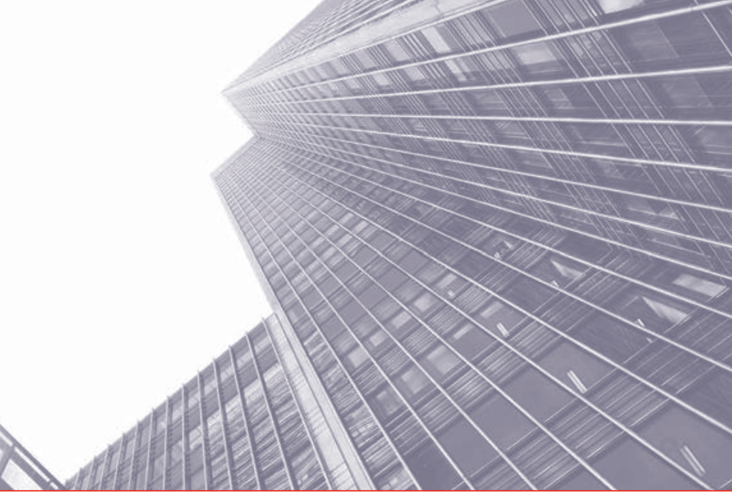


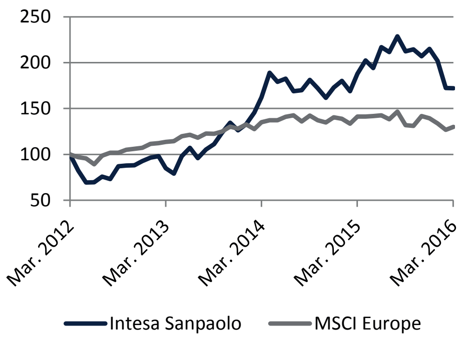
Independent Asset Management

MARCH 2016

Intesa Sanpaolo

Market profile

Country	Italy
Sector	Financials
Industry	Banks
Price (EUR)	2.52
52-week high	3.65
52-week low	2.12
Market Cap (mn)	40'030
Avg. daily volume	117'132'300
Beta	1.5
ISIN	IT0000072618



Key metrics

	2015	2016e	2017e		2015	2016e	2017e
EPS	0.175	0.222	0.256	PE	13.8x	13.9x	12.1x
YoY Growth	75.0%	26.9%	15.3%	P/TBV	1.0x	1.0x	1.0x
Dividend yield	5.9%	7.5%	10.0%	EBIT Margin	46.5%	51.6%	47.9%

Executive Summary

The Intesa Sanpaolo group is an Italian domiciled banking conglomerate. The group is active in consumer and industrial lending, banc-assurance and pension funds, asset management, fiduciary services and private banking.

Intesa Sanpaolo is present in each region of Italy with different brands. As of the 31st of December 2015, the Intesa Sanpaolo Group's operating structure had a total network of 5'386 branches, of which 4'144 were in Italy and 1'242 were abroad, with 90'807 employees.

Intesa Sanpaolo's revenues essentially come from two streams: net interest income (45% of total income in 2015) and net fee & commission income (44% of total). As per Intesa Sanpaolo's estimates, they are the #1 provider for loans (15% market share), deposits (17% market share, including bonds), pension funds, asset management, and factoring services in Italy.

Loans represent the biggest part of the group's operating income. Until 2015, loans have been contracting due to Italy's contracting economy. The demand for loans has nevertheless outstripped supply, but Intesa Sanpaolo must remain prudent in their lending standards, as non-performing loans already represent 18% of total loans. Even if non-performing loans are provisioned (at 47%); this is currently a huge drag on profitability and is a serious issue for the banking sector overall in Italy.

Intesa Sanpaolo is however one of the best capitalized banks in Europe and has one of the best cost/income structures. Another particularly interesting aspect is the dividend. Management have clearly committed to large dividends until 2017, which represent yields of 7.5% in 2016 and 10.0% in 2017.

