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Bank Of Nova Scotia - Buyable Despite Valuation

Sep. 08, 2021 6:20 AM ET | **The Bank of Nova Scotia (BNS)** | 13 Comments | 25 Likes

Summary

- I've written about Scotiabank earlier, and I own about 0.6% of my portfolio in the company.
- The bank's results have been impressive, yet for the past 4-5 months or so, the trend has been clear - and it's down.
- This opens up for a decent upside on part of the bank, and the current upside is well within double-digits per year.

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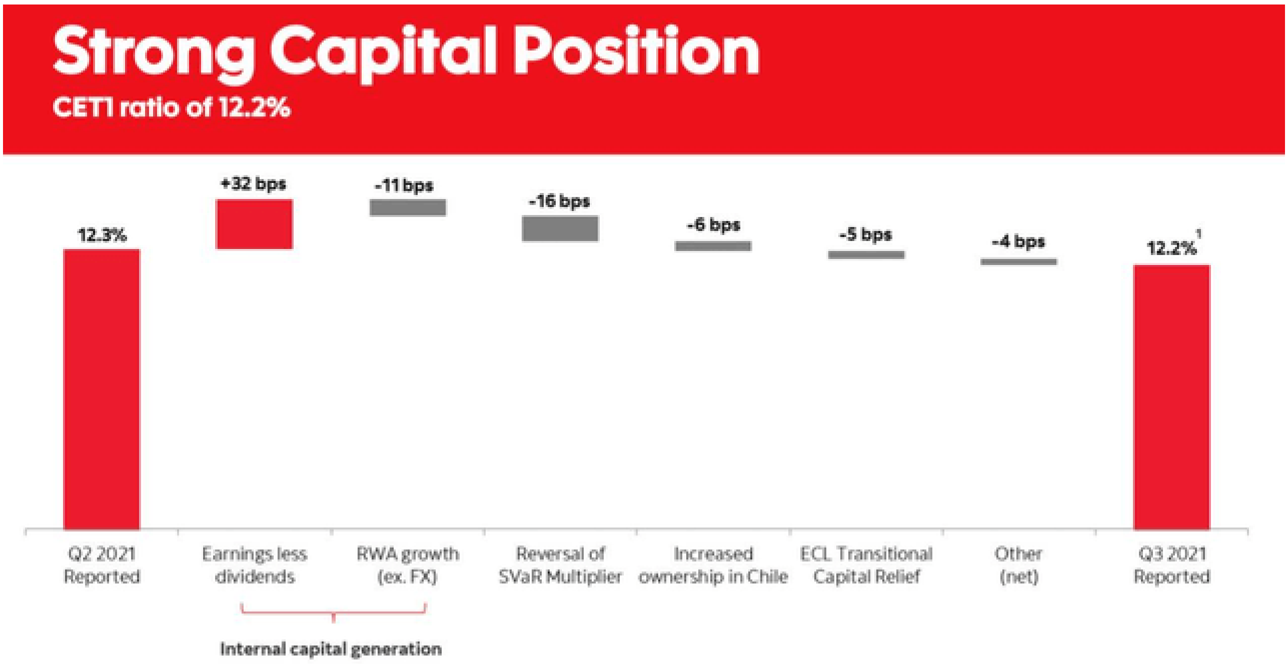
In this article, we look at Scotiabank (BNS) and the bank's performance and future prospects. I've written about the bank a few times before, and consider it one of the better-priced banks in all of NA at the moment. While the opportunity is not as great as say, Unum Group (UNM) or Reinsurance Group of America (RGA), it's still an excellent opportunity with a great upside.

Let me show you what I mean.

(Source: Scotiabank)

The bank recently reported 3Q21, and like most banks that reported earnings during the later quarters this year, results were good. Overall, BNS saw a strong performance from its businesses, and the international banking segment has recovered to the bank's own targets.

