

Surplus Capital Supports Higher Bank Dividends

Dividends growing faster than earnings as capital continues to pile up

Income momentum continues to build, supporting our positive view and thesis that the major Australian banks can increase dividends despite soft earnings growth. We expect limited growth opportunities, tight cost control and stable asset quality to continue, supporting strong organic capital growth. We argue the likely outcome will be surplus capital returned to shareholders, further enhancing an already attractive fully franked dividend yield. Capital management initiatives are likely within 12 months, particularly for Commonwealth Bank (CBA) and Westpac Banking Corporation (WBC). The uncertain economic outlook could derail our positive view on medium-term dividend rebasing, with a potential deterioration in economic conditions causing a step up in bad debt expense and hence lower earnings – but we do not rank this scenario highly.

Relative financial strength and conservative settings support our positive view on the narrow moat major banks. House prices are stabilising after softening through 2011 and early 2012. We expect solid medium to long term growth in shareholder value as the long term outlook for the domestic economy remains positive. The outlook for steady earnings growth underscores the appeal of investing in major banks and reinforces our thesis that major bank dividends are

sustainable despite current market and economic uncertainty. Key near-term challenges include weaker loan growth, customer deposit funding pressure and softening corporate credit quality.

Key Takeaways

- ▶ Capital growth accelerating with the return of surplus capital on the horizon
- ▶ Net interest margins remain under pressure
- ▶ Operating expenses tightly managed
- ▶ Moderate loan growth to continue
- ▶ Strong growth in low risk funding and liquidity
- ▶ Sound credit quality but outlook softening
- ▶ Bank rankings change with ANZ and WBC now on top
- ▶ FY12 profit results support our positive view on the major banks

Capital growth accelerating with the return of surplus capital on the horizon

The APRA Basel III common equity ratios of all four major banks comfortably exceed the 7% minimum requirement due to start in January 2013. When Basel III common equity Tier 1 ratios are consistently above 8%, the major banks can sustain higher dividend payouts. Basel III common equity Tier 1 ratios for WBC, National Australia Bank (NAB) and Australia & New Zealand Banking Group (ANZ) are 8.2%, 7.9% and 8.0% respectively at September 2012. CBA's Basel III common equity Tier 1 ratio was 7.5% at June 2012.

We expect higher future dividends across the sector from moderately higher earnings, soft loan growth, relatively benign economic conditions, but stable payout ratios. A substantial deterioration in loan quality leading to higher bad debts is the key



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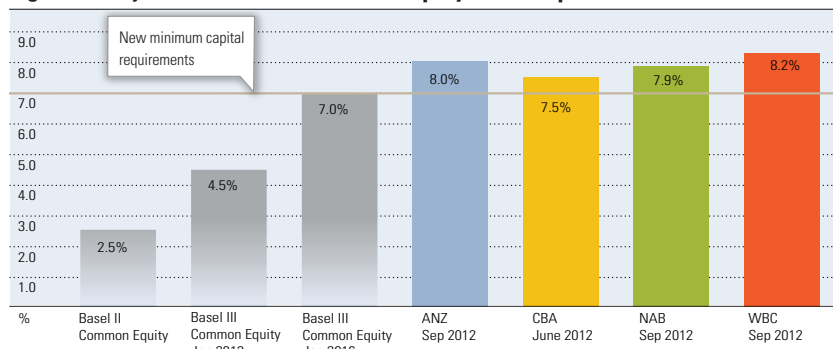
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Table 1: Morningstar Recommendations and Valuation Metrics as at 9 November 2012

Bank	Share Price \$	Morningstar Recommendation	Fair Value Estimate \$	Price to Fair Value Ratio %	Morningstar Forecasts			
					Dividend Yield FY13 %	PE Ratio for FY13 (x)	Price to Book FY13 (x)	EPS Change FY13 %
ANZ	24.56	Accumulate	31.00	79	6.0	10.8	1.7	4.7
CBA	58.82	Hold	60.00	98	5.9	12.5	2.1	3.0
NAB	23.81	Accumulate	31.00	77	7.6	9.9	1.3	6.9
WBC	25.17	Accumulate	29.00	87	6.6	11.8	1.8	1.4
BEN	7.95	Accumulate	9.00	88	7.5	9.1	0.8	3.6
BOQ	7.50	Hold	7.00	107	7.0	11.4	0.8	Large

Source: Morningstar Forecasts

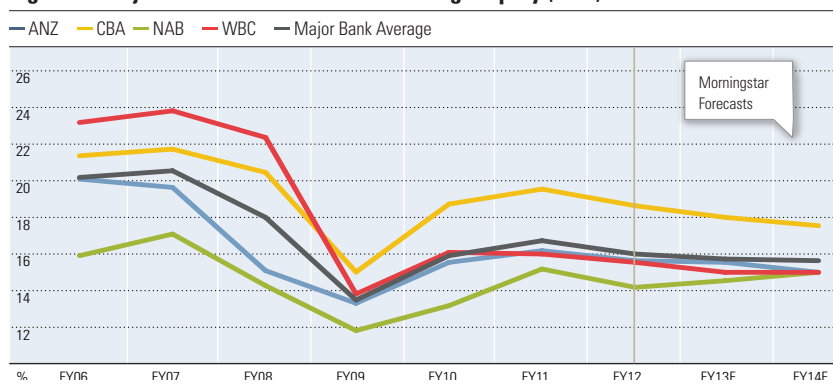
Figure 1: Major Bank Basel III Common Equity Tier 1 Capital Ratios



Note: Major bank ratios are based on APRA's strict Basel III interpretation.

