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.

SGJ reported net income of $9.05 billion in FY 2020, a decline of 31.37% or $4.14 billion versus the previous FY. The decline in profits was due to a significant increase in impairment charges from $2.6 billion in FY 2019 to $5.8 billion in FY 2020 due to revised assumptions incorporated into SGJ's impairment methodology resulting from the global pandemic. The increased impairment charges also impacted Total Operating Income (TOI), which fell by $4.38 billion or 10.30% to $38.2 billion.

As at the end of FY 2020 SGJ has total assets of $556.28 billion, an improvement of $7.30 billion or 1.33% from the end of FY 2019. The growth in SGJ's balance sheet was a consequence of growth in its loans portfolio and cash position. The increase in the Company's cash resources is directly linked to an increase in deposits.

SGJ has experienced a steady increase in price but, this trend reversed in early calendar year 2020. The decline in SGJ's stock price in recent times is similar to the decline experienced for the JSE Main Market. For the period under review (FY 2016 to FY 2020), profits have grown at a CAGR of -5.99% while SGJ's stock price increased at a CAGR of 9.89%. This has resulted in P/E multiple expansion, which expanded from an average of 8.75x in FY 2016 to 13.41x in FY 2020.

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Recent Developments

SGJ reported profit growth of 2.52% or $85.69 million to $3.49 billion for its 4th quarter ended October 2020. Of note, expected credit loss in Q4 FY 2020 was $590.45 million below the $672 million recorded at the end of Q4 FY 2019. However, the driver of TOI and Net Profit growth in the quarter was the surge in Other Revenue to $1 billion due to a one-off market making opportunity. The significance of the one-off gain tempers our view on the strength of Q4 FY 2020 earnings.

SGJ's board of directors has declared a dividend of $0.45 payable on January 20, 2021 to shareholders on record as at December 29, 2020. However, due to regulatory guidance this payment will be made to shareholders that own less than 1% of the Company's shares.

Table 1: SGJ Abridged Financial Statement and Selected Ratios

	FY 2016	FY 2017	FY 2018	FY 2019	FY 2020	CAGR
BVPS	29.52	32.92	37.17	37.96	35.59	4.79%
EPS	3.63	3.91	4.11	4.24	2.91	-5.38%
Dividend Per Share	1.71	1.83	1.92	4.76	1.55	-2.43%
Share Price	31.07	51.97	52.56	55.19	45.31	9.89%
JSE Main Market Index	166,759.27	292,895.09	365,133.89	495,187.93	375,386.39	22.49%
Total Operating Income	37,337,193	39,492,799	40,293,260	42,581,441	38,197,412	0.57%
NII after Impairment Charges	23,943,481	24,465,611	23,289,789	22,523,071	19,012,423	-5.60%
Net fee and commission income	7,016,045	8,638,362	8,127,028	8,104,741	7,158,568	0.50%
Insurance revenue	2,369,309	2,785,032	2,931,627	3,302,198	3,009,412	6.16%
Net gain on foreign currency activites	3,632,779	2,494,427	4,001,556	6,953,520	6,845,381	17.16%
Salaries and staff benefits	10,428,959	10,641,141	10,446,820	11,143,903	10,625,082	0.47%
Total Expenses	20,696,250	21,291,341	22,000,633	24,098,717	24,800,324	4.63%
Profit	11,590,602	12,407,290	12,770,915	13,190,054	9,052,047	-5.99%
Total Assets	477,391,654	490,882,681	521,862,287	549,001,676	556,281,348	3.90%
Loans	166,826,780	166,493,591	182,607,258	205,625,384	220,726,834	7.25%
Investment Securities	117,121,153	120,292,580	134,732,786	119,465,785	116,397,816	-0.15%
Deposits by the public	248,416,381	260,559,467	287,948,379	312,968,147	336,660,438	7.90%
Equity	91,855,773	102,431,566	115,647,730	118,114,076	110,755,634	4.79%
Ratios						**Average**
P/B	1.05	1.58	1.41	1.45	1.27	1.35
P/E	8.56	13.29	12.79	13.02	15.58	12.65
Dividend Yeild	5.61%	4.41%	3.66%	8.82%	3.16%	5.13%
Productivity Ratio	53.38%	51.09%	52.12%	53.34%	56.31%	53.25%
Financial Leverage	5.14	4.98	4.64	4.58	4.83	4.84
Asset Turnover	8.21%	8.16%	7.96%	7.95%	6.91%	7.84%
ROE	13.09%	12.77%	11.71%	11.29%	7.91%	11.35%
ROA	2.55%	2.56%	2.52%	2.46%	1.64%	2.35%
Dividend Payout Ratio	47.11%	46.80%	46.72%	112.29%	53.28%	61.24%

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Financial Overview

In FY 2020, Total Operating Income (TOI) declined $4.38 billion or 10.30% to $38.20 billion. TOI has three primary components namely Net Interest Income, Net Fee & Commission Income and Net Gain on Foreign Currency Activities which were $19.01 billion, $7.16 billion and $6.85 billion, respectively. The primary contributor to the decline in TOI for FY 2020 was Net Interest Income after Impairment losses which fell 15.59% or $3.51 billion to $19.01 billion. The primary reason for the decline was a 125.16% or $3.25 billion increase in provision for impairment losses on loans due to the expected impact of COVID-19 on its loan portfolio.

