Australian Banks: 2024 Q1

Shares rally as bad debt concerns ease.

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Morningstar Equity Research

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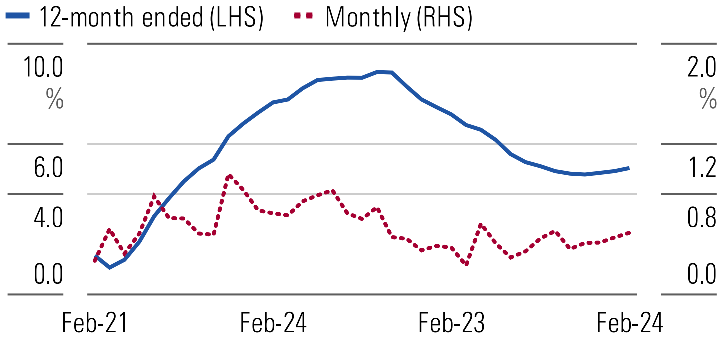
Executive Summary

Modest margin expansion to offset higher bad debts.

KEY TAKEAWAYS

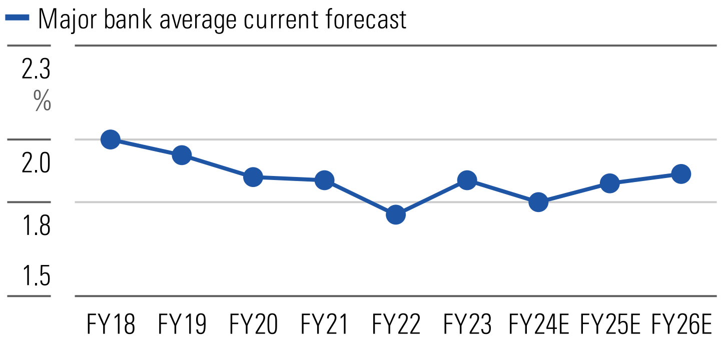
Modest Margin Expansion to Offset Higher Bad Debts

Credit Growth: Likely to Be Modest



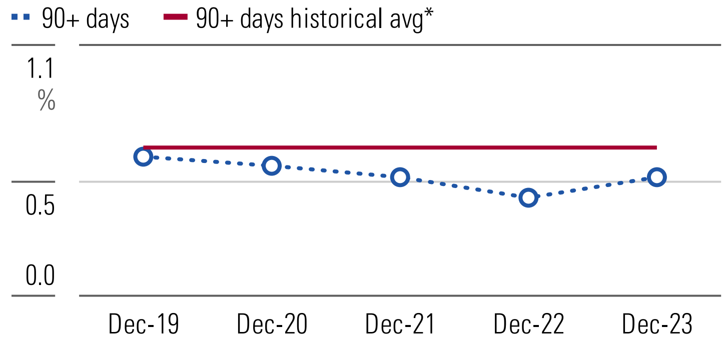
Source: Reserve Bank of Australia. Data as of Feb. 29, 2024.

Net Interest Margins: Positive Trajectory in 2025



Source: Company reports, Morningstar. Data as of April 3, 2024.

Bad Debts: Low Arrears and Banks Well-Provisioned



Source: Commonwealth Bank results. Data as of Dec 31, 2023.
Note: * Commonwealth Bank 15-year average.

Credit growth has eased as higher interest rates and inflation reduce borrower capacity. Total growth slowed to an annualized 4% in the three months ended February 2024. We expect low-single-digit medium-term credit growth on the back of modest economic growth.

Our expectation of low credit growth matches the Reserve Bank of Australia's forecasts for gross domestic product growth of about 2% in 2024 and 2025. Rising house prices and drawdowns of household savings could add to total credit growth.

Net interest margins are softening with competition in loan and customer deposit rates. Repayment of cheap Reserve Bank of Australia funding and above-average refinancing activity is elevating competition. When banks had a large loan book on higher rates, cheaper loans to new customers could be made with the bank still achieving strong returns overall. However, excess returns are now modest making it unlikely this trend will continue. We expect banks will pull back from aggressive competition on new loans and deposit rates to prevent return on equity from sliding below the cost of equity.

Low unemployment, a tight rental market, and rising house prices support low loan losses despite materially higher mortgage repayments. Current arrears are below 2019 levels, borrowers have larger equity buffers, and banks hold extra bad debt provisions. Most borrowers cut discretionary spending to meet repayments where necessary, including the growing percentage of borrowers considered at risk of mortgage stress or struggling to pay bills, where over 30% of income goes to mortgage repayments. Expired low-rate fixed-rate loans were a cause for concern but are performing in line with other loans.

VALUATION SNAPSHOT

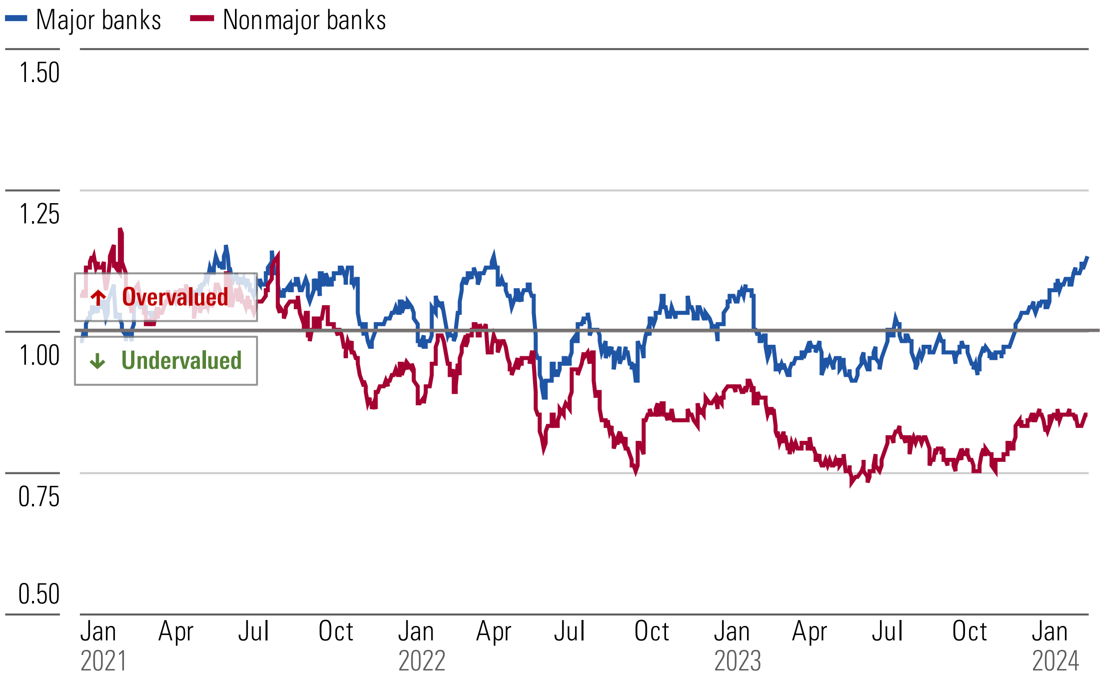
Major Banks Modestly Overvalued, Nonmajors Cheap

The major banks' weighted average price/fair value estimate is 1.14, versus 1.05 last quarter, while nonmajor banks trade at 0.85. Nonmajor bank margins are squeezed by intense competition, but we expect improvement as major banks prioritize returns.

On average, major bank share prices rose 23% from November 2023. A likely lower cash rate eases housing fears and provides banks an opportunity to reprice loans and deposits to protect margins. Global funds increasing ownership likely supported prices.

Nonmajor Banks Need Deposit and Mortgage Rate Pressures to Ease

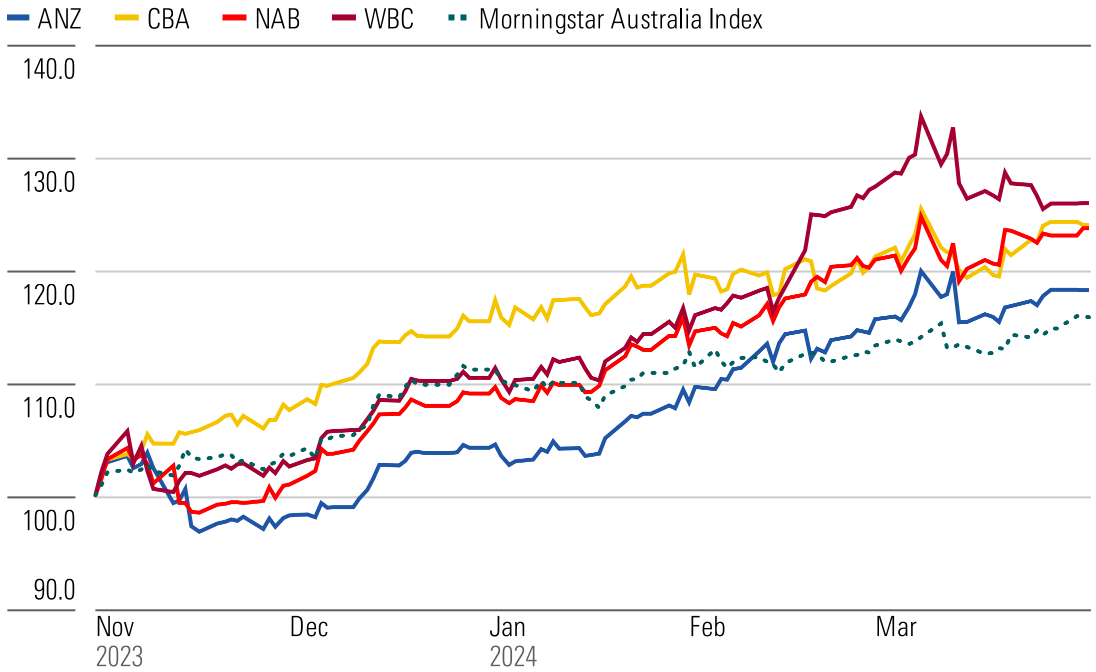
Weighted average price/fair value.



Source: Morningstar. Data as of April 3, 2024.

Share Prices Rallied in Anticipation of Earnings Growth

Bank share prices compared with S&P/ASX 200.



Source: Pitchbook, Morningstar Indexes. Data as of April 3, 2024.

Valuation

Pockets of value, mostly in nonmajors.

