

Banca Sistema

H1/Q217 results

Q2 shows further strength in factoring turnover

Banca Sistema's first half figures confirmed further strength in factoring turnover and overall loans outstanding. Market conditions for factoring in Italy remain favourable and salary and pension-backed lending continues to offer good opportunities with the potential for a lower capital burden subject to regulatory discussions. Banca Sistema still trades on modest multiples, but continued growth in the loan book combined with success in delivering a return on equity of over 20% should provide the basis for a rerating.

Year end	Net operating income (€m)	PBT* (€m)	EPS* (c)	DPS (c)	P/E (x)	Yield (%)	Price to book (x)
12/16	81.5	35.7	32.8	7.6	6.6	3.5	1.5
12/17e	87.7	41.2	35.3	9.0	6.1	4.2	1.3
12/18e	99.1	48.3	41.4	9.5	5.2	4.4	1.1
12/19e	107.1	54.1	46.5	11.0	4.6	5.1	0.9

Note: *PBT and EPS are normalised, excluding exceptional items.

H117 results

Second quarter factoring turnover increased by 32% and receivables outstanding by 23% compared with the same period last year: an encouraging confirmation of renewed growth following a weak final quarter in 2016. H117 net income of €10.0m compared with €15.7m for H116, but the reduction can be largely attributed to the absence of late payment interest accrual for earlier periods and a disposal profit which boosted the earlier period. Banca Sistema decided not to pursue a sale of a salary and pension-backed loan securitization as it could not secure favourable terms on the senior tranche. While this meant no profit was realised on a transaction, retention of the loans will bolster prospective interest income and the capital absorbed is set to be balanced by a Tier II bond tap issue.

Outlook

Banca Sistema is successfully generating more factoring turnover through its banking partners and hopes to extend this network in the current quarter.

Structurally there remains good potential to increase factoring penetration in Italy and for Banca Sistema to gain share. Scope for increased acquisition of salary and pension-backed loans also appears favourable while Banca Sistema remains open to new opportunities as illustrated by its pilot pawnbroking (mount of piety) operation.

Valuation: Modest in relation to comparators

Banca Sistema trades on the lowest prospective earnings multiple when compared with selected peers (page 6) and at the current share price a ROE/COE model implies a cost of equity of over 16% which also seems distinctly cautious. Our valuation of c €3.15 is maintained, more than 45% above the current share price.

Financial services

4 August 2017
Price **€2.16**
Market cap **€173m**

Net debt/cash (€m) N/M

Shares in issue 80.4m

Free float 54%

Code BST

Primary exchange Borsa Italiana

Share price performance



% 1m 3m 12m

Abs (8.3) (5.1) 17.0

Rel (local) (11.6) (9.3) (13.6)

52-week high/low €2.8 €1.8

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). The bank is also opportunistic, looking to diversify and has developed salary and pension-based lending.

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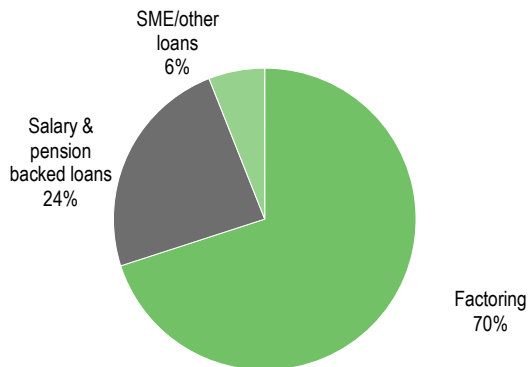
Company description: Specialist finance

Banca Sistema's main activity is providing financing (factoring) of trade receivables for companies supplying a range of Italian public sector entities including central and local bodies and state-owned companies (collectively labelled Public Administrations or PAs). These counterparties represent a low credit risk, comparable to the sovereign credit risk on an Italian government bond. The bank also undertakes factoring of receivables relating to VAT and other tax receivables and from private sector companies in Italy.

The bank seeks opportunities for attractive diversification and this led to the expansion of salary and pension backed loans and, recently, a pilot investment in institutional pawnbroking, currently comprising two branches. The group has also made loans to small and medium enterprises that benefit from a state guarantee. The announcement of a reduction in the level of guarantee prompted Banca Sistema to withdraw from this business and the book is in the process of being run down.

