Research Process

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BondAdviser

Rigorous research. Robust recommendations.

At BondAdviser, our focus is on delivering the highest quality data, research and insights so that investors can make intelligent decisions about the fixed income market. At the centre of our approach is a proprietary six-step research process for analysing fixed income securities in a rigorous and disciplined manner. Our approach results in a buy, hold or sell recommendation that investors can use to identify the most attractive investment opportunities.

Providing a clear investment recommendation on individual fixed income securities is a key benefit of our research process. It simplifies an otherwise complex procedure for investors into a simple and recognisable recommendation scale.

Our research process includes a combination of qualitative analysis (for example the competitive landscape, operational performance and broad economic trends) and quantitative analysis (for example historical and projected credit metrics). This ensures that all recommendations are based on a comprehensive understanding of the key drivers for each security.

Our six-step process

Step 1: Security Screening
All potential securities are put through our screening process in order to define the research universe.

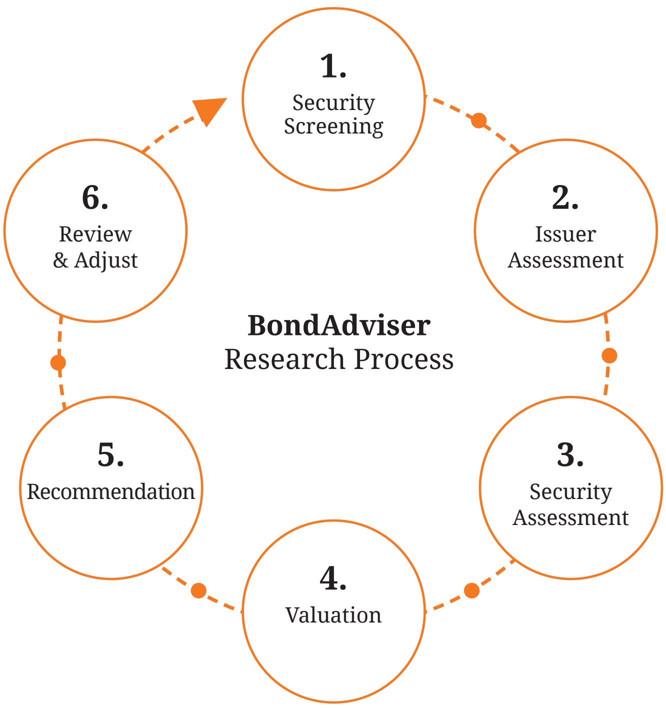
Step 2: Issuer Assessment
We begin our analysis by identifying the level of risk for the issuer of the security by analysing a range of qualitative and quantitative factors.

Step 3: Security Assessment
We then analyse the unique characteristics of the security itself via the offer document or prospectus.

Step 4: Valuation
We calculate a valuation for the security to determine whether investors are being appropriately compensated for the risk involved. We then rank this valuation relative to its closest security peers from the same sector and risk profile. This helps us identify market anomalies and make relative value recommendations between securities.

Step 5: Recommendation
We assign a research recommendation – buy, hold or sell – to the security.

Step 6: Review & Adjust
Finally, we conduct ongoing monitoring of changing conditions to ensure our research recommendation remains valid.



Step 1: Security Screening

Before a security can enter our research universe it is put through a security screening process. This exercise determines if the security meets our key conditions, such as whether there is sufficient data available to price it on an ongoing basis. Securities that pass the screen are set up in the BondAdviser Securities Management System and a sector-specialist analyst is assigned to conduct the analysis.

The detailed data entered into the Securities Management System is used in our calculation algorithm to provide the analyst with transparent and high-quality data based on Australian debt market conventions and standards. This provides a level playing field across all instrument types and helps analysts identify comparable securities for analysis.

Step 2: Issuer Assessment

The second step in our process involves identifying the level of risk for the issuer of the security. Our proprietary issuer risk rating process takes a clear and objective measure of a company's risk of default – that is, its ability and willingness to meet its financial obligations in full and on time. This forward-looking analysis based on fundamentals highlights the cashflow of the issuer rather than the after tax earnings.

