

Australian banking sector

Key themes for 2015

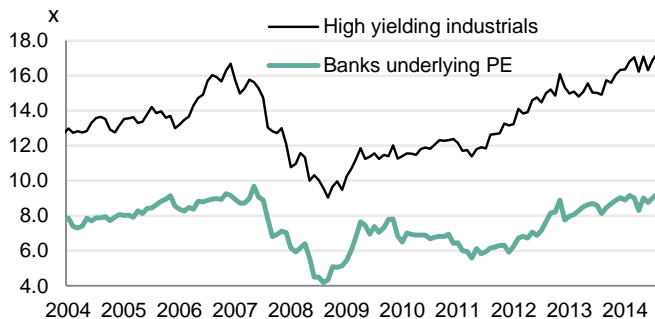
Prepared by: Victor German
Date: March 2015



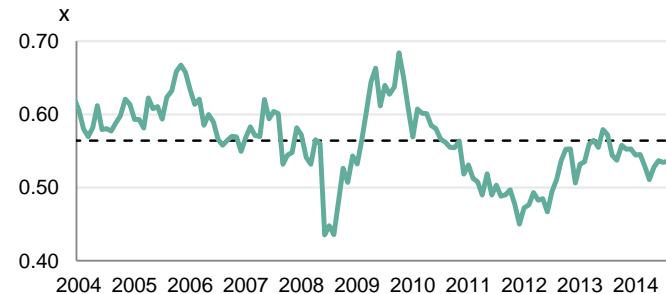
Remain tactically overweight the banks sector

- Banks continue to offer investors –
 - resilient earnings
 - attractive fully franked dividend yields, and
 - a supportive industry structure
- Acknowledge that banks appear expensive in absolute terms ...
- ... but we believe they offer relative value, particularly when compared to more expensive higher yielding defensive industrials sector

Underlying bank PE vs high yielding industrials



Underlying bank PE rel to high yielding industrials



Source: Company data, CBA Equities estimates

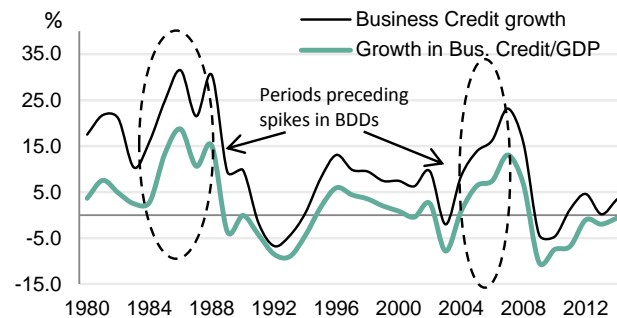
Note: High yielding industrials is an aggregate of telecommunication, utilities, transport, infrastructure and REITs.



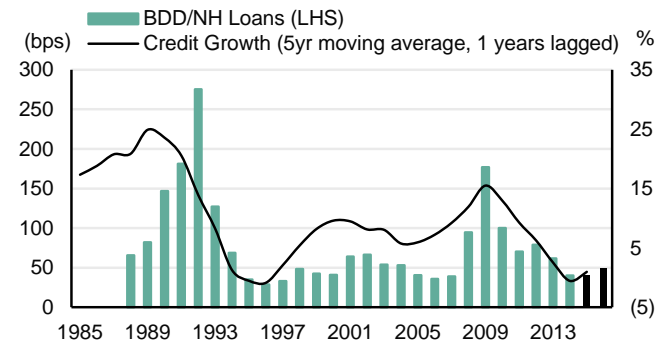
Credit quality is not a concern ... at least for now

- On the retail lending side, although households continued to borrow throughout the downturn, their balance sheets have been boosted by the recent increases in house prices and the significant reductions in the level of interest rates
- The relationship between credit quality and GDP growth and changes in the level of unemployment has historically been relatively strong
- Based on current economic forecasts, we believe credit quality should remain broadly stable to slightly improving in 2015, albeit there are arguably downside risks to economic forecasts