The yield is so high because the bank's shares are trading slightly below tangible book value. This represents a good long-term opportunity for patient investors.

Intesa Sanpaolo

Daniel Pfund, Analyst-Manager at IAM

March 2016

Business description

Fig. 1: Intesa Sanpaolo brands in Italy
Source: Company Data

The Intesa Sanpaolo group is an Italian domiciled banking conglomerate. The group is active in consumer and industrial lending, banc-assurance and pension funds, asset management, fiduciary services and private banking. Intesa Sanpaolo also owns banks outside of Italy, most notably in Eastern Europe (representing approximately 20% of total income). The group is still young, it was formed in 2007, but its history is rich (see details in next section). As such, the group employs numerous different brands and has different names depending on the region in Italy *(Fig. 1)*.

The group is an undisputed leader in Italian banking and is arguably one of the best run banks in the country, with best-in-class capital levels and cost efficiency.

History of the company

Intesa Sanpaolo was created on January 1, 2007, through the merger of two leading Italian banking groups, Banca Intesa and Sanpaolo IMI. These two groups are themselves the result of a wave of consolidation of the Italian banking sector in 1990's.

Banca Intesa

Banca Intesa was formed in 1998 from the merger of Cariplo and Banco Ambrosiano Veneto, two leading Italian retail and commercial banks. In 1999, Banca Commerciale Italiana (BCI) joined the Intesa Group. With the subsequent merger of BCI into Banca Intesa (May 2001), the group took the name IntesaBci. In December 2002 the Shareholders' Meeting resolved the change of the company name to Banca Intesa, effective as of January 1, 2003.

Sanpaolo IMI

Sanpaolo IMI was formed in 1998 from the merger of Istituto Bancario San Paolo di Torino and IMI (Istituto Mobiliare Italiano). These two banks were highly complementary: Istituto Bancario San Paolo di Torino was specialised in retail lending, IMI, a public entity founded in 1931 to support the reconstruction of the national industrial system, was a leading business and investment bank.

The formation of Intesa Sanpaolo group was aimed at creating an organization that had market leadership in all geographies and banking products in Italy. Until 2010, Intesa Sanpaolo was considered as a prudent bank that had emerged relatively unscathed from the global financial crisis. However, once the Eurozone sovereign crisis hit in 2011, Intesa Sanpaolo's exposure to the Italian sovereign brought the funding and capital levels of the bank into question. A prolonged Italian recession soon followed and the group's focus on Italian banking turned into its Achilles heel and continues to be a drag on profitability until today.

Geographic exposure

Intesa Sanpaolo is present in each region of Italy with different brands. As of the 31st of December 2015, the Intesa Sanpaolo Group's operating structure had a total network of 5'386 branches, of which 4'144 were in Italy and 1'242 were abroad, with 90'807 employees *(Fig. 2)*.

End markets exposure

The Intesa Sanpaolo Group has 6 business areas which we will detail below.

Banca dei Territori

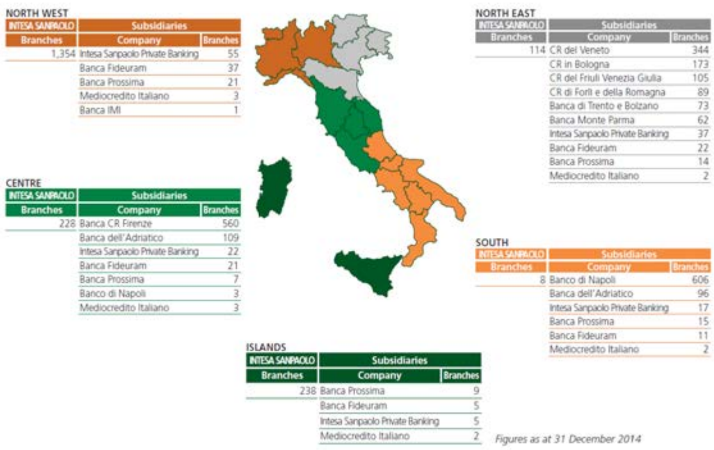
This division comprises retail customers (individual customers with financial assets up to €100'000), businesses/companies with low-complexity needs, personal customers (individual customers with financial assets between €100'000 and €1m), and SME customers, including companies whose group turnover is below €350m. This division is the largest and represented 42% of the group's total operating margin (operating income – operating costs) in 2015. At the same time, this is a very labor intensive business which requires many local branches with local personnel. As such, this division has a very high cost/income ratio of 54%, which is the worst ratio of all divisions in the group.

