Westpac Capital Notes (WBCPD): The new form of hybrid capital

Recommendation: Subscribe at a margin of at least 3.20%

Overview

Westpac Banking Corporation (WBC) is looking to raise at least AUD 500 million in new capital via a bank capital note (also known as bank hybrids). These perpetual securities, Westpac Capital Notes, are to be listed on the Australian Stock Exchange (proposed ASX Code: WBCPD) and are designed to provide tier 1 regulatory capital for the issuer which complies with APRA's newly implemented capital adequacy standards (Basel III requirements).

Westpac Capital Notes are fully paid, non-cumulative, convertible, transferable, redeemable, subordinated, perpetual, unsecured notes issued by Westpac. Although this security is legally a perpetual instrument it has embedded conversion mechanics which (subject to satisfying the conversion conditions) requires conversion into Westpac common stock at the scheduled conversion date (8 March 2021). However, as part of the structure the issuer reserves the right to redeem (or transfer) the securities earlier subject to APRA (banking regulator) approval (the optional redemption/transfer date being 8 March 2019). This option is standard for an issuer as it provides them with additional flexibility in managing their capital.

WBCPD pays fully franked discretionary and non-cumulative distributions payable quarterly in arrears, based on the 90-day BBSW rate plus a margin. Westpac has communicated that the indicative margin range is 3.20 - 3.40%.

Summary and Recommendation

We recommend investors subscribe. Morningstar's analysis takes into account the current relative value and the long term fair value of the new issue. Our analytical process takes into account fundamental issuer analysis and structural considerations before applying a quantitative method for assessing the fair value.

As part of our fundamental analysis we have assigned a medium business risk rating to Westpac and are comfortable with the issuer and sector risk from a default (or in the case of WBCPD, conversion) perspective. Therefore WBCPD falls into the lower issuer risk group of our debt and hybrid securities coverage universe. However, issuer risk does not take into account structural considerations which change the risk profile of the security itself. Features such as the capital and non-viability triggers change the dynamics of the security to make it unsuitable for defensive / conservative investors. Traditional fixed income investing is defensive in nature, in that its performance is inversely correlated to sharp corrections in equity markets. However, the performance of this security will be linked to the probability/possibility that the issuer will breach a minimum ratio of tier 1 equity capital (a focal point of capital trigger) or approach insolvency in the eyes of the regulator (a focal point of the non-viability clause). These are complex issues to understand which Morningstar explains in the body of this report.

On an absolute basis the security should offer a margin at or above our fair margin of 3.20%. From a relative value perspective similar tier 1 securities (CBAPC and to a lesser degree WBCPC and ANZPC) have contracted significantly since the middle of 2012 and are currently trading at margins between 3.20 - 3.30% with no real distinction of risk. A new issue should provide a slight premium to existing issues and therefore we would prefer a margin above what is currently offered in the secondary market.

WBCPD is suitable for investors looking for stable income with a stable to positive view on the credit profile of the issuer. This is not a defensive or growth asset and should be treated as such in the asset allocation process. It will not be subject to equity volatility except in the circumstance where there is a credible risk of unscheduled conversion.

Valuation

Westpac has a number of outstanding Tier 1 securities, which from a fundamental perspective all have the same issuer default risk, but this is where the similarities between the securities stop. Each security has a separate and distinct prospectus with

Nicholas Yaxley
Credit Analyst

Andrew Doherty
Head of Equities

Contact Details
Australia
Helpdesk: +61 2 9276 4446
Email: helpdesk.au@morningstar.com
New Zealand
Helpdesk: +64 9 915 6770
Email: helpdesk.nz@morningstar.com

terms that adjust the potential loss to investors based on specific scenarios. This means each security will have a different fair margin, below which we will not recommend investment.

Morningstar's long term quantitative fair value methodology is based on mapping our investment risk rating to the probability of conversion/default which is based on global empirical corporate default data over the past 25 years.

The structural terminology in WBCPD makes the loss given conversion higher than loss given default / conversion in previously issued WBC hybrid securities. Hence we assign a higher fair margin of 3.20% versus 2.65% for WBCPC and 2.40% for WBCPA and WBCPB. The fair margin is calculated using a base loss given conversion spread of 2.40%, an illiquidity cost of 0.10% and an additional 0.70% to account for structural features.

Commonwealth Bank's PERLS VI is structurally very similar to WBCPD and a good comparison point. However, we would argue that it has rallied to a point which no longer reflects the downside risks to investors – it is now trading at a margin of 3.20%. WBCPC and ANZPC are more reflective of their risk profiles currently trading ~ 3.30%. We think that WBCPD should price at a premium to these securities because of the inclusion of the non-viability clause. Therefore from a relative value perspective, we would prefer WBCPD to have a margin at or above 3.30%.

Issuer Credit Perspective
Morningstar's issuer credit perspective is our assessment of an issuer's ability to meet its legal obligations in a full and timely manner. Our process is based on four key pillars; Business Risk, Capital Stress Test, Bank Solvency and Probability of Default. We then consider the structural elements of the security that change the risk profile. It is important to look at all elements of the analysis before participating in the issue.

Business Risk
Morningstar's business risk rating is based on our understanding of the presence of any sustainable competitive advantages (economic moat), macroeconomic drivers of the industry (i.e. regulation, housing growth, unemployment), the reliance on debt capital markets (domestic and foreign) and quality of management (risk and capital sub-committees). Consistent with other domestic banks we assign Westpac a medium business risk.

