

20 August 2019

The Directors
Bananacoast Community Credit Union Ltd
69 Park Beach Road
Coffs Harbour NSW 2450

Dear Directors

Merger with P&N Bank

1 Introduction

On 13 December 2018, Bananacoast Community Credit Union Ltd (“bcu”) announced a proposed merger with Police & Nurses Limited (“P&N Bank”).

bcu and P&N Bank entered into a Merger Implementation Agreement (“MIA”) on 1 April 2019 under which bcu will merge with P&N Bank by way of a voluntary transfer of all of bcu’s business, assets¹ and members to P&N Bank in accordance with the *Financial Sector (Transfer and Restructure) Act 1999 (Cth)* (“Transfer Act”) and the *Financial Sector (Business Transfer and Group Restructure) Determination No. 2 of 2017 (Cth)* (“Transfer Rules”) (the “Merger”).

If the Merger is completed:

- bcu members (except the bcu directors²) will have their redeemable preference shares cancelled and will cease to be members of bcu; and
- each bcu member (including the bcu directors but excluding those bcu members who are already members of P&N Bank³) will be deemed to:
 - have become a member of P&N Bank on the earliest date that they became a bcu member (being membership held continuously up to the time of the Merger); and
 - hold one P&N Bank member share, credited as paid up to the amount paid up on the corresponding bcu redeemable preference share⁴. Any unpaid issue price will be payable in accordance with the P&N Bank Constitution.

bcu members who are already P&N Bank members will continue to be P&N Bank members and P&N Bank will recognise the length of membership from either bcu or P&N Bank, whichever is longer.

Following the Merger, bcu’s Australian Financial Services Licence, Australian Credit Licence and its banking authority under the *Banking Act 1959 (Cth)* will be cancelled and bcu will be deregistered as a company. There will be no surplus funds distributed to bcu members.

To facilitate the Merger, bcu will convene a general meeting of bcu members to consider a resolution to approve the merger of bcu and P&N Bank under the Transfer Act and the Transfer Rules. The general meeting is expected to be held on 22 October 2019.

¹ All of the assets and liabilities of bcu including bcu’s reserves and all deposits and loans held by bcu members.

² The bcu directors will remain bcu members until the deregistration of the company.

³ In which case bcu will refund the amount paid up on that member’s bcu redeemable preference share.

⁴ Assuming that all bcu redeemable preference shares have an issue price of \$10. If the amount paid for a redeemable preference share exceeds \$10, the bcu member will receive a refund equal to the difference.

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Under the MIA, it is intended that:

- the current brands of bcu and P&N Bank will be retained, and an umbrella brand may be adopted in the future to create a model for further industry consolidation;
- neither the bcu members nor the P&N Bank members are intended to be disadvantaged with respect to the benefits and pricing associated with any products or services held by a member on completion of the Merger. All P&N Bank members (including P&N Bank members who were previously bcu members) will have access to a broader range of products, services and channels;
- P&N Bank will continue to spend, at a minimum, the current annual investment by bcu in the mid North Coast region (including but not limited to costs of staff, service providers and sponsorship) at the date of the MIA, adjusted for the consumer price index each year;
- the head office of P&N Bank will be located in Perth, and the head offices of bcu in Coffs Harbour and Brisbane will be retained as organisational hubs for the bcu business of P&N Bank. No bcu or P&N Bank locations will be closed as a result of the Merger;
- all bcu employees will be offered a role in the Continuing Entity⁵ and no bcu or P&N Bank employee will be forced to take a redundancy as a result of the Merger:
 - the terms and conditions of employment (including any accrued entitlement to employee benefits) of each bcu employee transferred to P&N Bank and each P&N Bank employee on completion of the Merger will continue to apply after completion of the Merger; and
 - each current executive will have the opportunity to nominate for any position they currently hold which is substantially the same in both bcu and P&N or any other position they deem themselves to be suitably qualified for, and the selection process will be transparent, fair and based on merit;
- the P&N Board will comprise a maximum of 10 directors. Initially, the P&N Board will consist of:
 - six current P&N Bank directors (including the current P&N Bank Chairman, although it is intended that he will retire as a director of P&N Bank at the 2020 Annual General Meeting);
 - three current bcu directors (including the current bcu Chairman, who will be appointed as the Deputy Chairman of P&N Bank). At least one director must represent the bcu Mid North Coast, New South Wales region; and
 - P&N Bank's Chief Executive Officer ("CEO"), who will remain CEO of P&N Bank and continue as a director of P&N Bank;
- a general manager of the bcu business and a general manager of the P&N Bank business will be appointed to oversee each of the businesses and report directly to the CEO; and
- an Advisory Council will be established for each of the bcu and P&N Bank businesses responsible for representing the interests of members, acting as brand ambassadors and advising on priorities for local community initiatives. The bcu Advisory Council will initially comprise up to six member representatives, the majority of which must reside in the Coffs Coast region. It will initially include two current bcu directors who will not be appointed as directors of the Continuing Entity. An appropriate process to identify and invite other bcu members to become representative members of the bcu Advisory Council will be conducted after the Merger is completed.

The bcu Board has unanimously recommended that bcu members vote in favour of the Merger in the absence of a superior proposal.

The directors of bcu have engaged Grant Samuel & Associates Pty Limited ("Grant Samuel") to prepare an independent expert's report setting out whether, in its opinion, the Merger is in the best interests of bcu members and the benefits being provided to bcu members are fair and reasonable having regard to any loss of rights and change as to voting rights and rights to participate in the reserves and profits of bcu. A

⁵ P&N Bank after completion of the Merger (i.e. after the transfer of bcu's business, assets and members to P&N Bank).



copy of the report (including this letter) will accompany the Member Booklet to be sent to members by bcu. This letter contains a summary of Grant Samuel's opinion and main conclusions.

2 Opinion

In Grant Samuel's opinion, the advantages of the Merger outweigh the disadvantages and bcu members are likely to be better off if the Merger proceeds. Accordingly, in the absence of a superior proposal:

- **the Merger is in the best interests of bcu members; and**
- **the benefits being provided to bcu members are reasonable having regard to any loss of rights and change as to voting rights and rights to participate in the reserves and profits of bcu. As bcu members are effectively swapping an interest in one mutual for an interest in another mutual rather than exchanging their interest for cash and/or marketable securities in the acquiring entity, it is not possible to value a membership interest in either bcu or P&N Bank and therefore it is not relevant or meaningful to provide an opinion on whether the benefits being provided to members are "fair".**

3 Key Conclusions

- **bcu is facing a challenging external environment**

The Australian banking sector is dominated by the major banks, which have an estimated 80% market share. At 31 December 2018, there were 70 mutual ADIs (including mutual banks, credit unions and building societies) which collectively had a market share of around 3-4%.

Market conditions are extremely competitive, driven by new entrants and business models, and an extended period of low loan growth and low interest rates, which has intensified more recently due to weakness in housing prices and tighter lending policies (albeit there has subsequently been some relaxation of these policies). The consequent challenges for smaller mutual ADIs, such as bcu, are exacerbated by:

- increasing regulation and its impact on lending growth, capital requirements and compliance costs; and
- the requirement for ongoing, significant investment in technology and innovation to maintain an attractive and competitive banking offer that meets increasing customer expectations for banking products and services.

In addition to a difficult external environment, mutual ADIs, including bcu, are dealing with a declining and ageing member base, a high cost base (reflecting their sub-scale operations) and lack of an attractive digital offering. As a result, it is increasingly difficult for mutual ADIs to provide a relevant proposition to members and attract a younger generation of members. While members of mutual ADIs consistently report high levels of member satisfaction, indicating that there is a role for mutual ADIs in the Australian banking sector, scale is critical for mutual ADIs to remain relevant and competitive over the long term.

- **While bcu's business should be sustainable in the medium term, it will face increasing pressures on a stand-alone basis**

bcu's business should be sustainable in the medium term given its track record of profitable growth and its relatively conservative target operating parameters. However, it is facing increasing challenges and pressures on a stand-alone basis.

In particular, bcu's lack of scale and the requirement for ongoing investment in regulatory and mandatory technological change has meant that it does not have the necessary resources (staff and funding) required to develop and maintain an attractive digital offering. This constraint is ultimately



expected to reduce bcu’s future competitiveness and capacity to attract and retain members, particularly the younger generation, which is required to sustain the business over the long term.

■ **The bcu Board has recognised bcu’s position and has undertaken a process to consider alternatives**

The bcu Board has recognised that the status quo is not sustainable in the long term, and believes it is clear that bcu does not have the scale, on its own, to access the resources required to invest in enhancing its capabilities to enable it to maintain a relevant member proposition.

After conducting a review of the alternatives, the bcu Board concluded that merging with another banking organisation at some time in the future was inevitable and that a merger with a suitable mutual banking organisation to access the resources required was the most appropriate option to address the strategic challenges and risks.

Furthermore, proactively seeking to execute a merger now enables bcu to select the most appropriate partner for bcu members and its communities. Waiting until it must act could ultimately lead to a different merger in the future and an inferior outcome for bcu and its members.

■ **A merger with P&N Bank is an attractive proposition**

If the Merger is implemented, bcu will become part of a stronger and larger mutual ADI that is more capable of competing in the current market and more resilient to future strategic risks than bcu as a stand-alone entity.

The Merger will provide bcu’s business with access to the resources necessary to deliver digital capabilities to improve the proposition to existing members and attract new members (particularly younger members). These resources include P&N Bank’s current technology (that will be able to be leveraged to deliver more efficient services for bcu members) as well as its digital offerings (that will enable provision of an attractive banking offer for bcu members), financial capacity (P&N Bank currently spends around \$8-9 million per annum on IT) and its large and experienced IT team.

Importantly, given the separate geographical footprint of the two entities, there will be minimal organisational issues. bcu and P&N Bank have put considerable effort into developing an operating and governance model for the Continuing Entity which retains the bcu attributes that members value highly – its brand, staff and stores, local decision making, and commitment to the local community. There will also be some Board continuity (with three current bcu directors to join the P&N Bank Board) and an Advisory Council (of up to six bcu member representatives), both of which are required to include local representation.

There are expected to be significant cost savings of over \$5 million per annum (before tax), primarily from consolidating operations into a single set of systems and processes. These cost savings are expected to be achieved over a period of three years from completion of the Merger. There is also the potential for the Merger to deliver organic growth from deploying P&N Bank’s digital banking capabilities to target new home loan growth in bcu’s geographical markets and leveraging bcu’s capabilities and systems to provide a commercial and specialist property banking offer in Western Australia. While the quantum of any additional revenue has not been disclosed, it could add materially to the estimated cost savings.

The Merger may also provide opportunities for future inorganic growth through the potential for mergers with other mutual ADIs (although there is no certainty that such opportunities will eventuate).

■ **The Merger provides benefits for bcu members both as banking customers and as P&N Bank members**

Immediately following the Merger, there will be no change to products and no intended change to the banking details of existing bcu members. To the extent that changes are unavoidable, they will be designed to limit change and will be preceded by a communication process. Some bcu members will



specifically benefit from the cost savings expected to be achieved through a commitment to use a portion of these cost savings to remove monthly fees from personal access accounts and personal loans and certain transaction fees on personal access accounts. bcu members are also expected to be able to access an enhanced range of products, services and distribution channels, including:

- greater mobile banking capabilities. This will include access to all three digital wallets⁶ and the ability to issue instant digital cards to replace lost or stolen cards. Following conversion of bcu's banking system to P&N Bank's banking system, bcu members will have access to the full range of services provided by P&N Bank, including a new mobile banking app with greater features and capabilities; and
- enhanced services, with longer contact centre operating hours and access to a store and branch network across the east and west coasts of Australia.

As members of P&N Bank, bcu members will be customers of a more robust banking business while remaining members of a mutual committed to community involvement and service to members. In a post Royal Commission environment characterised by the erosion of trust (primarily in the major banks), bcu members will benefit from ongoing alignment of the interests of members and customers and being part of a mutual ADI that has been recognised as one of the banks that is most trusted by its customers in Australia.

■ **The Merger does involve some disadvantages and risks. However, in Grant Samuel's opinion, they are outweighed by the benefits of the Merger**

By voting in favour of the Merger, bcu members will forgo the opportunity to benefit from an alternative proposal, such as a demutualisation (accompanied by a sale of the company to a third party or a sharemarket listing) or a voluntary winding up, that could crystallise value for bcu members.

However, a demutualisation would only be possible if the bcu Board was to make the decision to put a demutualisation or similar transaction to bcu members for their approval. This is not consistent with the views of the bcu Board, which believes that a mutual structure provides the basis for a superior banking offer and is committed to the mutual structure provided that it can continue to deliver benefits to members. Furthermore, a demutualisation would only reward current members and would ignore the past members who have contributed over the course of many years to the accumulation of reserves.

Based on precedent transactions, the value realised through a demutualisation and sale could be in the order of \$3,100-3,500 per member (but would be less if bcu demutualised and listed). Moreover, access to this value could come at a cost to bcu members, particularly through the loss of the advantages of being part of a mutual organisation that is operated for the benefit of members rather than generating a return for shareholders/owners.

A voluntary winding up of bcu would require 5% of bcu members to requisition a meeting and 75% of members who vote to approve the winding up. It would not make economic sense for bcu members to seek to voluntarily wind up bcu as the amount received by members would be less than that received under a demutualisation and sale and a winding up would result in bcu members giving up all of the benefits of the mutual banking arrangements between bcu and its members (which is the very reason that they are members of bcu in the first place).

Importantly, if the Merger is implemented, the Continuing Entity will retain the ability to merge with other mutual ADIs (and will arguably be in a better position than bcu on a stand-alone basis because the Continuing Entity will have more scope to be the "acquirer" rather than the "target") or become an Alliance Bank in partnership with Bendigo and Adelaide Bank Limited.

⁶ A digital wallet is an app that stores credit or debit card information. It can be used to make contactless payments using a smartphone as well as for online shopping.

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There will be changes to the rights of bcu members, particularly the right to participate in bcu's reserves on a winding up or demutualisation. In reality, the entitlement to participate in bcu's reserves is a contingent right (i.e. it is only of value in the event that bcu is wound up or demutualises, both of which are considered unlikely). In any event, to the extent that these changes may be considered a disadvantage, they are mitigated by the right that bcu members will have as members of P&N Bank to participate in the distribution of the Continuing Entity's surplus and profits on a winding up or demutualisation of the Continuing Entity.

Voting participation and eligibility on a transfer of business or demutualisation resolution, quorums and director nomination rights as a P&N Bank member are different to those as a bcu member. However, the changes largely reflect the size of P&N Bank (and the Continuing Entity) compared to bcu and are not considered to be material in the context of the Merger.

There will also be transaction and implementation costs. bcu's transaction costs, while immaterial in the context of the Merger, are material to bcu and will be incurred by bcu on a stand-alone basis if the Merger does not proceed.

The main risks of the Merger are implementation risks. There will be a risk that the integration of the bcu and P&N Bank businesses takes longer or costs more than is expected (particularly as it is necessary to integrate the banking systems) and any delay in integration is likely to delay the provision of benefits to members. While there is a plan in place to minimise integration risks, it is not possible to eliminate them entirely. There will also be ongoing execution risks associated with successfully implementing the governance and operating model, having group executives geographically spread across the east and west coasts of Australia and managing cultural/organisational differences. Despite the operating and governance model, bcu members will also be exposed to the activities of P&N Bank (including its financial planning business, specialised property activities and reverse mortgage portfolio).

4 Other Matters

This report is general financial product advice only and has been prepared without taking into account the objectives, financial situation or needs of individual bcu members. Accordingly, before acting in relation to the Merger, members should consider the appropriateness of the advice having regard to their own objectives, financial situation or needs. Members should read the Member Booklet issued by bcu in relation to the Merger.

Grant Samuel has not been engaged to provide a recommendation to members in relation to the Merger, the responsibility for which lies with the directors of bcu. In any event, the decision whether to vote for or against the Merger is a matter for individual members based on their personal circumstances and the nature of their relationship with bcu, including the products and services they use and the importance they place on these products and services as well as their expectations of the benefits of being a member of P&N Bank. Members who are in doubt as to the action they should take in relation to the Merger should consult their own professional adviser.

Grant Samuel has prepared a Financial Services Guide as required by the Corporations Act. The Financial Services Guide is included at the beginning of the full report.

This letter is a summary of Grant Samuel's opinion. The full report from which this summary has been extracted is attached and should be read in conjunction with this summary.

The opinion is made as at the date of this letter and reflects circumstances and conditions as at that date.

Yours faithfully

GRANT SAMUEL & ASSOCIATES PTY LIMITED

Grant Samuel & Associates

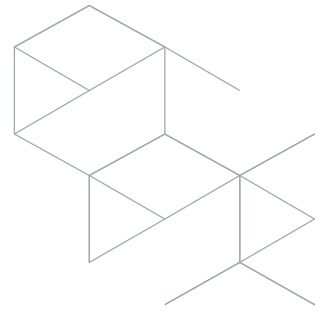


FINANCIAL SERVICES GUIDE
AND
INDEPENDENT EXPERT'S REPORT
IN RELATION TO A MERGER WITH
POLICE & NURSES LIMITED

GRANT SAMUEL & ASSOCIATES PTY LIMITED

ABN 28 050 036 372

20 AUGUST 2019



FINANCIAL SERVICES GUIDE

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The Corporations Act, 2001 (Cth) requires Grant Samuel to provide this Financial Services Guide (“FSG”) in connection with its provision of an independent expert’s report (“Report”) which is included in a document (“Disclosure Document”) provided to members by the company or other entity (“Entity”) for which Grant Samuel prepares the Report.

Grant Samuel does not accept instructions from retail clients. Grant Samuel provides no financial services directly to retail clients and receives no remuneration from retail clients for financial services. Grant Samuel does not provide any personal retail financial product advice to retail investors nor does it provide market-related advice to retail investors.

When providing Reports, Grant Samuel’s client is the Entity to which it provides the Report. Grant Samuel receives its remuneration from the Entity. In respect of the Report for Bananacoast Community Credit Union Ltd in relation to its merger with Police & Nurses Limited (“the bcu Report”), Grant Samuel will receive a fixed fee of \$285,000 plus reimbursement of out-of-pocket expenses for the preparation of the Report (as stated in Section 8.3 of the bcu Report).

No related body corporate of Grant Samuel, or any of the directors or employees of Grant Samuel or of any of those related bodies or any associate receives any remuneration or other benefit attributable to the preparation and provision of the bcu Report.

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“Grant Samuel and its related entities do not have at the date of this report, and have not had within the previous two years, any business or professional relationship with bcu or P&N Bank or any financial or other interest that could reasonably be regarded as capable of affecting its ability to provide an unbiased opinion in relation to the Merger.

Grant Samuel had no part in the formulation of the Merger. Its only role has been the preparation of this report.

Grant Samuel will receive a fixed fee of \$285,000 for the preparation of this report. This fee is not contingent on the conclusions reached or the outcome of the Merger. Grant Samuel’s out-of-pocket expenses in relation to the preparation of the report will be reimbursed. Grant Samuel will receive no other benefit for the preparation of this report.

Grant Samuel considers itself to be independent in terms of Regulatory Guide 112 issued by ASIC on 30 March 2011.”

Grant Samuel has internal complaints-handling mechanisms and is a member of the Australian Financial Complaints Authority, No. 11929. If you have any concerns regarding the bcu Report, please contact the Compliance Officer in writing at Level 19, Governor Macquarie Tower, 1 Farrer Place, Sydney NSW 2000. If you are not satisfied with how we respond, you may contact the Australian Financial Complaints Authority at GPO Box 3 Melbourne VIC 3001 or 1800 931 678. This service is provided free of charge.

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Grant Samuel is only responsible for the bcu Report and this FSG. Complaints or questions about the Disclosure Document should not be directed to Grant Samuel which is not responsible for that document. Grant Samuel will not respond in any way that might involve any provision of financial product advice to any retail investor.



TABLE OF CONTENTS

1	Details of the Merger	1
2	Scope of the Report	4
3	Overview of the Australian Lending Market	11
3.1	Lending Market	11
3.2	Regulation	13
3.3	Market Conditions and Outlook	15
4	Profile of bcu	18
4.1	Background	18
4.2	Structure and Governance	18
4.3	Membership and Member Rights	19
4.4	Business Operations and Strategy	20
4.5	Financial Performance	24
4.6	Financial Position	26
5	Profile of P&N Bank	28
5.1	Background	28
5.2	Structure and Governance	28
5.3	Membership and Member Rights	29
5.4	Business Operations and Strategy	31
5.5	Financial Performance	35
5.6	Financial Position	37
6	Impact of the Merger	40
6.1	Structure and Governance	40
6.2	Membership and Member Rights	42
6.3	Business Operations and Strategy	43
6.4	Financial Impact	45
7	Evaluation of the Merger	48
7.1	Summary and Conclusions	48
7.2	Background	50
7.3	Advantages and Benefits of the Merger	51
7.4	Disadvantages of the Merger	57
7.5	Risks of the Merger	67
7.6	Other Considerations	69
7.7	Member Decision	70
8	Qualifications, Declarations and Consents	71

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1 Details of the Merger

On 13 December 2018, Bananacoast Community Credit Union Ltd (“bcu”) announced a proposed merger with Police & Nurses Limited (“P&N Bank”).

bcu and P&N Bank entered into a Merger Implementation Agreement (“MIA”) on 1 April 2019 under which bcu will merge with P&N Bank by way of a voluntary transfer of all of bcu’s business, assets¹ and members to P&N Bank in accordance with the *Financial Sector (Transfer and Restructure) Act 1999 (Cth)* (“Transfer Act”) and the *Financial Sector (Business Transfer and Group Restructure) Determination No. 2 of 2017 (Cth)* (“Transfer Rules”) (the “Merger”).

If the Merger is implemented:

- bcu members (except the bcu directors²) will have their redeemable preference shares cancelled and will cease to be members of bcu; and
- each bcu member (including the bcu directors but excluding those bcu members who are already members of P&N Bank³) will be deemed to:
 - have become a member of P&N Bank on the earliest date that they became a bcu member (being membership held continuously up to the time of the Merger); and
 - hold one P&N Bank member share, credited as paid up to the amount paid up on the corresponding bcu redeemable preference share⁴. Any unpaid issue price will be payable in accordance with the P&N Bank Constitution.

bcu members who are already P&N Bank members will continue to be P&N Bank members and P&N Bank will recognise the length of membership from either bcu or P&N Bank, whichever is longer.

Following the Merger, bcu’s Australian Financial Services Licence (“AFSL”), Australian Credit Licence (“ACL”) and its banking authority under the *Banking Act 1959 (Cth)* (“Banking Act”) will be cancelled and bcu will be deregistered as a company. There will be no surplus funds distributed to bcu members.

To facilitate the Merger, bcu will convene a general meeting of bcu members to consider a resolution to approve the merger of bcu and P&N Bank under the Transfer Act and the Transfer Rules (the “Merger Resolution”). The general meeting is expected to be held on 22 October 2019.

Other elements of the Merger include:

- bcu and P&N Bank have agreed to certain exclusivity restrictions for the period up to 31 March 2020⁵ (the “exclusivity period”) including no-shop, no-talk and no due diligence provisions. The no-talk and no due diligence provisions do not apply to the extent that they restrict bcu or P&N Bank from undertaking any action with respect to a competing proposal provided that the relevant board has determined, in good faith and to satisfy its fiduciary or statutory duties, that not undertaking that act may involve a breach of the fiduciary or statutory duties owed by any director;
- during the exclusivity period, bcu and P&N Bank must notify the other party if it receives an approach by any person proposing a competing proposal, including details of the party making the proposal, the terms of the proposal and any material updates to the proposal (except to the extent that to do so may constitute a breach of the fiduciary or statutory duties of any director);

¹ All of the assets and liabilities of bcu including bcu’s reserves and all deposits and loans held by bcu members.

² The bcu directors will remain bcu members until the deregistration of the company.

³ In which case bcu will refund the amount paid up on that member’s bcu redeemable preference share.

⁴ Assuming that all bcu redeemable preference shares have an issue price of \$10. If the amount paid for a redeemable preference share exceeds \$10, the bcu member will receive a refund equal to the difference.

⁵ Or such other date agreed in writing between bcu and P&N Bank.

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- bcu and P&N Bank must use reasonable endeavours to procure that none of its directors recommend a competing proposal unless they have provided the other party with the material terms and conditions of the competing proposal and given the other party the opportunity to provide a counter proposal that is more favourable as a whole to their members than the terms of the competing proposal. If the directors determine, acting in good faith, that the terms and conditions of the counter proposal taken as a whole are more favourable to their members than the competing proposal, bcu and P&N Bank must use reasonable endeavours to implement the counter proposal and procure that each of their directors make a public statement supporting the counter proposal and recommend the counter proposal to their members; and
- bcu must pay P&N Bank a break fee of \$900,000 if:
 - during the exclusivity period, there is a failure to recommend the Merger, a withdrawal of the recommendation or voting intention, an adverse change or qualification of the recommendation or voting intention or a public statement indicating there is no longer support for the Merger by:
 - at least half of the bcu Board;
 - any one or more bcu directors, and bcu terminates the MIA; or
 - any one or more bcu directors, in circumstances where the P&N Bank Board continues to recommend and support the Merger but the Merger Resolution and P&N Bank's approval of the Merger are not passed;
 - a majority of the bcu Board supports or recommends a superior proposal for bcu; or
 - P&N Bank terminates the MIA as a result of a material breach by bcu.

P&N Bank must pay bcu a break fee of \$900,000 in the reverse circumstances.

The Merger is subject to a number of conditions that are set out in Section 6.1 of the Member Booklet. In summary, the key conditions include:

- receipt of all regulatory approvals and consents, including from:
 - the Commonwealth Treasurer ("Treasurer") (or the Australian Prudential Regulation Authority ("APRA") if the giving of such consent has been delegated) under Section 63(1) of the Banking Act and Section 13A of the *Financial Services (Shareholdings) Act 1998 (Cth)* ("Financial Services (Shareholdings) Act"); and
 - APRA:
 - of any statement under Section 20 of the Transfer Act (the "Section 20 Statement")⁶;
 - of the Merger under Section 11 of the Transfer Act;
 - issuing the Certificate of Transfer under Section 18 of the Transfer Act; and
 - in relation to P&N Bank continuing to use the "bcu" brand (as it is used by bcu in an acronym form) on terms acceptable to bcu and P&N Bank;
- satisfaction of any conditions imposed by APRA or the Treasurer in relation to the Merger;
- P&N Bank obtaining an amendment to its AFSL to authorise P&N Bank to provide retirement savings accounts;
- an independent expert issuing a report which concludes that the Merger is in the best interests of bcu members and the benefits being provided to bcu members are fair and reasonable having regard to

⁶ The Section 20 Statement specifies things that are to happen, or that are taken to be the case, in relation to the assets and liabilities that are to be transferred, or in relation to the transfer of the business that is to be effected in completing the Merger (see Section 6.4 of the Member Booklet for more details).

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any loss of rights and change as to voting rights and rights to participate in the reserves and profits of bcu;

- the relevant bcu members approve the Merger Resolution by the necessary majorities, and with the necessary bcu member participation required under the Transfer Rules and bcu's Constitution; and
- P&N Bank members approve the Merger.

The bcu Board has unanimously recommended that bcu members vote in favour of the Merger in the absence of a superior proposal.



2 Scope of the Report

2.1 Purpose of the Report

The MIA requires that the relevant bcu members approve the Merger Resolution by the majorities, and with the bcu member participation, required under the Transfer Rules and the bcu Constitution.

