WILSONS

Aussie Banks: Maintain Overweight Ahead of Results Season

Our monthly view on Australian equities.

9 April 2021

7 Months of Overweight Banks

The major banks outperformed again in March (+5.3%), above the S&P/ASX 200 +2.4%, marking the 7th month in a row where banks have overperformed.

Over the past 6 months, Australia and New Zealand Banking Group (ANZ) (+58%) has been the clear outperformer, followed by National Australia Bank (NAB) and Westpac Banking Corporation (WBC) at (+43%). Commonwealth Bank (CBA) has lagged (+30%), reflecting lower leverage to the recovery and the benefit of starting from a stronger position without the need to raise equity during COVID-19.

The upcoming bank results season is likely to be well received by the market and shaped by 4 areas of focus:

1. Bad debt provision reversals
2. Higher dividends
3. Pathways to capital management, which could potentially total ~$A20bn in size across the sector over FY22E
4. New strategic initiatives

The Australian Equity Focus List remains overweight the bank sector - ANZ, Macquarie Group (MQG), NAB and WBC. We continue to see upside across the industry as the economy recovers, lending growth improves and strategic initiatives take hold. Market conditions are likely to continue to remain favourable given the prospect of further upward moves in long bond yields through 2021 and acceleration in the domestic recovery cycle.

Where do Valuations Sit?

Australian banks no longer provide the deep value on offer in 3Q20. Valuations have risen dramatically from 0.9x book value in 3Q20 - when we began to close the Focus List's underweight in banks. Today, we are overweight the banks, with valuations sitting at around 1.4x.

While valuations have improved, share prices are still 15% below levels implied by looking at the long-term measures of price to book ratios (P/B), or on the same basis, 30% below 2015 levels before the multi-year bank derating process ended in mid-2020.

Exhibit 1: P/B ratio has re-rated by 40% since 3Q20

Source: Refinitiv, Wilsons.

From an earnings perspective, the re-rating has been quite dramatic. Price to earnings ratios (PER) have risen from 11x to 16x across the big four banks. These multiples are still based on depressed earnings estimates, consequently concealing the whole story.

FY21E consensus pre-provision bank sector earnings are around 30% below 2016 levels – the last year pre-provision earnings grew for the sector. To be clear, not all of the reduction in earnings is cyclical (Royal Commission, COVID-19). Banks divested ~15% of core earnings via asset management and life insurance asset sales.

Relative to the market, the sector trades at 0.88x, just above the long-term average of 0.85x. The prospect of further earnings and dividends upgrades through 2021 and capital management in 4QCY21 is likely to see this gap close in our view. We have seen PE relative as tight as 0.95x in prior upgrade cycles.

Where do Bad Debt Provisions Sit?

Consensus provisions for bank sector bad debts have halved since December 2020 from ~$8bn to $4bn off the back of stronger domestic economic performance. We think provision levels still look excessive given the economic performance of Australia.

Rising house prices, materially stronger employment numbers, and low-interest rates suggest provisions are still too high. We have seen two of the major banks - ANZ and WBC - already begin to write-back provisions at FY20 results in November 2020 and think this will be a theme in the upcoming May results.

Adding to the argument is the prospect of provisions releases. As of February 2021, less than 1 in 10 customers on support in mid-2020 continue to be on loan deferral programs. We will be watching closely for any impact on loan deferrals through April and May, given JobKeeper ceased at the end of March.

