Title:	**Westpac New Zealand update**
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Speaker:	**David McLean**

Start of Transcript

Andrew Bowden: Good morning and welcome to the update for Westpac New Zealand's division. This is Andrew Bowden and I'm Head of Investor Relations for the Westpac Group. Just about half an hour ago we lodged a presentation with the ASX and that presentation is now available on our website. On the call we'll run through these slides first. So if you haven't had the chance already, please take the time to download it now. Following the presentation we'll then open up for questions and answers.

Joining me on the call today, is David McLean, our New Zealand CEO, and our recently appointed CFO for New Zealand, Jason Clifton. Peter King is also with us, the Westpac Group Chief Financial Officer. With that, let me hand over to David.

David McLean: Thanks Andrew. Good morning everyone and thanks for dialing in. I appreciate it's been a very busy time for many of you, with reporting season and some very volatile markets. But having been formally appointed to the role of CEO of Westpac New Zealand just over 12 months ago, I felt that now was the right time to give an update on our progress.

In this past year I've focused on getting an experienced and quality executive team in place, maintaining our business momentum and building a clear strategy for growth. Westpac New Zealand is a business in very good shape. We have a sector leading balance sheet, we have a strong customer franchise, we have an excellent management team and there are significant upside opportunities to further build the business. So this morning I wanted to give you a bit of a snapshot on how we're positioned in the market, our current plans, along with a bit more detail behind some of the programs.

So turning then to slide 2, This slide maps out the five points I wanted to leave you with. Firstly, we do have a strong track record of performance. Like the rest of Westpac, we're very disciplined on things like pricing, returns and efficiency. Secondly, we have a sector leading balance sheet across all dimensions, be it capital, asset quality or funding. Thirdly, while we do have a market share of around 20% in housing and retail deposits, we're underweight in certain other segments. This points to opportunities for us and these include some higher growth areas such as wealth management. Fourthly, we're undertaking a very significant transformation program. Based around the emergence of digital, we see significant opportunities to change the way we do business and improve the customer experience. In turn, this will create efficiency opportunities for us as well. Lastly, we're positive about the outlook, despite some challenges in the operating environment.

So moving to slide 3 - I don't want to dwell too much on this slide, but just wanted to put a bit of perspective and dimension around the business. In aggregate, we are a business that would rank amongst the largest New Zealand companies, with cash earnings of just over NZ$900 million. We strive to achieve around a 20% market share across all areas. This is an important benchmark for us because it does, as I said, help guide our areas of focus for growth. We have a ROTE above 23%, an expense to income ratio in the very low 40s, both of which would place us in the ranks of some of the better performing banks globally. Lastly, you can see on the top right, digital take up by our customers is increasing at pace in New Zealand, as in Australia and elsewhere, and this is a big factor in our strategy as well.

So on slide 4, we map out our relative position on some key indicators, based on the ASX results of our peer banks. On performance we rank as the second largest in terms of cash earnings. Our loan book is also second largest, just ahead of two of the others. So we're the second largest in both cash earnings and lending, but we've achieved this with a much stronger balance sheet. That balance sheet strength is something we're particularly proud of across all dimensions, our funding mix, our capital base and our asset quality.

It's worth noting in New Zealand that we have a market dynamic that is similar to the position in Australia, we and one other bank are weighted more on a relative basis towards residential home lending, than the other two peer banks.

One area that we haven't called out on that slide, but one that we do lag our peers, is in customer metrics. We typically rank fourth for customer satisfaction and Net Promoter Score. This is something we're not happy about and is a particular area of focus for me going forward.

Turning to slide 5, The New Zealand economy, as you'll all be very aware, is much smaller than that of Australia, and therefore is much more prone to volatility from both internal and external factors. But it has been a solid performer since it had six quarters of negative growth during the GFC. Offsetting the disadvantages of that smaller size, is the fact that we've got a leaner and more responsive system of government, so no states and no Senate. We currently have a pragmatic centrist administration under John Key and that translates to things like a more effective tax regime. Furthermore, we have some policy flexibility with the budget now marginally in surplus and the official cash rate at 2.5%. Further cuts to the official cash rate are expected. Our economists are predicting probably two cuts this year, totaling 50 points overall, probably starting in June. But that's obviously a dynamic and evolving scenario.

