CommonwealthBank

Commonwealth Bank of Australia (ASX:CBA)

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

SELL

15% Downside

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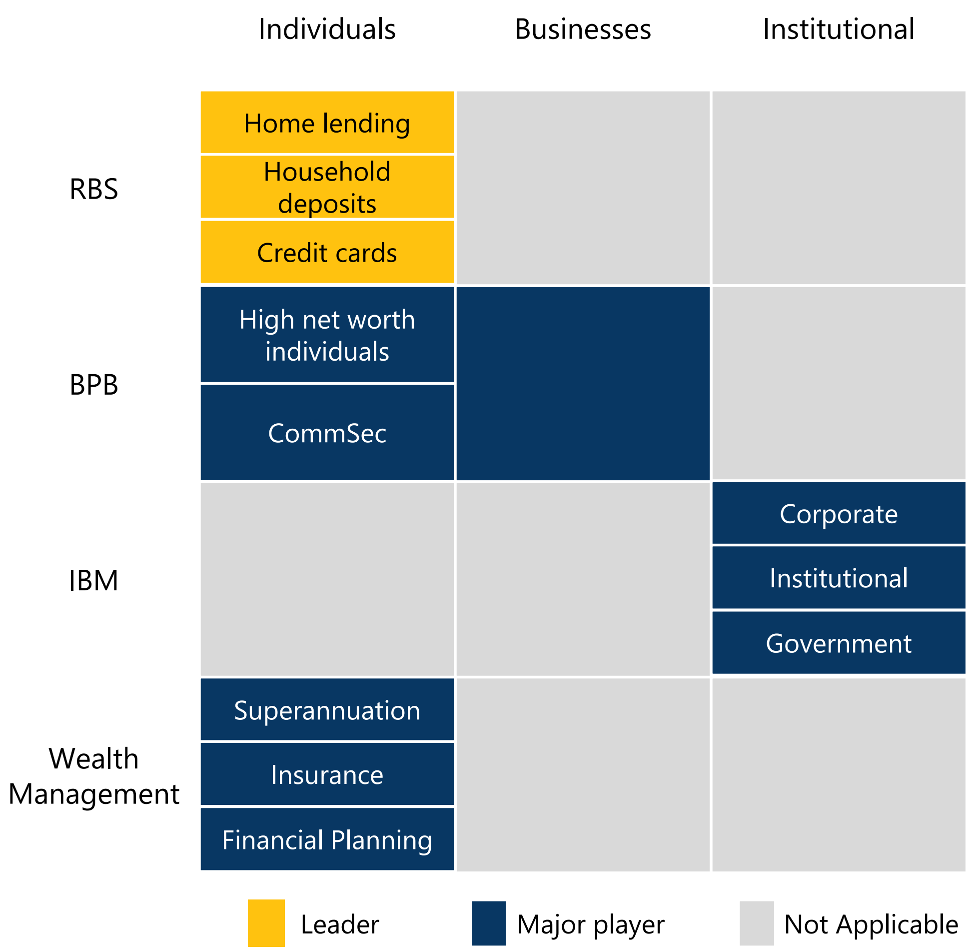
Sahil Arora | Jeffrey Brown | Jassis Chen | Tom Luo | Jessica Wu

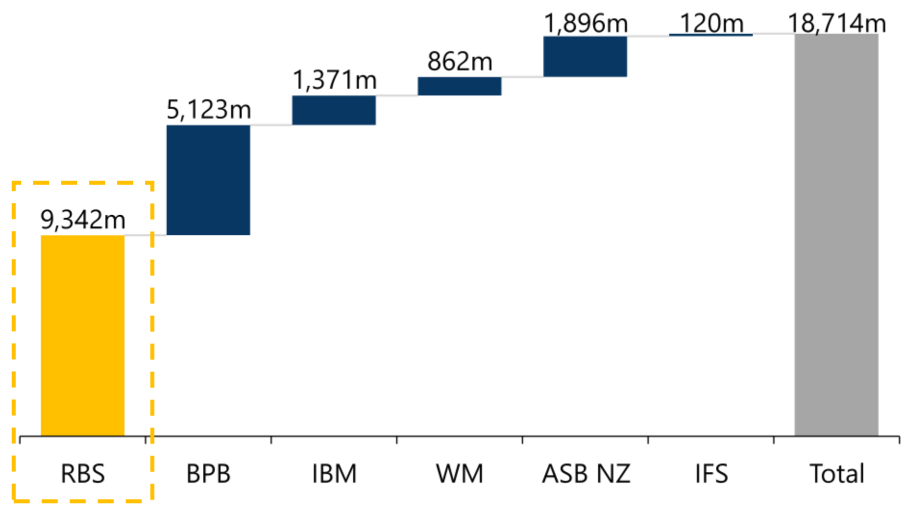
CommonwealthBank

Home lending moves CBA's needle

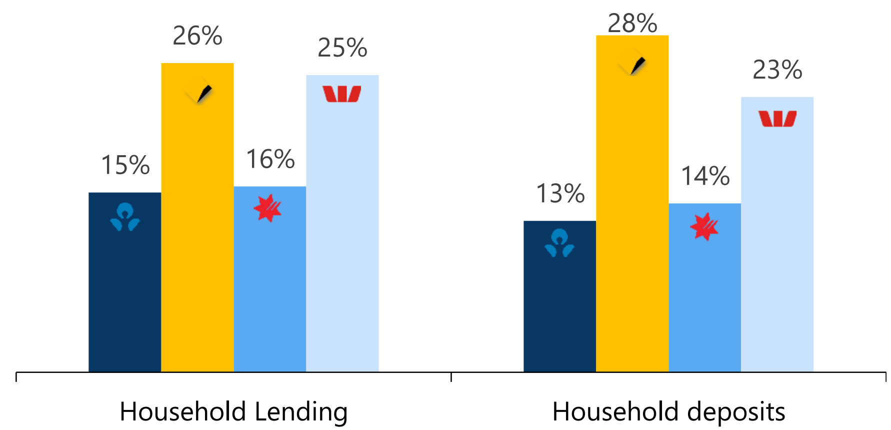
CBA operates in four key divisions servicing three customer segments …



… where its competitive advantage lies in retail banking …



… with leading market share



Source: Company data, APRA Monthly Banking Statistics, SURG Analysis

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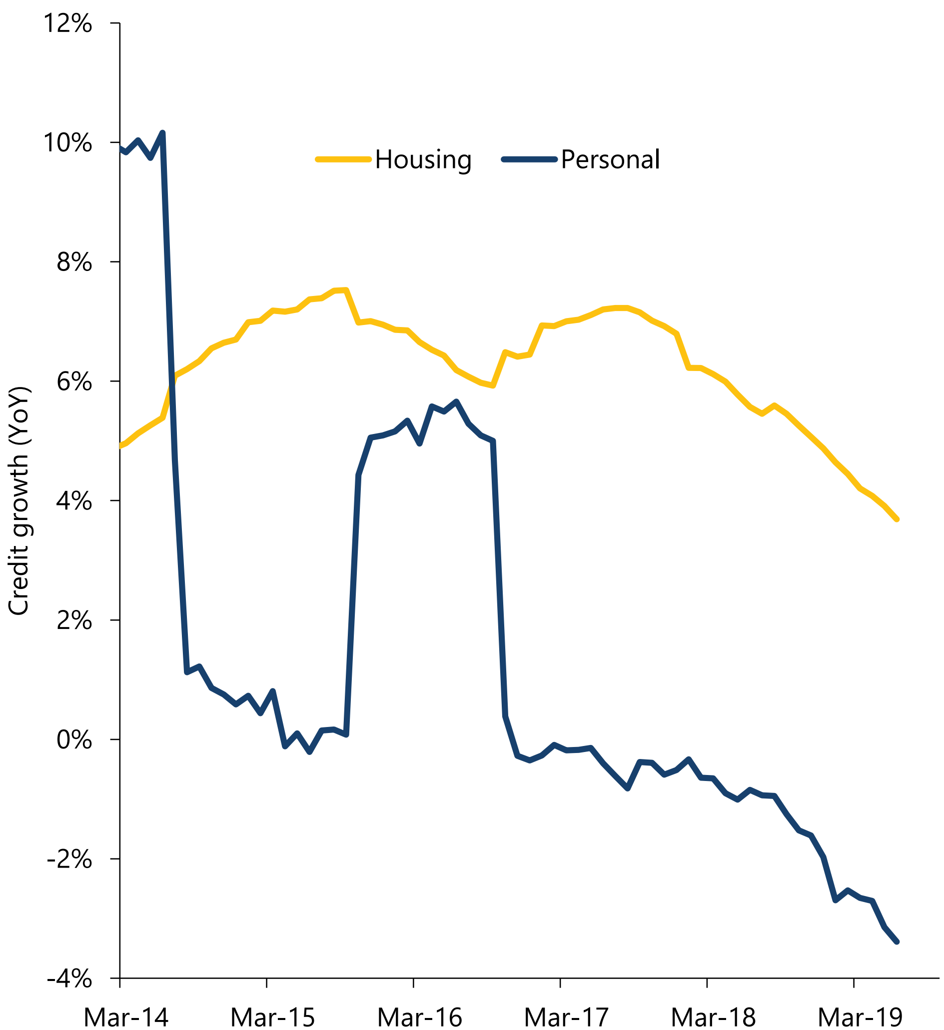
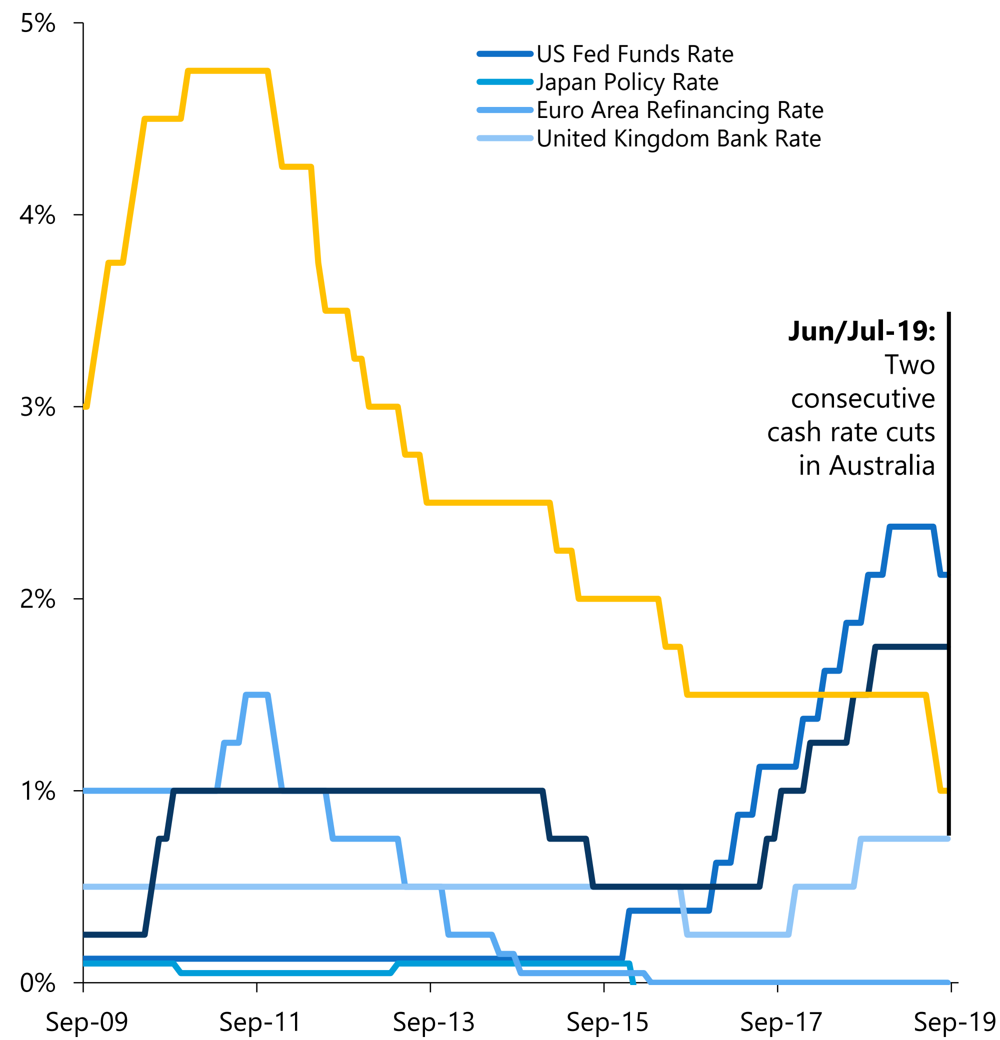
Weak macroeconomic conditions pose a challenging operating environment for banks

