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BANK SHARES IN AN “ANOMALOUS WORLD”

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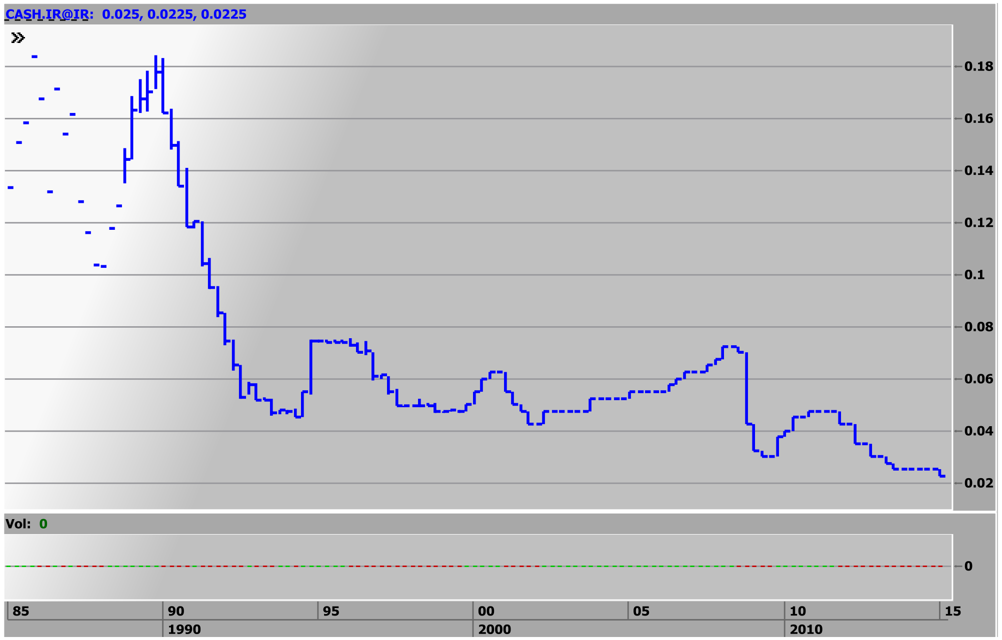
Inflation and Interest Rates – current levels have not been seen in the working lifetime of those listening to this webinar

Aust Official Cash Rate – 35 years history



Investor response (especially SMSF's/ private investors)?

- **Super low interest rates** forces investors to consider a **less risk averse mix** of investments in order to attain their **income objectives**.
- SMSF average cash weighting **~ 25 – 30%**

Choices:

❖ **Term deposits** (TD) yielding **2.6 – 2.7%** unfranked with no capital risk versus

❖ **Banks** yielding **4.5%** (CBA) to **5.3%** (NAB), despite strong run but with price volatility/ risk of capital loss. Grossed up yields **6.4%** and **7.6%** respectively, so even for CBA, still more than **140%** above TD yields.

Banks win if investors convinced:

❖ Meaningful **capital losses** in bank shares **unlikely**

❖ Any decline **temporary** (therefore acceptable to **long term investors**)

❖ The risk of a **decline in dividend payments** is downright **remote**

Why are Investors likely to be convinced?

- **GFC** once in a lifetime event, not repeatable anytime soon
- **Bank earnings** expected to manage **single digit growth** in the forseeable future
- Not currently at risk from **net interest margin** pressure (funding costs)
- Not currently at risk from **BDD provisions** (bad and doubtful debts, typically from the corporate sector)
- Not currently at risk from **cost pressures** or **competitive pressures**
- **Dividend payouts** sustainable, no issues with **capital adequacy** requirements
- **CBA** – one **dividend cut** in **23** years since listing (2009). Growth resumed following year, dividend higher by 2010 than in 2008
- **NAB** – **2 dividend cuts** in last **28** years (1991 & 2009). Growth resumed in 1993 and 2010 respectively, dividend higher by 2014 than in 2008

Yield will continue as pre-eminent pricing mechanism for banks – hence more "Yield Compression" to come, based on bank yield margin over TD's

- Ultimately **subjective** but have been using **4.5% FF** as fair value
- Feb interest rate cut lowers that to **4.25% FF** (ignoring possible further cuts)
- Rational to use **'15/16** forecasts at this point

Share price targets based on a 4.25% FF yield applied to '15/16 forecast DPS

	Current Share Price $	F'cast '15/16 Dividend $	Share Price Target @ 4.25% yield	% Change from Current Share Price
ANZ	36.79	2.00	47.06	+27.9
CBA	96.32	4.51	106.12	+10.2
NAB	39.39	2.28	53.65	+36.2
WBC	39.73	2.00	47.06	+18.4

CONCLUSIONS

- **Super low interest rate** environment still has legs (incl. USA)
- **Banks overwhelmingly priced** on the back of **yields** (forget PE's, NPV's etc)
- **Bank yields excessive** versus the **risk free rate (TD's)**
- Little risk of **capital losses** in **Banks,** virtually no risk to **dividend payments**
- **"Yield Compression"** process to continue, suggested **target 4.25% FF**

- **What could overturn the above?**
  1. **Above all else, interest rates starting to rise**
  2. **Recession/ high unemployment** (noting that 1 and 2 should not occur simultaneously)

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