The primary driver of business risk is Westpac's dependence on capital markets. WBC has multiple domestic and offshore funding programs in place which help to diversify their exposure to what are inherently unpredictable capital markets. We do not believe Westpac's survival depends on access to these markets (note that WBC currently has sufficient liquidity to cover redemptions for the next 16 months). We could argue that the issuer is of such domestic importance to the economy that if external funding was unavailable the government would provide a guarantee facility similar to what was made available during the global financial crisis. However, this does not provide a clear and independent assessment of the issuer and therefore we maintain a stand-alone assessment in terms of reliance on capital markets.

Australian banks have been slowly reducing their reliance on capital markets over the past few years, replacing term debt with deposit funding (this is also a function of the new liquidity requirements). Partially mitigating the risk of reliance on capital markets is Westpac's ability to access open market operations of the Australian Office of Financial Management (AOFM). This is by no means a lender of last resort but a function provided by the government for banks to access funding if required.

Economic Moat
The economic moat concept is a cornerstone of Morningstar's investment philosophy and is used to distinguish high quality companies. An economic moat is a structural feature that allows a firm to sustain excess returns over a long period of time. Without a moat, profits are more susceptible to competition. Companies with a narrow moat are likely to achieve normalised excess returns beyond ten years while wide moat companies are likely to sustain excess returns beyond 20 years.

We assign a narrow moat to Westpac. Banking in Australia is an effective oligopoly, with the four major banks controlling over 90% of the business and consumer lending markets, plus the vast majority of bank deposits. Commonwealth Bank (CBA) and Westpac control over 50% of the housing loan market and retail deposits sectors. Despite the dominant market position, competition is intense between the four major banks. Westpac keeps tight control on credit and operating costs, consistently delivering net returns well in excess of our cost of equity estimate. Importantly, we expect this to continue.

Westpac is a diversified financial services business, benefiting from economies of scale and a sticky customer base. The concentrated industry benefits from high barriers to entry across most segments, making it hard for new entrants to gain any sort of foothold, particularly in retail and business banking. Westpac leverages its strong distribution network and high-profile investment platform to further expand into wealth management. Customer inertia is high as most customers view the major banks as providing similar levels of service. Most major bank customers have multiple product relationships with their bank, ensuring limited switching due to cost and time pressures. Westpac's focus on deeper customer relationships promotes customer loyalty, reduces switching and improves profitability.

Regulation and highly profitable customer lending limits risk taking in non-lending asset classes, with negligible exposure to dodgy European sovereign debt. The concentrated market ensures above-average risk-adjusted returns. Mortgage lending is consistently profitable and currently accounts for a large 67% portion of total loans. Pricing is opaque as higher advertised rates are discounted for customers, and mortgage interest rate changes tend to be matched by competitors. Standard loans require lenders' mortgage insurance (LMI) if loan/value ratios (LVRs) exceed 80%, limiting credit risk on a large portion of higher LVR loans. Low-doc mortgage loans above 60% LVR require lenders' mortgage insurance, so mortgages resemble a fee-based business with significant operating leverage, and Westpac benefits handsomely due to its large market share. Mortgage insurance is paid by borrowers but benefits the bank in the event of a mortgagee-in-possession property sale below the outstanding loan amount.

LMI covers about 26% of Westpac's Australian mortgage portfolio. Mortgage insurers in Australia are regulated by the Australian Prudential Regulation Authority (APRA), with both insurers regularly stress test their mortgage insurance portfolios and are capitalised to withstand loss severity rates significantly higher than worst previous experiences. Mortgage insurance covers 100% of the insured loan amount for the loan life.

Australian lenders are legally obligated to assess a borrower's financial capacity to meet loan repayment obligations. If a lender makes a loan to a borrower who cannot initially afford the loan, the courts can extinguish the loan. All home loans in Australia are full recourse and banks have clear title to the mortgaged property and other assets. Often home loans are cross-collateralised against other property, particularly common for homes purchased as an investment property and or weekender/beach house type properties.

Management

Prior to appointment as chief executive in February 2008, Gail Kelly was CEO of St George Bank for nearly six years. Kelly is well-regarded across the industry and we consider her an inspirational leader for the retail-focused bank. However, Westpac is more than just retail and her leadership skills are being tested in the more challenging institutional and commercial divisions. We believe chief financial officer CFO Phil Coffey is a first-class executive, capably supporting the CEO and executive team. Coffey joined the bank in 1996 before being appointed CFO in 2005.

The majority of management are long-serving executives of Westpac, St George and/or BT. Management's track record in successfully integrating St George, cutting costs and executing its domestic multi-brand growth strategy is delivering better customer retention, improved cross-sell and higher return on equity (ROE). We view the growth strategy as positive for several reasons. First, the St George acquisition continues to provide increased revenue and cost reduction opportunities, leading to improved productivity. Second, the relaunch of Bank of Melbourne in Victoria provides much better long-term growth opportunities compared to the St George brand in that state. Third, the rotation and promotion of key executives in 2010 enables a deeper understanding of the group and greater expertise in senior management ranks. Fourth, other than New Zealand, management is not distracted with offshore operational and economic issues, enabling management to aggressively progress the domestic growth strategy.

