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Italian Bank Rescue: What is €5bn among friends? Not enough to pay for the first round of drinks...

Ticker	Rating	CUR	12 Apr 2016 Closing Price	Target Price	TTM Rel. Perf.	Cash EPS 2014A	Cash EPS 2015E	Cash EPS 2016E	P/B 2014A	P/B 2015E	P/B 2016E	Yield
ISP.IM	O	EUR	2.24	3.90	-12.6%	0.12	0.23	0.28	0.8	1.0	1.0	6.3%
UCG.IM	M	EUR	2.98	5.50	-36.8%	0.39	0.40	0.56	0.4	0.4	0.3	4.0%
MSDLE15			1320.15			94.04	86.54	87.69	NA	NA	NA	3.7%

O – Outperform, M – Market-Perform, U – Underperform, N – Not Rated

Highlights

On Monday evening, among a lot of tension and anger, agreement was reached on the creation of the Atlas fund for the rescue of the Italian banking system. It's aptly named after Atlas, the god of endurance condemned to hold up the sky for eternity. One would need a similar deity to prevent the roof from caving in on the Italian banking system with only €5bn of spare change, the size of the fund. We have a quick look whether the numbers reported so far add up, or rather don't add up.

- **The Atlas fund: what is it?** It's a fund with a dual purpose: 1) to act as a backstop for capital raising banks who do not find buyers for their new share issues; 2) invest in the equity tranche of Bad Debt securitizations (the private Bad Banks that were approved by the EC). More detail in our quick-take yesterday Quick Take - Italian Bank Rescue Plan... First Cut The reported size of the fund is ~€5bn with ISP, UCG each contributing €1bn, insurers another €1bn, the foundations €0.5bn and the remainder made up of Popolare banks, CDP and SGA. ***It was reported in the press that the fund would buy Bad Debt at close to the net book value.***
- **Is it enough to remove all Bad Debt from the Italian Banking system at book value? No.** At an overall system level, there is €360bn of Impaired Loans (NPLs) and €202bn of Bad Debt. Coverage on the former is ~45% and on the latter ~60%. So, at a system level there is ~€80bn of Net Bad Debt. If €5bn is the size of the equity tranche in the securitization vehicle, to buy ~€80bn of Net Bad Debt, we need 16x leverage or an equity tranche that is only 6.25%. 50% would come from state guaranteed senior notes and the remainder from mezzanine notes. We also need to make the unrealistic assumption that the IPO of BaVen and BPVi will need no intervention of the Atlas fund. None of this seems realistic.
- **Is it enough to at least remove the Bad Debt of ISP, UCG, BMPS, Carige and 8 Popolare[1] banks at book value? No.** The idea here is to fix the large banks first before taking on the tail of ~600 smaller Popolari and Co-ops. The Net Bad Debt at the large banks is ~€56bn. If we assume that the capital raise for BaVen (€1bn) and BPVi (€1.78bn) goes swimmingly and no back-stop intervention by the Atlas fund is required, it can invest the full €5bn in the equity tranche of the Bad Debt securitization vehicle. This would lead to 11x leverage (or 9% equity tranche) if all the Bad Debt is going to be bought at Net Book Value. Very unlikely. Things get worse when one considers the roof caving in on the BaVen and BPVi IPO requiring the Atlas fund in the worst case to pick up the tab of €2.76bn. In that case there would be only €2.24bn left to put into a Bad Debt securitization, leading to 25x leverage (or 4% equity tranche).

[1] BPE, CVAL, UBI, BPSO, PMI, BP, BPVi, BaVen

European Banking

See Disclosure Appendix of this report for important disclosures and analyst certifications.

