Commonwealth Bank
Defying Gravity

**Event**
- CBA reports its full-year result on 15 August. We forecast full-year cash NPAT of A$7,118m (4.1% yoy growth), full-year cash EPS of 433cps (2.9% yoy growth) and a full year dividend of 325cps (1.6% yoy growth). Given the stock has been super-charged by the yield thematic, we believe the result is likely to focus on areas addressing dividend sustainability/enhancement such as capital generation (capital intensity, BankWest Basel 2 advanced impact) and earnings growth outlook (particularly cost and margin outlook).

**Impact**
- **Yield thematic super-charging CBA stock price with certain markets pricing c5% dividend growth despite negative EPS growth expectations**
  - Recently, the options market has priced the CBA 2H12 dividend as high as 190cps (consensus: 190cps; MQG: 188cps). This represents c. 5% pcp dividend growth, despite consensus forecast EPS growth of -1% pcp. This is likely to set the tone for the result with a focus on yield sustainability, keeping in mind the market appears to be forecasting 5% dividend growth next year.

- **Case for (absolute) dividend sustainability – Cost containment and BankWest Basel 2 advanced status**
  - The CBM program nearing completion and redundancies may result in better than expected cost growth (FY12 forecast 2.1%). More importantly cost out, if quantified, could provide an all important offset in the presence of anaemic balance sheet growth. There is also a chance at this result that CBA may announce that BankWest has attained Basel 2 advanced status which could add c30bp to core tier 1.

- **Case against (absolute) dividend sustainability – Anaemic balance sheet growth, margin outlook, BDD normalisation and rising capital intensity**
  - CBA loan growth has been sub 2% over 2H12 suggesting continued sluggish balance sheet momentum. While likely to have benefited from recent repricing moves, deposit cost pressure remains raising questions over the margin outlook for CBA. CBA’s BDD’s remain at below normal levels in our view, with normalisation likely in FY13. Finally we also expect that this result may shed light on the changing capital intensity for the Group as business lending becomes a bigger driver of balance sheet growth.

**Earnings and target price revision**
- No change

**Price catalyst**
- 12-month price target: $A48.03 based on a DDM/PE methodology.
- Catalyst: FY12 result – 15 August 2012.

**Action and recommendation**
- While yield has driven the recent share price run, we view this as one off in nature and a de-rating risk. Given this, our longer term thesis on CBA remains intact and is strengthened by CBA’s record premium to peers. Underperform.
Analysis

- CBA reports its full-year result on 15 August 2012. We forecast full-year cash NPAT of A$7,118m (4.1% yoy growth), full year cash EPS of 433cps (2.9% yoy growth) and a full year dividend of 325cps (1.6% yoy growth).

**Fig 1 Key result forecasts**

<table>
<thead>
<tr>
<th></th>
<th>2H11</th>
<th>2011</th>
<th>1H12</th>
<th>2H12</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash NPAT (A$m)</td>
<td>3,500</td>
<td>6,835</td>
<td>3,576</td>
<td>3,542</td>
<td>7,118</td>
</tr>
<tr>
<td>Cash EPS (A$)</td>
<td>215</td>
<td>421</td>
<td>219</td>
<td>214</td>
<td>433</td>
</tr>
<tr>
<td>Net Interest Margin (%)</td>
<td>2.20%</td>
<td>2.16%</td>
<td>2.14%</td>
<td>2.09%</td>
<td>2.12%</td>
</tr>
<tr>
<td>Loan Growth (%)</td>
<td>1.6%</td>
<td>1.0%</td>
<td>2.5%</td>
<td>2.1%</td>
<td>4.7%</td>
</tr>
<tr>
<td>Deposit Growth (%)</td>
<td>1.5%</td>
<td>7.1%</td>
<td>7.6%</td>
<td>2.1%</td>
<td>9.9%</td>
</tr>
<tr>
<td>Cost growth (%)</td>
<td>1.7%</td>
<td>4.6%</td>
<td>2.7%</td>
<td>2.1%</td>
<td>4.6%</td>
</tr>
<tr>
<td>Cost / Income (%)</td>
<td>45.6%</td>
<td>45.5%</td>
<td>45.5%</td>
<td>46.5%</td>
<td>46.0%</td>
</tr>
<tr>
<td>Impairment Cost (A$m)</td>
<td>558</td>
<td>1,280</td>
<td>545</td>
<td>557</td>
<td>1,102</td>
</tr>
<tr>
<td>Impairment Cost (bp GLAA)</td>
<td>22</td>
<td>25</td>
<td>21</td>
<td>21</td>
<td>20</td>
</tr>
<tr>
<td>DPS (A$)</td>
<td>188</td>
<td>320</td>
<td>137</td>
<td>188</td>
<td>325</td>
</tr>
<tr>
<td>Payout Ratio (%)</td>
<td>87.4%</td>
<td>76.1%</td>
<td>62.6%</td>
<td>87.9%</td>
<td>75.1%</td>
</tr>
</tbody>
</table>

Source: Company data, Macquarie Research, August 2012

- Given the stock has been super-charged by the yield thematic, we believe the result is likely to focus on areas addressing dividend sustainability/enhancement such as capital generation (capital intensity, BankWest Basel 2 advanced impact) and earnings growth outlook (particularly costs and margin outlook).