GDP growth this year is expected to reach 2.4%, mainly driven by net migration, construction and tourism. The headwinds to the economy are two mainly. One is the Christchurch rebuild, which has now plateaued. So instead of being a stimulus to the economy, from now on it's going to be a slight drag on GDP growth. Offsetting that, however, is a high level of pent up demand for construction, particularly in places like Auckland where the net migration is going to. That will cushion that decline in construction activity in Christchurch. Secondly, commodity prices as we know are soft, in agricultural commodities as well as others, and that is a headwind to our economy. Dairy prices, Fonterra's revised down overnight its forecast payout from $4.15 to $3.90. That will obviously have an effect on the agricultural sector. It's worth noting though that the dairy sector in New Zealand directly constitutes about 2.3% of GDP, so some of the commentary can perhaps be overstated, in terms of the effect on the whole economy of that.

Looking now at slide 6, A sign, I think, of the attractiveness of the New Zealand banking market is the fact that it is so highly competitive. We're still seeing lending growth at around 6.5%, well in excess of underlying GDP growth. Driven obviously by housing to a large extent, but we still see good lending growth across all sectors. The competitive environment continues. While back book margins remain robust, there is strong pressure from the competition for new lending across both consumer and business lending. Asset quality is remarkably benign. Housing delinquencies are at record lows, almost record lows I should say.

There is some stress emerging in the agri book associated with those low milk prices. But that is yet to flow through, and the mix of our book and the size of our book means that it's not a worrying issue for us. Banking regulation remains a hot topic. In New Zealand we have an active regulator, in the Reserve Bank of New Zealand. It's both following global trends and also innovating in regulation with the use of macro-prudential measures.

These have actually had the effect of making our lending book safer over time.

Turning to slide 7, Not surprisingly we have a strategy that is consistent with that of the Westpac Banking Corporation Group. But what I've done in the last 12 months in the role, is establish 10 key programs of work that align with the Group's five strategic priorities. Underpinning them all, number one, is our transformation program, #fitforfuture, which I'll dive into in a bit more detail shortly.

But onto slide 8. I just wanted to call out that, from a strategic perspective, it has been a big year for us, with a couple of big wins and a change in our brand direction. We talked a bit about the Airpoints program in our results last year, I wanted to share some of that success with you. Prior to 2015 we weren't involved with the Air New Zealand Airpoints program. It was a real gap for us and it kept us out of some key relationships with affluent customers. We turned that around last year, gaining a primary position in the relationship with Air New Zealand Airpoints, replacing one of the other banks in the program. That change had two significant benefits, one around growth and the other around efficiency. On growth, this was a once-in-a-decade opportunity for us to expand our affluent customer base and also enhance our product offering to existing customers. As you can see from the stats on the page, we were successful.

The second, and perhaps more important, development was on the technology front. We knew that we had to acquire a large number of customers in a very short space of time. To do that, we had to do things differently from the way we'd done it in the past. Both the customer applications, fulfilment of the cards and then activation of the cards. So in a very short space of time, using new agile means of IT delivery, we built new systems for onboarding, including onboarding card applications, online pinning of the card, and we've since rolled that out again with the first Airpoints debit card in the New Zealand market. Learnings from this process are now being rolled out to the wider business.

The second milestone I wanted to call out was being confirmed as the Government's main bank for another eight years, something I was personally involved in quite heavily. This is a contract Westpac has held since the Government first privatised its banking back in 1989. But this was the first time the Government had actually tendered it formally. It was a strongly contested process that took over three years. There are two big benefits of the win for us. Firstly, the credibility it offers us when pitching for other customers' business. This is quite important in some segments you might not expect, such as new migrants moving to New Zealand. Secondly, the scale of the contract. Government spending is 45% of GDP, Government payments are approximately 20% of all electronic payments in the system. That scale, combined with the joint commitment we've made with the Government to innovate in the payments area, provides us with an ongoing pipeline of product and service development which we can then roll out to the wider corporate customer base.

Then finally, as I alluded to earlier, I'm not at all happy with our customer metrics which lag behind most of our peers. Now obviously there's several dimensions to this problem, but one of them related to our brand identity. Previously our brand lacked meaning and consistency. Its main theme was around the concept of “help”. But our customer research showed that the warm and fuzzy connotations of “help” were at odds with the perception of Westpac in the New Zealand market, as being a large, strong, corporate entity, slightly impersonal but very financially astute. To address this a new brand campaign was extensively researched and tested and has been launched. It aims to help motivate and inspire New Zealanders and give them the confidence to act in sorting out their financial position. Our launch brand film, starring that guy you can see in the picture who I won't go into, has now been viewed nearly a million times via social media, so it's reached over one in five kiwis. It's very early days obviously but the initial signs are that it's having a very positive effect on customer perception.

