HCP NOTES

The Canadian Banks – The End of an Era

May 26, 2011

Globe and Mail Special Comment

On May 26th, the Globe and Mail featured our piece entitled, *"The Canadian Banks – The End of an Era"*. This article is based on material researched for our investor luncheons last fall by the same name. This *"Special Comment"* expands on the contents of the article with additional commentary for the benefit of our investors.

As discussed in the following pages, the Canadian banks experienced a golden era over the last twenty years, generating a total return in the mid-teens. This tremendous accomplishment was supported by three important earnings drivers that we believe have largely passed.

Looking forward, we expect incremental returns to come from the banks' foreign platforms. Given that the banks' foreign platforms are, with rare exceptions, significantly less profitable than their domestic platforms, the shift from domestic consolidation to foreign expansion will make it much more difficult for Canadian banks to generate the double-digit earnings growth to which investors have become so accustomed.

Expanded version of article published in the Globe & Mail on May 26th, 2011.

The golden era for the Canadian banks has ended. This era, which began in the late 1980's with the acquisition of the major broker-dealers, and continued for two decades, saw Canadian bank stocks generate a total return of nearly 14% annually. This is an astonishing achievement for a banking sector in a developed economy.

Not surprisingly, since this period overlaps the career of virtually all financial journalists, analysts and stock-brokers, this exceptional performance has resulted in a near evangelical-like faith from investors, who have come to view this performance as "normal".

As we will explain, it is not.

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Hamilton Capital

Part I: Defining the Golden Era

In our view, the golden era began in the late 1980's when the banks were allowed to buy the investment dealers. This policy change utterly transformed the Canadian banks for the better. This transformation overlapped some very significant and very favourable macro-economic trends, which together, created three earnings drivers that underpinned the sector's outsized performance for the past twenty years. We discuss the three factors, and, of great importance, explain why their positive benefits have largely passed.

Earnings Driver #1: Declining Tax Rates

A large decline in corporate tax rates in the past twenty years provided a highly material lift to bank earnings. In the last decade alone, effective tax rates declined a massive 10 percentage points (and 14 percentage points over the past twenty years!), providing a noteworthy contribution to earnings growth.

Given the surge in government deficits, further large tax cuts are unlikely. We also do not believe investors should rule out higher taxes over the medium term, especially if the Government of Canada and/or the Province of Ontario find it difficult to balance their budgets within their targeted (multi-year) timelines.

Earnings Driver #2: A Highly Favourable Macro-economic Backdrop

The banks have benefited from a highly favourable macro-economic backdrop for most of the last two decades. Between 1990 and 2010, the Canadian prime rate declined over 10 percentage points, while inflation declined dramatically. The result was a near-perfect environment for financial assets, pushing values for stocks and bonds ever higher.

Lower financing costs helped fuel nominal growth, spurring (arguably excessive) consumer borrowing, and drove real estate prices higher, buttressing collateral values (which, in turn, reduced loan losses). This "virtuous circle" provided an exceptional backdrop for bank earnings, and its impact should not be underestimated.

Unfortunately, while there may be fierce debates as to the amount and timing, interest rates and inflation will eventually rise and this will not be positive for financial assets or bank profitability. Of course, the velocity of the rate increases will play a role in sector valuations.

Should the eventual rise in rates be disorderly, investors can expect to see bank stocks suffer as price-to-earnings multiples compress. Over time, the impact would be felt on earnings, albeit less directly. Capital markets activity would likely slow, and valuations across a wide array of financial assets would decline.

A disorderly rise would be especially painful if home prices decline materially, as some have speculated might occur in Canada (and has happened before). Although losses on mortgages for the Canadian banks are generally close to zero, they have been significantly higher many times in the past, and given the massive size of these portfolios, an increase to even a very modest loss rate could cause a noticeable dent in earnings.

If, as seems more likely, rates rise gradually, the negative impact to the banks would be more measured, and presumably less painful. Slower volume growth, higher "normal"

loss rates (especially given excessive consumer debt levels) and declining values of financial assets are all possible, if not likely[1].

Earnings Driver #3: Highly Favourable Regulatory Changes

The banks also benefited enormously from regulatory changes that allowed them to acquire the broker-dealers in the late 1980's, and then the largest trust companies in the 1990's. This consolidation ushered in arguably the greatest transformation in Canadian bank history, as the sector evolved from "just banks" to powerful domestic conglomerates.

