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Westpac Convertible Preference Shares (WBCPC)

Fixed Interest

Issue overview

Issuer	Westpac
Issue ASX code	WBCPC
Face value	$100
Estimated offer size	$750m
Bookbuild margin range	3.20-3.50%
Franking	100%
Dividend payments	Half yearly
Minimum application	$5,000
First optional conversion	31 Mar 2018
Mandatory conversion	31 Mar 2020

Timeline

Lodgement of prospectus	16 Feb 2012
Bookbuild margin	23 Feb 2012
Announcement of margin	24 Feb 2012
Offer opens	24 Feb 2012
Offer closes:	
Securityholder	19 Mar 2012
Broker Firm	22 Mar 2012
Issue date	23 Mar 2012
ASX listing (deferred settlement)	26 Mar 2012

Value at the top end

Westpac has launched its first hybrid issue in three years with the new Westpac CPS (Convertible Preference Share) issue (ASX code: WBCPC). Essentially the issue structure is the same as the ANZ CPS3 (ANZPC), which was the first issue APRA approved that qualified as Additional Tier 1 Capital under the Basel III framework. One key requirement is the Common Equity Capital Trigger Event, where the security must convert into ordinary shares if the Westpac's Core Tier 1 ratio falls below 5.125%.

The expected bookbuild margin of 3.20-3.50% over 180 BBSW (grossed up for franking) is historically high, although this margin range is now required to compete against some of the attractive higher ranking subordinated note offers currently in the market. The ANZ Subordinated Notes (ANZHA) bookbuild margin at 275-300bp, while the Colonial Subordinated Notes (CNGHA) bookbuild margin is 325-375bp.

The current flood of new issuance combined with the market surprise at CBA issuing a 5 year domestic covered bond at a margin of 175bp has seen the trading margins (i.e. gross yield to maturity less BBSW) of ASX listed bank hybrid market increase from ~210bp in the early January to as high as 330bp. This has essentially ignored the 40bp decline in trading margin on the CBA covered bond to 135bp, supporting our view the current hybrid pricing is a short term anomaly investors should take advantage of.

In assessing our fair value margin on WBCPC, a premium to the 325bp margin on CNGHA is required, especially as the CNGHA margin reflects the full cash amount of interest payments. By contrast the WBCPC margin reflects the grossed up value of franking credits. A premium is also required to reflect the time value of money on receiving half yearly versus quarterly dividends, as well as the longer duration of the security. Overall we assess a fair value margin of 3.40%.

Figure 1: Trading margins on debt and equity securities

	Ranking	Security	Trading Margin over BBSW	Maturity	First Call
Higher Ranking	Secured debt	Westpac covered bond (issue margin 175bp)	135bp	Feb 2017	
	Unsubordinated unsecured debt	Westpac senior debt	156bp	May 2016	
	Subordinated unsecured debt	ANZHA	275bp	Jun 2022	Jun 2017
		Colonial (CNGHA)	325bp	Mar 2037	Mar 2017
	Preference securities	**WBCPC**	**320-350bp**	**Mar 2020**	**Mar 2018**
Lower Ranking	Equity	Ordinary Westpac shares	>600bp	Perpetual	

SOURCE: YIELDBROKER, BELL POTTER

Key features

- **Initial gross running yield of 7.55-7.85%:** floating rate based on 180BBSW of 4.35% + 3.20-3.50% bookbuild margin. First half yearly dividend to be paid 30 Sep.
- **Option to redeem at year 6 with mandatory conversion at year 8:** Westpac has the option to convert in March 2018 or on any subsequent dividend payment date.
- **Ordinary dividend restrictions:** applies on the non payment of WBCPC dividends
- **Automatic conversion under the Capital Trigger Event**

Westpac Convertible Preference Shares

Historically high issue margins limit downside

WBCPC will be the fifth consecutive bank issue offering an issue margin above 3.00%. These high margin bank hybrid issues have proved incredibly defensive given the high levels of volatility seen in financial markets in recent months. If we exclude the tumultuous trading session on 9 August 2011, both WBCPB and CBAPA have continuously traded above face value since listing, while ANZPA and ANZPC have not traded below $99.00.

This underpins our investment view that high margin offers such as WBCPC provide clients the opportunity to lock in the historically high issue margins on offer for a longer period.

