GRANT'S
INTEREST RATE OBSERVER®
Vol. 42, No. 24d 233 Broadway, New York, New York 10279 • www.grantspub.com DECEMBER 20, 2024

# Your BFF in Italy

Evan Lorenz writes:

We write to befriend, in the investment way, an unusual European bank. It's cheap, profitable and obscure (at least to American investors), and it fills a business niche almost by itself. Fittingly, its name is BFF—or, in full, BFF Bank SpA (BFF in Italy).

BFF's birth story explains its business model. In 1985, some big pharmaceutical companies joined forces to create a new financial institution. Their motivation was the Italian state—it took forever to pay its bills. BFF's forebear, Banca Farmafactoring SpA, was founded to solve the problem. It would buy the drug companies' aged receivables and collect the unpaid balances. It, not the drug companies, would write dunning letters destined for the circular file, place phone calls fated to go unreturned and embark on litigation almost certain not to be quickly settled. In short, it would be Big Pharma's Italian bill collector.

BFF, as the bank presently came to be known, bounced from one set of owners to the next. Private equity firms Apax Partners (in 2006) and Centerbridge Partners L.P. (in 2015) each had its turn before the public bought control in 2017. Along the way, BFF expanded its product lines to include payment-processing and custodial services—the 2021 acquisition of Banca Depositaria Italiana SpA, a.k.a DEPObank, saw to that.

But there's more corporate continuity than those twists and turns imply. For one, the bank remains true to its core business of factoring public-administration receivables. For another, Massimiliano Belingheri has been at the bank since 2006, first as a member of the board of directors and later, since 2013, as CEO. Belingheri is also BFF's largest shareholder with a 5.8% stake, which, at the current market capitalization of €1.6 billion ($1.7 billion), is worth €100.8 million.

"BFF isn't run like a typical Italian company," Vitaliy Katsenelson, CEO of Investment Management Associates, Inc. and a BFF shareholder, relates via email. "Their internal language is English, and they have a hardworking culture, which is not always the case in Italy (we heard this from ex-employees who used to work for BFF)."

In the first nine months of the year, factoring produced 54.7% of revenues, followed by payments at 8.4% (aggregating and processing transactions between banks and financial-tech companies like Nexi SpA); security services at 3.1% (providing custody and depository services to Italian pension, mutual and alternative-investment funds); and interest income, mainly from a €5 billion bond portfolio, at 33.8%. BFF has expanded to other European countries, but Italy remains the point of focus, accounting for 58.3% of the factoring book at the end of the third quarter. After Italy come Poland (18.1%), Spain (9.6%) and Portugal (4.8%).

Most specialty lenders finance themselves in costly wholesale markets; thanks to the DEPObank acquisition, BFF can tap into low-cost deposits. As of Sept. 30, the ratio of the factoring and loan portfolio to deposits was 68%. Shunning interest rate risk as it does credit risk, BFF has built a bond portfolio consisting entirely of government-issued securities, of which 80% pay floating-rate coupons.

Unpaid invoices, piled in government accounting offices, are public debts no less than sovereign bonds, but the slow loans, unlike the bonds, do not count in official calculations of government indebtedness expressed as a percentage of GDP. To encourage its member states to come clean on the true state of their finances, the European Union penalizes late payments on unpaid invoices. Past-due state debts begin accruing interest after 30 days at 8 percentage points over the European Central Bank's refinancing rate (currently 3.15%); national healthcare systems suffer the same penalties after 60 days, and on top of it all is a €40 fee for each late invoice. So BFF has a kind of silent partner in the promotion of sound public-sector finance.

BFF buys receivables at a slight discount to their face value on a nonrecourse basis, say 2% or 3%. The state typically pays invoices six months after BFF buys them, but collecting the late-payment interest (LPI) and the €40 fee usually requires litigation. In Italy, the process takes an average of five to six years.

While public officials are slow to pay, they eventually do cough it up. Over the past 17 years, BFF's credit losses from factoring sum to €6.2 million compared with a factoring book that, as of Sept. 30, summed to €5.4 billion. The reason for any factoring losses at all is that BFF buys portfolios of corporate receivables, too, including claims against private hospitals. It's these private operators that account for most of the de minimis losses. Government entities are currently responsible for 95% of BFF's receivables.

