

Banking on further gains

As we noted in our half year review, a key determinant of how the ASX200 is going to perform in the second half of the year will rest on the financials (40 percent of the index), and in particular the banks. Collectively, the banks make up around a quarter of the ASX200's market capitalisation, and of course are also well valued by investors for their dividend paying attributes.

The banks though have been catching it from several quarters this year as we have previously noted, with CBA providing more fuel for the haters. AUSTRAC is taking the company to the Federal Court, alleging Australia's biggest bank breached the Anti-Money Laundering and Counter Terrorism Act, not reporting suspicious transactions valued at around \$625 million using the bank's ATMs.

Prior to this, banking executives have been hauled in front of Senate committees to explain why their companies are making 'too much money' and are not passing on RBA rate cuts. This is also while many don't seem to realise that banks are privately owned institutions in the business of making money, and are not non-profit organisations or owned by the government.

The Federal government has also established that it would be a good idea that the big four banks (ANZ, CBA, NAB, Westpac) and Macquarie, should fill the budget hole with a new bank levy. To rub further salt in the wounds, the South Australian government has come along with their own version of the levy (although the Liberals are blocking this), and singled out the banks as 'fair game.'

The public and government though should realise that the question of why base rate cuts are not being passed on (and what will happen with the bank levies) is fairly straightforward. Any normal business when faced with lower volumes (as mortgage books are tightened) and higher costs (funding, regulation and levies) will respond in any way they can.

The banks will pass the levies on – that is a given in our view. Costs are also being taken out, while businesses are also being right-sized to shore up balance sheets. The banks though have also caught a major break, with the Australian Prudential Regulation Authority (APRA) coming out with capital targets that were less onerous than expected (ourselves and a few others excluded).

APRA's new target for common equity tier 1 capital is 10.5%, which is just 50 basis points above current levels, and equates to around \$8 billion in additional capital. This is probably at the bottom end of what was expected, and the regulator has also given the four major banks 2½ years to build up their reserves.

This is a pivotal moment for the key banking sector in our view. APRA's decade long (yes 10 years in the making) reform plan aiming at building strength in the financial system has been hanging over the sector.

Fair to say the regulators have succeeded, with Australian banks today amongst the best capitalized in the world.

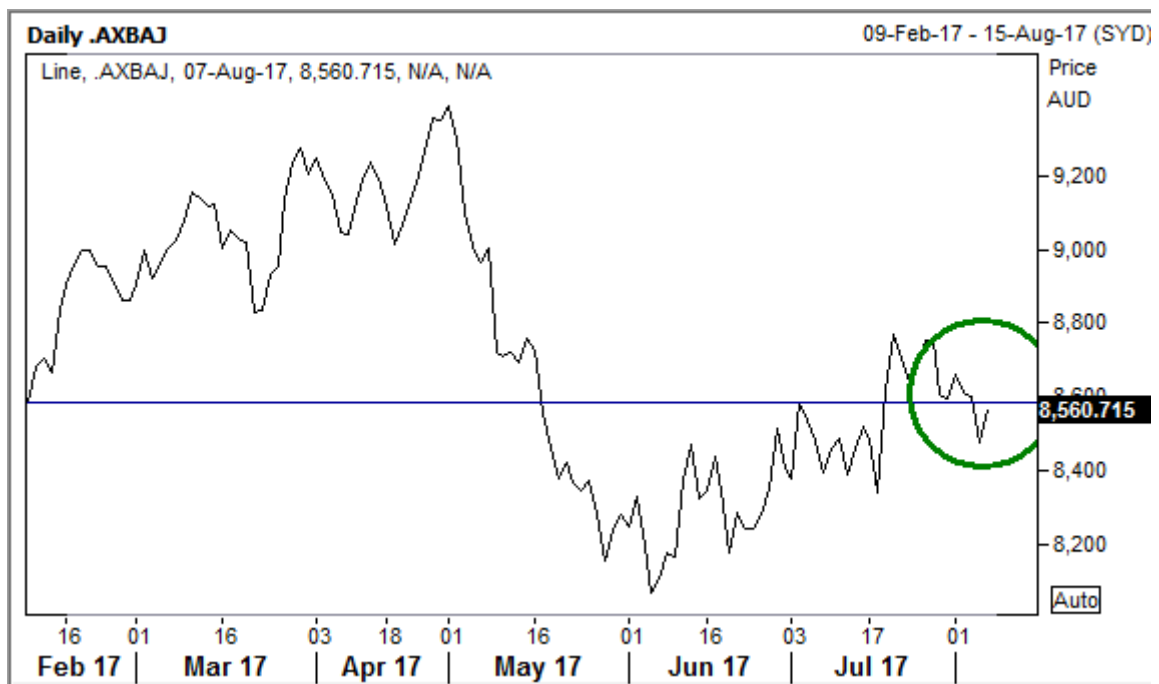
APRA has done a first-class job in reining in risk and lending and, are to be commended for their efforts. And thanks to APRA, this distinguishes Australia's banking sector today with that of the US in 2007 pre the GFC, just prior to the housing bubble implosion.

