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Morgan Stanley & Co. International plc+

Daniele Antonucci
Daniele.Antonucci@morganstanley.com
+44 (0)20 7425 8943

Alvaro Serrano
Alvaro.Serrano@morganstanley.com
+44 (0)20 7425 6942

Antonio Reale
Antonio.Reale@morganstanley.com
+44 (0)20 7425 2138

April 20, 2015

Economics and Banks

Italy: Now or Never

The Italian economy looks set to grow again. But whether a subpar recovery turns into a more sustained upswing hangs on whether Italy is able to engineer deep structural change. While there's more to do, what's underappreciated in the marketplace is that a reform process is now well underway. *Renzi*nomics is the best chance in years to escape from two decades of quasi-stagnation.

Cyclical pick-up: Our recently upgraded economic forecasts project the Italian economy to have come back onto a growth path, courtesy of a 'triple booster' of euro weakness, ECB QE and cheap oil. All this, along with a more growth-friendly fiscal policy, is reviving economic activity, which we think is likely to surprise market expectations to the upside. While exports look set to strengthen too, domestic demand, which should also benefit from a return of confidence, is likely to be the main driver of the recovery.

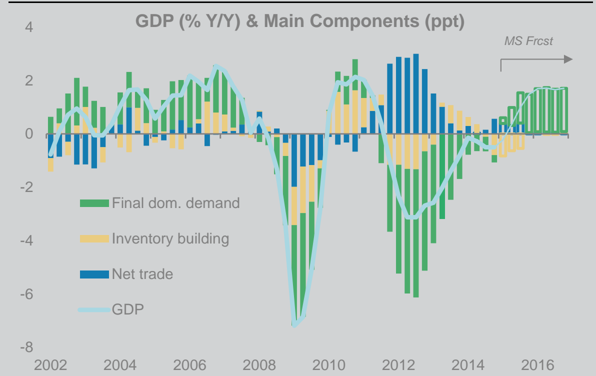
Structural progress: While we're more bullish than the consensus on Italy's prospects in the *near term*, we're well aware that its 'low-growth malaise' is not cured yet. But markets still have to catch up with the idea that a process of economic and institutional reform, known as *Renzi*nomics, has started successfully. If anything, the return to growth puts Italy in a 'sweet spot' to execute extra policy measures, which we expect to be announced shortly. Further signs that implementation is happening would make us more positive on the Italian economy in the *long term* too.

Banks: We estimate that Italian banks' ROTE will reach 8% in 2017, driven by a reduction in loan loss provisions from 175bp in 2014 to 60bp in 2017. A sustained recovery driven by the reform agenda, however, could accelerate the normalisation of provisions (40-50bp pre-crisis) and drive >10% upside to our estimates. We also think that M&A post *popolari* reform, and the related cost-cutting, has the potential to lift returns even further – to over 10% ROTE for the banks involved.

Beginning of a Cyclical Upswing

Source: Istat, Morgan Stanley Research estimates

Recovery in Domestic Demand



Source: Istat, Morgan Stanley Research estimates

Daniele Antonucci is an economist and is not opining on any securities. Alvaro Serrano, Antonio Reale and Anna Maria Scaglia are equity research analysts and are not opining on economics. Their views are clearly delineated.

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Italy: Now or Never

"Don't let the data get in the way of a good story."

– Anonymously adapted from Mark Twain

Summary & Conclusions

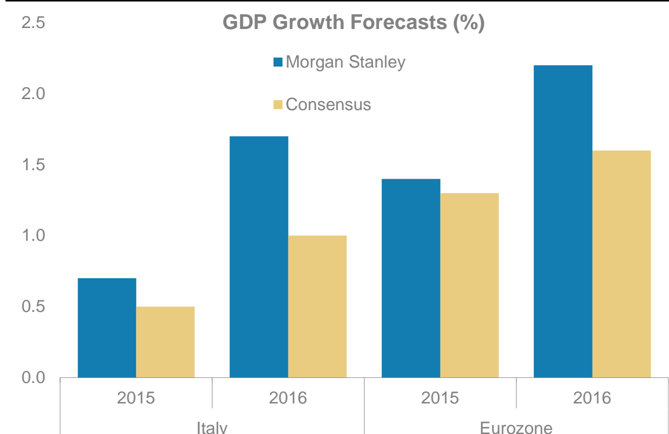
Italy's macro *story* looks good to us. The economic *data* are now turning and growth should accelerate soon – even though it's not robust just yet. **We're more bullish than the consensus,** which looks likely to be surprised to the upside in 2015-16. Our strategists are overweight Italian equities and see in BTPs one of the most favourable risk-adjusted return profiles in their cross-asset risk-reward framework.

The pick-up in activity is happening first and foremost because of a **'triple booster' encompassing currency depreciation, loosening financial conditions and cheaper oil.** While this is lifting growth everywhere in the eurozone, **Italy – so far a laggard relative to the other large economies in the region – is likely to see the biggest swing** in macro prospects from last year to this year and next, with an improvement in GDP growth of about 100bp per year.

What's even more underappreciated in the marketplace is that Italy's recovery puts it in a 'sweet spot' to reform its economic fabric and raise potential growth. We forecast a pace of expansion that's not too weak to obstruct a newly found political drive to engineer structural change, known as *Renzi*nomics. That's crucial, as there would simply be no 'buy in' if the economy was still in free fall. Equally, while significantly better than in recent years, we're forecasting a pace of expansion that's not too strong to put urgently needed *structural* change once again at the bottom of the 'to do' list. This would be the case if a very strong *cyclical* upswing were to 'relax' policymakers' efforts to address Italy's deep-rooted deficiencies. The good news is that it's not happening. Rather, **even though the reforms have not yet reached 'critical mass', they're starting,** and are reviving confidence.

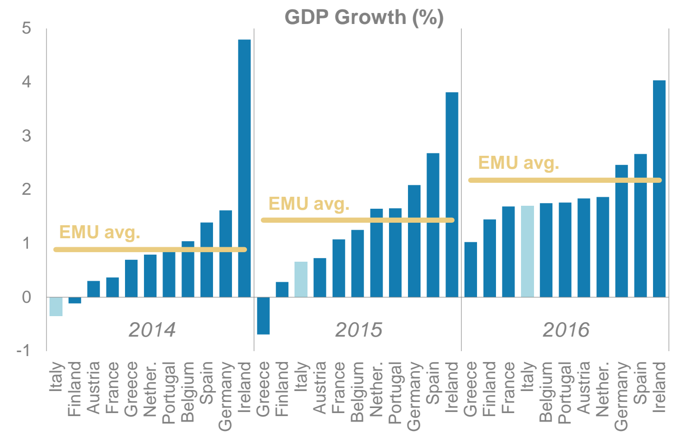
We expect further steps to follow the recent labour market and banking system reforms, along with a more growth-friendly fiscal policy and the proposed institutional changes such as a new electoral law to improve governability and reduce political volatility. Even **stronger policy efforts would make us more positive** on Italy's long-term prospects.

Exhibit 1
We're More Bullish than the Consensus



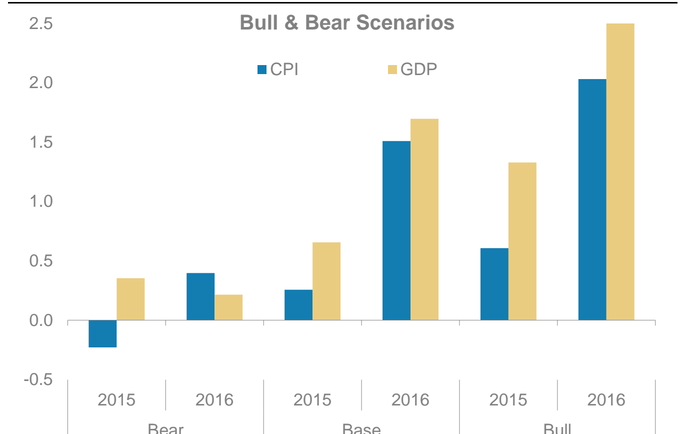
Source: Bloomberg, Morgan Stanley Research

Exhibit 2
Italy: Lagging Behind, but Now Improving Fast



Source: Morgan Stanley Research forecasts

Exhibit 3
Stronger Reforms May Shift Forecast to Bull Case



Source: Morgan Stanley Research forecasts

DEBATE	CONSENSUS VIEW	OUR VIEW
Is the business cycle turning?	Italy should grow by about 0.5% in 2015 and 1% in 2016.	**We expect Italy to have returned to growth in 1Q. We're more bullish than the consensus and think that the economy is likely to expand by 0.7% in 2015 and 1.7% in 2016, thanks to external tailwinds, mostly cyclical in nature, ranging from cheaper oil to euro weakness and looser financial conditions – courtesy of ECB QE. A growth-friendly fiscal policy and confidence-enhancing reforms should help too.** The recovery should gain momentum in the coming quarters. Sentiment has improved a great deal. While this may well overstate the actual pace of growth, it looks as if production and spending have a lot of catch-up to do. Industrial output, the key driver of Italy's business cycle, should benefit the most, along with exports. Job creation has already come back and the unemployment rate has peaked. Yet the pace of growth of the former and the decline of the latter both look rather slow. While this is quite typical when the economy is troughing, as firms try to make better use of idle capacity and productivity rises – rather than adding more workers from the onset – a cyclical upturn, wage moderation, fiscal incentives to hire and more flexible labour rules should all boost employment.
Are structural reforms truly happening?	It feels as if something is moving, but whether it's very little or a quite a lot is anybody's guess.	**Italy is in a 'sweet spot' when it comes to the possibility of engineering genuine structural change. Reforms are harder to do when the economy is in free fall, just like the incentive goes away when growth is very strong. The economic fabric hasn't yet changed, but what's exciting about Italy's macro story, and less appreciated in the marketplace, is that key changes are taking place and may lift potential growth further down the line.** The structural reforms have not yet reached 'critical mass'. Much more is needed to raise long-term trend growth from near-zero. Yet, we feel that Italy has now a pretty good chance to emerge from its two decades of quasi-stagnation. The recent tax-wedge cut is a key step to begin recovering competitiveness. And the labour market reform – despite its limitations – is important too. We'd expect to see some effects within 1-2 years. A new electoral law is likely to be approved. Public administration and justice system reforms will follow. If implemented, this would make us more positive, as it would mean that the ability and willingness to reform is strong, and could perhaps contribute to lift Italy's sovereign rating too.
How about the banking system?	Italian banks will not be able to cover their cost of equity.	**We estimate an average ROTE of 8% for Italian banks in 2017 vs. a CoE of 9-10%; but a more sustained economic recovery could provide c.10% upside to earnings if provisions return to pre-crisis levels (40-50bp). We also see further upside potential driven by sector specific banking reforms such as the *popolari* reform and the possible creation of a bad bank.** We expect legal reforms to be announced this year to speed up the recovery of bad loans, which may include the creation of a bad bank. We think a transfer of some NPL portfolios to such a vehicle, together with the economic recovery, could lift ROTEs by 150-160bp. Additionally, we think the *popolari* reform could trigger consolidation in the sector in the short term. In a theoretical merger of equals, where combined costs were cut by 10-15%, we believe ROTEs could go up 175-260bp. Both the front-loading of provisions and M&A could lift ROTEs to 10-11% for the banks involved compared to an average 0.9x P/TBV trading multiple.

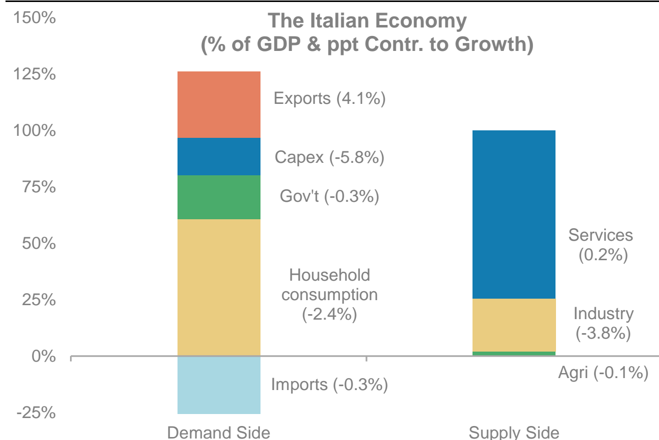
I. Business Cycle: Getting Better *(Daniele Antonucci)*

1. Hard data pointing to (modest) recovery

The Italian economy is just at the beginning of an upswing, which we believe will bring back growth in 2015-16 after a three-year recession. The acceleration is likely to be rather slow initially, but should gather momentum throughout the year. This is why the 2015 average, optically, is likely to look somewhat low. Yet, going into 2016, a good pace of expansion should lift GDP more visibly. The economic data seem to have turned, even though they point to just a fractional pace of growth in 1Q. **Industrial production** – by far the most crucial indicator when it comes to the business cycle – has strengthened, and **factory orders** as well as **exports** suggest a continuation of the current uptrend. Yet **retail sales** remain quite weak, though leading indicators such as household sentiment, even when taken with a pinch of salt, do suggest a recovery in **consumer spending.**

Exhibit 4

Sustained Growth Needs Capex and Industry

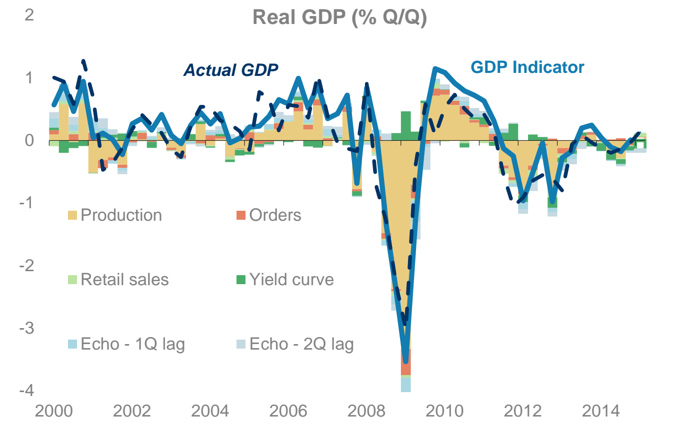


Note: The numbers in brackets show the contribution to GDP growth from 2004 to 2014; supply-side bar refers to gross value added and abstracts from tax changes.
Source: Istat, Morgan Stanley Research

On the supply-side, despite accounting for only a fifth or so of total gross value added, **manufacturing** punches way above its weight when it comes to affecting the swings of the economy, as it's far more cyclical than **services.** Similarly, on the demand-side, even though **capex** is much smaller than **household consumption,** it drives the overall cycle so much more. Therefore, for a sustained pace of growth to be maintained, what's needed is that **industry** and **business investment** continue to recover. Solid growth in Germany (Italy's main trading partner), currency weakness, loosening financial conditions and lower oil prices all bode well, along with a more growth-friendly fiscal policy – both nationally and at the European level – together with an acceleration of the structural reform process.

