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Banks Results: Sizing up the capital management

Our monthly view on Australian Equities

14 April 2021

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Bank reporting season

Bank reporting season delivered what we were looking for across three key areas:

1. High single-digit (underlying) earnings growth and dividend beats;
2. Falling bad debt provisions ahead of the market; and
3. Strong capital levels, suggesting capital management is not too far away.

Share price reaction was mixed, reflective of an exceptionally strong period of bank outperformance relative to the market over the last 9 months and a lack of 'new' areas for potential earnings surprise. Westpac (WBC) performed the strongest after announcing credible cost-saving measures and benefiting from a low base (was worst-performing bank over the last 3 years).

Looking ahead, we believe banks are well placed to continue to outperform. Underpinned by an improving domestic economy, fewer regulatory headwinds and prospects for outsized capital management against valuation levels that don't reflect mid-cycle earnings.

We also believe banks can show improved core earnings leverage to the cycle, which was absent from the recent results season.

While we acknowledge the rate of outperformance is likely to slow, investors should continue to stick with the banks. The Wilsons Australian Equity Focus List is 1.2x overweight the banks, led by WBC, ANZ, and NAB.

Sizing up capital management

Bank capital levels are approaching 13% at core equity tier one level (CET1), well ahead of regulatory minimums, implying it's only a matter of time before banks begin returning this capital. This could happen as early as full-year results in November.

Shayne Elliot, CEO of ANZ, stated last week that the bank was exploring the idea of returning extra capital to investors.

"We're sitting on a record level of capital. That money serves us no purpose other than it is a sense of safety and prudence in a time of uncertainty."

The level of capital is now so high that we don't think it is imperative to have complete clarity on the traditional 'gate openers' for capital management:

1. **APRA regulatory certainty** – regulators are yet to confirm new Basel IV regulations. These could potentially be drawn out until 2023/24. APRA is due to report back in late 2021 with its version of new rules, with implementation 1 January 2023.
2. **COVID ending** – banks need clarity that the economic impact of COVID-19 has bottomed, and we are not going to have a further period of extended domestic lock-downs.
3. **Economy self-sustaining** – we are now past peak government stimulus for COVID-19. Is there any hang-over as COVID-19 support programs end? Can the economy grow without government support?

Exhibit 1: Bank sector capital management opportunity

		ANZ	CBA	NAB	WBC
CET1 pro-forma*	%	12.5	13.0	12.8	12.7
Risk weighted assets*	$Abn	408	454	418	429
Share Price	$A	27.06	94.70	26.98	26.17
Market Cap	$Abn	77	168	89	96
Share on Issue	m	2846	1774	3299	3669
Implied Surplus @ CET1 11%	$Abn	6.1	9.1	7.5	7.3
% of Mcap	%	7.9%	5.4%	8.5%	7.6%
Buyback					
FY22 EPS buyback accretion^	%	9.3%	6.2%	9.8%	8.8%
Special Dividend					
FY22 Ordinary Dividend	$A	1.42	3.40	1.30	1.25
FY22 Special Dividend	$A	2.52	5.91	2.65	2.32
Dividend yield ordinary	%	5.2%	3.6%	4.8%	4.8%
Total implied dividend yield#	%	9.9%	6.7%	9.7%	9.2%

* 1H21 Results
^ assumes buyback midway through FY22, surplus capital earns 0.05% return and bank generates 20bps of CET1 in FY22.

Assumes Special dividend is split over FY22 and FY23 in equal amounts.

Source: Company Data, Wilsons.

The quantum of capital return is likely to be significant. We estimate a surplus capital range of 5.5-8.5% of market capitalisation or almost $A30bn. Banks raised ~4% of market cap in equity capital and dividend issuance in 2020.

We suspect that banks will prefer share buybacks over special dividends due to long-term benefits to EPS from reduced shares on issue and relatively low franking credit balances. Buybacks would also reinforce the view that action to increase capital in 2020 was a temporary event. Therefore, balance sheets should not be weighed down with permanent measures (i.e. higher shares on issue).

Share buybacks could be EPS accretive to the tune of 6% - 9% across the banks on an FY22E basis.

If banks were to go down the special dividend route, the effective dividend yield (ordinary + special) could be almost in order of 7-9%, double the markets current level of dividend across both FY22E and FY23E.

