

Italian Banks

2Q16 preview: still relevant, capital in focus

Equities

Italy
Banks, Ex-S&L

Despite systemic concerns, results are likely to be important

Similarly to last quarter, 2Q16 is also likely to be overshadowed by systemic concerns and the upcoming stress test results on July 29th. However, with both Intesa and UniCredit trading within a c.10% range of our price targets, we see numbers as relevant, mainly to determine whether the c.10-20% downward revisions we carried out post UK "leave" vote ([here](#)) are sufficient, with core revenues again appearing as the most vulnerable area, and one-off gains adding volatility to the LLPs line. For UniCredit, solvency developments will be closely monitored, given the market's focus on the potential size of a likely capital increase and following the two (unexpected) Fineco and Pekao stake disposals.

Revenues still lacklustre, higher provisions as Visa gains are used

Core revenues should not offer major surprises, with NII still suffering from falling Euribor and fees recovering only modestly, failing to show the rebound expected earlier this year. The Visa Europe gains (c.€150mn for ISP, c.€250mn for UCI) will boost results this quarter, though we expect both banks to increase LLPs to avoid coverage erosion. Italian asset quality should prolong the stabilising trends seen in recent quarters

Close attention to capital, several headwinds in place

With Q2 we will find out if UCI's asset sales responded to a worsening capital position or a sign of proactivity. Headwinds are abundant: AFS reserves, revaluation of pension liabilities and Atlante's contribution. Barring any meaningful RWA reduction, we see it difficult for UCI to generate capital in Q2 even pro-forma of the stake disposals, which will likely not be welcomed by investors. Due to the lack of pension exposure, headwinds should be smaller for ISP, though capital formation will be structurally constrained by higher dividend assumptions, which we expect to be reiterated by management.

Systemic concerns: still waiting for details

Given the lack of additional detail, we still sit on the sidelines on the systemic debate, with unanswered questions still relating to (i) the extent of the problem (banks involved, amount of NPLs transferred and transfer price), and (ii) the source of new capital if needed. We expressed our views in more detail [here](#). For Intesa and UniCredit, we believe the most unfavourable scenarios would comprise a broad-based sector push to increase NPLs coverage and/or additional contributions to Atlante.

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Results preview

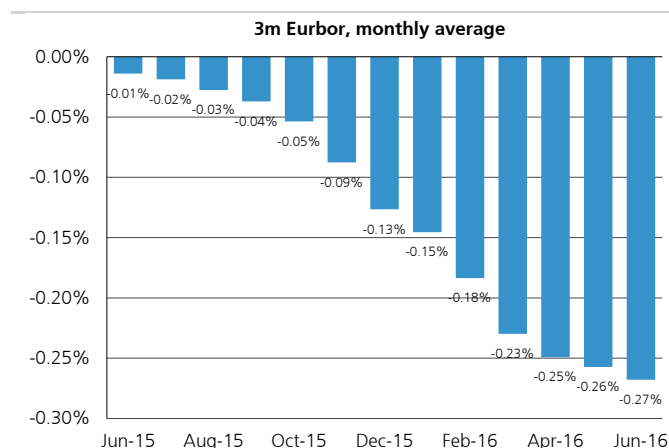
Revenues

Net interest income

The steady reduction of **Euribor** continued during 2Q16 (Figure 1): 3m Euribor went down on average 7bps in 2Q16 versus 1Q16 and closed 1H16 at -29bps having started the year at -13bps. Moreover 3m Euribor has lost one additional basis point since the end of the quarter. This reduction of Euribor is particularly detrimental for the NII of Italian banks, given the large majority of Italian loans are floating and have a frequent reset.

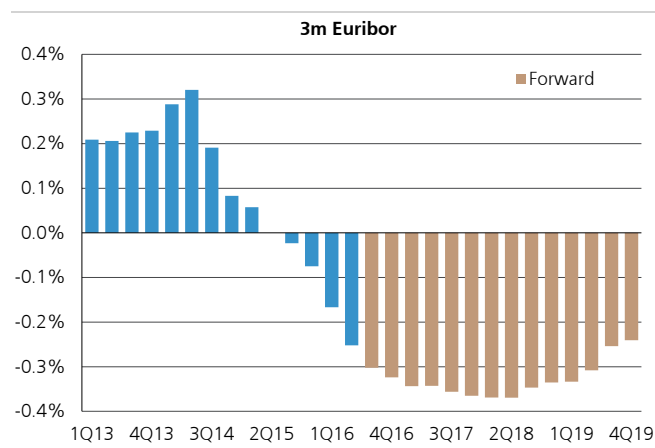
Additionally, forwards currently indicate a further expected reduction of Euribor in the coming quarters. This is one of the main risks from the UK referendum vote, as we discussed in our [recent note](#).

Figure 1: 3m Euribor went down on average 7bps in 2Q16 versus 1Q16



Source: Datastream and UBS

Figure 2: Forwards indicate a further expected reduction of 3m Euribor in the coming quarters



