Banca Sistema

Q118 results

Growth on track

Financial services

There was a small one-off provision in the first quarter but, that aside, trading was in line with management expectations and Banca Sistema (BST) continues to focus on delivery of its recently published three-year plan which, on our estimates, points to substantial growth in receivables and earnings between 2018 and 2020. The shares in this specialist lender remain modestly valued, both in relative and absolute terms.

Year end	Net operating income (€m)	PBT* (€m)	EPS* (c)	DPS (c)	P/E (x)	Yield (%)
12/17	82.5	38.9	33.3	8.6	6.4	4.1
12/18e	90.2	39.2	33.7	9.0	6.3	4.2
12/19e	116.5	52.1	44.7	9.7	4.7	4.6
12/20e	135.9	60.6	52.0	10.5	4.1	5.0

Note: *Reported PBT and EPS.

Q118 shows strong loan and income growth

Factoring receivables and pension and salary-back loans continued to show good year-on-year growth at 35% and 68%, respectively. As expected, the shift in loan mix towards lower-risk/lower-yield assets, including VAT receivables, is resulting in a reduction in the interest income margin, but this is coupled with low impairment levels (22bp) and longer duration. The growth in pension and salary backed (CQ) loans also contributes to this mix change at group level. Interest cost was amplified by a one-off €0.8m provision related to the TLTRO funding rate applied in prior periods and, while reported net earnings growth was limited to 7% year-on-year (to €4.7m), adding back the provision would result in growth of 18% (to €5.2m).

Prospects for receivables growth remain good

BST only recently announced its three-year strategic plan and the first quarter results do not suggest any modification to the outlook. The bank's focus is on its two core areas in factoring, and CQ lending and the plan targets 28% and 25% CAGR in lending to 2020 respectively. Tax receivables are seen as a particularly promising area within factoring and a potential reduction in capital requirement could add to the attraction of CQ lending. BST reports that the competitive environment remains stable. The political background in Italy is uncertain, but neither business area appears particularly sensitive to this.

Valuation: Estimates and valuation maintained

Our estimates are essentially unchanged following the results (see financial summary, Exhibit 4, page 5) and compared with a selected peer group BST appears modestly valued in terms of P/E and price-to-book multiples. Our ROE/COE valuation is unchanged at €3.40.

16 May 2018

Price	**€2.25**
Market cap	**€181m**

Net debt/cash (€m)	N/M
Shares in issue	80.4m
Free float	54%
Code	BST
Primary exchange	Borsa Italiana
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	(2.0)	(2.4)	(4.5)
Rel (local)	(5.8)	(9.2)	(14.1)
52-week high/low		€2.61	€2.10

Business description

Banca Sistema is a speciality finance provider with a primary focus on factoring receivables from the Italian public sector (public administrations or PAs), with salary and pension-based lending forming a second core activity. The bank is also opportunistic, and is looking to diversify into new areas such as its gold and jewellery-backed lending business.

Next events

Q218	26 July 2018

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Q118 results: Meeting management expectations

Banca Sistema's first quarter results compared with Q117 showed 10% growth in net interest income and a near-60% increase in net fee income resulting in a 22% increase in operating income. A swing back from an impairment write-back to a charge meant this fed through to a 14% increase in pre-tax profit, while a higher tax rate led to a 7% increase at the earnings level (see Exhibit 1). There are several points to bear in mind when looking at this comparison.

1. The **interest income margin** was lower at 4.3%, reflecting a combination of lower yield on factoring receivables, which mainly reflects a mix change towards lower-risk and lower-yield assets, including VAT receivables and PA portfolios already in legal collection when acquired. The larger proportion of pension and salary-backed lending within total customer loans also results in a lower average yield. Against this, the lower-risk, longer duration and, for tax receivables, lower capital absorption all contribute to overall returns.
2. Most of the **fee income** arises in the factoring business, where fee and interest income are effectively interchangeable. Adding factoring fee income to the interest income percentage shown below would give figures of 5.6% for Q117 and 5.1% for Q118.
3. Interest expense for Q118 was increased by a **one-off provision** of €0.8m relating to TLTRO funding where a benefit of 40bp was recognised in earlier periods, and it now seems likely that factoring and pension and salary-backed lending will instead qualify for a zero interest rate. Without this provision, profit after tax would have been €5.2m.
4. The positive figure for **impairment losses** for Q117 reflected a write-back, while the loan loss provision in Q118 at 22bp of average loans compares with the target for below 30bp on average set in the recently announced three-year strategic plan.

