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Australian Banks Give Investors 30 Billion Reasons to Smile

Buybacks are likely but an 'excessive' payout ratio makes sense.

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Contents

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Executive Summary

Australia's major banks have around AUD 34 billion in excess capital and we think most of it should be returned to shareholders. If the excess is used to boost the dividend payout ratio to 100%, and the remainder goes toward buybacks, the majors would trade on fully franked dividend yields of around 6%. We think these yields are attractive, particularly in a low-cash rate environment; but the catch is the attractive yields are temporary and not sustainable beyond fiscal 2024. However, limited franking credits and foreign ownership will most likely sway the banks to opt for share buybacks. An off-market buyback can still be an attractive option for Australian shareholders. With a component treated as a fully franked dividend, shareholders subject to low tax rates could be much better off selling into a buyback, rather than on market. Shares of the major banks trade around our fair value estimates (except for Commonwealth Bank). We think the strong wide-moat franchises and prospects for material capital management initiatives still make the banks attractive holdings in a fairly overvalued Australian market.

Key Takeaways

- We expect all major banks to make off-market buybacks within the next 12 months, with the remainder of surplus capital returned via an annual dividend top-up between fiscal 2021 and 2024, and on-market buybacks once franking balances deplete.
- Based on a target common equity Tier 1 ratio of 11%, we assume AUD 30 billion is returned to shareholders. Between fiscal 2021 and fiscal 2025, we estimate Commonwealth Bank returns around AUD 5.50 per share, ANZ and National Australia Bank around AUD 2.20 each, and Westpac AUD 1.90.
- Only Westpac has enough franking credits to fully frank all returns of excess capital. We estimate Commonwealth Bank could frank 66% of returns, National Australia Bank 39%, and ANZ Bank 19%.
- We think the Commonwealth Bank could kick things off as soon as August 2021 with an approximate AUD 5.5 billion off-market buyback. However, the bank's conservatism around loan loss provisioning and dividends during 2020 and 2021 suggests shareholders may need to wait until 2022.

Our fair value estimates assume the banks have returned excess capital to shareholders by 2025. This may occur sooner, but timing is not material to our fair value estimates. We have not included dividend top-ups in our forecasts given uncertainty around timing.

Companies Mentioned

Name/Ticker	Economic Moat	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Morningstar Rating	Market Cap (Bil)
ANZ Banking Group ANZ	Wide	AUD	29.00	28.3	High	★★★	80.4
Commonwealth Bank CBA	Wide	AUD	77.00	99.2	High	★★	176.0
National Australia Bank NAB	Wide	AUD	26.00	26.4	High	★★★	87.0
Westpac Banking Corp WBC	Wide	AUD	29.00	26.1	High	★★★	95.7

Investors Can Bank on Capital Management Initiatives

We estimate the Australia major banks have a combined AUD 34 billion in excess capital, which grows to around AUD 39 billion once all earmarked divestments complete. For ANZ Bank it equals AUD 2.80 per share of excess capital (9.7% of our fair value), National Australia Bank AUD 2.35 per share (9.0%), Commonwealth Bank AUD 5.90 per share (7.6%), and Westpac AUD 2.15 per share (7.4%).

We think returns to shareholders are the best use of excess capital. The Australian banks are very strong but ultimately mature franchises. Growth outside the core business would likely be a worse use of capital and counter to the post-Banking Royal Commission regulatory push to simplify the banks. Hence, we expect the banks to focus on the core business of lending, primarily to housing and secondarily to businesses. We do not expect the core banking operations to require the current levels of capital, particularly as we forecast relatively pedestrian credit growth of around 3% annually for the next five years. This demand can be covered by the banks' organic capital generation, as we assume about 70% of earnings are paid out annually as dividends. The approximate 30% of retained earnings is sufficient to meet the capital needs for loan growth in the relatively sedate demand environment we expect.

We don't envisage large acquisitions, such as when the major banks diversified into wealth management roughly 20 years ago. The wealth management diversification has largely been unwound now. We think the lack of success from those efforts, coupled with regulatory pressure, is likely to make the banks circumspect on future material acquisitions. Given the market share each of the majors has in the mortgage market, ranging from 14% to 26%, or 77% combined, it is difficult to envisage the ACCC giving the bank the all clear to buy a smaller lender such as AMP or Suncorp Bank.