Corporate and Investment Banking

This division includes an international network responsible for managing relationships with approximately 1'200 global industrial corporates operating in eight key industries with high growth potential (automotive & industrial, basic resources & diversified, consumer retail & luxury, healthcare & chemical, infrastructures, oil & gas, power & utilities, telecom-media-technologies). This division is also responsible for corporate and public finance, which manages relationships with approximately 700 large to mid-sized Italian corporates and provides services to government, public entities, local authorities, universities, public utilities, general contractors, and public and private healthcare providers. Banca IMI is also included in this division as it operates in investment banking (M&A and advisory), structured finance, capital markets and primary markets (equity and debt capital markets).

This division is somewhat more cyclical than the retail division, but highly profitable with a cost/income ratio of only 30%. Overall, this division represented 21% of the group's operating margin in 2015.

Fig. 2: Intesa Sanpaolo's geographic presence in Italy
Source: Company Data



International Subsidiary Banks

As the name suggests, this division is responsible for operations in international markets through commercial banking subsidiaries and associates. It is responsible for defining the group's development strategy related to its direct presence abroad, including exploring and analyzing new growth opportunities in markets the group already has a presence as well as in new ones. Intesa Sanpaolo has a presence in South-Eastern Europe (Croatia, Serbia, Bosnia and Herzegovina, Albania and Romania), in Central-Eastern Europe (Slovenia, Slovakia, and Hungary), in Russia and Egypt.

This division is quite small, and only represented 10% of the group's total operating margin in 2015. Because of the group's small size outside of Italy, the profitability is not great. The division's cost/income ratio is fairly high at 49%.

Private Banking

The private banking division serves the top customer segment (private and high net worth individuals) through Fideuram and its subsidiaries such as Intesa Sanpaolo Private Bank (Suisse). Although the division is small in the grand scheme of the group (only 11% of total operating margin), it is growing nicely and has already achieved a good profitability with a cost/income ratio of 32%.

Asset Management

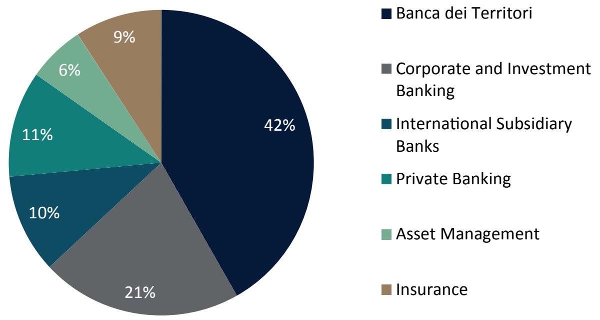
This division develops asset management solutions targeted at the group's customers, commercial networks outside of the group and the institutional clientele through Eurizon Capital. Eurizon Capital is a Luxembourg company specialized in managing mutual funds with low tracking error. The company also owns Epsilon Associati, a company specialized in managing structured products and mutual funds using quantitative techniques.

The Asset Management division is the smallest (only 6% of the group's total operating margin in 2015) but at the same time one of the most profitable, with a cost/income ratio of only 19%.

Insurance

The insurance division develops products tailored for the group's clients and coordinates the operations of Instesa Sanpaolo Vita and Fideuram Vita. Insurance only represented 9% of the group's total operating margin in 2015, but it is the most profitable business line with a cost/income ratio of 15%!

