Cambodian Banks
High Growth Opportunity vs Low ROE Conundrum

November 2014

Cambodian Banks

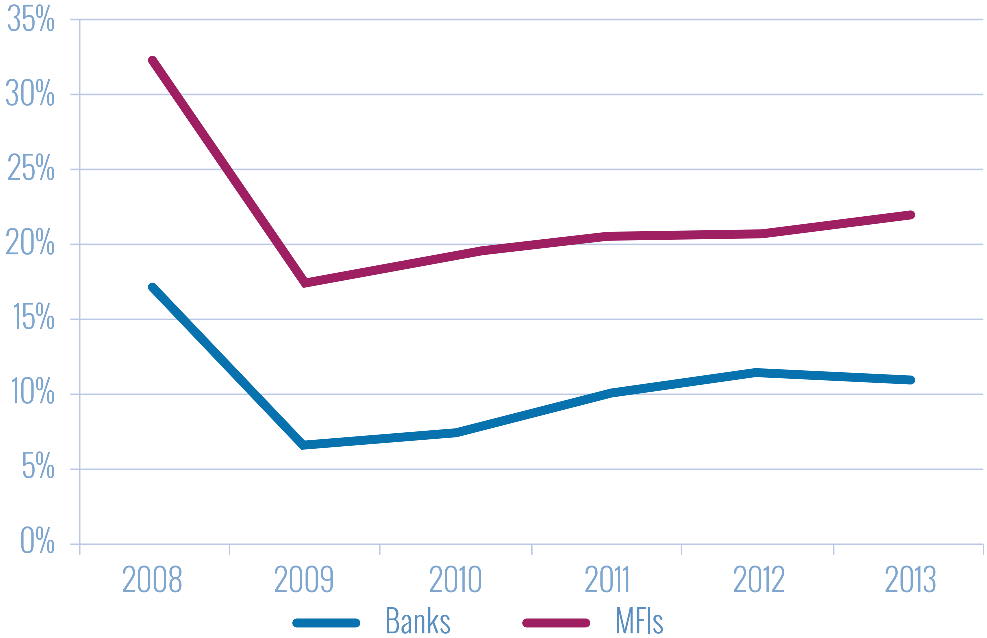
High Growth Opportunity vs Low ROE Conundrum

Key Points

- Only five of 43 banks earned an acceptable ROE of 15% or more in 2013.
- Return on Equity in the Cambodian finance sector fell significantly during the GFC. While MFIs are back above 20%, average Bank ROEs are low at just 11%.
- Excluding the big four banks, the average ROE was just 6%.
- While competition is a factor, the bigger issue is lack of scale for many banks, and further consolidation is needed in the sector.
- Achieving an acceptable ROE is clearly proving a challenge for many banks. The situation however can be remedied provided the causes of underperformance are addressed.

Of the 43 banks in Cambodia in 2013, just five earned an acceptable return on capital (above 15% ROE[1]) with the remainder effectively destroying value for their shareholders. The overall sector ROE was just 11.6%, well below the 22% achieved by the MFI sector. Outside of the big four banks, average ROE was a very disappointing 6%.

Return on Equity



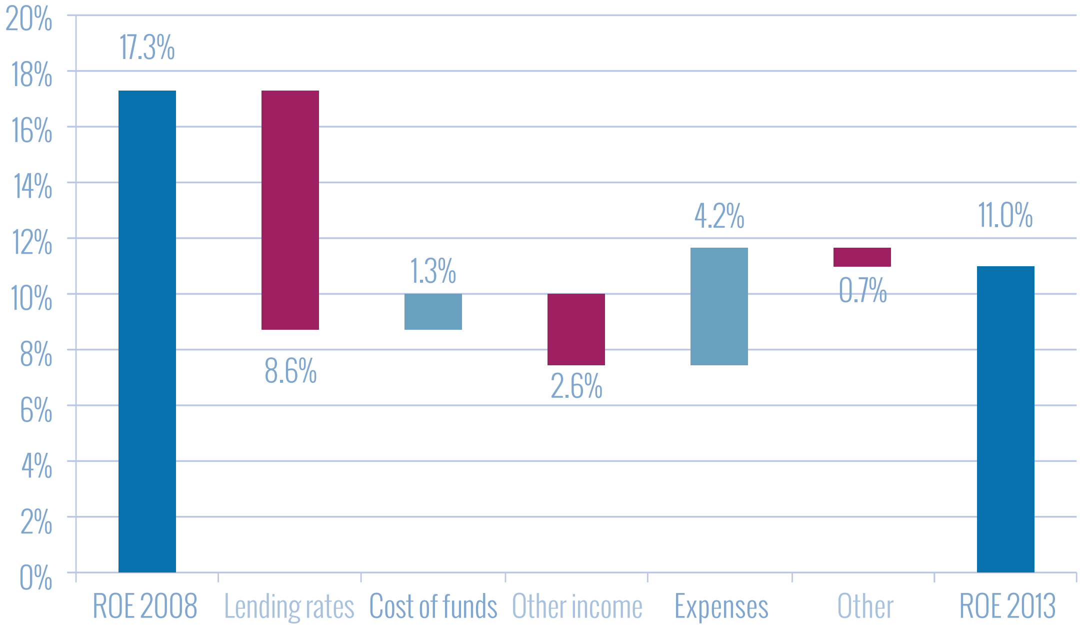
1. In the absence of reliable inputs to use in the Capital Asset Pricing Model, we have looked at required returns in other markets, along with discussions with other investors on what they regard as a minimum return to invest in Cambodia. Based on this, we believe that 15% is the minimum that any bank should target, and ideally closer to 20%

