

Update Report

June 3, 2008

RBC FINANCIAL GROUP (RY - \$50.65)

Recommendation

Buy

Risk

Low

Target Price

\$63.00

Price

\$50.65

52-Week Range

\$59.16 - \$42.82

% Below High

-14.4%

% Above Low

18.3%

Shares O/S

1,294 million

Market Cap

\$65 billion

Average Daily Volume

3,565,700

Year-End

October 31

C\$	EPS	& Mult
2007a	\$4.24	11.8x
2008e	\$4.45	11.4x
2009e	\$5.00	10.1x
Book Value	\$18.35	2.7x

	Amount	Yield
Dividend	\$2.00	4.0%

Analysts

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Data Source: www.BigCharts.com

SECOND-QUARTER EARNINGS

HIGHLIGHTS

- Q2/08 Earnings Slightly Disappointing
- Partly Due to Currency but also Higher Credit Losses
- Remains a Top Choice

CONCLUSION

BUY: 12-Month Target Remains \$63.00

RBC Financial Group (RY) adjusted operating Q2/08 EPS were slightly disappointing, coming in about \$0.05 per share or 5% below our estimate. The bank reported cash Q2/08 EPS (fd) of \$0.72, which included \$854 million (\$436 million after-tax or \$0.33 per share) of writedowns previously announced and outlined below. Excluding these writedowns, adjusted operating earnings were \$1.03 per share.

Net income this quarter was impacted by higher provisions for credit losses (PCL) - up 85% Y/Y, largely the result of higher credit card losses and continued losses in the U.S. Domestic banking overall was solid, up 15% Y/Y driven by strong insurance earnings. Wealth Management (down 6% Y/Y) was weaker, due to the strong C\$ versus US\$ and lower transaction revenues. Otherwise, the underlying growth in Wealth Management remained remarkably strong given the recent market volatility. Capital Markets overall had strong trading revenues but experienced an 11% decline in net income. U.S. Banking was disappointing, with a significant increase in credit losses from U.S. Residential Builder Finance and currency translation. Cash adjusted ROE in the period continued very strong at 23.2%.

We believe that a large part of the writedowns this quarter relates to liquidity issues, and when securities are marked to market, the result is book losses. However, unlike credit losses on loans, many of these securities, particularly the municipal securities, when held to maturity will payout in full with no loss. Therefore, the probability of recoveries on these securities in future quarters is very high.

We have lowered our 2008 EPS estimate to \$4.45 from \$4.50, with the new estimate representing a Y/Y increase of 5%. Our EPS estimate of \$5.00 for 2009 remains unchanged. We expect continued weakness in U.S. Banking and slower Capital Markets revenue growth. Our loan-loss expectations have been increased to reflect the higher run rate currently being experienced. We have lowered our expected dividend increase over the next 12 months to the \$2.20- \$2.25 per share level, which now represents an increase of 10%-12%, down from the 12%-15% range.

RBC continues to be one of our top choices in the Canadian banking sector, as it appears intent on expanding its wealth management business both inside and outside Canada, a strategy we highly endorse. Although we have scaled back our expectations for dividend growth, we are maintaining our Buy recommendation.

Valuation

The Bank has clearly demonstrated that it can generate exceptional returns. We have applied a 12.6x multiple to the 2009 EPS forecast for RY, which is a premium to the average of the other majors but in line with BNS and TD. On this basis, we have maintained our target share price of \$63.00. RY remains a BUY. The total 12-month expected return is 28.3%.

Pre-Announced Writedowns of \$854 Million or \$436 Million After-Tax

- \$204 million in valuation adjustments related to exposure to a subsidiary of U.S. monoline insurer MBIA Inc.
- \$87 million in net writedowns on its positioning in U.S. subprime Collateralized Debt Obligations (CDOs).
- \$184 million in writedowns relating to Auction Rate Securities.
- \$142 million in writedowns on U.S. municipal GIC business.
- \$21 million in writedowns on U.S. Commercial Mortgage Backed Securities.
- \$76 million provision in U.S. insurance and Pension Solutions.
- \$140 million as a result of the deterioration in the U.S. subprime market on certain holdings classified as available-for-sale (AFS).

Update on Sub-Prime Risk Exposure - Appears Manageable

Management indicated that the Bank's gross exposure to U.S. subprime mortgages is US\$2.1 billion and US\$2.7 billion of CDOs (not sub-prime). We believe RY has the issue well under control and any further writedowns are very manageable.

