

## Scotia Group Jamaica Limited (SGJ)

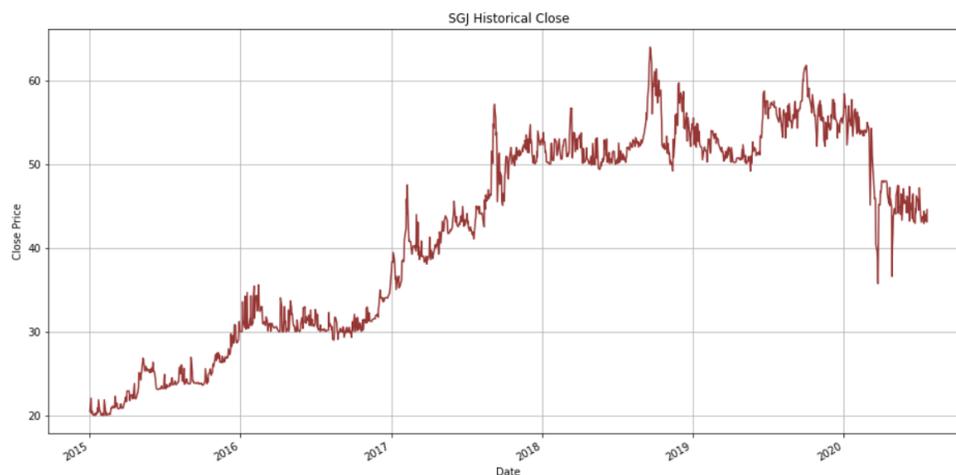
### Executive Summary

Scotia Group Jamaica Limited (SGJ) is a 71.78% subsidiary of Scotiabank Caribbean Holdings Limited, which in turn is a 100% subsidiary of The Bank of Nova Scotia Canada. SGJ is the parent of the Bank of Nova Scotia Jamaica Limited (100%) and Scotia Investments Jamaica Limited (100%). The primary operations of SGJ include Banking, Mortgage Financing, Life Insurance, Investment Banking and Fund Management.

Scotia Group Jamaica (SGJ) reported net income of \$4.02 billion for the 6-months ended April 2020, which represents a 28.44% decline versus the comparable period last year. The decline in profits was due to a significant increase in impairment charges in Q2 FY 2020. The increased impairment charges also impacted Total Operating Income (TOI) for the 6-month period, which fell by \$1.74 billion or 8.36% to \$19.01 billion.

As at the end of Q2 April 2020 SGJ has total assets of \$551.95 billion, an improvement of \$2.95 billion or 0.54% from the end of FY 2019. SGJ's most recent balance sheet is dominated by loans of \$223.11 billion and investment securities valued at \$145.07 billion accounting for 40.42% and 26.28% of total assets, respectively.

SGJ has experienced a steady increase in price, but this has reversed recently as indicated below. These gains have fuelled P/E multiple expansion due to improved investor sentiment. For the period under review (FY 2015 to FY 2019), profits have grown at a CAGR of 6.81% while SGJ's stock price increased at a CAGR of 20.51%. This has resulted in P/E multiple expansion from an average of 6.02x in FY 2015 to 14.16x in FY 2019.



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### Recent Developments

SGJ reported a \$1.26 billion or 12.52% decline in Total Operating Income (TOI) to \$8.84 billion for Q2 FY 2020. **The primary reason for the decline was a surge in expected credit losses from \$487.35 million to \$1.77 billion.** This was due to additional provisions made for expected loan defaults resulting from the global pandemic. Profits were materially impacted, declining \$1.06 billion or 32.10% to \$2.23 billion.

Meanwhile for the 6 months ended April 2020 SGJ's total assets only increased by 0.54% or \$2.95 billion to \$551.95 billion. **The primary reason for the marginal growth was SGJ's 'Cash Resources' declining 31.88% or \$43.04 billion to \$91.96 billion.** However, 'Investment Securities' increased by 21.43% or \$25.6 billion to \$145.07 billion. While 'Loans after Allowances for Impairments' increased by 8.50% or \$17.48 billion to \$233.11 billion. Deposits also increased by 3.65% or \$11.42 billion throughout the 6 months period ended April 2020 to \$324.39 billion.