There is no question these steps taken by policy makers resulted in substantial benefits, the most important being the creation of a very powerful domestic brokerage industry. This allowed for a Canadian capital markets sector controlled by Canadians, for the benefit of Canadians, to become entrenched. And this was no doubt preferable to the alternative, which was a takeover by the large New York brokerage firms.

Empowered by the regulator and policy makers, the Canadian banks then began to leverage their massive size and distribution powers to dominate virtually the entire domestic financial services sector. Some investors may forget that the banks' large and highly profitable investment banking and wealth management segments did not even exist in 1989.

Today, they account for over a third of earnings.

In investment banking, the impact on the competitive landscape was transformational. By combining lending products with their lucrative underwriting and advisory businesses and pricing holistically, the banks crowded out a bevy of independent brokers lacking the ability to offer loans.

Overwhelming distribution advantages had similar market share benefits on the high-ROE retail brokerage business, as the banks were able to refer retail bank customers into their investment advisory channel (although some banks were more successful than others).

However, the most significant driver to incremental revenue growth and profitability over the past two decades was trading. When they acquired the brokers, the banks provided these businesses with low cost funding, flow business (i.e., embedded market share), risk management infrastructure, and most important of all, capital.

The result?

The combination of the banks and the broker-dealers resulted in an explosion in trading and market sensitive revenues, which together grew an exceptional 15% a year in the following two decades (rising from 5% of gross revenues in 1989 to approximately 20% today). The takeover of the independents also provided scale benefits and, of course, removed competitors. Not surprisingly, these factors had a highly material impact on revenue growth (and, as a result, on earnings growth).

Although not yet complete, the banks are also well on their way to dominating the domestic mutual fund business. Without the requirement to provide open architecture in their branch networks, or to pay for distribution, the banks have been able to

[1] On the bright side, the banks may benefit from some margin expansion, if loan yields rise faster than deposit costs.

manufacture and sell their own low priced, no-load mutual funds to their millions of retail banking customers, relentlessly building on their already large market share.

The impact of this consolidation on the Canadian competitive landscape has been dramatic (and not entirely positive). There is now one large – growing – domestic fund company not controlled by a larger financial (CI, and even it relies heavily on its distribution arrangement with Sun Life)[2]. There is one large independent institutional broker (GMP), and only one independent broker with a noteworthy retail brokerage network (Canaccord).

Three Significant Earnings Drivers in Past Two Decades Fading

Over the past twenty years, a combination of declining tax rates, a highly favourable macro-economic backdrop, and regulatory reform has been extremely beneficial to the banks, driving earnings, dividends and ultimately share prices ever higher. This has raised investor expectations considerably. Unfortunately, these factors have largely passed, making the future growth increasingly dependent on other factors.

So, going forward, what should investors expect?

Part II: Going Forward, Foreign Expansion Expected to Be Dominant Driver

In the very short term, a solid domestic economy and some remaining credit "normalization" should support somewhat higher earnings growth for the banks than a more "normal" rate of high single-digits. However, looking out a few years, the most important variable impacting incremental earnings growth and share returns will almost certainly be the performance of foreign subsidiaries.

This trend, which accelerated in the mid-2000's, has already weighed on earnings growth. Moreover, its continuation will make it much more difficult for the sector to repeat the double-digit returns experienced during most of the past two decades, a challenge it is not clear Canadian investors fully appreciate.

For example, unlike domestic acquisitions, foreign deals are almost always dilutive to earnings per share growth. And while EPS dilution is generally small, the dilution to return on equity is often not. Moreover, with each incremental foreign acquisition, investors become less exposed to highly profitable and dominant Canadian franchises.

Success of Foreign Expansion is Highly Correlated with Scale

Investors often ask why the Canadian banks' foreign platforms have not performed as well as their domestic operations. There is a major reason. In Canada, the banks are able to use their huge scale and distribution advantages to dominate the market. Outside Canada, this key success factor is almost always absent.

In many instances, the Canadian bank does not even hold a top ten market position (much less the more desirable top five). In fact, there is a near perfect correlation between the size of a bank's foreign platform and its success. In markets where it is a significant player, performance has been better. In markets where it is a marginal competitor, performance has suffered.

