

TD BANK FINANCIAL GROUP (TD-TSX \$68.70)

Recommendation

BUY

Risk

Low

Target Price

\$86.00

Price

\$68.70

52-Week Range

\$77.08 - \$58.57

% Below High

-10.9%

% Above Low

17.3%

Shares O/S

803 million

Market Cap

\$55 billion

Average Daily Volume

3,231,200

Year-End

October 31

C\$	EPS	& Mult
2007a	\$5.75	11.9x
2008a	\$5.75	11.9x
2009e	\$6.55	10.4x
Book Value	\$36.70	1.9x

	Amount	Yield
Dividend	\$2.36	3.5%

Analyst

Robin Cornwell



Data Source: www.BigCharts.com

SECOND-QUARTER REVIEW

HIGHLIGHTS

- Q2/08 Below Expectations Due To Weak Capital Markets
- Loan Losses Increase But Not A Cause For Concern
- Good Asset Quality & Risk Management

CONCLUSION

BUY - 12 Month Target Maintained at \$86.00

TD Bank Financial (TD) reported results below our expectations and below consensus estimates by about 8%. Adjusted cash EPS was down 3% Y/Y to \$1.32 which excludes a restructuring charge and the timing impact of the Commerce Bancorp transaction as well as amortization of intangibles. Wholesale Banking (Capital Markets) posted a 57% Y/Y decline in net income driven by a 53% decline in underwriting fees. Canadian Retail (TD Canada Trust) delivered a steady performance and benefited from strong retail loan growth. Wealth Management slowed considerably and will present challenges over the next several quarters. TD Ameritrade (AMTD) delivered good earnings albeit growth was much slower than in previous quarters. TD Banknorth reported steady earnings. Total U.S. sourced earnings represented 20% of the TD earnings this quarter but that should increase to 27% next quarter with the inclusion of Commerce Bancorp. PCL increased 35% Y/Y but was down from last quarter. Adjusted operating cash ROE for TD declined to 15.3% in the quarter down from 19.7% last quarter.

Earnings were of high quality with over 70% derived from TD Canada Trust operation. With the inclusion of TD Commerce we expect retail to account for 80% of TD's earnings going forward. Management has strategically avoided the balance sheet risks experienced by the other majors. We consider TD to have the lowest asset risk of all the Canadian majors. Although the exceptional Canadian

retail performance is expected to moderate as interest spreads remain tight and the provision for credit losses (PCL) increases, it should continue to be the mainstay of earnings. The Commerce Bancorp acquisition is expected to present many challenges, however we believe long-term it will prove to be a valid strategy.

Our EPS estimate for 2008 has been lowered to \$5.75 from \$6.05 and represents flat earnings from 2007. We have also lowered our EPS forecast for fiscal 2009 to \$6.55 from \$6.65, which would imply a gain of 14% Y/Y and also includes a full year of Commerce Bancorp. Based on our assumed 41% payout ratio, we expect further dividend increases to the \$2.50 to \$2.60 level over the next 12 months, a gain of 5% to 10% Y/Y.

Valuation

We continue to view the TD as just plain superior to its peers. We have concluded that the TD's risk level and solid earnings performance from its personal banking operations deserves at least a 5% premium to our other two top recommendations namely, RY and BNS. On this basis we have maintained our 12 month target share price for TD Bank of \$86.00. Total 12-month expected return is 28.6% and we continue to recommend the bank as a Buy.

Commerce Bancorp Acquisition Completed But Not Included in Quarter

On March 31, 2008, TD completed the acquisition of Commerce Bancorp – now know as “TD Commerce”. TD issued 83.3 million shares in the period to purchase Commerce Bancorp. However due to timing issues, the second quarter results do not include any of Commerce Bancorp results. The recent quarter excluded two items of note relating to the Commerce Bancorp transaction, namely (i) a restructuring charge of \$48 million (\$30 million after-tax or \$0.04 per share) and (ii) the impact of timing of \$0.04 per share. The latter resulted from the Commerce Bancorp's reporting period being March 31 and therefore having a one month lag with TD's of April 30. This resulted in no Commerce Bancorp earnings included in the quarter just ended for TD.

Commerce Bancorp adds nearly 460 locations throughout New Jersey, New York, Connecticut, Pennsylvania, Washington DC, Virginia, Delaware, Maryland and Southeast Florida and will add about \$57 billion in assets of which \$18 billion are loans (no subprime mortgages) and about \$25 billion are securities. TD Bank is now the 7th largest bank in North America as measured by branch size (on a combined basis is 2,102 branches) and doubles the size of TD Banknorth (TD Bank's previous U.S. banking operation) and now renamed TD Commerce.

