OCBC CREDIT RESEARCH

AUD Bond Market

Friday, October 18, 2019

Broadening Horizons

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Welcome to our look at a select number of Australian domiciled issuers. We have decided to look further abroad towards Australia due to investor interest but also for both diversification as well as a means to provide context to our existing SGD bond market coverage.

While issuers are predominantly domestic focused aside from Macquarie Group Limited and Qantas Airways Limited, there are synergies in the names selected with issuers in the property, airline, financials and telecommunications sectors.

Broadly speaking, the issuers included in this report are high quality in our view and exhibit solid market positions in their respective industries and sound financial profiles. Disclosure is also generally transparent and detailed.

Before delving into the selected issuers, our macro colleagues have given an overview of Australia's economic outlook. While the economy has slowed and questions have been raised about future performance, there are signs of a turnaround in 2020.

We intend to update our views on these Australian domiciled issuers periodically on significant and material developments that may influence our view of the issuer profile assigned. Our SGD bond market coverage remains our primary focus.

We welcome your feedback as we continue to seek good quality names for investors. As always, we thank our readers for your continued support and hope you find our publications useful.

With appreciation,
OCBC Credit Research

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Turnaround in property market key to economic rebound fortunes

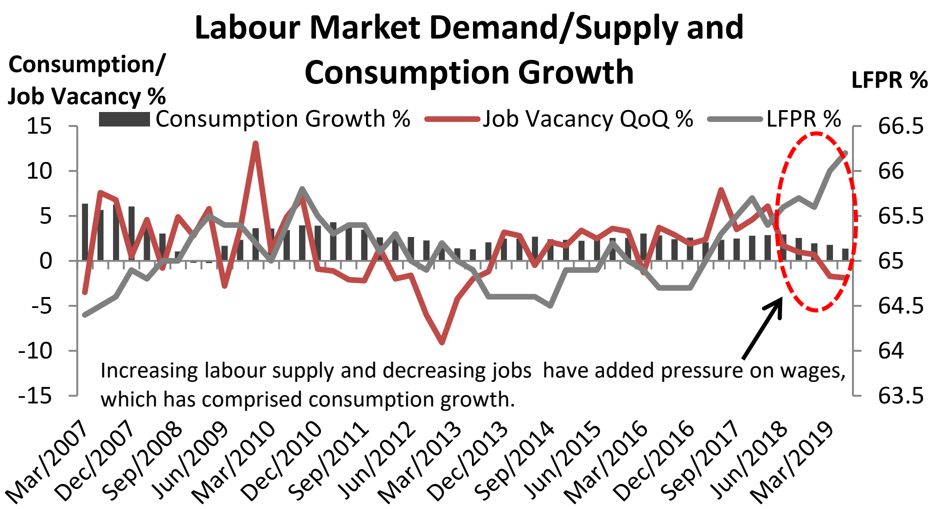
- **The domestic labour market continues to remain weak, as job vacancies decline amid a backdrop of increasing labour participation.**
- **Slow wage growth has hurt household consumer spending.**
- **Housing market woes remain a primary concern, but there are some signs that housing turnover is picking up.**
- **Tax refunds and further fiscal stimulus, together with RBA's multiple rate cuts, may usher in an economic turnaround in 2020.**

Overview

Three main themes continue to dominate Australia's economic landscape – slow wage growth underpinned by a weakening domestic labour market, falling consumer discretionary spending and the decline in housing prices, notably in Sydney and Melbourne. The Australian government and the central bank, however, have taken corrective steps to ease the slowdown in the domestic economy and an economic turnaround looks likely in sight.

Weak labour market has led to falling wages and consumption

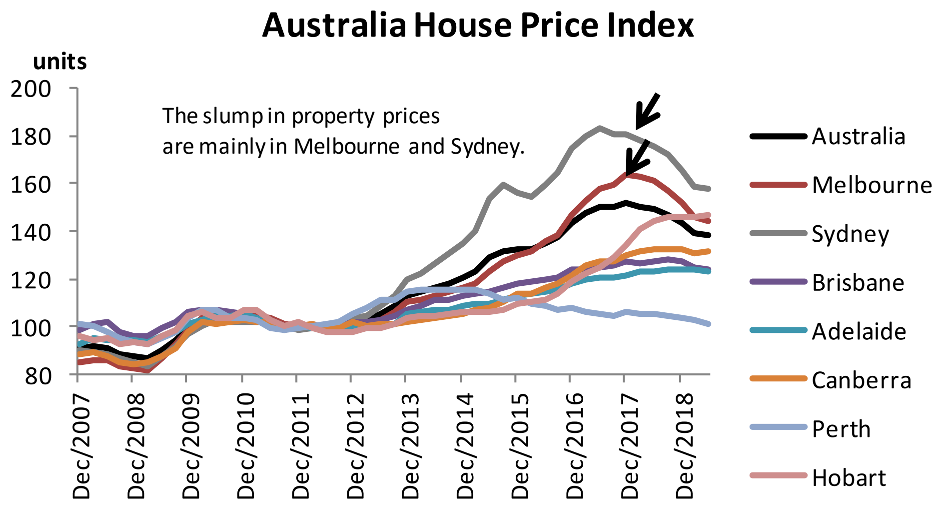
The domestic labour market continues to remain weak, with the unemployment rate having picked up from a multi-year low of 4.9% in February to a 5.3% in August. This is also consistent in the uptick in the underemployment rate, which has risen from 8.1% to 8.6% in the same period. An explanation for this development is the increase in the size of the labour force, with the labour force participation rate having risen to 66.2% but with the number of job vacancies on a declining trend. The result is a downward pressure on wages, which in turn has dampened consumer spending.



Source: ABS, Bloomberg, OCBC Bank

Housing market woes remain a concern

Recent declines in housing prices, particularly Sydney and Melbourne, have added strains on consumer discretionary spending. With housing prices in Melbourne now underwater for a year and 6 quarters in Sydney, asset wealth levels in the country have decreased, which has led to consumers tightening their discretionary spending. The secondary impact on declining residential construction activity as well as a decrease in spending on furniture and household appliances, both due to a dip in housing turnover rate, have added pressure on economic growth.



Source: Bloomberg, OCBC Bank

Tax refunds, rate cuts to boost economic growth

To tackle the issues of falling consumer spending and to stem the decline in housing prices, both the Australian government and the Reserve Bank of Australia ("RBA") have implemented fiscal and monetary stimulus in a bid to engineer a soft landing for the economy. The government has issued tax refunds to almost 7 million Australians at present, worth a total of $17.4bn to-date, with approximately half of the population still yet to file their annual returns. Putting cash back directly into the bank accounts of Australians is expected to boost spending, although the effectiveness of this policy is still up for debate. In particular, a survey by Westpac Banking Corporation suggests that most consumers are keen to save the tax refunds rather than spend it, which continues to show weakness in consumer sentiment.

The multiple rate cuts by the RBA, however, appear to have more impact on the economy, with recently updated dwelling prices and auction clearance rates in Melbourne and Sydney picking up noticeably.

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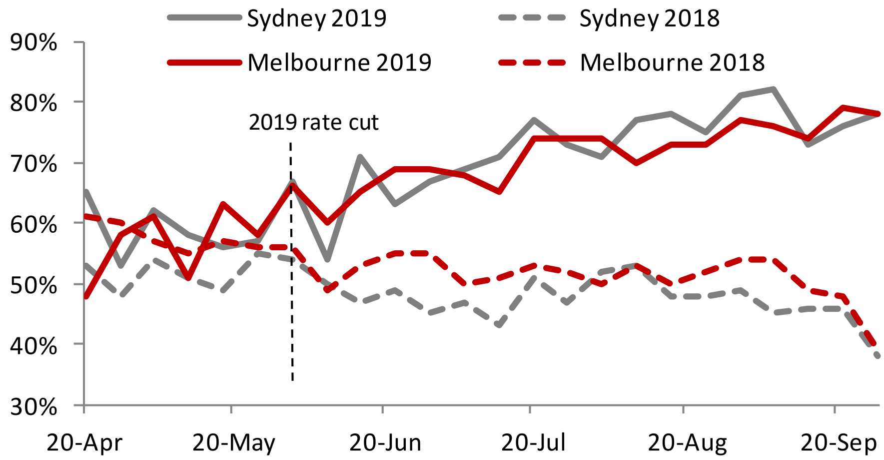
Property Auction Clearance Rate



Source: Domain Australia, OCBC Bank

Bottoming out in sight

The RBA has reduced the benchmark interest rate thrice this year to a new record low of 0.75% and is likely to keep monetary policy loose in the near future. The rate cuts have already had a positive impact in its stabilisation of housing prices, evident in the uptick in dwelling prices and the pickup in auction clearance rates. GDP growth in 1H 2019 has picked up to 0.8% yoy versus 0.7% in 2H 2018, signaling a gentle rebound in economic activity. The continued depreciation of the Australian dollar via the ongoing rate cuts and expected quantitative easing ("QE') programmes, coupled with the tax refunds and ongoing investments in infrastructure, appear to be spurring green shoots in Australia's property sector. This suggests that an economic turnaround in 2020 is likely in sight.

Issuer Profile:
Neutral (3)

Ticker:
ASTAU

Industry:
Utilities

Geography:
Victoria, Australia

Market cap:
- AUD6.7bn as at 10 Oct 2019

Ownership:
- 30.8% Singapore Power International Pte Ltd
- 19.7% State Grid International Development Ltd

AusNet Services Ltd

I) Company Background

AusNet Services Ltd ("AST") is an energy infrastructure business located in Australia, primarily serving the most densely populated state in the country, Victoria. AST owns and operates three regulated energy network businesses – (1) Victoria's primary electricity transmission network, (2) one of five electricity distribution networks in eastern Victoria and (3) one of three gas distribution networks in western Victoria. AST also has an unregulated business ("Mondo") which provides unregulated infrastructure services and specialized utility-related solutions (such as design and build systems that generate, manage, store and share energy for a business, assist with energy monitoring, and integration of on-site energy generation and storage). AST has a combined regulated and contracted asset base of AUD10.3bn as at FY2019 (+4.9% y/y).

Although AST has been publicly listed on the Australian Stock Exchange since 2015, the history of the company traces back to 1995 where the business was acquired from the Victorian State Government. At present, Singapore Power Limited, a Singapore energy utilities company (wholly owned by Temasek) indirectly owns 30.8% of AST through Singapore Power International Pte Ltd while State Grid International Development Ltd, subsidiary of State Grid Corporation of China, holds a 19.7% stake. The balance 49.5% is owned by public investors. Market capitalisation at 10 Oct 2019 was AUD6.7bn. On the management front, Nino Ficca, Managing Director who has been with AST since 2003 will be retiring in 2019. The successor is yet to be determined. Adam Newman, Executive General Manager and Chief Financial Officer joined AST in 2013.

The AUD bonds are issued by AusNet Services Holdings Pty Ltd, a wholly owned subsidiary and central funding vehicle of AST. The guarantors are operating companies (also wholly-owned subsidiaries of AST) – AusNet Gas Services Pty Ltd, AusNet Electricity Services Pty Ltd, AusNet Asset Services Pty Ltd and AusNet Transmission Group Pty Ltd. As such, we assess the credit worthiness of AST to determine that of AusNet Services Holdings Pty Ltd.

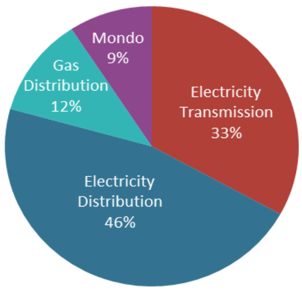
II) Recommendation Summary

- Although regulated revenue at AST has dipped, the nature of its business provides resilience and certainty with regards to revenue and cashflow, with over 80% of its revenue being locked-in till 2022. AST has also embarked on a cost-efficiency program (operating expenses: down 5.2% y/y) which has partially offset the lower revenue.
- Mondo, AST's unregulated commercial energy business, is a catalyst for growth. It is well positioned to capture the rapid growth in the renewable energy sector, with infrastructure assets that serve customers in the renewable, utility, water, gas, and rail business. AST has targeted to grow its contracted asset base (i.e. unregulated) to AUD1.5bn by end FY2024, from AUD949mn (including signed contracts) as at end FY2019. We think AST has sufficient funds on hand to realize this growth target that is spread over the next five years.
- Net gearing for AST stood at 2.31x at end FY2019. We are not overly concerned of the high leverage level as AST has a significant amount of assets given its business nature and net debt to regulated and contracted asset base was 67.1% (2018: 66.7%).
- While AST's outstanding debt is substantial at almost AUD8.0bn, debt maturities are generally well distributed, with a maximum of AUD869mn coming due in each calendar year, and AUD706mn (9.3% of total debt outstanding) are junior subordinated debt maturing in 2076 (67 years from 2019). AST has AUD339mn cash on hand and access to AUD778mn undrawn committed bank debt facilities to cover any potential shortfalls in interest and principal payments. Access to capital markets is also strong, having issued four bonds in YTD2019 amounting to AUD706mn. EBITDA/Interest (based on our calculation) was decent at 3.8x in FY2019. **As such, we are assigning AST a Neutral (3) issuer profile.**

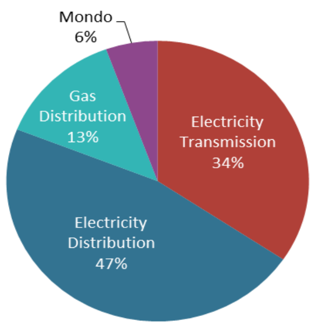
III) Key Considerations

- **Regulated networks offer revenue certainty:** The regulated component of AST's revenue was 81.5% for the year ended March 2019 ("FY2019") at AUD1.5bn (FY2018: 82.7% at AUD1.6bn). Such revenues are determined for each of the networks for a specified regulatory period by the Australia Energy Regulator ("AER"). Specifically, the AER determines the maximum revenue that the business segments can earn through a periodic determination or reset process, where the company is required to submit a proposal to the AER, detailing how much revenue it needs to earn to cover the costs of providing a safe and reliable electricity or gas supply. This determination process typically occurs once every five years. Notably, the upcoming regulatory reset dates for AST's electricity distribution network, electricity transmission network and gas distribution network are 1 January 2021, 1 April 2022 and 1 January 2023 respectively. As such, while AST has no ability or flexibility to charge more without regulatory approval, these revenues are confirmed until end 2020 (based on the above reset dates) which offers some revenue certainty. That said, total regulated FY2019 revenue was down by 3.9% y/y largely due to the hand-back of previously received metering revenue (as AER disallowed AST from keeping excess revenue) of AUD29.4mn and AUD29.1mn lower reliability incentive revenue. Of the three networks, electricity distribution contributes the majority (51.4% of total regulated revenue), followed by electricity transmission (35.4%) then gas distribution (13.3%).

Total Revenue* by Segment (FY2019)



EBITDA by Segment (FY2019)



Source: Company, OCBC
*Total Revenue: Regulated revenue, Unregulated revenue, Customer contributions, Service revenue and Other revenue

- **Cost-efficiency program offsets lower revenue:** FY2019 EBITDA fell by just 0.8% y/y to AUD1.1bn, despite 2.5% y/y lower revenue as operating expenses fell by a greater extent of 5.2% y/y (i.e. AUD39.6mn) due to the cost efficiency program and Mondo's strategic refocus (exited a number of field services agreements). Noticeably, operating expense over revenue has fallen to 39.1% (FY2018: 40.2%, FY2017: 43.0%). We think the trend of a reduction in operating expenses offsetting lower regulated revenues is likely to persist as AST still has room to improve efficiency. In particular for the electricity distribution network, it still has some way to go to realize AST's goal of being in the top quartile even though it has already recorded an efficiency improvement of 14% in the latest regulatory benchmarking in 2019. Some ways to improve efficiency includes developing and adopting new solutions, avoiding expensive network asset replacement though a detailed plan was not disclosed.

- **Unregulated business a catalyst for growth:** We note AST has proposed up-front price cuts in 2021 and movements linked to inflation thereafter for the next Electricity Distribution Price Review. While the extent of the price cut was not disclosed, we think revenue from electricity distribution segment will most likely come in lower. We may however see higher revenue from Mondo (its unregulated business) in FY2020 as that segment is expected to see the completion of the majority of the construction of high voltage assets for six wind farms by end 2019.

- **Growth in asset base:** AST's regulated asset base increased by 3.5% y/y to AUD9.6bn in FY2019. Of the three networks, electricity distribution grew the most (+5.8% y/y to AUD4.4bn). Electricity transmission's asset base though was somewhat flattish at +1.0% y/y to AUD3.5bn. Gas distribution saw its asset base grow 3.1% y/y to AUD1.6bn. Capex for its regulated business was AUD779mn in FY2019 (+11% y/y). For the contracted asset base, growth was much more significant at 27% y/y to AUD712mn (or AUD949mn if we were to include contracts that have been signed but not yet completed). This came on the back of the completion of Salt Creek, Bulgana and Crowlands wind farm connections and Ballarat Energy Storage System. Over the year, AST also signed Stockyard Hill Wind Farm connection assets contracts and commencing preliminary works for Dundonnell Wind Farm. The expected capex for these projects in FY2020 is AUD140mn. As AST continues to incur capex (which outstrips its depreciation), it is on track to achieve its AUD1.0bn asset base target two years ahead of it plan. As at end March 2019, AST has an aggregate asset base of AUD10.3bn (or AUD10.3bn including signed contracts).

- **Weaker though still manageable credit metrics:** EBITDA/Interest (based on our calculation) was 3.8x, versus 4.1x a year ago, due to lower revenue and higher debt borrowings. AST's net operating cash flow (after tax) dipped 8.2% y/y to AUD813.7mn as revenue was lower. Over the year, AST also incurred AUD882.9mn in investing activities (+23.2% y/y) to grow its asset base, and also paid out AUD283.2mn in dividends. This led to an overall lower cash amount of just AUD339.4mn versus AUD658.2mn a year ago. As such, net debt over asset base rose to 73.9% from 70.4% last year. If we were to exclude junior subordinated debt, we find the adjusted net debt over asset base at 67.1% (FY2018: 66.7%). Net gearing (based on our calculation) was also higher at 2.31x in FY2019, from 1.94x in the preceding period. AST's short-term debt stood at AUD979.7mn as at end March 2019. AUD283mn of which were repaid from cash reserves in April 2019. This leaves AST with AUD696.7mn of short-term debt, which AST has more than sufficient undrawn committed bank debt facilities available (AUD778mn) to cover. The long-term debt of AST cumulates to AUD7.0bn. While this is substantial, we take comfort in that debt is somewhat well distributed with a maximum of AUD869mn coming due each calendar year and AUD706mn (i.e. 9.3% of total) are junior subordinated debt maturing in 2076. We think the upcoming maturities will be manageable for AST as it continues to demonstrate good access to the financial market, having raised five tranches of bonds in 2018 amounting to AUD1.1bn and four tranches of bonds amounting to AUD706mn in the first seven months of 2019. In addition, AST's EBITDA of AUD1.1bn is sufficient to cover its reported maintenance capex of AUD326mn, income tax of AUD118mn, dividend of AUD342.5mn and interest expenses of AUD323.2mn.

- **Restrictions on sale of infrastructure assets:** AUD9.6bn of AST's assets (93% of total) are regulated infrastructure assets, with them being heavily regulated by the AER and the state of Victoria. Should the need arise for AST to liquidate some of their assets to service their debt or interest; it might be hard for them to do so in a timely manner and at a reasonable price. An example would be in 2018 when Cheung Kong Infrastructure ("CKI") and its associates launched a takeover bid for APA Group ("APA"), Australia's largest gas pipeline business. Although the bid was cleared of any anti-competitive concerns by the Australian Competition and Consumer Commission ("ACCC"), the Treasurer rejected the bid, due to concerns of it being 'contrary to the national interest' on the advice from the Foreign Investment Review ("FIRB").

IV) Business Overview

Business Segment:

A. **Electricity Distribution** – This segment involves stepping down high-voltage electricity received from the transmission network to low-voltage electricity, making it safe for delivery to households for consumption. AST's electricity distribution business operates in eastern and northeastern Victoria, and Melbourne's north and east. AST is the second largest electricity distributor in Victoria by customer base, behind Powercor in the oligopoly market. Electricity distributors such as AST do not sell electricity to customers; instead energy retailers will purchase electricity from the wholesale market and network services from network owners and collect service revenue on AST's behalf. AST also earns revenue when it connects new customers to their distribution grid, such as when new housing developments are built. The maximum revenue the electricity distribution business can earn is regulated by the AER on a five-year cycle, with the next reset period set on the beginning of 2021.

B. **Electricity Transmission** – AST has a natural monopoly in this business segment in Victoria, where it owns the transmission assets (such as towers, wires, underground cables, transformers, switching equipment, reactive power devices, and monitoring and telecommunications equipment) in the state. Electricity transmission involves the conversion of low-voltage electricity to high-voltage electricity and transporting it over long distances from electricity generators to Victoria's five distribution networks. Despite being a monopoly, the planning and decision making, such as network expansion decisions, lies in the hands of the Australian Energy Market Operator ("AEMO") who is also AST's main Electricity transmission customer. The AEMO bulk purchases transmission services from AST for users of the transmission network. AEMO is a not-for-profit public company limited by guarantee. Members are made up of Australian governments (60%) and industry participants (40%) with the primary responsibility of managing and maintaining energy system security for all Australians. This segment does not purchase or sell electricity. Revenue generated from the electricity transmission business is regulated by the AER on a five-year cycle, with the next reset period set at April 2022.

C. **Gas Distribution** – AST owns a network of underground gas pipelines which is used to supply and distribute natural gas to residential and commercial customers in western Melbourne, central and western Victoria region. Similar to the electricity distribution business, AST does not sell gas to the end users directly; instead it charges the gas retailers and commercial customers regulated rates for the usage of its network. The AER though goes one step further beyond determining the maximum revenue the business can earn and determine the access tariffs (prices) that the network owner can charge to its users. These tariffs are determined on a five-year cycle, with the next reset period set at beginning of 2023.

