Commonwealth Bank of Australia 05/09/2017 FAT-AUS-838

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Fat Prophets take profits

It has been an action packed few months for Commonwealth Bank of Australia (ASX, CBA) since our last review. With the impact of a new Federal levy sinking in, the bank, along with the rest of the sector received a boost from APRA's decision on capital requirements, which was less onerous than expected. A cause for joy though was relatively short-lived, with the announcement that financial intelligence agency AUSTRAC had initiated Federal Court action against CBA for breaches of the Anti-Money Laundering and Counter Terrorism Act.

The possible ramifications of the legal action also served to take some of the gloss off a strong full year result last month. Adding further to the soap opera has been the prospect of a shareholder class action, as well as confirmation from CEO Ian Narev that he will be stepping down during the 2018 financial year.

This is all a lot for any company to handle in a few years, let alone a few months, and the market has also cast its vote, with the CBA selling off relative to its peers. We also believe that sentiment is likely to remain fragile, and that the bank, which has historically traded at a premium to the sector, will lose further lustre. This also could be a drawn out process with the next hearing on the AUSTRAC case not scheduled till next April.

We are positive on the banking sector, and indeed hold the big Four, as well as Bank of Queensland in the Fat Prophets Portfolio. We have though tended to favour the laggards, and indeed we have not issued a buy recommendation for some time on CBA, and especially while near current levels. Our last recommendation for 'action' on CBA was in fact a 'sell half' call at $80 in 2014.

While CBA is not overly expensive at 13 times earnings, and with a yield of 6 percent, the case for holding is no longer as compelling in our view, and given material bank-specific uncertainties on various levels. **We therefore recommend that Members sell their holdings in CBA**, banking a gain of 112 percent (including dividends) since our initial recommendation.

Turning to the charts, and with reference to the daily, prices have broken below the 50-day moving average (green line) (as well as the 200 day in red), which is suggestive that momentum is rotating south. A zone of support (see monthly chart) around $80 has also been breached.

Recent Developments

There has been plenty to chew on since our last coverage of CBA in mid-May. Working in chronological order, in late May, management estimated that the earnings impact of the Federal government's levy would be around $220 million after tax. This is probably a cautious forecast though, as we expect that the bank tax inevitably will be passed on by the big players to customers.

The APRA decision on capital requirements though was more positive, with a Common Equity Tier 1 (CET1) Capital target of 10.5 percent set in stone. CBA along with others though have till January 1, 2020 to reach this. Recent results show CBA's CET1 at year end was 10.1 percent, leaving some more work to do than other banks, but also with plenty of time up its sleeve. In any event, CBA, as with the other banks, are indeed 'unquestionably strong', which is also ironic given a ratings downgrade (by Moody's) seen by the sector in June.

At the start of August, a company specific blow came with financial intelligence agency AUSTRAC (Australian Transaction Reports and Analysis Centre) initiating Federal Court action. The agency alleges CBA breached the Anti-Money Laundering and Counter Terrorism Act, not reporting suspicious transactions valued at around $625 million using the bank's ATMs, also ignoring warnings from various authorities including the Federal Police.

Banks are required to report to AUSTRAC all transactions above $10,000 and AUSTRAC alleges there were over 50,000 instances since 2012 where CBA did not do so. Each breach carries a maximum penalty of $18 million or a potential fine of almost $1 billion. As such, CBA now has a fight on its hands, and has gone into damage control to show that any operational failings are being addressed, but as usual the maximum penalties will never see the light of day.

The issue though is the level of uncertainty it will create, and which is set to drag on. Yesterday it was announced that CBA had been given till 15th December 2017 to file a defence, with AUSTRAC's response due by 16th March 2018. A further hearing has been set for 2 April 2018, so this case is likely to drag on for a year at a minimum, if not much more.

Added to the situation is the prospect of class actions by shareholders as a result. US regulators have also been drawn into proceedings (CBA holds banking licences there), and apparently are in ‘dialogue’ with the bank.

A further unknown is to what extent CBA’s brand will be damaged as the saga drags on. While this could well prove to be a ‘storm in a teacup,’ this will not be clear for some time yet. The market though has already spoken with CBA shares down around 10 percent since the AUSTRAC claim, versus a fall of around 3 percent for the ASX 200 banking index.

