Financial Services in Emerging Markets

Executive Summary

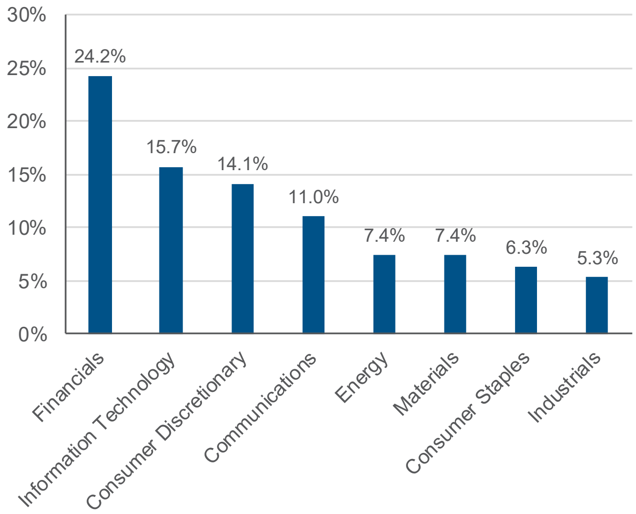
Profitable, fast growing and structurally attractive

- The largest and most liquid sector in emerging markets
- Benchmarks and UK "Asian" banks give high China or Hong Kong exposure, less favoured by us
- Asia dominates geographically (in EM) and banks dominate by subsector (of financials)
- Growing middle classes provide a considerable tailwind to the sector's growth
- Falling interest rates make borrowing affordable and broaden the savings industry
- Asia has the added advantage of a strong savings culture
- Structural benefits include a large proportion of unbanked and cash-driven consumers
- Governments are increasingly promoting financial inclusion
- Specialists areas such as insurance and asset management are set to grow
- Fintech will be important with benefits for both incumbents and new players
- EM include some of the most profitable banking sectors with strong balance sheets
- Loan growth has slowed but this has enabled higher levels of dividends
- Valuations rather than fundamentals are often the limiting factor to further investments
- All themes are invested in through the Polar Capital Financials Trust, Polar Capital Financial Opportunities Fund and Polar Capital Asian Opportunities Fund

A large, diverse and expanding sector

For most investors in the developed world, investing in financial services businesses such as banking and insurance is generally about capturing either value or yield and there is limited focus on growth as a driver of prospects. This is not surprising considering the lacklustre top-line loan growth seen in many developed markets in recent years but it is important to understand that the dynamics of the industry are materially different when looking at emerging markets.

Chart 1: MSCI EM Sector Breakdown



Source: MSCI, 31 December 2019

Chart 2: Top 10 Banks by Market Cap (US$ bn)

Name	Market cap (US$bn)
JPMorgan Chase	431
Bank of America	308
Industrial and Commercial Bank of China	**272**
China Construction Bank	**209**
Wells Fargo	199
Agriculture Bank of China	**170**
Citigroup	167
HSBC	151
Bank of China	**142**
China Merchants Bank	**128**

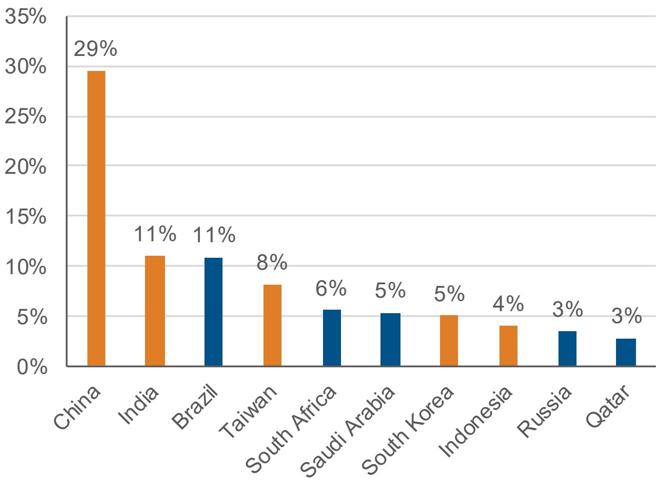
Source: Bloomberg, 7 February 2020

For 20+ years, we have been investing in this space. Not only is it the largest sector in emerging markets by a considerable margin (see chart 1) but equally there is a broad breadth of liquid stocks to actually invest in. In many markets the banks are the largest and most liquid stocks to own, so are owned as bellwether stocks for the overall economy. Though dominated by China, banks in EM also rank highly when compared to banks globally (see chart 2). Added to this there has been a broadening of the range of stocks in recent years as state banks become quoted companies (as happened in China) or family businesses are forced to raise external capital to maintain their growth momentum. Twenty-plus years ago, the vast majority of investments were in banks in regional centres such as Hong Kong and Singapore while today these account for a relatively small part of portfolios, with insurance and finance companies a growing proportion.

Buying the benchmark gives high Chinese exposure

This is a space where it pays to be active since most benchmarks will provide you with exposure to state-owned banks (primarily in China), a sector best avoided unless you have special access to government and political decision-making. Widely used indices (e.g. MSCI) have anomalies where key stocks are not even included, such as HDFC Bank, India's most valuable lender and largest private sector bank and arguably one of the best managed banks in the region. Equally, do not think that owning HSBC or Standard Chartered adequately captures the trends we highlight below. These banks have a strong bias to Hong Kong and developed Asia as well as other non-emerging markets such as the UK and US, and though they have good franchises in many emerging markets, they have been losing market share for the past 30 years and now are minnows in many of them. By way of example, in 1975 foreign banks in Malaysia had a similar market share to domestic banks while today this has fallen to under 30% . The combination of limits on branch expansions, regulatory focus on boosting domestic 'national champions' and reduced appetite from foreign banks in view of macro instability have all served to reduce foreign banks' market share. It is important to invest locally which explains our constant visits to the region to visit even peripheral finance companies and the high active share across all our funds, specifically in terms of emerging markets.