Fig. 3: Weight of each division in terms of Operating Margin
Source: Company Data



Industry Overview & Competitive positioning

Intesa Sanpaolo's revenues come from essentially two streams: net interest income (45% of total income in 2015) and net fee & commission income (44% of total). As per Intesa Sanpaolo's estimates, they are the #1 provider for loans (15% market share), deposits (17% market share, including bonds), pension funds, asset management, and factoring services in Italy.

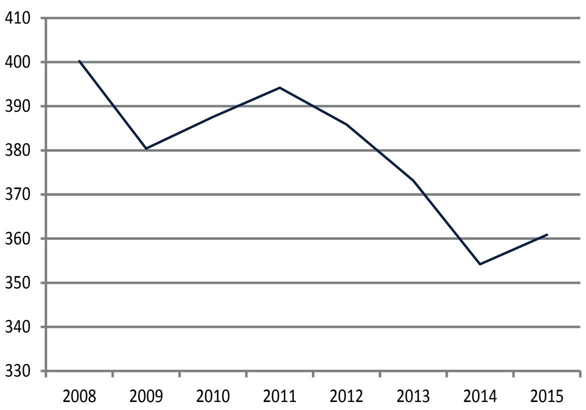
Financial Analysis

Growth

Loans are the traditional way banks make money and represented the biggest part of the group's operating income. Intesa Sanpaolo is keen on emphasizing the local economy support they provide. For example, in 2015, Intesa Sanpaolo had approximately €48bn of medium/long-term new lending, of which approximately €41bn were originated in Italy (up 54% versus 2014). Approximately €34bn of these loans were granted to households and Small and Medium Enterprises (SMEs), an increase of 68%.

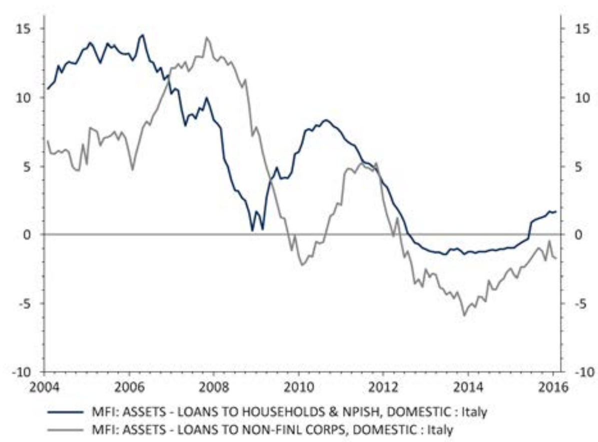
If we look at the group's balance sheet, we can see that loans have been in contraction. This is due to Italy's contracting economy.

Fig. 4: Intesa Sanpaolo's loans over time
Sources: Bloomberg, IAM research



The demand for loans has nevertheless outstripped the supply in the country. As a bank, Intesa Sanpaolo has to remain prudent in their lending standards. Indeed, the credit risk remains with the bank. If a borrower falls late in a reimbursement, then the loan is classified as "non-performing". Non-performing loans curb the extension of new loans and thus diminishes the chances of an economic recovery in Italy. The different levels of non-performing loans at the Italian banks also hold back the possibility of a sector-wide restructuring.

Fig. 5: Overall loan growth in Italy to households and corporates
Sources: ECB, Datastream

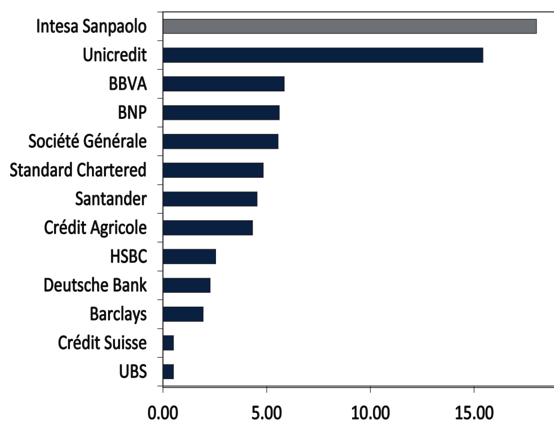


Overall, Italy is just barely showing positive loan growth for households, while corporate loans are still in decline year over year, as shown in *figure 5*.

