Commonwealth Bank of Australia CBA

Valuation and triggers upgraded

Analyst Recommendation: **Hold** 18 September 2009

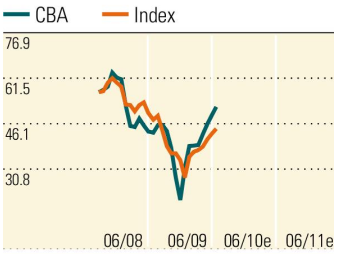
Buy	Accumulate	**Hold**	Reduce	Sell
$ 36.70	38.85	51.80	56.10	

▼**49.09** Last Price

Snapshot

Business Risk	Medium
Price Risk	Medium
Moat Rating	Narrow
Fair Value $	43.15
Market Cap $Mil	74,558
Morningstar Style Box	
Last Price $	49.09
52 Week High/Low $	49.87/24.03
Shares Issued Mil	1,519
Sector	GICS - Banks
Company Beta	0.73
Sector Beta	0.76

Price vs. Market



	06/08	06/09	06/10e	06/11e
NPAT	4,685.0	4,358.0	4,730.0	5,400.0
EPS¢	344.4	292.7	309.9	353.8
EPS Chg%	1.4	-15.0	5.9	14.2
DPS	266.0	228.0	250.0	270.0
Franked%	100	100	100	100
Div Yld%	5.2	6.3	5.1	5.5
P/E	14.8	12.3	15.8	13.9

Source: Morningstar analyst estimates.

Business Description

Commonwealth Bank of Australia (CBA) is Australia's largest retail bank and one of the 'Big Four'. It also operates in New Zealand and Asia. Its core business is the provision of retail, business and institutional banking services. It is also a major fund manager and has increasing market shares in general and life insurance.

Investment Rating

CBA is one of the country's four major banks and provides banking and financial services in Australia, New Zealand and Asia. It has a powerful retail and business banking franchise in the first two. The branch network and the universally recognised brand are significant competitive advantages but interest margins are still vulnerable to price competition. The loan book is mostly conservatively managed but the current cyclical increase in bad debts is the main near-term earnings risk. The bank has consistently grown shareholder wealth in favourable economic times and major banks are more attractive to investors following the collapse of non-banks. Suitable for long-term income and growth portfolios.

Event

► CBA's FY09 impairment charges surged from $930m to $2.935bn and $3.048bn including Bankwest – after more than doubling in FY08 from $434m in FY07.

► The FY10 impairment charge will decline but will remain well above the average $472m for the five years FY04 to FY08.

Impact

► The impairment charge is expected to decline in FY10 but will remain elevated and well above the FY04-FY08 average. There should be a larger decline in the FY11 charge.

► Following the massive upheaval in the global banking sector we look for a more normal year on which to base our longer-term valuation. FY11 shapes as that year and we now move to an average of the FY10 and FY11 EPS as our base and apply an unchanged PER of 13. Fair value increases 7% to $43.15.

► During the period of heightened uncertainty we adopted and used varying discounts to fair value to set price triggers for the other major banks – ANZ, NAB and WBC. At the height of the GFC we used a discount of 30% for the Buy trigger and 20% for Accumulate and gradually reduced the discount as the risk abated and the global credit markets thawed. Westpac, the most comparable of the banks to CBA in terms of operational structure and risk profile, currently has the Buy and Accumulate triggers set at a 15% and 10% discount to fair value respectively. For comparability and consistency we move CBA from PER-based triggers to similar discounts. Similarly the Hold and Reduce triggers adopted for Westpac are introduced and are set at 20% and 30% premiums to fair value. The combination of a 7% lift in CBA's fair value and the adoption of similar discounts and premiums to Westpac results in changes to our price triggers.

Recommendation Impact

Upgrade from Reduce to Hold.

Commonwealth Bank of Australia CBA

David Walker
Morningstar Analyst

Analyst Note
Valuation and triggers upgraded

The global financial crisis was in fact a global banking crisis. Global banking shares were those worst affected and in many cases rightly so. As mentioned in the YMW overview on several occasions the US banking index fell some 90% to the March 2009 lows – another 10% and the market capitalisation was zero. There just had to be a bounce. The Australian banks fared very well in comparison due to tighter regulatory controls and the quick reaction by government to guarantee both deposits and offshore borrowings.

