WILSONS

Bank Reporting Season: Less Macro, More Micro

Our weekly view on Australian equities.

28 October 2021

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Reporting Season Underway

Major bank reporting season gets underway this week. We see FY21 results as being more about stock-specific issues rather than being driven by macro factors that have dominated recent results. As the sector has performed well in the lead up to reporting, investors' expectations for the results have been raised.

Recent results from Bendigo and Adelaide Bank (BEN), Bank of Queensland (BOQ) and Commonwealth Bank of Australia (CBA) were accompanied by share price sell-offs as challenges on net interest margins and higher costs weighed on the outlook. The market appears to have factored in both lower margins and higher costs for FY21E, but there is some risk that FY22E cost assumptions could be too low across consensus.

Low bad debts and capital management are well understood by investors.

Westpac (WBC) will be the key focus bank for capital management and any process update on the cost program. We look for an off-market buyback program in the range of $4.0-4.5bn.

The Wilsons Australian Equity Focus List is currently market weighting the major banks. Absolute valuations look expensive, offset by more attractive relative valuations and prospects for earnings normalisation post-COVID-19. Our order of preference across the majors is WBC, National Australia Bank (NAB) and Australia New Zealand Banking Group (ANZ).

Exhibit 1: Bank reporting season - summary table

Company Name	Reporting Date	Result	Cash EPS (FY1)	DPS (FY1)	Key Focus Feature
Australia and New Zealand Banking Group	28/10/2021	FY21	2.08	1.39	Mortgage volumes
Commonwealth Bank of Australia	17/11/2021	1Q22	5.58	3.96	Earnings momentum
National Australia Bank	9/11/2021	FY21	2.00	1.23	Revenue growth, AUSTRAC
Westpac Banking Corp	1/11/2021	FY21	1.68	1.13	Buyback, cost out program
Macquarie Group	29/10/2021	1H22	9.07	5.53	AUM, capital deployment, outlook

Source: Refinitiv, Wilsons

Four Key Themes of Bank Results Season

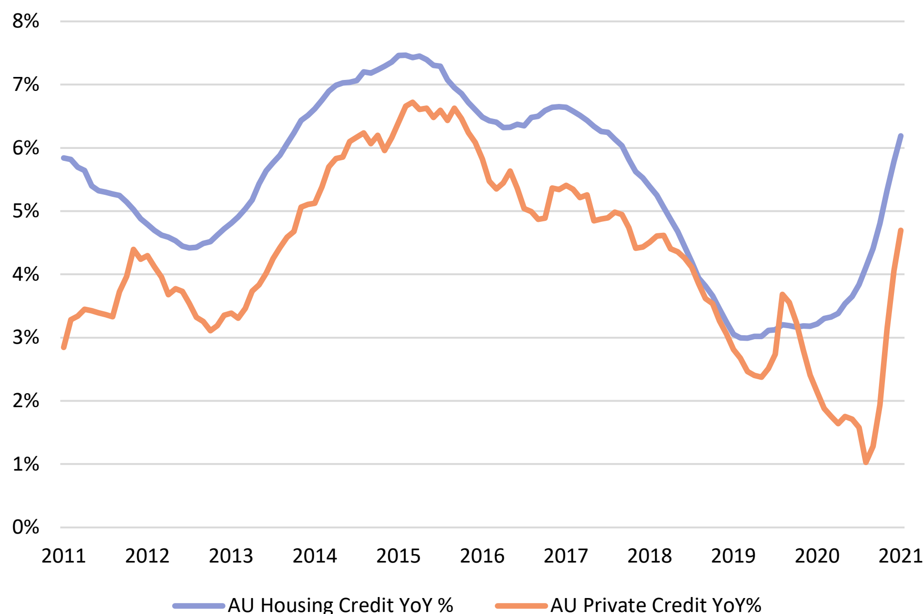
1. **Revenue momentum** - Underlying revenue growth (excluding the volatile markets segment) across the sector is likely to be flat on the prior half.

   Housing credit growth has been running ahead of consensus throughout 2021, offset by the impact of lower rates and elevated competition dampening revenue growth. Any signs of stronger underlying revenue performance is likely to be very well received by investors. Recent upward moves in the yield curve suggest the outlook for margins could be a little brighter in the coming periods.

2. **Costs** - Recent bank results have all seen consensus cost assumptions being revised upwards into FY22E. BEN, BOQ, CBA all have volume growth ahead of September year-end banks at present, which makes cost control a different prospect.

   There remains a risk to consensus earnings that there is "catch-up" on cost assumptions for ANZ, NAB, WBC despite all three having structural cost out programs. Spending around risk and compliance still remains elevated, and the market has not changed the cost assumptions for these three banks since 1Q21.

