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Diversified Banks
Western Europe

Veneto Banca

Putting the Past in the Past

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- **Putting the Past in the Past** — Veneto Banca ("VB") has reached the time for a profound transformation after the storm broke in 2014. Like Queen Elsa (in Frozen), VB needs to put its past behind and address the main legacy issues (capital, funding, asset quality) and leverage on its core activities. The management has to focus on the delivery of the bank turnaround, which is challenging in our view given the multitude of actions needed at the same time, but if successful could provide a brighter future for the bank and its shareholders. The recent developments at peers could have heightened perceptions of risk on the bank, but the launch of the Atlante fund and government actions on NPL recovery could prove supportive. The newly appointed board will also have to restore shareholder confidence and address close regulatory scrutiny. Given potential for market consolidation, we cannot rule out involvement by VB in possible M&A over time.
- **"Let It Go!"** — Management seems focused on addressing all the bank main issues: restoring the group's capital position above regulatory minimum (via a €1bn capital increase, disposal and profits), improving the funding profile, addressing the group's asset quality and at the same time tackling costs, revamping the commercial banking operations and strengthening customer relationships. We believe the main opportunities for restoring the group's capital position lie in restructuring the bank balance sheet via improving AQ/funding, and increasing profitability (via lower funding costs/provisions, improving fees and cost cutting).
- **Many Actions to Be Implemented At The Same Time** – The execution risk of this plan is high, in our view, given that many of the restructuring actions need to be implemented at the same time and also depend on external factors. Our estimates are well below VB's targets (which assume a net profit well above the historical peak, with a smaller balance sheet and different macro backdrop). The most challenging target in our view is the revenue increase, as this depends not only on the bank's actions but also macro conditions. The reduction of the cost base seems achievable, with potentially some scope for higher cost saving. We forecast higher cost of risk than management as we believe that VB should consider higher NPL disposals (key for balance sheet de-risking), and this could affect capital rebuild.
- **Key Risks** — The main stock specific risks are represented by the legacy issues: low capital position, an expensive and concentrated funding, high level of NPLs and litigation. Industry-wide risks include: the low rate environment, asset spread compression due to competition, volatile financial markets, limited GDP growth, and sovereign and regulatory development. We see the restructuring as complex.
- **VB at Glance** — VB is the 9th largest Italian bank in term of loans, with a market share of c2% (significantly stronger in some key areas, eg. Veneto) and mainly focuses on traditional banking services to corporate and retail clients. VB transformed from Popolare bank into a joint stock company in December 2015.

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Putting the Past in the Past

The last three years have been particularly challenging for Veneto Banca (high loan losses have negatively affected capital, mainly due to the AQ issue). We believe the company has a clear understanding that the time has come for a new page of the story and to put the past in the past. The new management (appointed last year) seems strongly committed to re-establishing Veneto Banca original identity as the local bank for the territory and also leaving its options open for potential role in the pending possible M&A among banks in Italy.

Veneto Banca (VB) is the 9th largest bank in Italy in term of loans (c€21bn) and has a nationwide market share of c2%, with higher market share in the North East (c3%), and c6.5% market share in Veneto, among the top 3 regions by GDP in Italy. VB is mainly a retail and corporate/SME bank (c90% of loans in these areas) and it is mainly focuses on lending activities (loans are c70% of assets).

The company had to deal, over the past few years, with many issues. Namely, a c€500m capital increase in 2014, large losses posted in 2014 and 2015 (following mostly asset quality clean up due to the findings of the AQR and more stringent review of the loan book); fiscal investigations of former Chairman and former CEO, an ECB inspection, consumer association complaints, a significant decrease in the nominal value of the shares owned by existing shareholders and lately a successful (but complex) process for the transformation into joint stock company (following government reform) and an investigation by Consob. The AGM of 5th of May has appointed a new board and has elected Mr Ambrosini as new Chairman of the bank; he was heading the list representing the shareholder association which defeated the other list (Chairman candidate was Mr Bolla, the current chairman). Mr Carrus has been confirmed as General Manager of the bank. The new Chairman, in a speech post election, indicated that the bank “is under special surveillance from regulators”.

In our view, there are three main legacy issues that management has to face: a low capital position (the result of high losses), a low level (LCR at 78% in 1Q 2016) of expensive and concentrated funding and a high level of NPLs. Also, the group has an inefficient structure that could be simplified (eg cost cutting). One key aspect to consider is the need to re-establish strong relationship with existing customer base and deal with potential future litigation.

In our view, the main opportunities lie in the balance sheet derisking (via lower NPLs and better funding metrics) and improving profitability (reduction of the funding costs, the improvement of revenues mainly via fee income and restructuring of the bank via cost/cutting and improving cost of risk). Also, given the set-up of the Atlante fund, we cannot rule out an intervention of the fund in the bank equity or in supporting the NPL disposals. Additionally, any development in terms of M&A could be a swing factor for the bank’s future.

The management team is in our view fully committed to address the past issues via:

- **Strengthening of Control Functions** – VB has significantly increased headcount in the compliance department (+17%) and has created a new compliance structure and rules, as well as new risk management department.

- **Reviewing and Adopting New Credit Policies** – VB has done a full review of credit policies post AQR and completely reorganized the credit department and set up new monitoring tool for NPLs and performing loans (to pick up early stress signal). VB has introduced new training (credit process and risk monitoring).

- **Other SREP Identified Interventions** – The bank has created a more efficient and rapid processes and has significantly improved the flow of information to better monitor internal processes.

- **Revamping Commercial Strategy** – Management has identified a new business model to refocus on its local identity, optimizing its branches and strengthening commercial partnerships and increasing penetration on the existing client base. The bank has also developed a new commercial strategy to facilitate interaction within the bank and with its clients.

The four pillars of VB's strategy to re-launch the bank include:

- **Revenue Growth** – VB has a new service model to increased penetration of fee income. VB wants to increase its exposure to high-margin SME clients. Also VB plans to develop more the multichannel and digital platform.

- **Credit Risk Structural Improvement** – VB has implemented new credit risk management, significantly improving the monitoring and control of position and has now a proactive management of credit anomalies. VB has created a non-core unit dedicated to NPL management.

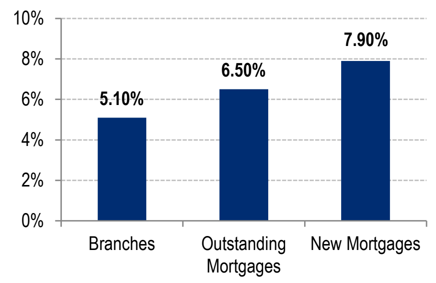
- **Greater Operating Efficiency** – VB is targeting a strong focus on costs via branch network rationalization, review of all organizational structure, outsourcing back office and headcount reduction.

- **Strengthening Capital Position and Improve Funding Structure** – VB is planning a €1bn capital increase (equal to c430bp) to strengthen group capital position, as well as disposal of some stakes (eg. BIM), rationalize the foreigner branch network and reducing the funding concentration.

We believe that the task is challenging and complex. The execution risk of the plan is high, in our view, as many of the restructuring actions need to be implemented at the same time and also depend on external factors (eg. macro).

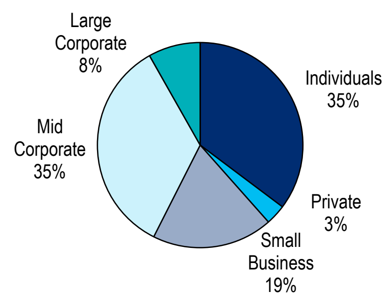
Company Snapshot

Figure 1. VB – Veneto Market Share, June 2015



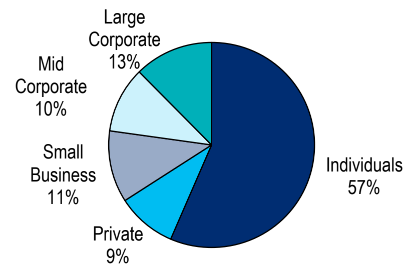
Source: Company data

Figure 2. VB – Loan Mix, 2015



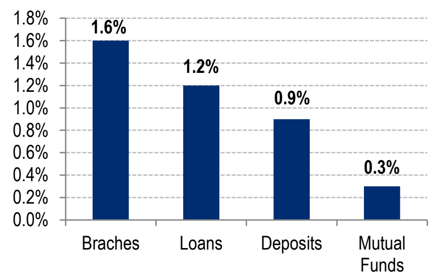
Source: Company data

Figure 3. VB – Direct Funding Mix, 2015



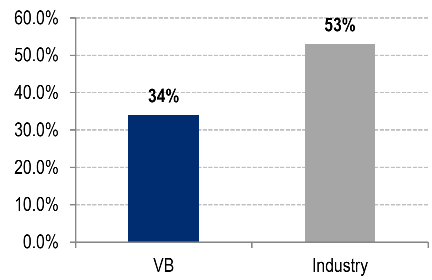
Source: Company data

Figure 4. VB – Italy Market Share, June 2015



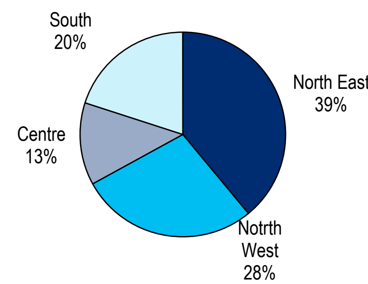
Source: Company data

Figure 5. VB – AUM Penetration (%), Sept 15



Source: Company data

Figure 6. VB – Branches by Geo, 2015

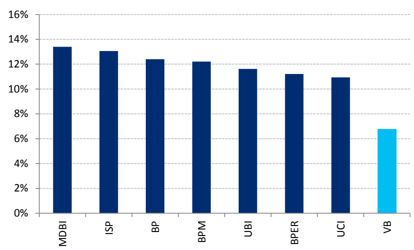


Source: Company data

Three Main Legacy: Capital, Asset Quality and Funding

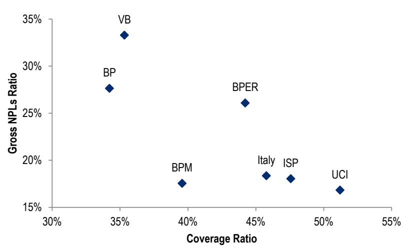
We believe there are three main legacies from the past representing the main company specific risks for investing in VB. These include: low capital position, challenging funding and a high level of NPLs. Management is focused on dealing with these issues in the turnaround business plan, but execution risk seems high.

Figure 7. CET1 Fully Loaded, 2015



Source: : Company data and Citi Research

Figure 8. Net NPLs on Loans, 2015



Source: Company data and Citi Research

Low Capital Position – VB has a low capital position following the high losses posted over the last 3 years (cumulative c€2bn). The CET1 fully loaded stood at 6.8% in Dec 2015 (and at 6.8% in March 2016), the lowest among banks in our coverage (average is c12% as of Dec 2015). The group capital ratios are also below the ECB SREP capital requirement of 10% as of Dec 2015, which will be increased to 10.25% from 30th June 2016. VB is planning a €1bn capital increase (equal to c430bp) to complete at the time of the IPO and this, coupled with several disposals (eg. BIM, international franchise, other stakes) and restructuring actions, is expected to bring CET1 FL at c12.4% by 2018 (we forecast c12.0%). VB capital ratios are based on standard methodology and include a c€300m negative filter for financed shares, and those could represent capital buffers in the medium/long term.

High Level of NPLs – VB's gross NPLs increased by c185% since 2011, more than twice the peer group (+c80%) due to larger AQR effect and reclassification of loans following more stringent criteria. VB has now a very high level of NPLs and the weakest asset quality among the Italian banks in our coverage. VB has the highest level of NPLs on loans (gross NPLs are c33.2% of total net customer loans and net NPLs c21.5% of total net customer loans), well above peers (c18.3% gross and c9.9% net). Also the coverage ratio is c10pp below peers, at c36%, possibly also explained by the higher weighting of unlikely to pay on total NPLs (c47% for VB vs c40% for peers). This high amount of UTP could also have some negative effect on NII, if they migrate to Sofferenza. VB has, on the positive side, one of the highest levels of collateral in the system, but the recovery time/process could affect its value. VB has set up a special recovery unit for NPLs with an enhanced NPL management and collection process and this could drive higher recovery. Also, better risk management tools should improve loan book monitoring and earlier recognition of problematic situation. VB plans c€1.9bn of net NPL disposals in the plan, and this could be even higher in our view, also depending on market condition and government actions. The Atlante fund could be a support for NPL sales as well.

Reduction of a Concentrated Funding – The group funding position has deteriorated over the last two year, showing large deposit outflows. Also in 1Q the group showed a c9%reduction of direct funding (including a decrease in CCG repo), possibly due to market volatility and increased risk perception among customers. Also, VB shows a high concentration of funding in the corporate space. This has also been reflected in higher interest expense than peers. VB funding has decreased significantly more than peers, possibly due to increased concern on the solvency of the bank and deterioration in customer relationships following the press coverage of bank developments and turmoil around the recent EGM for the transformation. As of Dec 2015 the LCR ratio stood at 53% and it is recovered to c78% in 1Q 2016 and company expects it to be c90% (at the completion of the planned capital increase). Maturities in 2016-17 are c16% of total funding in 2015.

Figure 9. Total Deposit Trends

	2013	2014	2015
VB	-7.8%	-6.5%	-8.6%
Italian Banks	-3.3%	-2.4%	1.1%
Italy	-1.9%	-1.2%	-0.6%

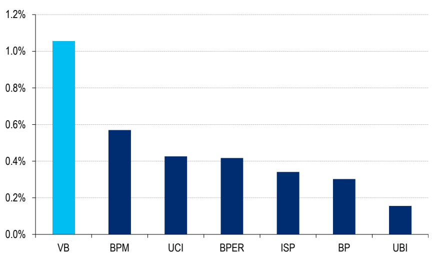
Source: Company data, ABI and Citi Research

Management has presented a business plan and updated it post the 1Q results; the main differences are lower revenues, mostly offset by lower taxes, and lower funding and indirect deposits.

Three Main Opportunities: Funding Costs, Fee Income and Restructuring/Recovery

In addition to a successful turnaround of the main issues listed above, we think VB's story could offers opportunities, thanks to its gearing to a recovery in the Italian economy and Italian wealth allocation (once market turbulence stabilizes).

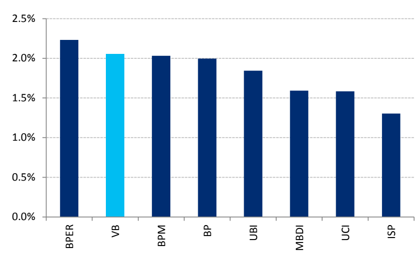
Figure 10. Deposit Funding Costs, 2015



Source: Company data and Citi Research

Decreasing Funding Costs – VB's funding costs are the highest among the domestic banks in our coverage universe. In particular, VB shows a significantly higher level of deposit funding costs than peers (c3x at c1.3% in 2014, calculated as deposit costs in interest expense over total deposits). Deposit costs represent c41% of total interest expense of VB, almost double the average of peers (c23%). We expect a diversification of the funding sources (eg. less expensive and volatile corporate deposits), an increase in the institutional funding (with also securitisation), the low interest rate environment (especially supporting institutional funding), and potentially a rating upgrade (in the medium term if balance sheet strength starts to improve). These could all support a decrease in funding costs. Also, the lower contribution to NII from securities income (only 13% of NII compared to c30% for peers, calculated as interest income from securities over securities) should ease YoY comparison vs peers. A key question is the impact of low rates for longer on both liabilities and assets, as we have more conservative expectations than VB.

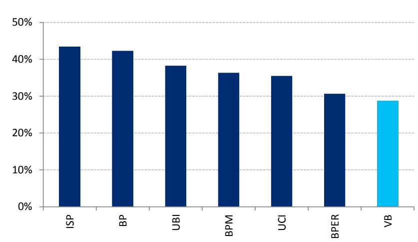
Figure 11. Costs to Assets Ratio, 2015



Source: Company data and Citi Research

Restructuring/Recovery – VB has the highest cost/income ratio among the banks in our coverage universe (c72% vs average of c57% in 2015) leaving large scope for rationalisation of the cost base. We prefer to focus on the cost to asset ratio to better assess the company gap vs peers (as also revenue mix/rends are very different) and on this metric VB is the second worst with a c50bp gap vs average (2.05% in 2015 for VB on a reported basis vs c1.55% for our coverage), and we expect that via the planned rationalisation the gap could more than half by 2018. Management could have some more scope for rationalisation would the revenue environment remain challenging in our view. Also, other opportunities in restoring the group's profitability relate to the cost of risk decrease, following the large clean up implemented in 2013-2015, the better risk management and the potential recovery of Italian economic conditions. We expect cost of risk to decrease to c100bp in 2018 (vs c270bp average 2013-2015), higher than peers in order to rebuild coverage and facilitate NPLs disposals.

Figure 12. Fee on Total Revenues, 2015



Source: Company data and Citi Research

Leveraging on Underpenetrated Fee Income – VB has a low penetration of fee income to total revenues, and within this the penetration of investment product/fee is well below peers. Total commission income represents only c29% of total revenues, c10pp below peers. Looking at margin, the investment fee margin on AUM is among the lowest (possibly also due to the composition of AUM/AUC) and the banking fee margin is the lowest among Popolari banks. A rise in volume and better margins would support fee income growth. VB expects c8% CAGR 2015-20 in fees, while we expect c3/4%. One key variable to consider is the ability of the company to increase the AUM, while also rebalancing the funding, but the market volatility that could limit client risk appetite.

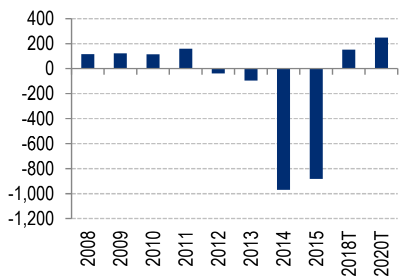
A non-fundamental opportunity that could be also considered is the potential for M&A, as VB could be part of the pending possible consolidation among smaller banks in Italy following the Popolari transformation decree approved by the government last year. Management's plan is based on a stand-alone basis, but nevertheless the theme could be topical for VB.

Financial Review

We summarise VB's main financial targets and our own financial forecasts and also compare those with the evolution of peers' profitability.

Management targets net income of €152m in 2018, equivalent of a c5.1% ROTE, while we are more conservative and forecast c€50m and a ROTE of c2% for the same year.

Figure 13. Veneto Banca – Net Profit (€m)



Source: Company data and Citi Research

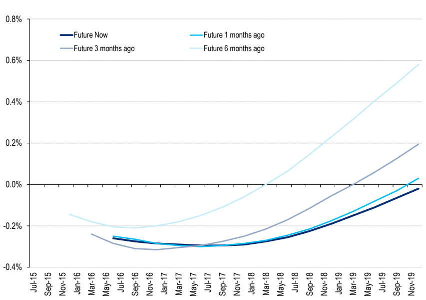
Figure 14. Veneto Banca – Key Financial Targets*

	2015N	2018E	2020E	CAGR 15-18E	CAGR 18E-20E	CAGR 15-20E
P&L (€m)						
NII	505	544	596	2.5%	4.7%	3.4%
Fees	273	346	394	8.2%	6.7%	7.6%
Total Revenues	**874**	**950**	**1055**	**2.8%**	**5.4%**	**3.8%**
Operating Costs	-609	-526	-513	-8.5%	-1.2%	-5.6%
GOP	264	424	542	30.9%	13.1%	23.5%
Loan Loss provisions	-754	-210	-177	-34.7%	-8.2%	-25.2%
Net Income	**nm**	**152**	**249**			
Balance Sheet (€bn)						
Loans	22.7	22.4	23.4	-0.4%	2.2%	0.6%
Funding	22.5	20.7	21.3	-2.8%	1.4%	-1.0%
Indirect Funding	16.3	18.2	20.4	3.9%	5.9%	4.6%
RWAs	23.1	19.7	19.8	-5.1%	0.3%	-3.0%
KPIs						
Cost Income	70%	55%	49%			
Cost of Risk (bp)	332	93	76			
ROTE	**nm**	**5.1%**	**7.5%**			
LCR	53%	105%	105%			
LDR	101%	108%	110%			
CET	6.8%	12.4%	14.5%			
Net NPE/Loans	20.1%	17.2%	13.6%			
Coverage	34.7%	40.1%	43.2%			

Source: Company data and Citi Research. N stand for Normalised data.*Revisited

Our forecasts are more conservative than management mostly on revenues, broadly in line on costs and more conservative (higher coverage/higher disposals) on cost of risk. The difference on revenues is due to our more conservative macro assumptions (mainly on rates).

Figure 15. Europe – 3M Euribor Implied in Future Contracts



Source: Bloomberg

Figure 16. Main Macro Assumptions

	2016E	2017E	2018E	2019E
3M Euribor				
Market Implied	-0.27%	-0.29%	-0.24%	-0.03%
VB	-0.20%	-0.30%	-0.20%	0.10%
Italy GDP				
Citi Economists	1.00%	0.80%	0.70%	1.10%
VB	1.00%	1.20%	1.00%	1.10%

Source: Bloomberg, Citi Research and Company data

Figure 17. ROA Comparison – Veneto Banca vs Italian Banks (2018E vs 2015 difference)

	VB	Italian Banks
NII	0.28%	-0.04%
Fee	0.31%	0.09%
Revenues	0.33%	0.02%
Costs	0.24%	0.13%
GOP	0.56%	0.14%
Provisions	1.47%	0.15%
Adj ROA	nm	0.19%

Source: Company data and Citi Research estimates

Figure 18. Veneto Banca – Citi Estimates vs Company Target, 2018E

€m	Citi	VB	Diff
NII	485	544	-11%
Fees	280	346	-19%
Total Revenues	**829**	**950**	**-13%**
Operating Costs	-524	-526	0%
GOP	305	424	-28%
Loan Loss provisions	-216	-210	3%
Net Income	**56**	**152**	**-63%**
Loans	20.6	22.4	-8%
Funding	19.9	20.7	-4%
Indirect Funding	17.8	18.2	-2%
RWAs	19.2	19.7	-2%
Cost Income	63.2%	55.4%	
Cost of Risk (bp)	105	93	
ROTE	2.0%	5.1%	
CET 1 FL	12.0%	12.4%	

Source: Company data and Citi Research estimates

We compare VB's profitability metrics and decompose its ROA within the main P&L lines in order to see what the main areas of difference vs peers. The improvement in VB's metrics vs peers can be mostly explained by its different phase in the restructuring process, as this is just starting for VB, but has been ongoing since 2011/2012 for many of its peers.

Figure 19. Veneto Banca – ROA Decomposition

	2008	2009	2010	2011	2012	2013	2014	2015E	2016E	2017E	2018E	2019E	2020E	18 vs 15	20 vs 15
NII	2.20%	2.15%	1.74%	1.57%	1.53%	1.40%	1.42%	1.51%	1.63%	1.78%	1.80%	1.83%	1.88%	0.29%	0.36%
Fee	0.80%	0.83%	0.97%	0.87%	0.91%	0.83%	0.80%	0.82%	0.89%	0.98%	1.04%	1.09%	1.14%	0.22%	0.32%
Revenues	**3.03%**	**3.22%**	**2.96%**	**2.48%**	**2.69%**	**2.42%**	**2.36%**	**2.84%**	**2.75%**	**3.00%**	**3.08%**	**3.16%**	**3.26%**	**0.24%**	**0.42%**
Staff Costs	-1.19%	-1.20%	-1.12%	-1.07%	-0.97%	-0.94%	-1.01%	-1.02%	-1.22%	-1.15%	-1.07%	-1.04%	-1.02%	-0.05%	0.01%
Other Costs	-0.84%	-0.85%	-0.85%	-0.78%	-0.72%	-0.63%	-0.69%	-1.03%	-1.08%	-0.94%	-0.88%	-0.85%	-0.82%	0.16%	0.21%
Costs	**-2.03%**	**-2.05%**	**-1.97%**	**-1.85%**	**-1.69%**	**-1.56%**	**-1.71%**	**-2.05%**	**-2.29%**	**-2.08%**	**-1.95%**	**-1.88%**	**-1.84%**	**0.11%**	**0.22%**
GOP	**0.99%**	**1.17%**	**0.99%**	**0.63%**	**1.00%**	**0.86%**	**0.66%**	**0.78%**	**0.45%**	**0.91%**	**1.13%**	**1.28%**	**1.42%**	**0.35%**	**0.64%**
Provisions	-0.50%	-0.66%	-0.34%	-0.47%	-1.16%	-1.20%	-1.98%	-2.26%	-1.02%	-0.96%	-0.81%	-0.72%	-0.70%	1.46%	1.56%
Others	0.27%	0.22%	-0.06%	-0.04%	-0.03%	-0.02%	-2.00%	-1.51%	-0.24%	-0.07%	-0.05%	-0.05%	-0.05%	1.46%	1.46%
PBT	**0.76%**	**0.73%**	**0.59%**	**0.12%**	**-0.19%**	**-0.37%**	**-3.32%**	**-2.99%**	**-0.80%**	**-0.12%**	**0.27%**	**0.51%**	**0.68%**	**3.26%**	**3.66%**
ROA	0.55%	0.53%	0.34%	0.42%	-0.10%	-0.26%	-2.68%	-2.65%	-0.68%	-0.09%	0.21%	0.39%	0.51%	2.85%	3.16%
Adj ROA	**0.31%**	**0.30%**	**0.34%**	**0.42%**	**-0.10%**	**-0.27%**	**-0.61%**	**-1.01%**	**-0.54%**	**-0.09%**	**0.21%**	**0.39%**	**0.51%**	**1.22%**	**1.53%**

Source: Company data and Citi Research estimates

Figure 20. Italian Banks – 2018E ROA Decomposition

	ISP	UCI	UBI	BPER	VB	All
NII	1.13%	1.31%	1.37%	2.02%	1.80%	1.29%
Fee	1.24%	0.94%	1.16%	1.27%	1.04%	1.06%
Revenues	**2.62%**	**2.51%**	**2.81%**	**3.50%**	**3.08%**	**2.62%**
Costs	-1.26%	-1.41%	-1.67%	-1.94%	-1.95%	-1.44%
GOP	**1.36%**	**1.10%**	**1.14%**	**1.56%**	**1.13%**	**1.18%**
Provisions	-0.36%	-0.33%	-0.49%	-0.66%	-0.81%	-0.42%
Adj ROA	**0.62%**	**0.42%**	**0.31%**	**0.53%**	**0.21%**	**0.43%**
ROTE	**9.9%**	**7.4%**	**4.3%**	**6.5%**	**2.0%**	**7.0%**

Source: Company data and Citi Research estimates

Figure 21. Veneto Banca – Group Data by Year

€m	2011	2012	2013	2014	2015	2016E	% Chg	2017E	% Chg	2018E	% Chg	2019E	% Chg	2020E	% Chg
GROUP P&L	63%	57%	58%	60%	53%										
Net Interest Income (NII)	596	613	522	513	505	450	-11%	473	+3%	485	+3%	497	+2%	515	+4%
Net Commission Income	331	364	309	288	273	246	-10%	262	+6%	280	+7%	297	+6%	313	+5%
Dividends and Other Income	10	16	9	7	5	5	+12%	5	+5%	6	+5%	6	+5%	6	+5%
Gain (Loss) from Financial Transactions	14	108	74	57	179	61	-66%	63	+3%	64	+2%	65	+2%	67	+2%
Other Net Operating Income	-11	-19	-12	-10	-15	-2	-84%	-6	nm	-6	+0%	-6	+0%	-6	+0%
Total revenues	**940**	**1,082**	**902**	**855**	**947**	**760**	**-20%**	**797**	**+5%**	**829**	**+4%**	**859**	**+4%**	**895**	**+4%**
Staff costs	-405	-389	-349	-367	-341	-337	-1%	-305	-9%	-288	-5%	-282	-2%	-279	-1%
Other expenses	-242	-238	-193	-205	-275	-250	-9%	-202	-19%	-189	-6%	-186	-2%	-184	-1%
Depreciation	-54	-52	-41	-45	-70	-48	-31%	-47	-2%	-46	-2%	-44	-5%	-42	-5%
Total operating expenses	**-701**	**-680**	**-583**	**-617**	**-685**	**-635**	**-7%**	**-554**	**-13%**	**-524**	**-5%**	**-511**	**-2%**	**-504**	**-1%**
Operating profit pre provisions	**239**	**402**	**320**	**238**	**261**	**126**	**-52%**	**243**	**+93%**	**305**	**+26%**	**348**	**+14%**	**391**	**+12%**
Goodwill	0	0	0	-671	-418	0	nm	0	nm	0	nm	0	nm	0	nm
Bad Debt Provisions	-177	-467	-448	-717	-754	-283	-63%	-256	-9%	-216	-16%	-196	-10%	-193	-1%
Provisions for risks and charges	-16	-12	-6	-51	-88	-36	-59%	-18	-50%	-15	-20%	-13	-10%	-12	-5%
Associate Income	0	1	-3	-1	8	0	nm	0	nm	0	nm	0	nm	0	nm
Gain (Loss) from Sale of Inv/Others	0	0	0	0	-6	-29	nm	0	nm	0	nm	0	nm	0	nm
Profit before tax	**46**	**-76**	**-136**	**-1,202**	**-996**	**-222**	**nm**	**-32**	**nm**	**74**	**nm**	**139**	**nm**	**185**	**nm**
Taxes	109	4	34	226	191	42	nm	7	nm	-16	nm	-30	nm	-41	nm
Integration Costs and PPA	0	0	0	0	0	0	nm	0	nm	0	nm	0	nm	0	nm
Profit (Loss) from Discontinued Operations	0	0	3	-9	-101	-14	nm	0	nm	0	nm	0	nm	0	nm
Net Profit	155	-72	-100	-984	-906	-195	nm	-25	nm	58	nm	109	nm	145	nm
Minority interests	5	32	3	16	24	7	nm	1	nm	-2	nm	-3	nm	-4	nm
Net Income Attributable	**160**	**-40**	**-96**	**-968**	**-882**	**-187**	**nm**	**-24**	**nm**	**56**	**nm**	**105**	**nm**	**140**	**nm**
Adjusted attributable profit	**161**	**-40**	**-99**	**-220**	**-338**	**-150**	**nm**	**-24**	**nm**	**56**	**nm**	**105**	**nm**	**140**	**nm**
OPERATING RATIOS															
Revenues on avg RWAs	3.73%	4.21%	3.59%	3.45%	3.97%	3.47%		3.97%		4.29%		4.49%		4.68%	
Cost to asset ratio	1.85%	1.69%	1.56%	1.71%	2.05%	2.29%		2.08%		1.95%		1.88%		1.84%	
Cost / income ratio	75%	63%	65%	72%	72%	83%		70%		63%		60%		56%	
Provision charge / customer loans	**0.65%**	**1.74%**	**1.70%**	**3.01%**	**3.32%**	**1.32%**		**1.25%**		**1.05%**		**0.93%**		**0.90%**	
Tax rate	-238%	6%	25%	19%	19%	19%		22%		22%		22%		22%	
Return on Equity (Adj/ Tangible, All)	**13.6%**	**-2.7%**	**-6.2%**	**-9.8%**	**-17.7%**	**-5.5%**		**-0.9%**		**2.0%**		**3.7%**		**4.8%**	
SHARES OUTSTANDING															
Fully diluted total number of shares (mn)	105	103	109	115	122	339	+178%	339	+0%	339	+0%	339	+0%	339	+0%
BALANCE SHEET ITEMS															
Total Assets	37,969	40,165	37,307	36,167	33,349	27,702	-17%	26,617	-4%	26,884	+1%	27,152	+1%	27,424	+1%
Net customer loans	**27,046**	**26,858**	**26,392**	**23,832**	**22,703**	**21,395**	**-6%**	**20,509**	**-4%**	**20,612**	**+0%**	**21,024**	**+2%**	**21,444**	**+2%**
Total Customer Deposits	25,683	28,529	26,313	24,607	22,482	19,826	-12%	19,722	-1%	19,939	+1%	20,297	+2%	20,676	+2%
Shareholder Equity	2,563	2,851	2,984	2,774	2,008	2,821	+40%	2,797	-1%	2,853	+2%	2,941	+3%	3,050	+4%
REGULATORY CAPITAL															
Risk-Weighted Assets	25,980	25,408	24,911	24,607	23,091	20,733	-10%	19,433	-6%	19,239	-1%	19,046	-1%	19,237	+1%
'Core" Tier 1 ratio	7.6%	7.9%	7.7%	9.6%	7.2%	11.3%		11.5%		12.0%		12.7%		13.3%	
Tier 1 ratio	7.6%	7.9%	7.7%	9.6%	7.2%	11.3%		11.5%		12.0%		12.7%		13.3%	
Total ratio	10.1%	10.0%	9.3%	10.3%	9.1%	13.4%		13.8%		14.3%		15.0%		15.6%	
Core" Tier 1 ratio - B3 FL				**9.0%**	**6.8%**	**11.3%**		**11.3%**		**12.0%**		**12.7%**		**13.3%**	

Source: Company data and Citi Research estimates

Valuation

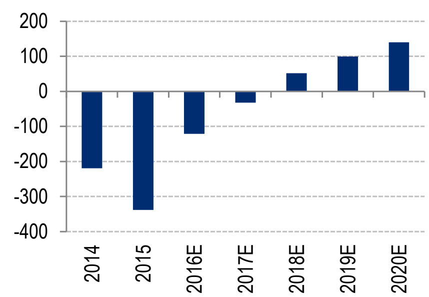
A number of standard valuation approaches are usually applied to banks, including:

- P/E vs earnings growth ('g') on a theoretical basis
- Price/Tangible Book Value (P/TB) vs Return on Tangible Equity (RoTE) on a theoretical basis (Warranted Equity or Gordon Growth model)

The above methodologies could also be considered for observed data and not only on theoretical/expected data.

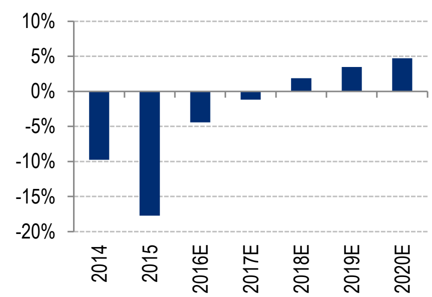
In the charts below we present the different drivers of VB's valuation, including underlying net attributable profit, the RoTE outlook, as well as expected tangible book value and dividends.

Figure 22. Veneto Banca – Adj Net Profit (€m)



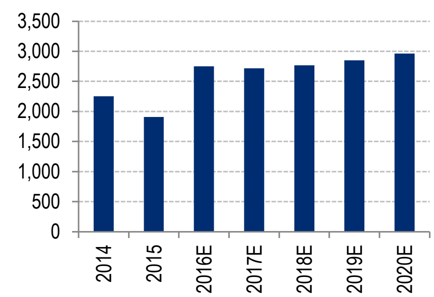
Source: Company data and Citi Research

Figure 23. Veneto Banca – ROTE (%)



Source: Company data and Citi Research

Figure 24. Veneto Banca – Tangible BV (€m)



Source: Company data and Citi Research

Peer Group Analysis

Comparative multiple analysis, while relatively crude, is a common metric used to assess the value of banks. Below we illustrate the key valuation metrics of a range of European banks. Each bank therefore has a different business mix, asset quality metrics, growth ambitions and profitability.