The Merger is to be implemented by way of a voluntary transfer of business under the Transfer Act. Rule 12 of the Transfer Rules prescribes that a transfer will be adequately adopted for the purposes of Section 13 of the Transfer Act if it is approved by:

- 75% of votes cast by members (if the constitution of the body provides for only one vote per member); or
- 75% of members voting (if the constitution of the body does not provide for only one vote per member),

(either in person or by proxy) on the resolution to adopt the transfer at a general meeting of members.

Clause 7.39(b) of the bcu Constitution requires that, in addition to the requirements of the Corporations Act in relation to special resolutions, a resolution relating to the transfer of business for all or part of its assets shall be deemed not to have been carried unless at least 25% of bcu members who have been members for at least 24 months vote on the resolution (either in person or by proxy) at a general meeting of bcu members.

The Merger will not trigger a demutualisation under Part 5 of Schedule 4 of the Corporations Act. However, Grant Samuel has been advised that the Merger Resolution will be a “Demutualisation Resolution” under Schedule 5 to the bcu Constitution and, in accordance with clauses 3(e) and 3(f) of Schedule 5 to the bcu Constitution and clause 7.38 of the bcu Constitution, only members who have been members of bcu for at least 12 months (“eligible members”) are entitled to vote on the Merger Resolution and it will only be passed if:

- at least 5% of members who have been members for at least 12 months vote on the Merger Resolution;
- at least 25% of members who have been members for at least 24 months vote on the Merger Resolution; and
- at least 75% of the votes cast by eligible members approve the Merger Resolution.

Consequently, the bcu Constitution effectively applies two separate thresholds which must be met:

- voting eligibility and majority: only members who have been members of bcu for at least 12 months will be eligible to vote on the Merger Resolution and, of those members who actually vote, 75% must vote in favour of the Merger Resolution; and
- participation threshold: even if the voting majority above is met, the Merger Resolution will only be passed for the purposes of the bcu Constitution if:
 - at least 5% of members who have been members for at least 12 months; and
 - at least 25% of members who have been members for at least 24 months, actually vote on the Merger Resolution (whether for or against)⁷.

Although there is no requirement in the present circumstances for an independent expert’s report pursuant to the Transfer Act, the Transfer Rules, the Corporations Act or the bcu Constitution, the directors

⁷ Although if the requirement that at least 25% of members who have been members for at least 24 months vote is met, the requirement that at least 5% of members who have been members for at least 12 months vote will, by definition, also be met.



of bcu have engaged Grant Samuel & Associates Pty Limited (“Grant Samuel”) to prepare an independent expert’s report setting out whether, in its opinion:

- the Merger is in the best interests of bcu members; and
- the benefits being provided to bcu members are fair and reasonable having regard to any loss of rights and change as to voting rights and rights to participate in the reserves and profits of bcu.

A copy of the report will accompany the Member Booklet to be sent to members by bcu.

This report is general financial product advice only and has been prepared without taking into account the objectives, financial situation or needs of individual bcu members. Accordingly, before acting in relation to the Merger, members should consider the appropriateness of the advice having regard to their own objectives, financial situation or needs. Members should read the Member Booklet issued by bcu in relation to the Merger.

Voting for or against the Merger is a matter for individual members based on their personal circumstances and the nature of their relationship with bcu, including the products and services they use and the importance they place on these products and services as well as their expectations of the benefits of being a member of P&N Bank. Members who are in doubt as to the action they should take in relation to the Merger should consult their own professional adviser.

2.2 Basis of Evaluation

Regulatory Guidelines

The Australian Securities and Investments Commission (“ASIC”) has issued Regulatory Guide 111 which establishes guidelines in respect of independent expert’s reports. ASIC Regulatory Guide 111 differentiates between the analysis required for “control” transactions (essentially, where one party acquires more than 20% of another party) and other transactions. In the context of control transactions (whether by takeover bid, scheme of arrangement, the issue of securities, selective capital reduction or buyback), the expert is required to distinguish between “fair” and “reasonable”.

Fairness involves a comparison of full underlying value (including a premium for control) of the target entity and the value of the consideration offered. A “fair” transaction will always be “reasonable” but a “reasonable” transaction will not necessarily be “fair”. Reasonableness involves an analysis of other factors that members might consider prior to deciding to vote in favour or against a transaction. This may involve factors such as the likelihood of an alternative offer and alternative transactions that could realise value. A transaction could be considered “reasonable” if there were valid reasons to vote in favour of it notwithstanding that it was not “fair”.

There is no legal definition of the expression “in the best interests”. However, Regulatory Guide 111 provides guidance that control transactions that are “fair and reasonable” or “not fair but reasonable” will be in the best interests of members.

For most other transactions, the expert is to weigh up the advantages and disadvantages of the proposal for members. This involves a judgement on the part of the expert as to the overall commercial effect of the proposal, the circumstances that have led to the proposal and the alternatives available. The expert must weigh up the advantages and disadvantages of the proposal and form an overall view as to whether the members are likely to be better off if the proposal is implemented than if it is not. If the advantages outweigh the disadvantages, the transaction will be in the best interests of members.

Best Interests Opinion

It could be argued that the Merger is a control transaction as bcu’s business is transferred to P&N Bank. Under this approach, “fair” and “reasonable” would need to be examined separately. Grant Samuel has considered whether using the “fair” and “reasonable” tests applicable to a control transaction is



appropriate in the case of the Merger. However, as bcu members are effectively swapping an interest in one mutual (bcu) for an interest in another mutual (P&N Bank) rather than exchanging their interest for cash and/or marketable scrip in the acquiring entity (and giving up the benefits of their existing membership⁸), Grant Samuel considers that the application of a “fairness” test is not meaningful and potentially misleading:

- a membership interest in a mutual such as bcu has no current realisable value (other than repayment of the issue price of \$10 (to the extent that this has been paid up) on ceasing to be a member). Customers must be members and any “value” is attributed to being an active customer. Membership of bcu can cease or be cancelled on repayment of the issue price of \$10 (to the extent that that this amount has been paid up) if a member is not an active customer (e.g. if a customer repays their loan in full and requests that their membership cease or if a customer’s only account is a dormant deposit account⁹). In these circumstances, members are not entitled to any other “value”. Past members have no entitlement to any “value”, despite contributing to bcu’s profits and reserves while members. Similarly, a membership interest in P&N Bank has no current realisable value in the conventional sense;
- any underlying “value” within the entity is not able to be accessed by members unless bcu is wound up (voluntarily or involuntarily) or the bcu Board takes action to change the status of bcu (e.g. by way of demutualisation) and the necessary majority of members approve this change. Neither of these actions is currently contemplated. Similar issues apply to P&N Bank which plans to remain a mutual entity. In this sense, any “value” in either entity is contingent in nature.

In addition, bcu members are not giving up contingent value (e.g. for a cash payment) but instead are exchanging the contingent value in bcu for contingent value in P&N Bank (albeit that the quantum, basis of distribution and other terms and conditions of these rights may be different).

The existing rights of bcu members therefore cannot be “valued” in any meaningful sense (there is no “market value”) and cannot be compared directly with the “value” of rights as members of P&N Bank; and

- the real value of membership is in the products, services and other benefits made available to members which will vary from member to member depending on the extent to which members choose to utilise the products and services and take advantage of the benefits offered. This applies to membership of both bcu and P&N Bank.

Consequently, in Grant Samuel’s view, even if the Merger is a control transaction, it is not possible to form a view on whether the Merger is “fair” (as that term is defined under ASIC’s Regulatory Guides). As a result, Grant Samuel has evaluated the Merger for the purposes of the “best interests” opinion by assessing the overall impact on the members of bcu and has formed a judgement as to whether the expected benefits outweigh any disadvantages and risks that might result. To the extent possible, Grant Samuel has compared quantifiable benefits with quantifiable disadvantages. However, many of the potential benefits and disadvantages are by their very nature difficult, or even impossible, to quantify or verify. In this context, the overall conclusion as to whether the advantages of the Merger outweigh the disadvantages is to a large extent subjective.

In forming its opinion as to whether the advantages of the Merger outweigh the disadvantages, Grant Samuel has considered the following:

- the business and financial prospects for bcu as a stand-alone entity and the impact of the Merger on these prospects;

⁸ In these situations, the acquiring entity will typically have a single objective of maximising returns to shareholders and will have no mandate to provide ongoing benefits to members as customers (or to return value to members as customers).

⁹ A dormant deposit account is one on which there has been no transactions for at least one year.



- the effects of the Merger on bcu members (e.g. products and services offered);
- the current rights of bcu members and their rights as P&N Bank members;
- the contingent value attributable to bcu members and the circumstances in which this value could be accessed;
- the impact of the Merger on the ability of bcu to enter into alternative transactions that might realise value for bcu members;
- any other advantages and benefits arising from the Merger; and
- the costs, disadvantages and risks of the Merger.

If the advantages outweigh the disadvantages, the Merger will be in the best interests of members.

Fair and Reasonable Opinion

There is no regulatory requirement for the “fair and reasonable” opinion in relation to the benefits being provided to bcu members. The requirement for the opinion is contained in Schedule 5 to the bcu Constitution, which sets out the procedure for dealing with a proposed demutualisation of bcu. Although the provisions of Schedule 5 do not apply to the Merger, it would be expected that the same interpretation of “fair and reasonable” would apply to the opinion in relation to the benefits being provided to bcu members. No definition of the expression “fair and reasonable” is provided in the bcu Constitution.

As discussed above, “fair” and “reasonable” are, for regulatory purposes, regarded as two separate tests, where “fairness” involves a comparison of the value of the target company to the value of the consideration offered and “reasonableness” relates to other qualitative factors that members should consider before deciding to vote for or against a transaction. Application of Regulatory Guide 111 requires that this interpretation of “fair and reasonable” apply in bcu’s case.

However, for the reasons explained above, in Grant Samuel’s view, it is not possible to form a view on whether the benefits being provided to members are “fair” (as that term is defined under ASIC’s Regulatory Guides) and, as a result, Grant Samuel has only considered whether the benefits being provided to members are “reasonable”. For the purposes of this analysis, Grant Samuel has assessed whether the advantages of the benefits being provided to bcu members outweigh the disadvantages. If the advantages outweigh the disadvantages, the benefits being provided to bcu members will be “reasonable”. This is the same test used in forming a view on whether the Merger is in the best interests of bcu members and requires that the same factors be addressed.

2.3 Sources of Information

The following information was utilised and relied upon, without independent verification, in preparing this report:

Publicly Available Information

- Member Booklet (including earlier drafts);
- P&N Bank Member Information Document (including earlier drafts);
- summarised annual reports of bcu for the four years ended 30 June 2018;
- detailed annual report of bcu for the year ended 30 June 2018;
- bcu Constitution;
- annual reports for P&N Bank for the four years ended 30 June 2018;
- P&N Bank Constitution;



- press releases and media presentation material by bcu and P&N Bank including information available on their websites; and
- recent press articles and other research on bcu, P&N Bank and the mutual and Australian banking sectors.

Non Public Information provided by bcu

- MIA between bcu and P&N Bank dated 1 April 2019;
- draft Section 20 Statement prepared by bcu and P&N Bank;
- financial performance for bcu for the six months ended 31 December 2018 and financial position of bcu at 31 December 2018;
- FY19¹⁰ budget and FY20-FY21 forecasts for bcu prepared by bcu management;
- the combined bcu and P&N Bank (i.e. P&N Bank after completion of the Merger or the “Continuing Entity”) financial model for FY19 to FY21;
- due diligence reports on P&N Bank and the Merger prepared by bcu’s financial, legal and accounting advisers; and
- other confidential documents, board papers, presentations and working papers.

Non Public Information provided by P&N Bank

- financial performance for P&N Bank for the six months ended 31 December 2018 and financial position of P&N Bank at 31 December 2018;
- FY19 budget and FY20-FY21 forecasts for P&N Bank prepared by P&N Bank management; and
- other confidential documents, board papers, presentations and working papers.

In preparing this report, representatives of Grant Samuel held discussions with, and obtained information from, senior management of bcu and its advisers and senior management of P&N Bank. Grant Samuel was also provided with access to P&N Bank’s data room and limited access to bcu’s data room.

2.4 Limitations and Reliance on Information

Grant Samuel believes that its opinion must be considered as a whole and that selecting portions of the analysis or factors considered by it, without considering all factors and analyses together, could create a misleading view of the process employed and the conclusions reached. Any attempt to do so could lead to undue emphasis on a particular factor or analysis. The preparation of an opinion is a complex process and is not necessarily susceptible to partial analysis or summary.

Grant Samuel’s opinion is based on economic, business trading, financial and other conditions and expectations prevailing at the date of this report. These conditions can change significantly over relatively short periods of time. If they did change materially, subsequent to the date of this report, the opinion could be different in these changed circumstances.

This report is also based upon financial and other information provided by bcu and its advisers and P&N Bank. Grant Samuel has considered and relied upon this information. bcu has represented in writing to Grant Samuel that to its knowledge the information provided by it was then, and is now, complete and not incorrect or misleading in any material respect. Grant Samuel has no reason to believe that any material facts have been withheld.

¹⁰ FYXX is the year end 30 June 20XX (e.g. FY19 is the year end 30 June 2019).

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The information provided to Grant Samuel has been evaluated through analysis, inquiry and review to the extent that it considers necessary or appropriate for the purposes of forming an opinion as to whether the Merger is in the best interests of bcu members and whether the benefits being provided to bcu members are fair and reasonable having regard to any loss of rights and change as to voting rights and rights to participate in the reserves and profits of bcu. However, Grant Samuel does not warrant that its inquiries have identified or verified all of the matters that an audit, extensive examination or “due diligence” investigation might disclose. While Grant Samuel has made what it considers to be appropriate inquiries for the purposes of forming its opinion, “due diligence” of the type undertaken by companies and their advisers in relation to, for example, prospectuses or profit forecasts, is beyond the scope of an independent expert. While Grant Samuel has had access to the due diligence reports on P&N Bank and the Merger prepared by bcu’s financial, accounting and legal advisers, the due diligence reports on bcu prepared by P&N Bank’s accounting and legal advisers have not been provided to Grant Samuel and Grant Samuel is not in a position, nor is it practicable, to undertake its own “due diligence” investigation of the type undertaken by accountants, lawyers or other advisers.

Accordingly, this report and the opinions expressed in it should be considered more in the nature of an overall review of the anticipated commercial and financial implications rather than a comprehensive audit or investigation of detailed matters.

An important part of the information used in forming an opinion of the kind expressed in this report is the opinions and judgement of management. This type of information was also evaluated through analysis, inquiry and review to the extent practical. However, such information is often not capable of external verification or validation.

Preparation of this report does not imply that Grant Samuel has audited in any way the management accounts or other records of bcu or P&N Bank. It is understood that the accounting information that was provided was prepared in accordance with generally accepted accounting principles and in a manner consistent with the method of accounting in previous years (except where noted).

The information provided to Grant Samuel included:

- bcu’s FY19 budget prepared by bcu management and adopted by the directors of bcu;
- bcu’s FY20-FY21 forecasts prepared by bcu management;
- P&N Bank’s FY19 budget prepared by P&N Bank management and adopted by the directors of P&N Bank;
- P&N Bank’s FY20-FY21 forecasts prepared by P&N Bank management; and
- FY19-FY21 pro forma financial information for the Continuing Entity,

together, the “forward looking information”.

Grant Samuel has had regard to the forward looking information in undertaking its analysis but has not relied upon it in forming its opinions. Given the nature of the transaction, the forward looking information is not the fundamental basis for assessing the Merger. Rather, other factors such as the implications for bcu’s business and its members are more important.

In forming its opinion, Grant Samuel has also assumed that:

- matters such as title, compliance with laws and regulations and contracts in place are in good standing and will remain so and that there are no material legal proceedings, other than as publicly disclosed;
- the assessments by bcu and its advisers with regard to legal, regulatory, tax and accounting matters relating to the Merger are accurate and complete;

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- the information set out in the Member Booklet sent by bcu to its members is complete, accurate and fairly presented in all material respects;
- the publicly available information relied on by Grant Samuel in its analysis was accurate and not misleading;
- the Merger will be implemented in accordance with its terms; and
- the legal mechanisms to implement the Merger are correct and will be effective.

To the extent that there are legal issues relating to assets, properties, or business interests or issues relating to compliance with applicable laws, regulations, and policies, Grant Samuel assumes no responsibility and offers no legal opinion or interpretation on any issue.

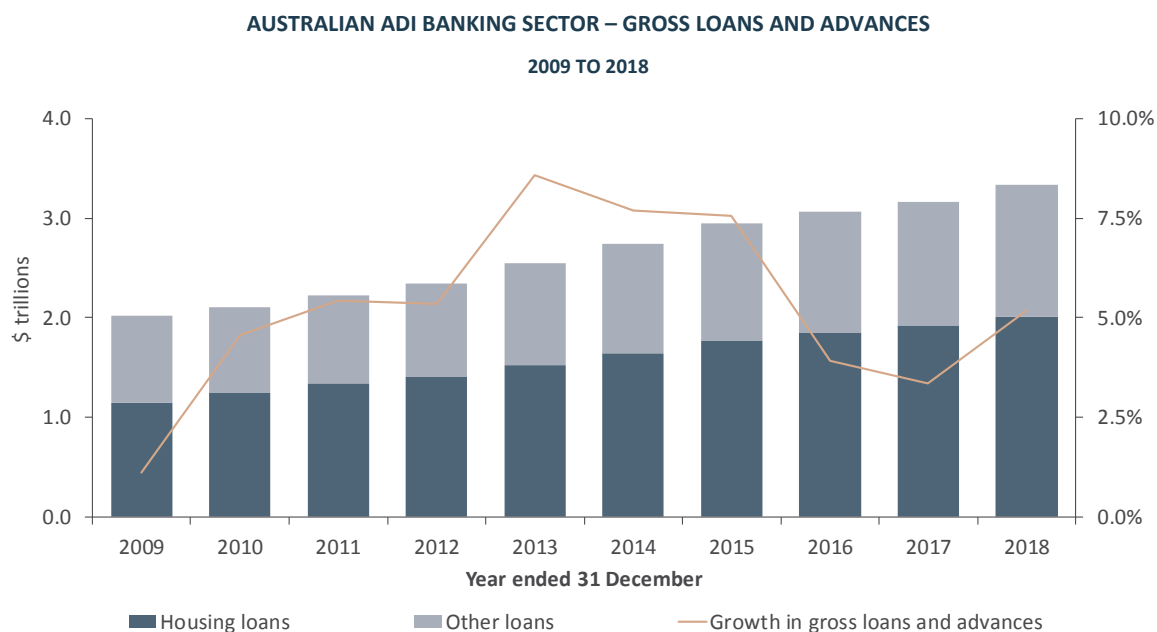


3 Overview of the Australian Lending Market

3.1 Lending Market

Size

Total gross loans and advances for all Authorised Deposit-taking Institutions (“ADIs”) in Australia has grown from approximately \$2.0 trillion in December 2008 to \$3.3 trillion in December 2018, representing average growth of 5.3% per annum over the past 10 years:



Source: APRA Quarterly Authorised Deposit-taking Institution Performance Statistics, December 2018 (released 20 March 2019)

Housing loans are the largest credit exposure in the Australian banking system, representing around 60% of gross loans and advances. Over the past 10 years, the value of all housing loans financed by ADIs has grown from approximately \$1.0 trillion to \$2.0 trillion, representing average growth of 6.9% per annum. Growth in the value of housing loans has been driven by a growing population, stable and low unemployment and historically low interest rates, which has resulted in an increase in the volume and size of housing loans, across both owner occupiers and investors (although over the period from 2015 to 2018, regulatory policies slowed investor loan growth¹¹).

More recently (in 2018 and 2019), growth in the value of housing loans has been more moderate, reflecting tighter lending criteria from the banks (following the Final Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (“Royal Commission”) released in February 2019), a lift in variable mortgage interest rates and falling house prices.

The chart above shows gross loans and advances for ADIs. It excludes loans and advances provided by other participants in the Australian lending market (albeit their contribution to the lending market is currently relatively minor) such as:

¹¹ APRA introduced restrictions for ADIs on interest-only loans (from December 2014, lifted in April 2018) and investor loans (March 2017, lifted in January 2019) to address concerns in relation to increasing housing prices, high and rising household indebtedness, subdued household income growth, historically low interest rates and strong competitive pressures.



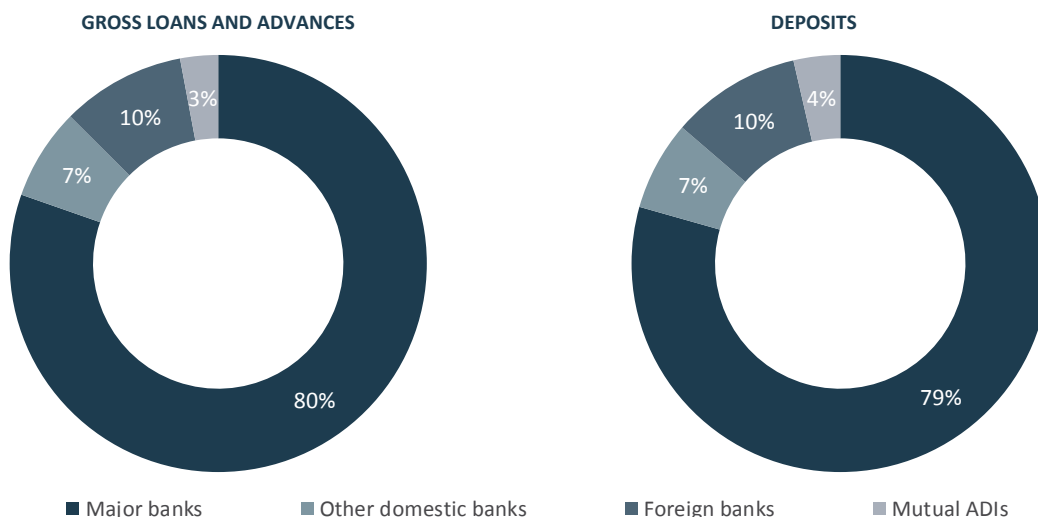
- traditional non-ADI financial institutions, primarily finance companies (including general financiers and pastoral finance companies)¹², securitisers¹³ (such as Bluestone Mortgages Australia, Firstmac, Pepper Group, Resimac Group, LaTrobe Financial Services, Liberty Financial) and money market corporations¹⁴. Traditional non-ADI financial institutions had total assets of approximately \$350 billion at 31 December 2018¹⁵; and
- financial technology (“fintech”) businesses operating in lending markets. These fintechs generally engage in peer to peer lending or crowdfunding and operate in niche markets such as personal loans (e.g. MoneyPlace, Society One) and small-to-medium sized enterprise (“SME”) loans (e.g. Moula Money, Judo Capital, OnDeck Australia), but participants are also starting to operate in the home loan market (e.g. Tic:Toc, a start-up that launched in early 2019). It has been estimated that the alternative finance market raised US\$1.15 billion (approximately \$1.6 billion) in 2017¹⁶.

Participants

The Australian ADI banking sector is dominated by the major banks¹⁷, which held around 80% of gross loans and advances and deposits at 31 December 2018:

AUSTRALIAN ADI BANKING SECTOR – MARKET SHARE

AT 31 DECEMBER 2018



Source: APRA Quarterly Authorised Deposit-taking Institution Performance, December 2018 (released 20 March 2019)

Mutual ADIs collectively represent only around 3-4% of the Australian banking sector (based on either gross loans and advances or deposits). While mutual ADIs have a larger share of the housing loan market at 4.5%, this is at the expense of the foreign banks (that tend to focus on specific market segments) as the major banks’ share of the housing loan market is approximately 84%.

¹² Finance companies provide loans to households and SMEs and raise funds from the wholesale markets and retail investors (through debentures and unsecured notes).

¹³ Securitiser are special purpose vehicles that issue securities backed by pools of assets (e.g. residential-mortgage backed securities). The securities are usually credit enhanced (e.g. through the use of guarantees from third parties).

¹⁴ Money market corporations operate primarily in wholesale markets, borrowings from, and lending to, large corporations and government agencies (as well as providing other services).

¹⁵ Source: Reserve Bank of Australia Statistical Tables, Assets and Liabilities, Assets of Financial Institutions (B1).

¹⁶ Source: The 3rd Asia Pacific Region Alternative Finance Industry Report, November 2018.

¹⁷ The major banks are Commonwealth Bank of Australia (“CBA”), Westpac Banking Corporation (WBC), Australia and New Zealand Banking Group Limited (“ANZ”) and National Australia Bank Limited (“NAB”).



The charts above exclude loans and advances provided by traditional non-ADI financial institutions and fintech businesses. Tighter regulation of ADIs over recent years has contributed to some lending activities migrating to less regulated non-ADI lenders. However, lending by the traditional non-ADI sector has remained steady at around 7.5% of the financial system¹⁸, with limited growth over the past 10 years (0.5% per annum) largely as a result of the significant decline in lending by securitisers following the global financial crisis. The market share of fintechs is extremely small, but has shown very high growth rates of more than 150% on average per annum since they entered the Australian finance system in 2013.

At 31 December 2018, the mutual ADI sector comprised 70 entities ranging in size from \$15.6 billion to less than \$150 million in total assets. The top 10 mutual ADIs represented approximately 68% of the total mutual ADI sector (based on total assets). Despite their relatively small market share, over the 12 months ended 31 December 2018, mutual ADIs grew at more than double the rate of the major banks in their key markets of housing loans and deposits:

AUSTRALIAN BANKING SECTOR – GROWTH

12 MONTHS ENDED 31 DECEMBER 2018

	ALL ADIs	MAJOR BANKS	MUTUAL ADIs
Housing loans	4.5%	3.7%	8.1%
Gross loans and advances	5.2%	4.6%	7.6%
Deposits	3.2%	2.1%	6.0%

Source: APRA Quarterly Authorised Deposit-taking Institution Performance Statistics, December 2018 (released 20 March 2019)

Other participants in the Australian banking sector are neobanks such as Volt Bank Limited (“Volt Bank”), Xinja Holdings Limited (“Xinja”) and 86 400 Holdings Pty Ltd (“86 400”). Neobanks operate only via digital platforms and are in the start-up phase in Australia (but are much more established in the United Kingdom, the United States and Europe). Volt Bank received a full banking licence in January 2019 (i.e. it is an ADI) and expects to launch during 2019. Xinja was granted a restricted banking licence in December 2018 and is in the process of applying for a full banking licence. 86 400 is also in the process of applying for a full banking licence and expects to launch in 2019.

3.2 Regulation

The ADI sector of the Australian lending market is heavily regulated. APRA is the prudential regulator of the Australia financial services industry. It is responsible for overseeing the prudential framework under which ADIs must operate including, in particular, licencing and minimum capital requirements, capital adequacy, liquidity and credit quality.

The capital adequacy requirements aim to ensure that ADIs maintain adequate eligible capital to act as a buffer against the risks associated with their activities (calculated on the basis of risk weighted assets, including allowances for securitisation, market risk and operational risk). Liquidity coverage ratios require Australian ADIs to hold sufficient liquid assets to meet 30 day net cash outflows projected under an APRA-prescribed stress scenario (designed to switch funding to more stable sources and increase holdings of liquid assets).

More recent regulatory measures have focused on the stability of the financial system and have included:

- the imposing, and then lifting, of restrictions for ADIs on interest-only loans (December 2014 to April 2018) and investor loans (March 2017 to January 2019);
- an APRA review of capital and risk across ADIs that has resulted in proposed increased capital requirements (primarily for the major banks), including:

¹⁸ Source: Reserve Bank of Australia Statistical Tables, Assets and Liabilities, Assets of Financial Institutions (B1), December 2018.



