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# Hostile banking

No staycation for Mr. Market this year. Adventure in foreign parts is rather to his taste. Since January, the quoted value of the iShares MSCI Emerging Markets ETF has jumped by 37%, to $29.2 billion. Wall Street, with a nod to the Old Testament, once designated these countries as "waste places." Now, with reference to ZIRP, it calls them "places where you can maybe pick up a few stray basis points of yield if you look hard enough." Banks in Saudi Arabia and Russia figure bullishly in the narrative. Oil plays a supporting role; Turkey, Iceland, South Africa and India make cameo appearances.

Almost one year ago in these pages, Russell Napier identified Turkey as the biggest risk among 24 emerging nations (*Grant's*, Aug. 7, 2015). It was clear that he was on to something even before the failed July 15 coup d'état.

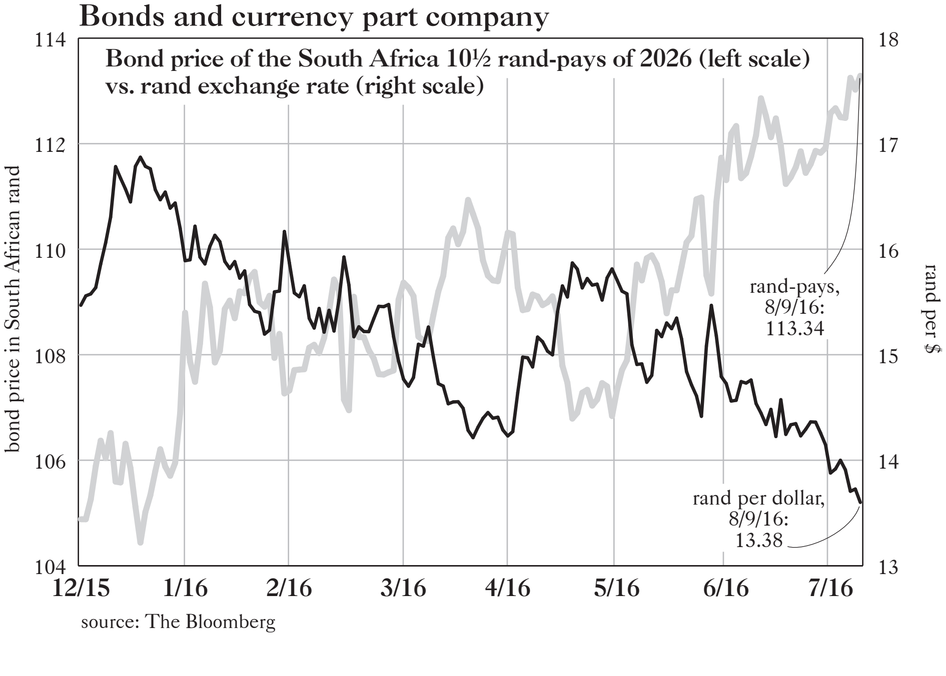
Slumping tourist traffic, rising inflation and a bulging trade deficit had already featured in the pre-coup headlines. In a July 19 blog post, Brad Setser, a senior fellow at the Council on Foreign Relations, likened Turkey's macroeconomic profile (big current account deficit, modest foreign-exchange reserves) to that made familiar by the emerging-markets crises of 1997–8. To which the economist added, "Turkey's external funding need—counting external debts that need to be rolled over—is about 25% of GDP, largely because Turkey's banks have a sizable stock of short-term external debt."

What ensued was a stifled yawn. The Turkish lira has actually rallied by 1.6% against the dollar since fighter jets roared over Istanbul. Yes, the Borsa Istanbul 100 Index has dropped 5.2% in lira terms and the yield on Turkey's 10-year dollar-denominated government bonds has inched higher by 45 basis points, to 4.43%. Even so, in the year to date, Turkish stocks are up 7.6% in dollar terms and the yield on the Turkish dollar-pay 10-year note has dipped by 61 basis points.

Colleague Evan Lorenz reached Napier by phone and renewed last year's question: "What are your biggest concerns in emerging markets today?" "Capital controls," came the reply. "I lived through the Mahathir [Mohamad] period when Mahathir implemented capital controls [in Malaysia on Sept. 1, 1998]," said Napier, independent strategist and the co-founder of Electronic Research Exchange. "My phone started ringing—I was doing the same job I do today. Clients asked me, 'What shall we sell? We have to sell something. We are getting redemptions, and we can't redeem Malaysia. What else can we sell, and who else is likely to put on exchange controls?' It changed people's perception. When you deliquefy what everyone believes is a liquid market, then you start to get real problems where people start to liquefy other things."

