26 April 2017

Financial Institutions

Unicredit SpA
Issuer Rating Report

STABLE OUTLOOK

A

Overview

On March 20, 2017 Scope Ratings upgraded Unicredit's Issuer Credit Strength Rating (ICSR) to A, with a Stable outlook, from A-. The upgrade reflects the bank's strenghtened position following the transformational capital increase executed in February 2017, aimed at a significant cleanup of the bank's balance sheet. Supported by a more promising macroeconomic background in Italy, and by lower need for bad loans provisions, Unicredit's profitability is set to improve, in Scope's view. The short-term rating is S-2, 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. For the full list of ratings see the **Ratings** section at the end of this report.

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.

Profitability remains impaired, but asset quality has stabilised for the last several quarters. The new business plan, supported by the large recently completed capital increase, will lead to an accelerated clean-up of legacy bad assets, as well as an improvement in group's earnings.

Rating drivers (Summary)

The rating drivers, in decreasing order of importance in the rating assignment, are:
1. Solid retail and commercial banking franchises in several different geographies
2. A convincing plan to restore profitability, although subject to execution risk
3. Improving Capital and Asset Quality profile

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Rating change drivers

Further material declines in the level of impaired loans. While declining, the stock of non-performing exposures (NPEs) remains very significant. Management is targeting further declines in both gross and net NPEs, which would add visibility to future earnings. Current targets include a gross NPE ratio of 8.4% in 2019, with coverage of 54%.

Improved efficiency and profitability. The path to higher profitability for Unicredit assumes material cost cutting through 2019. The number of branches is planned to decline by 25%, with a 14.000 reduction in full time equivalents (FTEs). If executed in line with the plan, this should lead to a cost income ratio of lower than 52% (>60% currently). In our view this would still leave room for further efficiencies, as customers keep moving 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 others countries in CEE, these markets are relatively smaller and contribute less to group's revenues and profits

Renewed tension on Italian bank and sovereign debt. Tensions surrounding peripheral European assets were sedated, for the past few years, by a strongly accommodative monetary policy. As economic recovery takes hold in Europe, the European Central Bank will gradually remove its support, starting with a termination of its asset purchase program in December 2017. Despite not directly affecting the P&L or accounting capital, rising yields on the bank's Italian sovereign bond holdings would raise questions on the bank's economic capital levels.

Rating drivers (Details)

1. Solid retail and commercial banking franchises in several different geographies

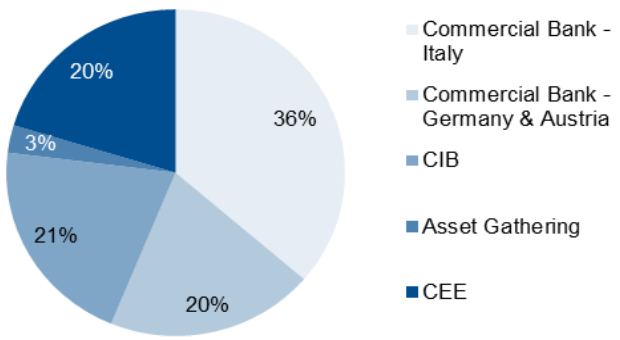
With 3,524 branches in Italy, Unicredit holds approximately 12% of the domestic loan market. It is the second largest bank in a system composed of two large banks and several mid-tier and small banks.

After merging with the HVB Group in 2005, Unicredit is now the third largest private bank in Germany by total assets as of YE2016, 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.

It is also one of the leading banks in the CEE region in terms of total assets and profits. With around 1,000 branches (excluding Turkey), 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 Poland in 2016, Russia, Czech Republic and Slovakia and Turkey are now the largest contributors to group's profits.

The businesses in Germany and CEE have been an important source of earnings diversification, especially in light of the still 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, 2016



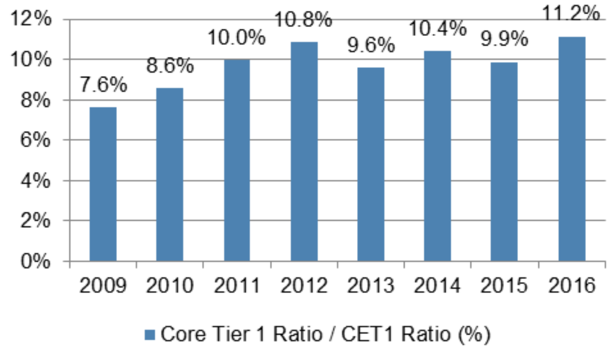
Source: Company data, Scope Ratings
Note: Excluding Corporate Center and Non Core unit. CEE includes Turkey and Russia, reflecting Unicredit managerial reporting.

