26 July 2019 Financial Institutions

UniCredit S.p.A.
Issuer Rating Report

SCOPE | A | STABLE

Overview

Scope Ratings has assigned an issuer rating of A, with Stable Outlook to UniCredit SpA. The rating was last affirmed on 12 July 2019, when the Outlook was changed to Stable from 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

- UniCredit's ratings are driven by its well positioned retail and commercial banking franchise in Italy, Germany, Austria, several East European countries, as well as Russia and Turkey.
- The extensive 'Transform 2019' restructuring programme has been largely executed. Indeed, UniCredit is well ahead of its business plan in many aspects, especially in terms of non-performing-loan and cost reduction. The weak economic environment in Italy has weighed heavily on asset quality in the last decade, but the group has over the past two years tackled its asset quality decisively, and de-risking is running ahead of original targets.
- The bank's capital position is satisfactory and in line with management targets, though the capital build-up in recent years has been supported by rights issues and asset sales.

The ratings could be upgraded subject to further material improvements in the bank's fundamentals, including asset quality, efficiency and profitability. Conversely, a further deterioration in operating conditions in Turkey is a key downside risk. Scope also flags that an Italian exit from the euro area or sovereign debt restructuring would materially raise uncertainty, with negative implications for the ratings.

Rating drivers (summary)

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

- Well positioned retail and commercial banking franchises in several European countries
- Renewed management credibility following delivery of a realistic plan
- Satisfactory capital position, ahead of requirements and in line with management targets
- Improving asset quality, with derisking ahead of targets

Ratings & Outlook

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

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Rating-change drivers

Further material improvements in credit fundamentals. Although the Transform 2019 plan greatly enhanced credit fundamentals, there is still room for improvement. In particular, asset quality and capital ratios remain weaker than those of international peers.

Deterioration in operating conditions in Turkey and Russia. Following the sale of Pekao in Poland, UniCredit's Central and Eastern Europe (CEE) Russia and Turkey have come to represent a larger proportion of Unicredit's CEE profits (30% in 2018). Both countries present material political and economic risks.

Impacts from worsening investor sentiment on Italian sovereign debt. The Italian government has embraced a more expansionary fiscal policy stance, which has resulted in increasing frictions with European institutions. Deteriorating investor sentiment towards Italy has reverberated through credit markets. We believe this could affect the bank negatively in the medium term via higher funding costs, a more challenging environment for further non-performing exposure (NPE) sales and generally less benign market conditions.

Any indication that Italy's membership of the eurozone is at risk. While we believe that a departure from the euro remains extremely unlikely, we note that some politicians, including in governing parties, have advocated leaving in the past. A change in a currency regime is extremely difficult to implement and would pose a material risk for financial institutions who would be likely to see a serious disruption in their activities and be exposed to funding runs. Such an event could result in a multiple notch downgrade for UniCredit, as well as for other Italian banks.

Rating drivers (details)

Well positioned retail and commercial banking franchises in several European countries

UniCredit SpA is the parent company of the UniCredit group, which operates commercial banking franchises across several European countries.

Strong market position in commercial banking in Italy, Austria and Germany.

With 2466 branches in Italy, UniCredit is the second largest bank in a system composed of two large banks and several mid-tier and small banks. The bank is a key player in the provision of services, including mortgages, consumer credit, business loans, factoring and leasing.

After merging with the HVB Group in 2005, UniCredit is the third largest private bank in Germany by total assets as of YE 2018, with a particularly strong presence in Bavaria. It operates through the Commercial Banking (including retail, private banking and the Unternehmer Bank) and Corporate and Investment Banking (including Financing & Advisory, Global Transaction Banking and Markets) business segments.

