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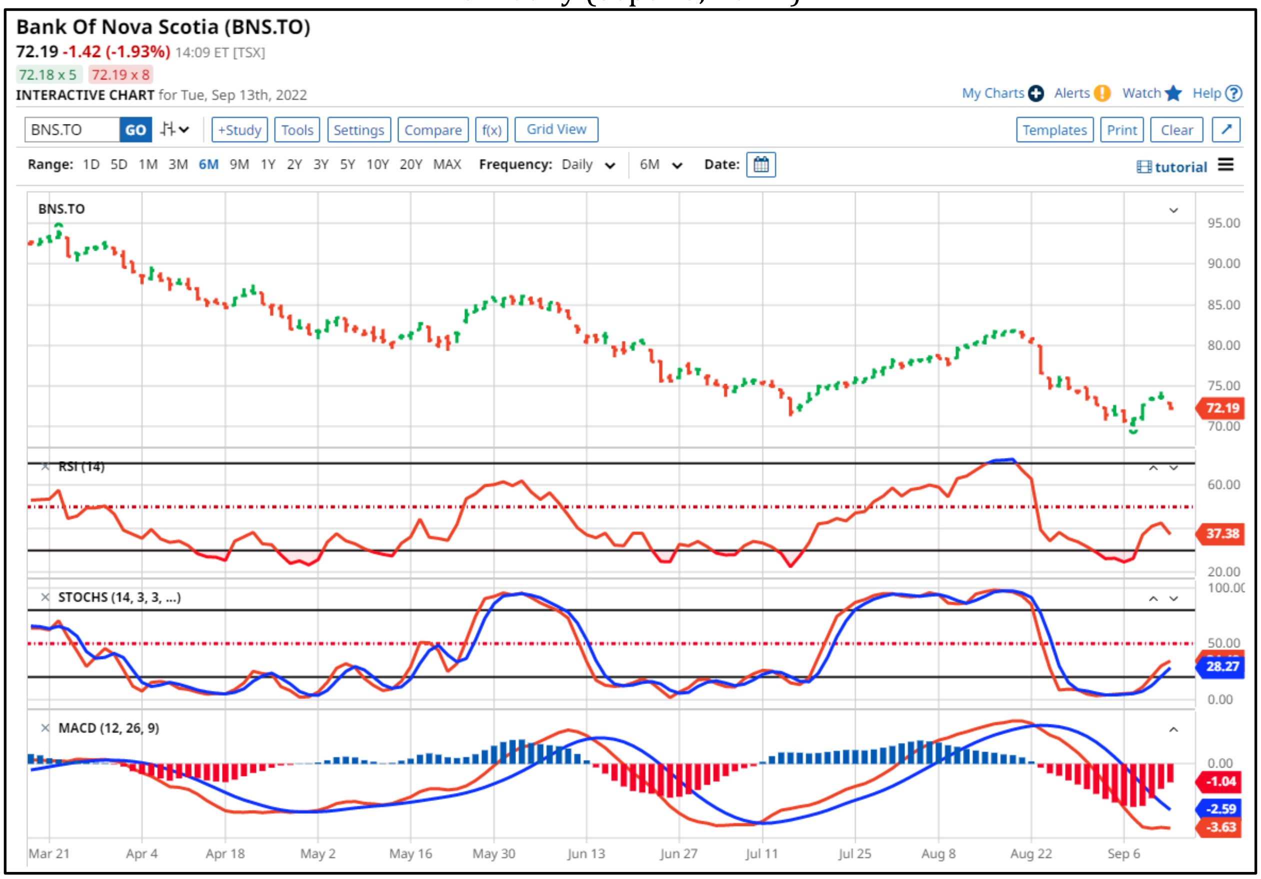
FOR EDUCATION PURPOSES ONLY

