COMMENTARY

May 7th , 2009

Dear clients and colleagues,

This week we'd like to introduce Australian Banks and profile a company recently added into our portfolio – Bank of Queensland (BOQ ASX) www.boq.com.au

Macro background

Compared with US and Europe, the contraction of Australian economy started rather late and to a more moderate extent. GDP growth shrinked 0.5% in 4Q08, the first slowdown in 8 years. The central bank forecasted GDP growth of 0.25% in 2009 and 2.5% next year. Unemployment rate is now at 5.4% and expected to rise.

Overall Australian banks have performed better than global peers because of limited exposure to subprime mortgages. However, the slowing economy due to weak business and housing investment still pushed up Australian banks' bad debt charges and funding costs.

Competition

There are 7 major banks in Australia, including 4 national (Big4s) and 3 regional. The Big4s are Westpac Banking (WBC), Commonwealth Bank of Australia (CBA), National Australia Bank (NAB), and Australia and New Zealand Banking Group, Ltd (ANZ). Regional banks are Suncorp-Metway Ltd (SUN), Bendigo and Adelaide Bank (BEN), and BOQ. The Australian government has a "four pillars" policy that prevents mergers between the Big4s. Interestingly, this is a landscape similar to that in Canada.

A further look at Bank of Queensland

BOQ is a regional bank of 135 years old, yet it manages to be the fastest growing retail bank in Australia. It has AUM of A$26B (US$20B), 283 branches, 650,000 customers and 2,600 ATMs nationwide (the 2nd largest ATM network in Australia). Asiamoney magazine named BOQ as the best mid cap company in Australia in 2007.

Market data

Market cap US$1.4B, dividend yield 8.3%, p/e (8/2009e) 8.8x, p/b 0.95x, total loan/dep 129%, tier 1 capital ratio 8.0%.

Competitive Advantage

- OMB model

Since 2001 BOQ has implemented a unique Owner Managed Branch (OMB) franchise model, where owner-managers (OMs) receive a share of the branch's profit. The franchise agreement lasts 5 years. The OM provides establishment and operational costs, while BOQ centrally controls credit approval, products, brand, and minimum service levels.

The OMB model has enabled the bank to achieve superior growth. Retail revenue grew at a CAGR of 19% from 2002 to 2007. In the past 12 months, BOQ's mature branches continue to outperform the industry in terms of loan and deposit growth: Loan +13% vs. +8%; deposit +25% vs. +24%.

Growth Strategy
BOQ is at a growth phase called Project Pathways, i.e. a phase to target distribution in high-margin low-capital niche markets and to seek strategic partners for further expansion.

Basically niche markets refer to markets previously held by St. George Bank (now owned by Westpac) and Bankwest (now owned by Commonwealth Bank of Australia). A strategic partner is expected to be unveiled by July 2009.

Risks
- Impairment may grow further due to weak economy and rising employment, as 70% of total loan is related to housing.
- Margin may be under pressure due to high funding costs.

Investment Theme
BOQ is a bank with clear vision and strategy, guided by very experiened CEO David Liddy (former CEO of Westpac). It aims to be a big small bank, not a small big bank, by focusing on niche markets.

We believe its successful OMB model will continue to drive the bank to achieve superior growth. Meanwhile, the announcement of the strategic partner could be a catalyst to enhance its growth potential.

Valuation
One-year target price is A$12.0, based on p/b of 1.2x and BV/sh (8/2010e) of A$10.0. Expected return is 43%.

Have a good week.

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