Intesa's new business plan: evolution rather than revolution

Scope Ratings

Intesa (issuer rating A) presented a new, ambitious business plan on 6 February, together with full-year results for 2017.

Scope believes that most elements of the plan are in continuity with the group's recent history, including a low capital intensity business model, a focus on operating efficiency, the centrality of wealth management and a generous dividend policy. The plan also envisages a more aggressive approach to non-performing exposure (NPE) reduction, which may involve portfolio sales, a commitment to revenue growth and to market share gains in property and casualty insurance, and some refocusing in central and eastern Europe.

2014-2017 business plan successfully executed

Excluding the cash contribution to the profit and loss statement from the Venetian banks' acquisition, adjusted net profit for 2017 stood at EUR 3.8bn, a 23% increase on the comparable figure for 2016, largely driven by higher revenues and declining loan loss provisions.

2017 marked the end of the previous business plan, which was successfully delivered in our view. Over the 2014-2017 period, Intesa's fundamentals strengthened materially:

- The fully loaded CET1 ratio at the end of 2017 stood at 13%, including approx. 100 bps impact from IFRS 9. This level is considerably above the fully loaded SREP requirement of 9.3% and also above the 2013 level of 12.3%. Indeed, Intesa's CET1 ratio is at the high end of the Italian bank peer group. The generous levels of capital combine with a fully loaded leverage ratio of 6.1%, one of the strongest among large European banks.
- Solid solvency was achieved through high organic profitability, setting the bank apart from most of its domestic peers. Net profit grew from EUR 1.2bn in 2014 to EUR 3.8bn in 2017, allowing Intesa to pay EUR 10bn in dividends over the period.
- Asset quality trends have reversed over the years, with gross NPEs reaching a peak of 16.9% of loans in 2014 before starting to decline, also reflecting the improvement in 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 contribution from fee-generating businesses, and particularly the good asset management and asset gathering performance (which helped keep profits robust despite the low interest rate environment), were key to the delivery of material balance sheet and profit and loss improvements over the past few years. The management's focus on cost control and the simplification of group structure were also important drivers, which are likely to continue under the current plan.

The improvement in fundamentals and the expectation of growing financial strength have been reflected in Scope's issuer rating on Intesa, which was first assigned in June 2014 at a level of BBB+, and today stands at A, with a Stable Outlook.

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New strategy for accelerated NPE reduction

For the past few years, Intesa's management has pointed out that its preferred strategy for the reduction of NPEs was based on recoveries, and that it would not have been in the best interest of its shareholders to sell NPEs on the market to return-hungry investment funds. We have held a similar view throughout, highlighting the paradox of barely profitable Italian banks selling NPEs with double-digit internal rates of return.

That said, it appears that Intesa is now ready to become a more active player in the secondary NPE market – also at the urge of the European supervisory authorities. In this context, Intesa's CEO has reiterated that he would not sell NPEs at a cost to shareholders, although in our view, the current levels of provisions (now up to 69% on bad loans and 57% on the whole NPE stock), the substantial levels of collateral and Italy's economic upswing mean that such transactions may not necessarily hurt the bank's profit and loss statement or capital base in our view, while being attractive to buyers. Moreover, given Intesa's current and targeted levels of profitability (return on tangible equity of 9.3% in 2017; targeted return on tangible equity of 14.6% in 2021) the hurdle rate for keeping capital tied up in NPEs is probably higher than it used to be.

Whether by means of sales or accelerated recoveries, balance sheet de-risking is one of the key pillars of the plan. 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.

We have a positive view of these objectives which we believe are realistic in the current environment. In fact, we expect that with the present levels of coverage Intesa may end up over-delivering on them, at least in terms of timing.

Ambitious efficiency targets

Cost containment remains central to Intesa's strategy, with a very ambitious target of reducing the cost/income ratio by almost 10 percentage points (from 53% currently to 45%) based on revenue growth and a slight decrease in the cost base.

Management actions will include the closure of 1,100 branches and the reduction 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.

These targets are bold in our view, given that the improving labour market conditions in Italy, and the success of Intesa itself in recent years, should result in more upward pressure on wages.

Nevertheless, we acknowledge Intesa's commitment to continuously optimize its distribution network, which has already been materially downsized over the past decade.

Revenue CAGR target of 4%, driven by loan volumes and fee business

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. Under the assumed macro scenario, the targets may appear optimistic, although Intesa's management team deserves the benefit of the doubt given the bank's good performance over the previous business plan cycle, specifically on growing fee-generating businesses.

Moreover, in our view, the macro assumptions are very conservative, and even assuming back-ended rate increases in 2020-2021, a by-then-cleaned-up balance sheet would benefit materially, potentially providing room for over-delivery in a better-than-projected macro environment.

Reviewing the strategic positioning in emerging markets

In a drive to simplify the group and facilitate better IT convergence, Intesa will create a managerial hub for its subsidiaries in Croatia, Slovenia and Bosnia and one for the banks in Slovakia, Czechia and Hungary.

In addition, Intesa's banking activity in Russia will now be reported under the corporate and investment banking division, and strategic options for the group's banks in Romania, Ukraine, Moldova and Albania will be considered.

China remains a key strategic growth option for Intesa. Its subsidiary Yi Tsai (100% owned) and joint venture Penghua (49% owned) are active in wealth management, with the latter managing the equivalent of EUR 75bn in assets.

Scope's ratings well positioned

Scope has acknowledged the progress delivered by Intesa over the past few years, with the issuer rating going from BBB+ in June 2014 to the current level of A, with stable outlook, one notch higher that the rating Scope assigned to the Republic of Italy. We believe this rating to be appropriate at present, although the successful delivery of the business plan targets would be positive from a credit point of view.

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