UBS

Global Equity Research

Australasia

Banks

Large Cap Market

# UBS Investment Research

## Australian Banking Sector Update

## The hare and the tortoise

13 January 2012

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■ **Aussie banks - some of the world's best performing. Winners by default**

Although most Australian bank investors would consider 2011 a challenging year, with prices down 7% and total returns around zero (post dividends), these numbers shine brightly relative to global banks. In fact the Australian banks were some of the best performing in the world, just behind the Canadians. However, the question remains - will the tortoise continue to beat the hare in 2012?

■ **Top line growth remains elusive**

We continue to be cautious on the outlook for credit growth. Despite RBA rate cuts helping to bail-out over-leveraged borrowers, we do not expect a significant pick up in the housing market. Most mortgagees will likely leave their payments unchanged leading to increased pre-payments. This may offset a pick-up in new lending activity. Businesses are also likely to remain cautious given the global environment. NIMs are clearly under pressure given funding & deposit markets. However, we are optimistic the banks will follow ANZ's lead and decouple rate decisions from the RBA. This is a structurally positive move. Trading income should bounce back in 1H12, but wealth & fee income remains subdued.

■ **Costs remain the main focus. Delivering limited growth in EPS & BVPS**

We expect the banks to be heavily focused on their cost bases. Solid reductions in headcount & discretionary costs are anticipated as banks react to the lower growth environment. This may be partially offset by increased amortisation of capitalised projects. Asset quality should remain benign despite pressure on the SME segment (property valuations are key here). This leads to around ~5% NPAT growth. However, this is offset by DRP dilution taking EPSg to ~2.5% & BVPSg to 6%.

■ **Expect another volatile market in 2012. Timing, not time-in.**

We expect bank prices to remain relatively volatile through 2012, with bouts of optimism offset by ongoing concerns over Europe, funding markets, Chinese outlook etc. Despite delivering flat total returns during 2011, the banks traded a 25% range. Given our expectation of ongoing price volatility, we believe investors should have clear entry and exit targets for each stock to maximise returns.

We believe the banking sector appears fairly valued at 1.6x book (ROE 16.3%), 10.3x PE and 7.2% dividend yields. We have Buy ratings on NAB (turnaround potential) and WBC (strong balance sheet). We are Neutral ANZ (LT Asian upside but need to show ROE improvements) and CBA (premium banking franchise, but it comes with a premium valuation). We remain overweight the banks relative to the domestic market.


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# Contents

page

**Will the tortoise beat the hare again in 2012?** 3

**Factors driving bank earnings and profitability in 2012** 4

— Housing credit likely to remain subdued ... 4
— Will rate cuts simulate housing credit growth? ... 8
— Businesses have stopped deleveraging, but don't expect a big rebound ... 10
— Net Interest Margins – Can a new pricing structure offset funding pressures? ... 12
— Costs – getting serious ... 15
— Asset quality ... 19
— Capital and liquidity ... 24
— Sector Earnings and Valuation Summary ... 26
— Sector Valuations Charts ... 29
— Stock Valuation Charts ... 30

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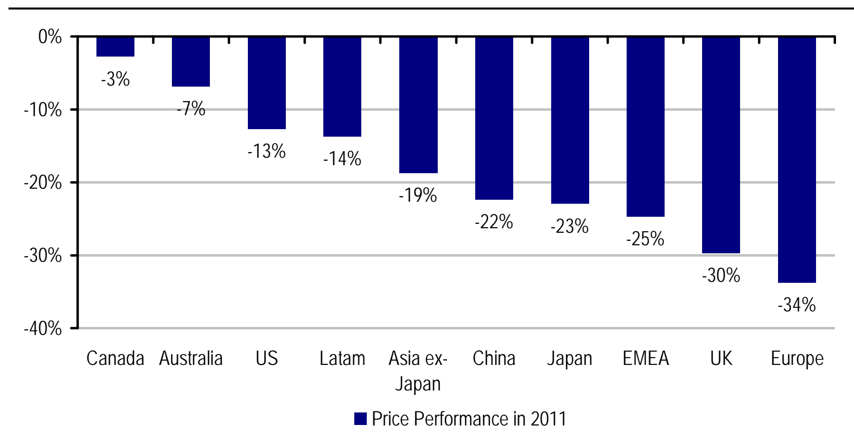
# Will the tortoise beat the hare again in 2012?

2011 proved to be another difficult year for the global banks, with macro-economic events in Europe, US and Asia, as well as ongoing regulatory pressures leading to significant weakness in share prices.

Chart 1: Global Bank Price Performance in 2011 (%)




Source: Bloomberg, UBS estimates

Aussie banks outperformed the global banks again in 2011

Although the -7% share price return (about zero post dividends) for the Australian banks was hardly spectacular, it stands out alongside the Canadian banks relative to the rest of the world. The Australian banks also outperformed the domestic market (ASX200) by around 10% post dividends during 2011. This was really a case of the tortoise beating the hare!

Volatility will most likely remain high in 2012.

When we look forward to 2012 we believe that many of the key themes seen in 2011 are likely to be repeated. The growth outlook for the Australian banks remains challenged, however, they remain profitable and are strong capital and dividend generators.

Performance will be driven be timing, not time-in

Volatility within markets is also likely to remain high with bouts of optimism likely to be offset by ongoing concerns over Europe, funding markets, the outlook for Chinese growth and other factors. Although the Australian banks generated zero total returns during 2011, it is worth remembering that they traded in a 25% high-to-low range. We would not be surprised to see a similar range during 2012.

The Australian banks are currently trading on 1.6x book (16.4% ROE), 10.3x PE and a dividend yield of 7.2% (fully franked). Although some may argue that this is cheap in an historical context (we believe that this is less relevant given the lower growth outlook and higher capital intensity) we believe these valuations are fair.

As a result, we believe investors need to have clear entry and exit target prices for each of the banks to maximise returns during 2012. Performance will be determined by timing, not time-in.

# Factors driving bank earnings and profitability in 2012

## Housing credit likely to remain subdued

We remain cautious on the outlook for housing credit growth during 2012. This is consistent with our indepth reports *Credit Growth – from Hero to Zero? Parts I & II* (dated 15 July and 5 Sept 2011).

We remain cautious on the outlook for housing credit

Although mortgage credit continues to track at all-time lows at 5.7% (lowest since WWII) this comes after a period of excessive leveraging within the housing sector. From 1977 to 2010 housing credit in Australia grew at 14% CAGR which is clearly unsustainable. We anticipate housing credit growth to continue to remain subdued, probably staying in the 4-6% range for some time.

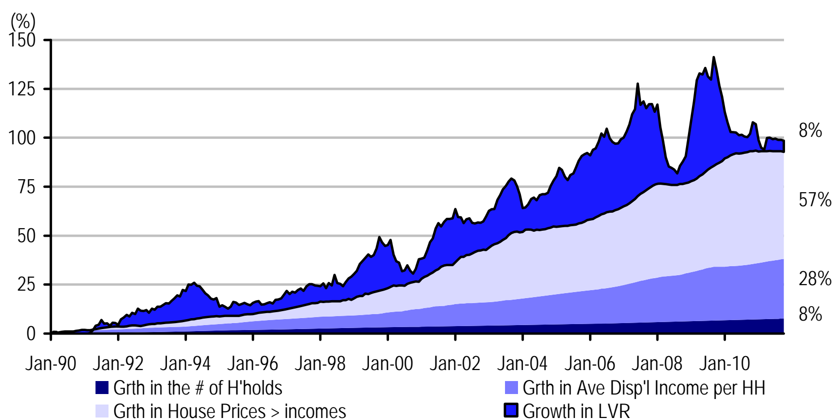
When we forecast movements in housing credit we tend to break this down into its moving parts, ie the growth in outstanding credit is equal to the flow of net new lending (ex refinancing) less principal repayments. This can also be broken down between owner occupied lending and investment lending.

### Movement in Owner Occupied Lending excluding Refinancing

The level of net new housing lending (excluding refinancing) remains subdued. This comes after a prolonged period of growth over the last twenty years, much of which (~57%) was attributed growth in house prices in excess of household incomes (refer Chart 2 below and indepth reports for more detail).

57% of the growth in owner occupied lending can be attributed to house price inflation above household income growth

Chart 2: Attribution of the growth in Owner Occupied Lending (ex Refinancing)




Source: ABS, Rismark, UBS estimates

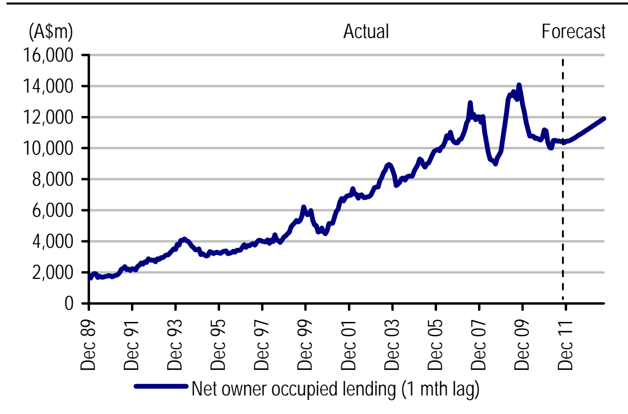
Although the recent cuts to the Standard Variable mortgage interest rates may potentially lead to an increase in demand for new lending we expect this to be relatively subdued. We believe the sentiment towards the housing market has softened, especially at the top end. We believe that activity levels at the lower end and first home owners segment may pick up slightly.

### This may be offset by increased mortgage paydowns

In Australia the vast majority of mortgagees are on variable rate products (approximately 90%). Recent cuts to interest rates will provide some easing of

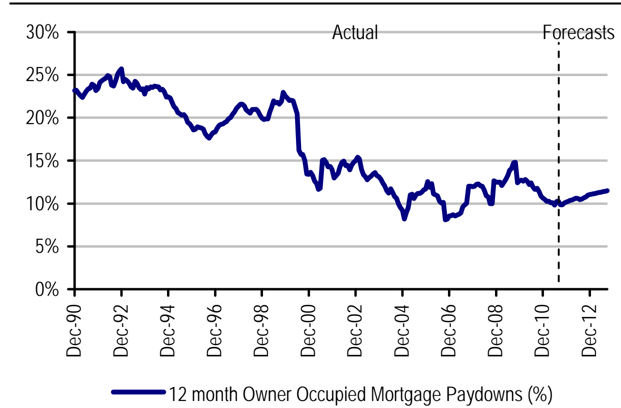
mortgage pressure on overleveraged borrowers. However, for the vast majority of customers the reduction in interest rates will not automatically trigger a reduction in mortgage repayments, as usually customers must contact the bank to arrange a change in their payment schedule. Instead these customers will just see a reduction in interest charged and an increase in their principal repayments. While this is good for consumer deleveraging and improves the security of the book, the faster amortisation of the mortgage portfolio will reduce credit growth.

Chart 3: Net Owner Occupied Lending Flow (ex Refinancing)




Source: RBA, ABS, UBS estimates

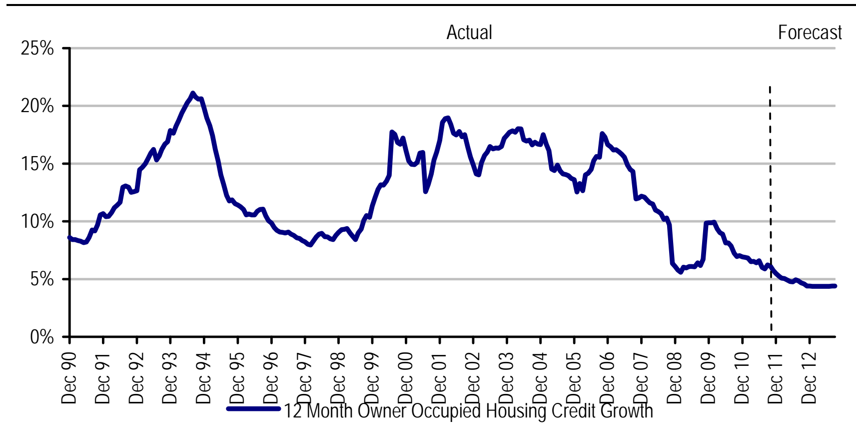
Chart 4: Owner Occupied Mortgage Principal Paydowns as % outstanding balance




Source: RBA, ABS, UBS estimates. Note: This measures the percentage of principal repayed by mortgagees as a percentage of the outstanding balance

Given these factors we would expect owner occupied housing credit growth to remain relatively subdued during 2012 as increased principal paydowns offset some increase in new lending activity. We expect total owner occupied housing credit growth to be around 4% to 5% during 2012 and 2013.

Chart 5: Growth in Owner Occupied Housing Credit (%)




Source: RBA, ABS, UBS estimates

### We are more cautious on the outlook for investor property

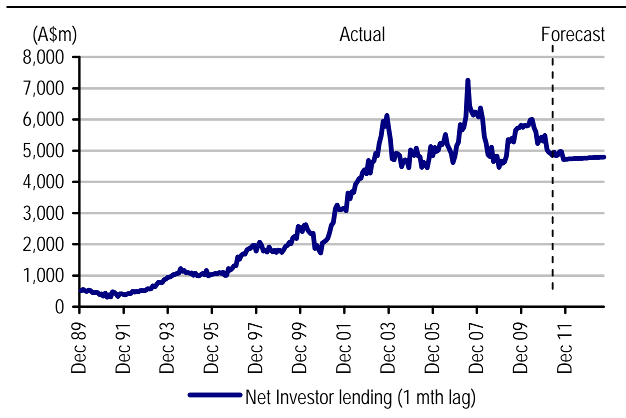
With the outlook for house price appreciation in Australia subdued at best (many would argue this is an optimistic view) we believe that investor appetite for additional housing leverage is low.

We are more cautious on the outlook for investment property lending

We believe that net new lending flow for investment lending will remain subdued. New lending flow for investment property has hovered around $5bn per month for around a decade, with three spikes during this time. Despite the recent cuts to interest rates we do not anticipate that many investors will be drawn into the housing market. To the same extent, we do not anticipate a collapse in lending activity unless global events turn significantly negative.

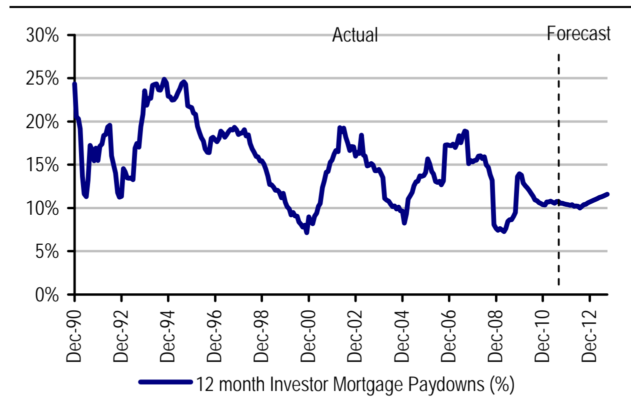
Consistent with owner occupied lending we are anticipating some pick-up in investor principal repayments as interest rates fall, albeit probably not to the same extent.

