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Australian Banks: First Quarter 2023

Well capitalised, profitable, and highly regulated, Australian banks are generally undervalued and set to benefit from higher rates.

MORNINGSTAR®

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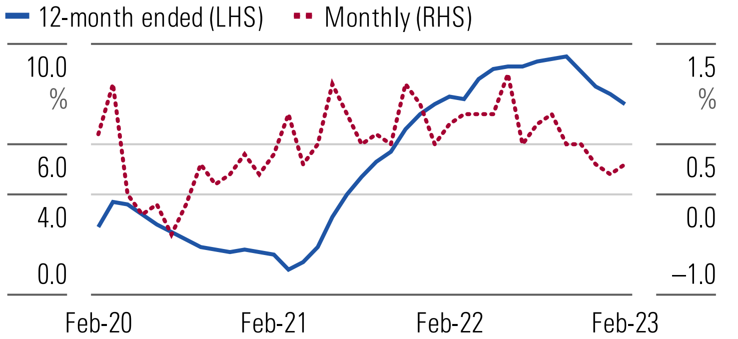
Executive Summary

Bank profits to grow as better margins outweigh slower credit growth and higher bad debts.

KEY TAKEAWAYS

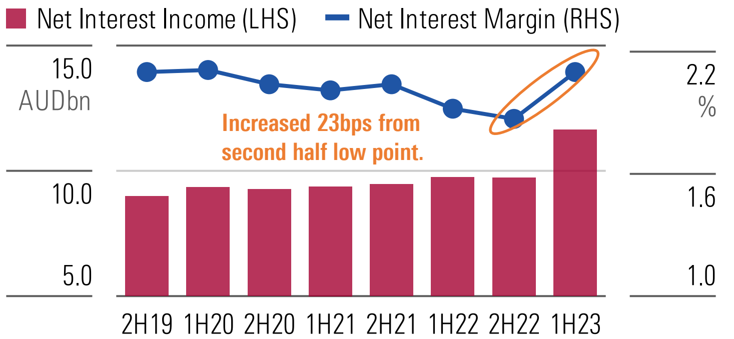
Higher Margins To Drive Earnings Growth as Credit Demand Growth Slows and Loan Losses Rise

Credit Growth Continues to Slow on Higher Rates



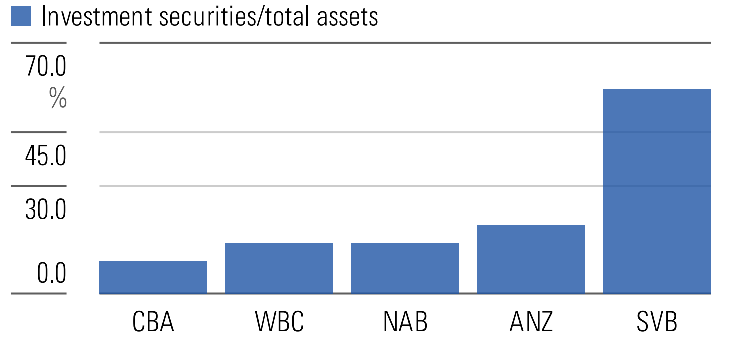
Source: Reserve Bank of Australia.

CBA Result Supports Our Margin Recovery Thesis



Source: Commonwealth Bank First-Half 2023 Result Presentation.

Loans Are Australian Banks' Key Assets, Not Securities



Source: Company reports, Morningstar.

Low rates underpinned strong credit growth in recent years, with total system loans up 18% in the three years to February 2023. With higher interest rates and inflation reducing borrower capacity, and falling house prices hurting investor confidence, we expect low-single-digit credit growth in the medium term. Growth slowed to an annualised rate of 3% in the last three months. Households drawing down on savings to meet higher mortgage repayments could aid credit growth. Offset account balances at the big four banks reverting to 2019 levels would add 2.5% to major bank home loan balances.

Banks passed on rate increases to existing borrowers in full. With customer deposit rates, a large part of funding, on average rising less, margins are up from compressed levels in the last half. But intense competition to retain customers as fixed rates mature and borrowers seek savings sees widespread discounting. We still expect banks with large loan books to benefit from higher rates. Once customer switching eases, we expect banks to reprice loans and discount less to deliver return on equity above our 9% cost of equity. This is expected to be driven by wide-moat-rated major banks.

Regulatory requirements on capital, liquidity, interest rate risk hedging, and lending standards give us comfort the highly profitable Australian banks will not face issues like those behind the banking crisis in North America and parts of Europe. Falling house prices, and borrowers facing a more than doubling of interest repayments increases loan loss risks. But we think bank balance sheets are sound. We gain significant comfort given loans were made with a 3% serviceability buffer, labour and rental markets are tight, and equity buffers and bank provisioning are substantial.

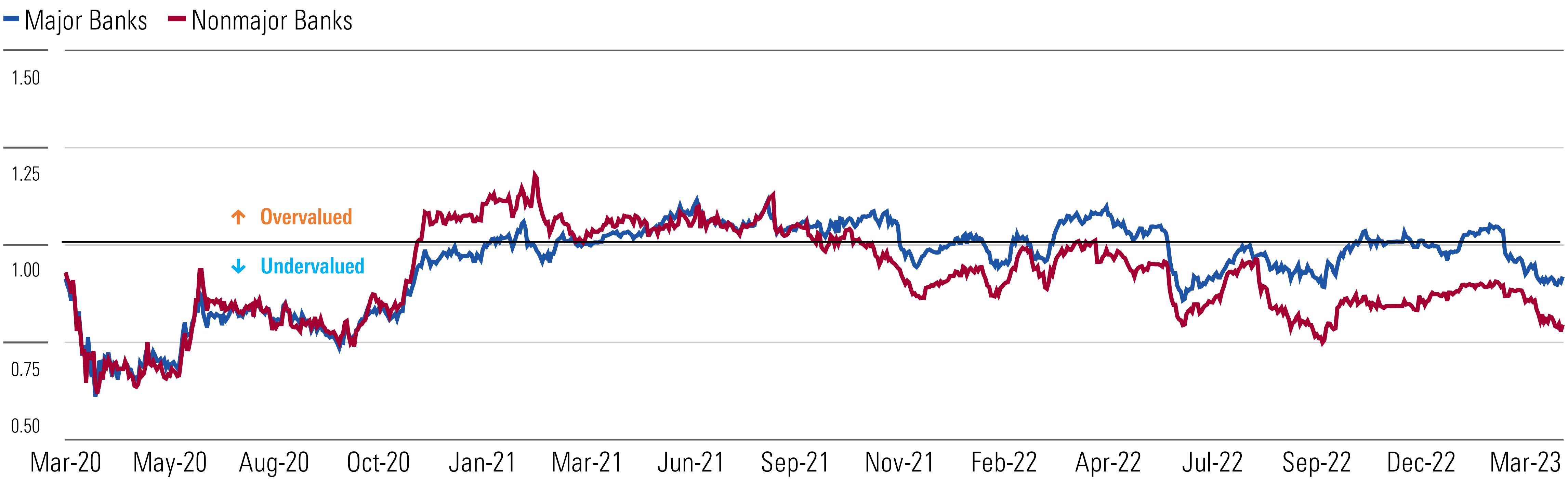
Major Banks Fairly Valued, Nonmajor Banks Cheaper With Funding Cost Disadvantages Real, but Overstated

The weighted average price/fair value estimate of the major banks is currently 0.95, down from 1.0 last quarter. All bank share prices fell in the quarter. For nonmajor banks, the deterioration is largely driven by Bendigo and Adelaide Bank where the bank slowed loan growth to help preserve margins.

Competition to retain home loan customers means net interest margin uncertainty is elevated, with rapidly rising rates also increasing the risk of higher-than-normal bad debts. We think investor concern around bad debts not coming to fruition over the next 12 months will help close the price/fair value estimate gap.

Harder for Nonmajor Banks to Compete in a Higher Rate and Lower Credit Growth Environment, but Earnings Outlook Still Positive

Westpac and ANZ Bank remain the cheapest major banks on price/fair value estimate.



Source: Morningstar. Data as of April. 4, 2023.

Valuation

Most banks undervalued as we expect elevated competition to abate.

Australian Banks Undervalued on Short-Term Margin and Bad Debt Uncertainty

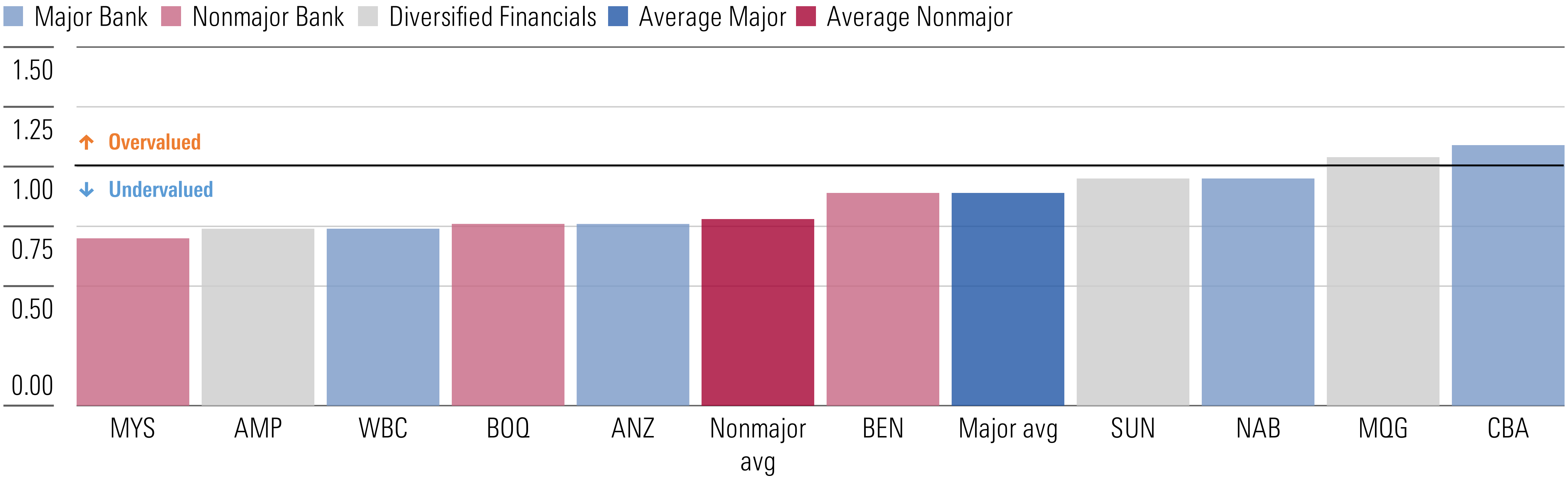
We think Westpac and ANZ Bank are best value among the majors. Commonwealth Bank remains an expensive outlier given industry leading return on equity, cost/income ratio, net interest margins, and market share.

Bank of Queensland shares fared better than nonmajor peers in the quarter, but the removal of the CEO last year still weighs. Earnings uncertainty has risen, but the market appears too pessimistic on loan quality and costs.

MyState shares price in declining home loan balances and compressed margins, but we think earnings growth will be underpinned by the small lender taking market share.

Opportunities in Major Banks as Market Doubts Market Share Losses Are Over, While Funding Cost Disadvantage of Nonmajors Overstated

Price/fair value estimate ranking. Unweighted for major and nonmajor averages.



Source: Morningstar. Data as of April 4, 2023.