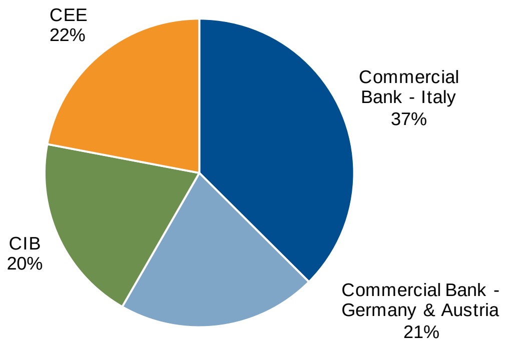
Through its subsidiary Bank Austria, UniCredit is the leading financial institution in corporate and private banking in Austria, as well as one of the largest retail banks, with a market share of 13.9% for loans as of December 2018.

Corporate and investment banking supports large corporate and institutional clients

The two banks' commercial banking activities are accounted for under the 'CB Austria' and 'CB Germany' segments, which made up 21% of the group's revenues in 2018 (Figure 1); their corporate and investment banking operations are included in the group's corporate & investment banking (CIB) division.

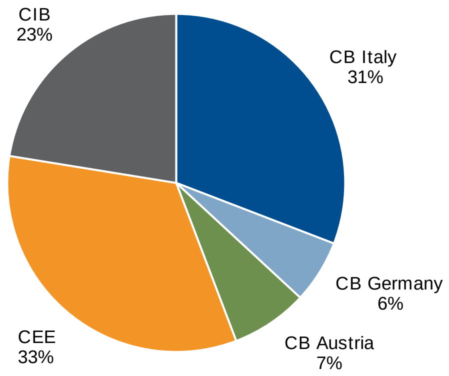
The CIB division mainly serves large corporate and multinational clients across 32 countries and has three product lines: financing and advisory (e.g. capital markets, corporate finance services), markets (market making), and global transaction banking.

Figure 1: Revenue breakdown by business, 2018



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

Figure 2: Profit before tax breakdown by business, 2018



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

Leading banking franchise in several CEE countries

UniCredit is also one of the leading banks in the CEE region in terms of total assets and profits. 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 considering the difficult operating environment in Italy in previous years. The CEE division (which includes Russia and

Turkey) remains a key investment area for UniCredit, although the group is now pursuing organic growth in the region.

Renewed management credibility following delivery of a realistic plan

The Transform 2019 strategic plan was a turning point in the bank's recent history

The latest business plan was presented by the new top management team in December 2016 and is intended to be executed by 2019. The aim of the plan was to draw a line under the financial crisis and return the bank to a reasonably clean balance sheet and a profitability level which is at least comparable with its main international peers. Indeed, for the best part of the past decade, UniCredit's successive management teams had been operating in an almost-constant state of emergency, often overpromising and underdelivering.

The 2016 strategic plan marked a clean break with the bank's recent past. The capital increase in 2017 afforded the bank the necessary resources to accelerate its asset quality clean-up and jumpstart the execution of the business plan. As of Q1 2019, strategic objectives have either been delivered or are within reach:

- Gross NPEs of EUR 37.6bn were lower than the target of EUR 37.9 bn (revised down from EUR 44.3bn)
- Cost of risk of 40 bps, lower than the 55 bps target (recasted from 49bps due to accounting changes)
- Cost income ratio at 52.8% vs a target of 52-53% (revised from >52% following downgrade of revenue targets in 2018)
- CET1 ratio of 12.25% vs a target of 12%-12.5% (revised down from >12.5%)
- Adjusted return on tangible equity of 9.4% vs a target of 9%

New business plan will be presented in December 2019

Having finally drawn a line under the crisis legacy, we believe UniCredit will have more leeway in the coming years to focus on profit growth.

The group will present a new strategic plan for the 2020-2023 period in December 2019.

