Australian Banks: 2023 Q4

Margins falling but bank earnings still solid.

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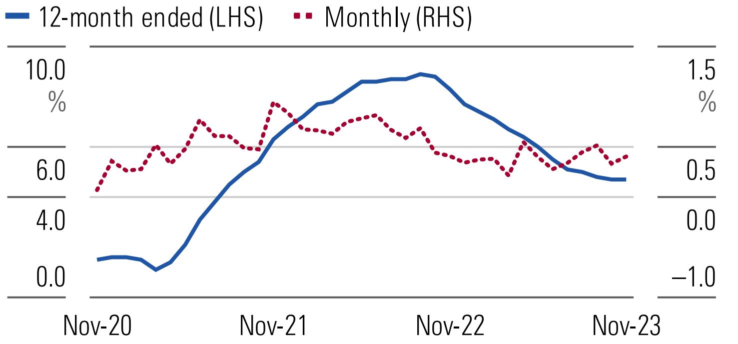
Executive Summary

Profits are robust despite margin and bad debt headwinds.

KEY TAKEAWAYS

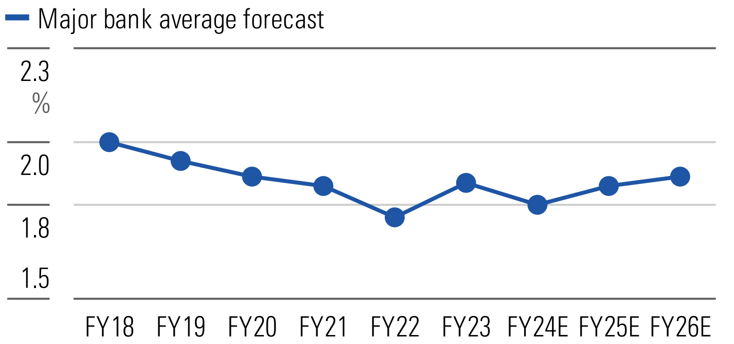
Higher Margins to Drive Earnings Despite Headwinds

Credit Growth: Expected to Remain Low



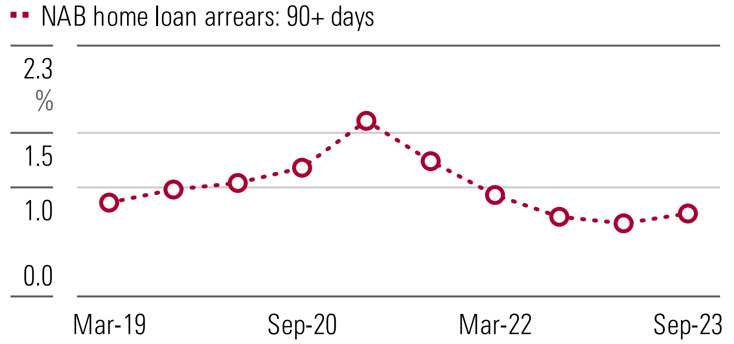
Source: Reserve Bank of Australia.

Net Interest Margins: Modest Recovery in 2025



Source: Company reports, Morningstar.

Bad Debts: Low Arrears and Banks Well-Provisioned



Source: National Australia Bank results presentation.

Credit growth has eased as higher interest rates and inflation reduce borrower capacity. Total growth slowed to an annualized 4.7% in the last three months and to 4.0% for housing, which makes up two-thirds of loans. We expect low-single-digit medium-term credit growth.

Our expectation of low credit growth is consistent with Reserve Bank of Australia forecasts for gross domestic product growth to average around 1.9% in fiscal 2024 and 2025. Rising house prices and drawdowns of savings add to total credit growth.

Net interest margins are softening because of competition in loan and customer deposit rates. Repayment of cheap Reserve Bank of Australia funding and higher refinancing levels are elevating competition. When banks had a back book of loans on much higher rates, cheaper loans to new customers could still deliver the bank strong returns overall. However, the difference in the average rate for new and existing loans has closed materially. We expect loan rates offered by banks will gradually increase to prevent return on equity from sliding below the cost of equity.

Loan loss risk is still elevated as borrowers face a material increase in interest payments. However, current arrears are below 2019 levels, borrowers have larger equity buffers, and banks hold extra bad debt provisions. Most borrowers have been able to cut discretionary spending to meet repayments where necessary. We gain significant comfort that loans were made with a 3% serviceability buffer, labor and rental markets are tight, and housing demand is spurring house price growth. Expired fixed-rate loans are performing in line with the rest of the home loan book.

VALUATION SNAPSHOT

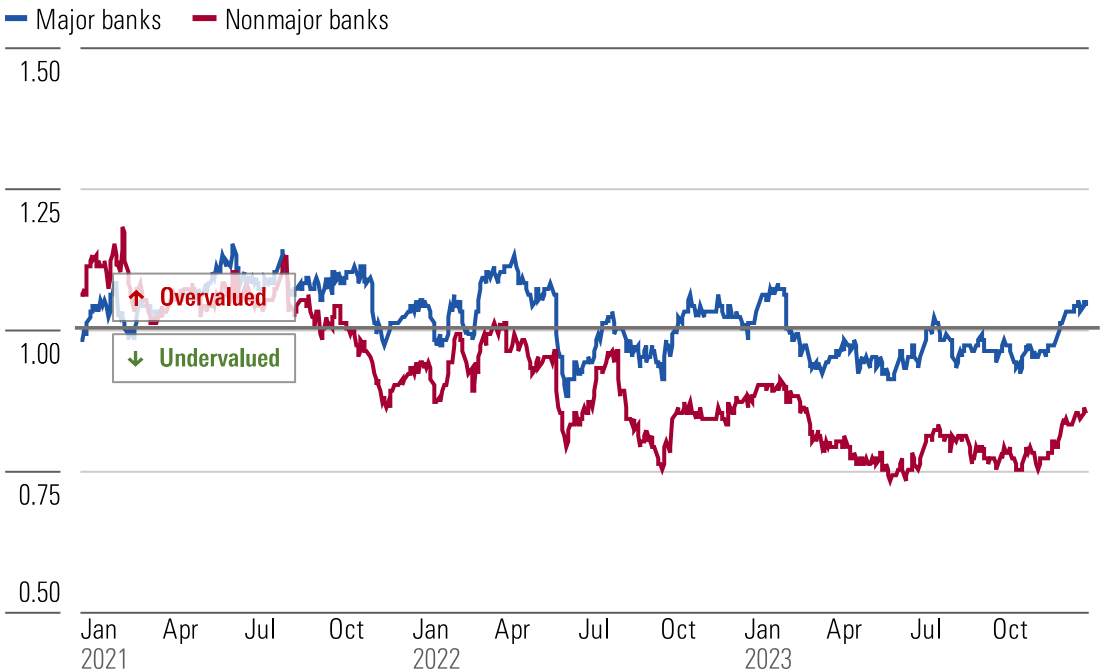
Major Banks Are Fairly Valued, Nonmajors Cheap

The weighted average price/fair value estimate of the major banks is 1.05, up from 0.97 in the last quarter. Nonmajor banks trade at a price/fair value of 0.85. Nonmajor bank net interest margins are squeezed by intense deposit and mortgage rate competition, but we expect an improvement as wide-moat major banks seek to improve returns.

Even after paying final dividends, on an average weighted basis, major bank share prices increased 7.9% in fourth quarter 2023 and 5.6% over the last 12 months. We see value in Westpac and ANZ Group. For Westpac, we think the share price overlooks the potential for the bank to lower its cost/income ratio and improve ROE, relative to peers.

Nonmajor Banks Need Deposit and Mortgage Rate Pressures to Ease

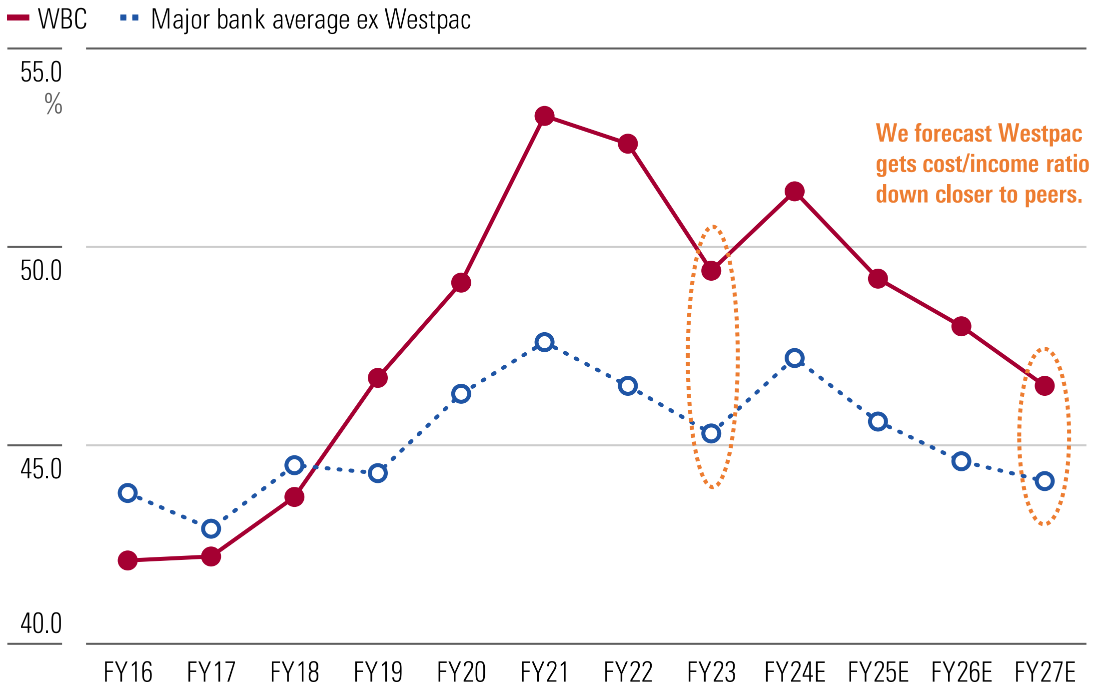
Weighted average price/fair value



Source: Morningstar. Data as of Jan. 12, 2024.

More Efficient Westpac Expected to Close the P/FVE of 0.83x

Cost/income ratio - operating expenses/total income



Source: Westpac, Morningstar.

Valuation

Opportunities remain as competition is likely to abate.

