Dividend Increases on Hold, but Canadian Banks Are Prepared for This Challenge

July 20, 2020

ANALYST(S)

James Shanahan, CFA

Companies mentioned in this report followed by Edward Jones:

- **Royal Bank of Canada** (RY–Hold; $95.78)
- **Toronto Dominion Bank** (TD–Buy; $61.80)
- **Bank of Nova Scotia** (BNS–Buy; $56.57)
- **Bank of Montreal** (BMO–Buy; $75.56)
- **Canadian Imperial Bank of Commerce** (CM–Hold; $93.68)
- **JP Morgan** (JPM–Buy; $99.73)
- **Bank of America** (BAC-Buy; $24.60)

Source: Reuters. Prices and opinion ratings as of market close on 7/17/20 and are subject to change.

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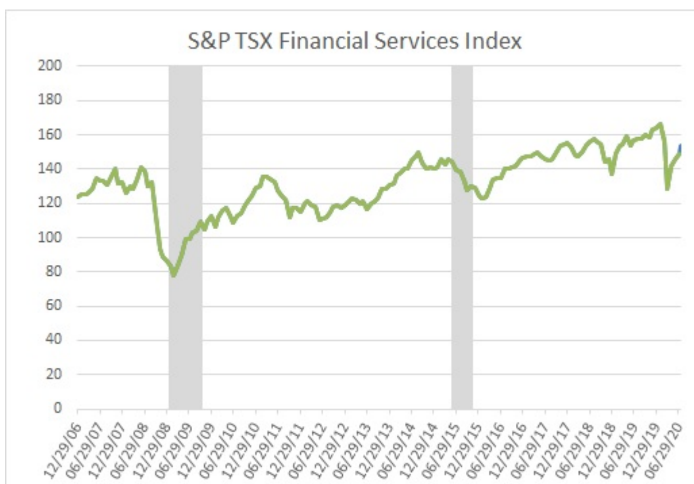
- By late March, the sharp decline in energy prices and the spreading coronavirus had driven the S&P TSX Index down by almost 35%. The index has recovered since then and is now down by only about 5% year-to-date. Financial services stocks have underperformed, however, and are still down by over 15% **(Figure 1 below).**

- Since early this calendar year, we have lowered our earnings estimates several times to reflect the impact of both lower interest rates and higher expected credit costs. If the economic impact of recent events is deeper or longer than we expect, additional negative estimate revisions could be necessary. The biggest risk, in our view, is widespread unemployment, given very high household debt.

- We believe that this pullback presents an attractive opportunity for long-term investors. Dividend yields have risen due to the decline in share prices. *While we expect the big five Canadian banks to halt dividend increases in the near term, we do not expect any dividend reductions, given solid balance sheets and consistent cash flow generation.*

Figure 1. S&P TSX 500 Financials Index



**Shaded area represents a recession. Source: FactSet. The S&P TSX Index is based on the average performance of 230 widely held common stocks. The S&P Financial Services Index consists of 26 financial services companies within the S&P TSX Index. Past performance is no guarantee of future results. Indexes are not managed and unavailable for direct investment. Data as of 07/17/20.*

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Look Back: The Great Recession of 2008-2009

The Great Recession was a severe financial crisis with rippling effects across the global economy. While the causes of events leading into the financial crisis are still being debated to this day, defaults in subprime (lower quality) consumer and mortgage loans exposed excessive risk-taking by the banks, particularly in the United States and Europe. Many banks failed, and even larger banks were tested, as governments eventually provided bailouts to keep the global financial system afloat.

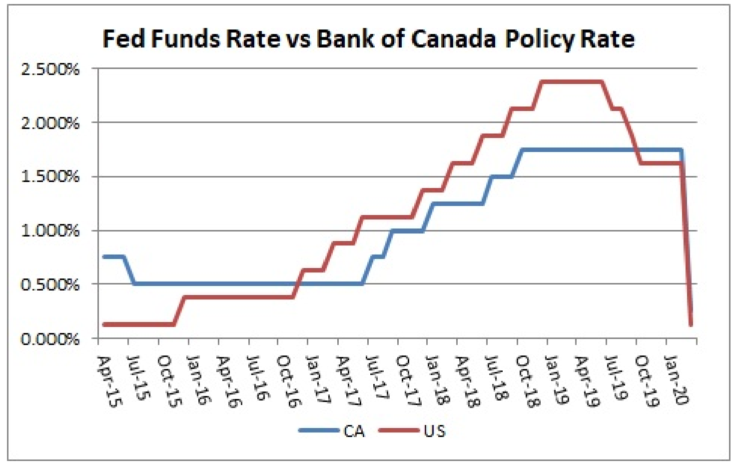
The Canadian economy ultimately fell into recession as its largest trading partners struggled. Canadian bank stocks traded sharply lower, and dividend increases were halted for several years. Over time, however, relative financial strength enabled the Canadian banks to capitalize on opportunities to acquire attractive franchises.

