

RBC FINANCIAL GROUP

(RY:TSX \$53.10)

Recommendation

Buy

Risk

Low

Target Price

\$63.00

Price (Dec 4)

\$53.10

52-Week Range

\$54.70-\$72.75

% Below High

-13.0%

% Above Low

9.3%

Shares O/S

1,276 million

Market Cap

\$68 Billion

Average Daily Volume

20-Day: 0

150-Day: 0

Year-End

October 31

C\$Mil	EPS	&Mult
2006A	\$3.61	14.7x
2007A	\$4.24	12.5x
2008E	\$4.65	11.4x
Book Value	\$17.58	3.0x

	Amount	Yield
Dividend	\$2.00	3.8%

Analyst

Robin Cornwell, MBA



Data Source: www.Stockhouse.ca

Q4/07 Earnings Disappointing Domestic & Wealth Management Remains Strong U.S. Loan Losses Creeping Up & Something To Watch

Conclusion: BUY - 12 Month Target Maintained At \$63.00

RBC Financial Group (RY) adjusted Q4/07 EPS was somewhat disappointing coming in at about \$0.06 per share or 7% below our estimate and below that of consensus. The Bank reported cash Q4/07 EPS (fd) of \$1.03, a gain of 6% Y/Y. Adjusted earnings were \$1.01 excluding 3 previously announced items (i) a \$360 million write-down (\$160 million after-tax or \$0.13 per share), (ii) a \$120 million (\$80 million after-tax or \$0.09 per share) charge on its credit card loyalty program and (iii) a gain from the global VISA restructuring of \$325 million (\$270 million after-tax or \$0.21 per share).

The net income this quarter was driven by a combination of solid Wealth Management (+9% Y/Y) and Capital Markets (+15% Y/Y) performances plus positive leverage from Domestic Banking. U.S. Banking was disappointing with a significant increase in credit losses from the housing sector. Cash ROE in the period continued very strong at 23.0%.

For fiscal 2007 as a whole, RY reported adjusted EPS of \$4.24 up from \$3.61 in fiscal 2006 for a Y/Y gain of 17%. Overall an excellent performance. Adjusted ROE was 24.6% up from 23.5% last year. The annual dividend rate increased to \$2.00 per share up from \$1.60 in 2006, an increase of 25% in the year. This represents a payout ratio of 47% which is at the low end of the target payout ratio of 45% to 50%.

We have lowered our 2008 EPS estimate to \$4.65 from \$4.85, with the new estimate representing a Y/Y increase of 10%. Our estimate is at the high end of managements guidance for fiscal 2008 of about \$4.55 to \$4.65 per share. We expect Wealth Management to continue strong but we are expecting continued weakness in the U.S. Banking and some slowing to develop in Capital Market revenues into 2008. We expect further dividend increases over the next 12 months to the \$2.25 to \$2.30 per share level, representing an increase of 12% to 15%.

Valuation

Our EPS and dividend growth projections plus an exceptional ROE continues to place RY at the top of all the Canadian banks. The Bank has clearly demonstrated that it can generate exceptional returns. We have applied a 13.6x multiple to the 2008 EPS forecast for RY which is a premium to the average of the other majors but in line with BNS & TD. On this basis we have maintained our target share price to \$63.00 previously lowered from \$67.00. RY remains a BUY. Total 12-month expected return is 22.4%.

Update On Risk Exposure – Appears Manageable

Management indicated that the Bank's total exposure to U.S. subprime mortgages in nil, Residential Mortgage Backed Securities (RMBS) and Collateralized Debt Obligation's (CDO) is net \$604 million, or 0.1% of total assets. Non-bank ABCP holdings of \$4 million. No direct sponsorship of SIV's and \$1 million of direct holdings and \$140 million of liquidity facilities with none drawn. In addition management indicated that the Bank does not originate sub-prime loans.

