Italian Banks

INITIATION

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NPLs: Far more firepower needed

We initiate coverage of four Italian banks, having run our own asset quality review ahead of the European Banking Authority's latest stress-test results due on 29 July and ECB guidance on NPLs later this summer. Intesa (Outperform, TP €2.5) and UBI (Outperform, TP €3.5) should have excess capital even in an adverse scenario, while Unicredit (Neutral, TP €2.28) and Monte dei Paschi (Underperform, TP €0.29) would likely face capital shortfalls.

Asset quality is the main issue for the sector, with €360bn of gross non-performing exposure (NPE)—or ~20% of Italy's GDP. Since the Brexit vote, Italian banks have suffered from increasing systemic risk.

- **For Intesa and UBI, capital shortfall concerns and risks of further rescue-fund participation look overdone:** Our stress test shows Intesa and UBI would actually have excess capital in our worst-case scenario, while UCG would have a potential shortfall of €4-9bn and MPS €0.6-3.5bn, resulting in an aggregate shortfall of up to c.€12bn for our universe. We think UCG is already largely pricing in a shortfall, while MPS would likely need state aid or face a resolution in our worst-case scenario. UCG is also exposed to Turkish political risk via its Yapi Kredi stake.
- **For the sector as a whole, no less than €30bn needed to solve the NPL issue:** We estimate the Atlante fund could buy up to €18bn of NPLs currently, but we think it would need no less than €30bn to properly downsize the sector's non-performing loans (by up to €130bn NPLs). However, we see potential for only €5-6bn of fresh money into the fund from new private investors. For now, we think the sector will need to rely on new government measures and banks raising their NPL coverage. Longer term, although the regulator does not currently allow a US-style TARP solution, we believe state aid may be needed to address the NPL issue.
- **We think the sector will need to raise NPL coverage by 8-10pp:** This is our central case and appears the most effective way to reduce the bid-offer price gap on NPLs and help other NPL initiatives bear fruit. In our bottom-up analysis, 8pp coverage uplift would reduce the price gap by 14pp.
- **New initiatives could reduce the price gap by 10pp:** Our top-down analysis highlights that Italy's new measures could reduce the NPL price gap by 10pp, of which 5pp is from new foreclosure decrees, with Atlante and the public guarantee schemes accounting for the remaining 5pp.

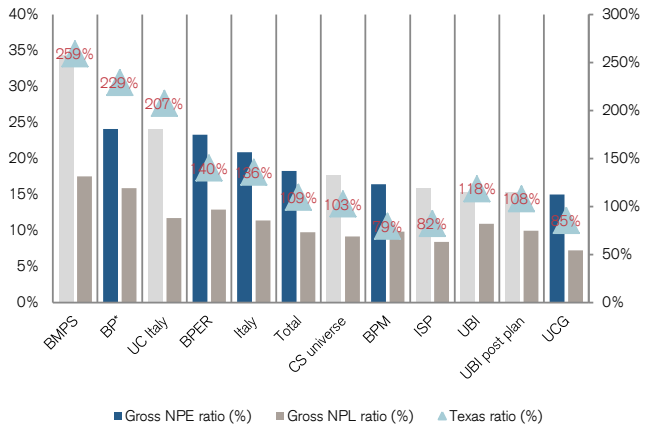
Figure 1: Italian banks ratings, TPs and multiples

(€, %, x)	Price	TP	Pot. up/downside	Rating	PTBV17E	RoTNAV17E
Intesa-SPI	1.93	2.50	30%	Outperform	0.78x	7.8%
Unicredit	2.18	2.28	5%	Neutral	0.30x	5.4%
Banca MPS	0.34	0.29	-15%	Underperform	0.10x	2.7%
UBI Banca	2.79	3.50	25%	Outperform	0.34x	5.1%
Italian banks					**0.43x**	**6.0%**
Eurozone banks					**0.64x**	**8.7%**

Prices as of 15/07/2016. Source: Company data, Credit Suisse estimates

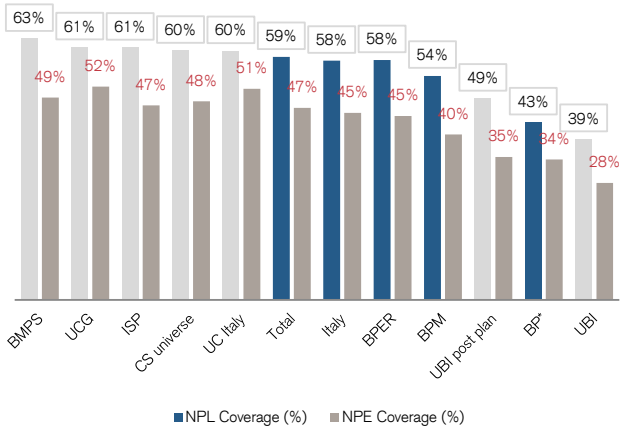
Key charts

Figure 2: Q1 16 Asset quality ratios



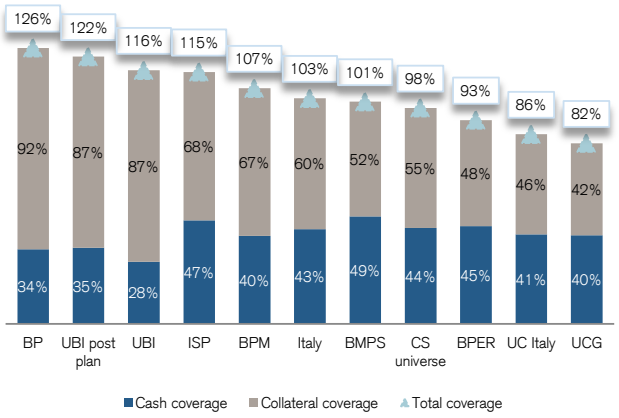
CS universe includes UCG, ISP, MPS and UBI.
Source: Company data, *Pre-the recent €1bn rights issue

Figure 3: Q1 16 Cash coverage ratios



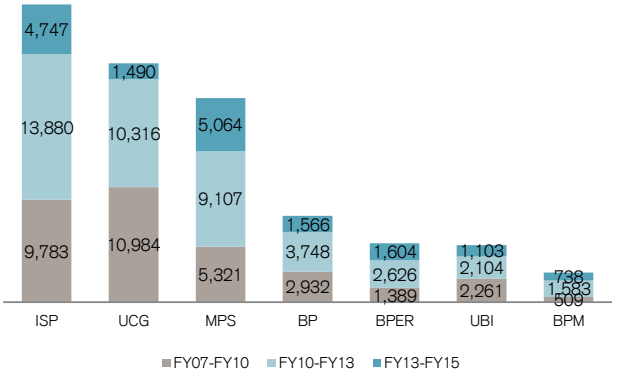
CS universe includes UCG, ISP, MPS and UBI.
Source: Company data, *Pre-the recent €1bn rights issue

Figure 4: Q1 16 Collateral and total coverage ratios



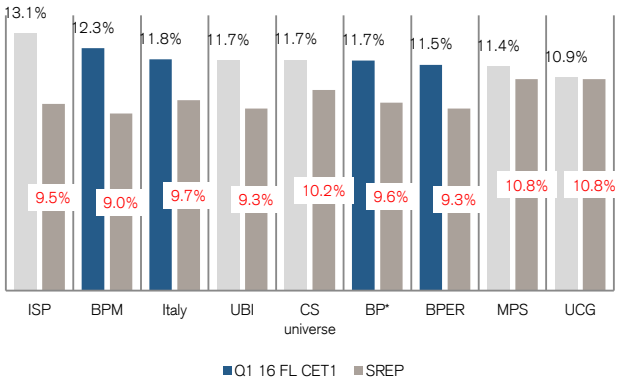
CS universe includes UCG, ISP, MPS and UBI.
Source: Company data

Figure 5: Gross NPL formation since 2007 (€m)



Source: Company data

Figure 6: Q1 16 FL CET1 and SREP requirements



CS universe includes UCG, ISP, MPS and UBI.
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Figure 7: Q1 16 Buffer/deficit to SREP requirements

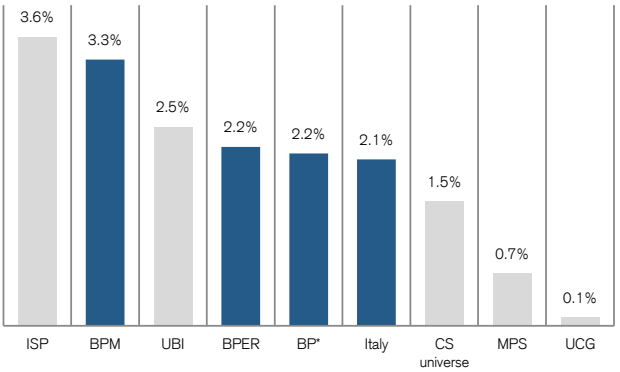

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Figure 8: Italian bank ratings, TPs and multiples

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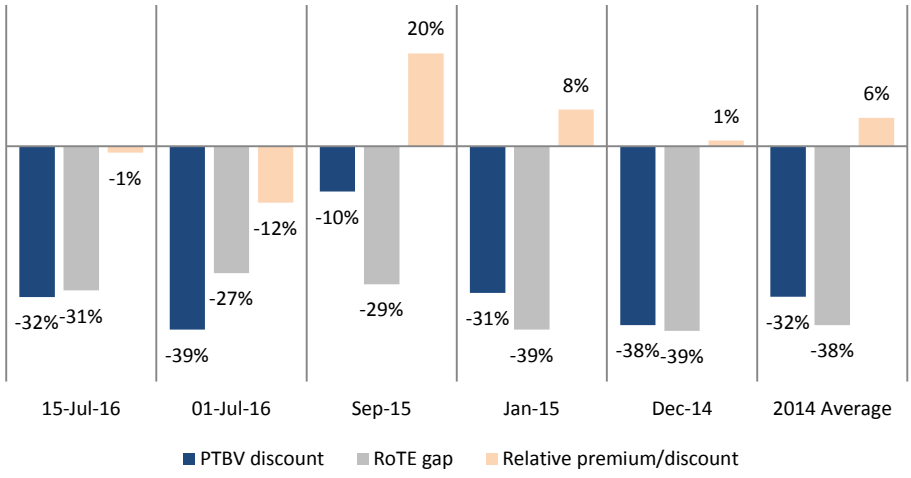
Source: Credit Suisse estimates

Figure 9: Italian banks' relative valuation

(X, %)	PTBV17E	vs. Europe	RoTE17E	vs. Europe	Relative
UCG	0.30	-53%	5.4%	-38%	-15%
ISP	0.78	21%	7.8%	-10%	31%
BMPS	0.10	-84%	2.7%	-69%	-15%
UBI	0.34	-48%	5.1%	-42%	-6%
Italy	**0.43**	**-32%**	**6.0%**	**-31%**	**-1%**
Eurozone	**0.64**		**8.7%**		
Large banks	0.54	-15.9%	6.6%	-24.6%	8.1%
Mid banks	0.22	-65.6%	5.1%	-41.9%	-23.7%
Mid vs Large banks	-59.1%		-23.5%		-35.6%

Source: Credit Suisse estimates

Figure 10: Italian banks' current and relative valuation trends



Source: Credit Suisse estimates

The Italian NPL issue: potential solutions

Figure 11: Potential solutions and their impact

Action	Nature	Amount	NPL deconsolidation Recapitalizations	NPL Price	Impact for banks	Impact for shareholders	Rule compliance	Market reaction	CSe probability (%)
Private fund (Atlante 1 or 2?) Capital from non-banks (e.g. CDP)	Private	€5-6bn	Up to €30bn	Higher than market price	Limited loss recognition	Private money to recapitalize few banks – Limited dilution	Y	Very positive	**Highly possible but limited impact on NPL stock (25%)**
Banks' coverage uplift Ahead of ECB guidance on NPLs	Private	€8bn new equity	Up to €43bn	In line with market price	Manageable loss recognition	Private money to recapitalize some banks – Limited dilution	Y	Very positive Lower systemic risk	**Highly possible but limited impact on NPL stock (25%)**
Private fund (Atlante 1 or 2?) Capital from non-banks	Private	€30-40bn	Up to €130bn	Higher than market price	Relevant loss recognition	Private money to recapitalize some banks – Relevant but manageable dilution	Y	Positive for all banks	**Technically possible – but unlikely that a private fund could raise up to €30-40bn (10%)**
Private fund (Atlante 1 or2?) Capital from banks	Private	€5-10bn	Up to €2bn for NPL €8bn for rescue banks	Higher than market price	Limited NPL loss recognition High impact on earnings and capital for rescuing banks	Profitability dilution Dividends cut Most solid banks likely to be very negatively affected	Y	Very negative Higher systemic risk	**Possible, but last resort (10%)**
TARP-2 style plan	Public	€30-40bn	Up to €130bn	In line with market value	Very heavy loss recognition	Public money to recapitalize banks Straight capital injection or bond subscribed by government at market conditions	Possible (Art 32 BRRD) / State aid issue	Positive/ Negative	**Limited (10%)**
Private fund (Atlante 1 or 2?) Capital from non-banks	Private	€30-40bn	Up to €130bn	In line with market value	Very heavy loss recognition	Private money to recapitalize some banks – Relevant dilution and implications for bondholders	Y	Negative for weak banks	**Limited – Many banks would need to recapitalize (8%)**
Foreclosure Decrees/GACS	Private Public	Limited	Limited for now	Higher than market price	Small	Positive	Y	Small positive	**Only 1 deal so far (5%)**
TARP style plan	Public	€30-40bn	Up to €130bn	In line with NBV	No loss recognition	Extremely positive	N	Very positive	**Very limited (5%)**
No actions	NA	NA	NA	NA	NPL stock up	Potentially negative implications for bondholders in case of forced clean-up	N ECB to set NPL guidance	Negative Higher systemic risk	**Very unlikely (2%)**

Source: Credit Suisse estimates

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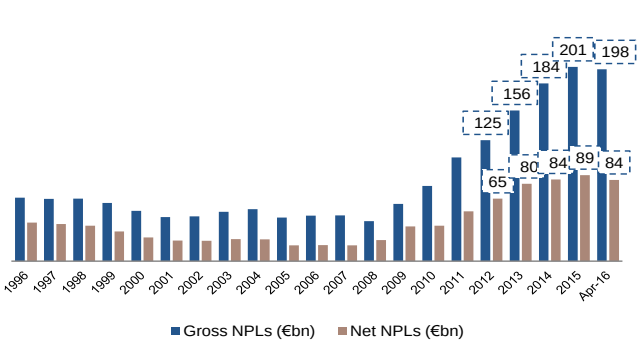
Executive summary

Italian banks' relative performance has dropped sharply this year. The Italian banking system is suffering from perceived higher systemic risk and a crisis of confidence, which the Brexit vote has further exacerbated. We believe stock prices are now factoring in a further increasing systemic risk, with MPS specifically posing a potential 'resolution risk' following the ECB's recent draft letter to the bank asking for a sizeable NPL reduction.

Worsening asset quality has been the main issue for Italian banks' profitability and capital adequacy in the last eight years: NPE jumped by €243bn to €360bn in 2015 from €117bn in 2008. In 2015, Italian banks seemed to be entering a new era with the 'Popolari' reform and the new bankruptcy law. Expectations of consolidation and a profitability uplift supported their sharp outperformance versus the SX7E and SX7P.

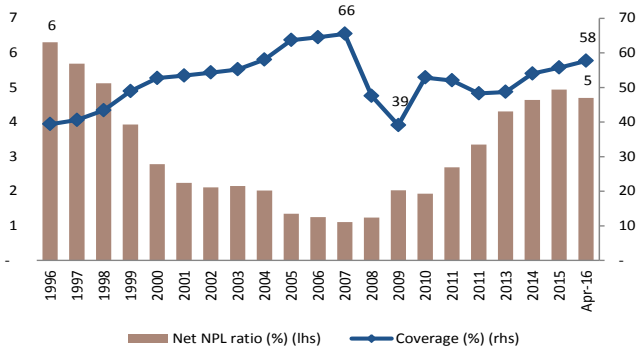
- **The systemic risk perception change: pricing in a resolution** – In November 2015 the rescue of four small local banks was a game changer that effectively meant 'game over' for Italian banks stocks' outperformance. The event lifted the systemic risk perception, setting new NPL mark-to-market standards. The recent UK referendum outcome has revived the systemic risk issue for the Italian banks sector, posing additional doubts on the capacity to manage the huge NPL stock and avoid a resolution of any fragile banks. As such, Italian banks fell ~30% vs. 20% for the SX7P in two days after the Brexit vote. In our recent report, *European Banks – Brexit not in the price*, the CS banks team showed that the Italian banks' profitability would be sharply hit by the macro economic implications stemming from Brexit.
- **The Italian government is working to avoid a banking crisis and an MPS resolution,** in compliance with the current resolution regulation. At end June, the European Commission authorized Italy to use government guarantees to provide liquidity support to its solvent banks. This is not a recapitalisation tool that could prevent a bank from a resolution, though. Media reports (e.g. La Repubblica, Il Sole 24 Ore, Bloomberg from July 4 onward) have flagged MPS as the main concern, following the ECB's recent draft letter to the bank asking for NPL reduction. We expect the government to seek a waiver of the rules under Article 32 of the Bank Recovery and Resolution Directive (BRRD), which allows "precautionary" public recapitalizations avoiding burden-sharing under special conditions.
- **Reasons for the pile of Non-Performing Exposures** – Over time, the banks had accumulated NPE which now does not seem manageable without substantial action. The high Small Business/SME exposure, the recession and an illiquid NPL market preventing Italian banks from offloading bad loans have been the main reasons for the NPL trends. Today, we believe the main issue is the wide gap in the bid-offer price for NPLs: the NPL market currently consists of a large number of forced sellers and a low number of specialist large scale buyers, according to Quaestio Capital Management, the asset manager of the Atlante fund.

Figure 12: Gross and net NPL historical trends



Source: Bank of Italy

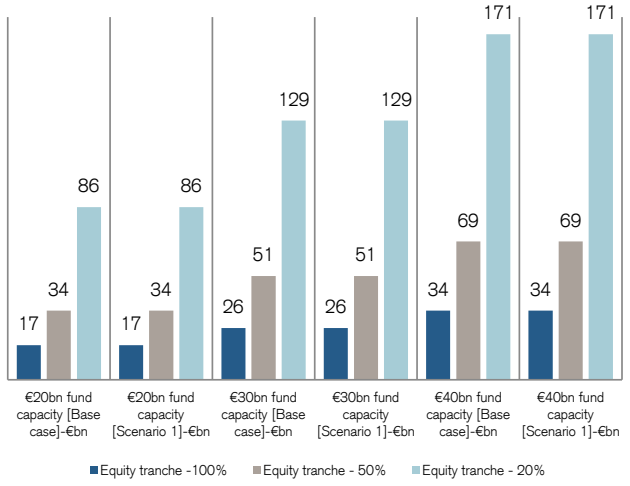
Figure 13: Net NPL ratio and coverage ratio



Source: Bank of Italy

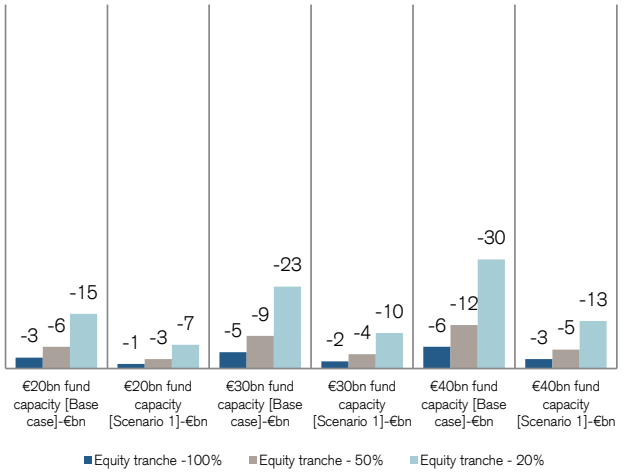
- **Many initiatives to revamp NPL market since 2015** – Public and private initiatives have been launched after the AQR in 2014 to tackle the issue. **On the public side**, the government approved two decrees (in 2015 and most recently in May 2016) to help reduce NPL recovery time. Early in 2016, a public guarantee scheme (GACS) was also approved. **On the private side**, the launch of the Atlante fund should help restart the NPL market. Atlante's mission is to serve as a backstop facility for the recapitalisation of troubled banks and to invest in NPLs in order to revamp the market.
- **Current NPL market price gap appears to be 20-34pp based on recent transactions –** The price gap is a function of the (i) NPL recovery time; and (ii) the NPL discount factor. Banks and investors use different discount factors for valuing NPLs. We see two ways to reduce the price gap: (i) higher NPL coverage; or (ii) a higher NPL price. The first implies additional loss recognition for the bank. To the extent banks are forced NPL sellers, they need to raise the discount factor used to value NPL. This implies coverage uplift (loss recognition for the bank). Alternatively, the reduction of the NPL recovery time would improve the market price. In our estimates, to narrow the price gap by 10pp, the recovery time would need to be shortened by three years and the discount factor increased by two percentage points, with each reducing the price gap by 5pp.
- **Atlante: uncertain impact in the lack of deals; current firepower too small** – The fund's capacity in terms of purchasable gross NPLs is a function of: (i) the mix of equity tranches (junior notes) that the fund could buy; (ii) the NPL price gap; and (iii) NPL coverage. Based on Atlante's current size, we estimate it could buy €4-18bn of NPLs, with banks recognising a loss depending on the price gap. The fund would achieve its goal if it were able to offer a higher NPL price than the market. However, at the current price gap the loss recognition would be heavy for banks, so banks wouldn't necessarily have an incentive to sell to Atlante versus another investor, resulting in an overall neutral impact on the market. In theory, the fund is supposed to be able to pay a higher price for banks' NPLs as the return targeted by the fund (6%) is lower than that required by other specialised investors (15% in our assumptions). Given the lack of a track record, though, we are unable to quantify Atlante's potential contribution to reducing the price gap. As such, we think banks will likely need to take additional provisions to help the disposals. On our estimates, Atlante would need to have firepower of €30-40bn and high leverage (in terms of junior/senior notes) to achieve NPL reduction of €51bn (25%) to €129bn (64%), depending on the leverage.

Figure 14: Fund size to maximize purchasable NPL



Source: Credit Suisse estimates

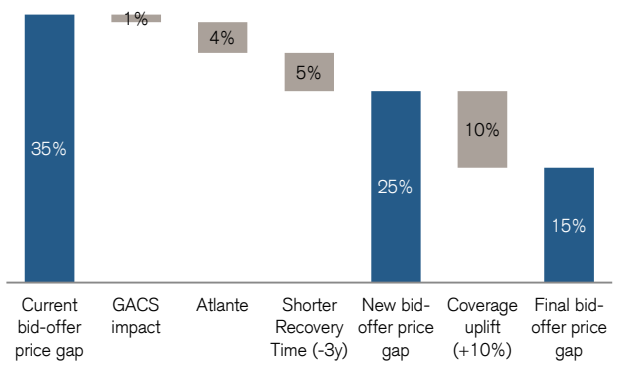
Figure 15: Potential loss recognition for banks



Source: Credit Suisse estimates

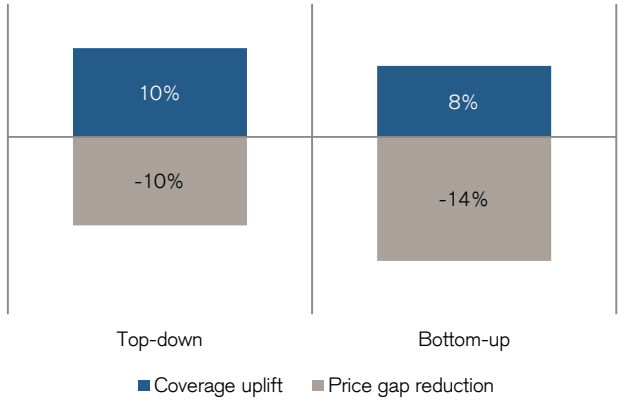
- **Who could provide €30-40bn for Atlante and solve the sector's NPL issue?** We think additional funds would need to come from other private investors other than the banks (like Cassa Depositi e Prestiti, SGA, Foundations, etc. already contributing to Atlante). However, we see potential for only €5-6bn of fresh money into the fund from new private investors. As a result, for now, we think the sector will need to rely on new government measures and raising their NPL coverage. Longer term, although the regulator does not currently allow a US-style Troubled Asset Relief Program, we think state aid may be needed to address the NPL issue.
- **Top-down approach: 10pp total price gap reduction from the new measures and 10pp from coverage uplift** – As a result of our top-down analysis, we estimate that the new measures could reduce the NPL market price gap by 10pp on average. Most of the impact would come from the foreclosure decrees (CSe: 5pp price gap reduction) while for the combined impact of Atlante and the GACS we estimate another 5pp. The overall impact from the new tools could be sizeable, but it's still uncertain. We estimate 10pp coverage uplift would be needed to help the new initiatives to become fruitful and to help revamp the NPL market. Finally, the size of the disposable portfolio depends on Atlante's purchasing capacity.
- **Bottom-up approach: with 8pp coverage uplift, we calculate up to ~14pp price gap reduction.** For our Italian banks group, we estimate the cost for reducing the bid-ask price gap from 29% to 15% would be limited to an 8pp coverage uplift, which we think is manageable for most banks. That would imply an overall -€5bn capital deficit to the Supervisory Review and Evaluation Process (SREP): under this scenario, we estimate the disposable NPL portfolio at 9-19% of the gross book value (GBV). Our stress test flags a €4-9bn capital shortfall range for UCG and €0.6-3.5bn for MPS. In our AQR's adverse scenario, MPS would likely need state aid.

Figure 16: Top-down – Price gap reduction



Source: Credit Suisse estimates

Figure 17: Price gap benefits from coverage uplift

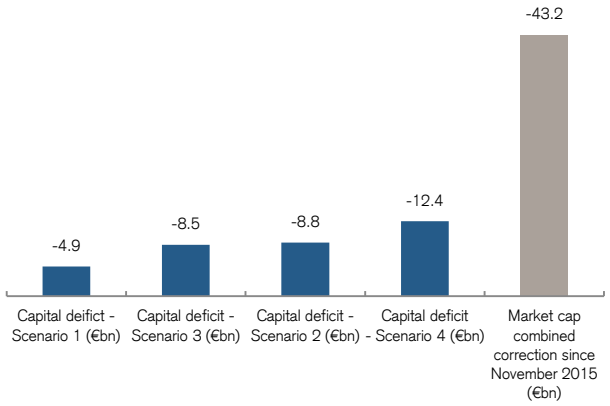


Source: Credit Suisse estimates

- **Our top-down and the bottom-up approaches reach the same conclusion: coverage uplift appears needed** – Additional loan loss recognition could create a positive loop as the other recent initiatives would start to bear fruit. We think the size of the asset quality issue is too large at this point to be remedied without substantial action. In 2012, Italy (in contrast to Spain) missed the opportunity of taking advantage of European Union funds to help troubled banks offload a big chunk of bad loans. As such, the problem has now become so large that we believe further action will be required in addition to the recent initiatives.
- **At the aggregate level, the market is currently factoring in a capital deficit larger than what we think is really needed to clean up NPLs** – For our coverage universe, we calculate a total capital shortfall of up to c.€12bn to fully clean up NPLs (i.e. to

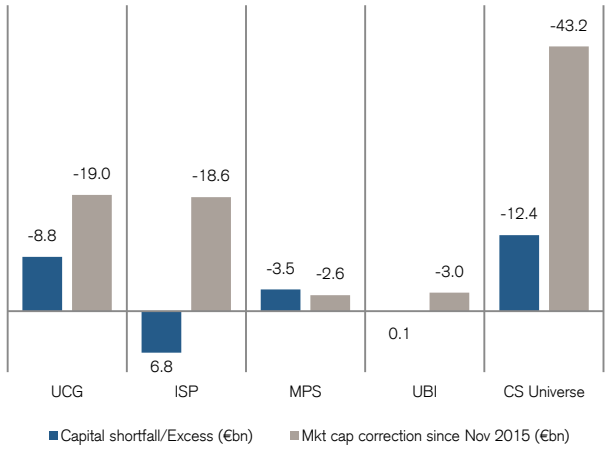
close the price gap) vs the €43bn combined market cap correction since November 2015 (when the four small local banks were put in resolution). We note that virtually all of the €12bn is at UCG and MPS. We think ISP has enough capital to potentially face the worst-case scenario and still have 240bp of excess capital on top of the SREP (or €6.8bn). We also estimate UBI would have excess capital under the adverse scenario, with €101m (20bp on top of 9.25% SREP). Our conclusions are in line with CS economists, who recently highlighted a manageable impact for Italian banks from a coverage uplift (see *Brexit contagion risk and the Italian banks*).

Figure 18: CS universe: Aggregate capital shortfalls under different scenarios vs market trends



Source: Credit Suisse estimates

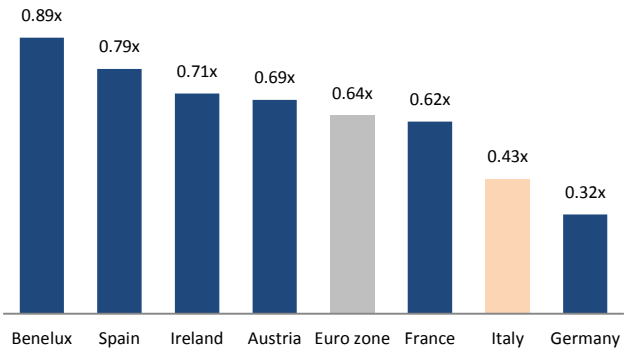
Figure 19: Capital positions by bank and aggregate in the worst case scenario vs market trends



Source: Credit Suisse estimates

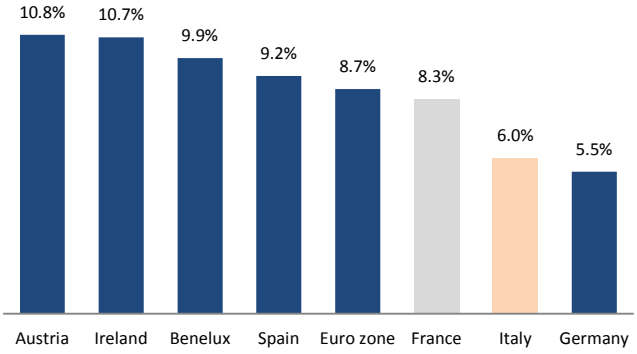
- **Italian banks are trading on 0.43x PTBV17E vs. 0.64x PTBV17E for Eurozone peers, implying a 32% discount.** Italian banks' average profitability lags behind at ~6% RoTNAV17E, and profitability is 31% lower than Eurozone peers. In terms of relative valuation (i.e., the difference between the PTBV gap and the RoTNAV gap), Italian banks now are trading at slight discount (-1%) to Eurozone peers, which looks attractive compared to the premium in recent years. In 2014, Italian banks' relative valuation stood at an average 6% premium, while in 2015 it jumped to a 15% premium before the resolution of the four small local banks. On 1 July, Italian banks showed a -12% relative discount (an all-time-low), which has since closed in less than a month: at the current levels the sector is still factoring in higher than average systemic risks.

Figure 20: PTBV17E by country



Source: Credit Suisse estimates, the BLOOMBERG PROFESSIONAL™ service, © 2016 Thomson Reuters

Figure 21: RoTNAV17E by country



Source: Credit Suisse estimates, the BLOOMBERG PROFESSIONAL™ service, © 2016 Thomson Reuters

Stock calls

Our stock selection is based on the banks' capital and balance sheet positions. We prefer stocks that have shown resilience in our bottom-up stress test (please see "The cost of a coverage uplift" section). ISP and UBI were the most resilient, showing excess capital even in our adverse scenario. UCG and MPS were the weakest, with fragile balance sheets and capital shortfalls of €4-9bn and €0.6-3.5bn, respectively.

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Source: Credit Suisse estimates

- **Intesa-SanPaolo (Outperform, €2.5 TP):** ISP has: (i) one of the most robust capital ratios in the Eurozone (~13%) FL CET1 in Q1 16); (ii) the highest profitability among Italian peers (7.2% adjusted RoTNAV15 vs 5% of the four banks under CS coverage); (iii) a high reliance on fee income (43% of 2015 revenue) and Private Wealth Management (~23% of revenue); (iv) the strongest asset quality ratio among Italian peers (an 8% net NPE ratio in Q1 16); and (v) a high dividend distribution capacity (90% average pay-out ratio, 13.3% dividend yield 2016E) on our numbers.

  At 0.77x PTBV16E ISP trades at a premium to Italian peers (0.44x), justified by its robust capital, solid balance sheet structure and superior profitability. However, at current levels, we think the stock is factoring in the risk of dividend cut from potential M&A action (for example, a forced rescue of a weaker bank) or further participation in any rescue fund. Risks to the downside are: (i) a potential regulatory cap on dividend distribution, (ii) additional pressure on NIM, (iii) a potential slowdown in asset management as a result of market turbulence, (iv) further hits to earnings/capital from participating in rescue funds (i.e., the one for the four local banks in November and/or Atlante), (v) potential dividend cut as a result of participating in any rescue fund; and (vi) M&A risk: a forced rescue of any fragile bank.

- **UBI Banca (Outperform, €3.5 TP):** At 0.35x PTBV16E, we think the current share price does not factor in the robust capital position (~12% FL CET1 in Q1 16) and the solid balance sheet. However, at current levels, we think the stock is factoring in a risk of further participation in any rescue fund. We think the recently announced business plan appears credible and shows short-term and long-term catalysts. The main pillars of the plan: (i) minority buyout to optimise the cost structure; (ii) the usage of the shortfall to expected loss to improve NPL coverage and the bad loans stock; and (iii) a strategy based on the asset management business in order to reduce NII reliance.

  Risks to the downside include: (i) execution risk of the plan's demanding revenue targets (mainly net fees), (ii) the asset management business potential slowdown as a result of market turbulence, (iii) further hits to earnings/capital from the participation in resolution/rescue funds (like the one for the four local banks in November and/or Atlante), and (iv) M&A strategy.

- **Unicredit (Neutral, €2.28 TP):** At current levels, we think UCG already discounts ~€6bn capital shortfall. UCG can count on ~10.9% FL CET1 (Q1 16) and a stretched 10bp buffer above SREP requirements. In 2015, UCG reported a weak 4.2% adjusted RoTNAV, slightly above the Popolari banks' profitability. The main drags on profitability are: (i) the Italian banking operations, harmed by a very large NPL stock; and (ii) the German and Austrian operations, affected by the high cost base. We think UCG's strategic options could be: (i) a straight capital raise; (ii) the disposal of core and non-core assets; or (iii) a mix of the two.

  In terms of potential asset sales, we would highlight the profitable Bank Pekao stake (now c41%) and the Yapi Kredi Bankasi stake (held through Unicredit's c50% stake in KOC Financial Services, which owns c80% of Yapi), and stakes in Fineco and Pioneer. UCG recently placed 10% stakes in Fineco and Pekao on the market, raising ~20bp CET1, and we expect more to come. However, we doubt the recent political events in Turkey will be helpful for a Yapi disposal scenario at this point: we think UCG may see some asset devaluation and a lower profitability contribution in the short term.

  UCG's valuation may appear compelling at current levels (0.30x PTBV16E vs. 0.44x of Italian peers), but the stock is not particularly attractive assuming a RoTE17E below 6.5% post a capital raising. The return to solid profitability, combined with balance sheet and capital repairs are large challenges for the newly appointed CEO. Downside risks include possible prolonged overhang risk in a rights issue scenario, potential dilution in the event of deconsolidating subsidiaries that are more profitable than the rest of the group, disappointing cost savings delivery, execution risk on net fees target and exposure to Turkish political uncertainty. Risks to the upside: a mix of capital management actions able to optimize capital accretion and minimize profitability dilution, potential Austrian business disposal without negative impacts, and a large NPL deconsolidation at a low gap to the net book value.

- **Banca MPS (Underperform, €0.29 TP):** Trading on 0.1x PTBV16E, we think the stock is partly factoring in the risk of a resolution or a bailout. The uncertainties related to additional potential coverage uplift stemming from the forthcoming EBA stress test publication on 29 July pose further risks to capital. We think a potential shortfall of more than €1bn (slightly above the current market capitalisation) could be difficult to manage without state support or the application of the BRRD rules (bail-in) or a state aid. The bank's very large NPL stock is the main issue. At a 18% net NPE ratio (7% net NPL ratio), MPS has among the worst asset quality ratios in Italy (along with Unicredit's Italian subsidiary). MPS has a 11.4% FL CET1 (Q1 16), 65bp above the SREP requirements. This buffer is in the low range of Italian banks (150bp for the four banks under CS coverage; 170bp including other Italian banks). The stress test will not impose a hurdle, in our view, but the outcome of the adverse scenario could be included in the new SREP requirement, forcing a potential NPL coverage uplift and a capital strengthening. In early July, the ECB sent a draft letter to the bank asking for a €14bn reduction of NPL GBV (-31%) by 2018 vs the €11.5bn already planned. The ECB is also imposing a 20% gross NPE ratio target (from the current 34%), which could represent a new reference for other Italian banks in terms of gross NPE ratio. In our view, the most likely outcome could involve a large NPL disposal subsidized by Atlante: a positive for the stock in the short term, but structural weakness remains.

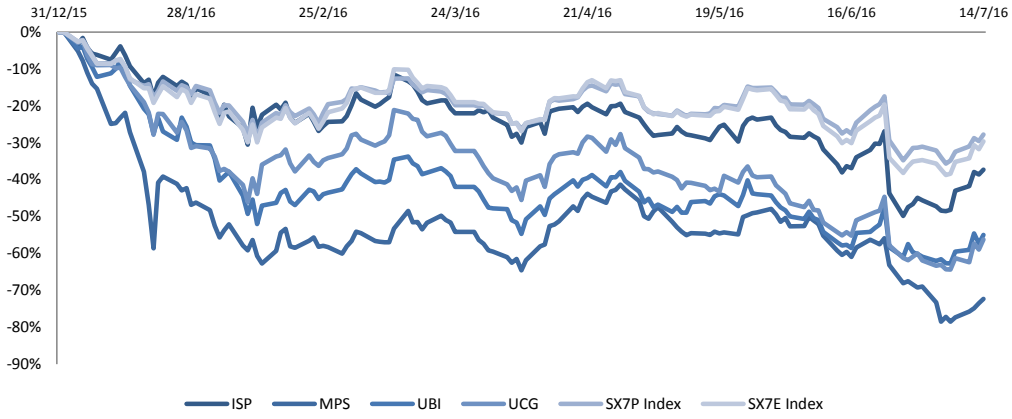
  Downside risks to our TP include: execution risk on the demanding revenue targets, execution risk on NPL stock reduction, and uncertainties related to the forthcoming EBA stress test in terms of additional SREP requirements. The main upside risks are disposal of a big chunk of NPLs at a price close to the NBV and potential favourable M&A scenarios.

Performance and valuation

Absolute and relative performance has fallen sharply year to date

Italian banks' relative performance has dropped this year. After the rescue of the four small local banks in November 2015, the outperformance posted last year reversed, touching lows this year comparable with the sovereign crisis in late 2011. We think Italian banks are suffering from perceived higher systemic risk and a crisis of confidence, which the Brexit vote further exacerbated, posing additional doubts on the capacity to manage the huge NPL stock and avoid a resolution of some fragile banks. The stock prices now appear to be factoring in a 'resolution risk'.

Figure 23: Italian banks performance vs SX7E and SX7P (YtD)

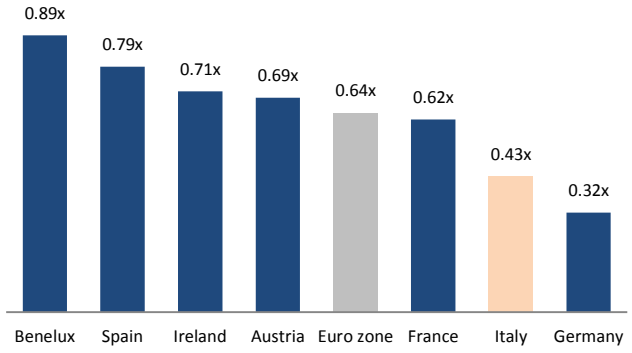


Source: © 2016 Thomson Reuters

Wide valuation gap to Eurozone peers

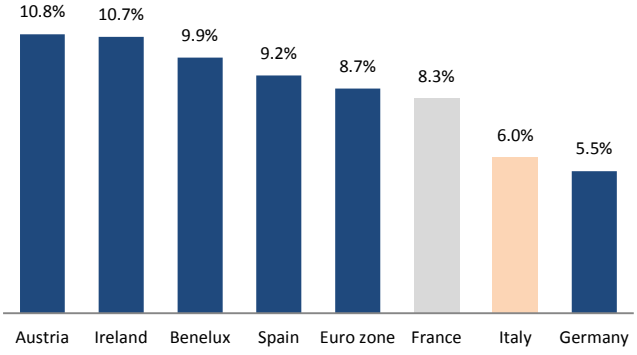
Italian banks are trading on 0.43x PTBV17E vs. 0.64x PTBV17E for Eurozone peers, implying a 32% discount. Italian banks' average profitability lags behind at ~6% RoTNAV17E, with profitability 31% lower than Eurozone peers.

Figure 24: PTBV17E by country



Source: Credit Suisse estimates, , the BLOOMBERG PROFESSIONAL™ service, © 2016 Thomson Reuters

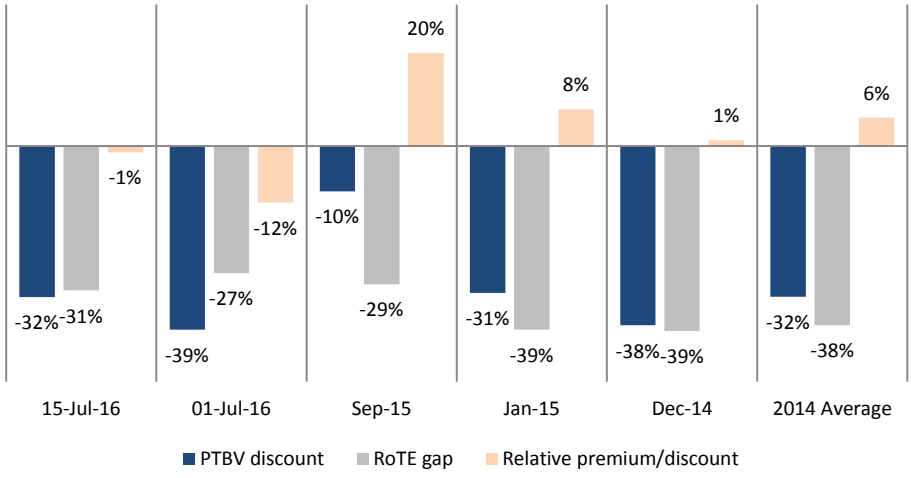
Figure 25: RoTNAV17E by country



Source: Credit Suisse estimates, the BLOOMBERG PROFESSIONAL™ service, © 2016 Thomson Reuters

In terms of relative valuation (i.e., the difference between the PTBV gap and the RoTNAV gap) Italian banks now are trading at a slight discount (-1%) to Eurozone peers, which looks attractive compared to the premium in recent years. In 2014, Italian banks' relative valuation stood at an average 6% premium, while in 2015 it jumped to a 15% premium before the resolution of the four small local banks. On 1 July Italian banks showed a -12% relative discount (an all-time-low), which has since closed less than a month: at the current levels the sector is still factoring in higher than average systemic risks.

Figure 26: Italian banks' current and relative valuation trends



Source: Credit Suisse estimates

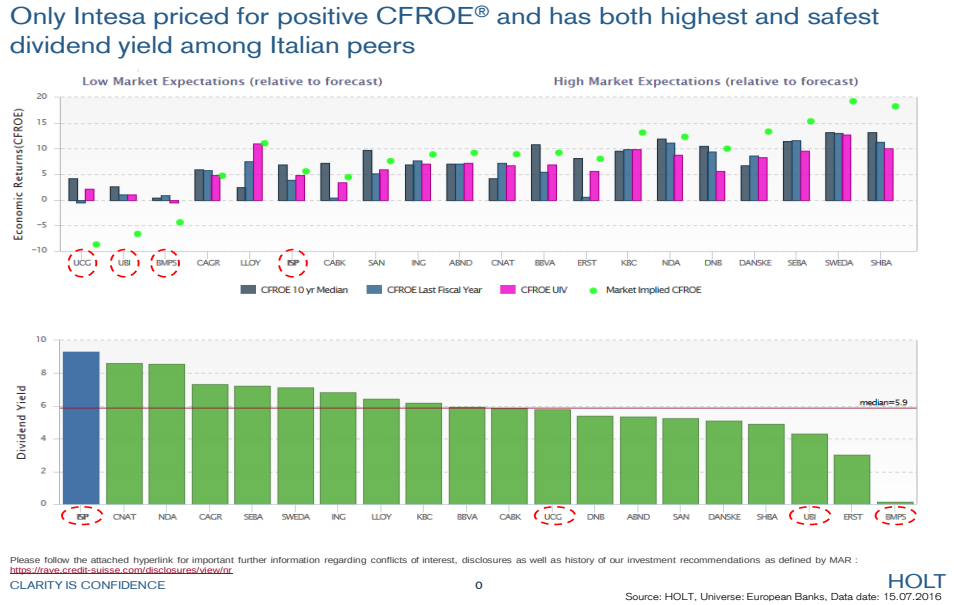
We think Italian banks' valuation multiples are discounting high risks on capital ahead of the stress test results, expected on 29 July. Current valuations are attractive versus historical levels, but more severe capital requirements could put further pressure on the banks. We think the key market concerns are: (i) the NPL stock; (ii) the difficulty in offloading the bad loans at a price which does not result in additional charges to the P&L and capital; (iii) more recently the stress test; and (iv) the prospect of a fragile bank potentially being put in resolution or backed by state aid.

With the above mentioned in mind, we recommend focusing on banks whose capital positions look best able to pass the stress test in an adverse scenario.

The HOLT® view on Italian banks

Credit Suisse HOLT® is useful in getting a sense of what current valuations imply for future growth and returns beyond our forecast horizon (ending in 2018E). On a CFROE basis, only ISP shows a positive outcome. We flag that "HOLT default" does not capture balance sheet- and capital-specific situations, as such UBI ranks below UCG. We think overly depressed market expectations represent a potential buying opportunity for UBI.

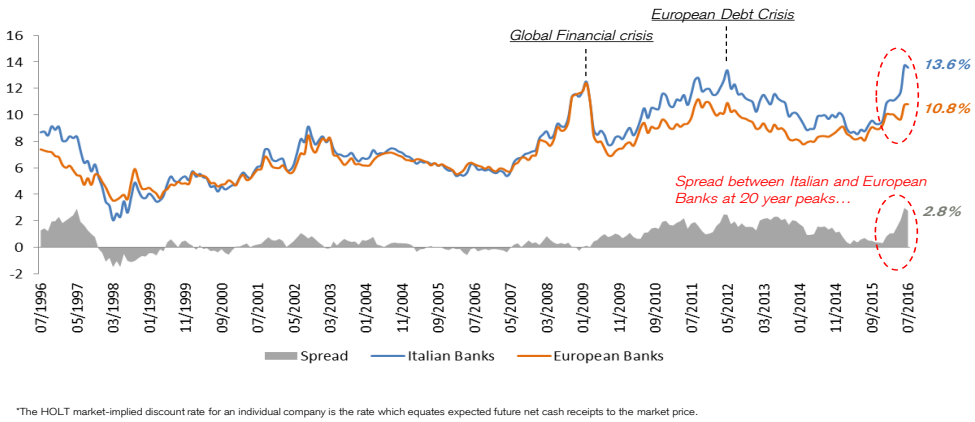
Figure 27: HOLT view – Positive CFROE for ISP only



Source: Credit Suisse HOLT

HOLT suggests that the market is currently factoring in the widest gap between Italian and European banks, in terms of cost of equity.

Figure 28: Italian banks vs. European banks – Valuation discount at the peak



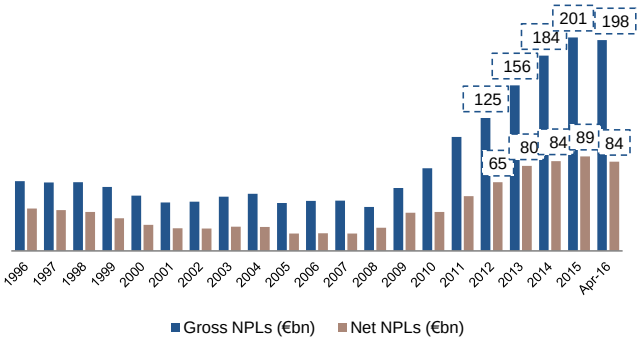
Source: Credit Suisse HOLT

Asset quality: an undesirable heritage

Italian Non Performing Exposures – the numbers

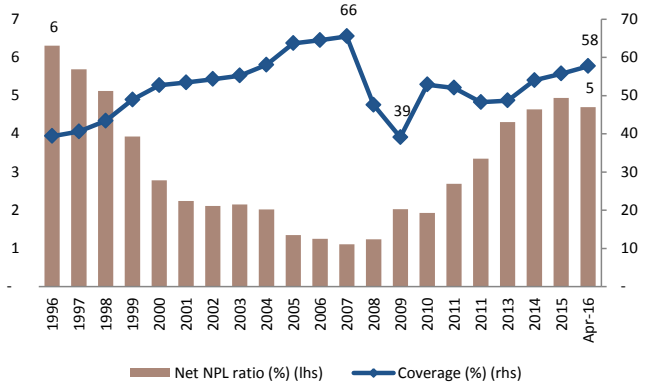
Italian banks' bad loans (non-performing exposures, or NPE) recently reached another historical peak, touching €360bn at end March 2016 (Bank of Italy data), of which €197bn was NPLs. If we consider the NPE universe, the ratio over total private sector loans is 25.5%, or 19.7% of Italian GDP. Limiting the scope to NPLs, this amount represents 14% of the total private sector loans and 10.7% of Italian GDP.

