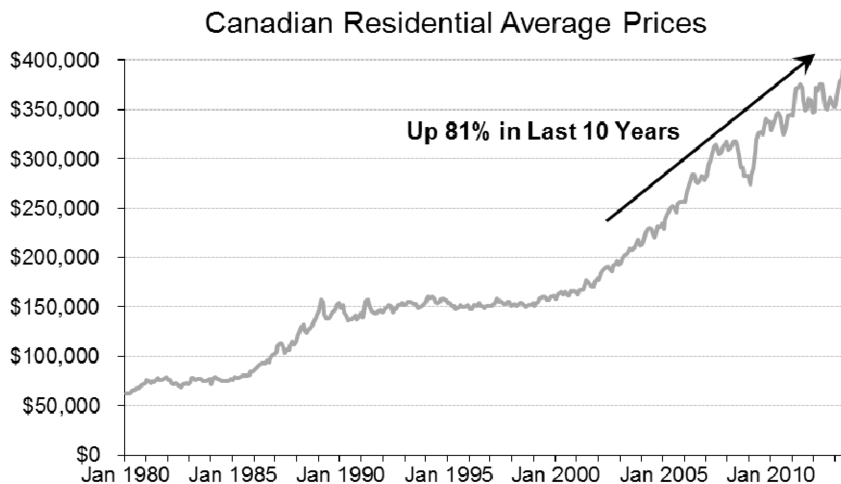
HCP NOTES

Why We're Not Short (or Long) the Canadian Banks

September 18, 2013

As we discussed in our July 11th post, ***"Are MICs the 'Canary in the Coal Mine'?"***, there has been a lot of discussion in recent months about the potential for a ***material*** decline in Canadian home prices and the possible fallout for Canadian financials, and the banks, in particular. The speculated financial services sector impact – should such a decline occur – has ranged from: (i) slower economic growth causing slower revenue/earnings growth (most likely), to (ii) a credit downturn (a possibility), or worse, (iii) some sort of systemic event (extraordinarily unlikely, in our view).



Source: The Canadian Real Estate Association, HCP

This issue has gained traction with investors and the media as a result of the significant increase in home prices, combined with the potential for a cyclical rise in interest rates (and by extension, mortgage rates – something we have already observed since this spring). After a near-vertical rise in Canadian home prices over the past decade (see chart), a trend that has been highly resilient, many believe home prices appear vulnerable to a decline.

And with rapidly falling home prices a significant factor in the 2008 credit crisis, financial services investors are understandably concerned about this risk. In this note, we explain why we are not short or long the Canadian banks.

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Hamilton Capital

Why We're Not <u>Short</u> the Canadian Banks (In Any of HCP's 3 Funds)

As we have posited previously, the first evidence of a credit downturn resulting from falling home prices is likely to emerge through losses in certain low-quality mortgage investment corporations ("MICs") – i.e., those with outsized exposure to land and development construction loans. However, a credit downturn would eventually impact the other Canadian financials, including the Canadian banks. Hence, as the risk of falling home prices has become more topical, we are often asked, "Are you short the Canadian banks?"

Our answer: "No".

So, why are we not short?

<u>First</u>, and perhaps most importantly, **there is simply no evidence of a significant credit downturn emerging**. Provisions for loan losses are low. Gross impaired loan trends are benign. And of course, profitability is robust, with most banks reporting ROEs in the high teens. This high level of profitability supports substantial capital generation, and capital return (i.e., higher yields). We would note that, post-crises, the Canadian bank ROEs are uniquely high when compared to those of their global peers.

<u>Second</u>, it is our view that **if a downturn in credit emerges as a result of falling home prices alone, it would very likely be shallow**. Generally, severe credit cycles are accompanied/amplified by a recession, which does not seem likely based on current economic trends. However, even though it is possible that home prices decline at such a velocity and to such a level that it weighs on nominal GDP growth, we still see it as unlikely to cause a recession. If home prices decline in absence of a recession, we would not expect to see a material rise in credit losses at the Canadian banks.