Distributions are an important part of total returns. Shareholders should be aware of the near-term potential for the Australian major banks to pay higher ordinary dividends or return capital to shareholders via share buybacks. Off-market buybacks can provide an attractive opportunity for Australia-based shareholders to sell depending on their tax circumstances. Given a large component of the buyback is treated as a dividend, and franked, the total return to the shareholder can be 20% higher than selling on market.

We think the most likely scenario is the banks make both off-market and on-market share buybacks, with the remainder of excess capital going toward dividend top-ups. Our estimates of the size of the different buybacks for each bank, as shown in Exhibit 1, is largely dictated by franking balances.

Exhibit 1 We Expect a Combination of Buybacks and Dividends as the Banks Return Excess Capital

	Off-market buyback (AUD billion)	On-market buyback (AUD billion)	Dividend 'top-up' (AUD billion)	Total Returned (AUD billion)	Total Returned Per Share ($)
ANZ	1.3	3.0	2.1	6.3	2.2
CBA	5.5	3.2	1.1	9.8	5.5
NAB	2.9	0.9	3.5	7.3	2.2
WBC	5.0	0.0	2.1	7.1	1.9

Source: Morningstar Analyst.

Buybacks Appear the Most Equitable Way to Return Capital to Shareholders

The appeal of an off-market buyback for Australian-based shareholders is that a large component of the share repurchase is treated as a dividend, as opposed to capital, and hence has a franked dividend component. For off-market repurchases, shares are typically bought back at a 14% discount to the prevailing market price, given the value of the franking credits to some shareholders. They are generally modestly beneficial to shareholders who don't participate given the small EPS and DPS accretion, assuming the shares are not repurchased at an excessive valuation. Foreign ownership in the Australian major banks averages around 25%, so an off-market buyback can be a fair way for those shareholders to benefit from the franking credits being paid out to shareholders.

Exhibit 2 Shareholders Outside Australia and New Zealand Likely to Prefer Buybacks Over Dividends

Bank	Foreign Ownership	Retail Ownership
ANZ	27%	43%
CBA	22%	52%
NAB	25%	43%
WBC	24%	47%

Source: Company Website, Morningstar

The post-tax value to investors is dependent on various factors, including their marginal income tax rate, the price paid for shares, how long the shares have been held for, and any existing capital gains from other assets.

Aside from Westpac, the major banks cannot fully frank an off-market buyback large enough to return all surplus capital. We estimate Commonwealth Bank could fully frank an AUD 6 billion buyback (around 60% of surplus capital), National Australia Bank a buyback of AUD 2.9 billion (37% of surplus capital), and ANZ a buyback of AUD 1.25 billion (16% of surplus capital). Westpac could fully frank a buyback returning its entire surplus of AUD 8 billion to shareholders.

Exhibit 3 Franking Credit Balances Could Influence the Board's Decision

Bank	Franking Credits ($billion)	Franking per share ($)	Excess Capital per share ($)	Excess Capital Which Can be Fully Franked
ANZ	0.48	0.17	2.08	19%
CBA	2.31	1.30	4.59	66%
NAB	1.10	0.33	1.94	39%
WBC	3.56	0.97	1.94	117%

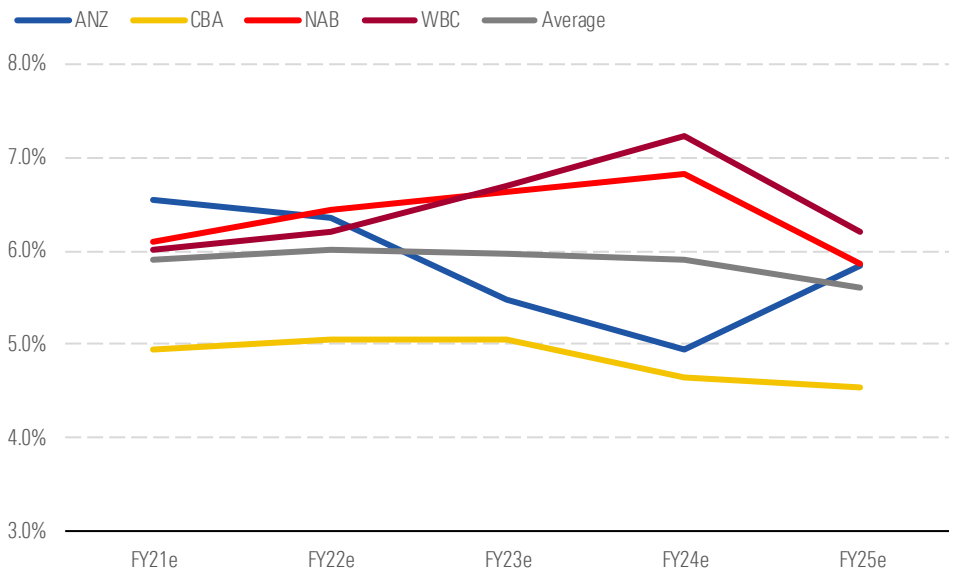
Source: Company Reports, Morningstar Analyst

