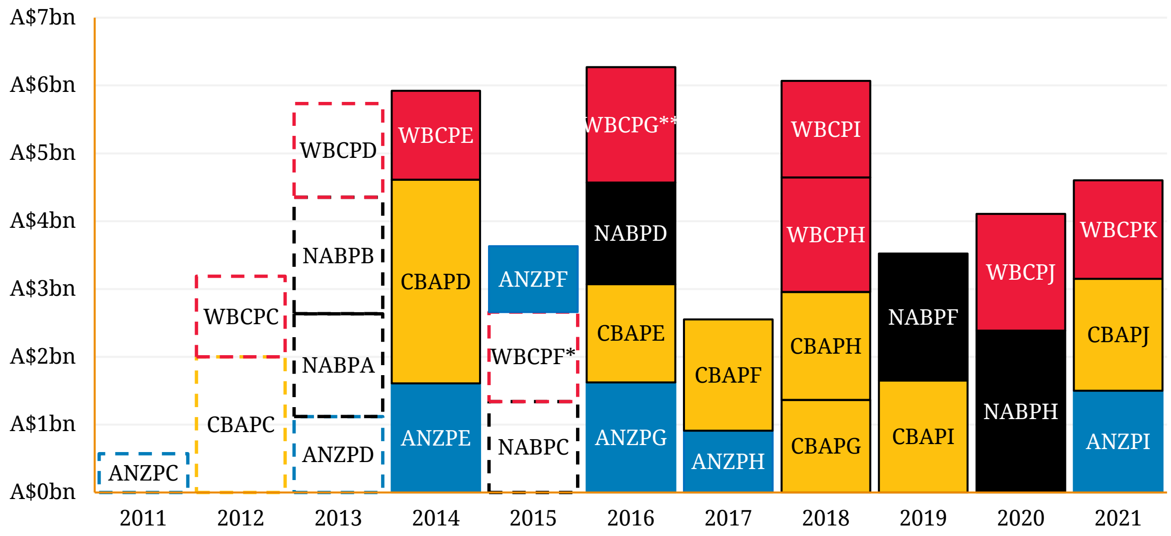
Figure 12. NOHC ASX-Listed Hybrid Maturity Profile (plus MBL)



*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 $350 million issuance of SUNPI.*

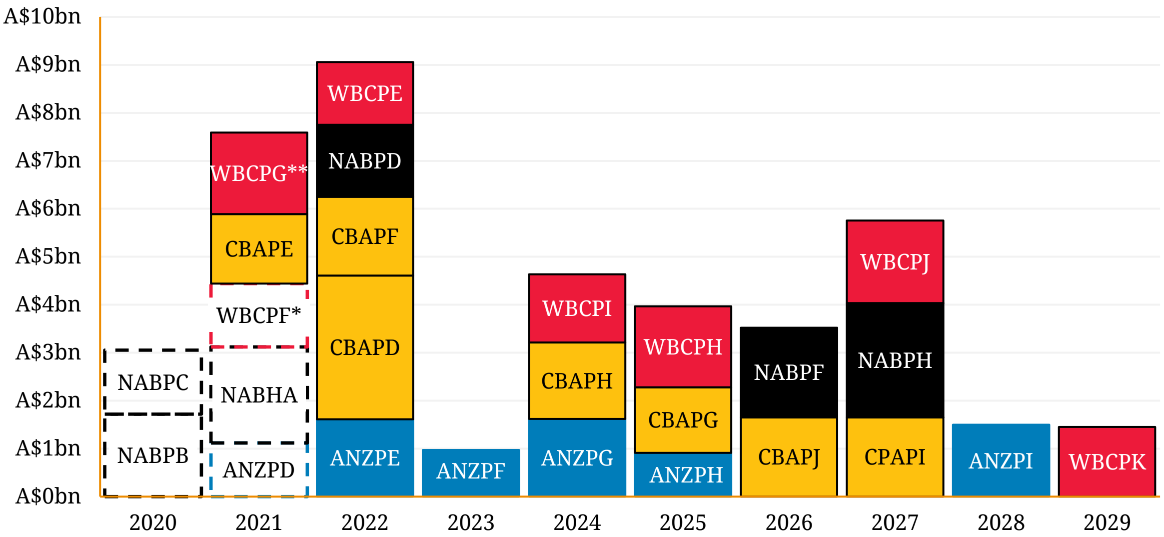
After a slow start, there has been a pickup in AT1 hybrid issuance in the second half of 2021 (see Figures 11 and 13): Commonwealth Bank (ASX: CBA) issued CBAPJ in April 2021 at a 2.75% margin over 90-day BBSW, first call October 2026; MGL issued MQGPE in March 2021 at 2.90% margin above 90-day BBSW, first call September 2027; 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; Macquarie Bank issued Macquarie Bank Capital Notes 3 (ASX: MBLPD) in August 2021 at a 2.90% margin over 90-day BBSW, first call September 2028; and Westpac launched an offer for WBCPK in August 2021 at a 2.90% margin over 90-day BBSW, first call September 2029.

