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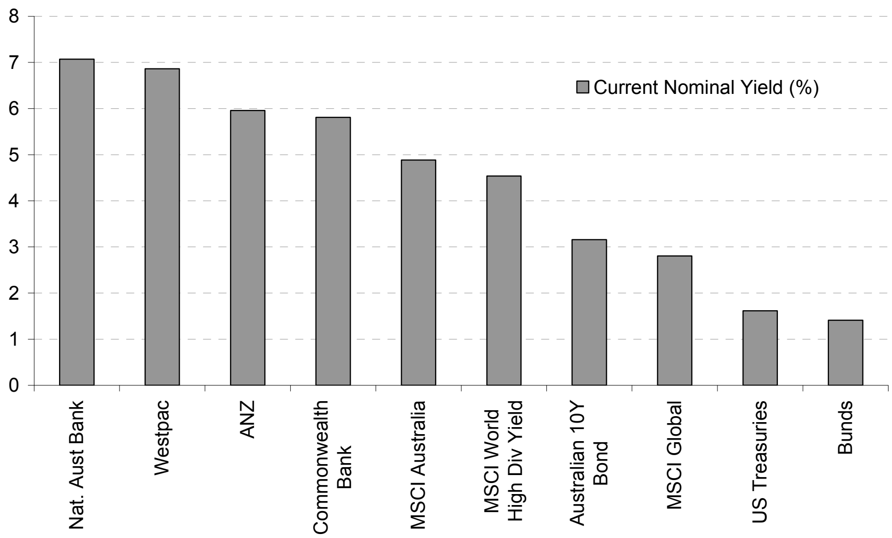
Equity Strategy (Citi)
Global

Global Equity Strategist

Global Search For Yield: Buy Australian Banks

- **The Search Has Intensified** — With interest rates in a number of countries now negative, the global search for yield has intensified. Australia has the highest dividend yield of the major global equity markets. The government has little debt, economic growth is solid and earnings are expected to recover. We are Overweight.
- **6% Dividend Yields** — At 6%, the big four Australian banks' dividend yields are in the top decile globally. But global income investors, scarred by US and European banks, remain sceptical that they are sustainable.
- **Secure Funding, Strengthened Balance Sheets, Strong Sovereign** — Australian banks have learnt from the mistakes of US and European banks. They have changed their funding sources, strengthened balance sheets and benefit from a strong sovereign. This should help underpin current high dividend payments and ensure dividend growth.
- **Global Reach** — This report was written with the help of Craig Williams, Head of Australian Banks Research, Ronit Ghose, Head of European Banks Research and Tony Brennan, Head of Australian Equity Strategy.

Figure 1. Australian Banks Feature Highly in the Global Search For Yield



Source: Datastream, Citi Research

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Beata Manthey is on maternity leave.

Global Search For Yield: Buy Aussie Banks

The global search for yield has intensified with interest rates in a number of countries moving into negative territory. The Australian equity market stands out for income-hungry investors. It has the highest dividend yield of the major markets globally. The big four Australian Banks yield 6% and our analysts forecast dividends to grow. But global income investors, many of whom have been scarred by US and European banks, remain sceptical. In this week's Global Equity Strategist, we test our Australian Banks analysts' sanguine view. We enlist the help of our Head of European Banks Research, who has seen first hand, what can go wrong with high yielding banks.

Craig Williams, Citi's Australian banks analyst argues that his companies have learnt from the mistakes of US and European banks over the last five years. Funding sources have been changed from short-term to long-term. Balance sheets have been strengthened further. Also the banks and the Australian economy benefit from a strong sovereign. All these factors make him think that the top decile dividend yields for the big four banks are sustainable. Global income investors looking to capture some of the highest dividend yields in the world should be considering these stocks, in our view.

