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Catalysts and conditions for a potential re-rating of the banks

Our weekly view on Australian equities.

24 September 2020

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Valuation Support Emerging

The recent fall in bank share prices through August and September saw banks give up around half the gains of late May/June, with the valuation lows of the COVID-19 era being re-tested. Bank valuations bottomed in late May, just prior to an aggressive, but short-lived, re-rating of bank share prices.

While we acknowledge valuation appeal – both relative and absolute – we remain guarded around adopting a more positive stance towards the banks in the Wilsons Australian Equity Focus List – where we remain underweight.

The catalysts and conditions which could lead to outperformance are not yet in place. Cheap valuations themselves may be a catalyst – somewhat like the late May/June rally – but operating and regulatory conditions are not yet favourable for a sustainable re-rating of the banks. In the absence of an acceleration in core earnings (ex-bad debts), we continue to only see low single-digit earnings growth on offer over the medium-term.

For patient, value oriented investors, current pricing holds appeal, given both depressed valuations and earnings. Over the medium-term, under a more normal operating environment, the banks should be able to generate early returns on capital in the early teens, which should command higher pricing than the 1.0x book value we have at present. Over the last 10 years the average price to book ratio (P/B ratio) has been closer to 1.5x for the banks.

The underperformance of the banks stands out against other "recovery basket" thematic trades. Until the start of this week only energy (falling oil price) and financials had lagged since August. The market may be wary of the late-cycle exposure banks typically have to any economic recovery. For those looking to play the recovery theme, the lagging share price performance of the banks begins to look interesting.

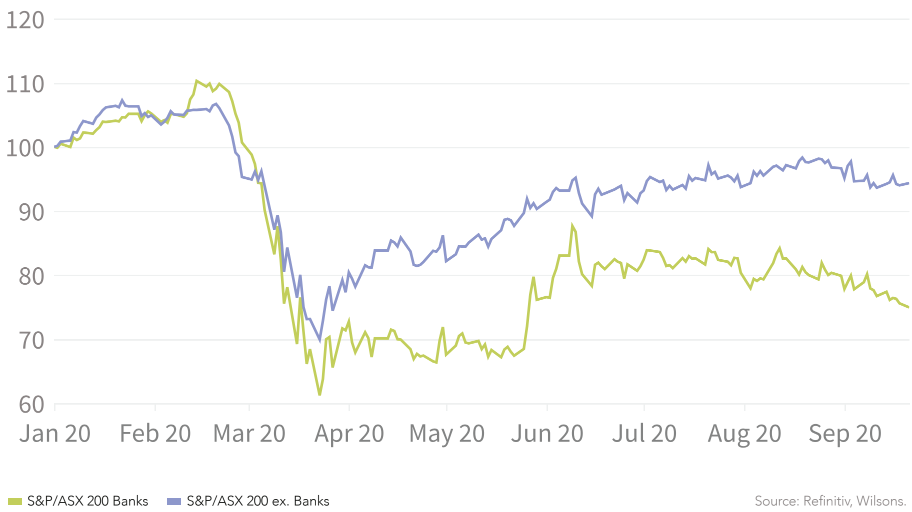
Read our examination of The Australian Equity Recovery Trade

How the Banking Sector Has Performed

Banks have underperformed the market by ~15% since the beginning of August. While a clear catalyst for this underperformance is hard to identify, a range of factors have likely drained investor enthusiasm from the banks:

1. Victorian COVID restrictions implemented in early August and extended to September
2. No assistance from domestic interest rates or yield curve
3. Prospect of reduced fiscal support as the number of programs expire on 30 September
4. Macquarie Group profit warning in mid-September – flagged increased provisioning within banking and financial services (most comparable division to major banks)
5. Global financials have underperformed over the same period

Exhibit 1: Banking sector has underperformed the market by ~15% since early August 2020



Source: Refinitiv, Wilsons.

Market Assumptions

The market has held a relatively static view of bank earnings since June, both in terms of the level and profile for forward estimates. Earnings have held relatively flat since June – down ~4% at a pre-provision level, and down 2-3% pre-tax. Bad debt provision forecasts have been mildly reduced.

The profile of earnings has remained much the same. FY20E being the trough year for earnings as bad debt provisions peak. FY21E sees only a small reduction in total provision levels. Currently, core earnings (i.e. earnings ex-bad debt provisions) are forecast to grow at 3-4% FY20E to FY23E, broadly the same rate of growth that was being forecast in June.

