Intesa Sanpaolo SpA Issuer Rating Report

SCOPE | A | Negative

Overview

Scope Ratings has assigned an Issuer Rating of A, with negative outlook to Intesa Sanpaolo 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 process.

Highlights

- The ratings are driven by Intesa's strong capital position and resilient profitability despite the challenging operating environment in Italy, where 81% of the loan portfolio is based. The group has been the leading retail and commercial bank in Italy since the merger of Intesa BCI and San Paolo IMI in 2007. Group earnings and asset quality have suffered from the weak domestic economic environment in the past, but pre-provision profitability has been resilient, and the group has remained profitable if we exclude large write-downs of goodwill in 2011 and 2013.
- Although it has operations in Central and Eastern Europe, Intesa's primarily domestic-based operations, combined with significant holdings in Italian sovereign debt, mean it is particularly exposed to market confidence in Italian banks and Italy in general.

Rating drivers (summary)

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

- Largest retail and commercial bank in Italy which remained profitable during the crisis
- A balanced revenue model, with significant fee-generating activities supporting profitability
- Challenged but improving asset quality
- Strong capital position and good capital generation potential going forward
- Decreasing but still material sovereign risk exposure remains a concern

Ratings & Outlook

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

Lead Analyst

Marco Troiano, CFA
m.troiano@scoperatings.com

Associate Analyst

Hannes Merlecker
h.merlecker@scoperatings.com

Team Leader

Sam Theodore
s.theodore@scoperatings.com

Scope Ratings GmbH

Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 203-457 0 4444

Headquarters

Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

Bloomberg: SCOP

Rating change drivers

Further progress in the workout of non-performing loans. The decline in non-performing exposure (NPE) formation in recent quarters, was coupled with a decline in NPEs in absolute numbers (both in gross and net terms) and an increase in coverage. We believe that the reversal in asset quality trends is partly due to the more favorable macro environment but also to a sharper focus on the management of NPEs at Intesa. The recently presented 2018-2021 business plan included a commitment to significant further debt recovery by means of a proactive credit portfolio management, the carve-out of its internal recovery platform, a new early delinquency detection tool for retail exposures and more openness towards portfolio sales.

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)

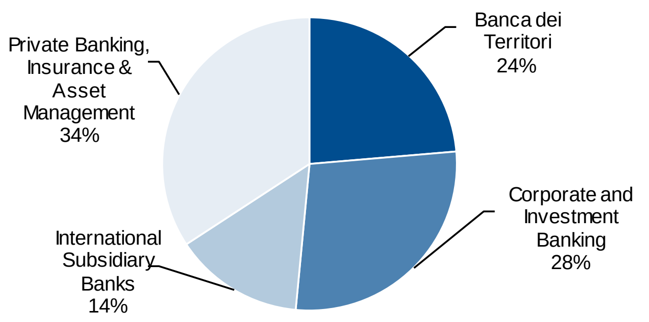
Largest retail and commercial bank in Italy which remained profitable during the crisis

Two large banks dominate the Italian banking landscape, with the residual market share split between a multitude of mid and smaller-tier players. Intesa is the leading retail and commercial bank in Italy with approximately 4700 branches in the country. Formed in 2007 through the merger of Gruppo Intesa BCI and Gruppo Sanpaolo IMI, Intesa is represented throughout the country and has a particularly strong footprint in the wealthiest regions of northern Italy. The group holds the number one position in loans (market share 18%), deposits (18%), pension funds (22%), life premiums (20%), factoring (29%) and asset management (20%).

Half of the group's operating revenues are derived from Banca dei Territori (domestic commercial banking) which offers traditional lending and deposit collection operations in Italy, servicing households, small businesses, SMEs, and Italian mid-size corporations with a turnover of up to EUR 350m, and distributing the group's asset management, insurance and private banking products. In terms of profits, however, Banca dei Territori only accounts for 24% of the group. The Private Banking, Insurance and Asset Management divisions account for 34% of group profit, excluding distribution fees. The other main contributor to profit is corporate and investment banking, which serves large corporate clients and financial institutions as well as public finance entities. In terms of international operations, the group is present in 10 countries, primarily in Central and Eastern Europe as well as in Egypt, with approximately 1,000 branches. The largest international operations are in Slovakia, Croatia and Hungary. As of year-end 2017, international subsidiary banks accounted for 11% of operating income and 7% of the total loan portfolio. Intesa's foreign presence, while material, does not contribute to significant revenue and asset diversification from the Italian market.