**Yield thematic super-charging CBA stock price with certain markets pricing c5% dividend growth despite negative EPS growth expectations**

- Recently, the options market has priced the CBA 2H12 dividend as high as 197cps (consensus: 190cps; MQG: 188cps).

**Fig 2 Recently, the market has priced in up to a 4.8% increase in CBA’s 2H12 dividend**

<table>
<thead>
<tr>
<th></th>
<th>2H11 (cps)</th>
<th>f2H12 (cps)</th>
<th>2H11 vs. 2H12 (pcp %)</th>
<th>Payout Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>MRE</td>
<td>188</td>
<td>188</td>
<td>0.0%</td>
<td>87.9%</td>
</tr>
<tr>
<td>Market</td>
<td>188</td>
<td>190</td>
<td>1.2%</td>
<td>88.8%</td>
</tr>
<tr>
<td>Options Market</td>
<td>188</td>
<td>197</td>
<td>4.8%</td>
<td>92.1%</td>
</tr>
</tbody>
</table>

Source: Company data, Macquarie Research, July 2012

- This represents c. 5% pcp dividend growth, despite consensus forecast EPS growth of -1% pcp. This is likely to set the tone for the result with a focus on yield sustainability, given the market appears to be forecasting 5% dividend growth next year.

**Shorter-term, a super-normal payout is possible although would be unusual given CBA is the lowest on capital and current macro concerns**

- While CBA could pay out 197cps at the 2H12 result, we believe it is unlikely. CBA’s 7.1% CET1 is the lowest of the majors, meaning it needs capital growth.
Fig 3 Core tier-1 by bank – CBA the lowest

- Similarly, it would be an unusual move given the current global macro outlook.
- A dividend of this size would equate to a 92% payout ratio relative to historic payout ratios of c87% and would see 2H12 capital generation drop by 3bps.

Case for (absolute) dividend sustainability – Cost containment and BankWest Basel 2 advanced status

- CBA’s Core Banking Modernisation (CBM) program is now in its final year. This has improved productively across the bank with significant gains being reported at the frontline. Whilst CBA has publicly announced that no major retrenchments will occur in response to the announcements made by peers on retrenchment targets, there have been reported retrenchments occurring during 2H12 including ~100 jobs in CBA’s Melbourne mortgage business in May this year. The combination of these may result in better than expected cost growth currently forecast to be 2.1% (HoH). More importantly cost out, if quantified, could provide an all important offset in the presence of anaemic balance sheet growth.
- Finally there is a chance that BankWest attaining Basel 2 advanced status could add c30bp to core tier 1, placing CBA slightly closer to peers in terms of capital.

Fig 4 Impact of BankWest Basel 2 Advanced Status – Could be 30bp

<table>
<thead>
<tr>
<th></th>
<th>Current RWA</th>
<th>Basel 2 Advanced</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate</td>
<td>12,584</td>
<td>9,931</td>
</tr>
<tr>
<td>Sovereign</td>
<td>11</td>
<td>183</td>
</tr>
<tr>
<td>Bank</td>
<td>1,352</td>
<td>1,678</td>
</tr>
<tr>
<td>Residential mortgage</td>
<td>24,148</td>
<td>11,032</td>
</tr>
<tr>
<td>Other retail</td>
<td>4,194</td>
<td>4,615</td>
</tr>
<tr>
<td>Other</td>
<td>4,508</td>
<td>5,029</td>
</tr>
<tr>
<td>Regulatory Scaling Factor</td>
<td>1,705</td>
<td></td>
</tr>
<tr>
<td><strong>Total RWA</strong></td>
<td><strong>46,797</strong></td>
<td><strong>34,173</strong></td>
</tr>
<tr>
<td><strong>Benefit</strong></td>
<td><strong>12,624</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Current RWA</strong></td>
<td>308,599</td>
<td></td>
</tr>
<tr>
<td><strong>New RWA</strong></td>
<td>295,975</td>
<td></td>
</tr>
<tr>
<td><strong>Current Core Tier 1</strong></td>
<td>7.10%</td>
<td></td>
</tr>
<tr>
<td><strong>New Core Tier 1</strong></td>
<td>7.40%</td>
<td></td>
</tr>
<tr>
<td><strong>Benefit from Basel 2 Advanced Status</strong></td>
<td>0.30%</td>
<td></td>
</tr>
</tbody>
</table>

Source: Bank data, Macquarie Research, June 2012
Case against (absolute) dividend sustainability – Anaemic balance sheet growth, Margin outlook, BDD normalisation and rising capital intensity

- Loan growth has been sub 2% over 2H12 for CBA suggesting continued sluggish balance sheet momentum.