Other Quarterly Highlights

- Total revenue growth was 5% Y/Y. Domestic Personal & Business revenues (excluding insurance) increased by 13%, Wealth Management was up 9%, U.S. & International revenue was up 6% and Capital Markets revenue increased by 6%.
- Net income for the quarter was \$1,324 million, up 5% Y/Y and down 5% sequentially.
- Canadian Personal and Business Banking (P&B) reported net income of \$901 million. Excluding the Visa gain and the loyalty program charge net income was \$711 million up 5% Y/Y. The quarter was in line with expectations as interest margins narrowed by 14bp on a Y/Y basis and 5bp sequentially. Revenue (excluding insurance) increased by 8% Y/Y while expenses increased by 6% for an increase in operating leverage of 2%. Domestic provision for Credit Losses (PCL) increased to \$212 million from \$173 million in Q4/06. The Y/Y increase was largely the result of higher provisions in the credit card and unsecured credit line portfolios but also generally reflected the 13% growth Y/Y in the loan portfolio. ROE for this group was 40.6%. Return on risk capital (RORC – excludes goodwill & intangible assets) was 52.9%.
- Global insurance operations reported net income of \$102 million about flat Y/Y.
- Wealth Management revenue increased 9% Y/Y due to good volume growth particularly in mutual funds. Net income was reported at \$185 million up 9% Y/Y. Mutual fund revenue was up 11% Y/Y. U.S. Wealth Management revenue increased by 19% Y/Y in constant currency while Canadian revenue increased by 11% Y/Y. Global Asset Management revenue increased in the quarter on a Y/Y basis by 14%. Total AUM was up over 13% Y/Y and RY reported total AUM of \$161.2 billion up 14% Y/Y. The ROE increased to 31.7% up from 28.7% in Q4/06 last year. RORC in the quarter was 62.4%, the highest of all reporting groups.

- U.S. & International (excludes wealth management) was very weak reporting revenue of \$455 million up 6% Y/Y and cash net income of \$36 million down from \$92 million last year. PLC increased sharply to \$72 million driven by losses relating to U.S. Residential Builder Finance. Interest margins remained under pressure declining 18bp sequentially and 26bp Y/Y. ROE is still low at 2.2%. RORC was 3.8%.
- RBC Capital Markets had a good quarter reporting net income of \$346 million (excluding the loss charge) up 15% Y/Y. Trading revenue continued strong at \$630 million up marginally from \$592 million last quarter and up 27% Y/Y. Underwriting and advisory fees increased Y/Y by 3%.
- Overall PCL was reported at \$250 million up from \$175 million in Q3/07 and up from \$157 million in Q4/06. PCL as a % of average loans increased to 42bp from 29bp in Q3/07 and now still in line with management's target of 40 to 50bp. For fiscal 2007, PCL was \$782. For 2008 we have increased our PCL estimate to \$925 million up from \$825 million previously.
- New Impaired loan formations were up in the quarter to \$589 million from \$383 million in the previous quarter, however of note, is that real estate gross impaired increased to \$345 million up from \$187 million last quarter and \$82 million in Q4/06.
- Gross impaired loans increased in the quarter to \$1,140 million up from \$940 million last quarter and up from \$834 million last year.
- Tier 1 capital was 9.4% up from 9.3% last quarter but down from 9.6% in Q4/06 with the decline Y/Y directly related to the strong loan growth.

Recent Events

RY Announces Intention To Buy Alabama National

On September 6, 2007, RY announced its intention to buy Alabama National Bancorporation through RBC Centura for US\$1.6 billion. The deal is about 19.8x 2007 EPS estimates and about 3x book value. The deal is expected to close in early 2008 and should be accretive to RY's 2009 EPS.

RY Reaches Agreement To Acquire RBTT Financial Group

RY announced on October 3, 2007 that it had reached an agreement to acquire RBTT Financial Group (RBTT) based in the Caribbean for \$2.2 billion. The deal will make the RBC the 4th largest bank in the Caribbean with proforma \$13.6 billion of assets (130 branches) just behind 3rd Scotiabank at \$16.1 billion. The deal will be paid 40% in RBC Shares and 60% in cash. RY to pay 14.2x trailing 2007 RBTT earnings and 3.05x book value. Expected to close in Mid-2008.

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