Bank of Montreal (TSX:BMO): An Undervalued Giant

Description

Canada's largest banks have been getting a lot of attention from both optimistic long-term investors and pessimistic short sellers. Although hedge fund manager Steve Eisman has placed an enormous bet against Canadian banks, retail and institutional investors have continued to pour capital into the sector, which has pushed the major banking stocks close to their historic highs.

After a decade of phenomenal returns, these banks currently offer some of the most lucrative dividend yields on the Canadian stock market. For investors seeking a stable source of passive income for the long-term, this is a great place to look.

Looking beyond the top three, some of the smaller and less popular banks seem to be striking the right balance between fundamental value and long-term growth prospects. One of those is the country's oldest bank: **Bank of Montreal** (TSX:BMO)(NYSE:BMO).

Fundamentals

BMO is a fundamentally strong bank with a robust balance sheet. Unlike its rivals in the sector, it has enough provisions to cover for bad loans and a spike in the default rate.

According to the short thesis against Canadian banks, the sector is ill-prepared for credit losses that could be triggered by the next spike in interest rates. In other words, banks haven't kept enough money aside to cover for delinquent loans at a time when the country's businesses and households are over leveraged and interest rates are creeping upward from a historic low.

However, BMO has set aside $137 million as provisions for credit losses, according to the bank's latest quarterly report, which represents 13 basis points or 0.13% of its loan book at the end of the quarter.

Not only is the financial situation stable at the moment, but the bank is also clearly delivering growth as well. Reported net income is up 8.15% quarter-on-quarter, while the adjusted Return on Tangible Common Equity (ROTCE) has climbed from 11.5% to 16.5% over the same period.

In short, BMO is steadily growing while maintaining an adequate buffer for macroeconomic upheavals.

Valuation

However, steady growth and capital adequacy are only half the story. Investors need to take a closer look to see if the stock's market price matches up with its intrinsic value.

As it isn't as big or as popular as the other major banks, BMO tends to trade at a relatively reasonable valuation. At its current price, the stock trades at 10 times annual earnings and a 42% premium to book value. By comparison, **Royal Bank** (TSX:RY)(NYSE:RY) trades at 12 times earnings and a 98% premium to book value.

At 4.16%, BMO's dividend yield is also higher than Royal Bank or **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD), which offer 3.92% and 3.87% respectively.

Bottom line

While Canada's banking sector seems overheated at the moment, there are pockets of value for investors keen on high dividends and long-term stability.

Bank of Montreal is a good example of this. Despite its size, the bank tends to fly under the radar for most investors, which has left its stock reasonably valued. The financial giant seems to have struck the perfect balance between responsible lending and impressive growth, which makes it a great candidate for a long-term, income-oriented portfolio.

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