- a requirement for the major banks to meet a higher minimum capital requirement (approximately 150 basis points) compared to a lower increase of 50 basis points for ADIs using the standardised approach to risk weighted assets (to be implemented by 2020);
 - a risk weighted asset floor for banks using the internal-ratings based approach (proposed implementation January 2021), which will result in the major banks applying a mandatory minimum risk weighting to their loan portfolios and requiring them to increase their capital position to support their lower risk-weighted loans; and
 - further proposed charges (an additional 3% of capital) to make domestic systematically important ADIs (i.e. the major banks) “unquestionably strong” by 1 January 2024 (with an overall target of 4-5% additional capital over the long term);
- an increased focus on values, culture and accountability, particularly following the APRA Prudential Inquiry into CBA and the release of the Royal Commission Final Report in February 2019, although regulatory changes did commence earlier. Examples of these changes include:
 - the Banking Executive Accountability Regime (“BEAR”), designed to improve the operating culture of ADIs and increase transparency and accountability across the banking sector. BEAR has applied to the major banks since July 2018 and applies to all other ADIs (including mutual ADIs) from July 2019; and
 - prioritising existing responsible lending obligations. ASIC’s *Consultation Paper 309 Update to RG 209: Credit licensing: Responsible lending conduct* (released on 14 February 2019, comments closed on 20 May 2019) sought feedback on ASIC’s proposals for updating guidance in this area. While the Royal Commission was focussed on the behaviour of banks only, alterations to Regulatory Guide 209 will apply to all providers of consumer credit in Australia; and
 - an increased focus on information security management. In late 2018, APRA released a new prudential standard *CPS 234 Information Security*, which sets out mandatory requirements for information security management for APRA regulated entities. The standard aims to strengthen the resilience of APRA regulated entities against information security incidents (including cyber-attacks) and their ability to respond swiftly and effectively in the event of a breach.

Following release of the Report on Reforms for Cooperatives, Mutuals and Member Owned Firms (the “Hammond Report”) in July 2017 and the Federal Government’s acceptance of all recommendations in the report, a number of positive legislative changes have been implemented (or proposed) for mutual ADIs which will:

- reduce the risk of mutual ADIs losing their mutual status when raising capital (by amending the definition of a mutual entity and removing uncertainty in determining when a mutual entity triggers the demutualisation provisions in the Corporations Act); and
- remove certain capital restrictions on mutual ADIs, allowing mutual ADIs to raise Tier 1 capital through the issue of special capital instruments (mutual capital interests) so that they are no longer reliant on retained earnings to meet their prudential capital requirements. This change puts mutual ADIs on a more equal footing with listed ADIs, giving them greater access to capital to grow and increasing competition the in banking sector.

Non-ADI financial institutions are not subject to the same level of regulation as ADIs. Australian regulators appear to be supportive of fintechs (e.g. the ASIC Innovation hub which is designed to assist Australian fintech start ups with consultation in relation to regulatory compliance and the release of *Regulatory Guide 257 Testing fintech products and services without holding an AFS or credit licence*, which establishes a licence exemption enabling fintechs to test their products without the need for required licences (i.e. AFSL, ACL)). However, legislation passed in early 2018 does require larger non-ADI lenders to regularly disclose the scale of their lending activity to APRA and also provides APRA with powers to impose rules on non-ADIs if their activities are judged to pose a material threat to financial stability.



3.3 Market Conditions and Outlook

Market Conditions

Market conditions in the Australian banking sector are very competitive, driven by:

- the continuing low loan growth and low interest rate environment putting ongoing pressure on net interest margins and cost to income ratios. Over the past 12-18 months, these conditions have intensified due to:
 - weakness in housing prices, particularly in the Sydney and Melbourne capital city markets. While the pace of decline in house prices has slowed, the geographic spread has widened to other housing markets; and
 - rising wholesale funding costs;
- increasing and changing regulatory requirements and their impact on lending growth, capital requirements and compliance costs. There is concern that tighter lending policies (albeit there has subsequently been some relaxation of these policies) and improved ethical behaviour from a greater focus on responsible lending laws has resulted in delays to the approval process, an increase in the cost of loans and lower loan capacity and volumes;
- constant and rapid change and the substantial and ongoing investment required in technology and innovation to keep up with digital transformation to meet evolving customer preferences. Recent new developments in this area that ADIs will need to incorporate into their offerings to remain competitive include:
 - the New Payments Platform (“NPP”) open access infrastructure for fast (i.e. simply addressed, real time, 24/7) payments in Australia which was developed via industry collaboration and launched in February 2018. While the NPP infrastructure supports the independent development of “overlay” services to offer innovative payment services to end-users, the only application offered to date is OSKO (“Osko”) (built by the BPAY Group), which allows payments to be sent and received in real time using bank account details or PayID (which allows customers to link their bank account details to their mobile number, email address, Australian Business Number (“ABN”) or organisation name);
 - Open Banking, which will provide accredited third parties with access to specific forms of customer banking data given the appropriate customer authorisation. The major banks are required to be Open Banking compliant by July 2019 with all other ADIs (including mutual ADIs) compliant by July 2020; and
 - Comprehensive Credit Reporting (“CCR”), which became mandatory in July 2018 (to be phased in by July 2019) and changes the type of consumer credit information that can be collected by credit bureaus and used by credit providers when making a lending decision. Under CCR, positive data is able to be included in credit reports; and
- increasing relevance of traditional non-ADI financial institutions, fintechs and digital banks. Growth in residential mortgage lending by non-ADI financial institutions remains high and well above that of ADIs (albeit from a low base and partly because higher interest rates being charged by banks for investor and interest only loans have made non-ADI financial institutions more competitive). Barriers to entry are decreasing, with APRA issuing restricted ADI licences to digital banks and requiring a lower amount of capital to use the term “bank”. Fintechs are capitalising on their focus on the customer experience.

This intense competition in the Australian banking sector has been exacerbated by:

- the decline in trust in the financial services industry generally following the release of the Royal Commission Final Report (albeit the focus has been on the major banks); and



- up until mid-May 2019, the potential for changes in government policy/regulation after the Federal election, although these concerns have abated following the return of the Coalition government.

Outlook for Mutual ADIs

In this increasingly competitive environment, many mutual ADIs are also dealing with:

- stagnant or declining membership and an ageing membership base, in part due to the majority of mutual ADIs having a regional focus;
- a predominantly retail deposit funding base and limited access to alternative funding sources. While mutual ADIs can now raise Tier 1 capital through mutual capital instruments, these instruments are new and untested and require an independent legal opinion on eligibility and other matters and the prior approval of APRA;
- increased capital and liquidity requirements from the implementation of Basel III and the associated compliance and administration impact;
- determining their technological strategy and where to deploy their limited resources; and
- deteriorating profitability and high cost bases. The average cost to income ratio for mutual ADIs outside of the top 10 is around 83%, reflecting their commitment to provide a high quality of service to members (e.g. branch structure and staffing levels). The top 10 mutual ADIs are more cost efficient (with cost to income ratios of around 72%) but are still much less efficient than the major banks (at around 42%).

This combination of factors creates challenges for mutual ADIs as they seek to deliver a relevant proposition to members. The overriding challenge is to achieve sustainable growth and profitability while continuing to operate as member owned and community based organisations, providing high levels of service to customers.

In an attempt to counteract these issues, almost one third (21 out of a total of 70 at 31 December 2018) of mutual ADIs had converted from building societies and credit unions to mutual banks¹⁹ to take advantage of the perceived security and strength associated with including the word “bank” in their name and to attract a younger generation of members (who do not understand the concept of building societies and credit unions). Mutual banks differentiate themselves from the major banks and regional banks by remaining customer owned and focused on delivering value to their customers. While there is a general belief that conversion to mutual bank status has had a positive impact, it is difficult to measure this in isolation from other factors.

There have been some recent positive outcomes for mutual ADIs:

- the Federal government and regulatory bodies appear to be supportive of a sustainable competitive alternative to the major banks (e.g. recent regulatory changes to enable access to alternative funding vehicles);
- the Productivity Commission Review into Competition in the Australian Financial System (released in June 2018) has recommended regulatory change to improve the ability of small ADIs (including mutual ADIs) to compete with the major banks;
- negative impacts for the major banks from the Royal Commission provide an opportunity for the mutual ADI sector and its focus on customer and trust (although the erosion of trust has had an impact across the sector e.g. BEAR applies to all ADIs); and

¹⁹ Since 2010, mutual ADIs with Tier 1 capital of at least \$50 million have been able to apply to APRA to present themselves as a bank.



- the shift to Open Banking and the introduction of CCR should also provide an opportunity for mutual ADIs (and non-ADI financial institutions) to capture a greater share of lending from the major banks as customers place greater emphasis on trust, transparency, affordability, convenience and choice.

However, scale is becoming increasingly critical to remain competitive and deliver value to members. The majority of mutual ADIs are sub-scale. There has been a substantial decline in the number of mutual ADIs over the past five years, with the number falling from 100 in December 2013 to 70 in December 2018. The reduction in the number of mutual ADIs is predominantly a result of mergers. Mergers provide economies of scale and enable investment in technology to enhance the customer experience. The rate of consolidation in the mutual ADI sector had been increasing, from three in FY15, to seven in FY16 and nine in FY17. Although only five mergers were completed in FY18, Grant Samuel is aware of a further five mutual ADI mergers that have been proposed or completed in the first nine months of FY19.

The disparity between the major banks, other domestic banks and mutual ADIs, as well as between the largest and other mutual ADIs, for selected key parameters, is illustrated in the table below:

AUSTRALIAN BANKING SECTOR – KEY PARAMETERS

2018 FINANCIAL YEAR

	MAJOR BANKS	OTHER DOMESTIC BANKS ²⁰	MUTUAL ADIs		
			TOP 10	BALANCE ²¹	OVERALL ²¹
Loan growth	3.1%	4.1%	6.6%	5.7%	6.3%
Net interest margin	2.00%	1.87%	1.95%	2.23%	2.04%
Cost to income ratio	42.2%	58.3%	72.0%	83.4%	76.4%
Cash earnings	\$29.5 billion	\$1.3 billion	\$333.6 million	\$118.8 million	\$452.4 million
Average cash earnings	\$7.4 billion	\$222.9 million	\$33.4 million	\$3.1 million	\$9.4 million
Return on equity	12.5%	8.8%	6.0%	3.8%	5.2%
Loan to deposit ratio	131.9%	124.2%	111.6%	91.5%	104.5%
Capital adequacy ratio	14.8%	13.8%	16.1%	16.9%	16.4%

Source: PwC Major Banks Analysis, November 2018, KPMG Mutuals Industry Review 2018, company annual reports

While consistently high levels of member satisfaction (in excess of 90%) indicate there is a role for mutual ADIs in the Australian banking sector, the table above clearly shows that scale is critical for mutual ADIs to remain sustainable, relevant and competitive over the long term.

²⁰ The other domestic banks included in this analysis are Bendigo & Adelaide Bank, Suncorp Bank, Bank of Queensland, ME Bank, MyState and Auswide Bank.

²¹ Based on an analysis of 48 mutual ADIs, representing over 90% of the mutual ADI sector by total assets and profit before tax.



4 Profile of bcu

4.1 Background

bcu is an Australian ADI regulated by APRA. It was established by a group of banana growers on the New South Wales North Coast in 1970, as The Nambucca Banana Growers’ Federation Members Credit Union, to lend money to other Banana Growers’ Federation members in the region. At 30 June 1971, it had 58 members and assets of \$6,809.

It initially had a common bond of Banana Growers’ Federation members in Nambucca, although this was subsequently extended to cover Banana Growers’ Federation members in other regions along the New South Wales Coast and, in 1975, to residents of those regions, at which time it changed its name to Bananacoast Community Credit Union Ltd. In 2003, it extended its bond area north to the Noosa River in Queensland. The bond was subsequently removed, and bcu now has an open membership.

While the majority of its growth has been organic, bcu has also grown through mergers with other credit unions. In 1985, it merged with Mid North Coast Credit Union (at the request of regulatory authorities due to financial difficulty) and in 2005, it merged with Big River Credit Union.

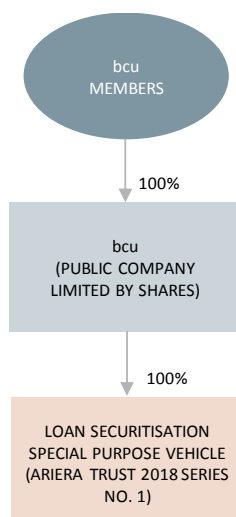
Today, bcu has almost 55,000 members, an asset base of \$1.7 billion and 21 stores extending from the Sunshine Coast in Queensland to Port Macquarie on the New South Wales North Coast. It remains a mutual, member based organisation, focused on local community banking and committed to its original purpose of providing a local alternative to the big banks, delivering leading products and services that meet members’ needs and reinvesting in the local community through a range of sponsorships and donations.

4.2 Structure and Governance

Structure

bcu is an Australian public company limited by shares and is owned by its members. bcu’s corporate structure is summarised below:

bcu – CORPORATE STRUCTURE



Source: bcu

Governance

bcu is overseen by a Board consisting of six non-executive directors. Under its Constitution, bcu’s Board must comprise no less than five directors. Each director holds one bcu redeemable preference share. bcu has three Board committees (covering risk, governance and audit) to assist it in carrying out its responsibilities.



Operational management is provided by the Chief Executive Officer (“CEO”) and nine senior executives responsible for governance and risk, credit, operations, company secretarial, sales and service, marketing, finance, human resources and products.

bcu has approximately 211 employees (199 full time equivalent employees).

4.3 Membership and Member Rights

Membership

bcu has an open membership. Any person is eligible for membership of bcu in accordance with bcu’s Constitution.

Customers (other than other member owned ADIs) must be members. bcu issues members with redeemable preference shares, and can issue only one redeemable preference share to any person, at an issue price of \$10 per share. Redeemable preference shares may be issued as wholly paid or partly paid. In the case of minors, redeemable preference shares are issued as partly paid to \$2. More recently (and in line with other mutual ADIs), bcu has issued redeemable preference shares on which the payment of the issue price has been deferred (i.e. the shares are paid up to nil).

Under its Constitution, bcu is also able to issue other types of shares, being Tier 1 shares²², redeemable capital preference shares²³ and bonus shares²⁴. bcu has never issued any Tier 1 shares or redeemable capital preference shares. It is understood that bcu has historically issued bonus shares, but these shares have subsequently been cancelled.

Membership increased in FY16 and FY17, but has subsequently been in decline. The reasons for the increase and the decline are unclear, although bcu has indicated that the increase may have in part been due to the introduction of Scoot Super Saver bank accounts for children. The decline in FY18 and YTD²⁵ FY19 may reflect the impact of legal actions involving the former bcu CEO. As a result, the current number of members is not materially different to the number of members at June 2016:

bcu - MEMBERSHIP

	AT 30 JUNE				AT 31 MARCH 2019
	2015	2016	2017	2018	
Opening members	53,187	53,228	54,957	56,570	55,817
New members	5,262	5,953	6,291	6,341	4,037
Redeemed members	(5,221)	(4,224)	(4,678)	(7,094)	(5,384)
Closing members	53,228	54,957	56,570	55,817	54,470

Source: bcu

Over the last 4½ years, membership growth has averaged only 0.5% per year. The number of members who have redeemed their redeemable preference share (effectively as a result of no longer being a

²² Tier 1 shares have no right to vote, the right to participate in dividends, an entitlement to repayment of paid up capital and any dividend accrued in the event of a winding up but no entitlement to share in any surplus assets or profits. They rank behind redeemable preference shares for repayment of capital on a winding up and may be redeemed at the option of the holder or bcu in accordance with their terms of issue.

²³ Redeemable capital preference shares have a minimum term of five years and can only be issued to members (with a maximum 10% holding by any one member). They have no right to vote, the right to non-cumulative preferential dividends (except over Tier 1 share dividends), an entitlement to repayment of paid up capital and any dividend accrued in the event of a winding up but no entitlement to share in any surplus assets or profits. They rank behind all creditors including depositors and redeemable preference shares for repayment of capital and the amount of any dividend due but not paid. They are transferable and may be redeemed at the option of the holder or bcu in accordance with their terms of issue.

²⁴ The payment of any dividend can be satisfied wholly or partly by the issue of bonus shares. Bonus shares have an issue price of \$1 and are issued fully paid. They have no voting rights and no entitlement to distribution of income or capital on a winding up or otherwise. They are not transferrable but are transmissible and are redeemable in certain circumstances.

²⁵ YTD is year to date.



customer) has generally been increasing, and in FY18 and YTD FY19, the number of new members has not been sufficient to offset the redeemed members (at 75-90% of redeemed members). This may in part reflect bcu’s demographics, with more than 60% of members over 55 years of age.

bcu has not retained historical records of the number of active members but has estimated that approximately 3,800 current members are dormant members. As a result, active members represent around 93% of total members.

Member Rights

The rights and obligations of bcu members, as set out in the bcu Constitution, are summarised below:

bcu – MEMBER RIGHTS AND OBLIGATIONS

RIGHT/OBLIGATION	COMMENT
Quorum	10 members entitled to vote on a resolution at the meeting (present in person or by proxy)
Appointment of directors	Two members must nominate a candidate A minimum of five directors All directors are elected by members (other than casual vacancies which are appointed by the directors but must be elected by members at the next Annual General Meeting (“AGM”))
Voting	One vote per member (other than a minor) Entitlement to vote by proxy
Dividends	No entitlement to dividends
Redemption	At request of member Entitled to repayment of issue price (\$10) (to the extent that this has been paid up)
Termination/cessation of membership	On expulsion, cancellation for a dormant account ²⁶ , redemption, bankruptcy, winding up or death
Transfer	Shares are not transferable
Transmission	On bankruptcy, winding up or death
Participation in winding up	Liability limited to unpaid amount on share Entitled to repayment of issue price (\$10) (to the extent that this has been paid up) Equal entitlement to any surplus assets On voluntary winding up, members may resolve to transfer any surplus to any company with a mutual structure
Transfer of business	Special resolution (at least 75% of members) where at least 25% of members who have been members for at least 24 months vote
Participation on demutualisation	Must have been a member for at least 12 months (“eligible members”) ²⁷
Requirements for demutualisation	Unless recommended by the directors, demutualisation resolution cannot be put to members if the same or a substantially similar resolution was put and not passed at a meeting held within the prior three years Special resolution (at least 75% of eligible members) where at least 5% of eligible members vote and at least 25% of members who have been members for at least 24 months vote ²⁷

Source: bcu Constitution

4.4 Business Operations and Strategy

Business Operations

bcu provides the following retail banking products and services:

- deposit products:

²⁶ bcu may cancel a member’s share if a member’s only account with bcu is a dormant account.

²⁷ Or for any proposal that is deemed to be a “Demutualisation Resolution” (even if there is no demutualisation under the Corporations Act).

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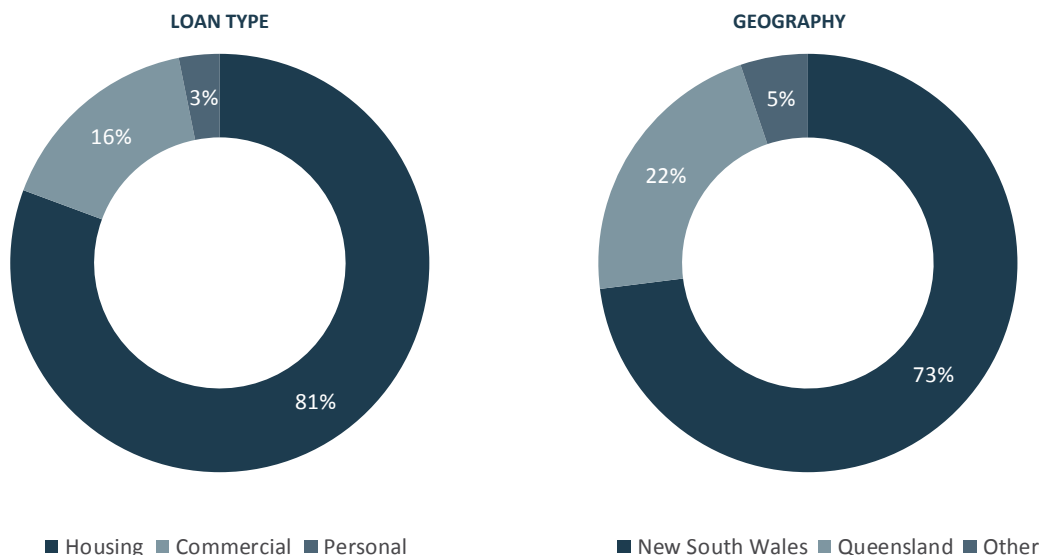


- transaction and savings accounts (personal and business), including products for children 0-12 years (combined transaction and savings account with bonus interest rate) and students 13-24 years (online savings account with high bonus interest rate);
 - term deposits (including farm management deposits for primary producers); and
 - retirement savings accounts (“RSAs”), a low cost, capital guaranteed investment product for superannuation and retirement savings; and
- lending products:
- home loans (owner occupied and investment);
 - commercial loans (SME and property finance); and
 - personal loans (secured, unsecured, car) and credit cards.

The composition of bcu’s loan book (by type of loan and geography) is illustrated below:

bcu – COMPOSITION OF GROSS LOANS AND ADVANCES

AT 30 JUNE 2018



Source: bcu

Although the majority of bcu’s loan book comprises housing loans in New South Wales, there is some diversification provided by the substantial commercial loan book (16% of gross loans and advances at 30 June 2018) and its presence in South East Queensland (22% of gross loans and advances at 30 June 2018). Approximately 25% of housing loan settlements in FY18 were sourced from mortgage brokers (with the balance originated in stores). Mortgage brokers primarily look to bcu for niche lending (e.g. high loan-to-value ratio, self-managed super fund and commercial lending).

bcu collaborated with one of the original sponsors of the NPP, Australian Settlements Limited, to adopt Osko (the payments platform that allows payments to be sent and received in real time using bank account details or PayID) when it launched in February 2018.



bcu also has arrangements in place with third parties to provide to its members:

- insurance products:
 - general insurance (home and contents, landlord, motor, caravan and trailer, boat²⁸), travel insurance²⁹ and consumer credit insurance issued by Allianz Australia Insurance Limited (“Allianz”);
 - life insurance (Ezicover) issued by Zurich Australia Limited (“Zurich”); and
 - lenders’ mortgage insurance issued by Genworth Mortgage Insurance Australia Limited and QBE Insurance (Australia) Limited (“QBE”); and
- foreign exchange services:
 - foreign currency, where bcu acts as a distributor for the Foreign Currency Notes service, which is provided by Travelex Limited (“Travelex”);
 - outward international transfers, where bcu uses AMEX to facilitate transfer of funds between bcu customers and overseas banks; and
 - inward international transfers, where bcu uses an intermediary Australian bank (Westpac, ANZ, CBA or NAB) to facilitate transfer of funds between the overseas bank and bcu via Australian Settlements Limited.

bcu’s distribution system includes:

- a network of 21 stores, with 19 on the New South Wales North Coast and two in South East Queensland (South Brisbane and Maroochydore);
- a contact centre (operating from 9.00am to 5.00pm, Monday to Friday AEST³⁰);
- access to almost 2,700 ATMs across Australia through an agreement that provides members with unlimited fee-free access to Westpac, St George, Bank SA and Coastline ATMs across Australia in addition to 49 bcu ATMs in its local regions³¹; and
- digital platforms including telephone and internet banking, a mobile phone app (bcu Connect App), and ActivePay (a wristband that allows bcu members to tap and go without having to carry a card).

bcu’s banking system and internet banking platform are provided under a long term arrangement with Ultradata Australia Pty Ltd (“Ultradata”) through its *Ultracs* software.

It has a head office co-located with its Coffs Harbour store, and it also has a corporate office in Brisbane.

bcu has received a number of awards in recent years including Money Magazine’s Credit Union of the Year Award in 2016, recognition by Mozo, Canstar and Money Magazine for a number of its product developments in 2017 and Money Magazine’s Best of the Best Gold Award 2019 for Best Kids Savings Account – Non-Bank category.

Community Involvement

bcu has a commitment to ensure that profits are channelled back into the local community and is one of the largest overall donors to local charities, clubs and organisations across its main regions of Port Macquarie, Coffs Coast, Clarence Valley, Northern Rivers and the Sunshine Coast. It supports a variety of

²⁸ In relation to boat insurance, bcu is an agent of Club Marine Limited, an agent of Allianz and a member of the Allianz Group.

²⁹ In relation to travel insurance, bcu arranges this insurance as agent for Allianz. Allianz travel insurance is issued and managed by AWP Australia Pty Ltd trading as Allianz Global Assistance, a member of the Allianz Group.

³⁰ AEST is Australian Eastern Standard Time.

³¹ Although bcu members also have fee-free withdrawal access to CBA, NAB and ANZ ATMs across Australia following the removal of ATM fees by the major banks.

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events, programs and charities on a local and national scale, through a range of youth, sports and community focussed initiatives, including:

- sponsorship of:
 - a number of local events including the bcu Coffs Tri (main sponsor since its inception in 2013), Ride Around the River (major sponsor of annual cycling event) and Scoot for Schools Cup (to encourage primary school students to do something active in their local community and give their schools a chance to win sporting equipment); and
 - the bcu Brand Ambassador program, which offers support to young local individuals who wish to excel in their passions;
- the Bill Ussher Scholarship, an annual award of \$2,000 scholarships to 5-10 student members of bcu (aged 13+ years) and studying full-time at high school, TAFE or university to assist with their education expenses; and
- the *member 2 member* program, where bcu businesses offer discounts, special deals and bonuses to all bcu members. In return, these bcu businesses are promoted to bcu members through bcu stores and online, giving them the opportunity to reach a wider audience, build repeat business and loyalty and attract new customers.

Strategy

bcu is committed to providing member-focused solutions to banking problems and keeping members' interests at the core of its business. Its strategy as a stand-alone entity was most recently considered in early 2018. At this time, in the short term, its focus was to:

- simplify its current product offer and continue to develop products in response to member needs and to support growth in key markets;
- streamline and automate its online loan application and assessment process and deliver mobile banking initiatives to extend/improve the mobile banking experience for members;
- emphasise staff training (core products knowledge, technical skills and sales and service skills) and accreditation (with formal accreditation programs for Store Ambassadors and Personal Lenders) and continue the store visitation program (implemented in January 2018) with the aim of identifying areas of improvement and providing tailored support to staff and management;
- concentrate its marketing initiatives on digital improvements, brand and data (integrity, using technology to drive segmentation and marketing, predictive analytics, machine learning); and
- increase its social media presence (grow Facebook and Instagram followers, establish a Youtube channel, enhance its LinkedIn profile).

More recent Board strategy discussions have focused on the strategic risks and challenges that bcu faces in continuing to provide an attractive banking offer for members. The bcu directors formed the view that bcu does not have the scale as a stand-alone entity to fund the investment required to mitigate these risks. The directors concluded that a merger with another mutual ADI was the most appropriate option to address the strategic challenges and risks. Since mid-2018, bcu's strategy has focused on the process of identifying an appropriate merger partner, undertaking due diligence and agreeing the terms of the Merger.



