Royal Bank (TSX:RY) Stock Investors Beware: Profits Are at Risk

Description

Royal Bank of Canada (TSX:RY)(NYSE:RY) has had an incredible quarter. The company recently reported a 45% bump in profits during the third quarter of 2020. That was higher than analyst expectations and the highest the bank has ever reported. Unsurprisingly, Royal Bank stock surged to an eight-month high.

However, the glowing report masks some underlying risks investors should beware of. Here are two reasons Royal Bank's profits are as precarious as ever.

Core banking

Despite the surging stock market and record profits, we mustn't forget that we're still in the middle of a historic crisis. The pandemic is far from over and the economic crisis has just been delayed.

Royal Bank's core operations of personal and commercial lending have declined. Profits in this segment dropped 18% in the third quarter. The bank has also deferred the mortgages of half a million of its global clients.

The Bank of Canada expects many of these deferred mortgages to default in October and November this year, as the deferral period ends. Surprisingly, Royal Bank set aside just $675 million to cover these losses — 76% less than the bank's loan loss provisions last year. One banking analyst described it as "surprisingly low."

Capital markets

The key reason for the Royal Bank stock surge was higher-than-expected profits. However, these profits were entirely driven by the company's capital markets operations. This segment works with institutional investors, private equity firms and pension funds to invest in stocks, bonds and direct deals.

In other words, wealthy clients making massive deals and trading sophisticated instruments were the sole reason Royal Bank was profitable this quarter. A downturn in the private market or the equity market could quickly evaporate these gains.

Royal bank stock valuation

Royal Bank doesn't seem prepared for a downturn in capital markets or the housing market. It has set aside too little to deal with losses on its balance sheet if clients default on loans.

However, Royal Bank stock doesn't reflect this risk. The stock is currently trading at 1.8 times book value. If loan losses escalate, book value will decline and this ratio will worsen.

By comparison, **Bank of Montreal** is trading at a price-to-book ratio of just 1.15. That bank set aside $1.05-billion in loan loss provisions. That's 55% higher than Royal Bank

Bottom line

Canada's largest bank is also one of its most lucrative dividend payers. Royal Bank stock offers a 4.2% dividend yield and trades at 13 times earnings. This week the bank reported higher-than-expected profits, which has boosted the stock price.

However, the reports masks some underlying risks. RBC has set aside too little to deal with potential loan losses. That's a risky move in a year where millions of Canadian have lost their jobs. A potential dip in the housing market is another risk the bank doesn't seem well-prepared for.

Meanwhile, Royal Bank stock is more richly valued than most of its peers. Cautious investors seeking stable passive income should be aware of the risks before betting on the bank.

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