It is also encouraging that the regulator itself acknowledges the strong positioning of Australian banks (CET1 capital ratios have risen 250 basis points since 2014), and has finally sought to cut the sector some relief. Significantly, several of the banks have second guessed the regulator's target, and are already well positioned, following capital raisings and non-core asset sales.

Although the market has been more pessimistic, we have been vocal for some time that the final capital imposition requirements would not be heavily onerous, with APRA wanting to strengthen the banks, but not completely shackle them (or the economy). This has now played out, and many other insto analysts (several of whom were scaremongering only last year over dividend pay-outs in the sector being slashed) have done about turns, with some acknowledging that capital management is now on the agenda.

This has all seen the ASX200 banking index reassert to the upside, and we believe some of the big reasons for 'avoiding' the banks are starting to dissipate. Although clearly some risk remains.

ASX200 Bank index



Lending rates (as they are now) will continue to rise, and at an even faster rate if we get the system inflation we are expecting. This will ultimately boost bank profitability, and underpin what remain some of the highest dividend pay-outs in the world.

Australian banks also have some of the sturdiest balance sheets in the world, and we believe this is the counter to the argument (endorsed by the rating agencies) that the sector is just too exposed in the event of a GFC housing market collapse. We do not foresee such a scenario, with APRA's moves providing some insurance, and a stamping out of the more toxic mortgage products.

We do though believe that a mild correction is likely to play out in the housing market in Australia, but that the banks (and regulators) have already moved ahead of time to prepare.

We also highlight the point that banks typically do well when interest rates rise (although not too quickly) as this provides a boost to margins. We therefore can see a scenario where default rates do not blow out, but slowly rising interest rates provide a boost to the bottom line of the banking sector.

