EDISON

Banca Sistema

Q317 results

Loan growth and ROE are positive features

Financial services

Banca Sistema's (BST) Q3 results showed continued growth in its main trade receivables financing and salary and pension-backed loan activities. Reported profits were augmented by a higher accrual rate for late payment interest but, excluding the element relating to prior years, BST still targets an ROAE of 20% for FY17. Given this and the potential for continued growth, the valuation in terms of price to book and multiples of our reduced earnings estimates appears very cautious.

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	6.8	3.4	1.6
12/17e	85.4	39.6	34.4	9.0	6.5	4.1	1.3
12/18e	93.0	42.8	36.7	9.5	6.0	4.3	1.1
12/19e	99.5	46.1	39.6	10.5	5.6	4.7	1.0

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

Q317 results

Factoring turnover increased by 25% compared with Q316 and the level of outstanding receivables at the end of the period rose by 19% to nearly €1.3bn. A third of factoring turnover is now originated by BST's network of partner banks, with three further agreements concluded during the quarter taking the total to 17. Salary and pension-backed loans outstanding nearly doubled to €0.4bn. An increase in the rate of late payment interest accrual complicates comparisons with reported net earnings increasing by 100% y-o-y, while stripping out the impact of the change in accounting completely would leave earnings up only slightly on Q316, in part reflecting the accumulation of loans under legal collection (now at 30% of outstanding).

Outlook

The continued strong growth in customer loans is encouraging and the prospects for further growth through market share gains and increased penetration of factoring of public administration receivables in Italy remain good. If the risk weighting applied to salary and pension-based loans is reduced, then growth in this area could be accelerated and the announcement of a small acquisition in this area with the results may provide useful additional access to and insight into this market. We have adopted more conservative assumptions in our forecasts for operating income and no longer factor in a securitisation sale in FY19. With operational gearing this means our earnings estimates for FY17-19 are trimmed by 3-15%.

Valuation: Cautious in all respects

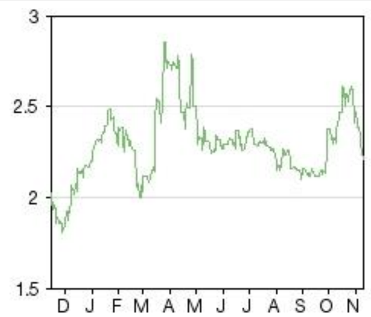
BST is the lowest rated stock among a selected peer group on both P/E and price to book multiples (page 5). Reflecting the reduction in earnings forecasts, we have reduced the ROE used in our ROE/COE valuation (now €2.80 compared with €3.15 previously), but positive surprises in loan book growth or interest margin are plausible sources of upside from this level.

13 November 2017

Price	**€2.22**
Market cap	**€178m**

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	(3.9)	(2.7)	11.2
Rel (local)	(4.5)	(6.1)	(18.0)
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, is looking to diversify and has developed salary and pension-based lending.

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FY17 results	February 2018

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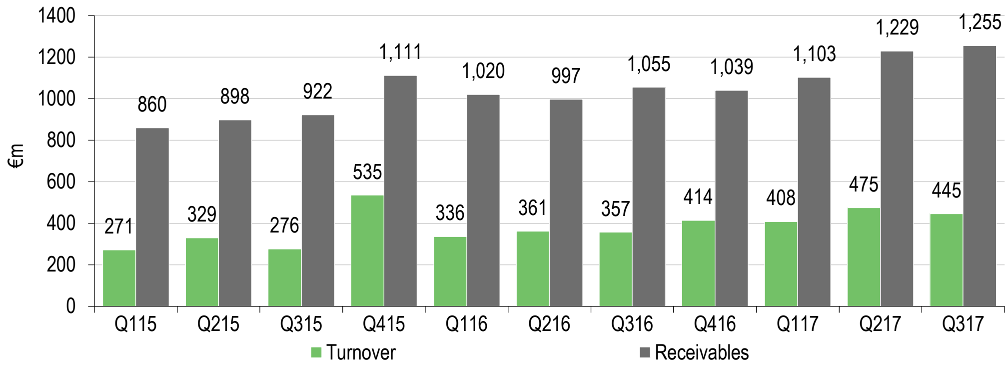
Q317 results: 20% ROAE in prospect for FY17

BST reported factoring turnover 25% ahead of Q316 and factoring receivables outstanding were up by 19% to €1,255m. Factoring origination agreements with banks have contributed to this growth and BST has added a further three banks to the list, taking the total to 17, which now account for about 33% of turnover. Exhibit 1 shows the progression of factoring turnover and receivables outstanding since the beginning of 2015.

