

## Recommendation

Buy

## Target Price

\$73.00

## Risk

Low

## Average Daily Volume

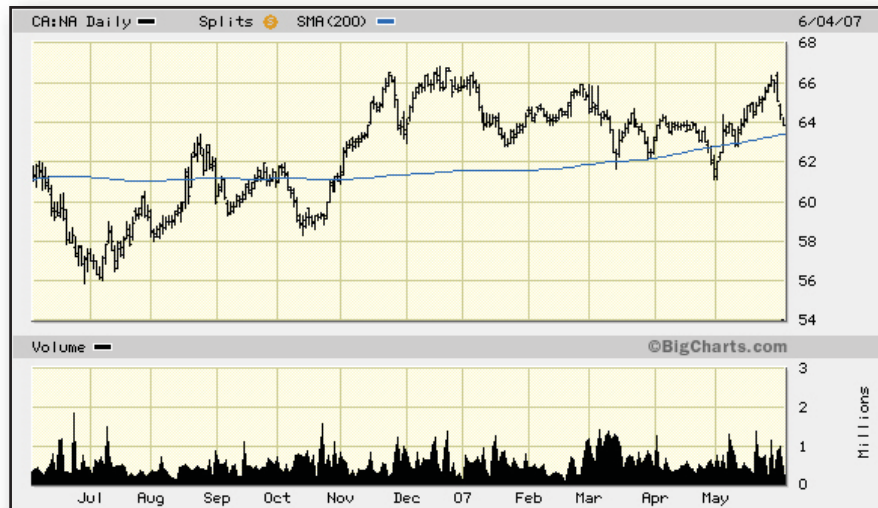
150 day: 546,340

## Quick Facts

**Recent Price** C\$65.10  
**Symbol** NA-T  
**Shares O/S** 159 million  
**52 Wk. Range** \$ 66.80-\$55.89  
**Fiscal Year End** October 31

	<u>EPS</u>	<u>Multiple</u>
<b>2006a</b>	\$5.05	12.9x
<b>2007e</b>	\$5.65	11.5x
<b>2008e</b>	\$6.10	10.7x
<b>Book Value</b>	\$28.92	2.3x
	<u>Rate</u>	<u>Yield</u>
<b>Dividend</b>	\$2.40	3.6%

# NATIONAL BANK OF CANADA



Data Source: BigCharts.com

*NATIONAL BANK OF CANADA is chartered under the Bank Act of Canada. The bank offers retail, commercial, corporate, international and treasury banking services through its branches and offices in Canada and around the world. National Bank Financial, a subsidiary of the bank, is an investment dealer. National Bank Trust, also a subsidiary, provides trust and asset management services.*

## CONCLUSION: BUY - 12 MONTH TARGET MAINTAINED AT \$73.00

Operating cash EPS (fd) was reported at \$1.40 up 13% Y/Y. Another good quarter (about 5 cents ahead of expectations) helped by strong trading and Capital Markets up 41% and 25% Y/Y respectively. Personal & Commercial (P&C) saw a spread contraction which restricted Y/Y net income gains to only 6%. Wealth Management had a Y/Y gain in net income of 10% which was lower than expected. Cash ROE was 20.3% down from 20.7% last quarter and flat Y/Y. Dividend per share increased to \$2.40 annually from \$2.16, an increase of 11% and a larger than expected increase.

We have increased our 2007 estimate to \$5.65 from \$5.60 to reflect the stronger than expected quarter. However we remain concerned that Financial Markets represented almost 41% of Q2/07 net income and that this level of contribution to overall earnings may not be sustainable. Consequently our 2008 EPS forecast, which has been increased to \$6.10 from \$6.00, reflects a slower EPS growth of only 8% going forward. Investors can expect to see continued good dividend growth as management recently increased the dividend payout ratio to the 40% to 50% range which is the second highest of the Canadian banks behind BMO and equal to that of RY. We expect the dividend payout ratio to average 46% in 2008 which means investors could expect to see a further dividend increase over the next 12-months to the \$2.75 to \$2.80 per share level for an increase of 15% to 17%. The 2007 and 2008 estimates are now predicated on a share repurchase program of 8.0 million shares annually. The shares remain a BUY with a total one year return of 15.8% expected.

## Valuation

NA is largely dependent on the domestic economy and will not benefit from foreign earnings growth. Our only real concern remains to be that the Bank's current earnings growth is benefiting from a higher than average dependency on the Financial & Capital group for revenues. The dividend policy and outlook plus the ability to repurchase shares remains very positive. We continue to believe that NA's performance is deserving of a multiple closer to the average of the majors, albeit still at small discount. Based on our 2008 EPS estimate, we have maintained our 12-month share price target at \$73.00.

## Other Quarterly Highlights

- Total net operating income for the bank in Q2/07 was reported at \$233 million or \$1.40 per share down from \$240 million in the previous quarter and up 13% Y/Y. Revenue was \$1,022 million a Y/Y gain of 9% while expenses increased by 7% Y/Y for a positive operating leverage of 2%.
- The Personal and Commercial group reported net income of \$110 million up 6% Y/Y. Revenues increased by 3% while expenses increased by 1%. The quarter was driven by continued good loan growth particularly in consumer and credit card lending with the combined portfolio up 15% Y/Y. Overall margins decreased by 4bp Y/Y and 10bp Y/Y as loan margins decreased 6bp Y/Y due to a mix to more secured lending. As expected the expense ratio increased in the quarter to 61.2% up from 57.6% last quarter as Q1/07 benefited from timing of some technology related expenses of about \$7 million.
- Wealth Management reported somewhat weak income of \$43 million up 10% Y/Y. Total revenue growth was only 6%. Retail brokerage revenue increased 10% Y/Y while investment management revenue, including mutual funds was up 10% Y/Y. Total AUM increased to \$106 billion up 9% Y/Y driven by segregated and private investment management AUM up 14% Y/Y. Expenses were well controlled improving efficiency ratios by 110bp Y/Y to 70.9%.
- Financial & Capital Markets reported very good net income of \$95 million up 32% Y/Y and up from \$87 million last quarter. Trading revenues were very strong at \$113 million this quarter up 41% Y/Y. Security gains were \$20 million down from the same quarter last year at \$31 million. Capital Markets revenue was strong at \$81.0 million a Y/Y increase of 25%.
- Provision for Credit Loss (PCL) was reported at \$23 million down from \$28 million last quarter and basically flat Y/Y from \$22 million in Q2/06. Gross impaired loans decreased to \$236 million from \$240 million last quarter and \$242 million last year. Net new impaired loan formations on the P&C portfolio remained relatively low at \$18 million. We now forecast PCL to increase to \$100 million in 2007 up from \$77 million in 2006.
- Unrealized security gains as at the end of the period were \$230 million up from \$162 million as at the end of the previous period.
- The bank repurchased 2.24 million common shares in the quarter for a total of 2.96 million in the first 6 months. Management stated that it intends to repurchase the maximum 8.1 million under the current normal-course issuer bid.

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