

Issuer Name

Westpac Banking Corporation

Security Name

Westpac Capital Notes 9

Security Recommendation

Subscribe

Security Risk

Upper Medium

Issuer Outlook

Improving

Stable

Deteriorating

Key Characteristics

Product Type	Capital Note	Issue Price	\$100.00
Issue Size*	\$750,000,000.00	Accrued	\$0.00
Par Value	\$100.00	Capital Price	\$100.00
Fixed/Floating	Floating	Running Yield**	5.24-5.44%
Payment Frequency	Quarterly	Expected Yield to First Call***	7.84-8.04%
Current Distribution**	5.24-5.44%	Trading Margin	3.40-3.60%
Issue Margin	3.40-3.60%	First Optional Call Date	[22] September 2028
Franking Credits Incl.	Yes	Scheduled Conversion Date	[22] June 2031
ASX Listed	Yes (ASX Code: WBCPL)	Next Ex-Date	[13] September 2022
Convertible	Yes	Next Payment Date	[22] September 2022
GICS Sector	Banks	Next Cash Distribution	[TBC]

* With the ability to raise more or less. ** Based on issue margin of 3.40-3.60% plus 90-day BBSW of 1.84%. *** Based on issue margin of 3.40-3.60%, an interpolated swap to call rate of 4.44%, and an expected call date of [22] September 2028.

Summary

On 21 June 2022, Westpac Banking Corporation (ASX: WBC, the Issuer) launched an offer for Westpac Capital Notes 9 (the Notes, expected ASX code: WBCPL), to raise \$750 million, with the ability to raise more or less. The purpose of the issue is to raise regulatory capital (Additional Tier 1) for WBC, with the proceeds to be used for general business purposes and to fund the refinance of Westpac Capital Notes 2 (ASX: WBCPE). These securities are structured as redeemable, unsecured, subordinated, perpetual, non-cumulative, convertible notes. Distributions are discretionary, non-cumulative, floating rate, subject to distribution payment conditions, and expected to be fully franked, paid on a quarterly basis in arrears until converted or redeemed. The margin is guided at 3.40-3.60% p.a. above 90-day BBSW. There is no obligation on Holders to pay WBC if the distribution rate was to become negative.

This security has no fixed maturity date but is scheduled for mandatory conversion into WBC ordinary shares on [22 June 2031], or later, when conversion conditions have been satisfied. At the Issuer's discretion, WBC can redeem (subject to approval by APRA), transfer, or convert the Notes into WBC ordinary shares (subject to conversion conditions) on [22 September 2028, 22 December 2028, 22 March 2029 or 22 June 2029]. The Notes may also be redeemed (subject to APRA approval), transferred, or converted into WBC ordinary shares (subject to conversion conditions) if a Tax or Regulatory Event occurs. The Notes will convert into WBC ordinary shares following an Acquisition Event (subject to conversion conditions). To qualify as Additional Tier 1 regulatory capital, this security contains the loss absorbing terms and conditions known as Capital and Non-Viability Trigger Events. Upon the occurrence of either of these events, this security will be automatically converted into WBC ordinary shares without the protection of conversion conditions. If conversion cannot occur for any reason within five business days, the Notes will be written off and all Holders' rights terminated.

Figure 1: Capital Structure¹

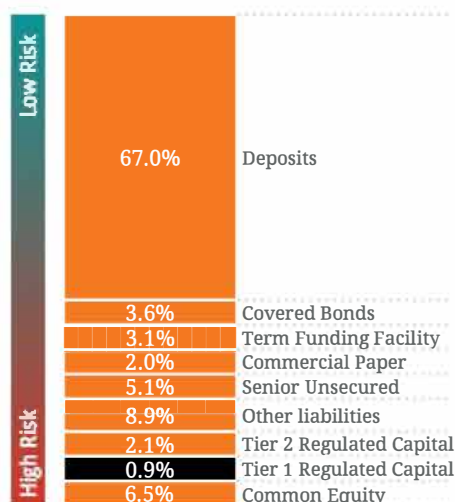
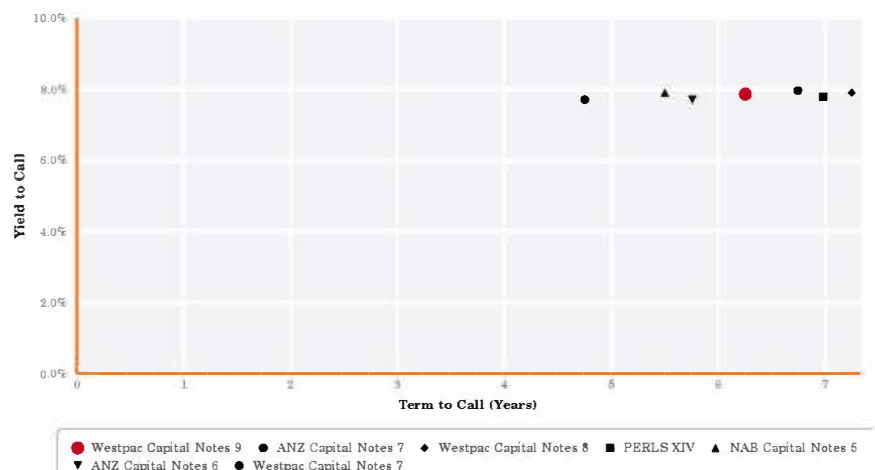


Figure 2: Relative Value



¹ Pro-forma balance sheet as at 31 March 2022, assuming a net \$[740] million raised after costs from WBCPL offer and \$1,311 million WBCPE redemption.

Security Recommendation - **Subscribe** as at 21 June 2022

We recommend investors **Subscribe** due to pricing reflecting fair-value and our fundamental credit comfort with the Issuer, WBC. We see fair value for outstanding comparable securities at the 6.25-year tenor at around the 335-340bps margin mark. At an issue margin at the bottom of the indicative range 340-360bps, WBCPL offers little to no concession premium. At the top end of the indicative range, we see a suitable concession premium. Consequently, we would bid in greater size at the top of the range than the bottom. To be clear, a concession is additional value to what we consider fair value. Further nuances are discussed in *Relative Value*.

The Major Banks are prominent AT1 issuers with a long and successful history of issuance. WBC's most recent AT1 issue, was in September 2021 - Westpac Capital Notes 8 (ASX: WBCPK) that raised \$1.75 billion at a margin of 2.90% p.a. above 90-day BBSW.

Our valuation assumptions for this security are based on redemption at first call ([22 September 2028]) and all distributions being made in full and in a timely manner. If this security is not called on the first call date, or a distribution payment is missed, the price of the security would likely fall. We do not anticipate this happening. Issuers are now incorporating more than one call date to give them more flexibility to redeem a security and subsequently issue a replacement. The inclusion of multiple call dates in recent AT1 issuance help avoid situations such as during COVID disrupted markets in early-to-mid 2020 when Challenger (ASX: CGF) was not able to redeem Challenger Capital Notes (ASX: CGFPA) on its optional call date. This is a positive for holders of securities that contain such optionality.

A new security should incorporate a new issue premium to compensate for the pricing uncertainty between the launch and settlement. This is especially pertinent during periods of elevated market uncertainty, such as now. That said, we acknowledge the attraction of buying in the primary market versus the secondary given the availability of liquidity at a known price – a particular driver for institutional buyers. Furthermore, we note that availability to retail investors in the primary market is now more restricted due to the new Design and Distribution Obligations (DDO) regime in part 7.8A of the Corporations Act. This may drive increased demand in the secondary market from retail investors excluded from primary issuance – such a dynamic was seen with the most recent AT1 hybrid deals being ANZ Capital Notes 7 (ASX: ANZPJ) and CommBank PERLS XIV (ASX: CBAPK).

Bank capital structures and security structures are different to pre-COVID days, making the multiple analysis of old less reliable (think structural shift). Senior unsecured and Tier 2 bonds of the banks have seen credit spreads widen consistently since at least February 2022. AT1 hybrid spreads of the banks were largely resilient to such moves, however, have been sold-off recently with noticeably higher dollar volumes. This lag is typical of the largely different investor bases and therefore investment horizons. We viewed such widening as being somewhat inevitable and now see the opportunity costs having normalised across debt capital structure alternatives.

Our relative valuation analysis incorporates several factors, some of which are subjective in nature. Whilst we have confidence in our Issuer curve analysis based on WBC ASX-listed AT1 hybrid securities, we emphasise our Big Four (ANZ, CBA, NAB, WBC) ASX-listed AT1 hybrid curve, given the larger dataset is a more robust estimator. More recent volatility has seen secondaries (meaning currently trading hybrids) exhibit more residual variance to our curve. Whilst we have material confidence in our curve calculations here, there is still room for error. Accordingly, we view fair value at the 6.25-year tenor being between 335-340bps. From this range, we then assess what is an appropriate concession to compensate for uncertainty between pricing and settlement. Based on our calculations, the prior five Big Four ASX-listed hybrid transactions have offered an average 21bps concession. More recent volatility and therefore uncertainty suggests that the offered concession should be larger. This would only be the case on the right-hand side of the issue margin range. Importantly, we still see valuation as fair, ultimately the concession is modest but this is a function of secondary trading, which has seen just 1% of par value change hands in ASX trading for Big Four ASX AT1 securities since the launch of NABPI on 6 June. At the same time, NABPI, at a tenor of ~7.5 years and margin of 315bps saw over \$2 billion in bookbuild demand. This summarises our opinion that the value offered is fair. Further analysis is described below in *Relative Value*.

WBCPL contains loss absorption triggers (Capital and Non-Viability Trigger Events) via conversion/write off, that are typical across Basel III AT1 securities, making them equity-like. If either of these events are triggered, investors face the risk of substantial capital loss. We consider the probability of such an event to be reasonably remote given WBC's sound capital position, but it is a risk investors need to be aware of.

The WBCPL Offer comprises: a Reinvestment Offer to clients of Syndicate Brokers and Institutional Investors who are Eligible WBCPE Holders; and a New Money Offer to eligible clients of Syndicate Brokers and Institutional Investors. As a result of the DDO regime, there is no specific offer for WBC security holders or the general public. An Eligible WBCPL Applicant is a Wholesale Client of a Syndicate Broker or a Retail Investor who is a client of a Syndicate Broker within the Target Market and has received personal financial advice from a licensed financial adviser to acquire WBCPL. Applications under both offers can only be made to Syndicate Brokers and not directly to WBC.