Meanwhile Net Fee & Commission Income and Net Gains on Financial Assets fell 11.67% and 1.56% respectively. The decline in Net Fee & Commission Income was a consequence of lower transaction volumes due to the COVID-19 pandemic and the adaption of electronic channels which attract lower fees. The decline in TOI for FY 2020 was offset by a 457.18% surge in Other Revenue to $1 billion. The key driver of TOI growth for the period under review was Net Gain on Foreign Currency Activities which increased at a CAGR of 17.16%. However, the growth in TOI was constrained by NII after Impairment Charges declining at a CAGR of 5.60% for the period under review.

Meanwhile, for the period under review operating expense has increased at a CAGR of 4.63% to $24.80 billion. The primary contributors to operating expense are Salaries & Staff Benefits and Other Operating Expenses. For the period under review, staff costs have increased at a CAGR of 0.47% to $10.63 billion and decline by 4.66% or $518.82 million in FY 2020. 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.

SGJ's Total Assets has increased at a CAGR of 3.90% to $556.28 billion for the period under review. The most significant assets on its balance sheet are Loans after Allowances for Impairment Losses, Cash Resources, and Investment Securities accounting for 39.68%, 25.39% and 20.92% respectively as at October 2020. For the period under review Loans after Allowances for Impairment Losses has increased at a CAGR of 7.25% to $220.73 billion. The growth in SGJ's loan book was due to a 21% increase in the commercial banking loan portfolio and a 15% increase in its mortgage business. In recent years in excess of 85% of SGJ's Investment Securities are Government Securities. Which indicates a relatively high stability of SGJ's balance sheet.

Deposits is the primary liability on SGJ's balance sheet, it has increased at a CAGR of 7.90% for the period under review to $336.7 billion. The two primary components of Deposits are Personal and Business and are split roughly equally.

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Meanwhile, SGJ's equity has increased at a CAGR of 4.79% to $110.76 billion for the period under review. However, the Company's equity fell 6.23% or $7.36 billion due to a significant decline in Loan Loss Reserve and Unappropriated Profits.

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 8.75x in FY 2016 to 14.16x in FY 2019 but declined to 13.41x in FY 2020. This is because of the ongoing global pandemic and the negative impact on the Jamaican economy.

SGJ dividend yield hit its highest level for the period under review in FY 2019 due to a special dividend of $2.68. FY 2020 dividend was impacted by restrictions on dividends only to shareholders below 1% ownership. SGJ productivity ratio hit its highest level for the period under review due to revenue decline while operating expenses increased marginally. SGJ's financial leverage has been stable for the period under review and materially lower than peers, indicating a highly stable balance sheet.

Forecast & Valuation

Historically SGJ has paid dividends consistently four times per year, at a steady growth rate. The company has increased dividend payment at a compounded annual growth rate (CAGR) of 5.93%[1] for the FY 2015 to FY 2019 period. Therefore, valuing the company using a Dividend Discount Model (DDM) was appropriate. However, in FY 2020 SGJ has not maintained its usual pattern of dividend payments therefore using the DDM at this point in our view is not appropriate. Furthermore, when SGJ commences regular dividend payments there is some uncertainty about the amount and timing of such. Therefore, we focus our valuation on a price multiple approach.

We used our projection of SGJ's FY 2021 EPS and BVPS and then applied the harmonic mean P/E and P/B and multiple of peers (adjusted for historical differences) to arrive at our price target of $48.90. Innate in our base-case assumption is that investor sentiment towards SGJ peers remain relatively stable. Below is a chart illustrating the relationship between SGJ's P/E ratio and its peer group average over the last five years. **To derive the upper and lower price targets, we used the average price of peers and adjusted it for historical high and low variation between the historical P/E and P/B of SGJ and its peer group over the last five years. This resulted in our lower and upper price targets of $37.21 and $63.37.**

