

Contrarian investing in the Italian banking crisis “The view of the European Equity team”

Wednesday, 09/13/2017

Playing the weakness in Italian financials on the back of the NPL crisis was one of our key themes in 2016. Since then, a number of steps have been taken to resolve the crisis and the Italian banking system is now on a much firmer footing. A year on from the depths of the crisis, we are taking the opportunity to explain our thinking at the time, how we played the crisis and review how those investments are performing.

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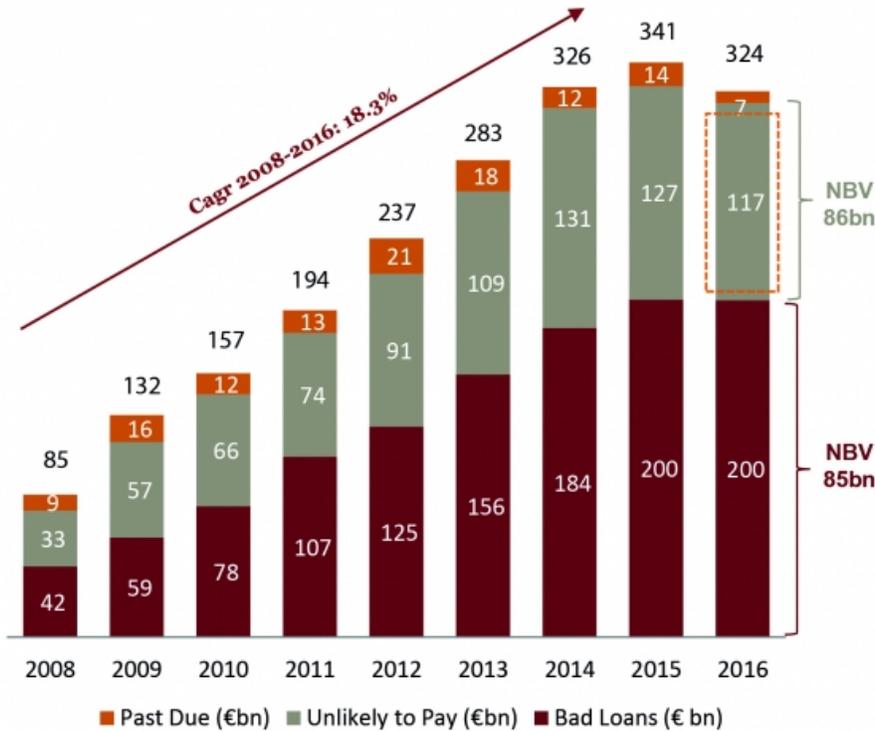
Background to the Italian banking crisis

The onset of the financial crisis, and the subsequent double dip recession triggered a collapse in credit quality as excessive leverage and weak profitability among Italian corporates and SMEs caused bank loans to sour. Non-performing loans (NPLs) began to rise forcing banks to crystallise losses, cut dividends and raise capital. However, this was no different to other banking systems across Europe, particularly in Southern Europe. Why then was the Italian banking crisis so severe? The situation in Italy was exacerbated by the unique structure of its system. More than half of the sector consists of mutual or cooperative banks that have strong ties to the local communities in which they operate.

This strong connection with clients, coupled with poor underwriting, led to a sharp ramp up in lending prior to the financial crisis. The subsequent losses in these portfolios were compounded by excessive red-tape and a weak and inefficient judicial system that made it difficult to collect loans or seize the collateral underpinning those portfolios. As a result, the deterioration in loan portfolios was particularly acute in Italy with the stock of NPLs more than tripling to cEUR340bn in 2015.

The NPL crisis peaked last year, as fears began to mount that the rising losses could trigger a spate of bank failures including Monte Dei Paschi (MPS) and maybe even the banking giant, Unicredit. With confidence in the sector crumbling, liquidity pressures spiked as depositors fled the weakest banks for fear they could also lose money if their bank failed. As a number of banks edged towards failure, share prices plummeted to deeply distressed levels.