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- **Taking the ambition level down further, is it sufficient to just buy the Bad Debt of the weakest large banks: BMPS, BP, Carige, BPVi, BPVen? Unlikely.** The Net Bad Debt of these 5 amounts to ~€19bn. If the full €5bn is pumped into the equity tranche of the Bad Debt securitization vehicle, we only need 4x leverage to buy the Net Bad Debt of these banks. Again we need to assume that no assistance will be needed for the IPO of BPVen and BPVi (see **Exhibit 1**).
- **For the Atlas fund to buy through the "Bad Bank" securitization vehicle the Bad Debt of the large Italian banks at Net Book Value is not only unrealistic, but essentially unfair.** Not all Bad Debt is created equal in Italy. There are large differences between banks. We look at Bad Debt along three dimensions: unsecured proportion, RE collateral level for secured Bad Debt and proportion of Bad Debt that resides in the South. Assuming a 15% unlevered return to the holders of the equity tranche in a Bad Debt securitization, 7 years recovery period for Bad Debt collateral (5 years for ISP and UCG) and 50% haircut on collateral in the South vs 10% haircut on collateral in North and Centre we derive the following "fair" sale prices for Bad Debt by bank (see **Exhibit 2**). On average the Net Book Value for Bad Debt is 40 cents/€ while we believe a "fair" disposal value through the "Bad Bank" securitization should be on average 30 cents/€ with large variation among the banks (see **Exhibit 4**).
- **How much should the Atlas fund size be under current debt collection horizon of on average 7 years? €20bn.** If we dispose the Bad Debt through the Bad Bank at our "fair" prices providing an unlevered return of 15% to holders of the equity tranche and assuming a recovery period of 7 years (except for ISP and UCG at 5 years), the Bad Bank securitization vehicle would pay €41bn for a Net Bad Debt of €56bn. This would lead to a recapitalization of the weakest banks (likely without access to capital markets) and UCG of about €10bn (see **Exhibit 5**). So, with 4x leverage in the securitization vehicle, one would need the Atlas fund to have €10bn as a backstop for the IPOs of UCG as well as BMPS, BP, Carige, BPVen and BPVi while putting in ~€10bn in the equity tranche of the Bad Debt securitization vehicle.
- **If Debt Collection can be shortened to 3 years on average and equity tranche investors do not require more than 10% IRR, the Atlas fund could make it work with €9bn.** Though unrealistic that Bad Debt collection could be sped up so fast in as short period of time (i.e. shortening by 4 years), the Atlas fund still requires almost double the current inlay of €5bn. Under this scenario, the securitization fund would buy at the current book value of Bad Debt, i.e. ~€56bn but make an instant profit of €9.4bn upon purchase (because of shorter recovery period and lower discount rate). At the same time, only €4.6bn in fresh capital would need to be raised at the weakest banks (which then do not include BMPS anymore). At 4x leverage, an equity tranche is needed of €14bn against which the profit net of backstop capitalization contribution €4.8bn (=€9.4 - €4.6) can be off-set so requiring an outlay of only ~€9bn by the Atlas fund.

Investment Conclusion

We believe that the Atlas Fund for the Italian Bank Rescue is underfunded by €15bn on current 7 year recovery assumptions and a 15% discount rate and by €4bn on very optimistic 3 year recovery assumptions and a 10% discount rate. Given that any single bank's contribution cannot exceed 20% of the fund, this could mean that ISP and UCG see their contributions increase to €4bn each. It would reduce the upside for ISP as €4bn out of their €10bn surplus over and above the dividend program of €3bn in 2016 and €4bn in 2017 which will remain because paid out of earnings. For UCG, it may lead to a capital raise.

Our preference for ISP over UCG remains. ISP outperform, UCG marketperform.

