

December 2022

Cembra

Market profile

Country	Switzerland
Sector	Financial
Market cap (CHF bn)	2.3
52-week high / low (CHF)	78.58 / 52.65

Key metrics (CHF)

	2021	2022e	2023e
EPS	5.50	5.61	5.45
PE	12.1x	13.1x	13.5x
Dividend Yield	5.6%	5.2%	5.5%

Executive summary

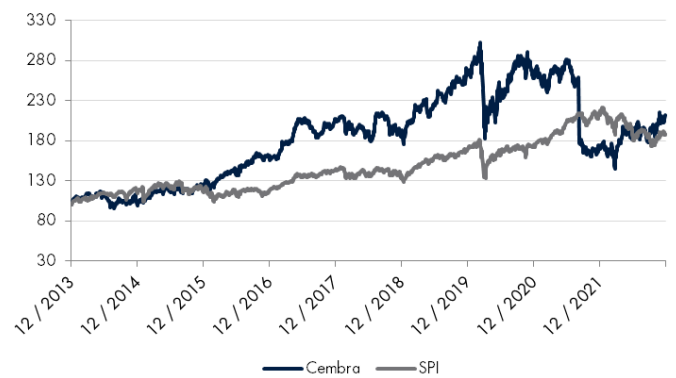
Cembra is a medium-sized financial company specializing in financing solutions and services. The company offers personal loans, auto leases, credit cards, invoice financing, as well as deposits and savings products. Cembra is exclusively active in the Swiss market. The Swiss Financial Market Supervisory Authority (FINMA) has classified Cembra as a category 4 bank.

The company has about 1 million customers in Switzerland and employs about 1000 people. Cembra owns a network of retail branches and also works with independent intermediaries and car dealers.

Revenues come from two streams:

1. Interest income (73% of total revenues)
2. Commissions and fees (27% of total revenues)

Evolution of the stock price (including reinvested dividends) with respect to the benchmark, total return (in CHF, rebased to 100).



The company has 3 lines of businesses: personal loans, car leasing and loans, and credit cards.

Cembra has very high operating margins. The company maintains an excellent level of capital, well above the required FINMA minimums and manages credit risk in the most stringent way. On the negative side, we should mention that Cembra is not investing much in technology and is definitely lagging fintech companies in that respect.

While Cembra will never be akin to a growth story, it is certainly one of the better financial companies in the Swiss market. The company has all the characteristics of financial companies in general: a low valuation (value stock), low growth, and a high dividend yield. The main differentiator is that Cembra is a reliable company dedicated to adding shareholder value over time with a progressive dividend policy.

Company description

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The company has about 1 million customers in Switzerland and employs about 1000 people. Cembra owns a network of retail branches and also works with independent intermediaries and car dealers.

The credit institution has been listed on the Swiss stock exchange since November 2013. Standard & Poor's has given Cembra a rating of A- and the company is included in the SXI Switzerland Sustainability 25 Index and in the Bloomberg Gender Equality Index. The bank is named after the Swiss cembra pine (Pinus cembra, cf Fig. 1), a sturdy and resilient tree with strong roots, symbolizing the bank's strength and origin.

History of the company

The roots of Cembra date back to 1912, when Banque commerciale et agricole E. Uldry & Cie. was founded in Fribourg. This bank later became Bank Prokredit.

In 1999, GE Capital merged Bank Prokredit with Bank Aufina, which it had acquired in 1997.

In October 2013, the Bank separated from its parent company GE, went public and was rebranded as Cembra Money Bank AG.

In 2019, Cembra strengthened its market position by acquiring the consumer finance provider cashgate.

At the start of 2020, the bank changed its brand name to simply "Cembra".

Geographic exposure

Cembra operates only in Switzerland, so it is highly dependent on the Swiss consumer. The financial results of the company are strongly influenced by domestic macroeconomic factors, especially gross domestic product (GDP), the unemployment rate and interest rates. The bank has very limited exposure to foreign currencies.