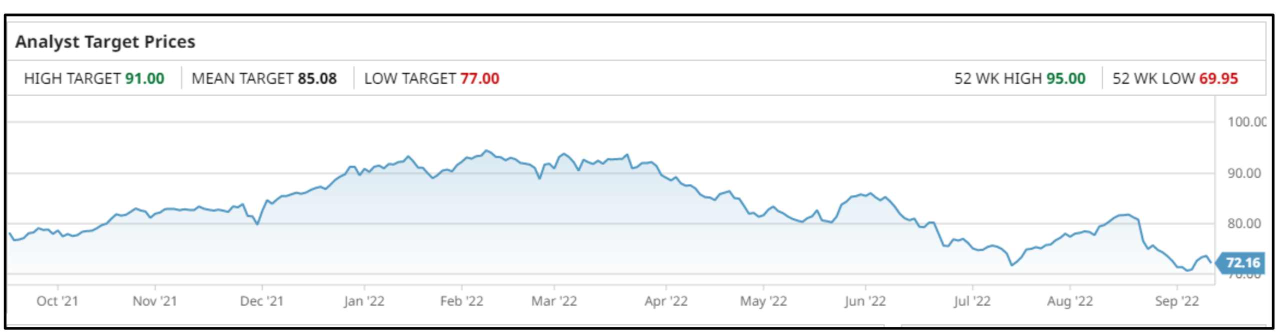
Bank of Nova Scotia (BNS)

Bank of Nova Scotia is a global financial services provider. The bank has five business segments: Canadian banking, international banking, global wealth management, global banking and markets, and other. It offers a range of advice, products, and services, including personal and commercial banking, wealth management and private banking, corporate and investment banking, and capital markets. The bank's international operations span numerous countries and are more concentrated in Central and South America.

6M daily (Sept 13, 2022.)



52W High: Feb 9, 2022, $ 95.00
52W Low: Sept. 7, 2022, $ 69.95



Key Statistics

Market Cap, $K	87,758,504
Shares Outstanding, K	1,192,209
Price/Earnings Forward	N/A
Price/Earnings ttm	8.81
P/E to Growth	N/A
Earnings Per Share ttm	8.36
Most Recent Earnings	2.09 on 08/23/22
60-Month Beta	0.89
Annual Sales, $M	30,913
Annual Net Income, $M	9,624
Annual Dividend Yield	4.12 (5.60%)
Most Recent Dividend	1.030 on 10/03/22

3Q Financial Performance:

Narrow-moat-rated Bank of Nova Scotia reported a weaker fiscal third quarter. Adjusted earnings per share were CAD 2.10, representing growth of 4% year over year but growth of negative 4% quarter over quarter. The biggest point of weakness was fees, particularly within the more market and activity sensitive investment banking, trading, and wealth businesses. This is a pattern we have already seen start to play out for the U.S. banks, and we expect to see similar trends as the rest of the Canadian banks report. Despite weaker fees, net interest income and expenses remain essentially in line with our expectations. After adjusting our near-term fee outlook down, we are lowering our fair value estimate to CAD 85/USD 65 from CAD 87/USD 68.

The relative lack of rate sensitivity for the Canadian banks compared to the U.S. banks was on full display in the quarter for Scotiabank, as net interest margins were flat quarter over quarter. This is despite the Bank of Canada raising rates 150 basis points during the quarter. Global wealth management saw a decline of 6% year over year for assets under management, as market declines weighed on the segment, while the global banking and markets segment saw a 23% quarter over quarter decline in net income as capital markets-related revenues suffered. The Canadian banking segment was the best performer, with solid balance sheet growth and some boost from rates helping net income grow 3% sequentially, while the international segment saw roughly flat sequential pre-provision pre-tax profits.

While the bank did adjust its macroeconomic forecast to be less favorable, causing some increase in performing provisions for credit losses, impaired PCLs dropped a bit and the total allowance for credit losses declined quarter over quarter. Impairments and write-offs continue to be low, and we aren't seeing much movement in delinquencies just yet. If a turn in credit is coming, it isn't showing up just quite yet.

