JULY 2024

MORNINGSTAR Industry Pulse

Australian Banks: Q2 2024

Borrower stress not denting bank earnings.

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Morningstar Equity Research

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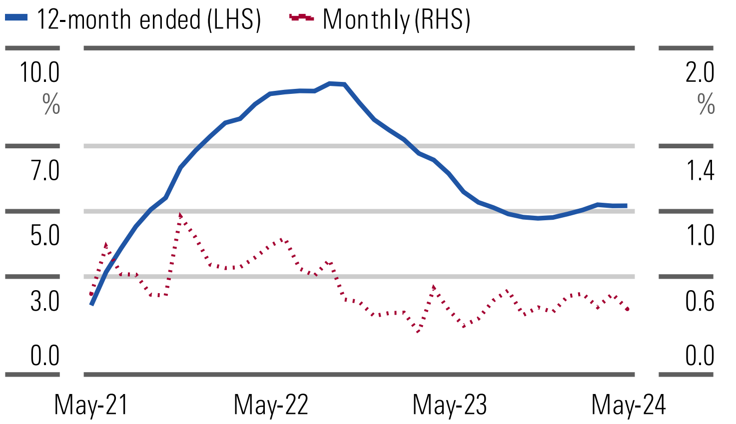
Executive Summary

Modest margin expansion needed to offset higher bad debts.

Modest Margin Expansion Needed to Offset Higher Bad Debts

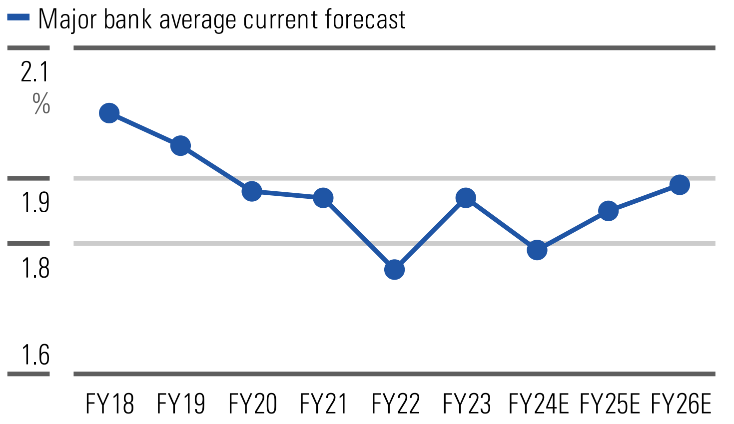
Credit Growth: Expected To Be Modest



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 May 2024. We expect low-single-digit medium-term credit growth given modest economic growth.

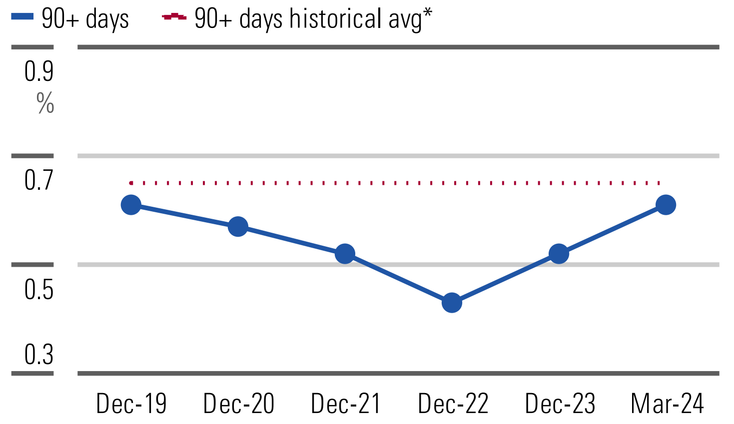
Our expectation of low credit growth matches the Reserve Bank of Australia's forecasts for gross domestic product growth of about 2% in 2025. Rising house prices and drawdowns of household savings could add to total credit growth.

Net Interest Margin: Repricing Improves the Trajectory



We expect bank medium-term margins to modestly improve as aggressive competition moderates to prevent return on equity from sliding below the cost of equity. This view is not anchored to a specific cash rate. If rates stay higher for longer, banks can continue to earn a larger margin on low-cost customer deposits and income from hedges. If rates fall, banks can offset headwinds by repricing loans and deposits to protect margins. In other words, reduce deposit rates by more than home loan rates.

Bad Debts: Arrears Rising but Banks Well Provisioned



In May 2024, banks reported rising arrears due to materially higher mortgage repayments but no negative impact on profits. The banks are already holding large loan loss provisions to cover rising defaults, and borrowers struggling to service loans are remedying their financial situation by selling into a strong housing market. Low unemployment, a tight rental market, large equity buffers, and rising house prices support low loan losses. Current arrears are similar to long-term averages and will likely trend higher as savings run down and as some low-rate fixed-rate loans only recently matured.

Source: Reserve Bank of Australia. Data as of May 31, 2024. (left). Company reports, Morningstar. Data as of June 30, 2024. (center). Commonwealth Bank results. Data as of March 31, 2024. (right).
* Commonwealth Bank 15-year average.

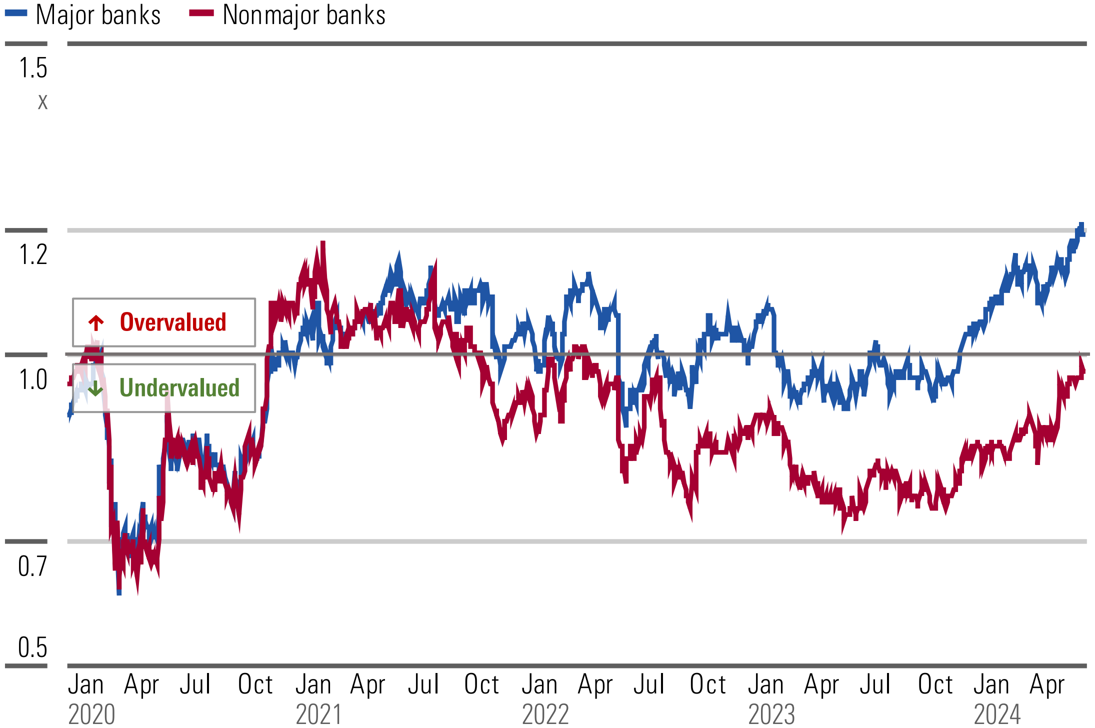
Best Value in Nonmajors

The major banks' weighted average price/fair value estimate is 1.19, versus 1.14 last quarter, while nonmajor banks trade at 0.97. Nonmajor bank margins are squeezed by intense competition, but we expect improvement as major banks prioritize returns.

On average, major bank share prices are up 26% since November 2023. Repricing loans and deposits to protect margins, and low loan losses, are positive for earnings. Global funds increasing ownership and inflows into passive funds also support prices.

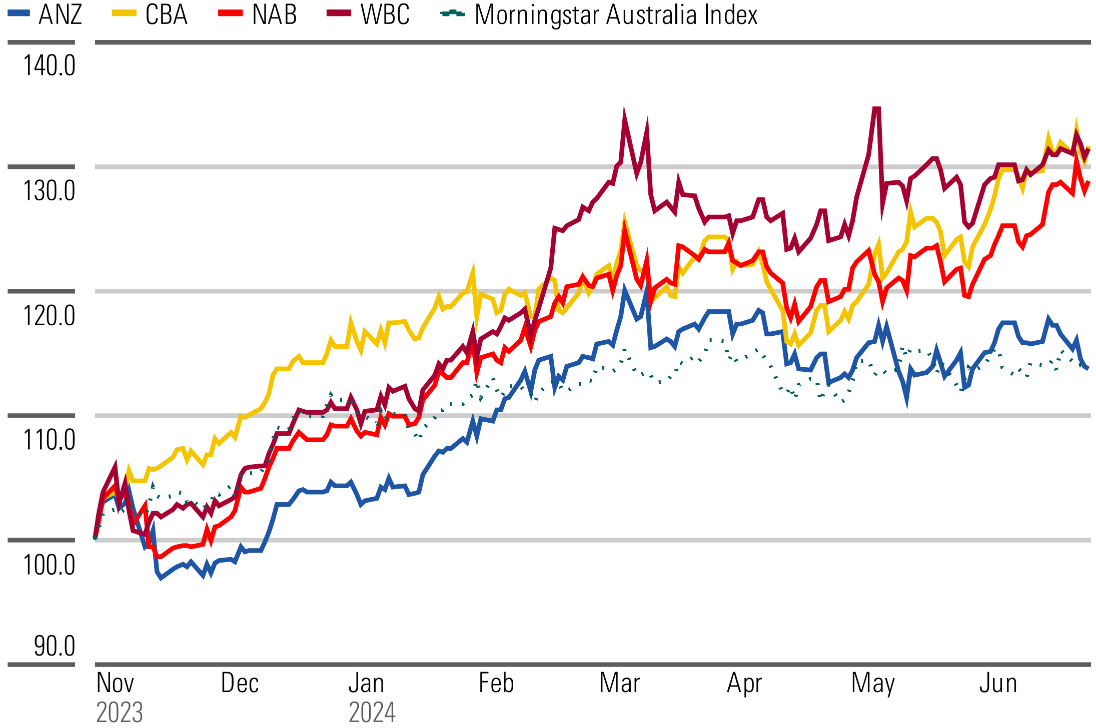
Nonmajor Banks Need Deposit and Mortgage Rate Pressures to Ease

Weighted average price/fair value.



No Clear Catalyst for Latest Rally

Bank share prices compared with Morningstar Australia Index.



Source: Morningstar. (left). PitchBook, Morningstar Indexes. (right). Data as of June 30, 2024.

Valuation

Pockets of value in overvalued sector.

