

# SA banks poised for growth and set to thrive as economic outlook improves

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South African banks have been operating well despite the uncertain macroeconomic environment, shifting political landscape and the highest interest rates in over a decade. Despite these challenges, the sector has remained remarkably resilient, continuing to grow profitability and (for the most part) improve returns. As the interest rates start to come off, the endowment benefit will wane, but the elevated levels of credit losses and improved activity levels should provide a comfortable level of support to earnings growth.

## Navigating the worst in the credit cycle

The banks have managed through some of the highest interest rates in more than 10 years. This was particularly challenging in retail lending, where most loans in South Africa are on variable rates. As the interest rates increase, so do the monthly repayments placing the average South African under financial strain, but as interest rates reduce this will reverse. The rate reduction will not only allow over-indebted consumers to play catch up, but it will also allow new customers the opportunity to access loans at more affordable installments. While there may be a lag between a rate reduction and the pickup in new business demand, this is usually temporary and the outlook for asset growth remains positive.

The cost of risk is currently at or above long-term, through-the-cycle ranges. The continued decline in impairments will be a meaningful driver to earnings growth in the sector. As the interest rates have started to come off their highs – non-performing loans are also improving, though this recovery is generally slow as consumers take time to recover. However, rates have notably passed the peak point. Recent pre-close guidance issued by the banks indicates that the credit loss experience is better than previously expected. While it is still early on, the two-pot pension withdrawals could be partly funding debt paydowns.

## Asset growth potential with the GNU

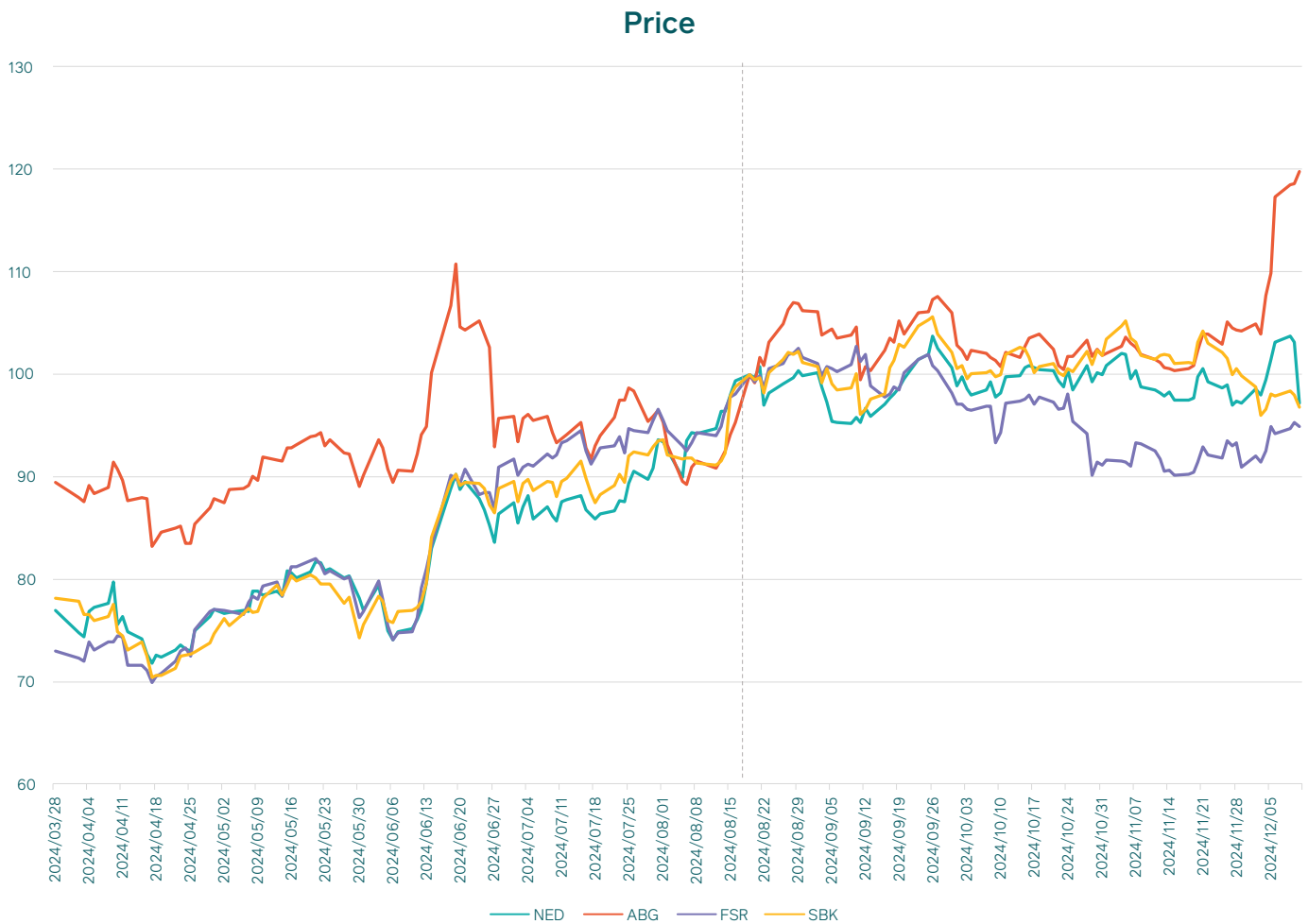
As positivity improves around the SA Inc narrative, this could be good for the macroeconomic outlook, which in turn will be supportive of asset growth in the banking sector. While consensus, in our view, is pricing in a normal recovery, it is not presently accounting for any benefit from the government attracting additional investments. The typical lead time on new corporate investments is between 12 – 18 months. We remain optimistic that this benefit could be more material than what is currently anticipated by the market and will start becoming more evident into 2025.