Business credit growth



BDD charges relative to credit growth



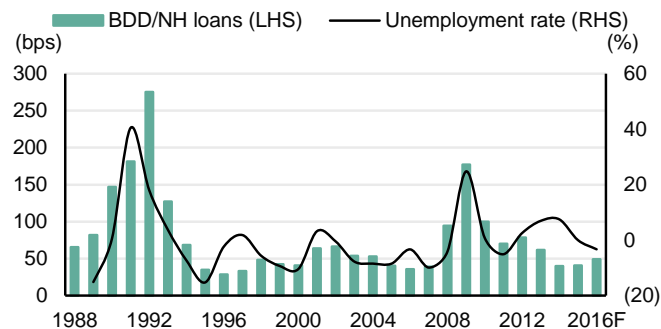
Source: *Company data, ABS, CBA Equities estimates*



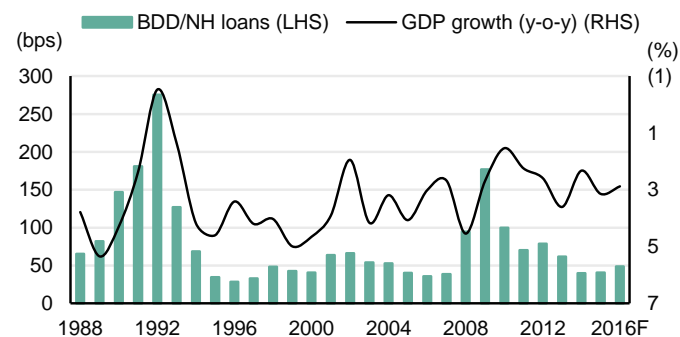
Leading indicators remain supportive

- Corporates and businesses are not overly geared and, with the record low interest rates, their ability to service debt is high
- Spikes in impairment charges generally occur following a period of buoyant economic activity and strong credit growth. As the figures below highlight, business credit growth remained weak and credit standards were generally conservative between 2010 and 2013 (although our model suggests we are approaching trough levels); and
- Global abundance of liquidity provides banks with an exit in the event of businesses defaulting limiting the extent of potential losses.

BDD/NHL vs % change in unemployment rate



BDD/NHL vs GDP growth



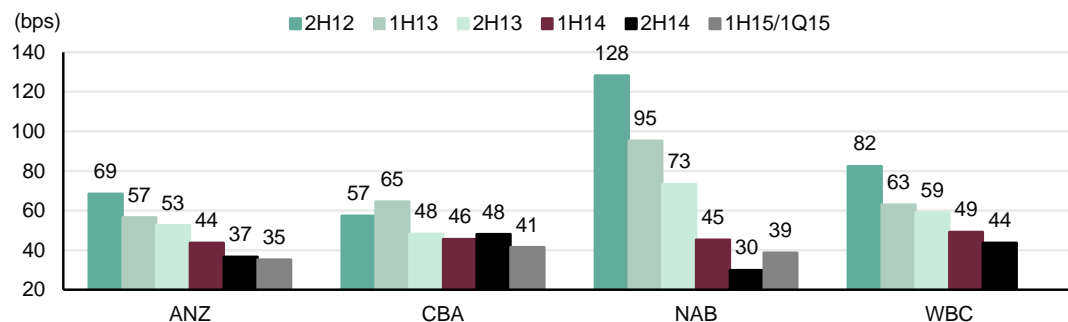
Source: *Company data, ABS, CBA Equities estimates*



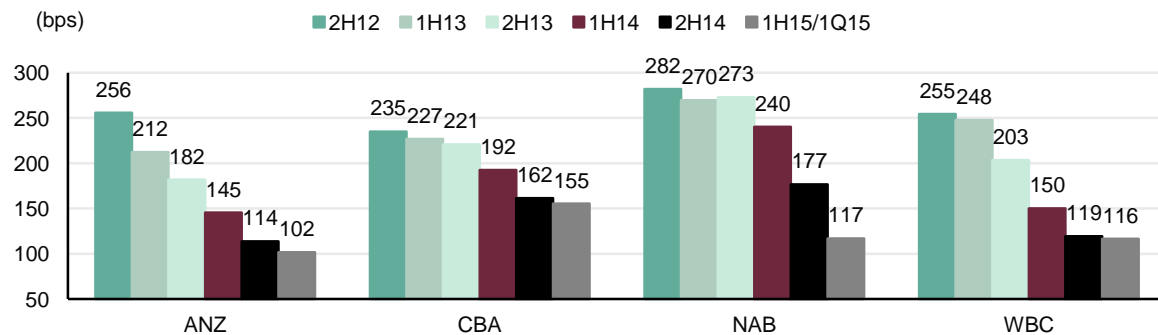
Banks' recent trends also confirmed that