One of the bank's banes is the increasingly non-performing loans ratio. As the following figure shows, we can see that the proportion of non-performing loans has reached 18%, the highest ratio of large European banks. Hopefully this represents a peak for Intesa Sanpaolo. A massive banking reform could help the Italian economy recover, but it is unclear today what form that would take, as political issues complicate the matter.

We must note however that these non-performing loans are covered up to 47% by provisions the bank already took. The coverage ratio even increases to 139% including collateral at the end of 2015.

Fig. 6: non-performing loans as a percent of total loans
Sources: Bloomberg, IAM research

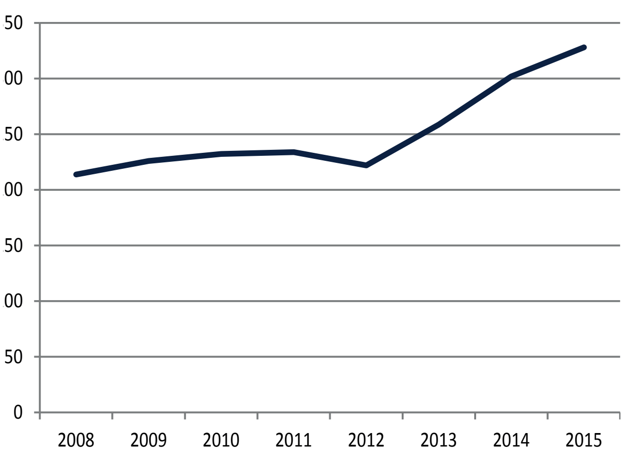


Commissions are the secondary source of income for Intesa Sanpaolo. Commissions come from the wealth management area (private banking and asset management) as well as from investment banking. A recurring revenue fee is derived from assets under management, which have shown a strong growth, now at €328bn *(Fig. 7)*.

Margins

Intesa Sanpaolo has taken several initiatives over the years to cut costs. The key initiatives have been to cut branches (about 800 closures out of 4'100 branches) and optimize the real estate portfolio (reduction of approximately 200'000

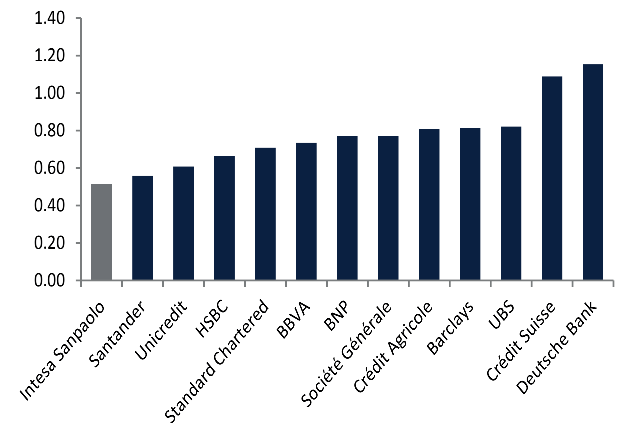
Fig. 7: Total assets under management (billions of EUR)
Source: Company Data



square meters). The Italian bank branch network seems relatively efficient with branch density directly proportional to the wealth of a particular region. Intesa Sanpaolo in general has a good market share in several wealthy regions of northern Italia such as Aosta, Lombardy and Veneto. They still have scope to increase share in certain other wealthier regions such as Trentino-Alto Adige and Lazio.

Intesa Sanpaolo now boasts one of the lowest cost/income ratios of large European banks.

