The View From The Outer

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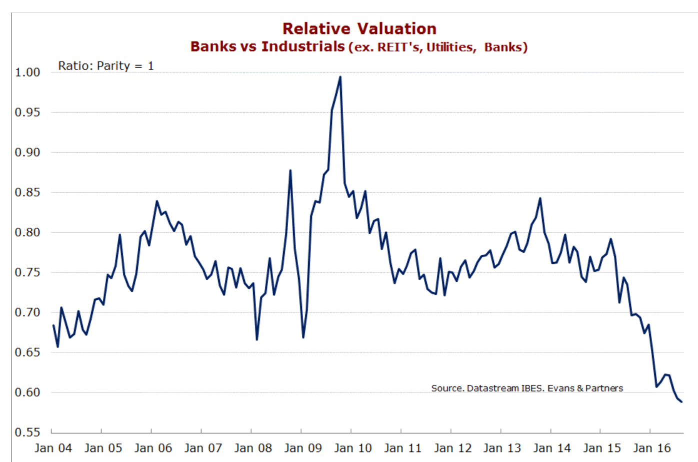
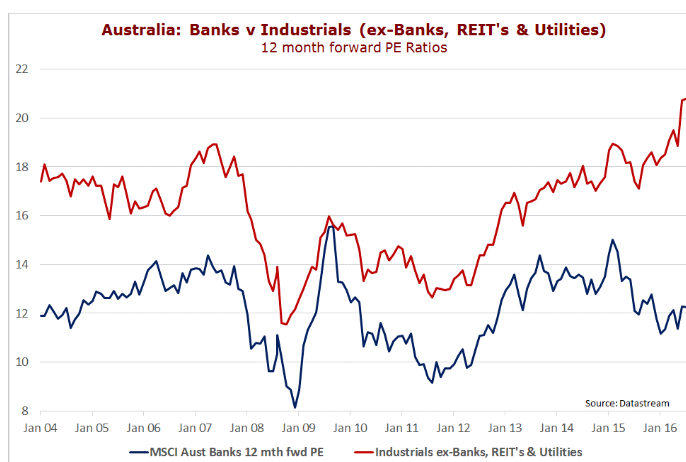
Banking sector update: relative value has improved but the structural challenges remain substantial.

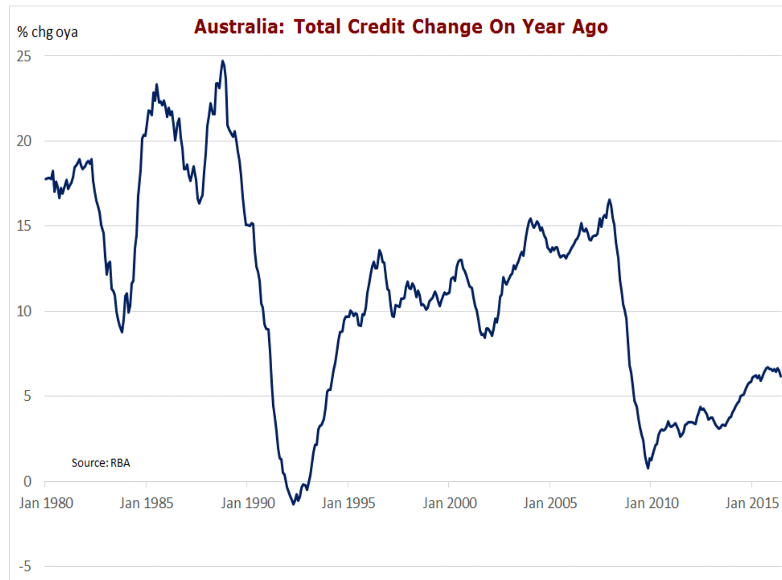
The relative Price-Earnings Ratio (PER) of the Bank sector to the Industrials excluding the Banks, REITs and Utilities has been substantially de-rated over the past 18 months. After an average discount of close to 25% over the past ten years the sector currently sits at a discount of around 40%, but given the change in the operating environment for banks, is this enough? Given the trends in likely EPS growth, probably not yet.

In a broader Australian equity portfolio construct, we remain somewhat underweight banks currently, but less underweight than previously, particularly given stretched valuations elsewhere in the market. Indeed the magnitude of the current discount has much to do with the 12 month forward PER of the Industrials ex-Banks, REITs and Utilities increasing by in excess of three PER points since August last year, to well over 20X currently. By contrast, the 12 month forward PER of the Bank sector remains, in aggregate little changed at somewhat over 12X.

