GORDON PAPE INCOME INVESTOR AUGUST 2007

Banking on Canada

Recommendation: Bank of Nova Scotia

Buy

DBRS/S&P/Moody's

Stock ticker: BNS-N;BNS-T

Last month, I recommended taking profits in CIBC (CM-T) on the grounds that, despite the excellent job Gerry McCaughey and his management team had done in reducing the bank's risk profile, its confirmed exposure to the sub-prime linked Collateralized debt Obligation (CDO) market indicated that there were still some traces of its former attitude around. The credit cycle was beginning to turn and having exposure to an aggressive financial institution at this stage was not recommended.

Subsequent events have proved that there was some merit to this view, as CIBC revealed it owned C$1bn in CDOs, and had written them down by C$290m (C$190m after tax). Despite this, Gerry McCaughey indicated that the bank had comfortably beaten its earnings estimates, proving that a Canadian bank is a very resilient animal. This month I'd like to suggest buying probably the exact opposite of CIBC in approach, the Bank of Nova Scotia, which long been amongst the most conservative, and certainly amongst the most efficiently run, banks in Canada.

WHY WE LIKE IT

Despite being the smallest of the Canadian banks in terms of branches and retail deposits, Scotiabank is the third biggest in terms of market capitalization, as its intense focus on cost controls have consistently seen its costs to revenue ratio the lowest of the Big 5 banks (61.3% in 2006). Furthermore, its strong investment banking presence via Scotia Mcleod has helped offset its relative weakness in retail banking and mutual funds, while its international strategy, responsible for 30% of its profits, is the most distinctive and successful amongst the Canadian banks.

It is on the latter that I want to focus, after acknowledging the factors that affect the domestic business, which is still, of course much larger. The major influence on Canadian banks this year has been the flat yield curve, as interest rates have been almost the same at the short end (4%) and the long end with the 10 year Govt. of Canada bond yielding less than 4.5%. This squeezed banks' interest margins, still the source of half their profit, and when Mr Dodge, citing the strength of the western Canadian resource boom, raised interest rates to 4.25% in July, banks sold off further, anticipating another interest increase or two. Also, the credit cycle, as noted, has begun to turn against the banks, as the economic recovery enters its fifth year, with the unsustainably low provisions for bad debts of 2004-05 gradually rising. Lastly, Scotiabank has been the wallflower at the mutual fund ball, as the other big banks either gained substantial market share (Royal, TD, Bank of Montreal) or at least retained a sensible presence (CIBC, National) while Scotia, with a small share to begin with, has failed to capitalize on the market's appetite for income or balanced funds. This led to the replacement of the head of the head of wealth management division earlier this year, and the hiring of several high profile fund managers away from Royal Bank. As a result, Scotiabank, along with the other banks, has essentially fallen 5% for the year, and is little higher than a year ago (7% total return, which includes the 3.6% dividend). With the credit crunch in global markets leading to the provision of over U$300bn in liquidity by central banks to markets worldwide in the last few weeks, and the Federal Reserve cutting its discount rate at which I provides emergency funding to banks from 6.25% to 5.75% in late August, it seems safe to assume that the Bank of Canada will not be raising interest rates any time soon.

The recent turmoil in financial markets has reminded investors that there is a great deal to be said for investments that are boring. Canadian banks are amongst the more boring of investments, as all they do is earn returns on equity of 20%+, returns on assets of more than 1%, and pay dividends that have risen by more than inflation over the last 15 years, while continuing to buy back stock and raise their pay-our ratio. Whether the Canadian government of the day will ever allow them to merge is one of those endlessly debated questions which is frankly, irrelevant to investors as they have been such successful investments. The major problem they face due to their failure to gain sufficient scale by merging, is that they have fallen down the league tables in terms of size, which makes a strategic acquisition to allow them to grow faster than the rate dictated by their domination of the Canadian market difficult to achieve.

REASONS TO BUY

This is where Scotiabank's non US international strategy becomes so attractive. Having opened a branch in Kingston, Jamaica before it opened one in Toronto, to fund the flourishing trade in cod and timber to the West Indies and rum and sugar back to the Maritimes, Scotiabank has always been well aware of the possibilities, and profitability of the Caribbean, where it is the largest foreign bank. It was interesting to note that CIBC bought its partner, Barclay bank, out its equal 47% share for $1.1bn in First International Bank of the Caribbean last year, as it too recognized the lower competition and higher margins available in emerging markets. Scotiabank also took advantage of the Mexican peso crisis in the mid 1990s to become the sixth largest bank in Mexico, with 424 branches in its Inverlat subsidiary, responsible for 12% of the bank's total profit.

In the last 18 months alone, Scotiabank has spent $1bn on banks in Peru (No.2), Costa Rica, Panama and El Salvador (No.2), as it continues to build its Latin American presence. Of course, occasionally, as with Argentina's default in 2001, one of these markets will blow up, but the $550m cost to write off the operation was the equivalent of one quarter's earnings, and Scotiabank is willing to accept this as the cost of doing business in more volatile but much faster growing markets. The ability to take techniques such as credit scoring, or issuance of debit and credit cards to higher risk clients in developed markets like Canada, and apply them to populations which have essentially been unbanked, means that these operations can have their efficiency improved very rapidly after being bought, as well as the benefit of lower funding costs due to the strength of Scotia's balance sheet.

More recently, Scotiabank has been dipping a toe in Asia, buying a 20% stake in the City Bank of Xian in China last year, and this year, paying $250m for a 24.99% stake in Thanachart, the eighth largest Thai bank. Reports in the last few weeks, confirmed by the bank, indicate that Scotia is bidding for Banco Desarollo in Chile, reputedly paying $450m, which would move it from the eleventh largest to the sixth largest bank in that country. With all Canadian banks generating excess free cash flow, Scotia is one of the best positioned to apply this in acquisitions that have consistently proved capable to generating high returns on assets employed, and are not overly dependent upon the health of the US economy, as useful counterbalance to the other Canadian banks, whose expansion in the US is not a great diversifier away from reliance on the Canadian economy.

RISK FACTORS

Scotiabank is exposed to the political and economic risks that are inherent in investing in emerging markets, witness the Argentine experience. It is also a laggard in mutual funds in Canada, which poses a threat to its traditional deposit base as its baby boomer clients look to achieve better returns for their retirement than can be found from investing in bank deposits and GICs, although recent aggressive measures have been taken to address this. The smaller size of its branch network is a modest competitive disadvantage, although it is increasing the number of net new branches opened, as are other Canadian banks. The last time that mergers were rumoured, in 2002, Scotia was the strong favourite to acquire the Bank of Montreal, having sat out the previous merger wave in 1998, and should mergers ever be on the agenda again, there could be operational and cultural risks in attempting to merge with another major financial institution, although Scotia's track record of integrating its Caribbean and Latin American targets has been good.

RECOMMENDATION Buy Now.

Price