PRUDENTIAL **INSIGHTS**

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INVESTMENT MANAGERS

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Can a Zebra change its stripes?

After vowing for decades that this would never happen, Investec has finally relinquished control of its asset management business (now called Ninety One), which was listed on the JSE on 16 March. With the bank still reeling from the Global Financial Crisis (GFC), a series of poor decisions, and now the Covid-19 pandemic, this is a welcome relief. While we agree that it does not alter the business overnight, we think that a series of benefits stemming from the listing will change the stripes on this particular zebra.

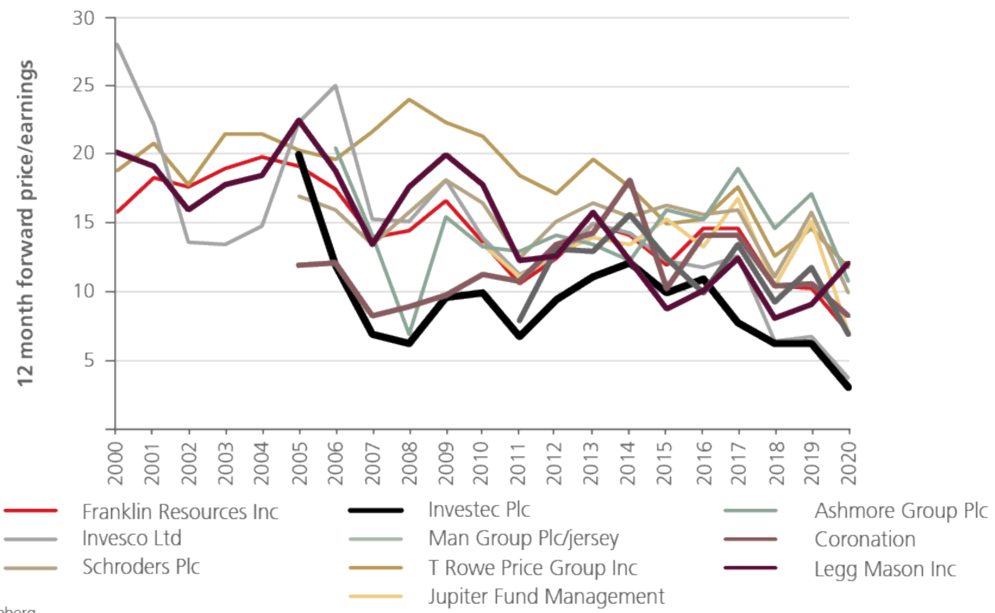
A greater focus on returns

The first of these benefits is management's ability to have a greater focus on returns. Historically as corporate banking empires were built, the foremost business driver was earnings growth, and this has been true for Investec as well. There was seldom a consideration for the returns that would be earned on incremental new business, much less an acknowledgement that banking returns might well be further supressed under the improvements in the Basel regulatory regime imposed after the GFC. Today these capital requirements are increasingly onerous, with banks often being forced to hold multiples of what has been initially invested to compensate for the equity risk. As a result, you can easily end up with a bank earning sub-par returns, justifying sub-par valuations.

Possibly higher equity valuation

The second benefit is the ability of Ninety One to capitalise on the stronger equity valuations of the asset management companies in the wider group, particularly in the UK and Europe. These companies are on average rated at around a 10x one-year forward price/earnings (P/E) multiple. This compares with Investec Group trading at low-single digits on a one-year forward basis. As shown in Graph 1, Investec has been valued consistently at or near the bottom of its peer group since the GFC in 2007-2008.

