MELBOURNE CENTRE FOR FINANCIAL STUDIES

Current Issues Paper 1 - 2007

Community Banking, Bank Consolidation and Bank Valuations

By Professor Kevin Davis, Commonwealth Bank Chair of Finance
Director, Melbourne Centre for Financial Studies

Bank of Queensland's (BoQ) takeover offer for Bendigo Bank is notable for several reasons. First, it signals that the recent resurgence in takeover and merger activity in the Australian financial sector is likely to develop further. Second, it raises a number of questions about the value of alternative organizational structures (such as Bendigo's community banking model and BoQ's franchise model). Third, the outcomes of such a rationalization process and shifts in head office locations have implications for the future development of regional financial centres.

Financial Services Sector Rationalization

Recent merger activity over the past year or so in the financial sector includes:

- BoQ's acquisition of Pioneer Permanent Building Society, soon after the latter listed on the ASX in 2006
- Suncorp-Metway's acquisition of the Promina Insurance group
- The merger of Home Building Society in WA with StateWest Credit Society in 2006 involving the demutualization of the latter.
- The merger of Credit Union Australia and Australian National Credit Union to form the largest credit union with approximately $4 bill assets

Although a rationalization process within the ADI sector is underway, and likely to accelerate, there has also been a significant amount of new entry into banking. Electronic service delivery and growth of alternative loan origination methods has made it possible for foreign banks and other new entrants to now penetrate the retail market as well as the business and corporate markets. Thus the four majors (each with assets of over $150 bill) now face substantial competition from a growing number of banks in (or approaching) the $10-30 bill size range (as well as St George at around $60 bill).

Most of the rationalization action seems likely to be focused on the retail financial markets, where there are many smaller domestic institutions offering potential rapid expansion opportunities for larger acquisitive foreign entrants. At the larger end of the market, the growing domestic importance of foreign banks and the four-pillars policy suggest relatively little scope for mergers between these players. But some of the mid-sized Australian owned banks (including BoQ and Bendigo) are potential targets. Whether, in the face of a growing number of other mid-sized banks the four-pillars policy remains relevant, is clearly open for debate.

Which mergers make economic sense, rather than being driven by CEO and Board hubris, requires a detailed analysis of relative strengths, weaknesses, integration costs and potential synergies. In this respect it is worth noting that both BoQ and Bendigo are marked by innovative approaches to the delivery of retail banking services in the form of franchise arrangements. For BoQ, the franchise model is one involving individual branch owner-managers being the franchisee. Bendigo has developed a model of community banks, where an operating company owned by local shareholders is the franchisee. In principle, both models could be operated by the same organization. But whereas the BoQ model probably relies on profit-oriented individuals for its success, the Bendigo model builds largely upon a community development, the less profit-oriented focus of its stakeholders. There could be some challenges in operating both incentive models under the same umbrella.

It is perhaps worth noting that Bendigo's model has been particularly successful in BoQ's home state of Queensland. Bendigo has 90 points of presence in that state, compared to BoQ's 141 (prior to the takeover of Pioneer Permanent Building Society), while Bendigo's 50 points of presence in NSW outnumber the 41 of BoQ. It is also worth noting (given that the offer would see BoQ shareholders emerge with 60 per cent of the combined entity) that Bendigo is the larger bank when measured by loan size ($12.5 bill compared to $10.8 bill) or by points of presence (437 compared to 201). However, BoQ has larger securitization activities and a large ATM network.

One implication of the Bendigo franchise model is that there is a wider group of relevant stakeholders than simply the owners of Bendigo Bank shares. The latter group will ultimately determine the bank's future, but the owners of shares in the community banks do not have a say in the ultimate future of the Bank with which they have a franchise relationship. This has the potential to create some social and community concerns, particularly if the ultimate winner of any bidding war for Bendigo is not as committed to the ethos behind the community bank model.

Community Banking and Bank Valuation

The BoQ approach has created some concerns among the owners of the 200 plus community banks which operate under franchise arrangements with Bendigo Bank. The individuals who have subscribed to share capital in those community banks are, naturally, unsettled about the consequences for the future of their banks and their equity investments.