Figure 25. Valuation Summary

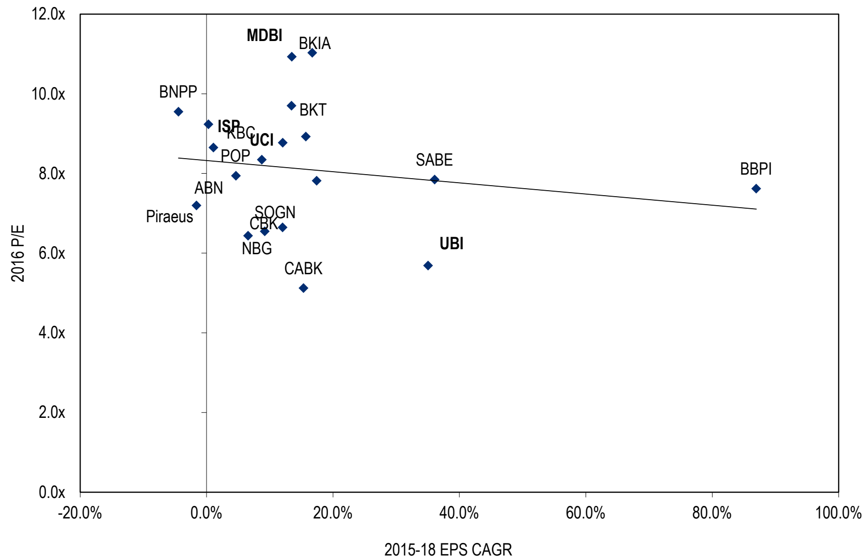
			Price		Adj P/E			PTBV			PGOP	ROTE		
	Rating		Current	Target	2016E	2017E	2018E	2016E	2017E	2018E	2016E	2016E	2017E	2018E
Intesa Sanpaolo	1	€	2.22	3.45	12.1x	9.7x	8.7x	0.9x	0.9x	0.9x	4.5x	7.5%	9.2%	10.0%
Unicredit	2H	€	2.91	4.00	7.7x	5.7x	4.7x	0.4x	0.4x	0.3x	2.0x	5.1%	6.6%	7.5%
Mediobanca	1	€	6.51	8.50	8.9x	9.6x	8.9x	0.7x	0.7x	0.6x	4.9x	7.8%	6.9%	7.2%
UBI	1H	€	3.34	4.90	13.7x	11.0x	8.7x	0.4x	0.4x	0.4x	2.6x	2.7%	3.3%	4.1%
BP Emilia	1H	€	4.30	6.80	10.7x	7.8x	6.8x	0.4x	0.4x	0.4x	2.6x	4.2%	5.6%	6.2%
Italy					9.8x	7.7x	7.0x	0.5x	0.5x	0.4x	3.7x	5.7%	6.5%	7.0%
Sector					11.0x	8.2x	7.2x	0.8x	0.7x	0.7x	6.1x	9.2%	10.4%	10.9%

Source: Powered by dataCentral. Note: Prices as of 13th May 2016.

P/E vs Earnings Growth

Investors usually refine price-to-earnings comparison by assessing P/E multiples in the context of expected earnings growth. When we chart P/E multiples of European peers against their expected EPS growth, there is a small correlation, especially for banks in a restructuring phase this screen could be volatile.

Figure 26. European Banks – 2016E P/E Ratio vs 2015-17E EPS GAGR



Source: dataCentral and Citi Research

Another way to arrive at a fair value P/E multiple is to use the Gordon Growth formula of Normalised P/E = Long-Term Payout Ratio / (Cost of Equity - Growth). The cost of equity can be implied by current market prices (back solved) or derived using the CAPM model using the following formula: Cost of Equity = (1-year forward 10-year Risk-Free Rate) + Beta x Equity Market Risk Premium.

For other Italian banks, we use a cost of equity of 10-12%, depending upon business mix, balance sheet strength and also considering the capital and restructuring risks. We also assume long-term growth of 1%, consistent with the long-term GDP outlook.

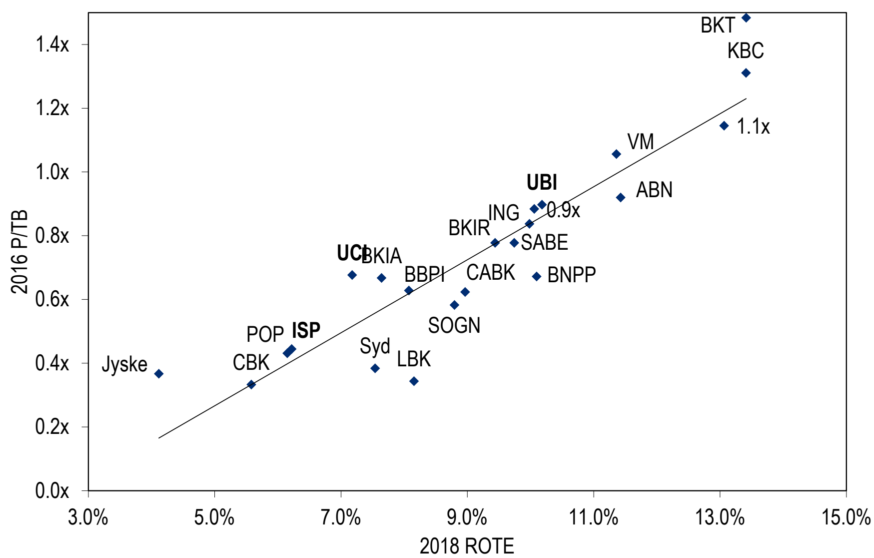
The ranges for our estimates of the inputs are therefore as follows:

- **Long-term dividend payout ratio:** 30% based on management guidance from 2018
- **Cost of equity:** c10-13% based on the cost of equity we use for other Italian banks and also considering the group characteristic in term of balance sheet, asset quality and execution risk in the restructuring
- **Long-term growth rate:** 0-1% based on the potential GDP growth rate

P/TB vs RoTE

Simple P/TB multiple comparisons are not particularly useful in assessing the value of a bank unless these multiples are seen in the context of expected RoTE. In general, investors are willing to pay a higher price-to-book multiple for banks that deliver higher sustainable returns. Thus, we chart the P/TB multiple of peers relative to their expected RoTE. Italian banks all trades at discount to P/TBV compare to European peers as their ROE is expected to be below the required cost of equity.

Figure 27. European Banks – 2017E RoTE vs 2015E P/TB



Source: dataCentral and Citi Research

A theoretical 'warranted' P/TB multiple for a bank can also be calculated mathematically using a Gordon Growth model where the warranted P/TB = (Sustainable RoTE - Growth) / (Cost of Equity - Growth), where 'Growth' equals a long-term sustainable growth rate in earnings.

The ranges for our estimates of the inputs are as follows:

- **Sustainable RoTE:** c2-6% based on our RoTE forecasts over 2018E-20E. Management's targeted ROTE ranges from 5.1% to 7.5% in 2018E-20E.
- **Cost of equity:** c10-13% based on the cost of equity we use for other Italian banks, combined with the business mix and balance sheet characteristic of VB.
- **Long-term growth rate:** 0-1% based on the growth rate used for Italian peers

In addition, investors could decide to apply a charge/benefit for any capital shortfall/ excess that is expected to be at the time of valuation.

The sovereign risk perception is mostly accounted in banks valuation via cost of equity. The table below shows a sensitivity analysis of implied tangible book value multiple based on different level of cost of equity and ROTE.

Veneto Banca Vs BP Vicenza

Recent developments at Popolare Vicenza (capital increase fully subscribed by Atlante fund and no listing on the stock exchange as planned) might have heightened investor perceptions of risk in respect of Veneto Banca. Both banks operate mainly in the North East, are in the middle of an extensive restructuring and have had extensive negative press coverage. The table below summarises some key metrics to compare the two companies.

Figure 28. Veneto Banca and BP Vicenza – Key Asset Quality Data, 2015

	Veneto Banca	BP Vicenza
Gross Sofferenze	3,484	4,369
Coverage	52.8%	56.8%
Total NPE	7,555	8,962
Coverage	35.3%	40.6%
Gross Sofferenze on Net Loans	15.3%	17.4%
NPE Split:		
Sofferenze	46%	49%
Unlikely to Pay	47%	50%
Past Due	7%	2%

Source: Company data and Citi Research

Figure 29. Veneto Banca and BP Vicenza – Key P&L Data, 2015

€ m	Veneto Banca	BP Vicenza
NII	505	504
Fee Income	273	322
Total Revenues	947	1,053
Total Costs	-685	-754
GOP	262	299
Loan Loss Provisions	-754	-867*
Net Income/Loss	-882	-1,407
as% of Assets		
NII	1.51%	1.27%
Fee Income	0.82%	0.81%
Total Revenues	2.84%	2.65%
Total Costs	-2.05%	-1.90%
GOP	0.78%	0.75%
Loan Loss Provisions	-2.26%	-2.18%
Net Income/Loss	-2.65%	-3.54%
Revenue Split		
NII	53%	48%
Fee	29%	31%
Others	18%	22%
Key Ratios		
Cost Income ratio	72%	72%
Cost of Risk	3.32%	5.29%
Loan to Deposit Ratio	101%	117%
ROTE 2018T/2020T - Company target	5.10%/7.50%	5.60%/8.20%

Source: Company data and Citi Research.*Excluding own capital deduction effect.

Figure 30. Veneto Banca and BP Vicenza – Key Balance Sheet Data, 2015

€ m	Veneto Banca	BP Vicenza
Total Assets	33,349	39,783
Customer Loans	22,703	25,178
Customer Deposits	22,507	21,471
Tangible Book Value	1,907	2,523
LCR	53%	47.5%
LCR (1Q 2016)	78%	78.6%
CET1	7.23%	6.65%
SREP (From June 2016)	10.25%	10.25%
RWAs	23,091	24,900
CET1 2018T - Company target	12.4%	12.0%
CET1 2020T- Company target	14.5%	12.9%
Own Share deduction	298	1,089
as % of tangible equity	16%	43%

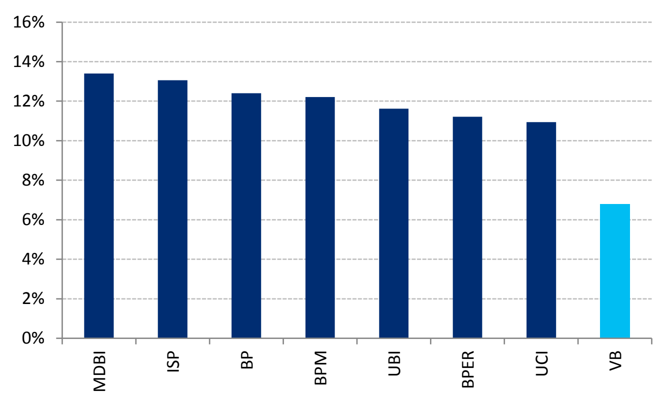
Source: Company data and Citi Research

Increasing Capital Ratio is The First Priority…

VB management's main priority is to address the group capital position, which has decreased significantly as results of the high loss incurred by the bank in the last three years (cumulative c€2bn losses).

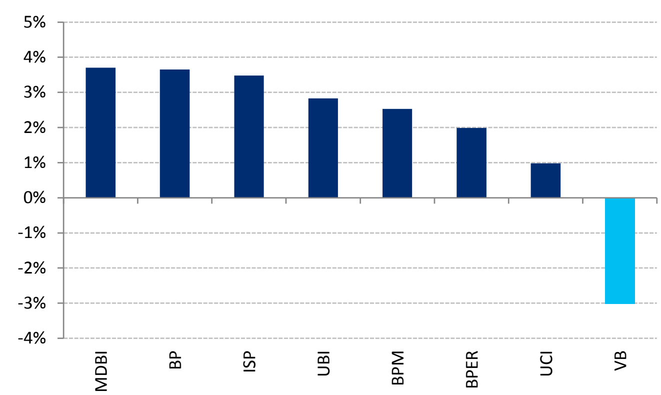
The CET1 fully loaded stood at 6.82% in Dec 2015, the lowest among the bank in our coverage of Italian banks (average is c12% as of Dec 2015). The group capital ratios are also below the ECB SREP capital requirement of 10% as of Dec 2015. The regulatory SREP was increased last November to 10.25% and will be effective from 30th June 2016. VB is the only bank in our coverage universe where the current CET 1 phase-in (7.23% in December 2015 and 6.9% in March 2015) is below the latest SREP requirement.

Figure 31. Italian Banks - CET1 Fully Loaded, 2015



Source: Company data and Citi Research

Figure 32. Italian Banks –CET1 Phase In vs SREP, 2015 Difference



Source: Company data and Citi Research

VB is planning several actions to rebuild its capital position, all with the approval of the ECB. Management plans to reach a CET1 FL of 12.4%% in 2018 and then further increase it to 14.5% in 2020 thanks to the capital increase, retained earnings, disposals and RWAs rationalization.

The first action will be the launch of a €1bn capital increase to be completed at the time of the IPO and this should result in an increase of c430bp of capital, bringing the proforma fully loaded CET1 at 10.9%. Timing is expected to be in 1H 2016. Management says that it is also looking at the disposal of several equity stakes to support its capital ratio, including Banca Intermobiliare di Investimenti e Gestioni (BIM) and foreign operations as well as potentially stakes in other assets. The planned disposal of assets is an additional important source of capital expected to be c100bp. We believe that one additional potential asset that could be considered is Arca, where the outcome is uncertain and depends on the development plan and group's capital generation ability.

BIM is a listed company active in the wealth management and private banking business. Despite being controlled by VB since 2011 (c71.4% stake), the network is fairly independent and has limited overlap with the group. It has c€12bn in indirect deposits, c€1.2bn of loans and c€1.4bn of RWAs and c€0.3bn of equity, with CET1 of c14%, all as of December 2015. VB has reportedly received two offers for its stake in BIM during the past year, but in both cases the transaction did not close due to factors outside of VB's control. The first offer, from BSI, was withdrawn by the buyer due to internal reasons, and the second offer, from a group of entrepreneurs for €289m (for a 51.4% stake), was blocked by the ECB due to the eligibility criteria for the buyer. Currently a data room is open with 4 to 5 interested parties.

Figure 33. BIM – Key Data, 2015 (€m)

P&L	2015	Balance Sheet	2015
Total Revenues	127	Loans	1,210
Costs	-93	Deposits	1,503
Loan Loss Provisions	-53	Shareholder Equity	334
PBT	-33	Total Assets	3,175
Net Profit	**-20**	**Indirect Deposits**	**12,000**

Source: Company data, based on BIM press release

VB is also rationalizing its international franchises. It has subsidiaries, mostly focus on corporate business, are in Croatia, Albania and Moldova and a direct operation in Romania. All together account for c€1.2bn in loans, c€1.7bn in total assets. The activities are mainly corporates and carried a net loss of c€46m in 2015.

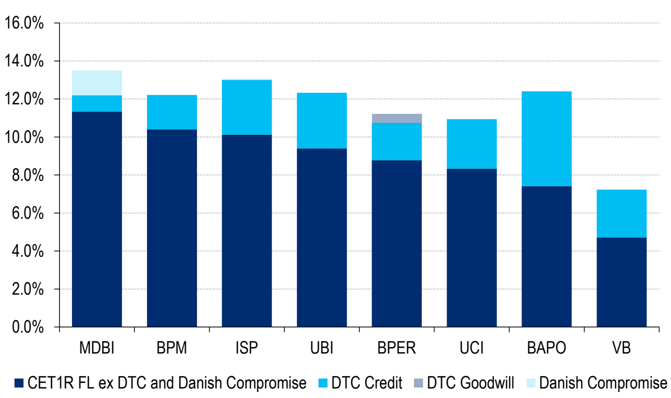
Figure 34. Veneto Banca – Foreign Operations Key Data, Sept 2015

€m	Loans	Net profit	Equity
Romania	0.8bn	-34	82
Albania	0.1bn	-8	34
Croatia	0.2bn	-7	22
Moldavia	0.1bn	2.5	58
Total	**1.2bn**	**-46.5**	**196**

Source: Company data

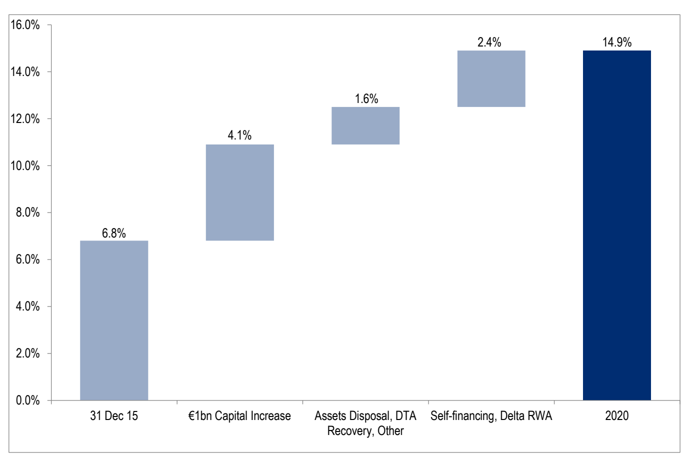
Further capital benefits can be achieved by using deferred tax assets (DTAs), as the company returns to profitability and some DTA become deferred tax credits (DTCs), which could be equal to c50bp, and from risk-weighted asset (RWA) rationalization. VB's clean capital seemed low in 2015 as DTCs are c40% of CET1.

Figure 35. Veneto Banca - CET1 Fully Loaded with DTC, 2015



Source: Company data and Citi Research

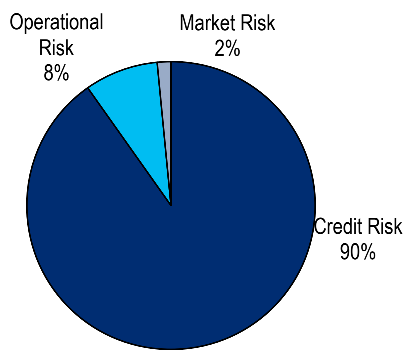
Figure 36. Veneto Banca - CET1 FL Management Target (presented in Feb 2015)



Source: Company data and Citi Research

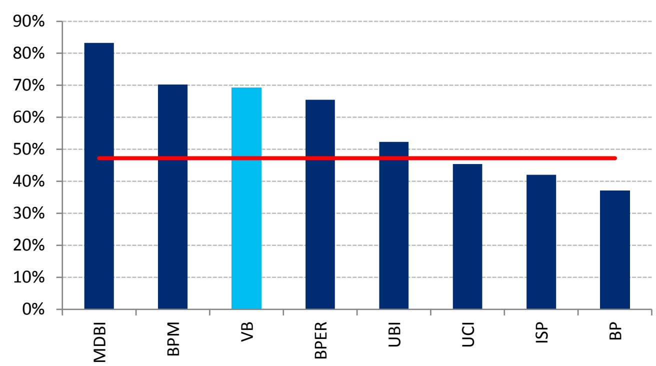
Given the simple group balance sheet (mostly loans on the asset side), c90% of total RWAs are related to credit risk. Looking at the client breakdown, c26% of RWAs are related to individuals, c6% to small businesses, c39% to corporates, c11% to large corporates and the remaining c20% to others. All the RWAs are still calculated under standardized approach methodologies, and the RWAs density (RWAs as a % of total assets) is among the highest of its peer group at c70% as of Dec 2015, possibly due to a combination of using the standard methodology and the high level of NPLs of the group. Based on the standard methodologies we believe NPLs average risk weight to be around c120%. This could decrease in the future if the bank is successful in the IRB model validation procedure with the ECB. We believe that this is premature, but could represent a buffer over the longer term of c80 to120bps based on peer results.

Figure 37. Veneto Banca – RWAs Split, 2015



Source: Company data and Citi Research

Figure 38. Italian Banks – RWAs Density, 2015



Source: Company data and Citi Research. Red Line is Peer group average.

Figure 39. Veneto Banca – Average Risk Weight by Category, Sept 2015

	Performing
Mortgages	54%
Overdraft	76%
Advances	79%
Others	67%
Total	**61%**

Source: Company data

The group capital position was negatively affected in 2015 by a prudential filter deduction on the financed shares for c€300m. This deduction originated following an ECB inspection and further checks carried out by the bank. The inspection identified certain positions for which the subscription (or purchase) of Veneto Banca shares by customers were carried out using existing or new loans disbursed by VB or a subsidiary. The total financed shares are c6% of group capital and refer to c1% of shareholders. This filter was firstly introduced in June 2015 (for c€116m) and was increased to €286m in 3Q and then increased again to c€297.6m in December 2015 (equal to c130bp of capital). Management's capital projection includes this filter with no mitigation over the plan period, and this could be reduced in coming years if those positions are closed or amended. Also, the ECB inspection had highlighted also some risk related to MIFID implementation (€156.4m) and compliance procedure (€80m).

Figure 40. Veneto Banca – Capital Prudential Filter in CET1

	2Q 2015	3Q 2015	4Q 2015
Financed Capital	116.3	250.7	249.4
Contractual Options		35.5	48.2
Total Filter	**116.3**	**286.2**	**297.6**
Pillar II risk			
Statistical Projection		51.1	55

Source: Company data

In our estimates, we forecast the CET1 FL in 2018 to reach c12.1%, below management target of c12.4%, mostly due to our lower retained earnings estimates.

Looking at the end of the plan period, we are puzzled by management's decision to target c15% CET1 in 2020, as it seems a very high level for capital, given that VB would have strengthen its balance sheet by then and would be significantly above its peers, and also it would dilute ROTE. We would prefer the company to implement more pronounced actions on NPLs disposals (as the NPL ratio would still be very high at c20% in 2020) possibly at the expense of capital ratio, given the potential need to fill the coverage gap.

Figure 41. Veneto Banca – Capital Development

€m	2011	2012	2013	2014	2015	2016E	% Chg	2017E	% Chg	2018E	% Chg	2019E	% Chg	2020E	% Chg
"Core" Tier 1 Capital	1,982	2,014	1,917	2,313	1,669	2,347	+41%	2,242	-4%	2,313	+3%	2,420	+5%	2,552	+5%
Tier 2 capital and others	641	527	393	190	424	2,347	+41%	2,242	-4%	2,313	+3%	2,420	+5%	2,552	+5%
Total capital	2,623	2,541	2,310	2,503	2,093	424	+3%	431	+2%	435	+1%	440	+1%	444	+1%
Risk-Weighted Assets	**25,980**	**25,408**	**24,911**	**24,607**	**23,091**	**2,769**	**+32%**	**2,673**	**-3%**	**2,748**	**+3%**	**2,860**	**+4%**	**2,996**	**+5%**
'Core" Tier 1 ratio Phase In	**7.6%**	**7.9%**	**7.7%**	**9.6%**	**7.2%**	**11.3%**		**11.5%**		**12.0%**		**12.7%**		**13.3%**	
Tier 1 ratio	7.6%	7.9%	7.7%	9.6%	7.2%	11.3%		11.5%		12.0%		12.7%		13.3%	
Total ratio	10.1%	10.0%	9.3%	10.2%	9.1%	13.4%		13.8%		14.3%		15.0%		15.6%	
Core" Tier 1 ratio - B3 FL				**9.0%**	**6.8%**	**11.3%**		**11.3%**		**12.0%**		**12.7%**		**13.3%**	

Source: Company data and Citi Research

The group leverage ratio is above regulatory requirement (3%) and stood at 5.2% in Dec 2015, given the group's high weighting in traditional banking businesses and its limited off-balance-sheet assets. The company expects this to be higher post the capital increase.

Figure 42. Veneto Banca – Leverage Ratio

	4Q 2014	2Q 2015	3Q 2015	4Q 2015
Leverage Ratio	5.20%	6.26%	5.10%	5.2%

Source: Company data

… While Improving Funding…

Figure 43. Veneto Banca – Direct Funding

€m	2015	1Q16	QoQ
Commercial Network	**16,702**	**15,218**	**-9%**
Deposits	14,545	13,397	-8%
Securities	2,157	1,821	-16%
Wholesale Funding	**5,805**	**5,238**	**-10%**
EMTN and Others	2,415	2,114	-12%
Securitization	1,697	3,063	80%
Others	1,692	61	nm
Total	**22,507**	**20,456**	**-9%**

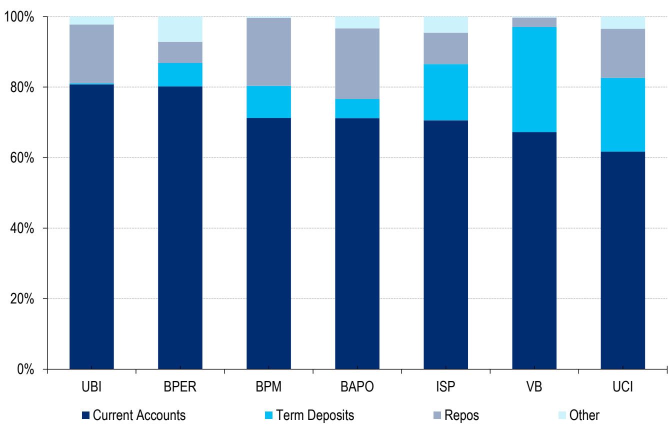
Source: Company data and Citi Research

VB's funding is mostly reliant on customer deposits (c70%) and has a lower weighting of bonds on total direct funding. Currently, it also seems significantly reliant on corporate deposits (more volatile and more expensive). The LCR ratio dropped to 53% in December 2015; it has improved to 78% in March 2016, but still remains low and the bank says it is working to increase it (2018 target is 105%). In 1Q, Veneto Banca showed a decrease of c9% QoQ of direct funding, mostly due to outflows driven by heightened market perceptions of risk following the bail-in of the 4 smaller Italian banks as well as uncertainty around the EGM. VB indicated that it has returned to record inflows, albeit small, from April, and has placed a €1.4bn performing loan securitization.

Most of the funding is generated by the commercial network (c75%), while c10% comes from EMTN bonds and c7% from securitization. As of December 2015 the group had c€1m of subordinated bonds in the hands of retail clients, only sold directly on primary issuance.

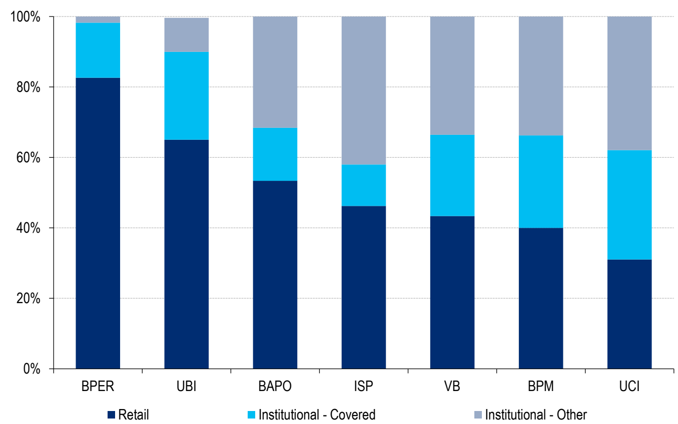
Within customer deposits, VB has the highest percentage of current account and term deposits c97%, while free deposits are in line with peers as of 1H 2105. The high level of term deposits could be linked to VB's customer mix.

Figure 44. Italian Banks – Customer Deposit Split, 1H 2015



Source: Company data and Citi Research

Figure 45. Italian Banks – Bonds Split, 1H 2015



Source: Company data and Citi Research

Looking at the maturity profile, the group has c15% of 2015 total direct funding maturing in 2016 and 2017. VB's commercial strategy has been to place any further retail bonds with their retail customers since June 2015.

Figure 46. Veneto Banca – Direct Funding Maturities

€m	2016	2017	2018	2019	2020	>2020
Retail Securities	664	603	477	87	20	0
Wholesale Securities	20	1,089	48	577	28	351
Securitization	601	803	572	270	241	577
Total	1,285	2,495	1,067	933	289	928
% of 2015 Direct Funding	**6%**	**11%**	**5%**	**4%**	**1%**	**4%**

Source: Company data and Citi Research

VB expects to keep total direct funding slightly down over the period of 2015-2020 (c-1% CAGR) with stable mix. The group is planning to improve its liquidity/funding profile via many actions, mainly by switching from non-collateralized to collateralized funding; increasing access to wholesale funding and securitization as well as altering the customer mix in favor of more retail/SME customers and fewer corporate/mid corporate clients.

Figure 47. Veneto Banca – Planned Funding Development

€bn	2015	2018T	2020T	CAGR 15-18	CAGR 18-20	CAGR 15-20
Customer Deposits	16.2	14.9	15.3	-2.7%	1.4%	-1.1%
Securities	6.3	5.8	6.0	-2.7%	1.4%	-1.1%
Total Direct Funding	22.5	20.7	21.3	-2.8%	1.4%	-1.0%
% of Total						
Customer Deposits	72%	72%	72%			
Securities	28%	28%	28%			

Source: Company data and Citi Research

The group has a unique funding split in our view among the different customer types. VB has almost the same amount of direct deposits in the retail and the corporate space. It seems to have highly concentrated funding in mid/large corporates (classified as companies with total revenues above €5m), but this has started to decrease. In December 2015, the top 20 direct funding exposure represented c9.24% of total funding, the top 30 to 50 clients were 4.67% of funding while the top 50 to 100 were 3.62% of the total.

Figure 48. Veneto Banca – Lending and Funding by Customer Type , 2015

€m	Loans	% on total	Funding	% on total	Criteria	L/D ratio
Individuals	8,054	34%	6,384	28%		126%
Private	679	3%	1,512	7%		45%
Corporate	3,208	14%	6,720	30%		48%
-Ow: Large Corp	2,412	10%			Turnover >€50m	
-Ow: Medium Corp	796	3%			€5m <Turnover< €50m	
Small Business	4,285	18%	2,184	10%	Turnover <€5m	196%
Others	7,188	31%	13,938	62%		52%
Group	**23,414**	**100%**	**22,506**	**100%**		**104%**

Source: Company data and Citi Research

The group has c€2.3bn of TLTRO financing, and it is planning to increase it to €2.6bn following TLTRO 2 (which is conservatively included in NII estimates at a 0% interest rate). The net interbank position increased in December 2015 vs September 2015, mainly due to lower bank loans, and has come back in March 2016.

Figure 49. Veneto Banca – Interbank Exposure

€bn	2014	2Q15	3Q15	2015	1Q16
LTRO/TLTRO	1.9	2.3	2.3	2.3	2.3
Interbank Position	-2.3	-3.4	-2.5	-3.6	-2.5

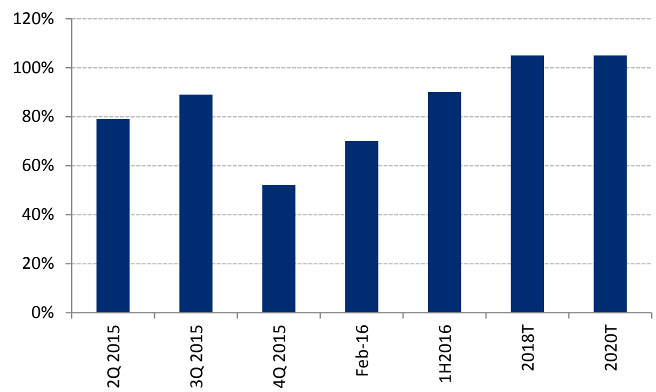
Source: Company data

Liquidity Coverage Ratio (LCR) of c53% in December 2015 was below the regulatory requirement of 60%, and has now moved back above (78% in March 2016). The LCR has decreased from c89% in September 2015, largely as a result of deposit outflows following the resolution of the four smaller Italian banks at the end of November 2015, the volatility around the bank EGM for the transformation into a joint stock company in December, and the increased depositor concern over bank deposits YTD (given VB's peculiar funding mix that consists of a high level of corporate deposits). The company expect this to be higher post capital increase.

The LCR is calculated by dividing the bank's high-quality liquid assets (HQLAs) by the total net cash outflows over 30 calendar days (calculated according to scenario parameters outlined by the Basel committee. The bank expects LCR to be above 105% by the completion of the capital increase (1H 2016).

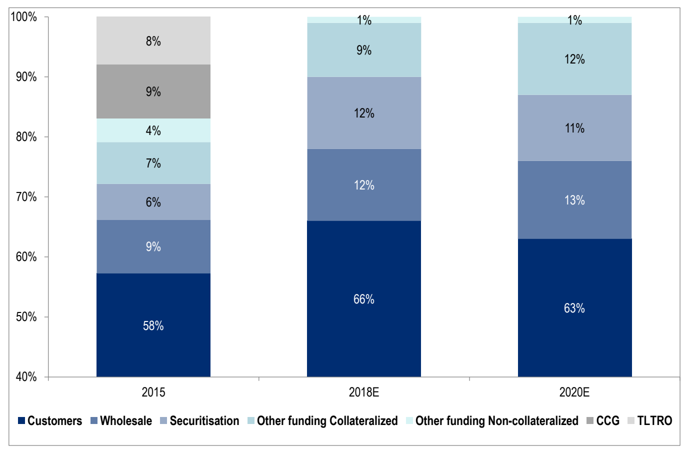
VB issued at the end of January 2016 c€600m of RMT trenched, and this could provide additional liquidity, and has placed new securitizations resulting in additional liquidity.

Figure 50. Veneto Banca - LCR



Source: Company data and Citi Research

Figure 51. Veneto Banca – Liquidity Profile



Source: Company data and Citi Research

The NSFR stood at 94.5% in September 2015 and decreased further in December at 88%. At present this is not a binding indicator, as it will become fully applicable from 2018.

Total eligible assets are €4.6bn in March 2016 decreasing further from December €5.9bn, and unencumbered eligible assets are c€1.8bn (were €1.6bn as of December 2015).

VB plans to change the funding mix, and as part of this issued €200m in Tier 2 bonds on 24 November 2015, with a coupon of 9.5% for a 10Y bond. Around 40% were subscribed by foreigner investors. We believe the current market volatility and investor perception of increased risk for Italian banks might negatively impact the group's ability to issue on the credit markets in the short term or render this expensive.

The changes in the funding mix and progress in restructuring should improve funding costs.

Credit Rating Matter

As the group plans to increase wholesale/institutional funding, we expect VB will likely monitor more closely its credit ratings (as funding costs will be highly sensitive to any change in credit rating). VB is focused on improving its balance sheet metrics and while it is premature to assume a rating improvement in the short term (as the Outlook/Trend rating given by S&P and DBRS are both negative), it cannot be ruled out that in the medium to long term the credit rating of the bank could improve, resulting in potentially lower funding costs. Likewise, if the negative outlook would manifest into a rating downgrade (in the case of a lack of balance sheet/profitability/capital progress) the effect on funding cost would be negative.

Markets tend to discriminate between issuers in terms of funding costs, which, over time, could provide a competitive edge for higher-rated firms and act as a hindrance for lower-rated firms. Funding costs are particularly sensitive at lower ratings, especially for senior unsecured medium- and long-term debt.

Credit rating changes can principally affect banks via the following channels:

- **Higher/lower funding costs**, particularly in relation to wholesale unsecured funding. Of course, this is also in the context of more stringent Basel 3 funding and liquidity requirements;
- **Counterparty confidence** which can impact business performance over time;
- **Availability of certain types of funding**, notably CP or commercial paper;
- **Requirement to post additional collateral** or cash payments under master trading agreements relating to the derivatives business, in case of credit rating downgrade.

Veneto Banca is rated by S&P (recently downgraded rating from B+ to B) and DBRS but not by Moody's (which stopped issuing a rating in 2014) and Fitch (which stopped issuing a rating in 2012). VB's credit rating is among the weakest of the Italian banks in our coverage universe, and as well as broader European peers.

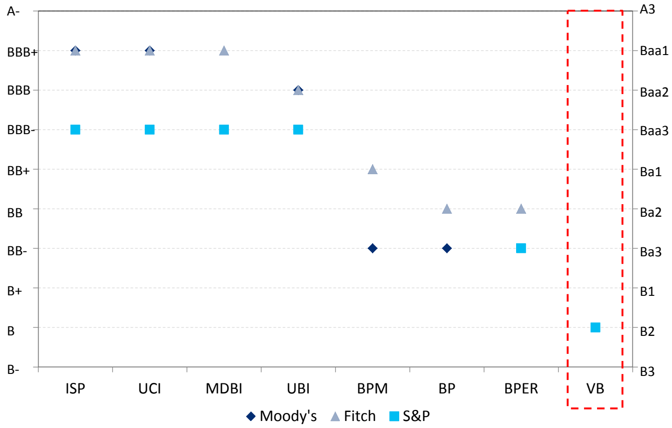
Figure 52. Veneto Banca – Credit Ratings (Latest)

	S&P	DBRS	Moody's	Fitch
Bank Ratings				
Long-term	B	BB		
Outlook/Trend	Negative	Negative		
Short-term	B	R-4		
Status	**Current**	**Current**	**Terminated**	**Terminated**

Source: Company Data

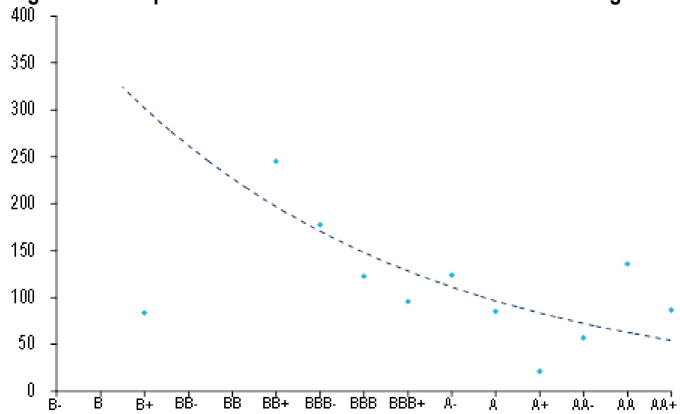
We have analyzed a significant number of bond issuances in the period 2013-2015 and tried to establish a relationship implied by their credit rating and funding costs. For example, we estimate that an increase (in the medium long term time frame) in the S&P rating from B to B+ could drive a c20bp to 40bp increase in senior unsecured funding costs.

