JN Fund Managers Ltd.
A member of the JN Group

Quarterly Update

Rating

BUY

LATAM (Caribbean)

Sector: Finance
Industry: Banking, Insurance,Wealth

Scotiabank

JSE	Bloomberg
SGJ	SGJ JA

9M-2023: New products, digital strategy, and enhanced customer service delivery help to drive profits higher.

(Reading time: 5 mins)

29-Sep-23	
Current price	33.07
Forcasted Dividend	3.06
Target price	39.14
Previous recommended price	N/A
TOTAL RETURN	27.61%

Company Data	
Outstanding shares	3,111,572,984
Market Cap	102,899,718,581
52-Week (Hi/Lo)	30.11/36.99
1Yr Daily Average Volume	141,770
5Yr Daily Average Volumes	179,836

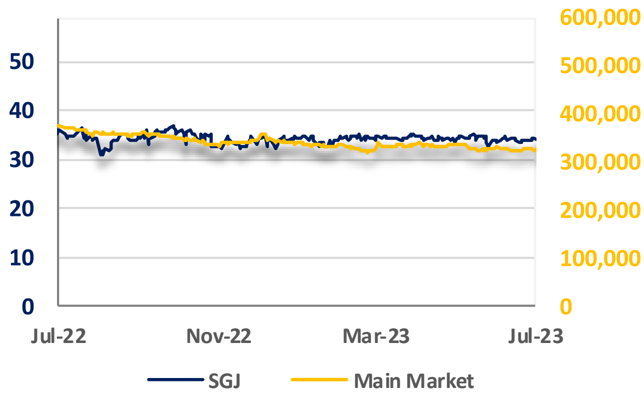
Major Shareholders	
Scotiabank Caribbean Holdings Limited	71.78%
Sagicor Pooled Equity Fund	1.90%
National Insurance Fund	1.86%

Key Financials

J$ Bn	FY21	FY22	FY23e	FY24e
Net Operating Income	37.81	42.79	53.11	55.24
Operating Profit	12.67	17.20	25.14	25.81
Net Profit	8.64	11.68	17.34	17.80
Net Profit Change (%)	-4.6%	35.2%	48.4%	2.7%
EPS	2.78	3.75	5.57	5.72
Dividend Yield	3.49%	3.89%	5.81%	9.63%

Price Performance

	1MTH	3MTH	1YR
SGJ	-2.1%	-5.5%	-7.6%
Main Index	0.9%	-3.0%	-17.5%



Source: Bloomberg; JN Fund Managers Limited

Investment Rationale

Scotia continues to stand as one of the region's most formidable financial institution. Firstly, the entities within SGJ continue to exceed regulatory capital requirements. Additionally, SGJ's exceptionally strong capital position puts it in a good position to withstand possible future regulatory changes and capitalize on growth opportunities that may arise.

Over the years, the Scotia Group has created a solid platform anchored by prudent risk management and operational efficiency. More recently, SGJ has sought to further improve these aspects by streamlining its (insurance) business, strengthening its product offerings and investing in its digital platform as it strives to make banking simpler and easier for its customers. This commitment to improvement culminated with the Bank being named "Bank of the Year" for 2022 by The Banker.

While maintaining a strong capital base to mitigate the risks associated with its business operations, Scotia has consistently delivered value to its shareholders through profitability and cash flows. With the improved efficiency delivered in recent times and projected to continue following recent changes, it is anticipated that cash flows could further improve for the Group in the short to medium term.

Looking ahead, the Group is well-positioned to continue accelerating new business origination across its various business lines, taking advantage of growth opportunities, and making further investments in its core operations to enhance shareholders' return. The stock currently trades at J$33.07 while our target price is J$39.12, implying that the stock is trading at a 15.5% discount based on this target price.

Financial Overview

Revenues & Profitability

For the nine-month period ended July 31, 2023 (9M-2023), Scotia Group Jamaica Limited ("SGJ" or "the Group") saw a marked improvement in performance, likely reflecting the company's successful implementation of strategic shifts made over the past few years. In recent times, the Group has launched several new products tailored for both retail and corporate clients, aggressively promoted its digital channels, streamlined its insurance business operations, and continued to enhance its customer service delivery.

Return on Equity 9M-2023	Return on Assets 9M-2023	Non Performing Loan (%) 9M-2023	CAR (Bank Only) FY-2022
14.22% + 7.76%	2.41% + 1.2%	1.6% - 10bps	14.15% - 2.13%
9M-2022: 6.46%	9M-2022: 1.21%	9M-2022: 1.7%	FY-2022: 16.28%

Financial Overview

Revenues & Profitability cont'd.