Figure 13. Major Bank 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. ** There is currently an offer for WBCPG holders to reinvest into WBCPK, with any remaining securities on issue expected to be redeemed on the 20- Dec-21 call date.*

Figure 14. Major Bank ASX-Listed Hybrid Maturity Profile

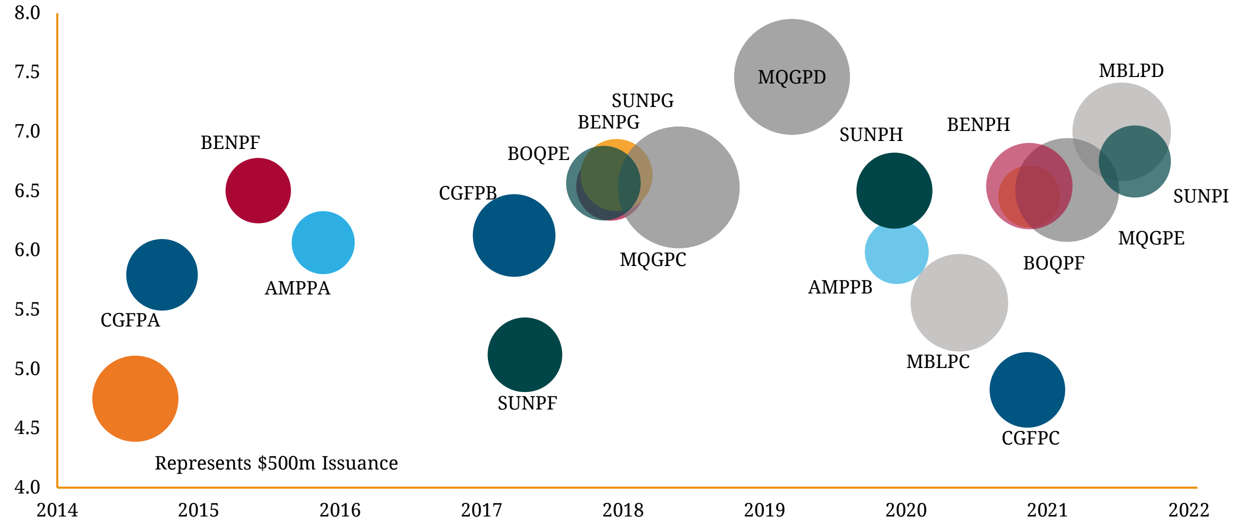


*Source: BondAdviser, * WBCPF ~$866m resold/reinvested into WBCPJ in Dec-20. The balance of $454m resold on Mar-21. Dotted line with no fill indicates redeemed Notes. ** There is currently an offer for WBCPG holders to reinvest into WBCPK, with any remaining securities on issue expected to be redeemed on the 20- Dec-21 call date.*

Refinancing of existing securities tends to be the main driver of new supply. The ANZPI, MQGPE and WBCPK were rollover transactions of ANZ Capital Notes (ASX: ANZPD), Macquarie Group Capital Notes 2 (ASX: MQGPB) and Westpac Capital Notes 4 (ASX: WBCPG) respectively). CBAPJ was an all-new monies deal. SUNPI is also a new money issue as there is no reinvestment offer for an existing SUN AT1 hybrid. We expect the offer to be well supported given the relatively small issue size, 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 two AT1 hybrids remaining on issue with call dates in 2021 (AMPPA and CBAPE). While not shown in these charts, there are also no regional bank hybrids due to be called over the remainder of this year.

