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Cambodian Bank Sector
2016 Performance Review

August 2017

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Key Points

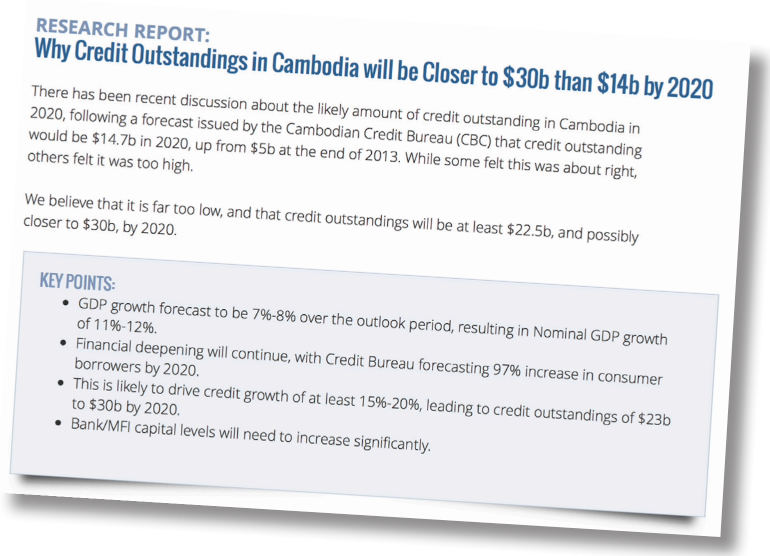
- Financial system on track for $30b in loans by 2020. National election not expected to have material impact on loan growth, likely to have some impact on deposits.
- Revenue growth strong, one of the highest growth rates globally.
- Revenue Share of big 4 banks down from 70%+ to 50% - while new entrants have taken some share, ABA Bank has been the big winner.
- Loan growth is driving bank profits higher in absolute terms, but ROE stuck between 11% & 12%.
- Average loan yields have stabilized, but efficiency gains appear harder to come by, with expenses growing faster than revenue.
- $400m in loans is the new “magic number”. Banks with a loan portfolio below this will struggle to generate an acceptable return.

Finance sector on track for $30b in loans by 2020

In 2014, we issued a report predicting that loan outstandings in Cambodia would be at least $22.5b, and potentially closer to $30b by 2020. We also expected that Bank/MFI capital would need to increase significantly to support this growth.

With an additional three years of data, we are increasingly confident in the loan growth prediction, while the NBC has already moved to increase capital levels in the sector.

At the end of 2016, total loans outstanding in the finance sector (Banks & MFIs) amounted to $16.9b. Our base case estimate is for average credit growth of 15% pa out to 2020, which should be comfortably achievable if IMF/ADB/WB estimates for GDP growth are met. At this level of credit growth, $30b in loans outstanding will be achieved in 2020.


RESEARCH REPORT:
Why Credit Outstandings in Cambodia will be Closer to $30b than $14b by 2020

There has been recent discussion about the likely amount of credit outstanding in Cambodia in 2020, following a forecast issued by the Cambodian Credit Bureau (CBC) that credit outstanding would be $14.7b in 2020, up from $5b at the end of 2013. While some felt this was about right, others felt it was too high.

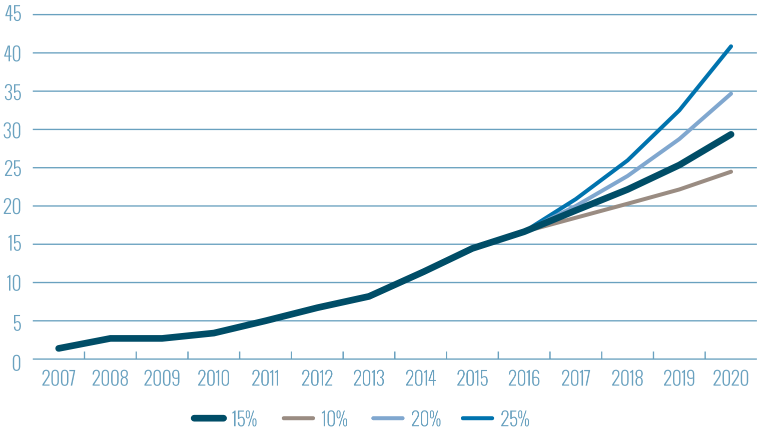
We believe that it is far too low, and that credit outstandings will be at least $22.5b, and possibly closer to $30b, by 2020.