Exhibit 1: Factoring turnover and receivables outstanding by quarter



Source: Banca Sistema

Salary and pension-backed loans outstanding (€423m) also showed very strong growth, nearly doubling compared with the prior year figure, and market share now stands at over 2%. The pre-tax profit for the third quarter was roughly double the prior year period. This was boosted by an increase in the rate of accrual of late payment interest, reflecting the accumulation of a longer run of data that resulted in a rise in estimated recovery rates (see further comments below).

We summarise other key points from the results announcement below, with comparisons between Q317 and Q316 unless stated.

- Interest income increased by 43%, reflecting the change in late payment interest accrual and growth in loans and advances to customers.
- Net fee and commission income rose by 12%.
- With the interest cost up by 12% (stable funding cost), subdued loan impairments (-9%) and operating expenses that increased by less than 2%, pre-tax profits increased by 106% to €16.6m.
- Net income also increased by more than 100% to €12.1m.
- The change in accrual rate for late payment interest on factoring receivables accounted for €9m of interest income. Within this, €3.7m related to prior years and €4.1m to H117. Stripping the €9m out of the Q3 figures would leave net income of €5.7m, just above last year's level.
- BST targets a year-end return on average equity of 20%, excluding the €3.7m of gross late payment interest accrual not related to the current year.
- BST capital ratios remain well above the minimum plus additional requirements set by the Bank of Italy. The CET 1 ratio was 12.4% (7.4% required), Tier 1 ratio 13.2% (10.7% required) and total capital ratio 16.1% (15.3% required).

Exhibit 2 shows the P&L for Q317 and the previous three quarters.

Exhibit 2: Q317 results summary

€000s	Q316	Q117	Q217	Q317	Q317/Q316 % change
Interest income	19,852	16,355	21,209	28,374	42.9
Interest expense	(3,687)	(3,932)	(3,747)	(4,128)	12.0
Net interest income	**16,165**	**12,423**	**17,462**	**24,246**	**50.0**
Net fee and commission income	2,447	2,249	2,358	2,745	12.2
Dividends and similar income	0	0	227	0	
Net income from asset sales/purchases and trading	257	231	207	490	90.7
Operating income	**18,869**	**14,903**	**20,254**	**27,481**	**45.6**
Net impairment losses on loans	(1,793)	488	(1,915)	(1,630)	-9.1
Net operating income	17,076	15,391	18,339	25,851	51.4
Staff costs	(3,682)	(4,274)	(4,598)	(3,900)	5.9
Other administrative expenses	(5,159)	(5,052)	(4,978)	(4,899)	-5.0
Other operating income/costs	(228)	116	(365)	(412)	80.7
Operating expenses	**(9,069)**	**(9,210)**	**(9,941)**	**(9,211)**	**1.6**
Profit/(loss) from equity investments	40	0	(32)	(30)	-175.0
Pre-tax profit	**8,047**	**6,181**	**8,366**	**16,610**	**106.4**
Tax	(2,332)	(1,783)	(2,781)	(4,472)	91.7
Profit after tax	**5,715**	**4,398**	**5,585**	**12,138**	**112.4**
Net interest margin %	5.19	3.60	4.79	6.23	
Loan loss provision as % of average loans	0.58	-0.14	0.53	0.42	
Cost income ratio %	47	63	47	32	
Return on average equity %	21	15	19	38	
Tax rate %	29	29	33	29	