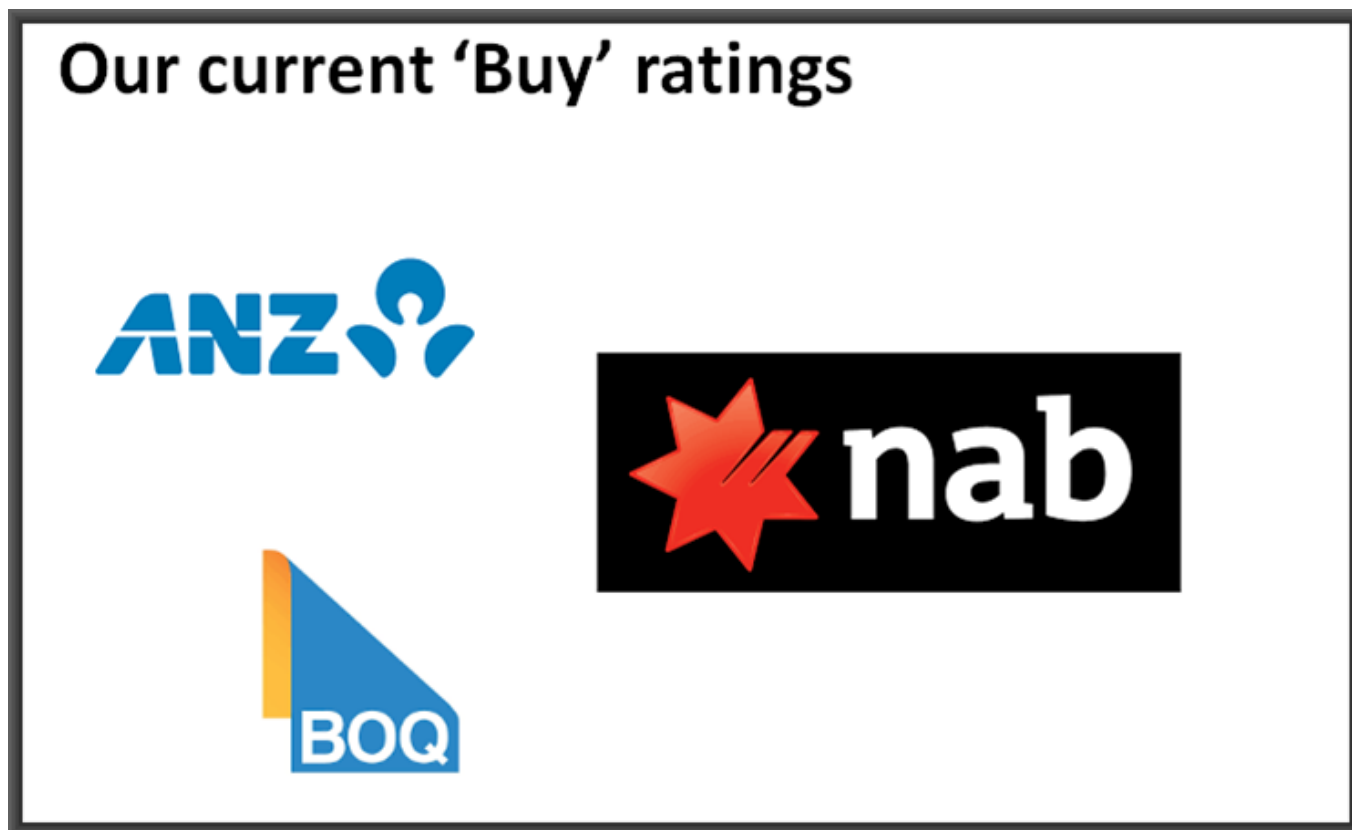
With reference to the monthly chart below, a confluence of support was respected at the 5934/6195 region in March 2016. This is made up of the long-term uptrend line (upward sloping green line) and 50% Fibonacci retracement (blue-solid set of retracements) respectively. This is a positive event, which led to a stern increase in the value of the index. At present, a short-term correction is in play, and should this continue then a zone of support is indicated between 6669.40 (61.8% Fibonacci retracement) and 6896.50 (50% Fibonacci retracement). In the grand scheme of things, as the underlying longer-term uptrend remains firmly intact, we would expect this to eventually steer the broader direction of the S&P/ASX 200 Financial-x-Property Trusts index.



We will know more on the market 'view' on the outlook once CBA reports tomorrow, and this could set the short-term tone for further buying or selling in the sector. **Ahead of this, we provide our view on where the best medium-term value lies in the sector, and our rating of the five banks currently in the Fat Prophets portfolio.**

