Bank of New York Mellon (BK)

Updated July 20th, 2018 by Josh Arnold

Key Metrics

Current Price:	$53	**5 Year CAGR Estimate:**	12.0%	**Volatility Percentile:**	53.9%
Fair Value Price:	$62	**5 Year Growth Estimate:**	7.0%	**Momentum Percentile:**	34.9%
% Fair Value:	86%	**5 Year Valuation Multiple Estimate:**	3.2%	**Valuation Percentile:**	83.8%
Dividend Yield:	1.8%	**5 Year Price Target**	$86	**Total Return Percentile:**	79.5%

Overview & Current Events

Bank of New York Mellon opened its doors in 1784 in the wake of the American Revolution, founded in part by Alexander Hamilton. The company was the first ever to make a loan to the US government and in the 230+ years since, has grown to $17 billion in annual revenue and a market capitalization of $53 billion.

The bank reported Q2 earnings on 7/19/18 and results weren't taken well by investors. Revenue was up 5% as fee revenue – the core of its business – was up 3% and net interest revenue rose 11%. Investment management was a bright spot as revenue rose 8% and segment operating earnings were up 20%. Total operating expenses were up just 3%, affording the bank 17% earnings-per-share growth against last year's Q2. In addition, Bank of New York Mellon repurchased 12 million common shares during the quarter for $651 million and further authorized $2.4 billion in additional purchases through Q2 of next year, good for almost 5% of the float at the current price. Earnings-per-share fell 6% sequentially against Q1 but overall, we see the bank's Q2 as another strong report.

Growth on a Per-Share Basis

Year	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2023**
EPS	$1.20	$1.07	$2.14	$2.03	$2.03	$1.74	$2.41	$2.85	$3.17	$3.31	***$4.25***	***$5.95***
DPS	$0.96	$0.51	$0.36	$0.48	$0.52	$0.58	$0.66	$0.68	$0.72	$0.86	***$0.96***	***$1.35***

Bank of New York Mellon's earnings-per-share were a bit underwhelming coming out of the crisis as earnings were roughly flat for 6 years. However, since 2013 we've seen strong growth as the bank has worked out its efficiency issues and has been better able to capitalize on its revenue growth. To that end, we are forecasting robust 7% earnings-per-share growth annually moving forward, in a continuation of the trend we've seen in the past five years.

Bank of New York Mellon will achieve this growth in a variety of ways. First, revenue continues to grow in the mid-single digits, something we expect to continue. Bank of New York Mellon is different from the other large banks in that its revenue is heavily dependent upon fees, not from interest income. Its assets under custody and administration continue to grow, which is a key driver of fee income. Its lending business is small but growing and continues to add to top line growth as well. We also see Bank of New York Mellon continuing its mid-single digit pace of share repurchases, resulting in a meaningful tailwind for earnings-per-share outside of revenue and earnings growth. Finally, we expect margins to continue to improve slightly over time as the bank realizes additional operating leverage from higher revenue outpacing expense growth, as we saw in Q2.

The dividend isn't a huge draw here as BK has never really been an income stock, but it is roughly at the broad market average at 1.8% today. We see the dividend rising from $0.96 to $1.35 in 5 years, keeping pace with earnings growth.

Valuation Analysis

Year	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**Now**	**2023**
Avg. P/E	31.8	---	13.0	12.4	11.2	17.2	15.1	14.5	12.7	15.1	***12.4***	***14.5***
Avg. Yld.	2.5%	1.9%	1.3%	1.9%	2.3%	1.9%	1.8%	1.6%	1.8%	1.7%	***1.8%***	***1.6%***

Bank of New York Mellon's price-to-earnings multiple has been fairly steady since the crisis ended but has fallen of late. Today, it stands at just 12.4. That is below what we assess as fair value at 14.5 and as such, we foresee a 3.2% tailwind to total returns as the multiple returns to more normalized levels over time. With the large banks selling off of late, BK looks to be a bargain at present. We see the yield as remaining roughly where it is today, but the rising valuation may cause it to tick down to 1.6% from today's 1.8%.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
ROA	0.60%	---	1.09%	0.77%	0.70%	0.59%	0.76%	0.82%	1.07%	0.99%	***1.08%***	***1.15%***
Debt/A	88%	86%	87%	90%	90%	90%	90%	90%	88%	89%	***89%***	***89%***
Int. Cov.	1.8	---	7.4	5.6	6.8	10.4	10.2	15.4	11.6	5.2	***5.0***	***4.2***
Payout	80%	---	16%	24%	25%	34%	28%	27%	25%	29%	***23%***	***23%***
Std. Dev.	32.6%	43.8%	24.4%	30.1%	21.5%	16.0%	17.8%	20.6%	26.2%	14.3%	***19.0%***	***24.0%***