4.5 Financial Performance

The historical financial performance of bcu for the four years ended 30 June 2018 and the six months ended 31 December 2018 is summarised below:

bcu - FINANCIAL PERFORMANCE (\$ MILLIONS)

	YEAR ENDED 30 JUNE				SIX MONTHS TO 31 DEC. 2018 ACTUAL ³²
	2015 ACTUAL	2016 ACTUAL	2017 ACTUAL	2018 ACTUAL	
Net interest income	37.0	41.9	44.5	47.0	23.3
Other income	8.7	9.4	9.4	10.0	4.5
Net operating income	45.7	51.3	53.9	57.0	27.8
Operating expenses	(34.2)	(36.3)	(37.7)	(39.8)	(21.7)
Impairment loss	(0.7)	(2.4)	(2.6)	(1.4)	0.2
Profit before tax	10.8	12.6	13.6	15.8	6.3
Tax expense	(3.1)	(3.8)	(4.5)	(5.1)	(2.0)
Profit after tax	7.7	8.8	9.1	10.7	4.3
Capital expenditure	0.7	0.8	0.3	1.6	1.3
<i>STATISTICS</i>					
Net interest margin	2.60%	2.83%	2.80%	2.81%	2.75%
Cost to income ratio ³³	74.9%	70.9%	69.9%	69.8%	78.2%
Impairment loss to loans and advances	0.06%	0.18%	0.19%	0.10%	nmc ³⁴
Reported profit after tax margin	16.8%	17.1%	16.9%	18.8%	15.5%
Return on assets ³⁵	0.75%	0.84%	0.86%	0.94%	nc ³⁶
Return on equity	7.3%	7.7%	7.4%	8.0%	nc
Growth in net operating income	+7.9%	+12.0%	+5.3%	+5.7%	nc
Growth in reported profit after tax	+70.1%	+14.1%	+4.1%	+17.3%	nc

Source: bcu and Grant Samuel analysis

bcu has generated an increase in net profit after tax over the past four years, driven by growth in interest bearing assets while maintaining its net interest margin and limiting operational expenditure. Net profit before tax has grown at an average rate of 24% per annum over the past four years (and at almost 12% per annum over the past three years).

The substantial growth achieved in FY15 was primarily the result of flat operating expenses (which resulted in a substantial decline in the cost to income ratio), in particular a reduction in occupancy expenses following termination of leases relating to bcu's store network. Growth in FY16 came from a combination of strong loan growth and an increase in the net interest margin due to a change in the mix of lending products and a reduction in the size and mix of the funding pool, resulting in a further reduction in the cost to income ratio. The net interest margin and the cost to income ratio have remained relatively stable over the period from FY16 to FY18.

Calculation of some ratios (i.e. net interest margin and cost to income ratio) has been impacted by changes to the classification of certain expense items that were previously netted against income but in FY17 and FY18 were classified as costs or costs that are being deferred in line with accounting policies.

³² bcu's financial performance for the six months ended 31 December 2018 is unaudited.

³³ Cost to income ratio is calculated as operating expenses divided by net operating income.

³⁴ nmc = not a meaningful calculation.

³⁵ Return on assets is calculated as net profit before tax divided by average total assets.

³⁶ nc = not calculated.



Factors to consider in assessing bcu's financial performance include:

- the relatively high net interest margin reflects the impact of bcu's substantial commercial loan portfolio which generates higher yields than its housing loan portfolio;
- other income, while generally increasing over the past four years, has fallen from 19% of net operating income in FY15 to 17% in FY18. Other income is primarily banking fee income (\$4.5 million in FY18) and mortgage servicing income (\$5.0 million in FY18). Transactional banking fees have been relatively flat over the past four years despite growth in loans and deposits as bcu has passed additional benefits to members;
- operating expenses have increased at an average rate of 3.4% per annum over the past four years. Around 45% of operating expenses are employment related, with fees and commission expenses³⁷, technology and communications and occupancy being the other major costs. Increases in operating expenses have been incurred in product development and achieving the optimum product mix, improving systems, processes and distribution channels for bcu's products, adapting to changes from advancements in technology and meeting regulatory requirements. The \$2.1 million increase in operating expenses in FY18 was in part due to an increase in professional fees associated with addressing queries from regulators and defending and bringing legal actions on behalf of bcu. Employment related expenses have only increased at an average rate of 1.7% per annum over the past four years, reflecting a slight reduction in the average number of employees combined with minimal increases in salaries over this period (albeit employee numbers have increased by over 20% in the last 18 months as bcu has invested substantially in its digital, IT, projects and other back office teams following a change in CEO in October 2017);
- impairment losses have been low at less than 0.2% of loans and advances (including provisions for business loans). The decline in the ratio in FY18 was the result of a decrease in the provision prescribed for regulatory purposes which more than offset additional specific provision³⁸ while the collective provision³⁹ was unchanged; and
- return on assets and return on equity have been relatively consistent over the past four years at around 0.8-0.9% and 7-8% respectively.

bcu's performance declined in 1HY19⁴⁰, although this was primarily a result of incurring costs associated with the Merger (which resulted in the cost to income ratio increasing from 69.8% to 78.2%). bcu has contained growth in non-Merger related operating expenses over the half year period. There was also a deterioration in the net interest margin (from 2.84% to 2.75%), as lending to high yielding self-managed super funds and property development was limited for regulatory and strategic positioning purposes respectively. The positive impairment loss represents recovery of a doubtful debt provision after selling the repossessed asset.

bcu's FY19 financial performance is not available at the date of this report. However:

- bcu expects the second half of FY19 to be stronger than 1HY19, with net profit after tax of approximately \$11 million forecast for FY19; and
- bcu will make the FY19 financial performance available to bcu members at least two weeks prior to the general meeting to consider the Merger Resolution and bcu members will be given the opportunity to consider and ask questions in relation to the FY19 financial performance.

³⁷ Fees and commission expenses relate to the arrangements with mortgage brokers to assist with the distribution of loan products. These costs increased considerably in FY17 and FY18 as a greater proportion of loans were sourced from mortgage brokers.

³⁸ The specific provision is recognised for loans that have defaulted.

³⁹ The collective provision is recognised on an expected basis for defaults that have not yet been reported or identified and for general deterioration in the loan portfolio.

⁴⁰ 1HY19 is the six months ended 31 December 2018.



bcu has historically spent very little on capital expenditure (plant and equipment and computer software), investing a total of \$4.7 million over the past 4½ years and around \$1 million per annum on average. This in part reflects its limited capacity for investment as well as its policy to expense, rather than capitalise, certain technology expenditure as it is incurred (approximately 35% of the annual spend is expensed). Approximately 50% of bcu’s annual investment spend is for business as usual expenditure (rather than innovation). Over half of the total capital expenditure over the past 4½ years was spent in FY18 and 1HY19 following the change in CEO, as the current CEO and management have focused on investing in new technology (NPP, ActivePay and an improved version of the bcu Connect App). In 1HY19, bcu invested in fit out for its new Coffs Harbour head office.

Overall, while bcu has achieved growth in its performance over the past four years, this has largely been achieved by being focused on the short term rather than the long term, as well as not investing in key areas such as wages and digital/information technology (“IT”). Although there has been a change in focus and an improvement in financial performance in FY18 following the change in CEO, bcu is expecting only a steady performance in FY19.

4.6 Financial Position

The financial position of bcu at 30 June 2015 to 2018 and at 31 December 2018 is summarised below:

bcu - FINANCIAL POSITION (\$ MILLIONS)

	AT 30 JUNE				AT 31 DEC.
	2015 ACTUAL	2016 ACTUAL	2017 ACTUAL	2018 ACTUAL	2018 ACTUAL ⁴¹
Cash and financial assets	239.0	197.1	231.7	265.2	279.5
Loans and advances	1,204.7	1,306.5	1,400.2	1,414.2	1,393.3
Property, plant and equipment	10.1	11.1	10.2	10.1	10.7
Intangible assets	0.4	0.2	0.1	0.7	0.8
Other assets	8.5	8.2	8.3	10.1	11.8
Total assets	1,462.6	1,523.1	1,650.5	1,700.4	1,696.1
Deposits	(1,304.5)	(1,360.9)	(1,479.7)	(1,543.4)	(1,542.6)
Borrowings	(35.5)	(29.8)	(25.5)	-	-
Other liabilities	(13.4)	(13.1)	(16.7)	(17.9)	(10.1)
Total liabilities	(1,353.4)	(1,403.8)	(1,522.0)	(1,561.2)	(1,552.7)
Net assets	109.2	119.3	128.4	139.1	143.4
<i>STATISTICS</i>					
<i>Growth in loans and advances</i>	+4.1%	+8.4%	+7.2%	+1.0%	-1.5%
<i>Growth in total assets</i>	+3.1%	+4.1%	+8.4%	+3.0%	-0.3%
<i>Growth in deposits</i>	+3.2%	+4.3%	+8.7%	+4.3%	-0.1%
<i>Loan to deposit ratio</i>	92.4%	96.0%	94.6%	91.6%	90.3%
<i>Growth in net assets</i>	+7.6%	+9.3%	+7.6%	+8.3%	+3.1%
<i>Capital adequacy ratio</i>	13.4%	13.3%	13.8%	14.8%	15.2%

Source: bcu and Grant Samuel analysis

At 31 December 2018, bcu had total loans and advances of \$1.4 billion. Growth in loans and advances has been mixed, exceeding system growth in FY16 and FY17, but falling below system growth in FY15, FY18 and 1HY19⁴². Home loans represent approximately 80% of the total loan portfolio by value. Growth in loans and advances in FY18 was impacted by a decline in business and personal loans. Housing loans grew by

⁴¹ bcu’s financial position at 31 December 2018 is unaudited.

⁴² System growth (i.e. growth across all ADIs) for loans and advances was 7.9% in FY15, 4.9% in FY16, 4.8% in FY17, 4.0% in FY18 and 2.7% in 1HY19.



2.6% in FY18 (compared to system growth of 4.1%). The \$21 million decline in loans and advances in 1HY19 reflects reduced home lending activity across bcu's geographical regions (from regulatory restrictions on investor loans) as well as the decision made during FY17 to reduce exposure to inner Brisbane high-density residential property development loans and the run-off of this portfolio. Average annual growth in loans and advances over the past 4½ years has been below system growth at 4.2% (compared to average annual system growth of 5.4%).

bcu is currently funded entirely by retail deposits, having elected to repay its \$5.5 million of subordinated debt in FY16 to move to funding on more favourable terms and capital treatment and buying back the \$25.5 million of loans and advances in the Trinity Mortgage Origination Trust in FY18 (and transferring them to Ariera Trust 2018 Series No.1⁴³). Growth in deposits has generally exceeded system growth (except in FY15 and 1HY19)⁴⁴. Deposits were flat in 1HY19 (relative to FY18) due to a business decision to hold surplus liquidity (which has been reduced subsequent to 31 December 2018). Average annual growth in deposits over the past 4½ years has been 4.5%, consistent with average annual system growth of 4.4%.

Property, plant and equipment includes land and buildings which, at 31 December 2018, had a book value of \$9.0 million. Intangible assets represents bcu's investment in computer software (in addition to IT costs that are expensed). Capitalised computer software costs are amortised over three years.

bcu is well capitalised with a total capital adequacy ratio well in excess of APRA's minimum prudential capital requirement of 8%. Its Common Equity Tier 1 ("CET1") ratio at 31 December 2018 was 14.1%, which is also well above APRA's "unquestionably strong" benchmark CET1 ratio of 10.5% that bcu is required to meet by January 2020.

bcu's financial position at 30 June 2019 is not available at the date of this report. However, bcu will make the 30 June 2019 financial position available to bcu members at least two weeks prior to the general meeting to consider the Merger Resolution and bcu members will be given the opportunity to consider and ask questions in relation to the 30 June 2019 financial position.

⁴³ As bcu retains substantially all the risks and rewards of ownership of the relevant loans and advances in the Ariera Trust 2018 Series No. 1, bcu continues to recognise the transferred assets within loans and advances and the transfer is accounted for as a secured financing transaction. The Ariera Trust 2018 Series No. 1 has been established to support the ongoing liquidity management at bcu.

⁴⁴ System growth for deposits was 6.2% in FY15, 3.7% in FY16, 6.0% in FY17, 1.5% in FY18 and 2.2% in 1HY19.



5 Profile of P&N Bank

5.1 Background

P&N Bank is an Australian ADI regulated by APRA. It was established in Western Australia in 1990 as Police & Nurses Credit Society Limited (“P&N Credit Society”) following the merger of the Western Australian Police Union Cooperative Credit Union Society Ltd (which had been established in 1969 and merged with the MTT Salaried Officers Association Credit Union in 1981) and the Western Australia Nurses Credit Society Ltd (established in 1972).

Membership initially had a common bond of Western Australian police (which was extended to members of the army, air force and navy following the merger with the MTT Salaried Officers Association Credit Union) and Western Australian nurses. This bond was subsequently extended to those employed in (or retired from) the wider healthcare, education and government sectors. While this common bond remains in P&N Bank’s Constitution, membership is no longer limited to these categories and P&N Bank essentially has an open membership.

In 2001, P&N Credit Society merged with Energy Credit Union Limited, which was itself the amalgamation of a number of smaller Western Australian credit unions (including ABC Credit Union (WA) Limited, Australian Manufacturing Workers Credit Union Limited and WA Fire Brigades Employees Credit Union Society Limited). In March 2013, after obtaining regulatory and member approval, P&N Credit Society became a mutual bank, Police & Nurses Limited (trading as “P&N Bank”).

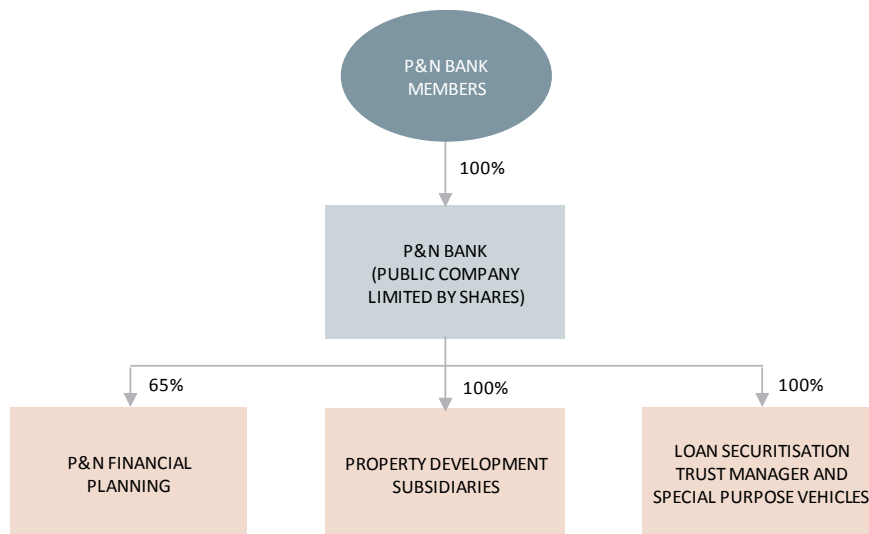
Today, P&N Bank is the only locally domiciled mutual ADI in Western Australia. It has almost 95,500 members, an asset base of \$4.2 billion and 15 branches (plus a contact centre in Perth’s CBD⁴⁵). P&N Bank’s purpose is to enrich the lives of its members by providing them with a superior banking experience and supporting their local communities.

5.2 Structure and Governance

Structure

P&N Bank is an Australian public company limited by shares and is owned by its members. P&N Bank’s simplified corporate structure (excluding dormant companies and companies in the process of being wound up) is summarised below:

P&N BANK – SIMPLIFIED CORPORATE STRUCTURE



Source: P&N Bank

⁴⁵ CBD means Central Business District.



P&N Bank holds a controlling 65% interest in Police & Nurses Financial Planning Pty Ltd (“P&N Financial Planning”), with the remaining 35% interest owned by Bridges Financial Services Pty Ltd (“Bridges”) (part of Australian Securities Exchange-listed IOOF Holdings Limited). P&N Bank and Bridges jointly acquired P&N Financial Planning in 2002, and the relationship between the shareholders is governed by a shareholders’ agreement.

The majority of P&N Bank’s property investments are in the process of being wound up and sold, consistent with P&N Bank’s decision to exit non-core businesses. The only remaining operating subsidiary is P&N Landreach Pty Ltd, an entity used to hold the land and property assets acquired for development and sale.

P&N Management Pty Ltd is a wholly owned subsidiary of P&N Bank that is the trust manager of securitisation special purpose vehicles for loans originated from P&N Bank. At 31 December 2018, securitised loans under management by P&N Bank amounted to \$1.2 billion and are held through five trusts. Each of the trusts is consolidated.

Governance

P&N Bank is overseen by a Board consisting of nine directors, eight non-executive directors and one executive director (the CEO, Mr Andrew Hadley). Under its Constitution, P&N Bank’s Board can comprise a maximum of 10 directors, being no more than six member elected directors (provided that the Board always comprises a majority of member elected directors), no more than three board appointed directors and, if the Board determines, the P&N Bank CEO.

Each director must be a member and hold one P&N Bank member share.

P&N Bank has three Board committees (covering audit, risk, and Board governance and remuneration) to assist it in carrying out its responsibilities. It also has a Nominations Committee to assist in conducting “fit and proper” assessments of re-nominating directors and candidates nominating for election as a director. None of the three members of the Nominations Committee are employees of P&N Bank.

Operational management is provided by the CEO and seven senior executives responsible for finance, risk, people & culture, member experience, IT, strategy & development and business transformation.

P&N Bank has approximately 350 employees.

5.3 Membership and Member Rights

Membership

P&N Bank has an open and voluntary membership within a common bond. Although the common bond set out in P&N Bank’s Constitution refers to police officers, nurses, persons employed in the health industry, teachers and prison officers, it also has a catch-all provision covering “any individual who intends to contribute to and benefit from membership” of P&N Bank. The common bond also extends to members of another ADI that transfers its business and members to P&N Bank under the Transfer Act.

Although P&N Bank is effectively no longer a bonded credit union, approximately one third of members are from the police, health, corrective services, defence, education and government sectors.

P&N Bank can only issue member shares and mutual equity interests⁴⁶. Mutual equity interests carry no voting rights, but may be entitled to payment of dividends. P&N Bank has not issued any mutual equity interests to date.

Customers (other than other ADIs and minors) must be members. P&N Bank can issue only one member share to any person, in return for payment of the issue price of \$10. Member shares may be issued as

⁴⁶ Mutual equity interests are equity interests which may be issued by P&N Bank to subscribers where such instruments have been issued to qualify as regulatory capital in accordance with *Prudential Standard APS 111 “Capital Adequacy: Measurement of Capital”* as published by APRA.

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wholly paid or partly paid. More recently (and in line with other mutual ADIs), P&N Bank has issued member shares on which the payment of the issue price has been deferred (i.e. the shares are paid up to nil).

Membership has grown steadily over the past 4¾ years, reflecting P&N Bank’s focus on providing a superior banking experience, in particular its focus on digital and attracting a younger generation of members:

P&N BANK - MEMBERSHIP

	AT 30 JUNE				AT 31 MARCH 2019
	2015	2016	2017	2018	
Opening members	75,710	78,693	83,138	88,192	92,107
New members	6,352	7,585	7,875	7,218	5,783
Redeemed members	(3,369)	(3,140)	(2,821)	(3,303)	(2,437)
Closing members	78,693	83,138	88,192	92,107	95,453

Source: P&N Bank

Over the last 4¾ years, membership growth has averaged 5.0% per year. While the number of members who have redeemed their member share (effectively as a result of no longer being a customer) has been declining, it increased in FY18 and in the nine months ended 31 March 2019 (on an annualised basis), although only back to the FY15 level and as a result of one off member remediation measures. The number of new members each year has more than offset the redeemed members (at 190-280% of redeemed members). P&N Bank’s product and service offering has attracted a younger demographic. Approximately 20% of P&N Bank’s customers are 25 years old or younger (with 46% in the 26-54 years age group and 34% 55 years and older).

At 31 March 2019, P&N Bank had 95,891 customers. P&N Bank has a greater number of customers than members as there are some customers who hold an account but who do not hold a member share (e.g. children who hold a “way cool saver” are customers but do not hold a member share).

Member Rights

The rights and obligations of P&N Bank members, as set out in the P&N Bank Constitution, are summarised below:

P&N BANK – MEMBER RIGHTS AND OBLIGATIONS

RIGHT/OBLIGATION	COMMENT
Quorum	25 members present in person or 50% of members eligible to attend and vote if less than 50 members are eligible to attend and vote at a meeting
Appointment of directors	Four members who have been members for 12 months or more have the right to nominate a candidate Nominations Committee determines whether person becomes a candidate (based on “fit and proper” assessment) No more than six member elected directors (out of a maximum of 10, with up to three appointed by the Board plus, if the Board determines, the CEO), provided that there is always a majority of member elected directors
Voting	One vote per member (other than a minor) Entitlement to vote by proxy (where vote is by poll)
Dividends	Right to participate in any dividend only if approved at general meeting of members Each member share has equal right to participate in dividends with every other member share
Redemption	At request of member Entitled to repayment of issue price (\$10) less any amount unpaid on the member share
Termination/cessation of membership	On redemption (at member’s request or by P&N Bank if accounts are dormant/member is inactive or on Board resolution), forfeiture or surrender On death, bankruptcy or mental incapacity of member



P&N BANK – MEMBER RIGHTS AND OBLIGATIONS (CONT)

RIGHT/OBLIGATION	COMMENT
Transfer	Member shares are not transferable
Transmission	On death (to a personal representative or a person entitled), bankruptcy (to trustee of the bankrupt member’s estate) or mental incapacity (to a person entitled) of member
Participation in winding up	Liability limited to unpaid amount on member share Repayment of issue price (\$10) less any amount unpaid on the member share Each member share has equal entitlement to any surplus assets
Participation on demutualisation	Must have been a member for not less than two years
Requirements for demutualisation	Special resolution (75%) where at least 25% of members vote (by postal ballot)

Source: P&N Bank Constitution

While P&N Bank’s Constitution does give holders of member shares the right to participate in any dividend that P&N Bank pays, as far as P&N Bank management is aware, no dividends have ever been paid by P&N Bank.

5.4 Business Operations and Strategy

Business Operations

P&N Bank provides the following products and services:

- retail banking, including:
 - deposit products:
 - transaction and savings accounts, including products for children 0-15 years (savings account that earns interest on balances up to \$5,000), students 16-25 years (transaction account with unlimited free transactions) and a retirement account for over 55 year olds (with a competitive interest rate, card access and optional *&Retirement and Rewards* products); and
 - term deposits; and
 - lending products:
 - home loans (owner occupied, investment and interest only);
 - personal loans (secured, unsecured, car) and credit cards; and
 - commercial (property finance) loans⁴⁷; and
- financial planning services through P&N Financial Planning. P&N Financial Planning has approximately 1,100 clients and \$400 million of funds under advice.

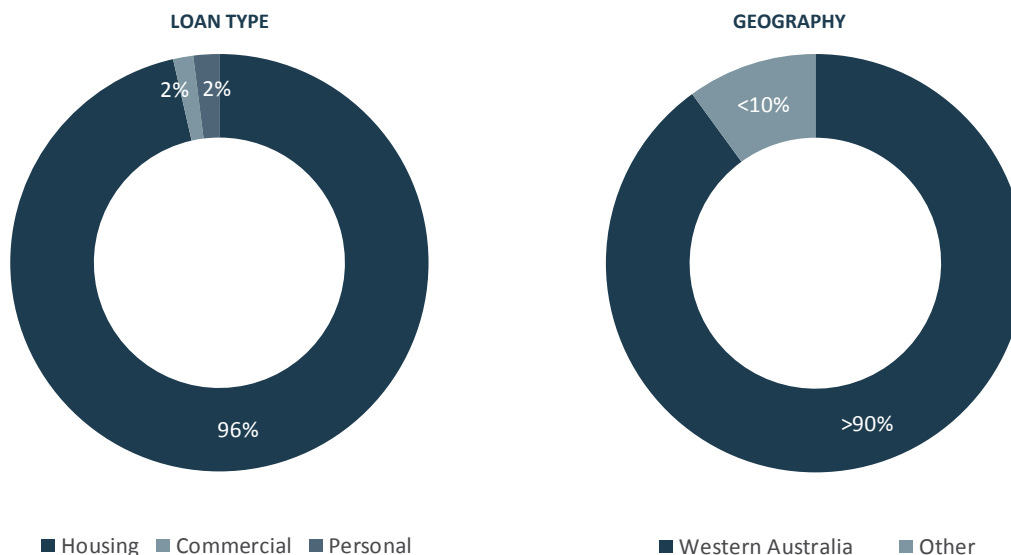
⁴⁷ Although this business is in the process of being wound down.



The composition of P&N Bank’s loan book (by type of loan and geography) is illustrated below:

P&N BANK – COMPOSITION OF GROSS LOANS AND ADVANCES

AT 30 JUNE 2018



Source: P&N Bank (note that composition of loan book by geography is based on estimates provided by P&N Bank management)

P&N Bank’s loan book is concentrated in housing loans in Western Australia (and within Western Australia, management estimates that more than 90% of loans are in the Perth region). P&N Bank management estimates that P&N Bank has a share of approximately 1-3% of the Western Australian home loan market and, consequently, has considerable organic growth potential in addition to any inorganic growth opportunities.

P&N Bank has a significant reliance on mortgage brokers, with approximately 50% of housing loan settlements in FY18 sourced from mortgage brokers. Mobile bankers and branches were each responsible for 25% of housing loan origination.

P&N Bank has invested heavily across its business to improve the member experience, delivering technological advances in the areas of:

- digital capability (to offer members the best possible online and mobile experience); and
- operational robotic processes (that save staff time allowing them to focus on more value adding interactions with members).

In FY16, P&N Bank was one of the first banks in Australia to offer members the convenience of all three digital wallets (Apple Pay™, Samsung Pay and Google Pay™)⁴⁸. In FY18, it was one of the first banks to adopt NPP technology to enable members to make and receive instant payments (via Osko and PayID) and was the first bank in Australia to offer an instant digital card for new debit cards and instant replacement of a lost or stolen debit or credit card. P&N Bank is continuing to develop banking solutions to remove more of the “pain points” that come with outdated banking technologies.

It also has arrangements in place with third parties to provide to its members:

- insurance products:
 - general insurance (home and contents, car, travel, loan protection, boat, caravan, motorcycle) issued by QBE; and

⁴⁸ A digital wallet is an app that stores credit card or debit card information. It can be used to make contactless payments using a smartphone as well as for online shopping.



- life insurance (Ezicover) issued by Zurich; and
- international payments services:
 - foreign currency, where Travelex supplies foreign cash and arranges for the issue of traveller’s cheques on behalf of American Express Travel Related Services Company Inc;
 - international transfers, which are provided by Western Union Business Solutions (Australia) Pty Ltd, an operating division of the Western Union Company (“Western Union”); and
 - Mastercard cash passport (a multi-currency debit card), which is arranged by Mastercard Prepaid Management Services Australia Pty Ltd in conjunction with the issuer, Heritage Bank Limited.

P&N Bank’s distribution system includes:

- a network of 15 branches, 13 of which are located in the city of Perth, covering the region from Rockingham (40 kilometres south west of the Perth CBD) to Mindarie (36 kilometres north of the Perth CBD) with one branch in each of Bunbury and Mandurah;
- a contact centre in Perth (operating from 8.00am to 6.00pm Monday to Friday and 9.00am to 5.00pm Saturday WST⁴⁹);
- a team of seven mobile home loan specialists covering the central, northern, southern and eastern suburbs of Perth; and
- digital platforms including online web chat (which is available from 8.00am to 6.00pm Monday to Friday WST) online banking, a mobile banking app, all three digital wallets and instant digital cards.

P&N Bank’s banking system and internet banking platform are provided under a long term arrangement with Data Action Pty Ltd (“Data Action”).

It has a head office located in Perth.

P&N Bank is progressively winding down its non-core businesses. The Jacaranda Gardens Retirement Village was sold in May 2018. “The Enclave” at Eagle Bay joint venture was dissolved in June 2018. P&N Bank’s only remaining material property asset is a receivable from Pindan Capital Two Rocks Pty Ltd as trustee for the Pindan Capital Two Rocks Trust (“Pindan Group”) (see Section 5.6 for details).

