STOCKS DOWN UNDER

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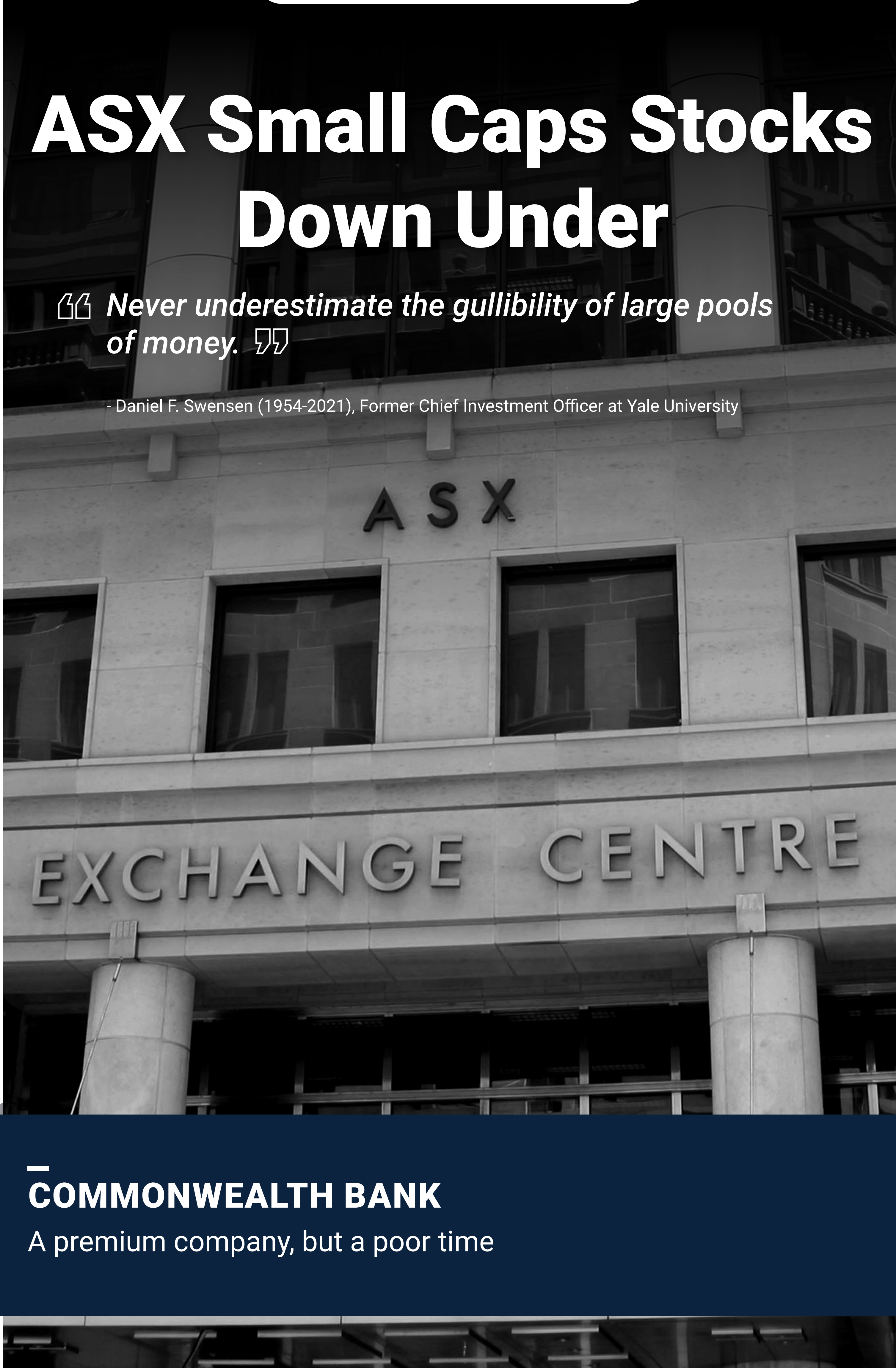
ASX Small Caps Stocks Down Under

> *Never underestimate the gullibility of large pools of money.*

- Daniel F. Swensen (1954-2021), Former Chief Investment Officer at Yale University



COMMONWEALTH BANK

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Stocks Down Under rating: ★★

ASX: CBA
Market cap: A$180.2BN

52-week range: A$86.98 / A$109.20
Share price: A$106.72

The Commonwealth Bank (ASX:CBA) is Australia's largest bank and the ASX's second biggest company after BHP (ASX:BHP). It trades at a significant premium to its other Big Four peers with a market capitalisation of over $170bn and a P/B multiple of nearly 2.4x (compared with the 1.7x sector average). You could argue that CBA deserves this premium, given that the bank has the most customers of the Big Four (over 15m customers), the largest market share in the home loans market (25%) and made the largest Return on Equity (ROE) of the Big Four two years running. But will this continue as interest rates rise?

