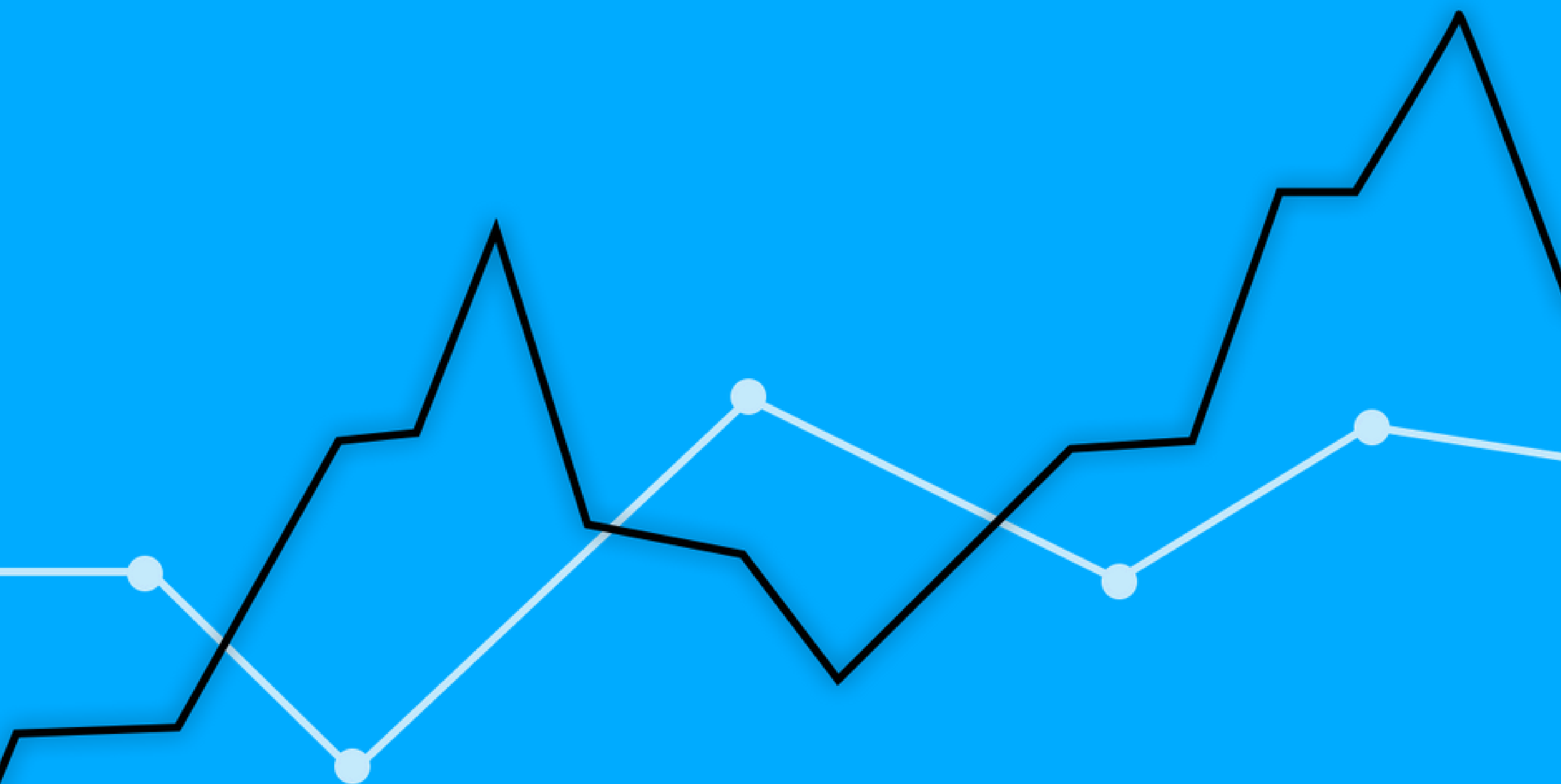
The Banks

Blue Chip Value

YOUR ONE-STOP SHOP ON BANK INVESTING

October 2024



under the radar REPORT

Your one-stop shop on bank investing

And why CBA is the safest bank

Banks in Australia are safe. They are protected. In fact, there is a ban on the Big Four – CBA, NAB, ANZ & WBC – merging. But this ban is irrelevant. CBA has 35% market share and continues to take share in mortgages and deposits, capitalising on the network effect, which you could also term incumbency. But does this mean it's worth buying now?

