Should Investors Be Concerned About the Bank of Nova Scotia?

Description

Despite reporting another quarter of solid results, analysts have raised some red flags regarding the **Bank of Nova Scotia's** (TSX: BNS)(NYSE: BNS) performance. These saw Credit Suisse recently downgrade the bank from outperform to neutral, with further downgrades expected.

These concerns and downgrades come on the back of ratings agency Moody's downgrading its outlook for the bank, from stable to negative in June of this year. Moody's downgraded Bank of Nova Scotia over concerns its business was becoming more risky by expanding its unsecured consumer lending portfolio. This expansion consisted of the acquisition of a 20% equity interest in **Canadian Tire Corporation Ltd's** financial services business and a 51% interest in Chilean retailer **Cencosud SA's** financial services arm.

Then Standard and Poor's also downgraded its outlook for the bank to negative in August of this year along with Canada's other big 5 banks, due to concerns regarding Ottawa's 'bail in regime' which places the burden for any bailout on the depositors and bond holders of Canadian banks rather than taxpayers.

This has triggered alarm bells for investors, with many starting to worry about Bank of Nova Scotia's future performance and the ability of its much vaunted international businesses to deliver value for the bank and its investors.

Exactly how bad were the bank's recent quarterly results?

Bank of Nova Scotia reported net income of $1.85 per share beating the consensus analyst forecast by 30%, while being up by an impressive 31% compared to the previous quarter and 36% against the equivalent period in 2013.

But these results can be attributed to a one off gain from the sale of the bank's interest in **CI Financial Corp.** (TSX: CIX) for $555 million or $0.45 per share. When allowing for this one-off gain, net income drops to $1.40 per share, a modest 1% gain quarter-over-quarter and 4% year-over-year, while being marginally lower than the consensus analyst forecast of $1.43. Canadian banking remained the key contributor to the bottom line, while the greatest growth driver was global banking and markets because of a record quarter in investment banking.

The bank's much vaunted growth engine, its international operations, which contributed 23% of its bottom line, failed to grow with net income remaining flat both quarter-over-quarter and year-over-year. This is despite strong performances from its Colombian and Peruvian business units, both Central America and the Caribbean businesses performing poorly due to poor economic growth.

Overall the bank's most recent results were on par with expectations. But there are a range of emerging headwinds which could derail the bank's performance over the short-to-medium term.

What does the future hold?

Chief among the headwinds concerning analysts are the growth prospects of Bank of Nova Scotia's key Latin American markets, Colombia and Peru, with economic expansion showing signs of not being as strong as expected. There are also concerns among analysts that Colombia's credit market will contract causing lending growth to drop off, while potential interest rate cuts in Chile and Peru will apply downward pressure to the bank's net interest margin in those countries.

These factors will have a significant impact on the bank's international operations given the size of its operational footprint in those countries, being the fifth largest bank in Colombia and the third largest in Peru. It will also see further concerns over its recent acquisition of a 51% stake in Cencosud's consumer lending business, with rating agencies Moody's and Fitch reiterating their negative outlook for the Chilean retailer.

It is also difficult to see how Bank of Nova Scotia can continue to achieve significant growth at home, with the Canadian financial services market already beyond saturation point. This is forcing the bank to act more aggressively domestically and take on more risk by expanding its unsecured consumer lending portfolio.

Risk indicators remain well within acceptable levels

Despite these issues, Bank of Nova Scotia remains well capitalized with a common equity tier one capital ratio of 10.9%, well above the regulatory minimum. The bank also retains a solid high quality credit portfolio with impaired loans as a portion of total loans continuing to fall, down two basis points quarter-over-quarter and three basis points year-over-year to a very healthy 0.43%.

All of which indicates the strength of Scotia Bank 's financial health with a low risk credit portfolio and the ability to ratchet up its risk appetite as a means of boosting returns.

But how good is that dividend?

Despite the murky results, Bank of Nova Scotia's management demonstrated further confidence in its outlook, hiking the dividend by a healthy clip of 3% to $0.64 per share quarterly. This gives investors a juicy yield of 3.7% coupled with a conservative payout ratio of 49% highlighting the dividend is not only sustainable but there is room for further hikes.

The dividend is a key attraction for investors, alone making Bank of Nova Scotia an attractive investment, particularly with the prospect of further dividend hikes. I also expect the headwinds impacting the bank's operations to dissipate over time and despite the headline-catching statements of analysts and ratings firms, I believe Bank of Nova Scotia should be a key holding in any portfolio.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NYSE:BNS (The Bank of Nova Scotia)
2. TSX:BNS (Bank Of Nova Scotia)

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