RESEARCH NOTE

Bank of Valletta p.l.c.

28th May 2020

BOV: Where do we stand in terms of the litigation cases?

Periods of uncertainty, as currently being experienced by this pandemic, pose a significant threat to the banking industry. As economic uncertainty continued to prevail on all fronts post COVID-19 outbreak in Malta, we have seen all local shares trading lower, including BOV, with the price dropping to a low point of €0.85 over the past couple of weeks, followed by a recovery back to the €1.05 level.

Prior to this outbreak, BOV seemed to be gradually addressing previous concerns, namely in connection to their ongoing litigation cases. Following the favourable judgement delivered by the Court of Appeal in respect of La Vallette Multi Manager Property Fund in December 2019, BOV remains involved in two material litigation cases, namely the Deiulemar Trust and the Falcon Funds Sicav.

In connection to the Falcon case, the Group announced that discussion between parties to resolve the matter are ongoing, with both parties agreeing to an independent mediator. The Group's financial exposure at this stage is still unknown, whereby BOV had expected to resolve the matter half way through 2020.

In relation to the Deiulemar case, BOV filed an application before the European Court of Human Rights (ECHR) during FY19 to defend its right for a fair hearing and also presented its submissions to the Court of Torre Anunziata to reconsider the Bank's request to appoint a valuation expert and to stay proceedings pending the ECHR application. It was thus expected that final judgement may have technically been delivered by the judge at Torre Annunziata as early as May/June 2020.

Moreover, BOV managed to obtain an independent legal advice on the matter, substantiating the basis on which the Bank's legal arguments are formed. Although this demonstrates that the Group still stands a chance to win this case, BOV is still facing an enormous amount of local pressure.

During FY19, the initial estimate of a €75m litigation provision recognised in FY18 was re-estimated to €100m which according to the bank is deemed to better reflect any resulting outflows, including potentially protracted legal costs and any negotiated settlements. This increase in litigation and claims provision of €25m is also deemed to be a prudent approach which reflects the likely economic outflows in terms of IAS 37 (Provisions, Contingent Liabilities and Contingent Assets).

This leaves the Group with €338m in potential damages (gross of tax) stemming from these outstanding cases. Of note, the above-mentioned provisions have not yet been utilised by the bank.

As per BOV's 2020 interim's directors' statement, these two remaining litigation cases are clearly being impacted by the current pandemic situation and final conclusions may be deferred into the following year (FY21). We therefore remain cognisant of the real risk of further provisions, which in addition to the implication brought about by the COVID-19 outbreak, might hinder the bank's ability to distribute a dividend to shareholders in the near future.

FY19 results: Update on BOV's financial performance

	FY17	FY18	FY19	CAGR/AVG
Net interest income (€'m)	146.4	156.5	152.9	2.2%
Net fee and commission income (€'m)	69.0	81.1	73.8	3.4%
Net Profit (€'m)	95.6	51.4	63.5	-18.5%
EPS (€)	0.164	0.088	0.109	-18.5%
DPS (€)	0.068	0.000	0.017	0.028
Dividend pay-out	33.1%	0.0%	15.8%	16.3%

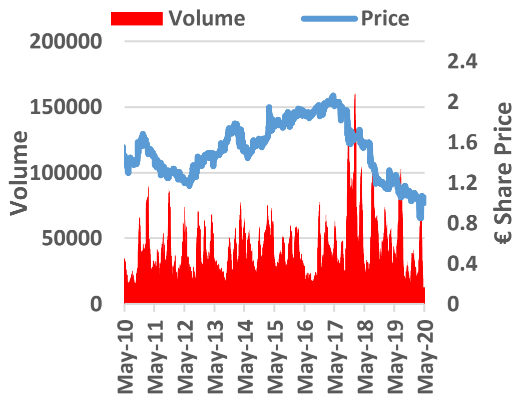
Country	Malta
Industry	Banking & Financial Services
Ticker	BOV
Price (as at 27/05/2020)	€1.03
Market Cap	€601.4m
Ranking on the MSE	2nd largest market cap
Shares Outstanding	583.8m
Free Float	64.8%
Price/ Book	0.57x
Net Dividend Yield[1]	1.7%
Current P/E (FY19)	9.6x

Company Overview:

Bank of Valletta p.l.c. ("BOV" or "Group") is licensed to carry out the business of banking and investment services as well to act as a tied insurance intermediary of MSV Life Assurance Company Limited.