Chart 3: China dominates EM financials
(MSCI Financials - Largest Markets %)



Source: MSCI Emerging Market Financials - Largest Markets, 23 January 2020

Chart 4: Largest holdings often not in indices
(Asian Opportunities Fund - Top 10 Financial Holdings)

Name	Fund Weight	MSCI EM Weight
AIA Group	4.6%	Not in Benchmark
HDFC Bank	4.5%	Not in Benchmark
Bank Central Asia	4.3%	0.4%
Ping An Insurance	3.1%	1.1%
China Construction Bank	2.9%	1.2%
E Sun Financial	2.7%	0.2%
Bajaj Finance	2.7%	0.2%
Bank Rakyat Indonesia Persero	2.6%	0.3%
Bank of Philippine Islands	2.3%	0.0%
HDFC Corp	2.1%	0.9%

Source: Polar Capital, 31 January 2020

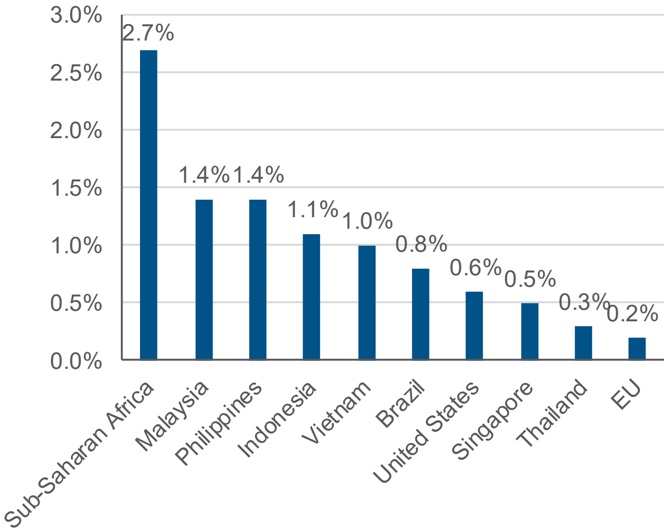
Much of this note focuses on Asia because Asian financial services account for the vast majority of the emerging market investible universe (over 60%) since many local banks in Latin America and Europe are foreign owned. We also talk a lot about the banking sector since it is very much the dominant financial sector in most emerging markets as long-term savings and capital markets have yet to evolve materially.

Macro trends drive underlying growth

GDP growth, demographics, urbanisation and interest rates all play a role

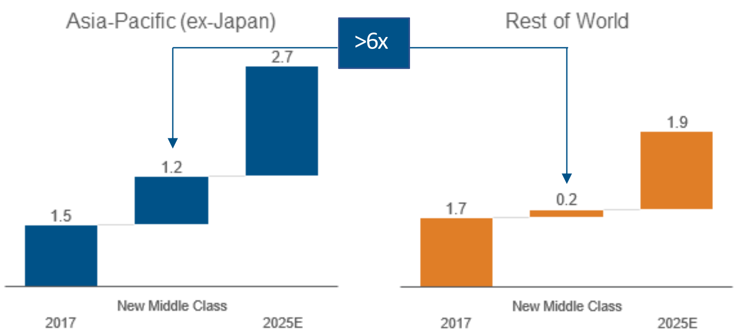
The development of financial services is intricately tied to a country's growth (GDP, demographics and urbanisation all play a role) and level of wealth (primarily through wages evolving further away from subsistence levels and a broadening of the middle classes), coupled with a fall in interest rates to make borrowing affordable. The starting point is strong population growth in driving demand and though demographic trends are less favourable in some markets, for many emerging markets they continue to have large, young populations which will provide a boost in the long term as wealth broadens into a larger middle class. Demographics have, however, become more complicated in recent years with some markets clearly showing a rising proportion of elderly which will have implications for the type of financial services that will do well (as people age they tend to use fewer loans and more savings and insurance products).

Chart 5: Demographics provide strong support (Population growth 2018 %)



Source: World Bank, 2018

Chart 6: Asian middle class to dominate (Growth in Middle Class - Billion)

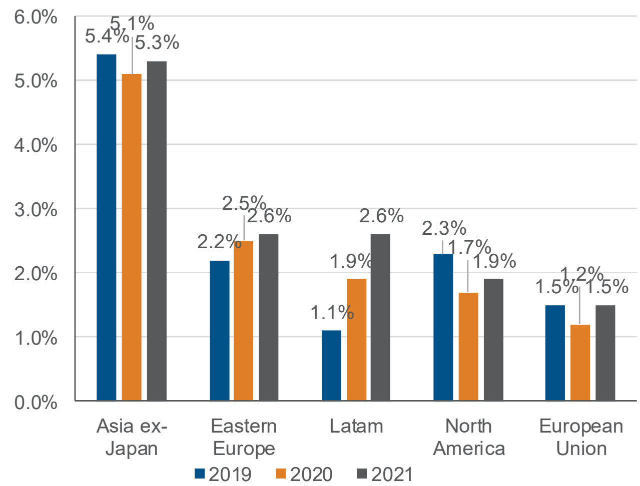


Source: AIA Presentation, 2019 interim presentation

A fall in interest rates is needed to spark growth in financial services

As would be expected, GDP growth continues to outperform developed markets, in particular in Asia, but less recognised is the need for lower interest rates to spark increased lending demand. The general trend of falling inflation feeding into lower interest rates has provided a considerable boost to bank lending and may help to explain why countries such as Argentina, despite having a reasonable GDP per capita, remains so under-borrowed (current rates on personal loans are 50%+). A simple way of looking at this is to compare domestic interest rates with banks' loan/asset ratios (after all, if you can get an excellent yield on domestic government bonds then why bother with the risk of domestic lending?). We have used the example of Bank Central Asia in Indonesia below since that country has seen one of the most dramatic falls in interest rates in recent years which has enabled the offering of a range of longer-term loan products such as mortgages. This trend still has opportunities in certain developing markets. For example, Pakistan has mortgage rates of 17% and one of their leading retail banks, MCB Bank, has a loan/asset ratio of 33% so considerable potential to gear up in the years ahead. Less well understood is that lower rates will also boost demand for a broader range of savings products as financial services start to broaden into fund management, insurance and pension products as investors chase higher yields than those offered by bank deposits.

Chart 7: Fastest growth in Asia (GDP growth %)



Source: Bloomberg, 4 February 2020

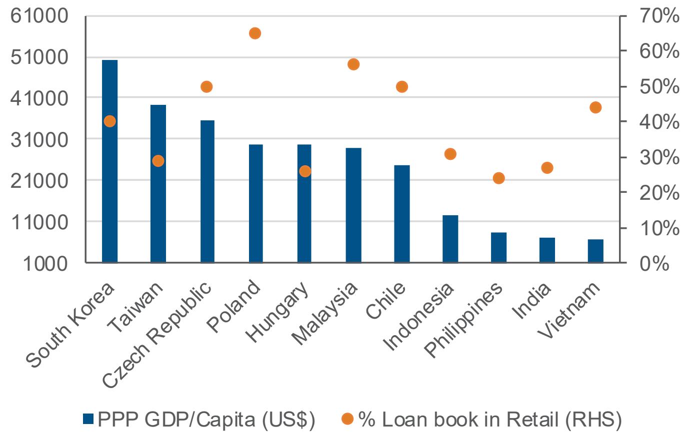
Chart 8: Falling rates help loan demand (Indonesian bond yields vs loan/assets of BCA)

Source: Company reports, 2018

It should not be assumed that recommendations made in future will be profitable or will equal performance of the securities in this document. A list of all recommendations made since the Fund's inception are available upon request. All opinions and estimates constitute the best judgment of Polar Capital as of the date hereof, but are subject to change without notice, and do not necessarily represent the views of Polar Capital.