Fig 8: Cost/income ratio of European banks
Source: Company Data



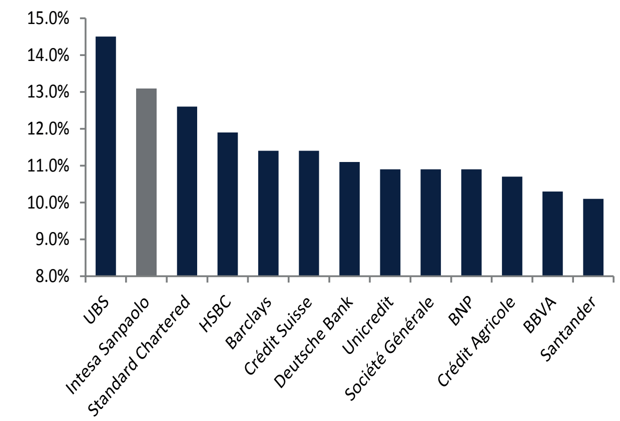
Balance Sheet

In the banking world, a common measure of a bank's capitalization is a regulatory ratio called "Common Equity Tier 1 capital as a proportion of Risk Weighted Assets", or commonly abridged as CET1 ratio. This ratio was introduced by the Basel Committee on Banking Supervision and is currently in its third installment, which is the reason for the regulation's name "Basel III". The intent of this regulation is to strengthen bank capital requirements by increasing bank liquidity and decreasing bank leverage.

Basel III introduced capital buffers that a bank should hold. The first requirement is that banks have to hold a total of 7% CET1 capital from 2019 onwards. A secondary "discretionary counter-cyclical buffer" allows national regulators to require up to an additional 2.5% of capital during periods of high credit growth.

Intesa Sanpaolo's CET1 ratio was at 13.1% at the end of 2015. This compares very well to other banks, notwithstanding the Swiss which have a special requirement of extra capital.

Fig.9: CET1 ratio of comparable banks
Sources: Bloomberg, IAM research



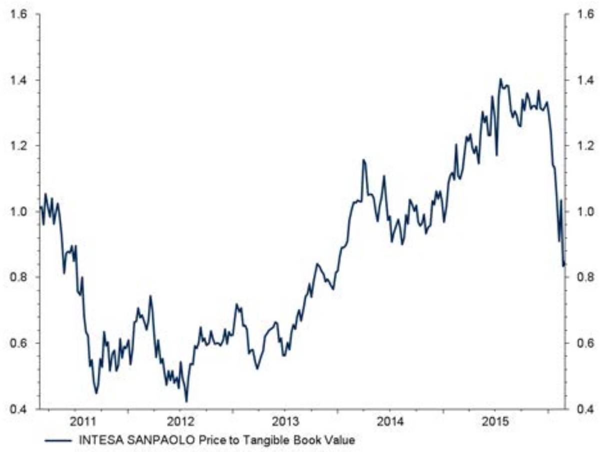
Dividend

Bank dividends are the byproducts of having too much capital. As we have seen, Intesa Sanpaolo's CET1 ratio is above the minimum requirements. While it would be imprudent to redistribute all the excess capital, a large portion is dedicated to shareholder dividends. Management is very shareholder friendly and has distributed most of the net income in form of dividends. The payout ratio in 2015 would be over 90% and the dividend yield would be approximately 5.9% if management's proposal of a cash dividend of €2.4bn is approved at the annual meeting.

Investment case

As we have seen, Intesa Sanpaolo is amongst the best capitalized banks in Europe. Its flaw is to be exposed to Italy, which desperately needs economic reforms. This domestic exposure has drastically reduced its valuation. The company now trades below tangible book value, a level last seen when Italy was in recession (2011-2014).

Fig.10: Price to Tangible Book Value over time
Sources: Datastream



On the other hand, this low valuation makes it an attractive buying opportunity if one believes that the Italian economy will turn around in the medium-term.