In recent years, Azerbaijan, Iceland, Greece and Cyprus have each deliquefied—in one form or another each has stifled the free movement of funds. The international fallout has been commensurate with the countries' diminutive sizes (Greece is the largest of the four with GDP of $195.3 billion and $35.4

Bonds and currency part company



source: The Bloomberg

billion in stock-market capitalization). Capital controls in Turkey—a nation with a $734 billion GDP and $189 billion of stock-market value—might prove a more explosive matter.

Investment risk is relative. What with a certain pair of American presidential candidates, Brexit and the rise of European populism, the politics of the emerging world suddenly don't seem so risk-fraught. Then, too, famished investors reason that some yield is better than none. (Less than none is currently on offer in many an "advanced" sovereign debt market).

Still, we wonder if Mr. Market isn't whistling by the graveyard. South Africa, whose jobless rate tops 26% and whose GDP is marginally contracting, has just had an election. Nelson Mandela's party suffered its worst defeat since the end of apartheid in 1994. A pro-enterprise party, the Democratic Alliance carried Mandela's old hometown. The disciples of Adam Smith will cheer this news and may even be inclined to buy the rand. Two problems present themselves. No. 1, the third-place finisher in the South African national elections is a Marxist party called Economic Freedom Fighters. No. 2, the rand (up 15.2% vs. the dollar in the year to date) and South African sovereign debt (the 10½s of 2026 have rallied by 24.5% in dollar terms in the year to date) have already celebrated.

"If you were to look at the political aspect, you would see a lot of these countries' impediments to doing what would seem to be the right set of reforms," Francis Daniels, co-founder and director of Africa Opportunity Partners, tells Lorenz. "I think from time to time people will be reminded that the enthusiasm was more euphoric than realistic." Standard & Poor's will have something to say about that in December when it passes judgment on South Africa's sovereign debt rating, which is wobbling at the low end of investment grade. The risk of a demotion to junk would not seem to be priced into the market.

If momentum is your emerging-market M.O., observe that the major equity indices in Brazil, Peru and Hungary have registered 2016 returns, in dollars, of 67.7%, 60.5% and 20%, respectively. Value-seekers may rather attend to the laggards. The Saudi Arabian Tadawul All Share TASI Index, down 7.6% in the year to date, also in dollar terms, is one of these underachievers. Only the Shanghai Stock Exchange Composite Index (off 16.6%), the Athens Stock Exchange General Index (down 8.9%) and the Prague Stock Exchange Index (down 8.3%) have fared worse. On a 12-month basis, the Tadawul stands with the Shanghai Composite. In dollars, both have plunged by 28%.

You don't have to look far for the reasons. Oil is one, of course. Political risk is another. Political revulsion might be counted a third. Not every American investment committee is prepared to roll out the welcome mat for Saudi Arabia (the country is off-limits to foreign individuals).

"Better days are coming," Lorenz relates. "The Saudi equivalent of the SEC, the Capital Market Authority, is expected to ease foreign investment restrictions as early as next month. Once upon a time, a foreign institution had to have $5 billion in assets in order to participate; now $1 billion is the AUM hurdle, and even that can be waived if an investor is willing to make Saudi Arabia a 5% portfolio position. The cap on foreign ownership on any particular stock is expected to be lifted to 49% from 10%, also as early as next month. In the works, too (perhaps in the first half of 2017), is the extension of trade-settlement times to T+2 from T+0. On-the-spot settlement means that an investor in Saudi Arabia must have a Saudi bank account."

With a $617 billion market cap, Saudi Arabia clearly belongs in the emerging-market category. All that remains is for that fact to be registered in the MSCI Emerging Markets Index—for now, Saudi Arabia is excluded, as is China. An analyst at Passport Capital tells Lorenz that, in his firm's view, there are major incentives for MSCI to place Saudi Arabia in the index: "1) a desire to diversify the index with more non-Asia economies, and 2) a desire to include Saudi as the region's largest and most liquid market."

It's likely only a matter of time before China, with its $6.3 trillion market cap, passes muster with MSCI. Come that day, the Emerging Markets Index will tilt heavily to the People's Republic. Should the index-maker feel the need to counterbalance China, the Saudi market would prove a helpful offset.

Even without Aramco, the Passport analyst adds, Saudi could represent 3% to 4% of the index, which would—that is, could—translate into $28 billion to $35 billion of inflows into the Riyadh market. No less than $1.5 trillion is tethered to the MSCI Emerging Markets index.