Figure 53. Italian Banks – S&P, Fitch and Moody's LT Ratings



Source: Bloomberg, Company data and Citi Research

Figure 54. European Banks – Senior Bonds Yield vs Credit Rating



Source: Bloomberg and Citi Research
Note: Trend line based on averages for c100 European Bank senior bonds (4Y average maturity). Based on the Z-spread, or the discounted spread over mid-swaps.

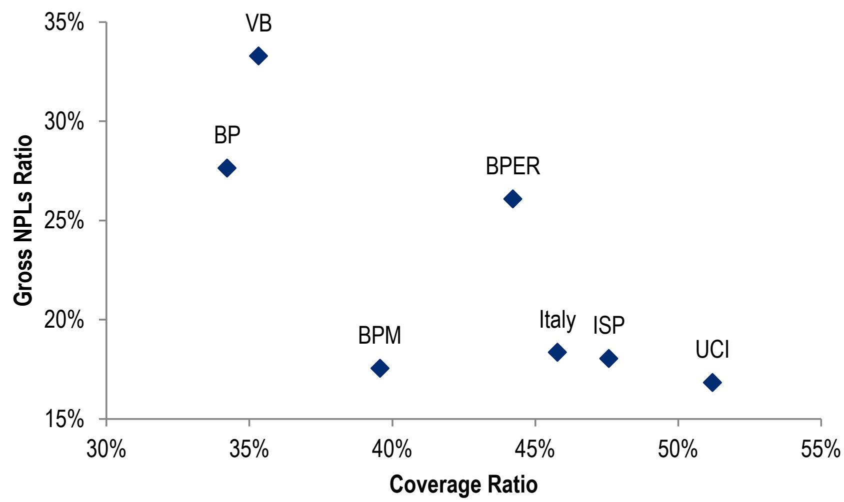
… As Well As Reducing NPLs Weight

VB's third main legacy from the past is the high level of NPLs. Total gross NPLs are c€7.6bn, and include €1.8bn of forborne. In March 2016, total gross NPLs increased by 1.7%, showing increasing NPLs and decreasing past due, suggesting the switch is ongoing.

In December 2015, gross NPLs had increased by c185% since 2011, more than twice the peer group growth rate over the same period (+c80%). This elevated increase is due to a large AQR effect in 2014 and reclassification of loans following more stringent criteria. VB has now a very high level of NPLs and the weakest asset quality among the Italian banks in our coverage.

Gross total NPLs are 33% of loans (vs peers of c18%) and net total NPLs are c22% of loans (vs peers c10%). This, coupled with a lower than peers coverage ratio (VB has c35%, vs peers c46%, or c10pp below), is possibly also explained by the higher proportion of unlikely to pay on total NPLs (c47% for VB vs c40% for peers). VB has the highest level of Texas ratio among the bank in our coverage universe at c165% based on Citi Research calculation. Coverage was broadly flat QoQ in 1Q 2016.

Figure 55. Italian Banks – Coverage Ratio and Gross NPLs Ratio, 2015



Source: Company data and Citi Research

Figure 56. Italian Banks – Key Asset Quality Data, 2015

€ m	ISP	UCI	UBI	BP	BPER	VB	BPM	Average
Gross Sofferenze	39,150	51,089	6,988	10,527	7,109	3,484	3,276	85,027
Sofferenze Coverage	61.8%	61.0%	38.6%	43.0%	58.2%	52.8%	54.5%	56.9%
Other NPLs -- Gross	23,964	28,671	6,447	11,138	4,286	4,071	2,721	65,214
Other NPLs -- Coverage	24.4%	33.7%	16.2%	25.9%	21.1%	20.4%	21.6%	25.3%
Gross Total NPLs	63,114	79,760	13,435	21,665	11,395	7,555	5,997	150,242
Total NPLs Coverage	47.6%	51.2%	27.9%	34.2%	44.2%	35.3%	39.6%	43.2%
Generic Coverage	0.71%	0.55%	0.55%	0.60%	0.54%	0.78%	0.60%	0.62%

Source: Company data and Citi Research

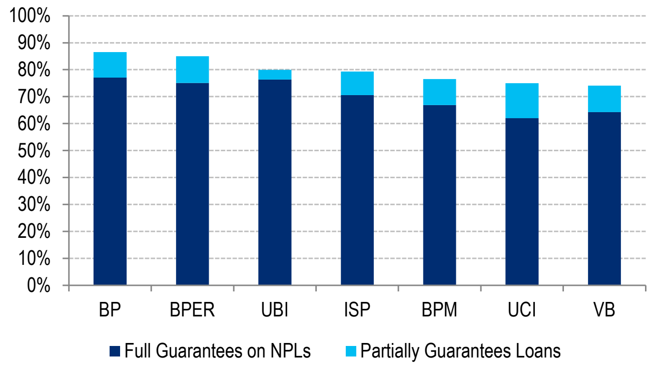
Figure 57. Italian Banks – Key Asset Quality Ratios, 2015

	ISP	UCI	UBI	BP	BPER	VB	BPM	Average
Gross Sofferenze on Net Loans	11.2%	10.8%	8.3%	13.4%	16.3%	16.6%	9.6%	8.1%
Gross Total NPLs on Net Loans	18.0%	16.8%	15.9%	27.6%	26.1%	34.9%	17.5%	14.3%
Gross Total NPLs on Tangible Equity	151.7%	179.9%	163.1%	335.8%	252.7%	403.0%	133.0%	224.5%
Gross NPLs / (Tangible Equity+Provisions)	88.1%	93.6%	112.1%	156.2%	119.3%	165.1%	87.1%	113.9%
Gross NPLs / (Equity+Provisions)	81.1%	87.7%	97.9%	136.2%	113.2%	161.5%	85.7%	105.3%

Source: Company data and Citi Research

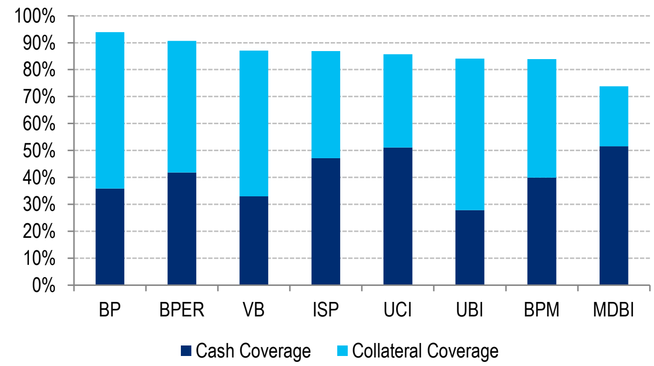
A bright spot comes from collateral information, which shows that the cash coverage can be integrated by collateral value. In the EBA transparency exercise data, VB value of the guarantees is among the top three banks in term of total coverage (cash+collateral). VB had an average c54% of value of guarantees over NPLs as of June 2015, based on EBA data. If this is added to the cash coverage it would significantly increase total coverage. Unsecured NPLs coverage was c64% in 4Q 15. Given the high level of collaterals, we would expect the group to have a level of loan to value in the lending business, below European average.

Figure 58. Italian Banks – Collateral Coverage, 2015



Source: Company data and Citi Research

Figure 59. Italian Banks – Collateral Coverage, 1H 2015



Source: EBA and Citi Research

Figure 60. VB – Guarantee Split, Sept 2015

	Performing	NPLs
Luxury	8%	8%
Residential	45%	55%
Rent	9%	10%
Hotel	7%	6%
Shop and Others	12%	14%

Source: Company data

We believe the coverage support coming from collateral should be able to partially reduce the potential negative capital impact of NPL disposals, even if the recovery timing (average 6-8Y in Italy, but could be reduce in coming year given recent government reform), recovery process, characteristics of the portfolio and NPV of the position would negatively affect the overall results.

VB plans c€1.9bn of net NPL disposals from 2017 to 2020, and this could be even higher, in our view, given the company's potential capital generation after 2017, which also depends on market conditions and government action. We calculate that for disposals VB would need additional coverage in the region of c12%-16% over the current coverage, based on our assumptions.

Figure 61. Veneto Banca – Simulated NPLs Disposal Effect

€m	2018T	2020T
P&L Disposal Costs	72	71
Additional Coverage For Disposal	16%	12%
Simulated Sale Value	30%	30%
Simulated Required Coverage	70%	70%
Implied Coverage	54%	58%
Gross NPLs	450	600
Provisions	-243	-349
Net NPLs	207	251

Source: Citi Research

VB has provided additional disclosure on the NPL book with regard to the breakdown between different categories and vintage. Given loan book split, we expect most of the NPLs to be concentrated in the Veneto and North West of the country and mostly in the corporate space.

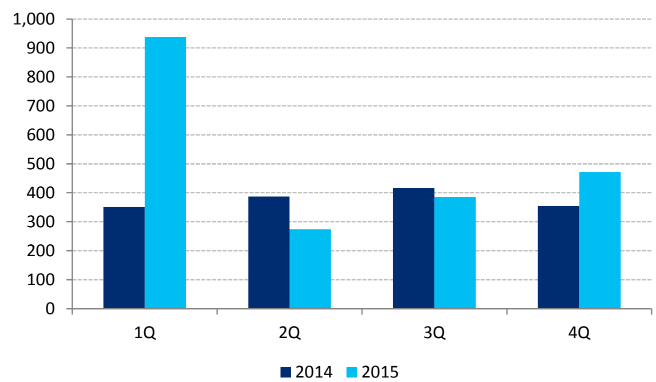
Figure 62. Veneto Banca – NPLs Vintage

	Past Due	Unlikely to Pay	Sofferenze	All
0-3	59.1%	18.2%	3.6%	13%
3-6	25.2%	11.3%	7.6%	13%
6-12	11.6%	22.8%	11.4%	21%
12-24	2.6%	24.1%	11.1%	16%
>24	1.5%	23.6%	66.3%	37%

Source: Citi Research based on Company data

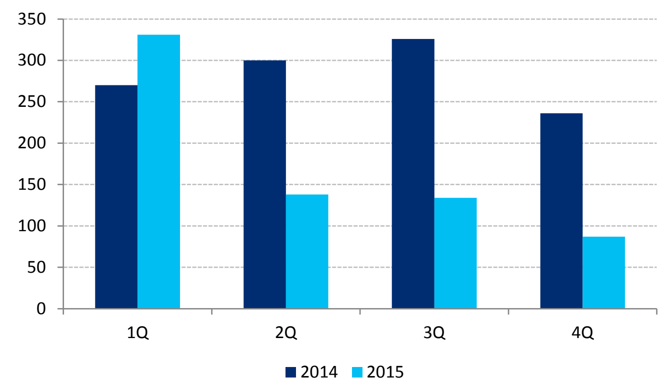
Also, based on company disclosure the total NPLs inflows were still not decreasing as of 2015 due to a rigorous classification process ahead of the IPO/capital increase process. VB expects flows to start decreasing from 2016, and in 1Q 2016 the flows showed the lowest level on net NPE flows from 2014.. There are some positive initial signs of recovery in the 'Past Due' category, which are decreasing YoY.

Figure 63. Veneto Banca – Gross NPLs Inflows, €m



Source: Company data and Citi Research

Figure 64. Veneto Banca – Gross Past Due Inflows, €m



Source: Company data and Citi Research

One of the possible concerns for the market could be the high level of 'Unlikely to Pay' NPLs within total NPLs, which is higher than the average of the peers. The potential negative effect of migration from Unlikely to Pay to Sofferenze could have a negative effect on the company's loan-loss provisions (as the coverage is lower, c22% vs 53%, respectively).

Figure 65. Italian Banks – Gross Total NPLs Breakdown, 2015

	ISP	UCI	UBI	BP	BPER	VB	BPM	Average
Sofferenze	62.0%	64.1%	52.0%	48.6%	62.4%	46.1%	54.6%	56.6%
Unlikely to Pay	36.0%	32.7%	46.0%	49.5%	35.1%	46.6%	43.7%	39.8%
Others	2.0%	3.3%	2.0%	1.9%	2.5%	7.2%	1.7%	3.6%
Total (€m)	63,114	79,760	13,435	21,665	11,395	7,555	5,997	150,242

Source: Company data and Citi Research

Figure 66. Italy – Key Asset Quality Metrics by Size of Banks

	Total Loans	Sofferenze	Coverage	Other NPLs	Coverage	Total NPLs	Coverage	NPLs Ratio
Top 5 Banks	1232	135	58.90%	90	27.90%	225	46.50%	18.30%
Large Banks	430	41	58.60%	35	25.60%	76	43.40%	17.70%
Small banks	148	15	61.50%	10	26.20%	25	47.60%	17.10%
Micro Banks	180	19	55.30%	15	22.50%	34	40.80%	18.70%
Total	**1990**	**210**	**58.70%**	**150**	**26.70%**	**360**	**45.40%**	**18.10%**

Source: Banca d'Italia

Figure 67. Italian Banks – Total NPLs Mix by Category

	2007	2008	2009	2010	2011	2012	2013	2014	2015
Sofferenze	65.2%	64.3%	61.0%	57.8%	56.5%	55.2%	58.6%	58.6%	57.4%
Unlikely to Pay	27.5%	26.9%	22.0%	21.7%	22.2%	22.6%	27.5%	26.9%	27.2%
Past Due	9.2%	9.6%	7.3%	9.4%	12.6%	11.5%	14.5%	16.1%	20.3%
Total	51.9%	48.7%	40.4%	40.6%	41.0%	39.7%	44.5%	45.1%	45.2%

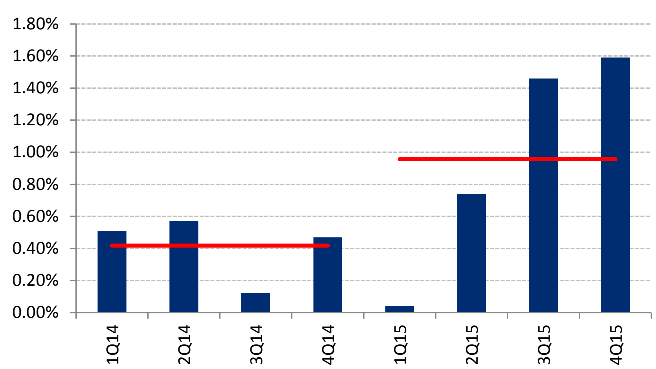
Source: Company data and Citi Research

Figure 68. Italian Banks – Coverage Ratio by NPLs Category

	2007	2008	2009	2010	2011	2012	2013	2014	2015
Sofferenze	65.6%	65.0%	62.7%	59.4%	58.4%	56.9%	61.1%	60.6%	59.6%
Unlikely to Pay	28.0%	27.3%	23.3%	23.1%	23.6%	23.6%	29.6%	27.4%	28.0%
Past Due	10.2%	9.6%	7.8%	9.9%	13.4%	12.4%	16.2%	17.9%	21.9%
Total	**53.0%**	**50.2%**	**42.8%**	**42.7%**	**43.2%**	**41.5%**	**47.2%**	**47.1%**	**47.5%**

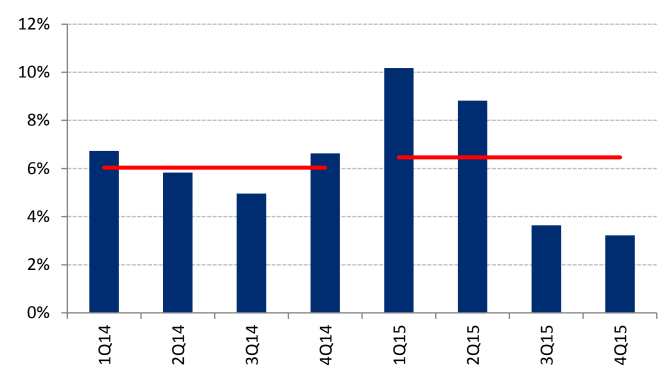
Source: Company data and Citi Research

Figure 69. Veneto Banca - Unlikely to Pay: Outflows to Performing



Source: Company data and Citi Research

Figure 70. Veneto Banca - Unlikely to Pay: Outflows to NPLs



Source: Company data and Citi Research

Total flows out of 'unlikely to pay' into other categories of NPLs (we believe mostly into Sofferenze) have been on average for the period 2007-2015 c40% of the stock of the previous year, peaking at 58% in 2009 and 48% in 2013. This ratio decreased to 24% in 2015 (also due to rising UTP stock, not only lower flows), and in our view it is difficult to see this falling significantly in the short term. This migration could also affect NII levels given the different accounting of accrued interest between UTP and Sofferenze.

Figure 71. Italian Banks – Deteriorated Exposure Contribution to NII, 2015

	ISP	UCI	UBI	BP	BPER	VB	BPM	Average
As% of NII	9%	8%	14%	13%	15%	20%	4%	11%

Source: Citi Research on Company data

Figure 72. Italian Banks – Outflows from Unlikely to Pay into Other NPLs as % of Stock (T-1)

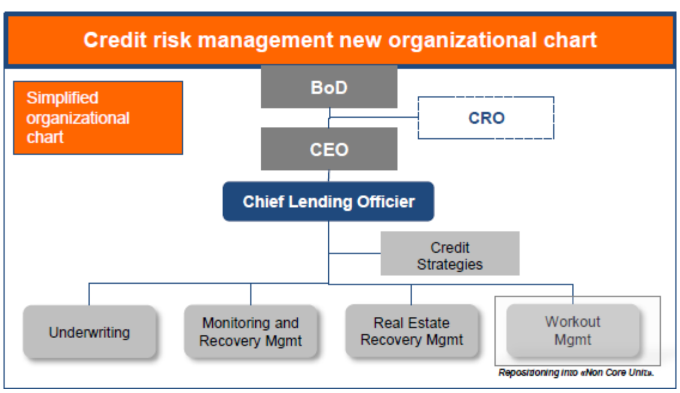
	2007	2008	2009	2010	2011	2012	2013	2014	2015
Outflows from UTP	**-43%**	**-41%**	**-58%**	**-44%**	**-37%**	**-43%**	**-48%**	**-35%**	**-24%**

Source: Company data and Citi Research

VB has created a non-core unit to manage the group NPL stock, and the key benefits include crate efficiency in the recovery procedure as well as synergies in terms of competency, and allows for the creation of models to optimize funding costs. Also, the segregated unit will likely improve transparency on the performance.

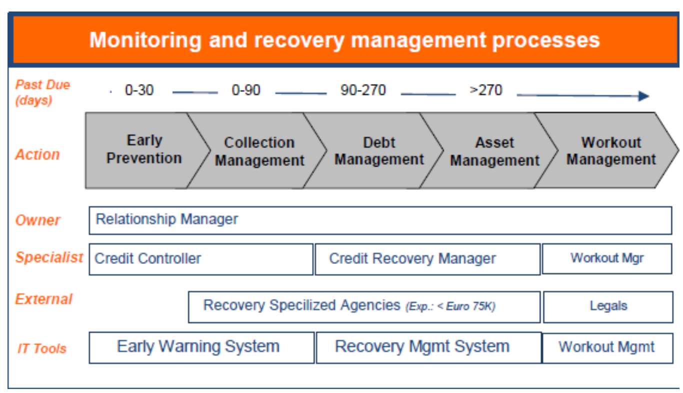
The new organizational structure implemented in June 2014 following the arrival of Mr Rescigno (the new CRO), has created different stages to better identify the different stages and actions of the credit lifecycle: underwriting, monitoring and recovery management and workout management. Credit monitoring has been strengthened and additional focus has been put on the monitoring phase in order to reduce the NPLs inflows. All this should be incrementally positive for the asset quality of banks.

Figure 73. Veneto Banca – CRM New Organizational Chart



Source: Company data

Figure 74. Veneto Banca – Monitoring and Recovering Process



Source: Company data

The level of NPLs disposal is still low in the industry and we believe this is mostly due to the difference between the price among sellers (e.g. banks) and buyers (e.g. private equity, specialized funds, etc.), stemming from different discount values, timing and also cost allocation. The Italian government approve some procedural simplification last summer (but evidence of the reform is still limited) and in January the government has proposed a guarantee scheme for NPLs securitization (whose full details are still to be digested by the market).

The level of NPLs inflows started decreasing at the system level in 2014 and this should support slower growth of NPLs stock (ex-disposals), VB is still in an earlier stage of NPLs classification/recognition. In 2014, Italian banks still had a low level of disposals but NPL inflows decreased.

Figure 75. Italian Banks – NPLs Flow Breakdown

Flows Analysis (€ m)	2007	2008	2009	2010	2011	2012	2013	2014	2015
Inflows from Performing	29%	57%	61%	51%	45%	50%	46%	44%	40%
Transfer Rate from Other NPLs	16%	22%	23%	34%	34%	35%	42%	40%	38%
Other Inflow Rate	55%	21%	15%	15%	20%	15%	13%	16%	22%
Total Inflows	**59,058**	**55,432**	**99,489**	**93,743**	**86,836**	**111,440**	**115,409**	**95,409**	**75,356**
Outflows to Performing	17%	21%	22%	25%	19%	17%	15%	15%	13%
Write-Offs	15%	11%	9%	8%	10%	11%	9%	12%	14%
Cash-in	23%	25%	21%	20%	20%	17%	15%	19%	23%
Sale Proceeds	6%	5%	1%	1%	1%	1%	1%	2%	2%
Transfer to Other NPLs	25%	29%	40%	40%	41%	45%	51%	45%	37%
Other Outflows	14%	8%	7%	6%	9%	9%	9%	7%	10%
Total Outflows	**(38,368)**	**(41,528)**	**(58,054)**	**(78,724)**	**(72,780)**	**(85,784)**	**(95,755)**	**(85,012)**	**(76,058)**
Flows in NPLs	**20,689**	**13,904**	**41,435**	**15,019**	**14,057**	**25,656**	**19,654**	**10,398**	**(702)**

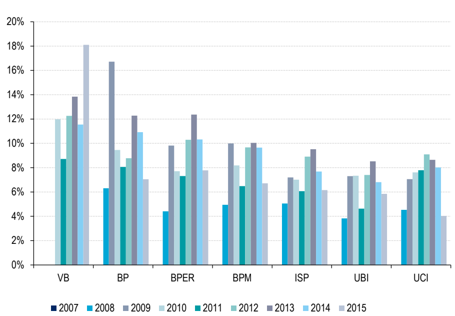
Source: Company data and Citi Research

Figure 76. Veneto Banca – Total NPLs Flows

€ m	**1Q 14**	**2Q 14**	**3Q 14**	**4Q 14**	**1Q 15**	**2Q 15**	**3Q 15**	**4Q 15**
Inflows	351	387	418	355	938	274	385	471
Outflows	-179	-124	-120	-182	-17	-49	-46	-62
Net Inflows	**172**	**263**	**298**	**173**	**921**	**225**	**340**	**409**

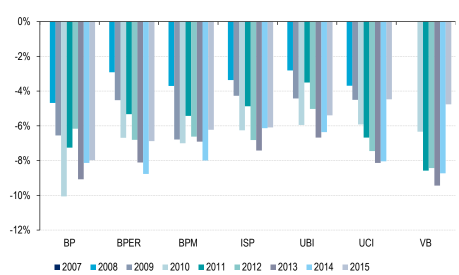
Source: Company data

Figure 77. Italian Banks — Total NPLs Inflows as % of Loans



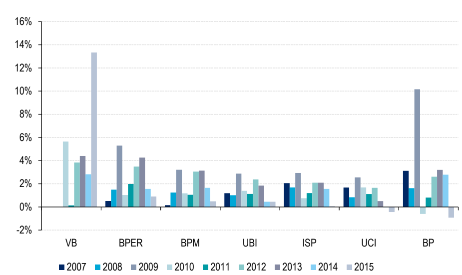
Source: Company data and Citi Research

Figure 78. Italian Banks — Total NPLs Outflows as % of Loans



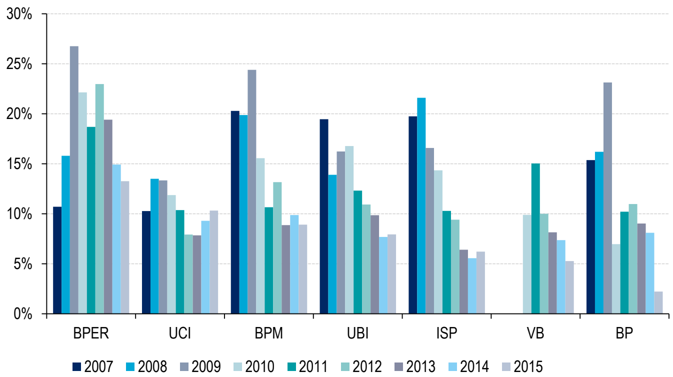
Source: Company data and Citi Research

Figure 79. Italian Banks — Net NPLs Flows as % of Loans



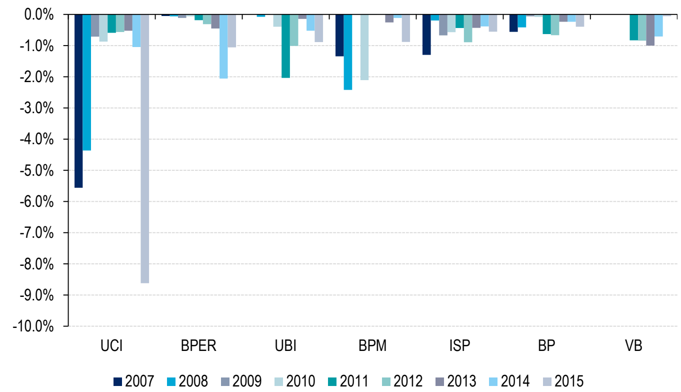
Source: Company data and Citi Research

Figure 80. Italian Banks – Cash In as % Gross NPLs (T-1)



Source: Company data and Citi Research

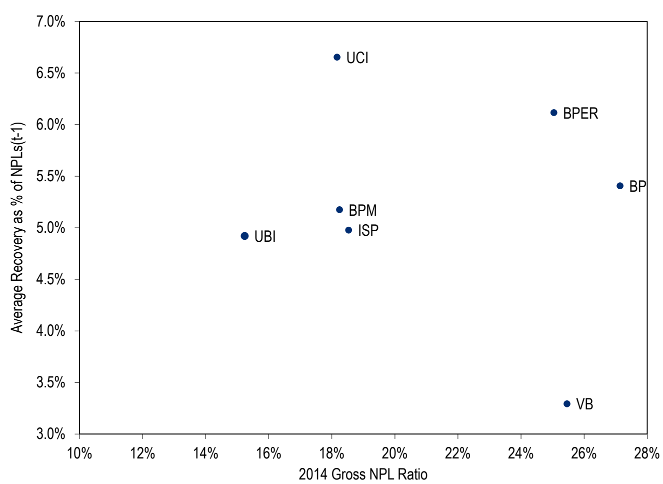
Figure 81. Italian Banks – Sales as % Gross NPLs (T-1)



Source: Company data and Citi Research

We have looked in detail at the NPLs flows and the average recovery rate for VB over the last 5 years is below that of peers, possibly due to the large effort of NPLs recognition required following regulatory review.

Figure 82. Italian Banks – Recovery and NPL Ratio



Source: Company data and Citi Research

Figure 83. Italian Banks – Recovery and NPL Coverage Ratio

Source: Company data and Citi Research

VB plans to reach a coverage ratio post-disposals of c39%, or c43% pre-disposals. We believe this can be achieved, but the main concern for us is the still high level of NPLs expected at the end of the plan. We expect higher disposals once the group's capital position has been restored to a level well above regulatory requirement. We forecast €2.3bn in NPL disposals, above the €1.9bn targeted by the company in 2017-20.

The cost of risk will remain elevated and above that of peers during the plan horizon.

Figure 84. Veneto Banca – Key Asset Quality Targets

	2015	2018T	2020T	CAGR 15-18	CAGR 18-20	CAGR 15-20
NPLs Stock (€bn)						
Net Sofferenze	1.5	1.4	1.1	-2.3%	-11.4%	-6.0%
Net NPLs	4.6	3.8	3.2	-6.2%	-8.2%	-7.0%
NPLs Ratio						
Net Sofferenze	6.5%	6.2%	4.7%			
Net NPLs	20.1%	17.2%	13.6%			
Coverage						
Pre Disposals	34.7%	40.1%	43.2%			
Post Disposals	34.7%	38.1%	38.8%			
Provisions (€m)						
Provisions	754	139	107	-34.7%	-12.3%	-25.2%
Disposals	0	72	71	nm	-0.7%	nm
Loans	22.7	22.1	23.2			
Cost of Risk (bp)						
Provisions	332	63	46			
Disposals	0	33	31			
Total	332	93	76			

Source: Company data and Citi Research

Figure 85. Veneto Banca – Key Asset Quality Forecasts

€m	2014	2015	2016E	% Chg	2017E	% Chg	2018E	% Chg	2019E	% Chg	2020E	% Chg
Bad Debt Provisions	-717	-754	-283		-256		-216		-196		-193	
Cost of Risk	**3.01%**	**3.32%**	**1.32%**		**1.25%**		**1.05%**		**0.93%**		**0.90%**	
Gross Sofferenze	2,852	3,484	3,311	-5%	3,376	2%	3,162	-6%	2,810	-11%	2,191	-22%
Coverage Ratio - Sofferenze	**48%**	**53%**	**55%**		**54%**		**54%**		**55%**		**56%**	
Total Gross Total NPLs	6,067	7,555	7,008		6,888		6,402		5,771		4,818	
Total Net Total NPLs	4,152	4,886	4,412	-10%	4,292	-3%	3,968	-8%	3,567	-10%	2,985	-16%
Coverage Ratio - Total Bad Debt (Post Disposal)	32%	35%	37%		38%		38%		38%		38%	
Coverage Ratio - Total Bad Debt (Pre Disposal)	32%	35%	37%		39%		40%		42%		43%	
Gross Sofferenze on Loans	12%	15%	15%		16%		15%		13%		10%	
Gross Total Bad Debt on Loans	25%	33%	33%		34%		31%		27%		22%	
Net Total Bad Debt on Loans	17%	22%	21%		21%		19%		17%		14%	
Texas Ratio	146%	165%	132%		130%		123%		114%		105%	

Source: Company data and Citi Research estimates

Our NPL Scenario Analysis

We have re-run our scenario analysis (Italian Bad Bank – To Be or Not to Be?) based on the assumption that banks will take actions to decrease the ratio of Sofferenze on loans (NPL ratio) to the 2009 level. We have run 4 different scenarios depending on the potential coverage ratio (range from 65% to 80%) required to transfer the Sofferenze to the private buyer or the special purpose vehicle (in the case of securitization). The lower the required coverage ratio, the lower the potential additional provisions needed to transfer the assets, so the smaller the impact on both tangible book value and capital ratios. Our analysis is based on static data as of 4Q 2015.

Figure 86. Italian Banks – Sofferenze on Loans Ratio, Evolution

	ISP	UCI - Non Core	MDBI	UBI	BP	BPER	VB	BPM	Citi Coverage
4Q15	11.2%	10.8%*	2.5%	8.3%	13.4%	16.3%	15.3%	9.6%	15.9%
2009	4.4%	5.8%*	1.6%	2.8%	5.1%	5.1%	1.7%	2.3%	5.0%
Diff	6.8%	nm	0.9%	5.5%	8.3%	11.2%	13.6%	7.3%	10.9%
Sofferenze Simulated Decrease	23,748	31,719	302	4,613	6,478	4,891	3,094	2,480	77,324
as % of 4Q 2015 Sofferenze	61%	85%	37%	66%	62%	69%	89%	76%	71%
4Q 2015 Sofferenze Coverage	61.8%	60.1%	68.0%	38.6%	38.3%	58.2%	52.8%	54.5%	56.7%

Source: Company data and Citi Research.* Group data, as non core division was created in 2013

- Additional provisions needed to reach the potential required coverage ratio;

Figure 87. Italian Banks – Simulated Level of Additional Provisions, €m

Target Coverage Ratio	ISP	UCI - Non Core	MDBI	UBI	BPER	VB	Citi Coverage
80%	4,333	6,323	36	1,908	1,068	841	17,842
75%	3,145	4,737	21	1,677	823	686	13,975
70%	1,958	3,151	6	1,447	579	532	10,109
65%	771	1,566	-	1,216	334	377	6,252

Source: Company data and Citi Research

- Impact on group tangible book value of the additional provisions required (net of tax effect);

Figure 88. Italian Banks – Simulated Impact on Group Tangible Book Value

Target Coverage Ratio	ISP	UCI - Non Core*	MDBI	UBI	BPER	VB	Citi Coverage
80%	7%	9%	0%	15%	15%	29%	10%
75%	5%	7%	0%	13%	12%	23%	8%
70%	3%	5%	0%	11%	8%	18%	6%
65%	1%	2%	0%	10%	5%	13%	3%

Source: Company data and Citi Research. *On Group Tangible BV based on 4Q15 RWAs

- Impact on group capital ratio of the additional provisions required (net of tax), also considering the potential shortfall already deducted from capital (pro forma the percentage decrease of Sofferenze, mainly an offsetting factor for UBI);

Figure 89. Italian Banks – Simulated Impact on Group Capital Based on 4Q15 RWAs

Target Coverage Ratio	ISP	UCI - Non Core*	MDBI	UBI	BPER	VB	Citi Coverage
80%	99bp	104bp	4bp	93bp	173bp	237bp	115bp
75%	71bp	78bp	2bp	68bp	133bp	193bp	87bp
70%	44bp	51bp	1bp	44bp	94bp	150bp	60bp
65%	17bp	25bp	0bp	20bp	54bp	106bp	32bp

Source: Company data and Citi Research. *On Group Capital based on 4Q15 RWAs

Figure 90. Italian Banks – Capital Ratio and SREP

	ISP	UCI - Non Core	MDBI	UBI	BPER	VB
CET1 Ratio (Transitional) 4Q15	13.0%	10.7%	12.5%	12.1%	11.2%	7.2%
CET1 Ratio (B3) 4Q15	13.1%	10.9%	13.3%	11.6%	11.2%	6.8%
SREP	9.50%	9.75%	8.75%	9.25%	9.25%	10.25%

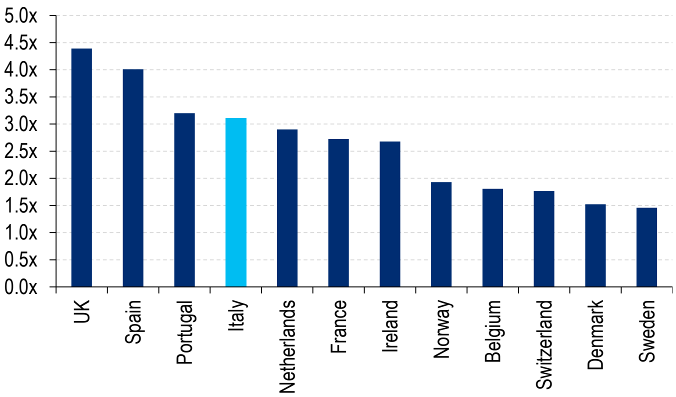
Source: Company data and Citi Research.

Decreasing Funding Cost to Support NII

NII represents c51% of Italian banks' revenues in 2014/15 (vs 56% for VB in 2014/15). On average NII has decreased by c5% CAGR over the period 2013-2015 for Italian banks and a touch more for VB. We expect on average a further c2% reduction in 2016 (concentrated mainly in 1H), and showing some positive growth in 2017. VB's trends could be more benign mainly due to two reasons: a more marked improvement in funding costs as well as a lower contribution to NII from securities portfolio, hence limiting the maturity refinancing effect.

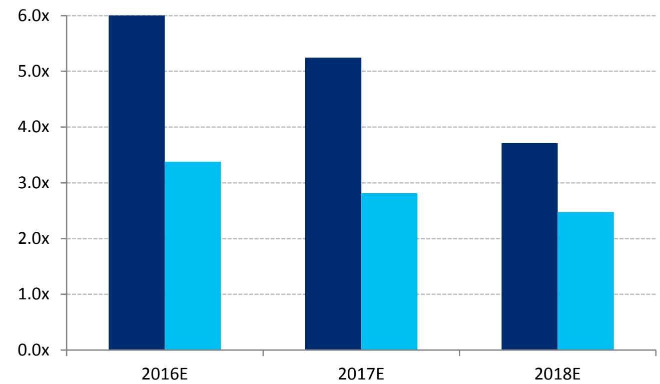
The profitability gearing of NII is high for Italian banks (c3.2x in 2016E and decrease further to 2.8x in 2017E) when compared with European banks. VB has a more marked gearing given the still high level for loan losses and lower ROTE vs peers.

Figure 91. European Banks – NII Gearing to Net Adjusted Profit, 2016E



Source: Citi Research

Figure 92. Italian Banks – NII Gearing to Net Adjusted Profit



Source: Citi Research

NII has been decreasing in absolute terms significantly since the beginning of the financial /economic crisis, driven mainly by the decreasing interest rate environment negatively affecting margins and declining lending volumes due to weaker macro and bank deleveraging.