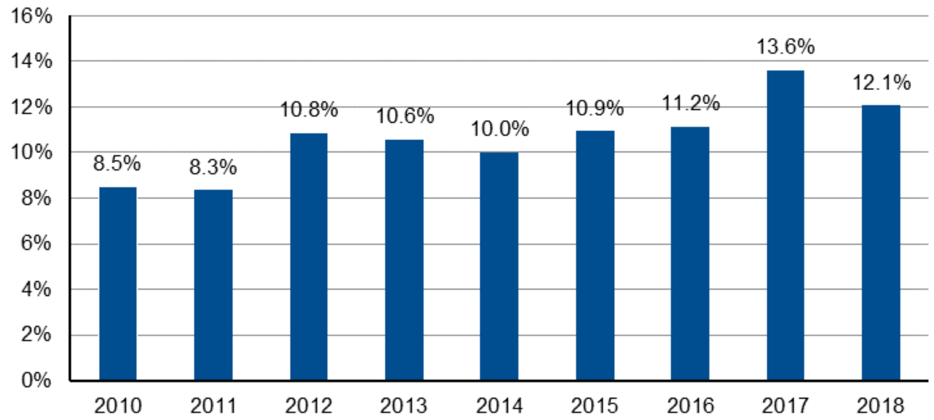
Satisfactory capital position, ahead of requirements and in line with management targets

UniCredit's fully loaded CET1 ratio stood at 12.25% as of March 2019, ahead of its SREP requirement of 10.07%, and within reach of its 2019 target. The group's leverage ratio was 4.96% on a fully loaded basis.

The improvement in group's capital position has been supported by asset sales and rights issues

Over the past few years, the group has materially strengthened its capital position, as shown in Figure 3. 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 sales of Pekao in Poland and the asset management business Pioneer, which helped bolster capital. In 2019, the group sold its remaining 35% stake in Fineco.

Figure 3: Core capital ratio, historical evolution



Source: Company data, SNL Financial, Scope Ratings
Note: Basel 2.5 from 2011, CRD4 transitional since 2014

As of 2018 YE, UniCredit's funding consisted mainly of current accounts (EUR 350bn) and time deposits (EUR 63bn), deposits from banks (EUR 128bn including EUR 51.2bn of TLTRO), and bonds (of which EUR 82bn were senior and EUR 10bn subordinated).

UniCredit complies with all capital and liquidity requirements

The group complied with regulatory funding and liquidity requirements at the end of 2018. The net stable funding ratio was above 100% and the liquidity coverage ratio stood at 151%.

The only Italian bank subject to TLAC requirements, UniCredit has been active in the issuance of senior non-preferred unsecured debt securities. At the end of March 2019, it reported a subordinated TLAC ratio of 18.41%, a buffer of 134 bps to its TLAC subordination requirement of 17.1%.

The group is well on track to complete its 2019 TLAC funding plan of EUR 9bn, with EUR 7.7bn already issued at the end of June 2019.

Improving asset quality, with derisking ahead of targets

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 recent years.

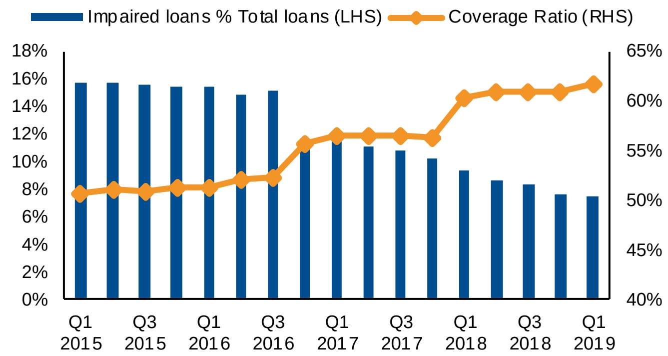
Asset quality started to improve in 2015

From 2015, the stock of NPE loans (comprising 'bad loans', 'unlikely to pay' and 'past due' loans) started to decline slowly. 2017 marked a turning point for asset quality: UniCredit announced a large capital increase, a material top up to NPE provisions and the sale of a EUR 17bn portfolio of NPEs, named project FINO. Aside from FINO, UniCredit continued to reduce its NPE stock in 2018 and 2019, both organically and through sales. Total NPEs have dropped from a peak of EUR 84.4bn in December 2014 to EUR 37.6bn as of March 2019 – faster than originally planned.