Our preference would be for the banks to pay out higher ordinary dividends over several years until the capital level falls to the banks' target level. This scenario would provide investors a steady flow of income, and importantly lessen the risk of the bank falling short of capital. This could happen with changes in economic conditions, changes to capital requirements, or a significant penalty. Despite unemployment being back to pre-COVID-19 levels and current record house prices, uncertainty is still higher than usual in our view. International borders remain closed in Australia and outbreaks could lead to future lockdowns and restrictions.

There are downsides to the dividend top-up alternative to returning capital though. Shareholders need to trust the banks are not tempted to make material investments outside their core wide economic moat rated banking franchises or in new initiatives that are likely to generate an inadequate return. A big return now, rather than apportioning it out over a few years, would mean shareholders could have the opportunity to redeploy the excess capital locked up in bank shares into other investments.

The forward dividend yield of the banks is very attractive if we assume excess capital is used to temporarily boost dividends. Using special dividends could also appropriately set shareholder expectations about future dividends.

Exhibit 4 If Banks Took the Dividend Top-Up Approach, Dividend Yields Would Be Very Attractive at Current Prices



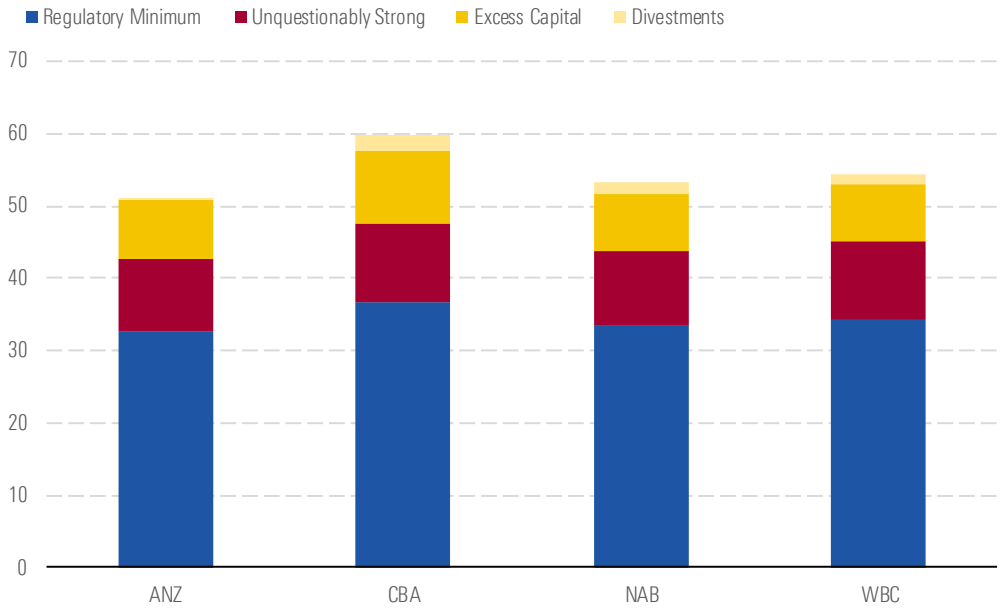
Source: Company Reports, Morningstar Analyst. Share Price as at June 23, 2021

Investors to Reap Dividends as Bank Capital Buffers Fall Over the Next Five Years

As banks revert to more appropriate capital levels, shareholders will benefit from higher distributions and share buybacks. We assume the major banks will run with a common equity Tier 1 ratio of 11% in the long term. We think the banks will no longer look to operate at the 10.5% "unquestionably" strong level, with a buffer above the regulator requirement prudent.