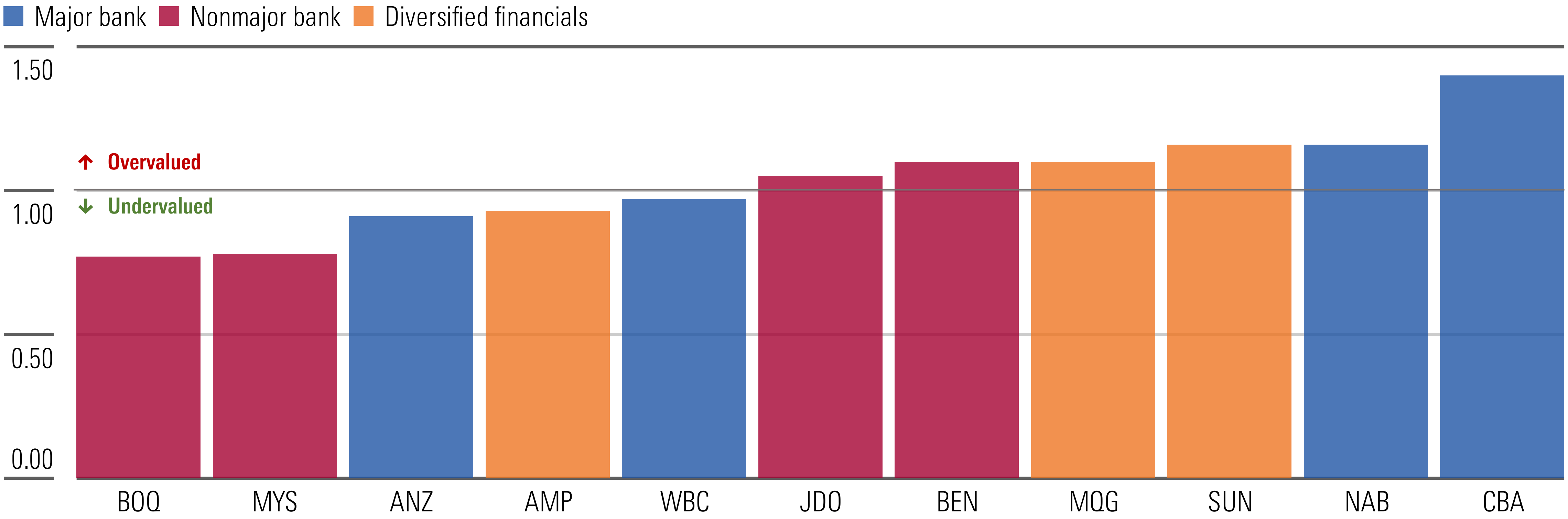
ANZ Group and Westpac Reasonably Priced, Most Value in Nonmajors

Bank of Queensland and MyState are cheapest. Both have relatively weak funding positions, but industrywide loan and deposit repricing is beneficial. ANZ Group and Westpac are the cheapest majors, with improved operating efficiency expected.

Commonwealth Bank is expensive. On a forward P/E over 20 times and a fully franked dividend yield under 4%, valuation metrics leave little room for disappointment. The share price strength is at odds with our three-year EPS growth forecast of 4% per year.

Fewer Opportunities After Sector Rerating

Price/fair value estimate ranking.



Source: Morningstar. Data as of June 30, 2024.

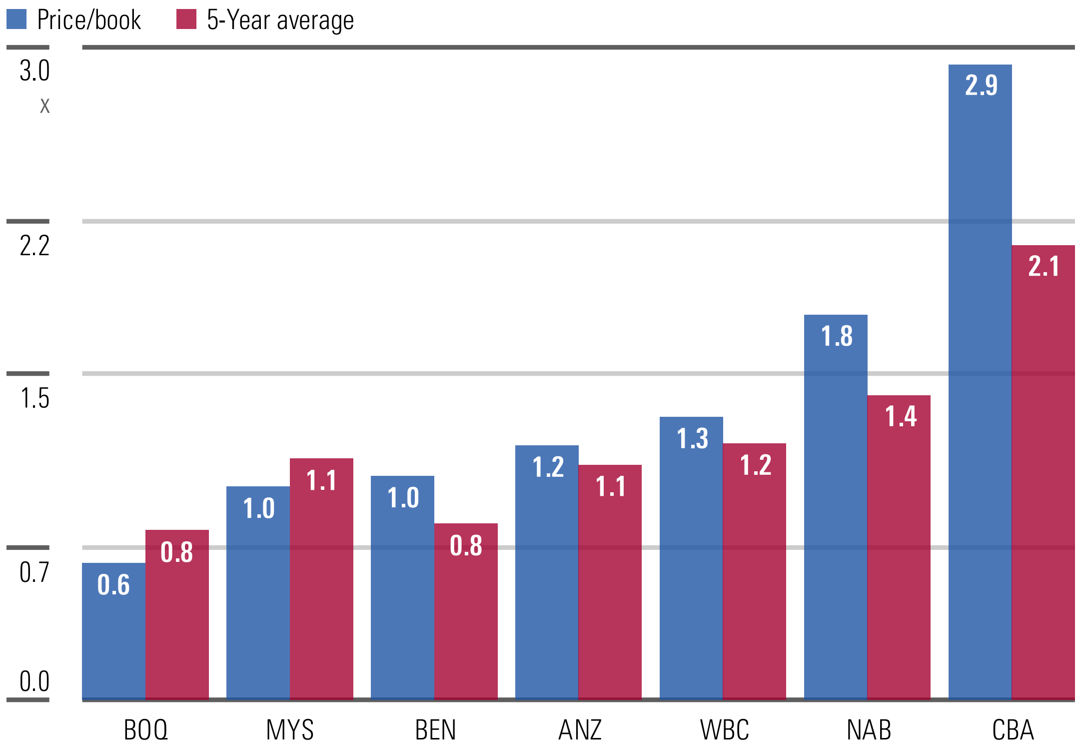
Dividend Yields Attractive but Earnings Growth Sluggish

The valuation divergence for Commonwealth Bank and peers ANZ Bank and Westpac is stark, and in our view, unjustified. Price/book discounts could unwind as ANZ Bank and Westpac hold market share and deliver similar earnings growth but on a cheaper PE.

After resetting payout ratios, dividends can grow in line with earnings. Weaker share price performance for most nonmajors sees their yields at more attractive levels than the majors. We think the nonmajors margin risk is more than reflected in their prices.

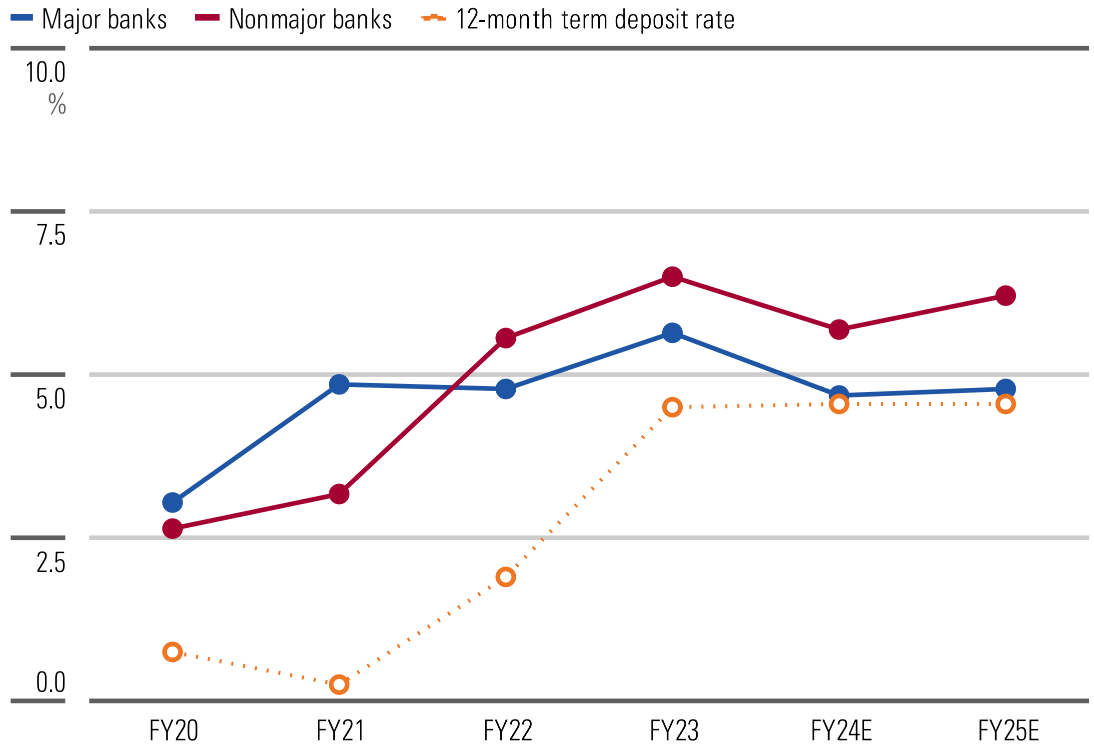
Price/Book Looks Reasonable for Most Banks

Five-year average is market-cap-weighted.



Mostly Fully Franked Dividend Yields Look Attractive

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



Credit Growth

Consumer headwinds dampen credit growth.

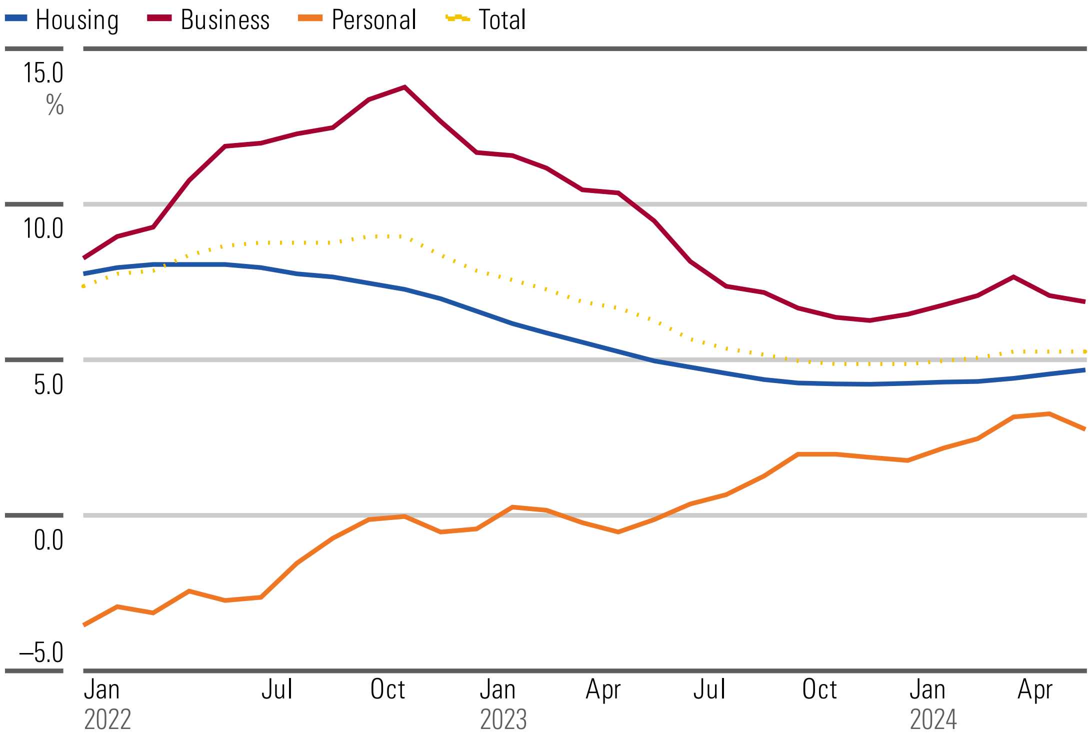
Constrained Consumer to Keep Credit Growth Modest

Trailing year housing credit grew 4.6% to the end of May 2024, with month-on-month growth rising over the last six months. Reduced borrowing capacity and persistent inflation constrains credit growth, despite higher wages and strong population growth.

