CORMARK
SECURITIES INC.

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FINANCIAL SERVICES

Canadian Banks

Canadian Banking's Rocky IV Moment

Bank of Montreal
Target Price: $85.00
Recommendation: Top Pick

◆Bank of Nova Scotia
Target Price: $70.00
Recommendation: Market Perform

Canadian Imperial Bank of Commerce
Target Price: $106.00
Recommendation: Buy

Canadian Western Bank
Target Price: $42.00
Recommendation: Market Perform

◆Laurentian Bank of Canada
Target Price: $61.00
Recommendation: Buy

National Bank of Canada
Target Price: $49.00
Recommendation: Market Perform

Royal Bank of Canada
Target Price: $80.00
Recommendation: Market Perform

Toronto-Dominion Bank
Target Price: $59.00
Recommendation: Buy

◆ During the past twenty-four months, Cormark Securities Inc., either on its own or as a syndicate member, participated in the underwriting of securities for these companies

Disclosure statements located at the end of this report

Canadian Banking's Rocky IV Moment

While many investors continue to believe that the Canadian banks are in store for some tough times ahead, we believe that domestic weakness is overblown and that much of the slowdown we are likely to see is already in the rearview mirror.

The Case For Multiple Expansion

Concerns over housing and an overleveraged consumer are keeping valuations in check even as other sectors are enjoying multi-year multiple expansion. We see that changing in late-F2014.

Rethinking Emerging Market Growth

While Canadian investors have tended to view emerging market exposure as the preferred international growth outlet over the past few years, we see the US as the best opportunity going forward.

Initiating Coverage:

We initiate coverage with Buy recommendations on BMO (our Top Pick) followed by TD. We remain cautious on BNS while fully acknowledging that its international footprint is centred in a relatively well-performing region of Latin America.

What Else Is In This Report?

- Why The Golden Age of Canadian Banking Is Not (Totally) Dead...
- Why Canadian Banks Are Destined to Become More International...
- Why Technology Does Not Bring Lower Expenses...

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Introduction: Canadian Banking's Rocky IV Moment

In the hit 1985 film Rocky IV, Rocky Balboa is on top of the world when the Soviet giant Ivan Drago shows up to challenge the champion and give him the biggest fight of his life. Right at the start of the unsanctioned 15-round bout Rocky takes the defensive, but despite a merciless pounding he holds his ground. Round after round Rocky takes the heavy punches and stays standing. Although the fight looks hopeless, he is resilient, finally winning the contest in the final round with a knockout. Rocky was supposed to go down for the count, but kept in the fight and eventually prevailed. As we introduce out first outlook for the Canadian Banking sector, we cannot help but think that the next two years will be the Canadian banks' Rocky IV moment.

Despite all the challenges that should have hobbled the banks in 2013, they rolled with the punches and continued to deliver solid and consistent earnings growth, coupled with growing dividends and expanding share buybacks. Some are predicting that a combination of a slowdown in housing (or even a crash) and an overleveraged consumer will severely challenge growth, but looking ahead to F2014 and F2015 we believe that the sector as a whole will prove itself as a national champion. Not only do we not see a significant slowdown in the cards, but we actually see results improving, helped by a strengthening US recovery that will increasingly support growth at home, and energize US-based revenue streams south of the border. Improving economic conditions will put a floor under contracting margins, keep credit charges low and stable, and drive ongoing excess capital generation that will lead to further dividend hikes, share buybacks and increased M&A activity. For 2014, we forecast average earnings growth across the Big Six Canadian banks of just 3% held down by notable weakness at CIBC as a result of the sale of 50% of its Aeroplan credit card volumes to TD Bank, but we see growth moving up to 10% in F2015.

As the sins of the past continue to dog many of the largest global banks through a combination of legal payouts and ongoing regulatory uncertainty, the Canadian banks remain clean stories with solid growth trajectories and deserve to be revalued higher on that basis. Despite the perception that Canadian banks are sleepy and boring, the coming years will see these institutions become even more international as they search for growth opportunities primarily in the US, but also in Europe and beyond. We have already seen whispers of this when BMO (Top Pick rating, $85.00 PT) announced the acquisition of European wealth manager F&C Asset Management (FCAM – London).

Multiple Expansion For Canadian Banks Has Lagged Most Other Sectors, But That Should Change

While forward trading multiples for non-resource, TSX-listed stocks have expanded significantly over the past few years, valuations for the large banks have not kept pace (see Figure 1). That underperformance is likely a function of lingering macroeconomic concerns, and specifically worries about the health of the Canadian consumer as household balance sheets continue to be stretched. Yet despite that lingering fear, the simple fact is that Canadian household finances are on solid ground and while the demand for credit by individuals is certainly slower that it has been for much of the proceeding 10 years (with the exception of a temporary sharp dip at the height of the financial crisis in 2008), it is unlikely to slow any further, let alone contract as it did in the United States.

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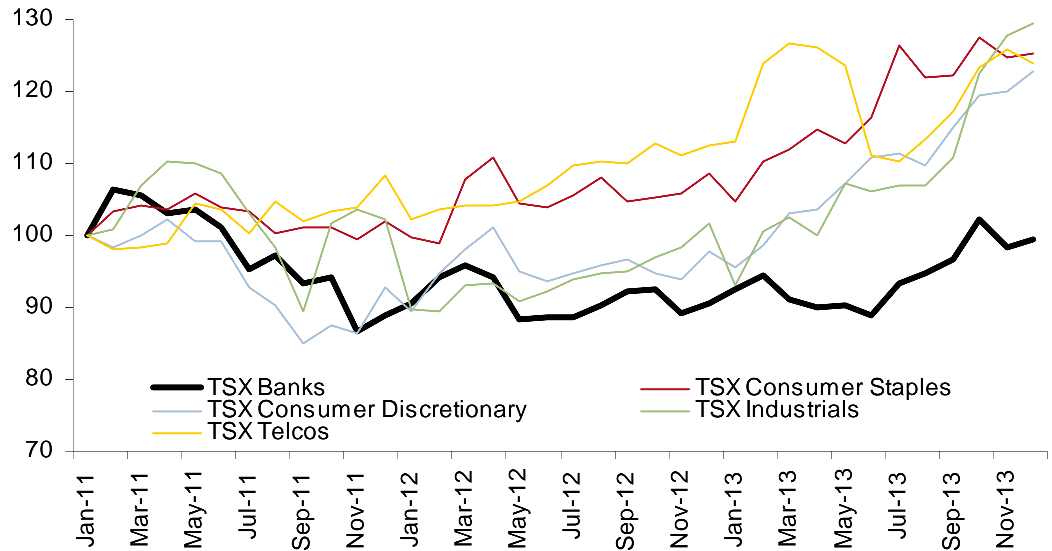
Figure 1 **Forward P/E Multiple Expansion Across Selected Sectors – Banks Lag**



Source: Bloomberg LP, Cormark Securities

While some investors wait for the other shoe to drop, a careful look at the data shows that the much feared slowdown in domestic consumer loan growth largely happened in F2013. And far from being a bad thing, it is actually a sign that households are behaving rationally and that efforts to weed out the excesses of the Canadian housing boom are bearing fruit.

The risk that was building in the Canadian banking system is actually coming down, helped by a number of policy changes that have toughened up lending standards, and an improving US economy that should help drive solid economic growth in Canada as well. Notwithstanding the recent volatility, solid macroeconomic progress will continue to put upward pressure on long rates which in turn should help stabilize net interest margins in F2014, before eventual rate hikes lead to margin expansion in F2015.

While the market continues to focus on slowing domestic growth, we believe that the Canadian P&C business will show remarkable resiliency in F2014 and F2015. Meanwhile, our outlook for the US P&C business has improved significantly as evidenced by the Fed's decisions to begin tapering its QE program this past December. Although F2014 will still be a transition year for the US banking business, F2015 will see the sector beginning to fire on all cylinders. Of all the banking markets in the world, the US will offer the most opportunity on a risk-adjusted basis, which is why we initiate coverage with strong buys on the Bank of Montreal (Top Pick rating, $85.00) and TD Bank (Buy rating, $59.00) – the two Canadian banks best positioned to benefit from the tremendous cyclical upswing in the American banking sector over the coming years.

Our other buy-rated stocks are CIBC (Buy rating, $106.00) where a successful retail transformation that has yet to be fully recognized by the market is taking place. Among the smaller banks, we favor Laurentian Bank (Buy rating, $61.00) which has seen its discount with peers widen despite quietly transforming itself into a much more diversified bank. We see F2014 as a transition year for the firm in particular. Our least favorite stock is the Bank of Nova Scotia (Market Perform rating, $70.00). Although we are positive about its domestic momentum, besides being a source of contagion risk, we believe that its international operations will grow at a slower pace than the market expects (see Figure 2).

Overall, though stepping above our individual bank rankings we see tremendous value in the sector as a whole, especially given the recent pullback in the shares. The Big Six banks currently trade at just 11.0x four-quarter forward consensus earnings, below the pre-crisis 10-year average of just under 12.0x and their peak-cycle forward multiple of over 12.0x. We see

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12.0x as an appropriate target multiple once the overhang from macro-economic concerns fade away later in the year with a forecast pick-up in Canadian economic growth.

Figure 2 **Earnings Estimates, Stock Recommendations and Target Prices**

Bank	Ticker	Price 2/7/2014	Mkt Cap (C$MM)	Our Cash EPS Estimates F2013A	F2014E	F2015E	Growth Rate F2013A	F2014E	F2015E	Price / EPS F2014E	F2015E
Bank of Montreal	BMO	$69.30	$44,654	$6.22	$6.34	$6.97	4.5%	1.9%	9.9%	10.9x	9.9x
Bank of Nova Scotia	BNS	$61.70	$74,584	$5.11	$5.24	$5.70	8.5%	2.6%	8.8%	11.8x	10.8x
CIBC	CM	$87.45	$34,863	$8.65	$8.53	$9.22	8.5%	(1.5%)	8.1%	10.3x	9.5x
National Bank	NA	$42.41	$13,820	$4.04	$4.18	$4.49	4.8%	3.4%	7.5%	10.2x	9.4x
Royal Bank	RY	$70.10	$101,018	$5.53	$5.68	$6.32	11.1%	2.6%	11.3%	12.3x	11.1x
TD Bank	TD	$48.58	$89,334	$3.71	$4.11	$4.72	0.1%	10.8%	14.9%	11.8x	10.3x
Big 6 Avg							**6.3%**	**3.3%**	**10.1%**	**11.2x**	**10.2x**
Canadian Western	CWB	$36.50	$2,907	$2.39	$2.68	$3.00	4.0%	12.0%	11.9%	13.6x	12.2x
Laurentian	LB	$46.03	$1,313	$5.25	$5.50	$5.87	5.2%	4.7%	6.8%	8.4x	7.8x
Avg for all Banks							**5.8%**	**4.6%**	**9.9%**	**11.2x**	**10.1x**

	Ticker	Rating	Target Price	Ret. to Target	P/E Multiple	Quart. Divided	Div. Yield	Book Value	Price/ Book	52-Week High	Low
Bank of Montreal	BMO	**Top Pick**	$85	23%	12.2x	$0.76	4.4%	$43.22	1.6x	$74.69	$58.68
Bank of Nova Scotia	BNS	**Mkt Prfm**	$70	13%	12.3x	$0.62	4.0%	$33.23	1.9x	$66.75	$55.10
CIBC	CM	**Buy**	$106	21%	11.5x	$0.96	4.4%	$40.36	2.2x	$91.90	$73.89
National Bank	NA	**Mkt Prfm**	$49	16%	10.9x	$0.46	4.3%	$22.97	1.8x	$46.96	$35.89
Royal Bank	RY	**Mkt Prfm**	$80	14%	12.6x	$0.67	3.8%	$29.88	2.3x	$73.35	$58.55
TD Bank	TD	**Buy**	$59	21%	12.5x	$0.43	3.5%	$25.65	1.9x	$50.28	$39.80
Big 6 Avg				**18%**	**12.0x**		**4.1%**		**2.0x**		
Canadian Western	CWB	**Mkt Prfm**	$42	15%	14.0x	$0.19	2.1%	$17.54	2.1x	$39.05	$27.04
Laurentian	LB	**Buy**	$61	33%	10.4x	$0.51	4.4%	$44.92	1.0x	$47.96	$42.41
Avg for all Banks				**20%**	**12.1x**		**3.9%**		**1.9x**		

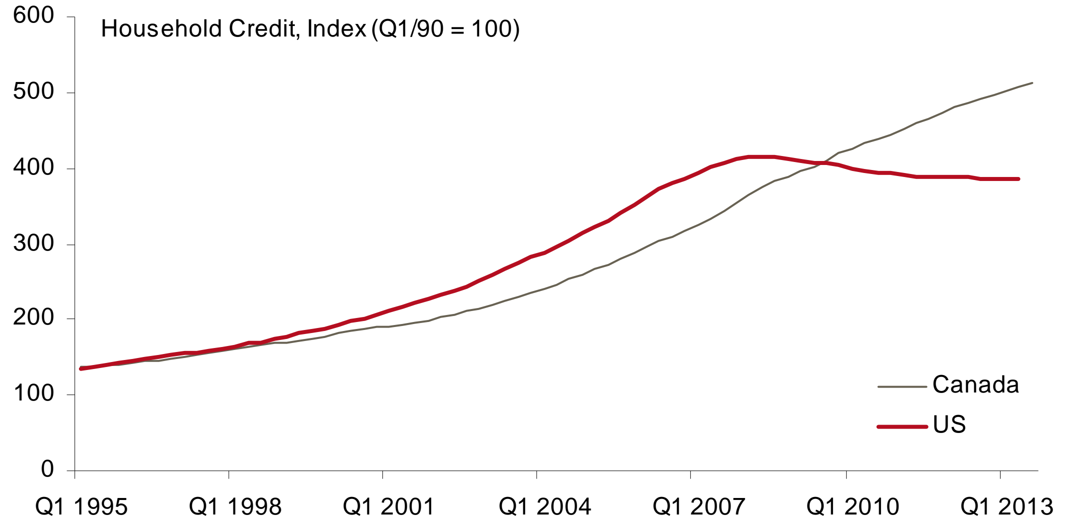
Note: Figures updated for the recent NA and TD stock split. Figures also reflect implementation of new IFRS standards except for CWB and LB.
Source: Bloomberg LP, Company Reports, Cormark Securities

Why Canadian Banking Woes Are Exaggerated

Leverage Ratios Stretched – But Details Matter

The stylized facts are well known. Canadian households have been on a sustained debt binge since the late-1990s when they finally shook off the sting of the prolonged recession that hit Canada in the early-1990s (see Figure 3).

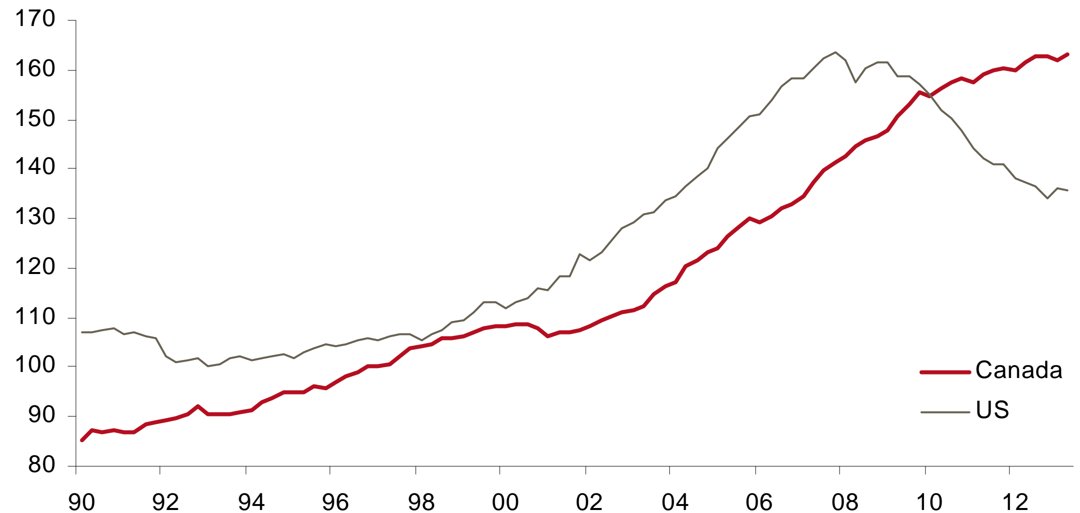
Figure 3 **Canadian Household Credit Has Continued to Climb Despite US Deleveraging**



Source: StatCan, Federal Reserve, Cormark Securities

In fact, based on the ratio of debt-to-disposable household income, Canadians are not only more levered than they have ever been, but also more levered than their US peers were before the great recession (see Figure 4).

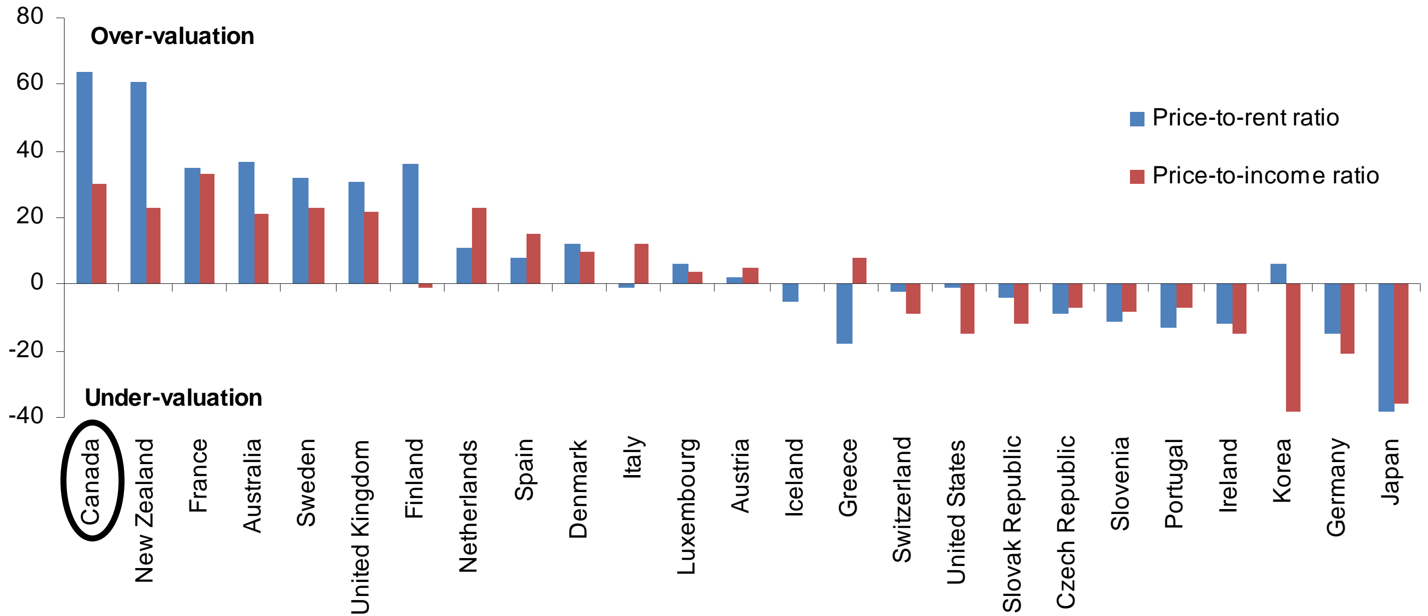
Figure 4 **Canadian Debt-to-Income Ratio is Above the US Peak**



Source: Statcan, Federal Reserve, Cormark Securities

Coupled with that is the fact that most measures of home price values in Canada are at record levels and near the top-end of global rankings (see Figure 5).

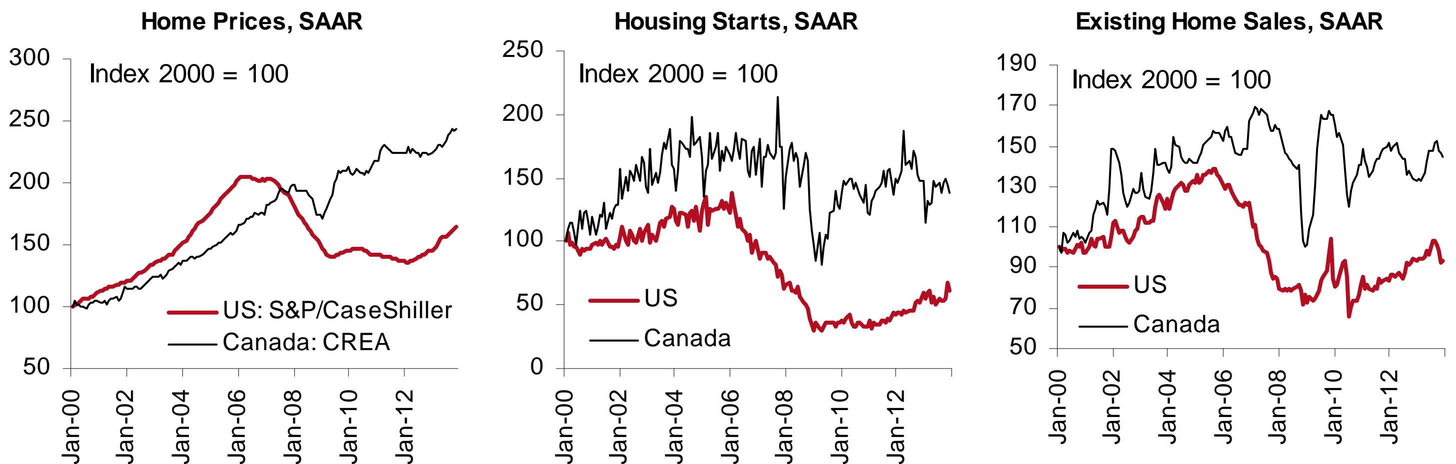
Figure 5 **Canadian Home Values Are Among the Highest in the World**



Source: IMF, Cormark Securities

The main thesis driving the Canadian housing bears is simple, and it is essentially the view that what happened in the US will happen in Canada. According to this analysis, the US is the leading indicator and all you have to do is follow the lines…down (see Figure 6).

Figure 6 **Housing: Does Canada Follow the US?**



Source: CMHC, CREA, Bloomberg LP, Cormark Securities

That is a very neat explanation, but besides the fact that it has not happened yet – fully six years after the US saw its biggest housing correction since the Great Depression – there are also a number of more fundamental reasons why a housing crash or even a significant correction is unlikely in the current environment. It is not that the risk is not there, but not only is there no credible catalyst on the horizon, this risk is also actually diminishing due to combination of government policy, moderating activity and a strengthening economy. While all economic expansion cycles end, they DON'T end from old age. There has to be a trigger.

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Five Reasons Why A Serious Correction In Canadian Housing Prices Is Unlikely Over The Next Few Years

Despite a very weak jobs report in December and continued sluggish export growth, the Canadian economy is on very solid footing and momentum should continue to build as the US fundamentals continue to improve. Q/Q annualized real GDP growth in Canada was a solid 2.7% in Q3, and according to the Bank of Canada's latest forecast should come in at a healthy 2.5% in Q4 (see Figure 7). The Canadian dollar may be sinking versus the greenback, but that should only help economic prospects going forward as the balance of trade improves. The Canadian unemployment rate has fallen by 150 bps since it peaked at 8.7% in August 2009 and job growth continues to trend positive despite a bad end of year result. Below are the five key reasons why Canadian bank investors should not expect a significant correction in housing prices over the next few years.

Figure 7 **The Bank of Canada's Latest Economic Forecast**

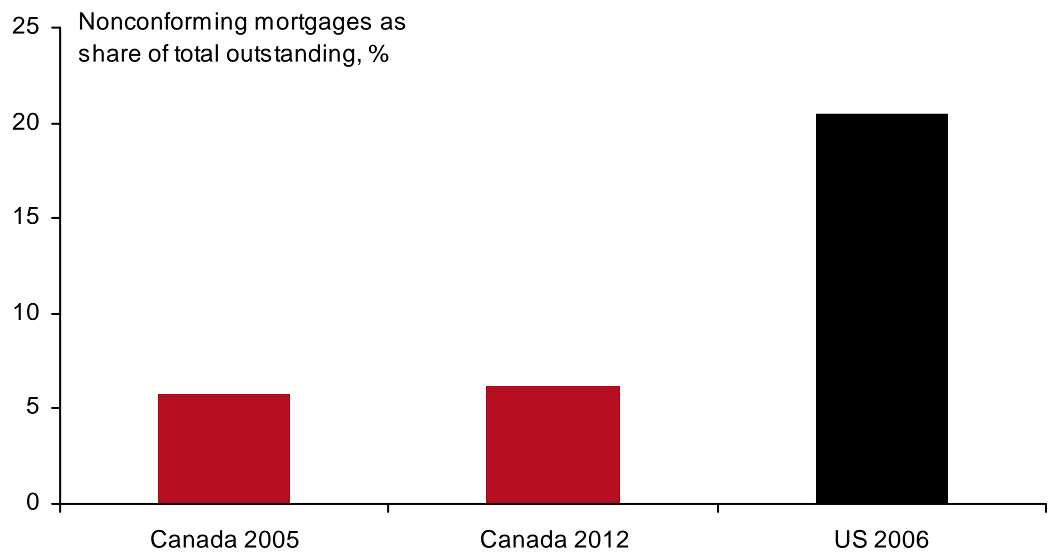
	2013E				2014E				2015E			
	Q1A	Q2A	Q3A	Q4E	Q1E	Q2E	Q3E	Q4E	Q1E	Q2E	Q3E	Q4E
Real GDP (Ann. Q/Q)	2.3%	1.6%	2.7%	2.5%	2.5%	2.5%	2.5%	2.6%	2.5%	2.5%	2.3%	2.2%
Total CPI (Y/Y)	0.9%	0.7%	1.1%	0.9%	0.9%	1.2%	1.4%	1.5%	1.7%	1.9%	1.9%	2.0%
WTI (US$/barrel)	94	94	106	98	93	93	91	89	87	86	84	83

Source: Bank of Canada MPR (January 2014)

1) The Sins of the Past Were Small

Canadian banks largely compete in the prime mortgage space, and even in 2005, at the height of the pre-crisis credit boom, nonconforming mortgages (subprime and Alt-A) accounted for only about 5% of total mortgages outstanding. That compares with close to 20% in the US just a year later in 2006 (see Figure 8).

Figure 8 **Non-conforming Mortgages Were Never a Big Part of the Canadian Market**



Source: Filogix, Financial Monitor, Cormark Securities

Furthermore, while securitization was, and continues to be, an integral cog in the Canadian mortgage market machine, it was never as significant a tool as it was in the United States. Pre-crisis in the US banks typically kept about 40% of their originated mortgages on balance sheet as opposed to 70% in Canada before IFRS implementation. Since during that period American banks were originating mortgages that were largely not staying on their balance sheets, underwriting standards naturally deteriorated over time (as risk was typically not retained by originators). In this way, securitization practices played a significant role in the US housing crash. Contrast that with Canada,

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where underwriting standards were more carefully adhered to because of both a lower reliance on securitization and the fact that strict mortgage insurance rules had a very strong role in upholding solid underwriting standards.

2) Mortgage Rules and Oversight Has Been Strengthened Since The US Crash:

The Government of Canada has made five significant regulatory changes to the CMHC mortgage insurance program over the past six years in an effort to cool what was at the time perceived to be a market at risk of dangerously overheating. Below is a brief chronology of those changes.

July 9, 2008 (implemented October 15, 2008):

- The maximum amortization period for new government-backed insured mortgages went to 35 years from 40 years.
- The minimum down payment for new government-backed insured mortgages moved to 5% (previously up to 100% loan-to-value was allowed).
- A consistent minimum credit score requirement was established. In addition, new loan documentation standards were introduced to ensure that there is evidence of reasonableness of property value and the borrower's sources and level of income.

February 16, 2010 (implemented April 19, 2010):

- Requirement that borrowers meet the standards for a five-year fixed rate mortgage even if they choose a mortgage with a lower interest rate and shorter term;
- The maximum amount Canadians can withdraw in refinancing their mortgages is lowered to 90% from 95% of the value of their homes.
- A minimum down payment of 20% on non-owner-occupied properties purchased for speculation is now required.

January 17, 2011 (implemented March 18 and April 18, 2011):

- The maximum amortization available went to 30 years from 35 years.
- The limit on refinancing went to 85% from 90% of the value of the home.
- The government withdrew government insurance backing non-amortizing lines of credit secured by homes, which limited this product to 80% loan to value.

June 21, 2012 (implemented July 9, 2012):

- The maximum amortization for insured mortgages went to 25 years from 30 years.
- The refinancing limit falls from 85% to 80% of a home's value (the limit was lowered from 90% to 85% in March 2011);
- The limit on borrower's gross debt service (GDS) ratio goes to 39% and total debt service ratio (TDS) goes to 44%. In 2008, the TDS was lowered to 45%.
- The government limited the availability of government-backed insured mortgages to homes with a purchase price of less than $1 MM.

July 9, 2013 (gradual implementation):

- Gradually limiting insurance on low-ratio mortgages (loan is less than 80% of the value of the property) unless they are part of a CMHC-backed mortgage insurance program. The aim of this rule is to eventually prohibit the use of bulk mortgage insurance.
- Prohibit CMHC-insured mortgages (both low and high ratio) from being used in any non-CMHC-sponsored securitization program.

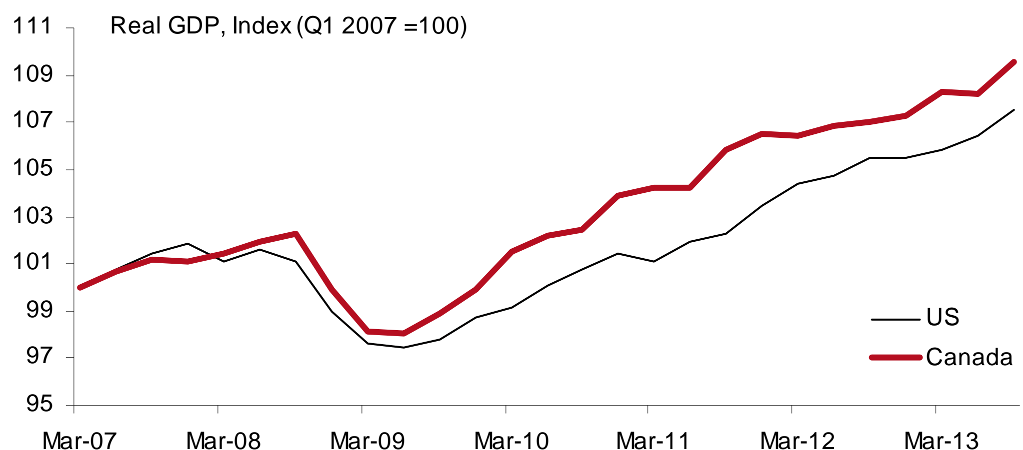
In addition to these regulatory changes, the Office of the Superintendent of Financial Institutions (OSFI) tightened up its oversight of the Canadian housing market in June 2012 when it released its B.20 Guidelines on the subject of Residential Mortgage Underwriting Practices and Procedures. Unlike the changes highlighted above which were authored by the Department of Finance and governed eligibility rules for government-backed mortgage insurance, the OSFI guidelines were authored by Canada's banking regulator and applied to regulated financial institutions making residential loans. The B.20 guidelines cover five key principles for sound mortgage underwriting.

1. Mortgage lenders should have a comprehensive mortgage underwriting policy including clearly articulated risk limits as well as lending criteria.
2. Financial institutions should perform due diligence to record and assess a borrower's identity and debt servicing ability, including credit history and evidence of past behavior.
3. Financial institutions should adequately assess borrowers' capacity to service their debt. This includes strong income verification and a focus on debt service coverage ratios such as GDS and TDS.
4. Financial institutions should have sound collateral management and appraisal process for all loans. Although there are no specific methodological requirements for appraisal, OSFI recommends that banks not rely on a specific method
5. Financial institutions should have effective credit and counterparty risk management practices and procedures. Mortgage insurance should not be used in place of rigorous underwriting practices

3) Closer Look At Canadian Household Debt: Leverage is High, But Debt Servicing Ratios Have Never Been Better:

While Canadian households are very levered relative to their income streams, this leveraging has been very rational considering that short-term interest rates have been hovering near record lows since the middle of 2009. When a central bank lowers rates, increased borrowing is just the behavioral response that policymakers are trying to achieve. In Canada, monetary policy did exactly what it was supposed to do during the financial crisis and great recession, which is why our economy outperformed the US during this period (see Figure 9).

Figure 9 **The Canadian Economy Outperformed the US During the Great Recession**



Source: StatCan, BEA, Cormark Securities

And while household debt levels in Canada continue to move higher, the cost of that debt has never been lower (see Figure 10).

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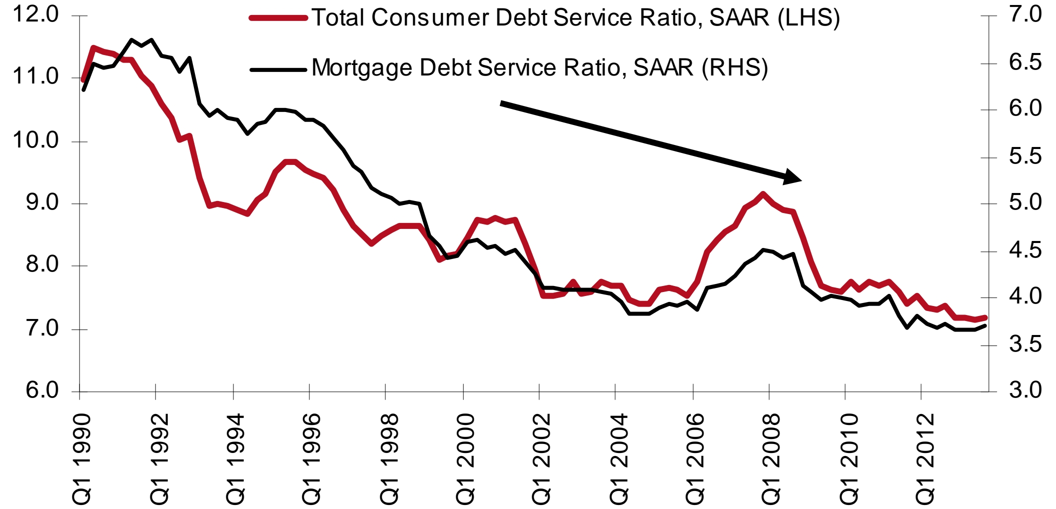
Figure 10 **Canadian Debt Service Ratios Remain Around Historic Lows**

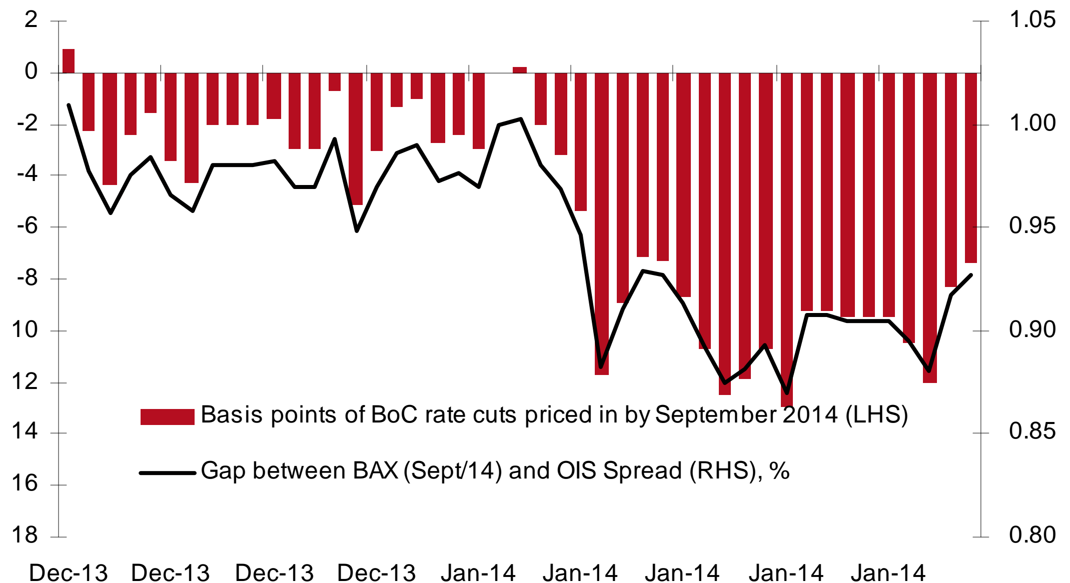


Source: StatCan, Cormark Securities

4)… And Rates Are Not Set To Spike

The debt/service ratio is a strong signal that debt levels are very manageable at current rates, a key indicator that illustrates just how rational households have been during this period of increasing leverage. The flip side of this argument is that rising rates pose a larger risk to financial stability than they have in the past, but the quantum of that rise is important. Although Canadian household finances are at risk of a large increase in borrowing rates, there are two mitigating factors. One is that according to both the Bank of Canada and the Federal Reserve's own forecasts base rates are not expected to rise until early-2015, and even then only very slowly. In fact, as Figure 11 shows, given the persistently low inflation readings we have seen in Canada and the Bank's very dovish tone, the market is actually pricing in odds (admittedly small) that the overnight rate actually goes lower.

Figure 11 **The Market is Starting to Price in Small Odds of a Rate Cut in Canada**

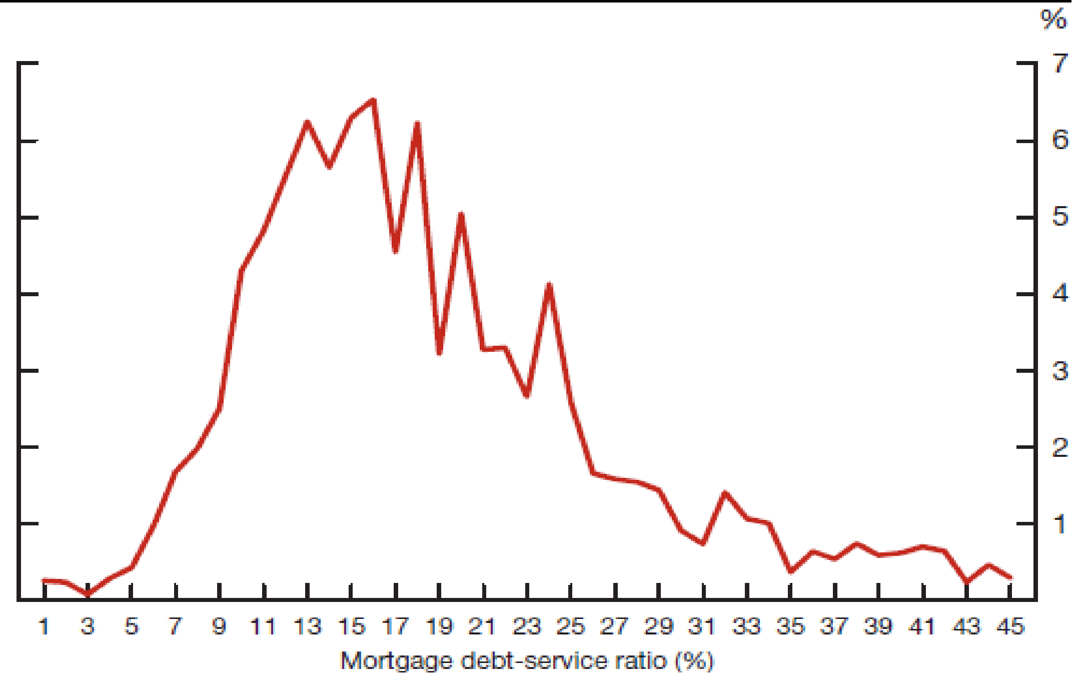


Source: Bloomberg LP, Cormark Securities

5) Leverage Is High, But The Details Matter

Finally, while it is undeniable that consumer leverage is high, the growth of consumer credit is the slowest in 20 years despite low debt-servicing costs as households are getting more cautious. Furthermore, not only has the proportion of households with a debt/service ratio of 40 or more and been stable since 2010, but the percentage of mortgage holders that add to their principal through refinancing has been heading lower as well. The fact is that in Canada growth in consumer credit has been concentrated among borrowers with relatively low debt/service ratios (see Figure 12). These households are less sensitive to modest increases in rates than highly levered borrowers who are just able to make their current debt payments at current low rates.