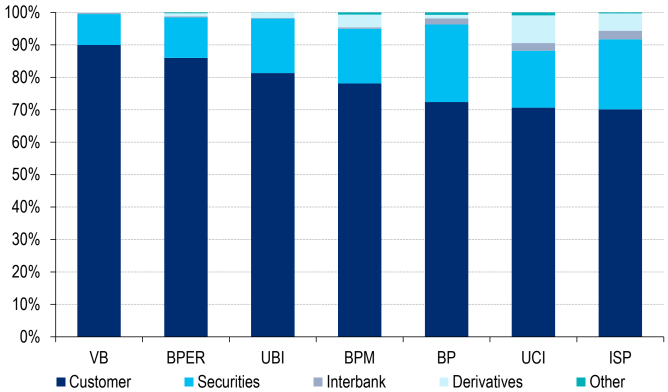
The implied 3M Euribor in the forward contract foresees rates remaining negative until 2018. This represents a major risk for Italian banks margin. Given customer mix, we expect VB to have a very high level of floating rate loan, possibly above peer levels. VB has indicated that it has introduced a floor at 0% Euribor in all the new production and also a floor at 0% is included on new production loans. This should offer some protection to the asset side of NII.

Italian banks' interest income comes mostly (c70-90%) from customer lending (including a c20% from NPLs) followed by income from securities (c10-20%, mostly from government bonds). Interest expenses are mostly for securities issued, given the relatively higher cost versus customer deposits.

VB has a higher percentage of customer interest income (c90%) given the higher level of loans in the balance sheet (c70% of total) and lower exposure to government bonds. VB has c€3.1bn of total financial assets (down from €4.1bn December) and c78% are Italian government bonds with weighted average maturity of c4Y and a modified duration of c0.3Y, hence the smaller than peers contribution to the interest income (c10% for VB vs c18% for peers).

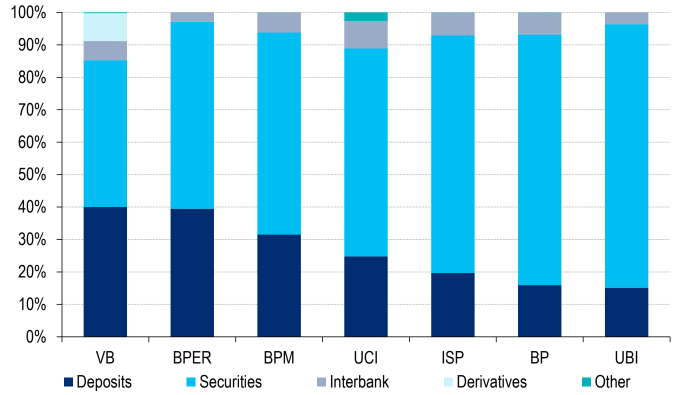
On the funding side, VB has higher than peer level of cost of deposits. This is possibly due to the higher weighting of corporate deposits (more expensive than retail deposits) and less diversified funding as the percentage of customer deposit on total assets is in the middle of the peer group.

Figure 93. Italian Banks – Interest Income Split, 2015



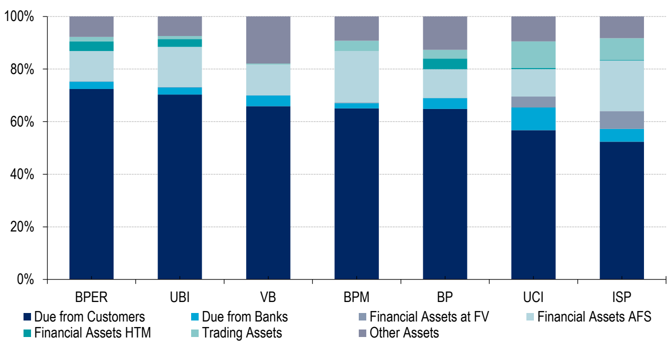
Source: Company data and Citi Research

Figure 94. Italian Banks – Interest Expense Split, 2015



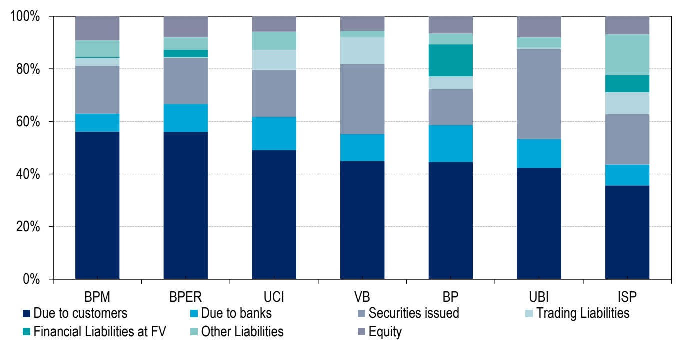
Source: Company data and Citi Research

Figure 95. Italian Banks – Assets Split, 1H 2015



Source: Company data and Citi Research

Figure 96. Italian Banks – Liabilities Split, 1H 2015



Source: Company data and Citi Research

Figure 97. Italian Banks – Sovereign Holding, 2015

€ bn	ISP	UCI*	BP	BPER	BPM	UBI	VB
Total Italian Sovereign Exposure	88.0	60.8	17.8	6.4	8.8	18.3	3.4
o/w AFS (%)	86%	93%	48%	73%	98%	79%	95%
Total Exposure as a % of							
Total Assets	13%	7%	15%	10%	18%	16%	10%
Tangible Equity	183%	127%	132%	103%	193%	175%	176%

Source: Company data and Citi Research. UCI as of 3Q15.

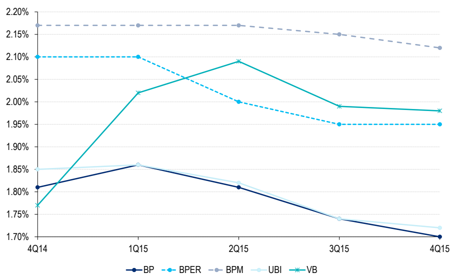
Figure 98. Veneto Banca – Sovereign Bond - Maturity

€m	2016	2017	2018	2019	2020	>2020
Maturity	450	647	15	22	4173	719

Source: Company data

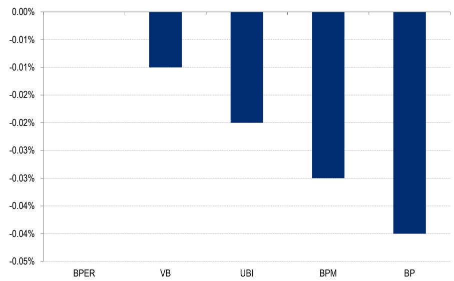
Looking at spread development in the last quarter, VB customer spreads (only commercial Italy) have been mostly stable QoQ and showed an improvement YoY, thanks mostly to lower funding costs.

Figure 99. Selected Italian Banks – Spread Evolution



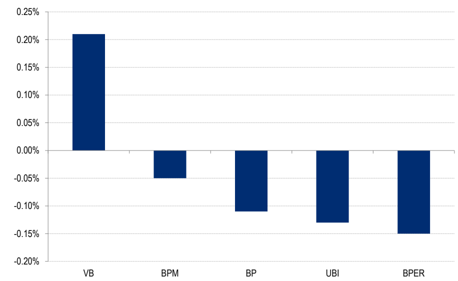
Source: Company data and Citi Research

Figure 100. Selected Italian Banks – Spread, QoQ Change, 2015



Source: Company data and Citi Research

Figure 101. Selected Italian Banks – Spread, YoY Change, 2015



Source: Company data and Citi Research

Figure 102. Veneto Banca – Commercial Spread

	4Q14	1Q15	2Q15	3Q15	4Q15	1Q16
Mark-Up	3.29%	3.35%	3.30%	3.24%	3.24%	3.34%
Mark-Down	-1.52%	-1.33%	-1.21%	-1.25%	-1.26%	-1.32%
Customer Spread	**1.77%**	**2.02%**	**2.09%**	**1.99%**	**1.98%**	**2.02%**

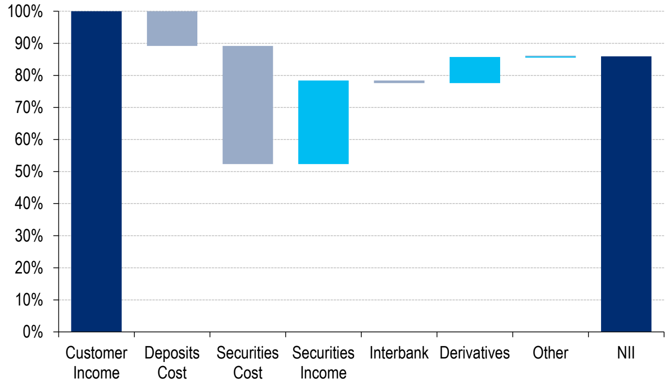
Source: Company data

Figure 103. Veneto Banca – NII Quarterly Development

	1Q14	2Q14	3Q14	4Q14	1Q15	2Q15	3Q 15	4Q 15	1Q16
Interest Income	269	269	252	227	237	237	228	217	197
Interest Expense	-132	-132	-124	-119	-110	-110	-94	-99	-85
Derivatives	-1	3	0	1	-2	-1	1	0	-4
NII	**136**	**140**	**128**	**109**	**125**	**126**	**135**	**118**	**108**

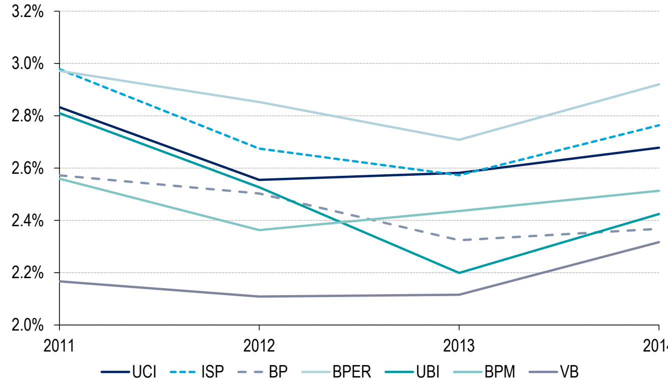
Source: Company data and Citi Research

Figure 104. Italian Banks - NII Decomposition, 2015



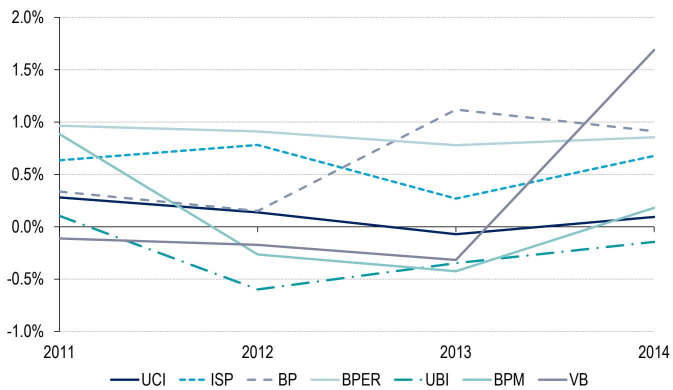
Source: Company data and Citi Research

Figure 105. Italian Banks - Customer Spreads



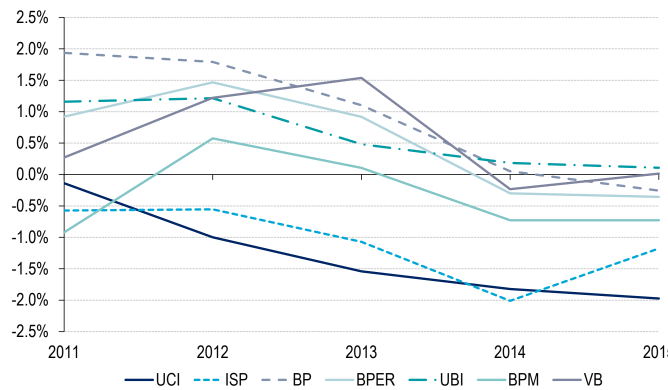
Source: Company data and Citi Research

Figure 106. Italian Banks – Inter-Bank Spreads



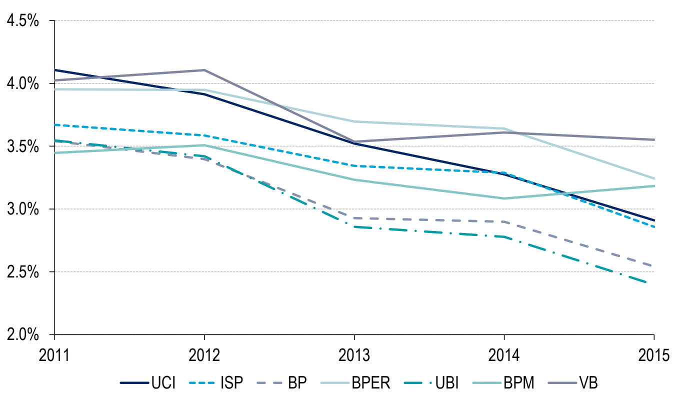
Source: Company data and Citi Research

Figure 107. Italian Banks – Securities Spreads



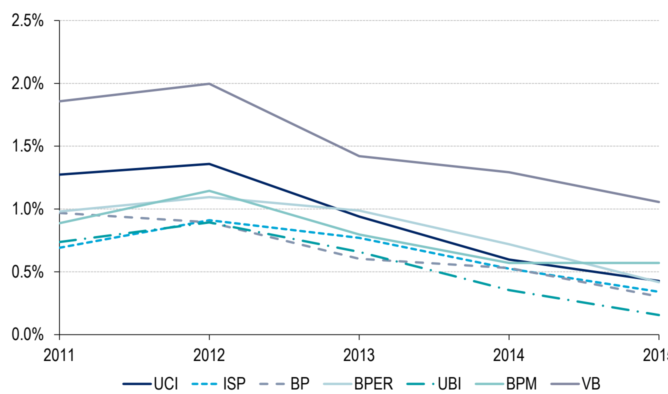
Source: Company data and Citi Research

Figure 108. Italian Banks – Customer Asset Rate



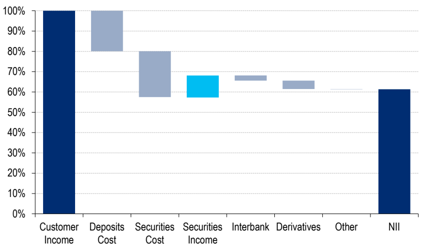
Source: Company data and Citi Research

Figure 109. Italian Banks – Customer Deposit Rate



Source: Company data and Citi Research

Figure 110. Veneto Banca – NII Decomposition, 2015



Source: Company data and Citi Research

Figure 111. Italian Banks – NII Breakdown, 2015

	ISP	UCI	BP	BPM	BPER	UBI	VB
Income	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**
Customer	71%	70%	72%	78%	86%	81%	90%
Securities	18%	22%	24%	17%	12%	17%	10%
Interbank	2%	3%	2%	0%	0%	0%	0%
Derivatives	9%	5%	1%	4%	1%	2%	0%
Other	1%	0%	1%	1%	0%	0%	0%
Expenses	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**
Deposits	25%	20%	16%	32%	39%	15%	40%
Securities	64%	73%	77%	62%	58%	81%	45%
Interbank	9%	7%	7%	6%	3%	4%	6%
Derivatives	0%	0%	0%	0%	0%	0%	9%
Other	3%	0%	0%	0%	0%	0%	0%

Source: Company data and Citi Research

VB targets a 3.4% increase in NII in the period 2015-2018, due mostly to better funding costs (decreasing in the period from 1.3% to 0.9%) as a result of the mix rebalancing in favor of more institutional/retail and less corporate. Based on our analysis of net interest income margin above, VB has the highest funding cost on deposits and it has among the highest funding costs for securities, due possibly to mix/customer composition.

Also, management expects some improvement in asset spreads, mainly due to different mix in the loan book (more SMEs, less large corporate) and positive effect from a more accurate risk adjusted pricing approach.

Management expects loans to increase by c0.6% over the period 2015-2020, mostly due to organic growth offset by disposal and a change in the mix. At the end of 2020, VB expects only c24% of its loan book to come from SME (10pp point more than in 2015), but still well below peers. Possibly this is due to a different classification criteria of customers.

Figure 112. Veneto Banca – NII Main Target

	2015	2018T	2020T	CAGR 15-18T	CAGR 18-20T	CAGR 15-20T
Commercial	449	510	563	4.3%	5.1%	4.6%
Securities	56	34	33	-15.3%	-1.5%	-10.0%
NII	**505**	**544**	**596**	**2.5%**	**4.7%**	**3.4%**
Loans	19.3	17.5	17.8	-3.3%	0.9%	-1.6%
SME	3.4	4.9	5.6	13.1%	6.8%	10.5%
Total	22.7	22.4	23.4	-0.4%	2.2%	0.6%
% on total						
Loans	85%	78%	76%			
SME	15%	22%	24%			
Total	100%	100%	100%			

Source: Company data and Citi Research

Figure 113. Veneto Banca – Customer Spread

	2015	2018T	2020T
Mark - up	3.30%	3.30%	3.10%
Mark - down	-1.30%	-1.20%	-0.90%
Customer spread	**2.00%**	**2.10%**	**2.20%**

Source: Company data and Citi Research

We are broadly in line with management growth target on loans, but more conservative on overall NII. This is mainly due to more conservative interest rate assumptions than the one included in the plan.

Figure 114. Veneto Banca – NII Trends Forecasts

€m	2014	2015	2016E	% Chg	2017E	% Chg	2018E	% Chg	2019E	% Chg	2020E	% Chg
Interest Income	1,017	918	788	-14%	768	-2%	764	-1%	770	1%	792	3%
Interest Expense	-507	-412	-329	-20%	-295	-10%	-279	-6%	-274	-2%	-277	1%
Derivatives	2	-3	0	nm	0	nm	0	nm	0	nm	0	nm
NII	512	504	450	-11%	473	5%	485	3%	497	2%	515	4%
Net Interest Margin on Loans	**2.2%**	**2.2%**	**2.1%**		**2.3%**		**2.4%**		**2.4%**		**2.4%**	
Risk Adjusted Margin on loans	-0.9%	-1.1%	0.8%		1.1%		1.3%		1.4%		1.5%	
Net customer loans	23,832	22,703	21,395	-6%	20,509	-4%	20,612	1%	21,024	2%	21,444	2%

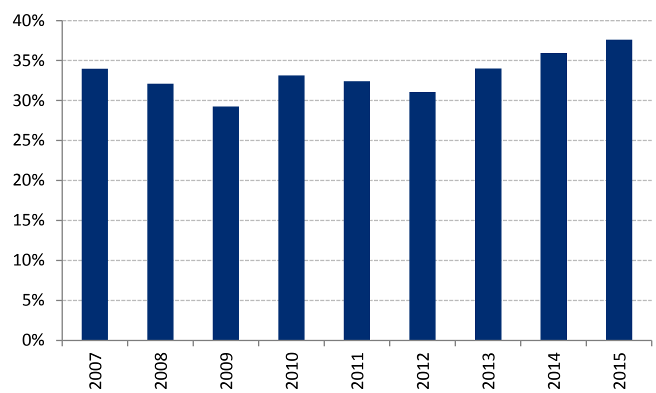
Source: Company data and Citi Research estimates

Increasing Fee Income

Veneto Banca has a low level of fee income on total revenues, compared with peers. This seems mainly due to the low level of AUM and its penetration on total customer assets driving low penetration of the investment related fee, and also to lower than peers margin (both on banking and AUM fees). We believe this could be a key area of development to support revenue growth. We are below management target, but still expect a 4% growth in fee for 2015-2020E. The recent market volatility and increased risk perceptions post the bail-in of smaller banks have negatively affected commission income, which decreased c23% YoY in 1Q, affected also by the low volume of activity and deleveraging.

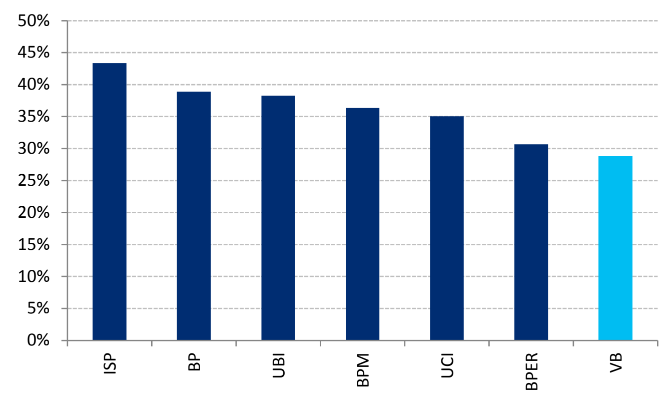
In 2015, fees represented c30% of total revenues in VB, well below the c40% of the peer group (with ISP showing the highest level).

Figure 115. Italian Banks – Aggregate Fees / Revenues



Source: Company data and Citi Research

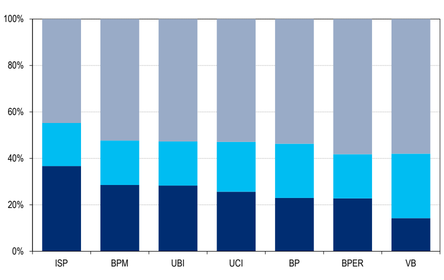
Figure 116. Italian Banks – Fees / Revenues, 2015



Source: Company data and Citi Research

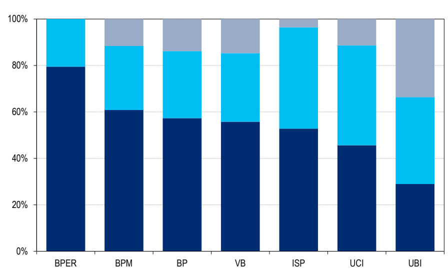
Looking at product penetration, VB has a wide gap vs peers, both in term of AUM on total indirect deposits as well as indirect on total assets and also in the different asset class.

Figure 117. Italian Banks – Total Asset, 2015



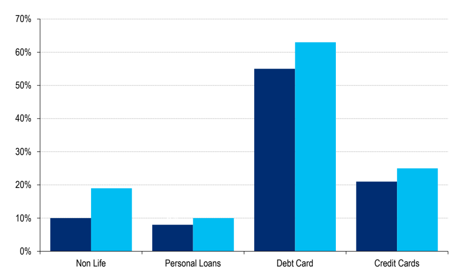
Source: Company data and Citi Research

Figure 118. Italian Banks – AUM Split, 2015



Source: Company data and Citi Research

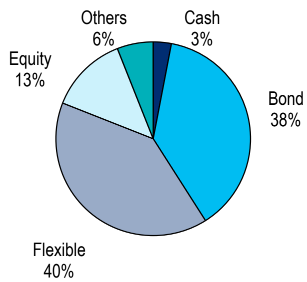
Figure 119. VB and Italian Banks – Penetration



Source: Company data. Data as of Sept 2015

Italian banks have shown strong momentum in asset management business lately (both in term of rising AUM as well as higher income). This increase at the system level could be supported by several factors, in our view: less pressure on banks' funding needs; attractive low capital absorption of the asset management/saving business; low interest rate environment; increased need for revenue diversification; and customers' search for higher returns given compression of both sovereign and bank deposit yields. VB, albeit a late starter and with a more challenging funding position (which could normalize more after the capital increase) and possibly a more complex customer penetration potential over the short term, could benefit from these trends as well.

Figure 120. Veneto Banca – Mutual Fund by Category, 2015

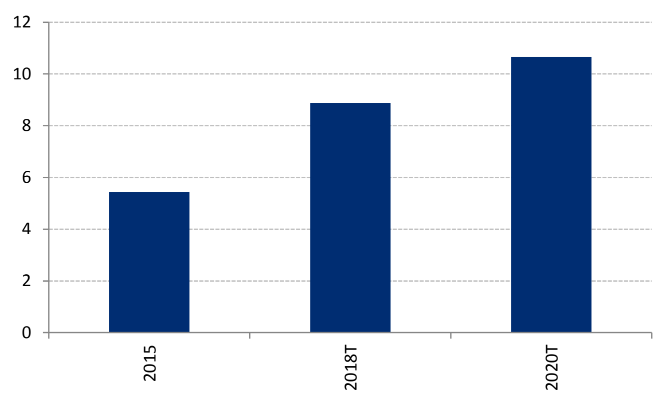


Source: Company data

VB's strategy is focused on an asset mix switch, rising AUM (CAGR c12% for 2015-2020 targeted), strengthening the advisory platform (doubling the number of financial advisors and increasing private bankers by c25%), and increasing penetration of insurance product (Uniqua is the group partner) both in life and non-life segment. These actions should also result in higher margins (from 0.41% in 2015 to 0.52% in 2020), considering a different AUM mix. Currently only c13% of mutual funds are invested in equities, a level below the industry average (c20%).

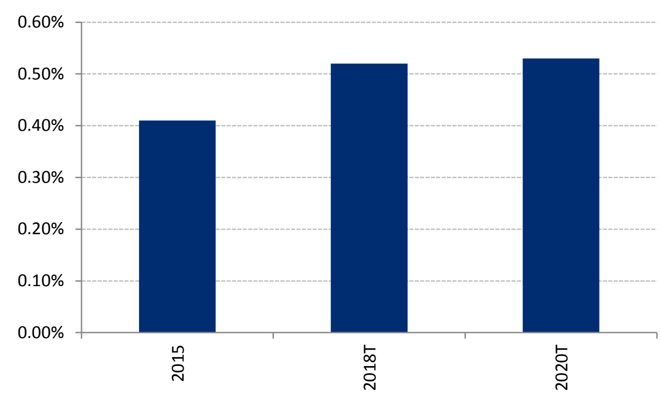
One open question is about the development of the asset management strategy as the group says it is planning to sell BIM and has several asset management partners. Arca seems to be the largest one (c€1.8bn) and VB has a c20% stake. The market is likely to look for clarification of the strategy around Arca.

Figure 121. Veneto Banca – AUM Volume, €bn



Source: Company data and Citi Research

Figure 122. Veneto Banca – Investment Fee Margin



Source: Company data and Citi Research

VB targets growth of c3% in total customer financial assets, but within the different categories AUM is expected to grow by c12% over the period 2015-2018, driving a c7% CAGR in investment fees in the same period. This seems quite challenging in our view. VB plans to have c€3.6bn in indirect deposit growth in 2015-2018 (or c€5.5bn for the period 2015-2020), and of this it expects c€1.9bn to come from internal growth, c€0.6bn from additional financial promoter recruiting and c€1bn from other private sources. Most of the growth is expected from AUM, and in particular in mutual funds. In AUC there are included also

Figure 123. Veneto Banca – Direct and Indirect Deposits Target

€ bn	2015	2018T	2020T	CAGR 15-18	CAGR 18-20	CAGR 15-20
Direct	22.4	20.6	21.3	-2.8%	1.6%	-1.1%
AUC	10.8	10.5	10.8	-1.0%	1.6%	0.0%
AUM	5.4	7.8	9.6	12.8%	11.0%	12.1%
Total	**38.7**	**38.9**	**41.7**	**0.1%**	**3.5%**	**1.5%**
% on total						
Direct	58%	53%	51%			
AUC	28%	27%	26%			
AUM	**14%**	**20%**	**23%**			
Total	**100%**	**100%**	**100%**			

Source: Company data and Citi Research

Figure 124. Veneto Banca – Fee Income Target

€m	2014	2015	2018T	2020T	CAGR 15-18	CAGR 18-20	CAGR 15-20
Investment Service	52	68	93	110	11.0%	8.7%	10.1%
Traditional Banking Fee	236	205	253	284	7.2%	6.0%	-0.1%
Total Fees	**288**	**273**	**346**	**394**	**8.2%**	**6.7%**	**7.6%**
% on total							
Investment Service	18%	25%	27%	28%			
Traditional Banking Fee	82%	75%	73%	72%			

Source: Company data and Citi Research

Looking at the recently published business plan of Italian banks, VB is showing a significantly higher fee income CAGR, possibly explained by the low penetration at the starting point.

Figure 125. Italian Banks – Fee Growth: Business Plan Target vs Achievement

	Business Plan		YoY Growth	
	Horizon	**Fees CAGR**	**2014**	**2015**
Veneto Banca	2015-18	8.2%	-6.6%	-5.7%
Intesa Sanpaolo	2013-17	7.4%	10.4%	10.8%
BPM	2013-16	6.3%	2.2%	8.9%
BPER	2014-17	6.1%	-1.1%	5.2%
Unicredit	2013-18	5.5%	3.1%	3.3%
BP	2013-16	2.0%	-0.1%	3.3%

Source: Company data and Citi Research. UBI have no published targets.

In our view the main challenge in this strategy is the large increase AUM volume at the same time as funding rebalance and with volatile markets, also considering that the group is starting this effort after most of the peers. We are more conservative than management on the growth of fee income.

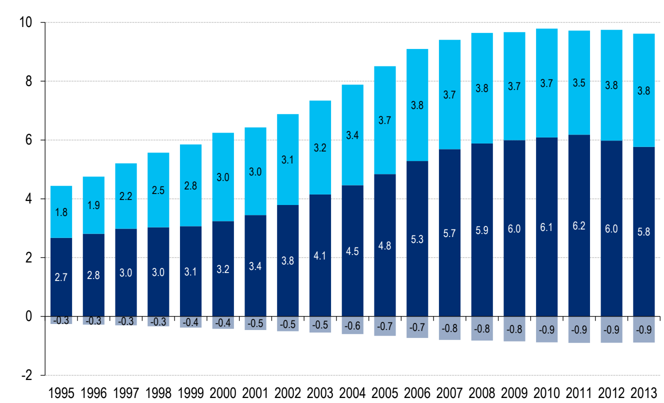
Figure 126. Veneto Banca – Net Fee Income Forecasts

€m	2014	2015	% Chg	2016E	% Chg	2017E	% Chg	2018E	% Chg	2019E	% Chg	2020E	% Chg
Banking Fees	236	214	-9%	204	-5%	209	2%	214	3%	220	3%	225	2%
AM Fees	52	59	13%	56	-4%	63	13%	73	14%	83	14%	94	14%
Others	0	1		-14	0%	-10	-25%	-7	-34%	-6	-9%	-6	-10%
Net Commissions	**288**	**273**	**-5%**	**246**	**-10%**	**262**	**6%**	**280**	**7%**	**297**	**6%**	**313**	**5%**
AUM	4,554	5,533	21%	5,593	1%	6,002	7%	6,502	8%	7,022	8%	7,584	8%
AUC	10,136	10,721	6%	10,828	1%	11,045	2%	11,266	2%	11,491	2%	11,548	0%
Indirect deposits	**14,690**	**16,254**	**11%**	**16,421**	**1%**	**17,047**	**4%**	**17,768**	**4%**	**18,513**	**4%**	**19,132**	**3%**
Direct Deposit	24,607	22,482	-9%	19,826	-12%	19,722	-1%	19,939	1%	20,297	2%	20,676	2%
Total customer Assets	39,297	38,736	-1%	36,247	-6%	36,768	1%	37,706	3%	38,810	3%	39,808	3%
Net AM Fees on AUM	**0.71%**	**0.72%**		**1.01%**		**1.06%**		**1.12%**		**1.18%**		**1.21%**	
Net Banking Fees on Loans	0.99%	0.94%		0.95%		0.96%		0.98%		0.99%		0.99%	
AUM/Indirect Deposit	31%	33%		34%		35%		37%		38%		40%	
AUC/Indirect Deposit	69%	67%		66%		65%		63%		62%		60%	
Indirect on Total	**37%**	**42%**		**45%**		**46%**		**47%**		**48%**		**48%**	

Source: Company data and Citi Research estimates

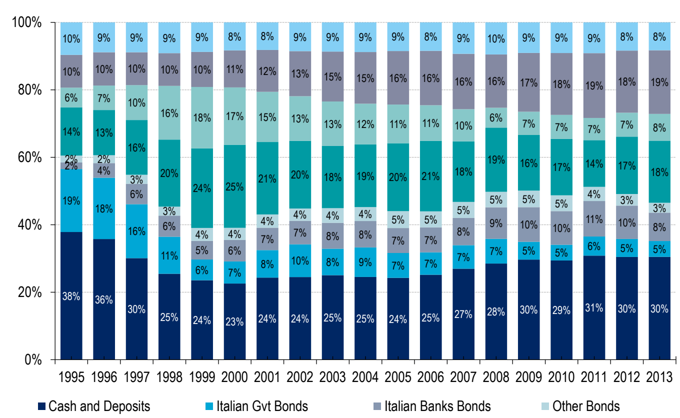
Support could come from the high and stable level of total financial assets in Italy, which have been broadly stable since 2006 at around €3.8trn (with only a marked decrease in 2011). This stability has been achieved despite the drop in the Italian savings ratio and the financial market crisis, possibly also due to the less risky Italian asset allocation with more bond/deposits and less equity exposure. Given also wealth distribution and the franchise distribution of VB this could represent an opportunity to increase fee income. In our appendix, we provide more details on the Italian saving/wealth trends.

Figure 127. Italy – Household Wealth, €trn



Source: Bank of Italy and Citi Research

Figure 128. Italy – Household Financial Assets Split



Source: Bank of Italy and Citi Research. Note: Insurance includes pension funds.

Benchmarking The Fee Income

We have reclassified the Bank of Italy reporting scheme of fees for 2015 (gross fee income) in order to standardize the reporting among banks and see the trends in the development of fees within the different components: asset management related fees, brokerage and banking fees. This reclassification, albeit not perfect, provides some information on mix and pricing trends. For UCI, given the large international exposure, the trends could be less comparable with more domestic banks, hence being a less significant peer for VB.

Banking fees were c55% of total fees in 2015, slightly less than in 2008, but showed decreasing importance in 2013-2014 given the increase in asset management related fees. VB has the highest weighting of banking fees (c82% of total fees).

Figure 129. Italian Banks – Fees Income Split

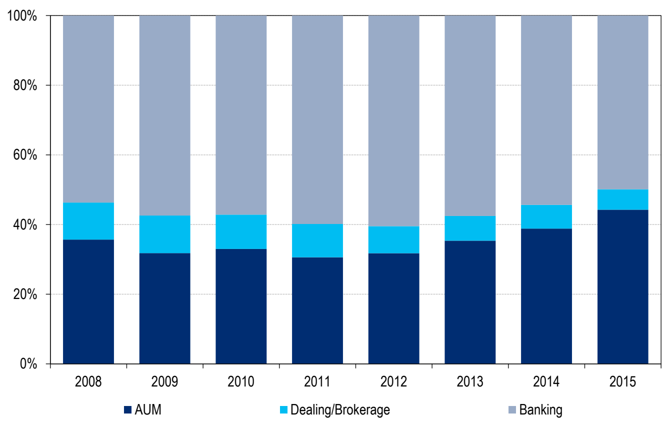
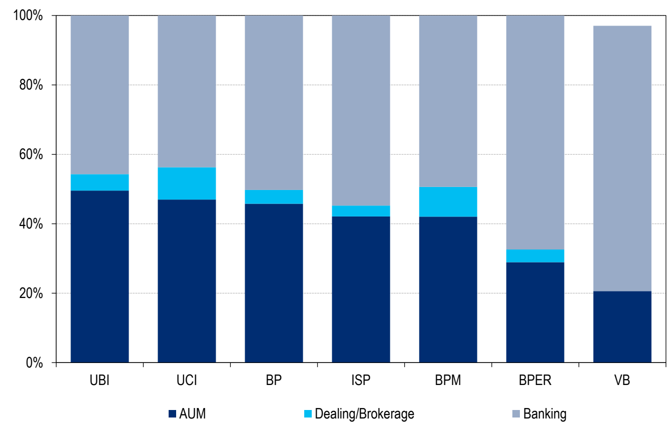


Figure 130. Italian Banks – Fees Income Split, 2015



Source: Company data and Citi Research. Note: Split is based on the Bank of Italy regulatory reporting to have data as uniform as possible across banks, however some differences in the split among banks may still be present. We define AUM fees as fees for: individual and collective portfolio management, placement of securities, third party products and advisory services. We define dealing/brokerage fees as fees for: dealing in securities and currencies, custody, depository and instruction gathering. All the remaining are categorized as banking fees.

The level of asset management fees over AUM has recovered in the last couple of years after reaching a minimum in 2012. On average it seems to be around 1.3% of AUM. BP seems to have the highest level of fees on AUM while VB, ISP and BPER show the lowest.

