WILSONS

Why we are Market Weight the Banks

Our weekly view on Australian equities.

16 February 2022

Market weight the banks

We outline our case for why investors should be market weight the major banks. This month, the mini bank reporting season is now complete, following updates from all four major banks.

Results were well received by the market with the major banks outperforming the S&P ASX 200 so far this month.

Looking ahead, we see the 'bull and bear' arguments towards the banks as being balanced. We see the sector as being on the slightly cheaper side of fair value from a valuation perspective.

One of the key sector headwinds - being net interest margins - has the potential to ease this year with the likelihood of higher cash rates from the RBA, perhaps as soon as August 2022.

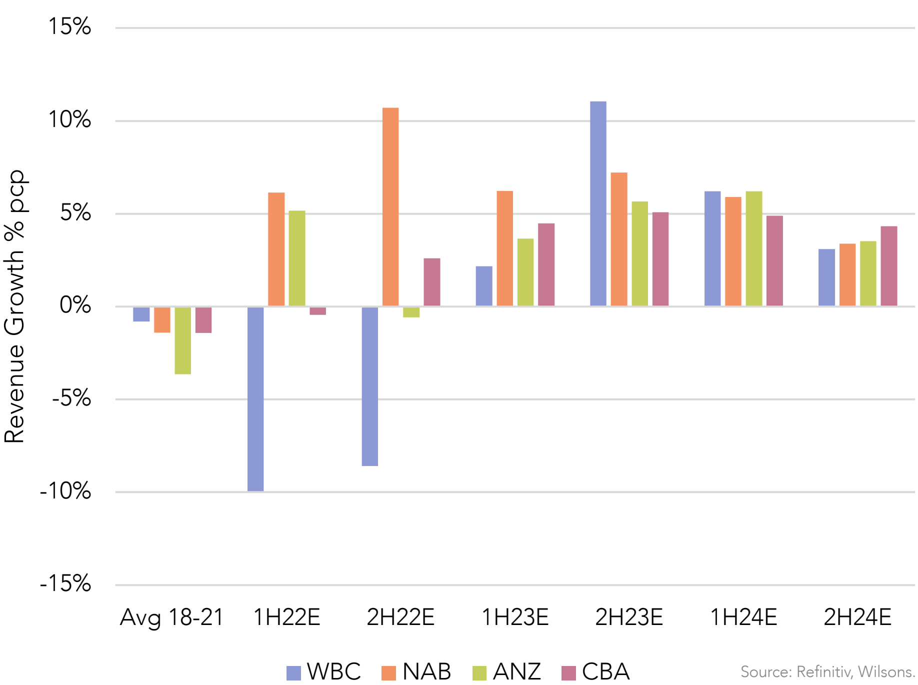
Read The Australian Economy, the RBA and Interest Rates

A move to higher local rates would likely be well received by the market. As of now, the market does not believe there will be any relief on margins out to 2024E, which we see as being too pessimistic.

Additionally, the intense competition, particularly for new mortgages, could start to fade as the rate cycle turns upwards and the cheap funding the banks have benefited from over the past 18 months fades.

However, the timing and magnitude of any benefit remain uncertain. Also, bank interest margins are likely to remain under pressure, with another period of falling margins ahead potentially providing ammunition for the bears on the sector.

Exhibit 1: Market is looking for an acceleration of sector revenue growth into 2024E



Source: Refinitiv, Wilsons.

The Wilsons Australian Equity Focus is market weight the bank sector, with our order of preference being National Australia Bank (NAB), Westpac Bank (WBC), ANZ Bank (ANZ), and Judo Bank (JDO).

Read Reporting Season: 2022 Earnings Recovery Still Visible

Banks: Core Investor Issues

We believe investors will focus on three core issues over the next 6-12 months:

1. **Revenue growth**
2. **Interest margin pressure**
3. **Cost growth**

Issue 1: Revenue growth

Core revenue growth for the banks is now a function of volumes and competition. In the period between 2018-2021 the sector saw revenue go backwards at ~0.5% per year (unadjusted for asset sales and includes the 2020 COVID period).