[1] Excluding special dividend payment

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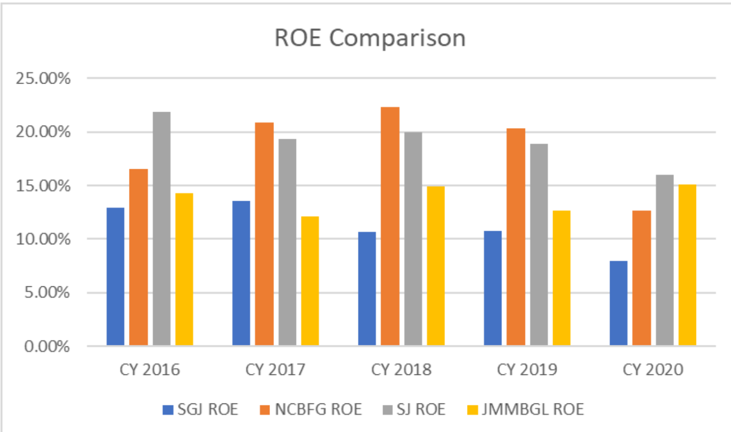
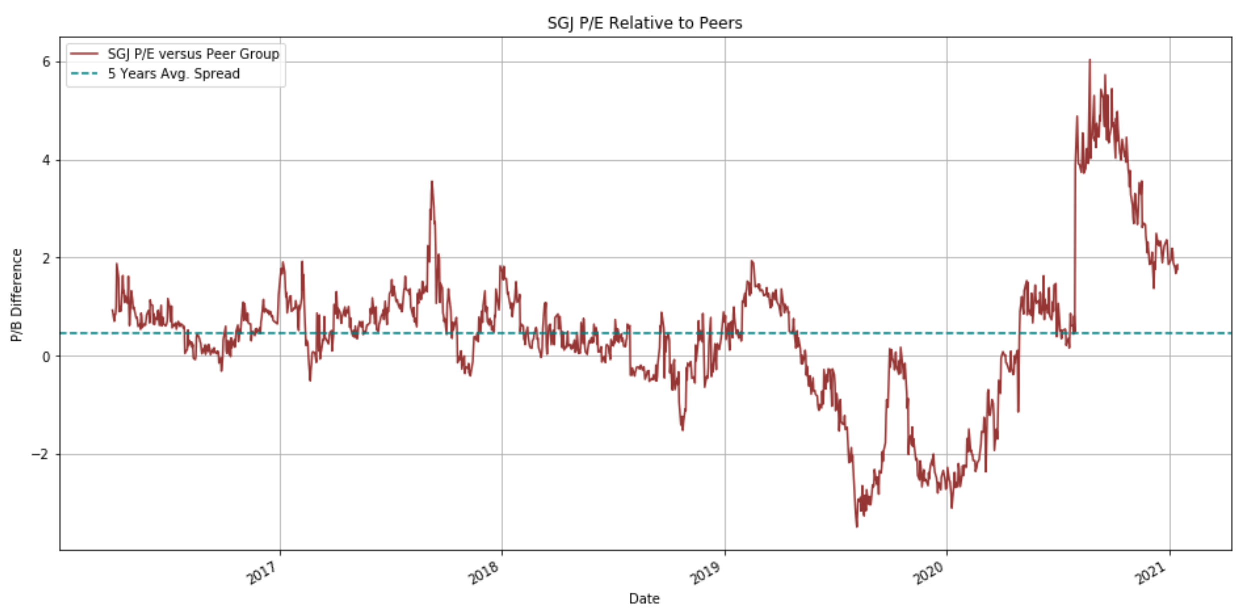


Over the period calendar year (CY) 2016 to September 2020 SGJ's average ROE has been below the peer group average. This explains why SGJ's P/B has been 0.33x below peers over the last five years. However, as indicated below historically SGJ's P/E ratio has exceeded its peers by 0.45x, this may be explained by SGJ's better dividend yield but curtailed by its slower growth rate relative to peers.



Outlook

In the medium to long-term we expect SGJ to report increased TOI and profits in FY 2021 due to reduced impairment charges on loans. Furthermore, we expect SGJ's growth in its loan book to help drive growth in Net Interest Income in FY 2021 and beyond. SGJ's push for adoption of its digital channels may result in near term decline in Fee & Commission Income. However, in the long-term we expect SGJ's focus on the use of digital channels to drive increased efficiency and increased earnings.

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Recommendation:

We recommend a MARKETWEIGHT rating on SGJ at this point given that the stock currently trades below our price target of $48.90 but above our lower-end price target of $37.70. 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 evident in its relatively low financial leverage. Investors seeking income and the potential for steady capital gains in the medium to long-term should consider adding SGJ to their portfolio.

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

APPENDIX

IMPORTANT DISCLOSURES

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

PLEASE NOTE THAT NO INDIVIDUAL ASSET IN YOUR PORTFOLIO SHOULD HAVE A WEIGHTING GREATER THAN 5% UNLESS OTHERWISE RECOMMENDED BY YOUR PORTFOLIO MANAGER OR A SPECIFIC JMMB RESEARCH REPORT. CONSEQUENTLY THE FOLLOWING **DEFINITIONS** ARE PROVIDED FOR CLARITY.

OUTPERFORM/OVERWEIGHT/BUY—EXPOSURE TO THIS ASSET SHOULD BE UP TO 10% OF YOUR TOTAL PORTFOLIO HELD AT JMMB

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

UNDERPERFORM/UNDERWEIGHT— ADJUST EXPOSURE IN YOUR PORTFOLIO HELD AT JMMB TO BETWEEN 2.5% AND 4.9% FOR THIS PARTICULAR ASSET

STRONGLY UNDERPERFORM/UNDERWEIGHT—REDUCE EXPOSURE TO THIS ASSET TO BELOW 2.5% OF YOUR TOTAL PORTFOLIO HELD AT JMMB

SELL—REDUCE EXPOSURE IN YOUR PORTFOLIO TO ZERO (0%).

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