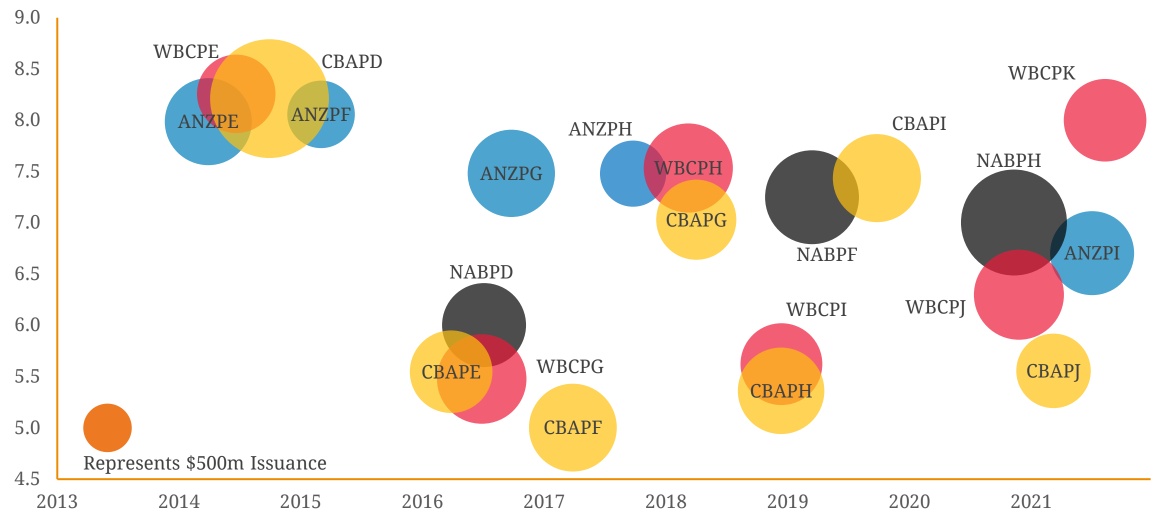
There is a very healthy appetite for AT1 issuance, if recent issuances are a guide. The MBLPD and WBCPK offers were significantly upsized – the MBLPD offer raised $655 million, well above the initial $400 million sought, while the WBCPK offer was increased from $1.0 billion to $1.45 billion following the bookbuild. We expect there will also be demand from investors looking to diversify their hybrid holdings that would be predominantly exposed to issuances from the Big Four.

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



Source: BondAdviser. Assumes $350 million issuance of SUNPI.

