

Financial stocks

that bring in the bucks

Australia's banking and financial sector continues to perform exceptionally well in light of the financial instability worldwide, so why not invest in the industry? *Your Money Magazine* discusses the sector's strengths and potential challenges, and picks the banking stocks most favoured by market experts.



Australian financial stocks, including the major banks, continue to perform strongly and are the envy of many other countries. A recent Morningstar analysis of the financial sector argued that share prices are currently at bargain levels, being more reflective of broader economic conditions than the true long-term value of the banks, insurers and others in the sector.

The financials are especially attractive for long-term value investors, as the sector is characterised by relatively stable returns with attractive valuations and dividend yields. Most pundits say the stocks offer average dividend yields of about 8% and as high as 10% when topped up with franking credits.

Many of the banks are well capitalised. Across the sector, banks have met the initial minimum requirements in the Basel III capital reforms and are likely to meet the 2013 standards. This means banks should be able to protect themselves in times of global market stress.

Home loan defaults are not expected to be a major concern in spite of the poor outlook for property markets. A recent survey by Genworth reveals that 41% of borrowers have overpaid their mortgage in the past 12 months.

Of course, financial stocks still have some challenges to face. Credit growth in Australia is in a slump, with Aussies choosing to save at record highs, cut their spending and use less credit. Bell Direct's Julia Lee predicts the slowdown in credit growth will continue for the next 18–24 months. This will have revenue implications for the banks.

“Yes, yields may be attractive but where will the business growth for banks come from?” asks Lee. Many expect banks to engage in serious cost-cutting to support their growth and protect profits. Banks are also diversifying their revenue bases, most commonly by expanding their wealth management divisions and acquiring shares in other companies. Wealth management activities are booming because of growing Baby Boomer demand for retirement funds.

Unemployment is another issue that could play against financial stock performance. The unemployment rate is expected to pick up over the next 12–18 months so it will be important to look at the asset quality of banks. Those that avoid holding a large proportion of low-doc loans are most desirable, says Lee.

Global economic developments also need to be watched. Australian financials have no exposure to public debt in Greece, and little exposure to Europe overall (Italy is the only European country with which the banks have substantial exposure).

The Australian financials are better placed than overseas banks because they are less reliant on wholesale markets and have higher levels of deposits that they can use to fund their lending and other activities. Lee says that about 60–65% of banks' funding is now coming from retail deposits.

Australian financial stocks wouldn't be completely immune to another global credit crunch (as a result of a European country defaulting on its debts). An ongoing deterioration in the European debt

crisis could hit Australian sentiment and share prices. However, Dennis Ng from Lincoln Indicators believes this risk has already been incorporated into the current share prices of the financials. Lee agrees: “Bank share prices are already down by 20% in the past year, so I think a lot of that (global market risk) has been priced in.”

► The experts

The following analysts provided *YMM* with their thoughts on how promising the financial sector is, and which stocks are leading the charge in terms of dividend yield and growth prospects for the months ahead:



Stan Shamu
Australian Stock Report



Benny Sada
Australian Stock Report



Dennis Ng
Lincoln Indicators



Julia Lee
Bell Direct





★ Commonwealth Bank of Australia (CBA)

Target price:	\$51.30*
Earnings forecast (YoY growth):	6.33%
Market cap:	\$68.35bn
52-week high:	\$55.77
52-week low:	\$ 43.41
PE:	10.95
Div yield:	7.53%
Recent price:	\$43.88

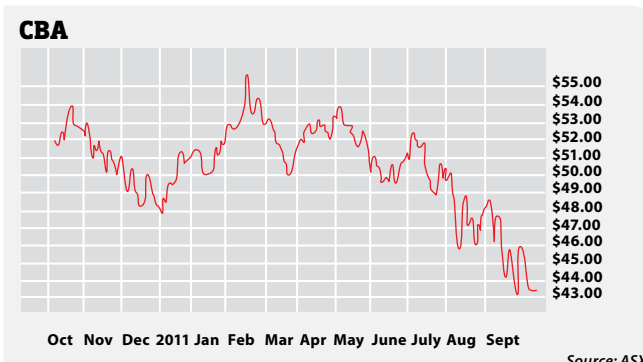
*Source: Australian Stock Report

The tip

Although the Commonwealth Bank has the priciest shares of the Big Four, it is a favourite for Ng. "It looks well-capitalised going into the future," he says. There are strong, stable dividend yields and the bank is well managed, although it could be difficult to maintain net interest margins.