Weak housing market has reduced demand for credit …



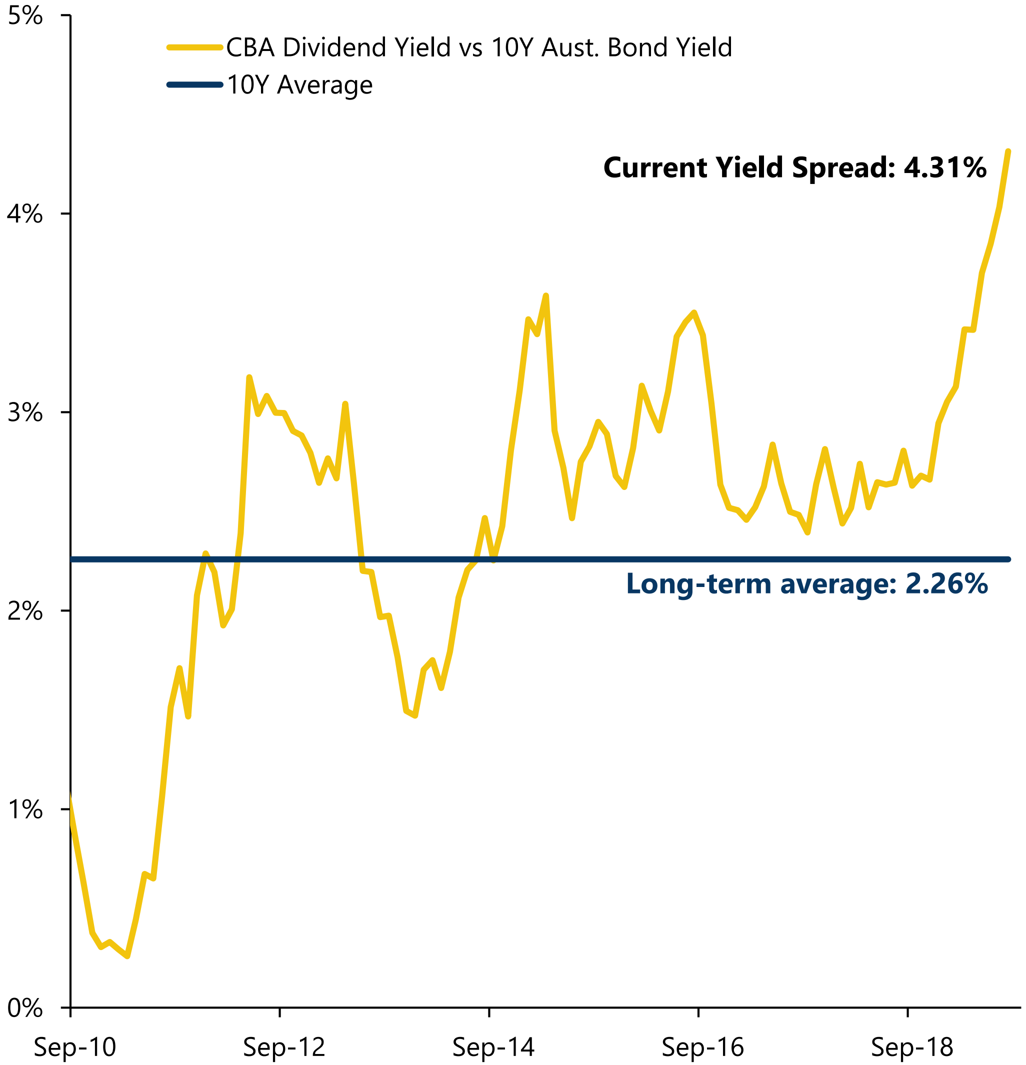
… while the historical interest rate differential has reversed



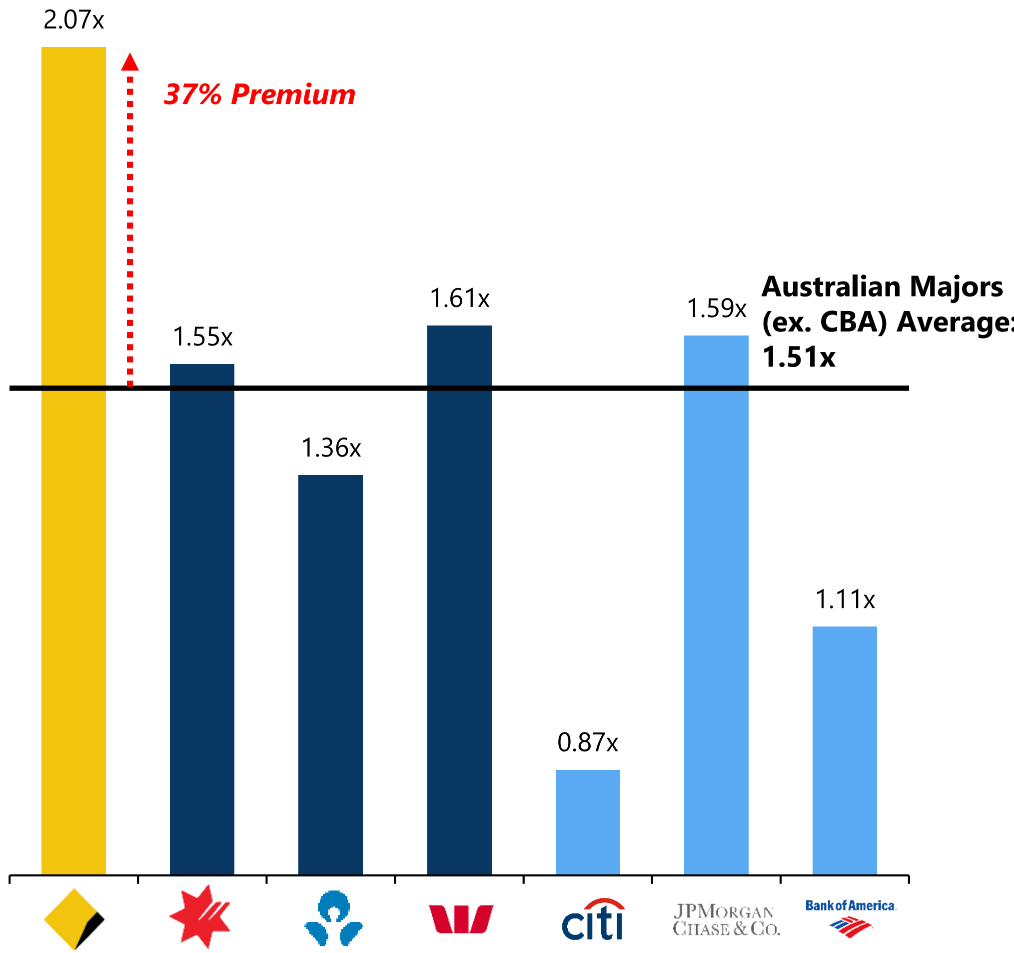
Source: RBA

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

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

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)