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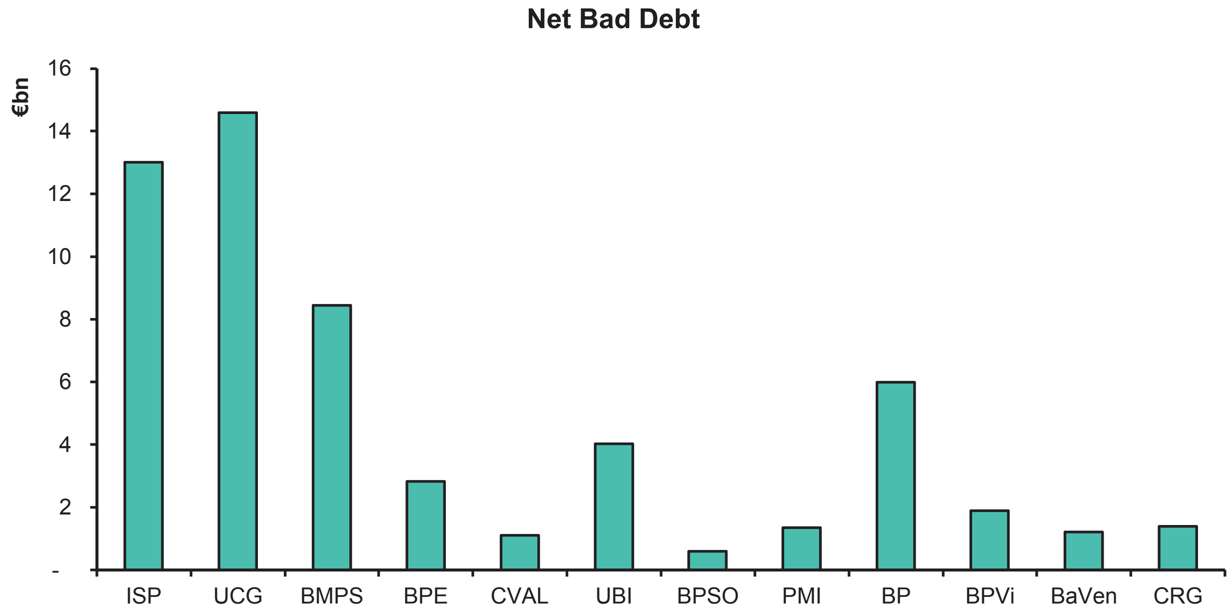
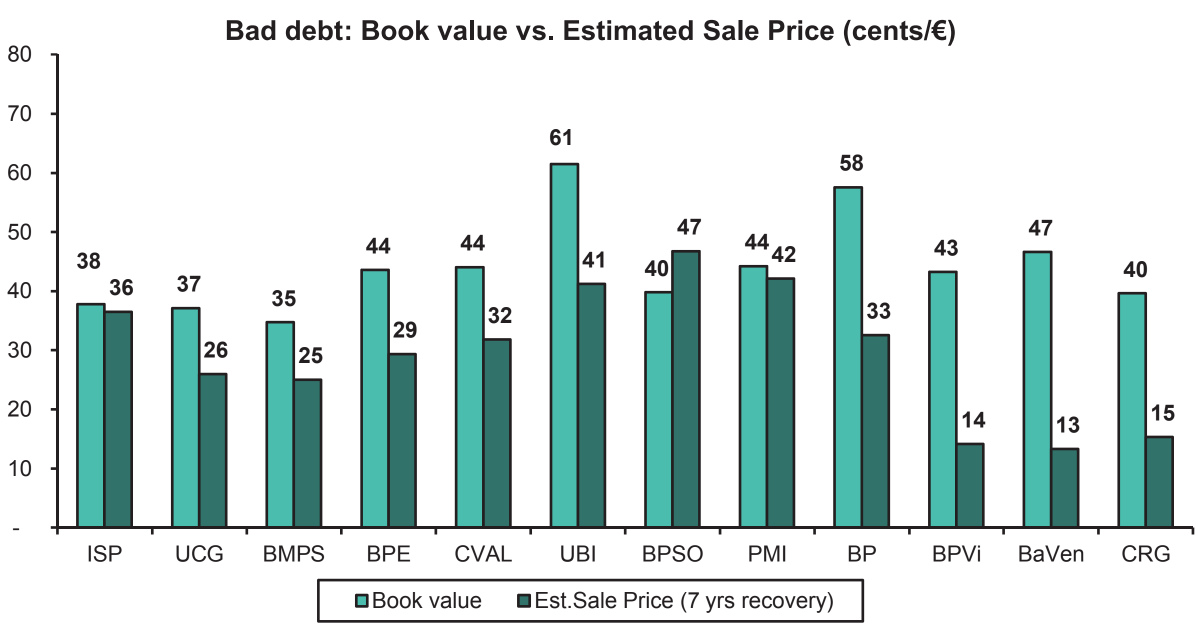
Details