The bank reported a 12% increase in its annual cash profit, which improved its return on equity to 19.5%. Earnings and dividends slightly exceeded analyst expectations.

With the bank currently trading at about 11 times its earnings, Stan Shamu from the Australian Stock Report believes the higher price isn't justified. According to Shamu, the bank is simply leveraging from its sizeable loan book, which will make it particularly vulnerable to the slowdown in credit growth.



★ Westpac (WBC)

Target price:	\$23.11*
Earnings forecast (YoY growth):	9.40%
Market cap:	\$58.15bn
52-week high:	\$25.60
52-week low:	\$17.84
PE:	7.83
Div yield:	7.90%
Recent price:	\$19.50

*Source: Australian Stock Report

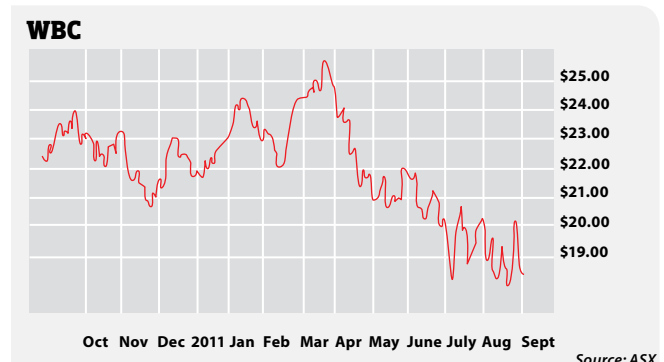
The tip

Shamu recommends purchasing this stock, as Westpac shares are trading at just under eight times their earnings. The more reasonable share price is due to the slow momentum in earnings following its merger with St.George.

Westpac has adopted a multi-brand strategy, recently relaunching the Bank of Melbourne. Morningstar says this strategy is "yet to be fully tested".

Westpac isn't a hot pick for Lee, as 7.1% of its mortgages are low-doc loans, the highest among the banks. There are not many cost-cutting opportunities, either.

Mirroring the Commonwealth Bank, Westpac has relatively high exposure to retail banking. "This is an area that may come under pressure," says Ng.





★ Australia and New Zealand Banking Group (ANZ)

Target price:	\$23.11*
Earnings forecast (YoY growth):	12.36%
Market cap:	\$49.37bn
52-week high:	\$25.95
52-week low:	\$17.62
PE:	9.41
Div yield:	7.24%
Recent price:	\$18.94

*Source: Australian Stock Report

The tip

ANZ has been the most aggressive bank in Asia, embracing an 'Asian footprint' strategy. "It has a significant hold on Asia, which most other banks don't have," says Shamu. Given the dismal prospects for growth in the US and Europe, Asia looks like the most promising region for future growth.

Benny Sada from the Australian Stock Report says ANZ has the best growth profile of the Big Four banks. "ANZ's leverage in Asia improves its funding mix, because the Asian region is high-saving. Having access to those savings means ANZ has lower funding costs."

Its expansion into Asia does make ANZ fairly risky, but gives it the potential to offset slowing credit growth in Australia.

ANZ recently announced that by 2017, 25–30% of its profit will come from Asia, the US and Europe.

★ National Australia Bank (NAB)

Target price:	\$26.87*
Earnings forecast (YoY growth):	18.92%
Market cap:	\$46.58bn
52-week high:	\$28.18
52-week low:	\$19.63
PE:	10.94
Div yield:	7.69%
Recent price:	\$21.63

*Source: Australian Stock Report

The tip

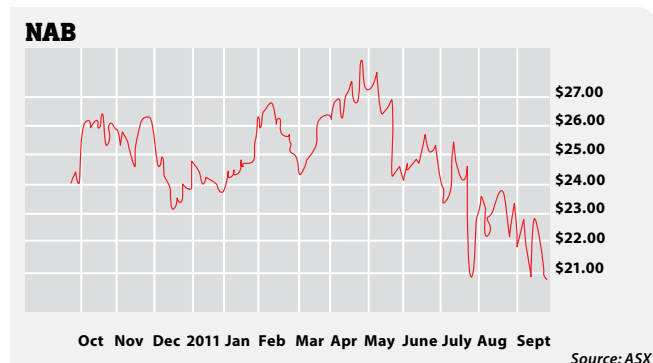
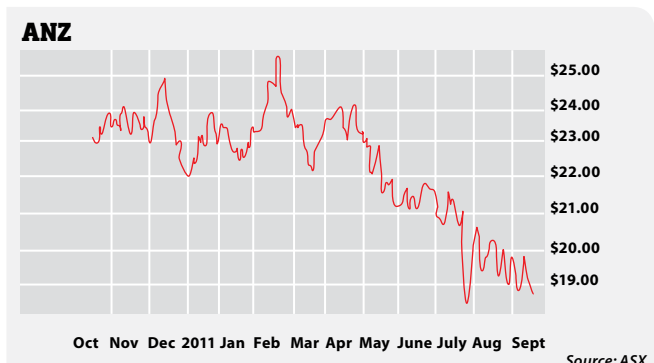
Lee says that NAB has some promising signs. Offering the lowest interest rates of the major banks, coupled with the successful 'Breaking Up' marketing campaign, has added to its market share. This move has cut into its margins but the bank says it will be beneficial in the long run.

