Italian banks turning the page on the crisis

Despite the impact of the conflict in Ukraine and mounting inflationary pressure, the Italian economy is benefitting from solid support thanks to the European recovery plan "Next Generation EU". The banking sector will play a key role in providing additional financing that will contribute to the multiplier effect of this wide-ranging plan. This volume effect should reinforce the momentum driven by the rebound in interest rates, the conversion of deposits into financial investments, and tight cost control post-pandemic. The Italian banking sector is therefore set to return to higher profitability, also thanks to excellent dynamics for non-performing loans, the consolidation of the domestic banking market, and the improvement in ratings assigned to Italian banks. A thriving environment, notwithstanding the persistence of long-term risks to which the Country has historically been exposed.

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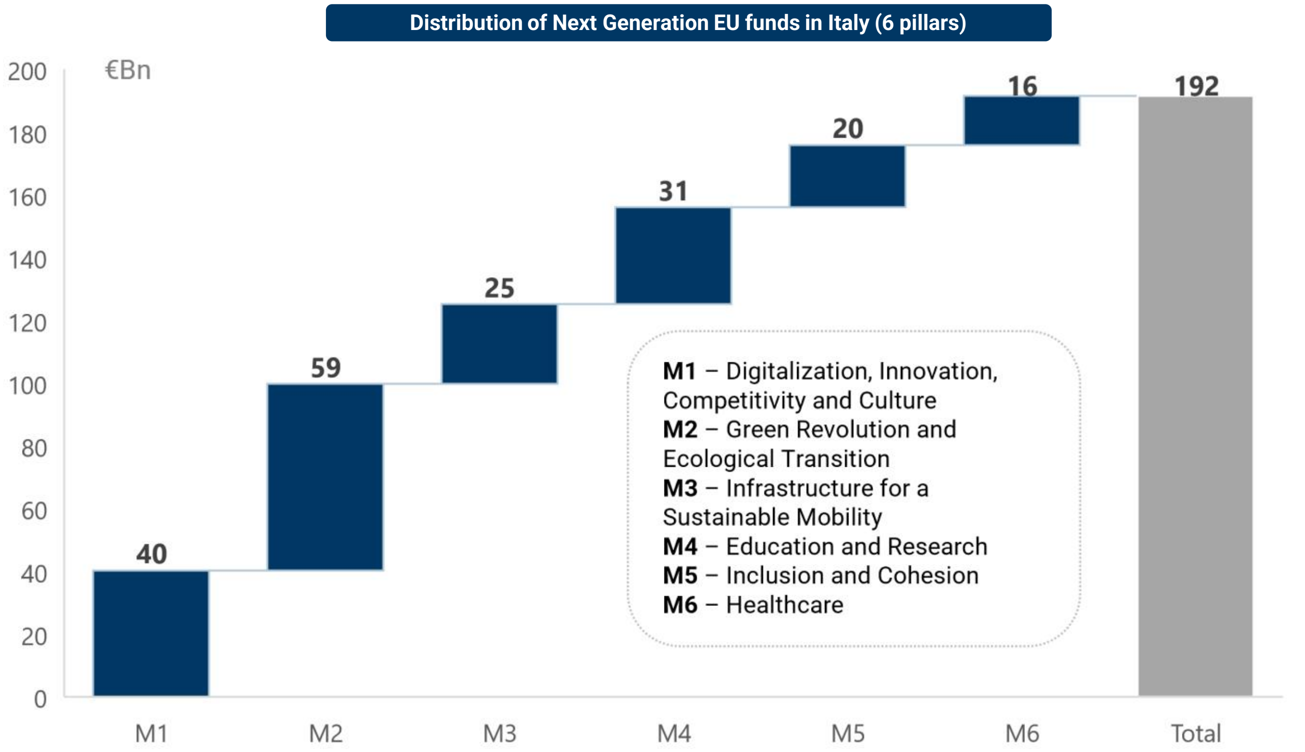
I - Italian growth bounces back

European fiscal support

After a pandemic-induced record recession of 8.9% in 2020, Italy experienced an economic rebound of 6.5% in 2021[1]. According to the government's latest estimates, **the recovery in growth is set to continue in 2022 (+3.1%) and in 2023 (+2.4%).**

By comparison, growth rates in Italy had never exceeded 2% since 2000[1]. The Italian economy is benefiting from the unprecedented support of the "Next Generation EU" plan, whose funds will be mostly allocated to the recovery plan "Piano Nazionale di Ripresa e Reslienza", totalling €192bn. This plan will fuel six pillars of the economy until 2026 (see diagram on next page).