Exhibit 5

***Macro* Data Suggest that Recession Is Now Over**



Source: Istat, Morgan Stanley Research

Experimental data combining hard and soft estimates for industrial output, **foreign demand** and **credit availability,** with **electricity consumption, production of paper and cardboard** and **motorway traffic flow** point in the same direction. These indicators, taken together, suggest that the economy started to expand – albeit only fractionally – at the end of last year. And the growth momentum should have strengthened somewhat most recently.

We expect growth to have returned in 1Q this year, and to accelerate through 2015 – slowly at first, but then more visibly. In fact, the only reason why GDP didn't expand in 4Q last year is that **inventories** contributed very negatively to economic activity. But, probably, this was because of de-stocking as firms saw stronger demand, given solid gains in **foreign trade** and continued recovery in **domestic demand.**

Exhibit 6

***Micro* Data Point to Small Uptick at the Start of 2015**

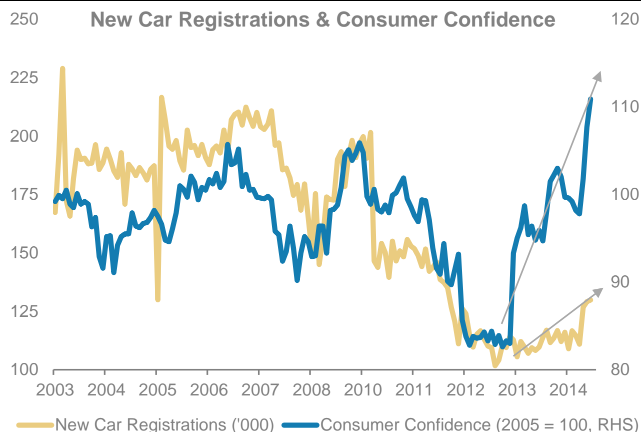
Source: Fondazione Economia CEIS Tor Vergata, Morgan Stanley Research

2. Soft data overstate the economic pick-up

While things have improved, we think that **the sentiment gauges are painting an excessively bullish picture.** The economy does look better. But the cycle is only beginning to improve and remains quite fragile. Taking the widely-watched **PMI survey,** for example, it looks as if the threshold of 50 is no longer separating expansions from recessions. Rather, our empirical work suggests that zero growth now happens when this indicator is about two points higher. So 52 is the new 50.

Imagine that, at the trough of a deep recession, a firm is asked whether things will be 'better' in six months. That firm may say 'yes', but that doesn't necessarily mean that 'better' describes the same degree of improvement prior to that deep recession, i.e., when the *typical* pace of economic expansion was different, or that things are 'good'. So, while a PMI at 50 meant stabilisation *prior* to the crisis, it will *now* have to improve further, in our view – to 52 – to signal an economy (or a sector) that is no longer shrinking but not expanding either. The good news is that we've finally reached that point.

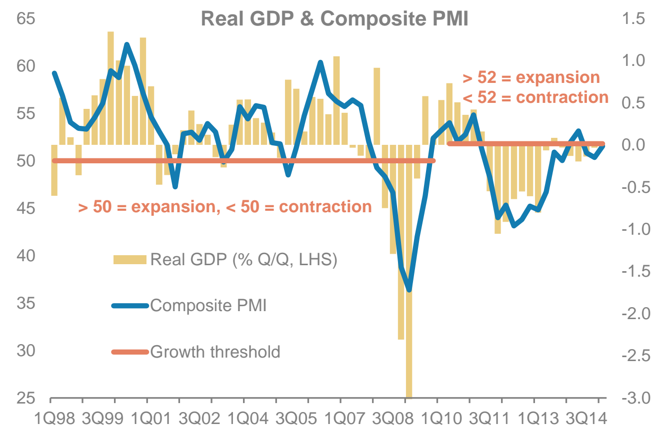
Exhibit 7
Consumer Confidence Is Way Ahead of Spending



Note: Structural break in June 2013. Source: ECB, Istat, Morgan Stanley Research

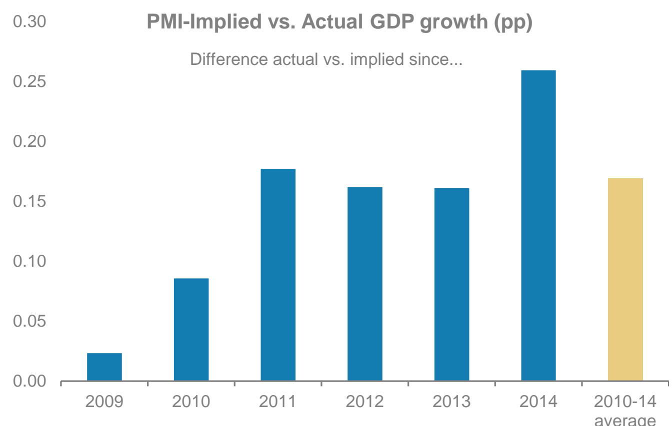
Or take **consumer confidence** – now at a multi-year high. True, the recession has finally ended, there's less uncertainty on the future of the eurozone and a positive domestic policy shift. Yet spending has only started to improve, e.g., **car registrations** are increasing, but their level remains depressed; it's nowhere near where it has historically been given the improvement in sentiment. And car *registrations* very likely overstate the pace of car *sales* (firms may register their vehicles more than once). This may mean that **production and spending still have a lot to catch up** but also, more realistically, that **the gap between soft and hard data will have to close somewhere in between.**

Exhibit 8
Sentiment vs. Activity: Changed Relationship



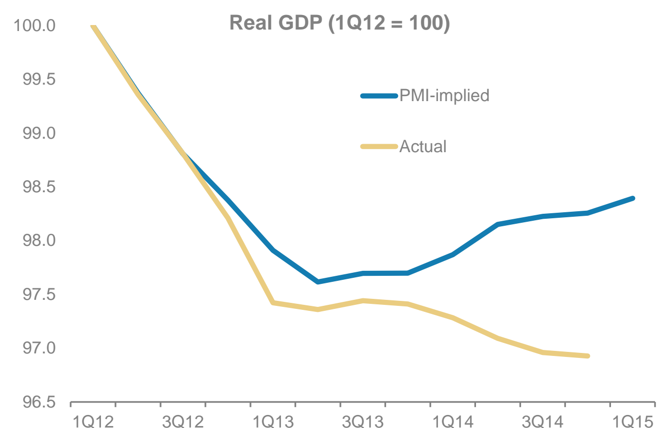
Source: Istat, Markit, Morgan Stanley Research

Exhibit 9
The Forecast Error of the PMIs Has Increased



Source: Istat, Markit, Morgan Stanley Research

Exhibit 10
Mind the Gap!



Source: Istat, Markit, Morgan Stanley Research

3. Fiscal policy now becoming growth-friendly

Italy has gone through four years of austerity – one of which almost unprecedented in terms of belt-tightening. What's changed is that **the fiscal drag is now over, and we expect a small fiscal stimulus in 2015-16,** somewhat larger than in the typical eurozone country.

The ***targeted* fiscal stimulus** recently announced, encompassing tax cuts for both households and firms, is likely to provide some relief to the economy. And, while not entirely new (see, for example, *Paying the Bills*, April 24, 2013), the Italian government's measures for the payment of a substantial portion of the general government entities' debts are likely to have more of an effect now, given that confidence has returned – so it's likely that **firms will focus less on precautionary cash hoarding and more on carrying out investment plans otherwise shelved for lack of funds.**

There are several reasons why **there's now some extra fiscal space:**

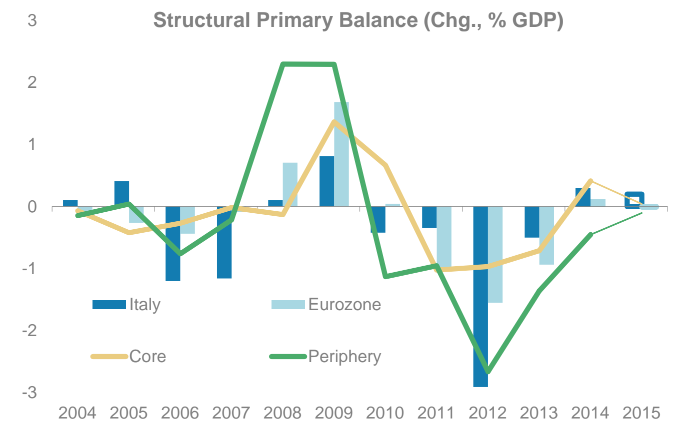
1. The **pick-up in both *real* and *nominal* economic growth** that we expect – along with lower bond yields courtesy of ECB QE – which is likely to generate, this year alone, extra savings in excess of €7bn (or about 0.5% of GDP) compared to previous budget targets.

2. **More flexible fiscal rules** allowing to deviate *temporarily* from the path towards their medium-term objective in order to finance some investment expenditure, provided that the budget deficit doesn't exceed 3% of GDP and that structural reforms are implemented.

3. National co-financing of the EU Structural Funds and contributions to the forthcoming European Structural and Investment Fund, i.e., the **Juncker Plan,** will *not* be included in the calculation of the structural adjustment because they are classified as temporary outlays.

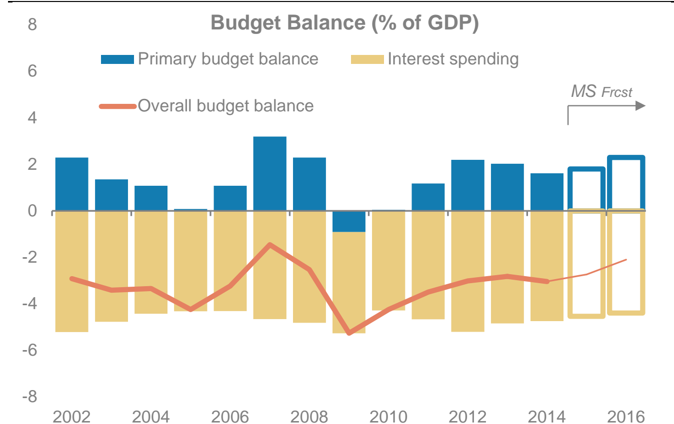
There's a limit to all this, because Italy's public finances, which are on a healing path from a budget-balance perspective, are still **vulnerable to shocks** from a debt-stock perspective (see *Debtflation – One Shock Away?* September 22, 2014). Yet, within these constraints, it looks like the Italian government is in the process of implementing **fiscal incentives to facilitate business investment,** such as the tax credit for the purchase of capital goods and a financing scheme for the purchase of machinery and equipment (together likely to activate capex plans amounting to about 1% of GDP). Measures likely to create an extra 1% of GDP in investment are in the process of being finalised.

Exhibit 11
From Fiscal *Drag* to Fiscal *Impulse*



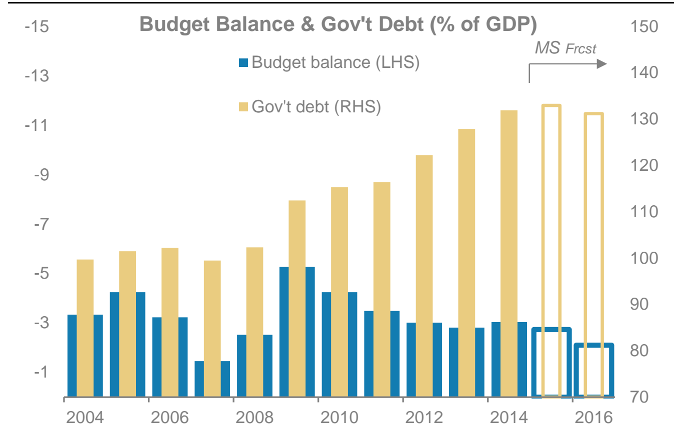
Note: We assume a fiscal multiplier = 1. Source: Eurostat, Istat, Morgan Stanley Research

Exhibit 12
Making Ends Meet: Substantial Primary Surplus



Source: Istat, Morgan Stanley Research estimates

Exhibit 13
Debt Trajectory: Vulnerable but Stabilised



Source: Istat, Morgan Stanley Research estimates

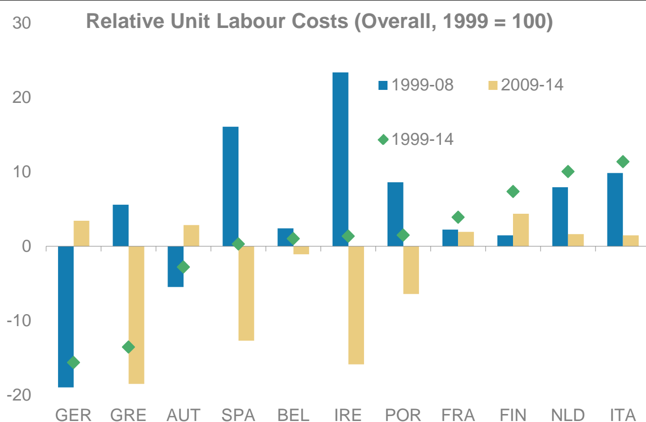
II. Economic Structure: Crucial Shift *(Daniele Antonucci)*

Italy is finally starting to tackle some of its main structural problems, from the labour market and the banking system to the institutional framework. This is not to say that the reforms have reached 'critical mass'. They're still incomplete. Rather, it's an observation that **the reform momentum appears to have picked up** – something that remains quite underappreciated in the marketplace, we think.

