

EQUITIES

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INTRODUCTION

By Alison Harrington

After such a large Equities Bulletin last time we are giving you a break by having just one in depth article on a sector we all have share holdings in either directly or indirectly - the banks. John Abernethy from Clime Asset Management, in his in depth six page analysis, gives a clear outline on how banks work, how to analyse them, and how to expect them to respond to external forces. John outlines what he thinks are the five possible threats to banks on their profitability and ranks the big four on their return on equity.

I happened to have followed Clime from Roger Montgomery's first IVEE calculator through to the detailed up to date fundamental analysis available through the purchasable Stock-Val programme. I have found them to be accurate, honest, thought provoking and educational. They constantly upgrade their knowledge base and correct the basis for their value calculations through back checking on their history.

This article is a good indicator of their standard of work. Companies like Stock Val, Stock Doctor, Eureka and authors such as Colin Nicholson, Alan Hull and many others are all important as they provide the investor a source of analysis separate from the brokers, managed funds and financial planners. The existence of these types of resources is invaluable to the share investor.

Alison Harrington is an AIA Councillor and Coordinator of the AIA Queensland Committee.

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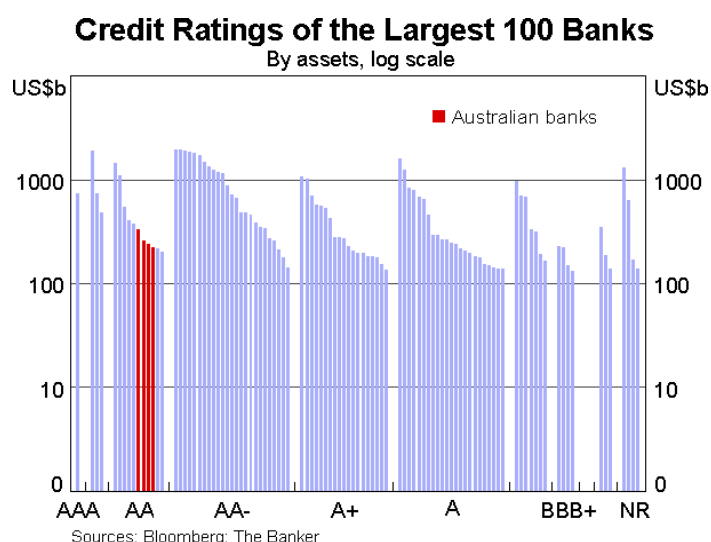
OUTLOOK FOR AUSTRALIAN BANKS

By John Abernethy

The recent interest rate increases by the Reserve Bank of Australia (RBA) gives us an insight into the trading outlook for the Australian banks. The RBA has noted the following in its published deliberations:

1. That the economic growth outlook for Australia is good and certainly better than other developed economies who are winding back on their government stimulation packages;
2. The lift in bulk commodity prices will have a significant positive impact on reported economic growth numbers for Australia in 2010/11; and
3. The rise in residential property prices is concerning.

These comments suggest to us that the trading environment for Australian banks is positive subject to the highly indebted household sector being able to weather a rise in the mortgage rates. Of course we must note at the outset that Australia's banks are amongst the highest rated in the world.



How to analyse banks

Banks are relatively simple businesses to understand. There are remarkably few moving parts that a high level overview needs to consider.

First, a bank generates its income from three sources, these are:

- a. Net interest which is the difference between interest earned on assets (loans) and interest paid on liabilities (deposits or funding);
- b. Fees charged by the banks to customers; and
- c. Trading profits generated by either facilitating customer transactions (e.g. foreign exchange) or taking positions in trading markets.

The net income generated by the banks from their assets is generally about 3.0% which is made up of about 2.35% in interest margin and 0.65% in fee and trading income.

Second, a bank has operating expenses that are mainly staff and premises costs. Banks often state their expenses as a percentage of net income. The major banks target an expense ratio of approximately 40% of income, which approximates to 1% of assets.

Third, the bank expenses and makes provisions for bad loans. This expense will rise when an economy weakens as bad debts increase. The ratio will improve when an economy strengthens. Generally the provision sits at about 0.2% of assets in good times and can go above 1% of assets in a recession.

Finally, tax is paid on the pre-tax earnings at the corporate rate of 30% on pre-tax earnings.