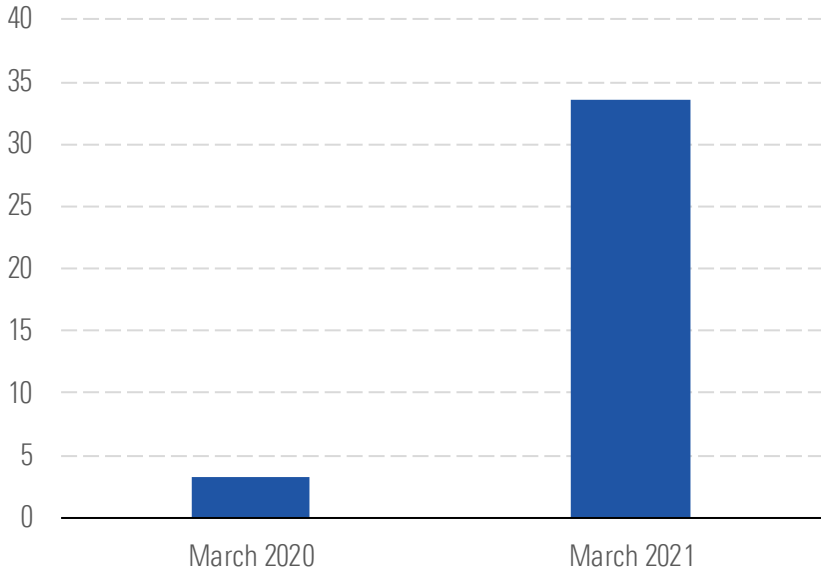
As at March 2021, common equity Tier 1 ratios across the major banks averaged around 12.5%, which we estimate to be AUD 34 billion above regulatory requirements collectively, compared with just AUD 3 billion in March 2020. If common equity Tier 1 ratios decline from current levels to 11%, the banks have a surplus which can be returned of around AUD 25 billion. Including divestments, this will rise to around AUD 30 billion.

Exhibit 5 Major Banks Hold More Capital Than Ever and Current Levels Are Excessive (AUD Billion)



Source: Company Reports, Morningstar Analyst as at 31 March 2021.

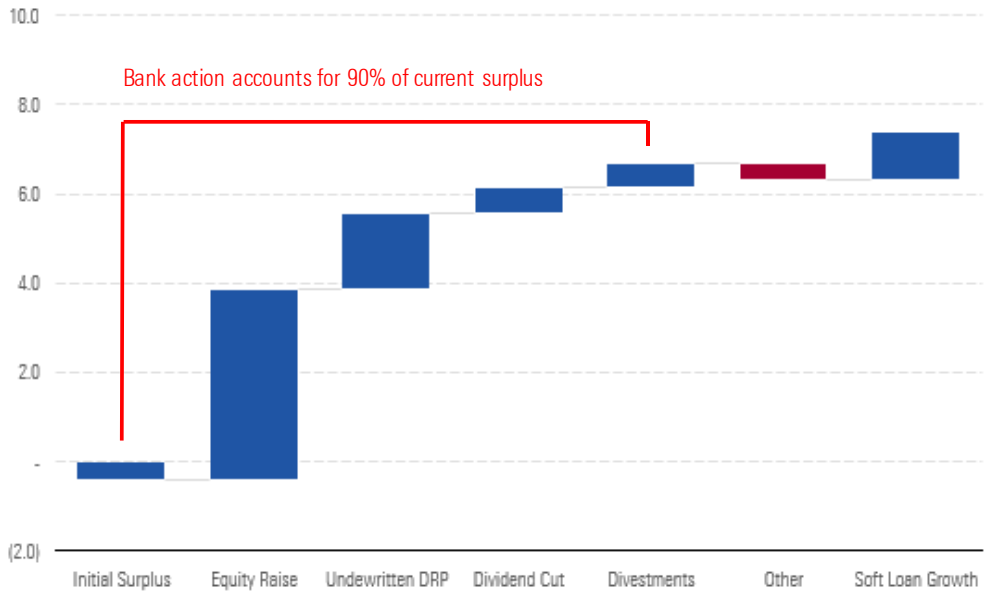
Exhibit 6 Surplus Capital Ramped up as Management and Regulators Turned Cautious (AUD Billion)



Source: Company Reports, Morningstar Analyst

Banks have excess capital because they cut dividends, were more conservative on lending, divested assets, and in Westpac's and National Australia Bank's cases, they raised equity. Westpac raised AUD 770 million by underwriting its dividend reinvestment plan, or DRP, with National Australia Bank going for a larger AUD 4.25 billion raising in May 2020. Since March 2019, National Australia Bank has also raised AUD 1.7 billion by underwriting DRPs.

