FIDENS PARTNERS

CONSULTING | STRATEGIC FINANCE | CAPITAL

Fidens (Latin) : *confident, without fear, courageous*

ACCA

Regain control of your banking relationship

23 Oct 2012

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Our banks….

SunTze's Art of War says:

"Know others, know self, hundred battles without fear"

So,

What is the business of banking?

How are our banks performing?

How do they manage their performance?

What "levers" do they pull to ensure performance?

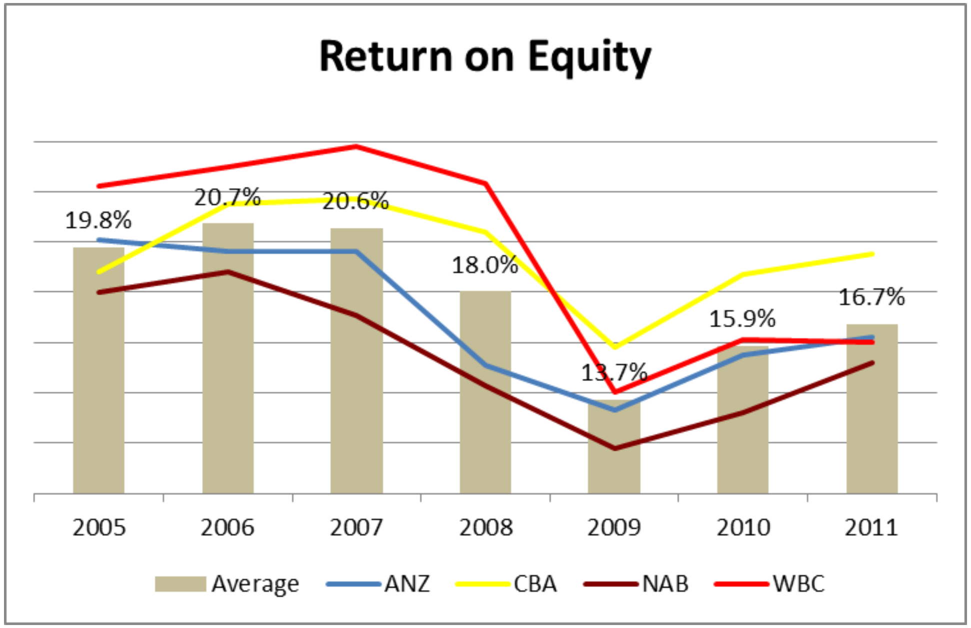
Some key stats:

- Four majors make up $290bn Mkt Cap
- 30% of ASX 100
- All financial shares make up 46% of ASX100

Banking is a business.

Like all businesses, they need to add value to shareholders

This leads to the importance of ROE

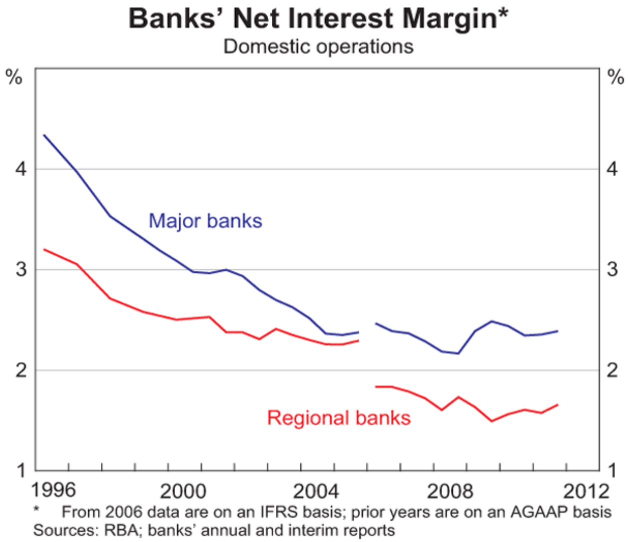


Data source: Comsec

- Despite all the reported super profit, our banks have under-performed since 2008.
- CBA, the ROE leader at 19.5%, is only 31st highest among ASX100.
- Considering the balance sheet of banks a leverage business by nature, their ROE performance is not impressive at all.

