The growing opportunity for investment banks in emerging markets

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The credit crunch that erupted in mid-2007 has already taken many new twists in the first half of 2008. But new McKinsey research shows that, amid the general uncertainty, the outlook for investment banking in emerging markets remains relatively bright.

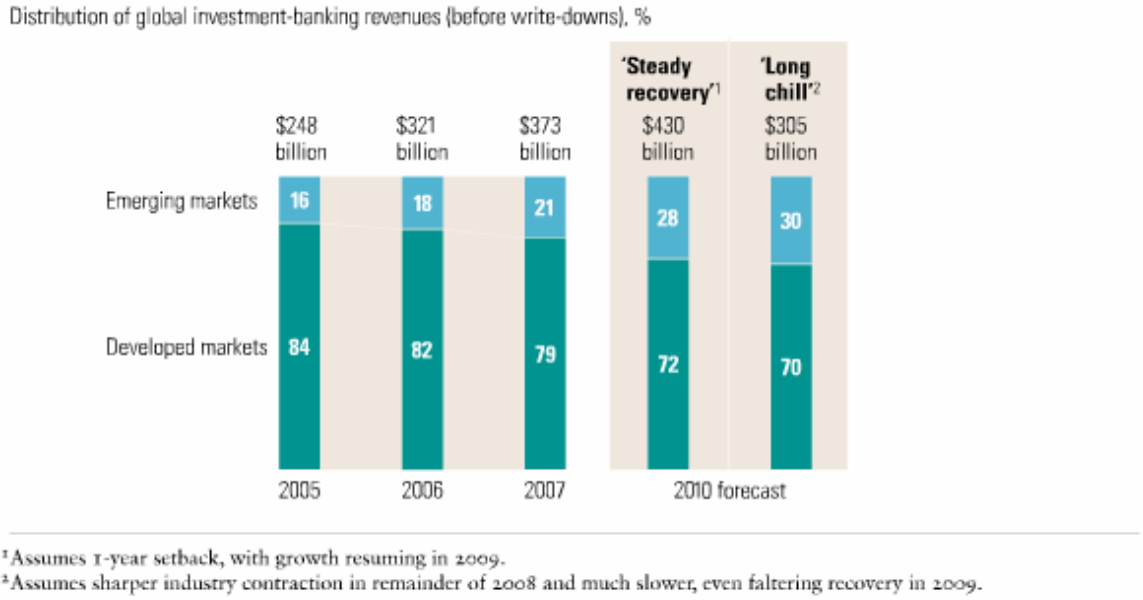
Even in the worst case, emerging Asia and Europe, the Middle East, and Latin America will probably show absolute revenue growth over the next three years. Under all likely outcomes, the proportion of global revenues from emerging markets will jump sharply. Collectively, indeed, revenues from investment-banking and capital market activities in these regions are projected to match those in North America by 2010; in 2006, before the credit crunch, they amounted to less than half.1 A case, perhaps, for referring to "emerged" rather than emerging markets in the future?

Exactly when capital market activity recovers around the world will depend on three critical uncertainties: the prospects for the US and global economies, the speed of recovery in credit markets, and the behavior of investors and regulators. But several factors already suggest that emerging markets will be big winners in the near future. First, their macroeconomic environment remains comparatively benign, even if talk of a complete "decoupling" of their economies from those of the United States and Western Europe was premature. Although, if trade flows with the West do suffer, regional demand for oil and commodities, growing intra- and interregional trade flows (especially within Asia and between it and the Middle East), and huge infrastructure-investment programs will continue to underpin growth. Second, a new breed of global corporate players, notably in countries such as China, India, and the United Arab Emirates (UAE), now demands the sort of sophisticated investment-banking services previously reserved for large Western multinationals. This new group thus represents an increasingly attractive fee pool.

On the supply side, the emerging world's capital markets will continue to develop. In part, their growth reflects intraregional competition, seen in the rush to develop financial centers in the Middle East and in government-sponsored bond issuance programs. At the same time, global investment banks are redirecting their resources—both human and capital—toward emerging markets, which they see as a new source of revenues to compensate for leaner times at home.

In the event of a relatively benign outcome for global capital markets—a one-year setback, with growth resuming in 2009—we calculate that revenues from investment banking in emerging markets will increase by 16 percent a year from 2007 to 2010, when they will generate 28 percent of the global total (exhibit). In this "steady recovery" scenario, Asia will continue to represent the lion's share (66 percent) of the emerging markets' revenue stream of almost $120 billion.