It's indeed a wonderful business, but where is the competition? Giant banks like UniCredit SpA and Intesa Sanpaolo SpA are natural competitors, one would suppose, except that they also provide treasury services to the Italian government. Dunning the same government with which they do a profitable treasury business may not be accounted a winning corporate strategy.

Further to mitigate risk, BFF deals only with large companies, such as Merck KGaA, Air Liquide S.A. and Baxter International, Inc. Caterina Della Mora, who heads investor relations, strategy and M&A for BFF, asks "Why?" and then answers: "Because the real credit risk lies with our clients. Let's say that Pfizer has issued an invoice which had the incorrect number of syringes. Then the public hospital says, 'OK, I'm not paying you. The invoice has an error.'

"In that case, we can put back the invoice to our client, Pfizer," Della Mora continues. "But if our client is a 'Ltd.' in the middle of central Italy, it is difficult to claim back the money we have paid out. If it is a large, solid company, this is a piece of cake."

There's a countercyclical element to BFF's business model, too. In a slump, public administrators, doing their bit to suppress a growing public-sector deficit, tend to pay even more slowly than usual. "In other words, the worse finances are in Italy, the more money they make," Katsenelson tells me. "At the same time, there's no credit risk."

BFF's policy is to pay out all earnings as dividends so long as the common-equity Tier 1 ratio is over 12%; it was 12.3% as of Sept. 30.

. . .

All's not well with the dividend. Trouble started last spring following an inspection from the Bank of Italy. BFF, you'll recall, frequently drags its Italian state counterparties to court. In the past, the regulator allowed BFF to count those past-due claims as performing as long as there was some measurable progress in the legal proceedings. Following a reinterpretation of a 2016 European Banking Authority rule, the Bank of Italy now mandates that BFF classify any paper 180 days or more past due as nonperforming, regardless of legal progress.

Worse, this reinterpretation has forced BFF to classify even newly purchased paper as nonperforming. Thus, for instance, if BFF has a single past-due invoice from the Policlinico di Milano, a government-run hospital in Milan, it must mark all invoices from the Policlinico as in default.

Nothing in the new edicts changes the fact that BFF's factoring book has suffered nary a default. What it does change is the amount of capital that BFF must hold. Suffice it to say that the risk weighting for performing assets is 20%, that for nonperformers, 150%. As a result of these changes, the volume of so-called problem assets on BFF's balance sheet soared to €1.9 billion from €333.4 million between Dec. 31, 2023 and Sept. 30, 2024. Risk-weighted assets leapt to €5.1 billion from €3.1 billion over the same span.

BFF announced the news of the accounting change on May 8. It simultaneously announced the suspension of the dividend. Over the next two sessions, the share price sold off by 33.9%.

The reclassification of nonperformers may ratchet up capital requirements even more beginning June 30, 2026. On that date, European banks must apply "calendar year" provisioning for nonperforming loans. Under the new regime, banks will have to set aside a certain level of provisions according to how long a loan has been classified as nonperforming. For non-recourse claims like the ones in which BFF deals, this means reserving 35% of a nonperformer's face value by year three and 100% by year four. Happily, this accounting problem has found an accounting solution.

BFF has already made adjustments to how it recognizes the revenue it receives in interest on late payments. Recall that LPI is one of two income streams it earns from the receivables it buys (the other is the simple movement to 100 cents on the euro from the discounted purchase price of perhaps 97 or 98 cents on the euro). BFF has tended to collect an average of 77% of the LPI it's owed; prior to the Bank of Italy's inspection this year, it accrued only 50%. Fortunately, according to International Financial Reporting Standards 9, BFF may book the fair value of the LPI. In other words, it may book all of that 77%.

Starting in the first quarter, BFF began accruing at a 65% rate (instead of the customary 50% or the maximum allowable 77%), which, along with the dividend suspension, has boosted common-equity Tier 1 capital to €625.8 million on Sept. 30 from €436.9 million on Dec. 31, 2023. As a result, BFF's capital weighed in at the aforementioned 12.3% at the end of the third quarter, slightly above management's 12% target. Now all the bank requires to resume dividends is a green light from the Bank of Italy.