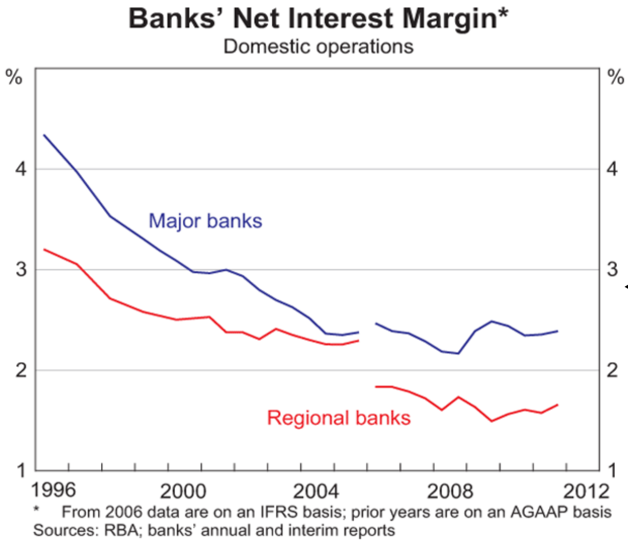
Banks will pull every levers they can to improve ROE

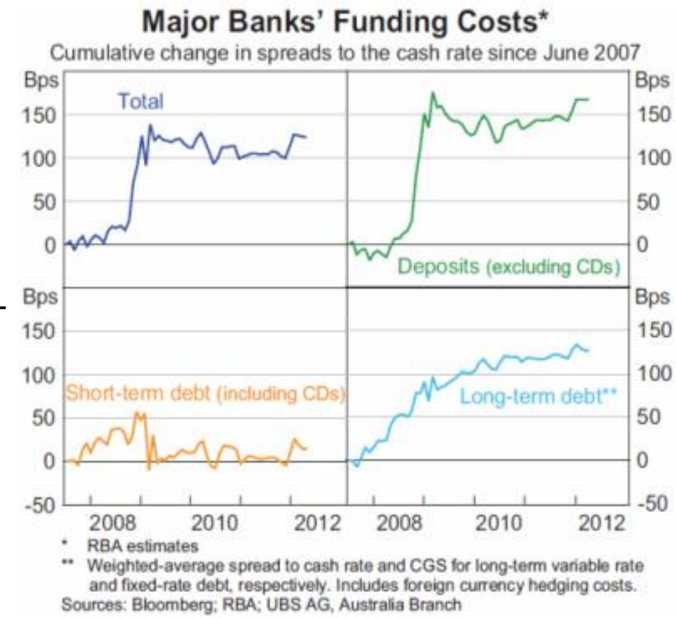
Profitability



- Net Interest Margin (NIM) – one of the best measurement of bank's profitability
- Downward trend for the past 16 years
- A slight hike in 2008 due to industry wide repricing