Of the Australian Big Four banks Commonwealth and Westpac weathered the crisis better than ANZ and National. While both had exposure to big name corporate failures and the normal portfolio impairments as the credit cycle tightened they were not exposed to offshore toxic derivative-style assets or conduit/special purpose entities. CBA's FY09 impairment charges surged from $930m to $2.935bn and $3.048bn including Bankwest – after more than doubling in FY08 from $434m in FY07. Despite the large increase in impairment charge, cash earnings fell $318m or 6.7% to $4.415bn – thanks to robust 14% growth in total operating income and good cost control. The FY10 impairment charge will decline but will remain well above the average $472m for the five years FY04 to FY08.

The impairment charge is expected to decline in FY10 but will remain elevated and well above the FY04-FY08 average. Hopefully there will be a more significant decline in the FY11 charge. Following the massive upheaval in the global banking sector we look for a more normal year on which to base our longer-term valuation. FY11 shapes as that year and we now move to an average of the FY10 and FY11 EPS as our base and apply an unchanged PE multiple of 13. Fair value increases 7% to $43.15.

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We use a PER of 13 to establish the longer-term fair value for all four major banks. The use of discounts allows a more flexible approach to setting price triggers in a volatile and still uncertain global environment. While the Australian banks operate in a relatively sound domestic credit environment the cost of raising funds in international credit markets is significantly influenced by global factors outside management control. This will affect interest rate decisions independently of moves in official rates.

While the Australian banks are in sound financial shape they are part of the global system and will have to comply with global requirements. It appears the too-big-to-fail banks, which would include Australia's Big Four, will be required to hold more capital in future, putting pressure on the recovery in the return on equity and EPS. There may be a substitution of equity for some hybrid Tier 1 capital and Tier 2 capital.

Commonwealth Bank of Australia CBA

Bulls Points

- CBA is taking large amounts of profitable market share from foreign banks and securitising non-banks unable to fund their loan books. This should increase earnings during the next economic upturn. Pricing power in home and business loans has increased.
- CBA is a play on recovery from the local recession and thawing world credit markets.
- The rally on equity markets will boost wealth management earnings.

Bears Points

- CBA has been able to sustain double-digit growth in banking income due to market share gains, but these cannot go on forever. At some point revenue growth will slow towards system rates.
- Elevated provisioning and impairment expense are probable in FY10.
- The company recently tarnished its reputation by not disclosing an increase in its bad debts guidance before an equity raising. There are now question marks over management's commitment to transparency with the market.
- The cost of wholesale funding remains high and price competition for deposits is vigorous. Both effects are pressuring net interest margins.

Enhanced competitive position post-credit crisis

Thesis Last Updated: 18 Sep 2009

CBA is one of Australia´s four major banks. It offers a full suite of banking services in Australia and New Zealand, also operates in certain Pacific and Asian countries, and sells wealth management, life and general insurance in Australia. The credit crisis exposed several costly examples of bad risk management but in the long run the bank has consistently grown shareholder wealth in favourable economic times. The loan book´s large weighting to home loans and the high proportion of deposits in funding have served the bank well. CBA has weathered the global financial crisis to remain one of the few AA-rated banks left in the world.

A narrow moat rating is justified. Securitising non-bank financials and foreign banks used to generate fairly strong competition for CBA in home and business loans and business deposits but the bank´s ROE has not fallen below the cost of equity for the last 10 years. Foreign banks are a diminished force now but in their heyday they never mounted a serious assault on the retail brand equity, market shares or branch networks of the major banks. The sunk costs and infrastructure were too great to replicate. Local regional banks have tended to follow the majors on pricing and are not currently in a position to threaten CBA´s economic returns.

The durable moat, zero investment in US subprime debt, reasonably well-regarded management, strong capital ratios and the diversified, overall conservative loan book enable CBA to raise enough capital to participate in the major banks´ post-credit crisis takeover of the local market despite rising bad debts in the recession. CBA and its peers are emerging with a stranglehold over retail and business deposits and home loans. In business loans the major banks are virtually able to dictate terms and take desirable market share long held by foreign banks. This substantial improvement in the majors´ competitive position should increase their profitability during the next economic upturn.