UniCredit's asset quality metrics compare well with Italian peers

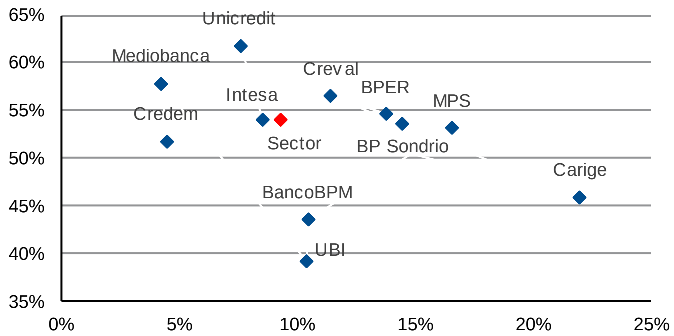
Moreover, the 2017 capital increase and the new round of provisions taken in Q4 2017 place UniCredit firmly at the top of its Italian peers in terms of coverage ratios. The gross NPE ratio stood at 7.6% at the end of Q1 2019. We think that UniCredit's asset quality will continue to improve in the coming years, albeit at a slower pace.

Figure 4: Group NPE and coverage ratio, historical



Source: SNL Financial, Scope Ratings

Figure 5: NPE (X) and coverage (Y) ratios, Italian banks

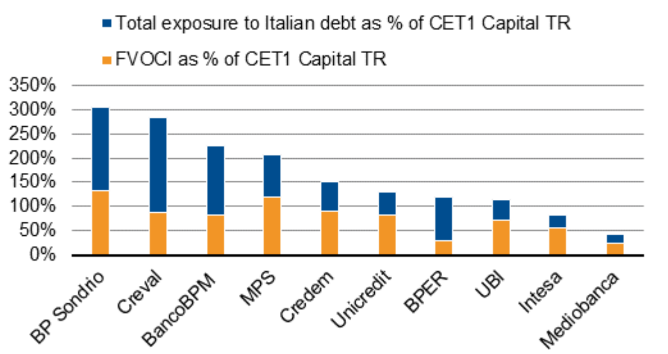


Source: Company data, Scope Ratings
Note: all the banks' data are as of Q1 2019, except for Carige's (Q4 2018)

Large concentrated exposure to Italian sovereign debt can be a source of risk

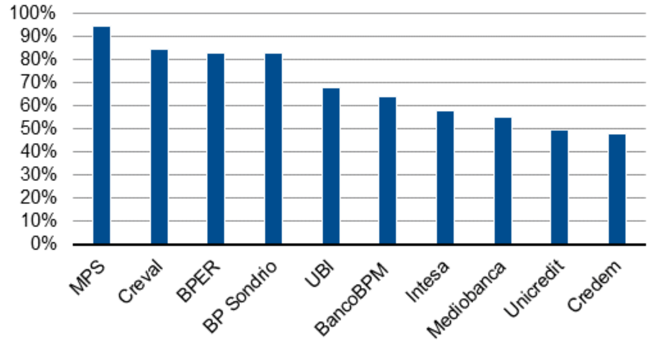
Like other Italian banks, UniCredit has a large, concentrated exposure to Italian sovereign risk. At the end of 2018, this stood at EUR 58.1bn, (comprising EUR 36.8bn in bonds accounted at FVOCI and EUR 18.4bn held at amortised cost), equivalent to 130% of CRD IV transitional common equity tier 1 capital. Italian government debt can be volatile, and proved a drag on Unicredit's capital build in 2018 when the BTP/Bund spread widened following the formation of a new governemnt and tensions over budget negotiations. Positively, we note that Unicredit's sovereign bond portfolio is more diversified than that of other Italian banks, with Italy accounting for just under 50% of the total. This has been the case for some time, reflecting the diversified nature of the group, which has material exposure to Austrian and German government debt.