A challenging operating environment will squeeze CBA's **NIM**

Cost-out program overly ambitious

Capital position overestimated, CBA cannot return funds to shareholders

SELL RECOMMENDATION

1. NIM Squeeze

Challenging operating environment to squeeze CBA's net interest margin

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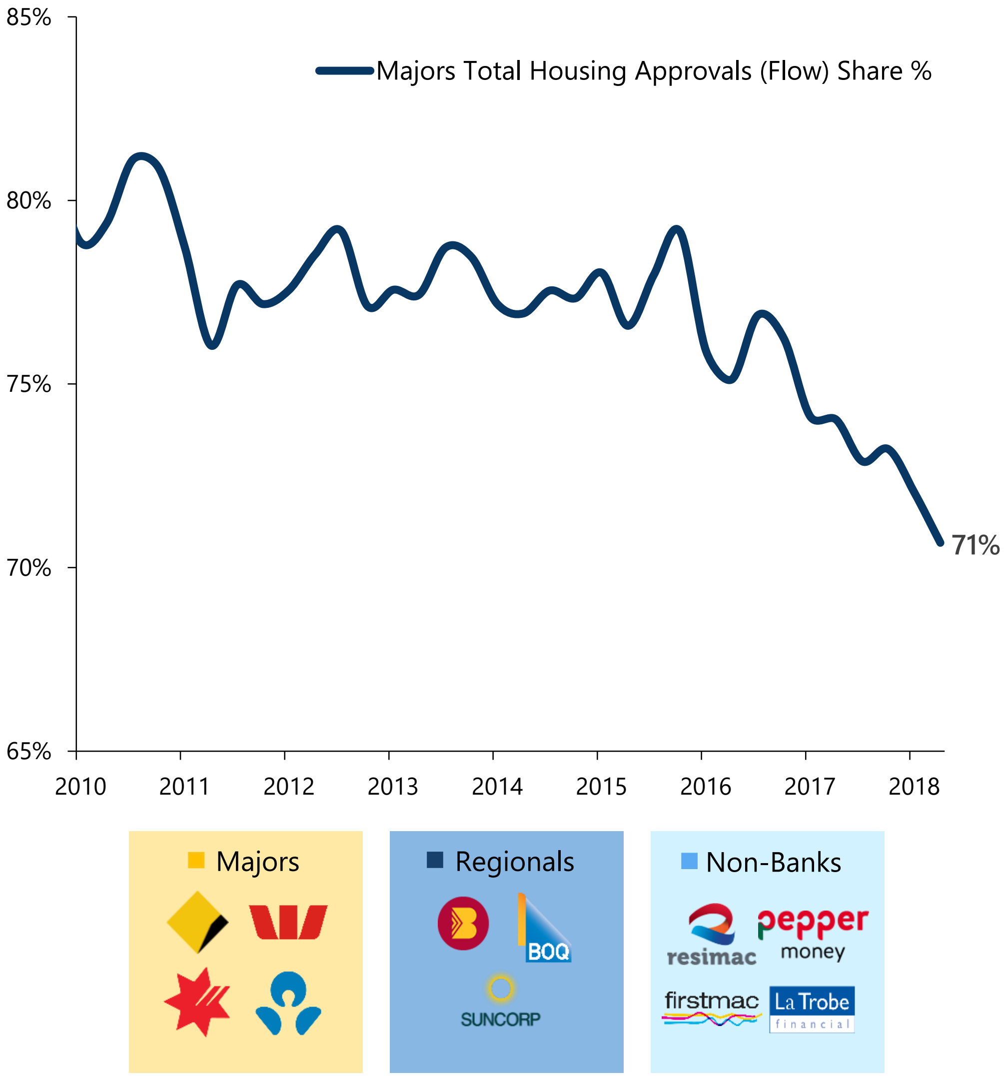
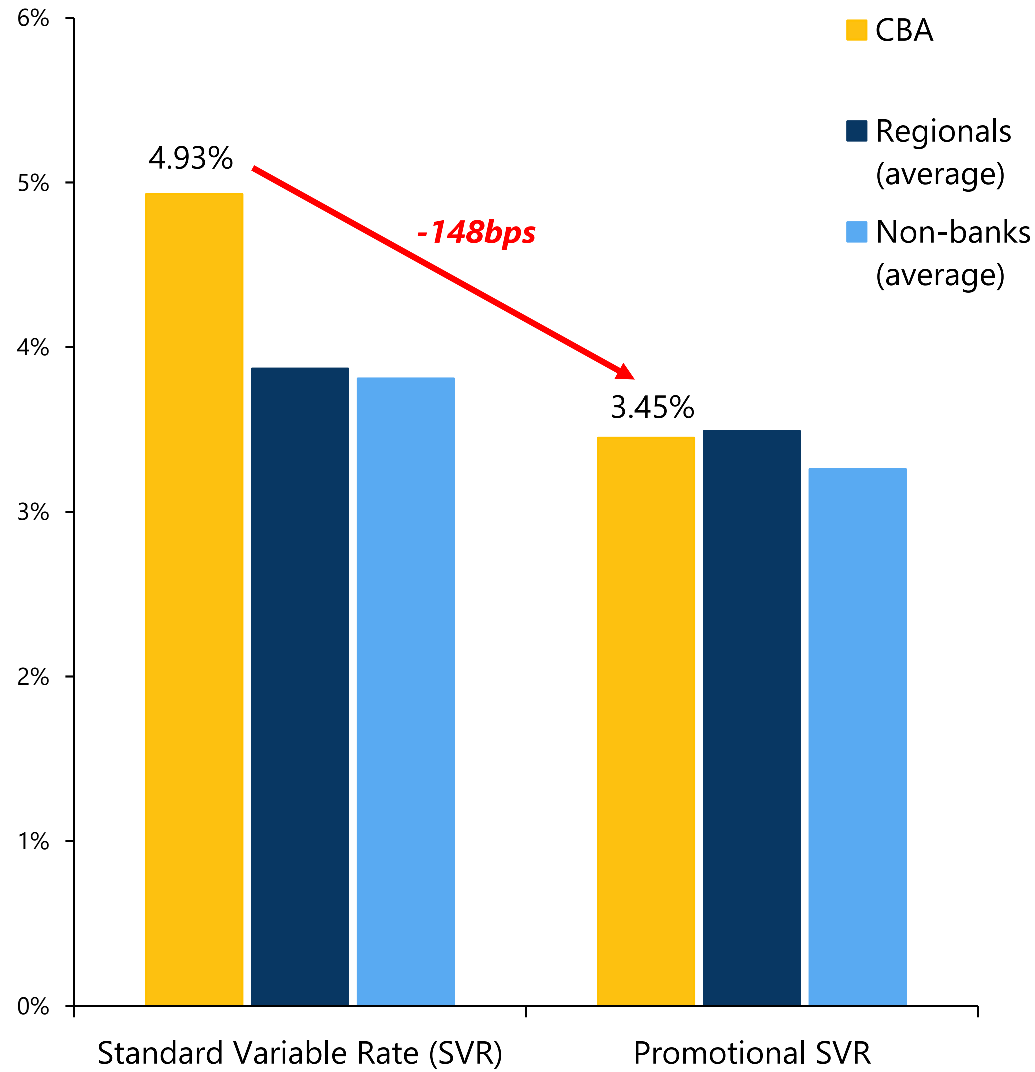
Competition is intensifying in the mortgage sector as non-banks undercut on price

