EUREKA report

I'm sticking with Rural Bank bonds

By Elizabeth Moran
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PORTFOLIO POINT: A change in the ownership means it's time to review Rural Bank's place in our bond portfolio.

When circumstances change, investors must make sure that their strategy still stands up. This is what we must now do for Rural Bank, one of the issuers in my $1 million bond portfolio (click **here**), which was privately owned 60% by Bendigo & Adelaide Bank and 40% by Elders, until it had a change in ownership last week.

Bendigo & Adelaide Bank acquired the 40% it didn't already own for about $176 million, comprising $165 million in a base sale price with the remainder a dividend representing profits for the period from July 1, 2010, to completion of the sale.

Elders will also receive an increased network access fee and the existing distribution agreement (Rural Bank products are sold via Elders branches) will continue.

Given the change in ownership, which does happen in fixed income markets, it's time to now analyse the risk/reward benefits of the bond and determine if it might be a good time to sell/switch.

The Rural Bank investment was the jewel in the crown for Elders, which has struggled under a heavy debt burden since the GFC. Rural Bank has been consistently profitable and been able to grow profits for the past six years, providing a sound income stream. Even when Elders faced significant financial pressure, the 70% of net profit that was distributed to the owners didn't change, nor did Rural Bank's business or strategy, making it an excellent, predictable and low-risk investment for bondholders.

The shareholder's strategy seemed to be to keep Rural Bank at arm's length, that is to let sound management continue to operate and grow the business. Further, both Bendigo and Elders had in the past contributed additional capital to the bank, signalling to bondholders their support if it was needed.

I think it's unlikely Bendigo will materially change the business or management structure of the Bank. Rural Bank has built strong relationships with its conservative customers across rural Australia, to the point where deposit balances almost fully fund the loan book.

However, with a new 100% shareholder, as a holder of Rural Bank bonds, I must now assess the credit worthiness of Bendigo and Adelaide Bank as they will be responsible for repaying Rural Bank sub-debt at maturity with a first call of February 12, 2015, or at final legal maturity on February 12, 2020.

A good deal for Bendigo?

The deal looks like a good one for Bendigo. The company is paying just 1.18 times book value or about 8 times earnings. That compares with about 1.70 times book for most recent bank merger transactions. Also, the majority of Australian banks are currently trading on double-digit earnings multiples without even allowing for a takeover premium.

The problem, though, is how the bank will finance the deal. Bendigo has advised that it is looking at a new subordinated debt issue to fund the purchase but at this stage will not be raising any capital. This raises a few questions, namely:

- What structure will APRA (Australia's financial market regulator) approve to allow this acquisition? That is, would it be a 10-year bullet or 10-year with a first call at five years?

- Does Bendigo expect the issue to contribute to tier-one capital? APRA requires minimum capital levels for all ADIs.
- Low resultant tier-one ratio due to the capital being spent on the acquisition is a concern, particularly when new Basel III regulations are likely to require banks to hold higher levels of capital. How does Bendigo expect to meet new higher debt levels?

This acquisition of the 40% stake in Rural Bank will result in a decrease in Bendigo's tier-one capital to about 7.92%. Bendigo was already towards the lower end of capital ratios among the banks and by further weakening its position, raises the prospect that the bank will have to raise capital at some point in the future.