Australian Banks Are Undervalued

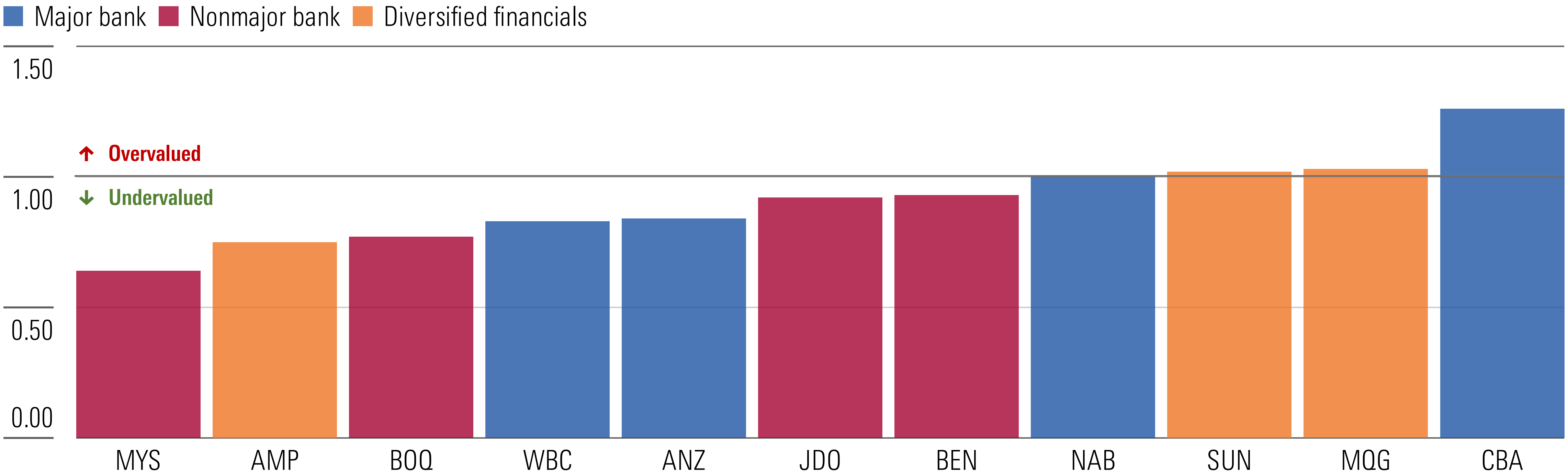
Westpac and ANZ Group are cheap: Both banks have addressed market concerns around lackluster loan growth, and the next catalyst will be the delivery of operating efficiency improvements.

Commonwealth Bank is expensive: On a forward P/E of almost 20 times and a fully franked dividend yield of just 4%, valuation metrics are stretched and leave little room for disappointment.

MyState is the cheapest: A higher risk proposition because of a weak competitive position, but industrywide loan and deposit repricing will support earnings growth. Loan growth and cost-efficiency gains are also expected.

Opportunities in Major and Nonmajor Banks

Price/fair value estimate ranking.



Source: Morningstar. Data as of Jan. 12, 2024.

VALUATION

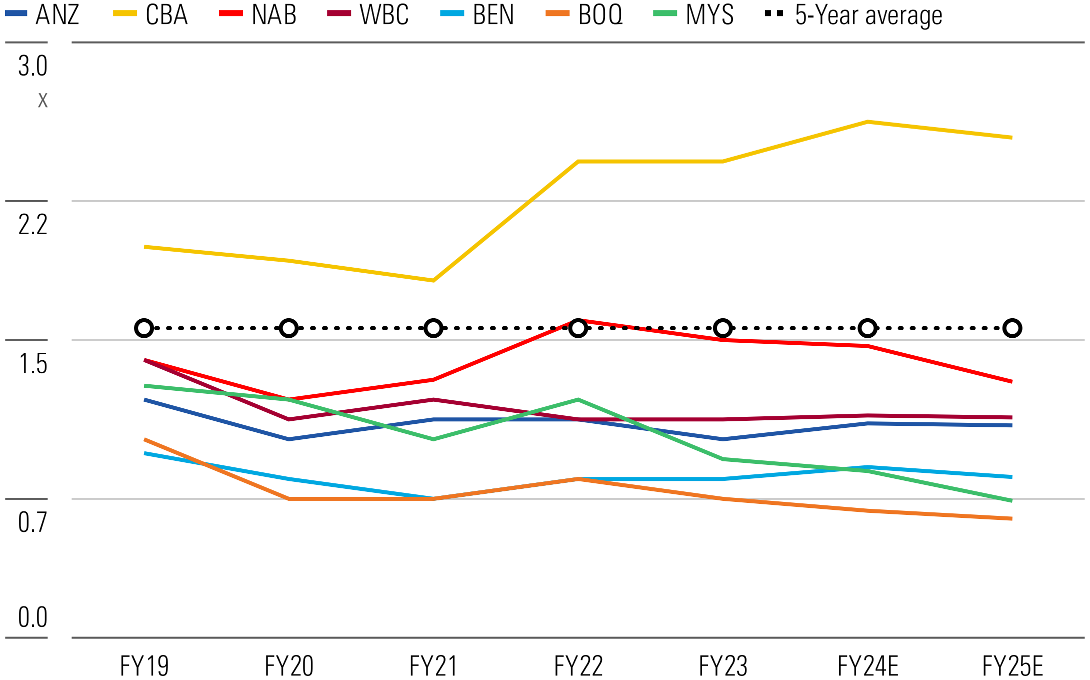
Dividend Yields Are Attractive Despite Higher Deposit Rates

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 Westpac and ANZ Bank hold market share and deliver earnings growth.

After resetting payout ratios, dividends can now grow in line with earnings. Share price weakness in most nonmajor banks has pushed dividend yields to attractive levels. Nonmajors have less cheap customer deposit funding, but the margin downside risk is now more than reflected in stock prices.

Price/Book Lower Across Most Banks

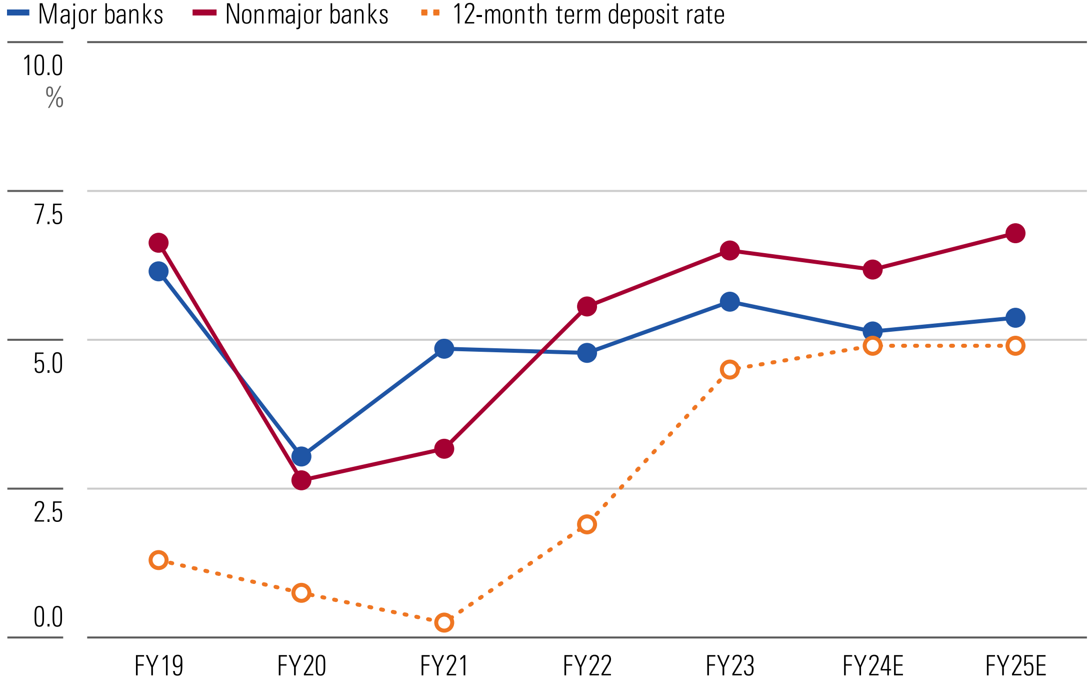
Five-year average is market-cap-weighted.



Source: Morningstar. Data as of Jan. 12, 2024.

Forward Dividend Yields Look Attractive

Forecast term deposit is based on average of major banks' advertised rate.



Source: Morningstar. Data as of Jan. 12, 2024.

Credit Growth

Consumer headwinds dampen credit demand growth.

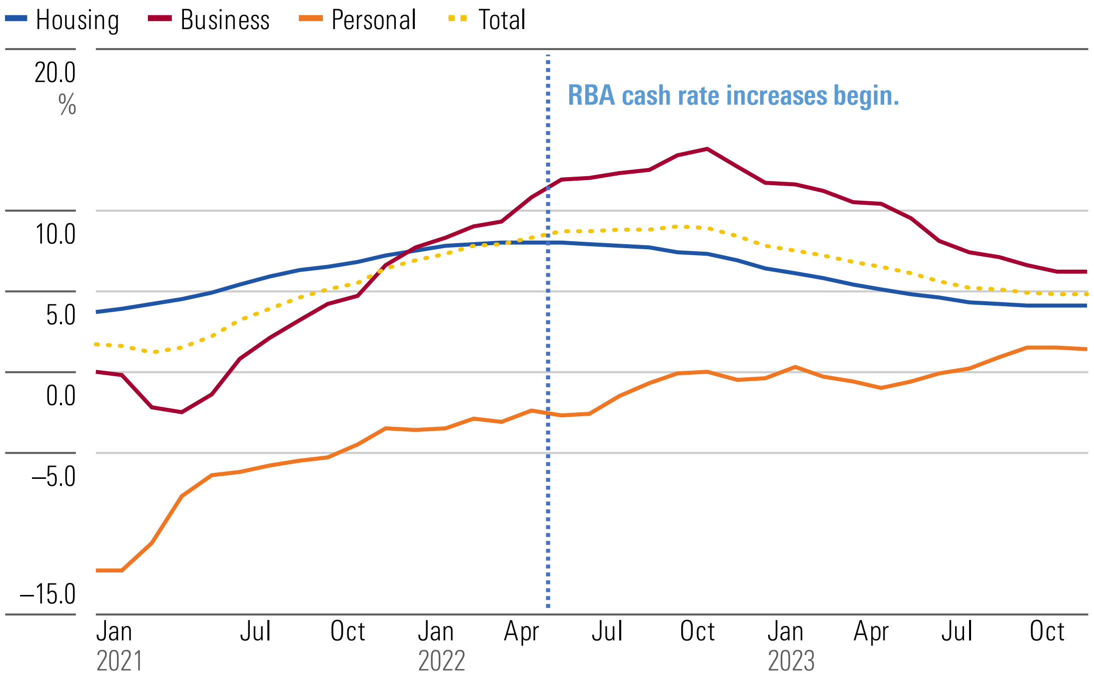
Weaker Consumer Spending to Slow Credit Growth

Trailing year housing credit growth grew 4% to the end of November 2023, with the downward trajectory continuing since the May 2022 peak of 8%. Reduced borrowing capacity remains a constraint on credit growth. With consumer spending slowing, businesses are more cautious about new investments.

