

Strength in numbers

By John Rumsey

One notable result of the inaugural Itaú 2013 Investor Outlook for the Latin American Banking Sector is the sense of assuredness investors have expressed for the industry – at a time of considerable broader anxiety over the future of global banking.

The picture that emerges from the study – produced jointly by *LatinFinance* and consultancy firm Management & Excellence (M&E) – is of a generally well-regulated industry that features conservative management across broadly resilient economies that, in turn, offer their banking sectors ample scope for growth, not least in areas such as wealth management and corporate bonds.

Colombia and Brazil are both surprises in the survey, although for strikingly different reasons. Colombia's government and banks are increasingly trusted, creating a virtuous circle. Meanwhile, Brazilian bank profits are being curtailed by an interventionist administration.

Investors are increasingly focused on the industry. Chevy Chase Trust, with \$13 billion under management, is overweight Latin banks, according to David Ross, its Maryland-based director of international equity investing.

Asian economies are slowing and bank funding sources tend to be wholesale and therefore not as stable as in Latin America, he says: "We look for balance sheet stability, trustworthiness of management and economic growth and we have gravitated to Latin America."

Opportunity and risk

In services, wealth management dominates with Chile (7.7) the most promising – and Brazil and Mexico breathing down its neck. The rise of the middle class is causing banks to refocus

In the wake of a landmark investor survey of Latin America's banking sector, *LatinFinance* takes stock of a range of views of investment professionals weighing up the merits of a fast evolving industry



Banking on a profit

on a much-wider mass affluent market than the traditionally narrow high and ultra-high net worth family market. Wealth is also being on-shored thanks to better regulatory environments; amnesties, in countries such as Brazil; and higher market returns than available in the developed world.

Corporate lending is widely seen as an attractive market with huge room for expansion to small and mid-sized companies. Chile leads (7.6) followed by Colombia (7.4) and Mexico (7.1). Chevy Chase is focused on business as opposed to consumer lending, Ross says.

He believes it's hard to keep consumer portfolios 'clean' and so they remain susceptible to unexpected rises in non-performing loans while corporates can be monitored more closely.

There are rich pickings in asset classes: Brazilian private equity, Chilean corporate bonds and Mexican corporate bonds topped the list with 7.3 each. Respondents gave corporate bonds the most promising average rating of all asset classes (6.12 for all five countries; 7.0 without Argentina) with the highest absolute scores in Chile, Mexico and Colombia.

Private equity in Brazil is enjoying a renaissance. At the start of the year, investors were on the sidelines, but the weaker currency and more realistic management attitudes to how much their businesses are worth, together with improving tax and regulatory benefits have changed attitudes, says Álvaro Taiar, lead partner in financial services for PricewaterhouseCoopers in São Paulo.

Moreover, a more genuine commitment to corporate governance is taking shape. “We worked with companies on due diligence several years ago and most firms were not in good shape, causing buyers to pull out. This time, there is real commitment and buyers sense it,” he says.

Latin corporates are enjoying lower interest rates with yields that are still attractive compared to developed markets, attracting investors worldwide. Latin companies tend to be unencumbered by debt.

Yet even blue chips offer yields several percentage points above US Treasuries. Banco do Brasil, for example, sold \$1.75 billion in new 10-year bonds in October, at a yield of 237 basis points wide to US Treasuries. International appetite has reached record highs with foreigners holding 29% of Mexico’s and 12% of Brazil’s government bonds.

Chile and Colombia dominate the top five for their positive regulatory outlooks with Chile ahead in shareholder rights (7.5) and Colombia in required reserve deposits (7.1). Latin banks have been conservatively regulated and capital ratios are high – Basel tier one capital ratios stand at 17.1% in Argentina and 14.5% in Brazil.

However, strongly growing credit markets have refocused attention on capital coverage in light of climbing non-performing loan ratios: Colombia’s credit volume has been growing at 20% and Brazil’s at 15%.

