



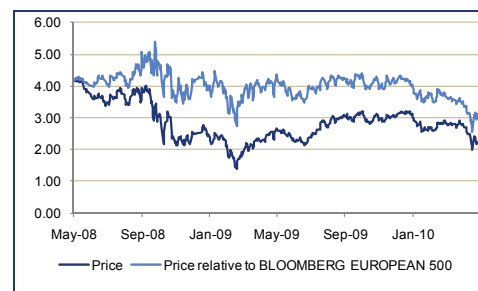
## Q1 2010 AHEAD ON LOWER LLC. BE WARY OF SOVEREIGN CONCERNS

Intesa Sanpaolo's Q1 2010 net profit was ahead of our estimates and that of consensus, by 10% and 18% respectively. The main reason was lower than expected loan losses. Operating profits were ahead by only a modest amount, with continued weakness in net interest income offset by lower than expected expenses. Overall, we note that Intesa still only achieved an annualised RoTNAV of 10.2% for Q1 2010 (and we expect a similar RoTNAV for FY 2010). We therefore believe the estimated 2010 P/TNAV of 0.9x is fair. We maintain our HOLD rating, but reduce our target price to €2.60 from €3.10 to reflect higher risks arising from the possible (albeit unlikely) default of Italian sovereign debt. Under this worst case scenario, we estimate that Intesa's 2010E Core Tier 1 ratio would fall substantially to just 4.6% (from 7.8%).

- The improvement in loan losses was the main positive surprise of Intesa's Q1 2010 results, being 12% better than we had expected. NPLs increased, both on an absolute basis (+5% QoQ) and as a percentage of gross loans (to 8.7% from 8.3%). However, the rate of NPL formation declined substantially compared to Q4 2009. The coverage ratio has also improved slightly to 42% (from 41%). Overall, we are encouraged by the development in asset quality this quarter, but remain wary of a double-dip scenario should economic conditions in southern Europe deteriorate further.
- Net interest income continued to weaken, with the NIM deteriorating to 2.31% from 2.38% in Q4 2009. The main drivers of this were the continued (albeit modest) falls in EURIBOR, and volume contraction. We expect NIM and NII to be fairly flat for the rest of 2010 with EURIBOR staying at low levels.
- Operating costs improved more than we had expected, even after taking into account the fact that costs in Q4 2009 were seasonally high. The cost/income ratio declined to 53.2% from 60.0% in Q4 2009.
- The Core Tier 1 ratio increased to 7.2% from 7.1% at the end of 2009, in line with our expectation. Although the improvement is modest, management is working on numerous measures (such as the sale of branches to Credit Agricole) to improve the ratio further by a minimum 150bps. We consider Intesa's capital adequacy to be average compared to its peer group.
- We analyse Intesa's exposure to peripheral European sovereign debt. Under a worst case (albeit unlikely, in our view) scenario of this debt being written down by 30% due to defaults, we estimate that Intesa's Core Tier 1 ratio would fall to 4.6% from 7.8%.

Rating	HOLD
Target price (€)	2.60
Yesterday's closing price (€)	2.20
Upside / Downside	18%
Market cap (€bn)	28.0
Sector	Pan-Euro Banks

(€/€m)	2009	2010E	2011E
Net interest income	10,486	9,763	9,824
Net fees & commissions	5,341	5,407	5,660
Trading profits/losses	1,122	1,045	1,578
Other revenue	531	649	709
Total operating revenues	17,480	16,864	17,771
Operating costs	-9,459	-9,725	-9,988
Operating profit	8,021	7,139	7,783
Total provisions	-4,003	-2,999	-2,493
Pre-tax profit	4,328	4,190	5,365
ROA	0.44%	0.47%	0.51%
ROE	5.52%	5.57%	5.89%
ROTNAV	11.52%	10.73%	10.97%
Cost/Income	-54.11%	-57.67%	-56.20%
Net interest margin	2.44%	2.37%	2.40%
LLC % gross loans	-0.99%	-0.75%	-0.60%
NPL ratio	8.25%	9.50%	8.00%
NPL coverage ratio	40.58%	45.00%	49.00%
Loans % deposits	94%	89%	86%
Core tier 1 ratio (Basel II)	7.13%	7.75%	8.09%
Est. Core tier 1 ratio (Basel III)	5.94%	6.56%	6.90%
EPS	0.22	0.23	0.26
DPS	0.08	0.09	0.11
Payout ratio	33.8%	35.0%	40.0%
P/E	10.02	9.37	8.44
P/TNAV	0.97	0.90	0.82
Div yield	3.64%	4.03%	5.11%