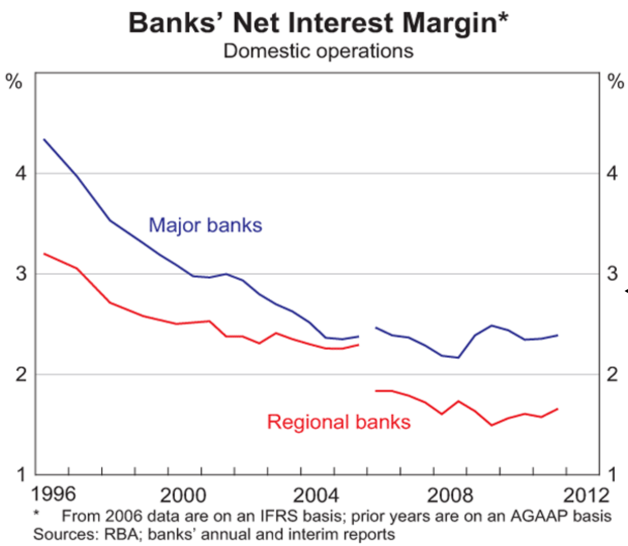
Profitability

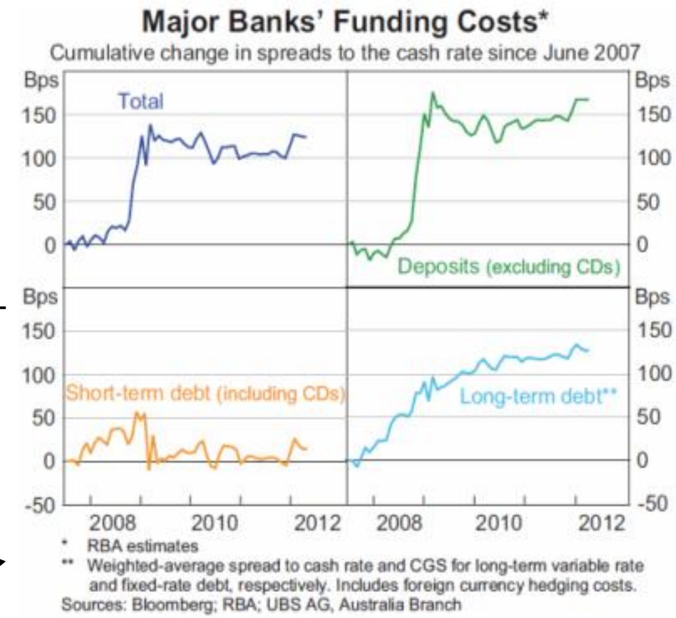


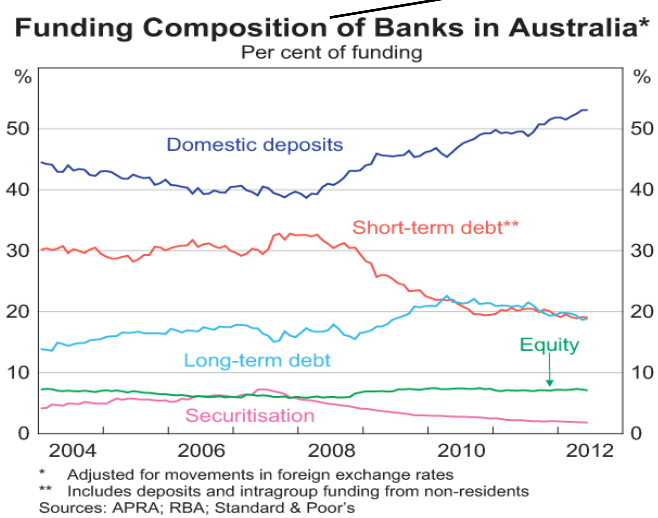


- Historically, banks rely on wholesale funding market (60% of total funding) which becomes very volatile
- Banks used to raise capital at 15bps overseas. In Aug12, NAB raised at 220bps 10 yrs unsecured & CBA at 325bps sub-debt
- Overall funding cost (Banks' Cost of Goods Sold) increased from 20bps to now 140bps

Profitability





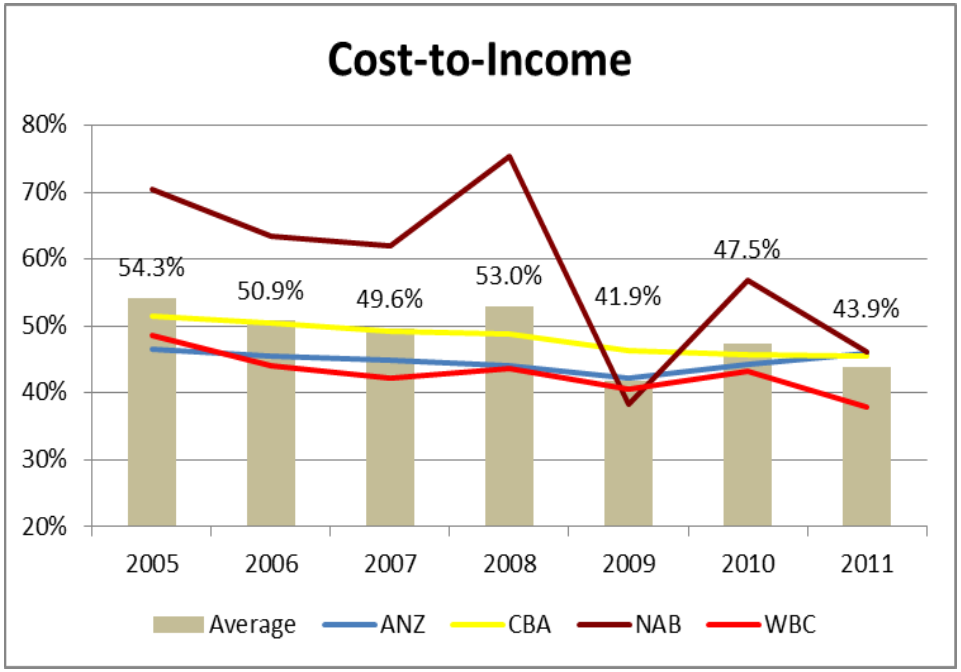


- Banks changed funding strategy
- Increase local deposit and less on wholesale market (now, 40%)
- Pass on Liquidity Premium (LP)
- Pricing quotes now:
  - BBSY + LP + Margin or COF + Margin where COF = BBSY + LP