Business Strategy & Outlook

Bank of Nova Scotia is the third-largest Canadian-based bank by assets and one of six Canadian banks that collectively hold almost 90% of the nation's banking deposits. It is known as Canada's most international bank as it derives a little over half of its revenue from Canada, over 40% from international operations (primarily Latin America, namely Mexico, Peru, and Chile), and a single-digit percentage from the United States. Its domestic operations are more concentrated in mortgages and auto lending, with leading market share in autos. The bank has been expanding its domestic wealth operations significantly with its acquisitions of MD Financial and Jarislowsky Fraser, making it the third-largest active manager in Canada. The bank has been reworking its Latin America footprint, making acquisitions in markets it likes (Chile, Colombia) while reducing exposure to businesses and geographies that are less favorable as it attempts to consolidate better share within the area. The international exposure gives the bank the potential for higher growth and return opportunities compared with peers, but it also exposes the bank to more risks, as we've seen during the pandemic. While theoretically beneficial, the bank's international exposure has tended to be more of a headwind than tailwind.

After numerous acquisitions, we think the bank has made substantial progress on rationalizing its many back-end systems and improving efficiency bank wide. The bank's original goal was to have an efficiency ratio of 50% by the end of 2021; however, this was delayed given the less positive economic backdrop caused by COVID-19, and we think it will likely be another year or two before the bank hits this goal.

While all banks in Canada are engaged in similar ongoing investments, Scotiabank has been spending a lot on within its technology and communication expenses. We think these efforts will ultimately pay off in the form of improved operating efficiency, customer engagement, and internal sales coordination. This leads us to believe that returns on tangible equity near 16%-17% are maintainable over the longer term for the bank.

Economic Moat

We believe Bank of Nova Scotia is worthy of a narrow Morningstar Economic Moat Rating. Although it has some of the best historical total bank operating efficiency, moaty nonbank businesses, and the ability to primarily operate in the favorable Canadian banking environment as its third-largest bank, we assign it a narrow moat rating instead of wide. The bank has significant, but not leading, market share in its domestic operations, and it has the lowest proportional exposure to Canada, at roughly 50% of revenue. Additionally, the bank's non-Canadian exposure is concentrated in Latin America, where we calculate the international segment earns returns on equity only slightly above the 11% average cost of equity we assign to that segment.

We argue that banks derive moats primarily from two sources: cost advantage and customer switching costs. We see a tightly regulated, oligopolistic market structure limiting excess competition within the Canadian system, therefore stabilizing product pricing and giving customers less incentive to switch banks. We see cost advantages stemming from three factors: a low-cost deposit base, excellent operating efficiency, and conservative underwriting; regulatory costs are also a factor we must consider. We view the Canadian banking environment as offering systemic cost advantages for the banks in its domain. These advantages manifest themselves in the form of lower operating costs, lower credit costs, lower regulatory costs, and lower absolute levels and better diversification of risk, all of which allow the banks to achieve greater risk-adjusted returns.

Bank of Nova Scotia has built up substantial market share within its Canadian retail operations and with large commercial clients. While the bank has number-one share within the fairly attractive auto and dealer floor lending space, the bank is usually not the number-one or number-two player for most products. The Canadian segment does earn returns on equity well in excess of the 9% cost of equity we assign to Canadian banking operations.

While its Canadian operations are strong, Scotiabank has the least proportional exposure to Canada among the Big Six banks, as nearly 50% of operations are outside Canada, primarily in Latin America. We believe these operations warrant a higher cost of equity of 11%, and at this point the bank earns roughly 14%-16% returns on equity in this segment. While we like the bank's international exposure to higher-return and higher-growth markets, it tends to not be the dominant player in most of these markets, although its scale is improving. In these regions, the largest players with the most scale tend to earn the best returns and be the moatiest (such as Banco de Chile in Chile, Bancomer in Mexico, and Santander in multiple locations).