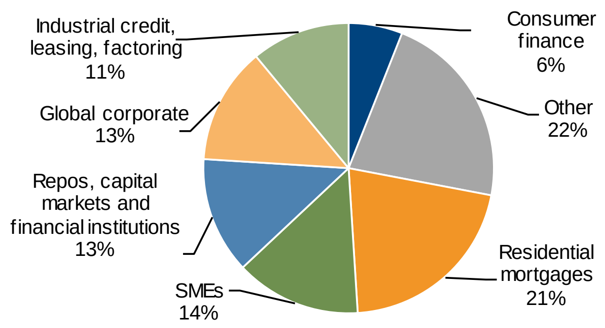
With 81% of total loans in Italy, Intesa Sanpaolo is heavily dependent on the performance of the Italian economy. The loan book is diverse (Figure 2) within its main segments: residential mortgages (22%, with an average loan-to-value ratio of 56% at year-end 2017); SMEs (14%); and repos, capital markets and financial institutions (13%). The group's loan exposure to non-financial companies is well-diversified by sector, with no single sector accounting for more than 6% of the total. The largest sectors are: services (5.8% of total loan portfolio), distribution (5.7%) and real estate (3.7%).

Figure 1: Net profit by division (2017)



Note: excluding Corporate Centre
Source: Company data, Scope Ratings

Figure 2: Loan book composition (2017)

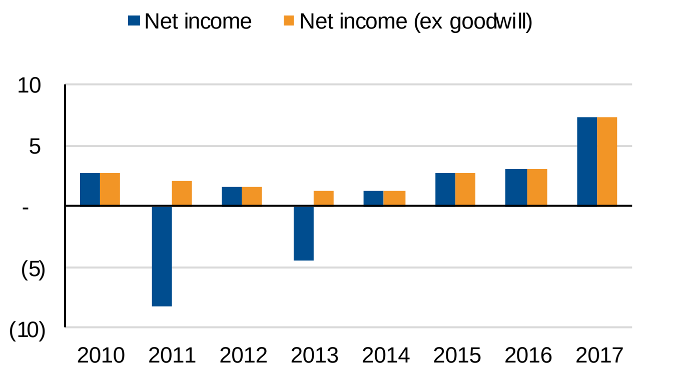


Source: Company data, Scope Ratings

Despite the difficult operating environment in its domestic market, Intesa has remained largely profitable at the operating level, and in 2017 posted its highest level of net on record. Indeed, while it has posted net statutory losses in 2011 and 2013 due to large write-downs of goodwill, operating performance has remained satisfactory, with pre-provision income able to absorb significant provisions, especially in 2013 (see Figure 4). The strong fee generating business, in particular strong net inflows in asset management since 2013, have kept profit in line with the preset objectives and successful execution of the expiring business plan.

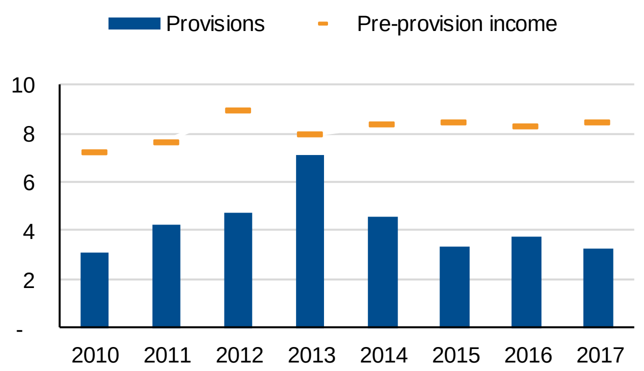
In February 2018 Intesa presented a new business plan for the 2018-2021 period. Cost cutting remains a central element in the business plan with a very ambitious target of reducing the cost/income ratio from a current 53% to 45%. Measures include the closure of 1,100 branches and cutting of the workforce from 97,400 to 90,800 employees, the rationalisation of the real estate portfolio, the reduction of legal entities, and tight control over administrative costs.

Figure 3: Intesa's losses were entirely driven by goodwill impairments (EUR bn)



Source: Company data, Scope Ratings.