Until then CBA will face slowing system lending growth and rising bad debts and loan writeoffs in the consumer and business books. Bad debt expense should fall significantly in FY11. The cost of deposit and wholesale funding remains high, though stronger pricing power should enable CBA to recover most of these extra costs.

Long-term investors should add to positions in CBA as and when the share price falls into our Buy and Accumulate ranges.

Valuation Last Updated: 18 Sep 2009

We value CBA at $43.15 for a long-term multiple of 13.0x the average of our FY10 and FY11 EPS forecasts. This multiple balances CBA´s market power and narrow moat with the risks created by the bank´s high leverage.

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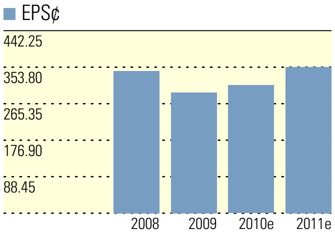
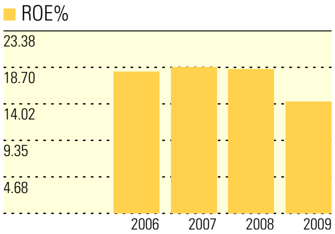
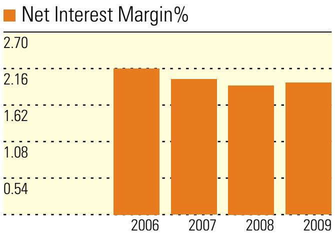
EPS



ROE



Net Interest Margin%



Risk Last Updated: 23 Jul 2009

CBA is a leveraged financial group which lends to all segments of the economy. It is therefore exposed to deteriorating economic conditions. Higher interest rates, inflation and unemployment can all reduce loan growth and increase bad and doubtful debts expense, while exchange rate volatility can affect certain sectors. Banks are tightly regulated and are thus exposed to adverse regulatory changes. An unexpected loss of market share in any major segment, coupled with contraction in net interest margins, would diminish net interest income. CBA might not be adequately provisioned for the bad debts arising out of the recession. Wealth management earnings depend on the levels and direction of equity markets.

Financial Overview

Growth

FY10 revenue growth should diminish as market share gains run their course and system credit growth slows.

Profitability

Earnings should recover moderately in FY10 as the large single-name provisions of 1H09 drop out. Earnings will remain under pressure from elevated provisioning on the consumer and SME books.

Financial Health

CBA’s capital ratios are some of the strongest in the world. The bank is one of the world´s few AA-rated banks.

Strategy Analysis Last Updated: 29 Jul 2009

CBA's strategy is focused on Australia, New Zealand and Asia. The CEO´s strategic priorities are customer service, business banking, technology and operational excellence, trust and team spirit, and profitable growth. CBA has invested heavily in customer service training and new staff to recover market share losses in home loans and deposits. The bank has recruited new business bankers and has upgraded its service offer. In IT there is a new shared services approach. CBA aims to improve staff engagement and reduce turnover. The bank sees medium-term growth opportunities in Asia and has built a portfolio of holdings in Asian banks. CBA avoids business it perceives to be high-risk or which doesn´t meet its return criteria; the aim is to keep credit quality strong. CBA is always assessing potential acquisitions and acquired Bankwest in 2008.