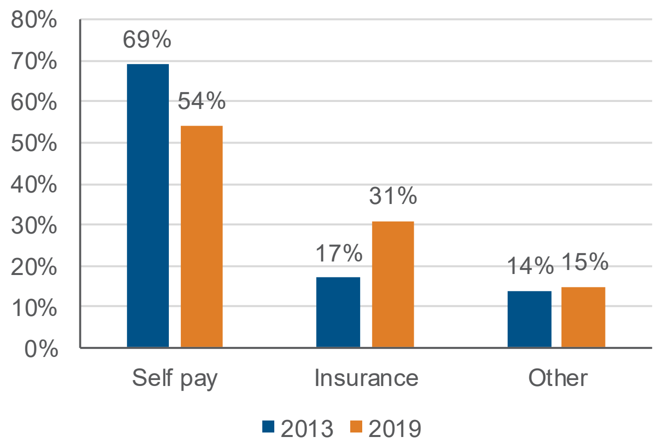
The use of finance is also intricately tied to domestic consumption and buying a bank is often a materially cheaper means of getting access to the theme of domestic consumption. Availability of finance and insurance drives growth in sectors such as autos, real estate, hospitals (as illustrated below) and education. Initially a country sees growth in motorcycle loans and small personal loans, then car loans and mortgages; broadly, the wealthier the country the greater the bias to consumer lending in the balance sheets of the banks (although as the chart below illustrates, the relationship does not always hold if a country has a history of banking

Chart 9: More Mature = more retail lending (GDP/Capita and Retail Lending as % of loans)



Source: UBS, 3 December 2019

Chart 10: Hospitals helped by insurance growth (BDMS Patient Revenue generation %)

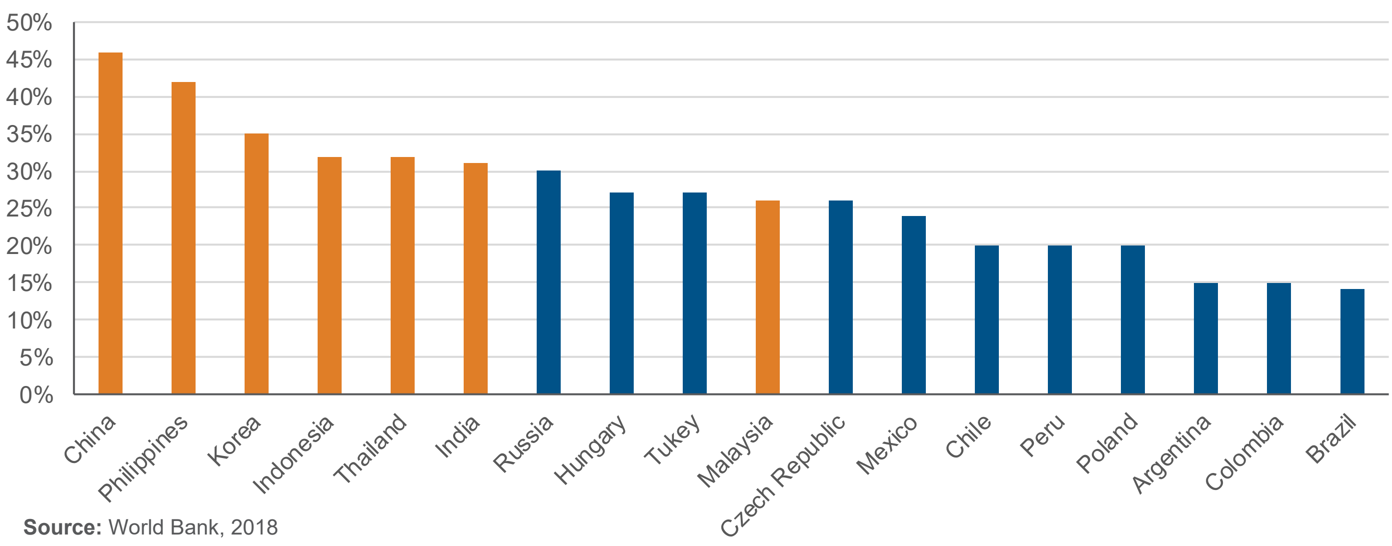


Source: BDMS, Q3 2019 presentation

Do not forget deposit bases still matter in emerging markets

Finance still needs to be funded and the evolution of a healthy finance sector requires a stable savings base since the alternative is banks becoming reliant on short-term, unstable, wholesale (and often foreign) capital markets. The strong savings culture which has been a hallmark of many Asian markets (see below) helps to explain why we also have a bias to Asian markets in many of our portfolios. Only in recent years have greater liquidity and duration started to be available in domestic emerging market capital markets (although this can dry up in a crisis as recently happened in India). Ultimately, we prefer banks in emerging markets to make their margins from a cheap deposit base rather than taking on too much risk on the lending side. This is an important differentiator between Asia and Latin America. However, it is also fair to say that too high a savings ratio may be a cause for excessive lending (as might be the case in China) and depressed domestic consumption.

Chart 11: Asia has strongest savings culture (Gross savings as % of GDP)



