OCBC Bank

Asia Credit Research

Earnings Review: Australia & New Zealand Banking Group Ltd ("ANZ")

Issuer Profile: Positive (2)

Ticker: **ANZ**

Background

ANZ Banking Group Limited ('ANZ') is one of Australia's big 4 banks and the largest bank in New Zealand. It is ranked in the top 25 globally by market capitalization with operations in 34 markets. Its business segments cover retail, commercial and institutional banking as well as wealth management. As at 31 March 2018, the bank had total assets of AUD935.1bn.

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Recommendation

- Improved underlying 1HFY2018 results for ANZ suggest a benign operating environment and the impact of ANZ's repositioning strategies. This has benefited earnings, balance sheet quality and capital ratios.
- A strong capital position will be important given challenges to future profitability facing Australian banks. As such, we retain our Positive (2) Issuer Profile.
- The ANZ 3.75% '27c22s represent the better value in the Aussie Tier 2 space. We currently rate all the Australian banks at a Positive (2) Issuer Profile.

Relative Value:

Bond	Maturity / Call date	CET1 Ratio	Ask Yield	Spread
ANZ 3.75 '27c22 (T2)	23/03/2022	11.0%*	3.25%	94
NAB 4.15 '28c23 (T2)	19/05/2023	10.1%*	3.43%	103
WSTP 4.00 '27c22 (T2)	12/08/2022	10.6%*	3.17%	83

Indicative prices as at 2 May 2018 Source: Bloomberg
*Common Equity Tier 1 (CET1) Ratio based on latest available quarter *APRA Compliant*

Key Considerations

- **Underlying profit performance helped by cost management:** ANZ reported 1HFY2018 results for the 6 months ended 31 March with underlying cash profits (which reflects the results of continuing businesses) up 4% y/y to AUD3.5bn. The better y/y profit performance was driven entirely by the cost side with a 2% y/y fall in operating expenses from lower personnel and premises expenses outside Australia and 43% y/y reduction in credit impairment charges mitigating a 2% y/y fall in operating income. The weaker operating income result was driven by a 1% y/y fall in net interest income as a 7bps y/y fall in net interest margins to 1.93% overshadowed a 3% y/y rise in average interest earnings assets. Other operating income was also weak, down 4% y/y due mostly to lower markets related income despite growth in market-related assets.

- **Segment performance reflects strategic initiatives:** Profit by segment reflects ANZ's on-going restructuring activities with solid profit growth in ANZ's core Australia and New Zealand segments of 9% y/y and 7% y/y respectively while Institutional and the remaining Wealth Australia segments fell 26% y/y and 24% y/y respectively. As such, the combined contribution of the Australia (comprises Retail and Business & Private Banking) and New Zealand (comprises Retail and Commercial Banking) segments to overall profits rose to above 90% for 1HFY2018, compared to ~70% in 1HFY2017. This remains in line with management's focus on more profitable segments with stronger net interest margins from Australia and New Zealand as opposed to the Institutional segment (comprises global institutional and business customers). Asia Retail & Pacific segment (comprises continuing operations) performance improved materially following the sale of ANZ's retail and wealth businesses in Singapore, Hong Kong, China, Taiwan and Indonesia to DBS Group Holdings Ltd and ANZ's retail business in Vietnam to Shinhan Bank Vietnam.

- **Restructuring also seen in balance sheet**: Total assets (including discontinued operations) grew 4.3% y/y to AUD935.1bn and was supported, amongst increases in cash and trading assets, by a 4.4% y/y increase in net loans and advances. This was driven mostly by foreign currency translation impacts with underlying growth in average net loans and advances of 1% y/y due to growth in home loans in Australia and New Zealand. Growth in markets-related assets drove a corresponding increase in ANZ's liquidity portfolio holdings. In line with reduced impairment charges, new impaired assets fell 46% y/y (-32% h/h) due to the Institutional segment's improved risk profile from portfolio rebalancing, better performance in New Zealand Commercial and Agri business and reduced exposure to Asia Retail and Wealth businesses following its partial sale. Gross impaired assets fell 31% y/y. However as individual provisions fell only 21% y/y, the fall in net impaired assets y/y was higher at 39% indicating still solid metrics for loan quality.

- **And supporting capital ratios:** Despite growth in total assets, risk weighted assets were broadly stable y/y. Along with solid earnings generation and asset divestments, ANZ's APRA compliant capital ratios improved with 1HFY2018 CET1/CAR ratios of 11.0%/14.9% against FY2017 CET1/CAR ratios of 10.6%/14.8% and 1HFY2017 ratios of 10.1%/14.5%. Ratios are now further above regulatory minimum requirements and APRA's minimum CET1 requirement of 10.5% by Jan 1, 2020 for 'unquestionably strong' capital ratios as recommended by the 2014 Financial System Inquiry. On an internationally comparable basis, the CET1 ratio improved to 16.3% for 1HFY2018 from 15.8% for FY2017 and 15.2% for 1HFY2017. This incorporates the 88bps impact from dividend payments and share buyback. Capital ratios will further improve once regulatory approval is obtained for recently announced Wealth Australia divestments and the transactions complete. Strong capital buffers will become increasingly important given the anticipated future impact from outcomes from the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry with earnings potential constrained by possibly lower loan growth and higher regulatory and operating expenses.

OCBC Global Treasury

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Explanation of Issuer Profile Rating / Issuer Profile Score

Positive ("Pos") – The issuer's credit profile is either strong on an absolute basis, or expected to improve to a strong position over the next six months.

Neutral ("N") – The issuer's credit profile is fair on an absolute basis, or expected to improve / deteriorate to a fair level over the next six months.

Negative ("Neg") – The issuer's credit profile is either weaker or highly geared on an absolute basis, or expected to deteriorate to a weak or highly geared position over the next six months.

To better differentiate relative credit quality of the issuers under our coverage, we have further sub-divided our Issuer Profile Ratings into a 7 point Issuer Profile Score scale.

IPR	Positive		Neutral			Negative	
IPS	1	2	3	4	5	6	7

Explanation of Bond Recommendation

Overweight ("OW") – The performance of the issuer's specific bond is expected to outperform the issuer's other bonds, or the bonds of other issuers either operating in the same sector or in a different sector but with similar tenor over the next six months.

Neutral ("N") – The performance of the issuer's specific bond is expected to perform in line with the issuer's other bonds, or the bonds of other issuers either operating in the same sector or in a different sector but with similar tenor over the next six months.

Underweight ("UW") – The performance of the issuer's specific bond is expected to underperform the issuer's other bonds, or the bonds of other issuers either operating in the same sector or in a different sector but with similar tenor over the next six months.

Other

Suspension – We may suspend our issuer rating and bond level recommendation on specific issuers from time to time when OCBC is engaged in other business activities with the issuer. Examples of such activities include acting as a joint lead manager or book runner in a new issue or as an agent in a consent solicitation exercise. We will resume our coverage once these activities are completed.

Withdrawal ("WD") – We may withdraw our issuer rating and bond level recommendation on specific issuers from time to time when corporate actions are announced but the outcome of these actions are highly uncertain. We will resume our coverage once there is sufficient clarity in our view on the impact of the proposed action.

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