Source: Banca Sistema, Edison Investment Research

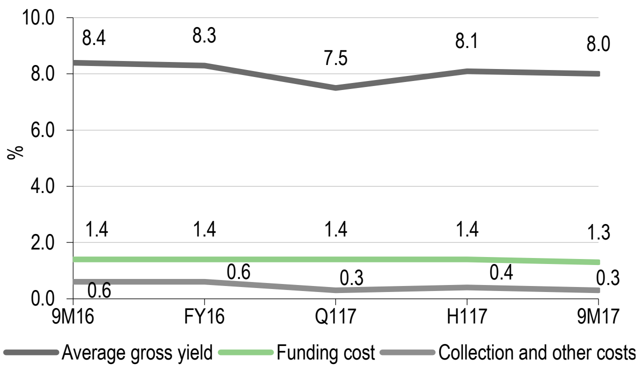
The group adopted a change in accounting for **late payment interest** (LPI) in June 2016. Previously, BST had only recognised this on a cash basis, but following the change it accounted for a portion of late payment interest accrued (in common with competitors). The policy reflected the adoption of a statistical model based on collection experience and is only applied where legal proceedings have begun. As noted above, with the Q317 figures BST changed the accrual rate for LPI. This reflected the collection of additional data points that feed into the statistical model. For receivables from the national healthcare system, the accrual rate is effectively unchanged at c 65% of qualifying late payment interest, while for other public sector receivables the percentage has increased from 15% to 31%. The average accrual rate of c 38% is still significantly below the 80% recovery rate that has been experienced. The change in rate resulted in the €9m increase in LPI mentioned above, of which €7.8m related to periods prior to the third quarter.

It is worth underlining that BST typically does not pursue a legal route to collect amounts owing and related interest, although it will do in some cases (c 10%). BST therefore differs from some competitors whose model is to focus on legal collection from the outset. However, because of the length of this collection process, the proportion of outstanding receivables under legal collection has risen to c 30% so LPI, both in the form of accruals and cash collection, has become an increasing part of total interest income.

Prospectively, factors that would affect the level of LPI in any period would include success in collection (positive for cash collection but reducing the outstanding level), the level of receivables entering legal collection, the mix of receivables in legal collection by sector and maturity, any sale of receivables, and any change in accrual rate generated by the output from BST's statistical model.

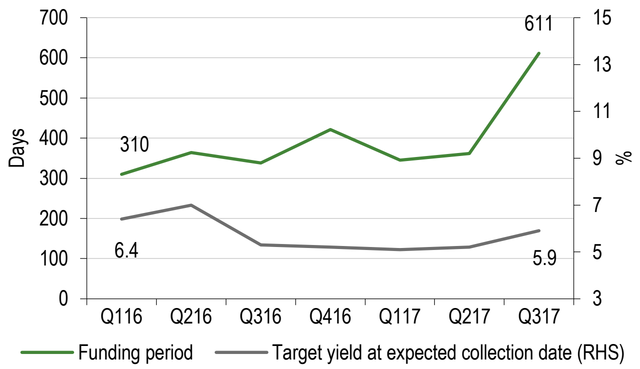
Turning to look at trends in the overall **yields in the factoring area**, Exhibit 3 shows the average gross yield including interest income and fees and commissions. BST has calculated these numbers on the new LPI accrual basis and, while 2016 numbers exclude Beta Stepstone, they are broadly comparable. The yield has fallen slightly over a year but has been largely stable within the period shown, with the exception of Q117 which was affected by the lower level of turnover experienced at the end of Q416. Exhibit 4 shows the yield at the target collection date at the time receivables are taken onto the book. Here the yield again includes fees and commission. Actual returns are usually above the target level because collection is predominantly made before the date used when setting pricing. Where collection is delayed and moves into legal collection, accrual of LPI (and eventual cash collection of the amount of LPI outstanding) compensates for the delay enabling BST to generate a return similar to or above the original target return. As Exhibit 4 illustrates, the target yield has been within a narrow range over recent quarters. The funding period has stepped up significantly in the third quarter, reflecting a single healthcare transaction of significant size with a long duration (accounted for in the pricing).

Exhibit 3: Average gross yield on factoring outstanding



Source: Banca Sistema. Note: recast to current LPI accrual rate.

