Unicredit SpA
Issuer Rating Report

A NEGATIVE

Overview

Scope Ratings has assigned an Issuer Rating of A, with negative outlook to Unicredit SpA. The rating was last affirmed on October 30, 2018, when the outlook was changed to negative. The short-term rating is S-1, with a Stable Outlook.

The ratings were not solicited by the issuer. Both ratings and analysis are based solely on publicly available information. The issuer has participated in the rating process.

Highlights

- With sizeable franchises in Italy, Germany, Austria, several East European countries, as well as Russia and Turkey, Unicredit can rightly claim to be a true pan-European bank, rather than just an Italian bank with some foreign operations.
- Over the past decade, Unicredit has suffered from bad asset quality, low profitability and difficulties integrating acquired banks.
- The extensive ‘Transform 2019’ restructuring programme has started to produce results. Indeed, Unicredit is well ahead of the business plan in many aspects, especially in terms of non-performing loan and cost reduction. The capital increase in 2017 and the completion of the second phase of Unicredit’s FINO project in January 2018 led to significant improvements in asset quality and profitability.

Rating drivers (summary)

The rating drivers, in decreasing order of importance in the rating assignment, are:

- Solid retail and commercial banking franchises in several different geographies
- A convincing plan to restore profitability, albeit subject to execution risk
- Improving capital and asset quality profile

Ratings & Outlook

Issuer Rating	A
Outlook	Negative
Senior unsecured debt	A
Senior unsecured debt (MREL/TLAC eligible)	A-
Short term debt rating	S-1
Short term debt rating outlook	Stable

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Rating change drivers

Further material improvements in asset quality. Although it is declining, the stock of non-performing exposures (NPEs) remains significant. Unicredit's management aims to achieve further decreases in both gross and net NPEs, which would add visibility to future earnings. Current targets include a gross NPE ratio of 7.8% in 2019, with coverage of at least54%.

Improved efficiency and profitability. The path to higher profitability for Unicredit requires material cost cutting through 2019. The number of branches is planned to fall by 25%, with a 14,000 reduction in full-time equivalents (FTE). If accomplished in line with the plan, this should lead to a cost-income ratio of under 52% (currently 57.9%). In our view, this would still leave room for further gains in efficiency as customers move from physical interaction to multichannel relationships.

Deterioration in operating conditions in Turkey and Russia. Following the sale of Pekao in Poland, Unicredit's CEE profits are concentrated in Russia and Turkey. Both countries present material political and economic risks. While Unicredit maintains strong market shares in several other countries in CEE, these markets are relatively small and contribute less to the group's revenues and profits

Political risk and potential impacts from worsening investor sentiment. The recently formed government alliance between The League and the five star movement has provided Italy with some degree of internal political stability, though at the cost of increasing frictions with the European institutions, culminating with the raft over the budget law in Autumn; deteriorating investor sentiment towards Italy has reverberated through credit markets and we believe that it could in the medium term affect the bank negatively via higher funding costs, a more challenging environment for further NPE sales and generally a less benign market environment.

Rating drivers (details)

Solid retail and commercial banking franchises in several different geographies

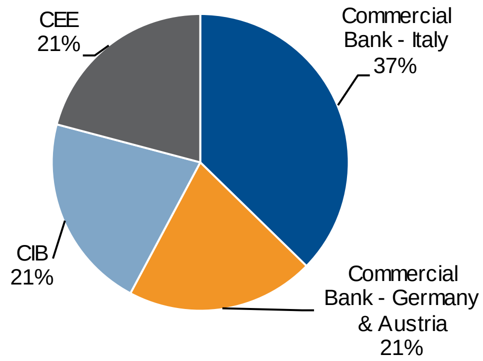
With 2,663 branches in Italy, Unicredit is the second largest bank in a system composed of two large banks and several mid-tier and small banks.

After merging with the HVB Group in 2005, Unicredit is the third largest private bank in Germany by total assets as of YE 2017, with a particularly strong presence in Bavaria. Through its subsidiary Bank Austria, Unicredit is the leading corporate bank and one of the largest retail banks in Austria.

