After Royal Bank of Canada's Big Move, Should You Buy the Shares?

Description

Well that didn't take long. Less than six months after taking over as CEO of **Royal Bank of Canada** (TSX:RY)(NYSE:RY), Dave McKay has made his first big move.

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On Thursday morning, RBC announced a US$5.4 billion takeover of **City National Corp.** (NYSE:CYN), a Los Angeles-based private and commercial bank. City shareholders will receive nearly US$94 per share, a 26% premium to the company's last closing price. Half of the purchase will be paid in cash, and the other half in RBC shares. Amazingly, the acquisition is the largest in RBC's history.

So what exactly was the logic behind this deal? And was it a good idea?

The deal itself

There are a lot of things to like about City National (not to be confused with **Citigroup**). It is focused mainly on high net worth households and commercial clients, both of which are very attractive segments to RBC. City is also well-positioned geographically, with a strong presence in New York, LA, and San Francisco.

Better yet, City has been growing very nicely. Since 2011, loans and deposits have grown by 18% per year and 12% per year respectively. On the wealth management side, client assets and fee income have grown by 10% and 19%.

As a bonus, there are opportunities for synergies. By year 5, RBC hopes to squeeze out US$210 million in additional pretax income through cost cuts, increased deposits, and growth initiatives.

Was it a good idea?

That said, the market is not a big fan of this deal. As of this writing, RBC's shares are down by nearly 4%. So what are the drawbacks of this transaction?

First of all, RBC seems to be paying full price. In fact, it's paying over 20 times City's expected 2015 earnings. As a result, the transaction is expected to decrease RBC's earnings per share until "the latter part of year 3".

Secondly, this deal is a lot bigger than RBC's previous wealth takeovers. For example, its 2010 takeover of London-based Bluebay Asset Management cost only $1.5 billion. And when speaking at a conference back in 2013, CFO Janice Fukakusa said RBC was looking at wealth management transactions of up to $5 billion. Based on today's exchange rates, RBC is buying City for $6.7 billion.

Finally, the timing of this deal is suspicious. After all, the United States economy is on fire, and Canada's is struggling. Is RBC looking to shift its earnings mix more towards the United States?

Maybe I'm being harsh, and maybe this deal will turn out very well. But I'm not yet convinced, and neither is the market.

So should you buy RBC?

I would hold off buying RBC shares at this point. Even after the price drop today, its shares are still very expensive relative to its peers, currently trading at 2.3 times book value. And this acquisition isn't much to get excited about.

But there are banks in Canada worth buying. For more information, just download the free report below.

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