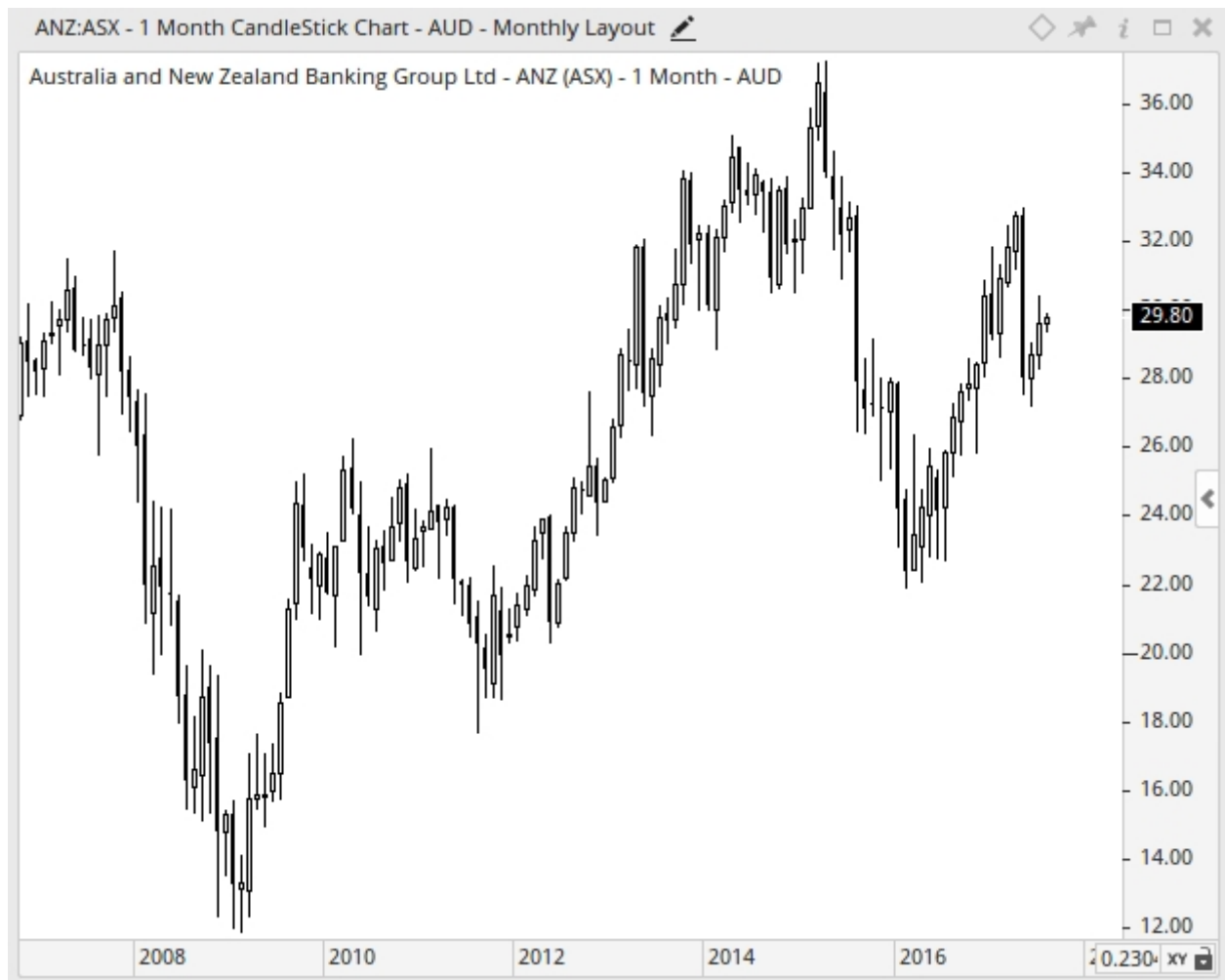
Banks in the buy zone in our view

Currently, we believe three banks are in the buy zone, and offer the most leverage to our view of an upward re-rating of the wider banking sector. We look at each in turn.



ANZ Banking Group

The banking sector has been facing pressures (price, volume and balance sheet) on multiple fronts in the past few years, but we believe that ANZ has got its house in order quicker than many of the other banks, and on a relative basis, justifies the share price outperformance seen over the past year. CEO Shayne Elliott is taking a more pragmatic approach to the company's Asian exposures, compared to his predecessor Mike Smith, which also provides a key point of difference.



