UNICREDIT

PAN-EUROPEAN BANKS

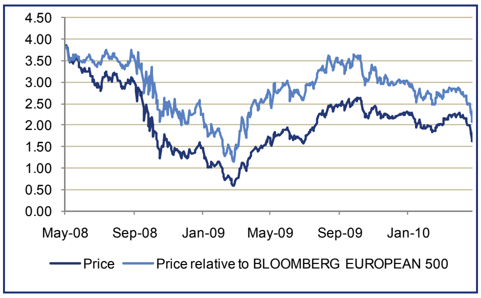
Q1 2010 EARNINGS BETTER ON LOWER LLC AND STRONG TRADING PROFITS

Rating	SELL
Target price (€)	**2.00**
Yesterday's closing price (€)	1.97
Upside / Downside	2%
Market cap (€bn)	37.5
Sector	Pan-Euro Banks

Unicredit reported strong Q1 2010 results, substantially ahead of our estimates. We believe they will be well received. The main positive for us is that loan losses are some 8% lower than we expected and 13% lower QoQ, with the cost of risk falling for the third quarter in a row. NII is in line with consensus estimates. On the negative side, the revenue beat is of questionable quality given that it was largely driven by strong trading profits. We believe Unicredit is beginning to show better earnings resilience compared to the past few quarters. However, we still see it as a very low ROE company (annualised ROE was 1.9% in Q1 2010). We maintain our SELL rating and target price at €2.00, seeing much greater upside at other companies in its peer group.

- Unicredit's Q1 net income was €520m, substantially ahead of our estimate of €290m. Pre-tax income and operating profit were also significantly better than our and consensus forecasts.
- The annualised cost of risk improved to 127bps from 146bps in Q4 2009. This is the main positive in the results in our opinion. Divisionally, there was a substantial increase in the cost of credit in Italian retail (to 148bps from 88bps in Q4 2009), which is more than offset by substantial improvements in certain CEE territories: notably Turkey to -5bps from 497bps (due to some provision releases); Kazakhstan to 268bps from 1515bps; and Russia to 142bps from 257bps. Management reassured on the conference call that the deterioration in Italy was largely due to a one-off reappraisal of some *Incagli* loans (with ~30% provisioning) to *Sofferenze* loans (with provisioning of ~50%). The cost of credit in Italy is expected to be lower in the remaining quarters of 2010.
- NII was ahead of our estimate by 4%, although in line with consensus and falling only 2.5% QoQ. NIM deteriorated again over the quarter, to 2.41% from 2.46%. However, we consider this a resilient performance. It is also somewhat mitigated by the 2% increase in interest-earnings assets, which marks a return to growth after the consistent quarterly falls that we have seen since late 2008. Management indicated that we should expect balance sheet growth going forward, which will have positive implications for NII.
- Management disclosed the exposure to sovereign bonds in Greece, Spain, Ireland and Portugal as about €1.6bn in total. This is small. Unicredit also owns about €31.5bn of Italian sovereign bonds. However, we consider Italy as having the lowest risk of default among the peripheral European countries, so we consider the balance sheet risk for Unicredit as low at present.

(€/€m)	2009	2010E	2011E
Net interest income	17,304	15,167	14,648
Net fees & commissions	7,780	8,509	8,908
Trading profits/losses	1,803	870	913
Other revenue	685	481	474
Total operating revenues	27,572	25,027	24,943
Operating costs	-15,293	-14,664	-14,199
Operating profit	12,279	10,364	10,744
Total provisions	-8,922	-7,024	-4,310
Pre-tax profit	3,331	3,099	6,269
ROA	0.18%	0.15%	0.36%
ROE	3.02%	2.18%	5.21%
ROTNAV	5.55%	3.68%	8.30%
Cost/Income	-55.47%	-58.59%	-56.93%
Net interest margin	2.59%	2.41%	2.39%
LLC % gross loans	-1.41%	-1.22%	-0.75%
NPL ratio	10.20%	11.75%	9.50%
NPL coverage ratio	46.13%	43.00%	51.00%
Loans % deposits	95%	90%	86%
Core tier 1 ratio (Basel II)	8.47%	8.92%	9.35%
Est. Core tier 1 ratio (Basel III)	6.49%	6.94%	7.36%
EPS	0.10	0.07	0.18
DPS	0.03	0.02	0.07
Payout ratio	33.36%	35.00%	40.00%
P/E	19.10	27.77	10.86
P/TNAV	1.12	0.94	0.87
Div yield	1.52%	1.26%	3.69%