Figure 29: Gross and net NPL historical trends



Source: Bank of Italy

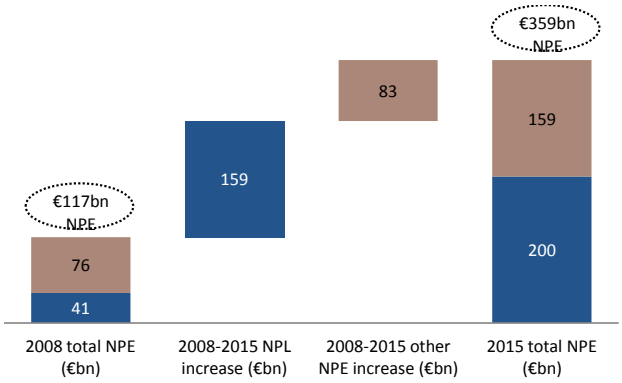
Figure 30: Net NPL ratio and coverage ratio



Source: Bank of Italy

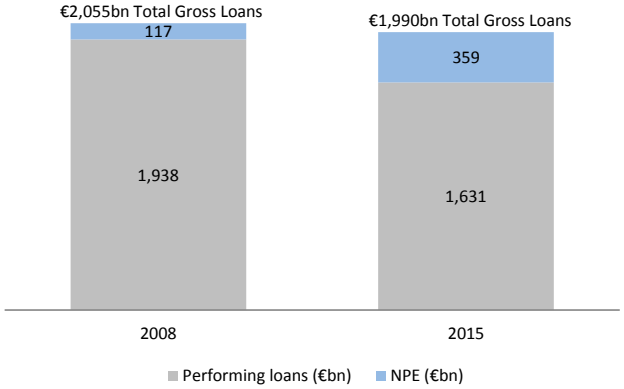
Since 2008, total gross customer loans (including NPE) has declined from €2,055bn to €1,990bn, or -0.5% CAGR 2008-15. The gross customer loans breakdown provides a more granular reading of performing and bad loans trends.

Figure 31: 2008-2015 NPE trends



Source: Bank of Italy

Figure 32: 2008-2015 customer loan trends



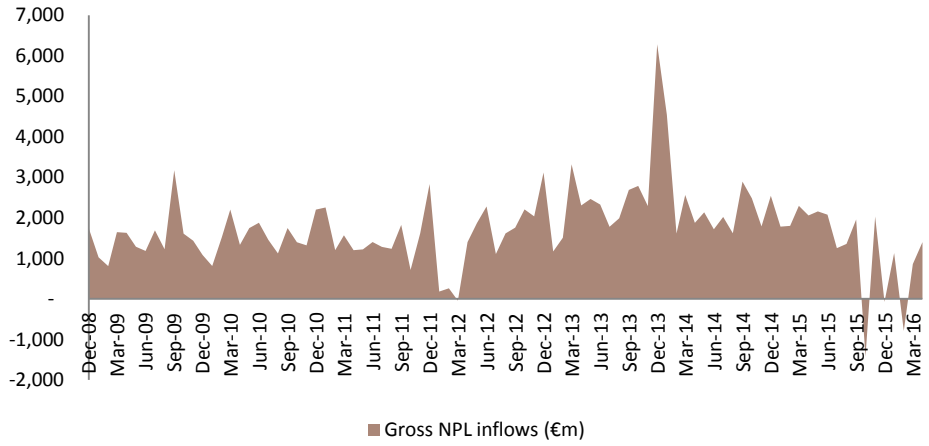
Source: Bank of Italy

Performing loans fell by -2.4% CAGR in 2008-15, while NPE rose at a CAGR of 17.4%. In seven years, the NPE stock more than doubled, jumping to €360bn from €117bn, with the €243bn increase being 2.1x the initial stock in 2008. Over the same time span, NPL stock skyrocketed by €159bn (3.9x the initial stock in 2008) from €41bn to €200bn, which is the bulk of the NPE jump. New NPE formation is focused in the corporate loans segment, which posted a €127bn NPLs jump over 2008-2015 (out of €159bn).

Recent NPL evolution and transactions

Bank of Italy and the Italian Banking Association (ABI) showed further €1.1bn new NPL formation in Q116 (adjusted by the recent market transactions). In Q415 and Q116, ~€6bn of gross NPL was sold out of ~€19bn since 2012. The larger chunk of NPL disposal took place in Q115, with the UCCMB deal (UCG's NPL management platform).

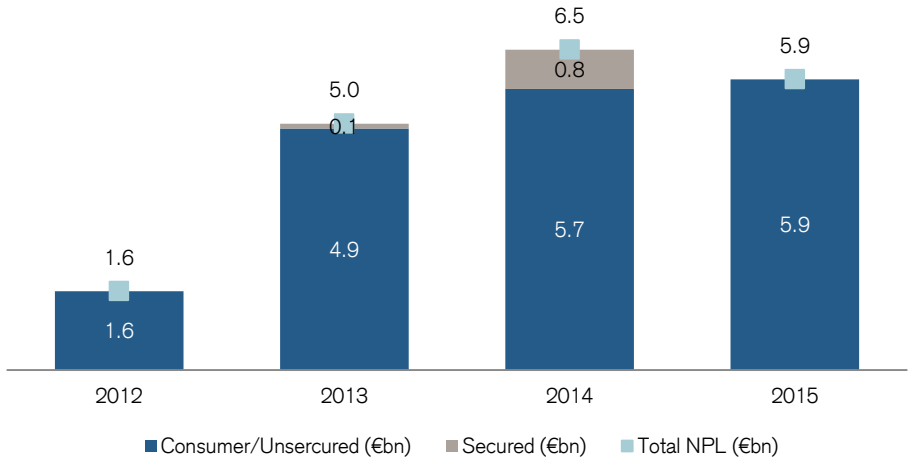
Figure 33: New NPL formation



Source: Italian Banking Association (ABI)

In Q315, the market showed some signs of recovery, even though the bulk of NPLs sold by banks to date was largely made up of consumer and unsecured bad loans (95% of the market transactions). The high coverage of unsecured NPLs, almost in line with the market price (3-5% of the face value) helped the closing of many deals. Secured NPLs still show a wide bid-offer price gap, as banks and investors base their NPL valuations on different discount factors. The long recovery time also has an impact on NPL valuation, as we'll explain later in the section "NPL market price and net book value: reasons for the difference".

Figure 34: Most recent NPL transactions



Source: Cerved, Credit Suisse research

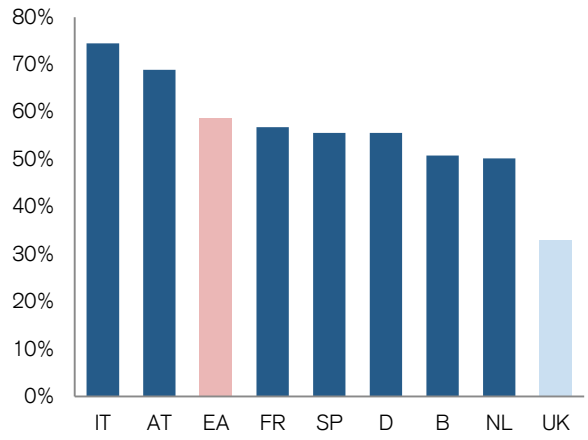
The reasons for the NPE pile

Italian banks have very high NPE ratios for three reasons: (i) the high gearing to corporate loans, due to the underdeveloped corporate bond market; (ii) the recession hitting the Italian economy in recent years; and (iii) the long foreclosure duration process.

1) High gearing to corporate loans

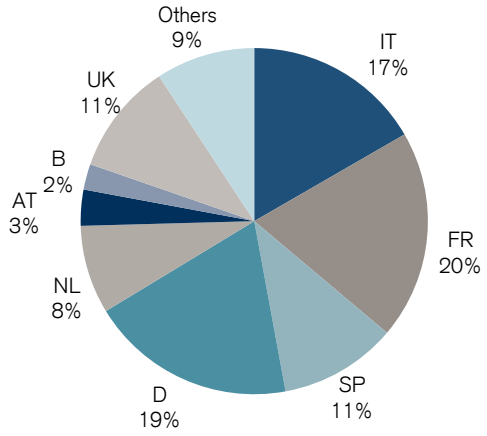
Banks provide most enterprises' funding needs. The average corporate size ranges from very small to medium at best, as the industrial backbone has been based historically and culturally on families. The average turnover of an SME can range between €3m and €50m. This industrial structure has not enabled the development of a large corporate bond market, while the government has not put in place legal and fiscal measures to accelerate the process.

Figure 35: Corporate and other than mortgage lending as a % of aggregate private sector loans



Source: ECB Statistic bulletins, Credit Suisse estimates

Figure 36: Corporate loans by country as a % of total aggregate corporate loans



Source: ECB Statistic bulletins, Credit Suisse estimates

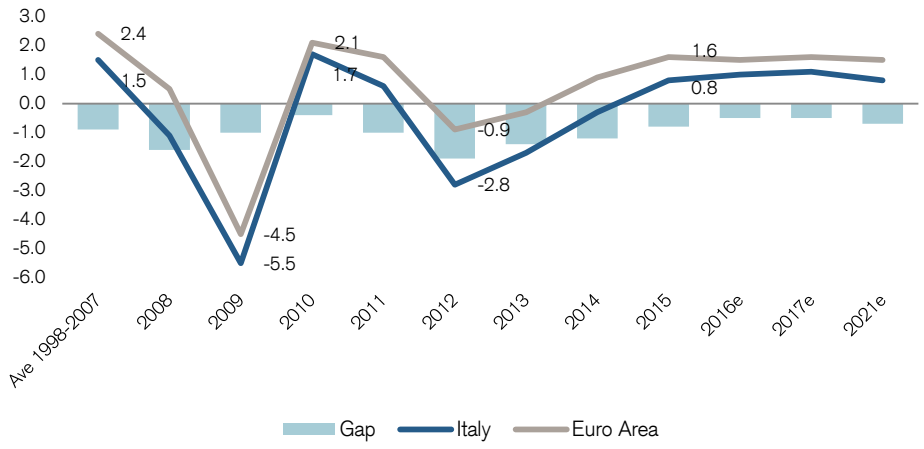
This has created a special situation: Italy is unique in its high gearing to corporate lending (Figure 35) and relatively low gearing to mortgage lending. With ~€800bn out of €4.7tn total loans, Italian corporate loans represent 17% of the European market including the UK (Figure 36); 19% assuming Eurozone only. As banks are the most important funding source for enterprises, the weight of corporate loans is a relevant factor for NPE trends. Corporate loan quality is a function of the firms' performance, which in turn is broadly reliant on the macroeconomic backdrop.

2) Macroeconomic turmoil

An economy heavily geared to corporate loans can suffer from a sharp and fast NPE increase in times of macroeconomic turmoil. The Italian economy was heavily hit by the global crisis in 2008. The recent years of recession have hit businesses hard, with bankruptcies driving NPE to new peaks.

Italian GDP has historically been a laggard in the euro area: during the 1998-2007 decade it showed a -0.9pp average gap, but the GDP trend was still positive. Since 2008, the gap has widened to -1.2pp, while GDP fell by 5.5% in 2009 and by 2.8% in 2013. In 2015, GDP normalized to growth of +0.8%.

Figure 37: Italian vs. Euro Area GDP trends (%) – Actual and forecast

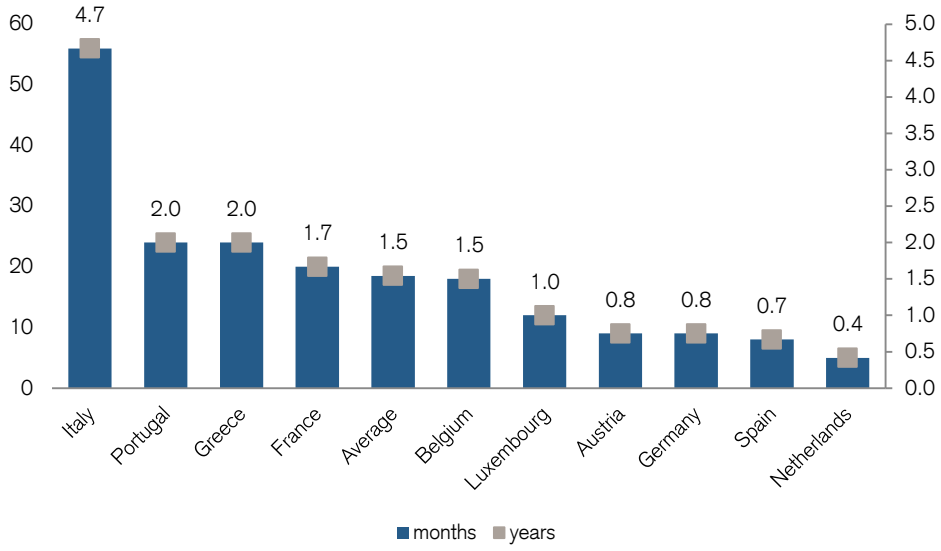


Source: IMF

3) Longest bad loan recovery time in Europe

Italy has an undesirable record of having the worst recovery time among European countries. As reported in the June 2016 issue of the International Central Banks Journal, Italy shows 56 months as the typical duration of foreclosure procedures. Greece and Portugal show quicker procedures with 24 months each. Among Southern European countries, Spain stands out with only 8 months.

Figure 38: Average duration of foreclosure procedures in the Eurozone

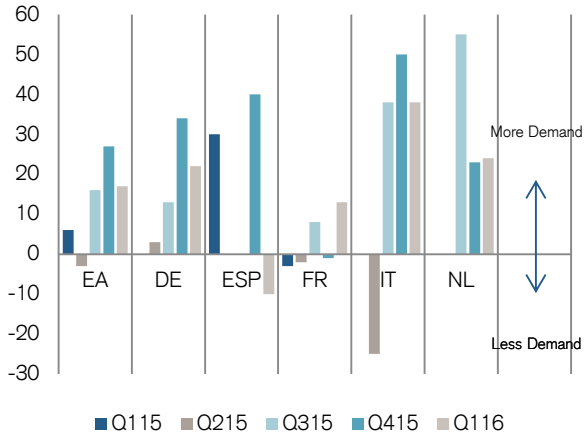


Source: The International Journal of Central Banks

NPE pile aftermath: a slow transmission mechanism

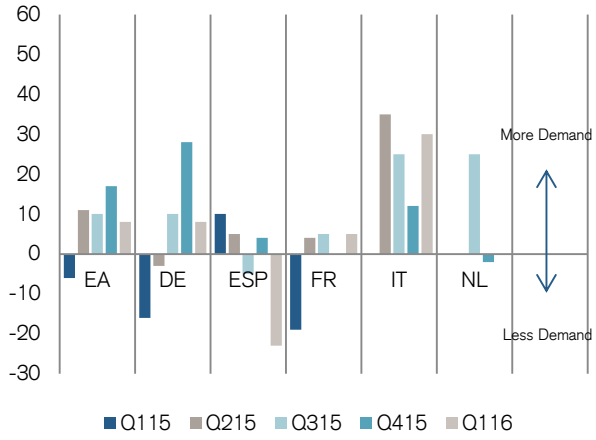
The huge amount of stock has impacted monetary policy's transmission mechanism in the last four years, as banks have been focused on keeping asset quality under control rather than expanding the loan book. As highlighted by Figure 32 on page 15, performing customer loans stock fell by €307bn in 7 years, or 17% of Italian GDP, partly replaced by NPE (+€243bn). This trend is the result of the deep recession hitting the Eurozone during the latest crisis. The ECB has launched a number of measures to stimulate the Eurozone economy, including the LTRO, TLTRO I and TLTRO II programs. For Italy, we think the positive impacts of the ECB's quantitative easing (QE) were lower than expected: private sector loans have posted only a shy recovery so far.

Figure 39: Corporate loans demand by country (%)



Source: ECB Quarterly Survey, Credit Suisse Research

Figure 40: Loans demand for fixed investments (%)



Source: ECB Quarterly Survey, Credit Suisse Research

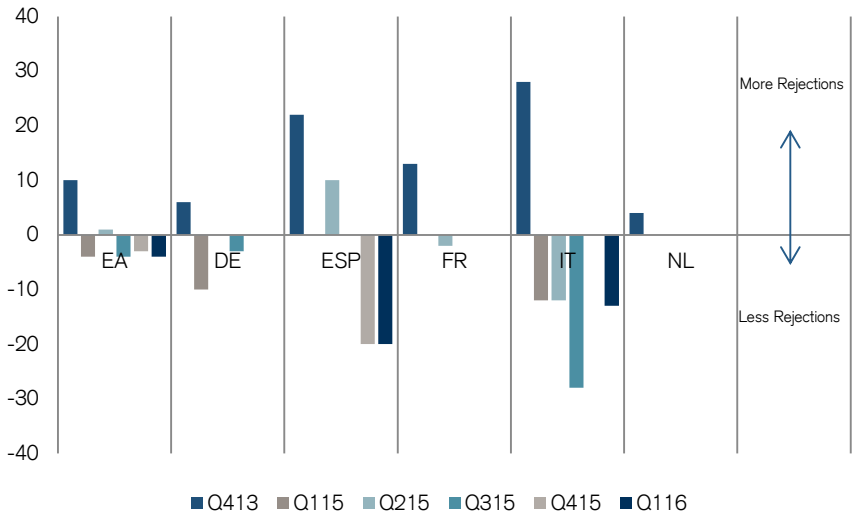
However, the situation is improving: the ECB lending surveys have reported a solid recovery in corporate loan demand since Q115, also driven by fixed investment, hinting at a return of demand quality.

Until 2014, many corporate loan applications were rejected by Italian banks as the focus was balance sheet repair. More recently, however, the ECB lending survey has flagged a reduction of corporate loan rejections in Italy since 2015.

With the recent economic recovery and the easing of monetary conditions (QE), the financial situation of Italian firms has improved, though at a modest pace. At the aggregate level, the decline in lending has been attenuated, but credit access has been still further differentiated according to risk. After a prolonged decline, lending by banks has shown signs of stabilization. While loans are increasing for enterprises whose economic and financial conditions are relatively sound (in particular the largest corporations), credit to small firms has continued to shrink.

The ECB quarterly and the Istat manufacturing surveys are reporting a decline in corporate loan rejections, but noting some difficulty in accessing credit for small firms, although less marked than before.

Figure 41: Corporate loans: net rejections trend (%)



Source: ECB, Bank of Italy, Credit Suisse Research

The rejections decline is a direct function of credit standards. Credit standards are in turn a function of: (i) cost of funds and balance sheet constraints; (ii) pressure from competition; (iii) perception of risk; and (iv) banks' risk tolerance.

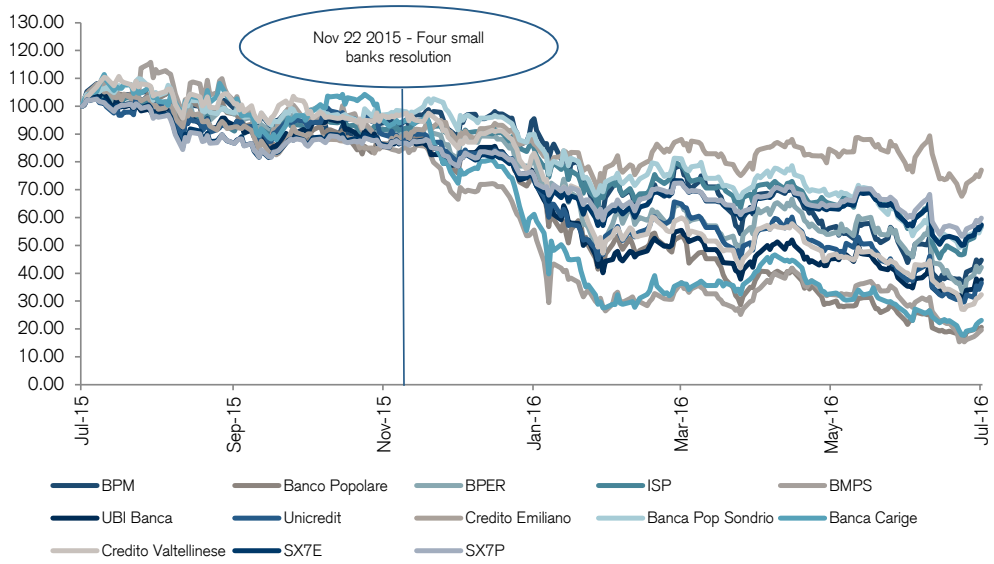
For Italian banks, we think increasing pressure from competition combined with a lower risk perception have been the main drivers of the declining rejections trends. However, banks have become more selective as they have been easing credit access to large and lower-risk corporates only.

A game-changer for systemic risk

In November 2015, four small local banks—Banca Marche, Banca Etruria, Cassa Risparmio di Ferrara and CariChieti—were hit by the first bail-in in Italy, totaling ~€4bn cumulative losses. The banks put in resolution were split and grouped into a new 'good bank' and a 'bad bank'. Shareholders and subordinated bondholders absorbed the banks' losses, grouped in the bad bank, where NPLs were moved once marked down by ~20%, to ~80% coverage from a 60% sector average. This very large mark-down was imposed by the European Commission. The largest Italian banks were required to contribute to a resolution fund (with a contribution proportional to their domestic market share), which represented the capital of the new good bank.

This event triggered the following consequences for the sector: (i) a reputational issue, resulting in higher volatility in deposits, mainly for small banks; (ii) increasing investor concerns about capital adequacy; and (iii) raising concerns on the asset quality situation, as the mark-down applied on NPLs on the rescued banks' books set a new standard for NPL coverage. Overall, the event increased the perceived systemic risk for Italian banks, hitting their stock performance since then.

Figure 42: Italian banks stocks and SX7 annual performances

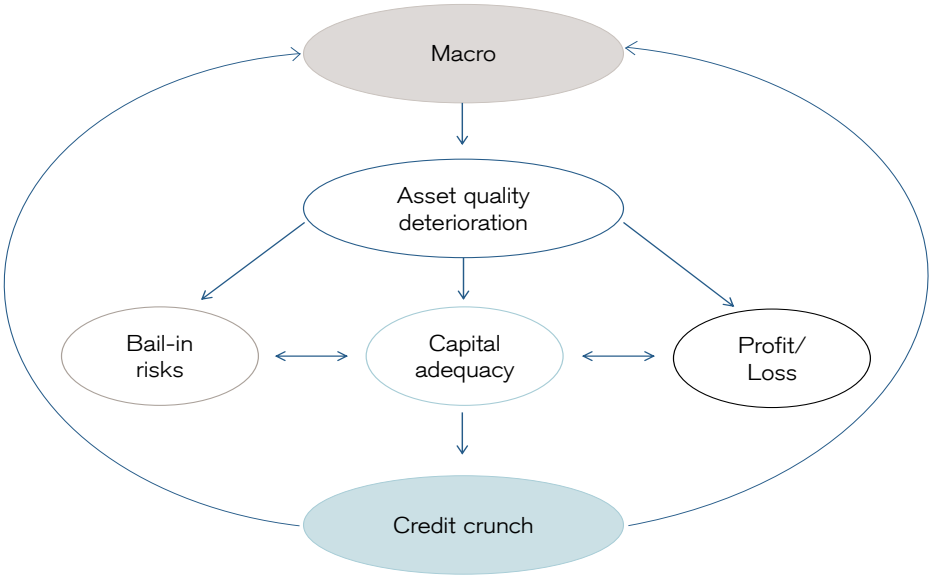


Source: © 2016 Thomson Reuters

The impact of asset quality

Asset quality has a central role for the economy and for banks' fundamentals. A worsening in asset quality sharply impacts on profitability, resulting in a fast deterioration of capital ratios and higher bail-in risks for the system. As such, the final result of this cycle is the impact on the macro due to banks' reluctance to expand their loan books. Under this scenario, the priority of banks is loan book clean-up.

Figure 43: Asset quality's central role for the economy and banks' fundamentals



Source: Credit Suisse research

Deteriorating profitability and unresolved legacy challenges (NPE stock) raise the risk that external capital and funding could become more expensive, particularly for weaker banks with very low equity valuations (PTBV of less than 60%), pointing to weak future prospects. Italian banks face a particular challenge in this regard, as market pricing has reflected investor concerns that some banks may face difficulties in growing out of their substantial NPL overhang, despite the constructive steps taken by Italian authorities to facilitate balance sheet repair. In theory, addressing the asset quality issue and strengthening the banking system should enhance the transmission mechanism through the banking system, increase confidence, and mitigate any adverse side effects of, and the need for, more negative rates.

The next challenges from the authorities

The European Banking Authority will publish the results of its latest stress tests on 29 July. Although these stress tests aren't designed to fail specific lenders, the European Central Bank could ask banks to raise more capital in their wake. Later this summer, the ECB plans to publish draft guidance on how banks should deal with NPLs.

ECB guidance on NPLs

The high level of non-performing loans remains one of the biggest problems for the Eurozone: the ECB is working on new proposals to fix the issue, according to Daniele Nouy, the chair of the Supervisory Board at the ECB (IIF meeting in Madrid on May 24; investors' conference in Paris on June 8).

Battling the legacy of its debt crisis, Eurozone banks still hold around €900bn of non-performing loans, limiting their ability to extend fresh loans and holding back growth. Italy could be either hit by or benefit from the measure as domestic banks have ~€200bn NPLs (or 22% of the region's total amount).

Nouy mentioned that **"Eurozone banks will be able to choose how fast they want to work off their bad loans under new guidelines due to be published by the ECB"**. She suggested a clean-up process would not start for several months and bankers would still be given discretion about how quickly they want to tackle the problem. In effect, then, the competent authorities (CAs) would leave bankers to decide whether they want to move faster or address them more gradually, in which case they would have to carry them for a longer period of time.

Nouy added that the ECB would talk to banks individually, suggesting the supervisor would be open to taking a tailored approach for each bank, rather than one-size-fits-all. High amounts of bad loans have been a problem in crisis-struck countries such as Greece and Italy, and the ECB has made tackling the issue one of its priorities for this year.

The ECB is close to publishing a report on non-performing loans, and banks will have the chance to give feedback on it before it becomes part of the ECB's supervisory guidance.

We cannot rule out the new guidance could require additional loss recognition on the banks' balance sheets. On 4 July, MPS announced that it had received a letter from the ECB requesting the reduction of NPL stock by 40% (NBV) by 2018. In the letter, the ECB also set a gross NPE ratio target at 20% (from 34% in Q1 16).

We think the MPS letter could be the first read-across in terms of NPL guidance from the ECB, although it seems somewhat contradictory to previous statements by authorities in May and June.

The forthcoming stress test: SREP requirements on the rise?

Before the publication of any guidance from the ECB, the EBA will perform the stress test on 51 banks representing 70% of EU banks' total assets. In 2016, the stress test will not be preceded by a coordinated EU-wise asset quality review (AQR) as was the case in 2014. The asset quality assessment is regularly undertaken by CAs as part of their supervisory work. The results of the EU-wide stress test are expected to be published in early Q3 2016 (29 July). The guidance of the 2016 stress test provides for the following main points:

- The 2016 EU-wide stress test does not contain a pass/fail threshold and instead is designed to be used as a crucial piece of information for SREP in 2016.
- The results will thus allow competent authorities to assess banks' ability to meet applicable minimum and additional own funds requirements under stressed scenarios based on a common methodology and assumptions.
- If CAs identify capital shortfalls leading to potential breaches of applicable own funds requirements revealed by the stress tests, they can employ the capital guidance to address their concerns.
- The capital guidance should be set above the level of binding capital (minimum and additional) and the combined buffer requirements, and institutions are expected to take it into account in their risk management frameworks.
- The capital guidance does not constitute any form of binding capital requirements and is not expected to trigger the automatic restriction of the distribution and calculation of the maximum distributable amount (MDA).
- The CAs will monitor the capital guidance and the way it is integrated into institutions' risk management and capital planning processes.

Banks have now moved to a more steady-state setting, and the aim of the 2016 exercise is rather to assess remaining vulnerabilities and understand the impact of hypothetical adverse market dynamics on banks. As mentioned, despite no hurdle rates or capital thresholds being defined for the purpose of the exercise, CAs will use stress test results as an input to the Supervisory Review and Evaluation Process (SREP).

Recent turbulence after the Brexit vote

Italian banks have lost more than half of their market capitalization since the beginning of the year due to investor concerns about some €360bn of bad loans still on their balance sheets, putting some banks at potential resolution risk. That compares to an average decline of less than one third of market value for European lenders.

The Brexit vote helped drag European banks down 21% in two days (23% for the SX7E), with Italian banks dropping 26-31%. Below we summarise the recent newsflow on the Italian government's actions to support the banking sector in the aftermath of the UK vote.

- **June 28: Italy looks at measures to prop up banks.** In view of the "special situation" triggered by the UK vote (Article 108 of the EU treaty), the Financial Times reported that PM Matteo Renzi planned to call for a suspension of state aid rules to allow government-sponsored capital injections to take place without triggering bail-in rules. Among the measures reportedly under consideration was a possible capital injection (up to €40bn) in the banking system in order to offload NPLs and boost capital ratios.

- **June 29: German government opposition to the Italian request.** La Repubblica reported that Chancellor Angela Merkel in a press conference opposed the public recapitalization of Italian banks, arguing that “rules are already in place and cannot be changed every now and then”. According to the report, Merkel is not in favour of a waiver to the bail-in rules, even in a temporary window.

- **July 1: €150bn public guarantees to provide liquidity support.** The European Commission authorized Italy to use government guarantees to provide liquidity support to its banks, according to the Wall Street Journal. The Italian liquidity-facility program includes up to €150bn in government guarantees, in line with similar support systems already in place across the Europe. Only solvent banks would qualify for the liquidity support, which will run until the end of the year. The approved liquidity facility could be used as a backstop to prevent investor panic, which could result in a run on deposits and affect banks’ liquidity: the support provides a temporary cushion for Italian banks. But it doesn’t solve the broader issue of how to raise sufficient capital to sustain writedowns of bad loans.

  Based on the data available, the banks under Credit Suisse coverage do not have a liquidity issue as they have plenty of eligible assets to take to the ECB. However, we think the lack of confidence caused by the NPLs and the recent market volatility could turn into a liquidity issue, which could accelerate NPL resolution and create a capital issue for some weaker banks (like MPS).

- **July 3: the Italian government is looking for some flexibility in Article 32 of the BRRD (La Repubblica).** Article 32 of the Bank Recovery and Resolution Directive (BRRD) provides a legal framework to allow a waiver in the following cases:
  - Capital shortfalls stemming from national, Union or SSM stress tests, asset quality reviews or equivalent exercises conducted by the ECB, EBA or national authorities.
  - Extraordinary public financial support is allowed to remedy a serious disturbance in the economy of a Member State and preserve financial stability.
  - The extraordinary public support may take any of the following forms: (i) a State guarantee to back liquidity facilities; (ii) a State guarantee of newly issued liabilities; (iii) an injection of own funds or purchase of capital instruments at prices and on terms that do not confer an advantage upon the institution.

  The local press (Il Sole 24 Ore) reported that the Italian government is aiming to obtain a waiver to the application of the bail-in rules, leveraging as much as possible the Article 32 (point (d) (iii)), to avoid the application of the bail-in rules specifically for MPS to prevent another resolution.

- **July 4: "Financial stability issues" could be called to justify a "precautionary public recapitalisation": MPS is the priority.** Il Corriere della Sera reported three potential solutions for stabilising the Italian banking system: (i) a private vehicle (like Atlante) to buy NPLs at the NBV and re-sell them to the government (a TARP-style plan); (ii) a direct action on banks' capital calling under Article 32 of BRRD (to prevent financial stability risks); (iii) an indirect action via the Cassa Depositi e Prestiti (CDP), which is off the state's balance sheet. According to the report, ongoing negotiations with Brussels include MPS following the recent ECB request to accelerate NPL disposal posing resolution risks for the bank in view of the forthcoming stress test. The government may call for Article 32 (financial stability) to inject public capital without calling for the resolution of the bank. The report said the Italian government aims to avoid another "Novo Banco" case when retail bondholders and depositors were relatively unaffected at the expense of the institutional bondholders. MPS has ~€5bn sub debt of which €2bn is in the hands of institutional investors.
- **July 7: €3-5bn capital shortfall for MPS: waiver or burden sharing?** La Repubblica reported that MPS would require a recapitalization of €3bn-€5bn as a result of the NPL deconsolidation acceleration request by the ECB (-40% net NPL by 2018). Assuming a €14.6bn gross NPE reduction, we calculate a capital shortfall of €1.8bn-€2.7bn. Such a sizable recapitalization would likely carry high un-subscription and resolution risks. As such, the Italian government is reportedly negotiating with the European Commission on room for manoeuver to avoid burden sharing for bondholders, at least for retail. As mentioned earlier, Article 32 of the BRRD provides a legal framework to allow a waiver in case of capital shortfalls stemming from national, Union or SSM stress tests, asset quality reviews or equivalent exercises conducted by the ECB, EBA or national authorities, if the extraordinary public financial support is required to remedy a serious disturbance in the economy of a Member State and preserve financial stability.

  La Repubblica reported that a rescue plan for MPS could materialize in two stages:

  - NPL deconsolidation: creation of a new Atlante fund with €5bn-6bn of fresh capital, injected by Cassa Depositi e Prestiti (CDP) among others. The fund would buy a large chunk of MPS' NPL.
  - Recapitalization via: (i) the issuance of a mandatory convertible bond like the former NSF ("Nuovi Strumenti Finanziari") at conditions not conferring an advantage upon the institution; (ii) ordinary share offer: the State would get the unsubscribed capital.

  Burden sharing is the main discussion point with the EC. European financial services commissioner Valdis Dombrovskis said that a "precautionary recapitalization" does not trigger bail-in when the bank is solvent in the baseline scenario. However, the report said Eurogroup Chairman Jeroen Dijsselbloem warned that Italy should comply with the BRRD and apply bail-in rules on subordinated bondholders, at least institutional investors. MPS has ~€6bn outstanding subordinated bonds, of which €2bn is in the hands of institutional investors who might face this burden-sharing risk.
- **July 8: MPS to stick to ECB guidance – Bank of Italy in favour of a public money support.** According to Reuters, MPS approved a reply letter to the ECB including a mix of preliminary actions to reduce NPLs to meet the ECB's target and avoid a rights issue. CEO Fabrizio Viola said that the bank is working intensively with authorities to find a structural, definitive and rapid solution on bad loans; he added that Q2 performance is "positive". According to Reuters, ECB Vice President Vitor Constancio said Europe should consider "small" state support for its banks to help them get rid of troubled assets. At the same time, Bank of Italy Governor Ignazio Visco said that public money should be used to help Italy's troubled banks, as the current market situation is "full of risks for financial stability," and a public backstop to support the banks is necessary and not prohibited by European rules.

- **July 12/13: MPS could offload up to €10bn NPL via securitization backed by the State guarantee (GACS) or by selling bad loans to Atlante.** According to media reports (Reuters, Bloomberg), MPS is working with JP Morgan on a jumbo NPL securitisation which could help offload €10bn of NPL. The structure of the securitisation would provide for the use of the State guarantee scheme (GACS). The reports said the bank is seeking to reach a deal by the end of July, when the results of European banking stress tests will be unveiled. MPS has not commented on the reports.

  According to Reuters and Bloomberg, Italy is also seeking a second bank support fund by end-July. The 'Atlante 2' fund would supplement the existing Atlante fund and have a size of €2bn and a focus on NPLs. Cassa Depositi e Prestiti (CDP) would reportedly contribute ~€400-€500m.

Based on the recent newsflow, in Figure 44 we have summarized 10 potential scenarios for MPS. In our view, the most likely outcome for MPS would be: (i) rescue by a private vehicle (e.g. an 'Atlante 2') funded by groups other than banks (CDP, SGA, Atlante 1 Foundations, etc.); (ii) a large NPL securitization backed by GACS; and (iii) partial burden sharing (for institutional investors involved in the sub-debt only).

We expect the issue to be solved via a market solution not involving public money. We do not expect the banks to contribute funds to a new Atlante fund: a rescue funded by the Italian banking system would be negative for the sub-sector. As such, we think investor concerns about solid banks having to contribute to another bailout fund are overdone.

Figure 44: Scenario analysis: Potential solutions for MPS

Potential outcome	Implications	Perceived impact on systemic risk	Potential impact	Investment implications	Nature of the actions/Burden sharing	Compliance with BRRD/ state aid rules	Max amount	CSe probability
Rescue by a private vehicle (e.g. an Atlante 2) funded by investors other than banks (e.g. CDP, SGA, Atlante 1 Foundations)	Very positive	Relief	New fund to buy out a large chunk of MPS' NPLs at higher than the market price – MPS might be able to launch a rights issue later	Likely outperformance of all banks	Private/N	Y	€5-6bn fresh capital injected in the fund	25%
Large NPL securitization backed by GACS	Depends on NPL valuation	Potential relief	MPS shareholders could benefit	Uncertain for MPS (depends on the NPL price); overall positive for other banks	Private/N	Y	€1.5-2.5bn capital hike depending on the NPL price	20%
Partial burden sharing (for institutional investors involved in the sub-debt only)	Deposits outflows More difficulties for all banks to tap the bond market	Big increase	Rising funding costs Some liquidity issues	MPS and weak banks might appear un-investible	Private/Y	Y	Big hit to part of sub-debt and all the equity	15%
Rescue by a private vehicle funded by the banks	Good for bad banks, bad for good banks	Increase	Good banks' earnings and capitals hit	Underperformance of all banks	Private/N	Y		10%
MPS rescued by another bank	Depending on the conditions of the loan book clean-up	Potential relief	MPS shareholders to benefit at the expense of the acquirer's shareholders	MPS equity up/ "White knight" equity possibly down	Private	Y		10%
State-backed bond issuance at tough conditions	Very positive	Strong relief	Positive for MPS shareholders (read-across from former state support – NSF)		Public	Flexibility/could not be state aid	€5bn	8%
Straight public re-capitalization	Negative impact for MPS/Positive for the sector	Relief	MPS equity effectively wiped out, positive impact on sub debt	Solid banks likely to outperform	Public	Flexibility/state aid	€5-6bn	5%
Full resolution	Risk of a bank run	Large increase	Cost of Equity jump Funding cost jump Liquidity issue	The sector might appear un-investible	Private	Y		3%
Self-funded recapitalization	MPS able to recapitalize without external help	Relief	MPS shareholders strongly diluted Positive for solid banks	MPS sharply hit	Private	Y	Up to €2.5bn	3%
Rescue by a vehicle public money funded	Very positive	Strong relief	Solution of the Italian banks NPL issue	TARP style plan – Italian banks to outperform	Public	N/State aid	€40bn	NA

Source: Credit Suisse estimates

Selling NPLs: price matters

NPL: gap between market price and net book value

The difference between NPLs' Net Book Value (NBV) on banks' balance sheets and the price at which investors are willing to buy is substantial, impeding the development of the NPL secondary market in Italy. Banks and investors use different methods to calculate NPL value. This is the main reason for the difference between NPLs' bid-ask price. Based on a recent Bank of Italy publication (see https://www.bancaditalia.it/pubblicazioni/note-stabilita/2016-0003/index.html), there appear to be three main drivers of this difference between NBV and market price:

1) Investors seek a relatively high rate of return. This return is used to discount the expected cash flows from NPL.
2) Banks adopt the IAS/IFRS international accounting principles instead of using the original effective interest rate on the assets, which is usually much lower, resulting in a lower NPL valuation.
3) Banks tend to include the indirect costs of managing NPLs in their financial statements of the year in which they were incurred, whereas potential acquirers deduct them immediately from the value, thus reducing the purchase price.

Note that the difference in market value and net book value relates mainly to secured loans, which are not properly marked-down as unsecured loans. As mentioned in the section "Recent transactions and NPL methodologies" on page 30, unsecured loans have represented the largest part of the NPL disposal so far (95%), as the bid-offer price gap is narrow.

Gross and Net Book Value

Italian banks' average NPL NBV is ~40% of the Gross Book Value (GBV), or ~60% coverage. Under current accounting standards based on IAS39, Italian and European banks calculate the book value of loans according to the amortized cost method, which provides for the discounting of future expected cash flows over the life of the loan at the original effective interest rate of the loan used as the discount factor.

The GBV is equal to the discounted sum of the expected cash flow generation. This methodology is also used to estimate NPLs' net value. In this case, the calculation includes: (i) the recovery probability of the entire amount of the loan; (ii) the recoverable amount, related to the guarantee securing the loans; and (iii) the cash flow recovery time.

The updated value of the deteriorated lending position is the NBV. The new NBV is impacted by the new financial situation of the borrower which implies a lower cash flow and higher than previous recovery time (to factor in the length of the collateral sale procedures).

The newly calculated expected cash flows from NPLs usually result in a write-down charged to the P&L for the year. The value adjustment is equivalent to the difference between the GBV and NBV.

Over time, the position could improve or deteriorate further. As such, the bank may post a write-back or additional impairment on the same position. In the calculation of the new cash flows, banks typically factor in the direct costs of managing NPLs (i.e. collection and collateral disposal), but they do not factor into the NBV calculation the fees paid to the servicer; these are charged to P&L instead.

Recent transactions and NPL methodologies

There is a wide range of prices for NPLs, as the market is very thin and illiquid. The price is a function of the loan's type, guarantee and coverage level. The price range could be between 3% and 45% of the GBV, depending if the loan is unsecured or secured by a prime real estate asset.

The lack of liquidity is a problem in pricing the massive amount of NPLs that Italian banks are looking to offload. One of the most recent market references for NPL value was provided by the bad loans portfolio assessment made when the four local banks were rescued in November 2015: for that portfolio, the mark-to-market was ~20% of the GBV.

The following table summarizes the NPL valuation gaps of recent transactions. The first one relates to the rescued banks (Banca Marche, Banca Etruria, CR Chieti, CR Ferrara). The NPL valuation was not based on an actual market transaction, but on the transfer price of the assets to the bad bank. The available data were only the price and the loss booked in the bad bank, from which we have estimated a proxy of the GBV.

Among other Italian banks, Credito Valtellinese has been the most active on the NPL market so far, having closed three deals, of which the first was a sizeable 11% of the total gross NPL (or 6% of the total gross NPE). 44% of the NPLs were secured, 56% unsecured: CreVal was able to sell, reporting a small loss (<€6m) thanks to the high coverage of the positions (~95%). The portfolio sold was vintage (among the older NPLs), which explains the high coverage. As such, we don't view the February 2016 transaction as a benchmark in terms of current market prices (and the bid-offer gap).

More recently CreVal placed two portfolios: €106m secured 'unlikely to pay' loans at 41% of GBV and €22m secured NPLs at 35%. To calculate the valuation gap (bid-offer price gap), we have used as a proxy the average coverage of the respective bad loans categories (25% and 52% each) with the caveat that the actual LGD could differ depending on the nature of the portfolio. In the case of the unlikely to pay portfolio, the coverage might be higher than the accounting cash coverage, while in the case of the secured NPLs, the coverage could be lower (in line with the practice of the secured NPLs). **With the caveat that we have only a limited number of transactions, based on the data in Figure 45, we estimate the current market bid-ask price gap at 20-34pp.**

Figure 45: Price of the recent market transactions

(€m, %)	Date	Category	GBV	Ave LGD	NBV	NBV/GBV	Price % GBV	Price	Price-NBV	Bid-ask gap
Rescued banks	Nov 2015	NPL [S+U]	7,556	60%	3,022	40%	18%	1,292	-1,730	-23%
CreVal	Feb 2016	NPL [S+U]	314	90%	31	10%	8%	25	-6	-2%
CreVal	May 2016	Un to pay [S]	106	25%	80	75%	41%	44	-36	-34%
CreVal	June 2016	NPL [S]	22	52%	10	48%	35%	8	-3	-13%
Total			7,998	61%	3,138	39%	17.1%	1,369	-1,769	-22%
Total - CreVal only			442	74%	116	26%	17.4%	77	-39	-10%
Total - Latest transactions			**128**	**34%**	**85**	**66%**	**40.2%**	**51**	**-33**	**-30%**

Source: Company data, Credit Suisse estimates

The following example is based on the Bank of Italy publication we previously mentioned and shows how banks value NPLs. The example shows based on a secured loan backed by a real estate asset, whose cash flow inflow depends on the disposal of the asset at a certain time. This example is our starting point to show how the bid-ask price gap is generated in the base case and how it could be impacted by moving the relevant factors.

Our base case shows two banks with NPL coverage in line with the highest standards of large Italian banks. The calculation shows a bid-ask price gap of 20-36%, close to the levels we estimate for current market trends. The main differential between the two banks in this example is how indirect costs are treated.

Figure 46: Bid-ask price gap base case – Banks and investors approach to NPL valuation

(€m, %)		Bank 1	Bank 2	Investor 1 [15% IRR]	Investor 2 [25% IRR]
Gross Book Value - GBV	A	1,000	1,000	1,000	1,000
Collateral - [book value]	B	600	600	600	600
Recovery time [years]	C	7	7	7	7
Investors' IRR	D	NA	NA	15%	25%
Indirect costs	E	0%	10%	10%	10%
Discount factor	I	5%	5%	15%	25%
DCF	J=B/(1+I)^C	426	426	226	126
Indirect costs	K=E*B	0	60	60	60
Net Book value – NBV	L1=J-K	426	366		
Price for investors [collateral mark-to-market]	L2=J-K			166	66
Expected Loss on position [provisions]	M=A-L	574	634		
Coverage ratio	N=M/A	57%	63%		
Bid-Ask price gap - Investor 1	P=L2-L1	-261	-201		
Bid-Ask price gap - Investor 2	Q=L2-L1	-361	-301		
NBV/GBV	R=L1/A	43%	37%		
Market Price/GBV	S=L2/A			17%	7%
Bid-ask price gap - Investor 1	**T=S-R**	**-26%**	**-20%**		
Bid-Ask price gap - Investor 2	**T2=S-R**	**-36%**	**-30%**		
Collateral mark-to-market/Collateral BV	U = L2/B			28%	11%
Discount to collateral BV	V = L2/B-1			-72%	-89%

Source: Bank of Italy, Credit Suisse estimates

Main determining factors of the gap

For a sale to be neutral for a bank, the NBV should be in line with the market price (or the coverage ratio on the book value should equal the haircut applied by the market). Most often, a 'pricing gap' between book and market values has to be recognized by the bank and cannot be transferred to an SPV or embedded in junior tranches as in the case of the Spanish and Irish bad banks.

The pricing gap depends on the perceived robustness of loan loss provisions, and is often calculated as a function of (i) the servicing and management cost, (ii) the assumed discount rate, which is equivalent for banks to the average for the loan (~5%), but for investors to the internal rate of return (IRR, ~10-30%), (iii) the rate and time of collateral decay, and finally (iv) the expected foreclosure time. Our conclusion is that **the longer the foreclosure time, and the higher the demanded return, the higher the pricing gap, hence the less likely banks are to sell their NPLs**. The duration of the foreclosure time is a function of the legal procedures of the repossession process.

We showed in the section 'The reasons for the NPL pile' that Italy is the worst country in the Eurozone in terms of its recovery process duration, with an average ~5 years. As to the discount factor applied, we think that banks should use a higher rate, as NPLs are funded by equity. The use of a higher discount factor by the banks would reduce the NPL mispricing, but additional impairments should be required.

Sensitivity to recovery time and to investors' IRR

Our sensitivity analysis shows how much the bid-ask price moves depending on changes in the recovery time and investors' IRR.

The first sensitivity shows the impact of a shorter recovery time, all else being equal. We have assumed four years from seven previously (i.e. shortening the time by three years). This would close the bid-ask price gap by 5.0-5.3 percentage points, on our numbers. As shown the in table below, the bank would post a write-back, as a result of the lower coverage required.

Figure 47: Sensitivity 1 – Recovery time shortening

(€m, %)		Bank 1	Bank 2	Investor 1 [15% IRR]	Investor 2 [25% IRR]
Recovery time [years]	**C2**	**4**	**4**	**4**	**4**
Indirect costs	E	0%	10%	10%	10%
Discount factor	I	5%	5%	15%	25%
DCF	J2	494	494	343	246
Indirect costs	K	0	60	60	60
New NBV	L3=J2-K	494	434		
New Market Value [MV]	L4=J2-K			283	186
New Expected Loss on position [provisions]	M2 = A-L3	506	566		
New Coverage ratio	N2 = M2/A	51%	57%		
Write-back/write-down [vs. base case]	X = M-M2	67	67		
New Bid-Ask price gap - Investor 1	P2 = L4 - L3	-211	-151		
New Bid-Ask price gap - Investor 2	Q2 = L4 - L3	-308	-248		
New NBV/GBV	R2 = L3/A	49%	43%		
New MV/GBV	S2 = L4/A			28%	19%
New Bid-ask price gap - Investor 1	**T3 = S2-R2**	**-21%**	**-15%**		
New Bid-Ask price gap - Investor 2	**T4 = S2-R2**	**-31%**	**-25%**		
Bid-ask price gap reduction vs. base case - Investor 1	Y = T3-T	5.0%	5.0%		
Bid-ask price gap reduction vs. base case - Investor 2	Z = T4-T2	5.3%	5.3%		
Collateral mark-to-market/Collateral BV	U2 = L4/B			47%	31%
Discount to collateral BV	V2 = L4/B-1			-53%	-69%

Source: Bank of Italy, Credit Suisse estimates

The second sensitivity is the discount factor. Investors' IRR is much higher than that used by the banks because (i) investors' funding is largely made of equity; (ii) they tend to have higher risk aversion; (iii) there are potential information asymmetries; and (iv) there is an impact from fund managers' fees.

With this in mind, we argue that: (a) banks use a low discount factor for accounting reasons, but NPL funding is broadly made of equity, as such the discount rate should be higher; and (b) investors are very unlikely to reduce the return they require, as the market currently consists of a large number of forced sellers and a low number of specialist large scale buyers. As such, in our view banks need to increase the discount rate.

