Exploring Value Opportunities in Philippines Financial Sector

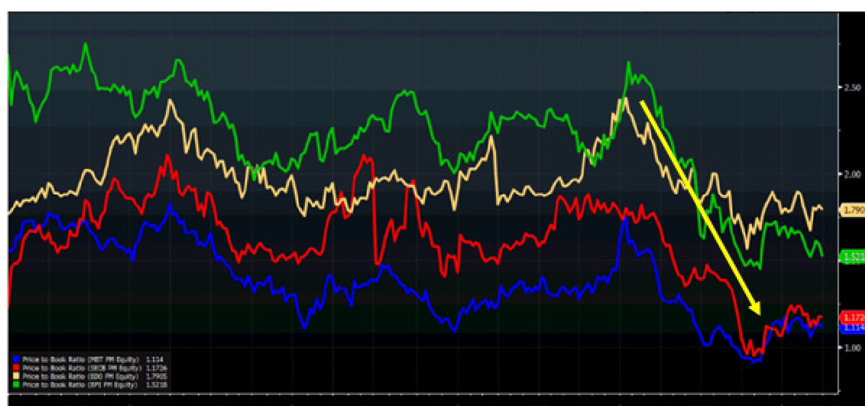
In this quarter's newsletter we share with investors our conviction on the Philippines financial sector, to which we have recently increased our exposure to over 10% of the Fund. The Philippines economy is expected to sustain GDP growth rate at ~6% in the foreseeable future, making it one of the fastest growing countries in Asia. We believe Philippines financial sector is an inexpensive way to get exposure to the fast-growing economy, which has a low financial penetration rate (Note 1). Most importantly from a value perspective, the sector has de-rated over the past 12-months and we can now find some Philippines banks trading at considerable discounts relative to their long-term value potential. Through elaborating our positive view on Philippine banks, we will also illustrate the framework in selecting financials which we have successfully applied over the life of the Fund.

Background of Our Exposure

We first gained exposure to Philippines banks not because of sector view, but rather due to stock specific opportunities identified with Security Bank (SECB PM) in early 2015 and later in 2017, with Metrobank (MBT PM). Throughout this period and up until early 2018, Philippines banks as a group traded at a considerable premium, reflecting the attractive fundamentals and growth prospects of the industry. We were compelled by Security Bank's ~30% discount relative to its peers and the strategic shift to 1) diversifying its loan book by aggressively pursuing a retail strategy and 2) reducing its investment book towards lending activities and shifting away from trading activities which had generated attractive but unpredictable and volatile trading income.

Before our investment thesis on Security Bank played out, MUFG (Mitsubishi Union Financial Group) made a large strategic investment in the company, taking a 20% stake at a considerable premium and presenting us an opportunity to lock in substantial gains. Then in mid-2017 we built an initial position in Metrobank when the stock was trading at a discounted valuation of ~11x P/E (about 20-25% discount to local peers). It was not until 3Q18, after the sector had gone through a substantial de-rating (Figure 1), that we added more aggressively to Metrobank. Earlier this year, we furthered the exposure to Philippines financials by re-establishing a position in Security Bank.

Figure 1: De-rating of Philippines Banks (P/BV) Brought Valuations to Reasonable Levels



Source: Bloomberg

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Our Selection Approach to Financials

While we approach each investment opportunity with an open mind and consider the nuances of individual cases, we find it useful to apply certain frameworks in some industries to identify investment ideas. As it pertains to financials, individual thesis is built on the following anchors, which we believe are important drivers for sustainable returns for the sector and are consistent with our cautious and conservative investment philosophy.