- The level of impaired assets continued to decline while BDD charges stabilised at relatively low levels

BDD expense to non-housing loans



Impaired assets to non-housing loans



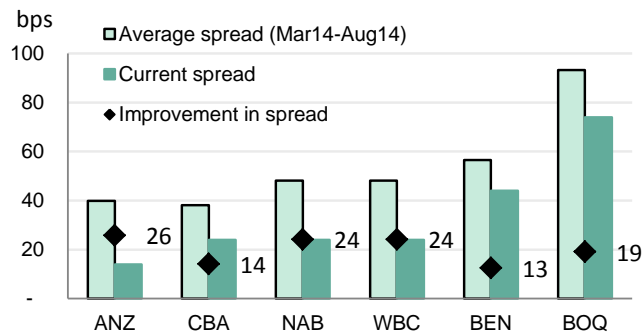
Source: Company data, CBA Equities estimates



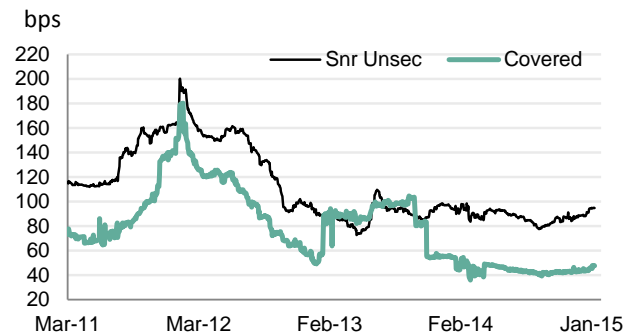
Funding benefits continue to support margins

- We expect the following drivers to impact banks margins
 - Lower interest rates (partially offset by banks' hedging) will continue to impact earnings from free funds;
 - Pressure on lending rates particularly in the larger institutional and corporate segments;
 - Higher cost of liquidity as banks had to meet LCR rules; and
 - Improving spreads on funding should provide an offset

Bank term deposit spreads to 3m SWAP rate



Wholesale funding costs



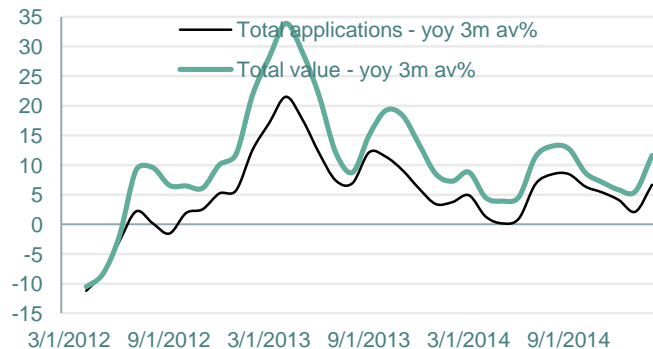
Source: CBA Fixed Income Research, CBA Equities estimates



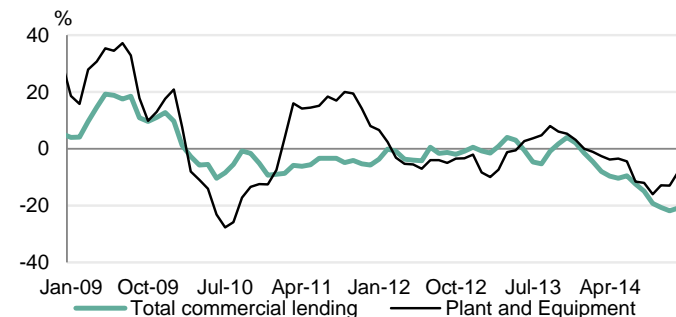
Balance sheet growth remains housing lending led

