BARINGS EMERGING EMEA OPPORTUNITIES PLC

Riyadh, Saudi Arabia

The Case for Emerging EMEA Financials in Turbulent Times

Matthias Siller, Head of EMEA Equities at Barings, explains why—at a time when banking and financial stocks in developed markets have been volatile—selected financial names in emerging EMEA are proving compelling as long-term portfolio holdings.

At Barings Emerging EMEA Opportunities PLC, our fundamental bottom-up analysis shows positive dynamics of the financial sector in Emerging EMEA. Here are some of the core factors driving our support for the sector...

1. Emerging EMEA banks are looking a lot safer

The regulatory environment in many emerging EMEA markets is looking a lot more conservative than elsewhere. And as scrutiny of liquidity and loan provisions intensifies, that prudence may look especially attractive to investors.

In some cases that conservatism has been borne out of past bad experience. The Greek banking sector, for example, was significantly impacted by the 2008 global financial crisis. What came out of that is a much stronger banking sector as a result of major debt restructuring and economic adjustment programmes. This, combined with fiscal prudence from the government and the strong performance of the economy post Covid-19 means the country is close to regaining its investment grade status.

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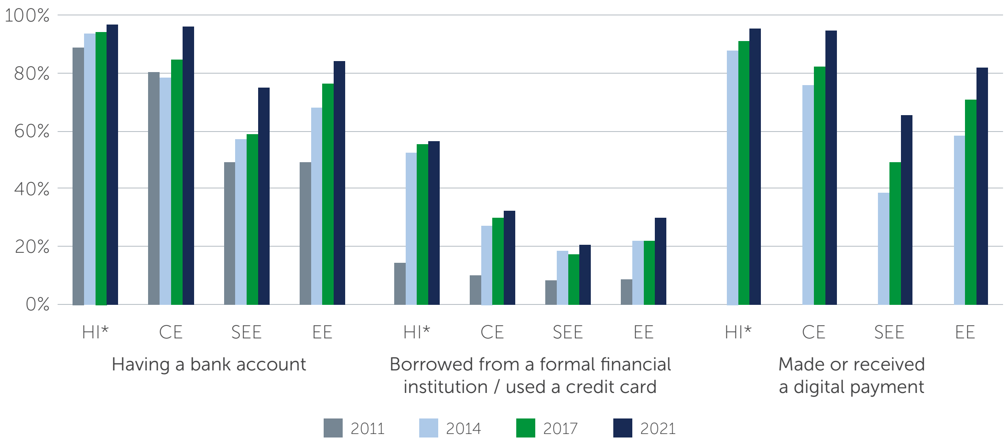
2. Their underlying growth potential is stronger

Across emerging Europe, financial penetration is lower than in other markets, so growth opportunities are more pronounced.

FIGURE 1: World Bank population financial inclusion index (Findex)



* (HI) High-income countries.
Median values; CE: PL, CZ, HU, SK, SI; SEE: RO, BG, HR, BH, AL, KO; EE: RU, UA, BY.
Source: World Bank, RBI/Raiffeisen Research.

This potential is supported by strong household finances and credit growth that looks set to remain well above the European Union average. In Greece, profitability in the banking sector has been restored and loan demand is now above EU averages. Because the client base is underpenetrated, that also provides extensive potential among quality franchises for cross-selling in areas such as wealth management, insurance and pensions.

3. The competitive landscape is smaller...

EMEA financials also benefit from a more concentrated competitive landscape. In Poland, for example, six banks control around 70% of the market. This concentration means that deposits tend be more 'sticky' and less vulnerable to outflows as interest rates change.

But that doesn't mean banks are complacent about their competitive position. We've also seen many banks work hard to increase efficiency–whether through branch rationalisation (a 40% branch reduction in Turkey since 2012, for example) or investing in IT to improve economies of scale. That, in turn, is translating into stronger earnings growth.

4. ...and the impact from disruptors is low

Of course, a big question in terms of competition is to what extent established brands are threatened by digital newcomers? In Emerging EMEA, we would say the answer is "Not much". Partly this is because of the generally conservative nature of consumers in the region. Also, many incumbent banks have invested extensively in IT to improve their digital functionality and compete with challengers.

