VICTORIA MUTUAL Wealth MANAGEMENT

Company Analysis: Scotia Group Jamaica (SGJ)

VMWM Research and Stockbroking | March 16, 2020

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- Recommendation: **BUY**
- Price Target: $61.92
- Current Price: $49.27[1]

- Shares Outstanding: 3,111,572,984 units
- Market Value of Shares Outstanding: $153.3 billion[1]
- Financial Year End: October 31

ABOUT THE COMPANY

Scotia Group Jamaica Ltd. is a publicly listed holding company traded on the Jamaica Stock Exchange. Its Head Office is located at the Corner of Duke and Port Royal Streets, Kingston, Jamaica. The Group is a 71.78% subsidiary of Scotia Bank Caribbean Holdings Limited located in Barbados. The Ultimate Beneficial Owner is the Bank of Nova Scotia domiciled in Canada. Moreover, the group has several subsidiaries which form a part of a full-service financial group offering commercial banking, mortgages, investments, asset management and insurance services.

The Group has boasted solid performances over the years but was overtaken by the National Commercial Bank in the late 2000's, as the largest financial institution based on its Total Assets. It remains the second largest financial institution in Jamaica.

FINANCIAL PERFORMANCE

	2015	2016	2017	2018	2019
Total Revenue ($ billions)	36.5	38.8	41.7	42.2	45.2
Net Profit ($ billions)	10.1	11.6	12.4	12.8	13.2
Return on Assets (%)	2.4	2.5	2.6	2.5	2.5
Customer Deposits ($ billions)	209.5	248.4	260.6	287.9	313.0

Outlook

SGJ is one of the largest banks in the island with a strong brand recognition and loyalty. As it seems to be less competitive than its peers, the group largely rely on its brand and loyalty to drive revenue growth. As other institutions become more competitive and fees decrease, this may pose risks to client retention and revenue growth. The group has exhibited low growth in recent years and has not strategically placed itself in an area to grow faster. We expected the company's growth to remain low especially in comparison to its competitors along with its historic levels of profitability.

Projections and Valuations

Using a combination of a Discounted Cash Flow Model with a required rate of return of 14.1% along with a dividend discount approach, we arrived at a target price of $61.92.

Risks to Price Target

A downturn in the Jamaican economy as a result of lower economic growth or a decline in business or consumer confidence is likely to result in lower than expected growth in the company's loan portfolio

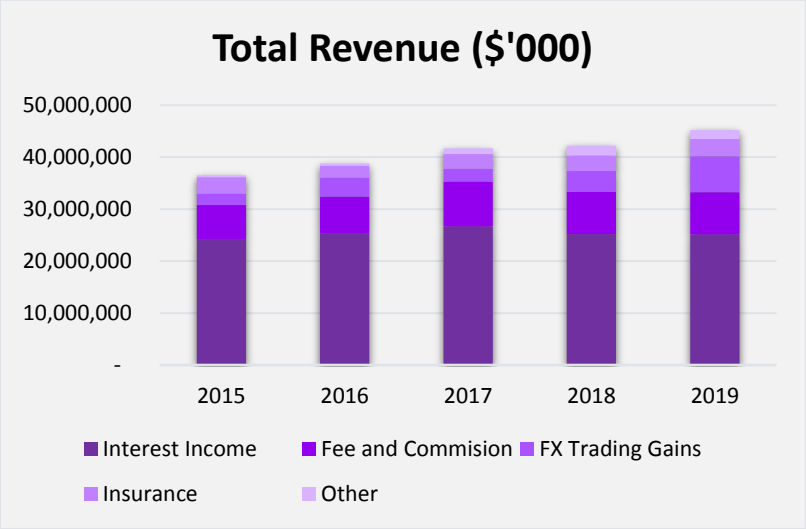
[1] As at March 13, 2020

FINANCIAL PERFORMANCE

	2015	2016	2017	2018	2019	2019 Q1	2020 Q1
Total Revenue ($ billions)	36.5	38.8	41.7	42.2	45.2	11.5	11.1
Net Profit ($ billions)	10.1	11.6	12.4	12.8	13.2	2.3	1.8
Return on Assets (%)	2.4	2.5	2.6	2.5	2.5	1.73	1.28
Return on Equity (%)	12.0	12.6	12.5	11.7	11.3	8.06	6.0
Loans ($ billions)	154.5	166.8	166.5	182.6	205.6	185.7	212.5
Customer Deposits ($ billions)	209.5	248.4	260.6	287.9	313.0	303.0	315.3

