

Company Analysis: Scotia Group Jamaica Limited (SGJ) 9M 2022/23

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-  876-960-5000
-  vmwmclientservices@myvmgroup.com
-  vmwealth.myvmgroup.com
-  53 Knutsford Boulevard, Kingston 5



- Recommendation: **OVERWEIGHT**
- Price Target: **\$41.73**
- Current Price: \$32.85

- Shares Outstanding: 3,111,572,984 units
- Financial Year End: October 31st

ABOUT THE COMPANY

Scotia Group Jamaica (SGJ) Limited, a Scotiabank Caribbean Holdings Limited subsidiary, has been delivering financial services in Jamaica since 1889. With a diverse portfolio of offerings, SGJ generates most of its revenue from personal, commercial, small business banking, and mortgages. It also generates revenue from Insurance services, including life and medical coverage, pensions, and annuities. The Group also offers investment management and treasury services.

Operating from nearly 28 branches with 285 ATMs, SGJ has a robust presence throughout Jamaica. Their focus on enhancing customer interactions has led to significant investments in digital technology. Consequently, SGJ provides online, mobile, and phone banking services. This digital shift proved beneficial, especially during the recent pandemic, as it supported business continuity, countered rising expenses in an inflationary setting, and stayed aligned with current digital banking trends.

Despite high-interest rate challenges and other headwinds impacting Jamaica's finance industry, SGJ continued to witness strong results, delivering solid profit out-turns and commendable segment performances up to the end of its nine-month period in July 2023.

FINANCIAL PERFORMANCE

J\$'000	FY 2020/21	FY 2021/22	9M 2021/22	9M 2022/23
Net Interest Income	22,711,489	28,619,337	21,275,236	28,329,387
Total Operating Income	37,807,860	42,794,236	29,381,972	39,859,898
Net Profit attributed to parent	8,410,244	11,679,898	7,342,169	12,788,960
Total Assets	585,444,271	595,598,196	590,564,645	646,405,380
Equity attributed to parent	113,603,050	110,850,773	104,438,620	113,835,832
Total Liabilities	471,841,221	484,747,450	486,126,025	532,569,548
Earnings per share	2.70	3.75	2.36	4.11

Dividend Policy

SGJ recently declared an interim dividend payment to Shareholders of \$0.40 per share to be paid October 19, 2023. Over the last three (3) years, the business has had a payout ratio of around 50.45%, on average.

Outlook

SGJ is prioritizing retail banking and mobile app enhancements to improve customer experience initiatives like e-statements and mobile app redesign aimed to boost transaction efficiency. The treasury department should benefit from high central bank policy rates in the short term, resulting in higher interest income. Still, the insurance segment's growth is expected to be modest due to complex dynamics in the high-interest rate environment. SGJ's partnership with the National Housing Trust offers opportunities, but the Group faces competition and a potential financial sector slowdown. Regulatory changes, including Basel III, may increase compliance costs, and industry competition poses challenges. The Group's Improved credit quality signals effective risk management, amid economic uncertainties and real estate market risks. Consistent dividend payments are expected to persist, which adds to investors' overall returns.

Projections and Valuations

We used a combination of a Comparative and an Absolute approach to determine the value for the stock. For the Absolute approach, a cost of equity 10.60% was used to determine the appropriate equity charge and discount the expected residual income. For the comparative approach, a 2024 forward BVPS of \$39.58 was used. An applied P/B 1.40x was deemed appropriate and used to determine a relative value. By averaging both approaches, we obtained a consensus target price of **\$41.73**

Risks to Price Target

As the BOJ continues to take a contractionary stance and tighten its monetary policy considering the current high inflation environment, we anticipate that broader interest rates associated with facilities such as auto loans, mortgages and credit cards will likely increase over the short to medium term. This could lead to higher interest income for SGJ. Downsides to the price target include the current high inflation environment and higher cost of borrowing; existing clients may face challenges in servicing their debt. This can cause a deterioration in the credit quality of SGJ's loan portfolio, thus putting downward pressure on the business banking performance.