Not surprisingly, fund managers see contagion – particularly from Europe – as the greatest. That could manifest itself with higher funding costs in Latin America.

Brazil

Brazil is the curate’s egg – good in parts

but worryingly weak in others.

Banks have proven resilient in the years of crisis and the image of banks is 7.5, second only to Chile (7.9). As the largest market for virtually all asset classes, Brazil leads in the overall outlook for asset investments. Brazil dominates the categories in “issues most likely to have an impact” on the banking system with asset quality (7.1), efficiency improvements (6.9).

“We look for balance sheet stability, trustworthiness of management and economic growth”

David Ross, Chevy Chase Trust

Yet Brazil is also generating considerable uncertainty and investors are polarized about future trends.

Government interference is an outlier score for Brazil with investors clearly unhappy and reflected in a low score (4.2). Only Argentina, which has limited access to US dollars and in July mandated the banking sector to lend \$3.3 billion to small businesses at rates below inflation, comes in worse, scoring 2.0.

Survey respondents also rate Brazil’s complex and in part antiquated tax laws lowest (4.8) among the top four countries (again Argentina trumps Brazil). Brazilian corporations are required to locally tax the income of foreign subsidiaries. Mining giant Vale, for one, is contesting a \$15.1 billion tax bill on foreign income.

Moves to reduce spreads by pushing public banks to reduce rates to customers have distorted market shares: public banks now dominate in loans to consumers, says Taiar. The rapid increase raises wider questions such as the long-term effect on NPLs, he says.

Investors use adjectives such as

‘heavy handed’ and ‘unpredictable’ when it comes to the Brazilian government. “Most Latin countries appreciate investors coming into their country. Brazil tends to think ‘you’re lucky that we let you in,’” says Ross.

The key question is what comes next.

“A lot of the government measures have already been taken – maybe six eighths of the measures - but I think the government will keep its foot on the neck of banks,” says Nicholas Morse, head of Latin American equities at Schroder Investment Management in London London and manager of the \$800 million SISF Latin America Fund. He reckons the government is unlikely to cap bank charges but it clearly cannot be ruled out.

That uncertainty deters investment. Ross, who is overweight in the region, is underweight Brazil. The country’s banks have become value traps in the last two or three years, he says: “They look cheap compared to the rest of region but that’s because of worrying fundamentals including much tougher competition, changing interest rates throughout the system and slower economic growth.”

Brazilians tend to have more sympathy with the government’s aims. Rogério Calderón, corporate controller and head of investor relations at Banco Itaú in São Paulo, argues that Brazilian authorities are in general rational and endorses their central aim of accelerating economic growth.

Gareth Morgan, emerging markets fund manager at F&C in London, is overweight in the country’s financial stocks and cautiously positive. “Banks have engaged with the government. That is clearly not the situation in utilities where heads have been butting,” he says. He believes NPLs probably peaked in the second quarter.

Another sea change is lower interest rates. The benchmark Selic is at 7.25%, down 5.25 percentage points since last August.

Is this the new paradigm? Calderón thinks so and that the results will be far-reaching. “Lower rates will stimulate mortgages and long-term lending with the fall in spreads counterbalanced by a lower risk environment. Delinquencies are peaking and adjusting to lower levels.”

Investor survey: Latin banking

In this new environment, Itaú emphasizes its consistent spreads over the cost of capital. “10 years ago we had much higher costs of capital and returns on equity were higher. Spreads over cost of capital have remained similar, though,” Calderón says.

Still, the damage wrought on ROE is long term. ROE margins have fallen from the upper 20’s to below 20 where analysts expect them to remain in 2013, says William Cox, chief executive at Management & Excellence.

With lower share prices and more realism about future prospects, some managers are looking to time an entry into Brazil. Ross is contemplating increasing his weighting in Brazilian financials. “We are starting to see some indications of possible changes: in macro conditions and a lightening up of government intervention,” he says. Improved credit scoring, including positive credit scores, will also help financial institutions assess risk.

