Bank of Montreal (BMO)

Updated December 9th, 2018 by Josh Arnold

Key Metrics

Current Price:	$93	**5 Year CAGR Estimate:**	12.1%	**Volatility Percentile:**	4.6%
Fair Value Price:	$112	**5 Year Growth Estimate:**	4.0%	**Momentum Percentile:**	43.6%
% Fair Value:	83%	**5 Year Valuation Multiple Estimate:**	3.8%	**Growth Percentile:**	21.0%
Dividend Yield:	4.3%	**5 Year Price Target**	$136	**Valuation Percentile:**	76.5%
Dividend Risk Score:	C	**Retirement Suitability Score:**	A	**Total Return Percentile:**	66.8%

Overview & Current Events

Bank of Montreal was formed in 1817, becoming Canada's first bank. The past two centuries have seen Bank of Montreal grow into a global powerhouse of financial services and today, it has more than 1,500 branches. Bank of Montreal produces more than C$23 billion in revenue each year and trades with a market capitalization of C$59 billion. Bank of Montreal is cross-listed in both New York and Toronto. We use Canadian Dollars throughout the report.

Bank of Montreal reported Q4 earnings on 12/4/18 and results were strong, slightly beating consensus. Adjusted earnings-per-share came in at $2.32, an increase of 19% year-over-year. Net interest income rose 5% while noninterest income rose slightly less than that, producing a total revenue gain of 4.7% in Q4. Adjusted net income from the Canadian P&C segment rose 8% year-over-year thanks to lower credit loss provisions and strong revenue growth. The US P&C segment saw its net income rise 31% thanks to higher revenue and a lower tax rate in the US, partially offset by higher expenses and higher credit loss provisions. The Wealth Management business saw its net income rise 21% as it grew revenue and enjoyed a lower tax rate. The one weak spot in the quarter was the Capital Markets business, which saw its net income decrease 2% as higher expenses and lower trading products revenue more than offset higher total revenue and a lower tax rate. In all, Bank of Montreal's operational metrics were quite strong in Q4, capping a great 2018.

In addition, the bank's capital position and profitability metrics continue to be a source of strength. Return on equity soared to 16.1% in Q4, up from 12.1% in the prior year. Its efficiency ratio fell to 58.3% in Q4, down from a very high level of 66.4% in the year-ago period. Its common equity tier 1 ratio was virtually flat year-over-year, as were its other major balance sheet metrics. However, Bank of Montreal's capital position is very strong and thus, it is returning more of its excess capital to shareholders via dividends and buybacks as it does not need to build capital on the balance sheet. Its earnings are strong enough that it can pay a sizable yield, buy back stock and still maintain more than adequate capital ratios. As a result, Bank of Montreal boosted its dividend payment to $1 per quarter, beginning in Q1 of fiscal 2019.

Growth on a Per-Share Basis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
EPS	$3.33	$4.75	$5.26	$6.15	$6.26	$6.41	$6.57	$6.92	$7.66	$8.99	***$9.55***	***$11.62***
DPS	$2.80	$2.80	$2.80	$2.82	$2.94	$3.08	$3.24	$3.40	$3.56	$3.76	***$4.00***	***$5.00***
Shares	552	566	639	651	644	649	643	646	648	639	***635***	***625***

Bank of Montreal's earnings-per-share performance has actually been very stable in the past decade, a period in which most banks have struggled. Since 2009, the bank has produced higher earnings-per-share every year and we expect that will continue for the foreseeable future. We forecast C$9.55 in earnings-per-share this year and 4% annual growth thereafter given the high level of performance Bank of Montreal continues to exhibit.

This rate of growth is fairly low simply because Bank of Montreal 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 stronger margins. Keep in mind, however, that loan loss provisions are near historical lows and fell further in Q4, meaning there is downside risk to earnings. If credit quality deteriorates, margins will suffer meaningfully, although no evidence of this occurring exists today. We are optimistic that the bank 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 $5.00 in 2024. That will keep Bank of Montreal firmly in the category of income stock for those seeking a high current yield.

Valuation Analysis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Now	2024
Avg. P/E	12.5	12.3	11.4	9.4	10.2	11.9	11.6	11.6	12.5	11.0	***9.7***	***11.7***
Avg. Yld.	6.8%	4.8%	4.7%	4.9%	4.6%	4.0%	4.2%	4.2%	3.7%	3.8%	***4.3%***	***3.7%***

Bank of Montreal'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 just 9.7 compares very favorably to its longer-term average of 11.7, which we see as fair value. That implies there will be a 3.8% annual tailwind to total returns from a valuation that is slightly in excess of fair value. We think the yield will move lower over as the share price outpaces gains in the dividend, but the stock should continue to yield nearly 4%.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
Payout	74%	61%	56%	47%	48%	49%	50%	51%	48%	42%	***42%***	***43%***