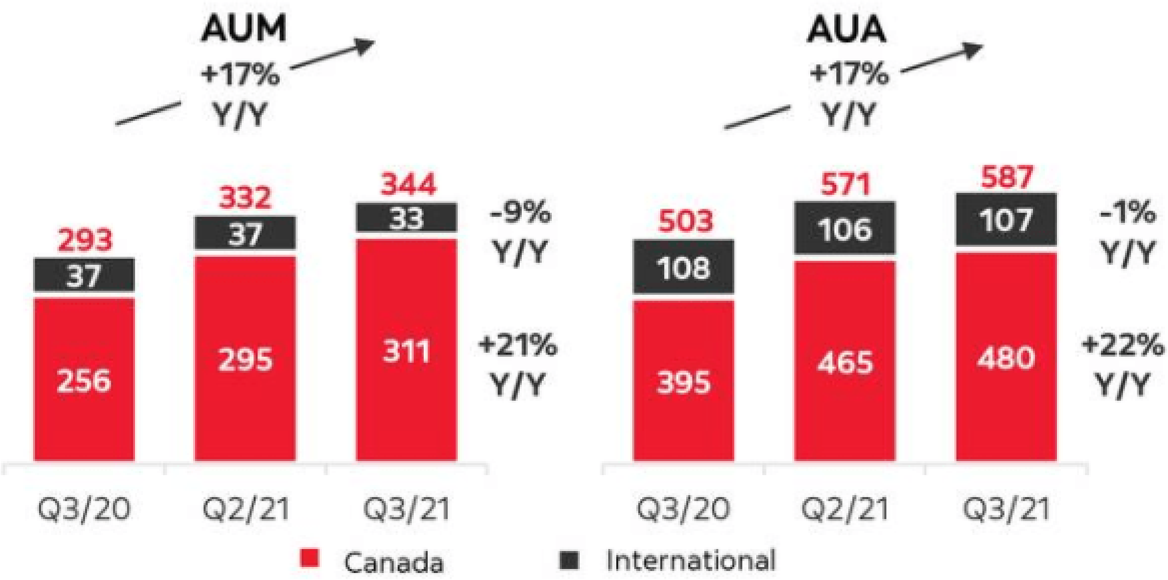
EPS was up 93% YoY, 6% on a sequential basis, where the sequential is more relevant due to COVID-19. Revenue was up 1% on an adjusted basis, and 5% excluding FX, and BNS saw slight margin improvements and a strong RoE above 15%. While BNS cannot compete with CET-1 ratios of DNB (OTCPK:DNBHF) and similar European banks, the bank nonetheless sports a decent capital position well within regulatory minimums.



(Source: Scotiabank)

The bank's segment saw good results, with net income up double digits sequentially in the Canadian segments, strong results in revenues, and a strong loan growth increasing net income. The bank is seeing more expenses, but this was more than weighed up by double-digit growth in residential mortgages and 7% in business loans. Non-personal deposits grew by 26%.

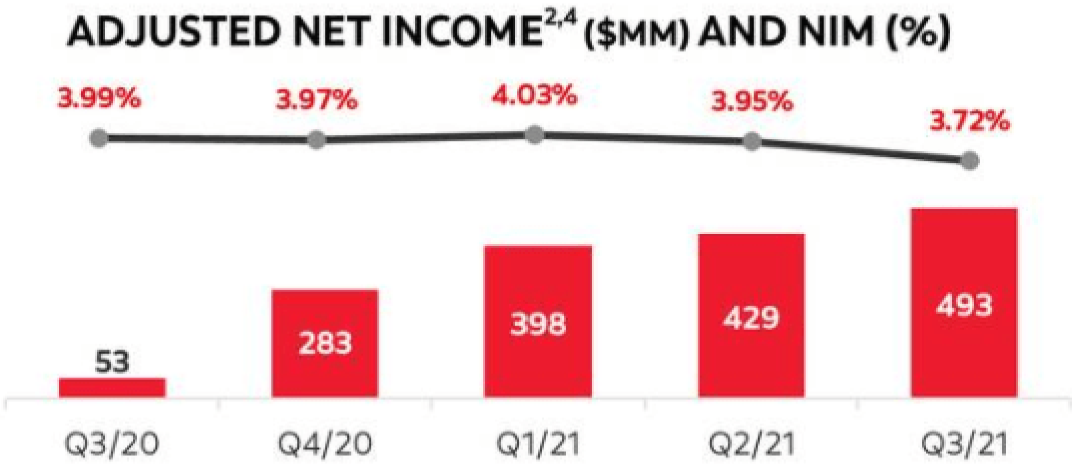
The global wealth management sector saw a high-income increase, nearly 20%, marking **ten consecutive quarters** of double-digit growth. BNS is becoming a powerhouse here, and the revenue increases came from the triad of mutual fee increases, brokerage fee increases, and volume growth from private banking/management. BNS has seen seven consecutive quarters of positive operating leverage for the segment. Trends are, simply put, extremely good here.



