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# Banking on China

Sitting in 126 crates on the Melbourne docks is a prefabricated, six-story hotel in which—boom-time thinking had it—workers on BHP Billiton's projected $22 billion harbor expansion project in Port Hedland, Western Australia, would lay their weary heads at night. But the project has been scrubbed, and the hotel maker is broke. The resource-led investment cycle that has fed Australia's growth is fading (*Grant's*, March 8).

What to do about it is the question before the house. An answer, we are about to propose, is to sell short a pair of at-risk Australian banks. First, however, some macroeconomic scene-setting.

Last week, the Australian Bureau of Statistics (ABS) announced that 71,500 new job seekers found work in February, the highest in 13 years and seven times the figure the market was expecting. The February jobless rate was 5.4%. Though unchanged from January and slightly higher than the 5.2% registered in February 2012, it positively glowed in comparison to unemployment rates of 7.7% in America and 11.9% in the euro zone. Well might a skeptic ask: What bust Down Under?

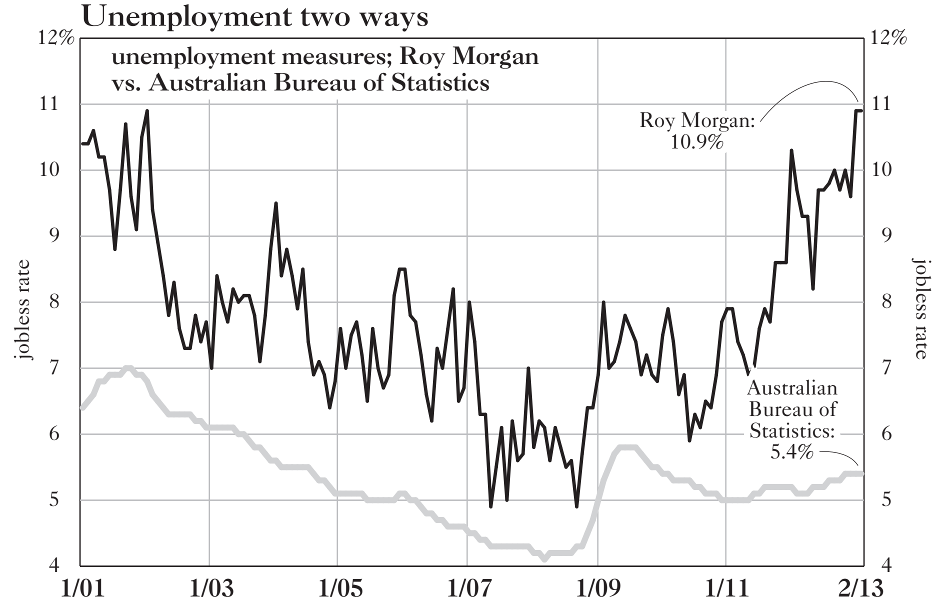
It's coming, we believe. Tellingly at odds with official Aussie jobless data are the results of a survey produced by Roy Morgan Research, which lives in Melbourne. "Unemployment" is, of course, a term of art, and Morgan's definition is stricter than the government's. For instance, the ABS classifies as employed a job seeker who put in the odd hour or two of freelance work in the previous month. The Morgan series counts the same individual as unemployed. Notably, then, the Morgan survey put the February jobless rate at 10.9%, up from 9.7% a year before.

What worries the Aussie cognoscenti is not the absolute level of the Roy Morgan series—by design it will always be higher than the government reading—but rather its divergence from the official series. What the Morgan statistics underscore is a surge in the number of discouraged and underemployed workers, especially in white-collar trades.

"If you were, say, a journalist that got sacked from the *Sydney Morning Herald* or *The Australian*, you became a freelance journalist," Brian Redican, senior economist at Macquarie Group, tells colleague Evan Lorenz. "You might only have a couple of articles accepted a week, but you are still technically employed. Even though there have been quite large job losses, when the Australian Bureau of Statistics comes around and surveys you, technically, you are still working, so you don't show up as unemployed, but you are underemployed. . . . [I]n areas like retail, for example, the major retailers aren't reducing the number of their employees but they are cutting back on the number of hours. Whereas, previously, you might have worked 25 hours a week, now you only have a few shifts—maybe you are only doing 15 hours a week. Again, you are not unemployed, but you are working a lot less than you were in the past."