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

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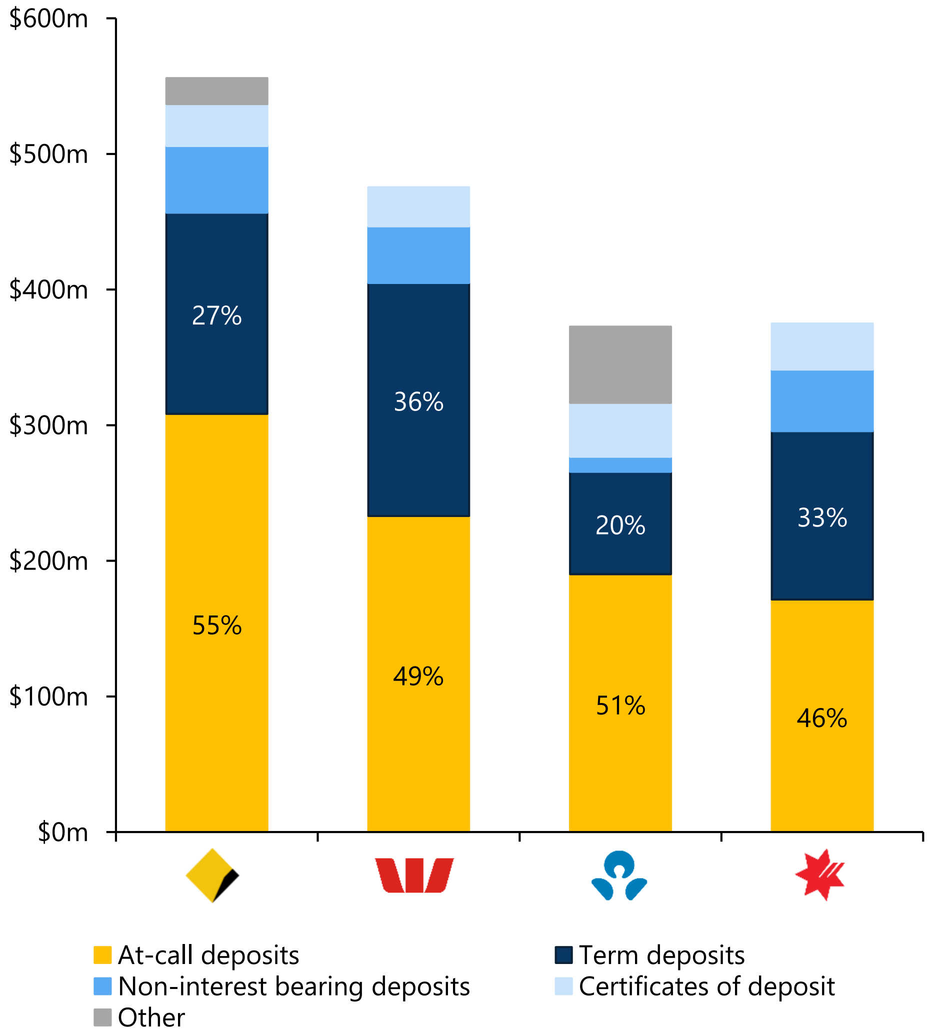
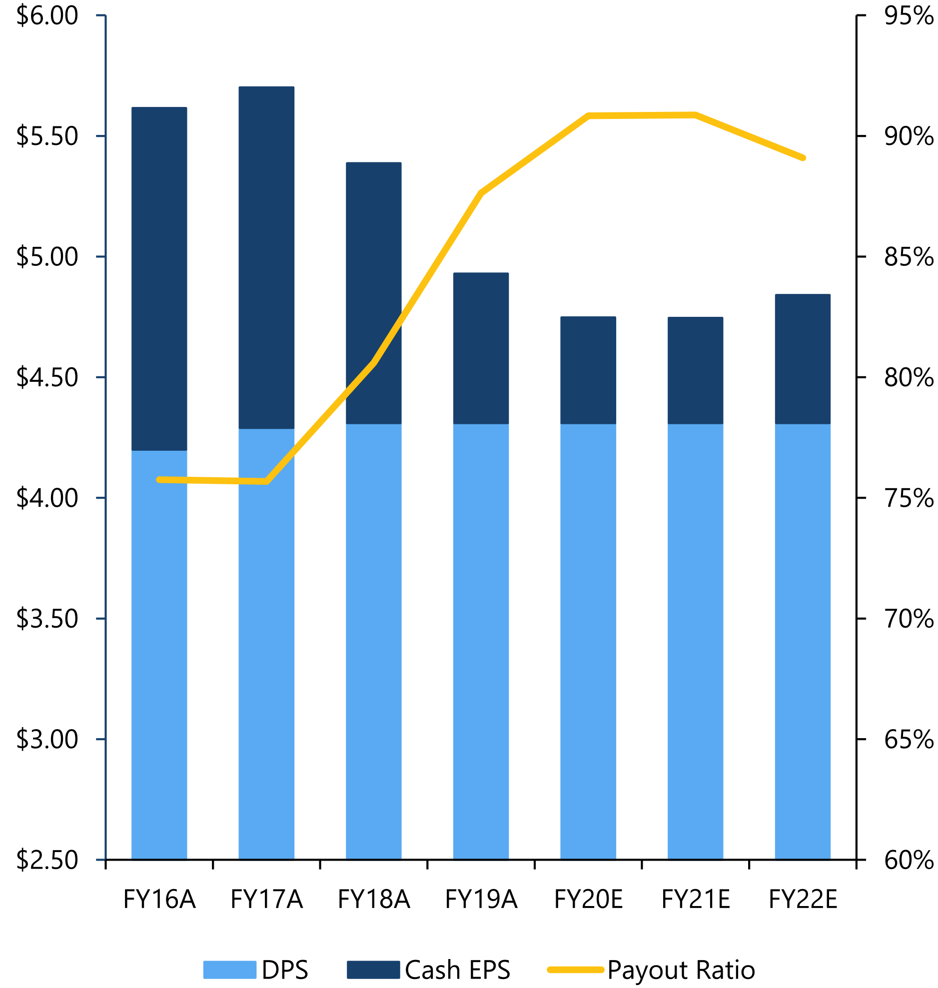
CBA's large, low-cost deposit base is more exposed to falling rates

CBA has the largest proportion of low cost deposits out of the majors…



… its NIM more vulnerable to low rates, threating earnings & dividends



Source: RBA, Company data, SURG analysis

2. Cost-out can't save CBA

Costs don't just disappear

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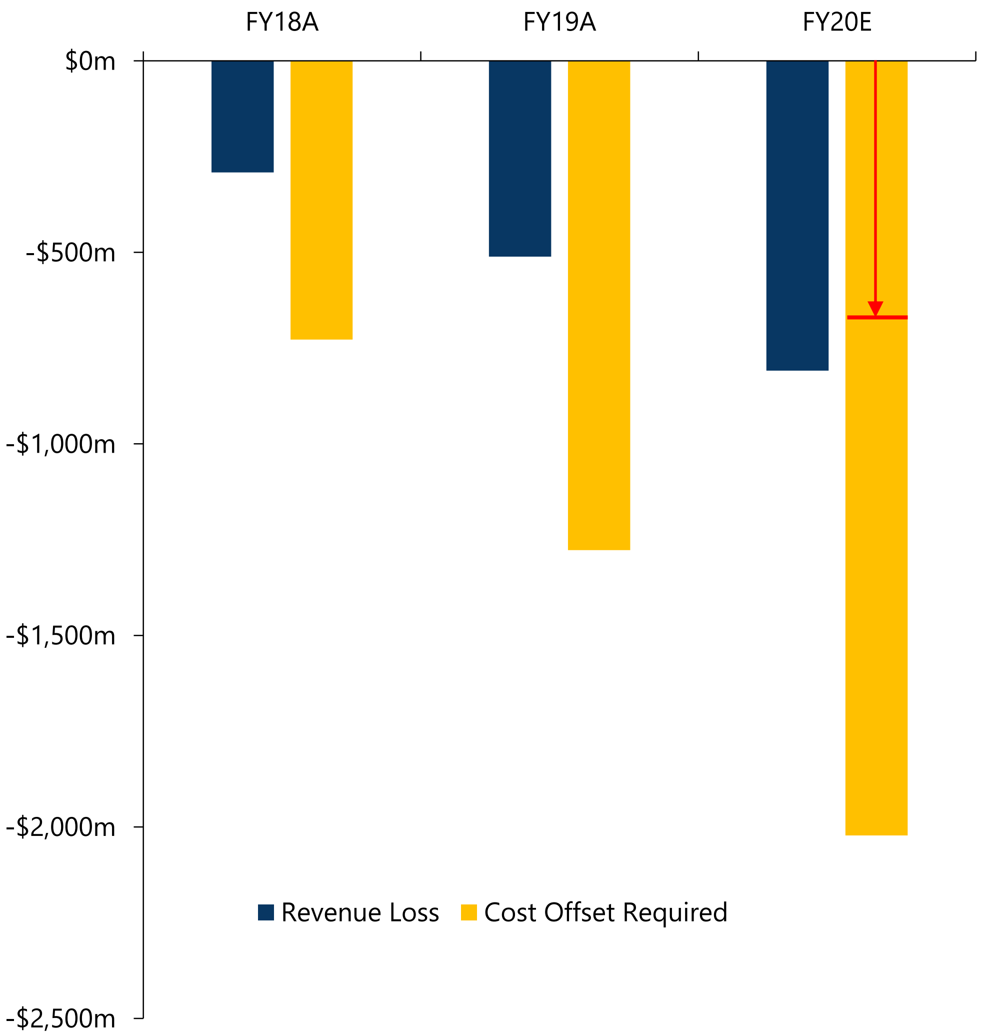
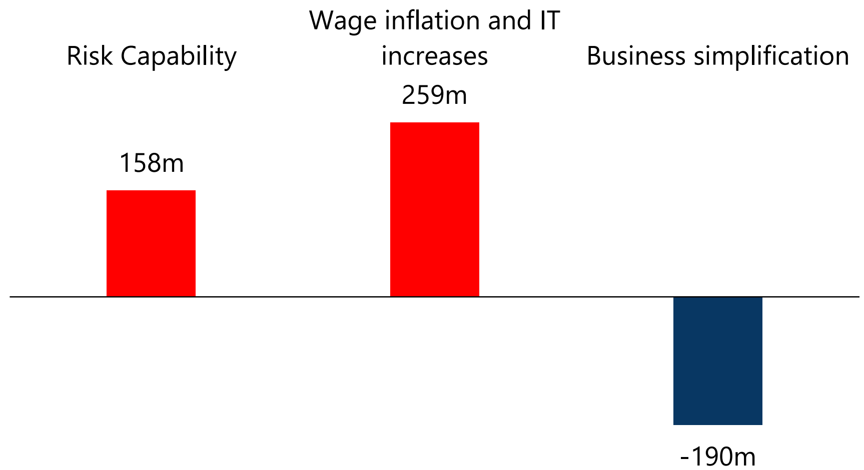
Costs are easy to add, hard to remove

