Bank of Montreal (BMO)

Updated June 29th, 2018 by Josh Arnold

Key Metrics

Current Price[1]:	$101	**5 Year CAGR Estimate:**	6.7%	**Volatility Percentile:**	25.7%
Fair Value Price[1]:	$95	**5 Year Growth Estimate:**	4.0%	**Momentum Percentile:**	52.9%
% Fair Value:	106%	**5 Year Valuation Multiple Estimate:**	-1.2%	**Total Return Percentile:**	76.9%
Dividend Yield:	3.9%	**5 Year Price Target**	$115	**Valuation Percentile:**	87.4%

Overview & Current Events

Bank of Montreal was formed in 1817, becoming Canada's first bank. The past two centuries have seen BMO grow into a global powerhouse of financial services and today, it has more than 1,500 branches. BMO produces more than C$22B in revenue each year and has a market cap of C$66B.

The bank's recently reported Q2 earnings were strong as adjusted earnings-per-share were up 15% on broad strength across its business segments. BMO also reported a 7% dividend increase as well as the repurchase of 5M shares of stock during the quarter. Its adjusted operating leverage target of 2% for this year was surpassed in Q2 with a 3.5% gain and its adjusted return on equity was very strong at 14.9%. Loan performance remains robust as well so overall, BMO's Q2 was quite good. Management seems optimistic that these results will continue for the rest of the year and given the results we've seen in the first half of the fiscal year, BMO's outlook is certainly very bright.

Growth on a Per-Share Basis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
EPS[1]	$3.77	$3.33	$4.75	$5.26	$6.15	$6.26	$6.41	$6.57	$6.92	$7.66	***$8.15***	***$9.85***
DPS[1]	$2.80	$2.80	$2.80	$2.80	$2.82	$2.94	$3.08	$3.24	$3.40	$3.56	***$3.90***	***$4.75***

BMO's earnings-per-share performance has actually been very stable in the past decade, a period in which most banks have struggled. BMO's earnings-per-share bottomed out in 2009 but it was still very profitable while other large financial institutions went out of business. Since that time, BMO has produced higher earnings-per-share every year and we expect that will continue for the foreseeable future. We forecast $8.15 in earnings-per-share this year and 4% annual growth thereafter given the high level of performance BMO continues to exhibit.

This rate of growth is fairly low simply because BMO is already hitting records for earnings due to its very high levels of profitability. It is therefore going to be challenging to continue to boost profitability as the base it is working from is quite high. However, we do see low single digit revenue growth as playing into our 4% forecast as well as a low single digit tailwind from share repurchases, although BMO's history with the latter factor is irregular, meaning forecasting the exact impact is difficult. It is possible there is a small amount of margin growth from operating leverage left for BMO but keep in mind that as loan loss provisions are also near historical lows, further improvement in overall margins will likely prove difficult. If credit quality deteriorates, margins will suffer meaningfully, although no evidence of this occurring exists today. We are optimistic that BMO will continue to perform very well but at this point, its growth outlook is a victim of its own past success.

We see the dividend as rising at about the rate of earnings-per-share growth, implying a payout of $4.75 in 2023. That will keep BMO firmly in the category of income stock for those seeking a high current yield.

Valuation Analysis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Now	2023
Avg. P/E	13.1	12.5	12.3	11.4	9.4	10.2	11.9	11.6	11.6	12.5	***12.4***	***11.7***
Avg. Yld.	5.7%	6.8%	4.8%	4.7%	4.9%	4.6%	4.0%	4.2%	4.2%	3.7%	***3.9%***	***4.1%***

[1]Figures in Canadian Dollars

BMO's price-to-earnings ratio has been quite steady in the past decade despite the tumultuous environment that has existed for banks during that time. The current ratio of 12.4 compares a bit unfavorably to its longer-term average of 11.7, which we see as fair value. That implies there will be a 1.2% annual headwind to total returns from a valuation that is slightly in excess of fair value. We think the yield will remain around where it is today, in the area of 4%, as the share price and dividend growth approximately pace each other's growth.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
ROA	0.48%	0.50%	0.68%	0.68%	0.80%	0.79%	0.74%	0.69%	0.67%	0.73%	***0.70%***	***0.72%***
Debt/A	95%	95%	95%	94%	94%	94%	94%	94%	94%	94%	***94%***	***94%***
LLP/Loans	0.6%	0.8%	0.5%	0.4%	0.3%	0.2%	0.2%	0.2%	0.2%	0.2%	***0.2%***	***0.2%***
Payout	75%	74%	61%	56%	47%	48%	49%	50%	51%	48%	***48%***	***48%***
Std. Dev.	40%	35%	18%	10%	11%	13%	10%	15%	14%	13%	***15%***	***18%***