2. Improving capital and asset quality

Despite weak profitability and the significant provisioning efforts in recent years, the Group has strengthened its capital position to satisfactory levels as shown in Figure 5. The increase 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 of the asset management business Pioneer, which also contributed to bolster capital.

The large loss in Q4 2016 partly offsets the benefit of the recent capital raising actions on the CET1 ratio, but at the benefit of much better reported asset quality.

Figure 2: 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

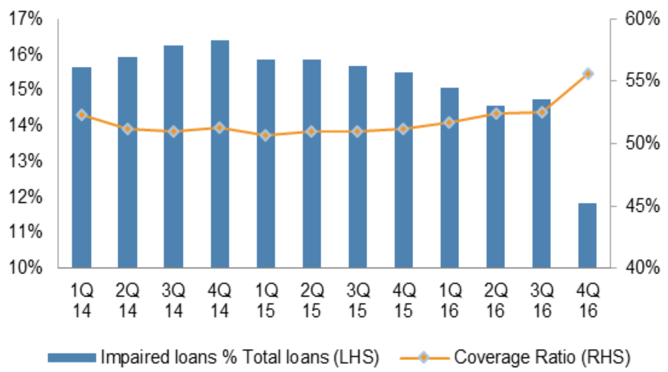
Post capital increase the fully loaded CET1 ratio stood at 11.15% as of December 2016 and the group's leverage ratio was 4.66% on a fully loaded basis.

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

In the past couple of years however, there has been a reversal in the NPE trend at Unicredit: the net flow into impaired loans turned negative in 2015, a trend which became more pronounced in 2016. The stock of NPEs loans (comprising "sofferenze", "unlikely to pay" and "past due" loans) started to decline: from a peak of EUR 84.4bn in December 2014 total impaired loans have declined to EUR 77.8bn as of December 2015, or 16% of total loans. Pro-forma for the FINO transaction (a securitization project allowing Unicredit to sell and deconsolidate EUR 17bn of bad loans), Unicredit NPE ratio stood at 11.8% at the end of 2016.

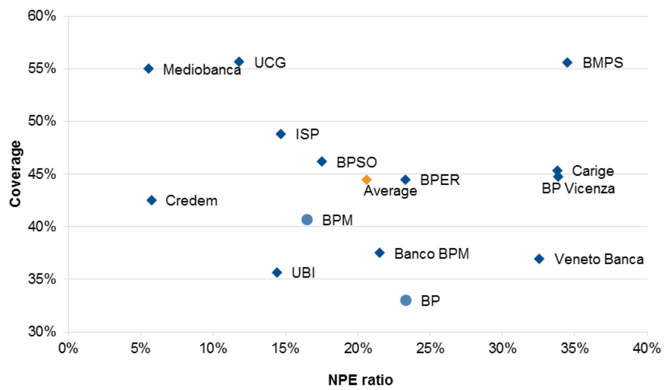
Moreover, the 2017 capital increase and the new round of provisions taken on Q4 2016 place Unicredit firmly at the top of its Italian peers for coverage ratios. We expect Unicredit's asset quality to continue to improve in the coming years, supported by a favourable macro environment.

Figure 3: Group Impaired loans ratio is high but improving



Source: SNL, Scope Ratings

Figure 4: Coverage versus national peers



Source: SNL, Scope Ratings

Aside from NPEs, one credit concentration worth mentioning is Unicredit's material exposure to Italian sovereign risk. This amounted to EUR 60.4bn as of December 2016 (comprising EUR 55.2bn of debt securities and EUR 5.2bn of loans), equivalent to 140% of CRD IV Common Equity Tier 1 capital, based on transitional rules and pro forma for the capital increase completed in March 2017.