A bank that has \$100 in assets will now need about \$6.00 of capital or shareholders equity (before risk weighting adjustments) to maintain its Australian banking license. The required risk weighting capital ratio is 8% but Australian banks have substantial mortgage assets (loans), which have a low risk weighting.

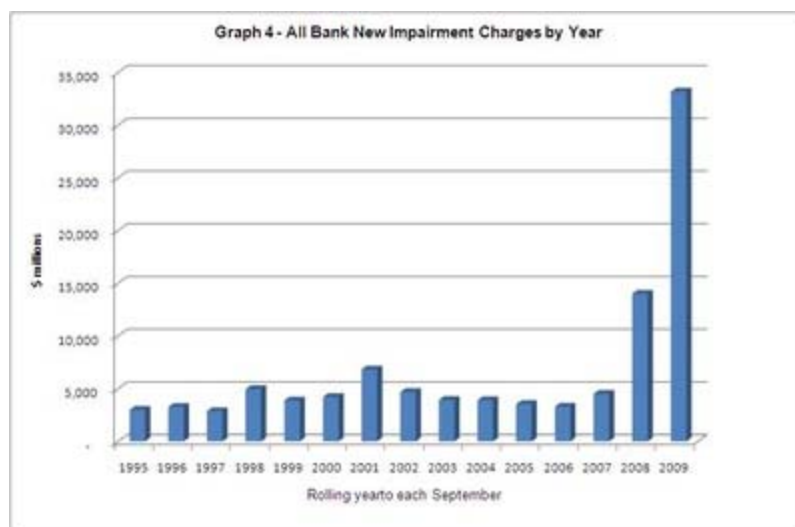
We can derive the following for a notional major bank in Australia, which has (say) \$100.00 in assets in a growing economy.

- Net revenue	\$3.00
- Expenses	(\$1.20)
- Bad debt provisions	(\$0.20)
- Pre-tax profit	\$1.60
- Tax paid	(\$0.48)
- Net Profit	\$1.12

In a recession economy the major line that is impacted is the provision for bad debts. If this reaches 1% of assets then the affect is substantial.

- Net revenue	\$3.00
- Expenses	(\$1.20)
- Bad debt provisions	(\$1.00)
- Pre-tax profit	\$0.80
- Tax paid	(\$0.24)
- Net Profit	\$0.56

We can see that a recession has a severe affect on both reported profits and the profitability of a bank as measured by return on equity. Effectively, in the above recession example, profits and profitability have halved. In the recent economic downturn Australian bank bad debt charges rose substantially but profits were less affected due to prior massive capital raisings.



Source ABA

As a rule of thumb a major Australian bank in a growing economy will report the following:

- Return on assets of about 1.1%
- Return on equity of about 18%
- Total return to owners (including franking of dividends) of about 22%

These are important ratios as they can flag issues for banks in good times which can become major problems in a recession. For instance, if a bank reports net revenue well above 3% of assets it may indicate that the bank is undertaking substantial trading activity. In a recession the trading income can fall away, investment losses are realised and bad debts appear. In such an environment, profit and profitability can fall substantially and surprise shareholders whom believed that they owned a bank that simply took deposits and lent money to households and businesses.

The banking environment of recent times

In the US and Europe it is now apparent that banks undertook substantial “risky” trading activities which surfaced with the GFC. These activities included trading debt securities, insuring debt securities against default and funding associated trading companies whom had excessive amounts of leverage (e.g. hedge funds).

