Samir Mehta, JOHCM Asia ex Japan Fund

A VIEW FROM ASIA

AUGUST 2020

Malleable – (of a metal or other material) able to be hammered or pressed into shape without breaking or cracking

Banks and non-banking financial companies (NBFCs) are, in my opinion, a poor investment in a post-Covid-19 world. I doubt whether most will be able to generate sustained long-term earnings growth or even a fair return on capital. The pandemic has exacerbated the difficult position banks find themselves in. Here are a few reasons which explain my thinking:

1. Lower interest rates usually lead to lower net interest margins; we are unlikely to see interest rates rise in a hurry.
2. Covid-19's impact has been severe, resulting in elevated and extended non-performing loans (NPLs); the normalized charge-off rates are likely to remain high. This could mean materially lower internal generation of capital; many banks will have to raise new capital.
3. Governments will nudge or insist that banks provide extended forbearance to customers in default without adequate compensation; banks will be asked to bear or share the burden of helping society at large.
4. Disinflation or deflation is not conducive for leveraged entities; banks are amongst the highest leveraged businesses in the world.
5. Technology disruption might affect banks where it hurts most; some of the most profitable fee businesses might be lost to tech platforms.

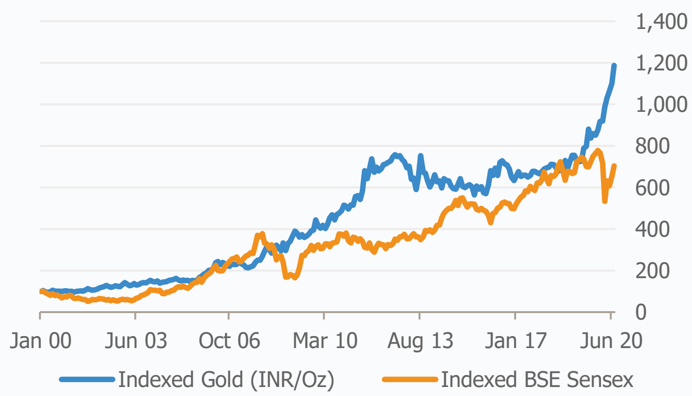
Yet, that does not imply every financial firm is likely to be a poor investment. You may notice that I do own financials in the Fund. I want to highlight one in particular, Manappuram Finance (MF), which I bought recently.

In essence, MF is a gold loan provider in India. One of the lessons from analysing lending firms is this simple premise – own those who lend against an asset whose value is likely to rise over time. This can be a recipe to largely 'idiot proof' the investment decision. You may immediately notice the risk in this approach – 'an asset whose value is likely to rise' is the call one has to make. If that call is correct, the loan to value (LTV) ratio falls through price action and provides a cushion for the lender in terms of the rising value of the collateral held on behalf of defaulting customers.

Mother knows best

Gold is one of the best performing assets this year. If you are in the camp that believes central banks are debasing fiat currencies, gold's function as a store of value is paramount. This is particularly true for emerging markets like India. I'll let you in on a family secret. My father has been a stock market investor for many years. My mother on the other hand would resolutely only buy gold jewellery with her savings. For years my father and I would try to persuade her to switch to stocks (which we contended were a much more lucrative investment). My mother's defining comment was "I can't wear your share certificates" and that was the end of the discussion. Today, my mother is smug in the knowledge that she not only enjoyed her ornaments but I grudgingly accept that my mother has been a shrewder investor than my father and me.

Who is the smarter one now?



Source: Bloomberg.

This ingrained belief in gold is a feature that defines not just Indians but citizens across several emerging markets. Through history, many countries have pursued policies which materially depreciated their currency; the mindset of the populace is conditioned to preserving the US dollar value of their savings. Gold represents the best proxy for this approach. According to the World Gold Council's November 2019 report, over 2009-2018, India accounted for approximately 23% of global gold demand.

The unorganised sector in EM

One characteristic of emerging markets is the preponderance of the unorganised sector. This provides a long runway for growth in the organised sector which normally is better managed and capitalised. Gold lending is also in the same bucket. According to a KPMG report on gold lending, close to 65% of loans against gold in India are still in the unorganised sector where rates charged by the lenders are exorbitant (45-100% p.a.) while procedures to avail a loan are manual and archaic. The organised sector helps reduce rates (as they themselves access funding from banks or commercial paper markets) and has taken advantage of technological developments to help digitise the whole process from applications to disbursement. Security of gold collateral is another critical part of the business – the organised sector is much better than this - banks usually use the branches whereas some NBFCs have set up electronic safe deposit boxes, a move that has helped reduce costs of security personnel as well.

Large aggregate holdings of gold and the rise in its value is just one part of the positive outlook for gold lenders. With the Indian economy struggling under Covid-19-induced lockdowns, business closures and migration of workers to villages, there has been widespread losses in individuals' income. This unfortunate set of circumstances provides the demand pull for loans. According to a World Economic Forum report in Jan 2019, there were approximately 220m households in India with less than US$8,500 of annual income, of which **127m households had less than US$4,000 annual income**. This was before the economic downturn we face today. It is unlikely that the banks or NBFCs might step in to fill the void for unsecured lending, especially since the financial sector itself is reeling from the effects on their overall portfolio. It seems to me that the potential for loans against the collateral of gold becomes a very attractive option for lenders.