We believe that **structural change is likely to intensify,** given a more reform-minded government that is enjoying little pushback in parliament, few alternatives from the opposition and quite limited resistance from the trade unions. Capitalising on the popularity of Prime Minister Matteo Renzi, **the government coalition has positively surprised in its resolve to strengthen Italy's economic fabric.**

Exhibit 14

Italy's Competitiveness Loss Not Yet Recouped



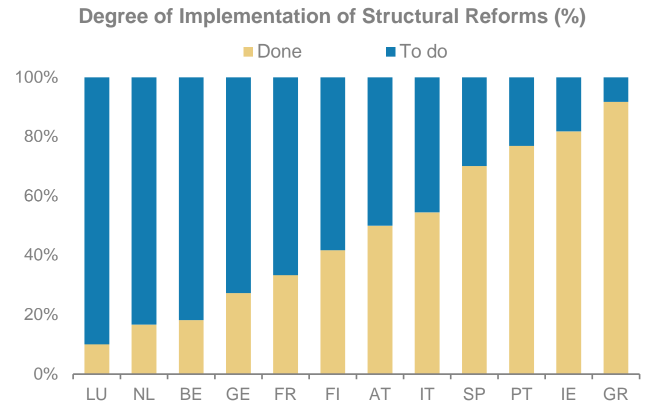
Source: European Commission, Morgan Stanley Research

This follows some attempts to engineer change, e.g., by the technocratic government from late 2011 to early 2013, but mostly on fiscal issues such as the **sustainability of the pension system** or the **soundness of the public finances,** or on **liberalising some of the product markets.** Conversely, competitiveness losses haven't really been recouped. It's not that Italy had become so much worse. It's that the other peripheral economies had improved a lot.

Looking at the **responsiveness to OECD policy recommendations** over the past three years, it looks as if **Italy is more or less the average country in terms of reform effort,** while **the Iberian countries, Ireland and even Greece, look above average.** So, what transpires is that the glass is only half full in Italy, which hasn't seen the same market pressure to reform as much as the small countries.

Exhibit 15

Glass Half-Full for the Italian Government

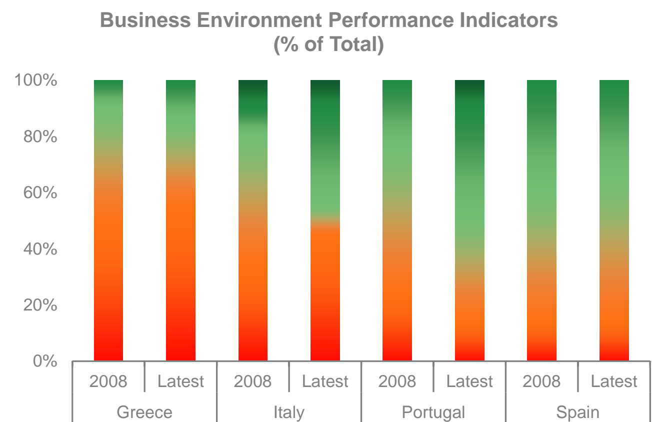


Note: This chart represents a scoring system in which policy recommendations take a value of one if 'significant' action is taken; zero if not. This indicator is a measure of the extent to which OECD countries have followed up on *Going for Growth* recommendations.
Source: Morgan Stanley Research estimates based on OECD's *Going for Growth*

Yet it also seems that, so far, Italy's reforms – while not far-reaching – have also been more *structural* in nature, as they've focused on improving the functioning of the business environment. In Spain, the focus has been mostly on cost cutting. This has improved competitiveness, but at the cost of job losses and political fragmentation, while the wider economic fabric hasn't changed much. In Italy, it seems that it's getting easier to do business, as our heat map below shows (see *The Structural Reforms Debate*, July 1, 2014). Put differently, enforcing contracts, resolving insolvencies, starting a business, legal structure and property rights, barriers to trade and investment, etc. are all getting somewhat better.

Exhibit 16

Who's 'Doing the Right Thing?'



Note: The colours represent a country's position relative to the EU average: Red = bad; Orange = weak; Light Green = good; Dark Green = strong.
Source: European Commission – DGECFIN, World Bank and IFC Doing Business, World Bank Governance Indicators, OECD, Fraser Institute, World Economic Forum, Intrum Justitia, CEPEJ, Morgan Stanley Research

Reform #1 – Competitiveness & taxation

What's the idea: Cut unit labour costs by lowering payroll taxes and use fiscal incentives to *boost price competitiveness* and *encourage hiring and spending.*

One of Italy's main problems is that its economy is quite uncompetitive, as shown by the rise in unit labour costs (ULCs) over the years, especially in the early period of the monetary union. While this was common to all countries in the EU periphery (and also to some in the core), what's changed is that the other southern European economies have now brought their ULCs relative to the eurozone average back to where they were when they joined the currency-block.

The competitiveness improvement in the smaller EU peripherals was mainly achieved via wage retrenchment and productivity gains – as employment contracted much more than output. All this did boost competitiveness and export performance, but at the cost of a deepening recession. **What's happening in Italy is that the strategy to regain the lost competitiveness will focus on reducing non-wage costs** such as payroll taxes and social security contributions, i.e., the tax wedge.

Because Italy's taxes on labour are quite high by international standards, there's considerable scope to improve on this front by lowering the tax wedge. This policy measure, now implemented, has three main parts: a tax credit, a tax cut and a social security contribution waiver. In detail:

1. **Tax credit** of €960 per year (€80 per month) for employees with medium-low incomes, which is likely to have contributed to the improvement in consumption.

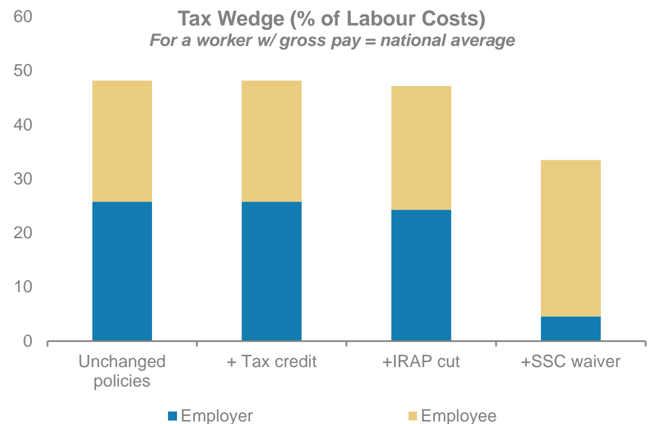
2. **Tax cut,** i.e., the labour component is now excluded from the tax base of the regional tax on productive activities (known as IRAP).

3. **Social security contribution waiver,** i.e., *zero* social security contributions paid for three years for newly hired permanent workers.

The incentive to hire, and the reduction in the tax wedge, are particularly strong for low-income earners, e.g., for workers with a gross pay equal to two-thirds of the national average. This is because, as with most other reforms in the process of being implemented, the idea of the current political leadership, in our view, is to **select those with the highest likelihood of having at least some *short-term* impact on *aggregate demand*, and not just a *long-term* impact on the *supply-side* of the economy.**

Exhibit 17

Recovering Competitiveness via Tax Wedge Cut



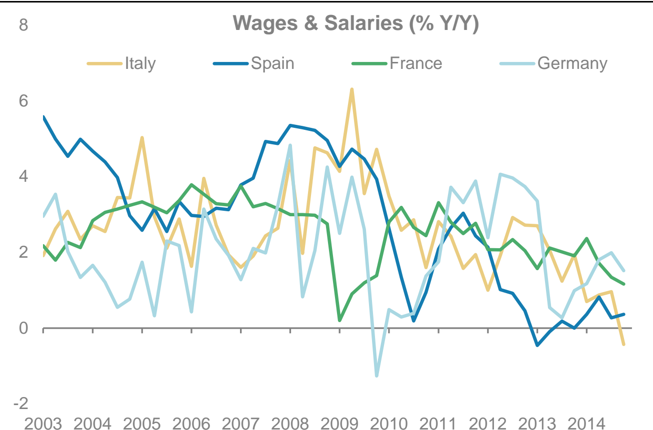
Source: Bank of Italy, Morgan Stanley Research

Some **internal devaluation is taking place,** but that's more the by-product of a weak economy – at least for now. It looks as if wage growth has started to moderate quite visibly. Apart from encouraging hiring, a reduction in the tax wedge, and a more growth-friendly fiscal policy from a broader perspective, may boost competitiveness and export growth to some degree – which would make us more positive on the medium-term economic outlook.

Of course, the key to recover competitiveness is not really just wage moderation. It's **making sure that productivity increases faster than wage growth** (which doesn't need to be near-zero). This is an unresolved issue and we'll be looking for further reforms to strengthen **decentralised wage-bargaining at the firm level.** Should this happen, Italy's cost competitiveness should improve faster.

Exhibit 18

Wage Moderation Finally Happening



Source: Eurostat, Morgan Stanley Research

Reform #2 – Job market

What's the idea: Reduce or eliminate a two-tier system by introducing simpler, fewer, more flexible and less costly labour rules to *encourage hiring and firm growth.*

The labour market reform, i.e., the so-called Jobs Act, is another structural change of macro relevance of the reform agenda of Mr. Renzi. The key decrees enacting the core of the reform are now fully operational. What they do is to deliver a new set of rules to:

- **Eliminate** most temporary contracts and **replace** them with one that gives new employees progressively greater safeguards until, after three years, they become entitled to a permanent job.
- **End** the right to reinstatement of workers judged to have been unfairly fired (article 18 of the Workers' Charter) and **substitute** this with financial compensation. That right will remain for cases of discrimination.

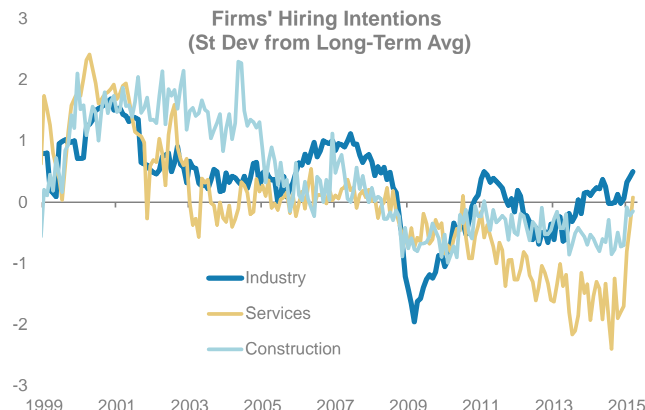
Via **easier and simpler hiring and firing rules,** this reform should contribute to rebalance a two-tier system whereby workers with permanent jobs are currently highly protected and workers with temporary jobs have little or no protection. It should also **incentivise job search** by creating a monthly payment for the *involuntarily* unemployed that can last for two years, but which starts to taper after four months. After that, a jobless worker becomes entitled to lesser benefits.

The reform has four limitations, though we believe they're likely to be addressed in future legislation:

1. **It only applies to private-sector workers.** Yet an upcoming reform of the public administration will likely extend some of these new mechanisms to public-sector workers too.
2. **It only applies to newly hired workers.** But since so many of Italy's workers are now on short-term contracts, its effects will soon be felt, in our view, as employers will get generous incentives to use the new contract.
3. **It may discourage labour mobility** since those *already* in permanent work will be put on the new (and, for them, less beneficial) contract if they change jobs.
4. **It may not raise** productivity and encourage investment, particularly from abroad, since decentralised wage-bargaining is not part of the reform.

Exhibit 19

Companies Now More Willing to Hire



Source: Istat, Morgan Stanley Research

Apart from **reducing the duality of the labour market,** which has to happen by design, whether this reform will **boost employment** remains to be seen. We think it will likely have a visible effect only taking a 2-3 year view, by changing the *structure* of Italy's labour market, which should become more adaptable to changing economic conditions. Given that article 18 only applied to firms with more than 15 employees, its elimination may also **encourage firms' dimensional growth.**

There could also be some beneficial effects over a shorter timeframe, as these new rules should lower the economy's escape velocity, i.e., the growth threshold that needs to be exceeded to create jobs. Half a percent, rather than 1%, may now be sufficient. In fact, **despite just a modest cyclical recovery, firms' hiring intentions in the manufacturing sector are now above their long-term average.**

Exhibit 20

Job Creation Is Coming Back

Source: Istat, Morgan Stanley Research

Reform #3 – Electoral law & constitutional changes

What's the idea: *Streamline the policymaking process* by introducing an electoral law capable of generating larger majorities and 'eliminating' the Senate.

One pre-condition to start fixing Italy's deep-rooted economic deficiencies is political stability, which is why we think that institutional changes to create large parliamentary majorities are crucial to upgrade our *medium-term* forecast meaningfully. There are two key aspects:

1. ***New* electoral law:** The approval of the new electoral law, a key step in this direction, is almost done. We'd expect the final 'go ahead' in early May. This will only apply to the Chamber of Deputies (i.e., the Lower House) as the Senate will effectively be 'disempowered' and will no longer vote on the budget, confidence to the government, etc. The goal is to produce a clearer electoral outcome in order to increase political stability: if no party wins more than 40% of the vote, a run-off would be staged between the top two with the winner getting an absolute majority. This law will become fully operational from July 1, 2016, to avoid a quick return to the polls, which could have slowed once again the reform momentum.

2. **Constitutional changes:** The other important reform has to do with constitutional amendments to make the Senate a sort of consultative chamber of 100 mostly regional delegates (down from 315 Senators), with drastically reduced powers and no indemnity. Other key changes eliminate a sub-national level of government (the provinces) and a consultative body (the CNEL). The 'new Senate' will no longer be able to vote on most areas of policy, including budgetary matters. All this should expedite decision-making, cut the number of MPs and other politicians, and generate financial savings. The final approval still requires several steps, probably later in the year, and a referendum likely to be held only in early 2016.

These institutional changes are possibly one of the most important items on the reform agenda, and they go hand in hand with the economic reforms. Their completion is likely to create some of the necessary conditions for urgently needed structural changes. So, even though tangible effects on GDP growth are only likely to be visible over the years, changing the rules of the political game, which have tended to create instability and short-lived governments, may contribute to strengthening Italy's dim growth prospects in the medium term, we think. This is because the new mechanisms are more likely to create broader and more homogeneous parliamentary majorities, therefore increasing the probability of seeing far-reaching economic policies and reforms after the *next* election has taken place. The current legislature can last until 2018, when the Italians must go to the polls by law. This seems to be the time horizon Mr. Renzi has in mind too for his cabinet and policy agenda, though changes in government have historically been quite frequent in Italy.

