EQUITY

Three Worries About Australia's "Big Four" Banks

August 23, 2016

Although Australian equities overall have posted moderately positive returns in 2016,[1] the share prices of Australia's major banks, collectively known as the "Big Four," have taken a negative turn year-to-date.[2] Alastair Hunter, lead analyst and investment manager, Franklin Local Asset Management–Australian Equity, lays out the reasons investors may have soured on banking stocks, and offers his take on those worries. He also discusses the potential fallout of Brexit and a more distant challenge—financial technology or "fintech"—to Australian banks.

The Australian equity market has seen positive returns so far this year,[3] but the country's bank stocks—particularly those of the country's "Big Four"—Commonwealth Bank of Australia, Australia & New Zealand Banking Group, Westpac Banking Corp. and National Australia Bank—generally haven't participated in the rally and have even lost ground.[4]

While overall we retain a positive long-term outlook on Australian banks, we attribute their current share-price dip to three investor concerns: earnings, capital levels and dividend sustainability.

- **Earnings:** Revenue growth is moderating, consistent with the slowdown in the Australian and New Zealand economies and due to competitive pressures in consumer and institutional markets. The collapse of a small number of high-profile corporations, particularly commodity-related companies, led to increased levels of impaired bank loans at the start of this calendar year, and those loans are now beginning to have some effect on bank earnings. We think earnings deterioration may continue near term, but we also believe the current credit cycle will be an average rather than a severe one, although the market appears to have priced in a severe cycle at the moment.
- **Capital levels:** Global bank regulators have said they will likely announce new capital requirements by the end of 2016. This comes on the heels of the local regulatory agency requiring an increase in capital that was announced in July 2015 and took effect in July of this year. The major Australian banks raised A$22 billion of new equity in calendar 2015.[5] The expectation, however, is that the second increase would not be implemented until 2018 or 2019, meaning this time, banks would have more time to prepare for it. And, despite some hand-wringing by observers, we believe banks will be able to use dividend reinvestment programs and retained earnings to shore up their capital levels, without resorting to large capital raisings, as many have done in the last 12 months.
- **Dividend sustainability:** The Big Four have maintained their dividend payout ratios in the 75%–80% range over the past few years,[6] but we believe those levels are likely above what is sustainable long term. One of the Big Four already has cut its dividend, and there is some risk that another of the four will decrease its dividend, but we believe the reduction will be modest. That said, we believe the banks' 8%–9% pre-tax yields,[7] when taking into account the benefit of what's known as "franking credits" for the Australian taxpayer, appear sustainable, and we consider them attractive compared with cash interest

rates and bond rates and against Australian equities in general, which on average have offered 6.5% pre-tax yields.[8]

Is the Post-Brexit Shock Over?

Turning toward the more global factors affecting Australian banks, we believe the June 23 decision of voters in the United Kingdom to leave the European Union will have few direct effects on the sector, given that Australian banks have little exposure to lending or customer activity in the United Kingdom and Europe.

Outside the Big Four, a bank that is listed both in Australia and the United Kingdom is exposed to the United Kingdom through its two UK businesses. Given the uncertainty surrounding the potential effects of Brexit on the UK economy, we are cautious about this particular bank's outlook at the moment.

The indirect impacts of Brexit have included the market volatility that followed in the first days after the vote. The results of the referendum surprised many observers, and stocks sold off immediately. The market has fully recovered since then, as investors are perhaps a little bit more sanguine about the fears that were initially being raised. So we are less concerned about the durational effects of the overall market volatility in the aftermath of the Brexit vote.

We are more concerned that events such as Brexit could raise the risk premiums Australian banks pay for their funding costs, of which 20%–25% is raised in international wholesale markets.[9] These wholesale funds provide banks with access to liquid markets that it uses to, for instance, lend to domestic borrowers. The banks already are bracing for a potential increase in funding costs because Australia's AAA credit rating as a sovereign country is under review by Standard & Poor's. A potential downgrade over the next one to two years would have direct funding cost implications for Australian banks.

Bracing for "Fintech"

Peering a bit into the future, the rise of financial technology ("fintech") companies could pose a challenge to traditional Australian banks. Fintech companies attempt to use technology to make financial services more efficient for end users, and they tend to challenge more traditional companies that are more reliant on physical distribution structures.

In the shorter term, which we consider the next three-to-five years, we believe fintech could have a modest impact on the banking sector. The Australian banking industry is heavily regulated and highly concentrated, so it is very difficult for new entrants to have a meaningful impact on the same scale as the existing players.

In the longer term, we think fintech companies will end up crimping banks' profitability. Australian banks have generally been able to earn well above cost-to-capital returns through the credit cycle, and we expect fintech operators to begin targeting those pockets of excess profitability and growth. As a result, we expect fintech companies could claw away some of the banks' profits over the next five-to-10 years.

We think fintech companies could pose a greater challenge to the payment system activities of the banking sector than the lending or deposit-taking activities of the sector because we believe the banks' own technology innovations (including alliances) and regulatory barriers reduce the potential market for the fintech entrants in those areas of the market.

We see stronger potential for fintech companies to gain profitable share from the banks in digital payments origination, particularly in the consumer and small and medium-sized enterprises segments as real-time settlement becomes a reality in Australia in late 2017 and mobile/Web-based solutions rapidly evolve. Threats could come both from large-scale players and local fintechs that are providing solutions to specific needs such as a company that is providing a cashless payment system in schools.

Uncertainty May Lead to Opportunity

This recent uncertainty around Australian banks has pushed valuation levels to the point where, on a medium- to longer-term basis, we consider the sector undervalued compared with other high-yielding sectors such as listed real estate trusts or infrastructure stocks. And we believe the banks will likely continue to offer sound fundamentals unless the country suffers a material economic retracement. With the expectation for continuing low domestic interest rates and the lower Australian dollar, we believe Australian equities in general—and banks in particular—offer attractive long-term value.

Hear more from Alastair Hunter about the potential effects of fintech on Australian banks in this brief video below:

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1. Source: Bloomberg LP, as of August 16, 2016. The Australian equity market is represented by the S&P/ASX 200, which comprises the largest 200 companies listed on the Australian Securities Exchange. Indexes are unmanaged, and one cannot invest directly in an index. They do not reflect fees, charges or expenses. Past performance is not an indicator or a guarantee of future performance. See www.franklintempletondatasources.com for additional data provider information.

2. Source: Bloomberg LP, as of August 16, 2016. See www.franklintempletondatasources.com for additional data provider information.

3. Ibid.

4. Ibid.

5. Source: Franklin Templeton Investments calculations using company data. The total does not include the issuance of hybrid shares.

6. Ibid.

7. Source: Franklin Templeton Investments calculations using company data, as of August 16, 2016.

8. Source: Australian Securities Exchange. The Australian equity market is represented by the S&P/ASX 200, which comprises the largest 200 companies listed on the Australian Securities Exchange. Indexes are unmanaged, and one cannot invest directly in an index. They do not reflect fees, charges or expenses. Past performance is not an indicator or a guarantee of future performance.

9. Sources: Reserve Bank of Australia, Australian Prudential Regulation Authority.