4 Key Questions for Investors in Bank of Montreal

Description

Bank of Montreal (TSX: BMO)(NYSE: BMO) has performed well over the past 18 months. In 2013, the stock appreciated nearly 16% compared to a gain of just 8.6% for the **S&P/TSX Composite Index** (TSX: ^OSPTX). So far this year, Bank of Montreal has kept pace with the broader market, and at its current price of $76, it's threating to establish a new 52-week high.

As the fourth largest bank in Canada, and the eighth largest in North America, the challenges for Bank of Montreal have been weak profitability in its U.S. operations, limited growth prospects in Canada, and difficulty achieving the level of scale and efficiency of its much larger peers.

What direction will Bank of Montreal's stock take? Let's answer four key questions and find out.

1. What are the expectations for earnings growth?

The stock market has traditionally been viewed as an indicator or "predictor" of the economy – a reflection of expectation about the future. The same can be said of individual stocks – how analysts and investors view the future earnings prospects of a company is particular important.

Earnings growth can stem from increased revenue, reduced costs, or measures that improve efficiency and productivity. Expectations for earnings growth at the Bank of Montreal are the lowest of the major Canadian banks. On average, analysts expect annual earnings per share growth of less than 6% over the next five years, and just 1.6% this year.

It's also important to know a company's track record for missing, meeting, or surpassing earnings expectations. Over the past six quarters, Bank of Montreal has surprised the market each time – five times it beat expectations, and just once did it disappoint the market by missing expectations.

2. How profitable is the bank?

A company that has a "moat" enjoys a competitive advantage that is difficult for competitors to overcome. The wider and more durable a company's competitive advantages, the wider the moat. And the wider the moat, the easier it is for a company to protect its market share and keep profits high.

One of the primary measures of profitability is net margin — calculated as net income divided by revenues. In essence, it measures how much out of every dollar of sales a company retains as earnings.

Bank of Montreal has the lowest profitability of the major banks in Canada at 26%. For comparison, Canada's most profitable bank is the **Bank of Nova Scotia** (TSX: BNS)(NYSE: BNS) at nearly 31%.

3. How effective is management?

For nearly any organization, its long-term success depends upon the effectiveness of management. And return on equity, measured as the amount of net income as a percentage of shareholder equity, is an excellent tool in evaluating management's ability at generating a profit from the money shareholders have invested**.**

Once again, Bank of Montreal trails its peers with a 14% return on equity. The leader amongst the large banks? **Canadian Imperial Bank of Commerce** (TSX: CM)(NYSE: CM) at nearly 23%

4. Is the stock overvalued, fairly valued, or value priced?

Everyone likes a sale, and even good quality companies can be purchased at a bargain price from time to time. But patience is required.

The forward price to earnings ratio, which takes into account the current stock price and the 12 month earnings forecast, and the forward PEG ratio, which divides the forward P/E ratio by the five-year estimated growth rate, are good initial indicators of a stock's relative value. In both cases, the lower the better.

The Bank of Montreal's forward P/E ratio of 11.8 is above its five-year average of 11.2. And its forward PEG of 2.0 also trades at a significant premium to its five year average of 1.5. On both measures, Bank of Montreal stock is expensive.

Foolish bottom line

The key to long-term investing success is to identify quality companies, buy them when they go on sale if possible, and hold them for the long term, or until your original investing thesis no longer applies.

Bank of Montreal lags its peers on the key measures of earnings growth, profitability and return on equity. And its current valuation is higher than it's been, on average, over the past five years. Investors may be interested in its dividend yield of 4%, but should not expect market-beating returns from an investment in the Bank of Montreal.

CATEGORY

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Date
2025/08/24
Date Created
2014/04/24
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