Growth in personal credit likely reflects lower household savings balances and cost-of-living pressures. The lift in personal lending will have very little impact on total credit as it makes up just 4% of credit.

Credit Growth Set to Decline

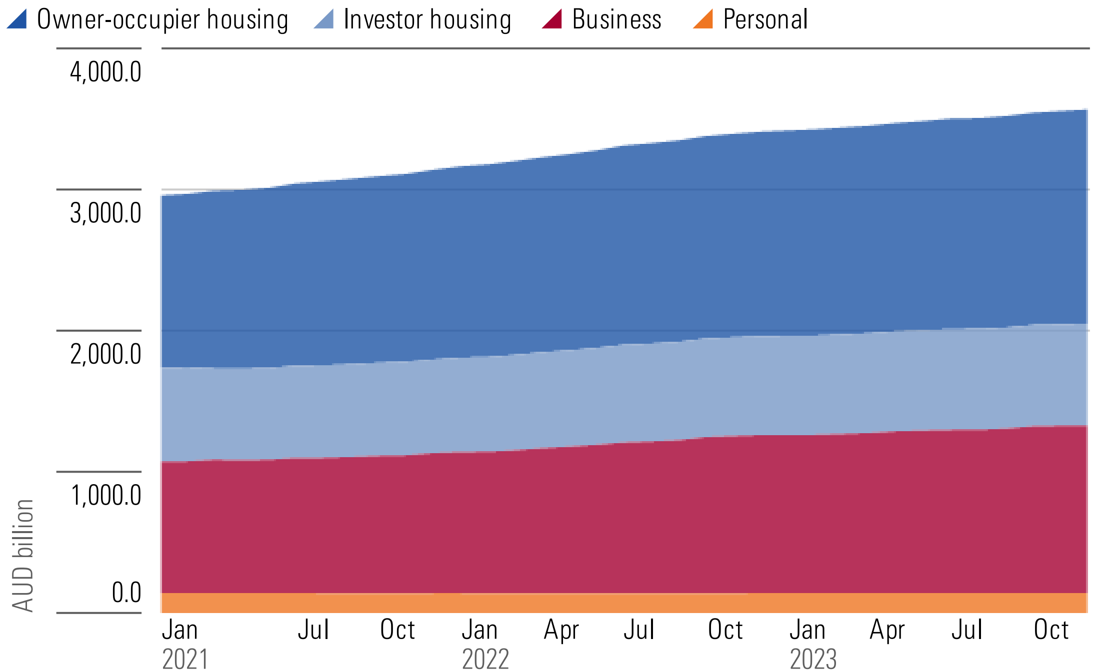
Australia credit growth by sector - 12 months ended November 2023.



Source: Reserve Bank of Australia. Data as of Nov. 30, 2023.

Housing Almost Two-Thirds of Outstanding Loans

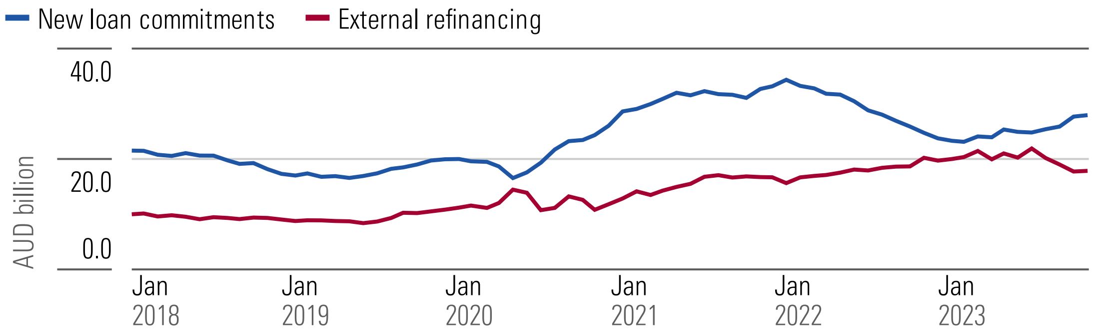
Australian credit by sector.



Source: Reserve Bank of Australia. Data as of Nov. 30, 2023.

Loan Demand Squashed by Higher Rates

Strong Refinancing and Slow Lending: Reduced Borrowing Capacity a Key Factor

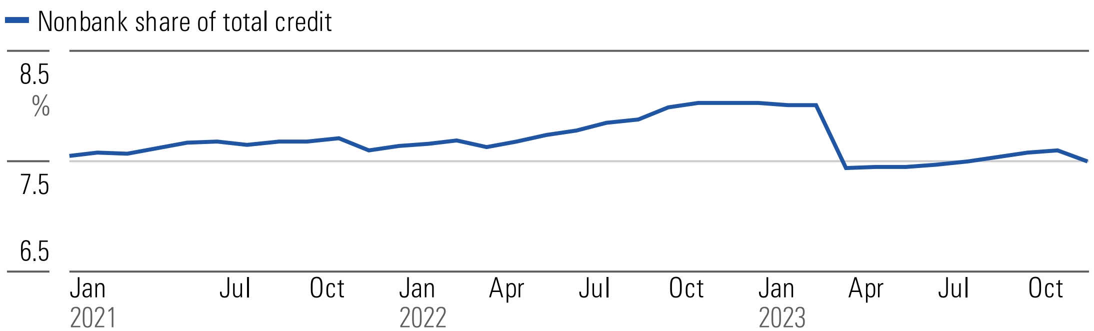


Source: Australian Bureau of Statistics. Data as of Nov. 30, 2023.
Note: New loan commitments exclude refinancing.

Slow loan growth is likely to continue after a low-rate binge. Interest rate increases weakened consumer confidence and significantly reduced borrowing capacity.

We expect refinancing activity to remain high in the first half of 2024 as a wave of fixed loans mature. This market dynamic, where banks are competing for a smaller pool of new loans, and fighting to retain existing customers, is also fueling intense competition on rates.

Nonbank Lenders Less Competitive: Reliance on Wholesale Borrowing Hurts Margins



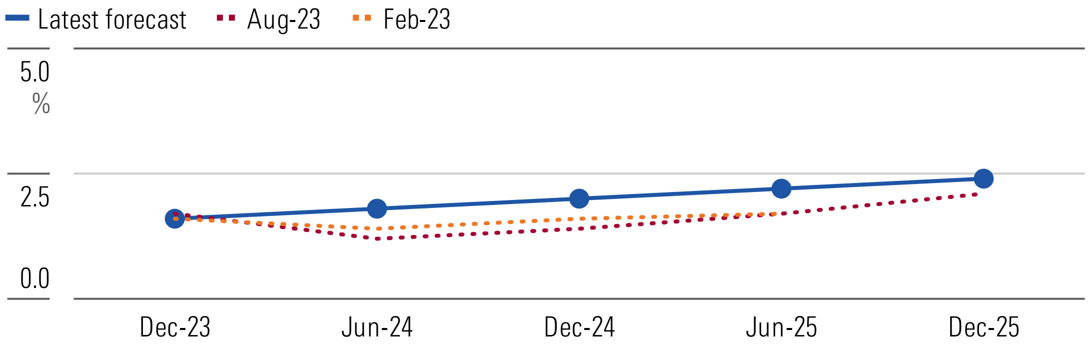
Source: Reserve Bank of Australia. Data as of Nov. 30, 2023.

Nonbank lenders could help fuel overall credit growth if rates fall. Nonbank lenders continue to lose share of total credit, making up 7.5% in November 2023 versus 8% in January 2023. In the 12 months to November 2023, nonbank credit contracted 2.3%.

Nonbanks are active in "low-doc" lending which majors no longer offer. Hence, nonbanks making credit more freely available could help lift overall credit growth as opposed to simply adding to competition.

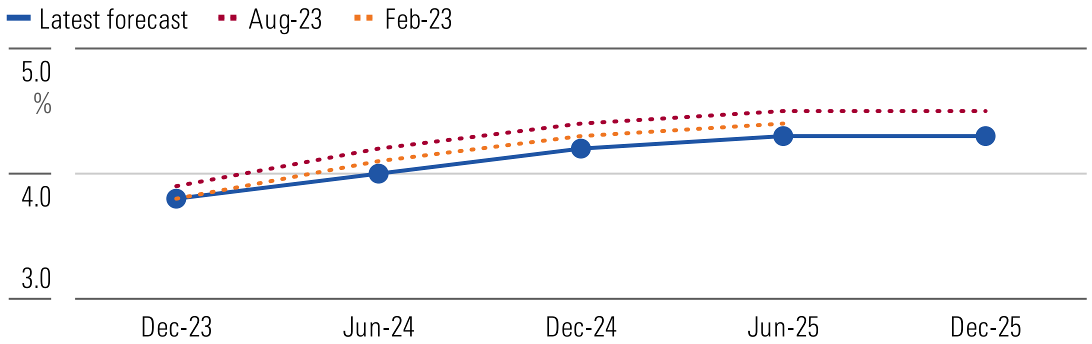
RBA Economic Growth Forecasts Imply Decent Backdrop for Banks

Moderate GDP Growth: Underpins Mid-Single-Digit Credit Growth



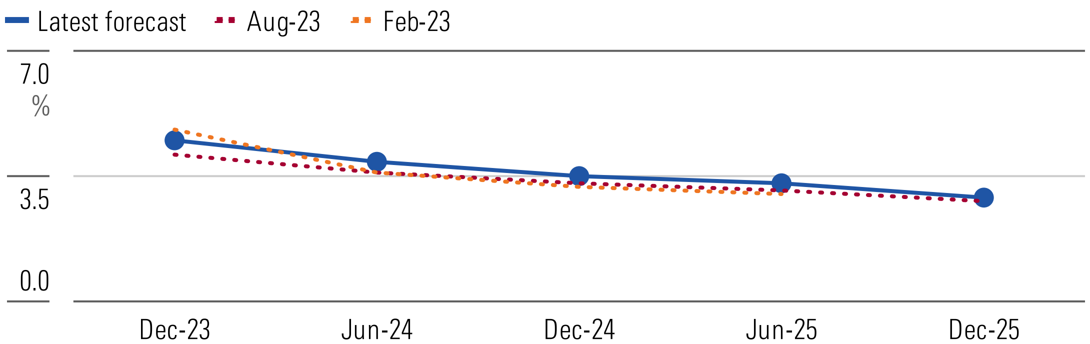
Source: Reserve Bank of Australia. Data as of Nov. 30, 2023.