Practical tips

1. **Scrutinise funding base rate – compare like-to-like**

Profitability



- Banks have been very successful to reduce Cost-to-Income (C.I) ratio from 55% to 44% by using technology & outsourcing
- But too fast and too much: A reduction of 10.5% in C.I ratio (2011 vs. 2005) is about $6.5bn in cost in today's term

~ Memory lapse syndrome ~

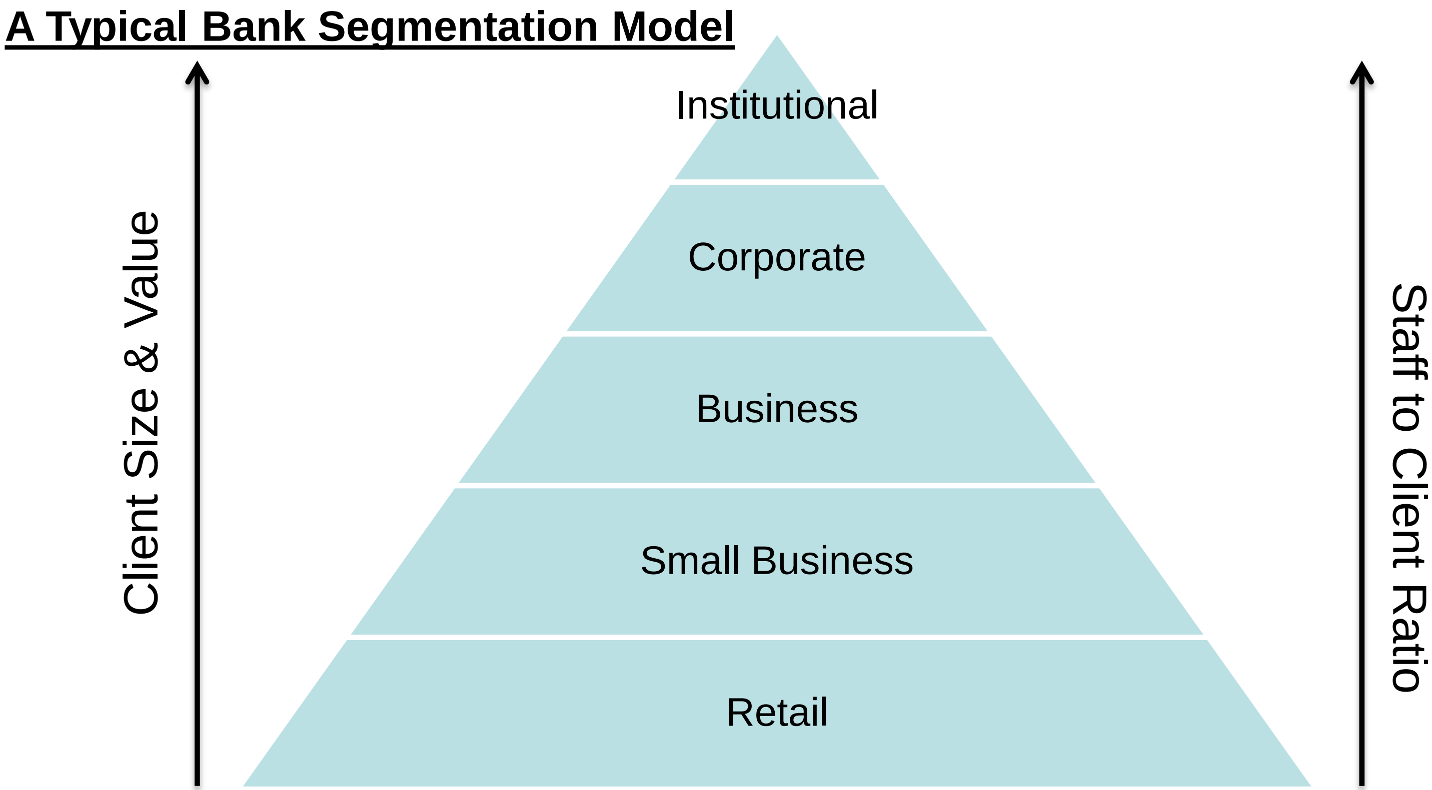
Banks lose memory of their customers and disregard relationship history

Practical tips

1. Scrutinise funding base rate – compare like-to-like

2. **Retain your relationship history and educate your banker frequently**

Profitability



- The size and complexity of your business determine where your account sits in the bank client segmentation
- The value of your account determines which manager looks after you

