



What Does the Future Hold for Investors in Canada's Largest Bank?

Description

Royal Bank of Canada ([TSX: RY](#))([NYSE: RY](#)) kicked off the Q2 earnings season for Canada's major banks late last week. By most measures, our nation's largest bank set the bar very high.

Compared to the same period a year earlier, net income increased 15% to \$2.2 billion, and diluted earnings per share increased 18%, up \$0.22 to \$1.47 per share, easily surpassing expectations. Maintaining its position as one of the strongest capital allocators among Canadian banks, Royal Bank delivered a 19.1% return on equity during the quarter.

There is very little to dislike in Royal Bank's latest quarter. Apart from the insurance segment, which experienced a slight deterioration in net income due to higher international claim costs, every other part of the business delivered impressive bottom-line growth.

For investors, it's important to understand that over the past 12 months, just three segments accounted for 88% of the income generated by Royal Bank — personal and commercial banking, capital markets, and wealth management.

Let's take a closer look at these three critical segments to better understand what's driving performance and what to watch over the coming year.

Personal and commercial banking

By far the largest contributor to net income at 54%, personal and commercial banking income grew 7% compared to the second quarter of 2013, driven primarily by volume growth and low loan-loss provisions.

Royal Bank is the market share leader in most product categories. With nearly 24% of the Canadian market for personal loans, including residential mortgages and credit cards, and between 25% and 30% of the market for business loans and deposits, Royal Bank is extremely dependent on the performance of the Canadian economy. The outlook for our economy is encouraging, with a slowly declining unemployment rate and increasing gross domestic product.

However, investors should pay close attention to Royal Bank's net interest margin, or NIM. It measures the difference between interest income earned on loans and interest paid to lenders for deposits, relative to the amount of interest-earning assets held by the bank. Royal Bank's NIM has held steady for the past few quarters at around 2.74%, but in the current low-interest and highly competitive environment, it may further contract, negatively impacting earnings for this important business segment.

Capital markets

Capital markets provides corporate and investment banking, equity and debt origination, and distribution to public and private companies, investors, and governments in North America, Europe, and Asia. Net income for the second quarter was \$124 million, an impressive increase of 32% over the same quarter a year earlier.

But unlike personal and commercial banking, Royal Bank's capital markets segment is not nearly as dependent upon Canada for success. During the second quarter, the U.S. accounted for 55% of revenue, with Canada representing just 28%. However, there are many clouds on the horizon. Regulator reforms, ongoing European sovereign debt concerns, and uncertainty regarding the direction of U.S. fiscal and monetary policy are a few issues that should get investors' attention, as they will likely impact earnings for Royal Bank's second largest segment.

Wealth management

Accounting for 11% of earnings over the past 12 months, wealth management may prove to be the primary growth driver for Royal Bank over the medium to long term. During the second quarter, earnings of \$278 million represented an increase of 25% compared to the same period a year earlier.

Royal Bank's wealth management income is based upon a percentage of the assets it manages for its high net-worth, and ultra-high net-worth clients. The record earnings in Royal Bank's wealth management segment were the result of a 15% increase in assets under management — driven by both new clients and the growing portfolios of existing clients.

Bank of Nova Scotia ([TSX: BNS](#))([NYSE: BNS](#)) shocked market watchers recently when it announced plans to divest its 37% stake in **CI Financial** ([TSX: CIX](#)), one of Canada's premier asset managers with over \$97 billion in assets under management. Royal Bank is focused on growing its wealth management business in the U.S. and internationally, so a play for CI Financial is unlikely. However, investors should watch for Royal Bank to make potential high net-worth distribution acquisitions outside of Canada's borders.

The future looks very profitable for Royal Bank, and its investors

Royal Bank is Canada's largest bank by market capitalization, fifth-largest in North America, and 12th largest in the world. And that kind of scale provides a host of advantages — Royal Bank is one of the most productive banks in Canada. With an efficiency ratio of 45%, calculated as non-interest expense divided by total revenue, more revenue finds its way to the bottom line.

Big and efficient: That's a powerful combination for continued earnings growth, and necessary to support ongoing dividend raises. Over the past few years, Royal Bank has developed a pattern of increasing its dividend during the first and third quarters. With a current yield of 3.8%, investors should

look for an increased dividend payment to be announced during Royal Bank's third quarter.

CATEGORY

1. Investing

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3. TSX:BNS (Bank Of Nova Scotia)
4. TSX:CIX (CI Financial)
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