1. Ample capital base

A solid capital base (as measured by CAR - Capital Adequacy Ratio and CET-1 – Common Equity Tier 1) is consistent with our approach of investing in under-geared companies as this provides for a considerable safety margin to weather through future downturns and / or unexpected operational hick-ups. For banks, having a solid CAR / CET-1 brings the additional benefit of being able to sustain higher growth beyond those supported by inherent profitability of franchise (i.e. net income less dividends). While not a rigid rule, we typically look for universal banks (i.e. multi-line businesses) with a minimum CAR of 15% and 12% CET-1, we believe these to be conservative levels of capitalisation while being well above minimum regulatory levels.

Because of their higher growth rates, Philippines banks have constantly faced capital calls as their excess CAR / CET-1 are consumed by strong loan book expansion. This factor has been one of the reasons why the sector has been under pressure for much of last year, as investors avoided the sector on overhang fears caused by such rights offerings.

Figure 2: Capital Raised by Philippines Banks since 2015

Bank	Amount (PhP Mln)	Amount (US$ Mln)	% of Total Capital	Date
Metrobank (MBT)	32,000	719	15.9	Apr-2015
Security Bank (SECB)	36,900	802	20.0	Apr-2016
Banco de Oro Unibank (BDO)	60,000	1,204	19.6	Jan-2017
Metrobank (MBT)	60,000	1,154	25.2	Mar-2018
Bank Philippines Islands (BPI)	50,000	962	14.2	Apr-2018
Total	**238,900**	**4,840**		

Source: Companies financial reports, Bloomberg

Applying to our two holdings, Security Bank currently boasts the highest CAR / CET-1 amongst its peers, at 18.7% and 16.4% respectively, thanks to the large capital injection in 2Q16 when MUFG entered with its 20% stake. This goes a long way to explain why Security Bank's ROE is so depressed at 8.1%: due to its over-capitalised base rather than inherently low levels of return from its core business. For Metrobank, during 2018 the bank decided to raise PhP 60bln (approx. US$1.2blns, about ~25% of its capital base). As this naturally created some overhang in the stock and pressured the share price down, we took the opportunity to add to our position. In general, we remain sceptical about the true intentions for a bank's capital raising, yet in this case the reason was clear - they were taking advantage of Standard Chartered's disposal of 40% minority stake in their credit card JV. The decision to consolidate ownership of a highly profitable and high growth subsidiary made strategic sense and, in our opinion, was a justified reason for the raise. Another benefit brought to the Bank was that it's henceforth better capitalised with lower risk of facing capital calls in the next couple of years. As of Dec 2018, Metrobank's CAR / CET-1 stood healthily at 17.0% / 14.6% respectively.

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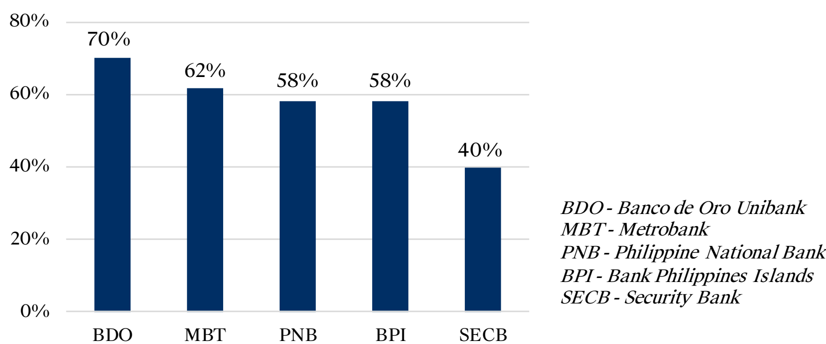
2. Strong deposit franchise (CASA ratio)

Perhaps this is the metric in which the Philippines banking system compares most favourably against most Asian (and global) systems. The extensive deposit franchises of larger banks allow them to enjoy high percentage of CASA (current account savings account as % of total deposits) and hence, presenting them with a critical strategic advantage of stable and low-cost funding (Figure 3).