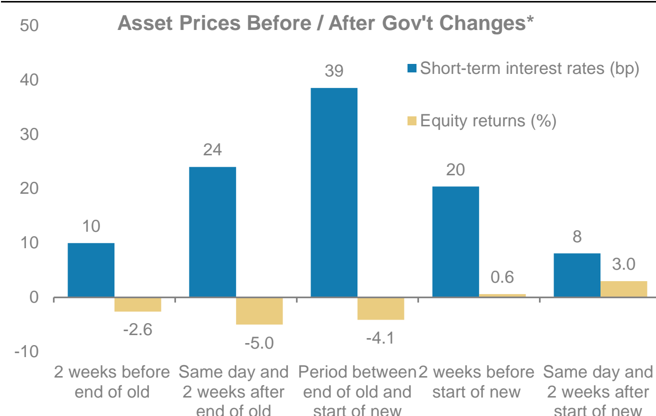
Exhibit 21
Large Sample of Political Crises

Government	Start	End	Government	Start	End
Andreotti II	26-Jun-72	02-Jun-73	De Mita	13-Apr-88	19-May-89
Rumor IV	07-Jul-73	03-Mar-74	Andreotti VI	22-Jul-89	29-Mar-91
Rumor V	14-Mar-74	03-Oct-74	Andreotti VII	12-Apr-91	24-Apr-92
Moro IV	23-Nov-74	07-Jan-76	Amato	28-Jun-92	22-Apr-93
Moro V	12-Feb-76	30-Apr-76	Ciampi	28-Apr-93	16-Apr-94
Andreotti III	29-Jul-76	16-Jan-78	Berlusconi	10-May-94	22-Dec-94
Andreotti IV	11-Mar-78	31-Jan-79	Dini	17-Jan-95	17-May-96
Andreotti V	20-Mar-79	31-Mar-79	Prodi	17-May-96	09-Oct-98
Cossiga	04-Aug-79	19-Mar-80	D'Alema	21-Oct-98	18-Dec-99
Cossiga II	04-Apr-80	27-Sep-80	D'Alema II	22-Dec-99	19-Apr-00
Forlani	18-Oct-80	26-May-81	Amato II	25-Apr-00	31-May-01
Spadolini	28-Jun-81	06-Aug-82	Berlusconi II	11-Jun-01	20-Apr-05
Spadolini II	23-Aug-82	13-Nov-82	Berlusconi III	23-Apr-05	16-May-06
Fanfani V	01-Dec-82	29-Apr-83	Prodi II	16-May-06	07-May-08
Craxi	04-Aug-83	07-Jun-86	Berlusconi IV	08-May-08	12-Nov-11
Craxi II	01-Aug-86	03-Mar-87	Monti	16-Nov-11	27-Apr-13
Fanfani VI	17-Apr-87	28-Apr-87	Letta	28-Apr-13	21-Feb-14
Goria	27-Jun-87	11-Mar-88	Renzi	22-Feb-14	Incumbent

Source: Morgan Stanley Research

Reducing political volatility may also have positive market implications in the near term. In Italy, econometric work based on historical evidence and 'event studies' suggests that, in the two weeks before and after a government collapse, the cumulative rise in short-term interest rates is about 24bp – controlling for other key factors – and equity markets fall by around 5%. These effects seem to be temporary and last for a few weeks only.

Exhibit 22
Politics Matters for Markets



*Cumulative changes in Italian asset prices based on a sample of 31 government changes over the period 1973-2007.
Source: Adapted from Fratzscher and Stracca (2009), *Does It Pay to Have the Euro? Italy's Politics and Financial Markets under the Lira and the Euro*, ECB Working Paper No. 1064, Morgan Stanley Research

Any benefit from the reforms?
The answer to this question is rather uncertain. This is because one can mainly use macroeconomic models to explore the possible impact based on many assumptions. The European Commission uses the distance-to-frontier approach (see here), among others, which assumes that the gap between the average of the three best EU performers and those under study closes gradually and partially across a variety of labour and product market indicators. The simulation is based on the QUEST model, which the Commission uses to assess the impact of structural or fiscal policies on the macroeconomy.

To avoid setting unattainable targets, **the scenarios involve only half of the gaps being gradually closed** and takes 'speed limits' into account, e.g., tax reforms are phased in over five years, while educational reforms lead to only very gradual changes in skill levels due to cohort effects. The reforms that the model simulates cover a wide range of areas, from market competition and regulation to R&D expenditure, skill structure, taxation, labour market participation, unemployment benefit 'generosity' and various active labour market policies.

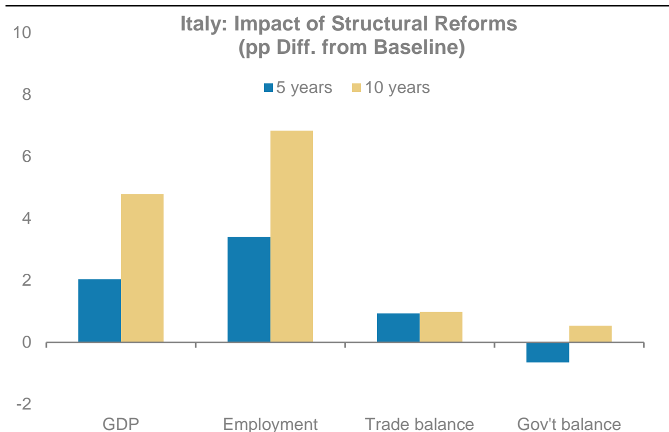
The simulations show that **even a *moderate* effort to fix Italy's economic fabric by 'copying' some of the best practices elsewhere in Europe – which may not necessarily be the most ambitious targets on a global scale – could lift GDP, boost employment, improve competitiveness and, further down the road, also the public finances.** Assuming that the results are roughly linear, more ambitious reforms closing the full gap would double the effects on various aspects of the economy.

These exercises also show that **the impact of the structural policies is likely to manifest itself only over time.** Even though this is true for all countries in Italy's peer group, i.e., the large eurozone economies, it looks as if visible effects may take longer to appear than in, say, Spain. One reason could be that **the Italian economy hasn't really been hit by one single shock as the Spanish economy** (deleveraging), i.e., a credit-fuelled housing and consumer boom turned bust. In a sense, that's easier to fix, because it mainly has to do with measures aimed at cost cutting.

So, when competitiveness is restored, the current account in surplus, the banking system recapitalised and restructured, and the public finances on a sounder footing (which still is work in progress for Spain and most other eurozone economies), then GDP growth could rebound more quickly, as the outperformance of the Spanish economy has shown. Conversely**, there's no single shock that has hit the Italian economy – which is rather balanced apart from high government debt. Its underperformance has to do with deep-rooted deficiencies.**

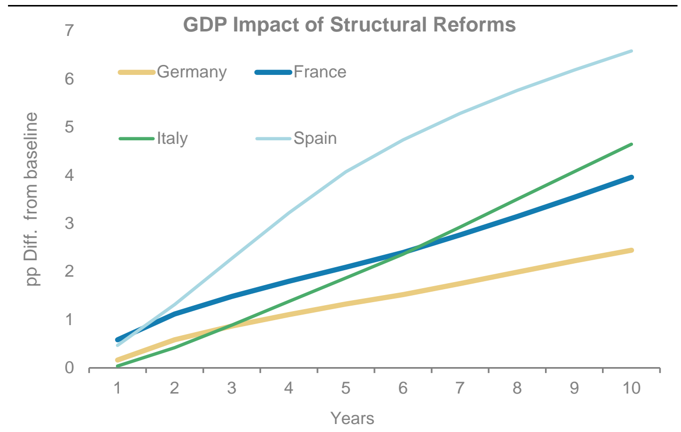
To stretch the argument a bit, just like Japan went through two lost decades of *deflation*, the Italian economy has gone through two lost decades of *stagnation*. These structural problems are more difficult to deal with, which means that the effect of reforms specifically aimed at tackling them may have visible effects only over a longer timeframe than those aimed at reducing leverage and cutting unit labour costs. Yet, **once structural change is enacted, the impact on GDP should manifest itself more strongly after a few years** and outpace that of, e.g., France (which has, however, a stronger economic fabric than Italy).

Exhibit 23
Substantial Long-Run Benefits



Source: European Commission – DGECFIN, Morgan Stanley Research

Exhibit 24
Starting Slow, but then Accelerating



Source: European Commission – DGECFIN, Morgan Stanley Research

The trigger to reform in Italy, rather than a single, big shock as in Spain, has been the accumulation of economic underperformance over the past 20 years. Not without setbacks and delays – and surely starting from a situation of underperformance relative to the smaller peripherals – we believe that **the Italian economy is just at the beginning of a more intense phase of structural change.**

What's in the pipeline?

The chart below shows what we expect the Italian government to deliver this year in terms of structural reforms or policy measures that are relevant from a macro standpoint, along with our own estimate of when approval and/or implementation is likely to happen.

These reforms, to truly shift our long-term growth forecasts for Italy, are equally important, because the economy needs *system-wide* changes. Should they happen, potential growth is likely to rise from near-zero to close to 1% taking a long-term view (e.g., ten years).

The main upcoming reforms and measures are:

- **Education:** Various measures are in the process of being implemented, ranging from recruitment of extra teachers to extra emphasis on merit-based approaches for career progression in schools and improvements in vocational-training schemes. More is needed on this front, we think.

- **Public administration:** Various laws enabling previously approved reforms, along with some new ones, to streamline end-user services, reduce bureaucracy, and improve performance measurement as well as increase efficiency gains in the civil service at large.

- **Justice:** Revision of penal code related to the statute of limitation, sanctions in case of excessive length of proceedings, responsibility of judges, for example. Separate legislation, likely to be passed at around the same time, will toughen rules against organised crime.

- **Asset sales:** *Start* of privatisation process of certain state-owned enterprises and other assets over the course of 2015 and in 2016. The expected income that the government envisages amounts to around 0.7% of GDP per year in 2015-17.

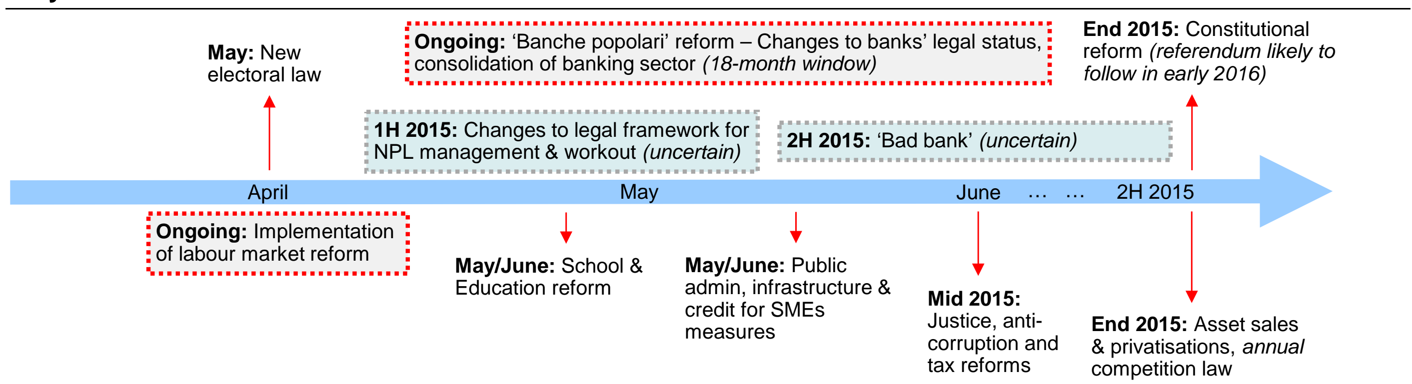
The risks around this timeline are skewed towards extra time needed for *full* completion. Yet, at least so far, the agenda has been executed relatively swiftly, with only minor disruptions to the main reforms. There have been delays and setbacks, but not really an overall derailment of the reform effort. Indeed, our impression is that **the commitment to structural change, despite non-negligible obstacles, has increased.**

These considerations also mean that, even though *Renzi*nomics has had a decent start especially after the EU election strengthened Mr. Renzi's leadership, **more needs to be done to raise trend growth beyond 1%** or so – which surely would be an improvement by Italy's standard, but remains a pace of growth that many DMs would consider quite dismal.

This may well happen, but it probably requires a longer policy horizon than 2-3 years, and perhaps a strong political mandate backed by an outright majority in parliament. This is why the institutional reforms are as important as the economic ones.

Exhibit 25

Italy's Reforms – What's the Timeline?



Note: Grey boxes = progressive implementation of fully approved measures; light blue boxes = uncertain timing and/or content. Source: Morgan Stanley Research

Reform #4 – Utilities *(Anna Maria Scaglia)*

What's the idea: Rationalisation of assets owned by public entities could lead to a reduction in the number of small-scale local utilities and to their consolidation.

The Stability Law for 2015, approved last December, introduces a series of incentives for the rationalisation of assets owned by local authorities.

The main proposal is the **possibility to spend income from asset disposals which would not be subject to the limits imposed by the so-called Stability Pact.**

Among the criteria for the rationalisation of assets owned by public entities, the Stability Law mentions specifically a **reduction in the number of small-scale local utilities and their consolidation.**

The Stability Law had set the deadline of March 31, 2015 for the presentation of a rationalisation plan by regions, provinces, municipalities and public entities.

Although there has been little progress so far, and no new deadline formally, the Economic and Financial Document for 2015 (DEF), presented last week, reiterates the same objectives, in particular the **rationalisation of assets owned by public entities, which could lead to a smaller number of local utilities,** via their aggregation.

What are the implications for the sector?

- The expectation is that the Stability Law could lead to further aggregation of Italian municipal utilities. On April 10, 2015, **A2A** (not covered by Morgan Stanley) presented its 2015-19 business plan.

  The company highlighted that it is **evaluating additional projects on top of those already included in its targets.** In particular, it sees the **potential for further aggregations in Lombardy,** which it indicated could lead to an incremental €50-100 million of EBITDA contribution.

