Royal Bank of Canada

Financials
NYSE: RY | TSX: RY
Market Outperform | Hold

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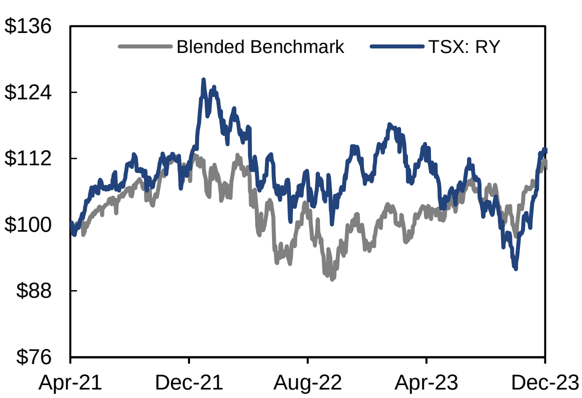
Return on Investment	
Current Share Price	$134.00
Target Price	$143.00
Dividend Yield	4.10%
Implied Return	11%
Conviction Rating	2

Market Profile	
52-Week Range	$107.92 - $140.18
Market Capitalization ($mm)	$188,108
Net Debt ($mm)	$17,898
Enterprise Value ($mm)	$206,006
Beta (5-Year Monthly)	0.83

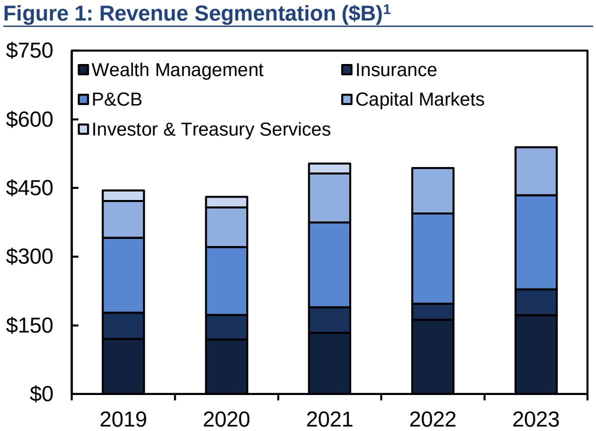
Metrics	2024E	2025E	2026E
Revenue ($mm)	$61,986	$67,756	$74,090
Net Interest Income ($mm)	$29,875	$32,734	$35,794
EPS	$12.27	$13.49	$14.85
P/BV	1.6x	1.4x	1.3x

Holding Period Trading Performance (Indexed to $100)



Source: Bloomberg

Figure 1: Revenue Segmentation ($B)[1]



Source: S&P Capital IQ

Business Description

Royal Bank of Canada (TSX: RY) is a Canadian financial services provider with over 94,000 employees in 29 countries worldwide. RY operates in four service segments: (1) Capital Markets, (2) Insurance, (3) Personal & Commercial Banking (P&CB), and (4) Wealth Management. RY is the largest Canadian bank and the 23rd largest in the world, measured by total assets.