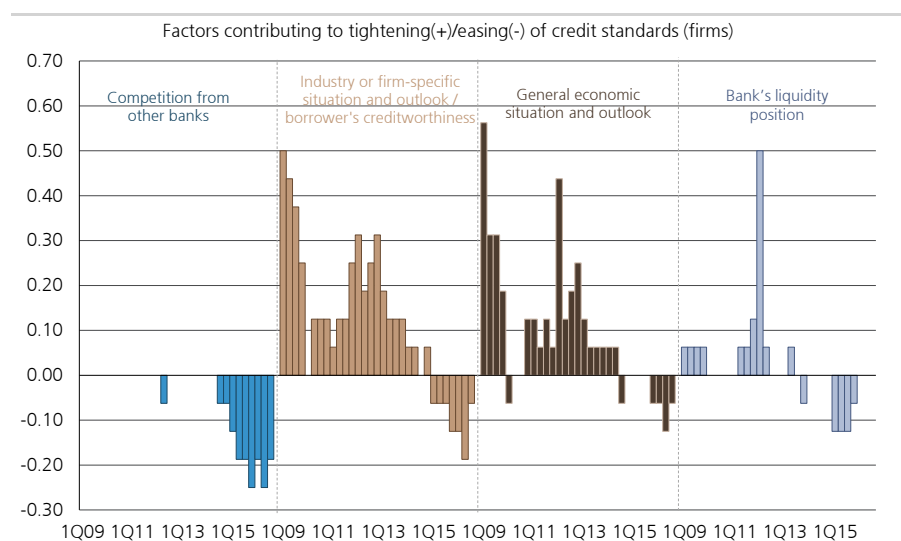
Source: Bloomberg, Datastream and UBS, as of 22 July 2015

Another consequence of the UK vote is likely to be a slower than previously expected loan growth on the back of greater economic uncertainty. However data on this front are so far limited. For example, while Eurozone Flash PMI data last week proved resilient our Economists think it is too early to draw strong conclusions from a single data point ([link to the note](#)).

Another possible indicator is the recent ECB'S 2Q16 **Bank Lending Survey** (BLS), although the data only partially captures the impact of the UK referendum given the survey was conducted between 14 and 29 June.

When considering Italy (for Europe please refer to [UBS Economics' note](#)) it clearly emerges that competition remains strong and is the main driver of easing credit standards for firms (Figure 3) and households (Figure 4). This trend has remained unchanged over the last several quarters.

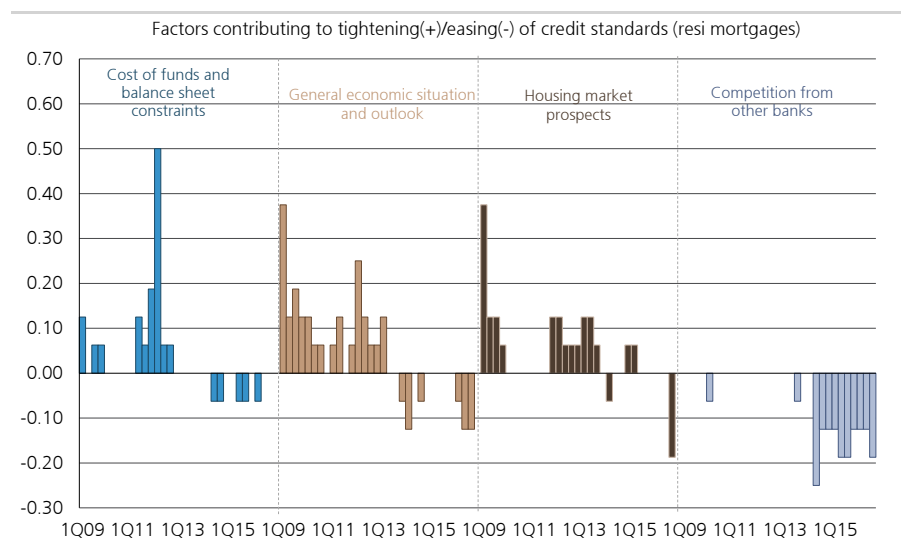
Figure 3: Strong competition continues to have an expansionary effect on credit standards on loans to firms



Source: Bank of Italy and UBS. Note: Positive values indicate supply restriction compared with the previous quarter. Diffusion indices are constructed on the basis of the following weighting scheme: 1 = tightened considerably, 0.5 = tightened somewhat, 0 = basically unchanged, -0.5 = eased somewhat, -1 = eased considerably. The range of variation of the index is from -1 to 1.

For residential mortgages another strong easing driver in the last reading of the survey was the prospects for the housing market, which looking forward could potentially be at risk from a drop in confidence.

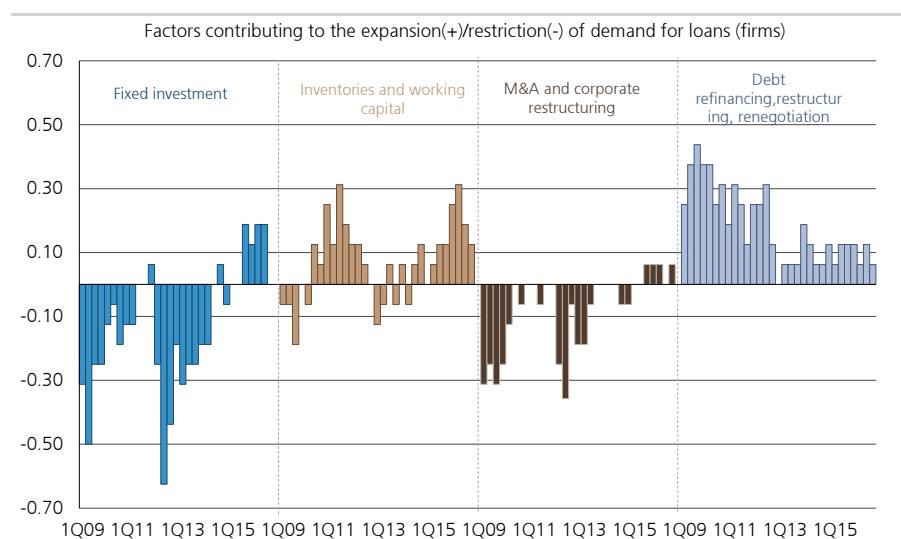
Figure 4: Also for residential mortgages strong competition remains an expansionary factor on credit supply



Source: Bank of Italy and UBS. Note: positive values indicate supply restriction compared with the previous quarter. Diffusion indices are constructed on the basis of the following weighting scheme: 1 = tightened considerably, 0.5 = tightened somewhat, 0 = basically unchanged, -0.5 = eased somewhat, -1 = eased considerably. The range of variation of the index is from -1 to 1.