Australia Trades on +5% Dividend Yield

Australia looks an attractive equity market to us. GDP continues to grow at trend levels and the economy is not unduly hampered by the deleveraging occurring in Europe or the US. Much of the economic growth has been driven by large investments in natural resources which should continue at a rapid rate for a few more years. Government debt is modest and corporate leverage is low. Household leverage, is considerable but is coming down without heavily constraining spending. Interest rate cuts by the central bank have been effective in supporting domestic demand and should help sustain corporate profits.

Overweight Australia

Indeed, Tony Brennan, Citi's Australian Equity Strategist believes corporate earnings will recover moderately as we go into the second half of 2012 and 2013. With almost a third of earnings coming from the commodity sector, the recovery will depend on the global economy, and China in particular. Despite these positives, Australian equities still look attractively priced. The dividend yield of more than 5% is highest of the major global equity markets. These are all reasons why we recently upgraded Australian equities to Overweight in our global allocation.

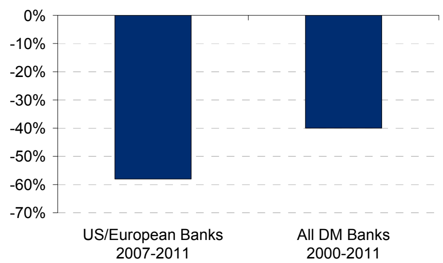
With short rates in a number of economies moving into negative territory, we believe the global search for yield has recently intensified. High Australian dividend yields have caught the attention of global investors, with some of the highest yielding sectors in Australia like the Telecoms, Utilities and REITs having performed strongly. However, the high yield also reflects suspicions about the sustainability of Australian dividends, especially when we consider that other markets which have a 5% yield include Spain and Portugal. So one of Australia's attractions (its high dividend yield) also reflects a risk (dividends may be cut). Much of this concern is focused on the Australian banks which have underperformed other "high-yielders".

Income stocks down-under

The big four banks in Australia – ANZ, Commonwealth, NAB and Westpac – currently pay dividends ranging from US$4bn to US$5.4bn per year, which puts them in the top 50 dividend payers of all listed stocks globally and top 10 in global Financials. The average yield for these banks is 6.4%. That initially looks attractive in an income-hungry world. But recent history suggests that investors should be wary when banks trade on high dividend yields. From 2007 to mid-2011, 92 US and European banks saw their dividend yields rise to above 6%. Of these 79% cut their

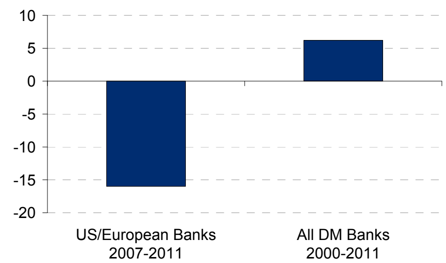
dividends within 12 months. On average dividends were cut by 58%. 19 of these banks cut their dividends to zero within 1 year and 38 within 2 years. The total return for these banks was -16% (-6.3% rel) 12 months after the 6% dividend yield threshold was first breached. High dividend yields were a sell, not a buy signal.

Figure 2. Avg DPS Change 12mth After 6% DY



Source: MSCI, Facstet, Citi Research

Figure 3. Total Return 12 Mth After 6% DY



Source: MSCI, Facset, Citi Research

The recent US and European experience could warn global investors to resist the temptation of a high dividend yield amongst Australian banks. But outside of the US and European experience over the last few years, owning banks with high dividend yields has not been so painful. If we take a sample set which includes all developed market banks beginning in 2000, buying banks once they cross the 6% div yield threshold has provided a total return of 6.2% (8.6% rel) in 12 months. So a broader dataset suggests that a high dividend yield may in fact be a reason to be bullish, not bearish, on the Australian banks.

