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June 5, 2020

# Canadian Banks Quarterly Review & Analysis

We have been cautious on the Canadian banks going well back into 2019. At that time the rationale included highly indebted Canadian consumers, significant issues in the energy (oil) sector and a slowing Canadian economy. The fall-out from the Coronavirus pandemic only amplified these issues and brought in the added concerns of massive unemployment, bankruptcy risks and near-zero interest rates squeezing net interest margins. The actions of the Bank of Canada and the federal and provincial governments have staved off a worst case scenario, namely an outright depression, but there still remains a very difficult backdrop for the Canadian economy and by extension the Canadian banks.

So, last week's reporting of the banks' fiscal Q2 results (February-April) was watched very closely by investors to gage the initial impact of the pandemic. With all of the "Big 6" banks having reported, we can make a few general observations:

- The impact to quarterly earnings was severe but not as bad as some had feared.
- The banks came in with very strong capital positions and continue to demonstrate that, despite significant provisions taken during the quarter.
- **There are still many unknowns**. Some are more immediate and linked directly to the pandemic and its impact on the timing and speed of an economic recovery. Some unknowns will be more long-lasting, tied to bankruptcies, societal changes and lower-for-longer interest rates.

## Q2 Earnings – Not Terrible but Got Some Help

Earnings for the Big 6 were down roughly 53% across the group. This was 10% worse than the consensus forecast, but many of the more bearish investors saw it as a generally positive report as the group results were skewed by a couple of big misses (RY and CM). We take the other side and think the numbers weren't fully representative of the damage to the industry and point to a number of qualifiers. First, there was a large dispersion of estimates with some analysts coming in as low as -48% but as high as -84%. Second, loan growth was surprisingly strong, but that came mainly from large corporate clients drawing down credit lines to give them cash buffers going into the recession (i.e. one-time in nature). Third, there was a reasonable relation to





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the banks that beat/missed and those that were most liberal/conservative in how they booked their provisions for credit losses (PCLs). *PCLs refer to capital set aside by the bank for estimated potential credit losses and count against the operating earnings of the bank.* Therefore, the more aggressive (conservative) a bank is in taking reserves the more they hurt their near-term earnings.

**Big 6 Q2 Scorecard**

| | Q2 EPS | Q2 EPS Reported | Q2 EPS Consensus | Q2 EPS +/- | CET1 Ratio* | ROE | % Foreign Revenue |
|---|---|---|---|---|---|---|---|
| **BMO** | Miss | $ 1.04 | $ 1.14 | -9% | 11.0% | 5.3% | 41% |
| **BNS** | Beat | $ 1.04 | $ 0.94 | 11% | 10.9% | 7.9% | 56% |
| **CM** | Miss | $ 0.94 | $ 1.48 | -36% | 11.3% | 4.1% | 26% |
| **NA** | Beat | $ 1.01 | $ 0.94 | 7% | 11.4% | 10.8% | 13% |
| **RY** | Miss | $ 1.03 | $ 1.54 | -33% | 11.7% | 7.3% | 38% |
| **TD** | Miss | $ 0.85 | $ 0.87 | -2% | 11.0% | 6.9% | 43% |
| ***Avg.*** | | | | *-10%* | *11.2%* | *7.1%* | *36%* |

Source: Company Reports, Raymond James Ltd. ** CET1 minimum = 9.0%*

In Q2, we saw a correlation between larger provisions and larger EPS misses and vice versa. By our metrics Royal Bank (RY-T) was the most conservative, taking the largest provision, while Bank of Nova Scotia (BNS-T) took the smallest relative provision and was the biggest beat on the quarter. National Bank (NA-T) stands out from the group as their PCL looked conservative and their EPS beat expectations.

**Big 6 Q2 Provisions for Credit Losses (PCL)**

| | PCL as % of Loan Book Reported | PCL as % of Loan Book Consensus | PCL as % of Loan Book +/- | % Performing | % Impaired |
|---|---|---|---|---|---|
| **BMO** | 0.94% | 1.01% | 0.07% | 0.35% | 0.59% |
| **BNS** | 1.12% | 1.31% | 0.19% | 0.56% | 0.63% |
| **CM** | 1.39% | 1.17% | -0.22% | 0.34% | 1.05% |
| **NA** | 1.28% | 0.91% | -0.37% | 0.30% | 0.98% |
| **RY** | 1.71% | 1.09% | -0.62% | 0.37% | 1.28% |
| **TD** | 1.76% | 1.73% | -0.03% | 0.53% | 1.23% |
| ***Avg.*** | *1.37%* | *1.20%* | *-0.16%* | *0.41%* | *0.96%* |

Source: Company Reports, Raymond James Ltd., Factset

Other factors in the EPS performance were net interest margins (NIM), which did not fall as much as expected (lower interest rates squeeze lending margins) and that capital markets results were surprisingly strong. We think both positive surprises could be fleeting as capital markets were buoyed by significant trading in the March market crash and April rebound. If the US market is a good proxy, we expect NIM to deteriorate as we move forward. Canadian spreads have been slower to adjust to the new normal than south of the border, likely due to a lower degree of competition in the Canadian market. However, we have every reason to believe that Canada will follow suit in the coming weeks and this will cut into profits.

