Daiwa Capital Markets

Intesa Sanpaolo SpA

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	Senior Unsecured	Outlook
Moody's	Baa1	Negative
S&P	BBB	Negative
Fitch	BBB-	Stable

Source: Moody's, S&P and Fitch

Background and ownership

Intesa Sanpaolo SpA ('ISP') was formed through the merger of Banca Intesa and Sanpaolo IMI in January 2007. In 2018, Intesa announced its intention to merge with its investment-banking subsidiary Banca IMI by incorporation, which was completed in July 2020. In keeping with the bank's articulated growth strategy, Intesa made a bid for domestic rival and Italy's fifth largest bank, UBI Banca, in early 2020 and acquired full control in late-July 2020. The merger into the parent company is expected to be finalised by 2Q21. With total assets of €1tr at end-2020, Intesa has become the largest banking group in Italy, ahead of the more internationally active UniCredit group.

ISP's activities are predominantly domestically focused where it is the market leader in retail banking, corporate banking and wealth management, with domestic market shares (incl. UBI) of 21% in customer loans, 22% in deposits, 25% in asset management and 24% in pension funds. ISP has also developed a sound retail banking presence in Central and Eastern Europe (CEE) and the Middle East and North Africa (MENA) with total assets and lending activities making up 6% and 8.4% of the group's total respectively. Intesa's shareholder base is fragmented with a free float amount of 76.9%. Relevant shareholders (share >3%) are Fondazione Cariplo (3.95%), BlackRock (5%) and Compagnia di San Paolo (6.12%).

Intesa – Key Data

	FY20
Total Assets (€bn)	1,002
Loan Book (€bn)	461.5
Loans to Deposits (%)	87.9
Cost to Income (%)	52.2
Net Profit (€m)	3,277
LCR (%)	>100
FL CET1 (%)	15.4
Leverage Ratio (%)	7.2
Market Cap* (€bn)	40.4
P/B*	0.69

*Source: Bank statements, Bloomberg. *As of 11/02/2021*

Main activities

Intesa Sanpaolo splits its operations into six business units: **Banca dei Territori** (BDT, 44% of the group's gross revenues in FY20), comprising the group's domestic retail and commercial banking operations, including private banking, insurance and consumer finance; **Corporate and Investment Banking** (CIB, 24%); **International Subsidiary Banks** (ISB, 10%) – subsidiary banks and branches in Albania, Bosnia, Croatia, Egypt, Hungary, Romania, Russia, Moldova, Ukraine, Serbia, Slovakia and Slovenia; **Asset Management** (AM, 5%) – operated by Eurizon Capita (AuM: EUR263bn); **Private Banking** (PB, 11%), which coordinates the activities of Fideuram - Intesa Sanpaolo Private Bank; and **Insurance** (6%), which oversees the activities of Intesa Sanpaolo Vita and Fideuram Vita.

Strategy and UBI acquisition

ISP's current strategy is based on its 2018-2021 business plan, built on three key pillars intended to increase value creation. It consists of: i) Continuation of significant de-risking of the balance sheet at no additional costs to shareholders, to be achieved through 'state of the art' recovery platform, NPL disposals at book value as well as proactive portfolio management. The 2021 target NPL stock of EUR26.4bn was already achieved one year ahead of plan with FY20 outstanding NPLs standing at EUR20.5bn; ii) Further cost reductions overseen by a chief cost management officer implementing headcount and branch rationalisations, fewer legal entities and lower administrative costs; iii) Revenue growth through new businesses and a greater focus outside of traditional CIB and retail banking activities. Development of P&C insurance business, strengthening of wealth management distribution network and increased focus on global corporates and international investors.

We deem the business plan to be well articulated and consistent with the bank's business model and risk appetite. Management have so far implemented many of the key points of the plan such as balance sheet de-risking, helped by the creation of an internal division for delinquency management. Furthermore, cost reduction measures are bearing fruit as the group's cost to income ratio of 52.2% compares favourably to its peer group average of 61.1%. Lastly, management have ensured that revenue generation remained robust in a challenging market environment and growth is focused around wealth and asset management as well as private banking activities.