Of the banks, NAB stands to benefit the most from cost-cutting initiatives; an option that most banks will adopt sooner or later because of the credit slump.

Low-doc loans make up a tiny 2% of NAB's total mortgage products, reflecting its high-quality assets. Despite the dwindling demand for home loans, NAB increased its home loans by an impressive 15% over the past year.

The bank has relatively low bad debt levels and its profits have improved slightly in the 12 months to June 2011.

Shamu is a little more sceptical about NAB's performance, arguing the stock is unjustifiably expensive.





★ Credit Corp Group (CCP)

Target price:	\$5.56*
Earnings forecast (EPS [^] growth):	20.34%
Market cap:	\$172m
52-week high:	\$6.15
52-week low:	\$2.87
PE:	8.11
Div yield:	5.26%
Recent price:	\$3.89

*Source: Lincoln Indicators

The tip

Ng believes this stock is a gem. As a debt collection agency, Credit Corp is performing well in the volatile climate. In times of high unemployment, debt ledgers are a cheap buy for Credit Corp. The company's operations continue to improve, although it is starting to operate in a fairly competitive environment.

^EPS: Earnings per share

★ IOOF Holdings (IFL)

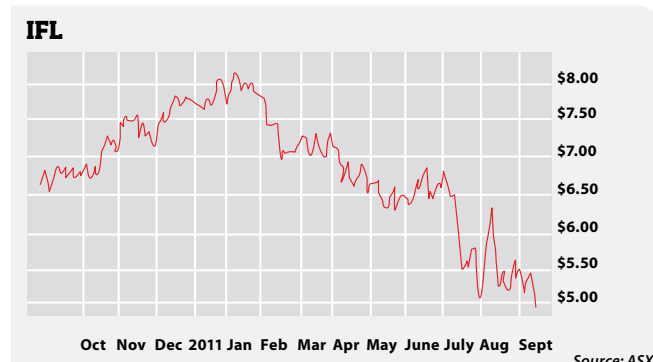
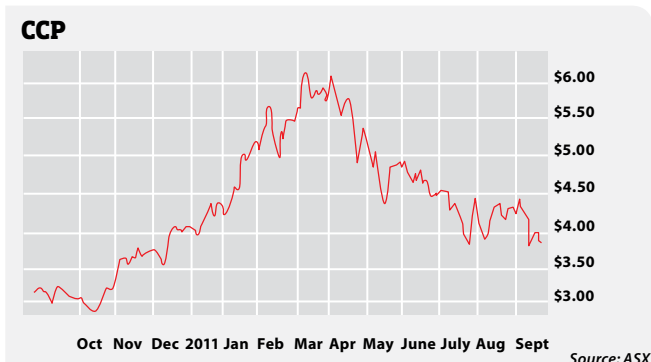
Target price:	\$7.39*
Earnings forecast (EPS [^] growth):	5.29%
Market cap:	\$1.41bn
52-week high:	\$8.09
52-week low:	\$5.12
PE:	10.65
Div yield:	8.40%
Recent price:	\$5.18

*Source: Lincoln Indicators

The tip

Also recommended by Ng, IOOF is performing well in terms of wealth management as reflected by its solid dividend yield. Although well-managed, the asset management company is exposed to any volatility in the equity markets. In the last financial year, IOOF reported a 29% jump in net profits after tax.

IOOF has over 650 financial advisory practices, having recently acquired DKN Financial Group, Kings Park Securities and Coastal Wealth Management.





★ MyState Limited (MYS)

Target price:	\$4.48*
Earnings forecast (EPS^ growth):	18.9%
Market cap:	\$239m
52-week high:	\$3.90
52-week low:	\$3.20
PE:	10.87
Div yield:	7.61%
Recent price:	\$3.55

*Source: Lincoln Indicators

The tip

With an impressive growth in earnings per share, MyState Limited gets the thumbs-up from Ng. The company provides a range of financial products and services through its two subsidiaries: MyState Financial and Tasmanian Perpetual Trustees.