Unicredit is also one of the leading banks in the CEE region in terms of total assets and profits. With around 1,693 branches, the group has a strong and diversified presence in the region, including top three market positions in Serbia, Bosnia, Croatia and Bulgaria. Following the sale of Pekao in Poland in 2016, Russia, the Czech Republic, Slovakia and Turkey are now the largest contributors to the group's profits.

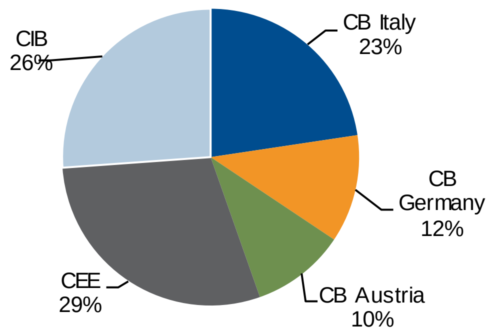
In the past few years, Unicredit's businesses in Germany and CEE have been an important source of earnings diversification, especially in light of the difficult operating environment in Italy. The Central and Eastern Europe division (which includes Russia and Turkey) remains a key investment area for Unicredit, although the group is now pursuing opportunities on a more selective basis than in the past.

Figure 1: Revenue breakdown by business, 2017



Source: Company data, Scope Ratings
Note: Excluding corporate centre and non-core units. CEE includes Turkey and Russia, reflecting Unicredit managerial reporting

Figure 2: Net breakdown by business, 2017

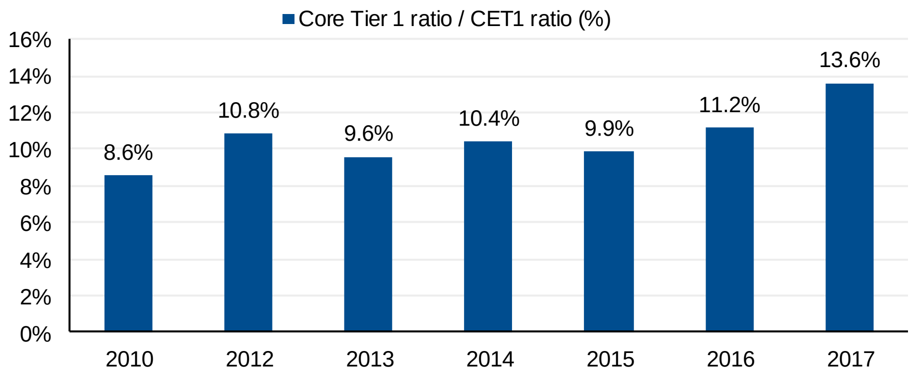


Source: Company data, Scope Ratings
Note: Excluding corporate centre, Fineco and non-core units. CEE includes Turkey and Russia, reflecting Unicredit managerial reporting

Improving capital and asset quality

Despite weak profitability and significant provisioning efforts in recent years, the group has strengthened its capital position to satisfactory levels as shown in Figure 2. The rise in capital ratios was supported by several capital increases, including a EUR 7.5bn rights issue in January 2012 and a EUR 13bn rights issue completed in March 2017. Unicredit also made several divestments, including the recent sales of Pekao in Poland and the asset management business Pioneer, which also helped bolster capital.

Figure 3: Core capital ratio, historical evolution



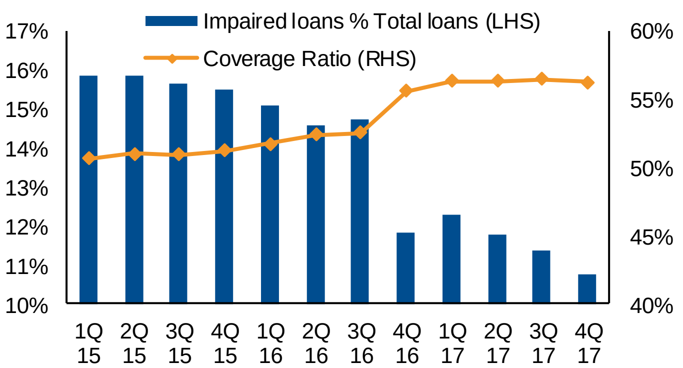
Source: Company data, SNL Financial, Scope Ratings
Note: Basel 2.5 from 2011, CRD4 transitional for 2014, post capital increase for 2016

Following the capital increase, the fully-loaded CET1 ratio[1] stood at 13.6% as of December 2017 and the group's leverage ratio was 5.55% on a fully-loaded basis.