Australian Banks Modestly Overvalued on Average

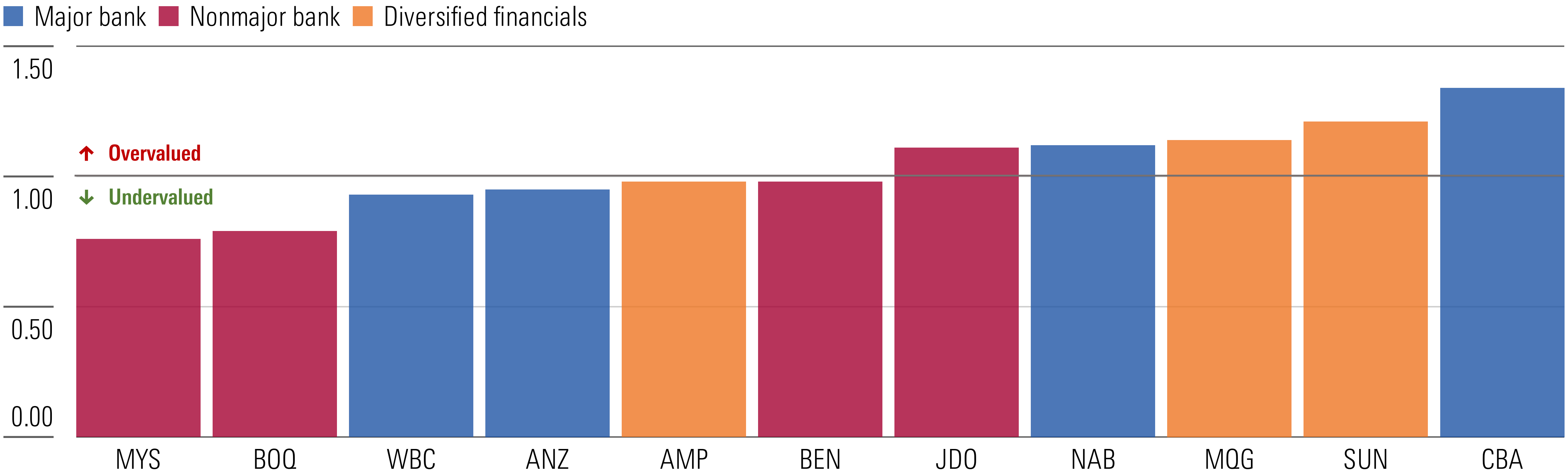
Westpac and ANZ Group modestly undervalued: Both have addressed market concerns around weak loan growth. The next catalyst is improving operating efficiency.

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

MyState and Bank of Queensland cheapest: Higher risk propositions given relatively weaker funding positions, but industrywide loan and deposit repricing supports growth.

Fewer Opportunities After Sector Rerating

Price/fair value estimate ranking.



Source: Morningstar. Data as of April 3, 2024.

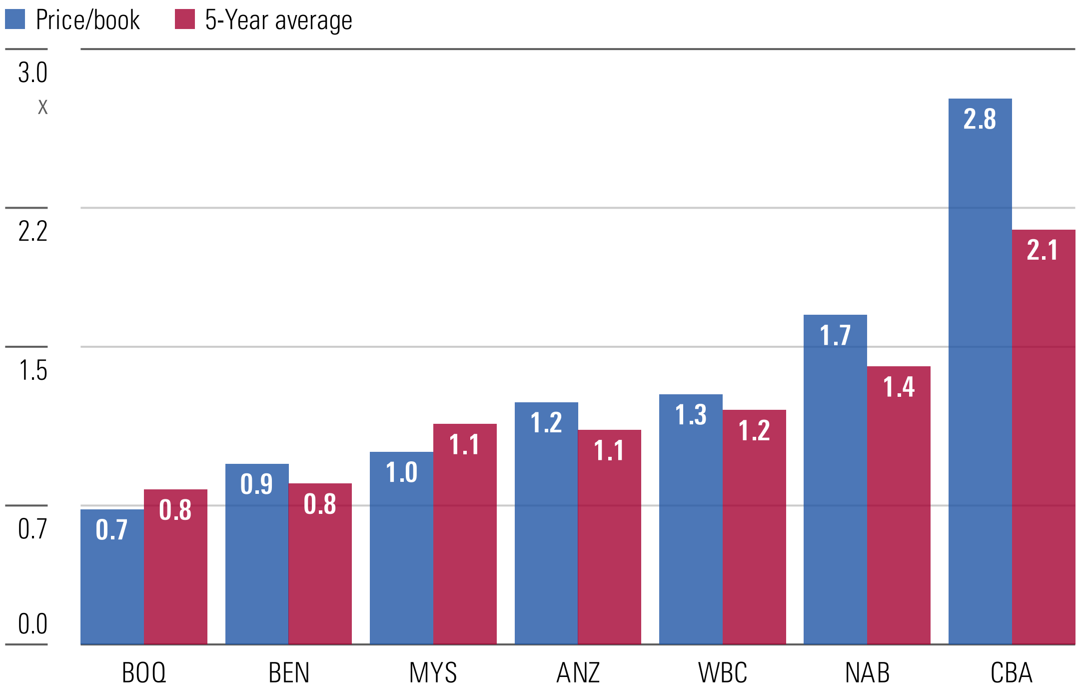
Dividend Yields Attractive Despite Higher Deposit Rates

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 similar earnings growth.

After resetting payout ratios, dividends can now grow in line with earnings. Share price weakness in most nonmajor banks sees yields at attractive levels. Nonmajors have more costly funding, but the margin downside risk is more than reflected in stock prices.

Price/Book Looks Reasonable for Most Banks

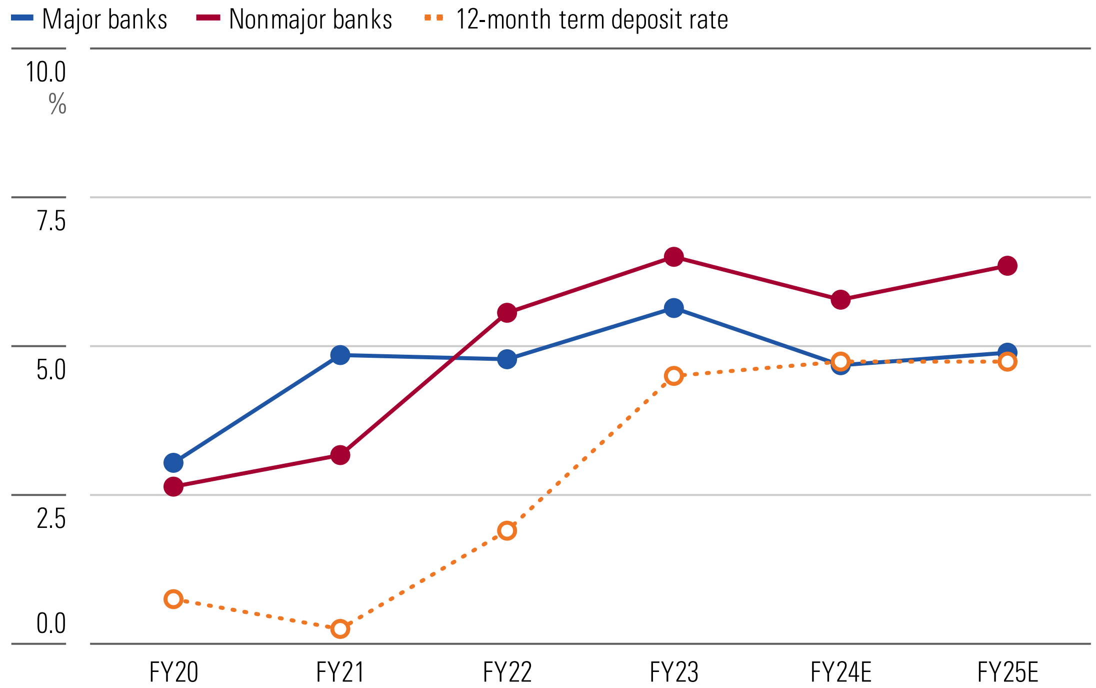
Five-year average is market-cap-weighted.



Source: Morningstar. Data as of April 3, 2024.

Forward Dividend Yields Look Attractive

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



Source: Morningstar. Data as of April 3, 2024.

Credit Growth

Consumer headwinds dampen credit growth.

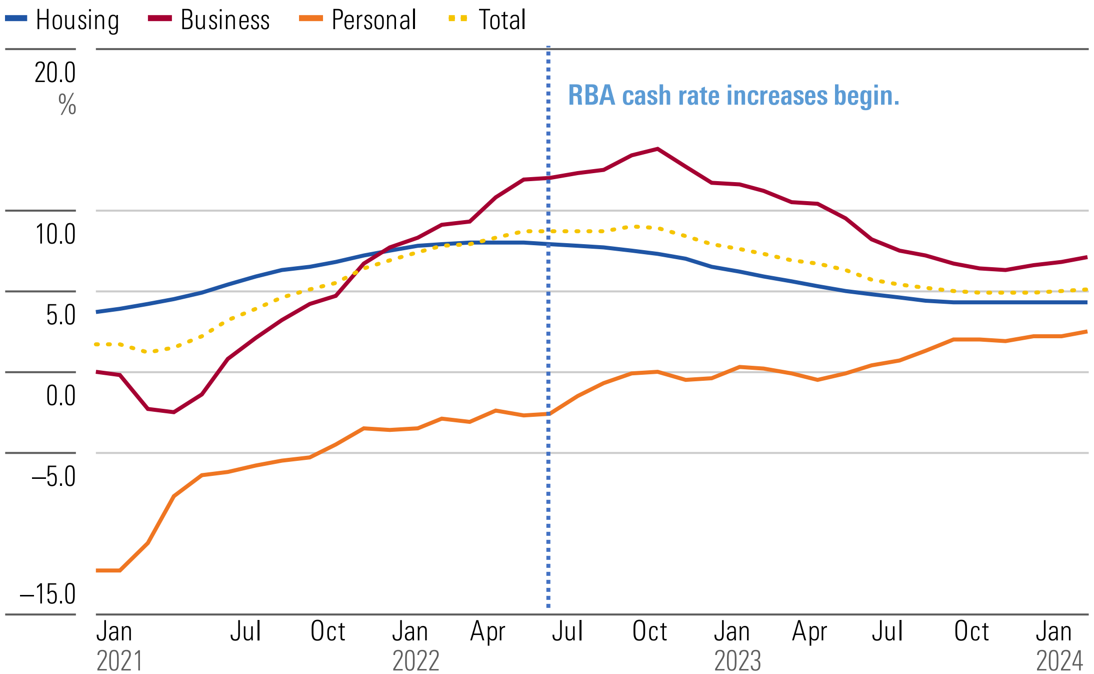
Weaker Consumer Spending to Slow Credit Growth

Trailing year housing credit grew 4% to the end of February 2024, with month-on-month growth of 0.4%, steady in the last six months. Reduced borrowing capacity constrains credit growth, and with headwinds to consumer spending, businesses are cautious too.