We have excluded franking credits from the analysis. Franking could be used to supplement both the buyback (off-market) and any potential special dividend. ANZ/NAB have relatively low franking credit balances, suggesting on-market buybacks. CBA/WBC have more available options, including off-market fully franked buybacks and/or fully franked special dividends.

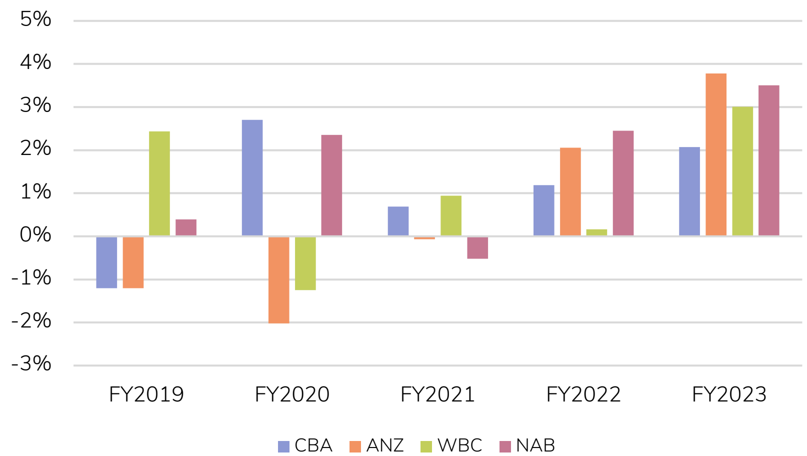
Improvement in core bank earnings still to come

The lack of revenue growth across the banks in the recent result season was probably the most disappointing aspect of the results. Despite an improving economy, revenue growth in the 1H21A averaged just ~1%.

This is despite both the economic momentum and housing credit growth accelerating in the half. We think this is the key reason that bank sector share price reaction was subdued through the result period.

So, what lies ahead? Bank revenue should begin to accelerate in the next half. The pressure from falling net-interest margins (NIM) should moderate, while the domestic housing cycle should see housing credit growth maintained in the mid-single-digit rate. This should translate into modest revenue growth.

Exhibit 2: Bank revenue growth should be visible from FY22E

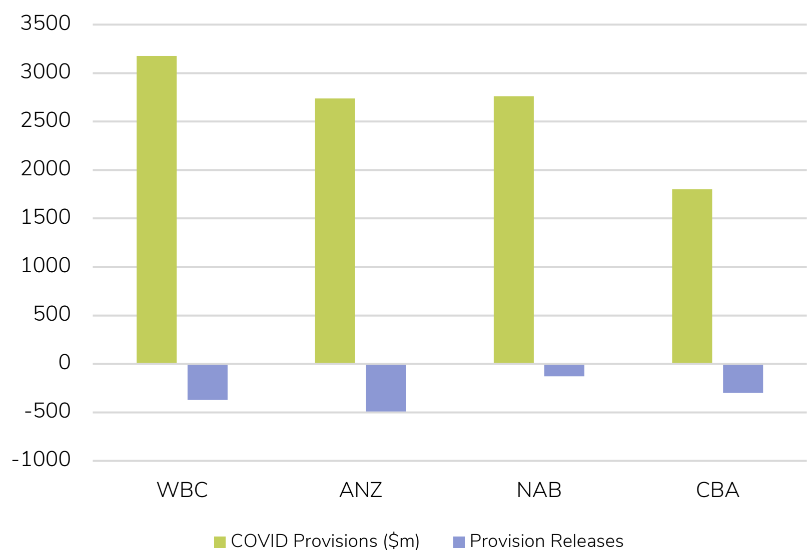


Source: Refinitiv, Wilsons.

Provisions releases could last well into FY23E.

Additionally, with all the banks now releasing COVID-19 bad debt provisions, this provides additional earnings and dividend buffers over the FY22-23E periods. So far, the provision release has been small, at less than 10% of what was built up in 2020.

Exhibit 3: Bank provision journey has only just started



Source: Refinitiv, Wilsons.