While the current bad debt estimates were struck in August during bank reporting season; the market could be worried about the potential impact of the extended Melbourne Stage 4 restrictions. We estimate that close to a third of major bank lending exposure comes from Victoria.

Sector trading at 1.0x book value

With the earnings outlook somewhat uncertain, many investors are looking at P/B ratios rather than P/E ratios (which have the banks at 14x) – something offshore investors have done for years. The sector is now trading under 1.0x, approaching the 0.95x level of late May. A P/B ratio < 1x implies the banks are eating into their capital base and are unable to replenish that capital – something which is inherently unsustainable.

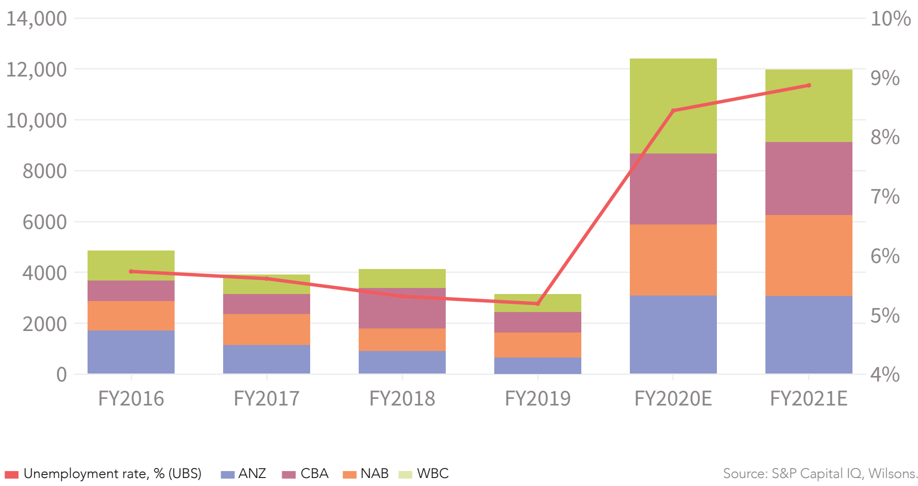
It is an aggressive implied valuation if you believe Australian banks can still generate returns ahead of their cost of capital. On a P/B measure, the valuation support is as strong as it has been since the GFC. Within the major banks ANZ at 0.75x, NAB and WBC 0.85x and CBA at 1.6x.

Dividend yields do not provide the same level of valuation support, with regulatory restrictions making this more difficult than is usually the case when assessing valuation. In short, the market has banks yielding ~3.7% (around the same as the broader market). Typically, banks

Exhibit 2: Banking sector performance stands out against other recovery plays*

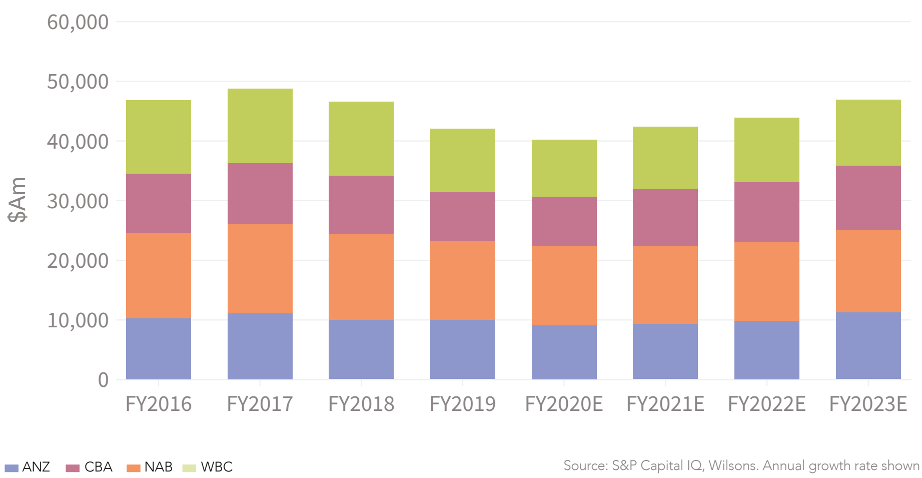
Source: Refinitiv, Wilsons. *Wilsons Recovery Baskets

Exhibit 3: Consensus is assuming bad debt provisions peak in FY20E



Source: S&P Capital IQ, Wilsons.