A larger share for emerging market



[1] Assumes 1-year setback, with growth resuming in 2009.
[2] Assumes sharper industry contraction in remainder of 2008 and much slower, even faltering recovery in 2009.

Suppose that the industry contracts more sharply during the second half of 2008, with a much slower, even faltering recovery in 2009. Revenues from emerging markets will still rise significantly (6 percent), according to our research, and will probably exceed $90 billion by 2010. In this "long chill" scenario, these regions will account for a bigger share of the global total (30 percent) than they would under our more benign scenario.

What's really likely to distinguish emerging and developed markets over the next few years is the different effects of the credit crunch. Emerging markets, after all, do not have as much fallout to manage as their Western counterparts do: by the end of the first quarter of 2008, they had generated only around 7 percent of investment banks' write-downs, as opposed to more than 21 percent of global revenues. Furthermore, revenues from credit and securitization—mostly plain-vanilla corporate bonds—represented just 9 percent of the emerging markets' revenue pools in 2007. By contrast, credit products were responsible for 18 and 10 percent of US and European revenues, respectively.

Of course, one could argue that these numbers do not tell the full story. With limited product origination in emerging markets, there has been little to securitize, and institutions there have consequently avoided the dramatic swings in valuation that have hurt their counterparts holding market-traded products in the developed world. Even if many institutions hold significant amounts of bad loans, they are not required to mark them to market.

The absence of a bond "culture" means that managers of institutions based in emerging markets can now focus harder on the areas most likely to generate future growth. Under our analysis, commodities and equity derivatives will probably be the big winners, no matter how markets perform more generally. Foreign exchange, interest rate swaps and futures, and equities (including derivatives) will do well under our benign scenario and will be relatively resilient even in the tougher one.

While all emerging markets are expected to fare comparatively well under both scenarios, we see some interesting nuances across regions.

Emerging Asia

Over the next few years, we expect wholesale banking revenues ($38 billion in 2006) in Asia outside Japan to double under our steady-recovery scenario and to increase by more than 60 percent even with a long chill.

Drivers will include robust economic growth—increasing both the stock and turnover of financial assets—and further deregulation in local markets. Emerging Asian countries, moreover, will integrate with global financial markets and become a target for financial players; as more Asian companies expand internationally, they will also become a source of new investments, funds, and wholesale-banking activities.

Sovereign wealth funds and hedge funds have emerged as new client groups and are growing rapidly, with the $200 billion fund of the China Investment Corporation (CIC) just one of the latest actors on the stage.

Indeed, China is the country to watch: its financial depth is already comparable to many developed markets. Its future growth will be mainly built around equities, rates, and an emerging debt capital market and corporate-bond market, as well as an appreciating currency, which should further boost revenue pools. Product diversity and innovation will increase in China: advanced products such as securitization, derivatives, and program trading should start to thrive as regulators continue to loosen restrictions.

India's growth is also expected to be strong under both our scenarios, with M&A and rates trading comparatively more important than they are in China. That said, lower growth and lower savings rates mean that India's accumulated financial stock will be only one-fifth of China's.

Asian markets are fast becoming as demanding and sophisticated as markets in Europe and the United States. Clients have developed a taste for complex financial products and demand good local service; domestic competitors are ramping up their skills and opening their checkbooks to attract international talent.

An onshore presence in emerging Asian markets, meanwhile, is becoming critical. The old model of the suitcase banker operating from hubs such as Singapore and Hong Kong will fail to satisfy clients and regulators seeking a true commitment to the local market.

Complex products (acquisition finance, exotic fixed-income products, equity derivatives, and proprietary trading) will develop in emerging local onshore markets and continue to grow in the bigger financial centers. As elsewhere, the lines between financial services are blurring with increasing overlap between investment banking, asset management, and private banking. A significant share of private wealth in Asia, after all, is generated through capital markets transactions.

Latin America

We expect Latin America's revenue pools to grow by 16 percent a year under our benign scenario and by 4 percent in the more pessimistic one. Brazil, representing half of Latin America's revenue pool, dominates the region's capital markets, followed by Mexico and Chile. Brazil's capital markets have developed recently—the primary markets are growing especially rapidly (there were 61 IPOs in 2007 alone), along with simple derivatives markets and cash equities brokerage.

In Brazil, we see four key growth drivers. First, local and international banks will invest in building sales and trading capabilities, especially in OTC products such as commodity derivatives. There is strong latent demand for this type of product in a country that is a leading exporter of several agricultural and mining commodities and where domestic players have had little opportunity to manage their risks locally. International banks (especially those based in New York) are also expected to move aggressively to build their presence in this market, which for them has the double advantage of being close to home and largely unaffected by the credit crunch.