KEY POINTS:
- GDP growth forecast to be 7%-8% over the outlook period, resulting in Nominal GDP growth of 11%-12%.
- Financial deepening will continue, with Credit Bureau forecasting 97% increase in consumer borrowers by 2020.
- This is likely to drive credit growth of at least 15%-20%, leading to credit outstandings of $23b to $30b by 2020.
- Bank/MFI capital levels will need to increase significantly.

If the growth over the next four years matches the 29% average of the past decade, then loans outstanding would increase to $46.7b. However we do not expect loan growth to be this high – while economic growth is expected to be largely in line with the average of the past decade, we believe the gains from financial deepening will be less pronounced than in the past.

By 2020, private sector credit to GDP would be around 110%. While this is a significant increase on where it is today, it would still be below levels seen in Vietnam, Thailand, and China at the equivalent stage of their development.

Loan growth to 2020 ($b)



What impact will the election have?

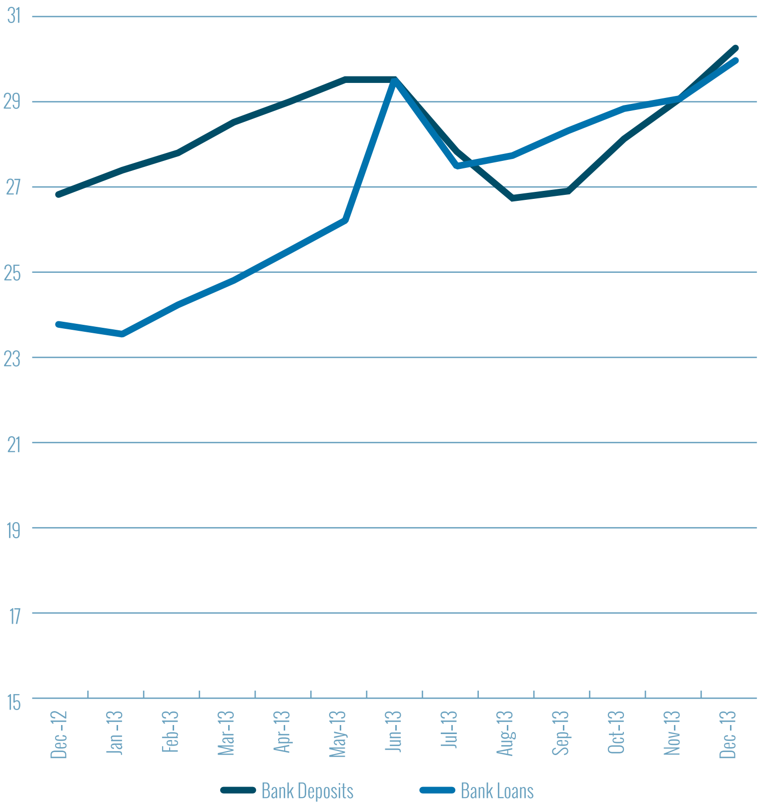
While it is difficult to predict what impact the upcoming 2018 election will have on the Cambodian finance sector, the experience of the 2013 election is instructive.

Bank loans - grew 26% for the 2013 year. While there was an apparent sharp fall in July of 7%, this appears to have been a normalizing of a very unusual 13% growth in the prior month.

Bank deposits - grew 12% for the 2013 year. In the first six months of the year, bank deposits were up 10%, and were on track to exceed 20% for the year. However in July and August, balances fell 10%, back to where they were at the start of the year before recovering by December.

MFI loans - grew a remarkable 48%. Only noticeable election impact was a fall of just 1% in August following the election, which was quickly recovered in September. Monthly deposit numbers are not available for MFIs, however anecdotal evidence from the time suggested that MFIs did see an outflow of deposits over the election period.

