Calamatta Cuschieri
INVESTMENT ADVISORS & STOCKBROKERS

Bank of Valletta p.l.c.

Executive Summary:

"We are maintaining our Hold recommendation on the shares of BOV with a 12-month price target of €1.16. The bank's shares have continued their downward trajectory in 2019, fuelled by the uncertainty surrounding the litigation cases, the lack of dividend distribution, the uncertainty concerning the bank's transformation programme and the bank's profit warning following the announced de-risking exercise across many of the bank's revenue centres. Despite this, we believe that at current levels the market has factored in all the known headwinds being faced by the bank.

We are cognisant of the real risk of further provisions as well as the failure to be in a position to distribute a dividend to shareholders in the near future. This could create continued downward pressure on the share price in the short term, countered by the value argument, as demand for the typically stable dividend paying stock remains mixed. We expect equity holders who have a medium to long term investment horizon to be rewarded in due course, as the bank resumes stable single digit ROE levels and dividend distribution to boot."

Company Overview:

Bank of Valletta p.l.c. 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.

The main companies forming part of the "Group" include Bank of Valletta p.l.c., BOV Asset Management Limited, BOV Fund Services Limited and BOV Investments Limited. The Group also has an associated company, Middlesea Insurance p.l.c., and a jointly controlled entity, MSV Life plc.

Latest developments:

- Litigation cases – The bank has been involved in at least three known litigation cases which have dominated the share price in recent months, the largest of which is the Deiulemar case, with a maximum exposure of €363 million. (Further information is available in the dedicated section).
- In the latest interim 2019 results, the bank concluded that provisions held as at December 2018 in respect of the ongoing litigation cases are adequate at the reporting date and thus no changes were necessary.
- The bank intends to issue up to €150 million in Additional Tier 1 capital by the end of 2019, in response to the increasing regulatory requirements, including MREL (Minimum Requirement for own

Stock Rating — Hold

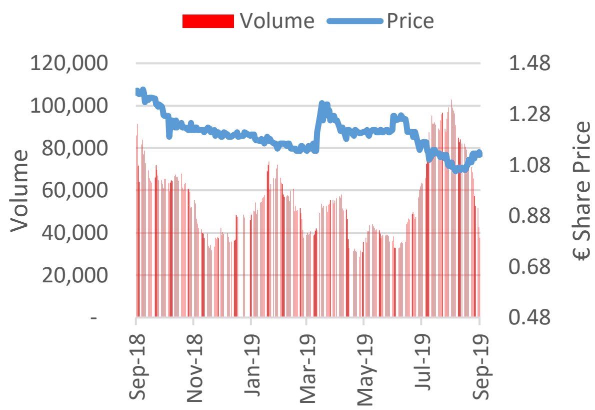
Price target (1Yr) — €1.16

Country	Malta
Industry	Banking & Financial Services
Ticker Symbol	BOV
Price (as at 03/09/2019)	€1.13
Price Target (1 Year)	€1.16
Upside / Downside to PT	2.7%
Market Cap	€659.7 million
Shares Outstanding	583.8 million
Free Float	64.8%
Net Dividend Yield *	N/A
Current P/E *	8.6x
Forward P/E **	10.4x

*** Based on the last twelve months (LTM) as of June 2019**
**** CC Estimates**

1-Year Range: Price Movement and Volume Movement (20 day moving average)

Exchange: MSE
Lowest Price: 1.06
Highest Price: 1.38



Source: Bloomberg

Market Research

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funds and Eligible Liabilities).

- The bank experienced a cyber-attack in February, whereby €13 million worth of funds were stolen. The vast majority of the funds were recovered, with around €1 million expected to be unrecoverable.
- The bank is currently engaged in widening its pool of overseas correspondent banks with respect to US Dollar clearing. It recently concluded an agreement with Raiffeisen Bank; however, we understand that the intention is to broaden this further.
- The bank is currently engaged in an extensive transformation programme, which includes the replacement of the bank's core IT systems as well as an overhaul of the bank's business practices in terms of risk management, compliance and internal governance.
- The bank has resolved not to declare an interim dividend while the recommendation for a final cash dividend will be revisited at the end of the financial year in line with developments in the second half of the year.