Exhibit 4: Funding period and target yield



Source: Banca Sistema. Note: yield includes commission income.

Turning to **loan loss provisioning,** the third-quarter P&L charge was, as noted, down by 9% compared with Q316 and stood at 48bps of average loans versus 58bps on an annualised basis. The provisioning level does fluctuate between quarters driven by writebacks and other factors, so we assume a modestly higher level in our estimates for the next two years (50bps). The level of net non-performing loans as a percentage of customer loans was similar to Q217 and FY16 at 9.5% compared with 9.7% and 9.2%, respectively. As the majority of the past due segment relates to normal course receivables business, the more relevant percentages are for bad loans (1.8% and stable) and unlikely to pay (1.0%, lower sequentially).

The **acquisition** of 19.9% stakes in ADV Finance and its subsidiary Procredit for a combined consideration of €0.8m was announced with the results. This purchase will add to the origination network for salary and pension-backed loans and if ADV reaches its own stretching target could generate incremental loans of €50m. Completion is subject to authorisation by the appropriate authorities. Chief Executive Gianluca Garbi noted on the results call that there has been increased discussion of the potential reduction in the risk weighting applied to salary and pension-backed loans. If there were a reduction from the current weighting of between 60% and 75% to c 35%, for example, then it would become a more attractive business to expand and loans would be likely to be retained rather than securitised and sold (subject to market pricing). In these circumstances, BST might consider becoming involved more fully in the origination of these loans including increasing its stake in ADV. While this would involve an investment, it would be justified by an increased share of the overall margin generated.

Financials

The changes in our estimates are summarised in Exhibit 5, with a tempering of our assumed interest margin trimming operating income in FY17 and FY18. For FY19 we have also removed our previous assumption of a securitisation sale; this removes the related profit on disposal, which is partly offset by increased interest income. With limited changes in operating expense estimates there is a larger impact at the EPS level, with reductions of between 3% and 15%. The latter is for FY19 and excluding the securitisation sale impact, the reduction would be in line with that for FY18 at 11%. We note that it is possible that our interest margin assumption may now prove conservative with the potential for LPI collection/accrual to outpace our forecasts, while customer loan growth in the salary and pension-related area could accelerate if the capital weighting in this area is reduced.

Exhibit 5: 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	87.7	85.4	-2.6	41.2	39.6	-4.0	35.3	34.4	-2.6	9.00	9.00	0.0
12/18e	99.1	93.0	-6.2	48.3	42.8	-11.3	41.4	36.7	-11.3	9.50	9.50	0.0
12/19e	107.1	99.5	-7.1	54.1	46.1	-14.8	46.5	39.6	-14.8	11.00	10.50	-4.5

Source: Edison Investment Research

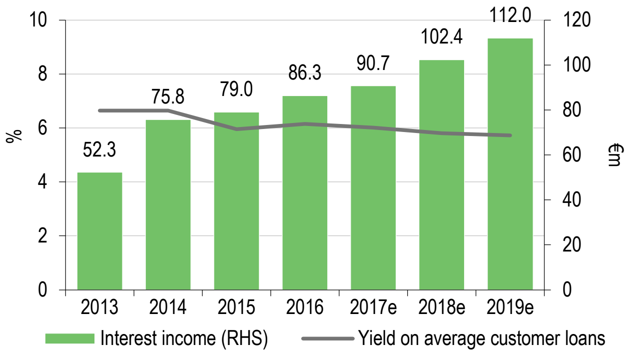
We have updated the charts (Exhibits 6 and 7) showing our assumptions for customer loans outstanding and the yield on customer loans. The first shows slightly lower assumed growth for factoring balanced by increased estimates for salary and pension-backed loans including removal of assumed securitisation disposal for FY19. The overall yield on average customer loans is broadly stable on our estimates with the slight downtrend apparent in Exhibit 7 mainly reflecting mix change towards salary and pension-backed loans.

