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FUNDS MANAGEMENT

THE ALTERNATIVE VIEW

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Banks Report Card 2016

Over the last week investors had a wild ride with bank reporting season, compounded by a somewhat surprising rate cut on Tuesday. Indeed Tuesday's share price moves in ANZ Bank were some of the wildest I have seen over the past 18 years of covering companies, ANZ opened down -4% as investors were dismayed by the headline numbers before finishing up +5.6% on the back of a strong performance at the results presentation by CEO Elliot and a 0.25% cut in the rate at 2:30pm. These are very unusual intraday moves for a company with a market capitalisation over $70 billion. The 1.75% interest rate represents the lowest official cash rate in Australia since James Cook turned up at Botany Bay in April 1770.

In this piece we are going to look at the common themes emerging from the banks' results, differentiate between them and hand out our reporting season awards to the financial intermediaries that grease the wheels of Australian capitalism.

Reporting season scorecard May 2016

Code	Share Price	Revenue growth	Cash earnings growth	Dividend growth	Net interest margin (reported)	Impairment charge as % of loans	Return on Equity	Forward PE Ratio	Forward dividend yield	2016 total return	Summary of 2016 result
WBC	$30.49	1.0%	3.3%	1.0%	2.14%	0.21%	14%	13.1	6.20%	-9.1%	Pros: Margin growth, cash earnings growth Cons: Big jump in bad debts, profits below expectations
ANZ	$25.34	-0.3%	0.0%	-7.0%	2.01%	0.32%	10%	12.3	6.40%	-9.3%	Pros: Tough decisions made by new CEO, rebasing earnings Cons: lower interest margin, big dividend cut
NAB	$27.84	2.0%	1.4%	0.0%	1.93%	0.14%	14%	13.2	6.9%	-4.4%	Pros: Solid result, better than expected margin, dividend maintained Cons: Bad debt charge looks too low
CBA (Feb)	$74.85	5.0%	6.4%	0.0%	2.06%	0.17%	17%	13.5	5.70%	-10.2%	Pros: All round solid set of results Cons: bad debts a touch higher

Source: Company reports, IRESS, Aurora Funds Management

- Across the sector **profit growth was mixed** with CBA leading the pack and NAB bringing up the rear. Whilst the cash earnings growth in the above table doesn't look too bad, all four banks earnings per share were weaker thanks to the 2015 capital raisings which generally added an additional 4.3% to the number of shares outstanding for most banks.

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- **Bad debt charges low but rising:** One of the key themes across the 4 major banks and indeed the biggest driver of earnings growth over the last few years has been the significant decline in bad debts. Falling bad debts boost bank profitability, as loans are priced assuming that a certain percentage of borrowers will be unable to repay and that the outstanding loan amount is greater than the collateral eventually recovered. This week we saw evidence that the bad debt tailwind is turning into a headwind for the Australian banks.

  Over the past six months the banks have reported impairments to large single name loan exposures such as Arrium, Slater + Gordon, Peabody Coal, Dick Smith and McAleese from loans that the borrower has either defaulted on payment or are deemed to be under severe stress. NAB had the lowest bad debt charge, though we see that this gold star comes with an asterisk. NAB's bad debt charge appears to be too low given their exposures to some of the large single names mentioned above. For example Westpac took a $160 million charge against their loan to Slater+Gordon, whereas NAB declined to take a provision against their $250 million loan to the troubled litigator. NAB in taking a less conservative approach towards provisioning allowed the bank to maintain their dividend, which surprised many in the market. Unless the credit quality improves in the second half, NAB may have just kicked this problems into the 2nd half 2016 result.

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- **Dividend growth stalled**: Across the sector dividend growth has essentially stopped, or in the case of ANZ rebased downwards by new CEO Elliot. This is a function of both the capital raisings last year that increased the number of shares outstanding and minimal profit growth. Westpac was the only bank that grew its dividend and was not rewarded for it by the share market. Paradoxically the ANZ were rewarded for rebasing their dividends downwards, as it was interpreted as a hard headed decision made by the new CEO. Whilst dividend growth across the banks is likely to be meager in the near term, the major Australian banks in aggregate are sitting on a tasty grossed up yield of 9%.

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- **Loan growth**: In 2016 the banks on average achieved a meagre 3% growth in their loan book, whilst loan growth is improving particularly in housing; overall deleveraging continues to have an impact on the net demand for new loans especially to corporates. Further loan growth has been capped by APRA guidelines designed to keep investment housing loan growth to less than 10% per annum and requiring banks to hold more capital against their loan book. Additionally in April banks such as Westpac have stopped lending to foreign property investors and announced that they also tightening lending standards on Australian citizens and permanent visa holders whose main source of income was from overseas, reducing the maximum amount it will lend them for property to 70% of the property's purchase price.

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- **Net interest margins** in aggregate expanded due to the banks seeing the full impact of the re-pricing of their loan book upwards mid last year. In 2016 CBA and Westpac had the highest and most stable net interest margins, whereas NAB and ANZ both delivered lower margins. This reflects the two Melbourne-based banks having greater relative exposures to business banking and CBA/Westpac's greater weighting to housing.

  In July the big four banks raised rates on investment housing loans and in October the four main banks raised rates for both investors and owner occupiers. One of the key things we looked at closely during this results season was signs of expanding net interest margin (Interest Received - Interest Paid) divided by Average Invested Assets). As expected we saw the banks passing on some of the costs of increased capital that have been born by shareholders onto customers. Further delays in passing on Tuesday's rate cut will result in a healthier net interest margin in the second half of the year.

Gold Star – Australian banking oligopoly

- **Total Returns**: In 2016 every bank has underperformed S&P ASX 200 total return (capital gain plus dividends), as investors have digested the approximately $18 billion of new capital raised last year and were concerned about the impact of rising bad debts. NAB has been punished the least in 2016 falling 4% versus the ASX 200's gain of 1%.

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Valuations: In 2016 the banks as a sector has been sold off and as a sector it is now back to its long term Price to Earnings ratio of 13x and an above average fully franked forward dividend yield of 6.3%. Looking across the sector ANZ and Westpac are the cheapest, with ANZ on a PE of 12.3x and 6.4% yield. This represents a PE of 85% relative

to the average of the major banks. Looking at yields the banks as a sector currently trades at a 6.6% premium to the one year term deposit rate, the largest spread over the past 30 years.

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