These franchise arrangements also create some complications for analysts wishing to estimate the fundamental value of such a bank. The franchise agreements involve risk sharing between the community bank owners, who underwrite the start-up costs of the franchise, and the franchising bank, with both parties anticipating sharing a growing stream of profits from the business generated by the community bank.

In estimating the market value of Bendigo Bank, it is necessary to incorporate forecasts of the likely growth of future earnings, which are heavily dependent on the successful growth of the relatively recently developed community banks. (Over half of Bendigo's branches are community banks, although the share of total bank business done through the branches is not public knowledge).

Not only is detailed information on the business share of the community bank branches not readily available, information concerning the profitability of these franchises is sparse.

However, some profit data is available for the 56 community banks which have listed on the Bendigo Stock Exchange, and which the Melbourne Centre for Financial Studies has collated together for purposes of analysis. While that is a small subset of the over 180 community banks currently operating, and potentially subject to selection bias (reflecting different characteristics of those community banks which have chosen to be listed) it does provide some useful insights.

Of the 56 community bank branches listed, 36% reported positive profits at the last annual reporting period (mid 2006). However, it needs to be remembered that typically, these banks are expected to take around 18 months to two years to reach profitability. Only 32 (57%) of the listed community banks have been established for more than two years. Of those which opened before the start of 2004, only 4 were not profitable.

Figure 1: 2006 Profit/Loss Distribution by Opening Year

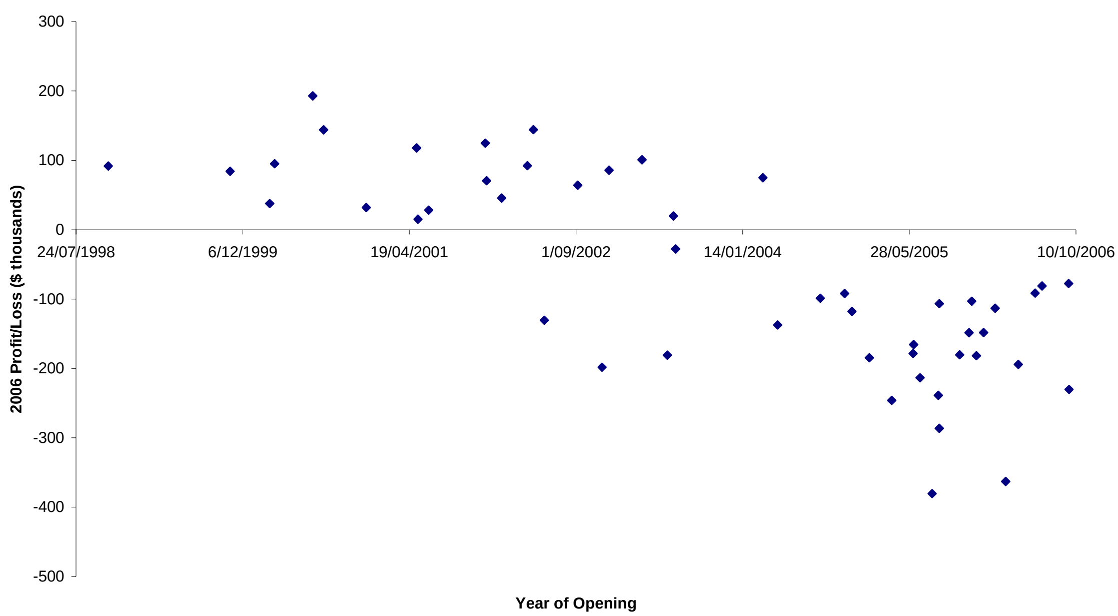
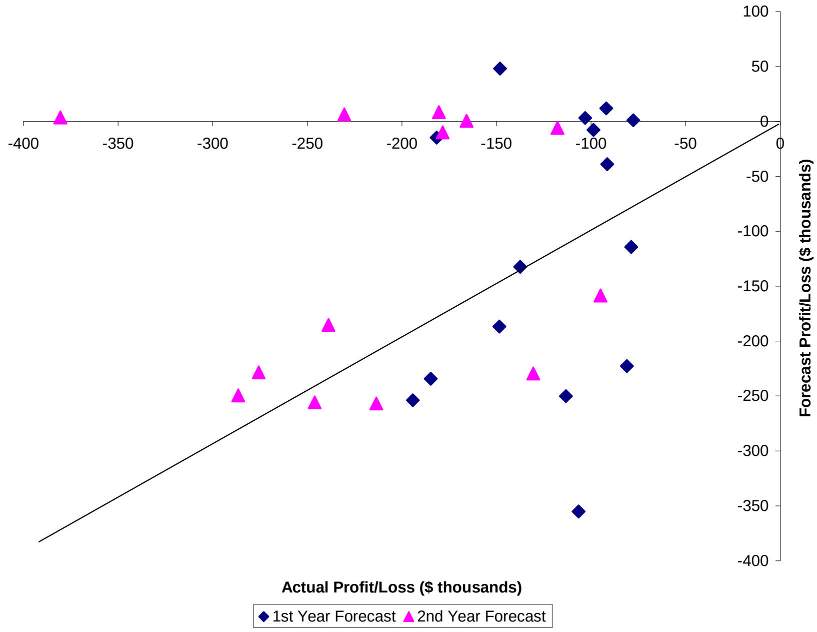