In September, MyState announced its takeover of The Rock Building Society. "The takeover is a good fit and is expected to add to earnings per share," says Ng. "Banking exposure in Tasmania provides the company with a more favourable operating environment than its peers." MyState Limited is a relatively low-risk stock, as it has minimal debt within its capital structure.

★ QBE Insurance Group (QBE)

Target price:	\$15.80*
Earnings forecast (EPS^ growth):	17.95%
Market cap:	\$15.64bn
52-week high:	\$19.44
52-week low:	\$12.04
PE:	9.88
Div yield:	10.45%
Recent price:	\$12.63

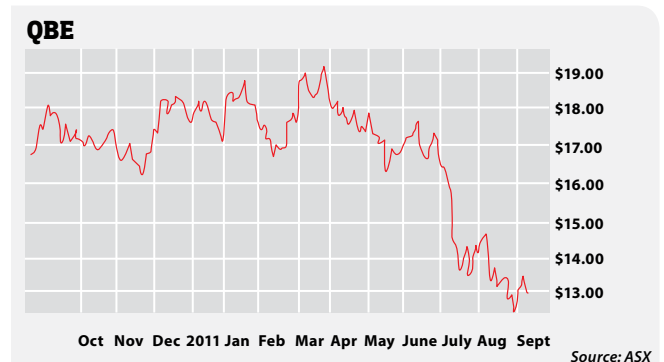
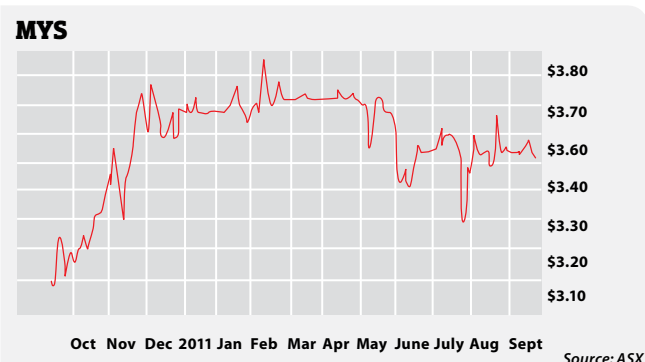
*Source: Lincoln Indicators

The tip

The frustrating uncertainty surrounding commodity prices and the Aussie dollar makes investment in QBE a great opportunity. As a well-managed global insurer with most of its operations in the US, the recent softening of the Aussie dollar means this insurer could be expected to perform well. This is promising, as QBE has come under pressure from various natural disasters. The QBE share price has hit a six-year low, making it quite cheap.

QBE recently announced it is on the hunt for acquisitions, and there are reports it has an eye on HSBC Holdings Plc. The National Insurance Brokers Association (NIBA) named QBE the country's top general insurer; a title QBE has held for 10 years.

Unfortunately, QBE does not pay Australian tax, which means full franking credits aren't paid to shareholders. But that shouldn't be an issue, given dividend yields alone are a sweet 10% and predicted growth in earnings per share is almost 18%.





Negative earnings growth but strong dividends

★ Bendigo and Adelaide Bank (BEN)

Target price:	\$8.40*
Earnings forecast (YoY growth):	11%
Market cap:	\$2.86bn
52-week high:	\$10.45
52-week low:	\$7.55
PE:	9.04
Div yield:	7.26%
Recent price:	\$8.22

*Source: Bell Direct

The tip

Cash earnings per share for Bendigo and Adelaide Bank have risen by 10.8%, which was above analyst estimates. Full-year dividends grew by 3.4% and the net interest margin rose by 0.5 percentage points, hitting 2.17%. Additionally, earnings are predicted to rise by 11% and retail deposits have grown by a nice 12%.

On the downside, the fall in the bank's Tier 1 capital ratios could affect dividends.

Don't let negative earnings growth forecast figures spook you – the following stocks still represent a great buy. Lee says banks continue to pull very strong profits, and these stocks should be able to maintain their dividends. The negative numbers simply mean the expected profit is likely to be less than that of the previous year. "It will be difficult for the banks to keep up with the increase in profits, given the emphasis on cost-cutting in this harder environment," says Lee.