Looking forward, growth is expected to accelerate across the sector into the 3.5-5.0%pa range. This is predicated on housing credit remaining in the mid-single digits and a return to more normal business lending volumes.

Revenue growth over the past 12 months was held back through the high level of fixed vs flexible mortgages, and the intense level of competition across the sector as banks try to win market share (CBA, NAB gaining share, ANZ, WBC losing share in mortgages over the past 12mths).

We do not expect these features to be as prevalent going forward, particularly concerning fixed vs flexible in mortgages. This was a result of the RBA's QE program (lowering the yield curve) and specific programs to lower bank funding costs through COVID.

Issue 2: Margins

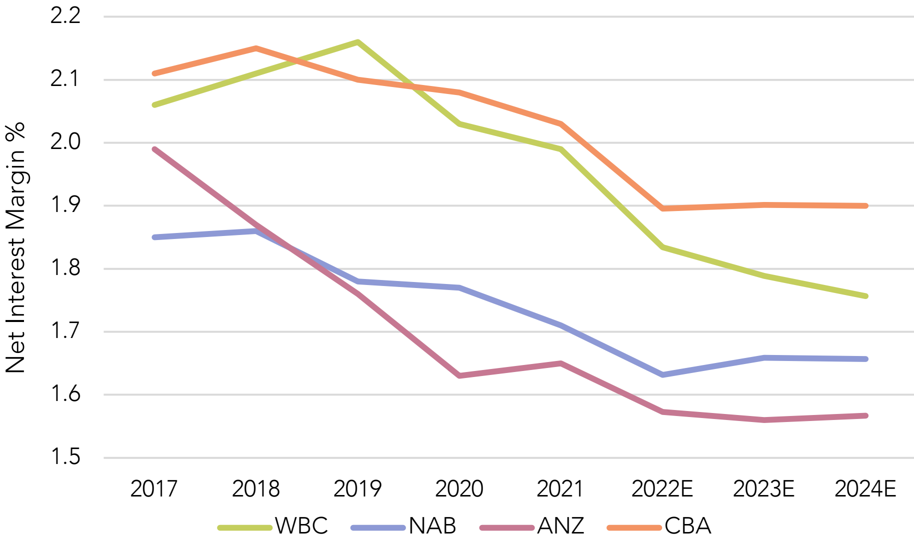
Net interest margins continued to be pressured over the 4Q21, with underlying margins down ~5bps for majors – except for WBC, where margins fell 10bps. While the market expected margins to fall - given competition and movement in some balance sheet items - it is still unclear to the market or us exactly when margins will bottom. Since 2018 net interest margins (NIM) have fallen around 20-30bps for each of the majors.

The question as to when margins bottom and start to improve is a critical one. We estimate that each 1bps lift in NIM across the sector could add ~1% to sector income. Higher cash rates from the RBA (August 2022 in our view) are the most likely catalyst for banks to re-price their lending books.

Precisely how much leverage the banks will get from higher margins is not completely clear. At some point, higher NIMs due to higher rates will begin to have some offset from increased credit charges.

For investors, this creates a dilemma. It may not be until well into the 2H22 that banks begin to show a slowing of NIM pressure. An actual increase in NIM is likely a 2023 event at the earliest. High levels of uncertainty around the outlook for margins is a key factor in our thinking around being market weight the banks in the Focus List.

Exhibit 2: The market is not forecasting any improvement in margins into 2024E, which could well prove conservative



Source: Refinitiv, Wilsons.

Issue 3: Costs growth

Cost continues to be a sticking point for the banks. In the last period, both CBA and NAB did well on the cost front, while Westpac's expenses started to decline, suggesting it has begun turn the corner. Only ANZ appeared to be behind its targets for cost out.