- Housing credit remains strong – underpinned by improving house prices and expectations for further rate cuts
- While both the market and banks have for some time been looking for the ultimate recovery in business credit, the improvement has been stubbornly slow and the market has been consistently disappointed.
- While we see scope for business growth recovery in the medium term, particularly given the favourable interest rates environment it appears that businesses are reluctant to borrow given the broader macro concerns.

CBA mortgage applications (growth %)



CBA business finance applications (yoy)



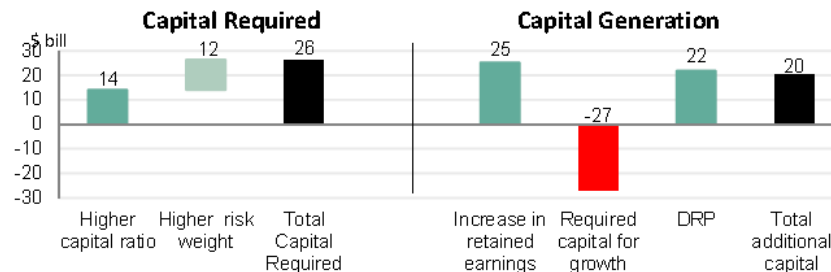
Source: CBA data



Regulation remains the key medium term risk

- We expect APRA to clarify its position on capital after Basel formalises its stance ... this is likely to be in the second half of this year
- We expect the following outcomes -
 - **Banks will have 3-5 years to grow into their new capital position.**
 - **Banks will be able to generate significant capital organically with ongoing DRPs.** Banks might need \$20-30 billion in extra capital, but are likely to generate \$25 billion in retained earnings and \$22 billion from DRPs over next 3 years.
 - **Banks will be able to recoup some profitability** from repricing mortgages and deposits
 - We expect the regional banks to ultimately be relative beneficiaries from regulatory changes

Scenarios for higher bank capital by 2017



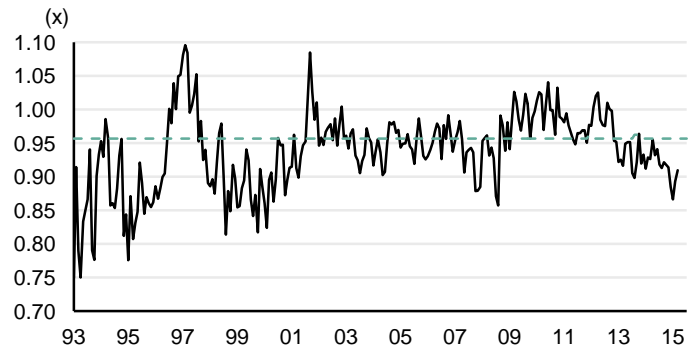
Source: Company reports, CBA estimates



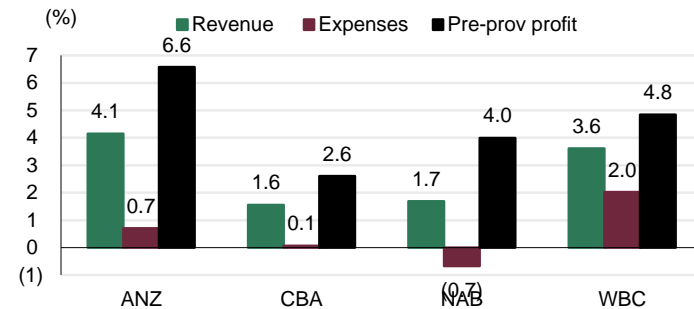
Key stock recommendations – ANZ (Overweight)

- ANZ is our preferred long term exposure to the sector underpinned by a supportive relative valuation
- ANZ is currently trading at ~10% discount relative to a 10-year average of ~4%
- While we acknowledge near-term risks around ANZ's overweight position to Asia, we note that in relative sense their position is small and ANZ's recent trends within its domestic business were favourable.

