The View From The Outer

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In this edition of The View From The Outer, Harry Dudley – Evans and Partners Research Analyst (Banks and Credit) discusses the outlook for the Australian Bank sector:

Why 2017 will be a better year for the banks

Revisiting EAP Core Drivers:

We review our EAP Core Drivers for the Australian banks in 2017 and are increasingly optimistic regarding the outlook for the sector. In particular:

1. Our **margin** outlook has improved
2. We see diminished **regulatory risks**
3. **Impairments** continue to be benign with some potential upside driven by commodities rallies

1. We have upgraded our margin expectations for FY17e-FY20e

This has been driven on the assets side of the balance sheet by:

- Direct repricing action on particular reference rates
- A subsiding competitive environment
- Higher returns on liquid “free funds” invested in Govt. Bonds
- Reversal in the market’s cash rate expectations

On the liabilities (funding side):

- Our Net Stable Funding Ratio requirements are being met (banks have built up longer date deposits and funding)
- Deposit competition environment has improved, material repricing has occurred since the August rate cut.

2. Falling regulatory risk

We still do not know the final regulatory requirements, and will not for some time (Basel outcomes have been delayed and we do not expect APRA implementation until 18-24 months after their finalisation). However, capital ratios were ahead of expectations in November full year results. When this is coupled with a slightly better earnings outlook we find further comfort that only minor action if any will be needed to reach new Basel and APRA requirements.

3. Bad Debts remain benign

We expect bad debts to remain benign, given they are below mid-cycle levels we consider this a positive. In 2017 we expect:

- Continued deterioration due to second order effects in the mining regions (consumer and small business loans)
- Little movement in mortgage impaired loans (except for the mining regions)
- Potential upside from the rebound in commodity prices, dairy and bulks, which have been drivers of new impairments in recent times

Incorporating improvement in the EAP core drivers we are more optimistic about 2017 for the banks - we upgraded our sector view to Neutral in December. Given the rally since we consider most of the above to be captured in the share price and therefore maintain a neutral view on the sector.

Prefer NAB (Positive), CBA (Positive)

NAB Remains our preferred bank. Continued gains are expected from its capital recycling program, driving ROE expansion in 2017. With legacy issues behind the management team, they now focus on banking activities and efficiencies. 2H16 saw NAB the leader in cost outs with expenses falling 1.9%. This was alongside broadly stable headcount as technology drove efficiencies, not redundancies.

CBA is our second pick. We consider its franchise to be the best of the Australian Majors. The ROE decline in recent years has been largely attributable to new regulation. We expect its ROE lead will persist, offering 1) strong organic capital generation 2) ability to increase dividends 3) room to grow balance sheet as lending picks up.

Margins

Margin compression has been a consistent theme for the bank over 2016. If margins remained steady over FY16 we estimate an additional $800-1,100m of cash NPAT (2.5-3.6% EPS) would be generated. We previously held a view that further rate cuts were possible (although not probable) and a continuation of a highly competitive environment – which would see further margin compression in 2017. We now expect slight margin expansion over FY17, with stable margins in the first half then margin growth in the second. We have changed our view here based on:

1. Repricing: Both Majors and regionals have begun out of cycle repricing on specific loan groups
2. Free Funds Benefit: The yield curve steepened sharply supporting returns from treasury funds
3. Rate Cycle Expectations: The implied probability and our expectations of further rate cuts have diminished.
4. Competition subsiding: discounts given on new loans are lower
5. Deposits cost headwinds unwinding

1. Repricing

4QCY16 saw each of the majors increase rates on specific loan groups ie interest only or investors. NAB increased the most, with investor loans up 15bps. Alongside this fixed rate loans increased 15-60bps for 2-5 years for CBA and WBC depending on maturity. Regional banks followed suit with BEN taking an additional 10bps across all loans and BOQ 15bps. We expect the regionals to continue to follow the majors' lead, increasing yields across the board and supporting margin expansion for BOQ and BEN in 1H17.

Chart 1: Reference rates and movements

Source: EAP, WSJ

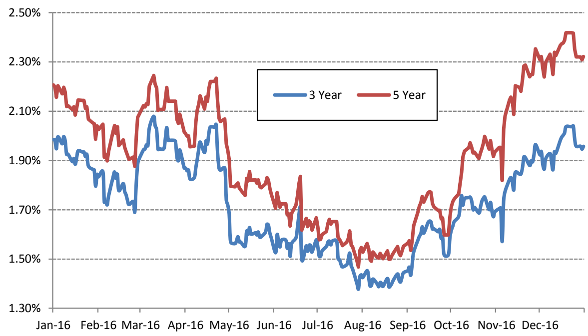
	ANZ	CBA	NAB	WBC
Reprice Action				
Investor Loans	8	7	15	-
Interest Only	-	-	-	8
Line of Credit	15	15	-	15
Portfolio Makeup				
Investor Loans	37%	35%	42%	39%
Owner Occupier	63%	65%	58%	61%

2. Free Funds Benefit

The steeper yield curve delivers higher returns on banks' funds that are required to be held in highly liquid securities. This is shareholder capital and low cost deposits not lent out but invested in medium term government bonds in which yields have all risen the past 3 months. We expect this to provide a slight benefit in the short term and clear benefit in the long run as new securities are purchased. There is also a secondary effect in increased *markets income* as clients hedging needs grow.

