Evaluating Canada’s Banks: Bank of Nova Scotia

Description

Since the beginning of the year, investors have received only a 4% price return by holding shares of **Bank of Nova Scotia** (TSX:BNS)(NYSE:BNS). The company, which is Canada’s third-largest bank by market capitalization, holds a unique position.

The bank has significant operations in South America and has more revenues coming from this part of the world than any Canadian competitor. Given the fluctuations in foreign exchange, this is going to be the bank that reports revenues and earnings with the least amount of consistency. Investors must also remember that many countries in South America also have higher inflation than in North America. A declining foreign currency can easily lead to a negative outcome for investors.

With a market capitalization of $92 billion, shareholders considering these shares at current prices will have to pay a multiple of 12.3 times earnings and receive a dividend yield of slightly less than 4% in the process. The dividends paid per share have grown from $2.36 in fiscal 2013 to $2.88 in 2016. The compounded annual growth rate (CAGR) for shareholders is 6.9%. Over the same period, earnings per share increased from $5.11 to $5.77, translating to a CAGR of 4.1%. Clearly, earnings have not followed the same growth as the dividends paid to shareholders.

In fiscal 2013, the dividend-payout ratio (calculated as dividends paid to shareholders divided by net income) was 46.7%, which increased to 49.9% in fiscal 2016. Shareholders are receiving a high percentage of the profits through dividend payments alone. When considering the share buybacks, the company has successfully kept the total number of shares outstanding consistent throughout the past four fiscal years. During the first half of fiscal 2017, the company paid dividends of $1.50 per share — yet another increase when compared to the prior year. Canadian banks have gotten very good at increasing their dividends on a consistent basis.

When we go behind the curtain and consider the company’s return on equity, it is important for investors to take note that this measure is one of the most important when evaluating a bank. As a financial institution, the company has the option to leverage the equity inside the company, borrowing for a cost and loaning that money back out (at a higher cost) in order to make a profit.

During fiscal 2013, the company made a total profit of $6.379 billion and ended the year with shareholder’s equity of $44.249 billion. The return on equity was 14.4% for the year. Moving forward to fiscal 2016, the net profit was $7.117 billion with ending equity of $56.251, leading to a return on equity of 12.6%.

Given that the company has a declining return on equity while experiencing an increase in total equity retained in the company, investors may have to make a very difficult decision. Investors can either buy a company with less leverage and more equity (accepting lower returns on their money) or take a risk by looking at other options.

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Date
2025/08/24
Date Created
2017/07/27
Author
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