

A VIEW FROM ASIA



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- A US government determined to keep the fiscal spigots open has lifted expectations of inflation, long bond yields and commodity prices.
- Banks are earning better-than-expected net interest margins while non-performing loans are significantly lower than expected.
- These trends provided the motivation for me to change my view on banks and in particular to buy State Bank of India (SBI).

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Review: a formal assessment of something with the intention of instituting change if necessary

In the past two years I have focused intensely on the aspects of my process that I felt needed attention. There were two areas in particular. Firstly, to be quicker in deciding to sell out of poor performing stocks or broken business models (after thorough analysis). Secondly, to revisit my held beliefs or opinions when evidence pointed to the contrary.

I have changed my mind on financials (as you can observe from the increased level of exposure in our portfolio). Looking back, the major impact on lives, economic activity and stock markets as a result of Covid-19 came in March-May 2020. At that time I concluded that banks were amongst the worst investments to make. I hypothesised they would become a de-facto arm of governments – forced to extend credit, asked to delay recognition of non-performing loans (allowing zombie companies to survive) and repressed in profitability through lower margins. At a macro level, I thought, with loose monetary policy and stagnant economic activity, deflation might be entrenched.

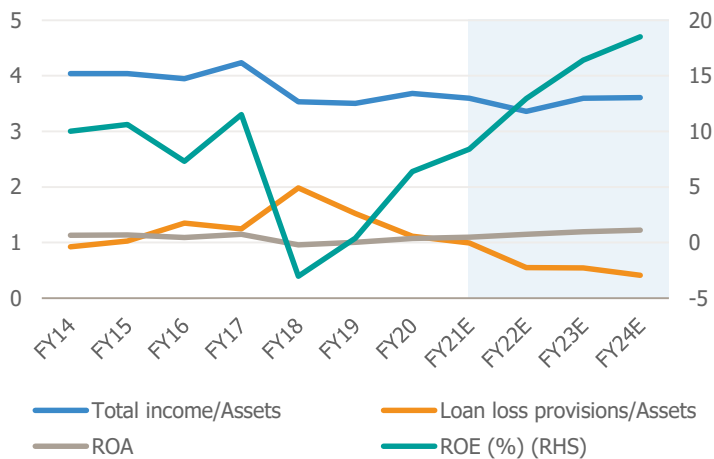
Clearly, many of those beliefs needed questioning. Contrary to my expectations, the US government is determined to keep the fiscal spigots open; far wider and for longer than most expected. The next part of its fiscal spend is on infrastructure – it is unclear how much will get legislative approval but the intent is clear. A combination of these trends has lifted expectations of inflation (and long bond yields) along with commodity prices. For several commodities, supply constraints have also contributed to higher prices. Many asset intensive businesses associated with commodities had losses in the past. They have turned profitable in a big way. Banks are earning better-than-expected net interest margins- higher interest rates help. Concurrently, non-performing loans (NPLs) are significantly lower than expected, especially from their most problematic sectors.

That in effect was the motivation for me to change my view on banks and in particular to buy State Bank of India (SBI). For decades, I had conditioned myself in not owning a public sector bank in any country, especially in India. Poor management beset with government interference, antiquated technology and perennial losses due to inadequate risk controls did not make for a strong investment case. Yet in SBI, we observe significant changes to governance, attitudes to risk and the adoption of technology. SBI launched a consolidated finance app called YONO in November 2017, which has become not just an avenue for customer acquisition but also a platform to cross-sell services. Only two of its subsidiaries, SBI Cards (which we also own) and SBI Life Insurance, are listed. But there are other equally value-creating subsidiaries in broking/general insurance and asset management. On a consolidated basis, SBI seems to be heading down the road of finally solidifying its brand advantage.