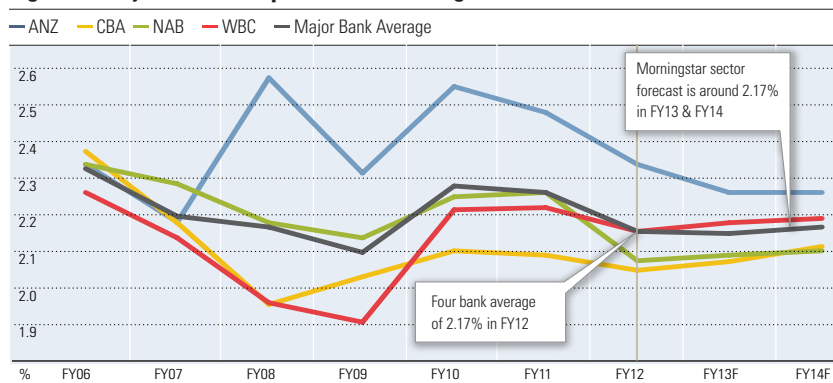
Source: Company Accounts/Morningstar

Figure 2: Major Bank 'Cash' Return on Average Equity (ROE)



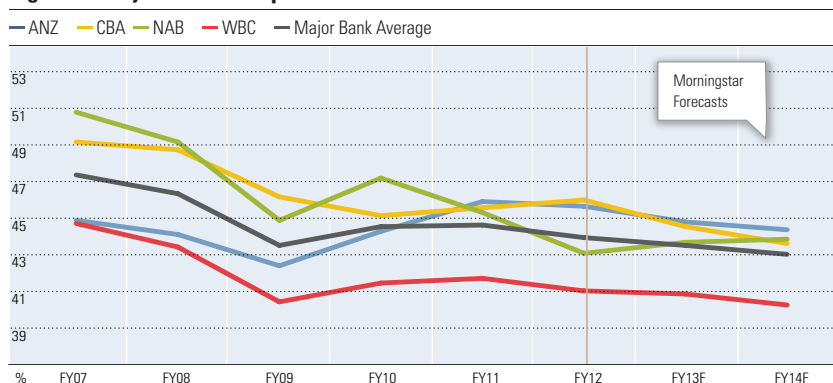
Source: Company Accounts/Morningstar Forecasts FY13 & FY14

Figure 3: Major Bank Group Net Interest Margins



Source: Company Accounts/Morningstar Forecasts FY13 & FY14

Figure 4: Major Bank Group Cost-to-Income Ratios



Source: Company Accounts/Morningstar Forecasts FY13 & FY14

factor that would derail our argument. The longer the period of low credit growth and high profits, the higher the probability of increased dividend payout ratios, buy-backs or special dividends. The banks have sufficient capital to support modest loan growth.

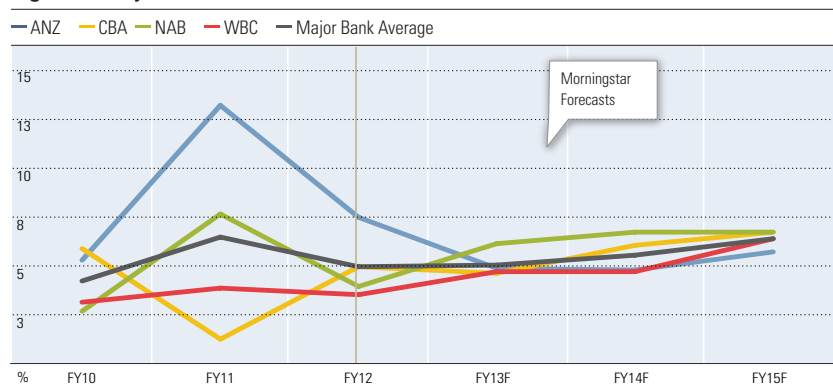
As long as bank profitability remains relatively high and credit growth relatively low then surplus capital will continue to accumulate. Bank capital ratios are calculated by dividing qualifying capital by risk weighted assets, and the major banks are growing risk weighted assets only moderately at best. Ironically, major bank ROE's actually declined in FY12, despite EPS growth for ANZ, CBA and WBC as the growth in the capital base exceeds the growth in earnings. Declining interest rates are also impacting investment returns on bank capital. Despite average dividend payout ratios around 73%, dividend reinvestment plan (DRP) take-ups are reducing actual cash payouts to shareholders, with 40–45% of dividends flowing through to retained earnings and increasing qualifying capital for capital adequacy calculations. Sterilisation of DRPs by buying equivalent shares on market would support EPS growth and we expect the banks will undertake this course of action in FY13 to partially utilise increasing capital surpluses.