[1] Source: Istat.



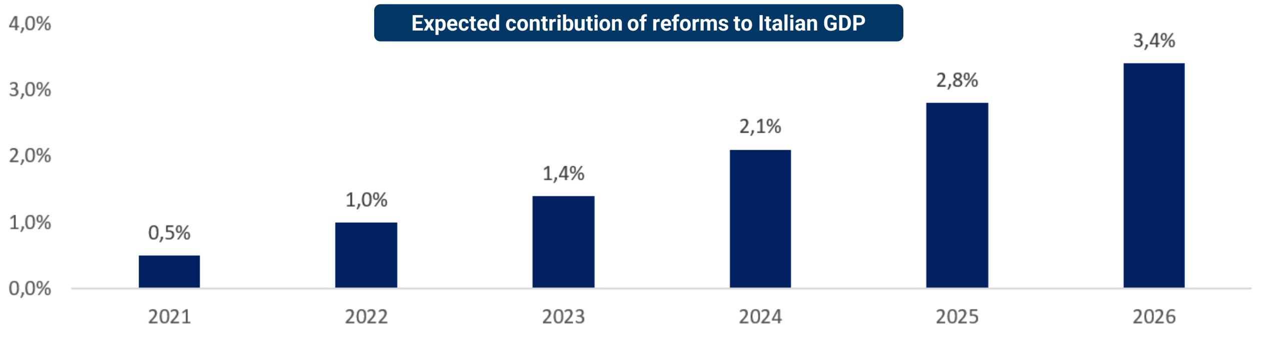
Source: Ministero dell'Economia e delle Finanze, 2021.

€69bn of the budgeted amount will be distributed in the form of subsidies (70% before the end of 2022), and €123bn in the form of loans. An initial tranche of €24.9bn was awarded in August 2021, and a second instalment of €21bn, the application for which was submitted in December 2021, was approved by the European Commission on April 13, 2022.

This plan is further reinforced by other recovery measures deployed under the NGEU ("Fondo Complementare" for €30.6bn and "Opere Specifiche" for €26bn), REACT-EU (€13bn), and more generally by the fiscal stimuli implemented by the Conte and Draghi governments to counter the effects of the pandemic.

Structural reforms

The instalments from the Next Generation EU plan are contingent on structural reforms and investments that will also contribute to supporting growth. In 2021, the Italian government fulfilled its planned strategy by reaching 51 intermediate targets to qualify for the next tranche of aid. The implementation of these measures has been facilitated by the current period of political stability, consolidated in January 2022 by the reappointment of Sergio Mattarella as President of the Republic and the retention of Mario Draghi as Prime Minister. The interim targets associated with the payment of the next instalment should therefore be achieved without major difficulties, at least until the parliamentary elections in spring 2023.

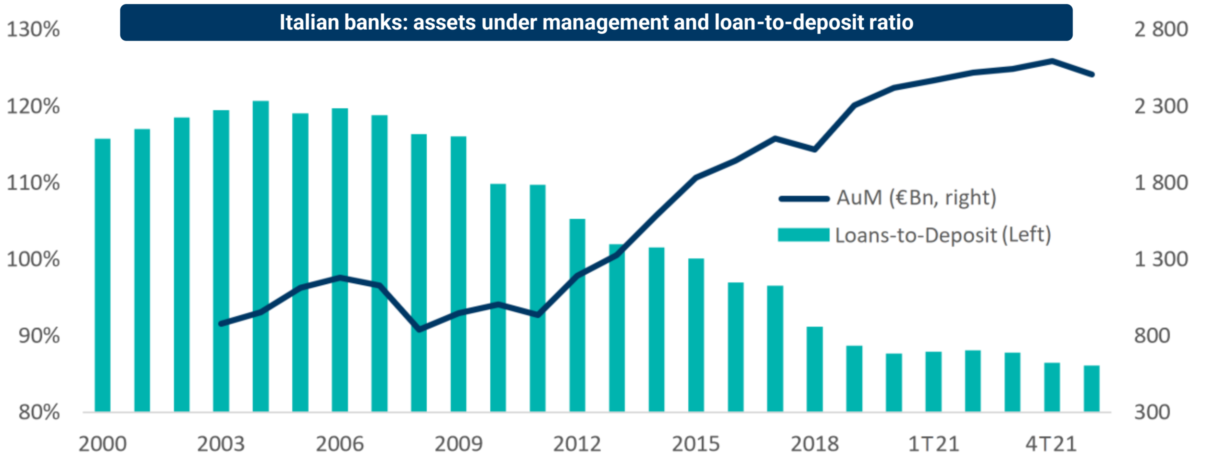


Source: Ministero dell'Economia e delle Finanze, 2022.