Almost for as long as I have been interested in investing – since I got my hands on CBA shares just after the float in 1991 (price of $5.40) at $10 a share – brokers have been saying that the bank is overpriced. Analysts have consistently underestimated the network effect.

Added to this, there has been a sector re-rating in the past 12-months. Bank valuations have been boosted by consensus that the housing market will remain robust. The "goldilocks landing" is forecast to continue, where interest rates are come down and employment stays robust, which follows the hike in rates during 2022.

News of China's stimulus package last week was revealing because it led to a sharp 5% sell off of the banks, where profits were ploughed into the big miners, notably **BHP** & **Rio Tinto (RIO)**, which actually jumped by more (so far).

We will go into detail below, but I wouldn't be buying them and, I would add, I won't be selling! Get reading because if you only read one report on the banks, this is the one.

Richard Hemming
Founder and Head of Investments

IN THIS REPORT

Why CBA is the safest bank
Rating: comparing Australian banks

What actions should members take?

Big Bank Analysis
Macquarie Group (MQG) Buy
Commonwealth Bank (CBA) Hold
National Australia Bank (NAB) Hold
Westpac Bank (WBC) Hold
ANZ Bank (ANZ) Hold

A Banking Bonus!
We discuss why banks have such a big role in the Australian market and give you a basic understanding of how they make money.

Investment Conclusion

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The Network effect

Australian banking is about bigger being better in a relatively closed market.

Banking is all about scale, which means you're spreading your costs over a larger deposit and lending base. CBA is the champion in a rich, relatively enclosed market, which is Australia.

Net Interest Margin

The bigger and safer the bank, the better the *net interest margin* – the difference between the rates at which a bank lends money and the rates at which that same bank pays on deposit or borrows from other banks (various swap rates).

Dollar Cost Averaging

We have argued that **CBA** is a very good candidate for dollar cost averaging, where you buy a certain dollar amount regularly – say every quarter – and in that way you build up a sizeable position at a low average price.

We would still do this, but an idea we explore below is being less aggressive – buying smaller amounts while valuations are at historically high multiples.

Index linked ETFs

CBA does have a size advantage, but there is another market gorilla that you cannot ignore – index linked ETFs. These funds, alongside momentum-based algorithms and macro funds betting on the Australian market – have been buying winners without thought to value.

CBA now trades on a PE multiple of 24 times and on a dividend yield of just over 3%. Yet net profit after tax is forecast to decline this year by 4% and grow at low-single-digit rates in the following two years. Dividends are expected to grow at about 2% a year.

Big Bank Ratings

Comparing Australian Banks.

BANK RATINGS

Banks	Price ($)	EPS ($)	DPS ($)	Market cap ($bn)	Dividend yield (%)	P/E ratio (x)	ROE (%)	RATING
NAB	37.35	2.25	1.71	114.9	4.6	16.6	11.3	HOLD
ANZ	30.48	2.26	1.67	90.9	5.5	13.5	9.6	HOLD
WBC	31.72	1.93	1.58	109.3	5.0	16.4	9.3	HOLD
CBA	135.39	5.85	4.72	226.6	3.5	23.1	12.9	HOLD
Average					4.6	17.4		
BEN	11.65	0.89	0.65	6.6	5.6	13.0	8.0	HOLD
MQG	232.37	10.80	7.40	88.6	3.2	21.5	12.1	BUY
BOQ	6.18	0.46	0.33	4.1	5.3	13.5	5.0	
ABA	4.14	0.33	0.28	0.2	6.8	12.5		
MYS	3.67	0.31	0.25	0.4	6.7	11.8		
JDO	1.65	0.07	0.00	1.8	0	23.6		

Key investment learnings from the table:

There has been a re-rating of banks from an average PE multiple five years ago of 14-15 to the current rating of over 17 despite pressure on profitability:

- Lower overnight rates means net interest margins will be under pressure due to reduced swap rates.
- The much-fabled mortgage cliff continues to roll off over the next 18 months where borrowers are hit with much higher rates.
- Economic growth is slowing fast, which reduces lending growth.
- Costs are remaining historically high.

