AURORA FUNDS MANAGEMENT

THE ALTERNATIVE VIEW

By Hugh Dive

6th November 2015

Banks Report Card 2015

Over the last week investors have been digesting multi-billion dollar profit results for the major trading banks, wading through voluminous investor discussion packs, whilst listening to bank CEOs and CFOs give details on their profit results. For 2015 ANZ, CEO Mike Smith's final results pack took the cake for the largest presentation with over 150 charts on 268 pages!

In this piece we are going to look at the common themes emerging from the results, differentiate between the banks and hand out our reporting season awards to the companies that grease the wheels of Australian capitalism. Further what to do with the banks is probably the biggest issue facing Australian equity investors. The banks have all raised capital in 2015, are repricing their loan book upwards and look cheap post a correction, but bad debt charges can only rise from current historic lows.

Reporting season scorecard November 2015

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	2015 total return	Summary of 2015 result
WBC	**$31.33**	3.6%	4.6%	2.7%	2.08%	0.12%	16%	12.4	6.10%	-2.0%	Pros: Margin growth, Costs low, low bad debts, good cash earnings growth Cons: Tax benefits slightly reduced earnings quality
ANZ	**$25.67**	4.8%	-3.7%	1.6%	2.04%	0.21%	13%	10.7	6.9%	-14.0%	Pros: Revenue growth, good dividend yield Cons: Asia, higher bad debts
NAB	**$28.53**	2.0%	2.8%	0.0%	1.87%	0.14%	14%	11.3	6.9%	-8.0%	Pros: New management being proactive Cons: Weak earnings, interest margin, weak business bank
CBA (Aug)	**$75.83**	5.3%	5.0%	4.7%	2.09%	0.15%	18%	13.8	5.70%	-6.0%	Pros: Solid headline number, well capitalised Cons: 5b raising will make it tough to maintain high ROE

Source: Company reports, IRESS, Aurora Funds Management

- Across the sector **profit growth was mixed** with Westpac leading the pack and ANZ bringing up the rear due to softer global markets income. Whilst the cash earnings growth in the above table looks pretty solid, the bigger issue facing all the banks is what earnings per share growth they can deliver on their expanded share base in 2016. For example Commonwealth Bank's $5 billion raising in August added 70 million new shares or an additional 4.3% to the number of shares outstanding. Obviously this should reduce CBA's return on equity.

  Over the last year WBC has been the star performer ensuring that revenues are growing faster than costs, which is referred to in banking circles as positive jaws (think the mouth of a crocodile).

  Gold Star

- **Bad debt charges low:** 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. A booming property market in NSW and Victoria has resulted in loans formerly classed as impaired returning to performing or being repaid. Westpac had the lowest bad debt charge (BDD), with their percentage of impaired loans over total loans now at the lowest level since the bank was founded in 1817. Whilst bad debt charges across the sector are extremely low, investors are watching for small upward changes in the charge. Last week we saw ANZ's BDD increase by 0.03%, due to a lift in impaired assets primarily in Asia.

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- **Dividend growth stalling**: Across the sector the rate of growth in dividends has been declining. This is a result of increased their dividend payout ratios (dividend divided by earnings per share) to relatively high levels. Furthermore given that in 2015 the banks suspected that they would be issuing new equity to build capital, they had an incentive to limit dividend growth to retain capital. CBA delivered the strongest dividend per share growth in 2015. Dividend growth in 2016 will be a more meaningful measure, as it will be on the new larger capital base. Looking out to 2016 the large banks are expected in aggregate to deliver +1.6% dividend growth, with CBA again expected to provide the highest dividend per share growth at +3%.

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- **Loan growth**: In 2015 the banks on average achieved 7.2% 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. In 2015 ANZ grew their loan book the most with 11%, with good growth in Asia and market share growth in domestic home loans.

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- **Net interest margins** in aggregate were steady as deposit competition has moderated and the banks have begun to re-price their loan book upwards. Over 2015 CBA and Westpac had the highest and most stable net interest margins, whereas NAB and ANZ delivered both lower margins and actually saw falls in these 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 will be looking closely at over the next year is for signs of expanding net interest margin (Interest Received - Interest Paid) divided by Average Invested Assets). We expect that the banks will reprice their loan book upward to pass some of the costs of increased capital that have been born by shareholders onto customers.

Gold Star – Australian banking oligopoly

- **Total Returns**: In 2015 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 over the year. Westpac has been the top returner amongst the banks giving investors a total return of almost -1.5%.

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Valuations: Since April 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 12.7x and an above average fully franked forward dividend yield of 6.3%. Looking across the sector ANZ and NAB are the cheapest, with ANZ on a PE of 10.7x and 6.9% 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 6.3% premium to the one year term deposit rate, the largest spread over the past 30 years.

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- **Aurora Absolute Return Fund (ASX code: ABW)**
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