A multiplier effect of bank financing

Alongside the fiscal stimulus and structural reforms, **credit institutions will play a key role in supporting Italian households and companies, which should result in an increase in outstanding loans and a possible rebound in the Loan-to-Deposit ratio.** To illustrate this phenomenon, it noteworthy that the agreement entitled "Competitvità, Innovazione, Sostenibilità", signed between Intesa Sanpaolo and the association Confindustria, expects €150bn in the form of loans granted to companies by 2024, whereas the previous agreement between the two parties provided for €200bn in loans over a 10-year period. More broadly, Intesa Sanpaolo plans to grant €410bn in loans by 2026. UniCredit and Banco BPM's business plans expect a 2%-3% loan growth per year until 2024.

This volume effect, combined with **growth in fees associated with asset management activities** (transformation of deposits into assets under management), should result in strong growth in the Net Banking Income of Italian institutions. **Such growth will likely be even more significant in terms of profitability, thanks to better-managed cost structures following the pandemic, resulting in positive operating leverage.**

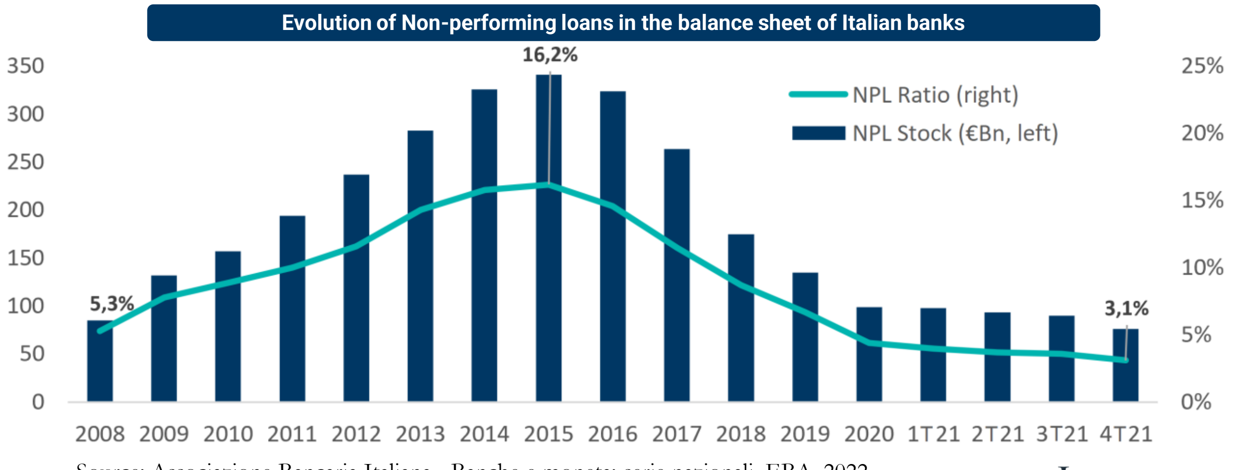


Source: Associazione Bancaria Italiana - Banche e moneta: serie nazionali, Assogestioni, 2022.

II - Banks back on a sound footing

Balance sheet clean-up: normalising the stock of Non-performing loans

In addition to this positive outlook, it is important to point out that **the volume of non-performing loans of Italian banks has shrunk considerably from its peak in 2015**.



Source: Associazione Bancaria Italiana - Banche e moneta: serie nazionali, EBA, 2022.