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

Credit Growth Set to Decline

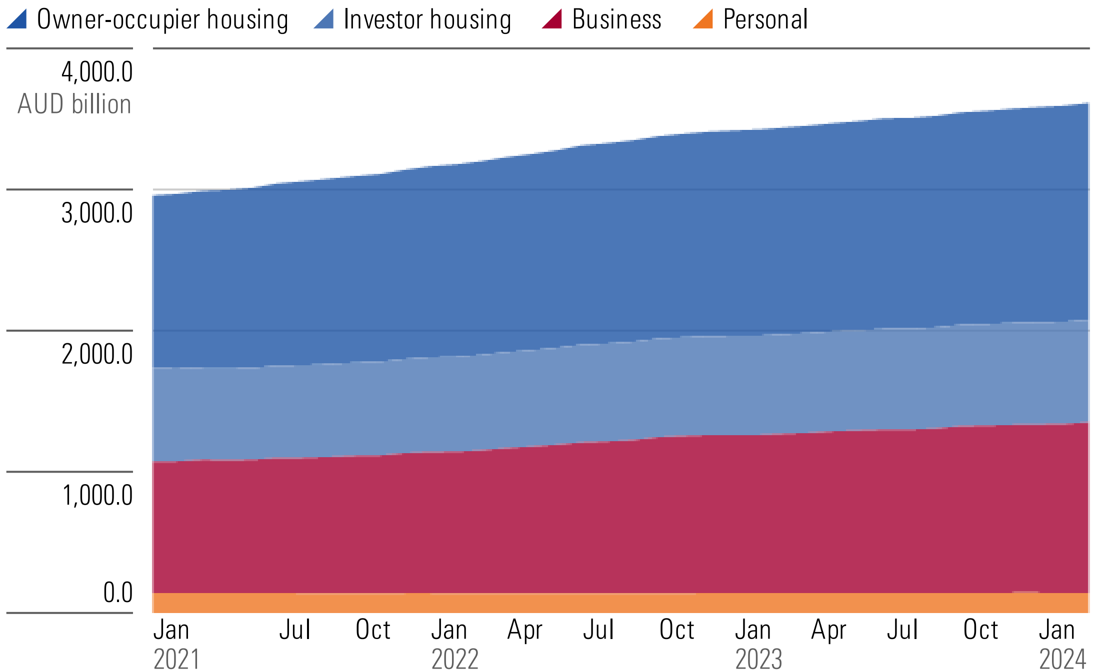
Australia credit growth by sector - 12 months ended February 2024.



Source: Reserve Bank of Australia. Data as of Feb. 29, 2024.

Housing Almost Two-Thirds of Outstanding Loans

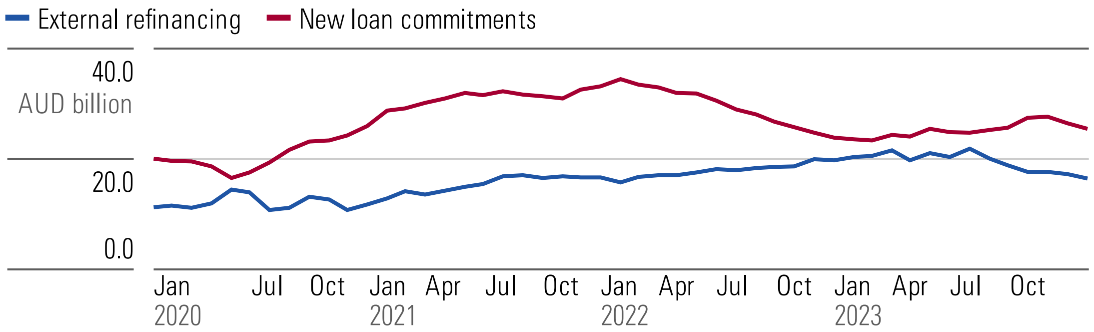
Australian credit by sector.



Source: Reserve Bank of Australia. Data as of Feb. 29, 2024.

Cash Rate Moves Drove a Jump and Slump in Loan Demand

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

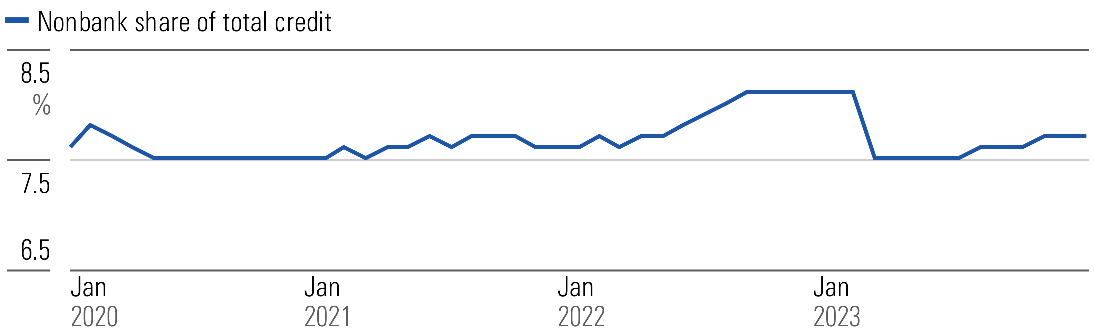


Source: Australian Bureau of Statistics. Data as of Feb. 29, 2024.
Note: New loan commitments exclude refinancing.

Slow loan growth set to continue: Interest rate increases weakened consumer confidence and significantly reduced borrowing capacity. This slower loan growth is to be expected, given the relative binge on credit in 2021 and 2022, as borrowers took advantage of low rates unlikely to repeat.

We expect elevated refinancing activity to persist in the first half of 2024 as a wave of fixed loans matures. This market dynamic, where banks compete for a relatively small pool of new loans and fight to retain existing customers, fuels intense competition on rates.

Nonbank Lenders Less Competitive: Reliance on Wholesale Borrowing Hurts Margins



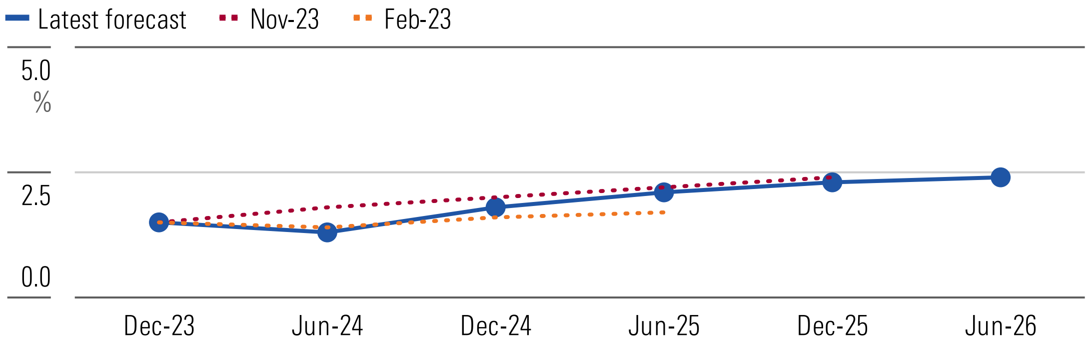
Source: Reserve Bank of Australia. Data as of Feb. 29, 2024.

Nonbank lenders can boost credit growth: Nonbank lenders make up 7.7% of total credit, down from 8.1% in January 2023. In the 12 months to February 2024, nonbank credit was up 0.3%, compared with bank credit, which was up around 5.0%.

Nonbanks are active in "low-doc" lending, which majors no longer offer. Hence, if nonbanks make credit more freely available, overall credit growth could lift. However, this depends on lower interest rates, given their greater reliance on higher-cost wholesale funding to finance loans.

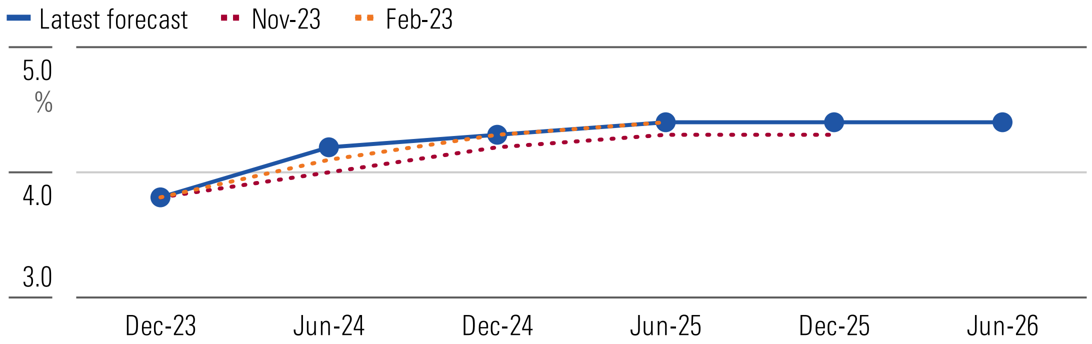
RBA Forecasts Imply Decent Backdrop for Banks

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



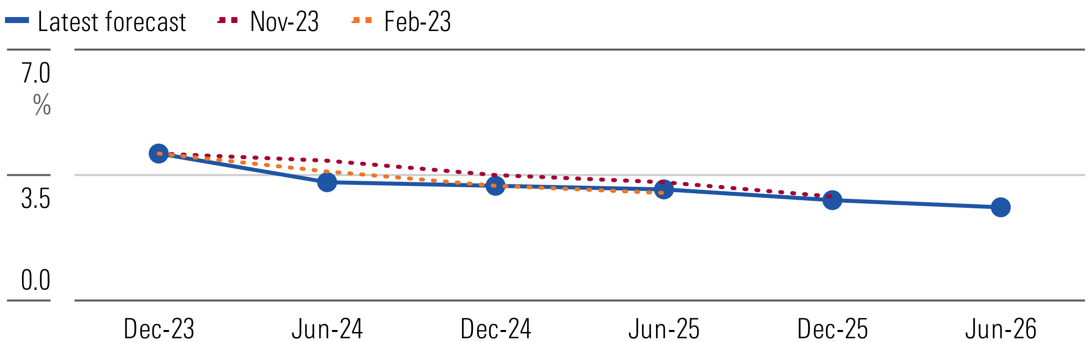
Source: Reserve Bank of Australia. Data as of Feb. 29, 2024.