Figure 1 provides information on profitability measured against year of opening. In using this data to estimate the profitability for Bendigo Bank itself from the community bank franchise network it is worth noting several points. First, the positive profit figures may understate the "true" profitability, since disbursements made to community causes (as required under the community bank constitutions) may be included as costs (and thus reduce reported profits). Second, the losses incurred by newly established banks reflect start up operating costs being borne by the franchisees, which are not yet being covered by the share of profits on the deposit taking and loan making (banking) business. Bendigo Bank itself is not incurring those costs (although there may be other costs it incurs), and is receiving its agreed share of the profits on the banking business.

Figure 2:   2006 Profit/Loss Forecast Vs. Actual



Of course, Bendigo's current share of profits from the community bank activities is reflected in its overall profits, and thus the major issue for analysts relates to the anticipated growth of business and revenue from the maturing and expansion of the community bank network. As figure 1 indicated, virtually all of the community banks have made losses (as anticipated) in their initial years of establishment. But most of the longer lived community banks have moved into profitability, and the important issue is whether the new franchisees are on track to do so as well. Figure 2 provides some relevant information, based on the population of listed community banks established for less than two years. It plots actual profit/loss (losses in all cases) against the forecast outcome shown in the listing information document. Figures below the 45^{o} line indicate that actual losses are below those forecast. It is clear that a number of the new community banks are "on track", in doing as well or better than their forecast outcomes. However, there are a significant number which were forecasting an (approximate) breakeven outcome, which has not eventuated. There is some need for more detailed analysis of these cases and their likely future.

Financial Centres

Rationalization of the financial services industry has implications for the relative growth and development of financial centres within Australia. The Suncorp -Metway takeover of the Promina group is anticipated to lead to head office activities of the latter being transferred from Sydney to Brisbane.

BoQ have indicated an intention to operate with two head offices if their merger proposal is successful, maintaining the Bendigo based head office. In practice, there are very few (if any) examples of a merged entity successfully maintaining two geographically disparate head-offices for any significant length of time.

Hence, a likely outcome of Bendigo Bank having been "put into play" is that the Victorian regional centre of Bendigo faces the risk of losing one of its major local companies, and that the state of Victoria risks loss of another financial services head office. This is undoubtedly an unattractive proposition (although probably not a completely unexpected eventuality) for Victoria's political leaders, and one which will attract significant attention. For a State attempting to maintain and grow its role as a major financial centre, the question is whether there is some potential outcome which could avoid the likely loss of a valuable head office and associated expertise. Whether there are any potential suitors around (such as among international banks with currently limited Australian presence) who might be interested in a Melbourne/Bendigo head office is a question likely to be asked in several circles.