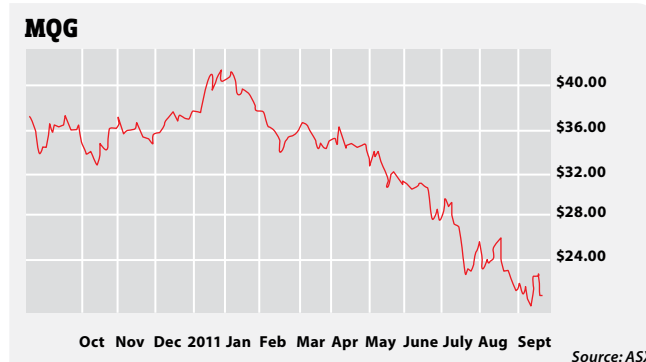
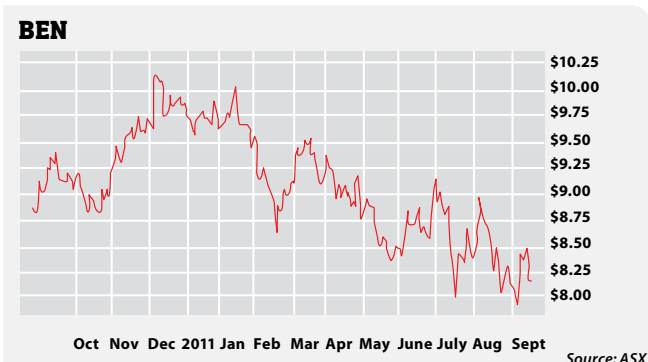
★ Macquarie Group (MQG)

Target price:	\$29.20*
Earnings forecast (YoY growth):	-12%
Market cap:	\$6.98bn
52-week high:	\$41.95
52-week low:	\$19.94
PE:	7.76
Div yield:	8.49%
Recent price:	\$21.44

*Source: Bell Direct

The tip

Macquarie is on an acquisition spree, recently buying stakes in Intercept Minerals, NRW Holdings, Aurora Oil & Gas, and DUET Group. Lee recommends a hold on this stock.





★ Suncorp–Metway (SUN)

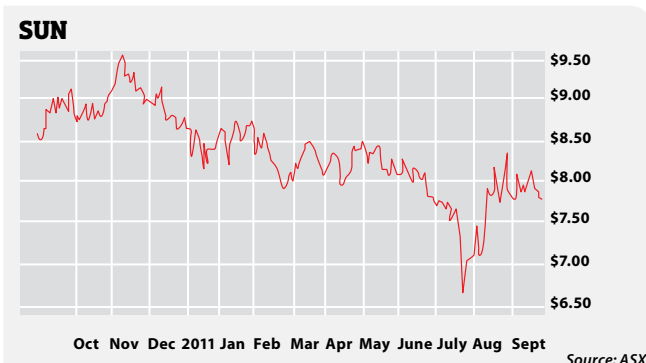
Target price:	\$9.70*
Earnings forecast (YoY growth):	-18%
Market cap:	\$10.2bn
52-week high:	\$9.76
52-week low:	\$6.03
PE:	22.75
Div yield:	4.33%
Recent price:	\$7.77

*Source: Bell Direct

The tip

According to Lee, Suncorp makes a good buy because it's cross-selling products to provide ongoing revenue streams. There's been an increase in its net interest margin from 1.80% to 1.90%, in the year to June. Morningstar noted Suncorp has also performed well in the home loan market, with its home loans growing by 6.1% in the year to July. Whilst the earnings forecast is negative, Lee says Suncorp still has strong profit and cash flow.

However, Suncorp announced that its profit in the last financial year dropped by 42%, citing a tough period of natural disasters in Australia, most notably, the Queensland floods. Subsequently, Suncorp experienced a higher-than-expected number of claims.



★ Bank of Queensland (BOQ)

Target price:	\$8.50*
Earnings forecast (YoY growth):	-14%
Market cap:	\$1.52bn
52-week high:	\$12.32
52-week low:	\$6.46
PE:	11.90
Div yield:	7.27%
Recent price:	\$6.96

*Source: Bell Direct

The tip

Mirroring Suncorp, the Bank of Queensland increased its home loan portfolio by a solid 7.7%. A buy on the Bank of Queensland is recommended by both Lee and Morningstar, as investors can expect to receive competitive dividend yields. The bank's debts were not as bad as expected, either.

However, return on equity is slow and the bank is struggling with capital requirements. With a PE ratio of almost 12, the shares are also over-priced.

CEO Stuart Grimshaw was appointed in August to replace the retiring chief executive. Grimshaw was brought in from the outside, and announced that he has no major plans to overhaul the bank's strategy.