ANZ PE Rel to peers



Australian banks 2H14 performance



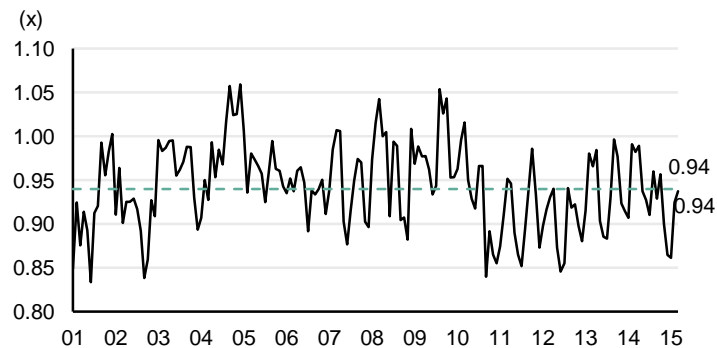
Source: Company data, CBA Equities estimates



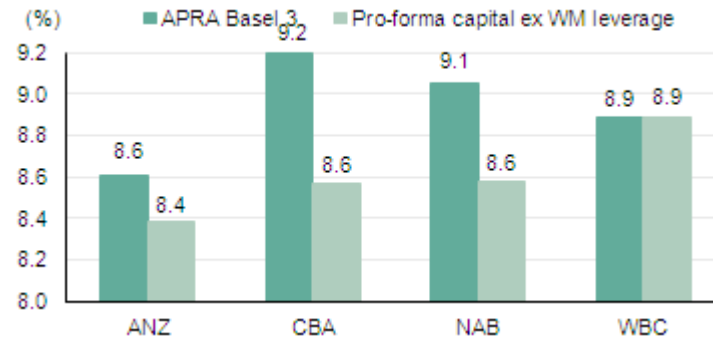
Key stock recommendations – WBC (Neutral)

- We expect WBC to increase its cost base as a result of further IT investment
- We also note that WBC's capital position is the strongest in the sector leaving it well placed to meet more stringent capital requirements in the future
- In the short term WBC should continue to benefit from growth in its housing portfolio (biggest investment portfolio) and stable margin trends
- WBC currently trades in line with its historical PE rel relative to CBA

WBC PE Rel to CBA



Core tier one capital position



Source: Company data, CBA Equities estimates



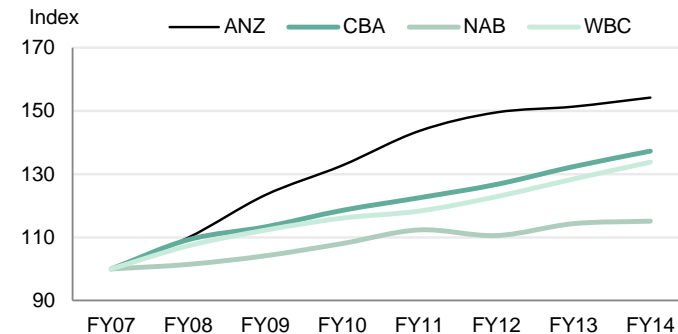
Key stock recommendations – NAB (Neutral)

- While potential announcements with respect to non-core divestments is likely to be viewed favourably by the market, we note the implied upside to returns is limited
 - While a sale of non-core assets should lead to an improvement in NAB's returns, the extent to which this will result in substantial creation of value to shareholders remains to be seen.
 - With increasing demands on capital from the UK business unit, we would expect part of the proceeds from a sale to be injected back into the group. We estimate NAB would need to leave ~\$1b as a top-up to its group capital base post any sale to maintain its current capital ratio
- Should the new management team look to adequately address domestic franchise issues we expect this to take time and require additional investment spend.

NAB PE Rel to peers



Banks' expense index (based on underlying growth)



Source: Company data, CBA Equities estimates



Disclaimer.