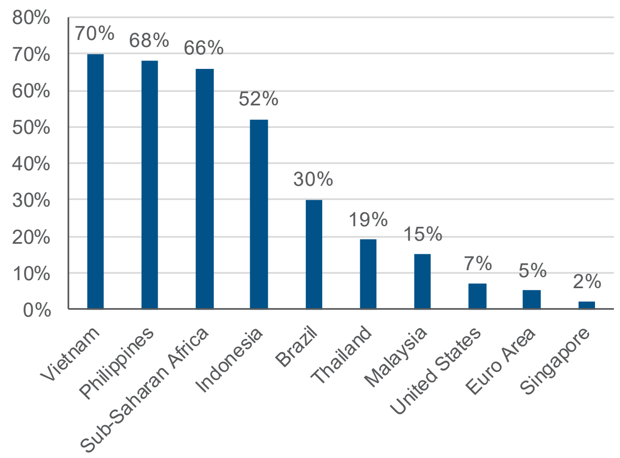
Source: World Bank, 2018

Structural industry trends to support long-term growth

New consumers of financial services are often the most profitable

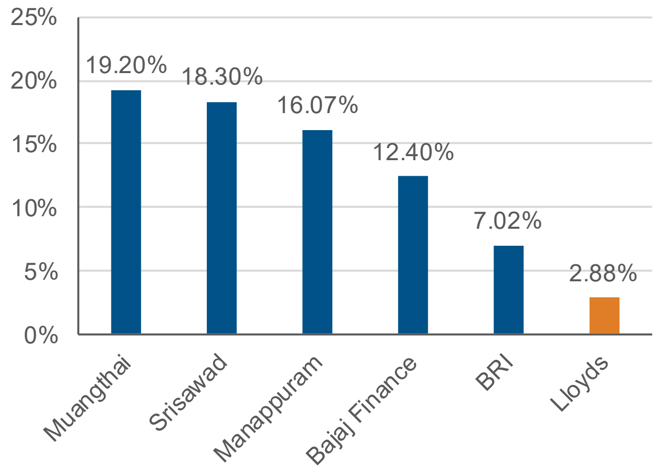
Surprisingly large sections of the population remain unbanked (as seen below) and though they offer limited revenue potential in the short term, these clients can often be the banks' larger clients of the future as their wealth increases. Investors also often forget the reality that most emerging markets have large informal lenders, such as pawnbrokers or worse, where interest rates are set at very high levels. Consequently, our experience has been the new entrants into the financial system can often be the most profitable clients for formal finance providers since, though the default experience can be poor, this is more than offset by the wider margins finance companies can charge as competition is limited (mainstream banks do not often want to enter this segment). The chart below highlights some of the margins of our holdings in this entry level of the financial system – there is a preponderance of motor loans in this segment since that is the entry level loan for new consumers).

Chart 12: Underbanked as % of population



Source: World Bank, 2018

Chart 13: Margins of our investments catering to "entry level" clients



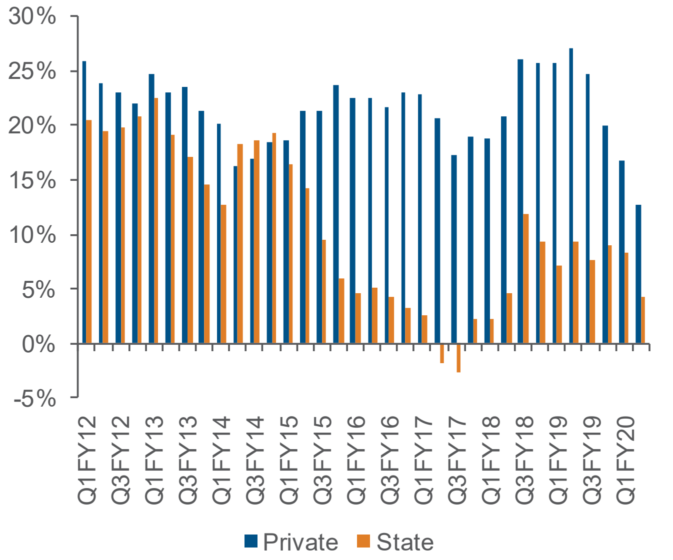
Source: Company Reports, Polar Capital, Q3 2019

Greater financial inclusion is becoming a growing theme

Governments are also, in theory, taking an active interest in pushing more people into the formal banking sector to improve tax revenues, since entering into the banking system also means the formal economy, as well as financial inclusion so enabling financial support for both spending and small businesses. However, there can often be an ambivalence in terms of actual government policy. At times, governments, usually driven by local politicians and at times with valid reason, often find it politically expedient to target such lenders as being usurious resulting in non-repayment of loans while at other times they implement regulations which tend to favour large and incumbent players that leads to less competitive pricing. Broadly there is growing government support for greater inclusion and certain core products such as mortgage lending (see below) remain in their infancy.

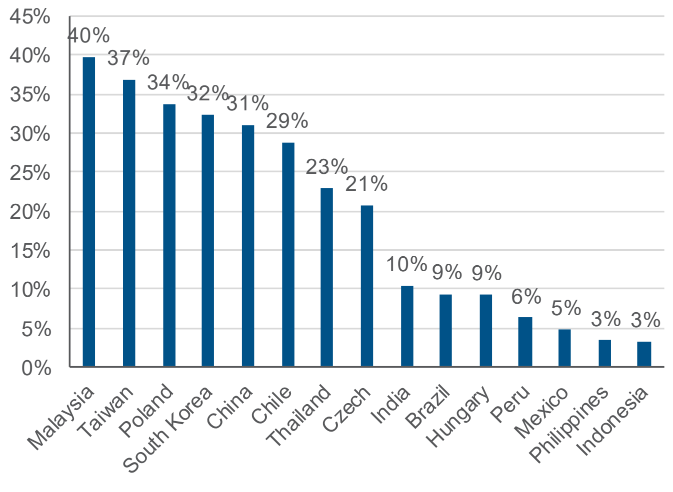
At the same time, government banks have become less important to the overall financial sector either because governments do not want to recapitalise them to deal with legacy problems (as is the case in India, resulting in much slower growth than their private sector peers – see below) or because governments involved in lending decisions have become discredited due to the risks of corruption and poor lending decision-making. Governments could do more over the next few years – one way of improving inclusion is through digital providers – but equally we expect to see a greater focus on tax incentives to boost longer-term savings. This has the added benefit of reducing the reliance on banks for corporate finance as an appetite for longer-term bonds is often driven by the long-term savings and insurance industries.