Fig.1: Swiss cembra pine (Pinus cembra)

Source: Wikipedia, IAM research



Industry Overview & Competitive positioning

Cembra offers a broad range of financing solutions in Switzerland:

- **Personal loans:** Cembra is a leading provider in the highly competitive personal loans market. The bank offers a personalized premium service and their products are available through their branches across Switzerland, through independent intermediaries and online. Cembra estimates that its market share of consumer loans in Switzerland is approximately 41%.
- **Auto loans and leasing:** Cembra is a large brand-independent auto loans and leasing provider in Switzerland. Their products are sold via a distribution network of around 4'000 car dealers, who act as intermediaries. A dedicated sales force of 24 field agents, together with the employees at four service centers, provide a personalized, flexible and efficient service. There are about 240'000 new cars registered in Switzerland each year, and about 800'000 used cars changing proprietor during the same time frame. The bank estimates that its auto leasing market share is about 21% of total leasing assets outstanding.
- **Credit cards:** Cembra is one of the leading credit card providers in Switzerland, with about 1.1 million cards in circulation. They offer a range of credit cards through partner programs with Conforama, Fnac, IKEA, LIPO, TCS, as well as their own credit card called *Certo*. The cards offer a range of attractive features, such as loyalty points, cash back, personalized designs and no annual fees. There are approximately 8.3 million credit cards issued in Switzerland, growing 4% annually. Based on the number of cards outstanding, Cembra estimates having a 13% market share.
- **Insurance products:** Cembra provides insurance products as an intermediary. Alongside their personal loans and auto leasing and loans, they offer financial protection in case of involuntary unemployment, accident, illness or disability. They also offer travel and flight accident insurance and card protection insurance for their credit card customers.
- **Deposits:** As Cembra is a bank, they can provide deposit and savings products at competitive interest rates for both retail customers and institutional clients.
- **Buy now pay later (BNPL)/invoice financing:** Cembra offers invoice financing through their subsidiary Swissbilling AG and the recent acquisitions Byjuno and Intrum Finance Services. E-commerce sales are estimated to be CHF 15 billion in Switzerland, growing double digits annually. Buy now pay later represents 8–11% of total e-commerce sales. Up to now, Cembra had a relatively low share of the BNPL market; the bank estimated its share to be between 10 – 20%.

Fig.2: Cembra's newest credit card brand

Source: Company data, IAM research



Fig.3: Cembra's interest income split

Source: IAM research

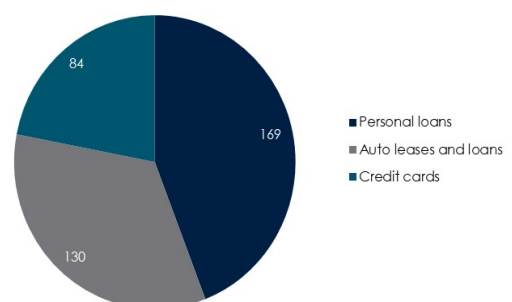
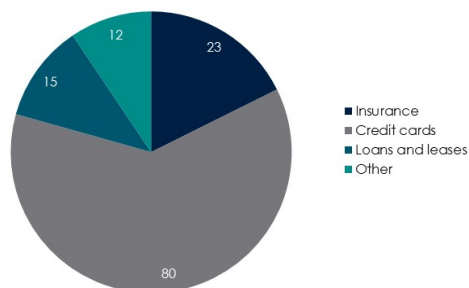


Fig.4: Commission and fee income

Source: IAM research



Revenues come from two streams:

1. Interest income (73% of total revenues)
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Interest income can further be split between the three main products that Cembra provides. The figure 3 shows the breakdown of interest income. The interest income includes the CHF 1.2 million expense for the negative interest rates Cembra had to pay for cash held with the Swiss National Bank and other institutions.

Commissions and fees are also split by products. We can see in figure 4 that the majority of these revenues come from credit cards. These commissions stem from the customer's transactions, as each time the customer pays with his credit card, Cembra receives a cut of that payment (but it's the vendor that has to finance this, not the customer directly). A very lucrative fee is when a customer uses the credit card abroad whereby Cembra adds another extra 1.5% fee for foreign exchange transactions (which is this time paid directly by the customer).