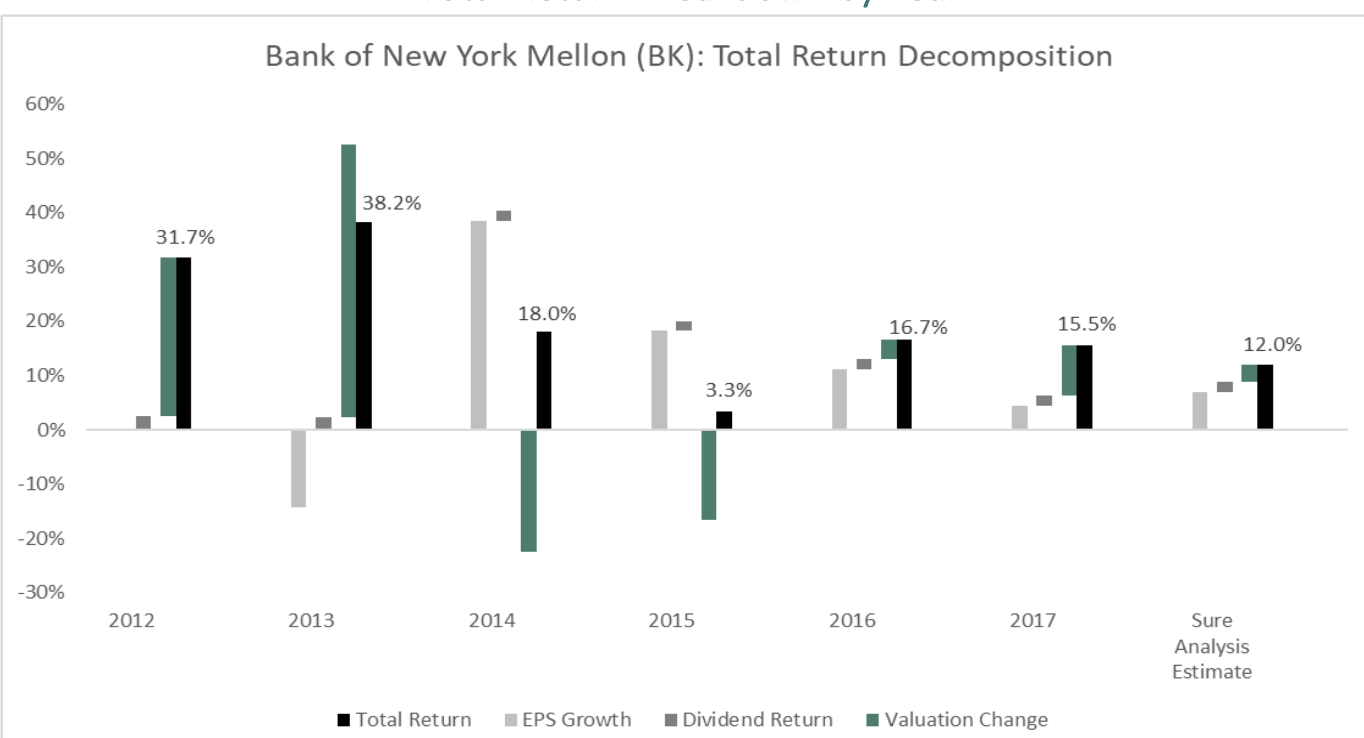
Bank of New York Mellon's quality metrics have moved around a bit over the past decade but overall, they have improved. Its margins are much higher with return on assets in excess of 1% after years of sub-1% results. We see that continuing as it enjoys its lower tax rate as well as additional operating leverage moving forward via prudent expense controls. Bank of New York Mellon's balance sheet is very steady at around 90% of assets financed by liabilities but its interest coverage has declined in recent years. We expect that will continue in the coming years, although the damage will be slight and is not a worry at this point given strength in the fee business and cost controls.

Bank of New York Mellon's competitive advantage is in its lack of reliance upon lending for revenue. This allows it to perform relatively well during recessions when other banks are struggling and while it isn't immune to downturns, its fee model is more resilient to such conditions than a bank that makes the majority of its revenue from interest income.

Final Thoughts & Recommendation

Overall, Bank of New York Mellon looks like an undervalued stock with strong growth potential. We are forecasting total annual returns of 12.0% going forward, consisting of the current 1.8% yield, 7% EPS growth and a 3.2% tailwind from the rising valuation. Bank of New York Mellon's recent selloff has made the stock attractive once more and we see it as appropriate for those investors seeking value or growth, as well as those that may be seeking diversification from traditional banks. Bank of New York Mellon's model works and with its focus on cost controls, the future looks bright.

Total Return Breakdown by Year



Disclosure: This analyst has no position in the security discussed in this article, and no plans to initiate one in the next 72 hours.