OCBC Bank

Asia Credit Research

Earnings Review: Westpac Banking Corporation ("Westpac")

Recommendation

- Westpac's results continue to reflect its stable and entrenched business positions in Australia and New Zealand with earnings and balance sheet growth indicating supportive business conditions.
- Asset quality shows some slight weakness h/h and together with anticipated cost increases and lower mortgage growth, earnings may not be so stellar going forward. That said, the results and solid capital position does not cause us to alter our Positive (2) Issuer Profile on Westpac.
- On a technical and fundamental basis, the ANZ 3.75% '27c22s represent the better value in the Aussie Tier 2 space in our view. We currently rate all the Australian banks at a Positive (2) Issuer Profile.

Relative Value:

Bond	Maturity / Call date	CET1 Ratio*	Ask Yield	Spread
WSTP 4.00 '27c22 (T2)	12/08/2022	10.5%	3.17%	83
NAB 4.15 '28c23 (T2)	19/05/2023	10.2%	3.43%	104
ANZ 3.75 '27c22 (T2)	23/03/2022	11.0%	3.25%	94

Indicative prices as at 8 May 2018 Source: Bloomberg
*Common Equity Tier 1 (CET1) Ratio based on latest available quarter *APRA Compliant*

Issuer Profile: Positive (2)

Ticker: **WSTP**

Background

Westpac Banking Corporation ('WBC') is Australia's oldest bank and second largest by market capitalization. It offers consumer, business and institutional banking services as well as wealth management and insurance across Australia and New Zealand using a multi-branded strategy. As at 31 March 2018, it had total assets of AUD871.9bn.

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Key Considerations

- **Firing on all cylinders:** Westpac's 1HFY2018 results for the 6 months ended 31 March 2018 appear on trend with domestic peers as a stable operating environment translated into broad based growth across business segments. Net operating income rose 4% y/y due to 9% y/y growth in net interest income from loans growth and the reported net interest margin improving 11bps to 2.16%. This was balanced by a 9% y/y fall in non-interest income from lower net trading income and economic hedges impact on New Zealand earnings. Expenses rose 2% y/y due to higher salary and technology expenses as well as an increase in regulatory and compliance costs. Of interest is that the cost increases already factor in costs associated with the on-going Royal Commission into misconduct in the Banking industry. That said, given the lower growth in expenses (versus income), net profit before impairment charges rose 5% y/y to AUD6.4bn and Westpac's cost to income ratio fell marginally to 41.7% against 41.8% y/y.

- **Still strong asset quality but for how long**: Impairment charges fell 20% y/y, primarily in individual provisions, as portfolio quality appears sound according to management. Westpac's reported stressed exposures as a percentage of total committed exposures was 1.09% as at 31 March 2018, down 5bps from 31 March 2017. In kind, the ratio of gross impaired asset provisions to gross impaired assets fell to 45.5% as at 31 March 2018 from 52.1% as at 31 March 2017. This trend should be watched considering the mortgages 90+ day delinquencies ratio rose marginally y/y (albeit from a low base) and the ratio of reported stressed exposures as a percentage of total committed exposures weakened h/h (1.05% as at 30 September 2017). The rise in stressed exposures came primarily from mortgage delinquencies. This explains why impairment charges rose h/h by 9%. As impaired assets and the gross impaired assets to gross loans ratio remained stable h/h at 0.22%, the rise in impairment charges was from collectively assessed provisions while individually assessed provisions continue to fall.

- **Broadly positive results by segment**: Lower impairment charges together with the positive JAWs ratio (Income Growth Rate - Expense Growth Rate) led to profit before tax up 7% y/y to AUD6.0bn. Segment performance by cash earnings (which reflects profits generated by ongoing operations) was broadly positive with y/y growth in cash earnings from Consumer Bank, Business Bank, BT Financial Group and Westpac New Zealand due to business growth and/or improved lending volumes as well as lower impairments. Only Westpac's Institutional Bank had a y/y fall in cash earnings although this came off a strong performance in 1HFY2017. This was reversed however on a h/h basis from a 6% increase in loans and a 2bps improvement in margins from better loan pricing and changes in the deposit mix.

- **Driven by loan growth**: Supporting segment performance was broad based loans growth with total loans up 2% h/h and 5% y/y. Growth occurred in all of Westpac's major geographic segments with Australian loans up 2% h/h and 5% y/y and New Zealand loans up 4% h/h and 6% y/y. While Other Overseas loans was up 14% h/h and 25% y/y, its contribution to overall loans as at 31 March 2018 remains low at 2%, loans dominated by Australia (87% of total loans) and New Zealand (11%). Loan growth in Australia and New Zealand was driven mostly by mortgage growth to owner occupiers, while the better loans growth in New Zealand was due to better business conditions, particularly in Agriculture. Overseas loan growth was driven mostly by increased trade financing in Asia.

- **Capital ratios above minimum requirements**: Given solid earnings, capital ratios improved 50bps y/y to 10.5% as at 31 March 2018, in line with the Australian Prudential Regulation Authority (APRA)'s minimum CET1 requirement by Jan 1, 2020 for 'unquestionably strong' capital ratios. This remains above the bank's minimum CET1 requirement of at least 8.0%. Improvement was driven by higher growth in CET1 capital (+8%) y/y against growth in risk weighted assets (+3% y/y). H/h trends were different with CET1 ratios marginally lower as 102bps improvement in cash earnings was offset by the impacts of final dividend payment (-70bps), regulatory model changes (-22bps) and RWA growth (-8bps).

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Explanation of Issuer Profile Rating / Issuer Profile Score

Positive ("Pos") – The issuer's credit profile is either strong on an absolute basis, or expected to improve to a strong position over the next six months.

Neutral ("N") – The issuer's credit profile is fair on an absolute basis, or expected to improve / deteriorate to a fair level over the next six months.

Negative ("Neg") – The issuer's credit profile is either weaker or highly geared on an absolute basis, or expected to deteriorate to a weak or highly geared position over the next six months.

To better differentiate relative credit quality of the issuers under our coverage, we have further sub-divided our Issuer Profile Ratings into a 7 point Issuer Profile Score scale.

IPR	Positive		Neutral			Negative	
IPS	1	2	3	4	5	6	7

Explanation of Bond Recommendation

Overweight ("OW") – The performance of the issuer's specific bond is expected to outperform the issuer's other bonds, or the bonds of other issuers either operating in the same sector or in a different sector but with similar tenor over the next six months.

Neutral ("N") – The performance of the issuer's specific bond is expected to perform in line with the issuer's other bonds, or the bonds of other issuers either operating in the same sector or in a different sector but with similar tenor over the next six months.

Underweight ("UW") – The performance of the issuer's specific bond is expected to underperform the issuer's other bonds, or the bonds of other issuers either operating in the same sector or in a different sector but with similar tenor over the next six months.

Other

Suspension – We may suspend our issuer rating and bond level recommendation on specific issuers from time to time when OCBC is engaged in other business activities with the issuer. Examples of such activities include acting as a joint lead manager or book runner in a new issue or as an agent in a consent solicitation exercise. We will resume our coverage once these activities are completed.

Withdrawal ("WD") – We may withdraw our issuer rating and bond level recommendation on specific issuers from time to time when corporate actions are announced but the outcome of these actions are highly uncertain. We will resume our coverage once there is sufficient clarity in our view on the impact of the proposed action.

Analyst Declaration
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