This Time Is Different

Countries across the globe continue to cope with unprecedented health crises related to COVID-19. Leaders are responding to the crisis with strategies to control the spread of the virus and to support businesses and families that have been impacted. The Canadian banks hold substantial capital and will once again be called upon to play an important role. Specifically, the big five banks can support the economy by providing loans and liquidity to individuals and businesses in need of assistance. We believe that this pullback presents an opportunity for long-term investors.

Governments Take Action

Both the Federal Reserve and the Bank of Canada have slashed short-term interest rates in response to the worsening crisis. As financial markets continued to sell off, it was clear that even additional support would be necessary. In both the United States and Canada, governments responded with unprecedented speed to support financial markets, businesses and individuals.

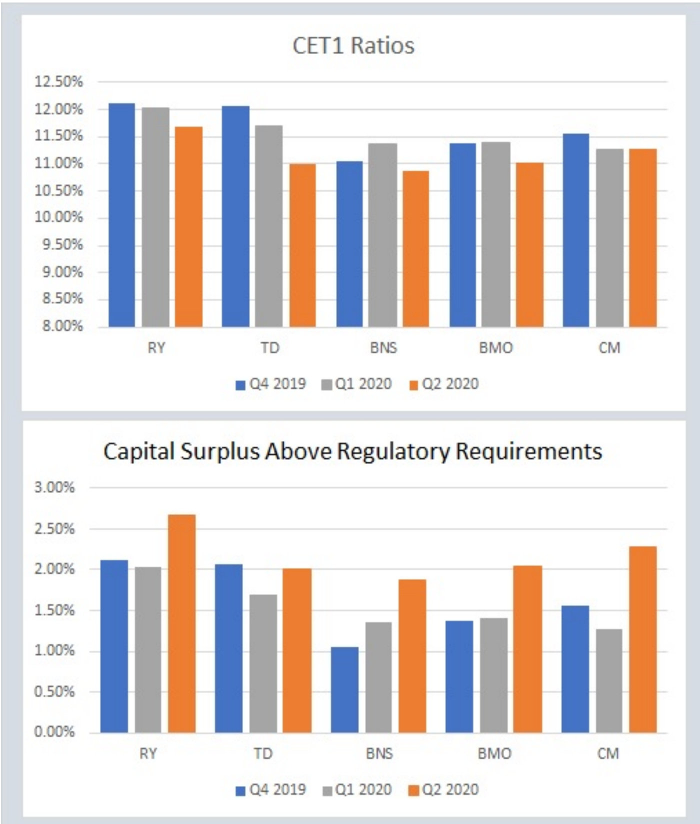


Source: Federal Reserve and The Bank of Canada

Meanwhile, the Office of the Superintendent of Financial Institutions (or "OSFI", the primary Canadian banking regulator) also announced a number of actions. Among them, OSFI announced a reduction in minimum capital requirements for the Canadian banks. OSFI has been steadily raising minimum capital requirements over the last several years, and minimums were expected to increase again at the end of April. Instead, OSFI lowered minimum capital requirements and pledged not to increase them again for 18 months. This was positive news for the Canadian banks because it significantly increased their available capital surplus. *At that time, however, OSFI also set the expectation that all federally regulated financial institutions would halt share buybacks and dividend increases.*

As of the end of the fiscal second quarter (period ended April 30, 2020), the Canadian banks were holding substantial capital, with stronger capital ratios than many large U.S. banks. In the charts below, the blue and gray bars represent regulatory capital ratios (top) and surplus above minimum capital requirements (bottom) for each of the five largest banks as of the end of the fourth quarter of 2019 and as of the end of the first quarter of 2020, respectively.

As a result of OSFI's decision to lower minimum capital requirements, the banks have considerably more excess capital, represented by the orange bars, which capture capital ratios and surplus as of the end of the second quarter of 2020. The spike in available capital has created substantial additional lending capacity for the banks, perhaps as much as several hundred billion dollars.



Source: Company Reports and Edward Jones Estimates

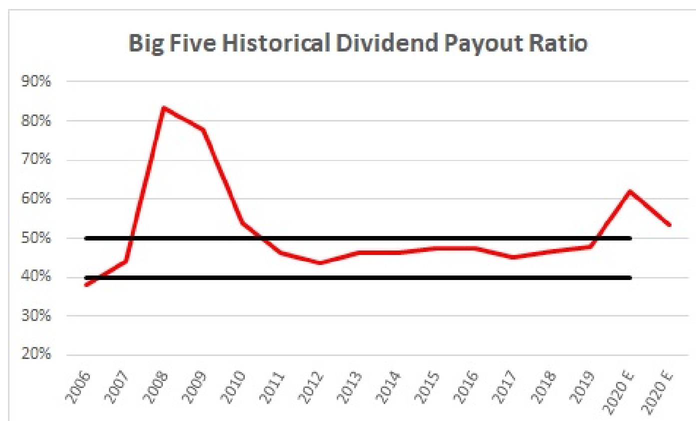
Near-term Earnings Challenged, but Long-term Opportunity Remains

- **Interest rates.** We expect falling interest rates to drive increased loan demand but to also apply incremental pressure to net interest margins. (Net interest margins capture the difference between yields on loans and other earning assets and the cost for deposits and other borrowings. A higher net interest margin is better for a bank, everything else held constant.)

