HCP NOTES

Moody's Bizarre View of Royal Bank

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Disclosure**: At the time of writing, no HCP fund or account had exposure, long or short, to Royal Bank.**

This past January, the once-powerful rating agency, Moody's, downgraded the long-term credit ratings of four of the "Big five" Canadian banks. The downgrades, which were attributed to the economic risks posed by the high level of consumer debt and hot housing market in Canada, were largely ignored by the debt and equity markets.

This, of course, is not terribly surprising or even really interesting. The ratings agencies have justifiably seen their prestige plummet since the credit crisis, and as a result, their ratings changes do not strike anything close to the fear they once did in the marketplace.

What ***is*** interesting, however, is just how little Moody's thinks of Royal Bank.

Believe it or not, this most recent downgrade ended a 7 month period where RBC was – ***by itself*** – the lowest rated bank in Canada and, incredibly, considered by Moody's to be the Canadian bank most likely to default on its bondholders (RBC is now tied with CIBC and BMO which saw their long-term debt ratings reduced in January[(1)]).

We believe Moody's ratings actions highlight a relevant issue in Canadian bank valuations. That is, relatively minor differences in business/revenue mix are becoming so exaggerated that they sometimes overwhelm the bigger picture.

To us, the big picture for RBC is that it is the pre-eminent financial services franchise in the country, dominant in literally every single Canadian business. It has the best domestic banking platform (with TD). It has the largest and highest quality wealth management business – both in asset management (with TD) and retail brokerage (with CIBC). It has, in RBC Capital Markets, the most powerful investment bank in Canada. Royal Bank is literally dominant in every single domestic business and its Canadian platform accounts for an enormous ~70% of the company's revenues.

So, how could Moody's arrive at the conclusion that Royal Bank was the weakest Canadian bank when even casual followers could persuasively argue it is the strongest? In its initial downgrade of the bank (December 2010) Moody's wrote Royal's: *"… commitment to its sizeable and growing capital markets business … potentially exposes bondholders to increased earnings volatility and poses significant risk management challenges"*. Virtually the entire opinion is about the risks of investment banking, with just a brief acknowledgement of Royal's "commanding Canadian franchises" and the "strength and diversification of RBC's domestic earnings".

For more information on any of HCP's funds, please contact:

Patrick Sommerville
Managing Director, Business Development
416-941-9250
psommerville@hamilton-capital.com

After reviewing their analysis, it is difficult not to conclude that Moody's basically started with two dubious premises: i) RBC's slightly greater exposure to trading more than offsets its other very formidable relative strengths, and ii) it is more like a global investment bank than a Canadian bank.

Here are some of the issues we have with Moody's rating of Royal Bank.

Moody's Groups RBC with DIS-similar Global Banks, versus VERY Similar Canadian Banks
Moody's paints RBC as a capital markets bank, placing it into a universe with "15 financial groups with global capital markets operations" – i.e., global banks and investment banks(1). It makes it clear that, for rating purposes, it believes this universe is more relevant to RBC than its Canadian bank peers.

There is no question that RBC has been building out its investment banking operations. Last year, it even had a global market share of 2.7%, good for #10(2). This growth has come – in part – from outside Canada. But to consider RBC more like a global bank/investment bank than the other Canadian banks is a ***HUGE*** stretch. To state what is obvious to anyone that follows the Canadian banks: these are very similar companies.

What makes this assertion even more curious is that in terms of managing through the Credit Crisis and European Sovereign Debt Crisis, both of historical significance, RBC's excellent record places it squarely with the Canadian banks, and very much at odds with almost every single one of the 14 other firms they have been grouped with for rating purposes, several of which narrowly avoided failure. The universe Moody's places RBC within even includes pure-play global investment banks, Goldman Sachs and Morgan Stanley.

When Moody's Says RBC Has Too Much "Capital Markets", It Really Means "Trading"
A read of Moody's commentary makes it is very clear that they do not like trading, and they believe RBC has too much. In fact, with respect to RBC, Moody's almost implies an outright disapproval of the bank's business strategy. According to Moody's, the 15 banks/investment banks with global capital markets operations: *"… have significant exposure to volatility and risk of outsized losses (i.e., tail risk) that is inherent in capital markets activities"*.