### Key Financial Data

	2015	2016	2017	2018	2019	CAGR	Q2 2019	Q2 2020	Change
BVPS	27.40	29.52	32.92	37.17	37.96	8.49%	38.50	36.13	-6.16%
EPS	3.19	3.63	3.91	4.11	4.24	7.37%	1.81	1.29	-28.66%
Dividend Per Share	1.62	1.71	1.83	1.92	4.76	30.93%	1.02	1.10	7.84%
Share Price	26.17	31.07	51.97	52.56	55.19	20.51%	51.20	41.62	-18.71%
JSE Main Market Index	131,284.04	166,759.27	292,895.09	365,133.89	495,187.93	39.36%	401,902.02	364,045.96	-9.42%
Total Operating Income	35,139,477	37,337,193	39,492,799	40,293,260	42,581,441	4.92%	20,749,372	19,014,186	-8.36%
Net fee and commission income	6,490,845	7,016,045	8,638,362	8,127,028	8,104,741	5.71%	4,099,449	3,434,097	-16.23%
Insurance revenue	3,203,932	2,369,309	2,785,032	2,931,627	3,302,198	0.76%	1,808,953	1,905,770	5.35%
Net gain on foreign currency activities	2,205,454	3,632,779	2,494,427	4,001,556	6,953,520	33.25%	3,370,066	3,551,560	5.39%
Salaries and staff benefits	10,654,035	10,428,959	10,641,141	10,446,820	11,143,903	1.13%	5,575,385	5,452,429	-2.21%
Total Expenses	20,895,341	20,696,250	21,291,341	22,000,633	24,098,717	3.63%	12,743,553	12,997,123	1.99%
Profit	10,134,005	11,590,602	12,407,290	12,770,915	13,190,054	6.81%	5,614,670	4,017,628	-28.44%
Total Assets	432,631,945	477,391,654	490,882,681	521,862,287	549,001,676	6.14%	544,470,384	551,951,470	1.37%
Loans	154,499,373	166,826,780	166,493,591	182,607,258	205,625,384	7.41%	189,396,391	223,106,088	17.80%
Investment Securities	105,436,140	117,121,153	120,292,580	134,732,786	119,465,785	3.17%	133,071,770	145,069,758	9.02%
Deposits by the public	209,461,602	248,416,381	260,559,467	287,948,379	312,968,147	10.56%	307,074,923	324,391,260	5.64%
Equity	85,257,232	91,855,773	102,431,566	115,647,730	118,114,076	8.49%	119,786,727	112,411,565	-6.16%
						Average			Change
Ratios									
P/B	0.96	1.05	1.58	1.41	1.45	1.29	1.33	1.15	-13.37%
P/E	8.20	8.56	13.29	12.79	13.02	11.17	13.69	11.18	-18.32%
Dividend Yield	7.16%	5.61%	4.41%	3.66%	8.82%	5.21%	1.94%	2.11%	9.15%
Productivity Ratio	57.25%	53.38%	51.09%	52.12%	53.34%	53.46%	57.69%	59.94%	3.91%
ROE	12.53%	13.09%	12.77%	11.71%	11.29%	12.53%	10.16%	9.99%	-1.72%
ROA	2.41%	2.55%	2.56%	2.52%	2.46%	2.51%	2.19%	2.11%	-3.58%
Dividend Payout Ratio	50.78%	47.11%	46.80%	46.72%	112.29%	47.85%	56.35%	85.19%	51.18%

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### Financial Overview

In FY 2019, Total Operating Income (TOI) increased \$2.29 billion or 5.68% to \$42.58 billion. TOI has three primary components 'Net Interest Income', 'Net Fee and Commission Income' and 'Net Gain on Foreign Currency Activities' which were \$22.52 billion, \$8.1 billion, and \$6.95 billion respectively. The primary contributor to TOI growth was 'Net Gain on Foreign Currency Activities' which increased by 73.77% or \$2.95 billion in FY 2019. Meanwhile 'Net Interest Income' and 'Net Fee & Commission Income' declined marginally. **Furthermore, the key driver of TOI growth for the period under review was 'Net Gain on Foreign Currency Activities' which increased at a CAGR of 33.25%.**

For the period under review operating expense has increased at a CAGR of 3.63% to \$24.10 billion. The primary contributors to operating expense are 'Salaries and Staff Benefits' and 'Other Operating Expenses'. Over the period FY 2015 to FY 2019, staff costs have increased at a compounded annual growth rate (CAGR) of 1.13% to \$11.14 billion. SGJ has improved efficiency with the use of technology which assisted the company in growing profits despite staff complement declining 23.04% from 2,144 in FY 2015 to 1,650 in FY 2019. The primary reason for the increase in 'Other Operating Expenses' is 'Technical and Support Services' which increased at a CAGR of 36.41% for the period under review to \$4.06 billion.

