EQUITY RESEARCH | Lombard Bank Malta p.l.c.

29th January 2021

Executive Summary

"In view of the pandemic related developments vis-à-vis the Bank's operational and financial performance, we maintain our Hold recommendation on the stock whilst lowering our 1-year price target to €1.98 from our previous target of €2.36, reflecting the challenges ahead.

Apart from the implications brought about by the pandemic on the banking industry, the current low interest rate environment, is eroding the core banking profitability globally, especially in Europe with average interest rates margins at the low of 1.3 percent.

As a positive, in Q2'20 we started to see an improvement in business sentiment and European banks started reversing part of these provisions. However, we are not privy to the same moves amongst local banks given the fact that local banks report semi-annually, whereas foreign banks report quarterly.

Thus, we will need to have more clarity in this regard once full year results are made public in the coming months. For this reason, specifically to Lombard, in our model we maintained the same levels of Expected Credit Losses (ECLs) across our projected period, until we have further visibility in the near future.

We believe that the banking industry is still facing a number of challenges with the low inflationary environment, namely in Europe, conditioning remarkably the forward looking expectations for the industry. In addition, more specifically, we are of the view that the increased costs will continue to hinder the bank's profitability in the near future. Given the aforementioned uncertainty we believe that a Hold recommendation with a 1-year price target of €1.98 is warranted."

Group Overview

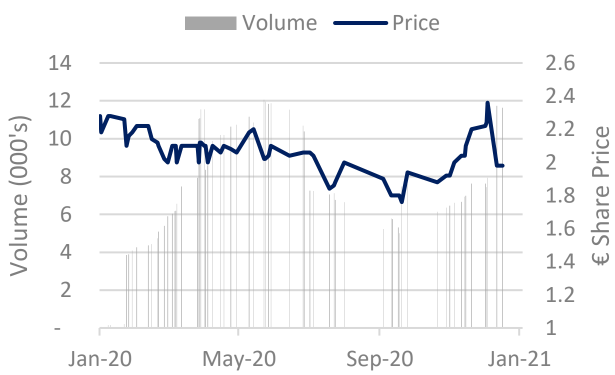
Lombard is licensed as a credit institution and as an investment service provider, offering the full range of traditional retail and commercial banking activities.

Redbox limited, a wholly owned special purpose vehicle subsidiary, owns 71.5% of MaltaPost p.l.c. (MaltaPost), which is Malta's leading postal services company.

The Lombard Group has 51% of its shares freely traded on the MSE and 49% owned by the National Development and Social Fund (NDSF).

Stock Rating	**Hold**
Price target (1Yr)	**€1.98**
Country	Malta
Industry	Banking
Ticker	LOM
Price (as at 28/01/2021)	€1.98
Price Target (1-Year)	€1.98
Upside/ Downside to PT	0%
12m cash div. (Forecast)	Nil
12m Total S'holder Return	0%
Market Cap	€87.3m
Shares Outstanding	44.2m
Free Float	51.0%
Net Dividend Yield	Nil
Current P/E	11.6x
1Yr Forward P/E	13.4x
Current P/B	0.73x
Exchange	Malta Stock Exchange (MSE)
52-week range	€1.76 - €2.36

Price and Volume Movement (20 day moving average)



Source: Malta Stock Exchange

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Group Update:

- **COVID-19 Update:**

While the Bank had a good start to 2020 with growth being in line with expectations, the latest financial data available as at Q3-2020, indicates that the ongoing COVID-19 pandemic continued to negatively impact the Bank's revenue streams also during the third quarter of the year.

As per latest announcements, the Bank recently reported that increased pressure on interest rates, including negative interest on prime quality assets, is expected to result into a smaller interest margin for FY20 and possibly beyond. Commission income, too, was negatively impacted by reduced volumes as business sentiment and activity continued to be affected by the economic slowdown. Consequently, the Bank further reported that profit before tax for Q3-2020 was lower when compared to the same period last year.