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

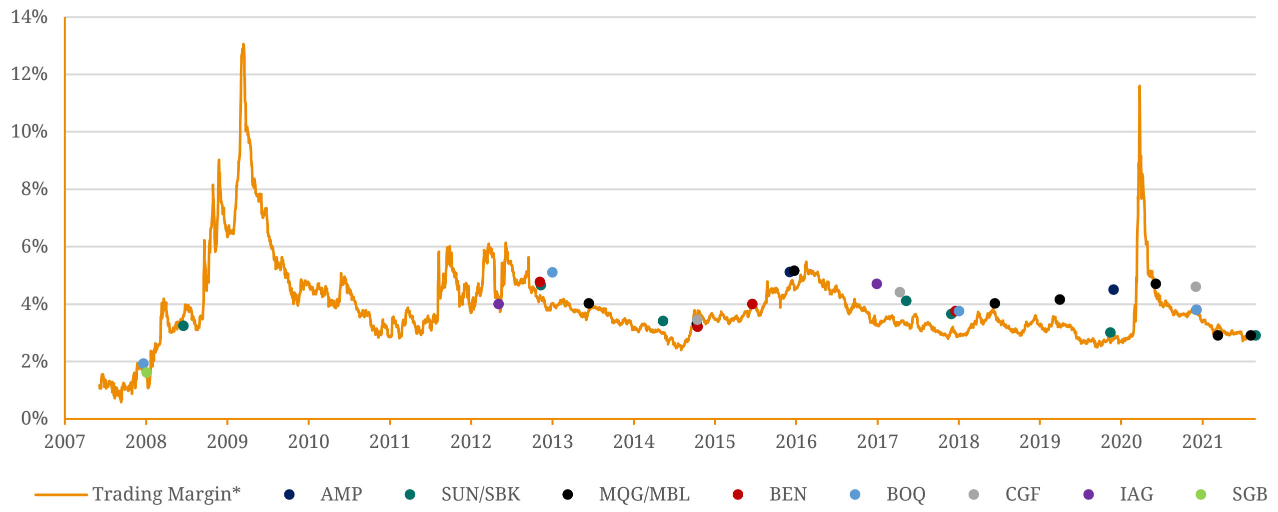


Source: BondAdviser. Assumes $1.45 billion raised after the bookbuild for WBCPK.

Figures 15 and 16 highlight trends in AT1 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 appears the case now, as a more risk tolerant market is able to digest larger sizes at longer tenors with lower issue margins. This logic also applies at the issuer level, when funding is expensive, issue less, with shorter maturities. When funding is cheap, issue more, with a longer maturity. In 2021, there has been a shift towards issuance of securities with longer tenors (term 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

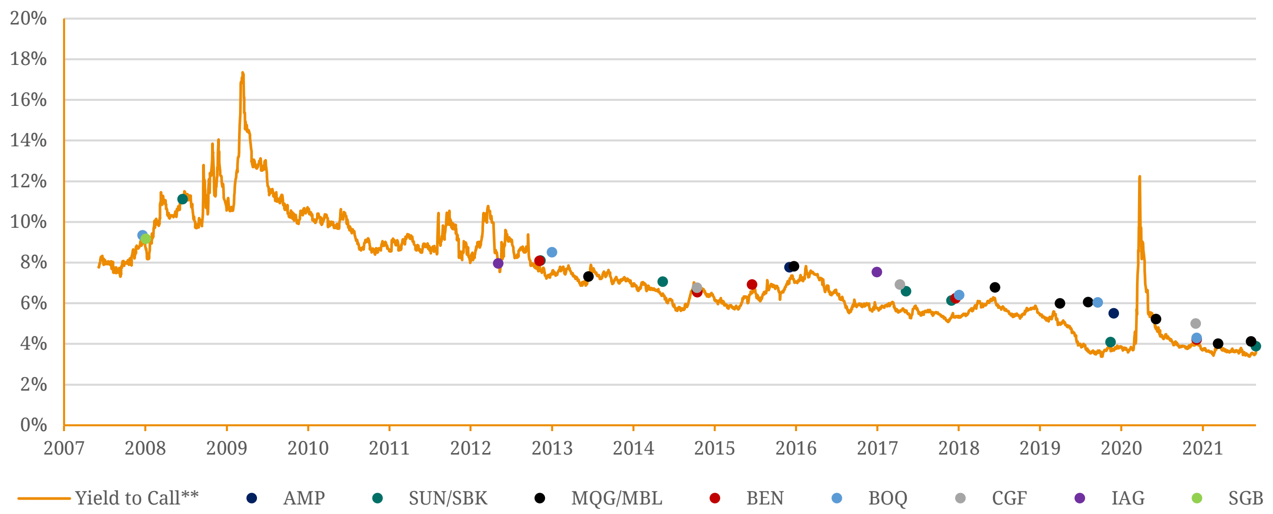
Figure 17. Non-Major Weighted Average Trading Margin, Non-Major AT1 Primary Issuance Margin*



	Last	1m	3m	YTD	1y	3y	5y	Inception^
Trading Margin	2.94%	2.84%	2.99%	3.37%	3.73%	3.13%	3.65%	0.89%
%Δ		3.52%	-1.67%	-12.76%	-21.18%	-6.07%	-19.45%	230.34%

Source: BondAdviser Index Platform: BANMAT1DFTR. As at 27 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 18. Non-Major Weighted Average Yield to Call, Non-Major AT1 Primary Issuance Yield to Call**