<u>Third</u>, **the Canadian banks are exceptionally well-diversified**. This is important since banks tend to run into credit problems when they are overly exposed to a particular loan category and/or geography. Canadian banks over the past twenty years have transformed from "just banks" to financial services conglomerates. As a result, the sector has impressive diversification by country, business line and product, contributing to the resilience of their business model. Their powerful investment banks and wealth management operations provide the best example of businesses that generate substantial earnings available to absorb credit losses in the Canadian personal and commercial banks, should they arise from a material correction in home prices.

<u>Fourth</u>, **valuations are relatively low**. Even with the recent rally post Q3 earnings season, the average price-to-earnings multiple for the "Big-6" banks is still just over 10x forward 2014 earnings[1] – which is near the bottom of their 10x to 12x trading range established over the past several years (Credit Crisis excepted). Over the past 20 years, long-term fundamental investors have seldom been hurt by relative multiple compression holding the group at these P/E levels.

<u>Finally</u>, **dividend yields are over 4% – and rock solid** – making it expensive to short the group, especially with positive nominal GDP growth buttressing revenue growth.

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[1] As of September 16, 2013, the average forward price-to-earnings multiple of the Big 6 banks was 10.4x. Source: Bloomberg, HCP.

Therefore, in absence of a macro event – *which is certainly possible* – it is our view that either earnings estimates or multiples would have to decline by a notable amount for Canadian bank stocks to experience material underperformance. With P/E multiples already close to 10x, Canadian bank bears are basically betting that estimates fall materially (or there will be a macro-driven event). Unfortunately for them, estimates have generally come up since reporting season last month (4 of 6 were revised higher). With implied growth rates for forward estimates for the Big-6 Canadian banks already averaging a modest ~6% (low of 0%; high of 11%), we see significant downward revisions as an unlikely outcome.

Hence, we are not short the sector.

However, we are not long either.

Why We're Not Long the Canadian Banks

Having laid out several reasons why we are not short the Canadian banks, one might think we are biased to the long-side for Canadian banks. However, at the time of publishing, we do not have any positions in our funds.

Why?

First, **there are just 8 publicly traded domestic banking institutions** (this includes mid-caps Laurentian Bank and Canadian Western Bank), **all of which are heavily covered by quality sell-side analysts and, therefore, relatively efficiently priced**. Moreover, stock prices for the six largest banks have extraordinarily high daily correlations (i.e., high 80's to low 90's) over almost any historical period, owing to their great similarities in business mix, and geography, to a slightly lesser extent. Therefore, the ability for investors to find "hidden" value within the Canadian banking sector is very difficult. In general, Canadian bank investing is focused on the sector's direction.

By contrast, the U.S. has well over 400 publicly traded banks, including nearly 140 banks with a market capitalization of over US$500 million (and ~225 with a market cap over US$200 million) and a plethora of special situations. There are ~115 banks in the U.S. trading at a price-to-tangible book value (P/TBV) of 1.0x or lower (although, we note, most are mid-cap and small-cap). In Europe, similar opportunities for value are available. In fact, more than 1/3 of the ~40 large-cap[2] European banks covered by Barclays trade at less than 1.0x TBV. While ***not*** directly comparable, the Canadian banks trade at ~2.0x book value and 2.5x TBV.

Second, **there is no M&A dimension to the Canadian bank sector owing to government restrictions**. While it is possible that Canadian Western Bank is acquired, there are policy arguments for the government to limit the number of potential buyers[3]. However, in the U.S., we believe over 300 (of the 400+) publicly traded banks could be considered legitimate takeover candidates. As we outlined in our December 2012 note **"100 Bank Mergers"**, we believe that ~100 will be acquired in the next three to five years (mostly mid-cap and small-cap). In fact, M&A in the U.S. has already begun, with a further pick-up in activity in recent months, after a multi-month lull.

[2] Using a market capitalization of €5 billion or higher.

[3] For a note on why we believe the "Big-5" should not be allowed to make additional domestic acquisitions, please see our essay, **"Are the Canadian Banks Becoming Too Powerful?"** (www.hamilton-capital.com), dated July 2012, which was excerpted in the Globe and Mail.