Despite Unicredit's high degree of international diversification, the weak economic environment in Italy has weighed heavily on asset quality in the last decade. Moreover, the ill-timed acquisition of Capitalia in 2007 added significant credit risk to the balance sheet precisely at the peak of the cycle. For the best part of the last 10 years, the group has tried to bring its asset quality under control by changing its internal processes and its risk appetite framework. Nevertheless, the legacy of bad loans from the past continued to haunt the bank until very recently.

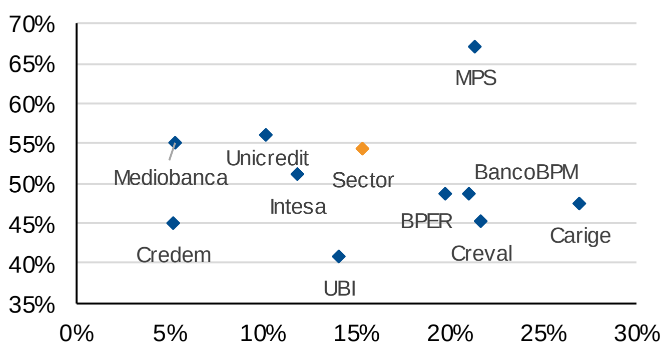
Recent years have seen the beginning of a significant trend reversal. The stock of NPE loans (comprising 'bad loans', 'unlikely to pay' and 'past due' loans) has started to decline: total impaired loans have dropped from a peak of EUR 84.4bn in December 2014 to EUR 48.4bn as of December 2017. Moreover, the 2017 capital increase and the new round of provisions taken in Q4 2016 place Unicredit firmly at the top of its Italian peers in terms of coverage ratios. We expect Unicredit's asset quality to continue to improve in the coming years, supported by a favourable macro environment. The first and second phase of FINO transactions (a stock of EUR 17bn of the lowest-quality NPEs to be securitised and sold) were successfully closed in July 2017 and January 2018 strengthening asset quality. The gross NPE ratio stood at 10.2% at the end of 2017.

Figure 4: Group NPE and coverage ratio, historical



Source: SNL Financial, Scope Ratings

Figure 5: NPL (X) and Coverage (Y) ratios, Italian banks



Source: Company data, Scope Ratings

[1] Before an IFRS9 estimated impact of -75 bps

Aside from NPEs, one credit concentration worth mentioning is Unicredit's material exposure to Italian sovereign risk. This amounted to EUR 65.8bn(EBA) as of June 2017 (comprising EUR 59.2bn in debt securities and EUR 6.6bn in loans), equivalent to 146% of CRD IV fully-loaded Common Equity Tier 1 capital.

A convincing plan to restore profitability, albeit subject to execution risk

The latest business plan, presented by the new top management team in December 2016 and to be executed by 2019, aims to draw a line under the financial crisis and return the bank to a reasonably clean balance sheet and to a profitability level at least comparable with its main international peers. The plan rests on five pillars:

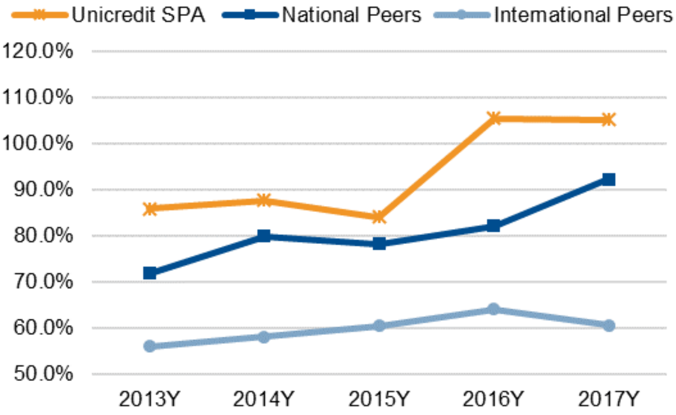
- **Strengthen and optimise capital.** The 2019 targets include a CET1 ratio of at least 12.5%, and a buffer of at least 200 bps. We believe these targets to be realistic.
- **Improve asset quality.** Targets include further reductions of NPEs, with the NPE ratio reaching 7.8% in 2019 (11.8% at the end of 2016). We consider these targets to be conservative.
- **Transform operating model.** Unicredit aims to achieve EUR 1.7bn in recurring cost savings by 2019 via a 25% reduction in Western European branches and a 14% reduction in Western Europe's FTEs, Unicredit is targeting EUR 1.7bn in recurring cost savings by 2019. The cost-cutting plan is sensible in our view, given the shift in consumer behaviour and the reduced need for physical in-branch interaction; it also builds on the material branch and personnel reductions of recent years, especially in Austria and Germany.
- **Maximise commercial bank value.** Cross-selling initiatives across the group, targeted growth in the CEE region and best practice sharing should support value creation. We view these steps as positive, but caution that progress on them will inherently be more difficult to monitor.
- **Adopt lean but steering corporate centre**. In 2015, the weight of the corporate centre on the Unicredit's group operating profit was -16.9%. The 2019 target is -2.6%.