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Forecasts	Actual				
	30 Jun 2005	30 Jun 2006	30 Jun 2007	30 Jun 2008	30 Jun 2009
Per Share					
Earnings ¢	328.5	296.7	339.7	344.4	292.7
Dividends ¢	197.0	224.0	256.0	266.0	228.0
Franking %	100.0	100.0	100.0	100.0	100.0
Profit & Loss $Mil					
Net Interest Income	5,966.0	6,514.0	7,036.0	7,907.0	10,301.0
Provision for Doubt. Debts	-644.0	-398.0	-434.0	-930.0	-3,048.0
Non Interest Income	12,021.0	8,806.0	9,307.0	6,749.0	7,075.0
Total Operating Income	17,343.0	14,922.0	15,909.0	13,726.0	14,328.0
Non Interest Expense	11,705.0	9,208.0	9,371.0	7,529.0	8,487.0
Profit Before Tax	5,638.0	5,714.0	6,538.0	6,197.0	5,841.0
Income Tax	-1,637.0	-1,900.0	-2,041.0	-1,433.0	-1,396.0
Outside Equity Int.	-10.0	-31.0	-27.0	-31.0	-30.0
Profit after Tax	3,991.0	3,783.0	4,470.0	4,733.0	4,415.0
Significant Items after Tax	–	145.0	–	58.0	308.0
Reported Profit after Tax	3,991.0	3,928.0	4,470.0	4,791.0	4,723.0
Growth %					
Assets	0.0	0.1	0.2	0.1	0.3
Net Interest Income	0.0	0.1	0.1	0.1	0.3
Ratios					
Net Interest Margin	2.4	2.2	2.0	1.9	2.0
Interest Spread	2.1	1.3	1.0	1.0	1.5
Non-Int Inc/Total Inc	69.3	59.0	58.5	49.2	49.4
Tot Op. Inc/Tot Assets	5.3	4.0	3.7	2.8	2.3
Return on Equity	16.5	18.2	18.7	18.5	14.3
Return on Assets	1.2	1.0	1.0	1.0	0.7
Cost to Income	63.3	59.8	56.9	50.7	48.0
Equity/Assets	7.9	5.8	5.7	5.4	5.1
Cash Flow $Mil					
Interest Income	16,205.0	19,712.0	23,123.0	29,464.0	31,745.0
Interest Expense & Prov.	-10,198.0	-12,555.0	-16,405.0	-20,786.0	-20,986.0
Cash From Operations	4,369.0	1,166.0	5,641.0	-2,075.0	1,476.0
Proceeds from Issues	389.0	988.0	74.0	3.0	4,830.0
Dividends Paid	-2,083.0	-2,163.0	-2,284.0	-2,351.0	-2,620.0
Change in Assets	23,040.0	40,068.0	56,036.0	62,433.0	132,800.0
Change in Liabilities	21,865.0	44,785.0	52,935.0	60,740.0	127,495.0
Free Cashflow to Equity	3,194.0	5,883.0	2,540.0	-3,768.0	-3,829.0
Cash at Beginning	2,846.0	1,276.0	2,038.0	4,084.0	2,265.0
Cash at End	935.0	2,038.0	4,084.0	2,265.0	2,186.0
Net Increase in Cash	-1,911.0	762.0	2,046.0	-1,819.0	-79.0
Balance Sheet					
Cash	1,869.0	2,063.0	10,108.0	7,736.0	11,340.0
Due from Other Banks	–	7,033.0	5,495.0	6,984.0	–
Trading Securities	28,693.0	33,290.0	36,050.0	37,336.0	49,629.0
Loans and Advances	217,888.0	259,307.0	299,779.0	361,282.0	466,631.0
Total PP&E	1,344.0	1,314.0	1,436.0	1,640.0	2,472.0
Other Non Earning Assets	62,455.0	47,786.0	53,550.0	54,316.0	75,572.0
Total Assets	329,035.0	369,103.0	425,139.0	487,572.0	620,372.0
Deposits	168,029.0	173,227.0	203,382.0	263,706.0	368,721.0
Due to Other Banks	8,023.0	11,184.0	14,386.0	17,672.0	15,109.0
Bonds & Notes	64,912.0	78,591.0	85,490.0	85,817.0	101,819.0
Other Liabilities	42,780.0	63,913.0	75,380.0	73,754.0	86,259.0
Total Liabilities	302,975.0	347,760.0	400,695.0	461,435.0	588,930.0
Share Capital	16,131.0	14,444.0	15,422.0	16,666.0	22,581.0
Retained Earnings	3,516.0	4,487.0	6,367.0	7,747.0	7,825.0
Other Equity	6,413.0	2,412.0	2,655.0	1,724.0	1,036.0
Total Shareholders Equity	26,060.0	21,343.0	24,444.0	26,137.0	31,442.0

Disclosure and Research Methodology

We seek undervalued stocks with a medium to long-term investment time horizon. Companies that make the best investments tend to be those able to grow earnings per share year after year and which are able grow at rates above the average of the market. Earnings growth supports a solid and growing dividend stream which is the essence of shareholder return.