Bank Sector 2013 (KHR Trillion)



The key takeouts from this are:

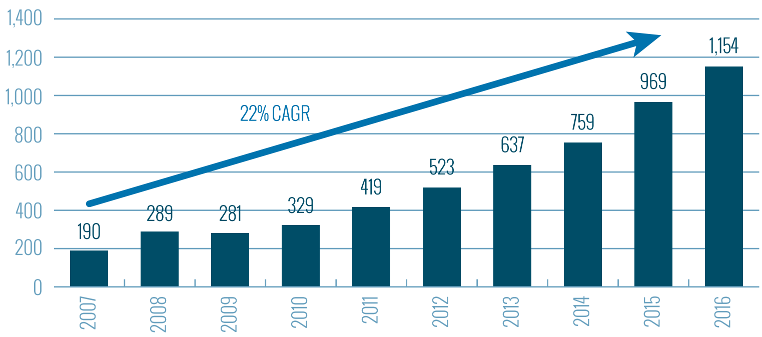
- Lending volumes for both MFIs and Banks are unlikely to see a significant impact from the election, but may moderate slightly.
- Deposits will be impacted, however we expect the banks will be holding additional liquidity in the lead up to help absorb this. The NBC will be well prepared for this as well in terms of providing liquidity support to banks that need it. The NBC's move to increase minimum capital levels will also ensure that most banks have a stronger capital base moving into this period.

Bank revenue growth remains strong

Bank system revenues were up 19% in 2016, continuing an impressive run of revenue growth which has seen the bank sector grow by 22% on average for the past decade. This is one of the fastest rates of growth globally, and exceeds the growth seen in China.

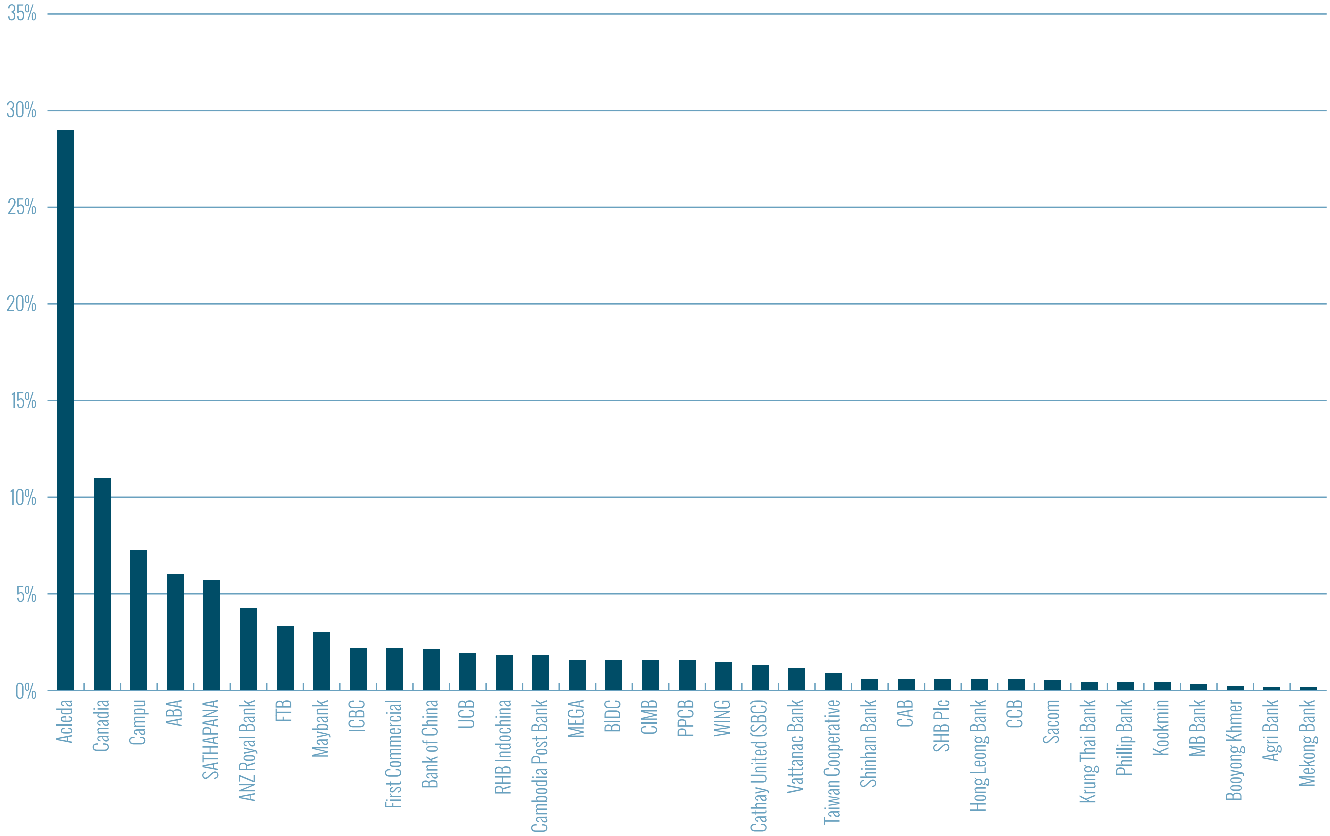
This revenue growth has been driven by average loan growth of 27% over the past decade, with net interest income representing 81% of system revenues.