Share price chart

Source: Tradingview

Dancing until the music stops

For the sake of investors that have been living on Planet Mars for the past three years, let's recap how CBA and its peers fared throughout the pandemic. The economic impact of the pandemic was not as bad as expected in Australia, leading to consumers taking out home loans at interest rates that were at record lows, because the RBA feared a doomsday scenario. This credit binge was manifest in the results of CBA, as we observed above.

But since May 2022, the RBA has delivered 7 consecutive interest rate increases, all passed on by CBA and its peers. At first glance you might think this is positive for the bank, given higher interest payments as fixed-rate loans revert to the new rates, therefore generating higher earnings. We would caution against making that syllogism, however.

Higher interest rates might not be a good thing

It remains to be seen how many of these customers who took out loans at record low rates can cope with such high interest rates. Remember that the RBA's cash rate has risen 3%-points, 50% more than the typical serviceability buffer banks use when considering new applicants. Many banks have made more substantial hikes, including CBA. When interest rates hit zero during the Corona Crash, you could obtain a fixed rate home loan of under 2% per annum. As of early January 2023, CBA's fixed home loan rates vary between 5.6% and 6.6%, dependent on the length of the fixed term. Variable rates have risen too, currently ranging between 4.8% and 6.5%, dependent on the Loan to Value Ratio (LVR).

Two further things should be borne in mind. First, CBA and its peers are also hiking deposit and savings rates. CBA's NetSaver has increased from 0.05% to 1.6% per annum in the last 12 months, with even higher introductory rates. In the three months to 30 September 2022, household deposits rose $7.9bn to $359bn. Secondly, CBA has to repay emergency money borrowed from the RBA during the height of the pandemic. CBA owes the RBA $19bn this year, nearly as much as all the non-major banks put together. More will be owed in 2024.

Still generating strong results

As of January 2023, the interest rate hikes do not appear to have impacted CBA or its customers just yet. The company's 1Q23 cash profit was $2.5bn (2% higher than 12 months ago), home loan lending rose by 6.3% and business lending rose by 12.6%. Bad debts actually declined during the quarter and were a paltry 0.1% of its average gross loans and acceptances. Although shareholders are likely to be pleased with this result, we would caution against investors getting ahead of themselves. We believe the impact of the RBA's interest rate hikes will take several more months to be reflected in CBA's results, as the bulk of the bank's fixed loans (75%) expire across the next 12 months.

Consensus estimates for FY23 anticipate $6.02 EPS on a normalised basis, up 8% from FY22. We would urge caution in using EPS to anticipate CBA's dividends in FY23, because how much it pays out is up to the board's discretion. Total income is expected to grow 14% from $24.4bn to $27.8bn. Consensus estimates for future years expect slower growth - FY24 estimates call for income of $28.8bn (up 3.6%) and $6.12 EPS (up just 2%). It appears that analysts expect that there will be some impact to CBA's bottom line from interest rate hikes, although not enough to decrease earnings.

A good company, but not the right time

Beyond the risk of interest rates and their impact on customers, we think the next biggest risk with CBA is regulation. Banking is highly regulated to begin with and new regulations are implemented regularly. One of the more important requirements is minimum liquidity levels. CBA has told shareholders that liquidity is well above minimum levels. The bank's common equity tier 1 (CET1) ratio is 11.1%, ahead of the 10.25% minimum requirement right now. But as long-term Big Bank shareholders would know, new regulations can emerge with little prior notice and have a significant impact.

We also observe that the bank's non-interest income is under significant pressure, falling 17% in 1Q23. This was due to lower profits from its investment in Chinese banks and lower insurance incomes. Both of these were one-off events, however. Another pressure on the bank is higher staffing costs – the latter accounted for the bulk of a 4.5% rise in expenses during 1Q23.

In our view, CBA deserves a premium over its peers. But we do not think now is a good time to invest in this company or the banking sector more generally, because of the uncertainty of rising interest rates, whether customers will cope and the unclear impact on the bottom line of CBA and its peers. As the largest Big Bank, CBA has greater exposure to these trends than its peers. We think it is way too early to definitively say there will be no net impact from rising interest rates and would rather wait until we have a clearer idea. We don't think investors will be able to tell for another 6 to 12 months - more likely the latter. Turning from growth-oriented investors to dividend-oriented investors for a moment, we don't think last year's 3.6% yield is enough to buy into the stock, given inflation is more than double that.

If consensus estimates are right, it is not going to be a doomsday scenario for CBA. But even so, we don't think now is the best opportunity for investors to buy the stock, either for growth or income focused investors - hence our two-star rating.

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