The Offer is expected to open on [29 June] 2022 and close on [14 July] 2022. The Bookbuild opens on [21 June] 2022 and closes on [28 June] 2022. Eligible clients of Syndicate Brokers and Institutional Investors can bid during the bookbuild process, which commences after the Prospectus is lodged on [21 June] 2022. The margin is expected to be announced on [28 June] 2022. Eligible WBCPE Holders can:

- Reinvest all or some of your WBCPE holdings into WBCPL via the Reinvestment Offer, subject to minimum reinvestment criteria. Eligible WBCPE Holders can also apply for additional WBCPL units through the New Money Offer. Investors that participate in the Reinvestment Offer will receive the final distribution on [23 September] 2022. Any remaining WBCPE holdings not reinvested will be redeemed for cash at face value (\$100 per security) plus payment of the final distribution on [23 September] 2022, unless they have already been sold on-market.
- Take no action and all WBCPE holdings will remain on issue until the first call date of [23 September] 2022, at which point all outstanding holdings will be redeemed for cash at face value plus payment of the final distribution, unless they have already been sold on-market.

WBCPE investors can sell their holdings on-market at the prevailing market price up to the last trading date, which is expected to be [13 September] 2022.

If an Eligible WBCPE Holder wants to continue to have exposure to WBC AT1 Notes reinvest in the new security. If they want to cash out, taking no action to have the Notes redeemed is preferable to selling on-market as there is price certainty and no

brokerage costs.

Ineligible WBCPE Holders will have holdings redeemed on the [23 September] 2022 call date for cash at face value plus payment of the final distribution, unless they have already been sold on-market.

Positive / Negative Risk Factors

What factors would change the Recommendation **UP**

- **Favourable Industry Dynamics.** The major domestic banks continue to benefit from favourable industry dynamics that support high market share. Supported by the four pillars policy, which maintains the separation of the four largest banks, the Major Banks (ANZ, CBA, NAB, WBC) dominate domestic banking. This includes residential mortgages and corporate lending. Despite the non-Major Bank lending drive gaining traction in recent years, the dominance of the four Major Banks looks set to continue for many years.
- **Strong Capital Position.** WBC, like its Major Bank peers, maintains a strong capital position. APRA's focus for the Banks remains common equity capital, with the expectation that the Major Banks are compliant with its updated benchmark of "unquestionably strong" minimum Common Equity Tier 1 (CET1) ratio of 10.25% of risk-weighted assets (RWAs) effective 1 January 2023. The domestic Major Banks now have a significant loss absorption cushion through earnings, capital, and loss provisioning, which are the primary defences against credit impairments.
- **Transparent Regulatory Oversight.** APRA continues to implement disciplined controls over domestic banking operations. Often stricter than banking peers globally, APRA has also displayed a willingness to work with the industry during times of stress to ease any headwinds where possible. Furthermore, APRA continues to work with the industry to support improved transparency which has come in many forms over the years.
- **A Supportive AAA-rated Federal Government.** As witnessed during the GFC, and most recently the COVID-19 crisis, domestic banking benefits from a supportive government. A recent example includes the provision of the Term Funding Facility for the industry to support lending to businesses. It is possible Australia may lose its AAA-rating in the medium-term, but this is not expected to impact levels of government support.

What factors would change the Recommendation **DOWN**

- **Regulatory Risk.** Banking remains a highly regulated industry, and regulation often comes at the expense of higher profitability. The Financial Services Royal Commission is one such example of the potential impact of regulatory risk, whereby regulators determined the industry had to make changes to its business model. In some instances, these changes came at the cost of higher margin operations.
- **Capital Based Trigger Risk.** This security includes Capital and Non-Viability Triggers Events. A Capital Trigger Event requires the Issuer to immediately convert all, or some, securities into ordinary shares if the CET1 ratio equals or falls below 5.125%. If conversion does not occur for any reason, the Notes will be written off and all Holders' rights will be terminated. The Non-Viability Trigger Event allows the principal of the security to be converted to common equity or written down when APRA deems the Bank to be non-viable. These remain low probability events in our view, considering the strong capital positions of the domestic banks. If breached, investors are at risk of substantial capital losses.
- **Subordination.** This security is heavily subordinated to the Issuer's capital structure and its features reflect this. For example, distributions are discretionary, non-cumulative and subject to payment conditions. Although we do not anticipate any failure on the part of the Issuer to meet its distribution payments, there is precedent overseas and this cannot be ruled out in a worst-case economic backdrop scenario.
- **Uncertain Macroeconomic and Geopolitical Environment.** Whilst unemployment and interest rates have been at historic lows, Australia and its banking system are now subject to strong inflationary forces. There is little evidence as to how this will change consumer behaviour in a new-aged technology economy. Supplementary risks to the banking system include that of geopolitical tensions and further COVID-19 risks in the form of new variants. This uncertain environment also exists at the same time that housing prices are elevated and debt-to-income levels are at historic highs.

Issuer Outlook - Stable *as at 21 June 2022*

It is over two years since the first case of COVID-19 was detected in Australia and the state of the Australian economy, bank balance sheets, and household finances are better than most expected in early-to-mid 2020. Relatively benign health impacts of the virus on the local population compared to other countries, combined with monetary and fiscal measures, including cuts to interest rates, JobKeeper and JobSeeker, temporary loan deferral arrangements, and access to superannuation, helped soften the economic consequences of the pandemic. This helped cushion the impact on banks and households. Australia now appears to have moved closer to living with COVID, so risks have lessened.

Bank balance sheets have remained strong. Bank common equity capital, the most equity-like and loss-absorbing part of a bank's capital structure, as measured by CET1, exceeds unquestionably strong requirements. This has been aided by several factors, including banks remaining profitable, APRA imposed restrictions on dividends and capital management initiatives in 2020, and the release of capital from asset sales amongst the Big Four Major Banks which are returning their focus to banking post the Hayne Royal Commission.

We expect bank revenues to be supported by reasonable, albeit slowing lending growth in 2H22, however, net interest margin (NIM) is expected to remain under pressure from relatively high levels of liquid assets, intense competition, and front-to-back book churn on debt. Rising interest rates should however be a positive and generate higher income on liquids and

capital. Banks should be able to manage operating costs tightly, but this needs to be balanced with maintaining appropriate levels of investment across the business, as some have been caught out by underinvestment in the past.

Rate cuts, the strength of the economy, increased household savings, stronger consumer balance sheets, and higher asset prices have seen household balance sheets strengthen and improve debt serviceability. Such conditions in a rising interest rate environment are expected to reverse, however, this takes time. Furthermore, there are growing risks to asset quality on the horizon in such an interest rate environment.

Overall, the domestic banking outlook remains challenging, but operating conditions are better than they were in 2020 and certainly not as bad as originally anticipated. Importantly, the banking industry continues to benefit from strong regulatory and government support. On balance, we believe the 2022 outlook for banking profitability is better than it was in 2020, due to the outperformance of the economy. That said, we remain wary of risks to growth and asset quality from higher interest rates. Healthy capital, funding, liquidity and loss provision levels, leaves the sector well-placed to manage the risk of higher loan impairments.

We retain a **Stable** view on the outlook for banks. In time, competitive and structural pressure on margins should normalise, however, this will likely be in parallel with a slowdown in lending volume as rates rise. We expect pressure on housing prices, and therefore asset quality, from higher mortgage rates. Hopefully this does not coincide with a normalisation of provisions and release of capital through buybacks and dividends. This remains fluid and our banking outlook going forward will likely be contingent on the housing market dynamic. Ultimately, it will be the strength of the Australian economy, particularly employment levels, that will determine the extent of decline in the quality of home lending books in a rising rate environment.

Despite not providing earnings guidance for FY22, WBC is relatively optimistic on the 2022 economic outlook for Australia, forecasting above average GDP growth, but expects growth to slow in 2023. The Bank remains focused on continuing to improve its risk and compliance management, alongside simplification of the Bank, by moving back to its core business of traditional banking and modernising the IT platform.

Operationally, management aim to improve mortgage lending performance while working towards an aggressive cost target for FY24. 2H22 costs are guided to be 0-2% lower than 1H22, but the FY24 \$8 billion per annum cost target appears optimistic considering it assumes inflation of 2.5% over FY22-24. NIM should benefit from rising interest rates, however we view risks to be on the downside from intense competition, particularly as we head into a slower lending growth environment. The Bank will have to carefully balance lending growth with NIM management and maintaining credit underwriting standards.

We maintain a **Stable** view on WBC's credit outlook based on its sound capital, funding, liquidity positions and loan loss provisioning levels.

1H22 Issuer Commentary

The following discussion is based on the most recent financial statements for the half-year ending 31 March 2022. All figures are in AUD unless otherwise indicated.

Earnings

WBC delivered an underwhelming result for the six months ending 31 March 2022, albeit ahead of consensus estimates. 1H22 cash NPAT fell 12% on 1H21 to \$3.10 billion. Excluding notable items, cash NPAT was down 19% to \$3.10 billion.

The underlying performance was weak compared to 1H21. Core earnings, which exclude notable items, impairment charges and tax was down 10% to \$4.59 billion. This reflected considerable net interest margin (NIM) compression, subdued Australian mortgage loan growth and lower non-interest income, which was partially offset by a reduction in operating costs. Lower operating costs saw 1H22 core earnings increase 6% compared to 2H21, though revenue performance was soft. Asset quality improved further, while capital, funding and liquidity metrics remain healthy. We maintain a **Stable** view of WBC's credit outlook.

Net interest income excluding notable items fell 4% on 1H21 primarily due to a 24 basis point contraction of NIM to 1.85%, largely the result of competition, loan mix changes and higher liquids. Total lending was up 5% over the year with Australian mortgage growth of 3% lagging the market as investor lending fell. Australian business lending performed better with growth at 10%. The New Zealand lending book was up 4% (in NZD terms) as higher housing lending was partly offset by lower business and personal lending. Non-interest income excluding notable items fell 13% on lower wealth, insurance, and trading income.

Cost performance was a feature. Operating costs before notable items declined 2% to \$5.14 billion compared to 1H21, as the benefit of productivity initiatives, lower software amortisation and third-party expenses offset increased staff spending to strengthen compliance and risk management. With total income excluding notable items down 6% to \$9.72 billion, the cost to income ratio deteriorated from 50.6% to 52.8%. WBC reaffirmed its \$8 billion operating cost base target by FY24 to be driven by digitisation, benefits from simplifying the business, divestments, and lower restructuring costs.

Impairment expense was \$139 million in 1H22 compared to a net positive (benefit) of \$372 million in 1H21 and \$218 million benefit in 2H21.

Capital

The Bank's capital position remains sound despite a decline in the CET1 ratio. It is comfortably above APRA's new 10.25% "Unquestionably Strong" benchmark effective 1 January 2023 and WBC's 11.0-11.5% internal target effective 1 January 2023. The CET1 ratio declined 99 basis points over the six months to 31 March 2022 to 11.33%, as the benefit of 1H22 earnings was outweighed by growth in risk weighted assets (predominantly due to higher interest rate risk in the banking book), payment of the final FY21 dividend and completion of the share buy-back.

An interim fully franked dividend of 61 cents per share was declared, up 3 cents on 1H21. This represents a 69% payout of cash NPAT excluding notable items versus a target of 60-75%. A DRP is in place for the interim dividend that will be satisfied by the purchase of shares on-market.

