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Suggested intra sector Italian pair trades for our cautious stance ahead of elections

Sector	Long	Short
Banks	PMI, UBI	ISP
Asset Gatherers	Azimut	MED, BGN
TMT	EI Towers	Mediaset
Oil	ENI	Saipem
Branded Goods	Ferragamo, Prada	Geox
Industrials	Fiat	Finmeccanica

Source: Mediobanca securities

What if we are wrong? Core holdings in case of government delivery, by theme

Theme	Stocks to Own
IMU tax cut	Beni Stabili
IVA tax cut	Autogrill, De Longhi
IRAP tax cut	MPS, UBI, Espresso, Mondadori
Tax credit on advertising	Mediaset, Espresso
Export incentive	FIAT, Fiat Industrial, Ferragamo, Prada, Luxottica
Real estate disposal	Beni Stabili
Spread narrowing	MPS, MED, Generali, BGN, Beni Stabili
Foundations 'shake up'	ISP, MPS
Bad bank	UCG, MPS, BP
Popolari governance	PMI, UBI, BPER, BP
Lower LLP from growth initiatives	MPS, UBI, BP, UCG
TMT network spin off regulation	Telecom Italia
Management change	ENI

Source: Mediobanca securities

Elections approaching, uncertainty rising

New elections needed in medium term the most likely scenario

What back in November seemed an easy victory for a standalone Democrats-led government is now simply not on the cards. Our base case is for a weak Bersani + Monti coalition potentially needing to be enlarged to take in other minor parties. This would clearly not generate a strong government: as Italian history shows the larger the coalition, the weaker its effectiveness. New elections might be in sight soon.

Berlusconi and Five Star the tail risk – OMT the bad news for Germany

Berlusconi is in a recovery trend and Five Star seems set to end up the real winner of these elections with around 20% of the votes. Such double tail risk actually creates the paradox of potential good news to us. It could actually scare the market and put pressure on the spread so to offer Italy the perfect excuse for what we keep seeing as the best way out for its unsustainably high public debt: applying for Draghi's OMT programme and putting Germany at the corner ahead of its own elections.

Spread does not say all – watch the yield gap BTPs vs BOTs

In contrast to bonds, T-Bills do not take part in any debt re-profiling in the event of default due to their short-term tenure. Hence, the yield gap between BTPs and BOTs of similar maturity is currently a better proxy of solvency risk than the spread per se, given the OMT back-up. Such a gap averaged 2 bps at end-2006, increased to 7bps at the start of the crisis, and reached 71bps at its height. The 18bps gap today is some 54% of the average 34bps yield offered by BOTs of the same maturity, and compares with 25% pre-OMT. Not only is the market not closing an easy arbitrage, but in relative terms it is asking a higher premium on BTPs vs BOTs of the same maturity than pre-OMT. Solvency risk is here to stay, and politicians should take heed.

A reality check – no room for cuts to taxes and public expenditure

Proposed political programmes show cumulated €150-225bn tax cut promises, but we show that IMU, IRPEF, IVA and TARES are destined to rise from July 2013, due to previously agreed commitments. Cutting IRAP (positive for banks) would leave the tax man with 2.5% of GDP lower revenues. Public spending is also too rigid to be cut without mining the welfare system, which would not be an easy task; it grew at a CAGR of 3.1% in 1995-2011, roughly in line with GDP growth and above the 2.9% tax revenues rise. We believe Italy needs to put public debt cut at the top of its agenda, as simple as that.

Fiscal Compact locks Italy into primary surplus – asset disposal needed

A balanced budget and lower debt are the two Fiscal Compact pillars captured into the EU Redemption Fund proposal (ERF). Our ERF simulation shows Italy would save 1.5% GDP on funding cost, but in the lack of growth support it would be constrained into 4 p.p. of primary surplus, twice the EU average. The ERF today would force EU 17 countries to spend 12% less, with Italy facing a 16% cut. Asset disposal remains the best solution, in our view (see our *CDP – Italy's gate to debt cut* report of 28 Feb 2012) and we show in this note what we think is preventing Italy from taking such a route.

Elections will hardly derail a resilient market, but best to stay cautious

We think the current strong markets should smoothly navigate the newsflow ahead whatever the outcome. However, risks on the spread lead us to prefer TMT, Oil, Industrials and Branded goods over Financials in Italy. We hereby scrutinise the open topics that our Italian coverage brings to the table of the new government, and conclude with the trade ideas shown here on the left.

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Executive Summary

New elections needed in the medium term the likely scenario

A coalition government between Bersani and Monti might not suffice

The outcome of the Italian general election scheduled for 24-25 February is becoming increasingly uncertain, in our view. As confirmed by the most recently disclosed polls, what back in November had seemed an easy victory for a strong and standalone Bersani government is now simply not on the cards. As such, a coalition between Bersani's democrats party and Monti's centrist party seems inevitable, but even that might not suffice, in our view.

Berlusconi and Five Star the tail risk . . .

Indeed, the two most relevant recent news items are that Berlusconi is in a strong recovery trend, and that the Five Star Movement will end up as the real winner of these elections with more than 20% of the votes, by our estimates. Both these factors are, in our view, destined to further weaken any PD+Monti government, especially in the Senate where a regional-based electoral system makes Lombardy (49 MPs to be appointed, 16% of the total) the 'Ohio' of Italy. We therefore set our expectations very low. Our base case is for a weak Bersani + Monti government agreement potentially forced to be enlarged to take in other minor parties. This would clearly not generate a strong government: as Italian history shows, the larger the coalition, the weaker it is (albeit the last Monti government supported by almost the entire Parliament being a rare exception, dictated as it was by the emergency situation at that time). The risk of new elections would therefore be material, in our view.

. . . and this is where bad news for Italy could become bad news for Germany

Paradoxically, the worst case scenario could actually become the best case, in our view. A booming success of the Five Star or a last-minute Berlusconi victory would scare the market sufficiently to put pressure on the spread so to offer Italy the perfect excuse for what we keep seeing as the only viable way out given the non-sustainability of the Country's high public debt: applying for Draghi's OMT programme (see our *Banking Union Clouds* note of 22 October). This would naturally end up putting pressure on Germany ahead of its September elections, and add renewed pressure to the EU convergence project.

Whatever the outcome, the market should not derail but risk is rising

Courtesy of Mr Draghi's OMT programme, we think the market should remain sufficiently resilient to navigate smoothly whatever the electoral outcome from Italy. However, if we agree that these elections are a crucial crossroads for the largest peripheral country to convince Europe on the virtuous trajectory started by Monti government, then we think the market might be under-estimating how much risks have risen.

Sovereign risk – the spread does not say all

BTPs are subject to debt re profiling, BOTs are not – watch the yield gap

The 184bps spread contraction Italy has enjoyed since August 2012 is largely due to the ECB's OMT announcement rather than to the Monti government per se, in our view. We therefore think the spread has lost much of its relevance as an indicator of the market's perception of the real underlying solvency risk of Italy given the back-up from Mr Draghi. In search of a new indicator of solvency risk perception, we have compared Italian BTP bonds coming to the end of their tenure with an equivalent T-Bill maturity (BOT). In contrast to bonds, T Bills do not take part of any debt re-profiling in the event of default due to their short-term tenure. Hence, we think the yield gap between the two becomes an interesting proxy of solvency risk perception by the market.

In relative terms the yield gap between BTP and BOT went up not down in spite of OMT

An efficient market exploiting arbitrage and not concerned for solvency risk should, we believe, require pretty much the same yield on a 3/6/9/12 month T-Bill and the equivalent off-the-run bonds with the same time to maturity. In the pre-crisis years this arbitrage seemed to hold true as the average spread between the maturing BTP and the matched BOT averaged just 2 bps. This increased to 7bps at the beginning of the sovereign crisis, and reached 71bps at the height of the crisis. Today, i.e. post the OMT-announcement, it is down to 18bps.

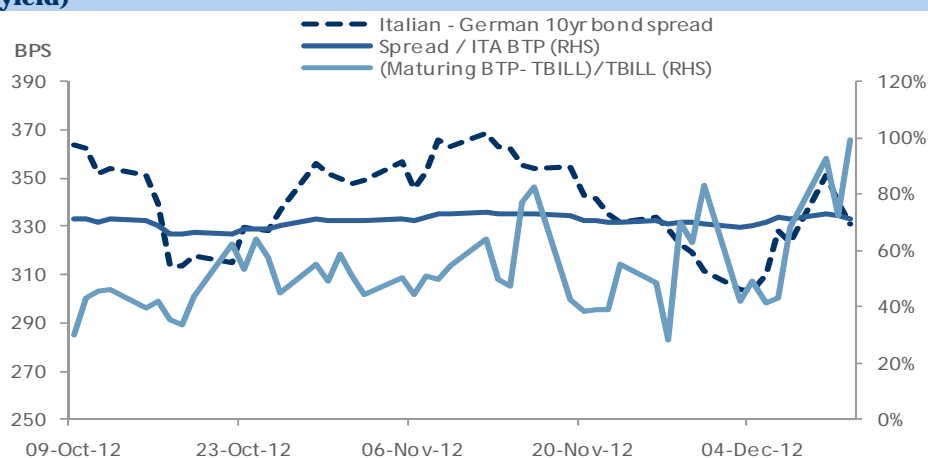
Average gap between BTP and BOT of similar maturity, in different periods

Period	Average spread of Italian 10yr and German 10yr yield	Average German 10yr yield	As % of German average	Average spread of maturing Bond and T-bill bps	Average T-Bill yield bps	As % of average T-Bill yield
8 Oct 09 - 14 Oct 10	109	290	38%	7	70	10%
26 Sept 11 - 21 Jan 12	430	195	221%	71	288	25%
9 Oct 12 - 11 Jan 13	325	144	226%	18	34	54%

Source: Mediobanca Securities

The 18 bps average premium the market requires on short-dated BTP represents some 54% of the average 34bps yield available on Italian T-Bills of the same maturity and compares with 25% pre-OMT. Hence, in relative terms the market today requires a higher premium on off-the-run bonds compared with T-Bills of the same maturity. The solvency risk is surely here to stay, even with the OMT.

Sovereign spread (as a % of BTP yield) and maturing BTP-BOT yield gap (as % Italian BOT yield)



Source: Mediobanca Securities

A reality check on fiscal policy . . .

In spite of electoral promises relevant taxes (IMU, IRPEF, IVA, TARES) should rise

Scrutinising the political programmes of the various parties, the result would mean a cumulated €150-225bn tax cuts promises. Our reality check shows that, contrary to political intentions, IMU, IRPEF, IVA and TARES are destined to rise starting from July 2013, due to previously-agreed commitments. This would hardly support consumer confidence and a growth recovery in Italy. We have also looked at the IRAP tax, where we see greater likelihood of a reduction.

IRAP could be cut (positive for banks) but not fully removed as it amounts to 2.5% GDP

Due to its unfair nature (similarity to VAT, tax obligations arising despite firms being loss-making), amendments to the IRAP tax regime are at the heart of the fiscal debate, with proposals ranging from its elimination to a substantial reduction. We calculate that reducing the bracket by just 1 p.p. would boost

banks' earnings by 5%, followed by +3% in TMT. However, we consider this move to be unlikely as this would reduce tax revenues by €7bn in 2013e, i.e. 70% of the cut in Government expenditures for the same year. IRAP tax revenues account for c.2%/2.5% of GDP, making any cancellation proposal unrealistic, in our view. Also, a progressive phase-out in 4/5 years through a steady reduction of the bracket is, in our view, hardly feasible without harming Italy's public finances, especially in the short term.

Tax revenue breakdown

€ bn	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	CAGR 95-10
VAT	52	54	59	66	69	77	78	80	79	82	85	93	96	94	86	97		4.2%
IRAP	-	-	-	28	25	27	31	31	32	32	35	38	39	36	32	32		1.2%
IRPEF	83	90	98	109	118	118	126	128	132	137	141	151	163	171	166	174		5.0%
IRPEG	11	14	21	19	29	27	29	27	25	24	30	36	47	44	34	34		7.6%
ICI	7	7	8	8	8	8	9	10	10	10	11	11	12	9	9	9		1.7%
Others	106	111	121	99	94	96	96	96	109	109	96	109	108	107	118	104		-0.1%
Total tax	260	277	306	330	342	354	369	372	388	393	398	438	465	461	445	450		3.7%
GDP	947	1,004	1,049	1,091	1,127	1,191	1,249	1,295	1,335	1,392	1,429	1,485	1,546	1,568	1,520	1,549		3.3%

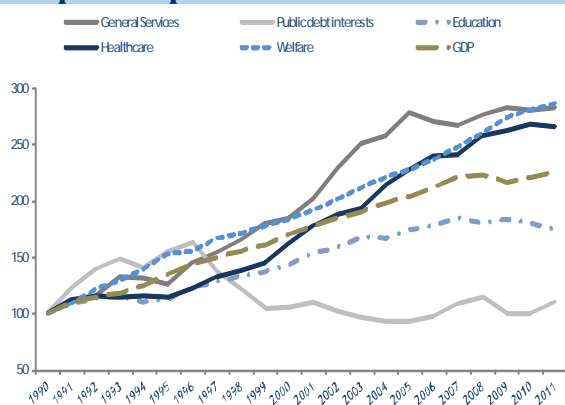
Source: Mediobanca Securities, MEF, Istat

... and on public expenditure rigidity ...