The recent dip in personal credit growth has very little impact on total credit as it makes up just 4% of total credit. Concern rates stay higher for longer, or rise, likely makes consumers more cautious on discretionary expenditure. Business are similarly cautious.

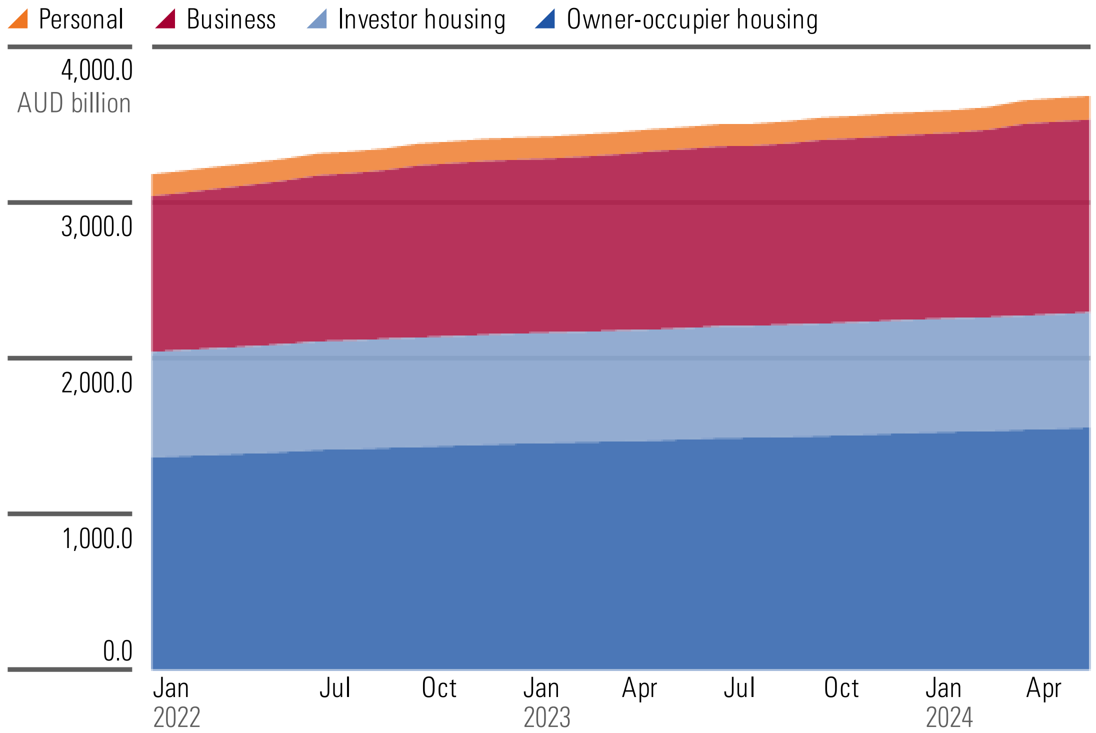
Credit Growth Expected to Stabilize

Australia credit growth by sector—12 months ended May 2024.



Housing Is Almost Two Thirds of Outstanding Loans

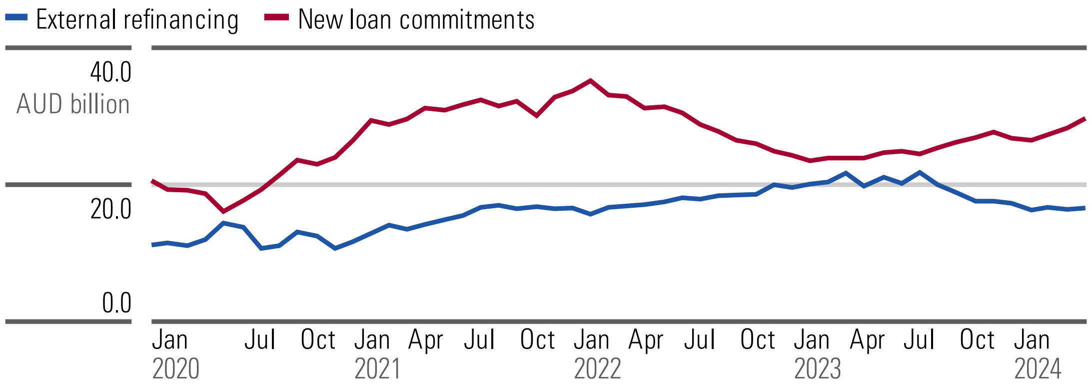
Australian credit by sector.



Source: Reserve Bank of Australia. Data as of May 31, 2024.

Loan Demand Influenced by Cash Rate Moves

Refinancing and Slow Lending: Trend Is Slowly Reversing

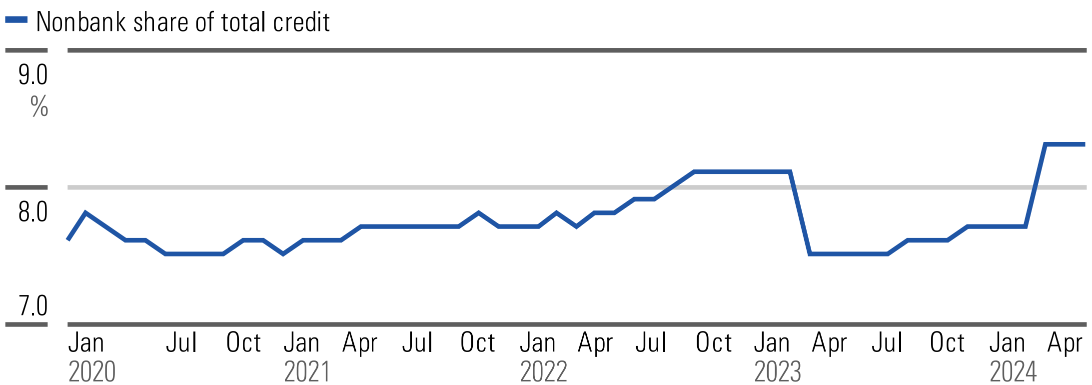


Slow Loan Growth Set to Continue

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 refinancing activity to continue to slow in 2024 with cheap fixed loans having largely matured. This market dynamic, where banks compete for a modest pool of new loans and fight to retain existing customers, fuels competition on rates.

Nonbank Lenders Hurt by Higher Rates: Likely Taking Share in Riskier Segments



Nonbank Lenders Can Boost Credit Growth

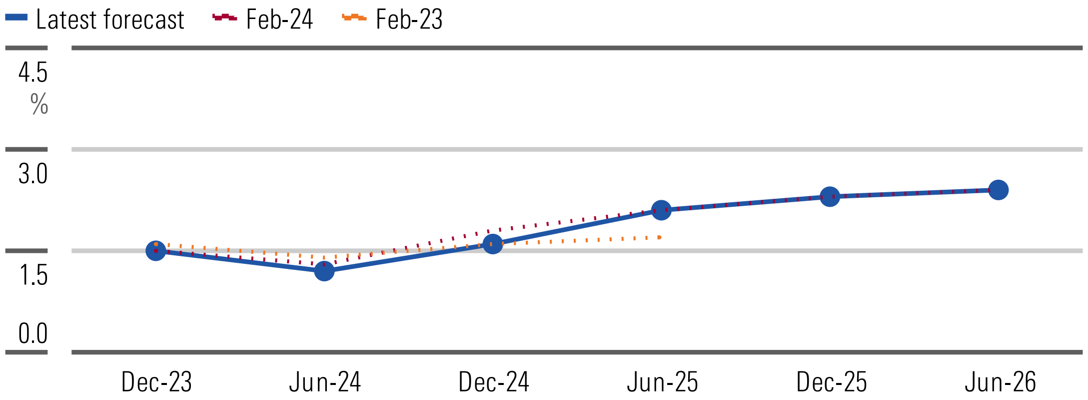
Nonbank lenders make up 8.3% of total credit, a decade high. In the five months to May 2024, nonbank credit was up 11.4%, compared with bank credit, up just 2.0%.

Despite being reliant on more expensive wholesale funding, nonbanks can take share by lending to higher-risk borrowers or sectors not well served by banks. This can be because of onerous capital requirements, risk appetite, or efforts to streamline loan application processes. Nonbank lenders are compensated by charging a higher lending rate. Nonbanks are active in “low-doc” lending, which majors no longer offer. These potentially higher risk loans remain a modest risk to the system overall.

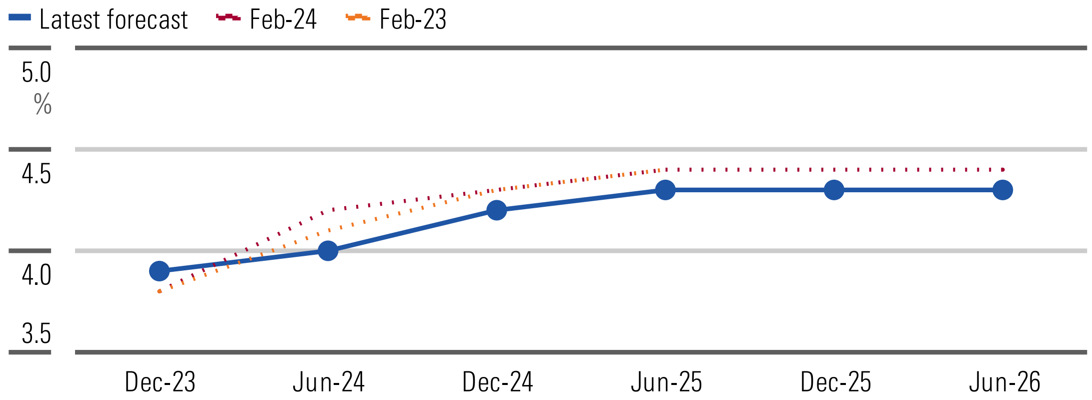
Source: Reserve Bank of Australia. Data as of May 31, 2024.

