

Wednesday March 21st - For Immediate Release**Community banking model at risk?**

The Melbourne Centre for Financial Studies today released its first *Current Issues* paper for 2007 – “Community Banking, Bank Consolidation and Bank Valuations” written by its Director, Professor Kevin Davis, Commonwealth Bank Chair of Finance.

The report identifies problems for analysts in valuing the fundamental value of Bendigo Bank arising from its community bank model, given the limited information available on likely business and profitability growth from that source, and provides some relevant statistical information. It notes that the community banking model creates a larger number of stakeholders (owners of the community banks) concerned about (and affected by) the future of Bendigo Bank, but without any voting rights on the merger issue. While the BoQ’s franchise model and the Bendigo Bank community bank model could operate jointly, they rely on quite different incentive structures (profit versus community benefit). A potential takeover also has significant implications for the future pattern of Australia’s financial centres.

The report notes 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. Bendigo also has a larger balance sheet than BoQ. BoQ has been able to propose merger terms, which would see its shareholders emerge with 60 per cent of the combined entity due to its higher P/E ratio which in turn reflects market expectations of a higher growth rate. This thus highlights the need for better information on future growth and profit prospects of the community bank network.

The BoQ bid has created some concerns among the owners of the 200 plus community banks which operate under franchise arrangements with Bendigo Bank. 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.

Not only is detailed information on the business share of the community bank branches not readily available, information concerning the current and likely future growth in profitability of these franchises is sparse.

However, some profit data is available for the 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. Of the 56 community bank branches listed, 36% reported positive profits at the last annual reporting period. However, it

needs to be remembered that typically, these banks are expected to take around 18 months to two years to reach profitability, and most of the “older” listed community banks have reached that position.

A likely outcome of Bendigo Bank having been “put into play” is that, despite the assurances of BoQ, the Victorian regional centre of Bendigo faces the risk of losing one of its major local companies, and that the State of Victoria risks the loss of another financial services head office. For a State attempting to maintain and grow its role as a major financial centre, the question is whether another potential suitor will emerge (perhaps from among the growing foreign bank presence) wishing, or willing to, be headquartered in Victoria.

While signaling that there will be further rationalization in the banking sector, any takeover would not greatly affect the level of competition in the retail banking market as a whole. The report points out the growing importance of mid-sized banks, often owned by foreign banks. 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.

Whether, in the face of a growing number of other mid-sized banks the “Four Pillars” policy remains relevant, is clearly open for debate.

This Report can be found at www.melbournecentre.com.au.

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