Figure 12 **Debt is Distributed Among Those Most Able to Service It**



Source: Canadian Financial Monitor, Bank of Canada

We are not apologists for the Canadian housing market, and we are not naïve enough to believe that there are no excesses, especially in the hottest markets of Toronto and Vancouver (even if these excesses are only backed by anecdotal examples). It is clear to all observers that the pace of activity that we have seen over the past 10 years is not sustainable. Yet that does not mean that a housing crash is inevitable. The structural elements are not there, the macro elements are not there … and activity is slowing down.

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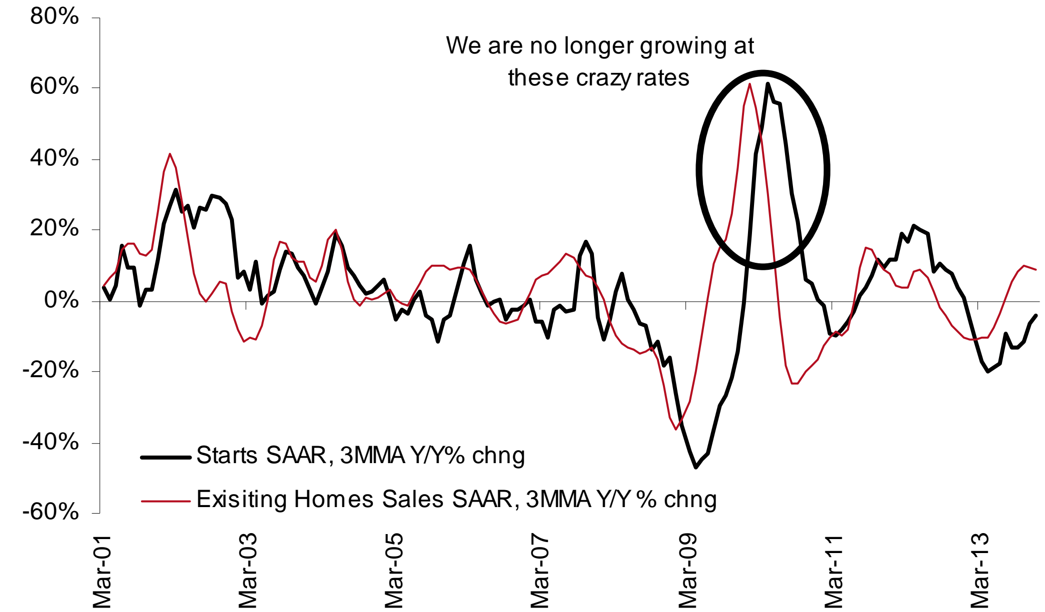
Figure 13 **Starts And Sales Have Slowed**

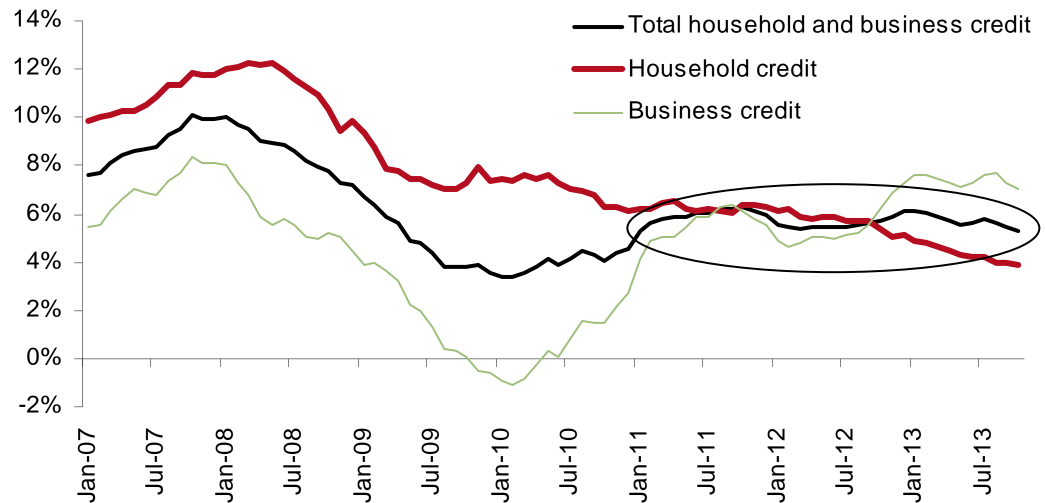


Source: StatCan, BEA, Cormark Securities

What If A Slowdown Happened And No One Noticed

Similarly, while the market continues to wring its collective hands at the impact that a slowdown in consumer lending volumes will have on bank earnings, the process has very quietly already played itself out. As shown in Figure 14, domestic credit growth has been quite flat for some time now.

Figure 14 **The Slowdown in Credit Growth Has Already Happened**



Source: StatCan, Cormark Securities

The aggregate data mask some interesting dynamics across various components. While business credit has been on the uptrend over the past few years, household credit growth has been slowing since it peaked in late-2008. The boom times are no longer here, that is clear, but the multi-year slowdown that has come in its wake has been moderate. Focusing on residential mortgage credit in particular, which is also the largest component of almost every Canadian bank's loan book, we can see a clear slowdown in growth first in 2008/09 and then again in 2013 (see Figure 15).

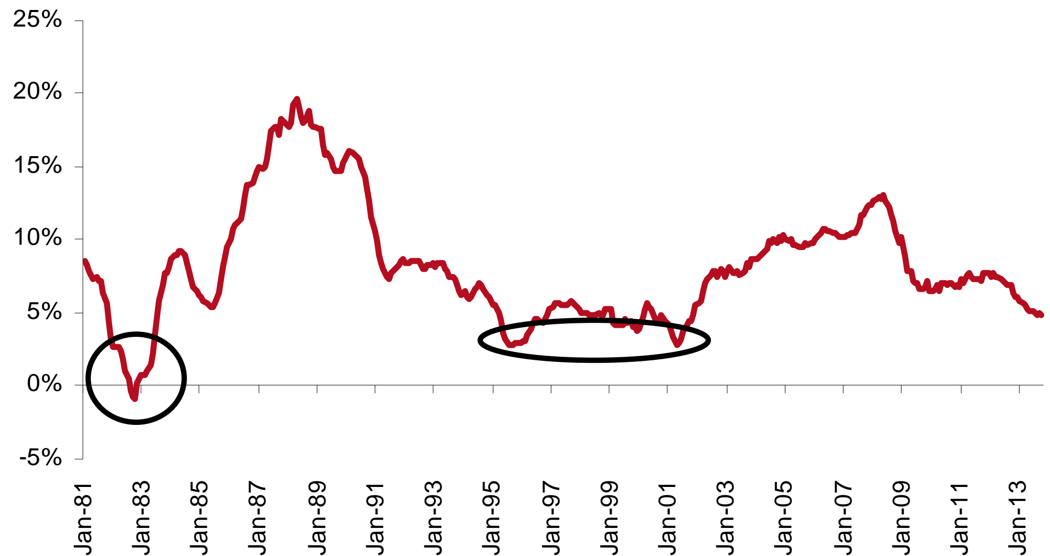
Figure 15 **Mortgage Credit Growth Has Already Slowed Significantly**

Source: StatCan, Cormark Securities

The big question that arises when looking at the above series is how much slower can mortgage growth get?

Taking a few steps back and looking at this same series across a much longer stretch of time, we can see that downside from current levels is not very large. While growth has at times been lower than it currently is, that typically coincides with recessions as was the case in the early-1990s and near-recessions as was the case in the early-2000s (see Figure 16). Looking at monthly data going back to 1980, there was only one brief period when Y/Y mortgage credit growth turned negative and that coincided with one of the deepest residential real estate corrections that Canada witnessed – and even then the contraction in mortgage credit was very temporary (see Figure 16). As we highlighted earlier in this report, not only is Canada not in a recession right now, but the consensus view is that economic growth is actually in a period of acceleration.

Figure 16 **Mortgage Growth Unlikely to Slow Much Further**



Source: StatCan, Cormark Securities

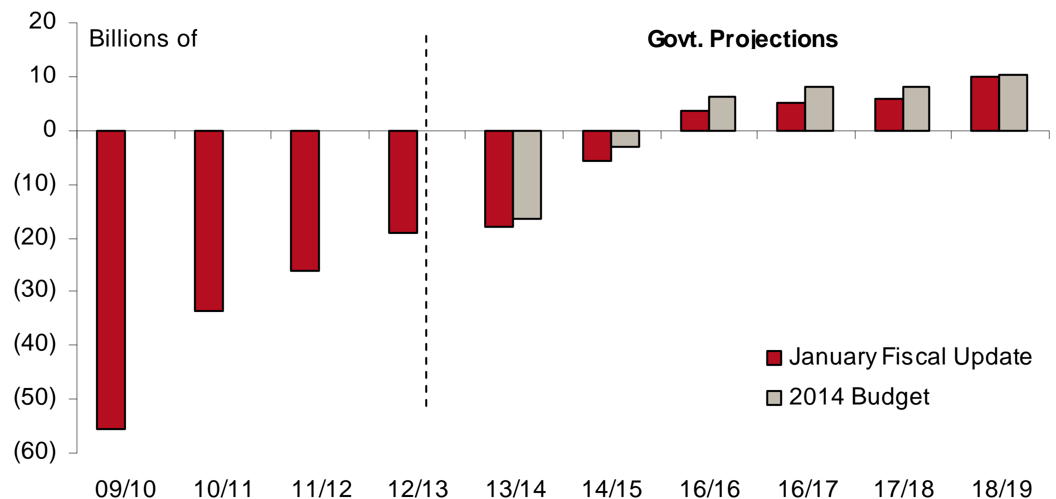
Is The Golden Era Of Canadian Banking Really Dead?

As we highlighted earlier, the general market outlook for Canadian banking is quite negative. The prevalent view out in the market is that the "Golden Age of Canadian banking" that began in the late-1980s as a wave of consolidation and favorable macro-economic developments, loosening regulation and low rates, is now over. We can see where this sentimentality comes from, given that between 1990 and 2007 the Big Six Canadian banks generated an average total return of about 13% per year. That pace of growth is unlikely to persist over the next 20 years, but before we get too pessimistic about the current investment outlook, it is worth highlighting that a number of the conditions that drove returns during the "golden age of Canadian banking" continue to be with us today.

1) Taxes

Starting in the late-1980s, Canada saw a massive decline in federal corporate tax rates, which provided a significant lift to bank earnings. Fast forward to the present, where despite some fiscal pressure in the wake of the global financial crisis, Canada's federal budget deficit is narrowing much quicker than expected and should swing to a surplus by 2016 (see Figure 17). The Department of Finance now projects $16.6 BB budget deficit for the 2013-14 budget year, but that narrows to a deficit of just $2.9 BB in 2014-15 (including a $3 BB reserve fund) and a $6.4 BB surplus in 2015-16. The government just announced an uneventful 2014 budget, but there are growing expectations that the 2015 budget will include tax cuts. These should largely be focused on the personal side, but the corporate sector may also be a beneficiary. At the very least, the current budget outlook does not portend any corporate tax increases.

Figure 17 **The Canadian Federal Budget Is Quickly Heading Back to a Surplus**

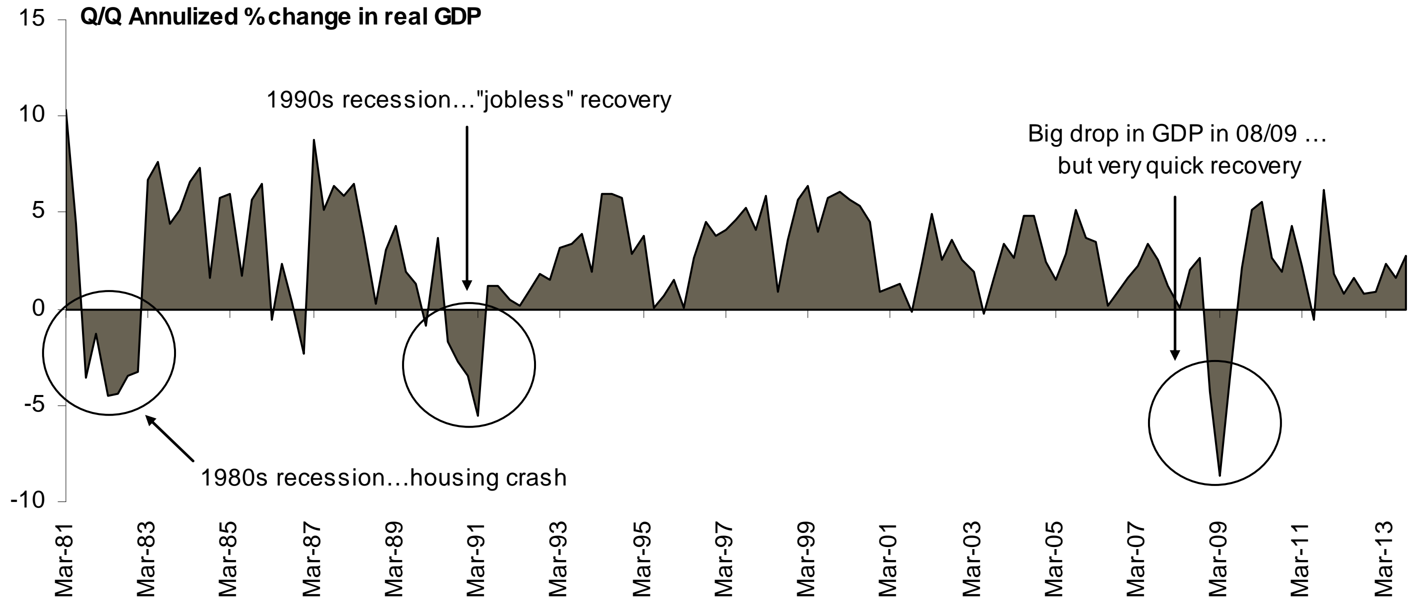


Source: Department of Finance Fiscal Monitor (January 2014) and 2014 Federal Budget , Cormark Securities

2) Economic Fundamentals

Although the Canadian economy is not booming, the data have been generally positive and the outlook is also positive. Real GDP growth likely came in at only about 1.8% in 2013, but that was weighed down by a weak first half of the year, and the Bank of Canada is now looking for growth of 2.5% in 2014 and 2015. More broadly speaking, Canada has been on a remarkable economic run since the early-1990s recession. Since 1992, the Canadian economy has only delivered 6 quarters (out of 86) of negative growth, and in all those cases the downturn was both mild and short-lived (see Figure 18).

Figure 18 **Quarterly Canadian Real GDP Growth**

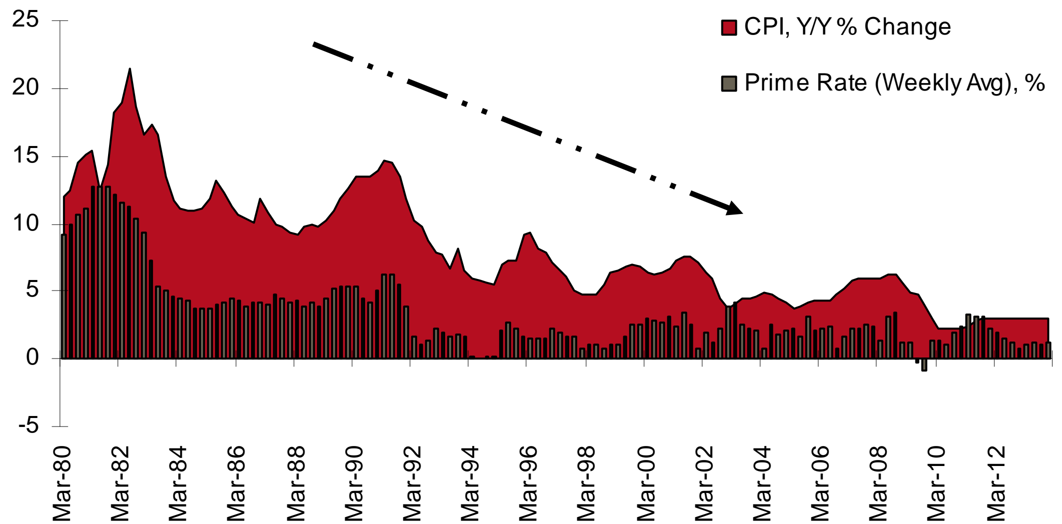


Source: Bloomberg LB, StatCan, Cormark Securities

3) Interest Rates

The 1990s ushered in a period of steadily declining inflation and interest rates in Canada and across most of the developed world (see Figure 19). The process came to a head in the wake of the financial crisis when overnight rates moved toward their lower bounds and longer-dated yields fell to historical lows. Although it is unlikely that rates in Canada will go meaningfully lower, and at the short end of the curve that is not even possible, there is also no indication that they are likely to surge anytime soon. According to the futures market, the Bank of Canada is unlikely to hike rates before 2015, and even then most economists expect small increases from there.

Figure 19 **The Canadian Prime Rate and CPI Since the 1990s**



Source: StatCan, Bloomberg LP, Cormark Securities

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4) Regulation

The 1980s ushered in a period of dramatic regulatory change that kicked off a process of consolidation that allowed the large Canadian banks to bring large swaths of the Canadian financial services landscape under their banners. The 1980 amendment to the Bank Act opened the door for banks to own mortgage loan companies such as Canada Trust, which TD acquired in 2000. Meanwhile, the 1987 amendment to the Bank Act effectively eliminated the Canadian equivalent of the US Glass-Steagall Act, which barred banks from competing in much of the securities business. We note that although the Canadian regulatory landscape is seen as very conservative and slow moving, this legislative change was well ahead of the United States as the Glass-Steagall Act was only repealed in 1999. During the late-1980s and early-1990s, the chartered banks entered the securities business, largely through the acquisition of existing securities dealers. More recently, the banks have also been effective consolidators in the wealth management business in particular, and active in the insurance business as well (P&C and life).

Although there are people calling for new laws that would reverse much of this consolidation across the financial services sector, especially the ability of commercial banks to own investment banks, these views are largely centred in the US and Europe – and even they have not gotten much traction. The solid performance of the Canadian banks during the financial crisis has ensured that bank regulation is not an important public issue. Regulatory change has come to Canada largely under the auspices of the Basel III rules, but even these changes (those both instituted and that are yet to be officially introduced) are not expected to require the Canadian banks to make fundamental changes to the way they operate or the businesses they compete in.

Rethinking Emerging Market Growth

The Promises Of Tomorrow Do Not Apply Today

Despite the fear of a deeper slowdown in the Canadian bank operating environment, the reality is that the outlook is generally stable. In this case boring is good, and we believe a lot better than what others are assuming. What is clear to all is that the real growth is to be found outside the country. The big question though is where?

For much of the 2000s, and especially in the wake of the US housing crash, emerging market exposure has tended to be viewed as a key strength across the Canadian financial services landscape. In bank-land this only really applied to the Bank of Nova Scotia, but it has also been a very popular theme among Canadian life insurance companies. Yet while the future theoretically belongs to emerging markets given their generally favorable demographics and development potential, as the economist John Maynard Keynes famously pointed out “in the long run we are all dead”.

In theory, living standards in poor nations should be able to catch up with developed nations, but history has shown that economic development frequently gets stuck at some point along the way. In fact, new research is now showing that these “development traps” are more likely to knock countries off their catch-up trajectories at a later stage of development that previously thought. In some cases, development traps even hit newly-rich countries such as happened to Argentina and Venezuela in the past century. Frequently boom periods are misinterpreted as clear evidence that emerging markets are successfully playing economic catch up, but these periods are typically not sustainable and tend to coincide with a commodity boom – like the one we just lived through.

Although this view goes against conventional wisdom, it is our position that the slowdown in emerging markets is not temporary. We are not predicting total collapse in emerging markets (although there will be pockets of crisis), but we do see the pace of growth in these countries slowing relative to the pace they have been growing at over the past 10 years. At the same time, we see growth rates in the developed world, the US in particular, going higher. As shown in Figure 20, the spread between emerging market growth and the G7 has already narrowed, and we expect it to narrow even more than IMF forecasts suggest. In this context, we believe that it is the US and not regions like Latin America that will be viewed as the favored growth market for the Canadian banks over the next few years.

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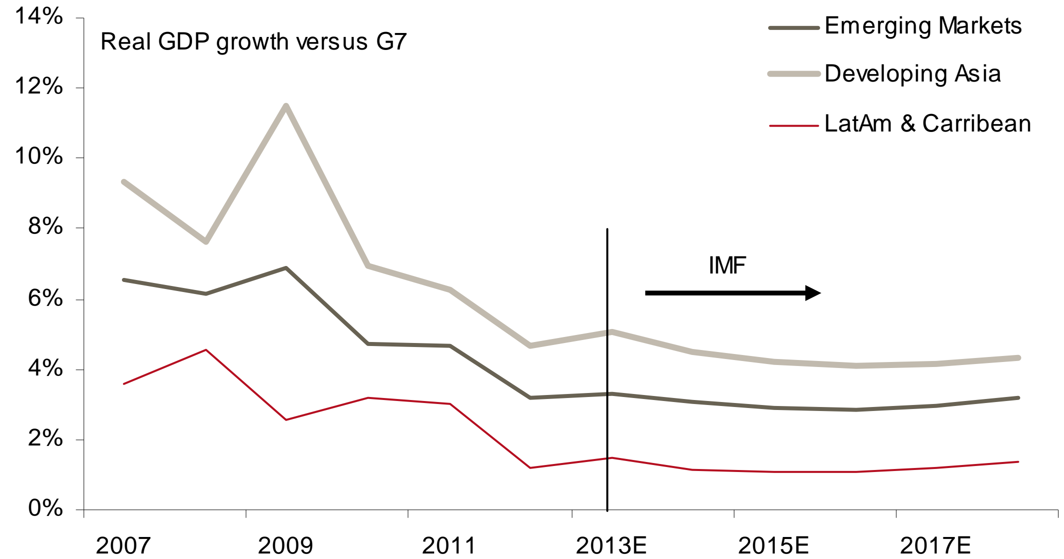
Figure 20 **Emerging Market Outperformance Has Narrowed … And This Will Continue**



Source: IMF, Cormark Securities

Far from being the new normal, the rapid emerging market growth that we saw between 2000 and 2012 was the product of a number of cyclical forces that are unlikely to repeat anytime soon. These factors include record low interest rates in the industrialized world, a commodities super cycle, an emerging market investment boom and a wave of political and economic reform in many of the most closed off countries in the world.

1) The Credit Cycle

As we have mentioned before, interest rates across the developed world and in the US in particular have been on a downward trend since the early-1980s. This came to a head in the wake of the financial crisis when these rates approached their lower bonds at the short end and longer-dated yields fell to historical lows. This decline in risk-free returns (and a flattening of the yield curve) in the US and across the Western world has helped drive capital flows to emerging markets as investors grasped for higher returns. With the rates in the developed world having nowhere to go but up (albeit slowly), these flows are reversing, and we have seen that outflow speed up over the past few weeks in particular (see Figure 21). Also helping to reverse capital flows is the growing risk in many emerging markets due to growing fiscal deficits, growing current account deficits, high levels of public debt and rising inflation. The World Bank recently warned that capital flows to emerging markets could contract by as much as 80% if monetary policy in advanced world economies tightens more quickly than expected. According to World Bank research, global factors including US interest rates explained about 60% of the increase in emerging market capital flows between 2009 and 2013.

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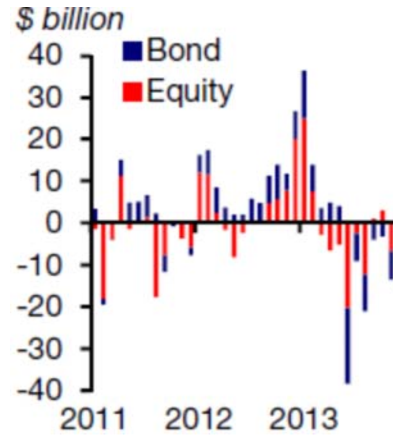
Figure 21 **Emerging Market Capital Flows**

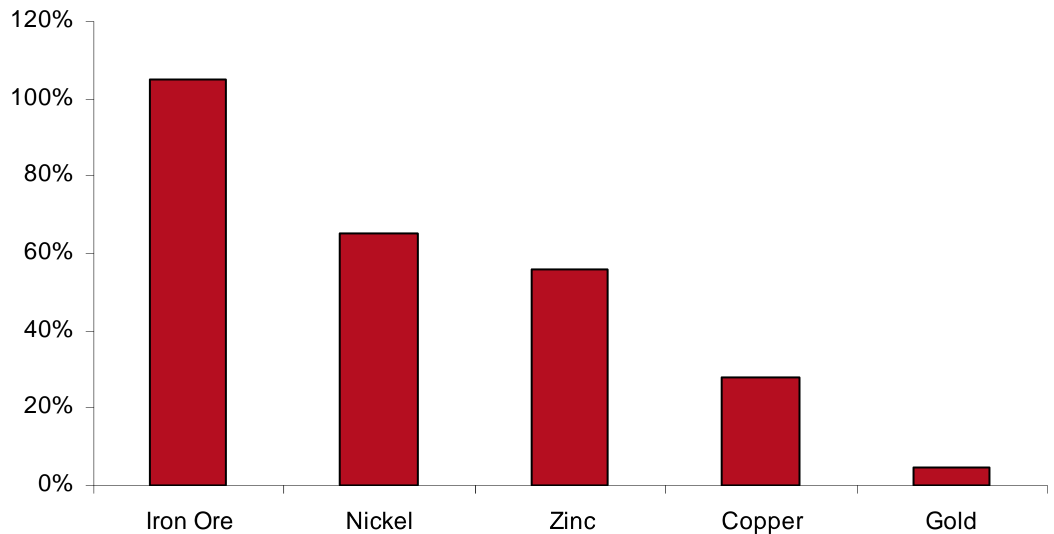


Source: EPFR

2) The Commodity Cycle

The commodity super cycle that helped fuel so much growth in many emerging markets around the globe, including much of Latin America in particular, has come to an end. Although broadly speaking prices remain quite high relative to history, they have come down quite significantly from their peaks due to a combination of lower demand and more fundamentally, increased supply. Since 2000, global supply of iron ore is up over 100%, nickel is up over 65% and zinc is up over 56% (see Figure 22).

Figure 22 **Supply Surges For Many Commodities**

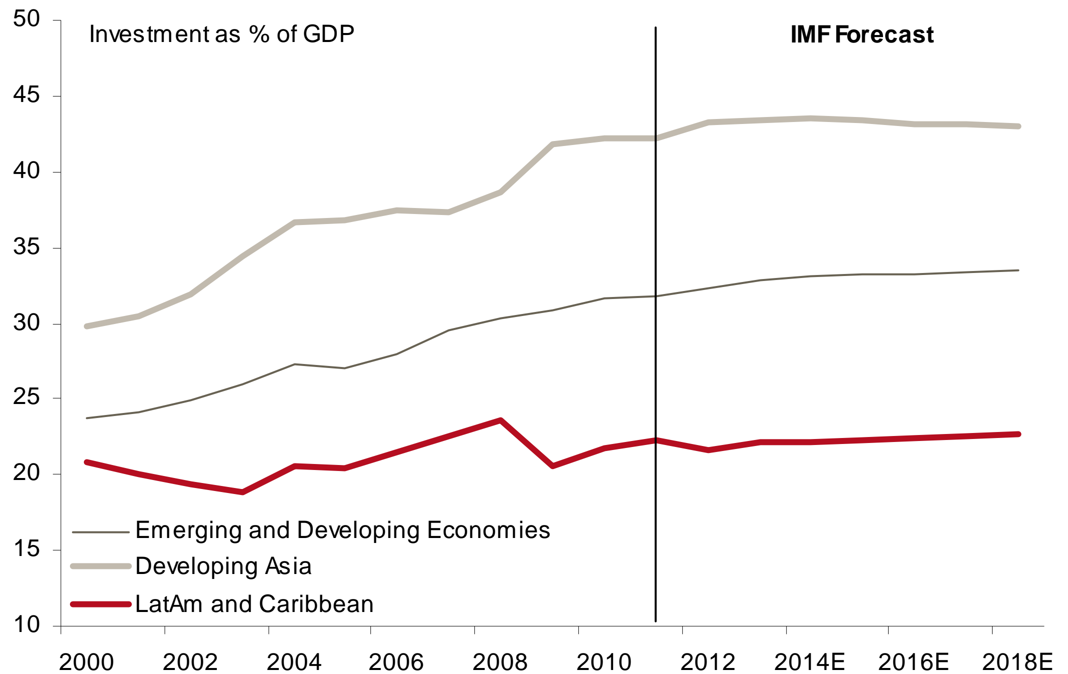


Source: Raw Materials Data, Stockholm, Wall Street Journal, Cormark Securities

3) The Investment Cycle

Investment ratios across the emerging markets have peaked and are predicted to flatten out over the coming years. In a number of countries, the pace of spending has slowed down simply because there is less of a need as infrastructure gaps have narrowed, and in other cases it is a function of capital availability as financing in those regions gets more expensive and harder to raise. Given the turn in global capital flows, it is unlikely that we will see renewed growth in investment ratios across the developing world for some time (see Figure 23).

Figure 23 **IMF Investment Ratio**



Source: IMF, Cormark Securities

4) The Political Cycle

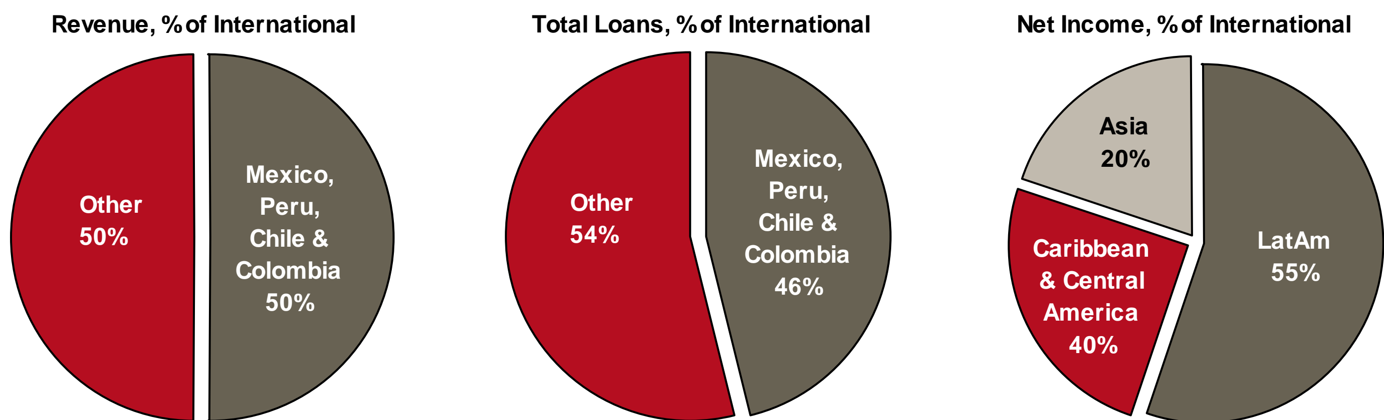
Finally, while many emerging markets did make significant economic and political reforms between 1980 and 2000, reforms have slowed since then as many governments drew the wrong conclusions from the financial crisis. Many developed economies have opened up their markets to the world, but emerging markets have not fully reciprocated as leaders in many of these countries take a more cautious approach to further trade liberalization. A wave of success over a number of years has led investors to underestimate the governance challenges facing many emerging markets and to overestimate their resilience. Emerging market equities underperformed the aggregate world index (measured by MSCI) by 29 percentage points in 2013. The reasons for this have included weaker top-line revenue growth, lower government stimulus, high profile corporate defaults (like OGX in Brazil) as well as renewed concerns about corporate governance and legal protections.

The Two Latin Americas

So over the next few years, we believe that emerging markets will deliver a slower pace of growth with a higher element of risk than they have over the past 10 years. At the same time, we see economic growth across the industrialized world, and particularly in the US, as improving at an increasingly rapid pace.

That said, it would be a mistake to paint the entire emerging market universe with the same brush. Zeroing in on Latin America specifically, where about half of BNS' international earnings are generated (see Figure 24), a clear distinction should be made between countries such as Mexico, Peru, Colombia and (to a lesser extent) Chile that have solid macroeconomic fundamentals and are being governed by sensible fiscal and monetary policy, and countries such as Venezuela, Argentina and increasingly Brazil that are showing growing signs of economic stress and are increasingly pursuing flawed economic policies. In Latin America, BNS' footprint is firmly entrenched in that first group (see Figures 25-28). Although even among that group, we note there are issues as Chile has only about one year's worth of foreign exchange reserves to cover its gross external financing requirements (GEFR) and in Mexico commercial bad debt rising.

Figure 24 **BNS International Revenue, Earnings and Loan Growth**

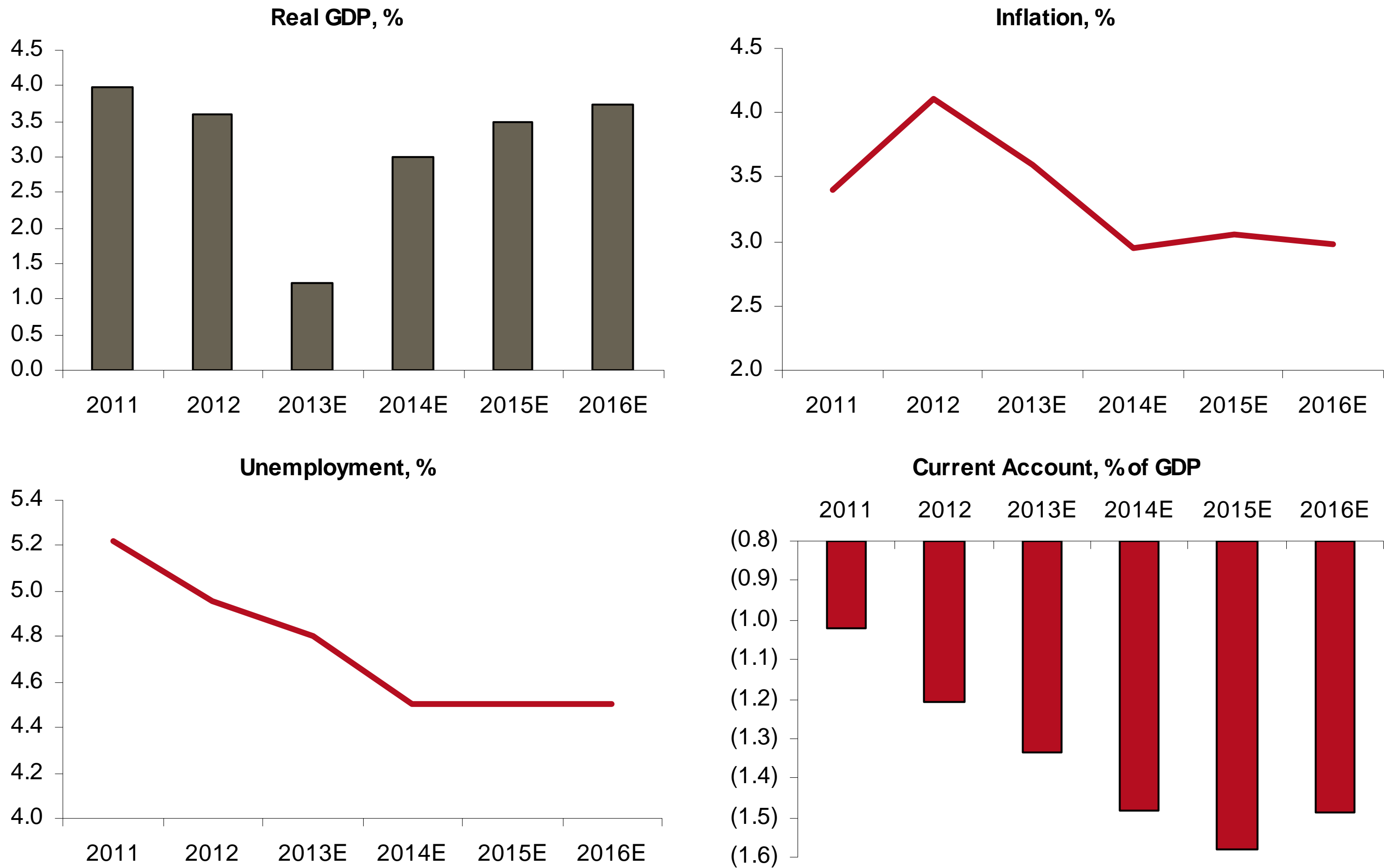


Note: Data is from F2012, International includes the International Banking Segment and a portion from the Global Wealth Management segment.
Source: Company Reports, Cormark Securities

Yet just because these economies are generally on a solid footing and are expected to perform reasonably well over the next few years, it does not mean that there is no grounds for concern. The tail risk for the region as a whole is growing as investment flows continue to move out of the region (as well as out of emerging markets as a whole). In addition, Brazil, by far the region's largest economy, is struggling under rising inflation and significant and growing capital outflows. As Canadians are all too familiar, when a dominant regional economic power is in trouble, its neighbors should be worried. That does not mean that they will necessarily experience the same fate, but it is a dangerous position to be in nonetheless, especially since contagion is not very well understood by economists…or equity investors.

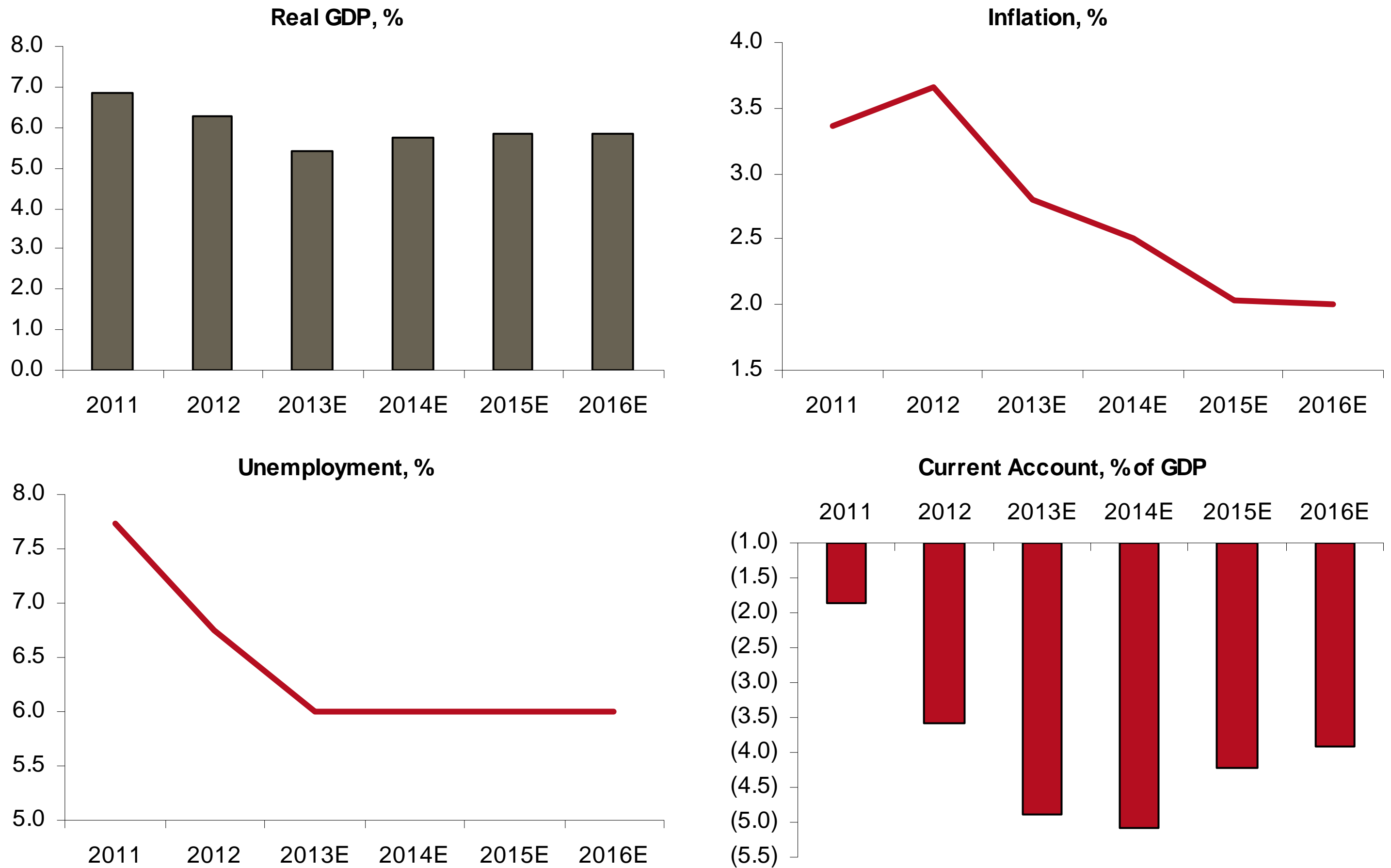
Think contagion cannot happen? Just look at the chronology of event in Asia in 1997 when problems in tiny Thailand spread to Hong Kong, Indonesia and South Korea. And while we are on the subject of Thailand, the country is going through massive political unrest and is teetering on the verge of a military coup. BNS owns 49% of the 5th largest Thai bank, Thanachart Bank. The unrest is impacting the economy and is likely to have a bigger impact the longer it goes on. In fact, the Thai government has just slashed its GDP forecast for 2014, and the Commerce Minister stating that real GDP growth this year would be well below the previous government forecast of 4-5%.