Dividend Dynamos vs Dividend Traps

Global conference call

So are Australian banks Dividend Dynamos or Dividend Traps? Head of Citi's Australian Banks Research team, Craig Williams, thinks they're Dynamos. He believes their dividends are sustainable and expects DPS to rise, not fall. But many global investors are wary, and for good reason. For US and European banks, a high dividend yield for the banks has been a better sell than buy signal over the last five years. To help us test Craig William's sanguine view on the Australian banks we recently chaired a conference call between him and Ronit Ghose, who is Head of European Banks Research and has seen first hand, during the global Financial Crisis, what can go wrong with high yielding banks. Tony Brennan, Citi' Australian Equity Strategist, also joined the discussion. Below is a summary of the call between Craig, Ronit, Tony and the Global Equity Strategy Team.

Housing

Ronit, what were the major reasons why investors lost so much money owning banks in the US and Europe over the last five years?

Ronit: One of the main reasons was housing. Bank investors in the US and Europe underestimated the severity of house price declines and the secondary effects of falling house prices in 2007-08. In the US, investors had not seen house price declines on a national scale so were not prepared when it did happen.

Were there any secondary effects associated with falling house prices?

Ronit: Many investment banks at the time were effectively housing market plays. Their asset inventory wasn't disclosed, wasn't valued correctly and so wasn't

understood by investors. Not only did commercial bank balance sheets get hit by house price declines, so did the investment banks. Another secondary effect was the drying up of wholesale funding markets.

Craig, what is happening in Australian housing and what is the outlook?

More stable housing activity in Australia

Craig: Australian house prices have held up better than in other countries which is foremost a function of remarkably stable unemployment rates. This has protected bank mortgage books. From here our economists believe house prices and housing activity in Australia should remain stable. They note that variable/flexible mortgage rates have fallen by 100 basis points since late last year and the household debt service ratio is the lowest since the middle of the last decade.

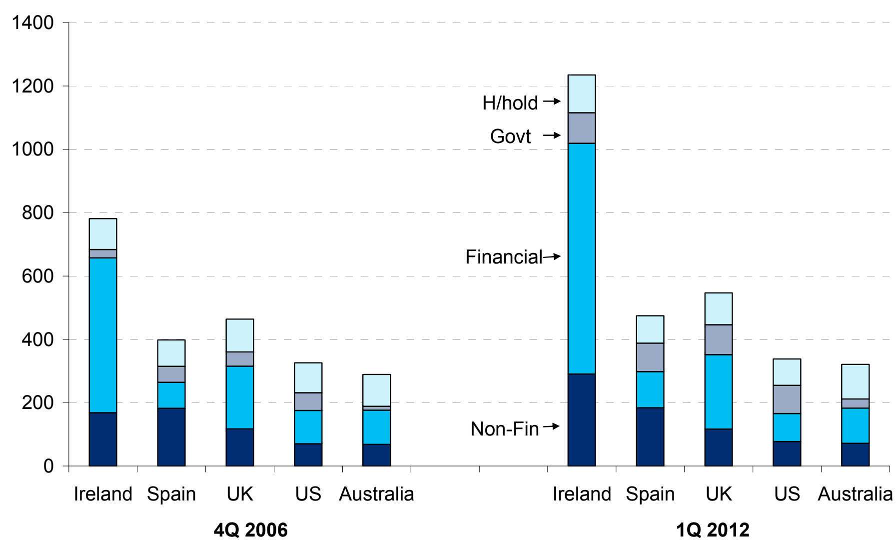
If house prices do fall, what will be the secondary effects in Australia?

Craig: I foresee minimal risks from losses on mortgage related securities holdings. Australian banks have simple balance sheets compared to elsewhere. Their assets are predominately loans (c80%) and the majority of these loans are mortgages, so the risks are more likely to be direct. Remember, during the UK housing market collapse, mortgage losses only peaked at 10-15 basis points despite a double-dip recession. These kinds of mortgage losses are easily manageable for the Australian Banks. Average Loan to Value now is about 50% because of more conservative origination standards, so there is considerable equity buffer. There is an additional "conservation buffer" applied by regulators. I think the bigger risk to investors involves the banks' corporate lending portfolios. But you need to consider here that corporate gearing ratios in Australia are at 20 or 30-year lows.