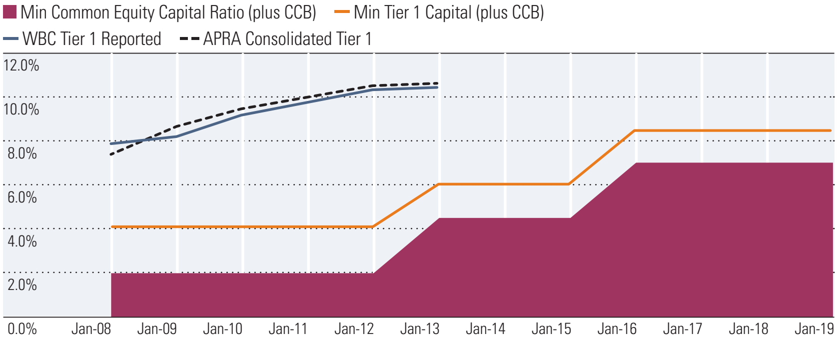
Bank Solvency - Capital, Funding, Liquidity & Asset Quality

Morningstar assesses the financial health of an issuer using a purely objective assessment based on bank-specific accounting metrics. Our Solvency Score measures a bank's most recent performance in four key areas: capital adequacy, asset quality, earnings power and liquidity. These measures are scored against a fixed set of thresholds set by our global credit committee.

Capital Adequacy

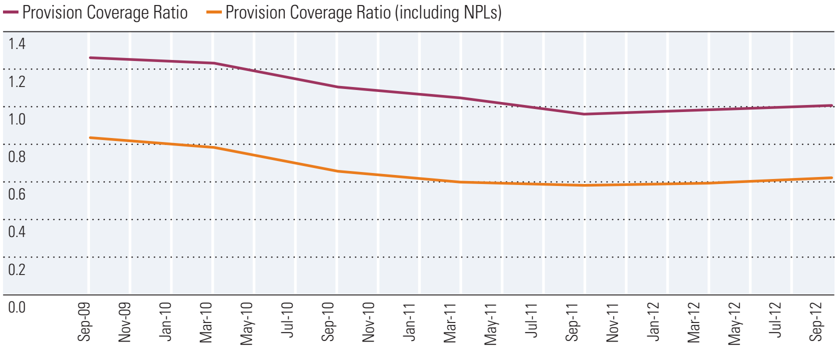
Westpac has historically been proactive in implementing its capital management strategy. It has maintained a strong total capital buffer above minimum requirements set out by APRA (see Figure 1). The transition into the new capital adequacy requirements (Basel III) has been relatively smooth for the Australian banking industry, in fact APRA was able to fully implement the new rules earlier than planned on 1 January 2013.

Figure 1: Westpac (Level 2) Tier 1 ratio relative to regulatory requirements



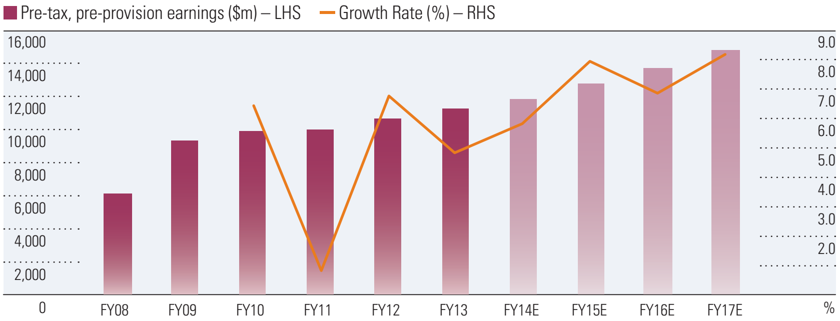
Source: RBA, Morningstar, WBC
Note: CCB is the capital conservation buffer.

Figure 2: Westpac: Provision Coverage Ratio (x)



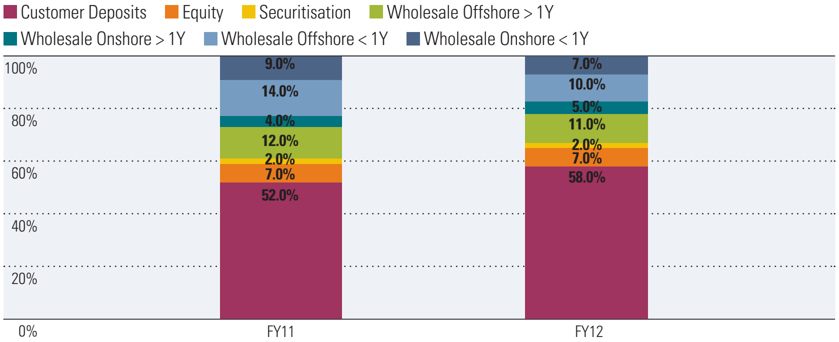
Source: Morningstar

Figure 3: Pre-tax, pre-provision earnings ($m) and growth (%)



Source: Morningstar Forecast for 2013-2017

Figure 4: Westpac Funding Mix



Source: Morningstar

In Westpac's most recent trading statement management set a preferred range of 8.0% to 8.5% for its common equity ratio which is 2.875% - 3.375% (or ~$8.5 – $10bn) above the capital trigger minimum of 5.125% (The capital trigger is a term within the prospectus which is discussed further in the structural considerations section). Not commonly known, APRA has undisclosed minimum requirements of core equity capital which is specific to each issuer, based on quantitative stress testing on the banking system. Once an issuer reaches these levels (unknown amount but we can reasonably suggest they are over and above the minimum disclosed requirements) APRA requires daily disclosures and a work out plan to ensure a safety buffer over and above the minimum requirments. Based on this information we can take comfort in the current core equity capital buffer and the framework around maintaining these levels.