P&N Bank has won a number of awards, including the Australian Banking + Finance Lending Award for Best Mutual in 2017 and 2018. Most recently, it has been awarded the 2018/19 AIM WA Pinnacle Curtin University Innovation Excellence Award, a Canstar 2019 Innovation Excellence Award (for its instant digital cards) and one of nine 2019 Mozo Experts Choice Awards for Best Banking App.

It also achieves strong results for member satisfaction and advocacy, generally ranking in the top five banks in the Roy Morgan Best Bank Customer Satisfaction Monitor over the past four years. At April 2019, P&N Bank had a net promoter score of +56, which is particularly high for the banking category and demonstrates high member advocacy.

Community Involvement

Community support is an essential part of P&N Bank’s member proposition. Its key areas of involvement are:

- community partnerships in the areas of:
 - mental health, through *Lifeline WA* (suicide prevention and crisis support); and
 - youth/children, through *The Fathering Project* (the importance of fathers in a child’s life and how fathers can connect with and encourage their children) and *Variety WA* (sick, disadvantaged and special needs children).

P&N Bank provides funding and other assistance to these organisations;

⁴⁹ WST is Western Standard Time, which is two hours behind AEST.

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- sponsorship programs, where P&N Bank supports a number of community groups and organisations including the Nine News WA Police Excellence Awards, the WA Nursing & Midwifery Excellence Awards and Crime Stoppers WA. P&N Bank is also an official membership partner of the Perth Wildcats basketball team;
- *Helping &ands* program, which provides assistance to individuals, families and not-for-profit groups nominated by members as needing support; and
- *Flourish @ work*, a volunteer program that allows staff to be involved in community work and support causes that are important to them.

Strategy

P&N Bank’s FY15-FY19 strategy is centred around its purpose, vision and values:

PURPOSE	VISION	VALUES
To enrich the lives of members and their communities	To be recognised as the Western Australian challenger brand in retail financial services, doubling the size of the business by 2020	Focus on members Improve and learn Trust and collaborate

P&N Bank aims to achieve these goals by delivering on its member value proposition – the reason why people should bank with P&N Bank and what sets it apart from its competitors in terms of:

- **people** – providing a unique support model that delivers the members’ voice and true relationship banking;
- **product** – products designed to offer choice, flexibility, simplicity and reward for loyalty;
- **place** – physical and online destinations that are more like meeting places than traditional banking branches; and
- **presence** – identifying ways to make the community stronger through donations, volunteering and the championing of important causes.

P&N Bank is in the final year of its five year strategic plan that commenced in FY15 and focused on three strategic themes, building member value, improving organisational effectiveness and partnering for growth. FY16 saw a brand refresh (“*The Power of &*”) and the roll out of new and improved products, public website and community platform. It also focused considerable effort on building an efficient and scalable lending origination capability. P&N Bank expects to continue to invest in its digital platforms as customer expectations and needs change.

With these foundations in place, P&N Bank then re-focused its strategy on the member experience and delivering on its core purpose to enrich the lives of members and their communities. Five key strategic themes were developed to deliver a differentiated experience and meet members’ expectations of a modern banking experience:

- **mobile-first banking.** An improved digital self-serve capability was executed in partnership with P&N Bank’s key technology partners, Data Action and Cuscal Limited (“Cuscal”). Major outcomes included the release of mobile payment wallets (delivered in partnership with Cuscal) and Australia’s first instant digital cards (delivered in partnership with Data Action);
- **grow deep relationships.** P&N Bank has invested in its ability to acquire new members, identify and fix “pain points” and provide a more tailored and personalised experience for its members to build loyal members who see P&N Bank as their primary financial institution;
- **digital end-to-end.** A key focus has been to streamline the application process for financial service products such as basic deposit accounts and consumer finance products, which are increasingly being



sold online. This has included investing in robotic process automation, which reduces the need for manual work, reduces risk and improves the member experience through faster turnaround times;

- **optimise its economics.** This stream has focused on P&N Bank’s transaction banking and payments capability and the shift to CCR, with a view to improving its return on assets in light of capital constraints and while continuing to deliver on its regulatory obligations; and
- **build collaboration platforms.** P&N Bank has improved its internal and external collaboration capabilities to bring differentiated experiences to its members. Internally, it has invested in technology platforms to support new ways of working. Externally, it is increasingly focused on open banking and the opportunities this brings to help members through improved insights into their financial wellbeing.

5.5 Financial Performance

The historical financial performance of P&N Bank for the four years ended 30 June 2018 and the six months ended 31 December 2018 is summarised below⁵⁰:

P&N BANK - FINANCIAL PERFORMANCE (\$ MILLIONS)

	YEAR ENDED 30 JUNE				SIX MONTHS TO 31 DEC. 2018 ACTUAL ⁵¹
	2015 ACTUAL	2016 ACTUAL	2017 ACTUAL	2018 ACTUAL	
Net interest income	64.6	69.1	65.6	68.1	34.4
Other bank income	14.9	16.0	17.7	19.8	8.9
Bank net operating income	79.5	85.0	83.3	87.9	43.3
Bank operating expenses	(64.1)	(67.6)	(64.4)	(67.6)	(34.9)
Impairment loss	(2.3)	(3.0)	(3.6)	(3.3)	-
Bank profit before tax	13.1	14.5	15.4	17.0	8.4
Bank tax expense	(2.9)	(3.9)	(4.3)	(4.8)	(2.5)
Bank profit after tax	10.2	10.6	11.1	12.2	5.9
Other activities (net of tax and non-controlling interest)	(0.9)	(2.0)	-	(0.1)	0.1
Profit after tax attributable to members	9.3	8.5	11.1	12.1	6.0
Capital expenditure	5.0	3.7	4.5	2.8	1.0
STATISTICS					
<i>Net interest margin</i>	2.18%	2.06%	1.81%	1.82%	1.69%
<i>Bank cost to income ratio</i>	80.6%	79.5%	77.3%	77.0%	80.6%
<i>Impairment loss to loans and advances</i>	0.09%	0.09%	0.11%	0.09%	0.00%
<i>Bank profit after tax margin</i>	12.8%	12.4%	13.3%	13.8%	13.7%
<i>Bank return on assets</i>	0.45%	0.43%	0.40%	0.42%	nc
<i>Bank return on equity</i>	4.3%	4.2%	4.2%	4.4%	nc
<i>Growth in net operating income</i>	+5.3%	+7.0%	-2.0%	+5.5%	nc
<i>Growth in bank profit after tax</i>	+14.7%	+3.7%	+5.0%	+9.6%	nc

Source: P&N Bank and Grant Samuel analysis

Bank operating performance excludes P&N Bank’s financial planning and specialised property activities. The specialised property activities have been loss making over the past 4½ years and while their overall contribution to P&N Bank’s consolidated performance has been minimal (particularly post FY16, as P&N

⁵⁰ P&N Bank’s FY19 financial performance is not available at the date of this report.

⁵¹ P&N Bank’s financial performance for the six months ended 31 December 2018 is unaudited.



Bank has wound down its specialised property activities), they distort the underlying performance of P&N Bank's banking operations.

P&N Bank has reported steady growth in underlying bank profitability over past four years despite a relatively flat Western Australian housing market. The higher growth in bank net profit after tax in FY15 reflected material tax offsets (reducing the effective tax rate in FY15 to 22%). FY15 and FY16 were the initial years of a five year strategic plan under which P&N Bank focused on investing across its business, including a brand refresh. P&N Bank has subsequently shifted its focus to identifying opportunities to create scalability and growth. Bank net profit before tax has grown at an average rate of 9% per annum over the past four years.

Calculation of some ratios (i.e. net interest margin and cost to income ratio) and FY17 growth rates has been impacted by changes to the classification of income and expenses relating to securitised loans which has resulted in a reduction in net interest income and operating expenses and an increase in other income in FY17 and FY18 (relative to prior years). This change is largely responsible for the decline in net interest margin and the bank cost to income ratio as well as the fall in net operating income in FY17.

Factors to consider in assessing P&N Bank's financial performance include:

- there has been a consistent tightening in the net interest margin over the period from FY15 to FY17 (even allowing for the change in treatment of securitised loans in FY17, with the restated FY16 net interest margin at 2.01%), although it has stabilised in FY18. P&N Bank's lower net interest margin relative to bcu reflects the impact of securitisation funding (which represents around 11% of total funding), as well as larger retail term lending and its concentration on lower return (i.e. lower risk) housing loans;
- while other income has increased over the past four years and represents an increasing proportion of net operating income (19% in FY15 to 23% in FY18), this is primarily a result of the change in treatment of, and growing fee income from, securitised loans. Other income is primarily other fees and commissions (which includes financial services fees, securitisation servicing fees and insurance commissions) (\$13.8 million in FY18) and transactional banking fees (\$2.6 million in FY18). Transactional banking fees and commissions have generally declined over the past four years as P&N Bank has removed or reduced certain financial services fees;
- operating expenses have increased at an average rate of 2.3% per annum over the past four years. Around 45% of operating expenses are employment related, with fees and commission expenses, technology and communications and occupancy being the other major costs. Employment related expenses have increased at an average rate of 2.3% per annum over the past four years (consistent with the average annual increase in total operating expenses), but the majority of this increase was in FY15, with employment related expenses relatively flat over the past three years (average annual increase of only 0.8%) as P&N Bank has focused on controlling costs. This has resulted in a steady decline in the bank cost to income ratio over the past four years. P&N Bank's bank cost to income ratio is considerably higher than bcu's cost to income ratio (by around 7 percentage points). Management of P&N Bank has indicated that this reflects its investment in the business as part of its strategic plan and it has acknowledged that the business is "cost heavy" (particularly taking into account P&N Bank's 15 branches relative to bcu's 21 stores) as well as its policy to expense a significant proportion of its innovation expenditure and amortise its capitalised investment spend over a period of three years;
- impairment losses have generally been very low, at or around 0.1% of loans and advances (and lower than impairment losses for bcu at around 0.2%) reflecting P&N Bank's concentration in housing loans; and
- bank return on assets and bank return on equity have been relatively consistent over the past four years at around 0.4% and 4% respectively (albeit at around half the level of bcu's return on assets and return on equity).



Subsequent to 30 June 2018, P&N Bank entered into a new 10 year leasing arrangement for its head office in Perth with a total commitment (over the 10 year period) of approximately \$24.1 million.

P&N Bank's bank performance declined in 1HY19, although, similar to bcu, this was primarily a result of incurring costs associated with the Merger (which resulted in the cost to income ratio increasing from 77.0% to 80.6%). There was also a deterioration in the net interest margin (from 1.82% to 1.69%), reflecting increased competition as well as the launch of P&N Bank's *&Intro* home loan at a 3.55% interest rate (compared to the basic home loan interest rate of 3.99%).

As a result of its lower net interest margin and higher bank cost to income ratio, P&N Bank's bank net profit after tax has been, on average, around 20% higher than bcu's net profit after tax, despite being 2.5 times the size of bcu (based on total bank assets). After allowing for the losses from P&N Bank's other activities (in particular, its specialised property activities that are in the process of being wound down), the difference has been lower although this is not as relevant in more recent years.

P&N Bank has invested considerably more in capital expenditure (on plant and equipment and computer software) than bcu, spending a total of \$17.0 million over the past 4½ years and \$3.8 million per annum on average (not far below bcu's total capital expenditure over the past 4½ years of \$4.7 million). Over the past 2-3 years, this expenditure has included significant investment in P&N Bank's digital footprint as well as regulatory projects. In 1HY19, P&N Bank has invested in fit out for its new head office, including an upgrade of its core infrastructure.

P&N Bank's annual IT budget (capitalised and expensed) is approximately \$8-9 million (including staff costs), \$2 million of which is spent on digital projects.

5.6 Financial Position

The financial position of P&N Bank at 30 June 2015 to 2018 and at 31 December 2018 is summarised below⁵²:

P&N BANK - FINANCIAL POSITION (\$ MILLIONS)

	AT 30 JUNE				AT 31 DEC. 2018 ACTUAL ⁵³
	2015 ACTUAL	2016 ACTUAL	2017 ACTUAL	2018 ACTUAL	
Cash and financial assets ⁵⁴	354.7	550.3	585.5	575.3	630.7
Loans and advances	2,616.1	3,164.0	3,374.8	3,551.3	3,587.2
Property, plant and equipment	7.4	7.1	6.9	4.9	5.7
Intangible assets	8.4	7.3	6.3	5.9	5.7
Other assets	21.3	13.1	10.8	9.6	18.0
Total bank assets	3,007.9	3,741.7	3,984.4	4,147.1	4,247.3
Deposits	(2,388.8)	(2,702.4)	(2,838.9)	(2,971.2)	(3,115.5)
Borrowings ⁵⁵	(336.9)	(754.0)	(853.1)	(864.5)	(816.8)
Other liabilities	(34.4)	(26.4)	(20.5)	(27.1)	(24.8)
Total bank liabilities	(2,760.1)	(3,482.8)	(3,712.5)	(3,862.8)	3,957.1
Bank net assets	247.7	258.8	271.9	284.2	290.2
Net assets of other activities (net of non-controlling interest)	3.1	1.1	1.0	1.0	(3.7)
Members' funds	250.8	259.9	272.9	285.2	286.5

⁵² P&N Bank's financial position at 30 June 2019 is not available at the date of this report.

⁵³ P&N Bank's financial position at 31 December 2018 is unaudited.

⁵⁴ Includes amounts due from securitisation facilities.

⁵⁵ Includes amounts due to securitisation facilities.

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P&N BANK - FINANCIAL POSITION (\$ MILLIONS) (CONT)

	AT 30 JUNE				AT 31 DEC.
	2015 ACTUAL	2016 ACTUAL	2017 ACTUAL	2018 ACTUAL	2018 ACTUAL ⁵³
<i>STATISTICS</i>					
<i>Growth in loans and advances</i>	+6.8%	+20.9%	+6.7%	+5.2%	+1.0%
<i>Growth in total bank assets</i>	+5.9%	+24.4%	+6.5%	+4.1%	+2.4%
<i>Growth in deposits</i>	+4.1%	+13.1%	+5.1%	+4.7%	+4.9%
<i>Loan to deposit ratio</i>	109.5%	117.1%	118.9%	119.5%	115.1%
<i>Growth in bank net assets</i>	+7.4%	+4.5%	+5.0%	+4.6%	+2.1%
<i>Capital adequacy ratio</i>	15.5%	14.4%	14.5%	15.4%	15.3%

Source: P&N Bank and Grant Samuel analysis

Bank net assets excludes P&N Bank's financial planning and specialised property activities (other than including investments in controlled entities at cost as part of other assets (\$2.8 million at 31 December 2018)). These other activities are immaterial in the context of P&N's consolidated financial position (particularly from FY16, as P&N Bank has wound down its specialised property activities).

At 31 December 2018, P&N Bank had total loans and advances of \$3.6 billion (including securitised loans of \$1.2 billion). Growth in loans and advances has generally exceeded system growth, particularly in FY16 (when system growth was 4.9% compared to P&N Bank's growth of 20.9%, achieved in a flat Western Australian market and making P&N Bank the fastest growing mutual ADI in Australia in FY16). Average annual growth in loans and advances over the past 4½ years has been well above system growth at 8.8% (compared to average annual system growth of 5.4%), albeit the majority of this outperformance was achieved in FY16. Growth in loans and advances was below system growth in 1HY19. Home loans represent more than 95% of the total loan portfolio by value, and there has been a declining trend in business and personal lending post FY15. Growth in housing loans has also generally exceeded system growth, with average annual growth in housing loans over the past 4½ years of 9.3%, well above average annual system growth of 5.5%.

Retail deposits represent approximately 80% of total funding, having fallen from around 88% of total funding over the past 4½ years as P&N Bank has sought to diversify its funding sources by doubling its securitisation facilities and introducing, and increasing its exposure to unsecured borrowings. Growth in deposits has been mixed, exceeding system growth in FY16, FY18 and 1HY19, but falling below system growth in FY15 and FY17. Average annual growth in deposits over the past 4½ years has been 7.0%, above average annual system growth of 4.4%. P&N Bank has a BBB investment grade long term credit rating from Standard & Poor's Ratings Services.

The majority of property, plant and equipment is leasehold improvements. P&N Bank does not own any land or buildings. Intangible assets represents P&N Bank's investment in computer software (in addition to IT costs that are expensed). Capitalised computer software costs are amortised over 3-10 years.

The reduction in net assets of other activities (net of non-controlling interest) over the past 4½ years (to a meet liability at 31 December 2018) reflects the winding down of P&N Bank's specialised property activities. Jacaranda Gardens Retirement Village was sold in May 2018. "The Enclave" at Eagle Bay joint venture was dissolved in June 2018 and P&N Bank assumed control of the two unsold lots valued at \$1.2 million which have been actively marketed for sale and one of these lots sold in 1HY19. The only remaining material property asset is a \$27.8 million receivable from the Pindan Group which, during 1HY19, was restructured as a three year debtor facility agreement, with a \$10 million repayment due in 2019, future payments due based on future lot sales and any residual debt to be fully repaid in 2021. The debtor facility is secured by a registered mortgage over the property development and a guarantee from a shareholder in the Pindan Group and is based on a commercial interest rate. Net liabilities of other activities at 31

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December 2018 includes \$1.5 million of goodwill in relation to the acquisition of P&N Financial Planning. Non-controlling interest represents Bridges' 35% interest in P&N Financial Planning.

P&N Bank is well capitalised with a capital adequacy ratio well in excess of APRA's minimum prudential capital requirement of 8%. Its Common Equity Tier 1 ("CET1") ratio at 31 December 2018 was 14.9%, which is also well above APRA's "unquestionably strong" benchmark CET1 ratio of 10.5% that P&N Bank is required to meet by January 2020.

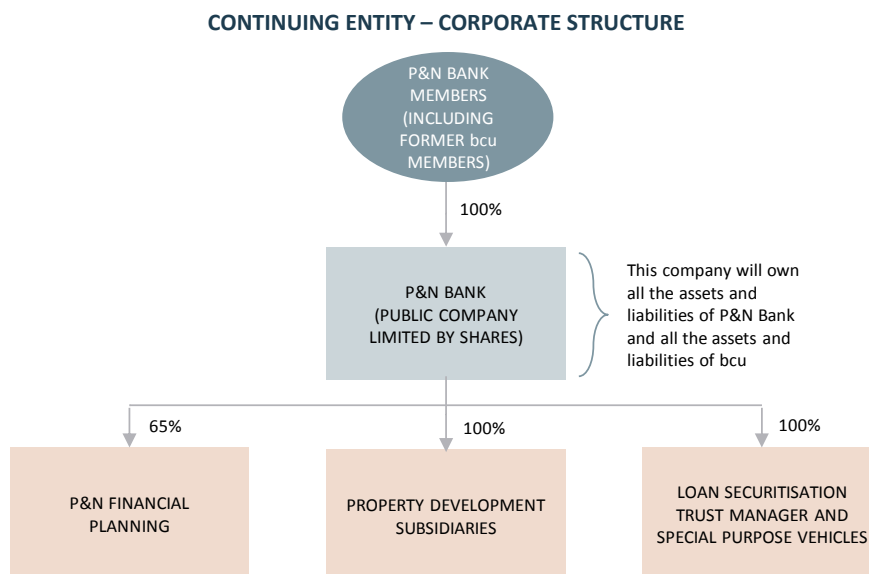


6 Impact of the Merger

6.1 Structure and Governance

Structure

The corporate structure of the Continuing Entity (i.e. P&N Bank if the Merger is completed) is set out below:



Source: P&N Bank, Member Booklet

If the Merger is completed:

- all of bcu’s business, assets and liabilities, including bcu’s reserves and all deposits and loans held by bcu members will be transferred to P&N Bank;
- bcu members⁵⁶ will have their redeemable preference shares cancelled and will cease to be members of bcu;
- each bcu member⁵⁷ will be deemed to:
 - have become a member of P&N Bank on the earliest date that they became a bcu member (being membership held continuously up to the time of the Merger); and
 - hold one P&N Bank member share, credited as paid up to the amount paid up on the corresponding bcu redeemable preference share⁵⁸. Any unpaid issue price will be payable in accordance with the P&N Bank Constitution.

bcu members who are already P&N Bank members will continue to be P&N Bank members and P&N Bank will recognise the length of membership from either bcu or P&N Bank, whichever is longer; and

- bcu’s AFSL, ACL and its banking authority under the Banking Act will be cancelled and bcu will be deregistered as a company.

⁵⁶ Except the bcu directors, who will remain bcu members until the deregistration of the company.

⁵⁷ Excluding those bcu members who are already members of P&N Bank, in which case bcu will refund the amount paid up on that member’s redeemable preference share.

⁵⁸ Assuming that all bcu redeemable preference shares have an issue price of \$10. If the amount paid for a redeemable preference share exceeds \$10, the bcu member will receive a refund equal to the difference.



bcu members will no longer have a direct interest in bcu in the form of bcu redeemable preference shares but will have an interest in bcu's business (as well as P&N Bank's business) through being a P&N Bank member and holding a P&N Bank member share (along with all other P&N Bank members).

Governance

If the Merger is completed:

- the P&N Bank Board will comprise a maximum of 10 directors, including:
 - six current P&N Bank directors (including the current P&N Bank Chairman). It is expected that these directors will be Mr Paul Gabb, Mr Ed Bradley, Ms Julie Elliott, Ms Kellie Properjohn, Mr Alan Philp and Mr Trevor Hunt. Mr Gabb, Ms Properjohn, Mr Philp and Mr Hunt will be member elected directors and Mr Bradley and Ms Elliott will be Board appointed directors;
 - three current bcu directors (including the current bcu Chairman). At least one director must represent the bcu Mid North Coast, New South Wales region. It is expected that these directors will be Mr Stephen Targett, Ms Louise Clarke and Mr Gary Humphreys. Ms Clarke and Mr Humphreys will be member elected directors and Mr Targett will be a Board elected director; and
 - P&N Bank's CEO, Mr Andrew Hadley.

Two of P&N Bank's current directors, Mr Stephen Melville and Mr Eric Smith, and three of bcu's current directors, Mr Geoffrey Hardaker, Mr Sinclair Black and Mr Michael Gould, will not be on the P&N Bank Board.

Each director will have a term of office that expires at either the P&N Bank AGM to be held in 2020 or the P&N Bank AGMs to be held in 2021 and 2022.

There will be no change to the P&N Bank Board committees (covering audit, risk and Board governance and remuneration) or the Nominations Committee;

- the current chairman of P&N Bank, Mr Paul Gabb, will remain as chairman of P&N Bank (although it is intended that Mr Gabb will retire as a director of P&N Bank at the 2020 AGM) and the current Chairman of bcu, Mr Stephen Targett, will be appointed as the Deputy Chairman of P&N Bank;
- P&N Bank's CEO, Mr Andrew Hadley, will remain CEO of P&N Bank;
- a general manager of the bcu business and a general manager of the P&N Bank business will be appointed to oversee each of the businesses and report directly to the CEO; and
- an Advisory Council will be established for each of the bcu and P&N Bank businesses responsible for:
 - advising on the needs and priorities of service delivery to customers;
 - observing and providing feedback on the financial and non-financial performance of the brand;
 - assisting in developing links with local employers and communities;
 - providing feedback on product development;
 - acting as ambassadors to grow and promote the brand;
 - advising on local economic conditions and impacts on business growth;
 - advising on the local competitor landscape and activities;
 - providing direct member feedback on service delivery and marketing strategy;
 - using local connections for introductions to staff;
 - advising on priorities for local community initiatives and sponsorships; and
 - providing input into strategic and business planning processes.



The bcu Advisory Council will initially comprise up to six member representatives, the majority of which must reside in the Coffs Coast region. Current bcu directors, Mr Geoffrey Hardaker and Mr Sinclair Black (who will not be appointed as directors of P&N Bank), from the Coffs Coast region, have agreed to become representative members of the bcu Advisory Council. An appropriate process to identify and invite other bcu members to become representative members of the bcu Advisory Council will be conducted after the Merger is completed. The P&N Bank CEO will be a non-member attendee of the bcu Advisory Council. The bcu Advisory Council is designed to give bcu members a voice on key matters relating to the needs and priorities of service delivery and priorities for local community initiatives, across the bcu regions.

Similarly, the P&N Bank Advisory Council will initially comprise up to six representative members (including current P&N Bank directors who will not be P&N Bank directors after the Merger is completed) with the P&N Bank CEO as a non-member attendee.

6.2 Membership and Member Rights

Membership

There is very limited overlap between members of bcu and members of P&N Bank. bcu and P&N Bank have estimated that there are only around 10 members of both mutual ADIs. As a result, if the Merger is completed, the total number of P&N Bank members will increase to almost 150,000 located across the east and west coasts of Australia.

Member Rights

The rights and obligations of P&N Bank members are set out in Section 5.3 of this report. While there are some differences to the rights and obligations of bcu members under the bcu Constitution, the key rights in relation to voting, redemption, termination/cessation of membership, transfer, transmission and participation in a winding up are similar. The key differences for bcu members are summarised below:

P&N BANK VS bcu – KEY DIFFERENCES IN MEMBER RIGHTS AND OBLIGATIONS

RIGHT/OBLIGATION	P&N BANK	bcu
Quorum	25 members present in person or 50% of members eligible to attend and vote if less than 50 members are eligible to attend and vote at a meeting	10 members entitled to vote on a resolution at the meeting (present in person or by proxy)
Appointment of directors	Four members who have been members for 12 months or more have the right to nominate a candidate Nominations Committee determines whether person becomes a candidate (based on “fit and proper” assessment) No more than six member elected directors (out of a maximum of 10)	Two members must nominate a candidate All directors are elected by members (other than casual vacancies which are appointed by the directors but must be elected by members at the next AGM)
Dividends	Right to participate in any dividend only if approved at general meeting of members ⁵⁹ Each member share has equal right to participate in dividends with every other member share	No entitlement to dividends
Participation in winding up		On voluntary winding up, members may resolve to transfer any surplus to any company with a mutual structure
Transfer of business	No voting eligibility restriction	At least 25% of members who have been members for at least 24 months vote

⁵⁹ Although as far as P&N Bank management is aware, no dividends have ever been paid by P&N Bank.



P&N BANK VS bcu – KEY DIFFERENCES IN MEMBER RIGHTS AND OBLIGATIONS (CONT)

RIGHT/OBLIGATION	P&N BANK	bcu
Participation on demutualisation	Must have been a member for <i>not less than two years</i>	Must have been a member for <i>at least 12 months</i> (“eligible members”)
Requirements for demutualisation	Special resolution (75%) where at least 25% of <i>members</i> vote (by postal ballot)	<i>Unless recommended by the directors, demutualisation resolution cannot be put to members if the same or a substantially similar resolution was put and not passed at a meeting held within the prior three years</i> Special resolution (at least 75% of <i>eligible members</i>) where at least 5% of eligible members vote and <i>at least 25% of members who have been members for at least 24 months</i> vote

Source: P&N Bank Constitution and bcu Constitution

6.3 Business Operations and Strategy

Business Operations

The principal activities of the Combined Entity will focus on providing financial services to retail consumers and SMEs. If the Merger is completed, it is intended that the current brands of bcu and P&N Bank will be retained, and an umbrella brand may be adopted in the future to create a model for further industry consolidation.

Neither bcu members nor P&N Bank members are intended to be disadvantaged with respect to the benefits and pricing associated with any products or services held by a member on completion of the Merger.