This being said, management explained that the Bank's overall financial position remains strong and there is no indication of significant deterioration in the Bank's assets, primarily as the majority of the lending exposures are well secured by high quality collaterals. It is also worth mentioning that despite the current distressed economic environment, Lombard's Total Capital Ratio as at June 2020, remained relatively unchanged and stood at 15.9% (FY19: 16%).

Management also clarified that regular reviews concerning credit loss provisions and developing strategies to support customers who will possibly face material difficulties, are also being implemented by the Bank on a regular basis. In this regard, the Bank further anticipates that a worsening in economic conditions may result into an increase in Expected Credit Losses (ECL's) allowances until the COVID-19 situation stabilises. Lombard's net impairment losses as at H1-20 stood at approximately €1.1m.

In terms of the Bank's main subsidiary, MaltaPost, management reported that after significant logistical difficulties experienced during Q2-2020 due to unavailability of international transport facilities, delivery of postal items, although not at full capacity, reached an acceptable level during Q3-2020.

Additionally, in an attempt to assist its customers survive the COVID-19 pandemic, Lombard has participated in the COVID-19 Guarantee Scheme introduced by the Malta Development Bank.

- **Dividend - H1-20 and beyond:**

Following supervisory guidance, the Board withdrew the proposed final dividend for FY19 (net dividend of €0.0455/ share). Consequently, the Bank recently resolved not to declare an interim dividend for H1-20 and as per guidance provided by management, potential dividend payments for FY20 and beyond are to be reassessed once the COVID-19 pandemic is no longer uncertain.

With regards the possibility of a future dividend distributions for banks, the European Central Bank last December recommended that banks should exercise extreme prudence on dividend distribution and share buy-backs. To this end, the ECB asked all banks to consider not distributing any cash dividends or conducting share buy-backs, or to limit such distributions, until 30 September 2021. The recommendation also reflects an assessment of the stability of the financial system and was made in close cooperation with the European Systemic Risk Board.

More specifically, given the persisting uncertainty brought about by the COVID-19 pandemic, the ECB restricted dividends and share buy-backs to below 15% of the FY19-FY20 cumulated profit and not higher than 20 basis points of the Common Equity Tier 1 (CET1) ratio, whichever is lower.

SWOT analysis

Strengths

- ✓ Notwithstanding the implications brought about by the COVID-19 pandemic, the Bank maintained a strong capital profile, with the Total Capital Ratio as at June 2020 standing at 15.9% (FY19: 16%)
- ✓ In comparison to other local peers, the application of IFRS 9 throughout the pandemic, resulted into a lower provision of expected credit losses. This reflects Lombard's high quality financial assets as well as the collateral cover held
- ✓ Management appears to be successful in taking strategic decisions aimed towards the long term sustainability of the Bank
- ✓ Prior to the COVID-19 outbreak, the Bank had a consistent track record of dividend distribution
- ✓ Qualified and experienced staff

Weaknesses

- × Highly exposed to the Maltese economy
- × Low interest rate environment weights on profitability of core banking segment
- × Large regulatory burden and compliance obligations present significant challenges
- × Currently has dividend suspended and historically, the Bank maintained a relatively low dividend payout
- × In comparison to local peers, the stock is less liquid
- × The pandemic has disrupted the operating environment of Lombard, with the possibility of the Bank providing for higher expected credit losses
- × Upcoming MREL and Basel IV requirements will continue increasing the Bank's regulations and capital requirements

Opportunities

- o Investment in the ICT systems and infrastructure should benefit the Bank from a cost perspective long term
- o Increased market presence through the extension of the Bank's ATM network and acquisition of new sites
- o Once the current situation stabilises an economic recovery should ensue, which would increase business opportunities
- o Current projections indicate that the local economy should start recovery in 2021, with the level of GDP set to reach and exceed 2019 levels by end of 2022

Threats

- ! The extent of the impact of the COVID-19 pandemic on the local economy is not yet known, implying that the prolongation of this situation might result into a further deterioration of the Bank's financial performance
- ! Potential property market crisis
- ! Increase in regulatory burden
- ! Data or system breaches
- ! Lack of available skilled workforce

Investment Stance

The COVID-19 outbreak sparked a serious economic downturn and is increasingly posing severe stress on the banking system. As economic uncertainty continued to prevail on all fronts post COVID-19 outbreak in Malta, we have seen all local banking shares trading lower, including Lombard, with the price dropping to a low point of €1.76 over the past couple of months, followed by a recovery back to the €1.98 level.

