

Stock Market Review

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BoV half-year pre-tax profits reduced to just €6.3 million

Subordinated bond issue to be launched shortly

Last week Bank of Valletta plc issued its financial statements for the six-month period to March 31, 2009. The BoV Group reported a pre-tax profit of just €6.3 million, significantly below the profit of €25 million generated in the first half of last year. The substantial decline in profitability is essentially due to three factors: the reduction in net interest income following the various interest rate cuts adopted by the European Central Bank; fair value mark-downs on the bank's overseas investment portfolio; and the negative performance by the bank's associate and jointly-controlled companies in the insurance business, Middlesea Insurance plc and Middlesea Valletta Life Assurance Co. Ltd.

The chairman of the BoV Group Roderick Chalmers hosted stockbrokers to a briefing shortly after the publication of the results. Mr Chalmers gave a very extensive presentation on these three factors which contributed to the profitability decline and provided a detailed insight into the current environment which led to this impact. BoV's chairman described the last six months as "the toughest period in the history of modern banking and finance", although there have been signs of an improvement in sentiment since early March as evidenced by the sharp recovery in the share prices of many international banks as well as a gradual increase in bond prices.

Following the bankruptcy of Lehman Brothers on September 14, 2008, various governments around the world were forced to bail out many banks and the recessionary environment led to an unprecedented reduction in interest rates and huge stimulus packages.

The reduction in interest rates by the European Central Bank (official rates shrank from 4.25 per cent in October to 1.5 per cent by the end of March) dented BoV's interest income to March 31 by almost €6 million. A sudden decrease in interest rates is negative for banks because the rates charged to bank's customers on their loans are reduced immediately while on the other hand, since a large proportion of their deposit base is fixed for a period of time, the bank must maintain the

originally fixed interest rate on these deposits until maturity. This time lag led to a reduction in the bank's net interest income by 9 per cent from €64.4 million in March 2008 to €58.4 million during the latest financial period. The chairman did however explain that the interest margin is being restored as fixed deposits are now being renewed at the lower rates and BoV is seeking to increase lending margins for certain customers.

With regard to the overseas investment portfolio, in line with IAS 39, BoV recognised net mark-downs of a further €32 million during the six months to March 31, 2009. This brings the total "hit" in the past 18 months to €84 million following the €26 million "hit" in the period to March 2008 and another €26 million in the six months to September 30, 2008 (which also included the €12.7 million loss from the Lehman bond exposure). Mr Chalmers explained that the main reason for the mark-downs in the past six months was due to the ineffectiveness of interest rate swaps during the period.

Under normal market conditions a gain or loss arising from movements in bond prices is usually offset by an opposite movement in the interest rate swap. However, the dislocated market conditions led to a temporary ineffectiveness on the hedging in place but this is expected to be restored as the bonds and interest rate swaps are held to maturity. Apart from this, the further widening of spreads in the overseas bond markets due to the adverse market sentiment led to unrealised mark-downs on a number of the holdings within the bank's investment portfolio.

BoV confirmed that its €2.6 billion portfolio does not contain any toxic assets but is spread across a wide range of some 600 holdings of sovereign, supranational, corporate and financial institution bonds with an average maturity of 3.5 years. BoV's chairman reiterated that the bank expects most of the €84 million mark-down recognised in the past 18 months to be recovered over time as the investments are held until maturity. Mr Chalmers explained that since the start of the crisis in mid-2007, various bonds with a value of over €700 million were redeemed at par. However, total defaults amounted to €23 million, mainly composed of the €12.7 million

Lehman bonds. The chairman did not disclose the names of the other defaulters but hinted that these were spread across a number of small holdings in certain banks.

The other contributing factor to the sharp decline in profits for the BoV Group was the negative performance from its insurance interests. BoV holds a 50 per cent shareholding in Middlesea Valletta Life Assurance and is the single largest shareholder in Middlesea Insurance plc with a stake of circa 22 per cent. While Middlesea Valletta Life saw its profits drop to €1.9 million in 2008 from €5.3 million in the previous year, Middlesea Insurance recently reported that it had incurred a loss of €20.6 million mainly resulting from losses incurred by its Italian subsidiary, Progress Assicurazioni SpA. More information on this will be provided next week.

Importantly, net commission and trading income for the six-month period under review at €24.9 million was marginally above that earned in the previous period, although the March 2008 figures included €1.4 million of foreign exchange income generated between the start of BoV's financial year on October 1, 2007 until the adoption of the euro on January 1, 2008. Furthermore, despite increases in staff costs due to the collective agreement, overall expenses eased by one per cent to €39.1 million as the bank adopted rigorous cost control measures on certain expenditure.

Another positive development was the continued increase in both customer deposits and loans. As at March 31, 2009, BoV reported total customer deposits of €4,676 million, representing an increase of €50.6 million during the six-month period. Moreover the bank's loan book increased by €78.4 million to €3,118 million. The quality of the loan book has remained healthy with the ratio of non-performing loans to total loans at 4.1 per cent. The chairman also highlighted that the bank continued to make credit available to individual as well as corporate customers and in recent weeks mention was made in the media that BoV had offered assistance to Virtu Ferries for the purchase of a new vessel.

BoV also participated in the syndicated loan to International Hotel Investments plc in respect of its new hotel in London. Mr Chalmers highlighted that this shows that there was no credit crunch locally although the local

economy is expected to suffer from the global economic recession in the short to medium term.

In conjunction with the publication of results, BoV also declared a gross interim dividend of €0.035 per share (€0.02275 net of tax), which represents a significant decline from last year's interim dividend of €0.1125 per share. While until the financial year to September 30, 2007, BoV had a dividend payout ratio ranging between 45 per cent and 50 per cent and usually distributed a final dividend of twice the amount of the interim dividend, Mr Chalmers explained that in view of the extraordinary circumstances, this policy is being reviewed and the amount of the final dividend normally announced late October or early November will be determined at the time based on the actual full-year results and the market conditions at the time.

During the stockbrokers' meeting, BoV's chairman also delved into the strong balance sheet of the bank with a Tier 1 capital ratio of 10.5 per cent. Mr Chalmers compared this ratio to some of the larger international European banks and it transpires that BoV is among the best capitalised and is only surpassed by Credit Suisse and UBS. Meanwhile, the international media are currently giving lots of publicity to the stress tests being conducted by the US government on the largest American banks.

A "well capitalised" bank in the US is considered to have a Tier 1 ratio of just over five per cent! BoV's robust balance sheet as a result of its conservative policies in past years enabled it to withstand the very tough market conditions and at the same time continue to provide credit and liquidity to the Maltese economy. In order to continue maintaining healthy liquidity ratios before the likely regulatory measures to increase the level of capital as well as in view of their currently listed subordinated bonds maturing during the course of 2010, BoV's chairman again reiterated the bank's intention to launch a subordinated bond issue shortly.

This also falls in line with the Financial Stability Report published by the Central Bank of Malta this week which indicated that although local banks have adequate capital and a strong liquidity profile, they need to strengthen their capital buffers well beyond minimum statutory ratios.

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