Exhibit 1
Net Bad Debt for the largest Italian banks is €56bn



Source: Company reports, Bernstein analysis and estimates

Exhibit 2
Bad Debt average book value is 40 cents/€ versus estimated disposal price of €30 cents/€ on average



Source: Company reports, Bernstein analysis and estimates

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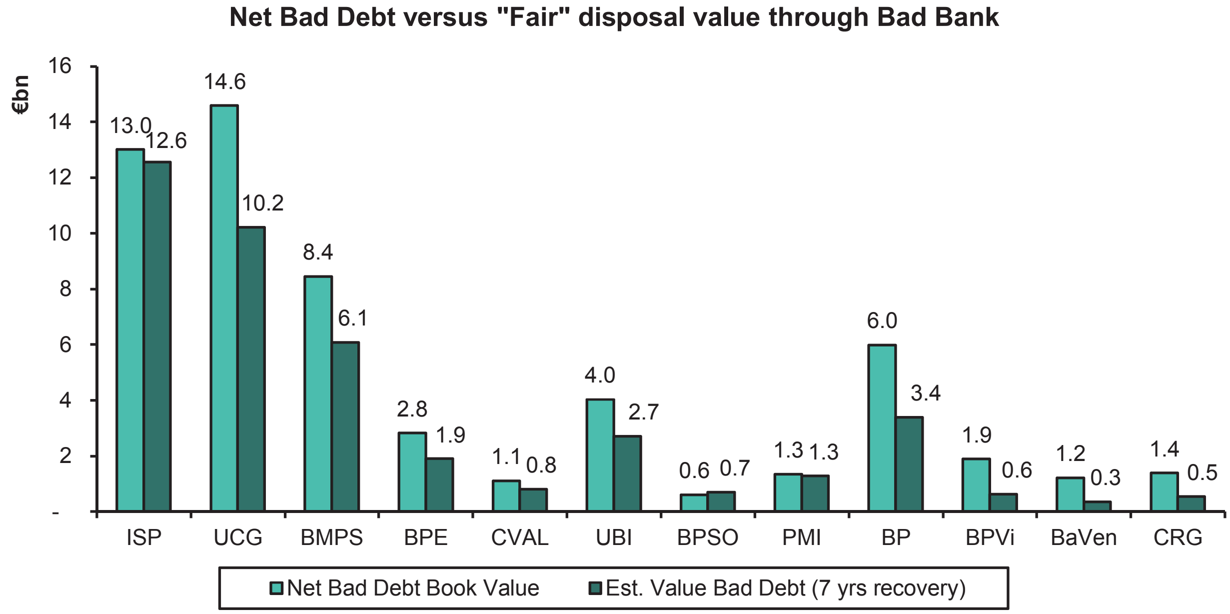
Exhibit 3

Net Bad Debt is €56bn in total versus "Fair" disposal price value of €41bn in total



