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EQUITIES

Emerging Market Banks: **Promise Amid Skepticism**

Past volatility may make investors pause when considering financial stocks in Asia, but we believe that the burgeoning Asian middle class can support long-term growth for financial firms in this traditionally underbanked region.

For many investors, emerging markets are an enigma that epitomizes the dichotomy between risk and reward. While these markets offer growth potential supported by secular tailwinds, these are also historically volatile markets and factors such as liquidity problems, political risks, weak regulations and currency instability compound investors' fears of negative surprises.

While the risks in emerging markets merit consideration, we focus on finding emerging market companies with a meaningful competitive edge, in the belief that such firms can better weather any short-term challenges in their markets and thrive over the long term. In particular, we see strong potential for companies that are well-positioned to serve members of the growing middle class in emerging economies, many of whom will be accessing a variety of services, such as banking and other financial services, for the first time (see chart).

Three financial companies discussed in this article—Housing Development Finance Corporation Bank (HDFC), AIA Group Limited, Inc., and Bank Rakyat Indonesia—are, in our view, excellent examples of firms poised to capitalize on the long-term secular emerging markets opportunity. Each is generating roughly double the return on assets of typical high-quality banks in developed countries, and each possesses attributes that we associate with successful emerging market growth investments.

The **Housing Development Finance Corporation Bank** (HDFC) is a private Indian bank that provides personal, non-resident Indian (NRI), and wholesale banking to its customers.

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In a country where approximately 70% of the market is controlled by state-owned banks, HDFC Bank distinguishes itself by building a differentiated franchise that focuses on high-yield retail products. Many Indian banks are burdened by government interference, offering their customers limited service while relying on outdated processes and technology, whereas HDFC offers a broad suite of online resources which connect customers to modern resources and products. In addition, HDFC has a proven track record of maintaining strong credit quality throughout the credit cycle. Its established position in an underpenetrated domestic market, combined with a prudent approach to credit underwriting, provides HDFC with what we believe is an opportunity to generate meaningful returns for many years to come. Beyond the online product suite, the bank is also turning gains from technology infrastructure into cost-cutting measures to improve its overall fiscal health.

We see **AIA Group Limited, Inc.** (AIA) as another company with strong advantages in emerging markets. AIA is one of the largest life insurance providers in Asia, and a top-three provider in key markets such as Hong Kong, Singapore, Thailand, and China. AIA's competitive advantage stems in part from an unparalleled agent network in Asia that allows it to address many underserved local markets. We believe AIA's life insurance database, one of the largest in Asia, better enables it to price risk. The company is led by a well-respected management team with an intense focus on creating shareholder value. While China is a major driver of new business at AIA, we believe that the firm's bias toward high-quality, protection-oriented policies steers it away from riskier policies in China and elsewhere and generally helps AIA remain structurally sound. Despite growing fears of a potential Chinese slowdown and concerns about a credit crisis, AIA remains well positioned as the market leader of pan-Asian insurers.

> **"Key competitive advantages separate these companies from their peers and provide an interesting case study on how we evaluate growing emerging market companies and identify their unique attributes."**

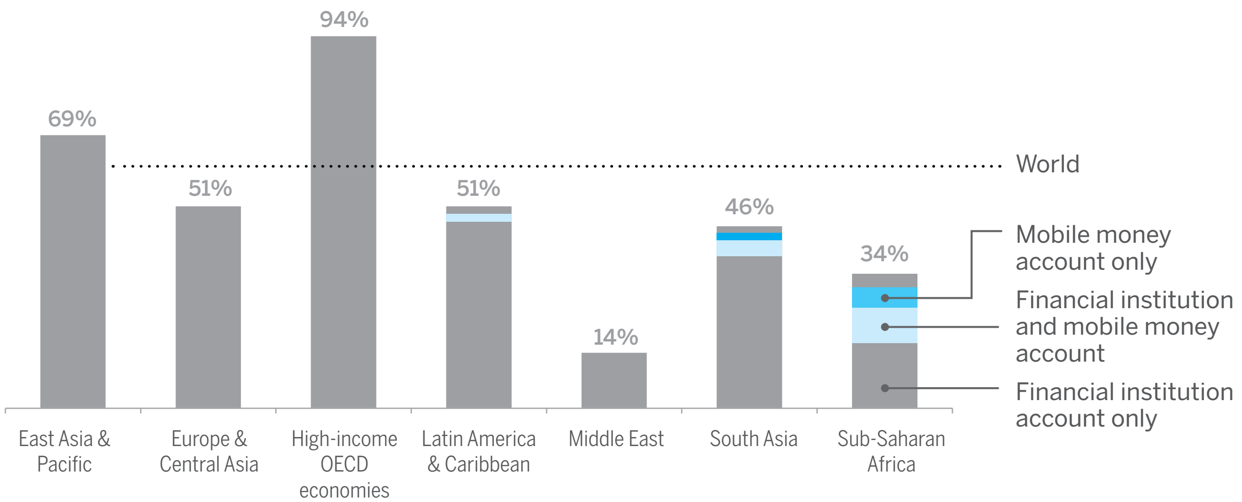
Finally, Indonesia's **Bank Rakyat** has found innovative ways to tap into non-traditional growth drivers. Founded in 1896, Bank Rakyat has been partially government-owned since Indonesia's independence in 1950, and has played a critical role in promoting the government's social agenda by advancing subsidized credit for rural enterprises. Indonesia has very low levels of financial services penetration, and thus its rural population is largely unbanked, with no real access to the modern financial sector except through microlending. Bank Rakyat is a crucial lender to the informal economy in these rural region and leads the Indonesian microfinance market. Through this role it has generated approximately a 25% return on equity over the past five years. Its rural credit infrastructure, combined with a community-based approach to lending, creates a difficult-to-replicate formula that creates a wide competitive moat and low levels (<1.5%) of non-performing loans. We believe that Bank Rakyat is well positioned to produce long-term growth, driven by increased adoption of its credit offerings by this largely unbanked population.

All three of these companies benefit from unique competitive advantages within their respective markets. While the overall macro outlook for some emerging markets may seem negative, using a bottom-up, fundamental research process helps us identify companies that are well-positioned to capitalize on important trends and succeed over the long term.

Serving the Underserved: The Emerging Market Banking Opportunity

A 2014 study of global banking trends showed growth in the percentage of citizens in emerging markets with access to banking services. While the number of "unbanked" citizens has fallen, banks still have a tremendous opportunity for emerging-market growth—in many regions, well over half of the population still has no relationship with the modern financial sector.

PERCENTAGE OF ADULTS WITH A BANK ACCOUNT, BY REGION (2014)



Source: Global Findex database.
The information in this database was collected in partnership with the Gallup World Poll and funded by the Bill & Melinda Gates Foundation. The 2014 study is the most recent Global Findex study.

ROE, or Return on Equity, is equal to a company's net income for a full fiscal year, divided by total shareholder equity.

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