Therefore, we expect major bank ROE's will continue to trend moderately lower unless surplus capital is returned to shareholders. We do not consider major acquisitions likely, except for ANZ in Asia, but we are confident the bank will only launch into a material transaction at an attractive price. There is upside to dividend forecasts, as we have not incorporated higher payouts, special dividends or buy backs in our forecasts.

Net interest margins remain under pressure

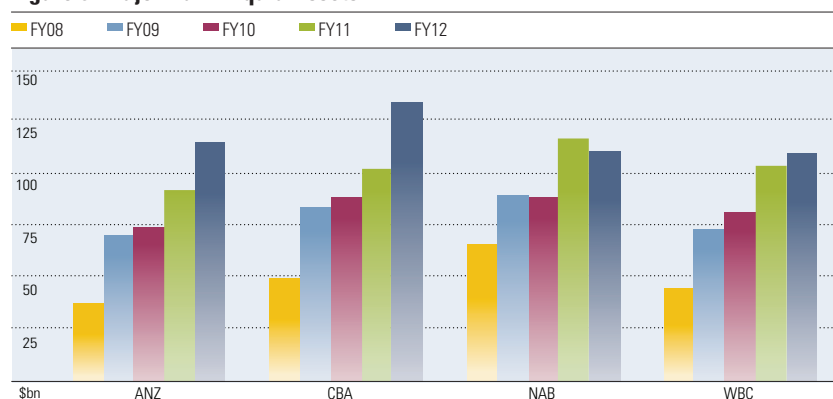
Margins remain under pressure from higher customer deposit costs and dwindling demand for credit. Household and business deleveraging continues, combined with investor caution and the safe haven status provided by the banks. Despite net interest margins for the four banks declining by 8bps on average in FY12 to 2.17%, we forecast margins to stabilise around these levels for FY13 and FY14 due to loan and deposit repricing. We expect funding costs to edge higher with pressure on term deposit margins and high interest investment accounts. Pleasingly, wholesale funding costs have eased over recent months and importantly, access to debt capital markets is not an issue for the highly rated major banks. Further margin decline will put downward pressure on our earnings forecasts, but partially offsetting this potential weakness is tighter cost control and increasing product cross sell, particularly in the wealth segment.

Figure 5: Major Bank Total Loan Growth



Source: Company Accounts/Morningstar Forecasts FY13, FY14 & FY15

Figure 6: Major Bank Liquid Assets



Note: Includes contingent capital (internal RMBS).

Source: Company Accounts/Morningstar

ANZ Bank ANZ

Price	\$24.56
Recommendation	Accumulate
Accumulate Below (\$)	28.00
Buy Below (\$)	22.00
Business Risk	Medium
Price Risk	Medium
Moat Rating	Narrow
Fair Value (\$)	31.00

Commonwealth Bank CBA

Price	58.82
Recommendation	Hold
Accumulate Below (\$)	54.00
Buy Below (\$)	42.00
Business Risk	Medium
Price Risk	Medium
Moat Rating	Narrow
Fair Value (\$)	60.00

Operating expenses tightly managed

Pressure on revenue will continue due to modest credit growth and difficulty in extracting further fee increases. Operating costs will remain a focus area, with the banks continuing to invest in automation to reduce costs or at least slow the rate of growth. The three major banks with a September year-end all reported lower cost to income ratios in FY12, and we expect further improvements in FY13 and FY14. WBC is peer leading with a FY12 efficiency ratio of 41% compared to an average of 45% for the three peers, meaning for every dollar of revenue WBC generates a greater proportion of profit. We are forecasting a major bank average cost to income ratio of 43.5% in FY13 down from 44% in FY12, and improving further in FY14 to 43%. Business simplification, economies of scale and new technology will assist in cost containment. Lower relative costs are important for our major bank thesis of steady earnings growth despite only modest credit growth. But we are confident in our operating expense forecasts, as management clearly realise tight cost control is imperative.

Moderate loan growth to continue

We have long argued the major banks can generate acceptable profits despite soft credit growth and FY12 clearly demonstrates the case. The four bank average loan growth for FY12 of 4.9% fell from 6.4% in FY11, but dividends are up an average of 4.8%. We forecast average loan growth of 5% in FY13, 5.5% in FY14 and 6% in FY15 due to a recovery in business loan growth and stable home loan growth around 5%. Lower interest rates in Australia could reignite demand for household credit, but we do not expect a strong rebound to pre GFC levels. Consumers are far more cautious and household deleveraging will likely continue for at least another 18-24 months. We expect major bank credit growth to exceed total financial system credit growth due the strong competitive position enjoyed by the four majors. Already dominant market positions will strengthen as the major banks take market share from regional banks and non-bank lenders.