Unemployment to Rise: Portending a Modest Increase in Borrowers in Distress



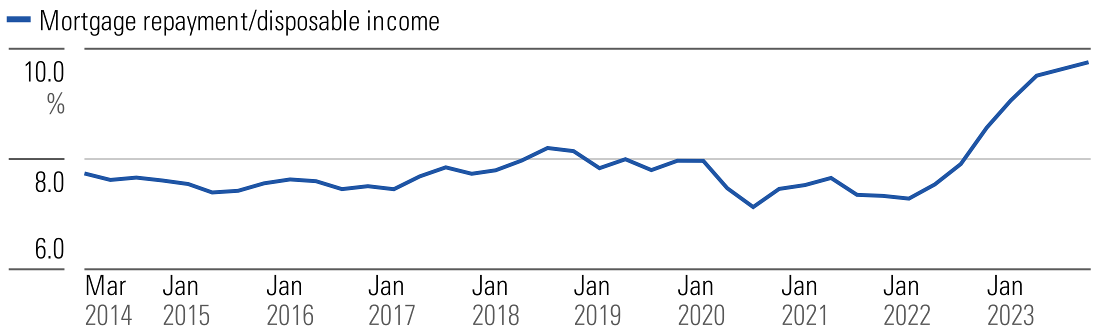
Source: Reserve Bank of Australia. Data as of Feb. 29, 2024.
Note: Unemployment Rate - quarterly %

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



Source: Reserve Bank of Australia. Data as of Feb. 29, 2024.
Note: CPI - % change over year to quarter

Mortgage Repayment/Household Income: Limits Borrowers From Increasing Leverage



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

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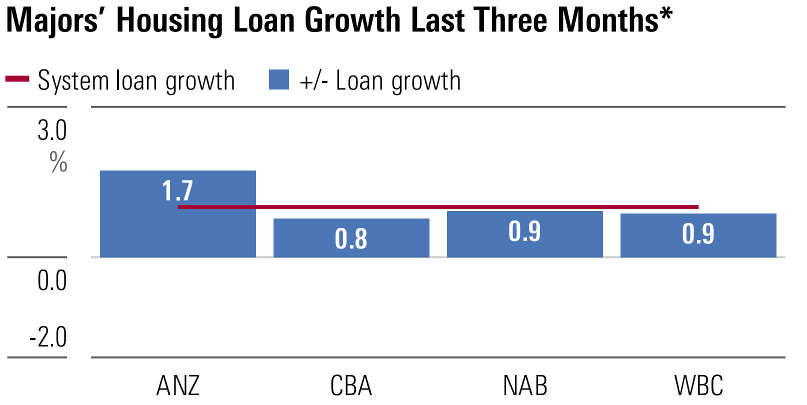
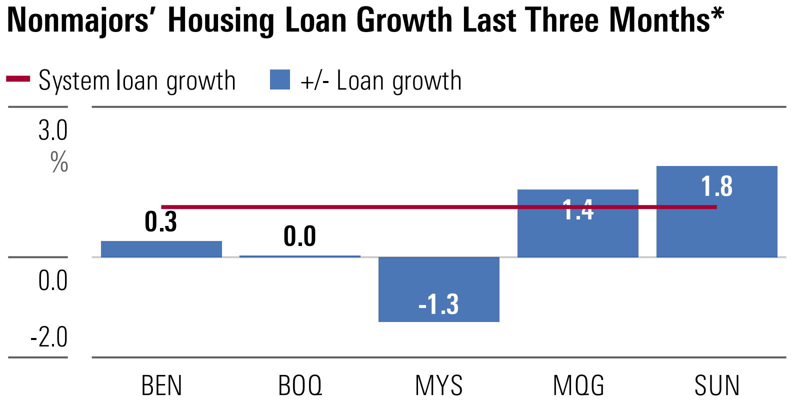
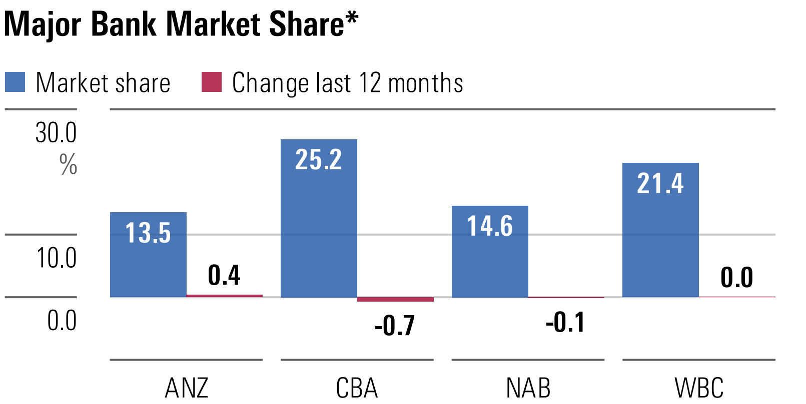
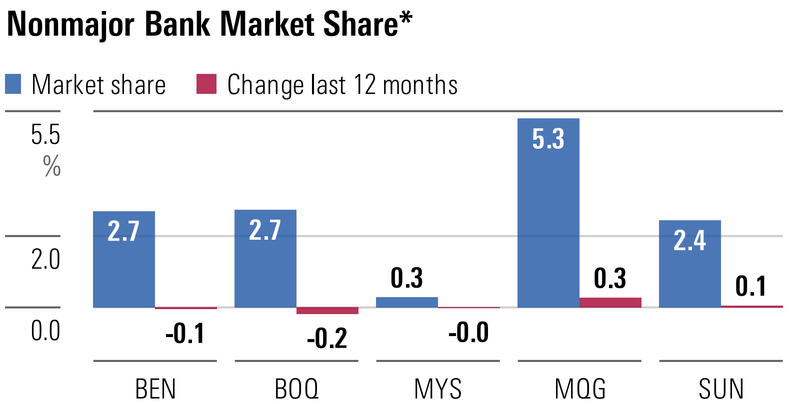
Housing Loans: Majors Split on Winning Share and Preserving Margins





Based on Australian Prudential Regulation Authority data, home loan balances grew 1.0% in the quarter to February 2024, or 4.0% annualized, down from 4.6% in the prior 12 months. Despite borrowing capacity being affected by higher rates, population growth and rising house prices are supportive of credit growth.



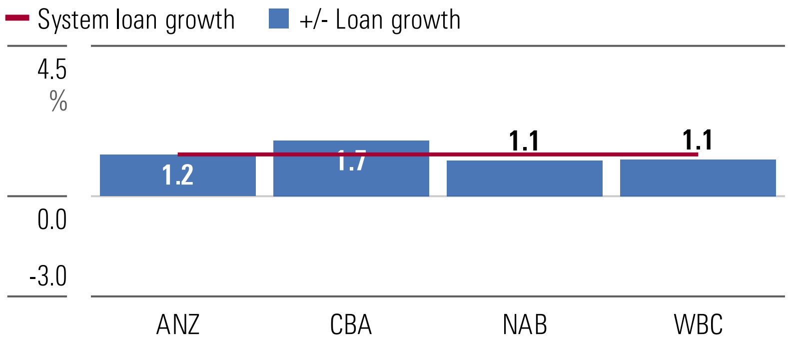


Source: Australian Prudential Regulation Authority, Morningstar. *Data for period ending Feb. 29, 2024.

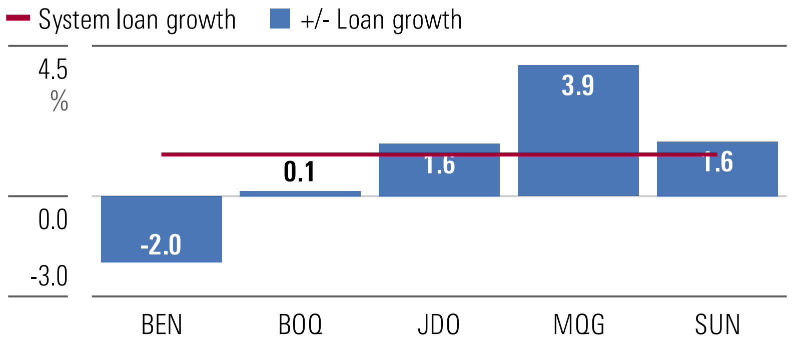
ANZ Bank is growing ahead of the market, driven by price and cash-back offers. We expect lending rate increases to slow this momentum. Commonwealth Bank trimmed rates late in 2023, narrowing the price difference between the cheapest and most expensive major bank rates. Loan growth of the major banks is now close to system. We expect Macquarie's share gains to slow with higher funding costs and a likely internal need for higher returns.

Business Loans: Steady Loan Growth

Majors' Business Loan Growth Last Three Months*



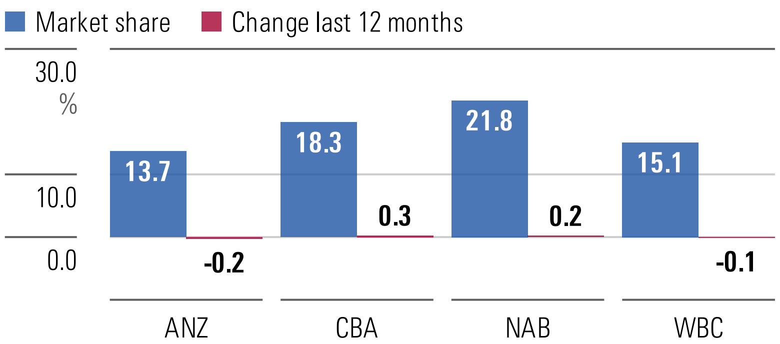
Nonmajors' Business Loan Growth Last Three Months*



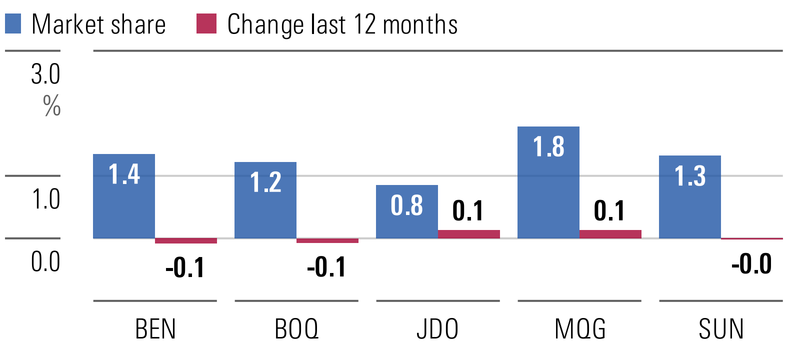
Based on APRA data, business loan balances grew 1.3% in the quarter to February 2024, an annualized rate of 5%. Growth has slowed, as we expected, after running at 16% annualized in the August 2022 quarter.