VALUATION

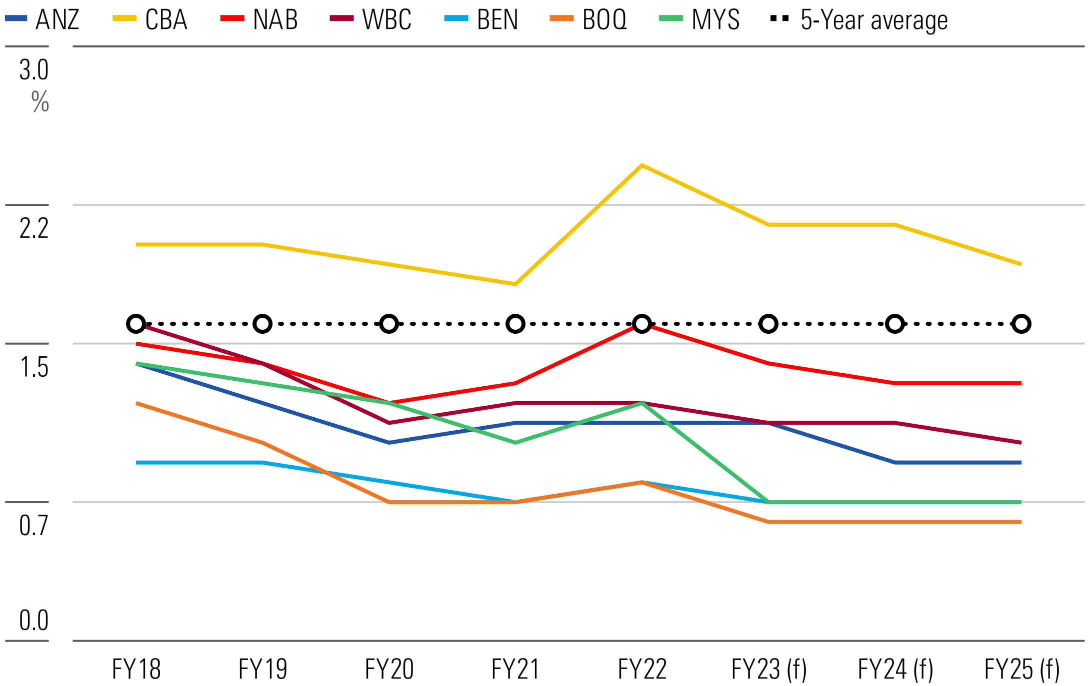
Dividend Yields Attractive Despite Much Improved Term Deposit Rates

The divergence in valuation between Commonwealth Bank and peers Westpac and ANZ Bank is stark, and in our view, unjustified. Price/book discounts are likely to unwind as the banks deliver earnings growth and stem market share losses.

After resetting dividend payout ratios, we think dividends can be maintained and grow in line with earnings. Share price weakness in most of the nonmajor banks relative to the majors has pushed dividend yields to very attractive levels. Nonmajors have more expensive customer deposit funding, but we think margin downside risk is overdone.

Price/Book Lower Across Most Banks

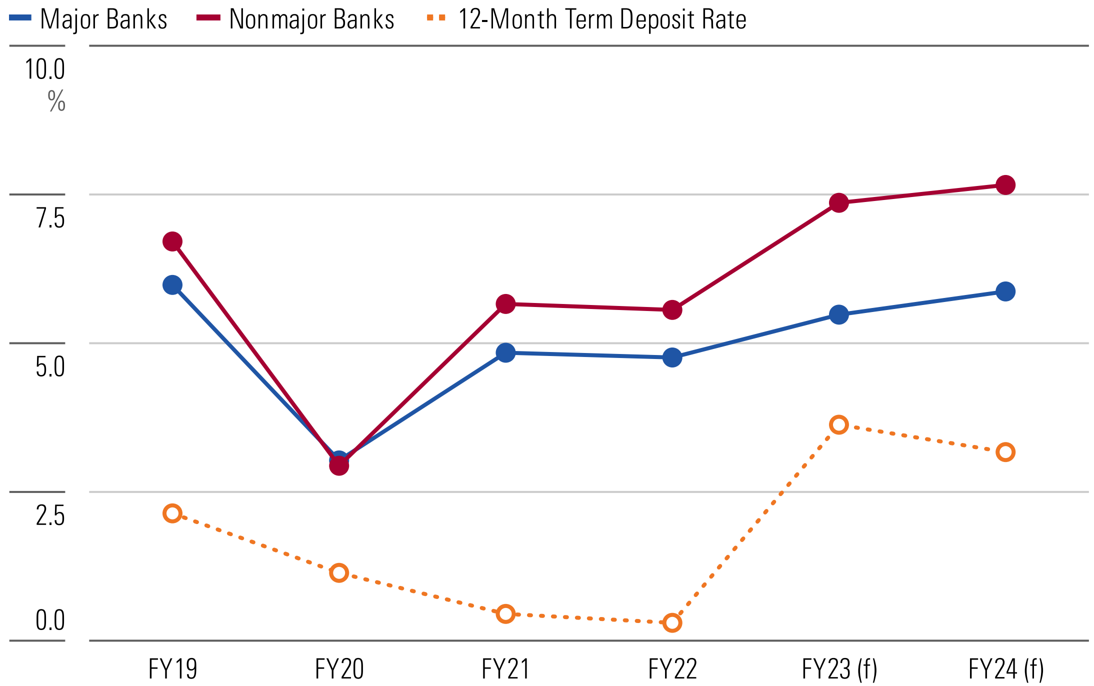
Five-year average is market cap-weighted.



Source: Morningstar. Data as of April 4, 2023.

Forward Dividend Yields Look Attractive (Even Before Franking)

Forecast term deposit rate assumes future cash rate in line with ASX Futures.



Source: Morningstar. Data as of April 4, 2023.

Credit Growth

Headwinds from lower borrowing capacity and softer house prices.

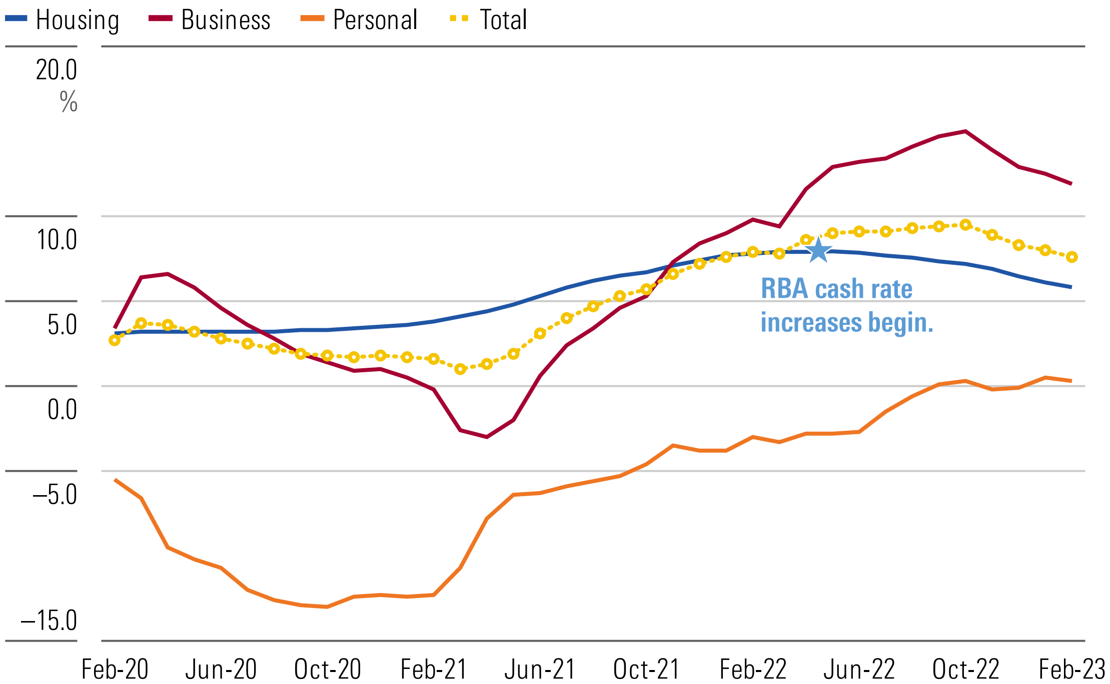
Higher Rates To Slow Housing Credit Growth, Business Demand Set to Fall Further as Consumer Spending Slows

Trailing year housing credit growth was up 5.8% to end-February 2023, down from the May 2022 peak of 8%. Rate increases have slowed demand, with February 2023 owner-occupier housing loan growth up just 0.23% month on month, or just 2.8% annualised.

Nonbank lenders are small but held share of total credit steady at 8%. We think major banks should make modest share gains in a higher rate environment, as nonbanks grapple with higher funding costs and a potentially higher risk loan book, with larger exposure to self-employed, low documentation, and high debt/income borrowers.

Financial System Credit Growth Expected to Decline Further

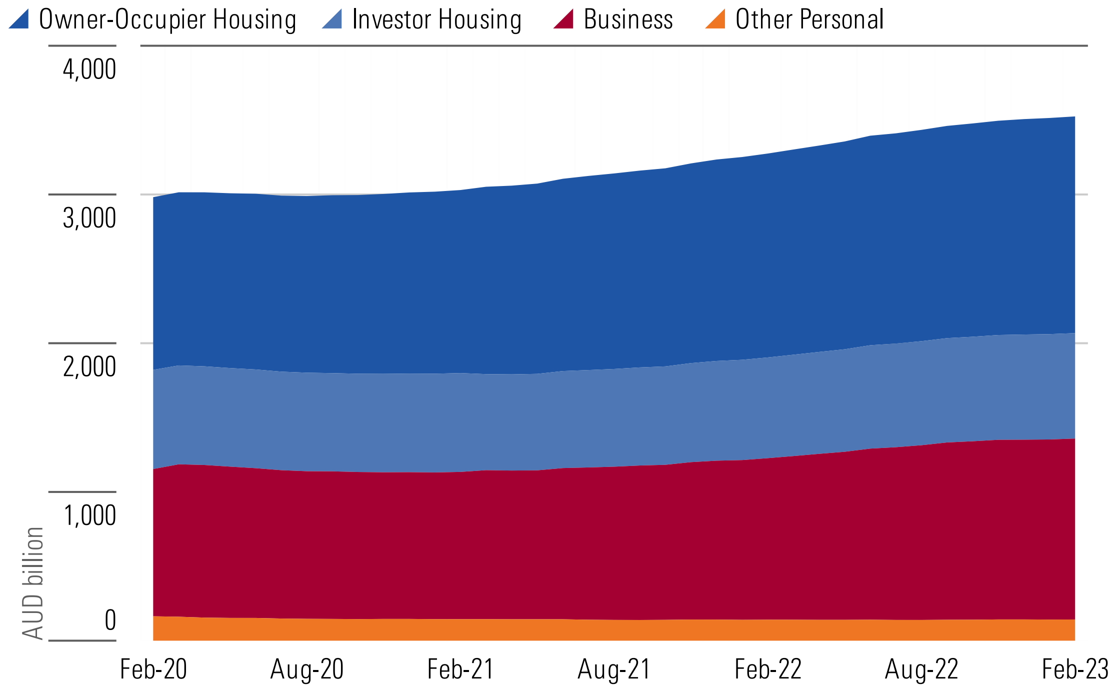
12 months ended February 2023.



Source: Reserve Bank of Australia.

Housing Accounts for Almost Two Thirds of Total Outstanding Loans

Housing loans are split roughly 67/33 owner-occupier and investor.



Source: Reserve Bank of Australia.

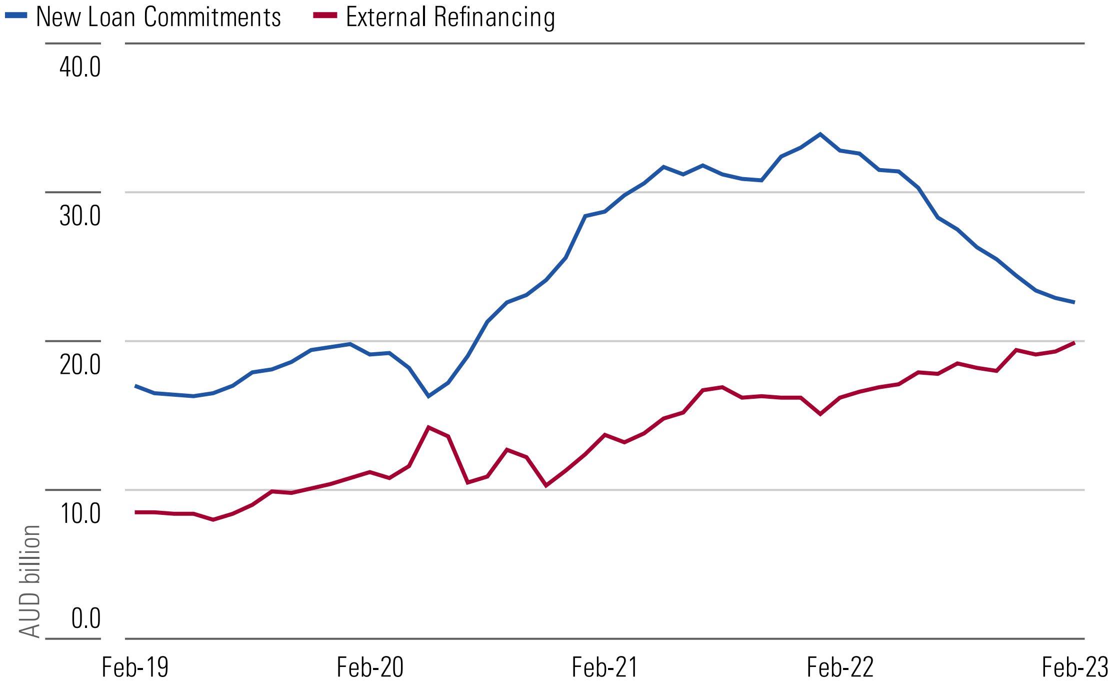
CREDIT GROWTH

Owner-Occupiers and Investor Loan Demand Squashed by Higher Rates

The value and number of new loans are falling as higher rates weaken consumer confidence and borrowing capacity. February commitments are down 31% from 12 months prior, but still 14% above January 2019 levels. We think refinancing will grow at the expense of new loan commitments as a wave of fixed loans mature through to 2024.