Colombia

One of the biggest surprises in the survey was the receptivity of investors to Colombia. In the average score for “outlook of attractiveness,” Colombia came second only to Chile (7.9) with a score of 6.8. Moreover, government interference in Colombia is in constructive

measures, such as requiring a sensible 9% rise in banking provisions last year.

The country’s long-tarnished image has largely been overcome. It has helped that Colombia is overtaking Argentina as Latin America’s fourth largest economy, says Taiar. Argentina averaged a disheartening 2.6 in its outlook of attractiveness and earned the dubious honor of winning a full house in the 10 risk categories covering macro and

significant, structural change. Better security has stimulated confidence, credit and mortgages,” Morse says. Bancolombia was also praised for the sophistication of its outreach to investors. Itaú has just opened an investment bank in Colombia and is actively assessing opportunities, says Calderón.

Neighboring Peru, although not covered in this year’s survey, is also viewed favorably.

Amid the euphoria, there is concern that Colombia is moving too quickly while there are some signs of overheating. Morse is cautious that Colombia may be running ahead of itself and is critical of Bancolombia’s “opaque” investment and IT projects. There have been some signs of strain with higher NPLs, he says.

Chile and Mexico

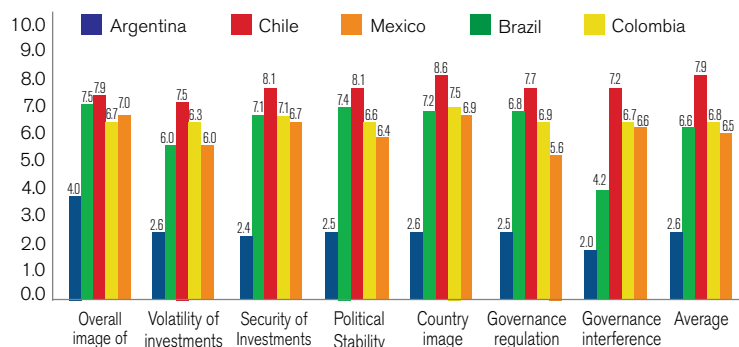
Accolades poured in for perennial favorite Chile. The country ranked high across the board.

It was top in all five categories for country image and enjoys a perception of being a lower risk than other Latin countries. Banks have little exposure to national debt and market risk is low overall while bank operations are cushioned by good management, including strong policies on asset write-downs and operational security, investors found.

The IMF has also praised the country

Laws of attraction

Investor perceptions of LatAm appeal in 2013



Source: Itaú, M&E, LatinFinance

business issues.

Chevy Chase is bullish on Colombia. Ross says he has been looking at the country for several years and decided to invest when president Álvaro Uribe honored the Supreme Court’s decision not to overturn a constitutional limit on third terms. “The rule of law has become fully established. Government policies are attractive to investors,” says Ross.

“The improving security is a

METHODOLOGY

The Itaú 2013 Investor Outlook for the Latin American Banking Sector, produced in partnership with LatinFinance and consultancy firm Management & Excellence (M&E), incorporates the responses of 32 analysts and investors from nine countries in Latin America, the US and Europe. It covers 719 data points, giving respondents the possibility of providing a broad range of replies and data. The study was carried out between August and October 2012. Scores are on a scale of 1 point (minimum, negative from an investor standpoint) to 10 points (maximum, positive from an investor standpoint) and were provided by the surveyed analysts and investors. Questions ranged from political views to services and issues impacting the banking sectors in each of the five leading LatAm countries: Argentina, Brazil, Chile, Colombia and Mexico.

for its robust financial regulatory and a supervisory system that is pushing for further strengthening of its independence and the legal protection of regulatory authorities.

Chile's banks are moving into higher end, higher margin businesses and are exploring a range of areas from asset management to corporate bonds and private equity. The one drawback is that investors do not see Chile as very innovative and the small size of the market pushes it into fourth place in terms of the outlook for asset class.