Source: Company reports, Bernstein analysis and estimates

European Banking

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Exhibit 4

Bad Debt valuation along the three lenses and impact on TNAV

	ISP	UCG	BMPS	BPE	CVAL	UBI	BPSO	PMI	BP	BPVi	BaVen	CRG
THREE LENSES ON BAD DEBT												
Lens 1: Secured vs Unsecured Bad Debt												
Unsecured Net Bad Debt	16%	24%	22%	44%	33%	20%	18%	24%	13%	23%	23%	18%
Lens 2: Cash & RE Collateral Coverage Secured Bad Debt												
Cash coverage Gross Secured Bad Debt	60%	60%	64%	34%	41%	17%	57%	48%	33%	50%	44%	58%
RE Collateral coverage Gross Secured Bad Debt	107%	83%	107%	234%	177%	197%	173%	183%	126%	53%	52%	53%
Lens 3: Presence of Gross Bad Debt in the South												
Bad Debt in the South as % of Total Gross Bad Debt	23%	29%	38%	48%	24%	13%	2%	8%	12%	22%	30%	8%
ASSUMPTIONS												
Blended recovery cost as % collateral	***19%***	***21%***	***25%***	***29%***	***20%***	***15%***	***11%***	***13%***	***15%***	***19%***	***22%***	***13%***
Recovery costs North/Centre as %Collateral	10%	10%	10%	10%	10%	10%	10%	10%	10%	10%	10%	10%
Recovery costs South as % Collateral	50%	50%	50%	50%	50%	50%	50%	50%	50%	50%	50%	50%
Recovery period	***5***	***5***	***7***	***7***	***7***	***7***	***7***	***7***	***7***	***7***	***7***	***7***
Investor discount rate applied to derive collateral NPV	***15%***	***15%***	***15%***	***15%***	***15%***	***15%***	***15%***	***15%***	***15%***	***15%***	***15%***	***15%***
IMPACT ON TNAV												
Loss on Net Unsecured Bad Debt / TNAV	***-3.6%***	***-5.5%***	***-23.0%***	***-18.7%***	***-13.5%***	***-6.7%***	***-3.0%***	***-4.9%***	***-8.9%***	***-11.3%***	***-9.8%***	***-7.0%***
assume mkt price 10c/€ versus net book value of 30c/€												
Loss/Gain on Net Secured Bad Debt / TNAV	***2.4%***	***-5.0%***	***-21.4%***	***-2.3%***	***-3.4%***	***-9.8%***	***7.3%***	***3.4%***	***-34.3%***	***-39.1%***	***-35.4%***	***-28.9%***
total loss on net secured loan / TNAV	-29.3%	-26.6%	-124.1%	-36.3%	-40.5%	-40.1%	-20.5%	-23.0%	-86.1%	-58.0%	-48.5%	-48.0%
recovery of RE collateral / TNAV	31.7%	21.6%	102.7%	34.0%	37.2%	30.2%	27.8%	26.4%	51.8%	18.8%	13.1%	19.1%
Net Impact on TNAV												
as % of TNAV	**-1.2%**	**-10.4%**	**-44.4%**	**-21.0%**	**-16.9%**	**-16.5%**	**4.4%**	**-1.5%**	**-43.2%**	**-50.4%**	**-45.2%**	**-35.9%**
in absolute € millions	**(446)**	**(4,376)**	**(2,366)**	**(920)**	**(306)**	**(1,328)**	**104**	**(64)**	**(2,599)**	**(1,272)**	**(862)**	**(854)**
per share in €	**(0.03)**	**(0.73)**	**(0.81)**	**(1.91)**	**(0.28)**	**(1.47)**	**0.23**	**(0.01)**	**(7.18)**	**--**	**--**	**(1.03)**
Impact on CET1 capital												
FL CET1 pre disposal	13.1%	10.9%	11.7%	11.2%	13.5%	11.6%	10.5%	12.2%	12.4%	5.9%	6.8%	11.5%
FL CET1 post disposal	13.0%	9.9%	8.6%	9.1%	11.8%	9.7%	10.9%	12.0%	7.0%	0.8%	3.2%	7.5%
Change in bps	**(14)**	**(101)**	**(305)**	**(208)**	**(174)**	**(196)**	**39**	**(16)**	**(540)**	**(507)**	**(361)**	**(395)**
SALE PRICE BAD DEBT & ADDITIONAL COVERAGE												
additional coverage on Gross Bad Debt	**1%**	**11%**	**10%**	**14%**	**12%**	**20%**	**-7%**	**2%**	**25%**	**29%**	**33%**	**24%**
Book value of Bad Debt (cents/€)	**38**	**37**	**35**	**44**	**44**	**61**	**40**	**44**	**58**	**43**	**47**	**40**
Potential sale price of Bad Debt (cents/€)	**36**	**26**	**25**	**29**	**32**	**41**	**47**	**42**	**33**	**14**	**13**	**15**