So turning to slide 9, Looking at some of the key programs of work under our strategic priorities, one of those we've called out is channel transformation. There's a number of angles to this but the essence is that what we're doing is looking at all of the channels, through which customers can interact with us, in an integrated way and designing them for the future. So for example, as customers migrate from physical interactions to digital ones, we needed a new internet banking platform. We've rolled out Westpac One, it's award winning, its rollout's now nearly complete. In our physical locations we've already been a leader. We were the first to put in 24/7 locations, the first to open cashless branches, we led the rollout of smart ATMs, we now have the largest fleet in the market at 161 of them, and we're now the first to roll out the next generation of hybrid ATMs into our branches.

Interestingly, ATM technology is rapidly changing and, if you haven't experienced it, these machines now are radically different and quite far removed from being mere cash dispensers. The Hyosung machines we're deploying have the capability to do virtually everything the customer would do with a teller. We'll be progressively adding these capabilities to the machines over time. Things like barcode scanning for making bill payments, video conferencing to a live banker, biometric ID. Because these machines offer a much broader range of services, they give us much greater flexibility in designing our physical network away from staff to branches, to other physical points of presence. Where there are staff in the location, it allows those staff to focus far more on interacting with customers rather than processing physical transactions. So together, all these changes are continuing to lead to dramatic changes in transaction behaviour. Our branch deposits are down 11%, offset by deposits taken through smart ATMs, now at 37% of all deposits.

So turning to slide 10. Another thing I wanted to call out in our strategy was the specific segments that we've identified as the growth areas we want to target. They are Wealth and Insurance, Small Businesses, Maori and Iwi, Auckland, and Agri. All of these areas are being allocated more resources and increased attention in stages. Just FYI, Maori and Iwi - Iwi means tribe. That is an emerging sector in the economy. It represents the investment arms of the Maori tribal groups. It's a sector worth about NZD40 billion and it's particularly strong in fishing, Agriculture, forestry, commercial property investment, and it is a sector that's growing strongly. The two I wanted to talk to you about in a bit more detail are first Wealth and Insurance, secondly Agri.

On Wealth and Insurance we see significant opportunities. Our wealth penetration continues to grow, at now 28.3% as you can see. KiwiSaver is a growing pool of wealth in New Zealand, and our KiwiSaver market share continues to grow as well. It's also receiving validation from external awards and recognition.

Agri is one area I do get a number of questions on. In particular, I get asked why we are targeting this sector for growth right now, given the stresses in the market. I admit it is a slightly contrarian strategy, but firstly if you want to have a strong presence in the New Zealand economy, you need to be well represented in Agri. So strategically it's been a bit of a gap for us. Our overall lending share in New Zealand as I said earlier is strong, but our Agri share is closer to 12%, now pushing up towards 13%, much lower than our share across other sectors.

Secondly, in banking our view is that you write your best loans at the bottom of the cycle, and your worst loans at the top of the cycle. There's no better time to build a relationship with customers than when the situation and conditions are challenging. Business that stacks up in this environment must be very sound indeed, but it does mean that we have to be highly targeted and very disciplined with our risk quality settings. That's something that we're actually very comfortable with.

On slide 11 I'll just talk a bit about our #fitforfuture transformation program. This program is delivered through a process supported by RTS, which is a division of McKinsey. We selected this based on the very successful experience of others with it, including two other large New Zealand enterprises. It's resulted in our people developing over 400 individual initiatives, each of which gets prioritised and then worked on under a very tight framework of weekly delivery and accountability that will stretch out over the next two years.

There will be some investment required into the program, particularly over the next two halves, but it will deliver us two big outcomes. Firstly, greater efficiency. The program and initiatives will deliver both cost out and revenue enhancement, which will give us a cost to income ratio sub 40% over the program. Secondly, and equally importantly, it will give us a change in culture to one much more disciplined and focused on accountability and delivery. The program operates on a weekly cadence. It's very similar to, as I said, agile delivery in the IT world. There's no room to hide in an accountability sense, and delivery of change overall is faster and less risky. Our people are already stepping up to this new way of working, and we're starting to see tangible benefits from this change already.

