March 3, 2016

Canada's banks: holding up well

Canada's Big Six* banks released their first quarter results over the past two weeks amid concerns they would suffer huge losses on their loans to oil and gas companies. As we expected, these concerns were unfounded.

Here are some salient points about the Q1 results:

- All the Big Six beat analysts' revenue expectations.
- Four of the Big Six beat analysts' expectations for cash earnings per share (EPS).
- Cash EPS for five of the banks were higher than in the same quarter a year earlier. Overall, the banks' cash EPS was up 6% from the same quarter last year.
- Four of the banks increased their dividends this quarter.
- The industry's provisions for credit losses (PCL) ratio was 32 basis points, up by a modest 3 basis points from the previous quarter. The PCL ratio is still below the 10-year average of 36 basis points, and much lower than the 79 basis points reached during the financial crisis of 2008-2009.

But what about the energy sector?

The banks did get hit by losses in the energy sector, but nowhere near what short sellers were hoping for.

Total credit losses were $2 billion, up 20% from $1.7 billion in the previous quarter. Half of the $300 million increase came from higher oil and gas losses, which rose to $259 million, from $110 million in the previous quarter. We estimate that the increased oil and gas losses reduced industry earnings growth by roughly 2% this quarter (from 8% to 6%).

The pessimists will look at the total oil and gas credit losses of $259 million as a ten-fold increase from the year-ago figure of $25 million. We look at this $259 million figure in the context of the Big Six's $9 billion in total earnings this quarter.

In addition, the banks' operations are diversified enough by sector, by business line, and geographically to weather the current difficulties in the energy sector. For instance, only 2% of the banks' total loan portfolio is directly exposed to the oil and gas industry.

* The Big Six banks are: Royal Bank of Canada, Toronto-Dominion Bank, Bank of Nova Scotia, Bank of Montreal, Canadian Imperial Bank of Commerce, and National Bank of Canada.

P.O. Box 200, 1 Adelaide Street East, Suite 2600, Toronto Ontario M5C 2V9
Tel 416.362.4725 Fax 416.367.1183 www.foyston.com

Some observers might assume the canary in the coal mine to be Canadian Western Bank (CWB), a relatively small financial institution with over 80% of its loans in Western Canada. This morning, CWB reported first quarter EPS in line with expectations. Its PCL ratio was 18 basis points, unchanged from the previous quarter and up 2 basis points from a year ago. CWB management expects its PCL ratio to range between 18 basis points and 23 basis points this year, still much lower than the average of the Big Six. If CWB succeeds in overcoming the difficult economic situation in Alberta, its bigger competitors in the banking sector, we expect, will be able to do the same.

What this means for our clients' portfolios

We buy quality companies at attractive prices.

The Canadian banks represent quality and are attractively priced. Their earnings continue to increase, as do their dividends.

We believe the concerns over the Canadian banks have been exaggerated, with valuations over-discounting current short-term headwinds. Based on our outlook for the banking sector, our Canadian equity portfolios continue to hold an overweight position in this sector.