In view of the pandemic related developments vis-à-vis the Bank's operational and financial performance, we maintain our Hold recommendation on the stock whilst lowering our 1-year price target to €1.98 from our previous target of €2.36, reflecting the challenges ahead.

Apart from the implications brought about by the pandemic on the banking industry, the current low interest rate environment, is eroding the core banking profitability globally, especially in Europe with average interest rates margins at the low of 1.3 percent. As clearly stated in prior sections of this report, Lombard recently reported a lower profit before tax for Q3-2020, with this being mainly attributable to the increased pressures from the low interest rate scenario.

Lombard's financial performance as at Q3-2020 was also characterised by a lower commission income, as business sentiment and economic activity continued to deteriorate due to the economic slowdown experienced throughout the pandemic. Lombard's profitability is also currently being squeezed through increased levels of operating expenditure, reflecting the Bank's ambition to enhance its ICT systems and infrastructure.

From a macroeconomic perspective, at the peak of the coronavirus crisis, banks across the globe (including Europe's largest banks) took a prudent approach by increasing provisions to combat possible defaults in their books. Inevitably, the increased provisions were ultimately reflected in price to book (in Europe) multiples which fell to levels below 0.55x. The said provisions were the biggest since the 2008-09 financial crisis.

As a positive, in the summer we started to see an improvement in business sentiment and European banks started reversing part of these provisions. However, we are not privy to the same moves amongst local banks given the fact that local banks report semi-annually, whereas foreign banks report quarterly. In the interim directors' statement, reported by the major local banks, no referral was made to the reversal of provisions as we experienced across European banks. Thus we will need to have more clarity in this regard once full year results are made public in the coming months. For this reason, specifically to Lombard, in our model we maintained the same levels of ECLs until we have further visibility in the near future.

Moreover, we are conscious of other possible headwinds surrounding the local banking industry in the short to medium term. Apart from the pandemic, we see possible demand/supply imbalances in the property market, in addition to the uncertainty brought about by the Moneyval saga.

Nonetheless, we also note that the Maltese economy is expected to rebound in 2021, and in this regard we adjusting upwards the forward price-to-book multiple to reflect this expected improvement. That said, the adjusted multiple is still below pre-pandemic levels, and thus we will adjust accordingly once we have more visibility from the pandemic outcome and its impact on the banking industry.

We believe that the banking industry is still facing a number of challenges with the low inflationary environment, namely in Europe, conditioning remarkably the forward looking expectations for the industry. In addition, more specifically, we are of the view that the increased costs will continue to hinder the bank's profitability in the near future. Given the aforementioned uncertainty we believe that a Hold recommendation with a 1-year price target of €1.98 is warranted.

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Valuation

Our 1-year price target of €1.98 is based on a P/B multiple of 0.65x on FY23 forecasted earnings. We implemented a discount rate of 12% within our valuation model.