In early 2020 Intesa announced its intention of acquiring UBI Banca and by late-July 2020 UBI shareholders voted in favour of Intesa's takeover bid with a 90.2% majority which was well above the 66.67% threshold targeted by Intesa. UBI's senior management had been opposed to the proposal ever since it was first announced and attempted to fend it off with legal actions and even considered alternative business combinations. Ultimately, Intesa acquired full control of extraordinary shareholder resolutions, easing potential branch rationalisation and speeding along the integration process. As per FY20 results, the pre-tax annual cost and revenue synergies are expected to exceed €1bn by 2024, above the initially anticipated €700m. The negative goodwill of EUR3.2bn from this transaction will offset integration costs of €1.4bn as well as EUR1.8bn additional loan loss provisions (LLP), which were booked in 4Q20 and are required to accelerate balance sheet de-risking of the combined entity. The merger makes Intesa the undisputed domestic champion by size and franchise strength while also making it the eight largest bank in the Eurozone. By April 2021, UBI's IT-integration into Intesa shall be completed while the full combination of both entities is expected by December of the same year. Part of the combination with UBI is the sale of 486 branches to BPER Banca with related assets and liabilities, a precondition to the merger imposed by Italian competition authorities. This will see the group's loan book decline by some €27bn.

Financial strength indicators

Asset quality – Intesa's diversified business model is reflected in its balance sheet, which is spread across retail lending and various corporate lending sectors. The bank's activities are primarily domestically focused with foreign subsidiaries only amounting to 8.4% of the group's lending. Net loans to customers amount to 46% of total assets. Asset quality has consistently improved over the past five years due to effective workout processes as well as disposals, bringing the NPL ratio to 4.9% (4.4% incl. UBI), down from 16.5% back in 2015. ISP reduced gross nominal NPL stock by €44bn since 2015 to €20.5bn as at FY20 (-34.6% yoy). In 2021, the group plans to dispose of at least a further €4bn in NPLs, which mostly originated from UBI. The coverage ratio is also adequate at 49.4%. NPL and coverage ratios are somewhat weaker than those of international peers as the European banking sector averages are 2.9% and 45.3% respectively, as reported by the EBA. In a domestic context, ISP's asset quality is considered above average.

Intesa - Additional Data			
Key Ratios (%)	**FY20**	**FY19**	**FY18**
FL CET1	15.4	14.1	13.6
Phased Total Capital	19.6	17.7	17.7
NPL	4.9	7.6	8.8
NPL Coverage	49.4	54.6	54.5
LCR	>100	>100	>100
Cost to Income	52.2	51.4	53.3
Balance Sheet (EURbn)			
Total assets	1,002	816.1	787.7
Loans to customers	461.5	365.6	359.9
Customer deposits	524.9	425.5	415.1
Debt securities	165.2	173.4	121.7
Total Equity	66.3	55.7	54.3
Income Statement (EURbn)			
Operating Income	19.0	18.0	17.8
Operating Expenses	9.9	9.2	9.4
Cost of Risk (bps)	104	53	61
Net Income	3.2	4.1	4.0

Source: Intesa earnings reports

The risk profile of Intesa has remained relatively unchanged following the combination with UBI, which predominantly operates in Italy's wealthy northern regions and has higher lending exposures to households (41% of loan book) and SMEs (23%) compared to Intesa's 30% and 20% respectively. Given the broad similarities in both banks' business profiles we deem execution risk of the merger to be limited. Loan loss provisions doubled in 2020 to €4.1bn of which 52% are Covid-related, consequently the cost of risk measure (CoR) rose to 104bps. Excluding Covid-related effects however, CoR has declined to 50bps against 53bps one year prior. Loans subject to payment deferral agreements amounted to €33bn (of which €5bn UBI), representing 7.1% of the total loan portfolio as of end-December 2020. As these schemes roll off in 2021 we expect to see a deterioration in asset quality over the course of the year, especially if the expected economic recovery is protracted.