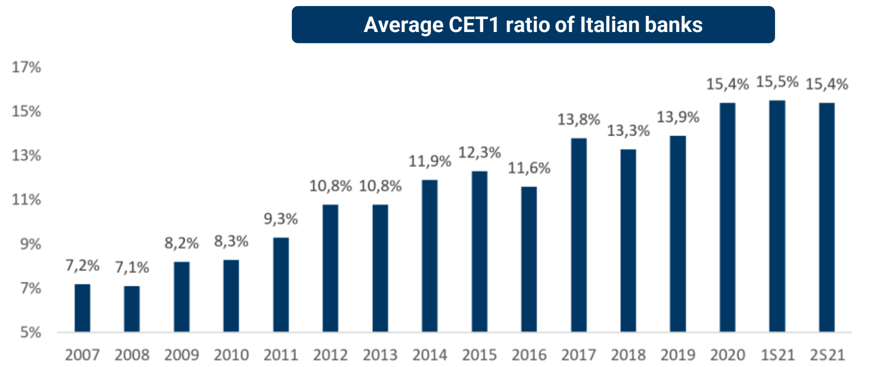
According to estimates from the Italian Banking Association, **the proportion of Non-performing loans in the balance sheet of Italian banks is expected to remain at levels equivalent to those observed prior to the 2008**. This phenomenon is explained by two concomitant factors:

1. The desire of the banks to reduce their stocks of non-performing loans by **disposing** of them, taking advantage of the favourable regulatory framework (introduction of the GACS guarantee regime in 2016). For example, by disposing of its Non-performing loans, Intesa Sanpaolo was able to reduce its NPL ratio (net of provisions) below 1%, by taking into account pre-financed disposals in the fourth quarter of 2021: one of the lowest levels in Europe.

2. A **limited influx** of new Non-performing loans, thanks in particular to the government's support measures during the pandemic. **These kept default rates subdued, especially for loans under moratorium**: the wave of insolvencies expected at the end of the year did not materialise, with defaults peaking at 4.1%, a fraction easily absorbed by the country's credit institutions. These figures were indeed much better than those initially envisaged by the banks.

Capital ratios at their highest level

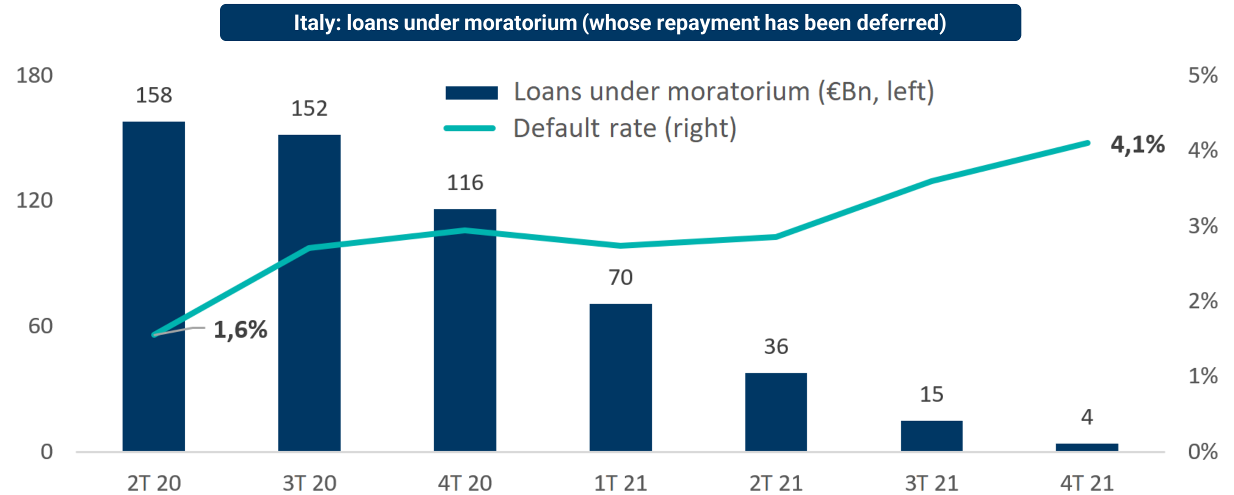
Alongside improved credit quality, **the average CET1 capital held by Italian banks is at an all-time high**, more than double the 2008 crisis levels.



Source: Bank of Italy, Corporate Investor Relations, data at end-2021.

It should be noted that many Italian banks have recently announced their intention to distribute part of their excess capital to their shareholders. UniCredit, for example, has announced that it will pay out a maximum of €16bn over the 2021-2024 period.

These forecasts seem reasonable: the return to profitability of Italian banks and **their organic capital generation should enable them to make these distributions without difficulty**. For example, Intesa Sanpaolo is expected to generate around 130 basis points of capital from its operations in 2022, or around 10% of its capital base, according to the market consensus.