Italian NPL market



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Source: PWC, "The Italian unlikely to pay market". Data as at 31.05.2017

Finding the right contrarian opportunity

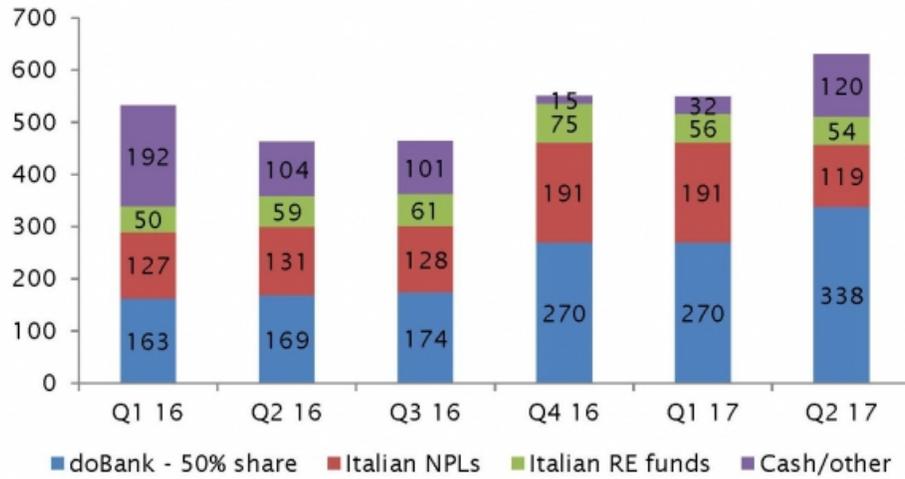
We sensed there was a contrarian investment opportunity amidst this crisis, but struggled to put a floor on the downside of the banks. Whilst the recovery potential in these distressed banks was huge, they didn't meet our investment criteria and were potential value traps in our view. Leveraged and opaque balance sheets, tight liquidity and exposure to political risks – investing in distressed banks at this time felt like guesswork with the possibility that shareholders' equity could be wiped out in a downside scenario. Investors were, at the time, focused mainly on MPS and Unicredit – both had massive NPL portfolios and needed to raise capital. Both teams were under enormous pressure to convince investors that they could turn around the fortunes of their banks. In the end MPS shareholders were wiped out while Unicredit shares recovered. While MPS potentially had more upside at the time (given its very distressed valuation), Unicredit ultimately had the more credible business plan with more levers to pull and assets to sell.

We steered clear of investing in the banks, but we did find very interesting opportunities to play the recovery without taking on the same risks. Our work on Unicredit and MPS ultimately led us to two of our key investments in this theme: Eurocastle and Anima.

Eurocastle: tapping the EUR 300bn NPL opportunity

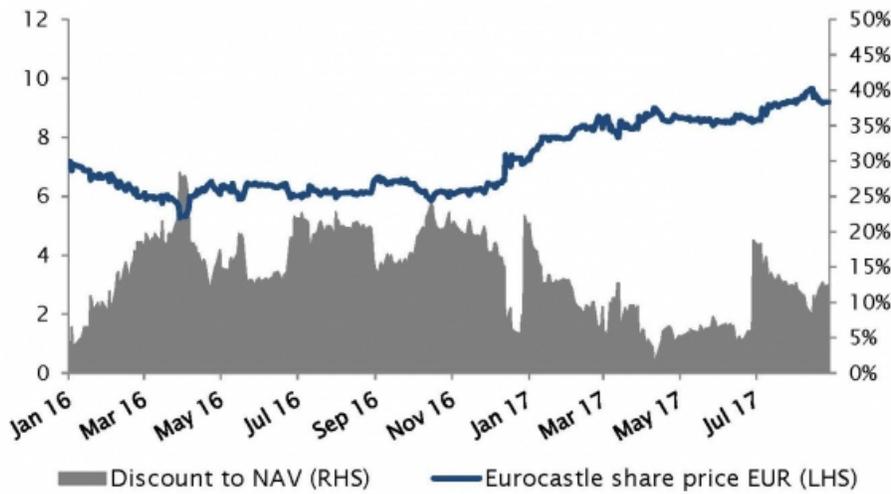
In our view, the Italian NPL crisis was an ideal hunting ground for debt purchasers and loan servicers. The market was full of distressed sellers of NPLs and the +EUR300bn mountain of NPLs would have to be serviced and cleared one way or another. We identified Eurocastle as uniquely positioned to benefit from this enormous opportunity.