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



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



With minimal room to move on physical costs …

$80m *Total savings in ATM reductions FY19 vs FY18*

$49m *Total savings in branch closures FY19 vs FY18*

Source: Company data, SURG estimates

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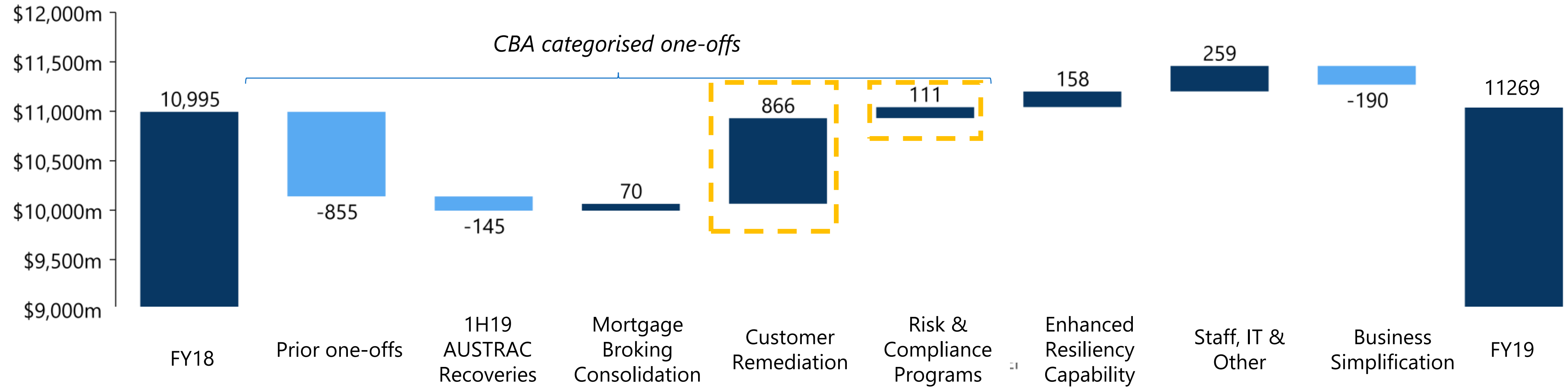
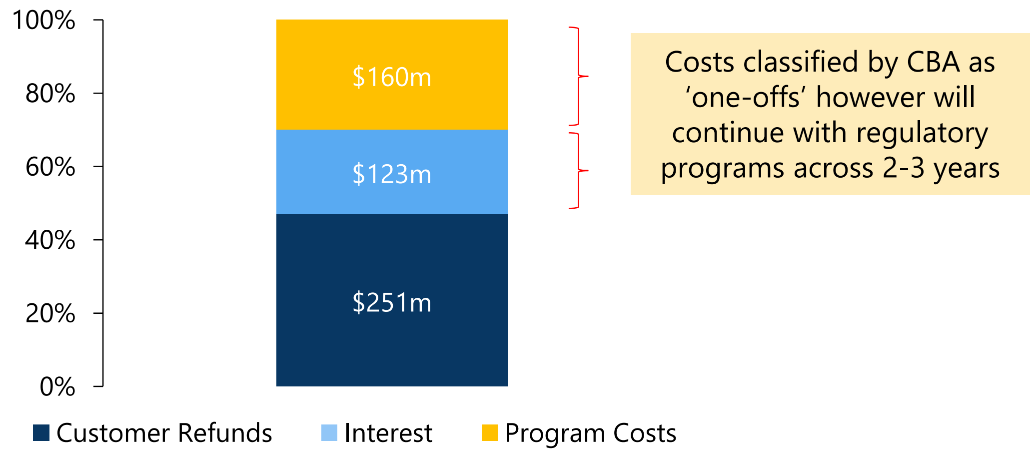
One-offs will continue to be sticky

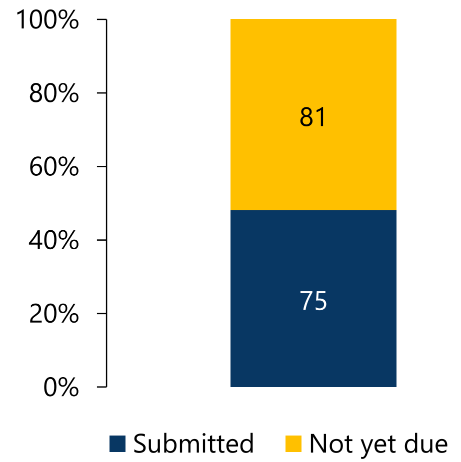
Remediation, risk and compliance costs will remain elevated for 3 years; one-off full-time employee (FTE) increases are sticky



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



Remedial Action Plan – still a long way to go



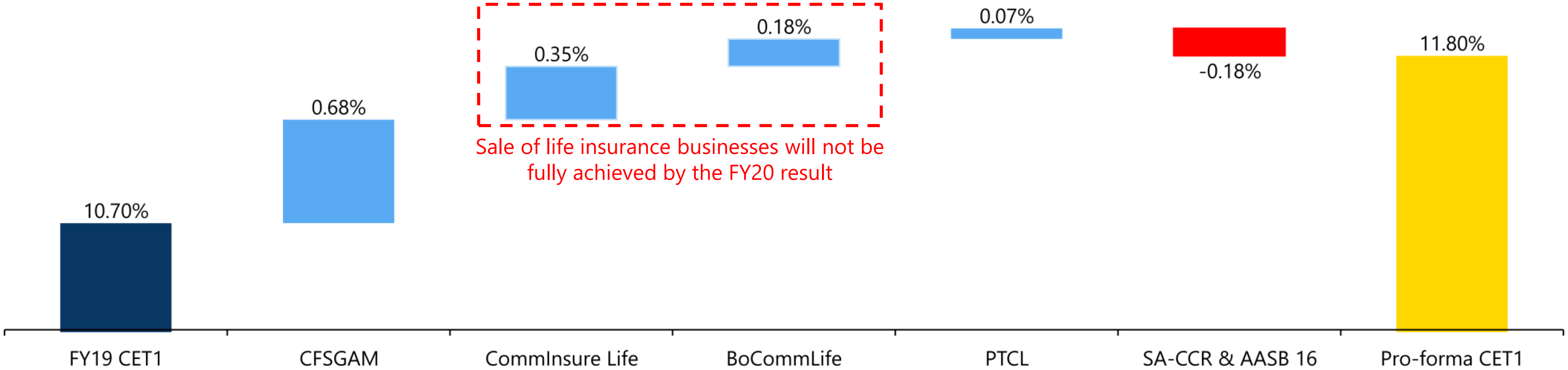
Source: Company Data, SURG Analysis

3. Capital Management Initiatives

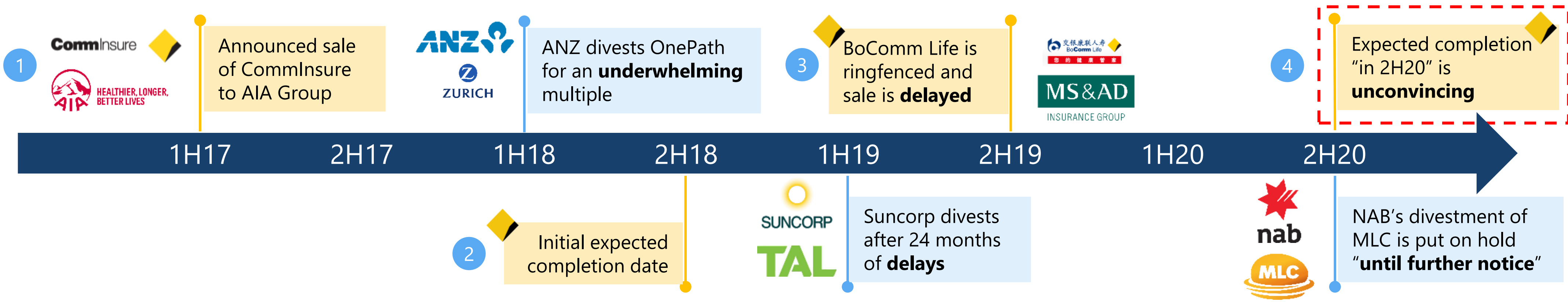
CBA is not as well-capitalised as the market perceives

Transaction risk is significant

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



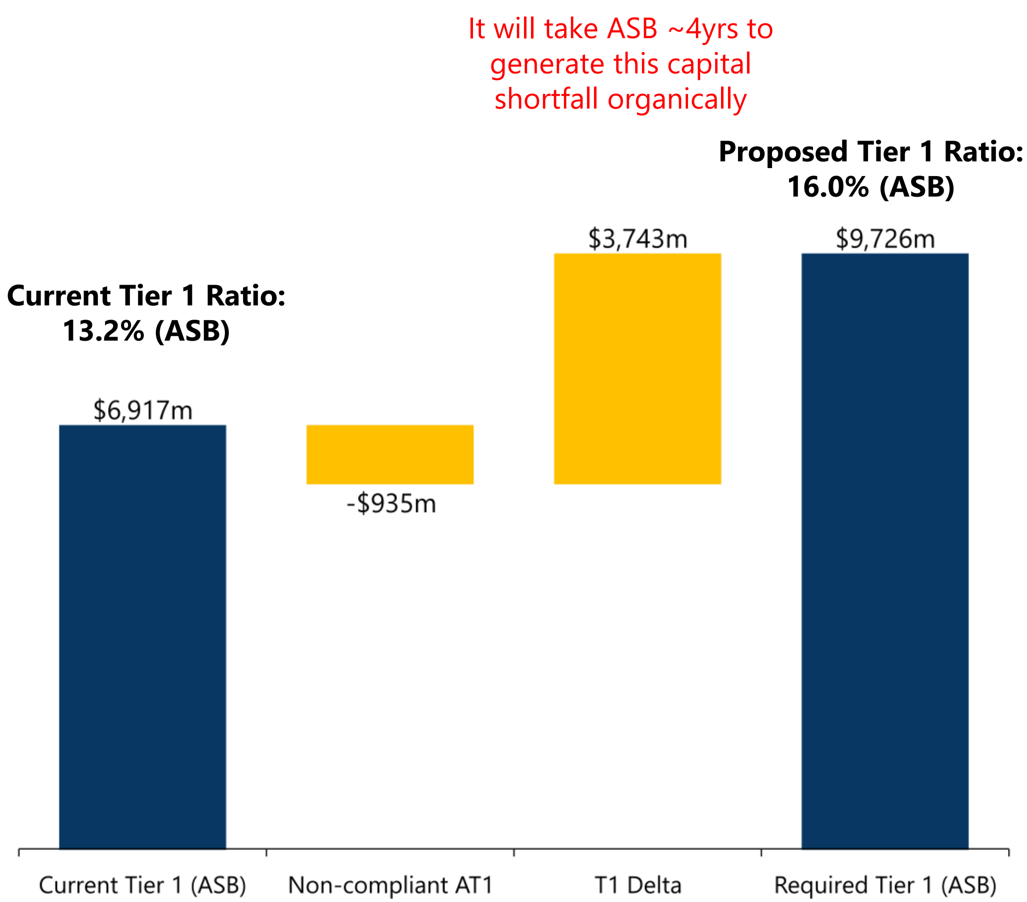
… however, divesting a life insurance business in Australia is a complex regulatory task