We believe that the business plan is realistic and the path to meeting most targets is positively jumpstarted by the 2017 capital increase and the frontloading of provisions in the last quarter of 2016.

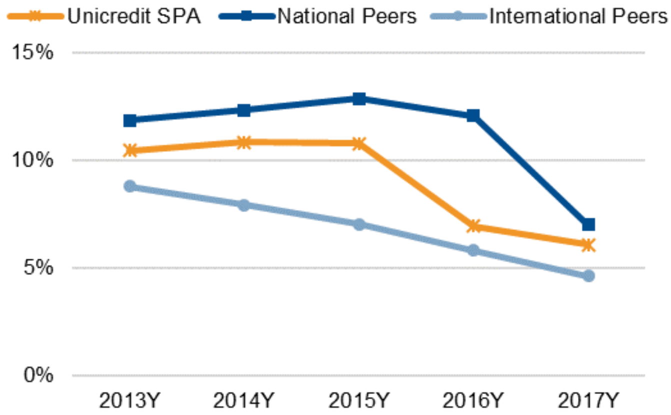
In 2017, the group's RoTE stood at 7.2% and is expected to reach over 9% by the end of 2019. The group benefited from strong results in all divisions with a net profit of EUR 5.4bn, 74% higher than 2016. The fully-loaded CET1 ratio of 13.6% does not yet include the impact of IFRS9 (-75 bps) and the second phase of FINO (+17 bps). The management is comfortable that the group will be able to absorb future regulatory impacts while still meeting its capital target of 12.5% in 2019. The cost-income ratio for 2017 was 57.9% with costs down 4.0% in the year, driven by the closure of 517 additional branches and FTE reduction of 6,352.

I. Appendix: Peer comparison

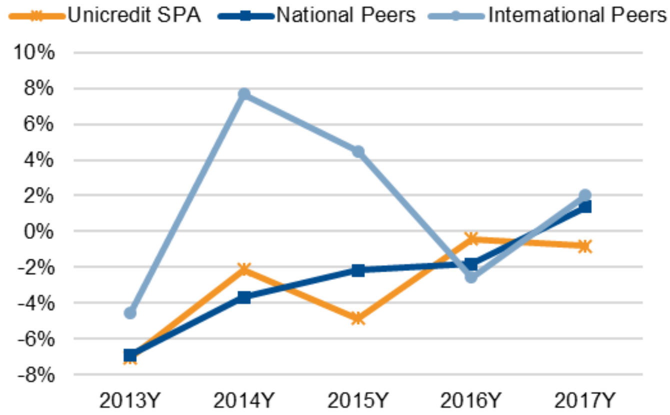
LLP stock % impaired loans (coverage ratio)



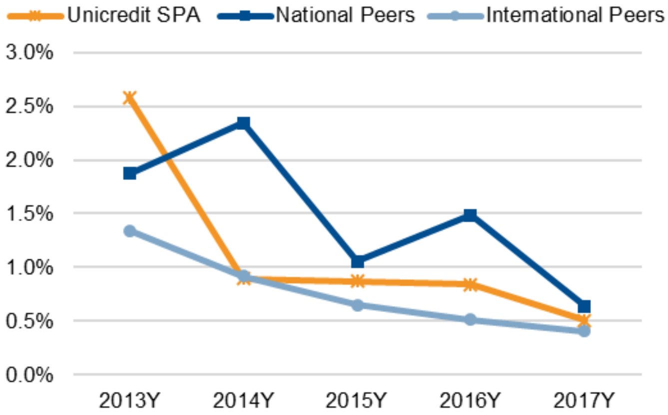
Impaired and delinquent loans % gross loans