Figure 25 **Mexico: Key Economic Measures**



Source: IMF, Cormark Securities

Figure 26 **Peru: Key Economic Indicators**



Source: IMF, Cormark Securities

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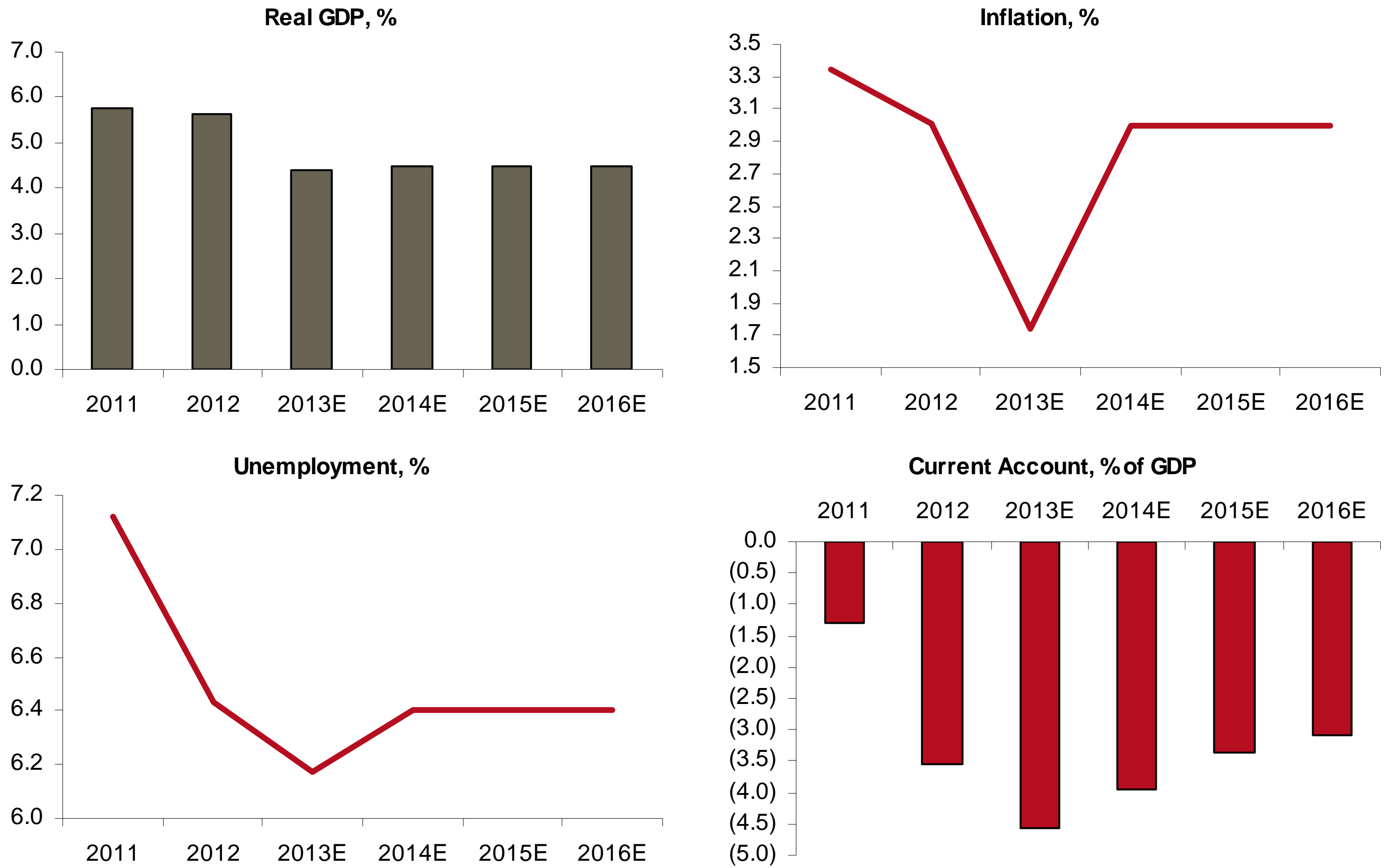
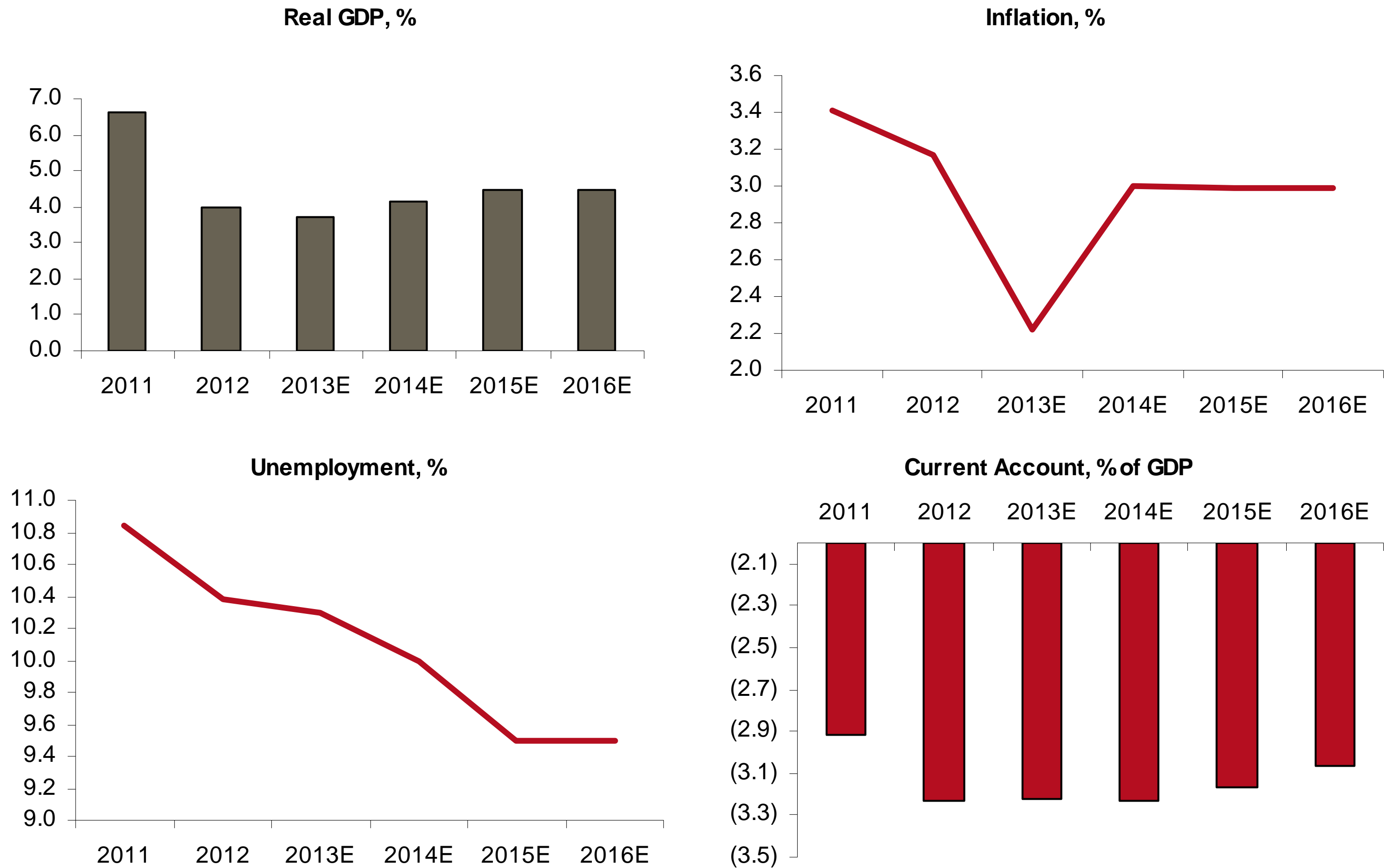
Figure 27 **Chile: Key Economic Indicators**



Source: IMF, Cormark Securities

Figure 28 **Colombia: Key Economic Indicators**



Source: IMF, Cormark Securities

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The Case for America

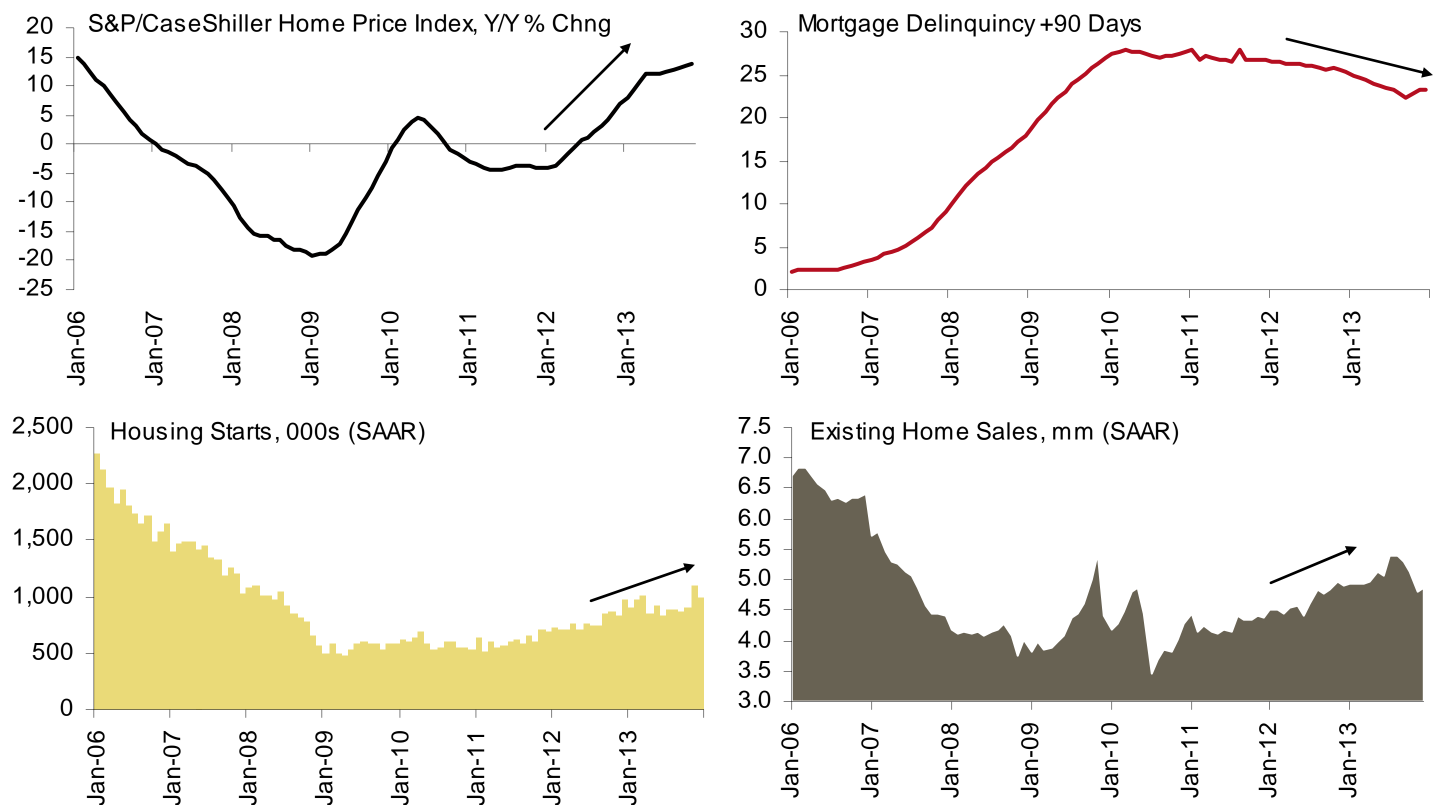
The US Economic Recovery Is Far Enough Along That It Is Largely A Consensus View

While the outlook for emerging markets is becoming less attractive, the outlook for the US economy as a whole, and the banking sector in particular, continues to improve.

The US recovery story is now far enough along now that it is largely a consensus view. Although real GDP growth for 2013 as a whole was 1.9%, that was largely due to a weak handoff in Q4/12 and a soft Q1. The second half of the year was very strong, with growth of 4.1% in Q3 and 3.2% in Q4. The unemployment rate is now 6.6%, down 340 bps from a peak of 10% in October 2009, and job growth is averaging 180K per month over the past six months. The recovery is solid enough in the eyes of policymakers that just this past December, the FOMC announced that it would finally begin tapering its bond-buying program.

The housing market, which was the epicentre of the Great Recession, is also recovering after going through its biggest contraction since the Great Depression. Housing starts are up over 100% since they troughed, and according to the S&P/CaseShiller Index home prices have recovered back to July 2008 levels (see Figure 29).

Figure 29 **The US Housing Recovery is on Track**



Source: Bloomberg LP, Cormark Securities.

Turning to the US consumer, the steep contraction in the stock of household debt that began in Q1/09 has finally reversed. This re-leveraging is moving very cautiously, but Q3/13 was the first quarter since Q3/08 that household credit actually showed a Y/Y increase. As in Canada, historically US household credit has tended to grow even during difficult economic periods. That highlights just how unique the contraction in US consumer credit was, and just how fleeting. With the labor market on track and income

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growth also trending higher, we expect households to increasingly lever up again over the next few years. We may not see debt-to-income ratios challenge pre-crisis levels anytime soon, but current measures have been unduly weighed down by a once-in-a-lifetime housing crash, and do not signal a new normal for American consumer behavior or savings rates.

The end of this deleveraging cycle is welcome news to the US banking sector since it was particularly damaging the consumer lending business. While the Canadian banking business is facing slow consumer loan growth for the foreseeable future, the US banking business is just now lifting off a cyclical trough of epic proportions. The US banking sector was hit so hard during the financial crisis and the subsequent recession that the only way is up, and the key question is really when. Investors have recognized this and have slowly pushed up bank valuations to quite heady levels for the regional banks in particular. Those firms are now trading at 15.5x 2014 consensus earnings (see Figure 30), compared with the Big Six Canadian banks at 11.0x 2014 estimates.

Figure 30 **US Regional Bank Valuations**

		Price	Sh. O/S	Mkt Cap.	52 Week		Earnings per Share		Price/Earnings		Price/	Div.
U.S. Regional Banks	**TKR**	**7-Feb**	**(MMs)**	**(MMs)**	**High**	**Low**	**2014E**	**2015E**	**2014E**	**2015E**	**Book**	**Yield**
Fifth Third	FITB	$21.10	855.3	$18,047	$21.96	$15.43	$1.78	$1.92	11.9x	11.0x	1.3x	2.3%
KeyCorp	KEY	$12.74	890.7	$11,348	$14.14	$9.14	$1.02	$1.13	12.5x	11.3x	1.1x	1.7%
Huntington Bancshares	HBAN	$9.03	832.2	$7,515	$9.91	$6.75	$0.72	$0.79	12.5x	11.5x	1.3x	2.2%
Popular, Inc.	BPOP	$27.03	103.4	$2,795	$34.34	$23.97	$2.99	$2.99	9.0x	9.0x	0.6x	na
M&T Bank	MTB	$113.00	130.6	$14,754	$119.54	$95.68	$7.77	$8.92	14.5x	12.7x	1.4x	2.5%
Washington Federal	WAFD	$21.92	102.5	$2,247	$24.35	$15.79	$1.58	$1.67	13.9x	13.1x	1.2x	1.8%
Zions Bancorp	ZION	$28.93	184.7	$5,343	$32.29	$23.10	$1.84	$2.04	15.7x	14.2x	1.0x	0.6%
First Horizon National	FHN	$11.49	236.4	$2,716	$12.75	$9.47	$0.71	$0.87	16.2x	13.3x	1.3x	1.7%
BOK Financial	BOKF	$63.44	68.8	$4,367	$69.36	$57.04	$4.24	$4.53	15.0x	14.0x	1.4x	2.5%
Hancock Holdings	HBHC	$33.81	82.2	$2,780	$37.42	$25.00	$2.38	$2.48	14.2x	13.6x	1.1x	2.8%
East West Bancorp	EWBC	$33.42	143.4	$4,791	$36.94	$22.56	$2.30	$2.50	14.5x	13.4x	1.9x	2.2%
Webster Financial	WBS	$29.36	90.3	$2,652	$32.67	$21.82	$2.08	$2.25	14.1x	13.0x	1.2x	2.0%
New York Comm Bancorp	NYCB	$15.35	440.8	$6,766	$17.39	$12.91	$1.04	$1.10	14.7x	14.0x	1.2x	6.5%
Properity Bancshares	PB	$61.56	66.0	$4,066	$66.90	$44.33	$4.15	$4.41	14.8x	14.0x	1.5x	1.6%
TCF Financial	TCB	$15.72	164.9	$2,592	$17.12	$13.27	$1.09	$1.27	14.5x	12.4x	1.5x	1.3%
Associated Banc-Corp	ASBC	$16.18	161.1	$2,606	$17.89	$13.57	$1.08	$1.17	15.0x	13.9x	0.9x	2.2%
Comerica	CMA	$45.75	182.3	$8,340	$49.95	$33.29	$3.03	$3.28	15.1x	14.0x	1.2x	1.7%
First Republic Bank	FRC	$49.39	132.4	$6,539	$52.94	$35.91	$3.00	$3.40	16.5x	14.5x	2.0x	1.0%
Bank of Hawaii	BOH	$55.99	44.5	$2,491	$60.69	$46.04	$3.64	$3.90	15.4x	14.4x	2.5x	3.2%
Valley National Bancorp	VLY	$9.66	199.6	$1,928	$10.73	$8.75	$0.57	$0.62	17.0x	15.5x	1.3x	4.6%
Cullen/Frost Bankers	CFR	$73.04	60.8	$4,438	$76.51	$59.11	$4.11	$4.31	17.8x	17.0x	1.8x	2.7%
BankUnited	BKU	$31.13	101.0	$3,145	$33.99	$24.17	$1.83	$2.12	17.0x	14.7x	1.6x	2.7%
Synovus Financial Corp.	SNV	$3.36	972.4	$3,267	$3.79	$2.44	$0.20	$0.22	16.9x	15.0x	1.2x	1.2%
City National	CYN	$70.55	54.4	$3,838	$81.34	$53.04	$4.08	$4.43	17.3x	15.9x	1.5x	1.9%
Signature Bank	SBNY	$121.57	47.3	$5,749	$129.83	$70.58	$5.78	$6.64	21.0x	18.3x	3.2x	NA
Westamerica Bancorp	WABC	$49.35	26.5	$1,308	$57.59	$41.76	$2.39	$2.54	20.6x	19.4x	2.4x	3.1%
SVB Financial Group	SIVB	$110.87	45.7	$5,063	$121.92	$65.45	$5.30	$5.53	20.9x	20.0x	2.6x	NA
								Average	15.5x	14.2x	1.5x	2.3%

Source: Bloomberg LP, Cormark Securities

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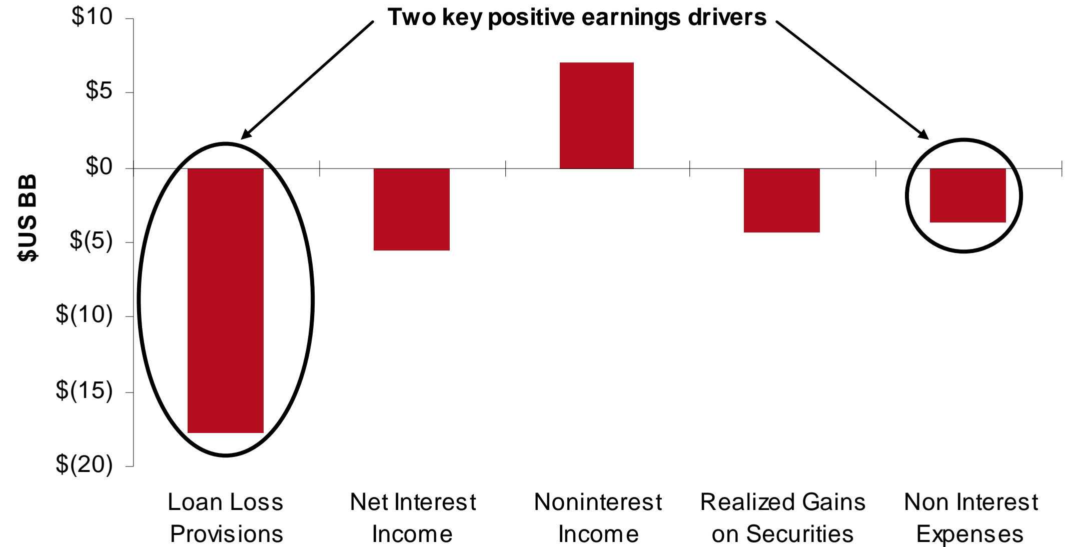
Earnings across the entire US banking sector have been good, although for the time being that performance has largely been driven by aggressive cost cutting and a significant improvement on the credit side (see Figure 31). Revenue growth has been very modest, but there are signs that this will change as loan growth increases and net interest margins begin to expand.

Figure 31 **Major Factors Affecting US Bank Earnings**



Note: Cover Q1/13 to Q3/13 for all FDIC regulated US banks
Source: FDIC, Cormark Securities.

Not only is the macro environment improving, but the regulatory and legal environment is also becoming clearer (albeit still challenging). Regulatory risk has been a significant headwind for the US banking sector since the early days of the financial crisis, but the bulk of the changes that were conceived to address the excesses (both real and imagined) of the banking sector before the crash in 2007/08 have largely been finalized and clarified – even if not fully implemented. These include a number of consumer protection regulations such as the Durbin Amendment and Regulation E. as well as full weight of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), which is the most comprehensive and wide-reaching regulatory change that the US financial services sector has seen since the Great Depression.

This 2,300-page bill was signed into law by President Obama in July 2010 and includes numerous provisions which range from ensuring accountability and transparency in the financial system, to protecting the American taxpayer in the event of bank failures, and protecting consumers from abusive financial services practices. About half the rules required under the law have been set as of January 2014.

A key aspect of the legislation is the Volker rule. Originally proposed by former Federal Reserve Chairman Paul Volcker, this rule restricts banks from making certain types of speculative investments that do not benefit customers. This provision is largely interpreted as a ban on proprietary trading by banks, but includes a number of exceptions, including allowing banks to invest in hedge funds and private equity funds that do make proprietary investments. The CFTC, FDIC, Federal Reserve, OCC and SEC released final regulations implementing the Volcker rule in December.

In addition, on July 2, 2013, the Board of Governors of the Federal Reserve System approved the final rules that would implement the Basel III capital framework in the US.

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On the legal side, 2013 was not a good year, with legal provisions ballooning across Wall Street to cover misdeeds stretching from improperly underwriting residential mortgage origination to manipulation LIBOR. Since the financial crisis began, the US banks have racked up billions in legal costs. As of the end of the year, litigation expenses at JP Morgan (JPM-NYSE), Morgan Stanley (MS-NYSE), Bank of America (BAC-NYSE) and Citigroup (C-NYSE) totaled $21.3 BB. The good news is that we are starting to see resolution to these matters. Legal woes will continue to capture headlines in 2014, but provisions should be increasing at a slower rate than they did in 2013.

BMO Or TD – Which Way To Play The US?

Given all the good stuff happening in the US, we believe that Canadian bank investors should overweight both TD and BMO given each bank's significant exposure to the US retail banking market. The other large Canadian banks all have operations in the US, but these are largely focused on the capital markets and wealth management spaces. RY had a retail banking network in the US, but was generally viewed as below scale and after years of underperformance it was sold it to PNC Financial Services Group (PNC-NYSE) in 2011 for $3.6 BB.

While we like both BMO and TD, the natural question for someone looking to play the US banking recovery from a Canadian perspective is: which bank provides better exposure over the next 12-18 months? In our view, BMO has the edge, as it is starting from a weaker position and we believe that its mid-Western footprint and commercial lending focus are poised to drive a turnaround in the business over the coming two years. The figure below summarizes how both firms stack up against each other south of the border (see Figure 32).

Figure 32 **Comparing U.S Footprints: BMO & TD**

	BMO	TD
US P&C Footprint - Top Three States by Deposits	Illinois, Wisconsin, Indiana	Delaware, New Jersey, New York
U.S. Branches (Q4/F13)	626	1,317
Avg. Deposits in US P&C (Q4/F13 - US$ BB)[1]	58,780	191,200
Avg. Assets in US P&C (Q4/F13 - US$ BB)	63,211	na
Avg. Loans & Bas in US P&C (Q4/F13- US$ BB)[2]	51,969	107,400
US P&C Loan-to Deposit Ratio (Q4/F13)	88%	56%
US National Deposit Market Share (2013)	0.83%	2.11%
Adjusted US P&C NI as % of Total (F2013)	15%	na
Y/Y % Change in US P&C NI	(1%)	an
Adjusted Total US NI as % of Total (F2013)[3]	25%	26%
Y/Y % Change in Total US NI[3]	9%	14%

1 TD deposits include TD Ameritrade
2 Excludes M&I purchased credit impaired loans
3 Excludes wholesale for TD
Source: Company Reports, SNL Financial, Cormark Securities

BMO's US Footprint

While BMO did enjoy a strong market position in Illinois before it acquired M&I Bank in 2011, this deal was responsible for significantly expanding the firm's US footprint across the Midwest, particularly in Wisconsin, and catapulting the bank into the Top 20 US banks by deposit market share (see Figure 33).

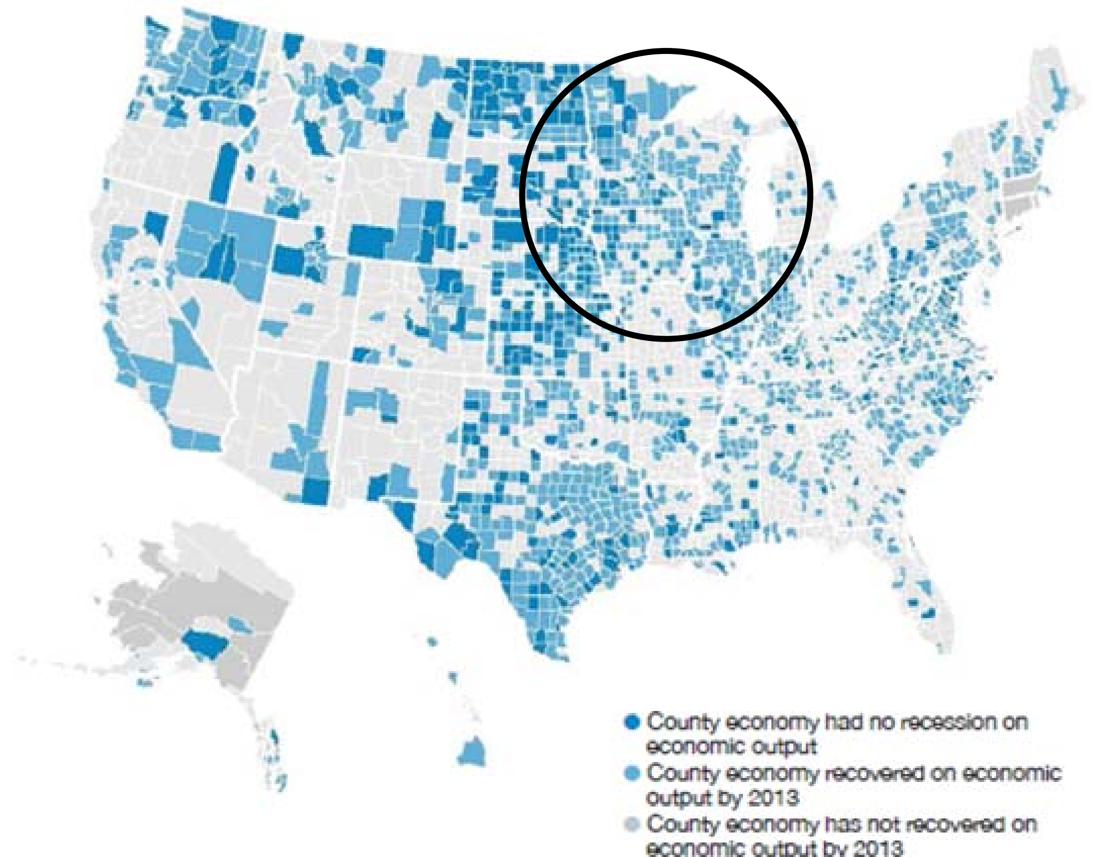
Figure 33 **US Bank Market Share By Deposits**

2013 Rank	2012 Rank	Institution (ST)	2013 Number of Branches	2013 Total Deposits in Market (C$000)	2013 Total Market Share (%)	2012 Total Deposits in Market (C$000)	2012 Total Market Share (%)
1	1	Bank of America Corp. (NC)	5,174	1,067,937,443	12.00	1,027,788,977	12.50
2	2	Wells Fargo & Co. (CA)	6,301	988,602,700	11.11	878,679,591	10.69
3	3	JPMorgan Chase & Co. (NY)	5,700	966,796,587	10.87	848,630,686	10.32
4	4	Citigroup Inc. (NY)	1,010	469,294,994	5.28	401,132,655	4.88
5	5	U.S. Bancorp (MN)	3,238	254,563,874	2.86	230,546,771	2.80
6	6	PNC Financial Services Group (PA)	2,880	221,281,167	2.49	207,320,641	2.52
7	7	Capital One Financial Corp. (VA)	918	198,349,320	2.23	192,940,274	2.35
8	**8**	**Toronto-Dominion Bank**	**1,314**	**188,091,486**	**2.11**	**162,420,484**	**1.98**
9	9	BB&T Corp. (NC)	1,859	146,087,216	1.64	139,769,041	1.70
10	11	Bank of New York Mellon Corp. (NY)	55	140,358,035	1.58	130,454,793	1.59
18	**17**	**Bank of Montreal**	**687**	**73,575,016**	**0.83**	**71,466,135**	**0.87**
		Total For Institutions In Market	**95,627**	**8,895,959,395**		**8,220,985,359**	

Source: SNL Financial, Cormark Securities

Headquartered and centered in Chicago (the third largest metropolitan statistical area in the US, behind New York and Los Angeles), the bank covers a region of the country whose economy has been and is expected to continue to outperform the national average. About half the counties in the US either had no recession or have fully recovered from the recession and a large share is in the Midwest – bested only by the south (see Figure 34).

Figure 34 **US Economic Recovery Centred in the Midwest and South**



Source: National Association of Counties (NACO)

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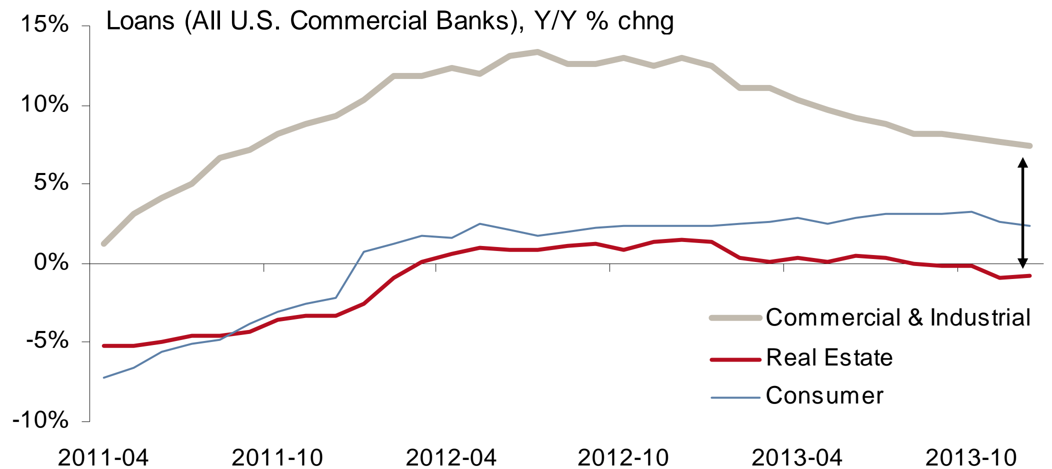
In 2013, BMO's US P&C segment (BMO Harris) made up approximately 18% of overall revenue and 15% of earnings for the firm. That does not include US-based revenue from the Wealth Management and Capital Market segments. Factoring all US-generated revenue into the mix, net income from the US across the entire firm was about 25% of total adjusted earnings in F2013. This is up from about 11% in F2011. While Canada is still the dominant geography for the firm, the US should be viewed as its key growth engine.

About 55% of BMO Harris' loan book comprised business loans (C&I loans and small business), versus less than 30% for TD's US segment. The focus on C&I loans at BMO is a key strength considering that C&I loans have outgrown (see Figure 35) and are expected to continue to outgrow, residential mortgage lending in particular.

Figure 35 **US Loan Growth By Type (Y/Y % Change)**

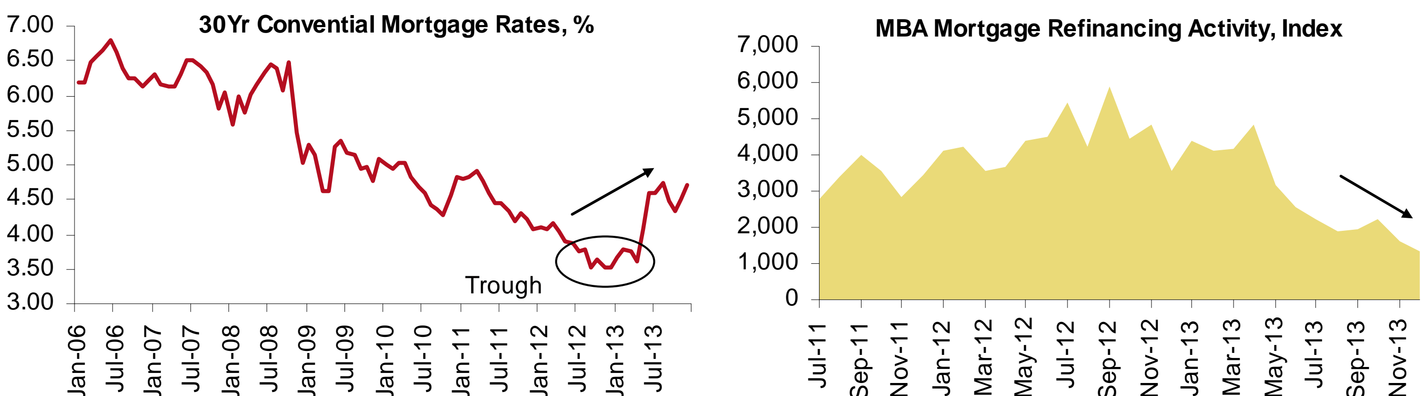


Source: Federal Reserve, Cormark Securities

C&I loan growth weakened earlier in 2013 as businesses became more cautious due to the US government shutdown, but with a budget deal now firmly in place and growing economic momentum, we should expect growth reaccelerate in 2014.

On the consumer side, despite the very strong improvement in US housing market fundamentals, mortgage growth remains constrained for the time being as rising mortgage rates have hurt refinancing volumes in particular (see Figure 36). Major lenders have cut thousands of jobs in their mortgage units, and have negatively impacted revenue growth across the space.

Figure 36 **US Mortgage Rates And Refinancing Activity**



Source: Bloomberg LP, Cormark Securities

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TD's US Footprint

TD's US P&C (personal and commercial) banking business is concentrated in urban centers along the Northeast, the Mid-Atlantic and Florida. The bank's current US retail footprint is the product of a number of acquisitions starting in the early-2000s. Among the most significant acquisitions was Banknorth, (a regional bank headquartered in Maine with roughly 410 branches) that TD acquired 51% in 2005 and then purchased the remaining stake in 2007. In 2008, TD completed another major acquisition, arguably its most ambitious, given the economic backdrop, New Jersey-based Commerce Bancorp. Commerce Bank had a business model focused on service and convenience, a model that meshed well with TD's positioning in Canada, and a clear differentiator in a crowded US market. In 2009, TD Bank completed the integration of these two main retail franchises and consolidated all its US branches (or stores as they call them) under the "TD" banner and the tag line "America's most convenient bank" (see Figure 37).

Figure 37 **TD's US Footprint**

U.S. Branches (1,315)

Source: SNL Financial

In F2013, TD's new US Retail segment (which includes US P&C, US Wealth including Epoch and TD Ameritrade) made up 27% of total revenues and 26% of adjusted net income (that compares with 22% in F2012).

While loan growth continued to be strong in F2013, there has been a slowdown in the rate of growth for residential mortgages and HELOCs as the mortgage business is being buffeted by rising rates and the end of a historic refinancing boom. Regulatory changes are also a factor including new guidelines from the new Consumer Finance Protection Agency.

Although these rules will act as a headwind to the mortgage business in the US, there is also an opportunity for banks like TD that have significant balance sheet flexibility. In particular, since there is no secondary market for jumbo loan sales in the US, lenders like TD that make these types of loans have a distinct advantage over banks that cannot operate in this space due to capital constraints. Although F2014 will still be quite challenging for the mortgage business south of the border, strong fundamentals in both

the housing market and the broader economy are signaling a significant improvement by F2015. As was noted in the minutes to the December FOMC meeting, there are a number of factors that support ongoing housing market recovery including:

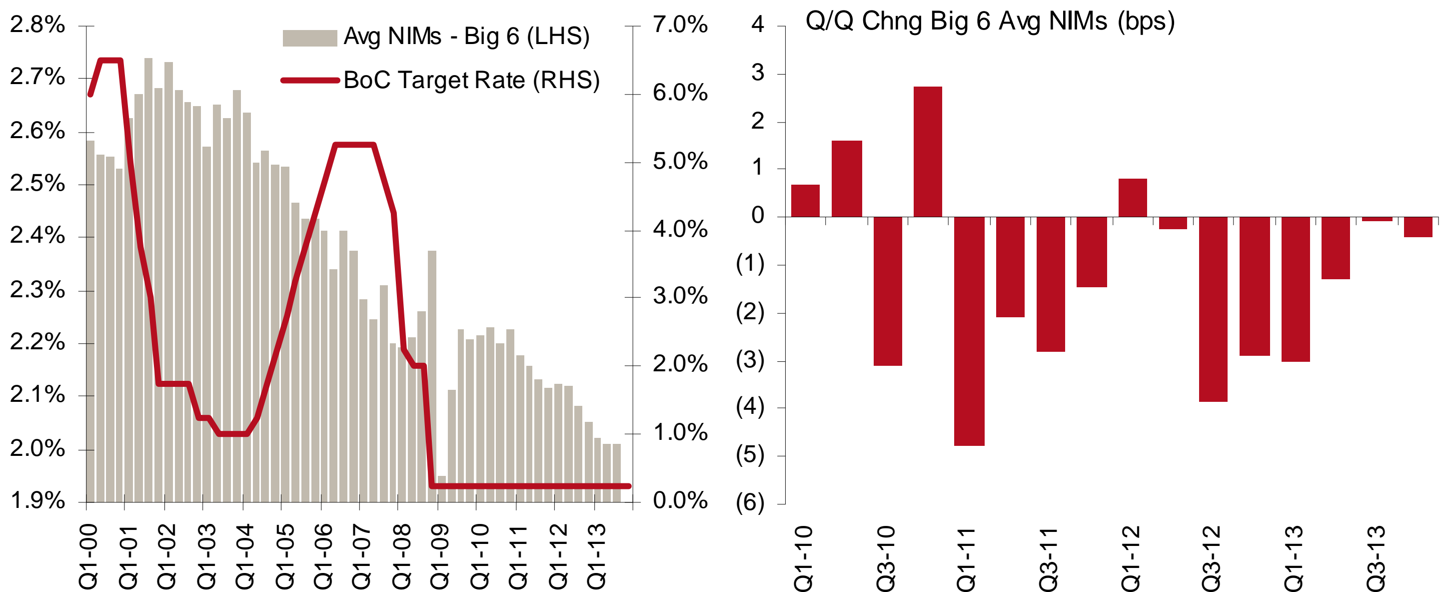
- expectations that despite their rise, mortgage rates will still remain quite favorable;
- rising home values will boost household wealth and reduce the number of underwater mortgages;
- and, a rise in consumer income and confidence will support household formation and home demand.