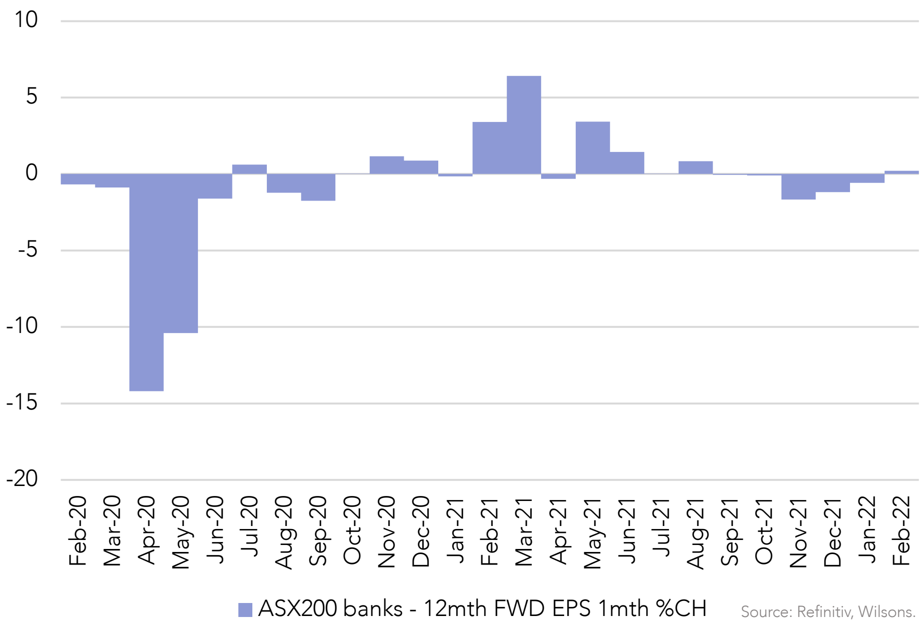
We remain cautious around the outlook for costs, given historically just how sticky they are. While higher inflation is not yet feeding into across-the-board wage growth, this is something to keep an eye on for banks given their workforces are +40k strong.

The relative lack of movement on costs hinders the operating leverage of sector. Despite consensus forecasting an acceleration in revenue growth 21-24E, EPS growth is remarkably similar suggesting little operating leverage.

Bank Results: Sector earnings upgrades

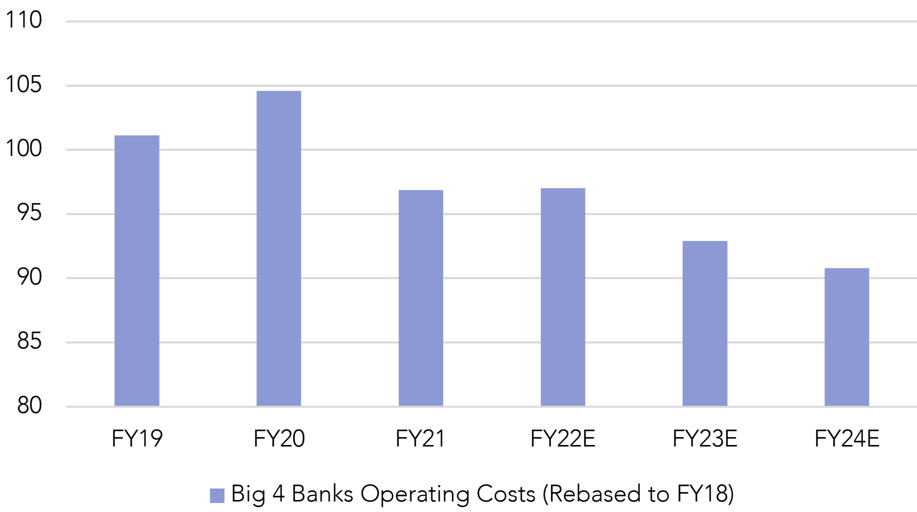
Updates from the banks since early February have been well received, with all banks outperforming the market. Sector earnings estimates have been upgraded by ~2% (FY1) for the first time since the middle of 2021, while FY2 has been upgraded by ~3%. Importantly, pre-provision cash earnings is where most of the upgrade was contained.

Exhibit 3: Bank sector FY1 EPS saw market upgrades over the past month, the first time since mid-2021



Source: Refinitiv, Wilsons.

