National Bank of Canada: A Contrarian Bet on Canada's Economic Recovery

Description

Canada's banks continue to attract considerable negative attention from investors, because of fears of a housing meltdown and Canada's slowing economic growth and exposure to a beleaguered energy patch. For these reasons, **National Bank of Canada's** (TSX:NA) share price has been hit hard and is down by 14% over the last year. This, I believe, makes it attractively priced, making now the time to add Canada's sixth-largest bank to your portfolio.

Now what?

National Bank's business is predominantly focused on eastern Canada, which makes it relatively immune to the ructions being caused by the sharp slump in crude.

In fact, of Canada's six largest banks, it has the lowest direct exposure to the beleaguered energy industry; the total value of its loans to the energy patch is $3.2 billion, or 2.7%. Whereas **Toronto Dominion Bank** has about $6 billion of drawn loans to the energy patch, and the **Bank of Nova Scotia's** exposure is a whopping $16.5 billion.

It should also be noted that National Bank's indirect exposure to the energy patch is negligible; just under 10% of its total loans are located in Alberta and Saskatchewan.

Meanwhile, the prospect of a U.S.-style housing meltdown in Canada is extremely unlikely, but analysts do expect the real estate market to cool, and this, along with a slowing economy, will impact short-term earnings growth for the banks.

However, any slump in the housing sector will have a minimal impact on National Bank because of the high quality of its loan portfolio. Its ratio of gross impaired loans to total loans is a mere 0.36%, well below this ratio for the other major banks.

Furthermore, 45% of its mortgages are insured, and its uninsured mortgages have a conservative loan-to-valuation ratio of around 70%, again ensuring that the impact of any property crash will be minimal.

National Bank also has minimal exposure to the property market in western Canada, which is considered to be the most vulnerable to a market crash. The bank has less than 6% of its mortgages located in Alberta and Saskatchewan.

Despite the difficult operating environment, National Bank continues to perform well. For the first quarter 2016, it reported a 4% year-over-year increase in net income, which was underpinned by a solid performance from its personal and consumer banking business. It also continues to maintain tight control of costs, reporting an efficiency ratio of 58.6% for the same period, an improvement of 10 basis points compared with the same quarter in 2015. And it remains well capitalized with a tier one common equity ratio of 9.7%, which is well above the regulatory minimum.

Investors shouldn't forget about National Bank's dividend. With a juicy yield of 5.2% and a very sustainable payout ratio of 43.5%, it's particularly attractive for income-hungry investors.

So what?

I believe that the risks associated with Canada's banks are over baked and the recent sell-off is unjustified. Nonetheless, National Bank is now attractively priced, making it a solid contrarian play on an eventual upturn in Canada's economy. And it has juicy dividend yield, which will consistently reward investors while they wait for the share price to appreciate.

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1. TSX:NA (National Bank of Canada)

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