Source: European Banking Authority, at end-2021.

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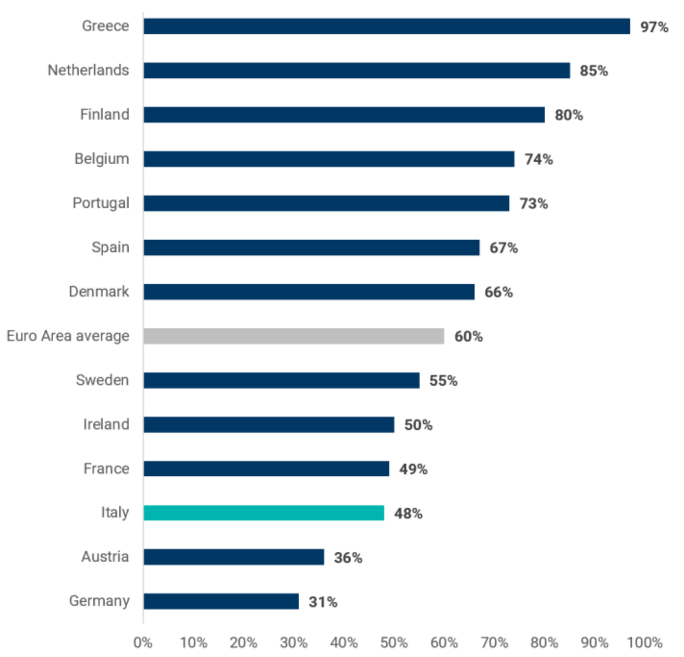
III - Sector consolidation to continue

A hitherto fragmented banking landscape

The Italian banking sector is also going through structural changes and a drive towards consolidation (mergers and acquisitions). After the acquisition of UBI Banca by Intesa Sanpaolo (2020), other projects that have been under discussion for several years now seem to be on the verge of becoming reality.

This trend is desirable: **the Italian banking market is one of the least concentrated in the European Union**, with a plethora of institutions with negligible market share at national level. This high level of competition is not beneficial, preventing banks from having the necessary base to benefit from economies of scale and generate more comfortable margins.

Market share of top 5 players per European country



Sources: JPMorgan Research, UBS Research, ABI. Data for 2019.

The geographical distribution of market shares is also heterogeneous, and varies between banks. Hence, a "horizontal" consolidation between credit institutions would strengthen their position: for example, a potential acquisition of BPM by UniCredit would enable the latter to achieve a regional market share of 20% in strategic regions such as Lombardy and Lazio, representing about 35% of national GDP.

Breakdown of market share by region

Region	Unicredit	BPM	BMPS	Bper	BP Sondrio
Total Italy	11%	8%	6%	8%	1%
Northern Italy	11%	10%	4%	6%	2%
Central Italy	11%	5%	10%	7%	n.d.
Southern Italy & Islands	12%	3%	7%	15%	n.a.
Lombardy	7%	14%	4%	7%	5%
Lazio	17%	5%	6%	5%	2%
Veneto	13%	9%	8%	2%	0%
Emilia Romagna	14%	8%	4%	13%	0%

Sources: JPMorgan Research, UBS Research, ABI, 2021.

The possibility of vertical integration

In addition to "horizontal" mergers, Italian banks could also undergo **"vertical" integration by absorbing upstream (production) or downstream (distribution) activities in the value chain of businesses such as Asset Management and Insurance**. The consolidation of well-established players in these relatively fragmented market segments could lead to the emergence of major players with diversified revenues and increased territorial integration.

Italian financial sector

UniCredit | Banco BPM | Monte dei Paschi di Siena | BPER: Banca | Banca Popolare di Sondrio

Asset Management: Amundi | Anima | Arca SGR

Life Insurance: CNP Vita | Bipiemme Vita, Vera Vita | AXA Assurances | Arca Vita

Insurance: CreditRas, Incontra | Vera Assicurazioni | AXA Assurances | Arca Assicurazioni