Chart 2: 3 and 5 Year Govt. Bonds

Source: EAP, Iress



3. **Rate Cycle Expectations**

The steeper yield curve also implies a change in the rate cycle sooner than previously expected. Importantly, the outlook for further rate cuts has diminished, with an implied 38% probability of higher rates in 2017 (Bloomberg). The point of inflexion reached in interest rate expectations helps supports our Net Interest Margin (NIM) outlook twofold:

   i. The likelihood of rate cuts in 2017 now appears remote, this was a consideration for much of 2016. Rate cuts were a key driver of margin compression in 2016
   ii. The increased market expectation of a rate hike in 2017 implies an opportunity for additional margin expansion in 2018 and beyond as banks quickly increase lending rates and delay repricing of term deposits.

Chart 3: Implied Probability of Rate Cut in 2017

Source: EAP, Bloomberg

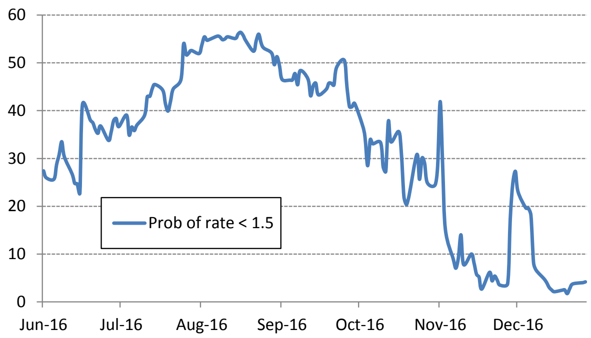
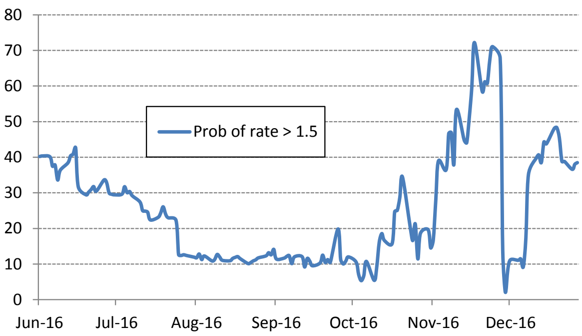


Chart 4: Implied Probability of Rate Hike in 2017

Source: EAP, Bloomberg



4. **Competitive environment subsiding**

A key driver of margins the past two years has been discounts on rates given on new loans amidst pressures to grow loan books. Discounting of up to 50bps on the advertised rate has been not uncommon. Our channel checks with brokers have suggested that competition has eased the past 6 months. The repricing action over the past 2 months is further evidence of this.

5. **Deposit Pressures Easing**
   Following the August rate cut it appeared that banks were reluctant to cut deposit rates, with CBA increasing rates on longer dated deposits. This was over an initial implementation period of the Net Stable Funding Ratio requirement - a new regulation that requires longer date term funding and deposits to ensure liquidity in times of stress. With all banks meeting the 100% threshold and material issuance of longer dated term funding in 1H17e, deposits competition appears to have eased with 6 and 12 month deposit rates pulling back ~15 to ~40bps across the majors and bonus rate offers pulling back.

Capital

In 2017 we see regulatory risks diminishing. Whilst we do not know any more than we did at FY16 about new requirements we have built further confidence in our thesis that the banks will be within close reach or at new requirements when they are handed down. This is supported by:

1. FY16 CET1 ratios were 30-50bps better than expected, capital recycling surprised to the upside
2. All big 4 are less than 50bps from our expected new ~10% CET1 target
3. We expect capital recycling to continue, whereby capital is redeployed into less intensive higher returning assets
4. In addition to the above, organic generation estimates rise with our improved margin outlook
5. Lastly, the Basel delay will likely lead to APRA delay offering additional time to grow organically

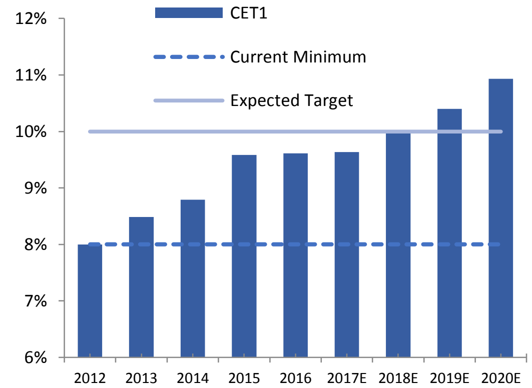
We have maintained a view that it is highly unlikely that the banks will need to raise capital to meet new requirements. This is still a point of contention in the market. With some investors still undecided we expect further clarity on measures to drive potential upside when investors agree on reduced regulatory risk for the banks.

The next step would be acknowledgement of the reduced financial risk that new measures have brought to the sector. We see scope for increasing DPS once APRA findings are known, however we expect them to remain flat for now as a prudent measure.

