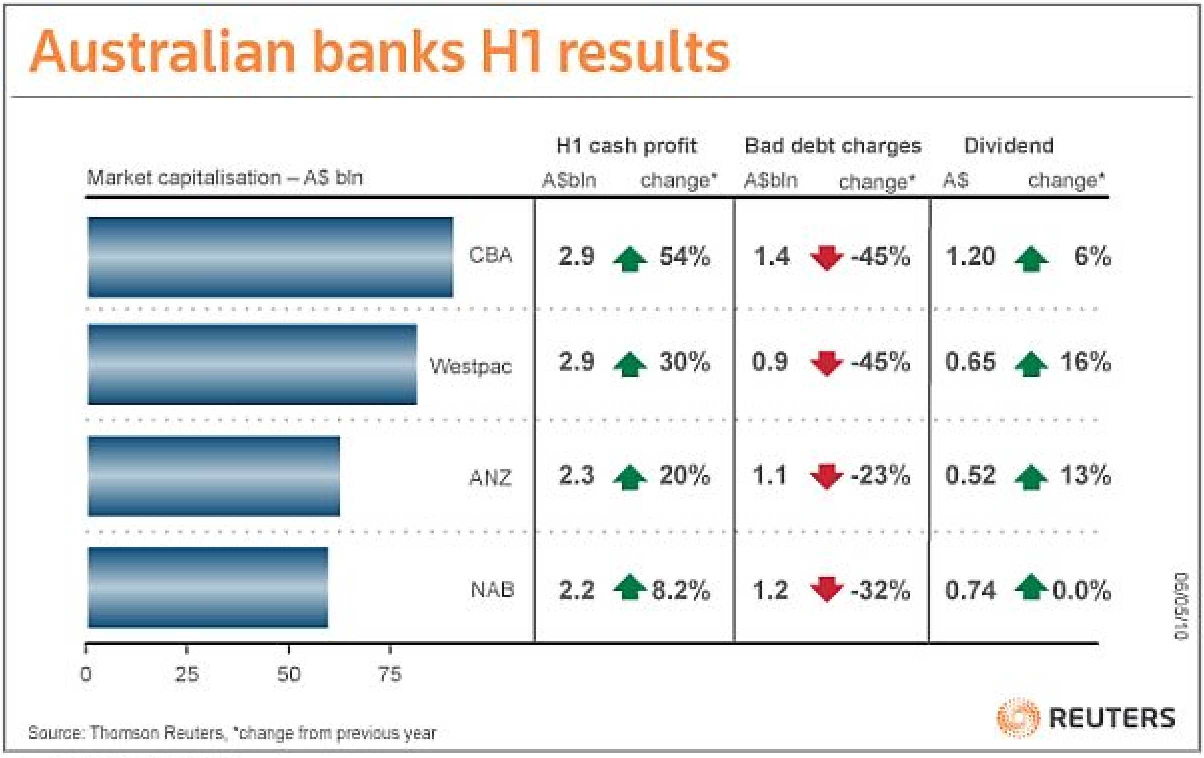
Westpac 11/05/2010 **FAT-AUS-473**

WBC AUD $24.82 Core **MED.** **B**

Super profits, but no super tax

The fallout from the Greek crisis and the market's less than enthusiastic response to the banks' interim results has provided a buying opportunity for long term investors.

The banks' impressive headline numbers were driven by substantially lower bad debts and the trend of interest margin recovery looks to be topping out, none of which impressed the market. Earnings growth over the next year or so may plateau, but the market's reaction suggests that euro contagion will spur another leg in the bad debt cycle. This is unlikely to be the case here in Australia.