FOR THE NINE (9) MONTHS ENDED JULY 31, 2023

For the nine months concluded on July 31, 2023, revenues, excluding expected credit losses, rose by \$10.0 billion, reaching \$41.5 billion. This marked a 31.5% surge compared to the same timeframe in the previous year. The main catalysts for this growth were a \$7.1 billion jump in net interest income, fueled by the robust expansion of the loan portfolio, an uptick in insurance earnings, and an increased fee and commission income, due to the considerable rise in transaction volumes.

Income from sources other than interest, referred to as 'other income', saw a rise of \$2.9 billion, marking a 25.3% growth. There was a significant boost in net insurance revenue, which grew by \$995.4 million or 194.0%, moving from \$513.1 million to \$1.5 billion. This growth was influenced by Enhanced contractual service margin, projected claims, and insurance cost releases, all rooted in the portfolio's performance and an increased revenue stream from the Creditor Life portfolio, which resulted from heightened transaction volumes. Net fee and commission earnings reached \$5.8 billion, marking a rise of \$1.2 billion or 24.8%, thanks to an uptick in client transactions and broader business engagements. Net gains from foreign currency activities and financial assets stood at \$6.8 billion, indicating a year-on-year (YoY) growth of \$1.5 billion or 28.2%.

Operating expenses totaled \$20.8 billion compared to \$18.7 billion in the previous year, reflecting an increase of \$2.0 billion or 10.9%. Higher technical support fees from higher transaction volumes drove the growth. The foregoing resulted in SGJ reporting a net income of \$12.8 billion compared to the \$7.3 billion recorded in the previous year, representing an increase of 74.2% YoY.

As of July 31, 2023, the Group's asset base grew by \$55.8 billion or 9.5% to \$646.4 billion. This was mainly due to substantial growth in the loan portfolio of \$40.5 billion or 18.5% and higher cash resources of \$29.6 billion or 19.5%. This was partially offset by a reduction in other assets of \$4.2 billion or 10.8% on account of the lower carrying value of the retirement benefit asset and the reduction in investment securities, including pledge assets of \$10.3 billion or 5.8%. Total Liabilities were \$532.6 billion as of July 2023 and showed an increase of \$46.4 billion or 9.6%. The increase was driven by increased customer deposits, which increased to \$445.2 billion, representing a growth of \$46.2 billion or 11.6%. The higher inflows were seen from both retail and commercial customers.

Shareholders' equity available to common shareholders totaled \$113.8 billion and reflected an increase of \$9.4 billion or 9.0% compared to July 2022. This was primarily due to the remeasurement of the defined benefit pension plan asset, lower fair value losses of the investment portfolio, recognition of the insurance finance reserve on adopting IFRS 17, and higher internally generated profits partially offset by dividends paid.

During the period, return on average equity (ROAE) improved to 15.7% from the 8.8% recorded in the previous year for the same period. Return on assets (ROA) also improved to 2.6% from 1.7%. The improvement in these ratios indicates that the Group is earning higher profits in relation to its equity and total assets, which are positive signs for investors and stakeholders. The Group's Productivity ratio decreased to 50.1% from 59.5%. The productivity ratio, often synonymous with the efficiency ratio in banking, measures a bank's operational efficiency. A lower ratio indicates a higher efficiency level, as it shows that the bank utilizes fewer resources to generate a unit of revenue. The decrease in the productivity ratio from 59.5% to 50.1% suggests an improvement in operational efficiency over the period in question. The bank is using its resources more efficiently to generate revenue.

OUTLOOK

Enhancements in Retail Banking and Mobile Application Should Create Higher Customer Satisfaction

SGJ's critical strategic initiatives are centered on safeguarding retail banking customers and enhancing user experience through digital transitions. E-statements and a redesigned flow within the mobile app are notable steps towards this goal. The new design incorporates shortcuts to accelerate transaction speed, thus promoting customer efficiency and convenience. Through these digital enhancements, the Group aims to bridge the strategic-customer service gap, as reflected in Scotiabank's clientele's increased adoption of non-branch touch points. The narrative underscores the ongoing commitment to digital and alternative banking, which has shown effectiveness and suggests a pathway towards stable returns due to the company's resilient and adaptive stance in the financial sector.