D. **Mondo** – Previously known as Commercial Energy Services, it provides contracted infrastructure asset services and specialized technology solutions. Some examples are design and build systems that generate, manage, store and share energy for a business, assist with energy monitoring, and integration of on-site energy generation and storage. Unlike the other business units, contracts under Mondo are directly negotiated agreements where AST receives fixed fee revenue over the contract period in exchange for the services provided. Mondo serves customers in the renewables, utility, water, gas, and rail business as well as businesses that own infrastructure assets in those sectors. AST targets to grow the contracted asset base to AUD1.5bn by FY2024, from AUD949mn as at end FY2019. The target was raised from AUD1.0bn, due to stronger than expected demand and growth. We believe Mondo's business is well supported by the transition to renewable energy such as environmentally friendly wind and solar power generation from traditional power generator sources like coal and fossil fuel.

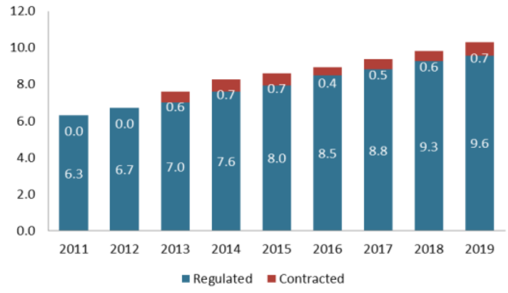
Business Strategy:

- **Growth** – Seek asset base growth to achieve profitable, consistent and sustainable cash flows
  - Regulated asset base had growth at 3.5% y/y from AUD9.3bn to AUD9.6bn as at end-FY2019. AST expects continued growth of ~3% per annum to FY2022.
  - Contracted asset base was AUD0.7bn at FY2019, +27.1% y/y. AST targets to increase this asset base to AUD1.5bn in the next five years.
- **Cost efficiency** – Improve efficiency to become part of the top quartile of efficiency benchmarks for all networks, and reduce costs
  - Both electricity transmission and gas distribution networks are in the top quartile of efficiency across the National Electricity Market.
  - AST is pursuing a similar ranking for its electricity distribution network, which made a 14% improvement in the latest regulatory benchmarking.
- **Customer Focus** – Deliver safe and reliable energy to customers

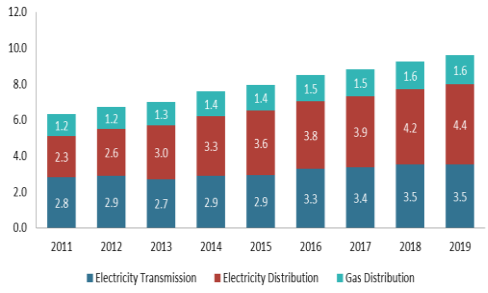
- **Digitalization** – Invest in digital tools to strengthen cyber resilience
- **Culture and Capability** – Equip employees with skills and attributes to drive sustainable, agile and ethical performance at a high level

Asset base:

Regulated and Contracted Asset Base (AUD'bn) Over Time



Regulated Asset Base (AUD'bn) Over Time



Source: Company, OCBC

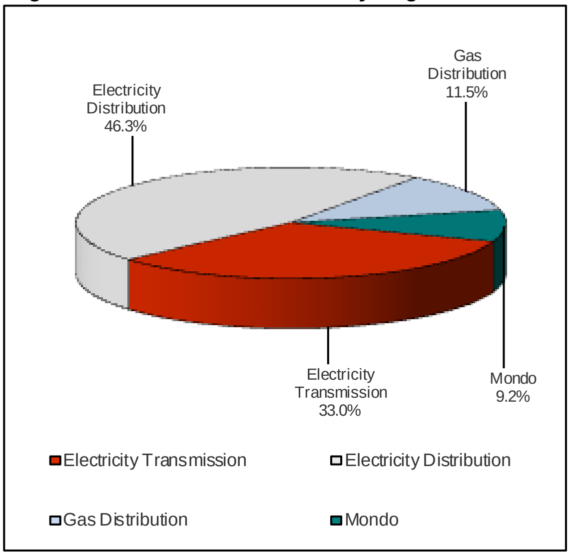
AusNet Services Ltd

Table 1: Summary Financials

Year Ended 31st Mar	FY2017	FY2018	FY2019
Income Statement (AUD'mn)			
Revenue	1,881.5	1,909.8	1,861.5
EBITDA	1,073.3	1,142.9	1,134.2
EBIT	647.4	700.5	677.8
Gross interest expense	302.3	299.8	324.2
Profit Before Tax	363.3	416.6	371.9
Net profit	255.1	291.4	253.9
Balance Sheet (AUD'mn)			
Cash and bank deposits	328.8	658.2	339.4
Total assets	11,756.5	12,517.3	12,815.8
Short term debt	398.4	465.4	979.7
Gross debt	6,665.3	7,565.1	7,946.4
Net debt	6,336.5	6,906.9	7,607.0
Shareholders' equity	3,698.4	3,556.0	3,289.1
Cash Flow (AUD'mn)			
CFO	457.5	1,163.4	1,087.1
Capex	888.2	732.7	893.1
Acquisitions	0.0	0.0	0.0
Disposals	4.3	7.1	1.4
Dividends	211.9	342.2	283.2
Interest paid	-285.3	277.0	273.4
Free Cash Flow (FCF)	-430.7	430.7	194.0
Key Ratios			
EBITDA margin (%)	57.04	59.84	60.93
Net margin (%)	13.56	15.26	13.64
Gross debt to EBITDA (x)	6.21	6.62	7.01
Net debt to EBITDA (x)	5.90	6.04	6.71
Gross Debt to Equity (x)	1.80	2.13	2.42
Net Debt to Equity (x)	1.71	1.94	2.31
Gross debt/total asset (x)	0.57	0.60	0.62
Net debt/total asset (x)	0.54	0.55	0.59
Cash/current borrowings (x)	0.83	1.41	0.35
EBITDA/Total Interest (x)	3.55	3.81	3.50

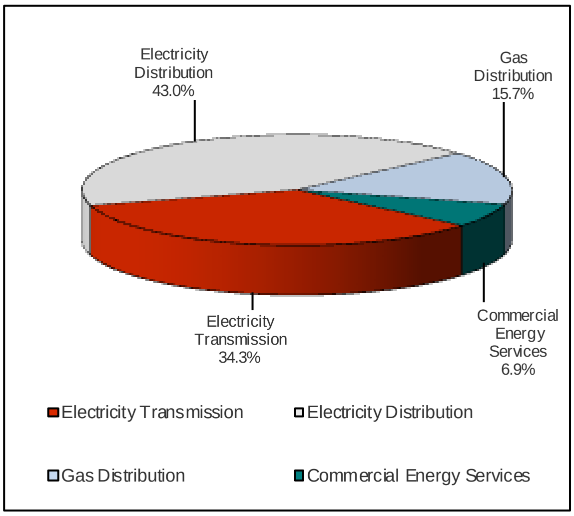
Source: Company, OCBC estimates

Figure 1: Revenue breakdown by Segment - FY2019



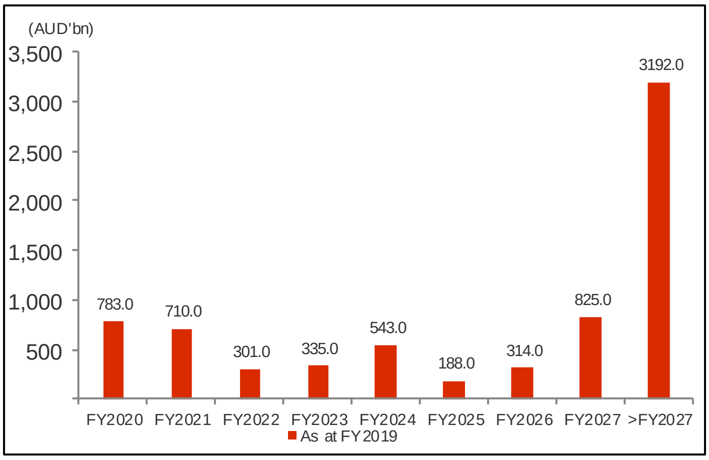
Source: Company

Figure 2: Asset breakdown by Segment - FY2019



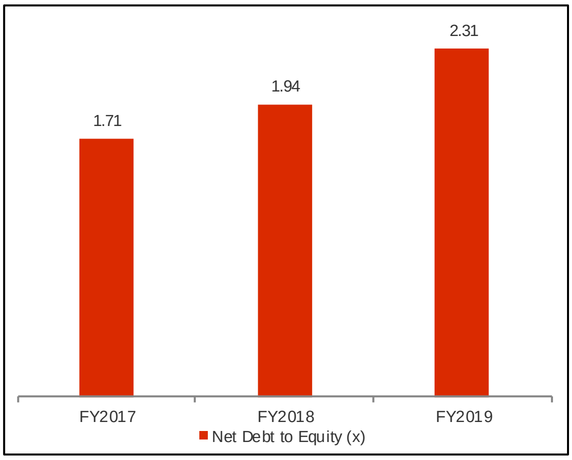
Source: Company

Figure 3: Debt Maturity Profile



Source: Company

Figure 4: Net Debt to Equity (x)



Source: Company, OCBC estimates

Issuer Profile:
Positive (2)

Ticker:
CBAAU

Industry:
Financial Institutions

Geography:
Australia, New Zealand

Market cap:
- **AUD142.4bn (As of 16 Oct 2019)**

Ownership:
- **CBA does not have a major strategic shareholder. Instead, shareholders are widely spread across institutional investors including BlackRock Inc (4.9%) and Vanguard Group Inc (5.0%) held through various nominees according to Bloomberg.**

Commonwealth Bank of Australia

I) Company Background

The Commonwealth Bank of Australia ("CBA") was founded in 1911 under the Commonwealth Bank Act to provide savings and general banking business and commenced operations in Melbourne in 1912. Through its early years, the bank grew in scale from mergers with state banks and expanded its commercial operations to include business banking and international operations. At the same time, it played key support roles for the government through providing banking services to servicemen during both World War I and World War II and acting as Australia's Central Bank from 1920 until the introduction of legislation in 1957 to separate CBA's commercial banking operations from its central banking functions. This was made official in 1960 with the creation of (1) the Reserve Bank of Australia to undertake Australia's central banking operations; and (2) the wholly government owned Commonwealth Banking Corporation to provide trading, savings and development banking.

Since then, CBA diversified further both domestically by business (foreign exchange, insurance, credit cards, managed investments) and internationally by location acquiring 75% of ASB Bank in New Zealand in 1989 and expanding further into Asia through the 1990s and 2000s. Deregulation of Australia's banking industry occurred in the 1980s which increased competition and the bank was privatized progressively in the early 1990s. Throughout this time, CBA has strived to be at the forefront of developments within Australia's banking sector where it is one of Australia's big 4 (along with Westpac Banking Corporation, National Australia Bank Ltd and Australia and New Zealand Banking Group Ltd) under the four pillars policy which restricts any mergers between the four major banks to ensure stability and address competitive concerns from the merger of any of these entities (although this policy would not stop a takeover of any of these entities by a foreign entity). That being said, there are increasing market participants who feel the four pillars policy is outdated and does not achieve its intended outcomes given the technological change occurring in financial services.

II) Recommendation Summary

- CBA benefits from scale as the largest retail bank in Australia and a business mix which results in consistent earnings ability. That said, its retail focus has led to numerous regulatory investigations and penalties and a need to concentrate on addressing outcomes from the recent Royal Commission.
- Recent strategic initiatives to simplify CBA's business going forward is expected to benefit both now (positive contribution to its capital position) and the future (improved earnings stability) and is a credit positive in our view. This along with CBA's solid business position should mitigate a potentially slower Australian economy and a recovering domestic housing sector.
- With its systemic importance to the Australian economy and APRA's pro-active regulatory stance, **we are assigning CBA a Positive (2) issuer profile.**

III) Key Considerations

- **Biggest of the big four:** CBA's credit profile begins with its solid business profile as the largest bank in Australia by total assets. It also has the largest market share by gross loans and deposits according to the Australian Prudential Regulation Authority with a market share of around 23-24% for both in 2018. This is followed by Westpac Banking Corp (~20-22%) and National Australia Bank (~17-18%). Supporting the size of CBA's balance sheet is the country's largest branch and ATM network which has enabled CBA to be the largest home lender and market leader in Australian retail banking with a higher market share of retail focused home lending and household deposits of 24-28% against its system-wide market share of gross loans and deposits. Home lending growth for CBA for the 6 months to 30 June 2019 improved to 1.3x system growth. CBA's Australian operations are complemented by its solid and entrenched domestic market position in New Zealand through ASB Bank Limited ("ASB"). ASB is the third largest bank by total assets in New Zealand behind ANZ Bank New Zealand Limited (wholly owned by Australia and New Zealand Banking Group Limited) and Bank of New Zealand (wholly owned by National Australia Bank Limited) with operations focused in Auckland and on residential mortgages.

- **But size is not without issues:** CBA's size and dominance in retail services has attracted numerous investigations and penalties. This includes the recent Australian Transaction Reports and Analysis Centre's (AUSTRAC) investigations on contraventions of the Anti-Money Laundering and Counter-Terrorism Financing Act 2006 (Cth) which resulted in a fine of AUD700mn to resolve this issue. In addition, the Australian Prudential Regulation Authority's ("APRA") final report from an independent inquiry to identify shortcomings in CBA's governance, culture and accountability frameworks resulted in several outcomes for CBA including (1) an Enforceable Undertaking by CBA to adhere to, and regularly report progress to APRA of, a remedial action plan to improve management of non-financial risks involving the completion of 156 milestones by a defined date; and (2) the application of an additional AUD1bn in minimum operational risk capital requirements until all milestones are satisfactorily completed. While APRA has also applied additional capital requirements to Australia's other big banks (Australia & New Zealand Banking Group Ltd, National Australia Bank Ltd, Westpac Banking Corporation) to address higher operational risk in each bank's risk governance self-assessments, the proposed temporary increase until remediation plans are completed is half that CBA's at AUD500mn. Most recently, the 76 recommendations from the Royal Commission into misconduct within the financial services industry covered most of CBA's businesses with 23 recommendations underway. As a result, CBA announced in March 2019 that it was suspending the demerger of its remaining wealth management and mortgage broking businesses as part of its simplification strategy to focus on implementation of the Royal Commission recommendations, refunding customers and remediating past issues. According to CBA's 2019 annual report, it paid around AUD1bn in FY2019 for refunds, interest and program costs related to CBA's financial advice businesses and has paid around AUD2.2bn to date. The bank also raised material provisions for customer remediation and risk and compliance programs which was highlighted as a key audit matter given the subjective judgements needed to determine any potential liabilities.

- **Strategy focused on the past and the future:** CBA's simplification strategy is consistent with its peers, seeking to simplify the bank by focusing on its core markets to reduce complexity and costs while improving profitability as a result. Key to simplification are the ongoing sales of several of CBA's life insurance and wealth management businesses including:
    - Completed Sales: Sovereign (life insurance in New Zealand), TymeDigital (also known as Commonwealth Bank of South Africa (Holding Company) Limited), Colonial First State Global Asset Management (global asset management business)
    - Announced divestments: Life insurance businesses in Australia (CommInsure Life), China (BoCommLife), and Indonesia (PT Commonwealth Life); financial advice businesses (Count Financial, CFP-Pathways, Financial Wisdom)
    - Intended managed exits: Colonial First State, mortgage broking operations (includes Aussie Home Loans and Mortgage Choice) and CountPlus (accounting, financial and business advice).
    - Under strategic review: General insurance, Vietnam International Bank.

  As well as simplification to reduce the amount and variety of risks, downsizing of CBA's product footprint is also to create capacity for future investment. This investment is focused on technology and digital platforms with AUD5bn of planned investments over the next five years. This includes investment in core banking systems as well as its CommBank app, a virtual banking assistant, payment functionality. Other key investment areas for the bank include (1) operational risk and compliance to address past issues; (2) data and analytics to use the bank's information; (3) innovation of customer facing applications and back office operations with innovation labs and open platforms; and (4) cost reduction from rationalization, digitalisation and automation to achieve a cost to income ratio below 40%.

  The final component of CBA's strategy, which is in line with the first two (simplifying its business and digital investment) is ensuring CBA remains and strengthens its position as the market leader

in its core competencies of retail and commercial banking. As such, CBA has undertaken to remain the largest branch network in Australia and maintain their call centres in Australia. This will also include investments in digital platforms targeted to retail and commercial clients and simplification of retail and commercial products. As an example, CBA reduced its home loan product range from 10 products to five core products.
We believe a focus on CBA's traditional business lines mitigates the lower earnings diversity. In particular, some of the exited businesses were a source of CBA's previous conduct and remediation issues in the past.

- **Financial Performance down on industry pressures:** FY2019's results were softer y/y with statutory profit down 8.1% y/y to AUD8.571bn while cash net profit after tax (based on continuing operations) fell 4.7% y/y to AUD8.492bn. Driving full year performance was a 2% y/y fall in operating income as volume growth in core businesses were offset by a 5bps fall in net interest margins ("NIM"), fee removals and reductions as well as higher insurance claims from weather events. Volume growth was driven by 2% y/y growth in group lending which was driven by 4% y/y lending growth in home and business lending that offset a 12% y/y decline in Institutional lending. At the same time, operating expenses rose 2.5% y/y due to higher remediation and risk/compliance costs, as well as a 9% y/y rise in investment spending translating to a rise in the cost to income ratio to 46.2% in FY2019 (44.1% in FY2018). Loan impairment expenses also rose 11.3% y/y on implementation of AASB9 and elevated levels of 90-day consumer arrears, particularly in personal loans, although the loan loss rate (calculated as the cash loan impairment expense as a percentage of average gross loans and acceptances) still remains low compared to historical ratios. In addition, provision coverage levels improved with the ratio of total provisions for impairment losses to gross loans and acceptances up to 0.63% as at 30 June 2019 against 0.49% as at 30 June 2018 and total impairment provisions up 32% y/y compared to a 19% rise in troublesome (+27% y/y) and impaired assets (stable y/y).

- **Retail driving segment contributions:** As expected, Retail Banking Services drives overall earnings contributing 50.2% of FY2019 cash net profit after tax from continuing operations ("NPAT"). This is followed by Business and Private Banking (31.3%), Institutional Banking and Markets (12.6%) and New Zealand (12.4%). Segment contributions were broadly similar compared to FY2018 although due to the aforementioned issues, as well as better performance in New Zealand (stronger income from balance sheet growth that offset higher investment and risk/compliance expenses and increased provisions), the contribution of Retail Banking Services fell y/y (54.1% in FY2018) as segment NPAT fell 11.5% y/y due to both lower income from a fall in NIMs and higher expenses from customer remediation and elevated risk and compliance costs. Similarly, higher remediation and risk costs offset business growth in Business and Private Banking with NPAT down 6.6% y/y while Institutional Banking and Markets NPAT was down 8.5% y/y on lower lending volumes and markets income. Overall, although group NPAT (including Wealth Management and IFS and Corporate Centre) was down 4.7% y/y, its reported NPAT of AUD8.49bn continues to show strong underlying earnings generation given its scale and solid retail market position.

- **Capital Ratios benefiting as a result:** Size, segment contributions, financial performance and strategy have all been accretive to CBA's capital position and mitigated dividend payments, growth in risk weighted assets and the ongoing impact of elevated costs from remediation and litigation. Its APRA compliant CET1 capital ratio of 10.7% as at 30 June 2019 rose 60bps y/y and is already above APRA's minimum 10.5% CET1 benchmark for 'unquestionably strong' capital ratios in Australia's banking sector which comes into force January 2020. On an internationally comparable basis, the CET1 ratio (including discontinued operations) improved 70bps y/y to 16.2% as at 30 June 2019, which compares favourably against international peers and is further above minimum requirements which also include a CET1 capital conservation buffer of 3.5% inclusive of a domestic systemically important bank requirement of 1.0%. Including the impact of previously announced divestments, CBA's proforma APRA compliant CET1 ratio improves an additional 110bps (net of regulatory adjustments of ~18bps) to 11.8%. CBA's strong capital position remains a key credit support given the prospect of ongoing elevated compliance costs, questions on Australia's future economic performance, and implementation of higher loss absorbing capacity requirements in Australia's financial system in the future.

IV) Business Overview

- **Core and non-core operations:** CBA is split across six business divisions although consistent with its strategy mentioned above, some are considered core and will remain part of CBA in the future. Non-core business areas are targeted for managed (orderly) exits:
    - **Anchored by Australian retail:** CBA generates the bulk of group net profit after tax (excluding Corporate Centre and others) from Retail Banking Services. Key services include home loans, consumer finance and deposit products as well as mortgage broking operations for retail customers. Following a recent re-segmentation of the consolidated group, the Retail Banking Services division also includes Bankwest as well as general insurance in Australia (which is currently under strategic review) and Commonwealth Financial Planning which was moved from the Wealth Management division. This segment serves over 10 million customers. Mortgage broking operations, which includes Aussie Home Loans and a stake in Mortgage Choice, are being exited.
    - **Business and Private Banking the next biggest contributor:** CBA's second core market is business banking through the provision of specialized banking services to business and agribusiness customers through relationship managers. As a result of the previously mentioned re-segmentation, Small Business banking was transferred out of Retail Banking Services to Business and Private Banking to consolidate CBA's business banking operations. Other activities within this segment include private banking to high net worth individuals, and margin lending and trading through CommSec, the bank's online trading platform.
    - **Institutional Banking and Markets:** This segment covers the commercial and wholesale banking requirements of the bank's major corporate, institutional and government clients by providing debt raising, financial and commodities price risk management and transaction banking services. Teams are structured by industry and products with international operations in London, New York, Japan, Singapore, Malta, Hong Kong, New Zealand, Beijing and Shanghai.
    - **ASB New Zealand:** CBA's New Zealand business is through ASB Bank Ltd ("ASB"), which was partially acquired in February 1989 with the remainder purchased by CBA in 2000. ASB provides banking and funds management in New Zealand and excludes Institutional Banking and Markets.
    - **Wealth Management:** This division provides superannuation, investment, retirement and insurance products as well as financial planning.
        - As part of CBA's remediation and rationalization strategy, this division is undergoing an orderly wind-down. In June 2018, CBA announced that it would demerge its wealth management and mortgage broking businesses however in March 2019 this exercise was suspended to focus on the outcomes of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (Financial Services Royal Commission) including implementation of the commission's recommendations, refunding customers and remediating past issues
    - **International Financial Services:** comprises the Indonesian retail and business banking operations as well as associate investments in China and Vietnam.
        - CBA's offshore footprint has reduced to streamline the business. As part of the restructure, CBA in October 2018 announced the sale of its 80% interest in its Indonesian life insurance business. As part of the sale, CBA's Indonesian banking subsidiary will continue to distribute life insurance products under a 15 year distribution partnership with FWD Group.

