

# Financial Penetration in Emerging Markets

Secular Trends — January 2019

Healthy expansion of financial participation in emerging markets—often supported by policy reform—should benefit select businesses positioned at the chokepoint of the shift toward formal financial institutions. We expect financial inclusion to generate broad-based gains for consumers, businesses, and governments, providing powerful growth tailwinds that could last for decades. Approximately 30 percent of adults globally remain unbanked, and they are disproportionately in developing economies.<sup>1</sup>

Financials businesses are not typically associated with growth investing—at least not in developed markets, where financial penetration is high. But for select companies in emerging markets, we believe the powerful secular tailwind of financial penetration will support years of above-average earnings expansion.

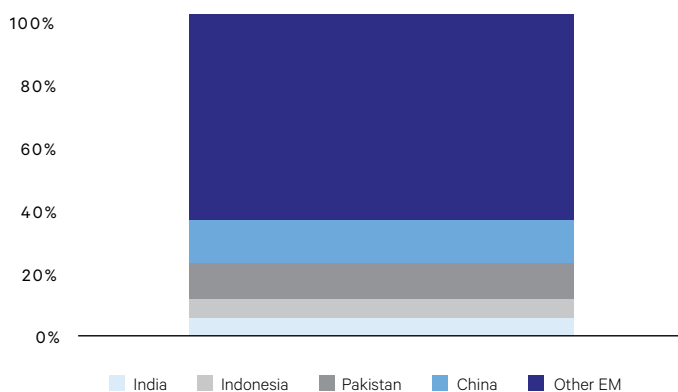
Every country has its own nuances, so we believe local expertise and selectivity are critical to identifying the financials businesses that are best positioned to benefit from—and in some cases, enable—this powerful secular trend.

## The Case for Emerging Market Financials

Nearly two billion adults globally—one-third of the world's adult population—remain unbanked.<sup>1</sup> Nearly all of them live in emerging markets. The lack of financial services is especially prevalent among women and among people outside major city centers. For example, only four countries—China, India, Pakistan, and Indonesia—account for over one-third of the world's unbanked, and more than half of adults in Bangladesh, Colombia, Ethiopia, Indonesia, Nigeria, and Pakistan lack financial accounts. Often, even those with access to the banking system still use inflexible, expensive informal services.<sup>1</sup>

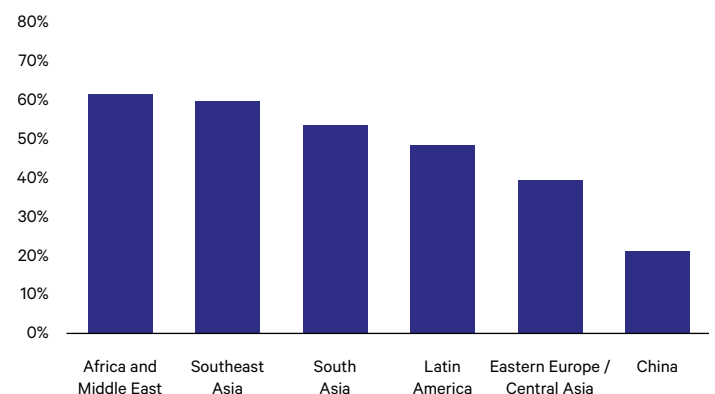
Several emerging market countries are enacting pro-growth reforms that should deepen financial penetration. This can be beneficial globally, ultimately leading to an estimated \$4.2 trillion in new deposits, 95 million new jobs, the closing of a \$2.2 trillion credit gap, and \$100 billion in annual leakage reduction for local governments.<sup>2</sup> These benefits—which span consumers, businesses, and the public sector—could underpin years of sustainable economic growth.

FIGURE 1: % OF GLOBAL UNBANKED, BY COUNTRY



Source: The World Bank

FIGURE 2: % OF UNBANKED ADULTS, BY REGION



Source: McKinsey Global Institute

## Selectivity Matters

All emerging markets are not created equal—and the broad-based lack of financial penetration does not create uniform opportunities across countries. Simply investing passively in the MSCI Emerging Markets (MSCI EM) index will not yield useful exposure to this trend. This is because of the index's exposure to state-owned enterprises (SOEs), especially in China.