Exhibit 7 With Hindsight, National Australia Bank Was Overly Conservative Raising Equity in 2020 (AUD billion)



Source: Company Reports, Morningstar Analyst

Capital Management Likely to Kick-Off With Off-Market Share Buybacks

We think the banks will undertake off-market buybacks and top-up dividends in the near term. Other alternatives include an on-market buyback happening sooner and the banks returning the remainder of excess surplus via higher dividends. For each bank, we have outlined two scenarios. Scenario 1 is more likely for each bank. It includes an off-market buyback in fiscal 2022, small dividend top-ups, and the remainder of the surplus returned via an on-market buyback in fiscal 2025 (except for Westpac).

We do not expect the banks to need the current capital surplus. We have assumed the banks generate enough organic capital to fund future loan growth and investments in the business, with an ordinary dividend payout ratio set within each bank's target range. Hence, all capital in excess of the common equity Tier 1 ratio of 11% is available to be returned to shareholders. We assume dividend payout ratios are capped at 100%. For simplicity we have assumed capital uplift expected from divestments occurs in fiscal 2022 and all capital is returned by fiscal 2025. On-market buybacks do not have to occur in one hit and could be spread out over the forecast period.

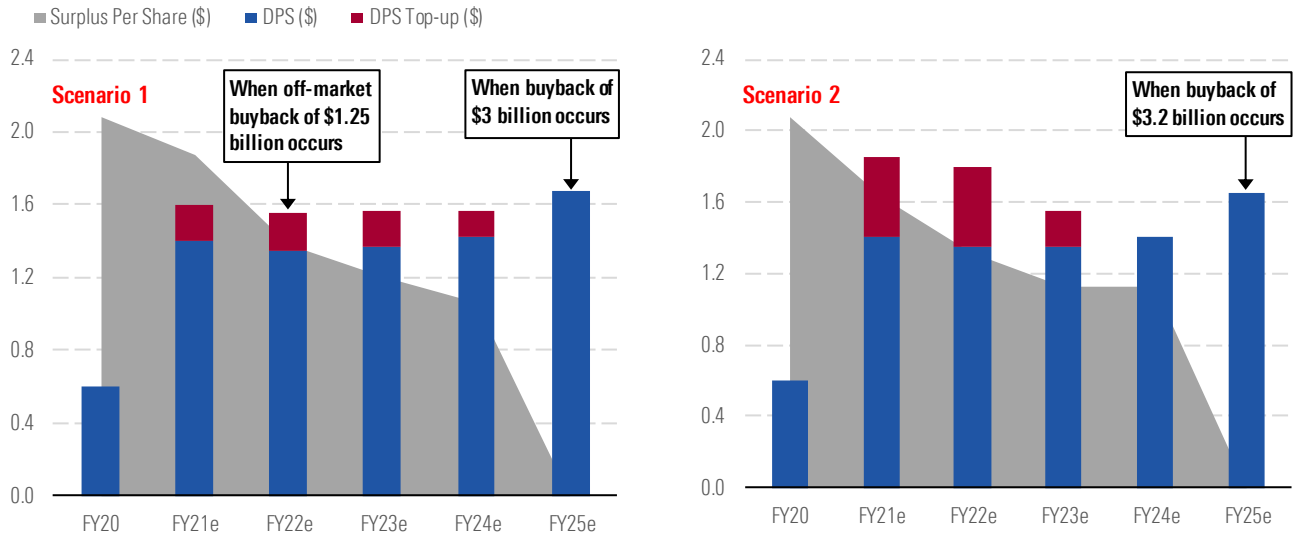
ANZ Bank More Likely to Gradually Buy Back Shares On-Market Compared With Peers

We believe the most likely scenario for ANZ Bank is to return around half of its excess capital via an on-market buyback, with an off-market buyback and dividend top-up limited by franking credit balances. With shares trading close to our fair value estimate, we believe this is an effective way to return capital to shareholders. Shares on issue reduce by around 4.5% over the forecast period. For shareholders looking for higher fully franked income, Westpac or National Australia Bank appear better options.