Figure 2: Issue margins on comparative major bank preference shares

Date of Listing	Issuer	Hybrid Code	Description	Margin over BBSW
7-Jan-04	CBA	PCBPA	PERLS II	0.95%
7-Apr-06	CBA	PCAPA	PERLS III	1.05%
22-Jun-06	WBC	WCTPA	Trust Preferred Securities	1.00%
11-Jul-07	CBA	CBAPB	PERLS IV	1.05%
29-Jul-08	WBC	WBCPA	Stapled Preferred Securities	2.40%
1-Oct-08	ANZ	ANZPB	Convertible Preference Shares	2.50%
30-Mar-09	WBC	WBCPB	Stapled Preferred Securities II	3.80%
13-Oct-09	CBA	CBAPA	PERLS V	3.40%
18-Dec-09	ANZ	ANZPA	Convertible Preference Shares 2	3.10%
29-Sep-11	ANZ	ANZPC	Convertible Preference Shares 3	3.10%
26-Mar-12	WBC	WBCPC	Convertible Preference Shares	3.20-3.50%

SOURCE: COMPANY DATA, BELL POTTER

Comparable trading margins currently 3.20-3.30%

The recent weakness in bank hybrid prices has increased the trading margins (i.e. gross yield to maturity less BBSW) as high as 3.30%. If the pricing of existing securities remains at current levels, WBCPC will need to be priced at the upper end of the bookbuild range.

Figure 3: Gross yield to maturity margin over BBSW ranking

Issue	Gross Margin Over BBSW	ASX Code	Price 15-Feb-12	Face Value	Mkt Cap	Maturity Reset	Conv Method	Gross Run Yld	Gross Yld to Mat	Gross YTM to Swap	Conv Disc
CBA PERLS III	105bp	PCAPA	$180.00	$200	$1,050	Apr-16	Step-Up	6.05%	8.75%	4.40%	2.5%
WBC TPS	100bp	WCTPA	$90.00	$100	$686	Jun-16	Step-Up	5.96%	8.55%	4.20%	2.5%
CBA PERLS IV	105bp	CBAPB	$197.37	$200	$1,446	Oct-12	Mand Conv	5.47%	7.92%	3.57%	1.0%
ANZ CPS1	250bp	ANZPB	$99.85	$100	$1,080	Jun-14	Mand Conv	6.91%	7.72%	3.37%	2.5%
WBC CPS	**335bp**	**WBCPC**	**$100.00**	**$100**	**$750**	**Mar-20**	**Mand Conv**	**7.70%**	**7.70%**	**3.35%**	**1.0%**
CBA PERLS V	340bp	CBAPA	$202.30	$200	$2,023	Oct-14	Mand Conv	7.66%	7.63%	3.28%	1.0%
ANZ CPS3	320bp	ANZPC	$99.65	$100	$1,335	Sep-19	Mand Conv	7.48%	7.61%	3.26%	1.0%
WBC SPS II	380bp	WBCPB	$102.90	$100	$935	Sep-14	Mand Conv	7.94%	7.56%	3.21%	1.0%
WBC SPS	240bp	WBCPA	$99.97	$100	$1,036	Sep-13	Mand Conv	6.77%	7.54%	3.19%	1.0%
ANZ CPS2	310bp	ANZPA	$102.20	$100	$2,012	Dec-16	Mand Conv	7.34%	7.44%	3.09%	1.0%

Projected running yield and yield to maturity assume 90BBSW and 180BBSW holds at the current level of 4.35%.

WBCPC data is calculated using the mid-point of the 3.20-3.50% bookbuild range

SOURCE: COMPANY DATA, BELL POTTER

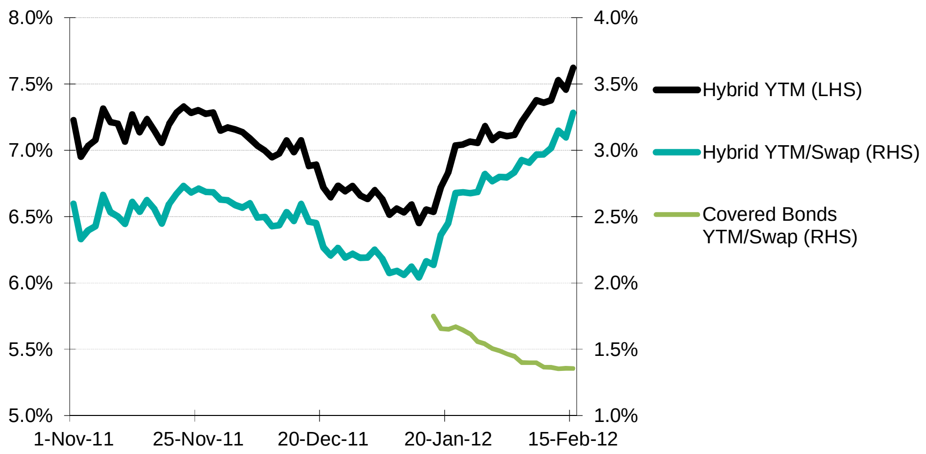
Westpac Convertible Preference Shares

Bank hybrid sell off commenced mid January

Figure 4 highlights the sharp selloff in hybrids that commenced in mid January. The middle blue line highlights a jump in trading margins from around 2.1% just before CBA issued its 5 year domestic covered bond at a margin of 175bp on 17 January.