## Why we prefer Absa

Among South African banks, Absa stands out as a top pick. We share why we prefer Absa, and outline exactly what we like about the investment case.

Absa is a universal bank with a diversified, pan-African franchise that should over time deliver a return on equity (ROE) in excess of 18%. While the present ROE is somewhat off at around 14%, recent management changes have been encouraging. The new leadership has made a candid, no-holds barred assessment of the company's challenges and are committed to working towards rectifying those concerns. The market has responded positively and since the change in leadership, Absa has outperformed its peers. From figure 1, we can see the significant positive price action on Absa following the management changes on 19 August 2024.

**Figure 1: Absa's price relative to peers**



Source: Factsheet

### Absa has hedged out the endowment impact in South Africa

As interest rates decline, the endowment impact (which is simply the interest income that the banks earn on their accumulated capital) will come under pressure as it earns a lower return. Absa has hedged against the impact of interest rate fluctuations, a strategy it adopted under Barclays' ownership. This hedging approach protects the bank from fluctuations in interest income due to changing rates, offering margin stability. To effectively hedge requires patience as one typically needs to introduce this over an extended period. Other banks have recognised the benefits of the hedging strategy and have all subsequently sought to introduce one to a varying degree. However, Absa has had it in place for the longest time, providing the bank with the most protection. On a relative basis, Nedbank (one of our underweights) is the most exposed.

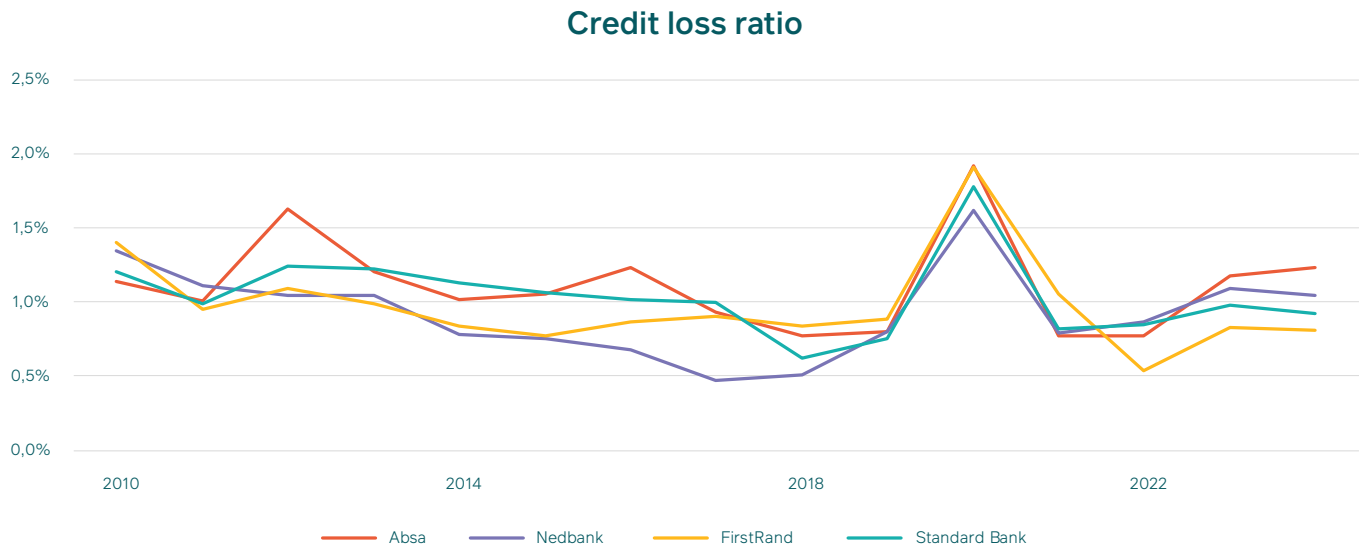
### Plagued by a series of once-offs that became two-offs

Part of the market's deep frustration with Absa has been the series of once-off challenges, such as losses in Nigeria, as well as the hyperinflationary accounting and sovereign debt write downs in Ghana. While the hyperinflationary accounting issue will persist into the first half of 2025, the rest are largely in the base. With improved focus on country risk and treasury management, Absa is unlikely to face these issues going forward. These factors alone could drive substantial earnings growth over the next two years. The diversified African franchise should deliver better earnings growth than South Africa and improved ROEs over time.

### High impairments relative to peers

Absa's impairment levels are elevated compared to peers, as well as its own history, due to the balance sheet led strategy, as seen in Figure 2. With a credit loss ratio of around 1.2% it remains the highest of the big four banks. However, as the interest rates decline, credit losses are expected to normalise, which will benefit Absa more relative to its peer group.

**Figure 2: Absa's credit loss ratio elevated compared to peers**



Source: Company data

## Renewed focus on ROEs

Absa has historically focused on market share and revenue growth ahead of return considerations. The market was always critical of Absa's capital allocation. Under the auspices of the new management team, all these issues are being reviewed with a laser focus on returns and profitability. The focus will not only be at a product level, but importantly at a client level with the promise to shut down sub-par offerings. This together with the embedded self-help and a renewed focus on non-interest revenue generation (that is ROE enhancing) will help to improve the return back up to around 18%.

## Banks: A safe bet for investors

The South African banking sector remains a safe investment choice, supported by positive sentiment that could further improve returns and the potential benefits of lower bond yields that positively impacts on cost of equity. As interest rates decrease, we believe that the banking sector is expected to deliver better-than-expected returns. We are particularly optimistic about Absa, as it is benefiting from a self-help strategy, a more favourable leadership outlook against a positive backdrop of regaining some lost ground. At M&G Investments, we are overweight on the banking sector and believe it remains poised for growth into 2025 and beyond.

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