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Not all ROEs are equal

Return on equity (ROE) is one of the metrics commonly used for assessing the profitability of a company. A business that can sustainably generate higher returns for every dollar of capital employed is a more valuable business than one that generates less. At Sionna, we try to invest in companies that we believe can produce superior profits and cash flows while trading at an attractive valuation; ROE is a useful indicator of the “earnings machine” capability of a business.

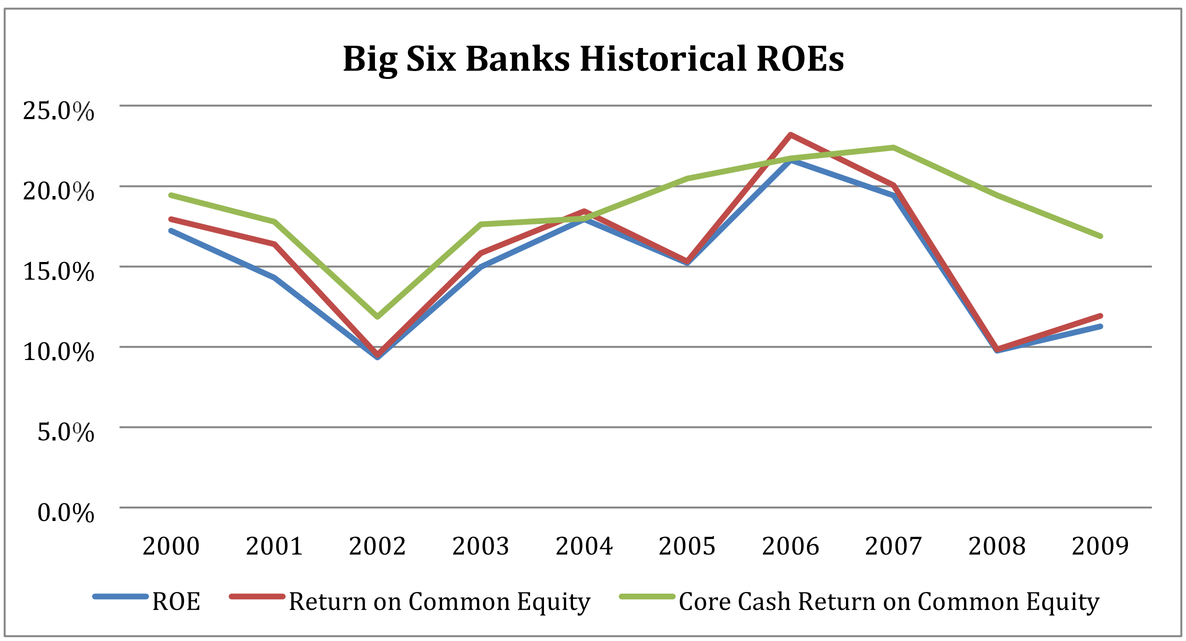
In the context of Canadian banks, it is quite common to hear discussions about ROEs from bank management and the sell side analyst community; However, the banking industry is different from others in that there are various conventions applied to calculating bank profitability. As a result, a discussion of ROEs can come in different forms. We have highlighted some of the more common references in the table below. To properly assess the ROEs of Canadian banks, we believe it is important to understand the distinctions between the different approaches to evaluating profitability.

Profitability Measure	Description
Return on Shareholders' Equity (ROE)	Simplest form of ROE and commonly used in most industries
Return on Common Equity	Excludes preferred shares
Adjusted/Core Cash Return on Common Equity	Non-GAAP measure. Cash earnings adjusted for unusual items

In its most basic form, ROE is calculated as net income divided by total shareholder’s equity. This is a common approach to assessing profitability across most industries. However, banks need to hold capital to guard against the risks inherent in their business and they rely on preferred shares and hybrid instruments as a form of capital. As a result, the banking community typically looks at return on common equity which refers to net income available to common shareholders divided by common shareholders equity. This formula excludes preferred share dividends in the numerator and preferred share equity in the denominator. Both of these approaches are GAAP-based measures founded on reported earnings. Since banks have relied on preferred shares as a source of capital over the last few years, this has had the effect of increasing total shareholders’ equity and reducing return on total shareholders’ equity overall.

The practice of using “adjusted” or “core” cash EPS is another frequently used measure of profitability in the banking sector. Bank management and sell side analysts will exclude what they consider to be unusual charges or one-time items. The rationale behind these adjustments is that they provide a clearer picture of the banks’ earnings power. During the downturn, as banks were forced to take write-downs and the earnings visibility became cloudier, these adjustments to earnings became more prevalent; however, Sionna believes that many of these 'unusual' items are part of the banks' core operations and as such should be reflected in an assessment of profitability. After all, banks are in the business of risk management and these write-downs are a part of the cyclical nature of the business. Classifying them as 'one time' would overstate the profitability of the business.

In the chart below, we have provided an illustration of the historical ROEs for the Big Six banks over the past decade which gives a sense of the impact of these different adjustments to earnings. The average ROE for the group over the period was 15%. To put this in context, the average return on common equity and adjusted core cash ROE returns were 16% and 18.5% respectively. A combination of the exclusion of preferred shares and adjustments to smooth out earnings has resulted in stronger returns under these alternative approaches to assessing ROE.



Ultimately, the price you pay you for an investment is the most important determinant of your investment returns. We continue to believe that banks are profitable businesses and the high barriers to entry and consolidated banking landscape in Canada will allow them to generate reasonable long term returns on equity. However, in our view the market continues to look at Canadian banks through rose-colored glasses, pricing in optimistic levels of returns on equity that are not sustainable in the long-run.

Canadian banks are looking expensive both in relation to their historical valuation levels and with respect to their global peers. Despite an attractive domestic franchise, these business face challenges as they struggle to find avenues for growth in a mature domestic market. Banks have deployed significant capital for acquisitions over the past decade, and for the most part, the returns on these acquisitions have been sub par. In addition to the significant capital that is being deployed abroad, we are also cautious about the banks seeking opportunities in wholesale banking. This business line brings additional volatility to their earnings stream and makes them more susceptible to risks that can be difficult to quantify. With a more stringent capital environment and concerns over a softening real estate market that could impact loan growth, it may prove to be difficult for banks to achieve the level of profitability that was attained over the past decade.