Figure 4: Total exposure to Italian debt as % of transitional CET1 (2018)



Source: Company data SNL, Scope Ratings

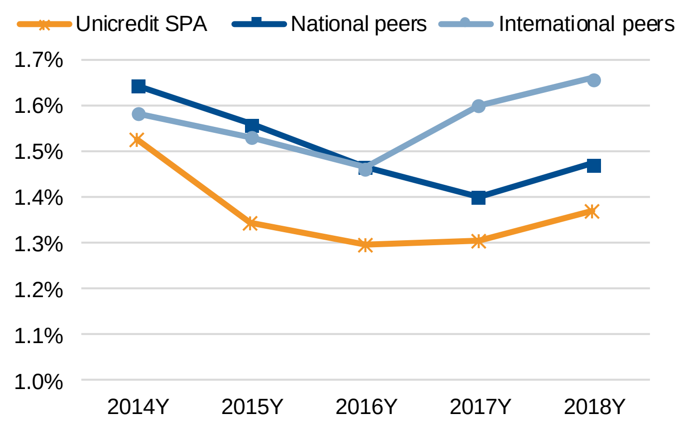
Figure 5: Italy as % of total sovereign exposure, Italian banks (2018)



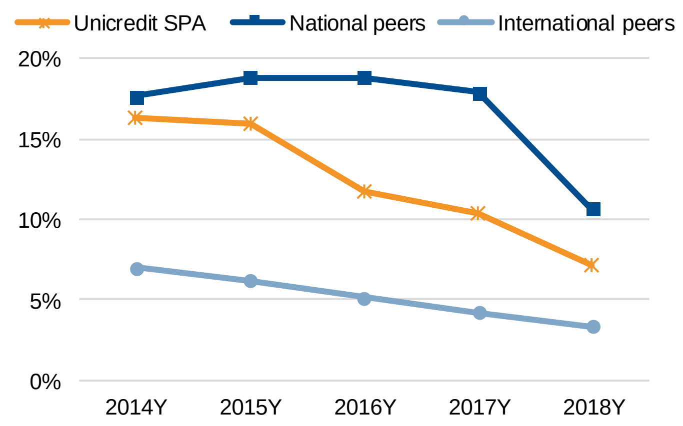
Source: Company data, Scope Ratings)

I. Appendix: Peer comparison

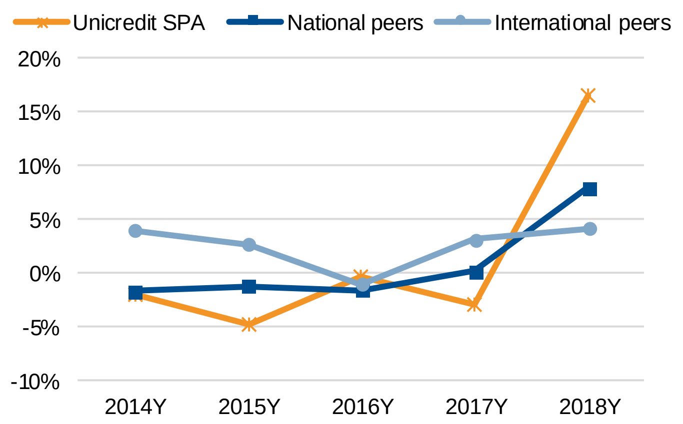
Net interest margin (%)



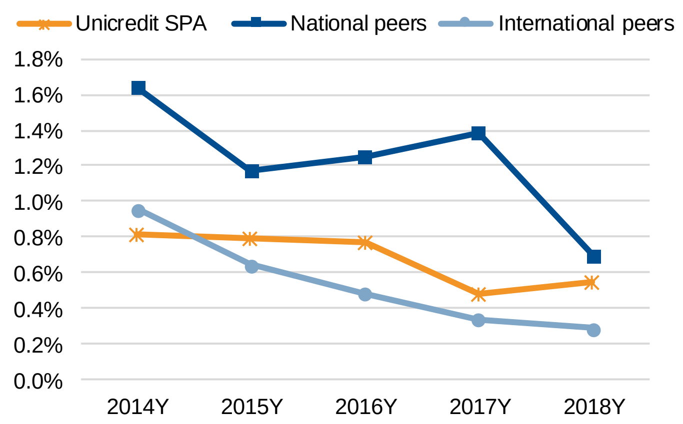
Problem loans/gross customer loans (%)