- **Business Loan Portfolio.** While the impact of the virus on the global economy is still uncertain, we do expect businesses to slow their pace of capital spending. Some companies are likely to be facing significant cash flow pressure, particularly companies operating in the energy, travel, auto, lodging and restaurant industries.

- **Energy Exposure.** In mid-2015, the largest Canadian banks held almost $45 billion in oil and gas loans on their balance sheets. Following the downturn in oil prices that began in fall 2015, impaired oil and gas loans climbed to over 6% by fall 2016 and credit costs approached $1.3 billion. Canadian bank loan portfolios have grown considerably since then, but growth in outstanding oil and gas loans has been slower. In late January, oil and gas loans held on the balance sheets of the largest Canadian banks totaled $58 billion, which represented just 2% of total loans. At the end of April, outstanding oil and gas loans spiked to almost $72 billion, as borrowers elected to draw down available capacity under existing credit facilities with the banks. We anticipate outstanding borrowings will have declined during the quarter ended July 31, 2020.

- **Consumer Loan Portfolio.** The deteriorating economy has led to a spike in unemployment, as businesses were forced to close or reduce operations. Recent unemployment data have reflected some improvement in labour market conditions. In addition, we believe that various stimulus measures could help soften the blow of record job losses. However, we still anticipate an increase in credit costs related to consumer-lending activities.



Source: Company Reports and Edward Jones estimates

- **Dividends Are Sustainable, in Our View**. We expect the Canadian banks to comply with regulator expectations and suspend share buybacks and dividend increases. From the end of 2005 through mid-2019, the five largest Canadian banks have paid over $190 billion in dividends, averaging less than 50% of reported earnings (see figure below). Over the last thirty years, there have been periods for each of the five largest banks, during which dividends were not increased. However, none of the five banks reduced their dividends, even during 2008-2009.

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Valuation Considerations for Bank Stocks. When valuing financial services companies, we use various methodologies. First, we often consider the current stock price relative to expected earnings per share, or the price-to-earnings ratio. A key consideration is that investors typically place a higher value on stocks with higher anticipated earnings growth. Another methodology is to compare the current stock price with the book value of equity (value of assets less the value of liabilities). With the price-to-book-value ratio, we often consider the company's return on equity in addition to the growth outlook. Everything else equal, a company with a higher return on equity and a higher growth rate is generally rewarded a higher price-to-book value multiple.

Our current earnings estimates for the Canadian banks reflect our outlook for both lower earnings and profitability in 2020, which supports price-to-earnings and price-to-book-value ratios below recent historical levels. On average, valuations for the big five banks have declined to approximately 1.6 times tangible book value (assets - liabilities - goodwill), below the five-year average of 2.2 times. Meanwhile, the large U.S. banks that we follow, which include JP Morgan and Bank of America, are currently valued at an average of 1.2 times tangible book value.

We continue to expect significant challenges in the near term. That said, we believe that this pullback in the share prices for quality, well-regulated Canadian banks has presented an opportunity for long-term investors. We currently have Buy ratings on TD Bank, Scotiabank and Bank of Montreal. Aside from other company-specific factors, these banks are generally more diversified geographically.

Price to Book Value Per Share (BVPS) and Return on Equity (ROE)

Bank	Symbol	Current Rating	17-Jul Price	Yield	Current Price to BVPS	5-Year Avg Price to BVPS	Average ROE 2017-19	Estimated 2020 ROE
RBC	RY	Hold	95.86	4.5%	1.7 x	2.0 x	17.4%	12.6%
TD Bank	TD	Buy	61.68	5.1%	1.3 x	1.7 x	15.8%	11.2%
Scotiabank	BNS	Buy	56.58	6.4%	1.1 x	1.6 x	14.5%	12.2%
BMO	BMO	Buy	74.60	5.7%	1.0 x	1.5 x	14.0%	9.2%
CIBC	CM	Hold	93.54	6.2%	1.1 x	1.8 x	17.0%	9.8%

Source: Bloomberg, FactSet and Edward Jones Estimates

Memo: *Valuation as of July 17, 2020. BVPS: Book value per share as of April 30, 2020.*

Risks. Some of the risks associated with investing in financial services companies include

- Sensitivity to the health of the economy. In the event of a weaker Canadian economy or a prolonged recession, share prices could be negatively affected as credit risks become elevated and asset values decline;
- Sensitivity to the pace and magnitude of changes in interest rates; and
- Regulatory and legal risks.

Please see our opinion on each of the companies mentioned in this report for more information on the benefits, valuation, and risks of investing in these stocks.

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