Asset Quality

Overall asset quality improved over the six months to 31 March 2022 with stressed exposures (watchlist, 90-day past due and impaired loans) as a percentage of total committed exposures reducing 26 basis points to 1.10%. Within this, watchlist loans were 9 basis points lower at 0.40%, 90-day past due loans declined 12 basis points to 0.56% and impaired loans were down 5 basis points to 0.14%.

Credit loss provisions were 6% lower as the benefit of improved asset quality was partly offset by increases to economic overlays to reflect higher risks due to a number of factors including rising interest rates, inflation, supply chain disruptions, geopolitical uncertainty and the impact of recent floods. Total provision coverage stood at 1.30% of credit risk weighted assets and remains above pre-pandemic levels of 1.07% at 2H19.

Funding and Liquidity

WBC has strong funding and liquidity levels with key metrics well above regulatory minimum levels of 100%. The quarterly average liquidity coverage ratio (LCR) increased 8 percentage points to 137% over the half to 31 March 2022, while the net stable funding ratio (NSFR) was steady at 125%. The customer deposit to loan ratio increased from 81.6% to 83.5%.

Bank funding and liquidity profiles have benefited from the RBA's Term Funding Facility (TFF) and Committed Lending Facility (CLF) implemented during the onset of the pandemic in 2020. However, drawdowns from the TFF ended on 30 June 2021 and the CLF will be phased out to zero by the end of 2022. We expect WBC to successfully manage the task of replacing its \$27.75 billion remaining allocation of CLF with additional High Quality Liquid Assets (HQLA) over the phasing out timeframe. LCR excluding the CLF was 118%.

Relative Value

Relative value is difficult to attain for this offer, as a function of more recent volatility across secondary trading in bank capital structures coinciding with the substantial delay between the launch date and commencement of trading on a normal settlement basis, as is typical of an AT1 issuance. Fair pricing judgement of WBCPL is further clouded by the newly implemented DDO scheme, along with the interest rate cycle. Accordingly, our analysis is viewed through a number of different lenses.

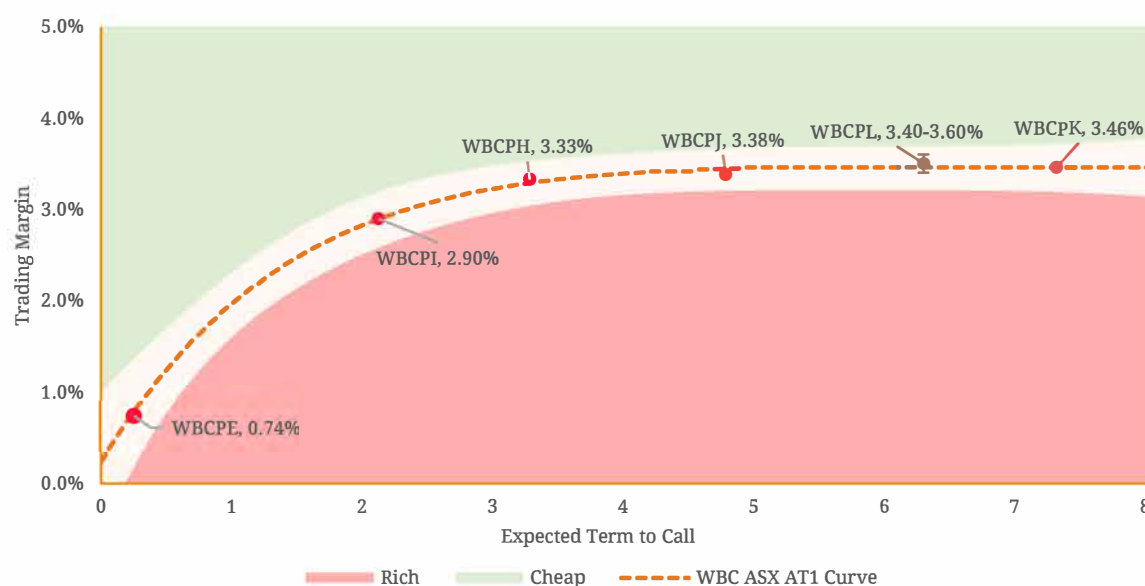
Firstly, we examine, WBC's outstanding ASX AT1 securities. Secondly, we analyse Big Four ASX AT1 securities. Finally, we look to understand what is an appropriate concession – with reference to market volatility, liquidity and historical concessions offered by ASX hybrids. **In summary, the guided margin range of 340-360bps screens as fair value at the mid-point, noting the concession is small compared to prior primary issuance.**

Issuer Comparables – WBC ASX AT1

The first screen of relative value for WBCPL is through the comparison of current secondary trading AT1 securities from the Issuer itself; Westpac. Due to the relatively high number of outstanding securities available as reference points for the Issuer curve, along with WBCPL placing within two data points, we view the fair value attained via interpolation as a good estimation. That said, following the recent sell-off, WBC's AT1 securities are pricing at more scattered levels to the Issuer curve than usual, obscuring the certainty we had in this lens of relative value.

Against the Issuer curve, a margin range of 340-360 basis points (bps) appears fair. We note the lack of term premium in credit spread, however this has been typical of AT1 markets more recently. Prior to COVID, a premium of anywhere between 5-15 basis points for an extra year of tenor was present, however more recently this has been 0-5bps. With WBCPJ trading at a margin of ~338bps and having a first call date being circa 1.5 years before WBCPK, the 340-360bps range screens on the richer side of fair, however we note more recent secondary trading volumes have been relatively small (i.e. 5-day value traded for WBCPJ is \$7.4 million, which is 4.3% of the outstanding amount).

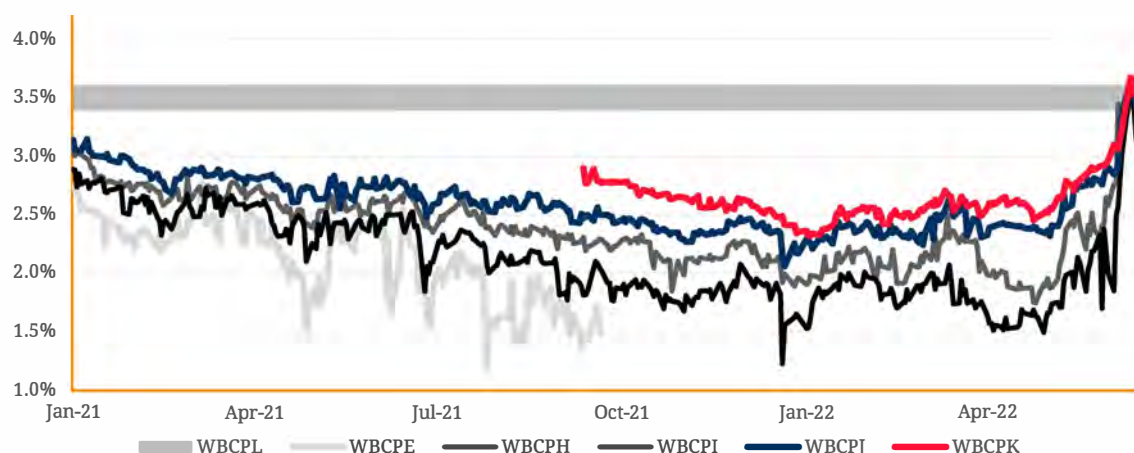
Figure 3. BondAdviser Valuation: WBC ASX AT1 Curve – Trading Margin



Source: BondAdviser Estimates, ASX. As at 20 June 2022.

As seen in Figure 3, using the volatilities (in terms of constant tenor trading margins, based on the prior six years of data) of the Big Four AT1 curve (a more robust estimator than the WBC securities alone), WBCPL screens as fair value to secondaries. We note again that interpolation to the six and a quarter year marker leaves room for error, and as such we later look to the ASX Big Four AT1 curve for another lens of relative value, as that universe has a larger number of reference points and more importantly, secondaries that are more closely tenored in terms of expected term to call.

Figure 4. WBC Existing ASX-Listed Hybrid* Historical Trading Margins & WBCPL



Source: BondAdviser; ASX. As at 20 June 2022. *Trading margin data for WBCPE ceases one year prior to the expected call date due to the impact of annualisation.

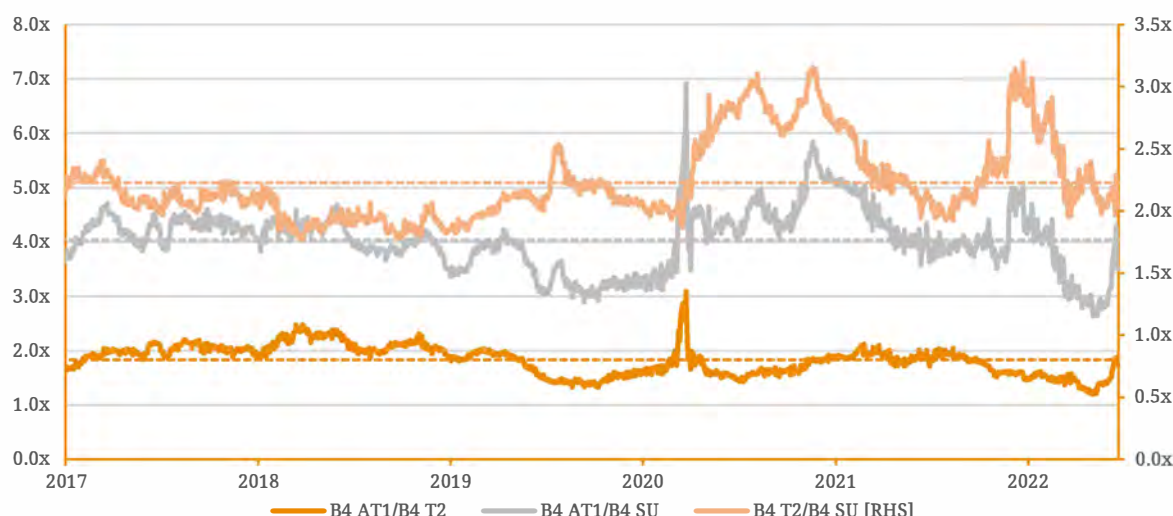
Credit Quality and Security Structure Comparables – Big Four ASX AT1

The critical portion of our relative value analysis pertains to value against ASX-listed Big Four AT1 hybrid alternatives. We view both credit fundamentals and security structures as being largely similar at the fundamental level and near identical at a structural level.

