

December 7, 2012

Current Price \$76.66

Intrinsic Value Estimate \$75.00

### **National Bank (TSX: NA) Q4-F12 Summary**

National Bank reported fourth quarter EPS of \$1.97. It was a noisier quarter than usual, with NA providing an adjusted EPS metric of \$1.93, exactly on the consensus expectation. We would note, however, that the bank's gain on sale from its share of Alpha to the TMX was not excluded from "core" earnings. The gain was \$25M pre-tax and \$18M after-tax, or \$0.11.

In National's defence, only one other bank specified its Alpha gain. That said, the Commerce highlighted its \$0.05/share Alpha-impact on roughly the same underlying EPS as NA. We typically use 5% as a rough materiality gauge for items that are non-recurring. Accordingly, we interpret the quarter as an eleven cent miss.

National, the only bank not to have raised its dividend at Q3, increased its quarterly payout to \$0.83, from \$0.79, a 5% increase. The payout ratio of the new dividend, as a function of F13 consensus EPS, is 40.7%, toward the low end of the group.

In addition to the buried Alpha gain and its impact on both reported and adjusted earnings, this quarter contained a number of issues for investors to digest:

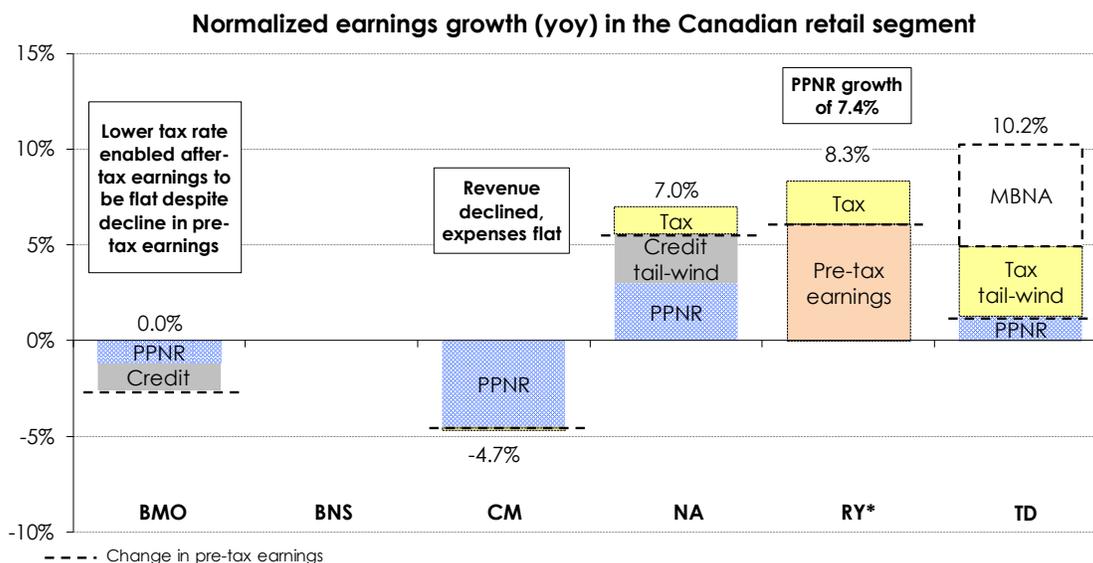
- The bank's Basel III-basis Common Equity Tier 1 ratio is only 7.3% (down 30bps sequentially). In a relatively short span, the bank has gone from having one of the highest capital ratios in the group to one of the lowest.
  - One reason for the sequential decline is that NA made an unconventional accounting choice, essentially early adopting certain cherry picking provisions of the next version of IAS19. The accounting choice, which can be characterized as "good for earnings, bad for capital", cost the bank 39bps of Bill-basis CET1. Management indicated that F13 earnings could be \$15M higher as a result of the change, which will result in no amortization in earnings of previously unrecognized actuarial losses.
  - A second reason for the more austere capital ratio is that NA repurchased \$75M of common shares during the quarter, essentially following through on an earlier pledge to return gains on restructured non-bank ABCP to shareholders.
  - While we understand management's desire to follow through on its commitment, we would note that the decision to "spend" the windfall pushes back the timeline for more sustainable buybacks, i.e. those powered by excess capital, especially in light of the "bad for capital" accounting decision noted above.
- Like BMO, NA took a restructuring charge in Q4 aimed at reducing costs going forward. NA's charge totaled \$65M pre-tax, \$48M after-tax.
- Like RY and TD, NA reported positive operating leverage in P&C; in NA's case, revenues outgrew expenses by 1.4%, slightly less than RY and TD.
- The dealer provided 38% of NA's earnings. Trading revenues advanced 43.6% from last year, and overall revenues in the dealer moved ahead 20.4%.
- Last quarter, formations of new impaired loans jumped, as \$60M of corporate loans became impaired. In the fourth quarter, corporate formations were -\$3M, but \$31M of commercial loans became impaired, the highest level since Q1-F11.