Financial analysis

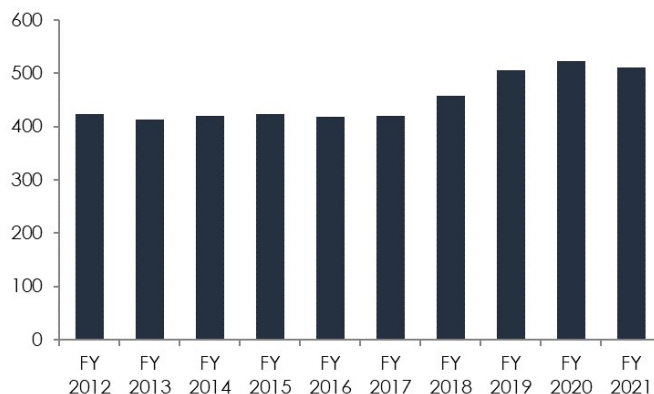
Growth

Figure 5 shows Cembra's top line since 2012 (the first year of public data).

As we can see, growth is very lackluster. Over the last 5 years, the compound annual growth rate was 4%. In 2021, revenues were even down, mostly due to COVID-19 restrictions impacting travel and spending.

Fig.5: Cembra's revenues over time

Source: Company data, IAM research



Factors that will influence growth are demographics, consumer spending/indebtedness, e-commerce growth, and overall credit card transactions replacing cash transactions. Credit card market share seems fairly stable overall in the saturated Swiss market (notwithstanding departures from co-branding cards like Migros' Cumulus; see risks at the end of this report).

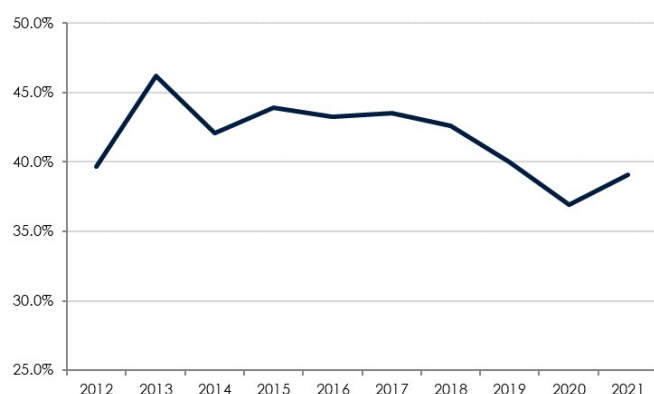
Longer term, we believe that Cembra will be able to grow a bit over GDP growth thanks to new initiatives such a BNPL, but unless the company makes a big acquisition, Cembra will never be a growth stock.

Margins

Figure 6 shows Cembra's operating margin since its IPO. We can see that margins are incredibly high, even during the impact of COVID, the company managed an operating margin of almost 37%.

Fig.6: Operating margins over time

Source: Company data, IAM research



Any manufacturing company would dream of such margins. But Cembra doesn't manufacture anything, so that's why their margins are so high. The infrastructure is minimal and the company is very frugal (even closing branches when deemed not profitable enough). It is possible that the company may be underinvesting, mainly in technology. We find that they are laggards compared to more modern fintech companies. For example, Cembra had only CHF 41 million costs dedicated to information technology in 2021.

A little bit over half of all costs are personnel costs (CHF 132 million out of CHF 246 million), so the company could still cut costs in case of a severe economic downturn. The company provides no guidance on margins.

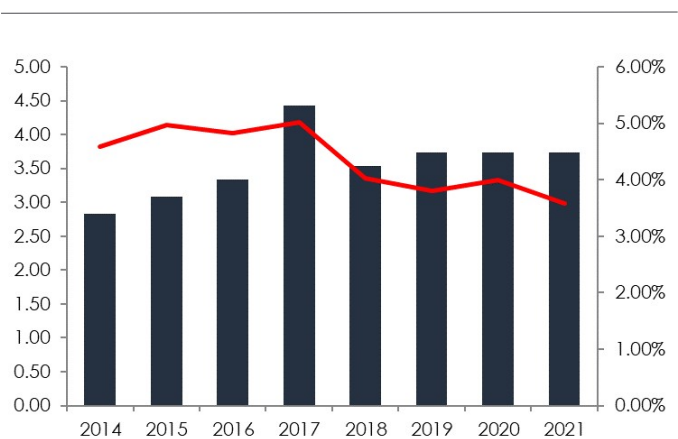
Dividends

Cembra's management is well aware that the dividend is one of the main attractions of their shares. Most financial companies are in this category: slow growth, value stocks. For this reason, the company has a progressive dividend policy in place (see figure 7; 2017 included a special 1 CHF return of capital). After three years of flat dividends, the company increased it by CHF 0.10/share to CHF 3.85 in 2022. Dividends are one of the company's guidance figure and the company wants to "increase the dividend based on sustainable earnings growth" longer term.