In our view ANZ is also ahead of the pack in getting its balance sheet in order, having the strongest common equity tier 1 (CET1) ratio of all the major banks. This is set to be boosted further by additional capital from the sale of its minority stakes in three Asian banks (potentially another 70 basis points of capital), as well as the wealth operations which are on the block.

With equity levels in excess of the regulator's new benchmark, this clears the way for ANZ to proceed with capital enhancing initiatives, and most likely share buybacks. From a valuation perspective ANZ is also very attractive, trading at 12.9 times, and below the median for the sector. **Accordingly, we maintain a buy rating on ANZ.** Members should note the bank is poised to deliver a trading update next Tuesday 15th August.

RELATIVE VALUATION >			
	ANZ		Peers
	LTM 8-Aug-17	NTM 8-Aug-17	NTM
PE	15.28	12.91	13.13
EV/EBITDA	11.90	12.53	8.54
Div Yield	7.67%	5.42%	5.89%
EV/Sales	4.38	6.18	4.79
P/CF	6.01	9.00	10.10
P/B	1.50	1.44	1.71

NAB

We also hold a positive view on NAB, which like ANZ has also been weighted down by offshore exposures. NAB did though exit its UK Clydesdale arm with precise timing, and prior to the Brexit vote.

This has strengthened the capital base, while the bank has also been progressing well on the cost out front, and with a number of key business transformation initiatives. We see these as boosting the bottom line over the medium-term, and helping with an upward re-rating relative to the likes of CBA and Westpac.



Valuation wise NAB is also compelling, with a forward PE of 12.4 times, and at a discount to the median. An above average dividend yield of 6.4% is adding further allure. **Accordingly, we maintain a buy rating on NAB.** Members should note the bank is set to deliver a trading update this Friday 11th August.

RELATIVE VALUATION >			
	NAB		Peers
	LTM 8-Aug-17	NTM 8-Aug-17	NTM
PE	13.86	12.44	13.13
EV/EBITDA	12.79	12.19	8.60
Div Yield	9.37%	6.43%	5.42%
EV/Sales	4.33	6.35	4.79
P/CF	3.64	9.74	10.10
P/B	1.58	1.56	1.71

Bank of Queensland

As covered in last week's week we also hold a positive view on regional player Bank of Queensland, with a number of points of difference versus the 'Bigger' Four.

One premise for being overweight the banking sector also hinges on the fact that lending rates are (and have already started) going up, which will boost margins, and compensate for lower volumes as the property market plateaus. We see Bank of Queensland having particular leverage here given a higher relative reliance on residential mortgages, compared to the Big Four which have a broader business mix.

Not caught by the Federal bank levy. Bank of Queensland will also benefit from a levelling of the playing field, and the inclination of the big banks to pass the government levy onto customers. This will offer BOQ more flexibility in improving its competitive position, or another margin boost if it chooses to simply follow suit.

Furthermore, APRA has decided that the theoretical minimum CET1 requirement for standardised banks (which includes BOQ) is 7.5%. Already having a CET1 ratio of 9.29% at the half year result, BOQ is therefore in a strong position to meet the requirement. The Board has set the company's CET1 target range to be between 8.0% and 9.5%, and noted that at 31 May 2017, the CET1 was 9.1%.



As far as capital adequacy goes we believe that BOQ is well positioned to withstand any deterioration in the housing market when it comes. We will also make the point that geographically around a half of the company's housing loan book is based in Queensland, which has not seen the breakneck price growth seen in parts of NSW and Victoria. This should also help insulate the impact if the 'hotspots' turn downwards.

In any event, the company's intent focus on better risk management practices has clearly reaped gains. At the half year, the loan expense fell 25 percent on the prior corresponding period to 13 basis points of gross loans. Management is also seeking to take costs generally out of the business, with key digitisation projects also lending a hand.