To take it further, in an announced review of RBC in February 2012, Moody's references *"structural vulnerabilities in the business models of global investment banks, which include confidence-sensitivity of customers and funding counterparties, risk management, and governance challenges, as well as a high degree of interconnectedness and opacity"*. These comments are obvious references to trading.

However, when assessing RBC's exposure to these "tail" risks, Moody's includes revenues from institutional commissions and underwriting and advisory for which the risk of material losses is basically zero (much less possessing "tail risk" to the bank). ***Contrary*** to market convention, the

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[1] For its Long-Term Rating, RY is at Aa3, now tied with CIBC and BMO. Again, TD (at Aa1) and BNS (at Aa2) are higher rated. Under Moody's Standalone Credit Assessment (STA), Royal Bank is C+/a2, making it tied with CIBC and BMO (following their downgrades in January). TD and BNS have higher ratings at B/aa3 and B-/A1, respectively.
revenues.
[1] These 14 other firms are: HSBC, JPMorgan, Barclays, BNP Paribas, Credit Agricole, Credit Suisse, Deutsche Bank, Goldman Sachs, Societe Generale, UBS, Royal Bank of Scotland, Morgan Stanley, Citigroup, and Bank of America.
[2] Source: RBC Investor presentation, as measured by Dealogic by investment banking revenues.

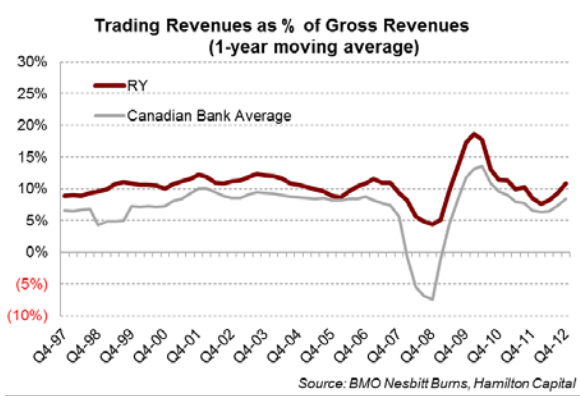
rating agency also includes non-capital markets revenues, like lending net interest income and credit fees in its definition of "capital markets". So, while corporate lending absolutely has "tail" risk (for all Canadian banks), the rating agency curiously does not make even a single reference to the key corporate credit risks (i.e., concentration, geographic, or sector), making it clear its commentary is entirely related to trading.

By adopting such an expansive definition of "capital markets", Moody's substantially increases its measure of RBC's exposure, making it easier to group with the "capital markets" global banks.

For RBC, Trading Revenues are <u>Not</u> Actually Growing

In all of its commentary about trading, Moody's implies the associated risks are actually rising, when they are arguably declining. In fact, the rating agency even wrote a report in September 2010 entitled, *"Capital Markets Activities of Canadian Banks: A Growing Risk".* The report concluded that Canadian banks were growing their exposures in an effort to reach for earnings, which was almost completely at odds with how Canadian bank executives were describing and executing their strategies at the time (and what happened subsequently).

So, how does one assess trading exposures given all of the volatility? In our view, quarterly market volatility makes it difficult to identify changes in underlying exposures to trading. Therefore, we use a rolling four-quarter average which we believe better illustrates the more relevant trends in changing exposures. While by no means perfect, we believe it is a highly credible measure. As the chart shows, there are some basic key takeaways.



<u>First</u>, RY does **<u>not</u>** have significant trading exposure relative to its Canadian bank peers. Its average trading revenues as a percent of gross revenues over the past 16 years is ~10%, versus the Canadian bank average at ~7% – for a difference of just 3% of total revenues[3].

<u>Second</u>, exposure to trading for RBC is not rising as Moody's suggested it was (and the implications were that it would continue to) in its September 2010 report. In fact, the rolling four quarter average in 2011 and 2012 were 10%, or exactly equal to its 16 year average.

<u>Third</u>, during periods of stress in the financial system, Royal Bank outperformed its peers (more on this below).

Moody's Ignores Royal Bank's Superior Execution/Risk Management

One of the most amazing things about Moody's reviews of Royal Bank is that they never address something that is obvious to any long-time followers of the bank: RY's lengthy record of superior execution. As we highlighted above, it is true that RBC has ***<u>marginally</u>*** more exposure to trading than its peer average. Yet, there is nothing marginal about its outperformance, both in terms of overall consistency and, importantly, in times of stress.