In the table below, we assume banks use a higher discount factor that is more consistent with the funding structure of NPLs. We show the impact of the increase of the discount rate from 5% to 7%: it results in an additional 5.3pp bid-ask price gap improvement, at the expense of an additional mark-down (higher coverage).

Figure 48: Sensitivity 2 – Discount factor change

(€m, %)		Bank 1	Bank 2	Investor 1 [15% IRR]	Investor 2 [25% IRR]
Recovery time [years]	C	7	7	7	7
Indirect costs	E	0%	10%	10%	10%
Discount factor	**I2**	**7%**	**7%**	**15%**	**25%**
DCF	J3	374	374	226	126
Indirect costs	K	0	60	60	60
New NBV	L5=J3-K	374	314		
New Market Value [MV]	L6=J3-K			166	66
New Expected Loss on position [provisions]	M3 = A-L5	626	686		
New Coverage ratio	N3 = M3/A	62.6%	68.6%		
Write-back/write-down [vs. base case]	X2 = M-M3	-53	-53		
New Bid-Ask price gap - Investor 1	P3 = L5 - L6	-208	-148		
New Bid-Ask price gap - Investor 2	Q3 = L5 - L6	-308	-248		
New NBV/GBV	R3 = L5/A	37%	31%		
New Price/GBV	S3 = L6/A			17%	7%
New Bid-ask price gap - Investor 1	**T5 = S3-R3**	**-21%**	**-15%**		
New Bid-Ask price gap - Investor 2	**T6 = S3-R3**	**-31%**	**-25%**		
Bid-ask price gap reduction vs. base case - Investor 1	Y2 = T5-T	5.3%	5.3%		
Bid-ask price gap reduction vs. base case - Investor 2	Z2 = T5-T2	5.3%	5.3%		
Collateral mark-to-market/Collateral BV	U3 = L6/B			28%	11%
Discount to collateral BV	V3 = L6/B-1			-72%	-89%

Source: Bank of Italy, Credit Suisse estimates

Overall, for a sizeable bid-ask price gap reduction to be effective on the NPL market, in our view a combined decrease in the foreclosure time and higher bank discount factors are needed. The reduction of foreclosure times is indeed the most important factor, in our view, to narrow the bid-ask spread and avoid further charges for banks in terms of bad loan impairments. In our view, in a blue sky scenario it could be possible to achieve a reduction of up to four years at best (i.e., a three-year foreclosure process), implying a reduction of the bid-ask price by 8-9pp.

Figure 49: Recovery time reduction and price gap narrowing

Recovery time reduction (years)	Bid-ask price narrowing (Pp)
1	1pp
2	3pp
3	**5pp**
4	**8-9pp**
5	11-14pp
6	15-21pp
7	20-30pp

Source: Credit Suisse estimates

Conclusions

A more realistic scenario may involve reducing the recovery time by three years, with an increase in the discount factor used by the banks (by two percentage points, up to 7%). **The combination of the two measures could narrow the bid-ask gap by 10-11pp**.

Figure 50: Scenario analysis: Combined impact of shorter recovery time and higher discount factor for banks on price gap

(percentage points)	Shorter recovery times	Higher discount factor for banks	Combined impact
Bid-ask price gap reduction vs. base case – Investor 1	5.0pp	5.3pp	**10.3pp**
Bid-ask price gap reduction vs. base case – Investor 2	5.3pp	5.3pp	**10.5pp**

Source: Credit Suisse estimates

We would expect banks to pay the bill in terms of losses booked to the P&L (with the consequent impact on capital), but this impact would be a one-off and pave the way to accelerating NPL stock disposal. We view this as an effectively inevitable charge for banks, as the supply of bad loans is much higher than demand at this stage.

Additional minor factors which may help reduce the bid-ask price gap are listed below, but their impact is not comparable to the above mentioned, in our view:

- **Data quality:** the quality of the process of archiving and maintaining information in databases.
- **Servicing:** the efficiency and the cost of credit collection services.
- **Market conditions:** prospective trends of the economy and real estate premiums.

A long-lasting issue recently tackled

It all started with the AQR in 2014

Since 2014, after the AQR addressed the issue, the Italian government has been tackling the asset quality issue with new measures aimed speeding up the disposal process for bad loans. In 2015, the government implemented a number of actions, including:

- the cooperative (so called 'popolari') banks reform,
- the banking foundations reform,
- the bankruptcy law reform,
- the new loan loss provisions (LLP) tax deductibility.

The most relevant reform approved in summer 2015 was a law to accelerate bad loans' recoveries (the reform of the bankruptcy law – Decree 83/2015 converted into law). This law focused on reducing the years needed to repossess the real estate assets in order to accelerate their disposal and the satisfaction of the outstanding loan. In theory, the new measures should reduce the process by one year on average (two years at best) from the usual length of seven years. That would improve time value adjustments, result in potential write-backs and reduce the bid-ask spread. However, the hoped positive effects have not materialized yet.

Decree 83/2015 converted into law

As part of Decree Law 83/2015, in June 2015, the government approved measures to remove some impediments to the liquidation of NPLs, with the aim of increasing the efficiency and speed of credit recovery proceedings. In August 2015, these measures were approved by parliament and therefore became law. These changes covered two sets of actions on bankruptcy and foreclosure procedures, along with a tax treatment for loan loss alignment with the rest of Europe:

Efficiency of the available restructuring tools

- Aim: To improve the efficiency of the available restructuring tools, promote a prompt solution to a firm's financial difficulties and prevent irreversible insolvency.
- How: By facilitating out-of-court workouts and prompter agreements between creditors.
- Example: (1) While in the previous framework dissenting creditors kept their right to be repaid in full, and therefore could block the rescue of a still viable company, agreements approved by more than 75% of creditors are now binding for the remaining 25%. (2) Similarly, creditors can now compete against firms for restructuring plans.

Reduced length of the process, both for insolvency and foreclosure procedures

- Aim: To reduce the length of the process and improve the efficiency of the sale.
- How: By imposing shorter deadlines, and subsequent sanctions for infractions, which did not exist previously.
- Example: (1) For each solvency procedure, data will be released for consultation, while the administrator is required to deliver the liquidity plan within 180 days from the date of the insolvency declaration, and to terminate the liquidation within two years. (2) For each foreclosure procedure, the maximum length for an auction sale is now 195 days (down from 330 days), and the likelihood of multiple auctions is greatly reduced (bids can now be accepted even at a price up to 25% lower than the reference price).

Furthermore, if a guarantee is provided, the buyer can now get immediate possession of the foreclosed property, whereas previously direct assignment of the asset was extremely rare.

Tax treatment of write-downs deductible immediately rather than over five years

- Aim: To bring Italy's rules into line with those of other major European countries.
- How: By modifying the tax treatment of new write-downs and loan losses, instituting immediate and full deductibility rather than over five years.
- Example: Until 2012, write-offs were not tax deductible without a court declaration of insolvency, usually taking several years. Banks were allowed to deduct provisions from taxable income up to 0.3% of outstanding loans. The rest was treated as deferred tax assets, deductible over 18 years, and five years since 2013.

The new measures launched in early 2016

Following the rescue of the four small banks in November 2015, the government put additional focus on asset quality. It initially considered the set-up of a public bad bank able to help banks deconsolidate bad loans, but that would not comply with EU state-aid rules. As such, the government began to explore alternative options to the creation of a bad bank funded by public money. The measures launched so far include:

- on the public/government side, the GACS and a new Decree on NPL recovery; and
- on the price side, the launch of the Atlante fund.

The government initiatives: GACS

In February, the government approved the Law Decree No. 18 (converted into law in April). The new rules set a state guarantee scheme ("GACS" - Garanzia sulla Cartolarizzazione delle Sofferenze) designed to assist Italian banks in securitizing and facilitating the NPL offload from banks' balance sheets. GACS is a state guarantee scheme available for senior tranches of securitized bad loans with investment-grade ratings offered at market conditions and as such is not treated as state aid.

The GACS cost is based on an average of CDS premiums for Italian issuers with equivalent ratings and will provide for a step-up after three years, in order to create an incentive to keep the securitized debt recovery times short. The state guarantee applies only to senior tranches.

Mechanism

An individually managed, private securitization vehicle (SPV) shall buy NPLs from banks. The SPV shall issue asset backed securities (ABS) and the relevant proceeds will be used to fund the NPL purchase price, which will then constitute the underlying assets backing the ABS. The issued notes shall be transferred to the SPV for a purchase price not higher than their net book value (i.e. gross book value net of provisions). The ABS shall be issued by the SPV in at least two tranches. The junior tranche of ABS shall be redeemed or repaid only if the other tranches have been redeemed in full; the SPV may issue one or more tranches of mezzanine notes, which are subordinated to the payment of interests of the senior notes but are paid in priority to the repayment of principal of the senior notes.

Servicing

The NPL servicer, an entity appointed to service and manage the NPL receivables, shall be an external and independent servicer (different from the selling bank and not belonging to the same banking group) to avoid the conflict of interest risks.

Repayments

The repayment of the principal before the maturity date is linked to the cash flows deriving from the amount recovered and the collections arising from the assigned NPL portfolio, net of all costs concerning the activity of recovery and collection of the assigned loans. The payment of interests is made in arrears quarterly, semi-annually or annually and it depends on the outstanding nominal value of the note at the beginning of the relevant interest period.

In addition, it may be provided that the remuneration of the mezzanine notes could be deferred under certain conditions or may depend on performance targets in the collection or recovery activities in respect of the portfolio of assigned loans.

Main features

The GACS shall cover exclusively the senior tranches and, in particular, the payments contractually provided in respect of interests and capital in favor of the senior noteholders.

The GACS becomes effective only when the relevant selling bank has transferred for consideration at least 50% plus 1 of the junior notes and, in any case, an amount of junior notes (and, if issued, mezzanine notes) which allows the de-recognition of the securitized receivables from the accounts of the bank.

Scope

The main purposes of the GACS should be: (i) to increase the credit-worthiness of the senior ABS, hence attracting a wide range of investors, increasing the investors' appetite for such securities, (ii) to reduce the funding costs of the SPV, and (iii) to incentivize banks to work out NPLs, facilitating the NPL disposal. In addition, it has been provided that the Italian State, the public authorities and the companies controlled, directly or indirectly, by public authorities cannot purchase the junior or the mezzanine notes.

Potential impacts

We note the following concerns on GACS:

- Banks will need to book losses in order to transfer loans; it is not clear that the appetite will be there to do so in size and across the whole banking sector.
- Some observers have argued that banks are primarily likely to transfer the highest quality loans with the highest level of provisioning, which would provide the least benefit to the banking system, and hence the economy. However, we disagree: NPLs with high coverage are usually 'vintage' and have a limited probability of recovery (hence they are low quality).
- Another concern is that demand for junior tranches will be a large determinant of success of the scheme and is unclear, both in terms of volume and price. Banks may be unwilling or unable to sell the loans at a haircut large enough to garner sufficient demand for the junior tranche. However, we note that one of the goals of Atlante, the private fund focused on the NPL market, is to buy junior tranche.
- Another key critique is that the clearest positive development for the NPL market would be a reduction in foreclosure times, but the new measures are likely to take years to flow through. However, we note that a new Decree (see below) is designed to provide a further stimulus to the procedure.

Based on the Finance Ministry (MEF) guidance, GACS could reduce securitization funding costs by 200bps, which could boost the value of the portfolio on sale. So far, the GACS scheme has not been as successful as hoped: only one deal has been carried out by Banca Popolare di Bari). While the cost of the GACS was disclosed, the disposal price of the NPLs wasn't; hence it is difficult to estimate the impact on the bid-ask spread.

Based on data from Quaestio Capital Management (the asset manager of Atlante), the GACS could lift NPL prices by +1pp, if not combined with other initiatives. Atlante could be able to buy the junior notes under the GACS scheme and help to offload the NPLs from banks' balance sheets.

The new NPL recovery Decree approved in May 2016

In early May, the government announced additional measures to help shorten credit recovery times and align them with international best practices. In a nutshell, the first draft of Decree 59/2016 included:

- the simplification of rules on collateral repossession, reducing court involvement;
- a shorter timeline in which borrowers can appeal enforcement decisions;
- the ability of the judge to issue a provisional enforcement order for claims which are not appealed within set timelines;
- the increased use of technology in court hearings and creditor meetings;
- the ability to remove an administrator who doesn't comply with the timeline set by the court;
- the creation of a digital register of proceedings which will be managed by the Ministry of Justice.

We think the most relevant legal measures are:

- **Pegno non possessorio** on machinery: the bank can extend its pledge rights also to machinery that can now be sold or rented out to cover the loan.
- **Patto Marciano**: in the case of real estate collateral from the client (excluding the personal residential property of the SME's owner) if contractually agreed previously it can be possessed by the bank after six monthly instalments are overdue. A third party will decide the value of the property to be disposed.
- **Shortening of foreclosures**: the decree states a general aim to accelerating the procedure, but at this stage it's not clear how this will be implemented. It looks to us as if the legislator is targeting an enforcement of the rights of the creditor.

All the above measures represent another step in the right direction, in our view. They should speed up the recovery time on newly originated NPLs, helping to improve the valuation of bad loans. It is too early to make a precise estimate of the positive impact, though: the Decree 83/2015 has not produced any significant positive return yet.

Overall, as we mentioned above, we estimate that reducing the foreclosure procedure by three years would translate into 5pp price gap improvement (see Selling NPLs: price matters). However, this acceleration has not materialized yet. For now, the fastest way to offload NPLs (and reduce the price gap) is charging an additional mark-down.

Atlante: a matter of price and capacity

In April 2016, the main Italian banks, insurers and other institutional investors agreed to participate to an alternative investment fund. The launch of Atlante, completely backed by private money and managed by an independent asset management company (Quaestio Capital Management), is an alternative to the creation of a bad bank funded with public money and is in compliance with EU regulations.

The resources of the fund will be invested in two types of assets:

- shares of banks undertaking capital hikes solicited by the Regulator; and
- tranches of securitised bad loans.

The Atlante fund's main mission is to "ensure the success of capital hikes requested by the supervisory authority for banks that face market difficulties" by acting as a subscriber of last resort. Up to 70% of the fund can be invested in banks with a lower capital ratio than the SREP threshold and therefore subject to capital strengthening measures imposed by the authorities. The fund should not underwrite more than 75% of an individual issue, unless the successful completion of the deal is conditional to the underwriting of a higher stake. The fund also aims to buy mezzanine and junior tranches of securitized bad loans: at least 30% of it will be invested in NPLs. The first type of investment is set to create a backstop for future capital increases by banks which may experience difficulties completing the placements. The second type aims to help the development of the NPL market, focusing on junior and mezzanine tranches of securitizations.

Size, subscribers and financial targets

The fund had €4.25bn equity at inception. Banks were the main subscribers, with a total combined €2.7bn investment (or ~64% of the fund's equity). The impact on CET1 (in terms of financial holding deductions) is in the range of -2bp (MPS) and -20bp (ISP) assuming full commitment. The fund's financial target is a return of ~6% per annum.

Figure 51: Main subscribers and impact on CET1

(€m, %, bps)	Amount	% on total	Impact on CET1
Intesa	**845**	**19.9%**	**-20**
Unicredit	**845**	**19.9%**	**-16**
Poste Vita	240	5.6%	
UBI	**200**	**4.7%**	**-13**
Generali	150	3.5%	
BPER	**100**	**2.4%**	
Allianz Italy	100	2.4%	
Cariplo Foundation	100	2.4%	
CreVal	**60**	**1.4%**	
MPS	**60**	**1.4%**	**-2**
Banco Popolare	**60**	**1.4%**	
CRT Foundation	50	1.2%	
BPSondrio	**50**	**1.2%**	
Cattolica	40	0.9%	
Cariparo Foundation	40	0.9%	
Reale Mutua	30	0.7%	
Carige	**20**	**0.5%**	
Sub-Total	2,990	70.4%	
Others	1,260	29.6%	
Total	**4,250**		

Source: Company data, Credit Suisse research

Atlante could theoretically buy €18bn of NPLs

The fund's capacity in terms of gross NPLs is a function of: (i) the mix of equity tranches (junior notes) that the fund would buy; (ii) the NPL price gap; and (iii) the NPL coverage. We assume that: (a) the scope of the purchasable bad loans is made up of secured NPLs: this implies lower coverage of ~30% versus the average of ~60%; and (b) the fund will take advantage of the GACS guarantee scheme.

Based on the most recent Bank of Italy data, NPLs showed €198bn GBV, €83bn NBV (implying ~60% coverage). Given the lack of April data for collateral, we use the end 2015 value. The collateral value is usually based on annual appraisals.

Figure 52: NPL, NPE, collateral

(€m, %)	Apr-16		Dec-15
Gross NPL	**198,349**	**Gross NPE**	**360,403**
Provisions	115,203	Provisions	163,403
Net NPL	**83,146**	**Net NPE**	**196,657**
Collateral*	85,000	Collateral	160,000
Cash coverage	58%	Cash coverage	45%
Collateral coverage	43%	Collateral coverage	44%

Source: Bank of Italy, *End 2015 data

Base case: current market conditions

In our base case scenario, we show Atlante's maximum NPL purchasable capacity starting from the current market conditions: we assume a 35% bid-offer price gap, as a result of 30% NPL coverage (equivalent to 70% NBV) and a 35% market price. The price gap generates a coverage uplift which fully translates into additional loss recognition for banks. Smaller equity tranches (i.e. increasing senior tranches and leverage) would have a multiplier effect on the fund's capacity. With a 20% equity tranche, we estimate Atlante's maximum purchasable GBV amount would be €18.2bn (equivalent to 9% of the total banking system NPL). This would imply a €3.2bn loss recognition for banks as a result of the coverage uplift, though.

We also note that up to €18bn NPL GBV disposal capacity is only 9% of NPL stock. With this capacity, Atlante would help but it would not be enough to reduce the large stock of NPLs and NPE (respectively at c.€200bn and €360bn).

Figure 53: Atlante capacity – Base case

(€m, %, x)	100% Equity tranche	50% Equity tranche	20% Equity tranche
Fund total capacity	**4,250**	**4,250**	**4,250**
Allocation to recaps	70%	70%	70%
Amount reserved to recaps	2,975	2,975	2,975
Allocation to NPLs	30%	30%	30%
Amount reserved to NPLs	1,275	1,275	1,275
Equity tranche / under GACS scheme	100%	50%	20%
Mezzanine-Senior tranche / under GACS scheme	0%	50%	80%
Purchasable Net NPL	**1,275**	**2,550**	**6,375**
Secured NPL Coverage	30%	30%	30%
NBV/GBV	**70%**	**70%**	**70%**
Purchase price	**35%**	**35%**	**35%**
Price gap	**-35%**	**-35%**	**-35%**
Loss recognition for banks	-638	-1,275	-3,188
New LGD	**65%**	**65%**	**65%**
Purchasable Gross NPL	**3,643**	**7,286**	**18,214**
Leverage	2.86	5.7	14.3
Total NPLs GBV	203,532	203,532	203,532
% of total GBV	**1.8%**	**3.6%**	**8.9%**

Source: Credit Suisse estimates

We estimate a €7.3bn maximum capacity in a scenario with a 50% equity tranche and 50% senior notes. Under this scenario, the amount of NPL GBV would be equivalent to just 3.6% of the total GBV. The coverage uplift impact would be €1.3bn. Under all our equity tranche assumptions, banks would take a heavy hit on their portfolios.

We assume Atlante will offer a higher price

We doubt there would be much interest from banks in selling NPLs to Atlante in our base case, as at those conditions, it would be neutral for them to sell either to Atlante or to another investor. To boost the NPL market, we think Atlante will need to buy NPLs at a higher price than the current market. In our view, thanks to its sector expertise (database management and servicing), combined with the use of the new tools (GACS and the new foreclosure law) Atlante should be able to offer a higher NPL price. This should trigger a positive loop and boost the NPL market's recovery. In theory, Atlante should be able to buy at a higher price as the return targeted by the fund (6%) is lower than that required by other specialised investors (15% in our assumptions).

Scenario 1: Atlante to offer a higher price

In this scenario, we show how combining a coverage uplift and higher price could match the purchasable NPL capacity in our base case. The main difference between this scenario and our base case is in terms of loss recognition for the banks, as the negative impact would be much lower than our base case, specifically stemming from the coverage uplift only (42.5% vs. 30% in the base case).

Figure 54: Atlante capacity – Scenario 1

(€m, %, x)	100% Equity tranche	50% Equity tranche	20% Equity tranche
Fund total capacity	**4,250**	**4,250**	**4,250**
Allocation to recaps	70%	70%	70%
Amount reserved to recaps	2,975	2,975	2,975
Allocation to NPLs	30%	30%	30%
Amount reserved to NPLs	1,275	1,275	1,275
Equity tranche / under GACS scheme	100%	50%	20%
Mezzanine-Senior tranche / under GACS scheme	0%	50%	80%
Purchasable Net NPL	1,275	2,550	6,375
Secured NPL Coverage	42.5%	42.5%	42.5%
NBV/GBV	**57.5%**	**57.5%**	**57.5%**
Purchase price	**45%**	**45%**	**45%**
Price gap	**-12.5%**	**-12.5%**	**-12.5%**
Price change vs. base case	*10%*	*10%*	*10%*
Coverage change vs. base case	*-12.5%*	*-12.5%*	*-12.5%*
Price + coverage changes	*22.5%*	*22.5%*	*22.5%*
Impact from price change	222	443	1,109
Impact form coverage change [loss for banks]	-277	-554	-1,386
Total impact	499	998	2,495
Impact LGD equivalent	**-22.5%**	**-22.5%**	**-22.5%**
New LGD	**65%**	**65%**	**65%**
Purchasable Gross NPL	**3,643**	**7,286**	**18,214**
Leverage	2.9	5.7	14.3
Total NPLs GBV	203,532	203,532	203,532
% of total GBV	**1.8%**	**3.6%**	**8.9%**

Source: Credit Suisse estimates

We use a 12.5% price gap in this scenario versus the 35% in our base case, thanks to the combined impacts of higher NPL prices and higher NPL coverage. The total final impact would be 'LGD equivalent' accretive: the bank would suffer only from the negative impact of the loss recognition for the higher coverage, while the higher price would boost the purchasable NPLs.

As such, we think it would be attractive for banks to dispose of NPLs to Atlante: the loss recognition would be lower than in our base case.

Impact and conclusions

Scenario 2 in the table below shows that increasing the NPL price and coverage would also increase the fund's capacity, with smaller a negligible impact in terms of marginal loss recognition versus our base case.

Figure 55: Our base case vs Scenario 1 and Scenario 2

Fund Size	**4,250**	**4,250**	**4,250**
Equity Tranche	**100%**	**50%**	**20%**
Base case			
Current coverage	30%	30%	30%
Price gap	-35%	-35%	-35%
Total price gap impact	**-35%**	**-35%**	**-35%**
Purchasable Net NBV	1,275	2,550	6,375
Max purchasable GBV	**3,643**	**7,286**	**18,214**
% of total GBV	1.8%	3.6%	8.9%
Multiplier - price gap reduction 0%	2.9	5.7	14.3
Potential loss recognition for banks	**-638**	**-1,275**	**-3,188**
Scenario 1			
Price gap reduction	-10.0%	-10.0%	-10.0%
Coverage uplift	12.5%	12.5%	12.5%
Total price gap impact	**-22.5%**	**-22.5%**	**-22.5%**
Equity Tranche	100%	50%	20%
Fund Size	4,250	4,250	4,250
Purchasable Net NBV	1,275	2,550	6,375
Max purchasable GBV	**3,643**	**7,286**	**18,214**
% of total GBV	1.8%	3.6%	8.9%
Multiplier - price gap reduction 10%	2.9	5.7	14.3
Price-gap narrowing impact	499	998	2,495
Loss recognition for banks	**-277**	**-554**	**-1,386**
Scenario 2			
Price gap reduction	-10%	-10%	-10%
Coverage uplift	15%	15%	15%
Total price gap impact	**-25%**	**-25%**	**-25%**
Equity Tranche	100%	50%	20%
Fund Size	4,250	4,250	4,250
Purchasable Net NBV	1,275	2,550	6,375
Max purchasable GBV	**4,500**	**8,500**	**21,250**
% of total GBV	2.1%	4.2%	10.4%
Multiplier - price gap reduction 20%	3.3	6.7	16.7
Price-gap narrowing impact	580	1,159	2,898
Loss recognition for banks	**-348**	**-695**	**-1,739**

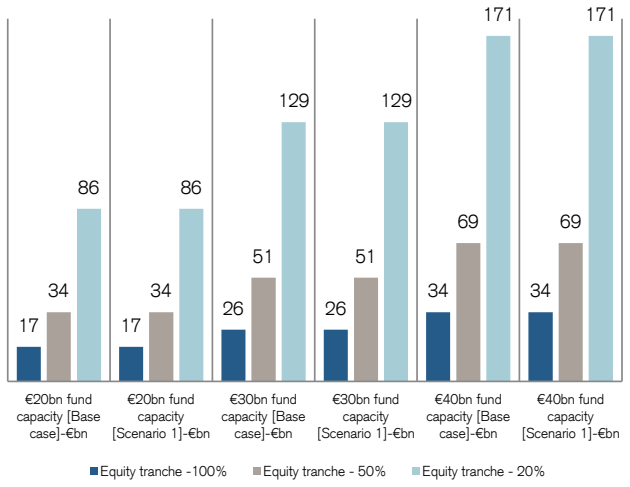
Source: Credit Suisse estimates

Given its lack of a track record, Atlante's potential contribution to reducing the price gap is uncertain at this stage. As such, banks would likely still be required to take additional provisions to maximize the impact and to help the market's recovery. Due to the lack of deals so far, we are unable to quantify the potential benefits to pricing. We therefore use the guidance of Atlante's fund manager, Quaestio Capital Management (see the slides in the fund presentation at http://www.quaestiocapital.com/en). To date, Atlante has been focused on the recapitalization of banks, but we expect it to focus on NPLs soon.

€30-40bn firepower needed to solve Italian NPL issue

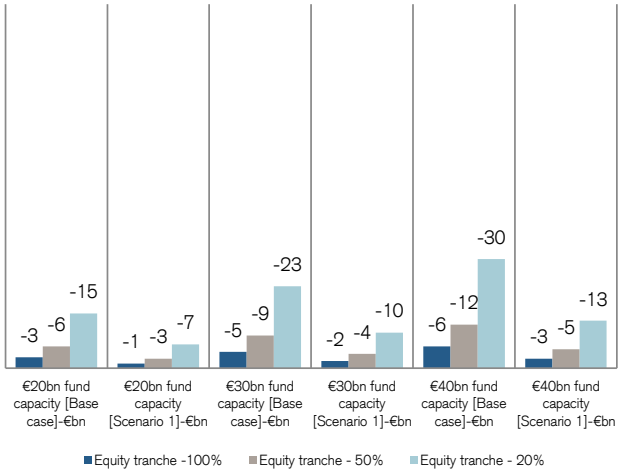
Given the size of the problem, we estimate that in order to offload a big chunk of NPLs (25-64% of the total amount, or ~€50-130bn), the size of the Atlante fund should be between €30bn and €40bn. Likewise, leverage should be high (equity tranche at 20%) to maximize the impact.

Figure 56: Fund size to maximize purchasable NPLs



Source: Credit Suisse estimates

Figure 57: Potential loss recognition for banks



Source: Credit Suisse estimates

The purchasable NPLs are a function the fund's capacity and of leverage (equity/senior tranches mix). Figure 56 shows that the level of purchasable NPLs does not change unless there is a combined impact from a price gap and coverage change (assuming the fund size and leverage remain equal). The price gap and coverage change are also relevant in terms of the loss recognition for banks: the higher the NPL price increase, the lower the coverage increase required to achieve the same final LGD equivalent level.

Figure 57 shows the different impacts in terms of loss recognition (fund size and leverage remaining equal). For example, in the case of €20bn and no leverage, assuming a 35% price gap is fully turned into coverage uplift (to 65%) we calculate a €3bn additional provisions for banks.

Assuming a 25% price gap and 12.5% coverage uplift, the final LGD result would be the same (65%), but the additional provisions for banks would be only €1bn. Assuming the largest size and highest leverage, Italian banks would need to take €6-30bn additional provisions in our worst case scenario. With the price gap mitigation, the loss range would by €3-13bn.

Measuring the potential impact on the price gap

Although we reiterate the limitations of this analysis given the lack of deals so far, using recent market transactions we show the potential evolution of the price gap including:

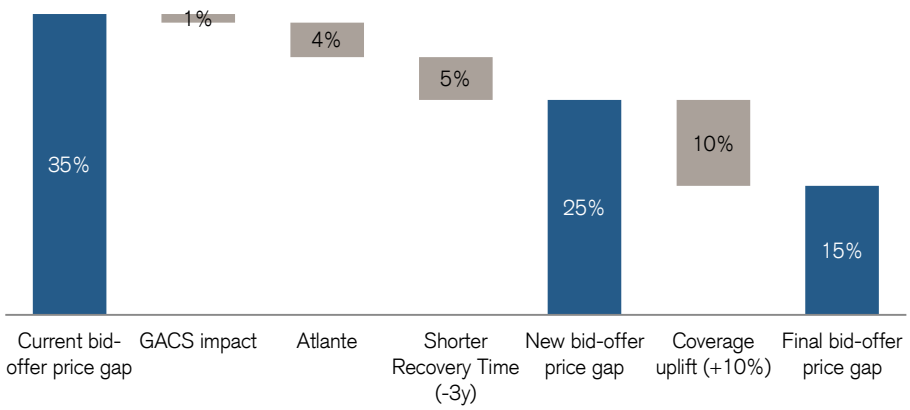
- the potential impact of the GACS,
- the potential benefits of Atlante, and
- the potential recovery time reduction stemming from the Decrees.

For the first two factors, we use the guidance from Atlante's manager, Quaestio Capital Management (see the slides at http://www.quaestiocapital.com/en).

To quantify the potential reduction in recovery time, we refer to the scenario we have shown in the section 'Selling NPLs: a matter of price'. We assume a three-year reduction, resulting in a potential 5pp price gap reduction. Increasing the recovery rate could also help reduce the price gap, but it depends in turn on other external factors. Shortening the recovery time is function of the legal process and data quality.

Finally, one of the most effective ways to reduce the price gap is changing the discount factor, as mentioned earlier. We think banks should apply a higher discount factor, which implies higher provisioning levels. Increasing coverage is the fastest way to speed up the offload of bad loans from banks' balance sheets. Figure 58 shows the potential dynamics of the price gap: increasing coverage would likely be the most effective action, as it could be done at any time.

Figure 58: Top-down approach: potential bid-ask price reduction



Source: Quaestio CM, Credit Suisse estimates

Top-down approach: a potential 20pp price gap reduction

As a result of our top-down analysis, we estimate the new measures could reduce the NPL market price gap by 10pp on average. Most of the impact would come from the foreclosure decrees (CSe: 5pp price gap reduction) while for the combined impact of Atlante and the GACS we estimate another 5pp. 10pp coverage uplift would help to reduce the price gap and revamp the NPL market. The size of the disposable portfolio depends on Atlante's capacity, and we believe banks could need to take markdowns. This top-down approach does not factor in some specifics, though: (i) the banks' collateral; and (i) the capital buffer to the SREP requirements (the capital levels). The first is relevant for the calculation of the appropriate coverage and the price gap. The second is crucial to understand the 'manageability' of a coverage uplift to offload bad loans, assessing the impact in terms of adjusted FL CET1 and buffer to the SREP.

The cost of a coverage uplift

A bottom-up approach

In this section, we adopt a bottom-up approach to assess: (i) the potential capital shortfall impact stemming from a range of coverage uplifts and (ii) the amount of disposable NPLs resulting from the clean-up. We calculate the cost of a clean-up in terms of excess/deficit capital to assess the room for maneuver for banks in terms of potential NPL disposal. The main steps include the following:

1) We focus on our covered stocks (ISP, UCG, MPS and UBI) but also include calculations for Banco Popolare (BP), Banca Popolare di Milano (BPM) and Banca Popolare Emilia Romagna (BPER) as cross-references. In the following tables, we show the potential impact on our 'Credit Suisse universe' (ISP, UCG, BPMS, UBI), 'Italy' names (UC Italy, ISP, BMPS, UBI, BP, BPM, BPER) and the combined group 'Total' (UCG, ISP, BPMS, UBI, BP, BPM, BPER). The four stocks in our coverage represent 67% of Italian banks' NPLs, while the Italian names also make up 67% and the combined group accounts for 72%.
2) We have estimated the split of secured and unsecured NPLs and focused on secured.
3) We have estimated the coverage of secured NPLs and calculated the secured NPL NBV.
4) Starting from the real estate collateral, we have used a DCF, based on a 5% discount factor and the current recovery time (seven years), to estimate the secured NPL value and assess the current provisioning level.
5) We have calculated the market value of the secured NPL (MV) assuming two IRR scenarios: 15% and 25%.
6) We have estimated the price gap (MV-NBV), adjusted by any provisioning shortfall stemming from the DCF analysis (see point 3 above).
7) We have calculated the total coverage increase needed to partly close the gap (by 10 percentage points) and to fully close it.
8) In the coverage uplift calculation, we have assumed the partial usage of the shortfall to expected loss already deducted from CET1.
9) We have assumed that the amount of disposable NPLs is equivalent to the marginal coverage uplift and estimated the impact on the GBV. We have assumed the NPL disposal to take place under 100% and 50% equity tranche scenarios.
10) We have calculated the impact on capital and the resulting buffer/deficit to SREP requirement to assess the final capital shortfall.
11) We have compared the potential capital shortfall with the market capitalization change since 23 November 2015, the date of the announcement of the rescue of the four small local banks. With the caveat that there are a number of factors impacting stock prices (for example, the Brexit vote, which adds volatility to the banks' CET1 via the sovereign exposure), this may give an indication of whether the market is already pricing in a capital shortfall for our covered stocks.

Scenario 1: 15% IRR

Under the 15% IRR assumption, we calculate an average 29pp bid-ask price gap (25pp adjusted by excess provisions on top of the resulting expected loss calculated on DCF value) for the four banks under our coverage, which could be increased by 8 percentage points total coverage uplift to 68% from 60% on average. We calculate -80bp average impact on FL CET1, down to ~11% from ~11.7%.

Figure 59: Scenario 1 (baseline): 15% IRR, partial price gap reduction

(€m, %)	UC Italy	UCG	Intesa	MPS	UBI*	CS universe^	BP**	BPM	BPER***	Italy	Total
Gross NPL (GBV)	41,600	52,032	38,924	27,733	7,122	125,811	10,667	3,380	7,277	136,703	147,135
Provisions	-25,100	-31,863	-23,801	-17,549	-2,775	-75,988	-4,587	-1,836	-4,231	-79,879	-86,642
Net NPL (NBV)	16,500	20,169	15,123	10,184	4,347	49,823	6,080	1,545	3,046	56,824	60,493
Current coverage	**60.3%**	**61.2%**	**61.1%**	**63.3%**	**39.0%**	**60.4%**	**43.0%**	**54.3%**	**58.1%**	**58.4%**	**58.9%**
Gross NPL ratio %	16.3%	9.9%	9.9%	20.2%	8.1%	14.7%	12.4%	9.2%	14.7%	13.1%	11.2%
Collateral BV	19,000	21,868	26,367	14,498	6,214	68,947	9,793	2,276	3,517	81,665	84,533
Collateral as % of GBV	46%	42%	68%	52%	87%	55%	92%	67%	48%	60%	57%
Secured NPL %	46%	42%	68%	52%	87%	55%	92%	67%	48%	60%	57%
Unsecured NPL %	54%	58%	32%	48%	13%	45%	8%	33%	52%	40%	43%
Secured NPL amount	19,000	21,868	26,367	14,498	6,214	68,947	9,793	2,276	3,517	81,665	84,533
Unsecured NPL amount	22,600	30,164	12,557	13,235	908	56,864	874	1,104	3,760	55,038	62,602
Secured NPL coverage	25%	22%	44%	33%	31%	32%	38%	34%	21%	32.0%	31.2%
Unsecured NPL coverage	90%	90%	98%	97%	97%	96%	98%	97%	93%	95.7%	95.8%
Provisions on secured NPL	4,750	4,702	11,470	4,726	1,895	22,793	3,731	765	739	26,168	26,358
Secured NPL NBV	14,250	17,166	14,897	9,772	4,319	46,154	6,062	1,511	2,779	53,589	56,506
Recovery time	7	7	7	7	7	7	7	7	7	7	7
Discount factor	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%
IRR	**15%**	**15%**	**15%**	**15%**	**15%**	**15%**	**15%**	**15%**	**15%**	**15%**	**15%**
Implied DCF	13,503	15,541	18,739	10,303	4,416	48,999	6,960	1,618	2,500	58,038	60,076
Price for investors	7,143	8,221	9,912	5,450	2,336	25,920	3,682	856	1,322	30,701	31,779
NBV/GBV	75%	79%	57%	67%	70%	67%	62%	66%	79%	66%	67%
Price for investors/GBV	38%	38%	38%	38%	38%	38%	38%	38%	38%	38%	38%
Bid-ask price gap	**-37%**	**-41%**	**-19%**	**-30%**	**-32%**	**-29%**	**-24%**	**-29%**	**-41%**	**-28%**	**-29%**
Adjusted Bid-ask price gap	-41%	-48%	-4%	-26%	-30%	-25%	-15%	-24%	-49%	-25%	-27%
Cov uplift to reduce gap to 15%	-26%	-33%	-4%	-11%	-15%	-16%	0%	-9%	-34%	-12%	-15%
New secured NPL coverage	51.3%	54.8%	46.0%	43.7%	33.7%	47.2%	38.2%	42.7%	55.3%	42.9%	44.4%
New secured NPL NBV/GBV	49%	45%	54%	56%	66%	53%	62%	57%	45%	55%	54%
New Bid-ask price gap	**-11%**	**-8%**	**-16%**	**-19%**	**-29%**	**-15%**	**-24%**	**-20%**	**-7%**	**-17%**	**-16%**
NPL GBV sales - 100% Equity T	9,746	13,293	1,424	3,647	590	18,954	35	487	2,182	18,111	21,658
% of the GBV	**23%**	**26%**	**4%**	**13%**	**8%**	**15%**	**0%**	**14%**	**30%**	**13%**	**15%**
NPL GBV sales - 50% Equity T	19,492	26,586	2,849	7,293	1,180	37,908	71	973	4,365	36,222	43,317
% of the GBV	**47%**	**51%**	**7%**	**26%**	**17%**	**30%**	**1%**	**29%**	**60%**	**26%**	**29%**
New total NPL coverage	**72.4%**	**75.2%**	**62.8%**	**69.1%**	**41.8%**	**68.1%**	**43.1%**	**60.5%**	**74.7%**	**64.9%**	**66.5%**
Total coverage uplift	**12%**	**14%**	**2%**	**6%**	**3%**	**8%**	**0%**	**6%**	**17%**	**6%**	**8%**
RWA	157,558	394,359	282,000	72,113	60,781	809,253	44,600	34,590	39,949	691,591	928,392
Potential impact to CET1	**-2.1%**	**-1.2%**	**-0.2%**	**-1.4%**	**-0.2%**	**-0.8%**	**0.0%**	**-0.4%**	**-2.0%**	**-0.8%**	**-0.8%**
Q1 16 FL CET1	9.5%	10.9%	13.1%	11.4%	11.7%	11.7%	11.7%	12.3%	11.5%	11.8%	11.8%
Adjusted FL CET1	**7.4%**	**9.6%**	**12.9%**	**10.0%**	**11.5%**	**11.0%**	**11.7%**	**11.9%**	**9.5%**	**-0.8%**	**-0.8%**
SREP	10.0%	10.8%	9.5%	10.8%	9.3%	10.20%	9.6%	9.0%	9.3%	9.7%	10.1%
Potential buffer/shortfall on SREP	**-2.6%**	**-1.1%**	**3.4%**	**-0.8%**	**2.3%**	**0.8%**	**2.1%**	**2.9%**	**0.3%**	**1.2%**	**0.9%**
Capital deficit/excess	-4,039	-4,343	9,726	-564	1,378	6,210	950	1,013	106	-8,571	-8,280
Potential total capital shortfall	-4,039	-4,343	0	-564	0	-4,907	0	0	0	-4,603	-4,907

*Based on data before 2019/2020 plan; **Pre-the recent €1bn rights issue; ***Pre AIRB Advanced model approval; ^UCG, ISP, MPS, UBI
Source: Company data, Credit Suisse estimates based on applying sector assumptions to latest reported data

This level implies an average 80bp buffer on the SREP. Coverage at UC Italy and UCG would exceed 70%, MPS would have 69%, while ISP would stand at ~63%, on our numbers. UBI remains the laggard (due to its lower starting point) at ~42%. The impact to CET1 appears manageable: 80bps on average, ranging from a negligible 20bps for ISP and UBI to 120bps for UCG and 140bp for MPS. **Overall, we calculate a ~14pp price gap reduction backed by an 8pp coverage uplift: this would equate to the potential disposal of €19-38bn NPLs for the Credit Suisse universe, or 9-19% of the NPL GBV**.

Scenario 2: 25% IRR

Under a more severe 25% IRR assumption, we calculate an average 46pp bid-ask price gap (42pp adjusted by excess provisions on top of the resulting expected loss calculated on DCF value) for the Credit Suisse universe, which could be reduced to 21pp thanks to 14 percentage points of total coverage uplift from 60% to 74% on average. We calculate -140bp average impact on FL CET1, down to ~10.4% from ~11.7%. This level implies an average 20bp buffer on the SREP.

Figure 60: Scenario 2: 25% IRR, partial price gap reduction

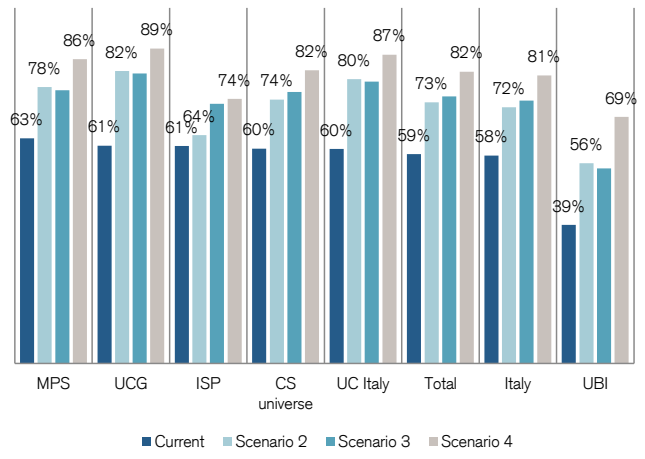
(€m, %)	UC Italy	UCG	Intesa	MPS	UBI*	CS universe^	BP**	BPM	BPER***	Italy	Total
Gross NPL (GBV)	41,600	52,032	38,924	27,733	7,122	125,811	10,667	3,380	7,277	136,703	147,135
Provisions	-25,100	-31,863	-23,801	-17,549	-2,775	-75,988	-4,587	-1,836	-4,231	-79,879	-86,642
Net NPL (NBV)	16,500	20,169	15,123	10,184	4,347	49,823	6,080	1,545	3,046	56,824	60,493
Current coverage	60.3%	61.2%	61.1%	63.3%	39.0%	60.4%	43.0%	54.3%	58.1%	58.4%	58.9%
Gross NPL ratio %	16.3%	9.9%	9.9%	20.2%	8.1%	14.7%	12.4%	9.2%	14.7%	13.1%	11.2%
Collateral BV	19,000	21,868	26,367	14,498	6,214	68,947	9,793	2,276	3,517	81,665	84,533
Collateral as % of GBV	46%	42%	68%	52%	87%	55%	92%	67%	48%	60%	57%
Secured NPL %	46%	42%	68%	52%	87%	55%	92%	67%	48%	60%	57%
Unsecured NPL %	54%	58%	32%	48%	13%	45%	8%	33%	52%	40%	43%
Secured NPL amount	19,000	21,868	26,367	14,498	6,214	68,947	9,793	2,276	3,517	81,665	84,533
Unsecured NPL amount	22,600	30,164	12,557	13,235	908	56,864	874	1,104	3,760	55,038	62,602
Secured NPL coverage	25%	22%	44%	33%	31%	32%	38%	34%	21%	32.0%	31.2%
Unsecured NPL coverage	90%	90%	98%	97%	97%	96%	98%	97%	93%	95.7%	95.8%
Provisions on secured NPL	4,750	4,702	11,470	4,726	1,895	22,793	3,731	765	739	26,168	26,358
Secured NPL NBV	14,250	17,166	14,897	9,772	4,319	46,154	6,062	1,511	2,779	53,589	56,506
Recovery time	7	7	7	7	7	7	7	7	7	7	7
Discount factor	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%
IRR	**25%**	**25%**	**25%**	**25%**	**25%**	**25%**	**25%**	**25%**	**25%**	**25%**	**25%**
Implied DCF	13,503	15,541	18,739	10,303	4,416	48,999	6,960	1,618	2,500	58,038	60,076
Price for investors	3,985	4,586	5,530	3,040	1,303	14,459	2,054	477	738	17,126	17,728
NBV/GBV	75%	79%	57%	67%	70%	67%	62%	66%	79%	66%	67%
Price for investors/GBV	21%	21%	21%	21%	21%	21%	21%	21%	21%	21%	21%
Bid-ask price gap	**-54%**	**-58%**	**-36%**	**-46%**	**-49%**	**-46%**	**-41%**	**-45%**	**-58%**	**-45%**	**-46%**
Adjusted Bid-ask price gap	-58%	-65%	-21%	-43%	-47%	-42%	-32%	-41%	-66%	-42%	-44%
Cov uplift to reduce gap to 15%	-43%	-50%	-6%	-28%	-32%	-27%	-17%	-26%	-51%	-23%	-25%
New secured NPL coverage	68.0%	71.5%	48.0%	60.3%	50.3%	58.2%	54.9%	59.4%	72.0%	54.8%	56.5%
New secured NPL NBV/GBV	32%	29%	52%	40%	50%	42%	45%	41%	28%	43%	42%
New Bid-ask price gap	**-11%**	**-8%**	**-31%**	**-19%**	**-29%**	**-21%**	**-24%**	**-20%**	**-7%**	**-22%**	**-21%**
NPL GBV disposals - 100% Equity T	12,010	15,288	2,491	6,644	2,448	26,870	2,992	988	2,491	30,062	33,341
% of the GBV	**29%**	**29%**	**6%**	**24%**	**34%**	**21%**	**28%**	**29%**	**34%**	**22%**	**23%**
NPL GBV disposals - 50% Equity T	24,020	30,576	4,982	13,288	4,895	53,741	5,984	1,975	4,981	60,125	66,681
% of the GBV	**58%**	**59%**	**13%**	**48%**	**69%**	**43%**	**56%**	**58%**	**68%**	**44%**	**45%**
New total NPL coverage	**80.0%**	**82.2%**	**64.2%**	**77.7%**	**56.3%**	**74.2%**	**58.4%**	**71.7%**	**82.8%**	**72.0%**	**73.4%**
Total coverage uplift	**20%**	**21%**	**3%**	**15%**	**17%**	**14%**	**15%**	**17%**	**25%**	**14%**	**15%**
RWA	157,558	394,359	282,000	72,113	60,781	809,253	44,600	34,590	39,949	691,591	928,392
Potential impact to CET1	**-3.4%**	**-1.8%**	**-0.3%**	**-3.6%**	**-1.3%**	**-1.4%**	**-2.4%**	**-1.1%**	**-2.9%**	**-1.7%**	**-1.5%**
Q1 16 FL CET1	9.5%	10.8%	13.1%	11.4%	11.7%	11.7%	11.7%	12.3%	11.5%	11.8%	11.8%
Adjusted FL CET1	**6.1%**	**9.0%**	**12.8%**	**7.8%**	**10.4%**	**10.4%**	**9.3%**	**11.2%**	**8.6%**	**10.0%**	**10.3%**
SREP	10.0%	10.8%	9.5%	10.8%	9.3%	10.2%	9.6%	9.0%	9.3%	9.7%	10.1%
Potential buffer/shortfall on SREP	**-3.9%**	**-1.7%**	**3.3%**	**-3.0%**	**1.2%**	**0.2%**	**-0.2%**	**2.2%**	**-0.7%**	**0.3%**	**0.2%**
Capital deficit/excess	-6,092	-6,706	9,374	-2,130	707	1,258	-108	767	-274	2,244	1,643
Potential total capital shortfall	-6,092	-6,706	0	-2,130	0	-8,836	-108	0	-274	-8,222	-9,218

*Based on data before 2019/2020 plan; **Pre-the recent €1bn rights issue; ***Pre AIRB advanced model approval; ^UCG, ISP, MPS, UBI
Source: Company data, Credit Suisse estimates based on applying sector assumptions to latest reported data

UC Italy and UCG coverages would jump above 80% coverage, and MPS would achieve ~78%, while ISP would be ~64%. UBI would keep the lowest coverage at 57%. Under this scenario, we calculate a 140bp average impact to CET1. The potential impact ranges from a negligible 30bps for ISP to 180bps for UCG. Under this scenario, UBI would suffer from 130bps impact to CET1 stemming from 17pp coverage uplift; however, the bank would keep a solid buffer to the SREP (>100bp). **Overall, we calculate a ~25pp price gap reduction backed by 14pp coverage uplift: this would result in a potential disposal of €27-54bn NPLs for the Credit Suisse universe, or 13-27% of the NPL GBV.**

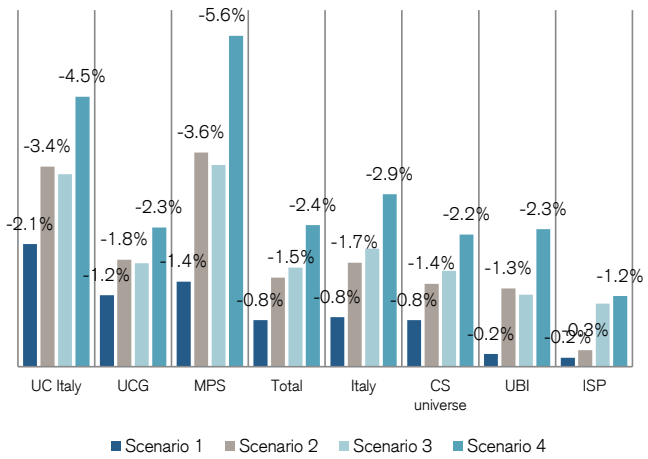
In Scenarios 3 and 4 (see the figures below), the main differential factor is the price gap reduction targeted. We show the impacts assuming the price gap to be fully closed. This exercise is purely theoretical and shows the magnitude of the capital shortfall in the event of a full NPL clean-up. We think this may be useful in assessing the level of capital shortfall already priced into current market prices for our covered stocks.

