Q&A with Brett Le Mesurier

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Rising interest rates are helping to buoy lending profitability at Australia's biggest banks but there is also uncertainty with the economy expected to slow. In this Q&A we asked Senior Equities Analyst Brett Le Mesurier what rising interest rates and inflation mean for Australia's major banks and preferences amongst the general insurers heading into 2023.

Rising interest rates mean higher revenue for Australia's major banks while bad debts remain subdued. Can you explain why net interest margin (NIM) is so important and how the Big Four have benefited / will potentially benefit?

A major part of the banks' revenue comes from net interest income, whose components are net interest margin and asset growth. Westpac's NIM increased from 1.85% in 1H22 to 1.9% in 2H22, which assisted its net interest income to increase by 7% over the period. ANZ's NIM increased from 1.58% to 1.68% from 1H22 in 2H22 and net interest income increased by 9%. These higher rates of income growth have two benefits. Firstly, they enable income to grow faster than expenses which increases the company's ROE; and secondly, they produce higher rates of profit growth, all else being equal. Both these characteristics lead to higher share price multiples.

NAB and Westpac are your two preferences amongst the major banks at the moment. Can you take us through your thinking here and what may change this assessment?

In my view, NAB has the best combination of Chair and CEO amongst the major banks. Both have extensive experience and a record of success in managing large banking businesses. NAB has substantially repaired its retail banking franchise and has maintained its market leading position in small and medium business. Westpac should trade on a multiple which is much closer to NAB as a result of its higher weighting towards the higher-returning retail business. It is also the only major bank which is actively seeking to reduce its expenses, and this will lift its share price multiple should it succeed.

Some Perpetual funds have positions in both IAG and Suncorp. Why are the big general insurers so attractive at the moment and which is your preference?

IAG and Suncorp have pricing power, are increasing their premium rates substantially and are currently experiencing elevated claims due to the wet weather pattern. Storms, hail and floods are the costliest perils on the driest continent on the planet. However, when the weather pattern changes to drier conditions, the claims ratios of IAG and Suncorp should fall and their insurance margins increase, which would lead to substantial share price increases. I favour IAG over Suncorp because it still has excess claims provisions to release, which relate to COVID-19 and business interruption insurance, and it's a higher-returning business.

The major insurers are facing up to issues such as reinsurance in the face of extreme weather events and, in the case of Suncorp, selling its banking operations to ANZ. Aren't these likely to be headwinds to future profits in the sector?

IAG and Suncorp are allowing for the increased cost of reinsurance in their premium rates and have recently increased their allowance for natural perils, which reflects the wet weather pattern that we have been experiencing. Premium rates can be expected to increase further next year. The sale of Suncorp's bank is beneficial for shareholders because its being sold for

a premium to the capital invested in it. This business had consistently failed to deliver a return greater than its cost of capital.

In terms of the other players in the financial services sector that you cover, would you like to comment on the fund managers or Macquarie?

Macquarie's business is leveraged to the market. Their revenue is highly correlated with the market and the cost to income ratio magnifies that correlation. Macquarie is typically an outstanding investment in strong markets and best avoided in falling markets. Janus Henderson has been suffering from net fund outflows for some time and that may well continue for another year, which makes it unlikely to have a strongly performing share price in the short term. The new CEO is a clear thinker and has a sensible plan to improve the business. Its successful execution should make this an interesting company and one to watch.

Has the legacy of the Financial Services Royal Commission changed the way you evaluate the Australian banking / financial services sector and specifically the stresses it can endure?

The legacy of the Royal Commission has been the simplification of the banks' businesses and an examination of operational risk. This has reduced the risk of investing in banks, but the biggest risk of credit quality will always remain. All the major banks have high levels of capital and credit provisioning. Nevertheless, do not expect their share prices to be healthy in a time of credit stress.

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