While the average margin on the CBA and Westpac covered bonds (bottom green line) has traded in 40bp to 135bp, the average trading margin on a sample of six bank converting preference shares (ANZPA, ANZPB, CBAPA, CBAPB, WBCPA, WBCPB) has traded out as high as 330bp. It is also worth noting the average duration on these six securities is 2.5 years.

Figure 4: Average Yield to Maturity of ANZPA, ANZPB, CBAPA, CBAPB, WBCPA, WBCPB

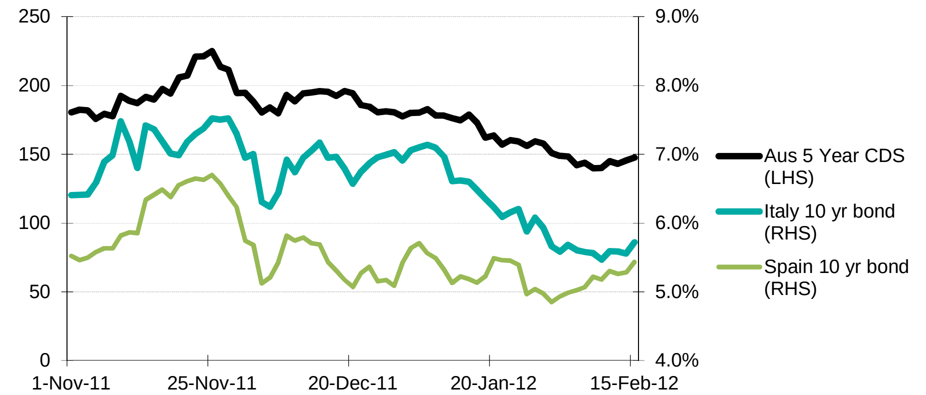


SOURCE: YIELDBROKER, IRESS, BELL POTTER

Anomaly highlighted as pricing of risk assets firms

As 25 November 2011 represented the recent peak in yields on a number of Eurozone bonds as well as the Markit iTraxx Australia index of 5 year corporate credit default swaps, it could be argued that the current spike in bank hybrid trading margins is a short term anomaly. Noting the trading margins on bank hybrids were around 2.7% on 25 November, it would appear reasonable to expect a reversion back to these levels in upcoming months once the market digests the flood of recent issuance.

Figure 5: Australia 5 year CDS versus Italy and Spain 10 year bond yields



SOURCE: BLOOMBERG, BELL POTTER

Westpac Convertible Preference Shares

Automatic conversion at 5.1% Common Equity Capital Ratio

The release of the APRA discussion paper on 6 September 2011 entitled "Implementing Base III capital reforms in Australia" outlined its proposals to implement a package of reforms to strengthen the capital framework for banks in order to prevent some of the issues caused by the GFC.

One key requirement is for banks over time to increase their Common Equity (Core Tier 1) to at least 7.0%, consisting of a 4.5% minimum plus a 2.5% capital conservation buffer.

This discussion paper also set out the interim eligibility criteria for new bank hybrid issues to be included as Additional Tier 1 Capital. Noting the ANZ CPS3 (ANZPC) was the first bank hybrid to satisfy these new requirements, WBCPC has essentially followed the ANZPC benchmark.

One key requirement for new bank hybrids to classify as Additional Tier 1 Capital is they must convert into ordinary shares under a Capital Trigger Event if an issuer's Common Equity Capital Ratio (Core Tier 1) falls below 5.125%, providing an immediate boost to Core Tier 1 capital. At 30 September 2011, Westpac's Core Tier 1 Ratio on an APRA Basel III methodology was estimated at 7.37%, providing a buffer of $6.9bn to the Capital Trigger Level.

The Capital Trigger Event provides the potential for WBCPC holder to receive less than face if the conversion price is below share price thresholds under the Mandatory Conversion Conditions. Although in practice this event will only occur in the unlikely scenario that Westpac suffers severe impairment losses and does not raise ordinary equity to absorb those losses.

Under APRA's proposed Basel III rules that apply from 1 January 2013, the Maximum Conversion Number under the Capital Trigger Event will be reduced from 50% to 20% of the Issue Date VWAP, which will result in investors receiving less than face value if the Westpac share price falls by more than 80% to below $4.00.

Assuming an Issue Date VWAP of $20.00, the Maximum Conversion Number will become 25.00 Westpac shares per WBCPC - i.e. ($100 / (20% x $20.00)) = 25.00. If automatic conversion is done at say $2.50 (including 1% conversion discount), WBCPC holders will only receive $62.50 of Westpac shares (i.e. 25.00 x $2.50).