Bank Revenues ($m)



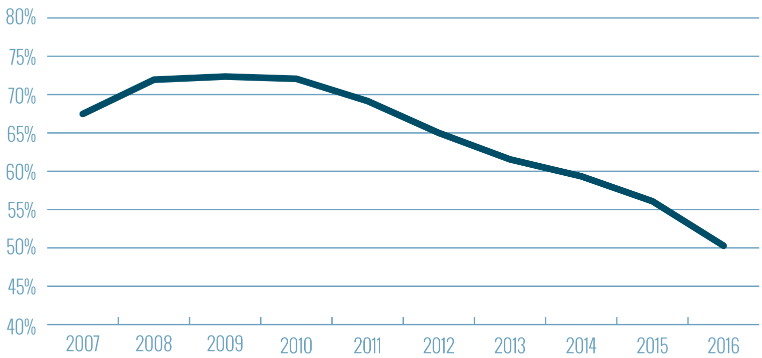
Revenue share

Bank Revenue Share



Traditionally the big 4 banks, Acleda, Canadia, Campu, and ANZR[1] have dominated the market, and until just 5 years ago were around 70% of system revenue. In recent years their share has fallen significantly, and they are now down to around half of system revenue.

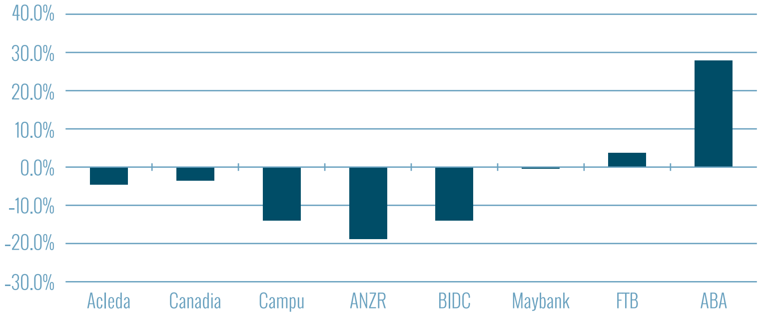
"Big 4" Revenue Share



1. In 2016, ANZR fell from 4th largest bank by revenue to 6th largest

If we look at how the big banks have grown revenues relative to the market over the last 5 years, we see that ABA has been a standout, on average growing revenues 28 percentage points faster than market and taking it to #4 position.

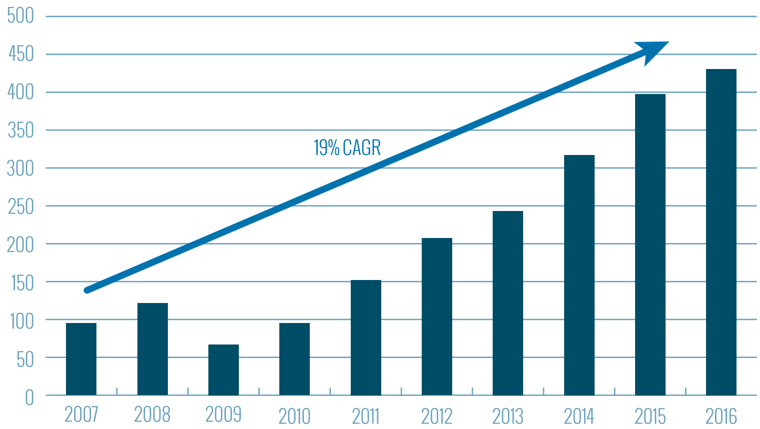
Revenue Growth Compared to Market - 5 Year Average