Reuters graphic/Claire Morel

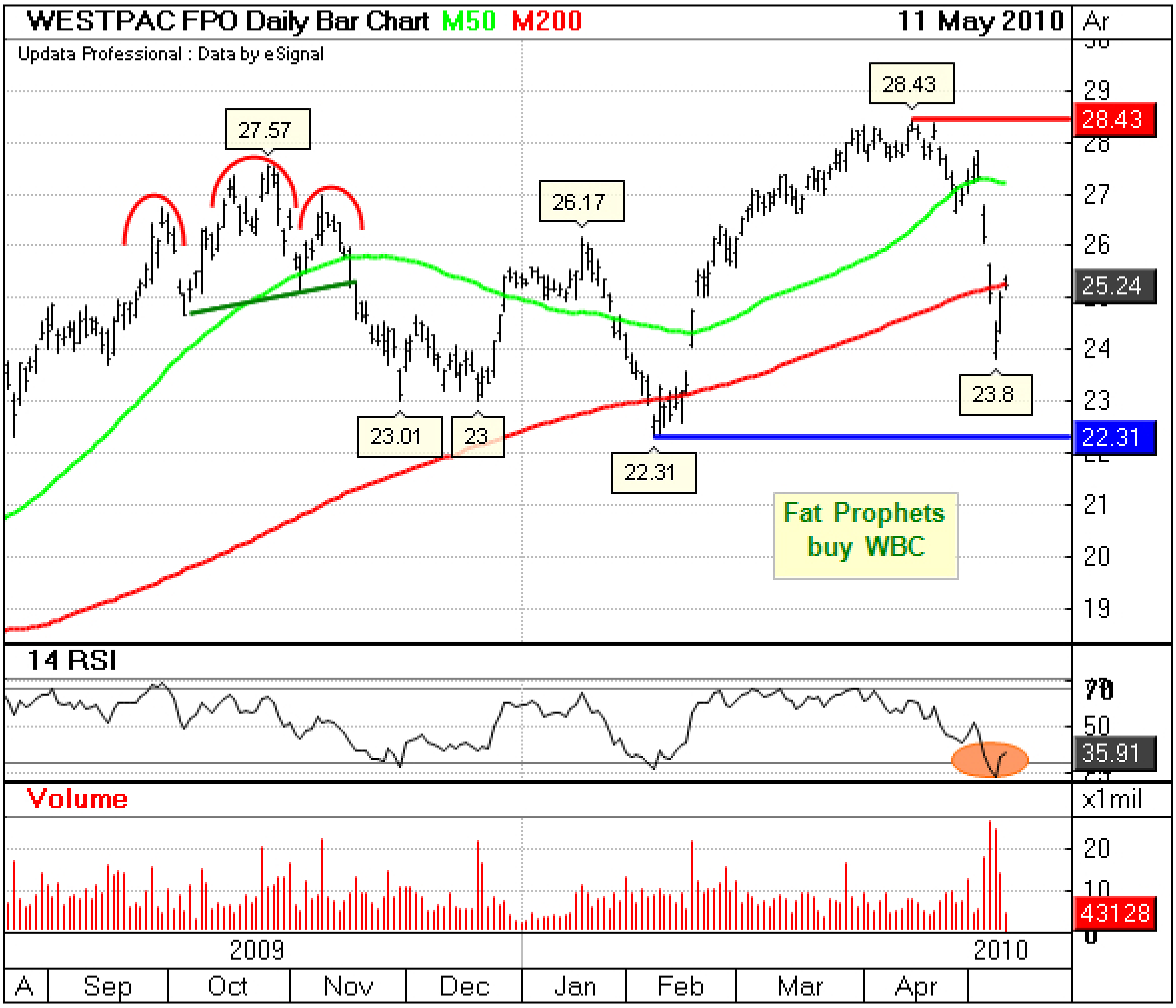
Note: CBA reported its interim result in February.

Turning to Westpac's first half result for the 6 months to 31 March 2010, cash earnings lifted 30% to $2.983 billion. Banks tend to prefer to quote cash earnings as this measure makes a number of adjustments to better reflect the banks actual operational performance. In this case the cash earnings figure is not significantly different to reported earnings of $2.875 billion.

Where there is a material difference is between cash earnings and core earnings, with the latter coming in at $5.183 billion. Core earnings are calculated before the impact of impairment charges. The weakness in the Westpac result is that core earnings growth was only 5%. Lower impairment charges (down 45% to $879 million) were therefore the primary driver of cash earnings growth, which handed management most of the 30% growth on a platter.

The other area of the result which led to some weakness was the dividend. Westpac delivered a healthy looking 16% lift in the dividend to $0.65. The dividend was however only 64.8% of earnings and the market had expected something a little higher.

The reason the banks have disappointed on the dividend front is that caution is a common thread among the major banks' management teams. Caution is a traditional banking trait that we are quite comfortable with and we would prefer dividends to be sustainable, rather than volatile.



The specific reasons for CEO Gail Kelly's caution is the potential for further ructions in credit markets and the potential for tougher international banking regulations. The potential for credit markets to once again come under stress is ably demonstrated by the European debt crisis. Please refer to the Market Comment for a discussion on this.

With regards to regulatory change, the Basel III banking reforms are scheduled to be finalised in 2012. While Australia's banks escaped the full force of the GFC by virtue of their better regulation and more prudent business practices, regulation is likely to be applied on a one size fits all basis. Australia's banks could therefore need to hold more capital and potentially also a larger amount of liquid assets within that capital.