SWOT Analysis

Strengths

- ✓ Largest Bank in Malta in terms of deposits
- ✓ Systemically important bank for Maltese economy
- ✓ Universal bank
- ✓ Proved resilient during financial crisis
- ✓ Strong capital adequacy ratios

Weaknesses

- × Large regulatory burden
- × Highly exposed to the Maltese economy
- × Currently has a high amount of litigation risk
- × Currently has dividend suspended
- × Political pressure due to government being the bank's largest shareholder
- × Profitability falling due to de-risking exercise and transformation programme

Opportunities

- ○ Strong, developing economy creating business
- ○ Strengthening property market is beneficial to loan portfolio
- ○ Digitalisation of bank could increase efficiency, attract more customers and increase return on investment
- ○ Improved risk management and de-risking programme could minimise one- off shocks

Threats

- ! Property market crisis
- ! Lack of available skilled workforce
- ! Litigation cases, which could result in further provisioning totalling €363 million
- ! Core funding issues if €150 million AT1 bond issue is unsuccessful
- ! Further rating downgrades could increase the weighted cost of capital
- ! The bank's transformation programme could permanently increase the operating leverage of the bank

Overview of litigation cases affecting the bank

Deiulemar Group Case

In July 2018, BOV charged a litigation provision of €75 million in connection with its exposure to three main cases of litigation which are currently ongoing. The largest and vast majority of the exposure is of €363 million in connection with the trust business; a company called Deiulemar Group which went bankrupt in 2012, and subsequent to which a lawsuit was filed in Torre Annunziata, Italy, against the Bank as trustee in 2014 by the curators of the bankruptcy of the Deiulemar Group.

The only assets settled in trust with the Bank were shares in the ultimate holding company of the Deiulemar Group. The Bank maintains that it has strong legal defences on the merits of the case. Nevertheless, upon the precautionary sequestro ("seizure") of funds equivalent to the sum being contested, and the subsequent failure to win the appeal to remove the seizure, the bank's Board revisited its previous stance, and it has now resolved to recognise a provision to reflect a higher probability of an eventual outflow of funds in connection with the case (current provision is equal to around 20% of the exposure to the Deiulemar Group). Furthermore, the bank announced that it will not be distributing a dividend in 2018 and will review the decision at the end of FY19.

Given that the hearing of the Deiulemar case has not yet commenced, it expected to be a drawn out process (4-5 years) which the bank intends on pursuing up to the highest European courts. The decision taken in the Italian court doesn't change the likelihood of the case being won and does not change the merits of the case. The initial judgement is not expected to be delivered before several months' time.

The key variable in the case is the value that is being contested. The bank is arguing that the €363 million being claimed is "fictitious" in that it represents the value of the ships, which were the assets, held in the Deiulemar Group. The bank held under trust the shares of Deiulemar, which had an equity value which is much lower when taking into consideration all liabilities, in fact it is our understanding that it is reportedly close to nothing. Theoretically, therefore the bank's exposure should be minimal.

Despite this, given that the case is being initially heard in a small provincial town which itself has a number of affected creditors, there is a real risk of the case being found against them, at least initially, and the bank subsequently being forced into providing for the losses. The consequence of this is the bank's income statement being affected, hindering the bank's ability to distribute dividends.

The bank is currently awaiting news of a decision after an appeal for the judge involved in the case in Torre Annunziata to recuse herself due to suspected conflicts of interest. Furthermore, in April 2018 the bank announced that it filed proceedings against Italy before the European Court of Human Rights in Strasbourg with a view to safeguard its fundamental right to a fair hearing in this matter in terms of the European Convention on Human Rights.

Other cases

The Group is involved in another two litigation cases, one involving La Valette Multi Manager Property Fund, which according to the interim financial statements for 2018 has been provided for, and the other being related to the custody business in the case involving Falcon Funds SICAV. The Swedish Pension Agency is claiming damages of €75 million with respect to its investment in Falcon Funds SICAV, to which the Bank reportedly was providing custody services. It is our understanding that no provisions were made in this respect and that the case remain under review.