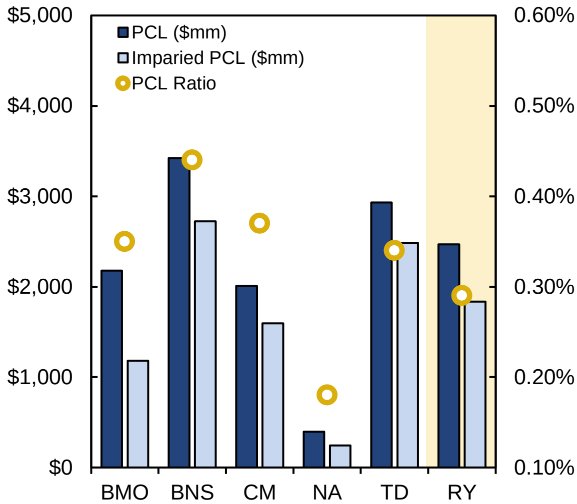
Industry Overview

The Canadian banking industry is comprised of six major players: Bank of Montreal (TSX: BMO), Bank of Nova Scotia (TSX: BNS), Canadian Imperial Bank of Commerce (TSX: CM), National Bank of Canada (TSX: NA), RY, and Toronto Dominion (TSX: TD). The industry operates as a tightly regulated oligopoly, which enables regulators to foster constant collaboration with a small number of banks. As a result, regulators can control domestic competition by influencing market pricing and minimizing the risk of pricing wars to gain market share. This model establishes high barriers to entry, stabilizes product pricing, and raises customer switching costs between banks. Regulators also impose minimum requirements for Common Equity Tier 1 (CET1) ratios, loan-to-value ratios, and debt service coverage ratios for P&CB loans, supported by government subsidies on deposit and mortgage insurance. Lastly, regulators prevent significant foreign competition, further contributing to market share rigidity. Compared to the U.S., which has less stringent regulation, the Canadian regulatory framework enables each bank to provide a wide variety of financial products without the risk of losing significant market share. In turn, this provides each bank with a large scale of operations, robust distribution networks, and diversification of business lines, leading to economies of scale and scope. This also allows banks to spread fixed costs across a larger operating base while achieving lower operating, credit, and regulatory costs, ultimately increasing operational efficiency.

The Bank of Canada is expected to maintain the overnight rate at 5.00% until H1 2024. Canadian banks are forecasting interest rate cuts to commence in H2 2024, although there is uncertainty regarding the number and magnitude of cuts. As a result, each of the major banks' operating segments is expected to benefit from interest rate movements in 2024. Net Interest Income (NII) and Net Interest Margins (NIM) on P&CB loans are expected to remain stable, offsetting low expected organic loan growth in H1 2024. Additionally, banks are confident that consumers will be able to withstand higher mortgage payments in H1 2024, as seen in the gradual decline in the mortgage delinquency rate from 0.38% in 2013 to 0.15% in 2023. This is further supported by existing regulatory requirements for mortgage issuances, which reduces the risk of banks accepting uncreditworthy customers. Moreover, 58% of Canadians with mortgages indicated a willingness to reduce discretionary spending to cope with rising interest rates, demonstrating consumer discipline in managing household debt. Wealth management segments are expected to continue providing stable earnings growth and high ROE, driven by low capital requirements, rapid growth, and stable performance from strong client retention. Wholesale banking segments are also expected to improve as a declining cost of debt could further stimulate capital markets activity. Although (cont.)

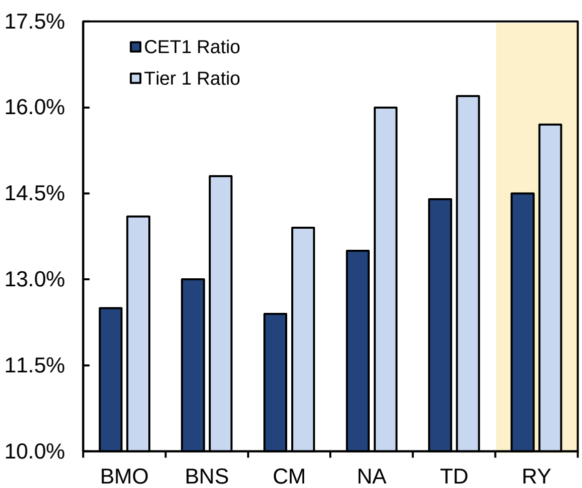
(1) Investor & Treasury Services segment was divided between Wealth Management and Capital Markets in Q1 2022

Figure 2: Q4 2023 PCL vs Peers



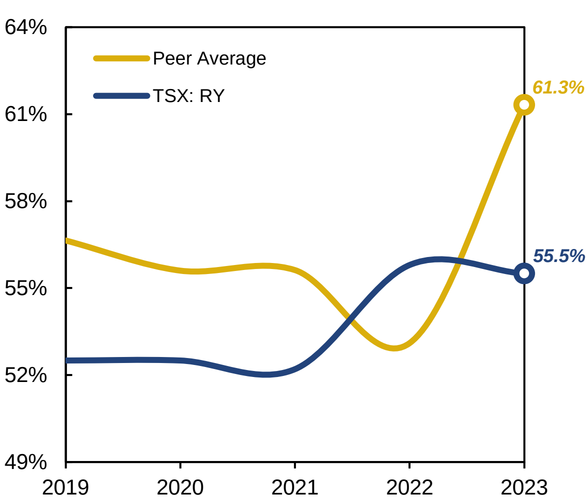
Source: Bloomberg

Figure 3: CET1 & Tier 1 Ratio vs Peers



Source: S&P Capital IQ

Figure 4: Efficiency Ratio vs Peers



Source: Company Filings

Provisions for Credit Losses (PCLs) could increase slightly in H2 2024 due to loan growth, the recovery in non-lending segments of banks is anticipated to offset a decline in earnings. Cost management has also become a major focus for banks as they routinely seek opportunities to enhance operational efficiencies. Altogether, these factors underpin expectations that banks will be able to generate sufficient internal capital to support operations, reducing their reliance on Discounted Dividend Reinvestment Plans (DRIP) to raise capital. Consequently, banks will be positioned to return capital to shareholders through continued dividend increases and share repurchases.

