The Market Observer

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Banking Challenges

The Australian Banking sector is attractive in part because of its valuation metrics and dividend yield, but troubled in other areas where growing margin pressures, rising impairments and increasing capital requirements are making it a difficult investment proposition at present.

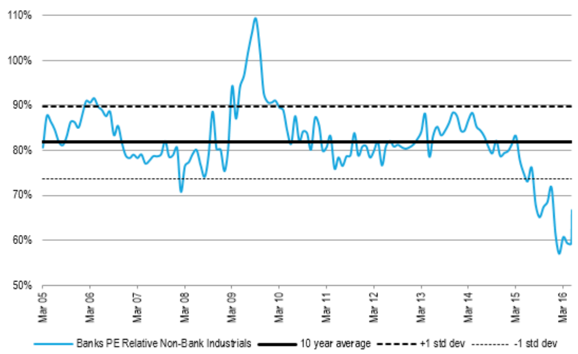
The recent May reporting season was marred by the pressure on earnings forecasts and while credit growth is tracking at a reasonable rate, margins are being impacted by rising funding costs, low interest rates and solid competition. This is, however, being tightly controlled by the management teams at the leading Banks, which have adopted repricing initiatives that are likely to continue for some time.

Within the sector there is also an intense focus on managing costs to deliver productivity gains that can then be used to help fund the necessary investment in technology and competitive positioning.

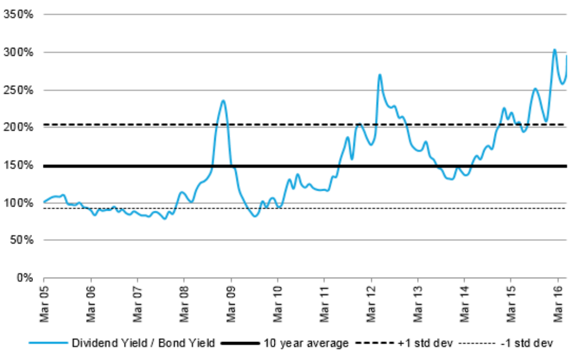
Capital levels were reported as broadly in line with our expectations, and while the trend is clearly rising, the quantum and timing of that outcome is less clear. Impairment charges are also moving up from a cyclically low base and this was exacerbated by the effects of several single name, problem corporate exposures.

In contrast to these issues, the valuation of the Banking sector relative to the 12 month forward PE of the other industrials is at a more than 10 year low, while the 12 month net dividend yield relative to the bond yield is the highest it's been in more than a decade.

12-mth forward PE relative to industrials ex-banks (IBES consensus)



12-mth forward net dividend yield / bond yield (IBES consensus)



At Ausbil Investment Management, we've assessed this problem of appealing valuation and dividend yield versus earnings pressure and moved tactically underweight the sector.

This decision was underpinned by a close examination of valuation support, margin pressure, bad debt expense, capital requirements and dividend sustainability, as well as a review of the concerns about housing prices and potential associated bad debts and the emergent threat of conduct risk.

Our in-depth research has reinforced the view that the Banking sector displays a favourable industry structure with the capacity to respond to the current challenges over time, but in the near term it is difficult to identify a catalyst that will drive a more optimistic earnings outlook.