Exhibit 1: Q118 profit and loss summary

€000s	Q117	Q417	Q118	Q118/Q117	Q118/Q417
Net interest income	**12,423**	**16,519**	**13,688**	**10.2**	**(17.1)**
Net fee and commission income	2,249	3,300	3,558	58.2	7.8
Other banking income	231	12	857	271.0	N/A
Operating income	**14,903**	**19,831**	**18,103**	**21.5**	**(8.7)**
Net impairment losses on loans	488	(2,295)	(1,087)	N/A	(52.6)
Net operating income	15,391	17,536	17,016	10.6	(3.0)
Personnel expenses	(4,274)	(4,859)	(4,764)	11.5	(2.0)
Other administrative expenses	(5,052)	(4,776)	(5,071)	0.4	6.2
Administrative expenses	(9,326)	(9,635)	(9,835)	5.5	2.1
Net allowance for risks and charges	(77)	74	(74)	(3.9)	N/A
Net adjustments to property and intangible assets	0	(74)	0	N/A	N/A
Other operating income/costs	193	(65)	4	(97.9)	N/A
Operating expenses	**(9,210)**	**(9,700)**	**(9,905)**	**7.5**	**2.1**
Profit/(loss) from equity investments	0	(78)	(43)	N/A	(44.9)
Pre-tax profit	**6,181**	**7,758**	**7,068**	**14.4**	**(8.9)**
Taxes on income from continuing operations	(1,783)	(2,813)	(2,351)	31.9	(16.4)
Profit after tax	**4,398**	**4,945**	**4,717**	**7.3**	**(4.6)**
Interest income % of average loans	4.9	5.0	4.3		
Funding cost % (ex-€0.8m one-off provision relating to TLTRO)	0.9	0.9	1.0		
Loan loss provision as % of average loans	(0.14)	0.53	0.22		
Cost income ratio (%)	62.6	48.6	54.3		

Source: Banca Sistema, Edison Investment Research

Within interest income of €20m, factoring accounted for €15m and within this total late payment interest income (LPI) of €4.8m (24% of total interest income) compared with €3.1m for Q117. Further, within the €4.8m of LPI accruals accounted for €2.9m versus €2.0m in Q117. Cash collections of LPI were €3m (v €1.7m) of which €1.1m (v €0.6m) related to amounts already accrued through the P&L in previous periods. The total stock of LPI at the end of the period stood at

€138m, of which only €35.2m has been recognised through accrual in the P&L since June 2016. BST's historical experience is that 87% or more of this interest should be collected over time. (See our outlook note published in March 2018 for a discussion of the accounting for LPI.)

Turning to the balance sheet, on a year-on-year basis, **customer loans** were up 44% while BST reports that, compared with end 2017 overall loans at amortised cost increased by 3%, within which factoring receivables were up 1% and pension and salary-based loans were increased 5%. Here it should be remembered that seasonal fluctuation and the incidence of transactions can result in significant quarterly fluctuation in loan growth and factoring turnover, which can in turn influence short-term results.

Contributing to the increase in factoring turnover (+24% year-on-year to €504m) have been partnership agreements with banks, which accounted for 36% of turnover in Q118 compared with 30% in the prior year period. A new agreement has subsequently been announced with **Unipol Banca** (260 branches), taking the total number of partnerships to 18.

Financials

Our estimates are essentially unchanged from those we made following the publication of the three-year plan (see our last note for detail). Details are shown in the financial summary (Exhibit 4).