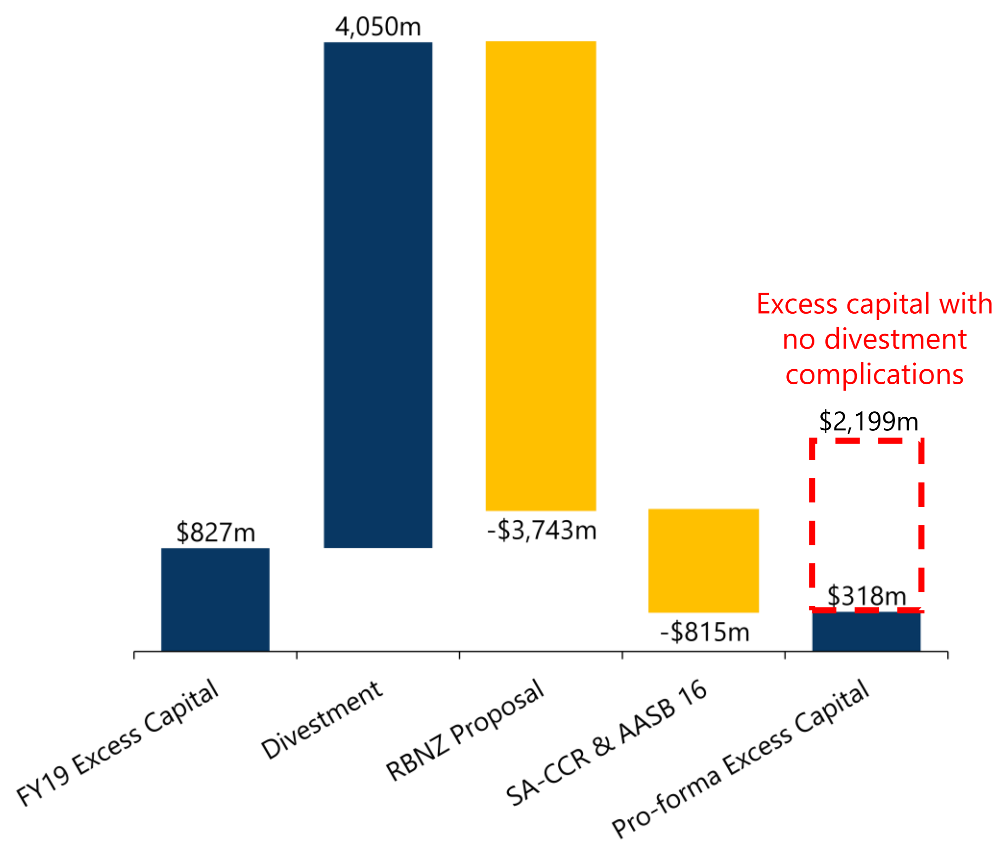
Source: Company data, Capital IQ

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



Source: Company data, RBNZ, SURG analysis

Valuation and Investment Risks

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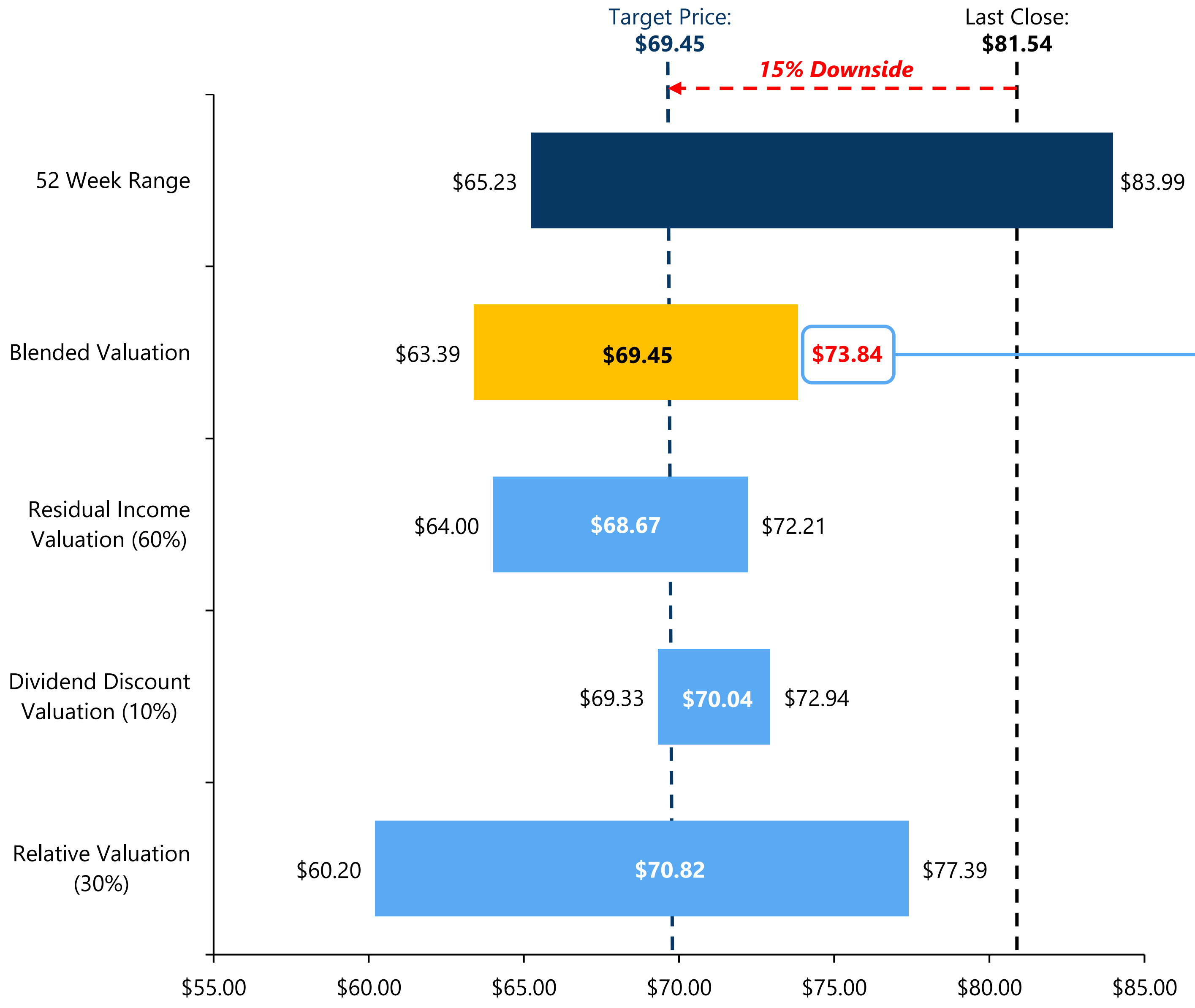
We calculate a target price of $69.45, a 15% downside to the close of $81.54