Exhibit 2: PER have re-rated significantly on still depressed earnings levels

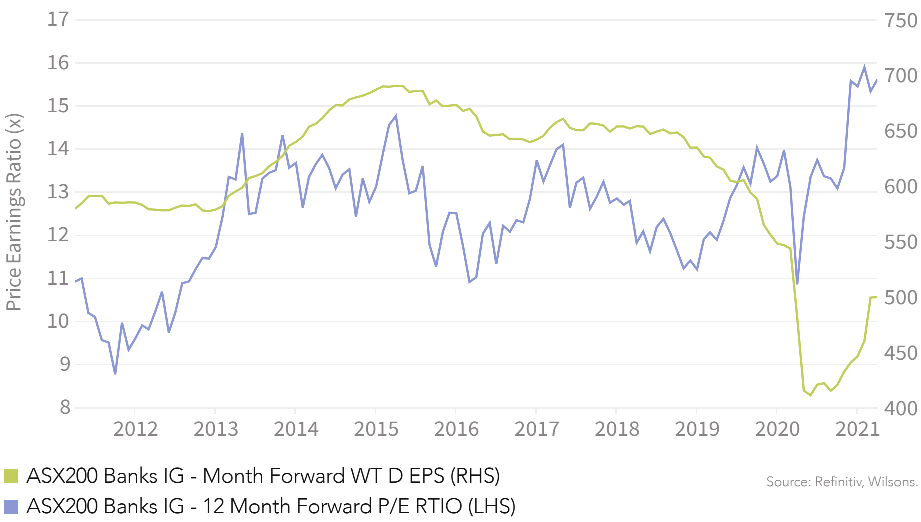


Exhibit 3: Consensus provision estimates have halved since last results season

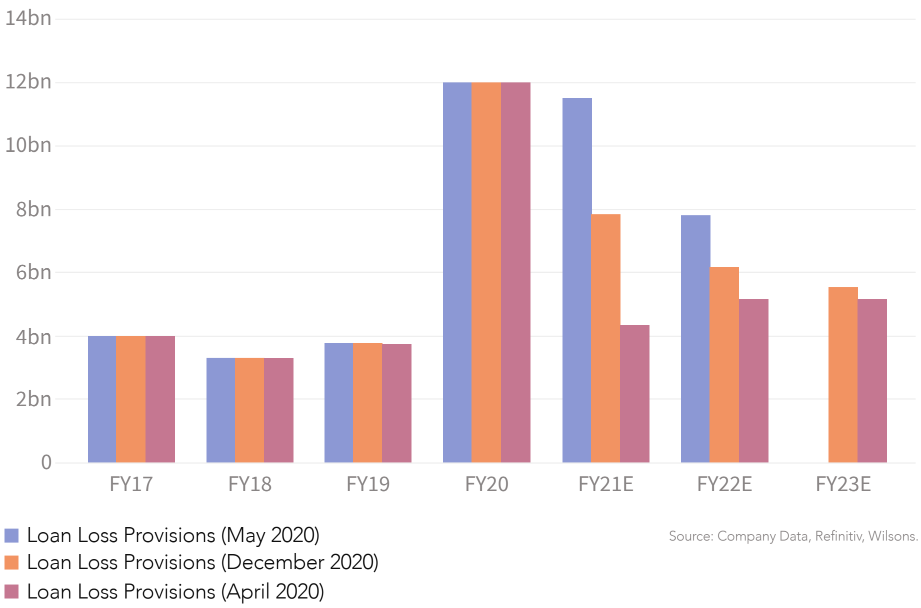
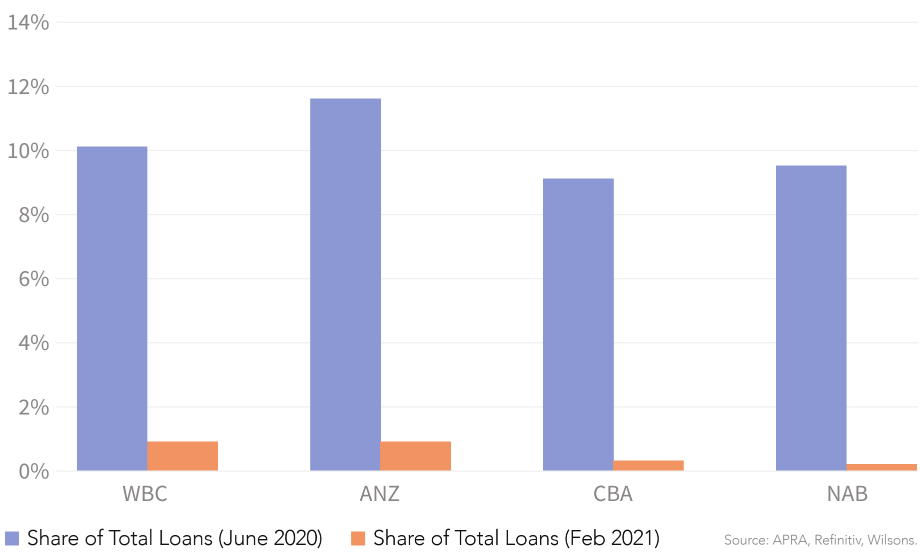


Exhibit 4: Loan deferrals have collapsed over the past 6 months



Where do Dividend Expectations Sit?

