



Third Party Research: Catalyst Research

September 6, 2011

TD BANK FINANCIAL GROUP

(TSX: TD)

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eResearch is pleased to provide a **Catalyst** report on: **TD BANK FINANCIAL GROUP.**

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September 6, 2011

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TD BANK FINANCIAL GROUP (TD - TSX \$78.60)

Recommendation: BUY
Target Price (1 Year): C\$93.00
Prior: C\$93.00
Total Return (1 Year): 21.8%
Risk: Low

Market Data

Current Price \$78.60
 52-Wk Range \$70.36-86.82
 Mkt. Cap. (mm) \$69,600
 Dividend \$2.72
 Yield 3.5%

Financial Data

Fiscal Y/E October 31
 Shares O/S (mm) 886.1
 BVPS \$44.87
 P/BVPS 1.8x
 Capital Ratio Tier 1 12.9%
 Total Assets (bill) \$664.8
 Adj. Cash ROE Annual 15.7%

Estimates (f.d.)

Year	2010A	2011E	2012E
EPS Cash	\$5.77	\$6.70	\$7.35
Prior EPS Cash	-	\$6.75	\$7.35

Valuations

Year	2010A	2011E	2012E
P/E Mult. Cash	13.6x	11.7x	10.7x

TD Bank Financial Group



Chart Courtesy Big Charts

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Notes:

All figures in Canadian dollars, unless otherwise specified.
 * Under Review

Please see the final pages of this document for important disclosure information.

Q3/11 Operating Results – Slightly Above Expectations Strong Security Gains Propelled Earnings This Quarter Dividend Increased by 3%

Conclusion: BUY – 12-Month Target Maintained at \$93.00

TD Bank Financial (TD) reported EPS of \$1.58 for Q3/11. Adjusted cash EPS, excluding the Items of Note below, was \$1.72 (a gain of 20% Y/Y). The adjusted results were \$0.02 per share above our estimate and \$0.08 per share above consensus. Adjusted operating cash ROE for TD increased to 15.7% from 15.3% last quarter. The Tier 1 capital ratio increased to 12.9% from 12.7%. The quarterly dividend per share was increased by 3% to \$0.68 (\$2.72 annually) from \$0.66 (\$2.64 annually).

Canadian Retail (TD Canada Trust) delivered a good performance this quarter, albeit at a slower growth than prior quarters, as net income rose 13% Y/Y. A 14% decrease in the Provision for Credit Loss (PCL) and strong loan volume growth had a positive impact on earnings in Canada partly offset by lower interest margins. Wealth Management net income was very strong, increasing by 24% Y/Y and 14% sequentially. TD Ameritrade reported lower earnings in the quarter. Wholesale Banking (Capital Markets) reported a poor quarter as trading revenue weakened. This quarter included about \$0.08 per share of security gains which was about triple the 8 month moving average. U.S. Personal and Commercial (US P&C) reported a 20% increase in net income on a Y/Y basis. The Durbin Amendment in the U.S. (see discussion below) will constrain profit growth of the US P&C. The US P&C ROE remains depressed at 8.0%.

We continue to view the TD as primarily a retail bank and of higher earnings quality with almost 65% derived from the TD Canada Trust and Wealth Management groups. However, competition in Canada is increasing and maintaining market share may be more difficult for TD Canada Trust going forward. With regard to the U.S., we believe that TD's risk level is increasing driven by increased regulation, uncertainties overhanging the economic recovery and a very competitive retail banking environment. We are becoming more uncertain as to whether the U.S. retail & commercial banking returns will improve as quickly as we had hoped and that it could remain a drag on earnings for many years. Overall, economic return on invested capital has averaged only 4%-8% in the U.S. versus returns in Canada of 25%-30%. However, having said that, the Canadian Retail and Wealth Management operations continue to perform very well.

For fiscal 2011, our EPS estimate has been lowered to \$6.70 from \$6.75 which reflects slightly weaker Q4/11 earnings expected in Canada. Our EPS estimate for fiscal 2012 remains unchanged at \$7.35 reflecting the expected positive impact of the MBNA transaction and the negative impact of the Durbin Amendment. These estimates imply a dividend payout ratio of 41% and 38% on 2011 and 2012 earnings respectively, both of which are at the mid-range of management's target range of 35% to 45%. Investors should expect another dividend increase in the spring of 2012.

We have maintained our 12-month target for TD at \$93.00. We continue to recommend the bank as a Buy.

Valuation

The TD is primarily a retail bank with good earnings quality in Canada, however, the U.S. economic and regulatory environment is of increasing concern to us which could restrain improved U.S. earnings. We continue to caution investors to be aware that TD could lose some of its premium P/E multiple with respect to the average of the other major Canadian banks, particularly if the regulatory environment deteriorates and/or competition in the U.S. banking sector intensifies. However, based on the exceptional earnings performance demonstrated to date, we have maintained our 12-month share price target at \$93.00 which implies a P/E multiple of 12.6X our 2012 EPS forecast which is slightly above the average of the major Canadian banks.