Figure 61: Total coverage potential dynamics



Source: Company data, Credit Suisse estimates

Figure 62: Potential impacts on CET1



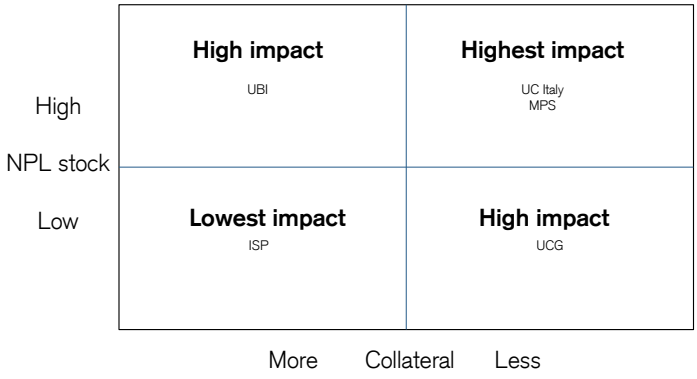
Source: Company data, Credit Suisse estimates

Bottom-up approach: 14pp price gap reduction

The impacts to capital look overall manageable only in scenario 1, while under the other scenarios all banks would be hit by relevant impacts to CET1, with the exception of ISP among our covered stocks. The impact is a function of: (i) the weight of secured NPLs and (ii) the NPL stock. The more secured NPLs, the smaller the impact; the more sizeable the stock of bad loans, the larger the impact. As such, we summarise the following potential impacts depending on the mix: (a) high stock of NPLs combined with low collateralization results in the worst impact; (b) high NPL stock combined with high collateralization results in high impact, as in the case of low NPL stock and low collateralization; and (c) the best case stems from the combination of low NPL stock and high collateralization. Figure 62 summarises the impacts on capital under the different above mentioned combinations.

The FL CET1 would decline from the average ~11.7% (Credit Suisse universe) to ~11% (Scenario 1), implying an 80bp buffer on top of the average SREP requirement (10.2%). Note that for UC Italy, we have used a proxy of the Italian banks average to determine its potential SREP requirement. We assume a 9.5% FL CET1 for UC Italy.

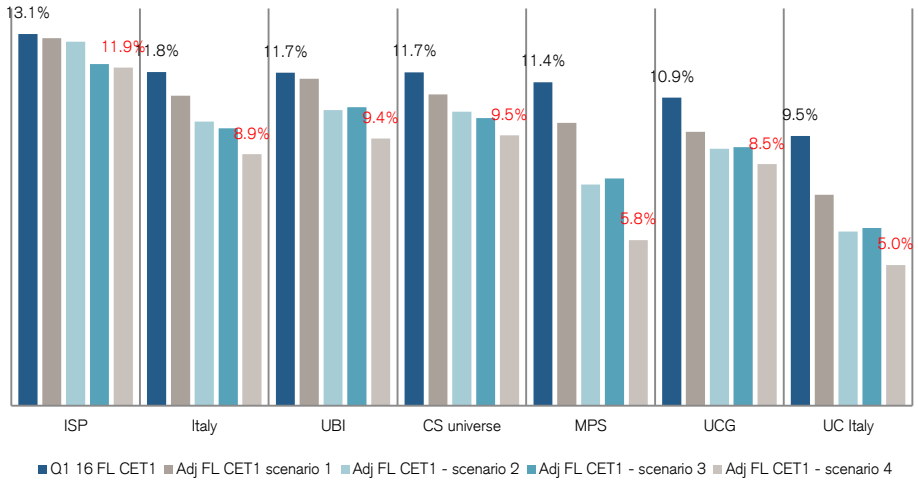
Figure 63: Potential impacts to capital



Source: Credit Suisse estimates

We think the overall baseline Scenario 1 looks manageable for our covered stocks. UCG would likely be the only bank in need of a capital raising, with MPS near needing to raise capital. For UCG, this conclusion is due not only to the lower-than-average collateralization and the high bad loans stock in Italy, but also for the lower-than-average actual FL CET1, which shows 10bp excess to the SREP requirement; this appears stretched for a G-SIFI.

Figure 64: FL CET1 under different scenarios



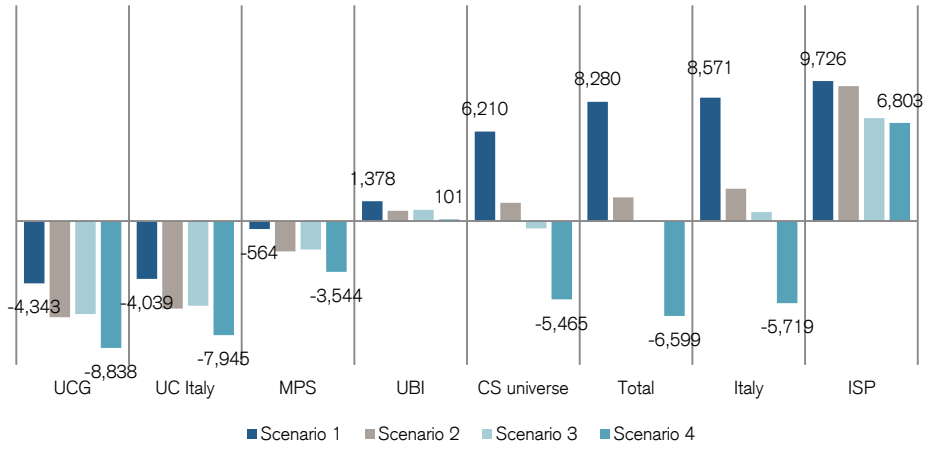
Source: Company data, Credit Suisse estimates

In conclusion, with an 8pp coverage uplift, we calculate up to a ~14pp price gap reduction. We estimate UCG would need to raise capital in this scenario. For the Credit Suisse banks universe, the cost of reducing the bid-ask price gap to 15% from 29% is limited to a manageable 8pp coverage uplift, implying an aggregated -€5bn capital deficit to the SREP. **Under this scenario, we estimate the disposal of NPLs amounting to 13-27% of the GBV**.

The market is factoring in more than the adverse scenario

The adverse scenario of a full clean-up, assuming 25% IRR, is helpful to show that ISP has the capacity to handle such a worst-case scenario. The bank would still show a 240bp excess capital buffer on top of the SREP (or €6.8bn). We also flag that UBI would have excess capital in the worst case scenario, with a small €101m (20bp on top of 9.25% SREP). MPS would not be able to manage such a clean-up without incurring substantial capital shortfalls (€3.5bn), in our view.

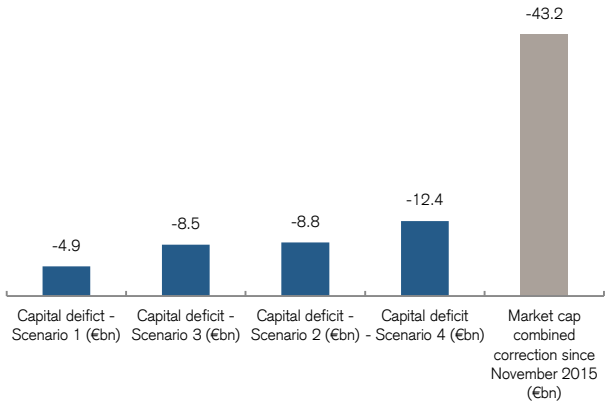
Figure 65: Excess/Deficit capital to SREP under different scenario



Source: Credit Suisse estimates

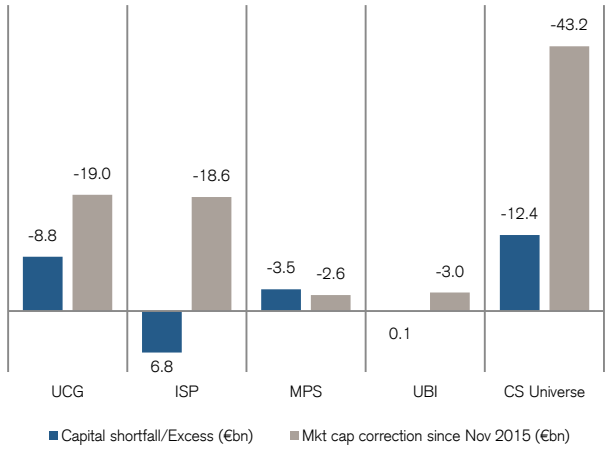
In the charts below, we show the aggregated capital deficit under the different scenarios and the market cap combined correction since November 2015 (when the resolution plan of the four small banks was announced).

Figure 66: CS universe – Aggregate capital shortfalls under different scenarios vs market trends



Source: Credit Suisse estimates

Figure 67: Capital positions by bank and aggregate in the worst-case scenario vs market trends



Source: Credit Suisse estimates

The capital deficit looks broadly overdone and factored into share prices for our stocks. The comparison between the market cap correction since November 2015 (at the time of the four banks resolution) and the capital shortfalls of our scenario analysis shows that the market seems to be already broadly discounting an adverse scenario.

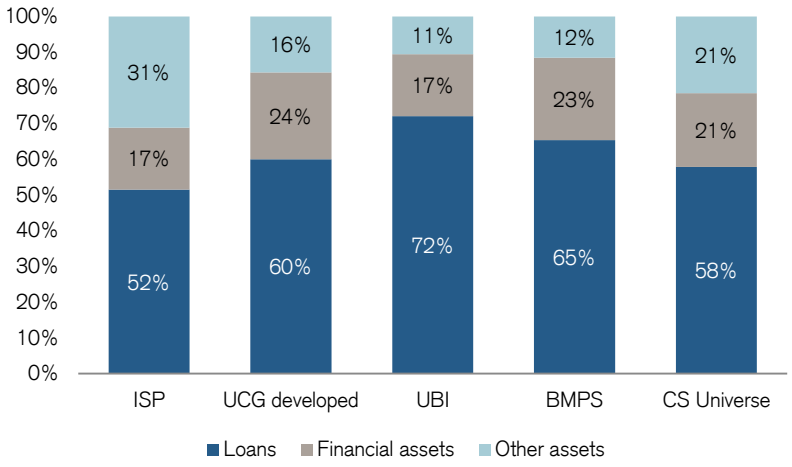
At an aggregate level, we think the market is currently factoring in a capital deficit larger than the real needs to clean-up NPLs. For the Credit Suisse universe, we calculate a €12bn aggregated capital shortfall to achieve a full clean-up (closing the price gap) versus the €43bn combined market cap correction since November 2015, when the four small banks were put in resolution. ISP has capacity to withstand our worst-case scenario and still have 240bp excess capital on top of the SREP (or €6.8bn). We also note that UBI would be in a decent capital situation in our worst-case scenario, with a small €101m (20bp on top of 9.25% SREP).

Italian banks' financials

Balance sheet breakdown

The Italian banks' balance sheet breakdown shows that customer loans represent the main group of assets, at 58%.

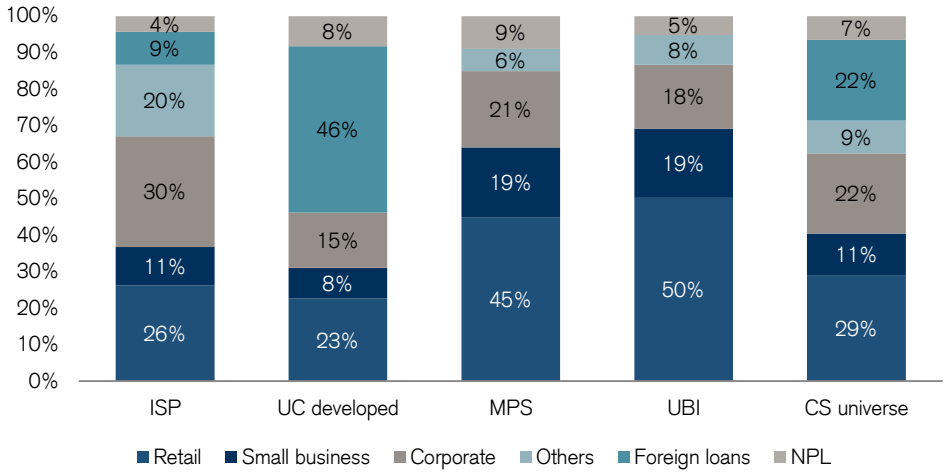
Figure 68: Asset breakdown in Q1 16



Source: Company data, Credit Suisse estimates

Based on the Q1 16 data for the Credit Suisse universe, the Italian banks loan breakdown is mainly made of corporate loans and small business (33%) and retail loans (29%). Other loans include leasing and factoring. Foreign loans include the foreign subsidiaries of UCG and ISP.

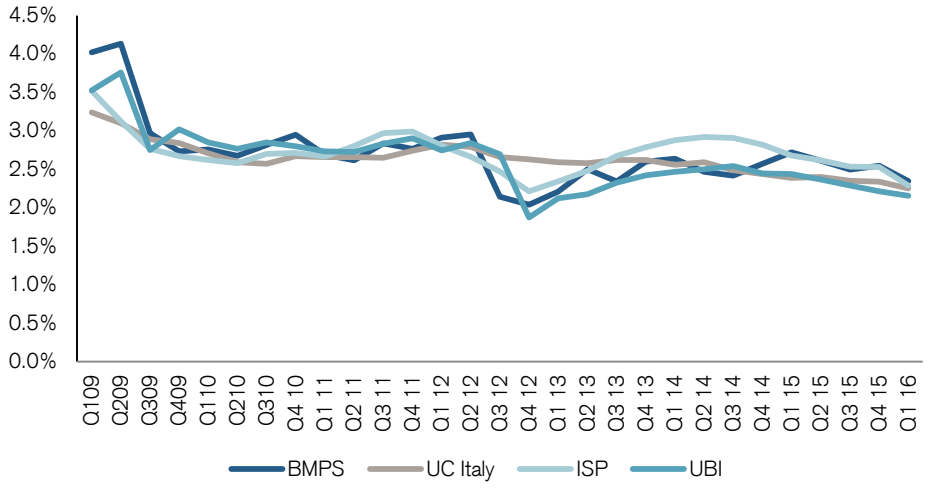
Figure 69: Italian banks' loan book breakdown in Q1 16



Source: Company data

We estimate an average quarterly commercial NIM of 216bp to 235bp in Q1 16, with a loan yield of 226bp-306bp and a deposit yield between 10bp and 72bp.

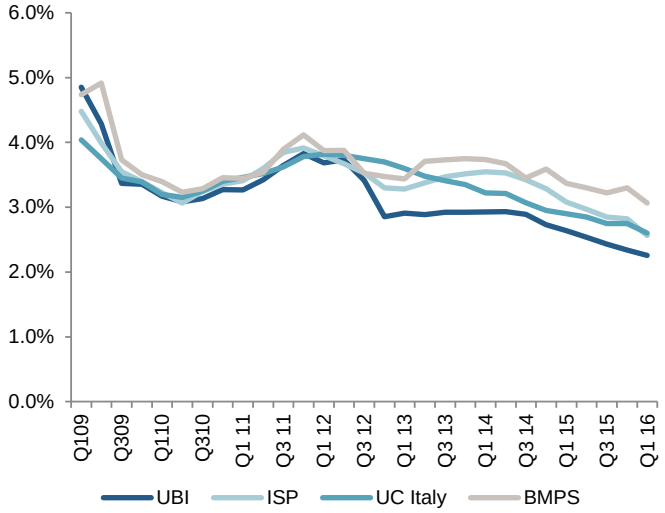
Figure 70: NIM quarterly trends



Source: Credit Suisse estimates

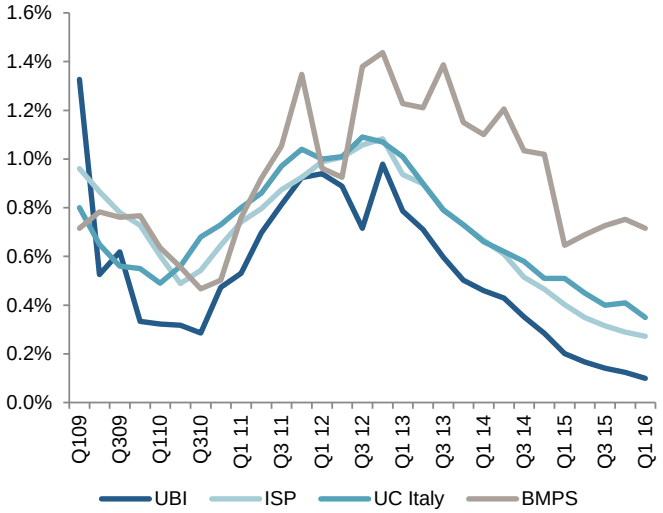
The trends of loan and deposit yields show relevant pressure on the mark-up, which were partly offset by the cost of funding decline. In Q1 16, the NIM pressure was 6bp-24bp, mainly on the asset side.

Figure 71: Quarterly loans yields



Source: Credit Suisse estimates

Figure 72: Quarterly deposits yields

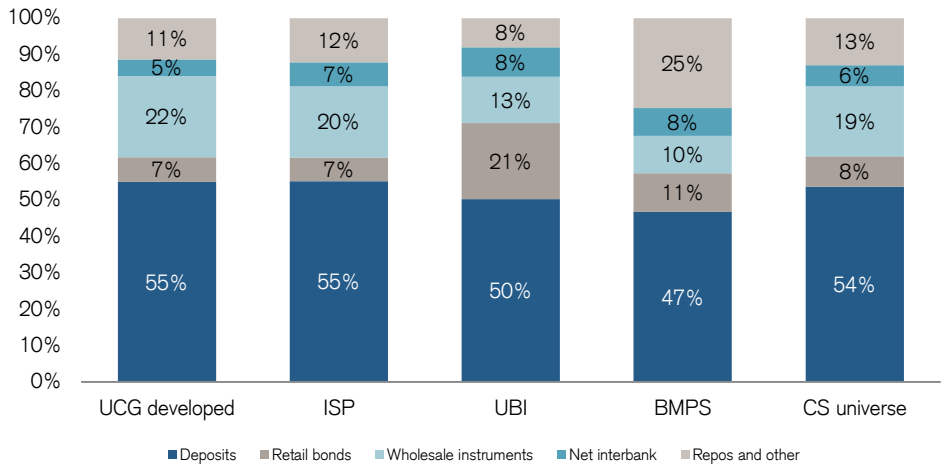


Source: Credit Suisse estimates

In Q1 16, the liability breakdown showed the banks' preferred funding is core deposits (54%), while retail bonds are falling as banks are refocusing clients on more profitable asset management products. The chart below shows that, while large banks have limited room for this, mid-sized banks (MPS and UBI mainly) have relevant reserves in terms of retail bonds that could be switched into asset management volumes. This is one of the main pillars of the business plan recently launched by UBI's management.

Wholesale funding represents 19% of total funding, but it is likely to increase as a result of the recent change in the funding policy of Italian banks.

Figure 73: Italian banks' funding breakdown in Q1 16

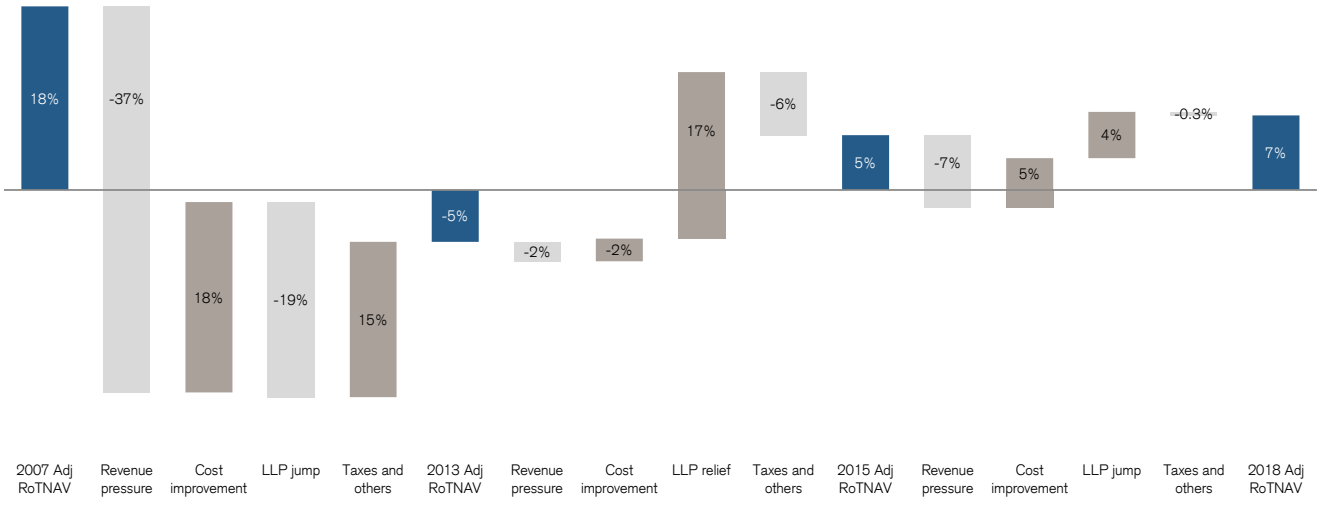


Source: Company data

Aggregated P&L historical trends and estimates

The Credit Suisse banks universe showed 18% aggregate pre-crisis RoTNAV in 2007. The global financial crisis triggered a sharp fall in profitability as a result of the margin pressure combined with the increase in LLP. Cost cutting measures were not able to offset these impacts.

Figure 74: Aggregated RoTNAV evolution 2007-2018E

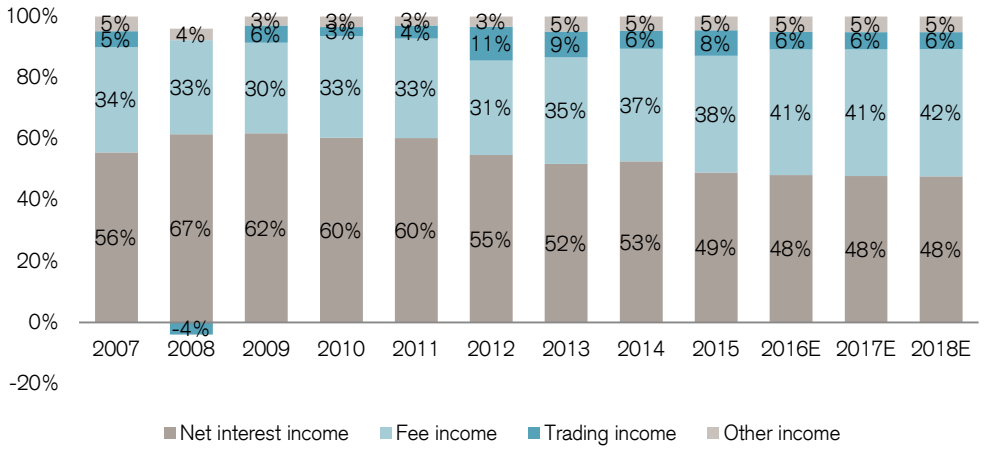


Source: Credit Suisse estimates

In 2013, Italian banks posted -5% aggregated negative profitability. Backed by the LLP relief, the aggregate adjusted RoTNAV15 jumped to 5%, still well below pre-crisis levels. In our 2016-28 estimates, we factor in severe margin pressure; we expect the main profitability drivers to come from cost improvement and additional LLP relief.

As a result, the adjusted RoTNAV18E should be only mid-high single digits at 7%. We expect the total income breakdown to be mainly made up of net fees (rising to 42% in 2018E from 38% in 2015) at the expense of NII (down to 48% from 49%) and of trading income (to 6% from 8%).

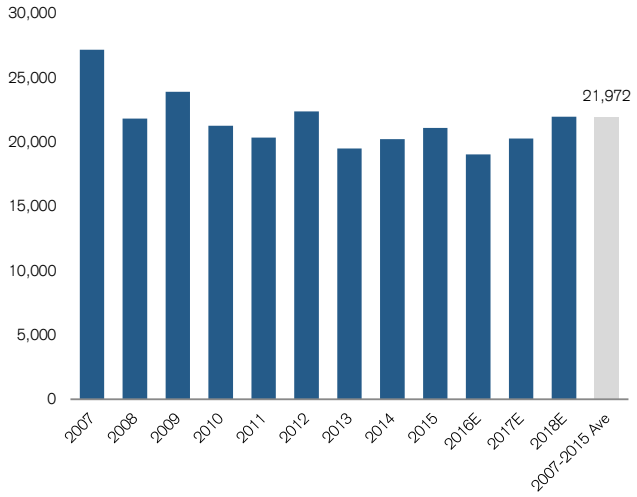
Figure 75: Total income breakdown evolution



Source: Company data, Credit Suisse estimates

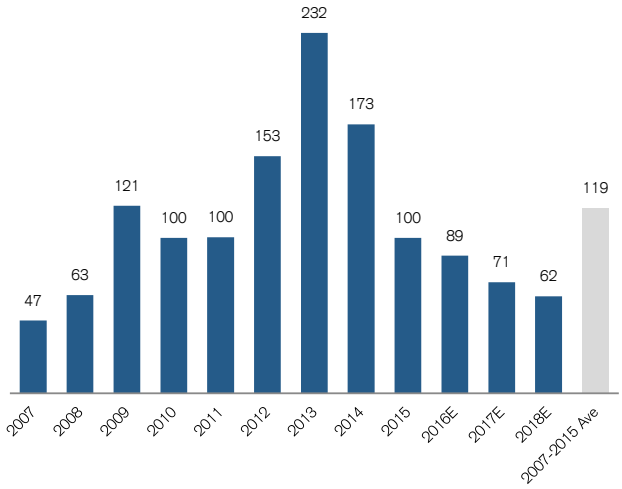
We expect the aggregated pre-provision profit to reach a 10-year low in 2016, bottom out as of 2017 and then post a sharp recovery. The cost of risk (CoR) should decline sharply from an average 100bp accrual in 2015 to 62bp in 2018, boosting the bottom line.

Figure 76: Aggregated pre-provision profit trends



Source: Company data, Credit Suisse estimates

Figure 77: Aggregated LLP trends



Source: Company data, Credit Suisse estimates

Intesa-Sanpaolo (ISP.MI)

Rating	**OUTPERFORM**
Price (15 Jul 16, €)	1.93
Target price (€)	2.50
Market Cap (€ m)	30,624.8

*Stock ratings are relative to the coverage universe in each analyst's or each team's respective sector.
[1]Target price is for 12 months.

Research Analysts

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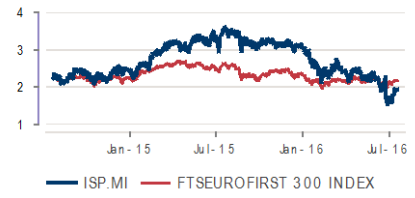
Quality deserves a premium

- **Initiating on ISP with an Outperform rating and €2.5 TP:** Trading at 0.77x PTBV16E, ISP's multiples are at a premium to those of Italian peers (0.44x), justified by its robust capital, solid balance sheet structure and superior profitability. However, at current levels, we think the stock is factoring in the risk of dividend cut from potential M&A action (for example, a forced rescue of weaker banks) or further participation in any rescue fund.
- **Solid capital and high dividend—a unique combination:** ISP has (i) one of the most robust capital ratios in the Eurozone (~13% FL CET1 in Q1 16), (ii) the highest profitability among Italian peers (7% adjusted RoTNAV15 vs 5% Credit Suisse Italian banks universe), (iii) high reliance on fee income (43% of 2015 revenue) and Private Wealth Management (~23% of revenue), and (iv) the strongest asset quality ratios among Italian banks (8% net NPE ratio), on our numbers.
- **The most resilient bank in our coverage uplift stress test:** Besides showing the most resilience in our stress test on coverage uplift, ISP shows a relevant buffer to the SREP in our worst-case scenario thanks to its solid capital, lower NPL stock and higher collateralization than peers.
- **Valuation and risks:** We derive our €2.5 TP from a 2017E SoTP, implying ~30% potential upside. The stock trades on 0.78x PTBV17E (7.8% RoTE17E), a 31% relative premium to Eurozone peers. Risks to the downside are: (i) a potential regulatory cap on dividend distribution, (ii) additional pressure on NIM, (iii) a potential slowdown in asset management as a result of market turbulence, and (iv) further hits to earnings/capital from participating in resolution/rescue funds (i.e., the one for the four local banks in November and/or Atlante); (v) potential dividend cut as a result of the participation to any rescue fund; and (vi) M&A risk: a forced rescue of any fragile bank.

Share price performance



The price relative chart measures performance against the FTSEUROFIRST 300 INDEX which closed at 1335.7 on 15/07/16
On 15/07/16 the spot exchange rate was €1/Eu 1.-Eu.91/US$1

Performance	1M	3M	12M
Absolute (%)	-5.1	-21.5	-46.2
Relative (%)	-8.8	-17.5	-28.4

Financial and valuation metrics

Year	12/15A	12/16E	12/17E	12/18E
Net income reported (€ m)	2,739	4,091	3,245	3,732
Adjusted net profit (€ m)	2,817	2,533	3,218	3,665
EPS stated (€)	0.17	0.25	0.20	0.23
CS adj. EPS (€)	0.17	0.15	0.20	0.22
Prev. EPS (€)				
Tangible book value (€ m)	40,581	41,287	40,959	41,656
ROTE avg (adj.) (%)	7.2	6.2	7.8	8.9
P/E (adj.) (x)	11.28	12.54	9.87	8.67
Price/Tangible BPS (x)	0.78	0.77	0.78	0.76

Dividend (12/16E, EUR)	0.21	B3 Transitional RWAs (12/16E, €)	286,065
Dividend yield (12/16E,%)	11.0	Basel 3 FL CET1 ratio (12/16E,%)	12.7
Free float (%)	75.8	Number of shares (m)	15,859.6

Source: Company data, Thomson Reuters, Credit Suisse estimates

Intesa-Sanpaolo (ISP.MI)

Price (15 Jul 2016): **€1.931**; Rating: **OUTPERFORM**; Target Price: **€2.50**; Analyst: **Carlo Tommaselli**

Income statement (€ m)	12/15A	12/16E	12/17E	12/18E
Net interest income	7,717	7,202	7,266	7,346
Fee and commission income	7,342	7,550	7,752	7,963
Trading income	1,034	754	775	798
Other non interest income	788	1,117	1,097	1,097
Total income	**16,881**	**16,622**	**16,890**	**17,205**
Admin expense	(5,286)	(5,244)	(5,296)	(5,349)
Other expenses	(2,720)	(2,774)	(2,802)	(2,830)
Total expenses	**(8,734)**	**(8,739)**	**(8,826)**	**(8,914)**
Pre-provision profit	**8,147**	**7,883**	**8,064**	**8,290**
Loan loss provisions	(3,306)	(2,800)	(2,431)	(1,939)
Other non-recurring pre-tax	138	1,800	0	0
Pre-tax profit	**4,412**	**6,353**	**5,163**	**5,881**
Minority interests & Other	138	229	214	209
Net profit (reported)	**2,739**	**4,091**	**3,245**	**3,732**
Net profit (adjusted)	**2,817**	**2,533**	**3,218**	**3,665**

Balance sheet (€ m)	12/15A	12/16E	12/17E	12/18E
Assets				
Net customer loans	350,010	356,912	367,122	380,792
Loan loss reserves	32,295	32,551	32,406	31,700
Avg interest earnings assets	661,475	679,947	688,503	700,443
Goodwill & intangibles	7,195	7,195	7,195	7,195
Total assets	**676,496**	**683,398**	**693,608**	**707,278**
Liabilities				
Total deposits	255,838	267,971	280,770	294,275
Shareholders' equity	**47,776**	**48,482**	**48,154**	**48,851**
Minority interests	817	817	817	817
Total equity and liabilities	**676,496**	**683,398**	**693,608**	**707,278**

Per share	12/15A	12/16E	12/17E	12/18E
Reported EPS (€)	0.17	0.25	0.20	0.23
CS adj. EPS (€)	**0.17**	**0.15**	**0.20**	**0.22**
Prev. EPS (€)				
% YOY change	135.16	(10.09)	27.07	13.88
Dividend (€)	0.15	0.21	0.18	0.21
% YOY change	100.00	45.83	(14.29)	16.67
Dividend payout ratio	85.20	138.20	93.22	95.50
Dividend yield (%)	7.56	11.02	9.44	11.02
TNAVPS	2.47	2.51	2.49	2.53
Shares outstanding (m)	16,450	16,450	16,450	16,450

Valuation	12/15A	12/16E	12/17E	12/18E
P/E (adj., X)	11.3	12.5	9.9	8.7
P/BVPS (x)	0.7	0.7	0.7	0.7
P/NAVPS (x)	0.8	0.8	0.8	0.8
ROE (%)	5.9	8.5	6.7	7.7
CS adj. ROTE	0.1	0.1	0.1	0.1
ROA (%)	0.4	0.4	0.5	0.5
RoRWA (%)	1.0	1.4	1.1	0.7
NIM (NII/AIEA) (%)	1.2	1.1	1.1	1.0
Cost / Income (%)	51.7	52.6	52.3	51.8
Loan/Deposit (%)	136.8	133.2	130.8	129.4

Asset Quality	12/15A	12/16E	12/17E	12/18E
NPLs	33,086	34,213	34,323	34,235
% YOY Change	(1.1)	3.4	0.3	(0.3)
NPL/ gross loans	8.7	8.8	8.6	8.3
Loan Loss Reserves/NPLs	97.6	95.1	94.4	92.6
Common Eq Tier1 Capital	-	-	-	-
Basel 3 Transitional CET1 capital	35,869	36,519	36,789	37,043
Basel 3 Fully loaded CET1 capital	35,869	36,519	36,789	37,043
Basel 3 Transitional RWAs	282,844	286,065	290,594	845,689
Basel 3 Fully loaded RWAs	284,319	286,601	291,862	293,210
Basel 3 Transitional CET1 ratio	12.7	12.8	12.7	4.4
Basel 3 Fully loaded CET1 ratio	12.6	12.7	12.6	12.6
Basel 3 leverage ratio	5.4	5.7	5.8	5.9

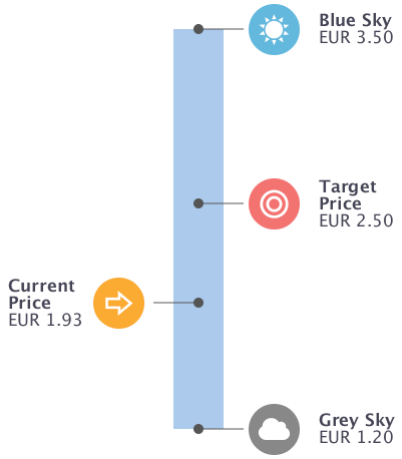
Earnings	12/15A	12/16E	12/17E	12/18E
Net Interest Income	(7.8)	(6.7)	0.9	1.1
F&C income	8.4	2.8	2.7	2.7
Trading income	33.1	(27.1)	2.9	3.0
Total revenues	(0.1)	(1.5)	1.6	1.9
Total expenses	2.2	0.1	1.0	1.0
Pre-prov operating profit	(2.5)	(3.2)	2.3	2.8
Pre-tax profit	28.4	44.0	(18.7)	13.9
Net customer loans	3.2	2.0	2.9	3.7
Customer deposits	11.2	4.7	4.8	4.8

Source: FTI, Company data, Thomson Reuters, Credit Suisse Securities (EUROPE) LTD. Estimates

Company Background

Intesa Sanpaolo is Italy's largest domestic lender, with relevant international presence in the Emerging Europe and Africa. ISP shows the largest market share in terms of loans and deposits. Branch productivity is the best among Italian banks.

Blue/Grey Sky Scenario



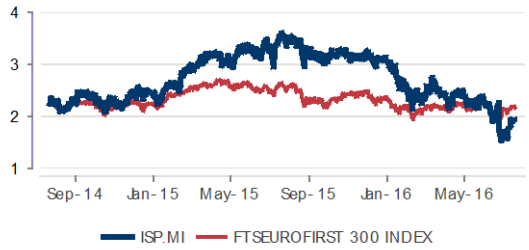
Our Blue Sky Scenario (€) 3.50

This scenario factors in the following assumptions: (i) 4% customer loans CAGR 2015-18E (from 3%); (ii) +10bp NIM; (iii) 113bp average AuM fees (from 108bp); (iv) 4% AuM CAGR 2015-18E (from 2.5%); and (v) 50bp average LLP (from 61bp). Under this scenario, the RoTNAV18E stands at 10%.

Our Grey Sky Scenario (€) 1.20

In this scenario, we factor in: (i) 0% customer loans (from 3%); (ii) marginal NIM pressure (-10bp); (iii) 106bp average AuM fees; (iv) 1% AuM growth; and (v) 70bp average LLP (from 61bp). The RoTNAV18E stands at 7% under this scenario. We also cut excess capital from €4bn in the base case to zero.

Share price performance



The price relative chart measures performance against the FTSEUROFIRST 300 INDEX which closed at 1335.7 on 15/07/16

On 15/07/16 the spot exchange rate was €1/Eu 1.- Eu.91/US$1

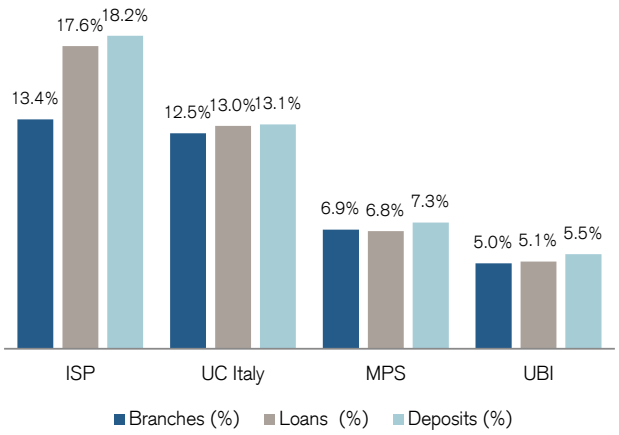
Company summary

Market leader in Italy

Intesa-Sanpaolo is the largest domestic lender, with 4,104 branches and a headcount of 64,412 in Italy. The bank has a sizeable international presence in Emerging Europe and Africa, with 1,234 branches and 26,107 employees.

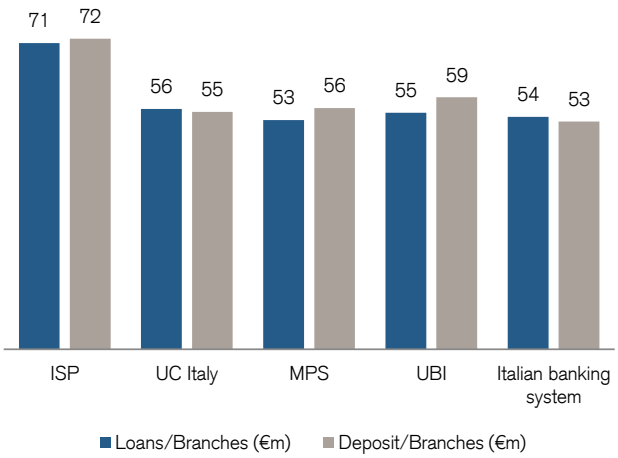
Among the four Italian banks in our coverage, ISP has the largest market share in terms of loans and deposits. Branch productivity is clearly the strongest.

Figure 78: Q1 16 Market shares



Source: Company data, Credit Suisse research, Bank of Italy

Figure 79: Q1 16 Branch productivity

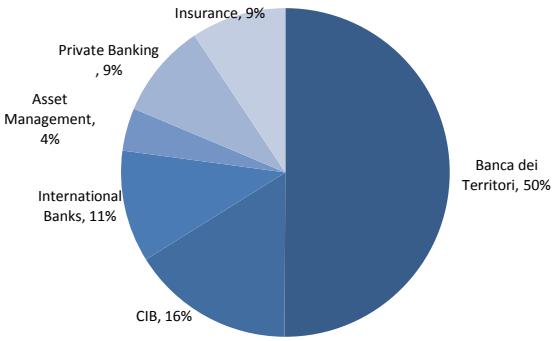


Source: Company data, Credit Suisse research, Bank of Italy

The business mix

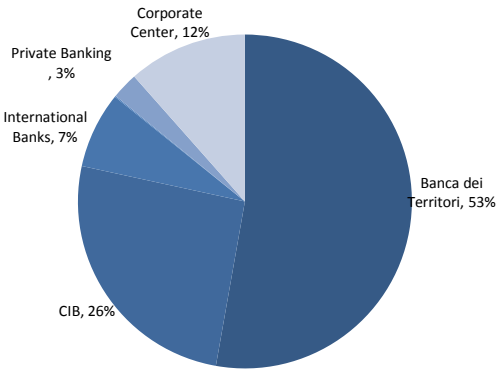
Based on 2015 data, the main business of ISP is domestic retail (Banca dei Territori division): 50% of total income. The exposure to fee income related business is high: ~23% of revenue stemmed from asset management, private banking and insurance in 2015. CIB represents 16% of total income, while the International Banks network contribution is 11%.

Figure 80: 2015 Revenue breakdown



Source: Company data, Credit Suisse research

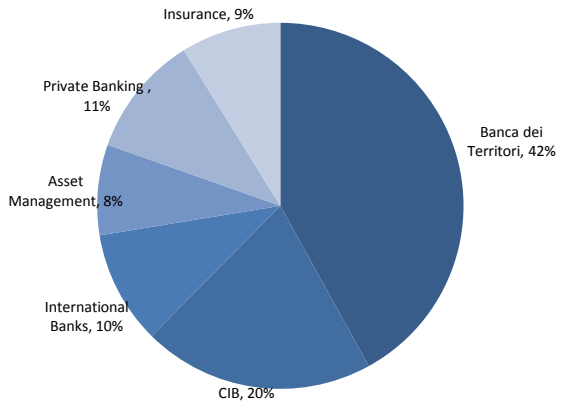
Figure 81: 2015 Loans breakdown



Source: Company data, Credit Suisse research

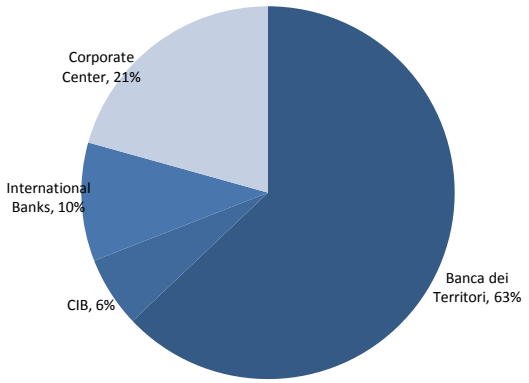
Including the corporate center deductions, the total domestic banking business' contribution to revenue is 66%. Of customer loans, 78% are allocated to the Italian operations (excluding corporate center). The international banks network's lending represents 7% of group loans. The Italian banking business contribution to pre-provision profit stands at 62%, while the private wealth management contribution is 28% (higher than the revenue contribution). LLP is a drag on banking business profitability; the chart below also shows the LLP charged in the corporate center. We allocate a corporate center LLP to each division on the back of their proportional contribution to pre-provision profit.

Figure 82: 2015 Pre-provision profit breakdown



Source: Company data, Credit Suisse research

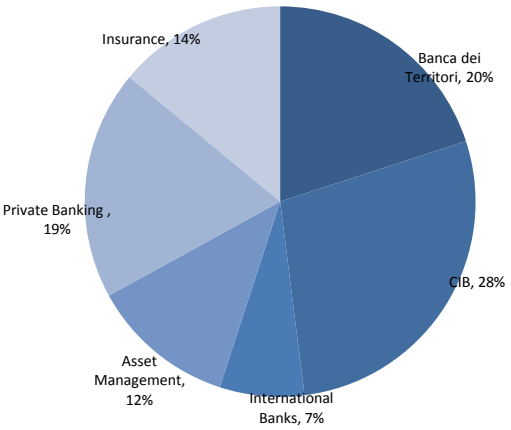
Figure 83: LLP breakdown



Source: Company data, Credit Suisse research

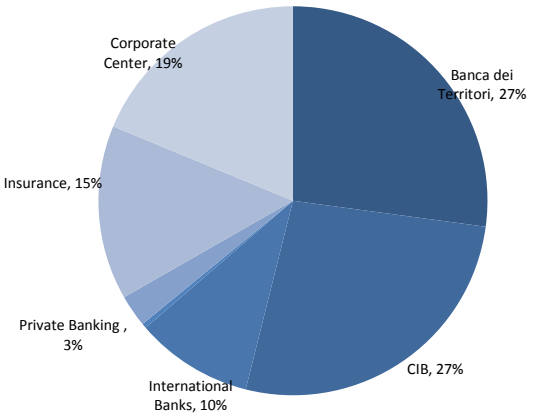
As a result, the domestic banking business represents only 48% of adjusted earnings. Including international banks and the negative impact of the corporate center, the total banking business represents 55% of net income.

Figure 84: 2015 adjusted earnings breakdown



Source: Company data, Credit Suisse research

Figure 85: 2015 capital allocation breakdown

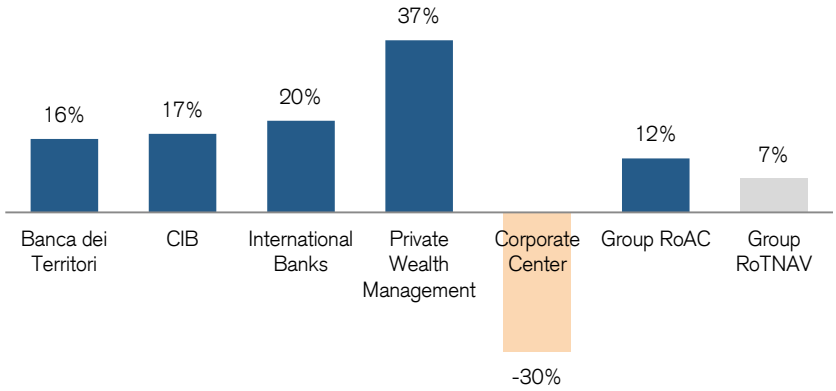


Source: Company data, Credit Suisse research

The asset management, private banking and insurance business contribution to the bottom line is well above that of Italian peers, with 45% of adjusted net profit. The banking business including the corporate center accounts for 55% of adjusted net profit.

The banking business absorbs most of the capital (64% of the allocated capital) before the corporate center (19% of the group capital). Asset management and private banking are low capital intensive businesses, with ~4% absorption, while insurance represents 15% of total capital.

Figure 86: 2015 RoAC by division, group RoAC and group RoTNAV



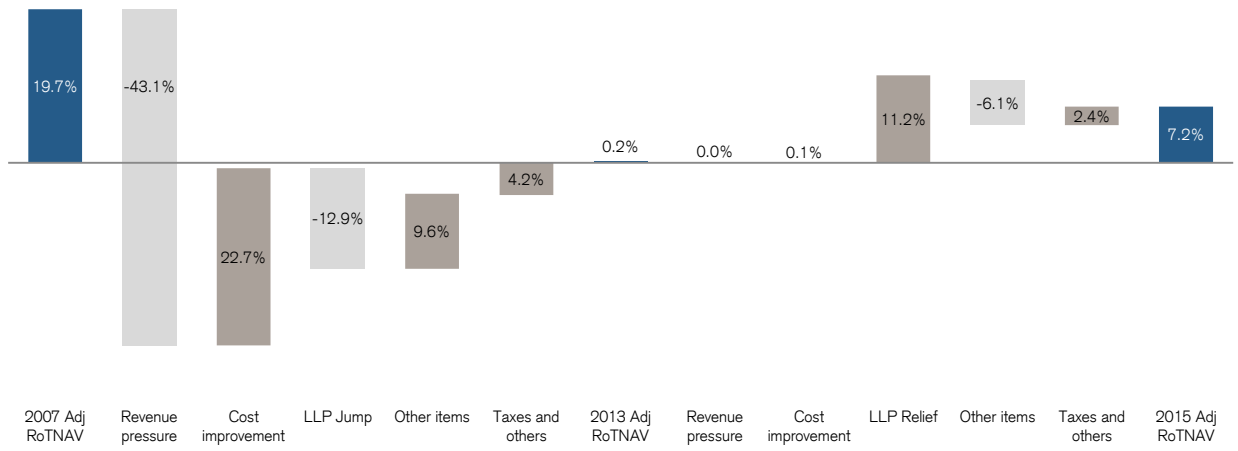
Source: Company data, Credit Suisse estimates

Based on the actual 2015 figures, the banking business shows an average return on allocated capital of ~17%, while the non-interest income driven business (private wealth management) delivers an average 37% return on capital (400% of this is from asset management, 101% from private banking and 16% from insurance). The corporate center's contribution to the consolidated RoAC is negative (-30% RoAC). The group return on capital stands at 12%, well above the group RoTNAV (7%) due to the large excess capital.

Historical trends and estimates

Since 2007, ISP has been the most profitable of the Italian banks, although it suffered from the recession as the others did. The average adjusted RoTNAV in 2007 was ~20%; at the peak of the crisis in 2013, it dropped to 0.2% before climbing back to ~7% in 2015 (still well below the double-digit pre-crisis level).

