Should Investors Forget the Big 5 and Invest in National Bank of Canada Instead?

Description

Canada's so-called Big Five banks get all the attention, and rightfully so.

Collectively, **Royal Bank of Canada**, **Toronto-Dominion Bank**, **Canadian Imperial Bank of Commerce**, **Bank of Nova Scotia**, and **Bank of Montreal** dominate the industry, controlling some 80% of Canada's banking system. These companies also collectively have exposure to the U.S. as well as places like Latin America, the Caribbean, and Asia. They are truly worldwide financials.

Because the large banks capture investor attention, Canada's smaller financials often get excluded from the discussion. Foreign investors especially refuse to acknowledge many of these smaller banks even exist. This exclusion has led to investors missing out on some terrific opportunities over the years.

Perhaps the best known Canadian financial not included in the Big Five is **National Bank of Canada** (TSX:NA). Should investors focus on it over its larger competitors? Let's take a closer look.

Valuation

Over the years, National Bank has consistently traded at a lower valuation compared with its peers. Does that still hold true today?

Currently, National Bank shares trade hands at just 10.5 times trailing earnings, which is a pretty significant discount compared with its peers. To compare, Royal Bank currently trades at 11.9 times trailing earnings, while TD Bank has an even higher multiple, coming in at nearly 13 times.

Of course, it's easy to make the argument that TD deserves a higher multiple than National Bank. TD has a significant presence in the United States, which looks contribute more to the bottom line once those profits are converted back to Canadian dollars. Plus, investors like the diversification.

Perhaps the best bank to compare National Bank with is CIBC, which is the most Canadian-centric of the Big Five. Right now, CIBC trades at 10.6 times earnings, suggesting the market values National Bank and CIBC as somewhat interchangeable.

Dividend

At a 4.5% yield, it's easy to see why many investors are attracted to National Bank's dividend, especially in a world where bond yields are pretty anemic.

Dividend growth has been stellar too. Over the last decade, National Bank has increased its quarterly dividend from $0.22 per share all the way to $0.52 per share where it sits today. That's a compound annual growth rate of approximately 9%, which is a pretty nice annual raise. And remember, National Bank just held dividends steady for a couple of years during the financial crisis.

Outlook

There's a pretty simple reason why National Bank trades at a low price-to-earnings ratio. It's the same reason why many stocks trade at low P/E ratios. Investors just aren't confident it can keep up the earnings.

In the United States especially, short sellers are aggressively circling Canadian lenders. Many investors think Canada's housing bubble will inevitably end as badly as the U.S. version did, leading to billions in bank losses. I'm the first to admit the short thesis looks at least plausible. Houses are overvalued in Canada, especially in markets like Toronto and Vancouver.

There's an easy way for National to distance itself from this, and that's to buy U.S. assets. This shouldn't be terribly hard, since the banking system down south is so fragmented once you get away from the giants that dominate the system.

To me, National Bank's failure to expand into the U.S. illustrates one of two things. Either the bank is content staying exclusively up north, or it's being very selective in looking at expansion plans. For it to increase its valuation more in line with the other banks, it's going to have to expand operations outside of Canada.

Of course, National Bank still has plenty of Canadian expansion potential left. It virtually doesn't even exist west of Ontario, with only about a dozen branches in the prairies and B.C. Perhaps it should get a more nationwide network in Canada before looking to tackle the U.S.

National Bank has plenty of growth potential, but doesn't seem to be seizing any of it. Until it does something the market truly likes, it's likely to continue to trade at a slightly lower multiple than its peers. Still, with solid retail operations, a 4.5% yield, and a dominant position in its home market, there's still a lot to like about National Bank.

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1. TSX:NA (National Bank of Canada)

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