Businesses invested heavily in 2022 to meet buoyant consumer demand, but the outlook for consumers is now more challenging given high living costs.

Major Bank Market Share*



Nonmajor Bank Market Share*



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

Macquarie is relying on digital origination and banking capabilities and, with increased investment, will likely add lending staff to support loan growth.

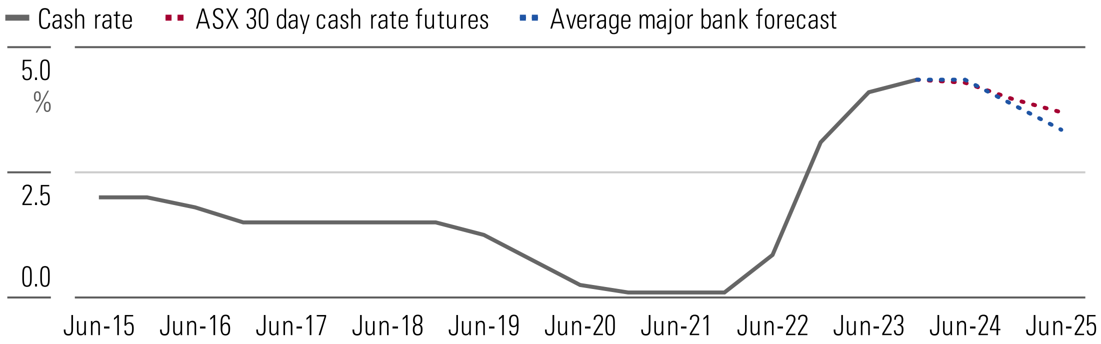
Source: Australian Prudential Regulation Authority, Morningstar. *Data for period ending Feb. 29, 2024.

Interest Margins

Competitive pressure on funding costs and lending rates.

Rate Cuts Likely

RBA Cash Rate: Expectations of Easing Supported by Cooling Inflation

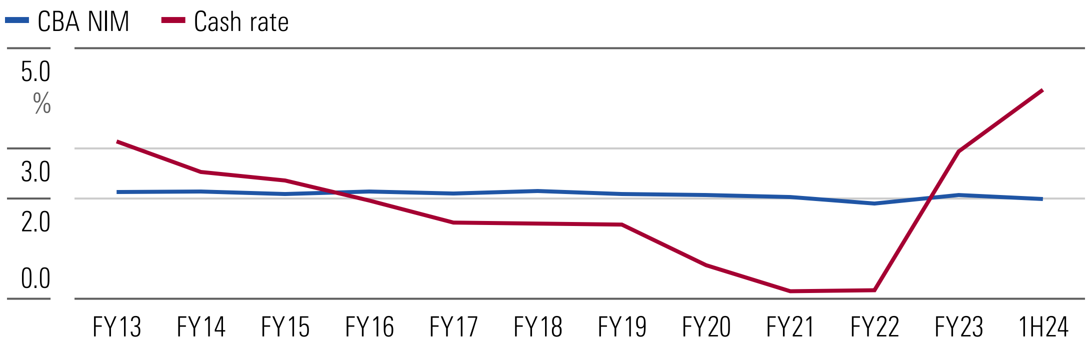


Source: RBA, ASX, Major bank average is CBA, WBC, NAB. Data as of April 3, 2024.

The cash rate is forecast to be below 4% in 2024. 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 3.5% 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. This follows a period of fast and materially rising rates to control inflation. The cash rate has risen to 4.35% from 0.10% in May 2022, as the central bank has taken decisive action.

CBA NIM Relative to Cash Rate: Industry Returns Drive NIM More Than Cash Rates



Source: Commonwealth Bank, RBA, Morningstar. Data as of Dec. 31, 2023.

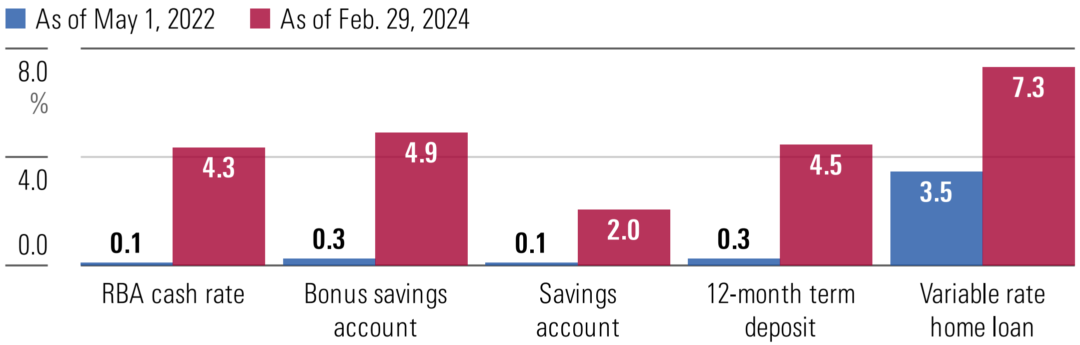
Higher rates are generally more favorable for margins. Having some funding not increase by as much as lending rates, such as low-rate savings and transaction accounts, all else being equal, is positive for bank margins.

However, competition is important. Banks aim to manage both lending and deposit rates to ensure a net interest margin to generate an adequate return on equity. Higher-than-normal refinancing, slow overall credit growth, and funding maturities are headwinds.

We see tentative signs of a focus shift from volume growth to margin expansion, with advertised home loan rates rising more than RBA cash rate increases and some deposit rates trimmed.

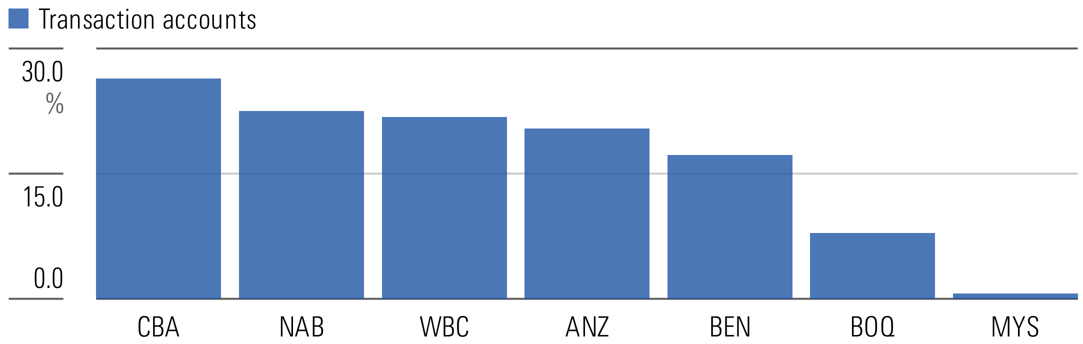
Banks Benefit From Cheap Deposits, but Customers Seek Higher Rates

Rate Increases: Deposit Rate Increases Outpaced Lending Rate by 50 basis points



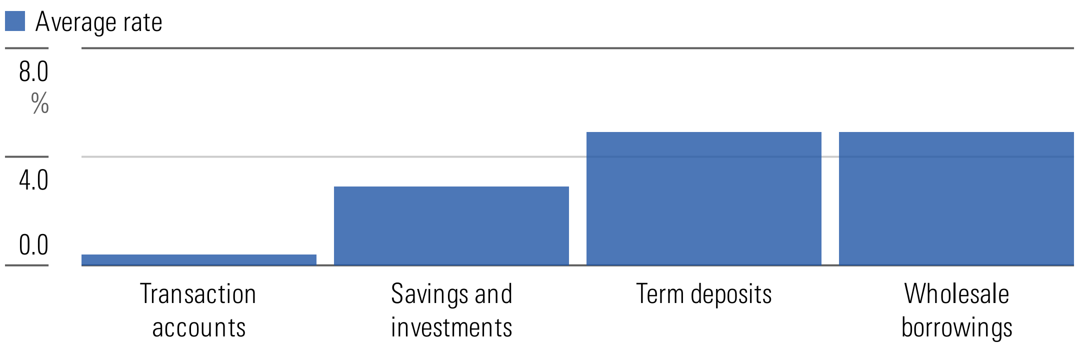
Source: Reserve Bank of Australia, Morningstar. Data as of Feb. 29, 2024

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



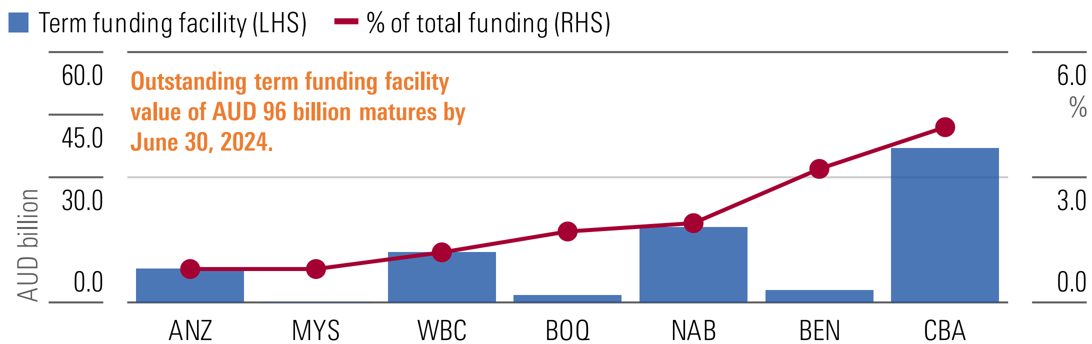
Source: Company reports, Morningstar. Data as of April 3, 2024.

Average Funding Costs : Banks Reliant on Term Deposits Face Most Margin Pressure



Source: Bendigo Bank result presentation, Morningstar. Data as of Dec. 31, 2023.
Note: Wholesale borrowings estimate to exclude Term Funding Facility

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



Source: Company reports, Morningstar.
Note: CBA and BEN data as of Dec. 31, 2023, compared with Sept. 30, 2023 for other major banks.