To give you a sense of progress in terms of its financial metrics, SBI has grown its retail portfolio at a compound annual growth rate of 22% over the last five years and has expanded its market share from 17% in FY15 (in total retail loans) to 23% in FY20. In mortgages, SBI's market share went from less than 15% in FY08 to 23%. Technology has driven improved turnaround times in processing loans, a better marketing strategy, and enhanced its focus on cross selling by better using its digital channels

such as YONO. The retail business currently generates c.150bps of return on assets (ROAs), in my opinion. If growth continues at its current pace, SBI's consolidated ROAs could improve by up to 50bps in a couple of years. Higher retail assets lend earnings stability while demanding lower capital requirements.

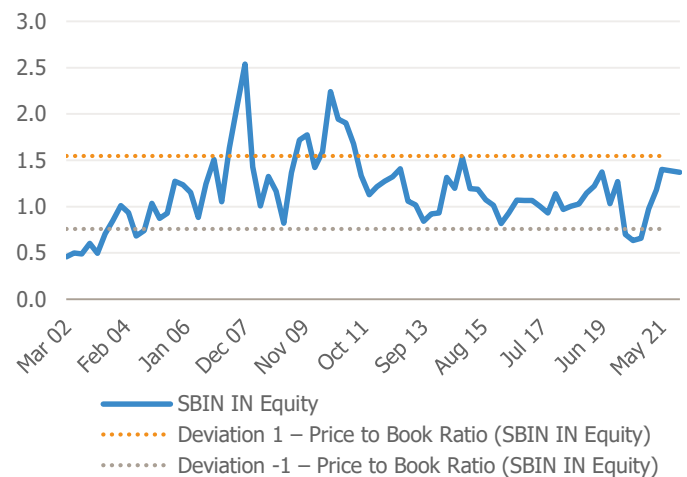
Finally a turn: State Bank of India ROA's



Source: Goldman Sachs estimates / Bloomberg.

In almost every bank, what shareholders care about most is growth with measured risk. The past three decades are littered with established and upshot financial institutions who thought they had discovered a better mousetrap and grew loans with gay abandon. Many have ended up bankrupt or in the arms of the state. In India, the case of Yes Bank was similar. Dubious management practices, growth at any price, the desire to show an 'asset-light' growth model and conducive capital markets for Yes Bank made it look like a star. In 2018/2019, following the IL&FS crisis in India, Yes Bank finally met its demise. I wrote some time ago that in true bumbling bureaucratic manner, the government called upon SBI to rescue the depositors. This still remains the biggest risk for SBI – the arm of the state extending out to collect the detritus of other's mistakes. Despite all my misgivings expressed last year, the financial system in India is relatively more stable today, in part thanks to the vast amounts of liquidity floating in the world, better global demand and higher profitability. The probability of another large bank failing in India in the next three years seems low, but I remain alert to that possibility. The other risk is more alive- waivers of loans to farmers, poorer segments of society and SMEs. Whose money is it anyway? Politicians will resort to populist measures to appease voters, especially in India where Covid-19 and mismanagement have laid bare the vulnerabilities of the country's governance and infrastructure. I can only take solace in the fact that SBI management has learnt from the past – they are pushing into retail, mostly housing loans and using technology for risk controls better than in the past. Finally, it's the valuation. Not only is SBI still cheap relative to its own history, but if my expectations are right, SBI's absolute valuations should re-rate and close the gap versus some of its bigger private sector peers.

SBI – Price/Book



Source: Bloomberg.



JOHCM Asia Ex Japan Fund
5 year discrete performance (%)

Discrete 12 month performance (%):

	31.05.21	31.05.20	31.05.19	31.05.18	31.05.17
A USD Class	62.78	5.95	-10.51	0.46	22.47
Benchmark	50.60	-0.51	-11.00	17.09	28.13
Relative return	8.09	6.49	0.55	-14.21	-4.41

Past performance is no guarantee of future performance.

Source: JOHCM/MSCI Barra/Bloomberg, NAV of Share Class A in USD, net income reinvested, net of fees as at 31 May 2021. The A USD Class was launched on 30 September 2011. Benchmark: MSCI AC Asia ex Japan NR (12pm adjusted). Performance of other share classes may vary and is available on request.

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