



# The Canadian Banks – Cheaper Than You Think

## Description

Bank earnings have been all over the headlines this week. Thus far, they have made a mockery of those concerned about a slowing housing market and pending doom for the Canadian economy. [As indicated in a prior post](#), for Canadian bank investors, it doesn't really matter what the economy does or how it impacts bank results – we need to know the scenario that's already priced into the stocks.

## A Handy Tool

Before we start, a warning. This gets a little analytical. Prepare accordingly.

To help us address this issue of what's priced in, we can lean on the following chart. Plotted is the average quarterly return on equity (ROE) and corresponding average price to book (P/B) multiple for the banks dating back to 1997. For example, in the second quarter of 1998 the Big 5 booked an average ROE of 13.9% and traded at an average P/B 2.2. A dot marks this intersection on the chart.

Bank ROE and PB

Source: Capital IQ

We see that the banks have traded in a P/B multiple range of about 1.5 to 3 over the past 15 years or so, and average ROE has ranged between 5% and 20%. The following table gives an idea where these metrics currently sit for each bank, and provides an average for the group.

Bank	LTM ROE	Current P/B
CIBC ( <a href="#">TSX:CM</a> )	19.7%	2.2
Scotia ( <a href="#">TSX:BNS</a> )	17.6%	2.1

Royal Bank ( <a href="#">TSX:RY</a> )	17.3%	2.4
BMO ( <a href="#">TSX:BMO</a> )	14.0%	1.6
TD ( <a href="#">TSX:TD</a> )	13.2%	1.8
<i>Average</i>	16.4%	2.0

*Source: Capital IQ*

According to the best fit line in our chart, when the banks average their current ROE of 16%, they should trade with a P/B multiple of about 2.5. They currently trade at a P/B multiple of 2 – a level that historically has corresponded with an ROE of 14%, again, according to the best fit line.

Guess what this means? The market is already treating these companies as though housing has rolled over and the Canadian economy has gone into a funk that has impacted bank profitability. Even though bank stocks are moving higher, their valuation reflects a stormier environment than the one that currently exists.

### Forecast

To determine just how stormy the market thinks it's going to get for the banks, let's look at one more set of numbers. We can project ROE expectations for the banks by taking book value, adding consensus earnings estimates, and subtracting dividends.

Bank	BVPS '12	EPS '13	EPS '14	DPS	Proj BVPS	Proj ROE
CIBC	\$37.91	\$8.43	\$8.88	\$3.76	\$47.70	18.6%
Royal Bank	\$27.31	\$5.39	\$5.74	\$2.52	\$33.40	17.2%
Scotia	\$29.76	\$5.10	\$5.51	\$2.28	\$35.81	15.4%
TD	\$48.17	\$7.82	\$8.38	\$3.24	\$57.89	14.5%
BMO	\$40.25	\$6.08	\$6.37	\$2.96	\$46.78	13.6%
					Average	15.9%

Source: Capital IQ

Currently, expectations are for the group's ROE to average 16% in 2014 – sounds familiar. Again, to warrant a P/B of 2, this ROE average should check in around 14%. Expect multiple expansion if these expectations are met. *An average ROE of 14% would require an across the board earnings cut of 15%.*

Because significant credit write-downs are unlikely (thanks to the Canadian government's CMHC) regardless of the housing market that evolves, a 15% across the board decline in earnings is incredibly severe. In my opinion, a worst case scenario in the face of a rollover in housing is merely flat earnings growth – not a decline.

### The Foolish Bottom Line

The banks have been on a roll and it is becoming ever more popular to opine that a collective pull-back is inevitable. Anything is possible, but from a valuation standpoint, the banks are already reflecting a less robust environment than currently exists. As a shareholder, this is a good sign. For a wannabe shareholder hoping for a great buying opportunity (me), this is not ideal. Assuming credit write-downs don't become an issue, bank stocks have the hatches shut and appear hunkered down for the storm.

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*Fool contributor Iain Butler does not own shares in any of the companies mentioned in this report at this time. The Motley Fool has no positions in the stocks mentioned above.*

### CATEGORY

1. Investing

### TICKERS GLOBAL

1. TSX:BMO (Bank Of Montreal)
2. TSX:BNS (Bank Of Nova Scotia)
3. TSX:CM (Canadian Imperial Bank of Commerce)
4. TSX:RY (Royal Bank of Canada)
5. TSX:TD (The Toronto-Dominion Bank)

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tmfohcanada

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