PRUDENTIAL **INSIGHTS**

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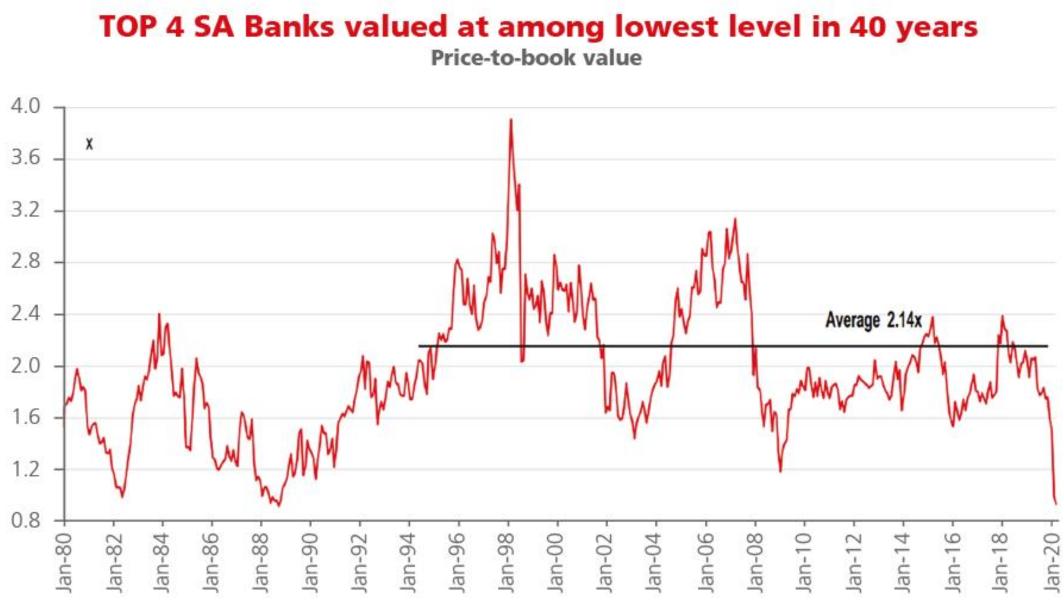
A good time to be buying SA banks?

The Coronavirus shutdown and resulting disruption to the South African economy and consumer finances has caused significant concern among investors around the increasing potential for worse-than-expected bad debts in the banking sector, and this has resulted in large drops in the share prices of South African banks. At the same time, the substantial rise in bond yields in South Africa during late March and April impacted negatively on the valuations of banks. Bond yields in South Africa have now fallen back to similar levels as before the start of pandemic, yet we have seen very little improvement in the share prices of the banks. Is it a good time to be buying SA banks?

At Prudential, our unit trusts including the Prudential Dividend Maximiser, Equity, Balanced and Inflation Plus Funds have been overweight in the South African banking sector. Our preference for the banking sector has been mainly due to their good valuations and very strong capital positions. Most certainly, the major South African banks have gone into this crisis with very strong provisioning and capital positions, and we think that these buffers place them in a good position to absorb any significant potential losses that may arise from the impact of the Coronavirus pandemic. One of the positive effects to have come out of the Global Financial Crisis a decade ago has been the far more conservative provisioning methodology of the SA banks. While it is always difficult to be fully prepared for such a significant and unexpected event, we think that the SA bank sector went into this crisis on a very sound footing.

There has been a lot of commentary around the expected cuts in dividends from the banking sector. We think that this conservative approach in the medium term is very sensible, and that none of the banks should declare dividends for the 2020 year in order to ensure they have an even stronger capital position in advance of what will undoubtedly be a period of high levels of bad debts.

Despite the gloomy outlook, what really excites us about an investment in the SA banking sector is the exceptionally low price-to-book valuations we are observing (as shown in the below graph). The market is pricing-in an exceptionally negative outcome from the impact of the Coronavirus. On balance we think that this may be a very good point to be buying banks and that prospective returns over the next five years may be very attractive.



Source: Company data and HSBC estimates

At Prudential we have observed that since financial markets started to recover from April, bond yields have fallen back to approximately the same levels where they were trading before the start of the pandemic, and yet the valuations of banks have not improved. The financial sector has been the laggard in the equity market recovery to date, returning only 13% for the three months to 30 June, compared to the FTSE/JSE All Share Index's 23% return.

As a result of these market moves, we think that the equity market is now embedding a substantial risk premium for an investment in SA banks, and has done this over a short space of time. We think that this very high risk premium is more than compensating us for the likelihood that dividends will be materially cut (or reduced to zero) by many banks for the next couple of years, and have therefore increased further our funds' overweight position in the banking sector during the last quarter.

Among our preferences within the sector are Standard Bank and ABSA, where we believe there is better value relative to certain other banking institutions, and we believe these counters have been priced exceptionally cheaply. Standard Bank, for instance, is a very high-quality bank with good returns on equity and its dividend growth over many decades has been exemplary. It has been a long-standing investor across Africa and now has some very valuable investments on the continent, specifically its investment in Stanbic IBTC in Nigeria, which owns by far the largest and best quality pension fund adviser and asset manager in that country.

South African banks have lived through many crises. The sector is well regulated, well-capitalised and led by experienced management teams. We think that it is well-prepared for the current crisis South Africa finds itself in and is now trading at some of the best valuations we have seen in at least the last 40 years.

To find out more about our views on financial markets and other investment-related matters, please visit the Insights page of our website. Alternatively, if you're ready to start investing now, you can do so online in under 10 minutes by completing our online application form.

For more information, please feel free to contact our Client Services Team on 0860 105 775 or email us at query@prudential.co.za.