**Fig 5**  CBA loan growth of sub 2% HoH is possible despite jump in business loans growth in the month of June 2012

- While likely to have benefited from recent repricing moves, deposit cost pressure remain raising questions over the margin outlook for CBA.

**Fig 6**  Margins – sustainable?

- CBA’s BDD’s remain at below normal levels in our view, with normalisation likely in FY13.

Source: APRA, Macquarie Research, August 2012
We also expect that this result may shed light on the changing capital intensity for the Group as business lending becomes a bigger driver of balance sheet growth.

**Investment View – Longer-term thesis remains intact**

- While yield has driven the recent share-price run, we view this as one-off in nature and a de-rating risk. Given this, our longer-term thesis on CBA remains intact and is strengthened by CBA’s record high premium to peers. We discuss our longer term thesis below.
- We continue to believe the RoE is likely to be under pressure from competitive intensity, regulatory changes and incremental investment.

**Fig 8 RoE – Partial Backfill from RoE enhancement initiatives**

- Despite this, and the shorter-term pressure on EPS, CBA is trading on a record PE and PBV premium to peers, only seen for a short-lived period at the end of 2007.
Fig 9  CBA PE premium – We’re now factoring in recessionary conditions

Source: IRESS, Macquarie Research, July 2012

- If this reflects the market’s concern about bad debts, in reality CBA is unlikely to remain unscathed and has the furthest to fall in valuation terms, in our view.

Fig 10  CBA PBV premium

Source: IRESS, Macquarie Research, July 2012

- This disparity becomes even starker when looking at the decomposition of CBA’s performance relative to peers. All outperformance over the past two years has come from PE expansion with the current PE expansion equalling those seen in Mid 2010 before the PE premium was de-rated shortly after the 2H10 results were announced. Without better-than-peer earnings delivery in the upcoming 2H12 results, a de-rating is a distinct possibility.
Fig 11  CBA’s performance relative to the sector – All PE expansion

Source: MQG Strategy Team, Macquarie Research, August 2012
Commonwealth Bank of Australia
Underperform

Current Price $48.03
Target Price $57.05

Total Shareholder Return -10.2%
Bloomberg: CBA AU
Reuters: CBA.AX

Macquarie Equities | Australian Banks

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Commonwealth Bank

Source: Company data, Macquarie Research, August 2012

8

9 August 2012
Macquarie Private Wealth

Important disclosures:

Recommendation definitions

Macquarie - Australia/New Zealand
Outperform – return >3% in excess of benchmark return
Neutral – return within -10% to +10% of benchmark return
Underperform – return <3% below benchmark return

Benchmark return is determined by long term nominal GDP growth plus 12 month forward market dividend yield

Macquarie – Asia/Europe
Outperform – expected return >10%
Neutral – expected return from -10% to +10%
Underperform – expected return < -10%

Macquarie First South - South Africa
Outperform – return >5% in excess of benchmark return
Neutral – return within 5% of benchmark return
Underperform – return <5% below benchmark return

Macquarie - Canada
Outperform – return >5% in excess of benchmark return
Neutral – return within 5% of benchmark return
Underperform – return <5% below benchmark return

Macquarie - USA
Outperform (Buy) – return >5% in excess of Russell 3000 index return
Neutral (Hold) – return within 5% of Russell 3000 index return
Underperform (Sell) – return >5% below Russell 3000 index return

Volatility index definition*

This is calculated from the volatility of historical price movements.

Very high–highest risk – Stock should be expected to move up or down 60–100% in a year – investors should be aware this stock is highly speculative.

High – stock should be expected to move up or down at least 40–60% in a year – investors should be aware this stock could be speculative.

Medium – stock should be expected to move up or down at least 30–40% in a year.

Low–medium – stock should be expected to move up or down at least 15–25% in a year.

Low – stock should be expected to move up or down at least 15–25% in a year.

Recommendations – 12 months

Note: Quant recommendations may differ from Fundamental Analyst recommendations

Financial definitions

All “Adjusted” data items have had the following adjustments made:

- Added back: goodwill amortisation, provision for catastrophe reserves, IFRS derivatives & hedging, IFRS impairments & IFRS interest expense
- Excluded: non recurring items, asset revailes, property, appraisal value uplift, preference dividends & minority interests

EPS – adjusted net profit / epowoa
ROA – adjusted ebit / average total assets
ROA Banks/Insurance – adjusted net profit /average total assets
ROE – adjusted net profit / average shareholders funds
Gross cashflow – adjusted net profit + depreciation
*equivalent fully paid ordinary weighted average number of shares

All Reported numbers for Australian/NZ listed stocks are modelled under IFRS (International Financial Reporting Standards).

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