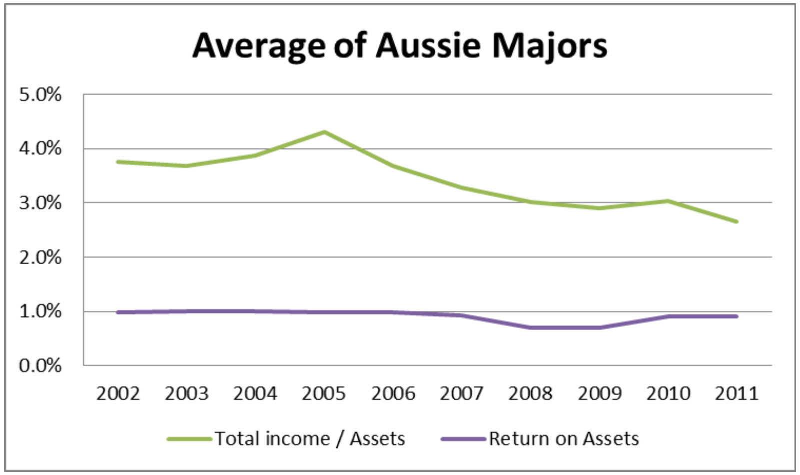
Practical tips

1. Scrutinise funding base rate – compare like-to-like

2. Retain your relationship history and educate your banker frequently

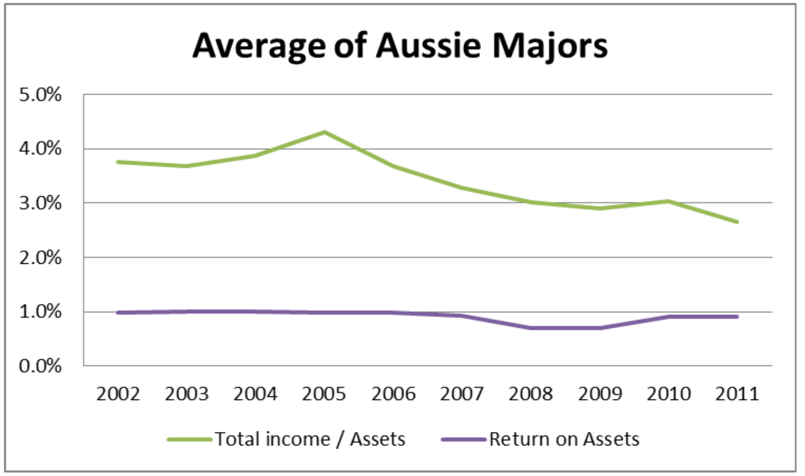
3. **Get their best relationship team to manage your account**

Operating Efficiency

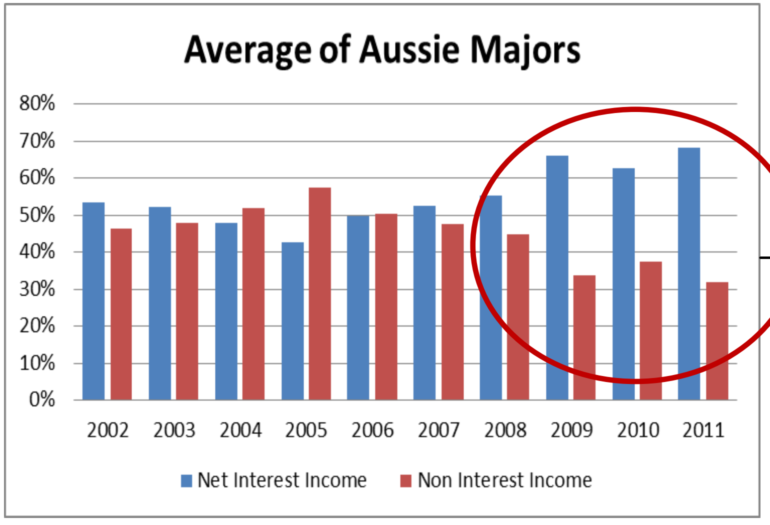


- ROA (risk adjusted) is relatively constant between 0.8-1%
- Income to Asset is on a downward trend
- Why?