Profitability – ISP profitability has traditionally been well above that of Italian peers, supported by diversified revenues from non-interest income, which offsets pressures from the low interest rate environment and low-growth operating environment. However, several non-recurring effects (additional UBI LLPs, integration charges, adverse account of UBI combination) weighed down bottom line results as did the sizeable loan loss provisions, which accounted for 46.5% of the €9bn pre-impairment operating profits. These adverse effects were partially offset by a €1.1bn capital gain from discontinued operations such as the sale of the payment system business Nexi SpA and the €3.2bn negative goodwill generated from the UBI merger. As a result, annual group net income stood at €3.27bn (-21.6% yoy), exceeding the min. ~€3bn net income target for 2020. For 2021 Intesa forecast a net income of >€3.5bn which is believed to benefit from >€1bn cost and revenue synergies more than the €700m initially anticipated. The additional benefits stem from a revised productivity and commercial performance expectation as well as a higher number of voluntary headcount exits. ISP expects to reap >80% of these synergies by 2023 and 100% by 2024.

Capitalisation – Intesa's capital position remained strong as the pro-forma fully loaded CET1 ratio rose to 15.4% from 15.2% just three months earlier. This was backed by solid retained earnings, which helped generate a capital buffer of +680bps above SREP requirements. Taking into account the RWA benefit from the mandatory branch disposal to BPER, the pro-forma fully-loaded CET1 ratio would rise to 15.9% which translates to €23.3bn in excess capital. The sizeable buffers above core capital ratios are well in excess of those reported by peers that averaged ~490bps. Intesa announced that they remain committed to maintaining a CET1 ratio above 13%. Unreserved impaired loan volumes amounted to 20% of nominal CET1 capital which is a marked improvement from 39% registered back in 2018, highlighting the de-risking of the balance sheet. The strength of Intesa's capital base is further underscored in its leverage ratio, which stood at 7.2% at FY20 up 50bps yoy and well above the 3% requirement. The bank is yet to disclose its MREL requirements and has also not communicated how these will change as a result of the UBI merger. ISP stated that it currently comfortably exceeds MREL requirements and that it would issue more SNP debt in 2021 to build buffers.

Funding & Liquidity – The group's funding structure is largely geared towards retail deposit funding due to its strong retail presence domestically while maintaining good access to capital market funding. Direct funding (customer deposits and customer securities) stood at €525bn at FY20, accounting for 56% of total liabilities and fully funding the loan book (loans to direct funding ratio of 88%). Refinancing operations with the ECB amounted to some €82.9bn for the combined entity and consisted entirely of the T-LTRO III programme with favourable funding conditions. The full permissible funding amount for ISP is EUR90bn, which gives the group the option to access future ECB auctions. The current uptake equates to 8.9% of total liabilities which is less than what we have observed among domestic peers. In 2020, ISP issued £350m in senior unsecured, €3bn in AT1 and €1.25bn in senior unsecured debt, which on average was subscribed to by 85% foreign investors. The average order books exceeded deal size by ~3.5x. Intesa also continues to operate from a strong liquidity position as unencumbered liquid assets stood at €164bn (€195bn incl. UBI) which equates to 16.3% and 19.4% of total assets respectively. LCR and NSFR ratios were comfortably above the required 100% requirement.

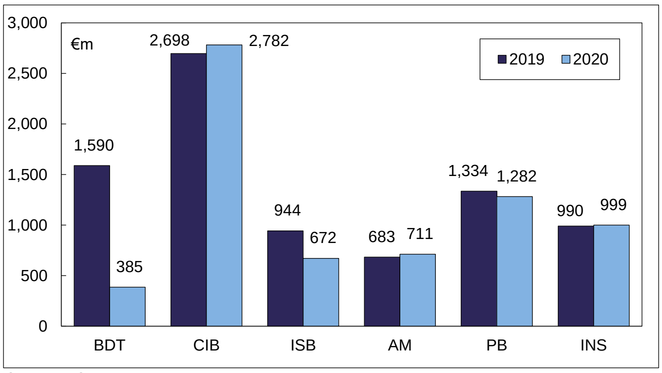
Rating agencies' views

Moody's: Intesa Sanpaolo's ratings reflect its modest but improved asset risk, sustained profit generation, sound capital buffers and large reliance on market funds, that is mitigated by an ample liquidity buffer. The ratings also reflect the limited impact that the acquisition of Unione di Banche Italiane S.p.A. (UBI Banca) will have on the group's standalone credit profile. However, there are risks to Intesa Sanpaolo's credit profile, namely in terms of asset quality and profitability, as a result of the coronavirus-induced economic downturn.