Full year results

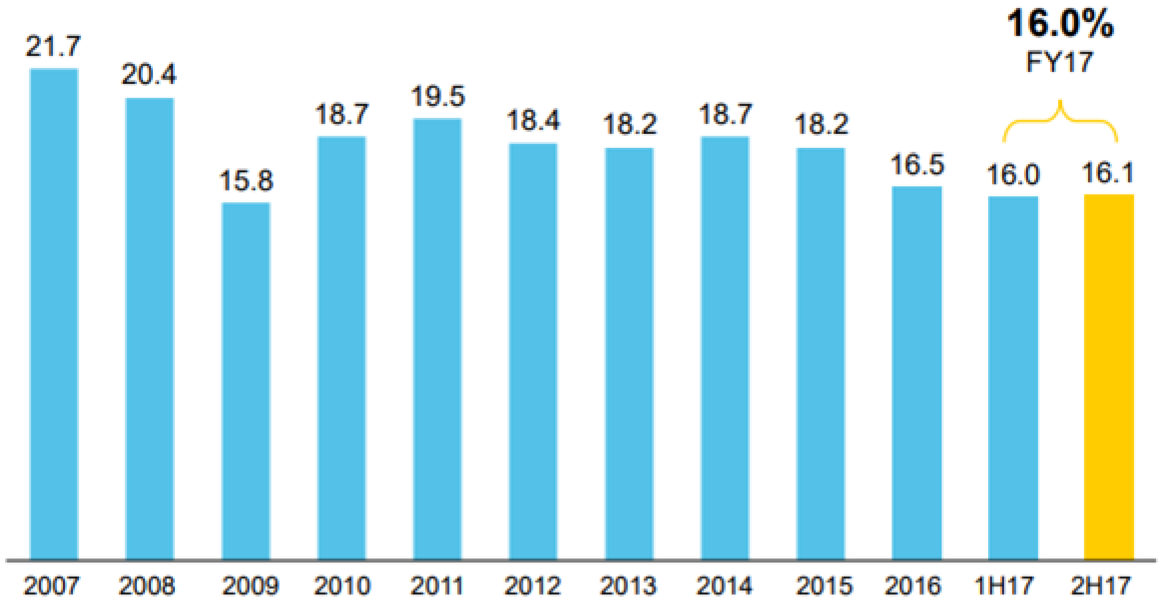
The filing also overshadowed the release of what was a strong full year result by CBA only a few days later. Cash profit for the 12 months to 30 June rose 4.6 percent to $9.88 billon, which was comfortably ahead of estimates of $9.8 billion.

Revenues rose 1 percent to $44.95 billion, while profit at the retail banking business leapt 9 percent during the year. Mortgage repricing initiatives are clearly having an impact and an ongoing trend here is a fundamental reason why we are (and have been) positive on the banks. Cost control was also impressive, with operating expenses falling 5 percent for the year, and also helped a 2.1 percent lift in the full year dividend per share to $4.29.

		Jun 17 vs Jun 16	
Statutory Profit ($m)	9,928	**7.6%**	
Cash NPAT ($m)	9,881	**4.6%**	
Cash Earnings per Share ($)	5.74	**3.5%**	
Dividend per Share ($)	4.29	**2.1%**	
ROE – Cash		**16.0%**	(from 16.5%)

Source: Company Results Presentation

Returns on equity though contracted over the year by 50 basis points to 16 percent. Management also revealed they were considering selling the bank’s life insurance arm, and in our view the timing might not be ideal to extract the best price here.