Source: Company reports, Bernstein analysis and estimates

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Exhibit 5

Capital Surplus and Shortfall after Bad Debt disposal on 7 year recovery and 15% discount rate

Healthiest banks

In €bn

	FL CET1	FL RWA	Bad debt writedown	Adj. FL CET1 ratio	SREP req	Surplus (%)	Surplus
ISP	37	284	0.4	13.0%	9.5%	3.5%	9.8
UCG	43	391	4.4	9.9%	10.8%	-0.8%	(3.2)
UBI	7	61	1.3	9.7%	9.3%	0.4%	0.3
Total	**87**	**736**					**6.9**

Weakest banks

In €bn

	FL CET1	FL RWA	Bad debt writedown	Adj. FL CET1 ratio	SREP req	Shortfall (%)	Shortfall	Capital raise announced	Shortfall
BMPS	8	71	2.4	8.6%	10.2%	-1.6%	(1.1)	-	(1.1)
BPVi	1	25	1.3	0.8%	10.3%	-9.5%	(2.4)	(1.8)	(2.4)
BaVen	2	23	0.9	3.2%	10.3%	-7.0%	(1.6)	(1.0)	(1.6)
CRG	2	20	0.9	7.5%	11.3%	-3.7%	(0.7)	-	(0.7)
BP	6	45	2.6	7.0%	9.6%	-2.6%	(1.1)	(1.0)	(1.1)
Total	**19**	**184**							**(7.0)**

Other banks

In €bn

	FL CET1	FL RWA	Bad debt writedown	Adj. FL CET1 ratio	SREP req	Surplus (%)	Surplus
BPE	4	40	0.9	9.1%	9.3%	-0.1%	(0.0)
CVAL	2	15	0.3	11.8%	8.3%	3.5%	0.5
BPSO	3	24	(0.1)	10.9%	9.3%	1.6%	0.4
PMI	4	35	0.1	12.0%	9.0%	3.0%	1.1
Total	**13**	**114**					**1.9**

Source: Company reports, Bernstein analysis and estimates

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Exhibit 6

Capital Surplus and Shortfall after Bad Debt disposal on 3 year recovery and 10% discount rate

Healthiest banks

In €bn

	FL CET1	FL RWA	Bad debt writedown	Adj. FL CET1 ratio	SREP req	Surplus (%)	Surplus
ISP	37	284	(5.6)	14.8%	9.5%	5.3%	15.0
UCG	43	391	(0.3)	11.0%	10.8%	0.2%	1.0
UBI	7	61	(0.1)	11.8%	9.3%	2.5%	1.6
Total	**87**	**736**					**17.6**

Weakest banks

In €bn

	FL CET1	FL RWA	Bad debt writedown	Adj. FL CET1 ratio	SREP req	Shortfall (%)	Shortfall	Capital raise announced	Shortfall
BMPS	8	71	(3.1)	15.4%	10.2%	5.2%	3.7	-	-
BPVi	1	25	0.8	2.8%	10.3%	-7.5%	(1.9)	(1.8)	(1.9)
BaVen	2	23	0.6	4.3%	10.3%	-6.0%	(1.4)	(1.0)	(1.4)
CRG	2	20	0.4	9.7%	11.3%	-1.6%	(0.3)	-	(0.3)
BP	6	45	(0.5)	13.4%	9.6%	3.8%	1.7	(1.0)	(1.0)
Total	**19**	**184**							**(4.6)**