Figure 3: Philippines Banks CASA Ratio

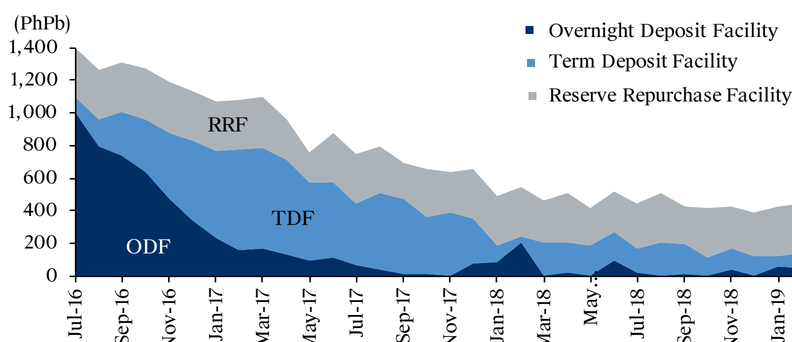


Source: Companies financial reports as of Dec-18

CASA ratio represents exposure in current accounts and / or retail saving accounts which have proven to be insensitive to market and policy level interest rates. We would argue that this inherent CASA strength amongst the large Philippines banks has not been reflected in their earnings power in recent years, as the system faced abundant liquidity and low funding costs. With the rise in policy rates last year (+175bps) and the concurrent drop in excess liquidity in the system, cost of funding on CASA deposits remained stable while wholesale funding costs (i.e. time deposits, commercial paper, interbank deposits and bond issuances) have steadily risen (Figure 4 / 4.1). This recent rise should enhance the competitive advantage and pricing power of larger banks as mid-tier and smaller banks with weaker CASA deposit franchises are forced to have greater pricing discipline.

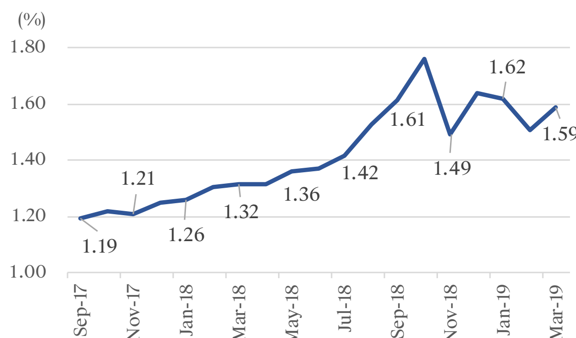
Figure 4: Reduction of System Liquidity...

BSP (Central Bank) deposit placements by banks are coming down.
ODF (PhP 121.7b) + TDF (PhP 99.3b) + Reverse Repurchase Facility (PhP 305b) = PhP 526b (as of Feb 2019).



Source: Bangko Sentral ng Pilipinas (BSP)

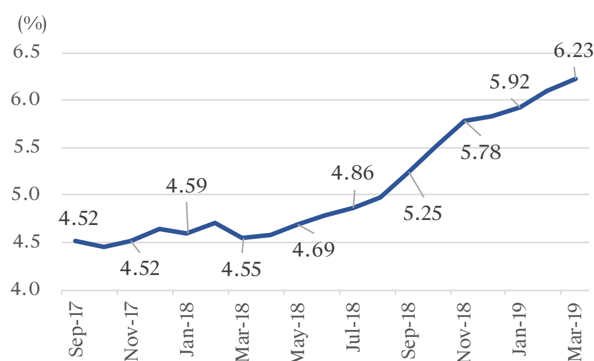
Figure 4.1 : ...Leading to Higher Funding Costs (30-days Savings Rate)



Source: Bangko Sentral ng Pilipinas (BSP)

Given how fast funding costs rose in the 2H18, coupled with repricing lag of some loans (i.e. initial fixed teaser rates for mortgages and most corporate loans), the expected net interest margin (NIM) expansion did not materialise in the manner most investors had hoped for and consequently FY18 earnings for most banks lagged expectations. Yet towards the end of FY18 and moving on to 1Q19, the market prime lending rates have shown an acceleration, indicating a firming of loan pricing within the system (figure 5). With funding costs stabilising, and banks repricing their loans upon renewals and new origination, FY19 should bring a higher and more relevant increase in interest spreads, especially amongst the larger banks with strong CASA franchises.