Figure 4: Pre-provision profitability has been enough to absorb rising credit provisions (EUR bn)



Source: Company data, Scope Ratings.

A balanced revenue model, with significant fee-generating activities supporting profitability

In our view, one key aspect supporting Intesa's revenue-generating potential is the diversification of its revenue sources. According to our calculations, fee income in 2017 amounted to 45% of total group revenues, a percentage higher than that of Intesa's domestic and international peers. In an operating environment in which interest revenues have been and remain under pressure from slow volumes, low policy rates and low yields on securities, we consider the flexibility to generate alternative income from non-banking activities an important competitive advantage.

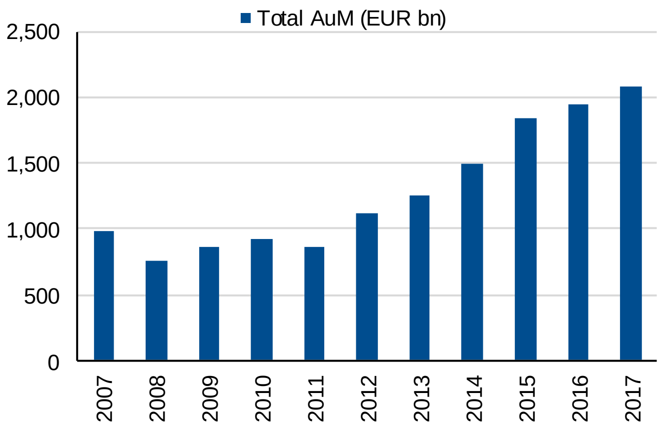
In particular, we highlight the strong performance of Intesa's asset management division Eurizon, but also of the private bank Fideuram, with net inflows of EUR 93bn since 2013, and the insurance business, contributing 11% of gross income.

Going forward, we expect these divisions to continue to drive revenue growth at Intesa. Industry data shows that the Italian asset management industry has been performing very strongly in recent years (Figure 5).

In our view, two important drivers for such solid performance remain in place:

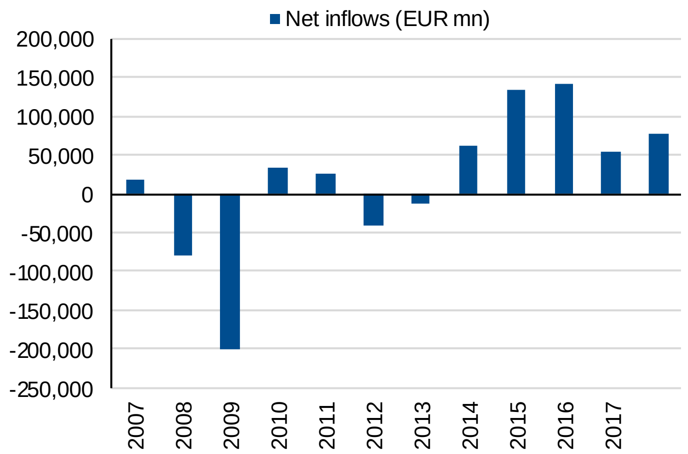
1. Savers' demand for higher returns while central bank policies keep yields low;
2. Banks' lower need for balance sheet customer funds, as limited volume growth coupled with advantageous funding allows them to focus distribution networks on higher margin products.

Figure 5: System assets under management are growing



Source: Assogestioni, Scope Ratings.

Figure 6: Net Inflows into mutual funds



Source: Assogestioni, Scope Ratings.

In our view, Intesa is well positioned to continue to capture the growth in the Italian asset management, supporting revenues going forward. Future revenue growth in asset management may also arise from new Wealth Management opportunities in China. With its subsidiary Yi Tsai (100% owned) and joint ventures Penghua (49% owned – EUR 75bn under management) and Bank of Qingdao (15% owned), Intesa has established another growth option in emerging markets.

In the new 2017-2021 business plan period, Intesa is targeting a 4% average annual growth in revenues, assuming moderate growth in Italian GDP and market rates still at zero in 2021. Revenue growth would mostly be fuelled by loan volume dynamics (in mortgages, personal loans, SMEs and the international division) and by fees, expected to expand at a 5.5% CAGR.

