

Do Australian Banks currently offer investors 'good value' or 'bad risk'?

In the face of continued negative economic and corporate news the debate rages as to whether the Australian equity markets March 2009 low point represented the bottom of the 'bear' market. Recent economic indicators and equity market action is suggesting that it was. International credit markets are beginning to show signs of recovery, credit spreads are declining and banks are beginning to lend again which are all positive signs for an improving global banking system. There has been a definite improvement in sentiment towards US Banks and, this should be a positive for sentiment in the global Financials sector.

The Reserve Bank of Australia's ('RBA') recent semi-annual Financial Stability Review ('FSR') commented that the "notable aspect of the recent poor profit results for many of the world's largest banks is the disproportionate share of losses that have been accounted for by write-downs on securities, rather than higher loan provisions....As a result, an adverse feedback loop has developed, with the troubles of the financial sector weighing on the real economy, which is in turn making it more difficult to solve the problems in the financial system."

In contrast to global counterparts, the RBA FSR included the following interesting comments about the Australian banks:

"The banks continue to report solid profits...are soundly capitalised, and the larger banks have high credit ratings. The Australian banks had not accumulated large holdings of high-risk securities, and their lending standards were not eased to the same extent as occurred in some other countries in the middle years of this decade. While loan arrears have risen from the unusually low levels of recent years, and a further increase is expected in the period ahead, the Australian banking system is considerably better placed to weather the current challenges than many other systems around the world."

Significantly, the four major Australian banks' are among only 11 worldwide with at least a AA credit ratings from S&P.

In addition, the industry dynamics are changing in favour of Australian banks as there is less competition from non-bank lenders and some foreign banks begin to withdraw their Australian operations. This structural industry change should benefit Australian bank profit margins over the medium term.

Chart 1 illustrates the extent of the Bank sector P/E de-rating relative to their recent history and relative to the Defensive sectors. The high Financials P/E in recent history is partly driven by the overvaluation of Australian REIT's, however, the divergence in Defensive and Bank P/E in more recent times seems excessive. Bank shares relative to the market also look interesting at first glance as can be seen in the P/E and earnings expectations of the Banks and the Market in Table 1.

Chart 1

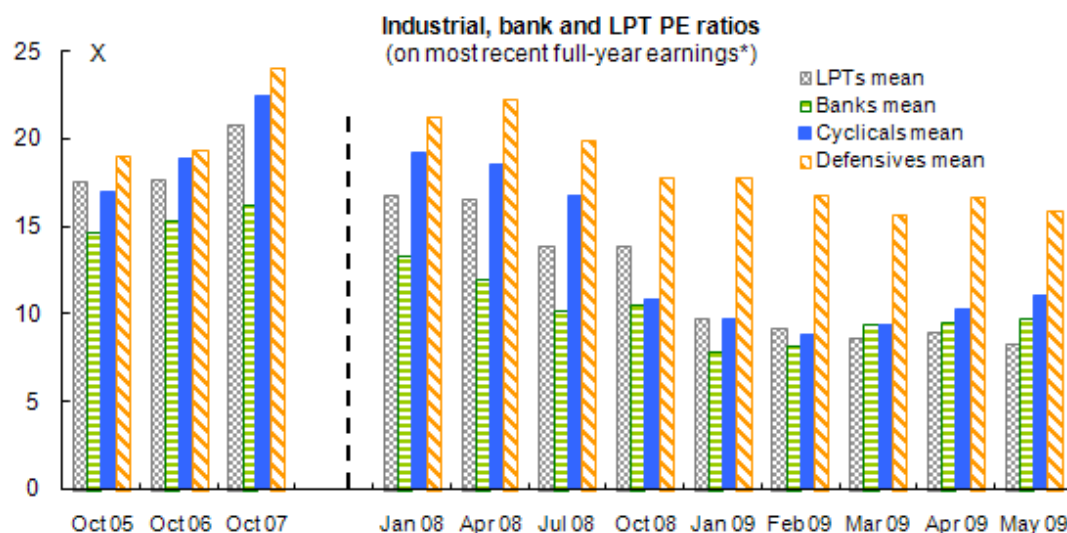


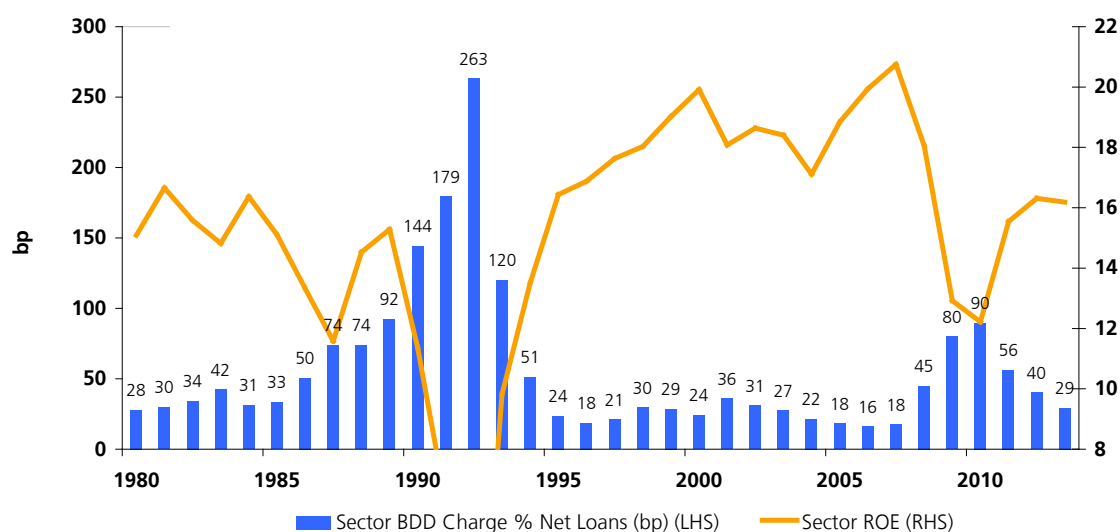
Table 1

| Sub Sector | EPS Growth FY09 | EPS Growth FY10 | PE FY09 | PE FY10 | Div Yield FY09 | Div Yield FY10 |
|------------|-----------------|-----------------|---------|---------|----------------|----------------|
| Financials | -13.01% | 3.69% | 11.62 | 11.21 | 6.10% | 6.25% |
| Banks | -16.14% | 0.61% | 11.68 | 11.61 | 6.27% | 6.32% |
| Market | -23.98% | 1.43% | 13.46 | 13.27 | 4.92% | 5.02% |

Source: Ausbil, Ausbil broker panel consensus forecasts
As at 31st May 2009.

The slowdown in economic growth and rising unemployment in Australian is a concern for bank bad and doubtful debts ('BDD'), with a number of Australian banks recently increasing their accounting provision for BDD. Chart 2 below illustrates the expectations for BDD to peak in 2011. Ausbil does not expect BDD to be anywhere near the levels seen in 1991, as Australian banks today are in a stronger capital position and are profitable. In the early 1990's Australian banks had much weaker capital positions and in some instances were technically insolvent.

Chart 2



Source: UBS

Australian Banks are in far better shape than their global counterparts from a capital adequacy and profit perspective. In addition, the structural industry changes have resulted in less competition and therefore profit margins and earnings are likely to improve. The uncertainty surrounding the extent of BDD is likely to limit investor enthusiasm for Banks in the short term. However, given that the sharemarket is forward looking, once investors become comfortable with the extent of the BDD and gain confidence, they are likely to reconsider the sector. In the short term, volatility is likely to continue and stock selection will continue to remain important.