Exhibit 6: Customer loan assumptions

€m	2016	2017e	2018e	2019e
Factoring	986	1,129	1,220	1,317
SME	79	60	30	10
Salary/pension-backed	266	472	589	702
Other	17	10	15	25
Total	1,348	1,672	1,853	2,054

Source: Edison Investment Research, Banca Sistema

Exhibit 7: Interest income history and estimates



Source: Edison Investment Research, Banca Sistema

Valuation

We have updated our comparative valuation table (Exhibit 8) showing BST in the context of selected peers involved in factoring, debt purchase, debt management and collection. BST trades on the lowest prospective P/E multiple and the highest yield within the group.

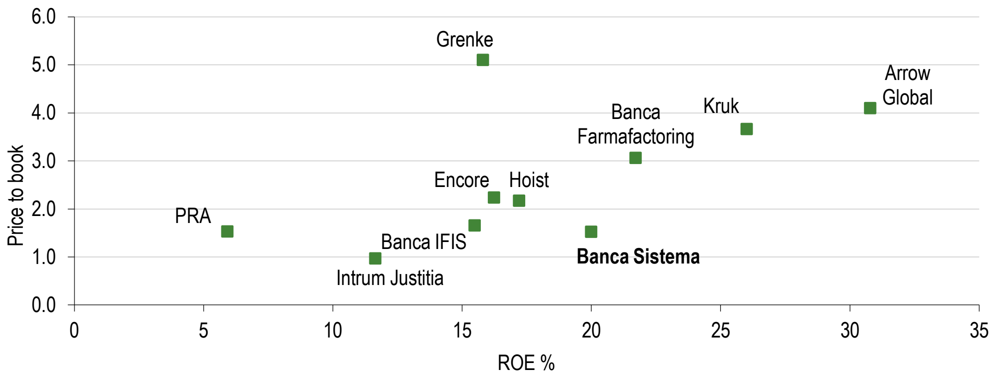
Exhibit 8: Valuation comparison

	Ticker	Market cap (€m)	CY17 P/E (x)	Yield (%)	ROE (%)	Price to book (x)
Banca Sistema	**BST IM**	179.3	6.5	3.4	20.0	1.5
Arrow Global	ARW LN	820.1	12.6	2.2	30.8	4.1
Banca Farmafactoring	BFF IM	1,019.8	11.3	N/A	21.7	3.1
Banca IFIS	IFIS IM	2,122.3	16.1	2.1	15.5	1.7
Encore Capital	ECPG US	1,092.2	12.9	0.0	16.3	2.2
Grenke	GLJ GY	3,666.5	30.0	0.7	15.8	5.1
Hoist Finance	HOFI SS	693.5	13.2	1.6	17.2	2.2
Intrum Justitia	IJ SS	3,821.3	16.7	3.2	11.7	1.0
Kruk	KRU PW	1,288.9	15.9	0.7	26.0	3.7
PRA	PRAA US	1,323.9	23.3	0.0	5.9	1.5
Average			**15.9**	**1.5**	**18.1**	**2.6**

Source: Bloomberg. Note: priced at 10November 2017

In terms of price to book ratio, BST is also well below the group average at 1.5x compared with 2.6x despite earning a return on equity of c 20%. Our next chart, plotting return on equity against price to book, highlights this cautious valuation. To position BST in line with peers on its current price to book ratio we would have to assume a return of equity between 10% and 15%, well below the returns we expect for FY17-19.

Exhibit 9: Comparing ROE and price to book



Source: Bloomberg

In our ROE/COE valuation we have used an assumed return of 20% (22% previously) to reflect the more conservative forecasts outlined in the previous section. Other assumptions are unchanged (including long-term growth of 4% and cost of equity of 12.4%). The resulting valuation is €2.80 compared with the €3.15 indicated in our last note. This is still 26% above the share price at the time of writing (€2.22).