Graph 1: Investec rated poorly versus peers



Source: Bloomberg

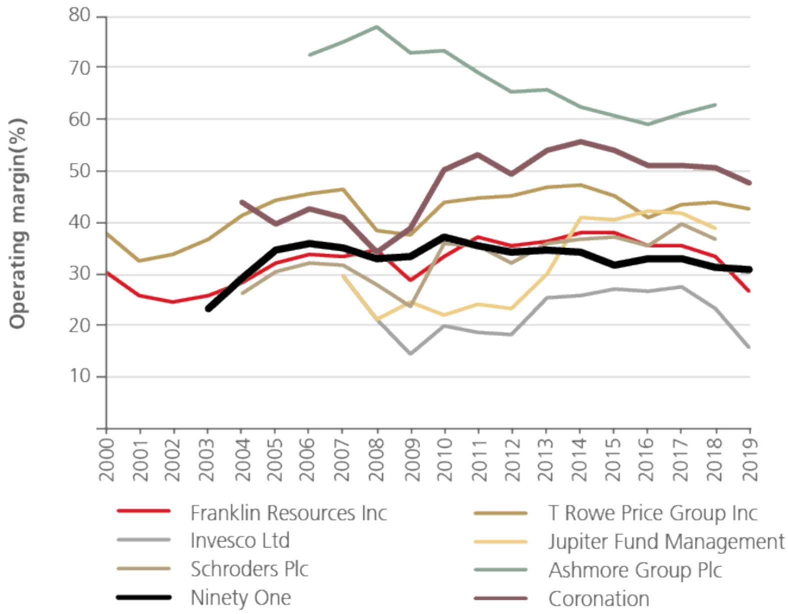
Improved management focus

The third benefit is the focus that separation will bring to the management teams. The bank's management in particular will have to justify its own existence, independent of any potential tailwinds from the asset management operations. The bank will have to focus on generating profitable new business that will improve its return on equity. The asset management business, meanwhile, will have the benefit of a dedicated board with relevant experience, as opposed to being a smaller part of a bank.

Merger possibilities

The fourth benefit is the new potential for mergers and acquisitions. As a separately listed entity in an industry that has seen quite a bit of activity recently, we think Ninety One's attractive new client cash flow generation and solid investment performance could complement a struggling business in need of further scale. The listing will also allow staff access to further incentivisation in the form of shares. Management (of both the bank and the asset manager) has provided the market with an undertaking that it will not issue shares to employees without buying the underlying in the market. This is a further important change in the group that will protect shareholder value. For a change, shareholder and management incentives are better aligned.

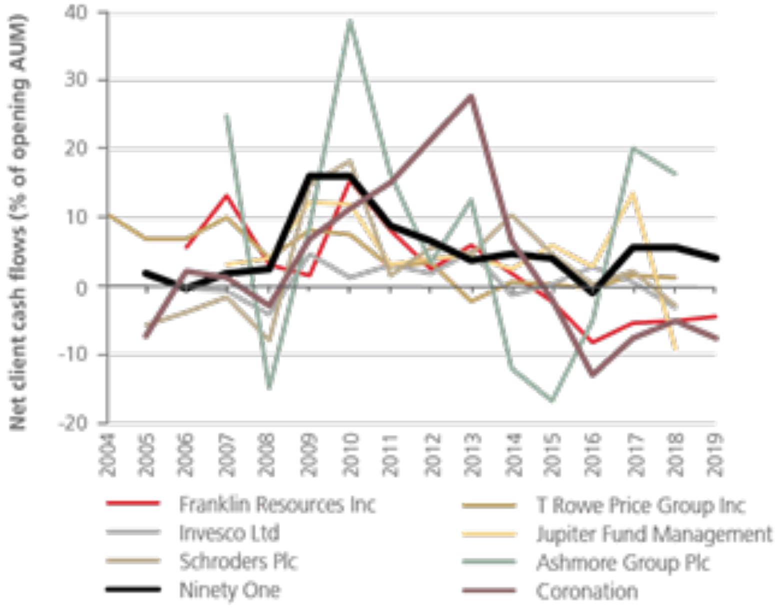
Graph 2: Ninety One's operating margin has proved robust



Source: Bloomberg

Investec's asset management business is world class. Although it will not generate the best margins in the financial services industry (as those are reserved for hedge funds or specialist asset managers), at around 30% these are still robust, as Graph 2 illustrates. With a global footprint spread across both developed and developing economies, Ninety One is better positioned to generate strong growth in net client cash flows (NCCF). While the possibility always exists for these to go backwards, on a through-the-cycle basis the new business generation should remain better than that generated by the market on average. Graph 3 highlights how, as of the end of 2019, Ninety One had been experiencing positive NCCF, faring better than most of its listed competitors.

Graph 3: Ninety One positioned to deliver above-average NCCF



Source: Bloomberg

What about dividends?

What remains a bit of a mystery is where Ninety One's dividend pay-out ratio will be set. Management has guided the market to a dividend/earnings ratio of around 50% as an ordinary dividend. On the face of it, this seems low, but it will also pay out a special dividend. While we assume the special dividend to be an annual occurrence, we are left wondering why they have not just provided a broader range of guidance for ordinary dividends (with no special dividend)? There is, however, precedent for this structure in the form of the Jupiter Group in the UK, and admittedly it will give management some flexibility. In our view the capital requirements of the group will be minimal going forward. Given its shareholding, management would be incentivised to maintain a healthy pay-out ratio in line with industry peers.

Sale of 25% shareholding delayed

Management remains strong owners of the business with an existing holding of approximately 20% and a stated interest to increase this by another 10% or so in the near future. Given the volatility in markets during the listing process, Investec Bank took the correct decision to delay the sell down of its 25% stake to a later date. Management put in a bid to increase its stake by 4.8% during the intended sell down, but will now become a natural buyer in the market.