INTEREST MARGINS

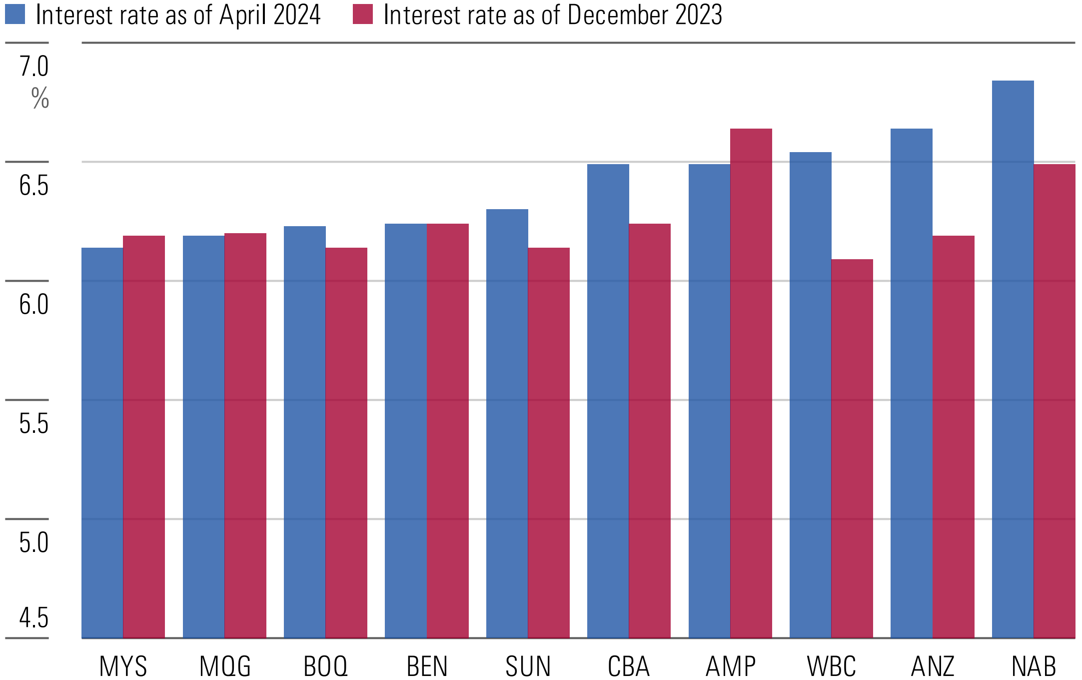
Home Loan Rates Are Higher, but Discounts Dampen Margins

While competition is intense, the major banks appear to be focusing on managing margins. The average major bank rate is around 0.36% higher than the nonmajors, versus about 0.12% higher 12 months ago.

APRA data suggests the spread between rates on outstanding loans and new loans has narrowed, meaning the future margin drag from repricing old loans is modest. Discounts to existing clients reflect a focus on client retention in the lower credit growth environment.

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

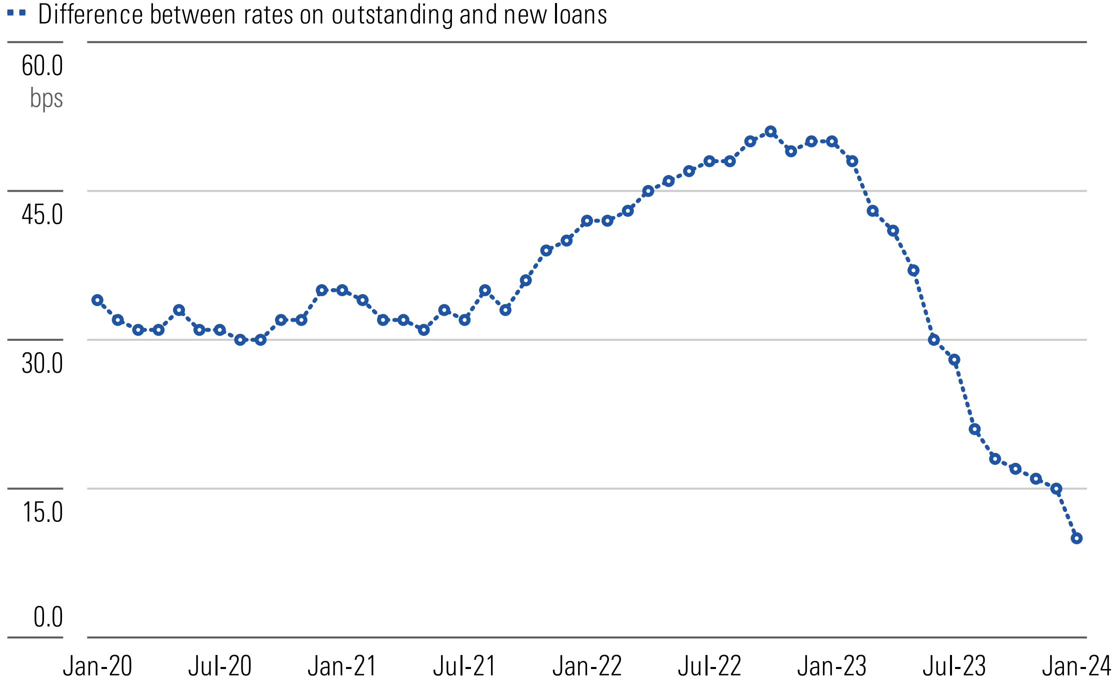
Variable rate: owner-occupier—principal and interest—loan/value ratio below 80%.



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

Discounts for New Borrowers Have Shrunk

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



Source: Reserve Bank of Australia, Morningstar. Data as of Jan. 30, 2024.

INTEREST MARGINS

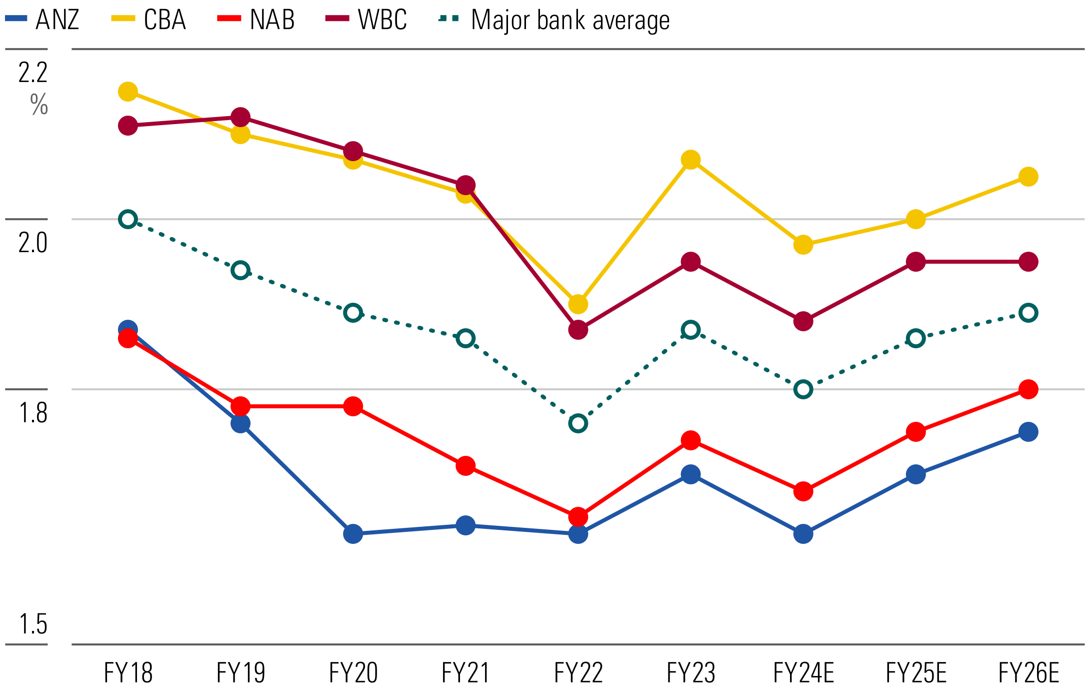
Banks Set to Hold Most of the Recent Margin Gains

Net interest margins likely peaked in first half fiscal 2023 and should fall in fiscal 2024. We expect competition for loans and deposits to ease and as the Term Funding Facility is repaid, we expect banks to begin to lower rates on savings and term deposits.

With higher NIMs and low-single-digit loan growth, we forecast 4% net interest income growth per year to fiscal 2026. Net interest income is 80% to 85% of revenue. While bad debts are likely to rise, cost containment should see cash profits grow with revenue.

NIM Rebound Likely to Flatten Out

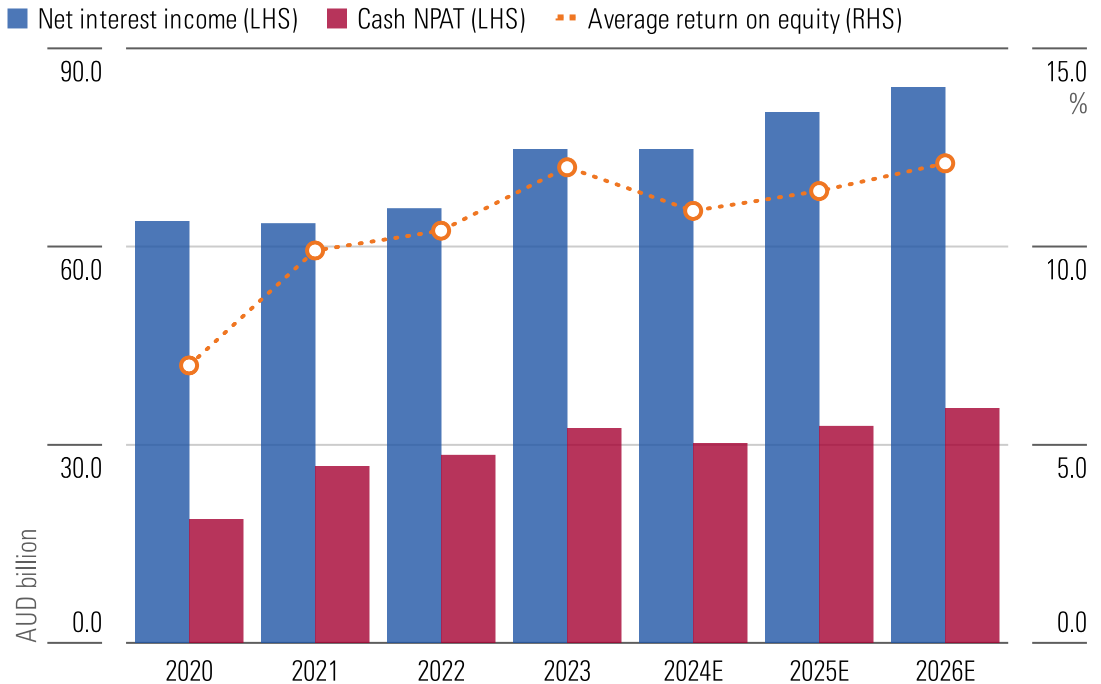
Morningstar NIM forecasts based on fiscal period.