On the positive front:

- Banks have high capital adequacy because of increased regulatory requirements.
- Corporate customers have cleaned up balance sheets, reduced debt.
- Employment is stable and not forecast to fall – with government assistance.
- Loan to value ratios are 80%, which means there has to be significant house price weakness (20%+) for banks to lose money on any loan.
- Bank deposits are guaranteed by the Australian taxpayer, up to $250k per account.

Macquarie Group (MQG): Buy

Radar Rating: Read our analysis on page 7.

Second Tier Banks

The smaller banks offer better value but are vulnerable if conditions deteriorate:

Bank of Queensland (BOQ): Hold

Current Price: $6.18
Market Cap: $4.08bn

52 week high: $6.57
52 week low: $5.07

Radar Rating: BOQ is a cautionary tale as it restructures its bank network. The regional banks will struggle to grow their loan books and will continue to have high costs. The average cost to income ratio for big banks is 40-50%, while for the regionals it's close to 70% - BOQ is 67% and forecast to decline after the restructure.

Judo Capital (JDO): Avoid

Current Price: $1.65
Market Cap: $1.81bn

52 week high: $1.785
52 week low: $0.792

Radar Rating: looks very expensive considering it's not paying dividends and has been increasing loans to smaller business at double digit rates, which is where economic conditions are hitting hard

Auswide Bank (ABA): Spec Buy & MyState (MYS): Hold

Radar Rating: There is an opportunity, pointed out in our Small Cap publication in the Auswide Bank (ABA) & MyState (MYS) merger, which adds up to one plus one equalling three. Check out the yield premium in the table; plus there is growth, albeit at relatively high risk.

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What actions should members take?

The big banks remain a solid anchor point for any portfolio, which is belied by their heavy weighting in the Australian market.

Portfolio Weighting

The banks represent about 35% of the benchmark S&P/ASX 200 index, which is too high for any individual portfolio. Review the percentage they hold in your portfolio. We would not advocate holding more than 20-25% in financial services.

Buying The Banks

The banks are a good anchor for your portfolio, but exercise caution by spreading your purchases.
When you need to increase your holding in the banks to balance your portfolio, buy slowly and systematically.

Over a longer-term horizon you can invest using dollar cost averaging, you just by 1% of a position, rather than 10% at a time, if you don't own something, or buy in dips.

Commonwealth Bank (CBA)

The banks are indeed too big to fail and have a cosy monolopoly because size does indeed matter. We continue to advocate buying CBA utilising dollar cost averaging, albeit at small increments. When it comes to costs, CBA followed by ***Westpac Bank (WBC)*** have a big advantage, with the biggest market share in retail lending, which translates to the mortgage business

Macquarie Group (MQG)

MQG is worth considering to add to your portfolio given it's a play on the green and tech investment waves over the next decade.

Regional Banks

Regional banks are at highest risk, but this can be compensated for with return potential – we would not be holding high levels in any portfolio – whether it's ***Bendigo Bank (BEN)***, ***Auswide Bank (ABA)*** or ***MyState (MYS)***.

Build Your Core Portfolio

INVEST TODAY

Macquarie Group (MQG)

RADAR RATING: BUY

Investment bank

Even though FY24 results were disappointing and down on FY23, we were right to maintain our BUY recommendations for MQG at $193 in May and at $211 in August. Macquarie is arguably the best of breed among Australian big banks, the only one to have successfully and sustainably expanded overseas, creating some huge businesses in global markets, essentially from scratch.

Current Price: $232.37
Market cap: $88.8bn

Dividend Yield: 3.2%*
Net assets: $33.996bn
Forecast PE: 21.8x

* FY25 Forecast $7.35

MQG has a 31 March year end and the first half of FY25 is just ending (30 Sep) against a backdrop of poor FY24, where the first half was particularly weak.

