AUGUST 2019

Cardinal Update

What's Weighing Down the Banks

Over the past year, the equal-weighted average total return of the Big Six Canadian banks has underperformed the broader TSX index.

Some of this underperformance is due to broader industry concerns, while the balance relates to name-specific concerns that have dragged down total returns.

Within the industry itself, Canadian housing, interest rates, and credit are the main areas of focus.

- Canadian housing: slowdowns in Ontario and B.C. were very much orchestrated with the introduction of government regulations that should be healthy for the market despite near-term disappointment in growth. We continue to believe that housing will not be a credit issue given underlying equity protection, market structure, and underwriting, but will rather prove to be a modest revenue headwind for banks.
- Interest rates: the recent decline in yields is a net negative for the group, but a manageable issue. What is important to understand is that the repricing of loans takes place over time as maturities roll over. While the asset side reprices lower, so does the funding side of the equation.
- Credit: the lower rate environment and low unemployment rates should help keep credit conditions benign. The metrics we continually monitor reflect a decent backdrop for credit. This remains a key difference between market perception and our belief that the credit cycle will be elongated.

On name-specific concerns, Scotiabank and CIBC have been laggards relative to the rest of the group.

Scotiabank's Latin America exposure amidst U.S.-Mexico trade tensions and the integration of acquired businesses has resulted in weaker investor sentiment. However, given Latin America is one of the stronger growing components of their business (+23% in earnings year over year in 2Q19) and acquisition integration appears to now be on track, we believe that the sentiment will eventually shift as the business continues to deliver profit growth.

CIBC's fiscal 2019 earnings are projected to be flat due to early dilution from the PrivateBancorp acquisition along with modestly elevated expenses from investments in technology and the business. The focus on the near-term sometimes obscures the longer-term strategic benefits, which is the case here. Diversification into the U.S. through acquiring a well-respected commercial banking operation is a strategically sound move, while ongoing investments in technology are necessary to maintain and grow the business – i.e. foregoing investment to show better earnings growth would be a mistake. Ultimately, the discount here is too wide, and should reset next year when earnings show growth again.

While the underperformance of the group has been disappointing, it is important to remember that the Canadian banks remain strong dividend-paying, dividend-growing companies. Case in point, despite the underperformance, to the end of F2Q19 the average dividend has increased +8% over the prior year with increases ranging from 5% to 10%. Coupled with the dividend growth, the banks remain attractively valued and trade around 9.6x estimated F2020 earnings (ranging from 8.1x to 10.8x). Consequently, we continue to support the Canadian banks as core holdings that will help drive a steadily growing income stream and deliver exceptional share price returns from current trading levels.

Company Focus:

AMGEN

Amgen is the world's largest biotechnology company, having produced blockbuster drugs such as Enbrel and Prolia as well as the recently launched drugs Repatha and Aimovig.

Amgen has six therapeutic focus areas: oncology/hematology, cardiovascular disease, inflammation, bone health, nephrology, and neuroscience. Amgen also develops biosimilars, which are copies of some of the world's largest drugs, providing a growth channel and a hedge as a few of their own drugs face biosimilar competition. The decline in Enbrel sales, Amgen's largest drug, has led to compression in the P/E ratio to just over 12x, which is at the bottom of its 5-year range.

Amgen has industry-leading margins and generates significant free cash flow. Biotechnology and pharmaceutical companies are capital-light businesses, allowing Amgen to return significant amounts of cash to shareholders via dividends and share repurchases, while continuously investing in research and development to drive future growth. Amgen has a 3.3% dividend yield and has increased the dividend at a 23% annual rate since its introduction in 2011. With a payout ratio of only 40%, Amgen should continue to grow the dividend with in-step with earnings growth going forward.

DIVIDEND INCREASES

Bank of America Corp.	20.0%
PNC Financial Services Group	21.1%
Simon Property Group	2.4%
Walgreens Boots Alliance	4.0%
Wells Fargo & Co.	13.3%

(During the period July 1 to July 31, 2019)

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400-1780 WELLINGTON AVENUE • WINNIPEG, MANITOBA • R3H 1B3 • WWW.CARDINAL.CA

CARDINAL CAPITAL MANAGEMENT, INC.