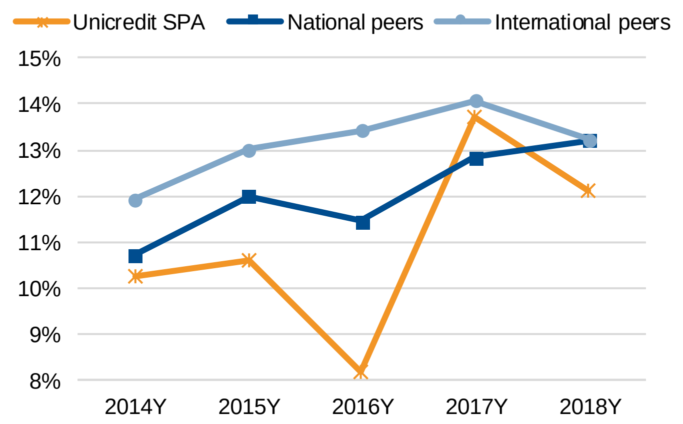
Net loan growth (%)



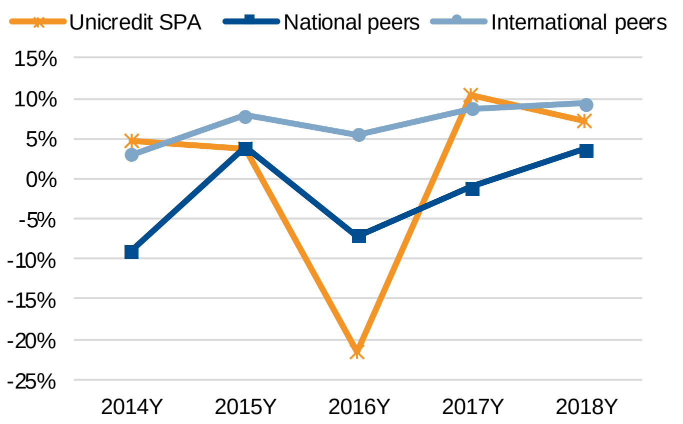
Loan loss provision/avg gross loans (%)



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, BPER, Credem, Creval, BP Sondrio, Mediobanca, Carige
**Cross-border peers: Santander, BBVA, Commerzbank. RBI, Erste Bank, KBC Group, ING Group, Societe Generale, Nordea, Bayern LB