Over the next few years Westpac will focus on the implementation of the capital conservation buffer (CCB - 2.5%) and the countercyclical capital buffer (this requirement will be announced in January 2015 and will be between 0 - 2.5% which are additional requirements imposed on the common equity capital ratio and are due to come into effect on 1 January 2016). This will mean the minimum core equity capital ratio required by APRA will increase to between 7.0% and 9.5% at 1 January 2016. Other capital buffers such as a domestic systematically important financial institution (SIFI) have been discussed but APRA has not yet made any public disclosures of whether or not this will be implemented. Effective regulation and supervision could substitute any additional requirements for capital buffers.

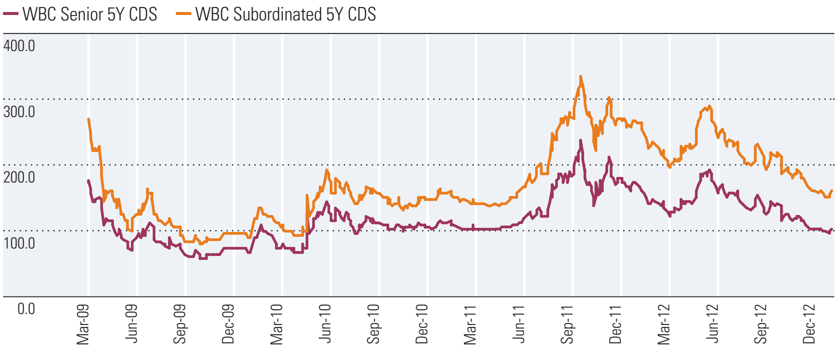
Morningstar is confident that Westpac will satisfy the 2016 targets primarily due to their ability to maintain strong organic core capital growth, as retained earnings has grown faster than risk-weighted assets (RWAs).

On a pro forma basis the estimated Basel III Westpac common equity ratio tier 1 ratio is 8.16% (WBCPD adding minimum 0.16% to tier 1 capital), well above the minimum requirement of 4.5% effective 1 January 2013 but broadly in line with the 2016 targets.

The total tier 1 ratio is 10.41% (Basel II) which is 4.41% over the minimum requirement but again broadly in line with 2016 targets.

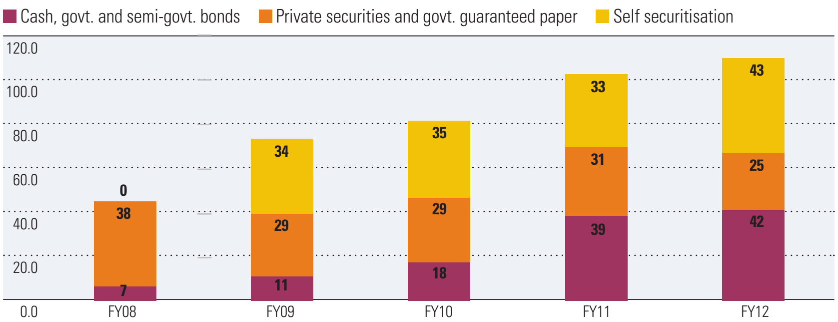
Asset Quality
The group asset quality is satisfactory with impaired assets as % of gross assets (0.59% as at September 2012) remaining fairly flat to improving over the past few years. There is an argument that domestic

Figure 5: Westpac Senior and Subordinate 5 Year Credit Default Swaps



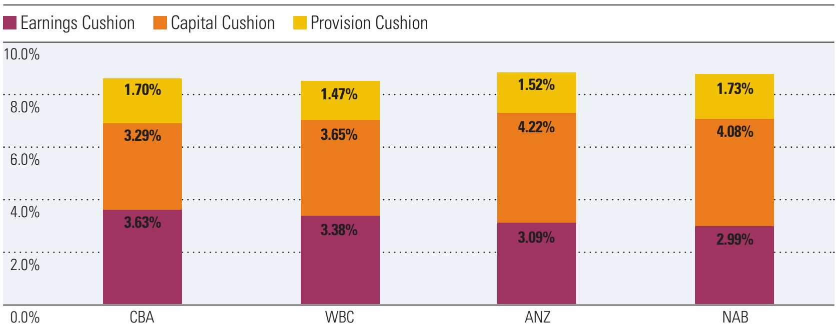
Source: Morningstar, Reuters

Figure 6: Westpac Liquid Assets ($bn)



Source: Morningstar, Westpac

Figure 7: Loss Absorption Cushion (as % of RWAs)



Source: Morningstar

Figure 8: Unscheduled Conversion Calculation

Source: Morningstar

Australian banks are under provisioned for a significant deterioration in the macroeconomic environment, but as the RBA continues to ease monetary policy this potential risk is starting to reduce. As a capital note investor we would prefer Westpac to increase the provision coverage ratio over the next few years to protect capital holders but this would be at the expense of shareholder returns which may discourage the board.

Morningstar is comfortable with Westpac's risk management framework with multiple levels of operating defence to identify deterioration in credit risk. We expect Westpac to adjust its provision coverage ratio if there are signs of credit deterioration in their loan book. The biggest risk to asset quality is a sharp increase in national unemployment as this has a direct impact on the performance of residential mortgages which forms a large proportion of the WBC asset base.

Earnings Power

The pre-tax, pre-provision earnings (PPE) are a bank's first line of defence against credit losses. As such, it receives the highest weighting in the Bank Solvency Score. The higher a bank's core earnings power, the more losses it is capable of absorbing without affecting its allowance for loan losses or common equity tier 1 capital balance.