P&N Bank will continue to offer its existing suite of products and services (set out in Section 5.4 of this report) as well as offering (at least initially) the products and services currently provided by bcu (set out in Section 4.4 of this report). Ultimately, it is expected that all P&N Bank members (including P&N Bank members who were previously bcu members) will have access to a broader range of products, services and distribution channels, including:

- deposit products (including RSAs) and lending products (home, business and personal loans);
- financial planning services;
- arrangements with third parties to provide general and life insurance and foreign exchange/international payments services; and
- a distribution network comprising:
 - 36 locations (bcu stores and P&N Bank branches):
 - access to contact centres operating from 9.00am to 8.00pm Monday to Friday and 11.00am to 7.00pm Saturday AEST; and
 - enhanced digital capability (online banking, mobile banking app, digital wallets, instant digital cards and ActivePay).

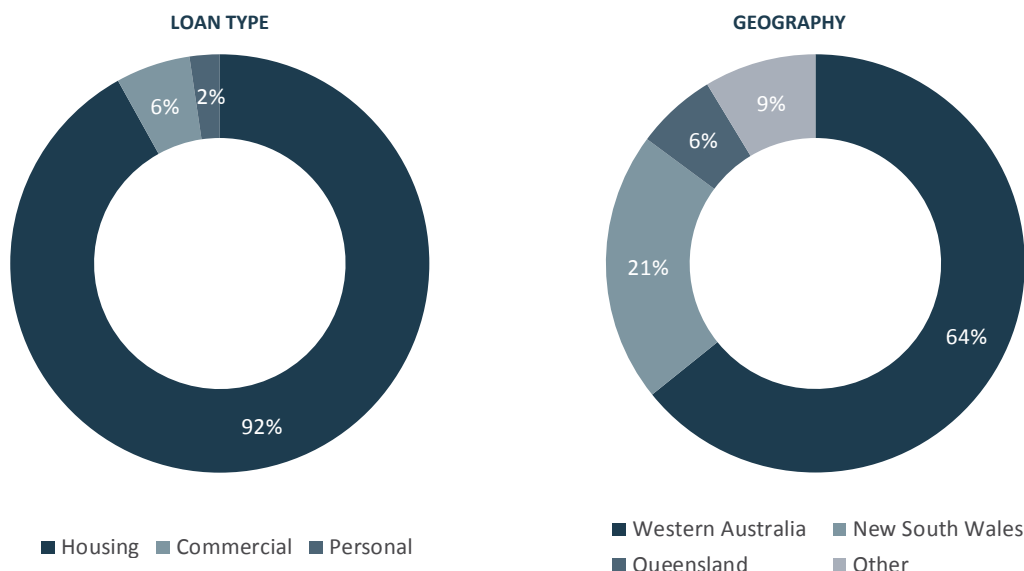
bcu members will also retain fee-free access to Coastline ATMs and 49 bcu ATMs in bcu’s local regions. P&N Bank branches will not be able to sell bcu products and bcu stores will not be able to sell P&N Bank products but all locations will be able to service bcu and P&N Bank customers.



The Continuing Entity will have a more diversified loan portfolio, by both type of loan and geography:

CONTINUING ENTITY – PRO FORMA COMPOSITION OF GROSS LOANS AND ADVANCES

AT 30 JUNE 2018



Source: P&N Bank and bcu

The Continuing Entity’s commitment to community support will continue. Under the MIA, P&N Bank has committed to spend, at a minimum, the annual investment by bcu in the mid North Coast region (including but not limited to costs of staff, service providers and sponsorship) at the date of the MIA, adjusted for the consumer price index (“CPI”) each year and part of the cost savings from the Merger are expected to be used for further annual charitable donations, with bcu members to be consulted on which charities should receive further support.

The head office of P&N Bank will be located in Perth, and the head offices of bcu in Coffs Harbour and Brisbane will be retained as organisational hubs for the bcu business of the Continuing Entity. No bcu stores or P&N Bank branches will be closed as a result of the Merger.

No bcu or P&N Bank employee will be forced to take a redundancy as a result of the Merger:

- the terms and conditions of employment (including any accrued entitlement to employee benefits) of each bcu employee transferred to P&N Bank and each P&N Bank employee at completion of the Merger will continue to apply after completion of the Merger; and
- the roles of P&N Bank and bcu senior executives will be restructured on completion of the Merger. Each current executive will have the opportunity to nominate for any position they currently hold which is substantially the same in both bcu and P&N Bank or any other position they deem themselves to be suitably qualified for, and the selection process will be transparent, fair and based on merit. The proposed executive team for the Continuing Entity is set out in Section 4.6(e) of the Member Booklet.

A suitable position has not been able to be agreed for the current bcu CEO, Mr Alan Butler, and he has indicated that his preference is to leave the Continuing Entity if the Merger is implemented.

Strategy

P&N Bank’s strategy is set out in Section 5.4 of this report. The Merger is consistent with P&N Bank’s vision to be recognised as the Western Australian challenger brand in retail financial services, doubling the size of the business by 2020. It is expected that P&N Bank will continue with its current strategy if the Merger is implemented.

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The Merger is intended to create a multi-brand ADI with an overarching group structure that operates to benefit and grow the current brands of each of bcu and P&N Bank, at the same time divesting decision making authority and autonomy to the respective brands within an agreed framework. For example:

- the Continuing Entity will maintain separate brands (bcu and P&N Bank) that will compete in the market, with the brand general managers responsible for design and delivery of the customer value proposition;
- all distribution channels will be available seamlessly to all customers (although the brands will not be able to sell the other's products through branded distribution channels);
- each brand will retain its front line presence (no jobs will be lost other than through natural attrition);
- there will be one common virtual contact centre platform;
- each brand will maintain separate business operations in areas where an extensive knowledge of the market and customers or a non-transmittable know-how is required;
- each brand will retain its own digital distribution channels, but these will be operated by the same back-end technology platform and there will be continuous investment in digital capabilities for both brands;
- there will be single common online banking systems and operating systems where possible (i.e. except where operating systems are not able to be migrated as it would result in a negative impact on customers, members or the running of the business); and
- all group support functions (human resources, technology, risk and compliance, property, legal/company secretary, data and market intelligence, strategy and development) will be consolidated and the Continuing Entity will shift to a virtual team model (allowing group executives to remain in their current locations).

This operating model recognises that the Merger is the first step in creating a model that may appeal to other mutual ADIs considering their future, providing the opportunity for further inorganic growth and creating a member-focused mutual ADI with the scale to compete effectively with other participants in the Australian banking sector.

6.4 Financial Impact

Impact on Financial Performance

The Continuing Entity pro forma financial performance for FY18 is set out in Section 5.2 of the Member Booklet. It has been prepared on the basis that the Merger was completed on 1 July 2017. The Continuing Entity pro forma financial performance for 1HY19 is not set out in the Member Booklet. To provide an indication of the Continuing Entity's financial performance for 1HY19, Grant Samuel has prepared the 1HY19 pro forma financial performance. The Continuing Entity pro forma financial performance is summarised below:

CONTINUING ENTITY – PRO FORMA FINANCIAL PERFORMANCE (\$ MILLIONS)

	YEAR ENDED 30 JUNE 2018	SIX MONTHS TO 31 DEC. 2018
Net interest income	115.1	57.7
Other income	29.8	13.4
Bank net operating income	144.9	71.1
Bank operating expenses	(107.4)	(56.6)
Impairment loss	(4.7)	0.3
Bank profit before tax	32.8	14.8
Bank tax expense	(9.9)	(4.6)
Bank profit after tax	22.9	10.2
Other activities (net of tax and non-controlling interest)	(0.1)	0.1
Profit after tax attributable to members	22.8	10.3



CONTINUING ENTITY – PRO FORMA FINANCIAL PERFORMANCE (\$ MILLIONS) (CONT)

	YEAR ENDED 30 JUNE 2018	SIX MONTHS TO 31 DEC. 2018
<i>STATISTICS</i>		
<i>Net interest margin</i>	2.10%	nc
<i>Bank cost to income ratio</i>	74.2%	79.6%
<i>Impairment loss to loans and advances</i>	0.09%	nmc
<i>Bank profit after tax margin</i>	15.8%	14.4%
<i>Bank return on assets</i>	0.40%	nc
<i>Bank return on equity</i>	5.5%	nc

bcu, P&N Bank and Grant Samuel analysis

The Continuing Entity pro forma financial performance represents the aggregation of bcu’s FY18 and 1HY19 financial performance (see Section 4.5) and P&N Bank’s FY18 and 1HY19 financial performance (see Section 5.5). While it is expected that:

- consolidating the operations of bcu and P&N Bank into a single set of systems and processes is expected to realise significant operational synergies equating to over \$5 million in annual cost savings (see Section 7.3.1(v)); and
- P&N Bank has committed to use a material portion of the cost savings to:
 - remove banking fees on certain products for P&N Bank members (including former bcu members) (see Section 7.3.2(ii));
 - pay higher interest rates on certain P&N Bank transaction and savings accounts; and
 - make further annual charitable donations, with bcu members to be consulted on which charities should receive further support (see Section 7.3.1(iv)),

the Continuing Entity pro forma financial performance does not reflect these cost savings and other initiatives. It also does not reflect any revenue from organic growth opportunities (see Section 7.3.1(vi)) or any transaction or integration costs expected to be incurred by bcu, P&N Bank and the Continuing Entity (see Section 7.4.3).

The Continuing Entity pro forma financial performance for FY18 in the table above differs from that shown in Section 5.2 of the Member Booklet as it shows P&N Bank’s non-banking income and expenses (i.e. financial planning and specialised property activities) separately as a single profit after tax figure from other activities (consistent with the presentation of P&N Bank’s financial performance in Section 5.5). The impact on pro forma profit after tax for FY18 and 1HY19 is immaterial.

The Continuing Entity pro forma financial performance shows a deterioration in the key statistics (i.e. lower net interest margin, higher bank cost to income ratio, lower bank profit after tax margin and lower bank return on assets and return on equity) relative to bcu on a stand-alone basis, reflecting the impact of P&N Bank’s bank operations on the Continuing Entity. However, it would be expected that these statistics would improve back to levels similar to those achieved by bcu on a stand-alone basis (other than bank return on assets and bank return on equity) if the cost savings and revenue from the organic growth opportunities eventuate.

As the Merger is expected to be completed in November 2019⁶⁰, the Merger will have no impact on the financial performance of bcu or P&N Bank in FY19. The impact of the Merger on P&N Bank’s FY20 earnings will be material as bcu will have been merged with P&N Bank for approximately eight months. P&N Bank will also incur transaction and integration costs. FY21 will be the first full year of operation of the Continuing Entity.

⁶⁰ Subject to the conditions precedent to the Merger being satisfied or, if applicable, waived. See Section 7.6.3.



Impact on Financial Position

The Continuing Entity pro forma financial position at 30 June 2018 is set out in Section 5.2 of the Member Booklet. It has been prepared on the basis that the Merger was completed on 30 June 2018. The Continuing Entity pro forma financial position at 31 December 2018 is not set out in the Member Booklet. To provide an indication of the Continuing Entity's financial position at 31 December 2018, Grant Samuel has prepared the 31 December 23018 pro forma financial position (prepared on the basis that the Merger was completed on 31 December 2018). The Continuing Entity pro forma financial position is summarised below:

CONTINUING ENTITY – PRO FORMA FINANCIAL POSITION (\$ MILLIONS)

	AT 30 JUNE 2018	AT 31 DECEMBER 2018
Cash and financial assets	840.5	910.2
Loans and advances	4,965.5	4,980.5
Property, plant and equipment	15.1	16.3
Intangible assets	6.6	6.5
Other assets	19.7	29.9
Total bank assets	5,847.4	5,943.4
Deposits	(4,514.6)	(4,658.1)
Borrowings	(864.5)	(816.8)
Other liabilities	(44.9)	(34.9)
Total bank liabilities	(5,424.1)	(5,509.8)
Bank net assets	423.4	433.6
Net assets of other activities (net of non-controlling interest)	1.0	(3.7)
Members' funds	424.4	429.9
<i>STATISTICS</i>		
<i>Growth in loans and advances</i>	<i>+4.0%</i>	<i>+0.3%</i>
<i>Growth in total bank assets</i>	<i>+3.8%</i>	<i>+1.6%</i>
<i>Growth in deposits</i>	<i>+4.5%</i>	<i>+3.2%</i>
<i>Loan to deposit ratio</i>	<i>110.0%</i>	<i>106.9%</i>
<i>Growth in bank net assets</i>	<i>+5.8%</i>	<i>+2.4%</i>
<i>Capital adequacy ratio</i>	<i>15.2%</i>	<i>nc</i>

Source: Member Booklet and Grant Samuel analysis

The Continuing Entity pro forma financial position represents the aggregation of bcu's financial position at 30 June 2018 and 31 December 2018 (see Section 4.6) and P&N Bank's financial position at 30 June 2018 and 31 December 2018 (see Section 5.6). It reflects the transfer of bcu's assets and liabilities to P&N Bank but does not reflect transaction costs associated with the Merger.

The Continuing Entity pro forma financial position at 30 June 2018 in the table above differs from that shown in Section 5.2 of the Member Booklet as it shows P&N Bank's non-banking assets and liabilities (i.e. financial planning and specialised property activities) separately as a single net assets figure (consistent with the presentation of P&N Bank's financial position in Section 5.6). The impact on pro forma total assets at 30 June 2018 is immaterial.

The pro forma financial position at 31 December 2018 shows that the Continuing Entity will have:

- total bank assets of \$5.9 billion and bank net assets of \$434 million; and
- a diversified funding structure, with retail deposits representing approximately 85% of total funding.

At 30 June 2018, the pro forma capital adequacy ratio for the Continuing Entity was well above APRA's minimum prudential requirements and benchmarks and above the internal limit imposed by the P&N Bank board.



7 Evaluation of the Merger

7.1 Summary and Conclusions

bcu is facing a challenging external environment. Market conditions, particularly for home loans, are extremely competitive, driven by new entrants and business models, and an extended period of low loan growth and low interest rates, which has intensified more recently due to weakness in housing prices and tighter lending policies. The consequent challenges for smaller mutual ADIs, such as bcu, are exacerbated by increasing regulation and the requirement to make ongoing investments in technology and innovation to maintain an attractive and competitive banking offer that meets the increasing expectations of customers.

While bcu's business should be sustainable in the medium term, it will face increasing pressures on a stand-alone basis. In particular, bcu's lack of scale and the requirement for ongoing investment in regulatory and mandatory technological change has meant that it does not have the necessary resources (staff and funding) required to develop and maintain an attractive banking offer (including digital). This constraint is ultimately expected to reduce bcu's future competitiveness and capacity to attract and retain members, particularly the younger generation, which is required to sustain the business over the long term.

The bcu Board has recognised that bcu does not have the scale, on its own, to access the resources required to invest in enhancing its capabilities to enable it to maintain a relevant member proposition. After reviewing the alternatives, the bcu Board concluded that merging with another banking organisation at some time in the future was inevitable and that a merger with a suitable mutual banking organisation to access the resources required was the most appropriate option to address the strategic challenges and risks.

The Merger is an attractive proposition. bcu will become part of a stronger and larger mutual ADI that is more capable of competing in the current market and more resilient to future strategic risks than bcu as a stand-alone entity. It will provide bcu's business with access to the resources necessary to deliver digital capabilities to improve the proposition to existing members and attract new members (particularly younger demographics). bcu and P&N Bank have put considerable effort into developing an operating and governance model which retains the bcu attributes that members value highly – its brand, staff and stores, local decision making, and commitment to the local community – which is possible because of the separate geographical footprints of the two entities. There will also be some Board continuity and an Advisory Council, both of which are required to include local representation. There are expected to be significant cost savings, primarily from consolidating operations into a single set of systems and processes, as well as the potential for organic growth from deploying P&N Bank's digital banking capabilities to target new home loan growth in bcu's geographical markets and leveraging bcu's capabilities and systems to provide a commercial and specialist property banking offer in Western Australia. The Merger may also provide opportunities for future inorganic growth through the potential for mergers with other mutual ADIs (although there is no certainty that such opportunities will eventuate).

The Merger has benefits for bcu members both as banking customers and as members of P&N Bank (the Continuing Entity). Immediately following the Merger, there will be no change to products and no intended change to the banking details of existing bcu members (with any unavoidable change communicated well in advance). Some bcu members will specifically benefit from the cost savings expected to be achieved as a result of the Merger through a commitment to remove banking fees from certain products. Expected cost savings will also be used provide further community support. bcu's members should be able to access an enhanced range of products, services and distribution channels, including greater mobile banking capabilities (all three digital wallets and instant digital cards). Following conversion of bcu's banking system to P&N Bank's banking system, bcu members will have access to the full range of services provided by P&N Bank, including a new mobile banking app with greater features and capabilities. Services will also be enhanced, with longer contact centre operating hours and access to a store and branch network across the



east and west coasts of Australia. As members of P&N Bank, bcu members will be customers of a more robust banking business while remaining members of a mutual committed to community involvement and service to members.

There are disadvantages, although most have mitigating factors:

- by voting in favour of the Merger, bcu members will forgo the opportunity to benefit from an alternative proposal such as a demutualisation (accompanied by a sale of the company to a third party or a sharemarket listing) or a voluntary winding up, that could crystallise value for bcu members. However, a demutualisation would only be possible if the bcu Board was to make the decision to put a demutualisation or similar transaction to bcu members for their approval, which is considered unlikely. If bcu members wanted bcu to be wound up as an alternative to the Merger, they have had ample opportunity since announcement of the Merger to communicate this to the bcu Board and this has not been the case. Furthermore, the Merger does not prevent other alternatives such as future mergers with other mutual ADIs or becoming an Alliance Bank in partnership with Bendigo and Adelaide Bank Limited (“Bendigo and Adelaide Bank”);
- there will be changes to the rights of bcu members, particularly the right to participate in bcu’s reserves on a winding up or demutualisation. In reality, the entitlement to participate in bcu’s reserves is a contingent right (i.e. it is only of value in the event that bcu is wound up or demutualises, both of which are considered unlikely). In any event, to the extent that these changes may be considered a disadvantage, they are mitigated by the right that bcu members will have as members of P&N Bank to participate in the distribution of the Continuing Entity’s surplus and profits on a winding up or demutualisation of the Continuing Entity; and
- there will be transaction and implementation costs. bcu’s transaction costs, while immaterial in the context of the Merger, are material to bcu and will be incurred by bcu on a stand-alone basis if the Merger does not proceed.

The main risks of the Merger are implementation risks. There will be a risk that the integration of bcu and P&N Bank takes longer or costs more than is expected and any delay in integration is likely to delay the provision of benefits to members. While there is a plan in place to minimise integration risks, it is not possible to eliminate them entirely. There will also be ongoing execution risks associated with successfully implementing the governance and operating model, having group executives geographically spread across the east and west coasts of Australia and managing cultural/organisational differences. Despite the operating and governance model, bcu members will also be exposed to the activities of P&N Bank (including its financial planning business, specialised property activities and reverse mortgage portfolio).

The Merger is mutually beneficial for bcu and P&N Bank. bcu requires scale and access to resources to remain relevant and competitive, and P&N Bank has a vision to double the size of its business by 2020. Each business also has something to offer the other through the cross selling of complementary products and distribution channels. By acting now, bcu is able to have some influence over its future (at the very least through merging with a partner of its choice). As a stand-alone entity, bcu’s ability to influence its future is likely to diminish over time given its position and current market conditions.

In Grant Samuel’s opinion, the advantages of the Merger outweigh the disadvantages and bcu members are likely to be better off if the Merger proceeds. Accordingly, in the absence of a superior proposal:

- the Merger is in the best interests of bcu members; and
- the benefits being provided to bcu members are reasonable having regard to any loss of rights and change as to voting rights and rights to participate in the reserves and profits of bcu. As bcu members are effectively swapping an interest in one mutual for an interest in another mutual rather than exchanging their interest for cash and/or marketable securities in the acquiring entity, it is not



possible to value a membership interest in either bcu or P&N Bank and therefore it is not meaningful to provide an opinion on whether the benefits being provided to members are “fair”.

7.2 Background

The Australian banking sector is dominated by the major banks, which have an estimated 80% market share. At 31 December 2018, there were 70 mutual ADIs (including mutual banks, credit unions and building societies), which collectively had a market share of around 3-4%.

Market conditions, particularly for home loans, are extremely competitive, driven by new entrants and business models, and an extended period of low loan growth and low interest rates, which has intensified more recently due to weakness in housing prices and tighter lending policies (subsequent to the Royal Commission). These conditions have put pressure on net interest margins and cost to income ratios. The consequent challenges for smaller ADIs, such as bcu, are exacerbated by increasing regulation and its impact on lending growth, capital requirements and compliance costs and the requirement for significant, ongoing investment in technology and innovation to maintain an attractive and competitive offering that meets increasing customer expectations for banking products and services.

In addition to a challenging external environment, mutual ADIs, including bcu, are dealing with a declining and ageing member base, a high cost base (reflecting their sub-scale operations) and lack of an attractive digital offering. As a result, it is increasingly difficult for many smaller mutual ADIs to provide a relevant proposition to members and attract a younger generation of members. While members of mutual ADIs consistently report high levels of member satisfaction, indicating that there is a role for mutual ADIs in the Australian banking sector, scale is critical for mutual ADIs to remain relevant and competitive over the long term.

bcu’s business should be sustainable in the medium term given its track record of profitable growth (albeit this has largely been achieved through a focus on the short term as well as not investing in key areas such as wages and digital/IT) and its relatively conservative target operating parameters (e.g. a reduction in the Board approved required return on assets would free up capital to fund investment in technology and innovation). However, it is facing increasing challenges and pressures on a stand-alone basis and it will be difficult for bcu to remain sustainable at its current size over the long term. In particular, bcu’s lack of scale and the requirement for ongoing investment in regulatory and mandatory technological change has meant that it does not have the necessary resources (staff and funding) required to develop and maintain an attractive digital offering. This constraint is ultimately expected to reduce bcu’s future competitiveness and capacity to attract and retain members, particularly the younger generation, which is required to sustain the business over the long term.

The bcu Board has recognised that the status quo is not sustainable in the long term, and believes it is clear that bcu does not have the scale, on its own, to access the resources required to invest in enhancing its capabilities to enable it to maintain a relevant member proposition. After conducting a review of the alternatives, the bcu Board concluded that merging with another banking organisation at some time in the future was inevitable and that a merger with a suitable mutual banking organisation to access the resources required was the most appropriate option to address the strategic challenges and risks. Furthermore, proactively seeking to execute a merger now enables bcu to select the right partner for bcu members and its communities. Waiting until it must act could ultimately lead to a different merger in the future and an inferior outcome for bcu and its members.

Prior to entering into the MIA, the bcu Board considered a number of potential member owned banking organisation merger partners, formed the view that P&N Bank was the most appropriate merger partner and undertook a due diligence process on P&N Bank. Based on this process, the Board decided unanimously to recommend the Merger to bcu members.



7.3 Advantages and Benefits of the Merger

The advantages and benefits of the Merger for bcu and for bcu members (both as banking customers and as P&N members) are set out below.

7.3.1 Impact on bcu

While bcu has achieved growth in its performance over recent years, its size restricts its ability to invest in the products, services and new technologies required to provide a relevant banking offer to bcu members and to attract new members, particularly the younger generation.

The Merger will provide bcu's business with access to scale and the resources necessary to grow and to better meet the needs of bcu members. The advantages and benefits of the Merger for bcu's business are discussed in more detail below.

(i) Scale

The Merger will secure a sustainable long term future for bcu. If the Merger is implemented, bcu will become part of a stronger and larger mutual ADI that is more capable of competing in the current market and more resilient to future strategic risks than bcu as a stand-alone entity. The Continuing Entity will be one of the top 10 mutual ADIs. At 30 June 2018, P&N Bank was the tenth largest mutual ADI (based on total assets), with total bank assets of \$4.1 billion and 92,107 members. The Continuing Entity would have been the eighth largest mutual ADI (at 30 June 2018), with pro forma total bank assets of \$5.8 billion and almost 148,000 members. The scale of the Continuing Entity should:

- provide geographical diversification (with significant loan and deposit portfolios on the east and west coasts of Australia) which should lower the risks associated with earnings volatility and portfolio concentration;
- allow it to leverage its largely fixed cost base, in particular, compliance and regulatory costs, enabling it to operate more efficiently and reducing the total cost on a per member basis; and
- better position the bcu and P&N Bank businesses to compete through an enhanced platform that provides members with greater access to services, convenience and more attractive products and services.

(ii) Access to Resources

The Merger will provide bcu's business with access to the resources necessary to deliver digital capabilities to improve the proposition to existing members and attract new members (particularly younger demographics) and enable the bcu business to remain competitive over the medium term. These resources include:

- P&N Bank's current technology (including modern back-office technology and systems) that will deliver more efficient services for bcu members as well as its digital offerings (including digital wallets and instant credit cards) that will enable the provision of an attractive banking offer for bcu members;
- financial capacity. P&N Bank currently spends around \$8-9 million per annum on IT, of which \$2 million is spent on digital projects. It is constantly updating and innovating to meet the changing expectations and needs of customers. P&N's annual IT budget is well excess of bcu's annual IT expenditure, and bcu does not have the financial capacity to match this level of expenditure; and
- a large and experienced IT team. P&N Bank has 20 IT staff and a further four focused on digital products with significant experience in digital/IT projects that will be able to be leveraged across bcu's business. In contrast, bcu has a relatively small existing IT team which does not have the depth of experience to pursue innovative digital and IT projects.



A stand-alone digital strategy would require a substantial investment and would be a prohibitively expensive and risky undertaking for bcu. As part of the Continuing Entity, an equivalent or better digital strategy should be able to be implemented for bcu members more quickly, at significantly lower cost and with lower risk.

(iii) Minimal Organisation Issues

bcu and P&N Bank have put considerable effort into developing an operating and governance model for the Continuing Entity which secures attributes that bcu members value highly over the medium term.

Under this agreed operating and governance model, and because the geographical footprints of bcu and P&N Bank do not overlap, the Merger has minimal impact on bcu’s organisational structure. In particular:

- the bcu brand, which is respected and trusted in bcu’s local communities and has high member engagement, will be maintained;
- there will be no store closures;
- all bcu employees will be offered a role in the Continuing Entity and there will be no forced redundancies of staff from bcu directly as a result of the Merger. There will also be increased job security and better opportunities for bcu staff in a larger business;
- the bcu business will have the authority and autonomy to make key local decisions (e.g. lending, marketing, recruitment etc), within the broader group framework;
- a general manager of the bcu business will be appointed to oversee the bcu business and will report to P&N Bank’s CEO; and
- three of the six current directors of bcu will join the P&N Bank Board (along with seven of the eight current directors of P&N Bank, including the P&N Bank CEO) and at least one director will represent the Mid North Coast, New South Wales region, ensuring some continuity and local representation at Board level as well as influence over the governance of the Continuing Entity. The bcu Board believes that three bcu directors is fair representation given bcu’s contribution to the Continuing Entity’s total assets (i.e. bcu contributes approximately 30% to the Continuing Entity’s pro forma total bank assets at 31 December 2018). While P&N Bank’s Chairman will remain as chairman of P&N Bank, bcu’s Chairman will be appointed Deputy Chairman of P&N Bank and the Chairman will retire at the 2020 AGM.

In addition, an Advisory Council will be established for the bcu business. The bcu Advisory Council will comprise up to six members, with the majority residing in the Coffs Coast region, and will be responsible for representing members interests, acting as bcu ambassadors and advising on priorities for local community initiatives (see Section 6.1 for more details on the Advisory Council).

An inability to agree these types of issues is often cited as the main reason why mergers of mutual organisations are not able to be completed.

(iv) Continued Community Involvement

As mutual organisations, both bcu and P&N Bank have long histories of involvement with the communities in which they operate. bcu focuses its community support into its local community and is one of the largest donors to charities, clubs and organisations across its main regions of Port Macquarie, Coffs Coast, Clarence Valley, Northern Rivers and the Sunshine Coast. P&N Bank’s community support is focused on organisations operating in Perth and Western Australia.