Eurocastle NAV



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 Source: Eurocastle. Data as at 31.08.2017

Eurocastle share price vs discount to NAV



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 Source: Eurocastle, Bloomberg. Data as at 31.08.2017

When we initiated our position in the third quarter of 2016, around 40% of Eurocastle's NAV consisted of its investment in doBank (Italy's largest NPL servicer), 40% was invested in Italian NPLs and real estate assets with the remainder being made up of cash. Given the weak sentiment at the time, we began buying the shares at a 15-20% discount to the NAV.

We saw two clear opportunities in Eurocastle. Firstly, its investment in doBank was materially undervalued in our opinion. doBank is the leading NPL servicer in the market with cEUR80bn of NPLs being managed on behalf of some key clients including Unicredit, Intesa and Fortress. The over EUR300bn stock of NPLs in the market still needs to be addressed, and we believe the independent servicers will play a key part. doBank is ideally positioned to benefit from this opportunity in the coming years, and this has started to feed through in its valuation. As at June 2016, Eurocastle valued its 50% stake in doBank at EUR169m. In July 2017, doBank was IPO'd valuing Eurocastle's stake at EUR350m and the doBank shares have since appreciated another c20% since listing. We continue to see the long-term potential in doBank, and therefore participated directly in the IPO.

The second opportunity for Eurocastle is investing directly in Italian NPLs and distressed real estate. Eurocastle's manager, Fortress, has been successfully investing in the Italian NPL market for several years. This has enabled it to build a strong platform for pricing, acquiring and managing NPLs. Eurocastle (via Fortress) has a strong relationship with Unicredit and worked closely on its strategic plan. Core to the plan was Project Fino ('Failure is not an option'), where Unicredit would sell EUR17bn in NPLs to securitisation vehicles managed by Eurocastle/Fortress and Pimco at an average price of 14 cents. The buyers managed to secure a very cheap price compared to other portfolios being sold in the market. The rationale for Unicredit was that the value created by providing balance sheet certainty, and therefore a lower cost of equity, would far outweigh any forgone cashflows from selling the portfolio cheaply.

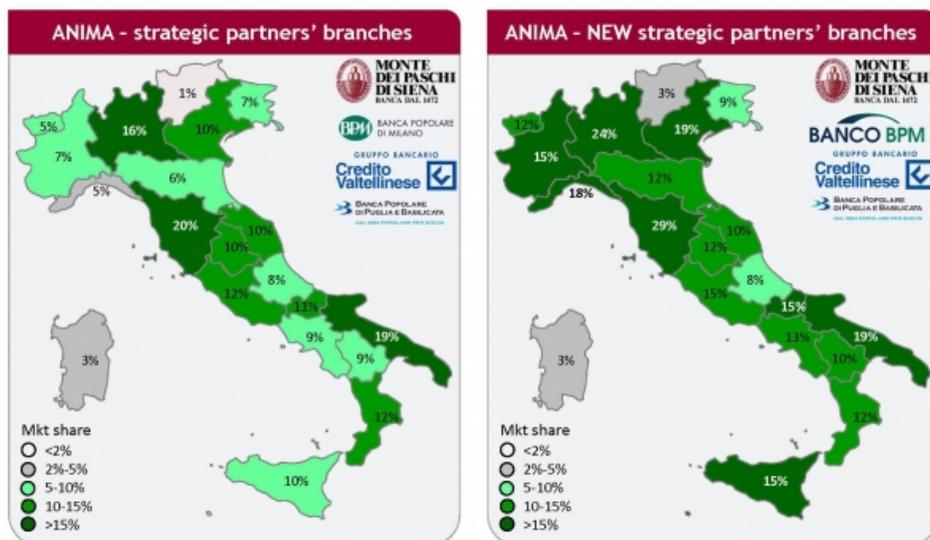
This has subsequently proven to be the case as Unicredit shares have rallied strongly since the plan was announced. We believe Eurocastle struck a very good deal in participating in FINO, and will benefit from this deal for years to come. By investing in Eurocastle, we obtained exposure to a recovery in the Italian banking system but without the risks associated with investing directly in a bank. Furthermore, as we were able to buy the shares at a discount to NAV, we secured an additional margin of safety (or locked in a higher return depending on which way you look at it).