Larger Mexico was a solid performer with investors excited by the outlook for wealth management (7.2) and loans for companies (7.1). Mexican banks suffered greatly in the 2008 crisis and the economy and financial sector are now bouncing back in tandem with the US economy, says Taiar.

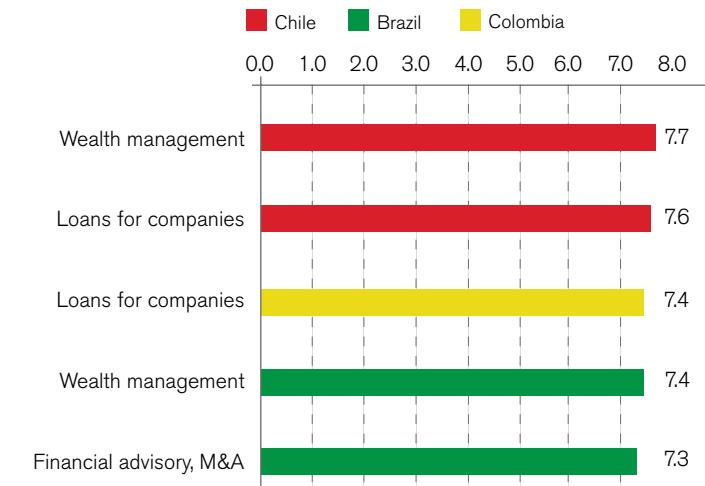
Today, the country benefits from its relatively low risk of contagion from the global financial crisis (4.7) and confidence in the liquidity of its banks (7.4). Investors are more worried about Europe and China than the US, says Taiar.

Mexico's solid macroeconomic background explains some of the share price run-up, says Morse. "We are seeing changes that have been awaited for years, decades even. This strong domestic scenario has given a great run in terms of loan growth and stock performance. Banks are conservative and under-leveraged. Government interference is a much lesser risk than in Brazil," Taiar says.

"Mexico has one of the best central banks globally with consistent and predictable policies. Its links to the US have helped," says Morgan. As in Brazil, the emergence of a higher-spending middle class is a key factor. Mexican banks are enjoying loan growth of 15%-

Best of the bunch (the top 5)

Investor perceptions of banking services



Source: Itaú, M&E, LatinFinance

20%, with particular emphases in credit cards and payroll loans, he says.

These dynamics help explain the success of the recent Santander IPO in spite of Spain's crisis. The deal carried "lots of interest from global funds" says Morse. It helped that Santander has underscored how it will only take more capital out via dividends, he says.

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**Nicholas Morse,
Schroder Investment Management**

Investments and innovations

The broadly positive environment is not without challenges, particularly the

efficiency of Latin banks (or lack of it). Investors agree that banks need to invest heavily in IT and risk management. With more data available on customers, banks need to beef up assessments of client risk.

"When you have just a few banks dominating the system and don't have competition coming in, banks can get lazy and fat," says Morse. "Most Latin banks have inflated cost bases which have survived thanks to the historical structure of the lending and funding market. When the crunch comes, as it has

in Brazil, they can be slow to adjust to the new environment."

Taiar says: "Efficiency has been on the agenda in last few years. Now, it is more of a priority. Pressure on spreads means banks need to be more efficient. They are optimizing processes and implementing technology for new areas and new, lower income customers."

Calderón says change has come already. Itaú is improving efficiencies in its asset quality and operations. "Costs as a proportion of revenues should improve. We have integrated different legacy systems and used that opportunity to improve cost-to-revenue efficiencies," he says.

Latin banks are uniquely well placed in a weak global environment to make money. Opportunities abound to diversify into wealth management, corporate bonds and private equity within what has proven to be strongly and sensibly regulated markets.

Chile should be a beacon for other markets and Colombia's sensible implementation of many Chilean norms has helped the country overcome an enormous image problem. At the other end of the spectrum, Argentina offers a cautionary tale of what happens when the government is interventionist and capricious. Brazil should take note. **LF**