Looking at the drivers of demand for firms' credit, after four quarters in expansionary territory fixed investments turned neutral. Working capital and inventories remain the main expansionary factors.

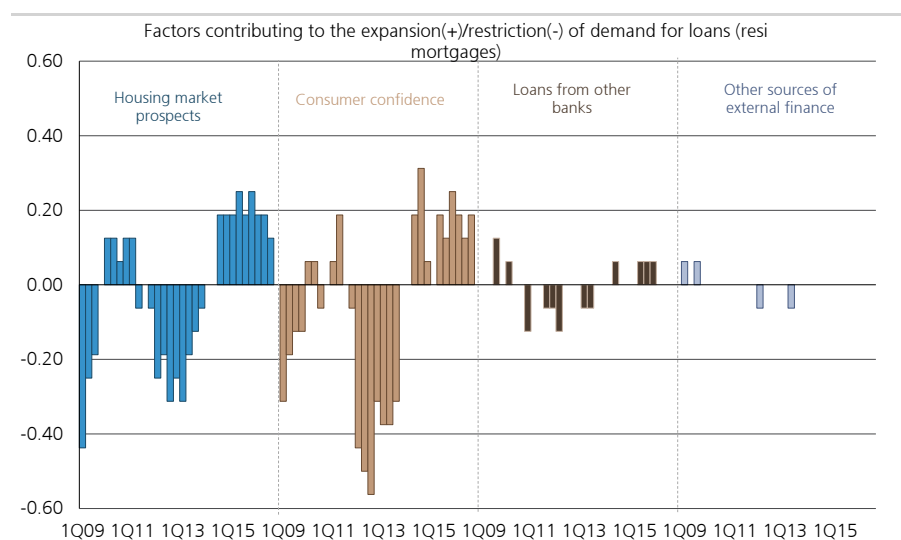
Figure 5: Fixed investments were no longer an expansionary factor for firms loans demand after four positive quarters



Source: Bank of Italy and UBS. Note: positive values indicate demand expansion compared with the previous quarter. Diffusion indices are constructed on the basis of the following weighting scheme: 1 = increased considerably, 0.5 = increased somewhat, 0 = basically unchanged, -0.5 = decreased somewhat, -1 = decreased considerably. The range of variation of the index is from -1 to 1.

For residential mortgages housing markets prospects and consumer confidence remained strongly in expansionary territory. It will be assessed in time what, if any, the consequences of the UK referendum will be.

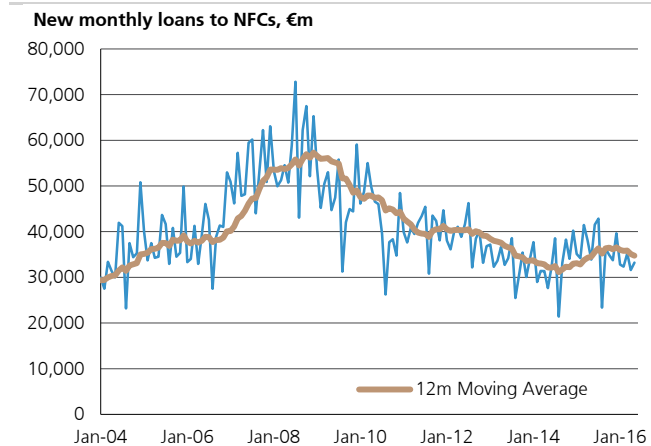
Figure 6: Consumer confidence and housing market prospects remained in expansionary territory, albeit the impact of the UK referendum will have to be assessed in time



Source: Bank of Italy and UBS. Note: positive values indicate demand expansion compared with the previous quarter. Diffusion indices are constructed on the basis of the following weighting scheme: 1 = increased considerably, 0.5 = increased somewhat, 0 = basically unchanged, -0.5 = decreased somewhat, -1 = decreased considerably. The range of variation of the index is from -1 to 1.

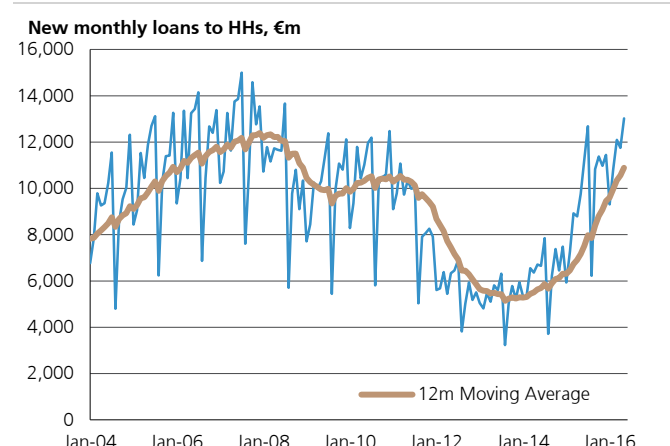
Moving from surveys to actual new production, we observe a slowdown in the new production of corporate loans while new loans to households remain buoyant.

Figure 7: New lending to corporates appears to be slowing...



