



Is This Canadian Banking Giant and its Juicy 5% Yield a Poor Investment?

Description

Canada's banks continue to attract considerable negative interest with the largest mortgage lender **Royal Bank of Canada** ranked as the most shorted stock on the TSX. Most of the [negative attention](#) is from U.S. hedge funds that believe a sharp decline in the quality of credit is looming, which — along with reduced growth opportunities — will cause earnings to fall sharply, impacting their market value.

There is increasing conjecture that despite [Royal Bank](#) being the most popular target, **Canadian Imperial Bank of Commerce** ([TSX:CM](#)) ([NYSE:CM](#)) is the most vulnerable. Canadian Imperial is the most domestically focused of the Big Five, making it the most vulnerable to any economic downturn, yet it is attracting far less interest from short-sellers than either **Toronto-Dominion Bank** or **Bank of Nova Scotia**.

Even after Canadian Imperial finally elected to expand beyond Canada into the U.S., with the US\$5 billion acquisition of Chicago-based PrivateBank after an earlier, costly foray into the Caribbean, most of its business is generated in Canada. For the second quarter 2019, that recently acquired business was responsible for a mere 12% of its net income, emphasizing Canadian Imperial's reliance on its Canadian retail and commercial banking businesses to drive growth.

Disappointing results

The bank reported some rather unimpressive second-quarter 2019 results, including a dismal 2.2% year-over-year increase in net income to \$1.3 billion, which was driven by a stronger performance from its U.S. and capital markets divisions. Canadian Imperial's core domestic personal and small business banking division reported that net income declined by over 2% because of higher expenses, deteriorating credit quality, and increased provisions. The value of gross impaired loans (GILs) shot up by 3% to \$908 million, while provisions for credit losses rose by a worrying 13% year over year to \$229 million.

This was to somewhat offset by Canadian commercial banking and wealth management reporting a 6% year-over-year increase in net income. That was primarily driven by higher revenue, although declining credit quality and increased lending loss provisions were an issue. The value of gross

impaired Canadian business and government loans more than doubled year over year to \$256 million, while provisions for credit losses spiked to \$23 million compared to \$1 million for the equivalent period in 2018.

For those reasons, Canadian Imperial's bank-wide lending loss provisions spiked by a worrying 20% to \$255 million, while the value of GILs shot up by a disturbing 34% to \$2 billion. The 0.11% year-over-year increase in the bank's second-quarter GIL ratio to 0.52%, which, while not the worst of the Big Five, indicates there are emerging issues relating to the quality of its credit portfolio.

The risks posed by Canadian Imperial's focus on domestic lending to drive earnings growth is underscored by 84% of its loans being originated in Canada and 53% of its credit portfolio being comprised of residential mortgages. That makes Canadian Imperial particularly vulnerable to any external shocks that could trigger weaker domestic economic growth.

You see, Canadian households — with a near-record debt-to-income ratio of 176% — are among some of the most indebted in the developed world. That means they are especially vulnerable to any economic shocks, which have the potential to trigger a marked uptick in the volume of loan delinquencies. While mortgage insurance and a conservative loan-to-value (LTV) ratio for Canadian Imperial's uninsured mortgages will mitigate the impact, this will still have a significant impact on earnings, particularly as capital is diverted from productive revenue-generating activities to ever-higher lending loss provisions.

Foolish takeaway

The sharp deterioration in credit quality combined with Canadian Imperial's significant domestic focus make it an unappealing investment. The other Big Five banks, notably Royal Bank, are far more attractive investments with superior growth opportunities. Even Canadian Imperial's 5% dividend yield does little to boost its appeal.

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