Bull Case Scenario

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

Maintains 10% Downside

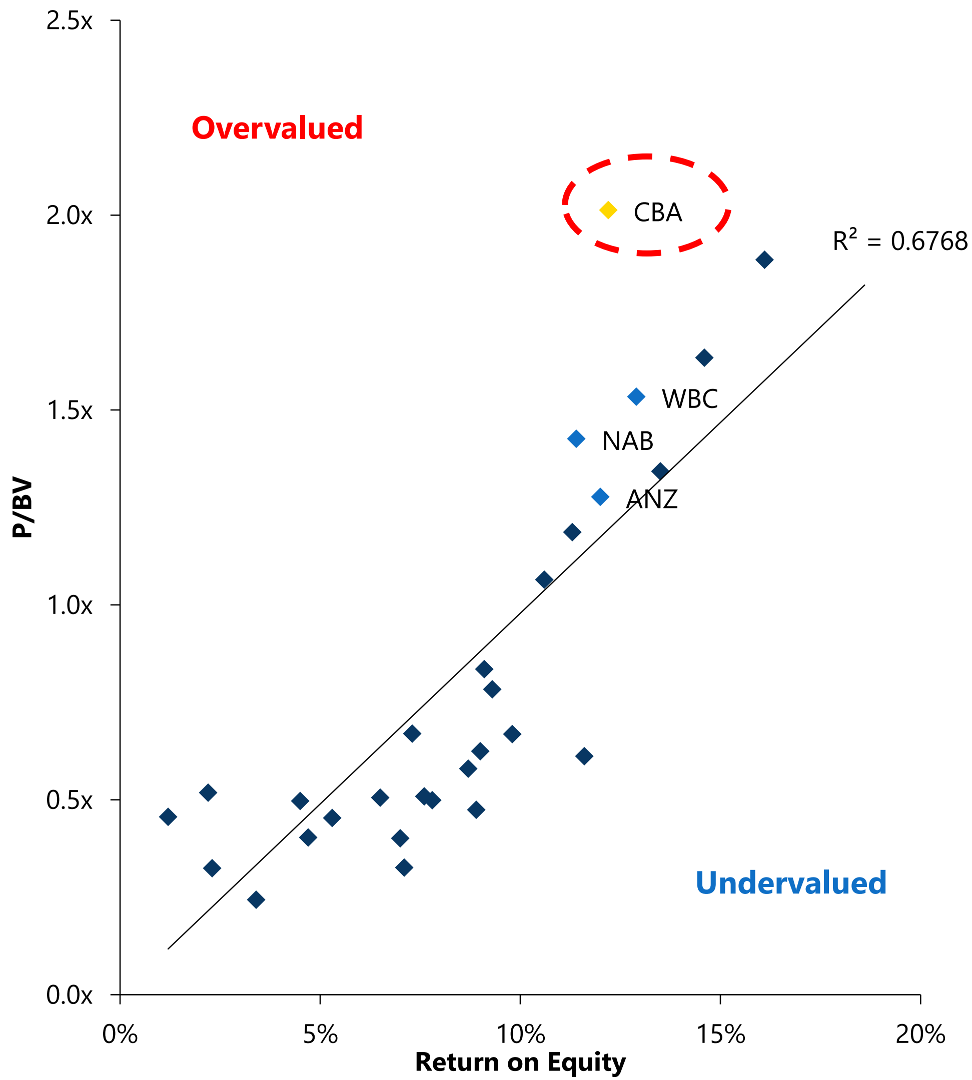
Target Trading Multiples

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

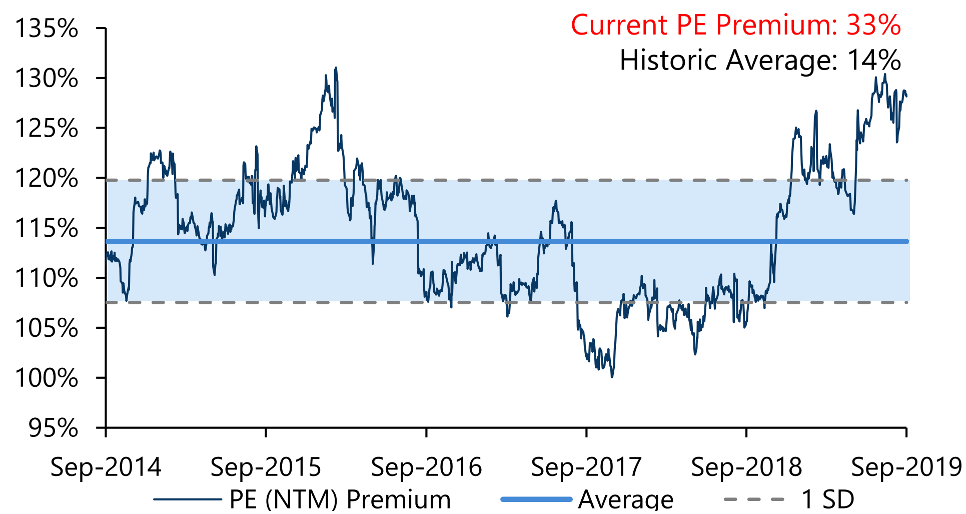
Sources: Company data, Capital IQ, SURG analysis

No comparable global bank is trading at 2x BV

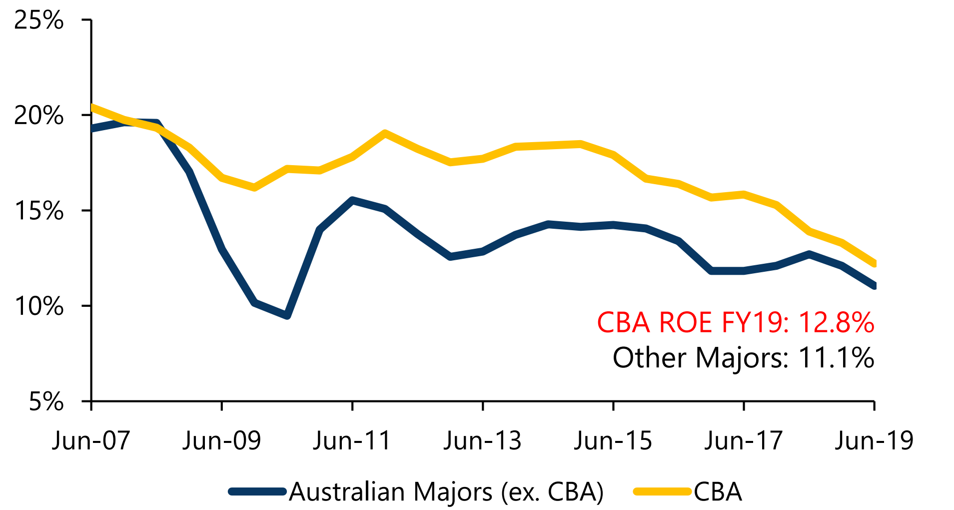
CBA is clearly overvalued compared to global peers…