Total Assets for SGJ has increased at a CAGR of 6.14% to \$549 billion for the period under review. The most significant assets on the balance sheet are 'Loans after Allowances for Impairment Losses', 'Cash Resources' and 'Investment Securities' accounting for 37.45%, 24.59% and 21.76% respectively as at October 2019. For the period under review 'Loans after Allowances for Impairment Losses' has increased at a CAGR of 7.62% to \$209.78 billion. At the end of FY 2019 the largest loan segments are 'Personal and Credit Card' (\$88.52 billion), 'Business and Government' (\$82.82 billion) and 'Residential Mortgage' (\$37.34 billion).

The fastest growing segment of loans has been residential mortgage which has increased at a CAGR of 13.30%. The majority of 'Investment Securities' at the end of FY 2019 are GOJ securities, which accounted for 94.78% or \$113.23 billion of the line item. **Deposits are the primary liability on SGJ's balance sheet, it has increased at a CAGR of 10.56% for the period under review to \$312.97 billion.** The two primary components are 'Personal' and 'Business' which make up \$161.81 billion (51.70%) and \$151.09 billion (48.28%) of deposits, respectively. The main contributor to the growth rate in deposits is 'Business' which has increased at a CAGR of 11.78% versus 'Personal' which grew at a CAGR of 9.49%.

Key relative value measures such as P/B and P/E have steadily increased for the period under review. The P/E ratio has seen notable expansion moving from an average of 7.4x in FY 2015 to 14.16x in FY 2019. However, so far for FY 2020 average P/E has been 12.38x indicating falling investor sentiment, which we see as justified given the ongoing global pandemic and the negative impact on the Jamaican economy. The primary driver for this multiple expansion has been an increasingly positive sentiment among investors triggered by improved economic indicators. However, for FY 2020, as a result of the surging stock price SGJ's dividend yield has trended lower since FY 2015 moving from 7.16% to 3.66% in FY

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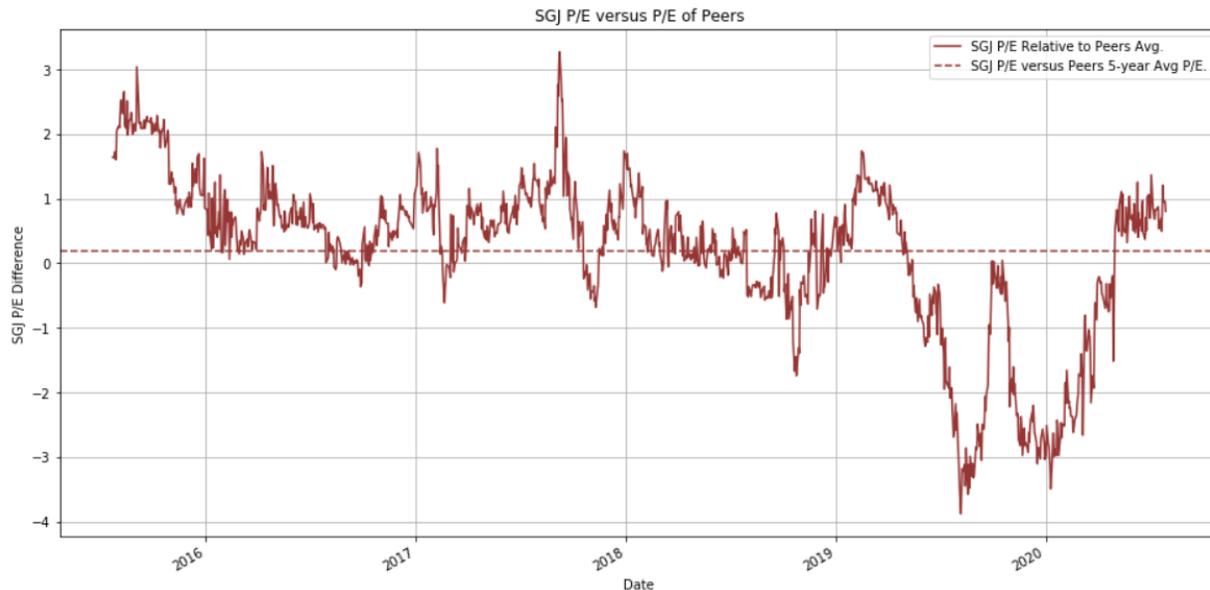
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2018. However, in FY 2019, dividend yield reached a high of 8.82% due to two special dividend payments of \$1.94 and \$0.74. SGJ had a minor increase in its productivity ratio in FY 2019 to 53.34% from 52.12% in FY 2018. Furthermore, the first half of FY 2020 saw productivity ratio increasing to 59.94% from 57.69% in the first half of FY 2019.

