Stock Market Review

Record profits, dividends for BOV shareholders

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The publication of the financial results by the two major banking institutions are key calendar events for the local financial community, as they are the largest companies by market capitalisation and have the highest number of shareholders. Additionally, the financial statements are useful in understanding the performance of various sectors of the economy and are important for overall investor sentiment.

This year's announcement by Bank of Valletta plc was possibly more eagerly awaited than in previous years as it was the first set of numbers to be reported by incoming chairman Frederick Mifsud Bonnici. A few days before the announcement there was renewed media coverage on the ongoing complaints and requests for settlement by a financial services practitioner on behalf of some of BOV's clients.

Under the chairmanship of Roderick Chalmers between 2004 and June 2012, the semi-annual presentations to the financial community were reminiscent of a lecture in economics and financial matters. The insight and clear analysis of the developments of the financial year under review by Mr Chalmers were generally regarded as the most informative presentation for local financial analysts.

This year's presentation was somewhat different but equally informative. Mr Mifsud Bonnici provided an overview of the key macro-economic themes and the main highlights of the year for the bank. This was then followed by a more detailed presentation by chief executive officer Charles Borg on the main factors impacting this year's numbers.

The BOV Group generated record pre-tax profits of €110.7 million and the bank recommended the payment of a final gross dividend to shareholders of €0.13 per share. This is the highest final dividend to shareholders and the total dividend of €0.19 per share (including the €0.06 interim dividend paid in May) is just short of the all-time record distribution given to shareholders in respect of the 2007 financial year.

Similar to the previous five years, BOV also recommended a bonus share issue. At the annual general meeting scheduled for December 19, shareholders will be requested to approve a bonus issue of one new share for every nine held. BOV has adopted such a strategy in recent years to gradually increase the bank's permanent capital base in view of more stringent regulatory obligations in the future.

At the start of his address to members of the financial community, BOV's chairman delved into the key international and local developments that provided the backdrop to this year's financial performance. Mr Mifsud Bonnici explained that BOV is in a very different situation to most banks in Europe as it retains high levels of liquidity and the balance sheet is funded by a strong depositor base.

The CEO explained that the core operating profitability of the bank was largely unchanged at €100.3 million, reflecting the resilient fundamentals and the sustainability of the retail and corporate business despite the volatile economic environment. The strong core profit of €100.3 million came about from an improvement in the net interest income (up eight per cent to €147.8 million), a two per cent increase in fee and commission income including foreign exchange activities, higher expenses (mainly increased wages to reflect the new collective agreement and continued investments in IT infrastructure), and a 42 per cent increase in impairment provisioning despite the improvement in the ratio of non-performing loans to 4.4 per cent of the overall loan book.

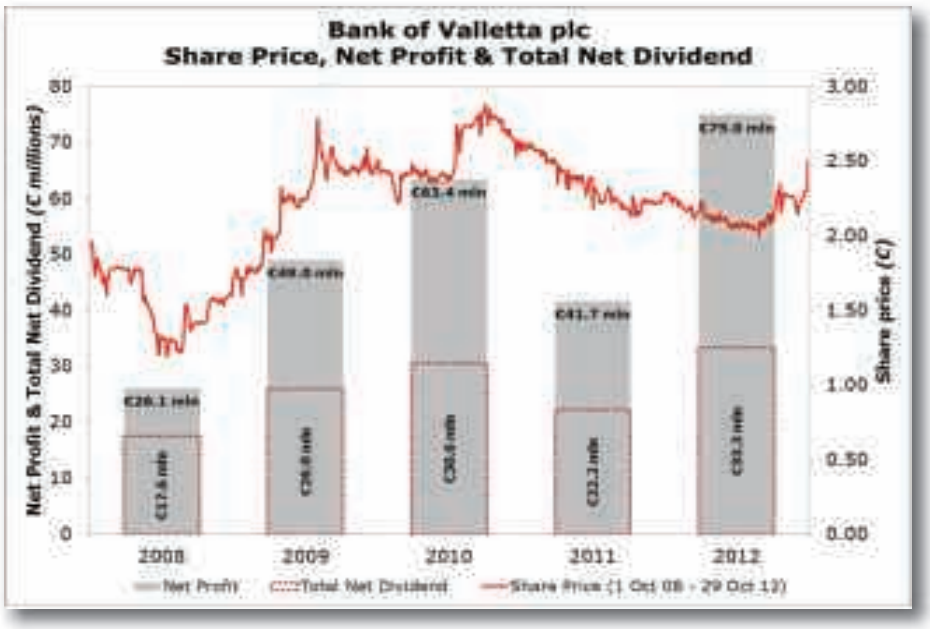
The CEO noted that out of the total impairments of €22.8 million, only €6.5 million related to net specific impairments. The balance mainly comprises collective impairments in respect of certain economic sectors which are deemed to be more vulnerable to an economic downturn. Mr Borg explained that this mainly related to the construction and real estate sectors. The CEO noted that in recent years, the bank deliberately sought to reduce the overall exposure to these sectors.