Higher Interest Rates Expected to Boost Treasury Segment Performance over the Short-term; Modest Growth expected for Insurance Segment

The Group's treasury department is expected to ride the wave of high central bank policy rates in the short term, boosting interest income. Additionally, there's optimism around SGJ benefitting from Fair Value Gains with some asset prices mirroring economic recovery. On the flip side, after a 25% surge in 2022, the insurance segment is projected to witness single-digit growth at best. This subdued outlook is attributed to opposing dynamics like high yields on assets being neutralized by lower returns on investments amidst a high-interest rate environment adversely impacting the returns on financial instruments. This scenario outlines a cautious short-term growth forecast while the long-term investment business strategy unfolds, albeit with marginal growth expectations.

Partnership Initiatives and Competitive Positioning

SGJ's partnership with the National Housing Trust (NHT) on the External Financing Mortgage Programme (EFMP) is a significant highlight, anticipated to channel \$25Bn in loan disbursements by 2024. Although not exclusive to Scotia, the Group is well-positioned to secure a substantial share due to its attractive mortgage package. While the partnership and Jamaica's stable ratings outlook provide a favourable backdrop, rising competition and a potential slowdown in the construction sector are seen as headwinds. The growth in the mortgage loan book and overall growth opportunities are primarily contingent on Scotia's capability to outperform competitors, especially those also transitioning towards a customer-centric digital model. The outlook encapsulates a blend of opportunities and challenges. Yet, investors could find appeal in Jamaica's strategic digital pivot, sector growth, and positive economic markers, indicating a potential for future profitability and investment appreciation.

Expected Regulatory Changes and Intense Competition

Implementing the Basel III Framework is a potential risk to the outlook. This framework could lead to stricter regulatory requirements, increasing compliance costs for SGJ and other banks. These added costs could be passed on to customers, potentially impacting the growth of deposits and loans. Additionally, changes in financial regulations can sometimes have unforeseen consequences that affect the banking industry. The banking industry is also highly competitive. New entrants, changing customer preferences, and evolving technology are expected to challenge established banks like SGJ. Maintaining market share and profitability in a competitive environment is an ongoing concern.

Economic Uncertainty Expected to Persist, but SGJ's Recently Improved Credit Quality Hints at Strong Credit Risk Management

There has been improvement in the quality of SGJ's loan portfolio, which is commendable given the high-interest rate environment and alludes to well-managed credit risk management. This is against the backdrop of an economic downturn or recession that could pressure SGJ's net income in the next two years. Economic downturns can lead to reduced consumer and business spending, increased loan defaults, and a decline in overall financial stability. Such events can adversely impact the profitability of financial institutions. Adverse real estate market trends are another potential business risk. A downturn in the real estate market could affect the quality of SGJ's loan portfolio, particularly if borrowers struggle to pay mortgages and real estate-related loans. This could lead to an increase in non-performing loans.

INVESTMENT POSITIVES

- **Strong Revenue Growth:** One of the significant investment positives is the substantial revenue growth of \$10.0 billion (31.5%) in the nine months ending July 31, 2023. Various income sources drive this growth, including net interest income, insurance earnings, fee and commission income, and gains from foreign currency activities and financial assets. This demonstrates the company's ability to generate higher revenues, potentially leading to higher investor profits and returns.
- **Improved Profitability:** The company's net income increased by 74.2% year-on-year, reaching \$12.8 billion. This indicates improved profitability, attracting investors seeking companies with solid earnings growth potential.
- **Asset Growth:** The Group's asset base grew by \$55.8 billion (9.5%) during the period, primarily due to the growth in the loan portfolio and higher cash resources. A growing asset base can enhance the company's ability to generate income and provide opportunities for further expansion.
- **Return on Equity (ROE) and Return on Assets (ROA):** The improvement in ROE to 15.7% and ROA to 2.6% suggests that the company is earning higher profits in relation to its equity and total assets. These improved ratios indicate efficient use of capital and assets, which can appeal to investors.
- **Operational Efficiency:** The decrease in the productivity ratio from 59.5% to 50.1% signifies an improvement in operational efficiency. A lower ratio indicates that the company is using its resources more efficiently to generate revenue, which can lead to higher profitability and shareholder returns.
- **Improved Credit Quality:** There has been improvement in the quality of SGJ's loan portfolio, which is commendable given the high-interest rate environment.
- **Regular Dividends:** SGJ is known for paying consistent dividends, thereby returning some of its profits to shareholders.

