RBC FINANCIAL GROUP

(TSX: RY)

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***e*Research Corporation** is pleased to provide a **Catalyst** report on: **RBC FINANCIAL GROUP**

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August 29, 2011

RBC FINANCIAL GROUP

(RY - TSX $48.98)

Recommendation:	**BUY**
Target Price (1 Year):	**C$63.00**
Prior:	**C$66.00**
Total Return (1 Year):	**33.0%**
Risk:	**Low**

Market Data

Current Price	$48.98
52-Wk Range	$47.98-61.53
Mkt. Cap. (mm)	$70,400
Dividend	$2.16
Yield	4.4%

Financial Data

Fiscal Y/E	October 31
Shares O/S (mm)	1,437
BVPS	$24.66
P/BVPS	2.0x
Capital Ratio Tier 1	13.2%
Total Assets (bill)	$727.5
Adj. Cash ROE Annual	17.1%

Estimates (f.d.)

Year	2010A	2011E	2012E
EPS Cash	$3.70	$4.45	$4.95
Prior EPS Cash	-	$4.60	$5.20

Valuations

Year	2010A	2011E	2012E
P/E Mult. Cash	13.2x	11.0x	9.9x

RBC Financial Corp.

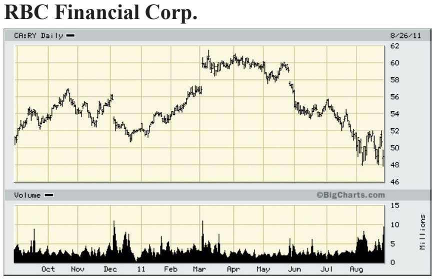

Chart Courtesy Big Charts

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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 Miss Expectations
Fixed Income Trading Revenue Collapses
U.S. Bank Sold – Capital Base is Very Strong

Conclusion: BUY – 12-Month Target Lowered to $63.00

RBC Financial Group (RY) reported Q3/11 EPS cash loss of $0.09. RY restated its earnings this quarter to exclude the operations of its U.S. personal and commercial bank. RY had announced earlier in the quarter that it had reached an agreement to sell the U.S. bank to PNC Financial (see discussion below). Excluding the $1.7 billion loss on the U.S. bank and several other minor non-operational items, EPS from continuing operations was $1.06, a gain of 13% Y/Y. These adjusted earnings were $0.08 below our estimate and about $0.03 below that of consensus. Overall, it was another disappointing quarter as trading revenues continued to be very volatile, declining over 40% sequentially. Fixed income trading basically collapsed sequentially. The Tier 1 capital ratio decreased in the quarter to 13.2% from 13.6% last quarter, however, after the sale of the U.S. bank, the ratio should increase by about 130 bps. Adjusted ROE was 17.1%, down from 15.8% last quarter.

Domestic banking earnings in the quarter were very solid, increasing 12% Y/Y. Wealth Management had a good quarter with net income up 14% Y/Y on an adjusted basis. Assets Under Management (AUM) increased 24% Y/Y driven by the BlueBay acquisition. Capital Markets reported very weak results as net income declined 38% Y/Y driven by much lower trading revenues partly offset by strong underwriting and advisory fees. International Banking (excluding the U.S. banking unit that was sold) reported a 14% Y/Y decline in net income. RY's Provision for Credit Loss (PCL) was about 5% lower than we expected.

For 2011, we have lowered our EPS estimate to $4.45 from $4.60. We expect the Capital Markets contribution to stabilize with continued solid growth in Domestic banking and Wealth Management.

For fiscal 2012, we have lowered our EPS estimate to $4.95 from $5.20. Further dividend increases are a real possibility in fiscal 2012 based on payout ratios of 48% and 44% on our 2011 and 2012 EPS estimates respectively. The 2012 payout ratio is slightly below the mid-point of management's targeted payout range of 40%-50%.

Although disappointed with RY's recent quarterly earnings, particularly Capital Markets, we continue to recommend it as a BUY. The Capital Markets model continues to be a struggle amid difficult market conditions particularly in Europe, but we applaud the sale of the U.S. personal & Commercial bank. The sale of the latter will place RY on a very solid capital base footing that, in our view, will allow the Bank to build on its strengths and position it as one of the top banks globally. Capital Markets is expected to improve and level out to a more consistent performance given time. Management also appears intent on expanding its Wealth Management business which is a strategy that we highly endorse. We expect more selective acquisitions in Wealth Management and Capital Markets.

Valuation

The Bank has clearly demonstrated that it can generate exceptional returns over the long-term. We have lowered our share price target to $63.00 from $66.00 which is consistent with the lower earnings outlook for fiscal 2012. Our share price target implies a 12.7x multiple on our 2012 EPS forecast which is a small premium to the Canadian bank average.

Credit Exposure to PIIGS

RY updated its credit exposure to the PIIGS as outlined below:

- Total credit exposure (largely investment grade) was $1.5 billion which includes loans, derivatives, counterparty risks and securities.
- Spain - $838 mm, Ireland - $347 mm, Italy - $281 mm, Portugal - $24 mm, Greece - $10 mm.