[2] AGF is an important competitor in the market, but its AUM has not grown materially for years (although it recently acquired the highly regarded Acuity). There are also, of course, some very large global asset managers with respectable market positions in Canada, namely Invesco (Trimark) and Fidelity, but even with their huge scale and product breadth, their presence is not sufficient to impede the ascent of the banks. Lastly, Investors Group is controlled by the Power Group and has its own proprietary distribution.

Without question, the need to achieve scale outside Canada in a bank's chosen market(s) is an important strategic challenge, and explains why the banks will continue to make acquisitions. This fact also helps explain the widely divergent strategies of TD and RBC in U.S. commercial banking.

The former has adopted a "go big or stay home" strategy, and has spent approximately $17 billion in its successful quest to become a top 10 bank in the U.S. However, this quest for longer-term scale has come at a (hopefully short-term) cost, namely lower capital ratios, EPS dilution, and lower returns on capital.

This explains why RBC has not made similar outlays. It appears to have concluded (for now) that these costs and the attendant risks outweigh the potential future growth, and has instead preferred to build upon its other non-Canadian operations. If press accounts are true, it is even considering selling its U.S. banking operations outright.

However, it is not all bad.

The Next Stage of Foreign Expansion Could be Less Daunting

Foreign expansion for the Canadian banks is not new. During the golden era, we estimate the banks made over 100 (mostly small) foreign acquisitions as the banks established and built upon their respective platforms (TD, BMO, RY in the U.S., BNS in Latin America, and CM in the Caribbean[3]).

However, with a few notable exceptions, Canadian banks have struggled to create shareholder value through foreign expansion, which has overall, been dilutive to both EPS growth and return on equity.

That said, several positive developments should make creating value from foreign expansion less daunting. First, the Canadian dollar has risen significantly, especially against the U.S. dollar. This has added to the sector's relative size and scale. Second, with foreign platforms getting closer to critical mass, the economics of successive in-market transactions will be more favourable (in contrast to the initial entry in the market, where cost synergies – the primary creator of value in bank acquisitions – were largely absent).

Third, the global banking sector continues to recover, but slowly, and the relative strength of the Canadian banks allows them to be potentially opportunistic (for example, BNS acquiring R-G Premier Bank in Puerto Rico, BMO buying Marshall & Ilsley). Fourth and finally, the reputation of the Canadian banks has never been higher, which should make it easier to find willing partners.

Part III: Is Regulatory Risk Growing?

Foreign expansion also introduces meaningful regulatory risk which is, quite frankly, new to Canadian bank investors. In the past twenty years, the banks have enjoyed a form of regulatory nirvana, as the regulators allowed them to essentially take over the domestic market with few limits placed on their market power.

While the Canadian banks distinguished themselves during the recent crisis, most foreign banks did not, and, in some cases, are suffering an intense political backlash as a result. Regulatory risk is, of course, particularly acute in the U.S., and has manifested itself in both predictable (higher required capital) and unpredictable (government mandated pricing of interchange fees) ways.

[3] National Bank has no material operations outside Canada.

Canada is not immune. Basel III rules will materially increase minimum regulatory capital requirements, which will reduce future returns on equity, and could over time weigh on price-to-earnings multiples.

In the near-term, Canadian bank investors should expect limited buybacks and conservative dividend increases. Periods like the mid-2000's, characterized by substantial buybacks that contributed materially to EPS growth, are unlikely to occur for the foreseeable future. It also appears OSFI is requiring more equity to be issued to fund foreign expansion, further increasing the costs (for example, TD buying TSFG).

Conclusion: Solid Companies with More "Normal" Growth

The Canadian banks are excellent companies that will continue to do well. They are well managed, and, as the most recent crisis highlighted, have a very diversified and resilient business model. However, the next five to ten years are unlikely to contain the same powerful tailwinds as the previous twenty.

Rather, an emphasis on foreign expansion will more likely introduce headwinds, making it more difficult for Canadian banks to generate the medium-term double-digit earnings growth to which investors have become so accustomed. Unfortunately, this also means the Canadian banks are not on the cusp of another golden era, a period which has definitely ended, and that will be remembered fondly.

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