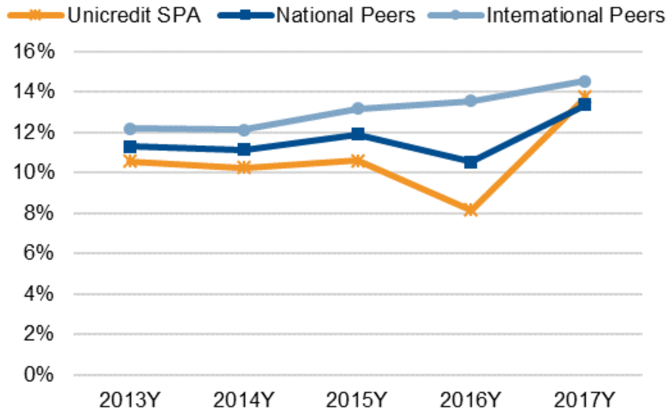
Net loan growth (%)



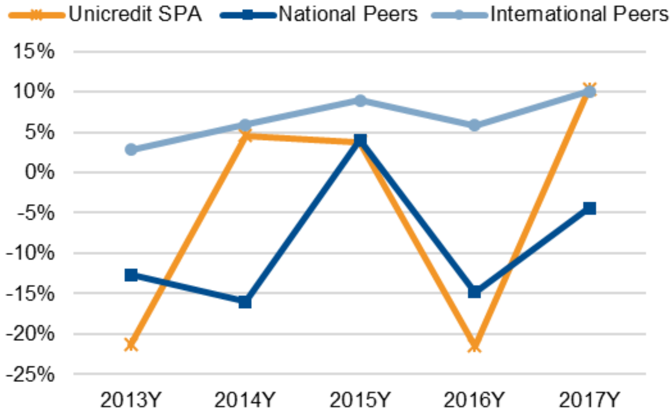
Cost of risk (LLC % average loans)



Common equity tier 1 ratio (transitional) (%)



Return on average equity (%)



Source: SNL Financial, Scope Ratings
*Italian peers: Unicredit, Intesa, Banca Monte dei Paschi Siena, Banco Popolare, UBI
**Cross-border peers: Santander, BBVA, Unicredit, Erste Bank, Nordea, KBC Group, ING

II. Appendix: Selected Financial Information – Unicredit Group

	2014Y	2015Y	2016Y	2017Y	2018H1
Balance sheet summary (EUR m)					
Assets					
Cash and interbank assets	78,379	89,332	90,543	138,654	96,633
Total securities	233,815	224,998	224,572	221,605	198,990
of which, derivatives	76,322	56,052	53,099	40,445	41,363
Net loans to customers	480,393	457,063	455,226	441,970	488,656
Other assets	51,630	89,040	89,192	34,561	39,629
Total assets	**844,217**	**860,433**	**859,533**	**836,790**	**823,908**
Liabilities					
Interbank liabilities	106,359	111,066	105,226	125,241	132,119
Senior debt	138,697	122,514	109,492	96,053	NA
Derivatives	77,088	57,059	53,111	38,589	38,957
Deposits from customers	418,861	434,379	468,879	477,563	470,834
Subordinated debt	18,572	18,286	15,262	12,699	NA
Other liabilities	NA	NA	NA	NA	NA
Total liabilities	**791,382**	**806,948**	**816,344**	**776,565**	**767,610**
Ordinary equity	47,501	48,198	36,952	54,721	50,852
Equity hybrids	1,888	1,888	2,383	4,610	4,610
Minority interests	3,446	3,399	3,853	894	837
Total liabilities and equity	**844,217**	**860,433**	**859,533**	**836,790**	**823,908**
Core tier 1/Common equity tier 1 capital	41,998	41,375	31,537	48,880	45,330
Income statement summary (EUR m)					
Net interest income	12,062	10,664	10,307	10,298	5,312
Net fee & commission income	7,506	5,488	5,585	6,392	3,528
Net trading income	1,350	1,282	1,486	1,141	531
Other income	2,671	2,204	1,645	2,026	1,336
Operating income	**23,589**	**19,638**	**19,023**	**19,857**	**10,707**
Operating expense	15,305	15,129	15,152	13,403	6,856
Pre-provision income	**8,284**	**4,510**	**3,872**	**6,454**	**3,851**
Credit and other financial impairments	4,520	4,019	4,691	2,413	1,070
Other impairments	84	NA	660	125	NA
Non-recurring items	0	NA	10,486	217	58
Pre-tax profit	**3,679**	**491**	**-11,245**	**3,700**	**2,719**
Discontinued operations	-124	1,377	630	2,682	14
Other after-tax Items	0	0	0	0	0
Income tax expense	1,167	-178	712	596	485
Net profit attributable to minority interests	380	352	464	313	111
Net profit attributable to parent	**2,008**	**1,694**	**-11,790**	**5,473**	**2,136**