WBC has significant earnings power primarily as a result of a large residential mortgage book. Morningstar's equity analysts project PPE to grow at an average of 6.7% per annum over the next five years giving investors comfort that the first level of defence against deteriorating asset quality has a solid outlook.

Funding and Liquidity

Over the past few years the biggest change to Westpac's balance sheet has been in its liquidity and funding mix. Although Morningstar does not weight funding heavily in its objective assessment, it is a significant component of our business risk analysis.

On an annual basis Westpac treasury reviews its funding profile against expected market conditions and balance sheet growth. The key measure that the Westpac risk management committee uses is the stable funding ratio which is designed to manage the stability of the overall funding base. Stable funding consists of customer deposits, equity and wholesale term funding with residual maturity greater than twelve months (including securitisation). As at 30 September 2012, the stable funding ratio was 83% (from 79% at 31 March 2012) relative to its internal target of 75%. This risk measure will be implemented as a prudential requirement from 2018 but the details of what can be included in this calculation have not yet been confirmed by APRA.

As at 30 September 2012 WBC had liquid assets of AUD 110 billion up 6% from 30 September 2011. These assets are sufficient to cover all debt maturities the next 16 months. Liquidity risk is defined as the ability to fund increases in assets and meet obligations as they come due. This risk is managed under the WBC liquidity risk framework which is managed daily by the group treasury.

The majority of domestic banks have warned that their cost of funding has increased substantially over the past few years. This is a result of a change in funding composition (from short term wholesale to a long term whole sale and deposit funding) more than an increase in wholesale funding costs. Figure 5 gives a proxy of the wholesale cost of term funding which has dropped significantly since its recent peak in September 2011. This short term drop in wholesale funding costs is positive for earnings, but has no significant impact on the group credit profile.

Stress Test – Loss Absorption Cushions

Morningstar's Bank Stress Test score evaluates a bank's capacity to handle additional losses in its loan and securities portfolios. This ability depends on the bank's initial capital position, provisioning and its 12 month forward PPE as the first line of defence.

The stress test score is based on a bank's expected capital position at the end of a two-year period of (hypothetical) elevated losses. Expected losses in various loan and security categories are applied to a bank's most recent asset composition (reported in APS 330). Losses are subtracted from the bank's last reported core equity tier 1 capital position. Overall Westpac performed very strongly against Morningstar's stressed scenario. This stress test is arguably not as severe as APRA's own hypothetical stress tests which are intended to test the boundaries of 'severe but plausible' macroeconomic deterioration.

Figure 7 shows WBC's total loss absorption cushion. This refers to losses (as a percent of RWAs) Westpac can absorb over a 12 month period before breaching the minimum total capital ratio of 8%. It also shows that there is very little difference between the major banks in terms of total capital cushion as percent of RWAs. This is part of the reason why it is difficult to differentiate credit opinions between the major domestic banks.

Importantly this is simply a general measure of loss absorption. Losses are recognised differently in core equity capital depending on how they are provisioned which varies between institutions due to quality and asset composition. While we do not expect losses to be sufficiently high enough to breach the capital trigger, if losses are large (and over a short time horizon) the structural elements of WBCPD will change how losses are attributed to different parts of the capital structure. This is discussed further in structural considerations.

Distance to Default

The final measure in Morningstar's credit opinion is our distance to default. This is an adjusted form of Morningstar's structural model of default. This measure provides us with a guide to the probability of an issuer meeting its obligations (without covenants). This does not have a large impact on our overall assessment but is designed as a quantitative measure of default probability.

Importantly our fundamental assessment suggests that our default probability estimates are conservative relative to other market based assessments (i.e. implied default probability from credit default swaps).

Structural Considerations

Morningstar's credit opinion is a measure of strength of an issuer and the probability that it will meet all future obligations. It does not form a complete view on the risk of Bank Capital notes such as WBCPD. The best way to think of the credit opinion in the context of WCBHB is a probability of non-conversion. Importantly this is not probability of default, which has a lower probability.

Structural considerations do not affect our credit opinoin of Westpac. However, they significantly changed the expected loss profile of the security upon conversion. This is explained further below.

Conversion of WBCPD will happen only in three scenarios (excluding an early redemption event):

- Scheduled conversion, subject to conversion conditions, on scheduled conversion date
- Unscheduled conversion due to :
    - Capital Trigger Event
    - Non-viability Trigger Event

The scheduled conversion date is 8 March 2021 (for valuation purposes this is the date which Morningstar uses as the expected maturity date). On this date holders of WBCPD will be converted into WBC common equity at a 1% discount ($101.01) to the volume weighted average price (VWAP) of WBC common equity during the 20 Business Days preceding the scheduled conversion date.

Scheduled conversion is subject to:

- First scheduled conversion condition – VWAP of WBC shares on the 25th business day preceding the scheduled conversion date (expected to be 1 February 2021) is greater than 56.12% of the issue date VWAP.
- Second scheduled conversion condition – VWAP of WBC shares during the preceding 20 business days before the scheduled conversion date is greater than 50.51% of the issue date VWAP.

These conditions are designed to protect the WBCPD holder from short term volatility in the WBC share price which might unnecessarily effect the scheduled conversion calculation.

In our opinion, unscheduled conversion is an unlikely, but severe, scenario which from a timing perspective is before default or insolvency. The threshold is clear for the capital trigger (being 5.125% of common tier 1 capital) but the point of non-viability has not been clearly defined. Both of these scenarios are the key to defining the security risk. The risk profile is asymmetric with a low probability that the security will be converted but loss given conversion can be high. These structural elements of WBCPD are described below and are designed to meet the loss absorption requirements set out by APRA.