The issue of liquidity is quite contentious as it represents an increase in Government bond holdings by the banks. The problem being that the Australian Government bond market is too small to support such a development. This is an issue that the banks will have to thrash out with APRA (Australian Prudential Regulation Authority). Given Australian banks' healthy tier 1 capital levels, the issue of absolute capital requirements is likely to be less of a challenge.

Westpac comes at the lower end of the scale with regards to capital, holding tier 1 capital of 8.64% as at 31 March 2010. This is well above current regulatory requirements, but also a long way short of ANZ at the other end of the scale with 10.7%. As Gail Kelly pointed out during the analyst briefing however, Westpac does not have a capital hungry acquisition agenda. One would therefore expect the bank to hold less capital than its peers.

One advantage of Westpac's lower tier 1 capital is that it weighs less heavily on the bank's return on equity. There is a long way to go before Westpac returns to the pre-GFC return on equity of 20-23%. Nevertheless, the first half result saw Westpac's return on equity lift from 13.4% in the previous six months, to 16.6%.

The improved return on equity is more interesting given that the bank's net interest margin (NIM) fell 11 basis points to 2.28%. The bank had enjoyed a post GFC expansion of its NIM as it re-priced its assets more appropriately (meaning it increased interest charges). This benefit was offset during the period by a higher cost of funding and an increased weight of mortgages within its asset portfolio, which are lower margin than business lending.

With regards to mortgages, Westpac has ramped up its exposure to this sector of the market at a considerably faster rate than its peers since the GFC. Indeed, management reported that the housing loan book expanded 18% during the period. The growth was 1.6 times system and took Westpac's share of the residential mortgage market from 25% to 27%.

Gail Kelly is quite content to maintain Westpac's market position, so we do not expect to see further market share gains. However, a key feature of Westpac's strategy is extracting more from each of its customers by selling them other products. Westpac's increased share of the mortgage market has increased its database of cross-sell opportunities and therefore enhanced the probability that this strategy will add meaningfully to future results.

In terms of the outlook, CFO Phil Coffey stated that he viewed further second half earnings growth as "challenging". This is not surprising given the part improved bad debt expenses played on the first half's strong headline performance and the improbability of a recurrence. Nevertheless, our investment case for Westpac is not based on the next six months, but its likely performance over the next few years.

On this front, we expect Westpac to leverage its strong position in the Australian market to deliver further return on equity expansion in the years ahead. Indeed, the bank has already demonstrated its ability to exercise pricing power without an offsetting impact on its business volumes. Meanwhile, an expected recovery in business lending through the course of the year and into 2011 should provide an offset to the stabilisation of mortgage lending.

From a valuation perspective, Westpac trades on an undemanding consensus 2010 price to earnings ratio of 12.9 times. Despite the market's disappointment with the dividend, the stock also provides a healthy and in our view secure dividend yield of 5-6%.

Turning to the charts, Westpac touched a recent high of $28.43 on April 15. Since then a sharp 16.29% retracement saw the stock hit a recent low of $23.80 on May 7. The steep decline has resulted in the relative strength index (RSI) moving into oversold territory.

Short term momentum remains to the downside, with the most recent decline breaking below both the 50 and 200 day SMA. Even so, the weekly chart depicts the resilient uptrend since January 2009 and the current short term retracement is a healthy correction within this.

As such, we recommend Westpac as a buy to all members around $24.82.

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Snapshot WBC

Westpac

Reuters: Westpac provides a range of banking and financial services, including retail, business and institutional banking, and wealth management services. Westpac operates in six segments: Westpac Retail and Business Banking (WRBB), St.George Bank Limited, BT Financial Group Australia (BTFG), Westpac Institutional Bank (WIB), New Zealand Banking (NZ) and Other. WRBB is responsible for sales, marketing and customer service for all consumer and small to medium enterprise customers within Australia under the Westpac and RAMS brands. St.George Bank is responsible for sales, marketing and customer service for its consumer, business and corporate customers in Australia under the St.George brand. It also includes the management and operation of Bank of South Australi (BankSA). On December 1, 2008, Westpac completed its merger with St.George Bank Limited.

Market Capitalisation:$74bn

	FY1	FY2
Price to Earnings	12.9	11.5
Dividend Yield (%)	5.4	6.2
Price to Book	2	1.8
Return on Equity (%)	16.2	16.6