Source: SNL Financial

III. Appendix: Selected Financial Information – Unicredit Group

	2014Y	2015Y	2016Y	2017Y	2018H1
Funding and liquidity					
Net loans/deposits (%)	114.7%	106.1%	98.3%	94.8%	104.4%
Liquidity coverage ratio (%)	NA	NA	132.0%	165.7%	179.2%
Net stable funding ratio (%)	NA	NA	NA	NA	NA
Asset mix, quality and growth					
Net loans/assets (%)	56.9%	53.1%	53.0%	52.8%	59.3%
NPLs/net loans (%)	17.9%	17.5%	12.7%	11.0%	8.9%
Loan-loss reserves/NPLs (%)	54.3%	53.8%	59.5%	60.5%	66.8%
Net loan growth (%)	-2.1%	-4.9%	-0.4%	-2.9%	21.1%
NPLs/tangible equity and reserves (%)	90.7%	84.9%	76.6%	56.2%	52.3%
Asset growth (%)	2.2%	1.9%	-0.1%	-2.6%	-3.1%
Earnings and profitability					
Net interest margin (%)	1.5%	1.3%	1.3%	1.3%	1.3%
Net interest income/average RWAs (%)	3.0%	2.6%	2.6%	2.8%	3.0%
Net interest income/operating income (%)	51.1%	54.3%	54.2%	51.9%	49.6%
Net fees & commissions/operating income (%)	31.8%	27.9%	29.4%	32.2%	33.0%
Cost/income ratio (%)	64.9%	77.0%	79.6%	67.5%	64.0%
Operating expenses/average RWAs (%)	3.8%	3.7%	3.9%	3.7%	3.9%
Pre-impairment operating profit/average RWAs (%)	2.1%	1.1%	1.0%	1.8%	2.2%
Impairment on financial assets /pre-impairment income (%)	54.6%	89.1%	121.1%	37.4%	27.8%
Loan-loss provision charges/net loans (%)	0.9%	0.9%	0.8%	0.5%	0.5%
Pre-tax profit/average RWAs (%)	0.9%	0.1%	-2.9%	1.0%	1.5%
Return on average assets (%)	0.3%	0.2%	-1.3%	0.7%	0.5%
Return on average RWAs (%)	0.6%	0.5%	-2.9%	1.6%	1.3%
Return on average equity (%)	4.6%	3.8%	-21.5%	10.4%	7.7%
Capital and risk protection					
Common equity tier 1 ratio (%, fully loaded)	10.0%	10.9%	7.5%	13.6%	12.5%
Common equity tier 1 ratio (%, transitional)	10.3%	10.6%	8.1%	13.7%	12.6%
Tier 1 capital ratio (%, transitional)	11.1%	11.5%	9.0%	15.4%	14.1%
Total capital ratio (%, transitional)	13.4%	14.2%	11.7%	18.1%	16.4%
Leverage ratio (%)	4.5%	4.4%	3.2%	5.6%	5.2%
Asset risk intensity (RWAs/total assets, %)	48.5%	45.4%	45.0%	42.6%	43.8%
Market indicators					
Price/book (x)	0.7x	0.7x	0.5x	0.7x	0.7x
Price/tangible book (x)	0.4x	0.4x	NA	0.1x	NA
Dividend payout ratio (%)	35.3%	44.2%	NA	11.5%	NA

Source: SNL Financial

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