



Is Royal Bank of Canada a Value Trap?

Description

As of October 30th, 2015, **Royal Bank of Canada** ([TSX:RY](#))([NYSE:RY](#)) is one of Canada's most shorted stocks. This means that investors—in this case, largely American investors—are betting that there is large downside risk for RBC.

The reasons may seem obvious. Oil prices are projected to remain low, which will pressure the bank's earnings. In addition, economists at **TD Bank** are expecting housing starts in Canada to fall by 9.6% in 2016 and 5% in 2017, which is a sign that Canada's overextended housing market is finally slowing. This poses a risk to RBC's earnings growth and adds risk to the balance sheet as well.

While there are certainly headwinds, RBC is currently trading well below its five-year average trailing price-to-earnings ratio, which makes RBC seem like a bargain. So, is RBC currently a value trap?

Looking at RBC's valuation

Looking just at RBC's trailing price-to-earnings ratio (P/E), the bank seems like a bargain. Over the past five years, the company has traded at an average of 14 times its earnings for the prior four quarters. Currently, RBC is trading at about 11.6 times its prior four quarters' earnings, making the company seem cheap.

However, the earnings multiple a company trades at is supposed to be a reflection of its future growth, and while RBC's valuation may have come down, so has its projected earnings over the next five years. Historically, RBC has grown its earnings per share in the low double digits annually (12.1% in 2014, for example), but projected earnings growth for the next five years is in the 4-10% range, with the consensus being about 7%.

This means that while RBC may be trading at a lower than average valuation, this low valuation may be justified, making RBC not such a bargain. Fortunately, there are a few ways to check this.

One way is to look at the forward price-to-earnings growth (PEG) ratio. This takes RBC's forward P/E ratio (or the current price divided by next year's estimated earnings) and divides that by the projected five-year growth rate. This basically states how expensive the company is relative to its projected

growth rate.

In this regard, RBC currently has a PEG ratio of 1.6 compared with the five-year average of 1.5. The end result is that when you compare RBC's seemingly low valuation to its lower projected growth rate, the company does not appear undervalued, but it does not appear to be overvalued either.

What about further risks to RBC's earnings?

RBC does not seem like a value trap if it can manage to maintain its projected earnings growth rate over the next five years. However, it could easily become one if a major deterioration in economic conditions reduces its earnings growth rate even further.

Fortunately, the further downside risk to RBC's earnings seems limited. While the housing market is poised to slow, most experts are expecting a soft landing. Interest rates are likely to rise gradually, Canadian debt-servicing costs as a percentage of disposable income are at historical lows, and significant foreign investments should prevent the housing market from coming down quickly.

In the event that it does, Royal Bank has 45% of its domestic mortgages insured by the CMHC, and its loan portfolio is well diversified across the country.

On the oil-price front, continued low oil prices could impact bank earnings. When an outstanding loan becomes impaired, banks are required to withhold the amount from their earnings (this is known as a provision for credit loss). This reduces earnings.

RBC has stress tested their loan portfolio and found that if oil prices were to decline and stay lower, the bank's provision for credit losses would increase from about 0.26% of loans outstanding to 0.40-0.50% of average loans and acceptances.

While this would impact earnings, the effect would be manageable, and extreme oil-price weakness would also likely be short lived since very low prices would take further supply offline and stimulate demand.

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