As indicated previously, the implementation of IFRS 9 has had only a limited impact on the balance sheet, reducing the CET1 and total capital ratios by 2bp (they stood at 11.8% and 15% respectively at the end of the quarter).

Valuation

We have updated the valuation comparison showing BST and selected peers used in previous notes. BST trades on the lowest P/E multiple and one of the higher yields.

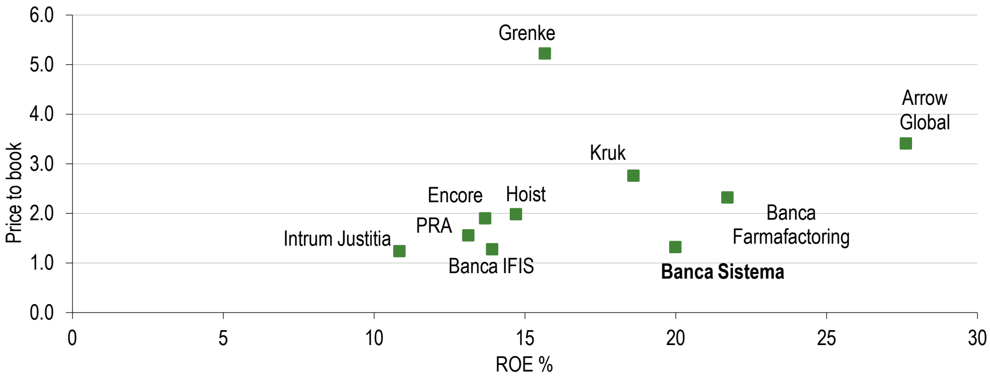
Exhibit 2: Valuation comparison

	Ticker	Market cap (€m)	CY18 P/E (x)	Yield (%)	ROE (%)	Price to book (x)
Banca Sistema	**BST IM**	**177.7**	**6.5**	**3.9**	**20.0**	**1.3**
Arrow Global	ARW LN	667.0	8.7	3.4	27.6	3.4
Banca Farmafactoring	BFF IM	888.8	8.9	9.4	21.7	2.3
Banca IFIS	IFIS IM	1,747.8	11.6	3.1	13.9	1.3
Encore Capital	ECPG US	967.4	9.6	0.0	13.7	1.9
Grenke	GLJ GY	4,471.2	34.2	1.7	15.7	5.2
Hoist Finance	HOFI SS	618.6	10.5	2.4	14.7	2.0
Intrum Justitia	IJ SS	2,829.3	11.3	4.3	10.9	1.2
Kruk	KRU PW	1,024.7	11.8	2.1	18.6	2.8
PRA	PRAA US	1,462.1	19.1	0.0	13.1	1.6
Average			**13.2**	**3.0**	**17.0**	**2.3**

Source: Bloomberg. Note: Prices as at 14 May 2018.

BST also trades on a below average price to book ratio despite a return on equity of c 20%. Plotting the ROE against price to book for the same companies underlines the relatively conservative valuation on which the company currently trades (see Exhibit 3). With our forecast effectively unchanged we have not amended our valuation of €3.40. This reflected the output of an ROE/COE model assuming 20% ROE, long-term growth of 4% and a cost of equity of 11.9%.

Exhibit 3: Comparing ROE and price to book



Source: Bloomberg

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Exhibit 4: Financial summary