Bank of Nova Scotia has built a decent-size wholesale banking and capital markets group. Based on deal credit, it tends to be a top 10 player within Canadian offerings, and it does a fair amount of business internationally. Also, while not historically a dominant asset manager among the Canadian banks, a series of acquisitions have improved the bank's standing here. Scotiabank is now the third-largest manager among the banks, and with roughly CAD 300 billion in AUM, it should be seeing decent fee income from this segment. This gives the bank exposure to this higher-margin fee-based business that we don't think will change in the near term as the banks still have the dominant branch and distribution networks.

We believe the Canadian banking environment offers systemic cost advantages that lead to returns above the cost of capital, allowing the main banks operating under its jurisdiction to possess moats.

Barriers to entry are very high for the Canadian banking system. Existing regulations prevent foreign competition, as non-Canadian residents may not own more than 25% of the shares of a bank unless approved by the government, preventing foreign takeover. Foreign banks can operate in Canada only under certain restrictions, preventing significant direct foreign competition. The federal government also controls domestic competition, as Canada's banking system historically developed to favor a few large banks controlling the majority of the domestic market, and this is actively enforced through the handling of chartering by the federal government exclusively. Additionally, the rejection of merger proposals in 1998 between Royal Bank of Canada and BMO, and between Toronto Dominion and Canadian Imperial Bank of Commerce, created a precedent where no further consolidation between the main Canadian banks will be accepted by the regulators.

Having larger banks helps to spread out fixed costs across a larger operating base, increasing operating efficiency, as the four largest Canadian banks are all bigger than the largest U.S. regional bank. The Canadian banks arguably have some of the most powerful distribution networks within Canada because their branch networks are spread out through all of Canada. This offers cost advantages via lower customer acquisition costs. In addition, the banks are involved in nearly every major financial product, including asset management, wealth management, insurance, investment banking, and a variety of other consumer and commercial banking products and services. On a bigger scale, powerful distribution networks, a multitude of products, and diversification of business lines lead to economies of scope in addition to those already achieved.

We believe a more protective and efficient regulatory system also leads to cost advantages, primarily through risk reduction. Less fragmented and well-integrated banking systems like the Canadian system have tended to be more stable over time, reducing risk. Also, the Canadian regulators must only primarily monitor and develop relationships with the Big Six Canadian banks, which is much easier than trying to monitor the thousands of banks that exist in the U.S., for example. This leads to more collaboration and cooperation between regulators and banks as well as greater institutional memory and more coordinated and easily implemented responses if strains begin to appear in the system. Regulators also help to control pricing in the market at times, such as on mortgage products, helping to reduce the potential for pricing wars to gain market share at the expense of underwriting standards. In many ways, Canadian regulation makes it more difficult for banks to issue bad credit, including mandatory insurance and standards on riskier mortgage loans, not having a GSE like government subsidized mortgage securitization market, and forcing banks to hold more of the risk on their own balance sheets. These factors help contribute to better absolute risk reduction in the system as well as regulatory economies of scale.

The Canadian banks are also more geographically diversified on average than, for example, the majority of U.S. regional banks that often have concentrations within individual states or local economies. This diversifies credit risk, lowering the overall risk for each individual bank. Canada's system of higher taxes, more social safety nets, and undoubtedly other complex factors have also led to a more robust and stable middle class that contributes to economic and political stability, further reducing systemic risk.

Combine all of these factors, along with explicit government subsidies on deposit insurance and mortgage insurance as well as the implicit subsidy of being too big to fail domestically (all Big Six Canadian banks are labeled as DSIBs), and we believe an environment exists where excess returns for banks are almost certain to exist in Canada.

Profit Drivers

After incorporating the latest quarterly results, we are decreasing our fair value estimate to CAD 85 per share from CAD 87. Our fair value estimate is 2.1 times tangible common book value as of July 2022.

Our base-case scenario assumes that the net interest margin for Bank of Nova Scotia gradually expands from 2022 through 2025 as rate hikes, both in Canada and internationally, begin to feed through the balance sheet. We see loan growth of 13% in 2022 (up from 10% previously) as economic growth continues, before falling back down to 4% thereafter. We see deposit growth of 11% in 2022 before falling back to 4%-5% each year thereafter. We forecast for charge-offs to decline in 2022 due to a stronger economic backdrop and as the bank continues to shift toward a high mix of secured lending.