Chart 14: State banks lag private banks
(loan growth of Indian state and private banks)



Source: Company Reports, Polar Capital, Q3 2019

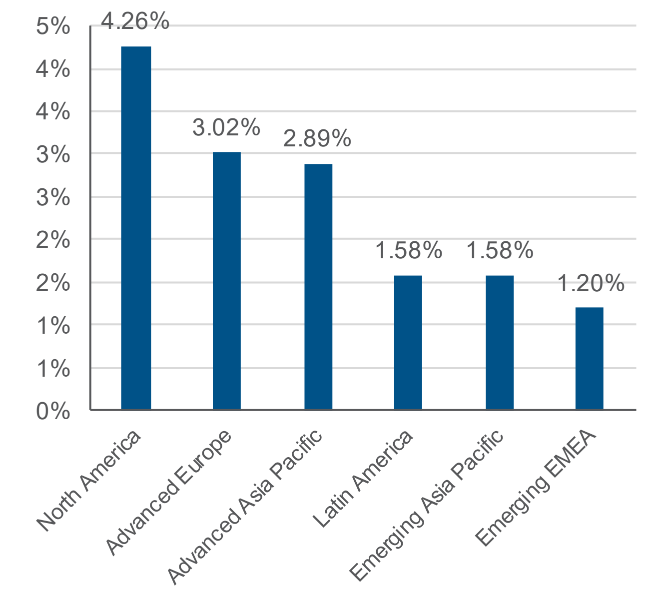
Chart 15: Retail lending still has room to grow
(Mortgages/GDP %)



Source: UBS, 3 December 2019

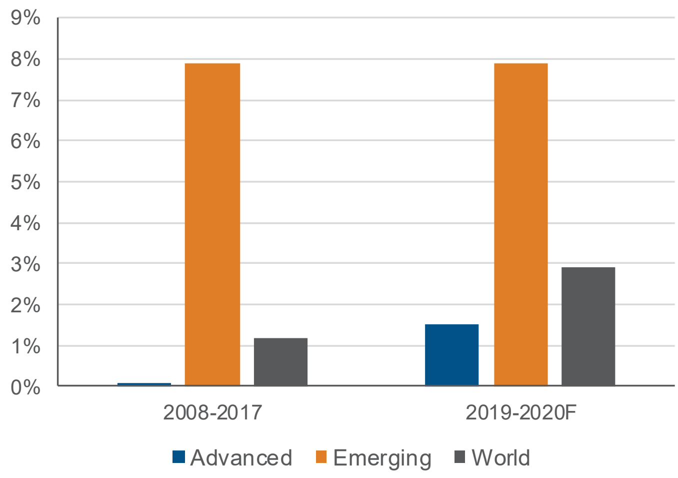
The last point is worth reinforcing in that banks dominate the financial sector in emerging markets in a way not generally seen in developed markets. The insurance sector is small, and liquidity and risk appetite often hamper the development of deep capital markets. This oligopolistic structure helps to reinforce the strength of the incumbents and explains why much of our exposure remains focused on the banks. Added to which specialist areas such as insurance are often controlled by foreign companies.

Chart 16: Low levels of insurance coverage
(premiums as % of GDP)



Source: Sigma Swiss Re, July 2019

Chart 17: High rates of premium growth
(Real Premium growth %)

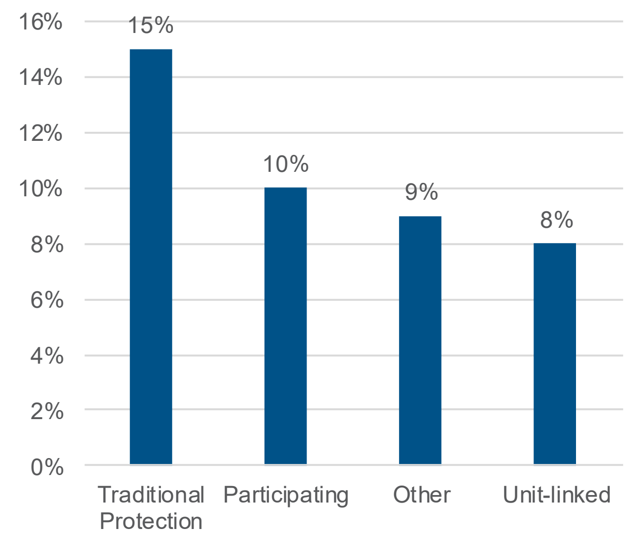


Source: Swiss Re Institute, July 2019

Insurance and other long-term savings products offer huge potential

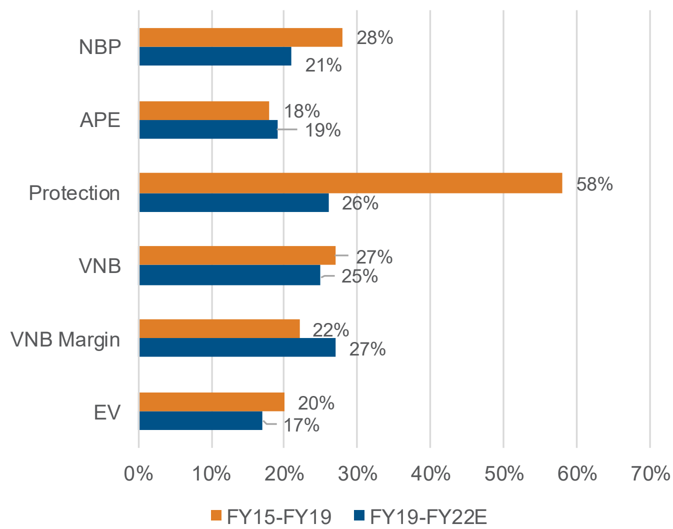
We are not just investing in the banking sector and, though the opportunities are more limited, we also buy insurance companies in the region (AIA Group is the largest insurer by market cap globally and one of our largest holdings across all our funds). As the charts above highlight, not only are growth expectations in terms of insurance premiums much stronger in emerging markets but equally insurance remains highly underdeveloped in many markets. Insurance is also becoming more profitable (a key negative has been the low margins in the past) since historically insurers offered deposit-type products which had a slightly better yield and with volatility in sales depending on where bank deposit interest rates were trending. Such deposit-type products generally have low margins while, as the population makes greater use of insurance, risk or protection products with higher margins are becoming more common (see below). Equally, in terms of non-life insurance, low interest rates (i.e. low yields on investment portfolios) are forcing insurers to price for risk and so earn underwriting profits – one of the key issues stopping us from investing was the mispricing of risk. For the sake of brevity we will not focus on growth in other long-term assets such as private equity, asset management and pensions since there are few stocks to actually invest in this space but they are experiencing similar high growth trends.