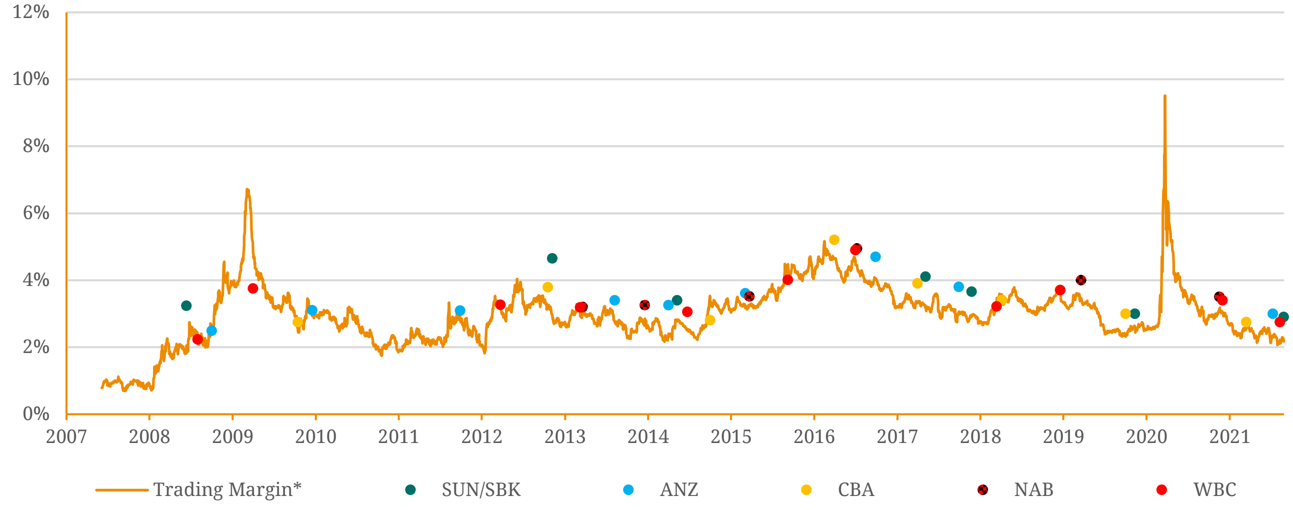


	Last	1m	3m	YTD	1y	3y	5y	Inception^
Yield to Call	3.59%	3.42%	3.63%	3.69%	4.05%	5.49%	5.52%	7.36%
%Δ		4.97%	-1.10%	-2.71%	-11.36%	-34.61%	-34.96%	-51.22%

Source: BondAdviser Index Platform: BANMAT1DFTR. As at 27 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.

Appendix 2. Historical Comparison

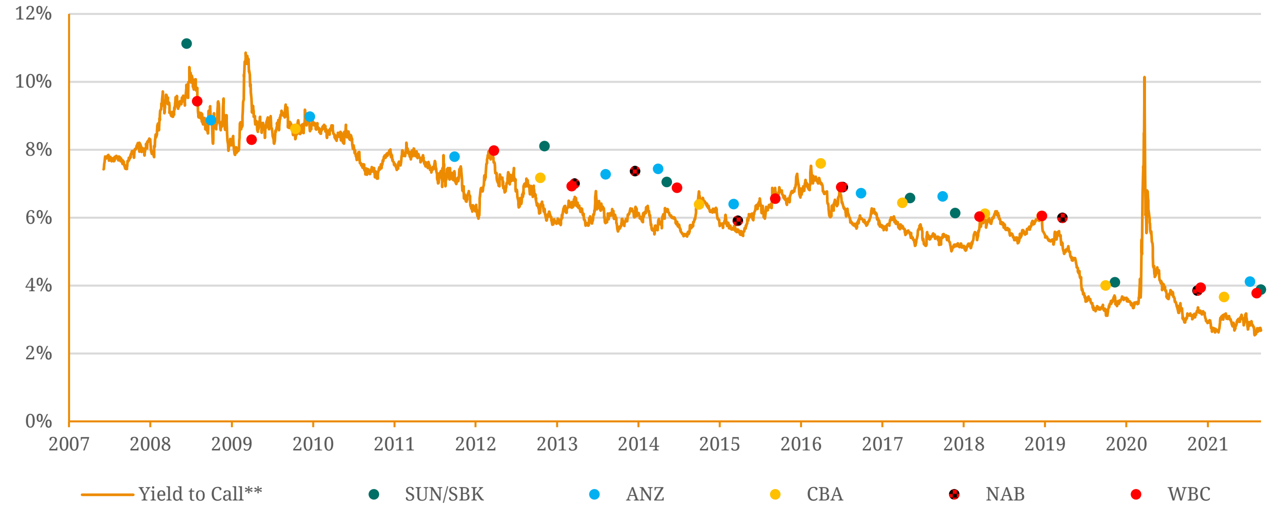
Figure 19. B4 AT1 Weighted Average Trading Margin, B4 & SUN AT1 Primary Issuance Margin*