Investment Stance

We are maintaining our Hold recommendation on the shares of BOV at current price levels, with a price target of €1.16. The bank's shares have continued their downward trajectory in 2019, fuelled by the uncertainty surrounding the litigation cases, the lack of dividend distribution, the uncertainty concerning the bank's transformation programme and the bank's profit warning following the announced de-risking exercise across many of the bank's revenue centres. Additionally, the bank issued bonus shares in June, further increasing pressure on the share price of the bank.

Despite this, we believe that at current levels the market has factored all the known headwinds being faced by the bank. In our bear-case scenario, whereby the bank is assumed to have suffered the full blow of the litigation cases they are facing, the valuation of the bank's shares is €1.06 using a book value multiple approach (see the valuation section for further detail). We view this as the floor to the current value of the shares.

The bank's market cap currently stands at €659.7 million, €374.9 million below the current equity value on the bank's balance sheet. The bank's future maximum exposure to the known litigation cases is of €236 million on an after tax basis. This discrepancy forms the basis of our short-term price target, discounted for the lack of dividend distribution. Furthermore, the bank remains profitable, despite the announcement operational transformation programme which involves de-risking and an investment of "several millions" in both human and technical resources. This could be the basis of an argument for upside potential once more clarity is available to shareholders and a measure of confidence returns. The case for upside potential is strengthened by the fact that, according to the available information, the bank is not likely to incur the full extent of the litigation exposure brought against it.

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. Bank's focus on service fee related revenues are curtailed by risk management practices as well as competitive elements.

In BOV's case the cost/income ratio spiralled to 59.6% in 1H19 compared to 49.1% in FY2018, mainly pushed on the cost side by the bank's transformation programme. BOV is largest bank in terms of deposits, which continues to grow. This unfortunately contributes to the cost side of the equation, as the bank already has substantial excess liquidity, which is held at the ECB at negative rates. The bank's Return on Equity currently stands at 7.4% (annualised) which compares unfavourably with the double digit ROEs experience in the past. The Bank itself announced that the longer term expected return on equity is in the single digits. Furthermore, the bank faces a significant degree of financing risk because of the €150 million Tier 1 bond issue it is required to conclude by the end of 2019. Despite this, given the significant contraction in share price over the past 12 months, we do not see the case for further significant downside.

We are cognisant of the real risk of further provisions as well as the failure to be in a position to distribute a dividend to shareholders in the near future. This could create continued downward pressure on the share price in the short term, countered by the value argument, as demand for the typically stable dividend paying stock remains mixed. We expect equity holders who have a medium to long-term investment horizon to be rewarded in due course, as the bank resumes stable single digit ROE levels and dividend distribution to boot.

Valuation

Our 1yr price target is €1.16. The price target, which is reflective of our base case scenario, is calculated using a price-to-book value model, with a discount rate of 10% using a scenario analysis approach given the key litigation event risk.