With this as a backdrop, companies like MF are in a good position to take advantage of the growth opportunity with controlled risks. The company has been in operation since 1992, with 4,600 nationwide branches. During 2008-12, MF and the gold loan industry enjoyed supernormal growth. The Reserve Bank of India had allowed gold lending to qualify under the Priority Sector Lending (PSL) scheme (banks have to meet a certain percentage of their loan book for vulnerable and underdeveloped parts of the economy). Bank loans to NBFCs like MF would qualify for PSL and this resulted in an abundance of funding for MF. The loan to value (LTV) ratio was pegged at 85% for gold loans which, in a rising gold price environment, was not a risk. In those gung-ho days, the total loans granted by MF grew by five times in five years.

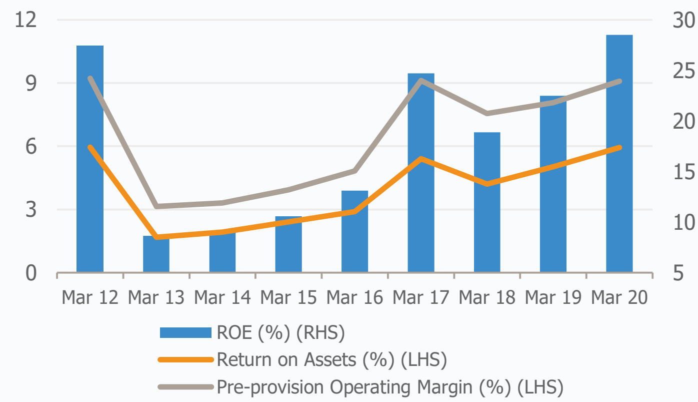
The RBI clampdown

Then came the RBI clampdown. 2012-14 were tough years for MF as the RBI withdrew the PSL benefit and reduced the LTV to 75% in an effort to slow down and better regulate the industry. It also coincided with a fall in the price of gold. As you can see from the chart on the right, the net interest margin, return on asset and return on equity ratios were decimated for MF.

This was a blessing in disguise. It forced MF to diversify its funding source, but, importantly, it forced the company to start offering shorter tenor loans of three to nine months (this helps mitigate price volatility). The net effect was a dramatic reduction in the risks – both against the potential of a falling gold price as well as volatility in funding markets. The demonetization in India in 2016 forced the company to embrace technology more quickly. As part of that exercise, the company has focused on areas of cost reduction while enhancing the technological platform for customers. The last three years have put the company on a fundamentally and technologically sound footing. The results are evident in the chart on the right.

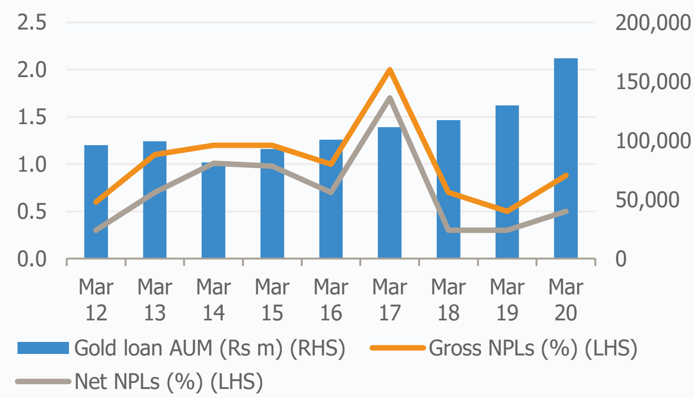
These two distinct periods of challenge have brought out the malleable qualities of the management and the business. The tests of dealing with myriad risks that a lending institution can face has pushed MF to come out as a much better business. I still have to be open to regulatory risks – the RBI did cap the margins of micro finance lenders to 10% and there is a possibility that it might target the gold lenders in case there is huge growth. However, with the economy in the shape it is, the RBI's primary concern today is making sure consumers have access to loans. The other risk is increased competition – banks and NBFCs who are struggling in their other areas of lending are starting to focus on gold lending. This might increase the addressable market but might also mean pressure on lending rates. From my readings, MF still has some advantages in the time it takes to approve loans and the technology they have to allow clients to store their gold. These process advantages can and will be copied but, in my view, as the industry is in a sweet spot, competition might be benign. Clearly the biggest risk is a reversal of gold prices. Even though I did mention that shorter tenors of loans have, to a large degree, mitigated the risk, a 20% plus fall in prices will not just be a risk to NPLs but a dampener on valuations of the business. With these risks in mind, I do still believe that MF will be in a position to overcome the challenges of Covid-19 and indeed take advantage of the growth that I foresee.

Inherently profitable; hiccups cleared



Source: Bloomberg; Manappuram Finance.

Sentimental attachment and liquid colateral



Source: Bloomberg; Manappuram Finance.

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

Discrete 12 month performance (%):

	31.07.20	31.07.19	31.07.18	31.07.17	31.07.16
A USD Class	17.24	-2.84	-7.19	18.97	-0.07
Benchmark	12.20	-2.92	5.14	27.28	-1.33
Relative return	4.50	0.08	-11.73	-6.52	1.28

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 July 2020. 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.