



Toronto-Dominion Bank's Value Drops by \$9 Billion; Why Are Investors Overreacting?

Description

Last week, **Toronto Dominion Bank** ([TSX: TD](#))([NYSE: TD](#)) reported fourth-quarter profits that were slightly below market expectations. Since the results announcement, the market value of TD Bank declined by 8%, erasing almost \$9 billion from the market capitalisation and raising the question of why investors consider the bank to be worth so much less after the results.

From market comments, it would seem that the main reasons for the sharp share price decline are the following.

Fourth-quarter results were below expectations

Adjusted fourth-quarter 2014 profit came in at \$1.9 billion with diluted earnings per share of \$0.98, 3% ahead of the previous year but slightly below expectations. For the full year, on an adjusted and fully diluted basis, the bank reported profits of \$4.27 per share, 15% higher than the previous year. The quarterly dividend of \$0.47 was 9.3% higher than last year and the annual dividend of \$1.84 was 14% higher than 2013.

At the overall group level, the return on equity, as a key measure of performance, declined slightly to 14.0% during the quarter but was higher at 15.9% for the full year. Another key measure, the efficiency ratio (that is non-interest expenses as a portion of total revenue) deteriorated slightly during the quarter and also for the full year caused by a variety of factors including corporate expenses related to ongoing investments in productivity initiatives.

Based on the overall results, especially in the light of the full-year performance, it is difficult to share the market's pessimism about the results.

Lower oil price will impact loan growth and credit losses

While it is certainly possible that the lower oil price will impact economic activity and bank lending negatively in oil producing regions, the direct bank loan exposure to pipeline, oil and gas producing entities constitutes 0.7% of the total loan book. This is not enough to make a major difference to the

bank.

Obviously there is also an indirect exposure through mortgage and consumer lending to individual borrowers employed in the oil industry who may be negatively impacted as their employers start to cut costs in a lower oil price environment. Although the bank does not provide the geographical loan breakdown beyond the country level, it is conceivable that this possible negative impact may be countered by the positive economic impact of lower energy prices in non-oil exporting regions.

Operating environment expected to be “more challenging” in 2015

The CEO of the bank stated on the post results conference call that the objective remains to grow earnings per share by 7%-10% over the medium term but that it will be difficult to reach this target in 2015. He referenced various negative factors, including a difficult operating environment with low interest rates and increasing competition, ongoing investments in technology and the distribution network, and a possible lack of support from further credit improvements. Consensus profit expectations for the 2015 financial year declined by around 3% after the profit announcement.

Nevertheless, despite the somewhat bleak picture painted by the CEO, the bank profits remain sensitive to higher interest rates with an indication of a 4% increase in net profits for every 1% increase in interest rates. U.S interest rates may move higher in 2015. Ongoing weakness in the Canadian dollar may again support the results as 28% of revenue is now derived from the U.S. and another 6% for other international operations.

How should investors react?

TD Bank is a high quality operation trading at a reasonable valuation of 12 times the expected 2015 profits, 1.8 times the 2015 book value, and an attractive 3.8% dividend yield. It is worth noting that the bank generates a high 15.9% return on equity and has grown its dividend on average by 11% per year for the past five years.

To my mind the sell-off has been overdone, creating an attractive opportunity for investors.

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Author

deonvernooy

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