Other banks

In €bn

	FL CET1	FL RWA	Bad debt writedown	Adj. FL CET1 ratio	SREP req	Surplus (%)	Surplus
BPE	4	40	0.0	11.2%	9.3%	1.9%	0.8
CVAL	2	15	(0.3)	15.0%	8.3%	6.7%	1.0
BPSO	3	24	(0.6)	12.6%	9.3%	3.4%	0.8
PMI	4	35	(0.7)	14.0%	9.0%	5.0%	1.7
Total	**13**	**114**					**4.4**

Source: Company reports, Bernstein analysis and estimates

Links to previous Italian Bad Debt reports

Quick Take - Italian Bank Rescue Plan... First Cut

Italian banks: desperation and urgency lead to Robin Hood method - steal from the rich, give to the poor...

Italian Bad Debt (Part III): What should be the "floor" under the share price after full Bad Debt disposal?

Italian Bad Debt (Part II): Bad Debt sale price per bank...Whose TNAV is hit by a quick Bad Debt disposal?

Italian Bad Debt (Part I): Until Debt do us part...PMI & BP the merger that cannot be allowed to fail...

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Valuation Methodology

We apply the following valuation approach to arrive at our price targets:

We look at the 2017 Return on Tangible Book (RoTNAV) and Growth (g) as key drivers of value. We have found that returns are the single largest driver of valuation across our coverage.

We use the formula below to derive our target P / TNAV:

P/TNAV = (RoTNAV - g) / (Ke - g)

We adjust our estimated RoTNAV for Basel III fully loaded capital requirements to reflect the true profitability of the business once Basel III requirements are fully implemented.

We have not placed any value on growth for our coverage as deleveraging in Western Europe, sluggish growth in emerging markets and regulatory uncertainty will continue to weigh on growth in the near to medium term.

We use a market implied historical long-term average Cost of Equity (Ke) for our coverage.

We then apply our target P/TNAV multiple to our forecast of 2016E TNAV and to this we add the estimated excess capital per share at the end of 2016 to arrive at our Target Price.

For UCG we apply a litigation discount based on our estimate of potential litigation liabilities arising out of investigations such as interest rate and foreign exchange manipulation as well as violation of US sanctions.

Before we added a normalization option value to the price derived from the Gordon Growth calculation above. This normalization option reflected the upside from Cost of Risk normalization in Italy over a longer term time horizon discounted to end 2016. This has now been taken out as the improved Cost of Risk falls within the valuation horizon and thus is part of the actual model.

Risks

Downside risk

- Governmental and regulatory headwinds in CEE and Austria leading to additional levies, taxes, capital buffers and forced CHF loan conversion (for UCG)
- Additional loan loss provisioning under IFRS9 rules
- Impact of risk weight harmonization under Basel 4
- Credit costs are higher than our estimates if the Italian economy takes a turn for the worse
- Introduction of bank levy in Poland (for UCG)
- Execution risk in cost reduction program (mainly for UCG)

Upside risk

- Deferred tax credits eligible as CET1 capital if Italy follows Spain example.
- Exits from businesses leads to higher than expected capital savings (Ukraine / Austria) (for UCG)
- Merger of Pioneer – Santander Asset management leads to +25bps impact on capital (for UCG)

Management is able to meet targets on NII and net fees

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    Outperform: Stock will outpace the market index by more than 15 pp in the year ahead.

    Market-Perform: Stock will perform in line with the market index to within +/-15 pp in the year ahead.

    Underperform: Stock will trail the performance of the market index by more than 15 pp in the year ahead.

    Not Rated: The stock Rating, Target Price and/or estimates (if any) have been suspended temporarily.