For the nine-month period ended July 31, 2023 (9M-2023), Scotia Group Jamaica Limited ("SGJ" or "the Group") saw a marked improvement in performance, likely reflecting the company's successful implementation of strategic shifts made over the past few years. In recent times, the Group has launched several new products tailored for both retail and corporate clients, aggressively promoted its digital channels, streamlined its insurance business operations, and continued to enhance its customer service delivery. In the first nine months of FY 2023 the banking and investment segment built upon the strong rebound posted in FY 2022, following the impact of Covid-19. It achieved this milestone by generating Net interest income after expected credit losses for the period, which exceeded the amount posted in the similar period of the previous year by 39.7% and even surpassed the total amount posted for the entire FY 2022 by 4.4%. Expected credit losses moved from $2.2 billion to $1.7 billion, a decline of 24.0%. However, despite this decline, the Group maintains confidence in the strength of its credit quality and believes it has made adequate provisions to support its loans going forward.

Thanks to increased transactions and the overall growth in business activity, Net fee and commission income grew by 24.8% to J$5.8 billion for the 9-month period ended July 31, 2023, when compared to the same period in FY 2022. Net insurance revenue increased by 194.0% to J$1.5 billion, driven by (1) higher contractual service margin, expected claims and insurance expense releases based on the performance of the portfolio and (2) higher revenue generated from its Creditor Life portfolio which benefitted from higher transaction volumes. Net gains on foreign currency activities plus Net gains on financial assets amounted to J$6.8 billion for a combined increase of 28.2%, versus the amount posted in the similar nine-month period in FY 2022.

At the same time, Operating expenses grew by 10.9% to reach $20.8 billion. This was largely as a result of higher employee compensation and other increased operating expenses due to higher technical support necessitated by the elevated transaction volume.

The strong revenue growth and the commendable cost management initiatives that SGJ implemented, combined to propel Profit before taxation to J$19.1 billion. As a result, even with a higher effective tax rate of 32.8% (vs 30.8% in the same period last year), Profit for the period was still 74.2% higher.

Risks to Monitor

Heath Outbreak – Notwithstanding the significant improvement illnesses may not only result in significant disruptions in the Group's activities but could also curtail economic growth, the Groups profitability and put further pressures on its resources.

High Interest Rate – The relatively high policy rate of 7.0% has increased the SGJ's cost of funding. As a result, this has compressed the spread it earns on its loans and driven valuation on some assets lower. Although inflation has been trending down, it is still relatively high. As a result, there is general expectation that the BOJ's policy rate will remain high for at least the next three quarters.

Slower Economic Growth – With the post pandemic boost to growth now subsiding, the Jamaican economy, which advanced by 2.3% in the second quarter of CY 2023, could slow even further going forward. Lower economic activity could lead to slower top and bottom-line growth for the Scotia Group. However, Jamaica's relatively high levels of employment, NIR and stable FX market could help to keep growth positive in the short run.

Basel III Implementation - The Bank of Jamaica (BOJ) is currently implementing the Basel III capital requirements (Pillar 1) and has updated the regulatory capital definitions. The new requirements come as the banking regulator is of the view that the current capital and liquidity requirements are no longer aligned with widely observed international regulations. After the (current) period of parallel reporting is complete, the rules will become mandatory for DTIs. The new requirements will require that DTIs adhere to stricter capital rules, potentially prompting SGJ to exercise greater caution in its lending practices, among other adjustments. The Group may also be forced to hold relatively low-yielding, high-quality liquid assets. This could reduce profitability as funds deployed to acquire these may not always yield the highest possible return.
Essentially, these requirements may create fundamental growth challenges for banks, especially those seeking to increase their asset base. These requirements, designed to foster sustainable growth, may initially lead to a slowdown, as the full impact assessment could take time to be fully integrated into the product pricing mechanism.

Financial Overview

Balance Sheet

As of June 30, 2023, SGJ's assets grew by 8.3% or J$49.4 billion when compared to the balance at the end of the FY 2022, reaching J$646.4 billion. The growth in assets was mostly driven by expansions in the Group's loan portfolio (up J$22.5 billion) and a jump in cash resources (up J$97.4 billion) but was partially offset by a decline of J$7.9 billion in Retirement benefits assets. These results highlight the Group's strong liquidity position, and the significant loan growth indicates that its core loan book continues to perform, despite the high interest rate environment.

Over the nine-month period, the Group reported non-performing loans (NPLs) of $4.3 billion, marking a 14.6% increase from the $3.7 billion recorded in 9-Month 2022. These NPLs represented 1.6% of the total gross loans, a decline from the 1.7% seen in the same period last year. Importantly, SGJ's NPL as a percentage of gross loans was also below the industry average of 2.5% for deposit taking institutions (DTIs) as at the end of June 2023, according to the Bank of Jamaica. This indicates that the Group has performed commendably in managing the credit quality of its loan portfolio, amid its strong expansion.