### Forecast and Valuation

SGJ pays dividends consistently; actually four times annually, at a steady growth rate. The company has increased dividend payment at a compounded annual growth rate (CAGR) of 5.93%<sup>1</sup> for the FY 2015 to FY 2019 period (period under review). Therefore, we view the use of the DDM as appropriate for the valuation of SGJ. **Our price target of \$45.80 per share is based on the dividend discount model (DDM) and relative value models. Using the DDM we arrived at a price target of \$41.16, the lower end of our price target. Meanwhile, using a relative value method, we arrived at a price target of \$50.44, the upper end of our price target.**

As indicated below for the last five years, SGJ has historically traded at a P/E multiple 0.18x higher than peers while it's P/B multiple has been -0.40x below peers. Applying the P/E premium and the P/B discount to the industry average provides our estimate for each multiple. We then applied these estimates to our expectations of FY 2021 EPS and BVPS this produces our relative value estimates.



<sup>1</sup> Excluding special dividend payment

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### Outlook

In the near-term we expect SGJ to report lower TOI and profits in FY 2020 due to increased impairment charges on loan and lower fee income and gain on financial assets. However, we expect a return to growth in FY 2021, as operations begin to normalize. We expect SGJ to see some benefit from the reduced asset tax rate in FY 2020. **Furthermore, in FY 2021 SGJ profit could be lifted in excess of \$500 million due to the reduction in asset tax rate to 0.125%.**

### Key Risks to Our Price Target

A key risk to our price target is a decrease in NII from increased competition on loans and impairment charges. If actual loan defaults exceed anticipated levels, this could result in impairment losses beyond our expectations and therefore lower earnings and TOI. Another key risk to our upper end price target is if sentiments on large cap banks continue to decline. The average P/E of large cap banks was about 8x in calendar year 2016 and reached a high of 15x in calendar year 2019 and has since deteriorated.

Large Cap Banks					
Ticker	Market Cap(\$M)	P/E	P/B	ROA	ROE
NCBFG	342,822.60	12.84	2.57	2.07%	19.76%
SJ	171,186.56	11.54	1.97	3.43%	17.81%
SGJ	138,624.10	11.96	1.23	2.11%	9.99%
JMMBGL	55,069.74	7.79	1.37	1.96%	20.11%
Average	176,925.75	11.03	1.78	2.39%	16.91%

### Recommendation:

**Our recommendation for SGJ is MARKETWEIGHT.** While SGJ's revenue and earnings growth has lagged peers, historically SGJ has commanded a marginally higher P/E multiple relative to peers. This may be due to SGJ maintaining a higher dividend yield versus peers. Furthermore, SGJ has less inherent risk versus peers, given the current structure of its balance sheet. Investors seeking income and the potential for steady capital gains in the medium to long-term should consider adding SGJ to their portfolio. **SGJ's FY 2019 dividend yield of about 8.8%, which includes a special dividend payment far exceeds peers, which is less than 2%.**

**Source:** <http://www.Jamstockex.com>, *JMMB Investment & Research, Bloomberg, Various Company Financial Statements.*

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# APPENDIX

## IMPORTANT DISCLOSURES

**ABSTRACT**—As a part of our new Portfolio Strategy we are recommending strict adherence to the following Portfolio Allocation **DEFINITIONS/RECOMMENDATIONS**.

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**UNDERWEIGHT**—REDUCE EXPOSURE IN YOUR PORTFOLIO TO LESS THAN 5% FOR THIS PARTICULAR ASSET

**SELL**—REDUCE EXPOSURE IN YOUR PORTFOLIO TO ZERO.

**HOLD/MARKETWEIGHT**—EXPOSURE TO THE ASSET SHOULD BE EQUAL TO 5% OF YOUR TOTAL PORTFOLIO HELD AT JMMB.

**OVERWEIGHT/BUY**—EXPOSURE TO THIS ASSET SHOULD BE BETWEEN 5% AND 10% OF YOUR TOTAL PORTFOLIO HELD AT JMMB

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