Unemployment to Rise: Number of Borrowers in Distress to Increase



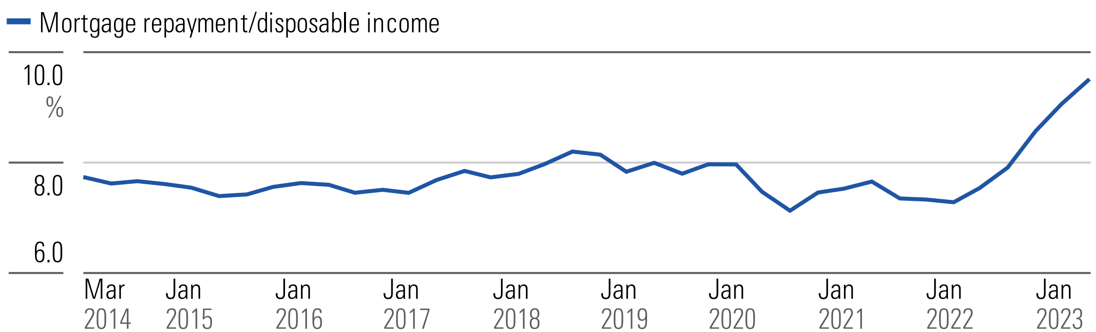
Source: Reserve Bank of Australia. Data as of Nov. 30, 2023.
Note: Unemployment Rate - quarterly %

Consumer Price Index Falling: Household Budget Strains Not Getting Materially Worse



Source: Reserve Bank of Australia. Data as of Nov. 30, 2023.
Note: CPI - % change over year to quarter

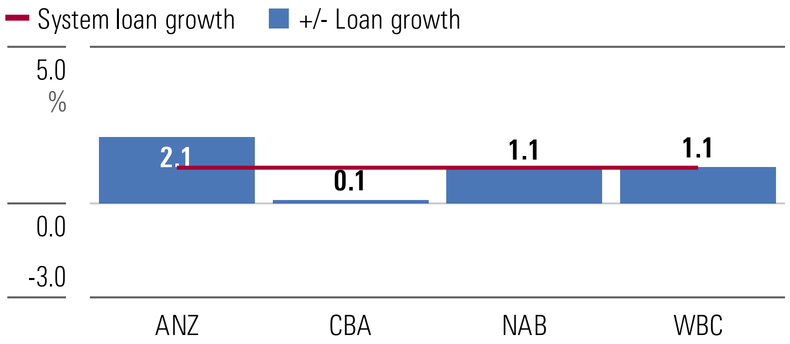
Mortgage Repayment/Household Income: Limits Borrowers From Increasing Leverage



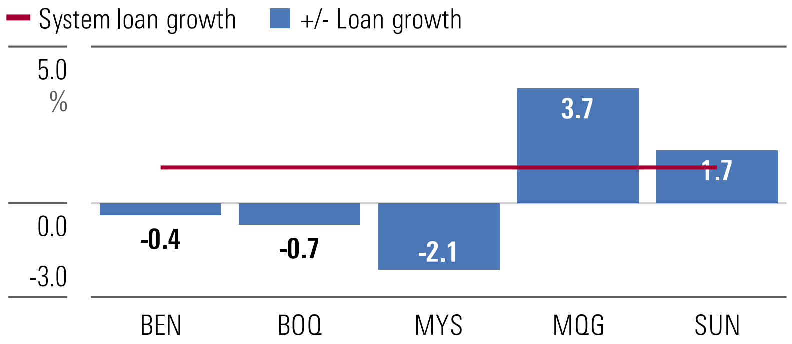
Source: Reserve Bank of Australia. Data as of June 30, 2023.

Housing Loans: Majors Split on Winning Share and Preserving Margins

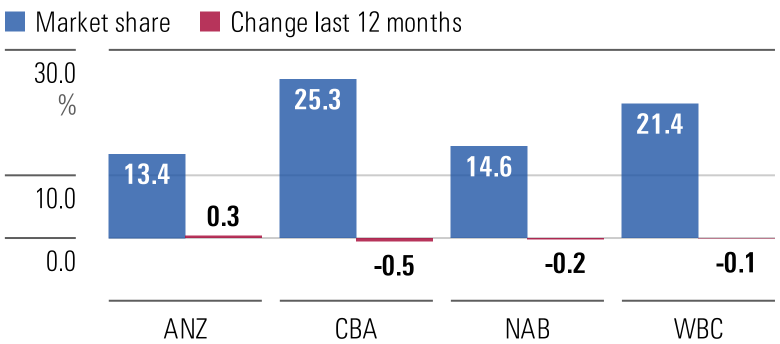
Majors' Housing Loan Growth Last Three Months*



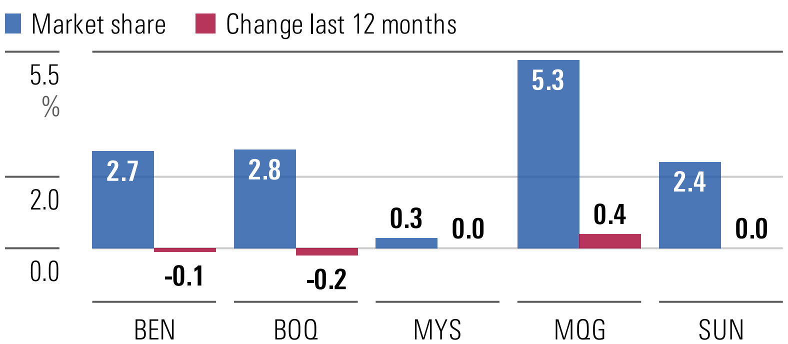
Nonmajors' Housing Loan Growth Last Three Months*



Major Bank Market Share



Nonmajor Bank Market Share



Source: Australian Prudential Regulation Authority, Morningstar. *Data for period ending Nov. 30, 2023.

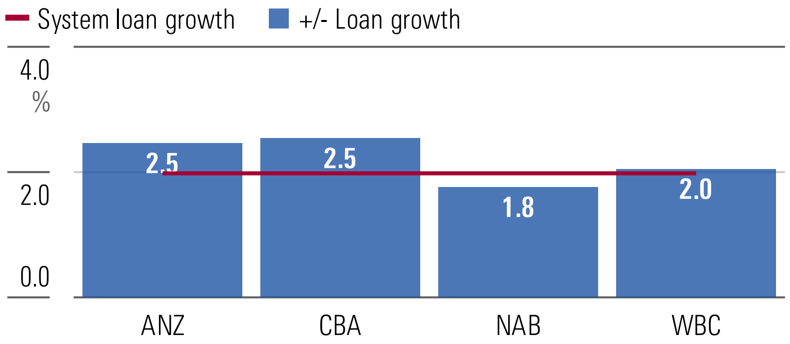
Based on Australian Prudential Regulation Authority data, home loan balances grew 1.1% in the quarter to November 2023. Annualized quarterly growth was 4.5%, down from 4.8% in the 12 months.

ANZ Bank continues to grow ahead of the market, driven by price and cash-back offers. In recent months Westpac and ANZ Bank modestly lifted rates, while Commonwealth Bank trimmed rates, narrowing the difference between the cheapest and most expensive major bank rates. This is expected to see loan growth of the major banks closer to the system in the coming months.

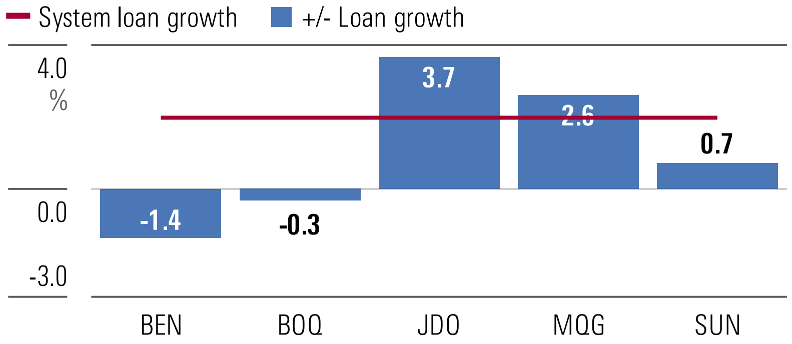
Macquarie returned to strong growth in the second half of 2023 once peers pulled cash-back offers. We expect Macquarie to take market share more slowly than the last three years, with a higher cash rate increasing funding costs, and internal return hurdles.

Business Loans: Loan Growth Stalls

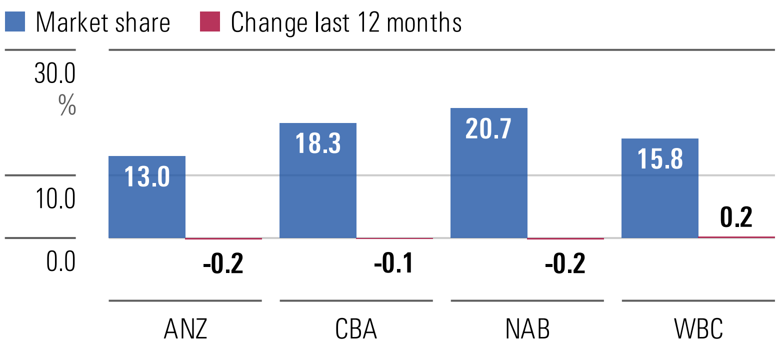
Majors' Business Loan Growth Last Three Months*



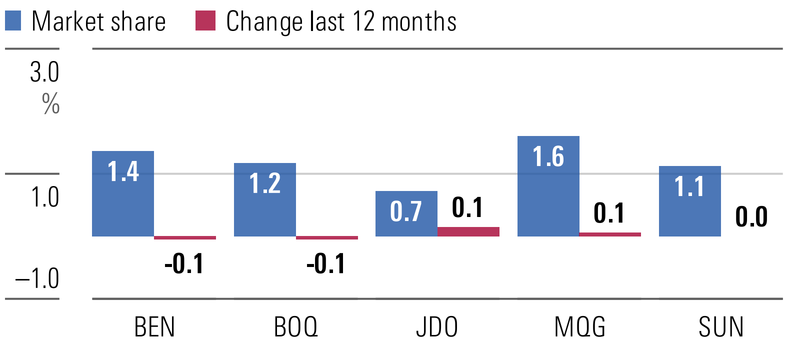
Nonmajors' Business Loan Growth Last Three Months*



Major Bank Market Share



Nonmajor Bank Market Share



Source: Australian Prudential Regulation Authority, Morningstar. *Data for period ending Nov. 30, 2023.

Based on APRA data, business loan balances grew 2.0% in the quarter to November 2023, an annualized rate of 7.9%. Growth has, as we expected, slowed after running at 16% annualized in the August 2022 quarter.

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

Market share changes in the last 12 months are modest. After taking market share via competitive pricing between 2020 and mid-2023, Commonwealth Bank's focus on margins has seen most of the share gains given back.