Inflation Risks on the Upside, but Economic Backdrop Still Decent for Banks

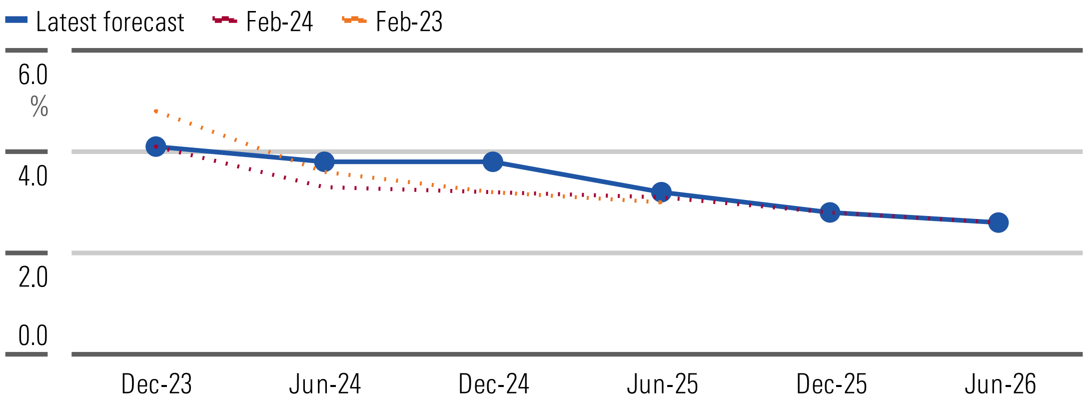
Moderate GDP Growth: Supports Low- to Mid-Single-Digit Credit Growth



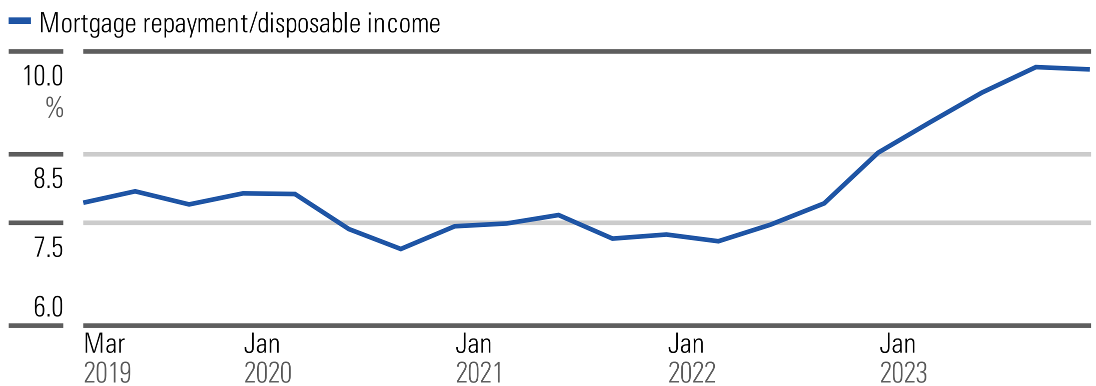
Unemployment to Rise: Portending a Modest Increase in Borrower Defaults



Inflation Remains High: Recent CPI Data Could Push Up Forecasts Again



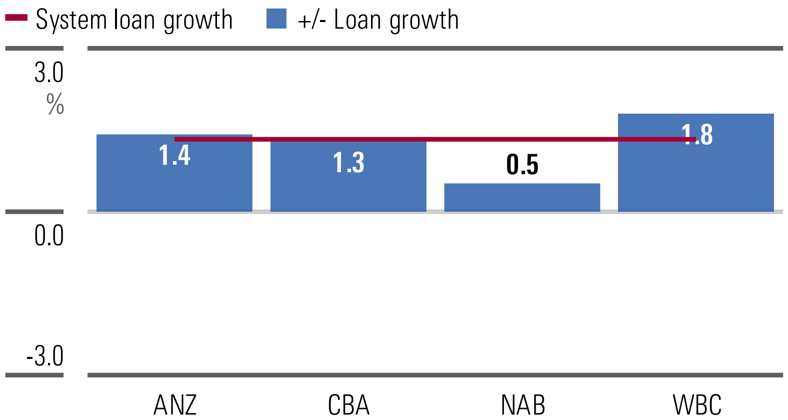
Mortgage Repayment/Household Income: Limits Increasing Borrowers' Leverage



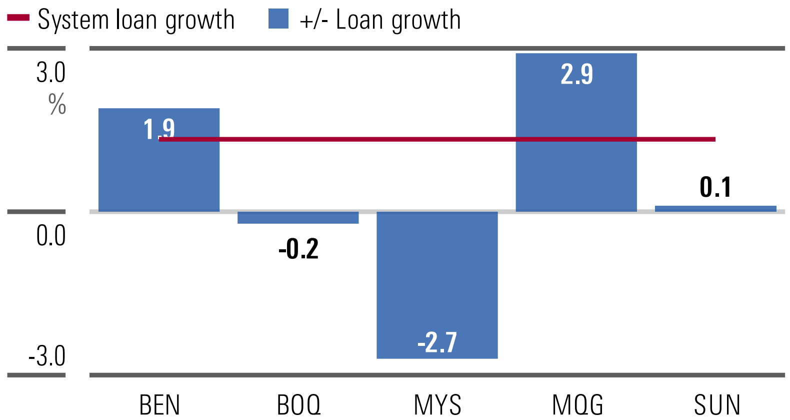
Source: Reserve Bank of Australia. Data as of June 28, 2024. (top left, top right, and bottom left). Data as of March 31, 2024. (bottom right).

Housing Loans: Majors Holding Market Share of Bank Loans

Majors' Housing Loan Growth Last Three Months*

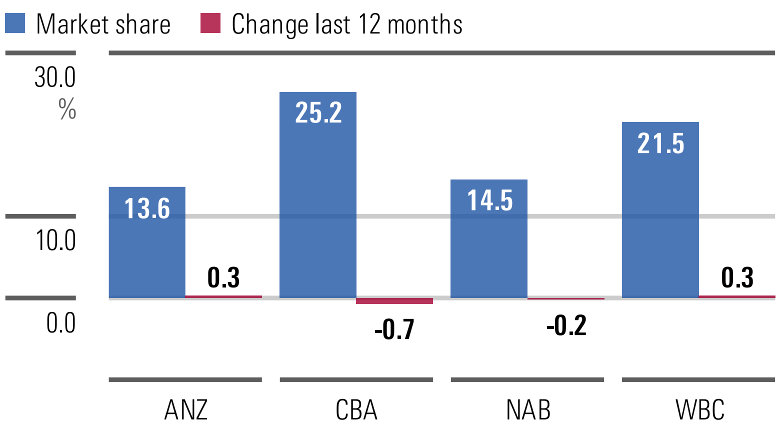


Nonmajors' Housing Loan Growth Last Three Months*

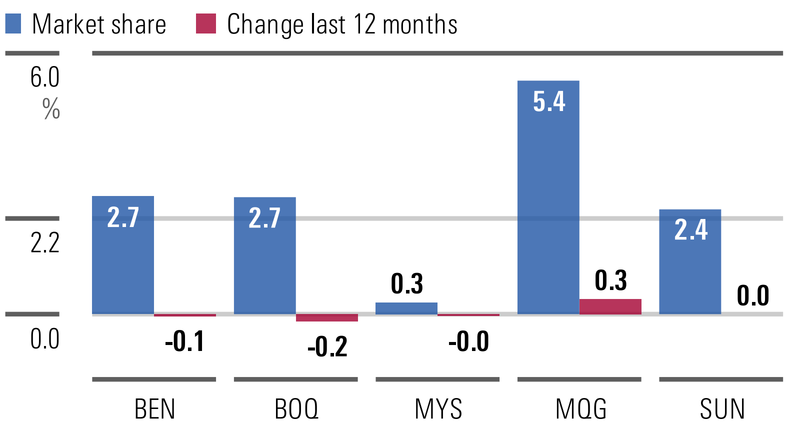


Based on Australian Prudential Regulation Authority data, home loan balances grew 1.3% in the quarter to May 2024, or 5.3% annualized, an improvement from 4.7% in the prior 12 months. Despite borrowing capacity being affected by higher rates, population growth and rising house prices support credit growth. With fears the RBA will tighten further, near-term borrower confidence could weaken.

Major Bank Market Share



Nonmajor Bank Market Share*

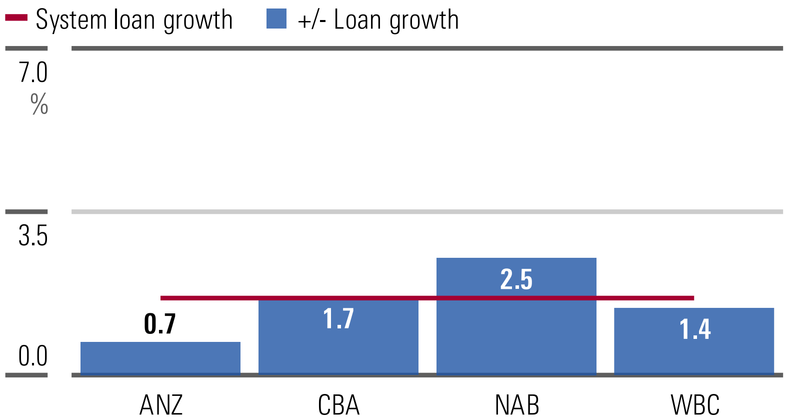


Commonwealth Bank trimmed loan rates late in 2023, narrowing the price difference between the cheapest and most expensive major bank rates. This has stemmed market share losses. Nonmajor bank performance is mixed. The nonmajors with highest funding costs have relinquished share to prevent material margin pressure. We expect Macquarie's share gains to slow given higher funding costs relative to majors and a likely internal need for higher returns.

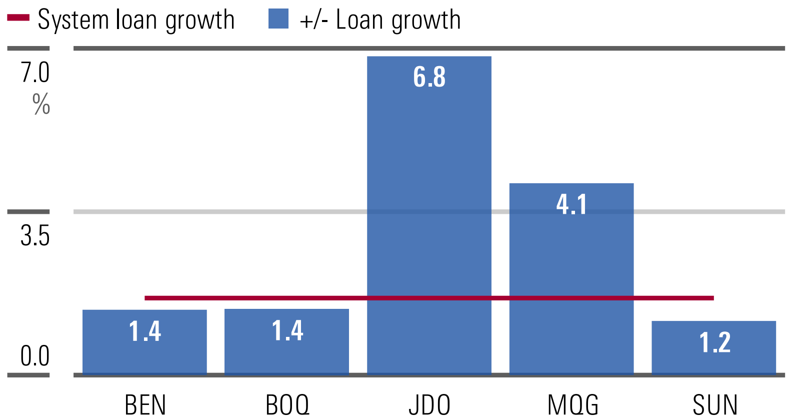
Source: Australian Prudential Regulation Authority, Morningstar. *Data for period ending May 31, 2024.

Business Loans: Steady Loan Growth

Majors' Business Loan Growth Last Three Months*

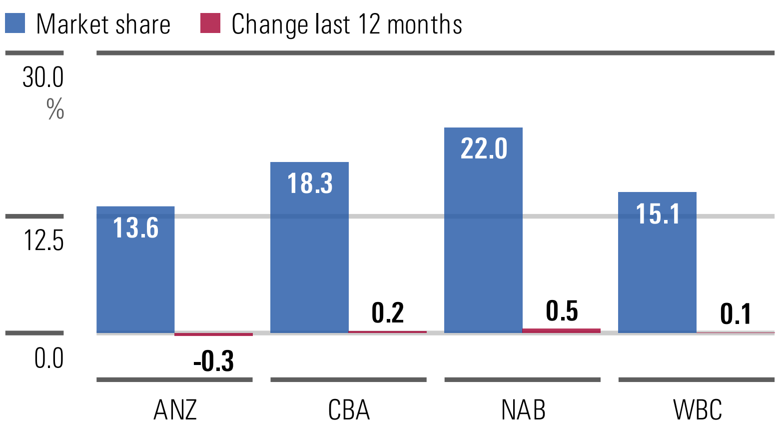


Nonmajors' Business Loan Growth Last Three Months*

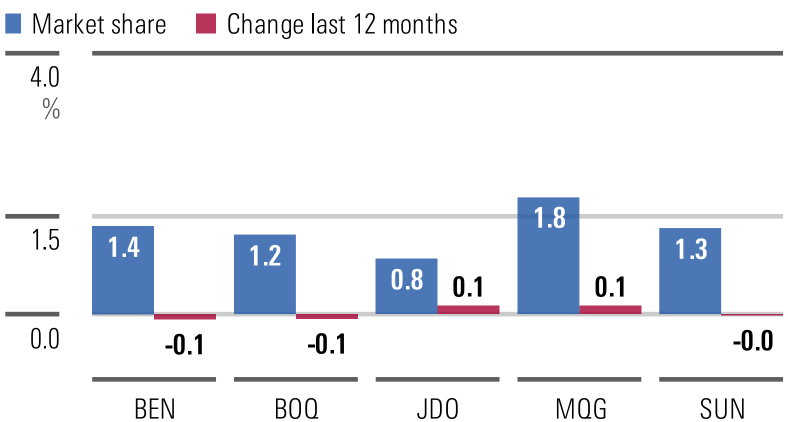


Based on APRA data, business loan balances grew 1.7% in the quarter to May 2024, an annualized rate of 6.6%. While the outlook for consumers is challenging given higher living costs, parts of the economy are expanding. Agriculture, metals and mining, the defence industry, healthcare, and manufacturing, where many companies are bringing supply chains onshore, support credit growth.