Apart from loan growth, both BMO and TD should benefit from rising rates in the US. Although short rates are currently anchored, the increase in longer-dated yields will help stabilize margins in F2014, before providing a lift in F2015. The rise in long rates is particularly impactful to TD's US business given its large deposit mismatch there. The bank is currently repositioning its securities portfolio to reduce duration and take increasing advantage of rising rates when they do come. This should boost US retail margins going forward even though it comes at the expense of securities gains.

Net Interest Margins – Hope & Change

The downward pressure on margins has been a key feature of the Canadian banking landscape since the early-2000s (see Figure 38). This downward trend in margins has been a function of the historic decline in interest rates over this period, as well as an outgrowth of increasing competition. When loan growth in Canada was strong, margin pressure had a strong counterbalancing force and was less of an issue. However, as loan growth has moved farther below its long-run average, margin pressure has come into focus and has been a significant challenge for the sector as a whole. A big part of the problem over the last few years has been that with base rates at or near their lower bounds in both Canada and the US, deposit rates have had nowhere to go even as asset yields were getting squeezed. In a more normal rate environment, banks would be able to get incremental margin relief on the cost side, but that is largely not possible today given the slope of the yield curve.

Figure 38 **Interest Margins Were On A Downward Trend Even Before The Crisis**



Source: Company reports, Bank of Canada, Cormark Securities

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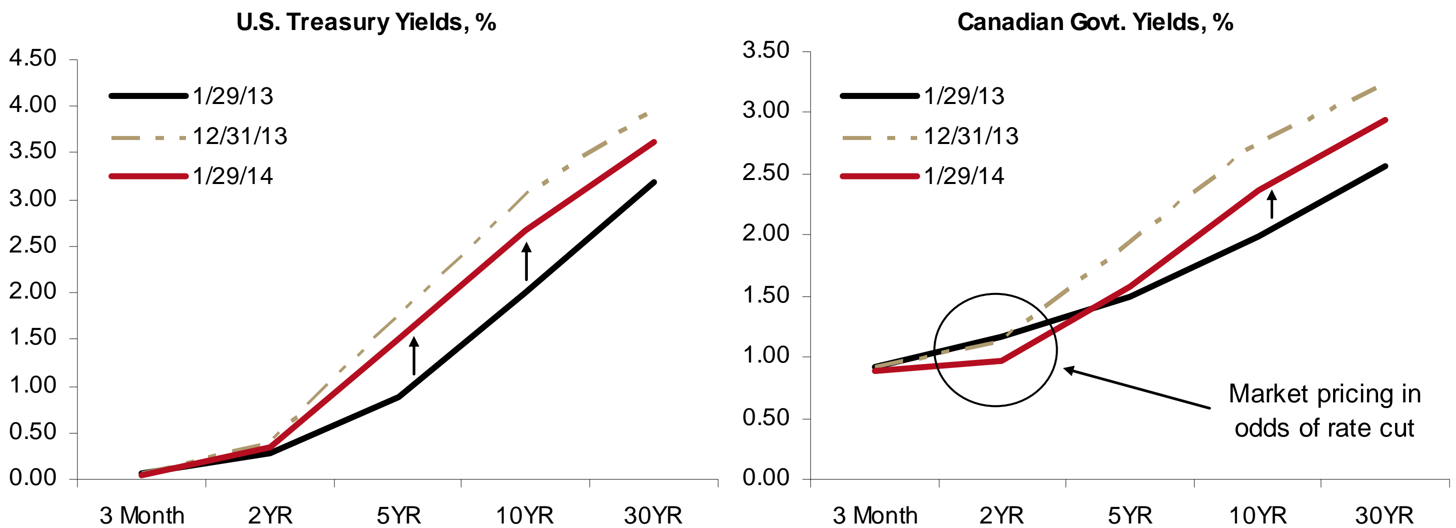
The good news is that even though short rates remain well anchored on both sides of the border, long rates have already started to climb higher in anticipation of central bank tightening in 2015 notwithstanding a modest rally to start off the year (see Figure 39).

Figure 39 **US and Canadian Yields Are Rising Despite Recent Bond Rally**



Source: Bloomberg LP, Cormark Securities

Given the amount of leverage being borne by Canadian households, a sudden spike in rates could be dangerous, but as we show earlier in this report that risk is overdone given the distribution of debt is skewed toward those that are more able to service it, as well as the fact that rates are expected to continue to increase quite slowly.

Understanding the impact that higher rates will have on Canadian bank margins requires that we step back to look at the two major components of the margin. These are the yield the bank earns on assets including loans and other investments (generally fixed income securities) and the cost of funds which come in the form of deposits and wholesale funding.

On the asset side, the bulk of Canadian banks' interest income is earned from loans. These loans are either fixed or variable. The variable rate loans are tied to short-term measures, like the prime rate. Meanwhile, fixed-term loans are more sensitive to rates farther out the yield curve, but generally not more that five years out in Canada (but longer in the US). In terms of investments, these can run the spectrum of the curve, but are generally short duration as well. On the deposit side, funds are generally short term in nature and therefore tied to the shorter end of the curve from Prime to five years, with very little tied to longer rates given the structure of the banks' loan books.

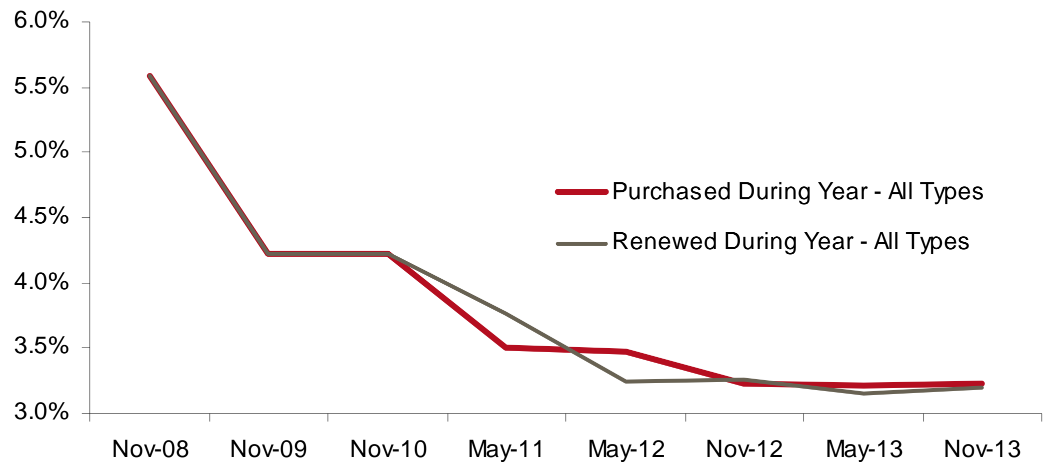
What complicates matters even further is it is not just current or future rates that matter. Historical rates are also important, since old loans are continually running off and are being replaced by new ones. This is a dynamic process that also impacts the margin and is a function of business mix, relative to volume growth across time as well as changing interest rates.

Given the number of intertemporal variables involved, it is exceedingly hard to model margin behavior with any precision at all. That said, given what we do know F2014 should be viewed as a turning point when it comes to margin pressure on both sides of the border.

Besides rising bond yields, this view is supported by a number of other developments including the fact that with the slowdown in mortgage growth, higher margin loans are

likely to become a bigger share of the overall loan books (BMO and NA are two notable exceptions in our view). Banks have also shortened the duration of their securities books making them more sensitive to higher rates, while new loans are increasingly being refinanced at rates that are at least not lower than what they were priced at originally. In Figure 40 we show how actual average mortgage rates have moved over the past few years. Note that we are capturing actual and not posted rates. This is an important distinction since discounting has been the norm in the Canadian mortgage market since the early-1990s. Under this practice, lenders advertise mortgage rates that are materially higher than the rates they are actually prepared to transact at. Although this spread changes depending on the customer and time period, the Canadian Association of Mortgage Professionals reports that the average discount off the posted rate for a five-year fixed rate mortgage is now around 215 bps (for five-year terms).

Figure 40 **What Have Actual (Not Posted) Mortgage Rates Been Doing?**



Source: Martiz survey for CAAMP, Cormark Securities

Below we show the banks' actual published sensitivities to rising rates. The banks are quick to note that these impacts are simplified since they assume a parallel shift in the yield curve and no dynamic response from management. In any event, they are generally the best indication we have (although both BMO and TD have in the past given the Street a little more detail). Comparing the change from F2012's published sensitivities, we can also see that these firms have largely positioned themselves to benefit from higher rates (see Figure 41).

Figure 41 **Impact On Net Income From 100 bps Move In Rates**

	Impact on After-tax NI of +100bps in Rates (Non-trading Activities - $ MM)		EPS Impact	
	F2012	F2013	F2012	F2013
BMO	$20	$95	0.5%	2.4%
BNS	$78	$97	1.4%	1.6%
CM	$81	$172	2.5%	4.9%
NA*	$8	$3	0.7%	0.2%
RY*	$230	$293	3.2%	3.6%
TD*	$169	$422	2.5%	6.2%
CWB*	$11	$11	6.3%	5.7%
LB*	$13	$7	9.8%	5.0%

Note: Reported sensitivities assume no further hedging. Does not include additional rate sensitivity from insurance activities for BMO, RY and TD

* Reported pre-tax, we assume a 25% tax rate

Source: Company Reports, Cormark Securities

In Figure 42, we try to look at the impact of rising rates from another angle, showing the modeled sensitivity of net income to a change in actual margins. What is clear is that the smaller banks should see the biggest benefit given their outsized reliance on traditional lending. To play the margin expansion story in general, we recommend overweighting Canadian Western Bank in particular as it is a low risk way to play this thesis. Laurentian Bank is also very leveraged to rising rates, but the main thesis there is synergies from recent acquisitions.

Figure 42 **EPS Sensitivity To Rising Margins**

	2014E EPS change resulting from	
	5.0% lower NIM/AEA	5.0% higher NIM/AEA
BMO	(6.7%)	6.7%
BNS	(6.1%)	6.1%
CM	(7.4%)	7.4%
NA	(5.3%)	5.3%
RY	(4.9%)	4.9%
TD	(7.4%)	7.4%
Big-6 Average	**(6.3%)**	**6.3%**
CWB	(8.3%)	8.3%
LB	(12.6%)	12.6%
Average for All Banks	**(7.3%)**	**7.3%**

Source: Company Reports, Cormark Securities

Bank Capital – What You See Is What You Get

Despite the common perception that tightening bank regulation is a growing threat to the banking business, regulatory reform is at such an advanced stage across most major jurisdictions that it is no longer a real headwind. That is not to say that oversight is not tougher than it was before the crisis, but much of that process is largely behind us, even if it is not yet fully implemented. The new rules are tougher than they were before the crisis, but the political will to set even more onerous requirements on bank capital levels and operations has been softened by economic realities and political expediency. Just look at the Basel Committee's decision to soften leverage rules, or even the US regulators decision to pass a version of the Volker rule that was less stringent than expected (as well as providing an important exemption for community banks after it was discovered that they would have to take big writedowns on their holdings of trust preferred securities).

In Canada, where the national bank supervisory model has been heralded as a global model and key reason that the country's financial system was able to ride the most recent financial crisis so successfully, regulatory changes have been largely driven by the decisions of the Basel Committee. On that front, changes are well underway. All Canadian banks have a Basel III Tier-1 common equity ratio above the minimum of 7% and the Big Six banks all have capital ratios well above the 8% minimum set by OSFI for domestic systemically important banks (see Figure 43).

Figure 43 **Basel III CET1 Capital Ratios**

	BMO	BNS	CM	NA	RY	TD	CWB	LB
CET1 Ratio As Reported (Q4/F13)	9.9%	9.1%	9.4%	8.7%	9.6%	9.0%	8.0%	7.6%
Impact From CVA Phase-in	(0.2%)	(0.2%)	(0.2%)	(0.2%)	(0.3%)	(0.2%)	0.0%	0.0%
Impact From IAS 19	(0.1%)	(0.1%)	(0.1%)	0.0%	(0.1%)	(0.1%)	0.0%	(0.2%)
Othe Adjustments*	0.0%	0.0%	0.2%	(0.4%)	0.0%	(0.1%)	0.0%	0.0%
CET1 Ratio Pr Forma (Q4/F13)	9.7%	8.9%	9.3%	8.1%	9.2%	8.6%	8.0%	7.4%

For BMO does not include impact of F&C acquisition (-75bps)
For CM includes impact from sale of 50% of Aeroplan portfolio to TD and the acquisition on Atlantic Trust.
For NA includes impact from the acquisition of TD's investor services business
For TD includes impact from the sale of its investor services business and the acquisition of Aeroplan balances from CIBC.
Source: Company Reports, Cormark Securities

Although OSFI has yet to issue final leverage guidelines, its Deputy Superintendent did announce that OSFI will be replacing the current Asset-Capital Multiple with the new Basel III leverage standard of 3% by January 1, 2015. Unlike US regulators who imposed a 5% leverage ratio for the largest eight bank holding companies that have been identified as globally systemically important (and 6% for those same firms' FDI-insured subsidiaries), the Canadian regulator is sticking to the international guidelines. We expect this same standard to hold with respect to the new Basel III liquidity rules. OSFI has also not issued final rules on this subject either, but in late-November it did release a draft guideline setting out how it will monitor and set expectations for the liquidity and funding profile of the banks. The comment period for the draft guideline closed on January 24 and OSFI will publish the final version of the guideline later in the year with full implementation at the start of 2015. A final piece of the Basel liquidity requirements will come in 2018 when OSFI expects to implement the Net Stable Funding Ratio (NSFR), which will focus on the extent to which a bank relies on short-term versus medium- to longer-term sources of funds.

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Longer-term Regulatory Changes To Think About

We do not see any political will in Canada to make any significant changes to bank regulation beyond the scope of the Basel III framework in the short run. But in the longer run, the potential for the government to make fundamental changes to the way Canadian banks insure residential mortgages, as well as how residential mortgages are treated from a capital perspective, is very real. In fact, the debate has already started with both the IMF and federal finance minister Jim Flaherty discussing the possibility of doing away with government-backed mortgage insurance. According to the IMF, despite certain advantages, the current system "*…exposes the fiscal budget to financial system risks and might distort the allocation of resources in favor of mortgages and away from more productive uses of capital.*" This debate is unlikely to make it to the front pages anytime soon, but all it will take is the government realizing some significant losses on CMHC's insured mortgage book to change that very quickly.

Another avenue for further regulatory reform goes to the heart of how much capital Canadian banks need to hold against their residential mortgages. The current capital framework allows banks to calculate capital requirements for credit risk in two different ways: the Standardised Approach and the Advanced Internal Ratings Based (AIRB) approach.

Both methods achieve the same goal – to weight bank assets (particularly loans) by their inherent riskiness. Rather than treat a heavily collateralized and insured residential mortgage the same way that it treats a credit card loan to a student, this process is an attempt to base capital calculations on the fact that different loans carry varying amounts of risk.

The basic approach uses specific formulas to calculate risk weights and is driven by key variables including the one-year probability of default (PD), loss given default (LGD), exposure at default (EAD), maturity (M), and correlation between exposures. Risk weights increase linearly with LGD, but for PD the relationship is concave. Under the advanced AIRB approach, banks are required to calculate their estimates of PD and LGD based on their historical experience, while under the standardised approach these variables are…standardised.

Although implementing the AIRB approach is expensive given the systems banks need to generate their default estimates, it is the generally preferred method because it lowers risk weighted assets and boosts capital ratios. The problem with that though, according to a recent research paper published by the Bank for International Settlements (BIS), is that it also leads to quite a lot of variability between banks. While some variability is to be expected, too much variation due to modeling choices is not ideal from a regulatory point of view because it harms comparability across institutions.

This issue is still being studied, but it is serious enough that in Q4/F13 Laurentian Bank actually announced that is was delaying its conversion work to the AIRB approach in order to give it time to see how this all shakes out.

The key risk for Canada right now is not that AIRB system gets scrapped completely. As OSFI's Deputy Superintendent commented, that would help comparability but decrease the quality of the calculation. Instead, the more likely scenario is that regulators eventually introduce the use of floors and other safeguards (including frontline supervision) in order to tighten up these calculations. The key for Canadian banks is these floors can significantly increase the risk weighting for residential mortgages, which are currently extremely low.

Although we do not believe that such a change is imminent, it is one longer-term structural change that is possible. This move even has a recent precedent. This past fall bank regulators in Norway announced these types of stricter capital rules in order to curb a booming housing market….sound familiar? According to the Norwegian Finance

Ministry, banks will need to raise their loss-given-default floor on mortgage assets from 10% to 20%. According to officials, this will translate into risk weights on mortgages of 20% or more, and is consistent with research out of the Norwegian central bank that showed that risk weighted asset (RWA) for residential mortgages should be around 20-30% compared to the roughly 11% that they averaged at the end of 2012.

A simple thought experiment for Canada shows the impact that a similar rule change would have on capital ratios for the Big Six banks. Assuming RWAs tied to residential mortgages are doubled for each of the banks, their Basel III CET1 ratio would fall by an average of 55 bps (see Figure 44). We acknowledge that this analysis is an oversimplification, especially since it penalizes banks with more residential mortgage RWAs whether that is because they have a riskier mortgage book or are just being more conservative.

Figure 44 **What Happens When You Double Mortgage Risk Weights**

	Revised (Assume Residential RWA Are Doubled)	Reported Ratio	Change (bps)
BMO	9.2%	9.9%	(65)
BNS	8.6%	9.1%	(57)
CM	8.8%	9.4%	(58)
NA	8.2%	8.7%	(57)
RY	9.3%	9.6%	(25)
TD	8.3%	9.0%	(69)
Average			(55)

Source: Company Reports, Cormark Securities

Will Canadian Banks Go Australian?

As one can see above, even a stricter application of capital rules for mortgages is likely to be quite manageable for the Canadian banks given their ability to consistently generate a high stream of excess capital. The suggestion has been that Big Six Canadian banks should deal with slower domestic growth and strong capital generation by boosting target dividend payouts from their current 40% to 50% closer to the 70% range that the Australian banks are at (see Figure 45).

While there are some clear similarities between the Canadian banks and their Australian peers, there are a number of reasons why we do not expect the Big Six to target materially higher payouts over our forecast horizon. First, Canadian banks have signalled their preference for buybacks as an increasingly important outlet for their excess capital. Second, as the experience in Australia has shown, the drawbacks to such an aggressive payout ratio are all to clear, and willingness to push the envelope of this issue is just not there among the Canadian banks. Finally, although M&A activity has slowed significantly over the past year, the large Canadian banks are still focused on growing through acquisitions. The targets in Canada have diminished, but with the possible exception of NA, each of the Big Six has shown its willingness to make significant investment abroad.

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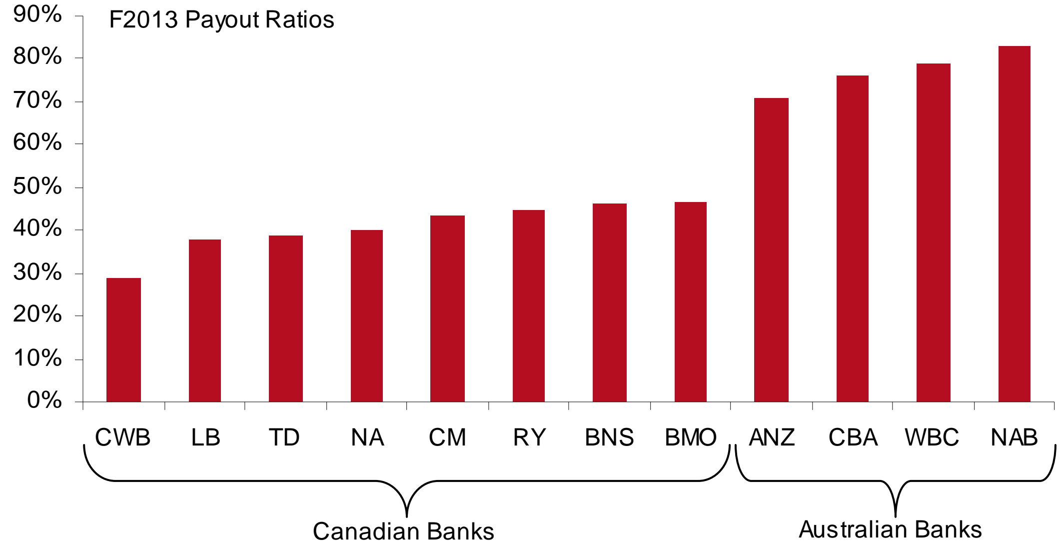
Figure 45 **Australian Versus Canadian Bank Payment Ratios**

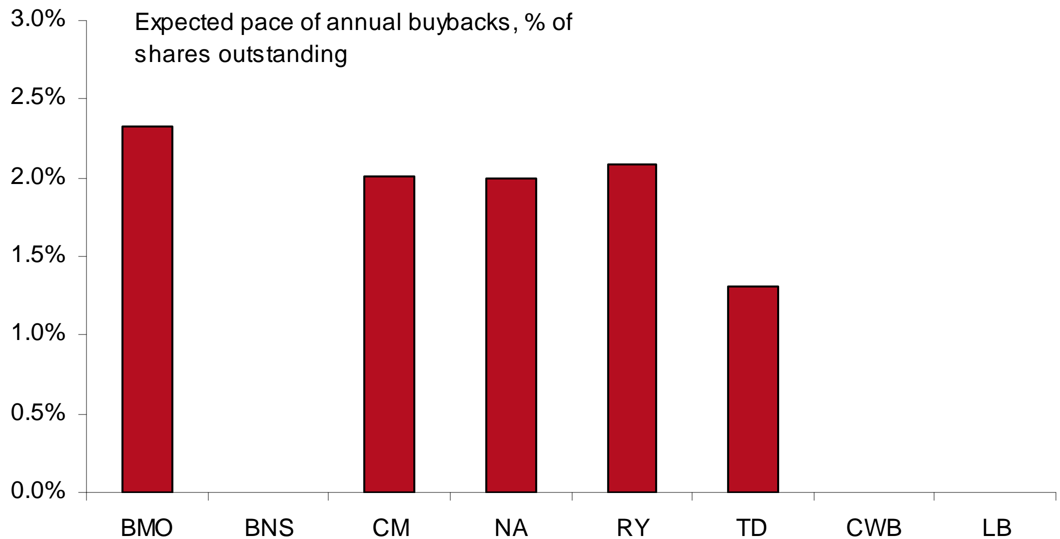


Canadian payout ratio based on adjusted earnings.
Source: Company Reports, Bloomberg LP, Cormark Securities

1) Canadian Banks Have Already Signaled Their Preference For Buybacks

For Canadian banks, F2013 marked the return of the share buyback with BMO, CM, NA, RY and TD all announcing share buybacks (see Figure 46). BNS is the only large Canadian bank without an active program as the firm views its extensive international operations as a better use of its excess capital. NA has a buyback in place but has said that it will not act on it until its CET1 ratio hits 8.75%. On a pro forma basis, after accounting for CVA phase-in and the implementation of IAS 19, it ended 2013 with CET1 ratio of 8.1%. Given that the firm generates about 20 bps of excess capital per quarter, we estimate that NA's buyback will be reinstated in Q1/15. BMO is also in the same position after announcing the F&C deal, and we also expect it to resume its buyback by F2015. For the other banks with an active buyback program in place, we would except buybacks to continue at a steady clip in F2014 and F2015 in the absence of further acquisitions which we cannot model.

Figure 46 **Canadian Banks Embrace The Buyback**



Source: Company Reports, Cormark Securities

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2) Australian Bank Payouts Are Proving To Be Problematic

The increase in Australian bank dividend payouts stemmed from a lack of investment options, strong capital levels, stable earnings and a clear regulatory outlook. That last part, however, changed this past December when the Australian Prudential Regulation Authority (APRA) announced that Australia's four largest banks are D-SIBs and will have to carry an extra 100 bps of core Tier-1 capital starting January 1, 2016. This will take the minimum capital ratio for ANZ, CBA, WBC and National Australia Bank Ltd to 8.0%. According to an analysis published by Moody's this past summer, payout ratios are sustainable in a cyclical downturn similar to what Australia experienced in 1991…but in a scenario where banks suffer large credit losses due to a more serious economic crisis like what the US went through in 2007-11, the analysis showed that the Big Four Australian banks would have to cut the dividend and raise capital. That is not a position Canadian banks would want to be in, and it is unlikely OSFI would be comfortable with that state of affairs either.

3) (Most) Canadian Banks Still Have Good Investment Opportunities

Also keeping a check on higher payout ratios in Canada (as well as more aggressive buybacks) is the fact that Canadian banks still have good investment opportunities. Acquisition targets are somewhat limited at home, but with the exception of NA each of the Big Six have shown that they are willing to spend significant money growing abroad. The most recent example of this is BMO, which recently announced the purchase of UK-based F&C Asset Management for $1.3 BB.

The Ongoing Internationalization Of Canadian Banks

Although there are a growing number of investors who prefer to view the Canadian banks as permanently slow growing regulated behemoths (essentially glorified utilities), we continue to see significant growth potential in the space over the medium term. True, growth in Canada is currently constrained by an extremely-leveraged household sector, as well as by a dearth of acquisition targets that are both large enough to move the needle and available for sale. Yet, there are still plenty of growth opportunities outside the country that Canadian banks can tap given their overall scale and strong capital positions and existing footprints. Over the coming years, the Canadian banks will continue to expand, but by necessity that expansion will take on a more international flavor.

A Closer Look At Domestic Growth Opportunities

While we believe that the coming years will be dominated by international deals, we do acknowledge that some of the biggest M&A deals over the last few years have been in Canada including DundeeWealth, ING Canada, Ally Financial and Aeroplan. Yet options are fleeting. In Wealth, there are only three large publicly-traded independent asset managers left in Canada, and one of them, CI Financial (CIX-TSX), is 36.9% owned by Scotia. Sizable insurance acquisitions are not likely given regulatory barriers, political considerations, operational impediments and funding issues involved. Meanwhile, on the capital markets side, none of the Big Six banks need domestic scale and can instead hire away talented individuals or teams from competitors as the need develops. In P&C banking, alternative lenders are growing, but are still quite small and largely exist to fill the gaps that banks consciously avoid like the subprime lending market. On the retail side, the only significant target is Canadian Western Bank, which in our view would make the most strategic sense for either CIBC or NA, but would be culturally challenging and expensive.

International Expansion – It's A Big World

The growth opportunities outside Canada are much more varied and likely where each of the Big Five are putting most of their attention these days. As highlighted earlier in this report, we believe that the best growth opportunities right now in the Canadian bank space belong to BMO and TD, given their substantial US P&C operations. Both should enjoy strong organic growth south of the border over the next few years after having built scale through big acquisitions in only the last few years. The US market is competitive, and ROEs are not nearly what they are in Canada, but returns will come with growth, which is significant given the size of the market and, the Canadian banks' relatively low loan market share, the fact that the US banking sector has just weathered a historic deleveraging cycle that is now over.

For BNS, notwithstanding the risks, we highlight in the emerging market section, Latin America is a land of potential, and promises big growth opportunity in the long run, as does Asia where BNS has an even smaller market presence.

The growth path for all three of these "international" Canadian banks is well understood and has been the product of significant investment. For the other two of the Big Five, namely CIBC and Royal Bank, international growth opportunities exist but are much less defined. Both firms have made signals and deployed some capital, but neither has made a big bet.

For CIBC, the target appears to be US wealth management, where according to Management it has had significant success with its 41% equity stake in American

Century, and has just closed another deal for Atlantic Trust, an American private wealth manager with US$5 BB in AUM.

CIBC wants to grow its wealth segment to 15% of total firm earnings over the medium term from 11% currently, and has acknowledged that acquisitions are the only way it will realistically achieve this goal. However, with valuations very high, mistakes are costly and accretion will likely take time. Strategic questions also remain including how the various assets will fit together.

When it comes to international growth opportunities, RY already has a sizable global capital markets business that it built organically over the past few years. Earnings power in this unit is still largely unrealized given the significant challenges that the capital markets business has faced in both Europe and more recently the US, but we expect that to change over time. While this unit is an important part of the bank, international acquisitions in this segment are unlikely.

An area where Royal Bank does appear to be focused on international deals is wealth management. However, progress here has been slow. The company purchased UK-based BlueBay Asset Management for $1.56 BB in 2010, but has not closed another significant wealth deal since then. This is likely partly a function of how hard it is to find suitable targets. Prices are high internationally and wealth management is a focus for many large global banking groups around the world including Deutsche Bank (DB-NYSE), UBS (UBS-NYSE) and Credit Suisse (CS-NYSE).

The good news is that with the ECB set to carry out an extensive review of the health of the European banking system before it becomes the chief regulator in November, there is a view that failing banks will be shedding asset at fire-sale prices. No doubt there is a strong hope that some wealth management assets will be shaken loose in the process, which could provide attractive opportunities for RY specifically.

Figure 47 **Recent International M&A Transactions**

Announce. Date	Closing Date	Bank	Target	Region	Business Type	Purchase Price (MMs)
Jan-14	pending	BMO	F&C Asset Management	UK & Europe	Wealth Management	$1,300
Apr-13	Jan-14	CM	Atlantic Trust	U.S.	Wealth Management	US$210
	Apr-13	BNS	AFP Horizonte	Peru	Wealth Management	$260
Dec-12	Mar-13	TD	Epoch Holdings	U.S.	Wealth Management	US$668
Oct-12	Mar-13	TD	Target	U.S.	Credit Cards	na
Aug-12	Dec-12	BNS	Colfondos AFP (51% stake)	Colombia	Wealth Management	na
Aug-12	Dec-12	BNS	Credito Familiar	Mexico	Micro Finance	na
Apr-12	Jul-12	RY	Dexia (50% it didn't own)	Global	Custodian Services	$1,100
Mar-12	May-12	RY	Coutts Private Banking (some divisions)	Global	Wealth Management	na
Oct-11	Jan-12	BNS	Baco Colpatria (51% stake)	Colombia	P&C Banking	US$1,180

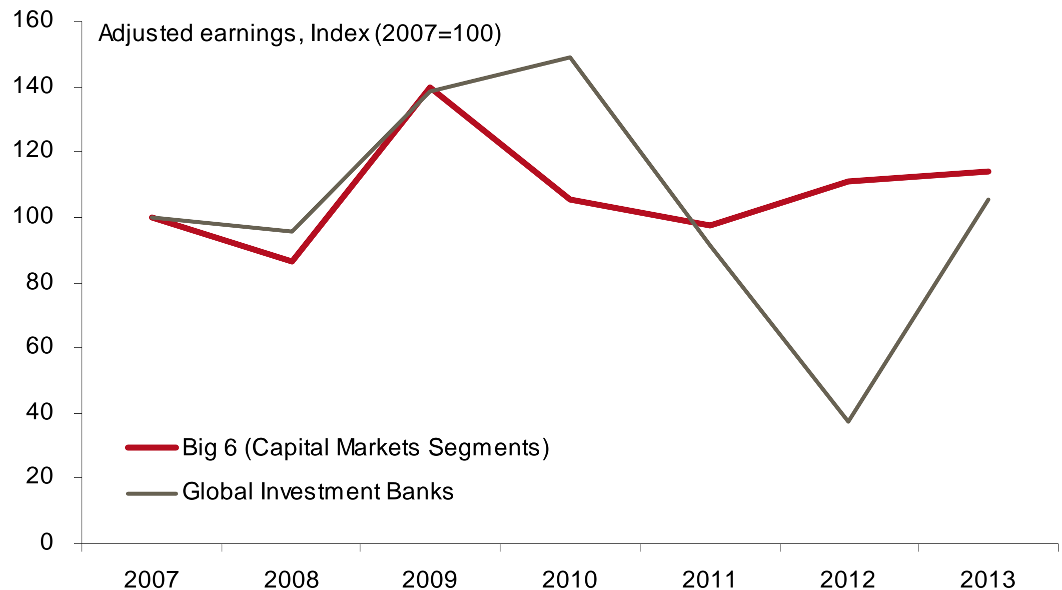
Source: Company Reports, Cormark Securities

Looking Beyond Lending

Capital Markets

According to a recent report by McKinsey and Co., while many industries are showing signs of recovery from the global economic slump, investment banks as a whole underperformed during this period, generating an average ROE of 10% – less than their cost of equity. These soft returns have largely been due to balance sheet recapitalizations as well as shrinking revenues and sticky costs. The report does, however, acknowledge that performance among the largest investment banks has been considerably worse than smaller institutions and national players. The Canadian banks are all definitely strong national players and their capital markets business performance has been quite stable over the past few years.

Figure 48 **Capital Markets Performance**



Source: Company Reports, Cormark Securities

While some global banks such as UBS and Credit Suisse are totally rethinking their capital markets strategy, for most players the shift is more gradual, with the focus shifting away from trading and toward underwriting and advisory services. The decline of trading is due in large part to stricter regulations, including the limitations imposed by the Volker rule and the Basel III leverage and liquidity restrictions. Given the scale of the crisis that we lived through, market perception of the risks inherent in the trading business is heightened, and that has impacted valuations for capital markets businesses across the globe including in Canada. In this challenging environment, we believe that the valuation gap between the best capital markets platform and worst platform has narrowed and will continue to be narrow for the foreseeable future. In a Canadian context, that should impact RY the most given its leadership position among its peers.

That said, from an earnings point of view Royal Bank's global platform does provide a level of geographic diversification that the other Canadian players can just not match. This should be especially true going forward over the next two years as we expect deal volume to pick up considerably in both the US and Europe while remaining relatively constrained in Canada. Although much smaller than RY, BMO's capital markets business is the only other platform with significant heft outside Canada.

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Figure 49 **RY Basically a Top-Ten Global Investment Bank**

Global Investment Banking Fees, Full Year 2013

Rank	Bank Name	Fees ($USMM)	Market Share
1	JP Morgan	$6,193	7.8%
2	BofA/Merrill Lynch	$5,643	7.1%
3	Goldman Sachs	$5,084	6.4%
4	Morgan Stanley	$4,544	5.7%
5	Citi	$4,084	5.1%
6	Deutsche Bank	$3,582	4.5%
7	Credit Suisse	$3,484	4.4%
8	Barclays	$3,417	4.3%
9	Wells Fargo	$2,247	2.8%
10	UBS	$2,070	2.6%
11	**RBC**	**$2,061**	**2.6%**
12	HSBC	$1,423	1.8%
13	BNP Paribas	$1,277	1.6%
14	Nomura	$1,190	1.5%
15	Mizuho Financial	$1,057	1.3%
16	Jefferies	$1,036	1.3%
17	RBS	$1,010	1.3%
18	Sumitomo	$929	1.2%
19	Mitsubishi UFJ	$830	1.0%
20	**BMO**	**$814**	**1.0%**

Source: Thomson Reuters, Cormark Securities

Credit Cards

The credit card business is an important product offering for all the large Canadian banks, and it has been an area of notable activity over the past few years, for TD in particular as it closed a number of key deals to reclaim its natural share of the Canadian credit card business. TD had lagged in the Canadian credit card market ever since it divested the Canada Trust MasterCard portfolio as a precondition for competition approval of its 2000 Canada Trust merger. Although all the Big Six banks (with the exception of NA) are now multi-card issuers, at the time of the Canada Trust deal, dual issuance was not allowed.

After acquiring the MBNA Canadian credit card portfolio in 2011, TD also made an important move in the premium travel rewards card market when it inked a deal with Aimia (AIM-TSX) to become the primary issuer of Aeroplan Visa credit cards starting in F2014. Under the terms of the agreement, CIBC will continue to issue Aeroplan cards, but TD will have the exclusive right to market the card outside its branch network. In addition, TD will acquire about half of CM's existing Aeroplan credit card portfolio. This portfolio is largely made up of customers with no other existing retail banking relationship with CM and amounts to about $3.3 BB in outstandings and $19 BB in purchase volumes. After this transaction, TD should be the No. 1 credit card issuer in Canada based on both outstandings and purchase volumes (see Figure 50).

Figure 50 **New Aeroplan Deal Changes Canadian Credit Card Rankings**

Before TD/CM Aeroplan Deal

Issuer	Rank 2012	Outstand. ($MM)	Rank 2012	Purchase Volumes ($MM)
CIBC	1	$15,497.3	2	$65,621.5
TD	2	$15,382.0	3	$54,170.3
RBC	3	$13,881.0	1	$71,419.8
BNS	4	$10,058.9	6	$21,182.3
BMO	5	$8,321.3	4	$42,943.6
Desjardins	6	$7,045.8	5	$23,016.6
Capital One	7	$4,534.1	10	$2,910.7
Canadian Tire	8	$4,342.3	8	$10,775.1
PC Financial	9	$2,342.9	7	$12,717.4
NA	10	$1,944.9	9	$8,221.0
Other	na	$4,176.0	na	$16,473.3
Total		**$87,526.5**		**$329,451.6**

After TD/CM Aeroplan Deal

Issuer	Rank 2012	Outstand. ($MM)	Rank 2012	Purchase Volumes ($MM)
TD (pro forma)	1	$18,682.0	1	$73,170.3
RBC	2	$13,881.0	2	$71,419.8
CIBC (pro forma)	3	$12,197.3	3	$46,621.5
BNS	4	$10,058.9	6	$21,182.3
BMO	5	$8,321.3	4	$42,943.6
Desjardins	6	$7,045.8	5	$23,016.6
Capital One	7	$4,534.1	10	$2,910.7
Canadian Tire	8	$4,342.3	8	$10,775.1
PC Financial	9	$2,342.9	7	$12,717.4
NA	10	$1,944.9	9	$8,221.0
Other	na	$4,176.0	na	$16,473.3
Total		**$87,526.5**		**$329,451.6**

Source: Nilsson Report, Cormark Securities

In between the two Canadian card deals, TD also inked an innovative US credit card deal with Target (TGT-NYSE) in 2012. Under the terms of the deal, TD not only bought Target's US retail card portfolio but also became its exclusive issuer on a go-forward basis. That deal should generate over $60 MM in net income for TD in F2014, after contributing an estimated $35 MM to the bottom line in F2013.

As a result of the Aeroplan deal, CM should slip to third place in the Canadian credit card rankings. The three-way Aeroplan deal with Aimia and TD was a good one for the bank, but only in so far as it was preferable to losing the right to issue Aeroplan cards all together, as was the case under the original deal between TD and AIM announced this past August. The annual earnings impact of the new Aeroplan deal on CIBC is expected to be a drag of about $0.45 per share, although it is important to note that Management has stated that the impact would have been $0.15 share even if CM had the option to renew its exclusive Aeroplan agreement without the involvement of TD.

CIBC has talked openly about the better economics of issuing an in-house travel card rather than the Aeroplan arrangement by which the bank buys points from Aimia. However, given the book of business already tied to Aeroplan, CM ultimately realized that simply dumping its legacy business would be too costly and disruptive. However, the bank just relaunched its in-house Aventura travel card (….do talking penguins ring a bell?) this fall and will look to transition as much business as possible to this card. While we do not have hard data, Management suggests that consumer demand is exceeding expectations for this new card. TD also has an existing in-house credit card offering called the Infinite Card, which it will continue to sell, although as opposed to CM we expect it to favor the Aeroplan card given the growth opportunity that is sees there.

While the credit card spotlight was on CM and TD for much of F2013, the other large Canadian banks also have competing premium travel-card offerings. The strongest competitor to Aeroplan is RBC's Avion card, which is the leading in-house program. Before the three-way Aeroplan deal was announced, the expectation was that RY would be a big winner in the expected "credit card wars" as all of CIBC's Aeroplan customers would have been up for grabs as the program transitioned to TD. That did not end up happening given the more orderly final agreement.