Figure 5: Improving Loan Pricing in the System



Source: Bangko Sentral ng Pilipinas (BSP)

3. Contained NPL problem

Credit costs (i.e. default / impairment charges from non-performing loans) are key to lending profitability. No matter how attractive lending spreads are (i.e. loan yield minus funding costs), they are only economically justified if they can cover for costs of default / impairment. Therefore, any lending activity should be evaluated based on net spread after considering default loss. In fact, we often find a link between the level of gross spread (loan yield minus funding rates) and the corresponding credit loss in financial products. This makes sense because the lending rates have to be adequately priced to reflect credit costs.

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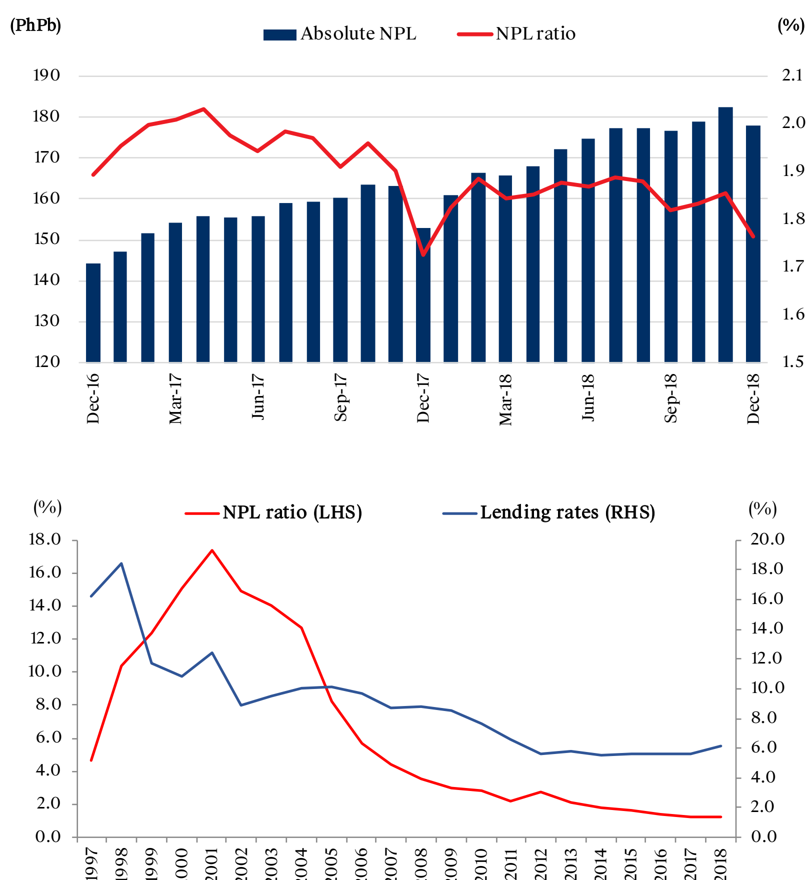
Philippine banks, like most of its peers in the region, encountered significant NPL problems during the Asian financial crisis in 1997-98, and spent the next decade nursing their balance sheet and capital base back to health. During the period they tightened underwriting standards and focused on enhancing returns by reducing credit costs (i.e. lowering NPLs). Combined with strict banking supervision, prudent measures and conservative liquidity management by the BSP (Bangko Sentral ng Pilipinas), the Philippines banking system enjoyed stable financial conditions for decades with NPLs remaining low and well controlled (Figure 6). In addition, most of the large banks in Philippines have adopted a conservative provisioning policy and built up sufficient reserves allowance for credit losses well above their NPLs levels. This implies even if the current NPLs were fully written off, there wouldn't be any immediate impact on the reported income of these banks. Although, realistically, additional provisions for future NPLs would be initiated on a precautionary basis and eventually would hit their P&Ls.