FOR THE LAST FIVE (5) YEARS:

The company's profitability over the period has remained relatively consistent as measured by the Return on Assets. Within the last two years the Return on Assets have held constant at 2.5% and over the period has fluctuated within a narrow band of 2.4% to 2.6%. The Return on Equity has trended down, measuring 12% in 2014, falling to 11.3% in 2019 after reaching a high of 12.5% in 2015.



Total Revenue over the period increased by a CAGR of 5.5% from $36.5 billion to $45.2 billion. Revenue growth was largely attributable to growth in Foreign Exchange Trading Gains which increased from $2.2 billion to $7.0 billion over the period. The low interest rate environment has proved challenging for the group. Over the period, Net Interest Income increased marginally, rising only 3.5%. There was a decline in Interest Income of 0.4% in 2019, attributable to a decrease in Interest Earning Assets. Operating Expenses increased at a slower average rate of 3.6%, moving from $20.9 billion to $24.1 billion which implies an increase in the group's productivity. Net Profits increased from $10.1 billion in 2015 to $13.2 billion in 2019.

The company's assets have increased by 26.8% between 2015 and 2019 from $432.9 billion to $549.0 billion. The increase in assets is attributable to a 70.4% increase in Cash, 286.3% increase in Financial Assets and a 161.9% Retirement Benefit Assets. Increases were offset by decreases in Intangible Assets, Taxation Recoverable and Pledged Assets. Throughout the years, the company's Loans and Cash have been the two main constituents of its Total Assets, accounting for 37.5% and 24.6% of Total Assets by 2019. Scotia's loan distribution is more conservative than other institutions with a loan to deposits ratio of 67.4% versus the industry average of 71.1%. This has led the way to a higher quality loan portfolio. The percentage of non-performing loans part of their loan portfolio is 1.80%, below an average of approximately 4.0%.

These assets were funded by a 25.2% increase in Liabilities and a 33.1% increase in Equity. The increase in Liabilities was driven largely by a 49.4% increase in Customer Deposits and a 136.5% increase in Deferred Tax Liabilities. The increase in Deferred Tax Liabilities implies that the company is expected to pay more taxes than is recorded on the Income Statement. The company's profitability led rise to its Retained Earnings and thus an increase in Equity. Th increase in Retained Earnings was offset by the quarterly dividends paid by the company. The company increased its dividend payments from $1.60 per share in 2015, to $2.08 per share in 2019. Additionally, in 2019 the company paid a special dividend of $2.68.

FOR THE FIRST 3 MONTHS OF FY2020

In the first quarter of its 2020 financial year, Scotia experienced a 3.5% decline in Revenue when compared to the same period in the previous financial year. This was as a result of a 0.5% decrease in Net Interest Income, 2.0% decrease in Fee and Commission Income and a 16.1% decrease in Foreign Currency Activities only slightly offset by revenue increases from its other sources. Decreases in Salaries and Staff Benefits along with Other Operating Costs factored into a 3.0% in Operating Expenses which tempered the decline in revenue on overall profitability. Net Profit for the period declined 23.3% versus Q1 of FY2019, from $2.3 billion to $1.8 billion. This caused an overall decline in profitability as measured by the Return on Average Equity and Return on Assets and which fell from 8.06% to 6.0% and 1.73% to 1.28% respectively.