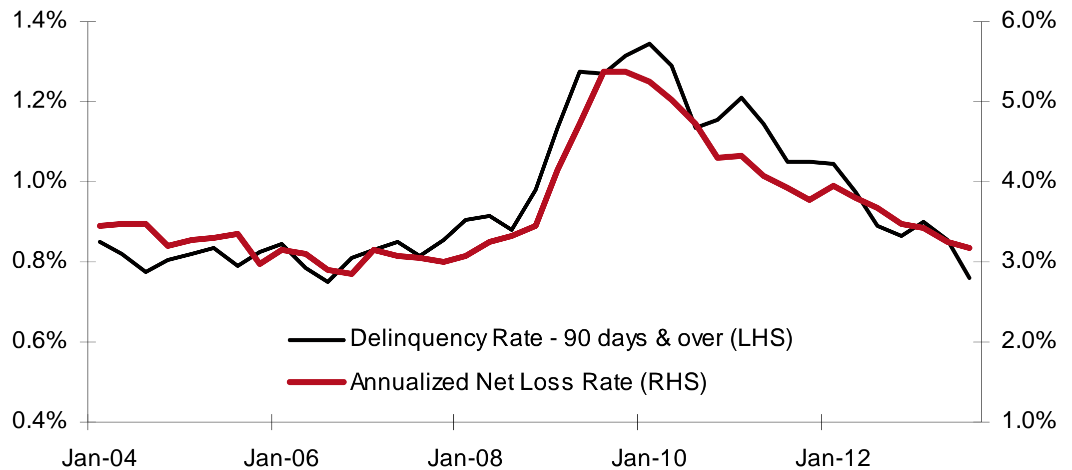
Among the other banks, BMO has the World Elite MasterCard while BNS markets a number of offerings under the VISA and Amex banners. BNS is an interesting case given the banks under penetration in the Canadian credit card business. Based on the latest

available data, the bank is ranked fourth among the Big Five banks (excluding NA) based on outstandings, but is five of five in terms of purchase volume, and looking at the entire universe even lags Desjardins. Given the progress BNS has made in other parts of its Canadian operation, we would expect a harder push on credit cards in the coming quarters and years.

Some may question the foresight in bulking on credit cards at exactly this point in the cycle given the state of consumer balance sheets, but there a number of good reasons to move now:

1. Given the established and competitive state of Canadian financial services, banks that are keen on growing their portfolios have no option but to transact when assets go on sale. TD may have preferred not to big on the Aeroplan business in F2013, but inaction would have left the asset locked up for another 10 years.
2. Although the consumer is leveraged, credit card loss rates and delinquencies are actually trending lower (see Figure 51). Although economic data has been somewhat disappointing lately, the Canadian economy is still expanding at a healthy pace and is likely to continue to do so as the US economic recovery continues to build momentum. Furthermore, the premium travel-card market tends to be less economically sensitive given that its target market is a more affluent consumer who uses it for points and a convenience rather that a true source of credit.

Figure 51 **Credit Card Loss Rates & Delinquencies**



Source: CBA, Cormark Securities

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Insurance

This past year has not been a particularly joyous for the Canadian P&C business given the confluence of natural disasters hitting the country including severe flooding in both Alberta and Ontario this past summer and an end-of-year ice storm. Add to those woes, skyrocketing fraud in urban areas such as Toronto and this business has had a year to forget. TD's large P&C business was hit particularly hard taking over $400 MM (after-tax) in insurance-related charges in Q3 and signaling that medium-term insurance earnings would be lower than the F2012 level of $600 MM.

Those losses, coupled with speculation that TD could use the freed up capital to make a large acquisition in the US, caused some investors to question whether TD needs its insurance arm at all. This view is quite short term in that it is driven by recent events as highlighted above. It also goes against the longer-term trend that we continue to believe holds true of the Canadian banks continuing to consolidate across the financial services space in Canada to the limitations of the law. We do not believe that this process is likely to reverse, and not even in the P&C insurance business. TD's P&C business has been particularly hard hit recently, but Management believes that these are temporary problems that can be worked through. This is after all a very valuable asset given that it is among the largest P&C operations in Canada and the largest among the Big Six banks (see Figure 52)

Figure 52 **TD Top P&C Insurer Among The Banks**

Issuer	Rank	% of Market	N.P.W.
Intact	1	15.06	$6,290,072,000
Aviva	2	8.23	$3,437,983,000
TD	**3**	**6.33**	**$2,646,002,000**
RSA	4	6.00	$2,507,328,000
Lloyd's	5	5.01	$2,093,962,000
Wawanesa	6	4.99	$2,083,019,000
Co-operators	7	4.84	$2,023,203,000
Desjardins*	8	4.65	$1,944,721,000
State Farm*	9	4.41	$1,842,450,000
Economical	10	4.13	$1,723,656,000
RBC General Insurance	18	1.29	$537,307,000
RBC Insurance Company of Canada	21	0.96	$400,871,000
Canadian Direct (CWB)	45	0.30	$125,410,000

Note: Ranking are for Canada (2012) and exclude all government entities.
* On January 15, 2014 Desjardins announced that is acquiring the Canadian arm of State Farm.
Source: Canadian Underwriter (June 2013), Cormark Securities

Wealth Management

Post the financial crisis, world banks all over the globe are attracted to the wealth management space given that it requires virtually no capital, delivers recurring fee-based revenue and entails very little risk. Canadian banks are no different and are no doubt scouring the globe for appropriate targets. Although earnings growth in the banks' wealth management segments has lagged Canadian retail over the past 10 years as loan growth benefited from a residential real estate boom, we expect wealth to outgrow the domestic P&C business over the coming years.

Despite the rush to continue to grow in this space, there are a number of impediments. In Canada, the big issue is a lack of large targets. After a wave of consolidation, most recently with BNS' acquisition of DundeeWealth in 2010, the number of sizable targets is very small, scarcity value has pushed up valuations and in the case of CI Financial it is already 36.9%-owned by BNS, having acquired its stake from Sun Life (SLF-TSX) in 2008. International valuations are also high with US asset managers trading at average forward P/Es of about 16.5x.

Figure 53 **US Asset Manager Valuations**

Investment Managers	TKR	Price 7-Feb	Mkt Cap. (MM)	52 Week High	52 Week Low	Earnings per Share 2014E	Earnings per Share 2015E	Price/Earnings 2014E	Price/Earnings 2015E	Price/ Book	Div. Yield
BlackRock Inc	BLK	$299.87	$50,596	$326.00	$233.80	$18.36	$21.07	16.3x	14.2x	1.9x	2.6%
Franklin Resources Inc	BEN	$52.15	$32,899	$58.87	$44.22	$3.78	$4.14	13.8x	12.6x	3.1x	0.9%
T Rowe Price Group Inc	TROW	$79.34	$20,806	$84.41	$69.85	$4.43	$4.92	17.9x	16.1x	4.3x	1.9%
Invesco Ltd	IVZ	$32.88	$14,560	$36.88	$25.46	$2.44	$2.82	13.5x	11.7x	1.7x	2.7%
Affiliated Managers Group Inc	AMG	$186.65	$9,865	$219.39	$141.90	$11.18	$12.77	16.7x	14.6x	4.6x	NA
Waddell & Reed Financial Inc	WDR	$67.05	$5,727	$69.64	$38.70	$3.69	$4.28	18.2x	15.7x	9.4x	2.0%
Legg Mason Inc	LM	$41.85	$5,048	$45.75	$27.10	$3.27	$3.80	12.8x	11.0x	1.0x	1.2%
Eaton Vance Corp	EV	$37.09	$4,497	$44.58	$35.59	$2.48	$2.68	14.9x	13.8x	6.7x	2.4%
Fortress Investment Group LLC	FIG	$7.89	$1,890	$9.16	$5.49	$0.78	$0.91	10.2x	8.7x	5.6x	3.0%
Federated Investors Inc	FII	$26.51	$2,773	$30.87	$21.92	$1.64	$1.91	16.2x	13.9x	4.9x	3.8%
Janus Capital Group Inc	JNS	$10.90	$2,061	$13.10	$7.86	$0.75	$0.85	14.6x	12.9x	1.4x	2.6%
AllianceBernstein Holding LP	AB	$22.10	$2,035	$27.38	$18.77	$1.72	$1.90	12.8x	11.6x	1.4x	7.2%
GAMCO Investors Inc	GBL	$74.23	$489	$90.20	$44.22	$4.85	$5.40	15.3x	13.7x	4.2x	0.3%
WisdomTree Investments Inc	WETF	$14.96	$1,950	$18.50	$8.30	$0.52	$0.67	28.7x	22.3x	17.9x	NA
Cohen & Steers Inc	CNS	$36.04	$1,595	$43.37	$30.36	$1.73	$2.07	20.8x	17.4x	6.9x	2.2%
Manning & Napier Inc	MN	$16.13	$220	$20.36	$14.55	$1.30	$1.42	12.4x	11.4x	1.3x	4.0%
Pzena Investment Mng.	PZN	$10.17	$124	$11.95	$5.43	$0.52	$0.66	19.6x	15.4x	42.9x	1.2%
Calamos Asset Management	CLMS	$11.18	$230	$12.26	$9.46	$0.55	$0.62	20.3x	18.1x	1.1x	4.5%
							Average	***16.4x***	***14.2x***	***6.7x***	***2.7%***

Note: xxxxx
Source: Bloomberg LB, Capital IQ, Cormark Securities

Another issue we focus on is the pressure that fund companies are coming under to provide better fee disclosure to their retail clients. Over the last few years, there has been a wave of regulatory reforms in a number of major international jurisdictions that have fundamentally changed the way retail investors buy investment funds and other financial products, as well as how they pay for financial advice. These include: the ban in the UK and Australia on advisor commissions set by financial product providers or embedded in financial products, and the imposition in Australia of a statutory best interest duty on advisors who sell financial products.

These global regulatory changes, together with the publication of a comparative studies on fund fees (see Figure 54), have prompted calls for greater scrutiny of fund fees in Canada. In response, the Canadian Securities Administrators (CSA) has announced new CSA disclosure rules (NI 31-103); some of which became effective on July 15, 2013, and others which will be phased in over three years. The changes require additional disclosure to clients, as well as changes in the methodology used to calculate investment performance (from time-weighted to dollar-weighted). We expect that these changes will require all firms to make changes to their IT systems and business processes. The banks have not quantified the impact that these changes will have on the bottom line, but they are in a better position than the smaller players to bear these additional costs given their scale. Although a total ban on trailer fees has not been announced, it is being debated and could have a more fundamental impact.

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Figure 54 **An International Comparison on Mutual Fund Costs**

	Canada	US	UK	Australia
Total fund AUM (C$bn)	762	12,814	903	1,585
# of Fund Manufacturers	103	713	241	159
Foreign Funds	Closed	Closed	Open	Open
Share of AUM Held by Top 10	75%	53%	45%	56%
Asset-Weighted Ave. MER	**1.93%**	**0.79%**	**1.14%**	**1.13%**
Components of MER	• Management fees (with embedded trailing commissions) • Operating expenses • HST/GST	• Management fees • 12b-1 fees (trailing commissions) • Operating expenses	• Management fees (with embedded trailing commissions pre-RDR) • Operating expenses	• Management fees (with embedded trailing commissions pre FoFA) • Operating expenses • GST (10%)
Typical Max. Trailer Fee	• 1.5%	• 1.0%	• 1.0% (pre-RDR reforms)	• 0.6% (pre-FoFA reforms)
Front-end Loan Charges	• Up to 5%, but often less than 1%, payable by the investor to the advisor • Negotiable with advisor	• Up to 5.75% of purchase amount payable by the investor to the mutual fund manufacturer, who in turn pays all or a portion to the advisor • Not negotiable with advisor, but eligible for load restrictions in breakpoints	• Up to 5% of purchase amount payable by the investor to the mutual fund manufacturer who in turn pays all or a portion to the advisor • Negotiable with advisor	• Up to 6% of purchase amount payable by the investor to the mutual fund manufacturer who in turn pays all or a portion to the advisor • Negotiable with advisor
Deferred Sales Charges	• Up to 6% (decreasing by about 1% each year) payable by the investor to the mutual fund manufacturer if redeem within 7 years • Up to 5% paid upfront by the mutual fund manufacturer to the advisor	• Up to 6% (decreasing by about 1% each year) payable by the investor to the mutual fund manufacturer if redeem within 6 years • Up to 5% paid upfront by the mutual fund manufacturer to the advisor	• Deferred sales charge option rarely offered	• Up to 4% (decreasing by about 1% each year) payable by the investor to the mutual fund manufacturer if redeem within 5 years • 3% paid upfront by the mutual fund manufacturer to the advisor
Low-Load/Level-Load	• 2% or 3% (decreases by about 1% each year) payable by investor to mutual fund manufacturer if redeemed within 3 years • 2% to 3% paid upfront by the mutual fund manuf. to the advisor	• 1% payable by investor to mutual fund manufacturer if redeemed within first year • 1% paid upfront by the mutual fund manufacturer to the advisor	• Low-load not available	• Low-load not available
No-Load	• No front-end load or deferred sales charges	• No front-end load or deferred sales charges	• No-load not available	• No front-end load or deferred sales charges
Caps on Fund Fees	• None	• Yes - under NASD/FINRA Conduct Rule 2830(d) that imposes caps on sales charges and 12b-1 fees (trailing commissions)	• None	• None

Source: CSA/ACVM

Overall, the Canadian mutual fund rankings tell a predictable story with RBC the largest mutual fund manager in the country let alone among the big banks (see Figure 55).

Figure 55 **Canadian Mutual Fund AUM Rankings (Only Includes IFIC Members*)**

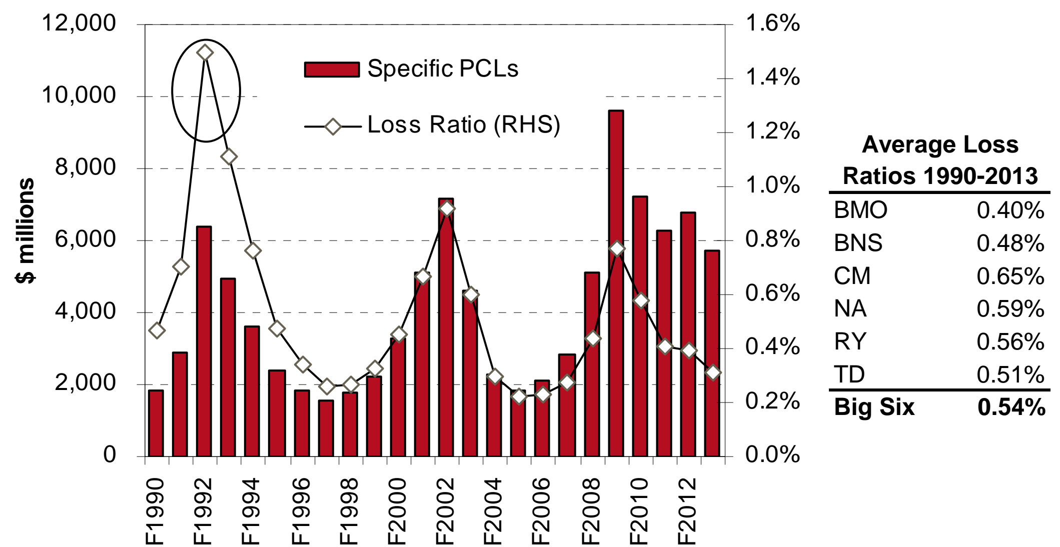
Rank	Company	Sep-2013 Net Assets ($MMs)	Aug-2013 Net Assets ($MMs)	% Change Prior Month	Sep-2012 Net Assets ($MMs)	% Change Prior Month	Net Sales Excluding Re-inv. Distributions - Sep 2013 ($000s) Total	LT	Mny. Mrkt
1	**RBC Global Asset Management**	**136,135**	**134,251**	**0.014031**	**121,099**	**0.124160**	**120,848**	**183,296**	**(62,448)**
2	IGM Financial Inc.	110,734	109,380	0.012372	101,959	0.086064	(100,415)	(101,907)	1,492
3	**TD Asset Management**	**76,388**	**75,251**	**0.015108**	**67,587**	**0.130219**	**330,406**	**319,777**	**10,629**
4	**Scotia Global Asset Management[3]**	**71,023**	**70,386**	**0.009051**	**66,412**	**0.069435**	**(382,356)**	**(308,221)**	**(74,135)**
5	**CIBC Asset Management**	**64,821**	**63,904**	**0.014342**	**56,763**	**0.141958**	**19,677**	**17,113**	**2,564**
6	Fidelity Investments Canada ULC	62,006	60,955	0.017247	54,274	0.142478	246,008	236,953	9,055
7	**BMO Financial Group**	**47,663**	**46,773**	**0.019038**	**41,672**	**0.143780**	**356,683**	**315,328**	**41,355**
8	Manulife Mutual Funds	25,189	24,675	0.020831	19,604	0.284849	242,628	244,264	(1,636)
9	MD Management Limited	21,842	21,601	0.011179	17,737	0.231421	(269,573)	(268,453)	(1,120)
10	Franklin Templeton	21,356	21,005	0.016704	20,140	0.060384	(93,801)	(91,064)	(2,737)
11	AGF Investments Inc.	18,741	18,588	0.008249	20,290	-0.076318	(169,958)	(167,311)	(2,647)
12	Fonds Desjardins	16,054	15,760	0.018611	14,016	0.145377	39,061	39,922	(861)
13	**National Bank Securities**	**14,261**	**14,105**	**0.010994**	**13,446**	**0.060598**	**(40,222)**	**(31,206)**	**(9,016)**

* Does not include CI Financial with mutual fund AUM of $85.6 BB as of Sep 2013
Source: IFIC, Company Reports, Cormark Securities

The Credit Cycle

Although credit proved to be a positive earnings driver in F2013 despite the fact that most investors thought it could not get any better, the prospect of further improvement from here is even less likely. Aggregate loss ratios (not including general provisions) have averaged 54 bps for the large Canadian banks since F1990, but are currently well below that at 31 bps (see Figure 56). Among the banks' relative performance is largely driven by business mix. For example, CM's group high loss ratio of 41 bps in F2013 (and group high average of 65 bps since F1990) reflects the bank's outsized exposure to credit cards (as a percentage of its total loan book), which tend to have much higher loss rates relative to other lending products.

Figure 56 **Historical Loan Loss Ratios**



Source: Company Reports, Cormark Securities

Flying Blind

We do not see loan loss provisions heading any lower in F2014 or F2015, but we also do not see them increasing significantly either. Although we do see some upward pressure this year from provisions in the Caribbean and Latin America where applicable. Overall we see provisions growing at roughly the pace of loan growth through our forecast period, with the notable exception of BMO. This should keep loan loss rates drifting only modestly higher, again with the notable exception of BMO where we will see a much more significant step higher (see Figure 57).

Figure 57 **Our Forecast for Loan Loss Provisions**

	F2012A	F2013A	F2014E	F2015E
BMO	0.19%	0.13%	0.24%	0.30%
BNS	0.33%	0.32%	0.35%	0.35%
CM	0.49%	0.41%	0.42%	0.42%
NA	0.21%	0.19%	0.20%	0.20%
RY	0.35%	0.31%	0.32%	0.33%
TD	0.47%	0.37%	0.39%	0.38%
Big-6 Avg	0.34%	0.29%	0.32%	0.33%
CWB	0.19%	0.19%	0.19%	0.19%
LB	0.14%	0.13%	0.14%	0.15%
Avg for all Banks	0.30%	0.26%	0.28%	0.29%

Source: Company Reports, Cormark Securities

BMO is an outlier because of the impact of the M&I acquisition, which has led to material credit recoveries tied to purchased impaired loans. Those recoveries totalled around $509 MM in F2012 and $410 MM in F2013, and according to Management will drop to $100 MM in F2014 and zero in F2015.

Our benign credit story is supported by our positive economic outlook for North America in particular. Relevant indicators including unemployment rates and bankruptcy statistics are showing continued improvement. While we believe that the benign credit story is the correct one for both F2014 and F2015, we are the first to acknowledge that it has been so long since Canada has experienced a significant consumer-driven credit downturn that it is hard to know what one would look like. One has to go back more than 30 years to see the impact of a big housing crash in Canada (refer back to Figure 56). In that time span, a lot has changed in Canadian banking including and possibly even consumer behavior.

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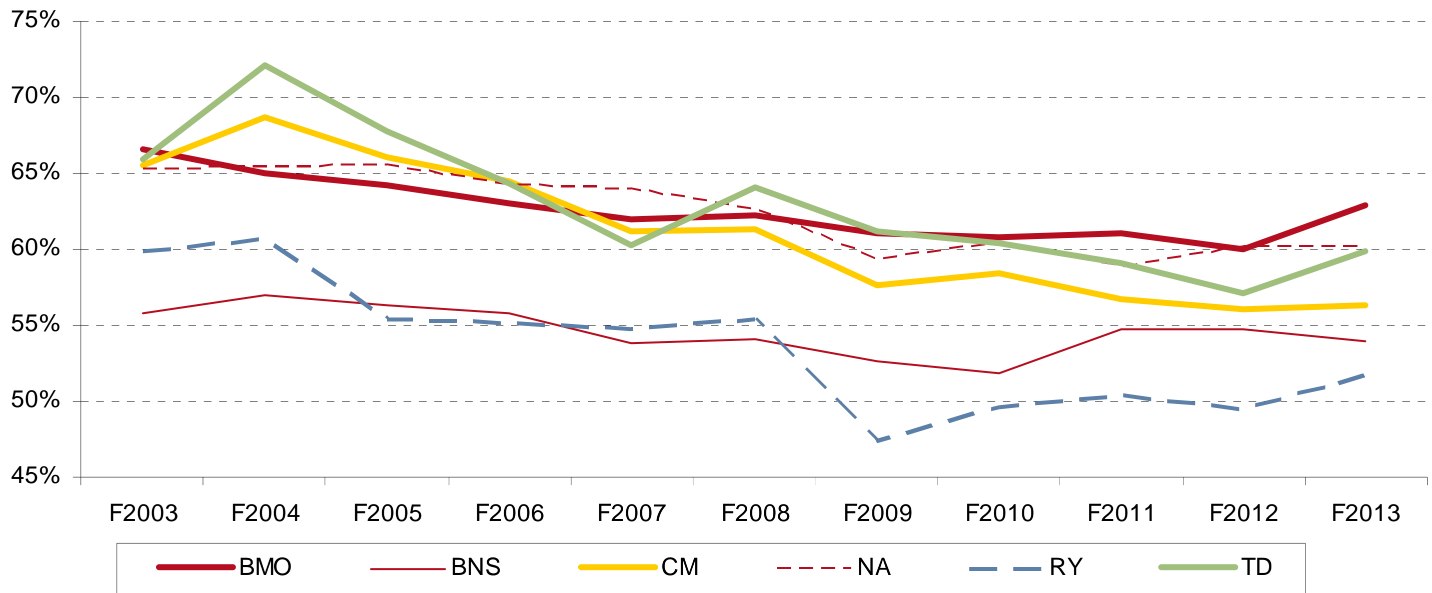
Efficiency Gains – The Downside Of Canada's Oligopoly

Given the slowdown in domestic revenue growth, there is more pressure than ever on banks to drive positive operating leverage through the expense side of the equation. The only problem is the public, and by extension government will not tolerate deep cuts from the banks given their high levels of profitability. So expense gains have to be earned the hard way, through smart expense management and attrition. Big layoffs are simply not an option in advance of significant red ink. Just how low the public tolerance is for bank job cuts is the controversy the RY found itself this past May when it ignited a scandal for an outsourcing deal involving just 45 employees (0.06% of total workforce as of the end of F2013) at its Investor Services unit.

Another impediment is the banks' own success at driving efficiency ratios lower over the last 10 years (see Figure 58). We have seen a clear improvement in expense control across the sector, leaving further gains harder to achieve. LB is a notable exception in our view, but in general we do not forecast significant declines in efficiency ratios over the next two years.

Figure 58 **Efficiency Ratios Have Trended Lower Over Time**



Source: Company Reports, Cormark Securities

Technology would seem to be an important part of the cost equation as the move to online banking reduces the need for branches and branch employees. However, in the banking sector, the rise of internet banking has not diminished the importance of branches. Since 2007, internet banking transactions have exploded even as the domestic branch count has continued to climb higher (see Figure 59).

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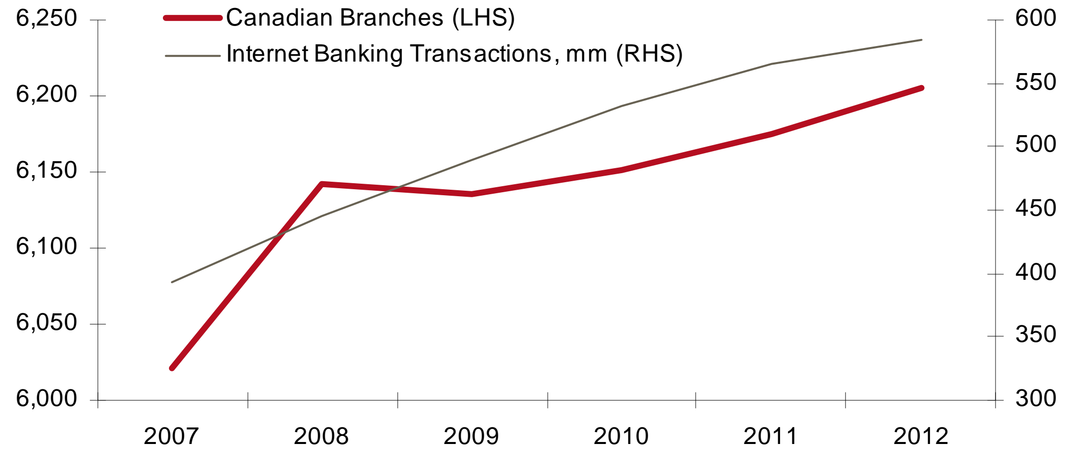
Figure 59 **Internet Banking Has NOT Let to Fewer Branches**



Source: CBA, Company Reports, Cormark Securities

Given the importance of the cross-sell in the current banking environment, the importance of branches has actually increased as firms have realized their usefulness in building relationships with customers and building multi-product customers. Although we have no precise data on this metric for the sector as a whole, we do know that hours have gotten longer not shorter at TD and CM in particular, and in TD's case remain a key selling point and brand differentiator. The branches of the future may be smaller and staffing levels more fluid, but so far despite the uptake in online banking the Canadian branch network has not seen its footprint scaled back.

That said, we do forecast modest operating leverage in F2014 as integration charges at BMO, NA and TD in particular go back to normal and Management continues to keep expense growth under tight control. We do see a further modest increase in operating leverage in F2015 as revenue growth surprises to the upside, helped by margin expansion and stronger momentum in the US (see Figure 60).

Figure 60 **Operating Leverage**

	F2009A	F2010A	F2011A	F2012A	F2013A	F2014E	F2015E
BMO	2.1%	0.5%	(0.5%)	1.8%	(4.9%)	1.3%	2.6%
BNS	3.0%	1.6%	(6.3%)	0.1%	1.5%	0.5%	1.7%
CM	6.2%	(1.4%)	3.3%	1.1%	(0.6%)	(3.6%)	0.9%
NA	5.8%	(1.8%)	2.8%	(2.3%)	(0.1%)	0.6%	0.5%
RY	18.6%	(4.3%)	(1.6%)	2.1%	(5.1%)	1.1%	2.1%
TD	5.6%	1.3%	2.4%	3.6%	(5.2%)	1.1%	2.7%
Big 6 Avg	**6.9%**	**(0.7%)**	**0.0%**	**1.1%**	**(2.4%)**	**0.2%**	**1.7%**
CWB	(6.0%)	8.9%	(1.0%)	0.1%	(2.5%)	0.7%	1.1%
LB	1.0%	2.7%	(3.2%)	(3.9%)	1.8%	1.8%	1.1%
Avg	**4.5%**	**0.9%**	**(0.5%)**	**0.3%**	**(1.9%)**	**0.4%**	**1.6%**

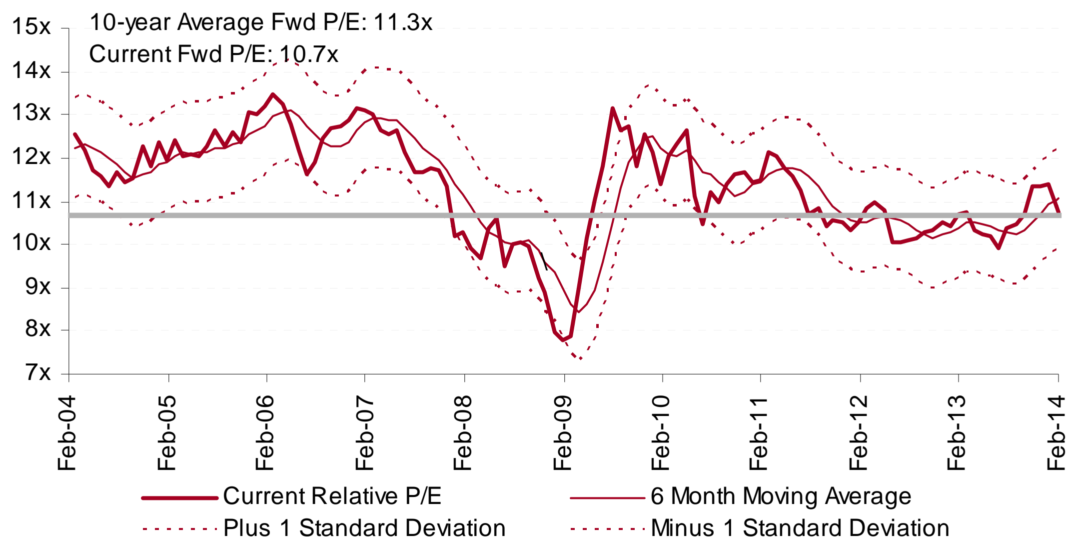
Source: Company Reports, Cormark Securities

Valuation – The Banks Are On Sale

As we highlighted in the introduction, we believe that the Canadians banks are cheap on a P/E basis. The Big Six banks are currently trading at 11.0x F2014 consensus earnings, which is below the pre-crisis, long-run average of 11.7x and well below the over 12.0x that the banks tend to trade at the peak of the cycle. Despite multiple expansion across much of the non-resource-based TSX, the banks have been left behind due to lingering macroeconomic fears, including fears of a hard landing for housing, and expectations for a continued deceleration in domestic loan growth. We do not share this view, instead we see evidence that domestic loan growth has stabilized after slowing earlier in F2013. We also see signs that margin pressure is abating, despite dovish views coming out of the Bank of Canada, and see the prospect of margin expansion in F2015. Furthermore, we see strong momentum coming out of the US in particular, which should help BMO and TD most directly among the Big Six.

Not only did the Canadian banking sector ride through the deepest global financial crisis since the Great Depression as a global model of stability, but six years after the start of the global financial crisis and the US housing crash, the Canadian banking system is safer than it has ever been given the changes made to underwriting rules and regulations. That stability along with solid results at home and further international upside coupled with steady dividend increases and buybacks deserve to be valued at least at its average historical multiple – not below. Granted this revaluation is not dependant on a single catalyst and so will take some time, but we believe that it will come by the end of F2014 as the strength of the US recovery gathers more steam and consensus builds that the Canadian economic expansion is also on track as well. See Figures 61 and 62 for historical P/E and P/B valuation charts for both the sector as whole and each individual bank.

Figure 61a **Canadian Banks Average 12-month Forward P/E Ratio**



Source: Thomson One Analytics, Bloomberg, CIBC World Markets

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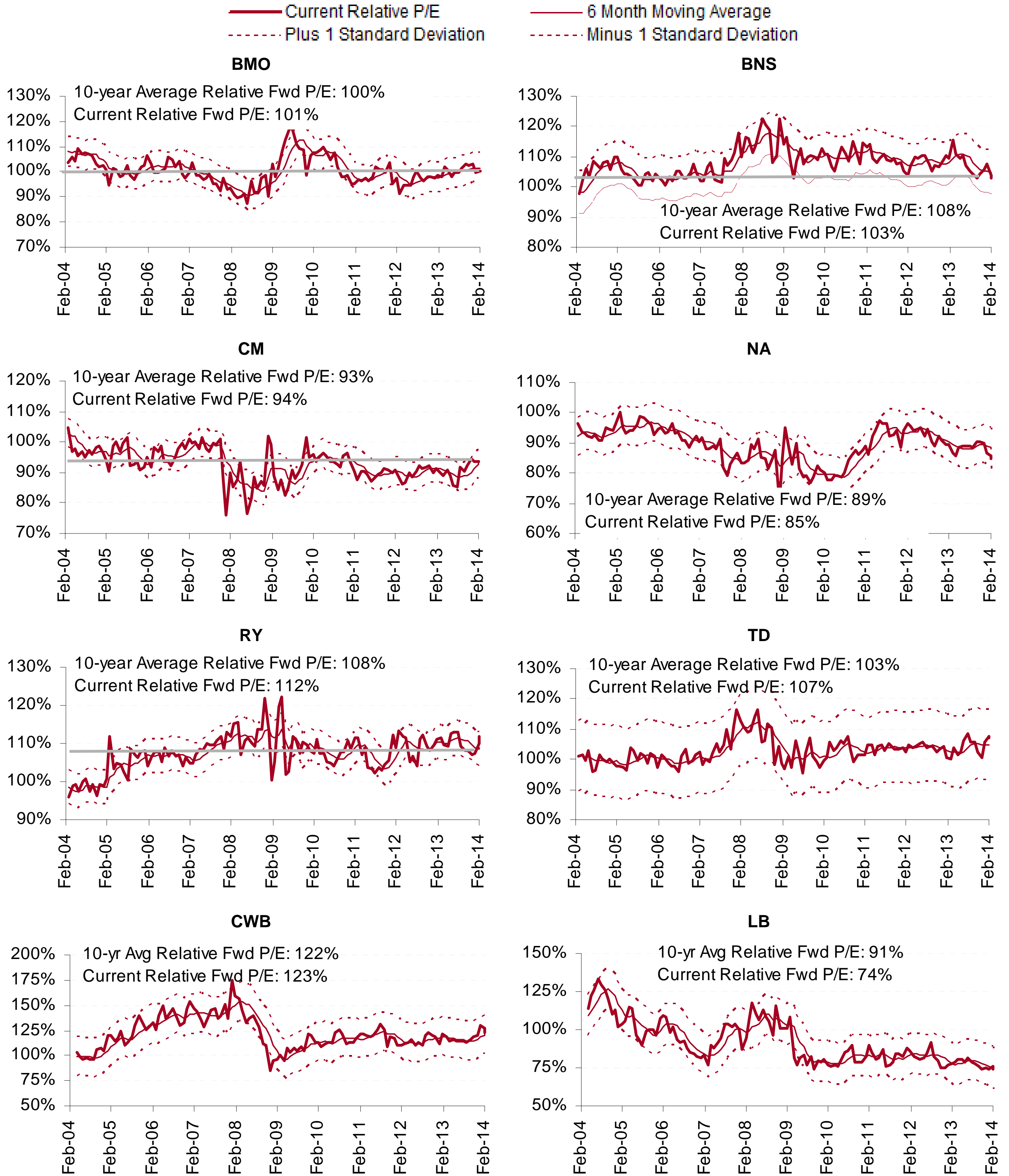
Figure 61b Canadian Banks Relative 12-month Forward P/E Ratio



Source: Thomson One Analytics, Bloomberg, CIBC World Markets

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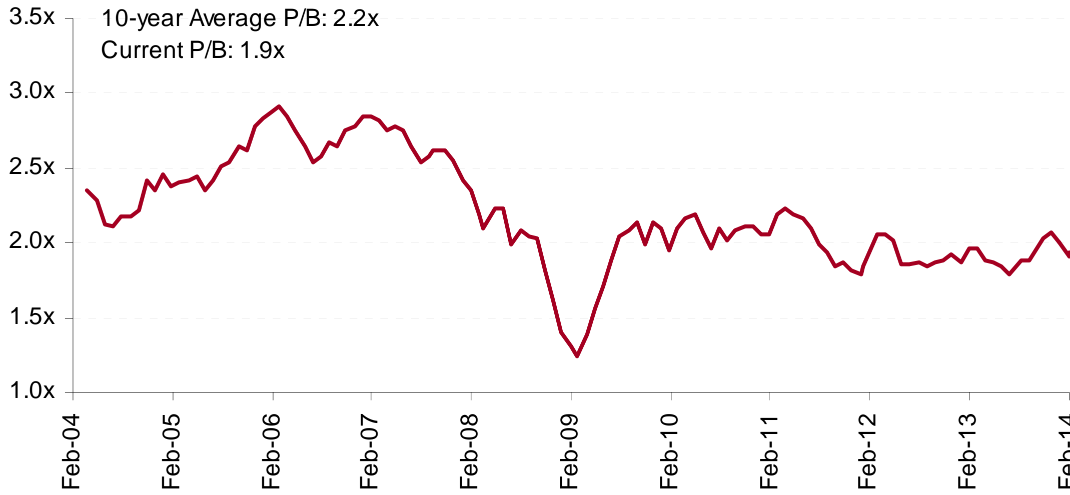
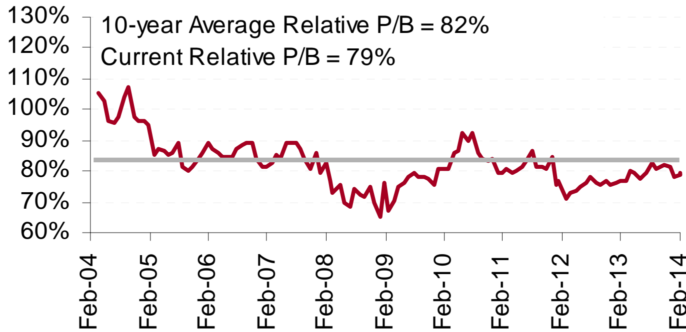
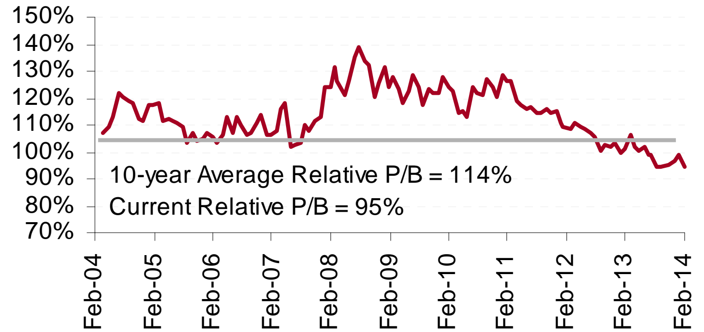
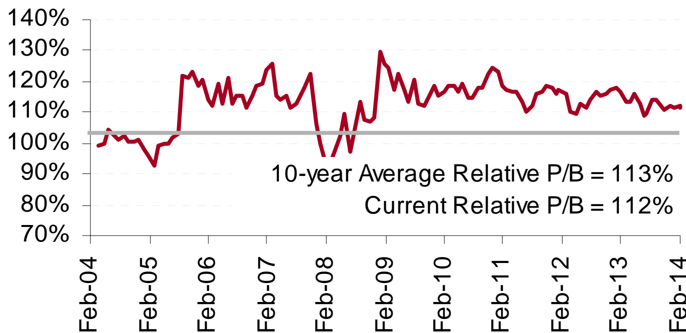
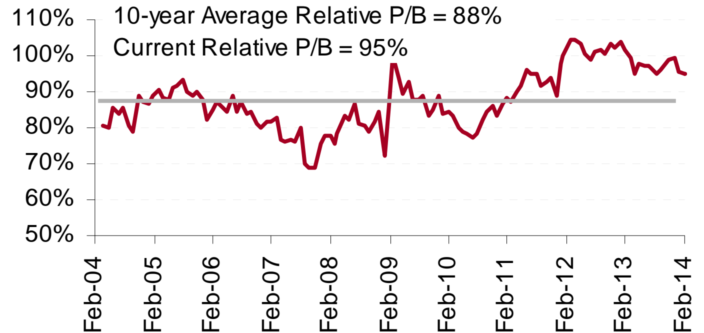
Figure 62a **P/B Valuation Charts**





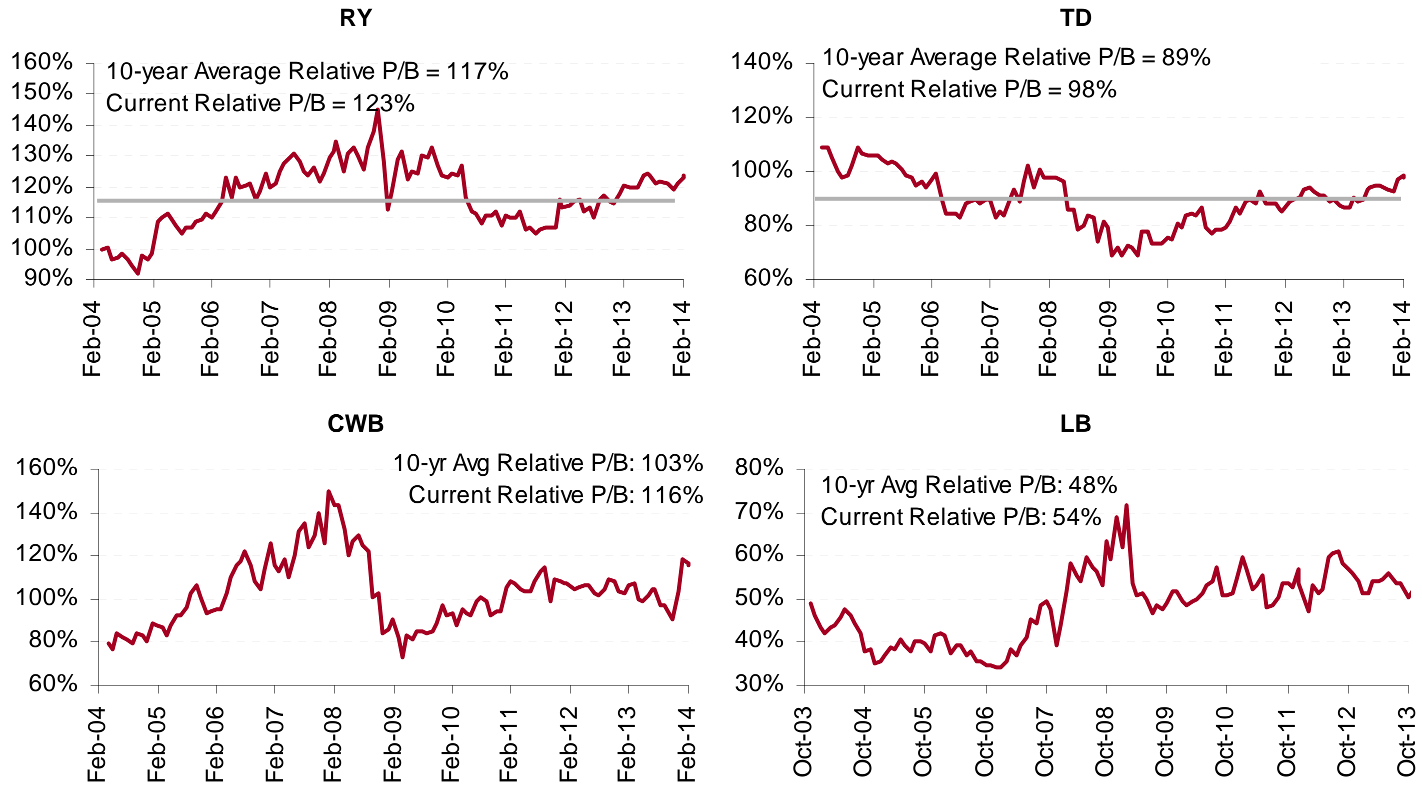






Source: Bloomberg LP, Cormark Securities

Figure 62a **P/B Valuation Charts**



Source: Bloomberg LP, Cormark Securities

The Fallacy Of Mean Reversion

There is a stream of thought among Canadian bank investors that you can outperform the group by continually buying last years losers. The intuition behind this strategy is logical enough, and is based on the concept of mean reversion. As the theory goes, the Big Six banks are all similar enough that over time their returns should converge to the average. Although this view is dangerous to a bank analyst's health, a cursory look at recent experience would suggest that it is indeed fruitful. Yet a deeper dive into the issue reveals that that this is simply a product of spurious statistics. In fact, depending on the period you are looking at you would be able to outperform based on buying last year's winner, last year's loser or the last year's middling returner (see Figure 63). In other words, that type of naïve strategy is random. It works when it works and all other time does not. The fact that it has been a clear winning strategy since 2008 does not mean that it will continue to be effective. In fact, we would argue that this period was clearly a unique period in Canadian bank investing, a period that saw certain banks underperform because of macro factors that tended to reverse the following year.