- **Australia's Housing Sector Outlook:** After a period of strong growth, Australia's housing sector experienced a slowdown over 2018 and 2019. Factors driving performance include the slowdown in the Australian economy, high household debt, still elevated property prices, and regulatory factors including steps by the Australian Prudential Regulation Authority ("APRA") to reduce built up risks in Australia's housing sector by limiting the proportion of investor and interest only loans. While housing credit growth is expected to remain sluggish for the remainder of 2019 and possibly extend into 2020, most market participants expect credit and pricing growth to stabilize at a lower level and recover from 2020 due to population growth, ongoing demand from first home buyers, low interest rates and expected low unemployment. A ~20% y/y fall in the latest building approvals data according to the Australian Bureau of Statistics also indicates lower supply in the future while supportive regulatory adjustments by APRA including the revision of serviceability assessments on residential mortgage loan applications is also expected to enhance borrowing capacity and hence property demand against generally tighter lending standards and economic headwinds. The price outlook by location however shows some dispersion with less populated cities such as Brisbane, Adelaide and Canberra expected to see decent growth from a relatively lower base while key markets Sydney and Melbourne should also see growth but on a limited basis given the high base. Conversely, markets in Hobart, Perth and Darwin are expected to see weaker conditions due to a mix of strong historical performance and weaker economic performance respectively. Current expectations reflect an improvement from prior expectations that house prices would continue to fall into 2020. According to CBA, key metrics indicate that its home and consumer lending exposures remain healthy with stable borrowing capacity and only a modest rise in portfolio loan to value ratios in FY2019. That said, the proportion of accounts in negative equity has risen indicating that while the outlook is more supportive, pockets of risk exist within the sector.

- **Regulatory environment provides additional support:** As a domestic systemically important bank, CBA benefits from some expectation of government support given its entrenched domestic market position and large retail franchise. It also means that CBA is subject to more regulatory oversight and a requirement to maintain higher loss absorbing capacity. This includes APRA's recently released response to submissions regarding its November 2018 discussion paper on increasing the loss absorbing capacity of banks. In its response, APRA now requires banks to raise their total capital ratio by 3% by January 1, 2024 with its original proposal of a 4-5% increase a long-term target. We have previously opined that we do not see this development as negative – rather it reinforces the strategic importance of Australia's big banks to the government and APRA's recognition of such through ongoing pro-active regulation. In general, we see APRA's pre-emptive regulatory oversight as an additional layer of comfort for CBA's credit profile in seeking to address stress before it occurs. New Zealand operations are also subject to strong oversight with the Reserve Bank of New Zealand ("RBNZ") recently proposing an increase in minimum CET1/Tier 1/CAR capital requirements from 7.0%/8.5%/10.5% to 14.5%/16.0%/18.0%. A final decision on minimum requirements is likely to be released before the end of 2019 following the RBNZ's consideration of recently received suggestions by external independent reviewers.

Friday, October 18, 2019

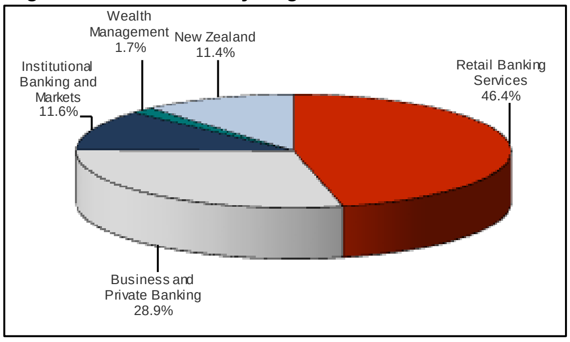
Commonwealth Bank of Australia

Table 1: Summary Financials

Year Ended 30th June	FY2017	FY2018	FY2019
Income Statement (AUD'mn)			
Net Interest Income	17,543	18,342	18,120
Non Interest Income	7,843	6,788	6,217
Operating Expenses	10,626	11,029	11,373
Pre-Provision Operating Profit	14,760	14,101	12,964
Provisions	1,095	1,079	1,201
Other Income/(Expenses)	0	0	0
PBT	13,665	13,022	11,763
Income Taxes	3,879	3,952	3,391
Net Income to Common Shareholders	9,928	9,329	8,571
Balance Sheet (AUD'mn)			
Total Assets	976,318	975,165	976,502
Total Loans (net)	731,762	743,365	755,141
Total Loans (gross)	736,539	748,029	760,981
Total Allowances	3,693	3,605	4,715
Total NPLs	3,187	3,179	3,622
Total Liabilities	912,658	907,305	906,853
Total Deposits	626,655	622,234	636,040
Total Equity	63,660	67,860	69,649
Key Ratios			
NIM	2.11%	2.15%	2.11%
Cost-income Ratio	41.7%	45.5%	47.8%
LDR	116.8%	119.5%	118.7%
NPL Ratio	0.43%	0.42%	0.48%
Allowance/NPLs	115.9%	113.4%	130.2%
Credit Costs	0.15%	0.14%	0.16%
Equity/Assets	6.52%	6.96%	7.13%
CETier 1 Ratio (Full)	10.1%	10.1%	10.7%
Tier 1 Ratio	12.1%	12.3%	12.7%
Total CAR	14.2%	15.0%	15.5%
ROE	16.20%	14.30%	12.60%
ROA	1.00%	1.00%	0.90%

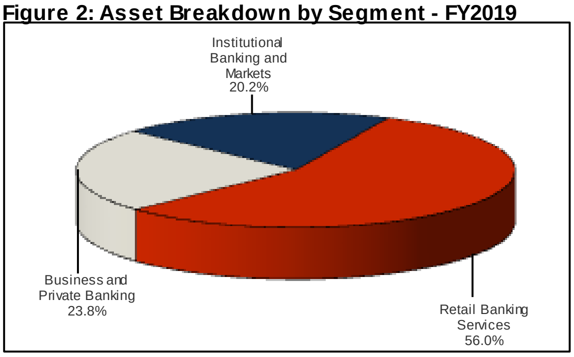
Source: Company

Figure 1: Cash NPAT by Segment - FY2019



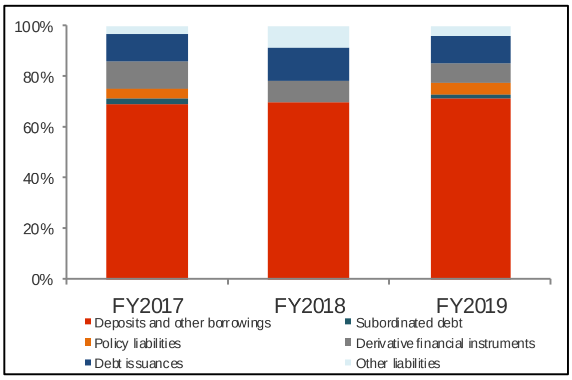
Source: Company | Excludes IFS and Corporate Centre

Figure 2: Asset Breakdown by Segment - FY2019



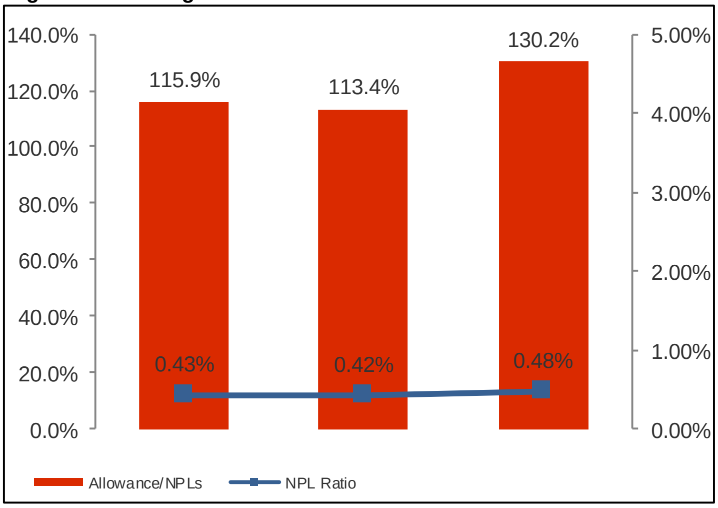
Source: Company | Excludes Wealth Management, New Zealand and Corporate

Figure 3: Liabilities Composition



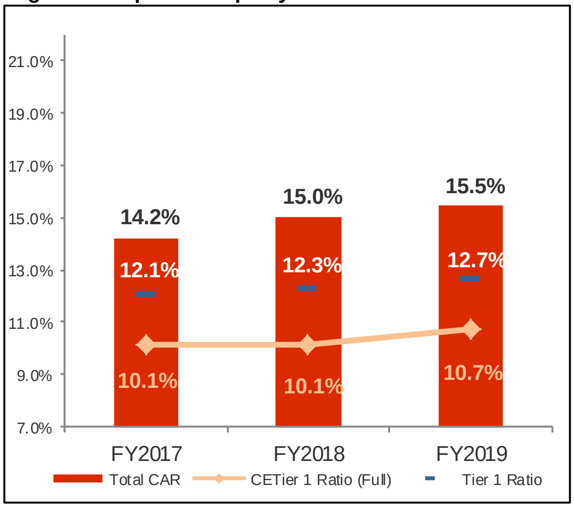
Source: Company

Figure 4: Coverage Ratios



Source: Company, OCBC estimates

Figure 5: Capital Adequacy Ratios



Source: Company

Friday, October 18, 2019

Issuer Profile:
Neutral (3)

Ticker:
MQGAU

Industry:
Financial Institutions

Geography:
Diversified

Market cap:
- AUD47.6bn (As of 16 Oct 2019)

Ownership:
- MQG does not have a major strategic shareholder. Instead, shareholders are widely spread across institutional investors including BlackRock Inc (5.8%) and Vanguard Group Inc (3.6%) held through various nominees according to Bloomberg.

Macquarie Group Limited

I) Company Background

Listed on the ASX, Macquarie Group Limited ("MQG") is one of Australia's largest financial institutions outside the big 4 (Commonwealth Bank of Australia, Westpac Banking Corporation, National Australia Bank Ltd and Australia and New Zealand Banking Group Ltd). Established in 1969 to provide advisory, lending and investment banking services to Australian and International corporates domestically, MQG has since grown to be a large financial services group diversified by business and geography with total assets of AUD203.2bn as at 31 March 2019 and offices in 30 markets and 65 global locations.

Expanding its offerings for corporates into commodities and foreign exchange hedging as well as futures and commodities trading in the 1970s, MQG branched into retail financial services in the 1980s following the creation of Macquarie Bank Ltd in 1985. It followed up this growth in the 1990s by progressing the expansion of its international presence through the establishment of offices in four global regions while also establishing its infrastructure financing capabilities. This competency drove MQG's growth in the 2000s with expansion of investments into airports, energy infrastructure and utilities. At the same time, MQG also grew its trading capabilities in gas, power and agriculture through acquisitions with a strong presence in North America. Most recently in the 2010s, MQG's focus has shifted towards funds management as well as aircraft and motor vehicle leasing.

Throughout this growth which has been both organic and through acquisitions, MQG has maintained an unbroken record of profitability while remaining true to its origins by continuing to act as an investment intermediary and provider of specialized products and services to institutional, corporate and government customers as well as to retail clients. This divergence in history and business footprint somewhat sets MQG apart from its larger peers and defines a different focus for MQG in managing its risk.

II) Recommendation Summary

- MQG's credit profile is characterized by both higher risk and higher returns compared to domestic peers. This is due to the larger contribution from markets-facing businesses and smaller scale of its retail banking business. Business complexity is also higher given that the majority of earnings are generated outside of Australia.
- Offsetting this however is MQG's business diversity, its experienced and long tenured management, and an independent and centralized risk management group that ensures risks are appropriately and consistently assessed and managed across the consolidated group. While we view MQG's risk functions as a positive, it is also a necessity given MQG's business risk.
- This has resulted in robust and consistent financial performance and a sound capital position that remains comfortably above minimum requirements. **We are assigning MQG a Neutral (3) issuer profile.**

III) Key Considerations

- **Structural subordination at the holdco:** MQG is a non-operating holding company with MQG's operating businesses held in wholly owned subsidiaries. While this corporate structure enables a better ability to address future business, market and regulatory changes according to management, lenders to MQG are structurally subordinated to the group's operating subsidiaries and dependent on their distributions to the holdco. The ability of MQG's bank group to upstream capital can be restricted given its need to comply with minimum regulatory capital requirements and the banking group's own funding plans. This leaves MQG's non-bank businesses as a source of distributions - per management's funding structure, MQG predominately funds the non-bank group. The risk profile of these businesses is weaker than MQG's banking businesses due to the more volatile nature of their market driven earnings and its weaker funding profile due to a lack of access to deposits, hence the need for MQG to support the funding needs of non-bank businesses.

- **Higher business risk offset by diversity:** Non-bank business contributions drive MQG's overall risk profile which is comparatively weaker against Australia's big 4 banks. This is due both to its larger markets driven businesses as well as its smaller retail banking business. That said, while markets driven businesses contribute more to consolidated net profit than peers, it also results in a better spread of businesses that partially offsets the higher business risk. For FY2019, Commodities and Global Markets, Macquarie Capital and Macquarie Asset Management each contributed between 22-25% of reported consolidated net profit before corporate costs, profit share and income tax. This was followed by Corporate and Asset Finance at 17% and Banking and Financial Services at 12%. In addition, the geographic diversity of MQG's total income is better than peers with 66% sourced internationally (Americas, EMEA and Asia contributed 29%, 28% and 9% respectively) while 34% was generated in Australia and New Zealand. In contrast, MQG's domestic peers generate at least 70% of operating income in Australia and New Zealand. In some cases, around 95% is generated domestically and in New Zealand which can result in concentration risk when the domestic economy is slowing.

- **And growth in recurring revenues:** MQG also benefits from the growing contribution of what it terms its "annuity style businesses." Comprising Macquarie Asset Management, Corporate and Asset Finance and Banking and Financial Services, they contributed 53% of MQG's FY2019 consolidated net profit. Growth in these businesses has been a focus of MQG's business strategy to increase the stability and resilience of the group's earnings performance. While the remaining businesses (Commodities and Global Markets and Macquarie Capital) which MQG classify as "markets-facing businesses" tend to be more volatile in nature, they nevertheless provide some level of stability to overall earnings and have exhibited stable performance through the years. This was seen in FY2019 results with 75.2% y/y growth in reported net profit before corporate costs, profit share and income tax from markets-facing businesses. This offset a 4.4% y/y fall in reported net profit from the annuity style businesses and resulted in consolidated reported net profit before corporate costs, profit share and income tax rising 21.1% y/y.

- **Contributing to stable financial performance:** Financial performance has been consistent with a 6 year run of y/y growth in net operating income and a 7 year run of y/y growth in net profit. Most recently, reported net operating income for FY2019 rose 17% y/y due to 15% y/y growth in net interest and trading income (better commodities performance and growth in average Australian loan, lease and deposit volumes) and a 18% y/y rise in fee and commission income (higher asset management fees and accounting changes). Higher asset realisations in Macquarie Capital and gain on sale of Energetics in Corporate and Asset Finance also contributed to a 56% y/y rise in other operating income. This offset the rise in operating expenses at a faster pace from higher employment, occupancy and other expenses (+19% y/y) and contributed to a 16.6% y/y rise in consolidated profit attributable to ordinary equity holders. From an operating group perspective, net profit from Commodities and Global Markets rose 65% y/y (client hedging activity in commodities and higher contribution from client structured foreign exchange deals) while net profit from Macquarie Capital rose 89% y/y (higher net income from asset realisations and better fee and commission income). Conversely for net profit performance from MQG's annuity style businesses, Macquarie Asset Management and Corporate and Asset Management fell 4% y/y and 10% y/y respectively on higher operating expenses and a high base in FY2018. This overshadowed a 3% y/y rise in Banking and Financial Services from higher volumes in Australian mortgages, business banking loans, deposits and funds on platform and led to the overall 4.4% y/y fall in reported net profit from the annuity style businesses.

- **Capital buffers are solid and should remain so:** Owing to MQG's consistent financial performance, capital ratios for Macquarie Bank Limited have strengthened over time. Its Australian Prudential Regulation Authority ("APRA") compliant CET1/Tier1 ratio was

11.4%/13.5% as at 31 March 2019 against 11.0%/12.8% as at 31 March 2018 and well above APRA's minimum requirements of 7.0%/8.5% as earnings growth more than offset dividend payments. On an internationally comparable Basel III basis, MQG's CET1/Tier1 capital ratios improve to 14.3%/16.5%. Capital ratios improved further in 1QFY2020 with the APRA compliant and internationally comparable CET1 ratio at 12.0% and 14.9% respectively. MQG also announced in late August a AUD1bn institutional placement which will combine with a share purchase plan to meet anticipated increased capital requirements of AUD1.6bn from equity investments in Macquarie Capital and implementation of SA-CCR (standardized approach for measuring counterparty credit risk exposures) in Commodities and Global Markets.

- **Management changes show continuity:** Despite a recent change, MQG's management turnover has been relatively low with 6 Chief Executive Officers since its inception 50 years ago. Recently retired CEO Nicholas Moore was in the position for 10 years and was at MQG for over 33 years. His replacement, current CEO Shemara Wikramanayake, has been at MQG since 1987 and was most recently head of Macquarie Asset Management for 10 years. Prior to that, she was involved in the establishment of Macquarie Capital and has also worked across countries and businesses within MQG. We see this continuity as credit supportive given the need to understand and appropriately manage the risks contained within MQG's diversified businesses. Other recent senior management changes in Commodities and Global Markets and Macquarie Capital also indicate continuity with new internal appointees having been with MQG for at least 20 years. Along with an independent Risk Management Group and stable financial performance despite higher complexity in its businesses, it appears that MQG's higher risk in theory is being appropriately managed in practice.

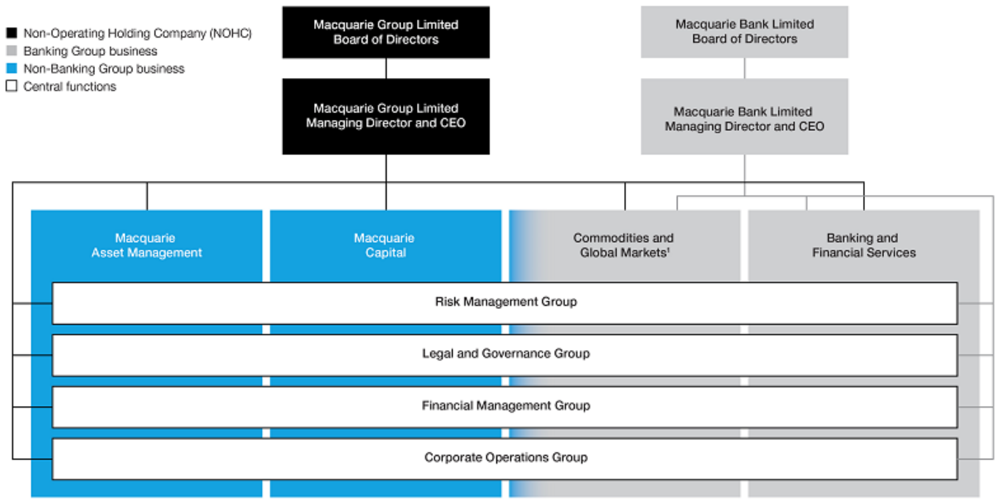
- **Strategy is considered and selective:** MQG's strategy is to expand selectively and focus on specialist areas where MQG can provide expertise to clients. This focus on specialized services likely helped contribute to y/y growth in MQG's reported return on equity since 2012 to 18.0% in FY2019. This is well above the return on equity of Australia's big 4 banks which has hovered around the 10-14% range and is on a declining trend over the same period. Its business strategy is medium term in nature and the aim is to generate resilient return on capital through shifting the business mix towards recurring income businesses and looking for organic growth and selective acquisitions that complement MQG's existing businesses. Growth ideas are usually formulated at the operating group level and while there are no specific targets in terms of business, market or region exposure, another aspect of MQG's business strategy is diversification by services and locations to offset any concentration risk and enhance earnings stability.

- **Lower likelihood for external support:** Australia's big 4 banks benefit from some expectation of government support given their entrenched domestic market position and large retail franchises. The same however cannot be said with conviction for MQG given the non-operating hold co structure, relatively lower contribution from retail banking, and the higher contribution from its overseas businesses. That's not to say though that MQG's operating environment is not supportive given APRA's strong and pro-active regulatory oversight.

IV) Business Overview

- **Unique in Corporate Structure compared to larger peers:** MQG was established as a non-operating holding company in November 2007 with the consolidated group comprising two main businesses – (1) the non-bank Group which includes MQG, wholly owned subsidiary Macquarie Financial Holdings Pty Limited ("MFH") and MFH's subsidiaries; and (2) the Bank Group which comprises wholly owned subsidiary Macquarie Bank Limited ("MBL") and MBL's subsidiaries. Across these two businesses are five operating groups with Macquarie Asset Management and Macquarie Capital part of the non-bank Group and Commodities and Global Markets, Banking and Financial Services and Corporate and Asset Finance part of the Bank Group. Operating groups are client focused and while strategy is determined at the operating group level given the specialized nature of its products, an Executive Committee (which includes the Chief Executive

Officer, Chief Financial Officer, Chief Risk Officer, Chief Operating Officer, CEO of MBL and heads of Macquarie's operating groups) oversees the consolidated group as a whole and ensures each operating group remains within overall group guidelines and adheres to MQG's risk management framework.