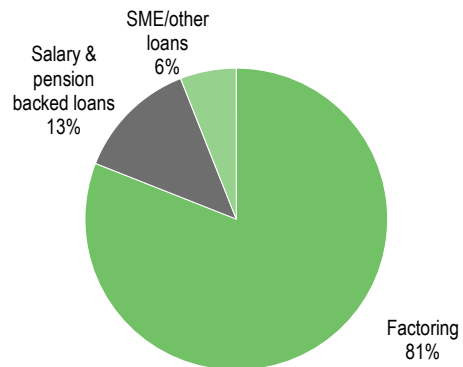
Exhibits 1 and 2 show the predominance of factoring within customer loans and net interest income.

Exhibit 1: Analysis of customer loans outstanding



Source: Banca Sistema (H117)

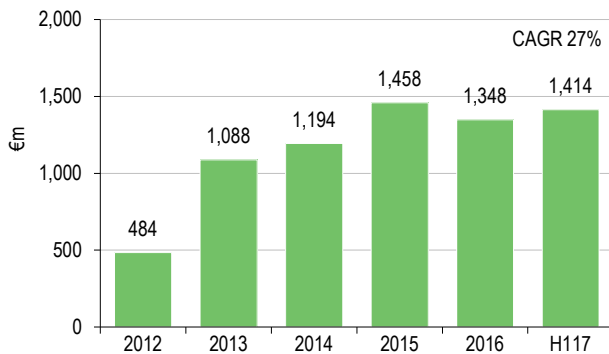
Exhibit 2: Net interest income analysis



Source: Banca Sistema (H117)

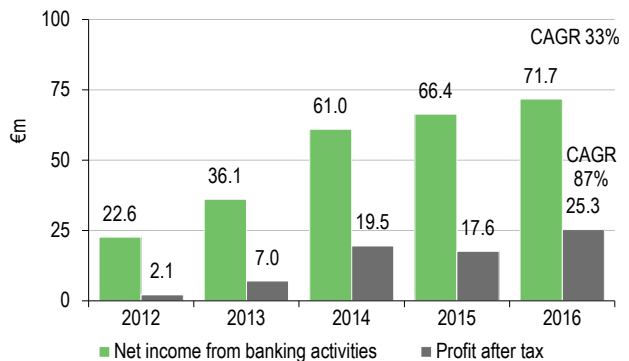
Exhibits 3 and 4 show the medium-term progression of customer loans, net banking income and profit after tax. Customer loan growth paused in FY16 reflecting the temporary impact of the cancellation of a factoring receivables purchase in the final quarter. The resumption of factoring turnover growth of over 20% in both the first and second quarters of the current year is reflected in the resumption of loan growth in H117. We discuss the H1/Q217 results in the next section.

Exhibit 3: Customer loan growth



Source: Banca Sistema

Exhibit 4: Net banking income and profit progression



Source: Banca Sistema

For further discussion of the factoring industry and description of Banca Sistema's business see our initiation note published in [May 2018](#).

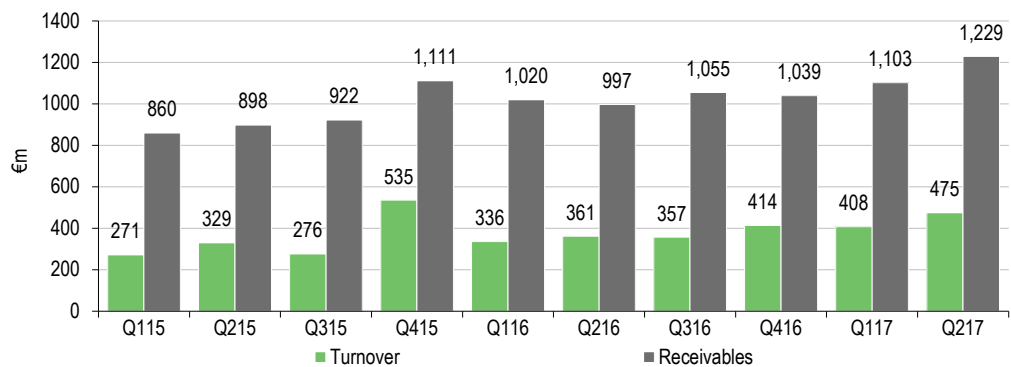
H1/Q217 results: Still targeting 20% ROAE

Banca Sistema's first half results showed net income down by nearly €6m to €10m but this primarily reflected the absence of a late payment interest accrual of €5m relating to prior periods and a €2.3m profit on the sale of a stake in CS Union which bolstered the H116 result.

