HCP NOTES

National Bank (NA)

November 4, 2013

Will National Bank (Continue to) Be Re-Rated?

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

Will National Bank (Continue to) Be Re-Rated?

When trying to forecast the best performing Canadian bank, investors need to consider which bank stock has the potential to be re-rated higher by the market – i.e., which could benefit from relative multiple expansion. Looking at historical returns for the Canadian banks over virtually any period shows that the top performing bank stock often benefited from being re-rated.

Given the incredibly high correlations, tight multiple ranges, and very similar EPS growth rates for the Canadian banks, a change in a stock's relative valuation is one of the most important factors contributing to its performance versus the Canadian bank index (positive or negative). With the Big-6 banks trading at an average forward P/E of ~11x, a one multiple point rise equates to nearly 10% of incremental performance – a highly material amount. Furthermore, with longer-term EPS growth normalizing closer to 7%, the importance of changes in relative value is obvious.

This brings us to **National Bank** (which we do not own in any **HCP Fund**).

Although seldom a top-pick by sell-side analysts, as of July 31st, National Bank (NA) has been **the top performing bank stock** in the past three years, five years ***and*** ten years, as its vastly improved operating performance resulted in a partial re-rating.

However, NA ***still*** trades at the lowest multiple of its large-cap peers**.** At ~10x forward earnings, NA trades at a highly material 1x multiple discount to the average (albeit an improvement from the ~2x discount NA traded at approximately 10 years ago), and an almost 2x discount to the highest multiple bank, RY (at 11.9x – *Source: Bloomberg, as of November 1, 2013*).

Having said that, there are reasons to believe that the re-rating of **National Bank** could continue.

Why?

In early October, National Bank gave an investor presentation on its Financial Markets segment[1] that underscored just how much the bank has changed. Specifically, the presentation highlighted National Bank's progress in addressing the most important issues cited as the rationale for its discounted valuation.

First, National has vastly improved its operating results over the past decade. In fact, the presentation highlighted that NA had a ***higher*** ROE than the average of its Big-5 peers in every single one of the last six years (i.e., since the financial crisis). Its ROE has exceeded 20% for the last two years, and last year was a highly material 300 bps ahead of the peer average. (Note, NA was one of just two banks -- the other being BNS -- that did not issue equity during the financial crisis.)

Please refer to the end of this document for an important disclaimer.

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

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

Hamilton Capital

NA has also grown (adjusted) EPS at a ***faster*** cumulative rate than its peer-average over the past five years (although basically in line over the last three years). This is interesting since we think many investors believe that, because of its exposure to Quebec (which is perceived to have a lower nominal GDP profile than other provinces), NA grows earnings at a slower pace than its peers.

Second, National's revenue mix by geography and activity continues to shift beyond its home province. For example, ~20% of P&C, ~50% of wealth management and ~70% of financial markets revenues are now generated outside Quebec. The company forecasts that over 40% of all revenues for the entire bank will come from outside Quebec by 2017, which if achieved would build upon the already significant progress made in diversifying its geographic mix. (It is worth noting that banks in the U.S. with geographic concentration do not trade at lower valuations.)

Third, the perception that the bank is overly reliant on trading, making for lower quality earnings, has arguably not kept up with the changes in its Financial Markets segment. The bank disclosed in its investor presentation that this segment has seen its contribution to firm-wide earnings decline from 30% to 26% over the last few years (and it is forecast to decline to 23% by 2017). NA also disclosed that 95% of its trading revenues are client-driven (versus principal). As a result, not only has the proportion of earnings from Financial Markets declined, but the quality of revenues ***within*** the division has also improved.

Fourth, NA is in the unique position of being the only Big-6 Canadian bank that can drive growth from material allocation of excess capital within Canada, where returns on capital are higher (versus its peers, which are focusing on foreign expansion, where returns on capital are generally lower). This implies its ***relative*** ROE improvements achieved over the past several years are sustainable.

To summarize, in the last decade NA has been the top performing bank stock. In the past five years, National Bank has had a higher ROE and higher cumulative EPS growth rate than the average of its larger peers. Yet … it continues to trade at a highly material 1.0x multiple discount.

Therefore, investors looking for a Canadian bank that has the potential to be re-rated might ask: should/will a bank with above-average operating performance established over a reasonably long period of time (five years and counting) continue to trade at such a large discount?

In other words, will National Bank (continue to) be re-rated higher?

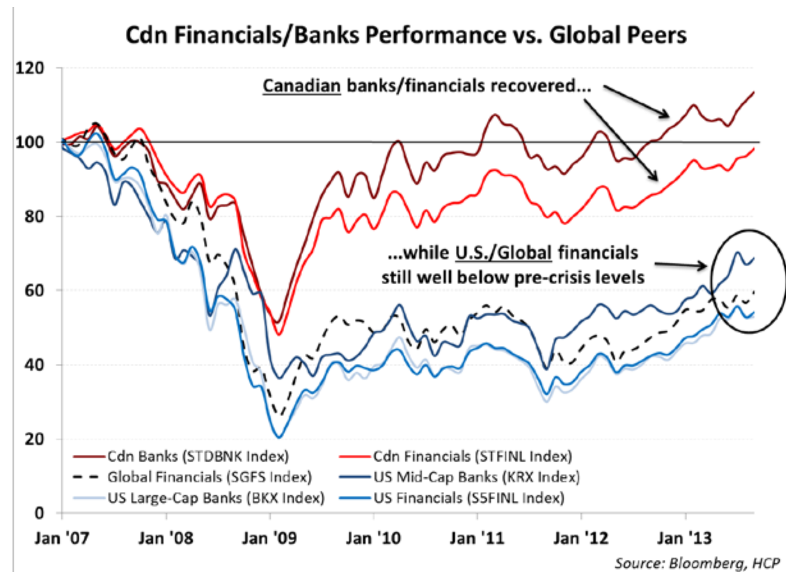
Notwithstanding the high quality of National Bank and its peers, we do not own National Bank or have any directional Canadian bank exposure in our funds.

Why?

Banking is cyclical. And one of the most important factors influencing returns for bank stocks is where the sector is within the economic/credit cycle.

As the adjacent chart indicates, the Canadian banks have fully recovered, while the global and U.S. financials remain as much as 40% below their pre-crisis levels, making Canadian banks comparatively much less attractive from an investing point of view.

For more information on our funds, please visit www.hamilton-capital.com.



Disclaimer

This information has been provided by Hamilton Capital Partners Inc. ("HCP") for informational purposes only. No information provided herein shall constitute, or be constituted as an offer to sell or a solicitation of an offer to acquire units of any HCP fund (and collectively, the "Funds"). This information is not intended for use, and no such units of the Funds shall be offered, in any jurisdiction where such use, or offer or solicitation is prohibited by law or regulation. There is no guarantee of performance, and past or projected performance is not necessarily indicative of future results. Investors should be aware that values change frequently and there is the risk of potential loss of principal. Commissions, trailing commissions, management fees and expenses all may be associated with investments. Please read the prospectus or offering memorandum before investing.