Other Quarterly Highlights

- **Net income for the quarter was up 7% Y/Y to \$1,341 million** (excluding the writedowns of \$436 million after-tax). Total adjusted revenue growth was up 2% at \$5.8 billion. Domestic Personal & Business revenues (including insurance) increased by 15% Y/Y, Wealth Management increased by 1% Y/Y, U.S. & International revenues were disappointing, down 30% Y/Y, and Capital Markets revenue decreased by 11% Y/Y.
- **Canadian Personal and Business Banking (P&B) reported strong net income, up 15% Y/Y**, of \$708 million. Bank-related earnings were up 11% Y/Y, while insurance earnings

increased by double Y/Y. Interest margins narrowed by 25 bp on a Y/Y basis and 8 bp sequentially. Revenue (excluding insurance) increased by 3% Y/Y while expenses were flat, for an increase in operating leverage of 3%. Domestic Provision for Credit Losses (PCL) increased to \$224 million, up 10% Y/Y and up marginally over the previous quarter. The Y/Y increase was largely the result of higher provisions in credit card (up 12% Y/Y) and personal loans (up 15% Y/Y) but also generally reflected the 15% growth Y/Y in the loan portfolio. ROE for this group remained strong at 35.5%. Return on risk capital (RORC - excludes goodwill & intangible assets) was 47.4%.

- **Wealth Management revenue increased 1% Y/Y**, due largely to lower transaction base revenues. Fee-based revenue increased by 3% Y/Y, driven by good volume growth, particularly in mutual funds. Net income was reported at \$182 million, down 6% Y/Y. U.S. Wealth Management revenue decreased by 4% Y/Y, but increased 10% in constant currency. Canadian revenue decreased by 2% Y/Y. Global Asset Management revenue increased in the quarter by 5% on a Y/Y basis. RY reported total AUM of \$173.1 billion, up 9% Y/Y. The ROE was 34.8%, flat from 34.3% in the same period last year. RORC in the quarter was 72.4%, the highest of all reporting groups.
- **U.S. & International was very weak, as cash net income dropped 30% Y/Y** to \$57 million from \$82 million. Revenue of \$564 million was up 14% Y/Y. PLC increased sharply to \$91 million from \$10 million last year and \$71 million last quarter, driven by losses relating to U.S. Residential Builder Finance. ROE is still low at 3.0%. RORC was 6.3%.
- **RBC Capital Markets reported net income down 11% Y/Y** to \$310 million (excluding the charges mentioned above). Trading revenue was very good at \$786 million (excluding charges), down from record levels in the same period last year and above the eight-quarter average of \$490 million. Underwriting and advisory fees decreased by over 45% Y/Y.
- **Overall PCL was reported at \$349 million, up 85% Y/Y** and up from \$281 million last quarter. PCL as a percentage of average loans increased to 54 bp from 44 bp last quarter and well up from 35 bp in the same quarter last year - and now above management's target of 40-50 bp. For 2008, we have increased our PCL estimate to \$1.4 billion from \$1.2 billion previously. For 2009, we have increased our estimated PCL to \$1.5 billion up, from our previous estimate of slightly over \$1.3 billion.
- **Gross impaired loans increased in the quarter to \$1,990 million**, up from \$1,494 million last quarter and up from \$879 million last year. New Impaired loan formations were up in the quarter to \$831 million, from \$715 million in the previous quarter. However, of note is that real estate gross impaired continued to increase materially in the quarter to \$766 million, up from \$597 million in Q1/08 and up from \$137 million in the same period last year. Most of this increase was U.S.-related in the residential builder finance portfolio and could result in higher PCLs going forward.
- **Tier 1 capital was 9.5% under the new Basel II guidelines**, down from 9.8% last quarter, based on the new OSFI guidelines under Basel II.

Recent Events

RY Completes Acquisition of Phillips, Hager & North Investment Management Ltd. (PH&N)

RY announced on May 1, 2008 that had completed the acquisition of PH&N. PH&N has about \$69 billion in Assets Under Management (AUM), with \$20 billion in mutual funds, an estimated \$6 billion in high net worth, \$10 billion in pooled funds and some \$33 billion in pension funds. RBC mutual fund AUM increases to slightly over \$100 billion, only \$3 billion short of the #1 player, IGM Financial. This transaction will likely not be accretive to earnings in the near term.

RBC Centura Completes Acquisition of Alabama National

RBC announced on February 25, 2008 that RBC Centura completed the acquisition of Alabama National Bancorporation (ABN), parent bank of 10 subsidiary banks in the states of Alabama, Florida and Georgia. RBC paid \$1.6 billion, consisting of 50% cash and the balance RBC shares. This acquisition doubles the bank's presence in Alabama and Florida, and adds 13 branches in Georgia and almost \$8 billion in assets. RBC Centura now has about 430 banking centres in the southwestern U.S.

RY to Acquire Ferris, Baker Watts, Inc.

RBC announced on February 14, 2008 that it had signed a definitive agreement to acquire Ferris, Baker Watts Inc. (FBW) through its subsidiary RBC Dain Rauscher Inc. Details were not disclosed. FBW is a privately-held full-service broker and investment banking firm, with 42 branches and 15 Capital Markets offices in 10 states and the District of Columbia, and approximately 330 financial consultants and about \$18.5 billion in assets under administration.

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