These proposed changes to the Maximum Conversion Number only applies where conversion occurs as a result of a Capital Trigger Event. The existing Mandatory Conversion Conditions will remain at 50% of issue date VWAP.

Westpac Convertible Preference Shares

Mandatory Conversion Conditions

Investors In order for bank Convertible Preference Shares (CPS) to qualify as Residual Tier 1 capital, APRA has imposed a maximum conversion number in order to limit the dilution of ordinary shares upon conversion.

This maximum conversion number represents the hybrid face value divided by 50% of the volume weighted average price (VWAP) of the issuer on the 20 business days preceding the issue date (Issue Date VWAP). For example, if Westpac's 20 day VWAP was $20.00 before the issue date, the maximum conversion number is 10.00 (i.e. $100 / (50% x $20.00)).

To protect holders from receiving less than face value at mandatory conversion, there are Mandatory Conversion Conditions which investors need to be aware of:

- First: VWAP of ordinary shares on the 25th business day before a possible Mandatory Conversion Date must be above a certain threshold (56% of the Issue Date VWAP for WBCPC)
- Second: VWAP of ordinary shares during the 20 business days immediately preceding a possible Mandatory Conversion Date must be greater than 50.51% of the WBCPC Issue Date VWAP

If Mandatory Conversion Conditions are not satisfied, mandatory conversion will not occur. The issuer does however have the option of applying to APRA for cash redemption.

In the event mandatory conversion does not occur, the security will remain on issue and continue to pay dividends at the same margin. Mandatory Conversion Conditions will be tested on each subsequent future dividend.

Figure 6: Mandatory Conversion Conditions

	ANZPA	ANZPB	ANZPC	CBAPA	CBAPB	MQCPA	SBKPB	WBCPA	WBCPB	WBCPC
Date of Hybrid Issue	18-Dec-09	1-Oct-08	29-Sep-11	13-Oct-09	11-Jul-07	8-Jul-08	13-Jun-08	29-Jul-08	30-Mar-09	23-Mar-12
Mandatory Conversion Date	15-Dec-16	16-Jun-14	1-Sep-19	15-Oct-14	31-Oct-12	30-Jun-13	14-Jun-13	26-Sep-13	30-Sep-14	31-Mar-20
Conversion Discount	1.0%	2.5%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%
Issue Date VWAP	$21.80	$17.35	$19.53	$50.49	$55.08	$48.79	$14.38	$20.09	$17.51	$20.96
50% Dilution Cap	$10.90	$8.68	$9.77	$25.25	$27.54	$24.40	$7.19	$10.05	$8.76	$10.48
Max Conversion No (Face Value/Dilution Cap)	9.17	11.53	10.24	7.92	7.26	4.10	13.91	9.95	11.42	9.54
Conversion Test 1 - % Issue Date VWAP	56.00%	56.00%	56.00%	56.00%	60.00%	55.56%	55.56%	55.56%	55.56%	55.56%
Conversion Test 1 Security Price	$12.21	$9.72	$10.94	$28.28	$33.05	$27.11	$7.99	$11.16	$9.73	$11.65
Conversion Test 2 - % Issue Date VWAP	50.51%	51.28%	51.28%	50.51%	50.51%	50.51%	50.51%	50.51%	50.51%	50.51%
Conversion Test 2 Security Price	$11.01	$8.90	$10.01	$25.50	$27.82	$24.64	$7.26	$10.15	$8.84	$10.59
Conversion Test 3 - Continuous Trading	Yes	Yes	Yes	n/a	n/a	Yes	Yes	n/a	n/a	n/a
Parent Share Price - 15 February 2012	$21.70	$21.70	$21.70	$50.23	$50.23	$26.54	$8.39	$20.96	$20.96	$20.96
Prem/Disc to Dilution Cap	99.1%	150.1%	122.2%	99.0%	82.4%	8.8%	16.7%	108.6%	139.4%	100.0%
Prem/Disc to Conversion Test 1	77.8%	123.3%	98.4%	77.6%	52.0%	-2.1%	5.0%	87.8%	115.4%	80.0%

SOURCE: COMPANY DATA, BELL POTTER

Westpac Convertible Preference Shares

Investment risks

Key Security Risks include:

- Adverse movement in credit spreads as a result of a tightening in the availability and cost of credit
- New issues may offer more attractive issue terms and margins, placing downward pressure on the security price
- Adverse change in Westpac's and financial performance which combined with a major bad debt event could lead to the Common Equity Capital Ratio falling below 5.125%, resulting in automatic conversion under the Capital Trigger Event
- Westpac's share price at the time of mandatory conversion may be below the thresholds set out in the mandatory conversion conditions

Key Business Risks of Westpac include:

- A material deterioration in global capital markets and the Australian economy
- Adverse regulatory changes
- Operational risks and trading errors
- Increasing competition.

Fixed Income

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