As at 1 September 2019.
1. Certain assets of the Credit Markets business, certain activities of the Cash Equities business and the Commodity Markets and Finance business, and some other less financially significant activities are undertaken from within the Non-Banking group

Source: Company

- Non-Banking Group Businesses
  - Macquarie Asset Management ("MAM"): MAM is a full-service asset manager with capabilities in infrastructure, real estate, agriculture, equities, fixed income, private credit, liquid alternatives and multi-asset solutions across two divisions segmented by the nature of the asset.
    - Macquarie Infrastructure and Real Assets: Specializes in infrastructure, real estate, agriculture and energy using public and private funds, co-investments, partnerships and separately managed accounts. Clients are mostly institutional investors.
    - Macquarie Investment Management ("MIM"): Provides securities investment management for fixed income, currencies, equities, hedge funds and multi-asset solutions. Clients are both institutional and retail clients, mostly in the US and Australia. MIM also uses partnerships with other specialist investment managers.
    - As at 31 March 2019, MAM had AUD542.7bn in assets under management and contributed 24% to FY2019 group net profit.
  - Macquarie Capital ("MC"): MC provides advisory, investment and capital raising services with a focus on infrastructure and energy during development, construction and operations. It contributed 22% of FY2019 group net profit.
- Banking Group Businesses
  - Banking and Financial Services ("BFS"): BFS operates mostly in Australia and covers MQG's retail banking and financial services businesses. Corporate and Asset Finance sits within this segment which is organized into four divisions:
    - Personal Banking: Provides mortgages, credit cards, transaction and savings accounts and vehicle finance to retail clients.
    - Wealth Management: Value added services to retail clients including cash management services, investment and superannuation products, financial advice, private banking and stockbroking.
    - Business Banking: Covering sole proprietors to corporates, Business Banking provides deposit, lending, payment solutions, and tailored business services to business clients.
    - Vehicles: Provides finance leases, novated lease agreements, loans and commercial hire purchases for vehicles and plant and equipment in Australia.
  - Commodities and Global Markets ("CGM"): The most global of MQG's operating groups, CGM operates across eight divisions that are sorted by products. These products include

cash equities and equities derivatives, fixed income, asset backed financing (mortgages and loans), foreign exchange, commodities, futures and specialized finance and asset management.

The non-operating holding company corporate structure differs from the corporate structure of its larger peers who operate on a consolidated basis.

- **Regulatory treatment differs as a result:** Although similarly regulated by the APRA, MQG's different corporate structure results in differing regulatory requirements to its larger peers. While MBL as an authorised deposit-taking institution has the standard regulatory requirement to comply with minimum capital ratios set by APRA, MQG's regulatory capital requirement as a regulated Non-Operating Holding Company instead has to maintain a minimum absolute level of capital which is reported as an excess over the regulatory minimum requirement. This minimum amount is made up of MBL's minimum Tier 1 capital requirement as a percentage of risk-weighted assets (the Banking Group's minimum requirements) and an additional capital requirement calculated using the board approved Economic Capital Adequacy Model (the Non-Banking Group's minimum requirement). The current minimum Tier 1 requirement for the Banking Group under Basel III is 8.5% comprising a minimum 7.0% in common equity Tier 1 capital and including a 2.5% capital conservation buffer. MQG's minimum absolute level of capital is around AUD15.7bn. As at 31 March 2019, MBL and MQG had met both minimums comfortably with a 13.5% APRA compliant Tier 1 capital ratio and APRA Basel III Group capital of AUD21.8bn.

- **Unique in Business Structure:** While the five operating groups are classified according to the 'form' or nature of their earnings for internal reporting and risk management purposes, MQG also classifies its businesses according to the 'substance' of its earnings based on whether earnings are recurring or markets driven (and hence more volatile or less predictable). Recurring or annuity style businesses comprise Macquarie Asset Management**,** Banking and Financial Services and Corporate and Asset Finance while Macquarie Capital and Commodities and Global Markets are classified as markets facing. Such presentation gives a truer picture of the underlying quality of MQG's cashflows and aligns with one key aspect of MQG's business strategy to grow its business mix towards more predictable and stable businesses.

- **Service groups bind them all.** To ensure efficiency and consistency with the group's overall guidelines, four service groups work across the operating groups to provide the support, framework and infrastructure for operating groups to manage their businesses. While the Corporate Operations Group (includes Business Improvement and Strategy, Human Resources, and Technology), Financial Management Group (includes Finance, Taxation, Group Treasury, Portfolio and Performance, and Corporate Affairs) and Legal and Governance Group provide necessary functions, MQG's key service group is the independent Risk Management Group. Functions include the management of credit, market, operational and behavioral risk. The Risk Management Group also has responsibility for internal audit, compliance and regulatory matters. The centralized nature of the Risk Management Group ensures risks are identified across the consolidated group and are continuously assessed, monitored and reported consistently on a group wide level. This function is critical to MQG given the nature of its businesses and its geographic breadth with the independent Risk Management Group responsible for assessing, on-boarding and managing risk throughout the group.

Friday, October 18, 2019

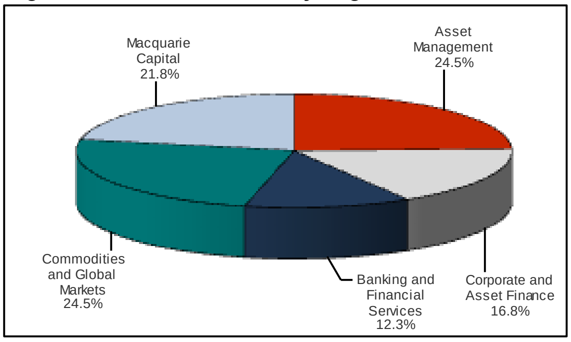
Macquarie Group Limited

Table 1: Summary Financials

Year Ended 31st Mar	FY2017	FY2018	FY2019
Income Statement (AUD'mn)			
Net Interest Income	2,185	1,986	1,760
Non Interest Income	8,572	9,059	11,602
Operating Expenses	7,260	7,456	8,887
Pre-Provision Operating Profit	3,497	3,589	4,475
Provisions	444	366	552
Other Income/(Expenses)	51	241	-56
PBT	3,104	3,464	3,867
Income Taxes	868	883	879
Net Income to Common Shareholders	2,217	2,557	2,982
Balance Sheet (AUD'mn)			
Total Assets	182,877	191,325	203,182
Total Loans (net)	76,663	73,509	78,474
Total Loans (gross)	77,537	73,979	79,014
Total Allowances	874	470	540
Total NPLs	1,071	572	618
Total Liabilities	165,607	173,145	184,818
Total Deposits	57,708	48,395	56,191
Total Equity	17,270	18,180	18,364
Key Ratios			
NIM	1.46%	1.37%	1.09%
Cost-income Ratio	70.1%	68.3%	69.7%
LDR	132.8%	151.9%	139.7%
NPL Ratio	1.38%	0.77%	0.78%
Allowance/NPLs	81.6%	82.2%	87.4%
Credit Costs	0.57%	0.49%	0.70%
Equity/Assets	9.44%	9.50%	9.04%
CETier 1 Ratio (Full)	11.1%	11.0%	11.4%
Tier 1 Ratio	13.3%	12.8%	13.5%
Total CAR	13.3%	12.8%	13.5%
ROE	15.20%	16.80%	18.00%
ROA	1.18%	1.30%	1.51%

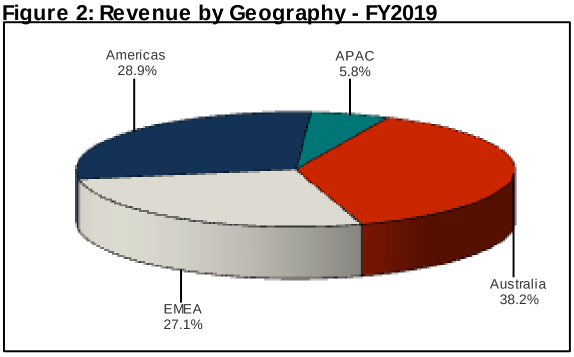
Source: Company

Figure 1: Profit Before Tax by Segment - FY2019



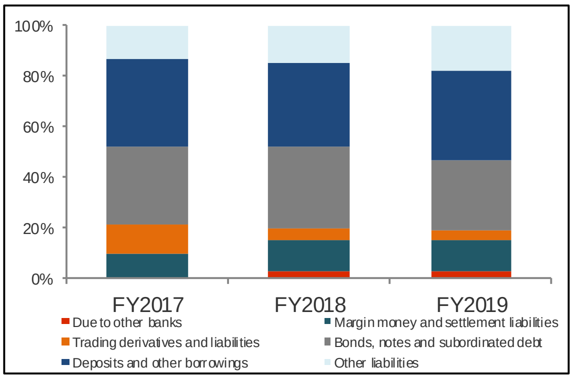
Source: Company | Excludes Corporate Centre

Figure 2: Revenue by Geography - FY2019



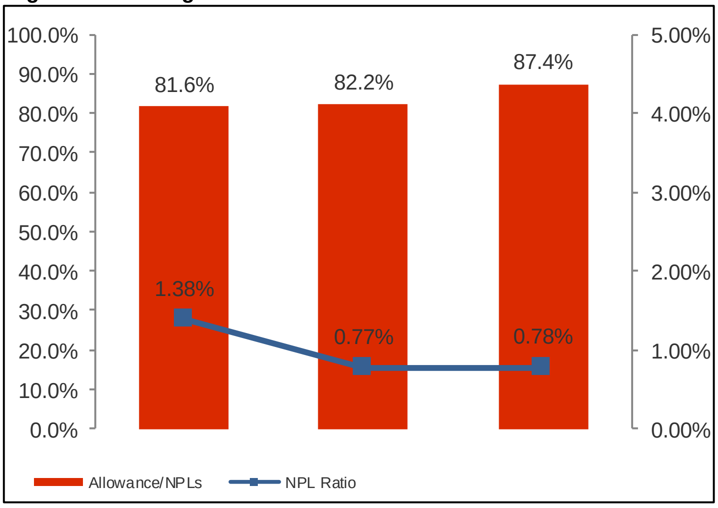
Source: Company

Figure 3: Liabilities Composition



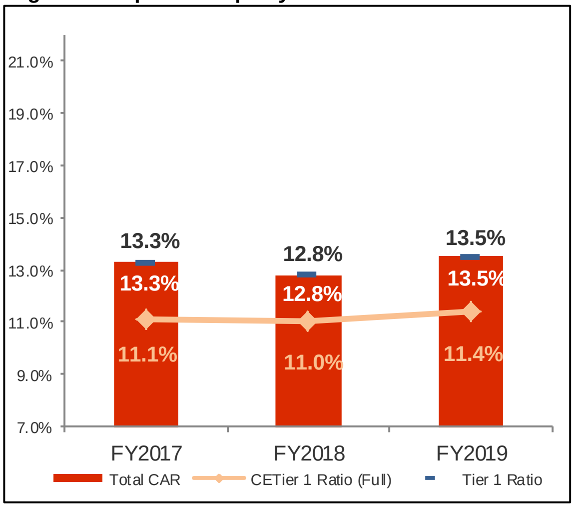
Source: Company

Figure 4: Coverage Ratios



Source: Company, OCBC estimates

Figure 5: Capital Adequacy Ratios



Source: Company

Issuer Profile:
Positive (2)

Ticker:
SCGAU

Industry:
Real Estate

Geography:
Australia

Market cap:
- **AUD21.1bn as at 10 October 2019**

Ownership:
- **10.3% Vanguard Group Inc**
- **8.6% UniSuper**
- **8.5% BlackRock Inc**
- **6.5% State Street Corp**

Scentre Group

I) Company Background

Scentre Group ("SCG") is a retail property group focused on investing and operating retail property in Australia and New Zealand, with capabilities in property management, leasing, design, development, construction, marketing and funds management. SCG owns and operates 41 retail properties valued at AUD54.2bn (SCG's share: AUD37.5bn), with over 11,500 retailers in more than 3.8mn sq m of retail space across Australia and New Zealand. Its portfolio of shopping centres includes Westfield Bondi Junction and Westfield Sydney in Sydney, Westfield Chermside in Brisbane, and Westfield Fountain Gate in Melbourne. SCG also has a 59.6% interest in Carindale Property Trust ("CPT") and exclusive, continuing and royalty free license to use the Westfield brand. Market capitalization of SCG was AUD21.1bn as of 10 October 2019.

The company was established in 2014 when Westfield Group was restructured to create two new independent companies, Scentre Group ("SCG") in respect of its Australia and New Zealand business and Westfield Corporation in respect of its international business. SCG is a stapled group consisting Scentre Group Limited ("SGL") formerly Westfield Holdings Ltd, Scentre Group Trust 1 ("SGT 1") formerly Westfield Trust, Scentre Group Trust 2 ("SGT 2") and Scentre Group Trust 3 ("SGT 3"), both formerly Westfield Retail Trust. SCG is listed on the Australia Stock Exchange.

Executive Director and Chief Executive Officer ("CEO") of SCG, Mr Peter Allen, was an executive Director and Chief Financial Officer of Westfield Group, prior to the establishment of SCG. He joined Westfield in 1996 and between 1998 and 2004 was Westfield's CEO of the United Kingdom and Europe. Peter is Chairman of the Shopping Centre Council of Australia.

II) Recommendation Summary

- SCG's strong portfolio of 41 quality retail malls recorded growth in footfall and retail sales in 1H2019, with overall net property income higher by 4.3% y/y to AUD930.7mn. With base rents being the key driver of its income, SCG reaps the benefit of a stable and visible cash flow.
- Expansion of Westfield Newmarket in Auckland, New Zealand which SCG has a 51% stake is underway and due to complete in 4Q2019. SCG is simultaneously working on two other projects to enhance its existing malls. We also think there is a chance of SCG pursuing acquisitions to continue to grow its asset base.
- Earlier in 2019, SCG divested a 50% stake in Westfield Burwood, Sydney and Sydney CBD office towers which unlocked capital. The funds were partially used to repay some of its debt. SCG also intends to buy back as much as AUD800mn worth of its stapled securities.
- Overall, we see SCG's credit metrics strengthening with adjusted EBITDA/Interest improving to 2.9x, from 2.2x a year ago. Net debt-over-total asset also fell to 32.0% from 35.3% at end June 2018. SCG has AUD0.7bn cash on hand and AUD3.5bn available committed financing facilities on top of a good access to the financial market having raised bonds every year since 2011. **As such, we are assigning SCG a Positive (2) issuer profile.**

III) Key Considerations

- **Strong portfolio of quality retail malls:** SCG, the largest owner of shopping centres by gross lettable area ("GLA") in Australia, has a portfolio of 41 shopping centres. SCG's share of asset under management (i.e. excluding stakes held by minority owners) is AUD37.5bn. SCG fully owns 12 malls (~AUD21.1bn) and has controlling stakes in 24 malls (~AUD13.9bn) in Australia. The malls are located in populous major cities with the distribution across Sydney/Brisbane/Melbourne at 51%/18%/16% of total portfolio. In New Zealand, it has a 51% stake in 5 malls which aggregate to ~AUD1.2bn. Notably, 7 of the top 10 malls in Australia and 4 of the top 5 malls in New Zealand are found in SCG's portfolio. According to the Shopping Centre News, a reputable publication for the shopping centre industry in Australia and New Zealand, of the five largest shopping centres in the year 2018 by moving annual turnover (i.e. sales for a 12-month period calculated on a monthly rolling basis), four of the top five shopping centres in Australia are SCG's Westfield shopping centres. With over 65% of the Australian population living within a 30 minute drive from SCG's malls, SCG recorded a footfall of 535mn (+0.9% y/y) in 2018. SCG also saw total annual retail sales of AUD24.4bn (+4.9% y/y) across 11,500 retailers as of 30 June 2019. Overall net property income rose 4.3% y/y to AUD930.7mn in 1H2019. SCG has consistently maintained very strong portfolio occupancy rates of above 99% for more than 20 years (30 June 2019: 99.3%), showcasing a healthy demand for these malls. SCG's weighted average lease expiry is ~6 years and has ~10% of leased area expiring each year. Overall, we think SCG has a strong portfolio of well-managed quality assets.

- **Stable and visible cash flow:** SCG's revenue is made up of 84% property income, 14% property development and construction and 2% property management. Its property income is 99% derived from contracted base rents, with just 1% being directly related to retailer sales. Anchor retailers generally have lease terms of 20 to 25 years with rental step-up throughout the term that can be a fixed percentage, linked to the consumer price index ("CPI") or sales turnover. Specialty retailers on the other hand have a shorter lease term of 5 to 10 years with annual contracted increases of CPI + 2% to 3%. These contracted rent escalations help SCG offset negative renewal lease spreads which was -4.8% in 1H2019 in part due to structural challenges in the retail sector and enhance rent stability. In addition, on a portfolio level, no single anchor retailer contributed more than 3% of rental income and no specialty store retailer contributed more than 2% in 2018. Net cash flows from operating activities-to-valuation of Investment properties was largely stable at 3.61% in 1H2019 (2018: 3.60%, 2017: 3.66%, 2016: 3.76%).

- **Significant projects under construction:** Expansion of Westfield Newmarket in Auckland, New Zealand (which SCG has a 51% stake in) to add 52,000sqm of space is due to complete in 4Q2019 (SCG's share of cost is NZD400mn). The project will bring the first David Jones, a leading Australian upmarket retailer, to Auckland, alongside a Farmers department store (targeting the mid-market), Countdown supermarket and over 200 other specialty stores. On completion, it will reclaim its position as the largest retail complex in the Newmarket suburb, catering to ~555,000 residents. Separately, SCG is also working on two other projects (1) AUD30mn expansion and refurbishment of Level 2 at Westfield Doncaster in Melbourne (SCG's share: AUD15mn) which is due for completion in 1H2020 and (2) AUD50mn to introduce Kmart and a new format David Jones at Westfield Carindale in Brisbane (SCG's share: AUD15mn) which is due for completion in 2H2020. In aggregate, the active projects underway for 2019 amount to AUD413mn (which SCG has more than sufficient funds for). SCG also has a pipeline of over AUD3bn future development activity beyond 2019. In 2018, SCG completed ~AUD810mn of developments collectively and added more than 106,000 sqm to its portfolio through projects at five malls (Westfield Plenty Valley, Westfield Carousel, Westfield Coomera, Westfield Kotara and Westfield Tea Tree Plaza) and recorded revaluation gains of AUD1.06bn. This year, in April, SCG completed the Bradley Street dining precinct at Westfield Woden, an AUD10.5mn project.

- **Recent divestments partially used to repay debt:** SCG sold a 50% stake in Westfield Burwood, Sydney for AUD575mn (~4% premium to 31 Dec 2018's book value) in May 2019 and disposed Sydney CBD office towers for AUD1.52bn a month later which was ~AUD800mn above investment cost. These transactions unlocked AUD2.1bn of capital for SCG. It intends to buyback AUD800mn SCG stapled securities and to repay some of its debt. This demonstrates the strength of SCG's assets and its ability to divest if need be to pare down debt. SCG has an implicit net gearing target of 30% - 35%. When SCG was first spun off in 2014, gearing was 37.3%, with a portfolio of 47 malls. The number of malls has since declined to 41, and net gearing (based on our calculations) has come down to 32% as of 30 June 2019.

- **Possible acquisitions:** Management had mentioned in August 2019 that they will continue to review and potentially acquire more of Carindale Property Trust ("CPT") which it currently holds a 59.6% interest in. SCG's current stake in CPT translates to a 50% interest in Westfield Carindale. In Jul 2018, SCG acquired a 50% interest in Westfield Eastgardens in Sydney for AUD720mn (representing a capitalization rate of 4.25%).

- **Strengthening credit metrics:** Adjusted EBITDA/Interest (based on our calculation which includes contributions of equity accounted entities and capitalized interest) improved to 2.9x, from 2.2x a year ago, on the back of lower interest cost and higher property revenue. We note that the weighted average interest rate of SCG debt is 4.25% (end 2018 & 2017: 4.4%, end 2016: 4.5%). SCG also saw improvement in its net debt-over-total asset which fell to 32.0% from 35.3% a year ago after repaying AUD1.3bn debt in 1H2019 with funds generated from the sale of assets. SCG's short term debt stood at AUD1.86bn as at end June 2019. We think this amount is very manageable for SCG as on top of AUD0.7bn cash on hand, it has AUD3.5bn of available financing facilities. Although SCG has total long term debt of AUD11.6bn and as much as AUD2.4bn debt coming due in 2023, we are not overly concerned. SCG has unencumbered assets amounting to ~AUD37.2bn based on our estimation that can be liquidated for funds if needed and has also demonstrated good access to the financial market having raised bonds every year since 2011. Its latest issuance is a EUR500mn senior unsecured 10 year bond in March 2019.

IV) Business Overview

Business Strategy

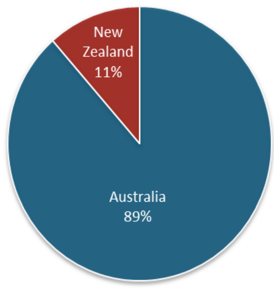
To create places to connect and enrich communities by owning, managing and developing the retail assets in Australia and New Zealand. The strategy consists of four components:

(1) **Asset management** – Maximize the operating performance of the shopping centres
(2) **Retail product and customer experience** – Curate a retail environment that connects customers with retail partners, and provides access to goods and services that resonate with the local community through integrating fashion, food, leisure and entertainment experiences in each shopping centre
(3) Development of shopping centres – Construct new shopping centres to own as well as refurbish parts of existing centres to maintain competitiveness
(4) **Capital management** – Optimize the capital structure through management of capital, funding and liquidity.