From a fundamental, forward-looking perspective the increase in factoring turnover and receivables outstanding is more important and is an encouraging indicator (Exhibit 5). Growth in the level of salary and pension-backed loans outstanding has also continued and at present the bank is not actively considering a sale of a securitisation of these assets, instead initiating a tap issue of Tier II subordinated loans. This means there has been no profit on disposal but the higher level of assets outstanding is set to increase prospective interest income.

Reflecting in part a second half bias in the level of expected late payment interest accrual and collection the group has confirmed its target remains a return on average equity of over 20%.

Exhibit 5: Factoring turnover and receivables outstanding by quarter



Source: Banca Sistema

We have set out a comparison of the H1 and Q2 income statements with the prior year periods in Exhibit 6 and highlight key features below with % changes against the same period in 2016 unless otherwise indicated.

- Q2 factoring turnover increased by 32% and receivables outstanding increased by 23% continuing the improvement seen in the first quarter.
- Salary and pension-backed loans outstanding increased by 15% during the quarter and were nearly double the prior year figure.
- SME loans continue to run off following the decision to halt new lending and group total customer loans were up 11%.
- The underlying average gross yield on factoring receivables (interest and commission) ticked up slightly from Q1 (6.9%) to 7.2%.
- Funding costs remain stable at 1.1% with retail accounting for 53% of total funding and 60% of the interest cost with an average residual maturity of 22 months.
- Net interest income was down c €5m but stable, excluding the H116 accrual of prior period late payment interest on adoption of a new accounting approach in June 2016. Drivers within this static position were a somewhat lower margin in factoring, a larger contribution from salary and pension backed loans, recognition of additional late payment interest at Beta Stepstone and a €0.54m contribution from the recognition of the -40bps saving on funding through TLTRO II.

- Following the net write-back seen in Q1 there was a more normal impairment charge in Q2 which was equivalent to an annualised 53bps of average loans outstanding.
- H1 operating expenses increased by 10% in line with the company's full year expectation.

Exhibit 6: H117 results summary

€000s	Q116	Q216	H116	Q117	Q217	H117	Q217/Q216 % change	H117/H116 % change
Interest income	20,168	22,420	42,588	16,355	21,209	37,564	-5.4	-11.8
Interest expense	(4,076)	(3,865)	(7,941)	(3,932)	(3,747)	(7,679)	-3.1	-3.3
Net interest income	16,092	18,555	34,647	12,423	17,462	29,885	-5.9	-13.7
Net fee and commission income	2,342	2,073	4,415	2,249	2,358	4,607	13.7	4.3
Dividends and similar income	0	227	227	0	227	227	0.0	0.0
Net income from asset sales/purchases and trading	642	161	803	231	207	438	28.6	-45.5
Operating income	19,076	21,016	40,092	14,903	20,254	35,157	-3.6	-12.3
Net impairment losses on loans	(1,471)	(1,659)	(3,130)	488	(1,915)	(1,427)	15.4	-54.4
Net operating income	17,605	19,357	36,962	15,391	18,339	33,730	-5.3	-8.7
Staff costs	(3,625)	(3,841)	(7,466)	(4,274)	(4,598)	(8,872)	19.7	18.8
Other administrative expenses	(5,213)	(5,026)	(10,239)	(5,052)	(4,978)	(10,030)	-1.0	-2.0
Other operating income/costs	(33)	272	239	116	(365)	(249)	-234.2	-204.2
Operating expenses	(8,871)	(8,595)	(17,466)	(9,210)	(9,941)	(19,151)	15.7	9.6
Profit/(loss) from equity investments	(6)	2,247	2,241	0	(32)	(32)	-101.4	-101.4
Pre-tax profit	8,728	13,009	21,737	6,181	8,366	14,547	-35.7	-33.1
Tax	(2,767)	(3,285)	(6,052)	(1,783)	(2,781)	(4,564)	-15.3	-24.6
Profit after tax	5,961	9,724	15,685	4,398	5,585	9,983	-42.6	-36.4
Net interest margin	4.62%	5.89%	5.23%	3.60%	4.79%	4.19%		
Loan loss provision as % of average loans	0.42%	0.53%	0.47%	-0.14%	0.53%	0.20%		
Cost income ratio	43%	45%	44%	63%	49%	54%		
Return on average equity	25%	25%	32%	15%	18%	17%		
Tax rate	32%	32%	28%	29%	34%	31%		

Source: Banca Sistema, Edison Investment Research

Looking more closely at **the increase in factoring turnover**, Banca Sistema highlights a rising number of new clients (26% of H1 turnover) and a larger contribution from its 14 partner banks (30% of turnover) during the period. The company hopes to expand this network of partners by adding a further two banks during the current quarter. With-recourse factoring (where Banca Sistema has recourse to the seller of receivables) has become a more significant part of factoring outstanding at 19% (versus 9% FY16) while public authority clients remain the dominant part of the book at 79%.