Even among millennials–the ideal customers for online brands like neobank Revolut–our analysis shows a tendency to move back to established banks when the time comes for major financial commitments such as a mortgage. So although traditional names may have smaller market share at the early stage of a young consumer's life, their ability to cross-sell a range of products and services appears to hold them in good stead later on.

In short...

A combination of solid loan growth, highly-capitalised and conservative balance sheets, a solid deposit base and attractive valuations are translating into a number of exciting investment opportunities for many banks and other financials in emerging Europe and beyond.

But again, it must be stressed that we continue to assess opportunities strictly on a bottom-up, company-by-company basis–never as a general sector play–to capture what we believe to be the most compelling investment opportunities across the sector.

Below, you can see some of the companies meeting our rigorous criteria on a range of measures including valuation, underlying growth and earnings potential, quality of funding, strength of franchise and–of course–quality of management and balance sheet.

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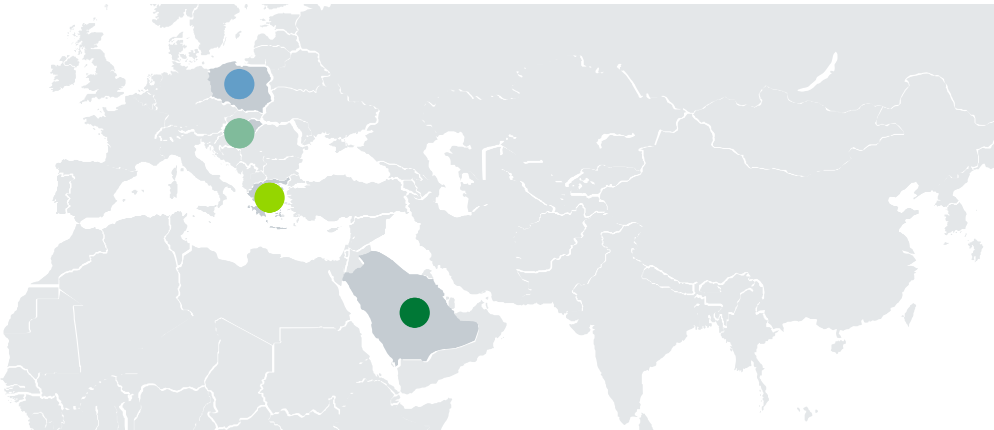

OTP

Country: Hungary

Hungarian bank OTP has successfully expanded its business into Frontier territory. Its home market currently represents a mere 1/3 of the loan book, with the Frontier Balkan markets of Bulgaria, Croatia, Serbia, Romania and Slovenia contributing 1/2. The bank's recent acquisition, Ipoteka Bank in Uzbekistan, aims at servicing retail clients in Central Asia's most populous country, while the decision to seek a buyer for its underperforming Romanian unit highlights the pragmatic approach of management.

AL RAJHI

Country: Saudi Arabia

Al Rajhi is the largest retail bank in the Middle East by deposits and income. A conservative Saudi regulator ensures the bank and its balance sheet are prudently managed, resulting in the highest total capital ratio in the region. Al Rajhi is one of the prime beneficiaries of the peak in interest rates and we should see a positive impact on its earnings per share as yields begin to fall and normalise. It also offers a comprehensive digital banking service, currently used by 10.4 million customers.

ALPHA BANK

Country: Greece

Alpha Bank has established itself as the number one player in Greek corporate lending. We believe it should continue to see strong loan demand in 2023 and 2024, driven by the Next Generation EU economic recovery package to help EU member states post Covid-19.

In 2021 Alpha rebuilt its capital base via a capital increase, allowing it to strengthen its balance sheet. The stock remains very attractively valued and can continue to grow its underlying profitability in coming years. We expect that the potential upgrade of Greek sovereign risk to investment grade could further support its investment case.

PKO

Country: Poland.

Poland's largest bank is also one of its biggest turnaround stories. Underperformance resulting from political decisions impacting the banking sector's profitability has started to be reversed thanks to a solid deposit-taking franchise and an environment in which being state-controlled is serving as an advantage.

We believe markets will be able to focus increasingly on the positives of PKO's investment case going forwards: high liquidity, a strong deposit franchise, high capitalisation (supporting future dividends), negligible use of wholesale funding, and high profitability (once windfall taxes are out of the way).

To explore our current holdings in the financial sector and elsewhere...

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Finding quality companies from Emerging Europe, the Middle East and Africa