Research

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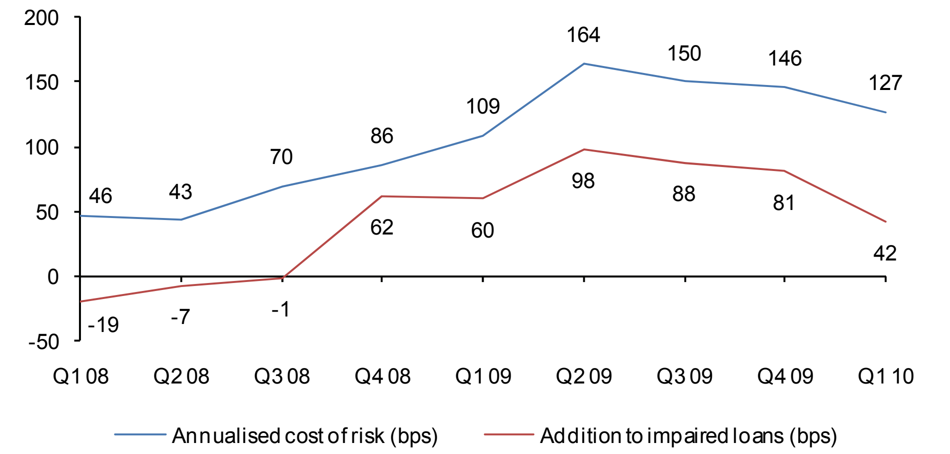
OTHER KEY POINTS

Gradual Improvement in Loan Losses the Key Positive

The improvement in group loan losses is the key positive, in our view. The magnitude of the improvement in loan losses is clearly not as marked as for the Nordic banks, but the positive trend is nevertheless slightly better than the more flat-bottomed trend that we had been forecasting. We see below that the addition to impaired loans, used as a lead indicator for loan losses, is improving at an accelerating pace, which should denote lower loan losses in the near term. This is the best way to look at Unicredit's overall asset quality development, in our opinion, and smoothes out the quarter-by-quarter over-provisioning in certain territories (such as Turkey in Q4 2009, and now Italian Retail in Q1 2010).

Figure 1: Development of Unicredit's Loan Losses and Addition to Impaired Loans



Source: Company data, Matrix Research

To be clear, we do not anticipate loan losses substantially better than consensus forecasts as we expect for Lloyds or the Nordic banks. On this basis we still judge Unicredit to be fairly valued at €2.00 per share, which is in keeping with our view that the bank should remain a low-ROE company for the foreseeable future. The annualised ROE in Q1 2010 was still only 1.9% by our calculations.

High Costs Were Mainly Due to Foreign Exchange Effects

Costs were high in absolute terms, at €3,878m versus our expectation of €3,730m and the consensus estimate of €3,822m. They were also 2% higher QoQ. However, given stronger-than-expected revenues (albeit buoyed by strong trading gains), the cost/income ratio actually improved to 57.0% from 59.0% in Q4 2009.

Perhaps more importantly, the costs included foreign exchange effects. On a constant currency basis, it would seem to us that operating costs increased only about 1% QoQ.

Core Tier 1 Ratio Disappointingly Flat QoQ

The Core Tier 1 ratio fell very slightly by 2bps QoQ to 8.45%, despite the stronger-than-expected earnings. This is partly due to dividend accruals for the year (to be expected), but also due to a 1% increase in RWA over the quarter. The RWA expansion was attributed by management to foreign exchange effects, specifically due to the weakening of the euro against CEE currencies. There may be further weakening of the euro given current sovereign debt concerns, but we would not expect this to be a major negative for the stock.

Pioneer Now Considered Non-core

Pioneer, Unicredit's asset management subsidiary, has now been declared non-core. This marks a surprising turnaround in strategy by management. We agree with management that, with only €185bn under management, the business cannot be considered market leading. Indeed, it is only the 17th largest asset manager in Europe.

Management was at pains to point out, however, that the strategic review of the business would not necessarily lead to a sale, so we think it is premature to think that a benefit to capital ratios (from a gain on sale) should be expected. Indeed, it could be the case that Pioneer is merged with another asset manager, in which Unicredit would take an equity stake.