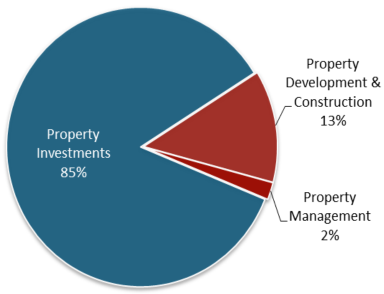
Business Segments

(1) **Property Investment** – This segment makes up the bulk of the income for SCG and includes base rent from shopping centres and other property income. The split between Australia and New Zealand is 96% versus 4%.
(2) **Property Development and Construction** – This segment includes all elements of development, design, construction and project leasing for shopping centres.
(3) **Property Management**– This segment involves day-to-day management, leasing and marketing of SCG's shopping centres.

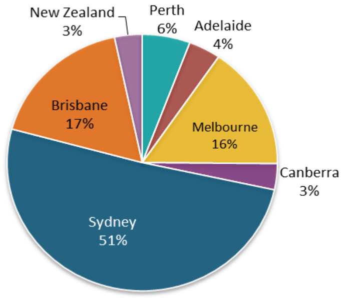
Revenue by Geography

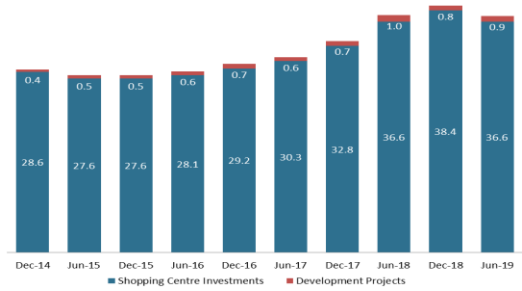


Revenue by Business Segment



Shopping Centre Investments by Geography	Asset under management (AUD'bn)





Source: Company

Overview of Australia's Retail Sector

According to the Australian Bureau of Statistics (ABS), July retail sales grew by 2.6% y/y which was stronger than June (+1.9% y/y) but weaker than May (+2.9% y/y). Areas which recorded growth are clothing & footwear (+4.5% y/y), department stores (+0.9% y/y), supermarkets (+3.9% y/y), and food retailing (+3.3% y/y). Online retail sales saw its first y/y contraction in Australian history (-1.1% y/y) in July, following a +0.5% growth in June and +4.8% in May. A total of AUD29.3bn was spent on online retail by Australians in the last twelve months to July 2019. This is equivalent to 9.0% of total brick and mortar retail sales. We view this development as positive for SCG, as it shows resilience in the demand for the retail offerings offered in SCG's shopping malls. That said, the general outlook for the Australian retail sector is mixed. Consumer spending is expected to soften in the near future, with weak GDP growth and commodity prices weighing on sentiment though monetary policy stimulus from the Reserve Bank of Australia, combined with a strong labour market, should help to reduce the impact of the economic slowdown.

Investment Properties (i.e. shopping centres)

State/City	Mall	Ownership	Valuation (AUD mn)	Cap Rate	Annual Sales (AUD mn)	Specialty Annual Sales (AUD/sqm)	Lettable Area ('000s sqm)	No. of Tenants
NSW	Sydney	100%	5361	4.10%	1252	23389	166	324
NSW	Bondi Junction	100%	3293	4.10%	1145	16906	131	468
QLD	Chermside	100%	2839	4.10%	1025	12386	177	496
VIC	Fountain Gate	100%	2285	4.10%	1053	10516	177	454
QLD	Garden City	100%	1730	4.80%	798	10333	142	404
WA	Carousel	100%	1475	5.00%	-	-	110	366
NSW	Chatswood	100%	1397	4.50%	579	11456	81	261
NSW	Hornsby	100%	1095	5.30%	657	8760	100	317
NSW	Kotara	100%	1095	5.00%	393	9261	71	289
ATC	Belconnen	100%	935	5.50%	540	8558	96	276
NSW	Tuggerah	100%	805	5.40%	480	9155	83	255
WA	Stirling	100%	331	6.30%	328	9524	47	172
NZ	Riccarton	51%	334	6.30%	536	14531	56	196
NZ	Albany	51%	308	5.90%	423	13941	53	146
NZ	St Lukes	51%	265	6.30%	363	13332	40	174
NZ	Manukau City	51%	219	6.40%	293	12722	45	189
NZ	Newmarket	51%	142	6.60%	-	-	-	-
NSW	Miranda	50%	1311	4.40%	953	12792	129	447
VIC	Doncaster	50%	1210	4.50%	935	14246	123	436
NSW	Parramatta	50%	1104	4.50%	849	12487	138	460
NSW	Warringah Mall	50%	938	5.00%	741	9013	132	388
VIC	Southland	50%	875	4.60%	850	9482	129	391
QLD	Carindale	50%	814	5.00%	897	10917	137	411
NSW	Penrith	50%	757	4.80%	677	12068	92	327
SA	Marion	50%	738	5.10%	839	11353	137	328
NSW	Eastgardens	50%	720	4.30%	595	9816	83	290
VIC	Knox	50%	578	5.50%	656	9279	142	416
NSW	Liverpool	50%	560	5.30%	499	9547	84	335
NSW	Burwood	50%	553	5.00%	480	11591	63	237
QLD	North Lakes	50%	490	5.00%	678	10697	115	278
NSW	Hurstville	50%	440	5.30%	560	10473	62	255
SA	Tea Tree Plaza	50%	410	5.40%	522	11103	99	262
ACT	Woden	50%	353	5.50%	360	9283	72	243
NSW	Mount Druitt	50%	333	5.50%	410	8900	60	235
WA	Whitford City	50%	315	5.80%	475	7495	85	295
VIC	Geelong	50%	267	5.70%	270	9012	52	172
VIC	Plenty Valley	50%	263	5.30%	404	8758	63	196
SA	West Lakes	50%	248	6.00%	393	9261	71	243
QLD	Helensvale	50%	238	5.80%	365	12490	45	188
QLD	Coomera	50%	223	5.50%	-	-	58	162
VIC	Airport West	50%	214	5.80%	345	9248	53	169
	Total		37,861		23,618	424,081	3,799	11,951

Source: SCG's property compendium released on 31 Dec 2018

Notes:

(1) NSW – New South Wales, VIC – Victoria, QLD – Queensland, SA – South Australia, WA – West Australia, ACT – Australian Capital Territory, NZ – New Zealand

(2) Adjusted for the sale of 50% stake in Burwood

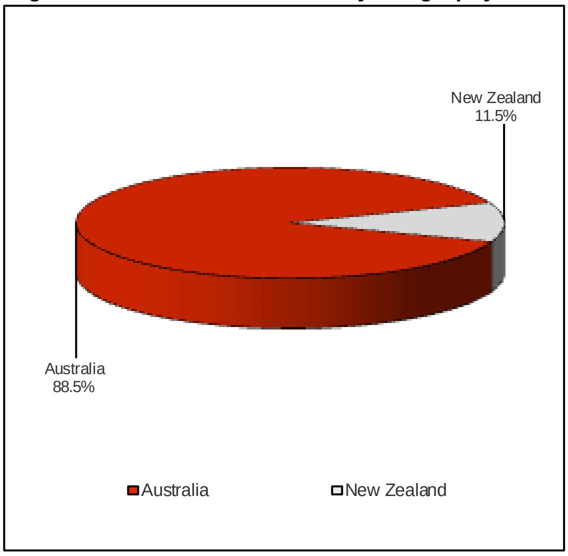
Scentre Group

Table 1: Summary Financials

Year Ended 31st Dec	FY2017	FY2018	1H2019
Income Statement (AUD'mn)			
Revenue	2,682.3	2,844.3	1,408.0
EBITDA	1,974.1	2,032.2	1,036.0
EBIT	1,920.3	1,964.4	995.5
Gross interest expense	756.3	685.1	339.7
Profit Before Tax	4,301.8	2,354.7	777.7
Net profit	4,231.4	2,295.9	744.0
Balance Sheet (AUD'mn)			
Cash and bank deposits	174.0	206.1	693.6
Total assets	37,415.6	40,875.0	39,953.2
Short term debt	1,595.1	1,945.5	1,857.8
Gross debt	12,323.7	14,643.1	13,460.1
Net debt	12,149.7	14,437.0	12,766.5
Shareholders' equity	22,781.3	23,865.8	24,024.3
Cash Flow (AUD'mn)			
CFO	1,737.1	1,803.8	890.6
Capex	684.7	776.1	195.4
Acquisitions	20.0	789.8	0.0
Disposals	369.9	90.6	2,098.1
Dividends	1,142.5	1,165.1	592.8
Interest paid	512.0	504.5	271.6
Free Cash Flow (FCF)	1,052.4	1,027.7	695.2
Key Ratios			
EBITDA margin (%)	73.60	71.45	73.58
Net margin (%)	157.75	80.72	52.84
Gross debt to EBITDA (x)	6.24	7.21	6.50
Net debt to EBITDA (x)	6.15	7.10	6.16
Gross Debt to Equity (x)	0.54	0.61	0.56
Net Debt to Equity (x)	0.53	0.60	0.53
Gross debt/total asset (x)	0.33	0.36	0.34
Net debt/total asset (x)	0.32	0.35	0.32
Cash/current borrowings (x)	0.11	0.11	0.37
EBITDA/Total Interest (x)	2.61	2.97	3.05

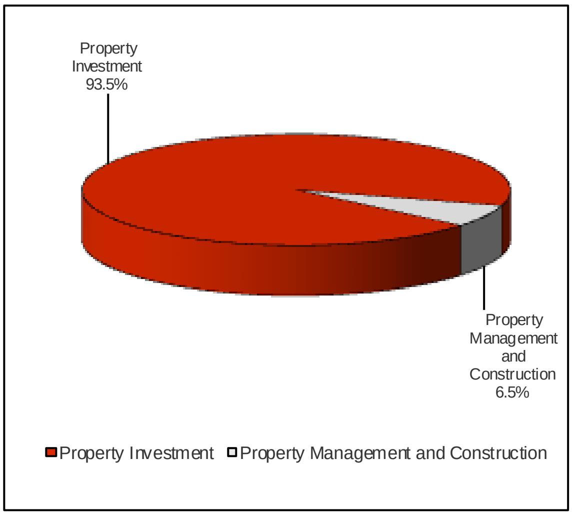
Source: Company, OCBC estimates

Figure 1: Revenue breakdown by Geography - 1H2019



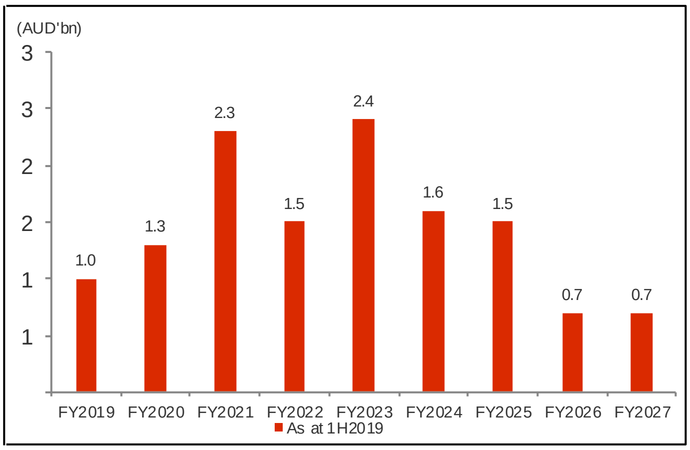
Source: Company

Figure 2: Net breakdown by Income Segment - 1H2019



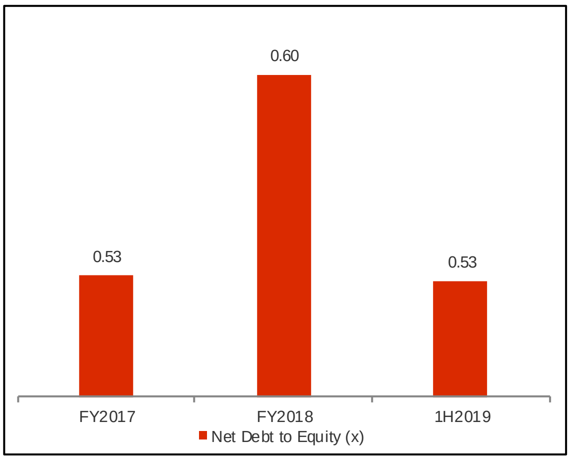
Source: Company

Figure 3: EBITDA/Total Interest (x)



Source: Company, OCBC estimates

Figure 4: Net Debt to Equity (x)



Source: Company, OCBC estimates

Issuer Profile:
Positive (2)

Ticker:
SGTOPT

Industry:
Telecommunications

Geography:
Australia

Market cap:
- Not listed

Ownership:
- Optus is wholly owned by SingTel, which is in turn 52.55%-owned by Temasek Holdings Pte Ltd.

Singtel Optus Pty Ltd

I) Company Background

Singtel Optus Pty Ltd ("Optus") is amongst the largest telecommunications company in Australia, providing various services (e.g. mobile, fixed voice, broadband, TV, data, application services) to retail as well as businesses of varying sizes. Optus also provides wholesale services to other carriers and service providers.

Optus is not listed though it is wholly owned by Singapore Telecommunications Ltd ("SingTel"). Optus accounts for 29.4% of SingTel's enlarged revenue (including SingTel's proportionate share of associates' revenue) and 26.3% of SingTel's proportionate EBITDA (which includes SingTel's proportionate share of associates' EBITDA). SingTel is listed on the SGX with a market cap of SGD51.1bn.

Optus structures its business along (1) Consumer Australia, which provides products and services to retail, small and medium-sized businesses and third-party operators as well as (2) Optus Business, which provides telecommunication services to corporate and government customers.

II) Recommendation Summary

- Optus is a leading telecommunications company in Australia, with AUD7.66bn revenue and AUD2.48bn reported EBITDA as of FY2019.
- Optus faces some pressure on mobile from price erosion due to intense competition though we expect prices to recover somewhat. On the broadband front, we think margin compression is likely to continue. While reported EBITDA rose 4.7% y/y to AUD687mn in 1QFY2020, this figure is not comparable on a y /y basis due to accounting changes.
- Overall credit metrics are still decent with net debt/EBITDA at 2.2x and EBITDA/Interest at 10.6x. We think that having SingTel as a parent is a credit positive though we factor only some uplift from potential parent support. **We assign Optus a Positive (2) Issuer Profile.**

III) Key Considerations

- **Strong position in the Australian telecommunications market:** Optus is the second largest telecommunications company in Australia, behind Telstra. According to the Australian Competition and Consumer Commission ("ACCC"), as of 30 June 2018 Optus holds 28% of the retail market share for Mobile, 14% for National Broadband Network ("NBN") broadband services and 15% for Fixed broadband services. By segment, the biggest contributor as of FY2019 is Consumer Australia, delivering AUD7.66bn revenue (Optus total revenue: AUD9.10bn) and AUD2.48bn reported EBITDA (Optus total reported EBITDA: AUD2.70bn). The remainder of revenue (AUD1.4bn) and reported EBITDA (AUD216mn) were contributed by Optus Business. By segment, mobile revenue is the largest contributor in FY2019, delivering AUD5.70bn revenue, followed by retail fixed (AUD1.42bn) Infocomm Technology and managed services (AUD634mn) and wholesale fixed (AUD540mn).

- **1QFY2020 results are not comparable y/y due to accounting changes:** From 1QFY2020, Optus adopted the new IFRS for leases. Lease payments are no longer recorded on the income statement and instead higher depreciation and interest payments are recorded. As such, Optus now records higher reported EBITDA of AUD687mn (+4.7% y/y), primarily driven by accounting changes. Without adding back depreciation and interest expense, profit before tax and exceptional items ("PBTE") fell 29.0% y/y to AUD169mn in 1QFY2020. This is in contrast to revenue which rose 3.3% y/y to AUD2.25bn, which is mainly due to equipment revenue (likely to be low margin) rising 31.8% y/y to AUD501mn. Meanwhile, the high-margin mobile service revenue (which excludes equipment and leasing revenue) fell 6.6% y/y to AUD856mn.

- **Mitigating the pressures on the Mobile front:** Despite significant growth in 4G customers (+5.3% y/y to 6.7mn), mobile service revenue dipped in 1QFY2020 mainly due to lower ARPU, noting the fall in postpaid ARPU to AUD38/mth (1QFY2019: AUD42/mth), prepaid ARPU to AUD18/mth (1QFY2019: AUD19/mth) and mobile broadband ARPU to AUD19/mth (1QFY2019: AUD21/mth). As of 30 Jun 2019, there were 5.73mn postpaid handset subscribers, 3.37mn prepaid handset subscribers and 1.18mn mobile broadband subscribers. While the fall in ARPU is partly due to higher mix of SIM-only plans, we note intense price competition on data (e.g. offering more data at a lower price). That said, further price erosion should be contained. Optus is following the footsteps of Telstra, which is the market leader on mobile, to raise prices. Optus is expecting a positive impact on ARPU and mobile service revenue as a result. As long as prices stabilize, we think Optus should benefit from the increasing use of data – coming from increase in downloads, streaming and other applications requiring data. However, we think the recovery may be shallow. According to ACCC, the market share of mobile virtual network operators ("MVNOs") has increased to 13% in 2017-18 (2016-18: 11%). We think the collective market share of MVNOs may continue growing (at the expense of operators like Optus); we note new entrants are still entering the market such as Circles.Life. Although Optus can capture revenue from MVNOs by reselling services to MVNOs via its wholesale mobile network, we expect the influx of MVNOs to be net negative to Optus by intensifying competition.

- **Trend towards NBN broadband likely to be a net negative:** As of 1QFY2020, NBN customer base (646k) has grown to become the largest contributor to the broadband segment, accounting for 57% (1QFY2019: 42%) of Optus' retail fixed broadband customer base of 1.14mn. By revenue, off-net revenue (which comprises mainly NBN) accounts for AUD251mn out of AUD386mn retail fixed revenue, with the remaining AUD135mn accounted for by on-net revenue from customers still using Optus' HFC cable and ULLDSL network. The growth in NBN is largely due to Optus progressively migrating customers from HFC and ULLDSL as part of the Australian government's reform of the sector. Optus receives revenues from migrating customers (1QFY2020 estimate: AUD98mn) to the NBN network though this is one-off; on a recurring basis this results in Optus relying on the NBN network which incurs access costs. Although the industry-wide mandatory migration will breakup Telstra's monopoly on broadband, we think the net impact on EBITDA may be negative as competition is expected to intensify, noting over 180 resellers of NBN services. We expect broadband margins to face compression (perhaps trend towards zero). Already, Optus' total broadband customers have declined 3.1% y/y to 1.14mn.

- **Increasing focus on 5G which could substitute for broadband though capex rise:** Optus is increasingly rolling out 5G, with the target to reach 1,200 sites by March 2020. Already, Optus has launched 5G home broadband services at selected places, which we think can be better positioned than 4G to substitute for broadband; we note the relative value of Optus 5G home broadband (AUD70/mth, unlimited data with at least 50Mbps) versus Optus NBN plan (AUD70/mth, unlimited data with at least 40Mbps). As of 1QFY2020, Optus mobile broadband subscribers have grown by 6.3% y/y to 1.18mn after growing from 13% of the market share in Jun 2016 to 16% as of June 2018. That said, capex may rise given the 5G rollout. Optus is guiding for AUD1.4bn capex in FY2020, which translates to capex to revenue of ~15.4% based on FY2019's AUD9.1bn revenue (FY2019: 12.6%). As of 1QFY2020, AUD340mn was spent on capex, of which AUD235mn is attributable to the mobile network (the remaining AUD105mn is attributable to Fixed and other core infrastructure).

- **Mobile landscape may evolve significantly with potential merger of rivals…:** Aside from intensifying competition from MVNOs, on Mobile, we think the biggest potential change to the competitive landscape could come from the potential merger of rivals TPG and Vodafone. Although the ACCC has opposed the merger, TPG and Vodafone have appealed to the federal court. We think a potential merger may be positive for Optus in the short term by reducing competition. However, it is uncertain how the competitive landscape may evolve in the longer term as a merger would result in a significantly stronger rival to challenge Optus.

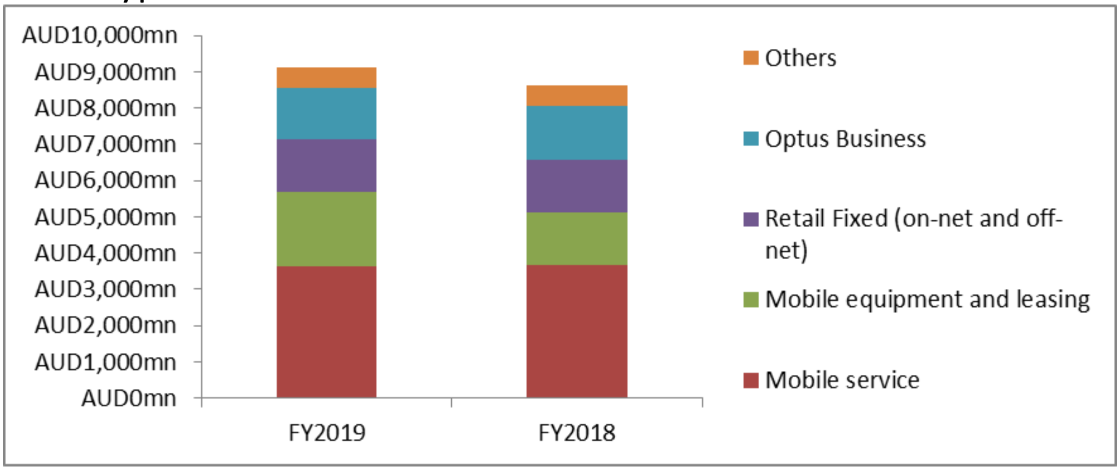
- **Challenging environment for Optus Business:** Optus Business saw revenue fall 19.2% y/y to AUD312mn in 1QFY2020 mainly due to declines in managed services (-26.1% y/y to AUD113mn) with lower spending by key government and financial sectors. We also note that revenues were higher in 1Q2019 due to a large ICT sale. In addition, Optus faces price erosion which drove carriage revenue lower by 17.2% y/y to AUD177mn, with steep declines in Data and IP (-15.8% y/y to AUD65mn), Mobile (-17.5% y/y to AUD60mn) and Voice (-18.7% y/y to AUD52mn).