We expect capital markets to improve, including IPOs and M&A, but it has been a long wait since interest rates turned higher. And turnover of green and renewable energy assets on MQG's balance sheet has still not recovered.

While some assets weigh down the balance sheet, and reduce return on equity, we expect the profits are deferred not lost. We were very impressed with the outcome of MQG's investment in domestic datacentre operator Airtrunk, where they participated in a value uplift from $3bn to $24bn in only a few years.

The ability of MQG to deploy its balance sheet into these opportunities is what investors are paying for. The fee businesses of banking and asset management will smooth out earnings, although FY23 peak earnings may not be surpassed for a couple more years.

The investment bank has revived its strategy to use third party monies through satellite funds to provide capital for their ambitions, and its first new fund has been seeded with some early stage assets at cost. The amount of capital required for the global energy transition is almost limitless, and MQG is uniquely positioned to benefit greatly in the medium and long term.

Radar Rating:
Global capital market recovery starting to deliver big returns

Commonwealth Bank Of Australia (CBA)

Big Bank

Buying CBA on the dips has proven to be the right strategy as it was in the sell-off in early August due to a reversal of the Yen carry trade when the stock dipped to $125. The FY24 result last month resulted in more buying, although some gains have been given back after profit taking prompted by news of China's stimulus package.

FY24 cash profit after tax was down 1% but ahead of expectations amid slowing mortgage volumes and increasing competition and costs. CBA's strong balance sheet again came to the rescue with core equity (CET1) of 12.3% also better than expected and underpinning expectations for dividend increases on a flat profit outlook. The bank announced a final dividend of $2.50 (FY24 total $4.65, fully franked) implying a payout ratio of 79%, which could be increased if economic conditions remain benign.

Ever since the Commonwealth Bank was first listed in the early 1990s, banking analysts have been saying it's too expensive. But banks are like big resources companies – they have the lowest unit costs and produce the highest returns because it's all about scale. CBA is the biggest by some margin and barring the domestic economy falling into a hole and unemployment climbs above 10%, this company will keep paying out big dividends.

In the domestic 4-pillar oligopoly – WBC, CBA, NAB, ANZ – CBA stands out with a cash return on equity of almost 14% is a whopping 3 percentage points higher than the average.

That is why despite our valuation being well above the current share price, CBA is worth holding and makes it one of the few stock candidates for dollar cost averaging (please read our Building Wealth From Scratch programme for more details).

RADAR RATING: HOLD

Current Price: $135.39
Market cap: $224.5bn

Dividend Yield: 3.5%*
Net assets: $73.088bn
Forecast PE: 23.0x

* FY25 Forecast $5.85

Radar Rating:

A classic for your core portfolio. Hold and buy on weakness.

National Australia Bank (NAB)

Big Bank

RADAR RATING: HOLD

Current Price: $37.35
Market cap: $114.0bn

Dividend Yield: 4.6%*
Net assets: $61,503m
Forecast PE: 16.4x

* FY25 Forecast $1.70

We favoured NAB over other banks during Ross McEwan leadership, which began in mid-2019 and contributed to the almost 15% a year the stock has delivered since.

Fast forward to today and the bank has gone from being something of an underperformer to being one of the best in the sector, with regard to the all-important return on equity, which sits at just under 12%, below the prior half, but at the top end of the sector, with only CBA in front at over 13%. Similarly, the bank's P/E of over 15times is above all but CBA, which confirms McEwan's "most improved" bank award. Can the outperformance continue?

New CEO Andrew Irvine previously worked for 12 years at the Canadian banking group BMO before heading up business and private banking at NAB in 2020.

NAB has a 30 September year end and last month provided a third quarter trading update to 30 June and Pillar 3 accounts, which covers capital adequacy. Revenue declined 1% on 1% volume growth, highlighting that costs are rising and competition is too.

Dividends are expected to grow at low-single digit rates, underpinned by a strong balance sheet, even after the buy back. Common Equity Tier 1 (CET1) capital is 11.75% keeps NAB out of trouble on the bad loans front and is well above the (APRA) regulator's guidelines of 11-11.5%.