Note that conversion conditions do not apply during unscheduled conversion.

Capital Trigger Event
A capital trigger event is defined as when the issuers' common equity tier 1 capital ratio reaches 5.125% of total risk weighted assets. This level was decided upon by the Basel Committee on Banking Supervision and implemented by APRA. Investors can monitor this trigger level on a quarterly basis as it is disclosed by the issuer in what is known as Westpac's Pillar 3 report.

Importantly investors should understand that at 5.125% of core equity capital Westpac still has significant enterprise value (this is different from market capitalisation) and hence investors will be converted when the company still has capital available to cover losses. To reach this capital level we expect the macroeconomic environment would have to deteriorate substantially with loan losses exceeding our worst case scenario. In the event that this scenario did eventuate WBCPD would be converted (conversion conditions to not apply at this point) into common equity to a point where the common equity tier 1 ratio is restored above the 5.125% level.

Unscheduled conversion will occur using a predefined calculation with the number of shares received by investors decided by a calculation known as the conversion number. This conversion number has a maximum limit (known as the maximum conversion number) which will automatically write down the value of your investment depending on the common equity share price over the preceding 5 days (% days VWAP).

This trigger event is not new and has been embedded in a number of securities to date (ANZPC, WBCPC and CBAPC). From Figure 8 we can see that in the circumstance where the share price drops below ~$5.30 the automatic write off mechanism is started and the number of shares an investor would receive is capped (this is based on Morningstar's assumptions of an issue date VWAP of $26.50).

The timing of conversion for a capital trigger event is significant because theoretically it should be before the point of non-viability and default / insolvency. If WBCPD is forced into unscheduled conversion it is likely that the issuer will require further equity capital injection and any recovery would be significantly diluted by new common equity capital. For this reason Morningstar conservatively assumes 0% recovery on unscheduled conversion.

Non-Viability Trigger Event
The point of non-viability is the second line of defence before a public injection of funds is necessary to support the issuer. This point has not been clearly defined and it will remain subjective for APRAs purpose (which is ultimately to protect the public from having to support a failing banking institution). It is Morningstar's opinion that the point of non-viability is before default or insolvency (but probably after the capital trigger) because it is in the interest of APRA to maintain solvency in domestic banking institutions.

A Non-Viability Trigger Event has been defined as when APRA notifies Westpac in writing that it believes:

- Conversion of all or some Notes is necessary because, without it, Westpac would become non-viable; or
- a public sector injection of capital, or equivalent support, is necessary because, without it, Westpac would become non-viable.

WBCPD is the second major bank capital security to incorporate a non-viability trigger. This trigger

Table 1: Comparable Converting Major Bank Capital Securities

	WBCPD	CBAPC	WBCPC	ANZPC
Name	Westpac Capital Notes	CBA PERLS VI	WBC CPS	ANZ CPS3
Type	Scheduled Conversion	Mandatory Converting	Scheduled Conversion	Mandatory Converting
Issuer	WBC	CBA	WBC	ANZ
Issue Size	Min $500m	$2.0bn	$1.189bn	$1.34bn
Face Value	$100	$100	$100	$100
Issue Date	8 March 2013	17-Oct-2012	23-Mar-2012	29-Sep-2011
Margin above Base Rate	Indicitive 3.20-3.40%	3.80% p.a	3.25% p.a.	3.10% p.a.
Trading Margin	-	3.15%	3.29%	3.29%
Base Rate	90-Day BBSW	90-Day BBSW	180-Day BBSW	180-Day BBSW
First Call / Exchange/ Redemption Date	8-Mar-2019	15-Dec-2018	31-Mar-2018	1-Sep-2017
Mandatory Exchange / Scheduled Conversion Date	8-Mar-2021	15-Dec-2020	31-Mar-2020	1-Sep-2017
Step-Up	None	None	None	None
Distributions	Discretionary, non-cumulative, fully franked distributions with a dividend stopper.	Discretionary, non-cumulative, fully franked distributions with a dividend stopper.	Discretionary, non-cumulative, fully franked distributions with a dividend stopper.	Discretionary, non-cumulative, fully franked distributions with a dividend stopper.
Capital Trigger Event	Yes, if Common Equity Tier 1 ratio is equal to or below 5.125%	Yes, if Common Equity Tier 1 ratio is equal to or below 5.125%	Yes, if Common Equity Tier 1ratio is equal to or below 5.125%	Yes, if Common Equity Tier 1is equal to or below 5.125%
Non-Viability Trigger Event	Yes	Yes	No	No
Conversion into ordinary shares	Yes	Yes	Yes	Yes
Ranking	Above WBC ordinary shares.	Above CBA ordinary shares.	Above WBC ordinary shares.	Above ANZ ordinary shares.

Source: Morningstar

ultimately gives APRA discretion to convert WBCPD into equity when it deems it appropriate. The use of this trigger event may not be limited to its concerns about WBC's capital levels and could extend to concerns about the bank's funding and liquidity.

Importantly the time distinction between the capital trigger event and non-viability trigger event would in all likelihood be small. A slow deterioration in capital would be captured by the capital trigger but a sharp deterioration where asset write-offs are very large would be captured by non-viability.

As with the capital trigger event conversion will occur using the same predefined calculation with the number of shares received being a function of a calculation known as the conversion number. This conversion number has a maximum limit (known as the maximum conversion number) which will automatically write down the value of your investment depending on the common equity share price over the preceding 5 days (5 days VWAP). As non-viability conversion is forced Morningstar assumes 0% recovery.