Items of Note in Q3/11 Amount to Negative \$0.14 Per Share

- **Change in the fair value of derivatives** for hedging of positive \$3 million after-tax or nil per share.
- **Change in the fair value of credit default swaps hedging** the corporate loan book of positive \$5 million after-tax or \$0.01 per share.
- **Amortization of intangibles** of negative \$120 million after-tax or negative \$0.11 per share.
- **Integration & restructuring charges to the U.S. P&C bank** of negative \$28 million after-tax or negative \$0.03 per share.
- **Integration & restructuring charges to the acquisition of Chrysler Financial** of negative \$6 million after-tax or negative \$0.01 per share.

Durbin Amendment Impact on U.S. Banking – Loss of \$200+ MM in Revenue Annually

Management cautioned that the Durbin Amendment in the U.S. (implementation date of October 1, 2011) would likely result in the loss of US\$200 to \$230 million pre-tax in revenue annually for the U.S. P&C bank. The Durbin Amendment is part of the Dodd-Frank Act calling for regulatory rulemaking changes in U.S. banking. The Durbin Amendment allows the Federal Reserve Board to set interchange fees restricting what a bank can charge for debit card transactions. Not too long ago, investors may recall Regulation E (which prohibited banks from charging fees to consumers for ATM and point of sale transactions that resulted in an overdraft), reduced revenue prospects for the bank but to a lesser extent (Reg. E was also part of the Dodd-Frank Act). Management hopes to mitigate some of this lost revenue over the next two years.

Other Quarterly Highlights

- **TD reported adjusted cash net income of \$1,578 million in Q3/11, up 21% Y/Y and 9% sequentially.** Revenue increased 13% Y/Y while expenses increased 8% Y/Y for positive operating leverage of 5%. Non-interest expenses were lower than expected as costs in the Canadian P&C operations increased only 3% Y/Y. We had expected more in the order of 5% Y/Y. Management indicated that negative operating leverage would persist in Q3/11, however, that did not materialize. Provision for Credit Loss (PCL) decreased 6% Y/Y to \$318 million in line with our expectations.
- **TD Canada Trust net income was \$954 million, up 13% Y/Y and sequentially.** A very strong quarter which beat our expectations. PCL continued to be a big factor in the higher earnings this quarter as it declined 14% Y/Y. Net interest margins decreased by 15 bps Y/Y and 1 bp sequentially due to segment transfers and increased pricing competition. Revenue growth was up 7% Y/Y (excluding segment transfers) driven by good mortgage loan growth, up 15% Y/Y. Expenses increased 3% Y/Y which provided for a 4% increase in operating leverage. On a sequential basis, operating leverage was a positive 5%. Management had previously indicated that this quarter may experience negative operating leverage which did not materialize.
- **Global Wealth Management had another strong quarter.** Net income was reported at \$195 million, up 9% Y/Y but down 6% sequentially. Excluding TD Ameritrade, net income was up 26% Y/Y and down only 2% sequentially. Revenues increased by 12% Y/Y. Expenses increased 9% Y/Y allowing for a positive increase in operating leverage. Mutual fund revenue increased 13% Y/Y driven by improved equity markets. Assets Under Management (AUM) of \$191 billion were up 10% Y/Y and included the AUM at South Financial. Assets Under Administration (AUA) increased 15% Y/Y. TD Ameritrade (46% owned) reported a lower quarter contributing \$48 million (equity contribution), down 23% Y/Y and 16% sequentially. The latter was driven by lower trading volumes.
- **U.S. Personal & Commercial (US P&C) adjusted net income was up 20% Y/Y to \$345 million.** On a constant currency basis, the U.S. segmented earnings increased 30% Y/Y. These results include the South Financial acquisition but exclude integration and restructuring charges. In total, the US P&C represented \$0.39 per TD share or 23% of TD's adjusted earnings this quarter. Loan volumes increased 12% Y/Y excluding acquisitions. Net interest margins improved by 11 bps Y/Y but declined 10 bps sequentially. The sequential decline was driven by tighter deposit spreads. PCL increased 38% Y/Y but was flat sequentially. PCL on a Y/Y basis, included the Chrysler Financial acquisition, otherwise, PCL on the remaining business was flat Y/Y. Gross Impaired Loans (GIL), excluding debt securities, increased marginally to \$1.5 billion from \$1.4 billion. Debt security GIL classified as loans was unchanged at \$1.7 billion. The increase in GIL excluding the debt securities was in line with expectations. ROE in the quarter increased to 8.0% from 7.4% last quarter.
- **Wholesale Operations (TD Securities) reported a very poor quarter** with net income of \$108 million, down 40% Y/Y and sequentially. Trading revenue declined 65% Y/Y and sequentially. Fixed income trading virtually collapsed in the quarter. Underwriting and advisory revenue was up 31% Y/Y but was flat sequentially. PCL was \$6 million versus a recovery of \$16 million in the same quarter last year.
- **Provision for Credit Loss (PCL) decreased 6% Y/Y to \$318 million,** in line with our expectations. Sequentially, PCL increased by 5%. The Canadian PCL loss ratio to average loans declined to 42 bps from 50 bps last year while the ratio for the U.S. P&C group declined to 70 bps from 144 bps last year and 89 bps last quarter. We expect that the dramatic decline in PCL has now come to an end. For fiscal 2011, we have maintained our PCL forecast at \$1.3 billion. For fiscal 2012, we are forecasting PCL to remain near \$1.3 billion.
- **Gross impaired loans were in line with expectations at \$4.0 billion** in the quarter, up 33% Y/Y and flat sequentially. The increase included acquisitions. Excluding debt securities, classified as loans and FDIC insured loans, GIL remained unchanged at \$2.2 billion. Formations increased in the quarter to \$814 million from \$695 million last quarter driven by new commercial formations in the U.S. and formations at Chrysler. We have maintained our GIL forecast for fiscal 2011 at \$4.0 billion and expect the GIL to remain elevated throughout 2012 near the \$3.7 billion level.
- **Security gains were particularly strong at \$107 million in the quarter (\$0.08 per share)** versus \$25 million last quarter and about triple the 8 month moving average. Unrealized gains increased to \$274 million from \$194 million as at the end of last quarter.