Bank ROEs fell from 17% in 2008 to just 11% in 2013. The main driver of this was a fall in lending rates from 15.2% (2008) to 11.1% (2013), taking 8.6% off bank ROEs. While banks have lowered their deposit rates in response to this, that has only improved ROEs by 1.3%.

average interest rate in 2013 was below 10%, at 9.75%.

Given the low sector ROE, and assuming banks make sensible risk return tradeoffs, we expect the rate of decline in interest rates to moderate.

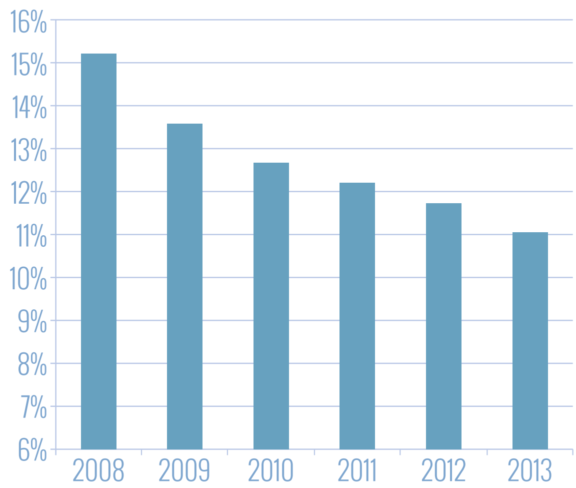
Why did Bank Sector ROE fall?



Lower fee income has also hurt the banks, reducing ROE by 2.6%. While banks have been able to drive efficiencies through greater scale (benefitting ROE by 4.2%), this was well short of offsetting the impact that competition has had on revenue. In fact, on a cost to income ratio basis, banks have not improved at all since 2008.

The decline in lending rates, which fell most dramatically between 2008-2011, was clearly good for borrowers and therefore the Cambodian economy. If Acleda is excluded (its higher MFI driven lending rates distort the picture), then the

Average Lending Rates Are Well Down



The Performance of Individual Banks

Acleda was a standout performer, generating an ROE of 25%[2]. ANZ Royal, Canadia, Maybank and First Commercial Bank also earned more than 15% ROE. Another five banks earned more than 10%, giving their shareholders some hope.

However the remainder were below 10%. While some are relatively new entrants, most have been in the market for five or more years, and some of these banks that have been in the market for 20 years do not even earn enough revenue to cover their costs.

Why is This So, and What Can Be Done About It?

Although competition has impacted ROEs, banks like Acleda, Canadia, and ANZ Royal have demonstrated there is still plenty of scope for individual banks to generate acceptable ROEs.

Indeed, the playing field should be conducive to a better ROE result than what we are seeing. The NBC has provided a set of regulations that gives banks every opportunity to earn a decent return on equity. Unlike some countries, there are no ill-advised interest rate caps/ floors, and there is no undue interference in the management of banks, outside of sensible prudential measures. Credit and deposit growth are both plentiful, and post GFC, credit quality remains healthy.

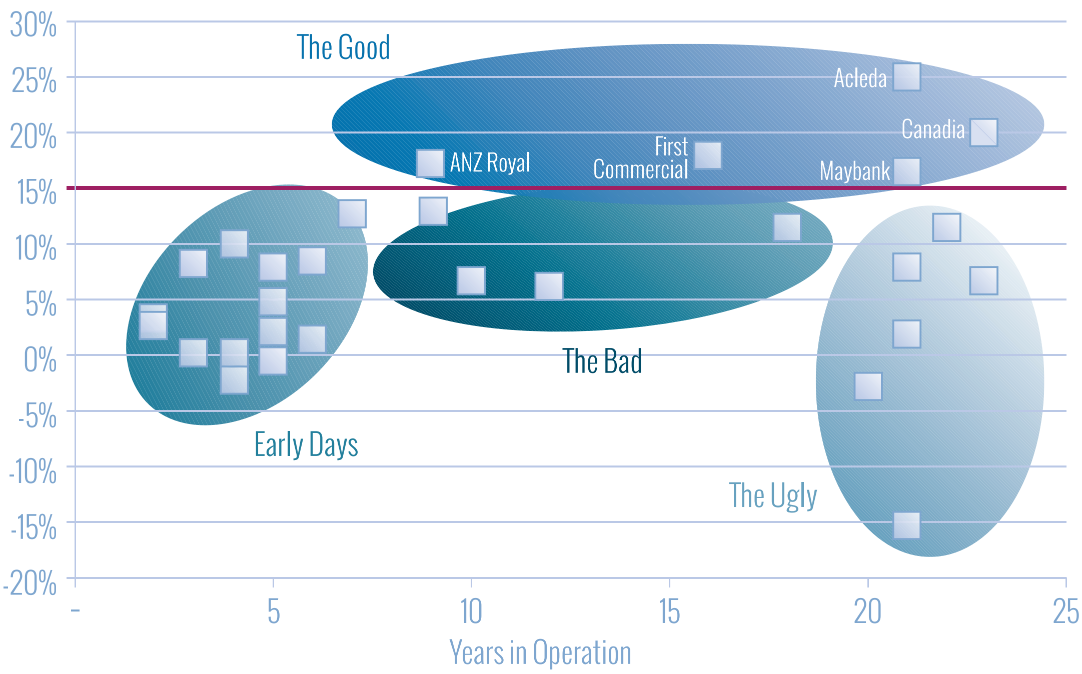
Despite that, some banks have achieved results that are simply appalling.