	Last	1m	3m	YTD	1y	3y	5y	Inception^
Trading Margin	2.17%	2.28%	2.55%	2.65%	3.05%	3.01%	3.89%	0.28%
%Δ		-4.82%	-14.90%	-18.11%	-28.85%	-27.91%	-44.22%	675.00%

Source: BondAdviser Index Platform: BANMAT1DFTR. As at 27 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 30/6/2004.

Figure 20. B4 AT1 Weighted Average Yield to Call, B4 & SUN AT1 Primary Issuance Yield to Call**



	Last	1m	3m	YTD	1y	3y	5y	Inception^
Yield to Call	2.68%	2.77%	3.07%	2.89%	3.32%	5.35%	5.77%	6.10%
%Δ		-3.25%	-12.70%	-7.27%	-19.28%	-49.91%	-53.55%	-56.07%

Source: BondAdviser Index Platform: BANMAT1DFTR. As at 27 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 30/6/2004.

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29 August 2021

Profit and Loss	2021	2020	2019	2018	2017
Gross Written Premium	10,531.0	9,952.0	9,811.0	9,559.0	9,456.0
Net Earned Premium ($m)	9,003.0	8,662.0	8,609.0	8,359.0	8,171.0
Net Incurred Claims ($m)	-6,301.0	-6,139.0	-6,102.0	-5,739.0	-5,616.0
Operating Expenses ($m)	-2,080.0	-2,015.0	-1,973.0	-1,878.0	-1,808.0
Inv Income on Insurance	246.0	265.0	465.0	270.0	218.0
Insurance Result ($m)	868.0	773.0	999.0	1,012.0	965.0
Other Income ($m)	137.0	59.0	107.0	92.0	128.0
GI Net Profit ($m)	712.0	591.0	792.0	780.0	734.0
Net Interest Income ($m)	1,242.0	1,191.0	1,163.0	1,181.0	1,131.0
Net Non-Interest Income	39.0	40.0	50.0	60.0	76.0
Operating Expenses ($m)	-731.0	-705.0	-682.0	-679.0	-636.0
Impairments on Loans	49.0	-172.0	-13.0	-27.0	-7.0
Bank Net Profit ($m)	419.0	242.0	363.0	375.0	396.0
Life Net Profit ($m)	35.0	38.0	64.0	94.0	114.0
Total Profit ($m)	1,166.0	872.0	1,220.0	1,263.0	1,205.0
Other Adj ($m)	-33.0	41.0	-123.0	-204.0	-130.0
Total Net Profit ($m)	1,033.0	913.0	175.0	1,059.0	1,075.0