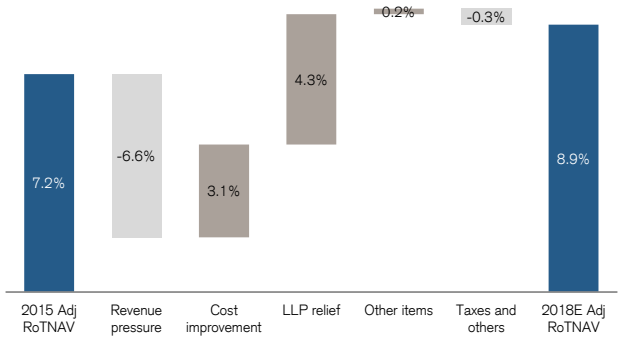
Figure 87: 2007-2015 RoTNAV dynamics



Source: Company data, Credit Suisse estimates

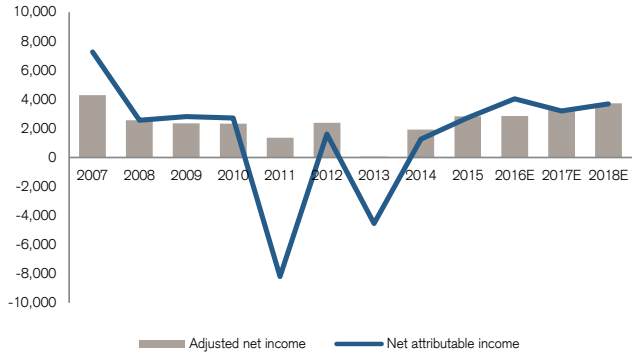
We forecast that ISP could post a RoTNAV uplift of 170bp in the next three years. In our estimates, we project the RoTNAV to rise to 8.9% in 2018 from 7.2% in 2015. In our assumptions, we factor in severe pressure on revenue.

Figure 88: 2015-2018E Adj RoTNAV potential projected evolution



Source: Company data, Credit Suisse estimates

Figure 89: Stated and adjusted net income historical trends and estimates

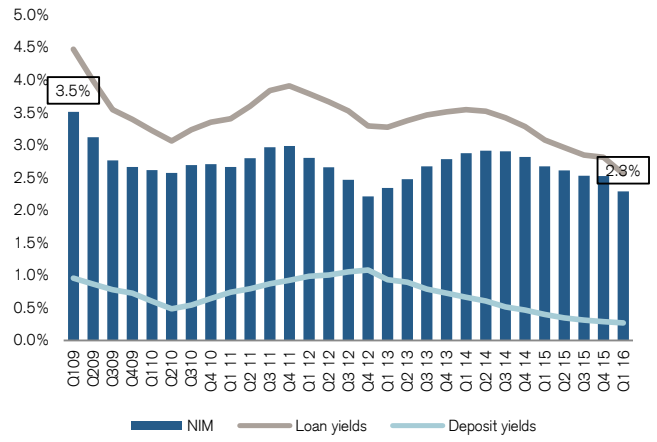


Source: Company data, Credit Suisse estimates

In 2016, stated earnings should benefit from a ~€900m post-tax gain from the payment instruments company disposal and a €150m post-tax gain from the AMEX Europe stake. We forecast a decline of adjusted RoTNAV, though, as a result of the NIM pressure and falling trading income. The asset management business will likely suffer from a slowdown due to market turbulence, but we expect the overall net fees contribution to be resilient.

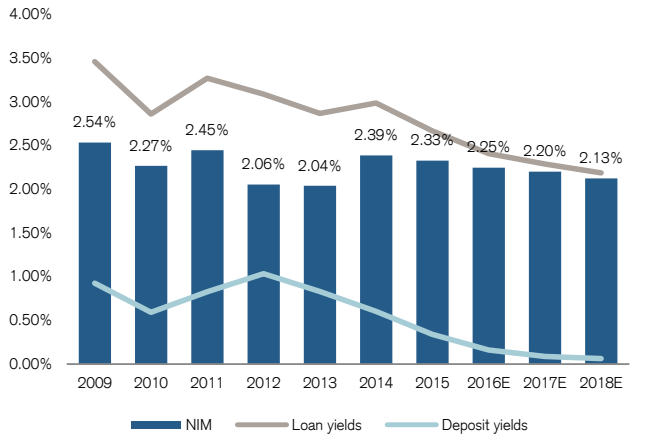
We expect the average commercial NIM to decline to 213bp in 2018 from 233bp in 2015. In 2016, NIM should come in at 225bp from 233bp; we expect the loans yield to be down from 267bp in 2015 to 241bp in 2016 (219bp in 2018), mitigated by falling funding costs from 16bp to 10bp in 2016 (and 9bp in 2018). We factor in a ~3% customer loans CAGR in 2015-18E.

Figure 90: Quarterly NIM – Historical trends



Source: Company data, Credit Suisse estimates

Figure 91: Annual NIM – Actual data and estimates



Source: Company data, Credit Suisse estimates

In 2016, we expect market turbulence to have an impact on AuM and fees. We are not factoring in the same management fee level as in 2015 (110bp) owing to a mix change. For 2017, we expect ISP to get close to its €342bn AuM target.

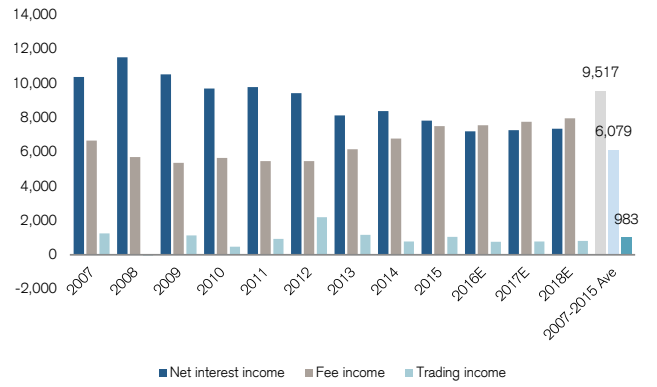
Figure 92: Asset management volumes and fees evolution

(€m, bp)	2010	2011	2012	2013	2014	2015	2016E	2017E	2018E	2017E ISP target
Assets under management	233,553	221,889	231,491	258,570	301,715	327,826	333,206	340,805	350,600	342,000
AUM fees	2,001	1,846	1,801	2,312	2,592	3,452	3,526	3,657	3,796	
Mgmt fees % of AuM (bps)	87	81	79	94	93	110	107	109	110	

Source: Company data, Credit Suisse estimates

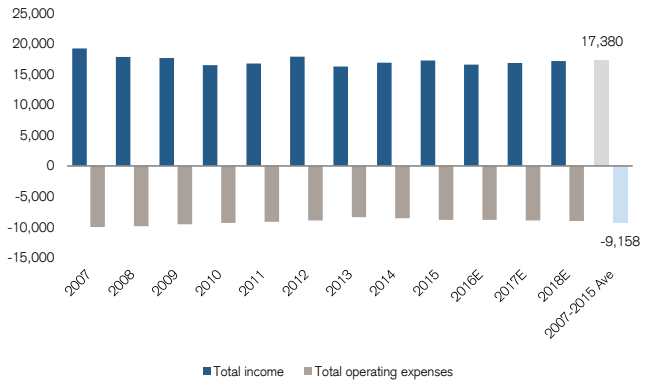
Our forecast for trading income is conservative; we factor in an average ~€780m profit, well below the 2007-15 average (~€980m). Our average total income forecast for 2016-18 stands 2% below 2015 revenue. We expect ISP to return to 2015 revenue levels in 2018.

Figure 93: Total income breakdown trends



Source: Company data, Credit Suisse estimates

Figure 94: Revenue and cost trends

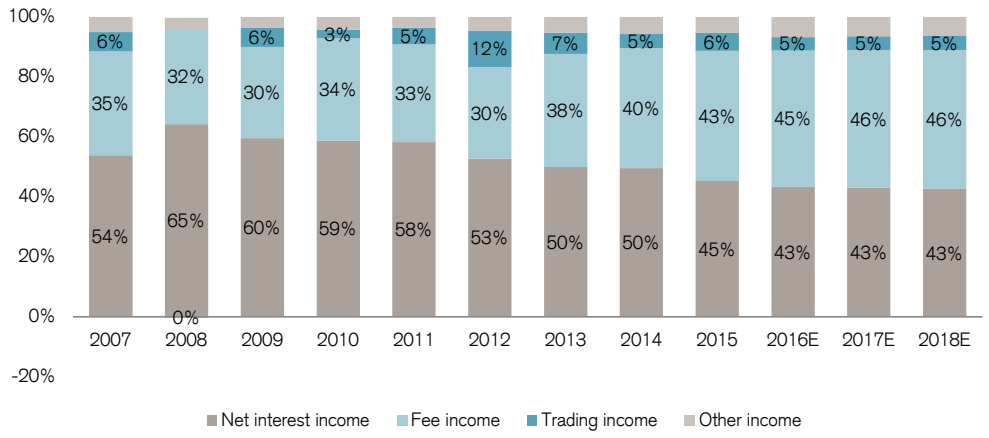


Source: Company data, Credit Suisse estimates

We estimate €16.9bn total income in 2017, 12% below the company's business plan (€19.2bn) mainly on am NII miss. We project €7.3bn NII in 2018 versus the company's €9.0bn target (from €7.8bn in 2015).

The revenue breakdown evolution shows the NII decline to be offset by a net fees increase. As of 2016, the commission income contribution to revenue is expected to offset NII.

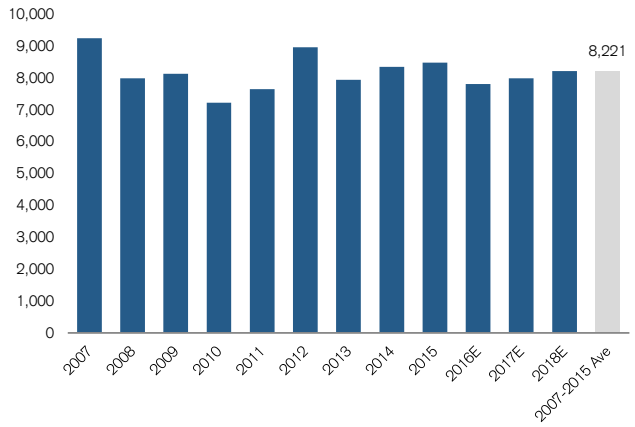
Figure 95: Total income breakdown trends



Source: Company data, Credit Suisse estimates

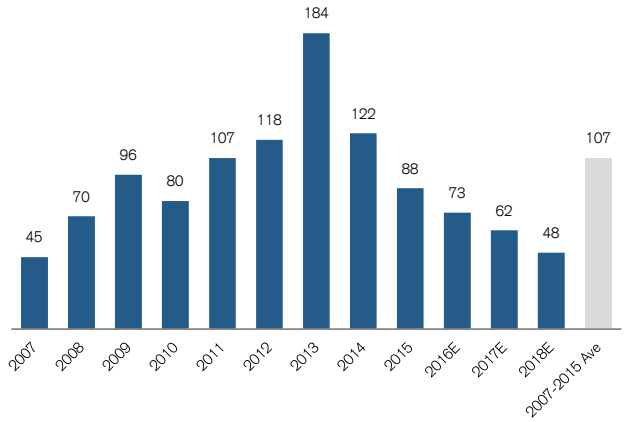
We expect a slow pre-provision profit evolution, below the 2015 level and below the business plan. Falling LLP should boost earnings. We expect the CoR to decline below the business plan assumptions (80bp).

Figure 96: Pre-provision profit evolution (€m)



Source: Company data, Credit Suisse estimates

Figure 97: LLP evolution (bp)



Source: Company data, Credit Suisse estimates

We estimate €3.2bn adjusted earnings in 2017, €1.3bn below the company target (€4.5bn). We stand 19% below consensus, which we believe is too optimistic on revenue trends (both NII and net fees). Our 7.8% RoTNAV17E compares with 11.8% company guidance. The reasons for the gap are: (i) actual and forecast GDP well below company expectations, and (ii) an ECB reference rate well above the current level.

Figure 98: 2017 main P&L items – CS vs ISP vs Consensus

(€bn, %)	2017E CS	2017E ISP	Gap	Consensus	Gap CS-Consensus
NII	7.3	9.0	-19.3%	7.8	-6.7%
Net Fees	7.8	8.2	-5.5%	8.2	-5.8%
Total Income	**16.9**	**19.2**	**-12.0%**	**18.1**	**-6.6%**
Operating expenses	-8.9	-8.8	1.1%	-8.9	0.4%
Pre-provision profit	**8.0**	**10.4**	**-23.2%**	**9.2**	**-13.3%**
LLP	-2.4	-3.0	-19.0%	-2.6	-7.4%
Adjusted earnings	**3.2**	**4.5**	**-27.8%**	**4.0**	**-18.7%**

Source: Company data, Credit Suisse estimates, Bloomberg consensus

Dividend and capital adequacy

ISP's business plan is focused on dividend distribution: a €10bn cumulated dividend over 2014-17E. Management is targeting a linear increase of the cash dividend amount to €4bn in 2017E from €1bn in 2014. ISP expects the fully loaded CET1 to be 12.2% in 2017, including the accrual of €4bn of dividends. In our estimates, ISP could distribute a cumulated dividend higher than company guidance but with a different timeline thanks to the extraordinary gains that the company is to post in 2016 (~€1.05bn). As such, we think the dividend paid on 2016 results could be higher than the dividend to be paid in 2017. We expect a 12.2% fully loaded CET1 in 2017, in line with company guidance.

Figure 99: Dividend distribution schedule

(€m)	2014	2015	2016E	2017E	Cumulated
Net profit – Actual & CSe	1,251	2,739	4,042	3,197	11,229
Dividend – Actual & CSe	1,200	2,400	3,500	3,000	10,100
Dividend – ISP plan	1,000	2,000	3,000	4,000	10,000
Dividend – Actual & Consensus	1,200	2,400	3,630	3,799	11,029

Source: Company data, Credit Suisse estimates, Bloomberg consensus

Valuation and risks

Target Price

We derive our €2.5 target price based on a sum-of the parts valuation methodology. We value each division separately, add up the parts and adjust for excess/deficit capital to determine the value attributable to shareholders. Our valuation basis is 2017E (12m forward), hence we discount back at a discount rate equivalent to the COE.

We value the banking business with a sustainable profitability methodology (RoE-g/CoE-g). For the Italian retail we factor in 12% sustainable RoE and 10.5% cost of equity. We set a 12% sustainable profitability for the Corporate Banking division, with 11.5% CoE. The International Banks Network should deliver an average 10% sustainable RoE at 13% CoE. Given the CoE, this methodology helps to calculate the 'right' (or warranted) PTBV for a stock. The private wealth management business valuation is based on a PE multiples basis, as a low capital intensive business. We have adopted a PE in line with the Italian peers (~9.5x). The non-operating divisions are valued with a multiple in line with the capital allocated.

Figure 100: 2017E SoTP

(€m, %, x) Division	Net Profit	Allocated Equity	Allocated CET1 Ratio	Divisional RWAs (€bn)	RoE (%)	Sust. RoE	CoE (%)	Growth (%)	Methodology	Value	Ps (€)	PE (x)	PTBV (x)
Italian retail banking	2,208	9,356	9.2%	101.7	23.6	12.0	10.5	1.0	RoE-g/Coe-g	10,150	0.65	4.6	1.1
CIB	1,364	9,997	10.5%	95.2	13.6	12.0	11.5	1.0	RoE-g/Coe-g	12,264	0.66	7.5	1.0
International banks	522	3,474	12.0%	29.0	15.0	10.0	12.6	3.0	RoE-g/Coe-g	2,438	0.16	4.7	0.7
Asset management	439	91	8.0%	1.1	482.9	400.0.	9.0	2.0	PE (x)	4,122	0.34	9.4	45.4
Private banking	840	718	8.0%	9.0	117.1	180.0	9.0	2.0	PE (x)	7,984	0.65	9.5	11.1
Insurance	704	4,600			15.3	20.0	10.0	2.0	PE (x)	6,335	0.50	9.0	1.4
Corporate center	-2,881	4,371	8.0%	55.6	-65.9	-40.0	10.5	0.0	1.0x BV	-4,371	-0.28	1.5	-1.0
Capital excess/(shortfall)	-27	4,279							1.0x BV	4,076	0.26	N.M.	1.0
Total ISP Group	**3,170**	**36,682**	**12.6%**	**291.9**	**7.7**	**8.5**	**11.2**	**1.4**		**40,999**	**2.64**	**12.9**	**1.1**
Adjusted discount factor											**1.06**		
Price Target										**38,861**	**2.50**	**12.3**	**1.1**

Source: Credit Suisse estimates

Rating

Our €2.5 target price implies ~30% potential upside from current share price levels. Based on our relative rating approach, this justifies an Outperform rating. ISP trades on 9.9x PE17E and 0.78x PTBV17E, which is a 31% relative premium to Eurozone peers.

Blue and grey sky scenarios

- **Blue sky scenario:** Our blue sky valuation of €3.5 factors in the following assumptions:
  - 4% customer loans CAGR 2015-18E (versus 3% in our base case);
  - +10bp 2016E-18E average NIM on top of our base case (which factored in a -20bp decline);
  - 113bp 2016E-18E average AuM fees (versus 108bp);
  - 4% AuM CAGR 2015-18E (versus 2.2%);
  - 50bp 2016E-18E average LLP (versus 60bp).

Under this scenario, the RoTE would rise to 7.5% in 2016E, 8.5% in 2017E and 10% in 2018E.

- **Grey sky scenario:** Our grey sky scenario of €1.2 factors in the following assumptions:
  - 0% customer loans CAGR 2015-18E (versus 3% in our base case);
  - -10bp 2016E-18E average NIM additional margin pressure on the base case (-20bp decline);
  - 106bp 2016E-18E average AuM fees (versus 108bp);
  - 1% AuM growth (versus 2.2%);
  - 70bp 2016E-18E average LLP (versus 60bp).

Under this scenario, the RoTE would decline to 5% in 2016E (from 6.2% in the base case), 6% in 2017E (from 7.8%) and 7% in 2018E (from 8.9%). In our grey sky scenario we also cut the excess capital cut from €4bn (currently factored in our SoTP) to nil.

Risks

The main downside risks to our TP are:

- A potential regulatory cap limiting the maximum distributable amount (MDA). This is part of the more general regulatory risk.
- Additional pressure on NIM, as a result of the expansionary monetary policy.
- A potential slowdown in the asset management business as a result of market turbulence. In view of the exposure to the asset management business, ISP is more geared than peers to market trends.
- Additional hits to earnings/capital from participating in resolution/rescue funds (like the resolution fund for the four local banks in November and Atlante).
- Potential dividend cut as a result of participating in any rescue fund.
- M&A risk: a forced rescue of any fragile bank.

Key management

Carlo Messina, CEO: Appointed as CEO in September 2013, he is the successor of Enrico Cucchiani (who had led the bank since 2011). Messina joined the Intesa Group in 1995 (former Banco Ambrosiano) as head of Planning. Following mergers and the group's evolution, he served as Group CFO and General Manager from 2008 to 2013. He was responsible for Banca dei Territori (the Italian retail unit) from May 2013 to January 2016. He is implementing the latest business plan focused on asset management business.

Stefano Del Punta, CFO: Former head of group finance, he was appointed Group CFO as the successor of Messina in 2013. He started his career with IMI (former Sanpaolo Imi group). He is a member of the group management board.

Gaetano Micicchè, General Manager and Head of CIB: Having joined Banca Intesa in 2002, he has been general manager since 2010 and head of the CIB division since 2007. He is also the chairman of Banca Imi, the group's investment bank.

Credit Suisse PEERs

PEERs is a global database that captures unique information about companies within the Credit Suisse coverage universe based on their relationships with other companies – their customers, suppliers and competitors. The database is built from our research analysts' insight regarding these relationships. Credit Suisse covers over 3,000 companies globally. These companies form the core of the PEERs database, but it also includes relationships on stocks that are not under coverage.

Figure 101: Intesa Sanpaolo PEERs map

Source: Credit Suisse PEERs

Unicredit (CRDI.MI)

Rating	**NEUTRAL**
Price (15 Jul 16, €)	2.18
Target price (€)	2.28
Market Cap (€ m)	13,467.6

*Stock ratings are relative to the coverage universe in each analyst's or each team's respective sector.
[1]Target price is for 12 months.

Research Analysts

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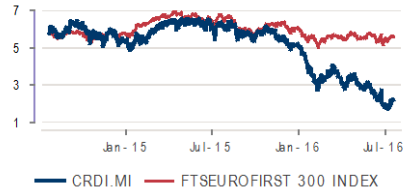
The conundrum

- **Initiating with a Neutral rating; we think the current price discounts at least a €6bn capital shortfall:** Although the valuation is already factoring in a capital shortfall, the stock is not attractive below a 6.5% RoTE17E post a potential capital raising, in our view. The return to solid profitability, combined with balance sheet and capital repairs, are large challenges for the new CEO.
- **Capital strengthening and profitability uplift needed:** UCG has a ~10.9% FL CET1 (Q1 16), a stretched 10bp buffer to SREP requirements (the smallest among Italian banks). In 2015, UCG reported a poor 4.2% adjusted RoTNAV, slightly above the level of profitability of Popolari banks. The main drags on profitability are the Italian banking operations (excluding asset management) harmed by the sizeable NPL stock and the German and Austrian operations affected by high cost/income ratios. We think UCG's strategic options could be: (i) a straight capital hike, (ii) disposal of core and non-core assets, or (iii) a mix of the two. Potential assets for sale might include the profitable Pekao, Fineco and Pioneer stakes: UCG recently placed 10% Fineco and Pekao stakes on the market, raising ~20bp CET1. We think recent political events in Turkey have likely postponed any potential disposal of UCG's c40% Yapi stake in the near term.
- **Worst position in our NPL coverage stress test:** UCG is the weakest bank in our stress test. We calculate a ~€4bn and ~€9bn capital shortfall to take NPL coverage up from 61% to 75% and 89%, respectively. We think capital management actions of at least €7.5bn are needed to raise coverage and boost CET1 to a more appropriate level for UCG (13% CET1 in our view).
- **Valuation and risks:** Our 2017E SoTP implies potential upside of ~5%. The stock trades on 0.30x PTBV17E (5.4% RoTBV17E) at a 15% discount to European peers. Downside risks include a rights issue scenario, potential dilution in the event of deconsolidating subsidiaries that are more profitable than the group, disappointing cost savings, execution risk on net fees target and Turkish political uncertainty. Risks to the upside: a mix of actions to optimize capital accretion and minimize profitability dilution, potential Austrian business disposal, and a large NPL deconsolidation at a low gap to NBV.

Share price performance



The price relative chart measures performance against the FTSEUROFIRST 300 INDEX which closed at 1335.7 on 15/07/16
On 15/07/16 the spot exchange rate was €1/Eu 1.-Eu.91/US$1

Performance	1M	3M	12M
Absolute (%)	-8.0	-35.7	-65.0
Relative (%)	-11.6	-31.7	-47.2

Financial and valuation metrics

Year	12/15A	12/16E	12/17E	12/18E
Net income reported (€ m)	1,694	1,605	2,588	3,447
Adjusted net profit (€ m)	1,765	1,613	2,395	3,156
EPS stated (€)	0.28	0.26	0.42	0.55
CS adj. EPS (€)	0.30	0.26	0.38	0.51
Prev. EPS (€)				
Tangible book value (€ m)	42,440	43,395	45,010	46,993
ROTE avg (adj.) (%)	4.2	3.8	5.4	6.9
P/E (adj.) (x)	7.38	8.42	5.67	4.30
Price/Tangible BPS (x)	0.31	0.31	0.30	0.29

Dividend (12/16E, EUR)	0.10	B3 Transitional RWAs (12/16E, €)	392,861
Dividend yield (12/16E,%)	4.7	Basel 3 FL CET1 ratio (12/16E,%)	11.1
Free float (%)	91.0	Number of shares (m)	6,177.8

Source: Company data, Thomson Reuters, Credit Suisse estimates

Unicredit (CRDI.MI)

Price (15 Jul 2016): **€2.18**; Rating: **NEUTRAL**; Target Price: **€2.28**; Analyst: **Carlo Tommaselli**

Income statement (€ m)	12/15A	12/16E	12/17E	12/18E
Net interest income	11,916	11,202	11,557	12,027
Fee and commission income	7,848	8,005	8,297	8,620
Trading income	1,644	1,372	1,372	1,372
Other non interest income	996	887	977	1,052
Total income	**22,405**	**21,466**	**22,202**	**23,071**
Admin expense	(8,339)	(8,142)	(8,153)	(8,096)
Other expenses	(4,350)	(4,064)	(3,916)	(3,698)
Total expenses	**(13,618)**	**(13,036)**	**(12,900)**	**(12,627)**
Pre-provision profit	**8,787**	**8,430**	**9,302**	**10,444**
Loan loss provisions	(4,114)	(3,836)	(3,442)	(3,288)
Other non-recurring pre-tax	(416)	(187)	13	13
Pre-tax profit	**2,671**	**3,305**	**4,772**	**6,067**
Minority interests & Other	840	711	731	760
Net profit (reported)	**1,694**	**1,605**	**2,588**	**3,447**
Net profit (adjusted)	**1,765**	**1,613**	**2,395**	**3,156**

Balance sheet (€ m)	12/15A	12/16E	12/17E	12/18E
Assets				
Net customer loans	473,999	483,103	494,386	506,066
Loan loss reserves	39,258	40,404	41,327	42,133
Avg interest earnings assets	852,327	862,984	869,274	877,047
Goodwill & intangibles	5,758	5,758	5,758	5,758
Total assets	**860,434**	**865,534**	**873,014**	**881,081**
Liabilities				
Total deposits	427,571	427,571	427,571	427,571
Shareholders' equity	**48,198**	**49,153**	**50,768**	**52,751**
Minority interests	0	0	0	0
Total equity and liabilities	**860,434**	**865,534**	**873,014**	**881,081**

Per share	12/15A	12/16E	12/17E	12/18E
Reported EPS (€)	0.28	0.26	0.42	0.55
CS adj. EPS (€)	**0.30**	**0.26**	**0.38**	**0.51**
Prev. EPS (€)				
% YOY change	(7.65)	(12.40)	48.49	31.78
Dividend (€)	0.12	0.10	0.17	0.22
% YOY change	0.00	(14.00)	61.08	33.21
Dividend payout ratio	40.60	39.86	43.24	43.70
Dividend yield (%)	5.50	4.73	7.63	10.16
TNAVPS	7.11	6.97	7.23	7.54
Shares outstanding (m)	5,972	6,229	6,229	6,229

Valuation	12/15A	12/16E	12/17E	12/18E
P/E (adj., X)	7.4	8.4	5.7	4.3
P/BVPS (x)	0.3	0.3	0.3	0.3
P/NAVPS (x)	0.3	0.3	0.3	0.3
ROE (%)	3.5	3.3	5.2	6.7
CS adj. ROTE	0.0	0.0	0.1	0.1
ROA (%)	0.2	0.2	0.3	0.4
RoRWA (%)	0.4	0.4	0.7	0.8
NIM (NII/AIEA) (%)	1.4	1.3	1.3	1.4
Cost / Income (%)	60.8	60.7	58.1	54.7
Loan/Deposit (%)	110.9	113.0	115.6	118.4

Asset Quality	12/15A	12/16E	12/17E	12/18E
NPLs	88,138	93,639	96,307	98,447
% YOY Change	4.5	6.2	2.8	2.2
NPL/ gross loans	17.0	17.9	18.0	18.0
Loan Loss Reserves/NPLs	44.5	43.1	42.9	42.8
Common Eq Tier1 Capital	-	-	-	-
Basel 3 Transitional CET1 capital	43,005	43,705	44,927	46,567
Basel 3 Fully loaded CET1 capital	43,005	43,705	44,927	46,567
Basel 3 Transitional RWAs	390,599	392,861	401,746	410,934
Basel 3 Fully loaded RWAs	390,599	392,861	401,746	410,934
Basel 3 Transitional CET1 ratio	11.0	11.1	11.2	11.3
Basel 3 Fully loaded CET1 ratio	11.0	11.1	11.2	11.3
Basel 3 leverage ratio	5.2	5.4	5.6	6.0

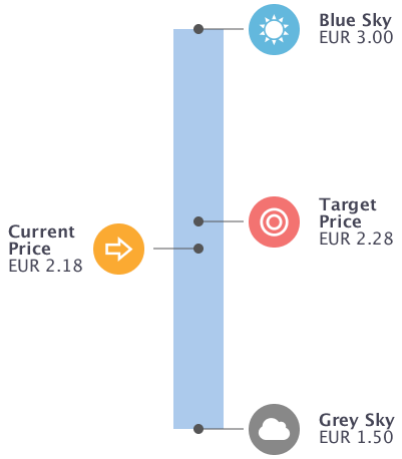
Earnings	12/15A	12/16E	12/17E	12/18E
Net Interest Income	(4.2)	(6.0)	3.2	4.1
F&C income	3.4	2.0	3.6	3.9
Trading income	7.1	(16.6)	0.0	0.0
Total revenues	(0.7)	(4.2)	3.4	3.9
Total expenses	0.8	(4.3)	(1.0)	(2.1)
Pre-prov operating profit	(2.8)	(4.1)	10.4	12.3
Pre-tax profit	(34.7)	23.7	44.4	27.1
Net customer loans	0.7	1.9	2.3	2.4
Customer deposits	4.2	0.0	0.0	0.0

Source: FTI, Company data, Thomson Reuters, Credit Suisse Securities (EUROPE) LTD. Estimates

Company Background

Unicredit is Italy's second largest domestic lender and a market leader in the Emerging Europe, mainly in Poland and Turkey. In Western Europe it shows relevant market shares in Germany and Austria.

Blue/Grey Sky Scenario



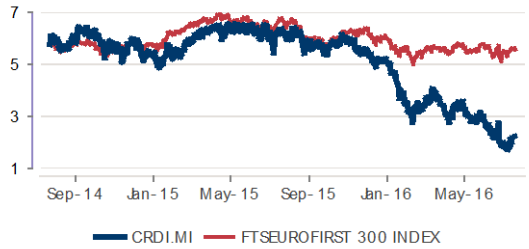
Our Blue Sky Scenario (€) 3.00

This scenario factors in 2% revenue CAGR 2015-18E (vs 1%). The uplift would come from higher net fees asset management and NIM. On the cost side, targeted CAGR 15-18E is improved to -3% (from -2%), as a result of additional streamlining vs plan. This scenario factors in 62bp average LLP accrual (vs 66bp). RoTNVA18E stands at 7.6% (from 6.9% in our base case). We factor in a €3bn capital shortfall in the blue sky scenario.

Our Grey Sky Scenario (€) 1.50

This scenario sees revenue flattish over 2015-2018E (vs +1%). We envisage a slowdown in AM fees and additional NIM pressure. Under this scenario cost inflation would offset savings, making the trend flattish. We forecast 70bp average LLP (vs 66bp). As a result RoTNAV18E stands at 5% from 6.9% in our base case. Our grey sky scenario factors in a €9bn capital shortfall.

Share price performance



The price relative chart measures performance against the FTSEUROFIRST 300 INDEX which closed at 1335.7 on 15/07/16

On 15/07/16 the spot exchange rate was €1/Eu 1.- Eu.91/US$1

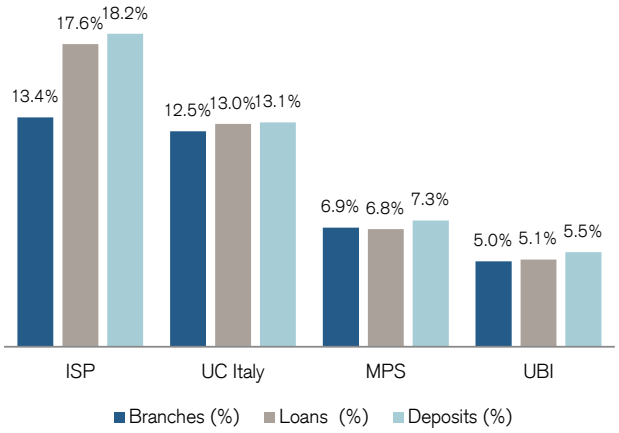
Company summary

Large domestic and international lender

Unicredit is one the largest domestic lenders, with 3,805 branches and a headcount of 43,479 in Italy. The bank has an international presence in Germany, Austria and Emerging Europe with 3,037 branches and 80,980 employees.

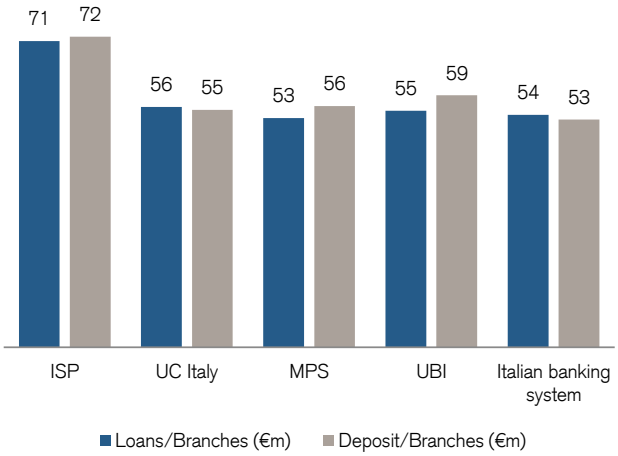
UCG shows the second largest market share in terms of loans and deposits in Italy. The Italian branches' productivity are above the Italian banks' average.

Figure 102: Q1 16 Market share



Source: Company data, Credit Suisse research, Bank of Italy

Figure 103: Q1 16 Branch productivity

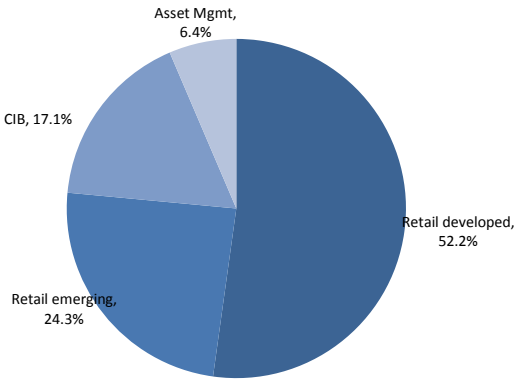


Source: Company data, Credit Suisse research, Bank of Italy

The business and geographical mix

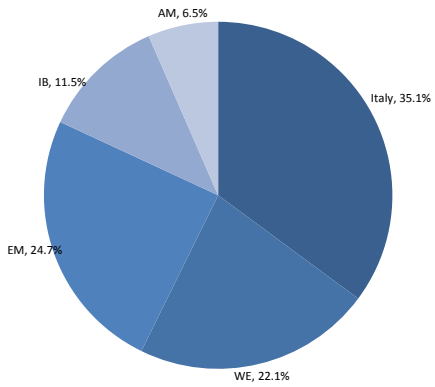
The main business of UCG is retail: 76.5% of total income in 2015, of which 52.2% came from Developed Europe and 24.3% from Emerging Europe. CIB represents 17% of revenue, while the asset management business (including Pioneer and Fineco) is 6.4%. The figures are net of the negative contribution of the corporate center.

Figure 104: 2015 Revenue breakdown by business



Source: Company data, Credit Suisse estimates

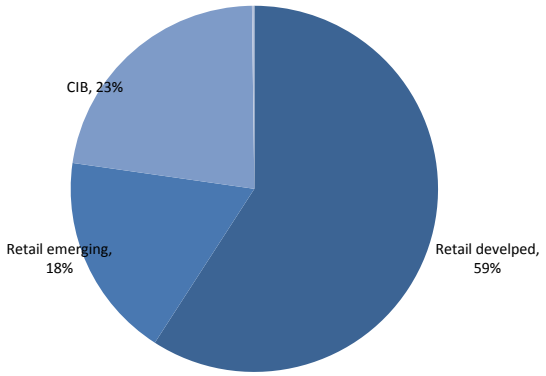
Figure 105: 2015 Revenue breakdown by geography



Source: Company data, Credit Suisse estimates

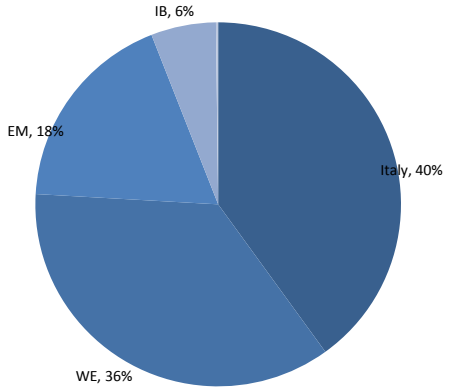
Our geographical breakdown is based on a different parameter compared to that used by UCG. We include the banking business only, excluding asset management and Fineco. Italy represents 35% of revenue, Western Europe 22%, Emerging Europe 25%, pure investment banking 12% and asset management 7% (Figure 105). The figures include a reallocation of the corporate center; we have also split the CIB by geographies, leaving markets and GTB in the pure IB. Of customer loans, 59% are allocated to the WE retail network, 18% in the retail emerging group and 22% in the CIB. In terms of geographies, most loans are allocated to the Italian operations (40%). Western Europe represents 36% of the loan book, Emerging Europe 18% and the remainder 6% is IB.

Figure 106: 2015 Loan book breakdown by business



Source: Company data, Credit Suisse estimates

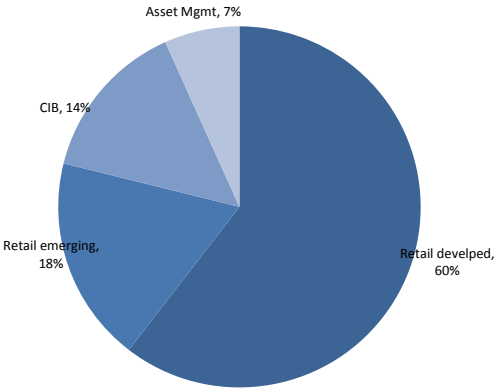
Figure 107: 2015 Loans breakdown by geography



Source: Company data, Credit Suisse estimates

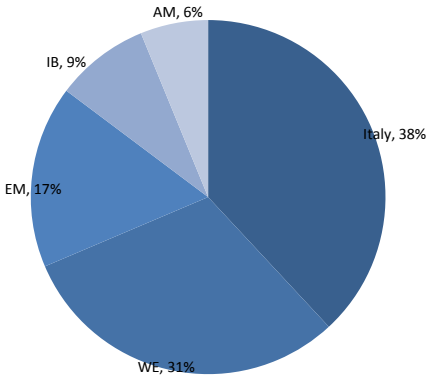
Western European retail has the largest cost base (60% of the total), or an implied 64% cost to income ratio, while Emerging European retail represents 18% (41% CIR). The geographical breakdown flags that most of the costs are allocated to Italy (38%), or a 67% cost to income ratio. Germany and Austria represent 31% of the cost base, implying the worst CIR in the Group at 83%. The asset management business absorbs 6% of the cost base, with a relatively high 57% CIR.

Figure 108: 2015 Cost breakdown by business



Source: Company data, Credit Suisse estimates

Figure 109: 2015 Cost breakdown by geography



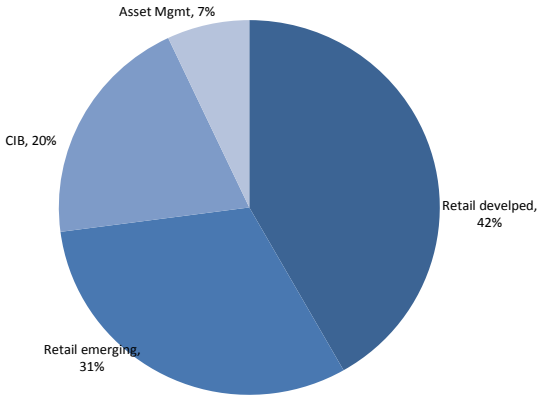
Source: Company data, Credit Suisse estimates

Germany and Austria have the heaviest cost bases. In our geographical split we have allocated 50% of the corporate center to Italy and 50% to Germany and Austria. The high cost to income ratios of the Western European retail network are reflected in the sharp reduction of the contribution in terms of pre-provision profit from that area. The low Western European retail business contribution to the pre-provision profit (40% from 52% revenue) is not surprising in view of the heavy cost burden.

The Emerging European retail network pre-provision profit represents 37% of the pre-provision profit, well above its revenue contribution (25%). The lower cost of personnel and the lack of heavy costs related to a corporate center support the operating income performance of the emerging countries where UCG operates.

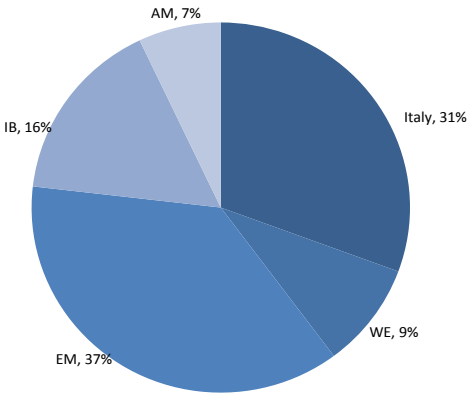
Asset management contribution to pre-provision profit is in line with revenue contribution (7%), a disappointing performance, in our view. On the other hand, IB weighs for 16% of pre-provision profit (from 12% of revenue).

Figure 110: 2015 Pre-provision profit by business



Source: Company data, Credit Suisse estimates

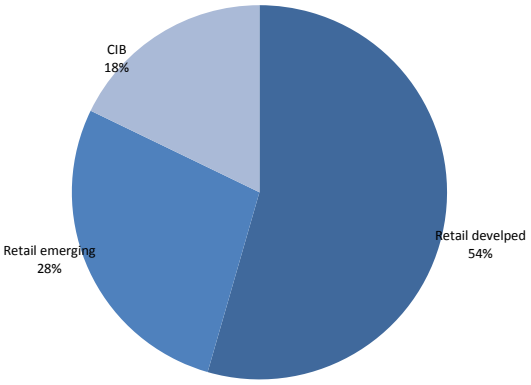
Figure 111: 2015 Pre-provision profit by geography



Source: Company data, Credit Suisse estimates

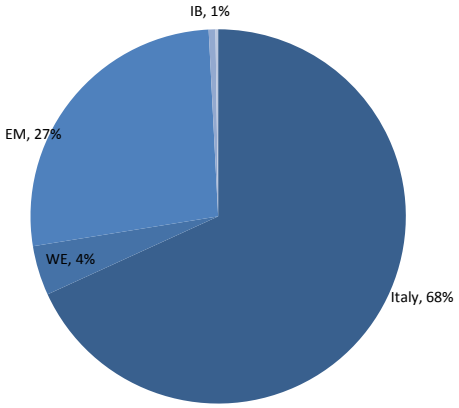
LLP is another differentiating factor of the different areas' performances; the geographical split shows that most of LLP are charged to the Italian operations (68%). Emerging Europe represents 28% of total LLP, while the CIB division 18% (1% excluding Corporate banking business, reallocated to the geographies).

Figure 112: 2015 LLP breakdown by business



Source: Company data, Credit Suisse estimates

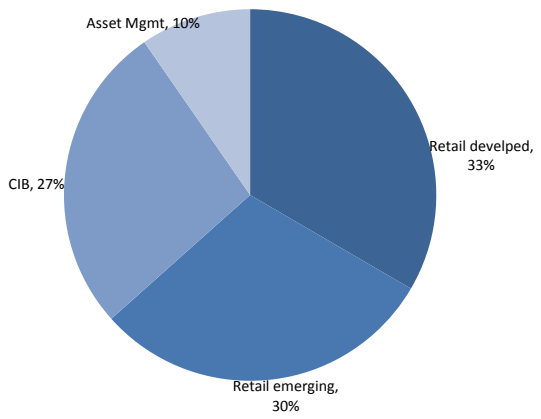
Figure 113: 2015 LLP breakdown by geography



Source: Company data, Credit Suisse estimates

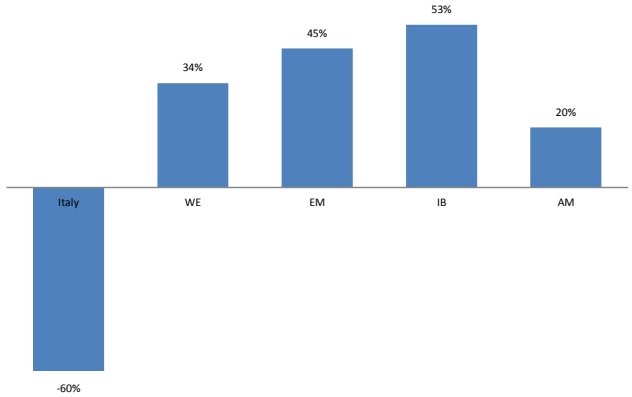
The Western European retail LLP is only 48bp, of which Italy 154bp. UCG's Italian Commercial Banks already show a high cost of risk at 90bp; the rest of the impact comes from the Non-Core division (~470bp). Emerging Europe's LLP stands at 133bp, of which 40bp come from Poland and 180bp from the other countries. The heavy cost of risk represents a problem for the Italian operations, which are loss makers and a heavy drag on group earnings and profitability. The combination of the heavy cost base in Germany/Austria and the high cost of risk put pressure on group profitability. In 2015 the Italian parent company result was -€1.44bn (vs a €1.04bn loss according to our divisional reclassification) that reflected the high cost of risk and a €2.06bn Bank Austria holding writedown as a result of the group simplification process (elimination of the sub-holding).

Figure 114: 2015 Earnings breakdown by business



Source: Company data, Credit Suisse estimates

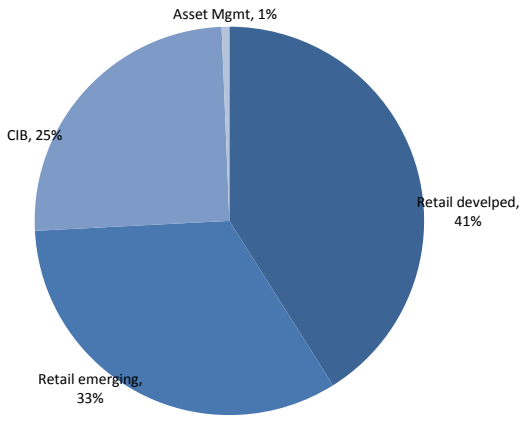
Figure 115: 2015 Earnings breakdown by geography



Source: Company data, Credit Suisse estimates

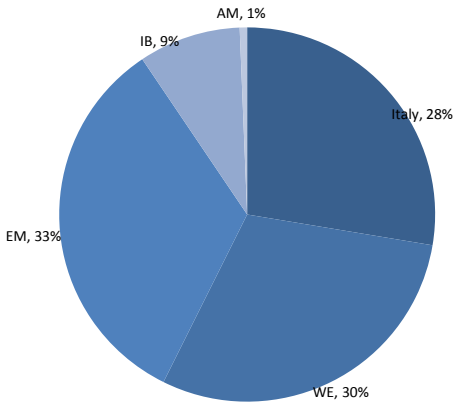
The banking business absorbs most of the capital (99% of the allocated capital). Asset management is a low capital intensive business, with 1% absorption. In terms of business, Western European retail absorbs 41% of capital, Emerging Europe 33% and CIB 25%. Geography wise, 28% of capital is allocated to the Italian operations, 30% to Germany and Austria, 33% to Emerging Europe and 9% to IB.

Figure 116: 2015 Capital allocation by business



Source: Company data, Credit Suisse estimates

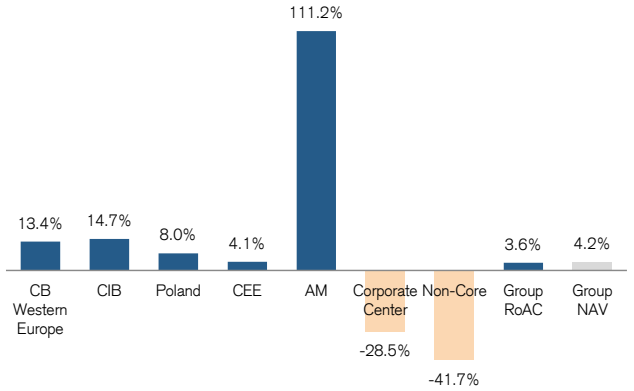
Figure 117: 2015 Capital allocation by geography



Source: Company data, Credit Suisse estimates

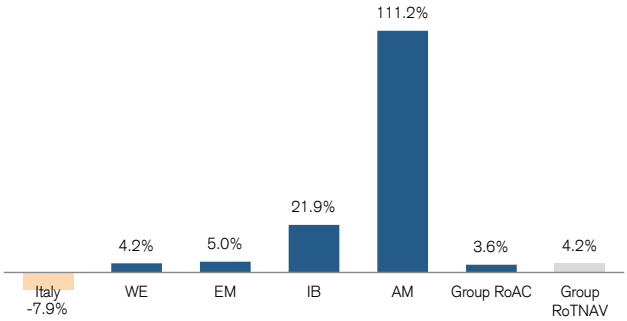
Based on the actual 2015 divisional figures and on Credit Suisse estimates on capital allocation, the Western European banking business shows ~13% RoAC (supported by tax relief in Austria). In addition, we calculate ~8% RoAC for the Polish operations and 4% for CEE. Asset management delivered a >100% return on average capital (well below Eurizon's 400%). Non-Core and the corporate center, with -29% and 42% RoAC, drag down the group RoAC to 3.6%. The group RoTNAV stood slightly above 4%, higher than the return on allocated capital as a result of the capital shortfall.