	1H2018	1H2019	2017Adj[1]	FY2018	LTM2019	FY2019F	FY2020F	FY2021F
	€000s	€000s	€000s	€000s	€000s	€000s	€000s	€000s
Interest and similar income:								
on loans and advances, balances with CBM and Tbills	81,102	84,642	159,198	165,177	168,717	170,132	174,386	178,745
on debt and other fixed income instruments	26,600	20,169	48,158	48,719	42,288	40,338	39,935	39,535
Interest expense	(28,734)	(27,223)	(60,998)	(57,350)	(55,839)	(54,483)	(62,850)	(61,279)
Net Interest Income	**78,968**	**77,588**	**146,358**	**156,546**	155,166	**155,988**	**151,470**	**157,001**
Fee and commission income	45,539	42,256	79,030	92,368	89,085	84,512		
Fee and commission expense	(5,164)	(5,743)	(9,998)	(11,231)	(11,810)	(11,486)		
Net fee and commission income	**40,375**	**36,513**	**69,031**	**81,137**	77,275	**73,026**	**71,565**	**72,281**
Dividend Income	758	377	1,540	1,075	694	500	500	500
Trading Profits	7,544	12,858	17,832	18,019	23,333	20,000	15,000	15,000
Net gain on investment securities and hedging instruments	290	143	5,618	989	842	500	500	1,000
Operating Income	**127,935**	**127,479**	**240,378**	**257,766**	257,310	**250,014**	**239,035**	**245,782**
Employee compensation and benefits	(32,693)	(35,550)	(63,800)	(65,696)	(68,553)	(72,266)	(75,879)	(79,673)
General administrative expenses	(26,289)	(39,768)	(47,570)	(54,596)	(68,075)	(87,354)	(91,721)	(73,377)
Amortisation of intangible assets	(2,138)	(2,650)	(3,946)	(4,607)	(5,119)	(5,000)	(5,000)	(5,000)
Depreciation	(2,816)	(3,517)	(5,684)	(5,699)	(6,400)	(7,000)	(7,140)	(7,140)
Net Impairment losses	20,155	(936)	4,982	10,816	(10,275)	(3,000)	(3,000)	(3,000)
Operating Profit before litigation provision	**84,154**	**45,058**	**124,359**	**137,984**	**98,888**	**75,395**	**56,295**	**77,593**
Litigation provision	(75,000)	-	-	(75,000)	-	-	-	-
Operating Profit	**9,154**	**45,058**	**124,359**	**62,984**	98,888	**75,395**	**56,295**	**77,593**
Share of results of equity accounted investees, net of tax	4,308	9,244	15,430	8,214	13,150	15,000	15,000	15,000
Profit before tax	**13,462**	**54,302**	**139,789**	**71,198**	112,038	**90,395**	**71,295**	**92,593**
Income tax expense	(813)	(16,148)	(44,190)	(19,788)	(35,123)	(27,118)	(25,000)	(32,000)
Profit for the period	**12,649**	**38,154**	**95,598**	**51,410**	76,915	**63,276**	**46,295**	**60,593**
Earnings per share	**0.022**	**0.065**	**0.164**	**0.088**	**0.132**	**0.108**	**0.079**	**0.104**

Equity Evaluation	1H2018	1H2019	2017Adj	2018	LTM2019	2020F	2021F	2022F	1Yr PT
Unadjusted	**945,595**	**1,034,676**	**962,087**	**994,133**	**1,034,676**	**1,059,798**	**1,106,093**	**1,166,686**	
Base Case						**1,059,798**	**988,118**	**1,048,711**	**€1.16**
Bull Case						**1,059,798**	**1,106,093**	**1,166,686**	**€1.27**
Bear Case						**1,059,798**	**870,143**	**930,736**	**€1.06**
P/B Multiple				**0.66x**	**0.64x**	**0.60x**	**0.60x**	**0.80x**	

[1] FY2017 15 month period annualised

Base Case:
• Litigation provision of €219 million in FY2020 (€142 million after tax), reflecting a provision for litigation up to 50% of the maximum exposure in relation to the Deiulemar Group case and Falcon Funds case.

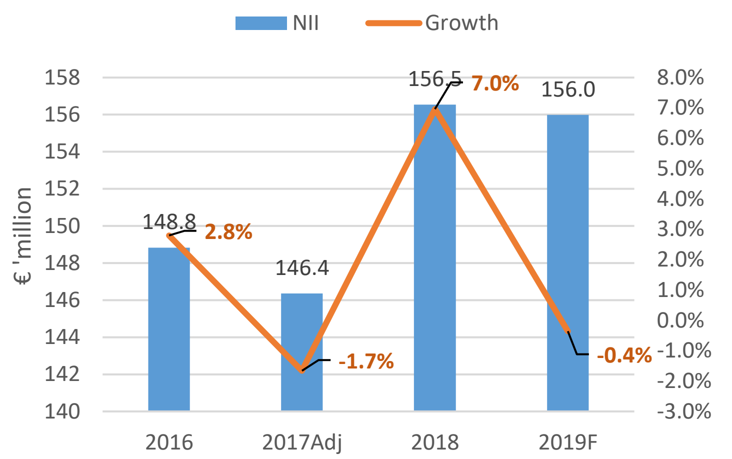
Bull Case:
• Litigation provision of €75 million (€49 million after tax) reversed in FY2022.

