Why Is Royal Bank of Canada 20% Cheaper Than it Was 12 Months Ago?

Description

At this time last year, **Royal Bank of Canada** (TSX:RY)(NYSE:RY) traded for $81 per share, equivalent to nearly 14 times earnings. And since then the bank's earnings per share have increased by more than 12%. Yet the bank's share price has fallen below $73.

Consequently, RBC now trades at just 11 times earnings, which is 20% lower than the ratio 12 months ago. How has this happened?

A familiar story

The headwinds facing the Canadian banks are well documented: Canada is in a recession; the housing market is due for a correction; consumer debt is at scary levels; and low interest rates are holding down lending margins.

This has put pressure on all the bank stocks, not just RBC. In fact, the Big Six bank stocks have all declined by at least 9.6%, even though earnings numbers have remained strong.

We don't yet know what effect these headwinds will have on the banks' earnings. But so far, at least, the market seems to have overreacted.

Exposure to energy

As we all know, Canada's recession is being driven by low oil prices. So, when looking at bank stocks, what really matters is the company's exposure to energy producers.

RBC's exposure is worrying. Including undrawn lines of credit, the bank has over $20 billion in loans outstanding to the oil and gas sector, about 3% of total loans outstanding. That may not sound like a lot, but it's significantly more than some of the bank's rivals.

Furthermore, RBC has above-average exposure to the province of Alberta. The bank's capital markets division counts energy as one of its specialties. And wealth management revenues could take a hitfrom declining energy stock prices.

Again, the full effect of RBC's energy exposure has yet to be felt. But unless oil prices start recovering, we're going to see some producers defaulting on their loans, and this will surely affect RBC's bottom line. This story has not ended.

Ignoring the positives

Investors have understandably been focused on the risks of RBC shares. But the bank has made a lot of positive steps in recent years, and this progress has seemingly been ignored.

Most notably, the bank has expanded its capital markets business internationally, while other banks have been retreating. This has made it easier for RBC to hire top talent.

Likewise, the bank has been expanding its presence in wealth management when other banks have been raising capital. That has allowed the bank to make some relatively cheap acquisitions in recent years.

Over time, such steps should allow the bank to keep growing its bottom line. And once investors give the bank more credit for its accomplishments, you could easily see some multiple expansions as well. At this point, there's clearly a lot of upside for RBC's shares, especially compared with last year.

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