Figure 118: 2015 divisional and group RoAC vs group RoTNAV



Source: Company data, Credit Suisse estimates

Figure 119: 2015 RoAC by geography, group RoAC vs group RoTNAV



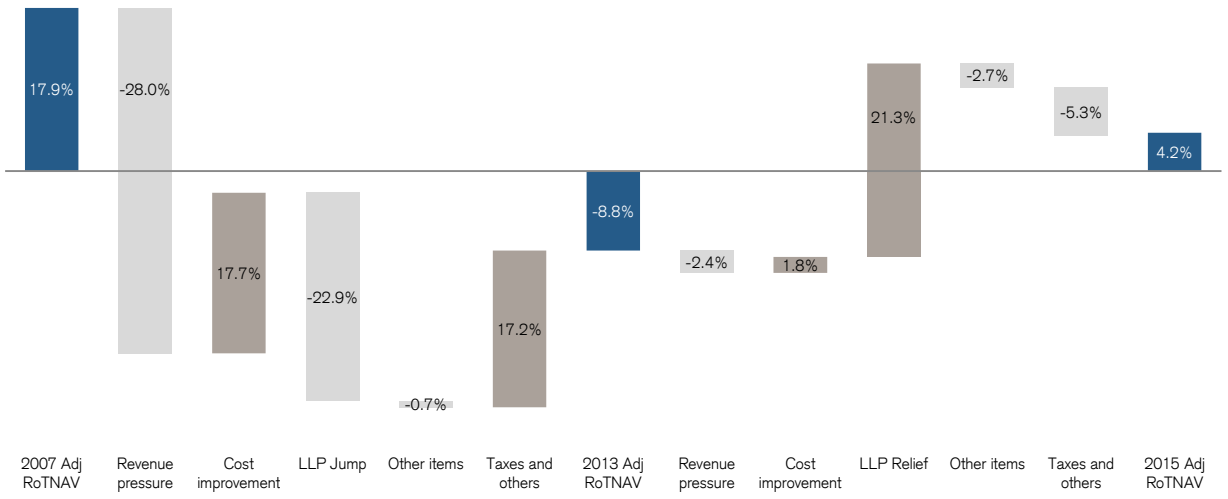
Source: Company data, Credit Suisse estimates

On a geographical basis, we calculate that the Italian operations destroy value due to the Non-Core division and the Corporate Center charges. The Western European banking operations, including corporate banking, are not as profitable as they appear in the divisional breakdown as they factor in the corporate center and the Non-Core operations. The pure IB shows 22% RoAC. The group return on capital is affected by Italy, Germany and some exposures in CEE.

Historical trends and estimates

UCG has suffered one of the sharper profitability drops among Italian banks since 2007, when it was one of the most profitable. The average adjusted RoTNAV in 2007 was ~18% but fell to -9% at the peak of the crisis in 2013. In 2015, UCG delivered a low single-digit adjusted profitability of ~4% (well below the pre-crisis level).

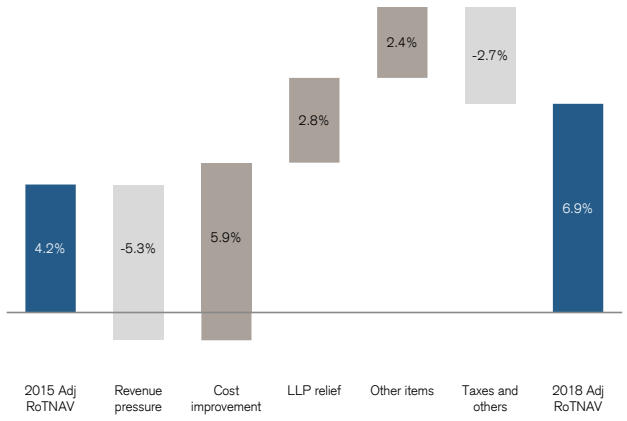
Figure 120: UCG - 2007-2015 RoTNAV dynamics



Source: Company data, Credit Suisse estimates

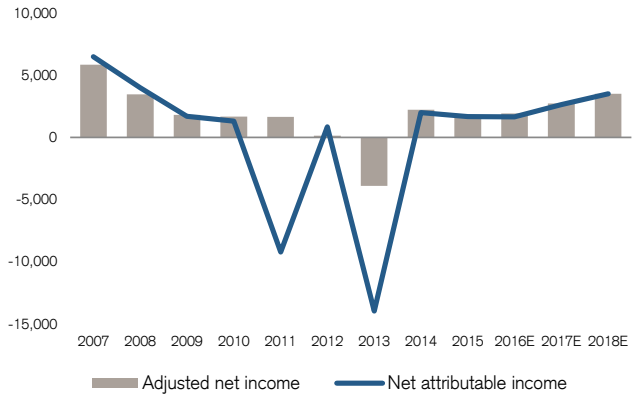
We forecast that UCG could post a 270bp adjusted RoTNAV uplift in the coming three years. In our estimates, we project the adjusted RoTNAV to rise from 4.2% in 2015 to 6.9% in 2018. In our assumptions, we factor in severe pressure on revenue, while the main profitability driver is expected to be cost cutting and to lower LLP to a lesser extent.

Figure 121: UCG - 2015-2018E Adj RoTNAV potential projected evolution



Source: Company data, Credit Suisse estimates

Figure 122: UCG - Stated and adjusted net income historical trends and estimates

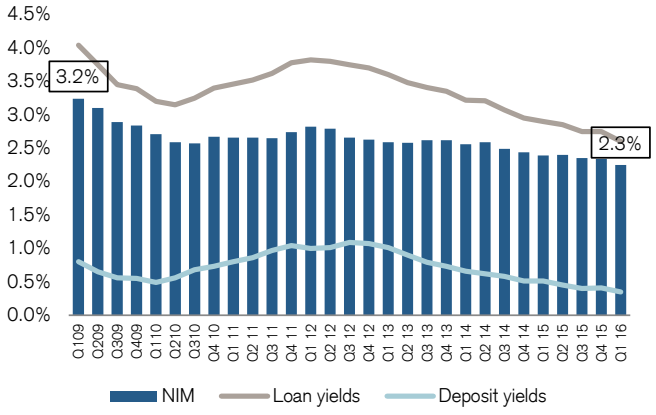


Source: Company data, Credit Suisse estimates

For 2016, we forecast a slight RoTNAV increase despite NIM pressure and falling trading income. Despite net fees support, revenue is expected to decline in 2016. The asset management business will likely suffer from a slowdown due to the market turmoil, but overall net fees contribution is expected to be resilient.

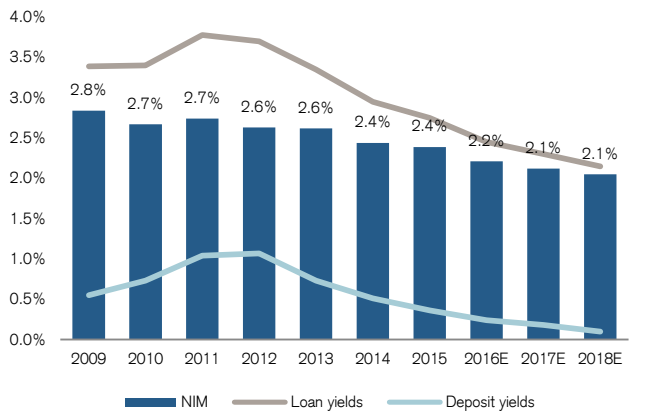
For UC Italy, we expect the average commercial NIM to decline from 239bp in 2015 to 205bp in 2018. In 2016, NIM should come in at 221bp; we expect the loans yield to fall to 245bp from 275bp (215bp in 2018), mitigated by a falling funding cost from 24bp to 16bp in 2016 (and 6bp in 2018). We factor in 2.5% customer loans CAGR 2015-18E. At the group level, we estimate 0.3% NII CAGR 2015-18E.

Figure 123: UCI - Quarterly NIM: historical trends



Source: Company data, Credit Suisse estimates

Figure 124: UCI - Annual NIM: actual and estimates



Source: Company data, Credit Suisse estimates

In 2016, the market turbulence will likely have an impact on AuM and fees. As such, we expect management fees to decline by a couple of basis points owing to a mix change. For 2018, we expect UCG to achieve €232bn AuM (Pioneer only), below the €277bn company target. Note that the total AuM target also includes the private banking division, set up in 2015. The business plan that was launched in November 2015 should be updated soon by the newly appointed CEO, Jean-Pierre Mustier.

Figure 125: Asset management volumes and fees evolution

(€m, bps)	2012	2013	2014	2015	2016E	2017E	2018E	2018E UCG target
Total AuM		**247,590**	**265,930**					**330,000**
AuM - Pioneer	157,916	173,925	201,030	223,614	210,800	221,485	232,380	277,000
AUM fees	684	719	769	900	869	929	1,044	
Mgm fees % of AuM (bps)	43	41	38	40	40	43	46	
AuM - Fineco		19,538	23,636	26,277	27,591	28,970	30,419	
AUM fees		102	118	157	175	190	207	
Mgm fees % of AuM (bps)		52	55	63	65	67	70	
Fineco+Pioneer AuM	157,916	193,463	224,666	249,891	238,391	250,455	262,799	
AUM fees		821	887	1,057	1,044	1,119	1,250	
Mgm fees % of AuM (bps)		47	42	45	43	46	49	

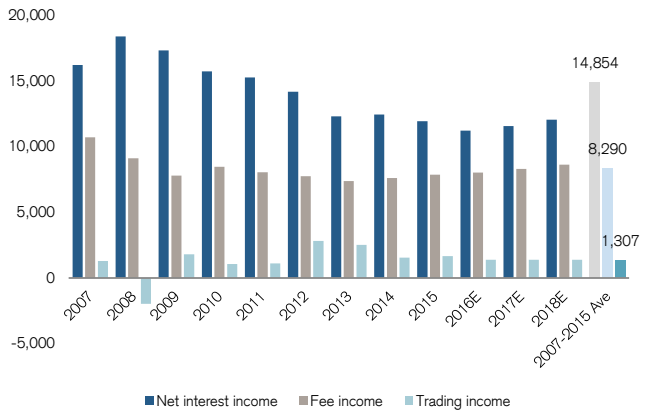
Source: Company data, Credit Suisse estimates

Our forecast on trading income is conservative: for 2016E-18E, we factor in ~€1.37bn average trading profit, significantly below the 2012-2015 average (~€2.1bn).

Our 2016-18 average total income forecast is slightly below 2015 revenue (-0.9%), with 2016 total income expected to fall by -4% yoy. The 2017 revenue should be in line with that of 2015, while in 2018 total income should be higher than the 2015 level. We estimate €23bn total income at year-end 2018, 8% below the current company target (€25.1bn)

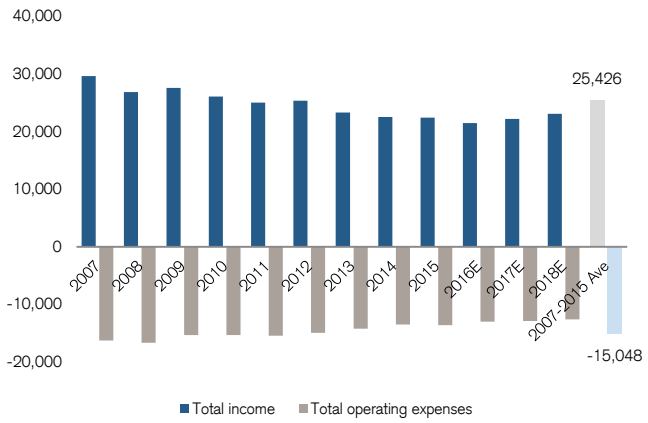
mainly on a commission income miss. We project €8.6bn in net fees in 2018 vs the €9.6bn target (from €7.8bn in 2015). The robust trend in commission income is one of the business plan pillars: UCG is targeting the reduction of the asset management under-penetration.

Figure 126: Group - total income breakdown trends



Source: Company data, Credit Suisse estimates

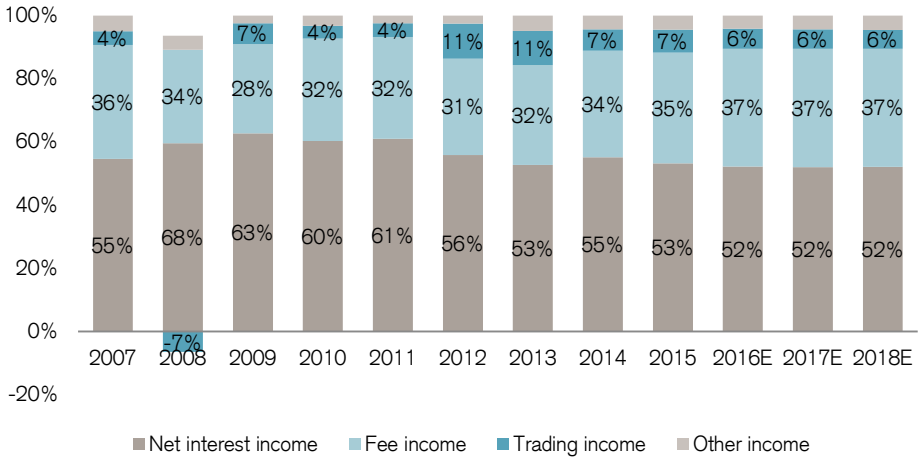
Figure 127: Group - revenue and cost trends



Source: Company data, Credit Suisse estimates

In contrast with our view on ISP, we envisage a revenue breakdown evolution embedding a slight shift from NII to net fees for UCG. We expect the commission income uplift to be 37% from 35% in 2016, at the expense of trading income and NII contributions. NII should stabilize at a still high 52% of the total income over the plan period from 53% in 2015.

Figure 128: UCG - total income breakdown trends

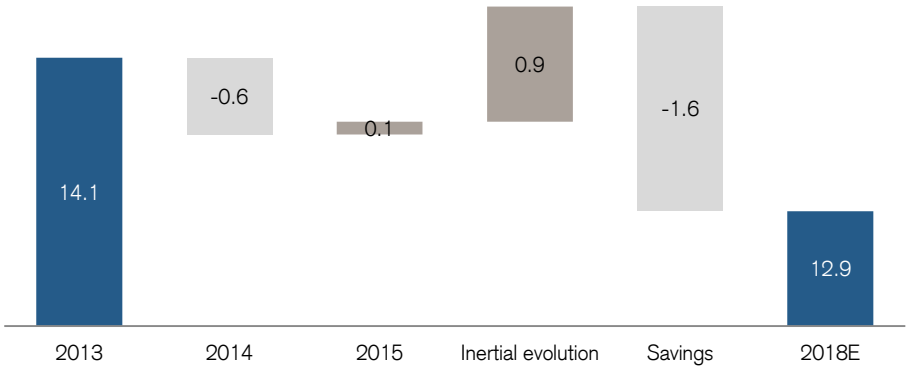


Source: Company data, Credit Suisse estimates

The pre-provision profit should touch a minimum level in 2016 and start robust growth as of 2017. In 2018, we expect the pre-provision profit to exceed €10bn (still below company target). The business plan is focused on cost cutting measures: UCG aims to streamline the group, thanks to simplifying the structure.

The business plan is targeting a reduction of the cost base to €12.9bn in 2018 (including inflation and investment impacts) from €13.6bn in 2015. The staff base should be reduced by 18k (-14%) over the plan horizon, backed by cuts in the corporate centers and networks in Western Europe.

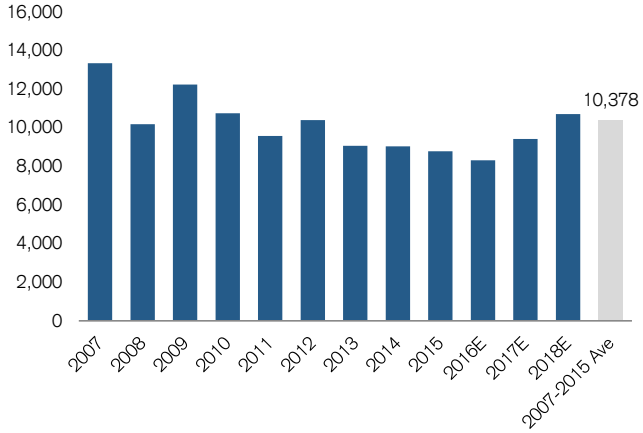
Figure 129: UCG cost evolution – Business plan target (€bn)



Source: Company data, Credit Suisse estimates

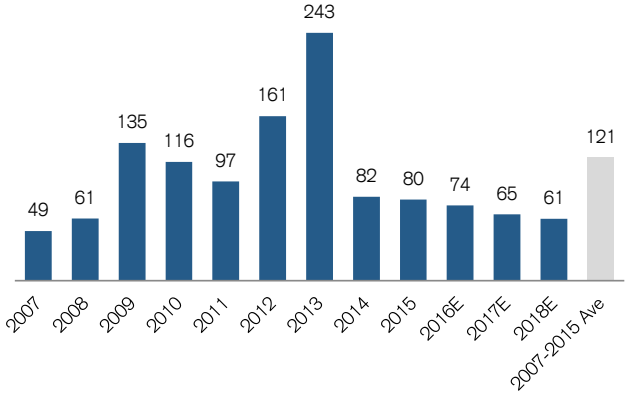
We forecast €12.6bn operating cost in 2018, below the company target; UCG should be able to extract additional cost cutting measures to offset the lower revenue uplift due to the slower macroeconomic recovery embedded in our scenario. We expect CoR to decline to 61bp, below company guidance of 67bp; we factor in 47bp LLP in the Core Bank (vs the 58bp target) and €1.1bn LLP in the Non-Core (€0.8bn target).

Figure 130: Pre-provision profit evolution (€m)



Source: Company data, Credit Suisse estimates

Figure 131: LLP evolution (bp)



Source: Company data, Credit Suisse estimates

As a result, our 2018 stated earnings stand at €3.5bn, 34% below the company target (€5.3bn) and 9.5% below consensus. Our 6.9% RoTNAV17E compares with 11% company guidance.

Figure 132: 2018 main P&L items – Credit Suisse vs UCG vs Consensus

(€bn, %)	2018E CS	2018E UCG	Gap	Consensus	Gap CS-Consensus
Net Fees	8.6	9.6	-10.4%	8.8	-2.3%
Total Income	**23.1**	**25.1**	**-8.1%**	**23.6**	**-2.0%**
Operating expenses	-12.6	-12.9	-2.1%	-13.1	-3.2%
Pre-provision profit	**10.4**	**12.2**	**-14.4%**	**10.5**	**-0.5%**
LLP	-3.3	-3.4	-2.4%	-3.0	10.5%
Stated earnings	**3.5**	**5.3**	**-33.5%**	**3.9**	**-9.5%**

Source: Company data, Credit Suisse estimates, Bloomberg consensus

Capital management options

Asset disposals

UCG is struggling with a 10.89% FL CET1, or a 10bp buffer on the SREP. We calculate the capital shortfall in a range of €4-9bn. We think capital management action could help the bank clean the loan book and gain a stronger capital position for a G-SIFI bank. UCG could sell some assets to reduce the shortfall, but in view of the current market environment, we doubt disposals would take place at very attractive prices, reducing the positive one-off contribution to CET1, with the profitability dilution being equal.

In valuing the options, the trade-off between profitability dilution and the positive impact on CET1 is crucial. We think UCG has several assets which could be sold, including the following options recently mentioned in the press (e.g. Il Sole 24 Ore, La Repubblica and Bloomberg): the Bank Pekao stake (now c41%) and the Yapi Kredi Bankasi stake (held through Unicredit's c50% stake in KOC Financial Services, which owns c80% of Yapi), and a possible listing or disposal of a Pioneer stake (also possibly via an IPO). In line with our expectations, on 11 July, UCG announced that it placed a 10% Fineco stake on the market for €328m and 8bp CET1 benefit. On 12 July, UCG announced the accelerated book building on a 10% Pekao stake (holding down from 51% to 41%). We estimate the impact on capital is ~12bp, mainly stemming from the capital gain. Although we think the Yapi stake might be an attractive disposal candidate, we think recent political events in Turkey have likely postponed any sale in the near term.

Figure 133: Potential options – Q1 16 P&L contributions

(€m, %)	Pekao*	Yapi**	Fineco*	Pioneer	Total	Group Q116
Revenue	383	296	140	208	1,028	5,476
Cost	-187	-130	-60	-135	-512	-3,291
Pre-provision profit	**196**	**167**	**80**	**73**	**516**	**2,185**
% of Group	**9%**	**8%**	**4%**	**3%**	**24%**	
LLP	5	-56	-1	0	-52	-755
Other provisions	-34	-19	-1	-11	-65	-694
Net operating income	**167**	**92**	**77**	**63**	**398**	**736**
% of Group	23%	12%	10%	9%	54%	
PBT	**167**	**92**	**77**	**63**	**398**	**736**
% of Group	**23%**	**12%**	**10%**	**9%**	**54%**	
Taxes	-35	-20	-43	-18	-117	-246
Minority interests	-66	0				-93
Others						10
Earnings	**66**	**72**	**33**	**45**	**282**	**407**
% of Group	**16%**	**18%**	**8%**	**11%**	**69%**	

Source: Company data, Credit Suisse estimates, *Before 10% placement, ** Line by line consolidation

We have run a scenario analysis adjusted by the recent capital management actions, which includes the disposal of: (i) the remaining 41% Pekao stake, (ii) the Yapi stake, (iii) an additional 10% Fineco stake, and (iv) a possible Pioneer IPO (30%). Assuming a disposal of the Bank Pekao stake, the disposal of Yapi Kredi, the placement of an additional 10% Fineco stake and a listing of 30% of Pioneer, we calculate a total CET1 uplift of 215bp, at the expense of ~80bp RoTNAV dilution out of 3.6% RoTNAV in Q116.

A disposal of Yapi at the market price (~0.77x PTBV) prior to the recent coup attempt in Turkey would have carried a small capital loss for UCG (based on our carrying value estimates). Consolidated at equity, the Yapi contribution to the P&L comes in terms of "other income from equity investments", but the RWA is consolidated. As such, its disposal would have a ~79bps positive impact on the back of RWA deconsolidation (€28bn), despite the small capital loss reducing the positive contribution to CET1. We expect the

political uncertainty in Turkey to harm the subsidiary's earnings/profitability contribution, while delaying any disposal. In Q1 16, Yapi was 18% of group earnings and ~52bp of profitability (out of 3.6% RoTNAV). Our central case is that the impact to CET1 will be limited (or potentially positive) in the event of a simple local currency devaluation. In a worst case scenario, UCG might lose the investment's carrying value and the P&L contribution, but we think the impact to capital would be neutral due to the RWA deconsolidation.

A Bank Pekao disposal at the current market price could provide a ~€1.75bn post-tax capital gain (assuming ~€2bn carrying value, which is not disclosed) and the deconsolidation of €25bn RWA. On the negative side, UCG would lose the positive contribution of minority interests (~€1bn eligible minority interests) and €194m of earnings. We estimate UCG could gain 90bp CET1 uplift from the Pekao deconsolidation.

A Fineco stake disposal and a potential Pioneer listing would be positive in terms of capital gains and little RWA reduction, on our estimates. On the other hand, the missing contribution in terms of minority and earnings would negatively impact the CET1. We have assumed a placement of Pioneer at ~12x PE16E (or 1% P/AuM) in line with Italian peers, while we pencil in a Fineco stake disposal at the current market price. In this scenario, we calculate a further 8bp CET1 uplift from the Fineco stake, in line with the actual impact from the accelerated book building, and 20bp from a 30% Pioneer listing mainly stemming from capital gain and goodwill deconsolidation. The disposal of the mentioned assets excluding Yapi would provide a 120bp CET1 uplift, with ~40bp RoTNAV dilution.

In our scenario analysis, before the coup attempt in Turkey, the best mix in terms of CET1 and RoTNAV uplift/earnings dilution would have come from a disposal of Bank Pekao and the stakes in the AM business: 120bp CET1 accretion vs 109bp deriving from a potential Yapi sale. A Pekao disposal would likely be less dilutive earnings- and profitability-wise (40bp RoTE dilution vs. 67bp).

Figure 134: Scenario analysis: Potential impact of disposals

(€m, %)	Pekao*	Yapi**	Fineco*	Pioneer	Total	All out	Ykb in/Peo out	Peo in/Ykb out
FL Q116 CET1 capital pro-forma	**43,529**	**43,529**	**43,529**	**43,529**	**43,529**	**43,529**	**43,529**	**43,529**
[+/-] Gain/Losses	1,745	-28	320	580	2,618	2,618	2,645	873
[-/+] Minorities/Goodwill	1,053	0	24	-191	885	885	885	-168
[-] Earnings	194	251	12	53	511	511	260	317
Total impact to CET1	**498**	**-279**	**284**	**718**	**1,222**	**1,222**	**1501**	**724**
Pro-forma CET1 capital	**44,027**	**43,250**	**43,813**	**44,247**	**44,751**	**44,751**	**45,030**	**44,253**
RWA	392,861	392,861	392,861	392,861	392,861	392,861	392,861	392,861
RWA change	25,431	28,461	200	570	54,682	54,662	26,201	29,231
Pro-forma RWA	**367,430**	**364,400**	**392,641**	**392,291**	**338,199**	**338,199**	**366,660**	**363,630**
Q116 FL CET1 pro-forma	11.08%	11.08%	11.08%	11.08%	11.08%	11.08%	11.08%	11.08%
New Pro-forma CET1	11.98%	11.87%	11.16%	11.28%	13.23%	13.26%	12.28%	12.17%
CET1 accretion/dilution	**0.90%**	**0.79%**	**0.08%**	**0.20%**	**2.15%**	**2.15%**	**1.20%**	**1.09%**
Q1 16 Pre-provision profit	9%	8%	4%	3%	24%			
Q1 16 PBT	23%	12%	10%	9%	54%			
Q1 16 Earnings	16%	18%	8%	11%	69%			
Q1 16 RWA	6%	7%	0%	0%	0%			
Earnings dilution (pro-forma)	194	251	12	53	511	1,096	1,347	1,290
% of Group earnings (FY16E)	**-12%**	**-16%**	**-1%**	**-3%**	**-32%**	**-32%**	**-16%**	**-20%**
RoTNAV Q116						3.6%	3.6%	3.6%
Pro-Forma RoTNAV	8.9%	8.9%	37%	19.0%	9.6%	2.7%	3.1%	3.,0%
RoTNAV accretion/dilution						**-0.79%**	**-0.39%**	**-0.67%**

Note: The 'All out' column assumes the disposal of all mentioned assets; the Ykb in/Peo out column assumes the disposal of Bank Pekao and of the asset management stakes; and Peo in/Ykb out assumes the disposal of Yapi Kredi (at pre-coup levels) and the asset management stakes. *Adjusted by the recent 10% stake placement. **Illustrative pre-coup attempt assumptions for Yapi. Source: Company data, Credit Suisse estimates

Besides the mentioned options, we note that UCG has a number of non-core assets that it could potentially sell, such as the Mediobanca stake (8.6%), plus some holdings in small German and Austrian banks. In our view, a disposal of the Mediobanca stake looks unlikely in the short term, as the current market value is well below the carrying value. However, it could provide a buffer in the future. The other stakes might be sold, but it might be difficult to find buyers willing to pay a full price in the current market environment.

Figure 135: Significant shareholdings

(€m, %)	Balance sheet value	Fair value	Dividends received	Stake (%)	Market value
Koc Finansal Hizmetler	2,892		57	50.0%	
Aviva	201		46	49.0%	
Bank Fuer Tirol	564	275	4	46.7%	
BKS Bank	240	199	3	32.8%	
CNP Unicredit Life	362		8	38.8%	
CreditRas Life	337				
Mediobanca	725	662	19	8.6%	376
Oberbank	541	495	5	29.8%	
Oesterreichische KA	373		10	49.2%	
Total	**6,236**		**150**		

Source: Company data, Credit Suisse estimates

Scenario analysis: potential capital hike

Alternatively, or in combination with the disposal of assets, UCG might consider its fourth rights issue since 2007. In this scenario, we assume a capital hike of €4-9bn, depending on the magnitude of coverage uplift the bank aims to target. The impact on the CET1 would be 100bps-230bps. A capital hike at the top of the range could help UCG post a full clean-up of its NPLs and offload the bulk of the bad loans from its balance sheet. The table below summarizes our scenario analysis.

Figure 136: Scenario analysis: impact of a potential capital raising

(€m, %)			
Capital hike amount	**4,000**	**6,000**	**9,000**
Issue price	**1.50**	**1.30**	**1.10**
Market price	2.09	2.09	2.09
Pre-money Nosh	6,239	6,239	6,239
New shares in issue	2,667	4,615	8,182
Post-money Nosh	**8,906**	**10,855**	**14,421**
TERP	**1.91**	**1.75**	**1.53**
Discount to TERP	**-22%**	**-26%**	**-28%**
Pre-money EPS	0.27	0.27	0.27
Post-money EPS	0.19	0.15	0.12
EPS16E dilution	**-30%**	**-43%**	**-57%**
Pre-money PE	7.8	7.8	7.8
Post-money PE	11.1	13.5	18.0
Pre-money TBVps	7.0	7.0	7.0
Post-money TBVps	5.33	4.56	3.6
TBVps16E dilution	**-23%**	**-35%**	**-48%**
Pre-money PTBV	0.30	0.30	0.30
Post-money PTBV	0.36	0.38	0.42
CET1 uplift	**1.02%**	**1.53%**	**2.29%**
RoTE16E dilution	**-0.33%**	**-0.47%**	**-0.66%**

Source: Company data, Credit Suisse estimates

For UCG we think a reasonable CET1 would be at least 13% in view of its complexity and geographical diversification (as a G-SIFI). The recent placements of the Fineco and Pekao stakes lift the FL CET from 10.89% in Q1 16 to 11.09% (pro-forma), still a stretched 28bp buffer to the SREP requirements. To achieve 13% FL CET1 from the current pro-forma 11.1% CET1, we estimate the bank would need ~€7.5bn of additional capital (between a straight capital raise and disposals), or 56% of the current market capitalization. Based on the TBVps17E and RoTE17E dilutions, we estimate that all the potential capital raising scenarios are value-destroyers (see table below). Based on the sustainable profitability methodology, we calculate the post-money fair values shown in the following table: we would need a post-money RoTE17E target not lower than 6.5% for a relevant upside potential.

Figure 137: Scenario analysis: Potential fair values post a capital raising

2017			
Potential capital raise	**4,000**	**6,000**	**9,000**
TBV post money	5.51	4.70	3.75
RoTE post money	5.0%	4.8%	4.5%
CoE	11.3%	11.0%	10.8%
g	1%	1%	1%
PTBV	0.38	0.38	0.36
Fair value	2.12	1.77	1.34
New CET1	12.1%	12.6%	13.4%
Excess/Deficit Capital	-3,623	-1,578	1,490
New NOSH	8,896	10,845	14,411
Excess/Deficit Capital ps	-0.41	-0.15	0.10
Potential valuation/share	1.71	1.62	1.44
Discounted back	**1.62**	**1.54**	**1.37**
TERP	**1.91**	**1.75**	**1.53**
Potential Up/Downside	**-15%**	**-12%**	**-11%**

Source: Credit Suisse estimates

Conclusions

We view a potential capital raising as the most likely option, given our estimate that the disposal of a subsidiary would lead to significant earnings and profitability dilution. According to our scenario analysis, the combination of disposing of some assets and a rights issue at the bottom of the range might be a reasonable option from a capital perspective but not in terms of potential profitability dilution: assuming a sale of Pekao and Fineco/Pioneer combined with a €4bn capital hike, the total CET1 uplift would be 211-222bp with a 98-71bp RoTNAV dilution, while a straight €6bn capital call would raise the CET1 by 153bp at the expense of 45bp RoTNAV dilution.

We think the best option would have been a mix of actions maximizing the capital impact (€7.5bn needed to achieve 13% CET1 threshold) and minimizing the profitability dilution. However, in view of the recent events in Turkey, the number of strategic options for UCG are now more limited, while the bank could also be affected by a lower Yapi earnings/profitability contribution in the short term. As such, a potential Bank Pekao disposal combined with a capital hike may no longer represent the best scenario for UCG.

At this stage, we think the bank would likely need to focus on alternative minority stake placements, given that a Yapi disposal looks unlikely in the near term.

Figure 138: Scenario analysis: Potential combined options

(€m, %)				
Potential capital raising	**4,000**	**4,000**	**6,000**	**9,000**
EPS16E dilution	-30.0%	-30.0%	-42.6%	-56.8%
CET1 uplift	1.02%	1.02%	1.53%	2.29%
RoTE16E dilution	**-0.31%**	**-0.31%**	**-0.45%**	**-0.64%**
Strategic options	**Yapi out***	**Pekao out**	**Pekao out**	**All out**
EPS16E dilution	-16%	-12%	-16%	-32%
CET1 uplift	1.09%	1.20%	1.20%	2.15%
RoTE16E dilution	**-0.67%**	**-0.39%**	**-0.39%**	**-0.79%**
EPS16E dilution - Combined	-45.6%	-42.1%	-58.7%	-88.6%
CET1 uplift - Combined	**2.11%**	**2.22%**	**2.73%**	**4.44%**
RoTE16E dilution - Combined	**-0.98%**	**-0.71%**	**-0.85%**	**-1.43%**

*Illustrative assumptions for Yapi pre the recent failed coup.
Source: Credit Suisse estimates

On 11 July, new CEO Jean-Pierre Mustier launched an in-depth strategic review encompassing all major areas of the bank. There will be specific focus on capital optimization opportunities, further cost reduction, cross-selling across group entities and above all further improved risk discipline. The placements of the 10% Fineco stake and the 10% Bank Pekao stake were first steps in the strategic review.

UCG's strong Italian roots make the domestic bank core to the Group. The reshaping of the retail network and the ensuing digitalization already underway will likely continue apace, while in corporate banking the move towards Italy's global exporters, dynamic local mid-sized companies and the burgeoning entrepreneurial sector is ongoing. According to UCG, strategic assets such as HVB, CEE and the Corporate Investment Bank will pursue their development, increasing cross-selling and synergies wherever possible, while maintaining a strong focus on process efficiency and RWA optimization.

The bank has said all assets, without exception, will be subject to the same disciplined capital management, and any incremental value-creating opportunities, potentially also via disposals, will be evaluated. A more proactive approach to the non-core credit portfolio is expected to accelerate the strengthening of the balance sheet.

According to media reports (Reuters and Il Sole 24 Ore, 15 July), the new management is expected to announce the business plan review in Q4 16.

Valuation and risks

Target Price

We derive our €2.28 target price based on a sum-of the parts. We value each division separately, add up the parts and adjust for excess/deficit capital to determine the value attributable to shareholders. Our valuation in based on 2017E (12m forward), hence we discount back at a discount rate equivalent to the COE. We value the banking business on the sustainable profitability (RoE-g/CoE-g).

For the Italian retail bank we factor in 9% sustainable RoE and 11% cost of equity. We set a 7.5% sustainable profitability for the CIB division, with 11.5% CoE. Retail Germany and Austria RoE is expected to be low, at 3% and 2% respectively (10% CoE). For the EM banks we expect a sustainable profitability in a range of 7% and 10%, with a CoE of 12-16%. For Poland we use the market value: we have factored in the recent 10% stake placement.

The asset management business (Pioneer) valuation is based on a PE multiples basis, as a low capital intensive business. We use 10x PE, at a slight premium to Italian peers to reflect its international exposure advantage (despite lower margins). Fineco is carried at market value (also adjusted by the recent 10% placement). The non-operating divisions are valued with a multiple in line with the capital allocated. Our SoTP factors in a €6.1bn capital shortfall, the maximum amount that we estimate could be raised via a straight capital hike. Additional capital could be raised via disposals, as mentioned in the previous sections.

Figure 139: 2017E SoTP

(€m, %) Division	Net Profit	Allocated Equity	Divisional RWA	Required ratio	RoE (%)	Sust. RoE (%)	CoE (%)	g (%)	Methodology	Value (€m)	Ps (€)	PE (x)	PTBV (x)
CORE BANK	**3,683**	**47,000**	**392,572**	**11.7%**	**8.0**	**17.2**	**11.9**	**1.1**		**24,44**	**3.92**	**6.6**	**0.5**
Retail Italy	1,501	9,827	89,334	11.0%	15.3	9.0	11.0	0.0	RoE-g/Coe-g	7,147	1.15	4.8	0.7
Retail Germany	212	5,311	35,404	15.0%	4.0	3.0	10.0	0.0	RoE-g/Coe-g	1,593	0.26	7.5	0.3
Retail Austria	48	2,402	24,019	10.0%	2.0	2.0	10.0	0.0	RoE-g/Coe-g	480	0.08	10.0	0.2
Poland	217	3,268	29,712	11.0%	6.6	8.0	12.0	3.0	MV	3,242	0.52	14.9	1.0
CIB	1,162	9,466	82,310	11.5%	12.3	8.0	11.5	1.0	RoE-g/Coe-g	6,310	1.01	5.4	0.7
Asset management (Pioneer)	242	156	1,949	8.0%	155.3	155.3	10.0	3.0	PE	2,421	0.39	10.0	15.5
Asset gathering (Fineco)	130	185	2,311	8.0%	70.1	77.9	10.0	3.0	MV	1,877	0.30	14.5	10.2
CEE	1,000	11,545	95,306	12.1%	7.8	7.8	14.5	2.5	RoE-g/Coe-g	5,653	0.91	5.7	0.5
o.w. Turkey	432	3,190	29,000	11.0%	13.5	10.0	16.0	4.0	MV	2,172	0.35	5.0	0.7
o.w. Rest	568	8,355	66,306	12.6%	6.8	7.0	14.0	2.0	RoE-g/Coe-g	3,481	0.56	6.1	0.4
Corporate center	-829	3,867	32,227	12.0%	-21.4	-21.4	11.0	0.0	1.0x BV	-3,867	-0.62	10.0	-1.0
NON-CORE BANK	**-1,095**	**3,741**	**31,174**	**12.0%**	**-29.3**	**-100.**	**11.0**		**1.0x BV**	**-3,741**	**-0.60**	**10.0**	**-1.0**
Excess/Deficit Capital	**-193**	**-6,062**							**1.0x BV**	**-6,062**	**-0.97**	**n.m.**	**1.0**
Total UCG Group	**2,395**	**49,767**	**392,861**	**12.7%**	**4.8**	**5.2**	**11.8**			**15,055**	**2.42**	**6.3**	**0.3**
Adjusted discount factor											**1.06**		
Price Target										**14,203**	**2.28**	**5.9**	**0.3**

Source: Company data, Credit Suisse estimates

Rating

Our €2.28 target price implies ~5% potential upside from current share price levels. Based on our relative rating approach, this justifies a Neutral rating. UCG trades on 5.7x PE17E with a 0.30x PTBV17E, which compares to 0.43x for Italian peers and 0.64x for Eurozone peers.

Blue and grey sky scenarios

- **Blue sky scenario:** Our blue sky valuation of €3 factors in the following assumptions:
  - 2% revenue CAGR 2015-18E (versus 1% in our base case): we factor in +10bp higher NIM 2016E-18E vs base case average (213bp for UC Italy) and +5bp to our case base average asset management fees 2016E-18E (46bp);
  - -3% cost trend CAGR 2015-18E (versus -2%);
  - 62bp 2016E-18E average LLP from 66bps.

Under this scenario, the RoTE would rise to 5% in 2016E, 6.5% in 2017E and 7.5% in 2018E. The scenario factors in a €3bn capital shortfall (assuming 12% CET1 threshold).

- **Grey sky scenario:** Our grey sky valuation of €1.5 factors in the following assumptions:
  - 0% revenue CAGR 2015-18% (versus 1% in our base case): we factor in -10bp higher NIM 2016E-18E vs our base case average and -5bp to our base case average asset management fees 2016E-18E;
  - cost trend flattish (versus -2%);
  - 70bp 2016E-18E average LLP from 66bps.

Under this scenario, the RoTE declines to 2.8% in 2016E, 4.5% in 2017E and 5.8% in 2018E. The grey sky scenario factors in a €9bn capital shortfall (assuming 13% CET1 threshold and loan loss recognition).

Risks

We think the capital shortfall is partly priced in, but the particularly long procedure to raise capital in Italy (60 days at least) does not help.

The main downside risks to our TP are:

- possible prolonged overhang risk in a rights issue scenario;
- potential additional dilution in the event of the deconsolidation of higher-than-group RoTNAV subsidiaries,
- disappointing cost savings progression;
- execution risk on the net fees target.

Risks to the upside include:

- acceleration in cost-cutting delivery;
- a mix of actions (core and non-core asset disposals, straight capital call) able to reduce the shareholders and profitability dilution;
- potential Austrian business disposal without negative impacts;
- a large NPL deconsolidation at a low gap to the net book value.

Key management

Jean-Pierre Mustier, CEO: As the newly appointed CEO, Mustier is the successor of Federico Ghizzoni, who served as CEO since 2010. Mustier, 55, began his career at Société Générale where he held various positions, primarily within Corporate & Investment Banking from 1987 to 2009. In 2003, he was appointed Head of Société Générale's Corporate & Investment Banking Division and member of the bank's Executive Committee. Afterwards, from 2011 to 2014, he joined Unicredit Group as Deputy General Manager and Head of the Corporate & Investment Banking Division. Currently he is partner at Tikehau Capital, an investment management company and member of the Board of Directors of Alitalia.

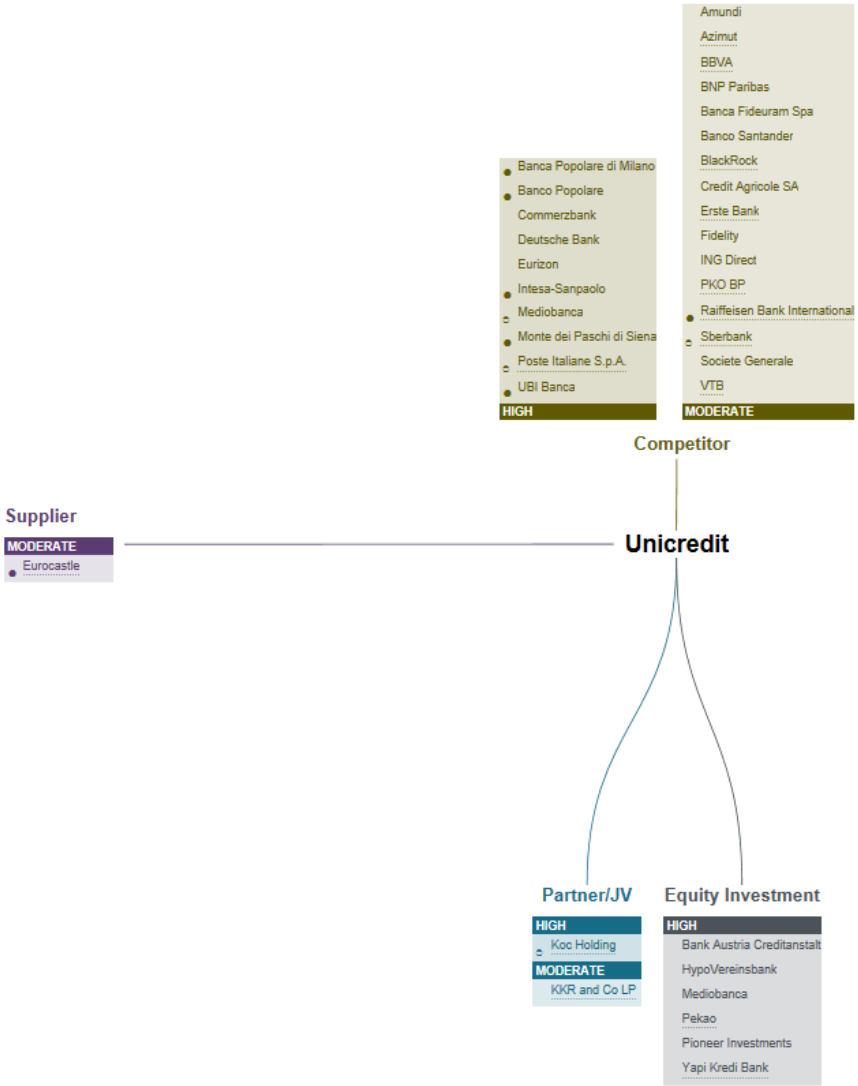
Marina Natale, Deputy General Manager - Head of Strategy and Finance: Natale started her career at UCG, joining the research and planning department in 1988. In 1997 she was appointed as the Head of Group M&A and Business Development department, managing the M&A operations of the group and being responsible for more than 50 transactions. She was responsible for the combination with HVB and the merger with Capitalia. In May 2009, she became CFO and in 2015 she became Deputy GM responsible for the Strategy and Finance Area. She is a member of the Executive Management Committee of UCG.

Bernardo Mingrone, Group Chief Financial Officer: Mingrone joined UCG in October 2015. He had been the Head of Finance & Operations at Banca Monte dei Paschi di Siena S.p.A. and Deputy General Manager. He served as Financial Reporting Officer at Banca Monte Dei Paschi Di Siena SPA until June 2013 and as its Chief Financial Officer.

Credit Suisse PEERs

PEERs is a global database that captures unique information about companies within the Credit Suisse coverage universe based on their relationships with other companies – their customers, suppliers and competitors. The database is built from our research analysts' insight regarding these relationships. Credit Suisse covers over 3,000 companies globally. These companies form the core of the PEERs database, but it also includes relationships on stocks that are not under coverage.

Figure 140: Unicredit PEERs map



Source: Credit Suisse PEERs

Monte dei Paschi di Siena (BMPS.MI)

Rating	**UNDERPERFORM [V]**
Price (15 Jul 16, €)	0.34
Target price (€)	0.29
Market Cap (€ m)	997.8

*Stock ratings are relative to the coverage universe in each analyst's or each team's respective sector.
[1]Target price is for 12 months.
[V] = Stock Considered Volatile (see Disclosure Appendix)

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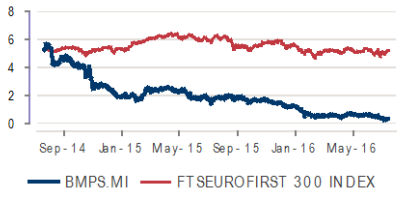
Steep discount, but for a reason

- **Initiating on MPS with an Underperform rating and €0.29 TP:** Trading at ~0.1x PTBV16E, the stock looks extremely cheap, as we believe it is discounting resolution/bailout scenarios. The forthcoming EBA stress test publication on 29 July poses further risks to its capital position. A potential shortfall above €1bn (slightly above the current market cap) could be difficult to manage without the application of the BRRD rules (bail-in) or state aid. We think the most likely outcome could be a large NPL disposal subsidized by Atlante: a positive in the short term, but structural weakness would remain.
- **NPL stock is the main issue:** With an 18% net NPE ratio (7% net NPL ratio), MPS has among the worst asset quality ratios in Italy (along with UC Italy), on our numbers. MPS has an 11.4% FL CET1 (Q1 16), 65bp above the SREP requirements. The buffer is in the low range of the Italian banks average (150bp for the four banks under Credit Suisse coverage, 170bp including other Italian banks). The stress test will not impose a hurdle, but the outcome of the adverse scenario could be included in the new SREP requirement, forcing a potential NPL coverage uplift and capital strengthening. The ECB recently asked the bank to accelerate its NPL stock reduction, setting very demanding targets.
- **Weak position in our NPL coverage stress test:** MPS was not the weakest bank in our stress test, but it showed a fragile capital situation under the adverse scenarios. We calculate a €0.6bn and €3.6bn capital shortfall to take NPL coverage up from 69% to 78% and 86%, respectively. In our estimates, MPS would need €2.7bn capital to stick to the ECB targets.
- **Valuation and risks:** We derive our €0.29 TP from a 2017E sustainable profitability methodology, implying ~15% downside potential. The stock trades on 0.1x PTBV17E (2.7% RoTBV17E), at a c15% relative discount to European peers. Downside risks to our TP include: execution risk on the demanding revenue targets, execution risk on NPL stock reduction, and uncertainties related to the forthcoming EBA stress test in terms of additional SREP requirements. The main upside risks are disposal of a big chunk of NPLs at a price close to the NBV and potential favourable M&A scenarios.