Chart 18: Better margins in protection products (AIA margins by product)



Source: AIA, 2019 interim presentation

Chart 19: High growth in protection (HDFC Standard Life -premium growth %)

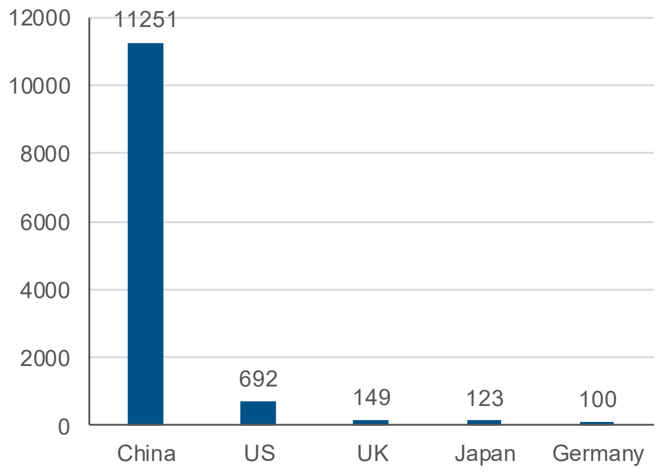


Source: Bank of America, Company Report, 6 February 2020

Fintech could become a game changer but it is many years away

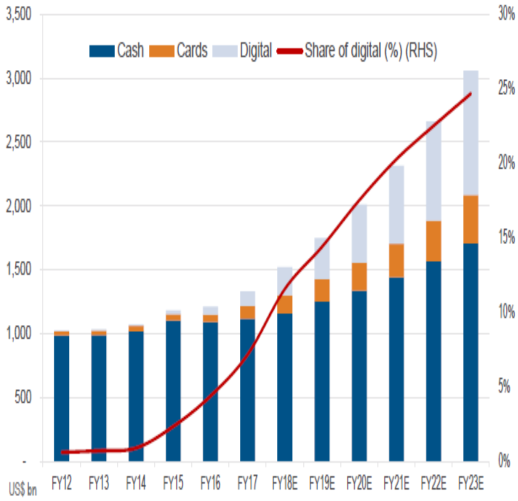
This brings us to the issue of digitisation which in itself could be an entire research note. Like in developed markets, digitisation is having an impact on financial services in emerging markets, potentially maybe more so than in developed markets in the longer term due to greater inclusion. For investors, there are limited options for fintech investments other than large tech conglomerates such as Alibaba Group Holding and Tencent or financial conglomerates such as Ping An Insurance. The growth is driven by the same issues as in developed banking, such as a lower cost of transaction processing, but there is the added issue that the financial industry's infrastructure is not as evolved so fintech offers the potential for greater inclusion. In truth, we view the use of technology to access new customers as even more important in emerging than developed markets – most people have a mobile phone although access to the internet can be sporadic. The success of companies such as Safaricom with Mpesa is often used as a model but standalone technology companies are increasingly driving the change rather than telecoms companies.

Chart 20: Top e-payment markets ($bn)



Source: CLSA, iresearch, Statista, eMarketer

Chart 21: Digitisation not disruption
(Indian digital payments trends)

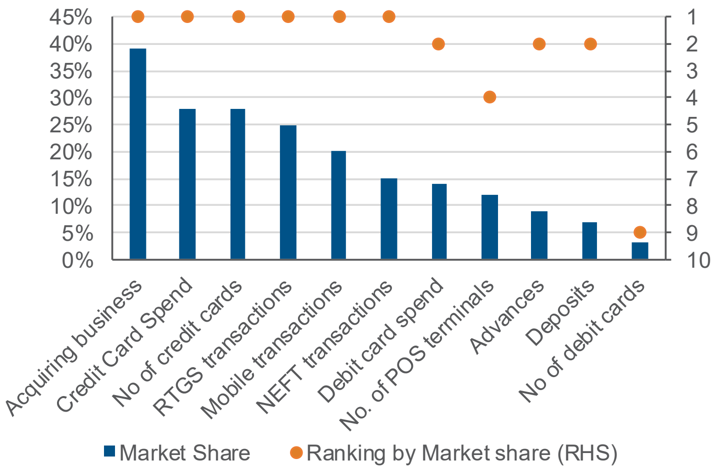


Source: RBI, CMIE, Credit Suisse Estimates

Initial fintech enthusiasm has been disappointing

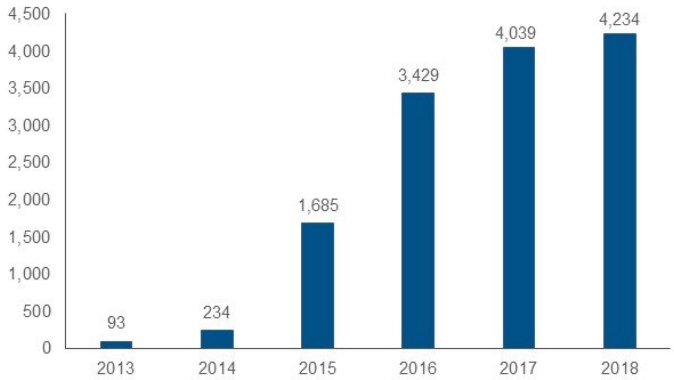
Though there is much talk about fintech, in reality it has very low market share, with the one exception of consumer lending in China. To date it has faced issues of pricing of risk (offering attractive interest rates to borrowers without assessing risks adequately), stability of funding, constant changes in regulation and high customer acquisition costs. The dramatic changes in the fortune of Chinese P2P platforms is a telling reminder that regulations are constantly evolving, and this can severely disrupt new business models (the companies also faced deteriorating asset quality). Sometimes investors can look at easier ways to play these themes, with HDFC Bank being strongly positioned (see below). Equally, as in developed markets we tend to prefer fintech companies focusing on the lower cost of processing rather than lending or deposit-taking and those opportunities remain limited for investments.

Chart 22: Incumbents can dominate
(HDFC Bank positioning in India)



Source: RBI, Company Data, Credit Suisse, 1 April 2019

Chart 23: Failed P2P Platforms in China



Source: Bloomberg

The regulatory framework will also dictate the extent to which large tech plays a role in financial inclusion. The Chinese government has allowed Alibaba Group Holding and Tencent to become dominant (93% market share in mobile payments) but this is not the case in other emerging markets. In India, the government has looked to drive financial inclusion through the banking system (300 million new bank accounts have opened since 2014) with banks part of an open loop system that incorporates payments through QR codes (in contrast to China's closed loop system).

Strong industry fundamentals

More profitable and better capitalised than developed market banks

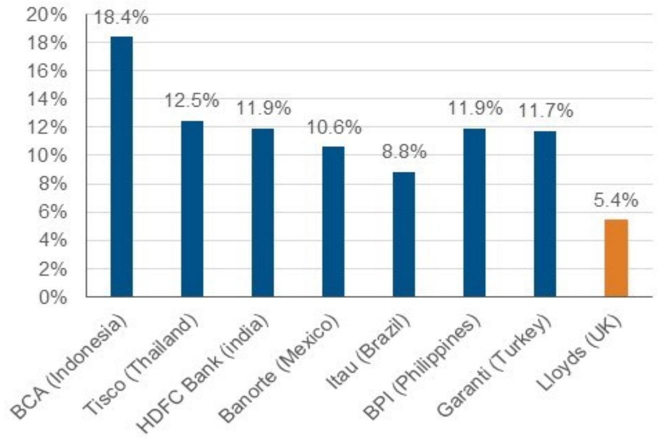
These long-term trends are all well and good but critically what types of business are investors buying now? The starting point is that some of these banking sectors, such as Indonesia and Mexico, are among the most profitable globally, reflecting the history of high interest rates, the oligopolistic nature of the industry (few new banking licences are issued), cheap deposit bases as well as limited alternatives for savers, and a better than expected default experience. We generally focus on RoAs (return on asset) rather than RoEs since most emerging market banks run with considerably more capital than their developed market competitors (their equity/assets ratio is much higher) which serves to understate true comparisons of RoEs.