- In the case of **Hera** (not covered by Morgan Stanley), its 2014-18 business plan includes €75 million incremental EBITDA contribution from **M&A.**

  According to the company, its expansion will be based on the same criteria as the past. Hera has indicated it will either look at **multi-utilities in contiguous areas** or at **strategic assets in liberalised businesses** (see here).

What are the implications for the stocks we cover?

- **One potential beneficiary of the process of rationalisation of assets owned by public entities could be Snam.**

  Italian gas distribution concession areas are set to drop from 6,700 to 177 by law. The so-called **'Milleproroghe decree'** establishes that **the tender process for new concession areas should start in 2H 2015.**

- **Snam, through Italgas, is the market leader in gas distribution and aims to have a key role in the process.**

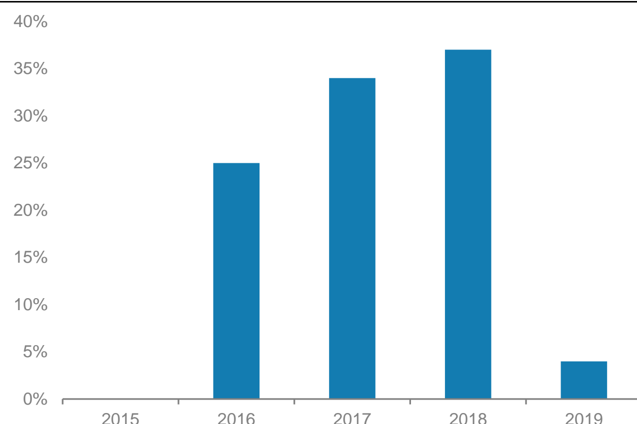
  We note that, during the recent 2015-18 strategy presentation, Snam's management indicated that it **aims to increase its market share by 10-12%, thus reaching 40-42%.**

- **Snam estimates to have financial flexibility for up to €1bn.** We believe Snam should be able to extract efficiencies thanks to its scale and operating efficiency.

  Furthermore, speaking at the strategy presentation, the CEO affirmed that the company would like to increase market share without increasing operating costs.

- We think that, despite the false starts of the past, recent regulatory developments make it plausible that the consolidation process of distribution concession areas will finally start. However, some minor delays are still possible, in our view.

Exhibit 26
Gas Distr. Concession Areas Renewal Schedule



Note: Snam estimates.
Source: Snam, Morgan Stanley Research

III. Banks *(Alvaro Serrano / Antonio Reale)*

Reform #5 – Addressing the NPL issue

What's the idea: Non-performing loans are a key drag on credit flow and profitability at Italian banks. Offloading NPLs through the creation of a liquid secondary market – either via a 'bad bank' and/or changes to the legal framework – has the potential to lift returns by 150bp, we estimate.

We forecast an average 8% ROTE for Italian retail banks in 2017 compared to >10% for eurozone banks, even though they operate under the same rate environment. One of the main obstacles to closing this profitability gap is the Italian banks' high levels of NPLs (17% on average in 4Q14). Recent comments by members of the government (Economy Minister Padoan, La Repubblica, Jan. 25) and bank management lead us to believe the Italian authorities could be contemplating the creation of a liquid secondary market for distressed assets. This could take the form of a bad bank and/or reforms to the legal framework, we think.

Italy's theoretical bad bank would differ from Spain and Ireland. In Spain and Ireland most of the non-performing loans that were moved into the bad bank related to residential and commercial real estate, while the NPLs in the Italian system are mostly related to SMEs. The complexity of these loans would probably limit the scope for a systemic solution.

Legal framework reforms needed before a bad bank would be possible. The transfer price of the NPLs is the main obstacle to the set-up of a bad bank vehicle, we think. Based on our market research, we believe the current bid on distressed loans ranges between 20-30c on the dollar (depending on the underlying collateral). With NPL coverage levels at 40% on average for secured 'sofferenze', this suggests that a large-scale bad bank may be more complicated. Any price paid above the current market price with government support would be deemed state aid and would thus trigger junior debt burden-sharing requirements.

We believe this means that, before any potential bad bank discussion, a focus on narrowing the bid-ask spread through structural reforms and lifting market bids would be required. Below we identify three ways we think this could be achieved:

1. **A more generous funding structure could reduce the bid-ask spread by c.10-15%.** Current funding for NPL purchases could be at libor +350/400bp with an average LTV of 50-60%. If leverage can be increased to 70-80% with favourable covenants, and reducing the spread closer to 100bp for example, the bid on the asset could improve from the current 20-30c on the dollar to 35-40c. We believe some form of government guarantee allowing ECB funding to be channeled could provide this type of funding condition.

2. **Legal framework changes could accelerate repossession.** Recovering the collateral value is a cumbersome and often slow process. Timing varies considerably from court to court across Italy. Average time to foreclose can be up to 7 years or more in southern regions, which we estimate could be responsible for a large proportion of the difference in the bid-ask spread. We believe measures could be taken to facilitate more out-of-court debt restructuring and change the bankruptcy law to rehabilitate distressed (but creditworthy) corporates. The government has proposed a package of judicial reforms (yet to be approved, but expected by June 2015), such as a 'fast track' procedure, reducing the number of holidays, for example. We believe a reduction in the time to workout the loan alone could improve bids on the assets by 20-25%.

3. **Tax reforms.** We think that tax incentives could make it attractive for both investors and banks, which should get a better price for their assets. This has allowed schemes in other countries such as Spain but also Japan and Sweden, to provide better prices for the assets. We believe an opportunistic fund that may currently require c.15% IRR could reduce that IRR substantially with the corporate tax and/or transaction tax waived. Additionally, tax reforms on the banks' side could help them to absorb larger discounts. Currently, loan loss provisions can only be deducted over 5 years. We see scope for this window to be shortened to 1-2 years, which would also speed up the rundown of deferred tax credits and allow banks to absorb more losses.

For more: *Italian Banks: Insight: Implications of a Bad Bank in Italy?* February 5, 2015.

What do we like? We believe UCG is the best way to play a restructuring theme, and believe the price discovery mechanism would give more credibility to the rundown of its non-core portfolio which is currently €1.7bn loss making in 2014e. UCG has underperformed ISP by >20% in the last 12 months and now trades on 0.8x P/TBV in 2015e vs. ISP at 1.4x. UCG achieves a 9% ROTE in 2017e; in our bull case where non-core losses go to zero, we see ROTE of c.10% and our PT would increase to €9.

Reform #6 – Demutualisation of *popolari* banks

What's the idea: Further market concentration is needed to unlock efficiency gains and improve profitability, especially within the midcap space. We believe the reform of the *popolari* banks removes an important hurdle for consolidation and has the potential to reduce fragmentation and improve corporate governance. We think that cost reduction as a result of consolidation could improve ROTEs by 175-260bp on average.

Italy is one of the least consolidated banking markets in Europe. With c.50 large/mid-sized banks covering 70% of the market share and the remaining 30% split between 600 small players, we think the market is too fragmented.

Addressing cost base and structural profitability. There are +31,000 branches in Italy alone, down 6% since the peak compared to a 30% reduction in Spain, for example. The *popolari* reform should contribute to a substantial reduction in branches and costs. Our branch analyser suggests network overlap could be material and banks could close on avg. 15% of branches. Consolidation could create fewer, stronger and more profitable banks. We estimate cost savings could reach 10-15% of the combined cost base in a merger of equals, which alone could increase ROTE by an average 170-260bp.

Exhibit 27

Hypothetical Cost Synergies on Average 10-15% of Combined

	Carige	MPS	BNL	BPER	BPM	BP Sondrio	Banco Popolare	Cariparma	Credem	Deutsche Bank	Intesa Sanpaolo	Unicredit	UBI	Veneto Banca
Carige	-11.2%													
MPS	-13.1%	-7.7%												
BNL	-12.4%	-14.4%	-4.3%											
BPER	-13.6%	-15.1%	-14.2%	-11.6%										
BPM	-12.6%	-12.0%	-9.8%	-12.1%	-7.4%									
BP Sondrio	-11.5%	-8.8%	-7.9%	-10.9%	-12.4%	-6.2%								
Banco Popolare	-16.8%	-19.5%	-13.9%	-14.9%	-14.0%	-12.1%	-9.5%							
Cariparma	-14.1%	-14.1%	-11.3%	-12.7%	-10.2%	-9.1%	-15.8%	-6.9%						
Credem	-10.5%	-12.0%	-10.0%	-15.1%	-8.2%	-5.5%	-13.1%	-9.9%	-2.9%					
Deutsche Bank	-13.3%	-10.4%	-9.5%	-12.9%	-10.9%	-13.5%	-12.4%	-11.5%	-7.5%	-6.7%				
Intesa Sanpaolo	-21.8%	-30.5%	-23.6%	-23.9%	-23.5%	-19.3%	-27.8%	-23.2%	-20.1%	-19.5%	-17.1%			
Unicredit	-22.6%	-31.2%	-26.0%	-25.5%	-21.8%	-20.2%	-29.8%	-23.9%	-21.9%	-20.9%	-40.6%	-18.1%		
UBI	-15.3%	-17.0%	-15.2%	-15.3%	-16.9%	-16.3%	-19.6%	-14.6%	-13.1%	-13.9%	-27.2%	-26.7%	-11.6%	
Veneto Banca	-11.2%	-12.2%	-8.0%	-11.5%	-10.5%	-7.6%	-13.9%	-8.7%	-6.9%	-8.1%	-20.3%	-21.4%	-14.7%	-4.8%

Note: For details of our methodology please refer to our note link.
Source: SNL, Morgan Stanley Research estimates

Size does matter: Industry targeting increasing average balance sheet size to €150-200bn total assets. The economic impact of achieving scale would lead Italian banks to benefit not only from efficiency gains (layoffs, IT platforms, branches) but also access to funding markets, as bond issuance has been generally limited and relatively expensive vs. large caps (pre-TLTRO). Indeed, evidence from Spain suggests that consolidation of a highly fragmented market could bring better pricing conditions on the back of markets with fewer players. Also, banks of a smaller size have faced significant difficulties in actively managing their non-performing loans. The *popolari*'s focus on traditional lending and the high reliance on collateral have encouraged sub-optimal practice, i.e., wait and collect, instead of writing off the losses and disposing of the positions. We think that the banks' increased focus on profitability as a result of the status change could facilitate NPL transactions within the sub-sector.

Exhibit 28

Sensitivity Analysis of Cost-Cutting on 2017 ROTE

2017e	UCG	ISP	PMI	UBI	BP	BMPS	Avg. Midcaps
Current ROTE	9.0%	11.8%	6.0%	6.8%	7.2%	6.5%	6.6%
Minimum improvement in ROTE (bp)	110	100	198	287	411	432	332
Maximum improvement in ROTE (bp)	110	100	267	366	517	528	420
New ROTE min. %	10.1%	12.8%	8.0%	9.7%	11.3%	10.9%	10.0%
New ROTE max. %	10.1%	12.8%	8.7%	10.5%	12.3%	11.8%	10.8%
Current P/TBV (2015e)	0.83x	1.41x	0.95x	0.86x	0.84x	0.77x	0.86x
M&A scenario							
(A) Cost cutting -10%							
ROTE new	-	-	7.4%	8.4%	9.3%	8.5%	8.4%
change, in bp	-	-	138	157	211	192	175
(B) Costs cutting -15%							
ROTE new	-	-	8.1%	9.2%	10.3%	9.4%	9.3%
change, in bp	-	-	207	236	317	288	262
Bad bank scenario							
40% discount / ROTE impact (bp)	80	40	40	90	130	140	100
50% discount / ROTE impact (bp)	110	100	60	130	200	240	158
60% discount / ROTE impact (bp)	140	150	80	170	280	360	223

No M&A scenario assumed for UCG and ISP Source: Morgan Stanley Research estimates

The reform should facilitate the entrance of large investors: could Italian foundations also play a role in *popolari* banks? Demutualising *popolari* banks is effectively a form of 'privatisation' of community-owned banks. The key decree improves the governance structure and should facilitate the entrance of large investors. We also see it as plausible that banking foundations could play an active role in the shareholding structure of *popolari* banks as the current intention from the government is to limit foundations' holdings of a single bank to 30% of their holdings, driving the need for diversification. This could be both to address limited availability of domestic capital, but mainly to serve as trustees to retain local ties and domestic control.

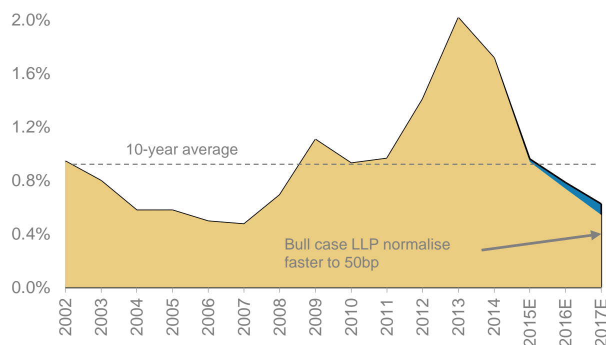
Theoretically, mergers likely to take place before conversion into joint stock co. Transformation into joint stock companies would likely happen only after the first round of M&A, to avoid hostile takeovers and allow banks to reach their targeted size (target €150-200bn in total assets has been stated by several of the *popolari* banks at our recent financials conference) (see *Italian Banks: Will AQR prompt M&A in Italian banks?* October 21, 2014).

What do we like? PMI is our preferred midcap as we think it would be better positioned in a consolidated market. Despite its relatively strong performance YTD, we like (1) its franchise value, (2) capital arbitrage from AIRB model approval of 400bp and distribution upside given solid 11.6% CET1 B3. Trading at 0.9x P/TBV for a 6% ROTE 2017e, we could see it reach 8% under a theoretical 15% cost-cutting scenario.

Theme #1: What is the bull case for Italian banks?

Roadmap to ROTE >10%? Italian banks' valuations reflect improving visibility and incorporate some reform momentum, but we believe they underestimate the potential uplift in returns from structural changes. With NPLs typically peaking 12 months after GDP bottoms, a sustained macro improvement should support the medium-term normalisation of provisions. Valuations at 0.9x 2015e P/TBV are still attractive, we think. We stay Overweight UCG, PMI and ISP. The improvement in economic growth prospects and the reforms provide upside risk to overall profitability in the banking system, we think. Our forecasts assume a reduction in loan loss provisions from a peak of 175bp in 2014 to 60bp in 2017. This is not yet at pre-crisis levels as with an NPL ratio of 17% for the system and some banks at 30%, the normalisation will take time, we think.