Share price performance



The price relative chart measures performance against the FTSEUROFIRST 300 INDEX which closed at 1335.7 on 15/07/16
On 15/07/16 the spot exchange rate was €1/Eu 1.-Eu.91/US$1

Performance	1M	3M	12M
Absolute (%)	-33.6	-46.4	-81.4
Relative (%)	-37.9	-43.5	-64.4

Financial and valuation metrics

Year	12/15A	12/16E	12/17E	12/18E
Net income reported (€ m)	388	75	230	403
Adjusted net profit (€ m)	16	105	258	428
EPS stated (€)	0.13	0.03	0.08	0.14
CS adj. EPS (€)	0.01	0.04	0.09	0.15
Prev. EPS (€)				
Tangible book value (€ m)	9,222	9,297	9,527	9,931
ROTE avg (adj.) (%)	0.2	1.1	2.7	4.4
P/E (adj.) (x)	61.84	9.48	3.86	2.33
Price/Tangible BPS (x)	0.11	0.11	0.10	0.10

Dividend (12/16E, EUR)	0.00	B3 Transitional RWAs (12/16E, €)	72,388
Dividend yield (12/16E,%)	0.0	Basel 3 FL CET1 ratio (12/16E,%)	11.4
Free float (%)	90.9	Number of shares (m)	2,932.1

Source: Company data, Thomson Reuters, Credit Suisse estimates

Monte dei Paschi di Siena (BMPS.MI)

Price (15 Jul 2016): **€0.3403**; Rating: **UNDERPERFORM [V]**; Target Price: **€0.29**; Analyst: **Carlo Tommaselli**

Income statement (€ m)	12/15A	12/16E	12/17E	12/18E
Net interest income	2,259	2,052	2,014	2,048
Fee and commission income	1,810	1,808	1,885	1,961
Trading income	1,033	300	320	350
Other non interest income	114	120	125	130
Total income	**5,216**	**4,280**	**4,344**	**4,489**
Admin expense	(1,653)	(1,636)	(1,603)	(1,575)
Other expenses	(760)	(737)	(715)	(693)
Total expenses	**(2,628)**	**(2,596)**	**(2,547)**	**(2,504)**
Pre-provision profit	**2,587**	**1,684**	**1,796**	**1,985**
Loan loss provisions	(1,991)	(1,295)	(1,155)	(1,050)
Other non-recurring pre-tax	-	-	-	-
Pre-tax profit	**440**	**157**	**371**	**615**
Minority interests & Other	40	32	30	27
Net profit (reported)	**388**	**75**	**230**	**403**
Net profit (adjusted)	**16**	**105**	**258**	**428**

Balance sheet (€ m)	12/15A	12/16E	12/17E	12/18E
Assets				
Net customer loans	111,366	111,366	112,511	114,042
Loan loss reserves	23,512	23,679	23,696	23,599
Avg interest earnings assets	176,228	167,662	164,984	162,472
Goodwill & intangibles	400	400	400	400
Total assets	**169,012**	**166,312**	**163,657**	**161,288**
Liabilities				
Total deposits	68,918	68,918	68,918	68,918
Shareholders' equity	**9,622**	**9,697**	**9,927**	**10,331**
Minority interests	0	0	0	0
Total equity and liabilities	**169,012**	**166,312**	**163,657**	**161,288**

Per share	12/15A	12/16E	12/17E	12/18E
Reported EPS (€)	0.13	0.03	0.08	0.14
CS adj. EPS (€)	**0.01**	**0.04**	**0.09**	**0.15**
Prev. EPS (€)				
% YOY change	100.03	552.32	145.29	65.98
Dividend (€)	0.00	0.00	0.00	0.00
% YOY change				
Dividend payout ratio	0.00	0.00	0.00	0.00
Dividend yield (%)	0.00	0.00	0.00	0.00
TNAVPS	3.15	3.17	3.25	3.39
Shares outstanding (m)	2,932	2,932	2,932	2,932

Valuation	12/15A	12/16E	12/17E	12/18E
P/E (adj., X)	61.8	9.5	3.9	2.3
P/BVPS (x)	0.1	0.1	0.1	0.1
P/NAVPS (x)	0.1	0.1	0.1	0.1
ROE (%)	5.0	0.8	2.3	4.0
CS adj. ROTE	0.0	0.0	0.0	0.0
ROA (%)	0.0	0.1	0.2	0.3
RoRWA (%)	0.5	0.1	0.3	0.5
NIM (NII/AIEA) (%)	1.3	1.2	1.2	1.3
Cost / Income (%)	50.4	60.6	58.6	55.8
Loan/Deposit (%)	161.6	161.6	163.3	165.5

Asset Quality	12/15A	12/16E	12/17E	12/18E
NPLs	23,349	20,913	18,561	14,959
% YOY Change	3.8	(10.4)	(11.2)	(19.4)
NPL/ gross loans	17.3	15.5	13.6	10.9
Loan Loss Reserves/NPLs	100.7	113.2	127.7	157.8
Common Eq Tier1 Capital	-	-	-	-
Basel 3 Transitional CET1 capital	8,443	8,272	8,402	8,705
Basel 3 Fully loaded CET1 capital	8,443	8,272	8,402	8,705
Basel 3 Transitional RWAs	70,800	72,388	73,132	74,127
Basel 3 Fully loaded RWAs	70,800	72,388	73,132	74,127
Basel 3 Transitional CET1 ratio	11.9	11.4	11.5	11.7
Basel 3 Fully loaded CET1 ratio	11.9	11.4	11.5	11.7
Basel 3 leverage ratio	5.0	5.0	5.1	5.4

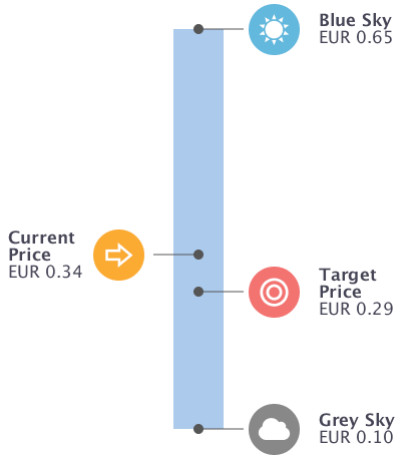
Earnings	12/15A	12/16E	12/17E	12/18E
Net Interest Income	4.4	(9.2)	(1.8)	1.7
F&C income	6.6	(0.1)	4.2	4.0
Trading income	294.2	(71.0)	6.7	9.4
Total revenues	23.3	(17.9)	1.5	3.3
Total expenses	(4.6)	(1.2)	(1.9)	(1.7)
Pre-prov operating profit	75.6	(34.9)	6.6	10.5
Pre-tax profit	(106.3)	(64.2)	135.9	65.5
Net customer loans	(6.9)	0.0	1.0	1.4
Customer deposits	7.4	0.0	0.0	0.0

Source: FTI, Company data, Thomson Reuters, Credit Suisse Securities (EUROPE) LTD. Estimates

Company Background

MPS is a regional lender with Italy's fourth largest domestic network. MPS has been experiencing a sharp restructuring and de-leveraging. Asset quality is the main issue, in our view. The ECB has suggested that MPS should merge with another lender.

Blue/Grey Sky Scenario



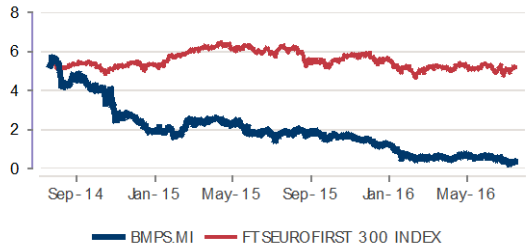
Our Blue Sky Scenario (€) 0.65

This scenario factors in: (i) 2% revenue CAGR 2015-18E (vs flattish), backed by a more favorable AuM mix; (ii) -3% cost CAGR 2015-18E (vs -2%); (iii) 95bp average normalized CoR (vs 104bp). Under this scenario RoTNAV18E would increase to 5.3%. We factor in a €0.7bn capital shortfall.

Our Grey Sky Scenario (€) 0.10

In this scenario, we expect: (i) -2% revenue CAGR 2015-18E, mainly on AuM fees weakness and further NIM pressure; (ii) flattish cost trends; (iii) 110bp average normalized LLP from 104bp. The resulting RoTNAV18E would be 2.8%. We calculate a €2.7bn capital shortfall under this scenario, paving the way to a bail-in/state aid.

Share price performance



The price relative chart measures performance against the FTSEUROFIRST 300 INDEX which closed at 1335.7 on 15/07/16

On 15/07/16 the spot exchange rate was €1/Eu 1.- Eu.91/US$1

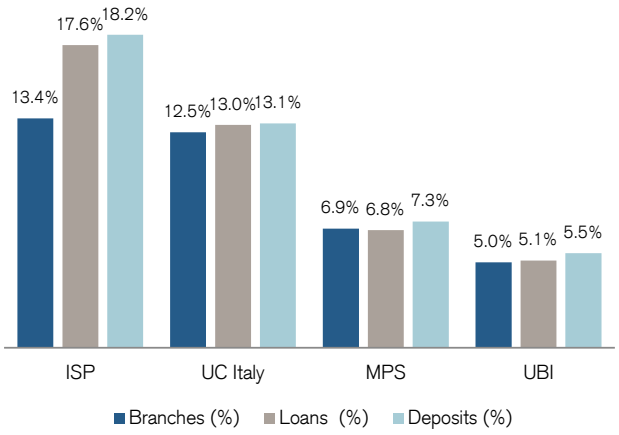
Company summary

The fourth largest domestic network

MPS is now the fourth largest domestic lender, with 2,132 branches and a headcount of 25,681 in Italy. Before the recent merger of Banco Popolare-Banca Popolare di Milano, MPS was the third largest lender in Italy.

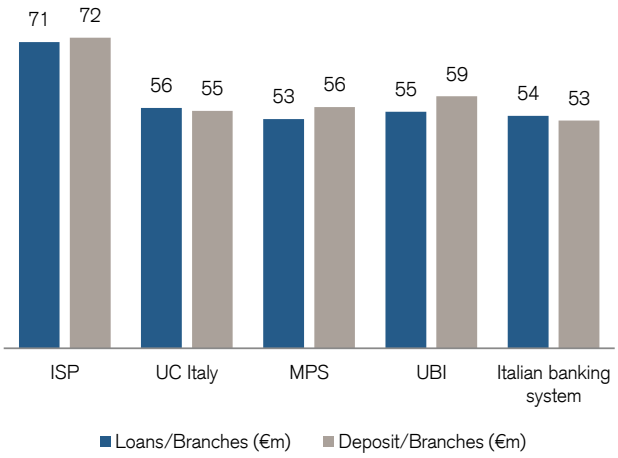
MPS has the fourth largest market share in terms of loans and deposits in Italy, after the national champions ISP, UCG and the new entity recently born from the BP-BPM merger. The Italian branches' productivity is below the Italian banks on loans (as a result of the recent company-specific de-leveraging), while it is higher in terms of deposits. MPS has significant market shares in Tuscany and Veneto.

Figure 141: Q1 16 Market shares



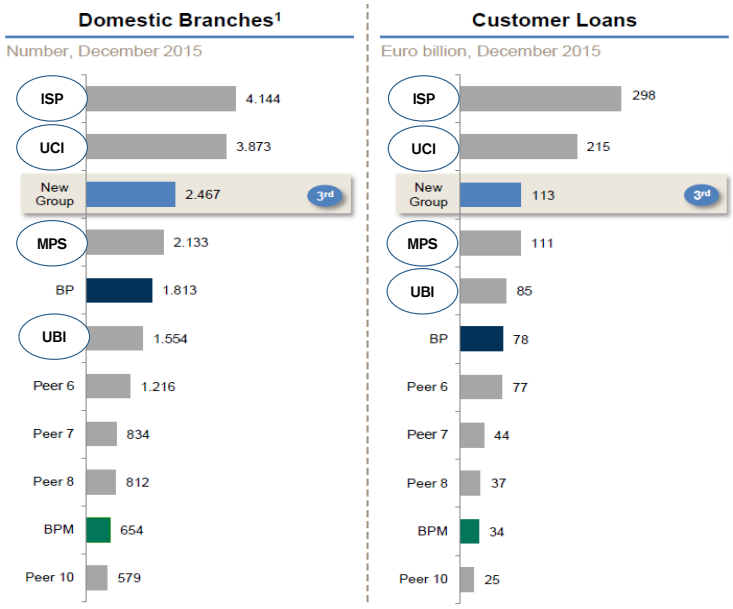
Source: Company data, Credit Suisse research, Bank of Italy

Figure 142: Q1 16 Branches productivity



Source: Company data, Credit Suisse research, Bank of Italy

Figure 143: MPS market shares

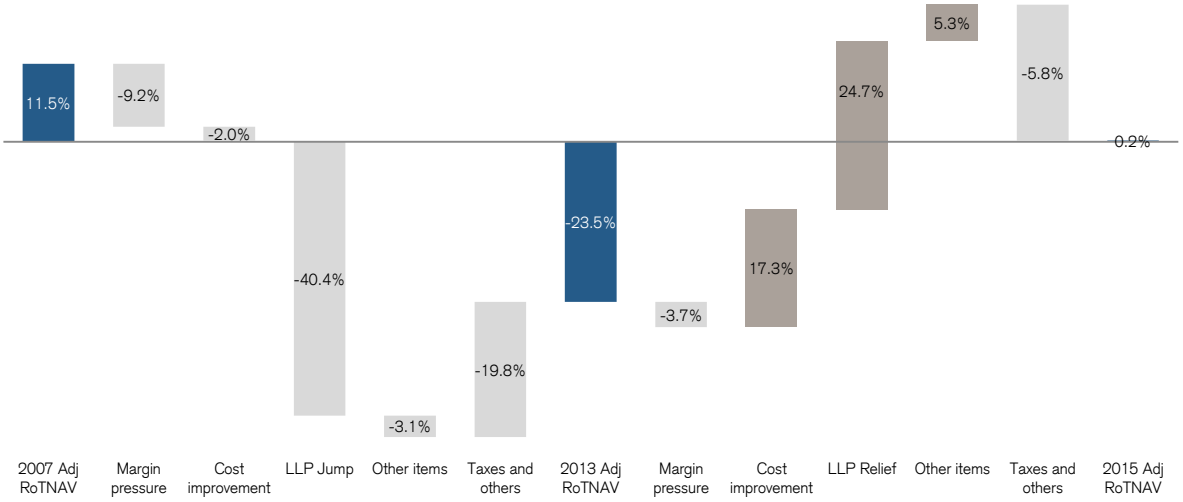


Source: BP-BPM merger plan

Historical trends and estimates

MPS was one of the banks hardest hit by Italian macroeconomic turmoil. The average adjusted RoTNAV in 2007 stood at 11.5%; at the peak of the crisis in 2013, it had -~84% negative adjusted RoTNAV. In 2015 MPS's adjusted profitability was break-even.

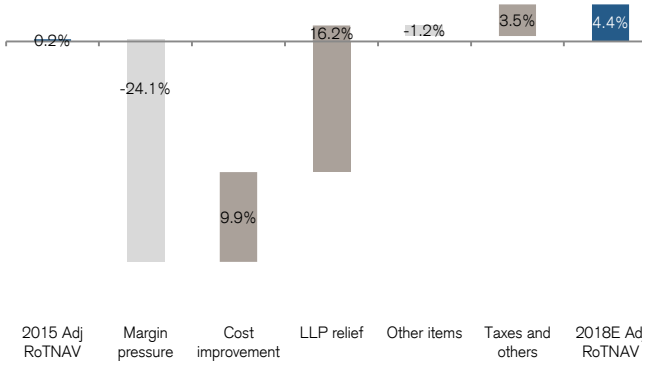
Figure 144: MPS - 2007-2015 RoTNAV dynamics



Source: Company data, Credit Suisse estimates

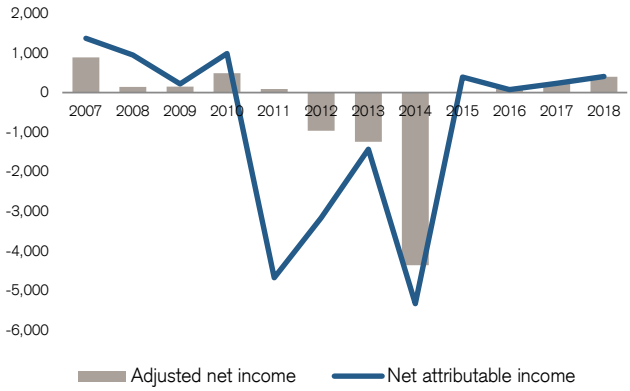
We forecast that MPS could post a 420bp adjusted RoTNAV uplift in the next three years. In our estimates, we project the adjusted RoTNAV to rise to 4.4% in 2018 from 0.2% in 2015. In our assumptions we factor in severe pressure on revenue, while the main profitability driver is expected to be lower LLP and cost savings.

Figure 145: MPS - 2015-2018E Adj RoTNAV projected evolution



Source: Company data, Credit Suisse estimates

Figure 146: MPS - Stated and adjusted net income historical trends and estimates

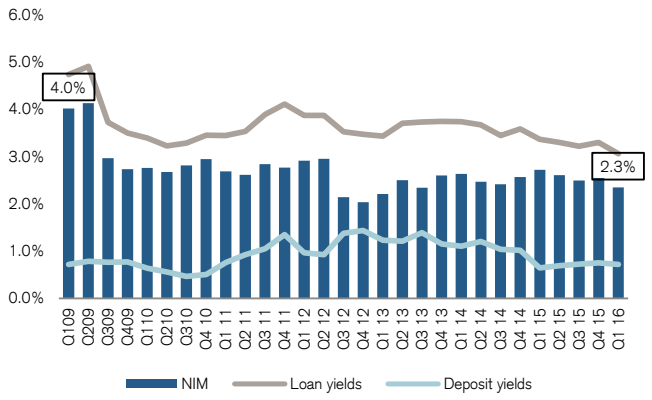


Source: Company data, Credit Suisse estimates for 2016-18

For 2016, we forecast a RoTNAV decline as in 2015 MPS benefited from some non-recurring items in trading income (Alexandria derivative settlement related). Despite net fees support, we expect revenue to decline in 2016 for the sharp drop in trading profit and the NII decline. The asset management business will likely suffer from a slowdown due to the market turmoil, but the overall net fee contribution is expected to be resilient.

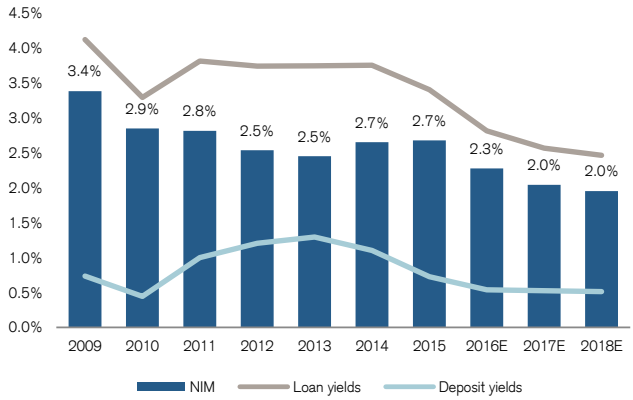
We expect the average commercial NIM to decline to 195bp in 2018 from 268bp in 2015. In 2016, NIM should come in at 228bp: loans yield is expected down from 341bp to 282bp (247bp in 2018), mitigated by a falling funding cost from 73bp to 54bp in 2016 (51bp in 2018). We factor in 0.8% customer loans CAGR in 2015-18E. At group level, we estimate -3% NII CAGR in 2015-18E, well below the business plan target (€2.05bn vs €2.5bn).

Figure 147: MPS - Quarterly NIM: historical trends



Source: Company data, Credit Suisse estimates

Figure 148: MPS - Annual NIM: actual and estimates



Source: Company data, Credit Suisse estimates

In 2016, the market turbulence should have an impact on AuM and fees. As such, we expect the management fee to decline by a couple of bps due to a mix change. For 2018, we expect MPS to have €62.4bn AuM (from €49.7bn in Q1 16).

Figure 149: Asset management volumes and fees evolution

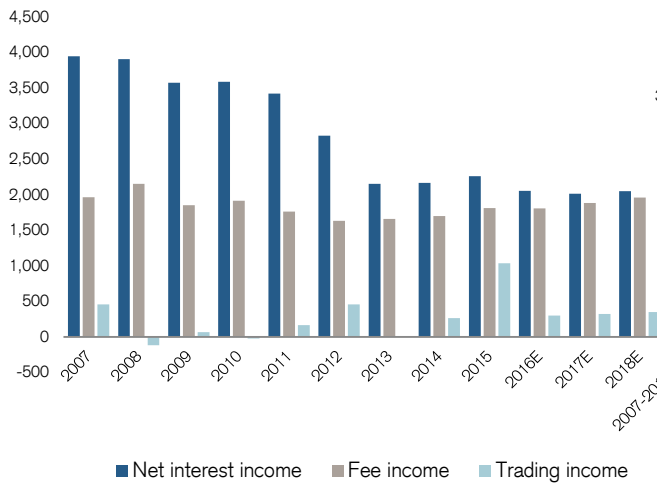
(€m, bp)	2013	2014	2015	2016E	2017E	2018E
Assets under management	45,106	51,519	55,500	57,720	60,029	62,430
AUM fees	308	336	405	341	355	369
Mgm fees % of AuM (bps)	68	69	76	60	60	60

Source: Company data, Credit Suisse estimates

Our forecast on trading income is conservative. For 2016E-18E, we factor in ~€320m average trading profit, well below the 2012-15 average (€440m). The 2016-18 average total income forecast is almost in line with the normalized 2015 revenue (-15% short of the stated total income), with 2016 revenue expected to fall by -17% yoy on the stated total income. Revenue should rise by 1.4% yoy in 2017 and by 3.3% in 2018 total income.

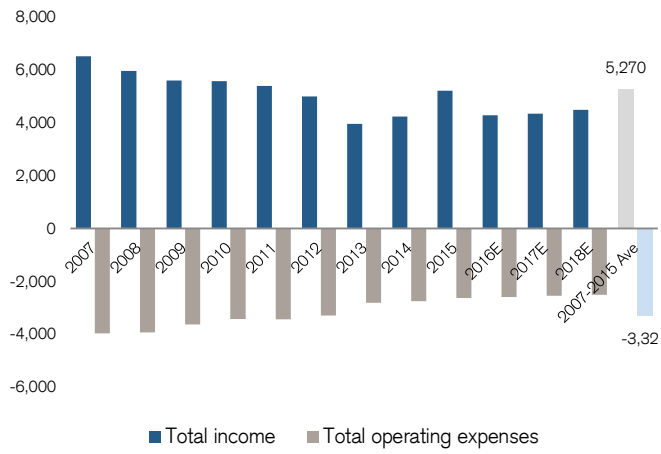
We estimate ~€4.5bn total income at year-end 2018, 12% below plan (€5.1bn) on NII and a commission income miss. We project €2.05bn NII vs €2.5bn MPS guidance and €1.96bn net fees in 2018 vs €2.25bn target. Our estimates are below company guidance due to (i) lower NIM and (ii) average AuM fee. Our revenue forecast is slightly above consensus (+1.3%).

Figure 150: MPS - Total income breakdown trends



Source: Company data, Credit Suisse estimates

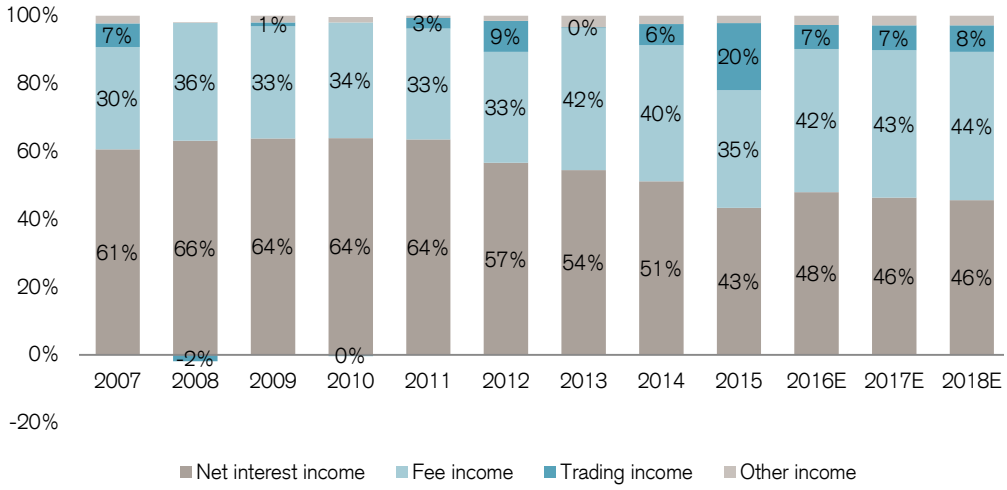
Figure 151: MPS - Revenue and cost trends



Source: Company data, Credit Suisse estimates

We envisage a revenue breakdown evolution embedding the shift from NII to net fees. We expect a commission income uplift to 44% in 2018 from 35% in 2015, mainly at the expense of trading income contributions. NII should stabilize at 46% of the total income over the plan period from 50% in 2015.

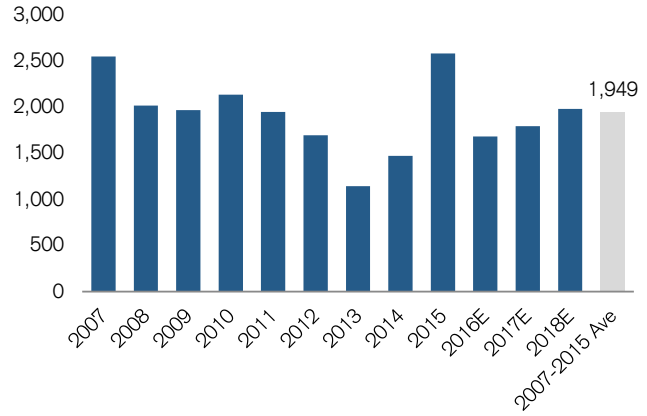
Figure 152: MPS - Total income breakdown trends



Source: Company data, Credit Suisse estimates

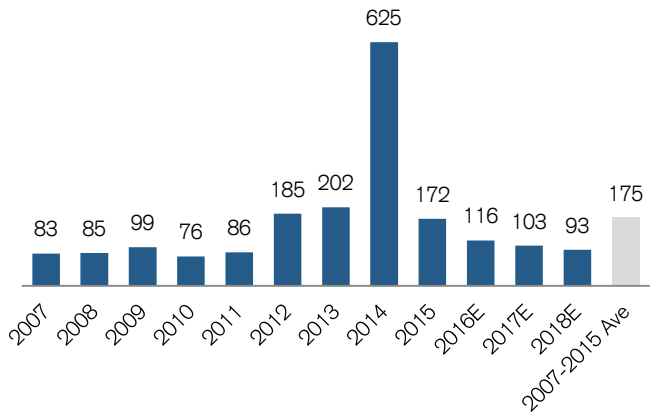
The plan is targeting a reduction of the cost base to €2.52bn in 2018 from €2.75bn in 2015. We forecast €2.5bn in operating costs, slightly below the company target. MPS should be able to extract additional cost cutting measures to offset the lower revenue uplift, in our view. In 2016 the pre-provision profit should touch €1.68bn, at the bottom of the normalized range posted by MPS in 2018 (€1.6bn-€1.8bn), on our estimates. The pre-provision profit should post robust growth in 2017 (+7%) and in 2018 (+10%), though well below the business plan target. The CoR could offer some buffer as MPS' target appears very cautious at 106bp in 2018. We forecast LLP to decline to 93bp.

Figure 153: MPS Pre-provision profit evolution (€m)



Source: Company data, Credit Suisse estimates

Figure 154: MPS LLP evolution (bp)



Source: Company data, Credit Suisse estimates

As a result, our 2018E stated earnings stand at €408bn, 54% below the company target (€880m) and 5.4% above consensus. Our 4.1% RoTNAV18E compares to 8% company guidance.

Figure 155: 2018E main P&L items – Credit Suisse, MPS and Consensus

(€bn, %)	2018E CS	2018E MPS	Gap	Consensus	Gap CS-Consensus
NII	2,048	2,549	-19.7%	2,165	-5.4%
Net Fees	1,961	2,251	-12.9%	1,945	0.8%
Total Income	**4,489**	**5,100**	**-12.0%**	**4,430**	**1.3%**
Operating expenses	-2,504	-2,517	-0.5%	-2,529	-1.0%
Pre-provision profit	**1,985**	**2,583**	**-23.2%**	**1,901**	**4.4%**
LLP	-1,050	-1,200	-12.5%	-1,284	-18.2%
PBT	615	1,383	-55.6%	529	16.2%
Net profit	**403**	**880**	**-54.1%**	**383**	**5.4%**

Source: Credit Suisse estimates, Bloomberg consensus

The ECB letter

On 4 July, MPS announced the receipt of a letter from the ECB asking for a sharp reduction in its NPE in three years. The letter also requires MPS to present by 3 October a detailed plan to reduce its gross NPE ratio to 20% in 2018 from the current 34%.

MPS said it presented its draft counter-arguments on 8 July. The bank released a chart, according to which in the next three years, it should reduce its non-performing loans and achieve certain ECB targets.

Figure 156: MPS: Bad loans reduction ECB requirements

(€bn, %)	2015	2016E	2017E	2018E	CAGR 15-18E
Gross NPE	46.9	43.4	38.9	32.6	-11%
Net NPE	24.2	21.8	18.4	14.6	-16%

Source: Company data

The current MPS plan envisages €5.5bn NPL GBV disposal and €6bn NPL workout (for a total €11.5bn reduction) versus €14.3bn requested in the ECB letter.

We view the ECB's letter as a potential read-across for its NPL guidance to be published later in the summer, which may impose the 20% Gross NPE ratio as the 'new gross NPE ratio threshold' set by the ECB for some Italian banks.

Note that we do not reconcile the NPE reduction related to the €33bn target provided by the ECB (in the table above) and the NPE ratio target of 20%, which implies €28bn NPE. Assuming a €14.6bn gross NPE reduction, we calculate a capital shortfall of €1.8-€2.7bn stemming from the acceleration of the NPL deconsolidation.

Figure 157: Potential capital shortfall stemming from accelerating MPS' NPL disposal

(€m, %)	Q1 16	2016E	2017E	2018E	Cumulated	%
Gross NPE	47,238	43,400	38,900	32,600	**-14,638**	
Net NPE	24,068	21,800	18,400	14,600	**-9,468**	
Provisions	-23,170	-21,600	-20,500	-18,000		
Coverage	49%	50%	53%	55%		
Gross NPL	27,733	25,480	21,395	17,278		
Net NPL	10,184	8,980	7,195	5,278		
Provisions	-17,549	-16,500	-14,200	-12,000		
Coverage	63%	65%	66%	69%		
NPL/NPE	59%	59%	55%	53%		
Gross NPE deconsolidation		-3,838	-4,500	-6,300	-14,638	
Gross NPL deconsolidation		**-2,253**	**-4,085**	**-4,117**	**-10,455**	**71%**
Net NPE deconsolidation		-1,957	-2,295	-3,213	-7,465	
Net NPL deconsolidation		-834	-1,511	-1,523	-3,868	52%
NPL - GBV on sale					**-10,455**	
Coverage uplift - 20% price gap					-2,091	
NPE - GBV on sale					**-4,183**	
Coverage uplift - 35% price gap					-1,464	
Total pre-tax coverage uplift					**-3,555**	
Post-tax coverage uplift (tax relief)					**-2,311**	
RWA					72,113	
Impact on CET1					-3.20%	
Q1 16 FL CET1					11.4%	
PF CET1					8.2%	
SREP					10.8%	
Shortfall to SREP					**-2.6%**	
Capital shortfall to SREP					**-1,842**	
Capital shortfall to 12% CET1					**-2,743**	

Source: Company data, Credit Suisse estimates

NPL deconsolidation and re-capitalization

Accelerating NPL deconsolidation would likely involve a recapitalization at a difficult time, with a high risk of un-subscription and a resolution. As such, the Italian government is reportedly negotiating with the EC to avoid burden sharing for bondholders, at least for retail. Article 32 of the BRRD provides a legal framework to allow a waiver in these cases:

- Capital shortfalls stemming from national, Union or SSM stress tests, asset quality reviews or equivalent exercises conducted by the ECB, EBA, or national authorities.
- Extraordinary public financial support is allowed to remedy a serious disturbance in the economy of a Member State and preserve financial stability.
- The extraordinary public support may take any of the following forms: (i) a State guarantee to back liquidity facilities; (ii) a State guarantee of newly issued liabilities; (iii) an injection of own funds or purchase of capital instruments at prices and on terms that do not confer an advantage upon the institution.

La Repubblica reported that a rescue plan for MPS could materialize in two stages:

- NPL deconsolidation: creation of a new Atlante fund with €5bn-6bn of fresh capital, injected by Cassa Depositi e Prestiti (CDP) among others. The fund would buy a large chunk of MPS' NPL.
- Recapitalization via: (i) the issuance of a mandatory convertible bond like the former NSF ("Nuovi Strumenti Finanziari") at conditions not conferring an advantage upon the institution; (ii) ordinary share offer: the State would get the unsubscribed capital.

Burden sharing is the main discussion point with the EC. European financial services commissioner Valdis Dombrovskis said that a "precautionary recapitalization" does not trigger bail-in when the bank is solvent in the baseline scenario. However, the report said Eurogroup Chairman Jeroen Dijsselbloem warned that Italy should comply with the BRRD and apply bail-in rules on subordinated bondholders, at least institutional investors. MPS has ~€6bn outstanding subordinated bonds, of which €2bn is in the hands of institutional investors who might face this burden-sharing risk.

According to Reuters, MPS' reply letter to the ECB included a mix of preliminary actions to reduce NPLs to meet the ECB's target and to minimize a potential rights issue. CEO Fabrizio Viola said that the bank is working intensively with authorities to find a structural, definitive and rapid solution on bad loans; he added that Q2 performance is "positive". According to Reuters, ECB Vice President Vitor Constancio said Europe should consider "small" state support for its banks to help them get rid of troubled assets. At the same time, Bank of Italy Governor Ignazio Visco said that public money should be used to help Italy's troubled banks, as the current market situation is "full of risks for financial stability," and a public backstop to support the banks is necessary and not prohibited by European rules. According to Reuters, MPS is working with JP Morgan on a jumbo NPL securitisation which could help offload €10bn of NPL. The structure of the securitisation would provide for the use of the State GACS scheme. The reports said bank is seeking to reach a deal by the end of July, when the results of European banking stress tests will be unveiled. MPS has not commented on the reports. Italy is also reportedly seeking a second bank support fund by end-July. The 'Atlante 2' fund would supplement the existing Atlante fund and have a size of €2bn and a focus on NPLs. Cassa Depositi e Prestiti (CDP) would reportedly contribute ~€400-500m.

Based on the recent newsflow, on page 28 we have summarized 10 potential scenarios for MPS. In our view, the most likely outcome for MPS would be: (i) rescue by a private vehicle (e.g. an 'Atlante 2') funded by groups other than banks (CDP, SGA, Atlante 1 Foundations, etc.); (ii) a large NPL securitization backed by GACS; and (iii) partial burden sharing (for institutional investors involved in the sub-debt only). We expect the issue to be solved via a market solution not involving public money. We do not expect the banks to contribute funds to a new Atlante fund: a rescue funded by the Italian banking system would likely be negative for the sub-sector.

Valuation and risks

Target Price

We derive our €0.29 target price based on sustainable profitability methodology (RoE-g)/(CoE-g). Given the CoE, this methodology helps to calculate the 'right' (warranted) PTBV for a stock. In the calculation of the TBV, we deduct the excess/deficit capital to determine the fair value. We then add the excess capital to the fair value obtained. As such, we get to a target fair value, which we discount back to achieve the final TP.

Figure 158: Sustainable profitability methodology

(€, %)	2017E
Adj TBV per share (€)	**3.62**
RoTBV17E	2.7%
Average RoTBV16E-18E	2.8%
CoE	11.0%
Growth rate	0.0%
Fair valuation multiple	0.25
Fair Value (€)	**0.81**
Excess/(shortfall) capital	**-0.50**
Discount factor	1.05
TP (€)	**0.29**
Upside/downside	**-15%**

Source: Credit Suisse estimates

Rating

Our €0.29 target price implies ~15% potential downside from current share price levels. Based on our relative rating approach, we believe that this justifies an Underperform rating. MPS trades on 3.9x PE17E with a 0.1x PTBV17E, which compares to 0.43x Italian peers and 0.64x European peers. Our TP factors in a ~€1.3bn capital shortfall.

Blue and grey sky scenarios

- **Blue sky scenario:** Our blue sky valuation of €0.65 factors in the following assumptions:
  - 2% normalized revenue CAGR 2015-18% (versus our base case -0.2%);
  - -3% cost trend CAGR 2015-18E (versus -2%);
  - 95bp 2016E-18E average normalized LLP from 104bps.

Under this scenario, the RoTE would rise to 2% in 2016E, 3.5% in 2017E and 5.4% in 2018E. The capital shortfall would reduce to €0.7bn.

- **Grey sky scenario:** Our grey sky scenario of €0.10 factors in the following assumptions:
  - -2% normalized revenue CAGR 2015-18% (versus -0.2%);
  - cost trend flattish (versus -2%);
  - 110bp 2016E-18E average normalized LLP from 104bps.

Under this scenario, the RoTE declines (vs. the base case scenario) to -1% in 2016E, 1% in 2017E and 2.8% in 2018E. The capital shortfall would jump to €2.7bn. This scenario factors in a resolution or state aid.

Risks

The main downside risks to our TP are:

- execution risk of the plan's demanding revenue targets;
- execution risk of the NPL stock reduction;
- further hits to earnings/capital from asset quality;
- potential resolution (bail-in) or state aid
- potential risks from the forthcoming EBA stress test in terms of additional SREP requirements.

Upside risks to our TP include:

- a disposal of a big chunk of NPLs at a price close to the NBV;
- a large NPL securitisation;
- delivery of part of the revenue growth factored in the plan;
- potential favourable M&A scenarios.

Key management

Fabrizio Viola, CEO: Viola has been the Chief Executive Officer and General Manager of BMPS since 2012. He served as BPER's CEO from 2008 to 2012. Before that, he was General Manager of Banca Popolare di Milano between 2004 and 2008. His background involves the asset management industry: he served as General Manager of Anima and of Bipiemme Gestioni Sgr since December 2002.

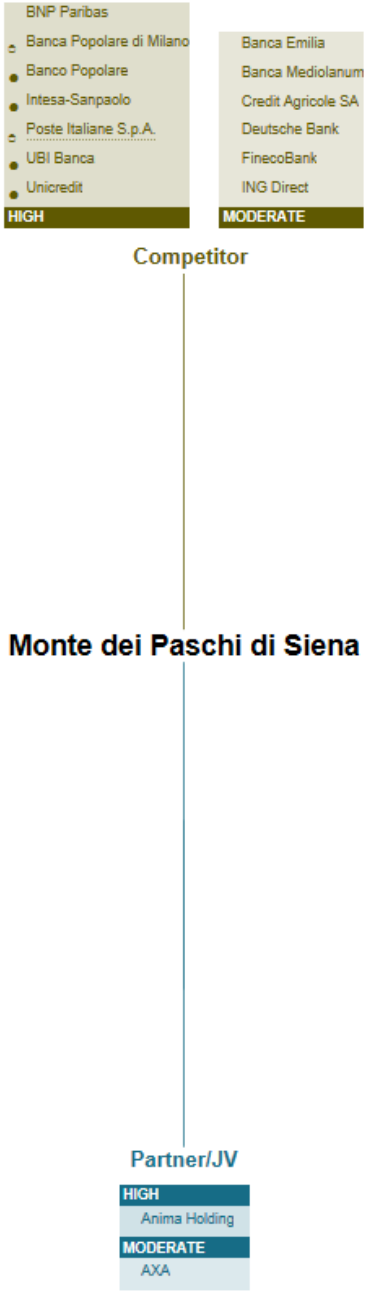
Arturo Betunio, CFO: He started his career with the Guardia di Finanza (Italian finance police) and was Head of Tax for several banking and insurance groups until 2009: INA, Poste Italiane, Capitalia, Unicredit Group. From 2009 to 2013 he was head of the Italian Revenue Agency's Central Regulatory Department. In 2013 he joined MPS, where he was appointed as CFO since 2015.

Andrea Rovellini, Head of Risk: The former head of Planning & Control and Risk Management at Banca Popolare di Milano, he was top manager of some subsidiaries of BPM Group and served on the Anima SGR BoD. He joined MPS in January 2013 as Head of Risk.

Credit Suisse PEERs

PEERs is a global database that captures unique information about companies within the Credit Suisse coverage universe based on their relationships with other companies – their customers, suppliers and competitors. The database is built from our research analysts' insight regarding these relationships. Credit Suisse covers over 3,000 companies globally. These companies form the core of the PEERs database, but it also includes relationships on stocks that are not under coverage.

Figure 159: MPS PEERs map



Source: Credit Suisse PEERs

UBI Banca (UBI.MI)

Rating	**OUTPERFORM**
Price (15 Jul 16, €)	2.79
Target price (€)	3.50
Market Cap (€ m)	2,515.9

*Stock ratings are relative to the coverage universe in each analyst's or each team's respective sector.
[1]Target price is for 12 months.

Research Analysts

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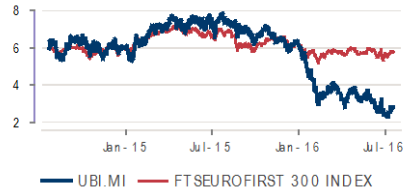
NPL coverage now fair, consolidation risk remains

- **Initiating on UBI with an Outperform rating and €3.5 TP:** Trading at 0.35x PTBV16E, UBI shows a sharp discount to Italian peers (0.44x PTBV16E). In our view, its robust capital and solid balance sheet warrant a relative premium. We think the bank can deliver on its recently announced business plan, which factors in catalysts for the short and long term. At current levels, we think the stock is already factoring in the risk of further participation in any rescue fund.
- **Focused on asset management, asset quality:** The plan includes several smart action points, in our view: (i) the buyout of the bank's network minority to optimize the cost structure; (ii) the usage of the shortfall to expected loss to improve coverage and bad loans stock; and (iii) a strategy focused on the asset management business to reduce the reliance on NII and increase net fees (50% of total income in 2019 from 38%).
- **Among the most resilient in our coverage uplift stress test:** UBI is among the most resilient banks in our stress test on coverage uplift. The bank shows a buffer to the SREP even in our worst case scenario thanks to its combination of solid capital, lower NPL stock and higher collateralisation than its peers, despite a lower-than-peers cash coverage.
- **Valuation and risks:** We derive our €3.5 TP from a 2017E sustainable profitability methodology, implying potential upside of 25%. The stock trades on 0.34x PTBV17E (5.1%RoTNAV17E), implying a 6% relative discount to Eurozone peers. Risks to the downside include: (i) execution risk of the plan's demanding revenue targets (mainly net fees), (ii) the asset management business potential slowdown as a result of market turbulence, and (iii) further hits to earnings/capital from the participation in resolution/rescue funds (like the one for the four local banks in November and/or Atlante) and (iv) M&A strategy.

Share price performance



The price relative chart measures performance against the FTSEUROFIRST 300 INDEX which closed at 1335.7 on 15/07/16
On 15/07/16 the spot exchange rate was €1/Eu 1.-Eu.91/US$1

Performance	1M	3M	12M
Absolute (%)	-0.9	-24.7	-63.9
Relative (%)	-4.5	-20.7	-46.1

Financial and valuation metrics

Year	12/15A	12/16E	12/17E	12/18E
Net income reported (€ m)	118	-387	378	498
Adjusted net profit (€ m)	271	159	401	518
EPS stated (€)	0.13	-0.41	0.39	0.51
CS adj. EPS (€)	0.30	0.17	0.41	0.53
Prev. EPS (€)				
Tangible book value (€ m)	8,224	7,738	8,116	8,463
ROTE avg (adj.) (%)	3.3	2.0	5.1	6.3
P/E (adj.) (x)	9.28	16.44	6.79	5.25
Price/Tangible BPS (x)	0.31	0.35	0.34	0.32

Dividend (12/16E, EUR)	0.11	B3 Transitional RWAs (12/16E, €)	61,369
Dividend yield (12/16E,%)	3.9	Basel 3 FL CET1 ratio (12/16E,%)	12.2
Free float (%)	97.6	Number of shares (m)	901.7

Source: Company data, Thomson Reuters, Credit Suisse estimates

UBI Banca (UBI.MI)

Price (15 Jul 2016): **€2.79**; Rating: **OUTPERFORM**; Target Price: **€3.50**; Analyst: **Carlo Tommaselli**

Income statement (€ m)	12/15A	12/16E	12/17E	12/18E
Net interest income	1,658	1,513	1,500	1,543
Fee and commission income	1,300	1,351	1,411	1,482
Trading income	291	160	160	160
Other non interest income	149	180	180	180
Total income	**3,398**	**3,203**	**3,251**	**3,366**
Admin expense	(1,295)	(1,295)	(1,280)	(1,264)
Other expenses	(727)	(662)	(649)	(642)
Total expenses	**(2,161)**	**(2,096)**	**(2,065)**	**(2,043)**
Pre-provision profit	**1,237**	**1,107**	**1,186**	**1,323**
Loan loss provisions	(803)	(1,255)	(544)	(510)
Other non-recurring pre-tax	(63)	(217)	0	0
Pre-tax profit	**352**	**(365)**	**642**	**813**
Minority interests & Other	59	78	33	30
Net profit (reported)	**118**	**(387)**	**378**	**498**
Net profit (adjusted)	**271**	**159**	**401**	**518**

Balance sheet (€ m)	12/15A	12/16E	12/17E	12/18E
Assets				
Net customer loans	84,586	84,619	85,639	87,211
Loan loss reserves	4,158	5,263	5,657	6,016
Avg interest earnings assets	111,057	108,716	108,686	109,066
Goodwill & intangibles	1,757	1,757	1,757	1,757
Total assets	**117,201**	**117,062**	**117,141**	**117,820**
Liabilities				
Total deposits	55,264	57,668	60,192	62,844
Shareholders' equity	**9,982**	**9,496**	**9,873**	**10,221**
Minority interests	536	50	50	50
Total equity and liabilities	**117,201**	**117,062**	**117,141**	**117,820**

Per share	12/15A	12/16E	12/17E	12/18E
Reported EPS (€)	0.13	(0.41)	0.39	0.51
CS adj. EPS (€)	**0.30**	**0.17**	**0.41**	**0.53**
Prev. EPS (€)				
% YOY change	59.59	(43.58)	142.27	29.34
Dividend (€)	0.11	0.11	0.16	0.20
% YOY change	37.50	0.00	41.13	31.93
Dividend payout ratio	36.58	64.84	37.77	38.52
Dividend yield (%)	3.94	3.94	5.56	7.34
TNAVPS	9.12	7.94	8.32	8.68
Shares outstanding (m)	902	975	975	975

Valuation	12/15A	12/16E	12/17E	12/18E
P/E (adj., X)	9.3	16.4	6.8	5.2
P/BVPS (x)	0.3	0.3	0.3	0.3
P/NAVPS (x)	0.3	0.4	0.3	0.3
ROE (%)	1.2	(4.0)	3.9	5.0
CS adj. ROTE	0.0	0.0	0.1	0.1
ROA (%)	0.2	0.1	0.3	0.4
RoRWA (%)	0.2	(0.6)	0.6	0.8
NIM (NII/AIEA) (%)	1.5	1.4	1.4	1.4
Cost / Income (%)	63.6	65.4	63.5	60.7
Loan/Deposit (%)	153.1	146.7	142.3	138.8

Asset Quality	12/15A	12/16E	12/17E	12/18E
NPLs	9,276	7,292	5,585	4,701
% YOY Change	2.8	(21.4)	(23.4)	(15.8)
NPL/ gross loans	10.5	8.1	6.1	5.0
Loan Loss Reserves/NPLs	44.8	72.2	101.3	128.0
Common Eq Tier1 Capital	-	-	-	-
Basel 3 Transitional CET1 capital	7,131	7,467	7,694	7,993
Basel 3 Fully loaded CET1 capital	7,131	7,467	7,694	7,993
Basel 3 Transitional RWAs	61,345	61,369	62,516	64,536
Basel 3 Fully loaded RWAs	61,345	61,369	62,516	64,536
Basel 3 Transitional CET1 ratio	11.6	12.2	12.3	12.4
Basel 3 Fully loaded CET1 ratio	11.6	12.2	12.3	12.4
Basel 3 leverage ratio	6.1	6.4	6.6	6.8

Earnings	12/15A	12/16E	12/17E	12/18E
Net Interest Income	(10.2)	(8.8)	(0.9)	2.9
F&C income	6.0	3.9	4.5	5.0
Trading income	45.6	(44.9)	0.0	0.0
Total revenues	(1.2)	(5.7)	1.5	3.5
Total expenses	3.6	(3.0)	(1.5)	(1.1)
Pre-prov operating profit	(8.5)	(10.5)	7.1	11.6
Pre-tax profit	(16.8)	(203.8)	(275.8)	26.7
Net customer loans	(1.2)	0.0	1.2	1.8
Customer deposits	7.1	4.3	4.4	4.4

Source: FTI, Company data, Thomson Reuters, Credit Suisse Securities (EUROPE) LTD. Estimates

Company Background

UBI is a domestic lender, one of Italy's largest regional banks. It has the 5th largest market share in terms of branches, loans and deposits in the country. UBI's largest market share is in Lombardy, the wealthiest region in Italy (22% of the GDP)

Blue/Grey Sky Scenario

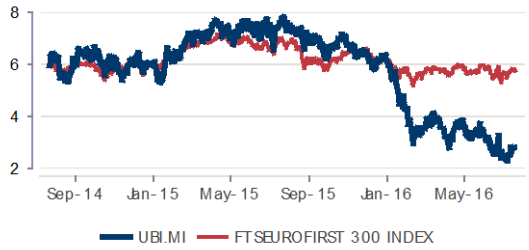
Our Blue Sky Scenario (€) 4.00

Under this scenario, we assume 2% revenue CAGR 2015-18E (vs flattish). The additional growth comes from AuM CAGR 2015-18E up to 8% (vs 7%) combined with an average management fee up to 75bp (vs 72bp). This scenario factors in -3% cost CAGR (vs -2%) and an average c60bp from 68bp LLP. As such, the RoTNAV18E is 7% (6% in 2017E).

Our Grey Sky Scenario (€) 2.50

Under this scenario, we factor in AuM CAGR 2015-18E slowing to 5%, which coupled with the average fee decline to 68bp, is the main reason for a revenue decline (-1% CAGR 2015-18E). This scenario factors in -1% cost decline and an average 75bp LLP. The grey sky RoTNAV would be 4% (vs 3% in 2017E).

Share price performance



The price relative chart measures performance against the FTSEUROFIRST 300 INDEX which closed at 1335.7 on 15/07/16

On 15/07/16 the spot exchange rate was €1/Eu 1.- Eu.91/US$1

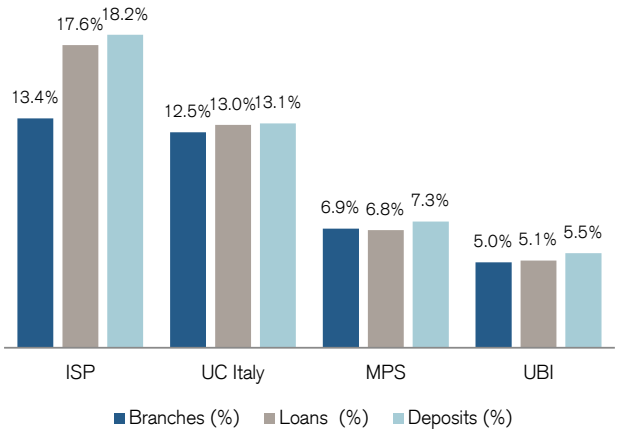
Company summary

Domestic presence

UBI is one the largest domestic lenders, with 1,554 branches and a headcount of 17,511 in Italy. The bank also has six branches abroad.

