

THE ALTERNATIVE VIEW

By Hugh Dive

Banks Report Card 2016

Over the last two weeks investors have had a wild ride with the markets fretting over the outcome of the US election, and in the middle of this the Australian banks reported their profit results which gained very little attention. We have no intention of adding to the pile of "expert opinions", nor commentating on what a Trump presidency means for Australian equities, as we see it as having a pretty minimal impact. Market pundits fretting over the impact of the US starting a trade war with China; ignore the fact that China holds 10% of the \$10 trillion publically traded US debt. Given the new government's fiscal stimulus plans and the associated deficits and thus increased borrowing; it makes little sense for the US to antagonize its largest creditor.

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.

Share Cash Code Revenue Dividend Net interest Impairment Return on 1 Year Total Summary of 2016 result Forward Forward Price growth earnings growth margin charge as Equity **PE**Ratio dividend return % of loans (reported) yield growth ANZ \$28.28 0.2% -2.5% 10.3% -2.5% 2.00% 0.34% 11.8 5.80% 10.8% Pros: Tough decisions made by new CEO, rebasing earnings Cons: untangling Asian strategy \mathbf{X} expensive \$75.20 0.18% 5.70% Pros: All round solid set of CBA (Aug) 5.0% 5.4% 0.0% 2.07% <mark>16.4%</mark> 13.7 4.42% results Cons: bad debts a touch 5 higher NAB \$27.71 2.2% 6.3% 0.0% 1.88% 0.15% 14.7% 11.5 6.7% 8.50% Pros: Solid result, better than expected margin, dividend X X maintained Cons: Bad debt charge looks too low WBC \$31.83 3.2% 3.4% 0.17% 14.0% 13.6 5.50% 8.73% Pros: best result of the banks 2.1% 0.5% Cons: questions about X sustainability of 80% div payout X ratio

Reporting season scorecard November 2016

Source: Company reports, IRESS, Aurora Funds Management

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 Across the sector profit growth was mixed with NAB leading the pack and ANZ bringing up the rear as the new CEO moves to rebalance the bank and exit from Asia. 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.



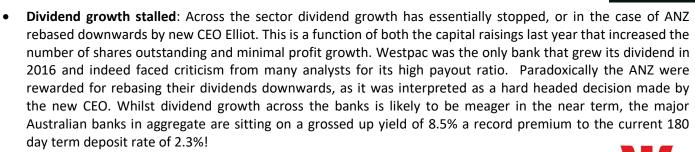
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Bad debt charges low but rising: One of the key themes across the 4 major banks and indeed the biggest driver of earnings growth over the last few years has been the significant decline in bad debts. Falling bad debts boost bank profitability, as loans 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. In May 2016 we saw signs of increasing bad debts and it was expected that bad debts would continue to trend up in the second half of 2016. The biggest surprise for me was how benign bad debts were in the second half, compared with the first half where the banks reported impairments to large single name loan exposures such

as Arrium, Slater + Gordon, Peabody Coal, Dick Smith and McAleese. For example Westpac reported \$471 million in new individual provisions in the first half, but this declined to \$256 million in the second half.

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Loan growth: In 2016 the banks on average achieved a meagre 4% 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. CBA and Westpac have been the most aggressive in growing their loan book, but 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.



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Net interest margins in aggregate contracted slightly, though there was a dispersion of results with Westpac seeing expanding margins and NAB reporting a contraction. 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 greater weighting to housing.

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 borne by shareholders onto customers. As the cash rate was cut twice in 2016, we see that maintaining a stable net interest margin of around 2% is a good result for bank shareholders.

Gold Star – Australian banking oligopoly

Total returns: Over the last 12 months ANZ has outperformed the ASX 200's return, whereas CBA has underperformed on a total return basis (capital gain plus dividends). Whilst the Australian banks quietly delivered cash profits of A\$29.6 billion, their share prices have been quite volatile over the past year due to concerns around European banks, additional capital requirements and yield stocks falling out of favour. As ANZ has been rewarded for rebasing earnings and cutting the dividend it will be interesting to see if the S follow suit.

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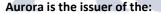
Valuations: Currently the banking sector is trading a forward Price to Earnings ratio of 12.9x, which is roughly in line with its long term average but at a 32% discount relative to the ASX Industrials. Looking across the sector NAB is the cheapest, trading on a PE of 11.5x and 6.7% yield. This represents a PE of 89% relative to the average of the major banks. Typically NAB has traded at a discount to the sector due to the issues with its United Kingdom based banks, however with the spin of Clydesdale and Yorkshire earlier this year, NAB now has fewer issues and has a cleaner investment case. Looking at yields the banks as a sector currently trades at a 5.8% premium to the one year term deposit rate.







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- Aurora Dividend Income Trust (Managed Fund) (ASX code: AOD)
- Aurora Absolute Return Fund (ASX code: ABW)
- Aurora Fortitude Absolute Return Fund
- Aurora Global Income Trust (ASX code: AIB)
- Aurora Property Buy-Write Income Trust (ASX code: AUP)



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