Record Refinancing and Slow Lending Growth Adds to Competitive Pressures

New loan commitments exclude refinancing.

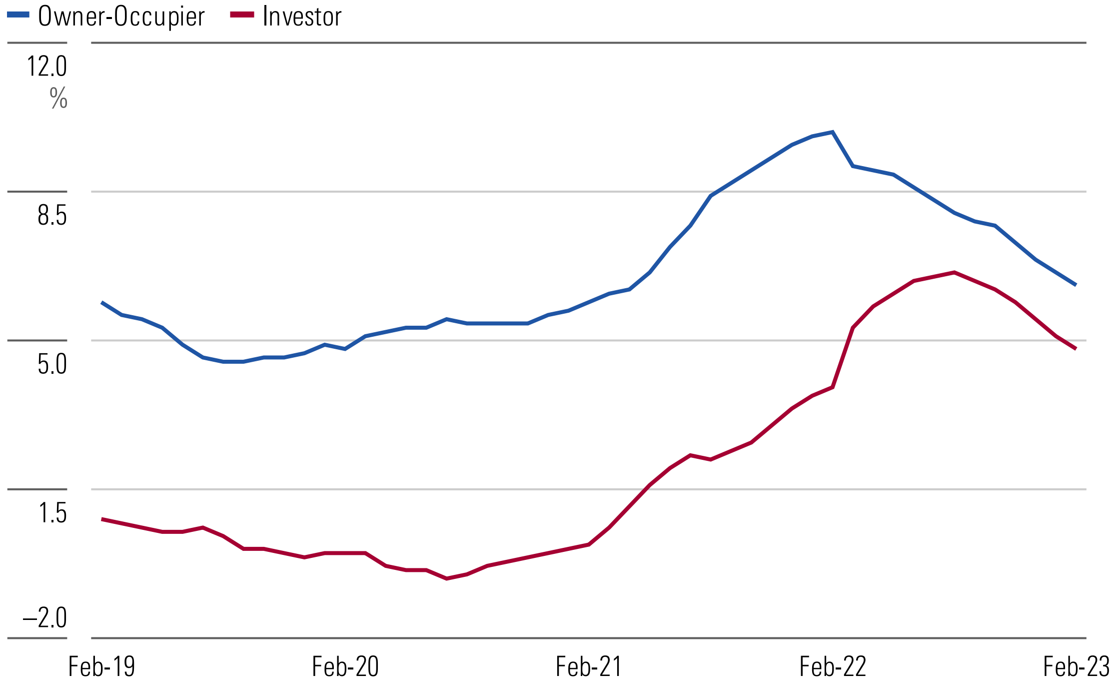


Source: Australian Bureau of Statistics.

We expect both owner-occupier and investor credit growth to slow. While some potential investors may see an opportunity as prices fall, latent investor demand is unlikely to outweigh the headwind from generally lower borrowing capacity from higher rated.

Demand for Owner-Occupier and Investor Housing Credit Continues To Ease

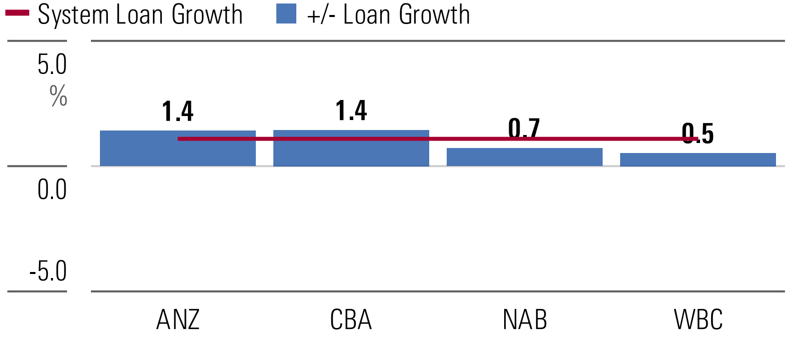
Rising interest rates can weaken the investment case for property, depending on rents.



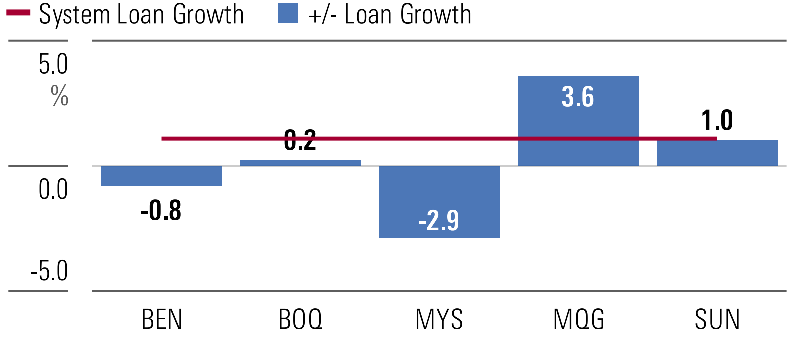
Source: Reserve Bank of Australia.

Major Banks Expected to Win Housing Loan Share as Small Lenders Struggle With Higher Funding Costs

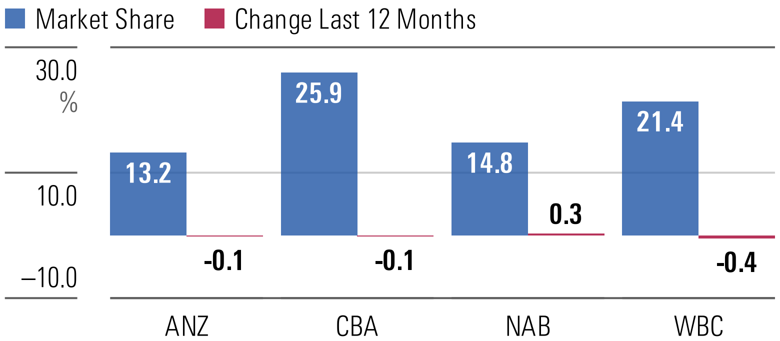
Major Bank Housing Loan Growth Last 3 Months



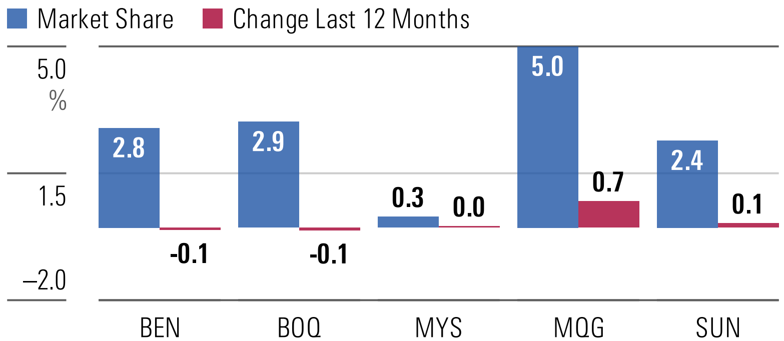
Nonmajor Bank Housing Loan Growth Last 3 Months



Major Bank Market Share



Nonmajor Bank Market Share



Source: Australian Prudential Regulation Authority, Morningstar. Data for period ending Feb. 28, 2023.

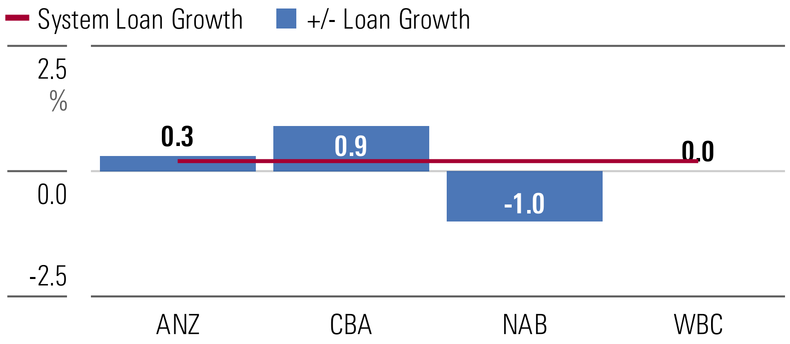
Based on Australian Prudential Regulation Authority data of authorised deposit-taking institutions, home loan balances grew 1.1% in the quarter to February 2023. The annualised quarterly growth rate was 4.4%, down from an annualised rate of 5.4% in the quarter to November 2022.

ANZ Group is now growing slightly ahead of market with market share steady over the last 12 months. Westpac is disappointingly still losing share, but the rollout of a new retail banking platform to improve efficiencies should level the paying field soon.

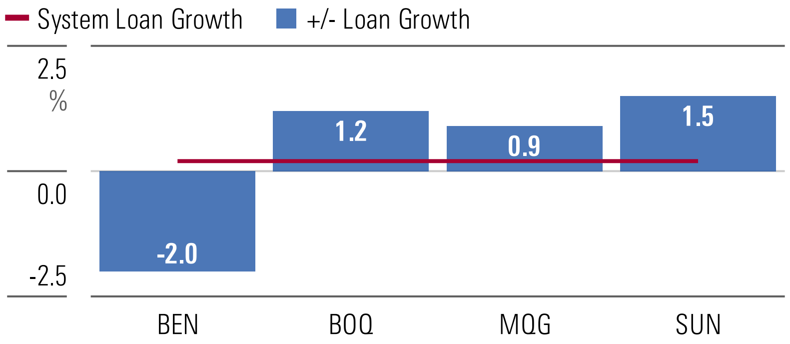
Macquarie continues to gain share via a good offering and price, but we expect this to slow as current pricing on loans and deposits is likely resulting in poor returns. Higher rates have already begun to hamper nonmajor banks, which do not enjoy the same low-cost transaction and saving deposits as the major banks. Funding cost advantages of the major banks underpin our wide moat ratings.

Business Loans: Commonwealth Bank Making Market Share Inroads as Growth Stalls

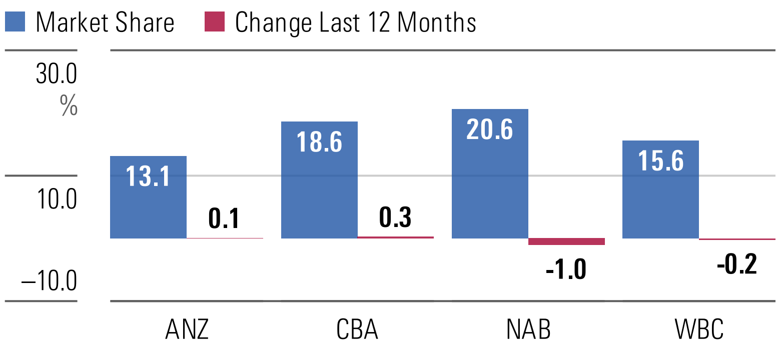
Major Bank Business Loan Growth Last 3 Months



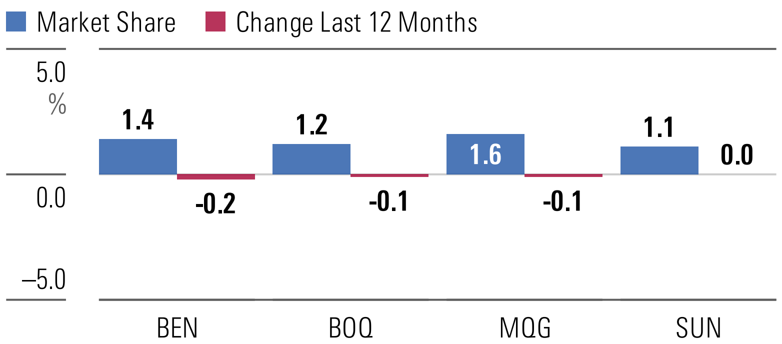
Nonmajor Bank Business Loan Growth Last 3 Months



Major Bank Market Share



Nonmajor Bank Market Share



Source: Australian Prudential Regulation Authority, Morningstar. Data for period ending Feb. 28, 2023.

