Q&A WITH TARIQ CHOTANI

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Australia's major banks make up a large chunk of the ASX and are a key component of most investors' portfolios. With each of the Big Four recently reporting half-yearly or quarterly results, we asked Perpetual's Financials, Insurance and Industrials analyst Tariq Chotani to reflect on the sector and some of the key trends he's seeing.

We got a good sense of how the Big Four banks are placed in May as three of the majors reported half-year results and one gave a quarterly update. What were your main takeaways?

They were all consistent with what the market was expecting. Bad debts were less of a factor than we expected on the back of a positive economic outlook thanks to the amount of money that's been thrown at the economy and at the system by the central bank and the Federal Government. Generally, the major banks are tracking as expected and even slightly better than expected. The large chunk of loans that went into deferral have now rolled off deferral and people have started getting back into the habit of paying down their debt. About 10% of mortgage holders were not paying anything, not paying down the debt or paying their mortgage for about four to six months. There was nervousness about whether people would get back into the habit and it seems like it's all largely tracking to plan. The other dynamic is the wrapping up of JobKeeper and JobSeeker, which were the two Federal programs introduced because of COVID. We are seeing little impact on the banks so far, but it will take about three to four months to see what the real impact will be.

From an asset quality perspective, the market was expecting a good outcome and I think it came through better than expected. Economic upgrades across the board have been better than expected. Then we come to the operational part, which is revenues and costs, and these are the things that the market was focused on before COVID. Now the market seems to be shifting back to analysing the top line on revenues and credit growth, which is not growing as quickly as people thought. On a net basis we are still seeing anaemic credit growth from households and while business lending has shown some signs of improvement, we still need to see how that flows through over the next three to six months. Those are the broad trends. Some banks are spending because they can, some banks are spending smartly because they know how to and some banks are hoping that they are on the right track and get to a sustainable level in the next three to five years, so it's going to be a fascinating couple of years.

Did we learn anything about the resilience of the sector in as much as the COVID pandemic and associated business disruption was a massive stress test of the Australian banking system?

I think the Australian banks were already in decent shape going into the COVID-19 stresses. It helps that you had regulators in both Australia and New Zealand who were proactive from the start. They've also been conservative, relative to global peers, in the way they calculate capital. Commentators may argue that the major banks have got a benefit versus the non-major banks because of risk weights for mortgage books and the likes, but there was undoubtedly a considerable amount of capital in the system going into COVID. It helped that this occurred after the Royal Commission where the issue of "unquestionably strong" levels of capital was front and centre. So, going into COVID, I believe we had built up capital because we had the Royal Commission to deal with and a conservative regulator, APRA.

APRA had set the tone and the phenomenal Federal Government and RBA response has also been extremely helpful to the banks, which have reciprocated by providing deferral programs so it's been a team effort. I don't like to quote politicians, but Team Australia did come out to play and help the economy significantly during this time. COVID resulted in different parts of the financial system to work together and, assuming we stay on top of COVID, we may be significantly better off than where we thought we would be 12 to 18 months ago. By our estimates, each of the major banks are sitting on between $7 and $10 billion worth of capital that can be distributed back to shareholders. So far, the banks in general have behaved very rationally and have managed margins and returns. We expect capital return and capital distribution to be the key narrative over the next six to nine months.

Pre-COVID, one of the big themes for the banks was digital disruption in the form of tech-savvy competitors moving into the financial services sector or overseas neobanks appealing to tech-savvy consumers in Australia. Is this still a key theme or have the incumbents addressed their deficiencies?

I'm more sceptical of the neobanks and insurtechs than some of the other participants in the market. My simple reasoning is around scale: you need to get scale and you need to get scale quickly. You need to reduce the cost of acquisition of a customer and you need to get to a steady-state capacity level, which can drive operating leverage. It is great that disruptors are offering a seamless customer experience but, at the end of the day, it's very generic and it is a commoditised offering on savings. Having said that, we've seen some really interesting offerings like Bendigo and Adelaide Bank's digital bank, UP, and the user experience from Athena. It's a great offering with smart UX design that is very intuitive. We've seen 86,400 Ltd (now part of NAB), which is the number of seconds in a day, which also had an interesting offering, but they just could not get to scale. Xinja was another big hope that went out hard with their rate offering to entice new customers, but they were unable to sustain their push into the market.