Nevertheless, we would like to remind investors that dividends are not a tax efficient way to return capital. Indeed, the dividend comes from money the company already paid taxes on, as it cannot deduct it as an ex-

Fig.7: Dividends per share in CHF and dividend yield (rhs)

Source: Company data, IAM research



pense. Afterwards, the investor is also taxed on this same amount (35% at source), so there is a double taxation of the distributed dividend. In contrast, share buybacks are a more efficient way to return capital back to shareholders, as they are only taxed at the company level.

Credit Risk

The group's risk and control framework operates along the three lines model:

- First line: business functions are responsible for ensuring that a risk and control environment is in place and maintained as part of day-to-day operations
- Second line: control functions provide independent control and oversight of risks, and
- Third line: the internal audit function evaluates the overall effectiveness of the control environment and provides additional independent assurance.

This three lines model ensures that direct accountability for risk decisions, implementation and oversight of risk management, and the independent control of the effectiveness of risk management are segregated. Internal regulation further detail the expected principles of risk management and control for each risk category.

Credit risk is the risk to earnings or capital that may arise from the possibility that a borrower or counterparty may fail to honor their contractual obligations. The obligations include, for example, principal repayment, interest and fees. A consequent loss may be partial or complete and may arise at any time as a result of a number of isolated or interlinked circumstances. Cembra is exposed to credit risk on all its lending products.

The group maintains stringent underwriting processes, which are continually monitored and optimized to ensure that credit risk is adequately and responsibly managed. Prior to granting credit, the customer's creditworthiness, credit capacity and, where applicable, collateral are assessed. The customer's creditworthiness is evaluated by an automated credit risk rating system, which includes the use of scorecards and leverages available information about the customer. This ensures consistent and systematic decision-making across all lending products.

The quality of portfolios and specific customer segments is thoroughly and periodically assessed. Specifically in

the area of vehicle leasing the group is exposed to risks related to the valuation of underlying assets or objects. Contractual residual values might differ from actual values of lease objects and distribution partners might fail to honor their contractual obligations. In addition to the consistent setting of residual values at lease origination the group regularly monitors its exposure to this type of risk and makes use of external data sources to verify results. The quality and performance of new business are monitored to ensure that the credit approval process continues to effectively mitigate credit risk, and underwriting procedures are being correctly followed. Scorecards are regularly monitored and back-tested to ensure their performance remains within expected levels and, if required, changes are made to the models. Segmented collection strategies are implemented to tailor activities to customer groups with different payment behaviors and to ensure optimal resource allocation and effective mitigation of credit risk.

For its lending products, the group uses consumer ratings (CR) to assess overall credit quality. There are five consumer ratings, each having an implied probability of default based on historical default experience, with default being defined as 90 days past due. (CR1 being the best rating) The group's financing receivables from non-defaulted customers (before allowance for losses) at 31 December 2021 and 2020 were distributed among the CRs as shown in figure 8.

Return on Equity

Figure 9 shows Cembra's return on equity (ROE) since 2013. The average is 15.9%.

For a company to add economic value, its ROE should be above its cost of equity. The cost of equity can be

Fig.9: Cembra's return on equity over time

Source: Company data, IAM research



calculated with the risk free rate, the market return and the beta. Which beta to use can be subjective, so this is not a science. With current risk free rates close to zero, we can calculate the cost of equity as the beta times the market return. Using an adjusted beta of 0.8 and historic market return of 8%, we find a cost of equity of 6.4%. This means that Cembra is adding quite some economic value with its average ROE of 15.9%.

