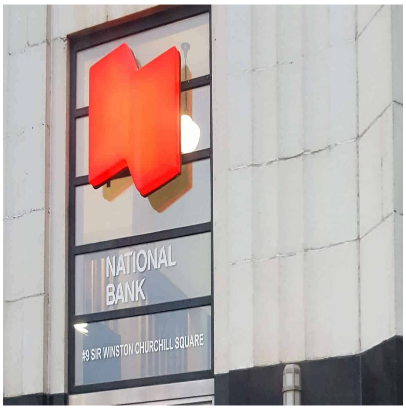

Better Buy: National Bank of Canada vs. Canadian Western Bank

Description

It's been a tough month for Canada's banks.

The **Home Capital Group** fiasco has been largely contained, but investors are still worried. It's obvious Canada's largest alternative mortgage lender has been severely damaged. It may never recover. If it fails, will it send a shockwave through the system that brings other banks and alternate lenders to their knees?

Even Canada's so-called Big Five banks have been impacted by this scandal. Each saw shares fall during April, although not nearly as much as the fringe players. A 5% downturn isn't very exciting.

Canadian Western Bank (TSX:CWB) and **National Bank of Canada** (TSX:NA) are a little more exciting. Both saw shares fall approximately 10% in the last couple of weeks, which is a large enough pullback to acquire a little interest.

Let's take a closer look at both of these Canadian banks.

Valuation

National Bank, on the surface, doesn't have a very appealing price-to-earnings (P/E) ratio. It's currently at 13.2, which is a little expensive.

But that includes a one-time charge of $175 million, which was incurred after the company wrote off the value of some intangible assets. Once we control for that, the trailing P/E is closer to 12.

Canadian Western Bank has also traditionally traded at a discount versus its larger peers. The company earned $2.05 per share in 2016, giving it a trailing P/E ratio of 12.5. Like National Bank, it's been impacted by a one-time charge; this one was for $32.5 million on some bad loans made to energy companies. After accounting for that, we get a trailing P/E ratio close to 10.

Dividends

Canadian Western Bank shares currently pay $0.23 per quarter — good enough today for a 3.6% yield. The payout ratio is under 40% of trailing normalized earnings. The company raised the dividend at least once annually between 2010 and 2015, but it hasn't hiked it since.

National Bank has a far better dividend today. Shares currently pay $0.56 each — good enough for a 4.3% yield. The payout ratio is a little higher, coming in at about 50% of normalized earnings, which is where most Canadian banks try to be. On average, National Bank has raised its dividend twice a year since 2010.

Exposure to the housing bubble

The good news for Canadian Western Bank is, it has virtually zero exposure to the Toronto housing market. The bad news is, it likely has some serious exposure to Vancouver, which many argue is just as overvalued as Toronto.

Canadian Western Bank has $4.2 billion lent out to real estate developers. Some of that money has been borrowed by folks building real estate in Vancouver. Total amounts aren't disclosed.

Loans to real estate developers are particularly troublesome because they aren't insured against default.

While National Bank is focused on the Quebec market, it has some exposure to both Toronto and Vancouver. Unfortunately, the company doesn't disclose specific exposure to each market.

Ultimately, I'd be much more concerned about Canadian Western's loan book today. Remember, Canadian Western has an active alternative mortgages division, while National Bank focuses on the prime market. Also keep in mind that Canadian Western's loan-loss reserves are much higher than National Bank's today.

Growth

National Bank has been dipping its toes outside Canada, acquiring stakes in small banks in Asia. It would love to make a bigger acquisition, but management just can't find a good opportunity.

Canadian Western has far better growth potential, at least in my mind. It's a much smaller bank with plenty of growth potential still remaining in Canada. In addition, the company has shown it's willing to make acquisitions to expand operations. National Bank seems pretty gun shy.

The bottom line

Both National Bank and Canadian Western Bank are cheaper than peers. While I like Canadian Western's growth potential, I'm not a particular fan of its loan book. In addition, National Bank has the higher dividend today.

Ultimately, however, if you're really concerned with Canada's housing bubble, it's probably best to avoid both of these stocks.

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