[3] Data is from BMO Nesbitt Burns and represents the longest history of quarterly data we could obtain for the Big 6 Canadian banks. Trading revenues include trading revenues (fees), plus trading net interest income measured on a taxable equivalent basis.

In the past 64 quarters – the longest history we could obtain – RBC did not have a single quarter with negative trading revenues (TEB)[(5)]. Over this period, the other Big-5 Canadian banks have all experienced at least one quarter where trading revenues were negative (overall). It is, however, worth noting that almost all of these negative revenue quarters were not material in the context of the overall banks[(4)].

In times of stress in the financial system, RBC has outperformed. It outperformed its Canadian bank peers during the 2002 Tech-Media-Telecom credit cycle (which ironically made last year's oft-cited 10 year EPS growth average look worse for RY than many of its peers). It outperformed during the 1998 Asian Crisis, when Q4 trading revenues went negative for the sector, but not for RBC. And RBC was not even close to losing money in 2008, the peak of the Credit Crisis – a historic event during which RY's trading revenues for the year were still above $1.0 bln (and positive in all four quarters). So far, RBC has not been noticeably affected by, much less had losses resulting from, the ongoing European sovereign debt crisis.

While it is true that all of these examples are backward looking, it does demonstrate a history of strong risk management, a critically important factor not addressed by Moody's.

No Credit for RBC's Superior ROE, An Important Cushion Against Losses
RBC is a very profitable bank as evidenced by its very high return on equity, which was 18.7% and 19.3% in 2011 and 2012, respectively. This is relevant when assessing risk, since a bank's first cushion against unexpected losses is one quarter's earnings (net of dividends). More profitable banks have higher cushions, and therefore, provide greater buffers for debt (and equity) holders.

RBC's lowest quarterly earnings in the last 8 quarters was ~$1.2 bln, which means that the bank – which has not had a negative trading quarter in the last 16 years – could absorb a large write-off or trading loss of ~$1.3 bln before it reduced capital (and ~$2.0 bln pre-tax before it was break-even for a single quarter). Given that RBC has material excess capital, the actual charge the bank could absorb before experiencing any erosion of core capital is even larger. Interestingly, Moody's does not address RBC's superior profitability as a mitigant against "tail risks".

Moody's Misses the "Big Picture"

Moody's emphasis on trading is, in some ways, understandable. The agency was severely criticized for not assessing the risks of certain instruments, like CDOs, that resulted in substantial trading losses to global banks in the recent crisis. Some of these banks did not even bother to sell what they underwrote, opting to hold them on their balance sheets, a near catastrophic risk management error that Moody's did not fully grasp at the time (even worse, it rated these very instruments triple A!).

However, to us, Moody's view of RBC and its capital market exposure serves as a good example of how minor differences in business mix can get so exaggerated that distorted conclusions result. Yes, RBC generates investment banking revenue outside Canada (as do all of the Canadian banks). Yes, RBC Capital Markets is expanding outside North America in a targeted fashion. And yes, RBC generates a higher percentage of its gross revenue from trading revenues than its Canadian bank peers (if only modestly).

[4] Only one bank, CIBC, had difficulty absorbing trading losses, without generating a quarterly loss to the entire bank, and that was during the Credit Crisis. We would also note that CIBC has ranked equal to or higher than RBC for much of the post-crisis period.

To Moody's, these variables overwhelm the big picture, which is that RBC is one of the best – and most stable – banks in the world. It is the best bank in Canada by virtue of its dominant position in every single line of business. It has an excellent ROE and an excellent capital position. It has produced stable earnings in both its bank and investment banking subsidiary over a very long period of time. And while RBC has had losses on certain instruments over the years, none were sufficient to generate even a single negative trading revenue quarter.

Obviously, when it comes to potential trading losses, one can never say "never". But the fact is that RBC has not only survived, it has prospered during every downturn in recent memory, including two crises of historic significance. Interestingly, none of the other Canadian banks can make all of these claims, nor do they have the same commanding market positions across such a wide range of businesses. Yet, they all had higher ratings than RBC in the recent past.

We are not alone in our view. The equity markets accord Royal Bank one of the highest price to earnings multiples, while the bond market prices its debt at one of the lowest spreads, implying virtually the ***entire capital markets*** believes it should be one of, if not the highest rated bank.

There is only one word to describe Moody's view of RBC.

Bizarre.

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