**Chart 6: Net Investor Lending Flow (ex Refinancing)**




Source: RBA, ABS, UBS estimates

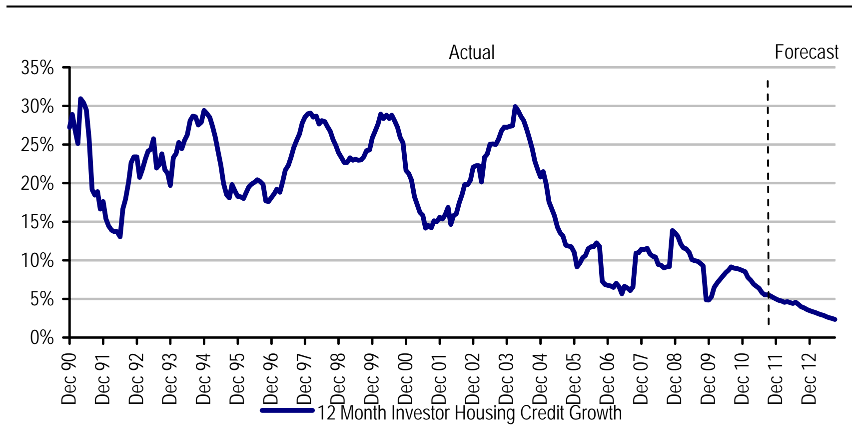
**Chart 7: Investor Mortgage Principal Paydowns as % outstanding balance**




Source: RBA, ABS, UBS estimates.

This implies investment housing lending is likely to continue to slow towards around 3% over the next year.

**Chart 8: Growth in Investment Housing Credit (%)**

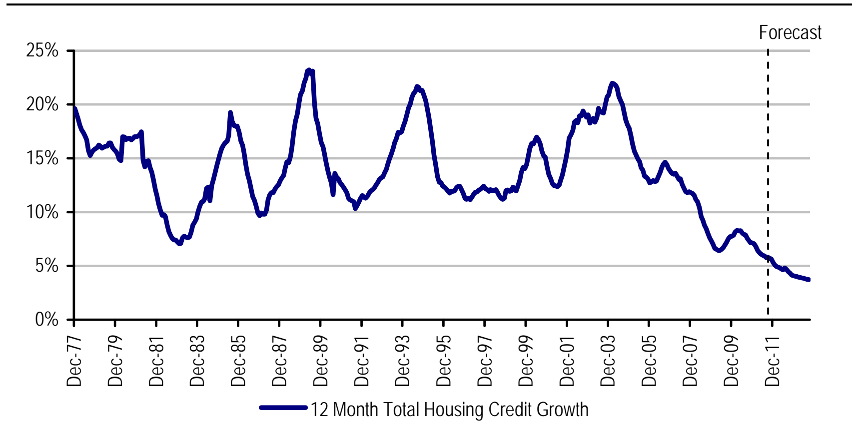



Source: RBA, ABS, UBS estimates

### Leaving Total Housing Credit growth relatively subdued ~4%

If we aggregate our bottom up forecasts for both owner occupied and investor housing, we expect total housing credit growth to continue to slow back towards around 4% over the next twelve months. This equates to a $51bn increase in the level of outstanding mortgage debt.

Chart 9: Total Housing Credit Growth (%)



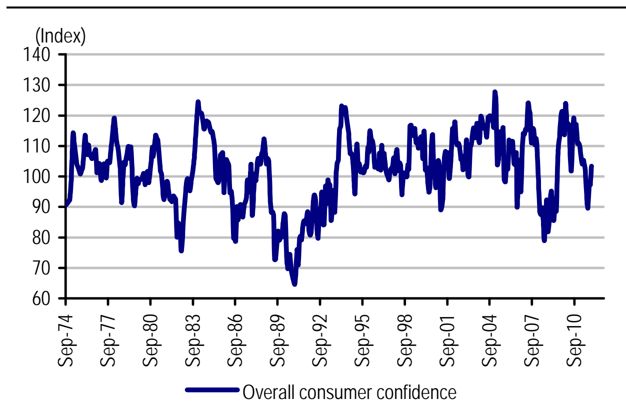

Source: RBA, ABS, UBS estimates

Overall, total housing credit growth is expected to slow

There may be some upside risk to this if the RBA cuts rates more aggressively than we expect, leading to a re-stimulation of house price appreciation and a re-leveraging of the consumer (an outcome we believe the RBA may wish to avoid). That said, such an outcome would again place further pressure on the banks' funding tasks, especially if it is associated with a reduction in the savings rate and deposit growth.

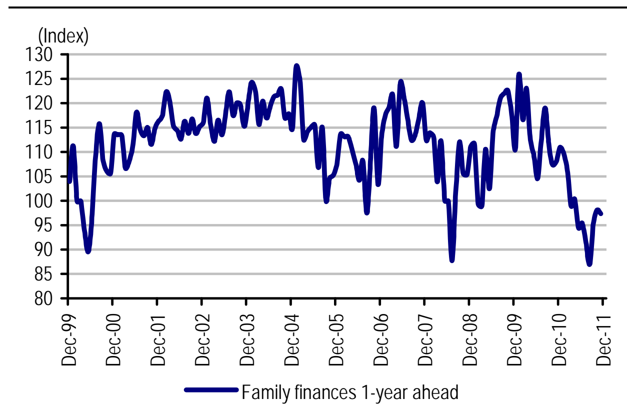
There remains downside to these forecasts if consumer confidence and sentiment remains subdued. In this case borrowers may continue to use the reductions in interest rates to accelerate the deleveraging process, further increasing principal repayments and slowing credit growth. In reality this may be the more likely outcome especially if European concerns continue.

Chart 10: Consumer Confidence




Source: Westpac, Melbourne Institute, UBS estimates

Chart 11: Consumer Confidence in Family Finances in 1 Year



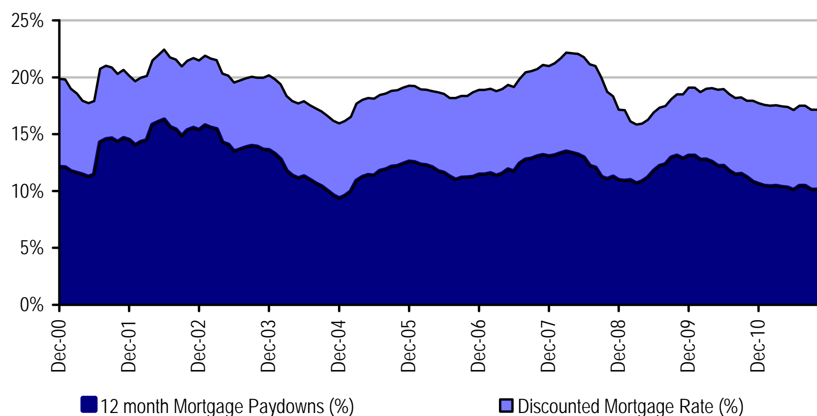

Source: Westpac, Melbourne Institute, UBS estimates

# Will rate cuts simulate housing credit growth?

### Back of the envelope sensitivity example:

- The Australian mortgage market is currently around $1,220bn. We estimate that around $1,100bn of this is variable rate.
- If we assume that mortgage rates fall by 150bp through this cycle (scenario only), then the interest bill for mortgagees falls by $16.5bn per annum.
- Then assume that 80% of customers leave their repayments unchanged. This results in a reduction in the interest component and an increase in the principal paydown component of around $13bn per annum.
- This increase in mortgage principal paydowns would reduce housing credit growth by 1.1%, all else equal.
- However, lower interest rates may lead to some stimulation in new lending activity (excluding refinancing). At present, housing lending (ex refi) is around $186bn per annum. It would need to rise by $13bn or 7% to offset the increase in principal paydowns.
- If the housing market reacted very positively to the reduction in interest rates and net new lending went back to the peak of $221bn (Feb 2010 at the end of the First Home Owner Grant and other stimulus), this would add around $22bn to the stock of outstanding credit (assuming no further changes to the repayment schedule). This equates to around 1.6% increase in housing credit growth from current levels.

Chart 12:Total Mortgage Payments (principal & Interest) as % of Outstanding Balance




Source: RBA, ABS, UBS estimates

## Table 1: Where would mortgage credit growth be in 2013? Sensitivity to changes in new lending and principal paydowns

| Mortgage Paydown Rate (%) | Change in Net New Lending (p.a.) | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | -12.5% | -10.0% | -7.5% | -5.0% | -2.5% | 0.0% | 2.5% | 5.0% | 7.5% | 10.0% | 12.5% | 15.0% | 17.5% |
| 7.5% | 2.7% | 3.3% | 3.8% | 4.3% | 4.9% | 5.5% | 6.1% | 6.8% | 7.4% | 8.1% | 8.9% | 9.6% | 10.4% |
| 8.0% | 2.3% | 2.9% | 3.4% | 3.9% | 4.5% | 5.1% | 5.8% | 6.4% | 7.1% | 7.8% | 8.5% | 9.3% | 10.1% |
| 8.5% | 1.9% | 2.5% | 3.0% | 3.6% | 4.1% | 4.8% | 5.4% | 6.0% | 6.7% | 7.4% | 8.2% | 8.9% | 9.7% |
| 9.0% | 1.5% | 2.1% | 2.6% | 3.2% | 3.8% | 4.4% | 5.0% | 5.7% | 6.4% | 7.1% | 7.8% | 8.6% | 9.4% |
| 9.5% | 1.1% | 1.7% | 2.2% | 2.8% | 3.4% | 4.0% | 4.6% | 5.3% | 6.0% | 6.7% | 7.5% | 8.3% | 9.1% |
| 10.0% | 0.7% | 1.3% | 1.8% | 2.4% | 3.0% | 3.6% | 4.3% | 4.9% | 5.6% | 6.4% | 7.1% | 7.9% | 8.7% |
| 10.5% | 0.3% | 0.9% | 1.4% | 2.0% | 2.6% | 3.2% | 3.9% | 4.6% | 5.3% | 6.0% | 6.8% | 7.6% | 8.4% |
| 11.0% | -0.1% | 0.5% | 1.0% | 1.6% | 2.2% | 2.9% | 3.5% | 4.2% | 4.9% | 5.7% | 6.4% | 7.2% | 8.1% |
| 11.5% | -0.5% | 0.1% | 0.7% | 1.2% | 1.9% | 2.5% | 3.2% | 3.9% | 4.6% | 5.3% | 6.1% | 6.9% | 7.7% |
| 12.0% | -0.9% | -0.3% | 0.3% | 0.9% | 1.5% | 2.1% | 2.8% | 3.5% | 4.2% | 5.0% | 5.8% | 6.6% | 7.4% |
| 12.5% | -1.3% | -0.7% | -0.1% | 0.5% | 1.1% | 1.8% | 2.4% | 3.1% | 3.9% | 4.6% | 5.4% | 6.2% | 7.1% |
| 13.0% | -1.6% | -1.1% | -0.5% | 0.1% | 0.7% | 1.4% | 2.1% | 2.8% | 3.5% | 4.3% | 5.1% | 5.9% | 6.8% |
| 13.5% | -2.0% | -1.5% | -0.9% | -0.3% | 0.4% | 1.0% | 1.7% | 2.4% | 3.2% | 3.9% | 4.7% | 5.6% | 6.4% |

Source: UBS estimates

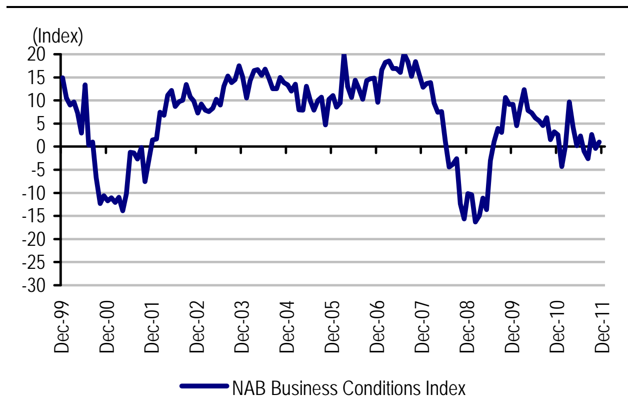
Note: (1) Mortgage Paydown Rate is the total amount of mortgage principal paydowns as a percentage of the balance. (2) The horizontal axis is the change in Net New Lending on an annualised basis until September 2013.

## Businesses have stopped deleveraging, but don't expect a big rebound

Australian businesses have significantly deleveraged over the last three years with total outstanding business credit falling by around $100bn to $690bn (representing a 13% reduction in outstanding business debt). Australian business' balance sheets are now relatively strong, with leveraging levels back at historical low levels.

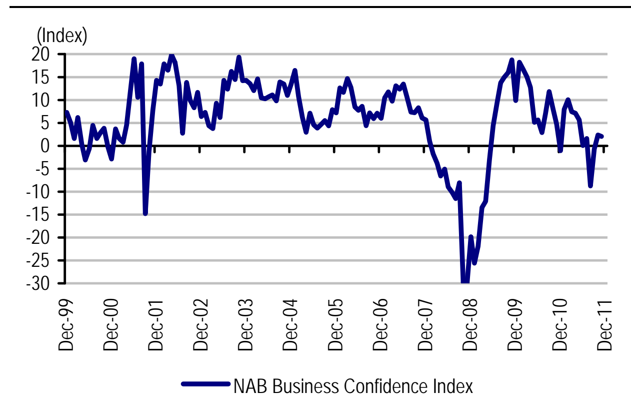
Australian businesses have deleverage by around $100bn since 2008

Chart 13: NAB Business Conditions Index (#)




Source: NAB, UBS estimates

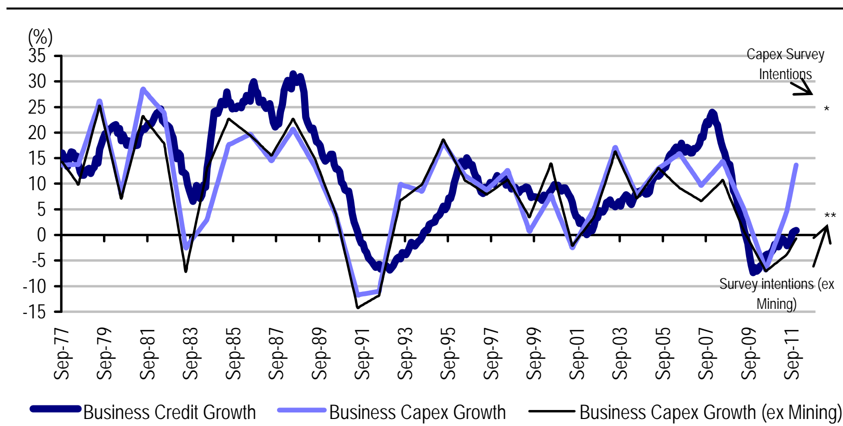
Chart 14: NAB Business Confidence Index (#)




Source: NAB, UBS estimates

Expectations for a sharp recovery in business credit have been elevated for some time. However, there have been many false dawns. It has now been almost two years since Joseph Healy, NAB's Head of Business Banking, stated that it had its strongest business pipeline in many years. Unfortunately business confidence and business conditions are subdued and are likely to remain this way until there is more certainty over the economic outlook for Europe and China in particular.