Balance Sheet

One of the group's principal management goals is to maintain a strong capitalization by taking a prudent approach to balance sheet growth and implementing a balanced dividend payment strategy.

The chart in figure 10 shows Cembra's Tier 1 capital ratio. The financial regulator (FINMA) set a minimum regulatory requirement for category 4 banks at 11.2%. Cembra is more conservative and aims to consistently maintain a capital base that is well above this mark, defining a mid-term minimum target for its Tier 1 capital

Fig.8: Cembra's loan distribution by type and consumer ratings

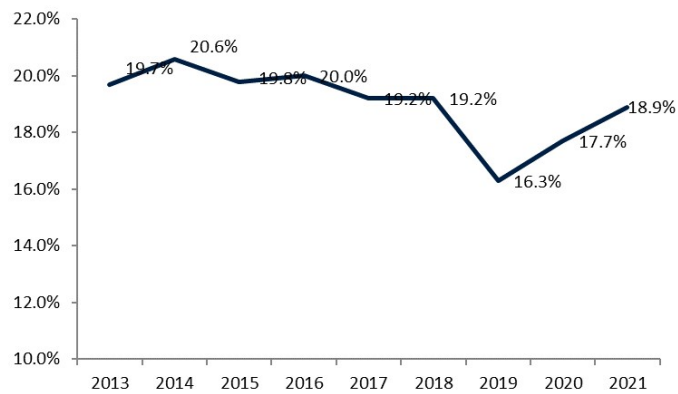
Source: Company data, IAM research

At 31 December 2021	Personal loans	Auto leases and loans	Credit cards	Total
CR1	42.2%	52.5%	75.4%	52.5%
CR2	33.1%	32.2%	17.9%	30.1%
CR3	18.1%	12.6%	6.3%	13.6%
CR4	5.0%	2.1%	0.5%	2.9%
CR5	1.7%	0.6%	0.0%	0.9%



Fig.10: Cembra's historic tier 1 capital ratio

Source: Company data, IAM research



ratio of 17%. As we can see, at the end of 2021, the group's Tier 1 capital ratio was 18.9%, in line with the mid-term target.

One of the most important aspect of lending money is making sure the client is capable of paying the interest and return the principal at the end of the loan. One way of measuring the quality of lending assets is analyzing the proportion of non-performing loans, otherwise known as delinquencies.

The following figure shows Cembra's delinquencies by line of business over the last 3 years. Non-performing loans (NPL) are those that are over 90 days past due.

Fig.11: Cembra's delinquencies by business segment

Source: Company data, IAM research

Personal loans

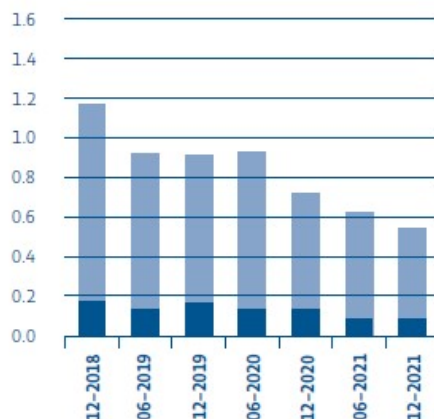
Delinquencies as %



■ Non-performing loans (NPL)
■ 30 days past due

Auto leases and loans

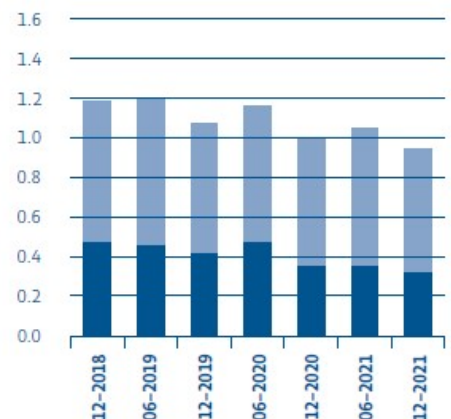
Delinquencies as %



■ Non-performing loans (NPL)
■ 30 days past due

Credit cards

Delinquencies as %



■ Non-performing loans (NPL)
■ 30 days past due

We can clearly see that there is not much risk in the auto leases and loans, as well as in the credit cards business. However, the personal loans business is clearly the most risky, and has had the worst impact from the COVID pandemic. We will be monitoring this figure closely when Cembra releases the full-year figures. Nevertheless, overall we can say that management is capable of mitigating their client's credit risk.