Based on APRA data of authorised deposit-taking institutions, business loan balances grew 0.2% in the quarter to February 2023, an annualised rate of just 0.7%. Growth ground to a halt as expected after running at an annualised rate of 16% in the August 2022 quarter.

Businesses invested heavily to meet buoyant consumer demand through the COVID-19 recovery, but the economic outlook is now much weaker.

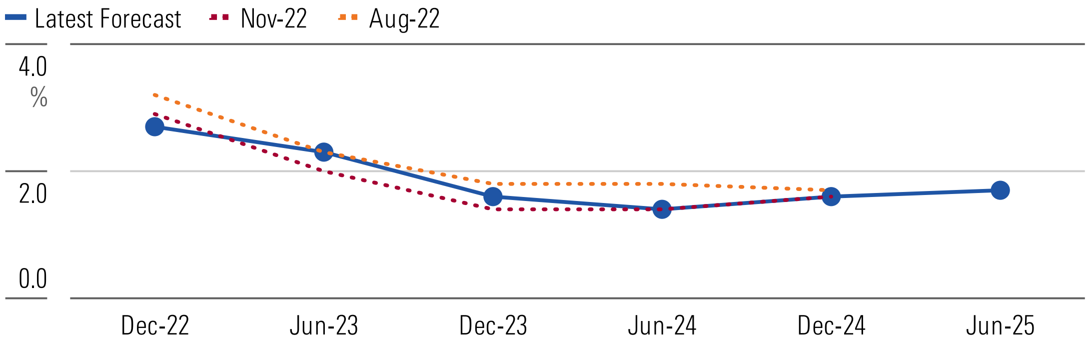
Nonmajor banks all ceded business lending market share in the last year as major banks, Commonwealth Bank in particular, focused on growing business loan balances and used prices do so. In the last three months, most nonmajor banks have turned this around and grew ahead of the market, perhaps a sign nonmajor competitors are turning attention to margin over volume.

Interest Margin Outlook

Competition heats up as mortgage repayments rise, but deposit-funded banks still set to benefit from higher rates.

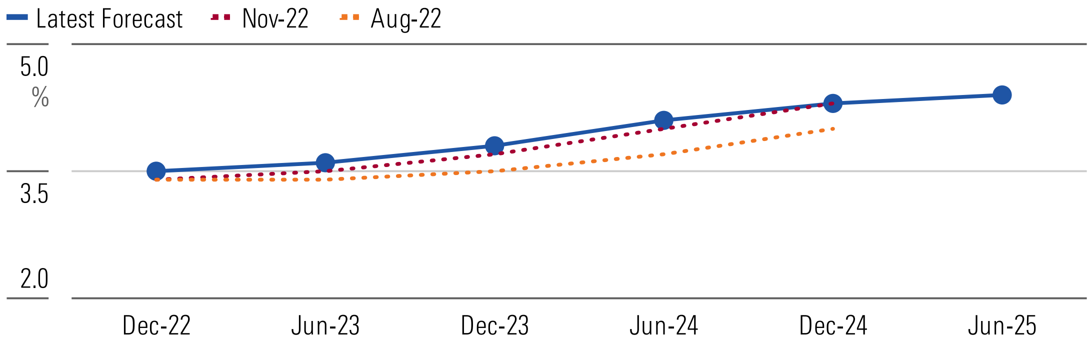
RBA Economic Growth Forecasts Lowered as High Inflation Persists Despite Rate Increases

GDP Growth—% Change Over Year to Quarter



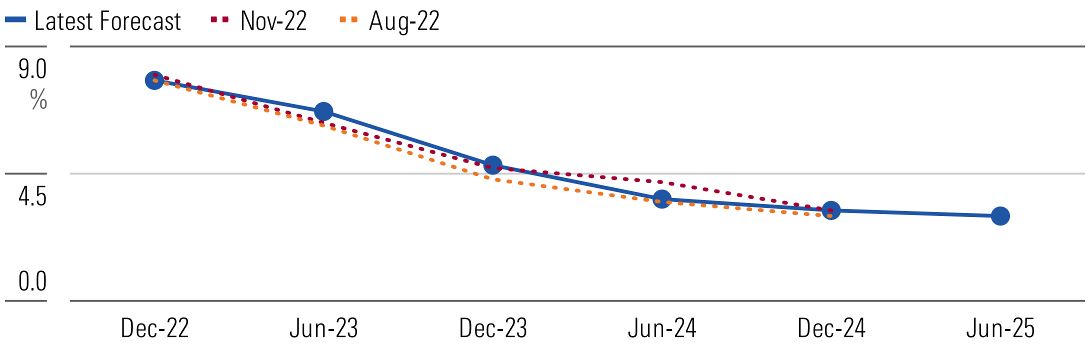
Source: Reserve Bank of Australia. Data as of Feb. 28, 2023.

Unemployment to Rise on More Overseas Arrivals and Moderating Labour Demand



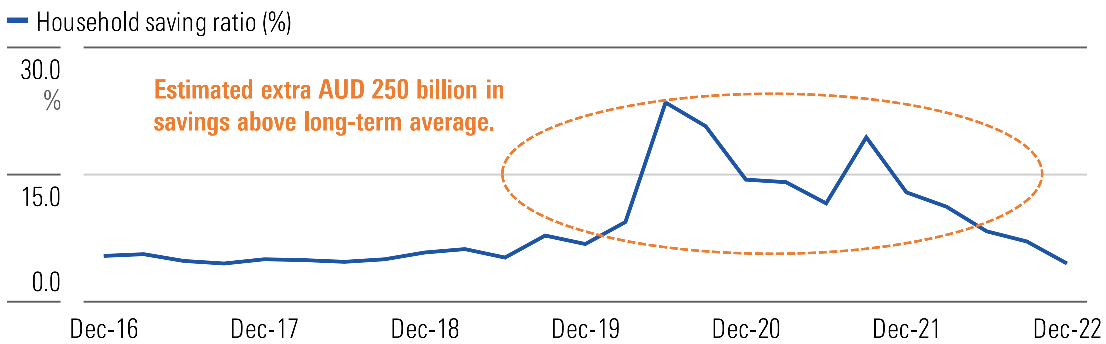
Source: Reserve Bank of Australia. Data as of Feb. 28, 2023.
Note: Unemployment Rate - quarterly %

Energy Prices, Rents, and Labour Costs Keeping CPI Higher in the Short Term



Source: Reserve Bank of Australia. Data as of Feb. 28, 2023
Note: CPI - % change over year to quarter

Household Savings Fall on Higher Living Expenses, Fewer COVID-19 Restrictions

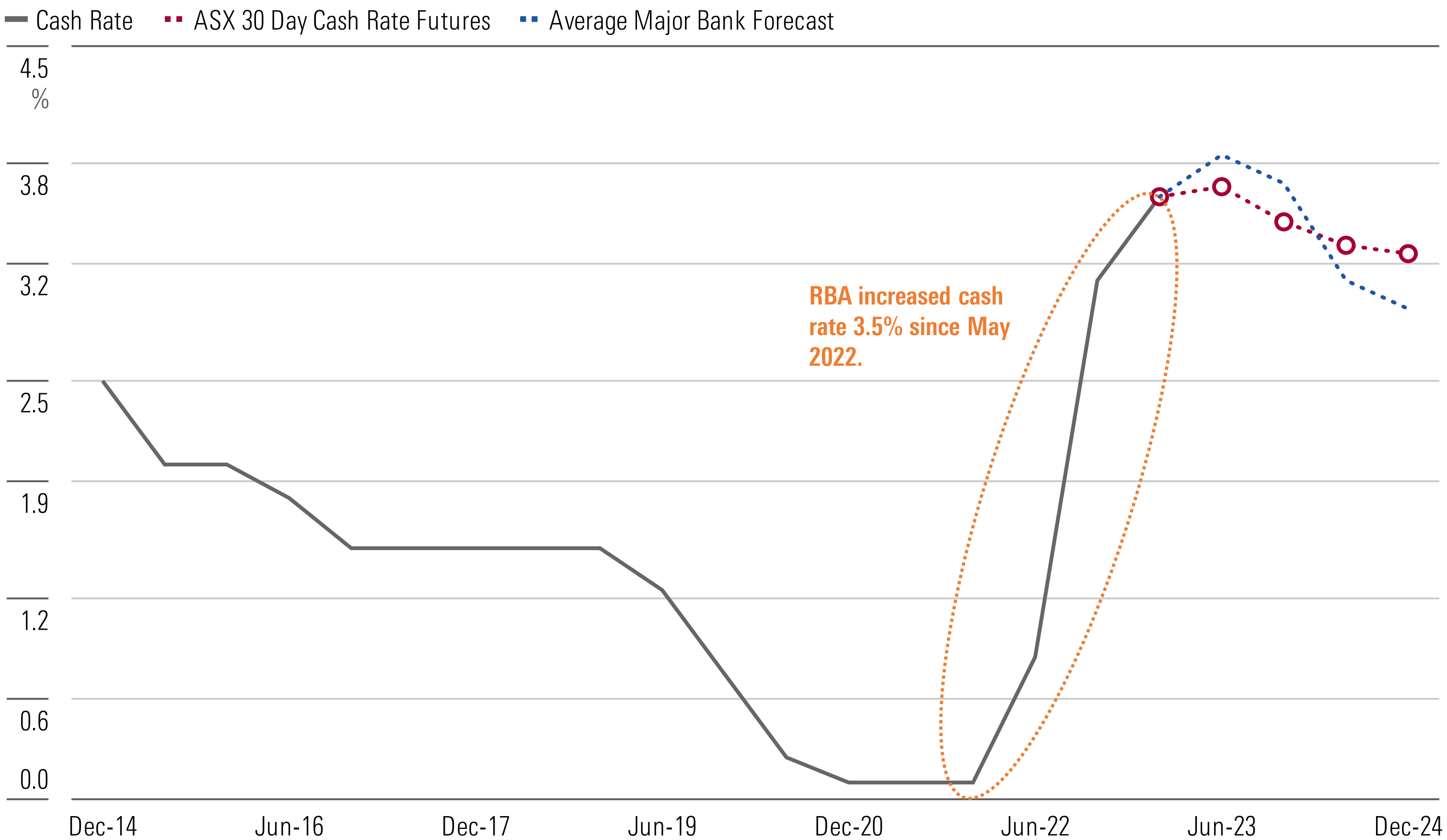


Source: Australian Bureau of Statistics.

Heavy Lifting on Rates Likely Done as RBA Hits Pause to Assess Impact of Past Tightening

Consensus No Longer Expects Materially Higher Cash Rates, but No Guarantee Inflation Is Under Control

Bank economists forecast a cash rate between 2.85% and 3.10% by December 2024.



Source: RBA, Australian Securities Exchange. Data as of April 4, 2023.

The cash rate has risen to 3.60% from 0.10% in May 2022, as high inflation led to faster rate increases than originally expected. We believe the annual inflation rate likely peaked at 8% in 2022.