We believe further moves to increase efficiency, both through digital initiatives and further consolidation abroad, should translate to improved efficiency ratios. We see low-single-digit percentage expense growth in 2022 and beyond. We project that fee revenue will come under some pressure in 2022 as investment banking, trading, and wealth fees stall out, leading to a 3% decline (down from flat previously) with 1% growth in 2023 before a bounce back to 5% growth as market levels and activity recover in 2024 and 2025. In sum, we forecast a terminal return on tangible equity of 15%-16%. We use a 10% cost of equity.

Risk and Uncertainty

Canadian banks face two primary risks: macroeconomic risks and risks related to future acquisitions. Canada has some of the highest median housing prices/annual median household income ratios in several of its major housing markets, and mortgage debt levels have consistently increased for more than a decade. While low interest rates have kept debt servicing ratios under control, this puts the economy in a riskier position as rates rise.

We also see the leverage of the Canadian consumer as a risk, as consumers have slowly levered up for more than a decade. Scotiabank's international portfolio helps diversify the loan book, giving the bank one of the smallest exposures to the domestic real estate market in Canada.

While there are uncertainties related to consumer debt levels and the mortgage market, we view them as a threat to future growth and not an existential risk to the Canadian banking system. Further, the Canadian banking system has historically been one of the more stable systems in the world, and the system is designed to protect industry profit levels and maintain this stability and promote economic stability. Given this setup, we assign our Canadian banks a Low Morningstar Uncertainty Rating.

From an ESG perspective, commercial banks are expected to have strong product governance. Predatory or discriminatory lending practices are examples of poor product governance, and this can affect certain banks at times. We view most product governance and social risks as manageable and incorporate a steady level of operational expenses related to compliance and litigation in our models. Outside of the rare, headline-grabbing scandals, we do not see social risks as having a material effect on our valuation. Banks also lend to certain sectors that can come under more scrutiny, such as gun manufacturers, or energy, for example. Commercial banks do not directly have a large environmental footprint and governance practices are in line with most companies.

Capital Allocation

We give Bank of Nova Scotia a Standard capital allocation rating. In our opinion, the company's balance sheet is sound, its capital investment decisions are standard, and its capital return strategy is appropriate. Scotiabank is above management's targeted common equity Tier 1 ratio of 11.5%, which we consider an appropriate goal. We view the company's capital investments as standard. While the bank has not been perfect, it has generally avoided value-destroying products and expansions while pursuing sensible investments and growth opportunities. We assess the company's capital return strategy as appropriate, and it is largely in line with peers, with a healthy focus on a dividend, and some additional earnings left over for repurchases, after internal investments.

Brian Porter has served as CEO since November 2013. He has been with the bank since 1981 and has held numerous positions largely concentrated in global banking and markets and international banking. Porter was chief risk officer for three years through 2008, group head of risk and treasury through 2010, and group head of international banking through 2012 as he was prepped for the role of CEO.

We like the approach Porter has taken, focusing on technology, shaking up management positions with many new appointments, and culling some of the less successful investments abroad. While the transition hasn't been painless, with write-downs, job cuts, branch closings, and restructuring charges, we think the bank will remain cost-focused and has moved in the right direction.

Bank of Nova Scotia's investments have not always worked out, which is partially to be expected when investments are concentrated in higher-risk areas abroad. It has had several major write-downs over the years, including a CAD 540 million write-down from investments in Argentina, losses during the crisis, a round of one-time charges in 2014, and a recent restructuring charge in 2021. We also note that despite concentrating its investments in higher-growth emerging markets, Bank of Nova Scotia has not consistently been a positive growth outlier compared with peers. Scotiabank's positioning internationally often leaves it with less dominant market share, and even with its latest string of acquisitions, Scotiabank is still often not the dominant player in a given area. Despite this, we think the international strategy does offer some interesting optionality for the bank, as returns and growth will be pressured for peers that are primarily expanding in markets like the U.S. This strategy could also offer some diversification if Canada begins to suffer any serious growth and credit issues. But for the time being, Canada remains one of the most attractive banking markets to operate in, and it is tough to do consistently better elsewhere. While we think Porter is bringing some needed change, all of the above factors lead us to rate the stewardship of the bank as Standard.

