Asia Credit Research

Earnings Review: National Australia Bank Ltd ("NAB")

Issuer Profile: Positive (2)

Ticker: **NAB**

Background

National Australia Bank Ltd ('NAB') provides retail, business and corporate banking services mostly in Australia but also in New Zealand under the Bank of New Zealand brand. These services are complimented by the bank's wealth management division which provides superannuation, investment and insurance services under various brands. As at 31 March 2018, the bank had total assets of AUD796.1bn.

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Recommendation

- NAB's future performance will be pressured by ongoing restructuring costs as well as industry margin pressures which could weaken internal capital generation.
- That said, recent performance of NAB's business bank franchise was solid and, despite comparatively lower capital ratios, we retain NAB's Positive (2) Issuer Profile.
- On a technical and fundamental basis, the ANZ 3.75% '27c22s represent the better value in the Aussie Tier 2 space in our view. We currently rate all the Australian banks at a Positive (2) Issuer Profile.

Relative Value:

Bond	Maturity / Call date	CET1 Ratio*	Ask Yield	Spread
NAB 4.15 '28c23 (T2)	19/05/2023	10.2%	3.43%	104
WSTP 4.00 '27c22 (T2)	12/08/2022	10.5%	3.17%	83
ANZ 3.75 '27c22 (T2)	23/03/2022	11.0%	3.25%	94

Indicative prices as at 8 May 2018 Source: Bloomberg
*Common Equity Tier 1 (CET1) Ratio based on latest available quarter *APRA Compliant*

Key Considerations

- **Restructuring still influencing results:** NAB's 1HFY2018 results for the 6 months ended 31 March 2018 were decent with revenue up 2.5% y/y on growth in housing and business lending and a 5bps y/y improvement in net interest margins ('NIM') from repricing and lower funding costs. Markets and treasury income was lower however. Underlying expenses rose 5% y/y due to continued investments. Including restructuring-related costs, expenses were up 25.3% y/y. This was previously foreshadowed by NAB, with cash earnings down 16.0% y/y due to restructuring expenses. Excluding these, underlying profit improved 0.4%.H/h performance was more muted with revenue up 0.7% h/h primarily due to a -0.3% h/h fall in net interest income as net interest margins fell 1bps due to the full period impact of the bank levy, lower markets performance and a 1.1% h/h rise in gross loans and acceptances.

- **Overshadowing a benign operating environment:** Credit impairment charges fell 5.3% y/y, as lower specific provisions more than offset higher collective provisions. Overall asset quality continues to improve in line with FY2017 trends with the ratio of 90+ days past due and gross impaired assets to gross loans and acceptances improving 14bps y/y to 0.71% as New Zealand dairy performance improved and workouts in Australian business lending are seeing some success. H/h loan quality weakened slightly indicating some loan weakness in certain sectors and this likely necessitated the higher collective provisions.

- **Segment performance focused on strength**: NAB's business remains anchored in its strong market position in Business Banking with the Business and Private Banking ('BPB') segment contributing 54% to 1HFY2018 cash earnings (45.1% excluding restructuring related costs). Improvement in NIM in BPB was noticeable, rising 13bps y/y and 6bps q/q to 2.97%. Segment contributions are followed by Consumer Banking and Wealth ('CBW') and Corporate and Institutional Banking ('CIB') at ~23/24% each and NZ Banking at 14%. In comparison, NIMs from these segments for 1HFY2018 were 2.06%, 0.79% (1.64% excluding markets) and 2.24% respectively. Going forward, CIB looks to be increasingly important to future earnings with NAB's focus on growth in Asian infrastructure financing opportunities in US, Europe, Asia and Australia. At the same time, NAB has announced the eventual exiting of its Advice, Platform & Superannuation and Asset Management businesses under the MLC and other brands. While the form of the divestment is yet to be decided, timing for the separation is expected towards the end of 2019.

- **Modest improvement in capital ratios:** The benefit to capital ratios from NAB's earnings were somewhat muted given the high restructuring related costs, with NAB's CET1 ratio up marginally y/y to 10.2% for 1HFY2018 from 10.1% in FY2017 (ended Sept 2017). NAB's capital ratios continue to lag peers with its CET1 ratio still below APRA's minimum 10.5% CET1 benchmark for 'unquestionably strong' capital ratios in Australia's banking sector (comes into force January 2020). Although management remain confident of meeting APRA's minimum CET1 benchmark, we think active capital management will likely remain key for NAB with expectations that expenses are expected to remain elevated with expenses to grow 5-8% in FY2018 as the bank continues to transform its business and improve returns through increased digitization and optimizing its workforce. According to management, these costs include workforce reductions which are scheduled to occur over the next 3 years. This, together with changes in its wealth management strategy indicates some potential volatility in capital ratios in the next 1-2 years.

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Explanation of Issuer Profile Rating / Issuer Profile Score

Positive ("Pos") – The issuer's credit profile is either strong on an absolute basis, or expected to improve to a strong position over the next six months.

Neutral ("N") – The issuer's credit profile is fair on an absolute basis, or expected to improve / deteriorate to a fair level over the next six months.

Negative ("Neg") – The issuer's credit profile is either weaker or highly geared on an absolute basis, or expected to deteriorate to a weak or highly geared position over the next six months.

To better differentiate relative credit quality of the issuers under our coverage, we have further sub-divided our Issuer Profile Ratings into a 7 point Issuer Profile Score scale.

IPR	Positive		Neutral			Negative	
IPS	1	2	3	4	5	6	7

Explanation of Bond Recommendation

Overweight ("OW") – The performance of the issuer's specific bond is expected to outperform the issuer's other bonds, or the bonds of other issuers either operating in the same sector or in a different sector but with similar tenor over the next six months.

Neutral ("N") – The performance of the issuer's specific bond is expected to perform in line with the issuer's other bonds, or the bonds of other issuers either operating in the same sector or in a different sector but with similar tenor over the next six months.

Underweight ("UW") – The performance of the issuer's specific bond is expected to underperform the issuer's other bonds, or the bonds of other issuers either operating in the same sector or in a different sector but with similar tenor over the next six months.

Other

Suspension – We may suspend our issuer rating and bond level recommendation on specific issuers from time to time when OCBC is engaged in other business activities with the issuer. Examples of such activities include acting as a joint lead manager or book runner in a new issue or as an agent in a consent solicitation exercise. We will resume our coverage once these activities are completed.

Withdrawal ("WD") – We may withdraw our issuer rating and bond level recommendation on specific issuers from time to time when corporate actions are announced but the outcome of these actions are highly uncertain. We will resume our coverage once there is sufficient clarity in our view on the impact of the proposed action.

Analyst Declaration
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