3. A convincing plan to restore profitability, although subject to execution risk.

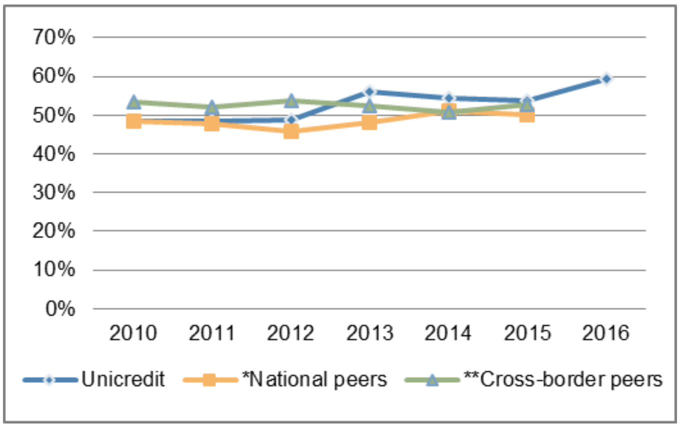
The latest business plan, presented by the new top management in December 2016 and to be executed by 2019, aims at drawing a line under the financial crisis and returning the bank to a reasonably clean balance sheet and to a profitability level at least comparable with its main international peers. It rests on 5 pillars:

- **Strenghten and optimize capital.** The 2019 targets include having a CET1 ratio of at least 12.5%, and an MDA buffer of at least 200bps. We believe these targets are realistic.
- **Improve Asset Quality.** Targets include further reductions in NPEs, with the NPE ratio reaching 8.4% in 2019 (11.8% at the end of 2016). We believe these target are conservative.
- **Transform operating model.** Through a 25% percent reduction in Western Europe 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 in our view sensible given the shifting consumer behaviour and the lower need for in-branch physical interaction, and builds on already material branch and personnel reductions in recent years, especially in Austria and Germany.
- **Maximise commercial bank value.** Cross selling initiatives across the group, targeted growth in the CEE region, best practice sharing should support value creation. We view these steps as positive, but we 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 group's group operating profit was -16.9%. The 2019 target is -2.6%.

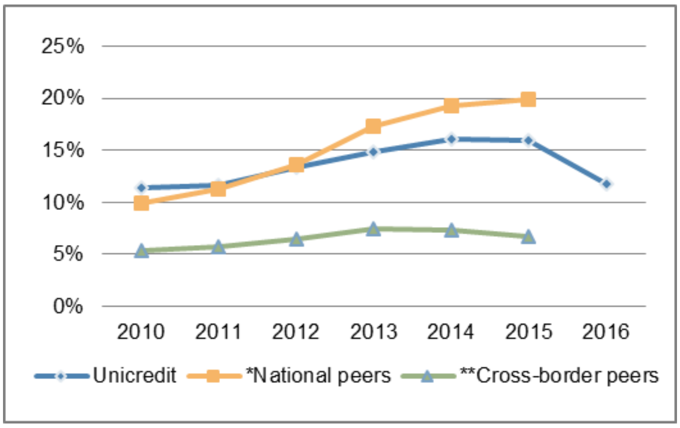
We believe the business plan is realistic, and the path to meeting most targets is positively jumpstarted by the 2017 capital increase and the frontloading of provisions in the last quarter of 2016. The group is targeting a RoTE of 9% in 2019, which we believe is not overly ambitious. We see inherent execution risk, but overall the plan represents in our view a turn for the better in the group's recent history.

Appendix A: Peer comparison

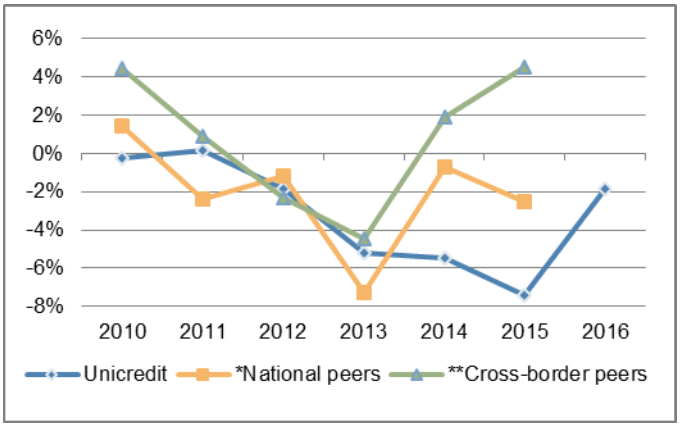
LLP stock % Impaired loans (Coverage ratio)



