Bank of Montreal (BMO)

Updated August 27th, 2019 by Kay Ng

Key Metrics

Current Price:	$89	**5 Year CAGR Estimate:**	13.6%	**Volatility Percentile:**	11.2%
Fair Value Price:	$107	**5 Year Growth Estimate:**	5.5%	**Momentum Percentile:**	34.6%
% Fair Value:	84%	**5 Year Valuation Multiple Estimate:**	3.5%	**Growth Percentile:**	52.2%
Dividend Yield:	4.6%	**5 Year Price Target**	$139	**Valuation Percentile:**	72.0%
Dividend Risk Score:	B	**Retirement Suitability Score:**	B	**Total Return Percentile:**	73.8%

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 about 1,500 branches in North America. Bank of Montreal produces about C$24 billion in revenue each year, and it currently trades with a market capitalization of C$57 billion. At a high level, it generates about 60% of its earnings from Canada and about 30% from the U.S. The bank is cross-listed in both New York and Toronto; we use Canadian Dollars throughout the report.

Bank of Montreal posted fiscal Q3 earnings on 8/27/19. Compared to the same quarter in the prior year, net revenue was up 5% to $5,779 million thanks to growth in its personal and commercial banking segments in the U.S. Adjusted net income was up 1% to $1,582 million. On a per-share basis, it also climbed 1% to $2.38. The bank's provision for credit losses (PCLs) climbed 64% to $306 million against the comparable quarter a year ago due primarily to higher provisions in its Canadian personal and commercial business. This is not a major concern as the quarter's PCLs ratio of 0.28% aligns with the big Canadian banks' average. We believe BMO continues to have a focus on prudent lending practices.

The results in the first nine months of the fiscal year look better with net revenue growth of 6% to $17 billion and adjusted net income growth of 4% to $4,642 million, which, on a per-share basis, translated to $7.00 for 7% growth.

The bank's capital position remains quite strong with its common equity tier 1 ratio at 11.4%. As BMO continues to generate more earnings than it distributes to shareholders, we expect its capital position to remain strong with the ability to weather economic downturns.

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	$8.82	***$9.43***	***$12.32***
DPS	$2.80	$2.80	$2.80	$2.82	$2.94	$3.08	$3.24	$3.40	$3.56	$3.78	***$4.06***	***$5.56***
Shares[1]	552	566	639	651	644	649	643	646	648	639	***625***	***615***

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, equating to growth of 11.4%, but that included strong growth coming out of the last financial crisis. Its five-year earnings-per-share growth was more normalized at 7.1%. We forecast about 7% growth or $9.43 in earnings-per-share this year and 5.5% annual growth thereafter given the expectation of an economic slowdown.

This rate of growth is fairly low partly also 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 playing into our 5.5% forecast as well as a low-single digit tailwind from stronger margins, as well as buybacks. Keep in mind, however, that loan loss provisions are near historical lows, meaning there is downside risk to earnings. If credit quality deteriorates, margins will suffer meaningfully, although no evidence of this is present today. We are optimistic that the bank will continue to perform well, but with more tapered growth over the next few years.

1. Shares in millions.

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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We see the possibility of the dividend rising by about 6.5% per year, higher than the estimated earnings-per-share growth due to the stock having a relatively low payout ratio. implying a payout of $5.56 in 2024. That will keep BMO firmly in the category of income stocks 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	11.5	***9.5***	***11.3***
Avg. Yld.	6.8%	4.8%	4.7%	4.9%	4.6%	4.0%	4.2%	4.2%	3.7%	3.7%	***4.6%***	***4.0%***

Taking out the outliers in 2009 and 2010, as the bank was coming out of a financial crisis, from 2011-2018, BMO's average price-to-earnings ratio was about 11.3. We think that's a fair ratio for our forecasted growth rate of 5.5%. The current ratio of 9.5 implies there's a 3.5% annual tailwind to total returns as the valuation drifts higher over time towards a fair multiple. We think the yield will remain at about 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%	43%	***43%***	***45%***

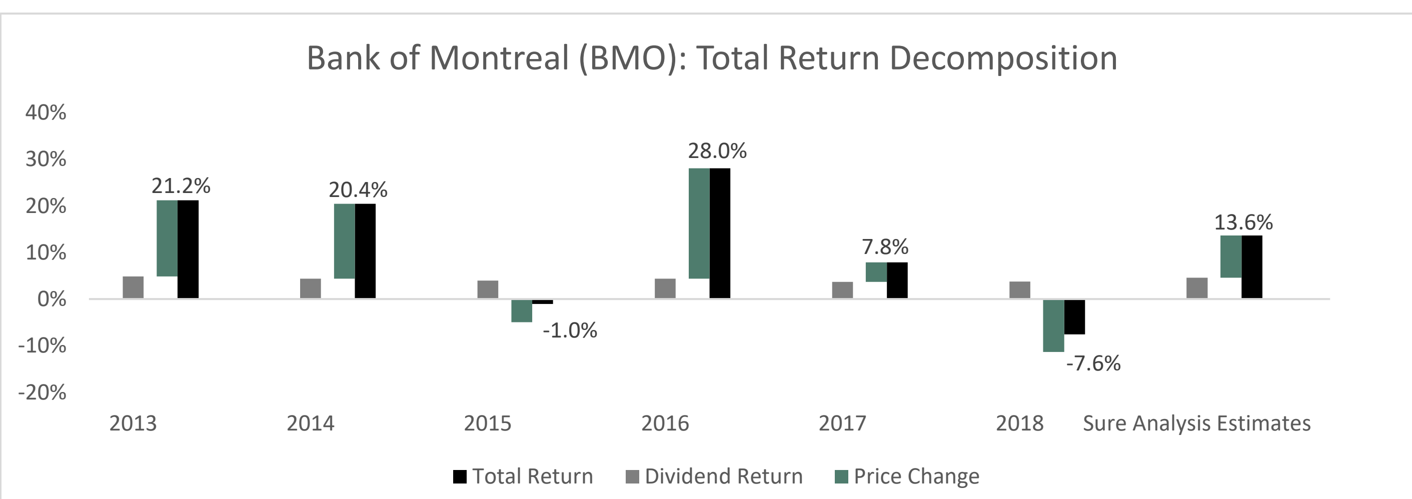
BMO's payout ratio is still just over 40% of earnings so it is very safe. In addition, the low payout ratio affords it the ability to continue to raise the dividend in the coming years. We expect the payout ratio to remain below 50% in the foreseeable future.

The bank's competitive advantage is in the long history and reputation of its brand, as well as its large size, and the fact that it's one of the Big Five banks, in a smaller market like Canada. Recessions are tough for banks, but BMO performed admirably during the last one by maintaining its dividend.

Final Thoughts & Recommendation

Bank of Montreal has become more attractive from our last report. We forecast 13.6% in total returns annually over the next five years, consisting of the current 4.6% yield, 5.5% earnings-per-share growth, and a 3.5% tailwind from a higher price-to-earnings ratio. Bank of Montreal is a good income stock and today, it is also trading at a modest discount to fair value. The stock provides a strong mix of current yield, value, and stable growth potential.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
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	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
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	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
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 Canadian Dollars unless per share or indicated otherwise.