Research

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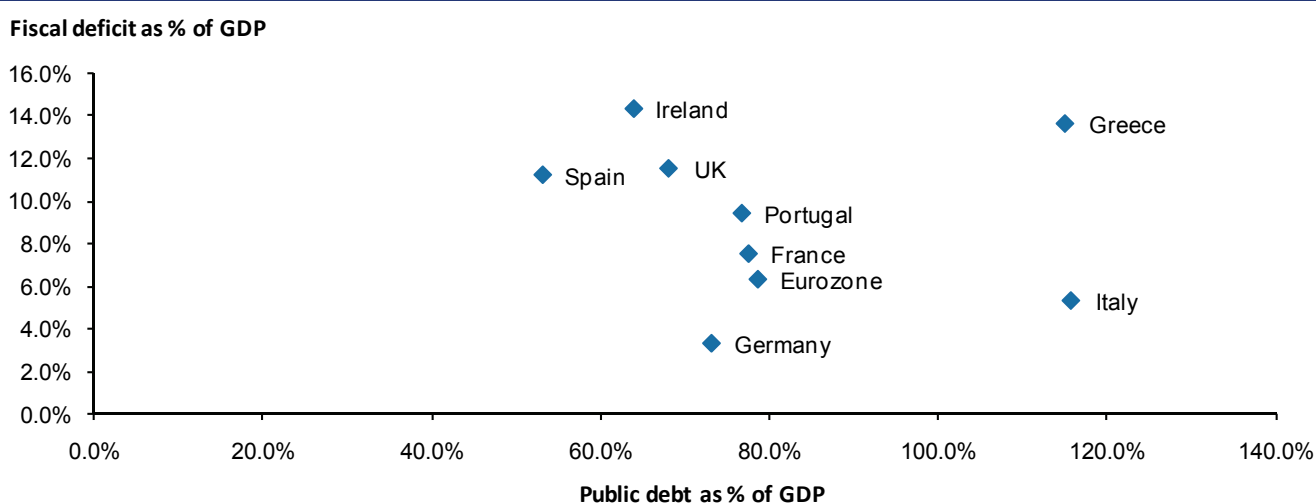
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## Exposure to Sovereign Debt

Intesa Sanpaolo has been more transparent than most of its peers in disclosing the exact details of its ownership of peripheral European sovereign debt. We see that its ownership of debt from Greece, Ireland, Portugal and Spain is relatively small, amounting to only €1.1bn in total. However, the ownership of Italian sovereign debt is unsurprisingly large, at €39.5bn.

We believe that the probability of default of Italian sovereign debt is, in isolation, quite small. Among the peripheral European countries deemed at economic risk from high levels of indebtedness, Italy stands out as having a very high ratio of public government debt to GDP of 116%, but a relatively low fiscal deficit as a percentage of GDP of only 5.35% (as at year-end 2009). As such, while the quantum of debt is large, the affordability of that debt appears manageable, in our view.

Figure 1: Sovereign Indebtedness as Indicated by Fiscal Deficit and Public Debt as Percentage of GDP. Year-end 2009 Data



Source: Eurostat, Matrix Research

*Italian sovereign debt would still suffer in the event of the Euro currency breaking up, in our opinion*

We believe that Italy, among the peripheral European countries, is in the most robust position in terms of being able to service its debt. However, we should acknowledge that tail risk exists due to the possibility of the Euro breaking up (if France or Germany were to leave the Euro, for example). The working practicalities of how this would occur are difficult for us to fathom at the moment. However, we understand that re-denominating the existing stock of peripheral European sovereign debt in a 'new' Euro (or other) currency rather than the existing Euro currency would constitute an act of default. We therefore have to address the possibility (however remote at present) that a substantial writedown of peripheral European debt could occur if the Euro is disbanded in some way.

We run through a scenario whereby the peripheral European debt owned by Intesa is written down by 30%. We regard any negative mark-to-market movements through earnings as currently negligible, so the application of a 30% writedown to all sovereign debt, regardless of categorisation, is reasonable in our view. We are therefore agnostic as to whether this debt is categorised as held-for-trading, held-to-maturity or available for sale.

We see from the following tables that Intesa owns very little sovereign debt from Greece, Ireland, Portugal and Spain. However, unsurprisingly, it owns considerable Italian sovereign debt, amounting to €39.5bn. If we assume a 30% writedown of this debt, then we estimate that the 2010E Core Tier 1 ratio would fall considerably to just 4.6% (from 7.8%).

Figure 2: Intesa's Exposure to Peripheral European Sovereign Debt

€b	Trading Portfolio	AFS	HTM and L&R	TOTAL
Italy	22.2	14.4	2.9	39.5
Greece	0.2	0.4	0.2	0.8
Ireland	0.0	0.2	0.0	0.2
Portugal	0.0	0.0	0.0	0.0
Spain	0.0	0.0	0.0	0.0
Total Peripheral Europe	22.5	15.0	3.1	40.6

Source: Company data, Matrix Research

Figure 3: Impact on Intesa's Capital Ratio Due to 30% Writedown of Peripheral European Sovereign Debt