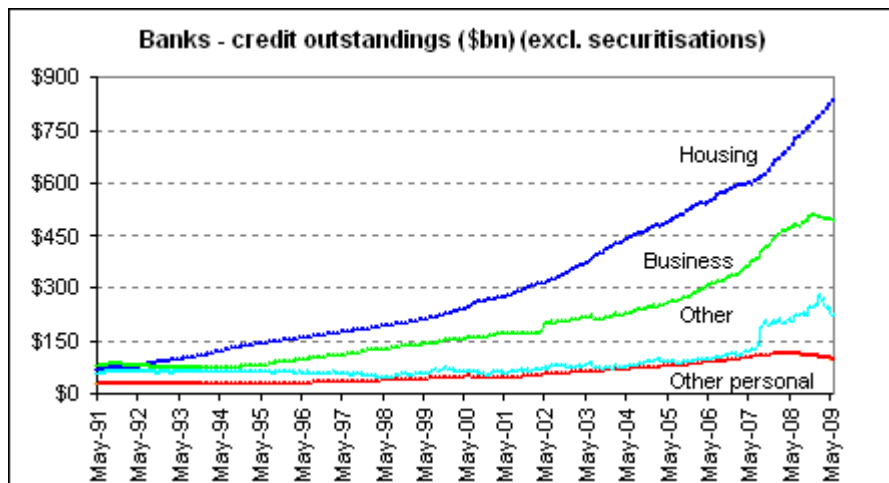
These activities are to be targeted in a round of regulatory changes proposed by the US Administration and likely to be put to the G20 this year. In Europe the governments are proposing tighter regulations and new bank levies. These levies are required to pay back taxpayers who funded bank bailouts.

In Australia, we clearly did not have a banking system which undertook significant risky activities. However, there were small and isolated cases. We now know that ANZ Bank and National Bank (NAB) had exposures to trading securities which were written off fairly quickly in 2008. In particular NAB has recently disclosed that it has about \$18 billion in trading assets to be worked out over the next ten years. However, this represents less than 4% of NAB’s assets.

Overseas the trading activities of major US and European banks were significantly higher and still remain high. In the recent Commonwealth Bank (CBA) half year result the bank compared its balance sheet with those of a UK Bank and US Bank. The comparison was startling. Whilst the CBA had over 80% of its assets in loans the UK bank only had about 60% and the US bank just 50%. What this shows is that the CBA operates as a “pure” bank by taking deposits and wholesale funding from which it provides loans. In the UK and US the banks had trading positions of between 30% and 40% of their assets. These trading positions are high risk activities and they amounted to multiples of the banks equity. These are precarious positions as trading losses due to unforeseen market moves could once again bring these banks to the brink.

This environment makes it important for investors to be acutely aware of the risks when investing in banks. Whilst Australian banks are well capitalised and don’t undertake excessive trading they are reliant and exposed to an international environment. We saw that the GFC caused massive dislocation to debt markets and disrupted Australian banks offshore funding lines. The severe downturn caused risk aversion in markets which required government intervention and support.

Another issue for the Australian banks is the growing level of Australian household debt. It was this debt that became a major focus for markets in the GFC. The fear of a severe recession, with resulting unemployment, would have pushed loans into non- performing and pushed residential property prices down. Australian household debt now approximates Australia’s GDP of \$1.2 trillion and it is over 150% of household income. These ratios are even worse than the highly leveraged US household sector. Even more worrying and certainly a focus for the RBA is the increasing bank lending to the residential sector at a time of rising house prices.



Source RBA

Australia averted a recession through a substantial government stimulation package and the largesse of the Chinese government whom spent 15% of GDP to maintain Chinese growth. Therefore what is the outlook for the banks in this new world post the GFC?

Current outlook for Australian banks

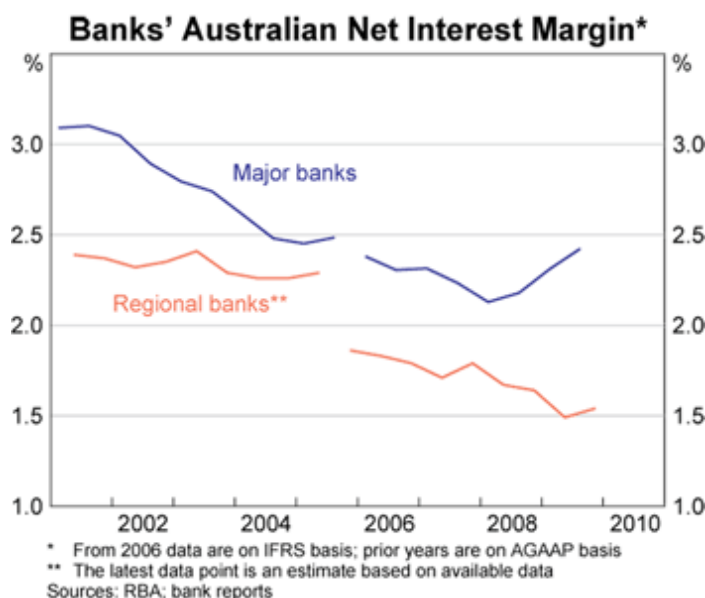
In the year prior to the severe global downturn (FY 2007), the major Australian banks (including St George Bank) reported combined profits of approximately \$17 billion. From this, approximately \$12 billion was paid out to shareholders in fully franked dividends. The return on equity for the banks averaged 22% and including dividends the return to owners equity was about 25%.