Bank sector is still trading below fair value

Australian banks have performed strongly since November 2020, yet have still lagged behind the recovery we have seen in global financials. This is partly due to lower valuation starting points for offshore financials going into COVID-19, but also more serious COVID-19 interruptions in offshore economies.

From a valuation perspective, our preferred measure of price-to-book (removes noise around earnings) still suggests Australian banks are trading ~15% below long-term fair value, closing to 1 standard-deviation cheap on price-to-book measure.

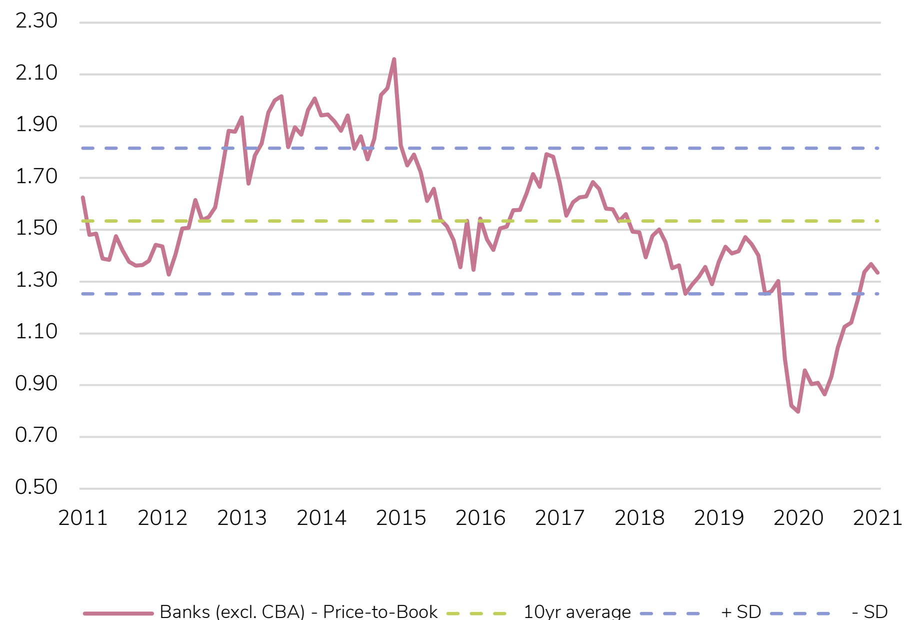
If this gap were to close entirely over the next 12 months, this would imply a total return of 20-25% when both an ordinary and 'special' dividend are included (before any franking is included).

Relative to almost all other sectors on the market, banks are still trading below long-term historical averages. With both the economic and market set-up still favouring cyclicals vs growth and likely to remain that way over 2021, we believe the value gap can continue to close.

Additionally, bank sector Return on Equity (ROE) is still depressed relative to where it has been in the past. We believe an improvement in ROE can occur with both sides of the equation assisting higher earnings and a lower share count.

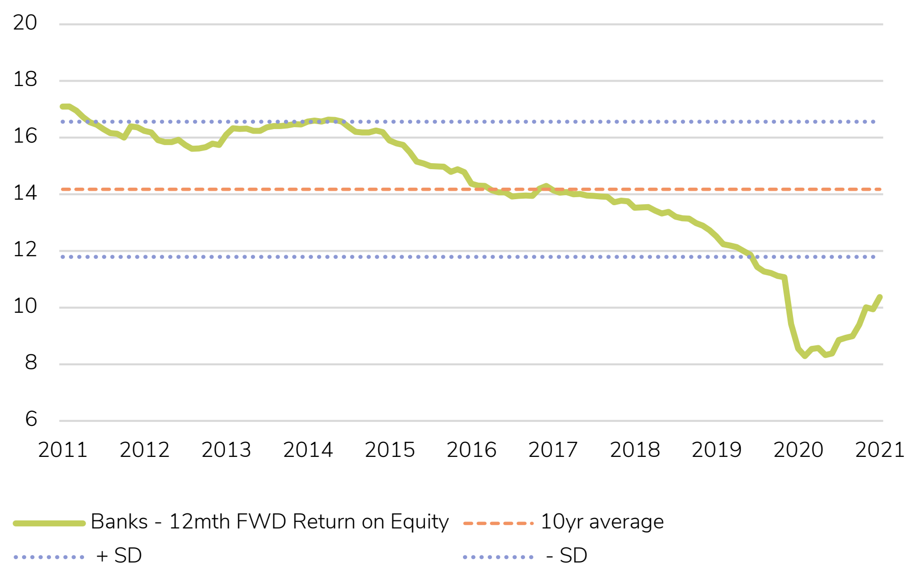
In short, the banks can still outperform over the remainder of 2021, but the rate of outperformance is likely to slow relative to what we have seen over the last 9 months.