Chart 15: Business Credit Growth vs Business Capex Growth (%)




Source: RBA, ABS, UBS estimates

Business capex is usually a good indicator of business credit growth.

However, capex intentions are heavily skewed to mining, where the banks have little exposure

Another indicator for the outlook for business credit is capital expenditure. This has proven to be a good lead indicator over the past thirty years. At present capex intentions have risen strongly, with surveys indicating around 26% growth in business capex over the next year. However, this is very heavily

skewed to the mining sector where capex is expected to be up by around 72%. This implies that business capex, ex mining is expected to remain more subdued, up around 4%.

Capex intentions ex mining remain subdued, up about 4%

Unfortunately the Australian banks have limited direct lending exposure to many of the big ticket mining capex projects currently underway or proposed. In addition, mining only makes up around 1-2% of the banks Total Committed Exposures, so even if this grows strongly it is unlikely to materially move the balance sheet.

Overall, we expect business credit to continue to slowly expand following this deleveraging process, recovering back toward 3-5% growth over the next year.

## Net Interest Margins – Can a new pricing structure offset funding pressures?

With global funding markets once again constrained with concerns over Europe, the cost of raising debt has once again spiked. Although the major bank's funding task has reduced materially over the last two years as a result of subdued credit expansion and solid deposit growth, the major banks will still need to raise between $80bn to $100bn from wholesale markets over the next year. As a result the banks' average funding costs are continuing to rise.

The pricing of a number of recent benchmark wholesale transactions has also caused some contention. With the first issues of covered bonds by Australian banks over the last few weeks, prices have been materially higher than anticipated despite the additional security. However, from the banks' perspective it is a case that they need to hit the markets regularly to ensure they are not falling behind their funding tasks.

Although funding tasks have come down, the banks will still require around $80bn to $100bn in term funding during 2012

Table 2: Summary of recent wholesale term issues by the major banks

| Date | Bank | Type | Currency | Amount (US$m) | Duration (years) | Landed Cost over BBSW (bp) |
|---|---|---|---|---|---|---|
| 10-Oct-11 | CBA | Senior | AUD | 977 | 3.28 | 115 |
| 13-Oct-11 | ANZ | Covered | EUR | 686 | 5.02 | 191 |
| 25-Oct-11 | ANZ | Senior | GBP | 479 | 3.02 | 130 |
| 26-Oct-11 | ANZ | Senior | AUD | 1,046 | 4.00 | 135 |
| 8-Nov-11 | CBA | Senior | AUD | 207 | 4.73 | 117 |
| 15-Nov-11 | ANZ | Covered | USD | 1,250 | 5.03 | 145 |
| 17-Nov-11 | WBC | Covered | USD | 1,000 | 5.03 | 145 |
| 25-Nov-11 | CBA | Senior | AUD | 341 | 1.49 | 100 |
| 13-Dec-11 | NAB | Senior | AUD | 811 | 3.02 | 130 |
| 16-Dec-11 | CBA | Senior | JPY | 641 | 5.02 | 228 |
| 4-Jan-12 | CBA | Covered | EUR | 1,951 | 5.02 | 220 |
| 5-Jan-12 | NAB | Covered | EUR | 1,300 | 5.02 | 220 |
| 9-Jan-12 | ANZ | Covered | EUR | 1,271 | 10.52 | 242 |

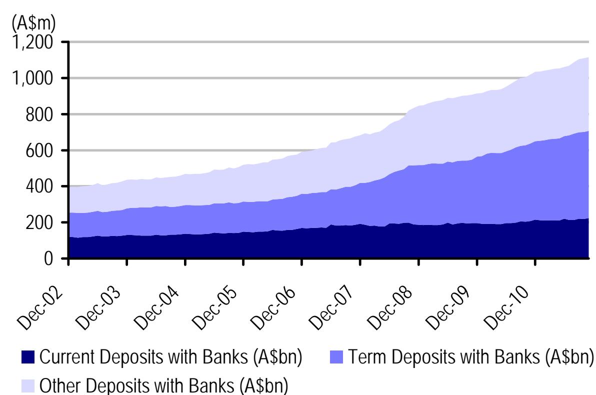
Source: Dealogic, Bondware, Bloomberg, UBS estimates

Offshore funding costs continue to rise

The banks are also continuing to face additional pressure on funding costs from both the mix and pricing of deposits. Flows into traditional low interest transaction accounts continue to be anaemic, while higher rate term deposit and online saving accounts are growing solidly. Further, although term deposit prices have come down over the last few months, this has not keep pace with changes in the yield curve. As a result, after a period of more rational pricing in the term deposit market, margins are again turning more negative.

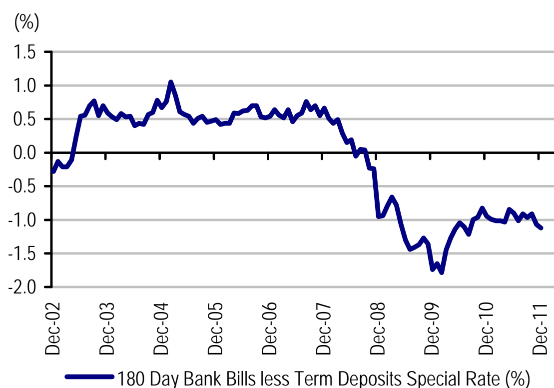
All this equates to additional pressure on the banks' funding costs, which is likely to negatively impact Net Interest Margins during the upcoming 1H12 reporting season (1Q11 trading updates for ANZ, NAB and WBC are due in February).

**Chart 16: Banks are becoming more reliant on Term Deposits**




Source: RBA, UBS estimates

**Chart 17: Term Deposit pricing remains competitive**




Source: RBS, UBS estimates

### ANZ officially disconnects Standard Variable Mortgage Rates from the RBA

While the banks have always had the ability to reprice their variable rate mortgage books, there has been substantial political pressure for the Standard Variable Rate to track movements in the RBA cash rate. This was seen acutely following the RBA's rate cut in December.

ANZ's move to decouple its lending rate decisions from the RBA is structurally positive

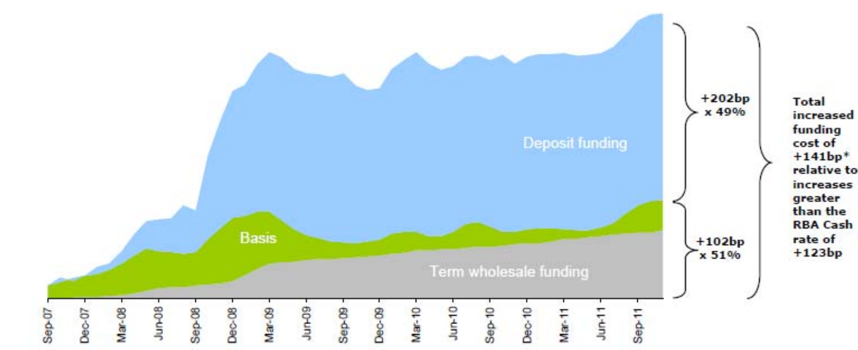
However, the bank's funding costs have very little correlation to movements in the official cash rate. This implies that if banks blindly passed through RBA cash rate movements across their loan book, the Net Interest Income would come under significant pressure as funding costs rise.

To break away from this political circus ANZ announced on the 8th December 2011 that "*Bank funding costs are now largely unrelated to movements in the Reserve Bank's Official Cash Rate. We have therefore taken a decision to announce future pricing changes for retail and small business variable interest rates on the second Friday of each month* [10 days after the RBA] *…This provides us with the flexibility to reflect movements in funding costs across the full spectrum of funding sources – not solely in response to the Reserve Bank's cash rate*".

As a result, going forward ANZ will consider all factors including the mix, duration and market conditions affecting real (not perceived) funding costs. The RBA's official cash rate will only be one of many factors considered in making these decisions. This process has now been formalised.

We believe that this new methodology of setting customer's interest rates by ANZ should provide it with a much more effective mechanism of managing its funding costs and Net Interest Margin.

Chart 18: ANZ Change in the Funding Costs of the Australian Retail Portfolio




Source: ANZ.
Note: As at 8 December 2011

### Will the other banks follow ANZ's lead?

We believe that over time the other major banks are likely to follow a similar process of managing customer's interest rates as ANZ. However, given first mover disadvantage in setting the Standard Variable Rate, there may initially be some gamesmanship. For example another major may decide to announce their interest rate changes on the third Monday of each month (ie after ANZ). However, over time this arbitrage will eventually be eliminated (ANZ could also change their announcement date) and we may potentially reach a point where each of the banks announce their interest rates simultaneously, in a scheduled manner.

We expect the other banks to follow ANZ's lead and move to scheduled rate decisions independent of the RBA

A simultaneous announcement of interest rates by the banks (well after the RBA Board meeting) would be a very positive for the industry structure, in our view. This would enable the banks to more effectively pass through additional funding costs to the customer and manage their Net Interest Margins, while maintaining the competitive dynamics of the market.

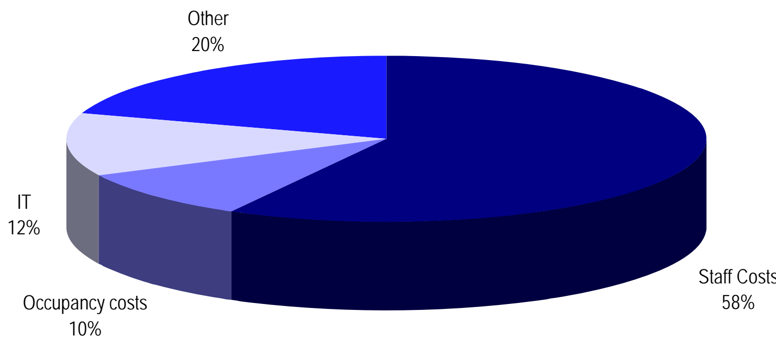
## Costs – getting serious

Following an extended period of strong revenue growth over the last two decades we believe that the revenue opportunities for the banks are now challenged. Consumer and business confidence is more subdued and is likely to remain so for some time as the globe deleverages and instability prevails. As a result we believe bank management are becoming increasingly focused on improving efficiency to deliver improvements in pre-provision profit.

### Staff costs

Staff costs are the biggest contributor to group expenses for all the banks, at 58% of the total cost base. This is an area which will need to be targeted by the banks as they address their expense levels.

Chart 19: Breakdown of the Banks operating cost bases




Source: Company data, UBS estimates

Staff costs account for 58% of total expenses.

We believe this is a key area of potential cost savings over the next few years

While the banks were active managers of headcount during the late 1990s and early 2000s, we believe that the banks have become more lax in managing staff numbers in recent years, "investing for growth" rather than managing costs.

Chart 20: Total Sector Staff Numbers (ex ANZ Asia) (FTE)

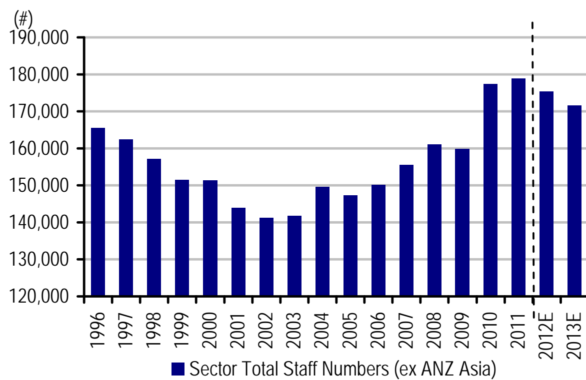
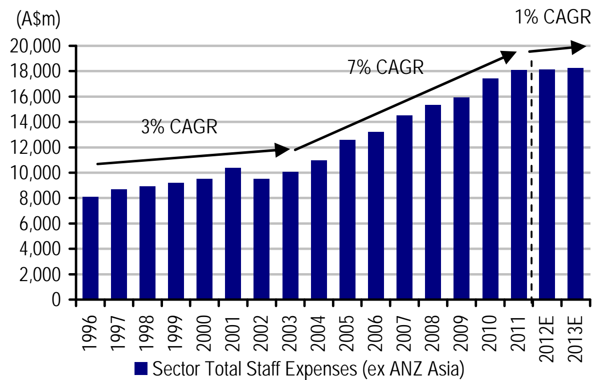



Chart 21: Sector Staff Costs Expenses (ex ANZ Asia) (A$m)




Source: Company data, UBS estimates. Includes: ANZ, CBA, NAB, WBC, BEN, BOQ as well as St George, BankWest and Adelaide Bank prior to acquisition

In 1996 the Australian major and regional banks employed 166,000 FTE. However, following a period of rationalisation this fell to 141,000 in 2002 as the

banks centralised a number of processes and reduced their branch footprints. However, since this time the banks have rapidly expanded their staff numbers which have now reached 179,000 (ex ANZ Asia).

This can be seen from the inflection in sector staff expenses. During the period from 1996 to 2002 the banks kept staff expense growth to 2.7% CAGR. However, as the banks rapidly re-staffed from 2002, employee expenses have grown at 7% CAGR.

The banks' management of staff costs has been poor over the last decade. This must be addressed

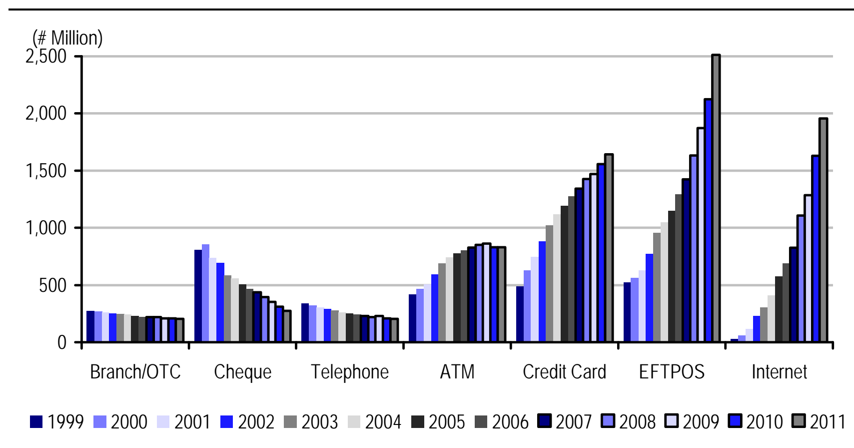
Going forward we are anticipating some solid reductions in headcount over the next two years down to 172,000 (ex ANZ Asia). This should help absorb underlying wage increases keeping total staff expenditure growth to around 1% per annum.

