You can bank on this

by Roger Montgomery

Let's take a look at everyone's favourite: the banking sector.

From a low of $70.87 in September 2016, Commonwealth Bank has touched a high of $87.66 and paid $6.51 in dividends. And from its low of $28.27, Westpac has risen to a high of $35.06 and paid $1.88 in dividends.

But since those highs have been achieved, bank shares have been sold down heavily in response to a number of factors. CBA's shares have fallen 13% and Westpac 10.3%. And despite these lower prices, bank share prices still only represent fair value at best, and at worst, are trading at price-to-book multiples well above long-term averages.

Meanwhile, the risks to banks are increasingly obvious with earnings positively but temporarily impacted by record low levels of bad debt charges.

It's difficult to imagine a superior business to own on an island than a bank, particularly one of the oligopolistic big four. Monopolies, duopolies and oligopolies tend to produce sustainable excess returns because barriers to entry are high and legislation or other conditions exist to supress competition. In 1990, when the Commonwealth Government of Australia enshrined the banking oligopoly, announcing the adoption of the "four pillars" policy and rejecting any mergers between ANZ, CBA, NAB and Westpac, it entrenched unusually high rates of returns on equity.

But even oligopolies can see returns 'mean-revert' through an economic cycle, especially if they act in concert. It's worth keeping in mind that at a very basic level banks have large asset balances (loans, particularly mortgages) and relatively little equity. A Domestic Systemically Important Bank could previously lend $100 of mortgages for every $1.60 of shareholders' equity. Clearly, a small problem in a very large asset, can cause a very large problem in a very small amount of equity.

Last year David Murray's Financial System Inquiry and associated recommendations. As a result of these changes, the big banks' future returns on equity must necessarily be lower than in the past. That makes them less valuable, all else being equal.

The risk of asset impairments for the major banks and their exposure to significant falls in asset prices, particularly property have been well highlighted. Any deterioration in the credit cycle (growth in borrowing by individuals and corporates is slowing), any pressure on net interest margins, higher expected funding costs, the aforementioned inadequate provisioning for bad and doubtful debts coinciding with a peak in the property market, and higher capital requirements, will put pressure on bank earnings in the near term.

Unsurprisingly, the 2017 half yearly results showed negligible revenue growth due to slowing loan book growth and disappointing net interest margins. The results were then compounded by a significant step-up in the political risks, with the Federal Government announcing a surprise liabilities levy in the budget, which at the very least, will require the banks to use up some of their pricing power headroom just to hold earnings and returns stable.

More recently, the market has again been put on notice that the tightening of regulatory requirements is far from over, with APRA expected to provide further details regarding its definition of 'unquestionably strong'. We currently expect the banks to be required to raise more capital. More importantly, an end to the construction boom and its flow on effects to the retail sector – two of the country's biggest employers – could lead to financial stress for many borrowers who

have collectively amassed record levels of debt. At the time of writing, banking analysts have not significantly adjusted their earnings expectations. If they are unduly optimistic, the downgrades could put the banks under further selling pressure.

The NAB (HOLD)

After an earnings peak in 2015, analysts currently don't expect any growth for NAB profits until 2019 – a year which the highly leveraged residential property market could be laid bare. At the time of writing, NAB's share price is lower than in April 1999 – that's 18 years with no share price appreciation. Investors have only achieved a rising yield, which is better than money in the bank, but much worse than many other investment options.

NAB's poor investment performance is largely due to a litany of large losses made on acquisitions made under CEO, Don Argus. The NAB lost $2 billion on Florida-based mortgage originator Homeside and over $4.1 billion on Clydesdale.

The stability of the banking oligopoly, and the relative competitive positions of each member in it, suggests that NAB's market share and profitability won't change dramatically enough to recoup the company's losses relative to its peers. We retain the view that unless a demonstrated improvement in performance becomes visible, NAB is worth the least among its peers.

Westpac (HOLD)

Overall, WBC's result was slightly higher than our forecasts, but for low quality reasons. High value recurring revenue lines (net interest, wealth management, insurance, fees and commissions) were generally lower than expected and showed negligible growth. The offset was a better performance from lower value trading revenue and lower bad debt provision charges. This is consistent with the 1H17 results released by ANZ and NAB.

If we adjust the trading revenues to more normal/sustainable levels and adjust net insurance revenue to a more normal claims ratio for the general insurance book, revenue would be around A$100m lower. This sustainable figure is only 0.2% higher than in the previous corresponding period.

Operating costs were marginally lower than expected and despite management's comments regarding the strength of its capital position, it has decided to reintroduce a 1.5% discount on DRP pricing in order to boost DRP participation, highlighting management's expectations for the outlook for regulatory capital requirements.

The bigger issue however remains exposure to a property correction with cracks already forming.

ANZ (HOLD)

The ANZ reported weak revenue in its half year 2017 results. The banks continues to rationalise its Asian loan book. In the recent reporting period, however, this didn't provide any benefit to the bank's net interest margin which was lower than the prior six months excluding the impact of markets & rates, with a repricing of loans benefit offset by higher funding costs and changes to the mix of deposits. This highlights that there are still a lot of offsets to repricing of mortgages.

Notably, the higher value 'fees & commissions' as well as wealth management revenues were weak, while cost control was good and the result was boosted by a lower bad debts expense. Impairments and delinquencies increased slightly, but at this stage in line with the loan book. Overall, the bank's result highlights how the banks are increasingly dependent on cost reductions to deliver any earnings growth going forward.

CBA (HOLD)

Over the long run, the CBA is the best performing bank in Australia. In its 3Q17 trading update cash earnings of circa A$2.4bn was slightly disappointing compared to market expectations. Mortgage growth in the 12 months to March 2017 was 7.8%, which was ahead of system growth of 7.0%, as was business lending growth of 3.7% ahead of market growth of 3.4%. Notably, mortgage growth was 8.0% in the year to 31 December 2016, so the 3rd quarter 2017 numbers represents a slowing of mortgage book growth. The bank's commentary pointed to the slowdown occurring mainly within the broking channel

and on investment loans, which has been a deliberate move by CBA as has its reduced exposure to apartment construction. But this is all relative as the CBA has the largest mortgage loan book of all the banks.

Bad debt provisions were extremely low at A$202m for the quarter. This was well below our own forecasts and well down on the previous corresponding period, despite a continued ticking up in delinquency rates. This will be something to watch very closely, especially with share prices now only representing only fair value rather than good value.

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