



TD Bank vs. Royal Bank of Canada

Description

The Canadian banking sector is dominated by five players that control over 90% of the bank deposits in the country. The two largest banks by market capitalization, **Toronto Dominion Bank** ([TSX: TD](#))([NYSE: TD](#)), and **Royal Bank of Canada** ([TSX: RY](#))([NYSE: RY](#)) are also among the largest banks in North America.

Over the past five years, the best-performing Canadian banking stock was TD Bank with a total investment return of 124%, of which almost a third was derived from dividend payments. Royal Bank lagged behind with a total return of 98%, with the other major listed banks ranking somewhere in between.

Why did TD Bank leave Royal Bank behind?

The key drivers of banking profits are normally growth in net interest income, provisions for bad debts, growth in non-interest income, and controlling expenses.

TD Bank had superior profit and dividend growth per share over the past five years. The main drivers for this performance have been a higher growth in loans, better interest margins on average, stronger growth in non-interest income, and a stronger curtailment of non-interest expenses.

Royal Bank did not perform poorly; TD Bank was just a little better.

Different business strategies

TD Bank's main focus is on retail banking, which contributed more than 70% of the bank's profits in 2013, with the balance coming from wealth management, corporate banking, and insurance. More than 65% of the corporate profit was derived from Canada and another 26% from the U.S.

Royal Bank has a wider focus not only on financial services in Canada but also on global capital markets and investor and wealth management solutions. The bank derives more than 50% of its profits from personal and commercial banking, with an additional 21% from capital market operations, including trading activities. In 2013, almost 20% of its revenue came from banking activities outside of

the U.S. and Canada.

What will the next five years hold?

These two banks dominate the banking sector in Canada and room for further growth is limited, especially when the stretched position of consumers and the elevated housing market are taken into account. Growth will have to come from outside Canada.

Royal Bank of Canada is well positioned to capture growth outside of Canada, especially in the investment banking field. However, it does carry considerable risks, as was recently demonstrated with the losses and sale of its operations in Jamaica and the losses incurred on the sale of its U.S. retail banking operations.

The bank's growth will be further constrained by U.S. prohibitions on proprietary trading and certain investments in hedge and other investment funds, also known as the Volcker Rule. The bank's current strategy may also be reviewed when David McKay replaces Gordon Nixon on August 1, 2014, as CEO.

TD Bank will also soon have a new CEO, Bharat Masrani. Its business strategy may undergo some change, although it is unlikely to be material. A major opportunity for TD Bank is to continue with the growth and development of its U.S. retail banking operations, where profitability is still a fraction of Canadian retail operations.

Consensus estimates indicate that TD Bank should continue to increase profits and dividends at a faster rate than Royal Bank over the next few years, although only marginally.

Valuations not materially different

The valuation of both banks is relatively cheap when compared to the overall market, and in line with the other main Canadian and U.S. banks. Royal Bank is trading at a 2014 P/E ratio of 12.4 times and a dividend yield of 3.75%, while TD Bank is valued at a P/E of 12.7 times and a 3.4% dividend yield.

Given its lower risk profile, more focused strategy, and considerable clear upside potential in the U.S., TD Bank could continue to outperform Royal Bank of Canada for the foreseeable future.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NYSE:RY (Royal Bank of Canada)
2. NYSE:TD (The Toronto-Dominion Bank)
3. TSX:RY (Royal Bank of Canada)
4. TSX:TD (The Toronto-Dominion Bank)

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Date

2025/08/21

Date Created

2014/06/12

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