Qualitative factors

The qualitative assessment of an issuer and its ability to navigate the economic landscape is equally as important as performing solid quantitative analysis. Our analysts follow a predefined process but have the flexibility to made subjective judgment calls based on a sound opinion. Some of the factors we assess in this process include:

- Industry positioning and competitiveness
- Regulatory framework
- Economic drivers
- Business risk
- Financial policies
- Management quality
- Issuer covenants (both funding and operational).

As part of this assessment we utilise external research and data which helps in the development of an assessment of issuer risk. This combination of internal and external research allows us to identify what is driving observable changes in market prices. This information is then used as an input into our proprietary assessment of the issuer's fundamentals, financial flexibility and liquidity.

Quantitative factors

Our research analysts use a range of credit metrics, such as leverage and interest coverage, when assessing the credit profile of the issuer. This enables a like-for-like comparison of issuers. The type of metrics used during our quantitative analysis includes:

- Gross and Net Debt
- Earnings before Interest, Taxes, Depreciation and Amortization (EBITDA), last 12 months
- EBITDA Interest Coverage
- Net Debt/EBITDA
- Funds From Operations (FFO) / Net Debt
- Debt / Capital
- Liquidity.

Research analysts analyse their expectations relative to market consensus estimates and continually update their view based on changing market and fundamental data. This analysis culminates in an assessment of the probability and severity of default (or conversion). All information is then used as an input into the Security Assessment. Our assessment of the issuer includes an outlook on how the credit profile will develop over the next 12 months, which is found in the 'Outlook' section of our research reports.

The qualitative assessment is then combined with our forward-looking quantitative assessment to define our issuer risk rating.

Step 3: Security Assessment

Understanding the operating conditions and financial trends of an issuer is important but is not sufficient for complete analysis. During the third step in our process, we analyse the unique characteristics of the security itself.

Each security has documentation which is customised to the individual security. These are often referred to as offering documents or the prospectus. These documents are often very similar in structure but contain terms and conditions which can vary the performance of the security greatly.

These terms and conditions can refer to the position of the security within the capital structure, optionality and whether the distributions are discretionary or not. These subtle differences can have serious consequences for investment strategies so it is critical they are accurately identified.

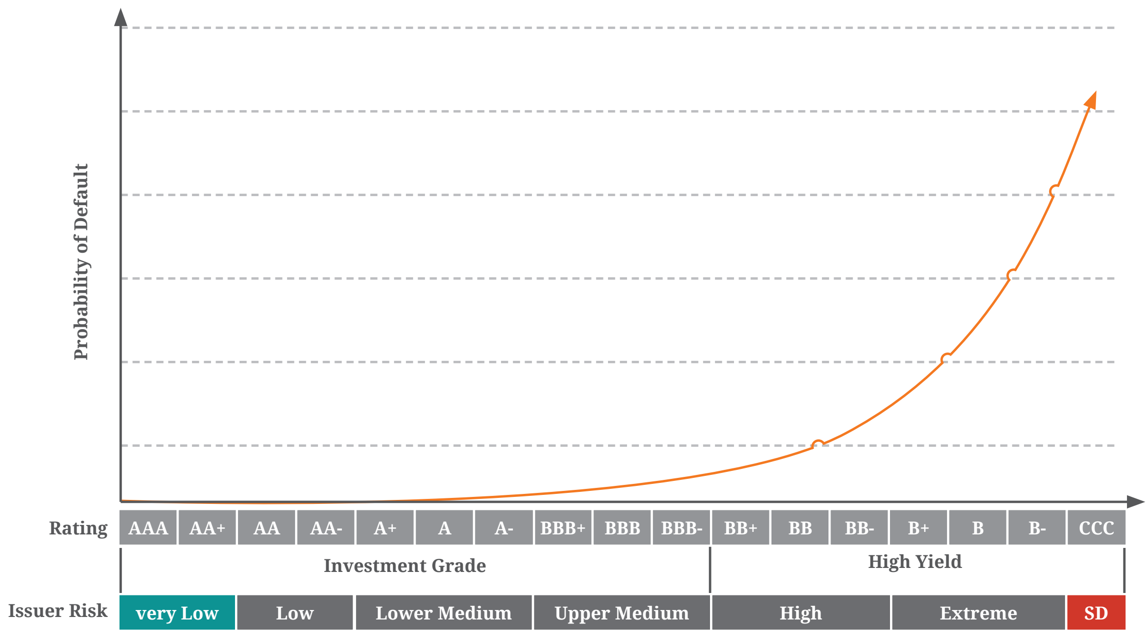
Key features of the terms and conditions are highlighted in our research reports which link through to an interactive education page that provides detailed explanations of more complex terms.