€'000s (unless otherwise indicated)	FY17A	FY18A	FY19A	LTM20[1]	FY20F	FY21P	FY22P
	€'000	€'000	€'000	€'000	€'000	€'000	€'000
Net Interest Income	15,434	17,511	19,680	18,758	17,746	18,920	19,109
Net Fee and Commission Income	4,133	4,716	5,405	5,064	4,865	4,962	5,160
Postal sales and other revenues	37,371	39,254	33,559	34,208	33,884	34,222	34,565
Dividend Income	326	369	211	58	24	200	250
Net Trading Income	619	880	992	788	700	900	900
Other Operating Income	-	55	90	81	-	-	-
Operating Income	**57,883**	**62,785**	**59,937**	**58,957**	**57,218**	**59,204**	**59,984**
Total operating expenses (exl. Impairment losses/ gains)	(46,074)	(48,890)	(44,094)	(45,092)	(44,907)	(46,514)	(47,773)
Credit Impairment Losses	(2,835)	(234)	(549)	276	(1,500)	(500)	-
Operating Profit	**8,974**	**13,661**	**15,294**	**14,141**	**10,812**	**12,189**	**12,211**
Share of profit/(loss) of investment accounted for using the equity method net of tax	(106)	109	-	-	-	-	-
Profit before taxation	**8,868**	**13,770**	**15,294**	**14,141**	**10,812**	**12,189**	**12,211**
Income tax expense	(3,165)	(4,831)	(5,424)	(5,013)	(3,784)	(4,266)	(4,274)
Profit for the year	**5,703**	**8,939**	**9,870**	**9,128**	**7,028**	**7,923**	**7,937**
Attributable to:							
Equity holders of the bank	5,129	8,447	9,320	7,572	6,525	7,411	7,414
Non-controlling interests	574	492	550	556	502	513	523
Profit for the year	**5,703**	**8,939**	**9,870**	**8,128**	**7,028**	**7,923**	**7,937**
Earnings Per Share	**0.116**	**0.191**	**0.211**	**0.171**	**0.148**	**0.168**	**0.168**

Equity Evaluation	FY17A	FY18A	FY19A	LTM20	FY20F	FY21P	FY22
Equity excluding non-controlling interests* - €'000s	96,140	108,310	119,128	120,403	125,653	131,700	137,705
Book value per share (discounted) - €	2.18	2.45	2.70	2.73	2.87	3.01	3.13
P/B Multiple	n/a	n/a	0.73x	0.73x	0.55x	0.60x	0.65x

Ratio Analysis	FY17A	FY18A	FY19A	LTM20	FY20F	FY21P	FY22
Cost Efficiency Ratio (excl. Impairment losses/gains)[2]	79.6%	77.9%	73.6%	76.5%	78.5%	78.6%	79.6%
Net Interest Income Growth	8.7%	13.5%	12.4%	-4.7%	-9.8%	6.6%	1.0%
Net Fee and Commission Income Growth	8.6%	14.1%	14.6%	-6.3%	-10.0%	2.0%	4.0%
Operating Income Growth	22.5%	8.5%	-4.5%	-1.6%	-4.5%	3.5%	1.3%
Earnings Per Share	0.116	0.191	0.211	0.171	0.148	0.168	0.168
Growth in EPS (YoY)	8.5%	64.7%	10.3%	-18.8%	-30.0%	13.6%	0.0%
Net Interest Margin	1.9%	2.0%	2.1%	1.9%	1.8%	1.9%	1.9%
Price/ Earnings Ratio	Nil	Nil	9.1	11.2	13.4	11.8	11.8
Return On Equity	5.6%	8.2%	8.1%	6.6%	4.9%	5.3%	5.0%
Earnings Yield	Nil	Nil	11.0%	8.9%	7.5%	8.5%	8.5%
Dividends Yield	Nil	Nil	2.4%	1.7%	Nil	1.6%	1.6%
Dividend pay-out ratio	22.4%	17.0%	21.7%	19.0%	Nil	18.4%	19.0%

*** Forecasted equity is calculated by aggregating the profitability with previous year closing equity, less any expected common dividend.**