National Commercial Bank, locally known as AlAhli Bank, is one of the more attractive Saudi value propositions—at least, so we judge at our immense remove from the scene of the Arabian action. The biggest Saudi bank, with June 30 assets of 452.7 billion riyals ($120.7 billion), NCB owns the first Saudi banking license. Its vital signs are positive: Equity constitutes 13.2% of its assets, loans amount to 86% of its deposits and nonperformers foot to 1.4% of total loans, while provisions cover slow loans by 145%.

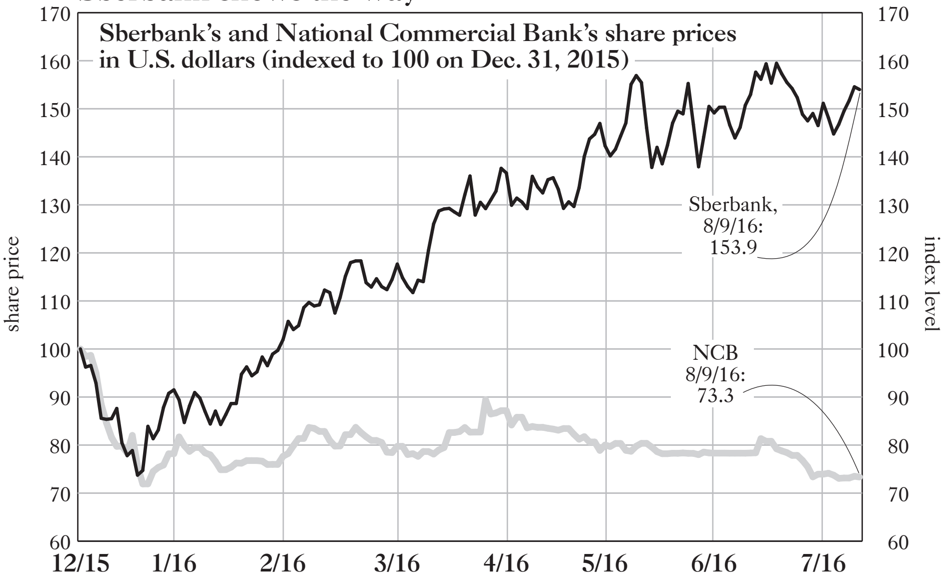
NCB has operations outside of Saudi Arabia—including a 67% interest in the Turkish bank Türkiye Finans Katilim Bankasi—but the kingdom furnished 89% of assets and 77% of earnings in the second quarter.

## Emerging stock markets pop
### Year-to-date returns in local currency and U.S. dollars

| Country | local FX (%) | USD (%) | Country | local FX (%) | USD (%) |
|---|---|---|---|---|---|
| Brazil | 33.1 | 67.7 | South Africa | -0.6 | 14.6 |
| Chile | 12.7 | 22.4 | Turkey | 9.5 | 7.6 |
| Colombia | 14.8 | 22.0 | UAE | 11.8 | 11.8 |
| Mexico | 10.8 | 3.4 | China | -14.5 | -16.6 |
| Peru | 55.4 | 60.5 | India | 7.5 | 6.6 |
| Czech Republic | -10.4 | -8.3 | Indonesia | 18.4 | 25.2 |
| Egypt | 16.4 | 2.7 | South Korea | 4.2 | 11.2 |
| Greece | -10.9 | -8.9 | Malaysia | -1.2 | 5.7 |
| Hungary | 15.4 | 20.0 | Philippines | 15.9 | 15.8 |
| Poland | 3.9 | 6.3 | Taiwan | 9.8 | 15.1 |
| Qatar | 4.7 | 4.7 | Thailand | 20.2 | 24.2 |
| Russia | 11.1 | 25.3 | Saudi Arabia | -7.7 | -7.6 |

source: The Bloomberg

**Sberbank shows the way**




source: The Bloomberg

Before the oil price plummeted, NCB was earning 20% on equity. In the second quarter, ROE weighed in at 17.1%. The bank's profitability is not strictly its own doing. The Saudi Arabian Monetary Agency (SAMA) has approved only 12 domestic-banking licenses and allows only 12 foreign banks to have branches in the kingdom.

"It is a gated sector," says the Passport analyst. "No one can start another bank. All of these 12 banks seem to be too big to fail. If you go back to 2008, the Saudi central bank immediately injected liquidity into the system without seeing any signs of risk. They did that as a preemptive action. If you look at the past 30 years of banking data, a lot has happened, but not a single Saudi bank failed."