…and relative to the other three major Australian banks

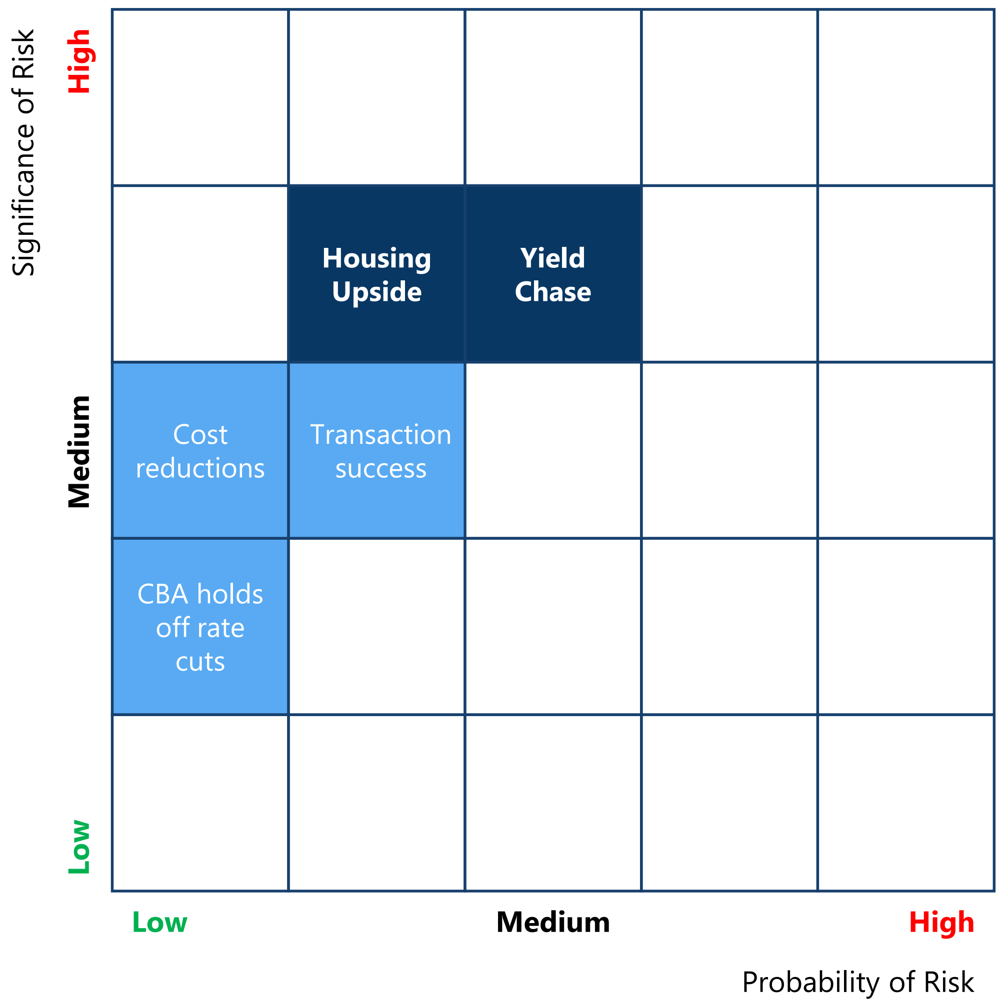


…even though CBA ROE leadership has declined



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



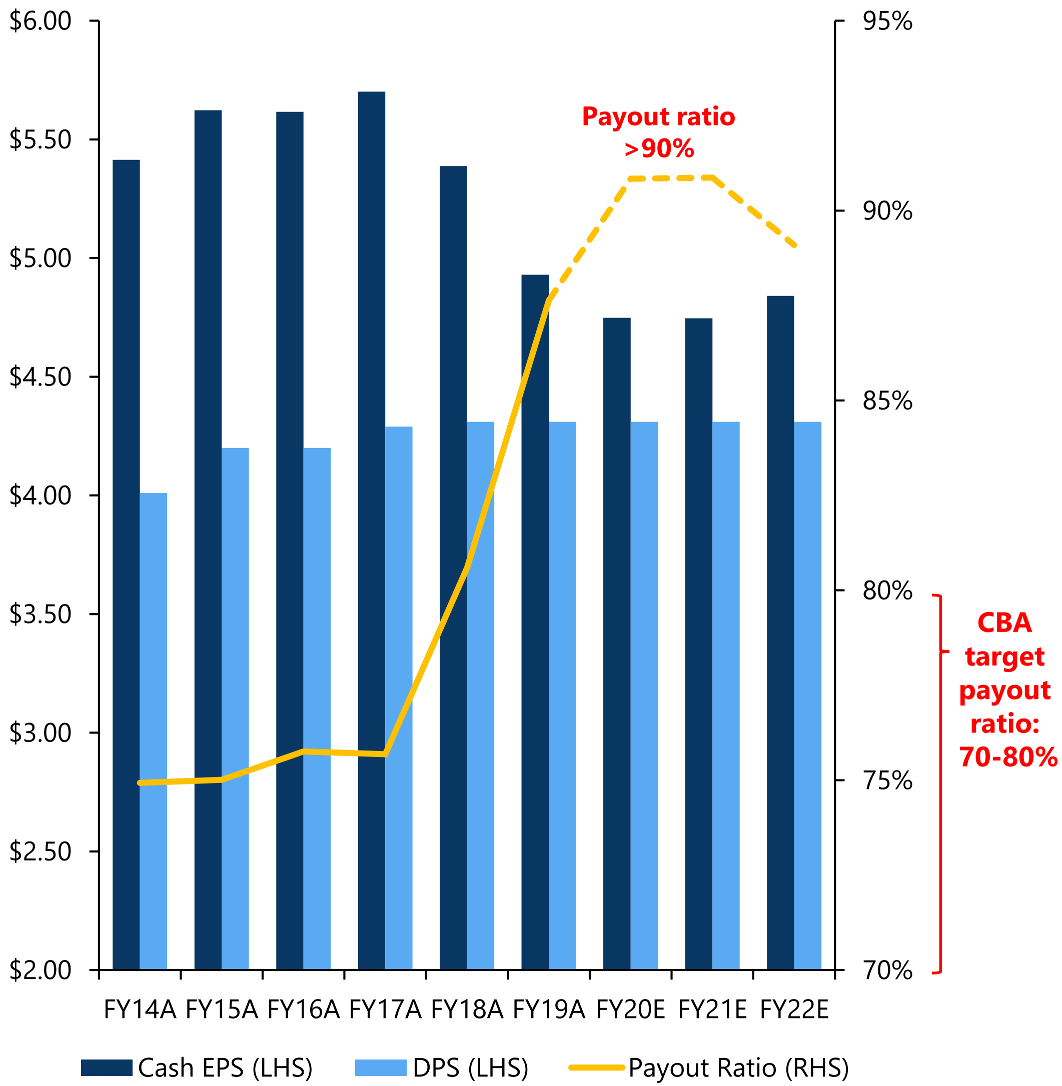
We have identified two key risks…

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

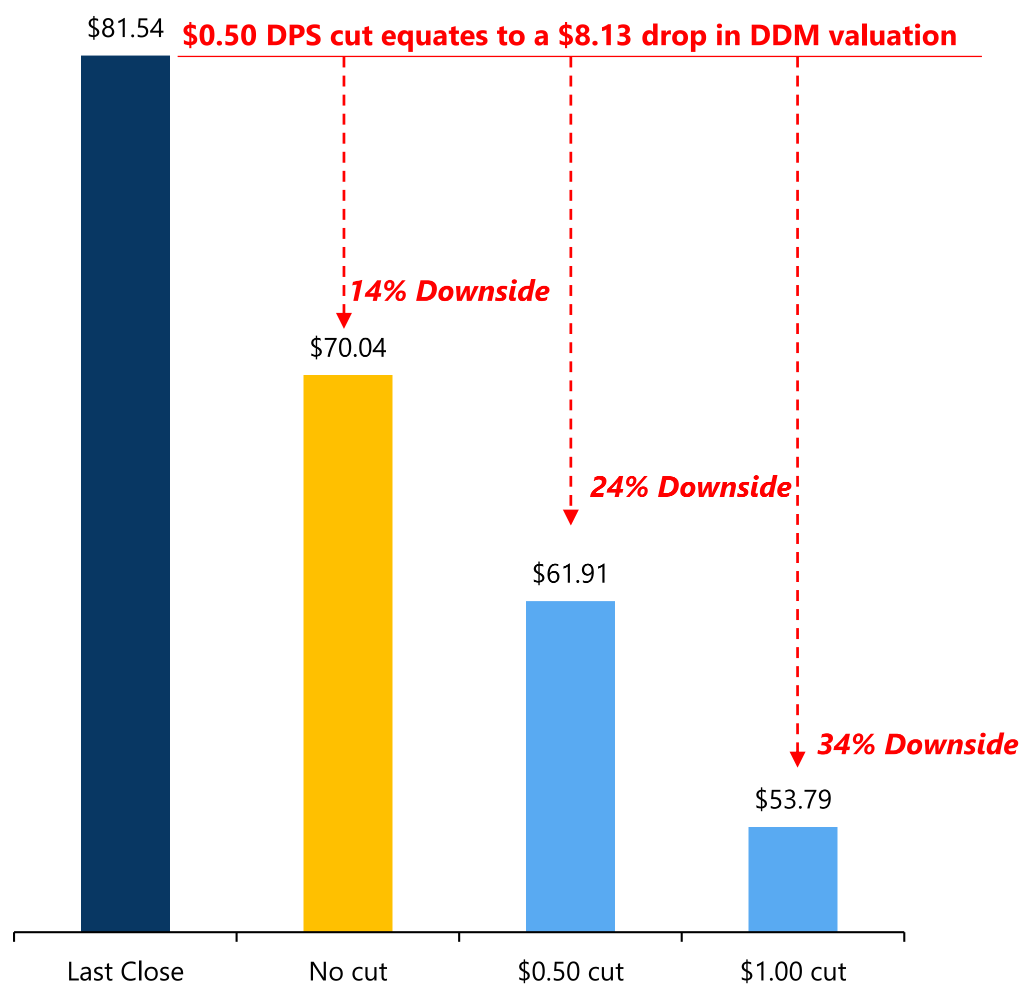
2. **Housing upside:** Recovery in house prices refuel housing credit growth

Yield-seeking investors remain stubborn

We forecast flat dividends but there are signs of weakness …



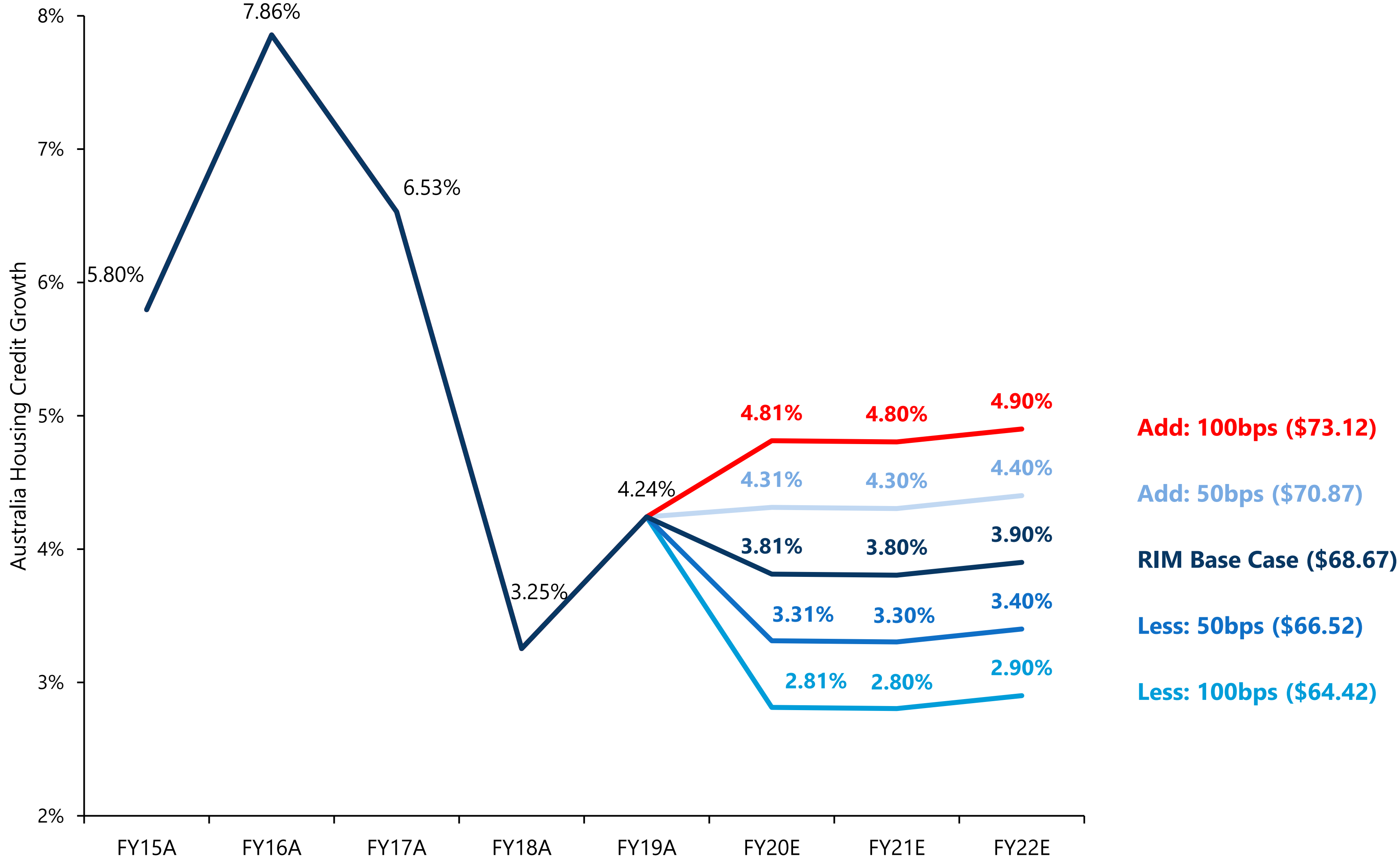
… which will lead to a significant share price reaction



Source: Company data, SURG analysis

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

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