



Toronto-Dominion Bank and Royal Bank of Canada: Which Should You Buy?

Description

This very well may be the buying opportunity of 2015 for Canadian banks — over the past three months the S&P/TSX Equal Weight Financial Services Index has fallen 7%. **Toronto-Dominion Bank** ([TSX:TD](#))([NYSE:TD](#)) and **Royal Bank of Canada** ([TSX:RY](#))([NYSE:RY](#)) mirrored the index, with TD shares dropping 7.5% and Royal Bank shares falling 7.9% over the same period.

Royal Bank and TD represent Canada's largest and second largest banks, respectively, by both assets and market capitalization, and have also represented Canada's best performing banks over the past 10 years by total return. With both banks trading slightly off their 52-week lows, which is a smarter buy?

To determine this, it is important to look at the valuations of both banks, their ability to handle the numerous headwinds banks face going forward, and their growth prospects.

TD Bank may be a slightly better value pick

Currently, TD Bank is trading at price-to-earnings (P/E) ratio of 12.14, compared to 12.03 for Royal Bank of Canada. While this may seem to indicate that Royal Bank is a better value pick, it is important to look at the 2016 forward P/E ratio. The forward P/E ratio uses the earnings estimate for 2016, which is useful for comparing to the current P/E to determine if it justified or not.

For example, TD Bank may seem more expensive at this point, but this may be due to the fact that is expecting stronger earnings than Royal Bank in 2015 and 2016, making the premium justified. Looking at 2016 earnings helps to determine if the banks current valuation is accurate given its projected growth.

In this regard, TD trades at a forward P/E of 10.75, compared to 10.71 for Royal Bank. With the historical 10-year average for banks being 11.4, and both banks historically trading at or above the average, it seems both banks have upside. Analysts at TD Bank are setting a target 2016 P/E for the group of 12, and suggest both TD and Royal Bank should trade a premium to the group given their strong projected growth and business models.

Should one bank trade at a premium to the other? It is hard to say, but given the fact that TD obtains

most of its revenue from more stable and predictable retail and wealth management revenues (compared to Royal Bank which has a large segment of its earnings originating from volatile and difficult to predict wholesale and trading revenues), it may make sense to give TD a slight edge.

TD Bank is better diversified

The banks face several headwinds going forward. Most of these headwinds, however, can be related to exposure to the Canadian economy. Relatively low GDP growth from the Canadian economy combined with weak oil prices, overvalued real estate markets, and an over-leveraged consumer are expected to put pressure both on loan growth and margins, as well as on capital markets activities like mergers and acquisitions from which banks generate fees.

TD is well insulated from these risks compared to RBC, largely thanks to how it is distributed geographically. Currently, TD has strong exposure to both the U.S., as well as to Ontario. The bank obtains about 66% of net income from Canadian retail, with 28% coming from U.S. retail and the remainder coming from wholesale banking.

This is in contrast to Royal Bank, which earns 93% of its personal and commercial banking segment revenue from Canada, which in turn comprises over half of the bank's total earnings. Approximately 86% of the banks gross loans outstanding originate in Canada, compared to 70% for TD Bank. Royal Bank also has additional Canadian exposure through its Wealth Management, Insurance, and Capital Markets segments.

While the Capital Markets segment is globally based, the bank's overall loan portfolio is still very sensitive the overall Canadian economy, which could act as a headwind.

TD Bank may offer stronger growth

Analyst consensus gives TD Bank an estimated five-year annual growth rate of 9.70% compared to 7.35% for Royal Bank. While these are just estimates, strong economic growth in the U.S., rising interest rates there, and solid housing demand should drive loan growth from TD's U.S. segment which could give it an edge with regards to growth.

CATEGORY

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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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