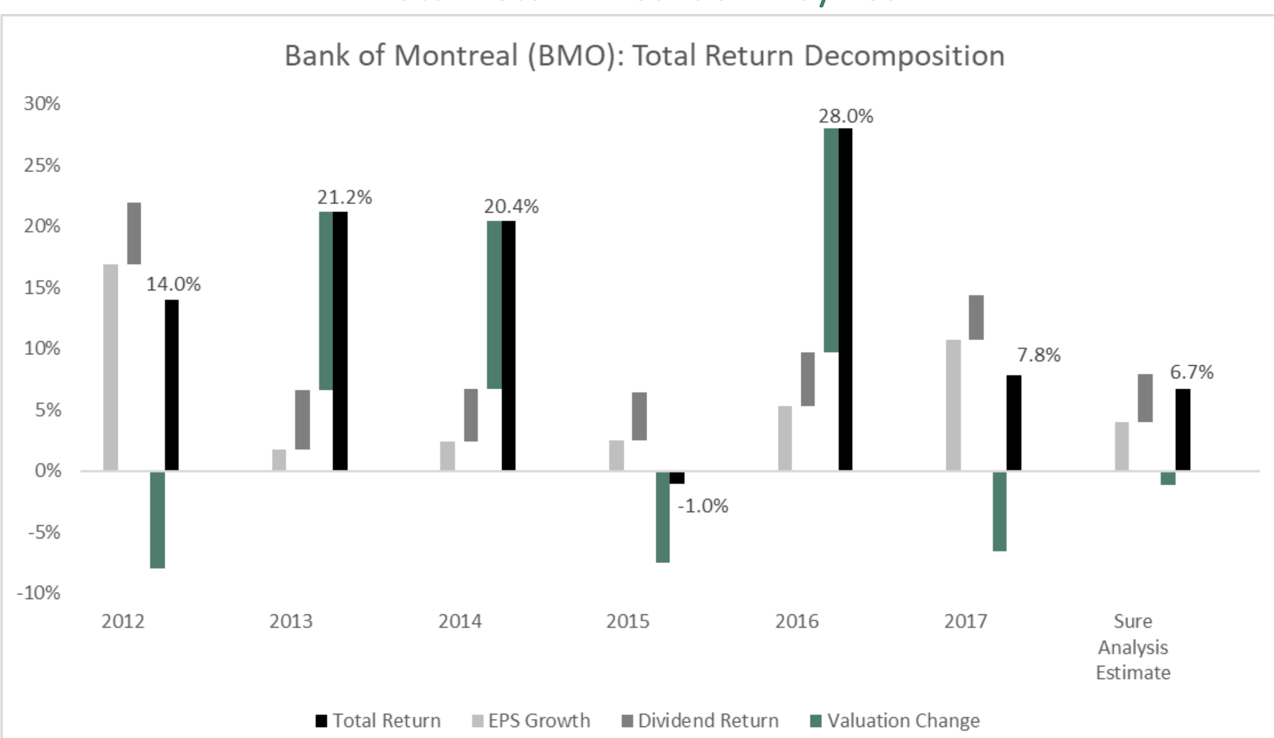
BMO's quality metrics have improved markedly in the past decade, meaning that further improvement will likely prove difficult. Return on assets and loan loss provisions as a percentage of total loans have moved firmly in the right directions since the Great Recession of 2008/2009 and we think BMO will have a difficult time further improving these key metrics. We do think they'll remain around where they are today, so we certainly aren't bearish.

BMO's competitive advantage is in the long history and reputation of its brand as well as its immense size in a smaller market like Canada. Recessions are tough for banks but BMO performed admirably during the last one, something which shareholders can expect moving forward given the significant strength this company is showing today.

Final Thoughts & Recommendation

Overall, we see BMO as being a hold at current prices and not a buy, although it is trading slightly in excess of fair value at present. We forecast 6.7% in total returns annually moving forward, consisting of the current 3.9% yield, 4% earnings-per-share growth and a 1.2% headwind from a lower price-to-earnings ratio. BMO is certainly adequate as an income stock and today, that is likely the only reason to own it. For those seeking value, a lower entry price is needed.

Total Return Breakdown by Year



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