

## NATIONAL BANK OF CANADA (NA-TSX \$52.50)

**Recommendation**

Hold

**Risk**

Low

**Target Price**

\$57.00

**Price**

\$52.50

**52-Week Range**

\$44.51 - \$66.50

**% Below High**

-21.0%

**% Above Low**

17.9%

**Shares O/S**

158 million

**Market Cap**

\$8 billion

**Average Daily Volume**

559,800

**Year-End**

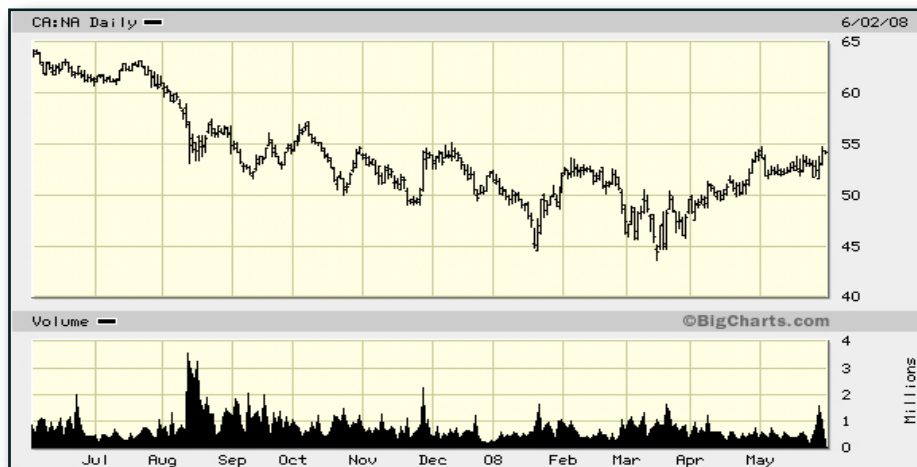
October 31

C\$	EPS	& Mult
2007a	\$5.65	9.3x
2008a	\$5.60	9.4x
2009e	\$6.00	8.8x
Book Value	\$28.76	1.8x

	Amount	Yield
Dividend	\$2.48	4.7%

**Analyst**

Robin Cornwell



Data Source: www.BigCharts.com

### SECOND-QUARTER REVIEW

**HIGHLIGHTS**

- Q2/08 Operating Earnings Better Than Expected
- 3rd Party ABCP Problems Will Continue To Linger
- NA Remains Highly Dependent On Financial Market Revenues

**CONCLUSION**

HOLD - 12 Month Target Maintained At \$57.00

National Bank (NA) reported cash operating EPS (fd) of \$1.00, but when adjusted for a \$73 million loss on a hedge transaction adjusted EPS was \$1.41 up 1% Y/Y and about \$0.07 above expectations driven by better than expected results in Financial Markets (about 35% of net income in the quarter). Wealth Management was weaker with net income down 2% Y/Y. Personal & Commercial (P&C) saw a spread contraction which limited net income to a flat Y/Y performance. It should be noted that the loss on the hedge transaction was directly related to the Banks 3rd Party ABCP holdings. Cash adjusted ROE was 20.2% up from 20.1% last quarter.

We have increased our 2008 EPS estimate to \$5.60 from \$5.50 but have lowered our 2009 EPS forecast to \$6.00 from \$6.10 representing a gain over 2008 of 7%. Investors should now expect to see slower dividend growth. We expect the dividend payout ratio to now average 44% in 2008 which means investors could expect to see a further dividend increase over the next 12-months to the \$2.58 to \$2.62 per share level for a gain of 3% to 5%. We have maintained our recommendation as a Hold.

## Valuation

NA is largely dependent on the domestic economy which we expect to slow further. Our real concern however, remains to be that the Bank's current earnings are benefiting from a higher than average dependency on the Financial & Capital Markets group for revenues and that capital markets activity is expected to soften further over the balance of 2008. We are maintaining our 12-month share price target of \$57.00 for a one year total projected return of 13.3%. This target represents a discount to the bank average of 15% to 20%.

## ABCP Issues Continue to Loom Over Current & Future Quarters

The \$2+ billion of 3rd party Asset Backed Commercial Paper (ABCP) held by the Bank continues to impact the Bank's performance even though no further reserves were taken in the quarter. The impact this quarter was as follows.

- **A \$73 million loss** (\$49 million after-tax or \$0.31 per share) on a hedge transaction put in place to cover the Bank against a potential significant downturn in markets.

For future quarters:

- **\$250 million in loans to be made available to clients holding riskier ABCP** paper with the only recourse being the ABCP paper itself. The Bank will lend up to 75% of the face value of the paper. This sounds like a way to appease unhappy clients and a sure way to incur more loan losses.
- **\$250 million of further writedowns are expected over the next six months** including losses incurred on the loan portfolio discussed above.

## Gain on Montreal Exchange Sale

Management indicated that the Bank would report a gain on the sale of its holdings in the Montreal Stock Exchange of \$88 million in Q3/08.

## Other Quarterly Highlights

- **Total adjusted net cash operating income declined 1% Y/Y in Q2/08** and was reported at \$229 million. These adjusted earnings this quarter exclude \$73 million (\$49 million after-tax or \$0.31 per share) of losses related to economic hedge transactions undertaken to protect the asset-backed commercial paper portfolio against a significant downturn in markets. Revenue was \$942 million down 11% Y/Y while expenses decreased by 5% Y/Y for a negative operating leverage of 6%.
- **The Personal and Commercial group reported flat Y/Y net income** of \$113 million and down from \$130 million last quarter. Revenues increased by 2% while expenses were unchanged for a 2% increase in operating leverage. Total loan growth was flat Y/Y, but personal loans and credit card volume increased by 18% Y/Y. Overall margins decreased by 14bp Y/Y but improved by 2bp Q/Q.
- **Wealth Management reported net income of \$44 million down 2% Y/Y.** Total revenues declined 9% Y/Y and expenses dropped by the same generating no operating leverage improvement. Mutual fund revenue was down 3% Y/Y. Total AUM increased to \$107 billion up from \$104 billion last quarter and up 1% Y/Y. The increase in AUM was entirely the result of two acquisitions (Aquilon Capital and Groupe Financier Everest) which added \$1 billion in AUM. As noted below the Bank announced the acquisition of Bieber Securities which should add about \$550 million in AUM.
- **Financial & Capital Markets reported net income of \$80 million down 10% Y/Y** but up from \$71 million last quarter. Underwriting and advisory revenue declined to \$94 million a Y/Y decrease of 13%. Trading revenues were \$80 million, down significantly from at \$115 million in the same period last year, driven by lower fixed income and equities revenue. Other revenue benefited from a strong \$27 million contribution from the Maple Partners

Group. Security gains were \$5 million or about \$0.02 per share down from \$21 million last year and \$30 million in the previous quarter.

- **Provision for Credit Loss (PCL) was reported at \$34 million up from \$32 million last quarter** and up from \$23 million in the same period last year. Gross impaired loans increased to \$252 million flat Q/Q. Net new impaired loan formations were \$26 million up from \$18 million last year and down from \$43 million last quarter. We continue to forecast PCL to increase to \$135 million in 2008 and \$160 million for fiscal 2009.

### Recent Acquisitions

NA announced on May 26, 2008 the intent to acquire Bieber Securities inc. based in Manitoba. Total AUM managed approximates \$550 million.

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