2. While Acleda's annual report claims an ROE of 21% rather than 25%, this is based on End of Period Equity rather than using Average Equity.

What are the Issues?

The single biggest issue for individual banks is lack of scale. With banks required to hold at least $37.5m of capital, they need a loan book of at least $150m to generate sufficient profits to get an ROE of 15% or more.

The Good, the Bad, and the Ugly



With good management, a loan book of $150m is achievable within five years, however at the end of last year, only 12 banks had done so. There were 15 banks operating for five years or more who had a loan book lower than $150m.

While each bank will have different reasons for having a subscale loan book, a number of recurring themes include:

- Lending policies that are too conservative, and/or not appropriate for the Cambodian market.
- Lax people management leading to chronic underperformance.
- Not establishing a cohort of experienced relationship managers who are able to bring business to the bank.
- Poor branding/marketing.

With banks required to hold at least $37.5m of capital, they need a loan book of at least $150m to generate sufficient profits to get an ROE of 15% or more.

- Recent entry to the market, and has not yet had time to build the loan book (this is obviously not a management failing). As noted above, we believe that banks should be able to build a loan book of $150m within five years of opening.

Assuming banks can deal with these issues, the next challenge is establishing a sustainable, low cost deposit book. There is a strong correlation between the size of a branded network (ie branches and ATMs) and the size of a bank's deposit book[3]. Banks with just one or two branches are unlikely to be able to build a sustainable deposit book that will allow them to fund sufficient lending growth to achieve an acceptable ROE.

The final key issue, related to sub-scale lending books, is having a lazy balance sheet, with the sector having average gearing (assets divided by equity) of just five times. Those banks that are generating a healthy ROE typically have a gearing level of seven to eight times.

While generating fee income provides a useful increment to a bank's ROE and should not be ignored, it is less important in Cambodia than in more developed countries. On average, banks in Cambodia generate 21% of their revenue via non-interest income, of which just under 40% relates directly to lending activities (ie around 12%-13% of bank revenue is truly non-lending related).

Furthermore, if banks can not achieve scale in their lending activities, it is unlikely that they will be able to generate the customer flow necessary to support sufficient investment in fee generating Markets and Trade Finance activities.

Implications for Public Policy

Small banks cannot afford to invest in the systems and products that are necessary to both generate value for shareholders, and to add value to the economy as a whole. Banks play a key role in resource allocation in an economy, and these small banks are a net drag on the economy.

While merging or selling would be the obvious solution, there is a curious lack of willingness to do so, and/or particularly unrealistic price expectations, even for banks that do not earn enough revenue to cover their costs, let alone make a modest profit.

As we noted in our research report on Credit Growth in Cambodia, the NBC needs to increase the minimum capital level for Cambodian banks, which will further lower the ROE of those banks who are sub-scale. This will hopefully force some level of consolidation.

However even for larger banks that have scale, a low ROE means that they do not have a large buffer to absorb higher bad debt charges during economic downturns, making them more risky.

Implications for Banks

The impact of new banks coming in, leading to heightened competition, has undoubtedly had a major impact on ROEs across the bank sector. However the wide range of ROEs being achieved suggests that low ROEs are being driven by bank specific factors, rather than a systemic issue beyond the control of the banks. As such, it is within the power of shareholders/management to improve the situation.

If these banks do not improve their ROE, they will not be able to fund the level of credit growth we expect in Cambodia going forward (15%-20% pa) without asking shareholders for additional capital. This will either lock them into a downward spiral in market share, becoming increasingly irrelevant, or will increase the pain for shareholders who have to come up with ever increasing amounts of capital.

3. The Impact of Network Size on Bank Branch Performance, Federal Reserve Bank of New York, June 2005

If these banks do not improve their ROE, they will not be able to fund the level of credit growth we expect in Cambodia going forward (15%-20% pa) without asking shareholders for additional capital. This will either lock them into a downward spiral in market share ... or will increase the pain for shareholders who have to come up with ever increasing amounts of capital.

For further information

Stephen Higgins
Managing Partner
Mekong Strategic Partners
sh@mekongstrategic.com

John McGinley
Managing Partner
Mekong Strategic Partners
jm@mekongstrategic.com