(Source: Scotiabank)

The global banking segment, which has been a bit of a problem for the bank at times, has normalized and saw loan growth, deposit growth, flat expenses, and improved productivity ratios. There was an overall normalization in the capital markets. On a YoY basis, results were still down - but trends are improving.

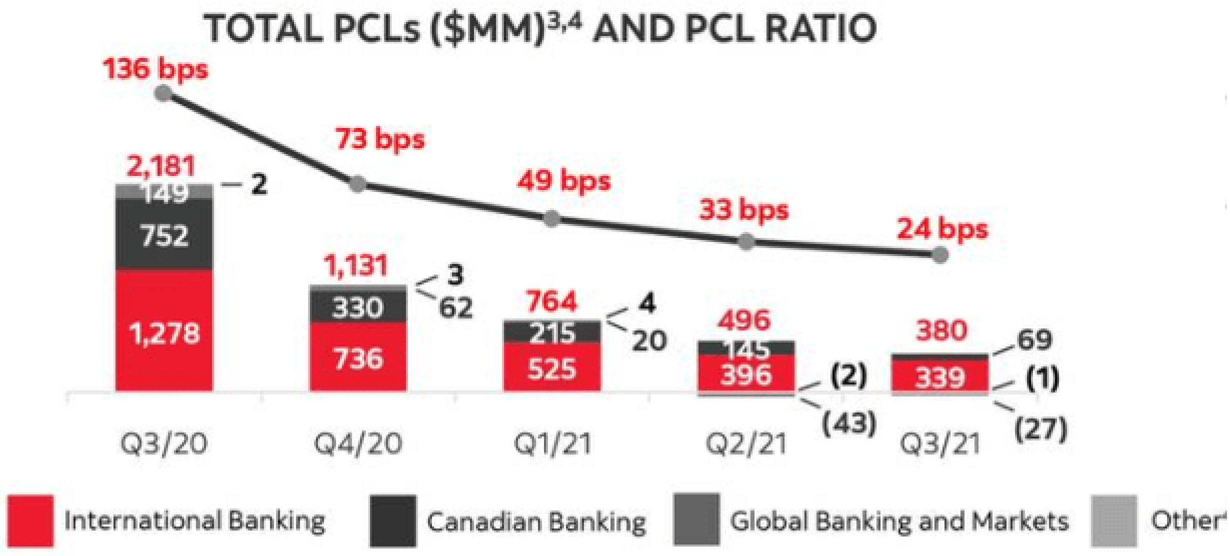
The last one, International banking, saw a strong recovery that's been ongoing for some time.



(Source: Scotiabank)

Every key indicator is nearly positive here, with income up, revenues up, loans up, and overall volumes up.

BNS saw a strong, improved credit ratio on an overall basis, and the current BNS credit ratio is actually below pre-pandemic levels. On that basis, BNS has managed a full recovery here. There are also lower overall write-offs, and numbers here are well below historical averages. Credit performance was excellent, and the company's overall PLCs has gone down yet again.



(Source: Scotiabank)

There have been net reversals of performing PLCs of almost half a billion dollars, and most of the impaired ones were driven by credit migrations in south-American countries, where Scotiabank maintains a very large presence in certain key nations. International retail banking has very much improved, and overall BNS trends are, once again, positive.