The most notable achievement this year was the repayment of loans totalling €100 million by a number of clients within these sectors. But the bank also reported that this was partially offset by new facilities provided for infrastructural projects.

> **"The price-to-earnings multiple of BOV at nine times represents a 36% discount to that of HSBC's ratio of 14 times"**

BOV's profits are generally impacted by a number of adjustments, some of which have been significant in recent years. In the previous financial year, BOV had registered a charge of €15 million in view of the compensation paid to the shareholders of a property fund as well as a fair value markdown of €24.9 million due to the adverse market movements on the bank's international bond portfolio.

During the year ended September 30, the international bond portfolio registered an uplift of €8.7 million following a strong upturn in reaction to comments by the president of the European Central Bank in July that the ECB will intervene to support the euro. Meanwhile, the bank also recognised a net amount of €4.6 million in provisions for the required additional compensation to the property fund shareholders and fresh claims from investors in other securities. This amount also takes into account certain unquantified recoveries that were obtained from third parties, namely the 40 per cent shareholding of Valletta Fund Management Ltd.



The balance sheet or the statement of financial position – as it is now referred to in terms of the revised International Accounting Standards – also provides some interesting highlights on the BOV Group. Total assets surpassed the €7 billion mark (a first for a Maltese retail bank), confirming BOV's status as the largest bank in terms of assets.

The chairman and the CEO remarked that despite the very intensive competitive environment from some of the newer banking institutions as well as from the Treasury through the regular Malta Government Stock issues, BOV successfully continued to expand its deposit base. Overall deposits advanced by 5.2 per cent (equivalent to €285 million) to a new record of €5.8 billion. Meanwhile, loans and advances to customers increased by €119.5 million to €3.9 billion. Similar to the other local long-established retail banks, BOV again reported a very conservative loan-to-deposit ratio of 66.7 per cent. This is one of the more important indicators that protected the local banking industry from suffering the same fate as the well-documented developments across many parts of the eurozone where government bailouts became the order of the day.

Another important item which may not have been discussed at length at last week's presentation to the financial community is "financial assets at fair value through profit or loss". The overall level as at September 30 of €768.3 million represents a decrease of €130 million from the previous year, and this has been on a downward trend since 2008. The lower level of financial investments being designated in this manner should give rise to reduced volatility of the BOV Group's profitability in future years.

Shareholders' funds as at September 30 amounted to €520.7 million with a Tier 1 capital ratio of 10.7 per cent. BOV's CEO clearly stated that notwithstanding the requirement for higher capital ratios in future years, BOV will not require any capital injections to be compliant wih Basle III by 2019. Given BOV's strong core profitability and the current dividend payout ratio, the annual profit retention will enable the bank to gradually build up the required capital levels.

Mr Mifsud Bonnici indicated that the current uncertain economic climate due to the eurozone sovereign debt crisis is expected to continue and, as such, interest rates are anticipated to remain at historically low levels for the coming years. Mr Mifsud Bonnici also touched upon certain local macro-economic issues. He referred to the positive performance of the local tourism industry and the need for the Government and the private sector to continue to carry out further upgrades to the product offering to attract higher-end tourism.

He also urged the Government to continue to restructure a number of Government entities and also to carry out the much-awaited private pension reform. Mr Mifsud Bonnici urged the MFSA to "desperately" review the corporate bond listing policies as these could lead to negative economic consequences if they are not amended and companies do not manage to tap the market for funding.

BOV's share price reacted positively to the record results as the equity rallied by 7.4 per cent at the start of the week. More importantly, there was very high trading activity with over 150,000 shares changing hands on the day.

In view of the small number of companies listed on the Malta Stock Exchange, it is normally difficult to perform a peer comparison. But in the case of the two large banks, certain valuation multiples can be easily compared, given the similar business models and market share. Despite the share price rally earlier this week, the price-to-earnings multiple of BOV at nine times represents a 36 per cent discount to that of HSBC's ratio of 14 times based on the 2011 historical financial statements.

The dividend yield on BOV at 7.6 per cent is also superior to that of HSBC at 5.5 per cent. It is widely viewed that HSBC ought to be priced at a premium to BOV, given the strength of the ultimate parent company and the less volatile nature of HSBC's profitability.

Financial advisors and seasoned investors have lengthy discussions on this very subjective topic. The actual size of the premium seems to be too wide at this juncture.