Exhibit 4: Bank sector cost base has proven difficult to reduce over recent years



Source: Refintiv, Wilsons. Big 4 banks equally weighted. Numbers include any benefit from asset sales.

Sector Valuation

We see the sector as being on the cheaper side of fair value, primarily as we believe earnings risks over the medium-term are skewed to the upside – higher NIMs, lower shares on the issue given further buybacks.

On a PE relative basis the sector is around fair value at 0.9x, close to the average of where the sector has traded over the past decade.

On a price to book (P/B) measure, the picture is similar with a strong recovery in valuations, leaving the 1.5x P/B slightly cheap relative to the 2016-2020 period for the banks.

Exhibit 5: Bank sector PE rel vs market looks around fair value

Source: Refinitiv, Wilsons.

On dividends, there remains upside risk to dividend estimates.

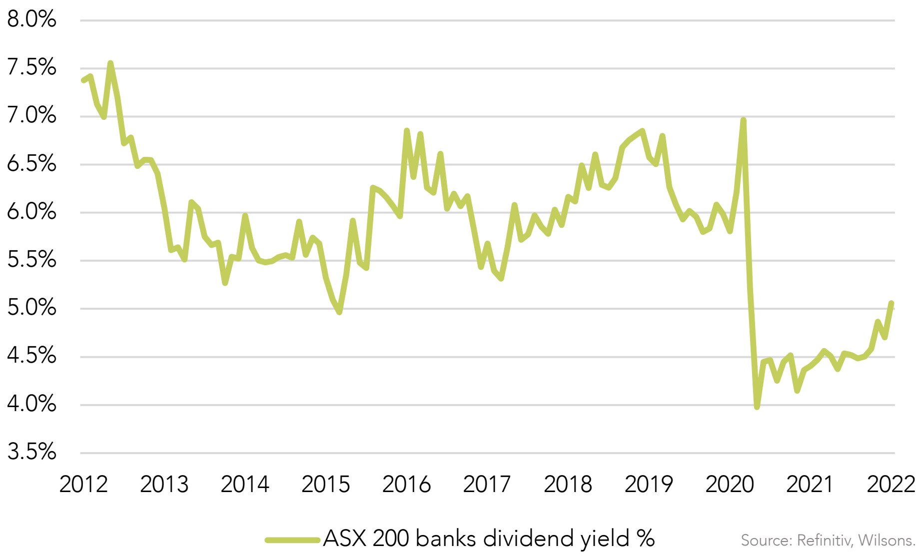
Read Reporting Season: 2022 Earnings Recovery Still Visible

This is primarily a function of payout ratios that sit ~10% points lower than pre-COVID recovering, but also reflective of the sector's strong capital positions and lack of internal reinvestment opportunities. The 12-month forward consensus estimate of 5.0% dividend yield excludes any potential upside from new capital management programs (buy-backs), which could add 0.5-1.0% to sector yield over the next 12 months. We see ANZ, NAB, and WBC as all likely to go again this calendar year on capital management.

Exhibit 6: Bank sector P/B has recovered strongly vs the COVID trough of 2020, but is not stretched by historic standards

Source: Refinitiv, Wilsons.

Exhibit 7: Bank sector dividend yield has risen as the dividend outlook has improved



Source: Refinitiv, Wilsons.

Banks: Focus List Market Weight

In our view, the downside risk to bank share prices relative to the market is relatively modest. Much of the bad news on the earnings outlook is well known. The prospect of an improving domestic economy and rising rates over 2022-2023 should also help the banks. The market is forecasting low to mid-single digit 3yr EPS CAGR 21-24E for the sector. It must be remembered that banks are cyclical companies (and bad debt profile may become an issue at some point albeit not an issue presently).

The key question is around the timing of any potential improvement in margins, which could open a pathway to improved earnings momentum across the sector. If margins were to recoup just half the losses from 2018, consensus sector earnings would need to be upgraded by 10-15% in 2024E. For now, we remain market weight the bank sector.

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Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures.

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