HSBC Acquisition

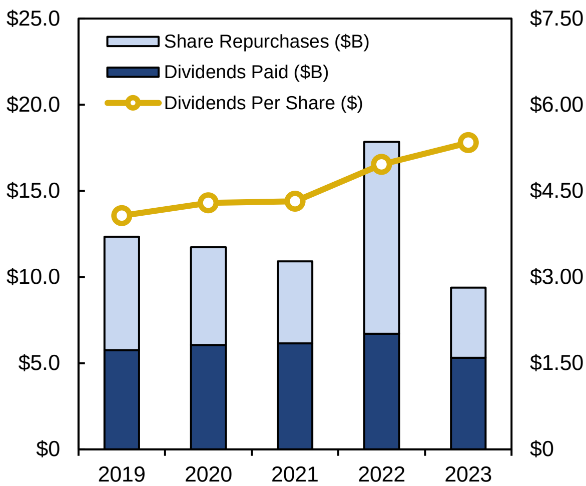
In November 2022, RY announced its acquisition of HSBC's Canadian business unit for $13.5B cash consideration, reflecting a 2024E P/E of 9.4x and a P/BV of 2.5x. The deal was approved by the Competition Bureau in December 2023 and is expected to close in Q1 2024. The deal is estimated to be 6% accretive to RY's 2024 EPS, yield an IRR of 14%, provide pre-tax synergies of ~$740mm, and boost the Company's CET1 ratio to ~12%. The acquisition adds ~770,000 retail and ~12,000 commercial clients to RY's client base. 40% of Canadian retail clients are considered affluent, allowing the Company to cross-sell various financial products to its new client base. The remaining 60% of retail clients are globally connected, which positions RY as the preferred bank by newcomers to Canada. Furthermore, 92% of HSBC Canada's retail lending portfolio is residential mortgages, expanding the Company's portfolio of lower-risk assets and contributing to stable NII and NIM. HSBC Canada's commercial banking portfolio offers diversification through exposure to additional business banking, mid-market, large corporate, and public sector clients. As well, ~80% of commercial clients being long-tenured presents a low probability of turnover, and ~50% of clients being globally connected expands RY's international client base.

Mandate Fit

Quality Management: RY's management team has been consistently recognized for their focus on innovation, international expansion, and sustainable growth strategies amidst global economic uncertainty. Management has identified retention of RY's position as the top financial services provider in Canada and wealth management expansion into the U.S. and Europe as the most compelling opportunities moving forward. David McKay has led the Company as CEO and President since 2014, having held several executive positions since joining in 1983. His recent successes have led to his appointment as Canada's Outstanding CEO of the Year for 2022. McKay has overseen the completion of several successful acquisitions, most notably the City National acquisition, which has paved the way for the successful integration of HSBC Canada. Lastly, RY has a compelling compensation structure, with 89% of CEO pay and 84% of NEO pay classified as at-risk.

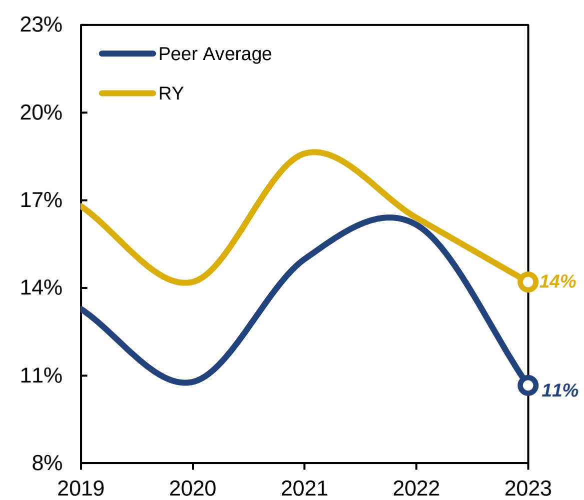
Competitive Advantage: RY's competitive advantage stems from its leading market share and diverse offering in all key retail and business products. The Company has the second largest portfolio of P&CB assets out of its peers at ~$858B, trailing its next largest competitor TD at ~$903B. RY has a higher proportion of non-NII generating segments compared to peers, as only 39% of 2023 revenue was derived from its P&CB segment versus the peer average of 60%. Furthermore, RY's Wealth Management segment has $1.1T in AUM compared to its next largest competitor TD, at $0.4T. This segment generated 31% of the Company's 2023 revenue versus the peer average of 18%. RY holds the leading market (cont.)