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 relies on digital origination and banking capabilities. With increased investment, the firm will likely add lending staff to support loan growth.

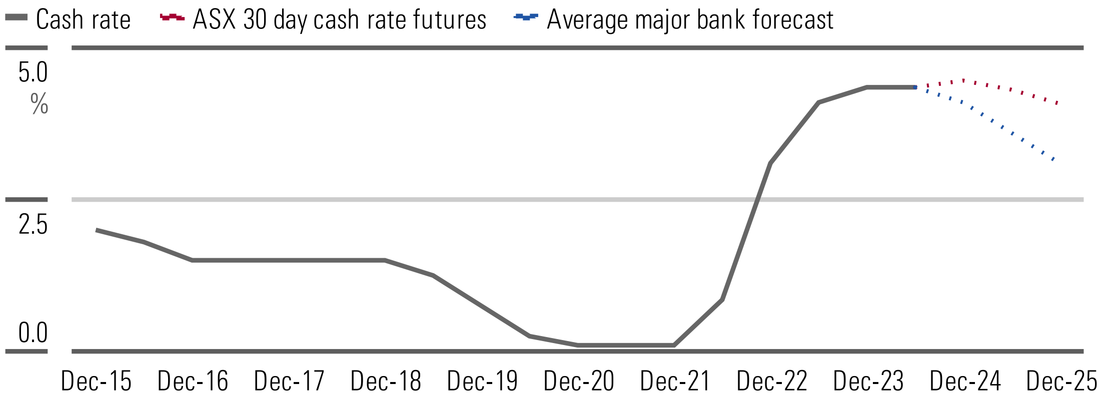
Source: Australian Prudential Regulation Authority, Morningstar. *Data for period ending May 31, 2024.

Interest Margins

Pressure on funding and lending rates moderating.

Sticky Inflation Makes Near-Term Rate Cuts Less Likely

RBA Cash Rate: Jobs and Inflation Data Could Drive Economist Forecast Revisions

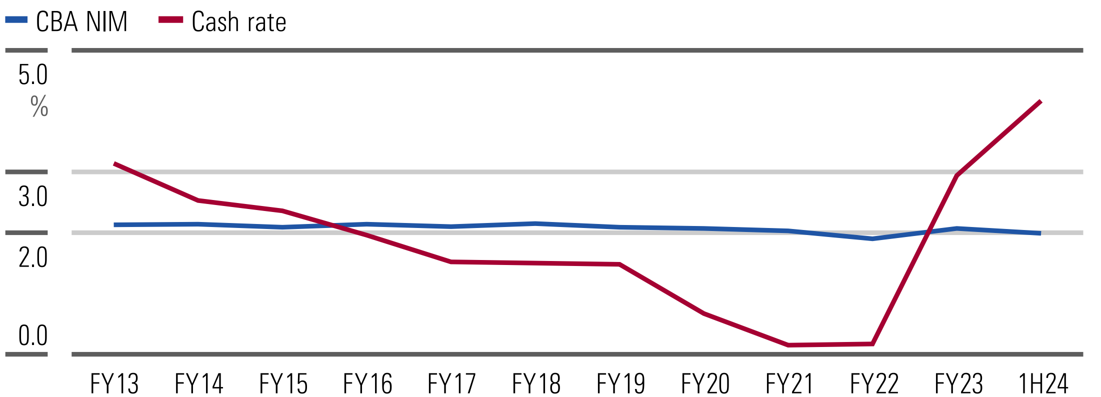


Rate Cuts Could Be Pushed Out If Labor Market and Consumption Stay Strong

The RBA seeks to return inflation to the 2%-3% target and forecasts the Consumer Price Index eases to 3.2% by June 2025 because of higher interest rates. Inflation is falling slower than expected, and the monthly inflation indicator rose to 4% in the 12 months to May 2024, from 3.6% in April, meaning additional tightening may be required.

The market pushed out rate cut expectations. ASX 30-day futures point to the cash rate of 4.35% being unchanged in 12 months, compared with last quarter where the market expected rates would be down to 3.70%. Major bank economists expect multiple RBA cuts during the next 18 months.

CBA NIM Relative to Cash Rate: Competition Drives NIM More Than Cash Rates



Higher Rates Are Generally Favorable for Margins

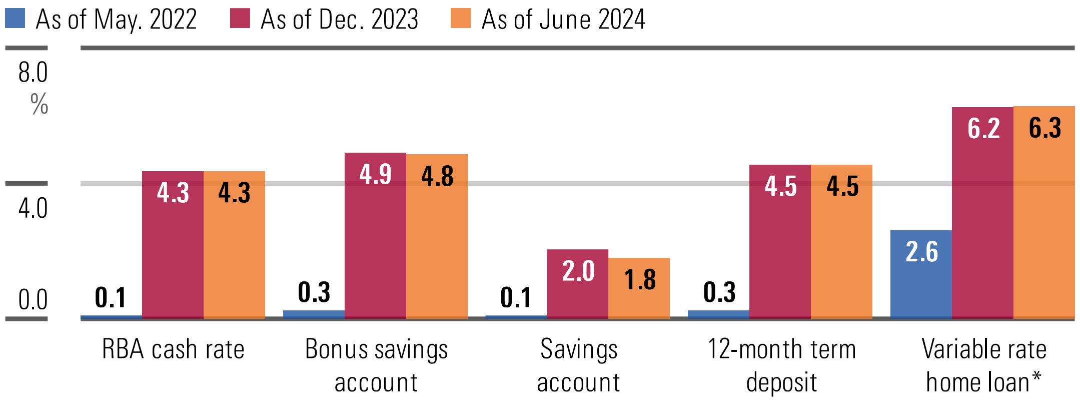
With some funding costs not increasing by as much as lending rates, such as low-rate savings and transaction accounts, higher rates is positive for bank margins, all else equal. But the intensity of competition is an important variable. Banks aim to manage both lending and deposit rates to ensure a net interest margin sufficient for an adequate return on equity. Higher-than-normal refinancing, slow credit growth, and funding maturities are headwinds.

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

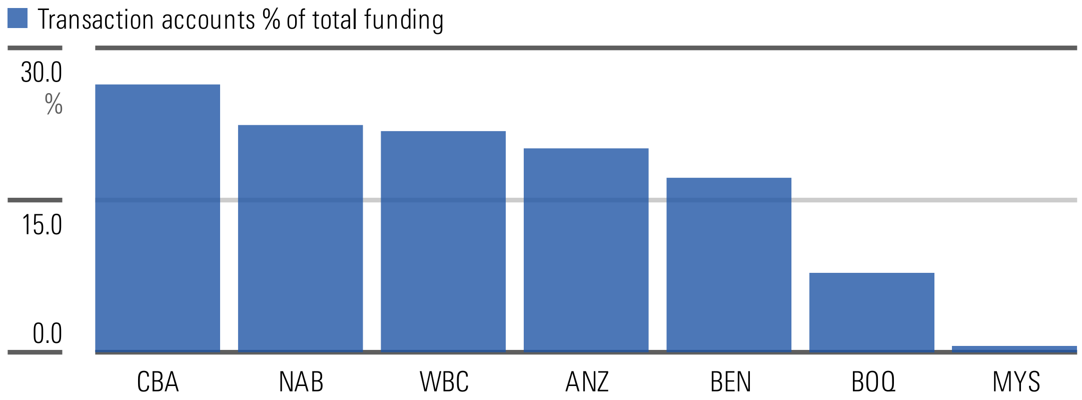
Source: RBA, ASX, Major bank average is CBA, WBC, NAB. Data as of July 2, 2024. (top). Commonwealth Bank, RBA, Morningstar. Data as of Dec. 31, 2023. (bottom).

Banks Benefit From Cheap Deposits, but Customers Seek Higher Rates

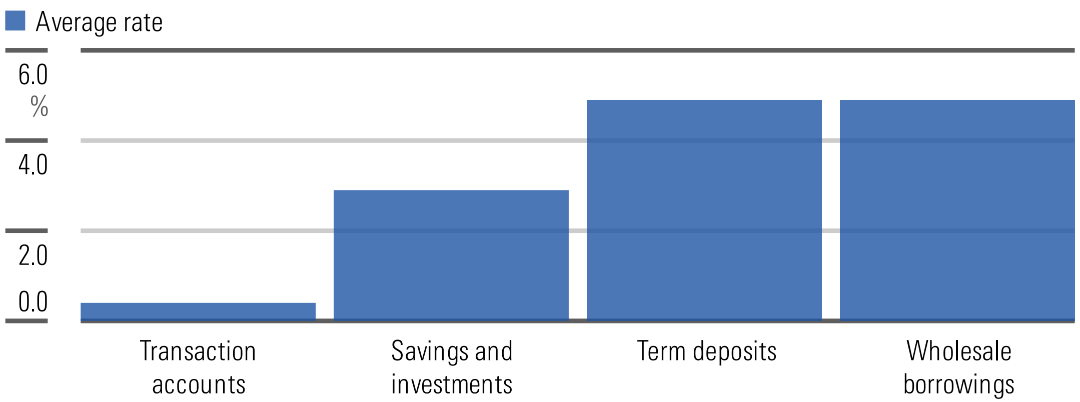
Rates: Average Deposit Rates Moderating After Outpacing Lending Rate Rises



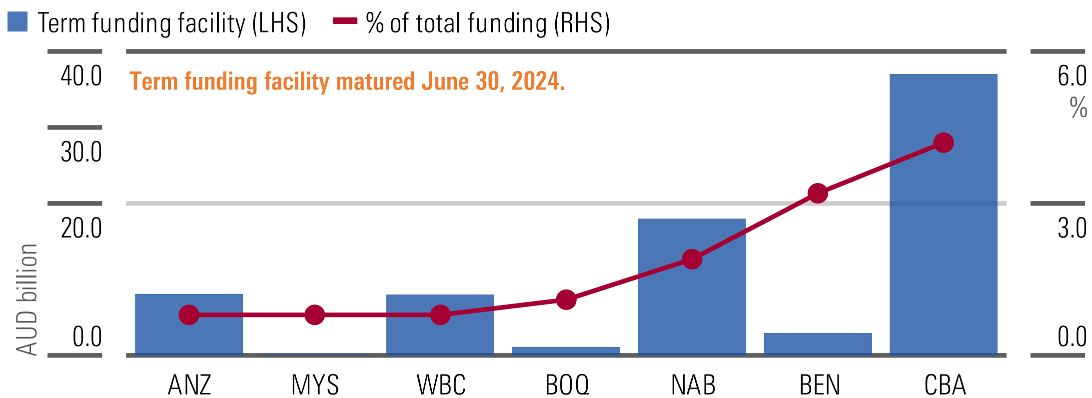
Deposit Funding: Banks With Low-Cost Deposits Best Placed to Compete



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



Term Funding Facility: Refinancing Cheap Funding Added to Deposit Competition



Source: Reserve Bank of Australia, Morningstar. Data as of June 30, 2024. (top left). *Variable rate for new home loans. Company reports, Morningstar. Data as of March 31, 2024. (top right). Bendigo Bank result presentation, Morningstar. Data as of Dec. 31, 2023. (bottom left). Company reports, Morningstar. CBA, BEN, MYS as of Dec. 31, 2023, compared with March 31, 2024, for other major banks. (bottom right).