The good news for dividend-focused investors is that dividend revisions are significantly outpacing earnings revisions. This is something we flagged in late 2020.

> Read our Australian Equities - Potential Re-Rating of the Banks.

The pace of dividends per share (DPS) upgrades has accelerated post the removal of DPS restrictions from both Australian and New Zealand regulators in recent months.

In terms of 1H21 DPS estimates, the market is currently looking for +80% growth 1H21 on 2H20. The market is looking for 1H21E dividends of: ANZ 70cps, NAB 58cps and WBC 58cps.

Payout ratios are still below pre-COVID-19 levels, implying banks will likely be growing core equity tier-1 (CET1) capital as a result. This is something regulators are likely to look favourably at, despite little immediate need to do so in the eyes of many investors. Guidance on future payout ratios will be sought-after from bank management teams, with NAB already committed to giving more detailed guidance at these results.

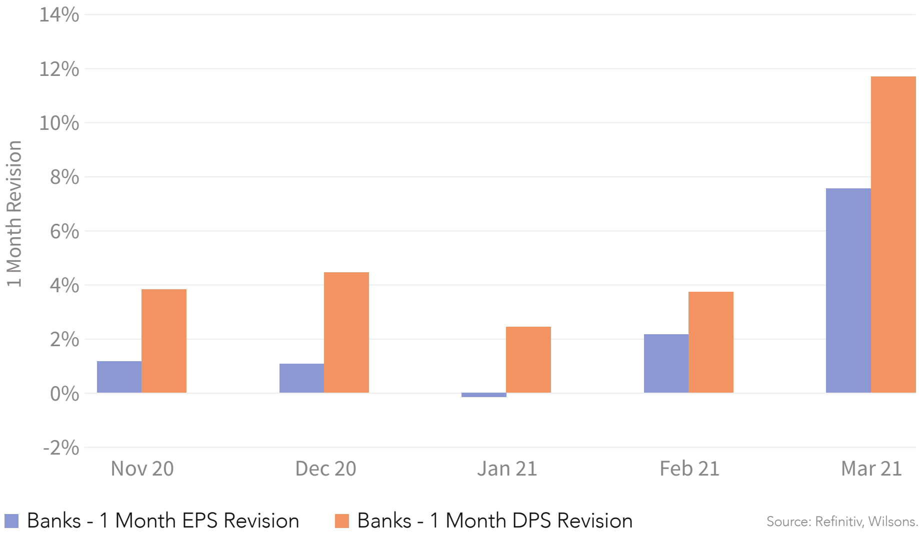
Currently, banks yield ~4.5% 12month fwd, which compares to the broader market currently at 3.4%.

Surplus Capital

We expect banks to show proforma CET1 levels of ~12.3%, in part influenced by where the dividend payout ratio is struck. There remains some ambiguity as to where APRA will end up being comfortable with CET1 levels. We think a 11.0% (low) to 11.5% (high) range is likely, which implies between $9bn and $20bn of potential surplus capital across the big four banks. At current prices, that is broadly equivalent to an additional dividend payment.