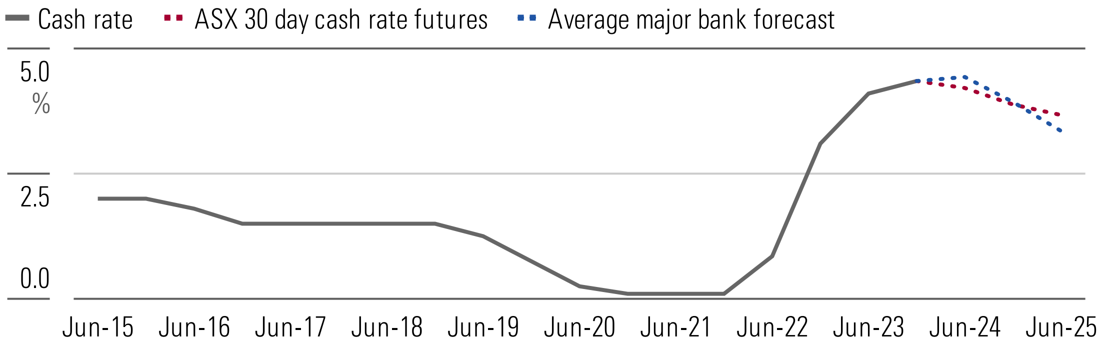
Judo Capital's focus on customer service offerings, including a dedicated banker and fast approvals, is expected to deliver more market share gains.

Interest Margins

Competitive pressure on funding costs and lending rates.

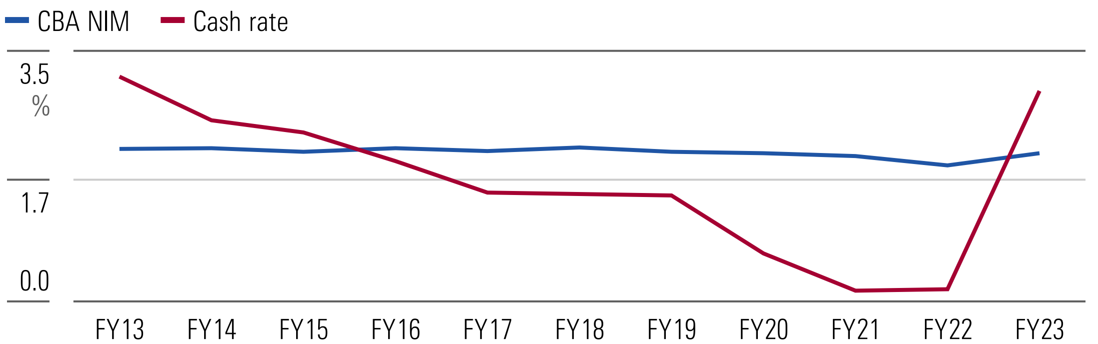
Rate Rises Likely Near an End

RBA Cash Rate: Expectations of Easing Bolstered by Recent CPI Numbers



Source: RBA, ASX, Major bank average is CBA, WBC, NAB. Data as of Jan. 12, 2024.

CBA NIM Relative to Cash Rate: Competition and Industry Returns are More Important



Source: Commonwealth Bank, RBA, Morningstar. Data as of Jan. 12, 2024.

The cash rate is forecast to be below 4% in 2024. The cash rate has risen to 4.35% from 0.10% in May 2022, as high inflation necessitated a fast and material increase in rates.

The RBA seeks to return inflation to the 2%-3% target and forecasts the Consumer Price Index eases to 3.5% because of higher interest rates. ASX 30-day futures and major bank economists expect the RBA cash rate will begin lowering the cash rate in 2024.

The 3.4% midpoint of economist expectations for the cash rate target by June 2025 portends low credit growth, decent margins, and manageable bad debts for the major banks.

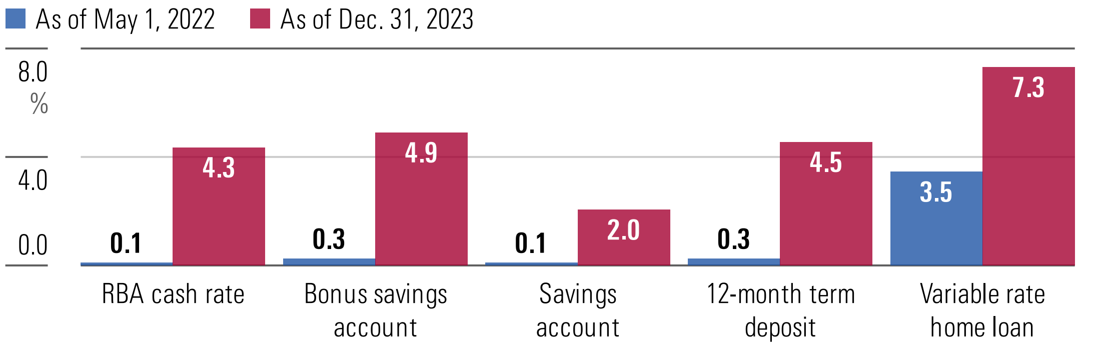
Higher rates are generally more favorable for margins. Having some funding not increase by as much as lending rates (or not at all), all else equal, is positive for banks.

However, competition is important. Banks aim to manage both lending and deposit rates to ensure a NIM that delivers an adequate return on equity. Higher-than-normal refinancing activity, slow overall credit growth, and funding maturities are current headwinds.

In the second half of 2023, major banks on average lifted advertised home loan rates by 20 basis points more than RBA cash rate increases, and some term deposit rates were trimmed. We see tentative signs of a focus shift from volumes to margins.

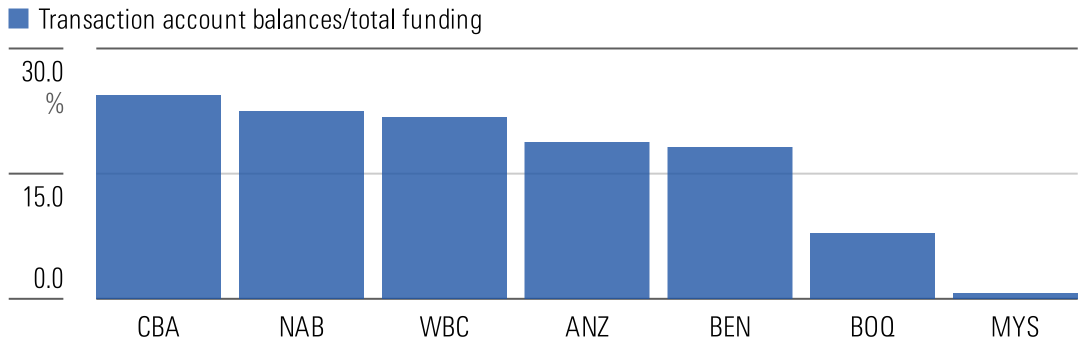
Banks Benefit From Cheap Deposits, but Customers Seek Higher Rates

Rate Increases: Deposit Rate Increases Outpaced Lending Rate Rises



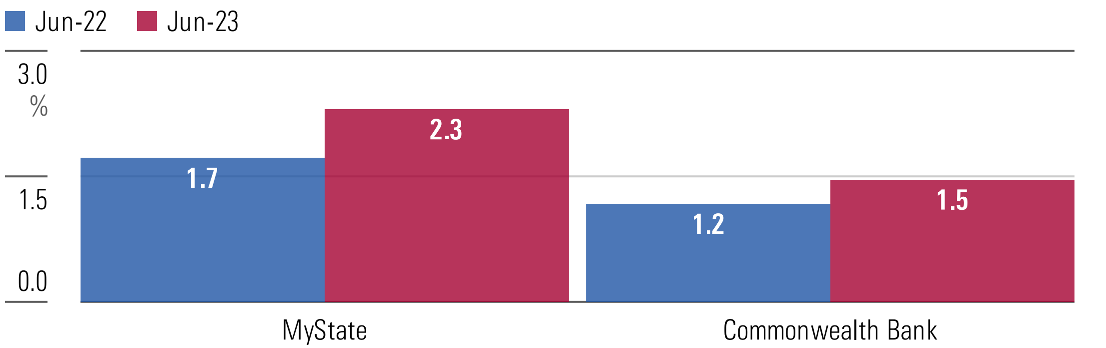
Source: Reserve Bank of Australia, Morningstar.

Deposit Funding: Banks With Low-Cost Deposits Best Placed to Compete



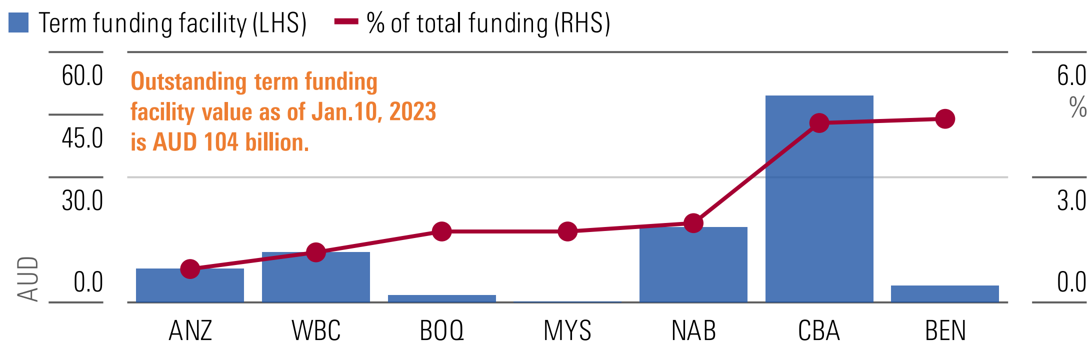
Source: Company reports, Morningstar.

Average Deposit Rate: Banks Reliant on Term Deposits Hurting Most



Source: Commonwealth Bank and MyState company reports, Morningstar.

Term Funding Facility: Repayment a Headwind for Deposit Competition Fiscal 2024



Source: Company FY23 reports, Morningstar.
Note: CBA and BEN data as of June 2023 compared with September 2023 for other major banks.