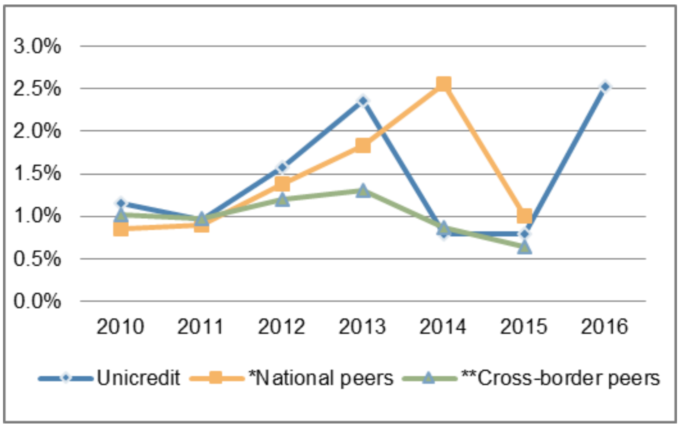
Impaired loans % Gross loans



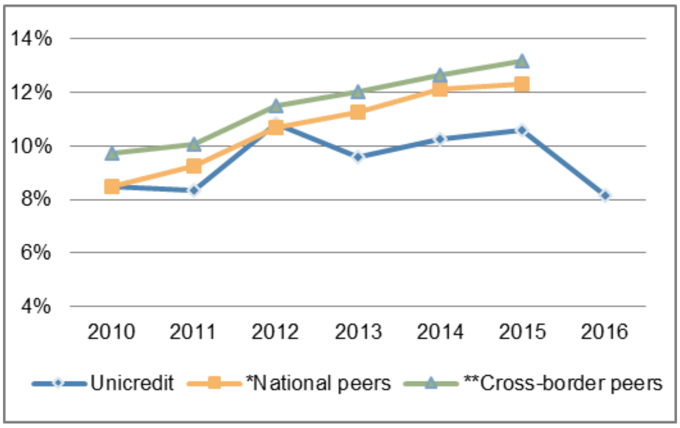
Total gross loan growth (%)



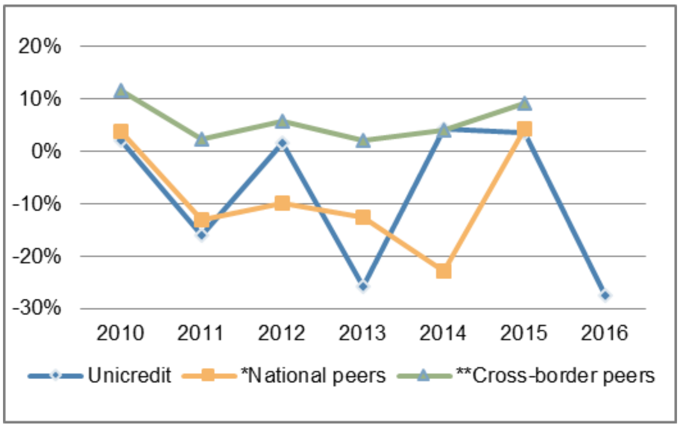
Cost of Risk (LLC % Average Loans)



Common equity tier 1 ratio (transitional) (%)



Return on average equity (%)