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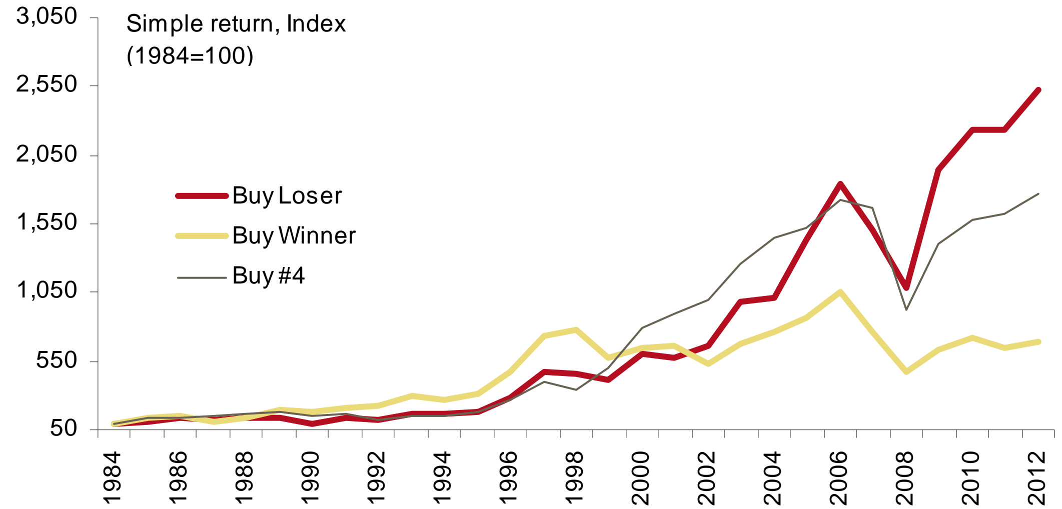
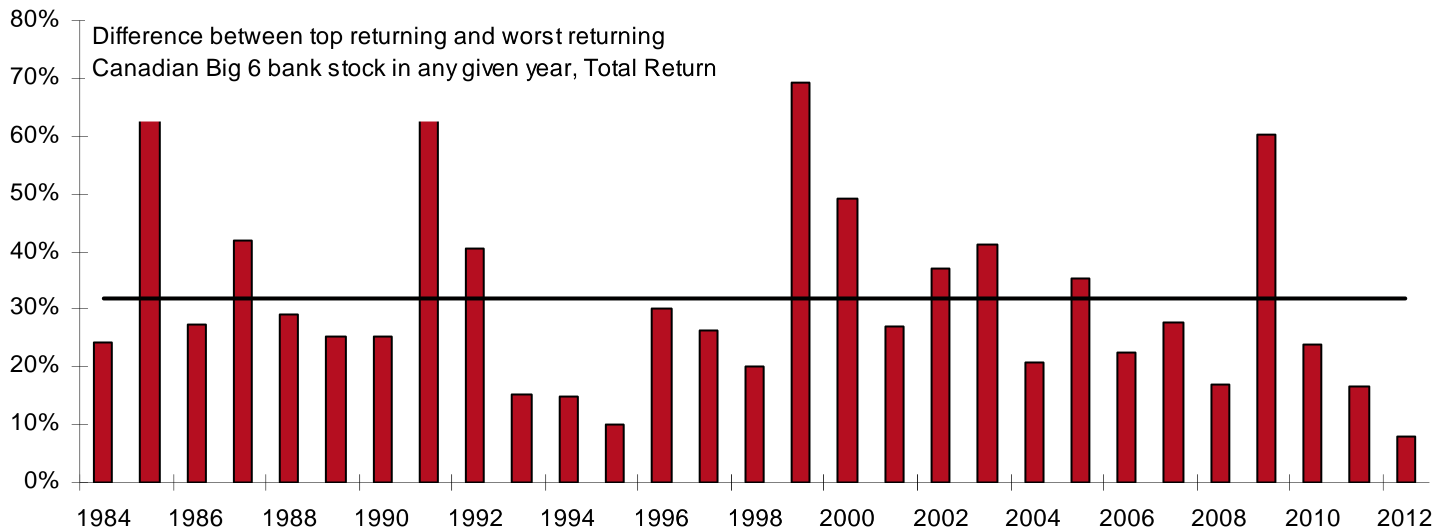
Figure 63 **Mean Reversion Works… Only Sometimes**



Source: Bloomberg LP, Cormark Securities

Although we do not agree that a naïve approach to picking winners and losers is effective in the long run, we clearly do see the value of being able to pick the best and worst bank stocks in any given year. Although the banks are very similar in many respects, history has consistently shown that the returns available to investors who are able to make the right pair trades are indeed substantial. In fact since 1984 picking the right winner and shorting the right loser in the space would have netted one an average annual total return of about 31%. That is skewed by some monster years, but the strategy tends to deliver strong results year in and year out (see Figure 64). The bottom line is that there is hope for bank analysts.

Figure 64 **Pair Trade Analysis**



Source: Bloomberg LP, Cormark Securities

Bank of Montreal

(BMO - $69.30, TSX)

Recommendation: TOP PICK Target Price: $85.00

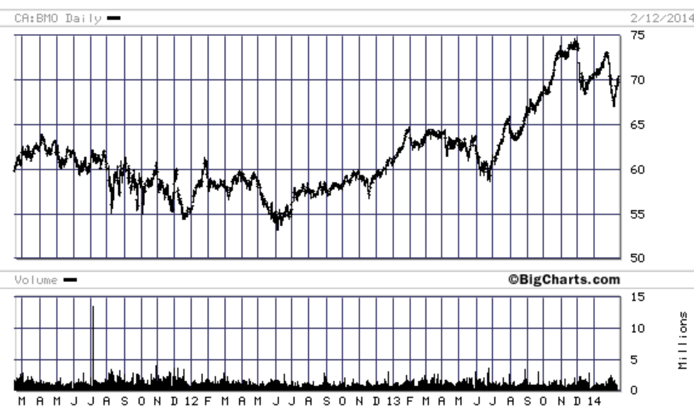
Figure 65 Statistics & Estimates

Current Price	$69.30	Shares Outstanding (MM)		
52 Wk High	$74.69	Diluted		646
52 Wk Low	$58.68	Market Cap (MM)		$44,775
BVPS	$43.22			
Dividend	$3.04			
Dividend Yield	4.4%			

Fiscal YE Oct. 31		2013A	2014E	2015E
Adj. EPS (dil.) *	Q1	$1.50	$1.49	$1.63
	Q2	$1.44	$1.52	$1.68
	Q3	$1.66	$1.65	$1.81
	Q4	$1.62	$1.69	$1.85
	FY	**$6.22**	**$6.34**	**$6.97**
BVPS		$43.22	$46.52	$49.93
Tang. BVPS		$34.81	$38.18	$41.43
BVPS Growth	y.o.y.	10%	8%	7%
EPS Growth	y.o.y.	11%	2%	10%
ROE**		15.1%	14.2%	14.5%
P/E		11.1x	10.9x	9.9x
P/BVPS		1.6x	1.5x	1.4x
P/Tang. BVPS		2.0x	1.8x	1.7x

Source: Company reports, Cormark Securities Inc. estimates

Figure 66 Price Chart



Source: BigCharts.com (February 12/14)

Our Recommendation

We are initiating our coverage on BMO with Top Pick rating and $85.00 target price.

BMO is the fourth largest Canadian bank by market capitalization, and also ranks fourth by assets at $537 BB as of the end of F2013. The bank has four operating segments (not including corporate) which are: Canadian P&C, US P&C, Wealth Management (which includes insurance), and BMO Capital Markets. BMO has 933 branches in Canada and 626 in the US.

Our Thesis – The Best Way to Play The US.

After surviving one of the biggest meltdowns in history, the US banking sector is now one of the most attractive markets in the world, and in our view the best way to play this recovery from the perspective of a Canadian bank investor is BMO. Roughly two years after the transformational M&I acquisition, BMO's US business is poised to see significant earnings growth even as loan losses move higher after being held down by a stream of purchased impaired loan recoveries.

The US is not the only thing going right for this bank. As we saw in Q4, Canadian banking results are also improving through a combination of above-average earnings growth and good expense control. Although the Canadian retail margin has seen the most contraction among the Big Six banks that has been largely driven by group leading domestic mortgage growth as BMO gains market share in business where it has lagged for some time now. We see this process continuing, but slowing down later in F2014. This should still lead to above-average loan growth, and less margin stability than its peers. Nevertheless, even here margin pressure should ease up as longer rates continue to slowly climb higher in F2014 and the Bank of Canada and Fed finally raise rates in F2015.

Finally, BMO's underappreciated Wealth Segment is also poised for solid growth, helped by its sizable life insurance business. The recently-announced acquisition of UK-based F&C Asset Management illustrates that this unit has potential to become a more significant global business as well.

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The Top Three Issues

1. **Will The US Business Live Up To Expectations?** BMO's US business had an underwhelming year in F2013 with revenue growth down 5% Y/Y in US dollar terms. In C$ terms adjusted net income was down a less disappointing 1% Y/Y, as lower credit provisions and lower expenses helped soften the top-line hit. Revenue was impacted by an additional 38 bps of margin pressure during the year and loan growth of only 1.5%. That said, there are signs that top-line momentum is starting to build, especially with respect to commercial loan growth in the US where BMO has significant exposure. We are also getting more positive on the outlook for the margin as long rates continue to move up in F2014 ahead of an expected Fed rate hike in F2015. BMO's footprint is in the heartland of the US economic recovery and its focus on business lending positions it well to take advantage of an upswing there even as the mortgage business continues to be negatively impacted by the end of a refinancing boom.

2. **Is Domestic Earnings Momentum Sustainable?** BMO's Canadian banking operation has been viewed as a below average platform for a long time now, but there are growing signs that this is changing. The firm has seen its domestic market share among the Big Six increase more than any other large peer over the last two years. A big part of the push has been in mortgages when the firm is unrepresented relative to its overall size. That has squeezed margins given the tight spreads that this product carries relative to other loans, but we see that improving as BMO gets less aggressive and margin pressure eases for the sector as a whole.

3. **Can BMO Become A Global Wealth Manager?** In the post financial-crisis world, banks all over the globe are attracted to the wealth management space given that it requires virtually no capital, delivers recurring fee-based revenue and entails very little risk. Canadian banks are no different and are no doubt scouring the US and the globe for appropriate targets. Although Europe is not a key area of wealth management operations for the Canadian banks, that is slowly starting to change. Royal Bank spent $1.56 BB to acquire UK manager BlueBay in 2010. With market dominance at home, Canadian banks need to grab market share internationally and BMO is no exception. BMO wants to build a global wealth platform and its recently announced deal to buy F&C Asset Management is the bank's most significant step to date in that direction.

Loan Growth And Margins

Although BMO has seen the most margin contraction among the Big Five Canadian banks in F2013 (down 13bps Y/Y), it also saw the second strongest loan growth of the group (+10.5% Y/Y). The margin pressure is a direct outgrowth of the loan growth as BMO works to bulk up its market share in the Canadian mortgage business. The effort is working as BMO's total share of the Canadian P&C market among the Big Six has gone from 12.5% in Q4/F11 to over 13% as of the end of F2013. Looking ahead, we expect margin pressure to ease up as BMO gets less aggressive in the mortgage market and interest rates continue to head higher.

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Other Income

As we mentioned above, the growth potential inherent in BMO's Wealth Management segment is underappreciated. For one thing the business has significant international growth potential as highlighted in the recent deal to purchase F&C Asset Management. That deal is expected to be only modestly accretive in F2014, but the impact could be more significant in F2015, especially if the European recovery continues to gather steam. BMO's insurance business is also an underappreciated asset given the leverage this business has to rising interest rates. Insurance net income was only 31% of the Wealth and Insurance segment's profits in F2013, but it grew by 65% Y/Y.

We also have a favorable view of BMO's capital markets business given that it is the only other bank apart from Royal Bank with a significant US presence. About 20% of adjusted earnings in the Capital Markets Segment came from the US in F2013 compared to 10% in F2011 and it is expected to trend higher given the strong outlook we have for US investment banking activity relative to Canada.

Credit

BMO's credit picture is a little more complicated than for its peers given that the firm has been enjoying significant recoveries from its M&I purchased impaired loan book. The recoveries totaled $509 MM in F2012, $410 MM in F2013 and according to Management should total about $100 MM in F2014, before heading to zero in F2015. With the company finally on the verge of moving past the M&I credit noise, we see the stage set for a material increase in its loan loss ratio, although we suspect that given the overall benign credit environment the Street may be overly conservative here. After reporting a loan loss ratio of 0.13% in F2013, we forecast an increase to 0.24% in F2014 and 0.30% in F2015.

Expenses

We forecast below average expense growth for BMO in F2014 led by the Canadian P&C business, which showed extremely disciplined expense management in F2013 and which we expect to continue through our forecast horizon. Spending in the US business has been helped by post-deal synergies. Those are largely behind us, and while do expect spending to grow at a faster pace from here, that should be accompanied by higher revenue growth as well.

Capital, Dividends & Buybacks

BMO ended the year with a Basel III CET1 ratio of 9.9%, which is the highest among its peers. On a pro forma basis, excluding a -20 bps from the CVA phase in as well as another 5 bps from the transition to IAS19, that ratio comes down to a still strong 9.7%. This does not include the projected roughly 75 bps hit to capital from the recently announced acquisition of F&C Asset Management.

Although we believe that the bank would be interested in tuck-in acquisitions within its US retail footprint, a large transformational acquisition like M&I is unlikely given the scale that the bank now has in the Midwest. As the F&C deal highlights, international expansion on the wealth management side is clearly on Management's radar, and we would expect further deals of this nature and this size over the coming years. Although the F&C deal will entail temporary suspension of the share buyback, we estimate that it will only take a little more than three quarters for BMO to bring its CET1 capital ratio back up to where it was prior to the deal announcement. We therefore model no further buyback in F2014, but do model the 15 MM share buyback coming back in F2015.

Earnings

We forecast core cash EPS of $6.34 for BMO in F2014 followed by $6.97 in F2015. That works out to growth of 2% in F2014 followed by growth of 10% the year after. The lift in F2015 is driven by solid margin expansion and rising loan growth in the US and stabilization in the US credit picture. We expect all these factors to drive earnings per share growth to the upper end of the firm's 5-10% medium-term target in F2015.

Valuation

We derive our $85.00 target by applying a 12.2x P/E multiple to our F2015E EPS estimate. Our target multiple represents a 2% premium to the group, versus a 10-year historical average of premium of zero. The stock currently trades at 10.9x our F2014 EPS estimate and 9.9x our F2015 EPS estimate.

Figure 67 Bank of Montreal Summary Forecast Model ($MM)

Fiscal YE October 31			2014E					
All Information on Core Bases	2012A	2013A	Q1E	Q2E	Q3E	Q4E	2014E	2015E
Core Net Interest Income	7,981	7,894	1,998	1,961	2,056	2,097	8,113	8,784
Other Income	7,167	7,826	2,023	2,069	2,116	2,166	8,373	8,997
Gross Revenue	15,148	15,720	4,021	4,029	4,172	4,263	16,486	17,781
PCL	(471)	(357)	(140)	(170)	(175)	(205)	(690)	(935)
Gross Revenue After PCL	14,677	15,363	3,881	3,859	3,997	4,058	15,796	16,846
Non-Interest Expense	(9,096)	(9,884)	(2,580)	(2,532)	(2,553)	(2,576)	(10,241)	(10,782)
Net Income Before Taxes	5,581	5,479	1,301	1,328	1,444	1,482	5,555	6,064
Income Taxes	(1,618)	(1,345)	(319)	(325)	(354)	(363)	(1,361)	(1,486)
Non-Controlling Interest & Other	(74)	(65)	(13)	(13)	(13)	(13)	(52)	(52)
Net Income	3,889	4,069	969	990	1,077	1,106	4,142	4,526
Pref. Div. & Capital Instruments	(124)	(120)	(29)	(29)	(29)	(29)	(116)	(116)
Net Income to Common	3,765	3,949	940	961	1,048	1,077	4,026	4,410
After-Tax Intangibles	96	89	22	22	22	22	88	88
Core Cash Earnings	3,861	4,038	962	983	1,070	1,099	4,114	4,498
Reported GAAP EPS (Fully Dil.)	$6.15	$6.27	$1.45	$1.48	$1.61	$1.65	$6.20	$6.83
Cash EPS (FD Excl. EO Gains)	$5.95	$6.22	$1.49	$1.52	$1.65	$1.69	$6.34	$6.97
Profitability, Capital Ratios & Other								
Core Cash ROE (Excl. EO Items)	15.7%	15.1%	13.6%	14.1%	14.5%	14.6%	14.2%	14.5%
Return on RWA's (Trailing 4-Qtr.)	1.82%	1.87%	1.84%	1.84%	1.80%	1.80%	1.80%	1.83%
Efficiency Ratio (Excl. EO Items)	60.0%	62.9%	64.2%	62.8%	61.2%	60.4%	62.1%	60.6%
Book Value	$39.41	$43.22	$43.96	$44.72	$45.61	$46.52	$46.52	$49.93
Core Effective Tax Rate	29.0%	24.5%	24.5%	24.5%	24.5%	24.5%	24.5%	24.5%
Common Dividends	$2.82	$2.94	$0.76	$0.76	$0.76	$0.78	$3.06	$3.16
Payout Ratio	47.1%	47.2%	51.1%	50.1%	46.1%	46.2%	48.3%	45.4%
Basel III CET1 Ratio	8.7%	9.9%	9.9%	10.0%	10.1%	10.1%	10.1%	10.2%
Tier 1 Capital Ratio	12.6%	11.4%	11.5%	11.5%	11.5%	11.6%	11.6%	11.5%
Average Shares O/S (FD)	650	646	647	648	650	651	651	642
Credit								
Specific Provisions	$471	$357	$140	$170	$175	$205	$690	$935
Avg. Net Loans & Acceptances	$246,097	$265,441	$282,061	$287,651	$293,351	$299,164	$290,557	$308,228
PCL Ratio (% of Loans + Accept.)	0.19%	0.13%	0.20%	0.24%	0.24%	0.27%	0.24%	0.30%
Capital Markets								
Total Trading Revenue	$1,200	$1,289	$330	$330	$330	$330	$1,320	$1,360
Underwriting & Advisory Fees	$600	$659	$170	$170	$170	$170	$680	$720
Securities Commissions & Fees	$1,085	$1,124	$306	$321	$337	$354	$1,317	$1,451
Variable Compensation	$1,641	$1,682	$513	$451	$460	$470	$1,894	$2,012
Variable Compensation Ratio	56.9%	54.8%	63.7%	55.0%	55.0%	55.0%	57.1%	57.0%
Lending Net Interest Income								
Net Interest Income	$7,981	$7,894	$1,998	$1,961	$2,056	$2,097	$8,113	$8,784
Non-trading Average Earn. Assets	$390,447	$412,170	$430,829	$439,445	$448,234	$457,199	$443,927	$476,657
NIM On Non-trading AEA	2.04%	1.92%	1.84%	1.83%	1.82%	1.82%	1.83%	1.84%
Net Loans & BAs Outstanding	$253,846	$279,294	$284,828	$290,473	$296,229	$302,100	$302,100	$314,434
Operating Leverage								
Gross Revenue	$15,148	$15,720	$4,021	$4,029	$4,172	$4,263	$16,486	$17,781
Non-Interest Expenses	$9,096	$9,884	$2,580	$2,532	$2,553	$2,576	$10,241	$10,782
Operating Leverage	1.8%	(4.9%)	(4.4%)	2.1%	2.7%	1.3%	1.3%	2.6%

Source: Company Reports, Cormark Securities

CORMARK SECURITIES INC.

Bank of Nova Scotia

(BNS - $61.70, TSX)

Recommendation: MARKET PERFORM   Target Price: $70.00

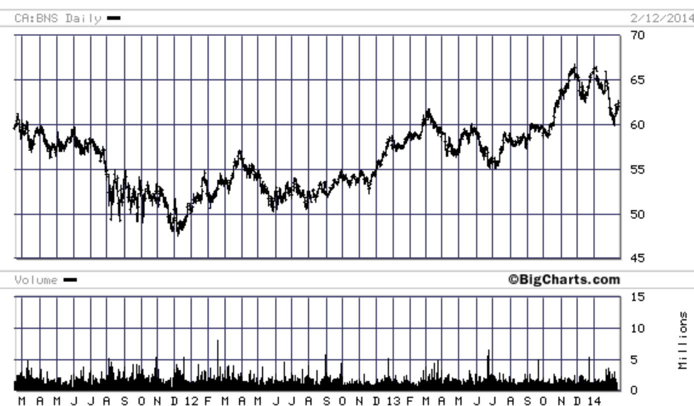
Figure 68 Statistics & Estimates

Current Price	$61.70	Shares Outstanding (MM)	
52 Wk High	$66.75	Diluted	1,210
52 Wk Low	$55.10	Market Cap (MM)	$74,657
BVPS	$33.23		
Dividend	$2.48		
Dividend Yield	4.0%		

Fiscal YE Oct. 31		2013A	2014E	2015E
Adj. EPS (dil.) *	Q1	$1.26	$1.32	$1.40
	Q2	$1.23	$1.26	$1.37
	Q3	$1.31	$1.33	$1.46
	Q4	$1.31	$1.34	$1.47
	FY	**$5.11**	**$5.24**	**$5.70**
BVPS		$33.23	$36.29	$39.56
Tang. BVPS		$24.37	$27.61	$31.04
BVPS Growth	y.o.y.	15%	9%	9%
EPS Growth	y.o.y.	13%	3%	9%
ROE**		16.5%	15.1%	15.1%
P/E		12.1x	11.8x	10.8x
P/BVPS		1.9x	1.7x	1.6x
P/Tang. BVPS		2.5x	2.2x	2.0x

Source: Company reports, Cormark Securities Inc. estimates

Figure 69 Price Chart



Source: BigCharts.com (February 12/14)

Our Recommendation

We are initiating our coverage on Bank of Nova Scotia (BMS-TSX) with Market Perform rating and $70.00 target price.

BNS is the third largest Canadian bank by market capitalization, and also ranks third by assets at $744 BB as of the end of F2013. The bank has four operating segments (not including corporate) which are: Canadian Banking, International Banking, Global Wealth Management and Global Banking and Markets. BNS has 1,038 branches in Canada and 2,010 branches internationally.

Our Thesis – All Eyes On International, But Canada Is A Rising Star

While the market continues to view BNS's international growth strategy as its crown jewel, we believe a more cautious approach is warranted. The past 10 years have been a golden age for emerging markets, but troubles in many of the fastest growing emerging markets suggest that the next few years may be a lot more challenging. Although the idea of convergence remains in vogue, there is not a lot of proof that economic development in emerging markets happens in a straight line. While BNS's international footprint is firmly rooted in the economic standouts of Latin America, the threat of contagion is real. In Asia, Thailand is also going through significant unrest that will impact economic growth at least in the short run. While some emerging markets are expected to grow at a faster rate than the G7 over the coming years, that gap is getting smaller while the risk is getting larger.

Instead, in our view the big star at Scotia is its Canadian businesses where it has utilized shrewd deal making to make the most strategic inroads of its peers. First came the $2.3 BB 2010 acquisition of the 82% of DundeeWealth that it didn't already own. Then came the $3.1 BB 2012 purchase of ING Canada. The Dundee deal transformed BNS into the third-largest wealth manager among the Canadian banks by mutual fund AUM, and the ING deal helped improve the bank's domestic funding disadvantage.

CORMARK SECURITIES INC.

The Top Three Issues

1. **Will BNS' International Segment Continue To Disappoint?** We do acknowledge that BNS's international footprint is firmly planted in countries with solid fiscal and economic fundamentals ….at least for time being. However, we take a very cautious view of this much heralded segment given the fact that contagion is a very real and growing risk across even the more stable emerging market economies. Even more fundamentally though we believe that the growth rates the market is assuming for this segment are overly optimistic given the cyclical pressures that we see building for all emerging markets, even the most stable ones.
2. **Will BNS Continue To Be A Serial Acquirer?** BNS has tended to be one of the more acquisitive Canadian banks, particularly in its faster-growing international segment. The perceived advantage that BNS has in terms of internal capital deployment is a reason that it is the only bank among the Big Six that does not have a common stock buyback program in place. Given the current turmoil in the emerging markets, we don't see any international deals coming down the line over the next few months, but we would expect the bank to be an opportunistic acquirer once market volatility settles down.
3. **How Does The Bank Continue To Drive Forward Its Domestic Banking Platform?** As we mentioned above, Scotia is known as a particularly acquisitive bank, but what is surprising is that of the $12.9 BB in acquisitions (where terms have been disclosed) that it has made since 2007 about 70% (in terms of deal volume) has been in Canada. Although Canadian deals are scarce, we do expect BNS to look to continuing to shore up aspects of its Canadian business that continue to lag, particularly credit cards where it ranks below all the other Big Six banks in terms of purchase volumes.

Loan Growth And Margins

Although BNS continued to deliver peer-leading loan growth in F2013, that was certainly helped by the ING acquisition. Looking forward, we see this pace slowing somewhat – although still growing above the group average – as demand moderates across emerging markets and the pace of international acquisitions remains slow. With respect to margins we see Canadian margins stabilizing in F2014 before seeing some expansion in F2015, but we also see the compression that we saw in the international segment in Q4/F13 continuing in F2014 as well.

Other Income

The opportunity to expand the firm's wealth offering in international markets is significant, but we do not see this as a significant earnings driver in F2014 or F2015 as a result of heightened market volatility across the region as well as the large investment that this push would require.

Credit

We forecast higher international provisions in the International Segment in F2014 as a result of more challenging economic fundamentals and as portfolio normalization in the firm's Colombia business continues. However, that should be somewhat moderated by stability in Canada. We see the international outlook improving in F2015, but look for loan losses in Canada to head higher as we expect the firm to improve its positioning in credit cards. For F2014, we forecast a loan loss ratio of 0.35% and the same in F2015. That compares to 0.32% in F2013.

CORMARK SECURITIES INC.

Expenses	We expect very little operating leverage for BNS in F2014 as revenue growth slows, but see solid positive operating leverage returning in F2015.
Capital, Dividends & Buybacks	BNS's Basel III CET1 ratio ended the year at 9.1%, adjusting for CVA phase-in (-15 bps) and the impact from IAS19 (-10 bps) the firm's pro forma capital ratio was 8.9%. That is well above the 8% minimum that OSFI has set for the Big Six banks. Standing apart from its large peers, BNS is the only one of the Big Six banks that does not currently have a buyback in place. Although the bank has the ability to repurchase stock we do not see that as a very likely scenario over the next two years. Instead, we look for the company to continue to prioritize reinvesting excess capital into its existing businesses and to help fund acquisitions – even if we believe that we will see a slow pace of international acquisitions in F2014.
Earnings	We forecast core cash EPS of $5.24 for BNS in F2014 followed by $5.70 in F2015. That works out to growth of 2.5% in F2014 followed by growth of 9% the year after. The drag we see in F2014 is driven by increased difficulties internationally including rising credit provisions and slower loan growth. That should only improve modestly in F2015. In F2014, we see EPS growth lagging the firm's 5-10% medium-term target.
Valuation	We derive our $70.00 target by applying a 12.3x P/E multiple to our F2015E EPS estimate. Our target multiple represents a 3% premium to the group, versus a 10-year historical average premium of 8%. The stock currently trades at 11.8x our F2014 EPS estimate and 10.8x our F2015 EPS estimate.

Figure 70 Bank of Nova Scotia Summary Forecast Model ($MM)

Fiscal YE October 31 All Information on Core Bases	2012A	2013A	2014E Q1E	Q2E	Q3E	Q4E	2014E	2015E
Core Net Interest Income	9,730	11,068	2,828	2,775	2,940	3,029	11,572	12,961
Other Income	9,336	10,393	2,692	2,713	2,734	2,756	10,895	11,401
Gross Revenue	19,066	21,461	5,520	5,487	5,674	5,785	22,467	24,363
PCL	(1,152)	(1,288)	(345)	(360)	(385)	(390)	(1,480)	(1,670)
Gross Revenue After PCL	17,914	20,173	5,175	5,127	5,289	5,395	20,987	22,693
TEB Adjustment	(288)	(312)	(77)	(77)	(77)	(77)	(308)	(308)
Non-Interest Expense	(10,436)	(11,590)	(2,945)	(2,987)	(3,029)	(3,113)	(12,074)	(12,889)
Net Income Before Taxes	7,190	8,271	2,153	2,064	2,183	2,205	8,604	9,495
Income Taxes	(1,448)	(1,751)	(452)	(433)	(458)	(463)	(1,807)	(1,994)
Non-Controlling Interest	(196)	(231)	(56)	(56)	(56)	(56)	(224)	(224)
Net Income	5,546	6,289	1,645	1,574	1,668	1,686	6,574	7,277
Pref. Divs. & Capital Instruments	(198)	(217)	(53)	(53)	(53)	(53)	(212)	(212)
Net Income to Common	5,348	6,072	1,592	1,521	1,615	1,633	6,362	7,065
After-Tax Intangibles	63	75	17	17	17	17	68	68
Core Cash Earnings	5,411	6,147	1,609	1,538	1,632	1,650	6,430	7,133
Reported GAAP EPS - Fully Dil.	$4.61	$5.03	$1.31	$1.24	$1.31	$1.32	$5.18	$5.65
Cash EPS (FD Excl. EO Gains)	$4.71	$5.11	$1.32	$1.26	$1.33	$1.34	$5.24	$5.70
Profitability, Capital Ratios & Other								
Core Cash ROE (Excl. EO items)	18.0%	16.5%	15.8%	14.7%	15.2%	14.9%	15.1%	15.1%
Return on RWA's (Trailing 4-Qtrs)	2.15%	2.19%	2.17%	2.16%	2.15%	2.12%	2.12%	2.14%
Efficiency Ratio (Excl. EO Items)	54.7%	54.0%	53.4%	54.4%	53.4%	53.8%	53.7%	52.9%
Book Value	$28.99	$33.23	$34.04	$34.75	$35.54	$36.29	$36.29	$39.56
Core Effective Tax Rate	20.1%	21.2%	21.0%	21.0%	21.0%	21.0%	21.0%	21.0%
Common Dividends	$2.19	$2.39	$0.62	$0.65	$0.65	$0.68	$2.60	$2.80
Payout Ratio	46.1%	46.5%	46.9%	51.7%	49.0%	50.9%	49.6%	49.1%
Basel III CET1 Ratio	7.7%	9.1%	9.5%	9.6%	9.7%	9.9%	9.9%	10.4%
Tier 1 Capital Ratio	13.6%	11.1%	11.4%	11.5%	11.6%	11.6%	11.6%	12.0%
Average Shares O/S (Fully Dil.)	1,184	1,210	1,218	1,224	1,230	1,236	1,236	1,260
Credit								
Specific Provisions	$1,152	$1,288	$345	$360	$385	$390	$1,480	$1,670
Avg. Net Loans & Acceptances	$347,746	$397,198	$414,835	$422,110	$432,663	$443,479	$428,790	$471,614
PCL Ratio (% of Loans + Accept.)	0.33%	0.32%	0.33%	0.35%	0.35%	0.35%	0.35%	0.35%
Capital Markets								
Total Trading Revenue	$1,570	$1,597	$400	$400	$400	$400	$1,600	$1,620
UW Fees & Other Advisory Fees	$493	$503	$125	$125	$125	$125	$500	$520
Brokerage Fees	$721	$848	$222	$226	$229	$232	$909	$977
Variable Compensation	$1,685	$1,780	$441	$443	$445	$447	$1,776	$1,839
Variable Compensation Ratio	60.5%	60.4%	59.0%	59.0%	59.0%	59.0%	59.0%	59.0%
Lending Net Interest Income								
Net Interest Income	$9,730	$11,068	$2,828	$2,775	$2,940	$3,029	$11,572	$12,961
Non-trading Average Earn. Assets	$503,336	$584,102	$593,645	$608,486	$623,698	$639,291	$616,280	$680,258
NIM On Non-trading AEA	1.93%	1.89%	1.89%	1.87%	1.87%	1.88%	1.88%	1.91%
Net Loans & BAs Outstanding	$361,510	$412,771	$416,899	$427,321	$438,004	$448,954	$448,954	$494,836
Operating Leverage								
Gross Revenue	$19,066	$21,461	$5,520	$5,487	$5,674	$5,785	$22,467	$24,363
Non-Interest Expenses	$10,436	$11,590	$2,945	$2,987	$3,029	$3,113	$12,074	$12,889
Operating Leverage	0.1%	1.5%	1.9%	(2.0%)	2.0%	(0.8%)	0.5%	1.7%

Source: Company Reports, Cormark Securities

CORMARK SECURITIES INC.

Canadian Imperial Bank of Commerce

(CM - $87.45, TSX)

Recommendation: BUY

Target Price: $106.00

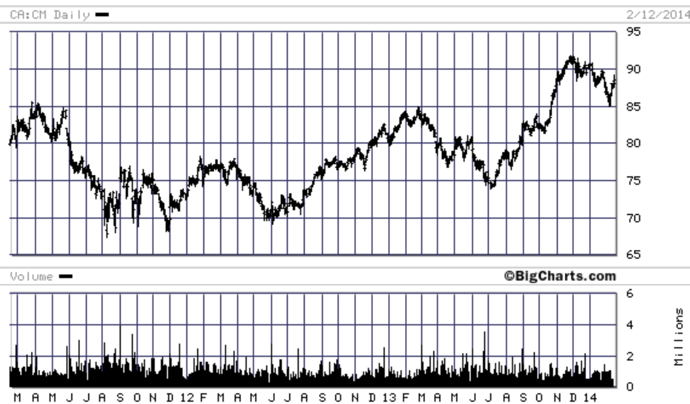
Figure 71 **Statistics & Estimates**

Current Price	$87.45	Shares Outstanding (MM)	
52 Wk High	$91.90	Diluted	400
52 Wk Low	$73.89	Market Cap (MM)	$35,002
BVPS	$40.36		
Dividend	$3.84		
Dividend Yield	4.4%		

Fiscal YE Oct. 31		2013A	2014E	2015E
Adj. EPS (dil.) *	Q1	$2.12	$2.17	$2.24
	Q2	$2.09	$2.02	$2.20
	Q3	$2.26	$2.14	$2.36
	Q4	$2.19	$2.19	$2.41
	FY	**$8.65**	**$8.53**	**$9.22**
BVPS		$40.36	$45.49	$51.26
Tang. BVPS		$34.12	$39.17	$44.86
BVPS Growth	y.o.y.	13%	13%	13%
EPS Growth	y.o.y.	14%	-1%	8%
ROE**		22.9%	19.9%	19.1%
P/E		10.1x	10.3x	9.5x
P/BVPS		2.2x	1.9x	1.7x
P/Tang. BVPS		2.6x	2.2x	1.9x

Source: Company reports, Cormark Securities Inc. estimates

Figure 72 **Price Chart**



Source: BigCharts.com (February 12/14)

Our Recommendation

We are initiating our coverage on CIBC (CM-TSX) with Buy rating and $106.00 target price.

CIBC is the fifth-largest Canadian bank by market capitalization, and also ranks fifth by assets at $398 BB as of the end of F2013. The bank has three operating segments (not including corporate) – Retail & Business Banking, Wealth Management and Wholesale Banking.. CIBC has 1,115 branches in Canada and 296 President's Choice Financial pavilions. The company's First Caribbean unit has 102 branches, banking centers and offices across 17 Caribbean countries.

Our Thesis – A Compelling "Micro" Story In A "Macro" Space

In a sector that is very macro focused, CIBC remains one of the best micro stories out there. After spending the better part of the 2000s managing a number of successive crises, the bank has turned its sights inward and is fixing a host of operational and structural issues in its largest segment, Retail and Business Banking. The changes afoot run from the common sense: upgrading computer systems and internal processes to the more strategic: exiting monoline businesses in favor of building deeper client relationships and driving the cross-sell.

The rundown of CIBC's FistLine mortgage broker business and the sale of 50% of the bank's Aeroplan portfolio to TD are examples of this transformational effort. These moves have, and will continue to, put pressure on loan growth, but have clearly boosted margins and overall profitability. Although the market is habitually expecting missteps from this bank, so far implementation of all these changes has been very smooth. In fact, Management commentary suggests that results are even better than expected when it comes to FistLine retention or customer demand for CM's new in-house travel card. Although EPS growth will be significantly impacted by the Aeroplan deal, we see growth improving significantly in F2015. Progress in the core business is coupled with building momentum in the wealth management space suggesting that the stock should continue to be revalued versus its peers.

CORMARK SECURITIES INC.