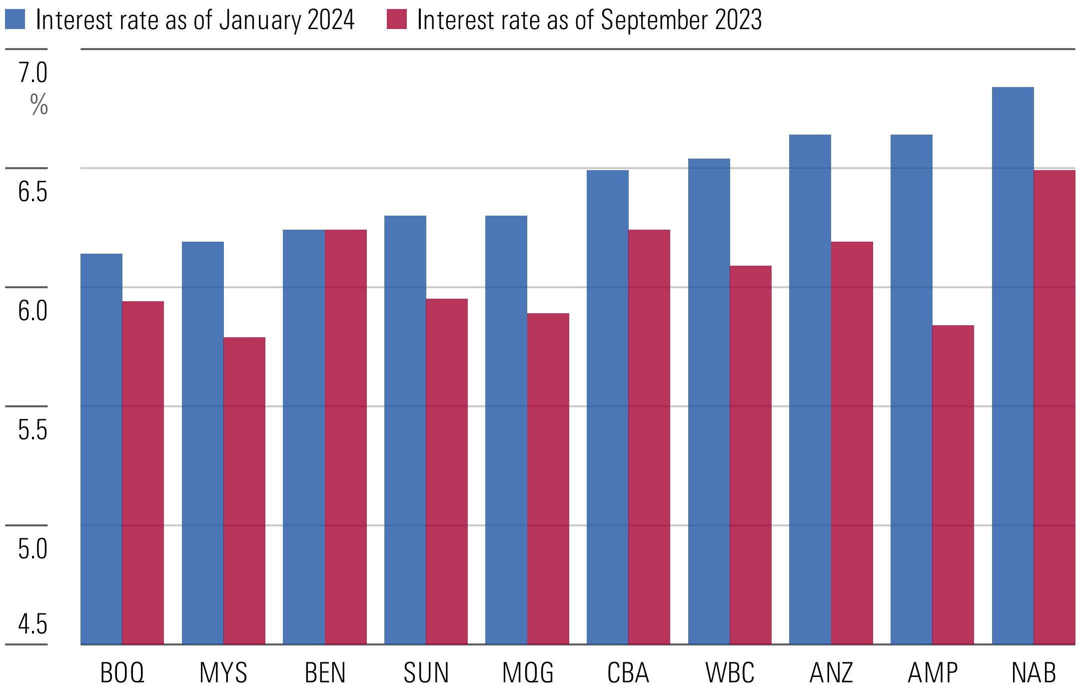
Home Loan Rates Are Higher, but Discounts Dampen Margins

While competition remains intense, the major banks appear to be leading an increasing focus on managing margins. Westpac and ANZ Bank are no longer among the banks offering the cheapest rates. In the last six months, advertised rates have on average increased by 0.7%, more than the 0.5% increase in the cash rate over the same period.

APRA data suggests the spread between rates on outstanding loans and new loans is now below pre-COVID levels of 30 basis points, with banks focused on client retention as fixed-rate loans mature. The gap largely closed as existing clients were given discounts, but new lending rates also lifted modestly in recent months.

Owner-Occupier Variable Rates Slowly Moving Higher Independent of Cash Rate

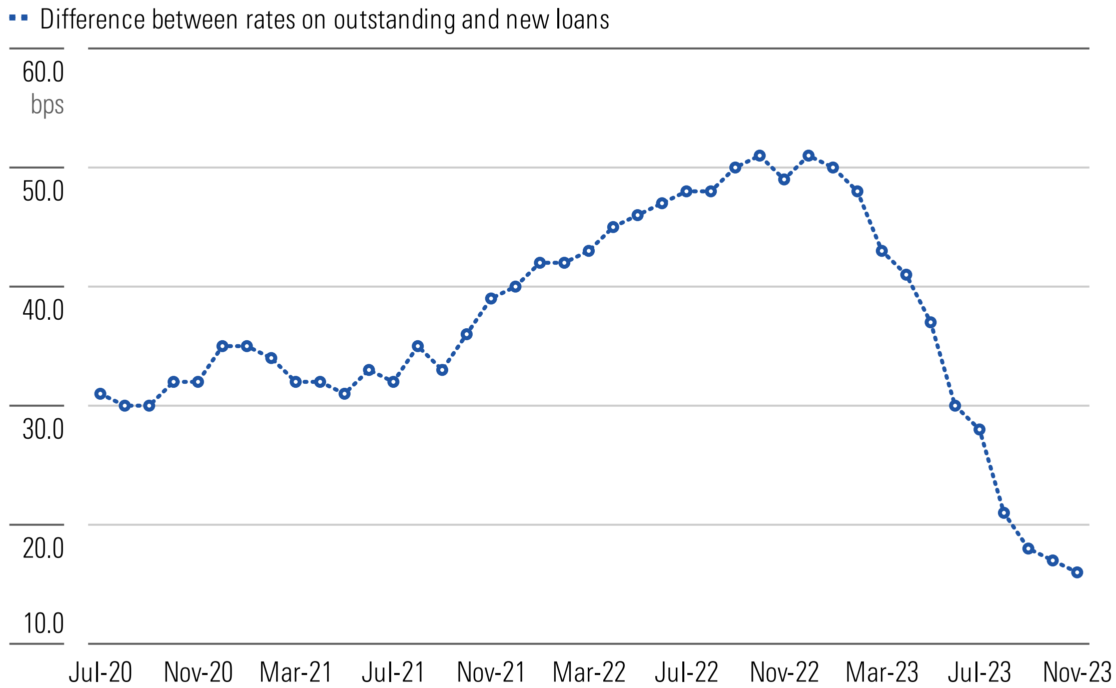
Variable rate: owner-occupier—principal and interest—loan/value ratio below 80%.



Source: Company websites, Morningstar. Data as of Jan. 1, 2024.

Discounts Shrink for New Borrowers Despite Slowing Credit Growth

Rate differences for outstanding and new variable owner-occupier housing loans.



Source: Reserve Bank of Australia, Morningstar.

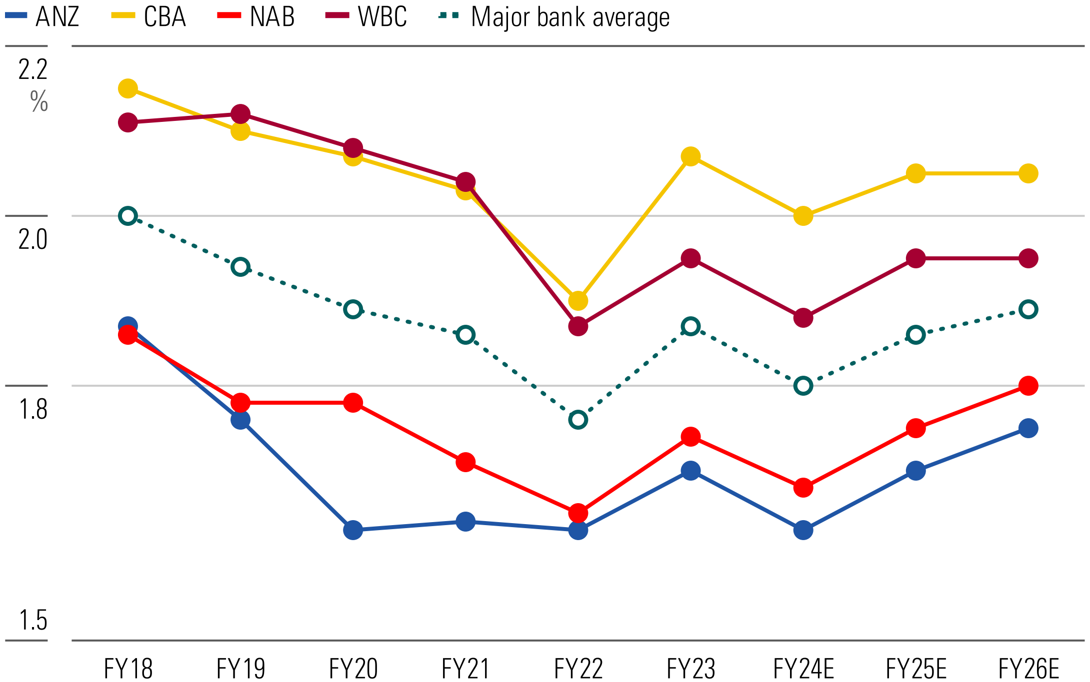
Banks Set to Hold Most of the Recent Margin Gains

Net interest margins likely peaked in first-half fiscal 2023 and are expected to fall in fiscal 2024. We still expect competition for loans and deposits to ease as banks focus on margins. Once the Term Funding Facility is repaid, we expect banks to begin to lower rates on saving accounts and term deposits.

With higher NIMs and low-single-digit loan growth, we forecast banks' net interest income to grow 4% per year to fiscal 2026. Net interest income makes up 80% to 85% of revenue. While bad debts are likely to rise, we anticipate cost containment to allow cash profits to grow broadly with revenue. Solid equity returns support our wide-moat ratings.

NIM Rebound Likely to Flatten Out

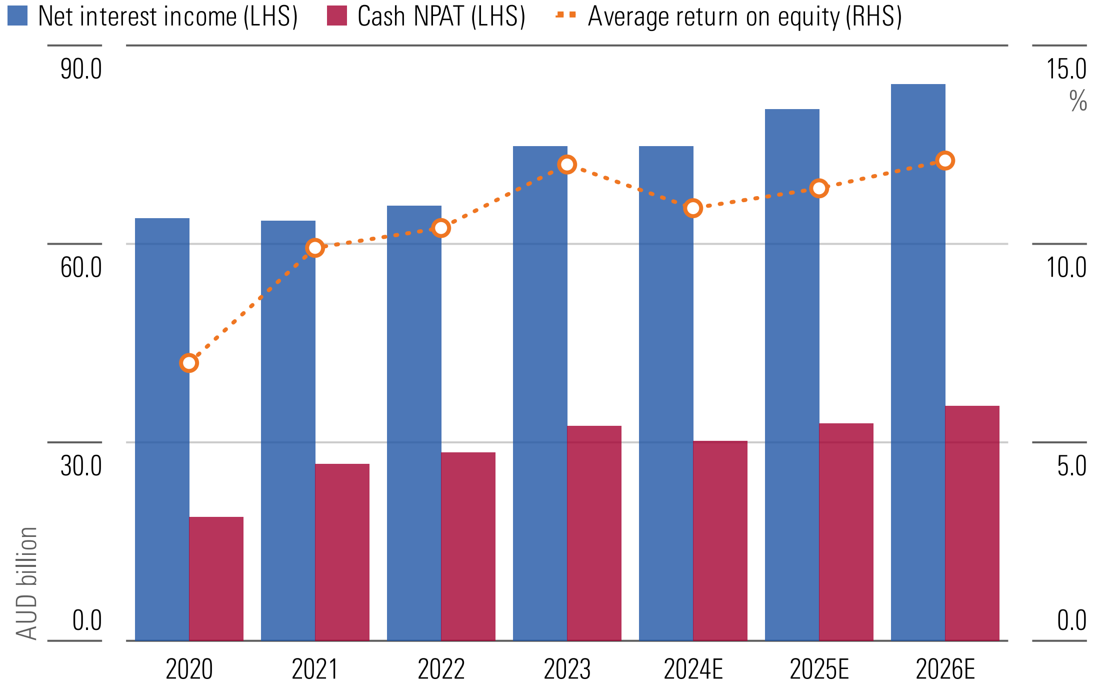
Morningstar NIM forecasts based on fiscal period.



Source: Company reports, Morningstar estimates. Data as of Jan. 12, 2024.

Net Interest Income Growth Key to Our Profit Forecasts

Total of major banks.



Source: Company reports, Morningstar. Data as of Jan. 12, 2024.
Note: NPAT = net profit after tax.

Capital and Credit Risk

Banks well-capitalized for higher bad debts.