Please view our website at www.research.commbank.com.au. The Commonwealth Bank of Australia ABN 48 123 123 124 AFSL 234945 (“the Bank”) and its subsidiaries, including Commonwealth Securities Limited ABN 60 067 254 300 AFSL 238814 (“CommSec”), Commonwealth Australia Securities LLC, CBA Europe Ltd and Global Markets Research, are domestic or foreign entities or business areas of the Commonwealth Bank Group of Companies(CBGOC). CBGOC and their directors, employees and their representatives are referred to in this Appendix as the “Group”.

This report is published solely for informational purposes and is not to be construed as a solicitation or an offer to buy any securities or related financial instruments. This report is for distribution only under such circumstances as may be permitted by applicable law. This report has been prepared without taking account of the objectives, financial situation or needs of any specific person who may receive this report. Any such person should, before acting on the information in this report, consider the appropriateness of the information, having regard to the specific person’s objectives, financial situation and needs and, if necessary, seek appropriate professional or financial advice regarding the appropriateness of investing in any securities or investment strategies discussed in this report. CBA believes that the information in this report is correct and any opinions, conclusions or recommendations are reasonably held or made, based on the information available at the time of its compilation, but no representation or warranty, either expressed or implied, is made or provided as to accuracy, reliability or completeness of any statement made in this report. Any opinions, conclusions or recommendations of CBA set forth in this research report are subject to change without notice and may differ or be contrary to the opinions, conclusions or recommendations expressed by other business areas or groups of the Group as a result of using different assumptions and criteria. The analysis contained in this research report is based on numerous assumptions; different assumptions could result in materially different results. CBA is under no obligation to update or keep current the information contained in this report. None of the entities within the Group or their directors, employees or agents accepts any liability for any loss or damage arising out of the use of all or any part of this report. Any valuations, projections and forecasts contained in this report are based on the number of assumptions and estimates and are subject to contingencies and uncertainties. The inclusion of any such valuations, projections and forecasts in this report should not be regarded as a representation or warranty by or on behalf of the Group or any person or entity within the Group that such valuations, projections and forecasts or their underlying assumptions and estimates will be met or realized. Past performance is not a reliable indicator of future performance. Foreign currency rates of exchange may adversely affect the value, price or income of any security or related investment mentioned in this report. In addition, investors in securities, such as ADRs, whose values are influenced by the currency of the underlying security, effectively assume currency risk. The Group may engage in transactions in a manner inconsistent with this research report. In the case of certain products, the Bank or one of its affiliates is or may be the only market maker. No inducement has been or will be received by the Group or any person or entity within the Group or the research analyst from the subject of this report or its associates to undertake the research or make the recommendation. The research staff responsible for this report receive a salary and a bonus that is dependent on a number of factors including their performance and the overall financial performance of the Group. Decisions about remuneration for research staff are not contingent on specific investment banking, corporate advisory or dealing transactions. Investment Banking does not set or determine the remuneration pool or levels for research staff. The Group provides, or seeks to provide, services to the subject of the report and its associates. This report is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or which would subject any entity within the Group to any registration or licensing requirement within such jurisdiction. All material presented in this report, unless specifically indicated otherwise, is under copyright to entities within the Group. None of the material, nor its content, nor any copy of it, may be altered in any way, transmitted to, copied or distributed to any other party, without the prior written permission of the Group or the appropriate entity within the Group.

US Equity Investors:

This research report is provided with the understanding that Commonwealth Bank of Australia CBA, ABN 48 123 123 124, AFSL 234945 (the “Bank,” and together with its subsidiaries and affiliates, the “Group”) (“CBA”) and its affiliates are not acting in a fiduciary capacity. This research report represents the views of CBA and is subject to change without notice. The securities discussed in this research report may not be eligible for sale in all States or countries, and such securities may not be suitable for all types of investors. Offers and sales of securities discussed in this research report, and the distribution of this report, may be made only in States and countries where such securities are exempt from registration or qualification or have been so registered or qualified for offer and sale, and in accordance with applicable broker-dealer and agent/salesman registration or licensing requirements. The preparer of this research report is employed by CBA and is not registered or qualified as a research analyst, representative, or associated person under the rules of FINRA, the New York Stock Exchange, Inc., any other U.S. self-regulatory organization, or the laws, rules or regulations of any State. CBA is incorporated in Australia with limited liability. CBA is not registered as a broker-dealer under the Exchange Act and is not a member of FINRA. This report is prepared, approved, and published solely by CBA. The U.S. Broker-Dealer is a wholly owned, but non-guaranteed, subsidiary of the Bank, organized under the laws of the State of Delaware, USA, with limited liability. The U.S. Broker-Dealer is not authorized to engage in the underwriting of securities and does not make markets or otherwise engage in any trading in the securities of the subject companies described in our research reports. The U.S. Broker-Dealer is registered under the Exchange Act and is a member of FINRA. The U.S. broker-dealer is the distributor of this research report in the United States and accepts responsibility for its content.