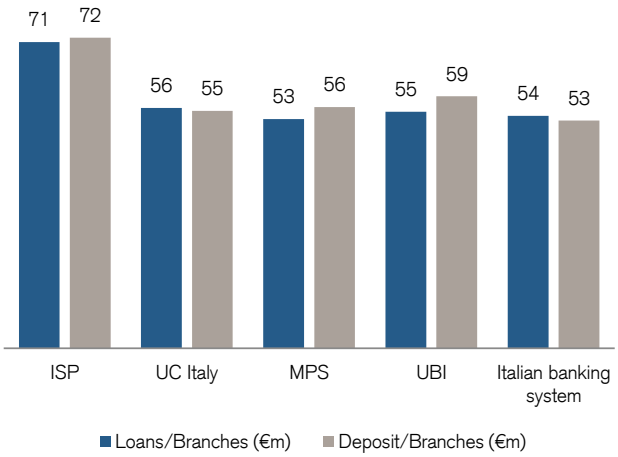
UBI has the fifth largest market share in terms of loans and deposits in Italy after the merger of Banco Popolare-Banca Popolare Milano. The Italian branches' productivity is above the Italian banks average. UBI has large market shares in Lombardy (12.6% of branches, 9.4% of loans and 8.4% deposits), the wealthiest region in Italy (22% of GDP).

Figure 160: Q1 16 Market shares



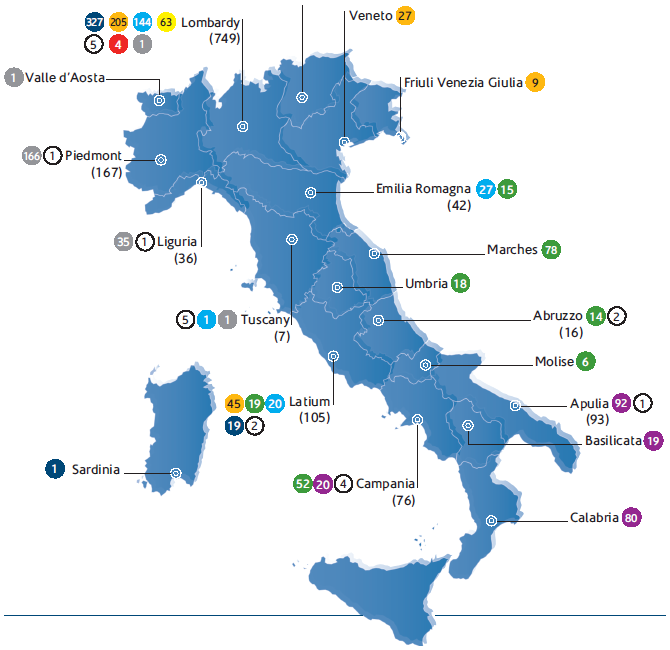
Source: Company data, Credit Suisse research, Bank of Italy

Figure 161: Q1 16 Branch productivity



Source: Company data, Credit Suisse research, Bank of Italy

Figure 162: UBI domestic network in Q1 16

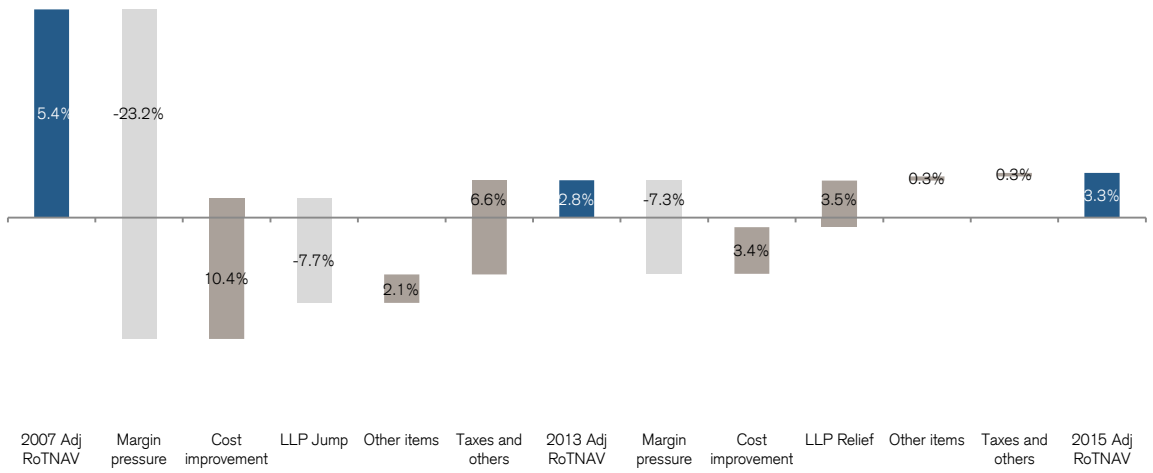


Source: Company data

Historical trends and estimates

As at other Italian banks, the macroeconomic turmoil which affected Italy also impacted UBI: the average adjusted RoTNAV in 2007 stood at ~15%; at the peak of the crisis in 2013, UBI reported ~-3% adjusted RoTNAV. In 2015, UCG delivered a low-single-digit-adjusted profitability of ~3% (well below the pre-crisis level).

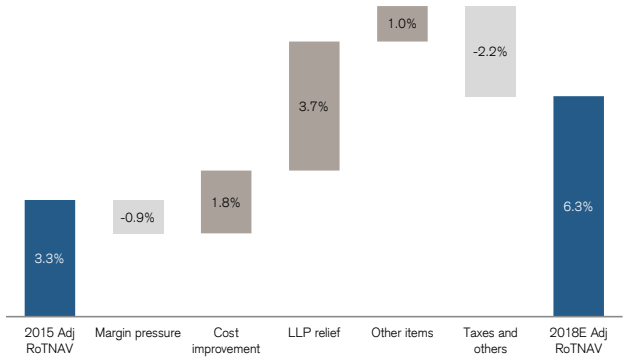
Figure 163: UCG - 2007-2015 RoTNAV dynamics



Source: Company data, Credit Suisse estimates

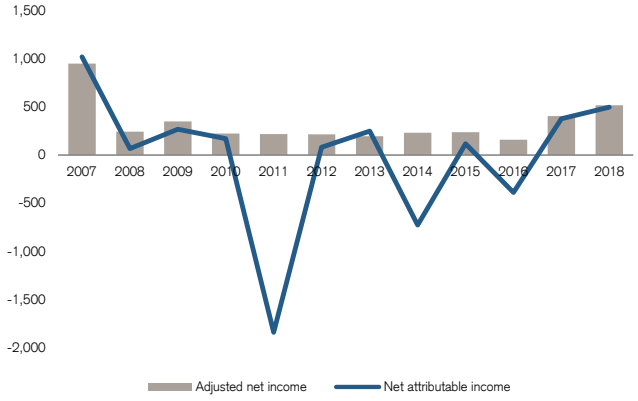
We forecast that UBI could post 300bp adjusted RoTNAV uplift in the next three years. In our estimates, we project the adjusted RoTNAV to rise to 6.3% in 2018 from 3.3% in 2015. In our assumptions, we factor in severe pressure on revenue, while the main profitability driver is expected to be lower LLP and cost-cutting to a lesser extent.

Figure 164: UBI - 2015-2018E Adj RoTNAV potential projected evolution



Source: Company data, Credit Suisse estimates

Figure 165: UBI - Stated and adjusted net income historical trends and estimates

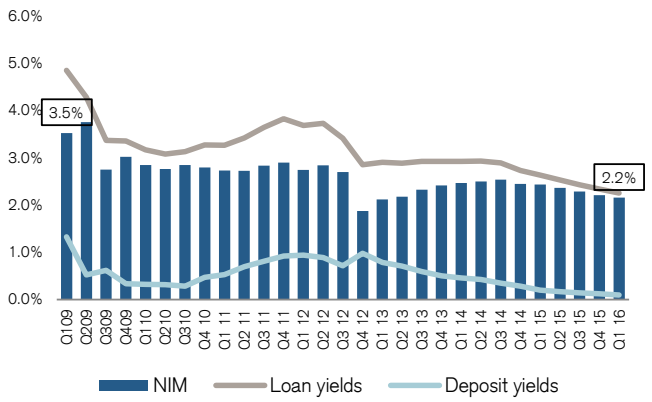


Source: Company data, Credit Suisse estimates for 2016E-2018E

For 2016, we forecast a slight RoTNAV increase despite NIM pressure and falling trading income. Despite net fees support, revenue is expected to decline in 2016. The asset management business will likely suffer from a slowdown due to the recent market turmoil, but the overall net fee contribution is expected to rise at the expense of the trading income and NII.

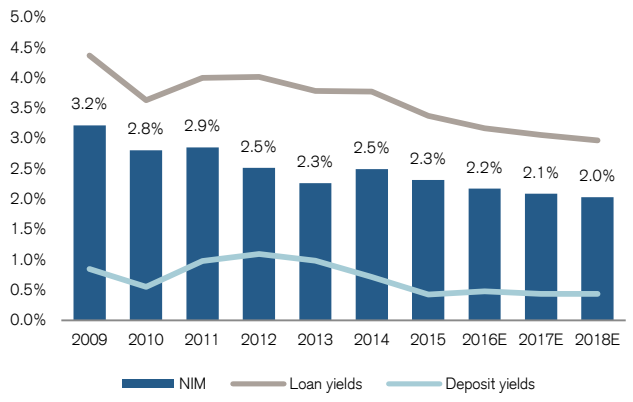
We expect the average commercial NIM to decline to 204bp in 2018 from 233bp in 2015. In 2016, NIM should come in at 218bp: we forecast the loans yield to fall from 247bp in 2015 to 227bp in 2016 (212bp in 2012), mitigated by the falling funding cost from 16bp in 2015 to 10bp in 2016 (and 9bp in 2018). We factor in 2.5% customer loans CAGR 2015-18E. At the group level, we estimate 0.3% NII CAGR 2015-18E.

Figure 166: UBI - Quarterly NIM: historical trends



Source: Company data, Credit Suisse estimates

Figure 167: UBI - Annual NIM: actual and estimates



Source: Company data, Credit Suisse estimates

Despite the market turbulence in 2016, we expect AuM to fuel fees, for which we forecast a lower contribution due to a less favorable mix. For 2019, we expect UBI to achieve €65bn AuM, well below the €72bn company target set by the plan just launched. Note that the total AuM target also includes insurance products. The company target factors in a ~€10bn shift from direct funding (banks bonds) and from assets under custody into asset under management.

Figure 168: Asset management volumes and fees evolution

(€m, bp)	2013	2014	2015	2016E	2017E	2018E	2019E	2019E UBI target
Assets under management	39,554	43,353	48,500	51,889	55,545	59,488	65,000	72,300
AUM fees	252	267	330	351	387	426	470	620
Mgm fees % of AuM (bps)	64	64	72	70	72	74	76	90

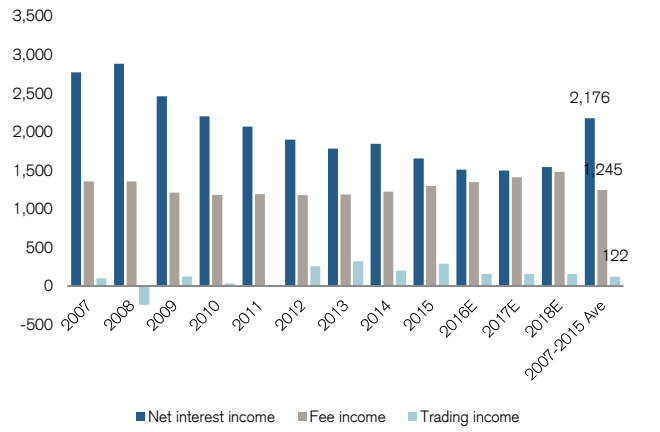
Source: Company data, Credit Suisse estimates

Our forecast on trading income is conservative. For 2016E-18E, we factor in a €160bn average trading profit, well below the 2012-15 average (~€270bn) in view of the fall in Italian sovereign bond yields and the gradual reduction of the bank's bond portfolio.

Our 2016-18 average total income forecast is 3.7% below 2015 revenue, with 2016 total income expected to fall by -6% yoy. We forecast a 1.4% revenue uplift in 2017 and 3.5% in 2018, when total income is expected to be in line with 2015.

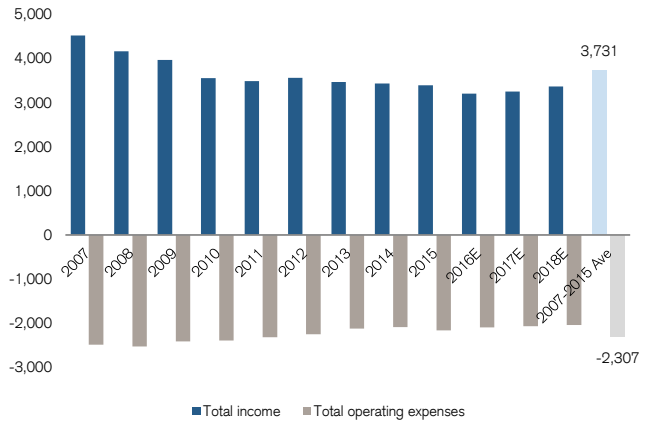
We estimate €3.5bn total income in 2019, 4% below the company's plan (€3.6bn), mainly on a commission income miss (11%). We project €1.6bn net fees in 2019 vs the €1.8bn target (from €1.3bn in 2015). As in the case of UCG, robust trends in commission income (double digit evolution) is one of the business plan pillars, but AuM penetration at UBI is higher.

Figure 169: UBI - Total income breakdown trends



Source: Company data, Credit Suisse estimates

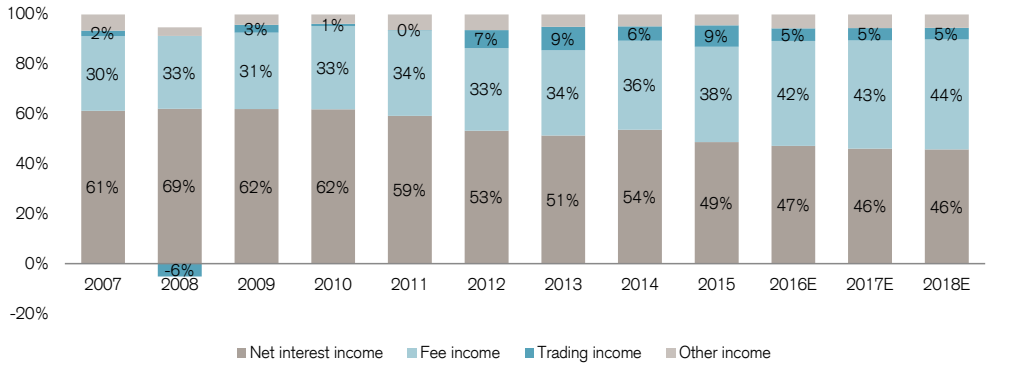
Figure 170: UBI - Revenue and cost trends



Source: Company data, Credit Suisse estimates

We envisage a revenue breakdown evolution embedding a further gradual shift from NII to net fees. We expect a commission income uplift to 44% in 2018 from 38% in 2015, at the expense of trading income and NII contributions. NII should decline to 46% of the total income over the plan period from 49% in 2015.

Figure 171: UBI - Total income breakdown trends



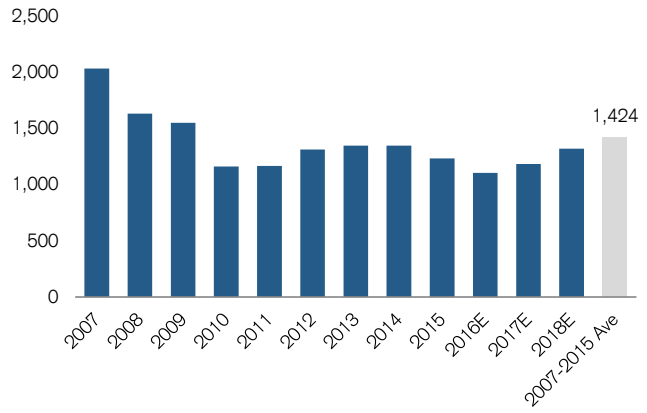
Source: Company data, Credit Suisse estimates

In 2016, the pre-provision profit will likely reach a minimum level; we expect robust growth to start in 2017 and continue in 2018 and 2019. The business plan is focused on cost cutting measures. The group reorganization following the adoption of an integrated model at the expense of the federal model ("banca unica" project) would help to gain €80m cost synergies at full speed on top of €152m cost savings measures.

The plan is targeting a reduction of the cost base to €1.97bn in 2019 from €2.16bn in 2015. The staff base should reduce by 1.65k (-9%) over the plan horizon, backed by cuts in the corporate centers and networks in Western Europe.

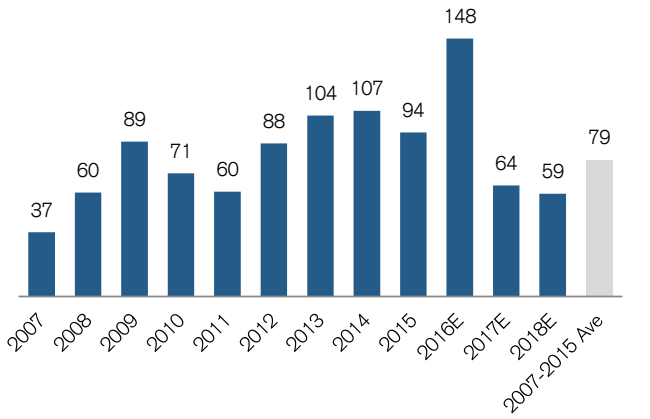
We forecast €2.04bn of operating costs in 2018 and €2bn in 2019, above the company target. However, UBI has a good track record in cutting costs and the company may be able to abstract additional cost cutting measures in the event of a net fees miss. We expect the CoR to decline to 59bp in 2018 and 55bp in 2019, almost in line with the company target (54bp).

Figure 172: UBI - Pre-provision profit evolution (€m)



Source: Company data, Credit Suisse estimates

Figure 173: UBI - LLP evolution (bp)



Source: Company data, Credit Suisse estimates

As a result, our 2018 stated earnings stand at €498m, 17% above consensus thanks to lower LLP. Our stress test on asset quality shows UBI's relative strength versus peers, thanks to its relatively low NPL stock and high collateralization. We expect €662m net profit in 2019, ~10% below company guidance (€732m). Our 7.2% RoTNAV19E compares with the 9.4% company target.

Figure 174: 2018-2019 main P&L items – Credit Suisse, consensus and UBI

(€m, %)	2018E CS	2018E Consensus	Gap	2019E CS	2019E UBI	Gap
NII	1,543	1,664	-7%	1,550	1,553	-0.2%
Net Fees	1,482	1,432	4%	1,610	1,801	-10.6%
Total Income	**3,366**	**3,409**	**-1%**	**3,500**	**3,633**	**-3.7%**
Operating expenses	-2,043	-2,083	-2%	-2,000	-1,967	1.7%
Pre-provision profit	**1,323**	**1,326**	**0%**	**1,500**	**1,666**	**-10.0%**
LLP	-510	-587	-13%	-400	-484	-17.4%
PBT	813	727	12%	1,050	1,182	-11.2%
Net profit	**498**	**420**	**19%**	**662**	**732**	**-9.6%**

Source: Credit Suisse estimates, Bloomberg consensus

The business plan 2019-2020

On 27 June 2016, UBI announced its business plan for 2019-2020. The plan includes:

- actions on the group structure;
- actions on bad loans coverage combined with capital management actions (assuming no NPL disposal: a confirmation of the weak NPL market for now);
- a change in the balance sheet mix;
- a strong focus on the asset management business and insurance: management aims to switch clients out of retail bond assets under custody into AuM.

UBI's strategy appears clear, showing a strong underlying rationale despite being slightly back end loaded.

Simplification of the group's structure: the minorities buyout

UBI's single bank operation is a move from the federal model to an integrated model. The action is based on the merger by incorporation of its seven-bank network. UBI will buy out (via a UBI share swap) the stakes held by minority shareholders in Banca Popolare di Bergamo, Banco di Brescia, Banca Popolare Commercio e Industria, Banca Regionale Europea, Banca Popolare di Ancona, Banca Carime and Banca di Valle Camonica.

The purchase of all the minority stakes will involve the issue of a maximum of €75.8m worth of shares with a maximum dilution of UBI Banca's share capital of 7.8% against a more than proportional recovery in profitability. The benefit in terms of the CET1 fully loaded ratio is ~30bp positive. The gross benefits in terms of operating costs fully phased-in are estimated at approximately €80m (130 branches shut down, 600 headcount reduction) on top of which there could be tax benefits on the transfer of intragroup dividends (€8m in 2015). For the integration, UBI is factoring in a ~€198m one-off cost.

Coverage increase: usage of shortfall to expected loss

UBI is increasing NPE coverage with the partial usage of the provision shortfall (the so-called 'shortfall to expected loss' of €850m in UBI's plan) already deducted from the fully loaded CET1. This action reduces the amount of net non-performing exposures and the Texas ratio (net impaired loans/tangible equity) down to 108% already in 2016E (~100% according to the company's calculations). It also helps further potential reductions during the course of the plan (84% Texas ratio expected in 2020). The higher impairment losses recognition carried by the shortfall to EL usage represents an increase of NPE Q1 16 coverage to 43.3% from 37.8% and for NPL to 58% from 52.6% (coverages including write-offs). The shortfall re-absorption involves a tax relief impact on the CET1 (€300m from LLP deductibility), generating a benefit estimated at ~40bp accretion as of 2017.

The macroeconomic assumptions

We think the business plan projections have been developed on the basis of a prudent economic scenario, which involves predominantly negative interest rates over the course of the plan and modest GDP growth, affected by a lower contribution from population trends and by recent political events. The plan does not factor in any potential GDP slowdown implication due to the Brexit vote, though.

An account was also taken of the regulatory context, again more complex and developing, which requires increased rigor in terms of capital, liquidity and investments in staff and IT. Finally, the economic crisis and strong progress in technology have changed individual and business customer need priorities structurally. According to management, these are still not yet satisfied by the industry's current range of products and services, creating an opportunity for UBI.

Figure 175: UBI's underlying macroeconomic assumptions

(%)	2015	2016	2017	2018	2019	2020
GDP	0.6%	0.9%	1.0%	1.0%	1.0%	1.0%
3M Euribor	0.0%	-0.3%	-0.3%	-0.3%	-0.1%	0.3%

Source: Company data

Main targets and actions

The balance sheet policy is based on the change in the funding mix and the focus on the asset management business. Over the business plan timespan, UBI aims to lower direct deposits and raise wholesale funding. UBI also plans to roll customers out of retail bonds into asset management products “to protect customers consistent with the new bail-in rules”. The migration towards AuM is also planned from assets under custody (AuC). The migration from direct deposits and AuC into AuM is worth €10bn, on UBI's numbers. The loans growth includes the re-composition impact from NPLs to performing loans, which are expected to rise at a ~3% CAGR in 2015-18E. UBI expects performing loans to grow by ~€10bn in five years.

Figure 176: UBI plans - Balance sheet evolution

(€bn)	2015	Q116	2019E	2020E	CAGR 15-19E	CAGR 15-20E
Net loans	85	84	89	92	1.2%	1.7%
o/w Performing loans	75	74	82	85	2.2%	2.6%
o/w Non performing loans	10	10	7	7	-7.2%	-6.6%
Direct funding	**73**	**71**	**65**	**64**	**-2.6%**	**-2.4%**
Indirect funding	80	78	100	108	6.0%	6.3%
o/w asset under custody	31	29	28	29	-2.4%	-1.5%
o/w asset under management	**49**	**49**	**72**	**79**	**10.4%**	**10.2%**
Total funding (direct + indirect)	152	149	166	172	2.2%	2.5%
Institutional funding	**13**	**12**	**23**	**26**	**15.8%**	**14.7%**
Proprietary securities portfolio	**19**	**18**	**16**	**13**	**-4.2%**	**-7.3%**

Source: Company data

The detailed funding breakdown below shows that the bonds issued by the network banks are expected to sharply fell by 2020, replaced by covered bonds and EMTN issuances.

Figure 177: UBI's recent funding breakdown

(€bn)	Q115	Q415	Q116
Total direct funding	**72.7**	**72.5**	**71.1**
-Current accounts	44.1	47.7	48.6
-Term deposits	1.7	1.5	1.7
-Securities in issue	26.8	23.3	20.8
- o/w bonds issued by network banks + UBI	22.9	20.2	18.6
- o/w bonds distributed on extra-captive customers	3.2	2.8	1.8
- o/w others (mainly customer CDs)	0.7	0.4	0.3
Core direct funding from customers net of bonds distributed on extra-captive clients	**68.7**	**69.4**	**68.9**
Direct funding from institutional customers	**18.4**	**19.0**	**18.7**
-Covered bonds	9.8	9.9	9.2
-EMTN	3.1	2.5	2.5
-CD and ECP	0.5	0.4	0.7
-Repos with CCG	5.0	6.1	6.2
Total Direct Funding	91.1	91.5	89.8
Direct funding from institutional customers without Repos with CCG	**13.4**	**12.8**	**12.4**

Source: Company data

Management expects a €7bn retail bonds reduction, more than offset by the €11bn wholesale funding increase.

P&L and capital targets

Asset management fees should contribute 30-40% to the total income from 25% currently. AuM robust growth (+10% CAGR in 15-18E) and the increasing management fee (expected at 90bp from 61bp in Q116) support the sharp fee increase; commission income should jump by €362m over the timespan. Management says the volume target is achievable, while we think the main issue could be the AuM mix. NII growth is mainly based on funding cost reduction thanks to the change in the funding mix from retail bonds into wholesale bonds. The lower funding cost is expected to generate €192m additional NII, one of the main supports for the top-line growth combined with €209m loans growth impact and €118m mix effect. Among negative impacts, the management is also factoring in a €109m yield decline from the bond portfolio and a €75m lower loans yield.

Figure 178: UBI - P&L, profitability and capital targets

(€m, %, bp)	2015	2019E	2020E	CAGR 15-19E	CAGR 15-20E
Total income	**3,371**	**3,633**	**3,844**	**1.9%**	**2.7%**
-NII	1,631	1,801	1,886	2.5%	2.9%
-Net fees	1,300	1,553	1,662	4.5%	5.0%
Operating costs	**-2,277**	**-1,967**	**-1,982**	**-3.6%**	**-2.7%**
-Staff costs	-1,392	-1,181	-1,207	-4.0%	-2.8%
-G&A	-628	-559	-550	-2.9%	-2.6%
Pre-provision profit	**1,094**	**1,666**	**1,862**	**11.1%**	**11.2%**
LLP	-803	-484	-460	-11.9%	-10.5%
Net profit	**117**	**732**	**874**	**58.2%**	**49.5%**
CIR	68%	54%	52%		
CoR	95	54	50		
RoTNAV	**2.4%**	**9.4%**	**10.6%**		
FL CET1 ratio	**11.6%**	**12.1%**	**12.8%**		

Source: Company data

The organisational simplification should carry overall ~€300m cost savings, backed by headcount cuts (-1.65k), synergies from the integration and other optimisation. We think the cost cutting measures appear ambitious but achievable in view of UBI's track record.

The cost of risk (CoR) is expected to decline to 50bp in 2020 from 95bp in 2015, still a high level, in our view. This could offer a potential buffer in case of a revenue miss. The shortfall to expected loss usage raises the cash NPE coverage from 28% to 35% (43% including write-off) and the cash NPL coverage from 39% to 49% (58% including write-off).

Figure 179: Impact of shortfall to EL usage on coverage (Q1 16 data)

(€m, %)	NPL	Unlikely to pay	Past-due	NPE
Gross BV	7,122	6,111	263	13,496
Provisions	**-2,775**	**-1,040**	**-9**	**-3,824**
Net BV	**4,347**	**5,071**	**254**	**9,672**
Coverage	39.0%	17.0%	3.4%	28.3%
Shortfall to EL usage	-700	-150		-850
New provisions	**-3,475**	**-1,190**	**-9**	**-4,674**
PF coverage excluding write-off	48.8%	19.5%	3.4%	34.6%
PF coverage including write-off	58.0%	0.0%	0.4%	43.3%
Pro-Forma Net BV	**3,647**	**4,921**	**254**	**8,822**

Source: Company data, Credit Suisse estimates

As a result, we expect the net NPL, NPE and Texas ratio to improve to 4.1%, 10% and 108% from 4.9%, 11% and 118%, respectively.

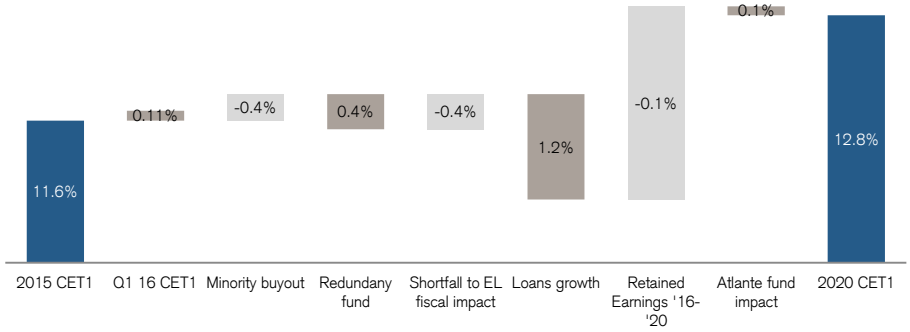
Figure 180: Impacts on NPL, NPE and Texas ratios (Q1 16 data)

(€m, %)	
Tangible Equity	8,173
Gross Loans	88,310
Net NPL ratio	4.9%
Net NPE ratio	11.0%
Texas ratio	118.3%
PF Net NPL ratio	**4.1%**
PF Net NPE ratio	**10.0%**
PF Texas Ratio	**107.9%**

Source: Company data, Credit Suisse estimates

UBI is targeting 9.4% RoTNAV in 2019 and 10.6% RoTNAV in 2020. We estimate 6.3% RoTBV18E and 7.2% RoTNAV19E. After the minorities buyout, we calculate the pro-forma CET1 would be 11.9%, >12% in 2017, >12% in 2019 and 12.8% in 2020, including new regulation (IFRS9, LGD, etc.). The average payout ratio, according to the company's business plan, is set at 40%. For 2015, management confirmed a dividend in line with that of 2015 for this year despite the loss.

Figure 181: UBI plan - FL CET1 evolution



Source: Company data, Credit Suisse estimates

We forecast 12.43% FL CET1 in 2018 and >12.5% in 2019. For 2020, we expect the FL CET1 to touch a level slightly above 12.6%.

Valuation and risks

Target Price

We derive our €3.5 target price based on the warranted equity valuation methodology, backed by the sustainable profitability. Given the CoE, the methodology helps to calculate the 'right' (warranted) PTBV for a stock. In the calculation of the TBV, we deduct the excess/deficit capital to determine the fair value. We then add the excess capital to the fair value obtained. As such, we get to a target fair value, which we discount back to achieve the final TP.

Figure 182: Sustainable profitability methodology

(€, %)	2017E
TBV per share (€)	**8.32**
RoTBV17E	5.1%
Average RoTBV16E-18E	4.5%
CoE	10.5%
Growth rate	0.0%
Fair valuation multiple	0.43
Fair Value (€)	**3.59**
Excess/(shortfall) capital	**0.07**
Discount factor	1.02
TP (€)	**3.5**
Upside/downside	25%

Source: Credit Suisse estimates

Rating

Our €3.5 target price implies 25% potential upside from current share price levels. Based on our relative rating approach, this justifies an Outperform rating. UBI trades on 6.8x PE17E and 0.34x PTBV17E, which compares with 0.43x for Italian peers and 0.64x for Eurozone peers.

Blue and grey sky scenarios

- **Blue sky scenario:** Our blue sky valuation of €4 factors in the following assumptions:
  - 2% revenue CAGR 2015-18% (versus our base case 0%);
  - -3% cost trend CAGR 2015-18E (versus -2%);
  - c60bp 2016E-18E average normalized LLP (from 68bps average normalized level).

Under this scenario, the RoTE would rise to 3% in 2016E, 6% in 2017E and 7% in 2018E.

- **Grey sky scenario:** Our grey sky scenario of €2.5 factors in the following assumptions:
  - -1% revenue CAGR 2015-18% (versus 0%);
  - cost trend flattish (versus -2%);
  - 75bp 2016E-18E average normalized LLP (from 68bps average normalized level).

Under this scenario, the RoTE declines to 1% in 2016E, 3% in 2017E and 4% in 2018E.

Risks

The main downside risks to our TP are:

- execution risk of the plan's demanding revenue targets (mainly net fees);
- asset management business potential slowdown as a result of the market turbulence;
- further hits to earnings/capital from the participation in resolution/rescue funds (like the one for the four local banks in November and/or Atlante);
- M&A strategy.

Key management

Victor Massiah, CEO and General Manager: After a long experience in consulting (Andersen Consulting and McKinsey & Co), Massiah worked at Banca Intesa group from 1997 to 2001. In 2002 he joined Banca Lombarda e Piemontese where he was appointed general manager in 2003. In 2007, he became the general manager of UBI Banca, following the merger of the Banca Lombarda and BPU groups. As of December 2008, he has been UBI's CEO.

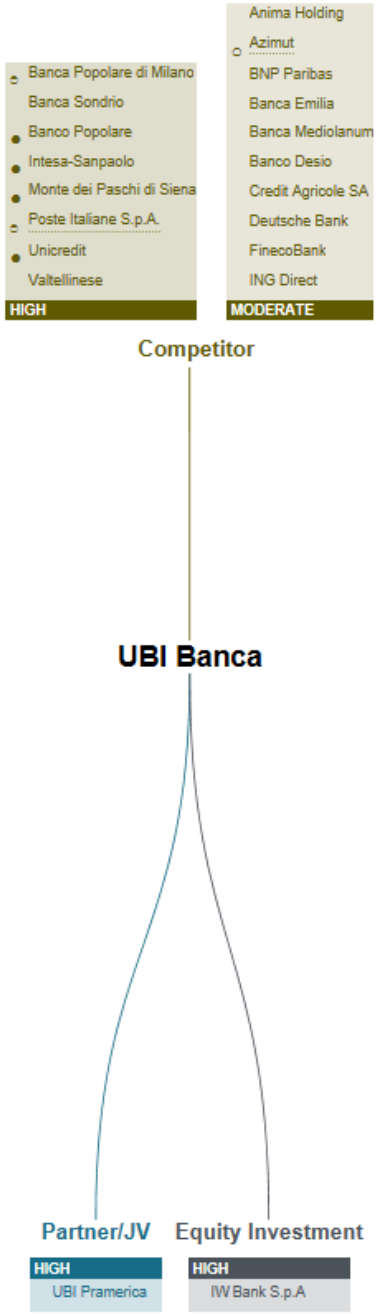
Rossella Leidi, Deputy General Manager and Chief Business Officer: Leidi joined the Group in 1983. In 2002 she was appointed as Head of the Risk Management, ALM & Capital Management Department. Since 2012 she has been the Chief Business Officer of the UBI Banca Group, with responsibility for the Commercial Area, Finance and Investment Banking, as well as for the International Division.

Letizia Brichetto Arnaboldi Moratti, Chairman: In the course of her private business career started in 1974, she has been Board Member of Banca Commerciale Italiana and President of Syntek Capital Group. As President and Managing Director of News Corp Europe, she created the European expansion plan for this group, headed by Rupert Murdoch. In the public sector, among other appointments, she was the first woman ever designated President of RAI-Radio Televisione Italiana, the national broadcasting company (1994-1996). From 2001 to 2006 she was Minister for Education, University and Scientific Research in the Berlusconi government. In 2006 she became the first woman elected Mayor of Milan. She also led the city's successful hosting of Expo2015.

Credit Suisse PEERs

PEERs is a global database that captures unique information about companies within the Credit Suisse coverage universe based on their relationships with other companies – their customers, suppliers and competitors. The database is built from our research analysts' insight regarding these relationships. Credit Suisse covers over 3,000 companies globally. These companies form the core of the PEERs database, but it also includes relationships on stocks that are not under coverage.

Figure 183: UBI Banca PEERs map



Source: Credit Suisse PEERs

Companies Mentioned *(Price as of 15-Jul-2016)*
Intesa-Sanpaolo (ISP.MI, €1.93, OUTPERFORM, TP €2.5)
Monte dei Paschi di Siena (BMPS.MI, €0.34, UNDERPERFORM[V], TP €0.29)
Pekao (PEO.WA, zł127.3)
UBI Banca (UBI.MI, €2.79, OUTPERFORM, TP €3.5)
Unicredit (CRDI.MI, €2.18, NEUTRAL, TP €2.28)
Yapi Kredi Bank (YKBNK.IS, TL4.16)

Disclosure Appendix

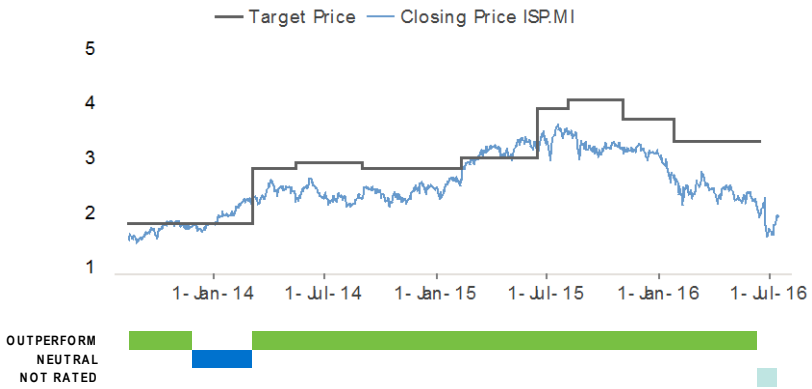
Important Global Disclosures

I, Carlo Tommaselli, certify that (1) the views expressed in this report accurately reflect my personal views about all of the subject companies and securities and (2) no part of my compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this report.

3-Year Price and Rating History for Intesa-Sanpaolo (ISP.MI)

ISP.MI	Closing Price	Target Price	
Date	(€)	(€)	Rating
14-Aug-13	1.50	1.80	O
27-Nov-13	1.75	1.80	N
05-Mar-14	2.29	2.80	O
16-May-14	2.27	2.90	
01-Sep-14	2.25	2.80	
11-Feb-15	2.60	3.00	
16-Jun-15	3.15	3.90	
05-Aug-15	3.46	4.05	
04-Nov-15	3.08	3.70	
26-Jan-16	2.67	3.30	
14-Jun-16	1.91		NR

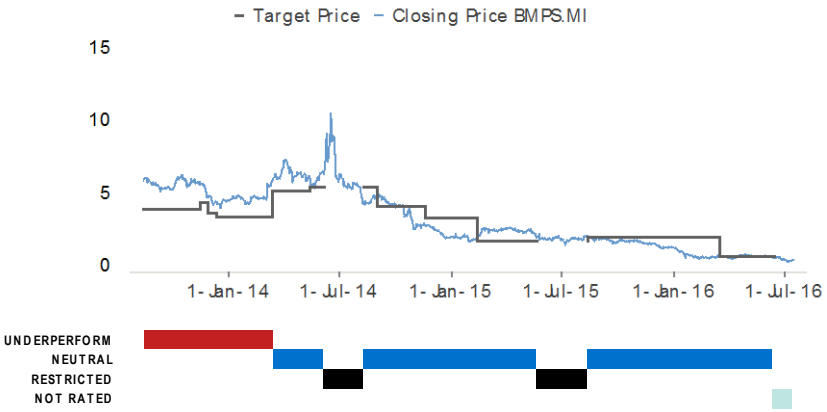
** Asterisk signifies initiation or assumption of coverage.*



3-Year Price and Rating History for Monte dei Paschi di Siena (BMPS.MI)

BMPS.MI	Closing Price	Target Price	
Date	(€)	(€)	Rating
14-Aug-13	5.88	3.81	U
15-Nov-13	5.56	4.32	
27-Nov-13	4.68	3.56	
11-Dec-13	4.34	3.31	
14-Mar-14	5.89	5.09	N
14-May-14	5.95	5.34	
06-Jun-14	6.27		R
11-Aug-14	4.27	5.34	N
01-Sep-14	4.51	4.07	
19-Nov-14	2.74	3.26	
12-Feb-15	1.97	1.63	
22-May-15	1.92		R
14-Aug-15	1.94	1.90	N
17-Mar-16	0.57	0.62	
14-Jun-16	0.49		NR

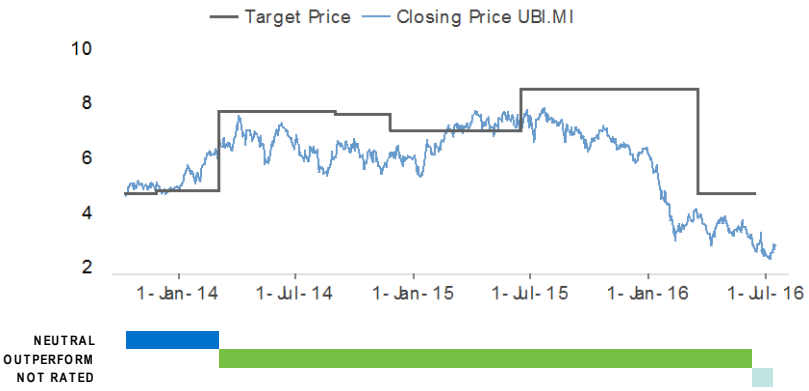
** Asterisk signifies initiation or assumption of coverage.*



3-Year Price and Rating History for UBI Banca (UBI.MI)

UBI.MI Date	Closing Price (€)	Target Price (€)	Rating
11-Oct-13	4.60	4.70	N
27-Nov-13	4.96	4.80	
05-Mar-14	6.40	7.70	O
01-Sep-14	6.02	7.60	
26-Nov-14	6.06	7.00	
16-Jun-15	7.05	8.50	
17-Mar-16	3.81	4.70	
14-Jun-16	2.61		NR

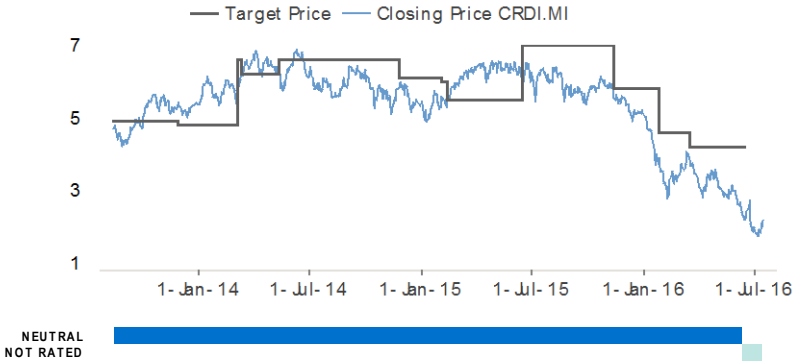
** Asterisk signifies initiation or assumption of coverage.*



3-Year Price and Rating History for Unicredit (CRDI.MI)

CRDI.MI Date	Closing Price (€)	Target Price (€)	Rating
14-Aug-13	4.70	4.90	N
27-Nov-13	5.33	4.80	
05-Mar-14	5.85	6.60	
12-Mar-14	6.45	6.20	
13-May-14	6.24	6.60	
26-Nov-14	5.85	6.10	
03-Feb-15	5.58	6.00	
12-Feb-15	5.33	5.50	
16-Jun-15	6.08	7.00	
13-Nov-15	5.55	5.80	
26-Jan-16	3.89	4.60	
17-Mar-16	3.75	4.20	
14-Jun-16	2.21		NR

** Asterisk signifies initiation or assumption of coverage.*



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As of December 10, 2012 Analysts' stock rating are defined as follows:

Outperform (O) : The stock's total return is expected to outperform the relevant benchmark* over the next 12 months.
Neutral (N) : The stock's total return is expected to be in line with the relevant benchmark* over the next 12 months.
Underperform (U) : The stock's total return is expected to underperform the relevant benchmark* over the next 12 months.
**Relevant benchmark by region: As of 10th December 2012, Japanese ratings are based on a stock's total return relative to the analyst's coverage universe which consists of all companies covered by the analyst within the relevant sector, with Outperforms representing the most attractive, Neutrals the less attractive, and Underperforms the least attractive investment opportunities. As of 2nd October 2012, U.S. and Canadian as well as European ratings are based on a stock's total return relative to the analyst's coverage universe which consists of all companies covered by the analyst within the relevant sector, with Outperforms representing the most attractive, Neutrals the less attractive, and Underperforms the least attractive investment opportunities. For Latin American and non-Japan Asia stocks, ratings are based on a stock's total return relative to the average total return of the relevant country or regional benchmark; prior to 2nd October 2012 U.S. and Canadian ratings were based on (1) a stock's absolute total return potential to its current share price and (2) the relative attractiveness of a stock's total return potential within an analyst's coverage universe. For Australian and New Zealand stocks, the expected total return (ETR) calculation includes 12-month rolling dividend yield. An Outperform rating is assigned where an ETR is greater than or equal to 7.5%; Underperform where an ETR less than or equal to 5%. A Neutral may be assigned where the ETR is between -5% and 15%. The overlapping rating range allows analysts to assign a rating that puts ETR in the context of associated risks. Prior to 18 May 2015, ETR ranges for Outperform and Underperform ratings did not overlap with Neutral thresholds between 15% and 7.5%, which was in operation from 7 July 2011.*
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Not Rated : Credit Suisse Equity Research does not have an investment rating or view on the stock or any other securities related to the company at this time.
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Volatility Indicator [V] : A stock is defined as volatile if the stock price has moved up or down by 20% or more in a month in at least 8 of the past 24 months or the analyst expects significant volatility going forward.

Analysts' sector weightings are distinct from analysts' stock ratings and are based on the analyst's expectations for the fundamentals and/or valuation of the sector* relative to the group's historic fundamentals and/or valuation:
Overweight : The analyst's expectation for the sector's fundamentals and/or valuation is favorable over the next 12 months.
Market Weight : The analyst's expectation for the sector's fundamentals and/or valuation is neutral over the next 12 months.
Underweight : The analyst's expectation for the sector's fundamentals and/or valuation is cautious over the next 12 months.
**An analyst's coverage sector consists of all companies covered by the analyst within the relevant sector. An analyst may cover multiple sectors.*

Credit Suisse's distribution of stock ratings (and banking clients) is:

Global Ratings Distribution

Rating	Versus universe (%)	Of which banking clients (%)
Outperform/Buy*	51%	(43% banking clients)
Neutral/Hold*	35%	(17% banking clients)
Underperform/Sell*	13%	(38% banking clients)
Restricted	1%	

**For purposes of the NYSE and NASD ratings distribution disclosure requirements, our stock ratings of Outperform, Neutral, and Underperform most closely correspond to Buy, Hold, and Sell, respectively; however, the meanings are not the same, as our stock ratings are determined on a relative basis. (Please refer to definitions above.) An investor's decision to buy or sell a security should be based on investment objectives, current holdings, and other individual factors.*

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Target Price and Rating
Valuation Methodology and Risks: (12 months) for Intesa-Sanpaolo (ISP.MI)

Method: We value the stock using an SoTP, applying a 11.2% blended CoE and adding the excess capital (at 1x). We factor in 12% sustainable profitability for the Italian banking business, 10% for the International banks. We value the Private Wealth Management division on a PE basis. We rate ISP Outperform, as we believe the bank has a comparatively superior capital position that should allow it to deliver on dividend commitments without losing its solvency advantage.

Risk: Key risks to our Outperform rating and target price include: (i) a worse-than-expected macroeconomic scenario, (ii) the regulator forcing it to rescue one or more weaker institutions, (iii) unexpected significant shocks in CEE countries where the bank is present, (iv) potential misuse of capital, (v) dividend cut, and (vi) additional rate cuts.

Target Price and Rating
Valuation Methodology and Risks: (12 months) for Monte dei Paschi di Siena (BMPS.MI)

Method: We value the stock using the traditional P/BV (RoTBV/CoE) method, applying an 11% CoE to the bank's average RoTBV levels. We adjust the fair value by the deficit capital. We rate the stock Underperform due to uncertainty regarding asset quality and the potential impact on capital levels.

Risk: Risks to our target price and Underperform rating include: (i) changes to interest rates (both to the downside and upside), (ii) a better/worse than expected macroeconomic scenario - which would have an impact on volumes and asset quality, and (iii) risks related to the consolidation of the market. The outlook is uncertain, given the potential impact that an additional balance sheet clean-up would have on the capital position.

Target Price and Rating
Valuation Methodology and Risks: (12 months) for UBI Banca (UBI.MI)

Method: We value the stock using the traditional P/BV (RoTBV/CoE) method, applying a 10.5% CoE to the bank's capital adjusted average RoTBV for the 2016-18E period - adjusting for the excess capital at 1.0x. We rate UBI Outperform as we believe it is in a comparatively better position than its local peers in what relates to asset quality and solvency and we think the bank will be a beneficiary of consolidation in the sector.

Risk: We see risks to our TP and Outperform rating arising from (i) further cuts to interest rates, (ii) a worse-than-expected macroeconomic scenario - which would have an impact on volumes and asset quality, (iii) potential misuse of the excess capital, and (iv) an enforced NPL clean-up scenario.

Target Price and Rating
Valuation Methodology and Risks: (12 months) for Unicredit (CRDI.MI)

Method: We value the stock using an SoTP, applying an 11.8% blended CoE also adjusting for the capital shortfall vs. our 12% benchmark by 2017E (at 1x). We have a Neutral rating on the stock, as we believe a large capital shortfall and lower-than-peers profitability is already reflected in the valuation multiples.

Risk: Key risks to our target price and Neutral rating are focused on the uncertainty surrounding a potential clean-up of the balance sheet, which we think could trigger a capital increase. Upside risks include (i) the potential sale of Bank Austria (which would release RWAs and eliminate the capital concerns), (ii) a timely over-delivery on cost cutting measures, and (iii) a faster economic recovery in Italy. Downside risks include (i) accentuated risks in CEE exposures, (ii) a slower macroeconomic recovery, (iii) up to €9bn capital shortfall, (iv) potential full disposal of profitable assets like Pekao, and (v) exposure to political uncertainty in Turkey via Yapi.

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