Commonwealth Bank of Australia (ASX:CBA)

12 Month Target: $69.45
Last Close (27/09/19): $81.54
Downside: 15%

SELL
15% Downside
## Business Overview

### Home lending moves CBA’s needle

CBA operates in four key divisions servicing three customer segments:

<table>
<thead>
<tr>
<th>Division</th>
<th>Individuals</th>
<th>Businesses</th>
<th>Institutional</th>
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<tbody>
<tr>
<td>RBS</td>
<td>Home lending</td>
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<td></td>
<td>Household deposits</td>
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<td>Credit cards</td>
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<td>BPB</td>
<td>High net worth individuals</td>
<td>Corporate</td>
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<td>CommSec</td>
<td>Institutional</td>
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<td>IBM</td>
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<td>Government</td>
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<td>Wealth Management</td>
<td>Superannuation</td>
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<td>Insurance</td>
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<td></td>
<td>Financial Planning</td>
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</tbody>
</table>

... with leading market share

![Market Share Chart](image)

... where its competitive advantage lies in retail banking ...

![Retail Banking Advantage Chart](image)

Source: Company data, APRA Monthly Banking Statistics, SURG Analysis
Industry & Market Analysis

Weak macroeconomic conditions pose a challenging operating environment for banks

Weak housing market has reduced demand for credit ...

... while the historical interest rate differential has reversed

Source: RBA
Introduction

What is driving CBA’s share price?

CBA’s dividend yield has risen to record levels ...

... and is trading at a record high valuation for its Price/Book Value

Source: Capital IQ, CIQ estimates

Current Yield Spread: 4.31%

Long-term average: 2.26%

37% Premium

Australian Majors (ex. CBA) Average: 1.51x
We issue a **SELL recommendation** with a 12 month price target of **$69.45**, representing a **15% downside** on the last close of **$81.54** (27/9/2019)

- **NIM**
  - A challenging operating environment will squeeze CBA’s **NIM**
- **Cost-out**
  - Program overly ambitious
- **Capital**
  - Position overestimated, CBA cannot return funds to shareholders
1. NIM Squeeze

Challenging operating environment to squeeze CBA’s net interest margin
NIM Squeeze

Competition is intensifying in the mortgage sector as non-banks undercut on price

The majors’ market share has fallen as non-banks enter the market...  ...CBA has aggressively discounted home loans to defend market share

Source: APRA, Company data, SURG analysis
NIM Squeeze

CBA’s large, low-cost deposit base is more exposed to falling rates

CBA has the largest proportion of low cost deposits out of the majors... ... its NIM more vulnerable to low rates, threatening earnings & dividends
2. Cost-out can’t save CBA

Costs don’t just disappear
Costs don't just disappear
Costs are easy to add, hard to remove

For each 1% fall in revenue, costs must fall by 2.5% ...

... however, CBA's underlying cost base rose at 2.4% YoY

Risk Capability
Wage inflation and IT increases 259m
Business simplification

With minimal room to move on physical costs ...

Total savings in ATM reductions FY19 vs FY18
$80m

Total savings in branch closures FY19 vs FY18
$49m

Source: Company data, SURG estimates
Costs don’t just disappear

One-offs will continue to be sticky

Remediation, risk and compliance costs will remain elevated for 3 years; one-off full-time employee (FTE) increases are sticky

Program costs remain in the cost base... (2H19 view of Customer Remediation)

Costs classified by CBA as ‘one-offs’ however will continue with regulatory programs across 2-3 years

Remedial Action Plan – still a long way to go

Source: Company Data, SURG Analysis
3. Capital Management Initiatives

CBA is not as well-capitalised as the market perceives
Overconfidence in capital management initiatives

Transaction risk is significant

Pro-forma capital position is contingent on the success of various transactions ...