Anima: a play on MPS but without the risk

Anima is the leading independent asset manager in Italy. Its distribution is primarily through its network of partner banks, including MPS and Banco Popolare Milano (BPM), as well as a recent tie up with Poste Italiane. A buying opportunity in the shares emerged as the crisis unfolded late last year. Anima's shares had been sold off on fears that the AuM sourced through the MPS and BPM networks were at risk. After careful analysis, we concluded that the share price was broadly pricing in the very worst-case scenario that Anima would lose the bulk of the AuM from these 2 networks (c35% of Anima's total AuM). We struggled to see this scenario panning out, even in the event MPS failed and needed restructuring. As we were able to put a floor on the downside, we felt more comfortable investing in Anima with the upside gearing coming from a stabilisation in the situations of MPS and BPM. As things panned out, Anima did record some outflows from the MPS network at the end of 2016 and the beginning of 2017 but this moderated and moved back into inflows as the MPS situation was gradually resolved. Additionally there was some uncertainty following the merger of BPM and Banco Popolare (BP). BP brought with it its own smaller asset manager Aletti Gestielle. The market feared that BPM could cut its relationship with Anima in favour of their new in-house asset manager, Aletti. This seemed unlikely at the time as it would have been damaging for all parties involved. This subsequently proved to be the case. Last month, Anima announced that it would be acquiring Aletti, consolidating its relationship with the merged BPM-BP entity (BAMI) and extending its distribution to the unpenetrated BP branches. In the space of nine months, sentiment towards Anima has moved from fearing a worst-case scenario of losing its major distributors to trying to price in the upside opportunities from Anima fully penetrating the giant distribution networks of Poste Italiane, BAMI and a restructured MPS. Following the acquisition of Aletti, Anima will now have unparalleled distribution in Italy, with access to more than 4500 branches focused in some of the richest parts of the country.

Anima was a complicated investment as it involved analysing the various circumstances of its bank partners. However, Anima met our quality criteria and we were able to invest at a point where the stock had been oversold based on concerns of its distributors but we believed the downside was limited. The same could not be said for its bank distribution partners, as ultimately prove to be the case with MPS.

Anima/Aletti coverage maps



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Source: ANIMA, «ANIMA and Banco BPM - Acquisition of Aletti Gestielle SGR» presentation. Data as at 31.08.2017

Our contrarian investment style in practice

The way we analysed the situation in Italy and the investments we made are typical of our process. Our contrarian instincts were alerted to the opportunity arising from the NPL crisis, but our quality bias steered us clear from the value traps such as MPS. We spent time understanding the issues underpinning the crisis, and our analysis drew our attention to the winners in this market, namely the loan servicers and asset managers. Analysis of our target companies, their competitive advantages and their valuations put a floor on the downside at which point we felt comfortable initiating positions. In this instance, our process uncovered investment opportunities at the smaller end of the market cap spectrum. This is not uncommon – it is often these companies, that operate under the radar of other investors, that are capable of generating the most alpha. Given our long-term investment philosophy, we were comfortable investing in these types of companies due to the upside we see in the coming years. We remain excited about the prospects for both Eurocastle and Anima.

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