Bank profits growing in absolute terms, but ROE still flat

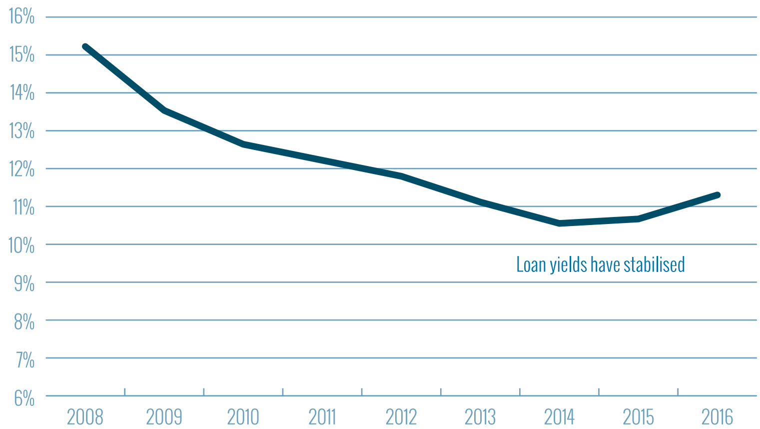
Profits for the Bank sector have increased over the past ten years from just under $100m to $431m last year, an average increase of 19% pa.

Net Profit After Tax ($m)



This profit growth is driven principally by increased lending, which has been partly offset by declining interest rates until the last three years when average lending rates began stabilizing. The increase in average rates in 2016 was assisted in part by the conversion of Sathapana to a commercial bank, with its high yielding MFI loan book.

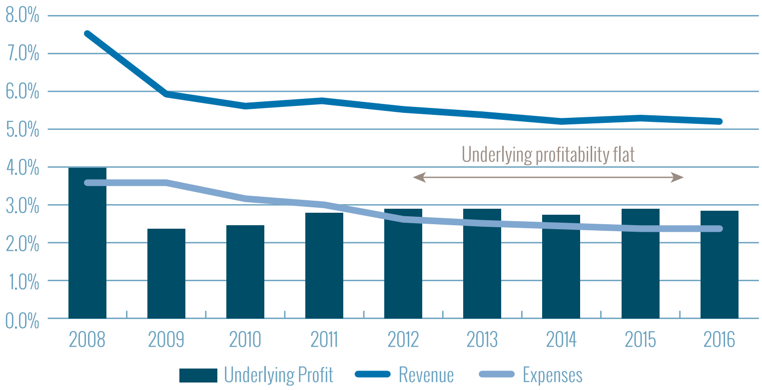
Loan Yield



Over the past 5 years, Cambodian banks have found efficiency gains hard to come by, with Expense to Assets ratio static at 2.4%. In 2016, expense growth for the bank sector was a high 20%, compared to 19% revenue growth.

As a consequence, the underlying profitability (profit before credit provisions) of banks has barely moved since 2011.

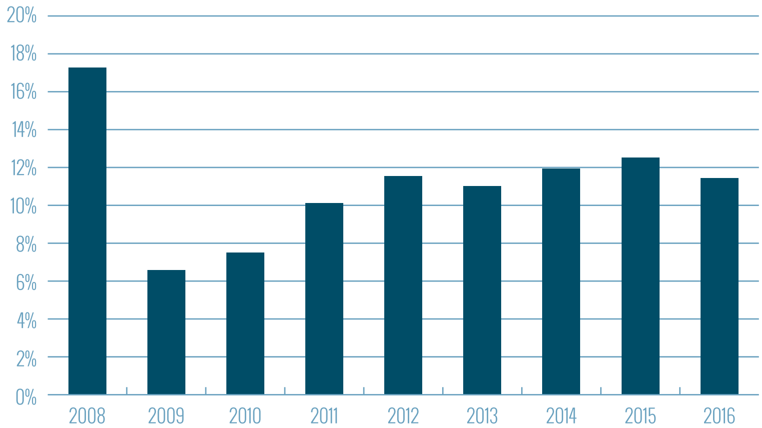
Profit Drivers (as % of assets)