As a reminder, the group adopted a change in accounting for **late payment interest** in June 2016. Previously, Banca Sistema only recognised this on a cash basis but it now recognises a portion of late payment interest accrued (in common with competitors). The policy reflects the adoption of a statistical model based on collection experience and is only applied where legal proceedings have begun. For receivables from the national healthcare system, 65% of qualifying late payment interest is accrued and for other public sector receivables, 15%. Banca Sistema typically does not pursue a legal route to collect amounts owing and related interest although it will do in some cases (c 10%, accumulating to 27% of outstanding in H117); it therefore differs from some competitors whose model is to focus on legal collection. In the next exhibit we show an analysis of interest income including the contribution of late payment interest based partly on the group's commentary and partly our own estimates of the different components.

Exhibit 7: Interest income analysis

€000	H116	H117	FY17e
LPI accrued	1.8	3.4	15.5
LPI cash collected	1.2	2.9	7.3
LPI relating to prior periods	5.0		
LPI subtotal	8.0	6.3	22.8
Interest income/other	28.4	24.0	53.6
Factoring total	36.4	30.5	76.4
CQS/CQP	3.0	5.4	11.5
SME	2.9	2.1	4.1
Other	0.3	-0.2	0.9
Total reported/estimated	42.6	37.6	92.8

Source: Banca Sistema, Edison Investment Research

Financials

There are limited changes in our overall estimates (see Exhibit 8) with the main adjustments within the numbers flowing from the assumption that Banca Sistema does not now carry out sales of securitisations of salary and pension based loans during FY17 and FY18. We have modestly tempered our previous assumed level of asset acquisition in this area but retention of the loans should at least compensate for the absence of profits on disposal. For the moment we have maintained the assumption of a securitisation sale in FY19 although Banca Sistema reports that regulatory discussions are continuing which may lead to a reduction in the level of risk weighting applied to these assets from 75%, potentially to 30%. At this level pressure on capital ratios would ease and the bank is unlikely to find a sale of these assets attractive.

Exhibit 8: Estimate revisions

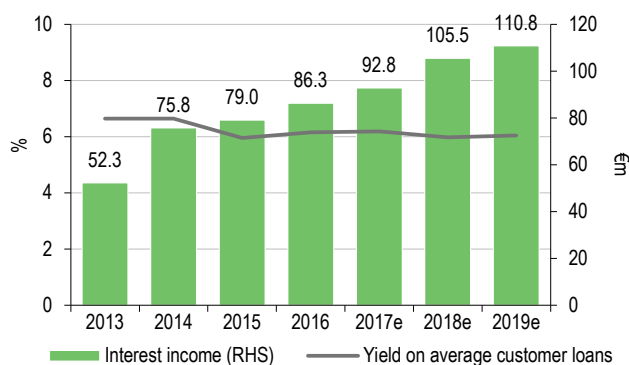
	Net operating income (€m)			PBT (€m)			EPS (c)			DPS (c)		
	Old	New	% chg	Old	New	% chg	Old	New	% chg	Old	New	% chg
12/17e	87.2	87.7	0.5	41.0	41.2	0.6	35.3	35.3	-0.1	9.00	9.00	0.0
12/18e	97.2	99.1	2.0	47.6	48.3	1.4	40.9	41.4	1.4	9.50	9.50	0.0
12/19e	104.2	107.1	2.8	52.1	54.1	3.9	44.7	46.5	3.9	11.00	11.00	0.0

Source: Edison Investment Research

In the next two exhibits we have updated charts showing our assumptions for customer loans outstanding and the yield on customer loans. The first shows continued growth in the main factoring activity while salary and pension backed loan growth is held back in FY19e by the assumed securitisation disposal. The overall yield on average customer loans is broadly stable on our estimates.