Exhibit 29
Gradual Normalisation of LLP Towards 50-60bp



Source: Company Data, Morgan Stanley Research estimates (E)

However, a sustained economic recovery driven by ongoing structural reforms has the potential to surprise positively, we think. If we assume pre-crisis levels of provisioning of 40-60bp vs. the 50-80bp we currently factor in for 2017e, we estimate >10% upside on average to our estimates.

Exhibit 30
A Return to Pre-Crisis Levels Would Drive a 100bp RoTE Improvement

2017	LLP base	LLP pre-crisis	RoTE base	New RoTE	% earnings	P/TBV '15
BP	0.70%	0.50%	7.2%	8.9%	24.8%	0.84x
PMI	0.60%	0.50%	6.0%	6.5%	8.5%	0.95x
ISP	0.70%	0.50%	11.9%	13.2%	11.1%	1.41x
UCG	0.52%	0.50%	9.0%	9.0%	0.0%	0.81x
BMPS	0.80%	0.60%	6.5%	8.3%	27.9%	0.40x
UBI	0.60%	0.50%	6.8%	7.7%	12.7%	0.85x

Source: Morgan Stanley Research estimates

Although in theory BP and BMPS are most geared into the economic recovery, visibility on asset quality remains low for both names and we see a more balanced risk reward to play a recovery via UCG.

UCG best way to gain exposure to asset quality turnaround. We believe UCG is the best way to play the Italian recovery story. UCG has underperformed ISP by c.30% over the last 12 months and now trades on 0.8x P/TBV in 2015e compared with ISP at 1.4x. We think the price discovery mechanism arising from the legal reforms, including the creation of a bad bank, would give more credibility to the rundown of its non-core portfolio which is currently €1.7bn loss making in 2014. Our PT is €6.75 for an implied 0.9x P/TBV.

€9.0 Bull Case 2017e 1.1x TBV. In our bull case**,** we see loan loss provisions decreasing from 90bp in 2014 to 54bp in 2017e. With non-core losses down to zero, we believe ROTE could reach 10% by 2017e vs. our base case of 9.0%. Our bull case fair value is €9.0 for an implied 1.1x P/TBV.

PMI our preferred midcap as we think it would be better positioned in a consolidated market. PMI continues to screen as most attractive among the midcaps, in our view. Despite its relatively strong performance >75% YTD, we continue to like it on solid franchise value – we think it is best positioned to benefit from the *popolari* status change and we see it as a beneficiary of potential M&A given profitability from cost cutting. Its resilient capital position – CET1 B3 at 11.6% – and better than peers' asset quality, provide upside potential to its cash return story, we argue. Also, the fact that it is still operating on standard models implies 400bp higher capital potential longer term as it migrates to advanced models (AIRB). Our PT is €1.0 for an implied 1x P/TBV.

€1.20 Bull Case 2017e 1.2x TBV. NII troughs in 2014 and grows at 2.5% CAGR (2014-17e).The pick-up is due to improving margins and higher volumes (loans increase at 2.8% CAGR in 2014-17e). Total revenues rise by 1.1% CAGR in 2014-17e. PPOP grows by 7% CAGR over the same period compounded by 10% cost reduction. Loan loss provisions continue to decrease from 2013 peak of 170bp and improve substantially by 2017 to 50bp. ROTE reaches 8.5% by 2017 vs. our base case of 6.0%, and there is 400bp of capital benefit from migration into AIRB. Our bull fair value is €1.20 for an implied 1.2x P/TBV.

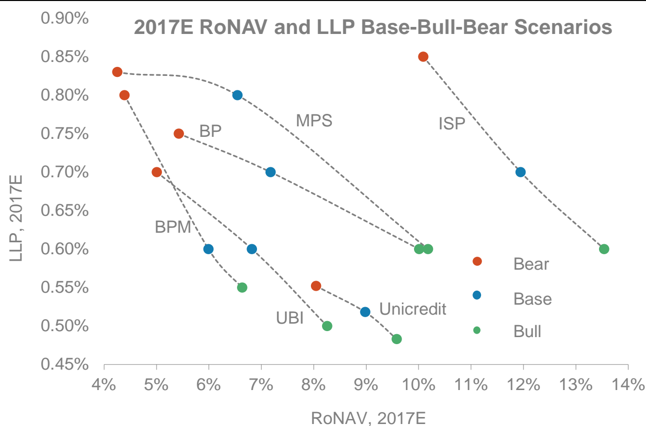
ISP's ability to pay dividends and grow AuM remains key bellwether. ISP is the only bank in Italy we expect to cover its cost of equity in the base case with an 11.9% RoTE 2017e,

and with a 12.7% CET1 B3 as of 4Q14. We believe this means it will be able to pay 50-75% dividend payouts over 2015-17 and it is currently yielding 5.3% in 2016e. As ISP continues to successfully replace time deposits into indirect deposits in the form of AuM (19% of system flows in Feb-15), fee income is likely to continue to support the top line. We forecast fee growth of 7.6% CAGR 2014-17. Our PT is €3.30 for an implied 1.5x P/TBV.

€4.30 Bull Case 2017e 1.9x TBV. In our bull case we see NII growing at 2% CAGR 2014-17. The pick-up is on the back of better volumes (loans increase at 2%) and better cost of funding. Loan loss provisions continue to decrease from 2013 peak of 197bp and improve substantially by 2017e to 50bp. We forecast ROTE to increase from 11.9% in our base case to 13.5% by 2017e. Our bull case fair value is €4.30 for an implied 1.9x P/TBV.

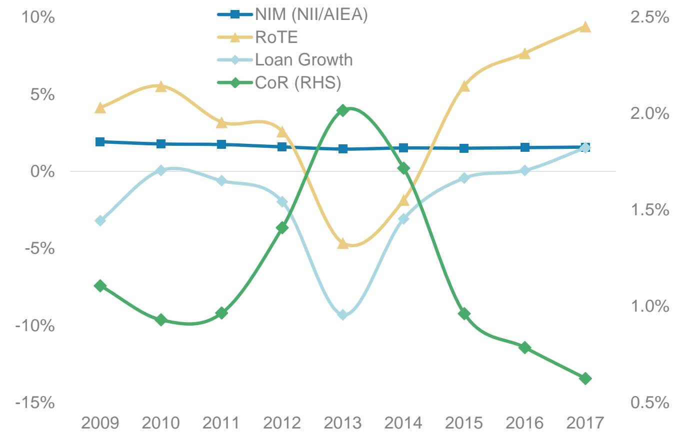
What are the risks around DTAs? In Italy, c.60% of DTCs were generated due to timing differences arising from loan loss provisions, which now have to be deducted from a fiscal stand point over five years and the rest from goodwill impairments. We expect further fiscal reforms in Italy, which could reduce the 5-year time horizon accelerating the rundown of DTCs. The faster rundown of DTCs and the lower individual bank impact make us think that even in the event that these are ruled as government aid the overall impact would be manageable. For ISP and PMI, we think the impact will be in any case minimal by 2017-18, and it is at BP and BMPS where we see DTCs' contribution as highest based on 2014 FY disclosure (see *Banks: DG COMP investigation steps up pressure on DTAs*, April 8, 2015).

Exhibit 31
Normalisation of Provisions Is Key for More Upside



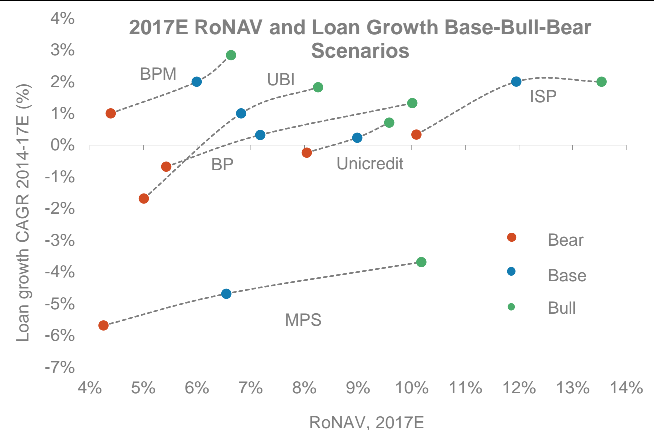
Source: Morgan Stanley Research estimates

Exhibit 32
For ROTE to Improve: Further Drop in LLP



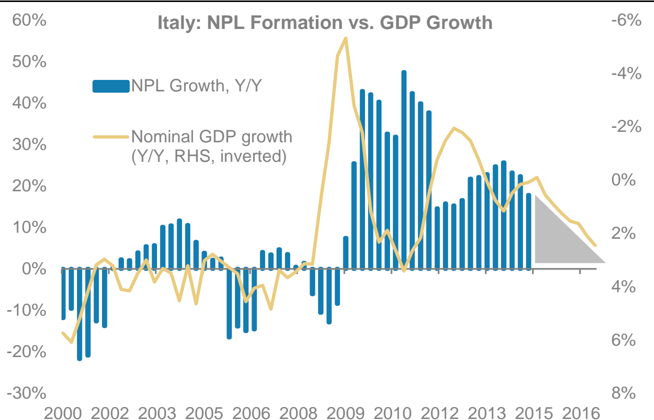
Source: Company Data, Morgan Stanley Research estimates (2015-17e)

Exhibit 33
Our Bull Case Is for 2-3% Loan Growth by 2017



Source: Morgan Stanley Research estimates

Exhibit 34
NPLs Are Linked to GDP growth (Now Troughing)



Source: Company Data, Morgan Stanley Research

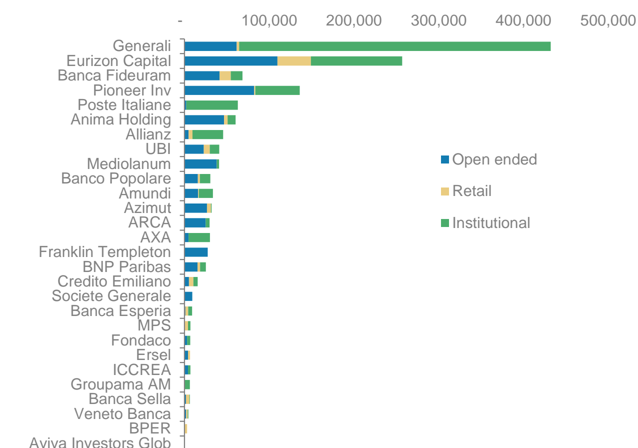
Theme #2 – Revenue resilience in a low rate environment

Ultra low rates and flat curves are important headwinds for banks' net interest margins. Italian banks have higher fee income due to their larger asset management/ bancassurance arms vs. their European counterparts. We think this provides more resilience in revenues and could be a source of positive surprises.

As banks continue to re-price and substitute the expensive household funding raised in recent years with cheaper rates, households are incrementally investing in asset management products, which is driving fee growth (managed savings fees are more than offsetting lower traditional banking fees).

The flow into mutual funds totaled €29bn YTD, and AuM have reached an historical peak of €1.7tn. ISP and UCG have gathered c.50% of the flow YTD. Besides ISP and UCG, which benefit from strong AM platforms, we think UBI and PMI can also (i) continue to migrate retail bonds into AuM products successfully and (ii) rely on solid distributional franchises.

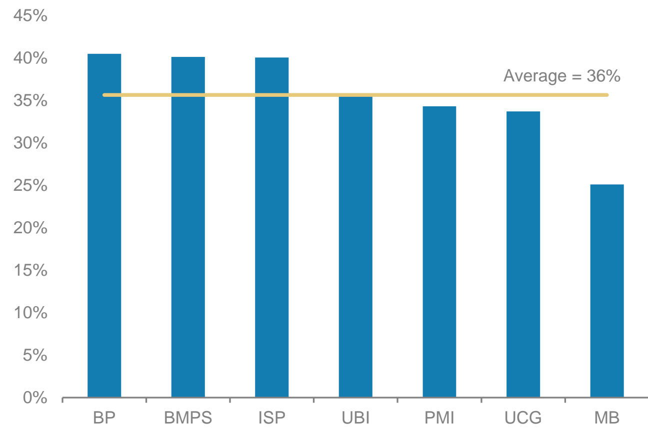
Exhibit 35
Solid AuM Growth at ISP Driven by Retail



Note: € million. Source: Assogestioni, Morgan Stanley Research; Note: ISP = Eurizon + Fideuram, UCG = Pioneer, Anima owned 16.8% by PMI and 10.3% by BMPS as of April 10, 2015

Historically, there's been a low penetration rate of pension funds/life products, which we think is set to change.

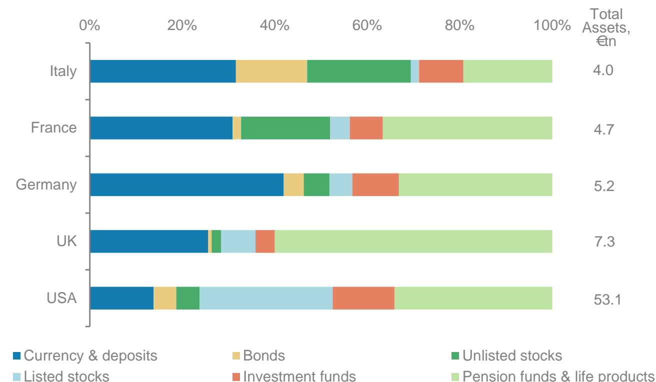
Exhibit 36
Commission Income as a % of Revenues, 2014



Source: Company Data, Morgan Stanley Research

The new driver for AuM growth could come from pension funds and life products, which remain structurally low in Italy. Life products are mainly sold through banks and post offices in Italy, with ISP best positioned to benefit from a pick-up in inflows through Intesa Vita (#1 largest life insurer in Italy), we believe.