Operating Efficiency

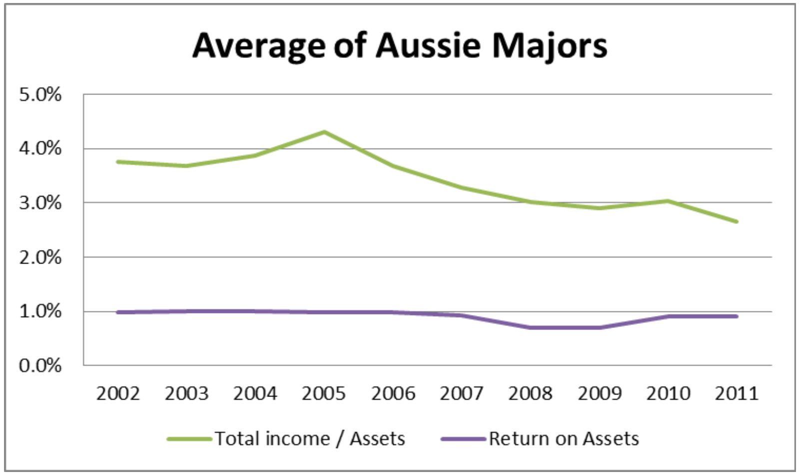


Income

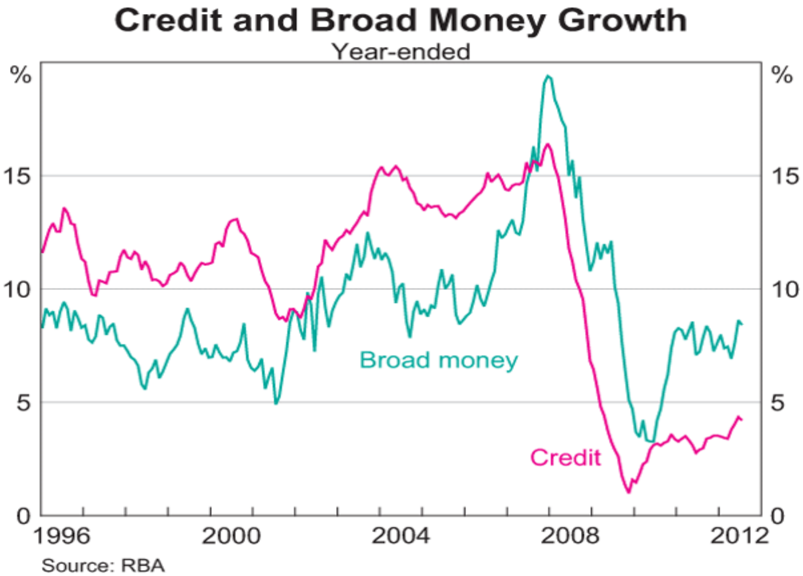


- Divergence of Interest vs. Non Interest income
- Non interest income proportion dropped since 2008 because:
  - Market-wide loan repricing
  - Acquisition of St George & Bankwest

Operating Efficiency



Assets



- Benign credit growth
- Growth of income must outpace growth of assets
  - Little incentive to reprice down current loan (complacency)
  - Won't chase after low yield assets
  - Focus on lifting non-interest income for every $1 lent out

Practical tips

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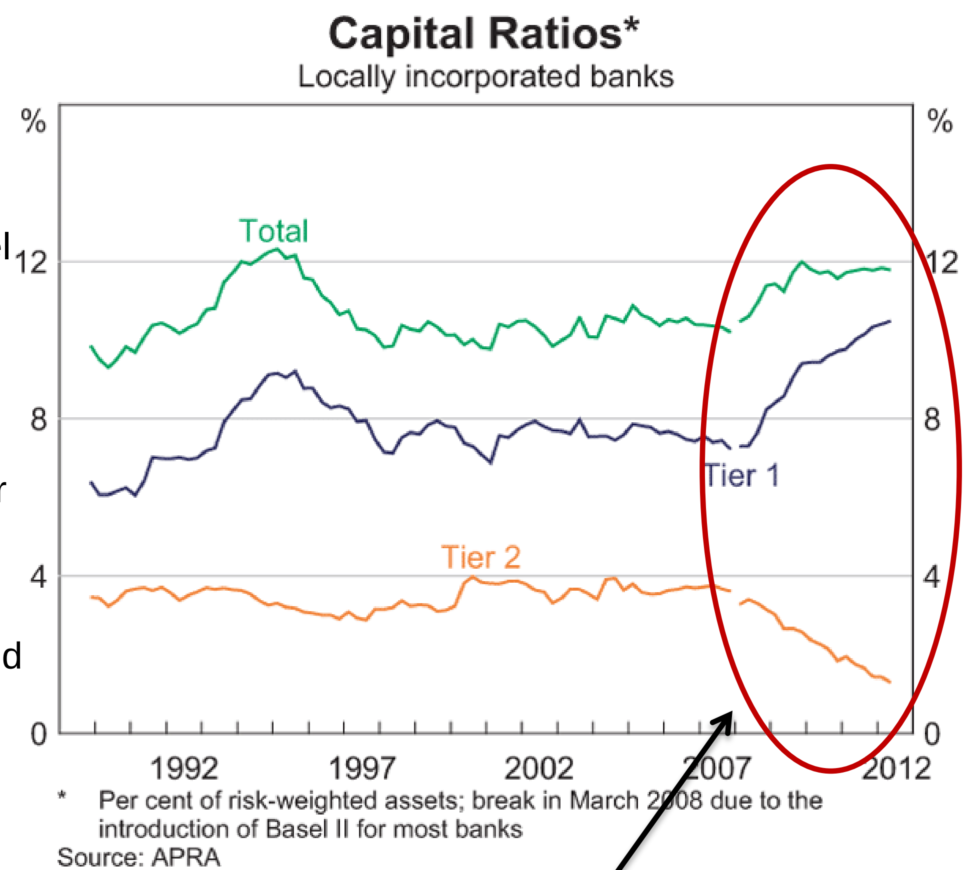
3. Get their best relationship team to manage your account
4. **Know your total banking wallet beyond just debt facility**
5. **Be pro-active on managing the “price” you pay**