Source: SNL, 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

Appendix B: Selected Financial Information – Unicredit Group

	2012	2013	2014	2015	2016
Balance sheet summary (EUR bn)					
Assets					
Cash and interbank assets	84.2	73.9	78.4	87.0	88.6
Total securities	122.7	144.1	157.5	169.2	167.0
Derivatives	102.6	61.9	76.3	76.3	76.3
Net loans to customers	548.8	510.3	480.4	445.4	444.6
Other assets	171.1	117.6	127.9	158.8	159.4
Total assets	**926.8**	**845.8**	**844.2**	**860.4**	**859.5**
Liabilities					
Interbank liabilities	118.0	110.6	106.4	110.3	103.9
Senior debt	159.2	146.8	138.7	138.7	138.7
Derivatives	104.3	60.7	77.1	77.1	77.1
Deposits from customers	414.5	419.3	418.9	419.7	452.4
Subordinated debt + non-equity hybrids	20.7	20.4	18.6	18.6	18.6
Other liabilities	44.9	37.7	31.8	42.6	25.7
Total liabilities	**861.6**	**795.7**	**791.4**	**806.9**	**816.3**
Ordinary equity	61.6	46.8	47.5	48.2	37.4
Equity hybrids	0.0	0.0	1.9	1.9	1.9
Minority interests	3.7	3.3	3.4	3.4	3.9
Total liabilities and equity	**926.8**	**845.8**	**844.2**	**860.4**	**859.5**
Core tier 1 / Common equity tier 1 capital	46.3	40.7	42.0	41.4	31.5
Income statement summary (EUR bn)					
Net interest income	13.9	12.3	12.4	10.9	10.3
Net fee & commission income	7.7	7.4	7.6	5.5	5.5
Net trading income	2.8	2.5	1.5	1.5	2.1
Other income	0.7	1.2	1.0	0.9	1.0
Operating income	**25.0**	**23.3**	**22.6**	**18.9**	**18.8**
Operating expense	14.8	14.3	13.5	12.3	12.5
Pre-provision income	**10.2**	**9.1**	**9.0**	**6.6**	**6.3**
Loan-loss provision charges	9.3	13.5	4.3	4.0	12.2
Other impairments	0.0	7.8	0.0	0.0	0.0
Non-recurring items	-0.6	-0.8	-0.7	-1.9	-5.1
Pre-tax profit	**0.2**	**-13.0**	**4.1**	**0.7**	**-11.0**
Discontinued operations	0.0	0.0	0.0	0.0	0.4
Income tax expense	-1.6	-1.7	1.3	-0.1	0.7
Net profit attributable to minority interests	0.4	0.4	0.4	0.4	0.5
Net profit attributable to parent	**0.9**	**-14.0**	**2.0**	**1.7**	**-11.8**

Source: SNL, Scope Ratings

Appendix C: Ratios – Unicredit Group

	2012	2013	2014	2015	2016
Funding/Liquidity					
Gross loans % total deposits	141.5%	132.7%	125.6%	116.1%	105.7%
Total deposits % total funds	58.2%	60.1%	61.2%	60.9%	63.2%
Wholesale funds % total funds	41.8%	39.9%	38.8%	39.1%	36.8%
Liquidity coverage ratio (%)					>100%
Net stable funding ratio (%)					>100%
Asset mix, quality and growth					
Gross loans % funded assets	71.3%	70.9%	68.6%	62.2%	61.1%
Impaired loans % gross loans	13.3%	14.8%	16.0%	16.0%	11.8%
Loan-loss reserves % impaired loans	48.6%	56.0%	54.3%	53.8%	59.5%
Gross loan growth (%)	-1.9%	-5.2%	-5.4%	-7.4%	-1.9%
Impaired loan growth (%)	11.8%	5.5%	2.4%	-7.7%	-27.6%
Funded assets growth (%)	2.2%	-4.5%	-2.3%	2.1%	-0.1%
Earnings					
Net interest income % revenues	55.5%	52.7%	55.2%	57.9%	54.8%
Fees & commissions % revenues	30.7%	31.5%	33.7%	29.2%	29.0%
Trading income % revenues	11.2%	10.7%	6.8%	7.9%	11.1%
Other income % revenues	2.6%	5.0%	4.3%	5.0%	5.1%
Net interest margin (%)	2.2%	2.0%	2.2%	2.0%	1.9%
Pre-provision income % risk-weighted assets (RWAs)	2.3%	2.2%	2.2%	1.7%	1.6%
Loan-loss provision charges % pre-provision income	91.4%	148.4%	47.5%	60.5%	192.3%
Loan-loss provision charges % gross loans (cost of risk)	1.6%	2.4%	0.8%	0.8%	2.5%
Cost income ratio (%)	59.3%	61.1%	59.9%	65.0%	66.2%
Net interest income / loan-loss charges (x)	1.5	0.9	2.9	2.7	0.8
Return on average equity (ROAE) (%)	1.5%	-25.8%	4.3%	3.5%	-27.5%
Return on average funded assets (%)	0.1%	-1.7%	0.3%	0.2%	-1.5%
Retained earnings % prior year's book equity	0.7%	-22.7%	4.3%	1.6%	-25.0%
Pre-tax return on common equity tier 1 capital	0.5%	-29.9%	9.9%	1.8%	-30.1%
Capital and risk protection					
Common equity tier 1 ratio (%, fully loaded)	n.a.	n.a.	10.0%	10.9%	7.5%
Common equity tier 1 ratio (%, transitional)	10.8%	9.6%	10.3%	10.6%	8.1%
Tier 1 capital ratio (%, transitional)	11.4%	10.1%	11.1%	11.5%	9.0%
Total capital ratio (%, transitional)	14.5%	13.6%	13.4%	14.2%	11.7%
Tier 1 leverage ratio (%)	n.a.	n.a.	4.9%	4.6%	3.6%
Total loss coverage (CET1 + loan-loss provisions) % RWAs	19.7%	21.3%	21.4%	21.3%	16.9%
Asset risk intensity (RWAs % total assets)	46.1%	48.1%	48.5%	45.4%	44.9%