Historically, in our opinion, valuation of new AT1 hybrids placed greater emphasis on multiples analysis between constant tenor trading margin alternatives across a bank's wholesale debt capital structure. In other words, Tier 2 bonds were priced off senior unsecured bonds and AT1 hybrids were priced off Tier 2 bonds. Whilst this is an over-simplification, we view multiples analysis as being less relevant today, given that since COVID, any normalisation of multiples has not consistently occurred. Whilst in time, we believe multiple analysis will return, we currently feel the lack of stability in multiples makes for little certainty in valuation. There is good merit also to suggest that AT1 hybrid multiples should fall as structural change has occurred both at the capital structure and security structure level. Banks now have more robust provisions and higher levels of capital. Additionally, the newer hybrids containing multiple call dates (where resale or redemption for cash is possible – as compared to conversion), in our view, makes the securities more predictable.

Nonetheless, using the average multiple (1.83x) between Big Four AT1 and Tier 2 securities at a constant tenor back to 2017, we calculate a fair value estimate of 353bps. When using 1.75x this equates to a 337bps fair value estimate. Whilst these multiples are calculated for a 5-year constant tenor, at the term to call for WBCPL is ~6.25, the lack of term premium at the long end provides us with greater comfort in the estimate. Whilst we place little weight here, we note that such a fair value estimate range is consistent with our other methods for delineating fair value.

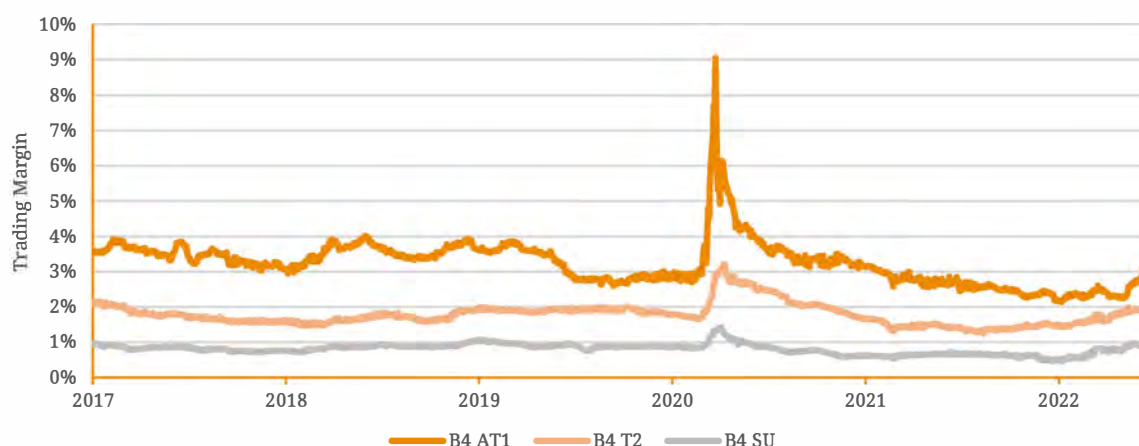
Figure 5. Big Four AUD 5-Year Constant Tenor Debt Capital Structure Multiples



Source: BondAdviser Estimates. As at 20 June 2022. Dotted lines indicate series average.

From the beginning of 2022, a pattern emerged driving the reduction in relevance of the above multiples analysis. Trading margins consistently rose for senior unsecured and Tier 2 bonds for the proceeding months, while AT1s held near all-time tight, until a gapping wider starting in mid-May. The rising margins across all classes of bank capital structure, regardless of the lag and speed at which they occurred, are a function of many reasons not limited to: (1) term funding facility (TFF) refinancing; (2) changes to high quality liquid asset (HQLA) criteria that can be held by bank treasuries; (3) additional total-loss absorbing capacity (TLAC) requirements of capital, which is set to increase the supply of Tier 2 bonds; (4) offshore debt markets selling-off on inflationary and now recessionary fears.

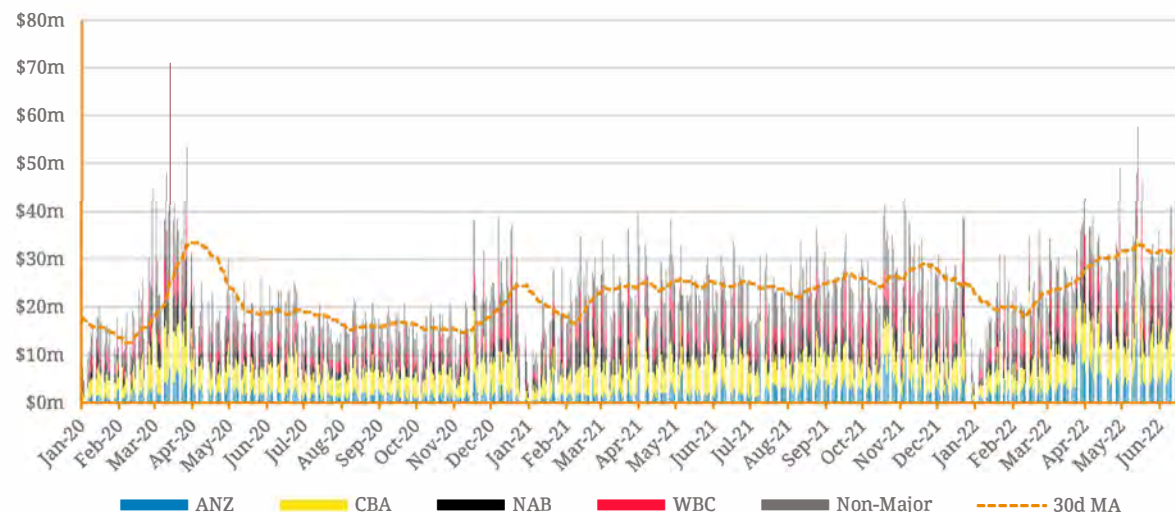
Figure 6. Big Four AUD 5-Year Constant Tenor – Trading Margins Across Debt Capital Structure



Source: BondAdviser Estimates. As at 20 June 2022.

We view the substantial and rapid sell-off in AT1 hybrid trading margins being reflective of a normalisation to more reasonable multiples, however, we do also note that 30-day average volumes in the ASX market have been relatively elevated prior to recent history – undoubtedly this was driving some price pressures.

Figure 7. ASX Hybrids Daily A\$ Volumes and 30-Day Moving Average



Source: BondAdviser, ASX, Bloomberg. As at 20 June 2022.

We can compare the current indicative offering to the historic movement in trading margins at the 6.25-year constant tenor of the Big Four AT1 curve (we note here this includes the OTC Big Four hybrids as part of the derivation – reflective of the delta to the curve in Figure 10) as another lens of relative value. Such analysis contextualises valuation through time, as compared to the strictly point-in-time analysis that is undertaken with our curve calculations. As depicted in Figure 8, prior to more recent times, trading margins across the Big Four AT1 space at the 6.25-year tenor generally trended downwards post-COVID. As already discussed, we view the drastic move wider to be one of normalisation and viewed the lows established in 2021 and early 2022 to have been extraordinarily low. At the offered trading margin of 340-360bps, the constant tenor margin screens valuation as fair. The inclusion of and consequent impact of the OTC securities here means we limit emphasis to such analysis but highlight that the spread offered appears more attractive due to the 25bps fall over the past six calendar days.

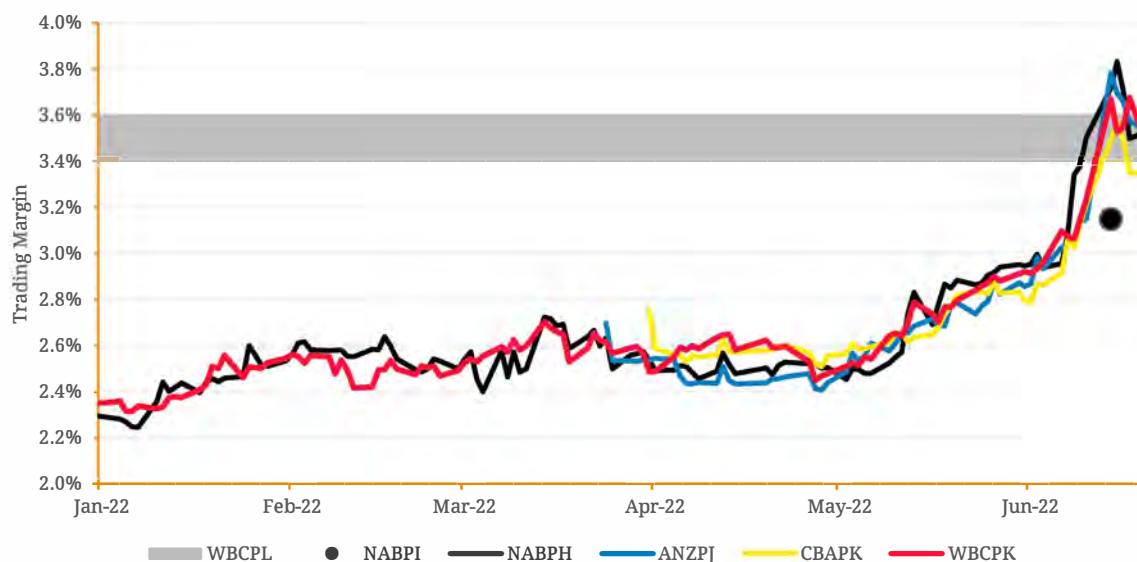
Figure 8. WBCPL Issue Margin Range to Big Four AUD AT1 Constant Tenor 6.25-Year Trading Margin



Source: BondAdviser Estimates. As at 20 June 2022.

We can further compare the offering to recently issued AT1s from the Big Four in CBAPK (issued at 275bps, with an initial 7.25-years to expected call), ANZPJ (issued at 270bps, with an initial 7-years to expected call), WBCPK (issued at 290bps, with an initial 8-years to expected call) and NABPI which although yet to be issued, the bookbuild was completed at a margin of 315bps and an initial 7.5 years to expected call. An important point to note is that unlike Figure 8, Figure 9 does not show trading margins at a constant tenor of 6.25 years, rather the chart below illustrates the movements in margins of newly issued securities which have similar terms to first call. In terms of the most recent issues: ANZPJ and CBAPK initially traded quickly into fair value, with new issue spreads compressing on “DDO orphan” buying before flatlining until late April. Spreads have clearly widened since early May across these new issues, with CBAPK trading 55bps higher and ANZPJ 67bps higher from the start of the month to 20 June 2022.