Exhibit 37
Low Penetration of Pension Funds and Life Products Provides for Upside Potential



Source: Assogestioni, Morgan Stanley Research

What do we like? ISP has good earnings visibility and a solid capital position with CET1 B3 of 13% and a clear commitment to return cash to shareholders. The top line is driven by fee-generating activity on strong AuM inflows, which should allow ISP to reach 11.9% ROTE in 2017e. ISP trades on 13x P/E 2016e which is still attractive we believe if seen as a gateway to gain exposure to the Italian asset managers (at 15-16x EPS 16e).

Current prices (16/4/2015): Unicredit €6.21, Banca Popolare di Milano €0.93, Intesa SanPaolo S.p.A. €3.10, Banco Popolare €13.94, Banca Monte dei Paschi di Siena €0.60, Snam €4.74

Valuation methodology and risks

Banca Popolare di Milano

We use a Gordon growth model per division on 2017e earnings and use three scenarios based on different underlying macro outcomes. We weight the outcome 80% to the base case, 10% bear case and 10% bull case. We assume a CoE of 9%.

Risks: 1) Failure to change popolari status. 2) The resurgence of a political risk premium in Italy could affect the stock's valuation. 3) Volatility in Italian sovereign spreads will likely continue to affect valuation both positively and negatively.

Unicredit

We use a Gordon growth model per division on 2017e earnings and use three scenarios based on different underlying macro outcomes. We weight the outcome 80% to the base case, 10% bear case and 10% bull case. We assume a CoE of 10.9%.

Risks: 1) A more severe recession in Italy could result in higher LLPs than expected. 2) The resurgence of a political risk premium in Italy could affect the stock's valuation. 3) Volatility in Italian sovereign spreads will likely continue to affect valuation both positively and negatively.

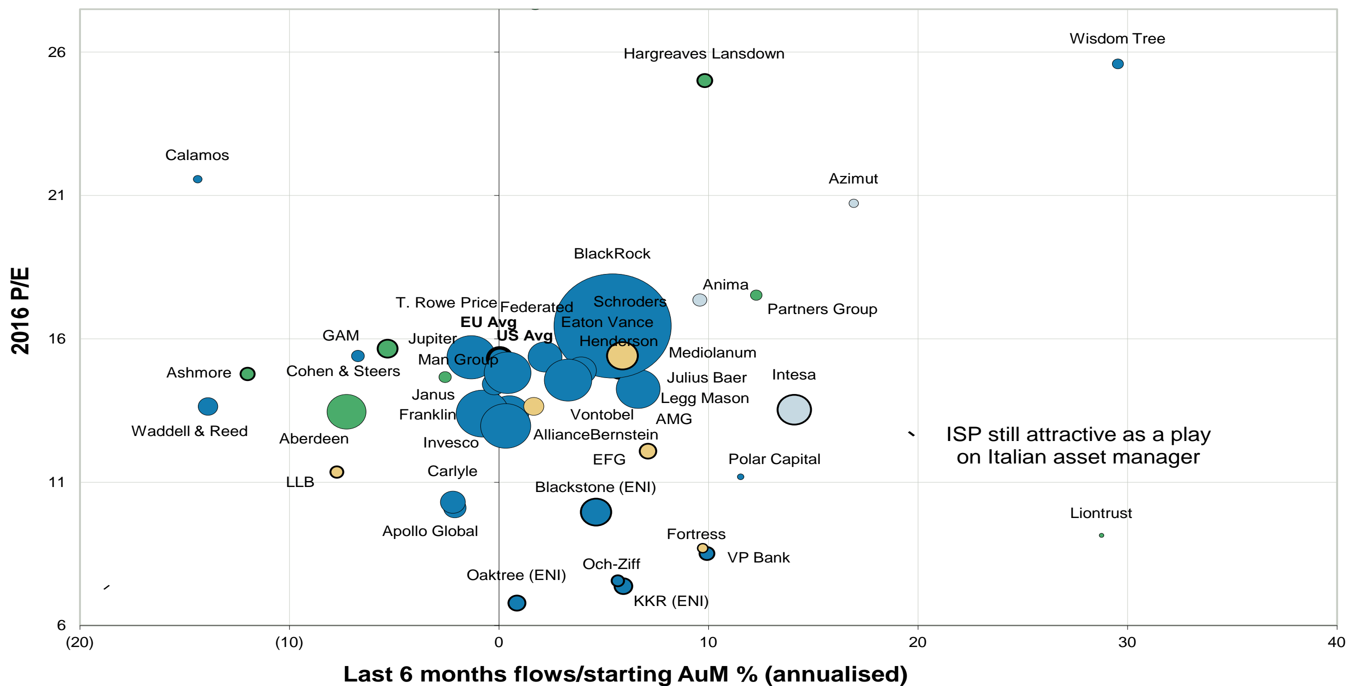
Intesa SanPaolo

We use a Gordon growth model per division on 2017e earnings and use three scenarios based on different underlying macro outcomes. We weight the outcome 80% to the base case, 10% bear case and 10% bull case. We assume a CoE of 9%.

Risks: 1) The resurgence of a political risk premium in Italy could affect the stock's valuation. 2) Volatility in Italian sovereign spreads will likely continue to affect valuation both positively and negatively.

Exhibit 38

ISP Still Attractive as an Asset Manager Play



Source: Thomson Reuters, Company Data, Assogestioni, Morgan Stanley Research estimates. Share price as of close on 15th April 2015. EPS based on Morgan Stanley Research estimates for Aberdeen, Ashmore, Intesa Sanpaolo, Julius Baer, Partners Group, Man, Schroders, Henderson, Hargreaves Lansdown, Alliance Bernstein, Franklin, Blackrock, Federated, Invesco, Janus, T.Rowe, Waddell & Reed, Wisdom Tree; others are Thomson Reuters consensus. Where possible 6m ending Dec14 /Sep14 / June 14 flows used. P/E is calculated using calendarised EPS. AuM latest reported. Intesa's assets under management based on Assogestioni data on Eurizon and Fideuram. Bubble size = assets under management.

Exhibit 39

Economic Forecasts at a Glance (% Unless Otherwise Indicated)

	2012A	2013A	2014A	2015E	2016E	2017-19E
Real GDP	-2.8	-1.7	-0.4	0.7	1.7	1.2
Private Consumption	-4.0	-2.8	0.3	1.1	1.7	
Government Consumption	-1.2	-0.3	-1.0	0.5	0.4	
Gross Fixed Investment	-9.4	-5.8	-3.2	0.8	3.3	
Construction	-11.5	-6.1	-4.4	-0.8	0.8	
Contribution to GDP Growth (%)						
Final Domestic Demand	-4.5	-2.8	-0.6	0.9	1.6	
Net Exports	2.8	0.8	0.3	0.3	0.1	
Inventories	-1.1	0.3	-0.1	-0.5	0.0	
Employment	0.0	-1.6	0.6	0.7	0.8	
Unemployment Rate (% of Labour Force)	10.6	12.2	12.7	12.1	11.9	
Inflation (CPI)	3.0	1.2	0.2	0.3	1.5	1.5
Current Account Balance (% of GDP)	-0.4	1.0	1.9	2.2	1.4	
General Government Balance (% of GDP)	-3.0	-2.8	-3.0	-2.7	-2.1	
Primary Government Balance (% of GDP)	2.2	2.0	1.6	1.8	2.3	
General Government Debt (% of GDP)	122.2	127.9	131.9	133.0	131.2	
Net Government Debt (% of GDP)	111.1	117.4	120.4	N/A	N/A	

Source: Istat, Morgan Stanley Research

E = Morgan Stanley Research estimates

Exhibit 40

Quarterly GDP and Inflation Profile

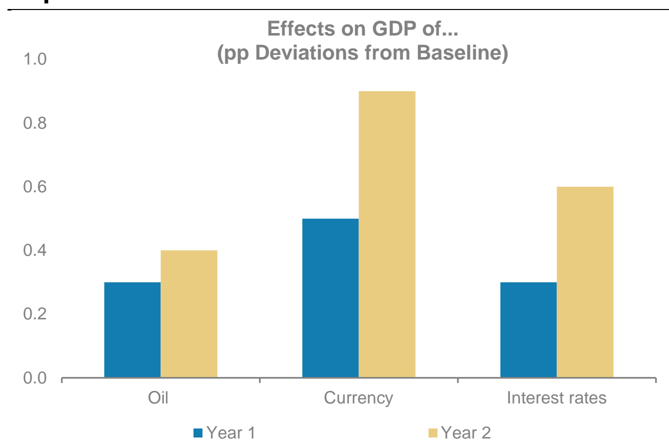
	1Q-14	2Q-14	3Q-14	4Q-14	1Q-15	2Q-15	3Q-15	4Q-15	1Q-16	2Q-16	3Q-16	4Q-16
Real GDP (%, SAAR)	-0.5	-0.8	-0.5	-0.1	0.6	1.5	2.0	1.8	1.4	1.6	1.8	2.0
CPI (%, Y/Y)	0.5	0.4	-0.1	0.1	-0.2	0.2	0.4	0.8	1.2	1.2	1.6	1.9

Source: Istat, Morgan Stanley Research

E = Morgan Stanley Research estimates

Exhibit 41

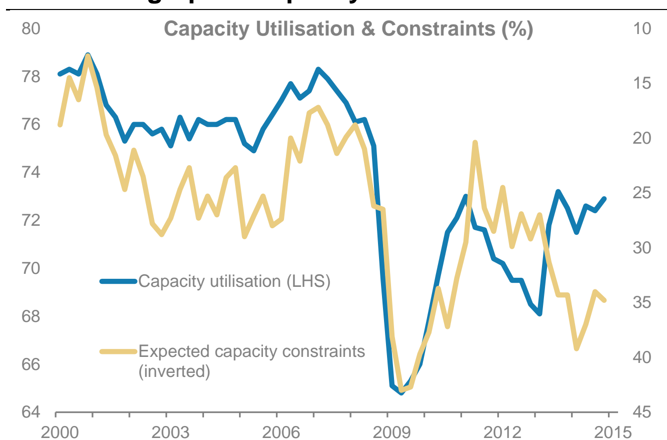
Impact of External Drivers on Growth



Note: The simulations assume a 50% decline in oil prices, 10% depreciation in the EUR trade-weighted exchange rate, and 100bp fall in short-term and long-term interest rates.
Source: Oil and currency sensitivities are based on Dalsgaard, André, and Richardson (2001), *Standard Shocks in the OECD Interlink Model*, OECD Economics Department Working Paper No.306; interest rate sensitivity is based on Fagan and Morgan (2005), *Econometric Models of the Euro-Area Central Banks*, Morgan Stanley Research

Exhibit 42

Diminishing Spare Capacity



Note: For expected capacity constraints, negative balances mean that capacity is less than sufficient, thus indicating high levels of capacity utilisation taking into account order books and production, and vice versa.
Source: European Commission, Morgan Stanley Research