Figure 131. Italian Banks – AUM Fees / Average AUM

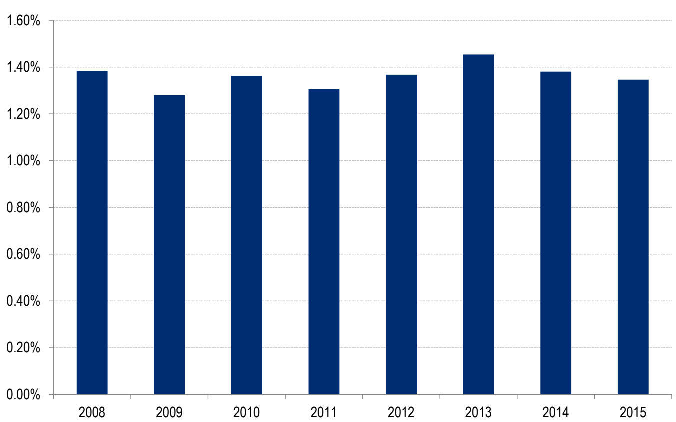
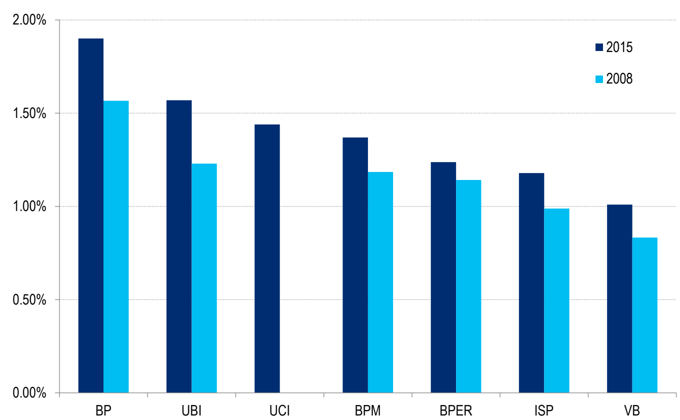


Figure 132. Italian Banks – AUM Fees / Average AUM



Source: Company data and Citi Research. See Figure 129 footnote for fees split definitions. Note: Unicredit based on 2014 AUM only.

Improving macro data and recovering lending volume would also be supportive for higher banking fees, which represents on average c55% of total fees. Also, a push towards more fee income generated from lending products could be supportive.

The level of banking fee on volumes (both loans and deposits) has been stable over the last few years (decreasingin 2015), but has increased since 2008. This is, in our view, the result of a strategy to improve the fee income generation out of the lending/commercial activities especially in the corporate space, given the decreasing trend in rates as well as capital constraints. Given the mix composition of AUM and the low penetration of asset management and insurance product, we would expect VB to have a level of upfront fees below peers on total fees.

Figure 133. Italian Banks – Banking Fees / Average Loans and Deposits

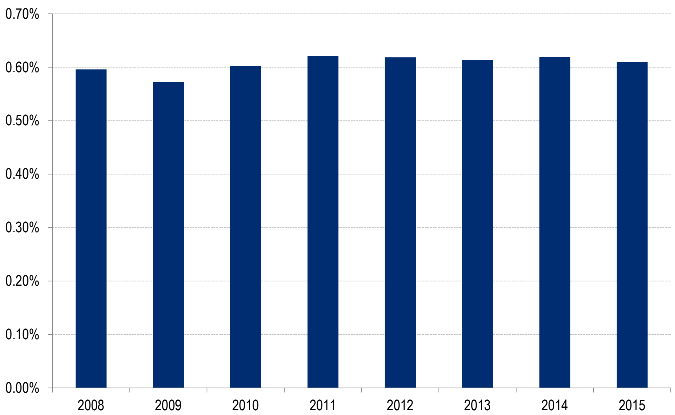
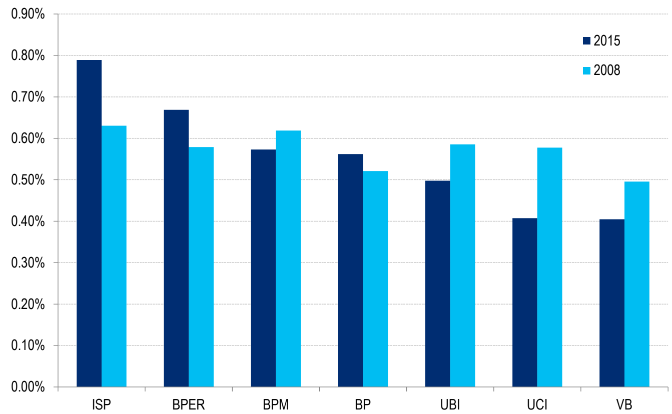


Figure 134. Italian Banks – Banking Fees / Average Loans and Deposits



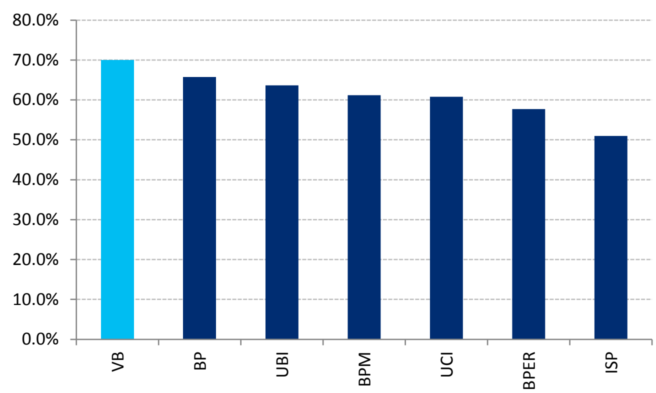
Source: Company data and Citi Research. See Figure 129 footnote for fees split definitions. Note: Using the strict definition of deposits, i.e. excluding all bonds.

Cost Restructuring

VB has the highest cost/income ratio among the banks in our coverage universe (c70% vs average of c57% in 2015), leaving large scope for rationalisation of the cost base.

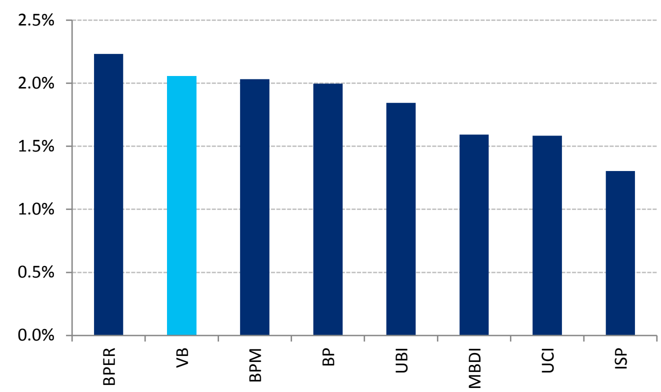
We prefer to focus on the cost-to-asset ratio to better assess the company gap vs peers (as also revenues mix/trends are very different) and on this metric VB is the second worst with a c50bp gap vs average (2.05% in 2015 for VB vs c1.55% for our coverage). Based on management targets and our estimates, we expect that via the planned rationalisation the gap could more than half by 2018.

Figure 135. Italian Banks – Cost/Income Ratio, 2015



Source: Company data and Citi Research

Figure 136. Italian Banks – Cost to Asset Ratio, 2015



Source: Company data and Citi Research

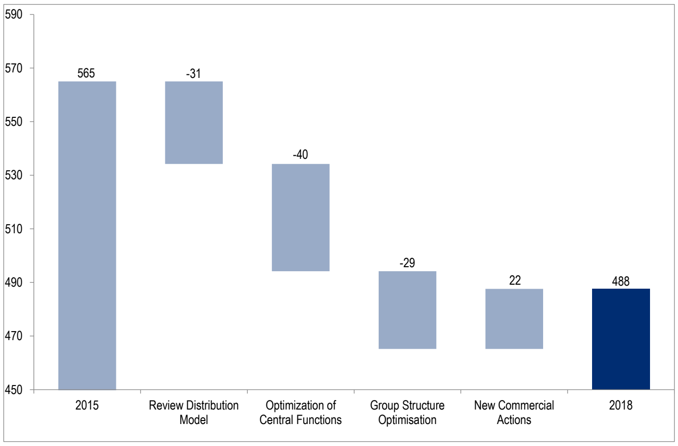
Management has identified several areas that could benefit from optimization:

- The rationalization of the **branch network,** with also the creation of a Hub and Spoke structure. The group has c490 branches and management plans c130 branch closure (of which already 70 have closed with no impact on commercial operations), the creation of 65 Hub branches linked with 200 Spoke branches. The remaining c95 branches will have an independent structure;
- Optimization of the **central structure** with focus on cost cutting project and reduction of ordinary expenses, as well as staff rationalization both in number and functions (eg. c30% of total staff are working in the headquarters);
- **Group structure** optimization will possibly include the rationalization of the foreigner subsidiary as well as further streaming of the group structure.

The staff rationalization, coming from both the branch closure and the transfer of staff from central function to the front office, will affect c430 employees (or c7.6% of total headcount). VB plans to have 170 employees to join the early retirement program, c180 employees will leave the group as a result of stopping the staff turnover and also 80 fixed-term contracts will not be extended (out of c250 fixed term contracts). The early retirement plan has a cost of €18m over the plan period: €5m has been already expensed in 2015 (for c35 employees), and the remaining future years. Looking at the staff composition, c11% of total staff is above 55 years old and 67 are in management (junior/middle) and this seem higher that system level.

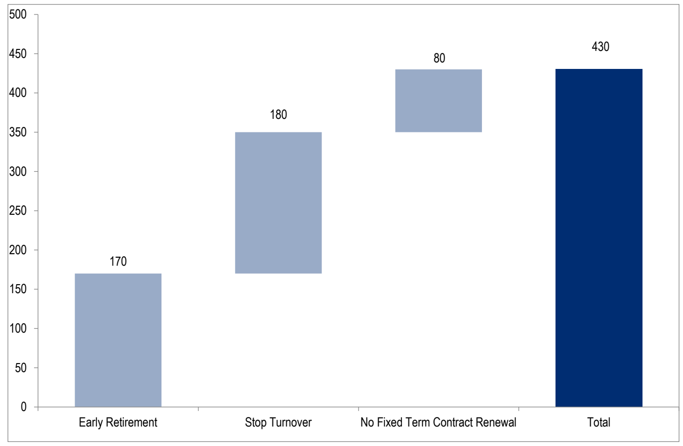
VB plans to close c130 branches within 2017, and as of February already 70 have been closed. The average cost for closing a branch is c€35,000 and the bank expects the longer term benefit to be c€80,000.

Figure 137. Veneto Banca – Costs Optimisation



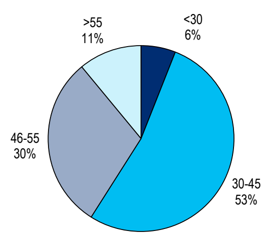
Source: Company data

Figure 138. Veneto Banca – Staff Rationalisation



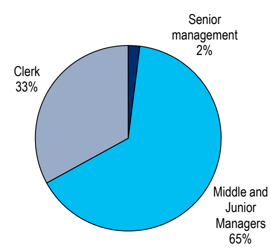
Source: Company data

Figure 139. Veneto Banca – Staff Age



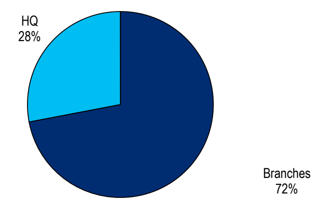
Source: Company data. Data as of Dec 2015.

Figure 140. Veneto Banca – Staff Seniority



Source: Company data. Data as of Dec 2015.

Figure 141. Veneto Banca –Staff Location



Source: Company data. Data as of Dec 2015.

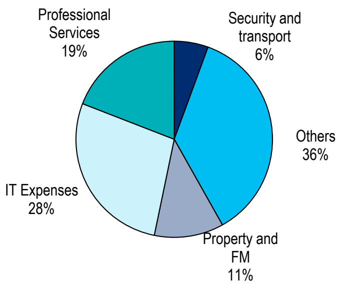
Figure 142. Veneto Banca – Staff Costs Development

	2014	2015		2016E		2017E		2018E		2019E		2020E	
Period-end Workforce	5,590	5,695		5,488		5,383		5,318		5,288		5,258	
Avg Workforce	5,590	5,703		5,572		5,436		5,351		5,303		5,273	
Exits of Employees		-34		-87		-25		-25		0		0	
Exits of Employees - Turnover				-40		-40		-40		-30		-30	
No Fixed Term Renewal				-40		-40		0		0		0	
Hires		0		0		0		0		0		0	
Net Headcount		65		-167		-105		-65		-30		-30	
Staff Costs (€ m)	-349	-342		-316		-301		-288		-284		-281	
Integration Costs (€ m)	-18	1		-11		-2		0		0		0	
Total Staff Costs (€ m)	**-367**	**-341**	**-7%**	**-333**	**-2%**	**-303**	**-9%**	**-288**	**-5%**	**-282**	**-2%**	**-278**	**-1%**

Source: Company data and Citi Research

Veneto Banca is planning c€53m of investment in the plan period, of which c70% (or €38m) is related to the commercial network (investment in new branch H&S system, staff training) as well as development of mobile/internet banking platforms. The remaining €15m will be invested in strengthening the IT control system.

Figure 143. VB – Administrative Expense Breakdown, 2015



Source: Company data

Within administrative costs, the major expenses in 2015 were for IT (c38%) and professional services (c19%). For example, the cost related to the capital increase project and group restructuring are indicated to be c€45m (for project Serenissima), and those should decrease after 2016. Most of the network is rented (c80% of the total). The cost for the resolution funds totaled over €50m in 2015 of which €31m were due for the rescue of the 4 Italian banks that were resolved in 4Q 15 and c€13m were for the recurrent annual contribution.

Figure 144. Veneto Banca – Costs Target

	2015	2018T	2020T	CAGR 15-18	CAGR 18-20	CAGR 15-20
Staff Costs	341	283	274	-6.0%	-1.6%	-4.3%
Other Admin	275	205	205	-9.3%	0.0%	-5.7%
D&A	70	46	36	-13.1%	-11.5%	-12.5%
Total Costs	685	526	513	-8.4%	-1.2%	-5.6%
Cost to Assets	2.00%	1.80%	1.60%			
Cost/Income	69.5%	55.3%	48.6%			

Source: Company data and Citi Research

We believe that the cost targets are achievable and could be excided in case the revenues environment would be more challenging than expected.

Figure 145. Veneto Banca – Operating Costs Forecasts

€m	2014	2015	2016E	% Chg	2017E	% Chg	2018E	% Chg	2019E	% Chg	2020E	% Chg
Staff costs	-367	-341	-337	-1%	-305	-9%	-288	-5%	-282	-2%	-279	-1%
Other expenses	-205	-275	-250	-9%	-202	-19%	-189	-6%	-186	-2%	-184	-1%
Depreciation	-45	-70	-48	-31%	-47	-2%	-46	-2%	-44	-5%	-42	-5%
Total operating expenses	**-617**	**-685**	**-635**	**-7%**	**-554**	**-13%**	**-524**	**-5%**	**-511**	**-2%**	**-504**	**-1%**
Cost to asset ratio	1.71%	2.05%	2.29%		2.08%		1.95%		1.88%		1.84%	
Cost / income ratio	72%	72%	83%		70%		63%		60%		56%	

Source: Company data and Citi Research estimates

Atlante – How Can it Help?

Atlante is a private specialised fund aiming to invest in the pending recapitalisation of banks and in the junior tranches of NPL securitization. It has been set up by an asset management company, Quaestio, and has already started acting with the subscription to the BP Vicenza capital increase.

Atlante fund has collected c€4.25bn of equity from 67 institutions and no investor has more than a 20% stake in the fund. The subscription period closed on 28 April, but it could be re-opened depending on some conditions (eg if 66.6% of investors vote in favor). The fund has a duration of 5 years, which could be extended up to 8 years. The Board will be appointed on May 16. The ECB will monitor the fund's governance/independence. The fund alone cannot fix all the problems of the Italian banking system, but it aims to create conditions for a change in market trends (eg bank valuation, NPL sales, confidence), reducing the tail risk in the system.

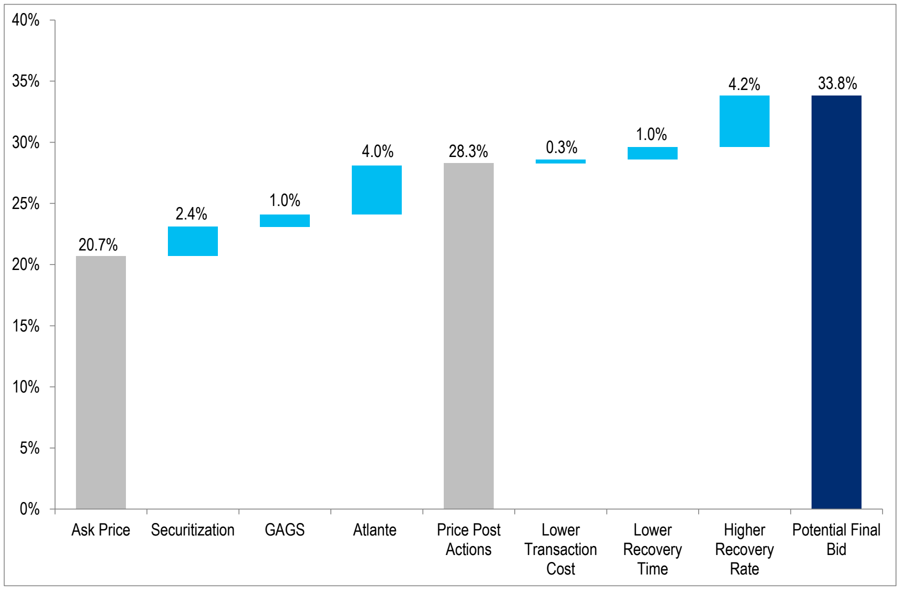
The fund will be a distressed security fund that will invest in bank equity as a backstop (initially c70% of capital) and in junior tranches (occasionally mezzanine) of NPL SPVs and could have other investments. The fund's target return of c6% is well below the level of the distressed funds (c12% pre fees), and it will look for opportunities for partnership/co-investment. Atlante will not have leverage; the indicated 110% gearing is for operational activities.

Atlante will invest in capital increases of banks, buy up to 75% of every single capital injection and will not participate in the event of a mandatory tender offer. The fund is not going to be involved in the ordinary management of the bank, and will focus on improving the value of the asset base (eg restructuring phase) and then look for divestment opportunities as soon as possible. It has been authorised by the ECB to acquire a stake in BP Vicenza already, and will be the main shareholder of the bank.

Atlante will have up to 30% of investment in NPLs until June 2017 and then this could increase. Atlante aims to co-invest in the NPL SPV. There is a wide gap between NPL bid and ask prices and this is due mainly to: data quality, servicing of NPLs, recovery times (vary significantly in Italy), use of guarantee schemes (eg GACS) and market conditions. With actions in these areas, we think prices of NPLs could increase from c20% to c33%. The overall firepower of the fund will depend on: leverage and percentage of junior stake acquired, price paid, coverage level and NPL mix, and many details are still pending. The fund has not committed to buy NPLs at book value. So far no evaluation of potential investment has been made.

Quaestio management has stressed the importance of three external factors that will help the fund activities: government actions to improve recovery time of NPLs; banks' ability to improve their profitability and a stable environment for the next two years (no shock) as the Sofferenze level depends also on flows from other NPL categories. We agree on the points above and have recently done a detailed analysis of NPL flows (Almost Midnight: Will It Be Prince or Pumpkin?).

Figure 146. NPLs – Potential Impact on Bid/Ask Price from Simulated Actions



Source: Quaestio, Citi Research

How can Atlante help Veneto Banca? Atlante could be a backstop facility in case of low demand for the capital increase as an additional option to the underwriting committee and also could be a potential buyer of NPLs that could be placed into a securitization vehicle. There are still a lot of details to be clarified, so it is difficult to predict the final outcome, but this should add an additional level protection to the transaction, in our view. The potential sale of NPLs via a securitization then subscribed by Atlante could be an easier option for decreasing the stock of NPLs of the group, potentially liiting the P&L and balance sheet impact.

We have run a sensitivity analysis on the potential NPLs targeted by the fund assuming different sizes of the fund and different weights of the junior tranches in the NPLs securitisation SPV. The outcomes vary significantly. For example, assuming the fund would have Eur1.5bn of equity available for NPLs SPV, different leverages of the junior tranche would result in different firepower: in the case of 25% weight of the junior tranche (eg 75% mezzanine and senior), the potential net NPLs scope could be cEur6bn net. This is assuming that Atlante would buy 100% of the junior tranche; in the case of Atlante buying a smaller portion of the junior tranche (banks need to sell 50%=1 of the junior to deconsolidate the assets), the effect could be bigger. The gross amount of NPLs transfer will depend on the coverage ratio of the portfolio transferred, and will be bigger the higher the coverage ratio, hence an additional open question concerns which portfolio banks will transfer to the funds (better covered/older vintage portfolio or portfolio with wider pricing gap?).

Figure 147. Atlante Simulated Firepower – Net NPLs, Eur bn

Funds Available / Weigh of Junior Tranche	1.0	1.5	2.0	2.5	3.0	3.5	4.0	4.5	5.0
20%	5.0	7.5	10.0	12.5	15.0	17.5	20.0	22.5	25.0
25%	4.0	6.0	8.0	10.0	12.0	14.0	16.0	18.0	20.0
30%	3.3	5.0	6.7	8.3	10.0	11.7	13.3	15.0	16.7
35%	2.9	4.3	5.7	7.1	8.6	10.0	11.4	12.9	14.3
40%	2.5	3.8	5.0	6.3	7.5	8.8	10.0	11.3	12.5
45%	2.2	3.3	4.4	5.6	6.7	7.8	8.9	10.0	11.1
50%	2.0	3.0	4.0	5.0	6.0	7.0	8.0	9.0	10.0

Source: Citi Research

The table below shows a simplification of the potential valuation gap between a bank's NPLs valuation (based on c4-5% discount rate) and the valuation of a potential buyer looking for a variable return (we simulate between 5-20%), based on different recovery times (between 1-10 years).

Figure 148. Corporate NPLs Value Simulation – Potential Buyers vs Potential Bank Valuation

Years/Potential Buyer Discount Rate	5.0%	10.0%	12.5%	15.0%	17.5%	20.0%
1	0%	-4%	-6%	-8%	-10%	-12%
2	-1%	-8%	-12%	-15%	-18%	-21%
3	-1%	-11%	-16%	-21%	-25%	-29%
4	-2%	-14%	-20%	-25%	-30%	-34%
5	-2%	-16%	-23%	-29%	-34%	-38%
6	-2%	-18%	-25%	-31%	-37%	-41%
7	-2%	-20%	-27%	-33%	-39%	-43%
8	-3%	-21%	-29%	-35%	-40%	-44%
9	-3%	-22%	-30%	-36%	-41%	-45%
10	-3%	-23%	-31%	-37%	-43%	-47%

Source: Citi Research. Assuming 4-5% potential bank discount rate.

M&A – The Wild Card

Popolari (and former Popolari banks like UBI and VB) banks could be at the center of the potential consolidation in the Italian banking system. Management's plan is based on a stand-alone basis, but nevertheless the theme could be topical for VB, as the restructuring exercise is complex and present execution risk. Popolari banks, other Italian Non-Popolari banks and/or also international players could all be part of the process. The two large Italian banks (ISP and UCI) stated clearly on several occasions that they would not take part in the process[1]. This could represent an opportunity for VB depending on the partners, the deal details as well as the potential synergies achievable. While it is impossible to forecasts M&A, as many factors are in place, it is worth highlighting the key debating points around it.

The government reform affects the ten largest popolari banks in Italy. This set of banks presents significant differences, first of all in terms of size: from the c€120bn of assets of UBI and BP to the c€10bn of BP Bari. There is an 11th Popolare bank that may be subject to the reform: the bank resulting from the merger between Volksbank and BP Marostica (c€8.5bn of combined assets), which was approved after the reform proposal.

Figure 149. Popolari Banks – Key Information , 2014

Bank (€m)	RIC	Assets	Cust. Loans	Total Cust. Funds	Sh. Equity	CET1 (PI)	Branches	Employees	Net NPL Ratio	Coverage*
Banco Popolare	BAPO.MI	123,082	79,824	86,513	8,064	11.9%	1,815	17,179	17.9%	34.2%
UBI Banca	UBI.MI	121,787	85,644	93,207	9,804	12.3%	1,670	18,132	11.1%	27.1%
BP Emilia Romagna	EMII.MI	61,262	43,920	44,483	4,870	11.3%	1,273	11,615	14.9%	40.7%
BP Milano	PMII.MI	48,272	32,079	36,685	4,537	11.6%	706	7,740	11.2%	38.5%
BP Vicenza	Unlisted	46,475	28,111	30,373	3,732	10.4%	654	5,515	15.0%	37.9%
Veneto Banca	Unlisted	36,167	23,832	24,607	2,774	9.6%	554	5,590	17.4%	31.6%
BP Sondrio	BPSI.MI	35,619	24,012	29,717	2,407	9.8%	322(1)	3,054(2)	8.6%	43.2%
Credito Valtellinese	PCVI.MI	28,814	19,005	20,746	2,020	11.0%	539	4,275	16.8%	37.2%
Banca Etruria(2)	PEL.MI	12,308	6,195	8,363	534	5.9%	191	1,915	27.5%	43.2%
BP Bari(1),(3)	Unlisted	9,437	6,285	6,791	917	9.4%	189	1,901	12.2%	41.1%
Total 10 Banks		**523,221**	**348,905**	**381,485**	**39,659**		**7,911**	**76,936**		

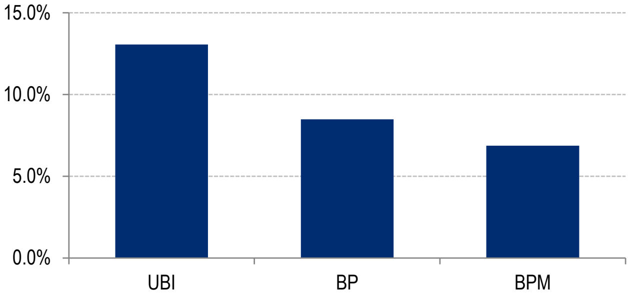
Source: Company data and Citi Research. All data as of Dec 14 except for: (1) As of Jun 14 and (2) as of Sep 14. Branches include Italian branches only. (3) Not including the Tercas acquisition. After this acquisition the bank has 386 branches. *Excludes write-offs

From a geographical point of view, most of these banks are headquartered in the center-north of Italy (the only exception is BP Bari), however, thanks to several acquisitions some of them have strong presences in the southern and islands regions.

We have a detailed market share analysis based on number of branches in Figure 156, but looking at the key regions from an economic point of view we see that three of the popolari banks we cover have the highest market shares in Lombardia while in Veneto two non-listed banks are in the top 3. BPER has a market leading position in Emilia Romagna (4th region by GDP, see Figure 154) while its presence is limited in Veneto and Lombardia, therefore there is limited overlap with the other popolari banks in our coverage. BPM's franchise is c65% concentrated in Lombardia.

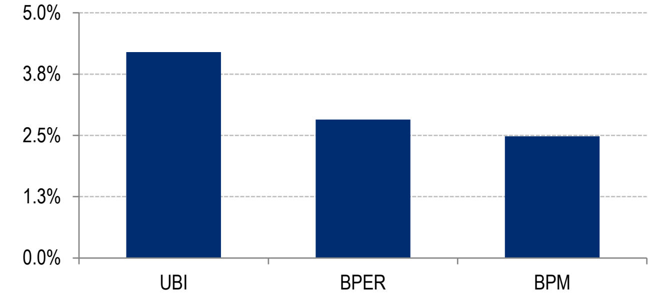
[1] Intesa 4Q14 Conference Call; il Giornale, "Ghizzoni: "Unicredit fuori dal risiko", 21st Jan 2015

Figure 150. Popolari Banks – Top 3 Branches Market Shares in Lombardia



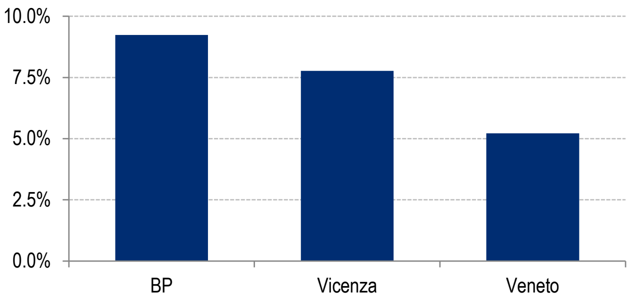
Source: Bank of Italy, company data and Citi Research. As of Jun 2014

Figure 151. Popolari Banks – Top 3 Branches Market Shares in Lazio



Source: Bank of Italy, company data and Citi Research. As of Jun 2014

Figure 152. Popolari Banks – Top 3 Branches Market Shares in Veneto

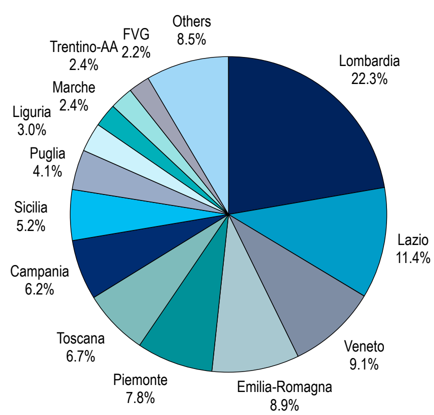


Source: Bank of Italy, company data and Citi Research. As of Jun 2014

Figure 153. Popolari Banks – Top 3 Branches Market Shares in Emilia Romagna

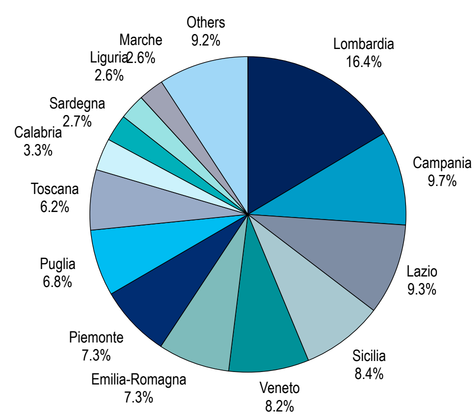
Source: Bank of Italy, company data and Citi Research. As of Jun 2014

Figure 154. Italian GDP by Region, 2013



Source: Istat and Citi Research

Figure 155. Italian Population by Region, 2013



Source: Istat and Citi Research

Figure 156. Italian Banks – Market Share by Branches

	BP	BPM	BPER	UBI	Creval	Vicenza	Veneto	Sondrio	Etruria	Bari	Unicredit	Intesa
Piemonte	8.9%	3.5%	1.1%	7.7%	1.1%	0.1%	2.8%	0.5%	0.0%	0.0%	16.6%	16.2%
Valle d'Aosta	6.3%	0.0%	0.0%	1.0%	1.0%	0.0%	0.0%	1.0%	0.0%	0.0%	19.8%	28.1%
Liguria	13.2%	1.2%	0.6%	5.2%	0.0%	0.6%	0.8%	0.7%	0.0%	0.0%	8.9%	12.3%
Lombardia	8.5%	6.9%	0.8%	13.1%	3.8%	1.5%	1.3%	4.1%	0.1%	0.1%	8.2%	15.2%
North-West	**9.0%**	**5.4%**	**0.8%**	**10.8%**	**2.7%**	**1.0%**	**1.6%**	**2.8%**	**0.1%**	**0.1%**	**10.6%**	**15.3%**
Trentino-Alto Adige	2.3%	0.0%	0.3%	0.1%	1.2%	0.2%	0.0%	0.6%	0.0%	0.0%	8.4%	8.5%
Veneto	9.2%	0.2%	1.0%	1.0%	0.6%	7.8%	5.2%	0.1%	0.0%	0.1%	15.3%	14.5%
Friuli-Venezia Giulia	1.8%	0.1%	0.0%	1.1%	0.0%	7.3%	1.9%	0.0%	0.0%	0.0%	15.2%	13.2%
Emilia-Romagna	6.8%	0.9%	9.8%	1.4%	0.2%	0.6%	0.3%	0.1%	0.3%	0.0%	15.2%	11.0%
North-East	**6.8%**	**0.4%**	**4.2%**	**1.1%**	**0.5%**	**4.1%**	**2.4%**	**0.2%**	**0.1%**	**0.0%**	**14.5%**	**12.3%**
Total North	**8.0%**	**3.1%**	**2.4%**	**6.3%**	**1.7%**	**2.4%**	**2.0%**	**1.6%**	**0.1%**	**0.1%**	**12.4%**	**13.9%**
Marche	0.1%	0.1%	0.8%	7.3%	3.3%	0.1%	4.3%	0.0%	1.4%	0.2%	8.0%	10.9%
Toscana	9.4%	0.2%	0.5%	0.3%	0.6%	3.8%	0.0%	0.0%	3.8%	0.2%	7.0%	15.7%
Umbria	2.5%	0.0%	0.4%	3.4%	0.6%	0.4%	1.9%	0.0%	3.8%	6.3%	16.1%	20.1%
Lazio	2.4%	2.5%	2.8%	4.2%	1.9%	1.1%	0.4%	1.6%	1.3%	0.8%	19.9%	13.7%
Centre	**4.5%**	**1.1%**	**1.5%**	**3.3%**	**1.6%**	**1.9%**	**1.1%**	**0.6%**	**2.4%**	**0.9%**	**13.0%**	**14.4%**
Campania	3.6%	0.1%	6.9%	5.5%	0.0%	0.0%	0.3%	0.0%	0.0%	3.6%	13.0%	22.9%
Abruzzo	0.0%	0.2%	15.4%	2.7%	0.0%	0.2%	0.6%	0.0%	0.5%	0.0%	6.6%	13.2%
Molise	5.8%	0.7%	7.2%	4.3%	0.0%	0.0%	0.7%	0.0%	4.3%	0.7%	23.9%	13.0%
Puglia	0.5%	3.0%	2.8%	7.6%	0.0%	0.1%	5.4%	0.0%	0.0%	6.1%	11.0%	16.2%
Basilicata	1.3%	0.0%	15.2%	11.7%	0.0%	0.0%	7.8%	0.0%	0.0%	14.8%	4.3%	10.9%
Calabria	0.2%	0.0%	9.2%	19.7%	0.0%	3.2%	0.0%	0.0%	0.0%	1.7%	5.6%	14.3%
South	**1.7%**	**1.0%**	**7.6%**	**7.6%**	**0.0%**	**0.4%**	**2.3%**	**0.0%**	**0.2%**	**4.1%**	**10.5%**	**17.5%**
Sicilia	7.3%	0.0%	1.2%	0.0%	8.1%	4.7%	0.0%	0.0%	0.0%	0.0%	23.5%	9.9%
Sardegna	0.1%	0.0%	62.0%	0.1%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	8.4%	14.4%
Islands	**5.2%**	**0.0%**	**18.8%**	**0.0%**	**5.8%**	**3.3%**	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**19.1%**	**11.2%**
Total	**6.2%**	**2.1%**	**4.1%**	**5.4%**	**1.7%**	**2.1%**	**1.7%**	**1.0%**	**0.6%**	**0.8%**	**12.8%**	**14.3%**

Source: Bank of Italy, company data and Citi Research. As of Jun 2014 except for UCI and ISP that are end 2014 and B.P. Bari that is end 2013 and therefore does not reflect the Tercas acquisition that lead to higher market share, mostly in Abruzzo.