Exchange	Malta Stock Exchange (MSE)
10-year range	€0.85 - €2.06

Price and Volume Movement (20 day moving average)



Source: Bloomberg – Prices adjusted for bonus issues

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[1] In view of the current pandemic, BOV decided to postpone their initial dividend proposal. Further detail regarding this issue may be found in the sections below

In line with growth in mortgages, interest on loans and advances during FY19 increased to €169.8m (FY18 €165.2m). However, net interest income declined overall as the return on the Group's treasury investment books reduced due to higher yielding assets maturing. Interest expense during FY19 was also lower following the issue of new debt at a lower coupon in comparison to those which matured during the year. As a result, the reduction in income from treasury activities, in combination with a higher burden of negative interest rates, drove the bank's net interest income for FY19 down to €152.9m (FY18: €156.5m).

Apart from the litigation cases, BOV appeared to be also gaining ground on its fully fledged transformation programme aimed at building a stronger and more effective governance, risk and control framework, while also implementing more robust anti-money laundering measures. It is key to note that this programme is significant for BOV in order to be able to address both current and future challenges. However, as expected, such measures impacted commission income especially around foreign payment commissions.

The Group also embarked on a de-risking exercise aimed at establishing a new risk appetite, increased internal controls and tighter policies. However, the de-risking measures implemented during FY19 reduced the volume of fees earned on various products. The bank highlighted that the application of new regulations related to investment products resulted in lower income from this segment. As a result, net fee and commission income generated during FY19 dropped by 9% and stood at €73.8m (FY18: €81.1m). The Group deems such decline in net commission income to be in line with expectations.

Operating expenses for FY19 stood at €139.1m, demonstrating an increase of 6.5% in comparison to FY18. It is worth mentioning however, that this operating expenses figure include additional investment costs amounting to €23.9m which were incurred on the transformation programme. Costs relating to this programme, which are expected to run over two years, cover various streams and initiatives aimed at lowering the BOV's risk profile, enhancing risk management and internal controls as well as establishing a solid overall governance framework. This ties with the overarching strategic objective of the Group to build a safer and stronger bank.

As a result, higher costs were mainly incurred on both IT and HR as BOV continued their investment in these two primary resources. Investments in new systems, including those related to IT security resulted in a higher IT expenditure, whereas further investment in people, particularly in control functions, resulted in higher employee costs. Increases in other administrative costs mainly relate to the bank's de-risking activities. The Group recently announced that the de-risking exercise is circa 50% completed up to April 2020, meaning that additional costs are expected to be incurred during the current financial year. BOV's cost income ratio for FY19 stood at 61.4% or 52.4% when the additional costs are excluded (FY18: 49.1%).

The proactive stance adopted in debt management, with a special focus on non-performing exposures, resulted in further recoveries being made in respect debt previously written off. As a result, a net impairment reversal of €11.6 million was recorded by the bank during FY19. The ratio of non-performing exposures to total lending improved from 5.3% during FY18 to 4.6% as per publication of the FY19 results.

In furtherance, both the life and the non-life business of the Group, reported improved performance, which included gains attributed to positive market movements. Furthermore, share of profits from associates during FY19 amounted to €15.9 (FY18: €8.2m). Upon taking the above factors into consideration, together with the increase in litigation and claims provision of €25m, BOV reported a profit before tax of €89.2m (FY18: €71.2m). It is also crucial to point out that as per FY19 results, BOV's CET 1 ratio stood at 19.5% (FY18: 18.3%).

As per publication of latest results, BOV announced their intention to propose, subject to regulatory approval, a net dividend of €0.017/ share in respect of FY19. However, in view of the current pandemic and following a strong recommendation of the European Central Bank (ECB) on dividend distribution to all European banks, BOV decided to postpone their initial proposal. As a result, BOV decided to make the actual dividend payment conditional to the reassessment of the situation once the uncertainty caused by COVID-19 disappear, the earliest of which, in line with the ECB's recommendation, would be 1 October 2020.

