Investment
PZENA Management

Giving Credit: Emerging Markets Banks

EM banks have come under intense pressure in the wake of COVID and its impact on the global economy. A careful study of previous crises indicates EM banks are actually operating amid a healthier macroeconomic environment and with much stronger balance sheets than in the past. At current valuations, banks in the emerging world present compellingly asymmetric investment opportunities.

More sophisticated oversight

Central banks and regulators have greatly improved how they regulate banks. Banks are carrying high capital levels and low leverage ratios.

Supportive macro environment

The macroeconomic balances of most emerging economies are in better shape today than at most other points in their histories.

Emerging market bank equities, like their global counterparts, have come under intense pressure, as investors contemplate the potential for meaningful credit losses in the wake of COVID-19 and its impact on the global economy. Although the notorious emerging market banking crises of the past (the Brazilian and Argentine banking crises (1999-2001), the Asian Financial Crisis (1997), and the Latin American Debt Crisis (1994)) provide a helpful framework for understanding the workings and vulnerabilities of emerging market banks, they are equally informative for drawing distinctions between macroeconomic conditions and bank fundamentals then and now.

Virtually all these prior crises were driven predominantly by macroeconomic imbalances exacerbated by banks' inappropriate risk exposures. Today, the macro backdrop for most emerging market economies is far more stable, regulatory regimes have matured and learned from past mistakes, and banks have much stronger balance sheets. As such, we enter the current period with only a short list of countries where macro instability is a significant concern, while banking systems in most emerging markets carry high levels of capital and low leverage ratios.

DEPENDENCE ON EXTERNAL FUNDING HISTORICALLY DROVE STEEP CREDIT CYCLES

Banking system crises generally follow a rapid expansion of credit that leads to bubbles in consumption and asset prices in the real economy. In emerging markets, the pain inflicted by the unwinding of these excesses is often compounded by a collapse of the currency and reduced access to global capital markets which exacerbates financial system losses.   Prudent management of a country's balance of payments and foreign exchange reserves are key ingredients to averting such a collapse.

Emerging economies have fewer degrees of freedom in managing their financial, capital, and current accounts (otherwise known as "balance of payments") than their developed world counterparts. They need to manage these accounts in such a way that foreign investors are willing to support their growth through capital inflows when domestic savings fall short of the capital required to fund a growing economy. The return on those flows must be high enough to support the return expectations of foreign portfolio investors, or there must be attractive direct investment opportunities available such as natural resource extraction or manufacturing that are far less susceptible to near-term capital flight. If neither of these conditions exist, capital flows out of the country, the current account deteriorates, and a balance of payments crisis ensues.

When a balance of payments crisis strikes, it usually leads to a depreciation of the local currency, which places inflationary pressures on the economy. If funded externally, the devaluation further impacts an economy's ability to service foreign currency denominated debts, and, if the mismatch in funding is great enough, the imbalance renders the banking system vulnerable to a liquidity crisis.

Historically, when faced with a balance of payment crisis, countries must reduce investment (which is recessionary) and/or force an increase in national savings through cuts to government spending or personal consumption, both of which are also recessionary. The forced devaluation, higher nominal interest rates, and decline in real GDP lead to a cycle of credit losses which hits financial institutions when they are at their weakest. This was broadly the blueprint for most emerging markets crises in the 1990s.