Recent Events

On August 15, 2011, TD Bank Financial (TD) announced an agreement to acquire MBNA Canada's \$8.5 billion credit card portfolio as well as certain other assets and liabilities from Bank of America (BAC-N) for \$7.5 billion in cash. Prior to closing the deal, which is expected in Q1/12, TD may issue up to 8 million common shares (approximately 1% dilution to TD).

- No impact on earnings outlook for 2011.
- Management expects the transaction to be accretive on fiscal 2012 by about \$0.05 per share and \$0.10 in fiscal 2013. This transaction is basically an acquisition of MBNA's US\$8.5 billion of assets, management team and includes both Visa and Mastercard assets. MBNA is Canada's largest Mastercard issuer.
- Negative impact on TD Bank's Tier 1 Basel II capital ratio by 20 bps, currently at 12.7%. TD reaffirmed its commitment to meet its targeted Common Equity Tier 1 ratio under Basel III of 7% to 8% by 2013.
- TD Bank expects about \$600 million of goodwill.
- TD will become a dual issuer of both Visa and Mastercard joining CM and RY.
- MBNA's credit loss profile is about 6.4% of outstanding loans versus TD's loss ratio of 4.2%.
- TD expects that about \$2.0 billion of the portfolio will run-off as MBNA was more promotional than TD.
- This transaction should place TD Bank with an equal market share with CM. Each will hold approximately 25% of Canada's credit card business (about \$15 billion each). RY is a close third at about \$12 billion.

On April 1, 2011, TD Bank Financial (TD Bank) acquired Chrysler Financial (Chrysler) from Cerberus Capital Management, L.P. (Cerberus) for US\$6.3 billion in cash.

- The purchase is comprised of net assets of US\$5.9 billion and approximately US\$400 million in goodwill.
- No impact on earnings outlook for 2011. Management expects the transaction to be accretive on fiscal 2012 by about \$0.11 per share.
- This transaction was basically the acquisition of Chrysler's US\$7.5 billion of assets, management team and operating systems.
- The margin on the auto business is expected to produce a net interest margin closer to 400 bps which is much higher relative to TD Bank's mainline banking business.

Definition of Risk Rankings

Low: Low financial and operational risk, high predictability of financial results with stronger than average balance sheet and strong free cash flows. Company may pay substantial dividends or have an active share repurchase program.

Medium: Moderate financial and operational risk, moderate predictability of financial results, positive free cash flows and may or may not pay a dividend.

High: High financial and/or operational risk, low predictability of financial results. Limited financial history, negative free cash flows, adequate working capital and no dividends.

Definition of Research Ratings

The Catalyst research recommendation structure consists of the following categories:

Buy: The stock's total return, including dividends paid, is expected to exceed a minimum of 15% on a risk-adjusted basis, over the next 12 months.

Hold: The stock's total return, including dividends paid, is expected to be between 0% and 15%, on a risk-adjusted basis, over the next 12 months.

Sell: The stock's total return, including dividends paid, is expected to be negative over the next 12 months.

Speculative: The stock's total return is expected to exceed 30% over the next 12 months; however, there is material event risk associated with the investment that could result in significant loss.

Note: Analysts have discretion within 500 basis points of the upper and lower limit of each rating to maintain the recommendation.

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