Banks Wrap: Banking on Higher Margins

Our weekly view on Australian equities.

18 May 2022

Outlook for the Banks Remains Positive

As we enter a period of rate hikes from the RBA, banks margin pressure will likely ease, and ultimately, this will be the key driver of earnings growth over the medium-term.

However, risks remain for Aussie banks. Rising rates could put pressure on house prices and asset quality, weighing on market sentiment.

We believe the net interest margins (NIM) of the majors will grow faster than consensus forecasts, leading to earnings upgrades over the next two financial years. Additionally, we believe bank valuations are still on the cheaper side, which could provide an opportunity for a rerate in the short-term.

Focus List Changes: Moving Overweight the Banks

We have increased our weighting to the banks by adding to Westpac (WBC) (1%) and ANZ (ANZ) (1%), taking us overweight the banks at an overall weight of 22.5% vs market at ~20.5%. The Focus List remains overweight the business lenders (through National Australia Bank (NAB) and Judo (JDO)). However, we believe valuations for Westpac and ANZ will start to rerate as we see margin improvement.

We have trimmed our exposure to BHP (BHP) (-1%), Aristocrat (ALL) (-0.5%) and News Corp (NWS) (-0.5%) to fall in line with market performance.

1H22 Results: Mixed but Positive Overall

Results for the 1H22 banks reflect the improved economic situation and strong demand for credit. Margin pressures continue to be the most significant headwind hampering the major banks' performances.

Net interest margins pressure - The banks continued to feel downward pressure on interest margins due to fierce competition for rates and a higher proportion of fixed rate (lower margin) mortgages. These factors have more than offset the benefits of lower funding costs. Although margins have continued to fall, the 1H22 results were largely in line or above consensus, which prevented any downgrades (a fear we had going into these results).

Costs lower - Banks are making mixed progress with cost management programs to support operating margins. Costs still remain high due to compliance, cyber security and investment in technology. Inflationary pressures are exacerbating cost management for banks. Cost targets were removed for NAB and ANZ, with cost pressures mounting for both. Westpac continued its $8bn cost out program, guiding to lower costs over the next half.

Asset quality is generally improving - Impairment risk has moderated as COVID-19 restrictions have eased. Most banks have low impairment expenses at present. Some are still reversing impairments made during the pandemic.

Higher Interest Rates, Higher Margins

NIM outlook is clearer

Australian banks generate 80% of their total revenue from net interest income and therefore are highly dependent on net interest margins to drive the top line. Given a rising RBA cash rate, this should ease the pressure on margins and boost profitability.

Margin expansion could deliver substantial revenue benefits over the next two years. Even if credit growth moderates as interest rates rise, banks are likely to prioritise margin expansion to drive revenue growth.

UBS analysis suggests a 25 basis point increase in interest rates could lead to a 1-3bps expansion in NIMs. We could see the RBA hike rates by 200 basis points over the next 12-18 months, which would equate to an 8-24bps increase in NIMs. Taking the middle point, this could deliver a 12% lift in earnings, all things being equal.

The market is very conservative on NIM expansion

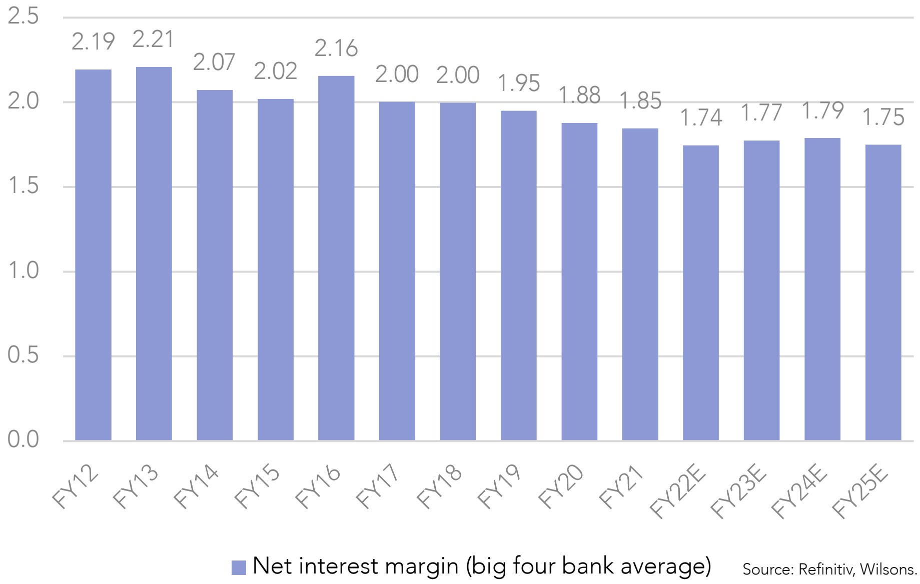
While the market has NIMs expanding over the next 2 years, consensus expectations are very low relative to our analysis. We expect that if the RBA hiked rates at a reasonable pace we could get to a pre-COVID level of NIMs, which is above the 1.79% expected in FY24. This could result in NIM upgrades for the banks.