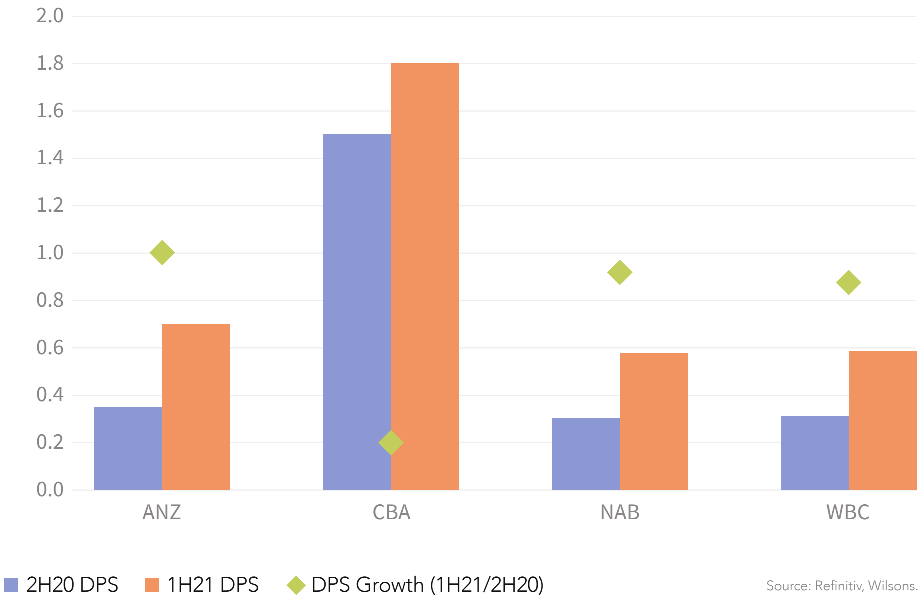
Timing? It is likely banks will show investors a pathway to capital returns in May, but will not act until the November FY21 results. Both banks and regulator conservatism will win the day. We suspect buybacks are preferred given franking balances and greater long-term benefit than a reduction in issued capital can provide. The banks may also opt for a phased approach at both the November 21 and May 22 results periods.

Exhibit 5: Dividend revisions have outpaced earnings revisions since Nov 2021



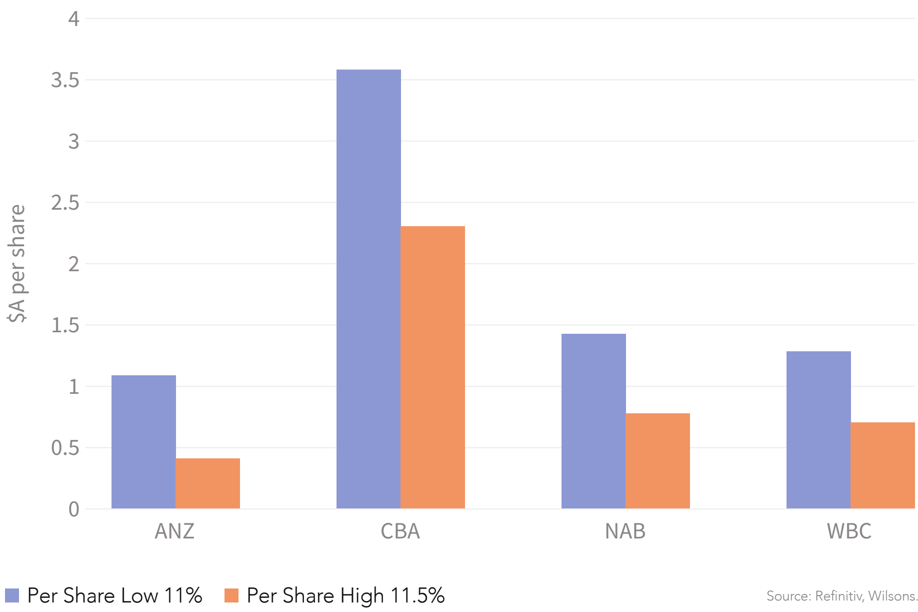
Source: Refinitiv, Wilsons.

Exhibit 6: 1H21 dividends are likely to be +80% on 2H20



Source: Refinitiv, Wilsons.

Exhibit 7: How much surplus capital do the banks have?



Source: Refinitiv, Wilsons.

Credit Growth

After going backwards in CY20 due to COVID-19 loan growth has accelerated, but still only 1.0-1.5%. Business and personal lending via the authorised deposit-taking institutions (ADIs) continues to be flat or in decline, respectively.

APRA statistics show loan growth running at >5% (3month ann) for housing credit at present. ANZ and CBA are showing the strongest housing-related loan growth, while NAB and WBC are lagging. All four majors are growing at slower rates than the regionals at present.