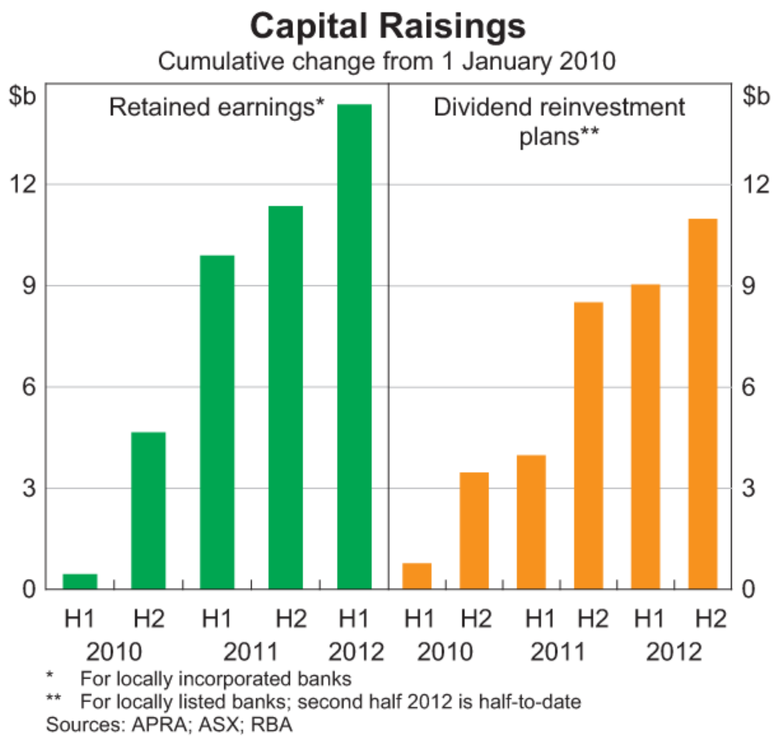
Leverage

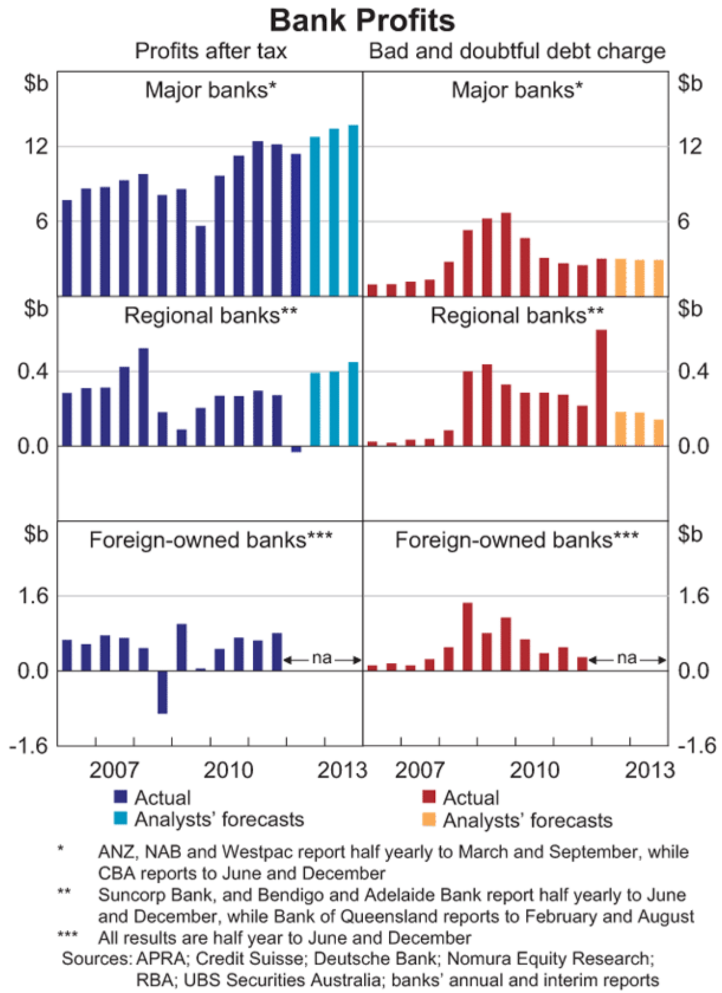
- Banks' ability to leverage is heavily regulated by APRA
- The higher the risk-adjusted-assets, the more capital banks have to set aside.
- Banks in 2013 will start to comply to Basel III – a new capital regulatory framework and to be fully complied by 2015
- Key points of Basel III
    - Lift the requirement for equity in Tier 1 capital
    - Tighten quality of equity to only common equity, retained earning and other income
    - Increase the requirement of holding liquid assets such as highly rated short term paper



Banks have started preparing for Basel III

Leverage





- The requirement to increase equity in Tier1 capital reduces the ability to leverage and thus decrease returns
- The riskier the assets, the higher the capital requirement, thus the lower the return

It is getting more expensive to run a banking business

Practical tips

1. Scrutinise funding base rate – compare like-to-like
2. Retain your relationship history and educate your banker frequently
3. Get their best relationship team to manage your account
4. Know your total banking wallet beyond just debt facility
5. Be pro-active on managing the “price” you pay
6. **Dress your company to be a high quality credit**

Practical tips

1. Scrutinise funding base rate – compare like-to-like
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4. Know your total banking wallet beyond just debt facility
5. Be pro-active on managing the “price” you pay
6. Dress your company to be of high quality credit

The last one:

This is unfortunate reality… no use to complain… learn to adapt

Apply to practice (Real case)

Company (Fictitious name)

Gourmet Food is a proud Australian family-owned company that specialises in providing gourmet food products to the Australian market. Among the 1,000 well-known brands it imports and distributes are Great Water, Yummy Pasta, Best Butter, and Choc Cheese.

Banking relationship