Chart 24: Very profitable franchises
(RoA of our largest EM positions %)

	Q3 2019
BCA (Indonesia)	3.65%
Tisco (Thailand)	2.54%
HDFC Bank (India)	2.26%
Banorte (Mexico)	2.20%
Itau (Brazil)	1.70%
BPI (Phillippines)	1.55%
Garanti (Turkey)	1.40%
Lloyds (UK)	0.66%

Source: Company Reports/ Polar Capital

Chart 25: Capital levels are strong
(equity/assets %)

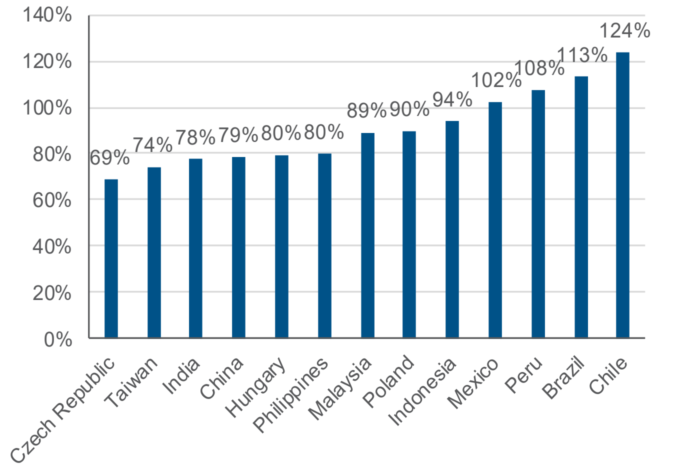


Source: Company Reports/ Polar Capital, Q3 2019

Management often used to macro volatility

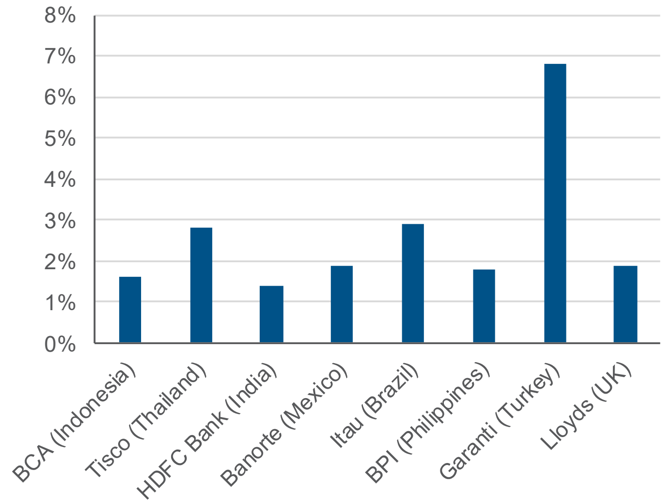
The latter point is often misunderstood in that assumptions are that lending is much riskier in emerging markets and so capital positions need to be stronger. This is driven by perceptions of macro volatility feeding into banks' balance sheets but often the experience can be better than developed markets. Currently, most of the banks we invest in offer strong balance sheets in terms of capital, funding and asset quality experience, and many managements have become used to dealing with volatile macro environments. Regulatory requirements can often be tougher partly because less sophisticated tools are being used (such as leverage ratios and reserve requirements rather than risk-adjusted capital ratios). Added to this, regulators can be highly interventionist, including setting lending limits or even providing loan/value limits. If anything, the 2008 crisis helped to highlight how the *laissez faire* approach in the developed world had probably gone too far and explains why many emerging market banks weathered the storm better. Often our experience is that managements have become used to dealing with issues such as high inflation or liquidity crises and so run their balance sheets more cautiously. The table below also highlights the weaker funding structures of Latin American banks.

Chart 26: Weaker funding in Latin America (loan/deposit ratio %)



Source: UBS, 3 December 2019

Chart 27: Good asset quality (NPLs/loans %)