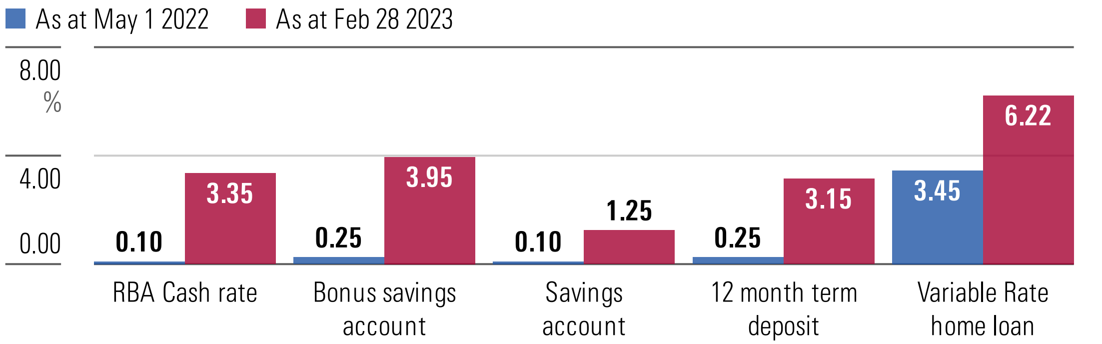
The Reserve Bank of Australia seeks to return inflation to the 2%-3% target over time and forecasts unemployment to rise to 4.3% by December 2024, with the consumer price index easing to 3.2%.

ASX 30-day futures imply the RBA cash rate has peaked, a change from three months earlier when rates were expected to reach 4% by December 2023. Major bank economists on average expect one more rate increase of 25 basis points before easing begins.

The 3.2% midpoint of market and economist expectations for the cash rate target by June 2024 portends low credit growth, attractive margins, and managable bad debts.

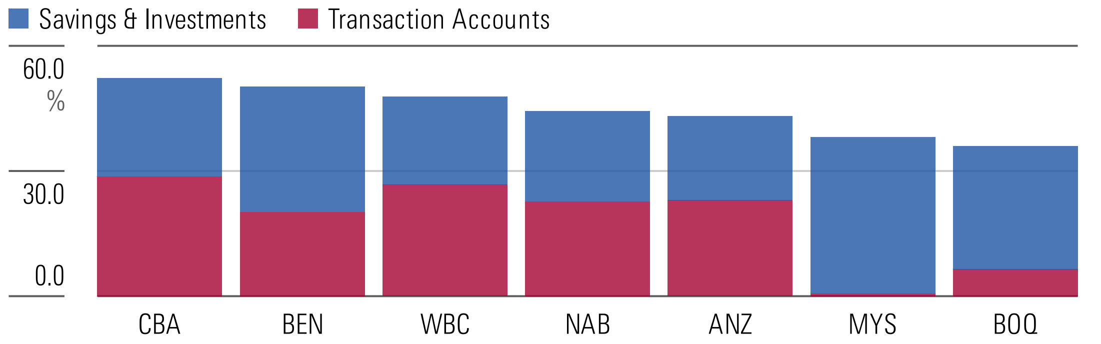
Banks Benefit from Cheap Deposit-Funding, Especially Majors, but Variable Rate Loan Discounts Caps Upside

Competition Forcing Banks to Lift Saving Rates and Give Borrowers Discounts



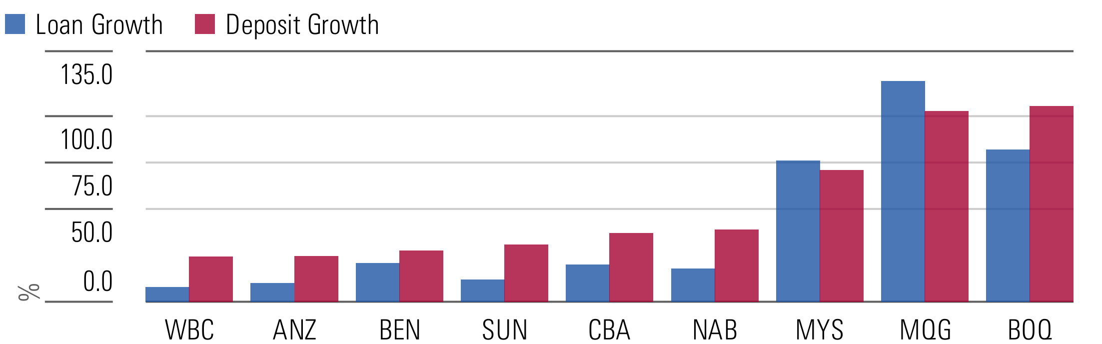
Source: Reserve Bank of Australia, Morningstar.

Banks With Low-Cost Customer Deposits Most Advantaged (% of Total Funding)



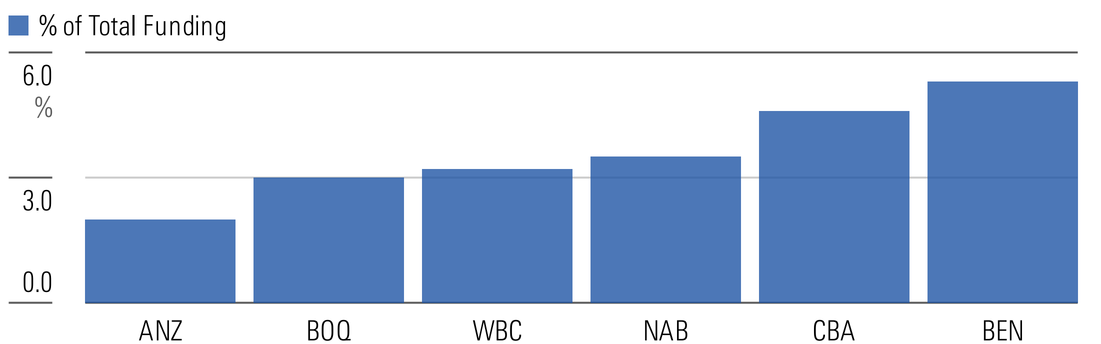
Source: Company reports, Morningstar.

Deposit Growth Far Ahead of Loan Growth in Last Three Years



Source: APRA, Morningstar. Data as of Feb. 28, 2023.

Repayment of AUD 188 Billion Term Funding Facility a Headwind for Fiscal 23/24



Source: Company reports, Morningstar.

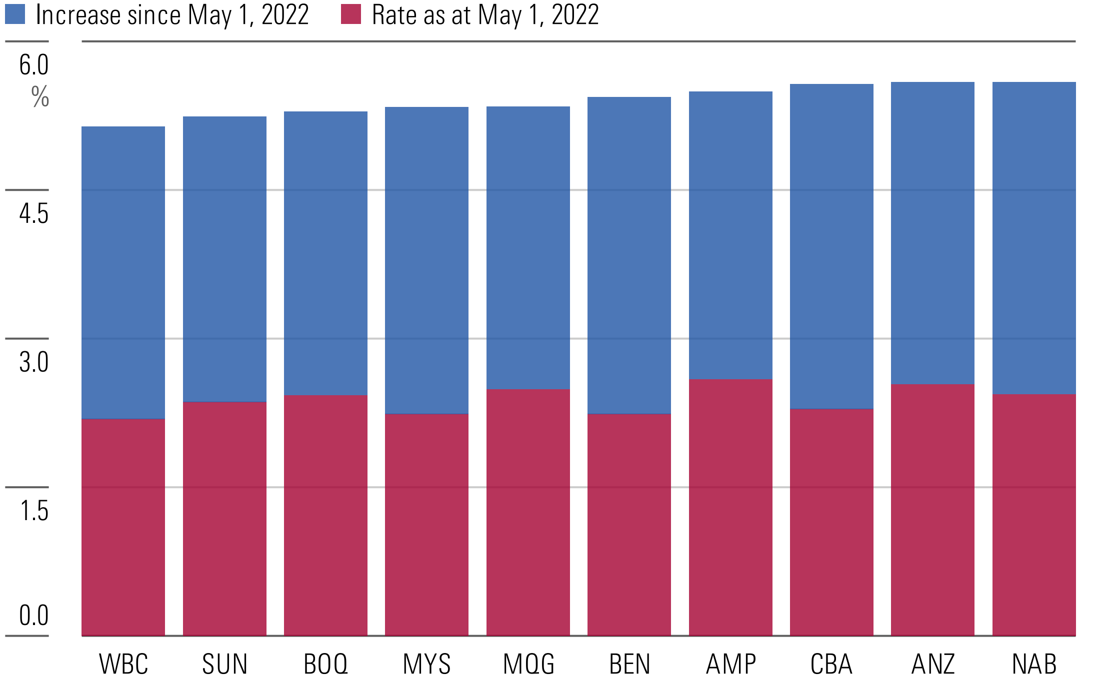
Home Loan Rates Much Higher, But Discounts for New Customers Dampen Margins

Australian banks have passed on higher cash rates to existing borrowers in full. Advertised rates on bank websites have largely not risen as much, reflecting competitive pricing for new borrowers. Westpac is most aggressive on advertised pricing as it looks to stem market share losses.

APRA data suggests the spread between rates on outstanding loans and new loans widened materially in 2022. While banks compete for new customers as fixed-rate loans mature and credit growth slows, existing borrowers increasingly contact banks to match offers in the market.

Owner-Occupier Variable Rates Have Doubled Since May 2022

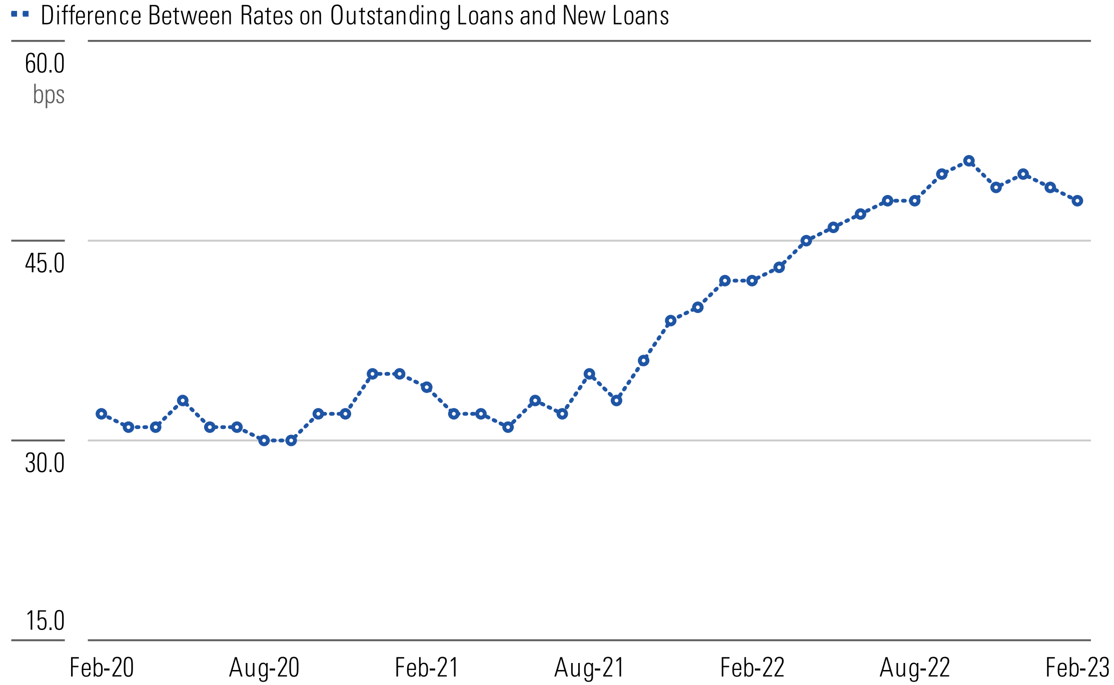
Variable rate: owner-occupier—principal and interest—loan/value ratio below 80%.



Source: Company websites, Morningstar. Data as of April 4, 2023.