If the Merger is completed, P&N Bank has committed to spend, at a minimum, the current annual investment by bcu in the mid North Coast region (CPI adjusted in future years) and has stated that it will provide further annual charitable donations, with bcu members to be consulted on which charities should receive further support.



(v) Cost Savings

bcu and P&N together undertook a detailed analysis of the potential to realise cost savings through combining their businesses. On the basis of this analysis, the Merger is estimated to generate over \$5 million of annual pre-tax cost savings, which are expected to be achieved progressively over a period of three years from completion of the Merger. The savings primarily come from consolidating operations into a single set of systems and processes (e.g. a common banking platform and IT, digital and technology infrastructure to support both brands, fraud and cyber security management and consolidation of operations and human resource management) and employees (only through natural attrition and voluntary redundancy). The estimated cost to achieve these savings is \$5 million (to be incurred over the period to 31 December 2020).

The quantum of the estimated cost savings is significant having regard to both bcu's and the Continuing Entity's financial performance, representing:

- more than 12% of bcu's FY18 operating cost base and almost 50% of bcu's FY18 net profit after tax; and
- around 5% of the Continuing Entity's FY18 pro forma operating cost base and around 20% of the Continuing Entity's FY18 pro forma net profit after tax.

bcu members will benefit from these cost savings through:

- specifically, P&N Bank's commitment to apply a portion of the cost savings to remove monthly fees from personal access accounts and personal loans and certain transaction fees on personal access accounts; and
- more generally, the Continuing Entity having greater capacity to invest in the business to deliver products and services that meet the needs and expectations of existing members and attract new members.

The Continuing Entity will also use some of the cost savings expected to be achieved as a result of the Merger to provide further annual charitable donations.

(vi) Organic Growth Opportunities

The Continuing Entity should have organic growth opportunities in the short term through:

- deploying P&N Bank's digital banking capabilities to target new home loan growth opportunities in bcu's geographical markets; and
- leveraging bcu's capabilities and systems to develop and execute a strategy to provide a commercial and specialist property banking offer in Western Australia.

P&N Bank's banking system has considerable capacity (up to one 1 million customers) and there are no practical limitations on the scalability of its digital platforms (within reason).

bcu and P&N Bank have not disclosed the additional revenue possibly available, but it could add materially to the estimated cost savings (see paragraph (v) above).

(vii) Future Inorganic Growth

In addition to organic growth potential, the Merger may provide opportunities for future inorganic growth through the potential for mergers with other mutual ADIs, further increasing the scale of the Continuing Entity and providing the ability to generate additional benefits to all existing and new members over the longer term.

At 30 June 2018 there were 71 mutual ADIs in Australia which collectively held \$113 billion in total assets. Excluding the 10 largest mutual ADIs, which arguably have sufficient scale to remain independent, the remaining smaller mutual ADIs had around \$38 billion in total assets.



As P&N Bank is the only locally domiciled mutual ADI in Western Australia, its logical expansion opportunity is to the eastern states of Australia. The membership and total assets of selected northern New South Wales and south east Queensland-based mutual ADIs (which are likely to be the potential candidates for some form of merger with the Continuing Entity) are set out below:

SELECTED NORTHERN NEW SOUTH WALES AND SOUTH EAST QUEENSLAND-BASED MUTUAL ADIS

AT 30 JUNE 2018	LOCATION	MEMBERS	TOTAL ASSETS (\$ MILLIONS)
Top 10			
Credit Union Australia	East Coast of Australia	473,310	15,617.9
Newcastle Permanent Building Society	Mid Coast of New South Wales	>325,000	10,716.1
Heritage Bank	South East Queensland	np ⁶¹	9,524.4
Greater Bank	North Coast of New South Wales	>250,000	6,711.2
Other			
Queensland Country Credit Union ⁶²	Regional and South East Queensland	~95,000	2,167.5
Regional Australia Bank ⁶³	Regional New South Wales	60,000	1,403.9
Unity Bank ⁶⁴	Central West and Northern New South Wales	np	1,090.5
QBANK	Brisbane	np	839.7
Summerland Credit Union	Northern New South Wales	np	689.2
Holiday Coast Credit Union ⁶³	Mid North Coast of New South Wales	25,000	607.7
Southern Cross Credit Union	Northern New South Wales	np	522.0
Warwick Credit Union ⁶⁵	South East Queensland	10,000	277.7

Source: KPMG Mutuals Industry Review 2018, company annual reports and websites

There is clearly the opportunity to significantly increase the scale of the Continuing Entity through merging with other northern New South Wales and south east Queensland-based mutual ADIs. The selected mutual ADIs in the table above (other than those in the top 10 mutual ADIs) had more than \$7.5 billion in total assets at 30 June 2018. While the operating and governance model that would apply to future mergers may be attractive to some of these mutual ADIs, there may be some impediments that could prevent or delay such mergers:

- there will be a minimum size below which a merger is not practicable as the costs of merging will outweigh the benefits; and
- any merger could only proceed on a co-operative “agreed” basis (i.e. it is not possible for a “hostile” merger to succeed). These mutual ADIs may not be responsive to a merger proposal from the Continuing Entity in the short to medium term, although this position could change if their performance deteriorates and/or there is positive feedback about the Merger.

7.3.2 Impact on bcu Members as Banking Customers

(i) No Change to Banking Products of Existing bcu Members

There will be no change to products and no intended change to the banking details of existing bcu members immediately following completion of the Merger.

⁶¹ np = not published.

⁶² Queensland Country Credit Union merged with Queenslanders Credit Union effective from April 2018.

⁶³ Regional Australia Bank merged with Holiday Coast Credit Union effective from 1 July 2019. The merged group has total assets of around \$2 billion and 85,000 members.

⁶⁴ Unity Bank merged with Central Coast Credit Union effective from December 2018. Central Coast Credit Union’s total assets at 30 June 2018 of \$39.6 million are not included in total assets in the table.

⁶⁵ Warwick Credit Union merged with Gympie Credit Union effective from February 2019. Gympie Credit Union’s total assets at 30 June 2018 of approximately \$12 million and its more than 1,400 members are not included in total assets in the table.



The MIA specifically states that it is not intended that bcu members will be disadvantaged with respect to the benefits and pricing associated with any products and services held by them at the time of the Merger.

However, while bcu is committed to avoiding any changes to the banking details of bcu members, there may be changes that cannot be avoided as a result of transitioning bcu's banking system to P&N Bank's banking system (during 2020). Any unavoidable change will be communicated to bcu members well in advance.

New products and services will be introduced for bcu members in the short to medium term, with the objective of better meeting the needs and expectations of members.

(ii) Removal of Fees

P&N Bank has committed to use a portion of the expected cost savings from the Merger to remove monthly fees from personal access accounts and personal loans and certain transaction fees on personal access accounts. It is expected that all other existing fees and charges will remain the same.

Removal of these monthly fees and transaction fees is, collectively, a meaningful benefit for those bcu members who pay these fees.

(iii) Enhanced Range of Products, Services and Distribution Channels

bcu members are expected to be able to access an enhanced range of products, services and distribution channels. Following completion of the Merger, P&N Bank will share its systems and digital banking technology and capabilities, giving bcu members access to:

- greater mobile banking capabilities. This will include:
 - access to all three digital wallets (which is a key driver to attract a younger generation of members) and;
 - the ability to be issued with instant digital debit and credit cards to replace lost or stolen cards (an innovative service that is not offered by other ADIs).

On conversion of bcu's banking system to P&N Bank's banking system, bcu members will have access to the full range of services provided by P&N Bank, including a new mobile banking app that will offer greater features and capabilities than the current bcu app; and

- enhanced services, particularly in terms of distribution, improving the level of service provided to bcu members, including:
 - extended contact centre operating hours (9.00am to 8.00pm Monday to Friday and 7.00am to 3.00pm Saturday AEST compared to the current 9.00am to 5.00pm Monday to Friday AEST) as a result of operating contact centres on the east and west coasts of Australia; and
 - access to a store and branch network across the east and west coasts of Australia. The number of locations will increase from 21 to 36 (albeit these additional locations are in Perth, Bunbury and Mandurah and P&N Bank branches will not be able to sell bcu products).

bcu members will also retain their existing access to Coastline ATMs and 49 bcu ATMs in bcu's local regions (as well as fee-free withdrawal access at over 6,000 major bank ATMs across Australia following the removal of ATM fees by the major banks).

Access to extended contact centre operating hours and a more extensive store and branch network are expected to be available to bcu members relatively quickly after completion of the Merger.

Over the longer term, the increased scale and financial capacity of the Continuing Entity is expected to support continuous investment and improvement in products and services (including new technologies) to maintain a relevant offer of banking products and services. This investment is materially greater (in terms of volume, complexity and cost) than bcu could deliver on a stand-alone basis.



7.3.3 Impact on bcu Members as Members of P&N Bank

(i) More Robust Banking Business

As members of P&N Bank, bcu members will be members and customers of a more robust banking business.

bcu members will gain access to an enhanced range of products, services and distribution channels that should improve customer retention and help to win new customers. The ability to utilise P&N Bank's digital banking capabilities should enable the bcu business to target new home loan growth opportunities in bcu's geographical markets and utilisation of bcu's SME capabilities and systems should enable P&N Bank to provide a commercial and specialist property banking offer in Western Australia. There may also be further opportunities for future inorganic growth.

The increase in scale as part of the Continuing Entity will allow the bcu business to operate more efficiently and should improve its ability to provide a relevant and competitive banking offer that meets the needs and expectations of bcu members over the long term.

(ii) Ongoing Membership of a Mutual

Based on the findings of recent market research focus groups, bcu members (particularly older members) value the mutual structure. As P&N Bank members, bcu members will remain members of a member owned and member-focused organisation committed to mutuality.

(iii) Cultural Alignment

Both bcu and P&N Bank have similar values based on their mutual heritage. Both organisations are member-focused and community-minded.

bcu's cultural values are one of the reasons bcu members choose bcu. The alignment of bcu's cultural values with those of P&N Bank is a benefit of the Merger for bcu members as the commitment to keep members' interests at the core of its business will continue.

In a post Royal Commission environment characterised by the erosion of trust (primarily in the major banks), bcu members will benefit from:

- ongoing alignment of the interests of members and customers; and
- being part of a mutual ADI that has been recognised as one of the banks that is most trusted by its customers in Australia.

(iv) Recognition of bcu Years of Tenure

If the Merger is completed, the P&N Bank membership deemed to be granted to a bcu member will recognise the bcu member's years of tenure. bcu members who are already P&N Bank members but have longer tenure as a bcu member will have their existing P&N Bank membership adjusted to reflect their longer tenure as a bcu member.

While the only real benefit of recognition of tenure is the right that tenure provides to participate in certain decisions relating to the Continuing Entity (i.e. the right to nominate a director of P&N Bank is only available to those who have been members for 12 months or more and the right to participate in a demutualisation of the Continuing Entity is only available to those who have been members for not less than two years), many members of mutual ADIs are proud of their years of tenure and regard it as qualitatively important. Anecdotal evidence suggests that members in the bcu heartland regions (including Macksville, Nambucca Heads, Coffs Harbour, Dorrigo and Bellingen) are very proud of being bcu members and the tenure of their membership. Over 18,000 members have been bcu members for more than 20 years (and are concentrated in these heartland regions).



7.4 Disadvantages of the Merger

7.4.1 Loss of Opportunity to Benefit from an Alternative Transaction

Introduction

If the Merger is completed, bcu members will forgo the opportunity to benefit from certain possible future alternative transactions. The most likely alternatives are a demutualisation (which could result in the release of reserves to bcu members), a voluntary winding up of the company, an arrangement with a non-mutual ADI or a proposal from another mutual ADI. These alternatives are considered below.

As set out in Section 2 of this report, a membership interest in a mutual such as bcu has no current realisable value (other than repayment of the issue price of \$10 (to the extent that this has been paid up) on ceasing to be a member). Any underlying “value” within the entity is not able to be accessed by members unless bcu is wound up or the bcu Board takes action to change the status of bcu and the necessary majority of members approve this change. Neither of these actions is currently contemplated.

As a result, these alternatives are hypothetical. Analysis of the potential alternatives is included only to provide context for bcu members. The analysis in no way represents any kind of warranty or guarantee (express or implied) as to the likelihood of an alternative proposal or the value that might be realised.

(i) Demutualisation and Sale

A demutualisation and sale of bcu to a shareholder-based entity (listed or private) could crystallise value for members. However, such an outcome would only be possible if the bcu Board was to make the decision to put a demutualisation or similar transaction to bcu members for their approval. This is not consistent with the views of the bcu Board, which believes that the mutual structure provides the basis for a superior banking offer and is committed to the mutual structure provided that it can continue to deliver benefits to members.

Furthermore, bcu’s reserves have been accumulated from current and past members and are held for the benefit of current and future members. A demutualisation would only reward current members and would ignore the past members who have contributed over the course of many years to the accumulation of reserves.

bcu members (particularly older members) also value the mutual structure. Without the support of the requisite majority of bcu members (i.e. approval by 75% of eligible members where at least 5% of eligible members vote and at least 25% of members who have been members for at least 24 months vote⁶⁶), a demutualisation and sale would not proceed.

There have been a number of transactions involving the demutualisation and sale of mutual ADIs. The key parameters of relevant transactions are summarised below:

COMPARABLE TRANSACTIONS INVOLVING MUTUAL ADIS

DATE	MUTUAL ADI	ACQUIRER	CONSIDERATION		MULTIPLE OF ADJUSTED NTA
			TOTAL (\$ MILLIONS)	PER MEMBER	
Sep 18	Maleny Credit Union	Firstmac	5.0	\$1,249	1.3
Dec 15	Your Credit Union	Auswide Bank	30.4-31.8	\$7,424-7,779	1.2-1.4
Oct 08	My State Financial Credit Union	Tasmanian Perpetual Trustees	122.8-170.6	\$1,026-1,425	1.1-1.5
Aug 05	StateWest Credit Society	Home Building Society	143.4-207.2	\$2,241-3,237	2.2-3.3

Source: Grant Samuel analysis

⁶⁶ Where an eligible member is one who has been a member for at least 12 months.



In analysing these parameters:

- more weight should be placed on the two more recent transactions. The acquisitions of My State Financial Credit Union of Tasmania Limited (“My State Financial Credit Union”) by Tasmanian Perpetual Trustees Limited (“Tasmanian Perpetual Trustees”) and StateWest Credit Society Limited (“StateWest Credit Society”) by Home Building Society Limited (“Home Building Society”) took place more than 10 years ago under different regulatory and economic conditions;
- each of the transactions, other than the acquisition of MCU Ltd (“Maleny Credit Union”) by Firstmac Holdings Limited (“Firstmac”), involved consideration consisting of listed scrip or listed scrip and cash. The ranges shown in the table reflect the relevant share prices on the date of announcement and on the date of the scheme booklet;
- the focus is on net tangible assets (“NTA”) multiples rather than earnings multiples. Invariably in these types of transactions, the earnings multiples are very high, reflecting the significant synergies expected to be achieved; and
- NTA has been adjusted for surplus capital in excess of a specified percentage⁶⁷ of risk weighted assets to reflect additional capital held in the mutual ADI above a target regulatory requirement (representing the APRA minimum requirement for all ADIs (at the time) plus an assumed mutual ADI buffer). Each of the mutual ADIs above had capital adequacy ratios in excess of this target regulatory requirement at the time of their respective mergers, in part reflecting their mutual status and their inability to distribute profits. This additional capital is not required to be held in the business and has therefore been treated as a surplus asset.

A demutualisation of bcu is unlikely to deliver as significant a value to members on an individual basis as the value realised in the December 2015 demutualisation of Your Credit Union.

Applying a multiple of 1.2-1.4 times NTA to bcu’s adjusted NTA gives an indicative value per member in the order of \$3,100-3,500:

bcu – INDICATIVE VALUE PER MEMBER

AT 31 DECEMBER 2018	REFERENCE	LOW	HIGH
Net assets attributable to members (\$ millions)	Section 4.6	143.4	143.4
Intangible assets (\$ millions)	Section 4.6	(0.8)	(0.8)
NTA (\$ millions)		142.6	142.6
Less: surplus capital ⁶⁸ (\$ millions)	footnote 68	(16.2)	(16.2)
Adjusted NTA (\$ millions)		126.4	126.4
NTA multiple		1.2	1.4
Business value (\$ millions)		151.7	177.0
Add: surplus capital (\$ millions)	footnote 68	16.2	16.2
Equity value (\$ millions)		167.9	193.2
Number of members (31 March 2019)	Section 4.3	54,470	54,470
Indicative value per bcu member		\$3,082	\$3,547

By way of comparison, the indicative value per bcu member equates to 4-4½ months’ interest on a \$250,000 home loan (assuming the bcu Owner Occupied Variable interest rate of 3.85% in August 2019).

Moreover, access to this value could come at a cost to bcu members, particularly through the loss of the benefits of being part of a mutual organisation that is operated for the benefit of members rather than

⁶⁷ 12% in the case of StateWest Credit Society, My State Financial Credit Union and Your Credit Union and 14% in the case of Maleny Credit Union. The higher percentage for Maleny Credit Union reflects the increase in regulatory capital required by APRA in recent years.

⁶⁸ Surplus capital of \$16.2 million = total capital at 31 December 2018 of \$144.5 million – (risk weighted assets at 31 December 2018 of \$950.7 million x target capital adequacy ratio of say, 13.5%).



generating a return for shareholders/owners (e.g. less favourable rates on banking products, lower levels of customer service and higher fees and charges). bcu members would need to take into account the loss of these mutual benefits, not all of which are quantifiable, on an ongoing basis, when considering the value they might receive in a demutualisation and sale of bcu.

(ii) Demutualisation and initial public offer (“IPO”)

A demutualisation and IPO does not require a third party to make a competing offer but it would require the bcu Board to make the decision to put such a transaction to bcu members. The same considerations would apply as in the demutualisation and sale scenario set out above except that:

- bcu members would become shareholders in a listed entity and would potentially be entitled to receive dividends;
- there would not be an immediate cash payment unless bcu members sold their shares on market; and
- shares would trade on a portfolio basis (i.e. trading prices would not incorporate a premium for control), which would be expected to be below the control value realised in a 100% sale.

In any event, it is arguable that bcu has insufficient scale to be viable as a listed entity on a stand-alone basis. Outside of the major banks and the regional banks there are only three listed ADIs:

- MyState Limited (“MyState”), a diversified financial products and services group (incorporating MyState Bank and The Rock) with a market capitalisation of \$415 million and NTA of \$236.4 million. MyState reported a profit of \$31.5 million in FY18;
- Auswide Bank Limited (“Auswide Bank”), which has a market capitalisation of \$230 million and NTA of \$189.0 million. Auswide Bank reported a profit of \$17.9 million in FY18; and
- BNK Banking Corporation Limited (“BNK Banking”) (formerly Goldfields Money Limited), which has a market capitalisation of \$45 million and NTA of \$55.6 million. BNK Banking reported a loss of \$0.4 million in FY18 (although underlying profit was \$0.5 million). BNK Banking is a diversified financial services company following its acquisition of Finsure in September 2018, offering banking and mortgage broking aggregation services.

MyState and Auswide Bank are larger and significantly more profitable than bcu. BNK Banking is considerably smaller than bcu. Prior to the acquisition of Finsure, and an earlier (October 2017) hostile (and ultimately unsuccessful) offer from Firstmac, BNK Banking had not been able to materially increase its value since listing in May 2012 (its share price prior to the initial offer from Firstmac was \$1.00, the same as its share price on listing).

Most small mutual ADIs that have demutualised and undertaken an IPO have subsequently been acquired by other listed ADIs. These ADIs have included Mackay Permanent Building Society Limited (acquired by Wide Bay Australia Limited, now Auswide Bank), Home Building Society (acquired by Bank of Queensland Limited (“Bank of Queensland”)), Pioneer Permanent Building Society Limited (acquired by Bank of Queensland) and The Rock Building Society Limited (acquired by MyState Bank). Each of these ADIs, other than Home Building Society, was smaller than bcu. However, these acquisitions have enabled shareholders to receive a control value for their shares.

(iii) Voluntary Winding Up or Payment of Dividends

A possible alternative transaction would be to voluntarily wind up bcu and distribute any remaining surplus to bcu members. A voluntary wind up would require that:

- the bcu directors make a declaration of solvency, confirming that bcu will be able to pay all of its existing debts within 12 months of beginning the winding up process;
- bcu members approve a special resolution to wind up bcu (i.e. 75% of votes cast are in favour of winding up bcu). The meeting at which this special resolution would be put to bcu members could be



called at the direction of the bcu Board or if 5% of bcu members (2,724 members based on the number of members at 31 March 2019) requisition such a meeting; and

- bcu ceases operating and a liquidator be appointed to sell bcu’s assets, pay all of its outstanding debts and manage the distribution of any surplus.

In this situation, bcu members would be likely to receive considerably less than the amount that would be received under a demutualisation and sale as any remaining surplus would be impacted by:

- no value being attributed to intangible assets;
- realisation of assets on a wind up basis; and
- the time and cost involved in realisation. The costs would include liquidator costs, staff redundancies, lease termination costs, etc.

In any event, in Grant Samuel’s view, it is unlikely that the bcu directors would propose that bcu be voluntarily wound up. It would not make economic sense for bcu members to seek to wind up bcu as a winding up would result in bcu members giving up all of the benefits of the mutual banking arrangements between bcu and its members (which is the very reason that they are members of bcu in the first place).

Similarly, it would also be possible for bcu members to requisition a meeting and approve a special resolution to change bcu’s Constitution to enable bcu to pay dividends as a means of unlocking value for bcu members. Assuming a prudential regulatory capital requirement (including mutual ADI buffer) of 13.5%, bcu would have had surplus capital of around \$16 million at 31 December 2018, or just under \$300 per bcu member, which could be distributed as a single dividend or over a period of time. However payment of dividends by bcu:

- is inconsistent with the principles of mutuality;
- would result in bcu members receiving significantly less than the amount that would be received under a demutualisation and sale and less than the amount that might be received on a voluntary winding up because of the requirement that bcu retain a minimum level of capital to meet regulatory requirements;
- could potentially result in loss of bcu’s mutual status (i.e. an unintended demutualisation) under ASIC Regulatory Guide 147 if paid out as a single dividend; and
- has the potential to lead to bcu breaching its minimum capital requirements and/or becoming insolvent if conditions change after a dividend was paid as a single amount.

If bcu members wanted bcu to be wound up or to change the bcu Constitution to enable the payment of dividends as an alternative to the Merger, they have had ample opportunity since announcement of the Merger to communicate this to the bcu Board and this has not been the case.

(iv) Arrangement with a Non-Mutual ADI

An alternative to demutualisation and sale/IPO would be for bcu to join Alliance Bank. Alliance Bank is a joint initiative between Bendigo and Adelaide Bank and its initial Alliance partners, AWA Mutual Limited, BDCU Limited, CIRCLE Mutual Limited and SERVICE ONE Mutual Limited, which was formed in March 2015 to create Australia’s first social enterprise bank network. A fifth partner, NOVA Mutual Limited, joined in May 2018. The Alliance partners collectively have over 40,000 members and 23 service centres.

Alliance partners enter into an Alliance Agreement⁶⁹ with Bendigo and Adelaide Bank under which:

- each Alliance Bank partner continues to exist and be wholly owned by its members with its own business strategy, branches, brand, staff and board, continues to make decisions about product

⁶⁹ An Alliance Agreement has an initial term of five years with options to renew for further five year terms.



delivery, pricing and credit, retains all of its capital (without the need to meet regulatory prudential requirements) and is responsible for member benefits and community support programs; and

- Bendigo and Adelaide Bank is responsible for APRA interface and management, regulatory licences and compliance, banking systems and digital technology, process administration, provision of white-labelled retail banking products and other products agreed with the Alliance Bank partners (i.e. they use Bendigo and Adelaide Bank’s ADI licence, all deposits and loans sit on Bendigo and Adelaide Bank’s balance sheet, Bendigo and Adelaide Bank bears the credit risk and all APRA obligations are transferred to Bendigo and Adelaide Bank).

Margins, fees and commissions are predominantly shared on a 50/50 basis between the Alliance Bank partner and Bendigo and Adelaide Bank, although partners earn revenue on loans and deposits.

Alliance Bank aims to achieve the scale and efficiencies required to remain sustainable as an independent, member owned mutual financial service provider over the long term, allowing the Alliance partner to use its capital to grow and develop its business around its members and its community purpose.

The Alliance Bank model has a number of advantages and disadvantages or challenges:

ADVANTAGES	DISADVANTAGES/CHALLENGES
<ul style="list-style-type: none"> • retain independence • remain 100% member owned • maintain brand • retain staff, management and board • continue to control business strategy, profitability parameters and operations • use capital to grow and develop business and address community need • able to provide members a full service banking offer • technology, compliance and back office processing costs borne by Bendigo and Adelaide Bank (saving cost and time) • both loans and deposits become revenue earning products 	<ul style="list-style-type: none"> • no longer able to use the term “credit union” and lack of understanding of the model • change in business model to earning revenue on loans and deposits and sharing revenue stream with Bendigo and Adelaide Bank • continued exposure to interest rate risk (although mitigated by maximising growth of both loans and deposits and managing the portfolio mix) • success requires growth of business and managing ongoing costs • maximising benefits of the model requires change from compliance focus to development and growth focus • regulatory risk replaced by partner risk (risks of the alliance itself and Bendigo and Adelaide Bank as partner)

Becoming an Alliance partner generally requires at least one membership vote to effect the partial transfer of the mutual ADI’s business to Bendigo and Adelaide Bank, where 25% of members must vote and at least 75% of members who vote must vote in favour of the proposal. In bcu’s case, becoming an Alliance partner would be a “Demutualisation Resolution” under Schedule 5 to the bcu Constitution and would only be passed if at least 5% of members who have been members for at least 12 months vote on the resolution, at least 25% of members who have been members for at least 24 months vote on the resolution and at least 75% of the votes cast by those members approve the resolution (i.e. the same requirement as for the Merger).

While becoming an Alliance partner was a lengthy and expensive process for the original partners, it was expected that it would be a much simpler process for new partners. However, the appeal of the Alliance partner model to date has been to small credit unions and the cost involved in becoming an Alliance partner (even now) has meant that not very many have done so. For example, prior to being acquired by Firstmac, Maleny Credit Union had identified the Alliance Bank model as the best option to enable it to meet APRA guidelines. It spent approximately \$0.3 million conducting preparatory work required to merge their systems, but over time it became clear that the cost would likely exceed \$1.5 million and was too expensive for Maleny Credit Union to proceed (even though there would have been ongoing cost savings subsequent to becoming an Alliance partner).



The Alliance partner model was considered by the bcu Board as part of its process but was discounted on the basis of cost, the impact on staff (in terms of redundancies) and because it limited bcu’s future strategic options (relative to the Merger).

(v) Merger with An Alternative Mutual ADI

A more likely alternative transaction would be for bcu to merge with another mutual ADI, for example, in the same geographic region. However, while a merger with another mutual ADI would increase bcu’s scale, whether this additional scale would be sufficient to make a difference would depend on the size of the merger partner. A smaller merger partner (e.g. the northern New South Wales-based Summerland Credit Union or Southern Cross Credit Union) would probably have limited impact as bcu would still not have the scale to secure its future sustainability. A larger merger partner (e.g. Heritage Bank or Greater Bank) would result in a loss of the bcu brand and local jobs as bcu would be the “target”.