### Product, Processing and Procurement

While the banks continue to develop additional products and offerings for their customers, we believe that they often neglect to rationalise more redundant offerings. While this may have been justifiable in a stronger revenue environment as many customers may have been happy with existing offerings, over time this leads to back-office complications, additional costs and operating risks. Often older products are no longer cost efficient or profitable. In this case customers need to be actively moved to alternative offerings.

We believe a good illustration of this comes from client transactions by distribution channel. Over the last decade there has been a material change in the way customers interact with the banks and with each other. This has been facilitated by technology advances, in particular the expansion of the internet and the further rollout of debit cards and EFTPOS (Electronic Funds Transfer at Point of Sale).

Chart 22: Estimated Bank Transaction Numbers (# million) per annum




Source: RBA, APCA, Company data, UBS estimates

Opportunities to achieve cost savings by moving processing offshore to India and other areas are now likely to be reinvestigated. We believe that this topic is highly political with the government putting pressure on the banks to refrain from moving additional roles offshore (to maintain domestic employment) during the financial crisis.

However, we believe that the banks are likely to reinvestigate offshoring as an alternative over coming years given the substantial savings on offer. A large number of non-client facing roles could potentially be moved to more cost efficient locations offshore.

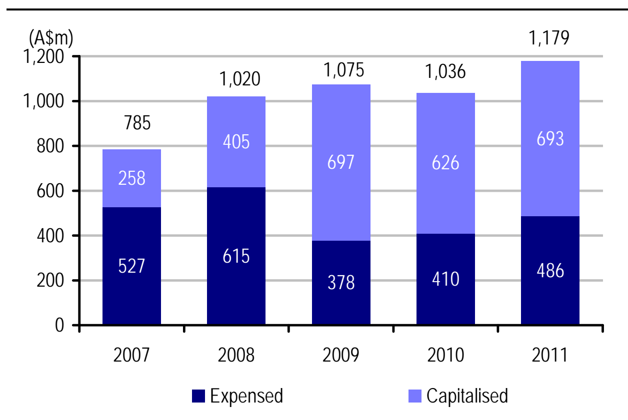
Offshoring and procurement will also be a big focus to improve efficiency

We believe that the banks are working to centralise a larger proportion of their procurement processes. This offers economies of scale and a better position to negotiate with suppliers. We believe that a number of other industries and companies (such as Woolworths) have been more successful that the banks at leveraging procurement opportunities. That said, procurement is a smaller proportion of the banks' cost base than other industries.

### Reprioritising Investment Spend

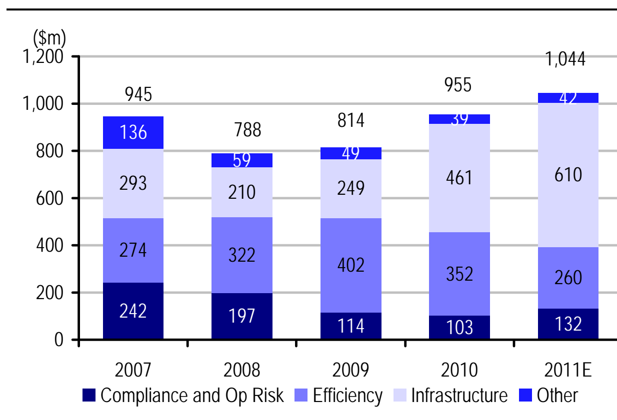
Over the last few years the major banks have materially increased their investment spend and capital expenditure, especially in areas like technology. We estimate that the banks total investment spend is now approaching $4b per annum. However, with the revenue outlook weaker we believe that many of these investment opportunities may need to be reviewed.

Chart 23: CBA total Investment Spend (A$m)




Source: Company data, UBS estimates

Chart 24: NAB Investment Spend Profile




Source: Company data, UBS estimates. Note: 2011E is 1H11 annualised

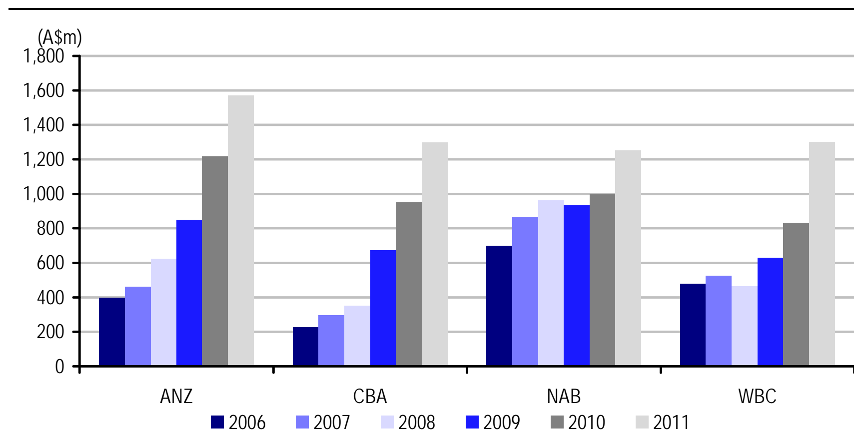
We believe that the banks may look to reprioritise much of their investment spend, similar to WBC's Strategic Investment Priorities (SIPs) program which looks to longer term savings and efficiency opportunities rather than new growth projects per se. Much of this spend is also offset by other productivity initiatives, ahead of implementation. Other projects which are more growth oriented with a riskier payoff will most likely be delayed until the revenue outlook improves (which may be some time).

The banks should also look to renegotiate with contractors, consultants and IT suppliers who are working to help develop and implement most projects. With the domestic economic outlook slowing these suppliers' work-flow is likely to come under pressure. As a result we believe that the banks are in a better position to negotiate cheaper rates from their suppliers. Contractors, consultants and IT suppliers' fees often run into the hundreds of millions of dollars per annum per bank, offering material savings potential.

### Capitalised Expenditure overhang

Since 2006 the Australian banks have seen a material increase in their balance of capitalised expenditure, which has grown at 25% CAGR. During 2011 alone the banks saw $2.5bn in Capex which represents around 6.3% of pre-provision profits. This takes the total balance of capitalised software across the sector to $5.4bn, which represents a 45bp deduction to the banks Core Tier 1 ratios (capitalised expenses are fully deducted from Core Tier 1 in Australia).

Chart 25: Capitalised software balances (A$m)




Source: Company data, UBS estimates

Banks' capitalised software balances have sky-rocketed over the last five years.

As amortisation kicks in this will add 1-2% to the banks' cost base.

We are sceptical about the increase in capitalised expenditure during the past few years, as greater cost efficiency is demanded by investors. We believe the bulk of this appears to be for compliance projects, technology infrastructure, data centres and customer-facing applications (online banking, collections). This appears to be largely 'stay in business' spending, particularly given the ongoing migration from branches to online/mobile channels, in our view.

We estimate that this increase in capitalised expenses accounted for 7% higher NPAT in FY11. However, this is not a permanent "free kick" for the banks as higher amortisation charges will begin to come to account over the next two years as many of these projects are turned on. We estimate that higher amortisation charges are likely to drag expenses 1-2% p.a. higher in coming periods, leading to a ~1.5% p.a. drag on NPAT.

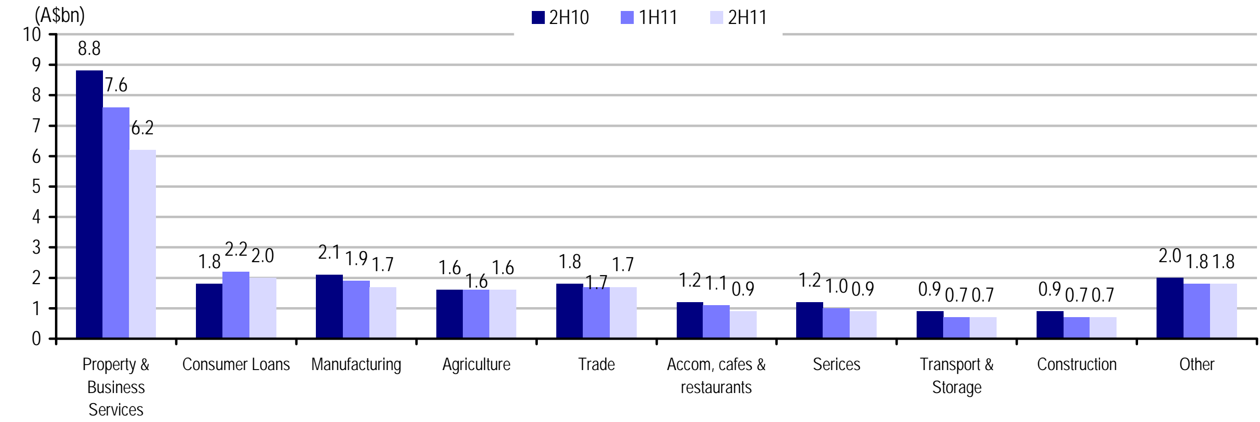
This headwind will put even greater pressure on the banks to address their cost bases and reduce expenditure as discussed above.

## Asset quality

Asset quality is a "sleeper issue" for the banks at the moment. The last reporting season showed impressive improvements in both the level of non-performing loans and watch-list positions across the banks, while the banks have spent significant effort cleaning up a number of single name and higher risk exposures over the last three years.

Asset quality is a "sleeper issue" for the banks

Chart 26: Breakdown of WBC's Stressed Exposures by Industry (A$bn)



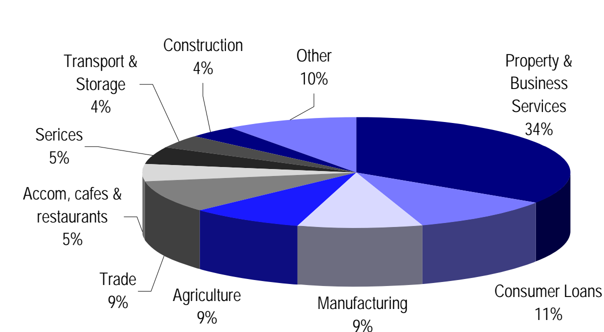

Source: Company data, UBS estimates

This can be illustrated by the reduced level of Commercial Property stressed exposures over the last twelve months at Westpac. It saw

Commercial Property exposures have been tidied up

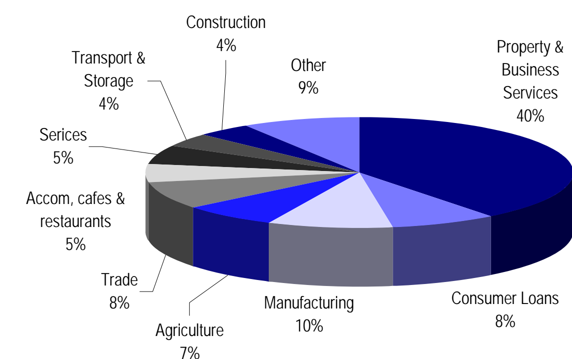
- Total Stressed exposures to Commercial Real estate fell from around $8.8bn in FY10 to $6.2bn in FY11.
- CRE now represents 34% of WBC's stressed exposures, down from 40%.
- 11.7% of WBC's CRE exposure is now considered stressed, down from 15.5% in FY10.

Chart 27: WBC Stressed Exposures by Industry FY11




Source: Company data, UBS estimates

Chart 28: WBC Stressed Exposures by Industry FY10



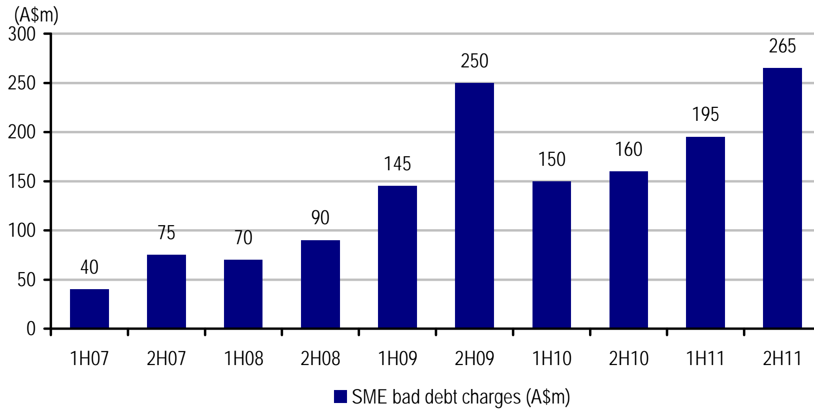

Source: Company data, UBS estimates

While Commercial Property still represents one of the biggest risk, across the bank's book, the riskiness of these portfolios has reduced substantially.

However, we believe that there is material pressure on many industries, especially within the less diversified SME sector. The high AUD, rising input costs and subdued consumer demand is making life difficult for many sectors of the domestic economy. While these smaller exposures are generally well secured by the banks, they are also reliant on asset price stability (mainly in residential and small business property prices). We believe that it is the SME sector which poses the greatest near term credit risk to the banks.

