EASTERN **PROMISE**

Will ANZ's venture into Asia soon reveal the worth of its strategy, or is the bank's regional quest a mission from which there is no safe return? By Mark Story

FACING A mature domestic market ANZ Bank turned to Asia, spending more than A$5 billion buying banking assets in Asia over the last four years, planning to become a super-regional bank in that space and make the strategy the core of its future growth. But ANZ is now suffering the market censure imposed on a company when the gap between its aspirations and investor expectations gets too wide.

At half-year 2011, ANZ reported a 16 percent return on equity, and its APEA division (Asia, NZ, Europe and the US) – of which Asia represents 50 percent of revenue – boosted underlying year-on-year earnings by 43 percent, while accounting for 14 percent of group underlying earnings.

Due largely to ANZ's acquisition of Royal Bank of Scotland's assets across Asia, the volume of its transaction banking/specialised lending has gone up exponentially. But the jewel in the Asian crown is arguably the deposit base, which is rising 50 percent year-on-year.

The net effect is that funding from the APEA division alone is reducing ANZ's wholesale requirements by more than 10 percent. But despite this encouraging news, the market doesn't appear to believe that the Asian strategy is adding the kind of value it expected. And fund manager sentiment towards financials fell in the June quarter to 42 percent from 56 percent previously, due to flow-on effects from the ongoing European sovereign debt crisis.

Investor bias

Debt issues aside, there's also an investor bias away from ANZ, with fund managers starting to second-guess their weightings in the stock. Adding to negative sentiment surrounding ANZ, high profile emerging markets investor Marc Faber recently told US magazine *Barron's* that investors should consider short selling the stock.

Revelations that income growth from Asia slowed to 3 percent over the last six months adds to the fear within an already spooked market.

ANZ deputy CEO Graham Hodges concedes that, short of a major fall in the A$, ANZ will undershoot its stated goal of getting 20 percent of earnings from Asia by full-year 2012. He says, though, that this goal was given as guidance – ANZ's Asian aspirations were never meant to be absolute targets.

Underperforming its peers

Be that as it may, ANZ shares slipped when first-half 2011 earnings, which didn't exceed consensus, were accompanied by a higher dividend. Given that top-line growth is harder for the Big Four to achieve in the mature domestic market, ANZ's Asian growth story should have been a positive point of difference.

Instead, much of ANZ's Asian wow-factor has been marginalised by investor uncertainty, and for this ANZ must share some of the blame. After all, it was ANZ's former CEO John McFarlane who expressed his distaste for Asia by selling down the bank's ownership of Grindlays Bank, with extensive operations across Asia, and invested the proceeds in New Zealand, one of the world's slowest-growing economies.

Investors who use PE and yield to invest will probably not think to buy ANZ first. The gap in share price growth between ANZ and its peers has widened to between 3 and 9 percent. The worst performer among the Big Four banks, ANZ's share price slipped 0.5 percent since 30 June 2010, while NAB, CBA, and Westpac have put on 5.5 percent, 2.9 percent and 0.9 percent respectively. Once dividends have been factored in, ANZ's total return of 5.7 percent pales in comparison with the 12.6 percent return delivered by best-performing NAB.

Unclear verdict

So is it ANZ's super regional strategy or its execution that's at fault? Paul Saliba, chief investment officer with Lachlan Partners, says it's probably too early to tell. But where the bank has come undone, says Saliba, is in its failure to help institutional investors connect the dots. What remains unclear is how the sum of all its Asian parts – oriented toward institutional clients – will eventually coalesce into a regionally and globally coherent network.

"The current macro-economic backdrop within some countries in Asia, notably China – now cooling its economy from inflationary pressures – make the execution of ANZ's Asian strategy much more difficult than in 2007 when the A$ was trading at around US$0.65," says Saliba.

Catch and throw

ANZ's ongoing success within Asia, says deputy CEO Hodges, is tied to institutional and Asian partnerships that represent 88 percent of the bank's revenue within the region. Consolidating this low-risk, high-demand, fee-generating bread & butter business, he says, means accelerating its "catch and throw" model within intra-Asia trade flows.

To Hodges this means being able to handle transactions at both ends for

ANZ'S ASIAN NETWORK

In hindsight, ANZ made an horrific strategic blunder when it sold Grindlays, the British colonial bank, to Standard Chartered Bank in 2000.

Perceived by some as a mini-version of Standard Chartered, ANZ operates primarily in Australia and NZ, and 26 markets in the Asia-Pacific region with sizable operations in Indonesia, Malaysia, Vietnam and Cambodia – and in June opened the first of what's expected to be 20 branches in India. ANZ subsidiaries now include:

- 100 percent of RBS assets in Singapore, Taiwan, Indonesia, Hong Kong, the Philippines and Vietnam
- 99 percent ANZ Panin Indonesia
- 55 percent ANZ Royal Cambodia.