Source: Bank of Italy and UBS

Figure 8: ...while new lending to households remains buoyant



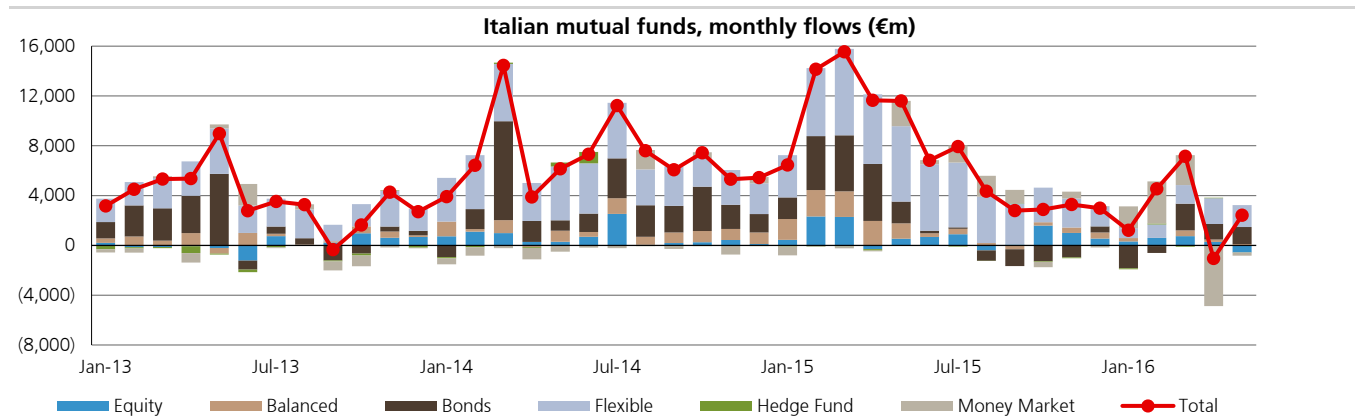
Source: Bank of Italy and UBS

When considering Intesa and UniCredit, we expect both banks to be affected by the further Euribor reduction despite on a quarterly basis calendar effects should provide some support. We expect small QoQ NII reduction for Intesa (-1%) and flat for UniCredit, which likely benefitted from a more benign volume growth in CEE.

Fees

In our [initiation report](#) (March 2016) we extensively reviewed why the Italian 'fee story' was expected to run out of steam, a scenario that largely materialised over 1Q16. The beginning of 2Q16 in terms of mutual funds flows, for the data available so far, has not shown the rebound that was expected by the market despite the somewhat improved conditions versus 1Q16 (before the UK "leave" vote). This plays, in our view, to our thesis of a structural plateauing of the AUM business of Italian banks. Moreover, the situation has likely deteriorated further for 2H16 due to the high volatility and negative market performance following the UK referendum ([link](#)).

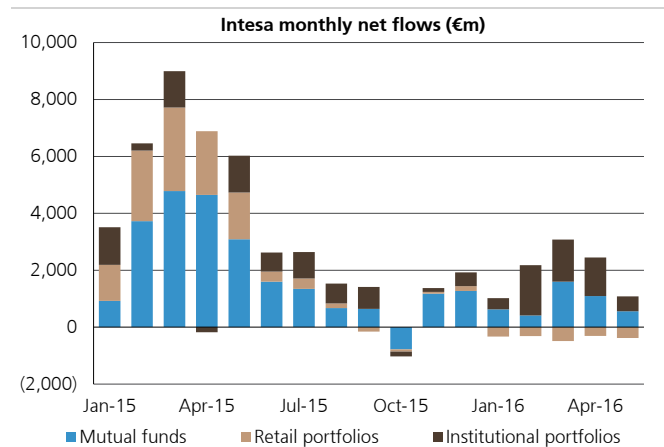
Figure 9: Flows into mutual funds remained subdued also in April and May



Source: Assogestioni and UBS

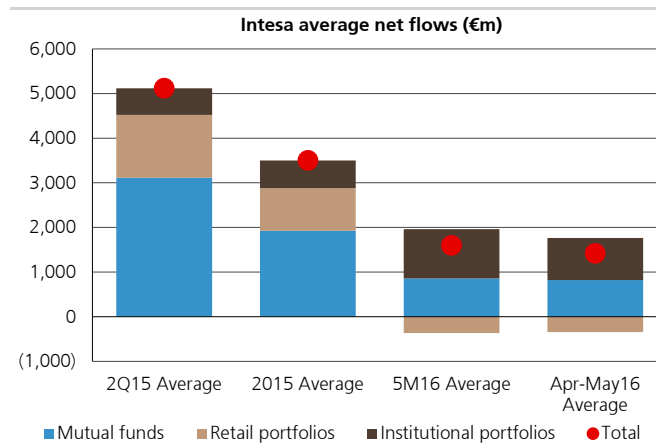
Looking at Intesa, its net flows, similarly to the system, failed to rebound significantly so far and were mostly supported by institutional portfolios, likely related to unit-linked or hybrid insurance policies.

Figure 10: Intesa's mutual fund flows in May proved particularly weak...



Source: Assogestioni and UBS

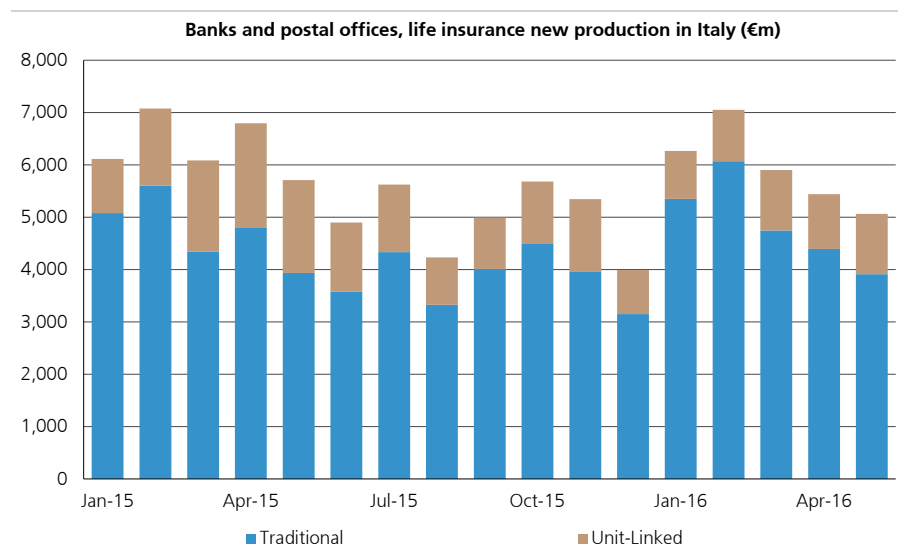
Figure 11: ...and mostly supported by institutional portfolios, likely insurance related



Source: Assogestioni and UBS

However at system level, life insurance new production by banks and postal offices continued to decrease in the first two months of 2Q16, with only a modest sign of recovery in the production of unit-linked policies.