## Capital Ratios – A Significant Bright Spot

Capital ratios were a definite positive for the quarter. The average tier 1 capital ratio (CET1) for the Big 6 was 11.2%, which was down modestly from Q1, but was 30 bps higher than the 10.9% forecast. It also compares to a minimum requirement of 9% set by OSFI, the banks' regulator. The higher CET1 ratios should give investors a greater sense of comfort in the sustainability of dividends and makes it less likely that the banks will be coming to market to issue dilutive equity. As a reminder, after the 2008 economic collapse, when the Canadian banks had less capital, they started raising equity within three months of the markets crashing, with TD issuing equity in November and RY and BMO following suit in December. We certainly do not discount the potential for equity issuance from the Big 6 during the current recession, but we do take some solace that after the initial shock, they are in a strong collective position.

## Dividends – On Hold

We usually report on bank dividend increases in our quarterly review. However, on March 13, OSFI released a directive that the banks would halt all dividend increases and share buybacks until further notice. The regulatory action, along with the relaxing of some domestic capital requirements, is expected to supplement the banks' capital position and increase available credit for temporary loan relief or deferrals to struggling Canadian families and businesses (more below).

We are fine with the directive as it takes away any controversy with investors over whether banks should or shouldn't raise payouts in an economic crisis. A greater concern is whether the dividends will be cut and although we are still early in the recession, we would note that none of the Big 6 cut dividends in the 2008 crisis despite weaker capital reserves at the time. That said, outside the Big 6, we have already seen a significant dividend cut from a smaller regional bank with Laurentian Bank (LB-T), reducing its payout by 40% due to its much weaker balance sheet. Another, less tangible benefit, from the directive is it gets the regulator and the industry ahead of some of the populist politics emanating from Europe where the ECB is pushing for banks to suspend dividends entirely during the pandemic.

## Loan Deferrals - $300 billion!

If we want to take a more pessimistic view of the Q2 results, one area we would point to is the Big 6 loan deferral book. It's an understatement to say that the current recession is different than normal. The economic slow-down is deeper and much more abrupt due to the fact that governments are effectively shutting down their economies to fight a global pandemic. The flip

side is that once restrictions are lifted, in theory, the global economies could rebound in a similar manner. As a result, both government (through OSFI) and the banks themselves are providing temporary subsidies or relief to Canadians to get through what will hopefully be a short-lived shutdown. The key transmission mechanism for the banks is loan deferrals. These deferrals take many shapes: outright suspension of all payments for a period of weeks/months, interest-only payments and "blend-and-extend" repayment terms, to give a few examples. The purpose is for the banks to avoid pushing their borrowers into insolvency and having to take greater credit provisions or downgrade loans to non-performing status.

**Big 6 Loan Deferral Book (dollar value & percentage of segment total)**

| | BMO | | BNS | | CM | | NA | | RY | | TD | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | $billion | %* | $billion | %* | $billion | %* | $billion | %* | $billion | %* | $billion | %* |
| Mortgages | $ 18.9 | 18% | $ 38.0 | 17% | $ 35.5 | 16% | $ 8.6 | 13% | $ 54.1 | 17% | $ 36.0 | 14% |
| Credit Cards | $ 0.3 | 3% | $ 0.4 | 5% | $ 1.8 | 15% | $ 0.1 | 3% | $ 1.7 | 10% | n/a | - |
| Other Personsal | $ 2.5 | 5% | $ 5.5 | 8% | $ 2.3 | 12% | $ 0.8 | 7% | $ 3.5 | 4% | $ 3.2 | 3% |
| Commercial | $ 15.1 | 17% | $ 16.7 | 28% | $ 8.6 | 13% | - | - | $ 17.3 | 7% | $ 6.5 | 8% |
| International | $ 4.7 | n/a | $ 31.0 | 23% | $ 1.2 | 3% | $ - | - | n/a | n/a | $ 12.0 | 7% |
| Total | $ 41.5 | | $ 91.6 | | $ 49.4 | | $ 9.5 | | $ 76.6 | | $ 57.7 | |

Source: Company Reports, Raymond James Ltd., Factset * = % of segment's total loan book

These deferrals make a lot of sense for the banks, their clients and the economy as a whole. However, the actual numbers are staggering in their size. Barely more than two months into the COVID-19 economic crisis, the Big 6 banks have collectively recorded over $300 billion in loans with some type of deferral. This number includes 16% of all Canadian mortgages underwritten by the Big 6 and 11% of their total loan book. The risk here is that if the recession is deeper or longer than anticipated and these temporary measures are not enough to bridge the gap, the deferral book could start to degrade into a larger non-performing loan book and create a need for materially higher PCLs across the banks.