€b / %				
Total Peripheral Europe				40.6
Assumed percentage writedown due to default				30%
Writedown (€b)				12.2
	<b>Before writedowns</b>	<b>After writedowns</b>	<b>% change</b>	<b>Absolute change</b>
Tier 1 capital, 2010E	34.0	21.8	-36%	-12.2
Core Tier 1 capital, 2010E	29.5	17.3	-41%	-12.2
RWA, 2010E	380.6	380.6		
Tier 1 ratio before writedowns	8.9%	5.7%		-3.2%
Core Tier 1 ratio before writedowns	7.8%	4.6%		-3.2%

Source: Matrix Research

This scenario is currently considered unlikely by consensus, but we believe the market is attributing an increasing probability of it occurring, judging by the continued weakness in the Euro currency. Without wanting to state the obvious, it is also important to note that Intesa is not alone in being exposed to the risk of peripheral European sovereign debt being written down. Many European banks, (not just those domiciled in peripheral Europe), will be exposed to significant writedown risk in such a scenario.

Figure 4: Intesa Sanpaolo Earnings table

INTESA SANPAOLO	Q4 2009	FY 2009	Q1 2010E	Q1 2010	FY 2010E	FY 2011E	FY 2012E
<b>Income Statement (€m)</b>							
Net interest income	2,487	10,486	2,519	2,407	9,763	9,824	10,366
Net fees & commissions	1,497	5,341	1,353	1,403	5,407	5,660	6,114
Trading profits/losses	129	1,122	287	218	1,045	1,578	1,650
Other revenue	160	531	132	195	649	709	786
Total operating revenues	4,273	17,480	4,292	4,223	16,864	17,771	18,916
Operating costs	-2,546	-9,459	-2,363	-2,247	-9,725	-9,988	-10,333
Operating profit	1,727	8,021	1,928	1,976	7,139	7,783	8,583
Total provisions	-1,168	-4,003	-983	-840	-2,999	-2,493	-2,116
Investment income	517	545	48	10	150	150	150
Impairments on other assets	-160	-235	-50	-5	-100	-75	-50
Goodwill impairment	0	0	0	-2	0	0	0
Pre-tax profit	916	4,328	944	1,139	4,190	5,365	6,568
Taxes	-169	-960	-229	-351	-1,266	-1,549	-1,868
Minorities	-57	-133	0	-22	-28	-35	-66
Other non-operating items	-147	-430	-93	-80	106	-450	-450
Net profit	543	2,805	622	686	3,002	3,331	4,183
<b>Assets (€m)</b>							
Loans to customers	374,033	374,033	371,098	369,481	361,082	363,298	378,863
Interbank loans	43,242	43,242	43,783	47,908	45,404	49,945	54,939
Total securities	132,246	132,246	133,698	149,928	136,316	139,982	143,831
Intangible assets	25,789	25,789	26,500	26,500	25,960	26,500	26,500
Total assets	624,844	624,844	623,394	643,669	647,613	669,011	690,922
Net interest-earning assets	417,275	417,275	414,880	417,389	406,486	413,242	433,802
<b>Liabilities (€m)</b>							
Interbank borrowings	43,369	43,369	43,152	44,693	44,916	46,740	48,638
Customer deposits	396,057	396,057	394,077	404,171	406,192	422,685	439,848
Total shareholders' equity	52,681	52,681	53,428	53,354	55,054	58,134	60,985
Tangible net asset value	26,892	26,892	26,928	26,854	29,094	31,634	34,485
<b>Important Financial Ratios</b>							
ROA	0.35%	0.44%	0.40%	0.43%	0.47%	0.51%	0.62%
ROE	4.15%	5.52%	4.69%	5.18%	5.57%	5.89%	7.02%
ROTNV	8.41%	11.52%	9.25%	10.21%	10.73%	10.97%	12.65%
Cost/income	-59.58%	-54.11%	-55.07%	-53.21%	-57.67%	-56.20%	-54.62%
Tax rate	-18.45%	-22.18%	-32.00%	-30.82%	-30.21%	-28.87%	-28.44%
Payout ratio	0.00%	33.80%	0.00%	0.00%	35.00%	40.00%	40.00%
Net interest margin	2.38%	2.44%	2.42%	2.31%	2.37%	2.40%	2.45%
LLC % gross loans	-1.14%	-0.99%	-0.98%	-0.82%	-0.75%	-0.60%	-0.48%
Non-performing loans % gross loans	8.25%	8.25%	8.75%	8.67%	9.50%	8.00%	3.00%
NPL coverage ratio	40.58%	40.58%	39.50%	41.88%	45.00%	49.00%	53.00%
Loans % deposits	94.44%	94.44%	94.17%	91.42%	88.89%	85.95%	86.14%
Tier 1 ratio	8.37%	8.37%	8.42%	8.39%	8.93%	9.23%	9.56%
Core tier 1 ratio (Basel II)	7.13%	7.13%	7.17%	7.20%	7.75%	8.09%	8.47%
Est. Core tier 1 ratio (Basel III)	5.94%	5.94%	5.98%	6.01%	6.56%	6.90%	7.28%
RWA % total assets	57.88%	57.88%	57.72%	58.83%	58.76%	59.20%	59.65%

Source: Matrix Research

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