Source: Company Results Presentation

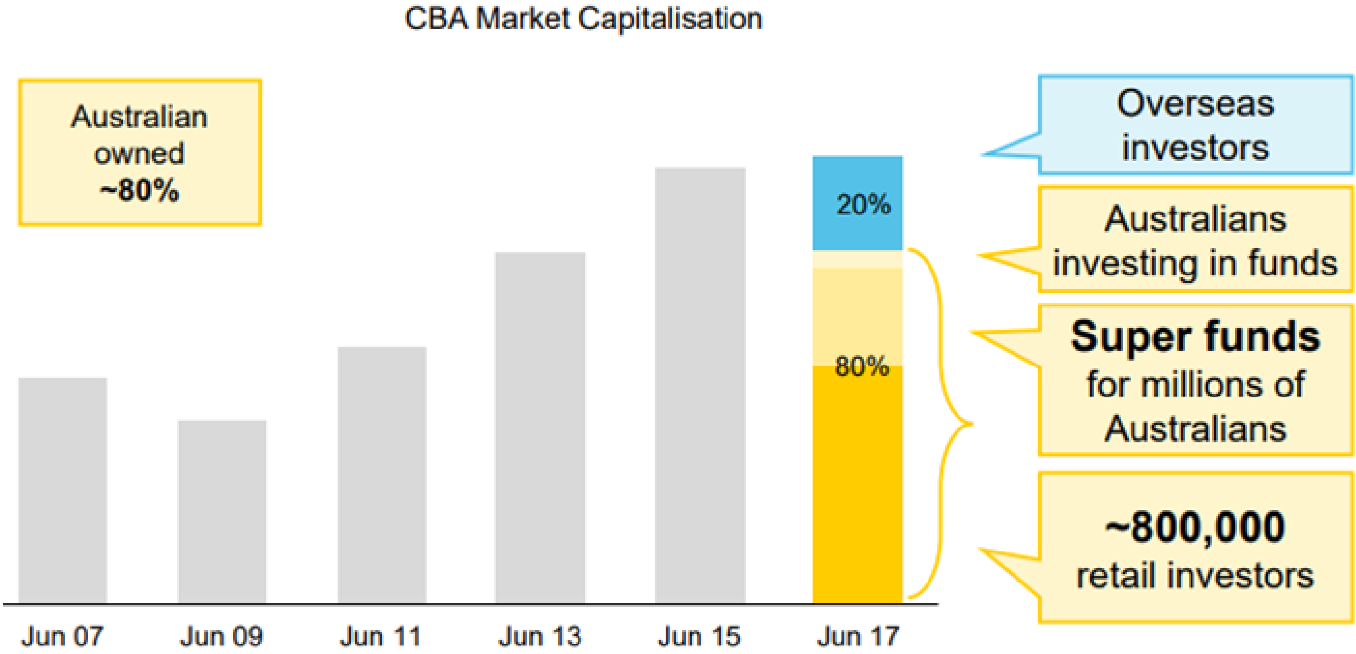
Certainly, there are still some margin pressures, with CBA's net interest margin falling 3 basis points to 2.11 percent. But on the other side costs are in focus, and impairments have been well contained – bad and doubtful debts are at their lowest for more than two years.

The bank though continues to see volume growth, despite a competitive market, with $102 billion in new funding over the period, driving the home loan book to $436 billion.

The bank did however note that compliance and risk spending had risen by 29 percent over the last five years to a cumulative $3.6 billion, including $230 million in anti-money laundering compliance and reporting processes and systems. Given the AUSTRAC matter, and potential outcomes, we expect further costs will be tipped in here.