Exhibit 9: Customer loan assumptions

€m	2016	2017e	2018e	2019e
Factoring	986	1,160	1,250	1,350
SME	79	60	30	10
Salary/pension backed	266	429	572	482
Other	17	10	15	25
Total	1,348	1,659	1,867	1,867

Exhibit 10: Interest income history and estimates


Source: Edison Investment Research, Banca Sistema

Source: Edison Investment Research, Banca Sistema

Turning to capital ratios, the end H117 CET1 ratio stood at 12.6% compared with 13.3% at the year end, while the total capital ratio was 16.3% versus 15.8%. In response to institutional investor

interest a tap issue of a €1.5m Tier II bond is to be offered (10 years, Euribor +450bps) and further issues up to €13.5m may follow. On our estimates this should allow the total capital ratio to remain above 16% while the CET1 ratio is likely to remain at a similar level to the half year at the end of FY17, potentially increasing thereafter subject to the rate of asset growth.

Valuation

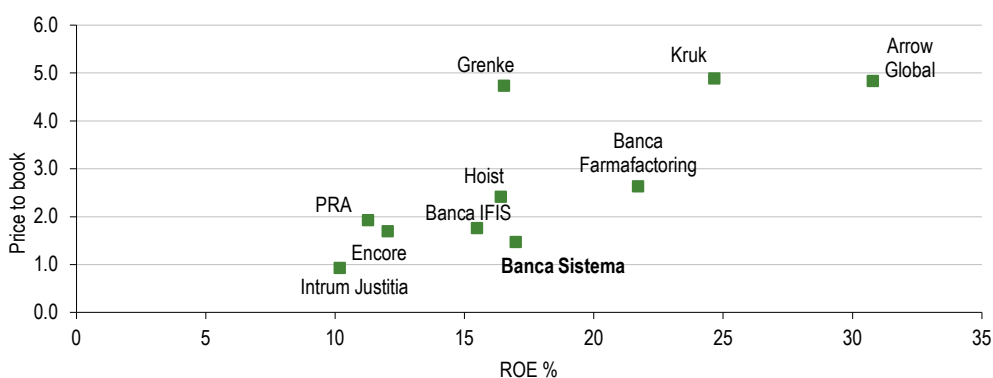
As a starting point we have updated our comparative table showing valuation metrics for Banca Sistema and selected peers involved in factoring, debt purchase, debt management and collection. Given Banca Sistema's focus on public sector receivables, the closest peer in the group is Banca Farmafactoring. Banca Sistema trades on the lowest prospective P/E and trades on a below-average price to book and above average yield.

Exhibit 11: Valuation comparison						
	Ticker	Market cap (€m)	CY17 P/E (x)	Yield (%)	ROE (%)	Price to book (x)
Banca Sistema	BST IM	173.4	6.2	3.5	17.0	1.5
Arrow Global	ARW LN	898.6	13.8	2.0	30.8	4.8
Banca Farmafactoring	BFF IM	876.1	9.6	N/A	21.7	2.6
Banca IFIS	IFIS IM	2,199.8	18.0	2.0	15.5	1.8
Encore Capital	ECPG US	856.5	11.0	0.0	12.0	1.7
Grenke	GLJ GY	3,399.7	28.0	0.8	16.5	4.7
Hoist Finance	HOFI SS	751.6	13.7	1.5	16.4	2.4
Intrum Justitia	IJ SS	3,599.0	15.0	3.4	10.2	0.9
Kruk	KRU PW	1,514.4	21.0	0.6	24.7	4.9
PRA	PRAA US	1,506.4	18.9	0.0	11.3	1.9
Average			15.5	1.5	17.6	2.7

Source: Bloomberg. Note: Priced at 3 August 2017.

Our next chart compares returns on equity (ROE) and price to book (P/B) ratios for the same peer group. Here, Banca Sistema appears broadly in line with its peers but we have used the H117 return on equity of 17% and if we were to apply our FY17 forecast of 22.7% (or the company's own indication of over 20%) then the shares would appear distinctly cautiously rated.

Exhibit 12: Comparing ROE and price to book



Source: Bloomberg

Reflecting the limited change in our estimates our ROE/COE valuation gives an unchanged central valuation of €3.15 (assumptions include 22% ROE, long-term growth of 4% and cost of equity of 12.4%). Alternatively, the model indicates that the current share price implies a cost of equity of over 16% again implying cautious assumptions being made by the market and suggesting scope for a re-rating as the bank delivers its target returns.