To be fair, we should note the Australian 10 year Government Bond has rallied strongly over the past year, from circa 2.7% to 1.85%; and a move of this magnitude should, all else equal, have supported some positive re-rating. This has not happened in part because the further long bond yields move away from a likely longer term equilibrium level, the less sensitive the market is likely to be to further change at the margin. More significant in our view, however, is that the market, has gained a better line of sight on, and to a significant degree priced in, the continuing structural challenges the banks face in 1) driving EPS growth and 2) maintaining (or limiting declines in) Returns On Equity (ROE), central to investor perceptions in assessing a banks' appropriate Price/Book Value. In this note, we briefly review these issues. A more detailed analysis is contained in the research report by our Banking Analyst Harry Dudley: *Bank Post-Reporting Season Wrap, 24 August, 2016,* which is available from your Evans and Partners Adviser.







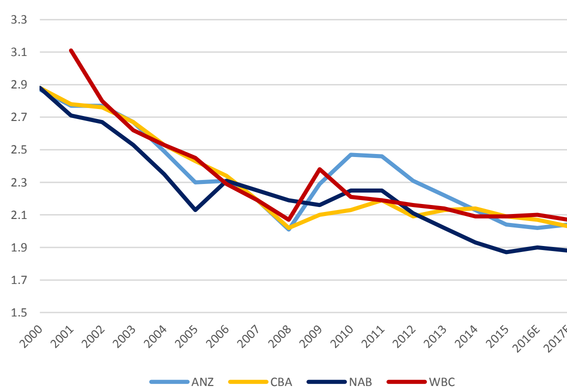
Ex- the recession of the early 1990's, the macro environment was supportive of a golden era of profitability for the banks stretching from the early 1980's until punctured by the GFC in 2008-09. The western world debt super cycle, commenced with the Fed breaking inflation expectations in the early 1980's, financial deregulation and globalization. The trend of declining inflation and interest rates, greater credit availability and rising asset prices fueled an extraordinary increase private gearing over a 25 year period. From current levels of private sector indebtedness and yields, that experience simply cannot be repeated.

While cheaper relative valuation helps assuage our concerns re the degree to which we wish to be underweight the banks, given the likely longevity of the headwinds currently facing the sector and that Australian Government 10 year bond yields are surely near the bottom at 1.85%, we remain somewhat underweight the bank sector.

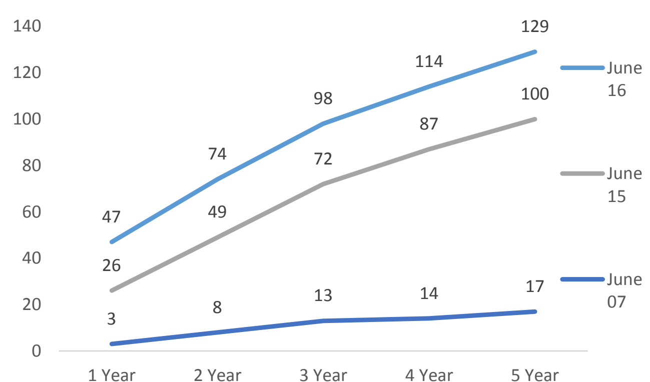
Concerns over structural headwinds confronting the banks

Net Interest Margins (NIM): Competition for customers remains fierce, with NAB and ANZ now refocused on the Australian mortgage market. The two recent RBA reductions in the Official Cash Rate to 1.5% have put pricing pressure on variable rate mortgages and impede returns on funds that the banks have not lent out, while existing deposits are slower to reprice. Another rate cut is partially priced in for 1H17. The Net Stable Funding Ratio (NSFR) requirements commencing January 2018 are requiring banks to hold more longer dated more "stable funding" (note the timing of an increase in term deposit rates coincident with a partial pass through of the rate cut to variable rate mortgages.) Further, while wholesale funding costs have come down materially from the February highs this year, they remain elevated. Indicative pricing suggests that it would still cost a major bank ~30bps more to issue 5 year bonds from a year ago and 112bps more than from 9 years ago. See chart below right.