We expect TD Bank has now achieved enough scale to allow for strong U.S. organic growth as Commerce Bancorp has experienced higher deposit growth than most U.S. banks through aggressive marketing (“The Power of WOW!”) and promotions. TD Bank is expected to derive about 85% of its business in the retail sector going forward reinforcing its retail bank strategy. TD Bank's Tier 1 capital ratio will decline to about 8.0% under Basil II. Management continues to project about \$750 million in earnings from the U.S. banking for fiscal 2008 and \$1,200 million in 2009.

Other Quarterly Highlights

- **TD reported adjusted net income of \$973 million down 2% Y/Y** from \$995 million in the same period last year. Sequentially adjusted net income was down 8%. Revenue declined 4% as did operating expenses. TD Canada Trust maintained a good performance offset by weak Wholesale Banking profits, the latter due to difficult market conditions.
- **TD Canada Trust net income was very solid at \$582 million up 8% Y/Y** but down 3% sequentially. Net interest margins declined sequentially by 2bp and Y/Y by 9bp. Operating leverage was a positive 2% as adjusted revenues increased by 7% and expenses increased by 6% Y/Y. Volume growth was strong as mortgage loans increased Y/Y by 24% and personal and credit card loans increased by 15% Y/Y. PCL increased 34% Y/Y to \$191 million which was about \$10 million more than we estimated.

- **Canadian Wealth Management net income declined by 15% Y/Y** and 10% sequentially to \$115 million. Revenues declined 6% Y/Y and 2% sequentially due to lower transaction revenues which decreased by 18% Y/Y. Trade volumes although higher at TD Waterhouse were offset by lower commissions per trade (TD Waterhouse recently lowered commission rates). Wealth management AUM increased to \$174 billion a 7% Y/Y increase. We expect that the current market volatility will continue to create challenges for this group over the next few quarters.
- **Wholesale Operations (TD Securities) net income declined by 57% Y/Y.** The group reported a significantly lower quarter with net income of \$93 million down from \$163 million last quarter and down from a very strong \$217 million in the same quarter last year. Strong FX trading was offset by weaker credit and interest rate trading. Underwriting and advisory revenue declined 53% Y/Y and trading losses were \$102 million down from a gain of \$192 million in the same period last year. PCL was essentially unchanged Y/Y at \$10 million but well down from \$56 million last quarter.
- **TD Banknorth (U.S. Personal & Commercial) net income was flat sequentially** and continued to drag down TD's overall performance. TD Banknorth contributed \$130 million (13% of the Bank's total or about \$0.16 per TD share) up from \$127 million (\$0.18 per TD share on fewer shares O/S) last quarter and up from \$62 million (\$0.09 per TD share) in the same period last year. ROE improved slightly to 5.9% up from 5.7% last quarter and 3.8% in the same quarter last year. Margins were down 15 bp sequentially and down 16 bp Y/Y due to intense competition for both loans and deposits. PCL increased to US\$46 million in the quarter from US\$26 million last quarter and \$30 million in the same period last year. Net impaired loans increased to \$315 million up 14% Y/Y and up 38% sequentially.
- **AMTD (U.S. Wealth Management) net income contribution increased 6% Y/Y**, although down 24% sequentially. In constant currency the earnings contribution increased 24% Y/Y. Earnings were driven by record trading volumes up 23% Y/Y. The quarter contributed earnings of C\$67 million (7% of TD's earnings) or about \$0.08 per TD share. This level of income reflects TD's equity share (39.9%) of AMTD's earnings.
- **Provision for Credit Loss (PCL) increased by 35% Y/Y to \$232 million** or 0.43% of loans, however, this was down from \$255 million last quarter. We expect the trend in PCL to move higher increasing to about \$1,050 million in 2008 including Commerce Bancorp.
- **Security gains increased 8% Y/Y but declined 28% sequentially.** Net securities gains were \$110 million in the quarter up from \$102 million last year and down from \$152 million last quarter. This quarter was only slightly above the 8 quarter average of \$101 million. Unrealized gains declined to \$746 million down from \$1,027 million last year and \$901 millions as at the end of last quarter.
- **Tier 1 capital ratio decreased to 9.1% under the new Basil II** measurement down from 10.2% last quarter under the old Basil I measurements. The Basil II adjustment for AMTD is expected to reduce Tier 1 by 130bp reducing the year-end ratio to about 8.0%.

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