Source: Lombard's Financial Statements and CC workings

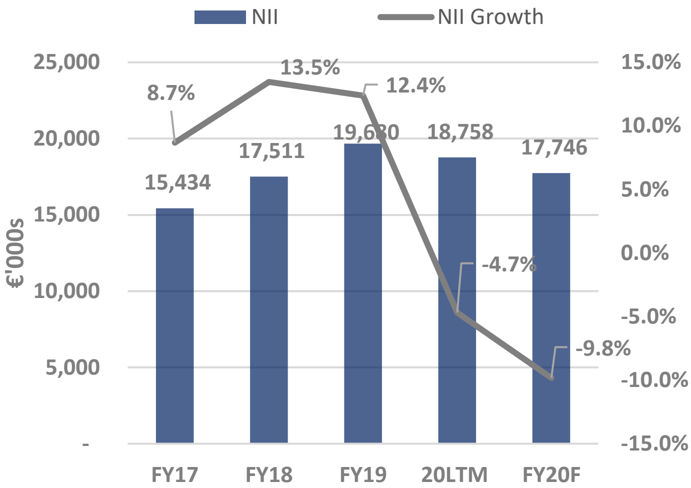
[1] LTM20 is calculated by adding the interim results (H1) of 2020 with the audited results of FY19, less H1 2019

[2] Includes the operating expenditure of Malta Post plc

Investment considerations

- **Net interest income (NII)**: As per H1-20 interim results, Lombard generated approximately €9.3m in net interest income, representing an overall decline of 9.1% on a comparative basis. This decline is mainly attributable to the persistent low interest rate environment which throughout H1-20 has exerted increased pressure on interest margins.

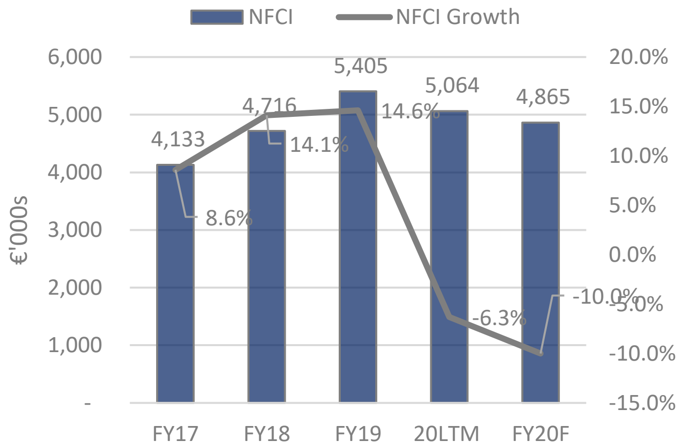
  Although Lombard's total interest bearing assets increased by 2.8% during H1-20, in view of the fact that such increase has been predominantly driven by an increase in balances with the Central Bank of Malta (CBM), which are currently attracting negative interest rates, we expect Lombard's net interest margin to drop to circa 1.8% during FY20 (FY19: 2.1% and LTM20: 1.91%). In this regard, we expect NII to amount to €17.7m in FY20, representing an overall decrease of 9.8% in comparison to FY19.



Source: Lombard's Financial Statements and CC workings

- **Net fee and commission income (NFCI):** During H1-2020, the Bank's net fee and commission income declined by 13% mainly on the back of much lower transactions volume, as business sentiment and economic activity continued to be affected by the economic slowdown especially in the second quarter of 2020.

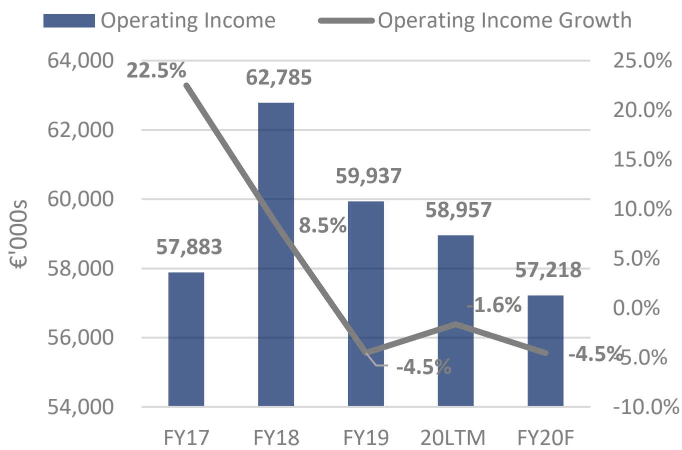
  Although we anticipate NFCI to partially recover throughout H2-2020, we expect Lombard's NFCI to approximately amount to €4.9m during FY20, demonstrating an overall yearly drop of 10%.