INVESTMENT NEGATIVES

- **Rising Operating Expenses:** Operating expenses increased by \$2.0 billion (10.9%) compared to the previous year. Higher technical support fees drove this increase due to higher transaction volumes. Rising expenses can potentially erode profitability and negatively impact investor returns.
- **Increased Liabilities:** Total liabilities grew by \$46.4 billion (9.6%) during the period, primarily due to increased customer deposits. While higher deposits can indicate customer confidence, it also means higher obligations for the company, which may limit its flexibility and ability to invest in growth opportunities.
- **Uncertain Insurance Segment Growth:** The insurance segment is projected to witness only single-digit growth at best despite a 25% surge in the previous year. Lower returns on investments in a high-interest rate environment are cited as potential challenges. This uncertainty in the insurance segment's growth could impact overall company performance.
- **Competition in Mortgage Market:** While the partnership with the National Housing Trust (NHT) presents growth opportunities, rising competition in the mortgage market and a potential slowdown in the construction sector are seen as headwinds. Increased competition can affect the company's ability to maintain margins and market share.
- **Interest Rate Risk:** Banks are sensitive to changes in interest rates. A sudden and significant shift in interest rates could impact SGJ's net interest income and the value of its investment portfolio.
- **External Shocks:** Unforeseen events, such as natural disasters or geopolitical crises, can have a significant impact on the financial sector. These events can lead to disruptions in operations, increased loan defaults, and reduced economic activity, all of which could affect SGJ's performance.
- **Economic Risks:** The outlook mentions potential challenges, including economic uncertainties and external factors. Economic factors can significantly impact the financial industry, and investors should be aware of these risks when considering their investment in the company.



CONCLUSION

Over the past two years, the BOJ has tightened its monetary stance by incrementally increasing its overnight policy rate to suppress the high levels of inflation currently being experienced. These adjustments have aided in boosting SGJ's Net Interest Income, trickling down to above-average profitability. We expect this to benefit the Group over the short term. However, as interest rates inevitably start falling, we expect the Group to return to its lower long-term growth rate.

SGJ is generally less aggressive than some of its peers in garnering market share and instead relies mainly on its brand and consumer loyalty for revenue growth. This has contributed to SGJ growing more slowly than its peers, putting it at risk of losing market share given the highly competitive nature of the financial industry in which it operates. Nonetheless, the company has maintained its performance and pays its shareholders dividends.

Though the company's performance dipped in 2020, mainly because of the pandemic, we believe that the experienced management team has been able to quickly get the company back on track to its usual performance. In addition, with new executive management hires, the company may re-emerge as a strong competitor in critical business areas.

Using a Residual Income Approach with a cost of equity of 10.6%, we valued the company at \$27.91 per share. Applying a P/B multiple of 1.40x, in line with the averages for other financial institutions on the Jamaica Stock Exchange, we arrived at a target price of \$55.56. Averaging both methods led to a consensus target price of \$44.91, a 36.72% upside relative to the current market price. As such, we recommend value/institutional investors who can withstand short-term price volatility and have the capacity to receive more value by way of dividend payments to **OVERWEIGHT** this stock.

SOURCES

Bloomberg, The Jamaica Stock Exchange and SGJ Limited Annual Reports, The Jamaica Gleaner, The Jamaica Observer, OUR Today, Financial Services Commission (FSC), PSOJ.

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DEFINITIONS

- **OVERWEIGHT** - Security is deemed to be undervalued and is expected to outperform compared to the average market return and/or return of comparable securities in the same sector or industry.
- **MARKETWEIGHT** - Security is expected to provide similar returns compared to the market in general or at the same pace as comparable companies; neither strongly positive nor negative.
- **UNDERWEIGHT** - Security is deemed to be overvalued and is expected to underperform compared to the average market return and/or return of comparable securities in the same sector or industry.
- **ZEROWEIGHT** - This security is substantially distressed or at risk of a shock which may significantly impair its value.