National Bank of Canada: It's Time for This Company to Make a Splash

Description

I've been bullish on **National Bank of Canada** (TSX:NA) for a while now for a couple of pretty simple reasons.

The first reason is valuation. While it doesn't look particularly cheap based on trailing earnings–it trades at a trailing P/E of about 13.5–it's quite cheap when we look at 2017's expected earnings. Analysts expect the company to earn $5.01 per share next year, putting shares at just 9.3 times forward earnings. Most of its peers trade at forward earnings multiples of between 11 and 13 times earnings.

This valuation discount shows up in the company's dividend as well. Shares currently yield 4.7%, which is succulent when compared to other income sources like government bonds. Only **CIBC** and its 4.8% dividend beat National Bank when compared to its peers.

Dividend growth has been fantastic too. From 2005 to 2015, National Bank grew its dividend at an average of 9% a year, which included holding the dividend steady through the Great Recession.

National Bank has also posted great returns on equity (ROE) over the past few years. In 2014 it posted a 18.5% ROE, while its competitors averaged 16%. And 2015 saw it post a 17% ROE, while peers averaged 14.7%. And thus far in 2016, it posted a 14.9% ROE versus a 14.2% mark for Canada's other big banks.

And finally, the company actually has potential to grow inside Canada. It dominates Quebec and has a presence in both Ontario and Atlantic Canada, but it really hasn't expanded to western Canada. That's an obvious growth path.

With all of these things going for it, why doesn't National Bank get more attention? There's a simple answer to that question.

Too Canadian

There are a number of risks plaguing the Canadian economy.

A big one is housing. We've all seen the alarmist headlines about the state of Canada's housing market, especially in markets like Toronto and Vancouver.

A related risk is our indebted consumers. With personal debt levels hitting record highs, Canada's banks could start to see more customers default on their loans.

There's also commodity prices. Weakness in oil and natural gas is hitting provinces like Alberta, Saskatchewan, and Newfoundland hard.

Investors are rewarding banks with a significant amount of U.S. exposure for diversifying outside Canada. These banks are getting higher multiples than those that make much of their money here at home.

CIBC has been feeling this punishment for years now, so management did something about it. The company announced it would spend $4.9 billion to acquire Chicago-based PrivateBancorp, which would contribute about 10% of the bank's total income. It's a nice start.

After the CIBC/PrivateBancorp deal closes, National Bank will be the only major financial institution left in Canada without significant foreign operations.

Dipping a toe in…

National Bank has been making acquisitions outside Canada. They just haven't been big enough to matter.

It owns 24% of a bank in the Ivory Coast, 17.5% of AfrAsia, a bank in the island nation of Mauritius, 90% of ABA Bank in Cambodia, and 10.5% of Tenger Financial from Mongolia. Altogether, these investments total about $380 million. That isn't much for a company with a market cap of $15.5 billion.

National Bank also invested $165 million into Maple Financial Group for a 24.9% stake in the company. This investment didn't go well. Operations in Germany were limited by a tax probe, and regulators took control of it. National Bank has written off its entire investment in Maple Financial.

Still, management doesn't seem discouraged. The company is actively looking to make acquisitions in developing markets where there's high GDP growth, young populations, and increasing banking penetration. Oh, and it wants to buy these assets at a cheap price.

There's certainly potential to make deals in these developing markets, and banks in newer stock exchanges do tend to trade at lower valuations. National has that going for it. But investors are growing impatient; they want the company to make a deal that actually matters to the bottom line.

If National Bank can do that, look for the valuation gap between it and other Canadian banks to decrease. It's that simple. Until then, expect the status quo to continue.

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