

Value Line: Westpac



By Roger Montgomery

PORTFOLIO POINT: Westpac has strong assets, is a good corporate citizen, and I'll be buying more shares if the price dips below intrinsic value.

Bank stocks are a perennial favourite of Australian investors. They are an unusual phenomenon delivering either good value, defensive characteristics or leverage to the cycle, depending on when you buy them.

Value Line owns shares in just one bank: Westpac. At the time they were acquired, it was believed the financial crisis would hobble the economic performance of Australian banks much more severely than now seems to be the case. ANZ and NAB did face a number of reputational issues

amid writedowns, and subsequent capital raisings have caused dilution of both per-share net assets and per-share profitability. But the hobbling of the banks in aggregate pales into insignificance compared to the (largely unjustified in my opinion) hobbling of investor sentiment toward them.

Injured by rising bad debts and fearful of a worsening economic outlook, the banks did reveal, once again, their sometimes schizoid lending practices. To reduce their exposure to Australian businesses they forced their clients to reduce dividends, sell off business divisions, move manufacturing offshore or raise significant amounts of capital to reduce or refinance debts. It is hard to believe that it was the action of the banks that has given share investors fifty billion reasons to cheer.

But it is now accepted that Australia will be at the receiving end of a fairly benign slap on the wrist from the global economic downturn and this will serve to limit the magnitude of any further provisioning. Reappraisal of the outlook has seen equity markets rally, making it surprisingly easy for corporations to raise billions to hand to the banks.

Value Line portfolio, as at August 4, 2009

Company	ASX	July 1 price	Price today	Est value	Margin of safety at time of purchase	Margin of safety	Shares bought	Invested capital (\$)	Capital value (\$)	Divs rec	Total return	Total return
JB Hi Fi	JBH	14.8	16.75	17.68	16.29%	5.6%	845	\$12,500	\$14,147	0	\$1,647	13.18%
The Reject Shop	TRA	11.62	13.51	11.45	-1.48%	-15.2%	513	\$5,959	\$6,928	0	\$969	16.27%
Westpac Banking Corp.	WBC	19.68	22.2	18.13	-8.55%	-18.3%	295	\$5,811	\$6,555	0	\$744	12.80%
Woolworths	WOW	26.16	26.71	22.86	-14.44%	-14.4%	206	\$5,377	\$5,490	0	\$113	2.10%
Cochlear	COH	56.36	55.38	48.7	-15.73%	-12.1%	102	\$5,744	\$5,644	0	-\$100	-1.74%
CSL	CSL	31.81	30.21	25.18	-26.33%	-16.7%	163	\$5,197	\$4,936	0	-\$261	-5.03%
Reece	REH	17.8	20.53	12.81	-38.95%	-37.6%	236	\$4,209	\$4,855	0	\$646	15.34%
Platinum Asset Mgt	PTM	4.06	4.54	2.18	-86.24%	-52.0%	854	\$3,467	\$3,877	0	\$410	11.82%

Since July 1

Security Value	\$52,432
Cash Value	\$51,736
Total Value	\$104,167
Total Return (\$)	\$4,167.44
Return Invested (%)	8.63%
Total Return (%)	4.17%
XAO Change	9.25%
Outperformance (I) - invested portion	-0.62%
Outperformance (T) - total portfolio	-5.08%

Under observation

ISOFT	ISF	0.635	0.745	0.038	-94.9%	-17.32%
Amcor	AMC	4.79	4.79	2.66	-44.5%	0.00%

Bank assets have thus been quickly repaired and Westpac's asset quality in particular remains relatively robust on most measures. While Westpac increased its provision for bad and doubtful debts in the last half, from \$400 million to \$1.6 billion, these were taken as part and parcel of the St George merger.

In the face of the global financial crisis and with the assistance provided by a strong regulatory framework and a large retail deposit base, Westpac has maintained its reputation as one of Australia's largest and best-managed financial institutions despite the first collective profit decline for the banks in 15 years.

Through its social responsibility practices and through chief executive Gail Kelly's commitment to customer service, Westpac is recognised as one of the country's best corporate citizens. Global branding consultancy Interbrand says Westpac is the fourth most valuable brand in the country.

This is particularly important because it will be the strongest brands that are best positioned to emerge from the downturn, capitalising on weaker rivals who have either lost market share or withdrawn completely during a flight to safety and a lack of access to credit markets.

A combination of these influences is already being reflected in improving net interest margins. Westpac reported in the half that its net interest margin had risen from 2.05% to 2.34%. Under these conditions, a bank can build equity very rapidly.

But while analysts seek to parade their knowledge of banks by describing in minute detail the changes in almost every ratio, it is the individual investor who can stand back and appreciate the big picture when fear pervades equity markets.

In the past decade domestic banking fee income, assets and loans and advances have all grown dramatically. Some of this has been at the expense of non-banks, whose growth in the same period has been comparatively anaemic.

Over longer periods, the stable competitive environment has served each member of the banking oligopoly well. It is only when they stray from their core business that problems have emerged. The lack of volatility in net income and return on equity ratios over many years, and in more recent years the general decline in costs to income, reflect the globally unique position Australian banks enjoy.

Thanks to strong margins, stronger relative non-interest income and the most efficient cost structure, Westpac enjoys a reputation as Australia's most profitable bank.

With the net interest margins relatively stable, profit growth must come from marginal reductions in costs or increases in non-interest income and asset growth. And without patience, this is where banks can lead their shareholders unwittingly into the tumultuous Seas of Acquisition.

Westpac's merger with St George, however, currently appears to be going smoothly thanks in no small part to the decision not to disrupt the front end of the business. More importantly, the acquisition metrics were not value-destroying for Westpac shareholders.

The law of large numbers and Australia's relatively small population will prevent the rates of growth experienced in the past from continuing indefinitely but market share gains at the expense of regional banks, overseas banks and non-banks – witness the recent announcements of the smaller rivals – will ensure a north-easterly direction for the charts of most of Westpac's key measures.

Banks are simple to understand: with relatively small amounts of shareholder equity – usually just 5–6% of assets, they borrow money at a lower rate than they lend it, keeping the difference, which over many years has averaged about 2% on assets. Assuming another quarter to half of that again is earned in fees and commissions, this “net revenue” is measured at 2–3% on assets.

Applying a cost to income ratio that has varied between 40% and 50% to the “net revenue on asset ratio” of 2–3%, you arrive at a pre-tax margin on assets of 0.8–1.5%. Subtract tax, and net profits will fall to 0.6–1.1% of assets, or 20–22% on equity. This return on equity represents the benchmark return on equity for banks in Australia and the majors have comfortably achieved for many years ... with the exception of NAB.

Buying an Australian bank that is making billions amid pricing that reflects the performance of overseas peers that have lost billions seems sensible. Their growth won't be as high as the past 15 years, but their prices are not where they were either. If Westpac shares fall substantially below intrinsic value, which they have not done yet, I will have no hesitation in adding more. ◆

Roger Montgomery is an independent analyst and investor, having previously founded and listed a boutique funds management investment firm.