- **Credit profile weaker though still decent overall:** Although 1QFY2020 results are not strictly comparable on a y/y basis, it is suggestive that credit metrics have weakened with net debt/EBITDA rising to 2.2x in 1QFY2020 (FY2019: 1.64x) and EBITDA/Interest declining to 10.6x (FY2019: 13.4x). This is mainly due to pressure on high-margin mobile service revenue. That said, we remain comfortable with Optus' credit profile, noting strong free cashflow of AUD229mn as of 1QFY2020 (FY2019: AUD446mn). That said, we think a substantial amount of free cashflow has been upstreamed to SingTel via dividends as we note that net borrowings remain relatively unchanged y/y at AUD4.19bn as of FY2019 (FY2018: AUD4.26bn).

- **Optus is a core subsidiary of SingTel though we factor only some parent uplift:** We think that Optus is core to SingTel given that it accounts for 29.4% of SingTel's enlarged revenue (including SingTel's proportionate share of associates' revenue) and 26.3% of SingTel's proportionate EBITDA. We note that Optus' has been fully owned by SingTel since Oct 2001. We believe that having SingTel as a parent improves Optus' access to capital. That said, we factor only some parent uplift as we think that it is possible for SingTel to dispose Optus or part of it, if SingTel chooses to. For example, SingTel was looking to sell Optus Satellite Pty Ltd though plans were cancelled in 2013 as bids fell short of SingTel's target of more than AUD2bn. We also believe that the business, operations and financials of Optus are sufficiently segregated from the rest of SingTel to allow a disposal.

IV) Product and Segment Overview

Revenue by product



Source: FY2019 full year financial results, annual reports

Segment	FY2019 EBITDA (AUDmn)	Brief Description
Australia Consumer	2,483	▪ Provides telecommunication services and products (e.g. mobile, voice, data, broadband, application services) to retail as well as small and medium-sized business ▪ Also provides wholesale services to third party carriers and services providers using Optus' infrastructure. ▪ Provide satellite services including direct-to-home broadcast and free-to-air services
Optus Business	216	▪ Provides telecommunication service and solutions to corporate and government customers

Source: FY2019 full year financial results, annual reports

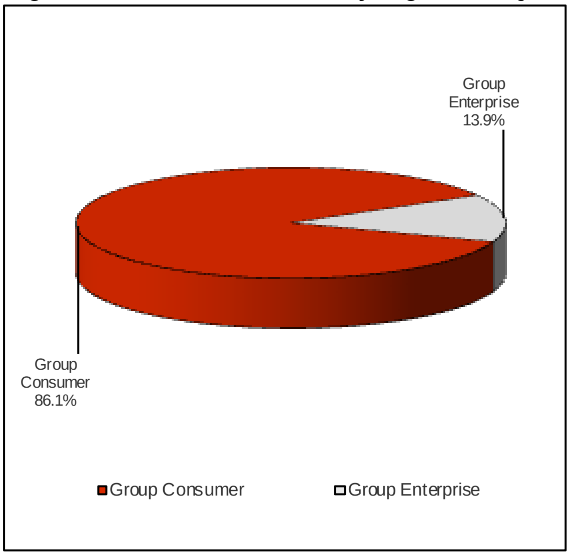
Singtel Optus Pty Ltd

Table 1: Summary Financials

Year Ended 31st Mar	FY2018	FY2019	1Q2020
Income Statement (AUD'mn)			
Revenue	8,612.0	9,099.0	2,250.0
EBITDA	2,537.0	2,564.0	658.0
EBIT	1,101.0	1,081.0	202.0
Gross interest expense	185.0	191.0	62.0
Profit Before Tax	1,106.0	967.0	157.0
Net profit	781.0	658.0	105.0
Balance Sheet (AUD'mn)			
Cash and bank deposits	118.0	96.0	109.0
Total assets	18,543.0	18,762.0	N/A
Short term debt	934.0	1,165.0	1,299.0
Gross debt	4,383.0	4,298.0	5,912.0
Net debt	4,265.0	4,202.0	5,803.0
Shareholders' equity	10,615.0	10,685.0	N/A
Cash Flow (AUD'mn)			
CFO	2,438.0	2,172.0	569.0
Capex	1,490.0	1,144.0	340.0
Acquisitions	0.0	0.0	48.0
Disposals	0.0	0.0	0.0
Dividends	600.0	600.0	0.0
Interest paid	187.0	195.0	57.0
Free Cash Flow (FCF)	948.0	1,028.0	229.0
Key Ratios			
EBITDA margin (%)	29.46	28.18	29.24
Net margin (%)	9.07	7.23	4.67
Gross debt to EBITDA (x)	1.73	1.68	2.25
Net debt to EBITDA (x)	1.68	1.64	2.20
Gross Debt to Equity (x)	0.41	0.40	N/A
Net Debt to Equity (x)	0.40	0.39	N/A
Gross debt/total asset (x)	0.24	0.23	N/A
Net debt/total asset (x)	0.23	0.22	N/A
Cash/current borrowings (x)	0.13	0.08	0.08
EBITDA/Total Interest (x)	13.71	13.42	10.61

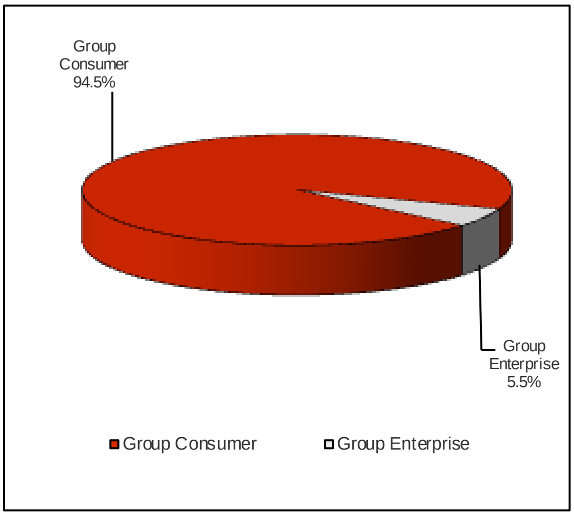
Source: Company, OCBC estimates

Figure 1: Revenue breakdown by Segment - 1Q2020



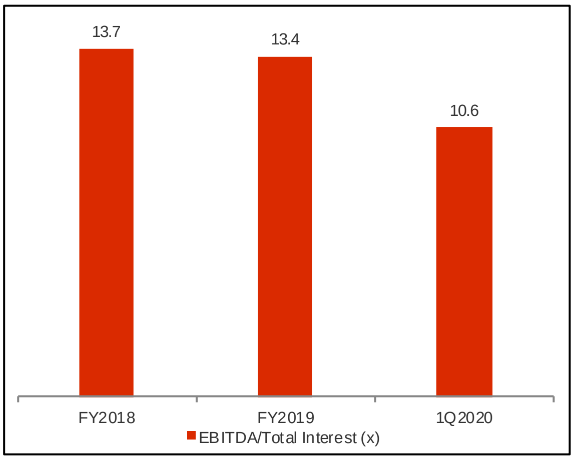
Source: Company

Figure 2: EBITDA breakdown by Segment - 1Q2020



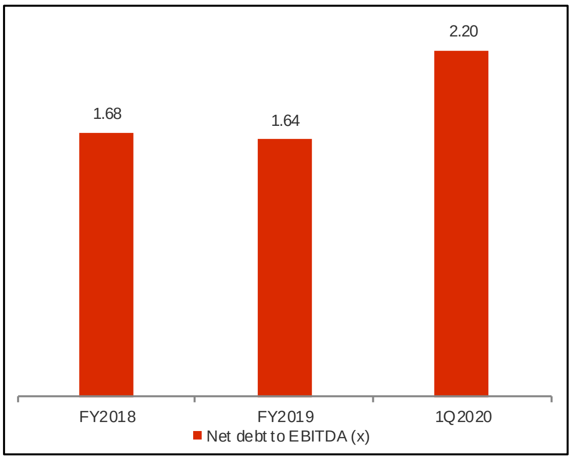
Source: Company

Figure 3: EBITDA/Total Interest (x)



Source: Company, OCBC estimates (1Q2020 EBITDA annualised)

Figure 4: Net debt to EBITDA (x)



Source: Company, OCBC estimates (1Q2020 EBITDA annualised)

Issuer Profile:
Neutral (4)

Ticker:
QANAU

Industry:
Airline

Geography:
Global

Market cap:
- **AUD10.4bn (As of 16 Oct 2019)**

Ownership:
- **Qantas' largest shareholder is the Pendal Group Ltd, an Australian based investment manager holding a 6.6% stake.**
- **AllianceBernstein holds 5.1% while National Australia Bank holds 3.1%.**
- **The rest of the shareholders hold less than 2% in the company. Per the Qantas Sales Act 1992, foreign ownership of the listed entity is capped at 49%.**

Qantas Airways Limited

I) Company Background

Qantas Airways Limited ("Qantas"), the flag carrier of Australia, is part of the ASX200 and by market cap the largest of four airlines listed on the Australian Stock Exchange. Qantas was founded in 1920, in Queensland. From operating leisure and charter flights, Qantas expanded its services linking Australia and Singapore as early as 1935 (mainly for onward flights to the UK). In 1947, the Australian government acquired Qantas until 1992 where sweeping reforms were introduced in the Australian aviation sector. In 1992, Australian Airlines, a separate government owned airline, was purchased by Qantas while the government begun privatizing the enlarged Qantas. Firstly, by allowing British Airways to buy 25% of the company and then in 1995, via an initial public offering of the remaining 75%-stake.

Originally as a defensive response to the competitive threat from Virgin Australia, Qantas launched Jetstar, its budget arm in 2003. Qantas today has a well-crafted dual-brand strategy with the main carrier "Qantas" ("QF") and "Jetstar". The "Jetstar" brand and its variations are also used for its international Jetstar business (three equity joint ventures based in Singapore, Japan and Vietnam respectively). Additionally, Qantas has three cornerstone alliances (also known as "joint ventures" in airline parlance), with Emirates, China Eastern and most recently American Airlines. These alliances allow merger-type benefits, without it being an equity joint venture or legal merger. A significant transformation begun in early 2014, amidst a period of high fuel prices. Among various issues, the plan targeted a reduction in cost base which had remained high versus peers, despite shedding its government ownership links two decades prior. Qantas' ranks as one of the top three most-trusted Australian brands per the 2019 Corporate Reputation Index, a survey carried out annually since 2008.

II) Recommendation Summary

- Qantas has a well-articulated airline business supported by its dominant position in Australia, dual-brand strategy with clear customer segmentation and well-established Loyalty business which provides a defensible income stream.
- Constraining the company's credit profile is the airline industry sector which the company operates in. Structurally, we see the airline sector as a cyclical and highly competitive industry which is simultaneously subject to the vagaries of fluctuations of fuel prices. While credit metrics are manageable, we expect capex to tilt up from Qantas' ageing fleet.
- **We are assigning Qantas a Neutral (4) issuer profile and expect this to be stable over the next 12 months.**

III) Key Considerations

- **Focused on profitability:** For the financial year ended June 2019 ("FY2019"), Qantas revenue was up 4.9% y/y to AUD18.0bn, mainly due to higher contribution from Qantas International, although all segments also saw revenue growth. Reported underlying EBIT though was down 14.9% y/y to AUD1.5bn due to weaker Underlying EBIT from Qantas International (down 28.4% y/y), Jetstar Group (down 19.0% y/y) and Qantas Domestic (down 3.3% y/y) although Qantas Loyalty saw Underlying EBIT increase by 8.4% y/y. While fuel expenses (up 19% y/y) was one big reason behind higher expenses (leading to a drop in Underlying EBIT), Qantas was also negatively affected by AUD weakness on non-fuel expenses and wage inflation. The company ended FY2019 with an Underlying Profit before Tax ("Underlying PBT") of AUD1.3bn (down 16.8% y/y). The airline industry is cyclical, with y/y returns variable, though Qantas had been able to turn a profit every year since its' dire FY2014 results, in part aided by lower fuel cost since then and a significant transformation plan that was carried out. Qantas' internal policy disallows speculative trading of fuel, which reduces risk of losses from fuel trading. Given that Qantas has fully hedged its fuel costs (expected FY2020 fuel costs at AUD3.95bn) and with capacity growth contained, we expect Qantas' profitable streak to continue for FY2020.

- **Benefits from a large hinterland:** Unlike its international regional peers (chiefly SIA and Cathay Pacific), Qantas benefits from being the dominant player for domestic air travel in Australia. While its market share had gradually declined in the past six years, the full service Qantas and Jetstar's domestic business collectively still command 60% of the Australian domestic market share in FY2018. The domestic businesses contributed Underlying EBIT of AUD1.0bn (~70% of total Underlying EBIT). It was reported that Underlying EBIT for Qantas Domestic on a standalone basis was AUD740mn in FY2019, implying that ~AUD294mn can be attributable to Jetstar's more leisure focused domestic business. As a country with a large hinterland, certain segments within the air travel market are driven by necessity and hence more defensive in our view versus international travel. For example, Sydney-Melbourne and the Sydney-Brisbane routes are among the top busiest domestic routes globally.

- **Qantas Loyalty segment as a defensive income generator and data depository:** Qantas Loyalty (mainly Qantas Frequent Flyer ("QFF") and Qantas Business Rewards ("QBF") and other new adjacent businesses such as Qantas Insurance, Red Planet and Qantas Money) contributed AUD374mn in Underlying EBIT for FY2019 (FY2018: AUD345mn), 25% of total Underlying EBIT. The QFF business is a market leader in Australia within the loyalty business segment with a membership base of more than 12 million members while QBF which targets small and medium sized enterprises has more than 200,000 members. Apart from building loyalty to Qantas, the company earns margins when points are sold to external partners, with external partners buying Qantas points to attract and retain their customers. For example, Woolworths, Australia's largest grocery chain, myriad sports and apparel retailers, departmental stores, petrol retailers. In our view, a successful loyalty business is reliant on "network effects", with a larger membership base begetting even more partners to sign up with Qantas. Net-net, we see Qantas Loyalty as a defensible business, albeit one that is inextricably linked to the appeal of Qantas as an airline.

- **Income variability in International segment while Qantas pushes boundaries:** Asia is a key part of Qantas' international strategy with Singapore as the company's largest hub outside of Australia. QF focuses on premium air travel between Asia-Australia (with China Eastern as a cornerstone partner) while Jetstar has associates based in Singapore, Japan and Vietnam to capture the price sensitive markets. In FY2019, Qantas International contributed AUD285mn in Underlying EBIT (making up 19% of total Underlying EBIT). This is a business which relies on international connectivity where Qantas also faces strong competition in each of the regions it operates in. For FY2019, the segment reported good unit revenue growth of 6.4%, although insufficient to fully offset negative foreign exchange impact and costs from transitioning its fleet type. Apart from continuation of its Asian strategy, Qantas is focusing more on point-to-point travel and has challenged both Boeing and Airbus to develop an economically viable ultra-long haul plane (eg: connecting eastern cities of Australia to London and New York), dubbed Project Sunrise. We have not factored in this possible capex, as a decision on whether or not Qantas will place Project Sunrise orders is only expected in end-2019.

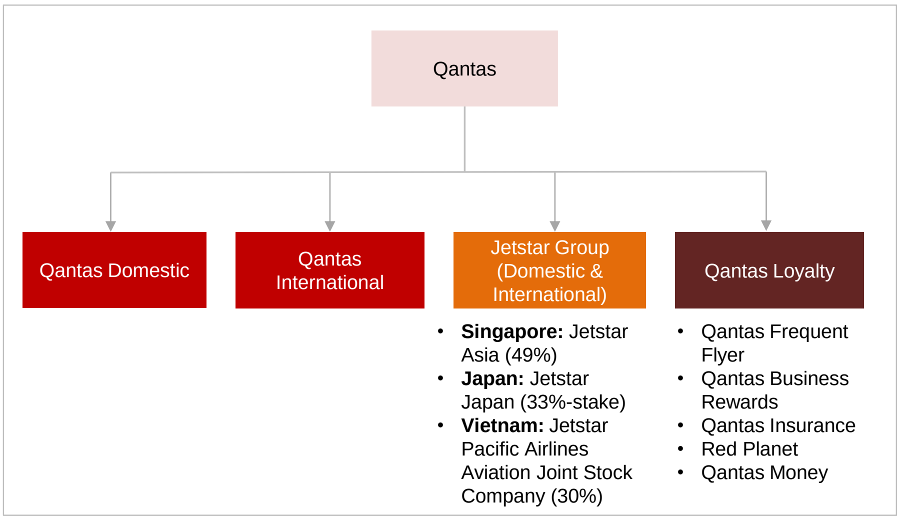
- **Manageable headline credit metrics for now:** Adjusted EBITDA (based on our calculation which does not include net gains on disposal and reversal of impairments) was AUD2.8bn in FY2019 (FY2018: AUD3.0bn), representing 12.2x (FY2018: 13.2x) interest coverage. Despite the fall in EBITDA, interest expense had only increased by 0.9% y/y, despite a 3.6% increase in average debt balance, indicating a fall in cost of debt. As at 30 June 2019, gross debt-to-Adjusted EBITDA was 1.8x while gross gearing was 1.5x, in line with end-2018 levels. We pay more attention to these ratios versus net gearing, given that revenue received in advance (liability item) are very significant at AUD5.8bn against AUD2.2bn of cash balance. Like its airline peers, Qantas is free to use the cash on its balance sheet (including for capex and debt repayment) though there is no guarantee that customers will not seek refunds and/or the company facing higher than expected operating cost to fulfil promised services down the road.

- **Sizeable lease liabilities:** From 1 July 2019 onwards, Qantas would account for leases under the accounting standard AASB 16 Leases where the right of use and the lease liabilities would be recognized on balance sheet. For the case of Qantas, these would be predominantly from its plane leases. The company estimates that it will recognize AUD1.3bn-AUD1.5bn in right-of-use assets and lease liability and other related liabilities of AUD1.5bn-AUD1.7bn. Taking the mid-point of these estimates, Qantas gross gearing may rise to ~2.0x. Based on our estimation, gross debt-to-Adjusted EBITDA would be between 2.0x - 2.5x, still manageable.

- **Expect capex to tilt up:** Qantas has guided a maintenance capex spend of AUD2.0bn for FY2020, which is at similar capex levels in FY2019 and FY2018, prior to taking into account of proceeds from sale of existing Qantas assets (eg: airport terminals). Against Qantas' operating cash flow, an annual capex of AUD2.0bn should be relatively comfortable in our view, without the need to take on additional debt. However, it is worth noting that this excludes growth capex and excludes possible capex on Project Sunrise. This also assumes that Qantas does not accelerate its aircraft renewal. We estimate that as of FY2019, the average age of Qantas' scheduled passenger aircraft (excluding freighters, Network Aviation fleet (charter flight services), Jetstar Pacific and Jetstar Japan) would be ~12 years, steadily creeping up over the past five years (FY2018: 11.1 years and FY2014: 7.7 years). While there is no urgency for Qantas to renew its fleet, we expect higher capex spend over the medium term especially as its fleet age diverges further with that of its regional peers. Singapore Airlines Limited, for example, has a fleet age of less than seven years.

- **Short term refinancing risk highly manageable:** As at 30 June 2019, Qantas has AUD635mn in short term debt coming due, representing only 12% of its gross debt. ~60% of the short-term debt comprises secured debt (secured against aircraft) while the remaining comprise of bonds. We see refinancing risk at Qantas as highly manageable given its well termed out debt structure until FY2024, availability of AUD1.0bn in undrawn facilities and diversified funding sources, including tapping US-based investors via a private placement of longer tenor debt. Additionally, boosting financial flexibility, Qantas also has ~USD3.1bn (~AUD4.6bn) of aircraft by market value (as shared by Qantas per AVAC market values) which remains unencumbered.