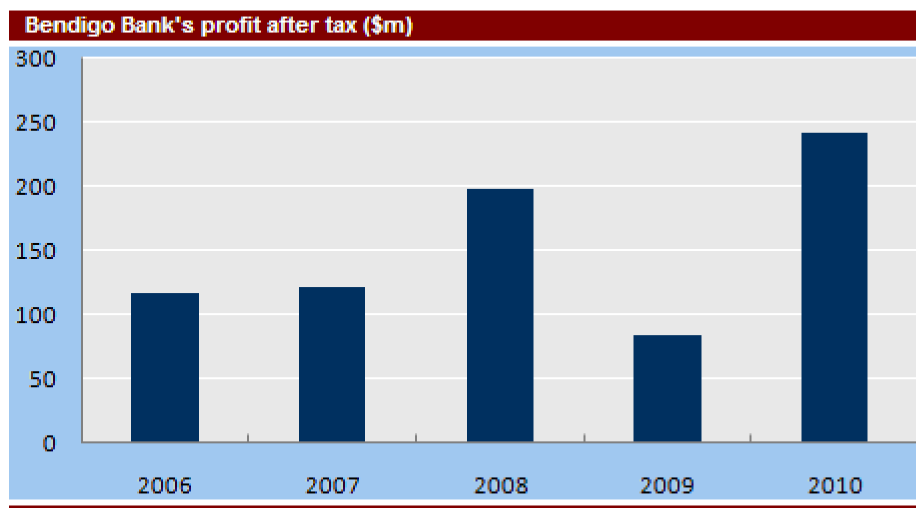
Until it does, with ratios substantially below its peers, it could be argued that its debt products remain comparatively higher risk. But, it's not just capital ratios that concern debt investors when assessing risk. I would consider Bendigo's:

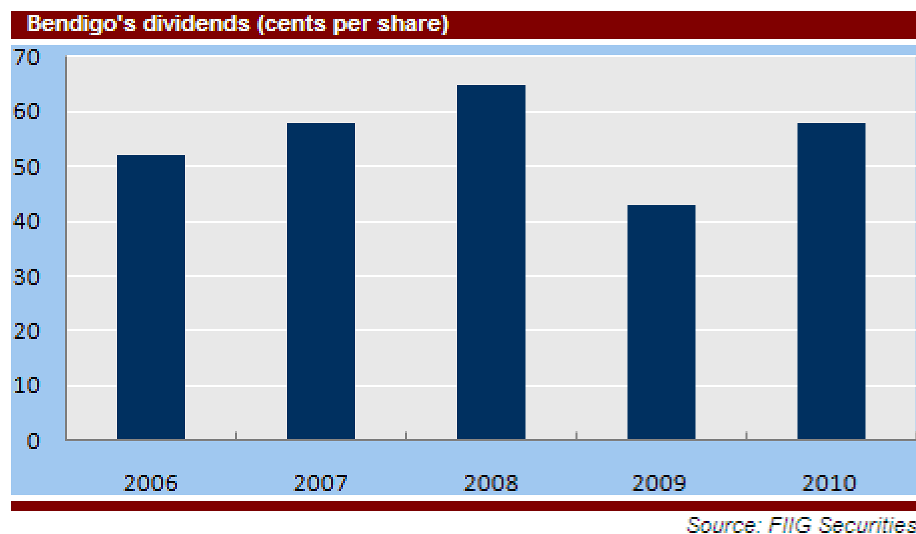
- Debt maturity profile.
- Access to funds to repay debt as and when it comes due (including being able to source additional equity).
- Saleable assets available to help meet debt commitments if Bendigo finds itself in difficulty.
- APRA's prudent supervision.
- Bendigo's historic distribution to shareholders as a percentage of net profit (has Bendigo consistently increased its dividend or has it at times held it flat or reduced it to retain funds in the business and thus support higher-ranking bond holders?)

While I would detail all of the points in a thorough analysis, I'll concentrate on assessing two here.

First, in the past 12 months to June 30, 2010, Bendigo raised $300 million in new equity and $3.6 billion through securitising assets, so my assessment would be that it has ready access to funding. I would expect that it could raise additional capital if needed.

Second, as seen in the graphs below, Bendigo cut dividends when profit declined during the GFC, a positive step to retain capital within the business and protect bondholders.





Both of these points lead me to conclude that Bendigo is not stripping the business of capital to pay ever higher dividends to shareholders, and provides comfort that they would cut the dividend in future if they thought it best for the welfare of the company. See below for more background about the company.