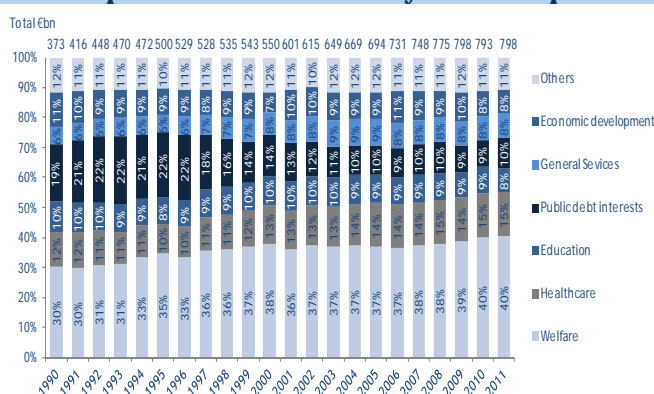
Severe cuts only by attacking the welfare system – not feasible we think

Pension (40%), education (8%), and healthcare (15%) expenses have represented a constant and inelastic >60% share of Italian public expenditure over the last two decades. Cutting public costs aggressively would essentially require attacking the existing welfare system, which is clearly not an easy task. Public expenditure grew by 3.1% CAGR in 1995-2011, roughly in line with GDP growth and slightly above the rise in tax revenues of 2.9%. Some 40% of tax revenues are made up of tax on personal income (IRPEF), but an estimated €150bn tax evasion and black economy means a big portion of taxable revenue effectively vanishes.

Italian public expenditure trend – 1990 = base



Public expenditure break-down by class of expense



Source: Company data, Mediobanca Securities analysis and estimates

... leads us to reiterate our view: Italy MUST cut its public debt

CDP remains our best option to help the state deconsolidating assets ...

With no more room for further fiscal pressure and in light of the inelasticity of public expenditure, it is on debt cut that Italy has a lot of work to do. We proposed our solution last year (see our *CDP – Italy's gate to debt cut*, 28 February 2012) pointing to CDP as the best vehicle to help deconsolidating state-owned assets, given the ample room here, namely: €425bn state-owned real estate, €100bn of listed equity stakes, €125bn of gold reserves, and €30bn of State concessions.

... but lack of delivery from Monti government has been the major disappointment

It looks almost counter-intuitive to us that no structural reform can really show full benefit in the near term as long as the country is burdened by the €80-100bn interest service on its debt per annum. A year after publishing our CDP proposal and following meetings with several relevant people, we list in this note what we think are the key reasons that have prevented Italy from an effective delivery on assets disposals.

Fiscal Compact is the other reason to cut debt

Redemption Fund – The Italian ‘Expiation Fund’ would save 1.5% GDP funding cost

Our urgency regarding the need to cut debt is dictated by the fact that this would be the best way to put Italy on a new growth trajectory by cutting its high interest service debt. Additionally though, Italy is committed to the Fiscal Compact, which in the absence of growth will end up adding even more fiscal pressure. Debt cut and balanced budget are the pillars of the Fiscal Compact. We think the European Redemption Fund (ERF) proposal from Germany best shows how these two constraints would work for Italy. We have simulated a roadmap towards a debt cut for Italy for the portion exceeding the 60% of GDP level, i.e. €950bn debt cut on a time horizon of 30 years. The funding costs savings would amount to €24bn pa, i.e. roughly 1.5% of GDP. The price to pay for that though would be a total annuity of €62bn pa at the beginning of the plan – almost equally split between capital paid down for 1/30 (€32bn) and interest payment as shown below.

Simulation – Italy: debt exceeding 60% GDP brought to zero in 30 years, €bn

	Residual capital	Interest payment	Capital payment	Total annuity	Gvt revenue (3% CAGR)	as % of government revenues
2012	949	(31)	(32)	(62)	750	8.3%
2013	917	(30)	(32)	(61)	773	8.0%
2014	886	(29)	(32)	(60)	796	7.6%
2015	854	(28)	(32)	(59)	820	7.2%
2016	823	(27)	(32)	(58)	845	6.9%
2017	791	(26)	(32)	(57)	870	6.6%
2018	759	(25)	(32)	(56)	896	6.3%
2019	728	(24)	(32)	(55)	923	6.0%
2020	696	(23)	(32)	(54)	951	5.7%
2021	664	(22)	(32)	(53)	979	5.4%
2022	633	(21)	(32)	(52)	1,008	5.2%
2023	601	(20)	(32)	(51)	1,039	4.9%
2024	569	(19)	(32)	(50)	1,070	4.7%
2025	538	(17)	(32)	(49)	1,102	4.5%
2026	506	(16)	(32)	(48)	1,135	4.2%
2027	475	(15)	(32)	(47)	1,169	4.0%
2028	443	(14)	(32)	(46)	1,204	3.8%
2029	411	(13)	(32)	(45)	1,240	3.6%
2030	380	(12)	(32)	(44)	1,277	3.4%
2031	348	(11)	(32)	(43)	1,316	3.3%
2032	316	(10)	(32)	(42)	1,355	3.1%
2033	285	(9)	(32)	(41)	1,396	2.9%
2034	253	(8)	(32)	(40)	1,438	2.8%
2035	221	(7)	(32)	(39)	1,481	2.6%
2036	190	(6)	(32)	(38)	1,525	2.5%
2037	158	(5)	(32)	(37)	1,571	2.3%
2038	127	(4)	(32)	(36)	1,618	2.2%
2039	95	(3)	(32)	(35)	1,667	2.1%
2040	63	(2)	(32)	(34)	1,717	2.0%
2041	32	(1)	(32)	(33)	1,768	1.8%
2042	(0)	0	(32)	(32)	1,821	1.7%

Source: Mediobanca Securities

Some 16% lower public spending in 2011 for Italy based on ERF . . .

This gives an idea of the budget constraint that Italy is currently facing: assuming the ERF at work would absorb some 8.3% of Italy's current government revenues at the beginning of the process. With the stock of debt reducing over time, the interest component is expected to halve after 15 years, and the total fiscal constraint to become less stringent. If the ERF had been implemented in 2011, EU 17 countries would have been forced to spend 12% less than what they effectively spent in 2011, with Italy suffering a more drastic cut of 16%.

Simulation – ERF Impact on Eurozone countries spending (€bn), 2011

Countries	Excess debt transferred to ERF	ERF related expenses	<i>o/w</i> Interest payment	<i>o/w</i> capital payment	Gvt revenue	Post ERF Gvt expenditure	Reported expenditure	Expenditure contraction
Greece	200	-13	-7	-7	88	-75	-108	-31%
Italy	949	-62	-31	-32	728	-666	-789	-16%
Ireland	75	-5	-2	-3	56	-51	-76	-33%
Portugal	82	-5	-3	-3	76	-71	-84	-15%
Belgium	140	-9	-5	-5	182	-173	-197	-12%
France	517	-34	-17	-17	1,014	-980	-1,118	-12%
Germany	546	-36	-18	-18	1,149	-1,113	-1,172	-5%
Austria	37	-2	-1	-1	144	-142	-152	-7%
Malta	1	0	0	0	3	-3	-3	-8%
Cyprus	2	0	0	0	7	-7	-8	-15%
Spain	91	-6	-3	-3	377	-371	-468	-21%
Netherlands	19	-1	-1	-1	283	-282	-312	-10%
Finland	-	0	0	0	102	-102	-103	-1%
Slovenia	-	0	0	0	16	-16	-18	-13%
Slovakia	-	0	0	0	23	-23	-26	-13%
Luxemburg	-	0	0	0	18	-18	-18	-1%
Estonia	-	0	0	0	6	-6	-6	0%
Peer group	2,659	-175	-86	-89	4,273	-4,098	-4,658	-12%

Source: Eurostat

. . . means the Fiscal Compact locks Italy into 25 years of primary surplus requirement

In summary, a virtuous roadmap towards a debt cut and balanced budget requires for Italy 4 p.p. of sustained primary surplus – twice the EU average.

The 'hot dossiers' on the next government table

The conclusion of our note focuses on the sectors and stocks potentially most exposed to the political newsflow ahead. We scrutinise the relevant open topics that our Italian coverage could bring to the table of the new government. These relate to potential fiscal interventions, governance issues, management changes and/or stock-specific situations.

Our Italian sector trades for a cautious view on the spread

Our cautious stance on the uncertain electoral outcome ahead and its potential negative impact on the spread lead us to prefer Telecom, Oil, Industrial and Branded & Consumer over Banks, Asset gatherers, Insurance and Real estate.

Our intra sector trades more stock specific related

On an intra-sector perspective, we also propose some pair trades that reflect our rating views, and try and capture our expectations of political impact on the stocks based on the cautious stance expressed in this report.

Italy – Intra sector pair trades based on our cautious stance ahead of the elections

Sector	Long	Short
Banks	PMI, UBI	ISP
TMT	EI Towers	Mediaset
Asset gatherer	Azimut	MED, BGN
Oil	ENI	Saipem
Industrials	FIAT	Finmeccanica
Branded goods	Ferragamo, Prada, Luxottica	Geox, Tod's

Source: Mediobanca Securities

What if we are wrong? The stocks to own in case of government delivery

Should our central cautious stance prove wrong and the coming government positively surprise us in terms of strength and delivery, we also list here below what we would consider the best stocks to own by theme.

What if we are wrong? Core holdings in case of government delivery, by theme

Theme	Stocks to own
IMU tax cut	Beni Stabili
IVA tax cut	Autogrill, De Longhi
IRAP tax cut	MPS, UBI, Espresso, Mondadori
Tax credit on advertising	Mediaset, Espresso
Export incentive	FIAT, Fiat Industrial, Ferragamo, Prada, Luxottica
Real estate disposal	Beni Stabili
Spread narrowing	MPS, MED, Generali, BGN, Beni Stabili
Foundations 'shake up'	ISP, MPS
Bad bank	UCG, MPS, BP
Popolari governance	PMI, UBI, BPER, BP
Lower LLP from growth initiatives	MPS, UBI, BP, UCG
TMT network spin off regulation	Telecom Italia
Management change	ENI

Source: Mediobanca Securities

A complex political landscape

The outcome of the Italian general election scheduled for 24-25 February is becoming increasingly uncertain to us. As confirmed by the most recently disclosed polls, what back in November seemed an easy victory for a strong and self-sufficient Bersani government is now just not on the cards. As such, a coalition between Bersani's democrats party and Monti's centrist party seems inevitable, but even that might not suffice. Indeed, the two most important recent news items are that Berlusconi is in a strong recovery trend, and that the Five Star Movement should end up as the real winner of these elections with around 20% of the votes, we suspect. Both these factors, in our view, are destined to further weaken any PD+Monti government, especially in the Senate where a regional-based electoral system makes Lombardy (49 MPs to be appointed) the 'Ohio' of Italy. We would therefore set our expectations very low. Our base case is for a Bersani + Monti government agreement forced to be enlarged to take in other minor parties. This would hardly generate a strong government: the Italian experience shows an inverse correlation between the number of parties forming a coalition and such a government's ability to implement key structural interventions (albeit the last Monti government supported by almost the entire Parliament being a rare exception, dictated as it was by the emergency situation at that time). The risk of early elections would therefore be material, in our view. Paradoxically, the worst case scenario could become the best case to us. A booming success of the Five Star or a last-minute Berlusconi victory would scare the market sufficiently to put pressure on the spread so to offer Italy the perfect excuse for what we keep considering the best way out for the non-sustainability of its high public debt: applying for the OMT programme of Draghi.

A complex political landscape

The Italian elections scheduled for 24 and 25 February are expected to be a cornerstone not only for the country itself, but much more importantly for the future progress of the European integration project.

Now, one week away from the elections, we are in the middle of the no 'pools' disclosure period, which leaves the market blind on the sentiment change of the electorate. The final outcome seems dependent on many moving parts, and with the election date fast approaching we think uncertainty is rising significantly.

What seems obvious in the numbers . . .