In fact, earnings for Scotiabank are at a much higher level YTD than before the pandemic in 2019. Furthermore, economic activity and growth is on the rise, and the bank considers itself very well-positioned for further economic growth. The results reflect an acceleration of growth, led by most of the company's segments, and an improved global macro outlook.

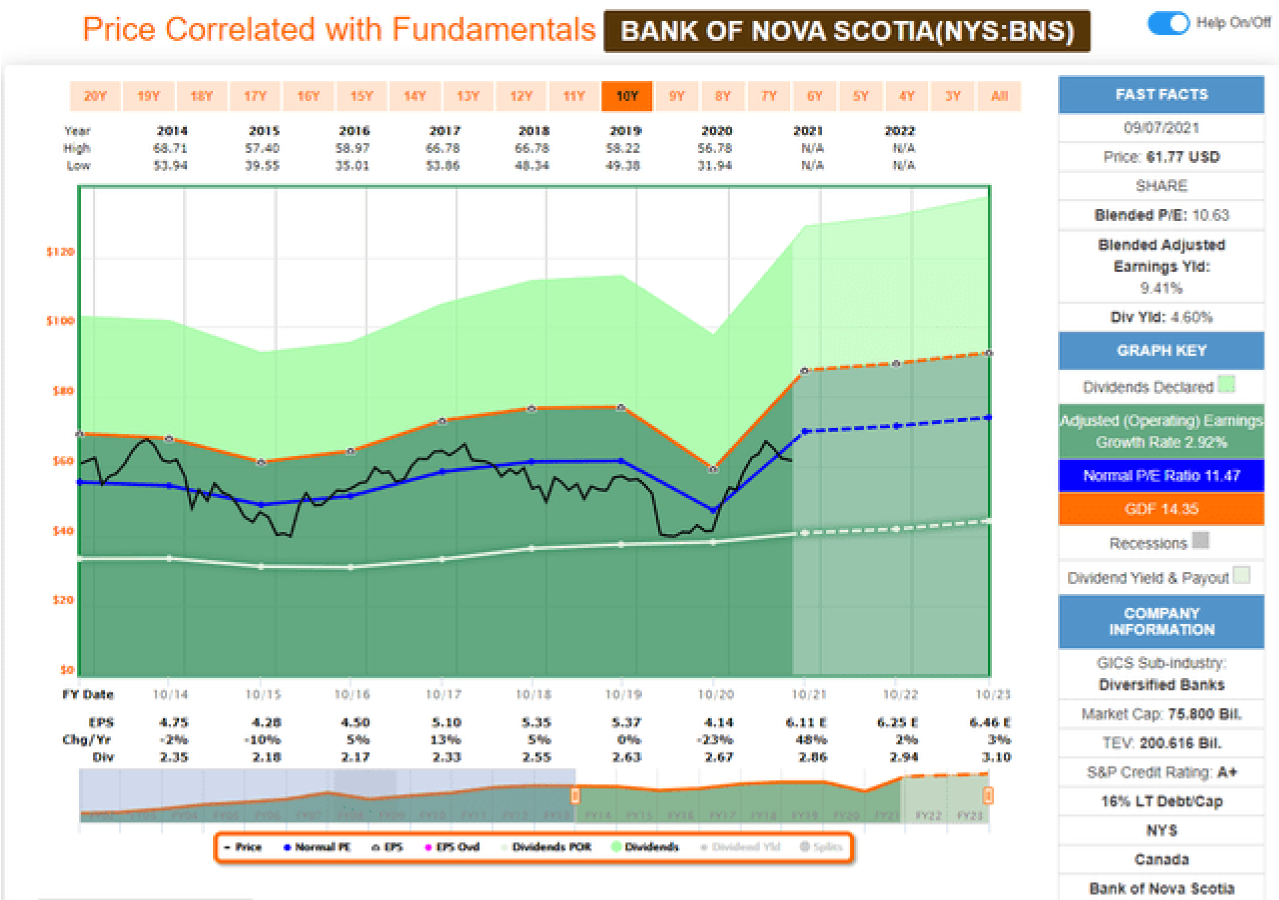
The bank initially stated that 2021 would be a year of return towards full earnings performance by Scotiabank - and this has occurred as management expected. Results are not only above the 2020 COVID-19 earnings, but well above the earnings of pre-pandemic 2019, and the growth has exceeded even the expectations of overall management. The question now is how to improve results even from here

More importantly now, what exactly are we paying for what BNS is delivering here?