Exhibit 13: Financial summary

Year end 31 December	2015	2016	2017e	2018e	2019e
Income statement					
Interest income	79,019	86,321	92,847	105,535	110,830
Interest expense	(21,013)	(15,321)	(16,211)	(18,895)	(23,236)
Net interest income	58,006	71,000	76,636	86,640	87,594
Net fee and commission income	11,168	9,060	9,863	11,295	12,045
Dividends and similar income	0	227	227	0	0
Profit on securitisation	0	0	0	0	6,281
Net income from asset sales/purchases and trading	2,640	1,196	500	1,200	1,200
Net interest and other banking income	71,814	81,483	87,665	99,135	107,121
Net impairment losses on loans	(5,439)	(9,765)	(6,366)	(8,958)	(9,159)
Net income from banking activities	66,375	71,718	81,299	90,176	97,961
Personnel expenses	(17,528)	(15,169)	(17,037)	(17,501)	(18,551)
Other administrative expenses	(24,350)	(22,529)	(22,750)	(24,421)	(25,276)
Administrative expenses	(41,878)	(37,698)	(39,787)	(41,922)	(43,827)
Other operating income/costs	59	(589)	(249)	0	0
Operating expenses	(41,819)	(38,287)	(40,036)	(41,922)	(43,827)
Profit/(loss) from equity investments	956	2,281	(32)	0	0
Pre-tax profit	25,512	35,712	41,231	48,254	54,134
Tax	(7,905)	(10,399)	(12,836)	(14,959)	(16,782)
Profit after tax	17,607	25,313	28,395	33,295	37,353
Adjustment for normalised earnings	6106	1095	0	0	0
Adjusted net income	23,713	26,408	28,395	33,295	37,353
Reported earnings per share €	0.22	0.31	0.35	0.41	0.46
Normalised earnings per share €	0.29	0.33	0.35	0.41	0.46
Dividend per share €	0.053	0.076	0.090	0.095	0.110
Balance sheet					
Assets					
Financial assets available for sale	925,402	514,838	363,673	363,673	363,673
Due from banks	2,076	83,493	35,564	35,564	35,564
Loans to customers	1,457,990	1,348,329	1,659,443	1,867,376	1,866,721
Property, plant and equipment	1,058	23,313	23,791	23,791	23,791
Intangible assets	1,872	1,835	1,850	1,850	1,850
Tax assets	7,353	10,528	9,491	9,491	9,491
Other assets	15,919	17,027	101,127	101,127	101,127
Total assets	2,411,670	1,999,363	2,194,939	2,402,872	2,402,217
Liabilities and shareholders' funds					
Due to banks	362,075	458,126	566,019	636,943	636,719
Due to customers	1,878,339	1,262,123	1,305,644	1,415,364	1,385,102
Securities in issue	20,102	90,330	119,470	119,470	119,470
Total tax liabilities	804	8,539	8,222	8,222	8,222
Other liabilities	55,317	59,825	48,532	48,532	48,532
Employee termination indemnities	1,303	1,998	1,871	1,983	2,102
Provisions for risks and charges	372	4,105	8,920	10,038	10,034
Total liabilities	2,318,312	1,885,046	2,058,678	2,240,552	2,210,182
Group shareholders' equity	93,358	114,297	136,231	162,290	192,005
Minority interests	0	20	30	30	30
Total liabilities and equity	2,411,670	1,999,363	2,194,939	2,402,872	2,402,217
Capital position					
Risk weighted assets	635,658	788,000	1,001,251	1,155,811	1,159,373
Credit risk/customer loans	37%	48%	51%	53%	52%
RWA/total assets	26%	39%	46%	48%	48%
Common equity tier 1	86,892	104,600	127,154	152,812	181,316
Total capital	106,892	124,700	162,154	187,812	216,316
CET1 ratio	13.7%	13.3%	12.7%	13.2%	15.6%
Total capital ratio	16.8%	15.8%	16.2%	16.2%	18.7%
Leverage ratio	4.2%	6.1%	6.6%	7.2%	8.4%
Other ratios					
Net interest margin	4.4%	5.1%	5.1%	4.9%	4.8%
Loan loss provision as % of average loans	0.41%	0.70%	0.42%	0.51%	0.50%
Total expenses % of interest and fee income	60.5%	47.1%	46.0%	42.8%	44.0%
Return on average equity	26.8%	25.4%	22.7%	22.3%	21.1%
Tax rate	31.0%	29.1%	31.1%	31.0%	31.0%

Source: Company data, Edison Investment Research

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