Banks Offering Discounts for New Borrowers as Credit Growth Slows

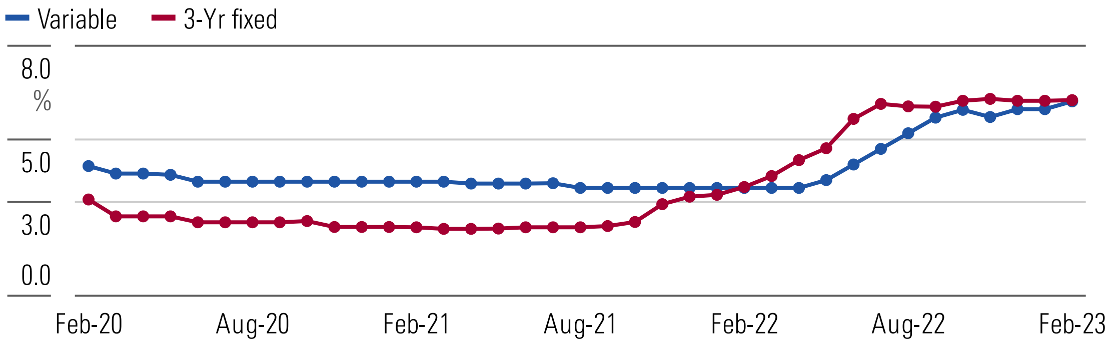
Rate differences for variable owner-occupied housing loans.



Source: Reserve Bank of Australia, Morningstar.

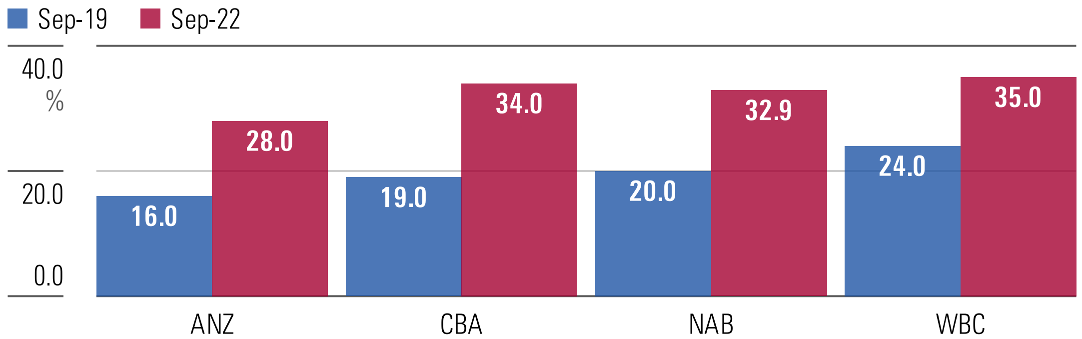
Unusually Large Fixed-Rate Home Loan Book Slows Repricing, but Variable Demand Now Dominates

Aggressive Fixed-Rate Offers Were Supported by the TFF and Low Bond Yields



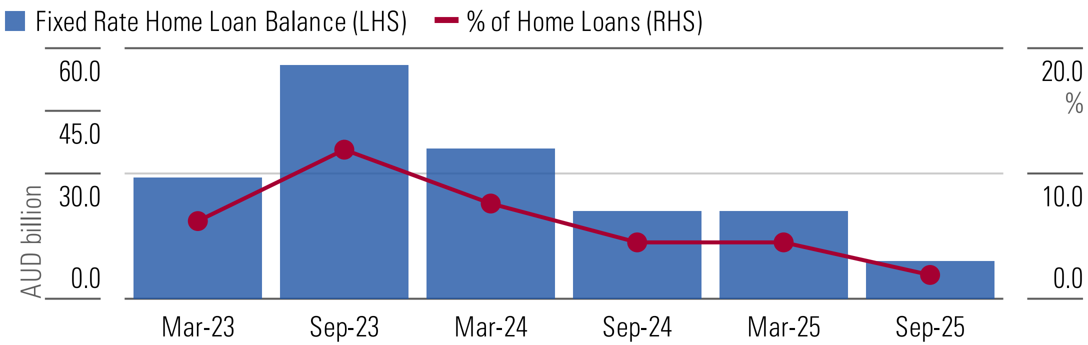
Source: Reserve Bank of Australia, or RBA.
Note: TFF = term funding facility. Three-year funding from the RBA at an interest rate of 0.1% to 0.25%.

Fixed Home Loans Way Above Average, but New Lending Now 90% Variable Rate



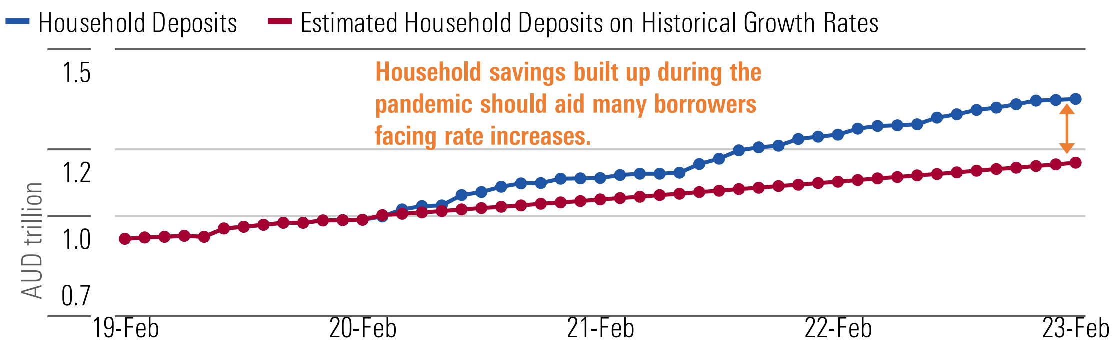
Source: Company reports (Commonwealth Bank and Westpac as of Dec. 31, 2022).

Majority of Westpac Fixed Home Loans Mature Over Next 18 Months



Source: Westpac First-Quarter 2023 Update.

Extra Savings Likely To Be Called Upon To Meet Higher Loan Repayments



Source: Australian Prudential Regulation Authority, Morningstar.

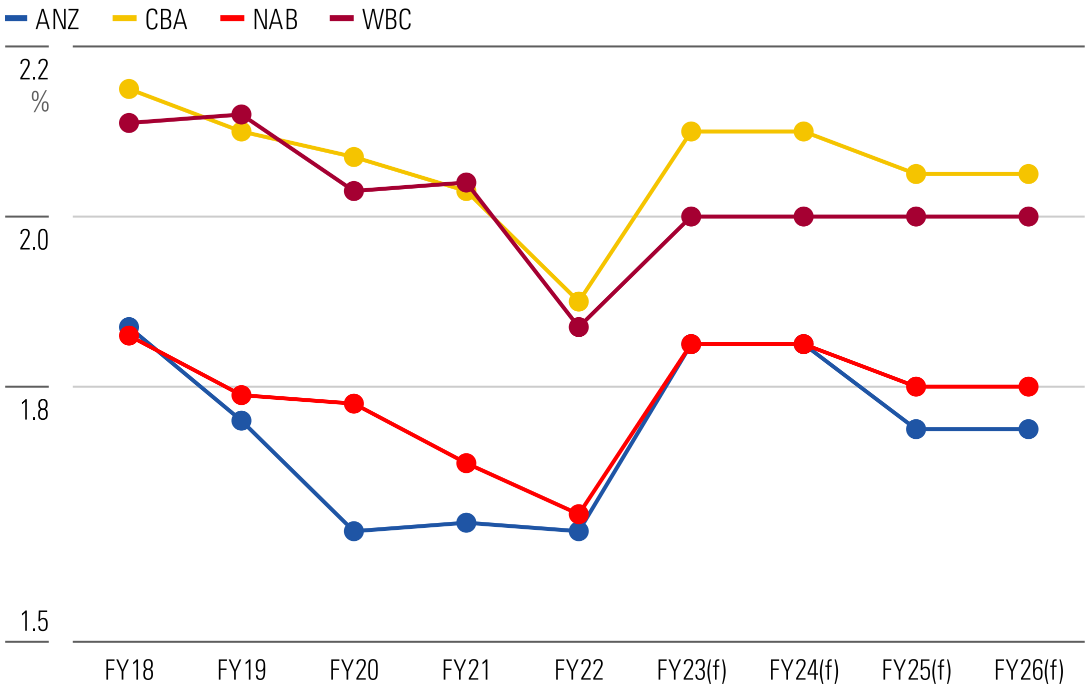
Banks Set To Hold Most of the Margin Gains From 2022 Lows

Net interest margins have likely peaked as the spread between bank funding costs – customer deposits – to what it charges borrowers widened quickly. We expect discounting to win/retain mortgage customers to ease as banks focus on making a decent return on equity.

With higher NIMs and low-single-digit loan growth, we forecast banks' net interest income to grow 6.5% per year to fiscal 2026. While bad debts are likely to rise, we anticipate moderate cost growth to allow cash profits to grow similarly to revenue. These returns are lower than historical levels but still support our wide moat ratings.

NIM Rebound Expected To Continue

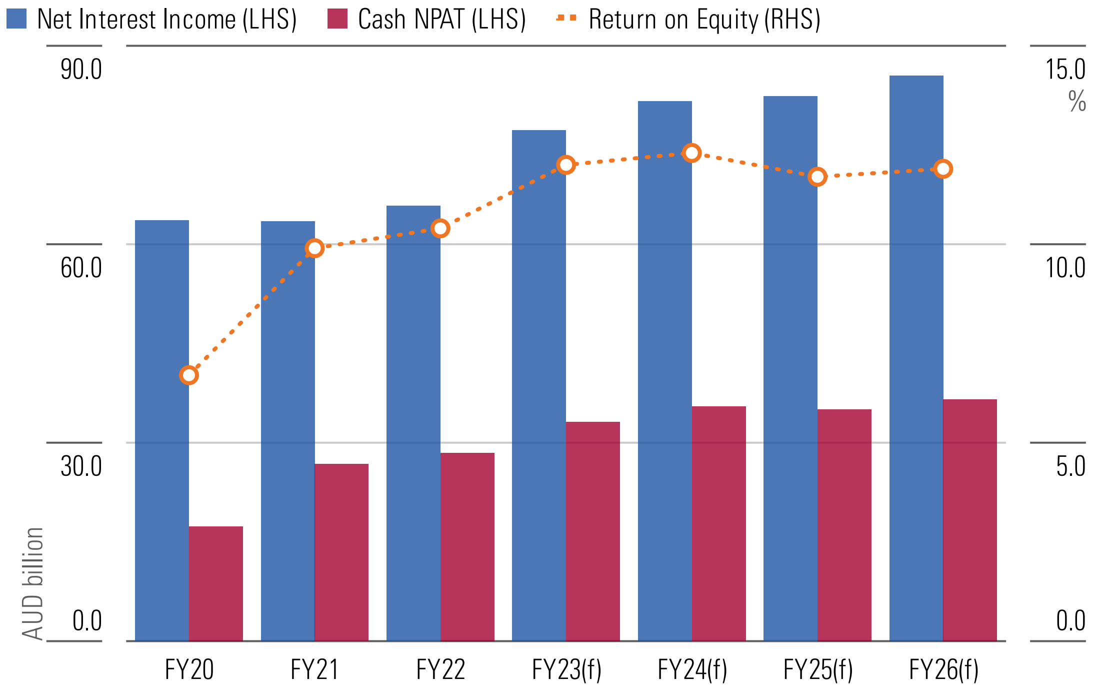
Morningstar NIM forecasts based on fiscal period.



Source: Company reports, Morningstar estimates. Data as of April 4, 2023.

Net Interest Income Growth Key to Our Profit Growth Expectations

Total of major banks.



Source: Company reports, Morningstar. Data as of April 4, 2023.
Note: NPAT = net profit after tax.