Last disclosed polls (SWG, 8 February 2013) provide the following picture:

- ◆ Centre-left coalition 33.8%
 - Pd (Bersani) 29.5%
 - Sel 3.6%
- ◆ Centrist coalition 13.4%
 - o/w Monti List 9.0%
- ◆ Centre-right coalition 27.8%
 - PdL (Berlusconi) 19.5%
 - Northern League 5.2%
- ◆ M5S 18.8%

. . . is less obvious in reality

At first sight the outcome seems obvious, with the consensus expecting a Bersani plus Monti coalition governing the country. However, some facts need to be flagged here, in our view:

- ◆ **PD will not make it on its own now.** What seemed to be a comfortable victory for the PD party on its own a few months ago following the primary elections pro Bersani vs Renzi, have become more uncertain today as a consequence, we believe, of:
 - The official decision of Monti to join the political arena. His centrist coalition is naturally attracting votes from both sides.
 - The MPS event which, as Draghi stressed recently, ended up being amplified in the media for the natural link between the PD party governing Siena and the Foundation controlling MPS, whose board is expressed by the City council of Siena.
 - The under estimated ongoing explosion of the Five Star movement.
- ◆ **One plus one is not two.** Adding numbers from the above list might well be misleading. The electoral law in Italy could offer easy control of the Lower House to the winning coalition given the majority premium embedded in the electoral system, but the same is not true in the Senate. The PMs allocation at the Senate is based on a regional mechanism, which makes the outcome depend on region by region basis.
- ◆ **Lombardy – the ‘Ohio’ of the Italian elections.** At the moment, Lombardy seems to be the ‘Italian Ohio’: the 49 PMs that will be decided in Lombardy are considered the crucial crossroads of these elections. The strength of the future government will, we believe, be a function of the electoral outcome in Lombardy – as simple as that. Also Sicily with its 25 PMs seems to show an open head to head situation.
- ◆ **Governing coalition to be known only after the elections.** This helps to pile on uncertainty as, in a very traditional and questionable Italian way, the governing coalition will eventually be decided after the vote and not before. So essentially Italians know the party to vote for, but they don’t know which government their vote will generate. This is why the potential coalition PD-Monti will be eventually announced only after the elections, when each party will try and negotiate its position.
- ◆ **Mr Berlusconi gaining momentum.** The recent recovery trend of Mr Berlusconi’s coalition is impressive: the 15 p.p. gap pre-Christmas versus the Bersani coalition has narrowed to just 4 p.p. today, and media expectations are for such a gap to narrow even further in the coming days. Whether or not Mr Berlusconi will win again, we think he can already declare some sort of victory as we believe his unexpected recovery could already be enough to somehow constrain the PD-Monti coalition into a political compromise with Berlusconi’s party, and even potentially forcing an enlarged coalition. This was simply unthinkable a few weeks ago. Although the market might welcome a de-ja vous of the first Monti government based on an enlarged coalition, we think the success of such a formula has been a clear exception by Italian standards, dictated as it was by the emergency situation and the sense of responsibility of the parties involved at that time. But the Italian experience shows an inverse correlation between the number of parties forming a government coalition and such a government’s ability to implement structural interventions.
- ◆ **Five Star will be the real surprise, we suspect.** It is a fact, in our view, that whatever the government coalition, the real winner of this election is going to be the Five Star Movement, possibly targeting 20% of the votes at its first national election. The traditional parties and the PD in particular completely under-estimated the ascendancy of the Five Star movement. Focused on attacking the admittedly overly aggressive and provocative approach of the Five Star movement leader Grillo, Italian politicians under-estimated, in our view, the new approach to politics of the Movement. This is essentially based on two pillars:

- New media campaign away from TV and entirely focused on the web, hence targeting the younger generations.
- A very concrete bottom-up action plan focused on green economy themes, alternative energy, severe cuts to the political cost of running the country, etc.

Admittedly some of the proposals are very controversial, such as the referendum on the Euro, but this will not prevent the Five Star movement representing the real surprise of the coming elections. This is why, making the outcome even more complicated, the Italian press is starting to speculate on a potential link between PD and the Five Star. Such a link should have been natural in our view given the many similarities of the PD and the Five Star programmes. The Five Star Leader Grillo made himself available for running at the primary elections of PD in 2008 elections, but he was not allowed to do so as he was seen as overly independent. Five years later he is now running on his own and naturally denting into PD electoral base.

Conclusion: it could be a short-lived government . . .

In conclusion, we think that realistically the chance for Italy to secure a solid and cohesive government able to remain in place for the next five years is extremely low. Depending on the election outcome, we might have a government focused mainly on implementing the long-expected institutional reforms, including a change of the electoral law and targeting new elections in the short term.

. . . forced to apply for OMT

Whatever happens we do not think the spread would necessarily be under pressure again should the market continue to be reassured by Draghi OMT bazooka, as has happened to date. However, we think risks are on the way up and the situation is quite open up to potentially forcing Italy to apply for the OMT programme. We advocated such a move a few months ago (see *Banking Union Clouds*, 22 October 2012) as we remain sceptical on the sustainability of the high Italian public debt. Hence we believe that Italian debt would be better off under some sort of 'EU ring fencing' and the potential worst case scenario of this election could provide the perfect excuse for Italy to apply for the OMT – to the disappointment of Germany, we suspect.

Sovereign risk: the spread does not say all

The 184bps spread contraction Italy has enjoyed since August 2012 is largely due to the ECB's OMT announcement rather than to the Monti government per se, in our view. We therefore think the spread has lost much of its relevance as an indicator of the market's perception of the solvency risk of Italy given the back-up from Mr Draghi. In contrast to bonds, T Bills do not take part of any debt re profiling in the event of default due to their short term tenure. Hence the yield gap between the two could be seen as an interesting proxy of risk perception. We have compared Italian BTP bonds coming to the end of their tenure with an equivalent TBill maturity (BOT). An efficient market exploiting arbitrage should we believe require pretty much the same yield on a 3/6/9/12 month TBill and the equivalent off-the-run bonds with the same time to maturity. In the pre-crisis years of H2 2006 to H1 2007, this arbitrage seemed to hold true as we have calculated the average spread between the maturing BTP and the matched BOT averaged just 2 bps. This increased to 7bps at the beginning of the sovereign crisis, and reached 71bps at the height of the crisis. Today, i.e. post the OMT announcement, it is at 18bps. This represents some 54% of the average 34bps yield available on Italian TBills and compares with 25% pre-OMT. Hence, in relative terms the market today requires a higher premium on off-the-run bonds compared with TBills of the same maturity. In other words our exercise shows that in relative terms the risk captured through this measure has gone up recently in spite of OMT.

In search for a different indicator of solvency risk

The spread has lost relevance as a risk indicator post-OMT, in our view

We believe that following Draghi's OMT announcement in August 2012, the spread lost a good part of its relevance as an indicator of the market's perception of the solvency risk of Italy. The 184bps spread contraction Italy has enjoyed since August is largely due to the ECB rather than the Monti government per se, in our view. The OMT announcement proved to be extremely powerful in convincing the market (at least for the time being) that the bazooka is ready and that Draghi can activate it at any time upon request by any member state.

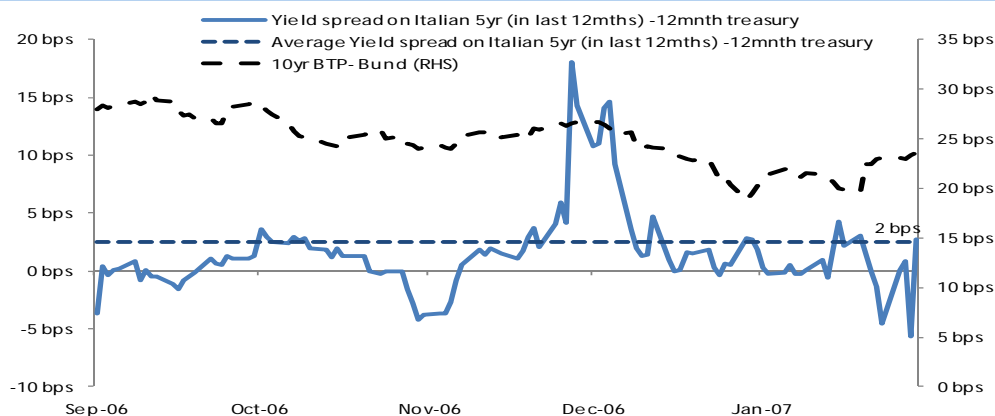
Inevitably, the OMT announcement ended up relaxing the pressure on Italian and EU politics. Most importantly though, in our view, the fact that the spread has contracted does not mean the market has substantially changed its stance on the solvency risk of Italy.

The yield gap between BOT and BTP is a better indicator now

We propose here (below) a different measure of risk perception that seems to show different conclusions to what the recent spread-narrowing seems to indicate. The history of sovereign defaults and the literature on debt restructuring (see above many *Das, Papaioannou, Trebesh, IMF WP / 12 / 203*) suggests that TBills tend to be excluded from any restructuring, presumably due to their short maturity tenures.

- ◆ We have done some work on monitoring sovereign stress that looks at bonds coming to the end of their tenure and matching them with an equivalent TBill maturity. An efficient market exploiting arbitrage should require pretty much the same yield on a 3 / 6 / 9 / 12 month TBill and the equivalent off-the-run bonds with the same time to maturity. All else being equal, in fact, the market would be lending to the same counterpart for the same maturity.
- ◆ As we show below, in the pre-crises years of H2 2006- H1 2007 and in spite of the different investors profile, this arbitrage seemed to hold true, as the average spread between the maturing BTP and the matched 12-months Treasury bill averaged just 2 bps. Admittedly reconstructing the time series for comparative reasons is not an easy exercise, which makes the process subject to a certain margin of error, we suspect. However, the general message holds true, in our view.

Pre crises we observe an average spread of 2bps between maturing BTP and Tbill

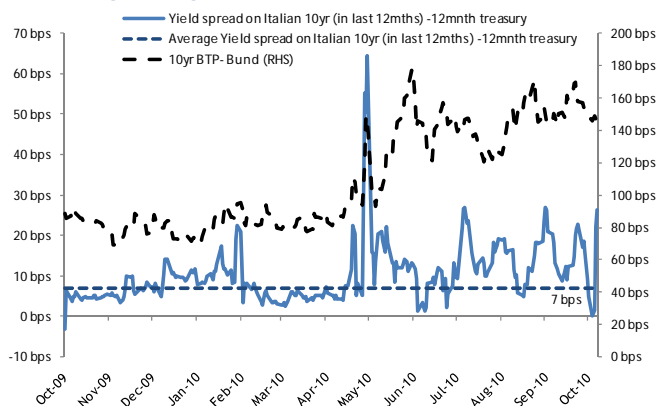


Source: Mediobanca Securities

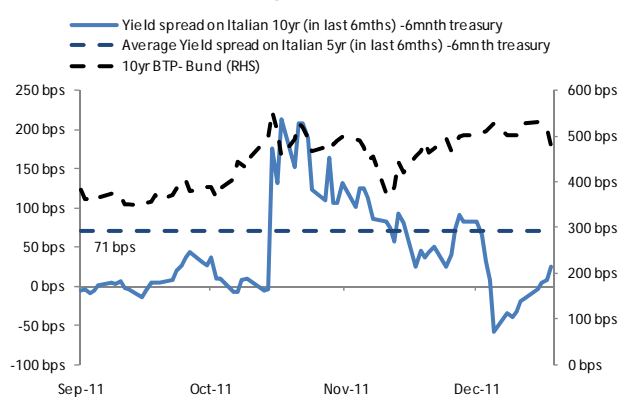
- ◆ This level increased to 7bps on average at the beginning of the Sovereign crises. In the chart below (left) we can see a spike surrounding the first Greek bailout package in May 2010.
- ◆ At the height of the sovereign crises (see chart below right) we see the market requiring on average 71bps premium to hold a BTP versus zero coupon Italian T-bill of the same residual maturity. This coincides with the LTRO announcement and increased fears on a Greek restructuring.