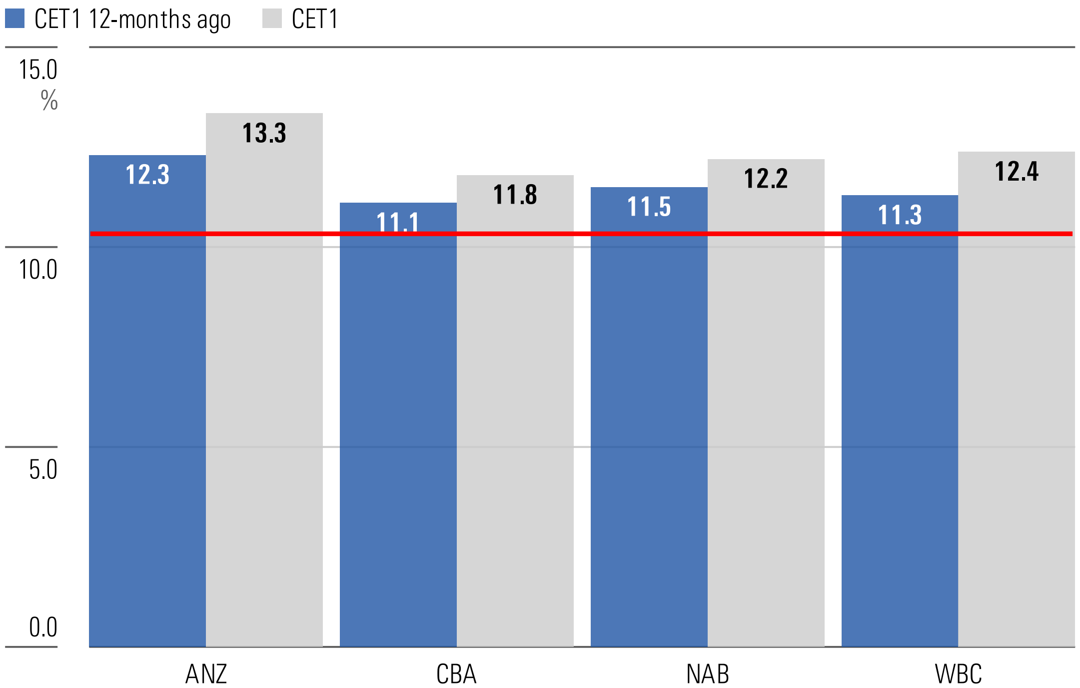
Bank Balance Sheets Are Sound

Major banks comfortably meet capital requirements. The regulatory minimum common equity Tier 1 ratio is 10.25%, but APRA expects the majors to operate at 11% to ensure flexibility to deal with adverse conditions and for financial system resilience. ANZ Bank figures include equity raised to acquire Suncorp Bank.

Banks are likely to take a conservative approach to balance sheet risk and capital management given the prevailing economic and regulatory uncertainty. Despite this, ANZ Bank is the only bank not actively buying back shares.

Major Banks Exceed Regulatory Capital Requirements

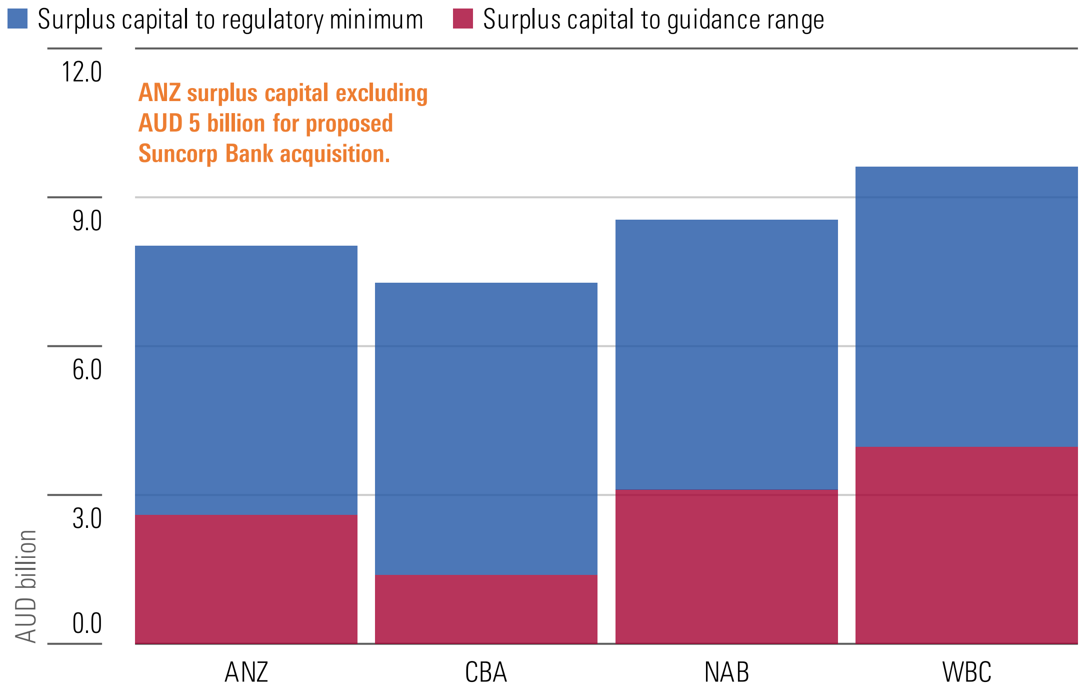
Latest CET1 ratio compared with 12 months prior and 10.25% regulatory minimum.



Source: Company reports. Data as of Sept. 30, 2023.
Note: CET1 = common equity Tier 1 ratios.

Major Banks Have Substantial Surplus Capital

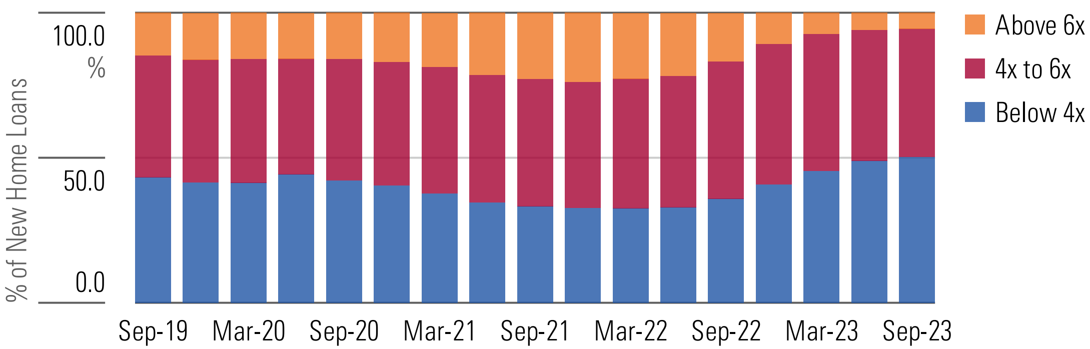
Each major bank has surplus capital to target range.



Source: Morningstar, Company reports. Data as of Sept. 30, 2023.
Note: Surplus to regulatory minimum assumes CET1 of 10.25%, guidance range assumes target of 11.5%.

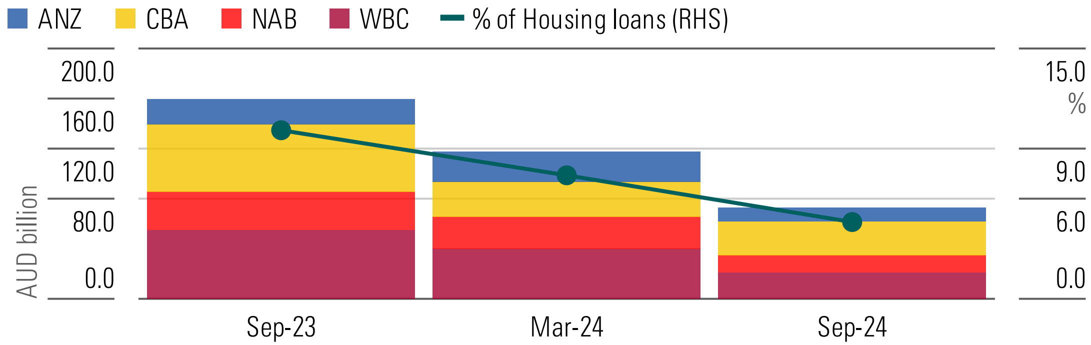
Higher-Risk Loans Relatively Modest and Arrears Low

Higher DTI Loans: Late 2021 and 2022 Borrowers at Greatest Risk of Stress



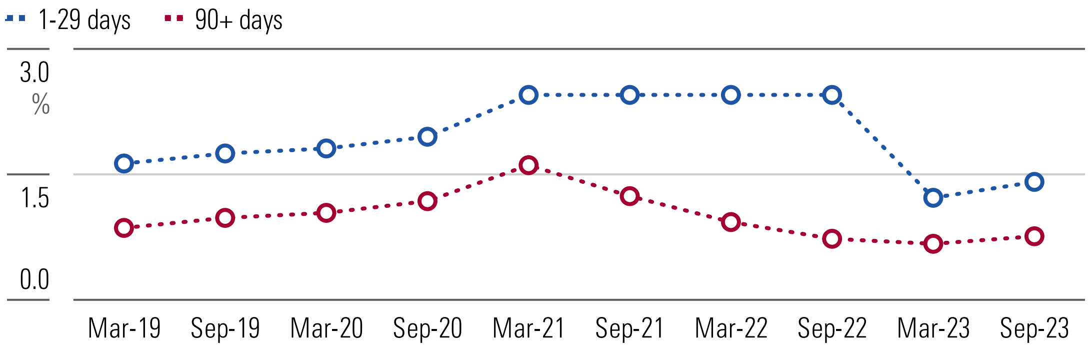
Source: APRA
Note: DTI = debt/income ratio.

Fixed Rate Mortgages: Large Share of Ultra-Cheap Loans Have Matured



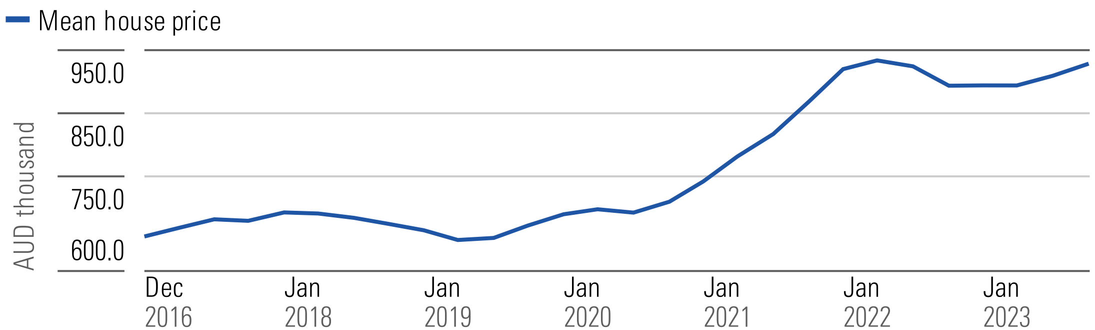
Source: Company reports.