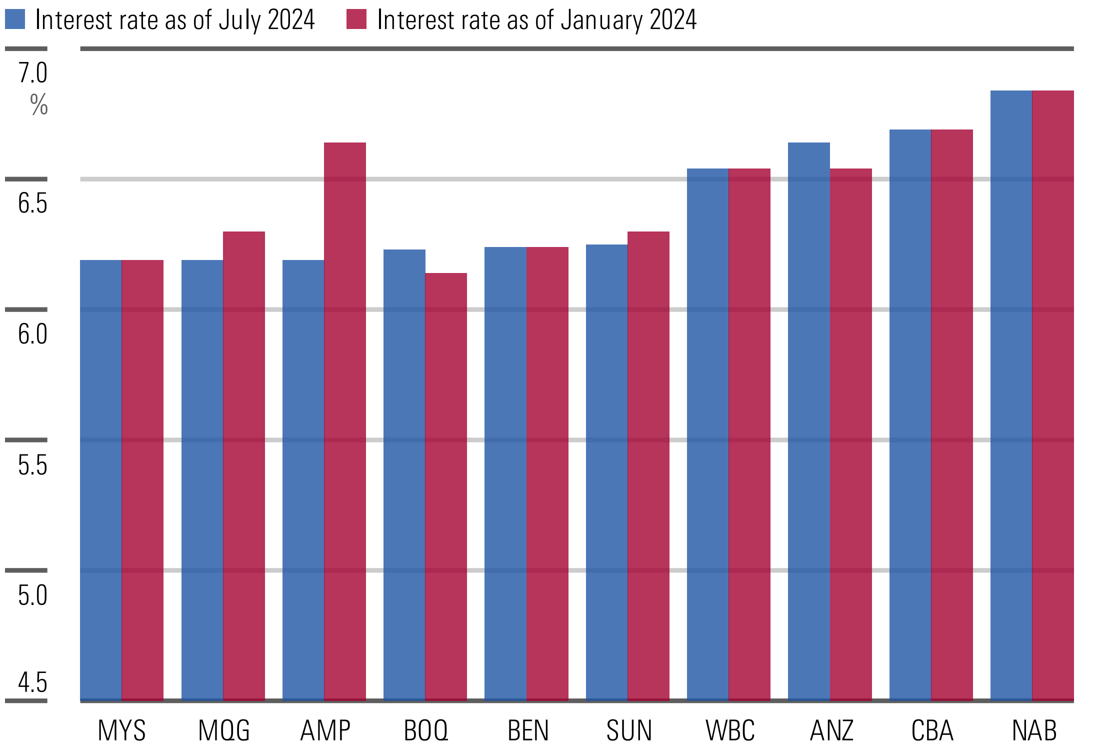
Home Loan Rates Higher, but Discounting Continues

While competition is intense, the major banks appear focused on managing margins. The average major bank rate is around 0.46% higher than the nonmajors, versus about 0.25% higher 12 months ago.

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 reflected a focus on client retention in the lower credit growth environment.

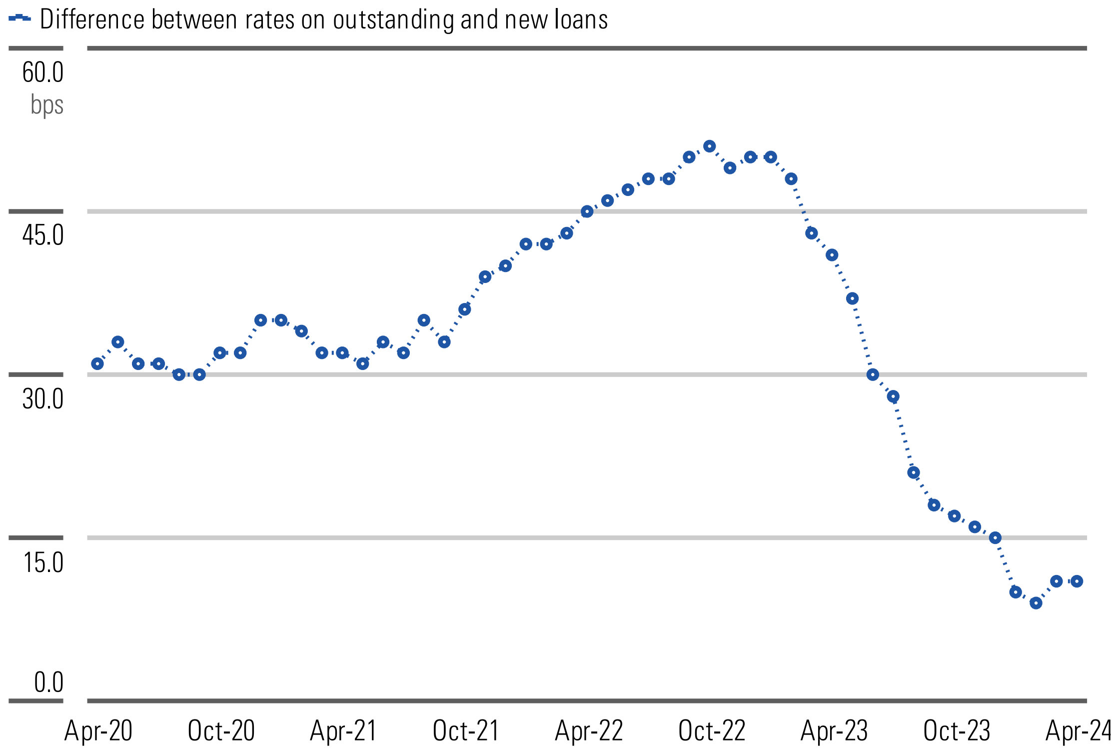
Owner-Occupier Variable Rates Steady in First-Half 2024

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



Discounts for New Borrowers Have Shrunk

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



Source: Company websites, Morningstar. Data as of July 1, 2024. (left). Reserve Bank of Australia, Morningstar. Data as of April 30, 2024. (right).

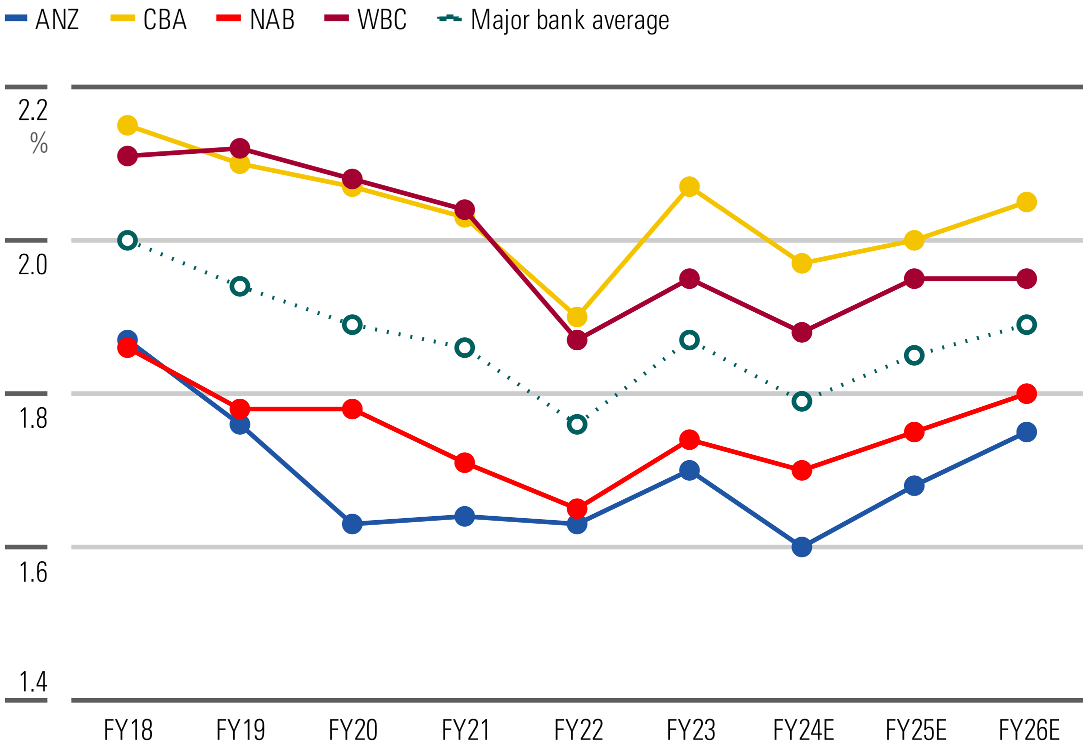
Bank Margins Not in Structural Decline

Net interest margins jumped in fiscal 2023 but are falling 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.

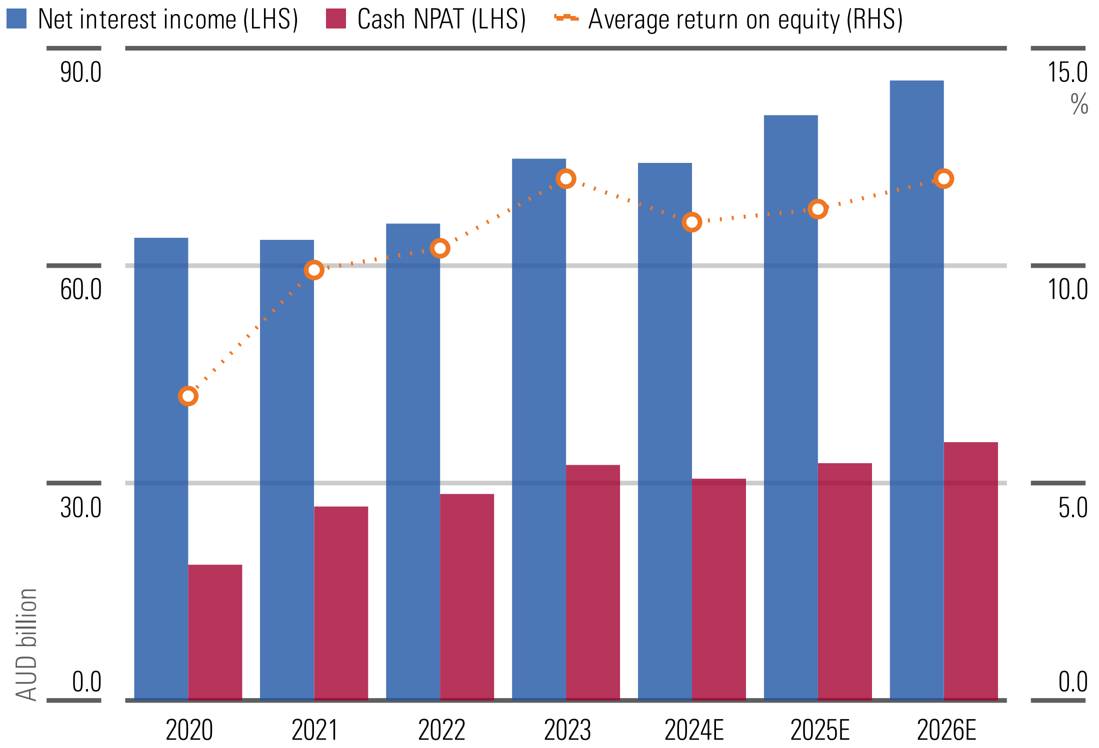
NIM Rebound Likely to Flatten Out

Morningstar NIM forecasts based on fiscal period.



