



NATIONAL BANK OF CANADA

(TSX: NA)

eResearch Corporation (eResearch) and **Catalyst Equity Research Inc. (Catalyst)** have reached an agreement whereby **eResearch** will distribute all reports provided by **Catalyst** to **eResearch** throughout its extensive electronic distribution network.

eResearch and **Catalyst** share a common mission: to provide quality investment research analysis, by ensuring that the research is a credible resource that investors can rely on.

eResearch was established in 2000 as Canada's first equity issuer-sponsored research organization. Our various research packages allow corporate management to choose the form of research coverage that best meets their company's needs.

Catalyst, which was founded in 2003, is Canada's sole independent equity research company specializing exclusively in the financial services sector. Headed by Robin Cornwell, who has more than 30 years of experience in research and investment analysis of financial companies, **Catalyst** provides comprehensive investment research and advisory services to the investment community.

eResearch is pleased to provide a **Catalyst** report on: **NATIONAL BANK OF CANADA.**

Bob Weir, CFA
Managing Director, Research Services,
eResearch Corporation

August 29, 2011

Note: Information and opinions expressed in Catalyst Equity Research Inc. reports and presented on the eResearch Corporation web-site are those of the contributing author and are provided in good faith and without legal responsibility. No representations, express or implied, are made by eResearch Corporation as to the accuracy, completeness, or correctness of this research. Such information and opinions expressed are as of the date of publication, and are subject to change without notice. Neither eResearch Corporation nor Catalyst Equity Research Inc. accepts any liability whatsoever for any direct or indirect loss resulting from any use of the research or the information it contains. Further, eResearch Corporation offers no opinion, express or implied, on the commentary herein, nor does it endorse the views and opinions expressed in this research report, which are those of Catalyst Equity Research Inc. only.

NATIONAL BANK OF CANADA (NA - TSX \$71.30)

Recommendation: BUY
Target Price (1 Year): C\$83.00
Prior: C\$86.00
Total Return (1 Year): 20.0%
Risk: Low

Market Data

Current Price \$71.30
 52-Wk Range \$58.14-81.98
 Mkt. Cap. (mm) \$11,500
 Dividend \$2.84
 Yield 4.0%

Financial Data

Fiscal Y/E October 31
 Shares O/S (mm) 162
 BVPS \$40.23
 P/BVPS 1.8x
 Capital Ratio Tier 1 13.9%
 Total Assets (bill) \$153.3
 Adj. Cash ROE Annual 17.5%

Estimates (f.d.)

Year	2010A	2011E	2012E
EPS Cash	\$6.25	\$6.92	\$7.55
Prior EPS Cash	-	\$6.95	\$7.70

Valuations

Year	2010A	2011E	2012E
P/E Mult. Cash	11.4x	10.3x	9.4x

National Bank of Canada

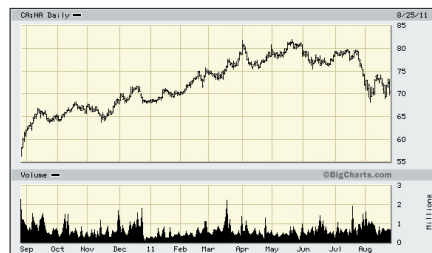


Chart Courtesy Big Charts

Robin Cornwell

416-910-7985

rcornwell@catalystresearch.ca

Notes:

All figures in Canadian dollars, unless otherwise specified.
 * Under Review

Please see the final pages of this document for important disclosure information.

Q3/11 Earnings Slightly Below Our Expectations NA Completes The Acquisition of Wellington West Possible Dividend Increase Next Quarter

Conclusion: BUY – 12-Month Target Lowered to \$83.00

National Bank (NA) reported cash operating EPS (fd) of \$1.84. Excluding the positive \$0.12 per share impact of the items of note discussed below, adjusted EPS was \$1.72, an increase of 10% Y/Y. This quarter's EPS was lower than our forecast by about \$0.02 but pretty much in line with consensus. Cash adjusted ROE in the quarter was 17.5% and lower than 18.1% last quarter. The Tier 1 capital ratio (Basel II) declined to 13.9% from 14.1% as at the end of last quarter but remains one of the best capitalized banks in Canada. NA also completed the purchase of Wellington West Holdings Inc. (Wellington).

The quarter was once again driven by solid results in the Wealth Management group whereby net income was up 28% Y/Y and benefited from higher volumes. The Wellington acquisition had a minimal impact on the quarter. Personal & Commercial (P&C) group reported a decent quarter in line with expectations. Financial Market earnings were somewhat weaker than the prior quarter and represented 34% of earnings versus 49% last quarter. Trading revenue this quarter was about 15% below the 8 quarter average.