Challenged but improving asset quality

The Italian economy has been in recession since 2014 but has been growing in recent years and we expect it to continue to expand. As a result of the recession, the group's gross NPE ratio reached a peak of 17.2% in September 2015 before starting to decline, reflecting the improved operating conditions in Italy. As of December 2017, and including the provisions for IFRS 9, the group's gross NPE ratio stood at 11.9%, with coverage of 56.8%. The net NPE ratio stood at 5.5%. The group has successfully executed the accelerated deleveraging of about EUR 13bn in NPEs since September 2015. The new 2018-2021 business plan envisages a further reduction in the NPE stock and a material derisking of the balance sheet, supported by the more favourable macro environment.

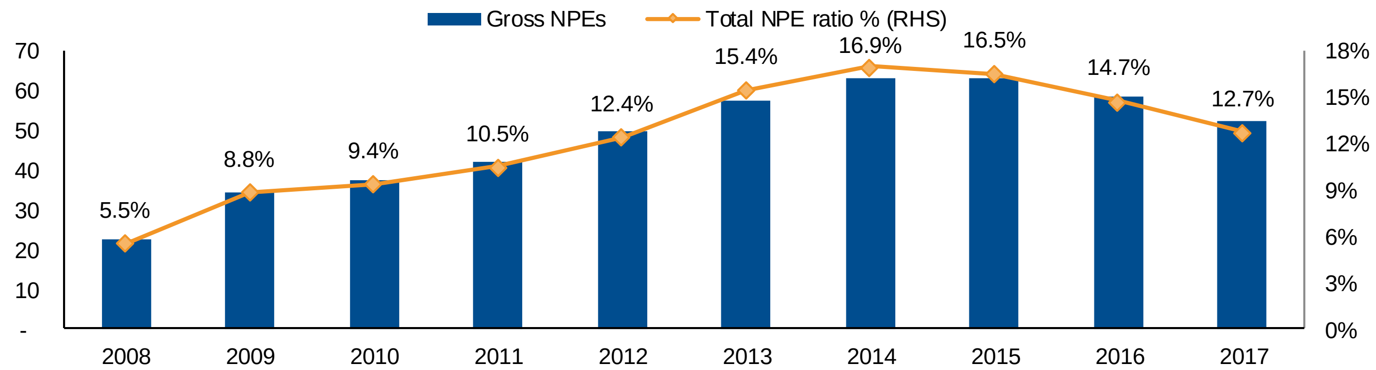
Key targets include:

- A decline in gross NPEs from EUR 52.1bn to EUR 26.4bn in 2021, i.e. from 11.9% to 6% of gross loans;
- A net NPE ratio of 2.9% in 2021;
- A fall in loan loss provisions to EUR 1.8bn by 2021 (EUR 3.3bn in 2017), with the cost of risk halving from the current 81 bps to 41 bps.

Key tools for achieving derisking include the carve-out of Intesa's recovery platform and the potential search for an industrial partner, portfolio sales, the creation of Pulse, a new early warning system for delinquencies in retail loans, and a generally more proactive approach to borrower credit quality management.

In our view, the objectives are realistic and achievable in the current environment.

Figure 7: Gross NPEs (EUR bn, LHS) and NPE ratio (%, RHS)



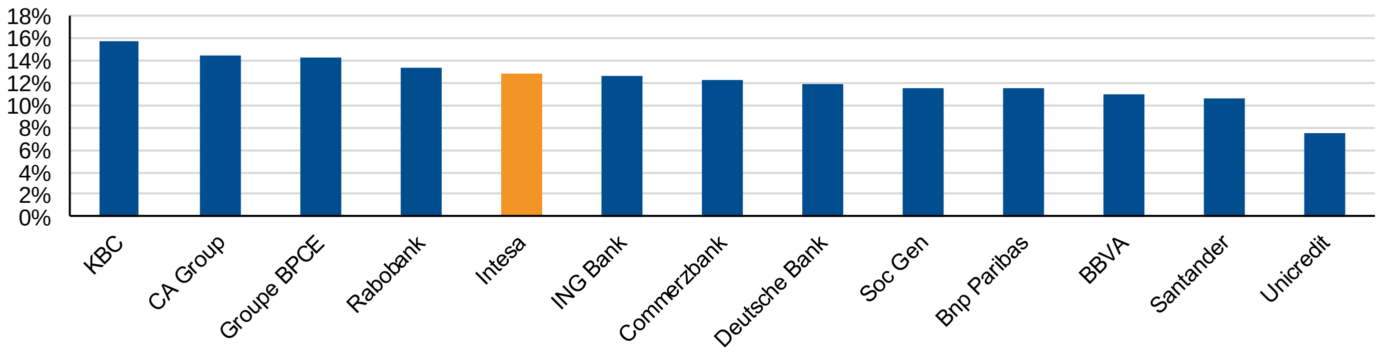
Source: Company data, Scope Ratings.
Note: Impaired loans = sofferenze + past due, Data excludes the contribution of the former Venetian banks