Sovereign Strength

Many investors thought the European sovereigns were in a strong position before the financial crisis, but this quickly changed. What they could have missed was not government debt, but total economy debt, which was quite high for Ireland, Spain and the UK. At least in Australia now total economy debt is not as high (Figure 4).

Figure 4. Australian Total Economy Debt to GDP Has Hardly Changed Over the Last 5 Years (%)



Source: National Flow of Funds Accounts, Haver Analytics, Citi Research

Tony, if the Australian Banks do need help from the sovereign, how much capacity is there for the government to step in?

The Australian sovereign has plenty of capacity to help

Tony: The federal government largely ran budget surpluses for the decade leading into the global financial crisis, so even with the stimulus provided in 2008/09, the federal government net debt remains less than 10% of GDP. And the unwinding of the earlier stimulus is projected to return the budget to a small surplus again in the current financial year. So the government has significant capacity to help if required. But as Craig said, the Australian banks could manage the sort of mortgage losses seen in countries like the UK. Where the government's fiscal capacity could be more relevant might be in helping to counter the impact on the economy and employment were another global shock to occur.

Ronit, what was the experience in the US and Europe when the sovereign stepped in to stabilise the banks.

Ronit: We learnt that a strong sovereign can bail out the bank depositors and debt holders if required, but where does that leave the shareholder? Will he/she get diluted as the financial system is saved? This is the main way shareholders have lost money in the US, UK and Ireland, less so Continental European banks. This may be a good reason to own the Australian Bank bonds, but it would be interesting to see if an AAA sovereign actually helps equity investors in the future.

Will the Australian sovereign really care about the shareholder when the financial system is at risk?

Craig: I think that Australian regulators have done a good job of mitigating against financial system risk. Much of the risk to shareholders depends on the size of the downturn in the Australian economy and housing in particular. While serious impairment in Aussie mortgage assets will likely lead to dilution, we consider this as low risk at this stage. Where our AAA sovereign certainly helps is via providing access to funding and limiting liquidity risk.

Leverage and funding

Ronit, why else did equity investors get it so wrong with the US/European Banks?

Ronit: Investors concentrated on the wrong leverage ratios during the financial crisis. Bank management and investors were trained to look at certain types of balance sheet measures from the 1980s onwards. Other than a rare few, US-based investors, there was hardly any discussion of leverage ratios or un-adjusted capital ratios. Anyone who used these was considered neanderthal.

But the cave-man was eventually proven right.

That's correct. What we realised during the financial crisis is that these capital measures were constructed differently between banks and between countries. In the US, the investment banks like Bear Stearns and Lehman Brothers began to transform the asset side of their balance sheets into less liquid assets. This increased the mis-match between funding and assets for these institutions. In Europe, the banks expanded substantially outside their home market and this was typically funded externally, usually with dollar funding. This became an Achilles heel for many banks. My concern for Australian banks is that this external funding may disappear just as quickly.

Craig, are you worried about funding?

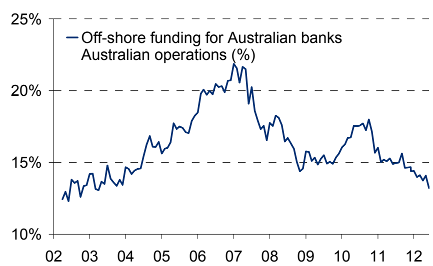
Funding remains an issue for Australian Banks but this is changing. Loan to deposit ratios are high at 140% but are coming down (they were 170%). The amount of funding the banks are doing in wholesale markets has come down accordingly. Banks are also helped by the AA-band credit rating, but this could change if credit quality worsens. The sovereign in Australia is in a position to help, more so than sovereigns in Europe or the US were in say 2007-08. This should help ensure funding for the banks. The Australian government guaranteed bank debt during the financial crisis. Unlike elsewhere, the capacity to do this again has not diminished.