Figure 12: While unit-linked new production has shown some improvement in the last few months the overall new production is slowing



Source: ANIA

For Intesa, having lowered our 16-18E fee expectations by c.10% since our initiation, we expect a small QoQ improvement (2%) thanks to seasonally stronger placement activity and better average AUM QoQ on the back of more stable market conditions. For UniCredit we expect a QoQ reduction of fee income (-2%) as we see part of the fees generated in 1Q16 (those linked to placement of third party bonds and non AUM related products) as non-recurring.

Other lines and asset quality

- From this quarter the **fee on DTC** payable to the state and announced in May ([link](#)) will come into force. Intesa, as announced in 1Q16 conference call, does not expect to pay a meaningful fee, thanks to the offset provided by taxes paid in the recent years. On the other hand, UniCredit this quarter should record a c€200m fee expense covering 2015 and 1H16, with additional c€65m to be expensed in 2H16.
- This quarter will also see the recording of the gains from the sale of **Visa Europe**. For Intesa the sale should translate into a gain of c€150m (net gain is very similar to the gross gain). For UniCredit the gain should be c€250m plus additional c€20m likely coming as a higher dividend from Yapi.
- In terms of **provisions**, we generally expect to see an increase this quarter for both banks. In the case of UniCredit, the bank sold €420m of unsecured NPLs to AnaCap¹ in April. These were likely extremely well covered and we expect the bank to increase provisions QoQ from €755m to €839m to avoid a drop in coverage. We also expect Intesa to increase sizably provisions QoQ from €694m to €880 as the bank, in our view, is likely to take the opportunity offered by the Visa gain to recover part of the coverage erosion saw in 1Q16.

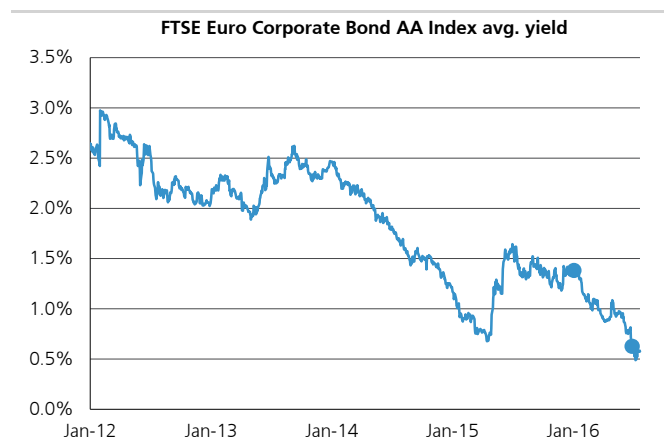
Capital – important quarter for UCI

Capital will likely be the main metric in focus by the market for UniCredit. In particular, results should show whether the recent placements of [Fineco](#) and [Pekao](#) were in reaction to a deteriorating capital position or a sign of proactivity.

For UniCredit the quarter is likely to present a sizable headwind in terms of reserves for defined benefit **pensions**. These liabilities are mostly due to HVB following the transfer to the state of the pension liabilities of Bank Austria's employees. UniCredit's pension liabilities are revalued semi-annually and, in short, increase when the discount rate decreases (Figure 14), which is what has happened during 1H16 (Figure 13). The increase in liability is reflected in valuation reserves which in turn impact CET1.

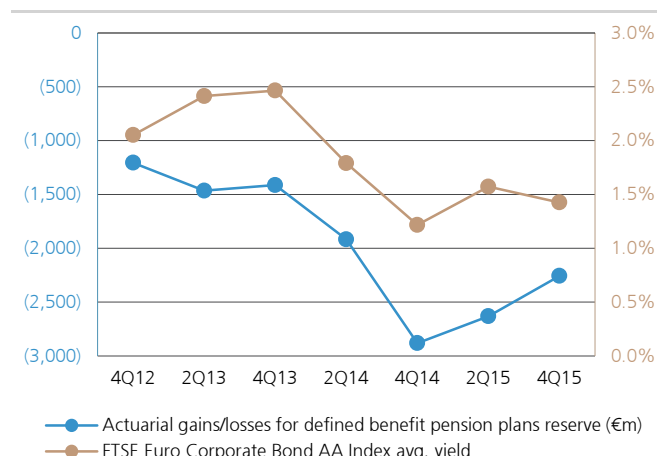
¹ Reuters: " UniCredit cede sofferenze ad AnaCap da 420 mln lordi, impatto su conti trim2 ", 13 April 2016

Figure 13: The yield of highly rated Eurozone corporate bonds is now at historical lows...