Balance Sheet	2021	2020	2019	2018	2017
Cash & Liquid Assets ($m)	1,200.0	1,046.0	1,086.0	1,165.0	1,840.0
Investments ($m)	21,230.0	19,763.0	20,470.0	24,345.0	23,847.0
Loans, Adv & Receivables	57,324.0	57,723.0	59,653.0	59,072.0	55,764.0
Reinsurance & Recoveries	1,997.0	2,468.0	2,656.0	2,377.0	3,353.0
Deferred Insurance Assets	918.0	926.0	898.0	834.0	837.0
Property, Plant & Equip.	504.0	576.0	208.0	211.0	200.0
Intangibles ($m)	5,225.0	5,275.0	5,460.0	5,722.0	5,821.0
Other ($m)	8,549.0	7,967.0	5,804.0	5,607.0	6,284.0
Total Assets ($m)	96,857.0	95,744.0	96,235.0	99,333.0	97,109.0
Deposits & ST Borrowings	41,200.0	46,160.0	46,190.0	45,550.0	45,105.0
Payables ($m)	2,197.0	2,438.0	1,980.0	2,062.0	1,999.0
LT Borrowings ($m)	11,599.0	10,607.0	10,358.0	9,854.0	9,216.0
Securitisated Liabilties	2,165.0	2,945.0	3,831.0	4,848.0	3,088.0
Other ($m)	26,248.0	20,810.0	19,523.0	21,652.0	22,520.0
Total Liabilities ($m)	83,409.0	82,960.0	83,102.0	85,360.0	83,319.0
Ordinary Shareholders	13,424.0	12,763.0	13,113.0	13,963.0	13,782.0
Other ($m)	24.0	21.0	20.0	10.0	8.0
Total Equity ($m)	13,448.0	12,784.0	13,133.0	13,973.0	13,790.0

Insurance Ratios	2021	2020	2019	2018	2017
Loss Ratio (%)	70.0	70.9	74.7	70.3	69.6
Expense Ratio (%)	23.1	23.3	22.9	20.9	20.4
Combined Ratio (%)	93.1	94.1	96.0	91.2	90.0
Insurance Margin (%)	9.6	8.9	11.6	12.3	11.8
Undelying Margin (%)	7.9	11.1	12.3	11.7	11.5

Group Capital	2021	2020	2019	2018	2017
Common Equity Tier 1	7,744.0	7,011.0	7,341.0	6,881.0	6,625.0
Additional Tier 1 ($m)	1,139.0	1,139.0	1,150.0	1,150.0	1,335.0
Tier 1 Capital ($m)	8,883.0	8,150.0	8,491.0	8,031.0	7,960.0
Tier 2 Capital ($m)	1,398.0	1,419.0	1,358.0	1,554.0	1,552.0
Total Capital ($m)	10,281.0	9,569.0	9,849.0	9,585.0	9,512.0

Insurance Capital	2021	2020	2019	2018	2017
Common Equity Tier 1 ($m)	3,478.0	3,146.0	3,413.0	3,280.0	3,115.0
Additional Tier 1 ($m)	554.0	540.0	565.0	565.0	510.0
Tier 1 Capital ($m)	4,032.0	3,686.0	3,978.0	3,845.0	3,625.0
Tier 2 Capital ($m)	580.0	555.0	555.0	555.0	555.0
Total Capital ($m)	4,612.0	4,241.0	4,533.0	4,400.0	4,180.0
PCA ($m)	2,708.0	2,520.0	2,450.0	2,394.0	2,358.0
CET1 Multiple (x)	1.28	1.25	1.39	1.37	1.32
PCA Multiple (x)	1.70	1.68	1.85	1.84	1.77

Bank Capital	2021	2020	2019	2018	2017
Common Equity Tier 1	3,352.0	3,091.0	3,085.0	2,935.0	2,963.0
Additional Tier 1 ($m)	585.0	585.0	585.0	550.0	825.0
Tier 1 Capital ($m)	3,937.0	3,676.0	3,670.0	3,485.0	3,788.0
Tier 2 Capital ($m)	818.0	864.0	803.0	899.0	897.0
Total Capital ($m)	4,755.0	4,540.0	4,473.0	4,384.0	4,685.0
Credit Risk ($m)	29,549.0	29,442.0	29,633.0	29,002.0	28,621.0
Market Risk ($m)	100.0	93.0	90.0	88.0	62.0
Operational Risk ($m)	3,635.0	3,572.0	3,530.0	3,473.0	3,424.0
Total RWA ($m)	33,284.0	33,107.0	33,353.0	32,563.0	32,107.0
CET1 Ratio (%)	10.07	9.34	9.28	9.01	9.18
Total Capital (%)	14.29	13.71	13.45	13.46	14.54

Source: Company data, BondAdviser estimates.

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