Capital and Credit Risk

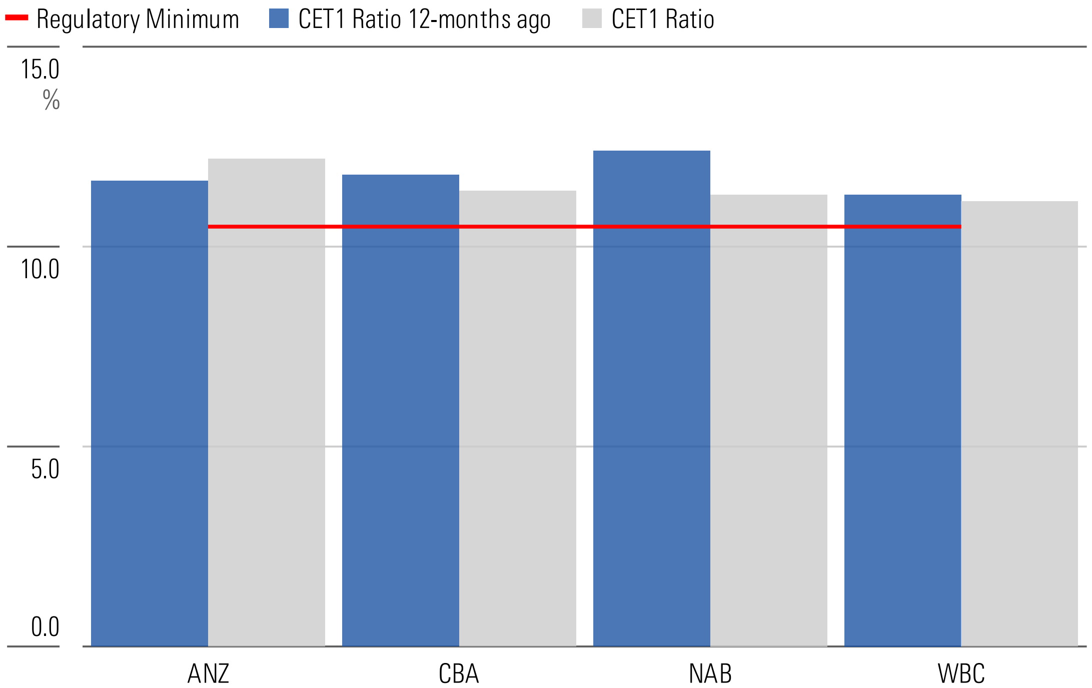
Banks well capitalised to withstand higher-than-expected bad debts.

Bank Balance Sheets Sound

Major banks comfortably meet capital requirements. From January 2023 a new capital framework applies with the regulatory minimum lowered to 10.25%, but APRA expects domestic systemically important banks to operate above 11% to ensure flexibility to weather adverse conditions and strengthen the resilience of the financial system.

We think the recent/ongoing share buybacks are unlikely to repeat in the short term. Banks are likely to take a conservative approach to balance sheet risk and capital management given heightened economic uncertainty.

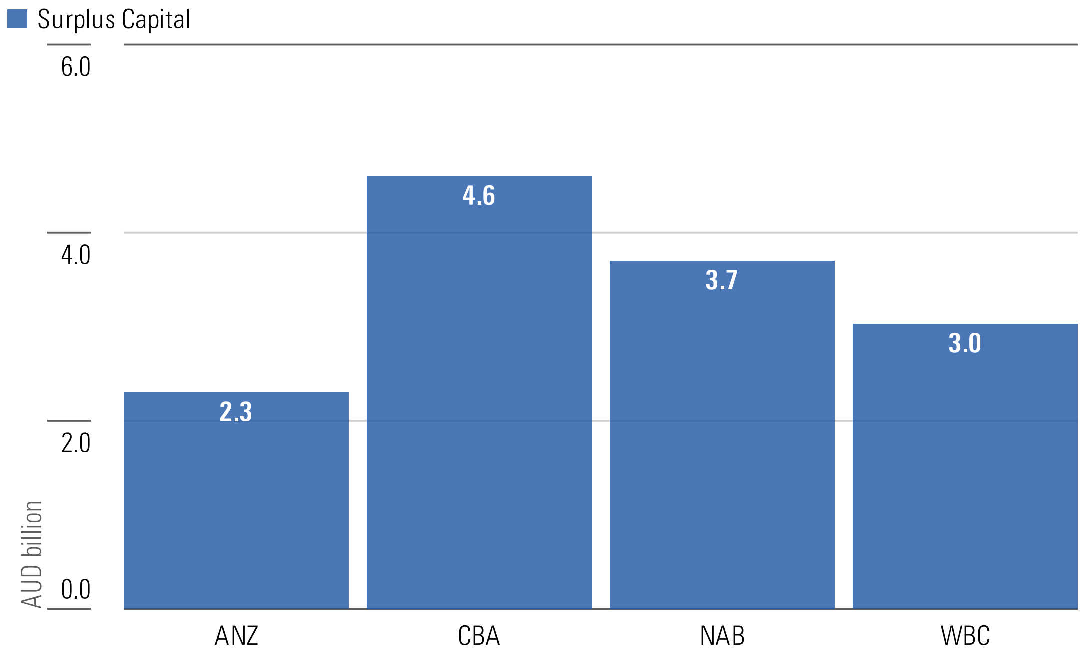
Major Banks Exceed Regulatory Capital Requirements



Source: Company reports. Data as of Dec. 31, 2022.
Note: CET1 = common equity Tier 1.

On Aggregate, Major Banks Sit on AUD 13.5 Billion in Surplus Capital

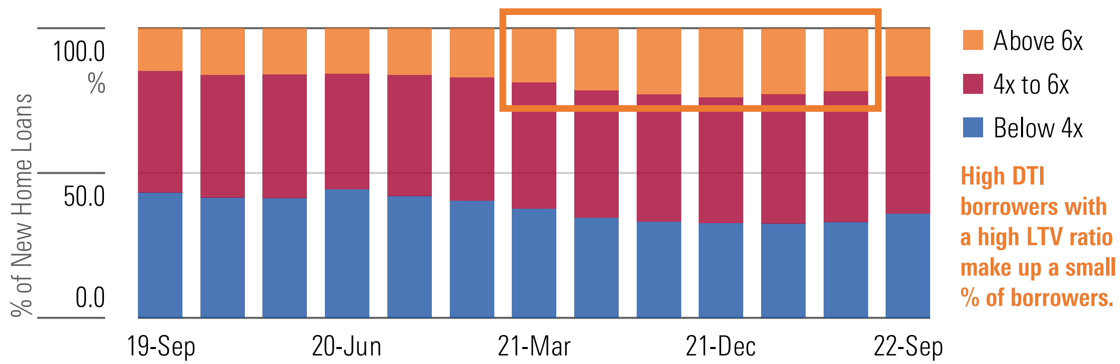
Surplus to regulatory minimum. ANZ Bank excludes funding for Suncorp Bank acquisition.



Source: Morningstar, Company reports. Data as of Dec. 31, 2022.

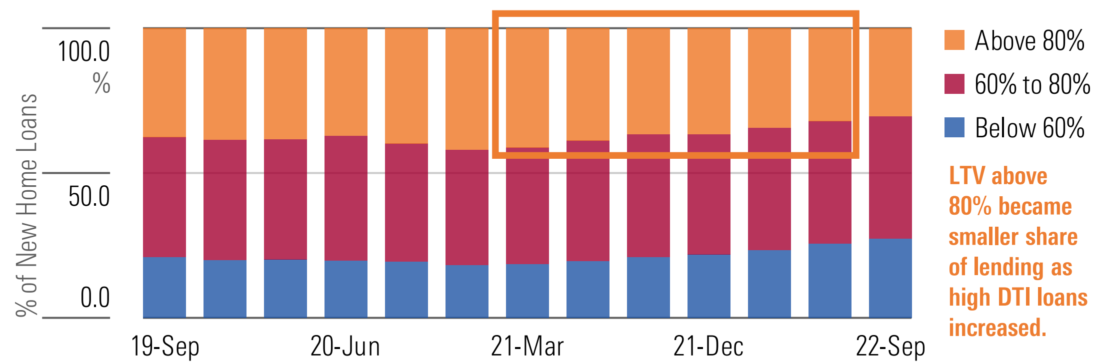
Higher-Risk Loans a Small Percentage of New Lending, but Risk Could Rise if Unemployment Jumps

Higher DTI Borrowers at Risk of Stress as Interest Repayments Jump



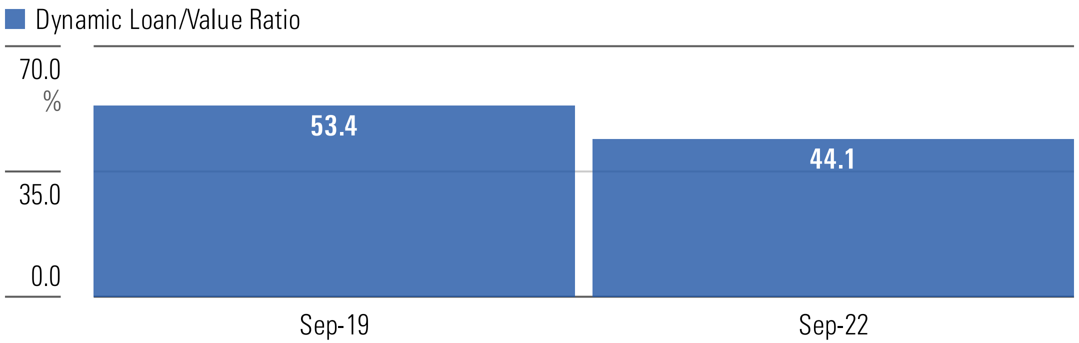
Source: Australian Prudential Regulation Authority
Note: DTI = debt to income ratios.

Borrowers With High Initial LTV Tend to Face Greater Repayment Difficulty



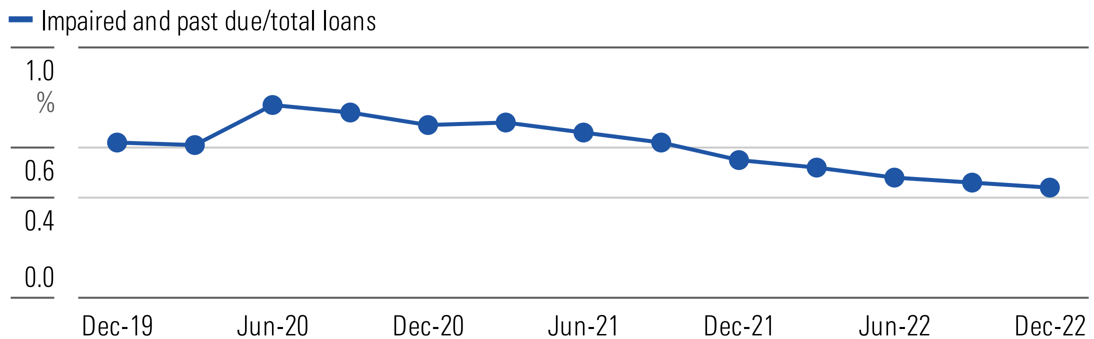
Source: Australian Prudential Regulation Authority

The Average Dynamic LTV Greatly Improved Since 2019



Source: Company reports, Major bank average. (Commonwealth Bank as of Dec. 31, 2022)

Impaired and Past Due Loans Set to Rise, but From Very Low Levels



Source: Company reports, Major bank average.

Fixed Rate Customers Face Material Increase in Repayments, but Serviceability Still Managable

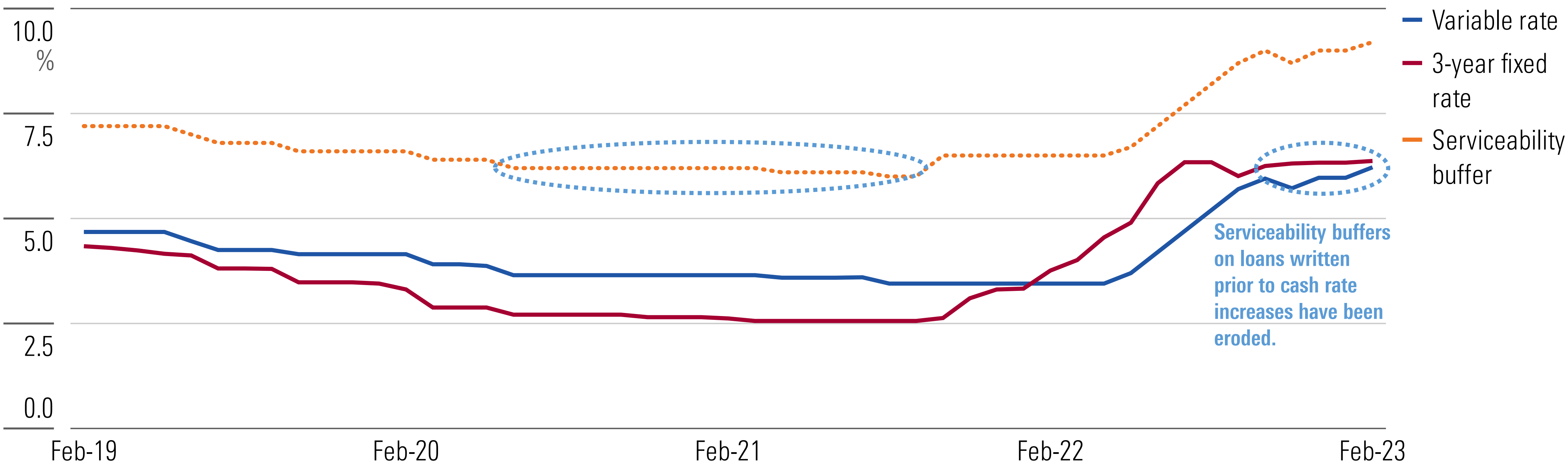
We expect households to cut back on spending, even perhaps below levels assumed by bank to assess loan serviceability. Discretionary purchases such as dining out, apparel, electronics, furniture, and so on, face headwinds.