The Top Three Issues

1. **Is The Retail Transformation Working?** The early indications suggest that CIBC's retail transformation is paying dividends. For one management commentary suggests that efforts to retain FistLine business under the CIBC banner are delivering better than expected results. Secondly, we see Canadian banking margins are holding in better than all of CM's peers, with Y/Y expansion of 8 bps versus an average 6 bps contraction among the Big Six banks. CIBC's retail platform has been an underperforming hidden treasure for a long time now. That fact that it has almost as many domestic branches as RY is surprising to many people, which in and of itself captures the extent of its underperformance and the scope of the existing potential.
2. **Will CIBC Be Able To Meet Its Wealth Management Growth Targets?** CIBC Management has clearly articulated that it would like the earnings contribution from its Wealth Management segment to go from 11% currently to 15% over time. Even if we assume that the rest of the company sees consistent earnings growth of 10% per year, in order to meet that 15% goal organically earning in the Wealth segment would have to grow by about 25% per year. Some of that growth will no doubt flow from existing acquisitions including the recently completed Atlantic Trust purchase, but CIBC will need to source additional deals if it wants to hit the goal it has set for itself.
3. **What Is CIBC's Longer-term Strategic Direction?** Although we expect CIBC's retail transformation to pay dividends over the coming few years, the big question is what happens the day after that is all done? While we expect the bank's cross-selling strategy to lift profitability from an underutilized domestic retail platform, the company has no clear avenue to drive above average earnings growth beyond that time. While the expansion into the US wealth management space is an area for future growth the unit is still quite small relative to rest of the business, and will remain so even if CM hits its ambitious 15% target. Furthermore, the strategy there has not been fully articulated. How do these acquisitions fit together? What is the path to control at American Century? How big could the US wealth management business get?

Loan Growth And Margins

CIBC was very transparent in its goals for FirstLine Exit. Expected retention of 25% (based on the assumption of 50% of mortgages making it to the end of term and 50% or those mortgages to be retained). Instead, 55% of mortgages are staying to term and of those about 90% are being retained for total retention of 45% (calculated as 90%*50%). This process started at the end of Q4/F12 and should continue into F2015. When the run-off was announced FirstLine was about one-third of CIBC's mortgage portfolio. Also impacting loan growth is CM's deal to sell 50% of its Aeroplan balances to TD. Those two impacts will leave loan growth squeezed in F2014, but we could see some very modest positive growth in F2015. In terms of the margin, we are looking for a flat F2014 largely due to the sale of part of the credit-card book.

Other Income

The fate of CIBC's Aeroplan program was a source of much drama in the space in F2013, and a source of much downward pressure on the stock. The final three-way agreement (between CM, TD and AIM) which closed on December 27, 2013, was a good result for CIBC, given the alternative was the loss of successful and large premium card program all together. Under the terms of the final deal CM was able to retain about 50% of its Aeroplan customers, with the remaining 50% (representing about $3.3 BB in outstanding credit card balances) going to TD. These are largely customers who do not have a deeper banking relationship with CIBC. The financial impact on CM is about negative $0.45/share annually, although management has noted that full renewal excluding TD would have led to a $0.15/share drag on EPS given the tougher terms that AIM was seeking. On the positive side, the deal will lead to a reduction in RWA of about $300 MM.

CORMARK SECURITIES INC.

Credit	CIBC's loan loss ratio should benefit from a significantly reduced credit card book after the sale to TD, but that will be counteracted by increasing provisions in the Caribbean.
Expenses	We see expenses rising in F2014 at a much faster clip than revenues as CIBC steps up spending to protect its existing market share for mortgages and credit cards. The operational changes in the retail business up until now have masked increased systems spending, but we see that offset breaking down a little. Not factored into our estimates is about $20 MM in additional expenses related to the development of CIBC's new Aventura card. Those expenses are being treated by the company as a non-core item.
Capital, Dividends & Buybacks	CIBC ended the year with a Basel III CET1 capital ratio of 9.4%. Including a 15 bps drag from the CVA phase-in and another 10 bps from the implementation of IAS19, a 20 bps drag from the close of the Atlantic Trust acquisition and roughly a 35 bps gain from the Aeroplan deal with TD this ratio is 9.3% on a pro forma basis. This at the high end of the group and well above OSFI's 8.0% minimum. The bank exhausted its 8 MM share buyback in Q3/F13 and on August 29 announced its intention of buying back another 8 MM shares (2% of outstandings). Given the company's strong capital buffer and strong internal capital generating ability we expect CM to proceed with the current pace of buybacks in both F2014 and F2015, although acquisition anywhere near that $1 BB mark will likely require a suspension of the buyback until capital levels are rebuilt. The company has been open that it is looking for sizable asset management acquisitions and has mentioned that it would be willing to spend more than the US$850 MM it spent on 41% of ACI in 2011.
Earnings	We forecast core cash EPS of $8.53 for CIBC in F2014 followed by $9.22 in F2015. That works out to a decline of 1.5% in F2014 followed by growth of 8% the year after. The drag in F2014 is largely a function of the sale of 50% of the bank's Aeroplan outstanding balances to TD. Consequently, F2015 will see a jump after that large drag and will also be helped by margin expansion due to rate hikes and increasingly diminishing run off from the FirstLine portfolio.
Valuation	We derive our $106.00 target by applying an 11.5x P/E multiple to our F2015E EPS estimate. Our target multiple represents a 5% discount to the group, versus a 10-year historical average discount of 7%. The stock currently trades at 10.3x our F2014 EPS estimate and 9.5x our F2015 EPS estimate.

Figure 73 **CIBC Summary Forecast Model ($MM)**

Fiscal YE October 31			2014E					
All Information on Core Bases	**2012A**	**2013A**	**Q1E**	**Q2E**	**Q3E**	**Q4E**	**2014E**	**2015E**
Core Net Interest Income	6,935	6,894	1,761	1,717	1,780	1,793	7,051	7,285
Other Income	5,821	6,154	1,536	1,511	1,528	1,545	6,121	6,438
Gross Revenue	12,756	13,048	3,297	3,228	3,308	3,339	13,172	13,723
PCL	(1,238)	(1,042)	(270)	(270)	(275)	(275)	(1,090)	(1,115)
Gross Revenue After PCL	11,518	12,006	3,027	2,958	3,033	3,064	12,082	12,608
Non-Interest Expense	(7,169)	(7,393)	(1,899)	(1,913)	(1,928)	(1,940)	(7,680)	(7,907)
Net Income Before Taxes	4,349	4,613	1,128	1,045	1,105	1,123	4,402	4,701
Income Taxes	(1,013)	(1,063)	(260)	(240)	(254)	(258)	(1,012)	(1,081)
Non-Controlling Interest	(9)	2	7	7	7	7	28	28
Net Income	3,327	3,552	876	811	858	872	3,417	3,648
Pref. Divs. & Remption Premium	(128)	(99)	(14)	(14)	(14)	(14)	(56)	(60)
Net Income to Common	3,199	3,453	862	797	844	858	3,361	3,588
After-Tax Intangibles	25	19	6	6	6	6	24	24
Core Cash Earnings	3,224	3,472	868	803	850	864	3,385	3,612
Reported GAAP EPS (Fully Dil.)	$7.85	$8.24	$2.16	$2.00	$2.13	$2.17	$8.47	$9.16
Cash EPS (FD Excl. EO Gains)	$7.98	$8.65	$2.17	$2.02	$2.14	$2.19	$8.53	$9.22
Profitability, Cap. Ratios & Other								
Core Cash ROE (Excl. EO items)	23.2%	22.9%	21.2%	19.1%	19.7%	19.5%	19.9%	19.1%
Return on RWA's (Trailing 4 Qtrs)	2.8%	2.7%	2.6%	2.6%	2.5%	2.4%	2.4%	2.6%
Efficiency Ratio (Excl. EO items)	56.2%	56.7%	57.6%	59.3%	58.3%	58.1%	58.3%	57.6%
Book Value	$35.83	$40.36	$41.70	$42.86	$44.15	$45.49	$45.49	$51.26
Core Effective Tax Rate	23.3%	23.0%	23.0%	23.0%	23.0%	23.0%	23.0%	23.0%
Common Dividends	$3.64	$3.80	$0.96	$0.99	$0.99	$0.99	$3.93	$4.08
Payout Ratio	45.6%	43.9%	44.1%	49.0%	46.2%	45.3%	46.1%	44.3%
Basel III CET1 Ratio	9.0%	9.4%	9.7%	9.9%	10.2%	10.5%	10.5%	11.8%
Tier 1 Capital Ratio	13.8%	11.6%	11.9%	12.2%	12.5%	12.8%	12.8%	14.0%
Average Shares O/S (Fully Dil.)	406	400	399	398	396	395	395	390
Credit								
Specific Provisions	$1,238	$1,042	$270	$270	$275	$275	$1,090	$1,115
Avg. Net Loans & Acceptances	$251,867	$253,284	$256,801	$257,645	$258,492	$259,342	$258,070	$262,497
PCL Ratio (% of Loans + Accept.)	0.49%	0.41%	0.42%	0.43%	0.42%	0.42%	0.42%	0.42%
Capital Markets								
Total Trading Revenue	$790	$918	$220	$220	$220	$220	$880	$940
Underwriting and Advisory Fees	$438	$389	$97	$97	$97	$97	$388	$400
Comm. on Securities Transact.	$402	$412	$102	$103	$104	$105	$414	$431
Variable Compensation	$1,236	$1,299	$318	$319	$320	$321	$1,278	$1,316
Variable Compensation Ratio	75.8%	75.6%	76.0%	76.0%	76.0%	76.0%	76.0%	74.3%
Lending Net Interest Income								
Net Interest Income	$6,935	$6,894	$1,761	$1,717	$1,780	$1,793	$7,051	$7,285
Non-trading Average Earn. Assets	$304,626	$309,109	$316,184	$317,132	$318,084	$319,038	$317,609	$323,046
NIM On Non-trading AEA	2.28%	2.23%	2.21%	2.22%	2.22%	2.23%	2.22%	2.26%
Net Loans & BAs Outstanding	$252,732	$256,380	$257,222	$258,068	$258,916	$259,768	$259,768	$265,244
Operating Leverage								
Gross Revenue	$12,756	$13,048	$3,297	$3,228	$3,308	$3,339	$13,172	$13,723
Non-Interest Expenses	$7,169	$7,393	$1,899	$1,913	$1,928	$1,940	$7,680	$7,907
Operating Leverage	0.8%	(0.8%)	(1.2%)	(2.9%)	1.7%	0.3%	(2.9%)	1.2%

Source: Company Reports, Cormark Securities

CORMARK SECURITIES INC.

National Bank of Canada

(NA - $42.41, TSX)

Recommendation: MARKET PERFORM   Target Price: $49.00

Figure 74 **Statistics & Estimates**

Current Price	$42.41	Shares Outstanding (MM)	
52 Wk High	$46.96	Diluted	329
52 Wk Low	$35.89	Market Cap (MM)	$13,936
BVPS	$22.97		
Dividend	$1.84		
Dividend Yield	4.3%		

Fiscal YE Oct. 31		2013A	2014E	2015E
Adj. EPS (dil.) *	Q1	$0.97	$1.02	$1.05
	Q2	$1.00	$0.99	$1.09
	Q3	$1.07	$1.06	$1.16
	Q4	$1.00	$1.10	$1.19
	FY	**$4.04**	**$4.18**	**$4.49**
BVPS		$22.97	$25.24	$27.74
Tang. BVPS		$16.95	$19.25	$21.66
BVPS Growth	y.o.y.	15%	10%	10%
EPS Growth	y.o.y.	18%	3%	7%
ROE**		18.8%	17.5%	17.1%
P/E		10.5x	10.2x	9.4x
P/BVPS		1.8x	1.7x	1.5x
P/Tang. BVPS		2.5x	2.2x	2.0x

Source: Company reports, Cormark Securities Inc. estimates

Figure 75 **Price Chart**

Source: BigCharts.com (February 12/14)

Our Recommendation

We are initiating our coverage on National Bank (NA-TSX) with Market Perform rating and $49.00 target price.

NA is the sixth largest Canadian bank by market capitalization, and also ranks sixth by assets at $188 BB as of the end of F2013. The bank has three operating segments (not including corporate) – Personal and Commercial Banking, Wealth Management and Financial Markets. The bank has 453 branches in Canada, the majority in the province of Quebec.

Our Thesis – Canada Wide Ambitions

Although people have recently made an issue about the outlook for the Quebec economy, economic volatility in the province tends to be below the national average. Additionally, as we highlight below, National Bank is increasingly focused on diversifying its earnings stream away from Quebec by expanding its mortgage business in the rest of the country. That will continue to put pressure on margins in F2014 in particular, but should also help keep loan growth very strong.

In terms of National Bank's other businesses we see some upside in wealth management due to the recently closed TD Institutional Services acquisition. Meanwhile, the derisking of the capital markets business should help ensure revenue consistency, but also takes away some of the upside. Last year that unit benefited from falling expenses which we do not expect to reemerge as a catalyst in either F2014 or F2015.

After being a high flyer for much of last year, NA's stock was hit hard after it reported Q4 results when it revealed that the impact to earnings from a change in pension accounting rules would be much higher than for its peers. That said, with rates likely to continue heading higher in both F2014 and F2015, that negative should turn into a positive in the coming years.

CORMARK SECURITIES INC.

The Top Three Issues

1. **Will NA Become A More Meaningful National Player?** We don't think that it is a coincidence that the terms "pan-Canadian footprint" and "pan-Canadian expansion" appear in NA's F2013 annual report three times, versus only once in F2012 and zero in F2010. Having achieved the status of a true national player in the capital markets business and completing some deals over the past few years to build out is wealth management footprint (Wellington West and the full-service advisory business of HSBC Canada) National is increasingly talking up its ambition to become more of a national player in P&C banking. To this end, the bank announced that it will deploy its mortgage platform outside of the country in F2014 in order to support mortgage lending across Canada. We expect NA to continue to grow nationally primarily through the broker channel, not by attempting to significantly build out its branch network. We see this expansion as expanding organically at least for the foreseeable future. Although NA could theoretically buy a loan origination vehicle in central and western Canada, we would expect its current push to lead to more than enough volume growth over the next two years. As of Q4/F13, about 67% on the bank's mortgages were in Quebec versus 71% in Q2/F12, and we expect this share to continue to decrease.

2. **Does The Stock Deserve A Premium To CIBC?** National Bank has historically traded at the widest discount to the group among the Big Six. That discount narrowed materially starting in mid-2010, to the point where the bank was trading at premium to CIBC for most of F2011 and the better part of 2012. That discount really began to widen again in F2013 as market perception of CIBC began to change for the better, but also due to some NA-specific factors including a big hit to pension expenses from the application of IAS19. We believe that CIBC deserves to trade at a premium to NA, and would expect that gap to widen in CIBC's favor through our forecast period.

3. **What Is The Outlook For Dividend Growth And Buybacks?** National Bank saw its declared divided grow by 12% in F2013, which was well above the group average of 8%. We expect dividend growth to continue to outpace the group in F2014 and F2015 as the bank pushes its payout ratio toward the mid-point of its target range. In terms of the buyback, the company has stated that it will resume its current program as soon as its Basel III CET1 ratio heads back to 8.75%, which we calculate will be the end of F2014.

Loan Growth And Margins

We expect NA to be able to drive above average domestic loan growth thanks to increased focus on building market share outside of its home province. Loan growth came in at just over 7% in F2013 and we expect a similar pace in F2014 before easing up a little in F2015. As with BMO, this push into mortgages has come at the expense of margins, and although we expect margin pressure to largely subside in F2014 for the group as a whole, NA should lag the group given the bank's changing business mix.

Other Income

Our outlook for NA's capital markets business is quite stable through our forecast period. Earnings grew by 15% Y/Y in F2013, but that was largely due to falling expenses and loan loss recoveries as revenues were up only 6%. We see revenues continuing at their current pace in F2014 with a modest improvement in F2015. However, we don't see much more room on the expense line. The firm highlighted that it will continue to maintain an efficiency ratio in the mid-40% range. NA has significantly reduced its proprietary trading activity, which is helping revenue consistency, but does limit upside.

Credit

National bank continued to have the lowest loss ratio among the Big Six banks in F2013 (BMO excepted), and in fact saw a decline from its already low level in F2012. Looking ahead, we expect these loss ratios to drift slightly higher, but not meaningfully so. For F2014 and F2015, we forecast a loan loss ratio of 0.20% that compares with 0.19% in F2013.

Expenses

Despite posting good overall results in Q4/F13, NA's stock got hit hard as the bank revealed that it would see a much larger hit to pension expenses from the adoption of IAS19 than any of its peers. At the time the bank estimated that this change would increase F2014 expenses by $51 MM after-tax or $0.31 per share, which is just under 4% of F2013 core cash EPS. We note that the charge has now been applied retrospectively. Although NA will saw the biggest hit to pension expenses this time around, it stands to benefit the most if rates head higher in future periods.

Capital, Dividends & Buybacks

The bank ended the quarter with a Basel III CET1 ratio of 8.7%, however excluding the charge from the CVA phase-in (-20 bps) and the charge from the acquisition of TD's institutional services business (-40 bps) the pro forma number is 8.1%. Note that NA will not see a hit to capital from the adoption of IAS19 as it elected to move away from the corridor approach and fully recognize changes to funded portion of its employee benefit plans in Q4/F12 just ahead of conversion to IFRS on November 1, 2013. NA made this change a year ahead of its peers in order to manage expenses in F2013.

NA has a buyback in place for 2% of shares outstanding, but has said it will not act on it until the CET1 ratio hits 8.75%. Given that NA generates excess capital at an average of about 20 bps per quarter we don't expect to see the buyback turned back on until the first quarter of F2015.

Earnings

We forecast core cash EPS of $4.18 for NA in F2014 followed by $4.49 in F2015. That works out to growth of 3.5% in F2014 followed by a gain of 7.5% the year after. Results in F2014 should be weighed down by ongoing margin pressure as the firm continues to drive lending growth as well as no growth in capital markets revenues.

Valuation

We derive our $49 target by applying a 10.9x P/E multiple to our F2015E EPS estimate. Our target multiple represents a discount of 11% to the group, which is in line with the historical average. The stock currently trades at 10.2x our F2014 EPS estimate and 9.4x our F2015 EPS estimate.

Figure 76 **National Bank Summary Forecast Model ($MM)**

Fiscal YE October 31			2014E					
All Information on Core Bases	**2012A**	**2013A**	**Q1E**	**Q2E**	**Q3E**	**Q4E**	**2014E**	**2015E**
Core Net Interest Income	2,042	2,016	528	510	541	558	2,136	2,352
Other Income	3,033	3,214	813	813	818	823	3,266	3,379
Gross Revenue	5,075	5,230	1,341	1,323	1,358	1,381	5,403	5,731
PCL	(180)	(181)	(50)	(52)	(53)	(53)	(208)	(229)
Gross Revenue After PCL	4,895	5,049	1,291	1,271	1,305	1,328	5,195	5,502
Non-Interest Expense	(3,051)	(3,147)	(811)	(804)	(807)	(810)	(3,230)	(3,410)
Net Income Before Taxes	1,844	1,902	480	467	499	518	1,964	2,092
Income Taxes	(485)	(479)	(120)	(117)	(125)	(130)	(491)	(523)
Non-Controlling Interest	(61)	(63)	(16)	(16)	(16)	(16)	(64)	(64)
Net Income	1,298	1,360	344	334	358	373	1,409	1,505
Preferred Dividends	(43)	(40)	(8)	(8)	(8)	(8)	(32)	(32)
Net Income to Common	1,255	1,320	336	326	350	365	1,377	1,473
Reported GAAP EPS - Fully Dil.	$4.58	$4.31	$1.02	$0.99	$1.06	$1.10	$4.18	$4.49
Cash EPS (FD Excl. EO Gains)	$3.85	$4.04	$1.02	$0.99	$1.06	$1.10	$4.18	$4.49
Profitability, Cap. Ratios & Other								
Core Cash ROE (Excl. EO Items)	20.5%	18.8%	17.8%	16.8%	17.6%	17.9%	17.5%	17.1%
Return on RWA's (Trailing 4-Qtr.)	2.33%	2.22%	2.20%	2.17%	2.13%	2.14%	2.14%	2.09%
Efficiency Ratio (excl. EO items)	60.1%	60.2%	60.5%	60.8%	59.4%	58.6%	59.8%	59.5%
Book Value	$20.02	$22.97	$23.48	$24.02	$24.61	$25.24	$25.24	$27.74
Core Effective Tax Rate	26.3%	25.2%	25.0%	25.0%	25.0%	25.0%	25.0%	25.0%
Common Dividends	$1.54	$1.70	$0.46	$0.46	$0.48	$0.48	$1.88	$2.08
Payout Ratio	39.7%	41.8%	44.6%	46.0%	44.8%	43.0%	44.6%	46.0%
Basel III CET1 Ratio	7.3%	8.7%	8.8%	8.9%	9.0%	9.1%	9.1%	9.3%
Tier 1 Capital Ratio	12.0%	11.4%	11.4%	11.4%	11.5%	11.5%	11.5%	11.6%
Average Shares O/S (Fully Dil.)	326	329	329	330	330	330	330	327
Credit								
Specific Provisions	$180	$181	$50	$52	$53	$53	$208	$229
Avg. Net Loans & Acceptances	$85,723	$94,430	$98,562	$101,040	$103,581	$106,185	$102,358	$111,914
PCL Ratio (% of Loans + Accept.)	0.21%	0.19%	0.20%	0.21%	0.20%	0.20%	0.20%	0.20%
Capital Markets								
Total Trading Revenue	$544	$674	$170	$170	$170	$170	$680	$700
Underwriting and Advisory Fees	$318	$301	$75	$75	$75	$75	$300	$312
Securities Brokerage Comm.	$343	$335	$80	$81	$82	$82	$325	$336
Less: Variable Compensation	$692	$678	$169	$169	$170	$170	$679	$701
Variable Compensation Ratio	57.4%	51.8%	52.0%	52.0%	52.0%	52.0%	52.0%	52.0%
Lending Net Interest Income								
Net Interest Income	$2,042	$2,016	$528	$510	$541	$558	$2,136	$2,352
Non-trading Average Earn. Assets	$110,080	$124,629	$131,685	$134,977	$138,352	$141,811	$136,706	$149,044
NIM On Non-trading AEA	1.86%	1.62%	1.59%	1.55%	1.55%	1.56%	1.56%	1.58%
Net Loans & BAs Outstanding	$90,922	$97,338	$99,786	$102,295	$104,867	$107,503	$107,503	$116,412
Operating Leverage								
Gross Revenue	$5,075	$5,230	$1,341	$1,323	$1,358	$1,381	$5,403	$5,731
Non-Interest Expenses	$3,051	$3,147	$811	$804	$807	$810	$3,230	$3,410
Operating Leverage	(2.3%)	(0.1%)	0.4%	(0.5%)	2.3%	1.3%	0.6%	0.5%

Source: Company Reports, Cormark Securities

Royal Bank of Canada

(RY - $60.10, TSX)

Recommendation: MARKET PERFORM Target Price: $80.00

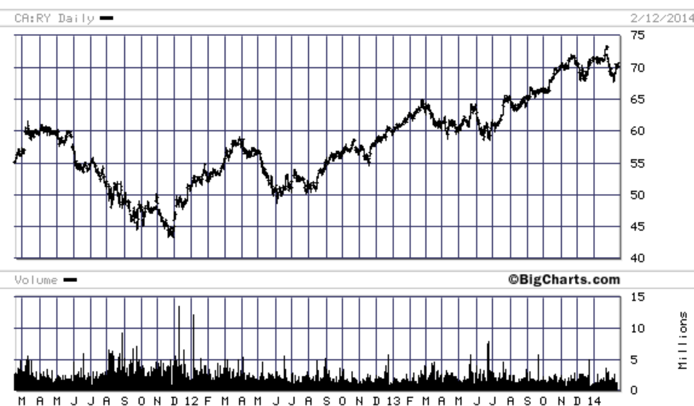
Figure 77 **Statistics & Estimates**

Current Price	$70.10	Shares Outstanding (MM)		
52 Wk High	$74.69	Diluted		1,463
52 Wk Low	$58.68	Market Cap (MM)		$102,537
BVPS	$29.88			
Dividend	$2.68			
Dividend Yield	3.8%			

Fiscal YE Oct. 31		2013A	2014E	2015E
Adj. EPS (dil.) *	Q1	$1.36	$1.41	$1.51
	Q2	$1.29	$1.38	$1.55
	Q3	$1.47	$1.44	$1.62
	Q4	$1.41	$1.45	$1.64
	FY	**$5.53**	**$5.68**	**$6.32**
BVPS		$29.88	$32.38	$35.28
Tang. BVPS		$22.18	$24.56	$27.35
BVPS Growth	y.o.y.	13%	8%	9%
EPS Growth	y.o.y.	14%	3%	11%
ROE**		20.0%	18.6%	19.0%
P/E		12.7x	12.3x	11.1x
P/BVPS		2.3x	2.2x	2.0x
P/Tang. BVPS		3.2x	2.9x	2.6x

Source: Company reports, Cormark Securities Inc. estimates

Figure 78 **Price Chart**



Source: BigCharts.com (February 12/14)

Our Recommendation

We are initiating our coverage on Royal Bank (RY-TSX) with Market Perform rating and $80.00 target.

RY is the largest Canadian bank by market capitalization, but ranks second by assets (just behind TD) at $860 BB as of the end of F2013. The bank has five operating segments (not including corporate) which are: Personal & Commercial Banking (which includes international banking), Insurance, Wealth Management, Investor and Treasury Services and Capital Markets. Royal Bank has 1,255 branches in Canada and 117 internationally.

Our Thesis – Where To Go and Grow?

There is no doubt that Royal Bank is a Canadian banking powerhouse, but given that domestic loan growth is constrained, that advantage is less meaningful than in a more robust environment. RY's scale give it a cost advantage relative to its peers, but despite the fact that the company has targeted further reduction in its efficiency ratio, we see its medium-term goal as particularly challenging.

Despite the stable earnings outlook for the Canadian P&C business, we see upside to estimates for both the Capital Markets segment driven by improving activity in the US and Europe, as well for Investor Services as short rates begin to rise in F2015.

More strategically, the bank is at a crossroad in terms of international expansion. After leaving US retail banking in 2011, and amid signs that it is pulling away from its Caribbean retail business as well, the bank needs to define what it wants to be rather than just what it doesn't want to be outside of Canada. RY successfully built out its capital markets business into a global powerhouse, but is unlikely to want to see this unit get bigger given current risk tolerances and regulatory constraints. Wealth management is the most logical area of international expansion, but the bank has not made a significant acquisition in this space since it purchased UK-based BlueBay Asset Management in 2010. We see these strategic questions as weighing somewhat on the bank's peer-leading valuation.

CORMARK SECURITIES INC.

The Top Three Issues

1. **Will Royal Leave The Caribbean?** The announcement on January 29 that RY was selling its Jamaican operations was not important from a direct financial perspective. After all, the deal whose terms were not disclosed will have no impact on capital ratios and the loss on sale that the bank will recognize amounts to only about $0.04 per share. Furthermore, why Royal Bank would not want to be operating a retail operation in Jamaica specifically is also clear. The country has been dealing with a string of economic crises for years, and is currently struggling under austerity mandated by the IMF in return for a $2 BB rescue package in 2013. The bigger more strategic question though is what does this all mean for RY's presence in the region altogether? In our view, given the opportunity, Royal would jump at the chance to get out of the Caribbean, and for many of the same reasons that it left US retail banking in F2011. Besides the cyclical issues facing the region, RY does not have enough scale in many markets and no desire to acquire that scale.

2. **Where Will RY Choose to Build?** The past few years have seen Royal Bank leave markets (US retail banking and now Jamaica), but it has yet to clearly articulate an international growth strategy. The answer does not appear to be capital markets, where the firm has already built a strong global platform largely organically. That leaves wealth management where the bank has already taken some tentative steps to build its global presence, but has not yet made any big moves. We see a potential opportunity for expansion in Europe given the region's aging demographics and the prospect for distressed sales as a result of the ECB's asset quality review (AQR).

3. **Can The Efficiency Ratio Be Driven Any Lower?** Although RY has set a medium-term target for its peer-leading efficiency ratio in the low-40% range, we believe that it will be increasingly difficult for the bank to achieve this goal, especially with revenue growth somewhat constrained by modest domestic loan growth. Although Royal has been able to lower its efficiency ratio from the 60% range in F2003 down to the high 40s and low 50s in F2009/10, progress has been largely nonexistent since then. Part of the reason is that unlike in other sectors technology is not leading to lower costs in the branch banking business. The rise of internet banking should have reduced the number of branches, but in fact they have gone up slightly during this period.

Loan Growth And Margins

Royal Bank saw solid loan growth of 8% in F2013. That was not at the top of the peer group, but was near the average. Loan growth in Canadian P&C was up about 7% Y/Y, which is about where it has been running at for the past eight quarters. We expect this figure to remain quite stable in F2014 and head modestly higher in F2015 helped by strong growth in RY's expanding capital markets loan book, which has expanded by over 40% over the past two years.

RY's reported net interest margin was negatively impacted this year by accounting volatility as well as the bank's acquisition of Ally Financial's Canadian auto finance business. However, on an adjusted basis RY's margin was little changed from F2012, and the bank continues to fare better than most of its peers. We see the margin continuing to hold relatively stable in F2014, followed by modest expansion in F2015.

Other Income

We believe that RY has a number of underappreciated fee-income levers that will become more apparent over the coming years. Everyone knows the dominance that RBC Capital Markets enjoys in Canada, but the earnings power of its international capital markets operations has remained hidden given that it has been hobbled by a series of headwinds in F2013 from the crisis in Cyprus to volatility in the US municipal bond market early in the summer. RY's diversified capital markets platform ensures that it is better positioned than any of its peers to benefit from improving deal volumes in both the US and Europe over the coming two years.

CORMARK SECURITIES INC.

Meanwhile, the bank's Investor & Treasury Services business also has latent earnings power that has yet to be proven given that it was born into a very difficult rate environment. We believe that this business is set to benefit from rising AUM and a steepening yield curve over the coming two years.

Credit

Although RY's loan loss ratio did move up a little toward the end of F2013 primarily as a result of higher provisions in Canada and the Caribbean, at 0.32% it is still well below where it was even at the start of the year. We continue to see credit as being an issue in the Caribbean, but that unit is small and with the pending sale of RY's Jamaican operation only getting smaller for the time being. Meanwhile, as we continue to point out, the Canadian credit environment looks very stable with no serious threats on the horizon. We see loan loss ratios inching up slightly in F2014 and F2015.

Expenses

RY posted negative operating leverage in F2013, but that was impacted by the Ally Financial transaction. Synergies from that deal are expected to come in this year. The bank is continuing to guide to an efficiency ratio in the low-40% range over the medium term, helped by a number of new initiatives including the launch of a new mortgage origination system for Canadian banking in F2014. Based on our numbers, RY's efficiency ratio was 51.8% in F2013, and we see it moving down to just 50.2% by F2015.

Capital, Dividends & Buybacks

Royal Bank ended the quarter with a pro forma Basel III CET1 capital ratio of 9.2%. That includes a 30 bps impact from the CVA phase-in as well as an additional 10 bps impact from the adoption of IAS19. The bank raised its declared dividend by 12% last year, and we expect that pace to continue given its strong internal capital generation. We also see the buyback continuing on pace. RY has a 30 MM share NCIB in place, which amounts to about 2% of total shares outstanding, and we expect it will be renewed at the same level in F2015.

Earnings

We forecast core cash EPS of $5.68 for RY in F2014, followed by $6.32 in F2015. That works out to growth of just 2.5% in F2014 followed by growth of over 11% the year after. The F2014 growth rate is being held down by slightly higher credit provisions as well as a slower pace of growth in net interest income after F2013 got a boost from the Ally acquisition.

Valuation

We derive our $80.00 target by applying a 12.6x P/E multiple to our F2015E EPS estimate. The target multiple stands at the top of our range, and represents a premium of 6% to the group. That compares to a 10-year historical average premium of 8%. The stock currently trades at 12.3x our F2014 EPS estimate and 11.1x our F2015 EPS estimate.

Figure 79 **Royal Bank Summary Forecast Model ($MM)**

Fiscal YE October 31			2014E					
All Information on Core Bases	**2012A**	**2013A**	**Q1E**	**Q2E**	**Q3E**	**Q4E**	**2014E**	**2015E**
Core Net Interest Income	10,712	11,590	2,992	2,909	3,037	3,082	12,019	12,770
Ins. Prem., Invest. & Fee Income	4,897	4,071	1,137	1,194	1,254	1,316	4,901	5,399
Other Income	13,657	15,541	4,021	4,067	4,113	4,160	16,361	17,451
Gross Revenue	29,266	31,202	8,150	8,170	8,404	8,559	33,282	35,619
PCL	(1,299)	(1,237)	(335)	(340)	(350)	(355)	(1,380)	(1,445)
Gross Revenue After PCL	27,967	29,965	7,815	7,830	8,054	8,204	31,902	34,174
Ins. p/h Ben., Claims & Acq. Exp.	(3,621)	(2,784)	(819)	(860)	(903)	(948)	(3,529)	(3,887)
Non-Interest Expense	(14,460)	(16,150)	(4,169)	(4,218)	(4,286)	(4,377)	(17,049)	(17,891)
Net Income Before Taxes	9,886	11,031	2,827	2,752	2,865	2,879	11,324	12,397
Income Taxes	(2,388)	(2,754)	(721)	(702)	(731)	(734)	(2,888)	(3,161)
Non-Controlling Interest	(97)	(98)	(24)	(24)	(24)	(24)	(96)	(96)
Net Income	7,401	8,179	2,082	2,026	2,111	2,121	8,340	9,139
Pref. Divs. & Capital Instruments	(205)	(200)	(48)	(48)	(48)	(48)	(192)	(192)
Net Income to Common	7,196	7,979	2,034	1,978	2,063	2,073	8,148	8,957
After-Tax Intangibles	112	117	30	30	30	30	120	120
Core Cash Earnings	7,308	8,096	2,064	2,008	2,093	2,103	8,268	9,077
Reported GAAP EPS (Fully Dil.)	$4.93	$5.55	$1.39	$1.36	$1.42	$1.43	$5.59	$6.24
Cash EPS (FD Excl. EO Gains)	$4.98	$5.53	$1.41	$1.38	$1.44	$1.45	$5.68	$6.32
Profitability, Cap. Ratios & Other								
Core Cash ROE (Ex. EO Items)	20.0%	20.0%	19.0%	18.2%	18.6%	18.4%	18.6%	19.0%
Return on RWA's (Trailing 4-Qtr)	2.61%	2.61%	2.56%	2.56%	2.52%	2.50%	2.50%	2.63%
Efficiency Ratio (Excl. EO Items)	49.4%	51.8%	51.2%	51.6%	51.0%	51.1%	51.2%	50.2%
Book Value	$26.54	$29.88	$30.51	$31.09	$31.75	$32.38	$32.38	$35.28
Core Effective Tax Rate	24.2%	25.0%	25.5%	25.5%	25.5%	25.5%	25.5%	25.5%
Common Dividends	$2.28	$2.53	$0.67	$0.70	$0.70	$0.74	$2.81	$3.12
Payout Ratio	45.0%	45.1%	47.5%	50.9%	48.6%	51.0%	49.5%	49.3%
Basel III CET1 Ratio	8.4%	9.6%	9.7%	9.8%	10.0%	10.1%	10.1%	10.6%
Tier 1 Capital Ratio	13.1%	11.7%	11.8%	11.9%	12.0%	12.1%	12.1%	12.5%
Average Shares O/S (Fully Dil.)	1,469	1,463	1,464	1,459	1,454	1,449	1,449	1,429
Credit								
Specific Provisions	$1,299	$1,237	$335	$340	$350	$355	$1,380	$1,445
Avg. Net Loans & Acceptances	$372,235	$403,043	$420,907	$425,135	$429,406	$433,720	$427,303	$440,767
PCL Ratio (% of Loans + Accept.)	0.35%	0.31%	0.32%	0.33%	0.32%	0.32%	0.32%	0.33%
Capital Markets								
Total Trading Revenue	$3,266	$2,906	$750	$750	$750	$750	$3,000	$3,160
Underwriting & Other Advisory	$1,434	$1,569	$400	$400	$400	$400	$1,600	$1,700
Securities Brokerage Comm.	$1,182	$1,337	$337	$341	$344	$348	$1,370	$1,425
Less: Variable Compensation	$3,638	$3,924	$967	$969	$971	$973	$3,880	$4,085
Variable Compensation Ratio	61.8%	67.5%	65.0%	65.0%	65.0%	65.0%	65.0%	65.0%
Lending Net Interest Income								
Net Interest Income	$10,712	$11,590	$2,992	$2,909	$3,037	$3,082	$12,019	$12,770
Non-trading Avg. Earn. Assets	$520,121	$569,042	$576,151	$581,912	$587,732	$593,609	$584,851	$612,393
NIM On Non-trading AEA	2.06%	2.04%	2.06%	2.05%	2.05%	2.06%	2.06%	2.09%
Net Loans & BAs Outstanding	$387,626	$418,803	$423,011	$427,260	$431,553	$435,888	$435,888	$445,393
Operating Leverage								
Gross Revenue	$29,266	$31,202	$8,150	$8,170	$8,404	$8,559	$33,282	$35,619
Non-Interest Expenses	$14,460	$16,150	$4,169	$4,218	$4,286	$4,377	$17,049	$17,891
Operating Leverage	2.1%	(5.1%)	(0.7%)	(0.9%)	1.2%	(0.3%)	1.1%	2.1%

Source: Company Reports, Cormark Securities

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Toronto-Dominion Bank

(TD - $48.58, TSX)

Recommendation: BUY

Target Price: $59.00

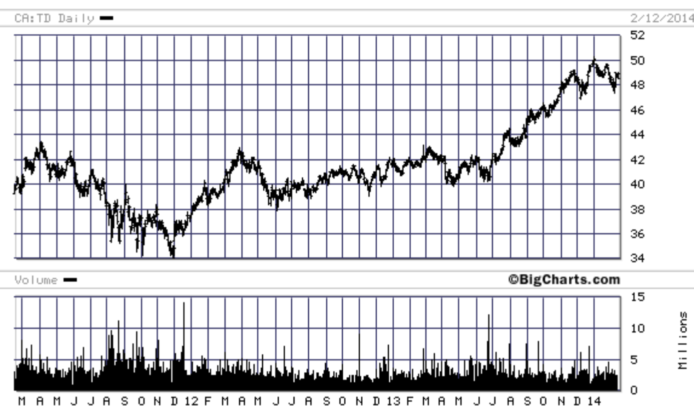
Figure 80 **Statistics & Estimates**

Current Price	$48.58	Shares Outstanding (MM)		
52 Wk High	$50.28	Diluted		1,839
52 Wk Low	$39.80	Market Cap (MM)		$89,339
BVPS	$25.65			
Dividend	$1.72			
Dividend Yield	3.5%			

Fiscal YE Oct. 31		2013A	2014E	2015E
Adj. EPS (dil.) *	Q1	$1.00	$1.02	$1.19
	Q2	$0.95	$0.97	$1.12
	Q3	$0.82	$1.06	$1.21
	Q4	$0.95	$1.06	$1.21
	FY	**$3.71**	**$4.11**	**$4.72**
BVPS		$25.65	$27.83	$30.37
Tang. BVPS		$17.75	$19.93	$22.46
BVPS Growth	y.o.y.	-23%	9%	9%
EPS Growth	y.o.y.	-21%	11%	15%
ROE**		15.0%	15.2%	15.8%
P/E		13.1x	11.8x	10.3x
P/BVPS		1.9x	1.7x	1.6x
P/Tang. BVPS		2.7x	2.4x	2.2x

Source: Company reports, Cormark Securities Inc. estimates

Figure 81 **Price Chart**



Source: BigCharts.com (February 12/14)

Our Recommendation

We are initiating our coverage on TD Bank (TD-TSX) with Buy rating and $59.00 target price.

TD is the second largest Canadian bank by market capitalization, but ranks first by assets at $863 BB as of the end of F2013. As of its year-end resegmentation, the bank now has three operating segments (not including corporate): Canadian Retail (including TD Auto Finance Canada and Canadian wealth and insurance), U.S. Retail (including TD Auto Finance U.S., U.S. wealth including Epoch, and the bank's investment in TD Ameritrade). TD has 1,179 branches in Canada and 1,317 in the US.