Higher Earnings, Higher Valuation

The return on equity (ROE) of major banks has continued to rise in 1H22. Compared to 1H21, the average ROE increased by 21 basis points to 10.6% in 1H22, rising back towards pre-COVID-19 levels of double-digit ROE. Higher cash profits and the share buy-backs have driven this increase.

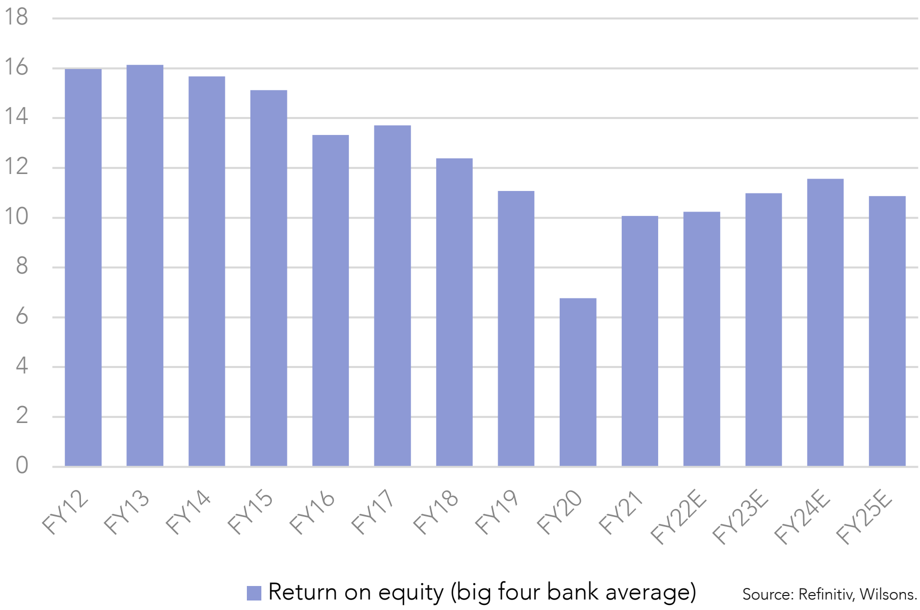
As earnings improve and the banks participate in more buy-backs, ROE will continue to rise. Also, like the NIMs, we believe consensus is overly conservative on the ROE outlook in the banks.

Figure 1: NIM consensus looks conservative



Source: Refinitiv, Wilsons.

Figure 2: Return on equity consensus also looks conservative



Source: Refinitiv, Wilsons.

Figure 3: Price to book (P/B) has been relatively correlated to ROE over the last 20 years

Source: Refinitiv, Wilsons.

ROE should be a key driver of banks' valuations. From our analysis, we would expect that as ROE starts to increase we should also see a rerating in the valuation of the major banks. Mid-cycle points like 2015-2017 may provide a reasonable guide to future valuations.

Hurdles to Rerate

Irrespective of the pace or expected peak of the rate hike cycle, the banks are going to find it challenging to adjust to a new environment of rising rates, sustained wage inflation and a subdued housing market. We outline some of the hurdles for banks over the next few years.