Scotiabank - What is the valuation?

Scotiabank has seen a slight negative trend for a few months now, though this reflects a return to the company's historical discount rate of about ~11 P/E. The company currently trades at about 10.6x to an average weighted P/E ratio, which gives us a prospective weighted EPS yield of 9.4%. Considering where things are going, this is excellent.

The market, as I see it, has not yet fully taken into consideration the positive impact of 2021 that the bank expects, of significantly improved earnings. FactSet analysts are currently expecting a 48% EPS increase for the fiscal.

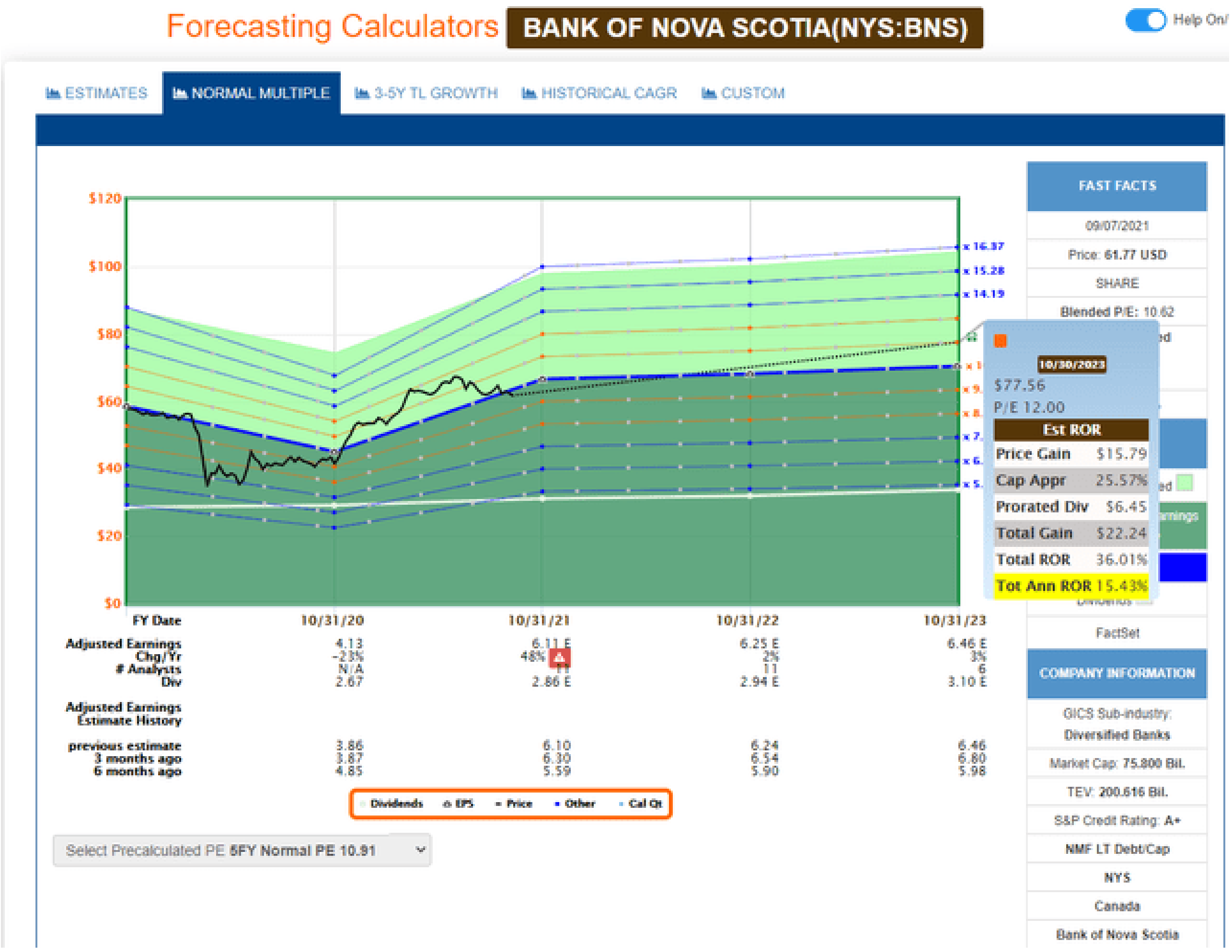


(Source: F.A.S.T. Graphs)

If these trends materialize, then the bank should not be done appreciating in valuation. We also need to consider that BNS, as soon as regulators allow, will probably increase the dividend to reflect EPS growth and normalization. Likely not a massive hike, but a small one. There are plenty of catalysts for potential shorter-term and medium-term appreciation to be had here.

While the bank could continue dropping, this would be in contrast to overall EPS expectations, and these have historically tracked the average discount of 10-12x P/E rather well.

Looking at forward multiples, a post-reversal Scotiabank is expected to grow earnings in the low single digits following its 40-50% EPS growth this year. For investors getting in now, this would lock in combined returns of between 10.8% and 15% p.a. until 2023.



(Source: F.A.S.T. Graphs)

This is only based on a 10-12x forward P/E ratio. It could go higher (or lower, of course). The point is, your upside at this valuation for this company is very well-protected. BNS is an A+ rated bank with a market cap above $75B, and one of the largest banks in all of North America with appealing international exposure.

There are no real realistic scenarios where this investment provides negative, long-term returns unless something catastrophic happens. While BNS has some of the characteristic volatility of a large bank, it also has some of the characteristic safeties of one, in a solid dividend and a high fundamental safety even in the face of a pandemic.