Other Quarterly Highlights

- **Reported a net operating loss** of $92 million for the quarter. Excluding the $1.7 billion loss related to the sale of the U.S. banking operation, net operating income was $1.6 billion, up 13% Y/Y and flat sequentially. Revenue from continuing operations was up 2% Y/Y while non-interest expenses increased 10% Y/Y for negative operating leverage of 8%. Expenses included higher pension and other fraud related costs which we estimate accounted for 4% of the expense increase in the quarter.
- **Canadian Personal and Business Banking (P&B)** reported net income of $855 million, up 12% Y/Y and flat sequentially. Interest margins increased 3 bps on a Y/Y basis but declined 4 bps sequentially. Management indicated that they have not cut prices as much as competitors and recently increased variable mortgage rates as spreads were too low on those products. Revenue increased by 7% Y/Y while expenses increased by 10% Y/Y. The higher expenses reflected higher pension expense as noted above as well as increased costs related to business expansion. Volume growth remained good, up 6% Y/Y. Domestic PCL was reported at $254 million, down 11% Y/Y and up 2% sequentially. ROE for this group was 31%, down slightly Y/Y.
- **Wealth Management** reported cash net income of $197 million, flat on a Y/Y basis and down 17% sequentially. Excluding positive $24 million accounting and tax adjustments last year, net income rose 14% Y/Y. Fee-based revenue was up 24% Y/Y driven by a 24% increase in client assets under management which included the BlueBay acquisition. Mutual fund revenue increased 34% Y/Y. Canadian revenue was up 14% Y/Y driven by higher average fee-based client assets. U.S. and International Wealth Management revenue decreased by 8% Y/Y, however, on a constant currency basis, revenue was flat Y/Y. Global Asset Management revenue increased 52% Y/Y and included BlueBay. RY reported total AUM of $310 billion. The adjusted ROE was 13%.
- **Insurance** net income was reported at $144 million, down 6% Y/Y and flat sequentially. Earnings were driven by lower investment gains partly offset by lower auto and reinsurance claims costs. The adjusted ROE was about 32%.
- **International Banking** reported net income of $31 million, down 14% Y/Y and well down from $45 million last quarter. Banking revenue was flat Y/Y in constant currency terms due to lower loan volumes. In addition, the bank experienced spread compression in the Caribbean as well as higher PCL. RBC Dexia IS reported revenues up 13% Y/Y reflecting higher fee-based client assets. PCL increased 19% Y/Y to $37 million due to 2 accounts in the Caribbean portfolio. Management commented that the Caribbean sector continues to experience lower volumes.
- **RBC Capital Markets** reported a very poor quarter with cash net income of $277 million, down 38% Y/Y and 32% sequentially. Trading revenue, adjusted to exclude the MBIA gains and other small items, was lower by 7% Y/Y and 43% sequentially. Lower trading revenue resulted from poor fixed income trading (largely Europe), lower client volumes, reduced market liquidity and increased competition. Fixed income trading was $71 million in the quarter, down from $396 million last quarter. Underwriting and advisory fees were up 23% Y/Y and 3% sequentially. PCL was $8 million versus a net recovery of $9 million in the same quarter last year and a recovery of $5 million last quarter. The ROE was 11% versus 9% in the same period last year.
- **PCL was reported at $275 million, down 1% Y/Y** but higher by 14% sequentially. PCL has been adjusted to exclude the U.S. banking operations now reported as discontinued operations. Overall, PCL came in 5% below our expectations. PCL as a percent of average loans increased to 38 bps from 35 bps last quarter but was lower than the 40 bps reported in the same period last year. PCL in Canada increased marginally due to volume growth. International banking PCL was higher driven by losses in the Caribbean. Capital Markets reported PCL of $8 million compared to a recovery of $5 million last quarter. For fiscal 2011, we are maintaining our adjusted PCL estimate at $1.0 billion which would represent a decrease of 20% from 2010. For 2012, we estimate the PCL to remain near $1.0 billion.
- **Gross Impaired Loans in the quarter amounted to $2.4 billion** which was down 11% Y/Y and higher by 3% sequentially. GIL was restated to exclude the U.S. banking operations now reported as discontinued operations (previously GIL was about $4.0 billion). Overall, this level was about in line with our expectations. New impaired loan formations in the quarter increased modestly to $511 million from $459 million last quarter. We continue to expect GIL to remain elevated for some time and have maintained our adjusted fiscal 2011 target at $2.4 billion and expect the 2012 GIL to remain near that same level.

Recent Events

Event: RY Reaches Agreement to Sell U.S. Retail Bank to PNC Financial

On June 20, 2011, RY announced the sale of its U.S. Retail Banking operations "RBC Bank (USA)" to PNC Financial Services Group Inc. (PNC) for $3.62 billion. JP Morgan Chase was its advisor on the transaction.

- RY recorded a $1.6 billion loss on the transaction, however, RY took a $1 billion write-down in 2009.
- The purchase price includes $3.45 billion for the U.S. retail bank and $165 million for related credit card assets. Closing is expected in March, 2012.
- Purchase price is in cash and up to $1 billion of PNC's common stock at PNC's option. Any shares of PNC received by RY can be sold without restrictions.
- Management stated that greater returns can be yielded by investing in growing its businesses organically, investing in targeted Wealth Management acquisitions, investing in Capital Markets and returning capital to its shareholders by way of dividends or share repurchases.
- RY has reported a negative economic profit on its investment in the U.S. retail banking for several years.
- The profit potential was limited in our opinion and the U.S. Retail would have required a large investment from this point on to make it achieve the necessary scale to succeed in a "highly competitive" U.S. retail market.
- The sale would recapture approximately $1.3 billion of goodwill from a capital perspective.
- RY's Tier 1 capital ratio would increase by over 130 bps to an estimated 14.5% from 13.2% or well above the six bank average of 13.3%.
- Earnings would benefit by a reinvestment of capital and thereby increase by an estimated $0.10 to $0.25 per share annually beginning in fiscal 2012.

Basel III Capital Rules – RY Meets New Standards

Under the current Basel II capital rules, RY's Tangible Common Ratio is 10.3% and its Tier 1 Capital Ratio is 13.2%. Management estimates that the Tier 1 Common Equity Ratio under Basel III (2019 rules) currently meets the 7.0% minimum required by 2019.

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

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