IV) Simplified Corporate Structure



Source: Company annual report, investor presentation and company website
Note: (1) Jetstar Asia is consolidated as a subsidiary. The other 51%-stake is owned by Singapore-based Westbrook Investments
(2) As of writing, Qantas is also the largest shareholder of ASX-listed Alliance Aviation Services ("AAS"), holding a 19.7% stake in the company, though the Australian Competition & Consumer Commission is investigating this purchase given that AAS is Qantas' sole competitor on certain routes

Friday, October 18, 2019

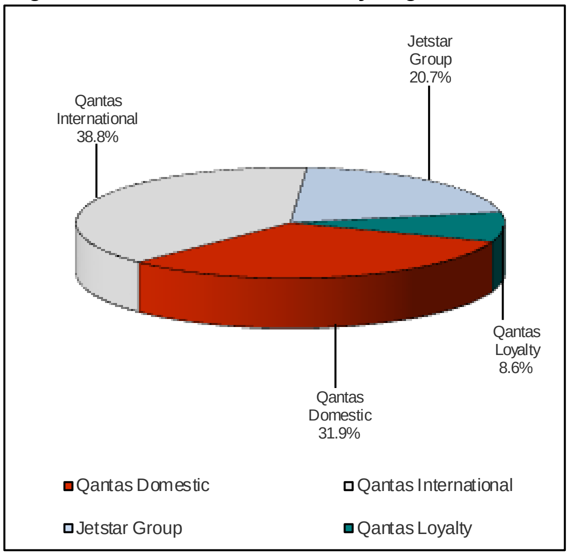
Qantas Airways Limited

Table 1: Summary Financials

Year Ended 30th June	FY2017	FY2018	FY2019
Income Statement (AUD'mn)			
Revenue	16,057.0	17,128.0	17,966.0
EBITDA	2,759.0	3,047.0	3,093.0
EBIT	1,377.0	1,519.0	1,428.0
Gross interest expense	235.0	230.0	232.0
Profit Before Tax	1,181.0	1,352.0	1,265.0
Net profit	853.0	953.0	891.0
Balance Sheet (AUD'mn)			
Cash and bank deposits	1,775.0	1,694.0	2,157.0
Total assets	17,221.0	18,647.0	19,377.0
Short term debt	433.0	404.0	635.0
Gross debt	4,838.0	4,748.0	5,224.0
Net debt	3,063.0	3,054.0	3,067.0
Shareholders' equity	3,540.0	3,955.0	3,436.0
Cash Flow (AUD'mn)			
CFO	2,831.0	3,533.0	2,934.0
Capex	1,368.0	1,959.0	1,944.0
Acquisitions	16.0	2.0	60.0
Disposals	34.0	34.0	483.0
Dividends	261.0	249.0	363.0
Interest paid	164.0	161.0	168.0
Free Cash Flow (FCF)	1,463.0	1,574.0	990.0
Key Ratios			
EBITDA margin (%)	17.18	17.79	17.22
Net margin (%)	5.31	5.56	4.96
Gross debt to EBITDA (x)	1.75	1.56	1.69
Net debt to EBITDA (x)	1.11	1.00	0.99
Gross Debt to Equity (x)	1.37	1.20	1.52
Net Debt to Equity (x)	0.87	0.77	0.89
Gross debt/total asset (x)	0.28	0.25	0.27
Net debt/total asset (x)	0.18	0.16	0.16
Cash/current borrowings (x)	4.10	4.19	3.40
EBITDA/Total Interest (x)	11.74	13.25	13.33

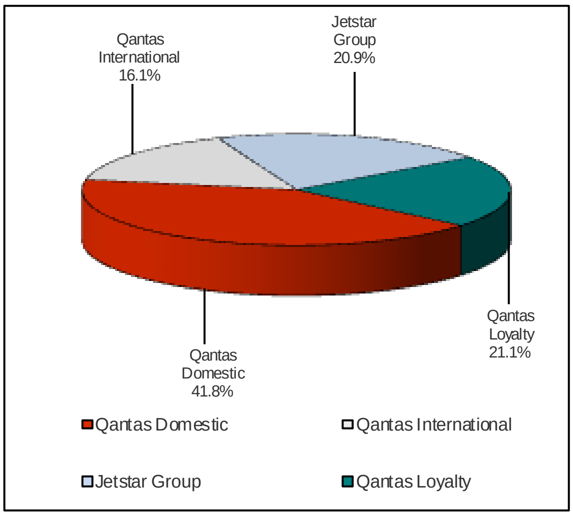
Source: Company, OCBC estimates

Figure 1: Revenue breakdown by Segment - FY2019



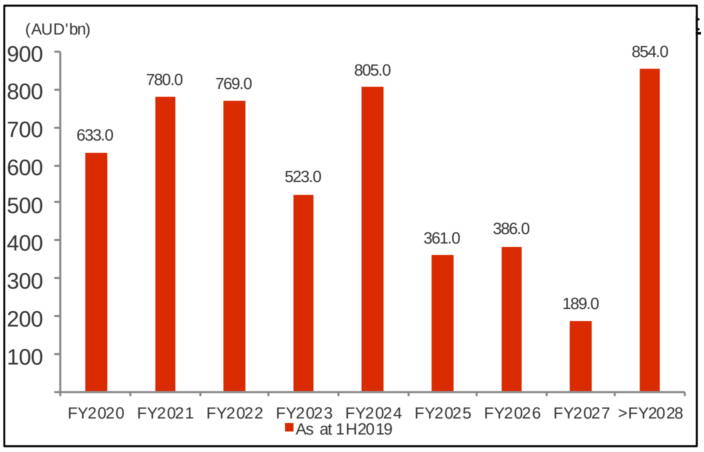
Source: Company

Figure 2: EBIT breakdown by Segment - FY2019



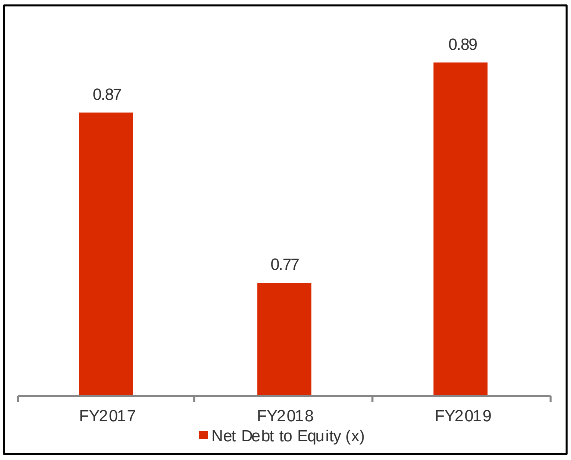
Source: Company

Figure 3: EBITDA/Total Interest (x)



Source: Company, OCBC estimates

Figure 4: Net Debt to Equity (x)



Source: Company, OCBC estimates

Telstra Corporation Limited

Issuer Profile:
Positive (2)

Ticker:
TLSAU

Industry:
Telecommunications

Geography:
Australia

Market cap:
- AUD41.2bn (As of 9 Oct 2019)

Ownership:
- Telstra does not have a major shareholder.
- The biggest shareholders include Vanguard Group Inc (2.0%), Legg Mason Inc (1.0%) and BlackRock Inc (1.0%).
- The scattered shareholding is partly due to restrictions on ownership. For example, individual foreign persons cannot control more than 5% of Telstra.

I) Company Background

Listed on the ASX, Telstra Corporation Limited ("Telstra") is Australia's largest listed telecommunications company. Telstra provides various services including mobile telecommunication (e.g. data, voice call, text), broadband access, subscription television, sale of handsets, data and IP services, cyber security, applications and tools for businesses and wholesale services to other carriers.

Telstra's origins can be traced back to the Australian government in 1901 when the Postmaster-General's department was established and 1946 when the Overseas Telecommunications Commission was established.

Telstra groups its businesses into 4 main segments: (1) Telstra Consumer and Small Business ("TC&SB"), Telstra Enterprise ("TE"), Networks and IT ("N&IT") and Telstra InfraCo.

II) Recommendation Summary

- Telstra is the market leader of mobile and broadband in Australia. However, the monopoly on broadband is being eroded as the business is progressively transferred to nbn Co. The eventual EBITDA impact is expected to be AUD3.0bn. Meanwhile, Mobile also faces intense competition.
- Mitigating the challenges are active steps taken to cut costs by AUD2.5bn and a reduction in dividend which helps to conserve capital. In addition, capex should trend down and free cashflow of Telstra is expected to remain healthy (~AUD3.0bn p.a.).
- Though credit metrics may still deteriorate somewhat, we are comfortable with a still decent 2.43x net debt/EBITDA and 7.9x EBITDA/Interest while pace deterioration may slow. Meanwhile, reported EBITDA margins of Mobile (Telstra's single most important product) remains decent at 34%. **We assign Telstra a Positive (2) Issuer Profile.**

III) Key Considerations

- **Market leader in the Australia telecommunications space:** Telstra is the largest telecommunications company in Australia with a market cap of AUD42.2bn. According to the Australian Competition and Consumer Commission ("ACCC"), Telstra has the largest market share for Mobile (June 2018: 42%), National Broadband Network ("NBN") wholesale access (June 2018: 50%) and retail fixed broadband services (June 2018: 41%). By product, the biggest contributor to Telstra is Mobile (FY2019 reported EBITDA: AUD3.6bn), followed by Data & IP (AUD1.5bn), Fixed (AUD1.0bn), Global connectivity (AUD0.3bn) and Network applications and services (AUD0.3bn). By segment, TC&SB is the largest contributor (FY2019 reported EBITDA: AUD5.6bn), followed by TE (AUD3.4bn) and Telstra InfraCo (AUD3.2bn). In total, FY2019 underlying EBITDA is AUD7.8bn.

- **Losing the monopoly on broadband…:** Telstra is no longer the national wholesale provider of broadband due to the compulsory progressive transfer of business to the government-owned nbn Co; nbn Co will instead hold the monopoly of wholesale broadband services in Australia. As part of the transfer, Telstra will be progressively disconnecting its copper and broadband services and transferring certain infrastructure assets to nbn Co. Telstra will lose the broadband wholesale business and instead have to pay nbn Co for access (FY2019 nbn payments: AUD410mn) as a reseller of broadband services. As a reseller, Telstra has warned that margins may trend near zero for some time given intense competition, noting over 180 resellers of nbn services, while wholesale pricing is relatively fixed. The decline in Telstra's FY2019 underlying EBITDA by 11.2% y/y to AUD7.8bn is mainly due to impact from the nbn (~AUD600mn).

- **… with further EBITDA pressure from NBN headwinds:** While Telstra is receiving sizeable net receipts (FY2019: AUD1.6bn, FY2018: AUD1.8bn) as part of the transfer to nbn Co, for example receiving AUD1.61bn as disconnection fees in FY2019 (FY2018: AUD1.78bn), this is largely one-off. In aggregate, the loss of the monopoly on broadband is credit negative as Telstra expects at least an eventual negative AUD3bn p.a. EBITDA impact when the nbn migration completes. According to Telstra, the recurring EBITDA impact has reached AUD1.7bn p.a. as of FY2019, with a further AUD0.6bn to AUD0.8bn impact expected in FY2020 due to further progressive transfers to nbn Co.

- **Some pressure on mobile…:** Mobile revenue increased 1.6% y/y to AUD10.5bn though reported EBITDA fell 8.7% y/y to AUD3.58bn. We think the divergence is because the increase in revenue is attributable to revenue growth in the lower-margin mobile hardware segment (+10.0% y/y to AUD3.11bn) which saw declines in margin. In addition, the Postpaid handheld segment (which contributed AUD5.29bn revenue) saw ARPU falling 3.1% y/y to AUD54.77, which likely weighed on margins. The decline in ARPU is partly due to an increase in customer mix from Belong®, which offers broadband and mobile at discounted prices. We estimate that Belong® customers comprise ~5% of Telstra's total customers of 8.2mn. Growth of Belong® may continue on the back of strong growth in FY2019 (+181k postpaid handheld retail customers). Aside from Belong®, Telstra also cited that ARPU fell due to lower out-of-bundle revenue (likely due to higher data allowances) and lower minimum monthly commitment ("MMC").

- **… with competition on mobile likely to persist in the short term:** Telstra guided that ARPU may continue declining in FY2020 due to intense competition. According to ACCC, the market share of mobile virtual network operators ("MVNOs") has increased to 13% in 2017-18 (2016-18: 11%). We think the collective market share of MVNOs may continue growing (at the expense of operators like Telstra); we note new entrants still entering the market such as Circles.Life. Although Telstra can capture revenue from MVNOs by reselling services to MVNOs via its wholesale mobile network, we expect the influx of MVNOs to be net negative to Telstra by intensifying competition.

- **Mobile landscape may evolve significantly with potential merger of rivals…:** Aside from intensifying competition from MVNOs, on Mobile, we think the biggest potential change to the competitive landscape could come from the potential merger of rivals TPG and Vodafone. Although the ACCC has opposed the merger, TPG and Vodafone have appealed to the federal court. We think a potential merger may be positive for Telstra in the short term by reducing competition. However, it is uncertain how the competitive landscape may evolve in the longer term as a merger would result in a significantly stronger rival to challenge Telstra.

- **… and the roll out of 5G may create opportunities and risks:** Telstra has already rolled out 5G in 10 cities (mainly in the CBD areas) and we expect full commercial deployment from FY2020 as Telstra is targeting to reach at least 35 Australian cities by FY2020-21. With 5G, Telstra sees opportunities in capturing new revenues and customers who will pay more, with 5G providing significant faster speeds and bandwidth which are useful for applications and technologies including Internet of Things, cloud computing, big data, artificial intelligence. We think that 5G will also allow Telstra to somewhat bypass NBN (as discussed above, Telstra expects margins on broadband to trend to zero) as consumers may replace broadband which with mobile as the latter may potentially be cheaper. According to ACCC, up to 30% of households will consider substituting broadband with mobile. However, it remains to be seen if sufficient returns can be derived from the AUD8bn cumulative investment in Telstra's mobile network over FY2014-19.

- **Pressure on Data and IP segment…:** Data & IP segment revenue declined 7.7% y/y to AUD2.36bn, with Telstra citing competition and industry ARPU declining for the segment. In addition, Telstra faces structural declines in Integrated Services Digital Network ("ISDN"), with revenue falling 17.8% y/y to AUD387mn, which relies on the legacy copper infrastructure. We note that Telstra has already ceased the sale of ISDN from 30 Jun 2018 and will be disconnecting the ISDN services over 30 Sep 2019 with a final exit from ISDN from 2022. Despite customer migration to equivalent voice products ahead of regulated migrations to the nbn, with growth in services in operation ("SIO") in fibre and nbn access, IP based Virtual Private Network ("IPVPN") revenue fell 6.4% y/y with intense price competition.

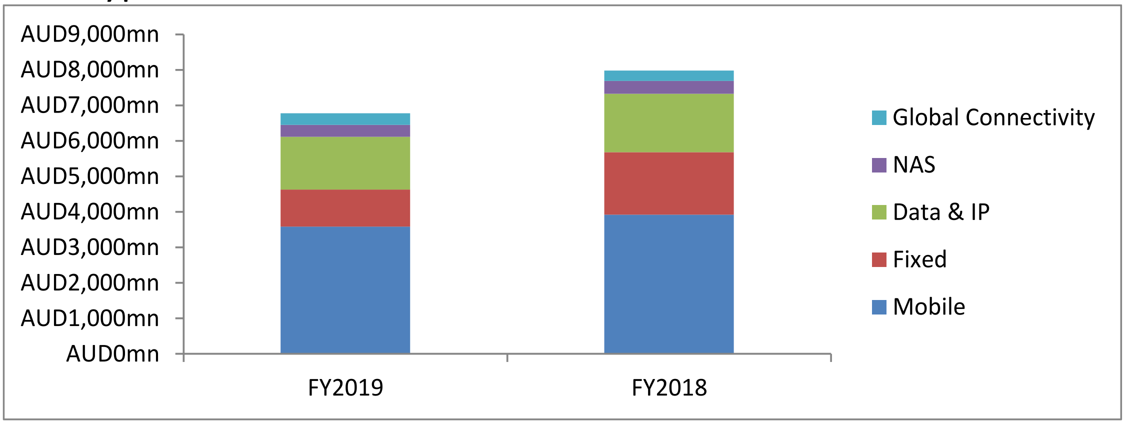
- **Credit metrics have deteriorated though still healthy overall…:** Credit metrics have weakened with net debt/EBITDA rising to 2.43x (FY2018: 2.03x) and EBITDA/Interest declining to 7.9x (FY2018: 10.0x) as we calculate that EBITDA has fallen by 24.4% y/y to AUD5.61bn. Somewhat further declines are expected with Telstra guiding FY2020 underlying EBITDA to range between AUD7.4bn and AUD7.9bn (FY2019: AUD7.8bn). That said, we think credit metrics still look healthy as they deteriorate from a very high base and we think the deterioration will slow. This is because (1) Telstra is explicitly committing to an 'A' band credit rating and (2) Telstra is already at the upper end of its comfort range of debt servicing of 1.3x to 1.8x (FY2019 reported debt servicing ratio: 1.8x). Other financial parameters laid out by Telstra include gearing at 50%-70% (FY2019 reported gearing: 50.3%) and interest cover more than 7x (FY2019 reported interest cover: 10.5x).

- **… with willingness to swallow the bitter pill by cutting costs and slashing dividends:** Due to the headwinds faced, especially from NBN, Telstra has committed to AUD2.5bn cost savings p.a. by FY2022. This will largely be effected through the reduction of full-time staff and equivalents ("FTEs"), which have declined by 4,855. In total, Telstra intends to reduce FTEs by 8,000 which in total should reduce labour costs by AUD1.5bn p.a. The restructuring exercise though resulted in AUD800mn restructuring costs in FY2019 (FY2020 Telstra forecast: AUD300mn). In addition, Telstra is targeting AUD660mn fixed cost reduction in FY2020 which include simplifying the business, reducing layers of management, using new technologies. Due to the expected reduction in costs, Telstra is guiding that underlying EBITDA (excluding impact from nbn) should increase by AUD500mn y/y (FY2019: AUD400mn decline). Separately, despite a record of maintaining or increasing dividends up till FY2017, Telstra has slashed dividend to AUD2.26bn in FY2019 (FY2018: AUD3.15bn), which comprises ~AUD1.19bn which represents 59% payout ratio of underlying earnings. Costs reduction and conservation of capital are credit positive moves, in our view.

- **Capex levels expected to trend down while free cashflow expected to trend up:** While capex has fallen 12.2% y/y to AUD4.14bn, this is somewhat elevated with capex to sales of 16.4% in FY2019 (FY2018: 18.2%) due to Telstra's strategic investment program which targeted an investment of AUD3bn over FY2017-19 to upgrade the networks (AUD1.6bn) as well as to digitize and automate systems (AUD1bn). From FY2020, capex should most likely trend down to AUD2.9bn to AUD3.3bn with Telstra targeting capex/sales of 14% from FY2020 and completion of the strategic investment program. Meanwhile, spectrum payments of AUD386mn from winning 143 lots in the 5G auction, expected to be paid in FY2020, looks manageable. Capex in the longer run (post FY2023) may decline further post the completion of the rollout of the nbn. Meanwhile, Telstra is guiding free cashflow in FY2020 to increase to AUD3.3bn-AUD3.8bn (FY2019 reported free cashflow: AUD3.2bn).

IV) Product and Segment Overview

EBITDA by product



Source: FY2019 full year financial results, annual reports

Segment	FY2019 EBITDA (AUDmn)	Brief Description
TC&SB	5,581	▪ Provides telecommunication products and services to consumer and small business customers in Australia ▪ Includes call centres, Telstra shops and Telstra dealership network
TE	3,411	▪ Provides sales and services to medium and large business and government customers in Australia and overseas ▪ Services includes technology solutions such as Data and Internet Protocol (IP) networks, Network Application and Services ("NAS") products (e.g. managed network, unified communications)
N&IT	(1,459)	▪ Plans and constructs Telstra network and supports revenue generating activities of other segments (e.g. product and technology, global business services, new business) ▪ Segment is loss-making as it includes the network service delivery costs for TC&SB, TE and Telstra InfraCo customers, as well as expenses in relation to the HFC cable network.
Telstra InfraCo	3,192	▪ Provides telecommunication products and services to other carriers, carriage service providers and internet service providers. ▪ Holds fixed network infrastructure assets including data centres, fibre, copper, cable, ducts, pipes ▪ Provides nbn co with certain access to infrastructure and services

Source: FY2019 full year financial results, annual reports

Revenue by segment and product

Amounts in AUD mn	TC&SB	TE	N&IT	All Other	Telstra InfraCo	**Total**
Fixed	4,144	262	0	12	805	**5,223**
Mobile	8,685	1,666	0	-16	210	**10,545**
Data & IP	162	1,757	0	-6	445	**2,358**
NAS	311	2,565	35	13	553	**3,477**
Media	781	1	0	50	0	**832**
Global Connectivity	0	1,954	0	-254	0	**1,700**
Others	173	8	0	168	775	**1,124**
Total	**24,368**	**16,164**	**70**	**-78**	**4,771**	**25,259**

Source: FY2019 full year financial results, annual reports

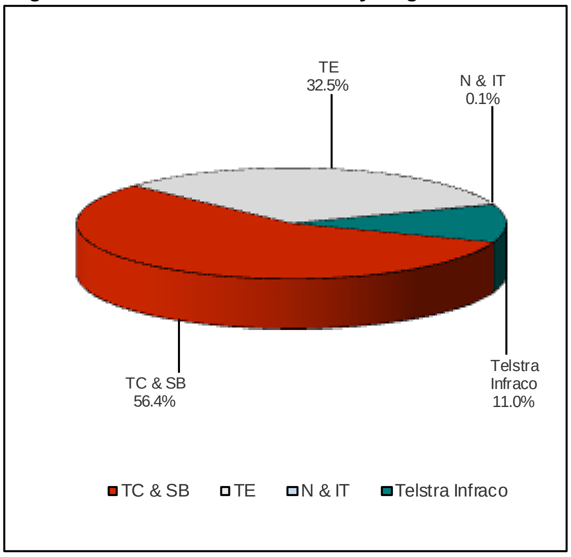
Telstra Corporation Limited

Table 1: Summary Financials

Year Ended 30th June	FY2017	FY2018	FY2019
Income Statement (AUD'mn)			
Revenue	26,013.0	25,848.0	25,259.0
EBITDA	9,074.0	8,030.0	6,858.0
EBIT	4,633.0	3,560.0	2,576.0
Gross interest expense	729.0	806.0	868.0
Profit Before Tax	5,647.0	5,139.0	3,072.0
Net profit	3,874.0	3,557.0	2,149.0
Balance Sheet (AUD'mn)			
Cash and bank deposits	938.0	629.0	604.0
Total assets	42,133.0	42,723.0	42,589.0
Short term debt	2,476.0	1,635.0	2,222.0
Gross debt	17,284.0	16,951.0	17,253.0
Net debt	16,346.0	16,322.0	16,649.0
Shareholders' equity	14,560.0	14,619.0	14,530.0
Cash Flow (AUD'mn)			
CFO	7,775.0	8,606.0	6,683.0
Capex	5,321.0	4,932.0	4,370.0
Acquisitions	145.0	138.0	162.0
Disposals	964.0	869.0	694.0
Dividends	3,736.0	3,150.0	2,259.0
Interest paid	854.0	896.0	860.0
Free Cash Flow (FCF)	2,454.0	3,674.0	2,313.0
Key Ratios			
EBITDA margin (%)	34.88	31.07	27.15
Net margin (%)	14.89	13.76	8.51
Gross debt to EBITDA (x)	1.90	2.11	2.52
Net debt to EBITDA (x)	1.80	2.03	2.43
Gross Debt to Equity (x)	1.19	1.16	1.19
Net Debt to Equity (x)	1.12	1.12	1.15
Gross debt/total asset (x)	0.41	0.40	0.41
Net debt/total asset (x)	0.39	0.38	0.39
Cash/current borrowings (x)	0.38	0.38	0.27
EBITDA/Total Interest (x)	12.45	9.96	7.90