Figure 157. Italian Banks – Franchise Distribution by Region

	BP	BPM	BPER	UBI	Creval	Vicenza	Veneto	Sondrio	Etruria	Bari	Unicredit	Intesa
Piemonte	11.6%	13.3%	2.2%	11.7%	5.4%	0.5%	13.4%	4.0%	0.0%	0.0%	10.6%	9.2%
Valle d'Aosta	0.3%	0.0%	0.0%	0.1%	0.2%	0.0%	0.0%	0.3%	0.0%	0.0%	0.5%	0.6%
Liguria	6.2%	1.6%	0.4%	2.8%	0.0%	0.8%	1.3%	1.9%	0.0%	0.0%	2.0%	2.5%
Lombardia	26.8%	62.6%	3.6%	47.5%	43.1%	13.5%	14.7%	76.7%	4.3%	3.2%	12.5%	20.6%
North-West	**45.0%**	**77.5%**	**6.1%**	**62.1%**	**48.6%**	**14.8%**	**29.4%**	**82.9%**	**4.3%**	**3.2%**	**25.5%**	**32.9%**
Trentino-Alto Adige	1.1%	0.0%	0.2%	0.1%	2.0%	0.3%	0.0%	1.9%	0.0%	0.0%	2.0%	1.8%
Veneto	16.0%	1.0%	2.6%	2.1%	3.9%	39.4%	33.3%	1.2%	0.0%	1.2%	12.8%	10.8%
Friuli-Venezia Giulia	0.8%	0.1%	0.0%	0.6%	0.0%	9.7%	3.3%	0.0%	0.0%	0.0%	3.4%	2.6%
Emilia-Romagna	11.6%	4.2%	24.6%	2.6%	1.5%	2.7%	1.7%	1.2%	4.8%	0.0%	12.4%	8.0%
North-East	**29.5%**	**5.4%**	**27.5%**	**5.4%**	**7.4%**	**52.2%**	**38.2%**	**4.3%**	**4.8%**	**1.2%**	**30.5%**	**23.1%**
Total North	**74.5%**	**82.9%**	**33.6%**	**67.5%**	**56.0%**	**67.0%**	**67.7%**	**87.3%**	**9.1%**	**4.5%**	**56.0%**	**56.0%**
Marche	0.1%	0.1%	0.7%	4.8%	6.8%	0.2%	9.2%	0.0%	8.6%	0.8%	2.2%	2.7%
Toscana	11.5%	0.7%	0.9%	0.4%	2.6%	13.7%	0.2%	0.0%	48.4%	1.6%	4.1%	8.2%
Umbria	0.7%	0.0%	0.2%	1.1%	0.6%	0.3%	1.9%	0.0%	10.8%	13.4%	2.1%	2.4%
Lazio	3.3%	9.7%	5.7%	6.6%	9.4%	4.6%	2.1%	12.7%	18.3%	8.1%	13.1%	8.0%
Centre	**15.5%**	**10.6%**	**7.4%**	**12.9%**	**19.4%**	**18.7%**	**13.4%**	**12.7%**	**86.0%**	**23.9%**	**21.5%**	**21.3%**
Campania	2.9%	0.3%	8.1%	5.0%	0.0%	0.0%	1.0%	0.0%	0.0%	21.9%	5.0%	7.8%
Abruzzo	0.0%	0.1%	7.6%	1.0%	0.0%	0.2%	0.8%	0.0%	1.6%	0.0%	1.1%	1.9%
Molise	0.4%	0.1%	0.8%	0.4%	0.0%	0.0%	0.2%	0.0%	3.2%	0.4%	0.8%	0.4%
Puglia	0.3%	5.8%	2.9%	6.0%	0.0%	0.2%	13.6%	0.0%	0.0%	32.4%	3.6%	4.8%
Basilicata	0.2%	0.0%	2.7%	1.6%	0.0%	0.0%	3.4%	0.0%	0.0%	13.8%	0.3%	0.6%
Calabria	0.1%	0.0%	3.3%	5.5%	0.0%	2.3%	0.0%	0.0%	0.0%	3.2%	0.7%	1.5%
South	**3.8%**	**6.4%**	**25.3%**	**19.5%**	**0.0%**	**2.6%**	**18.9%**	**0.0%**	**4.8%**	**71.7%**	**11.4%**	**16.9%**
Sicilia	6.2%	0.0%	1.5%	0.0%	24.6%	11.7%	0.0%	0.0%	0.0%	0.0%	9.7%	3.6%
Sardegna	0.1%	0.0%	32.1%	0.1%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	1.4%	2.1%
Islands	**6.2%**	**0.0%**	**33.6%**	**0.1%**	**24.6%**	**11.7%**	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**11.1%**	**5.8%**

Source: Company data and Citi Research. As of Jun 2014 except for UCI and ISP that are end 2014 and B.P. Bari that is end 2013 and therefore does not reflect the Tercas acquisition that lead to an higher concentration in some regions, mostly in Abruzzo.

On timing, the government's reform requires that Popolari banks will have to transform into joint-stock companies within 18 months of the final incorporation of the law into the Bank of Italy regulation, hence the deadline is December 2016. So far only UBI and VB have transformed.

Bank managements face a challenging task in assessing who could be the best future partner in case of consolidation. We have looked at the main criteria of M&A deals in the past waves of consolidation in Italy (early 2000s and mid-2000s cycles mainly) and the main rationales for these transactions are summarised below:

- **Market share increase in geographic areas of low presence,** aiming to find scarce branch overlap, in order to avoid local franchise disruption;
- **Leveraging on a vast, untapped deposits base** to increase lending and penetration of asset management;
- **Industrial fit among completely different entities** to diversify the revenue mix;
- **Cost savings opportunity following larger scale of the franchise**.

All of those could still be valid in the next wave and therefore we have tried to list also other key variable in the consolidation process:

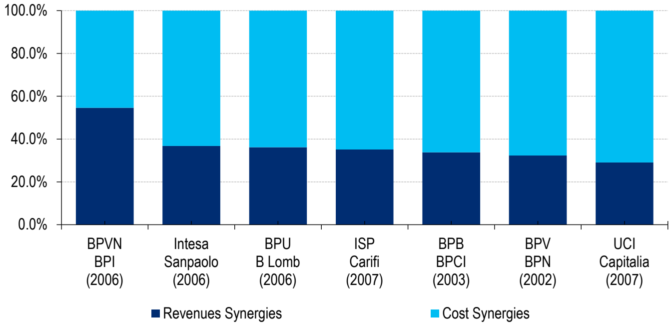
- **Strategic Fit** - Most of the Popolari banks have similar business mixes. Banks could look for a very similar peer in order to expand geographically or look for a more diverse business mix to expand product range.
- **Geographic Fit** - One of the key criteria in past M&A waves in Italy has been geographical expansion or access to strategic areas.
- **Balance Sheet/AQ/Capital** - Given the increased focus from regulators, managements and the market on banks' balance sheet's quality and dynamic, we believe that in the case of a merger, considerations on funding, asset quality, lending and balance sheet composition will also play a significant role.
- **Governance and Management** - Soft factors, like the bank managements' future role, could also play an important part in the upcoming consolidation dynamics.
- **Valuation** - The valuation of the assets in consideration in both absolute terms as well as versus peers is an essential part of any deal negotiation
- **Synergies Potential** - Synergy generation is also a major value creation driver in the case of a merger.

Focus on Historical Synergies

Announced cost synergies were on average c20% of the target cost base in previous deals, and we expect potential future synergies to represent some 1-3% potential upside on banks ROTE on average, depending on the deal components. Despite the stand-alone management focus on costs, and improved starting point in term of efficiency versus previous deals, we still expect on average banks to be able to deliver some 10-15% cost reduction of the target cost base, depending on the bank. The area of potential cost synergies could be different from the past (mainly staff and IT, scale related), as branch network rationalization could be more limited but central costs synergies could be more important especially in areas like risk management, capital management related costs, compliance, legal, etc.

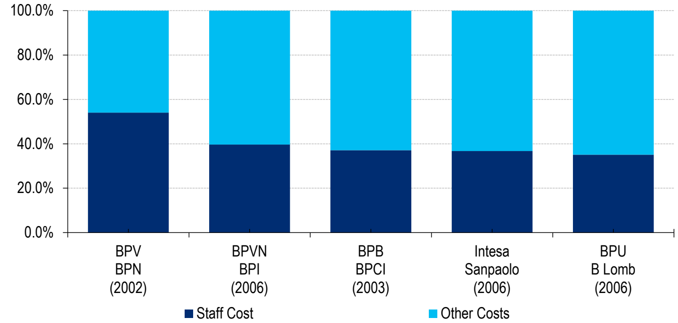
In the case of international players being involved in the consolidation, synergies could be lower given the absence of overlapping activities.

Figure 158. Italian Banks – Announced Revenues and Cost Synergies Split in Selected Previous M&A Deals



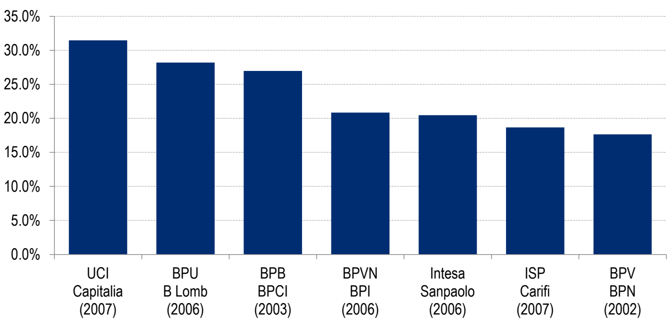
Source: Company data and Citi Research

Figure 159. Italian Banks – Announced Staff Costs and Other Costs Synergies Split in Selected Previous M&A Deals



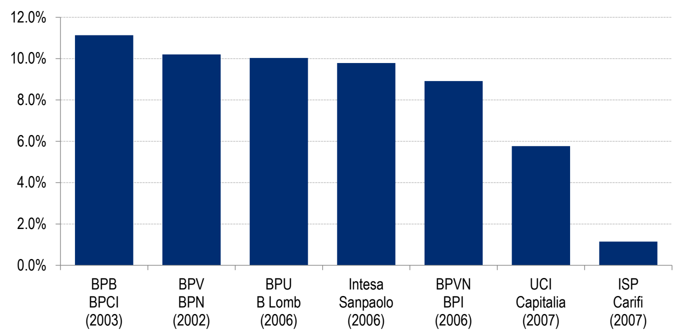
Source: Company data and Citi Research

Figure 160. Italian Banks – Announced Cost Synergies as a % of Target Cost Base in Selected Previous M&A Deals



Source: Company data and Citi Research

Figure 161. Italian Banks – Announced Cost Synergies as a % of Combined Cost Base in Selected Previous M&A Deals



Source: Company data and Citi Research

Figure 162. Italian Banks – Average Revenue and Cost Synergies Split in Past M&A Transactions*

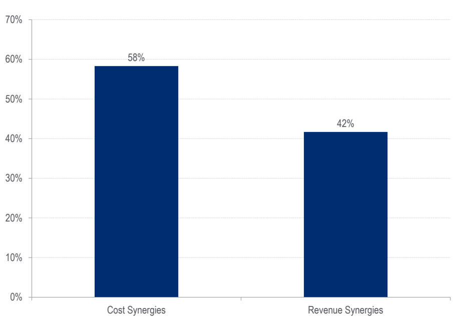


Figure 163. Italian Banks – Average Revenue Synergies as a % of Revenues Base*

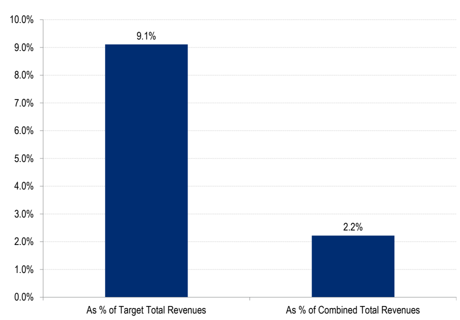
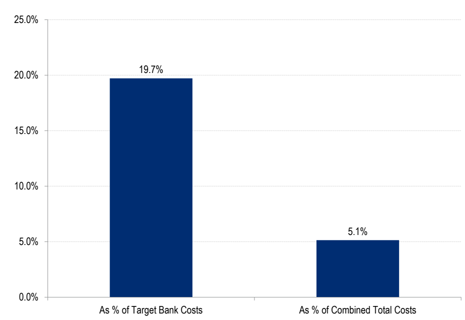


Figure 164. Italian Banks – Average Costs Synergies as a % of Costs Base*



Source: Citi Research. *Including deals from 1999 to 2007.

In addition to cost synergies, some deals could also include some form of revenue synergies. In past deals those have represented on average c9% of the target revenue base. These are less attractive from a market point of view and much more dependent on market conditions.

Deleveraging Weighing on Profitability in 1Q16

Veneto Banca has recently published its 1Q 2016 results which showed substantial balance sheet deleveraging (loans down 8% QoQ), with profitability suffering from this (net loss of €34m, due mainly to decreasing revenues). Results were also affected by several one-offs, reflecting the company's continued restructuring process/derisking. Net of one off the normalized net loss would reduce to -€11m.

The group liquidity profile has suffered from outflows (mostly concentrated in the first part of the quarter) and this seems to have stabilized now. LCR is at 78% vs c53% in December, still relatively weaker than peers, but above the regulatory minimum now. Counterbalacy capacity has reduced, possibly due to the scaling down of the government bond portfolio, and leaves the company with less room to manouevre, in our view. The capital position remains below the SREP requirement at c6.8% CET1 FL B3. Total gross NPLs increased by 2%, but flows from performing loans into non performing are slowing. Coverage remained stable at 52.8% for Sofferenze and at c35.6% for total NPLs.

Figure 165. Veneto Banca – Spread Evolution

	1Q15	2015	1Q16
Mark Up	3.35%	3.28%	3.34%
Mark Down	-1.33%	-1.26%	-1.32%
Spread	**2.02%**	**2.02%**	**2.02%**
3M Euribor	0.05%	-0.02%	-0.18%

Source: Company data and Citi Research

The NII was down c14% YoY due mainly to lower volume (loans down and lower financial assets), but the customer spread was stable and this is due to a mix effect in the deleveraging (VB decreased high-quality corporate low-yield assets such as overdrafts). The stable margin is not sustainable, in our view, given the volume trend and the high asset pressure at system level.

Fee income was weak and down 23%, due to a large drop in investment fee (-c50% YoY) given market turmoil and also decreasing traditional banking fees (-c10% YoY) given volume contractions.

During the EGM on 5th May, management informed shareholders of a letter sent by Consob with remarks on several governance aspects related to the upcoming capital increase; the authority has requested a board meeting to be called in the following 7 days.

Figure 166. Veneto Banca – 1Q 2016 Key P&L Data

	4Q15	1Q16	% change 1Q16 vs 1Q15	1Q16 Normalised
Net Interest Income	118	108	-13.5%	108
Net Fees	67	59	-23.3%	59
Dividends	0	0	-82.9%	0
Net Trading Income	175	7	-88.6%	18
Other Net Operating Income	-1	3	-176.3%	3
Operating Income	**360**	**178**	**-32.4%**	**188**
Personnel Expenses	-92	-95	11.4%	-86
Other Administrative Expenses	-106	-58	19.3%	-57
D&A	-12	-13	43.8%	-11
Operating Costs	**-210**	**-166**	**16.2%**	**-153**
Operating Profit	**150**	**12**	**-90.1%**	**35**
Loan Loss Provisions	-224	-59	-4.9%	-50
Net write-downs on Other Assets	-6	1	1.9%	1
Provisions for Risks and Charges	-48	1	NS	1
Impairment on Goodwill	0	0	NS	0
Net Income from Investments	-3	0	NS	0
Profit (loss) Before Tax	**-132**	**-45**	**NS**	**-14**
Income Tax for the Period	75	9	NS	1
Profit (Loss) on Assets Held for Sale, After Tax	-64	0	NS	0
Minorities	-10	-3	NS	-3
Net Profit (Loss)	**-112**	**-34**	**NS**	**-11**

Source: Company data and Citi Research

Appendix

Company Description

Veneto Banca is the 11th largest bank in terms of loan market share in Italy. The main area of businesses are: collecting deposits, lending, financial intermediation: bancassurance, international operations and financial services. It is also involved in consumer loans and salary-backed loans private banking and asset management factoring and leasing. The group has c87k shareholders, of which 45% are in Veneto and c95% are customers of the bank.

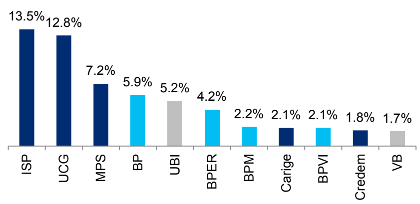
The company was incorporated as Banca Popolare di Asolo e Montebelluna under Italian laws in 1966, following the merger of Banca Popolare di Montebelluna and Banca Popolare del Mandamento di Asolo. Its name was changed to "Veneto Banca S.C.P.A." in 1999 and then to "Veneto Banca Holding S.C.P.A." in 2007. In 2011, the bank reverted to its previous name of "Veneto Banca s.c.p.a.".

Following the reorganisation of the Veneto Banca Group's distribution networks, through the mergers by the incorporation of the subsidiaries of Banca Popolare di Intra Spa in November 2010, of Veneto Banca Spa in November 2010, of Cassa di Risparmio di Fabriano e Cupramontana Spa (operating in the center of Italy) in May 2013 and of Banca Italo Romena spa (23 branches operating in Romania) in May 2014, Veneto Banca Scpa became a single bank operating in Italy and Romania, handling operations with customers and with the role of guidance coordination and control of the group.

The group's loan book is concentrated in the North East of the country, mostly mortgages (c60%) and mostly to corporate clients. Most of the guarantees are from real estate.

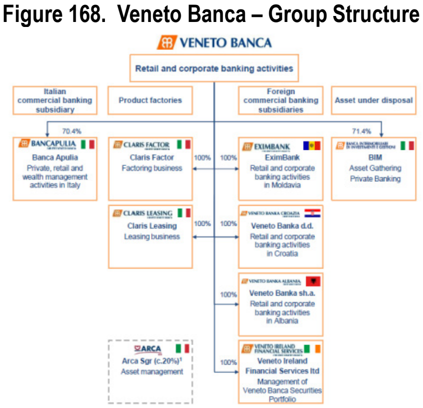
On December 19th, 2015, the Veneto Banca EGM has approved the transformation into a joint stock company with effect from January 2016.

Figure 167. Italian Banks – Market Share



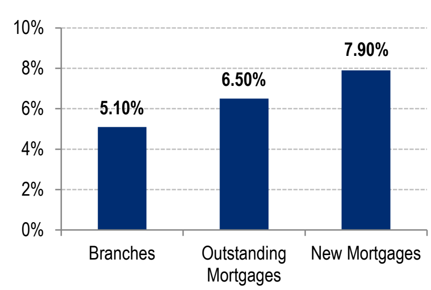
Source: Company data as of August 2015.

Figure 168. Veneto Banca – Group Structure



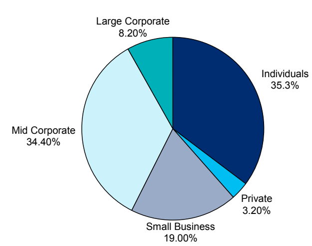
Source: Company data

Figure 169. VB – Veneto Market Share, June 2015



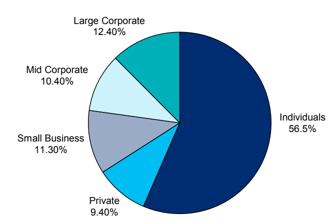
Source: Company data

Figure 170. VB – Loan Mix, 2015



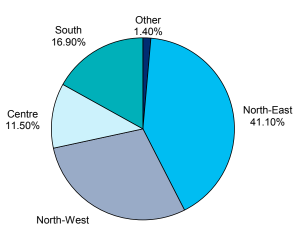
Source: Company data

Figure 171. VB – Direct Funding Mix, 2015



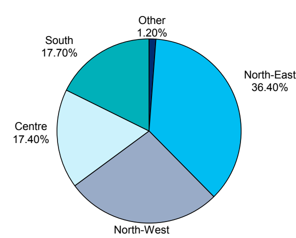
Source: Company data

Figure 172. VB – Loans by Geo



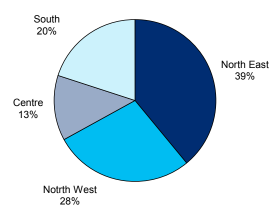
Source: Company data as of Sept 2015.

Figure 173. VB – Direct Funding by Geo



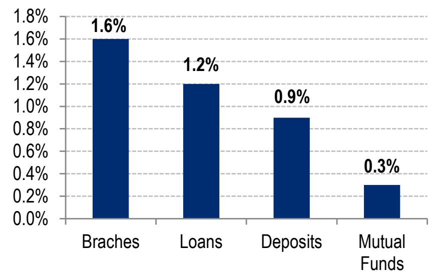
Source: Company data as of Sept 2015.

Figure 174. VB – Branches by Geo



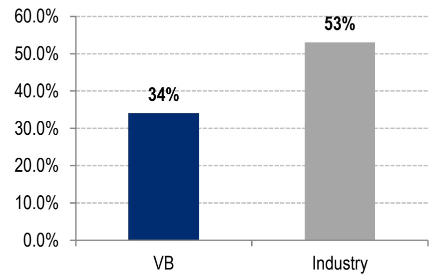
Source: Company data as of Dec 2015.

Figure 175. VB - Italy market Share



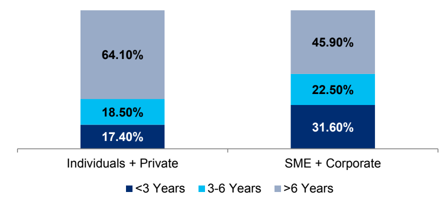
Source: Company data as of June 2015.

Figure 176. VB and Italy –AUM Penetration (%)



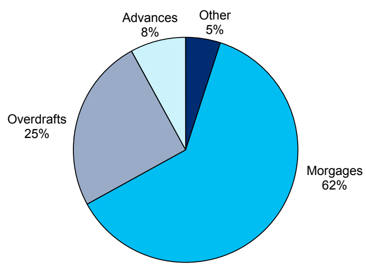
Source: Company data as of Sept 2015.

Figure 177. VB – Customer Loyalty



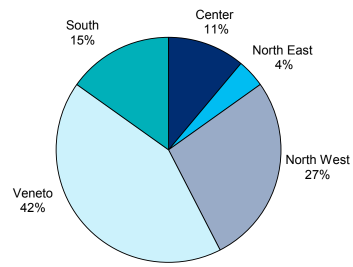
Source: Company data as of Sept 2015

Figure 178. VB+BAP – Loans by Product



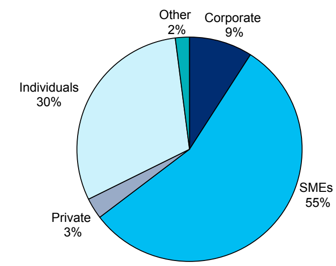
Source: Company data as of Sept 2015

Figure 179. VB+BAP – Loans by Geo



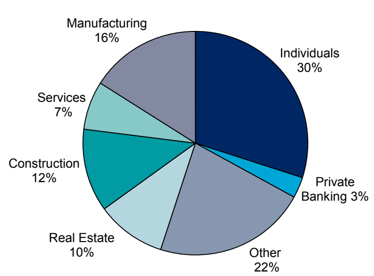
Source: Company data as of Sept 2015

Figure 180. VB+BAP – Loans by Client



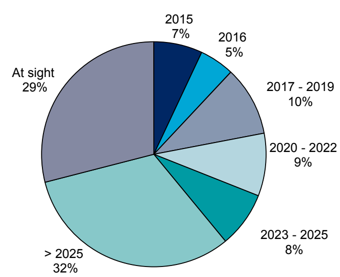
Source: Company data as of Sept 2015

Figure 181. VB+BAP – Loans by Industry



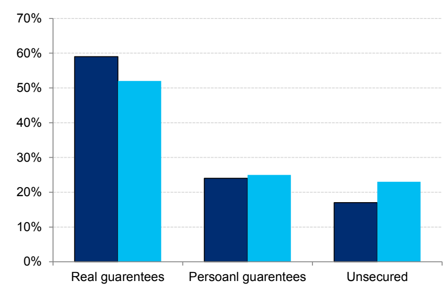
Source: Company data as of Sept 2015

Figure 182. VB+BAP – Loans by Maturity



Source: Company data as of Sept 2015

Figure 183. VB+BAP – Guarantees



Source: Company data as of Sept 2015

Management Biographies

Mr Cristiano Carrus - General Manager

Mr Carrus has 38 years of experience in the banking sector and joined Veneto Banca in October 2014, and he has been the CEO from October 2015 to May 2016. Previously he covered several senior roles within Banco Popolare group.

Mr Michele Barbisan – Chief Commercial officer and Deputy General Manager

Mr Barbisan has 30 years of experience in the banking sector and joined Veneto Banca in 1996. Previously he covered several roles within Veneto Banca and has worked in Credito Italiano.

Mr Stefano Fasolo – Chief Financial Officer

Mr Fasolo has 25 years of experience in the banking sector and joined Veneto Banca in March 2015. Previously he was the Governing and Planning Division Manager at Banca Caim ad was the Strategy and Value Creation Department Manager at Antonveneta-ABN AMRO.

Mr Gerardo Rescigno – Chief Risk Officer

Mr Rescino has 25 years of experience in the banking sector and joined Veneto Banca in January 2014. Previously he was the Value, Planning and Control Manager at MPS and also a Risk Manager at Banca IMI.

Governance

The new bank board has been appointed last 5th May, with 7,193 participating in the AGM. It includes 14 members: 10 independent, 1 executive and 3 non–independent. The Chairman is Mr Stefano Ambrosini. The board's term will expire in April 2018.

The main governance principles are:

- Protection of company's assets
- Care for the ecosystem of shareholders, clients and businesses
- Efficiency and effectiveness of the business processes
- Transparency of financial information
- Compliance with laws and regulations
- Compliance with company's by-law and internal procedure

Veneto Banca has taken prompt and decisive actions to address the requirement from the new supervisory system.

Management has both a fixed and variable component in compensation, but so far the variable compensation has never been applied due to company performance.

Figure 184. Veneto Banca – Key Governance Framework

Key areas of intervention	Objectives	Actions undertaken	Resources employed
Corporate Governance	Enhance the Governance and the transmission mechanisms of the Board's strategic guidelines to the entire Banking Group	Board Committees communication mechanisms Processes review compared to qualitative standards (Format, Timing, etc.)	Staff: **15 in-company** **10 advisors** Duration of the project: c. **5 months** **Involvement of one of the Big 4 firms**
Internal Control System	Enhance the capacity of the Internal Control Functions to identify and manage the business risks	Shared risks and processes terminology Shared methodologies and risk assessment metrics Planning and integrated reporting Coordination Committee of the Control Functions	Staff: **25 in-company** **15 advisors** Financial investments: **Euro 785,000** Duration of the project: c. **9 months** **Involvement of one of the Big 4 firms**

Source: Company data

Normalised Earnings

Figure 185. Stated Vs Normalized Profitability, 2015

	2015 Stated	Diff	2015 Normalised
Net interest income	505	0	505
Net Fees	273	0	273
Dividends	5	0	5
Net trading income	179	-73	106
Other net operating income	-15	0	-15
Total revenues	**947**	**-73**	**874**
Personal expenses	-341	-1	-342
Other administrative expenses	-275	52	-223
D&A	-70	26	-44
Operating costs	**-685**	**76**	**-609**
Operating profit	**261**	**3**	**264**
Loan loss provisions	-754	13	-741
Net write-downs on other assets	-7	0	-7
Provisions for risks and changes	-88	40	-48
Impairment on goodwill	-418	418	0
Net income from investments	8	-8	0
Profit (loss) before tax	**-997**	**474**	**-523**
Income tax for the period	191	-18	173
Profit (Loss) on assets held for sale, after tax	-101	87	-14
Minorities	-25	0	-25
Net profit (loss)	**-882**	**544**	**-338**

Source: Company data and Citi Research

Figure 186. Stated Vs Normalized Profitability, 2014

	2014 Stated	Diff	2014 Normalised
Net interest income	513	0	513
Net Fees	288	0	288
Dividends	7	0	7
Net trading income	57	14	71
Other net operating income	-10	0	-10
Total revenues	**855**	**14**	**869**
Personal expenses	-367	18	-349
Other administrative expenses	-205	0	-205
D&A	-45	0	-45
Operating costs	**-617**	**19**	**-598**
Operating profit	**238**	**33**	**271**
Loan loss provisions	-717	29	-688
Net write-downs on other assets	-14	0	-14
Provisions for risks and changes	-37	28	-9
Impairment on goodwill	-671	671	0
Net income from investments	-1	1	0
Profit (loss) before tax	**-1202**	**762**	**-440**
Income tax for the period	226	-13	213
Profit (Loss) on assets held for sale	-9	0	-9
Minorities	-16	0	-16
Net profit (loss)	**-968**	**748**	**-220**

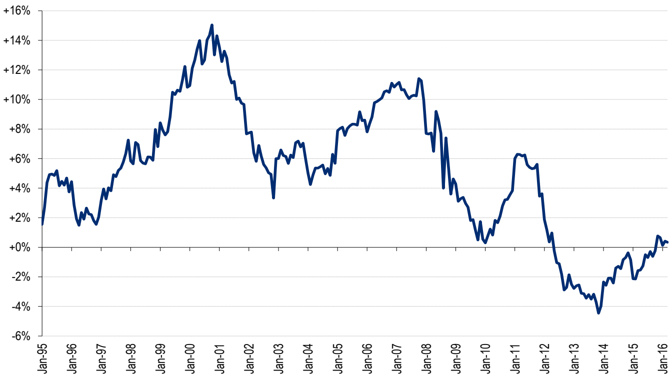
Source: Company data and Citi Research

Italian Banking Market

Loan Growth

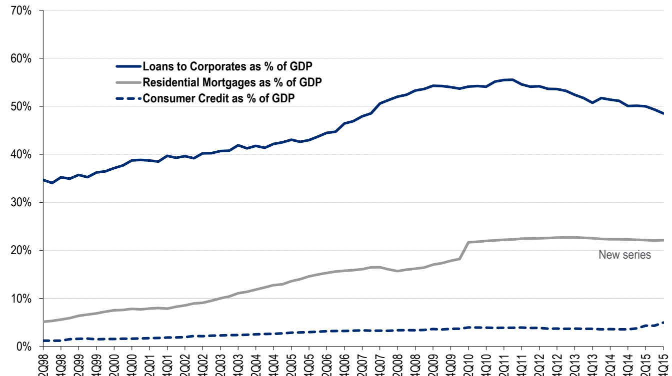
- Growth of loans to families and non-financial corporations is flattish YoY at c+0.3% YoY, below the level of December (c+1%).
- Retail lending growth continues (+4.0% YoY in February), while corporates' deleveraging is ongoing (-1.8% YoY).
- New mortgage origination continues to remain strong, while new corporate loans are starting to show signs of recovery. ECB lending survey shows easing of lending conditions and expected improvement in demand.

Figure 187. Italy — Loan Growth YoY*



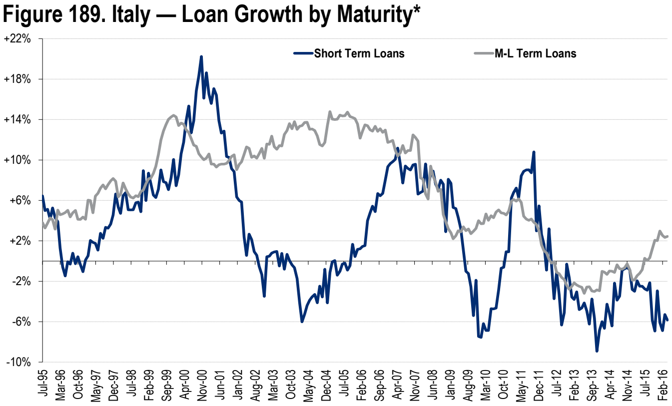
Source: Banca d'Italia and ABI. *Loans to households and NFCs

Figure 188. Italy — Loans as a Percentage of GDP



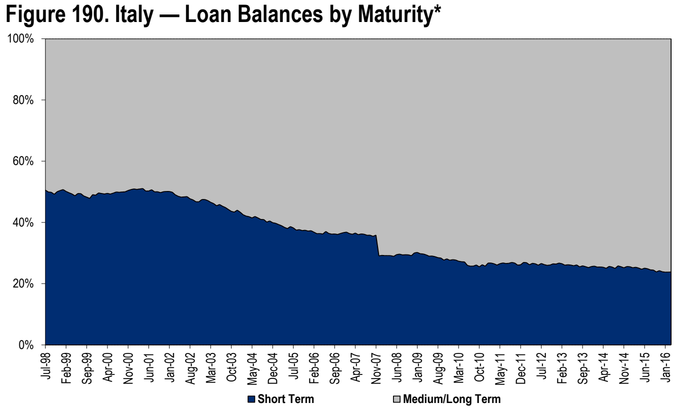
Source: Banca d'Italia, ABI, ISTAT and Datastream.