Net Interest Income Growth Key to Our Profit Forecasts

Total of major banks.



Source: Company reports, Morningstar estimates. Data as of June 30, 2024. Note: NPAT = net profit after tax.

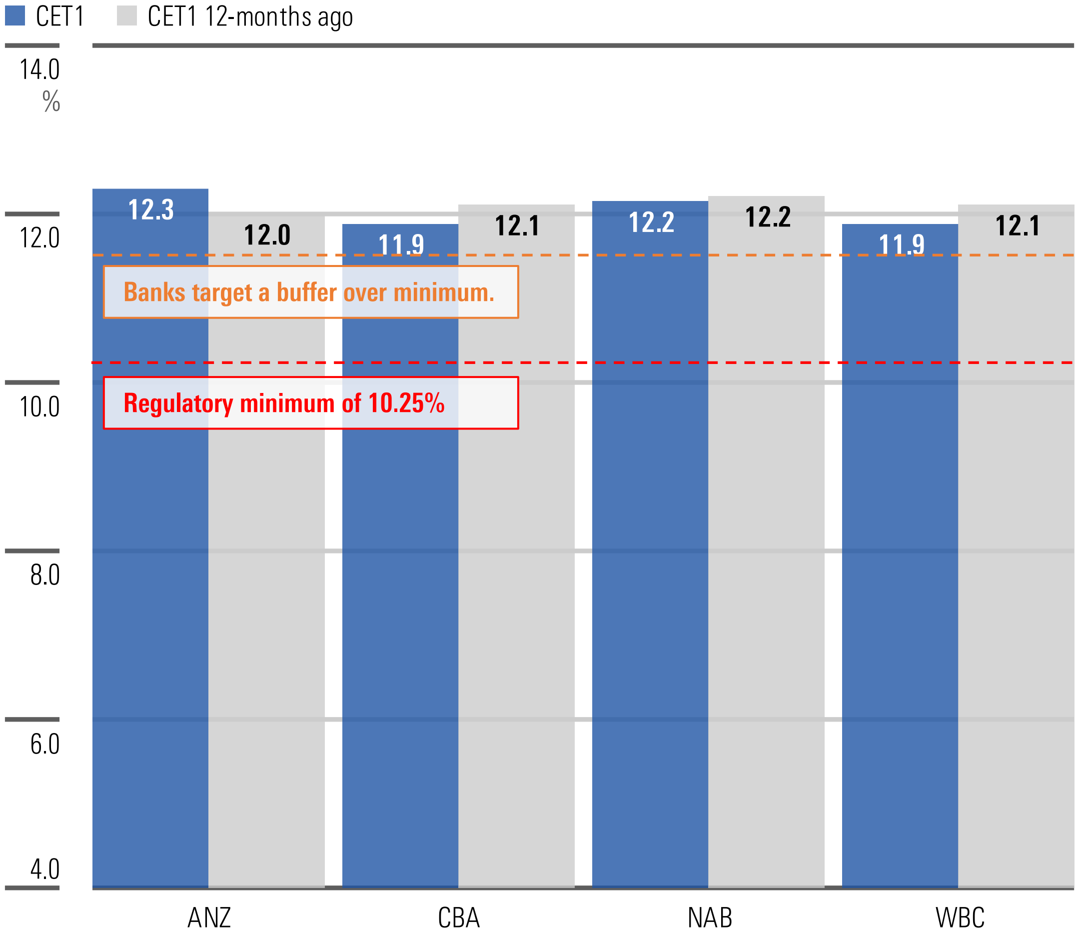
Capital and Credit Risk

Banks well capitalized for higher bad debts.

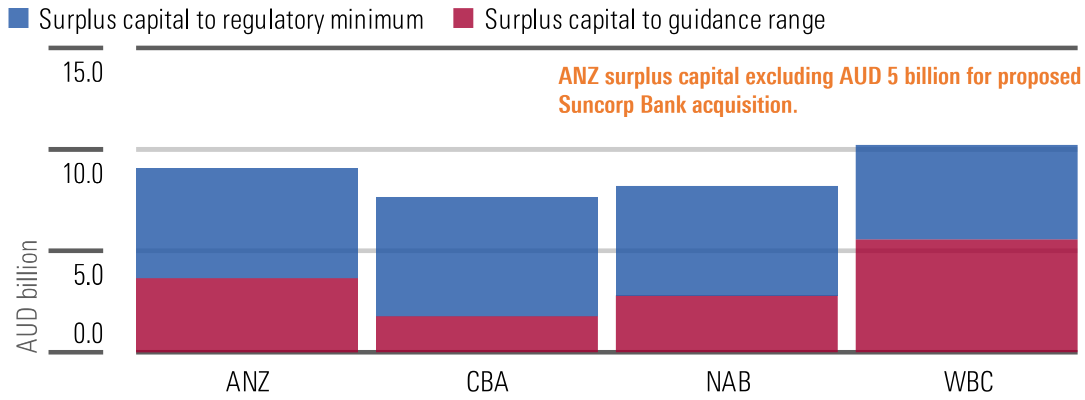
Bank Balance Sheets Are Sound

Major Banks Comfortably Exceed Regulatory Capital Requirements

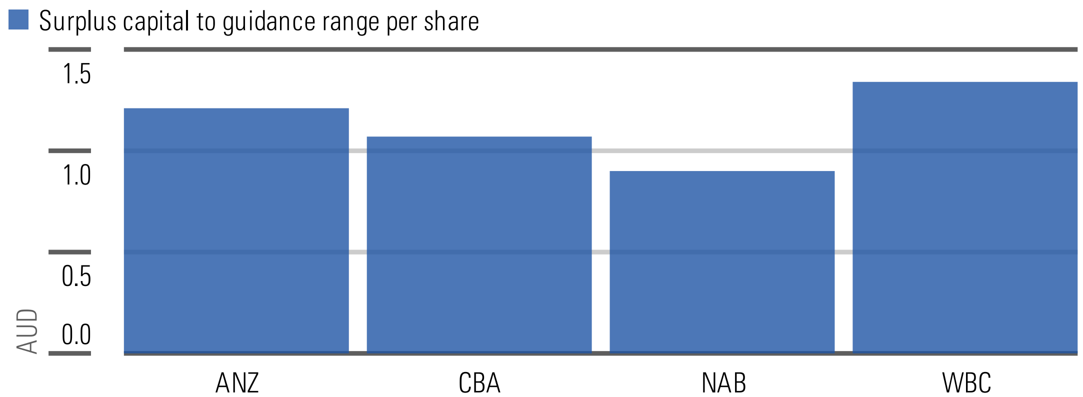
CET1 ratio compared with 12 months prior.



Substantial Surplus Capital Over Minimums and Target



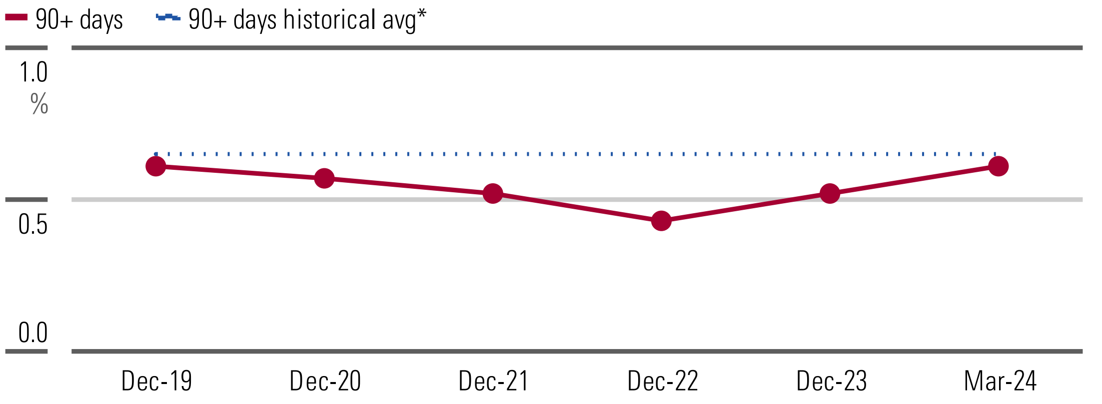
Provides Capital to Support Dividends and Buyback Shares



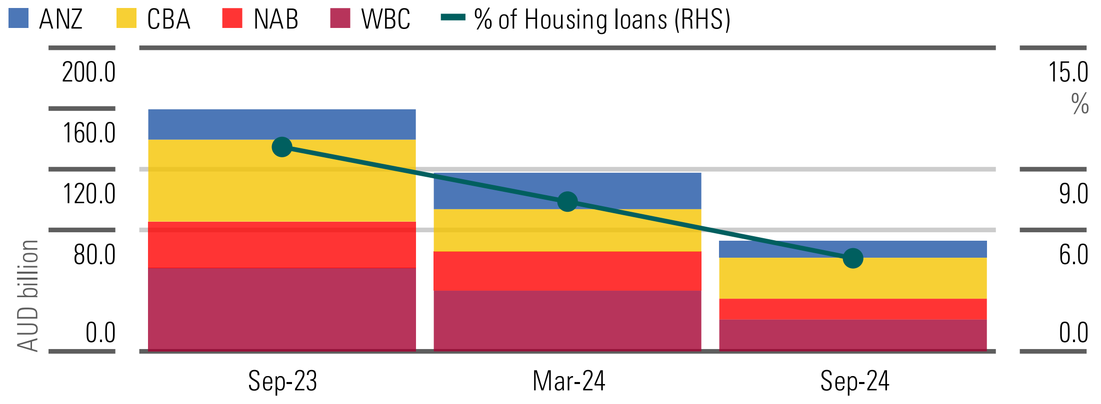
Source: Company reports. Morningstar. Data as of March 31, 2024. Note CET1 = common equity Tier 1 ratios. Surplus to guidance range assumes management target of 11.5%.