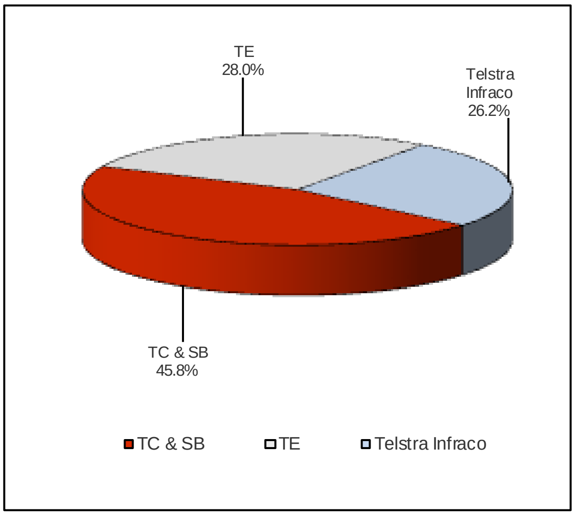
Source: Company, OCBC estimates

Figure 1: Revenue breakdown by Segment - FY2019



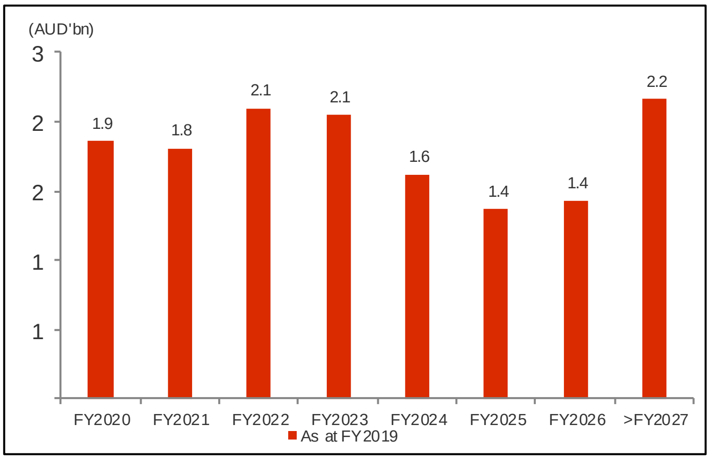
Source: Company (excludes All Other)

Figure 2: EBITDA breakdown by Segment - FY2019



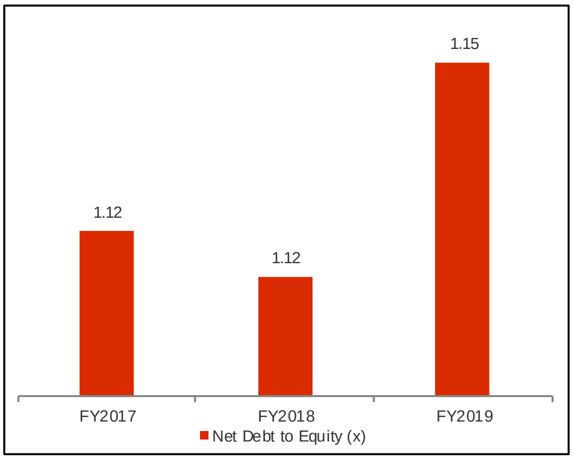
Source: Company (excludes All other, N & IT and eliminations)

Figure 3: Debt Maturity Profile



Source: Company

Figure 4: Net Debt to Equity (x)



Source: Company, OCBC estimates

Issuer Profile:
Neutral (3)

Ticker:
WESAU

Industry:
Conglomerate

Geography:
Australia

Market cap:
- AUD45.4bn (As of 16 Oct 2019)

Ownership:
- Wesfarmers does not have a major shareholder.
- The biggest shareholders include BlackRock Inc (6.0%), Vanguard Group Inc (3.97%), Norges Bank (1.3%), likely as part of their passive strategies.

Wesfarmers Limited

I) Company Background

Wesfarmers Limited ("WESAU") is part of the ASX50 index as one of the largest listed companies in Australia with a market cap of AUD45.5bn as at 25 September 2019. WESAU originated from a farmer's co-operative set up in 1914 in Perth with the intention of assisting farmers and growing the marketplace for their produce. By 1984, Wesfarmers was listed though was still controlled by a co-operative then. In 2001, the company underwent a restructuring to significantly increase its free float by removing its controlling shareholder (via exchange of co-operative shares for Wesfarmers shares).

Over the course of its history, the company had grown through mergers and acquisitions, culminating in its current corporate structure focusing on two key industry segments, namely Retail (Bunnings, Kmart Group, Officeworks) and Industrial (Wesfarmers Chemical Energy & Fertiliser ("WesCEF"), Wesfarmers Industrials and Safety ("WIS")). WESAU's holding company functions as a capital allocator and emphasizes divisional autonomy of its various businesses. Each segment is managed separately, with businesses having separate brand identities. WESAU also holds stakes in other joint ventures and associates, notably a 15%-stake in Coles Group Ltd (demerged and started listing again on the Australian Stock Exchange in November 2018). The company has exited its coal mining businesses and in September 2019 completed the acquisition of Kidman Resources, a lithium developer, who holds a 50%-interest in the Mt Holland lithium project in Western Australia. WESAU is part of the Dow Jones Sustainability World Index as of writing.

II) Recommendation Summary

- WESAU's strong income and cash flow generation is underpinned by the dominant position of its various businesses while credit metrics are broadly healthy. In 2018, it completed the demerger of Coles, Australia's second largest grocer and a lower return business versus the rest of WESAU. Retaining a 15%-stake, Coles is now WESAU's largest associate.
- Constraining the company's credit profile is its ~1.0x net gearing, on the back of significant lease liabilities crucial to its retail operations, despite low borrowings. M&A activities and expansion into adjacencies are part and parcel of WESAU's business strategy which increases the risk of the company "making wrong bets".
- **We are assigning WESAU a Neutral (3) issuer profile and expect this to be defensible in the next 12 months, notwithstanding Amazon's entry into Australia.**

III) Key Considerations

- **Defensible profitability in FY2019 despite softer consumption:** Revenue from continuing operations grew 4.3% y/y to AUD27.9bn for the financial year ended June 2019 ("FY2019"), on the back of revenue growth across all of WESAU's operating segments. Our Adjusted EBIT (which excludes AUD306mn impairment at Target in FY2018 and excludes Others) grew 2.5% y/y to AUD2.9bn. We take this number as it only factors the core operating businesses of WESAU. Adjusted EBIT grew mainly as Bunnings, which contributes ~57% of total Adjusted EBIT for FY2019 grew by 8.1% y/y or AUD122mn. WesCEF and Officeworks also grew by 14.2% y/y and 7.1% y/y during the year. Collectively, these more than offset the decline in the Kmart Group and WIS. Share of net profits from associates and joint ventures was AUD229mn during the year (albeit some one-off) and a lower finance cost of AUD175mn lifted reported profit before tax to AUD2.8bn (FY2018: AUD2.1bn). Since the demerger of Coles, the second largest grocery chain in Australia in a near-duopoly market in November 2018, Coles has become the largest associate of WESAU's by income contribution. Coles is separately listed with a market cap of AUD20bn (20 September 2019), where WESAU retains a 15%-stake.

- **Lords over Australian retail with its lure of low prices:** Despite the promise of low prices, return on capital ("ROC") which divisional management teams are measured against are impressive. In FY2019, Bunnings' reported rolling 12 months ROC was 50.5%. Kmart Group (comprising the troubled Target) and Officeworks reported ROC of 29.1% and 17.0% respectively. We see Bunnings, Kmart-standalone and Officeworks as "category killers" focusing on differentiated retail categories though have shared value propositions. Bunnings (founded in 1886) focuses on home improvements, Kmart (founded in 1969) being a discount everyday store and Officeworks (founded in 1994) focuses on office and stationary products. Despite the retail "doom and gloom" that is supposedly happening in many markets, these three businesses have managed to position themselves in the minds of its customers as a low price retailer with good quality of products/services and an interesting place to shop at. After Bunnings, Kmart Group is the second largest Adjusted EBIT contributor at 19% (AUD540mn). While the income split between Kmart-standalone and Target is not provided, comparable sales growth for Kmart-standalone was flat in FY2019 and down 0.8% y/y for Target. Target which has an unclear value proposition, is in the midst of a revamp and curtailing its product offerings to re-focus on apparel, soft home and toys. Officeworks is a smaller business contributing 6% to Adjusted EBIT, though fast growing with total sales growth of 7.6% y/y in FY2019 and we think it is becoming the "next Bunnings" of its category.

- **……though Amazon may pose longer term threats:** Amazon had entered the Australian market since 2018 and we do not see it being a threat yet, particularly for Bunnings who have a formidable in-store experience. Though this is something that will need to be monitored for potential longer-term threats (especially for Kmart, Target and Officeworks, while Bunnings is already being targeted by Amazon's garden offerings). In August 2019, WESAU completed the acquisition of Catch Group, a leading Australian online retailer for a small ticket size of AUD230mn. While Catch Group would be operated as a separate business, WESAU is likely to map out areas of co-operation between Catch Group and its other retail businesses.

- **Kaleidoscope of industrial businesses:** The non-B2C businesses of WESAU predominantly relate to Chemicals, Energy and Fertilisers under WesCEF and four main businesses that service industrial customers within WIS. While the financials are broken down between WesCEF and WIS, financial performances of the different businesses within these segments are not. WesCEF is a significant contributor to total Adjusted EBIT of 15% in FY2019, with segment Adjusted EBIT growing 14.2% y/y to AUD433mn, though management has flagged possible oversupply of explosive grade ammonium nitrate in Western Australia as a potential headwind beyond FY2020. WIS, a small contributor to Adjusted EBIT saw a large 27.1% y/y decline in Adjusted EBIT to AUD86mn, mainly due to weaker performance at Blackwoods, an industrial tools and supplies company which is grappling with enterprise resource planning problems and earlier, customer satisfaction issues. While the overall Wesfarmers portfolio has defensible businesses, the company has had in the past made mistakes in its capital allocation strategy. For example, in FY2018, the company took an AUD861mn impairment loss (pre-tax) on its Bunnings foray into the UK and Ireland.

- **Healthy headline credit metrics:** EBITDA (based on our calculation which does not include other income) was AUD3.0bn in FY2019, representing ample interest expense coverage of 17.4x (FY2018: 14.6x). As at 30 June 2019, WESAU's gross gearing and net gearing was optically low at 30% and 22% respectively while gross debt-to-EBITDA was 1.0x (indicating debt can be paid off with one year of EBITDA generation). Given the accounting change post-demerger of Coles, we find comparison with earlier periods less useful as Coles was still merged. Wesfarmer's entities no longer guarantee (or cross guarantee) the Coles entities. WESAU faces minimal short-term refinancing risk with only 12% of debt due in the short term as at 30 June 2019, while all debt remains unsecured.

- **……although lease liabilities very significant:** Common for a retailer, properties where business operations are carried out are vital to WESAU. The company does not typically own the properties outright although WESAU indirectly holds stakes in some of the properties (eg:

Bunnings operations) via its ~24.8% associate stake in the BWP Trust. From 1 July 2019, WESAU would have accounted for leases under the accounting standard AASB 16 Leases where the right of use and the lease liabilities would be recognized on balance sheet. Per company's impact analysis, assets will be increased by AUD6.7bn while liabilities will increase by AUD7.5bn. While EBITDA will likely increase (from the reduction in operating lease expenses), higher interest expenses will be recognized which will lead interest coverage lower, though we expect this to still be above 10x. Simplistically if we add AUD7.5bn into debt and assume cash and equity is unchanged, we find that adjusted net gearing may rise to ~1.0x with adjusted gross debt-to-EBITDA of 2.5x, still manageable.

IV) Business Overview

Continuing Operations:

Business	FY2019 segment EBIT (AUDmn)	Brief Description
Retail		
Bunnings	1,626	▪ Bunnings is the leading home improvement and outdoor living products retailer in Australia and New Zealand ("ANZ"). Historically the business focuses on do-it-yourself ("DIY") retail customers though has expanded into serving project builders, tradespeople and the housing industry. We see Bunnings as a "category killer" ▪ Brands include "Bunnings", "Bunnings Warehouse" and "Bunnings Trade" ▪ Exited an unsuccessful foray into the UK home improvement market in 2018 and is now an Australia and New Zealand focused business ▪ Positioned on low price, customer experience and convenience through its expansive sales network ▪ In end-FY2019, there were 267 Bunnings warehouses, 75 smaller format stores, 32 trade centres, additional 13 under construction.
Kmart Group	540	▪ Kmart Group comprises the (1) Kmart discount department store (2) Target a mid-price department store and (3) Newly acquired Catch since August 2019. Kmart and Target have no relationship with the businesses bearing the same brand name in USA <u>Kmart</u> ▪ Kmart focuses on "families' everyday items at low prices" ▪ We see Kmart being in a duopoly which mainly competes with Big W (owned by Woolworths) ▪ 231 stores in end-FY2019 across ANZ <u>Target</u> ▪ Target's positioning in the market is currently unclear amidst a bifurcation in the retail market. ▪ Competes with a broad range of retailers both online and offline including Kmart. ▪ Under a new CEO, Target is undergoing a turnaround, including closing floor space and refocusing on a narrower range of products. ▪ 289 stores in end-FY2019 across Australia <u>Catch</u> ▪ One of Australia's leading online retailers. While Catch will operate as a standalone unit, it is very likely that management will look to Catch to help in the digitalization strategy for the other businesses. <u>Others</u> ▪ Experimenting with "Anko" stores in Seattle, USA which sells private label products in a more digitally enabled environment ▪ Wholesales own-brand products to Thailand and Indonesia retailers
Officeworks	167	▪ Officeworks is the leading retailer and supplier of office products and solutions for home, business (especially micro, small and

		medium business customers) and education needs. We see Officeworks as a "category killer" ▪ Positioned on low price and immersive customer experience through its expansive sales network (ie: in part similar to Bunnings) ▪ Acquired Geeks2U, a provider of on-site communication and technology services in March 2019 ▪ 167 stores in end-FY2019 across Australia including its Mentone megastore touted as world's largest office supply store
Industrials		
WesCEF	433	▪ WesCEF comprises the Western Australian focused businesses within (1) Chemicals (2) Energy and (3) Fertiliser sectors Chemicals ▪ CSBP: A chemical and fertilizer manufacturer and supplier based in Kwinana, Western Australia. One of the world's largest explosive grade ammonium nitrate ("EGAN") manufacturers ▪ The chemicals business focuses on ammonia, ammonia nitrate sodium cyanide (used in the mining industry) and specialty products Energy ▪ Kleenheat and EVOL LNG. Kleenheat is a manufacturer, retailer and distributor of LPG and LNG. Also a retailer of natural gas and electricity Fertiliser ▪ CSBP and Decipher: Import, production, sales and distribution of fertilizers and via Deciper, provides agriculture technology services such as yield analysis to improve fertilizer productivity
WIS	86	▪ Services industrial customers within mining, manufacturing, construction, government, transport, energy and retail. Comprising mainly of four businesses Blackwood ▪ Largest business within WIS. Distributor of tools, safety gear, workwear and industrial supplies ▪ Had been struggling and in the midst of a significant turnaround including technology upgrade to handle its 200,000 SKUs WWG ▪ Manufacturer and supplier of workwear solutions with a 25-30% market share in Australia Coregas ▪ Industrial, medical and specialty gas supplier such as compressed gases and cryogenic liquids. Manufacturers gases in Australia and distribute across ANZ Greencap ▪ Risk management and compliance service provider (eg: hazardous materials, occupational hygiene, work health and safety, environmental services)
Key Associates	**FY2019[1] (AUDmn)**	**Brief Description**
Coles	162[2]	▪ Demerged Coles as a separately listed entity in November 2018. Still holds a 15%-stake with a market value of ~AUD3.0bn ▪ Coles is a leading supermarket chain in Australia operating in a near-duopoly with Woolworths. Discounter ALDI as the third largest player is emerging as a contender to this duopoly
BWP	42	▪ WESAU holds a 24.8%-stake with a market value of AUD630mn as at 25 September 2019 ▪ Owns 75 properties in end-FY2019, mainly properties leased to Bunnings for their operations (90% contribution to BWP income)

Source: FY2019 full year financial results, annual reports
Note: (1) Share of income from associates
(2) We take 15% of Coles'-standalone net profit from continuing operations for FY2019

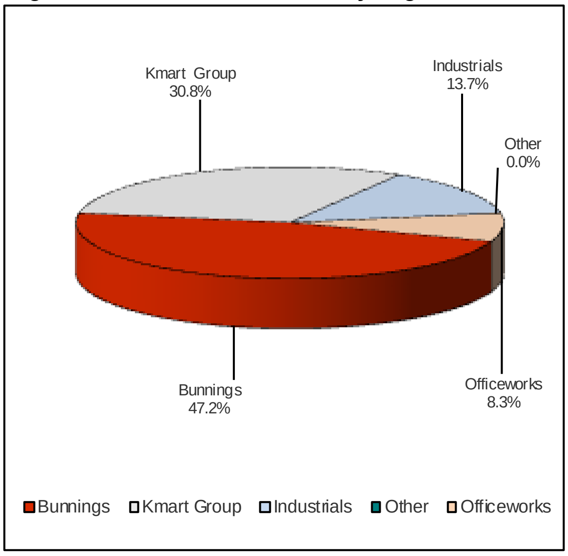
Wesfarmers Limited

Table 1: Summary Financials

Year Ended 30th June	FY2018	FY2019
Income Statement (AUD'mn)		
Revenue	26,763.0	27,920.0
EBITDA	3,065.0	3,043.0
EBIT	2,544.0	2,506.0
Gross interest expense	210.0	175.0
Profit Before Tax	2,134.0	2,799.0
Net profit	1,409.0	1,940.0
Balance Sheet (AUD'mn)		
Cash and bank deposits	683.0	795.0
Total assets	36,933.0	18,333.0
Short term debt	1,159.0	356.0
Gross debt	4,124.0	3,029.0
Net debt	3,441.0	2,234.0
Shareholders' equity	22,754.0	9,971.0
Cash Flow (AUD'mn)		
CFO	4,260.0	2,861.0
Capex	1,815.0	1,356.0
Acquisitions	0.0	17.0
Disposals	1,140.0	1,618.0
Dividends	2,528.0	3,628.0
Interest paid	195.0	170.0
Free Cash Flow (FCF)	2,445.0	1,505.0
Key Ratios		
EBITDA margin (%)	11.45	10.90
Net margin (%)	5.26	6.95
Gross debt to EBITDA (x)	1.35	1.00
Net debt to EBITDA (x)	1.12	0.73
Gross Debt to Equity (x)	0.18	0.30
Net Debt to Equity (x)	0.15	0.22
Gross debt/total asset (x)	0.11	0.17
Net debt/total asset (x)	0.09	0.12
Cash/current borrowings (x)	0.59	2.23
EBITDA/Total Interest (x)	14.60	17.39

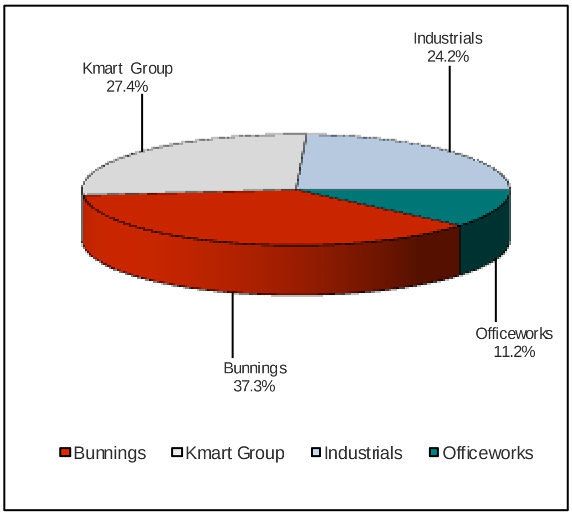
Source: Company, OCBC estimates | Wesfarmers underwent demerger of Coles in November 2018. Results from continuing operations for FY2018 and FY2019 income statement items

Figure 1: Revenue breakdown by Segment - FY2019



Source: Company

Figure 2: Asset breakdown by Segment - FY2019



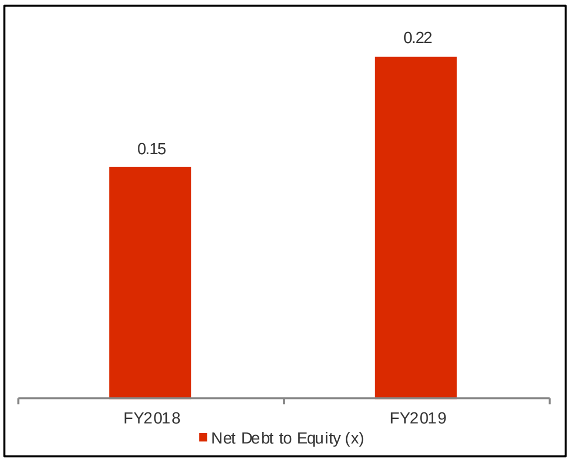
Source: Company | Excludes Others

Figure 3: EBITDA/Total Interest (x)

	As at 31/03/2019	% of debt
Amount repayable in one year or less, or on demand		
Secured	0.0	0.0%
Unsecured	356.0	11.8%
	356.0	**11.8%**
Amount repayable after a year		
Secured	0.0	0.0%
Unsecured	2673.0	88.2%
	2673.0	**88.2%**
Total	**3029.0**	**100.0%**

Source: Company, OCBC estimates

Figure 4: Net Debt to Equity (x)



Source: Company, OCBC estimates

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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

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. We may also suspend our issuer rating and bond level recommendation in the ordinary course of business if (1) we believe the current issuer profile is incorrect and we have incomplete information to complete a review; or (2) where evolving circumstances and increasingly divergent outcomes for different investors results in less conviction on providing a bond level recommendation.

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
The analyst(s) who wrote this report and/or her or his respective connected persons held securities in the following above-mentioned issuers or companies as at the time of the publication of this report: Telstra Corporation Limited.

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