Bank of Nova Scotia Halifax (TSX : BNS)					
Year	**Declaration Date**	**Ex-Dividend Date**	**Record Date**	**Payable Date**	**Dividend $ Amount**
2022	23-Aug-22	03-Oct-22	04-Oct-22	27-Oct-22	$ 1.03
2022	25-May-22	01-Jul-22	05-Jul-22	27-Jul-22	$ 1.03
2022	01-Mar-22	04-Apr-22	05-Apr-22	27-Apr-22	$ 1.00
2022	30-Nov-21	03-Jan-22	04-Jan-22	27-Jan-22	$ 1.00
2022 Total:					**$ 4.06**
2021	24-Aug-21	04-Oct-21	05-Oct-21	27-Oct-21	$ 0.90
2021	01-Jun-21	02-Jul-21	06-Jul-21	28-Jul-21	$ 0.90
2021	23-Feb-21	05-Apr-21	06-Apr-21	28-Apr-21	$ 0.90
2021	01-Dec-20	04-Jan-21	05-Jan-21	27-Jan-21	$ 0.90
2021 Total:					**$ 3.60**
2020	25-Aug-20	05-Oct-20	06-Oct-20	28-Oct-20	$ 0.90
2020	26-May-20	06-Jul-20	07-Jul-20	29-Jul-20	$ 0.90
2020	25-Feb-20	06-Apr-20	07-Apr-20	28-Apr-20	$ 0.90
2020	26-Nov-19	06-Jan-20	07-Jan-20	29-Jan-20	$ 0.90
2020 Total:					**$ 3.60**

Suggested Strategy:

Buy Target: $ 70/$ 75 range
Long Term (12 Months) Sell target $ 85.00

Note: Banks are primarily traded for long term dividend income. Short term strategy based on oversold positions.

Example: RRSP Account $ 55,000 & TFSA $ 35,000

RRSP Acct.:
Buy 500 shares @ $ 72 = Capital Invested $ 36,000. Sell target $ 74.00
Buy 200 shares @ $ 75 = Capital Invested $ 15,000. Sell target $ 78.00

Exposure: $ 51,000. Potential Profit $ 1,000 + $ 600 = $ 1,600 (ROI 3%) short term strategy

TFSA Acct.:
Buy 475 shares at $ 72 = capital Invested $ 34,200 Sell Target $ 85.00 (taking dividends until sell target executed).

What If:

BNS shares drop below $ 70?

So, what? Why are you holding bank shares (and other high div. companies)? Dividends!

BNS will rebound to suggested sell levels overtime. The 52W high is $ 95 with the 52W low about $ 70. We are looking at $ 70- $85 trading range.

NB: There are NO specific reasons why BNS (or other banks) shares decline sharply. The decline is usually due to being pulled down by overall TSX decline which usually declines due to talking heads uttering stuff e.g., inflation is so great that super recession is about to hit us before lunch! OR Putin is crossing the north pole to take over Kimmirut, Nunavut! (So, he can swim with the Polar Bears)).

What about stop losses?

It ultimately depends on ***YOUR RISK PROFILE*** (see Modules if you are a Gunslinger (cocky with a Midas attitude) or Mr Rabbit (fearful of your own shadow).

Only use them with shares that are vulnerable to economic challenges e.g., AC (travel); WFG (housing); AEM (interest rate increases); MG/LNR (subject to car chip shortage) etc.

If you are having difficulty with your trading strategy – redo the Modules 😊 That's the only answer.

END