Average spread between maturing BTPs and TBill

At the beginning of the Greek crisis



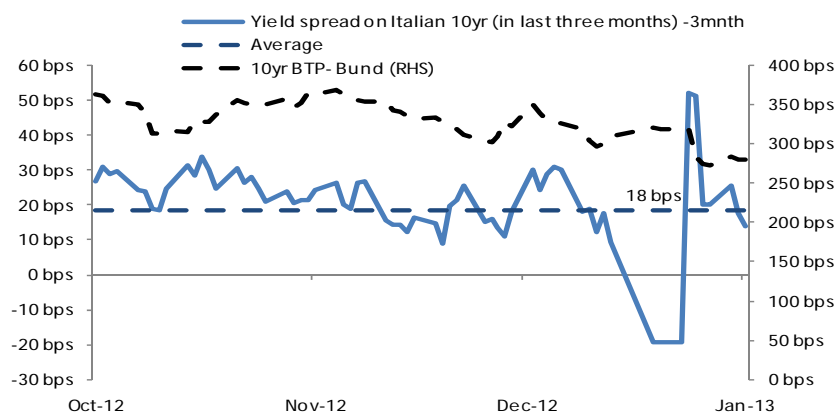
at the height of the crisis



Source: Mediobanca Securities

- ◆ Today, i.e. post the OMT announcement, the situation of the spread versus Germany has certainly improved. However, as we can appreciate here (see chart below) the market still requires an average 18bps higher yield on BTPs versus TBills of equivalent 3-months maturity. This is a relevant premium required when one considers that it represents some 54% of the current yield on 3-months T Bills, currently at 34bps.

Average spread between maturing BTPs and TBill post OMT announcement



Source: Mediobanca Securities

The yield gap in relative terms rose post OMT

Our analysis on the spread observations we captured when comparing a T-Bill with a bond of similar run-off maturity is summarised in the table below. We see that although the yield gap has reduced from 71bps to 18bps in the latest observed time period, i.e. following the OMT announcement, as a percentage of the average yield of the T-Bill the relative gap increased from 25% pre-OMT to 54% of the T-bill's average period yield. Included in the table, we also show the average spread of the Italian to German Sovereign bond. We see that although the spread has visibly narrowed between the two observed period from 430 to 325 bps on an absolute level, the spread as a percentage of the German Bund yield has remained pretty stable in the region of 220%. In other words, the whole curve came down and so did the spread, but actually when comparing the spread to the German Bund yield not much has changed in relative terms. Moreover, the gap between BTP and BOT of equivalent maturity as gone up as a % of the BOT yield. Why would the market not exploit such a large arbitrage between BTP and BOT yield? Our answer lies in the fact that BOT are not going to be part of any future potential debt re-profiling due to their short term maturity, hence the yield gap versus the equivalent maturity BTP becomes a proxy of the solvency risk perception of the market on Italy.

Average gap between BTP and BOT of similar maturity, in different periods

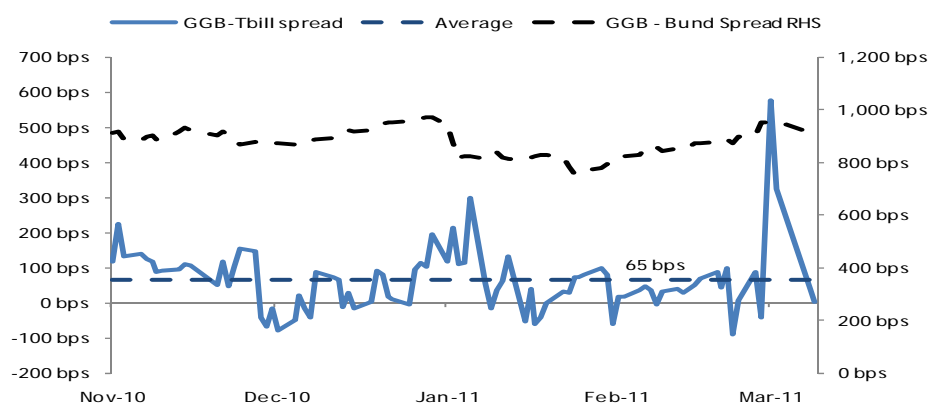
Period	Average spread of Italian 10yr and German 10yr yield	Average German 10yr yield	As % of German average	Average spread of maturing Bond and T-bill bps	Average T-Bill yield bps	As % of average T-Bill yield
8 Oct 09 - 14 Oct 10	109	290	38%	7	70	10%
26 Sept 11 - 21 Jan 12	430	195	221%	71	288	25%
9 Oct 12 - 11 Jan 13	325	144	226%	18	34	54%

Source: Mediobanca Securities

Solvency risk is still here

We have noticed the same trend in Greece as well. As we show below, the market asked on average 65bps higher yield on GGB versus TBills, throughout 2011.

GGB and TBill spread at 65bps



Source: Mediobanca Securities

Learning from previous debt restructuring

Our thesis gathers pace when looking at the table below, where we show the average time taken to agree on debt restructuring in previous situations. It can be seen that apart from a few exceptions it normally takes more than just a few months to agree on the PSI. In the case of Greece, it took almost a year before agreeing on the offers. This is why T Bills tend not to be included in debt re-profiling, and this is where the yield gap observed today in Italy between BTP and BOT becomes an interesting proxy of solvency risk perception, in our view.

Main Sovereign debt restructuring

	Announcement of restructuring	Total time to agree restructuring (Months)
Pakistan	Jul-99	11
Pakistan	Dec-99	4
Ukraine	Apr-00	4
Ecuador	Aug-00	25
Russia	Aug-00	23
Moldova	Oct-02	4
Uruguay	May-03	2
Serbia & Monten.	Jul-04	44
Dominica	Sep-04	15
Argentina	Apr-05	42
Dom. Rep	May-05	13
Dom. Rep	Oct-05	18
Grenada	Nov-05	13
Iraq	Jan-06	20
Belize	Feb-07	6
Ecuador	June/Nov-09	12
Seychelles	Feb-10	19
Cote D'Ivoire	Apr-10	21

Source: Mediobanca Securities on IMF

CACs and CNAVs further support our thesis

Two additional points help to explain the above findings.

- ◆ **Change in govies' characteristics.** The new EU-wide regulation calls for CACs (Collective Action Clause) in new government issuance starting in 2013. CACs do not apply to money market instruments (t-bills up to 12M maturity). Hence, a structural difference has been introduced between off-the-run govies and t-bills, and such difference will normally show up

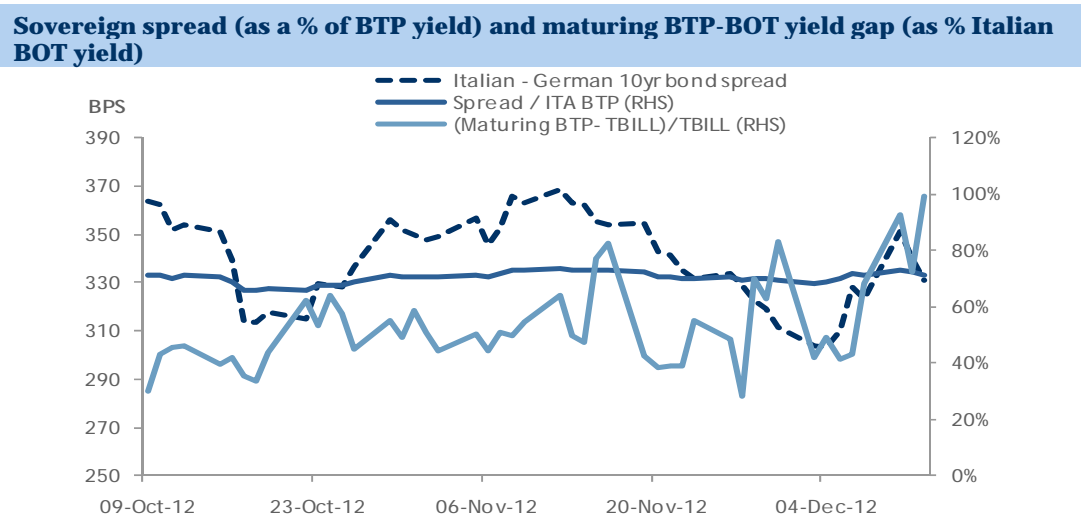
in the form we have highlighted in our charts above for future issuances when the time to maturity of newly-issued bonds will be 12M or lower.

- ◆ **Market “peculiar” rationality.** T-bills are money market instruments and, as such, their credit risk is perceived differently than off-the-run bonds with the same time to maturity. Here the “market-rationale” is two-fold:
 - money market access is the last bastion of issuance capability and the first place investors are willing to tip a toe when creditor’s solvency is questioned. Hence this area is normally safeguarded in any debt restructuring.
 - US money market funds (long only investors in money market products, e.g. t-bills) are CNAV (Constant Net Asset Value) and abide to the not-break-the-buck rule (i.e. when 1 usd invested returns less than 1 usd, or breaks the buck). Hence the fund sells the position entirely. EU money market funds may use a different accounting method (Variable Net Asset Value), which will not necessarily adopt the break-the-buck rule. Hence they are less prone to unloading assets.

In spite of the many caveats, adjusting variables and moving parts of this exercise, we think our conclusion holds true: the restructuring processes are designed to protect money market funds’ investors. As such, they do not tend to involve T Bills and more generally the short part of the curve.

Spread and Yield gap have not improved in % terms

We combine three time series in the following chart. The 10yr Sovereign spread, the spread as a percentage of the Italian BTP, and the yield gap between a maturing bond and an equivalent maturing Italian TBill as a % of the yield on the T Bill.



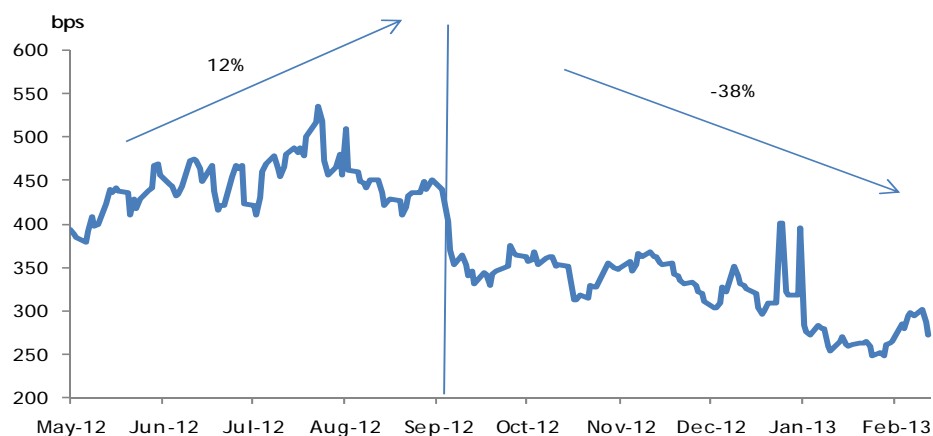
Source: Mediobanca Securities

- ◆ The conclusion from the chart is that although the spread of Italian sovereign has fallen over the period, such a spread expressed as a percentage of the Italian BTP remains flat whilst the spread gap between the maturing BTP and Italian TBill as a percentage of the Italian TBill is trending upwards.

Watch the steepness of the curve as well

We show in the following chart that in the preceding four months to the OMT, the average spread between the Italian 10-year BTP and equivalent German Bund increased by 12%, before falling by 38%. Indeed, we can actually see the spread narrowing in the chart below from the beginning of August when the ECB announced it would undertake bond buying in the secondary market. To-date, the spread has narrowed by 51% from its peak.

Italian 10-year bond vs German bund



Source: Bloomberg, Mediobanca Securities

We now compare the yield gap present in the Italian sovereign curve during the same period from May to the present. We explore this through taking a spread between the generic 10-year Italian Sovereign bond and the shorter term 3-month Italian T-Bill. We see a similar pattern emerge in that the spread peaks around the pre-announcement of the ECB intervention, and retraces post. In the period from May until September 2012, the spread increases by 8% before easing by 18% from September till today.

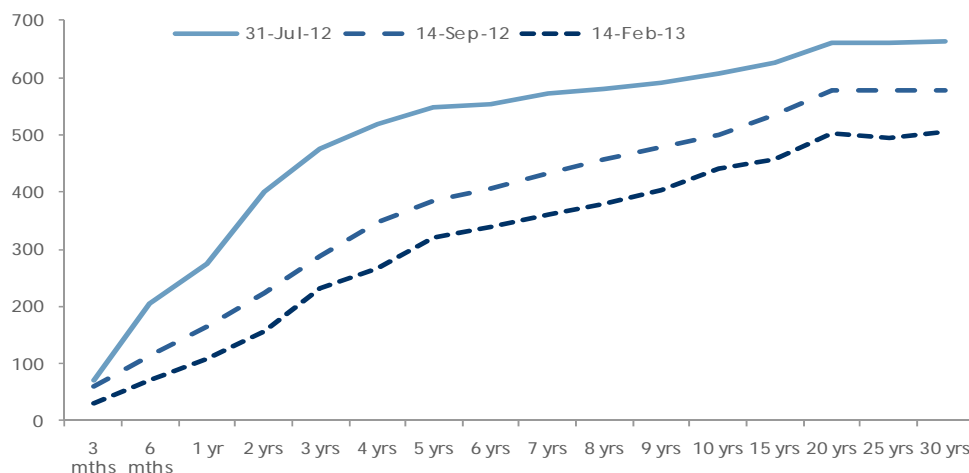
Spread between Italian 10-year bond and 3-month T-Bill



Source: Bloomberg, Mediobanca Securities

The higher return required on the long side of the curve is quite normal, especially when considering that the short side of the curve is 'protected' by the Draghi OMT umbrella. This is why the spread in the yield curve between the 2-year bond and 3-month Tbill moved from 328bps in July to 163bps in September and to 126bps today. We can see below the change in the yield curve in three different periods' pre-OMT, post-OMT and today.

