ITALIAN BANKS

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Market Views

"It has never been a secret that Italian banks have a larger proportion of NPLs (Non-Performing Loans) than most of their European peers. Intesa Sanpaolo's gross NPLs are around 18% of total loans outstanding. In an attempt to allow banks to de-leverage out of their non-performing loans at a quicker pace, Prime Minister Renzi tried to create a bad bank, where the NPLs could be off-loaded."

It has never been a secret that Italian banks have a larger proportion of NPLs (Non-Performing Loans) than most of their European peers. Intesa Sanpaolo's gross NPLs are around 18% of total loans outstanding (source: Company release). In an attempt to allow banks to de-leverage out of their non-performing loans at a quicker pace, Prime Minister Renzi tried to create a "bad bank" - where the NPLs could be off-loaded. Unfortunately, this was blocked by European law. Instead a guarantee system was set up to facilitate a market for the sale of securitized non-performing loans with the government issuing a guarantee against the asset. Whilst this new scheme was being devised by the Italian Central Bank, the attention it brought to Italian NPLs backfired. Some sell-side analysts took the view that the banks would be "forced" by the government to offload their non-performing loans at a significant discount. Whilst it is understandable that any offer to buy non-performing loans needs to be made attractive, the high returns built into some analysts' models (15% IRR) to attract private equity or hedge fund investors, implied that current coverage ratios used by Italian banks were too low.

Taking Intesa Sanpaolo as an example again, they have around 63bn Euros worth of gross NPLs, which are covered/provisioned at around 48%. The NPLs include around 39bn Euros worth of bad loans, which are covered/provisioned at 62%. Using the sell side analysts models of a 15% IRR, and including the new government guarantee system, this would mean Intesa Sanpaolo would have to write off roughly an additional 3.2bn of bad loans (implying a bad loans coverage ratio of 70%), resulting in a hit to their capital. During the recent sell off in Italian banks, market participants have given little emphasis to the fact that the non-performing loans have significant asset backing. In its last quarterly results presentation (click here to access quarterly results, see page 24 and 25), Intesa Sanpaolo showed that its NPL coverage ratio moves up to nearly 140% when including collateral. In other words, the non-performing loans are over provisioned for. Furthermore, they show that 90% is backed by real estate assets. Even if it takes them a long time to collect, the collateral has a free option on any upside in property prices. So why would they sell those NPLs at a big discount to a third party to reap all the benefits? Intesa Sanpaolo, furthermore, explains that over the period of 2009 to 2015 they managed to recover on average 134% of doubtful loans, again suggesting that coverage ratios are, if anything, too high. Intesa Sanpaolo is currently capitalized at Euro 40 billion and they claim to have Euro 10 billion in surplus capital. They have indicated to the market that they will look to re-distribute some of this to shareholders. Also, their Basel 3 CET1 pro forma fully loaded capital ratio stands at a very healthy 13.1%, well above the minimum required, once again showing a surplus of capital, not a shortfall. Intesa Sanpaolo has just announced a doubling of its dividend giving the stock a yield of 5.8%.

Not only has a structure been set up to quicken the pace for non-performing loans but Prime Minister Renzi has been relentless in trying to implement even more measures to improve the Italian banking system. The co-operatives have lost their status, meaning shareholders can now vote for restructuring and mergers. Renzi has also introduced measures

which should reduce the collection period of NPL collateral to an average of two to three years, down from the current seven. Again, this is making NPLs more valuable. In the latest attempt, the Italian government seems to be looking at ways to simplify headcount reductions (a key for Italian banking consolidation), and the possible reduction of stamp duty on the purchase of non-performing real estate.

A merger could now be close with Banco Popolare and Banca Popolare di Milano announcing that they are in deep discussion. Again, the stock market is putting very little emphasis on the potential benefits of this merger. If you simply take the total number of branches of the merged entity, 2430, more than 200 branches overlap. Banco Popolare's market cap currently stands at just 2.5bn and it has shareholder equity of Euro 8.5 billion. Consensus is looking for net income of 407m for 2017, which is an 11.8% net income margin. That gives you a PE of just 6.6x earnings. If you put a net income margin of 20% on 2017e revenues of 3.45bn, you find net income of 690m and a PE of 3.7x earnings. Ultimately, we think they could generate profits of over 800m even without a merger. On those numbers we can see significant upside. The story is similar for its peers.

For us, the consolidation and long overdue clean-up of the Italian banking industry has already started and is now selling at extreme levels.

INFORMATION

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