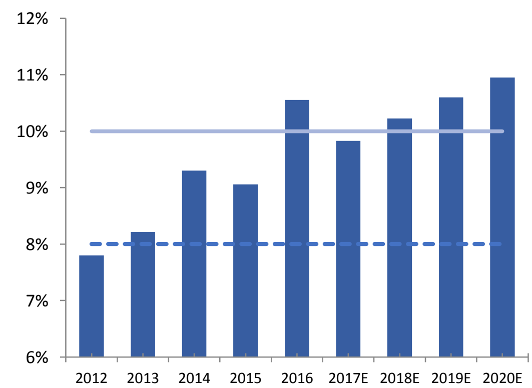
Basel Delay

APRA has previously expressed that its timeline for its own capital measures relies on the finalisation of Basel committee resolutions. This was expected to occur through 2017 with implementation in 2018. With the delay from the Basel committee (5 January) and no set date for finalisation, we expect APRA's finalisation to also be delayed. This allows the majors additional time to grow capital organically or shift asset mix to less capital intensive assets (specifically ANZ and NAB).

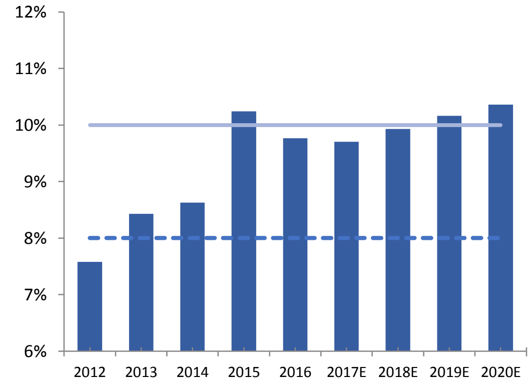
ANZ: CET1 Ratio, historical and forecast
Source: EAP, Company Accounts



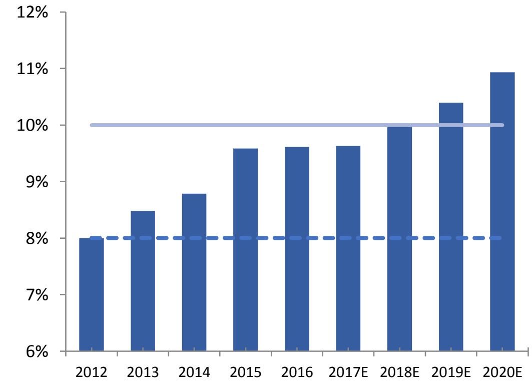
CBA: CET1 Ratio, historical and forecast
Source: EAP, Company Accounts



NAB: CET1 Ratio, historical and forecast
Source: EAP, Company Accounts



WBC: CET1 Ratio, historical and forecast
Source: EAP, Company Accounts



Bad Debts

We expect bad debts to remain benign, given they are below mid-cycle levels we consider this a positive. In 2017 we expect:

- Continued deterioration due to second order effects of mining region in consumer and small business loans, however, quantum remains immaterial
- Little movement in mortgage impairments except for the above areas, mortgages continue to be supported by the low rate environment
- Potential upside from the rebound in commodity prices, dairy and bulks, which have been drivers of new impaired assets in recent times - the boost in cash flows presenting opportunity to reduce debt.

Apartment Lending

As for apartment exposures, it is a theme we continue to monitor closely, we do expect an oversupply in these markets in coming years. We are of the view that the banks have so far done a good job of mitigating risks - increasing required security and putting the brakes on lending to certain areas and segments.

- Apartment *developer* lending in inner city areas makes up less than 1% of assets
- Apartment *mortgage* lending in inner city areas makes up less than 2% of assets

We also do not expect these geographies to move in a highly correlated manner without an exogenous shock and do not expect a significant increase in bad debts even if apartment prices fall ~20% (RBA estimates <$100m). The RBA forecasts that a fall of ~35% is needed for mortgage losses to reach ~$500m across the majors, to put this in perspective $500m is ~1.6% of NPAT (RBA, Banks' Exposures to Inner-city Apartment Market, October 2016).

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Positive	Stock is expected to outperform the S&P/ASX 200 over the coming 24 months
Neutral	Stock expected to perform in line with the S&P/ASX 200 over the coming 24 months
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Valuation	Composite of rolling 12 month prospective multiples and discounted cash flow (DCF), or DCF for resource stocks.
Earnings Outlook	Forecast 2 year EPS growth.
Earnings Momentum	Percentage change in the current consensus EPS estimate for the stock (rolling 1 year forward basis) over the consensus EPS estimate for the stock 3 months ago.
Shareholder Returns	Composite of forecast ROE (rolling 1 year forward basis) and the percentage change in ROE over 2 years.
Debt Servicing Capacity	Rolling 12 month EBIT Interest Cover ratio.
Cyclical Risk	Qualitative assessment of the 2 year outlook for a stock/industry’s profit cycle.
Industry Quality	Qualitative assessment of an industry’s growth/returns potential and company specific management capability
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