Currently, the Return on Equity (ROE) is very low at 5.9%. This is below the weighted average cost of capital, which means that Sanpaolo Intesa is destroying economic value. However, over time ROE should increase once again as margins increase and provisions for non-performing loans diminish. In 2014, the bank's management articulated a business plan for the period 2014-2017 in which they committed to get ROE back to 10% in 2017. Management also committed to distribute €3bn in cash dividends for 2016 and €4bn in 2017. The CEO confirmed these commitments at the end of 2015. With a current market cap of about €40bn, that would represent a dividend yield of 7.5% in 2016 and 10.0% in 2017.

Risks

A major risk is government intervention. Intervention could come from supra-national bodies as the Basel Committee, or from the Italian government. Indeed, as we have seen, not all Italian banks are in such a good capital position as Intesa Sanpaolo. All other Italian banks have non-performing loans and require more capital than Intesa Sanpaolo. The government could create a national bank for all the bad assets and ask each bank for a contribution to help fund the bad bank. Other scenarios include nationalization of poorly performing banks or forced mergers. Political uncertainties currently cloud the big picture; hence the lower valuations attributed overall to Italian banks. While these risks only remotely concern Intesa Sanpaolo, the group may be asked to help others and might suffer just as much as its peers.

Other relevant considerations

Ownership

Foundations have played an important role in Italian banking as long-term shareholders that supported the banking sector through the ups and downs of several economic and credit cycles. However, recently their role has come under scrutiny as corporate governance issues have been raised around the disproportionate influence exerted by foundations on the running of Italian banks. For Intesa Sanpaolo, foundations own a minority of the bank but account for over 80% of the board's representation. As of February 2016, foundations hold just over 22% of the capital (out of the top 5 shareholders, 4 are foundations).

Financial Data

Summary of key financial data from balance sheet, income and cash-flow statements over the last 5 years

Fig. 11: Financial Data
Source: IAM research

(in mio)	2011	2012	2013	2014	2015
Income Statement					
Net interest income	11'929	11'789	9'796	10'132	7'812
YoY % change		*-1.2%*	*-16.9%*	*3.4%*	*-22.9%*
Net fee and commission income	5'020	5'130	5'920	6'467	7'496
YoY % change	-	*2.2%*	*15.4%*	*9.2%*	*15.9%*
Provisions for loan losses	4'229	4'308	6'596	4'102	3'306
As a % of total loans	*1.1%*	*1.1%*	*1.8%*	*1.2%*	*0.9%*
Operating costs	10'671	10'036	11'346	9'641	8'816
costs/income	*61.0%*	*51.7%*	*64.0%*	*51.8%*	*51.4%*
Profit (loss) before taxes	-9'542	2'967	-4'789	3'009	4'395
Taxes	-1'415	1'313	-263	1'651	1'594
Tax rate	*14.8%*	*44.3%*	*5.5%*	*54.9%*	*36.3%*
Net Income (loss)	-8'190	1'605	-4'550	1'251	2'739
YoY % change	-	*-119.6%*	*-383.5%*	*-127.5%*	*118.9%*
Dividend	0.05	0.05	0.05	0.07	0.14
Payout Ratio	*-9.5%*	*48.3%*	*-17.0%*	*88.7%*	*81.1%*
Balance Sheet					
Total Assets	639'221	673'472	624'179	646'427	676'496
Assets under management	233'929	221'889	258'570	301'715	327'826
Tangible Book Value	31'999	34'894	37'049	37'440	37'840
Equity in % of Total Assets	7.5%	7.5%	7.2%	7.0%	7.2%
Customer loans	394'183	385'859	373'124	354'220	360'856
Financial Ratios					
Return On Equity	-16.3%	3.3%	-9.7%	2.8%	5.9%
Non-performing loans as % of total loar	10.6%	12.9%	15.4%	17.7%	18.0%
Cost/income ratio	61.0%	51.7%	64.0%	51.8%	51.4%
Basel 3 fully loaded CET1 ratio	10.1%	11.2%	11.9%	13.5%	13.0%