The Bank of Nova Scotia (BNS)

Updated May 24th, 2018 by Nick McCullum

Key Metrics

Current Price:	$80	**5 Year CAGR Estimate:**	13.0%	**Quality Percentile:**	N/A
Fair Value Price:	$84	**5 Year Growth Estimate:**	8.0%	**Momentum Percentile:**	N/A
% Fair Value:	95%	**5 Year Valuation Multiple Estimate:**	0.9%	**Total Return Percentile:**	N/A
Dividend Yield:	4.1%	**5 Year Price Target**	$124	**Valuation Percentile:**	N/A

Overview & Current Events

The Bank of Nova Scotia (often called Scotiabank) is the third-largest financial institution in Canada behind the Royal Bank of Canada (RY) and the Toronto-Dominion Bank (TD). These three banks along with the Bank of Montreal (BMO) and the Canadian Imperial Bank of Commerce (CM) form the 'Big Five' Canadian banks, which have majority market share in the Canadian financial services industry. Scotiabank operates in three segments – Canadian Banking, International Banking, and Global Banking & Markets – and is cross-listed on the Toronto Stock Exchange and the New York Stock Exchange. The bank's market capitalization is US$75 billion.

In late February, Scotiabank reported (2/27/18) financial results for the first quarter of fiscal 2018. The bank generated revenue growth of 4.1% and diluted earnings-per-share growth of 13.4%. This performance was driven by robust performance across each of the bank's operating businesses, as well as the contribution from several acquisitions in Chile and Columbia. The quarter also saw Scotiabank announce the acquisition of Jarislowsky, Fraser Limited, an asset manager with approximately CAD$40 billion of assets under management coming primarily from institutional and ultra high net worth clients. This acquisition meaningfully bolters Scotiabank's presence in the asset management space and creates the third-largest active asset manager in Canada. While the CAD$950 million purchase price is being funded primarily through the issuance of Scotiabank common shares, the transaction should be accretive by fiscal 2020 following a share repurchase program that will begin after the acquisition's close. Looking ahead, more acquisitions (primarily in international markets) should be the driver of the bank's growth for the foreseeable future.

Growth on a Per-Share Basis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
EPS[1]	$3.06	$3.31	$3.91	$4.62	$5.22	$5.15	$5.66	$5.67	$5.77	$6.49	***$7.00***	***$10.30***
DPS[1]	$1.92	$1.96	$1.96	$2.05	$2.19	$2.39	$2.56	$2.72	$2.88	$3.05	***$3.25***	***$4.75***

Scotiabank has compounded its earnings-per-share at 8.7% per year through the decade ending in 2017, a difficult time period that saw the global financial crisis as well as one of the worst oil price crashes in history. Looking ahead, we believe that the bank is capable of 8% annualized earnings-per-share growth over full economic cycles. The bank does not provide earnings guidance, but we believe that it is likely to generate around $7 of earnings-per-share in fiscal 2018. Applying an 8% growth rate to this figure gives a 2023 earnings-per-share estimate of approximately $10.30

Scotiabank has a noticeably differentiated growth strategy when compared to its peers in the Canadian banking industry. While other banks have focused on expanding into the United States, Scotiabank's future growth should come primarily from its rapidly-expanding International Banking segment, which provides banking services in emerging economies like Colombia, Chile, and Mexico. These markets are appealing because net interest margins are significantly higher. In addition, Scotiabank has the size and capital structure to implement a consolidation strategy in these fragmented banking markets. Early results are positive. The International Banking segment reported 7% annualized revenue growth and 18% annualized earnings growth in the most recent quarter while operating at a net interest margin of 4.66% (far higher than the 2.41% net interest margin generated by its Canadian Banking segment during the same three-month reporting period).

[1] All figures in Canadian dollars.

Valuation Analysis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Now	2023
Avg. P/E	15.7	11.3	12.8	12.1	10.1	11.3	11.9	11.3	10.9	11.9	***11.5***	***12.0***
Avg. Yld.	4.0%	5.2%	3.9%	3.7%	4.2%	4.1%	3.8%	4.3%	4.6%	3.9%	***4.1%***	***3.9%***

Scotiabank has traded at an average price-to-earnings ratio of 11.9 over the last decade. Using our 2018 earnings-per-share estimate of $7.00, the bank is currently trading at a price-to-earnings ratio of 11.5 – slightly below its long-term average price-to-earnings ratio. We believe that valuation expansion will provide a modest tailwind to Scotiabank's future total returns. If the company can revert to a price-to-earnings ratio of ~12 over the next 5 years, this will boost its total returns by 0.9% per year over this time period.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
Debt/A	95.6%	94.9%	94.6%	94.6%	93.8%	93.9%	93.9%	93.8%	93.5%	93.3%	***93.5%***	***93.5%***
Payout	62.7%	59.2%	50.1%	44.4%	42.0%	46.4%	45.2%	48.0%	49.9%	47.0%	***46.4%***	***46.1%***
Std. Dev.	29.0%	28.3%	14.3%	13.2%	11.5%	12.1%	12.8%	16.0%	15.8%	10.1%	***15.0%***	***15.0%***

Like all financial institutions, the Bank of Nova Scotia's balance sheet is composed primarily of debt. The company typically maintains a payout ratio between 40% and 50%, which leaves plenty of room for continued dividend growth in the event that earnings growth stalls temporarily. What truly stands out about Scotiabank's quality metrics is the financial institution's extraordinarily low stock price standard deviation, which is among the lowest in our investment universe.

Final Thoughts & Recommendation

The Bank of Nova Scotia has an excellent dividend history (it maintained its dividend during the 2007-2009 financial crisis, unlike virtually all of its U.S. peers) and should continue to grow its earnings at a compelling rate over the foreseeable future. Simultaneously, the bank trades at a *discount* to most of its peers south of the border. While this is partially due to a 15% withholding tax that U.S. investors pay on BNS dividends, it's important to know that this withholding tax is waived if BNS shares are held in a retirement account. We're recommending the Bank of Nova Scotia as a buy, with the advice that U.S. investors ensure that shares are purchased in a retirement (such as a 401k) to avoid unnecessary dividend withholding taxes.

Total Return Breakdown by Year