Strong growth in low risk funding and liquidity

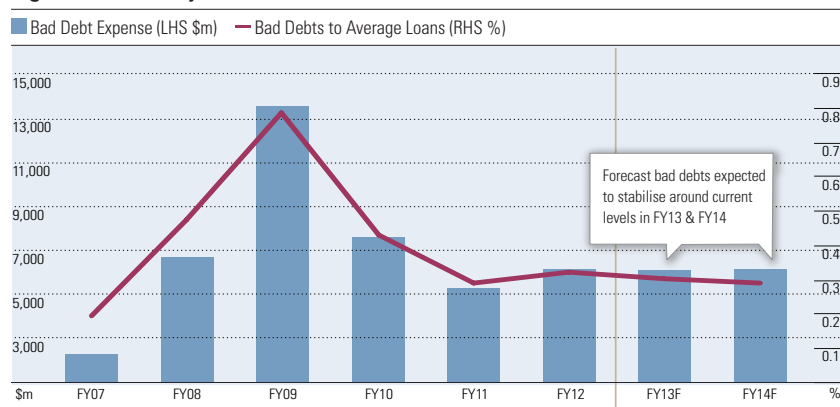
Funding and liquidity are under control, with very strong growth in customer deposits continuing as investors seek the safety of bank deposits rather than face market risk and increased volatility. Balance sheet dynamics continue to improve with customer deposit growth exceeding loan growth in FY12. Total liquid assets across the four major banks increased 14% or \$60bn to \$470bn in FY12. Key capital funding and liquidity ratios are all trending higher. Customer deposits are making an increasing contribution to total funding, relieving demand for offshore wholesale funding.

Changing the funding dynamics away from short term wholesale funding to higher quality customer deposits is well overdue, but is not necessarily under the complete control of bank management. A wide range of external factors have created the demand for bank deposits, but new strict international banking standards require the Australian banks to increase holdings of these much sought after but increasingly expensive source of funds. The restructuring of Australian bank balance sheets to ensure loans are at least matched funded by customer deposits is a long term goal and will take several more years at least.

Stable asset quality, but outlook softening

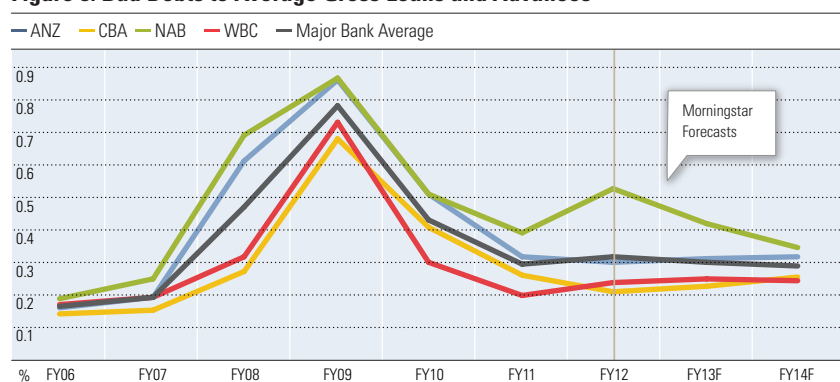
Sound credit quality across the sector is reassuring, except for NAB where weak economic conditions in the UK continue to savage commercial property loan values. Improvements in loan arrears in Australian and New Zealand consumer portfolio were offset by

Figure 7: Total Major Bank Bad Debts and Bad Debts to Loan Ratio



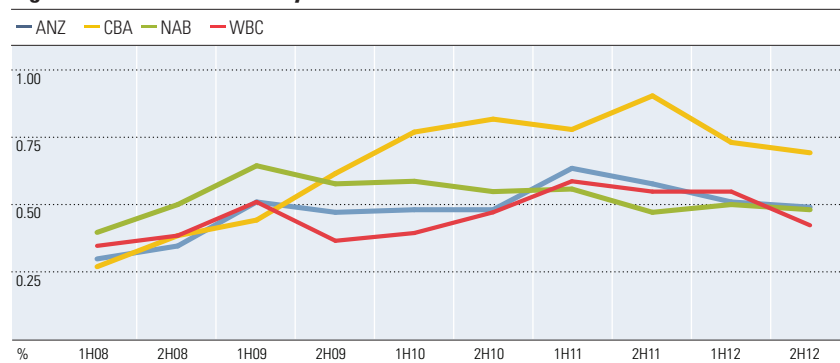
Source: Company Accounts/Morningstar Forecasts FY13 & FY14