Yield curve change post-OMT announcement



Source: Mediobanca Securities

In the following table, we measure the steepness of the curves above at various points. We see that through the three time periods there has been a steepening shown by the increasing multiples.

Observations of yield curve steepness

	31-Jul-12	14-Sep-12	14-Feb-13
30 year / 3 month	9.2x	9.6x	15.9x
10 year / 1 year	2.2x	3.1x	4.1x
5 year / 2 year	1.4x	1.7x	2.0x

Source: Mediobanca Securities

A reality check on fiscal policy

Delving into the political programmes of the various parties, different research institutes point to a cumulated €150-225bn tax cuts promises. Our reality check shows that, contrary to political intentions, IMU, IRPEF, IVA and TARES are destined to rise starting from July 2013, due to previously agreed commitments. This would hardly support consumer confidence and a growth recovery in Italy. We have also looked at the IRAP tax where we see more chances of a reduction. Such a regional tax on productive activities is levied on the value of production, but staff costs, financial charges (for industrials) and impairments (for financial companies) are not fiscally deductible. Hence the IRAP tax burden is particularly heavy for banks, as commercial banking is a labour-intensive sector that is impossible to delocalise. Due to its unfair nature (similarity to VAT, tax obligations arising despite firms being loss-making), amendments to the IRAP tax regime are at the heart of the fiscal debate, with proposals ranging from its elimination to a substantial reduction. IRAP tax revenues account for c.2%/2.5% of GDP, making any cancellation proposal unrealistic, in our view. We calculate that reducing the bracket by just 1 p.p. would boost banks' earnings by 5%, followed by +3% in TMT. However, we consider this move to be unlikely as this would reduce tax revenues by €7bn in 2013e, i.e. 70% of the cut in Government expenditures for the same year. So even a progressive phase-out in 4/5 years through a steady reduction of the bracket is hardly feasible without harming Italy's public finances, especially in the short term. Finally, we have looked at potential fiscal incentives to the export activity. This seems unlikely at the moment (although FIAT in particular is pushing for that), but we think any government should look at it positively as this could easily become a zero-sum game with tax discounts offset by higher GDP and increased consumption.

IMU, IRPEF, IVA, TARES: when tax cut promises are destined to fail

From theory: up to €225bn tax cuts proposed . . .

We think there is a clear contradiction between the need to maintain fiscal policy strictly under control and the various proposals that the parties are announcing in this campaign. Although this should not surprise during an electoral campaign, we still think there is a disconnect between promises and reality, which is worth having a look at. We have delved into the proposed political programmes of the various parties and, as expected, we have found a lot of emphasis on everyone's goal to cut taxes with virtually no visibility on where to cut expenditure. Whatever parties are saying, the only certainty we have is that starting from next year the Fiscal Compact will force Italy to comply with a balanced budget that we suspect will make many tax cuts promises simply unrealistic.

. . . to reality: taxes should keep going up

According to the various research institutes, the cumulative tax cuts proposed by the Italian political parties participating in the coming elections range between €150-225bn. We summarise below what we consider the key contradictions on fiscal policy of this electoral campaign proposing a reality check on some relevant taxes. Namely: IMU, IRPEF, IVA, TARES and IRAP.

IMU: land register reform will increase IMU tax collection

This real estate tax has been introduced by the Monti government to replace ICI, which was removed by the previous Berlusconi government. The government collected €23.7bn from IMU in 2012, of which €3.9bn on the first residential house. Hence, the average taxpayer paid €918 for IMU. This is by far the most debated tax in the media due to its electoral appeal.

- ◆ **Proposals:** the various proposals range from eliminating and fully reimbursing the IMU, to fine-tuning it in a more balanced way. Political discussions have mainly focused on the

maintenance / abolition / reduction of the tax for the “main residence” i.e. for the home in which the owner habitually lives.

- ◆ **Reality check:** not only do we think it unlikely this tax will be heavily changed by whatever government will be in power, what matters the most to us here is that the ongoing land register reform is making quick progress and within one year this will increase the real estate valuation parameters on which IMU is calculated. The conclusion is that IMU will most probably remain, and will collect even higher taxes next year. Before the introduction of IMU, the tax contribution coming from real estate amounted to 0.6% of GDP in Italy, half the OCSE countries’ average. IMU realigned such number to the average, raising it to 1.2%.

IRPEF: cutting it through lower tax evasion is a chimera EU cannot buy into

IRPEF is expected to collect some €165bn of taxes in 2012 (MBe as December data are still not available; last disclosed number as of November is €152bn). As usual, electoral campaigns in Italy target IRPEF as a very popular tax cut proposal, but this is hardly followed by any delivery.

- ◆ **Proposals:** this time around things are no different. Every party aims at reducing IRPEF through fighting tax evasion. Some aim at simplifying the IRPEF structure by introducing just two tax brackets or providing some sort of relief to households and lower classes.
- ◆ **Reality check:** funding tax cuts through tax evasion is something Italy can hardly commit to, given its extremely poor track record on tax evasion control (amounting overall to almost €150bn per year). Once again, real life will lead to the opposite we suspect: the so-called ‘addizionale IRPEF’, i.e. the supplementary IRPEF component controlled by city towns and regions has already risen by €96 per taxpayer in 2012, and this is expected to suffer a further top-up in the future.

IVA: increase from July on certain goods

IVA (VAT tax) is expected to collect some €108bn in 2012 (€99bn as of November).

- ◆ **Proposals:** every party is obviously aiming at reducing the burden of VAT.
- ◆ **Reality check:** IVA tax is already scheduled to increase. From July 2013 IVA will go up from 21% to 22% on petrol, cars and motorbikes. Consumer associations in Italy estimate this to translate in roughly €225 higher taxes per year for the average taxpayer.

TARES: significant increase from July 2013

TARES is the least advertised tax during this campaign. Such a local tax refers to garbage, but it also covers maintenance cost for streets and other public services.

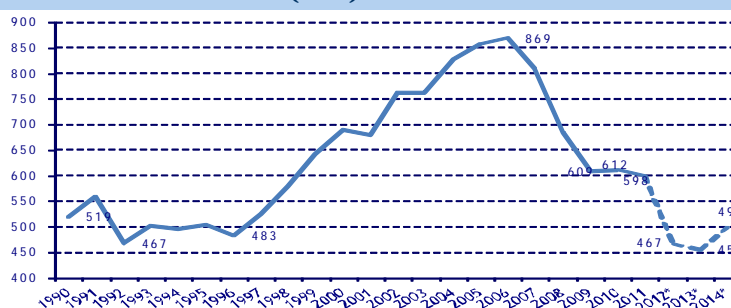
- ◆ **Proposals:** no mention from running parties of this tax in their programmes.
- ◆ **Reality check:** Tares tax will go live from July 2013, and again consumer associations estimate a potential increase of up to 30% on the current garbage tax.

This tax snapshot section tells us that not only will we not see any major tax cuts, but actually the measures already undertaken call for higher taxes in the pipeline already, which will hardly help fuelling the anaemic GDP growth of the country. While parties are fighting to convince of their intention to cut IMU, IRPEF, IVA and TARES, we estimate that the cumulative impact of these taxes will bring the June – July 2013 pro rata tax collection in the region of €22bn (€12bn on IMU, €4bn on IRPEF, €4bn on TARES and €2bn on IVA).

Additionally, we should not underestimate the negative impact that these uncertainties are already having on the underlying economic growth. The introduction of IMU, for instance, had a strong negative impact on households’ investments in real estate, contributing to worsening a situation

already extremely weak in terms of transaction volumes. However, assuming that by removing IMU the trend below will revert seems very optimistic to us, as this is largely determined by the general negative macroeconomic situation and by the still-tight credit conditions on mortgages.

Number of real estate transactions (000) – residential sector



Source: Mediobanca Securities

IRAP: the debate surrounding an unfair tax

IRAP: general features of a peculiar tax

The regional tax on productive activities (IRAP) was introduced in 1998 and replaced seven different types of taxes, among which the local income tax and the extraordinary tax on net assets. In general terms, IRAP is levied on the value of production generated in each Italian region, and it applies to companies, commercial and non-commercial partnerships and public and private entities.

- ◆ **Non-financial companies** – The taxable bases is the net value of the production in each region, calculated as the difference between the value of the production in the tax year and the cost of the production, with the exception of labour costs and interest and financial charges. The Italian fiscal regulation allows a lump sum deduction of c.€4,600 per year per each permanent employee.
- ◆ **Banks** – In general terms, IRAP taxable income is calculated as revenues (including 4% of interest expenses, which are not fiscally deductible) minus 90% of other administrative expenses and depreciation of tangibles and intangibles. In other words, neither staff costs nor loan losses can be deducted from the IRAP taxable income.
- ◆ **Insurers** – In general terms, the IRAP taxable income is calculated as the sum of life and non-life technical accounts minus 90% of other administrative expenses and depreciation of tangibles. Some 50% of dividends are added back to the taxable income. As with banks, staff costs and impairments are not deductible.
- ◆ **Real estate SIIQ** – In 2006, the Government of Italy proposed a special tax regime (Legge 296/2006) for real estate companies, whose prevailing activity is rentals. According to this special regime, rental income is subject neither to IRES nor to IRAP. After the transformation in SIIQ in 2011, the amount of IRAP taxes paid by Beni Stabili and IGD collapsed.

IRAP: banks suffer the heavier tax burden

IRAP tax burden is particularly heavy for banks, as:

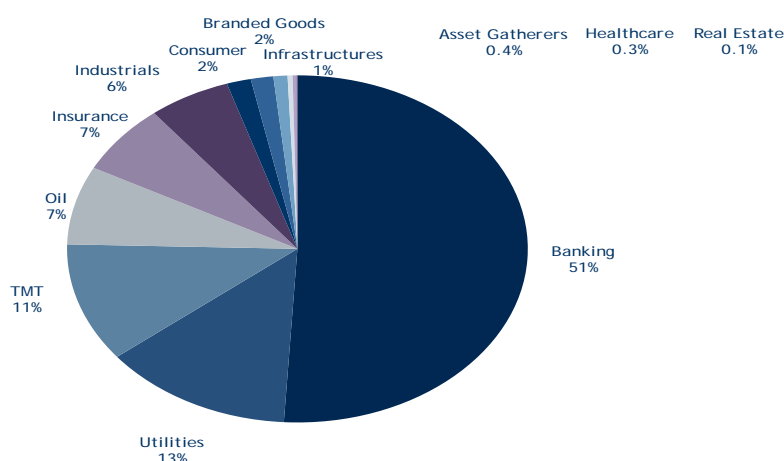
- ◆ Banking is a labour intensive sector;
- ◆ Unlike most of the manufacturing activity, retail banking business cannot be delocalised.
- ◆ Banks cannot deduct two factors of their ordinary business: staff costs (like all sectors) and loan losses, as credit impairment is an intrinsic part of the banking operations. Insurers cannot deduct impairments too, but these have little relevance in the insurance business.
- ◆ Other sectors cannot deduct financial charges, but – at least for the largest companies – the issuance of debt can be carried out by companies located in countries others than Italy.

Italy – IRAP Bracket by Sector, 2012

	National Base Bracket	Regional Discretion
Ordinary Base Bracket	3.90%	Max +1%
Industrials	3.90%	Max +1%
Concession Businesses (excluding motorways)	4.20%	Max +1%
Banks	4.65%	Max +1%
Insurers	5.90%	Max +1%
Public Administration and Public Entities	8.50%	Max +1%

Source: Agenzia delle Entrate, Mediobanca Securities analysis

Based on our coverage, we calculate approximately 50% of the IRAP tax revenues come from the banking sector, followed by Utilities and TMT as shown below.

MB Italian Coverage – Estimated Breakdown of IRAP Taxation, 2013E

Source: Mediobanca Securities estimates

Elimination/Changes in the IRAP tax regime at the heart of the fiscal debate

During the political campaign of the last few weeks, all the candidates proposed amendments to the current IRAP regime. This is due to the perceived unfairness of the tax (firms may be required to pay taxes even if they are loss-making) and to the doubts arising at European level on the peculiar nature of the tax. Indeed, in 1999 Popolare Cremona bank requested the refund of the IRAP paid in 1998-99 to the Italian government, believing that IRAP was similar to VAT and therefore illegal. The issue was addressed by the European Court of Justice, which in 2006 declared that IRAP essentially had the same nature of VAT. Nevertheless, due to the amount of the estimated refund and the possible repercussions in other sectors, the effects of the sentence were postponed until a later date.