Exhibit 10: Financial summary

Year end 31 December (€000s)	2015	2016	2017e	2018e	2019e
Income statement					
Interest income	79,019	86,321	90,693	102,351	111,998
Interest expense	(21,013)	(15,321)	(16,787)	(21,224)	(25,062)
Net interest income	58,006	71,000	73,906	81,127	86,936
Net fee and commission income	11,168	9,060	10,077	10,446	11,146
Dividends and similar income	0	227	227	0	0
Profit on securitisation	0	0	0	0	0
Net income from asset sales/purchases and trading	2,640	1,196	1,178	1,400	1,400
Net interest and other banking income	71,814	81,483	85,402	92,973	99,482
Net impairment losses on loans	(5,439)	(9,765)	(5,773)	(8,935)	(9,904)
Net income from banking activities	66,375	71,718	79,628	84,038	89,578
Personnel expenses	(17,528)	(15,169)	(17,034)	(18,141)	(19,502)
Other administrative expenses	(24,350)	(22,529)	(22,310)	(23,113)	(23,945)
Administrative expenses	(41,878)	(37,698)	(39,344)	(41,254)	(43,447)
Other operating income/costs	59	(589)	(661)	0	0
Operating expenses	(41,819)	(38,287)	(40,005)	(41,254)	(43,447)
Profit/(loss) from equity investments	956	2,281	(62)	0	0
Pre-tax profit	25,512	35,712	39,562	42,783	46,131
Tax	(7,905)	(10,399)	(11,914)	(13,263)	(14,301)
Profit after tax	17,607	25,313	27,647	29,521	31,830
Adjustment for normalised earnings	6106	1095	0	0	0
Adjusted net income	23,713	26,408	27,647	29,521	31,830
Reported earnings per share (€)	0.22	0.31	0.34	0.37	0.40
Normalised earnings per share (€)	0.29	0.33	0.34	0.37	0.40
Dividend per share (€)	0.053	0.076	0.090	0.095	0.105
Balance sheet					
Assets					
Financial assets available for sale	925,402	514,838	423,889	423,889	423,889
Due from banks	2,076	83,493	24,247	24,247	24,247
Loans to customers	1,457,990	1,348,329	1,671,514	1,853,331	2,054,322
Property, plant and equipment	1,058	23,313	23,975	23,975	23,975
Intangible assets	1,872	1,835	1,850	1,850	1,850
Tax assets	7,353	10,528	8,011	8,011	8,011
Other assets	15,919	17,027	99,848	99,848	99,848
Total assets	2,411,670	1,999,363	2,253,334	2,435,151	2,636,142
Liabilities and shareholders' funds					
Due to banks	362,075	458,126	543,390	602,496	667,836
Due to customers	1,878,339	1,262,123	1,378,970	1,478,370	1,588,675
Securities in issue	20,102	90,330	107,753	107,753	107,753
Total tax liabilities	804	8,539	11,605	11,605	11,605
Other liabilities	55,317	59,825	65,621	65,621	65,621
Employee termination indemnities	1,303	1,998	2,275	2,423	2,605
Provisions for risks and charges	372	4,105	8,075	8,953	9,924
Total liabilities	2,318,312	1,885,046	2,117,689	2,277,221	2,454,019
Group shareholders' equity	93,358	114,297	135,615	157,900	182,093
Minority interests	0	20	30	30	30
Total liabilities and equity	2,411,670	1,999,363	2,253,334	2,435,151	2,636,142
Capital position					
Risk weighted assets	635,658	788,000	1,048,820	1,184,794	1,324,974
Credit risk/customer loans	37%	48%	54%	55%	56%
RWA/total assets	26%	39%	47%	49%	50%
Common equity tier 1	86,892	104,600	126,534	148,422	171,406
Total capital	106,892	124,700	162,834	182,322	202,906
CET1 ratio	13.7%	13.3%	12.1%	12.5%	12.9%
Total capital ratio	16.8%	15.8%	15.5%	15.4%	15.3%
Leverage ratio	4.2%	6.1%	6.4%	6.9%	7.2%
Other ratios					
Net interest margin	4.4%	5.1%	4.9%	4.6%	4.4%
Loan loss provision as % of average loans	0.41%	0.70%	0.38%	0.51%	0.51%
Total expenses % of interest and fee income	60.5%	47.1%	46.8%	45.1%	44.3%
Return on average equity	26.8%	25.4%	22.1%	20.1%	18.7%
Tax rate	31.0%	29.1%	30.1%	31.0%	31.0%

Source: Banca Sistema data, Edison Investment Research

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