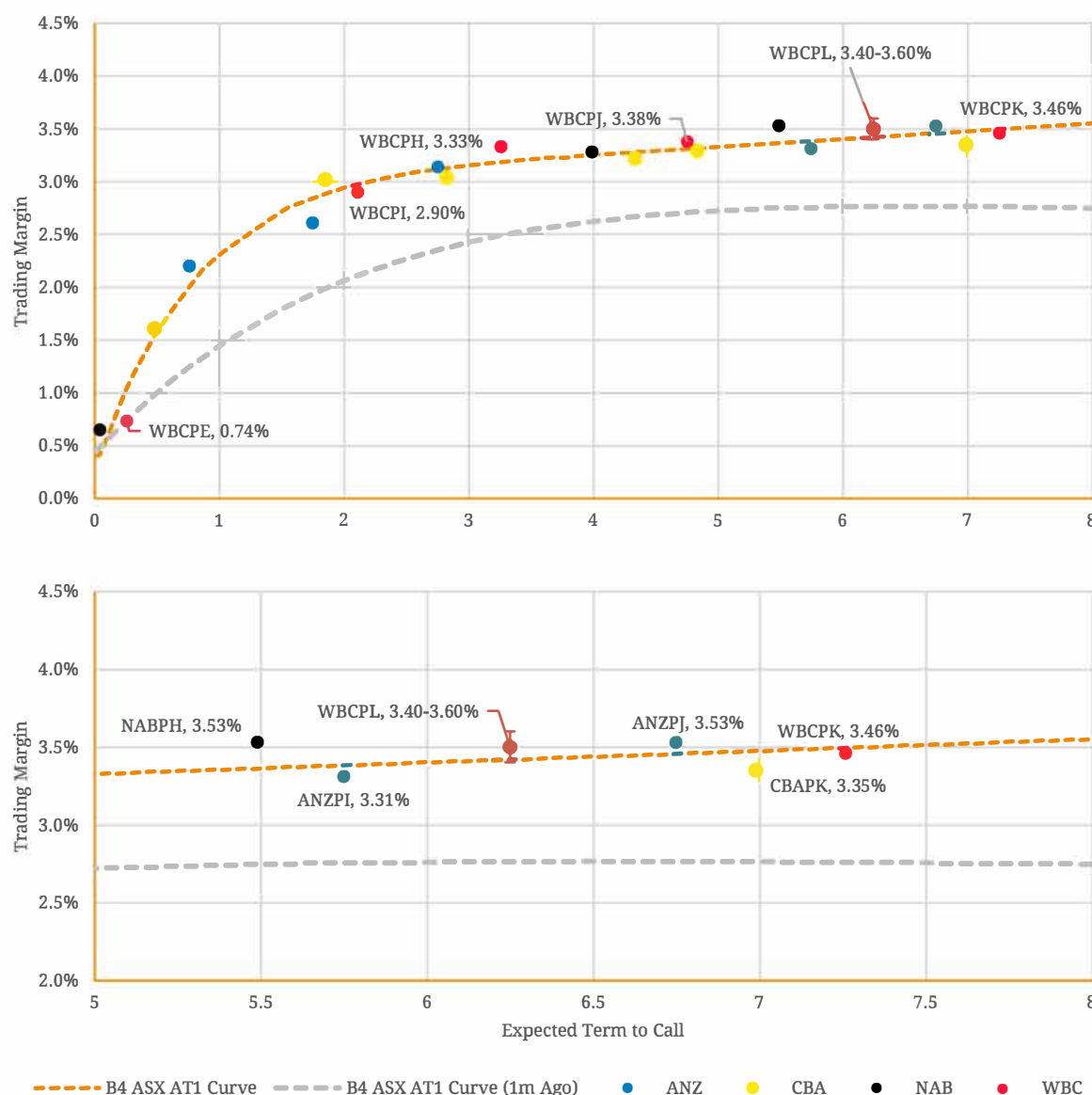
Figure 9. Recent New Issue Trading Margins & WBCPL



Source: BondAdviser, ASX. As at 20 June 2022.

Turning to the ASX Big Four AT1 hybrid curve, the aforementioned volatility has seen variance amongst secondaries with respect to residuals. In simpler terms, more recently, secondary pricing has exhibited a tendency to fit further away from the curve than close to the curve in aggregate. What this means is that the margin of error for curve derivation is wider. Accordingly, based on secondaries, we place fair value of the 6.25-year tenor for ASX Big Four AT1 hybrids to be between 335-340bps.

Figure 10. ASX Big Four AT1 Hybrid Curve – Trading Margin

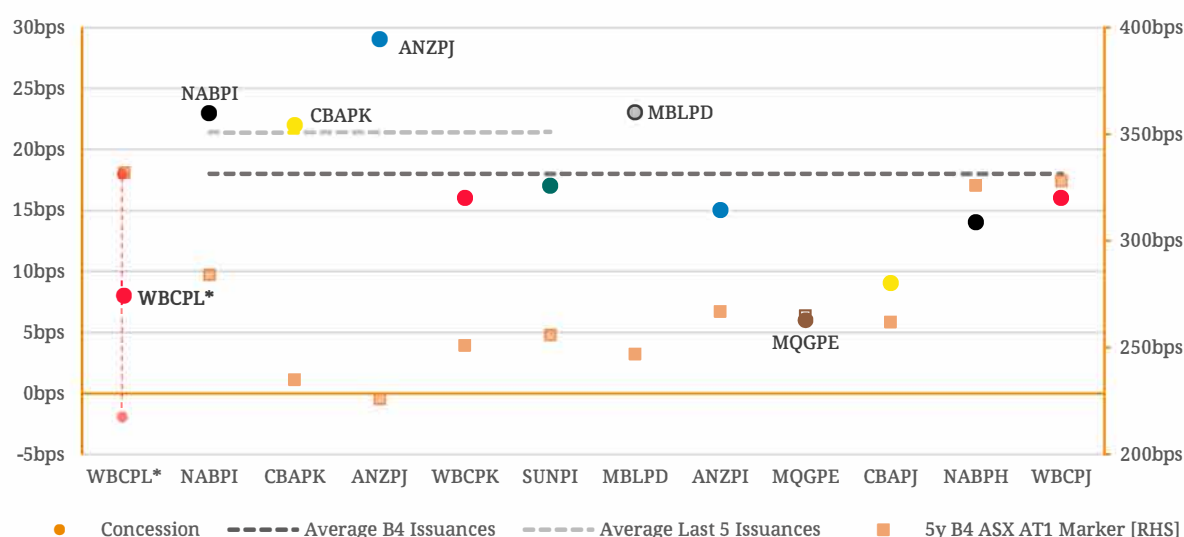


Source: BondAdviser Estimates, ASX. As at 20 June 2022.

Fair value is only one portion of understanding relative value upon primary issuance. Additional to fair value against secondaries, we need to understand what is an appropriate new issue concession to the curve. Concessions are provided for several reasons not limited to: compensating for the uncertainty between pricing and settlement, as well as accounting for recent volatility. It can be argued that this can be somewhat offset by pricing certainty that is offered in size, however such an argument falls flat empirically as seen in Figure 11.

Looking across the last ten ASX AT1 hybrid concessions, an average 17bps surplus to fair value was provided. Across the last five ASX AT1 hybrid deals, the average concession has been 21bps. When just looking at Big Four issuers, based on the last five primaries, this concession remains the same at 21bps. For WBCPL, at the mid-point of the range, the concession offered to the Big Four ASX AT1 hybrid curve would be 8bps. Such a concession is small compared to history and recent issuance – in our opinion the concession would be the smallest since MQGPE launched in February 2021.

Figure 11. New Issuance Concessions vs Constant Tenor B4 AT1 5y Trading Margin at Time of Issuance



Source: BondAdviser Estimates. As at 20 June 2022. * WBCPL marker shown at the mid-point. Averages exclude WBCPL.

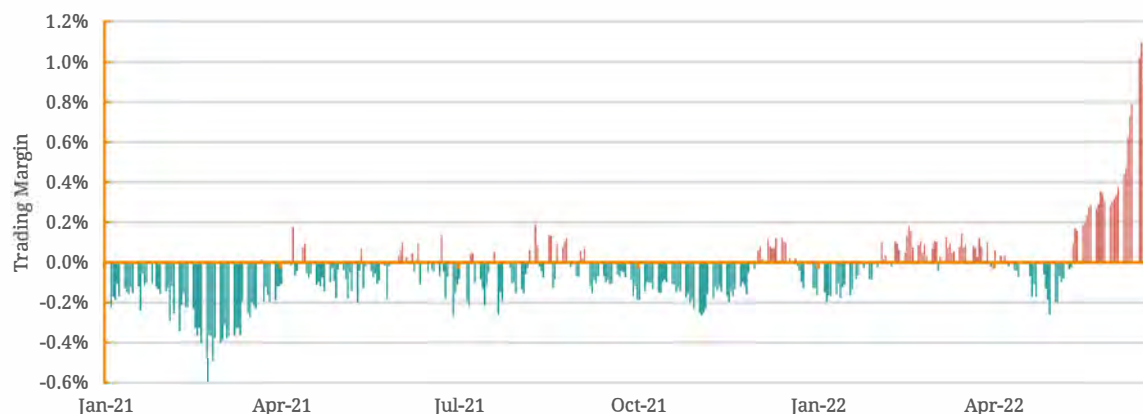
In terms of what is a fair concession for WBCPL, we take the historical averages as a good guide but build on this by incorporating an analysis of volatility with respect to trading margins. Recent volatility, as seen in Figures 12-13, has increased and spreads have pushed wider as previously mentioned. In our opinion, such higher volatility means the concession offered should be larger than the historical average. This would only be the case on the right-hand side of the issue margin range. Importantly, we still see valuation as fair, ultimately the concession is modest but this is a function of secondary trading, which has seen just ~\$255 million in value traded for the Big Four ASX AT1 since the launch of NABPI on 6 June. This equates to ~1% of our par value for our equivalent index. At the same time, NABPI, at a tenor of ~7.5 years and margin of 315bps saw over \$2 billion in bookbuild demand.

Figure 12. 30-Day* Constant 6.25-Year Tenor Moving Standard Deviation – Trading Margin



Source: BondAdviser Estimates. *Indicates trading days. As at 20 June 2022.

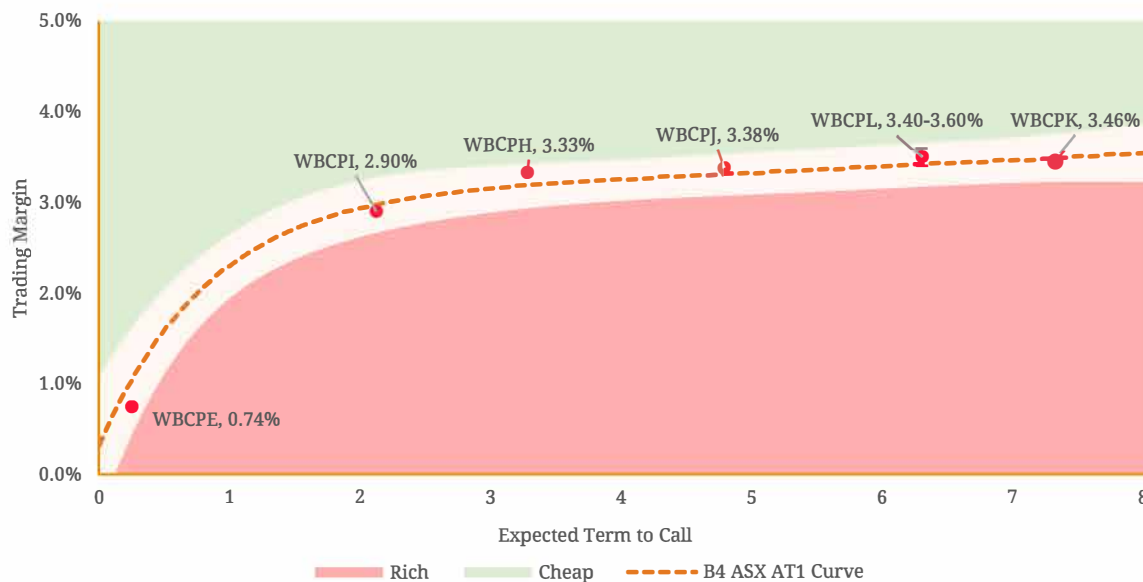
Figure 13. 30-Day* Change in Constant 6.25-Year Tenor Trading Margin



Source: BondAdviser Estimates. *Indicates trading days. As at 20 June 2022.