Today's debate sees different proposals. The former Prime Minister Berlusconi proposed the elimination of IRAP in five years for all corporations (including financial companies). The outgoing Prime Minister Monti has proposed to halve the tax rate by 2017 for the private sector and to include personnel costs in the computation of IRAP taxable income, so as not to penalise new hiring. According to Monti, this would result in a cut of roughly €11bn from the current stream of revenues from IRAP. The centre-left Prime Minister candidate Bersani has said he is willing to reduce IRAP tax rate, withdrawing the personnel costs from the taxable base, in order to support the manufacturing economy.

Italy can bear only moderate interventions on IRAP

According to Ministero dell' Economia, the total amount of IRAP collected in 2011 amounted to €34bn, representing c.2.2% of Italian GDP. In 2009, the revenues from IRAP amounted to c.€37bn, i.e. 2.4% of Italian GDP. From these figures, not only it is clear that Italy cannot bear the elimination of IRAP tout-court in one year, but that the progressive elimination (4/5 years) would require a remarkable effort in finding alternative sources of revenues or in cutting Government expenditures, equal to 0.6% of GDP per annum.

Based on the arguments above, we believe any intervention on IRAP must be moderate, especially at the beginning of the new legislature. As such, we simulate the earnings impact from the reduction of 1 percentage point in the bracket in 2013E, starting from standardised brackets used for all the companies in the same sector.

From our analysis on the MB Italian coverage, we calculate a c.20% drop in the IRAP tax revenues from a 1 percentage points cut in the bracket for each sector. Assuming to extend the outcome of our analysis to the whole national IRAP tax revenues, would result in €7bn lower revenues in 2013E, a level we see as barely tolerable for the unstable public finances.

Italy – Targeted cut in Government Expenditure, 2012-14

(€bn)	2012	2013	2014	Total
Spending Review Target per Year	4.5	10.5	11.0	26.0

Source: Italian Government, Mediobanca Securities analysis

We simulate below the EPS impact from 1 percentage point reduction in the IRAP tax bracket for all sectors, starting from the different levels shown above. In setting the brackets below by sector, we make no distinction between regions, assuming the same regional discretionary mark-up (*addizionale regionale*).

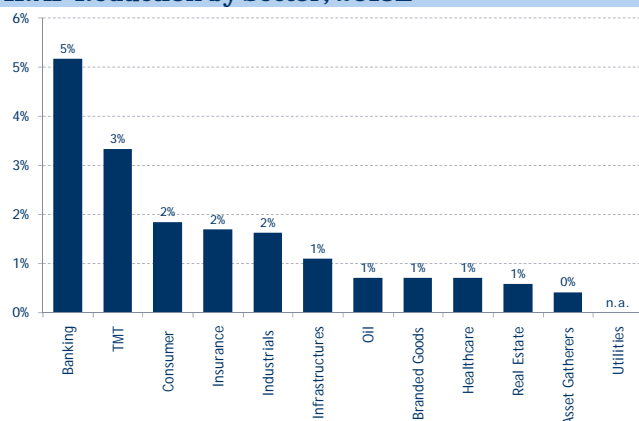
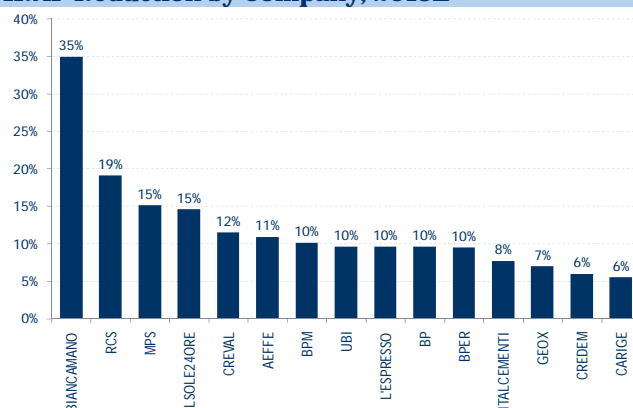
Italy – IRAP Bracket by Sector, 2012

	Estimated Bracket	Estimated Reduction
Asset Gatherers	5.6%	-1%
Banks	5.6%	-1%
Branded Goods	4.6%	-1%
Consumers	4.6%	-1%
Healthcare	4.6%	-1%
Industrials	4.6%	-1%
Infrastructure	4.6%	-1%
Insurance	6.9%	-1%
Oil	4.6%	-1%
Real Estate	4.6%	-1%
TMT	4.6%	-1%
Utilities	4.6%	-1%

Source: Agenzia delle Entrate, Mediobanca Securities analysis

As shown in the charts below, the aggregate banks' earnings would increase by c.5%, followed by TMT (+3%) and all the other sectors hovering over 2% or below. The impact is basically non-existent for asset gatherers – as asset gatherers pay taxes in the countries in which the management activity is based (Luxembourg, Ireland) – and for real estate – as rental income is not subject to IRES and IRAP.

With regard to banks, being UCG operations just partially Italian, the largest Italian banks would benefit the least among banks. MPS would be the most impacted, showing the highest weight of staff costs and loan losses on the pre-tax profits (6x).

MB Italian Coverage – Estimated Profit Impact from IRAP Reduction by Sector, 2013E

MB Italian Coverage – Estimated Profit Impact from IRAP Reduction by Company, 2013E


Source: Company data, Mediobanca Securities analysis and estimates

Fiscal incentives to export – unlikely for the time being

Most common ways of incentivising exports usually refer to financing of working capital, financing of capital investments, financing of infrastructure/logistic projects, rebates for energy-intensive productions, favourable banking fees on export business and duty drawback. Some of these solutions could be considered by the new government, although very little has been disclosed by the various parties. These could include IRAP reduction for the legal entities (i.e. plants) that produce goods to be exported or fiscal credit related somehow to the amount of goods exported. These measures could represent a zero-sum game for the government, with tax discounts offset by higher GDP and greater consumption. Furthermore, this could even attract foreign companies now that wages in areas such as Asia and Eastern Europe have grown significantly.

Many other countries use this approach. In the US, for instance, companies that qualify for the so-called “IC-DISC” law have taxation on 50% of their export income reduced by more than 50%. Profits are taxed at the dividend rate (currently 15%) as opposed to ordinary income tax rates (top rate currently 35%).

Incentive to export needs not to clash with EU rules

The main issue to overcome, in our view, is to design this support in a way that doesn't go against the EU rules for state-aid. Our understanding is that it is not state aid also because similar incentives are present in other European countries. Furthermore, there are technical opt-outs to the state-aid situation. Take, for example, the way it works in the US: the exporter pays commissions to the a new legal entity created according to the IC-DISC law. The commissions are deductible to the exporter, and the deemed or actual dividend payment of the commission income in the IC-DISC is taxed to the exporter's shareholders/partners at the 15% rate (as opposed to being taxed as ordinary income – ex. 35% rate).

Cutting expenses more difficult than cutting debt

Pension system (40%), education (8%), and healthcare (15%) expenses have represented a constant and inelastic >60% share of Italian public expenditure over the last two decades. Cutting public costs aggressively would essentially require attacking the existing welfare system, which is clearly no easy task. Public expenditure grew by 3.1% CAGR in 1995-2011, pretty much in line with GDP growth and slightly above the rise in tax revenues of 2.9%. Some 40% of tax revenues are made up of tax on personal income (IRPEF), but an estimated €150bn tax evasion and black economy means a big portion of taxable revenue effectively vanishes. After exploring the rigidity of cutting public expenditure, we conclude that targeting debt reduction would be an easier task for the country, given the ample state-owned assets available for sale, namely: €425bn state-owned real estate, €100bn of listed equity stakes, €125bn of gold reserves, and €30bn of State concessions. It looks almost counter-intuitive to us that no structural reform can really show full benefit in the near term as long as the country will be burdened by the €80-100bn interest service on its debt per annum. In *CDP – Italy's gate to debt cut* (28 February 2012) we identified CDP as the best vehicle to help deconsolidating state assets and reducing debt. A year later and following meetings with several relevant people, we list here what we think might be the key reasons that have not helped Italy delivering on assets disposals and attempt to explain what might have prevented the Monti government undertaking an aggressive debt cut plan.

Investigating the rigidity in cutting public expenditure

Pension, healthcare and education are > 60% of expenditure – limited room for cuts

Italian public expenditure looks quite rigid. The promises in this electoral campaign to cut public expenditure have to confront with the seemingly immovable >60% of the total expenditure absorbed by pension, education and healthcare. Hence, it seems difficult to achieve material results without touching the welfare system in Italy.

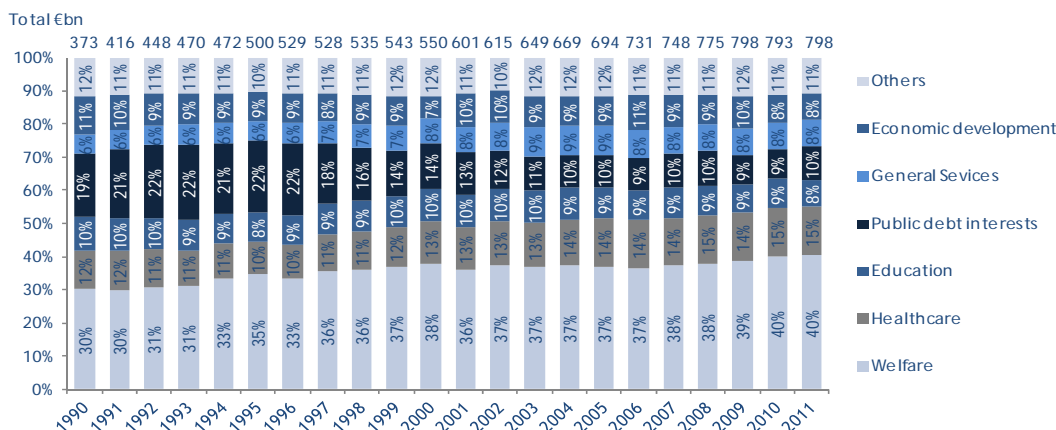
Former Italian Prime minister Monti's spending cuts plan targets €26bn of cost reduction in three years, leaving, in our view, limited scope for further effort:

- ◆ The heavy burden of the pension system has been curtailed somewhat by increasing the retirement age.
- ◆ Teaching and non teaching school staff have already been affected.
- ◆ Healthcare represents one of the largest cuts; the decree aims at rescaling public hospitals and reducing the cost of the overall health sector (€3bn in two years);
- ◆ Other cuts include justice, the purchase of goods and service by ministers and local authorities, and a reduction in the number of public sector employees.

Public expenditure grew at 3.1% CAGR in 1995-2011 vs tax revenues of 2.9%

The public expenditure has grown over the last 15 years with a compounded annual growth rate of 3.1% in Italy from 1995 (€500bn) to 2011 (€800bn), pretty much in line with GDP. This compares to a rise in tax revenues of 2.9%. As shown in the chart below, the weight of public expenses in welfare, healthcare and education have remained pretty stable at more than 60% of the total.

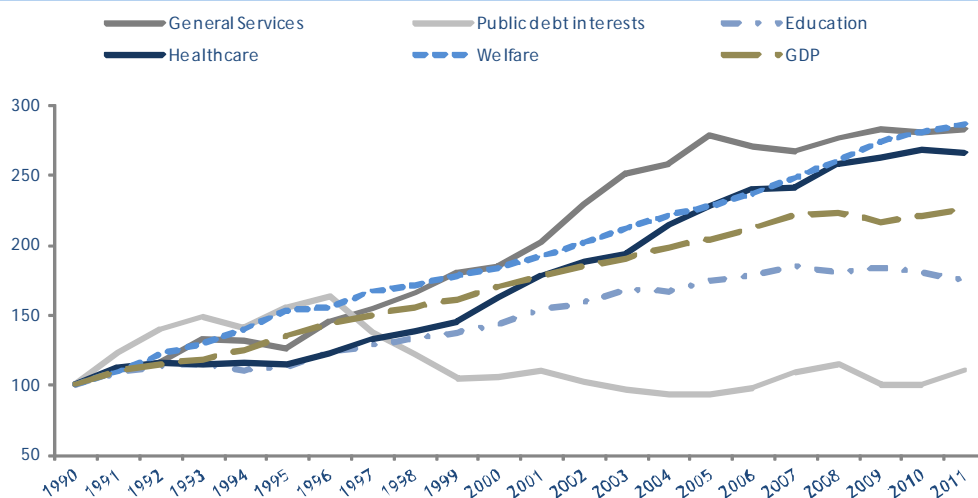
Italian Public expenditure breakdown by class of expense



Source: Mediobanca Securities on MEF data

As shown below, over the last two decades only the interest service on public debt (rebased to 100) has remained flat in relative terms, having benefited from the late 1990s' privatisations reducing the stock of debt and the Euro entrance with its positive impact on the cost of funding of Italy. All the other spending items have seen a stable annual increase. We see scope for potential although limited savings in the general service sector, which includes the heavy burden of the Italian bureaucracy.