Figure 8: Bad Debts to Average Gross Loans and Advances



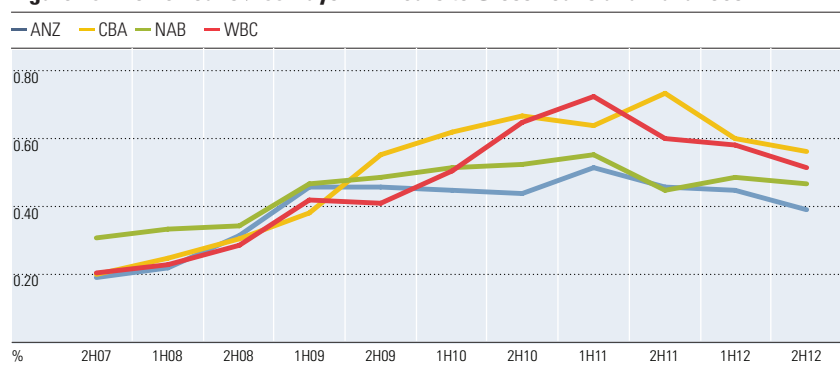
Source: Company Accounts/Morningstar Forecasts FY13 & FY14

Figure 9: Total Loans > 90 Days in Arrears to Total Home Loans



Source: Company Accounts/Morningstar

Figure 10: Home Loans > 90 Days in Arrears to Gross Loans and Advances



Source: Company Accounts/Morningstar

softer conditions in corporate loan quality. Total FY12 bad debt expense for the four major banks of \$6.2bn increased 16% on FY11, due primarily to NAB's 44% blow out. The four bank average bad debt expense to average loans increased marginally from 29bps in FY11 to 32 bps. Our FY13 bad debt expense forecast is \$6.1bn, equivalent to 30bps, but relies on a material improvement in NAB's result. Economic overlay provisions increased, with NAB accounting for the bulk of the change. Australian mortgage books continue to show moderate improvements in loan arrears.

Bank rankings change with ANZ and WBC now on top

Our key thesis remains intact for the four narrow moat major banks. Higher funding costs continue to exert pressure on net interest margins. Loan re-pricing partially offsets these higher costs, and the major banks are expected to fully recoup the lost margin over time due to their dominant market positions. The four major banks benefit from strong competitive advantages due to a highly regulated banking oligopoly, national franchise with high barriers to entry, diversified and highly profitable revenue base, large sticky customer base, efficient scale, improving funding mix, loan repricing capability and significant leverage in IT capability. Credit quality is stable, including impaired assets and consumer arrears.

We retain our positive banking sector view, but our major bank rankings changed in September when CBA strong share price performance triggered a downgrade in our recommendation from Accumulate to Hold. We continue to like CBA and value its low risk profile, stable earnings growth, conservative balance sheet settings and leading IT capability. But Australia's largest bank by market value is now relatively expensive and we now rank it third behind new top pick ANZ and fast improving WBC. ANZ is our top ranked major bank due to its strong earnings profile and differentiated growth strategy. CBA remains our preferred stock for less risk tolerant investors. National Australia Bank (NAB) carries most risk, but greatest upside potential, reflecting its higher exposure to growth opportunities in business and commercial banking in Australia. NAB's share price continues to underperform peers, with ANZ, CBA and WBC outperforming the S&P/ASX200 benchmark over the past 12 months.

Table 2: Major Bank FY12 Profits, EPS, Dividend and ROE Summary

Stock	FY12 Cash Net Profit \$bn	FY12 Cash NPAT Growth %	FY11 Cash EPS (cps)	FY12 Cash EPS (cps)	FY12 Cash EPS Growth %	FY12 Dividend Growth %	FY11 Cash Dividend Payout %	FY12 Cash Dividend Payout %	FY12 Cash ROE %
ANZ	6.0	6.4	218.4	225.3	3.2	3.6	64	64	15.6
CBA	7.1	4.1	438.7	449.4	2.4	4.4	73	74	18.6
NAB	5.4	-0.5	249.9	240.9	-3.6	4.7	69	75	14.2
WBC	6.6	4.7	209.3	215.9	3.2	6.4	75	77	15.5
	\$25.1	3.7	N/A	N/A	1.4	4.8	70	73	16.0

Source: Company Accounts/Morningstar

Table 3: Bank Reporting Summary - Actuals and Morningstar Forecasts

Stock	Morningstar Recommendation	Result	Balance Date	NPAT FY12 Forecast \$m	NPAT FY12 Actual \$m	FY12 Actual vs FY12 Forecast %	NPAT FY13 Forecast \$m
ANZ	Accumulate	FY12	30-Sep	5,950	6,011	1.0	6,420
NAB	Accumulate	FY12	30-Sep	5,701	5,433	-4.7	5,935
WBC	Accumulate	FY12	30-Sep	6,471	6,598	2.0	6,753