We think most borrowers on fixed-rate loans can service higher rates. Borrowers refinanced to take advantage of cheap fixed rates; most did not borrow at capacity and would have dynamic LTVs well below 80%.

Payments in advance and savings provide time to remedy financial difficulty should a borrower struggle with higher interest costs or face lower income. Rising rents and wages help offset some of the pain for landlords.

Borrowers Likely Need To Cut Back on Discretionary Spending To Meet Higher Variable Repayments

Some borrowers may be unable to refinance given current serviceability tests, eroding customer bargaining power on rates.



Source: Reserve Bank of Australia.

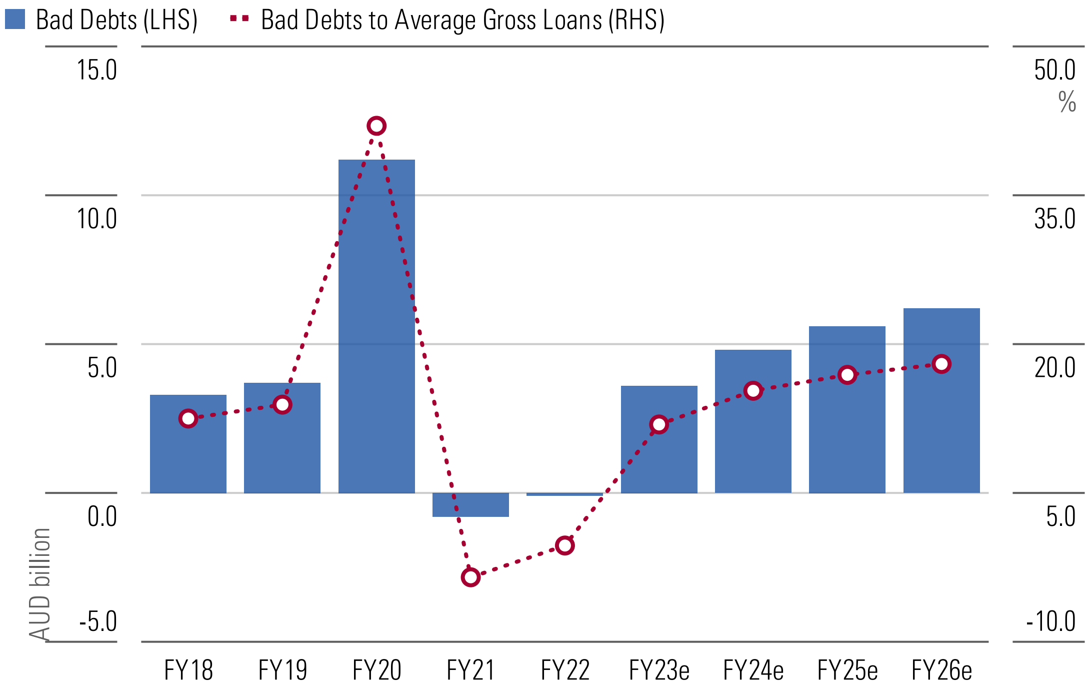
Bad Debts an Earnings Headwind After Two Years of Tiny Losses

Low unemployment, borrower equity buffers, and loans written on serviceability buffers of up to 3%, make a return to average loan losses more probable than a spike greatly above. Banks maintaining provisions as impairments normalise could elevate near-term bad debts but would be likely countered by a release of provisions later.

Provisions as a percentage of credit risk-weighted assets remain above 2019 levels. Prudently, banks remain cautious on how businesses and households manage higher rates, and the implications for economic growth and employment.

Major Bank Bad Debts Likely To Normalise but Unlikely to Spike

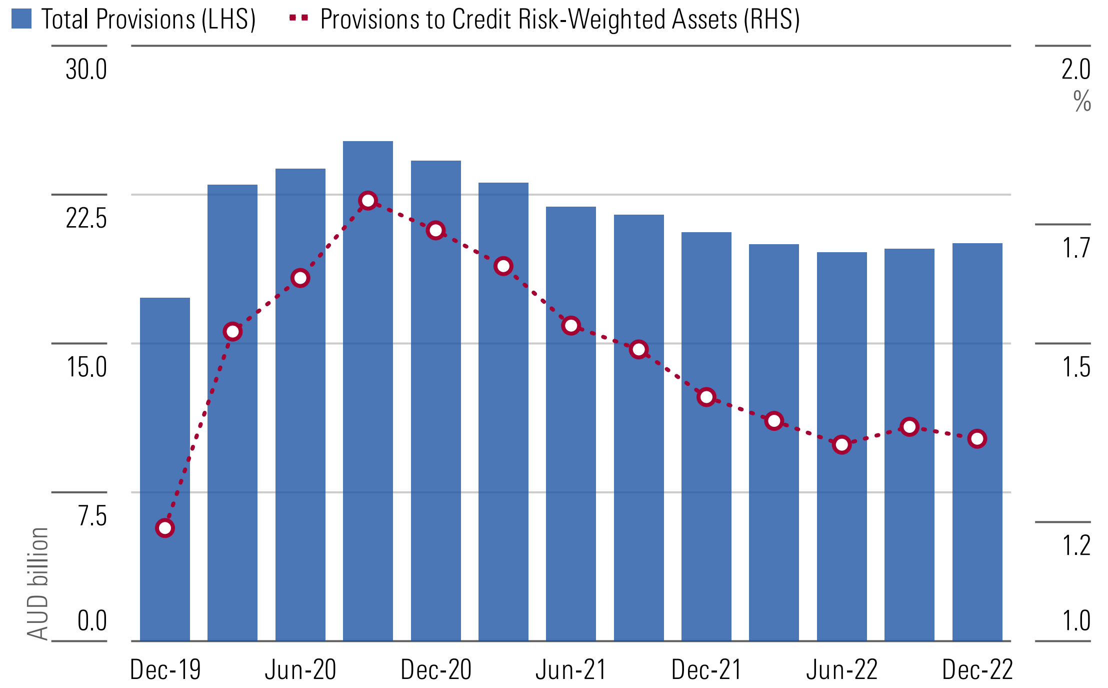
Total of major banks - bad debts include incurred losses and changes to provisions.



Source: Company reports, Morningstar. Data as of April 4, 2023.

Bank Provisions Provide Profit and Loss Buffer

Total of major banks - include collective and specific provisions.



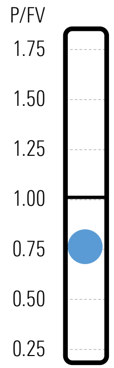
Source: Company reports..

Top Picks and Coverage

Most Australian banks trading below fair value.

Turnaround Stories Westpac and ANZ Are Top Picks; MyState Cheap as Market Overstates Margin Downside

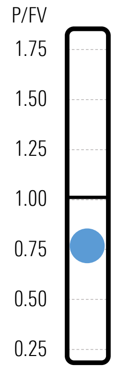
Australian Major Bank



Company (Ticker)	Market Cap	Rating	Last Close	FV Est.	Moat
Westpac Banking (WBC)	AUD 77 bn	★★★★	22.09	29.00	Wide

As the second-largest lender in Australia, we remain confident the funding cost advantages wide-moat-rated Westpac Banking enjoys will see a return to strong profits and returns on equity over time. Customer remediation, uplifting risk management and digital investment, and divesting nonbank businesses were costly and distracting. Not only did operating expenses rise as revenue was under pressure, but loan approval times were slow. Loan approval times (and loan growth) have already improved, but a rebasing of costs will take time. We think Westpac can maintain a dividend payout ratio of 70% which underpins an attractive fully franked dividend yield. The balance sheet is sound.

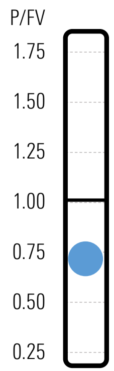
Australian Major Bank



Company (Ticker)	Market Cap	Rating	Last Close	FV Est.	Moat
ANZ Group (ANZ)	AUD 71 bn	★★★★	23.77	31.00	Wide

ANZ has lost material home loan market share, and having less funding sourced from low-cost household customer deposits, has incurred material margin pressure across the bank. We suspect shares do not factor in that rising cash rates help the bank's margins and process investments should make the wide-moat bank competitive again. While this comes with added operating expenses, it should help drive earnings growth and returns on equity. Suncorp Bank is expected to improve bank effeciency, but the acquisition and integration costs make it unlikely to be materially value-accretive.

Australian Nonmajor Bank



Company (Ticker)	Market Cap	Rating	Last Close	FV Est.	Moat
MyState (MYS)	AUD 0.4 bn	★★★★	3.73	5.20	None

MyState Bank is our pick of the no-moat-rated nonmajor banks, trading at a material discount to our fair value estimate. MyState commands a tiny 0.3% share of the Australian home loan market, but with investment in its digital offerings and expanded sales team, has demonstrated an ability to profitably grow loans. In fiscal 2022, the bank grew home loan balances by more than 25%, over three-times faster than the market. We expect market share gains to be more difficult, with cost inflation and rising wholesale funding costs affecting smaller banks more than major banks. While MyState will not benefit as much as the major banks from higher rates, due to a greater reliance on term deposits, it is still better placed relative to nonbank lenders. MyState focuses on lower risk owner-occupier borrowers with a loan/value ratio below 80%.

Source: Morningstar research. Data as of April 13, 2023

Westpac and ANZ the Cheapest of the Majors, With MyState Most Attractive of the No-Moat Nonmajor Banks

Company (Ticker)	Market Cap (AUD billion)	Moat Rating	Uncertainty Rating	Last Close	Fair Value Estimate	Star Rating	P/FVE	P/E	Yield	3-Mth Return	1-Year Return
ANZ Group (ANZ)	71.4	Wide	Medium	23.77	31.00	★★★★	0.77	9.8	6.4%	-2.9%	-12.8%
Commonwealth Bank of Australia (CBA)	165.7	Wide	Medium	98.22	87.00	★★	1.13	15.8	4.4%	-7.8%	-7.8%
National Australia Bank (NAB)	88.3	Wide	Medium	28.13	30.00	★★★	0.94	10.7	6.1%	-10.1%	-14.9%
Westpac Banking (WBC)	77.2	Wide	Medium	22.09	29.00	★★★★	0.76	11.1	6.1%	-7.0%	-9.1%
Major Banks (weighted avg)							**0.95**	**12.7x**	**5.5%**	**-7.3%**	**-10.5%**
Bendigo & Adelaide Bank (BEN)	5.0	None	Medium	8.79	10.20	★★★★	0.86	8.6	6.9%	-12.8%	-16.3%
Bank of Queensland (BOQ)	4.2	None	Medium	6.49	8.80	★★★★	0.74	7.6	6.9%	-7.9%	-23.9%
MyState Bank (MYS)	0.4	None	Medium	3.73	5.20	★★★★	0.72	9.6	6.5%	-7.7%	-24.3%
Nonmajor Banks (weighted avg)							**0.80**	**8.2x**	**6.9%**	**-10.4%**	**-20.0%**
AMP (AMP)	3.3	None	High	1.12	1.35	★★★★	0.83	21.3	0.0%	-17.1%	+6.2%
Macquarie Group (MQG)	69.1	Narrow	High	178.82	175.00	★★★	1.02	15.2	3.6%	+0.3%	-11.9%
Suncorp Group (SUN)	15.7	None	High	12.43	13.00	★★★	0.96	11.7	6.4%	+5.8%	+11.6%
Diversified Financials (weighted avg)							**1.00**	**14.8x**	**4.0%**	**+0.6%**	**-7.0%**

Source: Morningstar. Data as of Apr. 13, 2023.

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