Because, Down Under, it's been 22 years since the last recession, cost control is an art at which banks and businesses are a little rusty. The years 1992 to 2008 smiled especially on banks and

**Unemployment two ways**




source: Roy Morgan Research, Australian Bureau of Statistics retailers and the companies that dealt with them, as Lorenz points out: "Australian consumers boosted their collective ratio of debt to disposable income to 147.3% in 2008 from 53.3% in 1992. Over those 16 fat years, bank assets grew at a compound rate of 13.1% per annum, while nominal GDP grew at a compound annual rate of only 6.8%. There being not much need for cost control, costs went uncontrolled. Productivity suffered. Then came the thunderclap of 2008. In the subsequent four lean years, bank assets grew at a compound rate of just 2.6%, while nominal GDP chugged along at a compound rate of 4.8%."

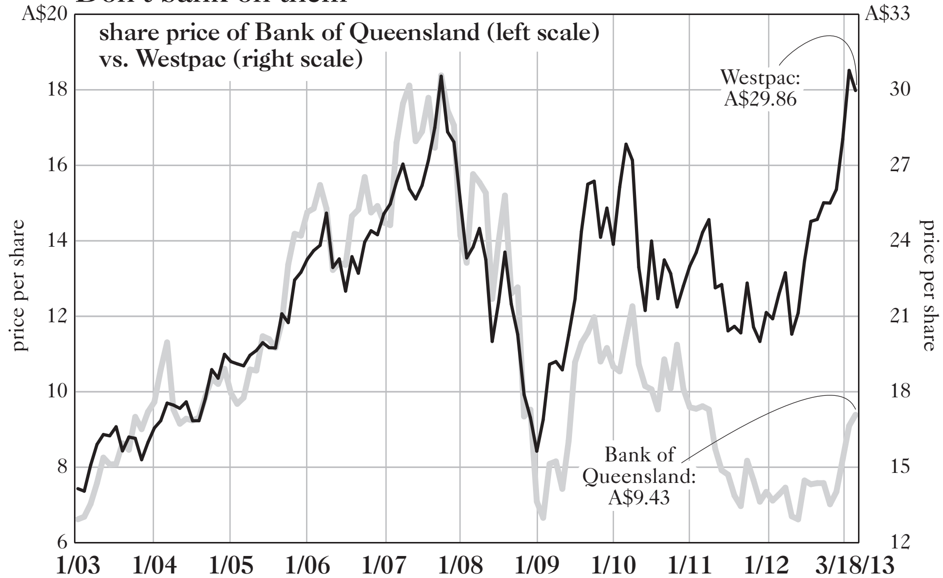
Corporate revenue growth is slowing while the politicians in Canberra are striving—actually competing with one another—to balance the national budget. How to protect profits in this setting? Why, Redican says, by cutting costs. "It's going to be a long effort to restore competitiveness and productivity, and I think that it is going to be quite painful and quite protracted," he says—especially so in the all-important resource sector.

Betting on an Australian recession has been a long-term losing proposition. But the non-mining portion of the Aussie economy—e.g., the economies of the states of Victoria, South Australia, Tasmania and the Northern Territory—is already in one, if the meaning of "recession" is two consecutive quarters of GDP decline. Mineral-endowed Western Australia accounted for no less than 89% of sequential GDP growth between the third and fourth quarters of 2012. But, as illustrated by that unassembled hotel on Melbourne's docks, the world is changing.

"It is mathematically difficult to replace the falloff in resource-led investment," Lorenz observes. "The Reserve Bank of Australia estimates that fully 18% of output had something to do with the resource industry in the 12 months ended June 30, 2012, double the level eight years earlier. The ABS reckons that mining capital expenditures will represent 68% of total private capital spending, in the grand sum of A$165.9 billion, in the 12 months to June 30, 2013. Government statisticians project an 8.1% drop in capital spending in the 12 months to mid-2014, paced by an 11.6% fall in mining outlays."

