Royal Bank of Canada’s (TSX:RY) Earnings Plunge: Is it Still a Buy?

Description

Canada’s largest lender, **Royal Bank of Canada** (TSX:RY)(NYSE:RY), posted a whopping 54% decline in net income today, but its stock soared. The bank is up almost 10% in less than a day, as investors blow off its poor earnings. The latest results, which are representative of the broader fears surrounding the outlook for the economy in a coronavirus world, have sparked doubts as to whether Royal Bank is a worthwhile long-term investment. I have been bullish on the bank’s outlook for some time, and Royal Bank’s prospects remain firm.

Bank earnings plunge

Royal Bank’s fiscal second-quarter 2020 net income tumbled 54% year over year to $1.5 billion. That sharp decline can be primarily attributed to an almost sevenfold increase in lending loss provisions rather than a marked deterioration in Royal Bank’s performance or fundamentals.

You see, like its Big Five peers, Royal Bank is anticipating a sharp spike in loan delinquencies, impaired loans, and credit losses because of the economic fallout from the coronavirus pandemic. That sees the bank building a large cash buffer to absorb the impact of a sharp downturn in the credit cycle.

There is also considerable pressure from regulators to amass such a large cushion to prevent a repeat of the 2008 financial crisis caused by the near collapse of systemically important banks. Royal Bank is systemically important to Canada’s financial system and was the first Canadian lender added to the list of global banks deemed too big to fail.

Nonetheless, there was moderate decline in revenue during the quarter. Net interest income fell 14.5% year over year, while non-interest income, including fees and mutual fund revenue, plunged 28%. That can be blamed on a marked decline in demand for credit, investments, insurance, and other financial services because of the coronavirus pandemic.

Credit quality is high

While such a large uptick in provisions for credit losses would normally be of significant concern, gross impaired loans only increased by 16% year over year in value to $3.5 billion. Even after that increase, Royal Bank's gross impaired loans ratio only rose by a very modest two basis points to 0.51%.

That ratio is still quite low, and less than some of Royal Bank's Big Five peers like **Scotiabank**, which has a ratio of 0.78%, highlighting the quality of its credit portfolio.

Compulsory insurance for all underwritten mortgages with a down payment of less than 20% is an important backstop for Canada's banks. Around 37% of Royal Bank's Canadian mortgages, including HELOCs, are insured. That coupled with its domestic residential lending portfolio having a conservative loan-to-valuation (LTV) ratio of 53% will mitigate much of the impact of the expected rise in impaired residential mortgages.

A greater risk is Roya Bank's commercial lending portfolio. However, its exposure to the deeply troubled energy patch is minimal. Royal Bank's total oil and gas credit exposure totals $9.4 billion representing a mere 1.3% of total loans. That further bodes well for its ability to emerge from the current economic crisis and keep delivering value for investors.

Is the dividend safe?

Those numbers have magnified fears that Royal Bank could cut its dividend, but that is highly unlikely at this time. Even after hiking the payment for nine year straight, giving it a 5% yield, Royal Bank's dividend has a conservative payout ratio of 46%. Such a low ratio indicates that it would require a much more dramatic decline in earnings and credit quality for the payout ratio to become unsustainable.

While there is considerable regulatory pressure being applied to Canada's big banks to retain cash and build a large buffer, it is unlikely that the government will demand a dividend cut. Big bank dividends are an essential contribution to the economy and income for self-funded retirees.

Foolish takeaway

For these reasons, Royal Bank's dividend is safe for now. The bank will continue to deliver significant value for investors over the long term, making it an attractive long-term investment, even during these difficult times.

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