

RESEARCH



BANKS: FORMER ROCKSTARS DUE FOR A COMEBACK?

These days it seems everyone is having a go at banks. Their customers are unhappy, the banks themselves have been caught charging fees for services they didn't provide and of lending too aggressively. On top, and in part because of this, regulators are again trying to make sure the system remains robust enough to endure any shocks. So, is enough, enough?

Investor perception of Australian banks is largely driven by time. Most remember the late 90s and 00s when banks were "rockstar investments" and at the peak traded at a multiple of 3.0x their book value. Share prices kept appreciating and dividends were high. Good times.

So what has happened to this rockstar sector given this same ratio has now fallen to circa 1.5x? Is this decline enough?

It may be a surprise, but prior to the “rockstar period”, Australian banks struggled to trade at more than book value. Indeed the average during the 80s, and remember this included boom times, was 0.9x. The change was brought about by a group of international bankers wanting to standardise measures of risk, namely Basel I. This introduced the concept of “risk weighted assets (RWA)” and Australian banks being by and large “mortgage banks”, this allowed the Australian Banks to lend more with the same or less equity. This got even better under Basel II as the banks were able to utilise internal models and further reduce “risk weighted assets” and lend even more.

THE FUNDAMENTALS... IT'S ABOUT THE LEVEL OF EQUITY CAPITAL REQUIRED

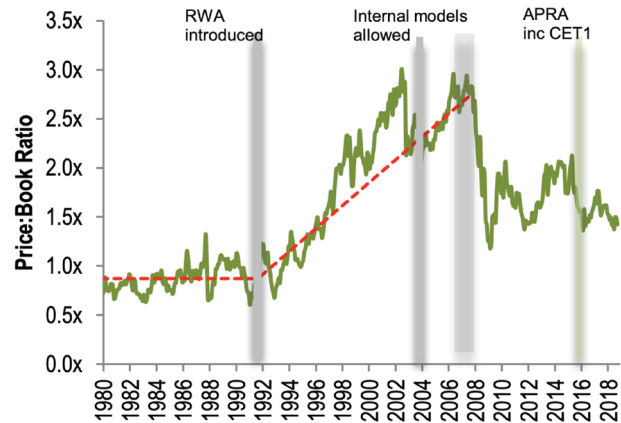
Looking past the issues of the Royal Commission impact on fee generation, fines and lending practices, Bank capital requirements have risen. Risk weighted assets as a percentage of actual total assets remain near their lows, however the amount of “equity” capital needed to be held to fund these assets has risen. The Australian Prudential Regulation Authority (APRA), which supervises banks, has increased core equity capital requirement to 4.5% of RWA plus 2.5%, representing a conservation buffer plus 1.0%, which strategically important banks need to hold. APRA also wishes these banks to be unquestionably strong vs. international banks.

Simply, the higher the equity capital required the lower the price to book ratio a Bank can command. Based on the historic relationship, banks seem to be fairly priced. The problem however is that the trend toward higher equity capital requirements remains. While this remains in place, downward pressure on price to book ratios and share prices remain. Time, it seems, is still on our side.



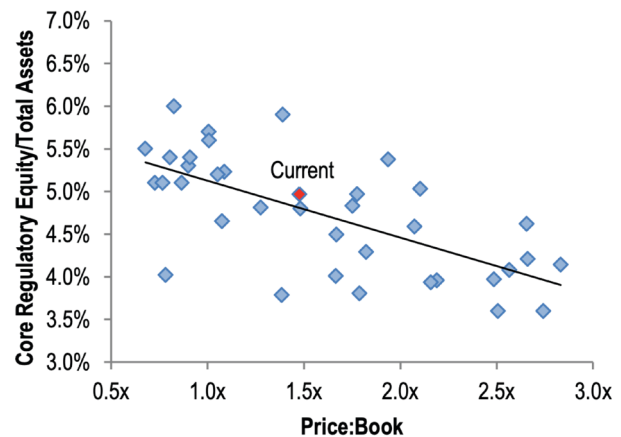
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Figure 1. A history of Bank Valuation



Source: Forsyth Barr analysis, Thompson Reuters Datastream, Company reports

Figure 2. Pricing...a function of capital required



Source: Forsyth Barr analysis, Thompson Reuters Datastream, Company reports