Through 2008/09 the banks collectively raised about \$30 billion of new equity and reported profits did not fall substantially. There was increased provisioning made against actual or potential bad debts, but the recession and hence unemployment was not as bad as feared. Reported profits fell to approximately \$15 billion and dividends were reduced. The large increase in the equity bases of the banks led to a substantial reduction in both return on equity and owner returns.

The share prices of the banks fell dramatically in late 2008 and early 2009. The collapse of US banks and reports of government bailouts led to panic selling. It was during this period that Australian banks raised their equity. In all cases the capital was raised at very low prices. Since then the share prices have rebounded strongly and so have reported profits. Indeed reported profits in 2010 will approximate those reported in 2007. However, it will be achieved with tens of billions of dollars of more capital.

Moving into 2010, all the major banks had the following characteristics:

- Strong balance sheets with capital ratios above 8%;
- Rising reported profits as assets begin to grow (credit growth) and provisions are written back;
- Increasing domestic deposits and reduced wholesale funding;
- An improvement in interest margins and maintenance of cost controls; and
- A reduction in trading income.



With the Australian economy being one of the best in the developed world, with unemployment falling and a resources boom developing the outlook for the banks is good. The RBA has increased interest rate settings but this is a reversion to more normal settings. Unfortunately compared to the rest of the world they look abnormally high and this indicates the depth of the overseas problems.

The Australian government is relaxing its direct assistance to the banks as it is no longer required. Australian banks did have the benefit of a wholesale guarantee from the Government if requested. That facility is no longer available from 31 March.

However, the good outlook for the banks needs to be balanced by some realistic observations of the international banking and credit environment. The recent experience with the GFC should ensure that investors remain conservative with their valuations of the banks and not become caught by irrational exuberance. Retail investors are naturally attracted to the banks as long term investments. The size and the brands are impressive. However, banks are highly leveraged businesses and downturns will have a severe affect on profits.

Hence, the realistic observations that investors should reference are:

1. The risk of a sovereign default is rising in Europe. This will lift the risk spreads or margins for all debt. Interest rates will rise throughout the world and debt may be rationed. The cost of offshore wholesale funding for banks may rise and impact bank margins;
2. Major US and European banks are still operating with significant government assistance. We noted the excessive trading activities of banks above and another economic downturn could undermine the confidence that is rebuilding in debt markets. Australian banks, no matter how strong, will be affected by this;
3. Banking regulations are to be tightened and there are strong suggestions that bank levies will be introduced. These levies will be a charge to profits;
4. Australian banks have high capital ratios (less leverage) and this will result in a decline in their returns on capital. The result of the GFC is that banks may make more profit but they cannot be as profitable as they were prior to 2007. The markets are currently pricing banks to rapidly return to high profitability and this may be optimistic; and
5. Australian banks have high exposures to a highly indebted Australian household sector. Should the RBA over tighten interest rates then there is the risk of household defaults and bad debts appear.

At StockVal we value companies based on their return on shareholder's equity. Our valuations are derived as a multiple of equity. A company, which can deliver a consistently high return on equity, will command a higher multiple.

In terms of return on equity, the banks are not the same. Trading losses, offshore operating results, differing amounts of capital raised and slightly different asset mixes are having an effect.

We rank the banks as follows in terms of owner return on equity:

1. Commonwealth Bank of Australia (ASX:CBA)
2. Westpac Banking Corporation (ASX:WBC)
3. Australia and New Zealand (ANZ) Banking Group (ASX:ANZ)
4. National Australia Bank Limited (ASX:NAB)

As for relative value, this will of course depend on the price in the market. We invite you to take a free trial of StockVal to assist you further in evaluating the banks.

John Abernethy is the Executive Director and Chief Investment Officer at Clime Asset Management.

To find out more, [click here](http://www.clime.com.au/request/) <<http://www.clime.com.au/request/>>

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