In searching for the best businesses in the market, we want to see an ability to turn revenue into profits and a record of strong returns to equity. The ability to generate strong free cash flow is critical as this is where the funds come from to pay dividends or to invest in new growth areas. The greatest free cash flow generators will have strong margins, good controls over working capital and limited requirement for capital expenditure. The best businesses will also have robust balance sheets including a not onerous level of debt. We believe in strong, experienced and disciplined management.

Recommendations

Our qualitative recommendations are simple and easy to understand:

- Buy: Suitable for purchase now
- Accumulate: Undervalued but there is time to purchase
- Hold: Appropriately priced, neither buy nor sell
- Reduce: Sell part holding
- Sell: Sell all holdings now
- Avoid: Not investment grade

Economic Moats

The pursuit of high quality businesses is central to our investment philosophy. These offer the greatest gains to the long term investor, so long as they are bought at a reasonable price. The concept of economic moats is valuable in assessing the quality of a business, with the phrase popularised by Warren Buffett and Charlie Munger. Just as wide moats protected castles from invaders in medieval times, businesses with wide economic moats have strong defences against their profits being competed away.

We ascribe a moat rating to each stock researched: Wide, Narrow or None.

The moat is the competitive advantage that one company has over other companies in the same industry. Wide moat firms have unique skills or assets, allowing them to stay ahead of the competition and earn above-average profits for many years. Returns on their invested capital will exceed the cost of that capital. Without a moat, highly profitable firms can have their profits competed away. Other companies will see how attractive the market is and try to move in to reap some of the rewards themselves.

Sources of economic moats include innovation skills or first mover advantages, a superior cost position, the ability to provide a range of products to suit the needs of a variety of markets, high switching costs or locking out of competitors.

The moat rating is just one of the ingredients used in determining whether a company is undervalued, though it is obviously an important one. We are not saying that no-moat companies should be avoided. Simply, the very best long term investments are in wide moat firms bought when they are undervalued.

Intrinsic Value

Intrinsic Value (otherwise known as Fair or Underlying Value) is the analyst's interpretation of what the stock is worth today. The stock is considered to be undervalued when the quoted price is below this point or overvalued where the price is above it.

Whether to invest in a stock will depend on consideration of the prospective return and the risk undertaken. Prospective return includes both share price moves and dividend yield. Our analysts incorporate the stock's risk in their intrinsic value. Other things being equal, lower risk stocks will have greater intrinsic value than higher risk ones. A stock becomes a buy when the quoted share price is at a discount to intrinsic value that provides a sufficient prospective return.

Business Risk

Business risk encompasses all operational risk and financial risk. Companies with low business risk have the most reliable earnings streams. A change in business conditions may reduce earnings predictability and therefore increase risk. Examples are market entry of a new competitor, unfavourable shifts in the economy, changes in key management personnel, major investment in an uncertain new venture or acquisition, and increased interest burden caused by higher debt levels or raised interest rates.

Pricing Risk

Pricing risk reflects the premium or discount implied in the current price of the shares. Many growth stocks trade on high earnings multiples giving them high pricing risk though they may have low business risk. Investors should consider their risk tolerance before investing in the share market. Many investors will decide to have only low risk stocks in their portfolio though others will accept higher risk levels in order to pursue higher returns.

Declaration

Declaration of personal and HIC shareholdings, disclosure list. These positions can change at any time and are not additional recommendations. AAX, ABS, ACL, AFG, AGK, AHI, ALL, ALS, ALZ, AMP, ANP, ANZ, APA, ASX, AVX, AXA, AXO, BBG, BCM, BHP, BKN, BKW, BVA, BXB, CAB, CBA, CBD, CBH, CDR, CEY, CMR, COH, CRK, CTX, CXS, CYG, DOM, DOW, EGL, EQN, ERA, FLX, FXJ, FXL, GCL, GNS, GWT, HIC, HIL, HIT, HVN, IAG, IIN, IVC, LYC, MCR, MFC, MIG, MLB, MQG, MSL, MTS, MXL, NAB, NHC, NHF, NLB, PBT, PGA, PGL, PGM, PMM, PNA, PPT, PRE, PTM, PTS, QBE, RHC, RIO, SBP, SFH, SGB, SGL, SGT, SHL, SMX, SRX, STO, STW, SUN, TAH, TEN, TLS, TOL, TRF, TRS, TSE, UGL, UXC, VGH, VPG, WBC, WES, WOR, WOW, WPL, WSA