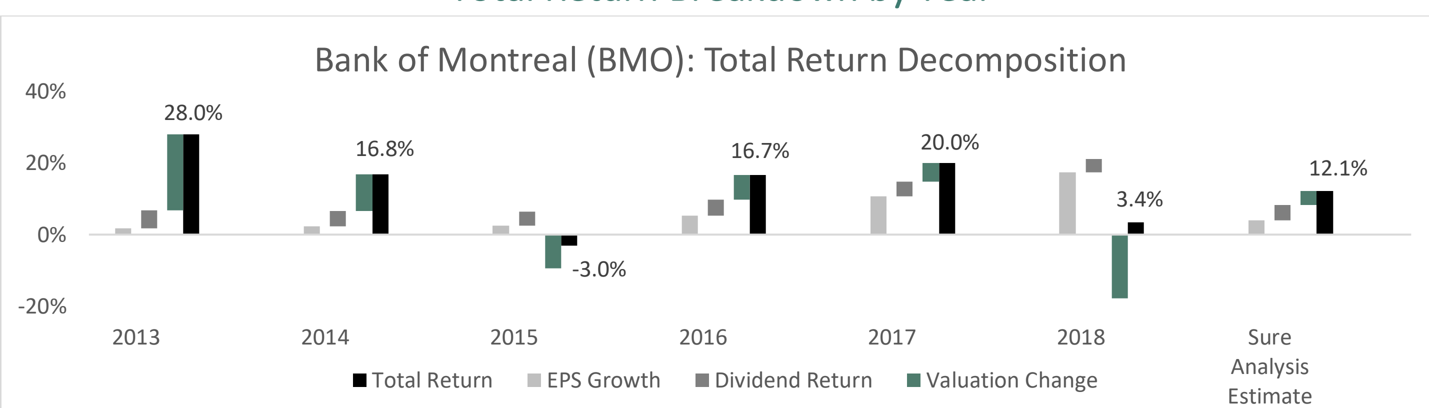
Bank of Montreal's quality metrics have improved markedly in the past decade, meaning that further improvement will likely prove difficult. Return on assets and loan loss provisions as a percentage of total loans have moved firmly in the right direction since the Great Recession of 2008/2009 and we think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

Bank of Montreal'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 Bank of Montreal performed admirably during the last one, something which shareholders can expect moving forward given the strength this company is showing today.

Final Thoughts & Recommendation

We are upgraded Bank of Montreal to a buy after the recent selloff. We forecast 12.1% in total returns annually moving forward, consisting of the current 4.3% yield, 4% earnings-per-share growth and a 3.8% tailwind from a higher price-to-earnings ratio. Bank of Montreal is certainly adequate as an income stock and today, it is also trading well under fair value. We see the stock as providing a strong mix of current yield, value and growth potential.

Total Return Breakdown by Year



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

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Income Statement Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Revenue	11064	12210	13943	15929	16830	18054	19182	20947	21874	22870
SG&A Exp.	5321	5360	5468	6405	7414	8578	9254	9865	9984	9766
D&A Exp.	472	470	538	682	694	747	788	828	876	903
Net Profit	1787	2810	3041	4082	4130	4277	4370	4622	5348	5450
Net Margin	16.2%	23.0%	21.8%	25.6%	24.5%	23.7%	22.8%	22.1%	24.4%	23.8%
Free Cash Flow	12414	-7065	977	9597	10829	-3664	1726	-3339	2117	17026
Income Tax	217	687	876	874	1055	903	936	1101	1296	1960

Balance Sheet Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Total Assets ($B)	388.46	437.71	500.58	525.45	537.04	588.66	641.88	687.94	709.58	774.05
Cash & Equivalents	13295	22617	25656	26282	32607	34496	47677	36102	39671	52050
Acc. Receivable	N/A	N/A	N/A	8674	6434	6983	7384	8833	7587	8371
Goodwill & Int.	2229	2431	5211	5269	5330	7405	8277	8559	8403	8645
Total Liab. ($B)	368.26	416.03	472.74	495.36	505.87	553.26	601.97	645.61	665.23	728.32
Accounts Payable	N/A	N/A	N/A	9901	8464	8763	9716	11067	11108	11402
Long-Term Debt	5386	4963	6169	4093	3996	4913	4416	4439	5029	6782
Total Equity	20197	17611	23492	26190	27842	31273	36182	38464	40114	41387
D/E Ratio	0.27	0.25	0.23	0.14	0.13	0.14	0.11	0.10	0.11	0.15

Profitability & Per Share Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Return on Assets	0.4%	0.7%	0.6%	0.8%	0.8%	0.8%	0.7%	0.7%	0.8%	0.7%
Return on Equity	9.4%	14.9%	14.8%	16.4%	15.3%	14.5%	13.0%	12.4%	13.6%	13.4%
ROIC	7.2%	10.8%	10.0%	12.0%	11.9%	11.3%	10.3%	10.1%	11.1%	10.7%
Shares Out.	552	566	639	651	644	649	643	646	648	639
Revenue/Share	20.40	21.68	22.97	24.56	25.90	27.84	29.64	32.42	33.55	35.46
FCF/Share	22.89	-12.55	1.61	14.80	16.67	-5.65	2.67	-5.17	3.25	26.40

Note: All figures in millions of U.S. Dollars unless per share or indicated otherwise.