With the RBS integration complete, ANZ now has much-needed critical mass in Asia with over 2.4 million customers across the region.

Bloomberg said ANZ was the second-largest arranger of loans in the Asia-Pacific area outside Japan. ANZ was just behind the State Bank of India and grew its share of the market to 6 percent this year from 4.9 percent in 2010, Bloomberg data showed. Its share of US dollar, euro or yen bonds in the region outside of Japan rose to 1.8 percent this year from 0.9 percent, putting it two places higher in 18th place.

In the Singapore dollar bond market, ANZ Bank is ranked No. 4, up from fifth in 2010, the data show.

ASIAN ASSOCIATES	$M*
20% Bank of Tianjin – China	28
20% Shanghai Rural Commercial Bank – China	102
39% PT Bank Panin – Indonesia	40
24% AMMB Holdings Berhad – Malaysia	53
40% Metrobank Card Corporation – Philippines	4
18% Saigon Securities Inc	2
Other associates	14
TOTAL	**243**

* Contribution to Group pre-tax profit half year – March 2011 $M

multinational companies doing business to and from Asia. "The business we're trying to attract in Asia is more around forex, trade, cash management, transaction banking, debt and capital markets than loan-led," says Hodges. "Given the nature of the region, the three areas we're continuing to specialise in include natural resources, infrastructure, and agribusiness."

Angus Gluskie, funds managing director with White Funds Management, says ANZ clearly needs to prove that by adopting the "catch and throw" business model within Asia it hasn't unwittingly hitched its fortunes to the weak US economy and currency. "The truth is that the ANZ may have gone too far down the Asian path to pull back, and may well have to go further in – through more acquisitions, and consolidating smaller positions – to prove its case long-term."

Decades of growth

Hodges encourages investors to focus on the decades of growth that are ahead of ANZ within a region set to grow at double the 3.5 percent seen locally, instead of dwelling on the milestones ANZ has not yet reached. "Our aim is to be a top-four international bank in these markets, and while we have an encouraging head start on local banks, we've got a lot of catching up to compete with the big Asian banks," says Hodges.

Roger Montgomery of Montgomery Investment Management says the market seems to have missed the point that despite falling short of its targets, ANZ has one of the best underlying performances of any domestic major – with Asia providing significant growth potential. He says institutional investors will get a better feel for ANZ's long-term upside by standing back from the numbers and focusing on group performance. "Otherwise they risk getting lost in the minutiae in an attempt to second-guess when the Asian assets will fulfill expectations."

Montgomery believes it's too early to know whether ANZ's APEA division will or will not deliver up to 30 percent of profit by full-year 2017. But, he says, the current discount on ANZ's share price should remind CEO Mike Smith of stock market short-termism, and the importance of under-promising and over-delivering. "Australia's Big Four have taken turns trading at discounts to their peers. We're likely to see a re-rating on the stock once a business upturn delivers more market share to ANZ throughout Asia."

Insufficient visibility

For Gluskie the trouble with that approach is the difficulty fund managers will have keeping their eye on group profit when the ANZ has made Asia the touchstone by which it is measured. He doubts the market will receive sufficient insight into whether the Asian strategy can deliver on stated long-term goals for at least the next two to three years.

Despite concerns over slowdowns in the US and China, Gluskie says institutional investors should see existing pressure points within ANZ's Asian strategy, exacerbated by currency headwinds, as an opportunity capitalise on the long-term upside ahead of any re-rating. He notes that ANZ continues to lag behind other banks in efficiency, but that it could be improved by ongoing expansion and consolidation of its operations in Asia and beyond.

To its credit, ANZ acquired its Asian assets during the GFC very cheaply, and with a Tier 1 capital ratio of 10.5 percent is well positioned to continue acquiring Asian assets. For example, ANZ plans to double its stake in Malaysian group AMMB to 49 percent, subject to regulatory improvements.

Opportunity vacuum

Hodges concedes that ANZ's Asian strategy could take longer to work than the market might like. But during recent roadshows he encouraged institutional investors not to lose sight of the deep pockets of value Asia has to offer.

The GFC, he argues, created an unprecedented opportunity for ANZ to consolidate its foothold in the region through M&A and organic growth. The subsequent pullback by Chinese banks, and the slowness of European and US banks to re-enter Asia, provides ANZ more chances to consolidate its market share. "So there's currently a vacuum within Asian markets that's allowed us to develop opportunities with less competition around."

Alex Thursby, ANZ chief executive for APEA, says there is low systemic risk across the region, given that many Asian banking systems have loan-to-deposit ratios of less than 70 percent. But competition in Asia for banking talent will only intensify with the return of foreign banks to the region. "Lack of broad-based generalist bankers with real experience who can see the full picture, understand the risks of leverage and are inherently conservative is a real problem," Thursby . "Without bankers with this type of experience, Asia risks eventually going down the same route as Europe and the US." ■

Graham Hodges

Roger Montgomery

Paul Saliba

Angus Gluskie