Source: Bloomberg

Figure 14: ...this should lead to a worsening of the valuation reserve of defined benefit pension

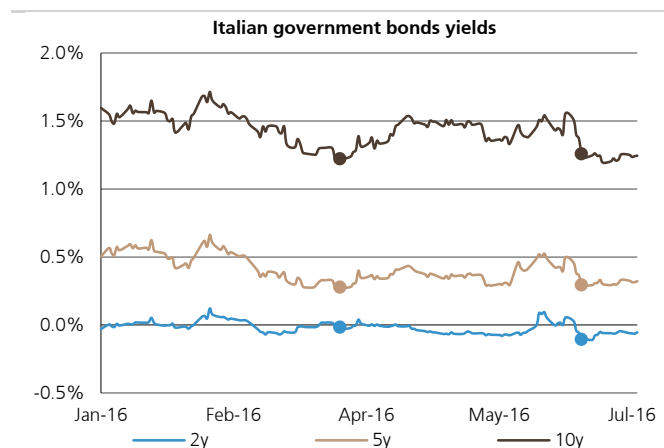


Source: Company data, Bloomberg and UBS

The exact calculation of the capital impact is difficult to perform due to the adjustments made to determine the discount rate starting from a base bond basket (generally a EUR Corporate AA, similar to the one in Figure 13). However, we estimate that an impact on CET1 Fully Loaded in the -c20bps area is likely.

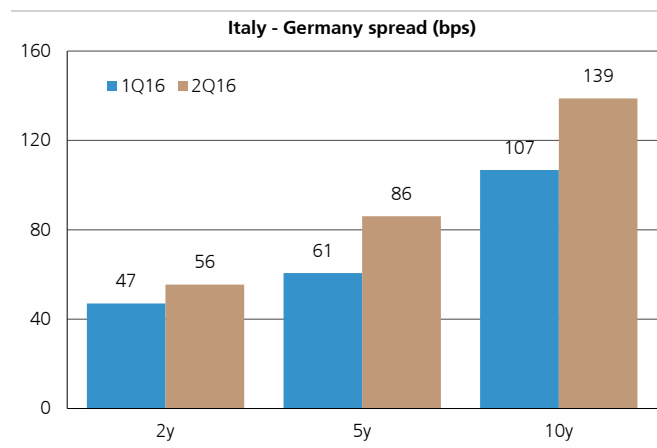
Additionally, 2Q16 saw also a widening of the Italy – Germany spread (Figure 16), despite yields of BTPs remained fairly stable versus 1Q16 (Figure 15). The widening of the spread should negatively affect the **AFS reserve** of both banks for the part of the bond portfolio swapped to floating, which we expect to be the majority. Overall we think that a negative 5-10bps impact on CET1 FL of both banks from the Italian bond portfolio is likely.

Figure 15: Despite the yields of Italian government bonds are only marginally moved QoQ...



Source: Bloomberg

Figure 16: ...due to the rally in German government bonds, spreads widened



Source: Bloomberg and UBS. Note: end of period values.

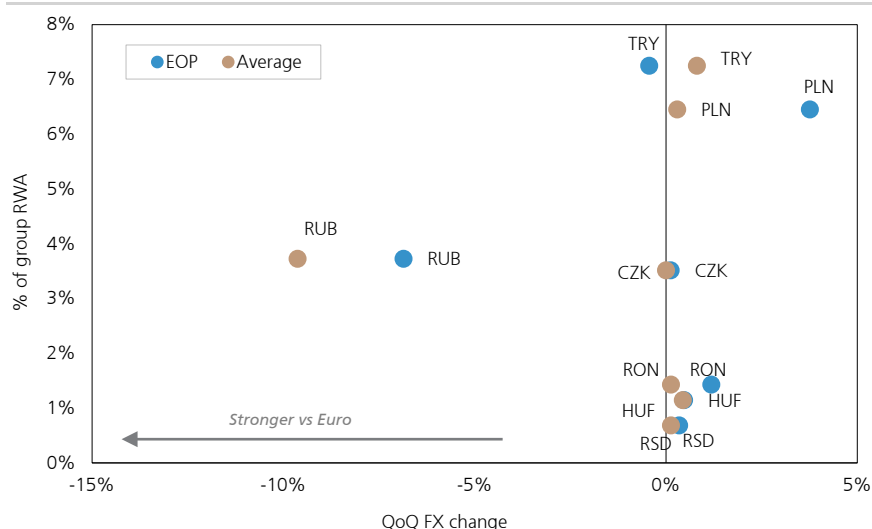
This quarter we should also see the full capital impact from the contribution to **Atlante**. These should be c10-15 bps for UniCredit and c15-20bps for Intesa.

As usual, another variable to keep in mind when considering UniCredit's quarterly results are the **FX movements** of the currencies of the group. In 2Q16 only the Russian ruble deserves a mention, with all the others remaining fairly stable (Figure 17). The RUB appreciated versus the Euro on average 10% QoQ and this will likely have a positive impact on earnings translation into EUR (for the unhedged part).

Moreover the strengthening should also likely have a small positive impact on capital.

While it will have no direct impact on 2Q16 results, it is worth flagging the recently agreed reduction of the **Austrian bank tax** (see [UBS Austrian banks note](#)). While the medium-term impact should be positive, in the short term the banking system will likely be called to pay a one-off €1.0bn contribution. Although details of this payment have to be clarified (i.e. payment in instalments or upfront), this could be an additional capital headwind for UniCredit. Bank Austria has a market share in the country of c15%.

Figure 17: Overall FX is little changed in 2Q16 for UCI with the RUB being the only significant mover



Source: Datastream, company data and UBS. Note: Czech Republic share of RWA also includes Slovakia as the country split is not available. EOP = end of period.

Intesa Sanpaolo (Buy, price target: €2.15)

Results Tuesday 2nd August, conference call at 14:00 UK (+442034271917).