For fiscal 2011, we have lowered our EPS estimate marginally to \$6.92 from \$6.95. Our 2011 forecast represents an ROE of about 17.5%, or the higher end of management's target range. Our EPS outlook for fiscal 2012 has been lowered to \$7.55 from \$7.70, an increase of 9% over fiscal 2011. The latter forecast includes some modest accretion in EPS from the Wellington acquisition offset by some slowing in capital markets activity.

Management is expected to review the dividend next quarter. If there are no unexpected negative surprises in the Basel capital rules, investors could expect further dividend increases as the payout ratio forecast for fiscal 2012 is 38% and below the lower end of management's 40% to 50% target range.

We have lowered our 12-month share price target to \$83.00 from \$86.00 and maintained our BUY recommendation.

Valuation

Our \$83.00 per share target represents a multiple of about 11.0x our 2012 EPS outlook. Overall, this valuation represents about a 6% discount to the bank average.

Items of Note For Q3/11 – Positive Impact of \$0.12 Per share

NA indicated the following earnings adjustments to Q3/11:

- \$5 million after-tax charge related to severance cost from the Wellington acquisition.
- \$8 million after-tax provision for litigation issues.
- \$11 million after-tax reversal of allowance for credit losses taken for loans and credit facilities secured by restructured notes of the master asset vehicle conduits.
- \$21 million after-tax gain from the reversal of provisions for income tax contingencies.

Basel III Impact

NA is in a very strong capital position with respect to the new Basel III capital requirements. In fact, management estimates that its current Common Equity Tier 1 ratio under Basel III is 8.0% and meets the full implementation of the Basel III program (minimum of 7.0% in 2019). NA's current Basel II Tier 1 capital ratio is 13.9%, down marginally from Q2/11 due to the Wellington acquisition. The Bank's tangible common equity ratio stands at 10.4%, down slightly from 10.6% last quarter.

Other Quarterly Highlights

- **Total Q3/11 net operating income was \$312 million, up 15% Y/Y.** Adjusted operating income, excluding the items of note, was reported at \$293 million, up 7% Y/Y and flat sequentially. Total revenue increased 3% Y/Y while non-interest expense increased by 5% for a negative increase in operating leverage of 2%. Expenses included severance charges related to the Wellington acquisition.
- **The P&C group reported net income in Q3/11 of \$168 million, up 6% Y/Y.** Sequentially, net income was also higher by 6%. Overall, a decent quarter and in line with expectations. Revenues increased by 3% Y/Y while operating expenses were up 3% providing no increase in operating leverage. Average loans were up 10% Y/Y. Mortgage loans increased 9% Y/Y. Personal loans and credit card volumes increased by 11% Y/Y and business loans increased 10% Y/Y. The volume growth was offset to some degree as interest margins decreased 12 bps Y/Y. PCL was \$44 million, flat Y/Y and down almost 20% sequentially.
- **Wealth Management reported solid net income of \$37 million, up 28% Y/Y but lower by 12% sequentially.** Total revenues increased 11% Y/Y and expenses increased by 6% Y/Y, generating a positive operating leverage of 5%. The efficiency ratio improved to 75% versus 78% in the same period last year driven by the higher volumes. The Wellington transaction had a minimal impact on the quarter. Assets Under Management (AUM) increased to \$57 billion, up 14% Y/Y and 2% sequentially. Assets Under Administration (AUA) increased to \$187 million or 6% Y/Y. Mutual fund revenue increased 17% Y/Y while brokerage commissions increased 1% Y/Y.
- **Financial & Capital Markets reported a steady quarter** with net income of \$106 million, up 13% Y/Y but lower sequentially by 27%. Total revenues were higher by 3% Y/Y and 4% sequentially. Underwriting and advisory revenues of \$76 million increased 6% Y/Y but were lower by 15% sequentially. Trading revenue was lower sequentially at \$103 million but above the \$92 million reported last year. Trading revenue this quarter was about 15% below the 8 quarter average. All areas of trading were weaker versus the prior quarter. The Financial Markets group represented 34% of net income this quarter versus 49% last quarter.
- **Security gains improved sequentially to \$26 million or about \$0.12 per share** versus a gain of \$22 million in the previous quarter and \$31 million in the same period last year.
- **Securitization revenue was \$74 million** versus \$69 million last quarter and \$68 million in the same quarter last year.
- **Unrealized securities surplus increased to \$379 million in the quarter** from a surplus of \$183 million last quarter. Equity surplus was \$38 million versus \$65 million last quarter.
- **Provision for Credit Loss (PCL) was reported at \$26 million versus \$33 million last quarter** and \$28 million in the same period last year. As a % of loans, PCL was about 16 bps versus 22 bps last quarter. Overall, a strong performance and about 20% lower than our forecast. Commercial PCL decreased 50% sequentially while Personal PCL was 15% lower sequentially. Management has lowered the expected loss ratio for PCL's as a % of average loans to a range of 23 bps to 28 bps from 25 bps to 30 bps. We have lowered our 2011 PCL expectation to \$125 million from \$145 million and now expect the PCL to remain at the \$125 million level in fiscal 2012.
- **Gross Impaired Loans (GIL) decreased in the quarter to \$382 million** from \$393 million last quarter and were about flat Y/Y. New impaired loan formations were \$14 million driven by higher formations in the retail sector and lower reversals in the commercial sector. The level of GIL this quarter was about 5% lower than expected. We have lowered our forecast of GIL to \$390 million from \$400 million for fiscal 2011 and expect the GIL will stay at the \$390 million level in fiscal 2012.
- **The Bank announced that it has US\$53 million in direct credit risk exposure to PIIGS countries.** The majority of \$45 million was to Ireland.

