Better Banking Stock: Toronto-Dominion (TSX:TD) vs. Royal Bank (TSX:RY)

Description

Today, I'll look at two of the largest Canadian banks by asset value. Uncannily, both banks have a total of $1.334 trillion worth of assets in the trailing 12 months as of the last reporting.

First, a background on valuation and, in particular, valuation of financial firms.

Valuing financial services firms is notoriously difficult.

First, the treatment of debt does not apply as neatly as it does at "traditional" businesses like **Coca-Cola** or even **Amazon**. Debt (or liabilities as a line item) is treated as a raw material rather than a source of financing. As banks borrow money (or take deposits) and lend it out at higher rates, it is obvious why analysts treat debt at a financial firm as an operating item.

Second, I must treat capital expenditures (capex) differently. In most cases, the capex at a financial firm is intangible. Traditionally, banks do not spend major amounts of money to expand physical plants or R&D. Most of their capex are actually hidden in operating expenditures, namely in training staff and building the brand through marketing channels and sales programs.

Third, if I use traditional working capital metrics, valuation will be distorted, as banks record current assets and liabilities to their respective market values. Working capital will be volatile and useless in this case.

With those out of the way, I cannot use traditional free cash flow approaches. A popular way to compensate for these weaknesses in traditional metrics, while still using a Warren Buffett approved method of valuing financial firms through a discounted cash flow approach; I will use the excess returns method.

The excess returns method values equity as such: the current value of equity plus the present value of expected excess equity returns. The former is simply found on the firm's balance sheet, while the latter is the following: (return on equity – cost of equity) * (current equity base).

Many inputs in the model are overly "scholarized" and, in many successful investors' opinions, do not

work well in practice; it may be fruitful to estimate these numbers based on historical figures. With this in mind, we will begin our valuation on **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD) and **Royal Bank of Canada** (TSX:RY)(NYSE:RY). For the purposes of this article, I will focus mainly on relative valuation.

TD and RBC are both exceptionally well-run banks; I will study these firms through three lenses: their current valuation ratios, loan portfolios, and management teams. Currently, both banks are trading at a P/(TTM E) of about 12.3 compared to the industry average of 11.4. P/B is 1.8 and two for TD and RY, respectively. Both banks are valued around the same, according to market consensus.

TD had recently issued higher provisions for loan losses, which may mean overall macroeconomic stalling in Canada. Perhaps RBC has not issued such provisions yet, as it is more globally diversified than TD is. In any case, both banks will have to deal with macroeconomic challenges, as they brace themselves for volatile markets and uncertain environments.

In evaluating management teams, it is crucial to begin with the compensation structure of key personnel. Are they being compensated fairly and in line with business performance?

According to a recent *CBC* article, the Big Five banks' CEOs received a pay hike, with Bharat Masrani's being the largest. He received $15.3 million for the fiscal 2018. On an absolute basis, it is a huge amount, but on a relative basis, TD performed exceptionally well for the year, both from an earnings perspective and an asset base perspective. Both grew about 4-5% in 2018. RBC's CEO experienced a similar pay increase, albeit a less drastic jump.

There is lots to like about the two financial institutions and many ways to value them. Both banks have similar valuations, management compensation structures, and competitive asset bases. Moreover, both banks have excellent credit quality and will be good holdings for the long run.

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