How much of the Aussie Bank funding is done off-shore?

Craig: About 15% of funding comes from offshore. This is mostly term funding with an average duration of 3-4 years. Little comes from say US short-term money market funds. This is something Australian banks have learnt to avoid from the painful experience of European banks. There is still a mismatch between duration and assets but not as much as before.

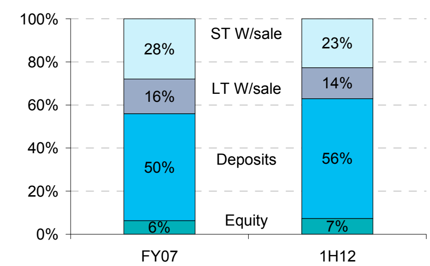
Funding sources being changed

Figure 5. Less reliant on international mks



Source: Company Data, Citi Research

Figure 6. Less Reliant on ST Funding



Source: Company Data, Citi Research

How about for the rest of the economy, how much funding is done offshore?

Craig: For the entire Australian economy, the external debt to GDP ratio is amongst the lowest in the world at close to 100% according to the IMF. The only advanced economies where this is lower is in Japan (c60%) and Canada (c80%). All this means Australian debt funding is less vulnerable to international capital flight.

Ronit, is this enough to swing a sceptical bank equity investor?

Ronit: It would probably help, but the reliance on US dollar funding by the wholesale banks in Europe, like the French banks, were single digit percentages of the balance sheet. These small amounts of funding seemed to trigger chain reactions across financial markets. Over the longer term the French banks adapted to less availability of US dollar funding. But it is the quick unravelling of funding markets and the contagion to other parts of the business that was the bigger concern. While the Australian banks are not as reliant on overseas funding markets, I wonder if there is any source of short duration domestic funding, if pulled, that will trigger some kind of panic?

So how much exposure is there to all short-term funding markets Craig?

Craig: That percentage is coming down. The Australian banks have had an opportunity to learn from what went wrong in Europe and the US and transformed their balance sheet and funding structures accordingly. Now 23% of Australian bank funding is from short-term sources and around two thirds of that is domestically

sourced. There is a circularity of bank bill holdings amongst the four major banks. To meet liquidity requirements banks need to hold a certain amount of short-term instruments and given the federal government has little outstanding debt, this has been met by owning the short-term debt of the banks. This insularity proved a source of stability for the bank sector in the worst days of the crisis.

Ronit, has there been much progress in transforming the funding sources and balance sheets of the US/European banks? How have investors reacted?

Ronit: There has clearly been some. But a major issue is that for emotional reasons many investors don't want to touch banks at all. While the Australian banks benefit from stronger balance sheets, they still remain highly leveraged when compared to non-financial companies. Standard Chartered has shown us that you can own a top quality bank with strong growth prospects and a sound balance sheet but still remain vulnerable to shocks. Perhaps a risk for Australian banks, which are considered relative safe havens in the global banks universe, is that investors may quickly flee if a shock strikes. Often the shock interferes with funding.

Craig, you may have the safest banks in the world, but they are still banks.

Craig: Agreed. These remain leveraged institutions and there is a certain degree of opacity with any bank balance sheet. But we think Australian banks are doing plenty to help control the risks. Ultimately liquidity or funding risk is borne out of the quality of the assets on the balance sheets. For Australian banks, that means there needs to be a shock to the housing market. The other obvious perceived concern is a sharp drop in commodity prices.

Commodity Exposure

A common perception is that the Australian economy and the banks in particular are leveraged plays on commodity prices. How exposed is the economy to commodities Tony?

Tony: The mining sector's output accounts for a reasonable proportion of Australia's GDP, 7-8%. But also incorporating the construction work associated with the sector's capital spending, and the combined amount is estimated to be around 15% of GDP at present. So it's quite significant. With the slowdown in global growth and China in particular in the past year, and the fall in commodity prices, some of the mining companies have been reviewing capital spending plans. But the actual work on projects already underway is large, in LNG especially, and this work can be expected to continue to complete the projects, given the work that's already been done. The projects have been undertaken on expectations about long-term prices, and aren't likely to be as impacted by short-term price moves.