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- Volume growth in the P&C bank outstripped revenue growth due to continued margin compression. In NA's case, volumes grew 10.2% year-on-year but margins were 14bps narrower, resulting in net interest income advancing only 3%. Fee income was also muted, resulting in 1.1% overall segment revenue growth.

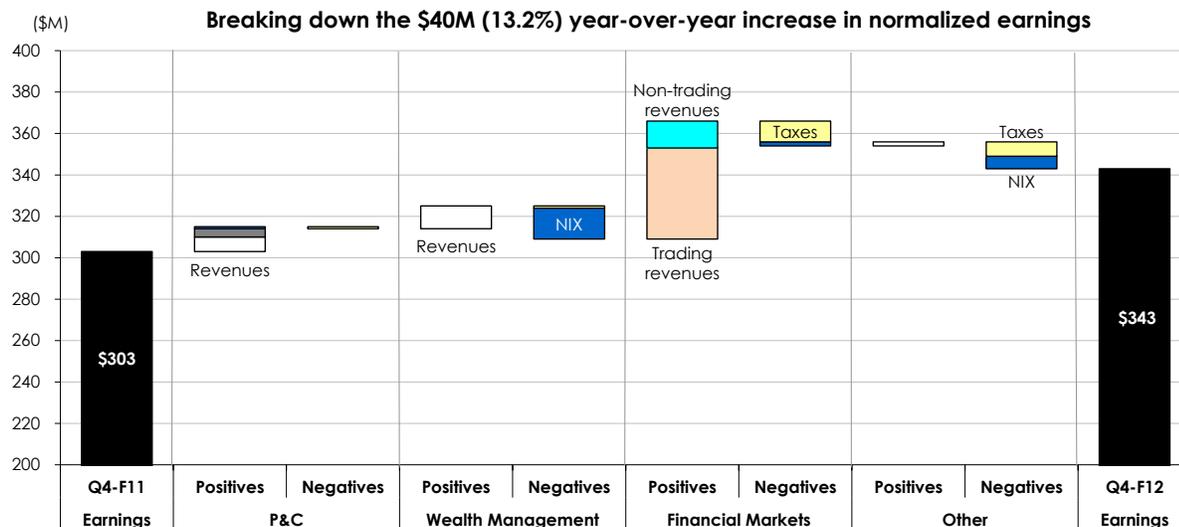
As in the case of CIBC, we do not see a lot of downside from current prices but maintain our cautious view. Although domestic credit expansion remains strong, well-capitalized banks chasing a decelerating credit market in a low interest rate environment will likely result in continued margin compression. Part of our rationale for downgrading NA in April was its exposure to both a two-speed economy within Canada and a lack of non-Canadian earnings streams.

We will reassess our forecast and valuation models in more detail after the quarter.



Source: Company reports, Veritas calculations and estimates.

\* We have not demarcated between PPNR and credit where trends had opposite pre-tax income impacts.

**National Bank (TSX: NA) Q4-F12 Summary**


Source: Company reports and Veritas calculations.

**NA - residential real estate metrics**

(\$billion)	Balances
<b>Residential mortgages</b>	
Insured	\$23.3
Uninsured	\$10.2
HELOC	\$13.8
<b>Total</b>	<b>\$47.3</b>
<b>Condo exposure</b>	
Developer <sup>1</sup>	\$0.1
<b>Trends</b>	
<ul style="list-style-type: none"> <li>• Mortgage portfolio up \$1B sequentially while HELOCs up \$300M.</li> <li>• Losses on mortgage portfolio currently at 5bps.</li> <li>• LTV ratio on HELOCs and uninsured mortgages remained at 54%.</li> </ul>	
<b>Notes</b>	
(1) According to Q2-F12 earnings call.	

Source: Company reports, Veritas estimates and calculations.

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