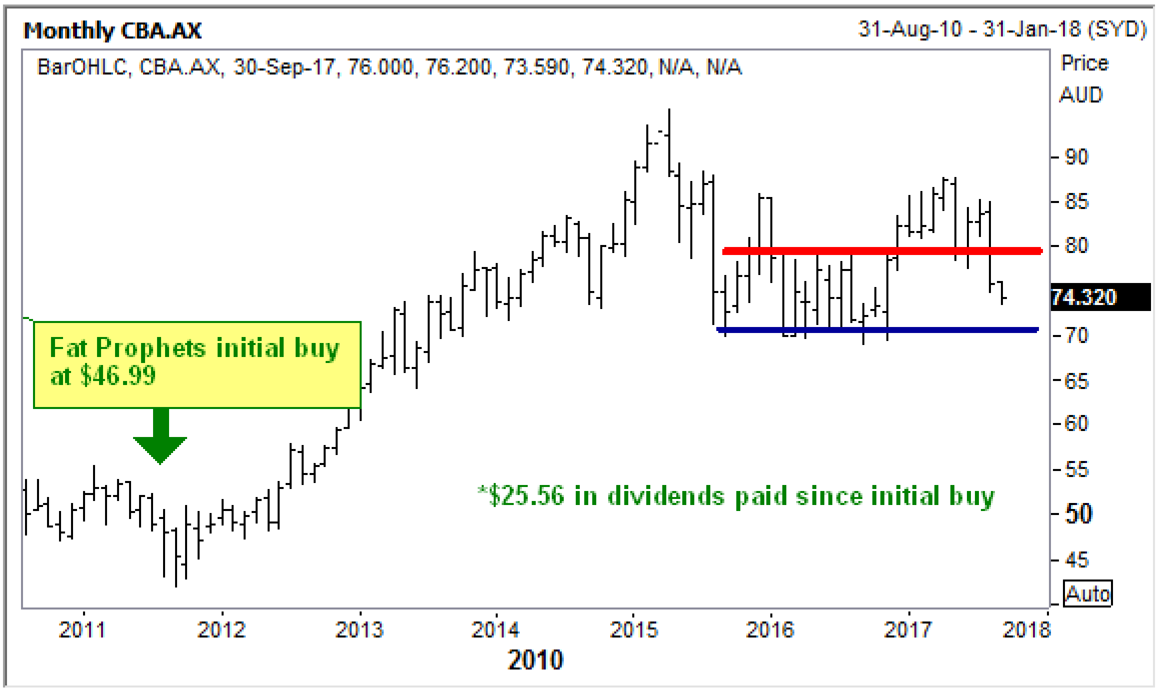
The actual trial when it comes will unlikely to be a matter for Ian Narev who is retiring by 30 June 2018. He has done a strong job during his tenure in our view, but the fact that the buck stops with the CEO meant that he was always likely to fall on his sword following the AUSTRAC action. The appointment of a new CEO could well be a positive, but it won't exactly draw a line under matters, and indeed only adds a further layer of uncertainty.

The question is how much more investors will react, and not just those domestically? Around 20 percent of the share register in CBA is held offshore, and arguably these may dwell on company specific headwinds as a reason to reposition into CBA's competitors.



Source: Company Presentation

With reference to the monthly chart, prices have entered a corrective phase of the overall technical cycle after printing a high of $87.69 intra-month in May. A break below support at $80 weakens the technical picture, with the next layer existing around the $70 mark.



Summary

It has been an action packed few months for Commonwealth Bank of Australia since our last review. With the impact of a new Federal levy sinking in, the bank, along with the rest of the sector received a boost from APRA's decision on capital requirements, which was less onerous than expected. A cause for joy though was relatively short-lived, with the announcement that financial intelligence agency AUSTRAC had initiated Federal Court action against CBA for breaches of the Anti-Money Laundering and Counter Terrorism Act.

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We are positive on the banking sector, and indeed hold the big Four, as well as Bank of Queensland in the Fat Prophets Portfolio. We have though tended to favour the laggards, and have not been inclined to buy into CBA's premium rating in recent years.

While CBA is not overly expensive at 13 times earnings, and with a yield of 6 percent, the case for holding is no longer as compelling in our view, and given material bank-specific uncertainties on various levels. **We therefore recommend that Members sell their holdings in CBA**, banking a gain of 112 percent (including dividends) since our initial recommendation.

Disclosure: Commonwealth Bank of Australia is held in the Fat Prophets Australian Share Income Model.

Snapshot CBA

Commonwealth Bank of Australia

Latest Closing Price: $74.49

Reuters: Commonwealth Bank of Australia (the Bank) is an Australia-based bank. The Bank, along with its subsidiary, is engaged in the provision of a range of banking and financial products and services to retail, small business, corporate and institutional clients. The Bank is a provider of integrated financial services, including retail, business and institutional banking, superannuation, life insurance, general insurance, funds management, broking services and finance company activities.

The Bank operates in seven segments: Retail Banking Services, Business and Private Banking, Institutional Banking and Markets, Wealth Management, New Zealand, Bankwest and Other. Its Retail Banking Services segment provides home loan, consumer finance and retail deposit products. Its Business and Private Banking segment provides banking services. The Bank operates primarily in Australia, New Zealand, United Kingdom, United States and Asia Pacific.

Market Capitalisation:$129.3b

	FY1	FY2
Price to Earnings	12.8	12.5
Dividend Yield (%)	5.9	6.0
Price to Book	1.97	1.86
Return on Equity (%)	16.1	15.6