When will mining capex peak out and what will Australian GDP growth be afterwards?

Mining capex to peak out in 2015

Tony: Our economists are forecasting capex to peak out in 2015 after which they're expecting a steady decline. They acknowledge that capex could fall away more sharply if the global outlook deteriorates further, though Australia would have decent capacity to ease monetary and fiscal policy to respond. The exchange rate could also be expected to adjust. But as things stand, when capex peaks they're expecting the production phase of the projects to fully kick in and exports to take up the slack, contributing to GDP almost as much as the decline in investment detracts. So if all this goes smoothly the impact on GDP should not be great. Also, the decline in resource capex should allow for more growth again in the rest of the economy,

which has been subdued in recent years to accommodate the resource expansion. Overall, our economists believe growth in Australia can remain at about 3-3½%.

Craig, how exposed are the banks to mining?

Craig: The direct lending exposure to the commodity sector remains low at 2-3% of balance sheet. The banks have not really lent much to mining companies. Of course there remains indirect exposure to say West Australian or Queensland real estate where much of the commodity production takes place, but this too is not significant. For example, there has already been a 30% decline in Gold Coast apartment prices and this has not had a material impact on balance sheets of the major banks.

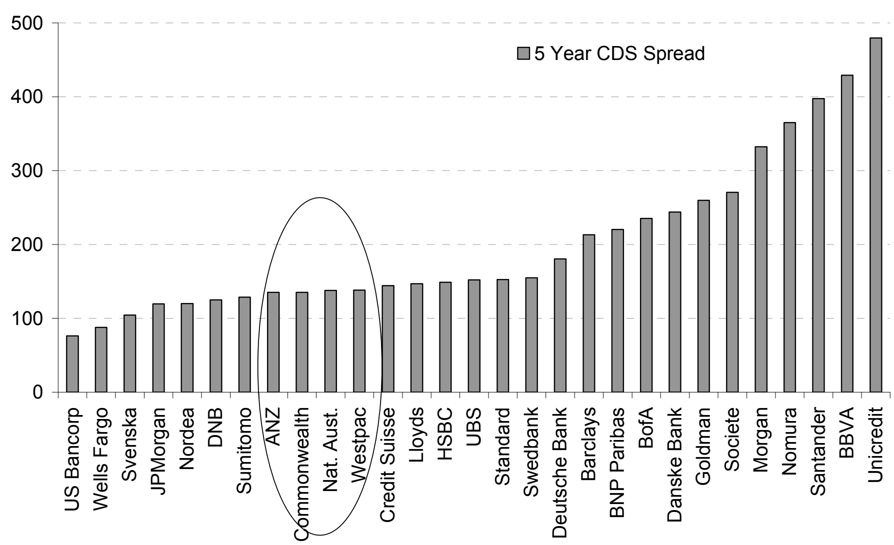
Credit Market Fears

A dividend strategy that has been successful in Europe and globally is our European Strategy team's CDS Adjusted Dividends approach. This strategy buys high dividend yield stocks but only if they have low CDS. While the Aussie Banks have amongst the lowest CDS of all banks globally, this is still at a level that might be consistent with a dividend cut. What can the Aussie banks do to help convince the credit and equity investors they are worthy investments?

Craig: Investors need to tread with caution here given the illiquidity of the Australian Bank CDS market. Perhaps the best they can do is to remain transparent in disclosing what is on the balance sheet. Their relatively simple balance sheets help. Also, there is no single component of the balance sheet which is generating unsustainable returns the same way sub-prime assets were for the US and European Banks in 2006-07. In hindsight we know these high returns were reasons to be cautious.