MAJOR BANK NET INTEREST MARGIN
Source: Company Data, EAP Research



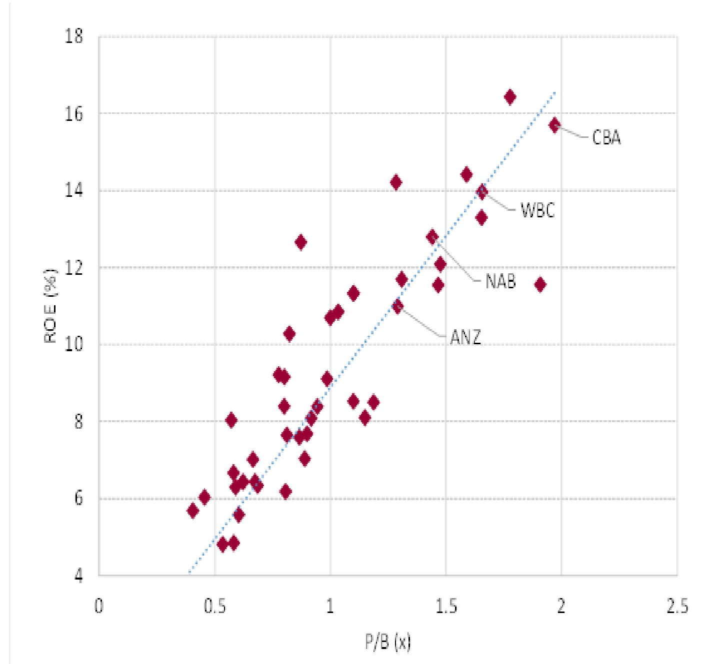
INDICATIVE FUNDING COST CURVE, BBSW SPREAD
Source: Company Data, EAP Research



Asset Quality, Capital Adequacy and Earnings per Share growth outlook: Asset quality remains relatively benign with bad debt charges off their lows but below 10 year average levels (see chart below). Lower rates may have ameliorated the exaggerated concerns some had for the outlook for house prices, while the broader economic growth continues to tick along at reasonable levels. That said, we do expect pockets of stress to continue via a handful of single name exposures in the institutional book and arrears picking up in mining regions in the consumer book. We have made minimal revisions in this area. We are still expecting a gradual pick up from our low point in the cycle, led by arrears in mining and agriculture related regions.

SECTOR: GLOBAL ROE v PBV

Source: EAP, Bloomberg



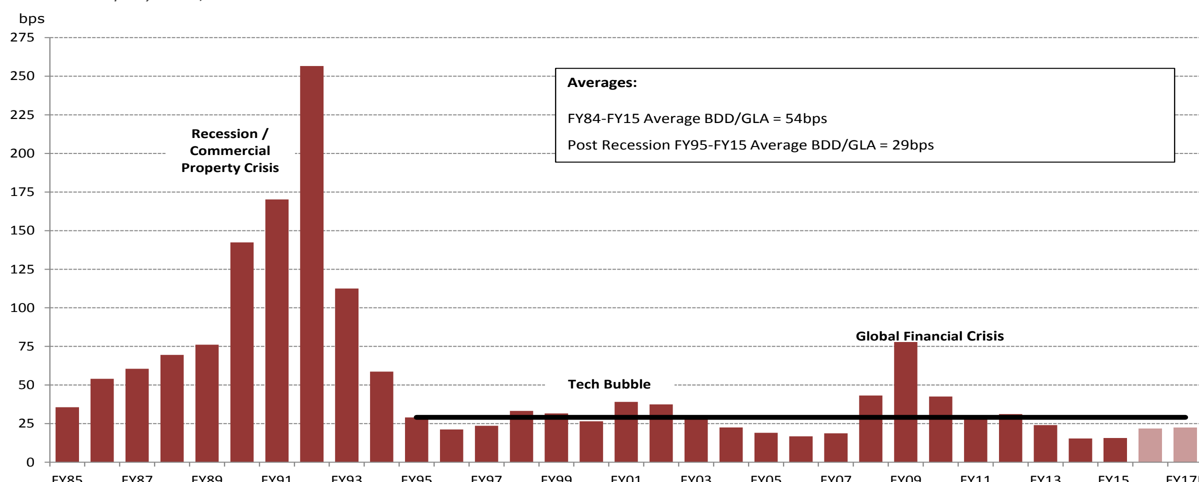
This sounds a relatively benign asset quality experience, and for now it is, but against a backdrop of very low single digit growth in Earnings per Share (EPS), it will not take much by way of greater than expected slippage in the Bad and Doubtful Debts experience to eliminate EPS growth.

Even on current consensus EPS expectations, Banks are not cheap on a typical price for growth measure such as a 2 year forward PEG Ratio. Subsequent EPS growth is also likely to be constrained by the still uncertain requirements for additional capital. Very low EPS growth and still elevated Dividend Payout Ratios on a sector average basis also limit the degree to which organic capital generation can be relied upon to meet these additional capital requirements.

Our recommended positioning remains somewhat underweight the bank sector relative to market benchmark.

BANK SECTOR: BAD DEBT CHARGE/GROSS LOANS AND ADVANCES

Source: Company Data, EAP Research



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