Bank of Nova Scotia's (TSX:BNS) Exposure to Latin America Increases its Vulnerability to a Recession

Description

Canada's third-largest mortgage lender **Bank of Nova Scotia** (TSX:BNS)(NYSE:BNS) has invested heavily in expanding its operations in Latin America. Through a series of acquisitions, it became a top-10 ranked bank by assets in Mexico, Colombia, Peru, and Chile.

Scotiabank's international business became an important growth lever, particularly as the Canadian housing and mortgage markets cooled. For the fiscal first quarter 2020, Scotiabank's international business was responsible for 30% of its net income.

There are signs that Scotiabank's significant exposure to Latin America will weigh heavily on its performance during the current crisis.

Heightened risk in Latin America

The region remains unstable, and there is considerable geopolitical risk associated with operating in that part of the world. Many Latin American countries, including Chile and Colombia, were wracked by civil dissent during 2019. That unrest impacted economic growth in both nations, where Scotiabank is the third- and fifth-largest bank, respectively.

Latin American nations are struggling to contain the coronavirus. A combination of fragile economies, shortage of fiscal resources, and poor health infrastructure have left them particularly vulnerable. A global recession coupled with weaker U.S. and Chinese economies will weigh heavily on the region.

The extraction and export of commodities, notably oil and base metals, is an important economic driver for many countries. Colombia is highly dependent on oil, which is responsible for around half of all exports by value. Petroleum prices have collapsed again, triggering another economic and financial crisis in a nation that is struggling to manage the coronavirus pandemic.

The international Brent price has lost 57% since the start of 2020 to be trading at around US$29 per barrel. There are signs that it will fall lower and remain weak for a sustained period. That will create havoc in Colombia and significantly reduce Bogota's fiscal revenues at a time when it needs to increase spending to offset the fallout from the coronavirus pandemic.

Chile's key export is copper, which makes up around half of its total exports. Copper has lost a stunning 23% for the year to date and will fall further, as the world enters a recession and manufacturing activity contracts.

Commodity-dependent economies will experience significantly softer growth. That will lead to reduced consumption and lower business activity, causing GDP growth to fall and demand for credit and other financial products to decline. Weaker growth coupled with stagnant wages and higher unemployment will not only cause demand for credit to fall but impaired loans to rise, further impacting Scotiabank's financial performance.

Weaker performance

Even before the coronavirus outbreak, there were indications that Scotiabank's Latin American operations were weighing on its performance. First-quarter 2020 adjusted net income for international bank plunged 18% on the back of weaker revenue. A combination of higher costs, lower margins, and a 23% spike in lending loss provisions impacted profitability.

That weighed heavily on international banking's return on equity (ROE), which is a key measure of profitability. The ratio declined by a worrying 3.2% year over year to 10.6%, or roughly half of the 20.6% reported by Canadian banking. As a result, Scotiabank was one of the least profitable among its peers for the first quarter with a bank-wide ROE of 14.2%.

Scotiabank's performance will continue to deteriorate, led by a sharp decline in the performance of its international business.

Looking ahead

I have been a tremendous fan of Scotiabank's strategy in Latin America. While it was proving to be a powerful growth driver that reduced the bank's dependence on Canada, it is will be a drawback in the current difficult operating environment. The region's economies are particularly fragile.

When coupled with a lack of health infrastructure and fiscal resources to manage the pandemic, many Latin American nations will experience far greater fallout than developed nations. This indicates that Scotiabank, compared to its peers, is uniquely vulnerable to the virus and related economic fallout. Events in Latin America could trigger a sharp decline in the bank's earnings.

This explains why Scotiabank has been roughly handled by the market, compared to other Big Six banks, losing 19% for the year to date.

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