Impairments may be a concern as uncertainty remains

Asset quality may come into question if cost of living pressures intensify and the key underlying asset for most families, their house, starts to fall in price. This may impact sentiment in the short-term.

However, the key measures of asset quality remain resilient. While Australia has a high household debt-to-income ratio, we consider it to be in good shape due to high savings, low unemployment and a buoyant housing market. Over the pandemic period many households have built a substantial buffer to higher rates – the median household is now 2 years ahead of its mortgage repayments.

The perception of asset quality is unlikely to deteriorate quickly as it did at the onset of the pandemic, but may still be a short-term concern for the market during this period of uncertainty.

A subdued housing market may be a headwind to credit growth

Recent robust credit growth may moderate as interest rates start to rise. If house prices start to subside, this may impact demand for housing and, therefore, loan growth for the home lenders. We expect some moderation in home loan growth over the next 12 months, but believe the housing sector will remain reasonably resilient to higher rates.

Figure 4: Market is reasonably efficient at pricing the banks for ROE differentials

Source: Refinitiv, Wilsons.

Figure 5: Costs fell in the most recent results but risks remain on cost pressures

Source: PWC, Wilsons.

Mortgage competition has also been an issue for the major banks during the pandemic. For a long time it was possible to ignore the rapid growth of non-majors, given their negligible relative market share. Despite a market share of just 6% in 2019, the 'Next Three' accounted for more than 20% of total loan growth since. This is unlikely to go away, but the majors should be able to use more of their financial muscle as rates rise.

Our expectation is business credit growth will continue to accelerate as tailwinds from reopening and a resurgent economy continue to provide businesses with opportunities that have been absent during the pandemic.

Business banking offers banks opportunities to differentiate themselves from the increasingly commoditised mortgage segment. This provides more of an economic moat against competition from non-bank lenders.

We hold a preference to the business banks NAB and JDO for these reasons.

Costs a Key Area of Focus for Investors

A strong focus on expense management reduced some of the margin compression and investment burden experienced by the banks during the pandemic.

Despite this, we remain cautious about the outlook for costs, given how sticky they have historically been. Higher inflation has not yet translated into more widespread wage growth. However, we continue to track wage growth since banks' workforces are over 40k, and NAB and ANZ have flagged higher costs in 2H22. Reducing costs may still be a challenge to our view and something we continue to monitor. We believe Westpac is best placed to reduce excess costs over the next 12 months.

Valuation Still Not Overdone

We see the sector as being on the cheaper side of fair value, primarily as we believe earnings risks over the medium-term are skewed to the upside – higher NIMs, and lower shares on the issue given further buybacks.

On a price-to-book (P/B) measure, the 1.55x P/B looks slightly cheap relative to the past decade for the banks, especially as ROEs can go higher which should rerate the P/B multiple further.

CBA still looks expensive versus the majors. We think NAB, WBC and ANZ could all outperform CBA over the next 12 months. Although NAB is close to its 10-year average P/B, we think the bank is a better quality bank than it has been over the past decade. ANZ and WBC still look cheap on a P/B basis.

Figure 6: Banks do not look expensive, especially if ROEs can lift

Source: Refinitiv, Wilsons.

Figure 7: CBA still looks expensive versus the other majors. WBC and ANZ could still rerate as earnings improve. NAB has become a better quality bank over the past year, P/B could push higher

Source: Refinitiv, Wilsons.

Figure 8: Fundamental table of the major banks (and Judo)

Company Name	Ticker	Dividend Yield (FY23)	Return on Equity (FY23)	Price to Earnings (FY23)	Price to Book (FY23)	EPS Growth % (FY23/FY22)
Commonwealth Bank of Australia	CBA	3.9%	12.4%	18.9	2.3	3.9%
National Australia Bank	NAB	5.1%	12.0%	13.7	1.6	8.7%
Westpac Banking Corp	WBC	5.4%	9.5%	12.9	1.2	22.4%
Australia and New Zealand Banking Group	ANZ	6.0%	10.1%	11.5	1.1	6.6%
Judo Capital Holdings	JDO	0.0%	4.4%	30.3	1.3	541%

Source: Refinitiv, Wilsons

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Recommendation structure and other definitions

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