Banking Update

June 2016

Ausbil Investment Management Limited is a leading Australian based investment manager. Established in April 1997, Ausbil's core business is the management of Australian equities for major superannuation funds, institutional investors, master trust and retail clients. Ausbil is owned by its employees and New York Life Investment Management (NYLIM), a wholly-owned subsidiary of New York Life Insurance Company.

Paul Xiradis co-founded Ausbil where he holds the position of Chief Executive Officer and Head of Equities. Paul has been instrumental in building the funds under management at Ausbil to circa $9 billion.

Paul has over 37 years of financial services experience with companies such as Westpac Banking Corporation's Investment Management Division, Mercantile & General and Legal & General Asset Management. Paul's career includes senior roles in management, investment and portfolio management in the funds management industry.

Paul is a member and Chairman of Ausbil's Portfolio Construction Committee.

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Like the Curate's egg, the Australian Banking sector can best be described as 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 dilemma facing investors was perfectly encapsulated in the recent reporting season when albeit strong profits were marred by the pressure on earnings forecasts.

Although 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.

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.

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

Ironically, given expectations were low heading into the May reporting season, there seemed to be a bit of a relief rally post the delivery of the results, but we suspect that had more to do with the somewhat surprising timing of the latest interest rate cut by the Reserve Bank of Australia (RBA), which served to highlight the relative attractiveness of the sector's dividend yield.

In an effort to explain the situation in more detail, let's take a closer look at the underlying elements driving our decision process, namely valuation support, margin pressure, bad debt expense, capital requirements and dividend sustainability, as well as concerns about housing prices and potential associated bad debts and the emergent threat of conduct risk.

Bank sector valuation is supportive on both an absolute and relative basis to the overall market when compared to long run metrics. The dividend yield at 6.2% is attractive relative to the broader market yield of 4.5% and especially so when compared to the 10 year bond yield of 2.3%.

While we acknowledge that the high dividend yield will provide support to the sector, especially if further cuts to official cash rates occur, we also fundamentally believe the banking sector has a favourable industry structure which will ultimately be effective in managing and responding to the challenges at hand. Nevertheless, we remain cautious on the short term outlook due to rising uncertainties and earnings risks across the sector.

Margin pressure is mounting in a number of areas, including rising funding costs and asset price competition in a relatively low growth environment, against a climate of low interest rates and ongoing regulatory pressures, such as the need to meet net stable funding ratio (NSFR) requirements. We tend to believe the Banks will need to continue re-pricing their customer loans upwards in response to the increasing margin pressure.

Global capital standards are still evolving and the Australian Prudential Regulation Authority (APRA) is yet to finalise the capital requirements for all Banks. It therefore remains uncertain as to how much additional capital the Banks will actually be required to hold in order to meet the so-called 'unquestionably strong' targets.

At Ausbil, we've estimated that the Banks may need to increase capital levels by circa $15 billion to $20 billion across the sector in total. Importantly, however, our central case assumes that APRA will take a measured approach which will allow the Banks enough time to build up their capital levels via retained earnings growth. We expect further updates on the capital requirement rules by late this year, or early next.

Elsewhere, we are likely to have seen the cyclical lows in impairment charges for the Banks, while asset quality has and is continuing to deteriorate in some segments of the economy. As a result, we expect impairment charges, or bad debt expenses, to rise in the next year, but the profile and pace of deterioration is the key uncertainty.

While the outlook for the Australian economy is constructive because of low interest rates and stable employment, any change in these two variables has usually been the precursor to systemic risk emerging in the credit cycle. Risks have also risen as the economy transitions from mining to non-mining growth drivers. As stated, the lowlights of the recent reporting season were a few large, single name, institutional exposures driving impairment expenses higher.

Investors have also found reason to question the sustainability of the Banking sector's dividends. The prospect for dividends is naturally influenced by the outlook for ongoing rising regulatory capital requirements and rising impairment charges, despite the modest credit growth outlook, which is supportive for capital generation.

Against this backdrop, we view the dividend yield to be more sustainable at the retail-orientated banks. As witnessed, ANZ recently reduced its dividend pay-out ratio target to a more sustainable level, while National Australia Bank (NAB), in our view, has the most optimistic near term dividend target, given its temporarily elevated pay-out ratio.

The media and some analysts may have been focussed on a housing correction because of the rising level of indebtedness and the implications a housing price collapse would have for bad debts, but we are of the view that the current environment of low interest rates and stable employment, both of which are highly supportive of loan serviceability, should mean that losses from mortgages won't be a material downside risk to overall Bank earnings.

With our keen focus on all Environmental, Social and Governance (ESG) matters and how they pertain to the quality and viability of our underlying investments, we have also closely monitored conduct risk within the Banking industry.

The various troubles associated with the recent Bank Bill Swap Benchmark Rate (BBSW) rigging, Bank planner advice and Life Insurance practices have more than justified our embedded ESG approach with its active ownership mentality. Unfortunately, these issues are on the rise and are deservedly garnering widespread attention. This in turn increases reputational risk and ultimately raises questions about the need to tighten process control within the vertically integrated model and we suspect business models may well need to adapt over time.

Looking at individual investment opportunities, Ausbil Funds currently hold overweight positions in CYBG plc (CYB), which is the holding company that owns Clydesdale Bank and Yorkshire Bank in the United Kingdom. It was demerged from NAB in February 2016 and is a pure play UK bank listed locally on the ASX.

CYB is one of our preferred bank exposures. The renewed management team and Board of CYB now have the autonomy and focus to improve their operations and market position. The medium term earnings outlook is also strongly supported by a significant cost-out opportunity.

The current cost-to-income ratio stands at 72% with a target of less than 60% over the next 5 years, which we view as eminently achievable. CYB's capital position is very strong with a Core Equity Tier 1 ratio of 13.2% and its asset quality is sound, with the loan book skewed towards residential mortgages. Valuation is also attractive, with the company trading at 0.75x book value (as at May 30th) and we expect the stock to continue to re-rate over the medium term as earnings and returns improve.

Regulatory risks do remain, however, given that conduct risk has been a key issue in the UK banking sector, but we believe that CYB is relatively well placed given the large level of provisions set aside for conduct-related costs, which includes a sizeable indemnity from NAB.

In conclusion and just like the Curate's reply to his Bishop's assertion "I'm afraid you've got a bad egg," in the famous Punch cartoon of November 1895, when he said "Oh no, I assure you that parts of it are excellent," the Australian Banking sector contains both favourable and risky elements.

Finally, 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.