Stock	Morningstar Recommendation	Result	Balance Date	NPAT FY12 Forecast \$m	NPAT FY12 Actual \$m	FY12 Actual vs FY12 Forecast %	NPAT FY13 Forecast \$m
BOQ	Hold	FY12	31-Aug	46	31	-33.9	211

Stock	Morningstar Recommendation	Result	Balance Date	NPAT 1Q13 Estimate \$m	NPAT 1Q13 Actual \$m	1Q13 Actual vs 1Q13 Estimate %	NPAT FY13 Forecast \$m
CBA	Hold	1Q13	30-Jun	1,850	1,850	0.0	7,415

Source: Company Accounts/Morningstar Forecasts

Banking sector profit results for FY12 support our positive view

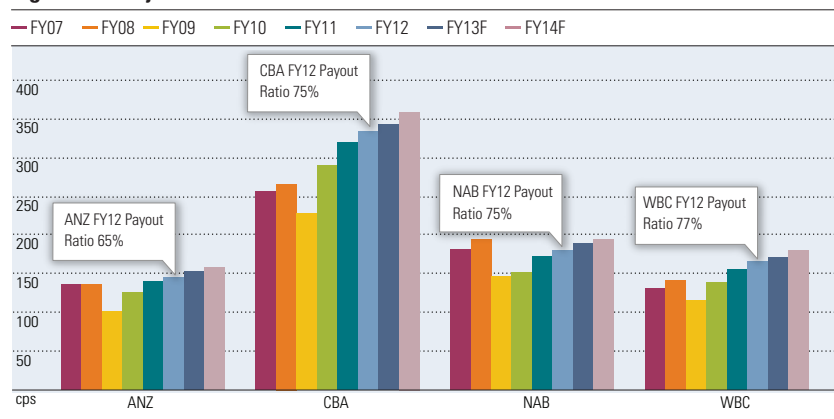
There are no material changes to our fiscal 2013 and fiscal 2014 profit forecasts, except for NAB. We continue to forecast moderate earnings per share growth, picking up in fiscal 2014. We expect stable net interest margins, moderate loan growth and modestly higher bad debt expenses. Cost to income ratios are targeted to improve over the next two years on the back of tight cost control. Higher dividends underscore our thesis the major banks are a reliable source of attractive fully franked dividends despite current market and economic challenges. The major bank growth strategies are on track and we are confident management can deliver, despite ongoing global banking and economic uncertainty. We remain upbeat on the medium-to long-term prospects and consider major bank's competitive advantages are intact, leveraging their privileged position in a rational and very profitable banking oligopoly.

WBC Fiscal 2012 Result: Profits and dividends exceed expectations

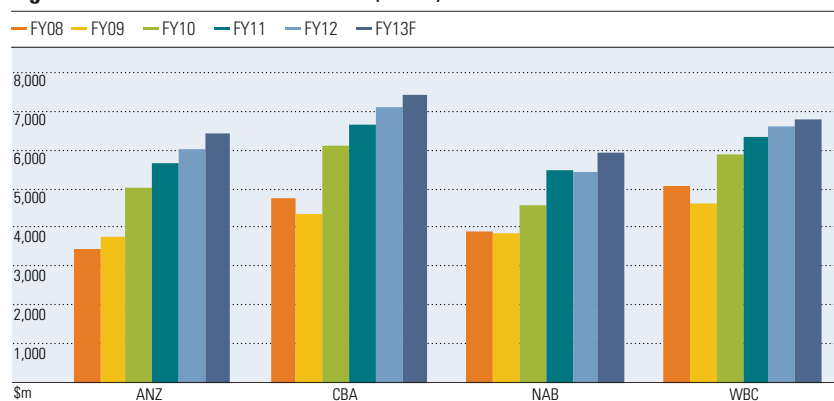
WBC is the standout performer of the three September balancing major banks, beating our profit forecast by 2%, hitting a record \$6.6 billion, with solid performances across all key profit and business lines. Revenue up 6%, costs up only 4% and core earnings up 7%. The strong 6% uplift in full year dividend is the highlight with the payout ratio increasing from 75% to a peer high 77%. A moderate upside surprise in earnings and dividend as Westpac delivered a solid increase in fiscal 2012 earnings. The 4.7% increase in underlying cash profit exceeded our \$6.5 billion forecast. We retain our positive view, with no major changes to our fiscal 2013 cash profit forecast of \$6.8 billion, equivalent to EPS growth of 1.4%.