In the US (for products other than Equities)

The Bank is authorized to maintain a Federal branch by the Office of the Comptroller of the Currency.

This document is made available for informational purposes only. The products described herein are not available to retail investors. NONE OF THE PRODUCTS

DESCRIBED ARE DEPOSITS THAT ARE COVERED BY FDIC INSURANCE.



This product is not suitable for investment by counterparties that are not “eligible contract participants” as defined in the U.S. Commodity Exchange Act (“CEA”) and the regulations adopted thereunder; or (ii) entities that have any investors who are not “eligible contract participants.” Each hedge fund or other investment vehicle that purchases the products must be operated by a registered commodity pool operator as defined under the CEA and the regulations adopted thereunder or a person who has qualified as being exempt from such registration requirement. CBA cannot execute swaps with any US person unless our counterparty has adhered to the ISDA Dodd Frank protocol. This report was prepared, approved and published by Global Markets Research, a division of Commonwealth Bank of Australia ABN 48 123 123 124 AFSL 234945 (the “Bank”) and is distributed in the United States by the Bank’s New York Branch and its Houston Loan Production Office. If you would like to speak to someone regarding securities related products, please contact Commonwealth Australia Securities LLC (the “U.S. Broker–Dealer”), a broker–dealer registered under the U.S. Securities Exchange Act of 1934 (the “Exchange Act”) and a member of the Financial Industry Regulatory Authority (“FINRA”) at 1 (212) 336-7737. The information contained herein is not intended to be an exhaustive discussion of the strategies or concepts mentioned herein or tax or legal advice. Investments and strategies are discussed in this report only in general terms and not with respect to any particular security or securities transaction, and any specific investments may entail significant risks including exchange rate risk, interest rate risk, credit risk and prepayment risk among others. There also may be risks relating to lack of liquidity, volatility of returns and lack of certain valuation and pricing information. International investing entails risks that may be presented by economic uncertainties of foreign countries as well as the risk of currency fluctuations. Investors interested in the strategies or concepts described in this report should consult their tax, legal or other adviser, as appropriate. This report is not intended to provide information on specific securities. The Bank’s New York Branch and its Houston Loan Production Office provides its clients access to various products and services available through the Bank and its affiliates. In the United States, U.S. brokerage products and services are provided solely by or through the U.S. Broker-Dealer. The U.S. Broker-Dealer is a wholly-owned, but non-guaranteed, subsidiary of the Bank, organized under the laws of the State of Delaware, U.S., with limited liability. The U.S. Broker-Dealer is not authorized to engage in the underwriting of securities and does not make markets or otherwise engage in any trading in the securities of the subject companies described in our research reports.

In the UK and Europe: This report is made available in the UK and Europe only for persons who are Eligible Counterparties or Professional Clients, and not Retail Clients as defined by Financial Conduct Authority rules. The Commonwealth Bank of Australia and CBA Europe Ltd are both registered in England (No. BR250 and 05687023 respectively).

Commonwealth Bank of Australia: Authorised and regulated by the Australian Prudential Regulation Authority. Authorised by the Prudential Regulation Authority. Subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details about the extent of our regulation by the Prudential Regulation Authority are available from us on request.

CBA Europe Ltd: Authorised and regulated by the Financial Conduct Authority.