Over one-third of emerging market financials are SOEs, and half of the top-10 financials companies in the MSCI EM are Chinese SOEs. SOEs pose unique issues for investors. Rather than maximizing shareholder value, they may divert business to areas based on a state's political agenda. Historically, Chinese financial SOEs served the state's infrastructure investment objective, shunning retail and small-business lending. Such practices stifle the free flow of credit to growth areas, and also can result in riskier exposures that wouldn't exist in a free-market system.

India is an example of where public-directed investment resulted in balance-sheet weakness, and ultimately, poor shareholder outcomes for investors in state-owned entities. Most Indian public banks are undercapitalized, and their balance sheets contain a high percentage of impaired loans.

## Our Approach

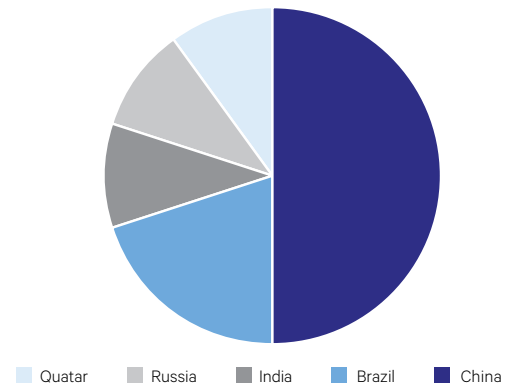
Our research on the emerging markets banking opportunity required extensive on-the-ground work. Over three years, we've taken 14 trips to seven countries, meeting with policy makers, bankers, and customers. We've gotten to know each country's banking system, regulatory environment, operating

## How Sands Capital Seeks to Identify Winners

We look for the following characteristics when evaluating businesses benefiting from the secular trend of financial inclusion:

**Dominance and Scale:** Footprint matters. We typically prefer businesses with strong and well-known brands, and broad geographic and economic presence (i.e., branch network, ATM network, digital banking platform). Market share leaders and scale are preferable across segments, including retail (auto, credit cards, mortgages), commercial (working capital, term loans, trade finance), transaction banking (cash management, custody, collection), and corporate finance (debt/equity capital markets, M&A, other advisory).

**FIGURE 3: TOP 10 MSCI EM FINANCIALS, BY COUNTRY**



Source: FactSet

Bad loans—which include non-performing, restructured, or rolled-over loans—reached a record high of \$148 billion in the middle of 2017. The level of bad loans has nearly doubled in recent years, following a long period of imprudent lending and weak underwriting standards.<sup>3</sup> These issues will likely constrain future loan growth and return on investment.

challenges, and individual companies. In our view, this approach—which we apply to all of our research—enabled us to identify 1) the companies best positioned to benefit from financial penetration and 2) the most constructive environments for earnings growth.

**Funding Advantage:** Our financial strength criterion is especially important for lending businesses. One metric we seek is a strong current and savings account (CASA) ratio, which indicates the availability of low-cost funding for lending activities. Another consideration is the level of core equity capital, which indicates the sustainability of lending growth before a lender resorts to external funding.

**Execution:** Management strength—including the team's stability, experience, and independence from the government—is a key attribute shared by many leading businesses. We believe that an independent management team is a critical

factor for lending businesses in many emerging market countries, where there can be a strong tendency for politicians to interfere in banks' lending decisions. This steers us away from state-owned lenders and toward private-sector banks. We also value customer-focused businesses that are willing to evolve to shifting consumer needs.

**Strong Risk Management:** We believe that significant shareholder value is created by a management team that can maintain a high-quality lending portfolio—with low and

manageable loan losses—through the economic cycle. We increasingly appreciate that the culture of prudent risk-taking within a bank or lending business is often more important than its mechanical risk management processes.

**Accommodative Environment:** While not a primary focus, supportive trends—including elevated economic growth, favorable demographics, and pro-business reforms—can increase the likelihood of above-average earnings growth for the best emerging market businesses in the financials sector.