I think the theory of neobanks is good and I like the idea of them coming into the market because they keep the incumbents honest and there are some incumbents who just will not spend money on technology. Westpac is spending on the front end but needs to get its back end in order. ANZ was lagging in terms of technology and their app experience but now they're spending money. Bank of Queensland will hopefully have a contemporary banking app soon. I think it's fair to say that the incumbents tend to get lazy. I agree with CBA's CEO Matt Comyn's comments at the recent Senate hearings that a number of technology providers are deliberately trying to build capability without an ability to scale or with a viable business model, but they may accelerate innovation if it were scaled. A lot of disruptor business models are predicated on wanting to get taken out by the big players. For the major banks it means that if you can't build it quick enough and cheap enough, then you buy it.

Can you take us through your investment process when considering the positions Perpetual takes in the major banks?

Analysing large companies can be a joy and a pain but it is rarely boring. I have looked at large companies in various countries and in various sectors and what I have learned is that it's better to keep things simple. Narratives are increasingly important for the markets and with large companies it is critical to get ahead of some of potential shifts in narratives. Ultimately, these are four large banks making up a large part of the index. However, there comes a point when they get really cheap – which is what we saw in the midst of COVID. It doesn't mean that they were riskless, but on a risk reward basis, with all the support that I spoke about previously, the probability of it not being managed well was low. It was a probabilistic bet and the stocks have performed really well over the last 12 plus months. Where do we go from here is the key question and this is what I've been debating and weighing things across the four majors.

While the four majors are large with different divisions, all of them except Westpac are now a lot simpler than they used to be. Westpac still has specialist businesses that it needs to get rid of, but the rest, at their core, have become simpler banks. CBA is looking to sell its general insurance business. ANZ doesn't have a wealth or a life business anymore. NAB's a pure bank now; it doesn't have a UK bank and it doesn't have MLC or a life business. They're much cleaner, core banking businesses but, even though they are simpler, they are still extremely large organisations and they're still complex. And it's not just loans, they're dealing with people and their lives and their assets and their businesses. More than ever, franchise value is tied to how the market and how consumers perceive these brands. Business and mortgage loan volumes are not as good as you'd hope for, but if volumes recover, you want to be in businesses that have good top-line revenue and that no longer need to deal with distracting issues within the business.

Given this framework, what's your current take on ANZ, CBA, NAB and Westpac?

For me, NAB and CBA exhibit these core themes that I want to see in a bank that wants to capitalise on an improving environment.

CBA and NAB exhibit the best franchise momentum for revenues and for volumes. NAB has managed its costs quite well while CBA, historically, has not cared about costs because they've always grown their top line faster than costs. But this also offers CBA the biggest opportunity if they ever get serious about taking costs out. Both banks are sitting on extremely healthy levels of capital, so if they see the opportunity to drive hard for growth, they don't have to worry about not being able to because of the lack of capital. So, for me, franchise momentum is critical at this juncture.

While ANZ has in recent months seen its mortgage loan momentum slow, the bank is very different from where it was six or seven years ago. It's a much simpler bank under Shayne Elliott. I believe that ANZ has shown the most consistent discipline on costs compared to its local peers. With regard to ANZ, the key is top-line momentum and that is a watching brief if ANZ can stabilise and turn that around. Westpac is the one that does scare me, and I don't use that word lightly. There's a really interesting chart in Westpac's most recent result presentation, which shows NPS momentum for them and their brand St George versus the major peers in the market. It is extremely poor and, for me, that's a key issue at this point of time.

Westpac's cost strategy means it needs to get leaner and get leaner quickly, because its competitors are not standing still. You've got a business that wants to take costs out at a core level by about 16% over the next three-and-a-half years, while at the same time trying to stabilise the overall business. A multi-year 16% cost reduction doesn't come without cutting people. So, how do you manage the internal dynamics? I know of very few companies that are expecting to cut people internally or rationalise costs and would have a motivated workforce to drive top-line growth. Westpac has shown some encouraging signs that their mortgage book is stabilising, but we're also seeing issues with the business bank; again, this is a complex business with many moving parts.

Any final thoughts on owning the banks in the current environment?

In summation, we think franchise momentum is the most important measure. At this point of time NAB and CBA stand out, with ANZ is in the middle and Westpac still with some ways to go before the franchise stabilises. I think about the banks as a cohort in terms of the portfolio. Do I want to own banks at this point of time in the cycle? The answer to that is yes. If I want to own banks, which are the banks I want to own? The answer to this question come back to my thoughts on franchise momentum at least for the near term.