Strong capital position and good capital generation potential going forward

Despite the weak operating environment, Intesa has significantly improved its capital position in recent years.

As of December 2017, the group's CRD IV fully loaded CET1 ratio was 13.0%[1], at the high end of Eurozone banks (see Figure 8). On a transitional basis, the CET1 ratio stood at 13.3%. Moreover, Intesa's high profitability coupled with limited RWA growth means that the bank generates capital organically.

Figure 8: CRD IV fully loaded CET1 ratio, selected eurozone banks (2017)



Source: Company data, Scope Ratings

In terms of leverage ratio, Intesa is one of the strongest large banks in Europe. The reported fully loaded leverage ratio in December 2017 was 6.1%.

Decreasing but still material sovereign risk exposure remains a concern

As discussed in our sovereign outlook report on Italy, we consider Italy to have a low-to-medium sovereign credit strength among the large European economies. Italy maintains a high debt position and suffers from an elevated degree of political uncertainty when compared to other Eurozone countries.

In recent years, Italy has succeeded in bringing its public deficit under control (2.3% of GDP in 2016, down from 5.3% of GDP in 2009[2]) despite the decline in GDP in the recessionary period. This was mainly achieved through the introduction of new taxes, but

[1] After IFRS9 FTA impact
[2] Source: European Commission 2017 winter forecast, Eurostat

also via measures to contain public spending, including a freeze on public sector wages and a reform of the pension system.

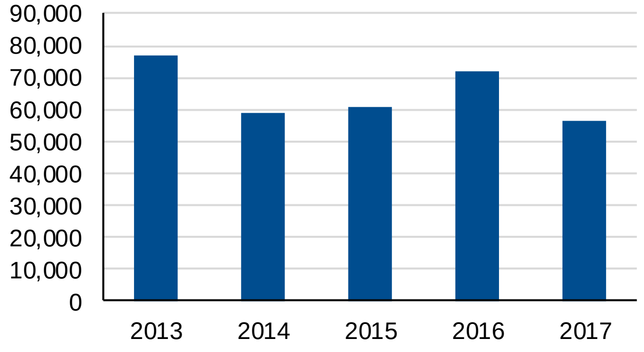
As the largest Italian bank, Intesa's exposure to Italian sovereign risk is material. As a result, the group is vulnerable to negative investor sentiment regarding the Italian sovereign.

In December 2017, Intesa's total exposure to Italian sovereign risk decreased to approx. EUR 40bn, including EUR 13bn of loans and EUR 27bn of debt securities, compared to approx. EUR 50bn at YE 2016 and over EUR 60bn at the end of 2014. Despite having fallen, this amount still represents an important concentrated exposure, close to 105% of group transitional CET1 capital.

We also note that over the past few quarters, the group has diversified its sovereign bond portfolio, adding exposures to several EU countries, especially Germany, France and Spain.

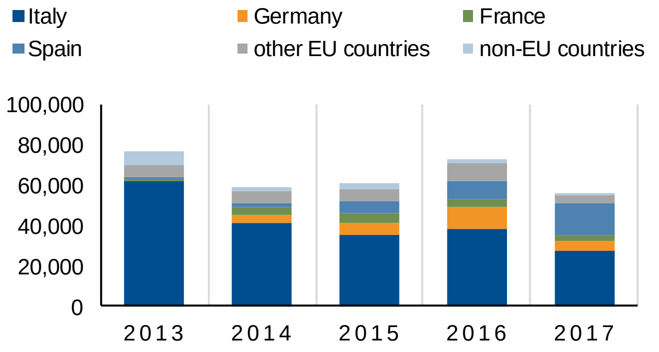
In 2013, Italian government bonds accounted for approx. 80% of the total sovereign bond portfolio, a portion that declined to around 40% in 2017. We have a favourable view of this trend, also in light of the ongoing regulatory and market debate around the capital absorption (or lack of thereof) of sovereign exposures and the potential for concentration limits.

