

# Westpac Banking Corp. (WBC)

Recommendation: Buy

19 May 2010

Share Price: \$22.97

With the credit cycle having peaked, the improving domestic economy and the full benefits still to accrue from the St. George merger, we remain positive on the outlook for WBC over the next few years.

## Event

- For 1H10, WBC reported a 30% increase in cash earnings to \$2.98b, largely reflecting a \$732m decline in credit costs. Cash EPS increased 22% and the dividend 16% to 65c per share (payout ratio 64.5%).

Mix impacts and asset repricing were the major influences on margins.

- We have lowered our cash earnings forecasts for FY10 and FY11 to \$5.93b (\$5.98b) and \$6.7b (\$6.9b) respectively, based on the weaker than expected 1H10 underlying earnings.
- Our fair value for WBC is now \$28.60.

## Impact

- Underlying earnings increased only marginally, which was slightly disappointing considering the strong market share gain in mortgages during the period. Net interest margins contracted 11 basis points on 2H09, which was surprising considering the trend in other banks.

## Recommendation Impact

No change to recommendation.

Issued Shares:		2,977m		
Market capitalisation:		\$68b		
Net tangible assets:		\$8.42		
12 month high/low:		\$28.43/\$18.27		
Year to 30 September (\$m)	2008	2009	2010(e)	2011(e)
Total income	14,858	16,787	17,362	18,641
Net interest income	9,652	11,497	12,773	13,974
Net interest margin (%)	2.02	2.32	2.29	2.28
Underlying profit ①	8,418	10,047	10,531	11,345
Net profit ② ③	5,047	4,625	5,931	6,707
EPS (c)	198.3	162.0	195.0	220.0
EPS growth (%)	4.7	(18.3)	20.0	12.8
P/E (x)	11.6	14.1	11.8	10.5
DPS (c)	142.0	116.0	135.0	152.0
Dividend yield (%)	6.2	5.1	5.9	6.6
Payout ratio (%)	72	73	69.0	69.0
Franking (%)	100	100	100	100

① Before impairment charge.

② Before significant items based on cash earnings after preference dividends.

③ Includes St. George from 1 October 2007.

Analyst: David Spry

## Overview

WBC is the leading Australian bank following the acquisition of St. George with around 27% of the home lending market. WBC is also the largest wealth management platform provider, which provides it with the capability to distribute an enlarged product range across a substantially larger customer base.

WBC paid a 'full price' for St. George and the key issue was whether WBC could realise the maximum revenue and expense synergies required. After the first twelve months of the integration process, WBC is ahead of target on key metrics. Customer numbers have increased by 2% and merger benefits are substantially exceeding original merger models (actual 1H10 net \$405m vs. FY10 \$310m model). Expense synergies of \$285m are 12% ahead of target for FY10.

The multi-brand model is underpinning strong customer growth across the group, which is being reflected in above system growth rates in mortgages and deposits. Over the past twelve months, WBC has gained 2% market share in mortgages (18% or \$43b increase in mortgages) including 60,000 first home buyers despite being about 20 basis points above the benchmark interest rate.

This growth focus has been part of a well defined strategy by WBC to take advantage of its strong comparative financial position during a period of market uncertainty. WBC is now able to leverage these new customers across Wealth Management, while tapping niches with sub-brands such as St. George and BankSA. These customers tend to be 'sticky' having on average a relationship (according to WBC) in excess of 11 years and approximately three products.

There has been a short-term cost to net interest margins (higher funding requirement) and the underlying earnings growth rate. However, we believe WBC will derive substantial longer-term revenue benefits from this move particularly when accompanied by a more efficient cost structure.

Overall, we believe WBC is well positioned despite continued uncertainties in global debt markets with:

- A low risk strategy and focus on sources of comparative advantage within core markets;
- Prudent funding and capital ratios; and
- Strict risk disciplines.

## Interim Result 2010 – Core earnings disappoints!

Profit & Loss (\$m)	3/09	3/10	Change %
Net Interest Income	5,678	6,043	+7.0
Other income	2,634	2,578	
<b>Total income</b>	<b>8,312</b>	<b>8,621</b>	<b>+4.0</b>
Expenses	(3,355)	(3,438)	
<b>Underlying profit</b>	<b>4,957</b>	<b>5,183</b>	<b>+5.0</b>
Prov. for impairment	(1,616)	(879)	-45.0
Tax	(1,005)	(1,289)	
Minority interest/Other	(41)	(32)	
<b>Net profit (cash)</b>	<b>2,295</b>	<b>2,983</b>	<b>+30</b>

On a pro-forma basis as if WBC merger with St. George was completed on 1 October 2007.

WBC reported a 30% increase in cash earnings to \$2.98b, in line with expectations. Cash EPS increased 22% and the **dividend 16.5% to 65c per share** (lower payout ratio than normal). A long-term pay-out ratio of 70% is seen as sustainable.

The 4% increase in underlying earnings was slightly disappointing considering the strong growth in mortgages during the period. Virtually all of the cash earnings increase was due to the lower credit cost, dampening the quality of the result.

WBC's capital and liquidity ratios remain strong. Tier 1 capital increased 53 basis points to 8.64%, reflecting only modest growth in risk weighted assets (RWA) and a high participation rate in the 2009 final dividend. Given the uncertain outlook and the upcoming regulatory reforms, WBC will continue to maintain a prudent level of Tier 1 capital.