Figure 18 shows our detailed estimates for Intesa's 2Q16 results. We flag the following items of the note for this quarter:

- (1) **Restated historical data:** historical data have been restated by the bank to reflect the effects of the sale of Setefi and Intesa Sanpaolo Card and of a portfolio of €2.6 billion extra-captive performing consumer loans.
 - The impact is a reduction of c1% of NII and c2% of fees versus what previously reported. We marginally amend our estimates by less than -1% on average over 2016-18E.
- (2) **Visa Europe gain:** Intesa should record a €150m gain on the sale of its Visa Europe stake. In our forecasts, this is included in the "profit (losses) on investments" line.

Figure 18: Detailed Intesa 2Q16 estimates

	Q115	Q215	Q315	Q415	Q116	Q216E	QoQ	YoY
Net interest income	1,950	1,954	1,887	1,926	1,855	1,840	-1%	-6%
Profits of equity-accounted investees	39	15	41	1	74	20	-73%	33%
Net fee and commission income	1,775	1,941	1,748	1,878	1,676	1,708	2%	-12%
Trading Income	596	380	1	57	228	160	-30%	-58%
Income from insurance business	343	282	241	131	332	230	-31%	-18%
Other net operating income/expense	-77	-59	209	-378	-142	-10	-93%	-83%
Gross operating income	4,626	4,513	4,127	3,615	4,023	3,948	-2%	-13%
Staff costs	-1,295	-1,263	-1,249	-1,479	-1,275	-1,290	1%	2%
Other administrative expenses	-629	-668	-632	-791	-595	-635	7%	-5%
Depreciation and amortisation	-174	-176	-178	-200	-177	-182	3%	3%
Total expenses	-2,098	-2,107	-2,059	-2,470	-2,047	-2,107	3%	0%
Pre-impairment income	2,528	2,406	2,068	1,145	1,976	1,841	-7%	-23%
Net provisions for risks and charges	-54	-68	-222	-55	-16	-38	134%	-45%
Net impairment losses on loans	-767	-847	-769	-923	-694	-880	27%	4%
Net impairment losses on other assets	-9	-31	-20	-108	-20	-30	50%	-3%
Profits (Losses) on investments	28	38	21	51	-5	150	n.m.	n.m.
Profit/(loss) before tax	1,726	1,498	1,078	110	1,241	1,044	-16%	-30%
Income tax	-634	-502	-339	-60	-383	-323	-16%	-36%
Charges (net of tax) for integration and exit incentives	-6	-25	-15	-37	-13	-16	25%	-35%
Effect of purchase price allocation (net of tax)	-26	-33	-27	-33	-29	-26	-10%	-21%
Goodwill Impairment	0	0	0	0	0	0	n.m.	n.m.
Profit/(loss) from disc.operations	15	14	15	15	13	8	-42%	-46%
Minority interests	-11	-12	10	18	-23	-10	-55%	-13%
Net attributable income	1,064	940	722	13	806	675	-16%	-28%

Source: Company data and UBS estimates

UniCredit (Neutral, price target: €2.10)

Results Wednesday 3rd August, conference call at 13:30 UK (+441212818003).

Figure 19 shows our detailed estimates for UniCredit's 2Q16 results. We flag the following items of the note for this quarter:

- (1) **Visa Europe gain:** UniCredit should record a c€250m gain on the sale of its Visa Europe stake. In our forecasts, this is included in "trading income".
- (2) **DTC fees:** for the first time from this quarter the fee on DTC will be payable to the state. UniCredit should pay c€200m for 2015 and 1H16. We included this expense in "systemic charges".

As mentioned in the previous pages, the market is likely to focus on UniCredit's capital generation. We note how this will be, at least, limited by revaluation reserves on AFS and pension liabilities despite a good quarter from an earnings point of view. We also note the c.20bps capital generation derived from Fineco/Pekao disposals will be presented as proforma this quarter, but only booked in Q3.

Figure 19: Detailed UniCredit 2Q16 estimates

	Q115	Q215	Q315	Q415	Q116	Q216E	QoQ	YoY
Net interest income	2,963	2,999	2,925	3,029	2,876	2,874	0%	-4%
Dividends and similar income	118	269	192	250	212	276	30%	3%
Net fee and commission income	2,014	1,997	1,902	1,935	1,946	1,913	-2%	-4%
Trading Income	619	473	250	302	362	651	80%	38%
Other net operating income/expense	34	-3	63	73	80	50	-38%	n.m.
Gross operating income	5,749	5,735	5,332	5,589	5,476	5,764	5%	1%
Staff costs	-2,093	-2,127	-2,067	-2,053	-2,028	-2,035	0%	-4%
Other administrative expenses	-1,289	-1,294	-1,286	-1,289	-1,202	-1,238	3%	-4%
Recovery of expenses	188	213	198	210	176	205	17%	-4%
Depreciation and amortisation	-224	-227	-228	-250	-237	-242	2%	7%
Total expenses	-3,418	-3,435	-3,383	-3,382	-3,291	-3,310	1%	-4%
Pre-impairment income	2,331	2,299	1,949	2,207	2,186	2,454	12%	7%
Net impairment losses on loans	-980	-913	-1,005	-1,216	-755	-839	11%	-8%
Other Charges & Provisions	-264	-359	-154	-807	-417	-528	27%	47%
<i>o/w Systemic Charges</i>	<i>-210</i>	<i>-196</i>	<i>-85</i>	<i>-410</i>	<i>-390</i>	<i>-395</i>	<i>1%</i>	<i>101%</i>
Integration costs	-1	-2	-8	-398	-260	-60	-77%	n.m.
Net income from investments	-5	18	20	-39	-17	0	n.m.	n.m.
Profit/(loss) before tax	1,080	1,043	802	-254	736	1,027	40%	-1%
Income tax	-343	-238	-197	640	-246	-252	2%	6%
Profit/(loss) from disc.operations	-58	-121	27	-143	14	0	n.m.	n.m.
Purchase Price Allocation effect	-65	-61	-48	-19	-4	-5	18%	-92%
Goodwill Impairment	0	0	0	0	0	0	-	-
Minority interests	-102	-100	-78	-72	-93	-88	-6%	-12%
Net attributable income	512	522	507	153	406	683	68%	31%

Source: Company data and UBS estimates

Valuation Method and Risk Statement

Valuation method: We have used the traditional Gordon growth methodology for valuation. We are advocates of ROTE being the main driver for valuation multiples. We clean profits from non-recurrent items and deduct AT1 coupons to get to our adjusted returns. As COE we use 11.0% for ISP and 12.0% for UCI. To determine whether banks have excess or shortfall of capital, which we value at 1x PTBV, we use an 11% fully loaded CET1 threshold for ISP and 12% for UCI, to reflect its GSIB buffer.