The other advantage it has is growth in business credit, which exceeded even the bank's expectations. This growth will slow despite being NAB's competitive edge. NAB is now more expensive than four years ago.

Radar Rating:
Low dividend growth for the foreseeable future.

Westpac Bank (WBC)

Big Bank

RADAR RATING: HOLD

We have been right on WBC, which has a very similar composition in earnings to CBA, but is cheaper due to management mis-steps, which means it has offered a higher dividend yield and more potential. That potential has largely been realised however, with the stock returning 63.5% in the past 12 months. You read that right.

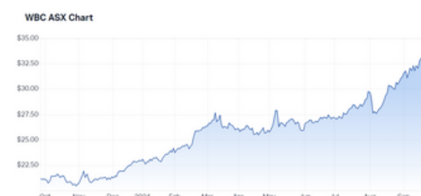
New CEO Anthony Miller, previously head of business and wealth and a former investment banker, will struggle to match that feat. His background is an interesting choice for the predominantly retail bank, especially considering the other internal rival was retail banking head Jason Yetton. He succeeds Peter King, who was CEO for close to 5 years.

Contrast the share price performance with the third quarter trading update to 30 June and you can see the mountain Miller needs to climb. Revenue was flat despite positive volumes in Australian home loans and deposits. The net interest margin was also flat at 1.94%, which was a good result.

Earnings growth is expect to be flat, while dividends are expected to decline after a boost in the current year (FY24 y/e 30 Sep).

The bank has a high-quality capital (CET1) ratio of 12.1% after the dividend boost and buy back; well above the bank regulator APRA's 11-11.5% target.

We estimate that WBC could spend another $5bn of capital above the current levels over the next two years before it gets to the top end of the target range, providing potential firepower for more special dividends and share buybacks above our forecasts. This is all factored into the share price, and then some.



Current Price: $31.72
Market cap: $110.0bn

Dividend Yield: 5.0%*
Net assets: $72.539bn
Forecast PE: 16.5x

* FY25 Forecast $1.59

Radar Rating:
Capital management can only take you so far and then there is Westpac.

ANZ Bank (ANZ)

Big Bank

RADAR RATING: HOLD

ANZ's $4.9 billion mega-deal to buy the banking arm of Queensland based Suncorp has great potential, but there is no doubt the Shayne Elliott led management has been distracted by allegations the bank's trading floor misled the government and manipulated the bond rate. ANZ now trades at a 22% discount to the big bank average PE multiple, while its forecast 5.5% dividend yield is well above Westpac's 5%, the next highest.

Is this a buying opportunity for the beleaguered bank? Based on valuation, ANZ looks the least over-valued of the big four. The dividend yield might be higher, but dividend growth is forecast to be flat, as the bank absorbs Suncorp.

The discount reflects management distraction, as well as the risk of the Suncorp merger, which involves invariable branch closures and the integration of IT systems. ANZ has long been a laggard on the systems front and two or so years ago hired ex-Google executive Maile Carnegie to head up its largest business, Australian Retail, with the great hope of bringing the bank into the 21st century.

Synergies will be limited in the Suncorp deal due to undertaking with the Queensland government that no branches will be closes or head count reduced there. Employees in other states will be looking over their collective shoulders.

ANZ is acquiring market share, which contrasts to the **Macquarie Group (MQG)** business model of growing aggressively through its own machinations (organically).

The bank needs to retain focus on its core business while the integration takes place; on top of which it needs to channel Carnegie's technological expertise.

Current Price: $30.48
Market cap: $91.0bn

Dividend Yield: 5.5%*
Net assets: $66.401bn
Forecast PE: 13.5x

* FY25 Forecast $1.67

Radar Rating:
The valuation looks fair, and dividends compensate for integration and technology risk.

A Banking Bonus

We discuss why banks have such a big role in the Australian market and give you a basic understanding of how they make money.

If you believe in the Australian economy, you can't do better than betting on the so-called Big Four banks: Commonwealth Bank of Australia (CBA), National Australia Bank (NAB), Westpac Bank (WBC) and ANZ Bank (ANZ).