Bendigo & Adelaide Bank

Bendigo & Adelaide Bank Group was formed in November 2007 as a result of the merger between Bendigo Bank and Adelaide Bank. A publicly listed company, the various parts of the business operate as four distinct brands under the Bendigo & Adelaide Bank umbrella.

The retail arm, Bendigo Bank, provides banking and wealth management services to individual and small to medium businesses. Bendigo Bank is represented in all states and territories with almost 900 outlets – including more than 190 company-owned branches, 250 locally-owned Community Bank branches, 90 agencies and 800 ATMs.

Through Adelaide Bank, the group operates a substantial wholesale banking business, providing mortgages via a network of brokers and mortgage managers. In addition, Adelaide Portfolio Lending funds aged care and third party credit providers.

In the wealth management area, the group is represented by Sandhurst Trustees, the trustee company and funds manager; margin lender Leveraged Equities; Oxford Funding, Bendigo Financial Planning; and debenture company Victoria Securities.

Recently, the group acquired 100% of Rural Bank but also participates in a range of joint ventures, including Community Sector Banking (with a consortium of 20 partners from the not-for-profit sector).

Bendigo and Adelaide Bank trading results as at June 30, 2010:

- Cash earnings of $291.0 million, up 60%.
- Net profit after tax of $242.6 million, up 190%.
- Net interest margin rebounded to average 2.09% for the year, up from 1.66%.
- 90 days arrears in residential mortgages – the key portfolio – improved from 1.08% to 0.97%.
- Credit quality in the margin lending business remains good, reflecting sound operational capability and risk management.
- Retail deposit base grew by $1.75 billion or 6.1% excluding Rural Bank, or $5.2 billion or 18.1% including Rural Bank.
- Tier-one capital increased from 7.43% to 8.57%, with total capital increasing from 10.91% to 11.17%.
- Rural Bank NPAT increased to $55.4m, a rise of 23%, with retail deposits funding in excess of 95% of Rural Bank's lending
- Bad and doubtful doubts expense fell from $80.3 million to $44.7 million.
- Total full-year dividend of 58¢, up from 43¢.
- Funds 88% of its business through retail deposits, not reliant on the government guarantee on wholesale funding.
- Growing steadily with retail deposits up 18.1%. Loans increased by 12.3% and branch numbers increased by 23.

- Interest expense fell 26% to $41.9 billion.

Summary

Now Rural Bank is fully owned by Bendigo & Adelaide Bank, the subordinated debt issued under both names should trade at similar levels given Bendigo will be responsible for repayment of both.

The Rural Bank fixed rate bonds I acquired in August are paying over 9% running yield and are technically lower risk since being taken over by Bendigo given that Bendigo has a credit rating that is one notch higher. The combined larger entity adds scale, an important component of credit rating assessment but also offers the opportunity to consolidate operations and reduce costs.

Rural Bank's very high retail funding should contribute to overall higher deposits for Bendigo and reduce the proportion of wholesale funding needed for the combined entity.

I expect Bendigo will have to raise additional capital unless retained earnings are able to grow quickly, but Bendigo has picked up a sound, reliable and saleable asset at a low cost.

So, the big question remains, is it time to sell my Rural Bank bonds? No, I'm happy with holding the asset and it's paying a great return given a possible marginal improvement in risk. While Bendigo isn't a "big four" bank, the returns being offered on its sub-debt are approaching the sorts of returns I'd expect from equities.

Yet the bonds provide a known return – unlike dividends, which can be cut at a moment's notice – and I can expect full repayment of principal at maturity. If the Rural Bank bonds I purchased contracted 50 basis points or more, I would consider taking profits and switching to another bond.

Rural Bank bonds may be hard to source as the issue was small, but other regional bank subordinated debt still offers investors great value. If I were to switch I'd look to replace the asset with a similar one. As I already have Macquarie Bank sub-debt in the portfolio, Suncorp or Heritage sub-debt would be worth considering. For the moment, I'll wait to see if the yield contracts, sending the bond price higher.

Elizabeth Moran is director of fixed income research at ***FIIG Securities****.*