Italian public expenditure trend - 1990 = base 100



Source: Mediobanca Securities on MEF data

Tax cutting proposals far from being executed

As is widely known, Italy currently has very high tax pressure:

- ◆ According to Confcommercio, in 2012 the tax pressure calculated on the one euro of legally declared product, is equal to 55%.
- ◆ The manifest fiscal pressure, given by the tax return versus GDP ratio, stood at 45.2% in 2012.
- ◆ Such high pressure is also caused by the high black economy in Italy, which effectively significantly reduces the taxable income. It was estimated in 2008 by the National institute of Statistics (Istat) that the underground economy stood at around €275bn, equal to 17.5% of Italian GDP and €154bn of tax evasion.

In spite of political promises, major taxes have only increased over the last few years, some of them much more than the GDP growth over the same period.

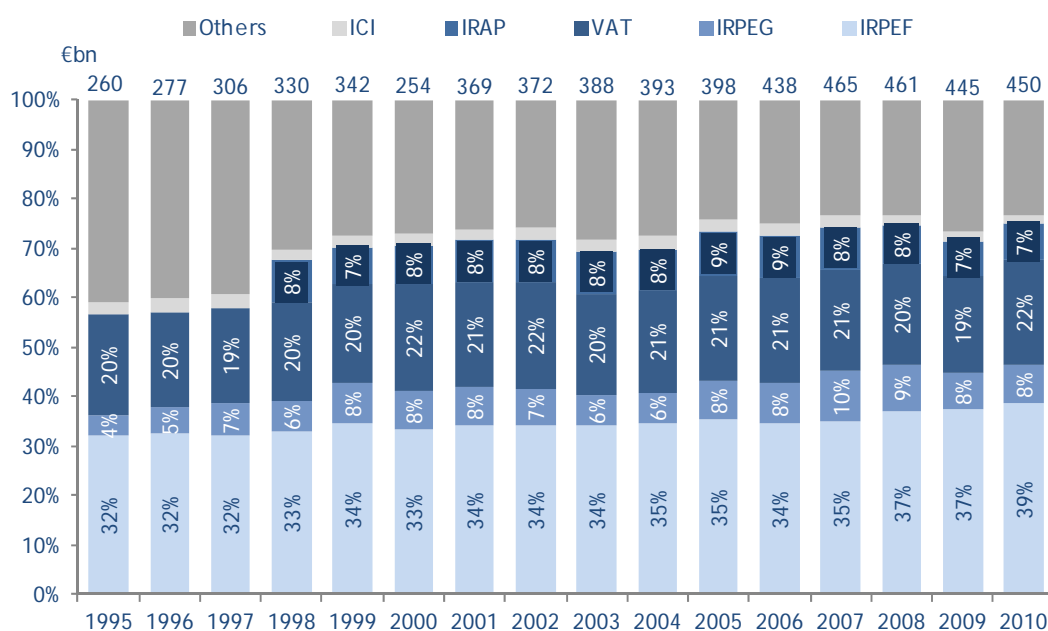
Tax revenue breakdown

€ bn	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	CAGR 95-10
VAT	52	54	59	66	69	77	78	80	79	82	85	93	96	94	86	97	4.2%
IRAP	-	-	-	28	25	27	31	31	32	32	35	38	39	36	32	32	1.2%
IRPEF	83	90	98	109	118	118	126	128	132	137	141	151	163	171	166	174	5.0%
IRPEG	11	14	21	19	29	27	29	27	25	24	30	36	47	44	34	34	7.6%
ICI	7	7	8	8	8	8	9	10	10	10	11	11	12	9	9	9	1.7%
Others	106	111	121	99	94	96	96	96	109	109	96	109	108	107	118	104	-0.1%
Total tax	260	277	306	330	342	354	369	372	388	393	398	438	465	461	445	450	3.7%
GDP	947	1,004	1,049	1,091	1,127	1,191	1,249	1,295	1,335	1,392	1,429	1,485	1,546	1,568	1,520	1,549	3.3%

Source: Mediobanca Securities, MEF, Istat

As shown in the chart below VAT, IRAP, IRPEF and IRPEG have always accounted for more than 60% of the total tax return on average.

Tax stream breakdown



Source: Mediobanca Securities on Eurostat data

Personal Income Tax: 3% of the population pays 31% of total tax (2010)

As shown above, the tax on personal income provided 39% of the total €450bn tax income in 2010. From the table below, we learn that in 2010 there were 41.5m taxpayers whose income was taxed by a total amount of €149bn. Among the different classes, we note that 65% of Italian taxpayers declare an income below €20,000 and only 3% of taxpayers declared in 2010 an income greater than €60,000.

Net Personal Income Tax (Irpef) paid by income class - 2010

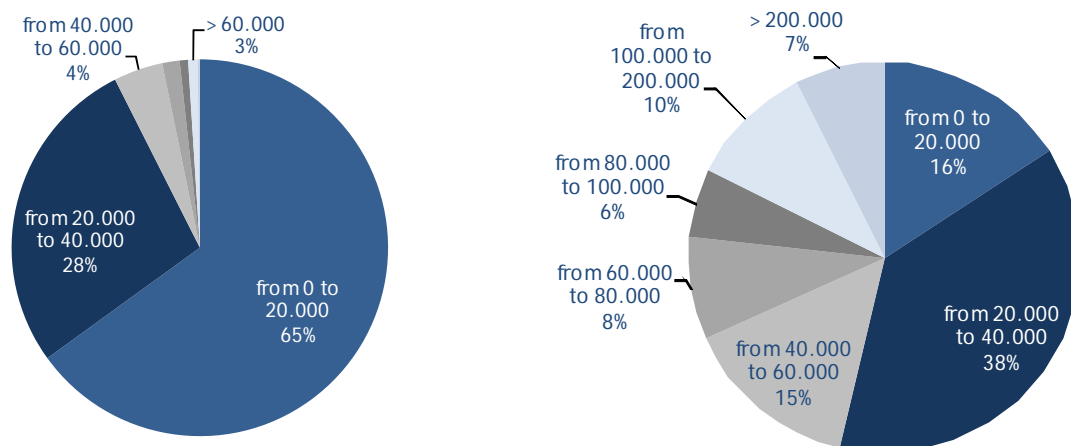
Income classes €	# payers	Amount paid € m
from 0 to 20.000	27,019,392	23,775
from 20.000 to 40.000	11,436,469	56,323
from 40.000 to 60.000	1,756,914	21,820
from 60.000 to 80.000	623,159	12,750
from 80.000 to 100.000	297,771	8,422
from 100.000 to 200.000	337,328	15,239
> 200.000	76,195	11,114
Total	41,547,228	149,443

Source: MEF

However, this 3% accounts for almost 31% of the total Irpef proceeds. On the contrary (see charts below), only 16% of the total amount comes from the taxpayers belonging to the lowest income bracket (€0-20,000). The biggest share belongs to the taxpayers that declare an income within €20,000-40,000. These represent 28% of the taxpayers with a total amount paid of over 35% of the total.

If we had to include the tax evasion and underground economy, we are certain to narrow down the lowest brackets in favour of the highest ones. Cutting debt and fighting tax evasion seem to offer much more scope for success than cutting the rigid public expenditure of the country, in our view.

Irpef taxpayer breakdown by income class (lhs) and Irpef taxpayer breakdown by amount paid (rhs)

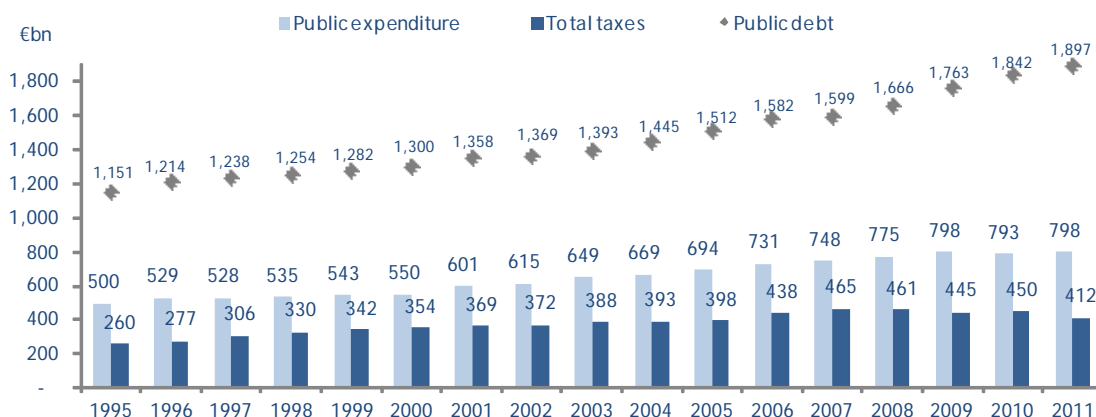


Source: Mediobanca Securities on MEF data

Tax income vs public expenditure: not enough and unpopular to stretch

The chart below puts into context the total public debt, the level of tax revenue and the total amount of public expenditure. As shown, tax revenue covers on average 60% of the total public expenditure (70% if we strip out the payment of interest on public debt). Another big chunk (not shown in the chart) that finances around 20-25% of public expenditure is the social contribution and other revenues not related to taxes. The remaining part is the deficit, which is in the region of 10% of the total tax revenue.

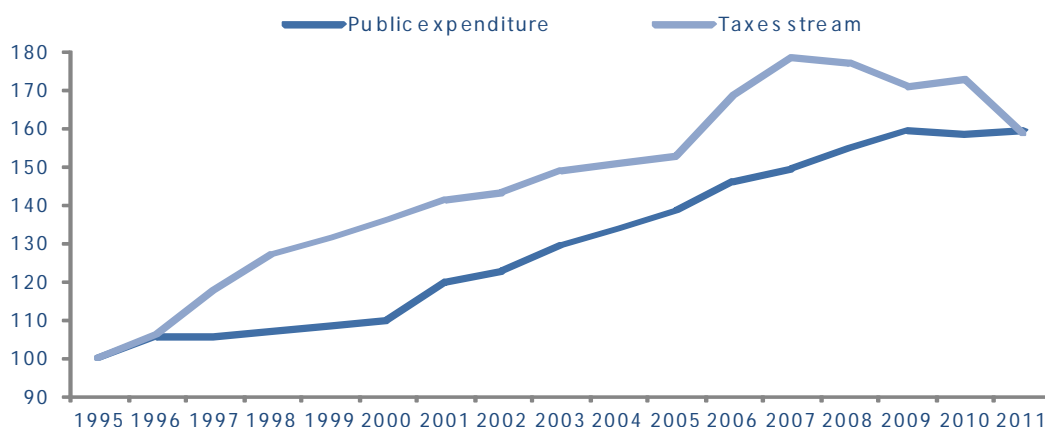
Tax stream, public expenditure and total public debt comparison 1995-2011



Source: Mediobanca Securities

Here below, we have compared the tax revenue and public expenditure trends starting from a common base (1995). It can be seen how the two components have been “walking together” over the last two decades and only in 2011 closed their gap, mainly due to the crisis that brought lower tax stream offset by higher public debt issuance.

Public expenditure and tax stream trend 1995 = base 100



Source: Mediobanca Securities

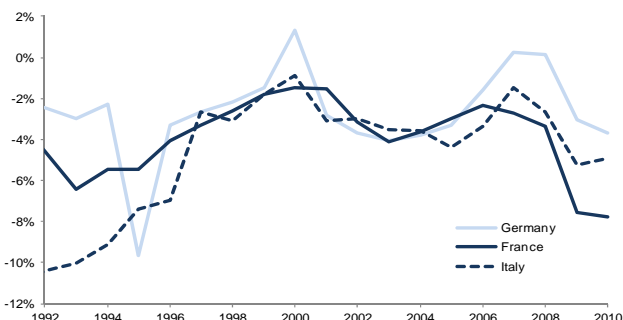
Debt reduction – a mandatory step to regain market confidence

No growth without cutting debt significantly

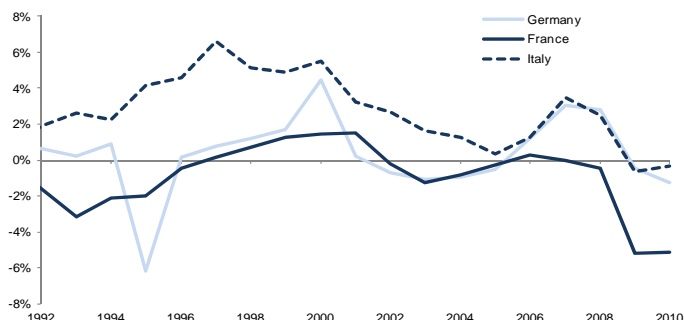
Given the above, we think it is a priority for any future government to put public debt reduction at the top of its agenda. This is not only for the solvency risk that Italy is facing for its high debt, but also for the huge amount of resources that the high interest service on debt (€80-100bn per year) is draining. Inevitably this is the main reason for the low growth of the country, and expecting this trend to reverse without reducing the debt remains overly optimistic, in our view.