Which brings us to our picks to click—actually, not to click. They are Westpac Banking Corp. (WBC in Sydney) and Bank of Queensland (BOQ, also in Sydney). Westpac, with assets of A$675 billion, is the second-largest bank by assets and market cap and a member, thereby, of the Big Four club that dominates Australian banking. Australia & New Zealand Banking Group (ANZ), Commonwealth Bank of Australia (CBA) and National Australia Bank (NAB) fill out the foursome. Bank of Queensland is the third-largest regional bank and a leader in its own backyard of Queensland, a golden land of beaches and theme parks, but also—in a new development—tumbling house prices.

**Don't bank on them**




source: The Bloomberg

Australia's top banks are well capitalized and well funded: At last report, deposits and equity accounted for 65% of average liabilities, up from 55% in 2008. The Aussie giants are profitable, too, "among the most profitable in the world," relates Fitch Ratings director, Tim Roche. They are priced at an average of 12.8 times the forward estimate and twice the book value, compared to nine times forward earnings and one times book for J.P. Morgan Chase. What they are not, therefore, is cheap.

Neither are the big Aussie banks contrite. For them, it has been two blessed decades without a credit dislocation. At year-end 2012, nonperforming loans amounted to an average 1.04% of their total loans, compared to 1.46% at JPM (which is down from 2.77% at year-end 2009).

"When I look at the banks," CLSA analyst Brian Johnson tells Lorenz, "what worries me are three things: Commonwealth Bank and Westpac are trading on [forward] P/Es of 14 times. ANZ and NAB are trading at [forward] P/Es of 12. Those are elevated P/Es relative to history, relative to any measure. What worries me the most is that between 1994 and 2008, system credit growth in Australia grew at 1.9 times GDP. In that environment, 10% asset growth every year, one way or another that equates to 10% EPS growth. The problem now is that system credit growth comes back down to nominal GDP and EPS growth slows. A P/E, particularly on Commonwealth at 14 times, looks silly for structural EPS growth of somewhere between 3% and 4%.

"When I look at it," Johnson continues, "all the rhetoric is that bank-asset quality is really strong, loan-loss charges are really low. To my way of thinking, there's only one way it can go, which is up. What we see at the moment is elevated numbers of small companies going bust. We see companies in the news every day basically sacking staff, yet the official unemployment numbers look incredibly steady, which makes no sense to me at all. The third thing we see is on bank balance sheets. We see elevated levels of past 90 days and impaired loans massively higher than they were in 2007. We see loan losses, but we also see the formation of new impaired assets much, much higher than in 2007, and we see the [high] Australian dollar creating all kinds of pressures."

At a glance, Westpac would seem to be standing at the pinnacle of cyclical good fortune—which we believe it is. Loan-loss provisions in the second half of 2012 were a mere 0.23% of overall loans. The shares are valued at 13.7 times the forward estimate and twice book value. The Tier 1 capital position stands at a respectable 10.3%.

And if the future could only deliver the gifts the Aussie past has so generously bestowed, Westpac would be no short-sale candidate at all. But the future, we expect, will look not at all like the past. Not least will the future diverge in the item of real estate.

Residential real estate mortgages constitute 67% of Westpac's Sept. 30 loans—which is not in the least a problem, Lorenz heard over and over. "In all my calls to Australia," he reports, "no one was willing to venture a bearish view on the Aussie housing market outside of a few suburbs in Queensland. Don't forget, people repeated, loans amortize over 25 years, there is full recourse to the borrower (i.e., you can't just walk away), mortgage interest isn't tax deductible and mortgage insurance is obligatory for those borrowing more than 80% of a house's value.