ANZ Fiscal 2012 Result: No surprises, on track for near-term earnings growth

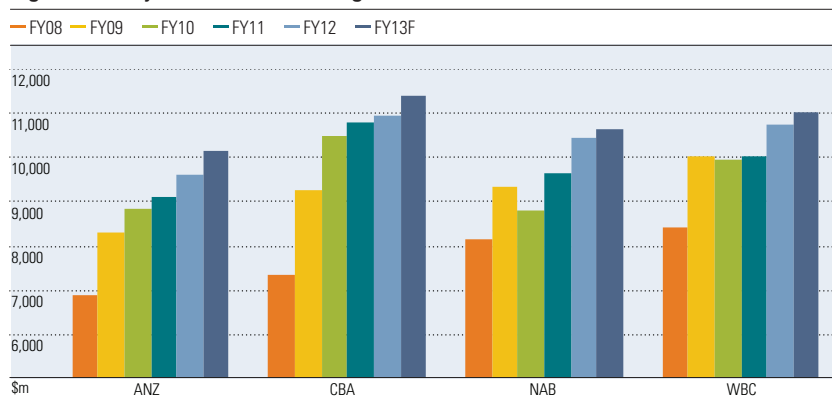
No major surprise in ANZ's robust 6% increase in FY12

Figure 11: Major Bank Dividends

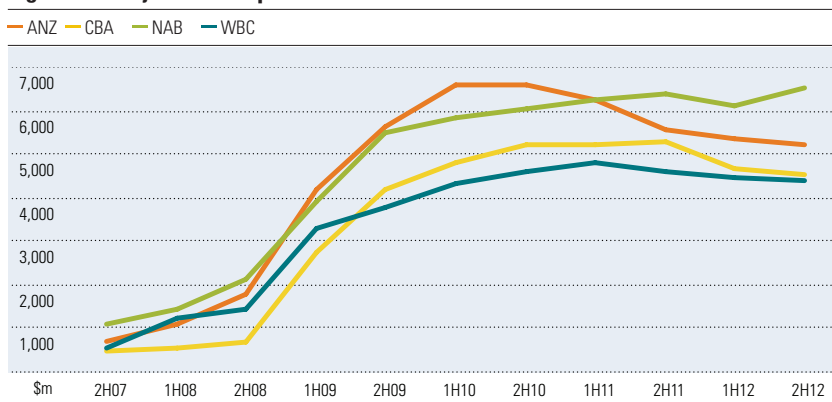
Source: Company Accounts/Morningstar Forecasts for FY13 & FY14

Figure 12: Cash Net Profits After Tax (NPAT)

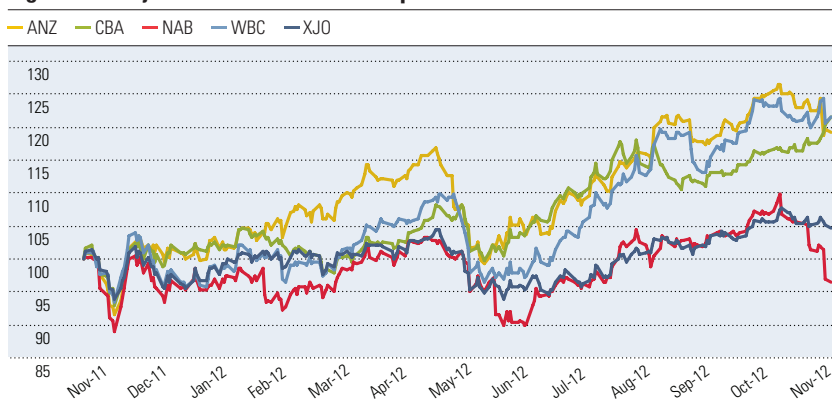
Source: Company Accounts/Morningstar Forecasts for FY13

Figure 13: Major Bank Core Earnings – Profits Before Bad Debts and Tax

Source: Company Accounts/Morningstar Forecasts for FY13

Figure 14: Major Bank Impaired Assets

Source: Company Accounts/Morningstar

Figure 15: Major Bank Share Price Comparison since November 2011

Source: Morningstar

increased 4% to a fully franked \$1.45 per share. We maintain our number one ranking for this narrow-moat bank, which we forecast to deliver FY13 EPS growth of 4.7%. Most key metrics improved as expected, with revenue up 5% and bad debts stable at \$1.2 billion, but ROE did ease from 16.2% to 15.6% due to a higher equity base. Funding pressure reduced net interest margin from 2.42% in FY11 to 2.31%, despite loan repricing. Statutory profit increased 6% from \$5.36 billion to \$5.7 billion. As expected, the DRP discount was removed for the 79cps final dividend.

NAB Fiscal 2012 Result: Pre-released but bad debts and margins are a setback

NAB disappointed with an earnings downgrade prior to releasing fiscal 2012 results, increasing loan loss provisions \$250 million due primarily to significantly weaker economic conditions in the UK. The 44% increase in bad debts to \$2.6 billion overshadowed an otherwise robust improvement in core earnings, with profits before bad debts and tax up an impressive 8%. The performance highlights the inherent risk in banks, where bad debts can quickly destroy otherwise solid underlying performance. Importantly, the 180cps full year dividend was in line with our forecast and represents a 4.7% increase on fiscal 2011 despite EPS declining 3.6% year on year. The higher dividend supports our thesis of higher sustainable dividends despite moderate loan growth. We expect more active capital management initiatives by the end of fiscal 2013, unless economic conditions weaken sharply. NAB is the cheapest major bank due a long history of expensive 'missteps' causing a loss of investor confidence despite new management and a successful refocus on core banking.