S&P: The agency expected the COVID-19 pandemic to cause a severe recession in Italy, where Intesa mainly operates, in 2020. They see a recovery in 2021, but anticipate it will not immediately and entirely offset the damage caused to the economy, household wealth, and various corporate sectors. S&P also believe Italian banks are more vulnerable to deteriorating economic conditions compared with other systems in Europe because of their high exposure to small and midsize enterprises (SMEs). S&P maintained the negative outlook on Intesa to reflect that on the Italian sovereign and our view that downside risks to its credit profile are increasing, particularly if the economic rebound the agency expects in Italy is delayed or fiscal countermeasures introduced by the government prove less effective than anticipated.

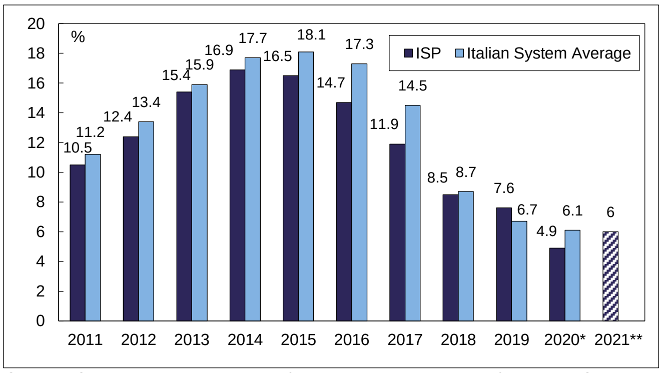
Fitch: The ratings are underpinned by IntesaSP's sound capitalisation and strong funding and liquidity profile. Capitalisation is a rating strength and Fitch expect that under various possible downside scenarios to their baseline that the bank would be able to maintain sufficient capital to absorb higher credit risks. IntesaSP's large pre-impairment operating profit provides an ample cushion against capital erosion, even in a scenario of significantly increasing loan impairment charges (LICs). The assessment also considers the moderate exposure to unreserved impaired loans and domestic government bond holdings. Fitch also expect inflows of new impaired loans to increase in the coming quarters, but acknowledge IntesaSP's capacity to generate sufficient profits annually to restore its asset quality metrics in the medium term and to operate with an impaired loan ratio below 5% (including UBI) as planned. The bank's asset quality remains weak by international standards and at risk of weakening should the operating environment in Italy prove worse than expected.

FY 20 pre-tax profit by business segment



Source: Company reports

ISP vs Italian Banking System NPLs



*Source: Company reports, Bank of Italy; *Italy average as of 1H20; **ISP target*

Recent Transactions

Issue Date	Security	Maturity/Call	Currency	Size (m)	Type	Coupon	Yield	Final Spread (bps)
25/08/2020	AT1	PNC7.5	EUR	750	Fixed	5.50%	5.50%	MS + 584.8
25/08/2020	AT1	PNC11	EUR	750	Fixed	5.875%	5.875%	MS + 608.6
03/06/2020	Tier 2	10Y	GBP	350	Fixed	5.148%	5.148%	UKT + 475
18/05/2020	Senior Preferred	5Y	EUR	1,250	Fixed	2.167%	2.167%	MS + 245

Source: Intesa Sanpaolo, BondRadar

This is an issuer profile and contains factual statements only. All statements are sourced from Intesa Sanpaolo financial reports, which can be found at https://group.intesasanpaolo.com/en/investor-relations

Daiwa Capital Markets

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