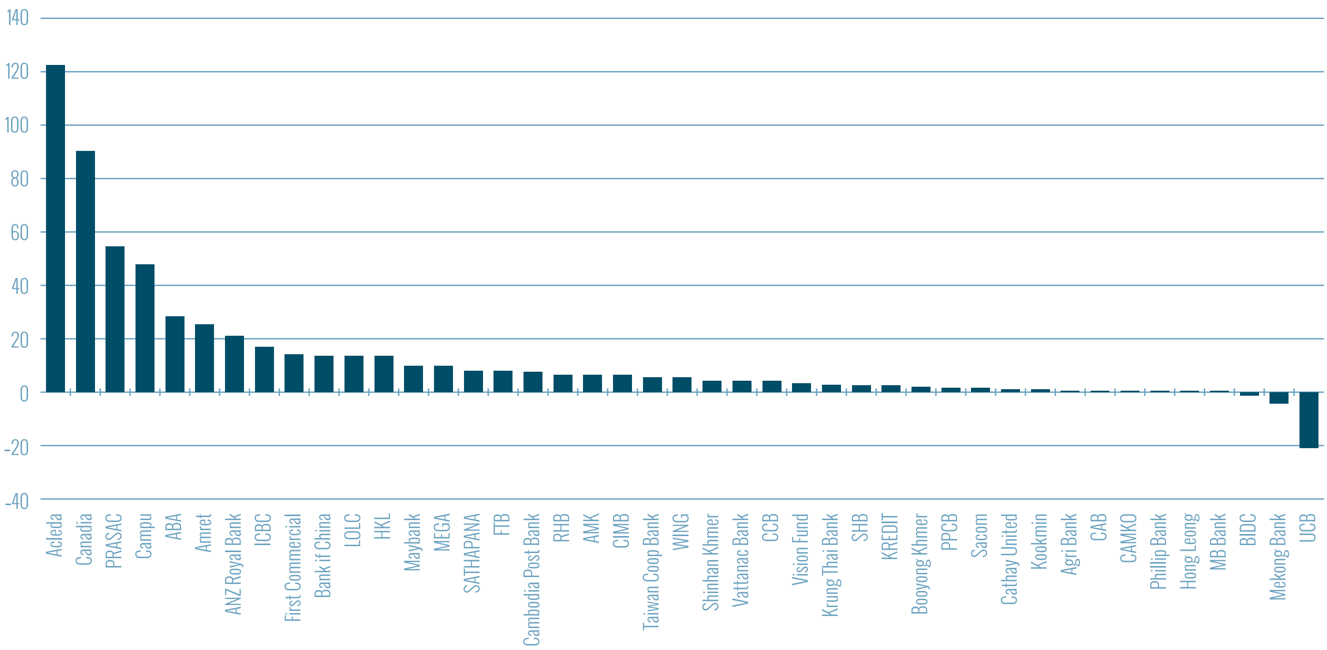
As a consequence of this stagnant underlying profitability, the Return on Equity for Cambodian banks has remained stuck between 11% and 12%, which is well below the cost of capital for these banks. At a minimum, we believe the cost of capital for Cambodian banks would be 15%, and more likely in the range of 16%-18%.

While banks like Acleda, ABA, and Canadia have demonstrated that strong returns are possible in this market, overall returns are being dragged down by smaller banks who need a radical change in strategy to achieve an acceptable return.

ROE



Net Profit After Tax (including MDI's) ($m)



Generating an acceptable return even harder under new capital requirements

Most banks operating in Cambodia lack scale, and this will be exacerbated by new minimum capital requirements with banks needing to hold $75m of capital.

At this level of capital, banks will need a loan book of at least $350m, and more likely $400m, to generate sufficient profits to achieve an ROE of 15% or more. An alternative way of looking at this is that market share of 3% is needed. This is up from a $150m minimum when we looked at this three years ago, with the difference being higher capital levels, lower interest margins, and higher staff costs.

Only around one third of banks in Cambodia currently meet this threshold in terms of loan book size, which explains why the industry overall has relatively poor returns.

While each bank will have its own challenges, some key themes emerge in terms of what banks can do to improve growth:

- Update lending policies so that they are appropriate for the Cambodian market.
- Modernise and improve people management processes.
- Establish a cohort of experienced relationship managers who are able to bring business to the bank.
- Improve branding/marketing.
- Have a clear customer value proposition.
- Strong digital capabilities.

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 5 times. Those banks that are generating a healthy ROE typically have a gearing level of 7-8 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 19% of their revenue via non-interest income, of which 42% relates directly to lending activities.

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For further information

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