Figure 9 Total Sovereign bond portfolio (EUR m)*



Source: Company data
*Banking business

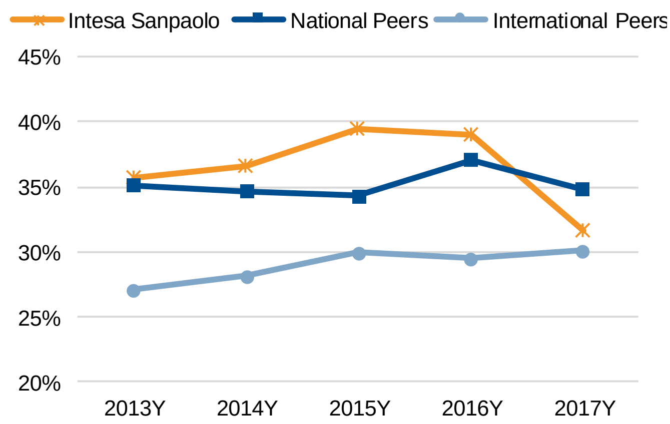
Figure 10: Sovereign bond portfolio composition (EUR m)*



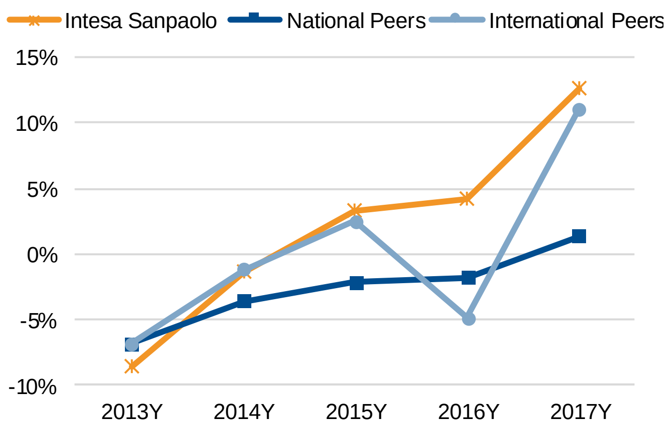
Source: Company data
*Banking business

I. Appendix: Peer comparison

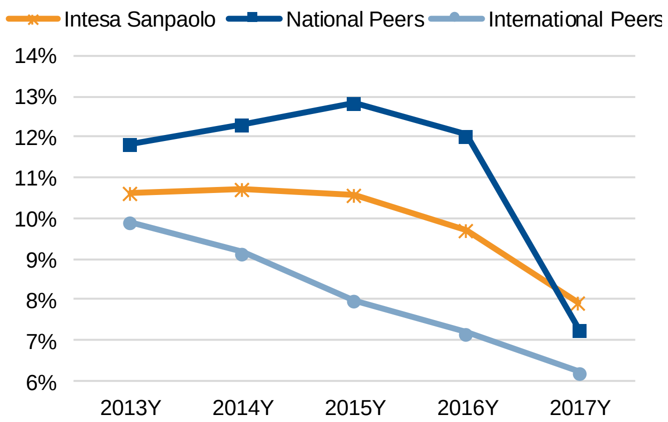
Fees & commissions % revenues



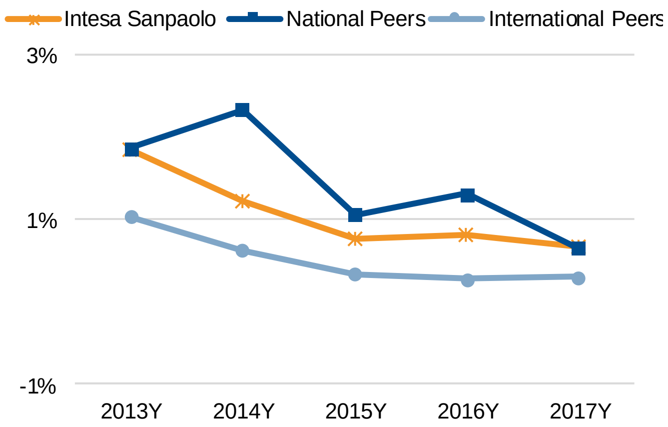
Net loan growth (%)