Year end 31 December (€000s)	2016	2017	2018e	2019e	2020e
INCOME STATEMENT					
Interest income	86,321	87,234	100,770	136,052	164,782
Interest expense	(15,321)	(16,584)	(23,269)	(33,747)	(43,615)
Net interest income	71,000	70,650	77,501	102,305	121,166
Net fee and commission income	9,060	10,652	11,413	12,879	13,395
Dividends and similar income	227	227	0	0	0
Profit on securitisation	0	0	0	0	0
Net income from asset sales/purchases and trading	1,196	940	1,240	1,280	1,320
Net interest and other banking income	81,483	82,469	90,154	116,464	135,881
Net impairment losses on loans	(9,765)	(5,352)	(6,912)	(9,681)	(11,423)
Net income from banking activities	71,718	77,117	83,243	106,783	124,459
Personnel expenses	(15,169)	(17,631)	(20,627)	(23,502)	(24,907)
Other administrative expenses	(22,529)	(19,705)	(23,260)	(31,154)	(38,957)
Administrative expenses	(37,698)	(37,336)	(43,886)	(54,657)	(63,864)
Other operating income/costs	(589)	(726)	(70)	0	0
Operating expenses	(38,287)	(38,062)	(43,956)	(54,657)	(63,864)
Profit/(loss) from equity investments	2,281	(140)	(43)	0	0
Pre-tax profit	35,712	38,915	39,243	52,126	60,594
Tax	(10,399)	(12,122)	(12,164)	(16,159)	(18,784)
Profit after tax	25,313	26,793	27,079	35,967	41,810
Adjustment for normalised earnings	1095	0	0	0	0
Adjusted net income	26,408	26,793	27,079	35,967	41,810
Reported earnings per share €	0.31	0.33	0.34	0.45	0.52
Normalised earnings per share €	0.33	0.33	0.34	0.45	0.52
Dividend per share €	0.076	0.086	0.090	0.097	0.105
BALANCE SHEET					
Assets					
Financial assets available for sale	514,838	285,610	453,501	453,501	453,501
Due from banks	83,493	36,027	24,652	24,652	24,652
Loans to customers	1,348,329	1,850,290	2,931,025	3,616,876	4,089,727
Property, plant and equipment	23,313	24,272	24,772	24,772	24,772
Intangible assets	1,835	1,790	1,850	1,850	1,854
Tax assets	10,528	10,198	8,271	8,271	8,271
Other assets	17,027	101,046	18,944	18,944	18,944
Total assets	1,999,363	2,309,233	3,463,015	4,148,866	4,621,721
Liabilities and shareholders' funds					
Due to banks	458,126	517,533	813,593	1,003,972	1,135,226
Due to customers	1,262,123	1,284,132	2,102,561	2,566,994	2,872,993
Securities in issue	90,330	281,770	283,013	283,013	283,013
Total tax liabilities	8,539	10,118	10,331	10,331	10,331
Other liabilities	59,825	71,996	86,879	86,879	86,879
Employee termination indemnities	1,998	2,172	2,237	2,237	2,237
Provisions for risks and charges	4,105	6,745	9,862	12,169	13,760
Total liabilities	1,885,046	2,174,466	3,308,476	3,965,596	4,404,439
Group shareholders' equity	114,297	134,737	154,509	183,240	217,252
Minority interests	20	30	30	30	30
Total liabilities and equity	1,999,363	2,309,233	3,463,015	4,148,866	4,621,721
Capital position					
Risk weighted assets	788,000	1,054,901	1,385,990	1,636,526	1,845,997
Credit risk/customer loans	36%	42%	39%	38%	38%
RWA/total assets	39%	46%	40%	39%	40%
Common equity tier 1	104,600	125,800	145,424	173,602	206,964
Total capital	124,700	162,100	179,324	205,102	238,465
CET1 ratio	13.3%	11.9%	10.5%	10.6%	11.2%
Total capital ratio	15.8%	15.4%	12.9%	12.5%	12.9%
Leverage ratio	6.1%	6.2%	4.6%	4.5%	4.8%
Other ratios					
Net interest margin	5.1%	5.0%	3.3%	3.1%	3.1%
Loan loss provision as % of average loans	0.70%	0.38%	0.30%	0.30%	0.30%
Total expenses % of interest and fee income	47.1%	45.9%	49.4%	47.5%	47.5%
Return on average equity	25.4%	21.5%	18.7%	21.3%	20.9%
Tax rate	29.1%	31.1%	31.0%	31.0%	31.0%

Source: Company data, Edison Investment Research

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