Similar to what we saw with the listing of Quilter by Old Mutual, it could take some time for the shares to switch into the hands of foreign buyers and achieve a re-rating. We do not expect this to happen quickly, especially given the very volatile markets.

Improving the bank's capital allocation

While everyone is focusing on the asset management business, we are not forgetting about the bank. With renewed focus, optimisation opportunities and greater motivation (in the form of revised executive incentivisation), it could all aid in catapulting the business to success. In order to execute on this plan, the bank needs to address issues relating to the sub-optimal allocation of capital and an overextended cost base.

For example, the bank should attend to the disposal of businesses where the Basel capital requirements are too onerous and the returns earned too low. Private equity operations and principle investments in South Africa are one such opportunity. While the time is not right for an IPO, management could find trade buyers for some of the assets, or alternatively spin these off into separately managed third-party backed funds. This will free up capital that is presently held at multiples of the equity investments that could then be switched into lending activities that offer greater returns on equity, or alternatively returned to shareholders.

Despite having performed a substantial clean-up post Kensington (its foray into sub-prime lending), Investec needs to do more with its balance sheet relating to the last of its poor co-investments (the disastrous Tianhe Chemicals, for example). We also think that Investec will not take such large equity stakes in future transactions given the changes made to the executive remuneration and the attention placed on returns from underlying investments.

Within the UK, Investec will hopefully continue to grow its UK bank in terms of both asset and client numbers, particularly in the high-net worth space. It has spent quite a lot of money over the last few year to set up the infrastructure needed to grow the private bank. Now it is in the position to attract new clients without the need to incur any substantial incremental costs. This will allow the business that is presently loss-making to break even and become marginally profitable over the next two years. As its return on equity (ROE) is currently inclusive of the losses, any improvements will drop to the bottom line quite quickly.

The bank has also had a clear focus on costs. This has been one of the few areas where we have already seen decent evidence of Investec's determination, with group costs steadily reducing over time and management planning further reductions in due course. Management should be able to achieve its cost-to-income targets with a ratio of below 65%, down from around 67.3% in the first half of its 2020 financial year.

Investec Bank has indicated it plans to implement a dividend policy of between 30-50% after the transaction. It is sufficiently well capitalised to support decent levels of asset growth. Added to this is the benefit that can come from selling down its remaining 25% stake in Ninety One, as well as any capital release following the sale of its private equity portfolios. This could result in a bank that would have more capital than it would be able to grow into, and hence the potential for additional dividends. We remain optimistic on this matter, but it is not included in our base case, which we think is attractive on a standalone basis.

The unbundling has also been accompanied by a change of the guard within Investec. The influence that the founders had on the business ought not to be underestimated. The change has allowed the younger generation to step up and try prove their own worth. We think this change in leadership is a good thing, as the younger team is closer to some of the issues and cares more about market perception.

Impact of the COVID-19 pandemic

The impact of COVID-19 on the respective businesses remains uncertain at this point, given that we are still in midst of the pandemic. In the instance of Ninety One, it will probably result in lower levels of assets under management (AUM) as market values have dropped sharply and investor risk aversion has led to a flight to quality. This may result in outflows and could decrease margins.

For Investec Bank, the impact is broader as activity levels decline in new loan generation, but trading and certain transactional volumes (such as credit card spending) appear to be holding up in the sector. Any concerns would mainly relate to higher levels of loan impairments. For the most part, the lockdowns will accelerate the demise of any business already under strain. If a loan is up-to-date prior to the onset of the virus but subsequently falls into arrears, the banking regulators globally will ring-fence these assets and allow banks to deal with them separately. This will create some scope for the banks to manage through the crisis. We believe that for the most part banks, including Investec, have been conservative in their lending practices and are well capitalised. Equally, they have sufficient liquidity and experience to deal with this dynamic situation. Should the need arise, we believe that governments will step in with additional aid to assist industries adversely impacted by the virus and temporarily unable to repay their loans.

In our view, at the current valuation multiples, the bad news is largely priced into the shares.

While we do think that a zebra can change its stripes, given the perennial issues that have plagued the business in the past, we also believe it will take some time as the market will adopt a wait-and-see approach. We do not expect earnings to blow the lights out, but rather a steady improvement in return-on-equity measures into the target range of 12-16% for the banks, and reasonable growth for Ninety One. However, we have already seen a rating improvement as Ninety One finally gets the better rating that it deserves. This shows that not only can a zebra change its stripes, it can also be rewarded for daring to change them.

For more information, please feel free to call our Client Services Team on 0860 105 77 or email us at **query@prudential.co.za**.