Unicredit SPA: Turning the Corner

Unicredit is at a turning point in its recent history, according to Scope Ratings. Despite the large loss reported in Q4 2016, the group now appears in good shape and should be able to deliver better profits and asset quality from 2017.

Scope this week upgraded Unicredit's Issuer Credit-Strength Rating to A, with Stable Outlook, and the developments highlighted in this brief report support our improved credit view.

Q4 2016 loss was a 'clean-up' exercise

On 9 February Unicredit announced its full results for 2016: a net annual loss of EUR 11.8bn, driven by a EUR 13.6bn loss in the fourth quarter. However, this result includes several one-off items that leave Unicredit well placed for the future:

- Additional loan-loss provisions of EUR 8.1bn: This brings Unicredit's coverage of non-performing exposures (NPEs) ahead of its peers' and in line with the prices demanded by NPE investors. These provisions should allow Unicredit to report a lower cost of risk in future quarters while offloading NPEs in the market.
- Integration costs of EUR 1.7bn: This should support ongoing operational restructuring, which targets material cost reductions over the group's business-plan horizon.
- Writedowns of EUR 3bn on deferred tax assets, goodwill, intangibles, participations, and other charges.

Adjusting for these one-off items would result in a net profit of EUR 1.3bn.

Extra provisions put Unicredit on the fast lane to de-risking

Unicredit's current strategy, presented in December 2016 by the new management team, aims at a fast de-risking of the balance sheet, including a material decline in NPEs.

Among other targets, Unicredit plans a material run-down of its non-core unit through 2019. This unit accounted for EUR 37.4bn of gross loans in December 2016, after the deconsolidation of the FINO portfolio, the vast majority of which are non-performing. Over the next three years, the group intends to reduce non-core gross loans to EUR 19.2bn.

These new provisions should allow Unicredit to sell material volumes of NPEs over coming years (EUR 5.5bn according to the November plan) on top of those in the FINO project, which consists of EUR 17bn in bad loans and was already reclassified as available for sale in Q4 2016.

The better coverage of the existing NPE stock should also reduce provisioning needs in the future, thereby supporting profitability. Cost of risk is projected to decline to 49bps of loans in 2019, from 269bps in 2016.

One-off restructuring to support further cost cuts in western Europe

The EUR 1.7bn of integration costs relate to the restructuring of the group's cost base, primarily in western Europe, where the group is targeting EUR 1.7bn of annual cost savings by 2019. Among other actions, Unicredit will cut its workforce by 14,000 full-time employees (14% of the total workforce) and reduce the number of branches in western Europe by 25%. In the past, we have highlighted structural changes in customer behavior and the need for distribution models to adapt, hence we welcome Unicredit's efforts in this direction.

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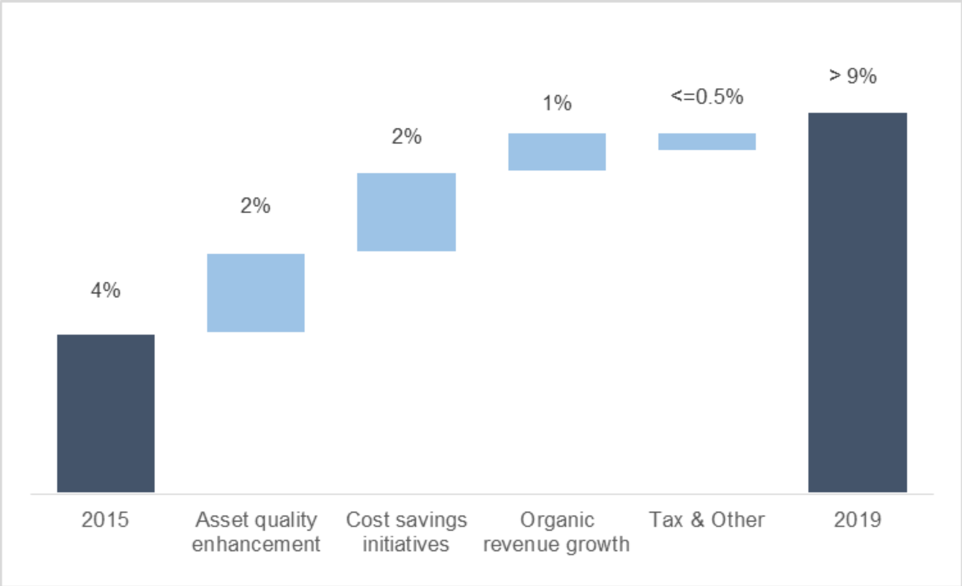
Bloomberg: SCOP

Return target of 9% is realistic

For the past few years, Unicredit has been unable to restore profitability to acceptable levels. Even disregarding the large loss years in 2011 (EUR 9.2bn), 2013 (EUR 14bn) and 2016 (EUR 11.8bn), we calculate that its annual return on tangible equity (RoTE) has remained below 5% since 2010. The 2019 RoTE target of 9% is, in our view, not overly ambitious, but realistic given the bank's starting point. It corresponds to its 2019 net profit target of EUR 4.7bn, more than three times the 2016 adjusted level of EUR 1.3bn – which excludes all negative one-off items. While this may seem challenging at first glance, we note that most of the increase comes from a reduction in operating expenses and costs of risk, while revenue-growth projections are very conservative (+0.6% CAGR in 2015-2019).

Figure 1: Unicredit's RoTE bridge to the 2019 target



Source: Company Data

Capital increase supported by investors

The recent large capital increase shows that investors support Unicredit's new strategy. Despite the relatively difficult environment for Italian banks, Unicredit has managed to raise EUR 13bn to materially clean up its balance sheet from legacy NPEs and set the basis for better profitability going forward.

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