Same bank since inception (25 yrs ago). Never changed or attempted to change banks

What happened

- The bank decided the company was too highly geared
- Tightened covenants
- Issue a breach letter for late quarterly reporting
- When the company asked for more expansion funding, its bank asked them to seek elsewhere.

Apply to practice (continued)

Findings

- X Inappropriate facility structure – funded by term debt and expensive overdraft;
- X Covenant structure did not help client grow
- X A lot of hidden variables in the pricing structure
- X All-in margins were higher than market
- X Plenty of errors in facility agreement

Apply to practice (continued)

Findings

X Inappropriate facility structure – funded by term debt and expensive overdraft;

X Covenant structure did not help client grow

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X All-in margins were higher than market

X Plenty of errors in facility agreement

What did we do

✓ Internal shadow credit assessment including security cover, facility structure, covenants.

✓ Estimated our total banking wallet to know our “worth” to them

✓ Drafted credit story for marketing to banks

✓ Invited other banks to tender

Practical tips

1. Scrutinise funding base rate – compare like-to-like √
2. Retain your relationship history and educate your banker frequently √
3. Get their best relationship team to manage your account √
4. Know your total banking wallet beyond just debt facility √
5. Be pro-active on managing the “price” you pay √
6. Dress your company to be a high quality credit √

Apply to practice (continued)

Results

- Increased the facility size by 25% ($26m)
- Released directors' personal guarantees and mortgage on his home
- Structured facility to enhance growth
- Transparent pricing structure – no hidden variables, only BBSY + margins
- Streamlined reporting – save on management time
- Significantly reduced pricing
- All up annual saving of circa. $300k for the next 3 years

The deal was won by the existing bank who was over-joyed to have maintained a valuable client