Probably as a reflection of trust and confidence from the Group's retail and commercial customer base, deposits climbed by J$48.0 billion or 12.1% above the amount at which it ended FY 2022. This helped to push Total liabilities to J$448.0 billion at June 30, 2023 or 8.8% higher than at the end of FY 2022. The growth in deposits was partially offset by a 35.5% decline in the 'capital management and government securities fund', which was partially due to the impact of the rising interest rates on the fair value of assets.

The Group's strong profitability over the 9-month period and growth in its Cumulative remeasurement gains from available for sale securities, pushed Total equity to J$113.8 million or J$6.4 billion above the FY 2022 year-end balance. This decrease was chiefly attributed to the falling carrying value of the defined benefit pension plan asset and dividend disbursements. As at July 31, 2023 the subsidiaries in the Group showed regulatory capital ratios which exceeded the required thresholds.

Valuation Summary

1. **Relative Valuation Method (Summary)**

   Industry Average P/B = 1.33x
   SGJ's Book Value = J$33.62
   P/B Valuation Est. = J$44.83

2. **DDM Valuation Method (Summary)**

   Required rate of return = 15.19%
   g = 4.54%, D_1=$2.61, D_2=$2.38, D_3=$2.15
   DDM Valuation Est. = J$33.41

SGJ's Average Valuation Est. = $39.12

Glossary of Terms

Bank of Jamaica……………………….. The Bank of Jamaica is the central bank of Jamaica located in Kingston. It was established by the Bank of Jamaica Act 1960 and was opened on May 1, 1961.
CY…………………………………….. Calendar Year (January to December)
D_1……………………………………… Next year's expected dividend
DTI – Deposit Taking Institutions ………Financial institutions that are authorized to accept deposits from customers and provide various banking services.
Efficiency Ratio ……………………….. The efficiency ratio shows expenses as a percentage of revenue (expenses/revenue). It essentially calculates how much a business spends to make a dollar.
FY……………………………………... Financial Year or Fiscal Year
Leverage Ratio (Assets/Equity) ………. The Asset to Equity ratio is derived by dividing a company's total assets by its shareholders' equity. This ratio is an indicator of the leverage (debt) used to finance the company.
NIR - Net International Reserve ……………. Net reserves are defined as that portion of the gross reserves attributable to MOST's interests after deducting royalties and interests owned by others.

NOI - Net Operating Income………………… Earnings reported by a bank or bank holding company, after deducting normal operating expenses, but before taking gains or losses from sale of securities, other losses and charge-offs, and additions to the reserve account for possible loan losses.
Net Profit Margin …………………….. Measures how much net income or profit is generated as a percentage of revenue.
NPL - Non-performing Loans ………. Non-performing loans are loans as to which there have been no payments of principal or interest for 90 days or more.
Non-performing Loans (NPL) ratio …. Non-performing loans as a percentage of gross loans and advances
QoQ - Quarter on Quarter ………… Used when comparing the financial performance between one quarter of one year to the same quarter of the previous year
Q1 ……………………………………. Quarter 1 or First quarter (usually of a company's financial year or country's fiscal year)
ROE - Return on Equity …………….. Return on Equity is a measure of financial performance calculated by dividing net income by shareholders' equity.
YoY - Year over Year ………………… Used to compare data or performance for a specific metric from one year to the same period in the previous year
YTD - Year to date ……………………. The period of time from the beginning of the current calendar year up to the present date.

Disclaimer: All information contained herein is obtained by JN Fund Managers Limited's Global Investment Research Unit from sources believed to be accurate and reliable. All opinions expressed are based on the Research Analyst's judgment as of the date of the report. As such, no warranty is made, expressed, or implied by JN Fund Managers Ltd. in any form whatsoever as to the accuracy, timeliness or completeness of the information contained in this report. JN Fund Managers Ltd. is therefore not liable for any actions taken in reliance on information contained herein.

JN Fund Managers Ltd.'s Global Investment Research Unit does not provide investment advice that considers the circumstances and objectives of the parties who receive this report. It is therefore recommended that before making any investment decision, investors seek the advice of a JN Fund Managers Limited's Investment Advisor.

This report does not represent an offer to buy or sell, or solicitation of an offer to buy or sell the securities mentioned. Past performance is not necessarily an indication of future performance. Estimates of future performance are based on assumptions that may not be realized. Additional information not available in this research report may be available upon request.

JN Fund Managers Ltd. is a multifaceted organization with, investment banking, investment management, fund administration, and brokerage business lines. JN Fund Managers Ltd. may, therefore, conduct investment banking or other business activities with some of the companies and countries covered by the Company's Global Investment Research Unit.

JN Fund Managers Ltd. may invest in and trade the securities covered in this report for its proprietary account and/or on behalf of its clients. JN Fund Manager Limited's trading activity in these securities may be contrary to the recommendation(s) indicated in this report.