## Energy – Sector and Regional Exposure

One of the most common types of questions we get about the banks is regarding their exposure to the Canadian oil patch. Investors are rightfully worried about how the loan book to Canadian oil and gas producers will fair after the industry has taken yet another massive hit. After two years of battling massive heavy oil price discounts, weak (sometimes negative) natural gas prices and interminable pipeline delays and politics, Canada has been joined by the rest of the global energy sector and hit by the greatest supply glut in post-war history.

**Big 6 Loans to Oil & Gas Sector, Prairie Provinces (% of total loan book)**

| | % of Loan Book | |
|---|---|---|
| | Oil & Gas | Prairie Provinces (Total) |
| **BMO** | 2.7% | 20.2% |
| **BNS** | 2.6% | 21.2% |
| **CM** | 2.4% | 20.4% |
| **NA** | 2.6% | 7.2% |
| **RY** | 0.2% | 22.7% |
| **TD** | 1.3% | 17.0% |
| ***Avg.*** | *2.0%* | *18.1%* |

Source: Company Reports, Raymond James Ltd., National Post

Despite some government intervention, we expect to see some bankruptcies and loans going into default in the Western Canadian oil patch. We hate to use any "positive" language when discussing the travesty that has beset the Canadian industry, but for bank investors, the silver lining is that direct loans to oil companies were at historically low levels going into the recession and range between 0.2-2.7% of the total loans of the Big 6 banks. With that said, the secondary and tertiary effects of numerous oil and gas bankruptcies would bleed into significant portions of the Alberta, Saskatchewan, BC and Newfoundland economies if Canadian oil and gas companies are not properly defended from the predations of government interference, OPEC+ and Coronavirus.

## Valuation – Cheaper Prices but Greater Risks

Our view on valuation prior to COVID-19 was that the banks weren't expensive on a historical basis, but we were not that tempted because the outlook for earnings growth was slowing and we saw more risks on the horizon. In a COVID-19 world, these risks are much greater. If we use our regular model to measure a reversion to a historical mean valuation, we see a mixed bag with a skew towards the smaller/riskier banks.

**Big 6 – Mean Reversion Valuation Model**

| | Current | | | | 10 yr Aver | | Mean Revert Projected Value | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Company Name | Last | P/E | P/B | BV per sh | P/E | P/B | P/E | P/B | Average | Upside |
| Royal Bank of Canada | $ 97.19 | 14.1x | 1.9x | $51.12 | 11.8x | 2.3x | $ 81.18 | $117.58 | $ 99.38 | 2.3% |
| Toronto-Dominion Bank | $ 64.96 | 14.0x | 1.7x | $40.50 | 11.9x | 2.4x | $ 55.10 | $ 97.20 | $ 76.15 | 17.2% |
| National Bank of Canada | $ 65.56 | 12.6x | 1.7x | $34.40 | 11.7x | 2.0x | $ 61.07 | $ 68.80 | $ 64.94 | -1.0% |
| Bank of Nova Scotia | $ 60.74 | 11.8x | 1.3x | $49.75 | 11.2x | 1.5x | $ 57.79 | $ 74.62 | $ 66.21 | 9.0% |
| Bank of Montreal | $ 76.80 | 11.5x | 1.4x | $64.73 | 10.3x | 2.0x | $ 68.80 | $129.47 | $ 99.14 | 29.1% |
| Canadian Imperial Bank of Commerce | $ 98.79 | 12.8x | 1.3x | $73.83 | 11.2x | 1.5x | $ 86.13 | $110.74 | $ 98.44 | -0.4% |
| *Average* | | *12.8x* | *1.5x* | | *11.4x* | *2.0x* | | | | |