The bcu Board underwent a detailed process that culminated in identifying P&N Bank as the most appropriate merger partner. The particular appeal of P&N Bank lies in:

- the agreed operating and governance model, which retains the bcu attributes that members value highly;
- its digital capabilities (current technology and digital offerings, financial capacity to invest in technology and innovation and large and experienced IT team); and
- its geographical separation from bcu, which creates a point of differentiation that removes many of the disadvantages often associated with merging with a larger merger partner.

Other mutual ADIs are unlikely to be able to offer this combination of features.

It is not possible to know whether there may be an alternative proposal that is superior to the Merger, either before the meeting to approve the Merger or at some time in the future. If a superior proposal did emerge prior to the meeting to approve the Merger, the bcu directors could consider it on its merits and could reconsider their recommendation in relation to the Merger.

Conclusion

Weighing the advantages and disadvantages of the Merger against the advantages and disadvantages of a possible demutualisation or possible voluntary winding up in the future is not straightforward, not least because each alternative involves consideration of a number of factors that cannot be quantified. Ultimately, such an assessment will depend on the individual views of bcu members and the relative importance they attach to the various aspects of their relationship with bcu.

In contrast, if the Merger is completed, the ability to merge with other mutual ADIs will be retained (and the Continuing Entity will arguably be in a better position than bcu on a stand-alone basis because as part of the Continuing Entity, it has more scope to be the “acquirer” rather than the “target”) or become an Alliance Bank in partnership with Bendigo and Adelaide Bank.

In deciding to enter into the MIA, the bcu Board considered bcu’s market and competitive position as a stand-alone business and the potential alternatives and undertook a due diligence process on P&N Bank. Based on this process, the Board decided to recommend the Merger to bcu members. However, bcu members could choose to vote against the Merger, in the expectation that bcu would be better off on a stand-alone basis or that an alternative, superior proposal might emerge.

In Grant Samuel’s view, however, bcu members would, ultimately, be worse off if the Merger did not proceed and bcu continued as a stand-alone company. bcu’s business would not benefit from the scale and access to resources necessary to grow and to better meet the needs and expectations of bcu members.



7.4.2 Loss of, or Changes to, Rights

If the Merger is completed, bcu members will no longer have a direct interest in bcu but will continue to have an interest in bcu's business (as well as P&N Bank's business) through their P&N Bank membership. bcu members will give up their rights as holders of bcu redeemable preference shares in return for rights as P&N Bank members and holders of P&N Bank member shares (unless a bcu member is already an P&N Bank member).

As a result, bcu members will have a different set of rights and liabilities. bcu members will no longer have direct influence over the governance of bcu, although as members of P&N Bank they will have some influence over the governance of P&N Bank. However, there will be changes to some of the rights of bcu members which could be considered to be disadvantageous. In particular, there will be changes to their right to participate in bcu's reserves on a winding up or demutualisation, the right to vote on resolutions for a transfer of business or a demutualisation, the requirements for a quorum and the right to nominate candidates to be appointed as directors. The impact of these changes on bcu members is discussed below.

(i) Participation in Reserves

If the Merger is completed, there will be changes to the rights of bcu members to participate in bcu's reserves. Under the bcu Constitution, bcu members are entitled to participate in bcu's reserves in two situations:

- on a winding up of bcu, bcu members are entitled to repayment of the issue price of their redeemable preference share (\$10, to the extent that this had been paid up) and to equal participation in any surplus; and
- on a demutualisation of bcu, bcu members who have been members for at least 12 months are entitled to participate in the distribution of bcu's profits and reserves.

If the Merger is completed, bcu members (as members of P&N Bank) will:

- forgo the right to participate in any surplus on a winding up of bcu (on an equal basis with all other bcu members) and the right to resolve to transfer any surplus to a company with a mutual structure, but will be entitled to participate in any surplus on a winding up of P&N Bank (on an equal basis with all other P&N Bank members); and
- forgo the right to participate in the distribution of bcu's profits and reserves on a demutualisation of bcu, but will be entitled to participate in the distribution of P&N Bank's surplus and profits on a demutualisation of P&N Bank (which will include bcu's profits and reserves), provided that they have been a P&N Bank member for not less than two years (although the basis on which any entitlement is allocated will depend on the terms of the proposal).

Participation in bcu's reserves through a winding up (of either bcu or P&N Bank as the Continuing Entity) is unlikely in the sense that:

- a voluntary winding up would require 5% of bcu members to requisition a meeting and 75% of members who vote to approve the winding up. If bcu members were to oppose the voluntary winding up, it would not occur. It would not make economic sense for bcu members to seek to voluntarily wind up bcu;
- in the event of an involuntary winding up of bcu, it would be unlikely that there would be any material surplus to distribute to members; and
- P&N Bank (as the Continuing Entity) would be likely to be wound up only if the business ceased to be financially viable. P&N Bank is, and the Continuing Entity will be, financially sound and based on its current financial position and the regulated environment in which it operates, it would be extremely unlikely for its financial position to deteriorate such that a winding up would be necessary.

G R A N T S A M U E L



Participation in bcu's reserves through a demutualisation requires the bcu Board to take action to change the status of bcu and for the necessary majority of bcu members to approve this change (i.e. approval by 75% of members who have been members for at least 12 months where at least 5% of members who have been members for at least 12 months vote and at least 25% of members who have been members for at least 24 months vote). If members were to oppose this change in status, it would not occur.

P&N Bank (and therefore the Continuing Entity) is committed to the mutual structure and has no current intention to demutualise. Mutuality is embedded in P&N Bank's history and its culture and its long term strategy assumes that it remains a mutual. While a future P&N Bank Board could arrive at a different conclusion in relation to P&N Bank's structure in different circumstances and in a different market environment, in the event of a demutualisation of the Continuing Entity, bcu members would be entitled to participate in the Continuing Entity's surplus and profits (which will include bcu reserves) on a demutualisation of the Continuing Entity as a P&N Bank member.

In this sense, the entitlement to participate in bcu's reserves is only a contingent right. As a result, except in the unlikely circumstance of a winding up or demutualisation, bcu members are not disadvantaged by any change to their rights.

In any event, to the extent that this change to the rights of bcu members may be regarded as a disadvantage of the Merger, this has been mitigated by the right that bcu members will have as members of P&N Bank to participate in the distribution of the Continuing Entity's surplus and profits on a winding up or demutualisation of the Continuing Entity (in the case of a demutualisation, provided that they have been a P&N Bank member for not less than two years). In this regard:

- on a winding up, bcu members will participate in the Continuing Entity's surplus and profits on an equal basis with other P&N Bank members. The quantum of any distribution of the Continuing Entity's surplus and profits to bcu members (as members of P&N Bank) could be greater or less than the quantum of any distribution of bcu reserves to bcu members on a per member basis. By way of example, NTA per member is as follows:

NTA PER MEMBER

	bcu	P&N BANK	PRO FORMA CONTINUING ENTITY
NTA at 31 December 2018 (\$ millions)	142.6	279.4	422.0
Number of members at 31 March 2019	54,470	95,453	149,923
NTA per member	\$2,618	\$2,927	\$2,815

Based on NTA at 31 December 2018 and the number of members at 31 March 2019, bcu members would be slightly better off (by \$197 per member) in the event of a winding up of the Continuing Entity (relative to their position in a winding up of bcu at the same point in time, assuming that the assets and liabilities of each entity were realised at book value);

- the basis on which any entitlement is allocated on a demutualisation will depend on the terms of the proposal and bcu members (as P&N Bank members) would have the right to vote on any such proposal. Assuming that the Continuing Entity was valued at the same NTA multiple as bcu (see Section 7.4.1(i)), the indicative pro forma value per member would be in the order of \$3,300-3,800 (around 8% higher than the indicative value per member on a demutualisation of bcu):



CONTINUING ENTITY – PRO FORMA INDICATIVE VALUE PER MEMBER

AT 31 DECEMBER 2018	REFERENCE	LOW	HIGH
Pro forma net assets attributable to members (\$ millions) ⁷⁰	Section 6.4	429.9	429.9
Pro forma intangible assets (\$ millions)	Section 6.4	(8.0) ⁷¹	(8.0)
Pro forma NTA (\$ millions)		421.9	421.9
Less: pro forma surplus capital ⁷² (\$ millions)	footnote 72	(47.1)	(47.1)
Pro forma adjusted NTA (\$ millions)		374.8	374.8
NTA multiple		1.2	1.4
Business value (\$ millions)		449.8	524.7
Add: pro forma surplus capital (\$ millions)	footnote 72	47.1	47.1
Equity value (\$ millions)		496.9	571.8
Number of members (at 31 March 2019)	Section 6.2	149,923	149,923
Indicative value per Continuing Entity member		\$3,314	\$3,814

- there will be continuity of membership for bcu members as a P&N Bank member (i.e. their years of bcu membership will be treated as years of P&N Bank membership) for the purposes of meeting the requirement of being a P&N Bank member for not less than two years (instead of at least 12 months under the bcu Constitution).

(ii) Voting Participation and Eligibility on Transfer of Business or Demutualisation

If the Merger is completed, there will be changes to the eligibility of bcu members to vote on any transfer of business or demutualisation proposal. Under the bcu Constitution:

- any transfer of business proposal must be approved by a special resolution (i.e. at least 75% of those voting either in person or by proxy) where at least 25% of members who have been members for at least 24 months vote; and
- a demutualisation resolution can only be put to members once every three years (unless recommended by the directors) and requires that:
 - at least 25% of bcu members who have been members for at least 24 months vote and at least 5% of bcu members who have been members for at least 12 months vote; and
 - only bcu members who have been members for at least 12 months are entitled to vote, and of these members, at least 75% must vote in favour of the resolution.

If the Merger is completed any transfer of business or demutualisation proposal will still require a special resolution of P&N Bank members (including bcu members), however there will be either no, or lower, participation and eligibility to vote requirements:

- there will be no requirement that at least 25% of P&N Bank members who have been members for at least 24 months vote on a transfer of business proposal; and
- a demutualisation proposal will be able to be put to members at any time and will only have a 25% member participation threshold (i.e. at least 25% of members must vote on the proposal). As a result, P&N Bank members will be entitled to vote on a demutualisation resolution even if they are not entitled to participate in the demutualisation proposal because they have been members for less than two years.

⁷⁰ Includes P&N Bank's 65% interest in P&N Financial Planning which has not been separately valued on the basis that it is immaterial in the context of the overall pro forma indicative value of the Continuing Entity.

⁷¹ Includes goodwill in relation to P&N Financial Planning of \$1.5 million (which is included in net assets of other activities in the table in Section 6.4).

⁷² Surplus capital of \$47.1 million = combined total capital at 31 December 2018 of \$413.1 million – (combined risk weighted assets at 31 December 2018 of \$2,711.2 million x target capital adequacy ratio of say, 13.5%).



As a result of these lower participation and eligibility hurdles, there will be a risk that in the event that a transfer of business or demutualisation resolution is put to members, proponents or dissidents of the proposal could become members of P&N Bank and vote on the proposal, potentially distorting the outcome such that the outcome does not reflect the views of long standing members.

These changes to voting participation and eligibility are not considered to be material in the context of the Merger. The basic requirement for a special resolution (i.e. support from the vast majority of members) for a transfer of business or a demutualisation is retained and the size of the Continuing Entity relative to the size of bcu means that a significantly greater number of members would need to vote in favour of any transfer of business or demutualisation proposal for it to succeed (assuming similar levels of voting participation by members), reducing the impact of groups of members with vested interests. Based on the number of members at 31 March 2019 and assuming 100% voting participation, a special resolution would require 40,853 bcu members to vote in favour, whereas the Continuing Entity would require 112,442 members to vote in favour (i.e. almost three times as many members). The additional protections incorporated into the bcu Constitution are more relevant to mutuals with smaller memberships, where relatively small changes in membership levels can have a greater impact on voting outcomes.

(iii) Quorums and Director Nomination Rights

If the Merger is completed:

- the number of members required for a quorum at meetings of members will increase from 10 to 25 (generally); and
- bcu members will no longer have a right to nominate or vote in relation to the appointment of bcu directors. As P&N Bank members, bcu members will have a right to nominate and vote in relation to the appointment of P&N Bank directors although these rights are different to the rights they have as bcu members:
 - four members who have been members for 12 months or more have the right to nominate a candidate to be a P&N Bank director (compared to two members required to nominate a candidate to be a bcu director);
 - the Nominations Committee determines whether a person becomes a candidate (based on a “fit and proper” assessment); and
 - no more than six directors are elected by members (out of a maximum of 10), with up to three appointed by the P&N Bank Board plus, if the P&N Bank Board determines, the CEO (compared to all bcu directors being appointed by members⁷³).

These changes to the requirements for a quorum and director nomination rights are not considered to be material in the context of the Merger. The basic requirement for a quorum and the basis right to nominate directors is retained and the additional requirements are not overwhelming. The P&N Bank requirements for a quorum and director nomination rights reflect the size of P&N Bank compared to bcu (95,453 P&N Bank members compared to 54,470 bcu members at 31 March 2019) and a desire to avoid small minorities of members influencing the ability to hold meetings of members and the composition of the P&N Bank Board (particularly in circumstances where there are generally very low levels of voting participation by members in relation to most matters).

7.4.3 Transaction and Implementation Costs

bcu’s transaction costs related to the Merger are estimated to total approximately \$1 million. These costs include adviser, legal, accounting, expert, communication and other consultant fees and printing, postage and meeting costs. bcu and P&N Bank have estimated that a further \$5 million of integration costs will be incurred over the period to 31 December 2020, primarily in the areas of IT (implementation and migration

⁷³ Other than casual vacancies which are appointed by the directors but must be elected by the members at the next AGM.



costs), people (integrating culture, voluntary redundancy⁷⁴ and retention payments⁷⁵) and integrating risk and compliance policies and procedures and products and standardising product terms and conditions.

These costs are predominantly one off and are not material in the context of the Continuing Entity's net assets (estimated transaction costs are 0.2% of pro forma Continuing Entity net assets and estimated total transaction and implementation costs are 1.4% of Continuing Entity net assets).

However, the transaction costs are material in the context of bcu's annual profit (around 9% of net profit after tax) and will be incurred by bcu on a stand-alone basis if the Merger does not proceed. In certain circumstances, bcu will also be liable to pay P&N Bank a \$900,000 break fee (although not if member approval is not obtained). On the other hand, there are also certain circumstances in which P&N Bank will be liable to pay bcu a \$900,000 million break fee.

7.5 Risks of the Merger

7.5.1 Implementation Risks

The Merger will involve a number of implementation risks that bcu members should take into account:

- there will be a risk that the integration of the bcu and P&N Bank businesses takes longer or costs more than is expected due to unforeseen issues, particularly as it is necessary to integrate the banking systems. The Continuing Entity will have a broader range of operations and will, as a result, be more complex and more difficult to manage than bcu on a stand-alone basis. Any delay in integration is likely to delay the provision of benefits to bcu members.

Integration planning is governed by the joint steering committee, which has been in place since the MIA was signed. Detailed planning commenced in June 2019 with the aim of minimising or avoiding integration risks. However, such risks cannot be entirely eliminated;

- there will be ongoing execution risk associated with:
 - successfully implementing the operating and governance model, in particular managing the multi-brand strategy and determining at which level certain decisions will occur (i.e. at the centralised group level versus the brand level). Some decision making will be straightforward, but for other decisions there will be less clarity as to who is (or should be) responsible. Getting the right balance between brand autonomy and central co-ordination to achieve cost savings will be key to successful integration;
 - having group executives geographically spread across the east and west coasts of Australia in terms of inclusion (being informed and kept up to date, working as a cohesive group), operating in different time zones and managing travel costs; and
 - cultural/organisational differences such as relative staffing levels, remuneration etc;
- despite the operating and governance model, bcu members (as P&N Bank members) will be exposed to the activities of P&N Bank, which include its financial planning business, specialised property activities (which although in the process of being wound down, could result in the write down or write off of its only material asset, the receivable from the Pindan Group) and reverse mortgage portfolio; and

⁷⁴ Including the payment to be received by the current bcu CEO, Mr Alan Butler, who will receive a payment equivalent to 12 months of salary, consistent with the terms of his employment contract, which also includes a nine month restraint on being able to be employed within the financial services industry.

⁷⁵ Includes payments to five members of bcu staff that are important to the success of the Merger and subsequent integration who are eligible to receive retention payments totalling approximately \$175,000 subject to meeting certain employment, performance and conduct requirements.



- while the Merger will provide access to organic growth opportunities through P&N Bank’s digital capabilities being deployed to target new home loan growth opportunities in bcu’s geographical markets and P&N Bank utilising bcu’s expertise to offer commercial and specialist property loans in Western Australia, there is no guarantee that the expected revenue from these types of activities will eventuate. Furthermore, inorganic growth will be required for P&N Bank to achieve its targeted scale (to double the size of the business by 2020). There is no certainty that such opportunities will eventuate.

7.5.2 Less Influence over Governance

bcu members will, collectively, have less influence over the governance of P&N Bank and therefore over the future of bcu’s business. While bcu members will have rights in relation to the nomination and appointment directors, as bcu members collectively represent only 38% of P&N Bank members, they will not have the ability to pass resolutions relating to the appointment of up to six member appointed directors (and, in any event, there will also be up to three directors appointed by the P&N Bank Board). As a result, there is a risk that:

- the directors representing the bcu Mid North Coast, New South Wales region on the P&N Bank Board (Mr Gary Humphreys and Ms Louise Clarke) do not remain on the P&N Bank Board in the longer term (i.e. once their initial terms expire at the AGMs held in 2020 and 2021 respectively); and
- while the governance and operating model is designed to preserve and safeguard the attributes of a stand-alone bcu that its members value such as its brand, staff and stores, local decision making (supported by the bcu Advisory Council) and its commitment to the local community, the P&N Bank Board could change this model at some future date.

While these outcomes are possible, they are inconsistent with the basis on which the Merger has been negotiated and would be detrimental to P&N Bank’s ability to achieve future inorganic growth through attracting other mutual ADIs to the governance and operating structure.

7.5.3 Future Changes to bcu’s Business

There is a risk that the business, products and services offered by the bcu business may change over time. There are some differences in terms of pricing and features between bcu and P&N Bank products. However:

- under the operating and governance model, bcu management will retain the discretion to price selected bcu core products differently to comparable P&N Bank products; and
- any future changes to products and services are expected to be consistent with P&N Bank’s commitment to providing members with an improved and attractive banking offer.

It is also possible that there may be unavoidable changes to the banking details of bcu members as a result of transitioning bcu’s banking system to P&N Bank’s banking system (during 2020). While this may inconvenience bcu members, the Continuing Entity will undertake a communication process well before any change and will aim to minimise the impact on bcu members.

7.5.4 General Insurance Products Held by bcu Members

bcu members hold general insurance policies issued by Allianz under an exclusive arrangement that operates on a rolling basis and has a standard notice period for termination. It is expected that these insurance policies will continue until a single general insurance provider is selected for the Continuing Entity.

If Allianz is not the general insurer selected for the Continuing Entity, there is a risk that bcu members renewing their general insurance policies will be asked to pay a higher premium for equivalent insurance



cover. However, bcu members will not be obliged to continue their general insurance policies (i.e. they can obtain quotes and take out policies from other general insurance providers).

7.5.5 Potential Loss of Customers

There is the potential for the bcu business to lose existing customers who are not in favour of the Merger. If a significant number of customers was lost, this could have an impact on the Continuing Entity's profitability and the reserves available for reinvestment.

However, the feedback on the Merger from bcu members to date has been generally favourable and a material loss of existing customers is considered unlikely.

In addition, the ability to offer bcu customers greater mobile banking capabilities (all three digital wallets and instant digital cards as well as a new mobile banking app with greater features and capabilities) should attract new customers to more than offset any loss of existing customers.

7.5.6 Potential Loss of Key Employees

bcu has a number of key employees whose experience and expertise are important to the ongoing operation of the business. Any loss of these key employees may have an adverse impact on the integration and performance of the bcu business. However:

- all bcu employees will be offered a role in the Continuing Entity and there will be no forced redundancies of staff from bcu directly as a result of the Merger; and
- certain key bcu employees will be paid retention bonuses if they remain employed by the Continuing Entity for certain minimum period (three or six months) after completion of the Merger and meet certain performance and conduct criteria.

7.6 Other Considerations

7.6.1 Taxation Consequences

There are not expected to be any tax consequences for bcu members from:

- cancellation of their bcu redeemable preference shares;
- becoming P&N Bank members; or
- holding P&N Bank member shares,

as a result of the Merger.

Further details on the taxation consequences of the Merger for bcu members are set out in Section 4.3 of the Member Booklet. If in any doubt, bcu members should consult their own professional adviser.

7.6.2 Minimum Voting Threshold

The bcu Constitution provides that:

- only members who have been members of bcu for at least 12 months will be eligible to vote on the Merger Resolution (and at least 75% of those eligible members who do vote must vote in favour of the Merger Resolution); and
- even if the voting majority above is met, the Merger Resolution will only be passed for the purposes of the bcu Constitution if:
 - at least 5% of members who have been members for at least 12 months; and



- at least 25% of members who have been members for at least 24 months, actually vote on the Merger Resolution (whether for or against).

If the requirement that at least 25% of members who have been members for at least 24 months vote is met, the requirement that at least 5% of members who have been members for at least 12 months vote will, by definition, also be met. However, the minimum turn out requirement is a more demanding voting threshold than is usually required to approve a transaction and means that (based on the number and tenure of members at 31 March 2019), at least 10,613 bcu members who have been members for at least 24 months must vote on the Merger Resolution. There is a risk that this minimum threshold will not be met.

If the 25% threshold is not met, the Merger Resolution will not be able to be approved (even if at least 75% of those bcu members who do vote, vote in favour of the Merger Resolution) and the Merger will not proceed. bcu has put in place a member engagement plan (with assistance from an external third party) to raise awareness of the Merger and to encourage bcu members to vote through use of staff, instore marketing (flyers, posters), digital assets (website, landing page, ibank, bcu app, bcu news), direct marketing and social media campaigns (e.g. wavelength blog) and local store and community forums.

7.6.3 Conditions Precedent

The Merger is subject to a number of conditions precedent that cannot be waived (in addition to bcu member approval of the Merger), including:

- P&N Bank member approval of the Merger; and
- certain regulatory approvals from APRA under the Transfer Act and the Transfer Rules,

which have not been received at the date of this report.

The meeting at which P&N Bank members will consider the Merger is scheduled to be held on 23 October 2019, the day following the general meeting at which bcu members will vote on the Merger. While there can be no certainty that P&N Bank members will approve the Merger, the directors of P&N Bank have unanimously recommended that P&N Bank members vote in favour of the resolution to approve the Merger.

Certain of the regulatory approvals from APRA under the Transfer Act and the Transfer Rules will only be received after the meeting of bcu members to consider the Merger Resolution has been held, which creates uncertainty about the outcome of the Merger. However, these approvals are largely procedural and the likelihood of them not being received is considered to be very low.

7.7 Member Decision

Grant Samuel has been engaged to prepare an independent expert's report setting out whether, in its opinion, the Merger is in the best interests of members and the benefits being provided to members are fair and reasonable having regard to any loss of rights and change as to voting rights and rights to participate in the reserves and profits of bcu, and to state reasons for those opinions. Grant Samuel has not been engaged to provide a recommendation to members in relation to the Merger, the responsibility for which lies with the directors of bcu.

In any event, the decision whether to vote for or against the Merger is a matter for individual members based on their personal circumstances and the nature of their relationship with bcu, including the products and services they use and the importance they place on these products and services as well as their expectations of the benefits of being a member of P&N Bank. Members who are in doubt as to the action they should take in relation to the Merger should consult their own professional adviser.



8 Qualifications, Declarations and Consents

8.1 Qualifications

The Grant Samuel group of companies provide corporate advisory services in relation to mergers and acquisitions, capital raisings, debt raisings, corporate restructurings and financial matters generally. The primary activity of Grant Samuel & Associates Pty Limited is the preparation of corporate and business valuations and the provision of independent expert's reports in connection with mergers and acquisitions, takeovers and capital reconstructions. Since inception in 1988, Grant Samuel and its related companies have prepared more than 560 public independent expert and appraisal reports.

The persons responsible for preparing this report on behalf of Grant Samuel are Jaye Gardner BCom LLB (Hons) CA SF Fin GAICD and Stephen Wilson MCom (Hons) CA SF Fin. Each has a significant number of years of experience in relevant corporate advisory matters. Each of the above persons is a representative of Grant Samuel pursuant to its AFSL under Part 7.6 of the Corporations Act.

8.2 Disclaimers

It is not intended that this report should be used or relied upon for any purpose other than as an expression of Grant Samuel's opinion as to whether the Merger is in the best interests of members and whether the benefits being provided to members are fair and reasonable having regard to any loss of rights and change as to voting rights and rights to participate in the reserves and profits of bcu. Grant Samuel expressly disclaims any liability to any bcu member who relies or purports to rely on the report for any other purpose and to any other party who relies or purports to rely on the report for any purpose whatsoever.

Grant Samuel has had no involvement in the preparation of the Member Booklet issued by bcu and has not verified or approved any of the contents of the Member Booklet. Grant Samuel does not accept any responsibility for the contents of the Member Booklet (except for this report).

Grant Samuel has had no involvement in bcu's due diligence investigation in relation to the Member Booklet and does not accept any responsibility for the completeness or reliability of the process which is the responsibility of bcu.

8.3 Independence

Grant Samuel and its related entities do not have at the date of this report, and have not had within the previous two years, any business or professional relationship with bcu or P&N Bank or any financial or other interest that could reasonably be regarded as capable of affecting its ability to provide an unbiased opinion in relation to the Merger.

Grant Samuel had no part in the formulation of the Merger. Its only role has been the preparation of this report.

Grant Samuel will receive a fixed fee of \$285,000 for the preparation of this report. This fee is not contingent on the conclusions reached or the outcome of the Merger. Grant Samuel's out-of-pocket expenses in relation to the preparation of the report will be reimbursed. Grant Samuel will receive no other benefit for the preparation of this report.

Grant Samuel considers itself to be independent in terms of Regulatory Guide 112 issued by ASIC on 30 March 2011.



8.4 Declarations

bcu has agreed that it will indemnify Grant Samuel and its employees and officers in respect of any liability suffered or incurred as a result of or in connection with the preparation of the report. This indemnity will not apply in respect of the proportion of any liability found by a court to be primarily caused by any conduct involving negligence or wilful misconduct by Grant Samuel. bcu has also agreed to indemnify Grant Samuel and its employees and officers for time spent and reasonable legal costs and expenses incurred in relation to any inquiry or proceeding initiated by any person. Any claims by bcu are limited to an amount equal to the fees paid to Grant Samuel. Where Grant Samuel or its employees and officers are found to have been negligent or engaged in wilful misconduct Grant Samuel shall bear the proportion of such costs caused by its action.

Advance drafts of this report were provided to bcu and its advisers. Advance drafts of this report were also provided to P&N Bank in accordance with bcu's obligations under the MIA. Certain changes were made to the drafting of the report as a result of the circulation of the draft report. There was no alteration to the methodology, evaluation or conclusions as a result of issuing the drafts.

8.5 Consents

Grant Samuel consents to the issuing of this report in the form and context in which it is to be included in the Member Booklet to be sent to members of bcu. Neither the whole nor any part of this report nor any reference thereto may be included in any other document without the prior written consent of Grant Samuel as to the form and context in which it appears.

8.6 Other

The accompanying letter dated 20 August 2019 forms part of this report.

Grant Samuel has prepared a Financial Services Guide as required by the Corporations Act. The Financial Services Guide is set out at the beginning of this report.

GRANT SAMUEL & ASSOCIATES PTY LIMITED

20 August 2019

Grant Samuel & Associates