

Bank of Nova Scotia (BNS)

Updated September 4th, 2020 by Kay Ng

Key Metrics

Current Price:	\$42	5 Year CAGR Estimate:	14.4%	Market Cap:	\$51.3B
Fair Value Price:	\$61	5 Year Growth Estimate:	2.0%	Ex-Dividend Date:	10/05/20
% Fair Value:	70%	5 Year Valuation Multiple Estimate:	7.5%	Dividend Payment Date:	10/28/20
Dividend Yield:	6.4%	5 Year Price Target	\$67	Years Of Dividend Growth¹:	9
Dividend Risk Score:	C	Retirement Suitability Score:	A	Last Dividend Increase¹:	3.2%

Overview & Current Events

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). Scotiabank reports in 5 segments – Canadian Banking, International Banking, Global Wealth Management, Global Banking & Markets, and Other – and is cross-listed on the Toronto Stock Exchange and the New York Stock Exchange using ‘BNS’ as the ticker. We’ll be using U.S. dollars throughout this report unless otherwise stated.

Scotiabank reported fiscal Q3 2020 results on 08/25/20. For the quarter, total revenue rose 1% to C\$7,734 million. Adjusted net income was C\$1,308 million, down 47% year over year. Adjusted diluted earnings-per-share dropped 45% to C\$1.04. It’s important to note that, much like the other big Canadian banks, BNS’s big drop in earnings is largely due to prudent loan loss provisioning in light of the COVID-19 impact. Specifically, the provision for credit losses more than doubled to C\$2,181 million from the prior year’s Q2 of C\$713 million.

The bank’s provision for credit losses ratio was 1.36% (against year over year’s 0.48%), as it set aside more money to cover the increase of bad loans from COVID-19 impacts. Based on a weaker economic outlook, BNS had C\$1,253 million provision for credit losses on performing loans in Q3. We believe BNS continues to have prudent lending practices. The provision for credit losses on impaired loans ratio was 0.58%, compared with a low level of 0.52% in the prior year.

The bank’s capital position remains quite strong with its common equity tier 1 ratio at 11.3%. Adjusted return on equity was 14.3% in Q3 compared to Q3 2019’s 13.5%. We expect BNS to be able to weather this economic downturn. However, impaired loan losses could take more than a few quarters to improve.

Growth on a Per-Share Basis

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
EPS	\$3.96	\$4.64	\$4.85	\$4.84	\$4.75	\$4.28	\$4.50	\$5.10	\$5.35	\$5.39	\$3.77	\$5.95
DPS	\$1.89	\$2.08	\$2.18	\$2.34	\$2.35	\$2.18	\$2.17	\$2.33	\$2.55	\$2.63	\$2.73	\$3.36
Shares¹	1,043	1,089	1,184	1,209	1,217	1,203	1,208	1,199	1,227	1,216	1,255	1,319

Scotiabank’s three-year EPS growth rate was just north of 7% in Canadian dollars and 6.2% when converted to USD. Due to COVID-19 impacts, resulting in higher unemployment and lower GDP forecasts, we continue to forecast earnings-per-share decline of about 30% in fiscal 2020 to \$3.77. A growth rate of about 5% can resume for longer term.

Eventually, there will be a rebound of earnings, but it could take more than a few quarters for COVID-19 to come to pass. Our forecast is based on an assumption of a rebound to normalized earnings in three years, followed by two years of 5% growth rate. BNS has maintained the same quarterly dividend of CAD\$0.90 per share for 5 quarters straight. We suspect the bank will freeze the dividend in this time of uncertainty and resume dividend growth when the skies are clearer. The 2020 dividend is a bit higher than last report’s estimate as there are fluctuations in the forex between U.S. dollars and Canadian dollars.

1. Years of dividend growth in C\$; TTM dividend per share over prior TTM dividend per share in C\$; Shares in millions.

Disclosure: Kay Ng owns shares in Scotiabank

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Valuation Analysis

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Now	2025
Avg. P/E	14.6	11.0	11.0	12.9	11.7	9.9	13.0	12.5	10.0	11.4	11.2	11.3
Avg. Yld.	3.5%	4.0%	4.0%	3.9%	3.8%	4.6%	4.0%	3.6%	4.7%	4.6%	6.4%	5.0%

From 2010-2019, Scotiabank traded at an average price-to-earnings ratio of about 11.8. However, we think the more conservative median P/E of 11.3 over the period makes more sense for BNS's above-average yield and slower growth over the next five years due to COVID-19 disruptions on the economy.