Figure 6: Evolution of NPLs in Philippines Banking System



Source: Bangko Sentral ng Pilipinas (BSP)

While it is important to diligently track and monitor the evolution of NPLs, the current trends of both reported and new NPL formation suggest that NPLs in the system will only rise gradually and remain at heathy levels in the foreseeable future. In effect, a sharp rise of NPLs that could derail earnings growth for Philippines banks remains an unlikely scenario in the near future. Coming back to our holdings, both Metrobank and Security Bank enjoy not only low levels of NPLs but their coverage ratios (i.e. allowance reserves built for such NPLs) currently stand at impressive rates of 105% and 216% respectively, placing both banks in good positions to weather future rise in NPLs.

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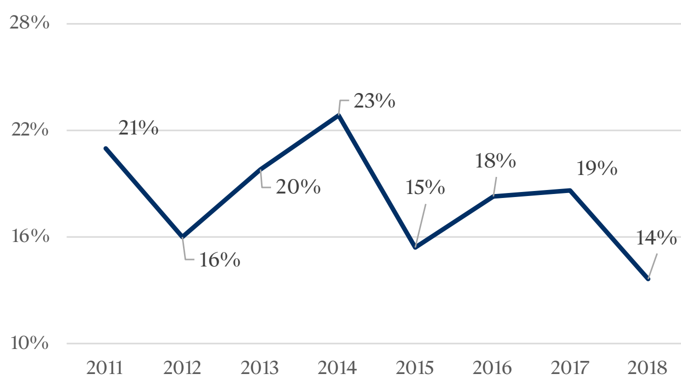
4. Growing and profitable core business

Consistent with our approach on non-financial sectors, we have a strong preference for financial companies with robust underlying growth in their core lending businesses. Growth protects valuation and helps sustain rating level of a stock. In general, banks that operate in an expanding market and / or cyclical upturn tends to face less severe competition for new loans and consequently, better loan pricing and healthier spreads. Also, an expanding loan book offers greater dilution of operating costs and thus higher profitability. Assuming proper lending spreads, growth can often help banks to dilute their past bad loan problems and rebuild capital bases.

Philippines remains a structurally underpenetrated market with significant growth potential in segments such as consumer and SMEs lending. Loan growth has been in the range of 14-23% over the past decade and we believe that even accounting for the higher loan base a decade onwards, the system should be able to comfortably sustain growth in the mid-teens levels (Figure 7). In both cases of Metrobank and Security Bank, they have enjoyed loan growth CAGRs over the past decade (ending Dec-18) of 15% and 20% respectively, and we believe they can sustain robust growth rates of 13-15% over the next few years.

Figure 7: Philippine Banking System Loan Growth (yoy)



Source: Bangko Sentral ng Pilipinas (BSP)

Through implementation of the above framework, we have been able to evaluate the fundamental attractiveness of financial businesses in Asia. By focusing on banks with robust levels of capitalisation, well established deposit franchises, solid credit controls and growing and profitable core businesses, we have been able to successfully capture alpha opportunities in this important space in our universe. It is fair to say that this framework steers us towards simple, boring and traditional spread lending banking businesses. While we approach each opportunity with an open mind and independently consider the peculiarities, generally we avoid companies with complex transactional and capital-markets based businesses since we cannot gain sufficient comfort and visibility over such financial operations. Although we have passed on a couple of opportunities that would have yielded considerable alpha to the Fund, we believe ultimately adhering to the discipline of only investing in businesses we understand is a responsible decision for our clients.

Note 1: According to a recent study on global financial inclusion by the World Bank (The Global Findex Database 2017 - Measuring Financial Inclusion around the World), Philippines ranks one the lowest major economies on banking penetration with only 34% of its adult population currently having access to banking services.

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