Equity Trustees

May 2024

ASSET CLASS INSIGHTS

AUSTRALIAN EQUITIES – BANKS REPORTING SEASON REFLECTIONS

Conclusion

- The major Australian banks reported solid results relative to low expectations.
- A more resilient than expected economy has meant that banks have benefited from a benign bad debt environment thereby lowering provisions and boosting earnings.
- The unwind of provisions along with strong capital positions of the banks has led to increased capital management initiatives which is supportive to share prices in the near term.
- Despite this, profit growth is relatively flat, valuations are expensive, and returns have been structurally reducing over time making the banks a less attractive investment.

Equity Trustees' Australian equities banks analyst Steve Coffey recently reviewed the major banks following the recent reporting season.

The May bank reporting period sees three of the four major banks report half yearly results and Commonwealth Bank (CBA) give a third quarter trading update. Here are our key takeaways:

- As the sector has moved past the peak maturity of fixed mortgage refinancing, mortgage competition has become a bit more rational, with most banks having stepped away from cash-back incentives.
- This coincided with the banks still benefiting from last year's cash rate increases, which are smoothed out due to hedging, allowing net interest margins to stabilise.
- The main driver of earnings this period though, was lower than expected bad debts, as the better-than-expected economy (especially when compared to the concerns last year) allowed the banks to reduce the provisions for credit losses which boosted earnings.
- Given the banks already strong balance sheets, this has allowed them to continue to pay out large dividends to shareholders, including special dividends, whilst also buying back billions of dollars in stock, which is boosting share prices in the near term.
- Adjusting for bad debts, the outlook for profit growth across the sector is relatively flat, with stable net interest margins, modest credit growth and ongoing cost growth offsetting each other.
- Despite the modest underlying earnings outlook, valuations, particularly on a pre-provision basis (or when adjusting for bad debts), are near record highs.
- Post results we had the opportunity to meet with senior members of bank management. In our discussions with senior management, they highlighted the resilience of the domestic economy despite higher interest rates, and strong bank balance sheets. We also raised the importance our investors place on returning capital in the form of franked dividends.

WHAT DOES THIS MEAN FOR THE BANKS IN THE NEAR TERM?

Near term, there are a few supportive factors for the banks including:

- Capital management initiatives - increased capacity to pay dividends and return capital to shareholders.

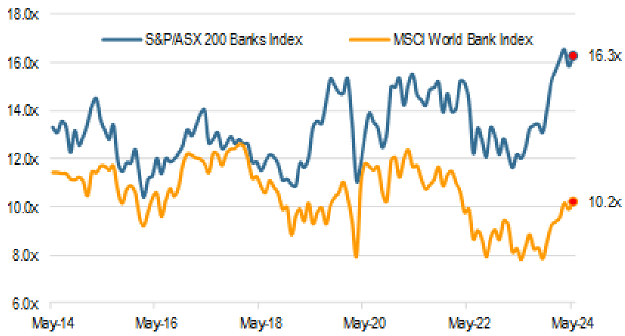
- 'Higher for longer' interest rates which help bank revenues.
- A relatively strong economic backdrop including fiscal stimulus (budget subsidies and upcoming tax cuts), higher house prices and solid current labour markets.
- Continued population growth courtesy of high levels of migration
- Strong balance sheets above target levels

MEDIUM TERM FUNDAMENTALS ARE LESS ATTRACTIVE

Australian banks have rallied strongly over the last six months due to a more resilient than expected economic environment leading to lower bad debts, a slight relaxation in mortgage competition, underweight investor positioning, capital management announcements and a switch from the major miners due to ongoing challenges in China. Despite this, under our "Quality at a Reasonable Price" process, the banks face some challenges to sustained outperformance. These include:

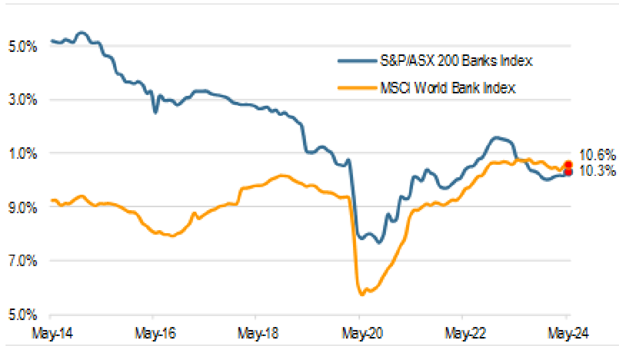
1) **Less attractive valuations due to the recent Price-earnings re-rating** – despite the rally in the banks, earnings forecasts have not changed that much. The earnings outlook is flat reflective of low credit growth and higher costs. The Australian banks now re-rated significantly relative to offshore peers, despite their return on equity falling over the last ten years.

1-Year forward Price-Earnings (Australian Banks vs MSCI World Banks) – 10 Year history



Source: JPMorgan, Bloomberg L.P.

Return on Equity history (Australian Banks vs Developed Market peers)



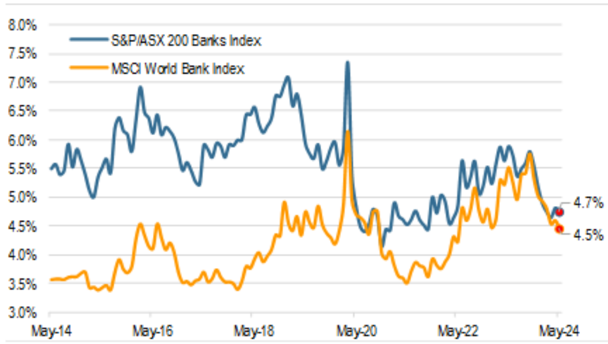
Source: JPMorgan, Bloomberg L.P.

2) **The Dividend yield is less compelling** in absolute terms, against offshore banks and relative to other asset classes.

Australian Banking sector Dividend yield less the Term deposit rate

Source: Barranjoey

1-Year Forward Dividend Yield (Australian Banks vs Developed Market peers)



Source: JPMorgan, Bloomberg L.P.

About the author:

Grant Mundell
Investment Specialist
+61 2 9458 5518
GMundell@eqt.com.au

STEVE COFFEY - Senior Investment Analyst, Equities

Steve joined Equity Trustees in 2020 and has more than 25 years' experience in the financial services industry. Prior to joining Equity Trustees, Steve was a member of UBS Asset Management's Australian equity team. Prior to that he was a Senior Portfolio Manager at QBE where he was responsible for the group's European, US and Australian equity portfolios.

About our process:

Equity Trustees is an active manager with a bias toward large capitalisation stocks. Equity Trustees has an experienced investment team which undertakes fundamental company research to identify these opportunities aided by proven proprietary screening tools. Our 'quality at a reasonable price' (QARP) investment style identifies strong companies that are trading in the market at a discount to fair value. We define 'quality' as companies with strong balance sheets, strong cash flows, sustainable dividends, earnings growth potential, quality management, and that operate in industries with favourable structures.

For more information on Equity Trustees Australian equity products - click here

For more information on Equity Trustees Asset Management - click here

For more information contained in this briefing, please contact Grant Mundell on the details noted above.