STABLE MACROECONOMIC CONDITIONS

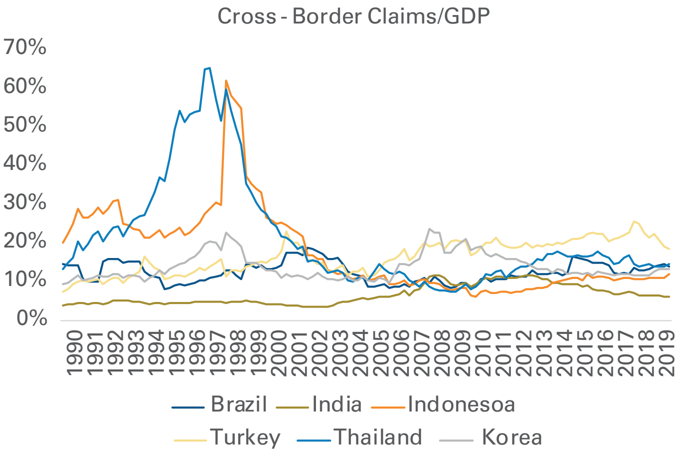
The good news is that today the macroeconomic balances of most emerging economies are in better shape than at most other points in their histories. Not only are their foreign exchange reserves at or near peak levels and significantly above periods of prior crises (Figure 1), but current account deficits have been supported by low energy prices, and US dollar lending exposures and funding have been tightly managed in most markets (Figure 2). The lack of capital booms has mostly made it easier for emerging market governments and central banks to remain prudent in managing their deficits. Unprecedented support from the US Federal Reserve to the emerging world in the form of swap lines has also helped alleviate the threat of illiquidity, as witnessed by the rapid Fed intervention at the outset of the COVID-19 outbreak. As a result, the risk of a severe macro failure in most of the emerging world appears low.

Figure 1: Foreign Exchange Reserves Are Significantly Higher

	% Reserves to GDP	
	1997	2019
Brazil	6%	19%
Indonesia	8%	12%
India	7%	16%
Korea, Rep.	4%	25%
Thailand	18%	41%
Turkey	10%	14%

Source: IMF Balance of Payments Yearbook, World Bank

Figure 2: US Dollar Funding Down Significantly at EM Banks



Source: Bank for International Settlements

MORE EFFECTIVE REGULATION

Another positive development for EM banks relative to history is the huge improvement in the sophistication of banking regulators, central banks, and finance ministries.

Regulators have improved on severing the links between large industrial groups and banking systems that historically led to massive loan losses. During the Asian financial crisis and the Latin American crises, oligarchs and tycoons owned banks that gathered deposits from consumers and businesses, and used those monies to fund untenable projects, or simply diverted the funds to their own bank accounts. In prior crises, net charge-offs exceeded 40% of loan balances in countries such as Thailand and Indonesia, versus 4% in Korea, a country with independent banks. Clearly, governance issues still exist to some extent and the uncovering of fraud will always be part of an economic downturn: this cycle has already seen its share (e.g., NMS Health, Hin Leong). However, unlike prior cycles, the use of banks as tools for carrying out illicit activities has greatly declined, and troubling exposures are likely to be of a much smaller magnitude.

As alluded to earlier, many central banks have also learned from the pain of mismanaging currency and external balances. Today, they regulate banks much more tightly, forcing more stringent capital requirements (Figure 3) and capital calculations, while also showing a willingness to take actions to limit asset price inflation. This isn't to say there aren't central banks that have gone backwards (South Africa and Turkey being good examples), but, in general, today's starting point is significantly healthier than history.

ATTRACTIVE BUSINESS MODELS AND INDUSTRY STRUCTURES

EM banks are generally simpler businesses than similarly sized institutions in the rest of the world. They tend to have strong deposit franchises, and their funding is dominated by deposits and equity with little use of volatile wholesale funding. Most markets are relatively consolidated where a few banks have very large deposit shares, providing market stability and sustainable scale advantages for the bigger banks. EM banks are critical for these economies to support growth due to the absence of deep and efficient capital markets and are generally simple businesses focused on traditional lending and deposit taking activities. In addition to a portfolio of loans, the other interest earning assets take the form of local currency bonds, nearly always issued by the government. Because of requirements demanding that local currency deposits fund loans, and because of the absence of capital market alternatives, banking market competition is lower. Broadly speaking, asset spreads in the emerging world tend to be wider than in the developed world. Higher asset spreads have major benefits: they allow the banks to be less interest rate sensitive on their lending books and lead to higher pre-provision operating income relative to assets than their developed market peers (Figure 3), which improves the banks' loss absorption ability.

Furthermore, EM banks are built assuming a higher level of losses than developed world peers. As such, capital ratio calculations are more conservative and risk weights higher, implying banks need to carry higher capital for a given amount of similar risk loans, and regulators in most EM markets have pushed high capital ratios, encouraging banks to run above their regulatory minimums. On the asset side of the balance sheet, the rate of EM credit penetration (the change in private credit/GDP) during the preceding three years has been below trend, as opposed to prior periods of crisis which came during periods of above trend credit penetration growth.