Management Changes

NA announced management changes with Ghislain Parent becoming CFO and EVP Finance & Treasury on August 29, 2011, replacing Patricia Curadeau-Grou who will assume the role of EVP Risk Management until June 4, 2012. Afterwards, she will become Strategic Advisor to the CEO.

Acquisition of Wellington West Holdings Inc.

On July 15, 2011, NA announced that it had completed the acquisition of all the shares that it did not own (82%) of Wellington West Holdings Inc. (Wellington) for approximately \$273 million (\$333 million for 100%).

- The consideration consisted of common shares of NA and cash. Approximately 2.2 million NA shares issued.
- Increased NA's level of Investment Advisors by almost 30%.
- The transaction is expected to be neutral on EPS for fiscal 2011 and accretive to fiscal 2012.
- Increases AUA outside of Quebec by about 50%.
- Focus on mining and energy in line with NA's objectives.
- Creates about \$280 million of new goodwill.
- Wellington forecast that for fiscal 2011, it expected to produce revenue of \$175 million, EBITDA of \$25 million and have AUA of \$11.0 billion with 172 Investment Advisors.
- In our opinion, NA valued Wellington (excluding cash) at an estimated 1.5x revenue, 10.5x EBITDA and 2.35% of AUA.

Definition of Risk Rankings

Low: Low financial and operational risk, high predictability of financial results with stronger than average balance sheet and strong free cash flows. Company may pay substantial dividends or have an active share repurchase program.

Medium: Moderate financial and operational risk, moderate predictability of financial results, positive free cash flows and may or may not pay a dividend.

High: High financial and/or operational risk, low predictability of financial results. Limited financial history, negative free cash flows, adequate working capital and no dividends.

Definition of Research Ratings

The Catalyst research recommendation structure consists of the following categories:

Buy: The stock's total return, including dividends paid, is expected to exceed a minimum of 15% on a risk-adjusted basis, over the next 12 months.

Hold: The stock's total return, including dividends paid, is expected to be between 0% and 15%, on a risk-adjusted basis, over the next 12 months.

Sell: The stock's total return, including dividends paid, is expected to be negative over the next 12 months.

Speculative: The stock's total return is expected to exceed 30% over the next 12 months; however, there is material event risk associated with the investment that could result in significant loss.

Note: Analysts have discretion within 500 basis points of the upper and lower limit of each rating to maintain the recommendation.

Analyst Certification

All of the views expressed in this report accurately reflect the personal views of the responsible analyst(s) about any and all of the subject securities or issuers. No part of the compensation of the responsible analyst(s) named herein is, or will be, directly or indirectly, related to the specific recommendations or views expressed by the responsible analyst(s) in this report.

The information contained in this report has been compiled by Catalyst Equity Research Inc. ("Catalyst") from sources believed to be reliable, but no representation or warranty, express or implied, is made by Catalyst, its affiliates or any other person as to its accuracy, completeness or correctness. All opinions and estimates contained in this report represent Catalyst's judgment as of the date of this report and are subject to change without notice and are provided in good faith but without legal responsibility. This report is not an offer to sell or a solicitation to buy any securities. Catalyst and its affiliates may have a relationship or may receive compensation for services with some or all of the issuers mentioned. Catalyst or its affiliates or officers, directors, representatives, associates may have a position in the securities mentioned herein, and may make purchases or sales of these securities from time to time in the open market or otherwise. The securities discussed may not be eligible for sale in all jurisdictions. To the full extent permitted by law neither Catalyst nor any of its affiliates, nor any other person, accepts any liability whatsoever for any direct or consequential loss arising from any use of this report or the information contained herein. No matter contained in this document may be reproduced or copied by any means without the prior consent of Catalyst. This report is not for distribution in the United States of America.