This is in line with terminology under section 5.1.9 of the prospectus where if for any reason coversion is not possible then the holders rights are terminated and WBCPD will be written down to 0.

Distribution Restrictions

As with all other tier 1 bank capital securities, distributions on WBCPD are discretionary. Historically distributions were only to be paid from distributable profits but this test was removed by APRA in 2012. However, WBCPD introduces distribution payment conditions

- the payment of the Distribution not resulting in a breach of Westpac's capital requirements
- the payment of the Distribution not resulting in Westpac becoming insolvent
- APRA not otherwise objecting to the payment.

WBCPD also includes terminology which restricts payments of dividends on common equity (dividend and capital stopper) if distributions on WBCPD have not been paid. These restrictions are not as strong as dividend stopper conditions from older hybrid securities but will be the standard for Basel III compliant securities. It is possible that Westpac could potentially keep paying distributions on WBCPA, WBCPB, WCTPA and WBCPC while not paying on WBCPD. This situation is unlikely but possible.

Early Redemption
Westpac has the option of early redemption of WBCPD on the optional redemption/transfer date (8 March 2019). WBC also has the option to redeem WBCPD at face value on any payment date if it deems a Tax, Franking or Regulatory Event has occurred. 20 business days of advanced notice must be provided to holders and redemption is subject to APRA approval. More information can be found in the prospectus appendix under section 6. Early Redemption.

Acquisition Event
In the event that WBC receives an unconditional takeover bid (or scheme of arrangement) an acquisition event will have occurred and WBCPD will automatically convert in common equity. Conversion will occur using the same calculations as conversion on the scheduled conversion date. More information can be found in prospectus appendix under section 5.7 Automatic Conversion upon the occurrence of an Acquisition event.

Other Risks
Excluding the risks described above Westpac Capital Notes are subject to a number of other risks which investors should be aware of:

Market Risk
WBCPD has embedded equity risk (through the conversion process) which means it is exposed to market risk as a consequence of its trading activities and/or the management of its financial position. Therefore it is reasonable to suggest it is exposed to adverse movements in levels and volatility of interest rates, foreign exchange rates, commodity prices, credit prices and equity prices.

Interest Rate Risk
WBCPD resets on a quarterly basis. Technically this is defined as short duration and therefore changes in benchmark interest rates will have a minimal impact on the capital performance of the security.

Systemic Credit Risk
Although idiosyncratic credit risk has been assessed in this document, systemic effects can have an impact on the performance of the security. This risk is difficult to quantify but Morningstar mitigates this risk by incorporating a systemic risk premium in its fair value assessment.

Event Risk
Event risks arise as a result of unforeseen or unexpected events such as natural disasters, political reforms, mergers and acquisitions.

Key Terms
- Bookbuild: 6 February 2013
- Announcement of margin: 6 February 2013
- Offer Opens: 7 February 2013
- Closing Date for Offer: 7 March 2013 (Broker Firm Offer)
- Issue Date: 8 March 2013
- Commencement of Trading: 12 March 2013
- First Distribution Payment Date: 8 June 2013
- Optional Redemption/Transfer Date: 8 March 2019
- Scheduled Conversion Date: 8 March 2021
- ASX code is expected to be WBCPD
- Face Value: $100 per security.
- Minimum Subscription Amount: $5,000 (50 units).
- Amount to be raised: Min $500m with the ability to raise more or less.
- Distribution Rate: (90-day BBSW rate + [3.20-3.40%]) x (1-Corporate Tax Rate).
- Margin: WBC has provided an indicative range of 3.20-3.40%
- Frequency of Distributions: Quarterly on 8th of March, June, September and December.
- Franking: Expected to be Fully Franked.
- Distributions: Distributions are at the sole discretionary of WBC and subject to payment conditions outlined above. Distributions are not cumulative meaning that WBC does not have to make up for missed distributions.
- Dividend Stopper: If a WBCPD distribution is not paid then dividend and capital restrictions will apply to WBC ordinary shares from that distribution payment date until a distribution is paid in full on a subsequent distribution payment date. Subject to conditions.
- Capital Classification: Additional Tier 1 Capital.
- Term: Perpetual. Subject to:
  - Scheduled conversion on the scheduled conversion date (8 March 2021) subject to conversion conditions;
  - Unscheduled conversion as a result of a capital trigger event or non-viable trigger event
  - Optional redemption (for the issuer and subject to APRA approval) on the optional redemption/transfer date (8 March 2019); or
  - WBC may redeem or exchange earlier following the occurrence of tax, franking or regulatory events (subject to APRA approval).

We have only presented a summary of the material terms. Investors should examine the prospectus in detail.

Limited Financial Services Guide and Research Methodology

Limited Financial Services Guide

Morningstar Australasia Pty Limited ('Morningstar') ABN: 95 090 665 544, AFSL: 240 892 (a subsidiary of Morningstar, Inc.) of Level 36 Australia Square, 264 George Street Sydney NSW 2000 is the provider of the general advice ('the service') provided in this report. The service is provided through research including the profiling and rating of companies and the securities they issue. Morningstar does not receive commissions for the service and does not charge companies to be rated. Morningstar is remunerated for the service by subscribers paying a subscription fee. This fee is variable depending on the individual subscriber's specific requirements. Morningstar has no debt or equity relationship with any issuers of any securities. Morningstar may provide a licence for the use and distribution of the service to issuers of securities which are the subject of a research report. Morningstar representatives are remunerated by salary and do not directly receive any commissions or fees. They may be eligible for an annual performance payment which is discretionary and based on reaching agreed performance levels. Please refer to our Financial Services Guide (FSG) for more information www.morningstar.com.au/fsg.asp.