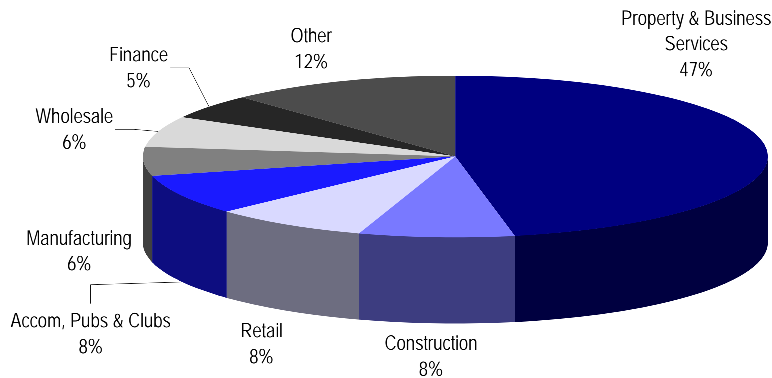
However, the SME segment is under significant pressure and is a risk area for the banks

Chart 29: NAB SME BDD Charge (A$m)



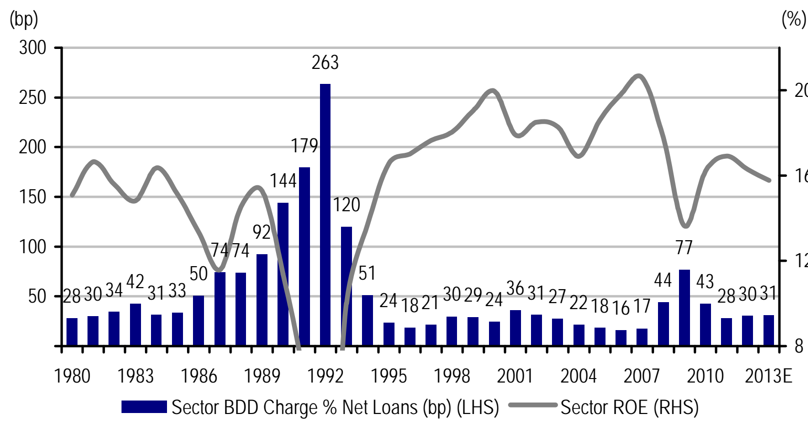

Source: Company data, UBS estimates

Chart 30: Breakdown of NAB's SME Business Loan Book



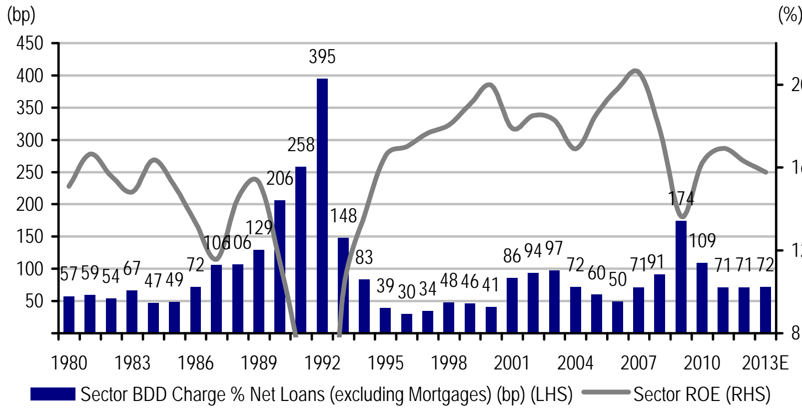

Source: Company data, UBS estimates

## Chart 31: Sector BDD charges to Total Loans



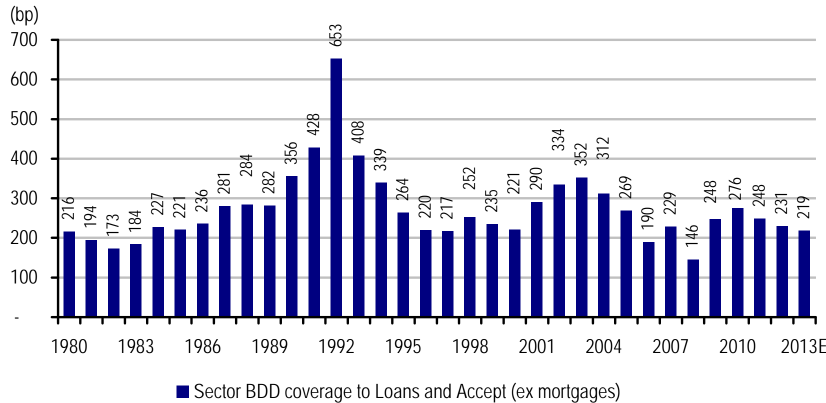

Source: Company data, UBS estimates

## Chart 32: Sector BDD charges to Loans (ex Mortgages)




Source: Company data, UBS estimates

## Chart 33: Sector Total Provision Coverage to Loans & Acceptances (ex Mortgages)




Source: Company data, UBS estimates

## Table 3: Sector Bad and Doubtful Debt Summary – 2011

| | ANZ | CBA | NAB | WBC | Majors |
|---|---|---|---|---|---|
| (A$m) | FY11 | FY11 | FY11 | FY11 | FY11 |
| **BDD charge to P&L (A$m)** | **1,200** | **1,280** | **1,822** | **993** | **5,295** |
| GRCL charge to reserves (A$m) | 11 | 0 | 26 | 0 | 37 |
| **Adjusted BDD charge to P&L (A$m, UBS Format)** | **1,211** | **1,280** | **1,848** | **993** | **5,332** |
| *BDD % change from prev year* | *-32.0* | *-38.3* | *-19.5* | *-31.8* | *-38.1* |
| **BDD charge to net loans and acceptances (bp)** | **30** | **25** | **38** | **20** | **28** |
| BDD charge to RWA (bp) | 43 | 45 | 53 | 35 | 45 |
| BDD charge to Credit RWA (bp) | 48 | 52 | 59 | 41 | 51 |
| Net write-offs to Loans and Accept (bp) | 30 | 35 | 42 | 39 | 37 |
| 90 Days Overdue (A$m) | 1,834 | 3,758 | 2,150 | 3,024 | 10,766 |
| **NPL ($m) (incl 90 Day O/D)** | **7,415** | **9,055** | **8,536** | **7,640** | **32,646** |
| *% Increase* | *-8.6* | *5.7* | *1.4* | *-1.1* | *-0.5* |
| **NPL as % of Total Loans (bp)** | **187** | **177** | **179** | **154** | **174** |
| Specific Provisions to NPL (%) | 23 | 23 | 17 | 19 | 21 |
| Total Provisions to NPL (%) | 66 | 57 | 70 | 58 | 63 |
| Movements in Balance Sheet Provisions (pre-tax) | | | | | |
| Specific Provision at End (A$m) | 1,697 | 2,125 | 1,475 | 1,461 | 6,758 |
| *% increase* | *-9.5* | *6.7* | *4.7* | *-9.9* | *-2.0* |
| Collective (General) Provision at End (A$m) | 3,176 | 3,043 | 3,469 | 2,953 | 12,641 |
| *% increase* | *0.7* | *-12.1* | *-5.9* | *-14.1* | *-8.0* |
| General Reserve for Credit Losses at End (A$m) | 0 | 0 | 1,023 | 0 | 1,023 |
| **Total B/S Provisions at Beginning (A$m)** | **5,028** | **5,453** | **6,091** | **5,061** | **21,633** |
| Charge to P&L (A$m) | 1,211 | 1,280 | 1,822 | 993 | 5,306 |
| Net Writeoffs (A$m) | -1,194 | -1,769 | -1,988 | -1,927 | -6,878 |
| Other acquisition, FX, IFRS adoption, etc. (A$m) | -172 | 204 | 42 | 287 | 361 |
| **Total B/S Provisions at End (A$m)** | **4,873** | **5,168** | **5,967** | **4,414** | **20,422** |
| *% growth* | *-3.1* | *-5.2* | *-2.0* | *-12.8* | *-5.6* |
| Provisioning Ratios | | | | | |
| Total Loans and Acceptances end (A$m) | 397,307 | 510,791 | 475,858 | 496,609 | 1,880,565 |
| Mortgages (A$m) | 215,382 | 335,841 | 253,064 | 333,065 | 1,137,352 |
| Total RWA end (A$m) | 279,964 | 281,711 | 341,069 | 279,961 | 1,182,705 |
| Collective Provisions to Loans and Accept (bp) | 80 | 60 | 73 | 59 | 67 |
| Specific Provisions to Loans and Accept (bp) | 43 | 42 | 31 | 29 | 36 |
| GRCL to Loans and Accept (bp) | 0 | 0 | 21 | 0 | 5 |
| (SP & CP) to Loans and Accept (bp) | 123 | 101 | 104 | 89 | 103 |
| **(SP & CP & GRCL) to Loans and Accept (bp)** | **123** | **101** | **125** | **89** | **109** |
| Collective Provisions to RWA (bp) | 113 | 108 | 102 | 105 | 107 |
| Specific Provisions to RWA (bp) | 61 | 75 | 43 | 52 | 57 |
| General Reserve for Credit Losses to RWA (bp) | 0 | 0 | 30 | 0 | 9 |
| (SP & CP) to RWA (bp) | 174 | 183 | 145 | 158 | 164 |
| **(Total Provisions & GRCL) to RWA (bp)** | **174** | **183** | **175** | **158** | **173** |
| (CP & GRCL) to RWA (bp) | 113 | 108 | 132 | 105 | 116 |
| Credit RWA (A$m) | 248,828 | 246,742 | 308,648 | 240,094 | 1,044,312 |
| CP/Credit RWA (bp) | 128 | 123 | 112 | 123 | 121 |
| SP/Credit RWA (bp) | 68 | 86 | 48 | 61 | 65 |

Source: Company data, UBS estimates

## Table 4: Sector Bad and Doubtful Debt Summary – 2012E

| | ANZ | CBA | NAB | WBC | Majors |
|---|---|---|---|---|---|
| **(A$m)** | **FY12E** | **FY12E** | **FY12E** | **FY12E** | **FY12E** |
| **BDD charge to P&L (A$m)** | **1,353** | **1,170** | **1,945** | **1,210** | **5,678** |
| GRCL charge to reserves (A$m) | 0 | 0 | 0 | 0 | 0 |
| **Adjusted BDD charge to P&L (A$m, UBS Format)** | **1,353** | **1,170** | **1,945** | **1,210** | **5,678** |
| **BDD % change from prev year** | **12.8** | **-8.6** | **6.7** | **21.9** | **6.5** |
| **BDD charge to net loans and acceptances (bp)** | **32** | **22** | **38** | **23** | **28** |
| BDD charge to RWA (bp) | 45 | 39 | 56 | 42 | 46 |
| BDD charge to Credit RWA (bp) | 50 | 45 | 61 | 49 | 52 |
| Net write-offs to Loans and Accept (bp) | 26 | 23 | 42 | 25 | 29 |
| 90 Days Overdue (A$m) | 1,927 | 3,817 | 2,314 | 2,973 | 11,033 |
| **NPL ($m) (incl 90 Day O/D)** | **7,793** | **9,198** | **9,188** | **7,512** | **33,692** |
| *% Increase* | *5.1* | *1.6* | *7.6* | *-1.7* | *3.2* |
| **NPL as % of Total Loans (bp)** | **183** | **171** | **181** | **144** | **169** |
| Specific Provisions to NPL (%) | 23 | 21 | 16 | 18 | 20 |
| Total Provisions to NPL (%) | 66 | 55 | 64 | 58 | 61 |
| **Movements in Balance Sheet Provisions (pre-tax)** | | | | | |
| Specific Provision at End (A$m) | 1,783 | 1,974 | 1,487 | 1,384 | 6,628 |
| *% increase* | *5.1* | *-7.1* | *0.8* | *-5.3* | *-1.9* |
| Collective (General) Provision at End (A$m) | 3,347 | 3,119 | 3,331 | 2,949 | 12,745 |
| *% increase* | *5.4* | *2.5* | *-4.0* | *-0.1* | *0.8* |
| General Reserve for Credit Losses at End (A$m) | 0 | 0 | 1,023 | 0 | 1,023 |
| **Total B/S Provisions at Beginning (A$m)** | **4,873** | **5,168** | **5,967** | **4,414** | **20,422** |
| Charge to P&L (A$m) | 1,353 | 1,170 | 1,945 | 1,210 | 5,678 |
| Net Writeoffs (A$m) | -1,096 | -1,217 | -2,111 | -1,291 | -5,715 |
| Other acquisition, FX, IFRS adoption, etc. (A$m) | 0 | -28 | 40 | 0 | 12 |
| **Total B/S Provisions at End (A$m)** | **5,130** | **5,093** | **5,841** | **4,333** | **20,397** |
| ***% growth*** | ***5.3*** | ***-1.5*** | ***-2.1*** | ***-1.8*** | ***-0.1*** |
| **Provisioning Ratios** | | | | | |
| Total Loans and Acceptances end (A$m) | 426,677 | 536,650 | 508,357 | 522,259 | 1,993,943 |
| Mortgages (A$m) | 227,228 | 350,954 | 269,513 | 348,053 | 1,195,748 |
| Total RWA end (A$m) | 303,644 | 303,639 | 350,194 | 287,335 | 1,244,811 |
| Collective Provisions to Loans and Accept (bp) | 78 | 58 | 66 | 56 | 64 |
| Specific Provisions to Loans and Accept (bp) | 42 | 37 | 29 | 27 | 33 |
| GRCL to Loans and Accept (bp) | 0 | 0 | 20 | 0 | 5 |
| (SP & CP) to Loans and Accept (bp) | 120 | 95 | 95 | 83 | 97 |
| **(SP & CP & GRCL) to Loans and Accept (bp)** | **120** | **95** | **115** | **83** | **102** |
| Collective Provisions to RWA (bp) | 110 | 103 | 95 | 103 | 102 |
| Specific Provisions to RWA (bp) | 59 | 65 | 42 | 48 | 53 |
| General Reserve for Credit Losses to RWA (bp) | 0 | 0 | 29 | 0 | 8 |
| **(SP & CP) to RWA (bp)** | **169** | **168** | **138** | **151** | **156** |
| (Total Provisions & GRCL) to RWA (bp) | 169 | 168 | 167 | 151 | 164 |
| (CP & GRCL) to RWA (bp) | 110 | 103 | 124 | 103 | 111 |
| Credit RWA (A$m) | 271,882 | 262,827 | 317,121 | 247,468 | 1,099,298 |
| CP/Credit RWA (bp) | 123 | 119 | 105 | 119 | 116 |
| SP/Credit RWA (bp) | 66 | 75 | 47 | 56 | 60 |

Source: Company data, UBS estimates

# Capital and liquidity

We believe that the Australia banks' capital positions are solid and they are well placed for the early adoption of Basel III. We believe that our view is consistent with the regulator, APRA.