Our Thesis – Red, White And Blue

Like BMO, our favorable view on TD is punctuated by its significant exposure to the recovering US banking sector which is on a clear cyclical upswing after being battered by a once-in-a-lifetime crisis. In the short run, TD's retail banking business will be weighed down by very weak refinancing activity in the residential mortgage market, but that should be short-lived as the economic recovery continues to gather steam and drive the real estate market up from still near trough levels in many parts of the country. Also boosting results in the US will be higher long rates in F2014, followed by increasing short rates by F2015. Although rising rates will significantly impact securities gains, that drag should be increasingly dwarfed by an expansion in margins. Additional short-term drivers in the US are the Target credit card and Epoch wealth management deals.

Significant growth opportunity in the US is complemented by a Canadian business that has already been delivering strong results, but is now ready to see increased momentum from its Aeroplan deal in particular. Canadian wealth management is also showing strong momentum excluding insurance, which had a particularly nasty F2013.

CORMARK SECURITIES INC.

The Top Three Issues

1. **What Is The Outlook For The US Segment?** We view the latent potential of TD's US retail franchise as a key reason why earnings growth here will lead the Big Six in F2014 and F2015, and why TD has the best long-term strategic position of all its peers. While some banks like CIBC and Royal are still trying to figure out a longer-term growth strategy, for TD all roads lead to the US. The bank built its platform largely in the lead up to the financial crisis, and is now ready to reap the rewards as the US banking sector lifts itself from a historic trough. That will not fully happen in F2014, but momentum will be building. There are some Canadian bank investors who obsessively lament the low ROEs that the US business earns relative to Canada, but by that measure the bank would not make any other investment. The fact is that returns in the US will probably never be as high as in Canada, but returns will increase over time. The growth potential the TD has south of the border is immense given both its small share of the US loan market and an extremely favorable outlook for US credit growth.
2. **Will TD Make More Acquisitions In The US?** A big overhang on the shares for much of F2013 was the question of whether TD would make a run for Citizen's Bank given the difficulty its parent RBS (RBS-NYSE) was having in the UK. From a strategic point of view, the deal had its pluses given the complementary footprint and the fact that this acquisition would catapult TD from a Top 10 player in US retail banking into the Top 5. That said, there were also negatives, including the fact that given its existing scale in the US, TD no longer feels compelled to pay up for acquisitions. In the end after a series of increasingly forceful denials, the issue went away. However, anytime a US retail banking asset comes up for sale, TD is invariably included in a list of potential buyers.
3. **Is TD Growing Its Balance Sheet Too Aggressively In Canada?** On the face of it, F2014 would seem to be an inopportune time for a bank to aggressively expand its credit card lending book given the overleveraged state of the Canadian consumer. Yet, TD signed up for just that when it became the prime Aeroplan credit card issuer and purchased 50% of CM's existing Aeroplan balances. This move makes a lot of sense for a number of reasons. First off is expediency. TD was underrepresented in this market for historical reasons and organic growth alone was not going to get it to its natural market share in a reasonable amount of time. Secondly, with personal loan growth slowing across the entire market, increasing market share is an effective way to drive above-average loan growth. Finally, despite the overleveraged consumer, we do not see any sign that credit will be an issue through our forecast period. Besides, premium cards are less cyclically sensitive than other cards.

Loan Growth And Margins

We see TD delivering peer-leading loan growth in both Canada and the US through our forecast period. In Canada, growth will be helped by the acquisition of 50% of CM's Aeroplan book of business, while in the US loan growth will be positively impacted by the Target deal and TD's ongoing efforts to continue to grab market share in the US. Temporary obstacles include the end of the mortgage refinancing boom, as well as still weak demand for new mortgages. However, demand should be steadily increasing through F2014 and particularly in F2015 as US economic momentum continues to build. In terms of margins, they should stabilize in F2014, before expanding in F2015. TD's margin performance should be better than the group average given that it has been more aggressive than its peers in shortening duration. The bank's US operations are also more sensitive to an increase in longer rates given how deposit-heavy the unit is. In addition, margins should also be boosted by a growing credit card business on both sides of the border.

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Other Income

We expect increased momentum in wealth management fees helped by the recently-closed Epoch acquisition, which according to Management commentary is doing significantly better than expected. Like most of its peers, we would expect TD to continue to look for modestly-sized asset managers in the US to build out its American wealth management business. These types of deals make particular sense for TD given its strong and growing branch distribution network in the US.

Credit cards are another area where TD should enjoy above-average growth after some savvy deal-making in F2013. The Aeroplan and Target card programs will deliver immediate scale in a business line in which TD was underrepresented, as well as ensure strong growth for years to come.

In terms of capital markets, F2013 was not a great year for TD, but while the company should see significant improvement in F2014 that is unlikely to continue in F2015. Given the fact that the domestic outlook for this business is quite mediocre and investors are less inclined to pay up for these revenues, we view TD's relatively smaller wholesale banking business as a plus.

Credit

TD carries a higher loan loss ratio than the Big Six peer average given its US exposure. We expect this measure to continue to move higher, particularly in F2014 as TD bulks up in credit cards on both sides of the border – which are a higher loss product.

Expenses

Although Management talked a lot about cost control in F2013, results were disappointing. Operating leverage was negatively impacted by the Target deal, but even excluding the Target deal was essentially zero. That situation should not repeat in F2014 or F2015 as the company is focused on delivering expense growth well below last year. We forecast positive operating leverage in both years. That is being helped by an uptick in revenue growth, but we also see a slower growth rate for expenses as well.

Capital, Dividends & Buybacks

TD ended F2013 with a Basel II CET1 ratio of 9.0%, or 8.6% on a pro forma basis excluding the impact from CVA phase-in (-18 bps) and the implementation of IAS19 (-10 bps), the benefit from the sale of bank's TS Waterhouse Investor Services to NA (10 bps) and the impact from the $3.3 BB in Aeroplan balances transferred from CM (-18 bps).

We expect TD to raise dividends at a faster pace than its peers given its lower payout ratio. Note that the company boosted its target payout range to 40-50% (in line with its peers) in Q4/F12 from 35-45% previously.

Earnings

We forecast core cash EPS of $4.11 for TD in F2014 followed by $4.72 in F2015. That works out to growth of 11% in F2014 followed by growth of nearly 15% the year after. The lift in F2014 is helped by both the Aeroplan and Target deals, while higher margins and slower expense growth help boost F2015.

Valuation

We derive our $59.00 target by applying a 12.5x P/E multiple to our F2015E EPS estimate. That is just below the target multiple that we use for RY. Our target multiple represents a 5% premium to the group, versus a 10-year historical average of premium of just 3%. The stock currently trades at 11.8x our F2014 EPS estimate and 10.3x our F2015 EPS estimate.

Figure 82 **TD Bank Forecast Summary Model ($MM)**

Fiscal YE October 31 All Information on Core Bases	2012A	2013A	2014E Q1E	 Q2E	 Q3E	 Q4E	 2014E	2015E
Core Net Interest Income	13,992	14,854	3,905	3,831	4,056	4,137	15,930	17,635
Other Income	9,575	9,611	2,524	2,643	2,668	2,693	10,528	11,021
Gross Revenue	23,567	24,465	6,429	6,474	6,724	6,830	26,457	28,656
PCL	(1,903)	(1,606)	(430)	(440)	(450)	(460)	(1,780)	(1,905)
Gross Revenue After PCL	21,664	22,859	5,999	6,034	6,274	6,370	24,677	26,751
Non-Interest Expense	(13,446)	(14,662)	(3,754)	(3,922)	(3,955)	(4,063)	(15,694)	(16,582)
Net Income before Taxes	8,218	8,197	2,245	2,112	2,319	2,307	8,984	10,169
Income Taxes	(1,626)	(1,565)	(427)	(401)	(441)	(438)	(1,707)	(1,932)
Non-Controlling Interest	(104)	(105)	(27)	(27)	(27)	(27)	(108)	(108)
AMTD Contribution (After-tax)	234	272	68	68	68	68	272	272
Net Income	6,722	6,799	1,860	1,752	1,920	1,910	7,441	8,401
Pref. Divs. & Capital Instruments	(192)	(185)	(49)	(49)	(49)	(49)	(196)	(196)
Net Income to Common	6,530	6,614	1,811	1,703	1,871	1,861	7,245	8,205
After-Tax Intangibles	238	232	59	59	59	59	236	236
Core Cash Earnings	6,768	6,846	1,870	1,762	1,930	1,920	7,481	8,441
Reported GAAP EPS (Fully Dil.)	$3.38	$3.45	$0.99	$0.93	$1.03	$1.03	$3.98	$4.59
Cash EPS (FD Excl. EO Gains)	$3.71	$3.71	$1.02	$0.97	$1.06	$1.06	$4.11	$4.72
Profitability, Capital Ratios & Other								
Core Cash ROE (Excl. EO It.)	16.3%	15.0%	15.7%	14.5%	15.6%	15.2%	15.2%	15.8%
Return on RWA's (Trail. 4-Qtrs)	2.73%	2.41%	2.35%	2.33%	2.44%	2.47%	2.47%	2.59%
Efficiency Ratio (Excl. EO items)	57.1%	59.9%	58.4%	60.6%	58.8%	59.5%	59.3%	57.9%
Book Value	$33.35	$25.65	$26.21	$26.70	$27.28	$27.83	$27.83	$30.37
Core Effective Tax Rate	19.8%	19.1%	19.0%	19.0%	19.0%	19.0%	19.0%	19.0%
Common Dividends	$1.45	$1.62	$0.43	$0.44	$0.44	$0.47	$1.78	$1.99
Payout Ratio	38.7%	43.5%	42.1%	45.5%	41.4%	44.2%	43.3%	42.1%
Basel III CET1 Ratio	8.2%	9.0%	9.3%	9.5%	9.7%	9.9%	9.9%	10.4%
Tier 1 Capital Ratio	12.6%	11.0%	11.3%	11.5%	11.6%	11.8%	11.8%	12.2%
Average Shares O/S (Fully Dil.)	1,840	1,839	1,831	1,823	1,815	1,807	1,807	1,775
Credit								
Specific Provisions	$1,903	$1,606	$430	$440	$450	$460	$1,780	$1,905
Avg. Net Loans & Acceptances	$403,765	$433,887	$452,488	$455,955	$462,848	$472,129	$461,498	$498,786
PCL Ratio % of Loans + Accept.	0.47%	0.37%	0.38%	0.40%	0.39%	0.39%	0.39%	0.38%
Capital Markets								
Total Trading Revenue	$1,334	$1,273	$320	$320	$320	$320	$1,280	$1,300
TD Waterhouse Fees	$384	$406	$120	$122	$123	$125	$490	$520
Underwriting & Advisory Fees	$437	$365	$95	$95	$95	$95	$380	$396
Full Serv. Brok. & Other Service	$562	$596	$149	$149	$149	$149	$596	$608
Variable Compensation	$1,561	$1,634	$424	$425	$426	$427	$1,702	$1,751
Variable Compensation Ratio	57.5%	61.9%	62.0%	62.0%	62.0%	62.0%	62.0%	62.0%
Lending Net Interest Income								
Net Interest Income	$13,992	$14,854	$3,905	$3,831	$4,056	$4,137	$15,930	$17,635
Non-trading Ave. Earning Assets	$581,804	$627,657	$645,508	$651,963	$665,002	$678,302	$660,194	$717,325
NIM On Non-trading AEA)	2.40%	2.37%	2.40%	2.41%	2.42%	2.42%	2.41%	2.46%
Net Loans & BAs Outstanding	$416,071	$451,321	$453,656	$458,253	$467,443	$476,815	$476,815	$521,249
Operating Leverage								
Gross Revenue	$21,664	$22,859	$6,429	$6,474	$6,724	$6,830	$24,677	$26,751
Non-Interest Expenses	$13,446	$14,662	$3,754	$3,922	$3,955	$4,063	$15,694	$16,582
Operating Leverage	2.2%	(3.5%)	5.6%	(3.8%)	3.0%	(1.2%)	0.9%	2.7%

Source: Company Reports, Cormark Securities

CORMARK SECURITIES INC.

Canadian Western Bank

(CWB - $36.50, TSX)

Recommendation: MARKET PERFORM Target Price: $42.00

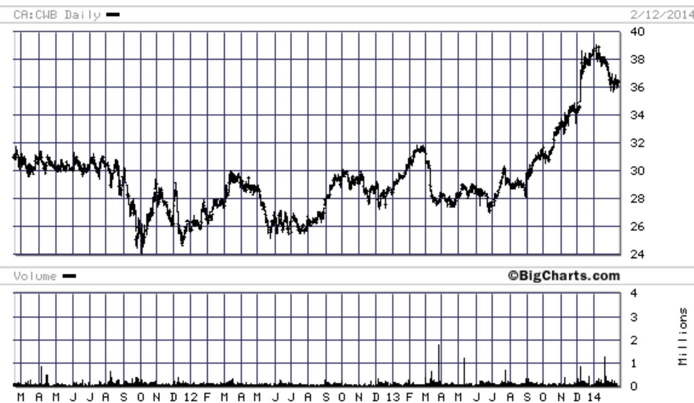
Figure 83 Statistics & Estimates

Current Price	$36.50	Shares Outstanding (MM)	
52 Wk High	$39.05	Diluted	80
52 Wk Low	$27.04	Market Cap (MM)	$2,916
BVPS	$17.54		
Dividend	$0.76		
Dividend Yield	2.1%		

Fiscal YE Oct. 31		2013A	2014E	2015E
Adj. EPS (dil.) *	Q1	$0.58	$0.65	$0.73
	Q2	$0.55	$0.61	$0.71
	Q3	$0.61	$0.70	$0.77
	Q4	$0.65	$0.72	$0.79
	FY	**$2.39**	**$2.68**	**$3.00**
BVPS		$17.54	$19.49	$21.72
Tang. BVPS		$16.04	$17.99	$20.22
BVPS Growth	y.o.y.	10%	11%	11%
EPS Growth	y.o.y.	7%	12%	12%
ROE**		14.4%	14.7%	20.3%
P/E		15.3x	13.6x	12.2x
P/BVPS		2.1x	1.9x	1.7x
P/Tang. BVPS		2.3x	2.0x	1.8x

Source: Company reports, Cormark Securities Inc. estimates

Figure 84 Price Chart



Source: BigCharts.com (February 12/14)

Our Recommendation

We are initiating our coverage on Canadian Western Bank (CWB-TSX) with a Market Perform rating and $42.00 target price.

CWB is the largest bank headquartered in Western Canada and the seventh-largest in the country. The bank has 41 banking branches including one commercial-equipment leasing centre, 8 trust locations, two centralized insurance centres, and two wealth management offices. Although the bank only has one reporting segment, it employs 2,037 people across nine business units including National Leasing, Canadian Direct Insurance and Optimum Mortgage. CWB's total assets were $18.5 BB at the end of F2013.

Our Thesis – The Safest Way To Play Margin Expansion

In our view, CWB is the safest way to play Canadian margin expansion. With over 80% of revenues coming from net interest income no bank in our coverage universe is as levered to the traditional spread lending business than Canadian Western Bank. Based on our calculations, a 5% increase in margins at CWB boosts EPS by over 8%.

The bank was under pressure for H1/F13 because of concerns over margin pressure, but the shares spiked in Q4/F13 when the company indicated that the margin has stabilized. This was helped by a number of corporate actions including raising lower cost funding through a successful deposit note program as well as by reducing liquidity levels, and should be further enhanced by rising rates.

While CWB's earnings have significant upside to rising rates, downside is limited given the strong loan growth that the bank is able to consistently deliver, and its stable credit position as a result of its conservative underwriting standards. The firm is clearly tied to the fortunes of western Canada, but direct exposure to oil and gas production (via production loans) is very small at less than 2% of the loan book.

CORMARK SECURITIES INC.

The Top Three Issues

1. **What Is The Outlook For CWB's Net Interest Margin?** CWB is very levered to margins, it is therefore no big surprise that share price rallied after the bank reported Q4/F13 largely due to guidance that the margin is stabilizing. The bank's net interest margin was actually up on the quarter both relative to Q3 and the year ago figure. Management explained that lower cost funding as well as lower liquidity levels came together to help stem further contraction, while rising long rates are also a net positive going forward.
2. **What Is The Greatest Risk To CWB?** CWB has what most Canadian banks continue to struggle for, a clear runway for above-average earnings growth over many years in in its home market. That growth opportunity is tied to western Canadian economic fortunes, which are expected to continue to outperform. Margin pressure is a threat, but it appears that the situation has stabilized and, if anything, is pointing to expansion over the next two years. CWB's biggest challenge appears to be capital given its funding disadvantage relative to the big banks, the fact that its loan book is weighted to commercial loans that have higher risk weights than residential mortgages and the fact that it is still operating under the standardized approach for calculating risk weights. Transition to AIRB is coming, but is many years out.
3. **Will CWB Be Taken Out?** One key support to CWB's high valuation is that it is a potential takeout candidate. Earlier in this report, we highlight the strategic sense that such an acquisition would make for both CM and NA. We acknowledge that there are challenges to making either deal happen, including issues of cultural fit and price given the big premium that the shares command, but there are no firm barriers. A deal would have to be friendly given the 10% ownership rules, and would require permission from the minister of finance, but a deal can get done.

Loan Growth And Margins

A number of factors conspire to ensure that CWB continually posts the fastest organic domestic loan growth among its Canadian peers. First is the fact that its loan book is small at only $18.5 BB allowing significant market share gains. Second, its loan book is focused in western Canada, a region that has consistently outgrown the rest of the country for many years. Finally, it is a niche player in the commercial lending and leasing space allowing it to effectively compete against much larger national competitors. CWB delivered Y/Y loan growth of 12% in F2013. That compares to the Big Six average of 6.5% in their Canadian retail segments.

The market was very concerned about CWB's margin contraction for the better part of F2013, but although the margin dipped early in the year, by Q4/F13 it was up 1 bps Q/Q and up 3 bps relative to the same quarter a year ago. Management commentary also suggested that the situation had stabilized in large part due to the success of the bank's bank deposit note (BDN) program which secured cheaper funding. The program was $250 MM at the end of the year and should grow to $500 MM in F2014. Also important was the fact that CWB reduced its liquidity position after building cash balances earlier in the year as a conservative measure. Although significant margin expansion won't come until the Bank of Canada raises rates, in the meantime help is being provided by the slow upward march of long rates.

Other Income

With more than 80% of revenues coming from net interest income, fee-based income is less significant at CWB than for every other bank in our coverage universe. The bank does generate fee income from its Canada Direct insurance unit and its wealth management business in particular, as well as credit-related fees. Insurance income should be more stable after taking a hit from severe weather in Alberta this past summer, but we expect much lower securities gains after a big increase in F2013.

Credit

Over the past several years, CWB's loan loss ratio has remained materially lower than its peers (five-year average of 19 bps versus Big Six banks average of 49 bps). We believe strong underwriting practices and CWB's exposure to the strong economy in Western Canada have been important aspects of this outperformance. Moving forward, both stable unemployment and insolvency rates should help sustain a solid credit record. Our model assumes a loss rate of 19 bps in F2014 and 21 bps in F2015, which is in line with Management's F2014 range of 18-23bps.

Expenses

Despite posting revenue growth of about 8.5% in F2013, CWB still posted negative operating leverage as expenses grew by 11% as the company invested in additional staff and an ongoing project to develop a new core computer system. Operating leverage should improve next year though as the margin pressure that was weighing on revenue growth this year is not coming back. Meanwhile, expense growth should be slower as a number of expense initiatives are now in the run-rate results. That said, expense growth should still be above the group average given the stronger top-line growth that this bank is expected to deliver.

Capital, Dividends & Buybacks

Near the height of the financial crisis, CWB issued $210 MM or rate-reset preferred shares at a yield of 7.25%. The yield is due to reset to Canadas +500 bps (or just under 7%) on April 20, 2014. CWB has announced that it would like to redeem the shares given the high reset rate relative to current yields as well as the fact that this type of share is being phased out of regulatory calculations. In order to maintain strong capital ratios well above the 7% minimum, Management announced at the end of Q4/F13 that it would need to replace $100-150 MM of this capital with either Basel III qualifying preferred shares (NVCC compliant capital to use the lingo) or barring that an equity issue in the same amount. The preferred share issue was financially preferable, but when it first flagged the issue in December the concern was that the market for this new type of qualifying preferred share was not yet developed. Since then, RY completed a $500 MM NVCC offering (upsized from $200 MM originally) at a yield of 4.00% annually, and NA completed at $350 MM NVCC issue (upsized from $200 MM originally) at a yield of 4.10%. This gave CWB a window to complete a $125 MM (upsized from $100 MM) NVCC preferred issue on February 10 at a yield of 4.40%.

Earnings

We forecast core cash EPS of $2.68 for CWB in F2014 followed by $3.00 in F2015. That works out to growth of 12% in F2014 and F2015. We expect EPS in F2014 to be at the lower end of the firm's 12-16% F2014 target as expense growth remains strong.

Valuation

We derive our $42.00 target by applying a 14.0x P/E multiple to our F2015E EPS estimate. Our target multiple represents a 19% premium to the group, versus a 10-year historical average premium of 21%. The stock currently trades at 13.6x our F2014 EPS estimate and 12.2x our F2015 EPS estimate.

Figure 85 **Canadian Western Bank Forecast Summary Model ($MM)**

Fiscal YE October 31 All Information on Core Bases	2012A	2013A	2014E Q1E	Q2E	Q3E	Q4E	2014E	2015E
Net Interest Income	$443.6	$477.5	$129.0	$127.5	$135.1	$138.4	$530.0	$591.0
Other Income	$84.4	$95.0	$24.9	$25.4	$25.8	$26.2	$102.3	$108.5
Gross Revenue	$528.0	$572.5	$153.9	$152.9	$160.8	$164.6	$632.3	$699.5
PCL	$(25.1)	$(27.8)	$(7.5)	$(7.5)	$(7.9)	$(8.1)	$(31.1)	$(38.0)
Gross Revenue After PCL	$502.9	$544.6	$146.4	$145.4	$152.9	$156.5	$601.2	$661.4
Non-Interest Expense	$(236.6)	$(262.5)	$(69.5)	$(71.2)	$(72.8)	$(74.6)	$(288.1)	$(315.4)
Net Income Before Taxes	$266.3	$282.1	$76.9	$74.2	$80.1	$81.9	$313.1	$346.0
Income Taxes	$(69.4)	$(72.2)	$(19.7)	$(19.0)	$(20.5)	$(21.0)	$(80.2)	$(88.6)
Non-Controlling Interest	$(7.1)	$(7.6)	$(2.0)	$(2.0)	$(2.0)	$(2.0)	$(8.1)	$(8.1)
Net Income	$189.9	$202.4	$55.2	$53.2	$57.5	$58.9	$224.8	$249.3
Preferred Dividends	$(15.2)	$(15.2)	$(3.8)	$(5.2)	$(1.4)	$(1.4)	$(11.7)	$(5.5)
Net Income to Common	$174.7	$187.2	$51.4	$48.0	$56.2	$57.5	$213.1	$243.8
After-Tax Intangibles	$3.6	$3.2	$1.0	$1.0	$1.0	$1.0	$3.8	$3.8
Core Cash Earnings	$178.3	$190.4	$52.3	$49.0	$57.1	$58.5	$217.0	$247.7
Reported GAAP EPS - Fully Diluted	$2.22	$2.35	$0.64	$0.60	$0.69	$0.71	$2.63	$2.95
Core EPS - FD Excl. EO Gains	$2.30	$2.39	$0.65	$0.61	$0.70	$0.72	$2.68	$3.00
Profitability, Capital Ratios & Other								
Core ROE (Excl. EO items)	15.5%	14.4%	14.7%	13.8%	15.2%	15.1%	14.7%	20.3%
Return on RWA's (Trailing 4-Quarter)	1.34%	1.23%	1.22%	1.22%	1.24%	1.25%	1.25%	1.27%
Efficiency Ratio (Excl. EO items)	44.8%	45.9%	45.2%	46.5%	45.3%	45.3%	45.6%	45.1%
Book Value	$15.94	$17.54	$18.02	$18.48	$18.98	$19.49	$19.49	$21.72
Core Effective Tax Rate	26.0%	25.6%	25.6%	25.6%	25.6%	25.6%	25.6%	25.6%
Common Dividends	$0.62	$0.70	$0.19	$0.19	$0.20	$0.20	$0.78	$0.94
Core Payout Ratio	26.8%	29.1%	28.9%	30.9%	27.9%	27.2%	28.6%	30.2%
Basel III CET1 Ratio	8.1%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Tier 1 Capital Ratio	10.6%	9.7%	9.7%	9.6%	9.6%	9.5%	9.5%	9.3%
Average Shares O/S (Gully Diluted)	77.5	79.6	80.3	80.7	81.1	81.5	80.9	82.6
Credit								
Provision for Credit Losses	$25.1	$27.8	$7.5	$7.5	$7.9	$8.1	$31.1	$38.0
Avg. Net Loans & Acceptances	$13,206	$14,792	$15,804	$16,199	$16,604	$17,019	$16,406	$18,109
PCL Ratio (% of Loans + Accept.)	0.19%	0.19%	0.19%	0.19%	0.19%	0.19%	0.19%	0.21%
Lending Net Interest Income								
Net Interest Income	$443.6	$477.5	$129.0	$127.5	$135.1	$138.4	$530.0	$591.0
Average Assets	$15,878	$17,680	$18,681	$19,148	$19,627	$20,117	$19,393	$21,406
Net Interest Margin	2.79%	2.70%	2.74%	2.73%	2.73%	2.73%	2.73%	2.76%
Net Loans & BAs Outstanding	$13,954	$15,577	$15,966	$16,365	$16,775	$17,194	$17,194	$18,979
Operating Leverage								
Gross Revenue	$528.0	$572.5	$153.9	$152.9	$160.8	$164.6	$632.3	$699.5
Non-Interest Expense	$236.6	$262.5	$69.5	$71.2	$72.8	$74.6	$288.1	$315.4
Operating Leverage	0.1%	(2.5%)	(0.4%)	(3.0%)	2.8%	(0.0%)	0.7%	1.1%

Source: Company Reports, Cormark Securities

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Laurentian Bank of Canada

(LB - $46.03, TSX)

Recommendation: BUY **Target Price: $61.00**

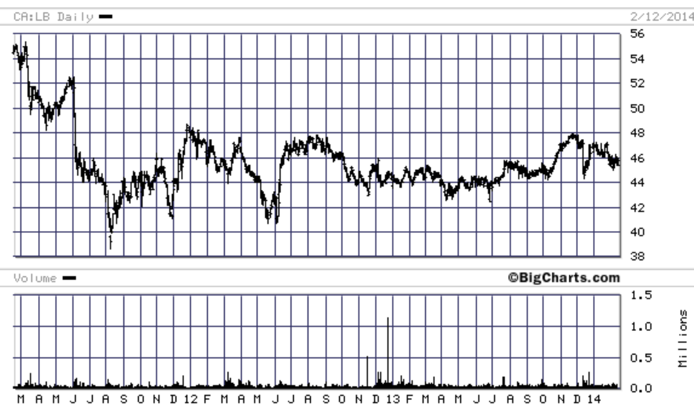
Figure 86 **Statistics & Estimates**

Current Price	$46.03	Shares Outstanding (MM)		
52 Wk High	$47.96	Diluted		28
52 Wk Low	$42.41	Market Cap (MM)		$1,311
BVPS	$44.92			
Dividend	$2.04			
Dividend Yield	4.4%			

Fiscal YE Oct. 31		2013A	2014E	2015E
Adj. EPS (dil.) *	Q1	$1.34	$1.26	$1.43
	Q2	$1.29	$1.24	$1.38
	Q3	$1.31	$1.49	$1.50
	Q4	$1.30	$1.50	$1.56
	FY	**$5.25**	**$5.50**	**$5.87**
BVPS		$44.92	$48.16	$51.93
Tang. BVPS		$35.75	$38.99	$42.76
BVPS Growth	y.o.y.	2%	7%	8%
EPS Growth	y.o.y.	-1%	5%	7%
ROE**		11.8%	11.8%	11.6%
P/E		8.8x	8.4x	7.8x
P/BVPS		1.0x	1.0x	0.9x
P/Tang. BVPS		1.3x	1.2x	1.1x

Source: Company reports, Cormark Securities Inc. estimates

Figure 87 **Price Chart**



Source: BigCharts.com (February 12/14)

Our Recommendation

We are initiating our coverage on Laurentian Bank (LB-TSX) with Buy rating and $61.00 target price.

LB is the eighth largest Canadian bank in terms of market capitalization and seventh largest based on assets with $34 BB as of the end of F2013. The company is headquartered in Montreal and has historically been focused on servicing the Quebec market, although that is changing. LB has three operating segments (not including corporate) after its recent resegmentation: Personal and Commercial, B2B Bank and Laurentian Bank Securities & Capital Markets. The bank has 153 branches almost all in Quebec.

Our Thesis – Ready To Beak Out

The knocks against LB are well known, it is too Quebec focused, it is too levered to real estate and it is too inefficient given a large unionized branch workforce. Yet, there are strong indications that all these things are changing and that F2014 will be a break-out year for the bank.

While many of its larger peers exited the financial crisis and global recession in largely the same strategic position that they found themselves at the start, Laurentian bank did not. In F2012 the bank made two significant acquisitions that together are quite transformational, helping shift revenue mix away from Quebec and away from net interest income. The reason these deals have not gotten the attention they deserve is that the associated expense synergies tied to the AGF deal will not be realized until later in F2014 (after RRSP season) while all the revenue synergies for both deals will only start to be harvested in F2015.

Meanwhile, apart from these coming synergies, LB is focusing on improving its efficiency ratio, and the product of this effort is already showing with expenses in Q4/F13 coming in down 3.5% Q/Q and down 1% Y/Y excluding a $0.16 per share restructuring charge.

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The Top Three Issues

1. **Can LB Bring Down its Efficiency Ratio?** LB tends to get a lot of the wrong type of investor attention given its group high efficiency ratio and unionized branch workforce, but there are growing signs that Management is focused on delivering serious expense control apart from ongoing expense synergies that it still hopes to realize from its AFG Trust deal. Not only is Management very vocal about this issue, but the year ended with a $6.3 MM ($0.16 per share) restructuring charge largely tied to severance. While those savings will only really be seen in F2014, it is worth noting that expense growth in the quarter was down 3.5% Q/Q and up just 1% Y/Y. The efficiency ratio was 72% in F2013 and we believe that it will improve over the next two years, coming close to the firm's medium-term target of 68% by F2015.

2. **When Will the Full Benefits from the MRS and AGF Acquisitions Appear?** Part of the underperformance of the shares over the past year is due to the fact that the large deals that it completed in F2012 have weighed on results as a significant amount of synergies have yet to be realized. While the cost synergies associated with the MRS deal have been realized, none of the cost synergies tied to the acquisition of AGF Trust have been achieved. The integration for this business will in fact only take place in H2/F14 after the end of RRSP season – which is the segment's most important season. Revenue synergies are also likely for both these deals, but according to Management these won't begin to be harvested until early-F2015.

3. **Will LB's Diversification Strategy Pay Off?** Laurentian Bank is very levered to both Quebec geographically and lending net interest income in terms of revenue streams. Yet, the bank is taking steps to diversify its business on both counts. The acquisition of the MRS companies was designed in part to provide additional sources of fee income, and diversify revenue away from net interest income. Meanwhile, the AGF deal provided significant geographic diversification given that at the time the deal was announced almost 90% of AGF's loan book was outside Quebec.

Loan Growth And Margins

Laurentian Bank's margins should improve not just as rates rise, but also due to internal factors. The company is focused on driving higher margin business, including leasing and Alt-A mortgages, although these initiatives will take some time to have an impact. Investors who would like to play margin expansion should note that this bank (along with CWB) is very levered to rising margins. In fact, a 5% increase in the margin at LB, boosts EPS by 12%, versus an average 6% lift for the Big Six banks.

Loan growth will continue to be constrained by the run-off of certain acquired portfolios, but should improve in F2015. In Q4/F13, the percentage of mortgage loans and HELOCs coming from Quebec was 76%, but we expect that percentage to decline over time. The AGF acquisition was driven in part by a push to accelerate geographic diversification.

Other Income

A big part of the rationale in completing the MRS deal specifically was to diversify revenue away from net interest income and toward more fee-based sources including mutual fund fees, brokerage commissions and account administration fees. In the B2B Bank unit where this business is housed, fee-based income went from $9 MM in F2011 just before the MRS deal closed to nearly $35 MM in F2012 and nearly $37 MM in F2013.

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Credit	Just when it seemed like LB's credit picture couldn't get any better than ti was in F2012, it did. The bank's loan loss ratio was just 0.13% in F2013, although it trended a little higher in Q4 as a result of acquired AGF loan book. A portion of that portfolio is riskier than LB's existing book of business and as such should deliver higher losses. That said, these loans are being run off, so this will be a temporary problem. Overall, we forecast the loan loss ratio climbing very modestly in both F2014 and F2015, but still remaining extremely low.
Expenses	LB worked hard in F2013 to control operating costs, an area that is frequently viewed as the bank's Achilles heel. Although cost synergies from the MRS deal are largely realized, integration of AFG Trust business will only happen on the cost side later in F2014 after RRSP season.
Capital, Dividends & Buybacks	LB ended the quarter with a Basel III CET1 capital ratio of 7.6%, on a pro forma basis that ratio is 7.4% excluding a drag of 20 bps from the adoption of IAS19. We note that Laurentian Bank calculates its RWAs using the standardized approach which understates its capital ratio relative to its larger peers. It is estimated that this ratio would be around 9.3% under the AIRB methodology used by the Big Six banks. Although the bank is working to implement the AIRB approach and optimize its regulatory capital, given the uncertainty surrounding potential regulatory changes to the way banks calculate RWA, LB has decided to slow the speed of implementation to 2018.
Earnings	We forecast core cash EPS of $5.50 for LB in F2014 followed by $5.87 in F2015. That works out to growth of 5% in F2014 followed by 7% the year after. The lift in F2015 is driven by revenue synergies and solid margin expansion. We expect both these factors to drive earnings per share growth toward the middle of the firm's 5-10% medium-term target in F2015.
Valuation	We derive our $61.00 target by applying a 10.4x P/E multiple to our F2015E EPS estimate. Our target multiple represents a 15% discount to the group, versus a 10-year historical average discount of 9%. The stock currently trades at 8.4x our F2014 EPS estimate and 7.8x our F2015 EPS estimate.

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Figure 88 **Laurentian Bank Summary Forecast Model ($MM)**

Fiscal YE October 31			2014E					
All Information on Core Bases	2012A	2013A	Q1E	Q2E	Q3E	Q4E	2014E	2015E
Net Interest Income	$531.0	$568.8	$140.8	$137.4	$142.1	$142.8	$563.1	$590.0
Other Income	$265.6	$296.6	$75.0	$75.9	$76.9	$77.9	$305.7	$315.7
Gross Revenue	$796.6	$865.3	$215.8	$213.4	$218.9	$220.6	$868.8	$905.7
PCL	$(33.0)	$(36.0)	$(9.5)	$(9.7)	$(10.0)	$(10.0)	$(39.2)	$(43.0)
Gross Revenue After PCL	$763.6	$829.3	$206.3	$203.7	$208.9	$210.6	$829.6	$862.7
Non-Interest Expense	$(582.5)	$(622.5)	$(156.5)	$(154.5)	$(150.9)	$(151.9)	$(613.8)	$(633.2)
Net Income Before Taxes	$181.2	$206.9	$49.9	$49.1	$58.1	$58.7	$215.8	$229.5
Income Taxes	$(40.6)	$(46.3)	$(11.2)	$(11.0)	$(13.0)	$(13.2)	$(48.3)	$(51.4)
Non-Controlling Interest	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0
Net Income from Continuing Ops.	$140.6	$160.5	$38.7	$38.1	$45.1	$45.6	$167.5	$178.1
Net Income from Disc. Operations	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0
Net Income	$140.6	$160.5	$38.7	$38.1	$45.1	$45.6	$167.5	$178.1
Preferred Dividends	$(12.8)	$(11.7)	$(2.6)	$(2.6)	$(2.6)	$(2.6)	$(10.5)	$(10.5)
Net Income to Common	$127.8	$148.8	$36.1	$35.5	$42.4	$42.9	$156.9	$167.5
After-Tax Intangibles	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0
Core Cash Earn. (Excl. Disc. Ops)	$127.8	$148.8	$36.1	$35.5	$42.4	$42.9	$156.9	$167.5
Reported GAAP EPS - Fully Diluted	$4.95	$3.98	$1.26	$1.24	$1.49	$1.50	$5.50	$5.87
Cash EPS - FD Excl. EO Gains	$4.99	$5.25	$1.26	$1.24	$1.49	$1.50	$5.50	$5.87
Profitability, Capital Ratios & Other								
Core Cash ROE (Excl. EO Items)	12.0%	11.8%	11.1%	11.1%	12.6%	12.5%	11.8%	11.6%
Return on RWA's (Trailing 4-Quarter)	1.06%	1.11%	1.10%	1.09%	1.13%	1.18%	1.18%	1.23%
Efficiency Ratio (Excl. EO Items)	73.1%	71.9%	72.5%	72.4%	68.9%	68.9%	70.6%	69.9%
Book Value	$44.03	$44.92	$45.64	$46.33	$47.24	$48.16	$48.16	$51.93
Core Effective Tax Rate	22.4%	22.4%	22.4%	22.4%	22.4%	22.4%	22.4%	22.4%
Common Dividends	$1.84	$1.98	$0.51	$0.52	$0.55	$0.55	$2.13	$2.32
Payout Ratio	37.0%	37.7%	40.3%	41.8%	37.0%	36.6%	38.7%	39.5%
Basel III CET1 Ratio	7.4%	7.6%	7.8%	8.0%	8.1%	8.3%	8.3%	8.8%
Tier 1 Capital Ratio	10.9%	9.1%	9.3%	9.5%	9.7%	9.8%	9.8%	10.2%
Average Shares O/S (Fully Diluted)	25.6	28.3	28.5	28.5	28.5	28.5	28.5	28.5
Credit								
Specific Provisions	$33.0	$36.0	$9.5	$9.7	$10.0	$10.0	$39.2	$43.0
Avg. Net Loans & Acceptances	$23,934	$27,157	$27,244	$27,162	$27,161	$27,297	$27,216	$27,986
PCL Ratio (% of Loans + Accept.)	0.14%	0.13%	0.14%	0.15%	0.15%	0.15%	0.14%	0.15%
Capital Markets								
Treasury & Financial Markets	$17.5	$17.9	$2.1	$2.1	$2.1	$2.1	$8.4	$8.4
Brokerage Operations	$54.8	$60.6	$15.1	$15.1	$15.1	$15.1	$60.5	$61.2
Variable Compensation	$42.4	$49.9	$11.0	$10.5	$11.0	$11.0	$43.5	$44.4
Variable Compensation Ratio	58.6%	63.6%	63.9%	61.0%	63.9%	63.9%	63.2%	63.8%
Lending Net Interest Income								
Net Interest Income	$531.0	$568.8	$140.8	$137.4	$142.1	$142.8	$563.1	$590.0
Average Earning Assets	$30,609	$0	$32,766	$32,667	$32,666	$32,830	$32,732	$33,659
Net Interest Margin	1.7%	#DIV/0!	1.7%	1.7%	1.7%	1.7%	1.7%	1.8%
Net Loans & BAs Outstanding	$26,663	$27,113	$27,036	$26,960	$26,963	$27,101	$27,101	$28,207
Securitization Revenue								
Gross Revenue	$796.6	$865.3	$215.8	$213.4	$218.9	$220.6	$868.8	$905.7
Non-Interest Expenses	$582.5	$622.5	$156.5	$154.5	$150.9	$151.9	$613.8	$633.2
Operating Leverage	(3.9%)	1.8%	(1.0%)	0.1%	5.0%	0.1%	1.8%	1.1%

Note: Numbers not revised for amended IFRS accounting standards.

Source: Company Reports, Cormark Securities

Recommendation Terminology

Cormark's recommendation terminology is as follows:

Top Pick	our best investment ideas, the greatest potential value appreciation
Buy	expected to outperform its peer group
Market Perform	expected to perform with its peer group
Reduce	expected to underperform its peer group

Our ratings may be followed by "(S)" which denotes that the investment is *speculative* and has a higher degree of risk associated with it.

Additionally, our target prices are based on a 12-month investment horizon.

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Analyst Certification

I, Meny Grauman, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject company(ies) and its (their) securities. I also certify that I have not been, and will not be receiving direct or indirect compensation in exchange for expressing the specific recommendation(s) in this report.

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