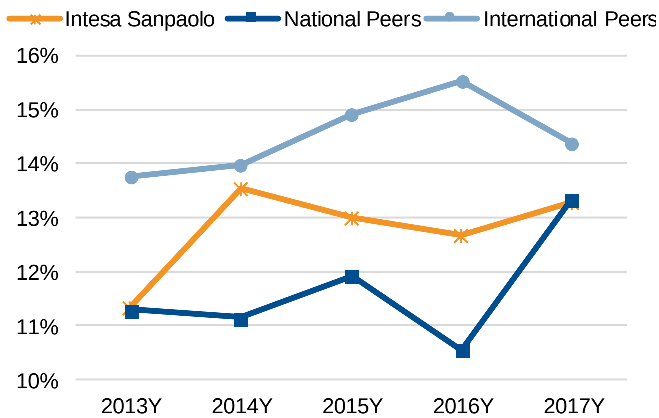
Impaired loans % gross loans (%)



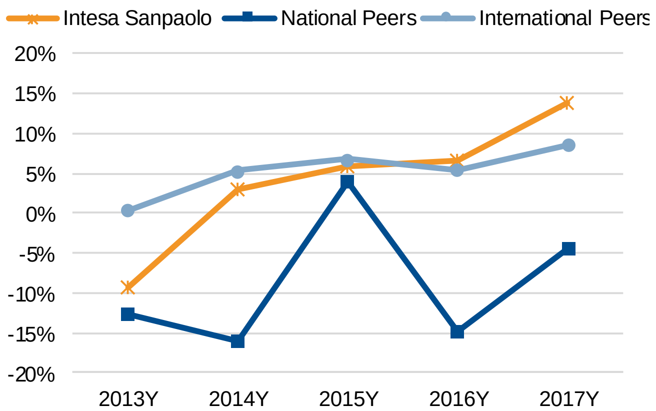
Cost of risk (LLC % gross loans)



Common equity tier 1 ratio (transitional) (%)



Return on average equity (%)



Source: SNL, Scope Ratings
National peers: Intesa, Unicredit, Monte dei Paschi di Siena, Banco BPM, UBI
International peers: Intesa, Caixa Bank,Commerzbank, Credit Agricole, KBC, Unicredit Bank, Unicredit Bank Austria

II. Appendix: Selected Financial Information – Intesa Sanpaolo SpA

	2014Y	2015Y	2016Y	2017Y	2018H1
Balance sheet summary (EUR m)					
Assets					
Cash and interbank assets	36,981	43,024	60,982	NA	77,205
Total securities	232,321	244,502	261,642	104,658	108,030
of which, derivatives	45,998	38,063	36,775	NA	NA
Net loans to customers	339,104	350,031	364,712	411,978	410,937
Other assets	38,021	38,939	37,764	NA	197,546
Total assets	**646,427**	**676,496**	**725,100**	**797,292**	**793,718**
Liabilities					
Interbank liabilities	53,443	62,497	76,782	99,992	97,675
Senior debt	112,629	100,620	84,845	NA	NA
Derivatives	51,321	43,994	45,309	NA	NA
Deposits from customers	230,927	255,739	291,834	NA	337,314
Subordinated debt	15,753	14,585	15,066	NA	NA
Other liabilities	NA	NA	NA	NA	NA
Total liabilities	**601,365**	**627,903**	**675,781**	**740,538**	**742,491**
Ordinary equity	44,683	46,899	46,794	52,102	46,760
Equity hybrids	0	877	2,117	4,103	4,103
Minority interests	379	817	408	549	364
Total liabilities and equity	**646,427**	**676,496**	**725,100**	**797,292**	**793,718**
Core tier 1/Common equity tier 1 capital	36,547	36,908	35,926	38,051	36,012
Income statement summary (EUR m)					
Net interest income	9,815	9,238	8,615	NA	3,728
Net fee & commission income	6,477	6,895	6,735	NA	3,826
Net trading income	2,107	2,399	2,534	NA	953
Other income	-699	-1,066	-644	NA	1,251
Operating income	**17,700**	**17,466**	**17,240**	**NA**	**9,758**
Operating expense	10,393	10,876	10,655	NA	5,470
Pre-provision income	**7,307**	**6,590**	**6,585**	**NA**	**4,288**
Credit and other financial impairments	4,329	2,824	3,288	NA	1,176
Other impairments	NA	NA	22	NA	NA
Non-recurring items	116	NA	318	NA	0
Pre-tax profit	**2,961**	**4,077**	**3,216**	**NA**	**3,112**
Discontinued operations	0	60	987	NA	0
Other after-tax Items	0	0	0	NA	0
Income tax expense	1,651	1,331	1,003	NA	916
Net profit attributable to minority interests	59	67	89	42	17
Net profit attributable to parent	**1,251**	**2,739**	**3,111**	**7,316**	**2,179**