Figure 3: Emerging Market Banks Are in a Strong Position to Absorb Credit Losses

Percent of Loans (2019)	Brazil	Turkey	Thailand	USA
Systemwide Excess Capital	2.7%	2.7%	7.8%	7.8%
Provision for Loan Losses	2.7%	5.5%	5.7%	1.2%
3 Year PPOP*	24.1%	13.2%	11.2%	10.1%
Total	29.4%	21.5%	24.8%	19.1%

*Pre-provisioning operating profit
Source: Company reports, Pzena analysis

COVID-19 AND GOVERNMENT MITIGATION

Like the developed world, regulators and central banks across the emerging world have acted aggressively to mitigate the knock-on effects of the COVID-19 crisis. The one downside for equity holders is that banks are one of the best tools for mitigation activities, and how these actions unfold will ultimately impact them. Because of funding limitations, most EM economies have not been able to do the kind of large-scale fiscal stimulus we've seen in developed economies. The social safety nets were smaller to begin with, and there isn't scope to dramatically increase their size without threatening macroeconomic balance.

Instead, one of the most common tools available to EM finance ministers is the use of widespread loan moratoriums, hoping that once the crisis is over businesses will be able to return to covering their financial obligations. In some respects, this approach means that the pain for EM banks will appear later than in the rest of the world, but it also means they can build more capital in the meantime to absorb the losses when they do finally come. While it is unclear to us what the ultimate outcome from these moratorium programs will be, we do think they favor banks with strong capital and culture to be proactive in recognizing potential issues as soon as possible.

THAILAND, BRAZIL, AND TURKEY – A STUDY IN CONTRASTS

As we highlighted above, we enter the current crisis with better macroeconomic conditions and better banking fundamentals across emerging markets in general. However, emerging markets are very diverse, and there are countries that have learned from the past and others that continue to repeat those mistakes. We use three countries – Thailand, Brazil, and Turkey – to compare how each has managed key macro issues and the fundamentals of their banking systems.

THAILAND – STRONG MACRO, GOOD BALANCE SHEETS

Thailand has gone from being one of the worst managed economies during the Asian financial crisis, to one of the most stable. The country has taken strong measures to shore up reserves, control twin deficits and reduce dependence on FX funding. While the local reaction to COVID has mostly been successful, the economy is one of the most tourism dependent in the world. With long-haul travel operating at a fraction of January levels, Thailand will see an outsized hit to its economy, some of which will not be recovered once the world normalizes. The good news is that the banking sector is both relatively consolidated with the four biggest payers controlling more than 60% of deposits, and extremely well capitalized. Additionally, while tourism is 12% of GDP, we believe it is around 5% of the direct credit exposure on the major banks balance sheets. An issue in Thailand had been a relatively fast pace of private credit expansion – mostly in the form of consumer lending. However, since 2016, actions from the Bank of Thailand have dramatically curtailed this growth, and credit penetration has been flat for the last four years. It is also informative to think about how much less levered bank business models have become. At the time of the Asian financial crisis, Siam Commercial Bank's equity was levered 15 times, compared to 7 times today, meaning the equity held against the gross loans has gone from 10% to 26% — implying a very large increase in the bank's ability to absorb losses and remain adequately capitalized. Despite the less levered business models, we think that on the other side of the crisis Thailand's market structure will lead to banks earning reasonable double-digit return on equity, an expectation not shared by the market.

We expect bank loan losses to surge among the small and medium enterprise loan books, however total credit extension to the tourism sector is only 5% of private lending, and, while we remain concerned around the ultimate impact from lending moratoria, we think broadly the Bank of Thailand has followed a reasonable path on bridging the shock.

BRAZIL – STABLE MACRO, STRONG FUNDAMENTALS

Brazil's economy is closest to the paradigm of old emerging economies. A large emphasis on commodities (e.g., iron ore, soy, oil) and low productivity leave Brazil vulnerable to balance of payments issues surrounding its current and capital accounts. It was also one of the economies that saw the most capital flight at the peak of COVID fears, but a relatively strong reserve position (greater than FX-denominated debt) left the country in a good position to weather the storm. However, the negative current account leaves Brazil materially exposed to volatility around capital flows/flight, even if solvency remains solid. The traditional bug bears of Brazil — stubborn inflation and low industrial competitiveness due to poor trade policy — remain issues, but fundamentally the country balance sheet is stable, assuming the government maintains reasonable monetary policy.

