Royal Bank of Canada

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

March 31, 2021

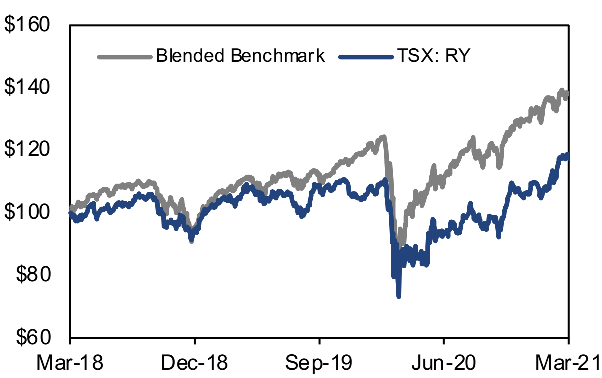
Jack Morgan, Investment Analyst

Return on Investment	
Current Share Price	$117.11
Target Price	$136.00
Dividend Yield	3.72%
Implied Return	20%
Conviction Rating	2

Market Profile	
52-Week Range	$80.72 - $117.97
Market Capitalization ($mm)	$166,907
Average 30-Day Vol (000s)	4,844
Shares Outstanding (mm)	1,424
Beta (5-Year Monthly)	0.80

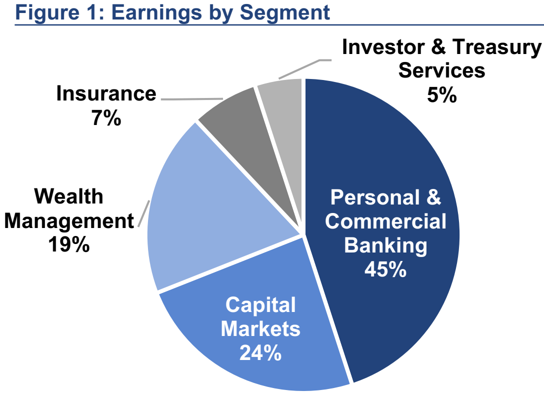
Metrics	2021E	2022E	2023E
Net Interest Income ($mm)	$21,990	$23,812	$25,771
Net Income ($mm)	$12,015	$13,153	$14,420
EPS	$7.95	$8.71	$9.55
P/B	1.8x	1.5x	1.3x

Historical Trading Performance (Indexed to $100)



Source: S&P Capital IQ

Figure 1: Earnings by Segment



Source: Company Filings

Investment Thesis Summary

- Superior margins and dominant market share elevate RY as a market leader and attractive investment opportunity versus peers
- Strong emphasis on return to shareholders through consistent dividend payout and share repurchases
- A tenured management team with an impressive track record of growth and performance

Business Description

Royal Bank of Canada (TSX: RY) is a Canadian financial services provider with over 86,000 employees operating in 36 countries globally. RY operates in five major service segments: Personal & Commercial Banking, Capital Markets, Wealth Management, Insurance, and Investor & Treasury Services. RY is the largest Canadian bank and the ninth-largest in the world by market capitalization.

Industry Overview

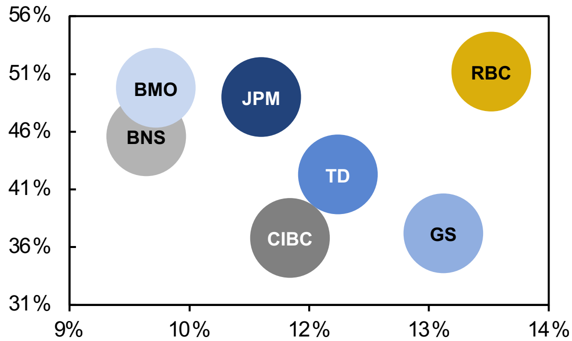
The Canadian banking industry is a highly condensed sector with a substantial level of domestic competition among the Big Five (TSX: RY, TD, CM, BNS, BMO). Due to the highly regulated nature of the industry, there is a relatively low threat of new entrants. In Canada, the financials sector contributes only 3.5% of GDP while American banking makes up nearly 8% of US total GDP. North American governments responded to the COVID-19 pandemic by dropping interest rates significantly, which has shifted bank profitability from interest-generated revenue to fee-based earnings and trading activities. Both Canadian and American federal interest rates are holding at 0.25% and are not likely to change until 2023 according to Bloomberg. Banks with well-diversified products and services tend to fare better during periods of low interest rates as it enables cross-selling optionality and increased customer retention.

Mandate Fit

Quality Management: RY has consistently been recognized as a top-tier bank largely due to its future-oriented and opportunistic management team. Management places significant emphasis on the importance of shareholder return via its 54% payout ratio and consistent funneling of excess capital into dividend hikes and share buybacks. Management compensation also aligns with shareholder interests as 88% of NEO target pay is performance based. President and CEO David McKay has been working at RY since 1983. He was appointed as the head of Canadian Banking in 2008 and CEO in 2014 and is known for his ability to effectively integrate, adapt, and evolve to rapidly-changing consumer demands.