Figure 5: LHS Dividends & Repurchases vs RHS DPS



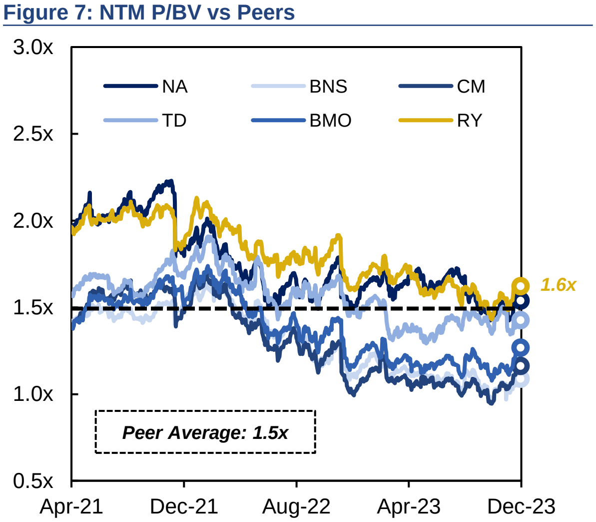
Source: S&P Capital IQ

Figure 6: ROE vs Canadian Peers



Source: S&P Capital IQ

Figure 7: NTM P/BV vs Peers



Source: S&P Capital IQ

share in Capital Markets and is a top-15 player globally. This is demonstrated through the Company's segmented revenue of $11.1B in 2023, versus its next largest Canadian competitor BMO at $6.5B. RY's strategy of U.S. expansion in Capital Markets allows it to grow its high-margin business segments, avoiding competition from peers such as TD and BMO, whose strategy involves expansion into lower-margin segments such as P&CB. RY's market position in higher-margin, fee-based business segments have translated to the Company's consistent generation of strong ROE, reaching 14.2% in 2023 compared to the peer average of 10.7%. RY's revenue profile, in addition to its disciplined cost control, has allowed it to achieve a best-in-class efficiency ratio among peers. The Company's diverse product offering also affords it significant cross-selling opportunities, as 18% of RY's customers hold multiple retail banking products compared to the peer average of 11%. The Company's acquisition of HSBC Canada expands cross-selling opportunities due to complementary capabilities in each company's retail segment, as well as RY gaining exposure to HSBC Canada's trade finance and cash management capabilities. Lastly, the acquisition is expected to grow the Company's total market share by 2%, which is a significant advantage for RY given market share rigidity within the industry.

Strong Balance Sheet: RY has maintained a strong balance sheet and remains an industry leader with a 14.5% CET1 ratio, well above the 11.5% regulatory requirement and the peer average of 13.4%. The Company has committed to sustaining this ratio above 12.0% pro forma the HSBC acquisition. Additionally, RY has an industry-leading position in credit quality, with non-performing loan ratios and net charge-off ratios of 0.13% and 0.40%, respectively. The Company has credit ratings of AA- and Aa1 from S&P and Moody's, respectively, with identical counterparty ratings.

Growing Free Cash Flow: RY continues to outperform peers in profitability and earnings metrics. The Company's FCF has been under pressure by slowing loan growth on the backdrop of unfavourable capital market conditions and expense overruns. Despite this, RY has maintained a FY 2023 efficiency ratio of 55.5%, and ROA of 0.76% which remain well ahead of the peer averages of 60.4%, and 0.59%, respectively. The Company's NII and NIM outlook remains stable for 2024, with expected rate cuts offsetting muted loan growth. As such, RY should see moderate FCF recovery in 2024, on track to meet its 5-year net income CAGR of 3.7%.

Investment Thesis and Valuation

RY was valued at $143 using a 10-year DDM with a Cost of Equity of 7.1%. The terminal value was determined through a 50/50 blend of (1) the Gordon Growth method, using a 2.5% terminal growth rate and (2) an average of a P/BV exit multiple of 1.4x and a P/E exit multiple of 10.3x.

The CPMT favours RY's dominant market share and diverse product offering. The Company's leading position in high-margin segments has allowed RY to consistently generate superior ROE and efficiency ratios compared to peers. Additionally, the Company has remained committed to balance sheet strength, demonstrated by its superior CET1 ratio following its acquisition of HSBC Canada. Furthermore, the Fund is optimistic about management's ability to integrate the acquisition successfully. The incremental market share gained from the acquisition fortifies RY's competitive positioning and allows it to continue its strategy of cross-selling P&CB products to its clients. The CPMT looks forward to the industry's reduced reliance on DRIPs and further shareholder value creation through dividend increases and share repurchases.