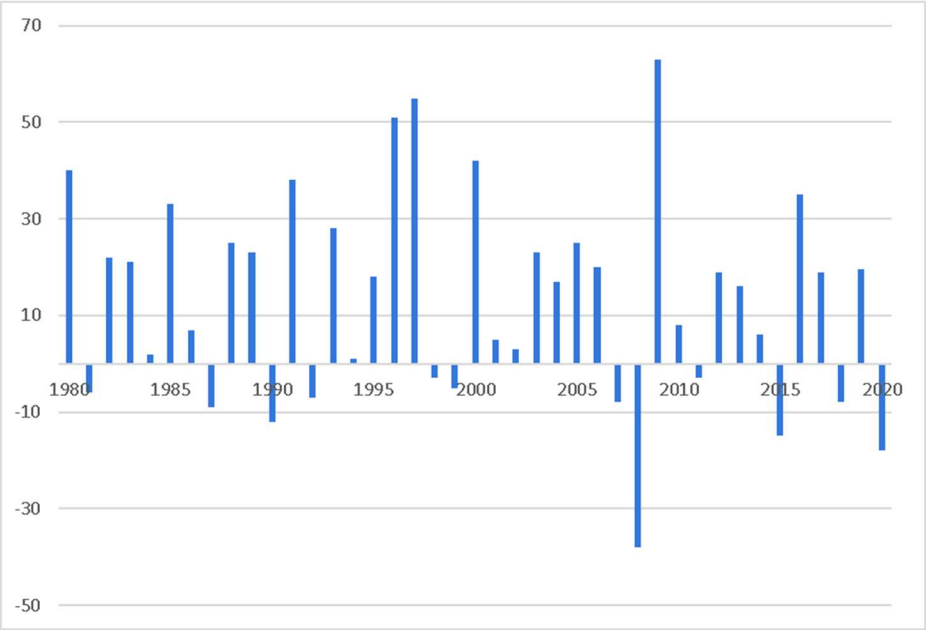
Source: Factset, Raymond James Ltd.

Moreover, the EPS assumptions the model is based on are highly suspect as we just don't have enough information yet to determine whether these numbers are achievable. Taking a conservative stance, we see the current consensus EPS forecasts are representing something of a best case scenario since a return to an economic "normal" ultimately requires a COVID-19 vaccine and, at this time, creating a successful one (and on an early 2021 timeline) is still a hypothetical. In summary, we are not putting too much weight to our mean reversion model this quarter as we don't trust the inputs enough.

## Valuation – Multiple Down Years are Rare

Putting our rose-coloured glasses back on, we can point to history for a note of hope for Big 6 shareholders. Going back 40 years, we have solid data that shows Big 6 bank stocks tend to bounce back significantly after suffering a particularly bad year in the markets. For example, the Big 6 saw a 63% rally in 2009 following a 35% drop in the 2008 crash. There will be a time to overweight the banks, but now may still be too early in the process.

**Canadian Banks Historical Annual Total Return (%)**




Source: Factset, Raymond James Ltd.

## Conclusion and Ranking – Sticking with Defense and Quality

If there is a general conclusion from our analysis of the fiscal Q2 results it is probably, "so far, so good but it's not over yet." Earnings could have been worse, capital ratios are strong, dividends are safe for now, but many questions remain. Are we going to develop a vaccine and how soon? How quickly and effectively can governments reopen their economies in the meantime? How deep and long will the recession be? Will there be a second COVID-19 wave? What permanent changes to societal norms will come from the pandemic experience? How well is the banks' loan deferral book going to hold up? What impact will near-zero interest rates have on profits?

With so little data to make concrete forecasts and the significant headwind of ultra-low interest rates for a protracted period, we continue to look at the banks as a sector of the market where we want to be cautious in weights and stock selection. This is reflected in our Guided Portfolios where we recently sold out of BNS and concentrated our Canadian bank positions in the two largest players, Royal Bank (RY-T) and TD Bank (TD-T).

Q2 results showed us that RY still firmly deserves its position at the top of the list due to margins, capital and balance sheet. TD remains a solid second choice and gives investors greater exposure to the US market. If pressed for a third pick, based on recent performance, we would choose National Bank (NA-T) despite its higher valuation. We were impressed by the resiliency of the bank's operating profits and very strong capital position, despite taking a fairly conservative position in PCL assumptions.

**Big 6 - Batting Order**

| | EPS Growth | | | | EPS Growth | | |
|---|---|---|---|---|---|---|---|
| Company Rank | 2019 | 2020e | P/E | % | 2021e | P/E | % |
| RY | $ 8.75 | $ 6.88 | 14.2x | -21% | $ 8.18 | 11.9x | 19% |
| TD | $ 6.25 | $ 4.63 | 14.0x | -26% | $ 5.40 | 12.0x | 17% |
| NA | $ 6.34 | $ 5.22 | 12.6x | -18% | $ 6.01 | 10.9x | 15% |
| BNS | $ 6.67 | $ 5.16 | 11.8x | -23% | $ 6.03 | 10.1x | 17% |
| BMO | $ 8.66 | $ 6.68 | 11.5x | -23% | $ 7.89 | 9.7x | 18% |
| CM | $ 11.19 | $ 7.69 | 12.9x | -31% | $ 9.64 | 10.3x | 25% |
| *Average* | | | *12.8x* | *-24%* | | *10.8x* | *18%* |

Source: Company Reports, Factset

We will continue to monitor our view on the banks as we make our way through the lockdowns, restarts and economic renewal. We think we need at least one more reporting period to determine a proper outlook for future revenue, earnings, capital position and valuation.

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