- As of 04/12/2016, Bernstein's ratings were distributed as follows: Outperform - 48.7% (0.7% banking clients) ; Market-Perform - 41.3% (0.4% banking clients); Underperform - 9.9% (0.0% banking clients); Not Rated - 0.0% (0.0% banking clients). The numbers in parentheses represent the percentage of companies in each category to whom Bernstein provided investment banking services within the last twelve (12) months.
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- An affiliate of Bernstein received compensation for non-investment banking-securities related services from the following companies ISP.IM / Intesa Sanpaolo SpA.

12-Month Rating History as of 04/11/2016

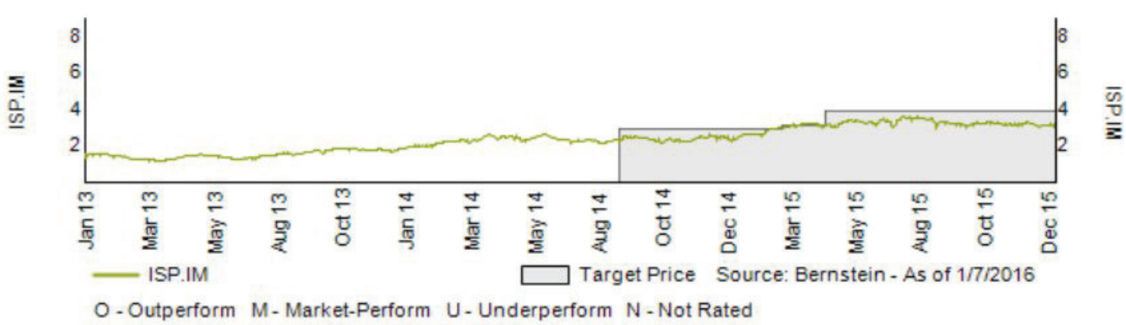
Ticker	Rating Changes	
ISP.IM	O (IC) 09/02/14	
UCG.IM	M (RC) 11/26/15	O (IC) 09/02/14

Rating Guide: O - Outperform, M - Market-Perform, U - Underperform, N - Not Rated
Rating Actions: IC - Initiated Coverage, DC - Dropped Coverage, RC - Rating Change

ISP.IM / Intesa Sanpaolo SpA

Date	Rating	Target(EUR)
09/02/14	O(IC)	2.90
03/05/15	O	3.10
04/24/15	O	3.90

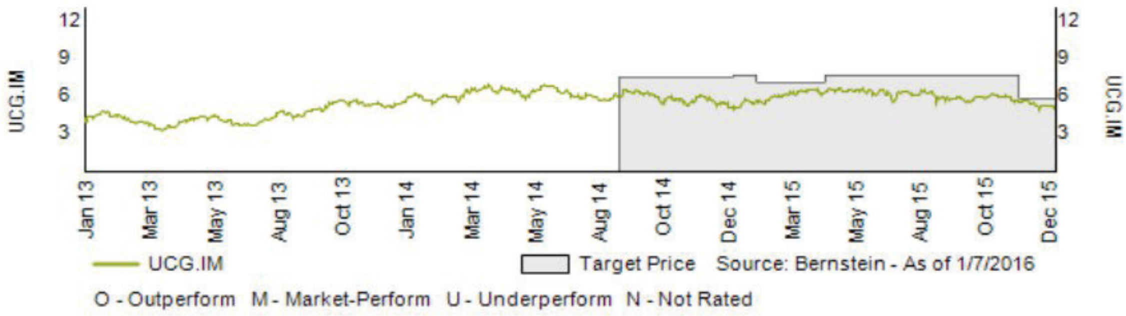
IC - Initiated Coverage



UCG.IM / UniCredit SpA

Date	Rating	Target(EUR)
09/02/14	O(IC)	7.40
10/13/14	O	7.45
01/09/15	O	7.60
02/03/15	O	7.00
04/24/15	O	7.60
11/26/15	M	5.70

IC - Initiated Coverage



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