Exhibit 4: Consensus core bank earnings are forecast to surpass FY19A levels in FY22E

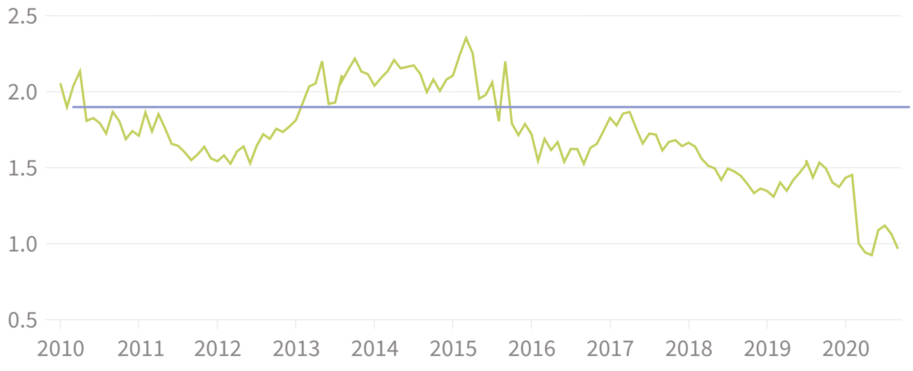


Source: S&P Capital IQ, Wilsons. Annual growth rate shown command a yield premium to the market as they are perceived as being more risky than the market.

The market is assuming that banks will payout ~50% of earnings in FY20E, before increasing to an average of ~60% across FY21-23E. In the three years prior to COVID-19, payout ratios averaged 80%.

Of course, with interest rates and term deposits <1%, the relative argument around the appeal of banks dividends still holds, as it does for the broader equity market.

Exhibit 5: Australian banks now trading <1.0x price to book

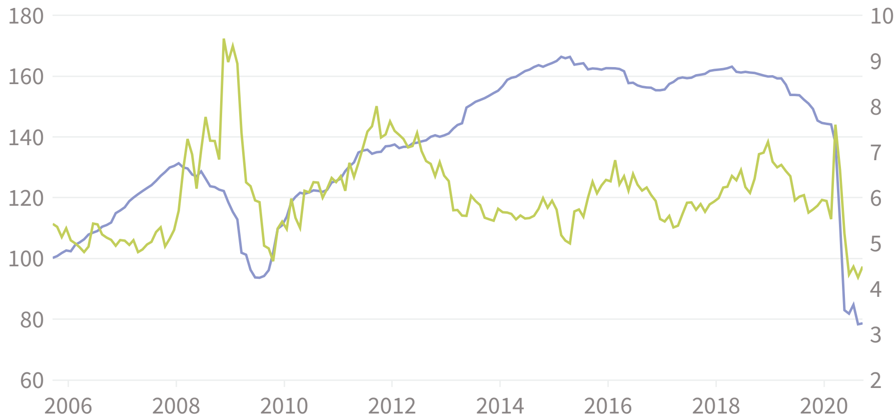


Source: Source: S&P Capital IQ, Wilsons.

What could cause a re-rating of the Banks?

1. Change in the market's narrative around value/growth sectors
2. Accelerated Australian economic re-opening
3. Steepening yield curve both globally and domestically
4. More confidence around a potential "V-shaped" recovery – October Federal Budget could play a part
5. APRA regulatory restrictions on dividends removed

Exhibit 6: Dividend yields have collapsed – low earnings and restricted payout ratios



Source: S&P Capital IQ, Wilsons.

Where we Stand

A number of factors have led to the banks' cumulative -15% underperformance since August, relative to the market. While valuation appeal has improved, it is not clear what might cause a re-rate, or more importantly a sustainable re-rate in bank share prices.

There are a number of factors which could drive a share price re-rate in the coming months – progress on vaccine development and an accelerated economic reopening – though much like May, it will be difficult to predict the timing/impact of these potential factors.

With current bank share prices at around book value, the market is heavily discounting any sort of earnings improvement over the medium-term. While earnings are depressed at current (dividends even more so), a return to a more normal operating environment along with less regulatory focus still leaves the banks in a dominant industry position. Over the medium-term, this should command a higher P/B ratio than 1.0x. For patient, value oriented investors, current pricing holds appeal.

Ultimately from a Wilsons Australian Equity Focus List perspective, we remain underweight the major banks – CBA and ANZ being our preferences – given longer-dated reservations around the ability to grow earnings and expand return on capital relative to other opportunities we see.

Disclaimer and disclosures

Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures

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