Second, the country's return to investment-grade status and a program of large infrastructure projects will create long-term financing needs and promote the development of a proper yield curve. Third, the recent relaxation of restrictions on investment—mutual funds can now place up to 20 percent of their assets overseas, for example—is expected to be followed by tax changes that will benefit foreign investors and the trading of derivatives. These moves should help boost capital flows and facilitate the use of more sophisticated financial instruments.

Finally, Brazil's overall macroeconomic outlook—4 to 5 percent GDP growth is expected under our benign scenario—will encourage new equity and debt issues, as well as M&A activity. Even in our more pessimistic scenario, Brazil should fare comparatively well, given its strong structural demand and the economy's focus on commodities.

Emerging Europe

The outlook for capital market businesses differs substantially across emerging Europe, but all of these countries share the prospect of strong underlying growth: 19 percent annually in the region as a whole until 2010 in our benign scenario, 7 percent in the event of the darker one. Russia, accounting for 42 percent of the region's capital market revenues and growing at more than 20 percent a year, is a major—but not the sole—part of the story. The opportunities in emerging Europe are sprouting in countries ranging from relatively developed Poland, which is preparing to adopt the euro, to truly emerging markets, like Kazakhstan. Notwithstanding the region's heterogeneity, we have identified a number of general trends.

While Russia and other parts of Central and Eastern Europe offer rich opportunities in primary products such as new debt and equity issues, secondary market products will provide the lion's share of the revenue pool—a mix that already mirrors Western Europe's. In the future, we believe, growth will probably shift from foreign exchange to interest- and equity-based derivatives, among other products.

Except in Russia, foreign-owned universal banks, using their corporate-banking arms for distribution, have mostly been quick to deploy their capital market expertise across emerging Europe. Universal banks have captured the bulk of the revenues in these markets. Local trading rooms, often with oversight from Western players, have proliferated. Russia is different. Global investment banks have aggressively built a presence there, but local boutiques have grown into serious players. Two of the top five Russian firms remain independent, and the founding management teams of the three acquired by global banks are still highly prominent. Furthermore, local universal banks are improving their capabilities significantly, and Moscow is well placed as a financial center to address the country's vast domestic market and the former Soviet republics.

The Middle East

Investment banks are reassigning more and more bankers from London and New York to the Middle East, despite the region's small capital markets (2007 revenues of $3 billion), a limited but growing number of listed companies, and debt markets that remain small relative to GDP.

Our research, however, shows that this region is likely to enjoy the fastest capital market expansion in the emerging world under both of our scenarios. Revenue pools will grow by 25 and 16 percent a year under the optimistic and pessimistic ones, respectively, from 2007 to 2010.

The oil-rich states of the Gulf Cooperation Council (GCC)—Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the UAE—are generating wealth at levels not seen since the 1980s. High oil prices have triggered an unprecedented wave of investment, including a huge pipeline of industrial and large-scale infrastructure projects, such as Saudi Arabia's new "economic cities." By some accounts, the GCC will have invested around $3 trillion in the region by 2020.

A number of domestic companies are using these resources to expand internationally and become “global champions,” while wealthy private investors are investing around the globe. Countries across the Middle East continue to modernize their regulatory and institutional frameworks, while governments and listed companies increasingly embrace Islamic structures supporting the growth of Sukuks (bonds that comply with Islamic law).

Even under our pessimistic scenario, the medium-term outlook for capital markets in the Middle East remains positive. The sheer magnitude of the wealth accumulated over the past few years should help support these markets if a protracted economic recession ever chokes global demand for oil and slows the flow of capital into the GCC.

Emerging markets now have a rare window of opportunity to catch up with the rest of the world, not least because they don’t have to mitigate the mess created by current market dislocation in the West.

Of course, unpredictable events—such as a major political upheaval or an escalation of regional tensions in the Middle East—could call this into question. But barring a geopolitical disaster, under the benign and the pessimistic scenarios alike, emerging Asia, Latin America, emerging Europe, and the Middle East should achieve sustained growth and capture close to 30 percent of the global investment-banking pie over the next few years.

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Notes

1Our scenarios rest on the findings of the McKinsey Global Capital Markets Survey (GCMS), a comprehensive, in-depth analysis of the state of the global investment-banking industry. The survey provides forward-looking estimates of revenues from capital markets activities for the years 2006 to 2010.

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