ANZ Bank has AUD 7.9 billion in excess capital, or AUD 2.80 per share as at March 31, 2021. Assuming a target common equity Tier 1 ratio of 11%, the bank has around AUD 5.9 billion in surplus capital, which rises to AUD 6.3 billion once divestments complete. This equates to a return of AUD 2.20 per share and 7.7% of our AUD 29 fair value estimate. The bank has a franking balance of AUD 480 million, or AUD 0.17 per share.

Given ANZ Bank does not have a large franking balance, and generates 25% to 30% of earnings in New Zealand, an off-market buyback would be relatively small. We estimate the bank could make an AUD 1.25 billion off-market buyback, which would reduce shares on issue by less than 2%. We assume the offer price is set at the maximum discount to the share price of 14%. We have assumed 90% of the return is treated as a dividend and 10% capital, which is an assumption we have made for scenarios across the banks.

Exhibit 8 ANZ Bank Expected to Return Almost Half the Excess Capital With On-Market Buybacks



Source: Morningstar Analyst

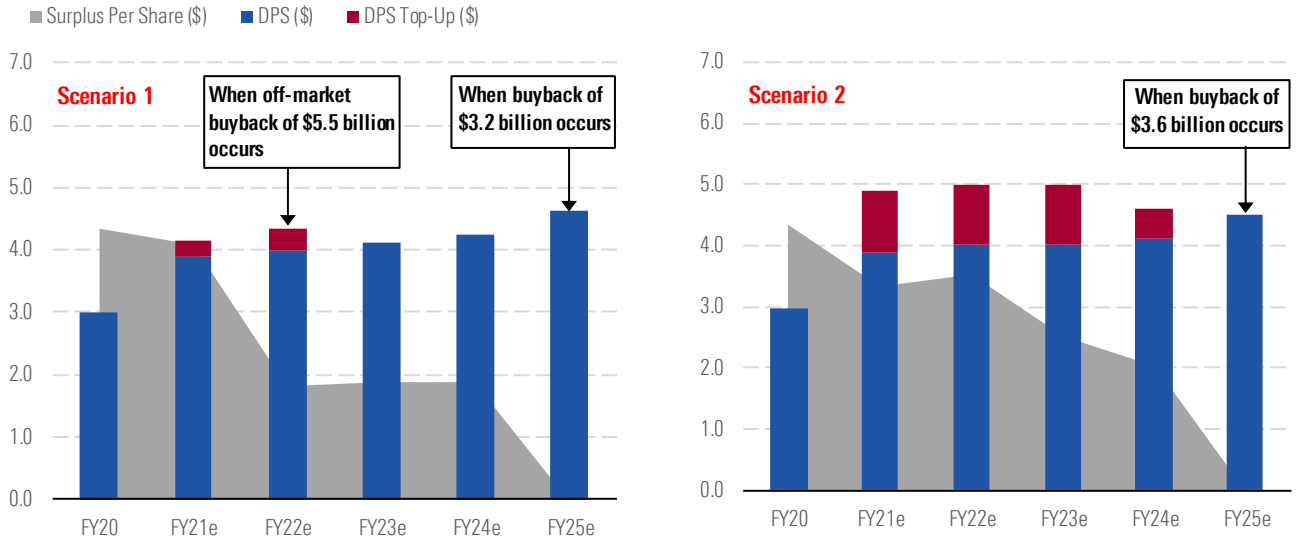
Commonwealth Bank Should Pump Up the Dividend, but Buybacks Not Materially Dilutive

We forecast Commonwealth Bank will undertake an off-market buyback of around AUD 5.5 billion, around 3.5% of shares on issue. Buying back shares at 11% premium to our fair value estimate is not materially dilutive to our fair value estimate. While the bank will likely be able to pay some small dividend top-ups (fully franked), we estimate around AUD 3.2 billion of surplus capital will be returned via an on-market buyback. In total, shares on issue reduce by around 5.5%.

Commonwealth Bank has AUD 10 billion in excess capital, or AUD 5.65 per share as at March 31, 2021. Assuming a target common equity Tier 1 ratio of 11%, the bank has around AUD 7.7 billion in surplus capital, which rises to AUD 9.8 billion once divestments complete. This equates to a return of AUD 5.50 per share and 7.2% of our AUD 77 fair value estimate. The bank has a franking balance of AUD 2.3 billion, or AUD 1.30 per share.