CBA 1Q13 Trading Update: Strong start with full-year earnings on track

CBA's first quarter fiscal 2013 unaudited cash profit of \$1.85 billion was up an impressive 6% on 1Q12 and 5% sequentially. No surprises, with earnings consistent with our fiscal 2013 forecast of \$7.4bn, equivalent to 3% EPS growth. Moderate revenue growth continues to exceed expense growth and importantly, net interest margins are broadly stable with second half 2012. Tough customer deposit pricing continues to pressure margins. Provisioning and balance sheet management remain strong, with funding and liquidity under control. Deposit funding continues to steadily increase, standing at 63% of total funding at September. CBA's sound credit quality is reassuring, but improvements in the consumer portfolio were offset by increased corporate loan impairments.

National Aust. Bank NAB	
Price	\$23.81
Recommendation	Accumulate
Accumulate Below (\$)	28.00
Buy Below (\$)	22.00
Business Risk	Medium
Price Risk	Medium
Moat Rating	Narrow
Fair Value (\$)	31.00

underlying profit to \$6 billion as the Asia regional growth strategy gains traction. ANZ's result was solid with good revenue growth, expense growth finally slowing below the revenue growth rate and core earnings up 5%. ANZ's conservative dividend policy delivered a moderate 4% increase in distributions, with the payout unchanged at 64%, the lowest in peer group. Underlying cash EPS increased 3% to \$2.25 and the full-year dividend

Westpac WBC	
Price	\$25.17
Recommendation	Accumulate
Accumulate Below (\$)	26.00
Buy Below (\$)	20.00
Business Risk	Medium
Price Risk	Medium
Moat Rating	Narrow
Fair Value (\$)	29.00

Bendigo Adelaide Bank BEN	
Price	\$7.94
Recommendation	Accumulate
Accumulate Below (\$)	8.10
Buy Below (\$)	6.30
Business Risk	Medium
Price Risk	Medium
Moat Rating	None
Fair Value (\$)	9.00

Bank of Queensland BOQ	
Price	\$7.50
Recommendation	Hold
Accumulate Below (\$)	6.30
Buy Below (\$)	4.90
Business Risk	Medium
Price Risk	Medium
Moat Rating	None
Fair Value (\$)	7.00

Suncorp Group SUN	
Price	\$9.31
Recommendation	Hold
Accumulate Below (\$)	8.10
Buy Below (\$)	6.30
Business Risk	Medium
Price Risk	Medium
Moat Rating	None
Fair Value (\$)	9.00

Macquarie Group MQG	
Price	\$31.16
Recommendation	Hold
Accumulate Below (\$)	29.00
Buy Below (\$)	23.00
Business Risk	Medium
Price Risk	Medium
Moat Rating	None
Fair Value (\$)	33.00

Bad debts of \$291 million are similar to the average for the four previous quarters, with a sector-leading impairment expense to average loans of just 21bps.

MQG First Half 2013 Result: Struggling against weak markets

Volatile market conditions continue to plague Macquarie with 1H13 earnings up 18% on 1H12 to \$361 million, but down 15% on 2H12. The strong result from Macquarie's three annuity-style businesses was partly offset by lack-lustre results from the three market-facing businesses. Our full year FY13 profit forecast of \$873 million requires a strong second half, which we expect will come from a recovery in equity markets and transactional activity, benefiting the high margin market facing businesses. Our fiscal 2013 dividend forecast of 151cps is unchanged and at current prices the stock is trading at a relatively attractive 5%, but unfranked yield. Guidance for FY13 remains vaguely positive with fiscal 2013 profits expected to exceed the fiscal 2012 \$730 million, subject to equity market conditions. We maintain our near term earnings forecast, despite headwinds such as funding costs, increased competition, tighter regulation, and the opportunity cost of a large capital and funding surplus.

BOQ Fiscal 2012 Result: Another disappointment

The fiscal 2012 result was in line with guidance provided in early October. Reported NPAT was a loss of \$17 million due to a number of significant items. Cash NPAT of \$31 million was down 83% on fiscal 2011 due to the impact of the massive \$401 million increase in bad debts as BOQ belatedly took the pain on loan quality issues in South-East Queensland. Our main concern is the flat underlying second half result versus first half. On a normalised underlying basis (excludes bad debt expense), pre-tax profit was largely flat over the year at \$444 million and on a half on half basis at \$222 million. The high exposure to the soft South-East Queensland economy continues to weigh on earnings and we don't expect these loan quality and loan growth issues to turn around quickly. The final 26cps fully franked dividend was stable on first half, but down on the 28cps from second half 2011. BOQ raised \$450 million of capital in first half 2012. ■■