National Australia Bank Home Loan Arrears: Rising but From Low Levels



Source: National Australia Bank result presentation.

House Prices: Recovery Provides Equity Buffers and Limits Bank Losses



Source: Australian Bureau of Statistics. Data as of Nov. 30, 2023.

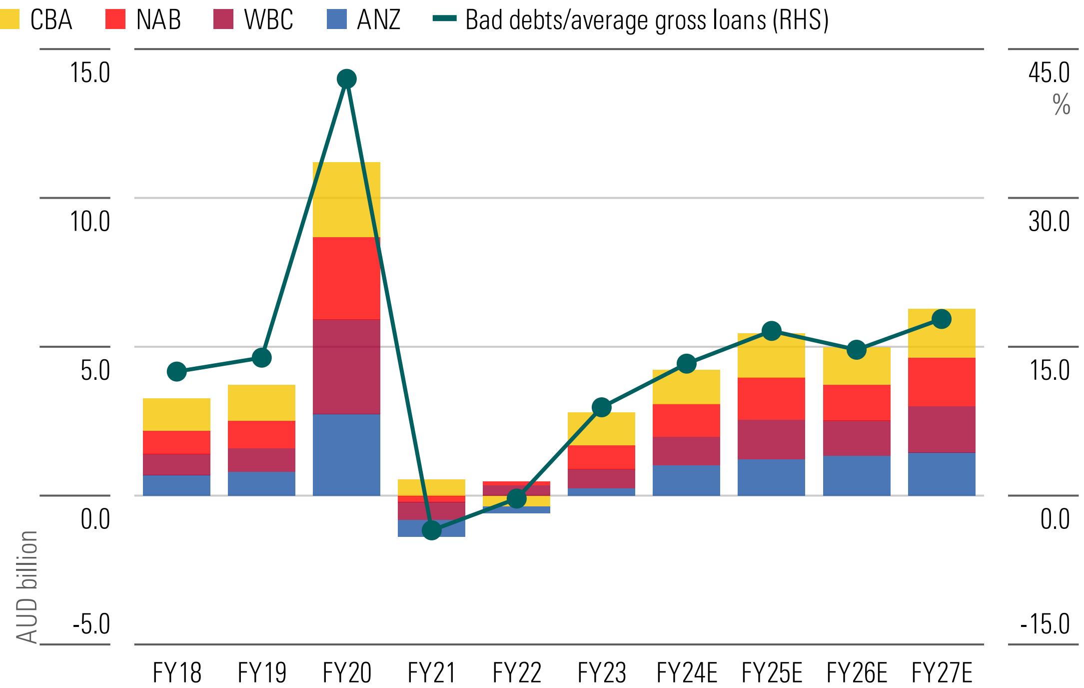
Bad Debts Becoming an Earnings Headwind

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. Banks maintaining provisions as impairments rise could elevate near-term bad debts, but this would likely be countered by the eventual release of provisions in fiscal 2026.

Provisions as a percentage of credit risk-weighted assets remain above 2019 levels. Prudently, banks are cautious about how businesses and households manage higher rates and the implications for economic growth and employment. Arrears are yet to move materially and are still below historical averages.

Major Bank Bad Debts Set to Normalize, Not Spike

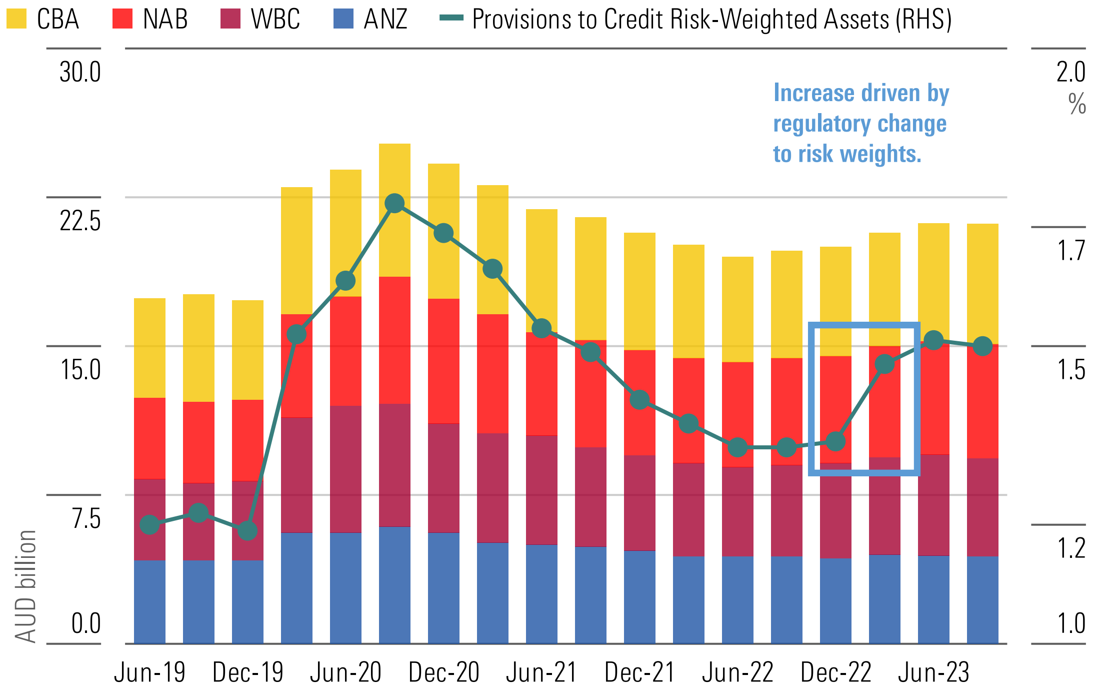
Bad debts (LHS) include incurred losses and changes to provisions.



Source: Company reports, Morningstar. Data as of Sept. 30, 2023.

Bank Provisions Provide Profit and Loss Buffer

Provisions (LHS) include collective and specific provisions.



Source: Company reports. Data as of Sept. 30, 2023.

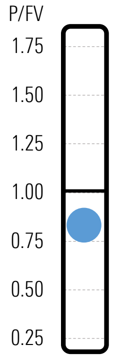
Top Picks and Coverage

Most Australian banks are undervalued.

TOP PICKS

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

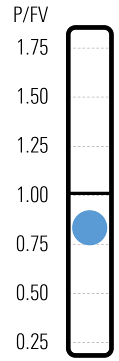
Australian Major Bank



Company (Ticker)	Market Cap	Rating	Last Close	FV Est.	Moat
Westpac Banking (WBC)	AUD 81 bn	★★★★	23.20	28.00	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.

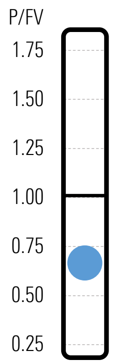
Australian Major Bank



Company (Ticker)	Market Cap	Rating	Last Close	FV Est.	Moat
ANZ Group (ANZ)	AUD 78 bn	★★★★	25.90	31.00	Wide

ANZ Bank 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. Process investments should make the wide-moat bank more competitive in home lending. While this comes with added operating expenses, it should help drive earnings growth and returns on equity. Suncorp Bank is expected to improve bank efficiency, but the acquisition and integration costs make it unlikely to be materially value-accretive.

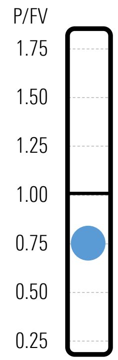
Australian Nonmajor Bank



Company (Ticker)	Market Cap	Rating	Last Close	FV Est.	Moat
MyState (MYS)	AUD 0.4 bn	★★★★★	3.20	4.80	None

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. 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 margins will likely fall more than major banks due to rising customer deposit funding, 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%.

Australian Nonmajor Bank



Company (Ticker)	Market Cap	Rating	Last Close	FV Est.	Moat
Bank of Queensland (BOQ)	AUD 3.9 bn	★★★★	6.00	8.00	None

We expect Bank of Queensland's medium-term earnings recovery to be driven by net interest margin improvement as industry competitive pressures ease and the bank extracts cost savings from consolidating banking platforms and digitizing more processes. Bad debts are almost certain to rise, but we take comfort that recent loan growth has not been driven by compromised lending standards. Increased exposure to home loans outside of Queensland is also helping to diversify risk. Our long-term bad debt/loans forecast of 12.5 basis points is below the 10-year average of 16.0 basis points, driven by changes in the mix of loans.

Source: Morningstar. Data as of Jan. 12, 2024.

Westpac Cheapest of the Majors, With More Value in 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
Westpac Banking (WBC)	81.3	Wide	Medium	23.2	28.0	★★★★	0.83	11.8	6.3%	+7.2%	-1.3%
ANZ Group (ANZ)	77.7	Wide	Medium	25.9	31.0	★★★★	0.84	11.9	6.3%	+0.2%	+6.8%
National Australia Bank (NAB)	96.5	Wide	Medium	30.9	31.0	★★★	1.00	13.0	5.4%	+4.6%	+0.4%
Commonwealth Bank of Australia (CBA)	190.3	Wide	Medium	113.6	90.0	★★	1.26	19.4	4.1%	+11.8%	+8.0%
Major Banks (weighted avg)							**1.05**	**15.3**	**5.2%**	**+7.4%**	**+4.5%**
MyState Bank (MYS)	0.4	None	Medium	3.2	4.8	★★★★★	0.67	10.2x	6.5%	+2.9%	-20.3%
Bank of Queensland (BOQ)	3.9	None	Medium	6.0	8.0	★★★★	0.75	11.6	5.7%	+7.9%	-14.0%
Bendigo & Adelaide Bank (BEN)	5.5	None	Medium	9.7	10.5	★★★	0.92	10.6	6.3%	+6.6%	-2.8%
Judo Capital (JDO)	1.1	None	High	1.0	1.1	★★★	0.92	20.4	0.0%	+11.5%	-30.2%
Nonmajor Banks (weighted avg)							**0.85**	**11.9**	**5.5%**	**+7.5%**	**-10.3%**
AMP (AMP)	2.6	None	High	0.9	1.3	★★★★	0.73	14.5	4.1%	-20.6%	-29.7%
Suncorp Group (SUN)	17.4	None	High	13.7	13.5	★★★	1.02	12.6	5.5%	-1.5%	+17.5%
Macquarie Group (MQG)	70.3	Narrow	High	182.7	175.0	★★★	1.04	18.1	3.8%	+7.0%	+3.2%
Diversified Financials (weighted avg)							**1.03**	**16.9**	**4.1%**	**+4.6%**	**+5.0%**

Source: Morningstar. Data as of Jan. 12, 2024.

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