Chart 34: ANZ Basel III Core Tier 1 (%)

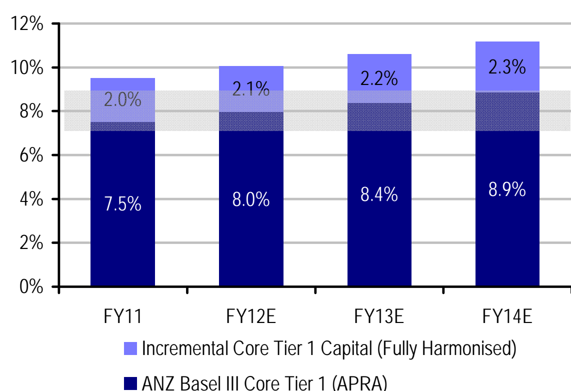



Chart 35: CBA Basel III Core Tier 1 (%)

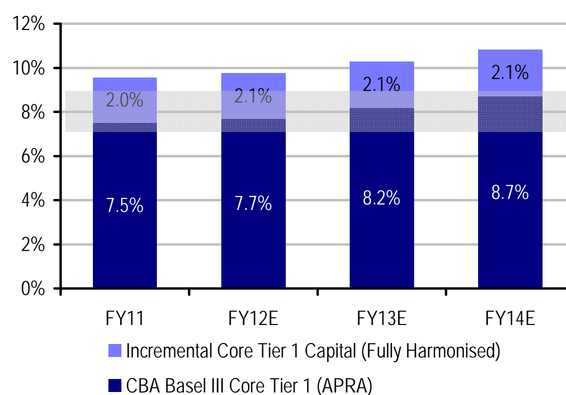



Chart 36: NAB Basel III Core Tier 1 (%)

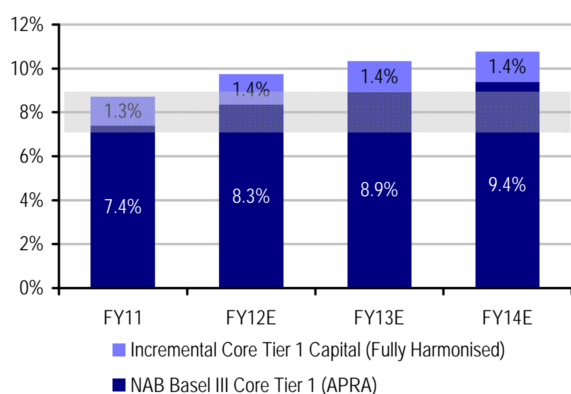
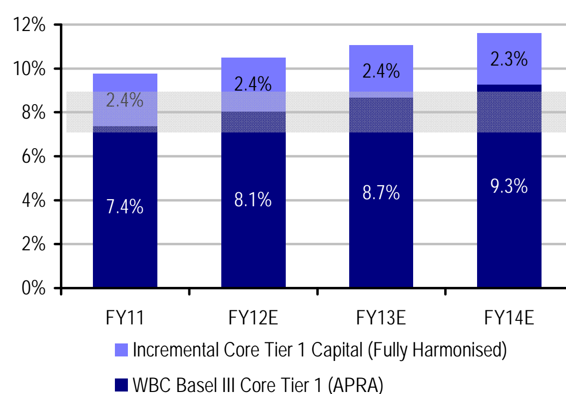



Chart 37: WBC Basel III Core Tier 1 (%)

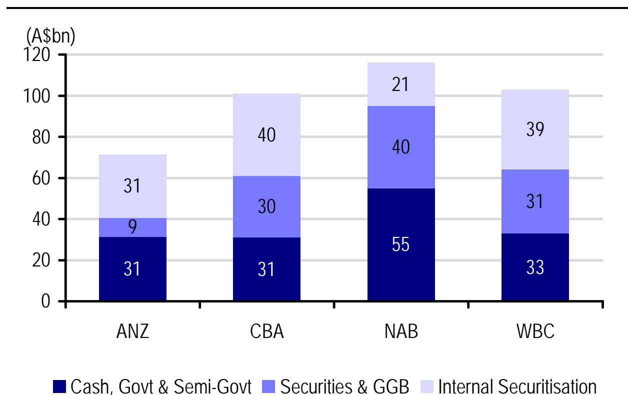



Source: Company data, UBS estimates

The Australian banks remain profitable, especially by global standards, with an expected ROE of 16.4% in FY12E. With limited credit growth and RWA growth this delivers strong free cash flow. Although much of this is used to fund dividends, with payout ratios between 65% and 76%, Dividend Reinvestment Plans reduce this ratio (albeit at the expense of share dilution) and enable the banks to continue to strengthen their capital positions.

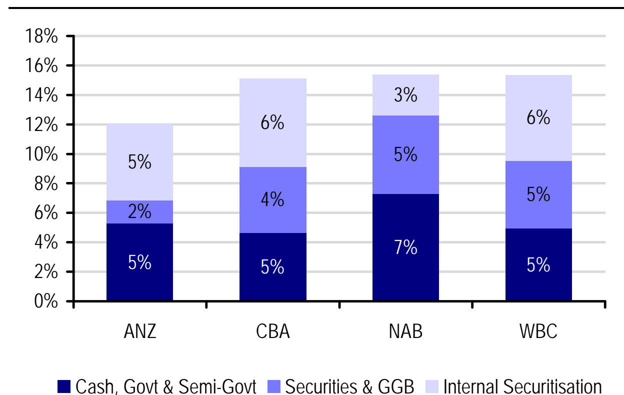
The Aussie banks are well positioned for the adoption of Basel III

**Chart 38: Major Bank Liquidity Portfolios (A$bn)**




Source: Company data, UBS estimates

**Chart 39: Liquidity Portfolios as % of Total Assets**




Source: Company data, UBS estimates

Following the release of the RBA's discussion paper on the implementation of the Basel III liquidity reforms in Australia, we are much more comfortable with the major banks' regulatory liquidity positions.

We are more comfortable with the major banks Basel III Liquidity positions following the release of the APRA discussion paper

Given the shortage of High Quality Liquid Assets in Australia, especially Commonwealth Government Securities, the RBA will establish a Committed Liquidity Facility (CLF). Once approved by APRA, the CLF (which includes repo eligible securities with the RBA including internally RMBS) will form part of the bank's Eligible Liquidity to meet the Liquidity Coverage Ratio. In return for providing this facility the RBA will charge a commitment fee which is currently set at 15bp of the drawn and undrawn component.

While APRA has taken a very strict interpretation of the Basel III Capital requirements in Australia, we believe that APRA and the RBA have been much more pragmatic in their interpretation of the Basel III Liquidity requirements. We view this as a prudent approach, as it is likely that a liquidity crisis within an Australian bank may be driven by offshore events, which may be beyond the institution's control. In this case both APRA and the RBA will provide significant support to ensure the ongoing stability of the financial system.

## Sector Earnings and Valuation Summary

| | ANZ | CBA | NAB | WBC | Majors |
|---|---|---|---|---|---|
| Recommendation | Neutral | Neutral | Buy | Buy | Overweight |
| Share price ($) 13 January 2012 | 21.20 | 50.07 | 23.80 | 20.68 | |
| Price Target ($) | 21.00 | 50.00 | 27.50 | 23.00 | |
| Implied 2012E Price to Book (x) | 1.4 | 2.1 | 1.5 | 1.6 | 1.7 |
| Implied 2012E PE (%) | 9.7 | 11.8 | 9.1 | 10.2 | 10.3 |
| % Price Upside to Price Target | -1% | 0% | 16% | 11% | 6% |
| Valuations | | | | | |
| PE (x) | | | | | |
| 2011 | 10.0 | 11.9 | 9.6 | 10.2 | 10.6 |
| 2012E | 9.7 | 11.8 | 9.1 | 10.2 | 10.3 |
| 2013E | 9.5 | 11.7 | 8.9 | 9.8 | 10.1 |
| 2014E | 9.2 | 11.3 | 8.6 | 9.5 | 9.8 |
| PE Relative to All Industrials (%) | | | | | |
| 2011 | 74 | 87 | 70 | 75 | 78 |
| 2012E | 80 | 96 | 74 | 83 | 85 |
| 2013E | 89 | 109 | 84 | 92 | 95 |
| 2014E | 93 | 115 | 87 | 96 | 0 |
| PE Relative to Major Banks (%) | | | | | |
| 2011 | 95 | 112 | 91 | 97 | n.a. |
| 2012E | 94 | 114 | 88 | 98 | n.a. |
| 2013E | 94 | 115 | 88 | 97 | n.a. |
| 2014E | 94 | 115 | 87 | 97 | n.a. |
| Price to Core Earnings (Pre-Prov'n Profit) (x) | | | | | |
| 2011 | 6.3 | 7.5 | 5.4 | 6.5 | 6.5 |
| 2012E | 6.0 | 7.5 | 5.1 | 6.3 | 6.4 |
| 2013E | 5.9 | 7.4 | 5.1 | 6.0 | 6.2 |
| 2014E | 5.7 | 7.1 | 5.0 | 5.8 | 6.0 |
| Diluted EPS growth (%) | | | | | |
| 2011 | 8.8 | 10.7 | 16.3 | 5.2 | 10.1 |
| 2012E | 3.3 | 1.1 | 5.9 | 0.7 | 2.5 |
| 2013E | 2.0 | 1.0 | 1.6 | 3.7 | 3.4 |
| 2014E | 3.6 | 3.0 | 4.2 | 3.2 | 3.4 |
| Growth in Book Value Per Share (%) | | | | | |
| 2011 | 8.5 | 4.4 | 6.1 | 8.1 | 6.6 |
| 2012E | 8.2 | 5.0 | 7.7 | 4.5 | 6.2 |
| 2013E | 6.0 | 4.9 | 6.0 | 4.3 | 5.2 |
| 2014E | 5.5 | 4.9 | 5.9 | 4.3 | 5.1 |
| Div Yield (%) | | | | | |
| 2011 | 6.6 | 6.4 | 7.2 | 7.5 | 6.9 |
| 2012E | 6.8 | 6.5 | 7.8 | 8.1 | 7.2 |
| 2013E | 7.0 | 6.6 | 8.1 | 8.5 | 7.5 |
| 2014E | 7.2 | 6.7 | 8.4 | 8.8 | 7.7 |
| Price to Book (x) | | | | | |
| 2011 | 1.50 | 2.18 | 1.41 | 1.50 | 1.69 |
| 2012E | 1.39 | 2.07 | 1.31 | 1.43 | 1.60 |
| 2013E | 1.31 | 1.98 | 1.23 | 1.37 | 1.52 |
| 2014E | 1.24 | 1.89 | 1.16 | 1.32 | 1.45 |
| Price to NTA (x) | | | | | |
| 2011 | 1.85 | 2.98 | 1.75 | 2.08 | 2.24 |
| 2012E | 1.70 | 2.77 | 1.58 | 1.95 | 2.07 |
| 2013E | 1.58 | 2.58 | 1.47 | 1.83 | 1.93 |
| 2014E | 1.48 | 2.41 | 1.37 | 1.72 | 1.81 |

| | ANZ | CBA | NAB | WBC | Majors |
|---|---|---|---|---|---|
| Financials | | | | | |
| Cash NPAT (UBS post prefs) ($m) | | | | | |
| 2011 | 5,640 | 6,793 | 5,423 | 6,301 | 24,157 |
| 2012E | 6,037 | 6,992 | 5,912 | 6,463 | 25,404 |
| 2013E | 6,288 | 7,198 | 6,151 | 6,792 | 26,429 |
| 2014E | 6,585 | 7,556 | 6,489 | 7,095 | 27,725 |
| Cash NPAT (Company format) ($m) | | | | | |
| 2011 | 5,652 | 6,835 | 5,460 | 6,301 | 24,248 |
| 2012E | 6,049 | 7,032 | 5,950 | 6,463 | 25,494 |
| 2013E | 6,300 | 7,238 | 6,189 | 6,792 | 26,519 |
| 2014E | 6,597 | 7,596 | 6,527 | 7,095 | 27,815 |
| Cash EPS (fully diluted) (cps) | | | | | |
| 2011 | 211 | 421 | 248 | 202 | n.a. |
| 2012E | 218 | 425 | 262 | 204 | n.a. |
| 2013E | 223 | 430 | 267 | 211 | n.a. |
| 2014E | 231 | 443 | 278 | 218 | n.a. |
| Basic EPS (Company format) (cps) | | | | | |
| 2011 | 220 | 439 | 250 | 209 | n.a. |
| 2012E | 229 | 443 | 265 | 212 | n.a. |
| 2013E | 234 | 448 | 269 | 220 | n.a. |
| 2014E | 242 | 461 | 281 | 227 | n.a. |
| Book Value Per Share (cps) | | | | | |
| 2011 | 1,409 | 2,298 | 1,692 | 1,380 | n.a. |
| 2012E | 1,524 | 2,413 | 1,822 | 1,443 | n.a. |
| 2013E | 1,616 | 2,532 | 1,931 | 1,505 | n.a. |
| 2014E | 1,705 | 2,656 | 2,046 | 1,569 | n.a. |
| Dividend (cps) | | | | | |
| 2011 | 140 | 320 | 172 | 156 | n.a. |
| 2012E | 144 | 327 | 185 | 167 | n.a. |
| 2013E | 148 | 331 | 192 | 175 | n.a. |
| 2014E | 153 | 337 | 200 | 183 | n.a. |
| Return on Equity (%) | | | | | |
| 2010 | 15.5 | 18.7 | 13.5 | 16.2 | 16.2 |
| 2011 | 16.2 | 19.6 | 15.0 | 16.0 | 16.9 |
| 2012E | 15.6 | 18.7 | 14.5 | 15.4 | 16.3 |
| 2013E | 14.9 | 18.0 | 13.9 | 15.3 | 15.8 |
| 2014E | 14.6 | 17.7 | 13.7 | 15.1 | 15.5 |
| Return on Assets (%) | | | | | |
| 2010 | 0.95 | 0.97 | 0.75 | 0.99 | 0.92 |
| 2011 | 1.00 | 1.05 | 0.85 | 1.02 | 0.99 |
| 2012E | 0.98 | 1.04 | 0.82 | 0.96 | 0.96 |
| 2013E | 0.96 | 1.02 | 0.80 | 0.96 | 0.95 |
| 2014E | 0.96 | 1.03 | 0.81 | 0.96 | 0.95 |
| Core Tier 1 (APRA Basel III, %) | | | | | |
| 2011 | 7.5 | 7.5 | 7.4 | 7.4 | n.a. |
| 2012E | 8.0 | 7.7 | 8.3 | 8.1 | n.a. |
| 2013E | 8.4 | 8.2 | 8.9 | 8.7 | n.a. |
| 2014E | 8.9 | 8.7 | 9.4 | 9.3 | n.a. |
| Core Tier 1 (Globally Harmonised Basel III, %) | | | | | |
| 2011 | 9.5 | 9.6 | 8.7 | 9.7 | n.a. |
| 2012E | 10.0 | 9.8 | 9.7 | 10.5 | n.a. |
| 2013E | 10.6 | 10.3 | 10.3 | 11.1 | n.a. |
| 2014E | 11.2 | 10.8 | 10.8 | 11.6 | n.a. |