Listed corporate income securities

Morningstar covers around 30 listed income securities. Our methodology is forward looking, based on our expectations of future cash flows. Analysis is carried out by our income securities team, which is a subset of the equities research team and thereby utilising the equity analysts' expert knowledge and cash flow models of the underlying businesses.

The focus of Morningstar's analysis is to assess the degree to which the underlying business is capable of supporting the commitments required by the securities. We analyse the following factors to place the security in one of the security risk categories of: Excellent, Investment Grade, Speculative or Distressed:

- Business Risk – comprising an assessment of whether there is an economic moat (presence of sustainable competitive advantages), the strength of management and how uncertain future cash flows are; and
- Financial Risk – based on testing the company under a series of leverage and cash low ratios.

We then calculate the yield that is justified by the risk of the security based on a transition model which identifies a range of credit spreads, primarily based on historic default rates. We add a spread to account for transaction costs associated with illiquidity, and small additional spreads to represent the inconvenience or risks associated with non-cumulative dividends or the security being a perpetual.

Listed Income Securities coverage criteria

Morningstar covers approximately 30 listed income securities. We operate an independent non-issuer paid model in all of our Australasia research, and therefore determine coverage of securities based on investor demand and our assessment of a security's attractiveness for investors. We use the following guidelines to determine income securities coverage in particular: (1) the underlying corporate or its listed parent are covered by Morningstar's equity research team, allowing us to leverage our depth of knowledge, (2) Morningstar's judgement of the investment merit of the security, such as non-esoteric structure, and (3) strength of existing and likely demand from our retail investor, broker, financial adviser, and institutional clients.

Timing and frequency of income security research reports

- Pre-IPO research reports on securities that meet the coverage criteria are published in the first week after the launch of the issue.
- Ongoing research reports are updated at least six monthly or sooner in the case of a major event.
- Income Securities Monthly reports provide a roundup of current pricing and recommendations and an outlook for the market.
- An archive of income securities research reports is available on Morningstar's Adviser Research Centre platform and Morningstar's retail investor website.

Research report content

Income securities research reports contain detailed issuer analysis and an investment recommendation on the security. Reports contain the following content:

- Recommendations – Subscribe/Don't Subscribe for IPO reports. Buy, Accumulate, Hold, Reduce, Sell or Avoid once security is trading.
- Investment Rating – overview of the risk and investment appeal of the security
- Analyst Note – analysis of a key event and implications on the investment appeal of the security
- Thesis – analysis of the business risk and financial risk of the underlying business
- Contract Summary – description of the specific characteristics of the security
- Security Valuation – key inputs to the valuation of the security
- Risks – analysis of potential risks to the underlying business and security
- Investment Perspective of underlying business – Investment Rating, Risk, Growth, Profitability and Financial Health of the underlying company
- Forecasts and key ratios of the underlying business
- Note: Morningstar Australasia does not provide credit ratings.

Morningstar's income securities analysis builds on the modelling expertise of the equities research team, including:

- At least five years of detailed pro-forma financial statements
- Extensive analysis of free cashflow and return on invested capital
- Uncertainty and scenario analysis, including upside and downside cases
- Forecasts of leverage, coverage and liquidity ratios
- Estimates of off-balance sheet liabilities

Economic Moats

Just as moats protected castles from invaders in medieval times, businesses with economic moats have strong defences against their profits being competed away. We ascribe a moat rating to each stock researched: Wide, Narrow or None. The moat is the competitive advantage that one company has over other companies in the same industry. Moat firms have unique skills or assets, allowing them to stay ahead of the competition and earn above-average profits for many years. Returns on their invested capital will exceed the cost of that capital. Without a moat, highly profitable firms can have their profits competed away as other companies see how attractive the market is and try to move in to reap some of the rewards themselves.

Across our research, we have discovered five economic moat sources: Intangible assets, switching costs, network effects, cost advantage and efficient scale. Intangible assets include strong brands which encourage repeat sales and support price rises over time. Intellectual property rights like patents, trademarks, copyrights and government approvals are other intangible assets that can lead to moats. Switching costs make it too expensive or time-consuming to shift to an alternative supplier. The network effect is a virtuous cycle allowing strong companies to get even stronger. It occurs when the value of a particular good or service grows as the number of users grows. Cost advantage can derive from increased scale and efficiency, allowing the company to increase margins. Efficient scale occurs when a limited market is effectively served by existing players and the profit opportunity does not justify entry by others.

Business Risk

Business risk captures the fundamental uncertainty around a firm's business operations and the cash flow generated by those operations. The following factors are key to determining business risk:

- diversity of revenue sources – a company with diverse revenue stream should have more reliable revenues as weakness in one area may be offset by strength in others.
- cyclicality of revenues – for example revenues of a housing products supplier will be tied to cyclical property demand cycles and will be more volatile than a supermarket retailer which should have more ongoing demand.
- the firm's fixed-cost structure – companies with high levels of fixed costs will have greater swings in earnings as revenues move up and down.
- financial leverage – companies with excessive debt levels may run in to troubles should conditions deteriorate, potentially causing unwanted asset sales, dilutive equities issues or even bankruptcy.
- contingent events – examples include outstanding litigation, risk of aggressive acquisitions at high prices, asbestos liabilities etc.