Exhibit 43

European Banks: Valuation Comparisons

Company name 17 Apr 15	MS Rating	Mkt cap (€bn)	Curr.	Price	Price Target	Up/Down side	P/E 2014	P/E 2015E	P/E 2016E	P/E 2017E	P/NAV 2014	P/NAV 2015E	P/NAV 2016E	P/NAV 2017E	RoTNAV 2014	RoTNAV 2015E	RoTNAV 2016E	RoTNAV 2017E	Div Yld 2014	Div Yld 2015E	Div Yld 2016E	Div Yld 2017E	1W	1M	3M	12M	YTD
							Price to earnings (MS Estimates)				P/NAV (MS Estimates)				RoTNAV (MS Estimates)				Div Yld (MS Estimates)				Stock Performance				
France		165.3					11.6x	11.9x	10.6x	9.6x	1.1x	1.0x	1.0x	0.9x	9.6%	8.9%	9.5%	10.1%	3.2%	3.8%	4.5%	5.1%					
BNP Paribas	E	70.2	EUR	56.3	61.0	8%	10.4x	11.2x	10.1x	9.2x	1.0x	1.0x	0.9x	0.9x	9.9%	8.9%	9.3%	9.8%	3.0%	3.5%	4.1%	4.9%	-2%	8%	22%	3%	14%
Societe Generale	E	36.7	EUR	45.6	45.2	-1%	10.5x	10.9x	9.9x	8.7x	0.9x	0.9x	0.8x	0.8x	9.0%	8.3%	8.8%	9.7%	3.4%	3.5%	4.5%	5.2%	-1%	7%	34%	6%	30%
Credit Agricole	E	35.5	EUR	13.8	14.8	7%	10.9x	10.9x	9.6x	8.9x	1.0x	1.0x	0.9x	0.9x	10.3%	9.0%	9.8%	10.1%	3.3%	4.5%	5.1%	5.5%	-3%	4%	29%	21%	28%
Natixis	O	22.9	EUR	7.4	7.6	3%	18.6x	17.1x	14.9x	13.2x	1.6x	1.6x	1.6x	1.5x	8.8%	9.4%	10.7%	11.6%	2.9%	3.8%	4.4%	5.0%	0%	11%	34%	40%	34%
Benelux		78.1					15.4x	12.1x	11.3x	10.7x	1.3x	1.3x	1.2x	1.1x	5.7%	10.8%	11.1%	10.9%	2.1%	2.6%	4.6%	5.0%					
ING	O	53.4	EUR	13.8	14.8	7%	NM	12.1x	11.1x	10.4x	1.1x	1.1x	1.0x	1.0x	1.8%	9.1%	9.4%	9.6%	1.1%	3.8%	4.2%	4.7%	-2%	2%	26%	38%	28%
KBC	E	24.7	EUR	59.1	57.8	-2%	15.4x	12.3x	11.9x	11.5x	1.7x	1.9x	1.6x	1.5x	14.3%	14.5%	14.6%	13.8%	4.3%	0.0%	5.5%	5.8%	0%	3%	28%	34%	27%
Germany		14.3					31.4x	15.9x	11.3x	NA	0.6x	0.6x	0.6x	NA	2.0%	3.8%	5.1%	NM	0.0%	0.0%	3.5%	NA					
Commerzbank	O	14.3	EUR	12.6	14.8	18%	31.4x	15.9x	11.3x	NA	0.6x	0.6x	0.6x	NA	2.0%	3.8%	5.1%	NM	0.0%	0.0%	3.5%	NA	-5%	0%	19%	-4%	14%
Greece		7.4					15.6x	20.5x	4.4x	2.5x	0.3x	0.3x	0.3x	0.2x	-11.7%	-1.2%	6.4%	9.7%	0.0%	0.0%	0.0%	0.0%					
Alpha Bank	E	2.8	EUR	0.2	0.6	150%	42.8x	NM	5.7x	2.9x	0.3x	0.3x	0.3x	0.3x	0.7%	0.3%	5.8%	10.6%	0.0%	0.0%	0.0%	0.0%	-18%	-28%	-51%	-68%	-53%
Eurobank Ergasias	E	2.2	EUR	0.1	0.2	133%	-1.2x	-5.0x	4.6x	2.8x	0.2x	0.3x	0.2x	0.2x	-17.9%	-5.1%	5.5%	8.4%	0.0%	0.0%	0.0%	0.0%	-23%	-13%	-49%	-78%	-54%
Piraeus	E	2.4	EUR	0.3	1.0	264%	-0.9x	44.4x	2.6x	1.9x	0.2x	0.2x	0.2x	0.2x	-20.8%	0.5%	7.9%	10.0%	0.0%	0.0%	0.0%	0.0%	-22%	-28%	-70%	-85%	-71%
Investment banks		155.2					13.1x	12.3x	10.3x	9.3x	1.3x	1.3x	1.2x	1.2x	10.2%	10.8%	12.2%	12.7%	3.6%	3.5%	5.1%	6.1%					
UBS	O	69.3	CHF	19.1	21.0	10%	15.2x	14.7x	11.5x	10.3x	1.6x	1.7x	1.5x	1.5x	11.1%	11.2%	14.0%	15.0%	4.6%	4.7%	7.9%	9.4%	0%	7%	38%	7%	12%
Deutsche Bank	E	43.8	EUR	31.7	36.0	13%	9.3x	9.1x	9.1x	8.1x	0.8x	0.8x	0.7x	0.6x	9.2%	9.1%	8.0%	7.8%	3.0%	2.4%	3.2%	3.2%	-4%	4%	28%	4%	27%
Credit Suisse	E	42.1	CHF	26.9	29.0	8%	13.7x	11.5x	9.6x	8.6x	1.3x	1.4x	1.3x	1.1x	9.7%	11.8%	13.7%	13.7%	2.8%	2.6%	2.6%	3.7%	-1%	8%	44%	-2%	7%
Ireland		11.7					17.7x	15.1x	11.5x	11.3x	1.7x	1.5x	1.3x	1.2x	9.9%	10.3%	12.2%	11.4%	0.0%	0.0%	0.0%	4.4%					
Bank of Ireland	E	11.7	EUR	0.4	0.4	1%	17.7x	15.1x	11.5x	11.3x	1.7x	1.5x	1.3x	1.2x	9.9%	10.3%	12.2%	11.4%	0.0%	0.0%	0.0%	4.4%	0%	1%	18%	29%	15%
Italy		114.7					23.9x	16.3x	13.0x	10.3x	1.1x	1.1x	1.0x	1.0x	3.2%	6.3%	8.3%	9.9%	2.4%	3.0%	3.9%	5.4%					
Intesa SPI	O	51.7	EUR	3.1	3.3	7%	31.9x	16.8x	13.2x	11.1x	1.4x	1.4x	1.3x	1.3x	4.4%	8.3%	10.3%	11.9%	2.9%	4.2%	5.3%	6.3%	-3%	0%	24%	28%	28%
UniCredit	O	36.5	EUR	6.2	6.8	9%	16.7x	14.8x	10.4x	8.2x	0.8x	0.8x	0.8x	0.7x	5.1%	5.5%	7.4%	9.0%	2.2%	2.4%	2.8%	5.4%	-4%	0%	19%	-3%	16%
Mediobanca	U	7.6	EUR	8.8	7.2	-18%	16.9x	18.6x	14.8x	12.2x	1.1x	1.0x	1.0x	0.9x	6.7%	5.7%	6.8%	7.9%	2.1%	2.3%	2.9%	3.5%	-4%	2%	29%	10%	30%
UBI Banca	E	6.6	EUR	7.4	7.3	-1%	36.0x	21.8x	15.2x	11.8x	0.8x	0.8x	0.8x	0.8x	2.4%	3.9%	5.5%	6.8%	1.3%	1.7%	2.9%	4.2%	-3%	5%	32%	5%	24%
Banco Popolare	E	5.0	EUR	13.9	12.8	-8%	-3.0x	24.4x	13.5x	10.9x	0.8x	0.8x	0.8x	0.8x	-28.1%	3.4%	6.0%	7.2%	0.0%	0.0%	3.0%	4.5%	-3%	-2%	45%	-9%	39%
Monte dei Paschi	U	3.1	EUR	0.6	0.4	-34%	-0.7x	-10.0x	23.9x	5.4x	0.7x	0.4x	0.4x	0.3x	NM	-5.0%	1.6%	6.8%	0.0%	0.0%	0.0%	0.0%	-3%	5%	32%	-59%	28%
Banca Popolare di Milano	O	4.1	EUR	0.93	1.00	8%	30.7x	20.4x	16.8x	14.7x	0.9x	0.9x	0.9x	0.9x	3.4%	4.5%	5.4%	6.0%	4.0%	2.5%	3.0%	3.4%	-2%	-1%	56%	51%	71%
Nordics		175.7					19.2x	13.3x	12.7x	12.0x	1.8x	1.7x	1.7x	1.6x	12.9%	13.2%	13.2%	13.5%	4.9%	4.9%	5.7%	5.9%					
Nordea	E	47.7	SEK	108.8	110.0	1%	14.3x	13.2x	12.6x	11.9x	1.8x	1.7x	1.7x	1.6x	12.6%	13.2%	13.3%	13.7%	6.4%	5.8%	6.1%	6.4%	0%	-3%	21%	21%	20%
Svenska Handelsbanken	E	26.3	SEK	382.6	375.0	-2%	16.4x	16.2x	15.9x	15.2x	2.1x	2.0x	2.0x	1.9x	13.6%	12.7%	12.6%	12.7%	4.8%	4.7%	4.8%	5.0%	-3%	-8%	5%	18%	4%
Swedbank	E	25.0	SEK	203.8	210.0	3%	13.2x	13.5x	13.1x	12.6x	2.2x	2.1x	2.0x	2.0x	17.0%	15.9%	15.8%	15.7%	5.8%	5.6%	5.8%	5.9%	-1%	-7%	10%	21%	4%
SEB	O	24.2	SEK	101.6	120.0	18%	11.5x	13.3x	12.8x	12.0x	1.9x	1.8x	1.8x	1.7x	17.4%	14.1%	14.1%	14.6%	4.8%	5.7%	5.9%	5.9%	0%	-5%	6%	18%	2%
DNB	O	26.8	NOK	137.1	145.0	6%	10.9x	11.0x	10.6x	9.7x	1.5x	1.4x	1.3x	1.2x	14.2%	12.8%	12.4%	12.8%	3.4%	3.6%	4.7%	5.1%	0%	7%	32%	37%	24%
Danske Bank	E	25.7	DKK	190.0	190.0	0%	53.1x	12.8x	11.5x	10.8x	1.4x	1.3x	1.3x	1.2x	2.7%	10.6%	11.4%	11.7%	3.3%	3.4%	6.3%	6.8%	0%	9%	17%	27%	14%
Spain		224.4					21.5x	15.3x	11.7x	10.4x	1.4x	1.4x	1.3x	1.2x	8.2%	10.0%	11.4%	11.9%	5.7%	2.9%	3.5%	4.2%					
Santander	E	97.2	EUR	6.8	6.5	-4%	14.3x	13.3x	11.6x	10.4x	1.6x	1.5x	1.3x	1.2x	11.9%	12.0%	12.0%	12.3%	8.9%	3.0%	3.2%	4.0%	-2%	7%	15%	4%	1%
BBVA	O	59.5	EUR	9.4	10.0	6%	22.8	14.0	10.7	9.5	1.4	1.5	1.3	1.2	6.7%	10.4%	13.0%	13.6%	4.6%	3.6%	3.7%	4.0%	-1%	5%	27%	10%	22%
Caixabank	E	25.1	EUR	4.4	4.3	-1%	39.6x	18.5x	11.7x	10.1x	1.2x	1.2x	1.1x	1.1x	3.0%	6.5%	9.8%	10.8%	3.1%	2.8%	4.4%	5.1%	-1%	6%	6%	0%	1%
Bankia	E	14.5	EUR	1.3	1.5	19%	19.4x	11.7x	9.5x	8.8x	1.2x	1.1x	1.0x	1.0x	6.2%	9.6%	11.1%	11.5%	1.4%	2.8%	4.4%	5.9%	-1%	-5%	4%	-16%	2%
Popular	U	9.7	EUR	4.6	3.8	-18%	33.7x	35.1x	16.9x	13.4x	1.0x	0.9x	0.9x	0.8x	2.9%	2.7%	5.4%	6.4%	0.9%	1.1%	2.4%	3.3%	-1%	15%	17%	-15%	11%
Sabadell	E	11.9	EUR	2.3	1.9	-17%	27.0	18.1	13.6	12.2	1.0	1.0	1.0	0.9	4.0%	5.7%	7.3%	7.8%	1.1%	1.8%	3.1%	4.0%	0%	14%	11%	12%	15%
Bankinter	U	6.4	EUR	7.1	6.6	-7%	23.3x	17.3x	15.7x	14.5x	1.9x	1.8x	1.7x	1.7x	8.5%	10.7%	11.3%	11.7%	2.3%	2.9%	3.3%	3.6%	1%	4%	9%	25%	6%
UK		199.3					11.4x	12.0x	12.7x	10.7x	1.1x	1.1x	1.1x	1.0x	11.4%	10.1%	9.7%	10.3%	1.2%	1.8%	2.7%	3.5%					
Lloyds BG	O	79.4	GBp	79.9	99.6	25%	9.9x	10.0x	10.0x	9.8x	1.5x	1.4x	1.3x	1.2x	15.9%	14.3%	13.5%	12.9%	1.0%	2.7%	4.7%	6.2%	1%	1%	7%	8%	5%
TSB BG	E	2.3	GBp	335.1	339.9	1%	15.9x	21.5x	14.9x	18.5x	1.0x	1.0x	0.9x	0.9x	7.2%	4.7%	6.4%	4.8%	0.0%	0.0%	0.0%	2.3%	0%	3%	22%	29%	20%
Barclays Bank	O	60.7	GBp	260.3	333.2	28%	15.3x	13.4x	10.6x	9.3x	0.9x	0.9x	0.9x	0.9x	6.1%	6.9%	8.6%	9.5%	2.7%	2.5%	2.7%	2.7%	1%	4%	16%	6%	7%
Royal Bank of Scotland	E	56.8	GBp	354.5	391.6	10%	8.9x	12.5x	18.2x	12.9x	0.9x	0.9x	1.0x	1.0x	10.6%	7.4%	5.3%	7.5%	0.0%	0.0%	0.0%	0.7%	2%	1%	-2%	17%	-10%
UK/Asia		199.6					10.9x	12.9x	11.8x	10.6x	1.1x	1.1x	1.1x	1.1x	10.5%	8.7%	9.5%	10.3%	5.4%	5.3%	5.4%	5.5%					
HSBC	E	162.9	GBp	606.8	600.0	-1%	10.8x	12.8x	11.7x	10.6x	1.2x	1.2x	1.1x	1.1x	10.9%	9.1%	9.8%	10.6%	5.3%	5.6%	5.7%	5.8%	-1%	6%	2%	-2%	0%
Standard Chartered	U	36.7	GBp	1,064.0	870.0	-18%	11.3x	13.6x	12.0x	10.2x	1.0x	1.0x	0.9x	0.9x	8.8%	7.2%	8.0%	9.0%	5.7%	3.7%	3.9%	4.0%	-4%	10%	18%	-20%	10%
Austria		14.8					-16.1x	17.0x	8.0x	7.0x	1.0x	1.0x	0.9x	0.8x	-12.4%	6.7%	11.5%	11.7%	0.0%	0.9%	0.9%	1.7%					
Erste Bank	O	10.4	EUR	24.1	25.0	4%	-7.0x	13.9x	8.4x	7.5x	1.2x	1.1x	1.0x	0.9x	-17.1%	8.4%	12.7%	12.8%	0.0%	1.2%	1.2%	2.5%	0%	4%	24%	-2%	25%
Raiffeisen International	E	4.5	EUR	15.2	11.2	-26%	-37.4x	24.3x	7.1x	5.9x	0.6x	0.6x	0.6x	0.5x	-1.5%	2.6%	8.5%	9.2%	0.0%	0.0%	0.0%	0.0%	3%	26%	52%	-34%	21%
ALL European		1,360.5				6%	14.9	13.3	11.7	10.3	1.28	1.25	1.19	1.13	9.0%	9.7%	10.6%	11.1%	3.7%	3.4%	4.3%	4.9%					
All Europe ex UK/Asia		1,160.9				8%	15.6	13.4	11.7	10.2	1.31	1.28	1.20	1.14	8.8%	9.9%	10.8%	11.3%	3.4%	3.1%	4.1%	4.8%					
Eurozone Banks		674.5				5%	16.0	13.9	11.3	9.7	1.20	1.16	1.08	1.01	6.7%	8.8%	10.0%	10.5%	3.5%	2.9%	3.8%	4.5%					
Nordics, Swiss, UK/Asia		486.6				2%	14.7	13.2	11.9	10.9	1.46	1.44	1.38	1.33	11.4%	11.0%	11.8%	12.4%	4.9%	4.8%	5.6%	6.1%					

E = Morgan Stanley Research estimates; Source: Company data, Morgan Stanley Research

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(as of March 31, 2015)

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Total	**3,335**		**775**		

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The Americas
1585 Broadway
New York, NY 10036-8293
United States
Tel: +1 (1) 212 761 4000

Europe
20 Bank Street, Canary Wharf
London E14 4AD
United Kingdom
Tel: +44 (0) 20 7 425 8000

Japan
1-9-7 Otemachi, Chiyoda-ku
Tokyo 100-8104
Japan
Tel: +81 (0) 3 6836 5000

Asia/Pacific
1 Austin Road West
Kowloon
Hong Kong
Tel: +852 2848 5200

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