Exhibit 2: Australian credit growth remains ahead of forecasts at the start of 2021

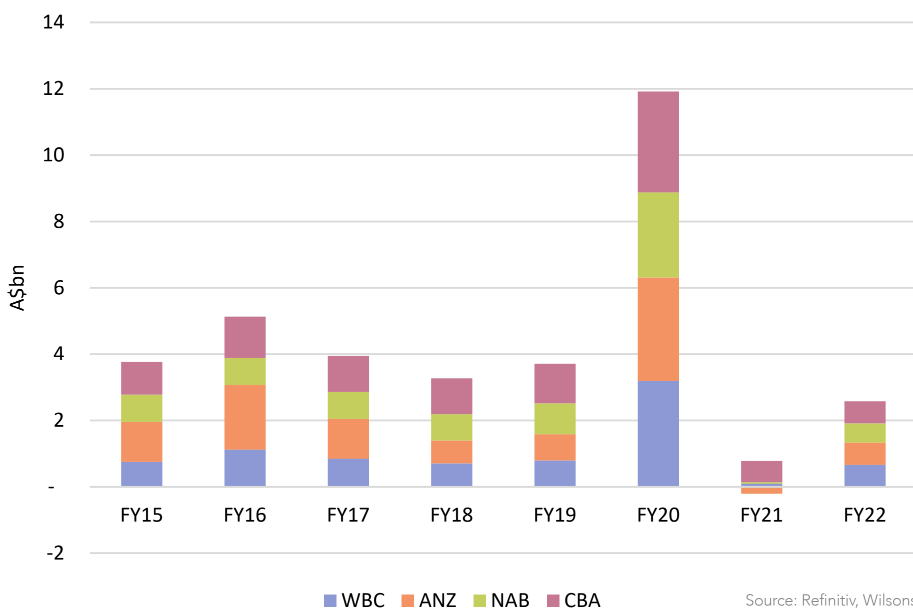


Source: Refinitiv, Wilsons.

3. **Markets income** - The volatile markets income line is unlikely to produce the upside surprise that we have just seen in the US bank reporting season. Australian banks do not have the same capital markets (particularly equity markets) as their US peers.

   Instead, markets income is likely to be subdued, down somewhere between 20-40% versus the previous corresponding period (pcp). Investors are well aware of this - primarily a function of low interest rates and low market volatility - but it is worth monitoring. Both NAB and WBC called this out in 3Q21 updates. Earnings momentum ex-markets, which better reflects core banking operations, will be closely scrutinised.

Exhibit 3: Major bank impairment forecasts have collapsed since Nov 2020



Source: Refinitiv, Wilsons.

4. **Impairment charges** - Despite COVID lockdowns in NSW/VIC for much of the 2H21, we see the risk of bad debts coming in below market expectations. The low uptake of the loan deferral programs offered by the banks and much improved economic conditions should ensure a beat on bad debts relative to the market. This was the trend witnessed across BEN, BOQ and CBA, who have all reported recently.

   Going forward, bad debts should begin to normalise at 15-20bps of assets as the economy reopens. In FY20, they printed at ~42bps, still half what the peak was in the GFC. Post provision reversals, the bad debt charge is likely to be around -5bps in 2H21.

Results Previews

ANZ | 28 October

- **Earnings** – Underlying profit growth still likely to flatten, held up by stronger NZ performance. With loan assets still decreasing (APRA data 2H21), investors will be keen to see a pathway to restore Australian mortgage growth.
- **Costs** – Expected to be lower in 2H21 as ANZ targets an $8bn cost base.
- **Capital** – ANZ has completed ~$700m of current $1.5bn on-market buyback. We look for commentary around the ultimate size of the capital management program.

NAB | 9 November

- **Earnings** – Likely to post sector-leading revenue growth (ex-markets), in part driven by strong application volumes and SME focus.
- **AUSTRAC** – Any movement towards enforcement action.
- **Costs** – Do the current cost targets still remain given higher ongoing anti-money-laundering costs are likely?
- **Capital** – NAB has completed <$500m of current on-market buyback.

WBC | 1 November

- **Earnings** – Underlying earnings expected to be flat at best given low interest rates and high relative share in mortgages. WBC has already guided to $1.3bn of large notable items impacting this result.
- **Costs** – Update on how the program is tracking against the FY24E target of $8bn cost base.
- **Capital Management** - WBC is the only major bank to not have a capital management program in place – a function of regulatory issues and the newest management team.

At the 3Q21 update, WBC said it would provide an update at FY Results. WBC has the largest franking credit balance of the major banks which suggests largest on-market buyback. We see the potential for $4.0-4.5bn buyback, which would equate to 3-4% of issued capital and being ~2% accretive to EPS.

- **Divestments:** WBC's superannuation and platform business are yet to be sold. Look for an update on both timing and potential value. Proceeds could help support further capital management in 2022-23.

Exhibit 4: Surplus capital levels across the major banks

		ANZ	CBA	NAB	WBC
CET1 pro-forma*	**%**	**12.3**	**12.2**	**12.2**	**12.8**
Implied Surplus @ CET1 11%	**$Abn**	**5.4**	**5.4**	**5.0**	**7.9**
% of Mcap	%	6.6%	3.0%	5.3%	8.3%
Potential FY22 EPS accretion	%	3.3%	1.5%	2.7%	4.2%

*August Bank Updates. Pro-forma adjusted for buy-back announcemnts.

Source: Refinitiv, Wilsons.

^ assumes surplus capital is returned evenly between FY22 and FY23.