The market expects credit growth to improve – but higher repayment levels and lower redraws are likely to put a cap on the ultimate level of credit growth. There also remains the risk in 2HCY21 that macro-prudential lending limits are applied to limit house price growth. Total system credit growth of >2% over 2021 would represent an upside risk to consensus earnings for the banks.

Exhibit 8: Can credit growth accelerate further in 2022-23?

Source: APRA, Wilsons.

Our Investment Thesis on the Banks

1. **Unwinding provisions**

   We believe the banks over provided for the risks of COVID-19 related bad debts. We are expecting an unwinding of these provisions over the next 12 months as the predicted surge in bad debts fails to materialise.

2. **Economic recovery**

   We believe the economy will recover faster than expectations, leading to further earnings upgrades for the banks. Banks tend to do well in a steepening yield curve environment.

3. **Dividends**

   A rebound in payout ratios, coupled with earnings growth will produce higher dividends in FY21. Capital management likely in FY22.

4. **Improving regulatory backdrop**

   The worst is behind the banks from a regulatory perspective. The reduction in potential risks is particularly important for our view on Westpac – the regulatory laggard of sorts.

5. **Valuation**

   We believe there is still more runway for the banks, with an improved economic and regulatory backdrop than pre-COVID-19. P/B ratios can expand a further 15%, which only takes valuation back to pre-COVID-19 levels.

Focus List Positioning

The Focus List remains overweight the banks (but underweight financials), with ~300bp active position across ANZ, NAB and WBC. We have zero exposure to CBA primarily on relative value grounds given our expectations around the value/growth rotation theme likely has at least another 6 months to run.

We look through near-term PE multiples – given earnings are depressed and share counts are inflated (perhaps by around 3-5%), instead focusing on P/B measures as a better reflection of value on multiple bases. This suggests +15% upside remains, implying a total returns potential in the +20% level over the next 12 months.

We remain cognisant of the longer-term structural challenges for the banks. To grow earnings ahead of GDP, when many growth options are being effectively regulated away (offshore, asset management, insurance etc), will be a hard task. We believe these are longer-dated issues that will not get in the way of a more normalised P/B valuation being achieved, powered by what looks like a convincing cyclical recovery story.

Over the next 6 months investors will be asking more from bank management teams around strategic initiatives to grow earnings in a post-COVI-19, post Royal Commission environment.

Westpac remains a standout in this regard. New CEO Peter King is expected to unveil the new WBC strategy at the May results. We have previously flagged that WBC costs look too high versus peers - likely to feature in the strategy reset program - leaving WBC vulnerable to further re-rating.

Exhibit 9: Wilsons banks preferences

Ticker	Company	AEQ Focus List Weight	Market Weight	Active Weight	Result Date	Wilsons' Comment
MQG	Macquarie Group	6.0%	2.5%	3.5%	07-May-21	First guidance for FY22E. Market looking for just 4% earnings growth - which is potentially conservative.
ANZ	Australia and New Zealand Banking Group	7.0%	3.7%	3.3%	05-May-21	1H21E further reduction in BDD, pathway to capital returns.
NAB	National Australia Bank	7.0%	3.9%	3.1%	06-May-21	Likely to provide more details on approach to capital management at 1H21 results in May.
WBC	Westpac Banking Corporation	7.0%	4.1%	2.9%	03-May-21	New management team. New cost targets expected in May 21, leverage to housing.

