Why This Year Could Be Toronto-Dominion Bank's Best Year Since 2013

Description

At the end of February, **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD) posted its 2016 first-quarter results, and TD did what it usually does—it showed a solid quarter of results that pleasantly surprised most investors.

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Despite oil prices in Canada averaging the lowest levels since 2004 in 2015 (and Q1 2016 being exceptionally weak), TD's Canadian operations posted solid earnings growth of 4% year over year. Most impressively, TD's overall impaired loans in Canada were only 0.28% of total gross loans (consistent with last year), and Canadian operations saw zero expense growth year over year.

This means Canadian operations are showing excellent resilience to low oil prices as well as strong expense control.

This is important, because many analysts are expecting oil prices to stage a comeback throughout 2016 (potentially up to the $50/bbl range). Should oil prices improve, it is very likely that TD will see earnings growth that is higher than expected. This is combined with an improving valuation that reflects rising oil prices as well as TD's better medium-term growth prospects compared with its peers.

The end result could be the best share-price performance in years.

Improving oil prices will push provision for credit losses down

Analysts covering TD have very conservative expectations for 2016. TD has a medium-term earnings growth objective of 7-10% annually; CEO Bharat Masrani recently stated that it is difficult to see how TD will reach its medium-term growth objective in 2016.

Analysts seem agree. **Royal Bank of Canada** (TSX:RY)(NYSE:RY), for example, is expecting earnings growth of only 3% for 2016, well below the target range.

It is important to note, however, that both TD and experts were pessimistic about TD's ability to hit the target range for 2015, but it did.

There are several assumptions baked into the muted growth outlook for 2016. For one, TD has recently stated that it underwent oil-price stress tests to determine how oil prices would affect loan losses, and it was determined that a weak pricing scenario would result in provision for credit losses (how much the bank sets aside to cover bad loans) to grow by 5-10% from 2015 levels.

What oil-price scenario did TD use to generate this outcome? TD assumed oil prices would average about $35 in 2016, then gradually recover to $50 over a four-year period. This is a very conservative outlook, especially given that U.S. oil supply (which is necessary to meet demand growth) is largely uneconomic below $40 per barrel.

If oil prices rise above TD's stress test level, the result is that earnings can come in higher than expected. This is because low oil prices lead to both impaired loans from oil and gas companies as well as credit losses from credit cards and auto loans in regions like Alberta. In order to protect against this, TD must essentially put money aside to cover potential loan losses, and this shows up as an expense, which reduces earnings.

Analysts are currently expecting high provision for credit loss levels because TD stated that the provision levels in Q1 2016 (about 0.45% of total loans—well above last year) are about what should be expected for the year as a whole. If oil prices improve, however, provisions could be much lower, which could result in higher earnings.

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TD also has room for valuation improvement

Currently, analysts at Royal Bank are expecting TD to earn $4.75 per share in 2016. This means that TD is currently trading at about 11.5 times expected 2016 earnings. This is slightly below TD's 10-year average of 11.6.

Analysts at Royal Bank think TD should trade around 12.8 times 2016 earnings (which is above TD's peer group) due to the fact that TD has better growth outlook than its peers. This would lead to a share price of $61 per share (above the current level of $55 and 14% above the $53.21 it started the year with, which would be the best returns since 2013).

If oil prices improve, however, earnings could grow above the level Royal Bank is expecting, which could drive prices even higher. Investors looking to buy should wait for a pullback from current levels, which would lead to more upside.

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