Exhibit 4: Bank sector valuation still looks cheap on price/book measure



Source: Refinitiv, Wilsons.

Exhibit 5: Bank sector ROE



Source: Company Data, Wilsons.

Focus List Positioning

We remain 1.2x overweight banks. When we include Macquarie Group (MQG), the Focus List is 0.85x underweight in Financials. Currently, we have no exposure to insurance/non-bank financials.

Westpac 9% weight

The sector lagged behind and is now in a catch-up phase. We think the new cost initiatives are credible and can be achieved through relatively conventional optimisation strategies. This should help close the EPSg gap which had emerged in WBC forward market earnings estimates. A change in focus on regulatory issues to internal execution excellence we believe can unlock value.

ANZ Group 7% weight

Strong management has seen NIM stabilise in this half. We think cost strategies can further offset revenue pressures in coming periods. ANZ is more than one standard deviation cheap vs the sector, whilst EPSg prospects are above the sector average.

NAB 7% weight

Cost management initiatives are well progressed which should deliver benefits earlier than other banks. The strong business exposure should also provide strong leverage to improving economic recovery (management already talking about improved volumes).

MQG 6% weight

Operationally MQG is performing strongly. Market conditions remain constructive to MQG to further deploy capital and fuel further growth. While the multiple has expanded in recent months, we think MQG still offers an element of structural growth absent in the major trading banks.

Sector Catalysts

- **August 2021 CBA FY21 Results** – likely to kick-off the capital management program for the sector.
- **August 2021 Trading updates** – ANZ, NAB, WBC.
- **November 2021 Major bank reporting season** – capital management launched.
- **Ongoing** – further evidence of housing/credit growth improvement and growing employment levels. This week's Federal Budget should assist here.
- **4Q21** - APRA expected to state its new position on CET1 levels.
- **4Q21** – possible introduction of macro-prudential lending controls.

Figure 6: Focus List valuation metrics

Ticker	Name	Sector	Focus List Weight Old	Focus List Weight New	EPS CAGR (FY1-FY3)	PE (12mth FWD)	Div Yield (12mth FWD)	ROE (12mth FWD)
Asset Valuation Plays								
AVN	Aventus	Real Estate	4.0%	4.0%	3.6%	15.4	6.0%	7.8
NWS	News Corporation	Communication Services	3.0%	3.0%	29.7%	53.4	0.6%	4.8
TLS	Telstra	Communication Services	0.0%	4.5%	6.9%	24.8	4.8%	11.5
Cyclical Quality Growth								
ALL	Aristocrat Leisure	Consumer Discretionary	3.5%	3.5%	27.5%	34.2	1.5%	23.4
WOR	Worley	Energy	4.0%	4.0%	38.7%	26.3	4.2%	5.1
BHP	BHP Group	Materials	8.0%	8.0%	-9.7%	12.4	4.9%	27.9
JHX	James Hardie Industries	Materials	3.0%	3.0%	16.0%	32.3	1.7%	34.1
MQG	Macquarie Group	Financials	6.0%	6.0%	7.9%	19.0	3.7%	13.5
Cyclical Value								
ANZ	ANZ	Financials	7.0%	7.0%	5.3%	13.0	5.3%	9.7
OZL	OZ Minerals Limited	Materials	3.0%	3.0%	14.9%	23.5	1.1%	11.1
NAB	NAB	Financials	7.0%	7.0%	2.7%	14.3	4.8%	10.2
RWC	Reliance	Industrials	3.0%	0.0%	2.4%	21.1	2.4%	12.0
STO	Santos Limited	Energy	4.0%	4.0%	2.0%	14.1	1.6%	10.1
SUL	Super Retail	Consumer Discretionary	3.0%	3.0%	-18.3%	9.1	4.9%	17.3
SVW	Seven Group Holdings	Industrials	4.0%	4.0%	9.5%	14.3	2.6%	14.8
WBC	Westpac	Financials	9.0%	9.0%	5.8%	14.8	4.7%	9.2
Defensive Growth								
NST	Northern Star Resources	Materials	3.0%	3.0%	38.9%	22.4	2.1%	21.9
SYD	Sydney Airport	Industrials	3.0%	3.0%	54.3%	NULL	2.5%	7.3
TCL	Transurban Group	Industrials	4.0%	4.0%	18.0%	NULL	3.8%	5.9
Secular Growth								
APT	Afterpay	Information Technology	2.0%	2.0%	131.3%	NULL	0.0%	4.1
CSL	CSL	Health Care	4.0%	4.0%	10.8%	41.8	0.8%	26.9
GMG	Goodman Group	Real Estate	3.0%	3.0%	11.3%	29.1	1.7%	11.2
RMD	ResMed	Health Care	2.0%	2.0%	11.6%	37.5	0.7%	25.5
TLX	Telix Pharmaceuticals	Health Care	2.0%	2.0%	NULL	NULL	0.0%	-13.9
XRO	Xero Limited	Information Technology	3.5%	2.0%	50.4%	333.0	0.0%	13.0
EML	EML Payments	Information Technology	2.0%	2.0%	47.6%	63.1	0.0%	10.3