## Where We Find Opportunities Today

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Across emerging markets, we are particularly attracted to financials businesses that are mainly focused on serving the needs of a growing middle class. With improving economic opportunities, stable employment, and rising per-capita income, there is the potential for strong and sustainable demand for consumer financing for housing (mortgages),

autos and motorbikes, consumer durable items (e.g., air conditioners and cookers), credit card spending, education, healthcare, travel, and other personal needs. Beyond lending, these businesses can also extend into insurance and wealth management to meet the long-term savings and retirement needs of the middle class.

### CHINA

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We prefer large financial technology businesses in China. These businesses have grown to fill major financial services gaps created by the banking sector, which is more focused on lending to SOEs and large commercial enterprises. By leveraging their popular technology platforms and large user bases, these companies are able to offer a range of financial products and services—including payments, lending, asset and wealth management, and insurance—seamlessly and cost-efficiently. Often, these services are available through the touch of a few buttons or by swiping a mobile phone at point-of-sale. We continue to avoid traditional Chinese banks and financial services businesses, due to the banking sector's lack of independence from state-directed lending, which has resulted in poor lending decisions and bad asset accumulation at many state-owned firms.

### INDIA

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We believe that India offers one of the most attractive backdrops for well-managed financial services businesses across all emerging markets. The businesses that we own mainly cater to the basic financial needs of individuals and households, and maintain leadership positions in what we view as attractive segments of the financials sector. A common thread among these businesses is that they are managed by professionals who focus on maximizing shareholder value, and lending decisions are largely free of political pressures or considerations.

### INDONESIA

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Indonesia, in our view, benefits from many of the same favorable macroeconomic and demographic trends as India. We own the country's largest private bank—and leading transaction banking franchise—by market share. This company benefits from extremely low funding costs—with the majority of funding derived from low-cost retail deposits—which enable the company to be extremely selective when lending, while still delivering margins that are among the highest of all emerging market banks.

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This information has been prepared from sources believed reliable but the accuracy and completeness of the information cannot be guaranteed. The views expressed were current as of the date indicated and are subject to change.

1. World Bank Group, The Global Findex Database 2017

2. McKinsey Global Institute, Digital Finance for All: Powering Inclusive Growth in Emerging Markets

3. <https://www.reuters.com/article/us-india-banks-badloans-analysis/for-indias-banks-the-worst-of-their-bad-loan-woes-may-be-yet-to-come-idUSKCN1FY1SH>

At Sands Capital, we are active, long-term investors in leading growth businesses globally. Our approach combines rigorous fundamental analysis with inspired thinking to seek innovative, high-quality businesses that are creating the future. By enabling our clients to participate in the growth of these businesses, our mission is to add value and enhance their wealth with prudence over time.

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#### ALL-IN CULTURE

We are one team dedicated to one mission and one investment philosophy. We strive to be highly efficient and highly effective at synthesizing information, unlocking insights, and putting them to work for our clients. Intentionally operating from one centralized office, we embrace collaboration, agility, and transparency—both internally and with our clients.

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#### GLOBAL PERSPECTIVE, LOCAL UNDERSTANDING

Innovation-driven change knows no geographic boundaries. Neither does our research team. Our people are hands on, on-the-ground, seeking context. We experience products and services firsthand, speak to consumers, investigate competitors, understand the nuances of local markets, and build relationships with experts and influencers.

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#### A COMMON APPROACH IN SEARCH OF THE EXTRAORDINARY

Businesses that can build a sustainable competitive advantage are few and far between. We consistently employ six criteria as the common lens across each of our strategies to separate signal from noise, find what matters most, and selectively invest in the businesses that are defining their markets.

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#### HIGH CONVICTION FOR HIGH IMPACT

Clients benefit from our belief in our portfolio businesses in our view. Our belief is built from deep, business-focused research, engaging management teams, taking thoughtful views of risk, and focusing on long-term outcomes. The result? Concentrated portfolios of high-quality businesses and the patience to pursue meaningful impact for our clients over time.