Bear Case:
• Litigation provision expense of €363 million (€236 million after tax) in FY2020 reflecting a full provision for litigation in relation to the Deiulemar Group case and Falcon Funds case.

Investment Thesis Variables

Financial Variables[2]

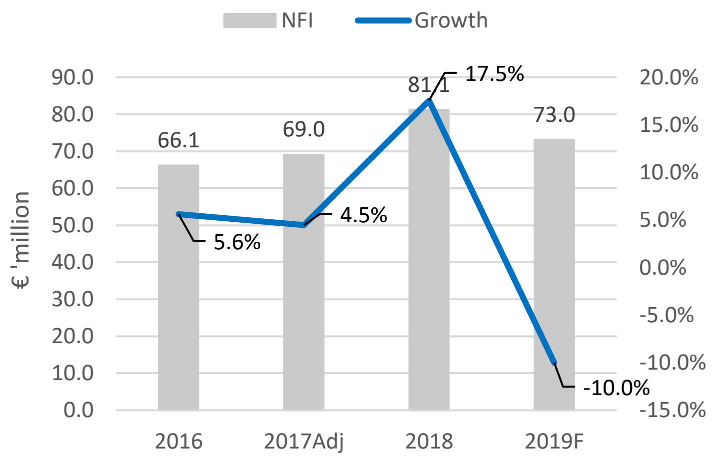
- **Net Interest Income (NII)** – We expect NII to decrease marginally in FY19, in line with the first six months of FY19, on the back of continued growth in customer deposits, which attract negative interest rates on higher liquidity levels. The measured growth in lending is expected to lend support; however, the low interest rate environment, higher competition from other local banks and the de-risking strategy of the bank is expected to a largely flat performance. In subsequent years, NII is expected to be negatively affected by the servicing of the €150 million Tier 1 issue.



Source: Financial Statements, CC workings

- **Net fee and commission income** – Fees and commissions are expected to be lower YoY due to a number of one-off gains recognised last year, lower income on forex due to risk mitigation and a reduction in fair value gains on equities. We expect this trend to have continued throughout the rest of the year, and FY20.

- **Operating Income** – We expect operating income to decrease to around €250 million in FY19, compared with €258 million in FY18. The decrease is attributed to lower NII and commission income, compensated in part with stronger Trading Profits.

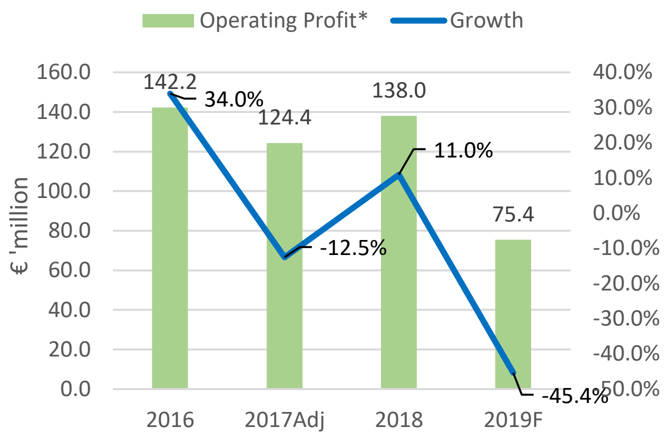


Source: Financial Statements, CC workings

[2] Reference to FY 2016 is as at 30th September of the given year, and Adjusted FY17 is a proportional adjustment given the 15-month period due to the change in year-end.

- **Operating Profit before litigation provision** – A steep increase in operating costs is expected for FY19. This increase is attributed to the holistic transformation programme that the bank is currently engaged in. Cost increases include staff costs and IT related expenses, which are expected to sharply increase in FY19 and FY20, and despite an expected contraction, these are expected to be recurrent in future projections.