Given Commonwealth Bank trades at a premium to our fair value estimate, our preference is to simply pay a higher dividend than it ordinarily would. In this scenario, shown as Scenario 2 in Exhibit 9, the dividend payout ratio could lift to 100% through to fiscal 2023. We believe the bank will lack franking credits to fully frank dividends on a 100% payout ratio out to fiscal 2025. The payout ratio would fall back to around 85% and 75% in fiscal 2024 and 2025 to fully frank dividends. The remaining AUD 3.6 billion in excess capital could be returned via an on-market buyback or capital return.

Exhibit 9 Commonwealth Bank Has the Option of a Large Off-Market Buyback (LHS) or Temporarily Boost Dividends (RHS)



Source: Morningstar Analyst

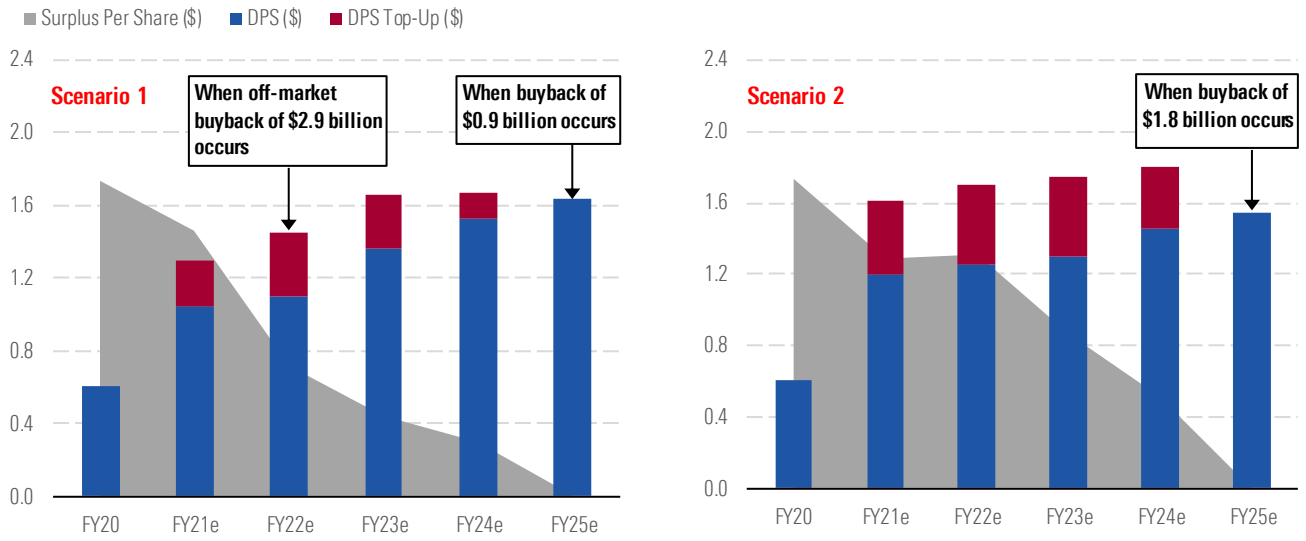
National Australia Bank Shouldn't Let a Recent Equity Raise Prevent a Capital Return Now

We think National Australia Bank will look to return a large part of the capital surplus with an off-market buyback of around AUD 2.9 billion, reducing shares on issue by 3.8%. The remainder of excess capital can be paid as dividend top-ups as the bank generates franking credits. The bank would be left with around AUD 900 million which could fund on-market share buybacks or a small capital return. We think this provides shareholders with an attractive mix of income and EPS accretion from buybacks. Raising equity at around AUD 14 per share in 2020 and buying shares back at AUD 23 per share is 2022 is not ideal, but it is preferable to management feeling obliged to making investments or aggressively growing the loan book. We have assumed the offer price is a 14% discount to the current market price

National Australia Bank has AUD 7.8 billion in excess capital, or AUD 2.35 per share as at March 31, 2021. Assuming a target common equity Tier 1 ratio of 11%, the bank has around AUD 5.7 billion in surplus capital, which rises to AUD 7.3 billion once divestments complete. This equates to a return of AUD 2.20 per share and 8.4% of our AUD 26 fair value estimate. The bank has a franking balance of AUD 1.1 billion, or AUD 0.33 per share.