These days the big banks are not so complicated. They're simply glorified building societies – they lend money secured mainly by residential property.

The bank borrows funds in the short-term, taking in deposits and short-term or overnight borrowings from places like the Reserve Bank at lower interest rates. They then lend over the longer term to home buyers and businesses at higher interest rates. The profit is called **net interest income**, while the **net interest margin (NIM)** is the net interest income as a percentage of its average interest earning assets. For the big banks, which have big low-cost deposit bases, the NIM is the key to their profitability.

Banks operate in a highly regulated environment. For example, no individual investor is allowed to own more than 15% of a bank without the consent of the Federal Treasurer. An informal but long-standing dictum, the Four Pillars policy, prevents a merger between any of the Big Four banks.

But banks are all about leverage, which means they lend out much more money than they hold in capital (equity). Hence, the **return on equity (ROE)** ratio is the all-important determinant of how efficiently a bank deploys this capital. On this score, the big four do well because of both their high net interest margin relative go global peers and their **cost to income ratio** at 40-50% is low by international standards and compared to regional banks, which average around 60-70%.

Why a higher ROE?

The Australian banks have a higher ROE than their international counterparts for two reasons:

1

Market Share

The Big Four account for around 90% of all lending, despite the best efforts of smaller regional banks and non-bank rivals to chip away at this share.

In bigger markets there tends to be much more competition, such as in the US where the five biggest banks account for less than 20% of retail banking (mainly mortgages). In the US there are countless small banks in a fragmented, state-based market.

2

Residential Mortgages

In Australia there is a big skew towards residential mortgage, which have relatively low risk compared to commercial loans.

Banks are not required to raise as much capital or equity finance for residential mortgages as they are for commercial loans. Australian banks operate off a slimmer capital base than their offshore counterparts.

How a Bank Works

The balance sheet of a non-financial firm is a by-product of its ability to produce goods and services at a profit as well as its capital structure (the amount of debt and equity which funds its asset base).

In contrast, a bank literally uses its balance sheet to generate profit.

Your assets are the banks liabilities (and visa-versa)

A bank has liquid assets in the form of cash and its overnight loans made at the official bank bill rate. These liquid assets are necessary in order to meet the bank's operating expenses, as well as to meet withdrawals by depositors. Banks keep about 20% of their total deposits in liquid form.

A Big Four bank's loan portfolio accounts for about two-thirds of its total asset base. An allowance for loan losses, called the loan-loss reserve, is deducted from this and is set up to cover bad debts (or loans in arrears).

On the liabilities side, deposits generally make up about one-third of what a bank owes, the remainder being funding from other banks.

Bank profits are all about leverage

Banks are naturally highly leveraged because every $10 lent out is backed by around $1 of equity.

The capital adequacy picture is further complicated by the weighting the banks give to the various classes of loans. With so much leverage, it is extremely important for a bank to operate in a growing economy in order to grow its balance sheet and grow earnings through a positive net interest margin (NIM).

While a bank may enjoy a healthy net interest margin and a low-cost ratio, it won't survive for long if bad debts (loan defaults) get out of control.

Asset quality, or credit quality, is the single most critical determinant of any bank's success or failure. A slim net interest margin and high operating expenses, while a hindrance to high profitability should not bury a bank. Poor credit quality, on the other hand, can quickly lead to insolvency.

Bank profits are all about leverage cont.

For example, $100m in loans with a net interest margin of 5% will generate $5m pre-tax income. It only takes one bad $5m loan to offset all of that income. Typically, poor underwriting practices are exposed when an economy falters.

The only thing that can save a bank with poor asset quality is sufficient excess capital to absorb loan losses or an injection of additional capital. In Australia, stricken banks have not gone ‘bust’ per se but they have been subsumed by a stronger bank at a steep discount to book value, often at the urging of the Reserve Bank.

Capital adequacy rules are overseen by the Australian Prudential Regulatory Authority (APRA) but ultimately the guidelines are set globally by the so-called Basel conventions, which have increased capital requirements for banks around the world.

Periodically, banks provide “Pillar 3” disclosures, which include a summary of their capital adequacy

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