So just to summarise on the last slide 12, having been in the role for 12 months now, I've made some fairly significant changes. There's a new and high quality team in place, and we have some real momentum in the business. We do have a strong base to work from, a clear strategy. We're undertaking a transformation program that will give us greater efficiency and a cultural change. We're set up to win in key segments, and to deliver digital innovation and improved customer experience. Overall that will ensure our ability to continue to deliver strong returns in the future.

Thank you very much.

Andrew Bowden: Thanks David, and we might open up for questions, but let me just highlight that let's focus our questions today on the New Zealand operations. Let me take the first question from Jon Mott please.

Jon Mott: (UBS, Analyst) You mentioned earlier on that it's a highly competitive industry in New Zealand, but just looking at the numbers, nearly all the banks have a return on assets of 1.2%, which is extremely healthy and implies an ROE in the high teens. You called out your return on tangible equity in the high 20s. How sustainable is it for the industry to maintain returns at this level, which is higher than anywhere else in the world, as you say in a highly competitive environment? Won't we just see returns continually get eaten away through competition, especially if interest rates continue to fall?

David McLean: Thanks Jon. The interesting thing is that if you look back over time, that level of return has been maintained across the industry at a reasonably strong level, despite that competition. What I think you'll see is that the competition in New Zealand drives the banks to be lean and nimble, and forces us to innovate, to find ways to maintain our overall ROTE. So I'm not at all pessimistic about the longer-term outlook based on the past performance of the industry in New Zealand.

Jon Mott: (UBS, Analyst) The returns at this level are sustainable at any industry level?

David McLean: I think when we look at the changes in the market, we're confident about it.

Jon Mott: (UBS, Analyst) Thank you.

Andrew Bowden: We'll take a call from Victor German please.

Victor German: (Macquarie, Analyst) Thank you Andrew. David, I was just hoping to touch on the Agri exposure. In NAB's recent trading update they've highlighted that the exposure to particularly milk part of that business has, from an impairment perspective, increased quite materially in the quarter. So they've highlighted around NZD420 million increased impaired assets. I'm looking at your impaired asset trends, and they're pretty much flattish within that portfolio. Just wondering why you think your trends might be different? Is it a definitional issue? How have you stressed the portfolio to get comfort around that part of the book?

David McLean: Yes, thank you. I'm very confident with the position of our dairy lending book. Two reasons; one, we have a relatively smaller market share than other banks at about 12.4%. Secondly, the disciplines we've put in place over time are showing up in good asset quality. So we stress test this regularly. We stress test it under different scenarios at different price payouts, and lasting for different lengths of time. What we see coming through is that there will be some level of farmers who will require additional support, but in our case we don't see that the likely result of the stress testing showing impairments at any alarming level. So I think across the different banks in the New Zeeland, there will be a different range of exposures to the industry. We're quite confident with our position.

Victor German: (Macquarie, Analyst) Just if I can follow up, I can appreciate your comments about it being alarming, and NAB also highlighted that they're not expecting material losses on that part of the book, but just so we know that we're comparing like for like, and I'm just trying to get a sense whether your book is materially different to theirs, are you able to give us a little bit of an indication of what sort of stress parameters have you assumed? Have you looked at if current milk prices stay for the next 12, 18 months, how your book performs on that basis? Just if you can give us a sense of when you're saying you're stressing the book, and we're looking at your impaired trends as they currently stand, what's in the numbers?

David McLean: Obviously we've got our half-year results coming up and we'll be able to give you an update on impairments in a hard dollar sense in May. But in terms of the stress testing, we stress test for what we consider to be pretty adverse scenarios, including payouts at this level or below this level, lasting for multiple years. So our worst-case stress testing is more conservative than the current environment, and lasting for a longer time than current forecasts expect. Even under those scenarios we don't see results coming through that I think would alarm you.

Victor German: (Macquarie, Analyst) Okay, thank you.

Andrew Bowden: We'll take a question from Brian Johnson please.

Brian Johnson: (CLSA, Analyst) Thank you very much for the presentation. I'd just be interested - and I think everyone would acknowledge that Westpac's done a great job in all of their operations. When you have a look at some of the earnings trends, in the last result you had a 7 basis point loan loss charge over 2015, and we know the NIM for a while now has actually been benefiting from this migration from basically lower margin fixed rate housing products to variable rate products, which I now sense is actually reversing. I'm just leaving this presentation a little bit confused. It feels to me as though there should actually be some fairly significant sectoral earnings headwinds in New Zealand.