The oil-price break has plunged Saudi Arabia into its very own kind of 2008. The kingdom's budget has swung from a 5.8% surplus in 2013 to a 13.5% projected deficit in 2016 (an improvement from the 16.3% shortfall in 2015). To make ends meet, Riyadh has liquidated foreign currency reserves (the national monetary mountain was reduced to $570.1 billion in June from a peak of $745.9 billion in August 2014), withdrawn deposits in Saudi banks and issued bonds.

These actions have drained deposits from Saudi banks and boosted the three-month Saudi money rate to 2.25% from 0.77% in early 2015. SAMA responded to funding problems in late June by offering 15 billion riyals' worth of liquidity at discounted rates. While NCB's balance sheet has weathered this better than most Saudi banks have, the NCB share price has not. After a 26.7% drop in the year to date, the stock is quoted at 8.1 times trailing earnings and 128% of book value; it yields 3.2%.

"In more ways than one," Lorenz observes, "NCB resembles Sberbank, the largest bank in Russia (*Grant's*, Aug. 7, 2015). Both institutions have struggled in the oil bear market, Sberbank with other, Putin-specific difficulties such as western sanctions. After rallying by 55% in dollar terms this year, Russia's top bank trades more or less where NCB does, at 9.7 times trailing earnings and 121% of book value; it yields 1.4%. Sberbank's preferred shares, tradable only in Moscow, change hands at 6.9 times trailing earnings and 86% of book value; they yield 2%.

The comparisons don't stop there. Like NCB, Sberbank is well-capitalized (equity amounts to 9.4% of assets) and reasonably liquid (loans foot to 104% of deposits). Provisions amply cover hefty (5%) nonperformers (by 125%). Russia is thriving even less than Saudi Arabia: In 2015 Russian output contracted by 3.7%, and another 1.8% decline is projected for 2016. No surprise, then, that Sberbank's return on equity has slipped, to 13.5% in the first quarter from 20.8% in 2013. On the bright side, Sberbank's NPLs might be peaking (as J.P.Morgan Cazenove analyst Alex Kantarovich ventures). If so, future earnings could get a lift from lower provisioning.

NCB and Sberbank share a notable resiliency to what might be termed exogenous difficulties. "As has been widely reported, Saudi is in a proxy war with Iran in Yemen and Syria," says the Passport analyst of NCB's part of the world. "ISIS is in Iraq and has an underground presence in Saudi. Succession and other challenges with the royal family have been a concern. Brent is down 58.5% since June 2014."

"Issues," indeed. Saudi Arabia's complicitness in 9/11 and Russia's annexation of Ukraine have pushed them close to the bottom of the list of most-desired American investment destinations. Then, again, it wasn't Sberbank (we think) that hacked the Democratic National Committee. The bank has rather been on the receiving end of digital assault.

In 2014, relates Boris Zhilin, cofounder of Armor Capital (and a holder of Sberbank preferred), "there were coordinated hacking attacks on the bank. Clients were receiving SMS messages saying that the next day Sberbank banking cards would be frozen. They lost about a trillion rubles in deposits in a week, and deposits were fleeing from all channels. Every channel was overloaded by a factor of 10: ATMs, online banking, mobile banking, branches. Then, on top of that, the refinancing rate got hiked from 9% to 17%. The ruble collapsed. They presumably were a lot less prepared for a shock of this magnitude in 2014, and they didn't lose money in a single quarter. They were profitable in both Q4 2014 and Q1 2015."

Sberbank CEO Herman Gref described the deposit flight in an Oct. 22, 2015, analyst meeting. "[A]t that point," he said, "all the things that were our strong suits became our liabilities, things that started to work against us. People started taking money out of us through all the outlets that were available—ATMs, branches, etc. We had not ever been able to imagine, in any stress test, that people can take that much liquidity away from us that quickly. Within one week, Sberbank paid out in excess of RUB1.3 trillion [approximately 8.3% of deposits], and that was a dramatic moment for us."

Sberbank survived those perilous times to become one-half of the entire Russian banking system. The plethora of empty bank storefronts in Moscow is testament to the competitors that have fallen by the wayside. ("More than 30 percent of Russian lenders have been labeled as mismanaged or under-capitalized and shut down since Bank of Russia Governor Elvira Nabiullina took over in 2013," Bloomberg reported on Aug. 5.)

"It has been quite remarkable how quickly earnings and ROEs have normalized," Zhilin reflects. "Granted the year is not over and you never know what the second half brings, but assuming no major dislocations of any kind, I think Sberbank is on track to report an ROE of around 19% and earn probably about 20 rubles per share in 2016 [Sberbank common and preferred are priced at 139.20 and 99 rubles]."