Source: Lombard's Financial Statements and CC workings

- **Operating Income:** Apart from NII and NFCI, the Bank's operating income is also composed of postal sales and other revenues generated by MaltaPost. In line with unavailability of international transport facilities throughout H1-2020 (March–June), MaltaPost experienced a sudden drop in postal volumes, thus resulting into significant logistical difficulties for the Group.

  Upon discussions held with MaltaPost's executive management, although the increase in tariffs implemented in January 2020 failed to compensate for the year-on-year decline in letter mail volumes, throughout H1-2020, MaltaPost benefitted from a one-off spike in letter mail volumes through the distribution of the registered vouchers which were granted by the Government of Malta to all eligible residents.



Source: Lombard's Financial Statements and CC workings

Additionally, we expect the Group to generate circa €33.9m in postal sales and other revenues during FY20, demonstrating a marginal increase of approximately 1% over FY19. In furtherance, Lombard's operating income also takes into account dividend income, net trading income and other operating income generated by the Bank.

- **Total operating expenditure excluding credit impairment losses:** Being the major cost item incurred by the Group, employee compensation and benefits as per H1-2020 results, increased by 3.4% on a comparative basis (the Bank's employee wages on a standalone basis increased by 8.7%). Such increase is mainly attributable to the need to recruit more specialized individuals in order to address the continuous evolving compliance obligations.

  The increase in employee compensation is also attributable to the Group recently signing a new collective agreement with the Malta Union of Bank Employees. Additionally, management further expect employee compensation to continue increasing moving forward as the Group envisages to continue employing and also retaining high-quality staff.

  Moreover, in ensuring maximum safety for both customers and employees throughout the pandemic, the Group incurred an increase in operating costs (+2.9%) throughout H1-2020 in relation to Covid-19. Otherwise, management confirmed that the Group's operating expenditure remained under control.

  Throughout the first half of the year, the Group also incurred an increase in the amortisation charge for the period, reflecting increased investments implemented by the Bank in relation to its respective IT and computer software departments. This further highlights progress in relation to Lombard's proposed digitilisation transformation. Additionally, in view of the above important considerations, we expect the Bank to incur approximately €44.9m in operating expenditure (FY19: €44.1m).

- **Credit impairment losses:** The Bank through its interim results reported that regular reviews concerning developing strategies aimed towards supporting customers who start experiencing material difficulties are regularly being implemented by the Bank.

  The Bank further anticipates that worsening economic conditions may result into an increase in ECL's allowances until the COVID-19 situation stabilises. Although the pandemic situation remains relatively fluid, and although it's still early to estimate the exact pandemic related impact on Lombard's operational and financial performance, we expect the Bank's credit impairment losses for FY20 to amount to approximately €1.5m and eventually taper down to approximately €0.5m during FY21, in line with the anticipated partial economic recovery as from the second quarter of 2021.

- **Profit before tax:** Upon taking the above important factors into consideration, the Bank reported a profit before tax of circa €5m for H1-20, representing an overall drop of 18.6% on a comparative basis. In accordance to all assumptions stated above, we expect Lombard to generate a profit before tax of €10.8m during FY20 (FY19: €15.3m).