Using our 2020 EPS estimate of \$3.77, the bank currently trades at a price-to-earnings ratio of 11.2, which makes the stock fairly valued in today's environment. However, on more normalized earnings, the P/E multiple is actually closer to 7.9, making the stock undervalued by about 30% for long-term investment. We believe that earnings will recover in time. The yield, which is relatively high today compared to historic standards, should moderate to 5% or so in the coming years. As a Canadian stock, BNS's dividends may be subject to a 15% dividend withholding tax for U.S. investors. This tax can potentially be avoided by investing in BNS through a retirement account.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
Payout	48%	45%	45%	48%	49%	51%	48%	46%	48%	49%	72%	56%

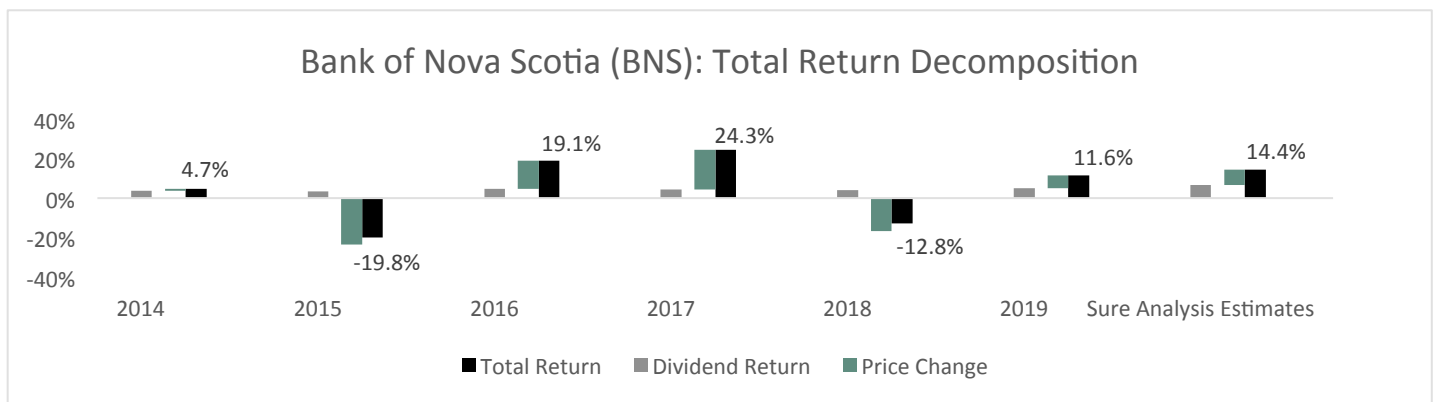
BNS normally has a payout ratio of about 50% that aligns with other big Canadian banks. This year, like its peers, its payout ratio is going to be elevated due to COVID-19 impacts. We are optimistic that the bank can maintain its dividend in this economic downturn.

The bank's competitive advantage is in its international growth strategy, as it is willing to acquire growth outside of its primary markets. Ironically, this strategy is working against the bank in today's stressful economic environment. Its international banking segment has a PCL ratio that's more than two times that of the bank's entire business. When the global economic environment improves, we expect its international strategy will be an advantage for growth.

Final Thoughts & Recommendation

In total, we see total annual returns of about 14.4% annually in the coming years. These returns should accrue from the current 6.4% yield, a 7.5% tailwind from a rising valuation, and 2% earnings-per-share growth. As a result, the bank continues to earn a buy recommendation from Sure Dividend.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Revenue	14923	17104	19107	20225	21269	19052	19560	20452	21931	22861
SG&A Exp.	5150	6211	6593	7017	6915	6210	6097	6417	6593	7168
D&A Exp.	321	419	444	506	483	471	516	582	659	792
Net Profit	4080	5251	6165	6257	6489	5652	5367	6121	6644	6313
Net Margin	27.3%	30.7%	32.3%	30.9%	30.5%	29.7%	27.4%	29.9%	30.3%	27.6%
Free Cash Flow	-3055	11109	5830	8607	4283	13009	3158	12680	13520	-9188
Income Tax	1679	1442	1561	1704	1837	1493	1531	1554	1851	1860

Balance Sheet Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Total Assets (B)	512	598	668	709	719	651	668	713	761	825
Cash	44759	54792	47346	50884	50657	56161	34545	46506	47461	35482
Accounts Rec.			3452	2591	2556	2830	2926	3001	3566	3864
Goodwill & Int. Ass.	3539	7684	8694	10212	9719	8698	9050	9436	13505	13264
Total Liabilities (B)	485	566	627	666	675	610	625	665	709	772
Accounts Payable			8853	7679	6677	5575	5954	6887	7162	6989
Long-Term Debt	26702	30725	10145	5572	4350	4696	5690	4626	4343	5508
Equity	23005	26512	35259	38317	40151	37289	39251	43225	46528	48331
D/E Ratio	0.99	0.99	0.26	0.13	0.10	0.12	0.14	0.10	0.09	0.11

Profitability & Per Share Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Return on Assets	0.8%	0.9%	1.0%	0.9%	0.9%	0.8%	0.8%	0.9%	0.9%	0.8%
Return on Equity	19.2%	21.2%	20.0%	17.0%	16.5%	14.6%	14.0%	14.8%	14.8%	13.3%
ROIC	8.5%	9.0%	10.8%	12.5%	13.4%	12.1%	11.4%	12.1%	12.2%	11.0%
Shares Out.	1,043	1,089	1,184	1,209	1,217	1,203	1,208	1,199	1,224	1,247
Revenue/Share	14.43	15.44	16.47	16.73	17.41	15.46	15.95	16.72	17.84	18.27
FCF/Share	-2.95	10.03	5.03	7.12	3.50	10.56	2.58	10.37	11.00	-7.34

Note: All figures in millions of U.S. Dollars unless per share or indicated otherwise.

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