Safe havens in the global Banks universe

Figure 7. Aussie Banks Have Amongst the Lowest CDS of all Developed Market Banks



Source: Bloomberg

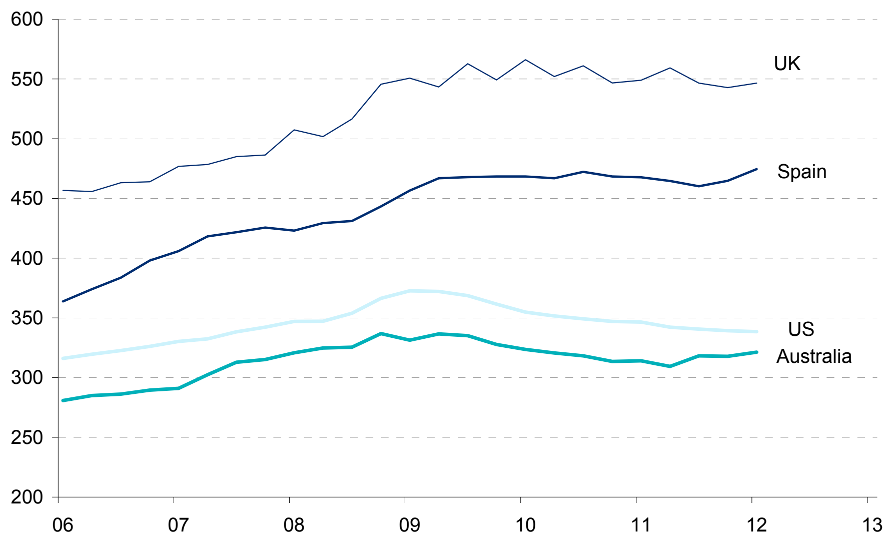
Is there anything else the international investor may be missing when looking at Australian banks?

Craig: What many investors could be under-estimating is how much Australian banks have transformed themselves over the last five years. They are stronger than US or European banks were in 2007-08. A relatively moderate economic downturn following the global financial crisis has allowed them to learn from the mistakes of their northern hemisphere peers. They have changed their funding sources and strengthened their balance sheets. While Australian banks had a good global financial crisis, it has not stopped their management from securing their institutions further. The stocks provide a 6% dividend yield and while investors fear dividend cuts, we forecast healthy DPS growth. So on our estimates they will be yielding 7-8% in 2014.

Tony: You can say the same for the rest of the economy. Australian households have started to de-leverage over the last few years. Similarly, debt levels for non-financial companies have come down (vs GDP) as has debt for financials. This means that the economy is better placed to withstand a shock if one happens. That should be good news for the banks.

Total economy leverage remains low

Figure 8. Australian Total Economy Debt Peaked in 2009 and Has Since Drifted Lower



Source: National Flow of Funds Accounts, Haver Analytics, Citi Research

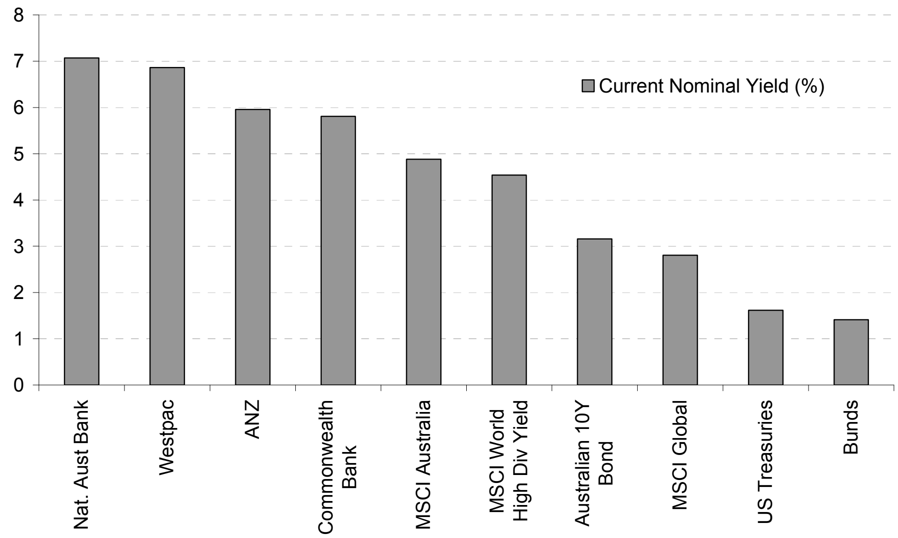
Ronit, Craig and Tony. Thank you for your thoughts.