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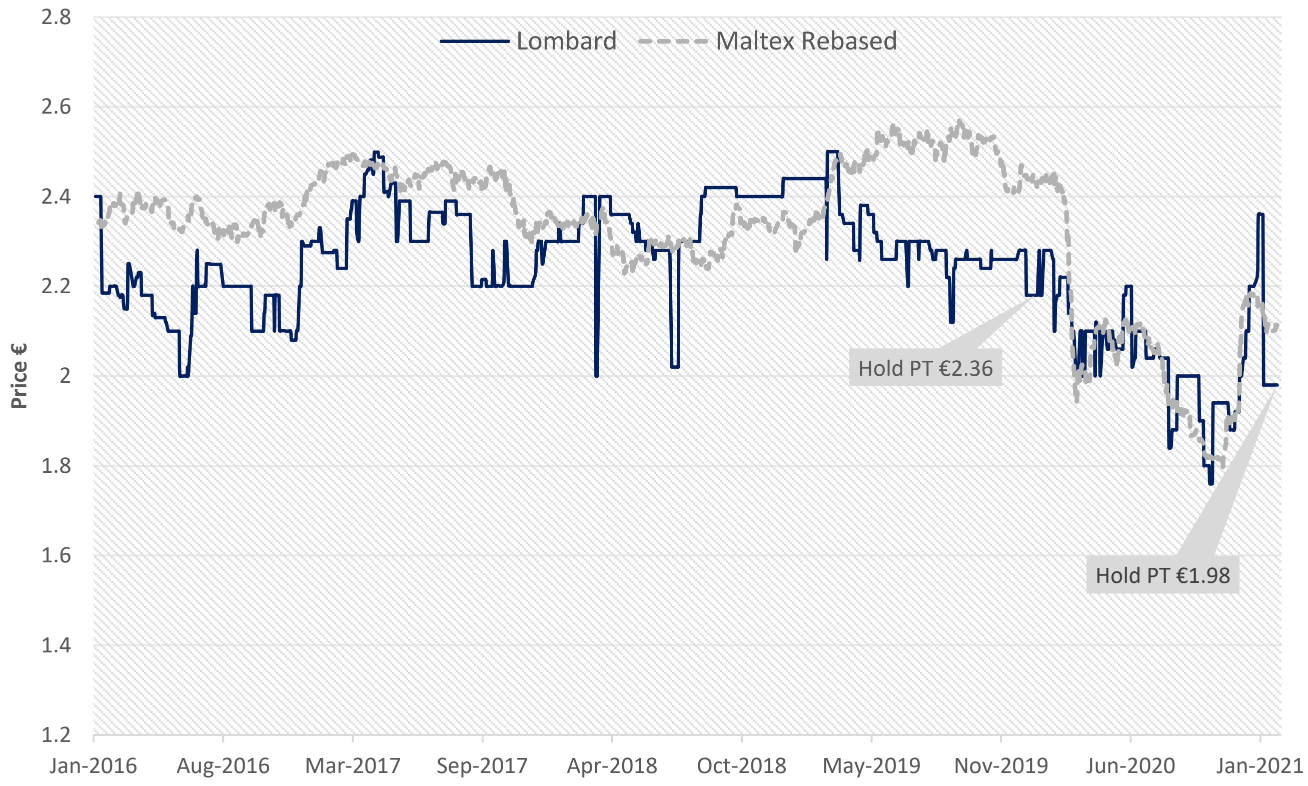
Key Financial Indicators

Lombard Bank Malta plc - €'000s (unless otherwise indicated)	Dec-17	Dec-18	Dec-19	Jun-20
Balance Sheet				
Interest earning assets	807,304	867,850	956,396	983,455
Loans and advances to banks	97,048	140,581	121,060	105,787
Loans and advances to customers	428,611	511,124	552,043	557,059
Loans and advances to banks growth yoy	-40.0%	44.9%	-13.9%	-12.6%
Loans and advances to customers growth yoy	24.8%	19.3%	8.0%	0.9%
Total deposits	738,513	788,898	870,864	907,134
Total deposits growth yoy	1.1%	6.8%	10.4%	4.2%
Shareholders' equity	102,874	115,835	126,802	127,891
Risk weighted assets	619,320	672,948	682,016	n/a
CET1 Capital	87,451	98,677	109,158	n/a
Total capital	88,826	98,677	109,158	n/a
Shares Outstanding (million's)	44.18	44.18	44.18	44.18
CET1 Ratio	14.1%	14.7%	16.01%	15.9%
Tier1 Ratio	14.1%	14.7%	16.01%	15.9%
Total Capital Ratio	14.3%	14.7%	16.01%	15.9%