Third, **interest rate sensitivity for the Canadian banks is comparatively low**, removing a potential key driver of incremental EPS growth for global banks over the next few years. As a result of the Canadian banks' conglomerate structure, the composition of revenues coming from net interest income is much lower than their "just banks" U.S. peers, for example. Moreover, the sector's interest rate sensitivity is also reduced because of their much more closely hedged loan balance sheets, versus most of their U.S. peers (the vast majority of which are less sophisticated). This is not to say that the Canadian banks' earnings leverage to rising rates is zero; it isn't. Rather, compared to U.S. banks, their leverage to this theme is much less significant, given the differences in balance sheet structures and asset-liability management.

Fourth, even after estimates increased post Q3 earnings season, **the growth profile forecast by the sell-side is anaemic**. Analyst estimates are forecasting forward EPS growth of ~6% (on average – see chart), which, if accurate, limits the sector's upside.

	2014 EPS			**2014 Implied Y/Y EPS Growth Rate**		
	20-Aug	13-Sep	**Change**	20-Aug	13-Sep	**Change**
BMO	$ 6.26	$ 6.35	1.4%	4.5%	3.8%	(0.7%)
BNS	$ 5.54	$ 5.50	(0.7%)	7.8%	7.3%	(0.5%)
CM	$ 8.63	$ 8.58	(0.6%)	1.7%	(0.2%)	(1.9%)
NA	$ 8.68	$ 8.86	2.1%	5.6%	5.6%	0.0%
RY	$ 5.78	$ 5.92	2.4%	6.5%	6.3%	(0.2%)
TD	$ 8.22	$ 8.39	2.1%	9.2%	11.5%	2.3%
Avg	nmf	nmf	1.1%	5.9%	**5.7%**	(0.2%)

Source: Bloomberg, HCP

Fifth, **the Canadian banks lack a recovery element**. Generally speaking, ROEs and earnings have "fully recovered" from the Credit Crisis lows, meaning EPS growth is heavily dependent on nominal GDP growth (since the sector operates in a mature oligopoly within a developed economy) and the impact of capital deployment (which is more likely to be a short-term headwind than a tailwind). Outside Canada, the selection of banks with some recovery element is significant, be it legacy credit, litigation expenses, run-off portfolios and/or other related costs.

For Canadian Banks, Downside – And Upside – Appears Limited

Given our view that both the downside and upside is limited for Canadian bank stocks, we have no directional exposure to the sector. In general, we believe the sector will have to cope with a series of very manageable headwinds, including falling real estate prices, a tepid commodities market, and below-average nominal GDP growth. All of these headwinds are cyclical, and while they will ultimately pass, most, in our view, are still yet to come. We believe that the sector is very well positioned to deal with these headwinds but that they will manifest themselves in the form of modestly lower EPS growth.

Therefore, in absence of a macro-event – which is possible – we would be surprised to see a material decline in Canadian bank share prices. If, during the next year or so, an unexpected event emerges, and causes dislocation in the global banking sector, say, in no particular order, Japan, China, or Europe, Canadian bank stocks would almost certainly correct – possibly materially, along with all global banks (recall, in the Asian Crisis, the Canadian banks declined over 30% in a few months and took two years to recover).

However, it is notoriously difficult to predict both the timing and nature of such macro events. Hence, we see little to be gained from shorting this extremely durable sector, given its relatively low P/E valuations and yield support. At the same time, we also believe that the sector does not offer attractive upside potential.

What do we like?

We hold best ideas across all financials (a universe of 1,000+ companies and more than $4.5 trillion in market cap). We still see value in virtually all parts of **insurance** (including mortgage insurance, special P&C situations, and certain life names). We also hold positions in global **banks** that we believe either hold a significant recovery element and/or could be acquired. In **capital markets**, our positions generally focus on companies that are either deep value, and/or have a recovery element. And finally, in "**other**" financials, we hold a variety of positions including some with direct exposure to a recovering U.S. real estate market.

We continue to focus on cyclical M&A activity in the U.S. mid-cap bank category (i.e., banks with assets of less than $10 bln) and those banks with material, but diminishing legacy credit costs. We have also taken our first European bank position, and expect this exposure to grow over the next year.

If you would like to learn more about HCP's funds, please go to www.hamilton-capital.com, email info@hamilton-capital.com, or call 416-941-9888.

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