We then adjust the issuer view developed in Step Two based on the outcomes of the specific security analysis. Once the analysis process is complete we assign individual securities with a 'Security Risk Score' of Very Low, Low, Lower Medium, Upper Medium, High or Extreme. These scores are continually monitored and assessed, and are available to subscribers in each research report.

Issuer and Security Risk Assessment Curve

The issuer and security risk assessment curve is our primary measure of the likelihood that an investor could loose capital value on an investment due to default and/or conversion. The risk scale consists of five ratings – Very Low, Low, Lower Medium, Upper Medium, High and Extreme. Each security is tagged with an issuer risk and respective security risk (which may or may not be the same).

This security risk assessment has a respective measure of default or conversion which is shown in the orange line. This curve is an extension of the APRA (Australian Prudential Regulation Authority) PAIRS (Probability and Impact Rating System) model which has been successfully managing regulated entities in Australia since October 2002.



Step 4: Valuation

A valuation is given to each security once our comprehensive analysis is complete. Our valuation methodology takes into account four measures of risk – default, term, liquidity and structural risk. This is a differentiating feature of the BondAdviser research process.

Securities are valued using an extended version of the Australian Financial Markets Association (AFMA) methods for pricing Fixed Rate, Floating Rate, Capital Indexed Bonds and Annuity Indexed Securities. This provides a disciplined and consistent approach to valuation which is commonly recognised by market participants.

The detailed data entered into our Securities Management System during our analysis phase is used in our calculation algorithm to provide the analyst with transparent and high-quality data based on Australian debt market conventions and standards. This provides a level playing field across all instrument types and helps analysts identify comparable securities for analysis.
The key purpose of the valuation process is to assess whether an investor is being adequately compensated for a given level of risk.

First and foremost we believe that conditional default probabilities drive the shape of the yield curve for investment grade securities (that is those securities with a risk rating of Very Low, Low, Lower Medium or Upper Medium). A conditional default probability is the probability of default contingent on what has happened in the past. If an issuer has not defaulted in the previous year then the probability of it will default in the following year is less. Hence, the yield curve is upward sloping but not a straight line. Another way of thinking about this is that as the investment time horizon increases so too does the uncertainty surrounding the investment.

There are a number of external factors apart from default risk which can influence the valuation but this is the primary assumption in BondAdviser's valuation model.

Our methodology suggests that the yield on a security can be broken down into four distinct components:

- A risk free default premium which is identified as the government bond yield curve.
- A default risk premium, defined as the yield premium required for a corporate security with an assumed default probability and recovery rate. This premium also takes into account term to maturity and volatility.
- A structural premium to allow for the probability that options embedded within the security are exercised.
- A liquidity premium to allow for the wider bid/ offer spread or lack of market makers.

The final phase in this process is to rank our valuation of a security relative to its peers. We select comparable peers in terms of risk profile and sector and make these available to subscribers in the form of a relative value chart.

Step 5: Recommendation

Every research report issued by BondAdviser includes a clear recommendation – Buy, Hold or Sell – on the security. This recommendation framework is designed to help investors navigate different investment opportunities by identifying the market price, yield, term to maturity, liquidity, volatility and risk.

Understanding our research opinions

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 inline 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.

Step 6: Review & Adjust

BondAdviser monitors developments that might affect the valuation of securities on an ongoing basis. This ensures that recommendations remain current and helps facilitate comparison between primary and secondary market investment.

Consequently, our recommendations are not static and do change over time. Recommendations may be changed in response to events or information that impact our valuation of a security. When this occurs recommendations are adjusted in a timely manner.

The reasons for recommendation changes can vary widely; from changes in the regulatory environment to company specific circumstances affecting a security. Often a number of securities from the same issuer will have their recommendations changed concurrently to express a particular view of the analyst.