Source: Lombard's Financial Statements and CC workings

Historical 1-Year Price Target

Reference	Date	Price	Price Target	Analyst	Recommendation
LOM	29.01.2021	€1.98	€1.98	Andrew Fenech and Rowen Bonello	Hold
LOM	20.01.2020	€2.18	€2.36	Andrew Fenech and Rowen Bonello	Hold



Source: Bloomberg

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

Glossary and definitions

Income Statement	
Net Interest income	Interest Income minus Interest Expense.
Operating Profit	Operating profit for financial services firms is the difference between operating income (revenue generation) and operating expenses (typically administrative expenses).
Profit after tax	Profit after tax is the profit made by the Group during the financial year both from its operating as well as non-operating activities.
Earnings per share ("EPS")	Earnings per share is the portion of a company's net profit allocated to each outstanding share of common stock. Earnings per share serves as an indicator of a company's profitability.
Profitability and other ratios	
Costs / Income ratio	It is an indicator of overall company efficiency. The ratio is calculated dividing total costs by total Operating Income.
Net interest margin	Net interest margin is the Net Interest Income for the year as percentage of average Interest-Earning assets.
Earnings yield	Earnings yield are the earnings per share for the most recent 12-month period divided by the current market price per share. Reciprocal of P/E ratio.
Dividends yield	This ratio indicates how much a Group pays out in dividends each fiscal year relative to its share price. It is computed by the dividing the Dividend per Share by the share price as at year-end.
Return on common equity	Return on common equity (ROE) measures the rate of return on the shareholders' equity of the owners of issued share capital, computed by dividing the net income by the average common equity (average equity of two years financial performance).
Return on Assets	Return on assets (ROA) is computed by dividing net income by the average total assets (average assets of two years financial performance).
Balance Sheet	
Interest Earnings Assets	Non-current asset are the Group's long-term investments, which full value will not be realised within the accounting year. Non-current assets are capitalised rather than expensed, meaning that the Group allocates the cost of the asset over the number of years for which the asset will be in use, instead of allocating the entire cost to the accounting year in which the asset was purchased. Such assets include intangible assets (goodwill on acquisition), investment properties, and property, plant & equipment.
Gross Loans	Gross Loans and Leases comprise Gross Loans to Customers net of Unearned Income, Allowance for Loan Losses, and other deductions from Gross Loans.
Total Deposits	Total Deposits include all customer and institutional deposits held at the Bank. They are essentially the core liabilities of banking institutions.
Shareholders' equity	Shareholders' Equity as reported by the Bank. Comprises Common Stock and Treasury Stock, Capital Surplus, Retained Earnings, Revaluations, Minority Interest and other components of Shareholders' Equity.
Risk Weighted Assets	Sum of all Risk-Weighted Assets as required for Regulatory Capital ratio measures.
Tier 1 Capital	Sum of permanent Shareholders' Equity (issued and fully paid ordinary shares/common stock and perpetual non-cumulative preference shares) and Disclosed Reserves (share premiums, retained profit, general reserves and legal reserves). In the case of consolidated accounts, this also includes minority interests in the equity of subsidiaries that are less than wholly owned. Excludes revaluation reserves and cumulative preference shares.
Total Capital	Sum of Net Tier 1 Capital and other more senior forms of capital (Tier 2 and Tier 3).
Financial Strength / Capital Adequacy Ratios	
Net impairment / gross loans	Net impairment gain/ (loss) on financial assets divided by gross loans.
Tier 1 ratio	Tier 1 Capital as a percentage of Risk-Weighted Assets.
Total Capital Ratio	Total Capital as a percentage of Risk-Weighted Assets.