The result of the variables of valuation and forward prospects results in only one conclusion to me - "BUY". Analysts consider the NYSE ticker of BNS to be undervalued around 16.7% to a mean target of $90.78, with the Canadian TSE ticker to be undervalued around 11% to a mean target of 86.43 CAD. I own the Canadian ticker and based on current estimates, I would give the bank a higher price target than we're currently seeing, potentially as much as over $75 CAD. The appeal here is the reversal we're likely to see this year, combined with a very attractive dividend. While not as positive as some of the analysts here, I give BNS an upside to a price target of at least 70 CAD, making it a "BUY" to me.

Thesis

My current stance on Scotiabank is:

- 3Q21 results have only confirmed my positive stance on this bank from the last article, showcasing a potential conservative upside of 10-15% p.a. on a 3-year basis.
- Risks are low or manageable, with the bank's legacy and core segments being extremely resilient.
- This is a proven NA bank, with amazing fundamentals, a good yield, and a good near-term upside coupled with a valuation that's been dropping for 3-4 months.
- I will be buying more.

Remember, I'm all about :

1. Buying undervalued - even if that undervaluation is slight, and not mind-numbingly massive - companies at a discount, allowing them to normalize over time and harvesting capital gains and dividends in the meantime.

2. If the company goes well beyond normalization and goes into overvaluation, I harvest gains and rotate my position into other undervalued stocks, repeating #1.

3. If the company doesn't go into overvaluation, but hovers within a fair value, or goes back down to undervaluation, I buy more as time allows.

4. I reinvest proceeds from dividends, savings from work, or other cash inflows as specified in #1.

This process has allowed me to triple my net worth in less than 7 years - and that is all I intend to continue doing (even if I don't expect the same rates of return for the next few years).

If you're interested in significantly higher returns, then I'm probably not for you. If you're interested in 10% yields, I'm not for you either.

If you however want to grow your money conservatively, safely, and harvest well-covered dividends while doing so, and your timeframe is 5-30 years, then I might be for you.

Scotiabank is currently a valid "BUY" according to #1, #3, and #4. I consider the price target $70/share for the Canadian ticker.

Thank you for reading.

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