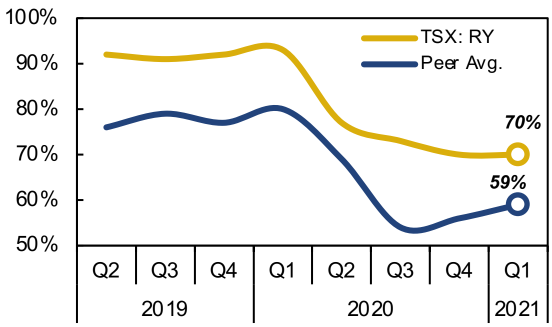
Growing Free Cash Flow: The Company has historically generated profitability metrics above average, currently holding best-in-class ROE and ROA at 13.4% and 70% respectively. RY's EBITDA margin also outpaces peers at 52.8%. While FCF growth is not typically indicative of bank profitability, the company holds an all-time high cash position of $149.6B, a 22.9% increase YoY. Profitability is likely to be driven by non-interest income generated from the Company's Capital Markets and Wealth Management segments as federal interest rates remain low, suppressing net interest margin.

Figure 2: EBITDA Margin (Y-axis) vs ROE (X-axis)



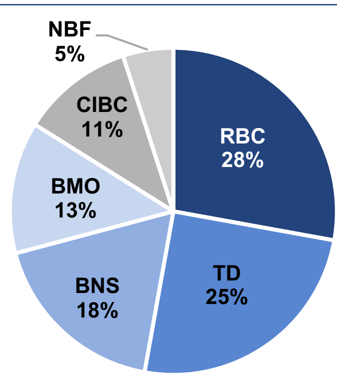
Source: Company Filings, Refinitiv Eikon

Figure 3: ROA vs Peers



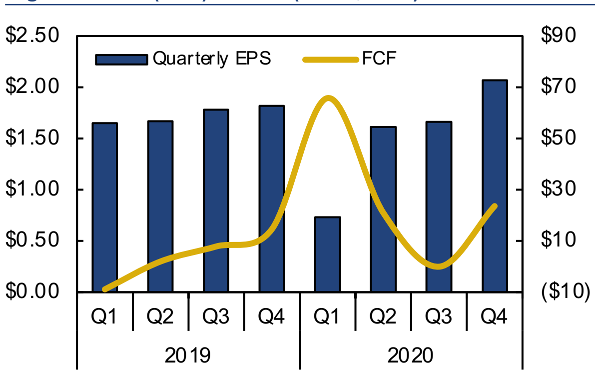
Source: S&P Capital IQ

Figure 4: Market Share vs Canadian Peer Group



Source: Refinitiv Eikon

Figure 5: EPS (LHS) vs FCF (US$B, RHS)



Source: Company Filings

Balance Sheet Strength: RY maintains secure financial health as an industry leader in CET1 ratio of 12.5%, a loans-to-assets ratio of 0.4x, and 67% of current debt comprised of low-risk liabilities. With an allowance ratio of 1.9x, the Company holds sufficient allowance for defaults and can withstand potential shocks to the balance sheet effectively. Credit ratings from Moody's and S&P remain stable at AA and AA- levels, allowing access to unsecured funding markets and enabling the Company's ability to cost-effectively engage in collateralized business activities.

Competitive Advantage: RY is the dominant force among Canadian banks and an internationally competitive player in the financial sector. RY is the largest Canadian bank by both revenue and assets under management at $47B and $843B, respectively. Its Canadian market share has increased by 4% over the last three years to 28%. RY has been recognized as the "North American Retail Bank of the Year" and plays a major role in the global economy as the first Canadian bank to be recognized as a Globally Systemically Important Bank (G-SIB). Quantitatively, the Company stands out among its peers when evaluating return and profitability metrics. Despite a challenging and volatile fiscal environment, RY has outperformed peers in terms of ROA over the last 12 months and recently recorded its highest quarterly EPS in over a decade, driven primarily by capital markets revenue.

Attractive Valuation: The target price of $136.00 was determined using a 50/50 blend of a Dividend Discount Model and Book Value comparable analysis. Key assumptions included a 2% terminal dividend growth and a 46% targeted payout ratio, in line with the historical averages. The average comparable P/BV was 1.5x and a comparable median P/E ratio of 14.5x was applied to derive the implied share price. RY currently trades in-line with peers, however the CPMT believes the name deserves a comfortable premium due to its competitive advantages and superior profitability.

Portfolio Fit

RY was previously purchased by the CPMT in April 2018 and held for nearly 11 months before being sold in March 2019. After a year of lackluster returns, the fund liquidated the position to fund our current holding of Mastercard (NYSE: MA). At the time, the mandate permitted investment in Canadian names only, however, has since expanded to include U.S. equities, allowing for the Fund to investigate international opportunities within the financial sector. As a result, the CPMT can weigh the Company against its peers more objectively. Given these restrictions have since been revised, the positive outlook on RY is a direct result of its operational performance and is no longer dependent on international exposure, although that is a benefit. As of March 31, the CPMT is underweight in the financials sector by ~9% and believes RY is a standout name worthy of increasing our financial sector allocation for.

Risks and Catalysts

Key risks moving forward include ongoing economic impacts caused by the unpredictability of COVID-19, rising concern surrounding inflation, as well as the substantial increase in federal North American debt as a result of the pandemic and stimulus efforts.

Potential catalysts include economic expansion as North America exits COVID-19 lockdown restrictions. Derivative benefits include increased retail lending and congruent interest income. Moreover, American exposure will benefit RY as the U.S. is expected to lead a more rapid recovery than Canada due to a more efficient distribution of vaccinations to vulnerable citizens.