We also remain encouraged by the novel ways that BOQ has been able to deliver growth through various niche segments. This includes the bank's Specialist business which predominantly services medical professionals. Annualised commercial and home loan growth came in at 8 percent and 27 percent respectively here at the half year. BOQ finance also saw a strong half, while the new Virgin Money mortgage product launch saw \$200 million of loan growth at the first half.

Accordingly, and with BOQ trading on a modest earnings multiple of 13 times, and offering a 6% yield, we continue to rate the shares as a HIGH CONVICTION Buy for Members without exposure.

RELATIVE VALUATION >			
	BOQ		Peers
	LTM 8-Aug-17	NTM 8-Aug-17	NTM
PE	15.10	13.06	12.89
EV/EBITDA	23.99	–	8.56
Div Yield	8.73%	6.18%	5.65%
EV/Sales	6.28	11.65	4.22
P/CF	–	13.99	9.35
P/B	1.30	1.28	1.56

Banks in the Hold zone in our view

You can't have everything as they say, and we have specific reasons as to why CBA and Westpac are not in the buy zone. That said for Members with exposure we continue to recommend holding, with downside capped in our view, and dividend payments likely to remain robust. We look at each in turn.

Our current 'Hold' ratings



CommonwealthBank

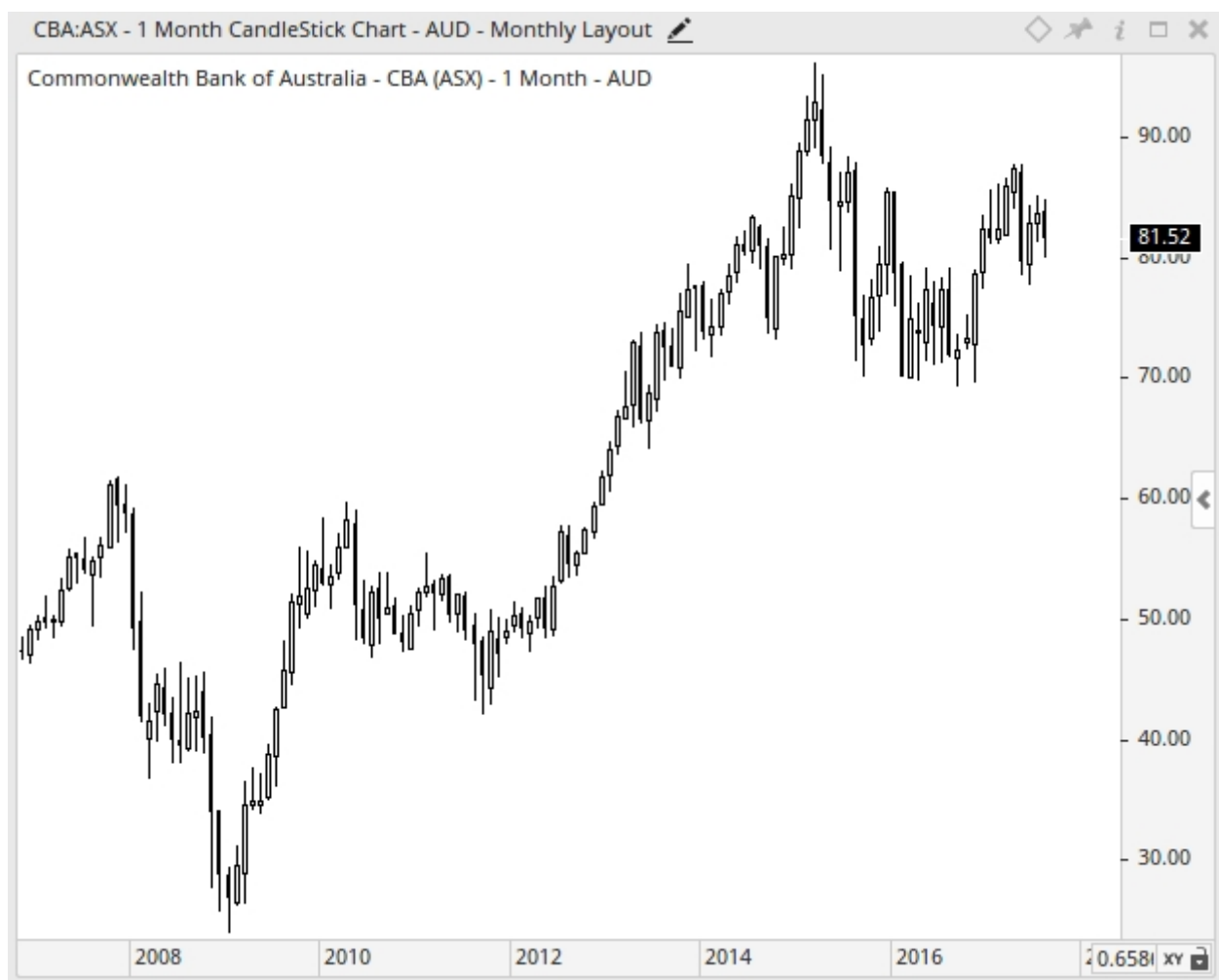
Westpac

Commonwealth Bank of Australia

We will know more about CBA tomorrow, with the company set to deliver full year results, but there are a number of reasons why we believe that the bank will underperform ANZ, NAB and BOQ.

First and foremost CBA is behind the curve in terms of getting capital adequacy in order. The bank though does have time on its side, and is said to be mulling options for the sale of its life insurance business. A deal would certainly take care of its obligations, with a \$5 billion price tag likely. That said until a deal is done and what it looks like, some uncertainty may hover over earnings, and ultimately dividends.

Sentiment has been further undermined with financial intelligence agency AUSTRAC initiating Federal Court action against Australia's biggest bank last week. The agency alleges CBA breached the Anti-Money Laundering and Counter Terrorism Act, not reporting suspicious transactions valued at around \$625 million using the bank's ATMs, also ignoring warnings from various authorities including the Federal Police.