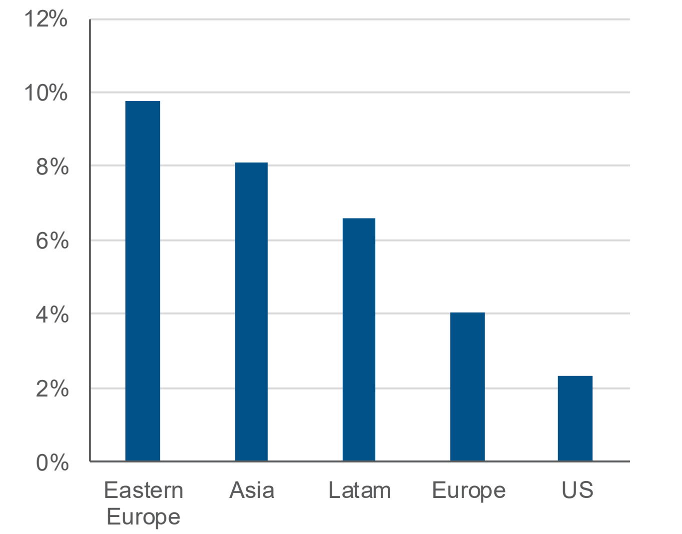


Source: Polar Capital, company reports, Q3 2019

Loan growth has slowed even in emerging markets

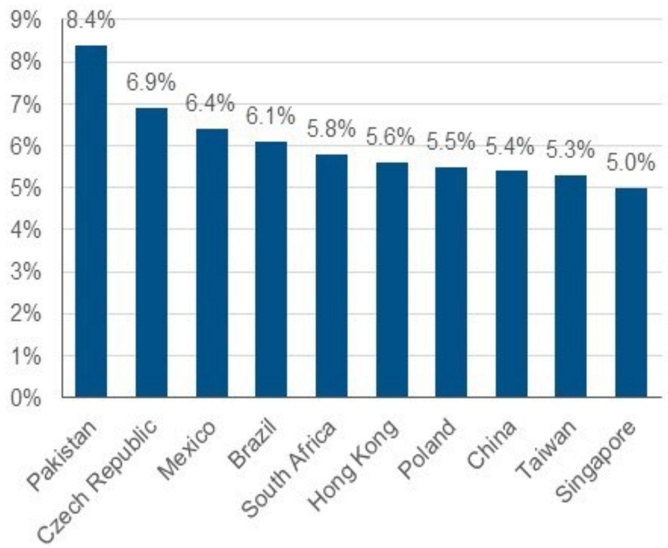
When investing in emerging markets, the underlying rationale tends to be to access better growth. Here, the picture has become less transparent with greater divergence between countries (as seen below). Though the overall rates of top-line loan growth have slowed in emerging markets, these remain materially better than those seen in developed markets (many European banking sectors have had negative loan growth over the past 10 years). Equally, absolute loan growth reflects nominal GDP growth so, with inflation having fallen sharply, it is not surprising loan growth has reduced. Ultimately, we are not in the camp that looks for high loan growth as a criteria for investing but instead we tend to focus on risk-adjusted growth – the asset quality experience and margins should be taken into account when assessing loan growth. Again, investors need to be a lot more discerning if growth is what they are looking for and avoid growth which simply reflects government edicts rather than commercially viable propositions. This is a key reason why we often avoid state banks in our portfolios.

Chart 28: Still the best rates of loan growth (loan growth Q319 y/y)



Source: Polar Capital, Company Reports, Q3 2019

Chart 29: Strong dividends yields



Source: UBS, 3 December 2019

Weaker growth has raised payouts

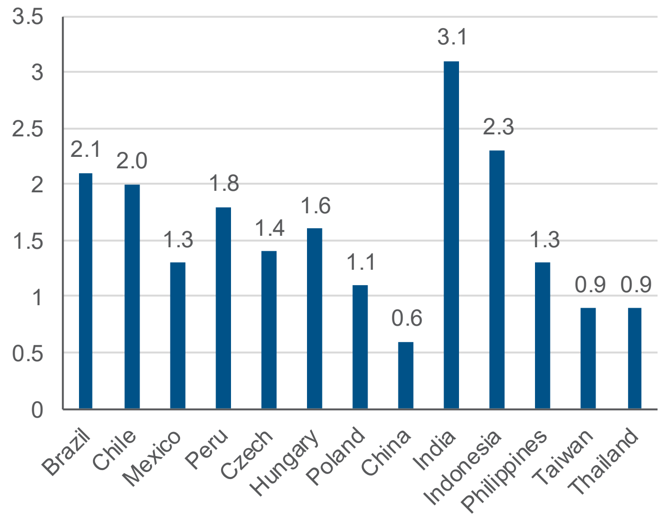
It is not all gloom for those emerging markets which have seen weaker loan growth since lower growth coupled with high profitability has often meant an acceleration in dividend payouts. Today you can find very attractive dividend yields among the more mature emerging markets such as Korea and Taiwan, and even China. We expect pressure for better capital management to increase going forward; this is already a theme in the Korean banking and insurance sectors.

The quality of disclosure has improved materially over the past 10 years and in some cases you can even get monthly data through the central banks. The access to management for investors has also improved (although some state banks remain bemused as to why they need to talk to investors and this attitude remains true in some frontier markets). We generally also find them easier to analyse than many developed market businesses since they are primarily national businesses focused on their domestic commercial banking operations. This means they have limited exposure to volatile and less transparent areas such as investment banking.

Why not invest more?

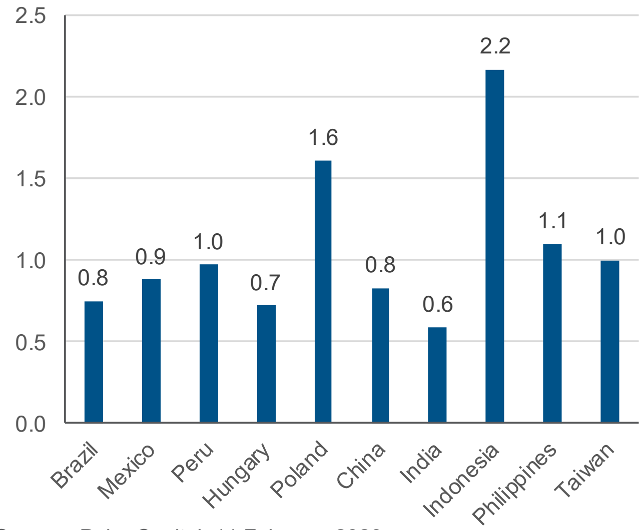
Arguably the greatest limitation to our investments in emerging markets have been valuations. Some of the best franchises do not trade at low valuations and are widely held by foreign investors, for example HDFC Bank, Bank Central Asia and Bajaj Finance. Value tends to be focused on the slower growing, less profitable areas (South Korea, Taiwan and China) or state-owned banks (even in India these trade at low absolute valuations). Though valuations are high relative to developed markets it should be noted that profitability and growth rates are also much higher and adjusting for this can still provide numerous opportunities.

Chart 30: EM Banks P/B



Source: UBS, 3 December 2019

Chart 31: EM Banks PEG Ratios



Source: Polar Capital, 11 February 2020

Volatility of macro trends also tends to limit our investments and many macro issues are often not domestically driven (some markets react to oil prices or the strength of the dollar) but they can have a direct impact on the banking sector (through higher cost of funding). Often these events have proven to be the key entry points for investing in these stocks and many of our holdings have, in the medium term, been immune to the ups and downs of macro and political trends.

Though banking and insurance globally are highly regulated industries, governments in emerging markets also tend to be interventionist when compared to developed markets and this can limit our appetite for investing in a country. Politicians will often use the financial sector to gain broader support (for example, allowing disadvantaged borrowers to forego paying back loans, or pressuring banks to lend to strategic sectors). It is fair to say that such pressures have become less as central banks and regulators have gained greater independence, but this remains a negative to us investing.

Finally, our exposure is reduced by the limited availability of financial stocks outside the banking system. Only India, South Korea, Brazil, China, Taiwan and South Korea have a broad range of stocks which include banks, brokers, insurance companies, finance companies and exchanges, with most countries having a few major banks and some attractive but often illiquid, family-owned finance companies. Having said this, over many years of investing in this space, many of the less liquid investments gradually become more liquid as they raise more external capital and the choice today is materially better than 20 years ago. We expect considerable further opportunities in the future.

Polar Capital Global Financials Team
February 2020

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