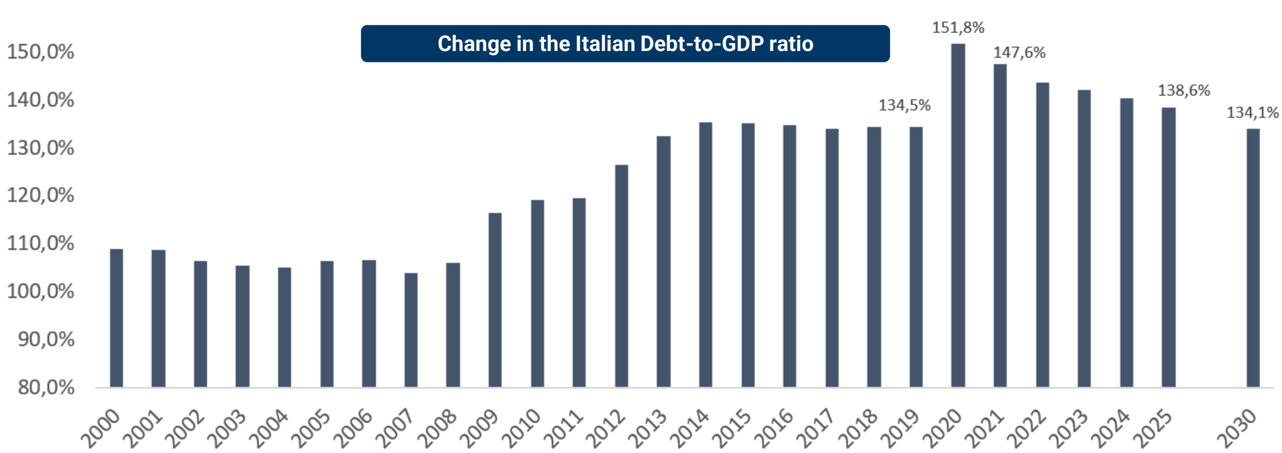
Source: Lazard Frères Gestion, Corporate Investor Relations.

IV – Encouraging trends in ratings

Finally, the Italian banking sector could benefit from an improvement in the ratings assigned to each institution by rating agencies (Moody's, Fitch, S&P). **The ratings of Italian banks are in fact limited by that of the Italian State**, as a banking issuer cannot exceed the rating assigned to its country of domicile. However, Italy's sovereign rating could be upgraded in the near future. According to the government, the Debt-to-GDP ratio (151.8% at the end of 2020) is expected to return to its 2019 level in 2030, also thanks to the support provided by the Next Generation EU and the associated structural reforms. Italy's debt would thus fall to 134% of GDP, mainly driven by strong economic growth.

The positive outlook on the Italian economy has already led to an initial improvement in ratings. **In December, Fitch upgraded its Italian sovereign rating from BBB- to BBB**. Previously, S&P upgraded its outlook from "stable" to "positive" in November. These improvements encompass the risks weighing on the country's economy, ranging from heavy indebtedness to persistent political risk.

The raising of this "ceiling," combined with healthier bank balance sheets, should pave the way for an improvement in the credit ratings of the main Italian banks. **S&P has already upgraded its outlook from "stable" to "positive" for five institutions**.



Source: Ministero dell'Economia e delle Finanze, 2022.

Sovereign rating of Italy and Italian banks

	Moody's	S&P	Fitch
Rating	Baa3	BBB	BBB
Outlook	Stable	Positive	Stable

INTESA SANPAOLO

Moody's	S&P	Fitch
Baa1 =	BBB Positive	BBB =

UniCredit

Moody's	S&P	Fitch
Baa1 =	BBB Positive	BBB =

Source: Moody's, S&P Global Ratings, Fitch Ratings, 2022. In green: upgrades observed since the end of 2020.

Conclusion

Admittedly, ranking among the most indebted European countries, Italy continues to face structural challenges. Visibility is hindered by political instability caused by the rooted presence of anti-establishment parties.

Nevertheless, Italy has entered a constructive period auspicious for growth, as massive support measures deployed by the EU towards 2026 pave the way for a brighter environment than that of the previous decade. Austerity is taken over by economic stimulus.

Concurrently, recent years' clean-up efforts bore fruit. Italian banks have indeed managed to dispose of the vast majority of their non-performing loans, and to build sound capital buffers.

As a consequence, the profitability of the sector has robust prospects for improvements in the years to come.

Overall, although the country's perception was tarnished since the "GFC", most indicators have now encouragingly turned positive.

From an investor's point of view, **the securities issued by Italian banks are therefore very attractive, especially in the subordinated debt segment**. Careful market observers, who are capable of identifying the intrinsic qualities of financial institutions, will indeed be able to identify excellent investments opportunities in the space.

About Lazard Group (31/12/2021):

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