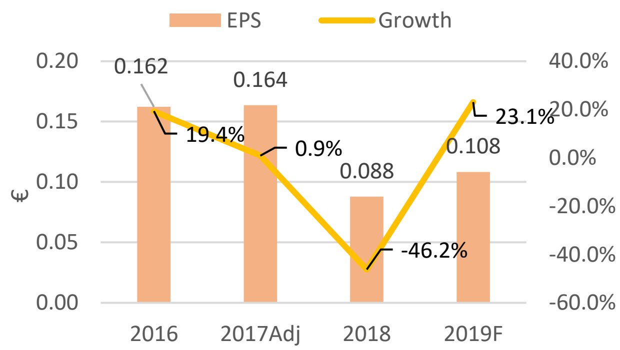
  Operating before litigation provision is expected to fall to €75 million for FY19 vs €138 million in FY18. We are forecasting a €3 million net impairment loss in FY19, in line with reported expected yearly levels.



**before litigation provision*
Source: Financial Statements, CC workings

- **Operating Profit** – The bank recognised a €75 million provision for litigation in FY18. Given the lack of material developments expected by the end of FY19, we do not see the case for the bank recognising further provisions at this stage.

- **Share of results of equity accounted investees** – This relates to the bank's shareholding in the insurance industry, namely MAPFRE Middlesea p.l.c. and MAPFRE MSV Life p.l.c. For FY19, we are forecasting a contribution of €15 million from equity accounted investees, and are assuming a similar contribution in the forecasted periods.



Source: Financial Statements, CC workings

- **Net Profit and EPS** – We are forecasting a net profit of €63 million in FY19 compared with €51 million in FY18, which translates to an EPS figure of €0.108 in FY19 compared to €0.088 in FY18.

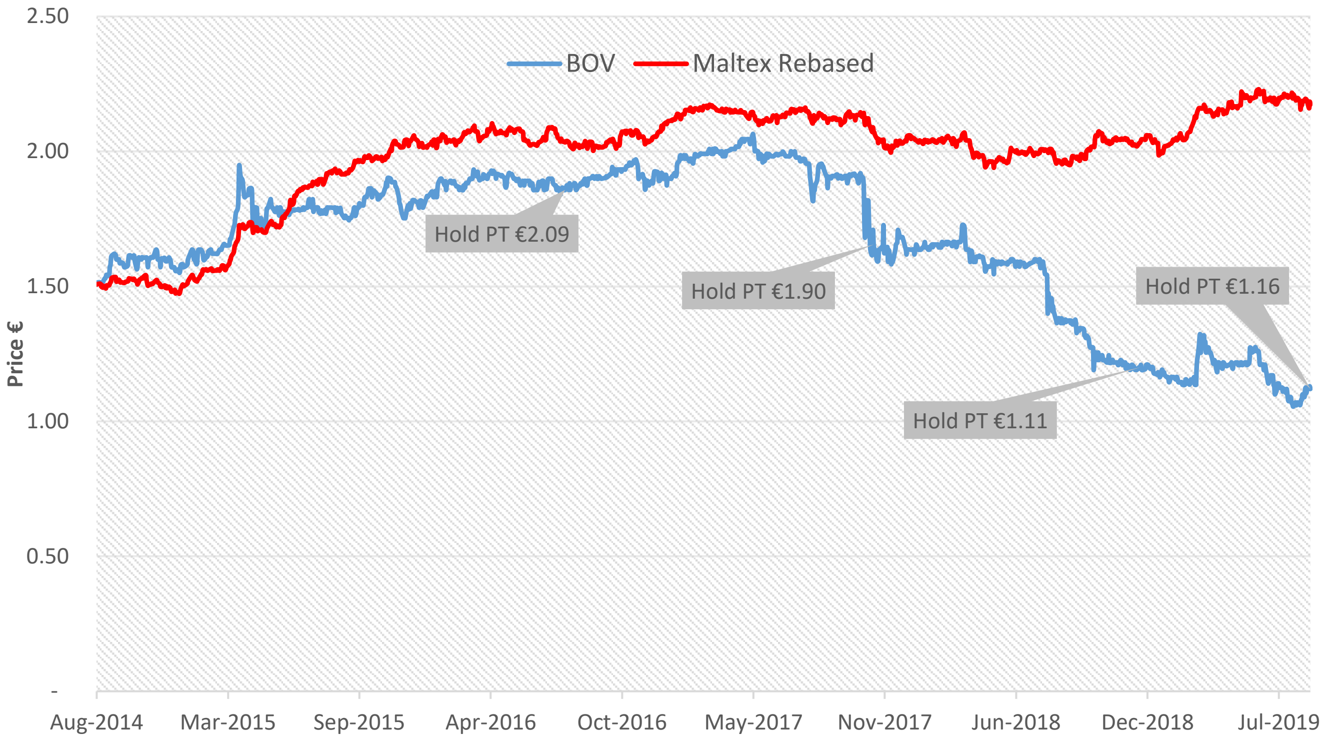
The bank's capital ratios remain satisfactory, with a CET 1 ratio of 19.1% in 1H19, up from 18.2% as at FY18 and which also compares favourably with other local peers. The bank however faces further stringent banking requirements; including possible future "Minimum Requirement for own funds and Eligible Liabilities" and Basel IV requirements, which pushes the bank to further enhance its' capital base through retained earnings and capital markets operations.