COVID-19 impact and further updates

BOV recently announced that mainly due to the current COVID-19 climate, the Group's financial performance for Q1 2020 was somewhat below expectations, as some adverse effects began to emerge towards the end of March due to the consequential economic impact. However, the Group also reported that asset balances and customer deposits were in line with expectations and no reduction in asset growth or customer balances were experienced by the bank up until April 2020.

BOV also highlighted that lower economic activity and reduced international trade started to indicate potential reductions in commission and exchange income. Likewise, the Group also reported that net interest income generated during Q1 2020 was marginally down in comparison to the previous corresponding period.

Although BOV kept experiencing volume growth in terms of their loan book, together with the continued preference for low yield deposit products, the Group maintained that the reduction in income from treasury activities and negative interest rates are the two main burdens which continue to exert additional pressure on the bank's net interest income.

Moreover, the Group recently emphasised that the implementation of risk sharing instruments over the years has been very popular with the local business community. This has eventually led the bank to hold discussions with the Malta Development Bank, resulting in the launching of two new products: the 'SME Invest' and the 'BOV Family Business Transfer Facility'. The SME Invest product has a portfolio capacity of €50m and was received very well with nearly €15m sanctioned from six months of its launch. Contrarily, the 'BOV Family Business Transfer Facility' was designed to facilitate the smooth transfer of family businesses from one generation to the next while ensuring proper governance and care of hard-earned assets.

In furtherance, the Group continued to make progress on its de-risking exercise while improving in-house capabilities in this regard so as to minimise costs. As a result, the Group explained that de-risking costs in the current financial year are expected to be below those incurred during FY19. As such, BOV also highlighted operating costs incurred during Q1 2020 were below previous budgetary targets.

Meanwhile, banks, through their financing, are exposed to potential significant credit losses and thus need to provide for credit losses as a result of this outbreak. This is further magnified by the most recent accounting treatment IFRS 9, which forces banks to provide for expected credit losses based on forecasted assumptions, rather than as previously accounted under the 'apparent evidence of a loss' framework. As per BOV's recent directors' statement, the Group explained that the situation on impairment provisions remained favourable up until Q1 2020, but the current difficult trading environment is likely to necessitate further provisions. However, the bank did not provide any concise indication in relation to expected credit losses provision which is expected to be provided for during FY20. Although a clear determination of the overall financial impact cannot be made at this stage, we expect the Group to experience additional credit losses during FY20.

The Group also ensured that the bank's liquidity remained at strong levels with short term funds continuing to grow above the €4b mark. The bank also maintained that there are no concerns in terms of capital adequacy measures and that BOV's capital ratios currently are at a strong level. In fact, the Group recently announced that the issuance of the €150m AT1 debt instrument is not an urgent matter at this stage.

In view of this pandemic situation, BOV has taken the necessary measures in order to support the local economy as well as to help safeguard the well-being of its employees and its customers. Amongst other measures, the Bank has launched a €10m fund, together to assist business customers who are being adversely affected by the current circumstances.

Outlook: FY20 and beyond

Apart from the negative consequences brought about by the COVID-19 outbreak across the globe, the broader context of the banking industry in Malta, as well as internationally, remains relatively unattractive, with larger capital requirements as a consequence of more stringent regulation, increased costs mainly related to risk management, compliance and IT related costs; coupled with a backdrop of punishingly low interest rates which are affecting interest margins across the board. As clearly discussed in the previous sections, BOV's focus on service fee related revenues are at present being curtailed by risk management practices as well as competitive elements.

Nevertheless, although it is too early to estimate the pandemic's impact on the Group's operational and financial performance, especially as the duration of the current situation remains unknown, we are of the view that a lower income and potentially growing credit losses will lead to reduced profitability for FY20.

Beyond FY20, much will depend on both the duration of this crisis and the extent of the impact on the local economy as well as, the scale and effectiveness of mitigating measures provided by the local and EU authorities. We look forward to continue monitoring the situation closely, and upon receiving additional concrete feedback from the Group/ Government, we will update investors with a more tangible direction on FY20 and possibly beyond.

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