II. Appendix: Selected Financial Information – UniCredit S.p.A.

	2014Y	2015Y	2016Y	2017Y	2018Y
Balance sheet summary (EUR m)					
Assets					
Cash and interbank assets	78,379	89,332	90,543	138,654	105,808
Total securities	233,815	224,998	224,572	221,605	170,908
of which, derivatives	76,322	56,052	53,099	40,445	39,274
Net loans to customers	480,393	457,063	455,226	441,970	515,124
Other assets	51,630	89,040	89,192	34,561	39,628
Total assets	**844,217**	**860,433**	**859,533**	**836,790**	**831,469**
Liabilities					
Interbank liabilities	106,359	111,066	105,226	125,241	127,526
Senior debt	138,697	122,514	109,492	96,053	82,288
Derivatives	77,088	57,059	53,111	38,589	36,729
Deposits from customers	418,861	434,379	468,879	477,563	490,751
Subordinated debt	18,572	18,286	15,262	12,699	10,433
Other liabilities	31,805	63,644	64,375	26,419	26,974
Total liabilities	**791,382**	**806,948**	**816,344**	**776,565**	**774,701**
Ordinary equity	47,501	48,198	36,952	54,721	51,231
Equity hybrids	1,888	1,888	2,383	4,610	4,610
Minority interests	3,446	3,399	3,853	894	927
Total liabilities and equity	**844,217**	**860,433**	**859,533**	**836,790**	**831,469**
Core tier 1/ common equity tier 1 capital	41,998	41,375	31,537	48,880	44,903
Income statement summary (EUR m)					
Net interest income	12,062	10,664	10,307	10,298	10,853
Net fee & commission income	7,506	5,488	5,585	6,392	6,870
Net trading income	1,350	1,282	1,486	1,141	1,028
Other income	2,671	2,204	1,645	2,026	1,566
Operating income	**23,589**	**19,638**	**19,023**	**19,857**	**20,317**
Operating expenses	15,305	15,129	15,152	13,403	13,936
Pre-provision income	**8,284**	**4,510**	**3,872**	**6,454**	**6,381**
Credit and other financial impairments	4,520	4,019	4,691	2,413	2,700
Other impairments	84	NA	660	125	-28
Non-recurring items	0	NA	10,486	217	116
Pre-tax profit	**3,679**	**491**	**-11,245**	**3,700**	**3,593**
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	-502
Net profit attributable to minority interests	380	352	464	313	216
Net profit attributable to parent	**2,008**	**1,694**	**-11,790**	**5,473**	**3,892**

Source: SNL, Scope Ratings

III. Appendix: Ratios – UniCredit S.p.A.

	2014Y	2015Y	2016Y	2017Y	2018Y
Funding and liquidity					
Net loans/ deposits (%)	114.7%	106.1%	98.3%	94.8%	105.6%
Liquidity coverage ratio (%)	NA	NA	132.0%	165.7%	149.8%
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%	62.0%
Problem loans/ gross customer loans (%)	16.3%	16.0%	11.8%	10.3%	7.2%
Loan loss reserves/ problem loans (%)	54.3%	53.8%	59.5%	60.5%	67.6%
Net loan growth (%)	-2.1%	-4.9%	-0.4%	-2.9%	16.6%
Problem loans/ tangible equity & reserves (%)	90.7%	84.9%	76.6%	56.2%	48.3%
Asset growth (%)	2.2%	1.9%	-0.1%	-2.6%	-0.6%
Earnings and profitability					
Net interest margin (%)	1.5%	1.3%	1.3%	1.3%	1.4%
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%	53.4%
Net fees & commissions/ operating income (%)	31.8%	27.9%	29.4%	32.2%	33.8%
Cost/ income ratio (%)	64.9%	77.0%	79.6%	67.5%	68.6%
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%	1.8%
Impairment on financial assets / pre-impairment income (%)	0.6%	0.5%	0.6%	0.3%	0.4%
Loan loss provision/ average gross loans (%)	0.8%	0.8%	0.8%	0.5%	0.5%
Pre-tax profit/ average RWAs (%)	0.9%	0.1%	-2.9%	1.0%	1.0%
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%	1.1%
Return on average equity (%)	4.6%	3.8%	-21.5%	10.4%	7.2%
Capital and risk protection					
Common equity tier 1 ratio (%, fully loaded)	10.0%	10.9%	7.5%	13.6%	12.1%
Common equity tier 1 ratio (%, transitional)	10.3%	10.6%	8.1%	13.7%	12.1%
Tier 1 capital ratio (%, transitional)	11.1%	11.5%	9.0%	15.4%	13.6%
Total capital ratio (%, transitional)	13.4%	14.2%	11.7%	18.1%	15.8%
Leverage ratio (%)	4.5%	4.4%	3.2%	5.6%	4.9%
Asset risk intensity (RWAs/ total assets, %)	48.5%	45.4%	45.0%	42.6%	44.5%
Market indicators					
Price/ book (x)	0.7x	0.6x	0.5x	0.6x	0.4x
Price/ tangible book (x)	0.7x	0.7x	0.5x	0.7x	0.5x
Dividend payout ratio (%)	35.3%	44.2%	NA	11.5%	15.8%

Source: SNL, Scope Ratings

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