| | ANZ | CBA | NAB | WBC | Majors |
|---|---|---|---|---|---|
| Key Earnings Drivers | | | | | |
| Growth in Ave Interest Earning Assets (%) | | | | | |
| 2010 | 2.8 | 14.3 | -2.3 | 5.3 | 4.9 |
| 2011 | 6.4 | 3.8 | 6.2 | 2.5 | 4.6 |
| 2012E | 7.7 | 3.7 | 7.0 | 4.8 | 5.7 |
| 2013E | 6.2 | 4.0 | 4.5 | 4.3 | 4.7 |
| 2014E | 5.5 | 4.0 | 4.2 | 4.0 | 4.4 |
| Margins (%) | | | | | |
| 2010 | 2.46 | 2.10 | 2.25 | 2.22 | 2.26 |
| 2011 | 2.46 | 2.16 | 2.25 | 2.22 | 2.27 |
| 2012E | 2.42 | 2.17 | 2.24 | 2.21 | 2.26 |
| 2013E | 2.35 | 2.14 | 2.19 | 2.18 | 2.22 |
| 2014E | 2.32 | 2.12 | 2.16 | 2.15 | 2.19 |
| Non-Interest Income Growth (%) | | | | | |
| 2010 | 9.0 | 8.4 | -8.8 | 0.4 | 2.7 |
| 2011 | 7.3 | -2.6 | 2.3 | -2.0 | 0.8 |
| 2012E | 5.4 | -1.1 | 3.0 | 3.2 | 2.3 |
| 2013E | 5.9 | 3.5 | 3.7 | 5.4 | 4.6 |
| 2014E | 4.7 | 4.5 | 3.7 | 4.9 | 4.5 |
| Revenue Growth (%) | | | | | |
| 2010 | 9.8 | 13.3 | -1.3 | 0.9 | 5.5 |
| 2011 | 6.5 | 3.1 | 5.4 | 1.3 | 4.0 |
| 2012E | 5.8 | 2.4 | 5.4 | 3.9 | 4.3 |
| 2013E | 4.0 | 2.7 | 2.7 | 3.8 | 3.3 |
| 2014E | 4.5 | 3.5 | 2.8 | 3.1 | 3.5 |
| Cost Growth (%) | | | | | |
| 2011 | 10.7 | 3.4 | 1.4 | 1.9 | 4.2 |
| 2012E | 4.0 | 2.3 | 1.2 | 3.0 | 2.6 |
| 2013E | 3.6 | 1.6 | 2.1 | 1.3 | 2.1 |
| 2014E | 3.9 | 1.7 | 1.6 | 0.8 | 2.0 |
| Cost to Income Ratio (%) | | | | | |
| 2011 | 45.9 | 45.2 | 45.2 | 41.5 | 44.4 |
| 2012E | 45.1 | 45.2 | 43.4 | 41.2 | 43.8 |
| 2013E | 44.9 | 44.7 | 43.1 | 40.2 | 43.3 |
| 2014E | 44.7 | 43.9 | 42.7 | 39.3 | 42.7 |
| Core Earnings Growth | | | | | |
| 2010 | 8.0 | 15.7 | -3.3 | -0.8 | 4.6 |
| 2011 | 3.2 | 3.0 | 9.0 | 0.8 | 3.9 |
| 2012E | 7.4 | 2.4 | 8.8 | 4.5 | 5.7 |
| 2013E | 4.3 | 3.7 | 3.2 | 5.5 | 4.2 |
| 2014E | 5.0 | 5.0 | 3.7 | 4.6 | 4.6 |
| BDD charge/loans (bp) | | | | | |
| 2010 | 50 | 41 | 51 | 30 | 43 |
| 2011 | 30 | 25 | 38 | 20 | 28 |
| 2012E | 32 | 22 | 38 | 23 | 28 |
| 2013E | 32 | 23 | 38 | 24 | 29 |

Source: Company data, UBS estimates.

# Sector Valuations Charts

Chart 40: Sector PE (x)

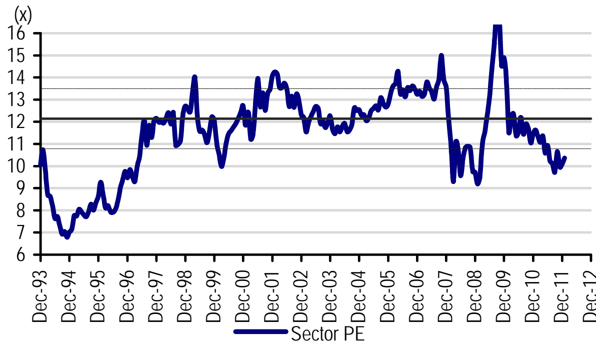



Chart 41:Sector PE Relative to the All Industrials (ex Financials)

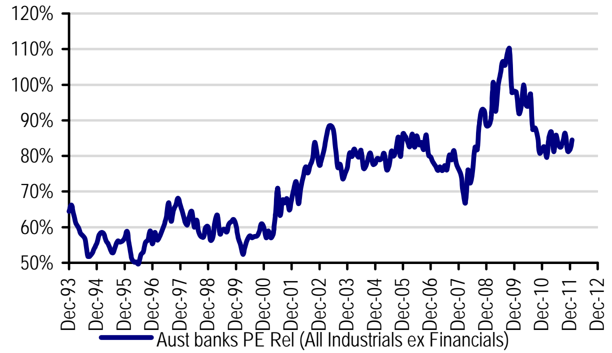



Chart 42:Sector Price to Pre-Provision Profits (x)

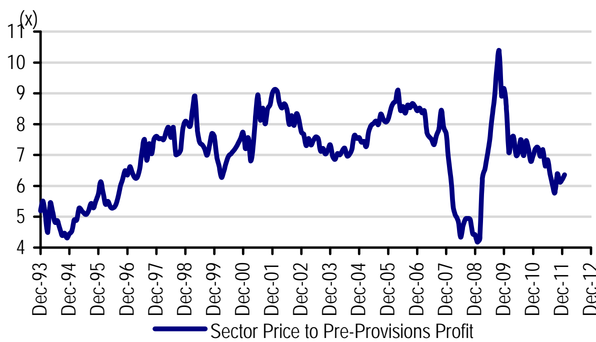



Chart 43: Sector Earnings Yield to Bond Yield (%)

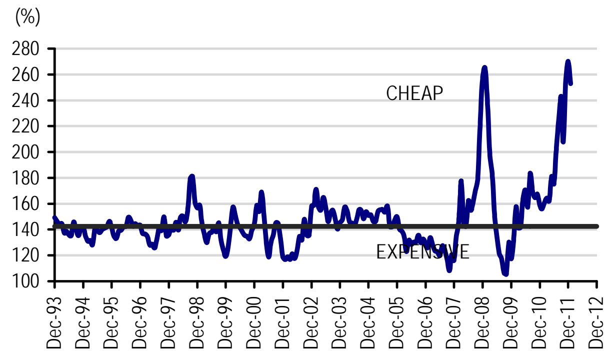



Chart 44: Sector Price to Book Ratio (x)

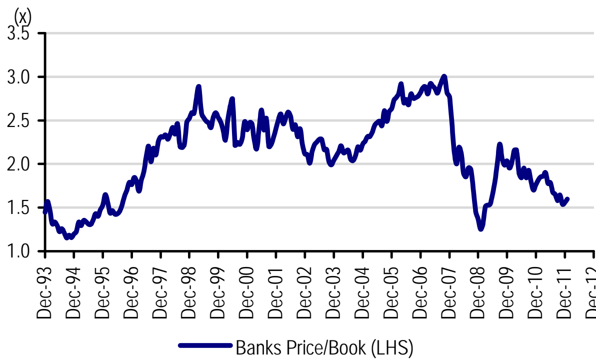



Chart 45: Sector Price to Book (x) vs Return on Equity (%)

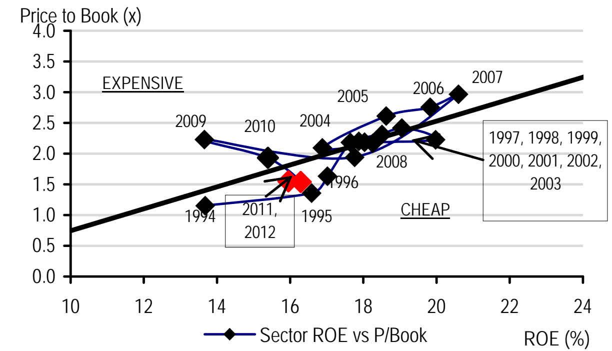



Chart 46: Sector Dividend Yield (%)

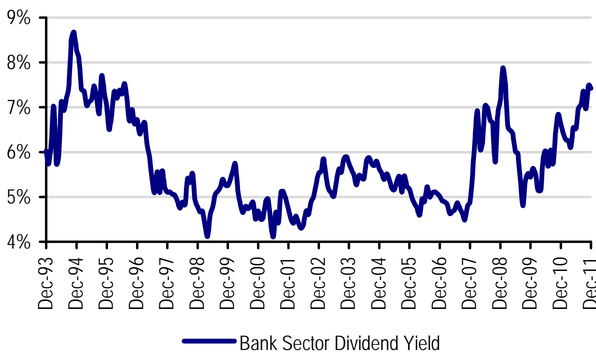
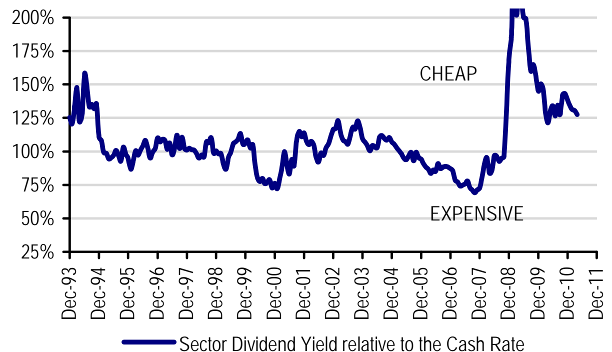



Chart 47: Sector Dividend Yield vs Cash Rate (%)




Source: Company data, UBS estimates

Source: Company data, UBS estimates

# Stock Valuation Charts

Chart 48: ANZ PE Relative to the Major Banks (%)

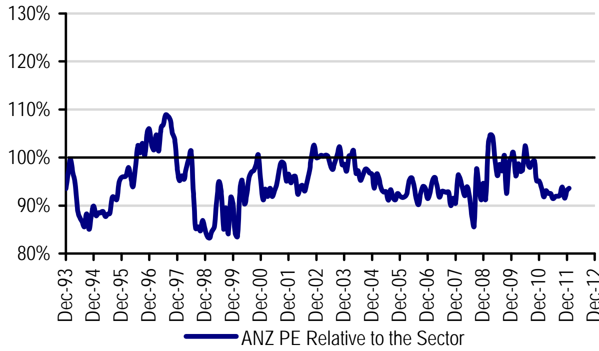


Chart 49: ANZ Price to Book (x) vs Return on Equity (%)

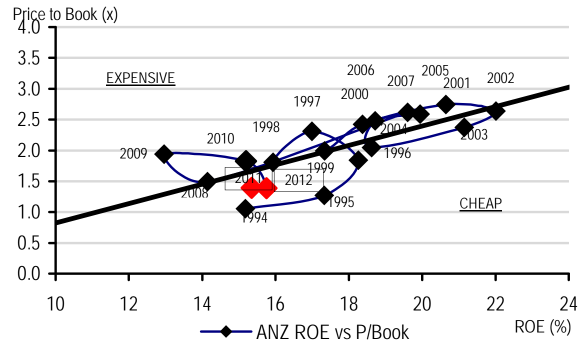


Chart 50: CBA PE Relative to the Major Banks (%)

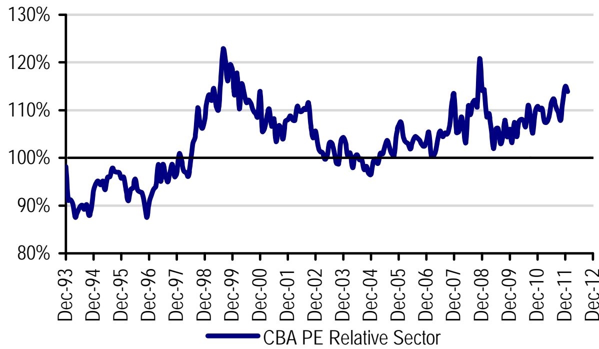


Chart 51: CBA Price to Book (x) vs Return on Equity (%)

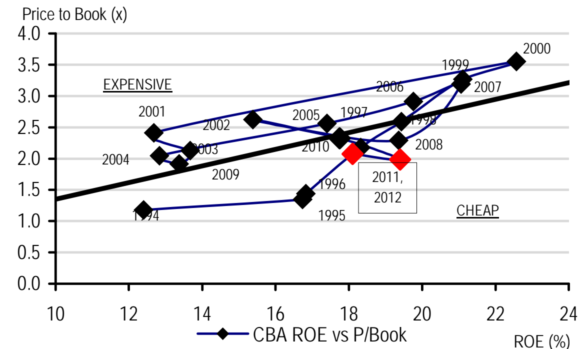


Chart 52: NAB PE Relative to the Major Banks (%)

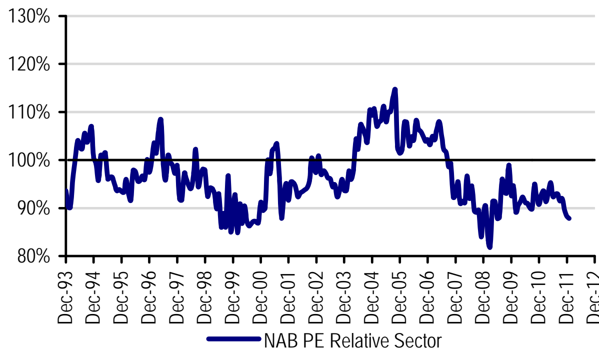


Chart 53: NAB Price to Book (x) vs Return on Equity (%)

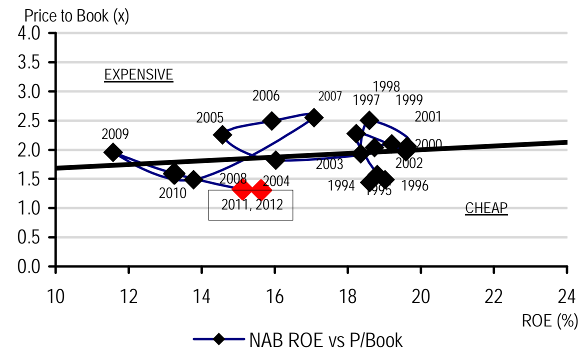


Chart 54: WBC PE Relative to the Major Banks (%)

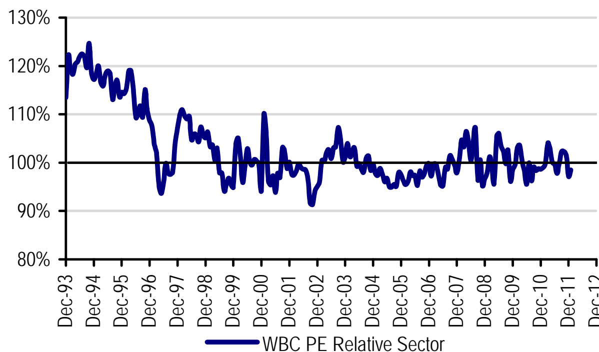
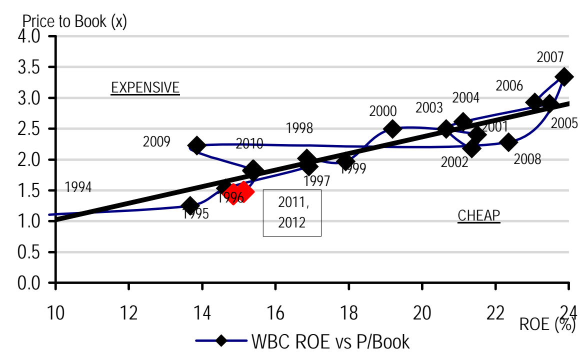


Chart 55: WBC Price to Book (x) vs Return on Equity (%)



Source: Company data, UBS estimates

Source: Company data, UBS estimates

## ■ Statement of Risk

Australian banks are large, highly leveraged financial institutions operating across a number of markets, and as such are subject to the risk of changes in the general business and economic conditions within these markets. A change in these conditions could include changes in interest rates, inflation, unemployment, monetary supply, exogenous shock, changes in foreign exchange rates, and the health of the general economy. The banks also face the
risk of regulatory changes and increased competition which could affect the profitability of the sector. A key risk that financial institutions face is associated with extending credit to other parties. Less favourable business conditions could cause potential losses from loans to increase putting pressure on the group's capital. The bank sector also faces operational risk from operating such large and complex businesses.