Source: Company reports, Morningstar estimates. Data as of April 3, 2024.

Net Interest Income Growth Key to Our Profit Forecasts

Total of major banks.



Source: Company reports, Morningstar. Data as of April 3, 2024.
Note: NPAT = net profit after tax.

Capital and Credit Risk

Banks well-capitalized for higher bad debts.

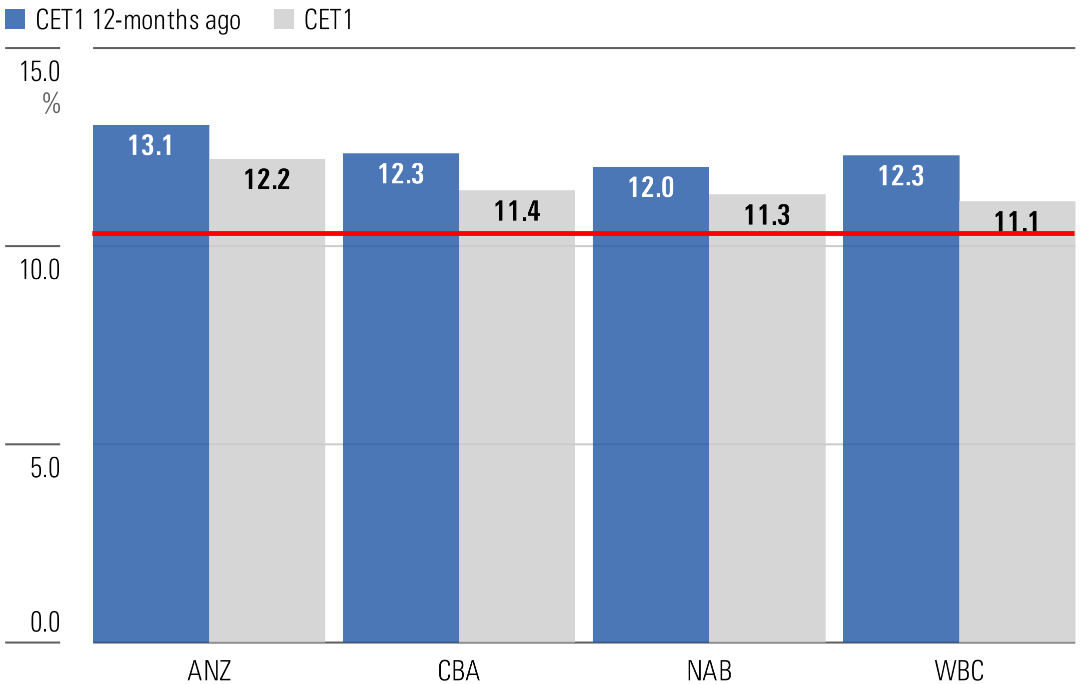
Bank Balance Sheets Are Sound

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 for adverse conditions and financial system resilience.

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

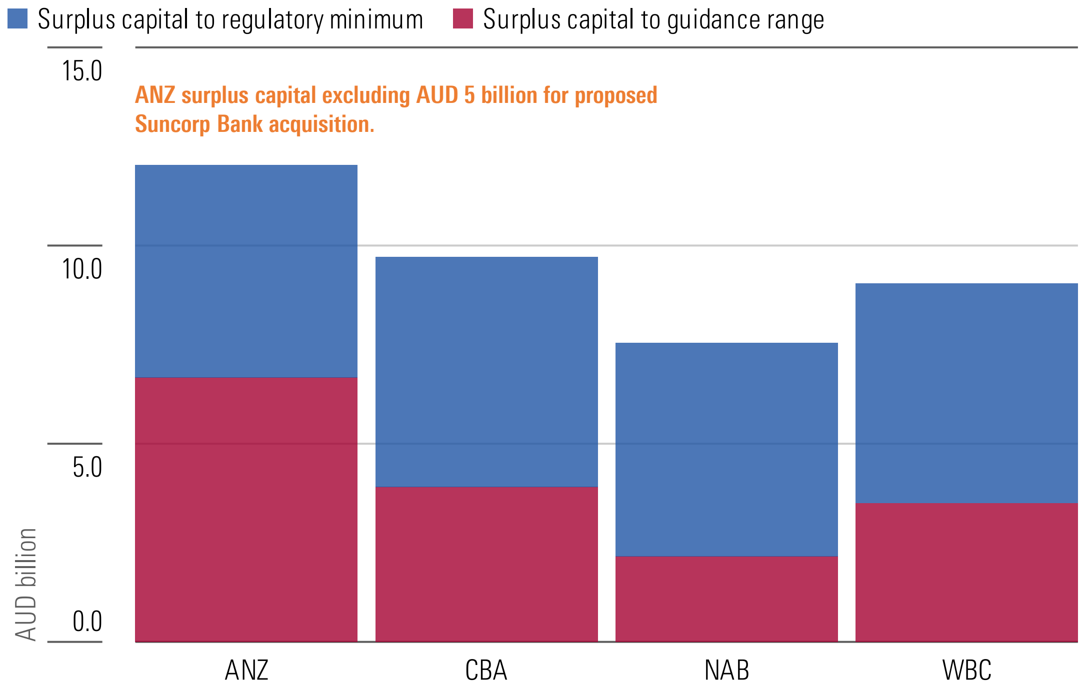
Latest CET1 ratio compared with 12 months prior and 10.25% regulatory minimum.



Source: Company reports. Data as of Dec. 31, 2023.
Note: CET1 = common equity Tier 1 ratios. *ANZ figures include equity raise to acquire Suncorp Bank.

Major Banks Have Substantial Surplus Capital

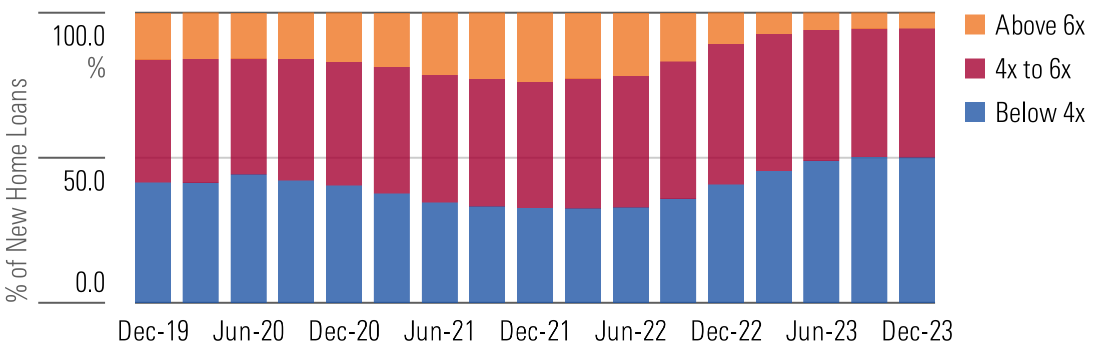
Each major bank has surplus capital to target range.



Source: Morningstar, Company reports. Data as of Dec. 31, 2023.
Note: Surplus to regulatory minimum assumes CET1 of 10.25%, guidance range assumes target of 11.5%.

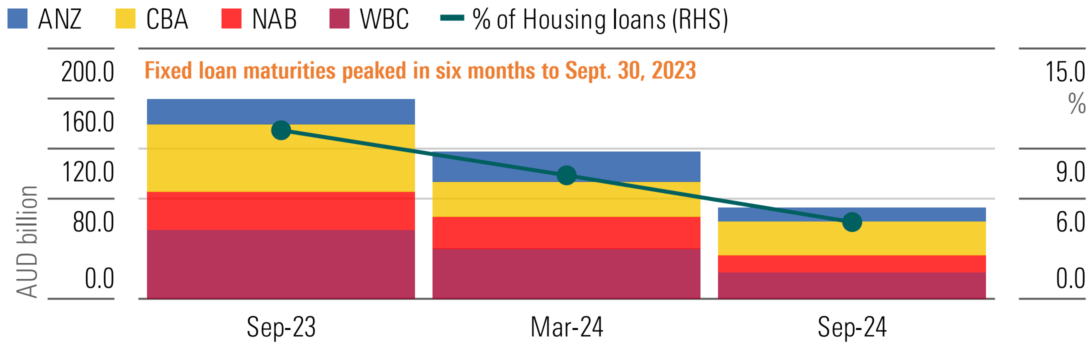
Higher-Risk Loans Relatively Modest and Arrears Low

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



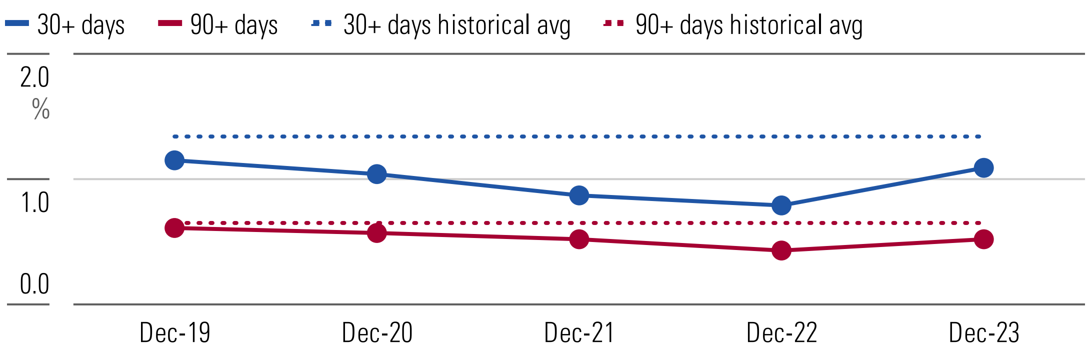
Source: APRA. Data as of March 31, 2024
Note: DTI = debt/income ratio.

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



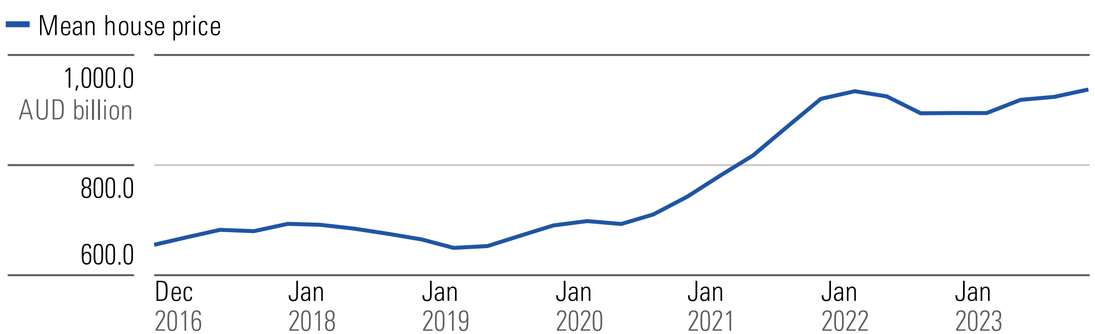
Source: Company reports. Data as of Sept. 30, 2023.