Our final curve, which incorporates volatility of constant tenors in delineating rich / cheap boundaries, plots the ASX Big Four AT1 hybrid curve, with the WBC issuances highlighted against this. Accordingly, at an issue margin of 340-360bps, on the left-hand side of the range the pricing sits at fair value, whereas the upper-bound offers a suitable concession and we would scale allocations accordingly.

Figure 14. BondAdviser Valuation: AUD B4 ASX AT1 Curve – Trading Margin



Source: BondAdviser Estimates, ASX. As at 20 June 2022.

Hybrid Commentary

Issuer Overview

Australia's first bank, Westpac Banking Corporation (ASX: WBC), is one of the four Major Banks that primarily operate across Australia and New Zealand. By market capitalisation it ranks as the third largest of the Big Four with a market capitalisation of around \$67 billion. Commonwealth Bank (CBA) is the largest with a market capitalisation of approximately \$150 billion, with National Australia Bank (ASX: NAB) capitalised at ~\$83 billion and ANZ Bank (ASX: ANZ) at ~\$59 billion.

The Bank provides a full suite of financial products and services to a wide variety of customers in Australia, New Zealand, Fiji, and Papua New Guinea. In Australia, WBC operates under the Westpac, St. George, BankSA, Bank of Melbourne, and RAMS brands. The Bank operates in New Zealand through its wholly owned subsidiary, Westpac New Zealand.

In Australia WBC is regulated by the Australian Prudential Regulation Authority (APRA), which sets minimum regulatory capital, funding, and liquidity levels for Authorised Deposit Taking Institutions (ADIs). In New Zealand, the Bank is under the prudential supervision of the Reserve Bank of New Zealand.

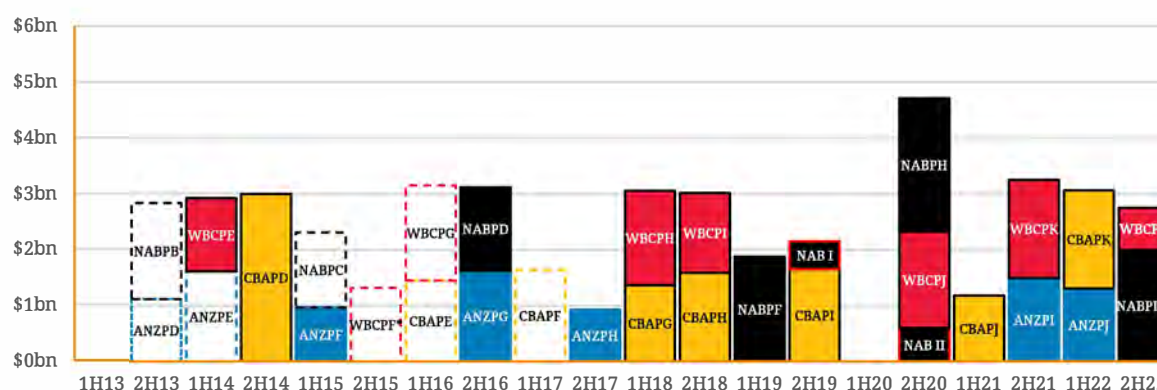
The Big Four are large and frequent issuers of AT1 and Tier 2 capital instruments, as these hybrid capital securities help meet their regulatory capital requirements. WBCPL will qualify as AT1 capital for WBC. AT1 securities have become popular amongst both retail and institutional investors. Key to this has been the pristine track record of Major Bank issuers with regards to paying distributions and meeting investors' principal call expectations. Additionally, investors are very familiar with the Major Banks as many are customers and shareholders.

A recent regulatory change, the introduction of a new target market determination (TMD) design and distribution obligation (DDO) regime effective 5 October 2021, has limited which investors can purchase AT1 securities in the primary market. Similar to recent AT1 transactions in 2022 by ANZ, CBA, and NAB, the WBCPL offer is limited to investors receiving personal financial advice and wholesale investors. This means a significant portion of retail investors will only be able to buy WBCPL in the secondary market, i.e., once the security is trading on the ASX. Depending on market conditions, this may result in higher demand in the secondary market if some retail investors that are locked out of the primary market, end up buying these securities in the secondary market. We previously estimated this to be around 20% of legacy noteholders. Such "DDO orphans" appeared to have some impact on the strong initial trading of ANZPJ and CBAPK, which commenced trading on 25 March 2022 and 1 April 2022 respectively. At this stage we do not know if this will be the case with NABPI, as this security begins trading on the ASX on 7 July 2022.

AT1 Issuance and Maturity Profile

As can be seen in Figure 15, the Big Four Major Banks are frequent issuers of listed AT1 securities, with a long history of issuance. So far, 2022 has been relatively busy for issuance with all four now having launched/issued AT1 deals over the past three months. NAB was the most recent, launching an offer for NABPI on 6 June 2022 seeking to raise \$1.0 billion, for this 7.5-year term to call AT1 issue. Demand for NABPI was very strong. We understand bids during the bookbuild exceeded \$3.1 billion, which saw the issue size doubled from \$1.0 billion to \$2.0 billion and the margin set at 3.15% p.a. above 90-day BBSW, which was the bottom of the guidance range.

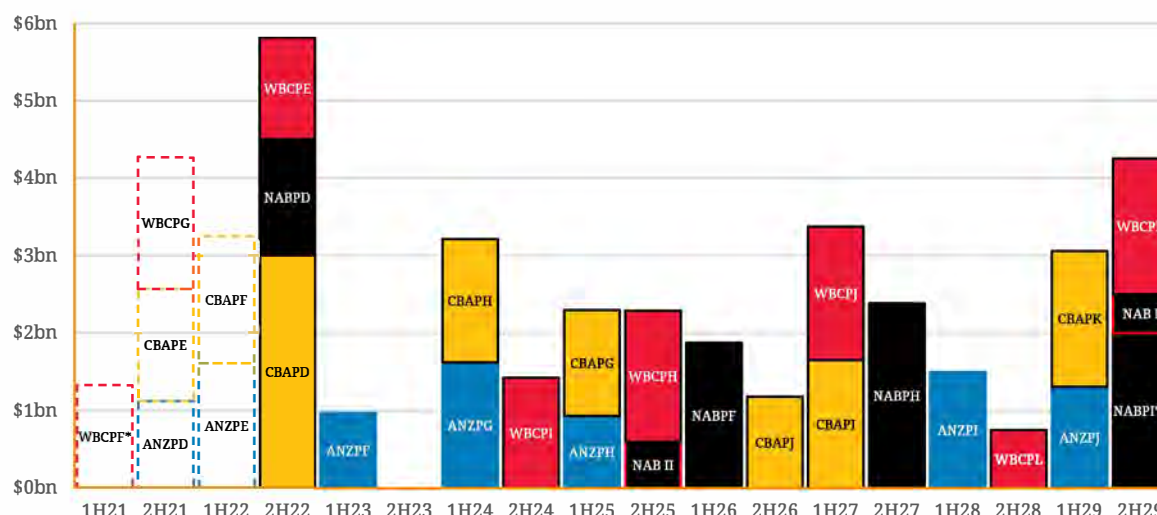
Figure 15. Major Bank AUD Hybrid Issuance



Source: BondAdviser. * WBCPF ~\$866m resold/reinvested into WBCPJ in Dec-20. The balance of \$454m was redeemed in Mar-21. ** Assumes \$2.0 billion issuance of NABPI as per the bookbuild. Dotted line with no fill indicates redeemed Notes. Assumes \$750 million issuance of WBCPL. NAB I and NAB II refers to NAB Wholesale Capital Notes I and II, respectively.

WBC has five ASX listed AT1 securities currently on issue (ASX: WBCPE, WBCPH, WBCPI, WBCPJ and WBCPK). The Bank's last AT1 issue was in September 2021 for Westpac Capital Notes 8 (ASX: WBCPK), which raised \$1.75 billion (first call September 2029) at a 2.90% p.a. margin above 90-day BBSW. Pertinent to the issuance and expected first call of WBCPL is such timing. Figure 15 illustrates that (inclusive of at least \$2.75 billion pricing shortly after June 30 2022), 1H22 has seen the most money raised in the Big Four AT1 market since the introduction of Basel III in January 2013. The three prior deals to WBCPL being ANZPI, CBAPK and NABPI were all issued to refinance ANZPE, CBAPF and NABPD respectively. The timing here for WBC could be viewed as inopportune given the Group are looking to raise funds after \$5.1 billion of demand has already been absorbed by the market this half (inclusive of the NABPI bookbuild). That said, the Group has limited AT1 hybrid market flexibility given the largest AT1 hybrid in CBAPD (\$3.0 billion) is due for refinancing next half – in that effect we view it as prudent in coming to market early.

Figure 16. Major Bank AUD Hybrid First Call Dates

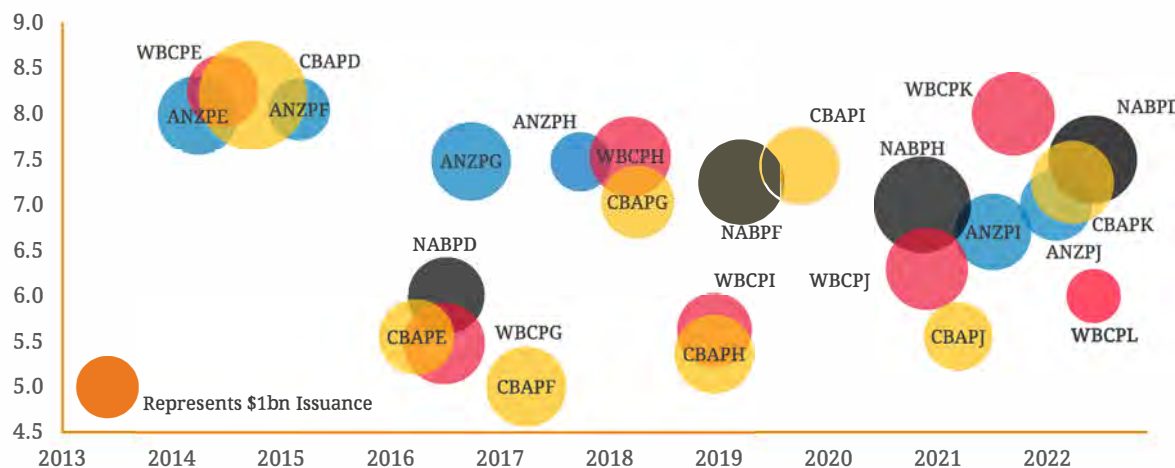


Source: BondAdviser; * WBCPF ~\$866m resold/reinvested into WBCPJ in Dec-20. The balance of \$454m was redeemed on Mar-21. ** Assumes \$2.0 billion issuance of NABPI as per the bookbuild. Dotted line with no fill indicates redeemed Notes. Assumes \$750 million issuance of WBCPL. NAB I and NAB II refers to NAB Wholesale Capital Notes I and II, respectively.