Australian Banks in a Global Context

So Australian banks appear to be in better shape than they were before the financial crisis. They also seem to be in better shape than many US/European banks were back then. Indeed, they have learnt many lessons from the disastrous outcomes over the last five years. The Australian economy has begun its de-leveraging and the government is well placed to help the banks if needed. Continued GDP growth in Australia should help ensure dividend growth.

How do the Australian banks stack up against other potential sources of income? Australian banks are in the top decile of dividend yielders globally. Other companies here include the Spanish Banks, European Telecoms and Utilities. Some of which have put through dividend cuts recently. As we show in Figure 9 the dividend yields are clearly higher than fixed income securities and higher than even high yield equity indices like the MSCI World High Yield Index. In our opinion the Australian Banks should feature in a global income portfolio.

Figure 9. Australian Banks Feature Highly in the Global Search For Yield



Source: Datastream, Citi Research

Figure 10. Current Prices & Ratings For Stocks Mentioned In This Report*

RIC	Stock	Price	Rating	Country
ANZ.AX	ANZ Banking Grp	23.76	1	Australia
SAN.MC	Banco Santander	5.39	2H	Spain
BAC.N	Bank of America	7.83	2	United States
BARC.L	Barclays	1.86318	1	United Kingdom
BBVA.MC	BBVA	5.72	2H	Spain
BNPP.PA	BNP Paribas	33.81	1	France
CBA.AX	Commonwealth Bank	55.54	1	Australia
CSGN.VX	Credit Suisse	17.05	1	Switzerland
DANSKE.CO	Danske Bank	101	2	Denmark
DBKGn.DE	Deutsche Bank	25.08	2	Germany
DNB.OL	DnB	66.3	1	Norway
GS.N	Goldman Sachs	105.18	1	United States
HSBA.L	HSBC	5.676045	1	United Kingdom
JPM.N	JP Morgan Chase	37.47	1	United States
LLOY.L	Lloyds Banking Grp	0.318357	1	United Kingdom
MS.N	Morgan Stanley	14.73	2	United States
NAB.AX	NAB	24.7	2	Australia
8604.T	Nomura	273	1	Japan
NDA1V.HE	Nordea	7.8	2	Sweden
SHBa.ST	SHB	241.2	2	Sweden
8316.T	SMFG	2466	1	Japan
SOGN.PA	Societe Generale	20.26	1	France
STAN.L	Standard Chartered	13.535741	1	United Kingdom
SWEDa.ST	Swedbank	120.7	2	Sweden
UBSN.VX	UBS	10.49	1	Switzerland
CRDI.MI	UniCredit	2.976	1H	Italy
USB.N	US Bancorp	33.22	2	United States
WFC.N	Wells Fargo	33.98	2	United States
WBC.AX	Westpac	23.66	2	Australia

Source: Citi Research, *Prices sourced from DataCentral as of 14 August 2012

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Appendix A-1

Analyst Certification

The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

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Craig Williams, Analyst, holds a long position in the securities of Australia and New Zealand Banking Group Ltd.

Henrik Christiansson, Analyst, holds a long position in the securities of Deutsche Bank.

Tony Brennan, Strategist, holds a long position in the securities of Deutsche Bank.

A member of the household of Keith Horowitz, CFA, Analyst, holds a long position in the securities of JP Morgan Chase & Co.

Tony Brennan, Strategist, received compensation from Deutsche Bank in the past 12 months.

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