Figure 189. Italy — Loan Growth by Maturity*



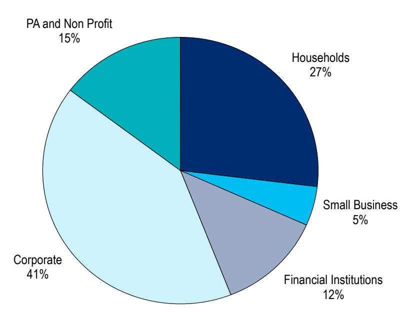
Source: ABI. *Loans to households and NFCs

Figure 190. Italy — Loan Balances by Maturity*



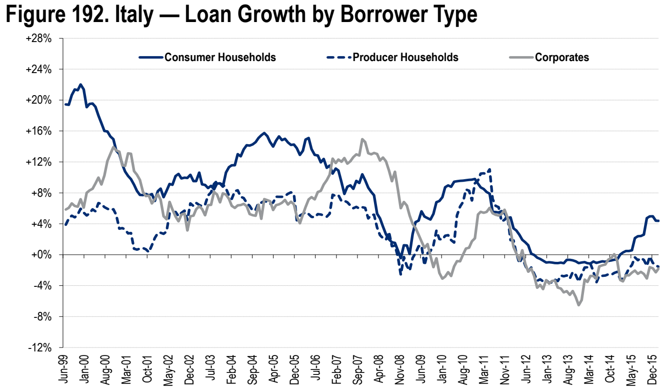
Source: ABI. *Loans to households and NFCs

Figure 191. Italy — Loan Balances by Borrower Type, Feb 2016



Source: Banca d'Italia

Figure 192. Italy — Loan Growth by Borrower Type



Source: Banca d'Italia

Figure 193. Italy — Retail Loan Growth by Type

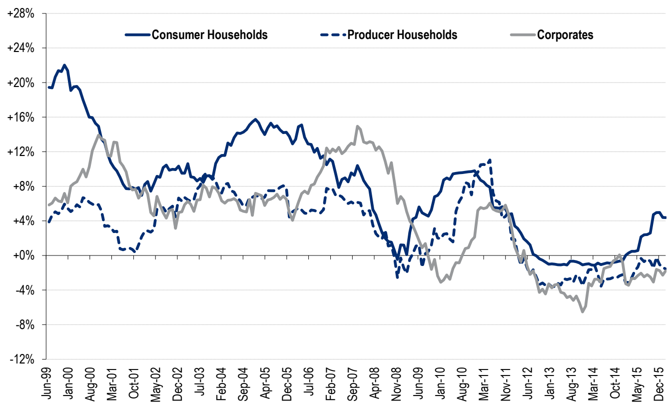


Figure 194. Italy — Retail Loan Balances by Type

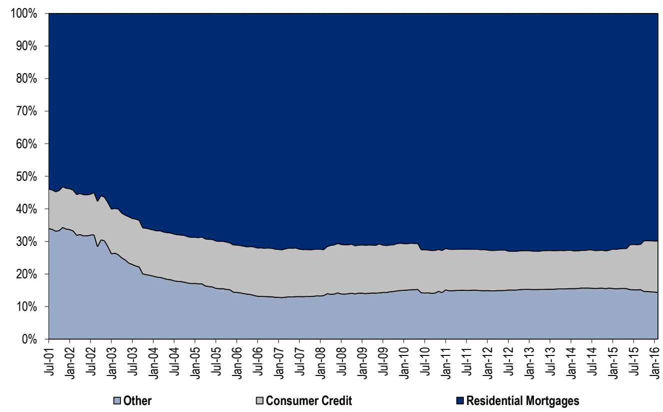


Figure 195. Italy — Corporate Loan Growth by Type

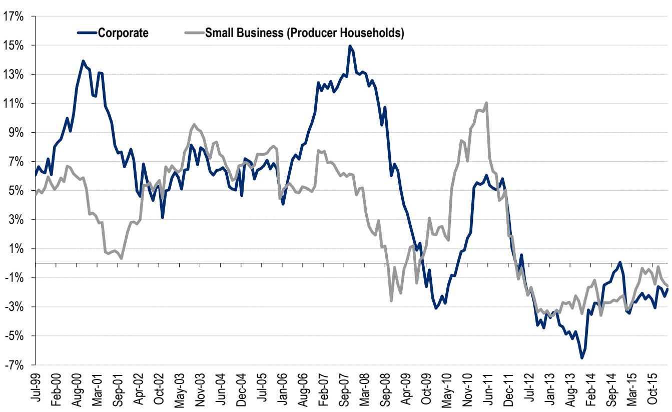


Figure 196. Italy — Corporate Loan Balances by Type (€m)

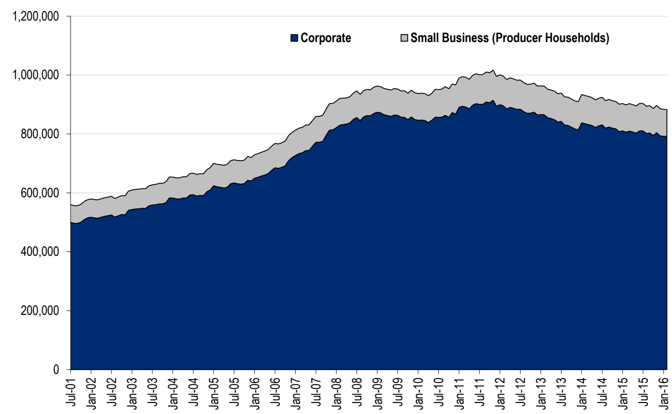


Figure 197. Italy — Corporate Loan Growth by Maturity

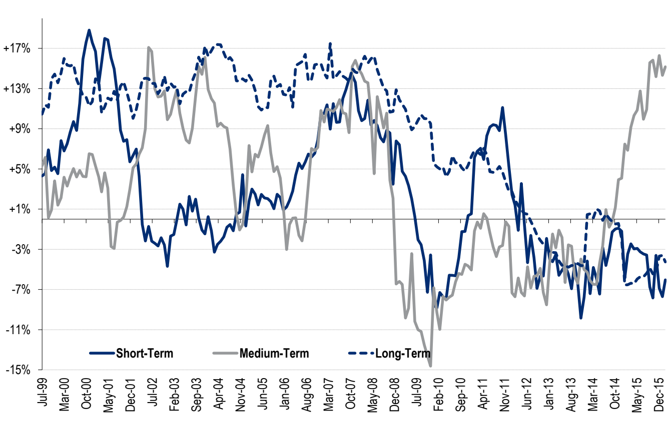
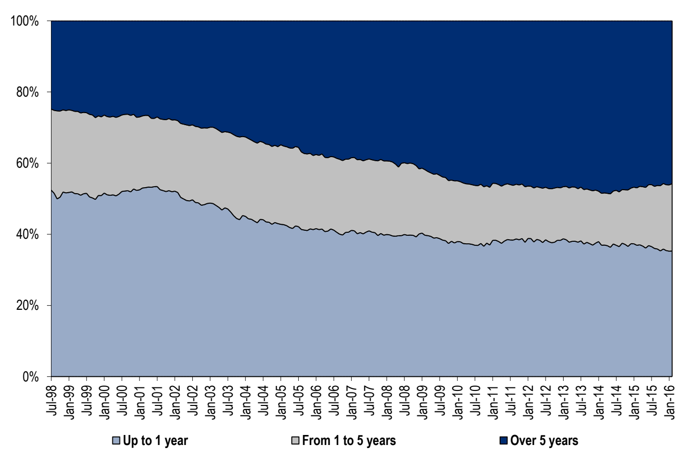
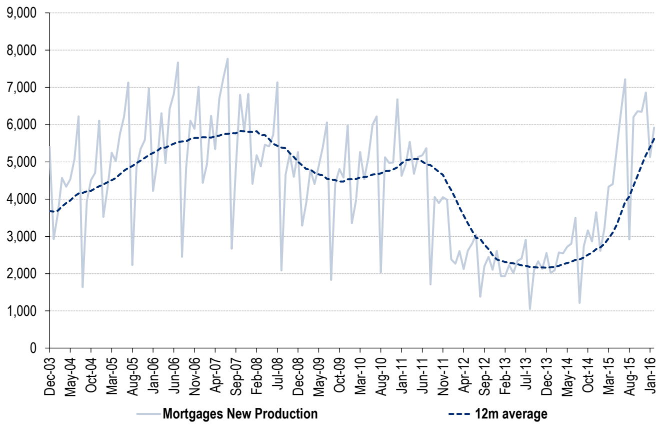


Figure 198. Italy — Corporate Loan Balances by Maturity



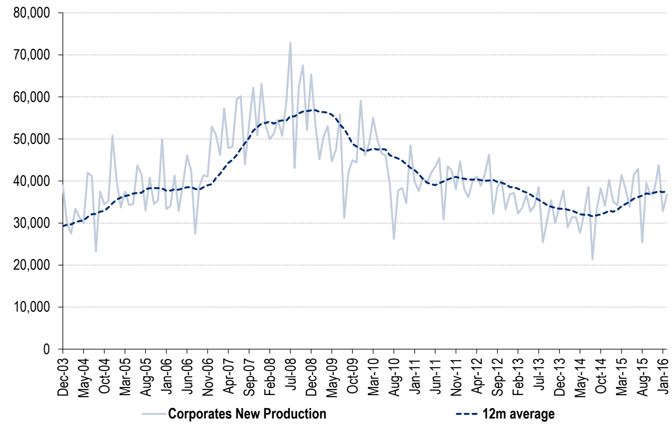
Source (For All Charts): Banca d'Italia

Figure 199. Italy – Mortgages New Production (€m)



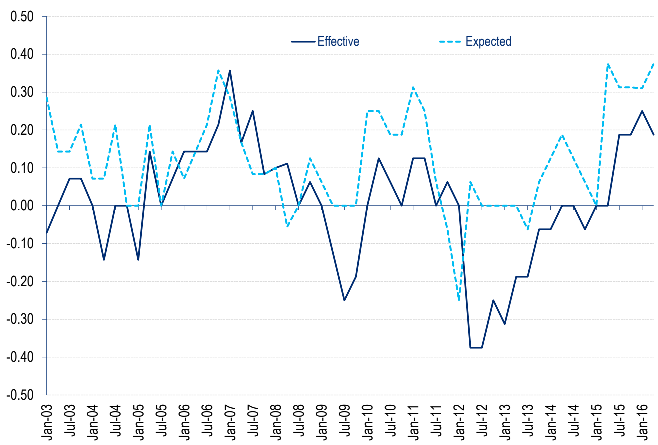
Source: Banca d'Italia and Citi Research

Figure 200. Italy – Corporate Lending New Production (€m)



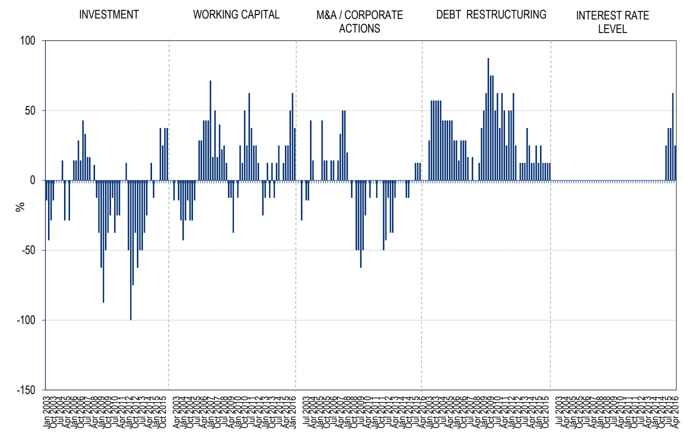
Source: Banca d'Italia and Citi Research

Figure 201. Italy BLS – Change in Corporate Lending Demand



Source: ECB and Banca d'Italia. BLS: Bank Lending Survey

Figure 202. Italy BLS – Credit Demand Drivers



Source: ECB and Banca d'Italia. BLS: Bank Lending Survey

Deposit Growth

- Total deposits showed an increase in the contraction pace (-1.7% YoY in February, vs -0.6% YoY contraction in December), with the well-established diverging trends of customer deposits and bonds continuing.
- Customer deposits were up 3.0% YoY (vs +c4% in December), driven by rising current accounts and Repo, while term deposits are decreasing. The bond component decrease continues (-15% YoY).

Figure 203. Italy — Domestic Deposit Growth YoY

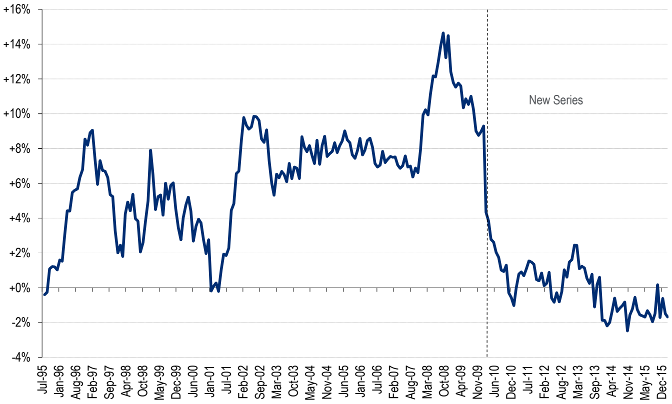


Figure 204. Italy — Loan-to-Deposit Ratio

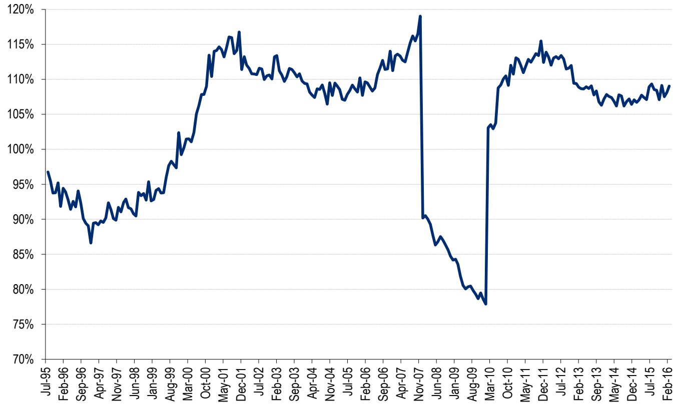


Figure 205. Italy — Customer Deposit Growth by Type

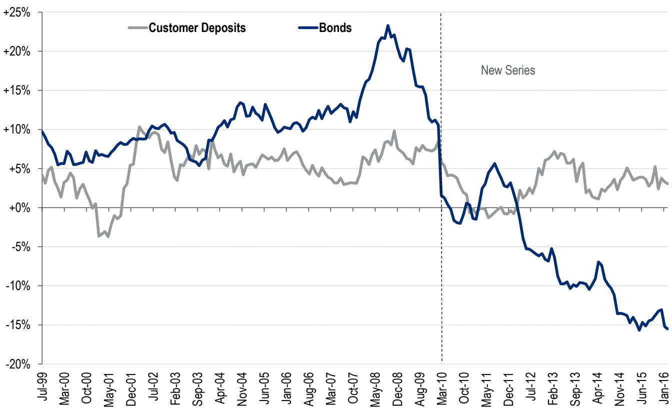


Figure 206. Italy — Deposit Balances by Type, Feb 2016

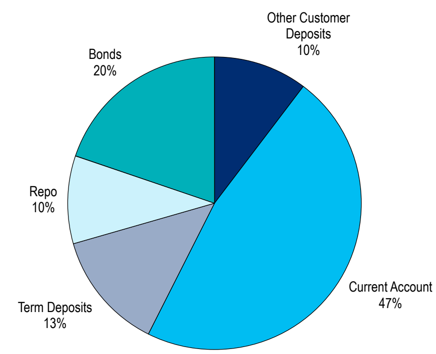


Figure 207. Italy — Current Account Growth

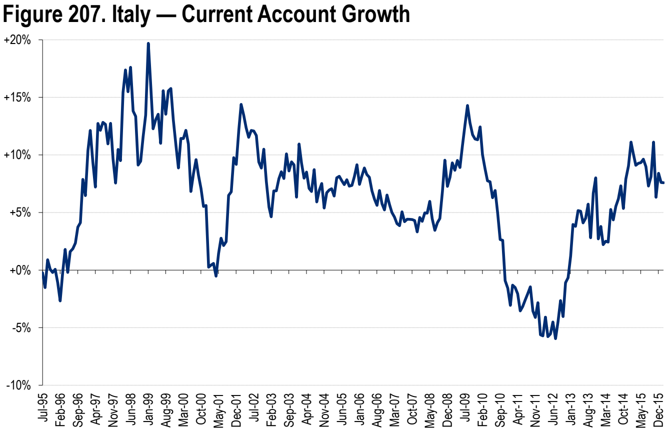
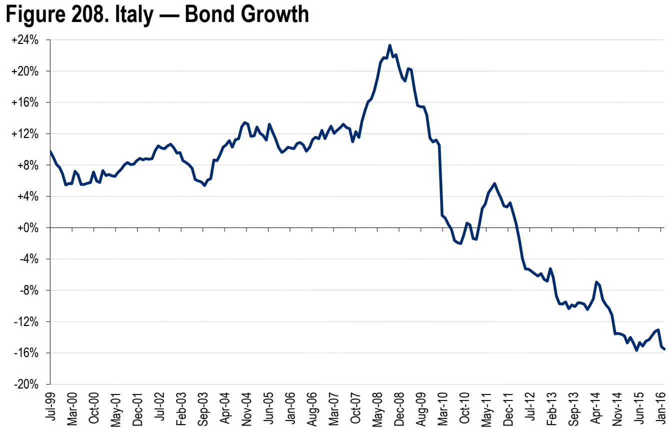


Figure 208. Italy — Bond Growth

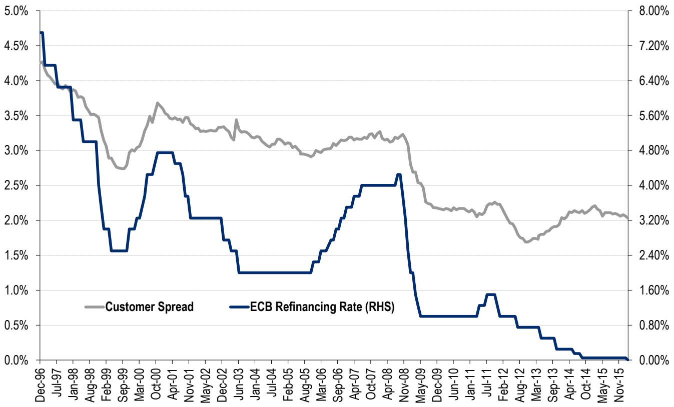


Source (For All Charts): Banca d'Italia and ABI

Margins

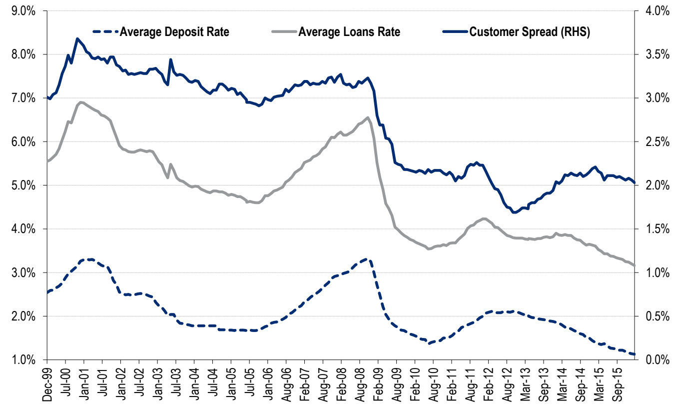
- Customer spread was down 3bp QoQ in March, as the decrease in cost of funding (-6bp QoQ) was not enough to offset the lower asset yield (-9bp QoQ). Customer spread decreased by 3bp QoQ in 1Q 2016.
- Asset yields continue to compress due to competitive pressures and the lower interest rate environment. The decrease is more pronounced in the corporate segment (-c70bp YoY on new production).

Figure 209. Italy — Customer Spreads and ECB Rates



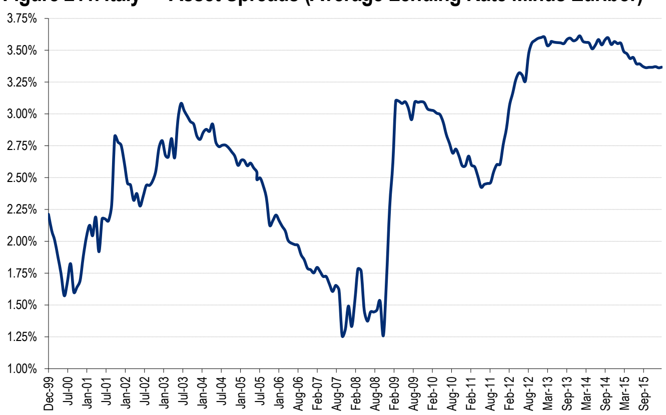
Source: Banca d'Italia and ABI

Figure 210. Italy — Customer Spreads



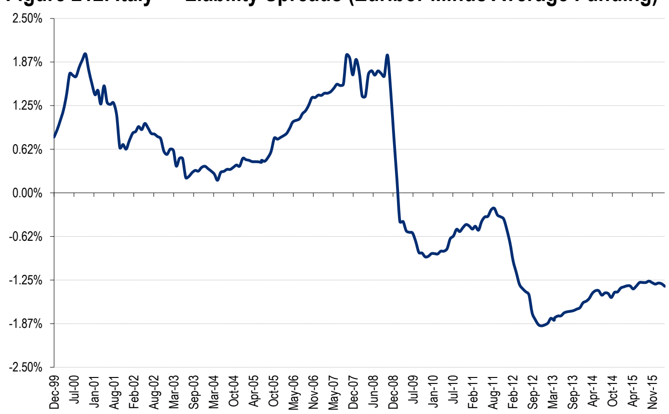
Source: Banca d'Italia and ABI

Figure 211. Italy — Asset Spreads (Average Lending Rate Minus Euribor)



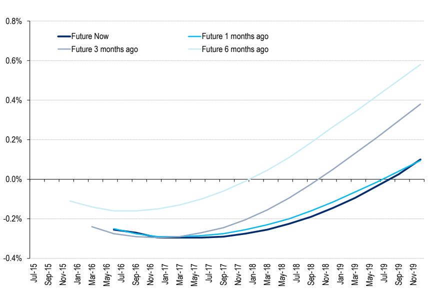
Source: Banca d'Italia, ABI and Datastream

Figure 212. Italy — Liability Spreads (Euribor Minus Average Funding)



Source: Banca d'Italia, ABI and Datastream

Figure 213. Euribor Implied by Futures



Source: Bloomberg

Figure 214. Italy – Loan and Deposit Rate, New Production

	Corporate Lending	Retail Mortgages	Consumer Credit	Term Deposits	Term Deposits Family	Term Deposits Corporate
Dec-14	2.57%	2.83%	6.86%	1.01%	1.20%	0.76%
Mar-15	2.27%	2.68%	7.10%	1.05%	1.24%	0.63%
Jun-15	2.13%	2.77%	6.96%	1.04%	1.24%	0.72%
Sep-15	1.82%	2.67%	7.02%	1.09%	1.08%	1.13%
Dec-15	1.74%	2.50%	6.44%	1.01%	1.22%	0.60%
Jan-16	2.03%	2.49%	6.92%	0.97%	1.14%	0.54%
Feb-16	1.70%	2.41%	6.95%	1.14%	1.12%	1.24%
YoY	-0.71%	-0.34%	-0.30%	-0.07%	-0.23%	0.42%

Source: Banca d'Italia

Figure 215. Italy — Average Lending Rate to Corporate and Households

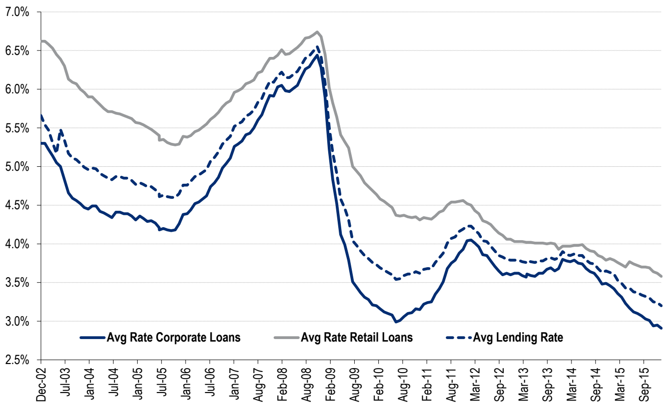


Figure 216. Italy — Average Cost of Funding

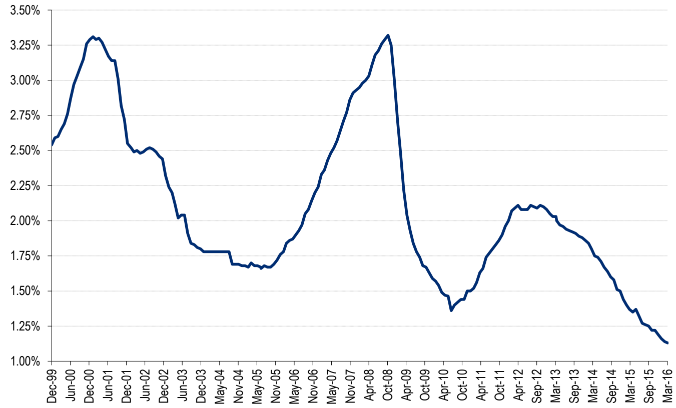


Figure 217. Italy — Average Lending Rate to Corporates

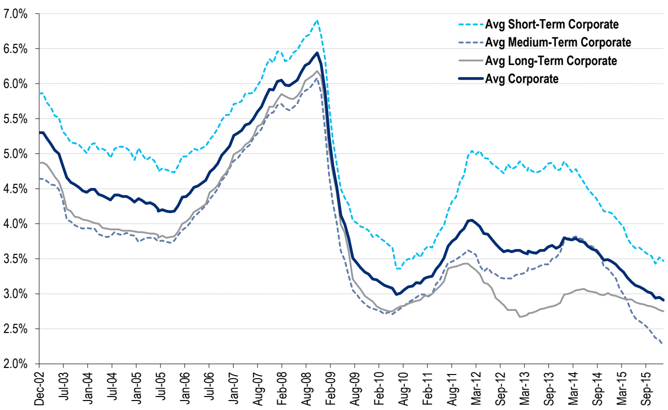


Figure 218. Italy — Average Lending Rate on Mortgages and Consumer Credit

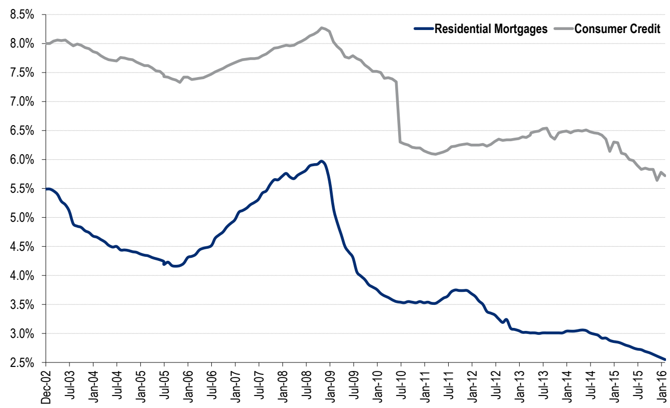


Figure 219. Italy — Average Rate on Current Accounts

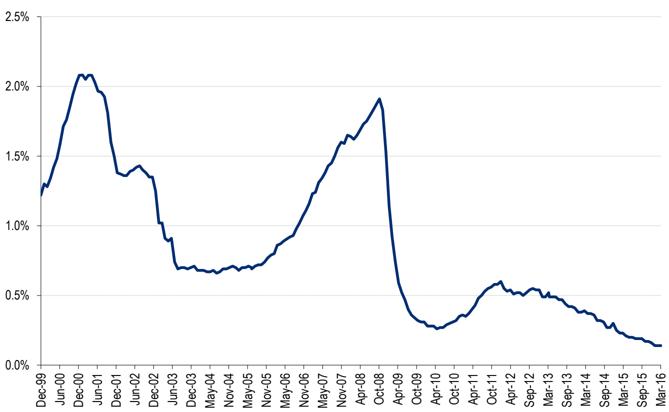
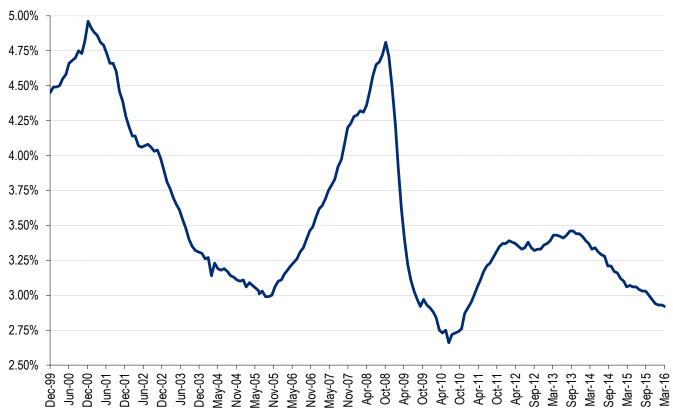


Figure 220. Italy — Average Rate on Bonds Stock



Source (For All Charts): Banca d'Italia and ABI

Non-Performing Loans

- Asset quality trends show positive momentum as the pace of deterioration continue to decrease. Sofferenze growth is now the lowest since the crisis (+5% YoY in Feb).

Figure 221. Italy — Non Performing Loans* (€m)

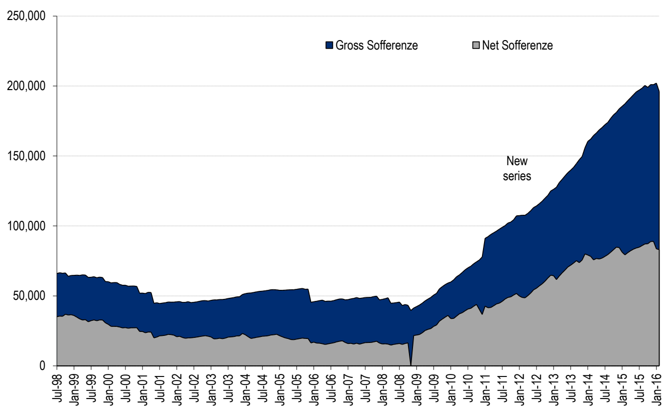


Figure 222. Italy — NPLs* Coverage

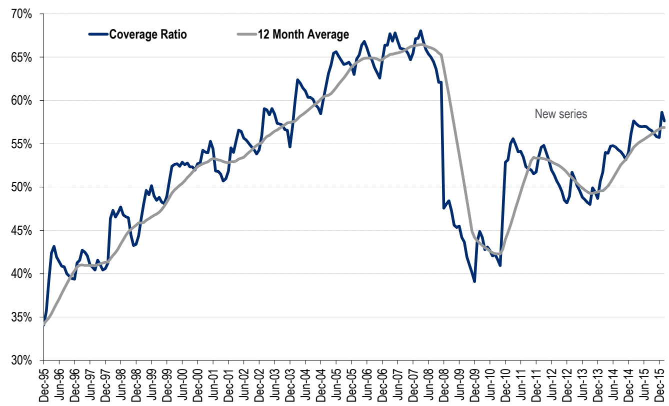


Figure 223. Italy — Net and Gross NPLs* Ratios

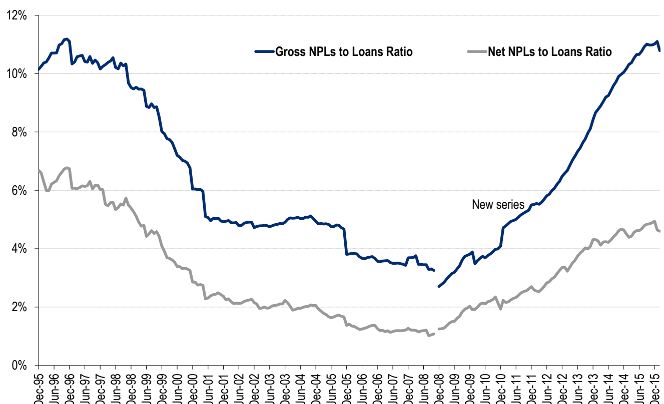


Figure 224. Italy — Net NPLs* as % of Equity

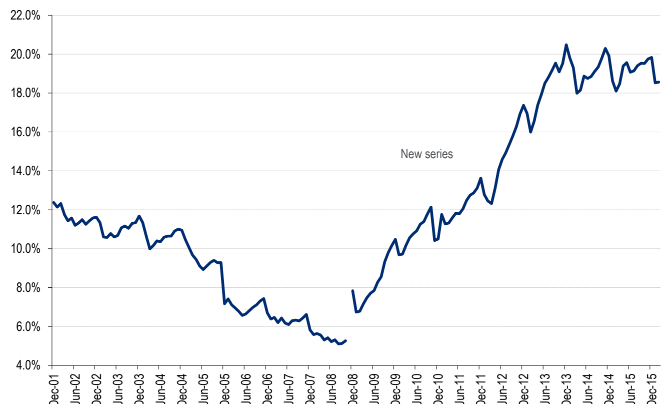


Figure 225. Italy — NPLs* Ratio by Sector

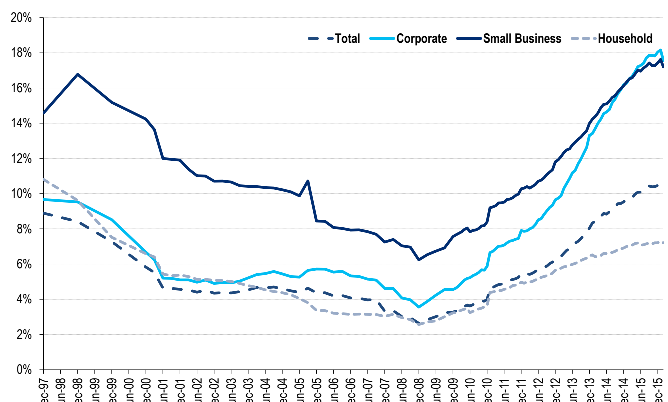
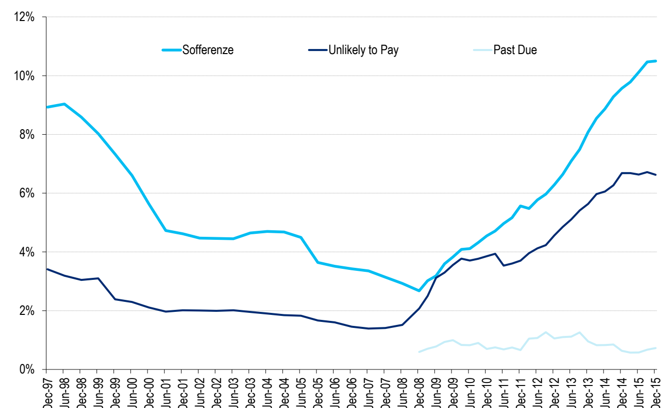


Figure 226. Italy — Total Non-Performing Loans Ratio by Category

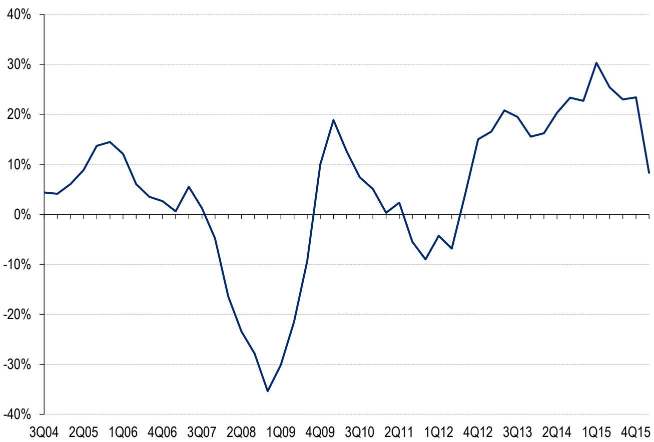


Source (For All Charts): Banca d'Italia and ABI. * Sofferenze

Mutual Funds

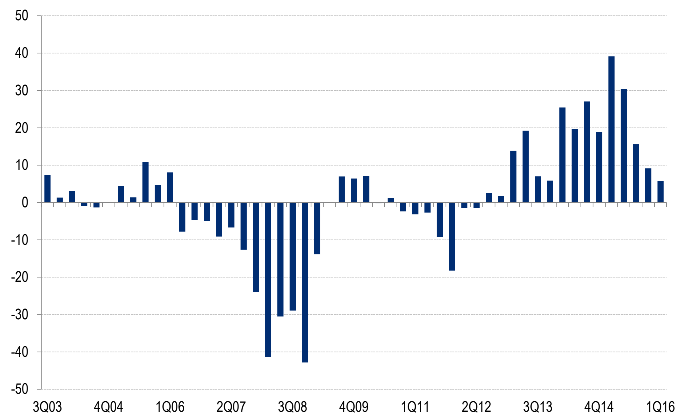
- Mutual fund stock showed a decrease of c2% in first few months of 2016, mostly due to weak performance effect (given market condition) and net inflows have slowed down.

Figure 227. Italy – Mutual Funds Stock YoY Growth



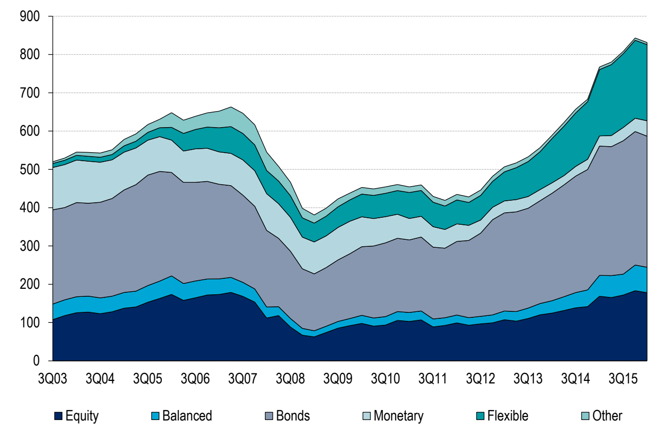
Source: Assogestioni and Citi Research

Figure 228. Italy – Mutual Funds Net Flows (€bn)



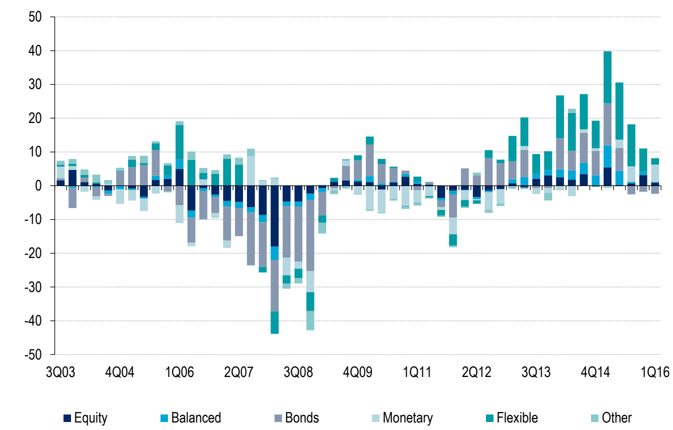
Source: Assogestioni and Citi Research

Figure 229. Italy – Mutual Funds Stock Split (€bn)



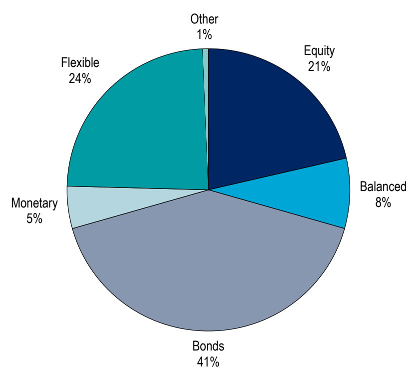
Source: Assogestioni and Citi Research

Figure 230. Italy – Mutual Funds Net Flows Split (€bn)



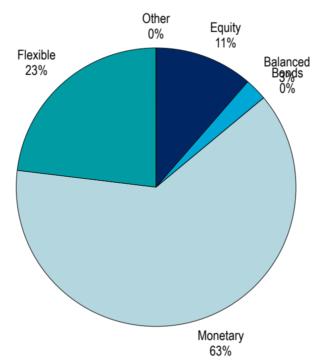
Source: Assogestioni and Citi Research

Figure 231. Italy – Mutual Funds Stock Split, Feb 2016



Source: Assogestioni and Citi Research

Figure 232. Italy – Mutual Funds Net Flows Split, YTD



Source: Assogestioni and Citi Research

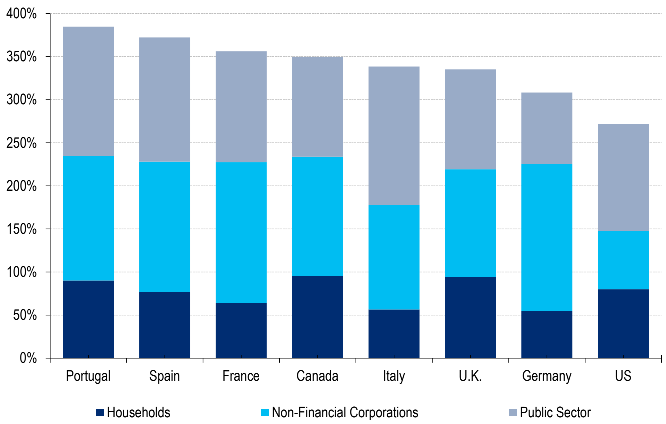
Italy – Wealth Overview

Italy – A Rich Private Sector

Italy has always been considered a highly indebted country – while this is obviously true from a government point of view, the corporate sector and even more so the household sectors have very low leverage when compared with peers. Moreover it is sometimes forgotten that Italian households are on average wealthy, even by international standards, despite the recent crisis and significant drop in GDP (c-10% cumulative since 2009).