National Australia Bank could keep the dividend payout ratio between 90% and 100% from fiscal 2021 to 2024 and fully frank dividends. The remaining AUD 1.8 billion could be returned via a capital return or even an on-market buyback.

Exhibit 10 National Australia Bank Encouraged to Repurchase Shares Despite Raising Equity in 2020



Source: Morningstar Analyst

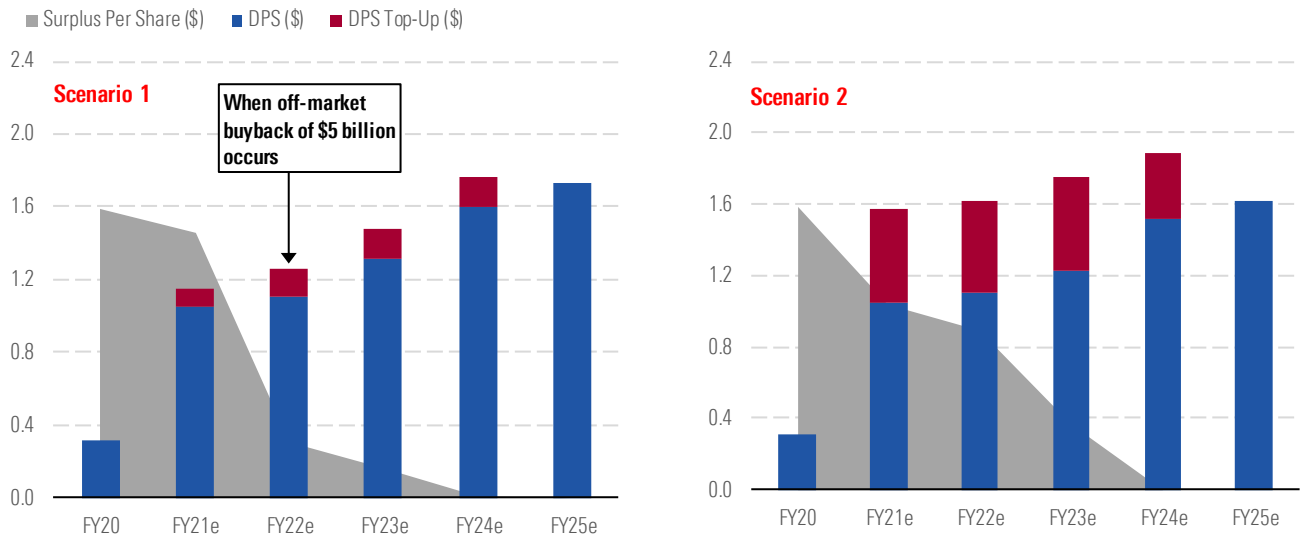
Westpac Has the Franking Credits to Make a Large Off-Market Buyback and Pay Higher Dividends

We believe Westpac undertaking a large off-market buyback would be an efficient way to get the value of the banks franking credit balance into shareholders hands. An off-market buyback of AUD 5 billion would reduce Westpac's share count by around 6%. We like that the bank would be buying back shares at a 23% discount to our AUD 29 fair value estimate, assuming the offer price is a 14% discount to the market price. While it would be slightly less accretive, it would be reasonable for the bank to make the off-market buyback smaller and grind down the capital buffer gradually returned via dividends. That way the bank retains a large equity buffer in the short-term while economic uncertainty remains elevated.

Westpac has AUD 7.9 billion in excess capital, or AUD 2.80 per share as at 31 March 2021. Assuming a target Common Equity Tier 1 Ratio of 11% the bank has around AUD 5.7 billion in surplus capital, which rises to AUD 7.1 billion once divestments complete. This equates to a return of AUD 1.90 per share and 6.6% of our AUD 29 fair value estimate. The bank has a franking balance of AUD 3.6 billion, or AUD 0.97 per share.

We think the likelihood of the bank payout out elevated dividends is less probable, simply because not all shareholders benefit from the franking credits equally. If Westpac topped up annual dividends to a 100% payout ratio, the annual dividend in fiscal 2024 would rise to around AUD 1.90 per share. While unsustainable, this would return dividends to fiscal 2018 levels and equate to a dividend yield of over 7% fully franked at the current share price.

Exhibit 11 Westpac Can Fully Frank Returns With a Buyback (LHS) or Elevated Dividend Payout Ratio (RHS)



Source: Morningstar Analyst

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