From a banking standpoint, the Brazilian banking market has a good industry structure with the top five banks controlling more than 80% of the market. As a result, banks have strong fundamentals and have generated very healthy operating profits, providing significant cushion to their loss absorbing capacity. Also, because of regulations requiring them to hold government securities, only 35% of bank assets are loans, implying the ratio of Tier 1 common equity to loans is as high as 30%. While COVID-19 can have a significant impact on the economy, bank fundamentals remain strong and we believe valuations are attractive and already priced in these risks.

TURKEY – WEAK MACRO, SELECTIVITY REQUIRED

Turkey's government appears to be repeating the mistakes of the past by supporting an untenable foreign exchange rate, mostly for populist reasons, while struggling to control a high current account deficit and inflation. Further, the central bank is increasingly borrowing reserves from state owned banks and using them to support the currency.

Even in a country where the macro environment is admittedly tough, there are opportunities in well-positioned franchises with strong balance sheets. In Turkey it is Akbank, which is currently earning double-digit returns on equity and has the strongest capital ratio and most conservative balance sheet in terms of loan mix and funding ratios. Akbank's loan book is heavily focused on corporations who may benefit from devaluation, with limited exposure to the retail sector.

WHILE COUNTRIES ARE HEALTHIER, SELECTING THE BEST POSITIONED BANKS STILL MATTERS

In each of the emerging market economies, even a healthy macroeconomic backdrop can be undone by poor governance at the company level. Thus, research can help identify the firms with the best range of outcomes during economic stress. Certain rules are simple: don't buy the bank that just gorged on credit in a boom. Other considerations take more work—e.g. which firm might have already done more work to develop an electronic platform to enable lower cost and better customer service for the long-run. Our goal, through bottom-up research, is to identify the winners in each of these geographies and, more importantly, stay away from firms that are more likely to face capital impairment if the recession is longer or deeper. It is this intersection between supportive macro and well-governed institutions that makes up the diverse set of financials in our emerging markets portfolio. They are all inexpensive and today there is no need to flirt with the weak to find good opportunities.

FURTHER INFORMATION

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PZENA Investment Management

While less patient competitors sway from their investment approach to boost short-term returns, we remain relentlessly committed to the value discipline. Ultimately, we believe style drift undermines long-term returns. PZENA INVESTMENT MANAGEMENT has adhered to a classic value, research-driven investment approach, continuously applied since its inception 25 years ago.

Research Excellence

We are committed to our classic value investing approach. This commitment requires an emphasis on research-driven stock selection. Our team shares a common understanding of the research task: A thoroughly vetted estimate of a business' ability to generate long-term, or normalized, earnings.

Before adding a position to the portfolio, we ask ourselves whether we would be willing to buy the entire company at the current price. We invest in companies whose share prices have dropped for reasons that we believe to be temporary. Thus, we take a long-term view on the nature of the business we are considering, the company's competitive positioning, and the management team's strategies for change. By focusing on businesses, instead of short-term share prices, we have an opportunity to deliver superior long-term returns.

Disciplined Investment Processes

We are disciplined bottom-up investors. Rather than focusing on outperforming peers or benchmarks, we construct concentrated portfolios consisting of the best value opportunities that we see in the market. Our investment approach emphasizes inexpensive stocks based on normalized earnings estimates.

Through our research, we determine if a company's business is strong, management's plan to generate earnings recovery appears sound, and there is downside protection.

Breadth and Independence

We oversee a range of investment strategies across market capitalizations and regions. As an independent asset manager Pzena is free to restrict capacity and preserve its ability to deliver high value-added strategies.

Client Service and Communication

We cultivate long-lasting client relationships through consistent management of assets along with timely, straight-forward and frequent communication. We try to bring a fresh perspective to the conventional thinking that dominates the investment world.

The client and investments teams work in partnership to ensure that our clients have a contact who is fully knowledgeable about the portfolio, our investment decisions, and our perspective. ■