Sale of life insurance businesses will not be fully achieved by the FY20 result

... however, divesting a life insurance business in Australia is a complex regulatory task

Source: Company data, Capital IQ

<table>
<thead>
<tr>
<th>1H17</th>
<th>2H17</th>
<th>1H18</th>
<th>2H18</th>
<th>1H19</th>
<th>2H19</th>
<th>1H20</th>
<th>2H20</th>
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<tbody>
<tr>
<td>Announced sale of CommInsure to AIA Group</td>
<td>ANZ divests OnePath for an underwhelming multiple</td>
<td>BoComm Life is ringfenced and sale is delayed</td>
<td>Expected completion “in 2H20” is unconvincing</td>
<td>Initial expected completion date</td>
<td>Suncorp divests after 24 months of delays</td>
<td>NAB’s divestment of MLC is put on hold “until further notice”</td>
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</table>
Overconfidence in capital management initiatives

RBNZ proposal will have a significant impact on capital management

In light of the RBNZ’s Tier 1 Proposal ...

... CBA will be unable to meet capital management expectations

It will take ASB ~4yrs to generate this capital shortfall organically

Current Tier 1 Ratio: 13.2% (ASB)

- Non-compliant AT1: $6,917m
- T1 Delta: $3,743m
- Required Tier 1 (ASB): $9,726m

Proposed Tier 1 Ratio: 16.0% (ASB)

- Divestment: 4,050m
- RBNZ Proposal: -$3,743m
- SA-CCR & AASB 16: -$815m
- Pro-forma Excess Capital: -$318m

Excess capital with no divestment complications

Source: Company data, RBNZ, SURG analysis
Valuation and Investment Risks
We calculate a target price of $69.45, a 15% downside to the close of $81.54.

**Valuation**

Sources: Company data, Capital IQ, SURG analysis

**Bull Case Scenario**

- Loan Growth: +4%
- NIM: +3bps
- CTI Ratio: -4.30%

**Maintains 10% Downside**

**Target Trading Multiples**

- P/E premium: 14%
- P/BV premium: 39%
- Adjusted P/E: 14.2x
- Adjusted P/BV: 1.78x

Sources: Company data, Capital IQ, SURG analysis
Valuation

No comparable global bank is trading at 2x BV

CBA is clearly overvalued compared to global peers...

...and relative to the other three major Australian banks

...even though CBA ROE leadership has declined

Source: Capital IQ, Factset, SURG analysis. Note: P/BV regression global peer set consists of 28 largest developed market banks
### Key upside risks to our recommendation

<table>
<thead>
<tr>
<th>Probability of Risk</th>
<th>Significance of Risk</th>
<th>Cost reductions</th>
<th>Transaction success</th>
<th>CBA holds off rate cuts</th>
<th>Housing Upside</th>
<th>Yield Chase</th>
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<tr>
<td>Low</td>
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<td>Medium</td>
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We have identified two key risks...

1. **Yield chase**: Low interest rates continue to attract yield-seeking investors and distorts share price.

2. **Housing upside**: Recovery in house prices refuel housing credit growth.
Investment Risks

Yield-seeking investors remain stubborn

We forecast flat dividends but there are signs of weakness ... … which will lead to a significant share price reaction

$0.50 DPS cut equates to a $8.13 drop in DDM valuation

14% Downside

24% Downside

34% Downside

Source: Company data, SURG analysis
Investment Risks

Australian housing market recovers faster than expected

We have analysed a variety of housing credit growth trajectories and find our intrinsic valuation remains robust.

Source: Capital IQ, SURG analysis

Australia Housing Credit Growth

FY15A FY16A FY17A FY18A FY19A FY20E FY21E FY22E

Add: 100bps ($73.12)
Add: 50bps ($70.87)
RIM Base Case ($68.67)
Less: 50bps ($66.52)
Less: 100bps ($64.42)

Source: Capital IQ, SURG analysis
Recommendation

The best of CBA is in the past; not worth its price

What has the market underestimated?

- **NIM** pressures never seen before
- **Cost** reductions are overly ambitious
- **Capital** management initiatives overestimated

**Recommendation**

SELL

**Target Price**

$69.45

15% Downside