The company's asset base increased from $537.1 billion to $556.8 billion. This was caused mainly by a 14.5% increase in Loans Receivables and a 33.0% increase in Retirement Benefit Assets, offset by a 14.0% decrease in Cash and a 1.9% decrease in Investment Securities. The increase in Total Assets was funded by a 3.6% increase in Total Liabilities and a 4.2% increase in Equity. Customer Deposits at the end of the period totaled $315.3 billion, a 4.1% increase over the $303.0 billion recorded at the end of Q1 of FY2019. The increase in Deposits was offset by decreases in Capital Management and Government Securities Funds, Retirement Benefit Obligation and Policyholder's Liabilities. The increase in Equity was as a result of the company's profit for the period as well as Remeasurement of the group's Defined Benefit Plan and Obligations.

OUTLOOK:

Specialized products for MSME's Can Boost Retail and Commercial Loans

The Jamaican economy is currently experiencing macroeconomic stability which has allowed for a high level of business confidence. It is expected that MSME owners will capitalize on this opportunity along with low interest rates to borrow funds. It is expected that as Commercial and Small Business customers grow their operations, they will seek to reap the benefits from this economic climate. Thus, if the group can offer attractive financial support for these business owners, this will help to boost the groups retail and commercial loans.

Scotia can Benefit from the Expansion of the Payment Services Industry

Mastercard has identified the Caribbean and Jamaica specifically as underbanked. The bank intends to raise the credit card penetration in the region with assistance from commercial banks such as Scotia. This increasing credit card penetration may lead to an increase in revenue earned from the distribution and use of credit cards by Scotia customers.

Lower Fee and Commission Income

The use of digital services come at a lower cost to consumers than in branch services. Thus, the continue adoption of online and other digital channels will reduce revenue earned from fees charged to Scotia's customers. The online migration of customers may be accelerated due to the risk of a coronavirus outbreak in the country.

The Impact of Coronavirus on the Local Economy and Scotia's Growth

Coronavirus, COVID-19, has been declared a pandemic by the World Health Organization (WHO). As of March 13, Jamaica had 8 confirmed cases of the disease with many persons in quarantine for being potentially exposed to it. The effects of the virus on the local economy are unknown as it is in its early stages and measures are being enacted to control the spread. The virus is likely to damper on business and confidence and pose a challenge to many businesses as their operations with be either slowed or closed. The group has stated that despite the expected slowdown in the economy, it expects its retail and commercial loans to increase, thereby increasing interest income. However, as consumers and MSME's may be hesitant to take up loans given the economic uncertainty, this may result in a lower than expected growth in the loan portfolio, or lower interest rate loans distributed. This may also decrease the rate of expansion of the payments industry in the country.

INVESTMENTS POSITIVES:

- Consistently pays dividends
- Strong brand loyalty and awareness
- Historically the company has maintained its profitability performance
- Relatively conservative approach to risk
- High quality loan portfolio as measured by the percentage of non-performing loans

INVESTMENT NEGATIVES

- Growth may be hampered by government and industry regulations.
- High level of competition in the local financial sector.
- Low interest rates are expected to continue to affect net interest income.

CONCLUSION

Scotia has been growing more slowly than its competitors which poses a major risk in this highly competitive financial industry. The group seems to rely largely on its brand and consumer loyalty as it does not seem to be aggressively advertising and discounting its prices like its competitors. Additionally, Scotia Caribbean does not seem to be a strategic focus of Scotia Canada as has sold some of its Caribbean and Latin American businesses in recent years. This may be a contributing factor to SGJ's slow growth. We expect SGJ to continue on its path of slow growth but maintain profitability as a result of cost containment measures and its relativity low loan portfolio.

Using a combination of discounted cash flow model with a required rate of return of 14.1% along dividend discount approach, we arrived at a target price of **$61.92.** This price represents a 25.7% price appreciation from current levels and therefore we recommend SGJ as a **BUY.**

SOURCES

Bloomberg, The Jamaica Stock Exchange and SGJ Limited Annual Reports

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