Exhibit 10: Focus List sector weights & reasons

Sector	Focus List Weight	Market Weight	Active Position	ISG Comment
Financials	27%	30%	-3%	Overweight banks. No exposure to insurance - still too much uncertainty around business interruption.
Materials	19%	20%	-1%	Slightly underweight - no exposure to EV minerals. We are overweight materials + energy combined.
Healthcare	8%	10%	-2%	Underweight - sector leader CSL likely to underperform. Higher 10yr bond yields are a headwind for healthcare.
Industrials	14%	7%	7%	Overweight transport - SYD and TCL still have upside over a 12 month view. Large overweight positions to RWC and SVW. Bullish housing and resources capex.
Information Technology	7%	4%	3%	Headwind of a steepening yield curve should be offset by the strong growth in these companies, such as APT with ~100% revenue growth.
Real Estate	7%	6%	1%	Overweight logistics and large format retail. Demand for these sectors brought forward during COVID-19. No exposure to office or residential.
Consumer Discretionary	6%	8%	-1%	Spending on goods is set to face an uphill battle into FY22 after a strong FY20/21. Services spending to improve, but believe valuations for travel companies like FLT are expensive. Overweightgaming through ALL.
Energy	8%	4%	4%	Oil can still move higher from here. WOR provides a diversified project management company that can pivot towards clean energy. STO for production growth.
Communication Services	3%	4%	-1%	Overweight advertising. Recovery likely in this sector after COVID-19. Underweight telecoms.
Consumer Staples	0%	6%	-6%	Portfolio is more cyclically focused at present.
Utilities	0%	1%	-1%	Portfolio is more cyclically focused at present.

Source: Refinitiv, Wilsons.

Exhibit 11: Focus List Table

Ticker	Name	Sector	Focus List Weight	Price	EPS CAGR (FY1-FY3)	PE (NTM)	Div Yield (NTM)	ROE (NTM)
Asset Valuation Plays								
AVN	Aventus	Real Estate	4.0%	2.9	4%	14.9	6.0%	7.8%
NWS	News Corporation	Communication Services	3.0%	32.2	26%	40.1	0.7%	4.3%
Cyclical Quality Growth								
ALL	Aristocrat Leisure	Consumer Discretionary	3.5%	35.9	26%	26.3	1.5%	22.8%
WOR	Worley	Energy	4.0%	10.9	41%	17.3	4.2%	5.0%
BHP	BHP Group	Materials	10.0%	45.9	-9%	11.7	5.1%	27.0%
JHX	James Hardie Industries	Materials	3.0%	41.7	15%	25.9	1.6%	33.5%
MQG	Macquarie Group	Financials	6.0%	151.7	8%	18.6	3.7%	13.6%
Cyclical Value								
ANZ	ANZ	Financials	7.0%	28.4	3%	14.0	4.9%	9.4%
WBC	Westpac	Financials	7.0%	24.8	3%	14.7	4.7%	9.0%
OZL	OZ Minerals Limited	Materials	3.0%	24.2	9%	20.3	1.1%	11.1%
NAB	NAB	Financials	7.0%	26.3	5%	15.2	4.6%	9.3%
RWC	Reliance	Industrials	3.0%	4.7	3%	20.4	2.5%	11.7%
STO	Santos Limited	Energy	4.0%	7.2	0%	14.0	1.4%	10.0%
SUL	Super Retail	Consumer Discretionary	3.0%	12.2	-16%	13.2	4.8%	17.5%
SVW	Seven Group Holdings	Industrials	4.0%	23.4	10%	14.6	2.2%	15.4%
Defensive Growth								
SYD	Sydney Airport	Industrials	3.0%	6.3	N/A	N/A	2.1%	3.6%
NST	Northern Star Resources	Materials	3.0%	10.7	25%	13.2	2.1%	22.6%
TCL	Transurban Group	Industrials	4.0%	13.7	N/A	475.8	3.8%	4.8%
Secular Growth								
APT	Afterpay	Information Technology	2.0%	118.5	N/A	354.6	0.0%	3.8%
CSL	CSL	Healthcare	4.0%	263.0	10%	38.7	0.8%	27.2%
GMG	Goodman Group	Real Estate	3.0%	18.6	11%	26.3	1.7%	11.1%
RMD	ResMed	Healthcare	2.0%	26.1	9%	36.1	0.7%	24.9%
TLX	Telix Pharmaceuticals	Healthcare	2.0%	4.2	N/A	N/A	0.0%	-17.4%
XRO	Xero Limited	Information Technology	3.5%	135.8	49%	261.9	0.0%	12.7%
EML	EML Payments	Information Technology	2.0%	5.4	42%	41.2	0.0%	9.9%

Source: Company Data, Refinitiv, Wilsons.

Disclaimer and Disclosures

Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures.

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