Still, some might ask, Why bother? Why stretch for returns when stretching is de rigueur? Why not settle for the Dodd-and-Franked, too-big-too-fail American banks like JPMorgan Chase & Co. or Wells Fargo & Co., institutions not extravagantly valued at 105% and 141% of book?

"They may be safe," replies Lorenz, "but they earn relatively pedestrian returns on equity, 9.9% for JPM and 12.2% for Wells Fargo. The U.S. banks with high exposures to the oil patch seem not much more attractive. Hancock Holding Co. and Texas Capital Bancshares, Inc. trade at 98% and 137% of book and generate ROEs of 3.9% and 8.2%, respectively (*Grant's*, Nov. 27). European banks trade at discounts to book value but are far less well capitalized than their American (or Russian or Saudi) peers. DNB ASA, of Oslo, and UBS Group AG, of Zurich and Basel, trade at 82% and 94% of book value and have equity-to-asset ratios of 7.3% and 5.9%. JPMorgan and Wells show equity-to-asset ratios of 9.4% and 9.5%. While DNB generates a 12.3% return on equity, the bank does business mainly in Norway, a country with bubblish housing prices and where household-debt-to-disposable-income towers at 227.3%. UBS generates a 9.2% return on equity."

Besides—for those inclined to stretch—NCB and Sberbank offer a kind of embedded call on the price of oil. At the *Grant's* Spring Conference, David D'Alessandro laid out the bull case for crude. The oversupply about which the market was preoccupied was fading fast. By Christmas, growth in demand of at least 1.5 million barrels a day would swamp the beginning-year overproduction of 600,000 to 750,000 barrels per day. Result: a year-end deficit of one-plus million barrels every day.

Four months later, draws from American storage have proven underwhelming. And as they constitute the world's chief window on oil demand, the price of oil has barely risen since D'Alessandro spoke—to $45.01 from $44.18. Persuaded by him at the time, we remain bullish. Perhaps oil reserves are dwindling in countries where the data are less frequently disseminated (and/or accurately measured) than the ones produced by the U.S. Energy Information Administration. And maybe production is not all it's cracked up to be in Nigeria. Let us say, for argument's sake, that the bull case is intact.

"Then contrast," Lorenz proposes, "our two value nominees with Wall Street's preferred emerging-market banks. The Street's favorites are FirstRand Limited and HDFC Bank Limited, the third-largest banks by assets in South Africa and India, respectively. FirstRand trades at 13 times trailing earnings and 293% of book value. HDFC Bank Limited trades at 24.5 times trailing book and 424% of book value. In the six months ended Dec. 31, FirstRand generated a 24.3% return on equity. In the 12 months ended March 31, HDFC produced an 18.6% return on equity. Which is to say, NCB and Sberbank generate similar ROEs to FirstRand and HDFC but trade at a fraction of the book value of those institutionally blessed banks."

The South African economy is slowing. Beyond the weak employment backdrop, according to the previously quoted Francis Daniels, government wage increases have lagged behind inflation and a drought has ravaged the earnings of lower-income consumers. "Interest rates," says our on-the-ground source, "even though they've paused, are generally in an upwards trend. In fact, Barclays Africa came out with its results and reported that we are seeing an uptick in mortgage arrears." FirstRand reports on Sept. 8. If the bank sees the same decline in credit quality as Barclays Africa, the mainstream darling may miss sell-side expectations.

India is a very different proposition. Passage, on Aug. 3, of a much-heralded law called the Goods and Services Tax promises a boost to long-term Indian growth. Still, India, a net importer of oil, has gained from the collapsed crude price. A reversal in that price could dent consumer spending and otherwise complicate life for a bank that is priced for clear sailing.

"Growth," Lorenz points out, "is a key part of the HDFC story. In the year ending March 31, the Indian bank boosted its assets by 20%. Between the first quarters of 2015 and 2016, Sberbank grew only half as fast. The bulls may hope that, for the Russians, past may be prologue. From 2010 through 2013, Sberbank expanded its balance sheet at the rate of 28% a year. Sberbank may not be priced for growth, though that is not to say that growth can't return when oil prices recover. HDFC is priced for growth, which may recede when oil prices bounce back."

Words unlikely to be heard anytime soon in the deliberations of a self-respecting investment committee: "Let's trade out of FirstRand and HDFC and leg into the top banks of countries that the patrons of this institution love the least." Make no mistake, emerging markets are the flavor of the season, and the season is aging. Still and all, pariah investments are the ones that not infrequently deliver the goods.

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