Reported CET 1 ratios as per published interim results for 1H2019	%
Bank of Valletta plc	19.1
HSBC Bank (Malta) plc	16.2
Lombard Bank plc	14.3
APS Bank Ltd[3]	13.9
MeDirect Bank	13.2

[3] As at FY 2018

Historical 1-Year Price Target

Reference	Date	Price[4]	Price Target[4]	Analyst	Recommendation
BOV MV	04.09.2019	€1.13	€1.16	Simon Psaila	Hold
BOV MV	19.12.2018	€1.20	€1.11	Simon Psaila	Hold
BOV MV	08.11.2017	€1.66	€1.90	Simon Psaila	Neutral
BOV MV	26.07.2016	€1.86	€2.09	Simon Psaila	Neutral



Source: Bloomberg

[4] Adjusted for Bonus Share Issues

Glossary and Definitions

Income Statement	
Net Interest Income	Net interest income is the difference between the revenue that is generated from a bank's assets and the expenses associated with paying its liabilities.
Net fee and commission income	Fee income is the revenue taken in by financial institutions from account-related charges to customers. Charges that generate fee income include non-sufficient funds fees, overdraft charges, late fees, over-the-limit fees, wire transfer fees, monthly service charges, account research fees and more.
Operating Profit (EBIT)	EBIT is an abbreviation for earnings before interest and tax.
Profitability Ratios	
Earnings per Share (EPS)	Earnings per share (EPS) is the amount of earnings per outstanding share of a Group's/Company's share capital. It is computed by dividing net income by total shares outstanding as at statement of financial position date.
Growth in EPS (YoY)	This represents the growth in Earnings per Share (EPS) when compared with previous financial year.
Dividends Ratios	
Dividend Pay-out ratio	The proportion of earnings that a company generates which are distributed via dividends to shareholders.
Financial Strength Ratios	
CET 1 Ratio	Common Equity Tier 1 (CET1) consists mostly of common stock held by a bank or other financial institution. CET1 ratio is a measure of a bank's capital against its assets. Because not all assets have the same risk, the assets acquired by a bank are weighted based on the credit risk and market risk that each asset presents. t is expected that all banks should meet the minimum required CET1 ratio of 4.50% by 2019.

Explanation of Equity Research Ratings

Buy: Based on a current 12- month view of total shareholder return (TSR = percentage change in share price from current price to projected target price plus projected dividend yield), we recommend that investors buy the stock.

Sell: Based on a current 12-month view of total shareholder return, we recommend that investors sell the stock.

Hold: We take a neutral view on the stock 12-months out and, based on this time horizon, we do not recommend either a Buy or Sell. Current shareholders should consider buying on dips and selling on peaks.

Newly issued research recommendations and target prices supersede previously published research.

Disclaimer