

COLLINGS' CORNER



Europe will not offer solace from UK's woes

The bullish outlook on European financials, which has rapidly become an investment consensus, reminds us of an expression – ‘mutton dressed as a lamb’.

The 2008 developed markets' crisis was caused by an attempt by banks in the established world to generate high ROEs in aged and over-ripened economies where it is no longer possible.

Management was sailing too close to the wind, and were incentivised to do so. The problem was economic maturity, not management of banks. So what has changed

since 2008 to suddenly make the European banking scene so attractive to investors?

We believe, other than an improvement in general market sentiment – very little.

If investors want exposure to financials, they should go for the emerging markets variety. European banks themselves are fighting for market share in major emerging economies, trying to appeal to the growing local retail clientele and to take advantage of double-digit annual growth in retail lending and mortgage finance.

The IMF has raised its forecast for global growth next year, as more than US\$2trn in stimulus packages and demand in Asia expects to pull the global economy out of recession.

China expects to grow 9% in 2010, after a 9% forecast growth in 2009. India is likely

to generate 6.4% next year.

This compares with 0.3% growth forecast for the eurozone by the IMF for 2010.

The comparison is similarly startling on the micro level. German banks' 2010 estimated ROE is -6% and France 3.6%. Indian and Indonesian banks, for example, generate 16.5% and 18.4% returns on equity respectively.

Customer loan growth in one of the largest Turkish banks, Garanti, is expected to be 18% next year; while Indonesian bank CIMB Niaga will post 22% loan growth and Industrial Bank of China is expected to show 26% increase. By comparison, the only double-digit loan growth in European banks should come from Société Générale at 12.4% – but even then the bank is exposed to 36 countries, many of which are

emerging. Meanwhile, German Commerzbank is showing a -11% drop in lending.

There is no question banking penetration in many emerging markets remains nascent and the growth potential is phenomenal. Mortgage to GDP ratio in Russia and Brazil is below 5%, this compares to a household debt in the UK, for example, at above 100%.

The much-talked corporate governance problems in emerging markets also proved an outdated concept. Last year showed Turkish banks ran prudent balance sheets compared with developed peers – a sign of good corporate governance. From a valuation perspective, emerging markets' retail banks also look much more attractive, especially given high ROEs.

On 2010 P/E estimates, Garanti bank is trading at 8.6 times, Bank Niaga at 12.5 times – while SocGen is on 26.7 times. Commerzbank's P/E is negative, because of negative returns.

Investment banks like UBS, which managed to survive the 2008 bonanza, have a 2010

estimated ROE of 14 times, albeit still with negative earnings projections for next year. Although investment banks in the developed markets are capable of generating double-digit ROEs, the risk is higher than in the fast growing retail segment, as seen with sub-prime mortgage disaster.

Emerging markets are the only asset class that can generate superior long-term returns, so unsurprisingly banks in the emerging markets are the only financial shares which can provide you with double-digit ROEs generated purely from the natural growth in underlying markets – and not from financial engineering of toxic instruments.

In sum, from a UK investment perspective, one should be weary of regarding Europe as an ‘international equity investment proposition’ and as an escape from the dire position in the UK. Frankly, it is jumping from a frying pan into the fire.

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