Source: SNL, Company Data, Scope Ratings

Ratings *

Issuer Credit-Strength Rating	**A**
Outlook	Stable
Senior unsecured debt	A-
Tier 2 Instruments	BBB
Short term debt rating	S-2
Short term debt rating outlook	Stable

* The ratings are not applicable to debt issued by unguaranteed subsidiaries of the rated parent.

Regulatory Disclosures

Information pursuant to Regulation (EC) No 1060/2009 on credit rating agencies, as amended by Regulations (EU) No. 513/2011 and (EU) No. 462/2013

Responsibility

The party responsible for the dissemination of the financial analysis is Scope Ratings AG, Berlin, District Court for Berlin (Charlottenburg) HRB 161306 B, Executive Board: Torsten Hinrichs (CEO), Dr. Stefan Bund.

The rating analysis has been prepared by Marco Troiano, Director

Responsible for approving the rating: Sam Theodore, Managing Director

Rating history

Date	Rating	Rating action
11.06.2014	BBB	First assignment
10.09.2015	BBB*	Review for upgrade
20.10.2015	BBB+	Upgrade
02.02.2017	A-	Upgrade
08.03.2017	A-	Review for upgrade
20.03.2017	A	Upgrade

The rating outlook indicates the most likely direction of the rating if the rating were to change within the next 12 to 18 months. A rating change is, however, not automatically ensured.

The rating was prepared independently by Scope Ratings, without a mandate (unsolicited rating) and with participation of the issuer.

Dr. Martha Böckenfeld, the chair of the supervisory board of Scope Ratings AG is at the same time a member of the UniCredit Board of Directors as an independent non-executive Director.

Key sources of Information for the rating

Website of the rated entity/issuer, Annual reports/quarterly reports of the rated entity/issuer, Current performance record, Detailed information provided on request, Data provided by external data providers, Interview with the rated entity, External market reports, Press reports / other public information.

Scope Ratings considers the quality of the available information on the evaluated company to be satisfactory. Scope ensured as far as possible that the sources are reliable before drawing upon them, but did not verify each item of information specified in the sources independently.

Examination of the rating by the rated entity prior to publication

Prior to publication, the rated entity was given the opportunity to examine the rating and the rating drivers, including the principal grounds on which the credit rating or rating outlook is based. The rated entity was subsequently provided with at least one full working day, to point out any factual errors, or to appeal the rating decision and deliver additional material information. Following that examination, the rating was not modified.

Methodology

The methodologies applicable for this rating "Bank Rating Methodology" (May 2015) & "Bank Capital Instruments Rating Methodology" (July 2015) are available on www.scoperatings.com. The historical default rates of Scope Ratings can be viewed on the central platform (CEREP) of the European Securities and Markets Authority (ESMA): http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml. A comprehensive clarification of Scope's credit rating, definitions of rating symbols and further information on the analysis components of a rating can be found in the documents on methodologies on the rating agency's website.

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