Risks: Intesa and UniCredit are exposed to macro risks, asset quality risks, unexpected changes in interest rates, any slowdown in the savings industry, developments in CEE, risks from insurance activities, regulatory and operational risks, and potential M&A activity with positive or negative implications for shareholders.

Required Disclosures

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12-Month Rating	Definition	Coverage ¹	IB Services ²
Buy	FSR is > 6% above the MRA.	47%	32%
Neutral	FSR is between -6% and 6% of the MRA.	38%	25%
Sell	FSR is > 6% below the MRA.	15%	21%
Short-Term Rating	Definition	Coverage ³	IB Services ⁴
Buy	Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.	<1%	<1%
Sell	Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.	<1%	<1%

Source: UBS. Rating allocations are as of 30 June 2016.

1:Percentage of companies under coverage globally within the 12-month rating category.

2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.

3:Percentage of companies under coverage globally within the Short-Term rating category.

4:Percentage of companies within the Short-Term rating category for which investment banking (IB) services were provided within the past 12 months.

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Company Name	Reuters	12-month rating	Short-term rating	Price	Price date
Intesa SanPaolo ^{2, 3a, 4, 5, 7, 13}	ISP.MI	Buy	N/A	€1.92	25 Jul 2016
UniCredit ^{2, 3b, 4, 5, 7, 20}	CRDI.MI	Neutral (CBE)	N/A	€2.29	25 Jul 2016

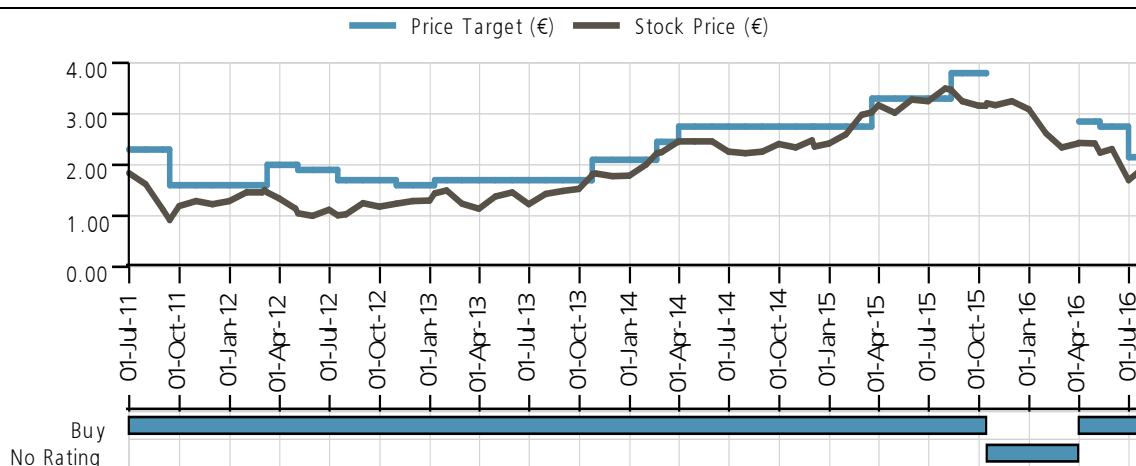
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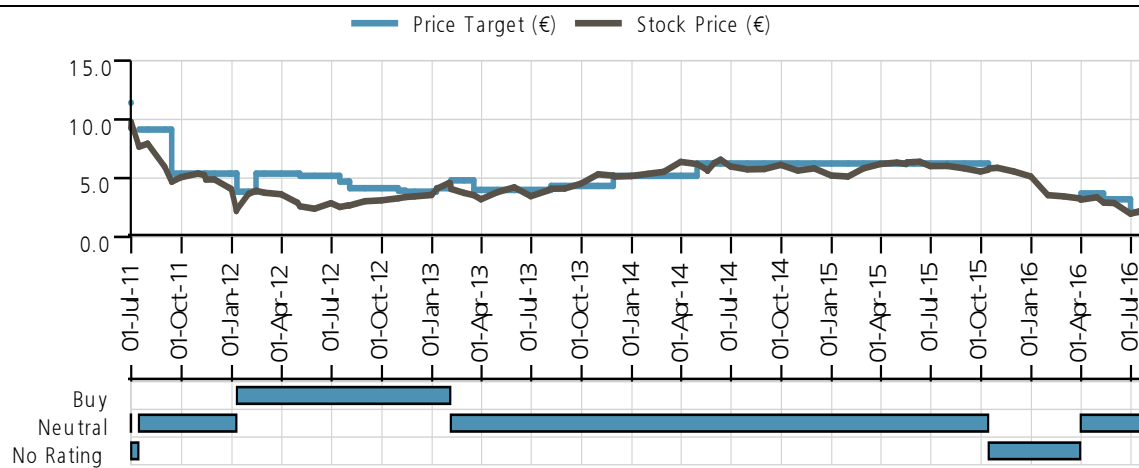
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Intesa SanPaolo (€)



Source: UBS; as of 25 Jul 2016

UniCredit (€)



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