This Beaten-Down Stock Deserves Better

Description

Laurentian Bank of Canada (TSX:LB) announced second-quarter earnings June 1 and they were reasonably good despite facing an ongoing mortgage problem that's putting a heavy burden on the Quebec bank's management team.

Trading around $60 last October, it lost 25% of its value as a result of the $392 million in mortgages sold to a third party that was either accompanied by insufficient documentation or were improperly flagged for sale to the third party. At no time was there any indication of fraudulent activity by bank employees.

Over the past six months, it underwent a thorough review of the loans in question. It will continue to examine all of its insured loans through the CMHC in its residential mortgage portfolio. That review will be completed by the end of fiscal 2018.

"We have made important headway in addressing this situation, which has no impact on our clients, and are confident that it will be completely resolved by the end of the fiscal year," said President & CEO François Desjardins on May 29. "This has been a learning experience, and since November 2017, we've been implementing enhanced quality control and origination processes throughout the bank. We firmly believe that this significantly strengthens our mortgage origination and securitization activities."

On two occasions in the past six months — first, in December, when the mortgage issue first came to light and then again in March when its stock dropped down to the mid $40s as the issue dragged on — I've argued that investors are unfairly punishing the bank for a group of loans, representing less than 2% of Laurentian's total residential mortgage portfolio.

In other words, investors have been making a mountain out of a molehill. It's akin to thinking your BMW is the best car on the road because Jeep and Cadillac just had vehicle recalls and your car maker didn't.

These issues happen at all of the Canadian banks; it's just that Laurentian isn't one of the Big Five and doesn't get a pass. Remember all the fees the Big Five have been imposing on their clients over the past decade? Where's the investor outcry about that?

This issue will pass by the end of 2018, but Laurentian will be much stronger for it, and that's a big reason to buy its stock while it's trading a level seen just three times in the past five years.

Business is good

The bank's adjusted net income in the second quarter was $64.6 million, which was 25.2% higher than a year earlier. If you exclude the $4.6 million after-tax gain from the sale of its agricultural commercial loan portfolio, it still grew adjusted earnings by 16.3% in the quarter.

By comparison, **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD) was the only Big Five bank to have a better quarter, with adjusted earnings up 21%. Yet TD traded for more than 13 times earnings, while Laurentian gets a single-digit multiple of eight.

Laurentian might have some warts, but the fact the bank grew its business loans portfolio by 19% over last year to $12.4 billion suggests that while investors are focusing on residential mortgages, it's building a nice little commercial lending business that's growing by the double digits.

The bottom line on Laurentian's stock

With a dividend yield of 5.6% and a business that's actually performing quite well, if you're a value investor, I'm not sure how you can pass on this opportunity.

If it's not at $60 by the end of 2019, I'd be shocked.

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