Highlighted rows indicate there has been a change to the Focus List.

Changes to the Focus List

Adding | Telstra Corporation (TLS) Weighting +4.5%

We have added Telstra to the Focus List. Telstra provides exposure to an asset breakup story, which the Board is now committed to. TLS's lower beta, more defensive earnings streams and 'value' traits are likely to be rewarded over coming quarters, particularly if the equity markets worry about that inflation will continue to remain elevated.

TLS earnings are seen as relatively defensive. We note that revenue momentum should improve as 'lost' COVID-19 revenues return, and TLS's recent price increases in Mobile (lower competitive threats from Optus and TPG/Vodaphone) lift APRU for the first time in over 3 years.

Combined with TLS's cost program, FY22E earnings should improve by over+7% FY21A levels.

The key enabler of longer-term value is TLS's proposed restructuring program. TLS is one of a dozen companies in the ASX100 undertaking a formal asset review process. The objective is to simplify and release latent shareholder value.

See report: Breaking up is hard to do

The pending separation of the mobile towers into a standalone business, should allow investors to apply an infrastructure like multiple to the towers business, while allowing the core business to reduce debt. We believe the dividend security from the core business will increase.

A sum-of-the-parts valuation under this scenario of $4.00-$4.50 per share is not unreasonable given the multiples mobile towers attracts in offshore markets.

See report:: Telstra – Unbundling Telstra

The next update on the timing of the mobile towers spin-off is expected in TLS's August FY21 Results.

Removing | Reliance Worldwide (RWC) -3%

RWC has performed well in the Focus List since being added in September, generating total returns of ~38%. However, we believe the stock, after being a COVID-19 winner, will underperform.

Investor concern over an earnings cliff in FY2022/23 could overshadow any further earnings upgrades in CY21. Also, a persistently elevated copper price will be a headwind for earnings as some of these cost increases will have to be absorbed by RWC.

RWC has been removed from the Focus List.

Trimming | Xero (XRO) -1.5%

After a strong year of performance in the Focus List since its inception in May 2020, we are trimming our weighting in XRO. We still believe in the long-term story and think it can outperform over the next 3-5 years.

Yet, in the short term, we believe that the macro environment of inflation uncertainty (with US CPI adding fuel to the fire on Wednesday night) and potential market volatility to be unconducive for the stock. The FY21 earnings (EBITDA) miss and the slowdown in revenue growth have also made us more cautious.

Focus listing weighting of 2%, down from 3.5%.

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Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures

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All figures and data presented in this research are accurate at the date of the report, unless otherwise stated.

Wilsons contact

john.lockton@wilsonsadvisory.com.au | +61 2 8247 3118

david.cassidy@wilsonsadvisory.com.au | +61 2 8247 3149

rob.crookston@wilsonsadvisory.com.au | +61 2 8247 3101

www.wilsonsadvisory.co