Commonwealth Bank Home Loan Arrears: Rising but From Low Levels



Source: Commonwealth Bank result presentation. Data as of Dec. 31, 2023.
Note: Peer group yet to report at time of publishing.

House Prices: Recovery Provides Equity Buffers and Limits Bank Losses



Source: Australian Bureau of Statistics. Data as of Dec. 31, 2023.

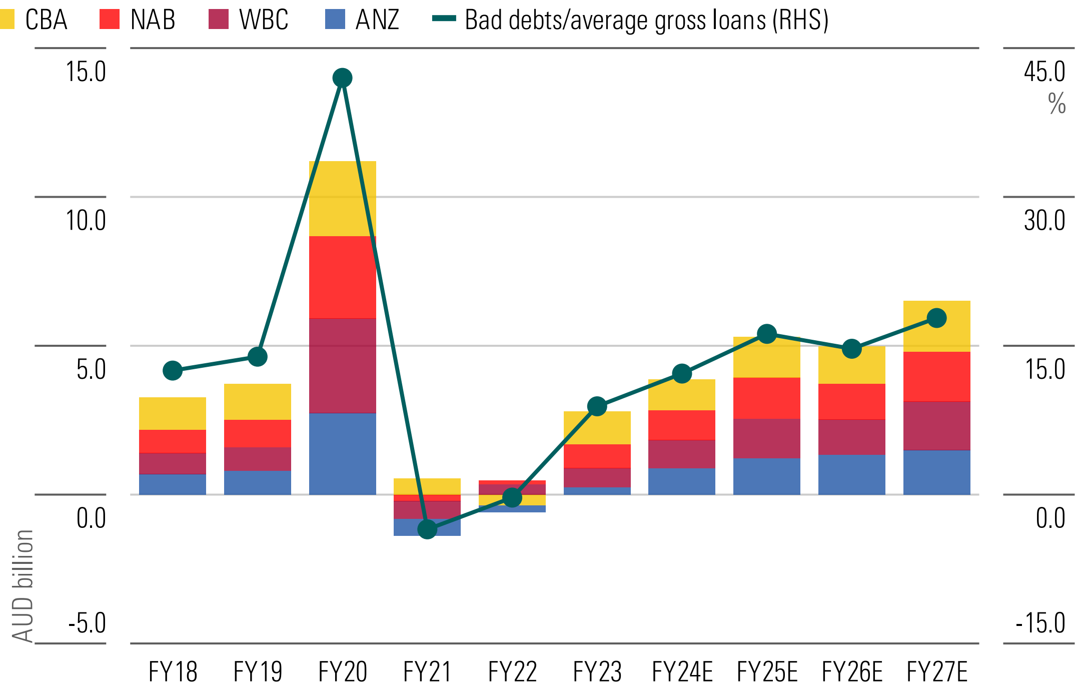
Bad Debts Becoming an Earnings Headwind

Low unemployment, borrower equity buffers, and loans written assuming borrowers can meet repayments if interest rates increase by 3%, make a loan loss spike well above long-term averages unlikely. Conservative provisioning is likely to unwind by fiscal 2026.

Provisions as a percentage of credit risk-weighted assets are above 2019 levels. Banks are cautious about how businesses and households manage higher rates and the economic growth and employment outlook. Arrears are still steady and below historical averages.

Major Bank Bad Debts Set to Normalize, Not Spike

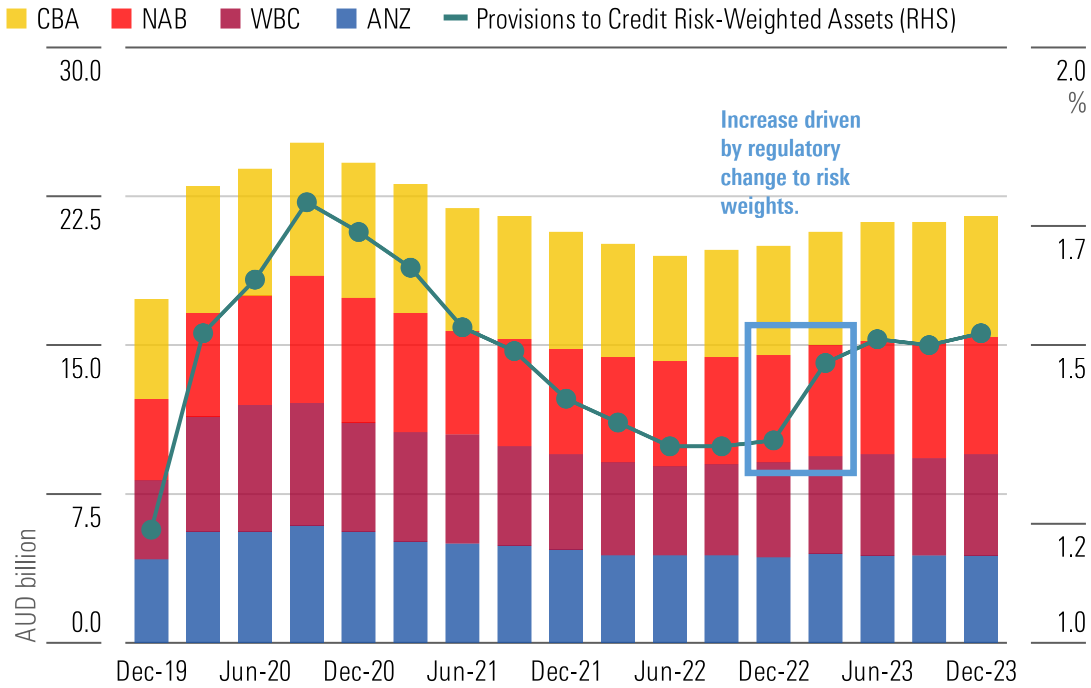
Bad debts (LHS) include incurred losses and changes to provisions.



Source: Company reports, Morningstar. Data as of April 3, 2024.

Bank Provisions Provide Profit and Loss Buffer

Provisions (LHS) include collective and specific provisions.



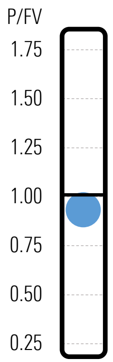
Source: Company reports. Data as of Dec. 31, 2023.

Top Picks and Coverage

Opportunities despite discounts narrowing.

Some Value in Westpac and ANZ Group; Market Overstates Margin Downside for Nonmajors

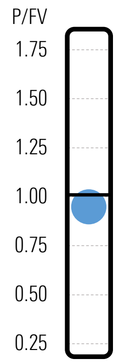
Australian Major Bank



Company (Ticker)	Market Cap	Rating	Last Close	FV Est.	Moat
Westpac Banking (WBC)	AUD 91 bn	★★★	26.10	28.00	Wide

As the second-largest lender in Australia, we are confident the funding cost advantages wide-moat-rated Westpac Banking enjoys will likely 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 cost rebasing takes 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.

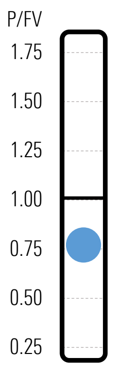
Australian Major Bank



Company (Ticker)	Market Cap	Rating	Last Close	FV Est.	Moat
ANZ Group (ANZ)	AUD 88 bn	★★★	29.40	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 costs, it should help drive earnings growth and returns on equity. We expect Suncorp Bank to improve bank efficiency modestly, but the drawn-out integration and associated costs make it unlikely to be materially value-accretive. Some acquisitions in the past failed to extract cost savings and contributed to customer service issues, which are risks for ANZ Bank.

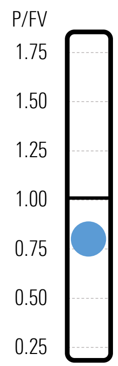
Australian Nonmajor Bank



Company (Ticker)	Market Cap	Rating	Last Close	FV Est.	Moat
MyState (MYS)	AUD 0.4 bn	★★★★	3.70	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 4.2 bn	★★★★	6.40	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 is not from compromising on 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 April 3, 2024.

Westpac and ANZ Modestly Undervalued, No-Moat Nonmajor Banks Moreso

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)	91.0	Wide	Medium	26.1	28.0	★★★	0.93	13.4	5.6%	+14.2%	+19.3%
ANZ Group (ANZ)	88.0	Wide	Medium	29.4	31.0	★★★	0.95	13.3	5.5%	+14.2%	+26.6%
National Australia Bank (NAB)	107.4	Wide	Medium	34.8	31.0	★★	1.12	14.7	4.8%	+13.8%	+24.8%
Commonwealth Bank of Australia (CBA)	201.0	Wide	Medium	120.1	90.0	★★	1.33	20.6	3.8%	+7.1%	+21.0%
Major Banks (weighted avg)							**1.14**	**16.6**	**4.7%**	**+11.2%**	**+22.5%**
MyState Bank (MYS)	0.4	None	Medium	3.7	4.8	★★★★	0.77	11.8	6.2%	+15.6%	+3.6%
Bank of Queensland (BOQ)	4.2	None	Medium	6.4	8.0	★★★★	0.80	11.9	5.5%	+5.8%	-2.1%
Bendigo & Adelaide Bank (BEN)	5.9	None	Medium	10.3	10.5	★★★	0.98	11.7	6.0%	+7.8%	+18.6%
Judo Capital (JDO)	1.5	None	High	1.3	1.2	★★★	1.12	20.0	0.0%	+37.4%	+10.7%
Nonmajor Banks (weighted avg)							**0.93**	**12.8x**	**5.1%**	**+11.1%**	**+9.8%**
AMP (AMP)	3.1	None	High	1.2	1.2	★★★	0.96	12.7	2.6%	+24.3%	+6.0%
Macquarie Group (MQG)	76.0	Narrow	High	198.3	175.0	★★★	1.13	20.1	3.5%	+9.4%	+12.1%
Suncorp Group (SUN)	20.6	None	High	16.2	13.5	★★	1.20	14.3	4.9%	+17.3%	+32.6%
Diversified Financials (weighted avg)							**1.14**	**18.7x**	**3.8%**	**+11.5%**	**+16.1%**

Source: Morningstar. Data as of April 3, 2024.

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