Peter King: Brian, I think as we've called out for the Group, on margins there's lots of moving pieces and competition on the asset book remains competitive in New Zealand. The cost of funds - I think if you look back at our result last year we had a 19 basis point improvement from lower funding costs and deposits. That's not at that level as we look forward. So yes, on the margin side it's getting a little bit harder. Impairments, we'll just have to wait and see what the cycle throws up. I think at this - right now we feel like we've got a good quality portfolio in New Zealand. Housing delinquencies are very low. The agricultural - the diary portfolio, I think, as David said is in great shape, but if these prices stay down then it will get a bit harder. So we'll just have to wait and see. Your premise is it might get harder. That might be what happens, but then again I feel like we're in good shape for this part of the portfolio.

Brian Johnson: (CLSA, Analyst) Can I also ask, having been in New Zealand recently, quite a few investors commented to me one of the reasons why the New Zealand dairy industry has continued basically - profitability hasn't yet really reflected perhaps how tenuous the dairy prices are, is the banks are willing to extend overdrafts to negative cash flow famers, and Fonterra is effectively increasing their interest-free loans to those same farmers. Can we just get a feeling as to what Westpac is actually doing with cash flow negative dairy farmers in New Zealand? Are you extending overdrafts to them?

David McLean: First of all, Fonterra has got a facility which ranks behind the banks lending to support the farmers. When we look at - we look at the farmers on a case-by-case basis. We have - our bankers have all undergone additional training. The team is working very hard, and they've analysed every relationship managed farming customer's business. Interestingly one of the things is that it's a very dynamic and evolving situation, because the farmers can actually - unlike many other businesses, can adjust the cost of their inputs to the economic climate. So for example they can dial down discretionary inputs into their farm. We had a much wetter than expected summer, and therefore the grass grew and there was less need for feed. So the situation is quite a dynamic algorithm that you have to work out to understand the farm budget.

Where we think a farmer is going to survive the medium term, we will obviously provide financial support to them to help them do that. So we're not in the business of pulling the rug out on a short-term view of the farmer's situation.

Brian Johnson: (CLSA, Analyst) But I suppose the point is it really hasn't been the short term. This is the third year.

David McLean: Yep, but we will take a view of the long-term profitability of that farm based on a fairly conservative view, as I say, of the commodity cycle. Some of those won't survive, but where we think they will survive, we will support them.

Brian Johnson: (CLSA, Analyst) Also if I was to go and have a look at the December Reserve Bank of New Zealand stress test, which didn't seem to actually stress values down for what we've subsequently seen, your internal stress testing - have you done actually more than the RBNZ did?

David McLean: We've done a lot more testing than the RBNZ, and under a different range of scenarios. But some of the Reserve Bank scenarios were quite adverse. I think one of their scenarios was a NZD3 payout and lasting for a long time. So they've done a couple of benchmark scenarios, one at NZD5.50 I think was another one. We've done them in between those ranges and we've done them under different scenarios as well.

Brian Johnson: (CLSA, Analyst) Okay, thank you very much.

Andrew Bowden: Thanks, can I just remind everyone if someone wants to ask a question, please dial * 1, and I'll take a question from Craig Williams please.

Craig Williams: (Citigroup, Analyst) Yes, good morning everyone. You mentioned, David, with respect to the government contract, that it was a competitive process and that you're making some investments in digital. Can you talk about the impacts of this in terms of the significance or materiality for margins and your expense growth outlook?

David McLean: Yes. Two things. First of all, the government contract mix has changed, so the government gained from a reduction in the cost of public transactions through the contract, which obviously is a decline in our revenue, but it brought a lot more agencies into the scope of the contract. So there's 39 core government agencies that are directly in scope, and there are over 400 other governmental agencies which are eligible to participate on the same deal. So it was a - the pie became much larger. That, in our view, has a positive impact on our revenues.

With the innovation, we've committed to an innovation program with government that will require some investment, but we see the innovation that we make for this - the largest transactional customer in the market. If we develop innovation for that customer, we will be able to expand that across our whole large corporate customer base, where we already have a good market position, and that will deliver greater returns over time. So when we look at the net benefit from the contract, it's quite startlingly positive.

Craig Williams: (Citigroup, Analyst) Okay, thank you.

Andrew Bowden: Well I've got no more questions on the line, so I might call things to a close. Good morning to everyone and thanks very much for participating.

END OF TRANSCRIPT