"But," Lorenz goes on, "there's more to the story than that. For one thing, Westpac has a captive mortgage insurer about which disclosure is meager (ANZ and regional lender Bendigo & Adelaide Bank also use captive insurers). For another, houses in the major Australian markets are priced at an average of 6.5 times median household income, compared to 3.1 times in the United States today and 4.6 times in the zany year of 2006. For a bet against Westpac to pay off, a short seller does not require a crash in house prices or, for that matter, a crash in China—some future state of middling imperfection will do."

Bank of Queensland, with footings of only A$41.7 billion and a market cap of just A$3 billion, has not much in common with Westpac except its promise as a short-sale candidate. You wouldn't guess it by a look at the Tier 1 capital ratio—9.5%—or even, necessarily, in the lack of regional diversification inherent in the fact that 60% of the loan book is concentrated in Queensland. But the bank made a dubious kind of history in 2012 by posting the first loss by any Aussie bank since 1992.

BoQ seeks to distinguish itself with the "exceptional personal service" of its local managers. Not just managers, these servants of the public are "owner-managers," i.e., franchisees who buy the right to operate a branch and, in exchange, earn fees for landing loans and deposits. From April 2001 through August 2011, under CEO David Paul Liddy, that structure of managerial incentives drove growth in assets of 24.2% per annum, compounded. Bank of Queensland outgrew other Aussie banks, which, in turn, outgrew GDP.

The bank paid the franchisees to generate loans. It mattered not to a manager's commission income whether the loans performed. Serving the Sunshine Coast and the Gold Coast, the bank seemed to adopt the fun-in-the-sun mindset of its vacationing clientele. Inputs like land values and house prices were conscientiously updated, every two years or so.

While the state of Queensland saw brisk growth in output in the December quarter—7% at an annualized, quarter-to-quarter rate—that growth was driven by resource-related investment. Tourism has been left in tatters by the high Aussie dollar exchange rate. Excessive development along the coast has left the state with falling house prices.

So it was that the Queensland bank tapped the equity markets for A$450 million last year to fund an A$401 million write-down of loans. Stuart Ian Grimshaw, who took the helm in November 2011, wasted no time diving into the loan book and scrutinizing the risk models. While house prices in Australia's main cities have fallen about 6% from the peak, Grimshaw told listeners on the company's Oct. 17 earnings call, "what we've seen certainly in the coastal areas of Queensland is that it isn't reflected of where some of the high-end properties have been seeing drops between 40% and 50%." And Grimshaw has begun to overhaul the way commissions are paid—franchisees no longer receive income from borrowers 180 days or more behind on payments.

Good and necessary improvements as far as they go. However, as Johnson observes, "Bank of Queensland's ROE is nowhere near approaching its cost of capital, but it is trading at a big discount to the major banks. Australian regional banks used to be able to use securitization to fund their business with zero-capital intensity. Provided that you have any margin at all, it was an infinite ROE. . . . The problem is when you look at it, even though securitization markets are opening up, it is still far, far cheaper for a major bank than it is for a regional bank. . . . These things are no longer the high-growth, infinite-incremental ROE vehicles and their ROEs are a lot lower."

Then, too, the Bank of Queensland is targeting growth well above the Australian banking average. To supplement asset origination at the branch level, the front office is collecting loans in bulk from residential mortgage brokers, even at the risk of alienating the fee-earning franchisees. And the bank is expanding its lending in Western Australia, where the resource boom was, but—if we are right—is no more. Queensland, too, is facing the fact of weakening Chinese demand for things that come out of the ground.

"On the coal side it is an interesting thing because the coal boom on the east coast is what has been driving a lot of businesses in Queensland," Adrian Hart, senior manager of BIS Shrapnel, a Sydney market research firm, tells Lorenz. "At the moment, the coal prices have fallen more substantially than iron ore and have not recovered like iron ore. The next round of projects, everyone is very dismal about.... For us, it means instead of looking at a peak a year ago that would last until 2014-15, we are now looking at being at the peak, if not now, then very shortly… we are going to see about a 40% decline in major projects work in Queensland over the next five years."

There will, of course, be another cycle, and Australia will shine again. But not before this cycle clocks out.

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