We view the placement of the first call date for WBCPL as strategically opportunistic, placing it in a half whereby there are no other deals requiring a refinancing. It is also well spaced for WBC's expected AT1 maturities.

Refinancing of existing securities tends to be the main driver of new supply. Each of the outstanding WBC issuances have been given a space of at least one half-year in order to ensure demand upon refinance can be adequately sourced. This prevents a stressful situation whereby the Group struggles to source sufficient demand for an unusually large maturity cliff. The WBCPK issue funded the \$1.7 billion roll of Westpac Capital Notes 4 (ASX: WBCPG). Similarly, proceeds from the WBCPL issue will be used to fund the redemption of WBCPE.

Figure 17. Major Bank Hybrid AUD ASX AT1 Tenor (to Call) by Issuance Year



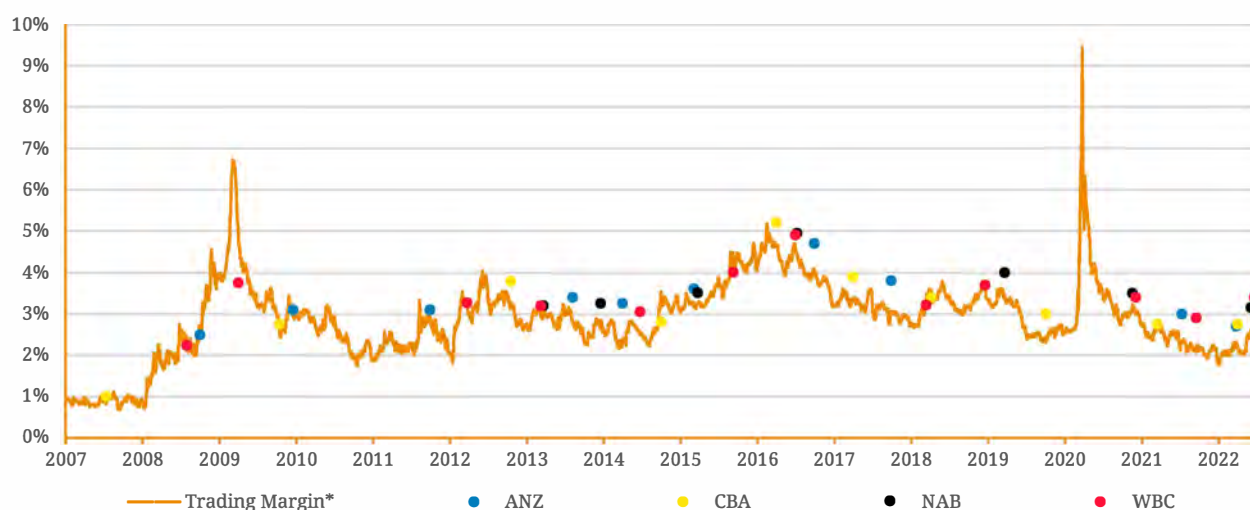
Source: BondAdviser. Assumes \$750 million issuance of WBCPL. Assumes \$2.0 billion issuance of NABPI as per the bookbuild.

AT1 issuance trends over the past few years loosely appear to suggest that in a risk-off environment, issue tenors typically fall, while issue margins and sizes increase. It also became apparent that in a low-rate environment, investors went further up the risk curve in the search for yield. This allowed the market to digest larger issue sizes at longer tenors with lower issue margins. However, risk appetites have and are abating rapidly, reflecting higher uncertainty from increased levels of volatility, rising interest rates, inflation, and geopolitical risks.

Although NABPI was offered with a higher credit spread, the size and tenor remained larger and longer respectively. Amongst the current volatile (and risk-off) market environment, WBCPL offers a shorter tenor, smaller size, and higher spread to recent history. Whilst WBC would rightly say this is a function of the Group's debt maturity management (than market conditions perse), WBCPL nonetheless represents the first Big Four AT1 hybrid to issue with a term to call tenor of ≤ 6.25 years since March 2021 (CBAPJ) – and the first time for WBC since WBCPI in December 2018.

Appendix 1. Historical Comparison

Figure 18. Big Four AUD Weighted Average Trading Margin, B4 AT1 Primary Issuance Margin*



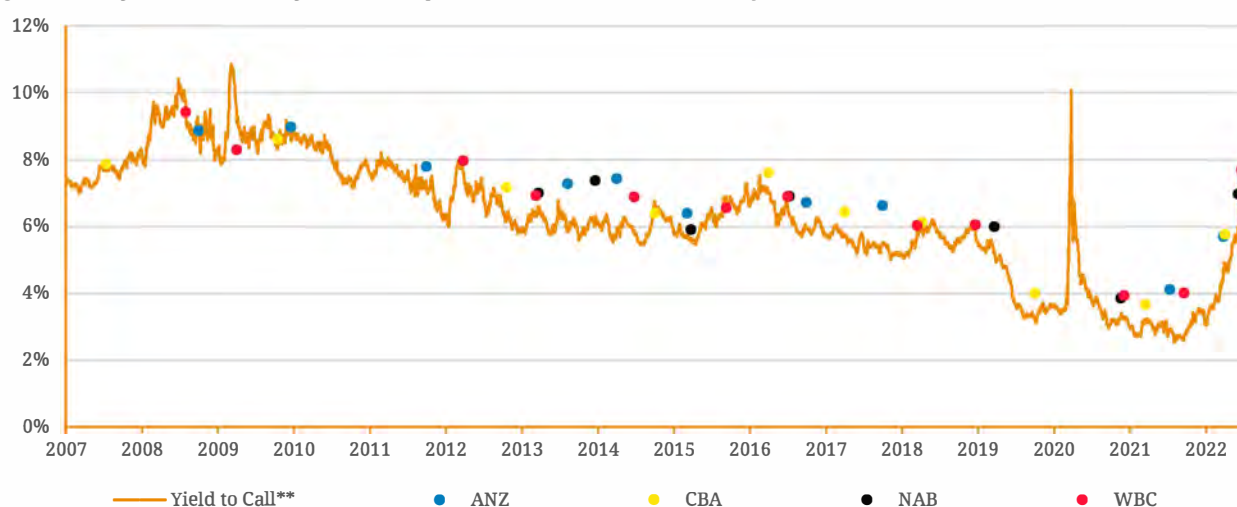
	Last	1m	3m	YTD	1y	3y	5y	Inception^
Trading Margin	3.18%	2.48%	2.21%	1.79%	2.58%	2.67%	3.59%	0.28%
%Δ		28.23%	43.89%	77.65%	23.26%	19.10%	-11.42%	1035.71%

Source: BondAdviser Index Platform: BAB4AT1DFTR. As at 20 June 2022.

* Weighted average based on market capitalisation. BAB4AT1DFTR is a franked, total return index that is rebalanced on a daily basis.

^Inception of BAB4AT1DFTR is 30/6/2004.

Figure 19. Big Four AUD Weighted Average Yield to Call, B4 AT1 Primary Issuance Yield to Call**



	Last	1m	3m	YTD	1y	3y	5y	Inception^
Yield to Call	7.44%	5.61%	4.27%	3.06%	3.14%	3.77%	5.80%	6.10%
%Δ		32.62%	74.24%	143.14%	136.94%	97.35%	28.28%	21.97%

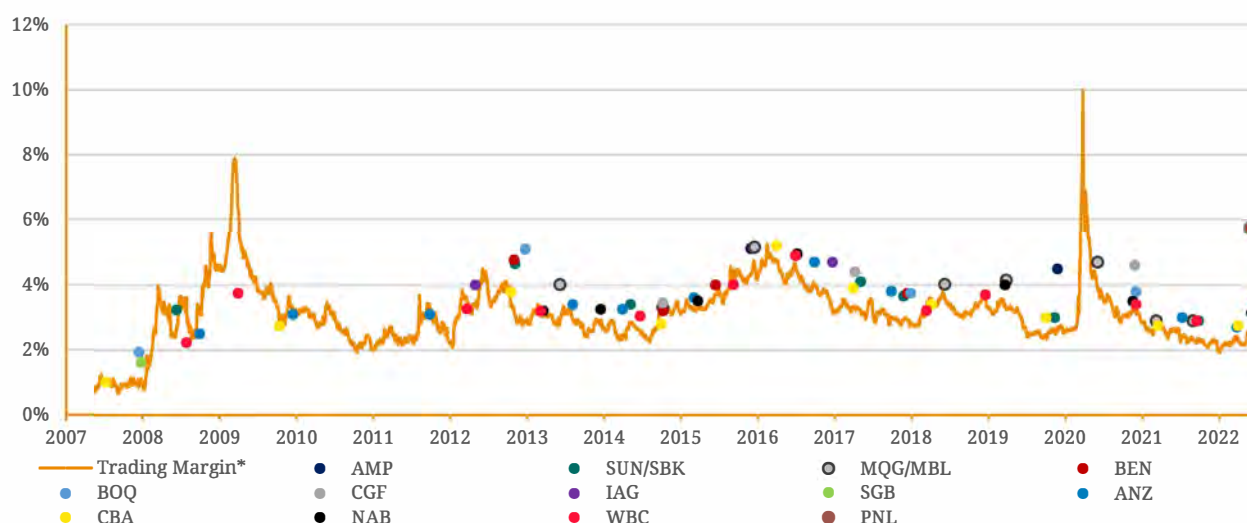
Source: BondAdviser Index Platform: BAB4AT1DFTR. As at 20 June 2022.

** Weighted average based on market capitalisation. BAB4AT1DFTR is a franked, total return index that is rebalanced on a daily basis. Yield to call based on BondAdviser estimates.

^Inception of BAB4AT1DFTR is 30/6/2004.