In Singapore: The information in this report is made available only for persons who are Accredited Investors or Expert Investor in terms of the Singapore Securities and Futures Act. It has not been prepared for, and must not be distributed to or replicated in any form, to anyone who is not an Accredited Investor or Expert Investor. If you are an Accredited Investor or Expert Investor as defined in Regulation 2(1) of the Financial Advisers Regulations (“FAR”), the Bank is obliged to disclose to you that in the provision of any financial advisory services to you, we are exempted under Regulations 33, 34 and 35 of the FAR from complying with the business conduct provisions of sections 25 (Obligation to disclose product information to clients), 27 (Recommendations by licensees) and 36 (Disclosure of interests in securities) respectively, of the Financial Advisers Act (“FAA”).

In Japan: This document is made available only for institutional customers. Commonwealth Bank of Australia, Tokyo Branch is a licensed banking business authorized by Japan Financial Services Agency.

In Hong Kong: The contents of this document have not been reviewed by any regulatory authority in Hong Kong. You are advised to exercise caution in relation to the offer. If you are in any doubt about any of the contents of this document, you should obtain independent professional advice.

The provision of this document to any person in the Hong Kong does not constitute an offer of securities to that person or an invitation to that person to acquire, apply, or subscribe, for the issue of, or purchase, securities unless the recipient is a person to whom an offer of securities may be made in Hong Kong without the need for a prospectus under section 2 and the Seventeenth Schedule of the Companies Ordinance (Cap. 32 of the Laws of Hong Kong) (“Companies Ordinance”) pursuant to the exemptions for offers in respect of which the minimum consideration payable by any person is not less than HK\$500,000 or its equivalent in another currency. Neither this document nor any part of it is, and under no circumstances are they to be construed as, a prospectus (as defined in the Companies Ordinance) or an advertisement of securities in Hong Kong. The products have not been, nor will they be, qualified for sale to the public under applicable Hong Kong securities laws except on a basis that is exempt from the prospectus requirements of those securities laws. Minimum Investment Amount for Hong Kong Investors: HK\$500,000

In Hong Kong for Equities: This document is distributed in Hong Kong by, and is attributed to, Commonwealth Bank of Australia, Hong Kong Branch (“CBAHK”), which is a registered institution with the Hong Kong Monetary Authority to carry out the Type 1 (Dealing in securities) and Type 4 (Advising on securities) regulated activities under the Securities and Futures Ordinance. Investors should understand the risks in investments and that prices do go up as well as down, and in some cases may even become worthless. If you have any queries concerning this document, please contact CBAHK’s registered representative, James Barratt (T. +612 9117 0109 and E. james.barratt@cba.com.au).

All investors: Analyst Certification and Disclaimer:

Analyst Certification and Disclaimer: Each research analyst, primarily responsible for the content of this research report, in whole or in part, certifies that with respect to each security or issuer that the analyst covered in this report: (1) all of the views expressed accurately reflect his or her personal views about those securities or issuers; and (2) no part of his or her compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by that research analyst in the report. The analyst(s) responsible for the preparation of this report may interact with trading desk personnel, sales personnel and other constituencies for the purpose of gathering, synthesizing, and interpreting market information. Directors or employees of the Group may serve or may have served as officers or directors of the subject company of this report. The compensation of analysts who prepared this report is determined exclusively by research management and senior management (not including investment banking).

Unless agreed separately, we do not charge any fees for any information provided in this presentation. You may be charged fees in relation to the financial products or other services the Bank provides, these are set out in the relevant Financial Services Guide (FSG) and relevant Product Disclosure Statements (PDS). Our employees receive a salary and do not receive any commissions or fees. However, they may be eligible for a bonus payment from us based on a number of factors relating to their overall performance during the year. These factors include the level of revenue they generate, meeting client service standards and reaching individual sales portfolio targets. Our employees may also receive benefits such as tickets to sporting and cultural events, corporate promotional merchandise and other similar benefits. If you have a complaint, the Bank’s dispute resolution process can be accessed on 132221.

Unless otherwise noted, all data is sourced from Australian Bureau of Statistics material (www.abs.gov.au).