Source: SNL

III. Appendix: Selected Financial Information – Intesa Sanpaolo SpA

	2014Y	2015Y	2016Y	2017Y	2018H1
Funding and liquidity					
Net loans/deposits (%)	147.0%	137.1%	125.0%	NA	121.8%
Liquidity coverage ratio (%)	NA	NA	NA	175.7%	170.7%
Net stable funding ratio (%)	NA	NA	NA	NA	NA
Asset mix, quality and growth					
Net loans/assets (%)	52.5%	51.7%	50.3%	51.7%	51.8%
NPLs/net loans (%)	18.5%	18.0%	15.9%	12.6%	9.6%
Loan-loss reserves/NPLs (%)	50.7%	50.8%	51.6%	NA	NA
Net loan growth (%)	-1.4%	3.2%	4.2%	13.0%	-0.5%
NPLs/tangible equity and reserves (%)	90.2%	85.9%	80.8%	NA	NA
Asset growth (%)	3.6%	4.7%	7.2%	10.0%	-0.9%
Earnings and profitability					
Net interest margin (%)	1.6%	1.5%	1.3%	NA	NA
Net interest income/average RWAs (%)	3.6%	3.3%	3.0%	NA	2.6%
Net interest income/operating income (%)	55.5%	52.9%	50.0%	NA	38.2%
Net fees & commissions/operating income (%)	36.6%	39.5%	39.1%	NA	39.2%
Cost/income ratio (%)	58.7%	62.3%	61.8%	NA	56.1%
Operating expenses/average RWAs (%)	3.8%	3.9%	3.7%	NA	3.9%
Pre-impairment operating profit/average RWAs (%)	2.7%	2.4%	2.3%	NA	3.0%
Impairment on financial assets /pre-impairment income (%)	59.2%	42.9%	49.9%	NA	27.4%
Loan-loss provision charges/net loans (%)	1.2%	0.8%	0.8%	NA	0.6%
Pre-tax profit/average RWAs (%)	1.1%	1.5%	1.1%	NA	2.2%
Return on average assets (%)	0.2%	0.4%	0.5%	0.9%	0.6%
Return on average RWAs (%)	0.5%	1.0%	1.1%	2.5%	1.5%
Return on average equity (%)	2.9%	6.0%	6.5%	13.8%	8.1%
Capital and risk protection					
Common equity tier 1 ratio (%, fully loaded)	13.3%	12.5%	12.9%	14.0%	11.7%
Common equity tier 1 ratio (%, transitional)	13.5%	13.0%	12.7%	13.3%	12.8%
Tier 1 capital ratio (%, transitional)	14.2%	13.8%	13.9%	15.2%	14.6%
Total capital ratio (%, transitional)	17.2%	16.6%	17.0%	17.9%	17.1%
Leverage ratio (%)	7.1%	6.4%	6.0%	6.1%	5.6%
Asset risk intensity (RWAs/total assets, %)	41.7%	42.0%	39.2%	36.0%	35.6%
Market indicators					
Price/book (x)	1.1x	1.3x	1.0x	NA	1.1x
Price/tangible book (x)	0.9x	0.9x	0.5x	0.2x	NA
Dividend payout ratio (%)	87.5%	87.5%	54.4%	17.4%	NA

Source: SNL

Scope Ratings GmbH

Headquarters Berlin

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main

Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389-0

Paris

1 Cour du Havre
F-75009 Paris

Phone +33 1 8288 5557

London

Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 203-457 0 4444

Madrid

Paseo de la Castellana 95
Edificio Torre Europa
E-28046 Madrid

Phone +34 914 186 973

Milan

Via Paleocapa 7
IT-20121 Milan

Phone +39 02 30315 814

Oslo

Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com

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