Appendix 2. Historical Comparison

Figure 20. All AUD AT1 Weighted Average Trading Margin, All AUD AT1 Primary Issuance Margin*



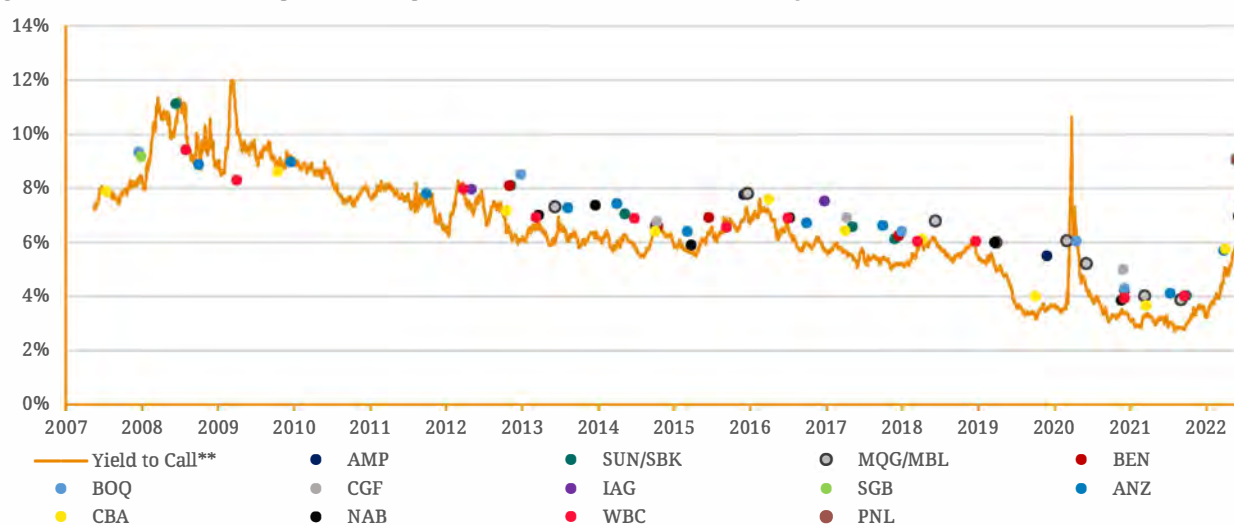
	Last	1m	3m	YTD	1y	3y	5y	Inception^
Trading Margin	3.30%	2.58%	2.34%	1.94%	2.65%	2.69%	3.58%	0.79%
%Δ		27.91%	41.03%	70.10%	24.53%	22.68%	-7.82%	317.72%

Source: BondAdviser Index Platform: BAAUAT1DFTR. As at 20 June 2022.

* Weighted average based on market capitalisation. BAAUAT1DFTR is a franked, total return index that is rebalanced on a daily basis.

^Inception of BAAUAT1DFTR is 17/5/2007.

Figure 21. All AUD AT1 Weighted Average Yield to Call, All AUD AT1 Primary Issuance Yield to Call**



	Last	1m	3m	YTD	1y	3y	5y	Inception^
Yield to Call	7.55%	5.73%	4.43%	3.24%	3.24%	3.80%	5.78%	7.26%
%Δ		31.76%	70.43%	133.02%	133.02%	98.68%	30.62%	3.99%

Source: BondAdviser Index Platform: BAAUAT1DFTR. As at 20 June 2022.

** Weighted average based on market capitalisation. BAAUAT1DFTR is a franked, total return index that is rebalanced on a daily basis. Yield to call based on BondAdviser estimates.

^Inception of BAAUAT1DFTR is 17/5/2007.

Westpac Banking Corporation: Financial Summary

Westpac Banking Corporation: Financial Summary

Recommendation Summary

Subscribe

21 June 2022

Profit and loss	2021	2020	2019	2018	Asset Quality & Provisions	2021	2020	2019	2018
Net Int. Inc. (\$m)	16,858.0	16,696.0	16,907.0	16,505.0	Provision Charge/GLA (%)	-0.08	0.45	0.11	0.12
Fee Income (\$m)	1,482.0	1,592.0	1,655.0	2,424.0	Gross Impaireds/GLA (%)	0.30	0.40	0.25	0.20
Trading Income (\$m)	719.0	895.0	929.0	945.0	Provisions/Impaireds (%)	54.44	41.45	44.92	46.12
Wealth & Insur. (\$m)	1,211.0	751.0	1,029.0	2,061.0	Coll. Prov./Credit RWA (%)	1.17	1.54	0.95	0.73
Other Income (\$m)	952.0	249.0	129.0	72.0	Provisions/GLA (%)	0.70	0.88	0.54	0.43
Total Revenue (\$m)	21,222.0	20,183.0	20,649.0	22,007.0					
Total Expenses (\$m)	-13,311.0	-12,739.0	-10,106.0	-9,566.0	Funding & Liquidity	2021	2020	2019	2018
Pre-Prov. Profit (\$m)	7,911.0	7,444.0	10,543.0	12,441.0					
Prov. Exp. (\$m)	590.0	-3,178.0	-794.0	-710.0	Net Stable Funding Ratio (%)	125.0	122.0	112.0	114.0
Taxation (\$m)	-3,038.0	-1,974.0	-2,959.0	-3,632.0	Liquidity Coverage Ratio (%)	129.0	151.0	127.0	133.0
Min. Int. & Prefs (\$m)	-5.0	-2.0	-6.0	-4.0					
Statutory NPAT (\$m)	5,458.0	2,290.0	6,784.0	8,095.0	Other Key Metrics	2021	2020	2019	2018
Adjustments (\$m)	-106.0	318.0	65.0	-30.0					
Cash NPAT (\$m)	5,352.0	2,608.0	6,849.0	8,065.0	NIM (%)	2.04	2.08	2.12	2.22
					Cost to Income (%)	63.1	61.6	48.6	43.8
Capital Adequacy	2021	2020	2019	2018					
CET1 (%)	12.32	11.13	10.67	10.63					
AT1 (%)	2.33	2.10	2.17	2.15					
Tier 1 Capital (%)	14.65	13.23	12.84	12.78					
Tier 2 Capital (%)	4.21	3.15	2.79	1.96					
Total Capital (%)	18.86	16.38	15.63	14.74					
Credit RWA (\$m)	357,295.0	359,389.0	367,864.0	362,749.0					
Market RWA (\$m)	6,662.0	8,761.0	9,350.0	6,723.0					
Op. RWA (\$m)	55,875.0	54,090.0	47,680.0	39,113.0					
Other RWA (\$m)	16,818.0	15,665.0	3,900.0	16,799.0					
Total RWA (\$m)	436,650.0	437,905.0	428,794.0	425,384.0					
Div. Payout (%)	79.30	48.90	88.80	79.50					
Balance Sheet	2021	2020	2019	2018					
Loans (\$m)	709,784.0	693,059.0	714,770.0	709,690.0					
Cash (\$m)	71,353.0	30,129.0	20,059.0	26,788.0					
Trading Assets (\$m)	21,101.0	40,667.0	31,781.0	23,132.0					
Investment Securities	83,417.0	91,539.0	73,401.0	61,119.0					
Intangibles (\$m)	10,109.0	11,497.0	11,953.0	11,763.0					
Other (\$m)	40,113.0	45,055.0	54,662.0	47,100.0					
Total Assets (\$m)	935,877.0	911,946.0	906,626.0	879,592.0					
Deposits (\$m)	626,955.0	591,131.0	563,247.0	559,285.0					
Debt Issues (\$m)	128,779.0	150,325.0	181,457.0	172,596.0					
Loan Capital (\$m)	29,067.0	23,949.0	21,826.0	17,265.0					
Other (\$m)	78,984.0	78,467.0	74,589.0	65,873.0					
Total Liabs (\$m)	863,785.0	843,872.0	841,119.0	815,019.0					
Equity (\$m)	72,092.0	68,074.0	65,507.0	64,573.0					

Source: Company data, BondAdviser estimates.

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Every research report prepared for Research Digest includes a clear recommendation on the security. This recommendation framework is designed to help investors navigate different investment opportunities by identifying the market price, yield, term to maturity, liquidity, volatility and risk.

The guide below may help you understand our research opinions. For further information on the research approach by one of our contributors, you can refer to the RG79 statement by [clicking here](#).

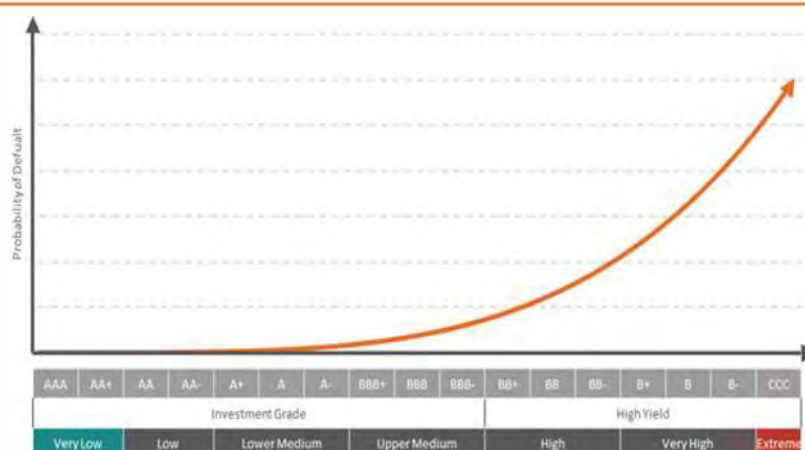
Research Opinions key

- **Buy** - Over the next 12 months, the analyst expects the security to outperform the current yield due to credit spread tightening or favourable movements in the underlying yield curve.
- **Hold** - Over the next 12 months, the analyst expects the security to provide stable returns broadly in line with the current yield but with little credit spread tightening.
- **Sell** - Over the next 12 months, the analyst expects the security to underperform the current yield due to credit spread widening or adverse movements in the underlying yield curve.
- **Suspended** - The recommendation has been suspended temporarily due to the disclosure of new information or market events that may have a significant impact on our recommendation. This also includes situations where we have been given non-public information and we need to temporarily suspend our coverage in order to comply with applicable regulations and/or internal policies.
- **Not Rated** - A security that has not been assigned a formal recommendation.
- **Ceased Coverage** - The recommendation has ceased due to issuers failure to disclosure necessary information or coverage is subjectively removed in accordance with our Research Governance Statement.

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The issuer and security risk assessment curve is our primary measure of the likelihood that an investor could lose capital value on an investment due to default and/or conversion. The risk scale consists of seven ratings – Very Low, Low, Lower Medium, Upper Medium, High, Very High and Extreme. Each security is tagged with an issuer risk and respective security risk (which may or may not be the same).

This security risk assessment has a respective measure of default or conversion which is shown in the orange line. This curve is an extension of the APRA (Australian Prudential Regulation Authority) PAIRS (Probability and Impact Rating System) model which has been successfully managing regulated entities in Australia since October 2002.



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