STOCKS DOWN UNDER

28 FEBRUARY 2022

ASX Top 200 Stocks Down Under

"A banking system is an act of faith: it survives only for as long as people believe it will."

- Michael Lewis (b. 1960), Author of 'The Big Short'

WESTPAC

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Stocks Down Under rating: ★★

ASX: WBC
Market cap: A$80.3B

52-week range: A$20.00 / A$27.12
Share price: A$22.83

For the third week in a row, ASX Top 200 Stocks Down Under is looking at the banks and today it's Westpac's (ASX: WBC) turn to face the spotlight. Westpac is the oldest of the Big Four Banks, beginning in 1817, but in recent times it has also been the worst performing bank thanks to impacts of COVID-19 and reputational damage from breaches of AML/CTF regulations. Although management is trying to turn things around, we aren't confident the bank is out of the woods just yet.

Share price chart

Source: Tradingview

COVID-19 was just the tip of the iceberg

All big bank shares plunged during the Corona Crash, but Westpac's downtrend had begun several months earlier, in the December quarter of 2019. The catalysts were the bank's disappointing FY19 results and AUSTRAC launching legal action against the bank for alleged Anti Money Laundering (AML) breaches – catalysts that led to the departure of then CEO Brian Hartzer. AUSTRAC's action against the bank succeeded and the Federal Court issued Westpac a $1.3bn fine in October 2020 - the largest in Australian corporate history.

When the pandemic began, Westpac braced itself for further impacts to support customers. It kept branches open and offered relief, including loan repayment deferrals, bridge financing and merchant terminal fee relief. It took a $1.6bn impairment charge to brace itself for a longer-term impact. The bank still made a $2.3bn profit in FY20, but this was down 66% from FY19.

Fast forward to November 2021 and Westpac's profit was back up to $5.5bn, but investors were unimpressed, wiping $7bn off its market value. Although Westpac's profit was more than double FY20, it was propped up by a $3.8bn swing in provisions after forecast pandemic losses failed to materialise and the bank clawed back some of its buffers.

More importantly, however, the bank had promised to cut its cost base to $8bn by 2024, but costs actually rose from $12.7bn in FY20 to $13.3bn in FY21. Admittedly, these costs included expenses related to selling assets, fixing its compliance systems and compensating customers. But with the implementation of the AUSTRAC reforms ongoing, investors clearly aren't confident this goal can be reached.

Will the squeeze ease?

Earlier in February, the bank gave a quarterly update where it showed some progress. Expenses, excluding notable items, fell 7% - enough to increase the bank's cash earnings by 74% over the prior corresponding period - but were still $2.7bn. The bank boasted a strong balance sheet with a common equity tier 1 (CET1) ratio well above APRA's 10.25% benchmark.

Lending was up by $5bn, or 0.7%, but APRA data released in the days prior showed its mortgage book growth trailed NAB and CBA. And as with its peers, Westpac's Net Interest Margin (NIM) was under pressure with high competition and record low interest rates. Westpac's 1.91% margin was behind CBA and ahead of NAB and ANZ. Westpac's NIM fell by eight points – behind CBA's 17-point drop, equal with ANZ, but below NAB's 5-point drop.

The bank's presentation told shareholders to brace for a further decline in FY22. Undoubtedly, shareholders are hoping interest rates will rise and the squeeze will ease. But it will depend on the extent to which Westpac passes on hikes, and with the recent uplift in loans being made at fixed rates, it may take some time to manifest in the bank's bottom line.

It also remains to be seen how interest rates will impact demand and with it, the growth of Westpac's loan book. It already trails NAB and CBA, growing at just 0.4x the system's growth in December for housing lending and is seeing similarly small levels of growth in business lending.

Cheap, but for good reason

Consensus estimates give Westpac the lowest Price to Book (P/B) value of its peers at ~1.1x. Its FY23 P/E ratio is just under 12x, roughly in line with ANZ, but behind CBA and NAB. As we said in last week's edition of ASX 200 Stocks Down Under, only CBA and NAB have clear positive momentum. But we also outlined that NAB felt the wrath of the Royal Commission more than any other and turned things around. No doubt Westpac shareholders are hopeful their company can make a similar turnaround. But can it, really?

We do have some sympathy for Westpac management who are in a difficult position. Management needs to cut costs, but at the same time needs to invest in technology to keep pace with its competitors. It's a situation where it is difficult to see both happening at the same time and that's before you even think about the implementation of the post-AUSTRAC reforms.

Management is clearly determined to succeed, but we still think it's too early to definitively say progress is being made on either or both fronts and we believe its peers are more attractive, even if you're paying a premium. It's two stars for now, but we might give a higher rating next time if the bank's NIM is higher and costs are lower.

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