Figure 2: Unicredit Earnings Table

UNICREDIT SPA	Q4 2009	FY 2009	Q1 2010E	Q1 2010	FY 2010E	FY 2011E	FY 2012E
Income statement (€m)							
Net interest income	4,017	17,304	3,763	3,917	15,167	14,648	15,044
Net fees & commissions	2,114	7,780	2,074	2,169	8,509	8,908	9,328
Trading profits/losses	152	1,803	250	560	870	913	957
Other revenue	160	685	195	159	481	474	478
Total operating revenues	6,443	27,572	6,281	6,806	25,027	24,943	25,808
Operating costs	-3,803	-15,293	-3,730	-3,878	-14,664	-14,199	-14,605
Operating profit	2,640	12,279	2,551	2,928	10,364	10,744	11,203
Total provisions	-2,300	-8,922	-2,021	-1,946	-7,024	-4,310	-2,545
Investment income	217	232	110	69	-40	35	35
Goodwill impairment	0	0	0	0	0	0	0
Other income	63	-258	-50	-6	-200	-200	-200
Pre-tax profit	620	3,331	590	1,045	3,099	6,269	8,493
Taxes	-124	-1,010	-189	-403	-1,212	-2,006	-2,717
Minorities	-63	-332	-48	-63	-269	-512	-693
Other non-operating items	-62	-256	-63	-58	-250	-250	-250
Net profit	371	1,733	290	521	1,369	3,501	4,833
Assets (€m)							
Loans to customers	564,986	564,986	550,366	563,894	536,429	531,016	551,989
Interbank loans	78,269	78,269	78,269	91,862	78,269	82,182	86,292
Total securities	198,167	198,167	200,568	209,401	205,589	212,618	219,999
Intangible assets	5,332	5,332	5,050	5,288	5,132	4,932	4,732
Total assets	928,760	928,760	931,048	948,867	956,673	992,298	1,031,254
Net interest-earning assets	643,255	643,255	628,635	655,756	614,698	613,198	638,280
Liabilities (€m)							
Interbank borrowings	106,800	106,800	104,664	112,828	117,285	125,708	136,070
Customer deposits	596,396	596,396	596,396	592,539	595,502	619,681	644,843
Total shareholders' equity	59,689	59,689	64,113	65,288	65,675	68,697	72,130
Tangible net asset value	33,866	33,866	39,063	39,185	40,543	43,765	47,398
Important Financial Ratios							
ROA	0.16%	0.18%	0.12%	0.22%	0.15%	0.36%	0.48%
ROE	2.49%	3.02%	1.88%	3.33%	2.18%	5.21%	6.86%
ROTNAV	4.40%	5.55%	3.19%	5.70%	3.68%	8.30%	10.60%
Cost/income	-59.03%	-55.47%	-59.38%	-56.98%	-58.59%	-56.93%	-56.59%
Tax rate	-20.00%	-30.31%	-32.00%	-38.59%	-39.10%	-32.01%	-32.00%
Payout ratio	155.81%	33.36%	0.00%	0.00%	35.00%	40.00%	40.00%
Net interest margin	2.46%	2.59%	2.37%	2.41%	2.41%	2.39%	2.40%
LLC % gross loans	-1.46%	-1.41%	-1.39%	-1.27%	-1.22%	-0.75%	-0.41%
Non-performing loans % gross loans	10.20%	10.20%	10.70%	10.66%	11.75%	9.50%	6.50%
NPL coverage ratio	46.13%	46.13%	44.00%	46.54%	43.00%	51.00%	59.00%
Loans % deposits	94.73%	94.73%	92.28%	95.17%	90.08%	85.69%	85.60%
Tier 1 ratio	9.49%	9.49%	9.89%	9.40%	9.89%	10.21%	10.41%
Core tier 1 ratio (Basel II)	8.47%	8.47%	8.86%	8.45%	8.92%	9.35%	9.58%
Est. Core tier 1 ratio (Basel III)	6.49%	6.49%	6.88%	6.47%	6.94%	7.36%	7.60%
RWA % total assets	48.70%	48.70%	47.85%	48.05%	46.71%	46.40%	47.15%

Source: Matrix Research

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