4 Reasons Toronto-Dominion Bank Can Grow Earnings Even if Oil Plunges

Description

The prospect of a near-term recovery in the price of oil is looking slimmer every day, and Canadian bank investors will need to factor this reality into their earnings-growth expectations. **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD) is no exception.

While U.S. oil production is finally coming down as low prices discourage production, the International Energy Agency does not see the oil market rebalancing until 2020 (at $80/bbl). They did not rule out the possibility of oil being at $50/bbl in 2020 if U.S. production costs continue to lower and OPEC expands market share.

This is bad news for banks, and a recent **CIBC** report revealed that some banks could lose as much as 5.8% of forecasted 2016 earnings in some oil-price scenarios. Fortunately, low oil prices shouldn't derail TD's growth plans, making TD an excellent choice for investors concerned about the oil environment. Here's why.

1. TD has the lowest exposure to oil and gas loans

How do oil prices affect banks? They affect banks directly when loans to the oil and gas sector become impaired or defaults occur and indirectly through weaker lending and more loan losses.

Fortunately, only 0.08% of TD's gross loans and acceptances are to the oil and gas sector. To put this in perspective, **Royal Bank of Canada** has about 1.6% of loans to the oil and gas sector, and **Bank of Nova Scotia** has about 3%.

A bank is also exposed to the oil and gas sector through undrawn credit lines. Even adding this exposure, TD's total oil and gas exposure of about $15 billion is considerably lower than Royal Bank of Canada, Bank of Nova Scotia, and **Bank of Montreal**.

TD currently has some of the lowest exposure to Alberta of the big banks. TD only has slightly over 10% of its loans exposed to Alberta compared with RBC, for example, which has over 20%.

2. TD also benefits from weak oil

Low oil prices hurt TD's earnings, but there are also positives to continued oil-price weakness that could probably offset some of the negative earnings effects.

For example, TD gets 33% of its revenues from the United States. These revenues come largely from the northeastern U.S., where TD is active in seven of the 10 wealthiest states. Low oil prices will actually boost consumer spending not only in these regions, but in the U.S. as a whole. It is estimated that every 10% decline in the oil price adds to U.S. GDP growth by 0.1-0.2%. This is because the U.S. is a net importer of oil.

This should translate into higher loan growth from TD's U.S. segment, which could help to offset weakness from Canada. In addition to this, as oil drops, the Canadian dollar weakens compared with the U.S. dollar, which means TD's U.S. earnings receive a boost when converted back to Canadian dollars.

The weakness in the Canadian dollar and lower oil prices would also be a positive to central Canada and Ontario, where TD's Canadian operations are largely concentrated.

3. TD Bank's stress tests show that the impact of low oil will be modest

Recently, TD conducted a stress test. It checked what the effect would be of $35 /bbl oil recovering gradually to $50 over a four-year period. They found that the total effect would be an increase in provision for credit losses of about 5-10% per year for two or three years.

What does this mean? As loans become impaired, banks need to put aside the value of the loan by charging that value against their earnings. This charge is called a provision for credit losses, and it reduces earnings.

This is a fairly mild impact. Provisions for 2015 are estimated to be about 0.33% of TD's average loans and acceptances. A 10% increase would boost totals to 0.36% for 2016, which is still well below TD's long-term average of 0.56%.

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