Investment case

We like Cembra for its defensive qualities. The diversification between consumer credits, car leasing, and credit cards adds a sense of resilience. Of course the company will not be immune in case of a recession, but this is not a cyclical company as industrials could be.

We also like management's prudence and long term approach. While they are not at the forefront of technology, they are slow adopters and will eventually catch up with the required technology over time.

Cembra is also one of the few companies that will benefit from rising interest rates. As it makes a margin between its lending rate and financing rate, increasing rates will allow the company to charge a higher price for loans. In 2023, the Swiss government should raise the interest rate

cap, which is directly applicable to Cembra's credit card business.

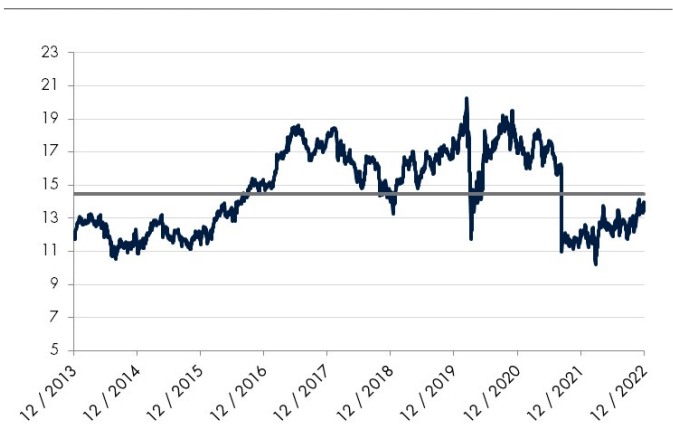
Valuation

The chart in figure 12 depicts Cembra's price to earnings (P/E) multiple over the past decade and its average (14.5x).

We can see that the current valuation is under its historic average. Indeed, the share price has still not recovered from a massive drop in August 2021 (explained in the Risks section below). This is another positive argument for why we think the shares are attractive.

Fig. 12: Historic P/E since the IPO

Source: IAM research



Risks

Apart from overall macroeconomic risks (including COVID-19 induced slowdowns), the company was also highly dependent on one strategic partner: Migros. The Federation of Migros Cooperatives had a long-term agreement with Cembra to provide their customers a free credit card with financial incentives (free points spendable at Migros each time a consumer used the card). The 15 year agreement abruptly came to a halt in August 2021 when Migros decided to insource the credit card business to its own bank. Migros Cumulus credit cards represented more than 850'000 cards (out of a total of roughly 1.1 million Cembra issued cards), so clearly a major risk. The agreement terminated formally only in June 2022, and currently, we do not have any information on how many customers have closed their Cembra credit cards and moved to Migros bank's offer. We do have a precedent when Coop dissolved its partner-

ship with their then credit card provider Swisscard. Ultimately, 85% of the Coop card customers remained with Swisscard because it was the default solution.

We believe that it's also likely that 85% of Migros Cumulus card holders kept their Cembra credit card, as this is the default solution. If customers didn't actively cancel their card, they received a new Certo (Cembra) credit card.

On the day the partnership termination was announced in August 2021, the stock price took a major hit (-31%). We will only know on the 23rd of February, with the full year financial results, how many clients Cembra was able to retain. But more importantly, it will be key to monitor the transaction volume, because a free issued card doesn't generate any revenue without transactions. So even if Cembra should announce that it has retained 85% of customers, we do not expect the share price regaining 85% of that 31% drop in a day.

There are of course several other business risks, most notably cyber and information security control. But overall, the group is aware that severe events beyond its control (such as natural disasters) may result in an inability to fulfil some or all of its business obligations, particularly where its physical and information technology infrastructure would be damaged or made inaccessible. In compliance with the recommendation for business continuity management (BCM) issued by the Swiss Bankers Association, the group has implemented a BCM program which involves identifying critical processes and their dependency on systems, applications and external service providers. We believe the group is well aware of risks involved and is capable of controlling and managing them satisfactorily.