## ■ Analyst Certification

Each research analyst primarily responsible for the content of this research report, in whole or in part, certifies that with respect to each security or issuer that the analyst covered in this report: (1) all of the views expressed accurately reflect his or her personal views about those securities or issuers and were prepared in an independent manner, including with respect to UBS, and (2) no part of his or her compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by that research analyst in the research report.

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### UBS Investment Research: Global Equity Rating Allocations

| UBS 12-Month Rating | Rating Category | Coverage[1] | IB Services[2] |
|---|---|---|---|
| **Buy** | **Buy** | 57% | 36% |
| **Neutral** | **Hold/Neutral** | 37% | 35% |
| **Sell** | **Sell** | 7% | 17% |
| **UBS Short-Term Rating** | **Rating Category** | **Coverage[3]** | **IB Services[4]** |
| **Buy** | **Buy** | less than 1% | 0% |
| **Sell** | **Sell** | less than 1% | 12% |

1:Percentage of companies under coverage globally within the 12-month rating category.
2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.
3:Percentage of companies under coverage globally within the Short-Term rating category.
4:Percentage of companies within the Short-Term rating category for which investment banking (IB) services were provided within the past 12 months.

Source: UBS. Rating allocations are as of 31 December 2011.

### UBS Investment Research: Global Equity Rating Definitions

| UBS 12-Month Rating | Definition |
|---|---|
| **Buy** | FSR is > 6% above the MRA. |
| **Neutral** | FSR is between -6% and 6% of the MRA. |
| **Sell** | FSR is > 6% below the MRA. |
| **UBS Short-Term Rating** | **Definition** |
| **Buy** | Buy: Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event. |
| **Sell** | Sell: Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event. |

**KEY DEFINITIONS**

**Forecast Stock Return (FSR)** is defined as expected percentage price appreciation plus gross dividend yield over the next 12 months.

**Market Return Assumption (MRA)** is defined as the one-year local market interest rate plus 5% (a proxy for, and not a forecast of, the equity risk premium).

**Under Review (UR)** Stocks may be flagged as UR by the analyst, indicating that the stock's price target and/or rating are subject to possible change in the near term, usually in response to an event that may affect the investment case or valuation.

**Short-Term Ratings** reflect the expected near-term (up to three months) performance of the stock and do not reflect any change in the fundamental view or investment case.

**Equity Price Targets** have an investment horizon of 12 months.

**EXCEPTIONS AND SPECIAL CASES**

**UK and European Investment Fund ratings and definitions are:** Buy: Positive on factors such as structure, management, performance record, discount; Neutral: Neutral on factors such as structure, management, performance record, discount; Sell: Negative on factors such as structure, management, performance record, discount.

**Core Banding Exceptions (CBE):** Exceptions to the standard +/-6% bands may be granted by the Investment Review Committee (IRC). Factors considered by the IRC include the stock's volatility and the credit spread of the respective company's debt. As a result, stocks deemed to be very high or low risk may be subject to higher or lower bands as they relate to the rating. When such exceptions apply, they will be identified in the Company Disclosures table in the relevant research piece.

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**UBS Securities Australia Ltd:** Jonathan Mott; Chris Williams, CFA; Adam Lee.

## Company Disclosures

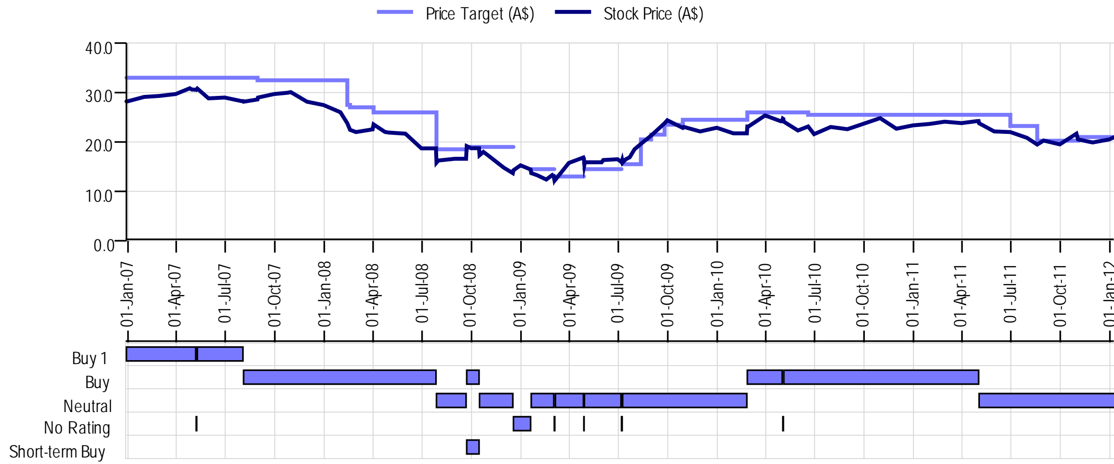
| Company Name | Reuters | 12-mo rating | Short-term rating | Price | Price date |
|---|---|---|---|---|---|
| **ANZ Banking Group**[2, 4, 5a, 5b, 6, 16, 22] | ANZ.AX | Neutral | N/A | A$21.10 | 12 Jan 2012 |
| **Commonwealth Bank of Australia**[16] | CBA.AX | Neutral | N/A | A$49.91 | 12 Jan 2012 |
| **National Australia Bank**[4, 6, 16, 22] | NAB.AX | Buy | N/A | A$23.56 | 12 Jan 2012 |
| **Westpac Banking Corporation**[2, 4, 5a, 6, 16, 22] | WBC.AX | Buy | N/A | A$20.61 | 12 Jan 2012 |

Source: UBS. All prices as of local market close.
Ratings in this table are the most current published ratings prior to this report. They may be more recent than the stock pricing date

2. UBS AG, its affiliates or subsidiaries has acted as manager/co-manager in the underwriting or placement of securities of this company/entity or one of its affiliates within the past 12 months.
4. Within the past 12 months, UBS AG, its affiliates or subsidiaries has received compensation for investment banking services from this company/entity.
5a. UBS AG, Australia Branch or an affiliate expect to receive or intend to seek compensation for investment banking services from this company/entity within the next three months.
5b. UBS AG, its affiliates or subsidiaries expect to receive or intend to seek compensation for investment banking services from this company/entity within the next three months.
6. This company/entity is, or within the past 12 months has been, a client of UBS Securities LLC, and investment banking services are being, or have been, provided.
16. UBS Securities LLC makes a market in the securities and/or ADRs of this company.
22. UBS AG, its affiliates or subsidiaries held other significant financial interests in this company/entity as of last month`s end (or the prior month`s end if this report is dated less than 10 working days after the most recent month`s end).

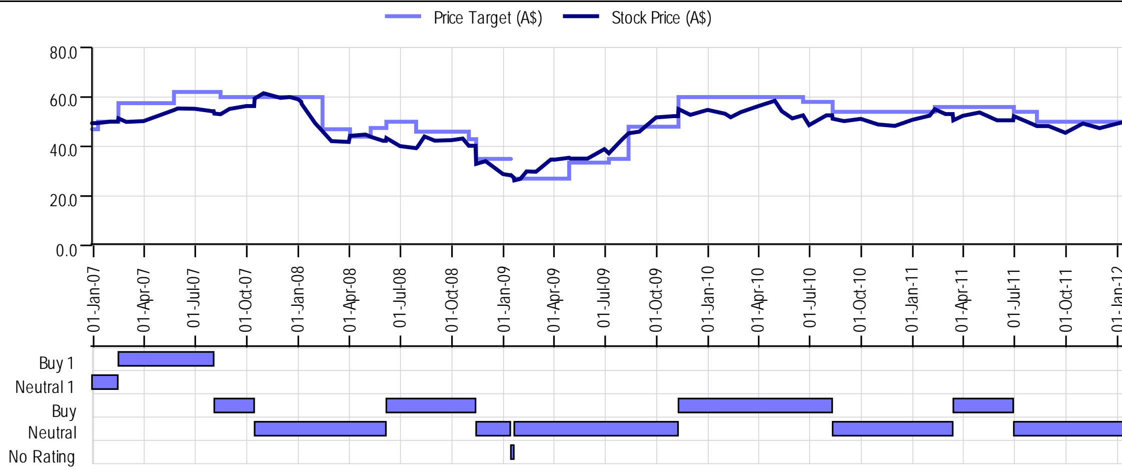
Unless otherwise indicated, please refer to the Valuation and Risk sections within the body of this report.

## ANZ Banking Group (A$)



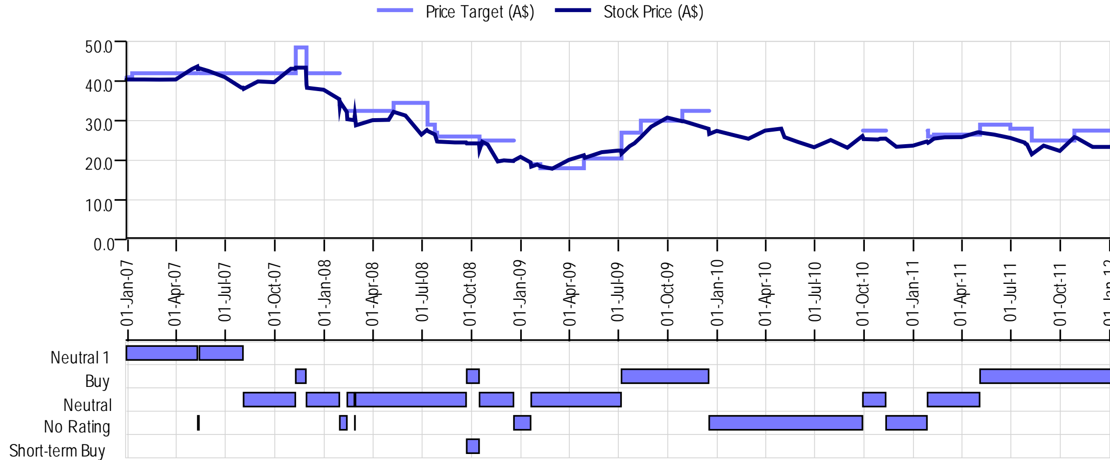

Source: UBS; as of 12 Jan 2012

## Commonwealth Bank of Australia (A$)



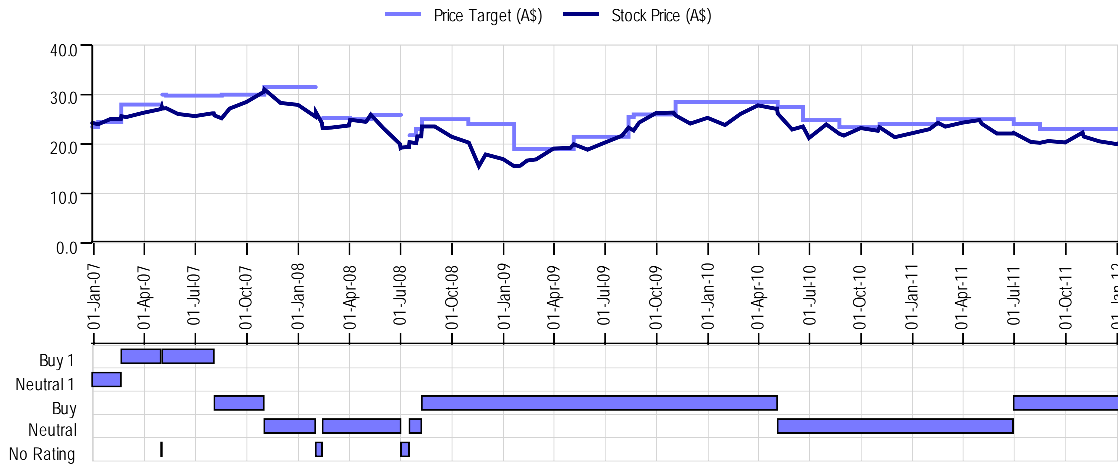

Source: UBS; as of 12 Jan 2012

## National Australia Bank (A$)




Source: UBS; as of 12 Jan 2012

## Westpac Banking Corporation (A$)




Source: UBS; as of 12 Jan 2012

Note: On August 4, 2007 UBS revised its rating system. (See 'UBS Investment Research: Global Equity Rating Definitions' table for details). From September 9, 2006 through August 3, 2007 the UBS ratings and their definitions were: Buy 1 = FSR is > 6% above the MRA, higher degree of predictability; Buy 2 = FSR is > 6% above the MRA, lower degree of predictability; Neutral 1 = FSR is between -6% and 6% of the MRA, higher degree of predictability; Neutral 2 = FSR is between -6% and 6% of the MRA, lower degree of predictability; Reduce 1 = FSR is > 6% below the MRA, higher degree of predictability; Reduce 2 = FSR is > 6% below the MRA, lower degree of predictability. The predictability level indicates an analyst's conviction in the FSR. A predictability level of '1' means that the analyst's estimate of FSR is in the middle of a narrower, or smaller, range of possibilities. A predictability level of '2' means that the analyst's estimate of FSR is in the middle of a broader, or larger, range of possibilities. From October 13, 2003 through September 8, 2006 the percentage band criteria used in the rating system was 10%.

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