Wilsons estimate of total surplus capital. NAB we assume the Citi Credit Card acqusistion goes ahead.

Our View on the Sector

We see the outlook for the banks' performance as broadly in line with the market over the next 12 months. Since June 2021 the major banks have performed in line with the market. We neutralised our overweight banks call back in August in the Focus List.

We see the big macro debates across the bank sector as:

1. Provision releases
2. COVID earnings recovery
3. Capital management (ex WBC)

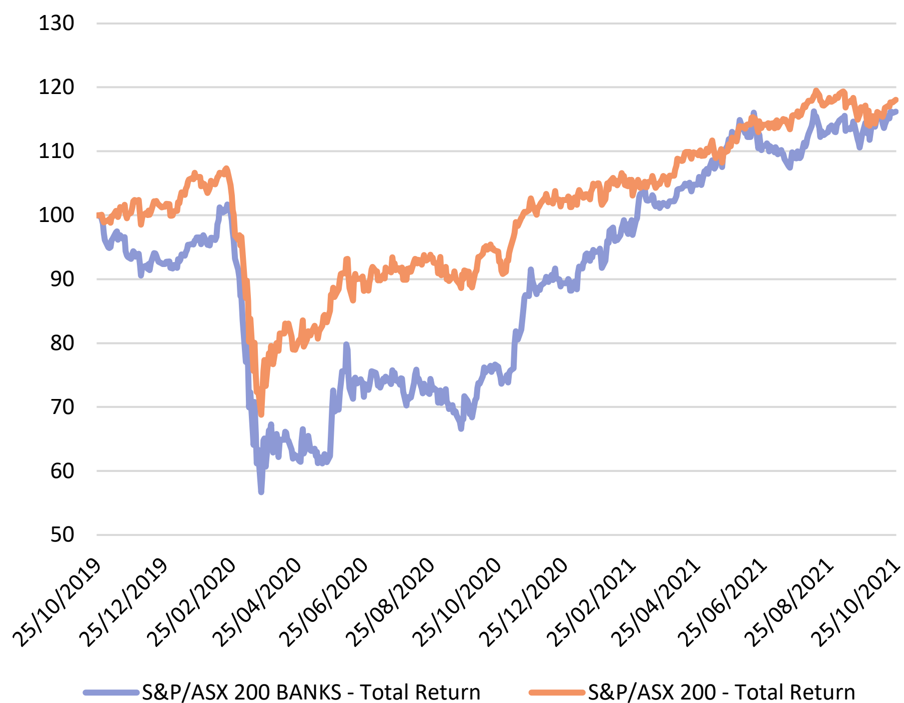
We believe that these are largely reflected in the banks' share price.

A steeper global yield curve/higher interest rates over 2022 could present upside risks to Australian banks. Buoyant credit offers upside risk, but the extent is modest given actions from APRA to slow credit growth in response to strong house price growth.

Looking at valuation, on a price to earnings (PE) relative basis, banks are now trading at a small premium versus the market – explainable given earnings (or ROE) have still not fully recovered from the COVID impacts of the past 18 months.

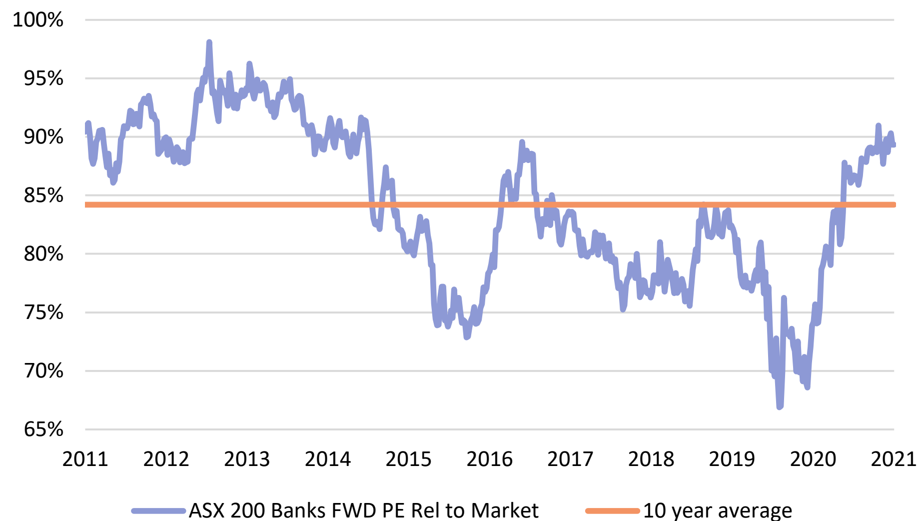
Our order of preference within the Focus List is WBC (9% weight), NAB (7% weight) and ANZ (3% weight). The Focus List has no exposure to CBA given the high premium it currently trades on relative to the rest of the sector.

Exhibit 5: Major bank outperformance vs market has narrowed since June 2021



Source: Refinitiv, Wilsons.

Exhibit 6: Major bank PE relative vs the market suggests banks now fairly priced given prospects for low single digit earnings outlook



Source: Refinitiv, Wilsons.

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Recommendation structure and other definitions

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

Disclaimer

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