

INVESTING

Banking stocks fell sharply in December 2015

Banks: Long-term value outweighs the risks

Despite the meaningful risks looming over South Africa's banking sector, the current combination of attractive dividend yields and relatively cheap valuations presents attractive prospective medium-term returns for investors in local bank shares, despite fairly muted earnings growth expectations in the low- to mid-single digits. This is according to Craig Butters, Equity Portfolio Manager and Banking Sector Analyst at Prudential Investment Managers.

Banking stocks fell sharply in December 2015 on the back of the large jump in bond yields in reaction to the surprise firing of Finance Minister Nene, to levels well below their historic valuations. They have remained under pressure due to the increased risk of a downgrade of South

Africa's sovereign foreign currency credit rating to non-investment grade (or 'junk') status.

"Banking shares are pricing in this downgrade risk, and until there is clarity on this – perhaps in the December round of ratings agency reviews – we see limited scope for the banks' valuation multiples to rebound back to historical levels," says Butters. "Currently, banks are trading at a substantial discount of 35% to the overall SWIX index (on a forward price-earnings basis), compared to an average 13% discount since 1990."

Depending on the extent of a likely weakening of the rand on news of a downgrade to junk status, the South African Reserve Bank (SARB)'s monetary policy response could have a profound impact on the banking sector, he explains. To the extent that a weaker currency results in increased

actual or expected inflation, the response by the Monetary Policy Committee in hiking interest rates will be key.

On balance, Butters explains, gradual and measured interest rate increases are positive for banks since they receive higher interest income – as we have seen so far in the SARB's current rate hiking cycle. The gain in interest income generally outweighs the rise in bad loans as more people are unable to repay the higher interest. However, if the SARB responds by implementing large and rapid interest rate hikes, this could increase loan defaults by consumers and impair bank balance sheets.

Another important factor is that South African banks have been much more disciplined in their lending in recent years compared with the 2006-2008 lending spree – and provisions have been far more conservatively struck for potential bad debts down the line. Capital levels are strong, and banks have generally been well managed in the period leading up to a potential sovereign credit rating downgrade.

According to Butters, "On a risk-reward basis, Prudential is overweight with bank shares in our equity portfolios, preferring Barclays Africa and FirstRand, followed by Standard Bank.

We also have exposure to Nedbank through Old Mutual. It is too easy to come to the conclusion that investors should avoid banking shares based on the potential of a sovereign downgrade. Second-order thinking is required during these challenging times. While bank share prices would almost certainly be hit in the short term in the event of a downgrade to junk status, SA banks offer good long-term value and attractive dividend yields at current levels."



Craig Butters

Gradual and measured interest rate increases are positive for banks, since they receive higher interest income



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Is it time to relook at Africa as an investment destination?

Africa has long held a very ambivalent, almost bipolar, place in most investors' minds, with even the most experienced commentators getting it completely wrong.

For example: In the early 2000s the *Economist* magazine's front cover lamented 'The Hopeless Continent', painting a bleak picture of a continent ravaged by war, famine and disease. African equities (MSCI Africa excluding South Africa)

promptly shot up about 8 fold in USD from mid-2002 to the end of 2007, significantly outperforming the MSCI Emerging Markets (up only around 4 fold). Just over a decade later that same magazine boldly heralded 'Africa Rising' and then 'Aspiring Africa' cover stories, which almost perfectly coincided with the top of the market. Since mid-2014 Africa is down almost 30%. Given the importance of commodities, especially

oil, to African economies it should come as no surprise that the last 15 years has seen a close correlation between commodity prices and African equity performance.

Despite sustained, strong GDP growth, even in the face of market volatility, Africa has almost become 'The Forgotten Continent' as an investment story over the past couple of years (which is of course usually a great time for the long-term investor!) and as a result Africa is currently

attractively valued. Using Price to Earnings ratio (PE) as a valuation measure we can see that African stocks are cheap on a 10X PE compared to the 12X for Emerging Markets, and 18X for Developed Markets. On this measure South Africa looks quite expensive, also on an 18X PE.

It is also probably worth pointing out, to South African investors in particular, that not only is Africa significantly cheaper than South Africa, but even

in the face of a significant commodity spawned bear market over the past two years, African equities have still managed to outperform South Africa by almost 18% in USD over the past few years. Going forward the IMF expects Africa (ex SA) to grow at close to 4% per year over the next two years, compared to South Africa's anaemic sub-1% growth.

While it is impossible to correctly call the peaks and troughs of commodity prices, the fact that we appear to be at, or near, the bottom for oil prices in particular, coupled with strong GDP growth and attractive valuations, suggests that now may indeed be a very good time to relook at Africa.

African equities have still managed to outperform SA