Impaired Loans (\$m)	3/09	9/09	3/10
<b>Impaired loans</b>	<b>3,299</b>	<b>3,770</b>	<b>4,295</b>
Individually assessed provision	1,416	1,228	1,576
Collective provision	3,067	3,506	3,697
Provision for credit commitments	(340)	(350)	(340)
<b>Total provisions</b>	<b>4,143</b>	<b>4,384</b>	<b>4,993</b>
Individually assessed provision/impaired assets (%)	43%	33%	37%
<b>Total provisions/impaired assets (%)</b>	<b>136%</b>	<b>116%</b>	<b>123%</b>

Despite the increase in impaired loans, loan quality has stabilised and should progressively improve. In most cases, the increase in impaired assets was from known exposures and the strength of security means that significant future losses are unlikely. Most of the stress remains in commercial property (9.6% of gross lending down from 13% at December 2008) and in some parts of the consumer portfolio.

Below we highlight the divisional contributions to cash earnings with the most notable disappointments being in Retail and Business Banking and St. George.

## Business Unit Performance

Cash Earnings (\$m)	3/09	3/10	Change %
Westpac Retail & Bus.	990	873	-12.0
St. George Retail & Bus.	573	472	-18.0
Institutional Bank	158	807	Large
BT Financial Group	215	301	+40.0
NZ	168	100	-40.0
Pacific Banking	69	34	-51.0
Group Business Unit	122	396	Large
<b>Cash NPAT (pro forma)</b>	<b>2,295</b>	<b>2,983</b>	<b>+30.0</b>

### Retail and Business Banking

Operating income declined 1%, with a 7% increase in net interest income being offset by a 29% reduction in non-interest income. Operating costs increased 3% (cost/income ratio 49.5%), while credit costs rose \$78m mainly in the consumer and business portfolios.

The business has good momentum, although cash earnings declined over the past year as a result of the decision to reduce bank fees, higher funding costs and the lag impact of slower activity increasing credit costs.

Lending growth was 14%, principally driven by mortgage growth of 21% (1.8x system), with cards and personal increasing 3% and business down 5%. Deposits increased 11% (household deposits 1.5x system). Unfortunately, the strong volume growth did not translate fully into net interest income, due to a 13 basis point contraction in net interest margins (despite WBC's variable rate being above the benchmark).

The growth in mortgages was part of a deliberate strategy by WBC to increase market share, taking advantage of its strong financial position. However, this has necessitated lower net interest margins due to the significantly higher funding requirement.

WBC has been increasingly extending the term of its wholesale funding base (both short and long-term), which has improved the quality of the balance sheet, but has come at a cost to net interest margins. In addition, the growth in term deposits has been reflected in strong competition and deposit spread pressure.

### St. George Bank

The 18% decline in cash earnings reflected a 67% increase in credit costs. Operating income was steady at \$1.6b but declined 3% on 2H09. This was despite 15% growth in mortgages (1.7x system) and 8% growth in Personal lending. Business lending declined 4%. Deposit growth was 1.6x system. The solid volume growth came at a cost to net interest margins which declined 9 basis points to 1.92% and 15 basis points from 2H09. Credit costs rose \$133m, with commercial property causing the most concern.

### Institutional Bank

Operationally, this was a subdued result with core earnings rising 6% to \$1.20b. Net loans declined 15% to \$70b as customers continued to reduce debt. Despite the lower volumes, net interest income benefitted from repricing and higher spreads. Higher line fees and fees associated with early repayment also added to income. The credit cost declined to \$73m (\$907m in 1H09), which was responsible for the significant increase in cash earnings.

### BT Financial Group

The rebound in equity markets was responsible for the 40% increase in cash earnings. Average funds under management increased 12% to \$34b, and funds under administration 31% to \$81b. The Insurance operations increased cash earnings 19%, due to solid growth in premiums and a higher contribution from Lenders Mortgage.

### New Zealand

The NZ operations continued to struggle with cash earnings declining 40% on 1H09 despite a 4% increase in net loans. Higher funding costs, lower fees and higher credit costs, were the major contributing factors. However, there was a significant improvement over 2H09 earnings, which was the peak of the credit cost cycle.

### Outlook

WBC remains cautious on the outlook despite marked signs of improvement in the Australian and NZ economies. The effects of the GFC are expected "to be with us for many years". Recent events in Europe highlight the fragile nature of the recovery in some global markets.

In Australia, we will continue to see impacts particularly over the next two years, as the transition towards new regulatory arrangements

begin and the economy adjusts to post-crisis credit costs. As a result, we believe it is important to retain prudent balance sheet settings to deal with the challenges ahead.

System credit growth should improve in 2H10 and accelerate in FY11 (in particular business lending). We expect WBC to grow in line with system, given the substantial market share gains already made in the mortgage market. The average cost of funding will remain high as competition for deposits continues and wholesale term funding is sourced at a cost above pre-GFC levels.

WBC will continue to implement its customer focused multi-brand strategy, which is progressing well. We believe WBC is in a position to achieve superior performance over the longer-term, particularly as efficiency measures (including new platforms) being implemented, gain full traction.

## Valuation

Using a long-term multiple of 13x our forecast FY11 earnings, we believe fair value for WBC is around \$28.60. EPS is expected to increase 13% in FY11. We have factored in a slight premium for WBC based on its conservative settings and track record through the GFC.

## Activities

WBC is the leading Australian bank providing a complete range of banking and financial services in Australasia and is represented in Asia, the UK, US and Europe. WBC has a strong position in Wealth Management through its 60% shareholding in BT Financial Services.

## Dividend History (2 Years)

Date Paid	Amount (c)	Franking (%)
21/12/09	60.0	100
2/7/09	56.0	100
17/12/08	72.0	100
2/6/08	70.0	100

## Important Dates

Interim Result Announced	Shares Ex-Interim Dividend	Interim Dividend Paid
5 May	9 November	21 December
Final Result Announced	Shares Ex-Final Dividend	Final Dividend Paid
Early November	Mid-November	Late December

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