Another problem—a business problem, not an accounting annoyance—looms just over the horizon. DEPObank was spun off from the European

## BFF Bank SpA at a glance

**all figures in € mns except per share data**

| | TTM* | 2023 | 2022 | 2021 | 2020 |
|---|---|---|---|---|---|
| total income | €487 | €392 | €380 | €273 | €209 |
| profit before taxes | 343 | 235 | 331 | 197 | 124 |
| net income | 247 | 172 | 232 | 197 | 91 |
| earnings per share | 1.30 | 0.91 | 1.25 | 1.01 | 0.52 |
| shares outstanding | 187.9 | 188.2 | 186.3 | 195.5 | 177.3 |
| loans and receivables | 5,396 | 5,617 | 5,442 | 3,763 | 4,067 |
| bond portfolio | 4,997 | 4,957 | 6,130 | 5,793 | 1,682 |
| deposits | 7,975 | 9,125 | 7,199 | 8,696 | 4,606 |
| equity | 840 | 759 | 759 | 572 | 463 |
| total assets | 12,261 | 12,292 | 13,342 | 11,177 | 5,714 |

*12 months ended Sept. 30, 2024.

sources: company reports, the Bloomberg

financial-technology firm Nexi in 2018. As part of the demerger, Nexi contracted to do business with DEPObank's payment-processing division through 2026; the contract makes up a large part of the payments-unit business, which accounts for the aforementioned 8.4% of BFF's total revenues. There's a risk that Nexi will choose to take its business elsewhere in two years' time, but there are also reasons to suspect that it will choose to stand pat. For one, the two companies share a common technology infrastructure. For a another, BFF is a client of, as well as a vendor to, Nexi. For a third, BFF is the only independent intermediary in the Italian market; Nexi counts the other payment processors as competitors in such services as enabling merchants to accept debit- and credit-card payments, helping companies issue credit cards and keeping fleets of automatic teller machines operational.

. . .

To whittle down the towering €1.9 billion in loans now marked as impaired, BFF has also changed how it attempts to collect from government obligors: It is filing injunctions against slow payers rather than pursuing them through normal legal actions. The upside to this change is that, in Italy, injunctions are cheaper to file, require less paperwork and typically lead to faster collections. Management speculates that the change will substantially reduce nonperformers prior to June 30, 2026.

"We used to use injunctions prior to the entry in force of new regulations on defaults, so prior to January 2021," Della Mora says. "But when the new guidelines as interpreted by the Bank of Italy came into force, we shifted to an ordinary legal process. Why? Because in the articulated interpretation of those guidelines, there were mitigants [in the ordinary legal process] which could put a halt to the counting of past-due days."

If BFF is unable to reduce the stock of receivables currently marked as impaired before mid-2026, Della Mora continues, management will consider selling or securitizing some of the portfolio. Again, the problem is not that BFF is unlikely to collect on these assets, but rather how much capital BFF must hold against them.

On the Nov. 11 earnings call, management reaffirmed its goal to boost earnings per share to €1.40 in 2026, a target first laid out in a June 29, 2023 investor presentation. If it could hit that mark, the bank would be trading at 6.2 times 2026 earnings. Based on consensus estimates, BFF trades at 7.4 times the estimates for 2025 earnings and is priced to a 11.3% dividend yield (analysts assume that the dividend light will turn green by next year).

While the BFF factoring business has faced its share of regulatory headwinds, there's a tailwind brewing, too. The European Union is in the process of revising its late-payment protocols. Early proposals would steepen the fine for late invoices to around €100 from the current €40 and have late-payment interest on national healthcare invoices accruing after 30 days rather than the current 60. The increase in late fees could raise revenues by around €50 million a year; around two-thirds of BFF's factoring book comprises healthcare claims.

Business moats come in all different forms and sizes. The one within which BFF does its factoring business consists of regulators issuing rules (some helpful, others not) and passive-aggressive bureaucrats refusing to write a timely check in payment for an aging, legitimate invoice. As moats go, it sounds deep and formidable.

The Street is friendly to BFF—6 of the 10 analysts on the case say buy and none says sell—but insiders have dumped a net 517,671 shares over the past 12 months for proceeds of €5 million. Perhaps there's a mitigating reason for it. Vice presidents receive around half of their remuneration in bonuses; this year, following the dividend suspension, management withheld the usual executive payouts. Some insiders sold shares to balance their family's budget.

"I'm able to buy a company where there is very little risk," Katsenelson sums up the investment case. "I'm getting 11% a year in dividends [when they resume], and I'm getting 10%–15% earnings growth. I'm paying a single-digit multiple for that, and BFF has very good management. And nobody knows about it."

Well, no one knew about it.

•