Rising Arrears but House Price Strength Derisks the Potential for Large Loan Losses

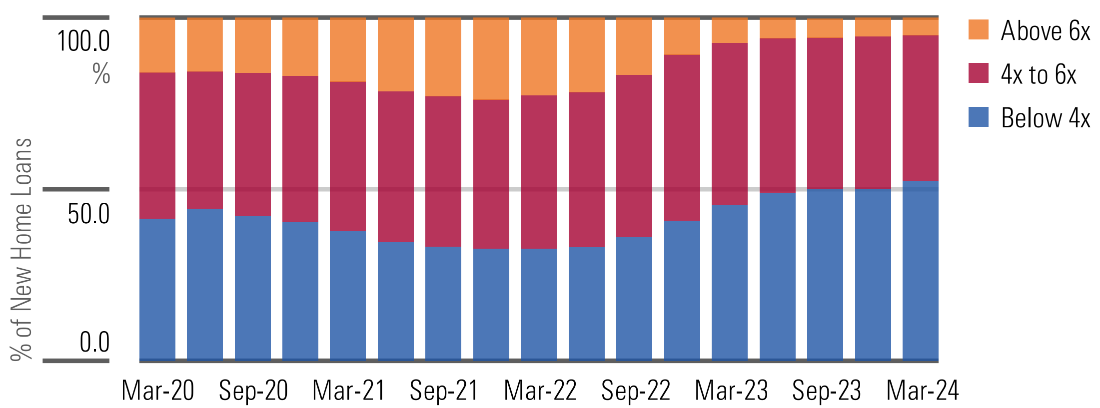
Commonwealth Bank Home Loan Arrears: Rising From Low Levels



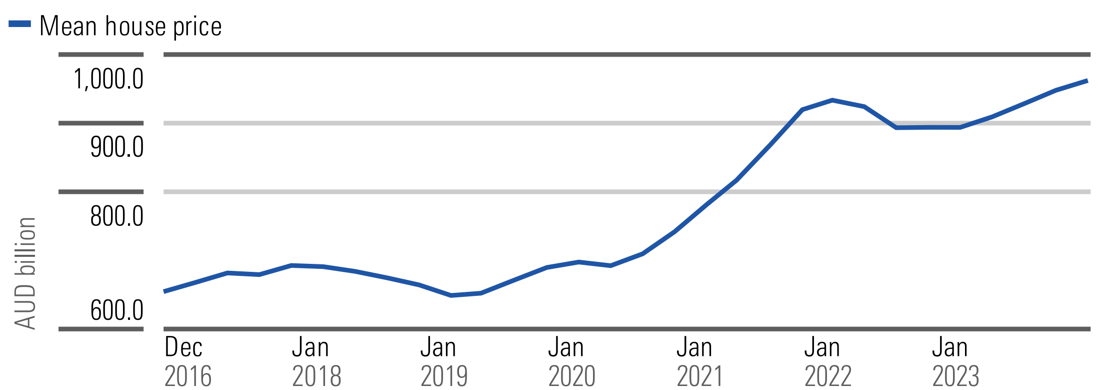
Fixed Rate Mortgage Maturities: Ultra Cheap Loans Have Mostly Matured



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



House Prices: Expands Equity Buffers and Limits Bank Losses



Source: Commonwealth Bank. (top left). * Historical average is between fiscal 2008 and 2023. Company reports. (top right). APRA. (bottom left). Note DTI = debt/income ratio. Australian Bureau of Statistics. (bottom right). Data as of March 31, 2024.

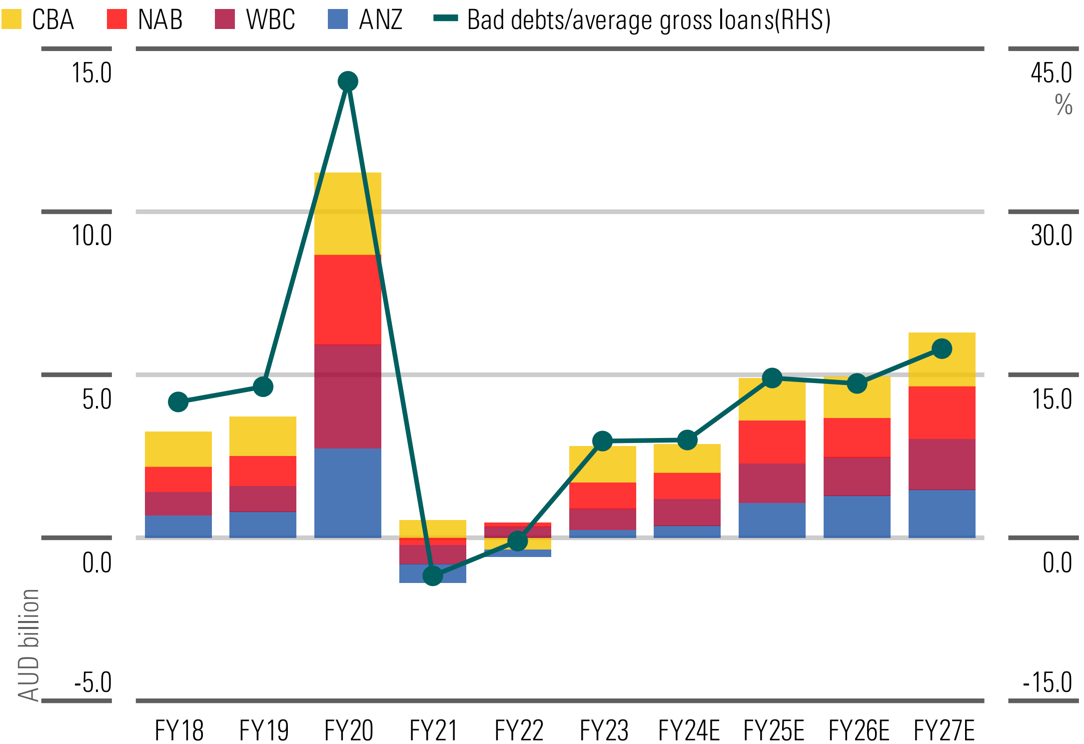
Bad Debts Becoming an Earnings Headwind

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 below historical averages.

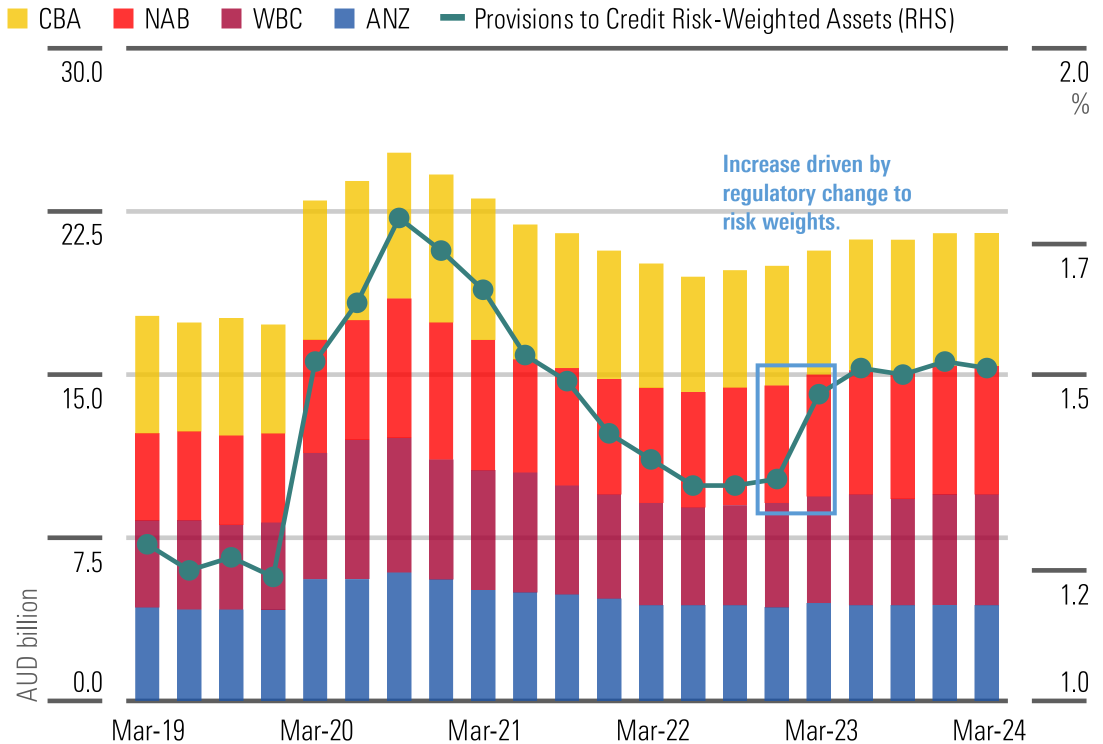
Major Bank Bad Debts Set to Normalise, Not Spike

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



Bank Provisions Provide Profit and Loss Buffer

Provisions (LHS) include collective and specific provisions.



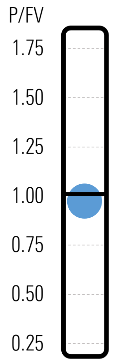
Source: Company reports, Morningstar. Data as of March 31, 2024.

Top Picks and Coverage

Opportunities despite discounts narrowing.

ANZ Group and Westpac Modestly Undervalued, Commonwealth Bank Premium Is Puzzling

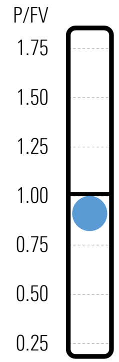
Australian Major Bank



Company (Ticker)	Market Cap	Rating	Last Close	FV Est.	Moat
Westpac Banking (WBC)	AUD 95 bn	★★★	27.23	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.

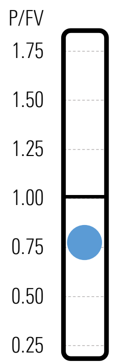
Australian Major Bank



Company (Ticker)	Market Cap	Rating	Last Close	FV Est.	Moat
ANZ Group (ANZ)	AUD 88 bn	★★★	28.24	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.

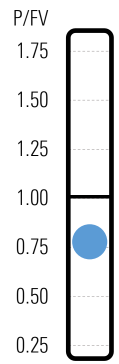
Australian Nonmajor Bank



Company (Ticker)	Market Cap	Rating	Last Close	FV Est.	Moat
Bank of Queensland (BOQ)	AUD 3.8 bn	★★★★	5.81	7.50	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.

Australian Nonmajor Bank



Company (Ticker)	Market Cap	Rating	Last Close	FV Est.	Moat
MyState (MYS)	AUD 0.4 bn	★★★★	3.74	4.80	None

MyState commands a tiny 0.3% share of the Australian home loan market, but with investment in its digital offerings and an 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 with rising customer deposit funding costs, 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. Data as of June 30, 2024.

Some Value in ANZ Group and Westpac, Margin Downside for Nonmajors Overstated

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)	84.8	Wide	Medium	28.2	31.0	★★★	0.91	12.4	5.8%	-3.9%	+19.1%
Westpac Banking (WBC)	94.5	Wide	Medium	27.2	28.0	★★★	0.97	14.0	6.0%	+4.3%	+27.6%
National Australia Bank (NAB)	112.1	Wide	Medium	36.2	31.0	★★	1.17	15.3	4.7%	+4.6%	+37.4%
Commonwealth Bank of Australia (CBA)	213.1	Wide	Medium	127.4	90.0	★	1.42	21.8	3.6%	+5.9%	+27.0%
Major Banks (weighted avg)							**1.19**	**17.3**	**4.7%**	**+3.6%**	**+28.1%**
Bank of Queensland (BOQ)	3.8	None	Medium	5.8	8.0	★★★★	0.73	11.9	5.7%	-8.1%	+5.8%
MyState Bank (MYS)	0.4	None	Medium	3.7	4.8	★★★★	0.78	12.0	6.1%	+2.2%	+18.0%
Judo Capital (JDO)	1.4	None	High	1.3	1.2	★★★	1.05	18.4	0.0%	-5.3%	+6.3%
Bendigo & Adelaide Bank (BEN)	6.5	None	Medium	11.5	10.5	★★★	1.09	11.7	5.6%	+12.1%	+33.8%
Nonmajor Banks (weighted avg)							**0.96**	**12.5x**	**5.0%**	**+3.4%**	**+21.3%**
AMP (AMP)	2.9	None	High	1.1	1.2	★★★	0.91	12.1	2.8%	-6.4%	-3.1%
Macquarie Group (MQG)	78.4	Narrow	High	204.7	185.0	★★★	1.11	19.1	3.4%	+2.5%	+15.2%
Suncorp Group (SUN)	22.2	None	Medium	17.4	14.5	★★	1.20	16.3	4.3%	+6.3%	+29.1%
Diversified Financials (weighted avg)							**1.12**	**18.3x**	**3.6%**	**+3.1%**	**+17.7%**

Source: Morningstar. Data as of June 30, 2024.

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