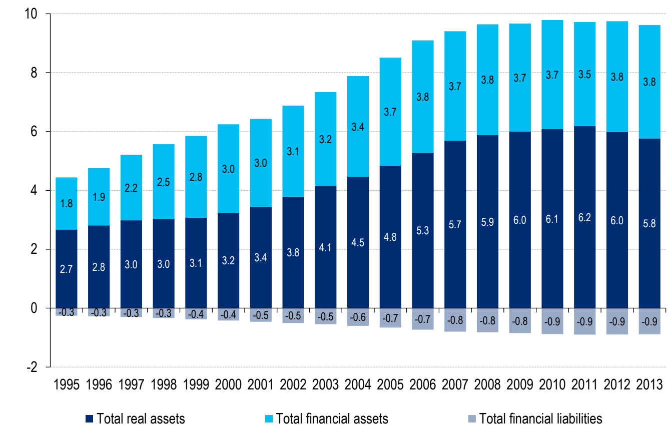
Italian households have c€8.7trn of net wealth, of which real assets account for €5.8trn, financial assets for €3.8trn and less than €0.9trn are financial liabilities. To give a proportion, this compares with €2.2trn of public debt (c132% of GDP).

Figure 233. Gross Debt / GDP by Sector



Source: National Central Banks, Citi Research. As of Dec 2014, Italy as of Sep 2014.

Figure 234. Italy – Household Wealth, €trn



Source: Bank of Italy and Citi Research

This wealth was accumulated thanks to decades of sustained savings. However since the 1990s the saving rate has been declining and is now at the lower end when compared with peers. Several reasons have been put forward in the economic literature to explain this phenomenon[2]. Among these some suggest that Italian households tried to smooth their living standards by tapering the saving ratio in the face of a severe contraction of their purchasing power, partly also due to the restrictive fiscal measures enacted in the last 25 years following major crises (1992, 2011) and changes (entry in the Euro). Moreover the secular reduction in real yields might have tilted the inter-temporal choice between saving and consumption in favor of the latter. Finally, demographic changes could have also played a role: the Italian population is aging and in the later part of the life-cycle saving is reduced whilst consumption is increased.

[2] Among others: A. Bassanetti, C. Rondinelli, F. Scoccianti, "The Italian Saving Rate: Vanishing?" and L. Campiglio, "Why Italy's Saving Rate Became (So) Low?"

Figure 235. Household Net Saving Rates

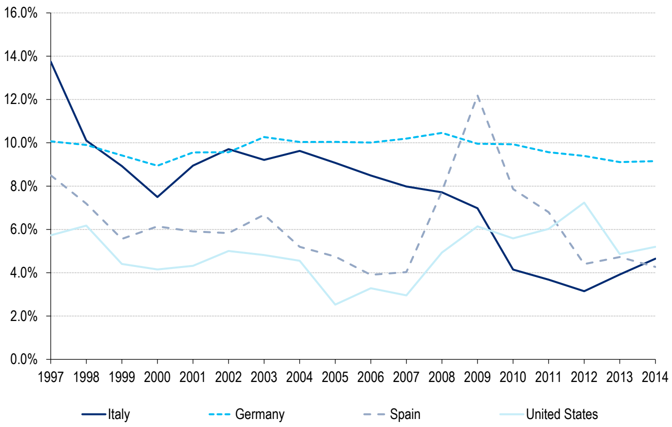
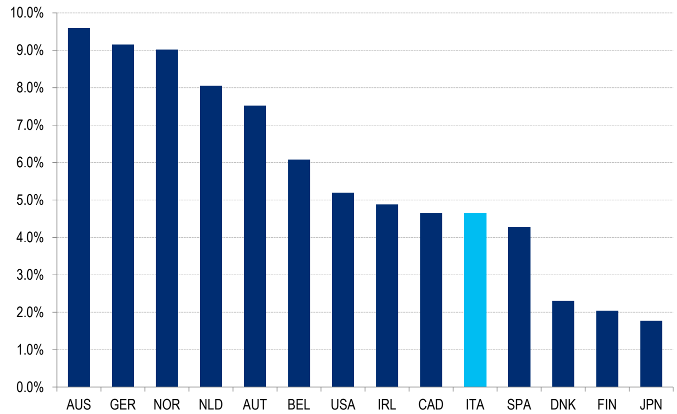


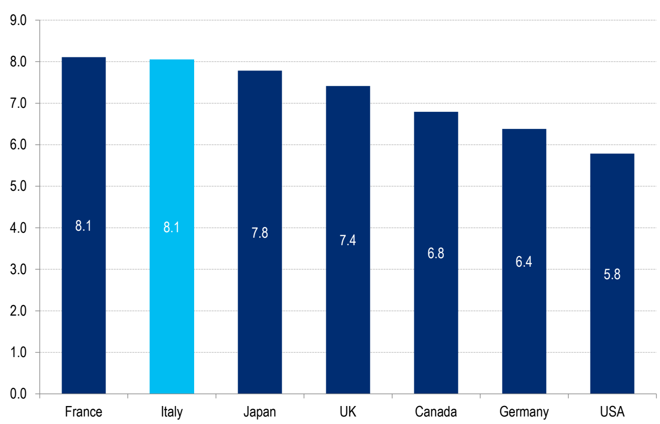
Figure 236. Household Net Saving Rates, 2014



Source (for both): OECD, Citi Research. Note: expressed as a % of disposable household income. France and UK not included as only gross saving rates, which are without deducting consumption of fixed capital from both saving and disposable income, are available.

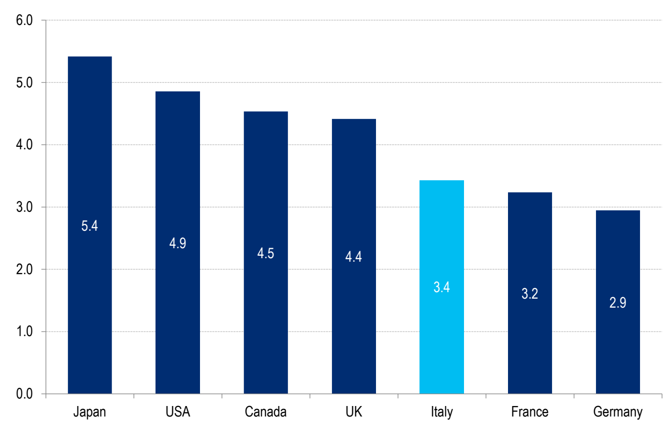
Despite this lower propensity to save than in the past and the strong GDP contraction, the stock of wealth has remained fairly stable over the last 7 years and when looking at the net wealth over disposable income, Italy screens particularly well. On the other hand, when only considering financial assets the comparison is less benign, given that the largest part of wealth for Italian households lies in real assets and overwhelmingly in their dwellings.

Figure 237. Households – Total Net Wealth / Disposable Income



Source: Bank of Italy and Citi Research. As of 2012.

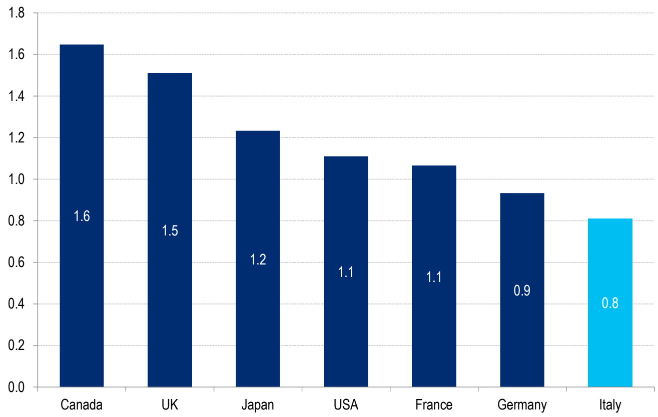
Figure 238. Households – Financial Assets / Disposable Income



Source: Bank of Italy and Citi Research. As of 2012.

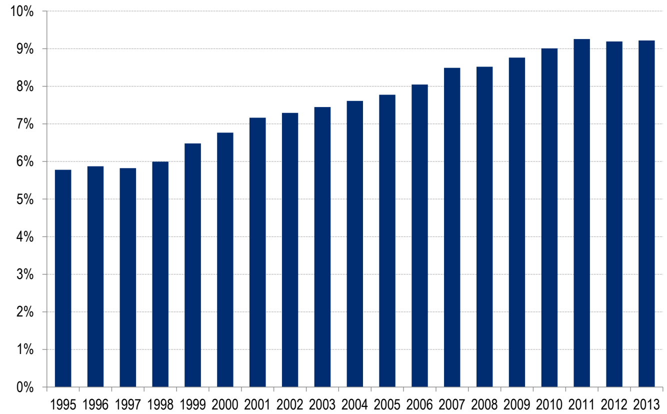
As mentioned previously, Italian households are among the least indebted among developed countries under several metrics (multiple of GDP, disposable income etc.) and financial liabilities only represent c9% of assets despite liabilities having risen over the last 20 years, potentially due to lower real rates and a relatively well-performing housing market.

Figure 239. Liabilities / Disposable Income



Source: Bank of Italy and Citi Research. As of 2012.

Figure 240. Italy – Households Leverage (Liabilities / Assets)



Source: Bank of Italy and Citi Research

What Italian Households Wealth Is Made Of

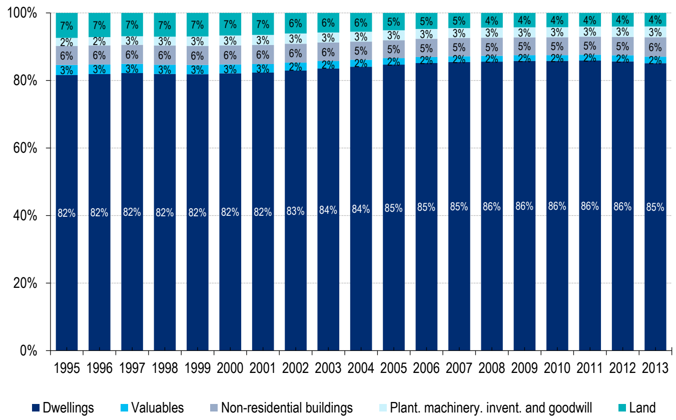
Real assets constitute c60% of the total for Italian households with residential real estate property taking up 85% of that. This is due to the fact that home ownership is widespread in Italy but also that real estate has historically been considered a safe haven investment for many Italian savers.

The composition of financial wealth is more varied now and shows some interesting changes over the last two decades. However in general the risk profile of Italian households has remained relatively low with a large portion invested in liquidity and domestic bonds. This conservative positioning has helped to preserve the stock of wealth across the years.

In 2013 the largest part of the financial assets was kept in liquidity (cash and deposits, 30%), followed by insurance (in a loose sense, including pension) products (19%) and equity holdings (18%)[3]. Investment funds and bank bonds account for 8% each while Italian government bonds are only 5% of households' financial assets.

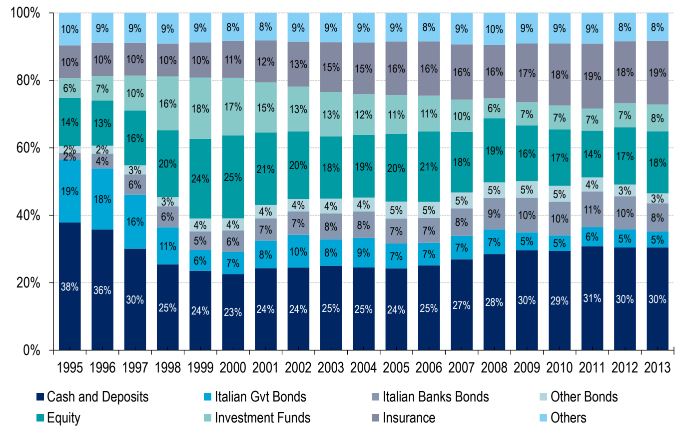
[3] Including both listed (2%) and non-listed (16%) equity holdings both in Italy and abroad.

Figure 241. Italy – Household Real Assets Split



Source: Bank of Italy and Citi Research

Figure 242. Italy – Household Financial Assets Split



Source: Bank of Italy and Citi Research. Note: Insurance includes pension funds.

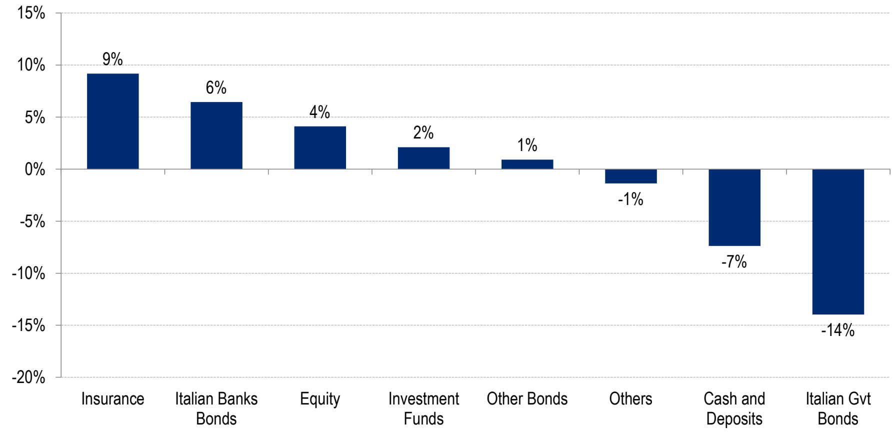
The current low share of government bond holdings could be surprising to some, in fact historically this was one of the most important components of households' portfolios, accounting for 19% in 1995. What could have been the main drivers of this radical change? Most of the shift happened in the years preceding the introduction of the Euro, with the consequent reduction of Italian inflation and nominal interest rates. At the same time there was a large expansion of shares held in investment funds and, to a lesser extent, listed equity and a decrease in the cash component. Italian households were most likely trying to keep the yield on their wealth constant in the face of drastically changing macro conditions by taking on more risk.

After the tech equity bubble burst, Italian households lowered their risk profile reducing the share of funds and equity and increasing their exposure to insurance products and gradually to bank bonds. These trends continued in the following decade without any radical change following the global financial crisis and the European sovereign crisis.

In summary what really changed over the last two decades in terms of households financial assets allocation in Italy?

- Decrease in cash and deposits in favor of products with higher expected returns;
- Government bonds have been substituted with assets having a similarly perceived low risk, like insurance/pension products and banks bonds. Households tried to offset the secular reduction in government bond yields by (more or less implicitly) extending duration via insurance products or taking on banks' credit risk, although recently bank bonds are starting to be reduced;
- Investment funds are taking up just 2pp more in 2013 than in 1995, despite the long way that the asset management industry has come in terms of services, products and financial education of customers.

Figure 243. Italy – Household Financial Assets 1995-2013 Split Change

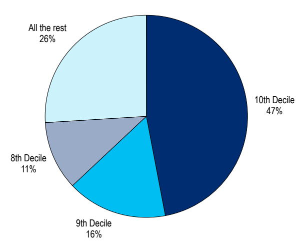


Source: Bank of Italy and Citi Research

Wealth Distribution

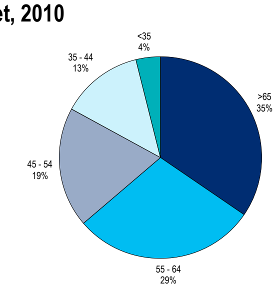
There are c23m households in Italy and wealth is quite concentrated. According to Bank of Italy, over 45% of financial wealth is in the hands of just 10% of households. Total addressable financial wealth[4] in Italy amounts to c€2.7trn. Wealth is concentrated in older age bracket and in the northern part of the country.

Figure 244. Italy – Financial Wealth by Households Decile, 2010



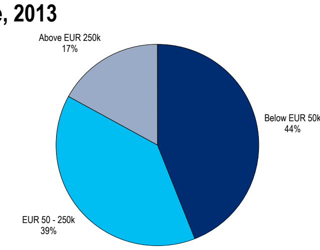
Source: Bank of Italy and Citi Research

Figure 245. Italy – Financial Wealth by Age Bracket, 2010



Source: Bank of Italy and Citi Research

Figure 246. Italy – Breakdown of Bank Deposits by Size, 2013



Source: Bank of Italy and Citi Research

From a geographical point of view, c33% of the GDP, loans and deposits are located in the north-west of Italy, one of the most economically active areas of the country (as shown by the higher GDP per capita). Indirect funding share is much higher (c45%) but it might be affected by some accounting issues (e.g. some entities booking the assets in the Milan headquarters irrespective of clients' locations). A similar effect may be also occurring in Lazio, Rome's region.

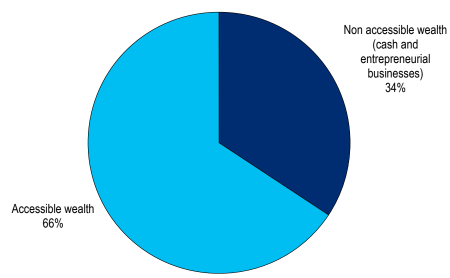
[4] Based on Assoreti Relazione Annuale 2013 (deposits+ bonds and securities+ mutual funds+ life insurance products+ pension funds)

Banks Control The Market

The traditional banking system has historically controlled the bulk of Italian households' financial wealth[5], with c70% market share in the allocation of the financial wealth of the country. The financial networks have c11% market share, after many years of good track-record.

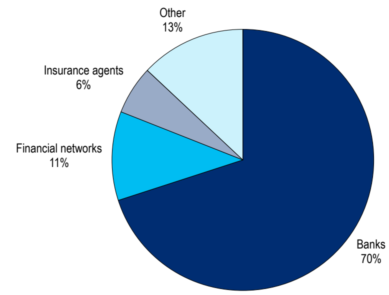
Distribution is a critical success factor in the Italian market, as the distribution channel controls the relation with the client and has great influence over investment choices, given also the lower average level of financial education of the customers.

Figure 247. Italy - Households Financial Wealth, 2013



Source: Citi Research on Mediolanum presentation

Figure 248. Italy - Accessible Financial Wealth, 2013



Source: Citi Research on Mediolanum presentation

The Main Products

Mutual funds, bancassurance and pensions as well as private banking are the main areas of income or future income for banks in the asset management/saving industry space. We have looked at the market trends, key players and potential opportunities in those segments.

Mutual Funds

The mutual funds industry was created in Italy at the end of the 90s, when interest rates of Italian Government Bonds decreased significantly due to the creation of the Euro area. It is a very cyclical industry (as seen in the risk section) and the dotcom bubble and the crisis in 2008 and onwards has resulted in large outflows and decrease in AUM. Given the low rate environment, abundant liquidity, and favorable market trends, mutual funds inflows are now coming back.

Mutual funds' AUM are mostly in bonds (c45% of total), equity are c20% and flexible funds represents c20% (showing the highest growth rate among the different categories). This asset allocation reflects Italian savers' risk aversion (lower equity, more bonds), but the trend we are witnessing shows a bit more willingness to increase the risk level (growth coming from increasing flexible fund and decreasing bond funds). Inflows into flexible funds represent the bulk of total inflows into mutual funds in the last 2 years, and equity funds are showing recovery vs 2010-2012, while monetary funds shows the main decrease.

[5] Based on Assoreti Relazione Annuale 2013 (deposits+ bonds and securities+ mutual funds+ life insurance products+ pension funds)

Figure 249. Italy – Mutual Funds Stock YoY Growth

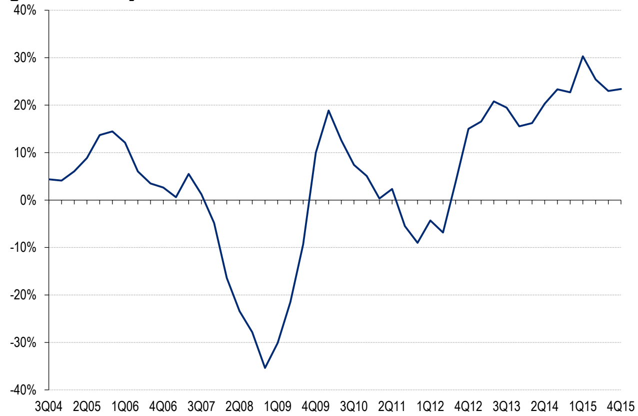


Figure 250. Italy – Mutual Funds Net Flows (€bn)

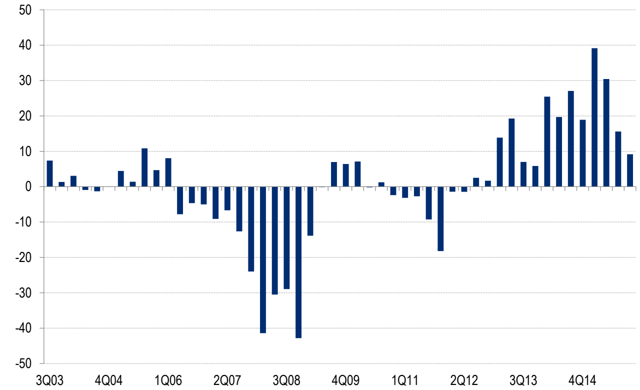
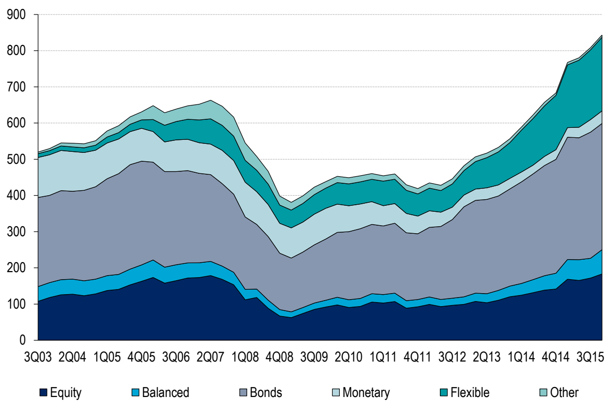
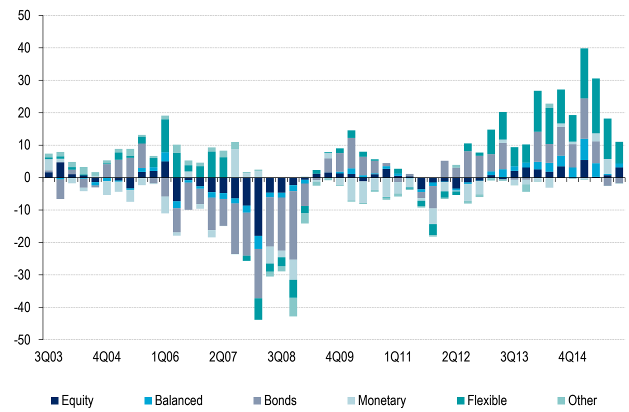


Figure 251. Italy – Mutual Funds Stock Split (€bn)



Source: Assogestioni and Citi Research

Figure 252. Italy – Mutual Funds Net Flows Split (€bn)

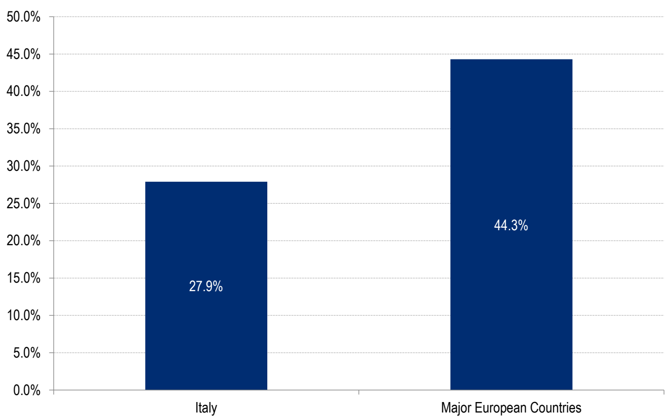


Source: Assogestioni and Citi Research

Insurance

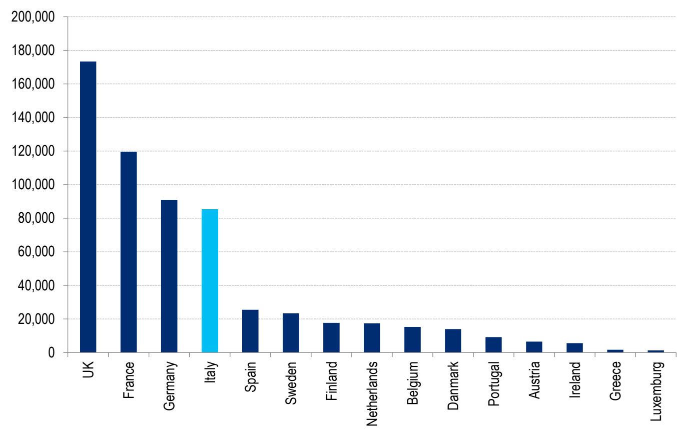
The Italian life insurance market has been expanding in recent years, with premium coming back to the levels of 2009-10. The level of technical reserve over GDP is among the highest in Europe, but below the level of France and UK.

Figure 253. Life Insurance – Technical Reserves / GDP



Source: Intesa 2014 Annual Report. Note: Major European countries include France, Germany, UK and Spain.

Figure 254. Italy – Life Insurance Premium by Country, €m, 2013



Source: Ania

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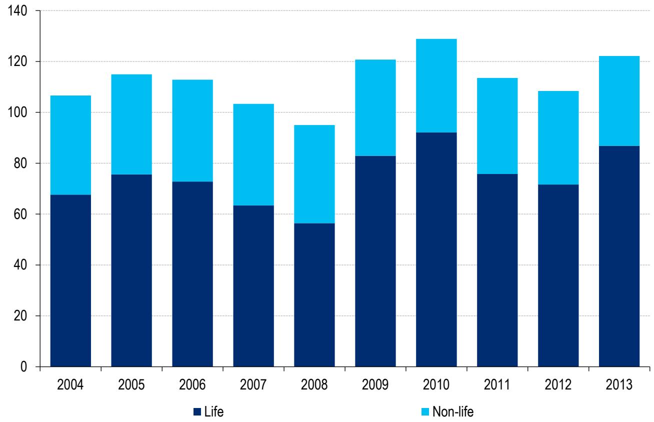
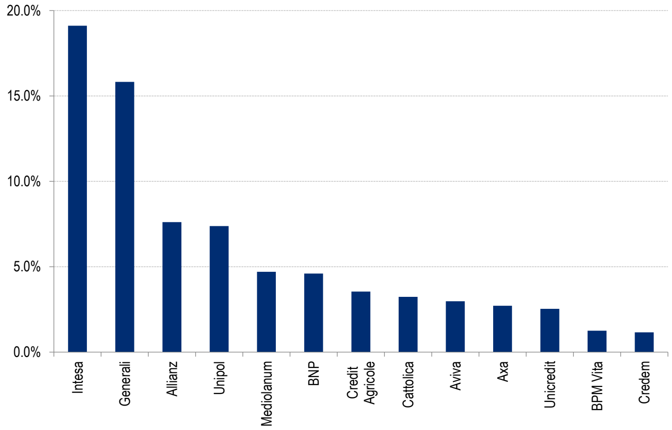
The Italian insurance market includes both Life and Non-Life products. Banks mostly distribute life insurance products and are starting to expand in the non-life (but still very small for them). Banks have c60% market share in life insurance gross written premium in Italy, while only 4% of the Non-Life gross written premium. The largest group in terms of market share of premiums is Intesa, followed by Generali.

Figure 255. Italy – Total Insurance Premiums, €bn



Source: Ania

Figure 256. Italy – Life Premium Market Share, 2014



Source: Ania. Note: Intesa includes both Intesa Sanpaolo Vita and Fideuram Vita.

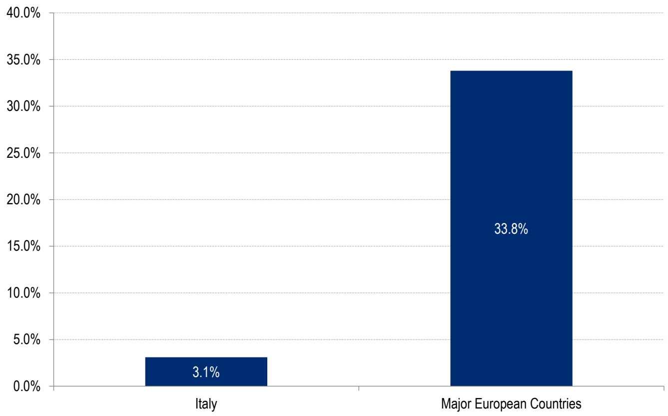
Most of the products sold are more investment solutions than life protection (Ramo I products represent c55% of total and classic unit product are c40%). The market is characterized by single premium products, representing c95% of the total. Looking at how insurance companies (also part of banks and other group) invest their portfolio, the majority is bonds, and only 10% is in equity shares. Banks distribute c80% of the Ramo I product (investment insurance, mostly at single premium) and 50% of Ramo III products.

Pensions

The private pensions market is still at a very immature stage in Italy, with pension funds representing only 3.1% of national GDP, c10x lower than the average of other large mature European markets. We think the main reason behind this is related to the fact that the State is the main provider of pension in Italy and individual integrative pension are on voluntary basis and not mandatory.

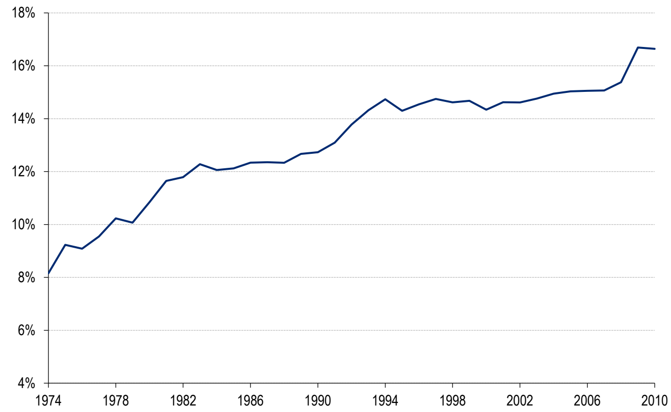
There have been several changes in the past to the public pension system, trying to reduce the overall government expenditure on pensions targeting an increase of the retirement age as well as changing the contribution system. While it is difficult to see a dramatic pick up in this market in the short/medium term, this could be an opportunity in the long term.

Figure 257. Pension Funds – Stock / GDP



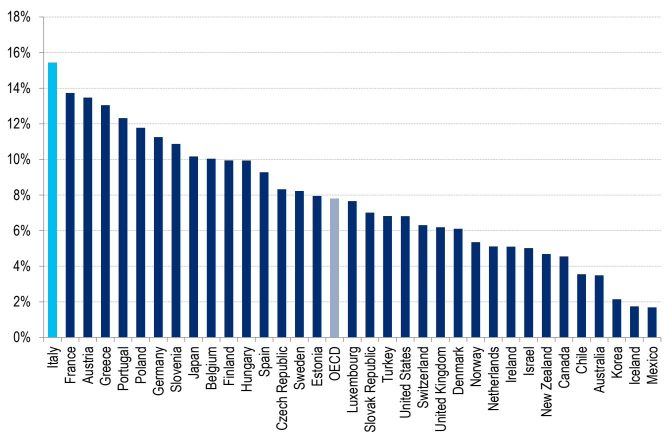
Source: Intesa 2014 Annual Report. Note: Major European countries include France, Germany, UK and Spain.

Figure 258. Italy – Total Pension Expenditure as a % GDP



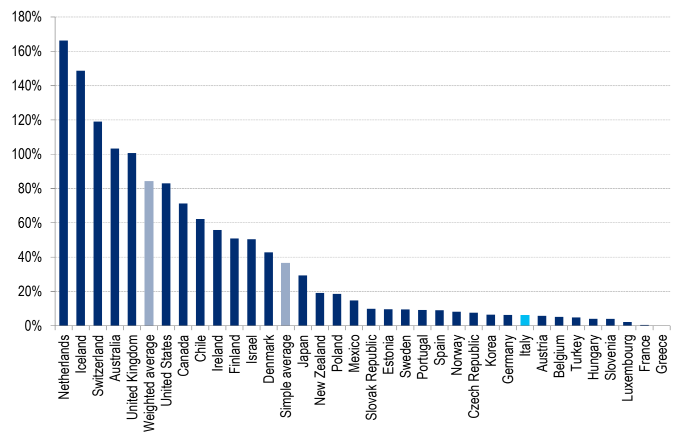
Source: Istat

Figure 259. Public Pension Expenditure / GDP



Source: OECD. As of 2009

Figure 260. Pension Funds / GDP

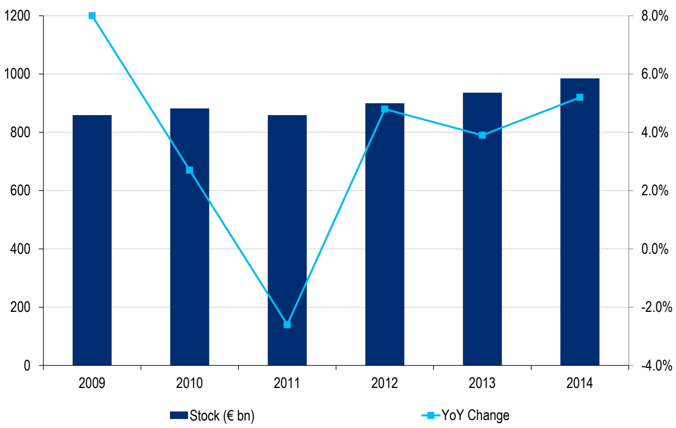


Source: OECD. As of 2013

Private Banking

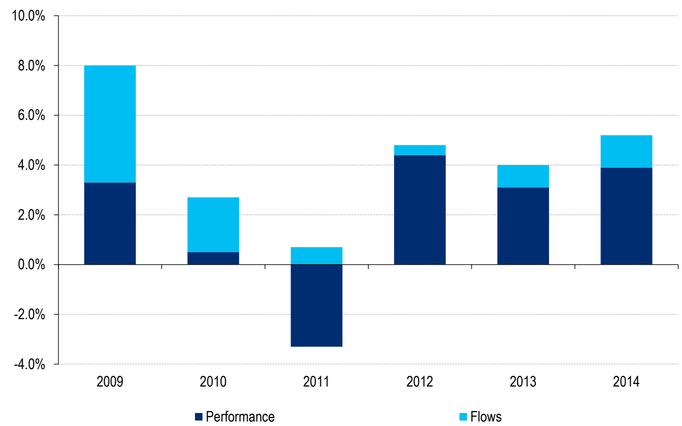
The private banking market (clients with over €500k financial wealth) is worth over €900bn. The trend in asset mix shows decreasing exposure to liquidity/monetary products as well as bank/sovereign and corporate bond, and showing increasing exposure to equity, insurance and investment funds.

Figure 261. Italy – Private Banking Assets and YoY Growth



Source: Intesa Sanpaolo Private Banking Annual Report

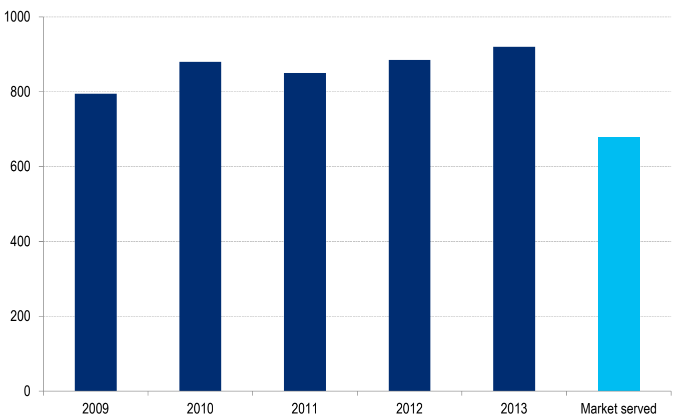
Figure 262. Italy – Private Banking Assets YoY Growth Split



Source: Intesa Sanpaolo Private Banking Annual Report

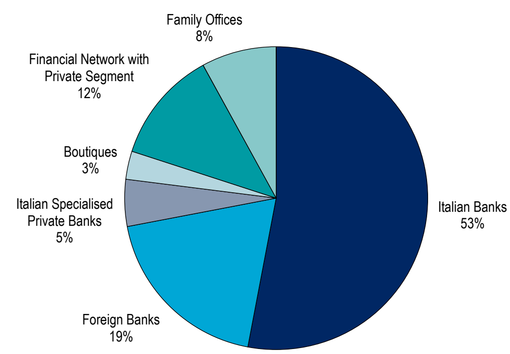
Italian banks with specialized divisions account for over 50% of market served (mostly UniCredit and Intesa private banking), and c20% is served by foreign private banks. According to Magstat, c25% of the potential market is not covered, and this, coupled with asset mix, represents the main opportunity in the space.

Figure 263. Italy – PB Market Potential vs. Market Served, €bn



Source: Magstat

Figure 264. Italy – Breakdown of Private Market by Player, 2013



Source: Magstat

Appendix A-1

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The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

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