Banks are required to report to AUSTRAC all transactions above \$10,000 and it alleges there were over 50,000 instances since 2012 where CBA did not do so. Each breach carries a maximum penalty of \$18 million or a potential fine of almost \$1 billion. CBA now has a fight on its hands, and has gone into damage control to show that any operational failings are being addressed, although we don't think that the maximum penalties will ever see the light of day.

In any event, on a valuation basis Australia's biggest bank is expensive relative to the rest of the sector. CBA will remain held in the Fat Prophets Portfolio.

RELATIVE VALUATION >			
	CBA		Peers
	LTM 8-Aug-17	NTM 8-Aug-17	NTM
PE	15.13	14.23	12.89
EV/EBITDA	14.04	–	8.60
Div Yield	7.38%	5.35%	5.89%
EV/Sales	8.34	10.45	4.22
P/CF	–	10.06	9.35
P/B	2.29	2.11	1.44

Westpac Banking Corporation

Finally, we have Westpac which is, in many ways from our perspective, 'stuck in the middle.' The company has outperformed historically, and like CBA being somewhat domestically focussed has avoided pitfalls overseas, but has also less room for major change.

Priced higher than ANZ and NAB, but lower than CBA, we are happy to take a neutral stance. It is worth noting though, that WBC is finding more favour with some institutions, including Goldman Sachs who has put it on their buy list.

From our perspective though, Westpac will remain firmly held in the Fat Prophets Portfolio.

RELATIVE VALUATION >			
	WBC		Peers
	LTM 8-Aug-17	NTM 8-Aug-17	NTM
PE	14.37	13.16	12.89
EV/EBITDA	14.24	–	8.56
Div Yield	8.41%	5.90%	5.65%
EV/Sales	8.72	12.00	4.22
P/CF	–	10.13	9.35
P/B	1.81	1.71	1.44

Disclosure: ANZ Banking Group Bank of Queensland, and NAB are held in the Fat Prophets Concentrated Australian Share model. ANZ Banking Group Bank of Queensland, CBA, NAB, and Westpac are held in the Fat Prophets Australian Share Income model.

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