The huge debt pressure that Italy is now facing has its roots in at least 30 years of dysfunctional political culture. Deficit spending was the new ‘in vogue’ political approach to running the country in 1980s. Public debt exploded from under 60% of GDP in 1980 to > 120% of GDP in 1994; very close to today’s level. The two charts below compare the budget balance of Italy versus Germany and France over the period 1992 – 2010. By the mid 1990s, given the size of its public debt, Italy was forced to run primary surpluses in order to cover the high interest service on its debt.

Budget balance



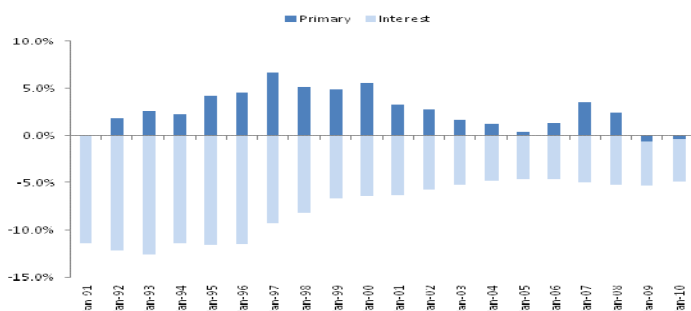
Primary budget



Source: Mediobanca Securities, European Commission

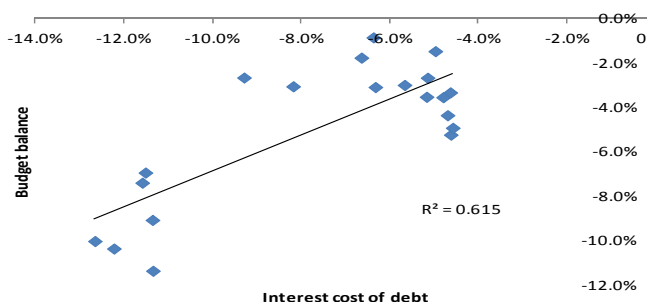
The two charts below summarise the specific Italian problem by breaking down the budget balance into the primary balance and interest cost of debt. The virtuous primary surplus of the last two decades did not even cover the painful cost of interest: as we show in the chart below (right), over the last two decades the interest service on public debt accounted for more than 60% of the budget balance of the country.

Budget balance – split between primary and interest



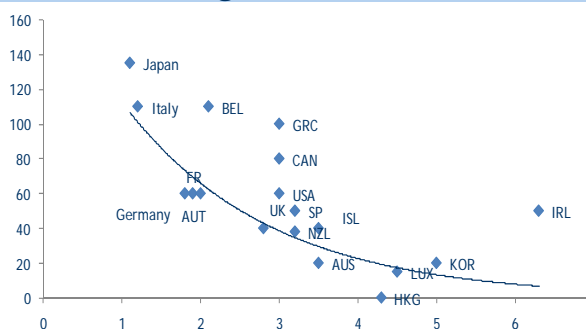
Source: Mediobanca Securities, European Commission

Budget balance vs interest cost of debt, 1991-2010



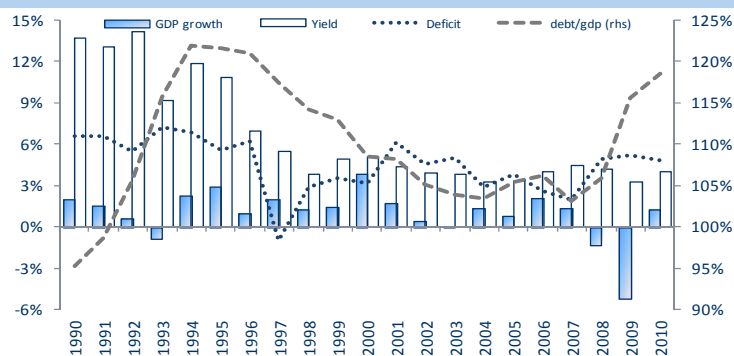
The extremely low growth achieved by the country over the last two decades therefore comes as no surprise, and its reversion must be the priority number one, in our view. There are plenty of examples in history of high public-debt levels slowing GDP growth, with Japan being the most notable recent case. Italy was also no exception: allocating resources to service the cost of debt rather than for economic growth created a large, costly and malfunctioning public administration based on political opportunism and with little benefit for the country. Only in late 1990s did Italy manage to cap public debt increase by undertaking a severe privatisation and assets disposal plan listed in the next page.

Real GDP growth (% X axis) vs debt/GDP (% Y axis), average 1992-2008



Source: Mediobanca Securities, Bank of Italy data, IMF

Italian growth vs debt evolution



Italian privatisations/disposals in 1992-2000, Italian Lira

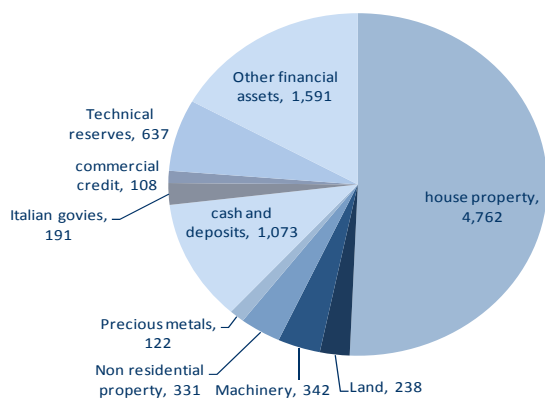
Year	Company	Stake sold %	Proceeds (Lit Bn)	Year	Company	Stake sold %	Proceeds (Lit Bn)
1992	Acciaierie e Ferriere di Piombino (1)	100,0	289	1996	Alumix - rami aziendali	100,0	450
	Cementir	51,8	480		AMGA	48,9	208
	Tubi Ghisa	75,0	121		Dalmine	84,1	301
			890		ENI - ramo fertilizzanti	100,0	166
1993	Agip Argentina	100,0	110		ENI 2	15,8	8,872
	Cirio-Bertolli-De Rica	62,1	311		IMI 3	6,9	501
	Credito Italiano	54,8	1,801		INA 3	31,0	3,260
	EBPA	39,3	271		MAC	50,0	223
	Italgel	62,1	431		Montefibre	66,4	187
	Pavesi 2 (2)	51,0	255		Nuova Tirrena	91,1	548
	SIV	100,0	210		SME 3 (6)	15,2	238
			3,389				14,954
1994	AgipCoal (America)	100,0	171		1997	Aeroporti di Roma 1	45,0
	Alcantara	51,0	195	Alfa Romeo Avio		100,0	238
	AST	100,0	624	Banca di Roma		14,4	666
	COMIT	51,3	2,891	ENI - cavi in fibra ottica		100,0	242
	EVC International	34,2	194	ENI 3		17,6	13,230
	IMI 1	27,4	1,794	Fincantieri - ramo diesel		Magg.	325
	INA 1	47,2	4,530	Nuovo Pignone 2		9,3	150
	Liquipibigas Distribuzione	100,0	221	San Paolo 1		23,2	2,629
	Nuovo Pignone 1	69,3	699	SEAT		44,7	1,653
	SME 1 (3)	32,0	723	Telecom Italia		28,0	22,880
	STMicronics 1	14,8	165				42,607
		12,207	1998	AEM		49,0	1,473
1995	Carbones de Guasare	49,5		236	Alitalia	18,4	787
	ENI 1	15,0		6,300	BNL	62,2	6,706
	EniChem Augusta	85,0		355	EBPA (7)	62,2	1,300
	ILP (4)	100,0		2,332	ENI - ramo alberghi	100,0	244
	IMI 2	19,0		1,200	ENI 4	14,2	12,994
	INA 2	18,4		1,687	NST	100,0	116
	Inca International	80,0		262	SAIPEM	18,7	742
	ISE	74,0	370	STMicronics 3	13,1	985	
	Italtel (5)	40,0	1,000			25,347	
	Sidermar	100,00	129	1999	ACEA	49,0	1,808
SME 2	14,9	341	Autostrade 1		56,6	8,105	
STMicronics 2	11,3	277	Banca MPS		27,0	4,292	
		14,489	ENEL 1		31,7	32,045	
			Mediocredito Centrale		100,0	3,944	
Total 1992-2000 period				STMicronics 4	10,5	2,089	
						52,283	
				2000	Aeroporti di Roma 2 (8)	51,2	2,572
			Autostrade 2		30,0	4,911	
			Finmeccanica		43,7	12,359	
						19,842	
						186,008	

Source: MBRES, Mediobanca Securities

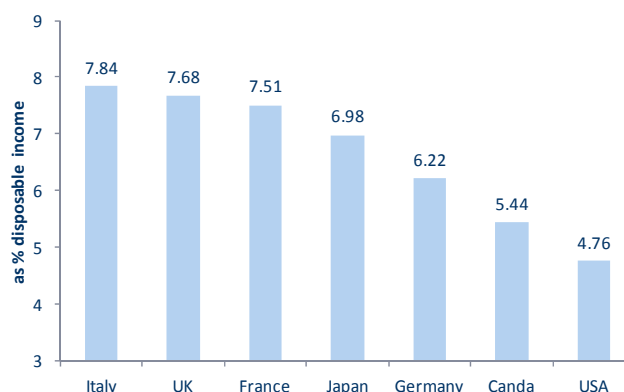
Public debt cut the game changer

We wrote extensively last year on what we consider the priority number one of the country, i.e. the need to massively cut the public debt (see *CDP: Italy's gate to debt cut*, 28 February 2012). Although the Italian net private wealth of roughly €8.5trn covers the country's public debt by 4.5x, we think this is no longer necessarily enough to guarantee the long-term funding capability for Italy. Nor can Italy keep relying indefinitely on its G7 leading position in terms of its household net wealth / disposable income ratio.

Italian wealth breakdown, €bn, 2010



Household net wealth/ disposable income, 2010 (x)



Source: Mediobanca Securities

Monti did not deliver on public debt – why?

The Monti Cabinet surely deserves credit for some important structural reforms undertaken throughout 2012, with the pension reform at the top of the list, in our view. However, it looks almost counter-intuitive to us that no structural reform can really show full benefit in the near term as long as the country will be burdened by the €80-100bn interest service on debt per annum.

Not delivering on cutting public debt is our major disappointment

Monti's lack of delivery on this front is, in our view, the major disappointment. Admittedly, Grilli worked on a plan of €15-20bn asset disposal per year but the short life of the Monti government did not allow, we suspect, for a proper action plan. Why is Italy not aggressively tackling this task given the many state-owned assets available? As a reminder, we list the most relevant ones below:

- ◆ €425bn state owned real estate assets.
- ◆ €100bn listed equity stakes.
- ◆ €125bn gold reserves.
- ◆ €30bn of state concessions.

We do believe in the initial genuine intention of Monti, Passera and Grilli to deliver on this front. This makes the lack of delivery even more worrying as something must have happened in due course that prevented the Monti Cabinet from delivering.

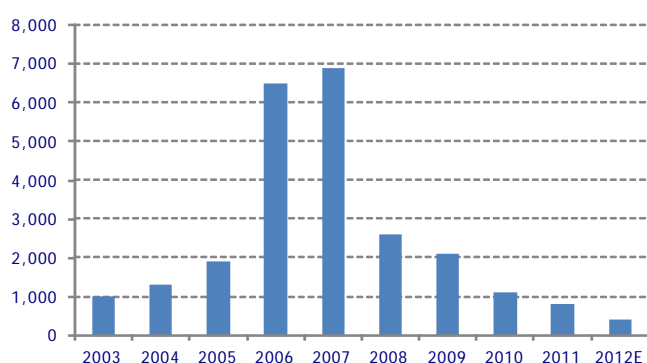
Our best guess on why Italy is so late on assets disposals

We list below what we see as the key reasons contributing to explain such a lack of delivery. Such a list is largely based on the visibility we have gained on this topic from our discussions with the relevant people involved over the last year following our CDP note.

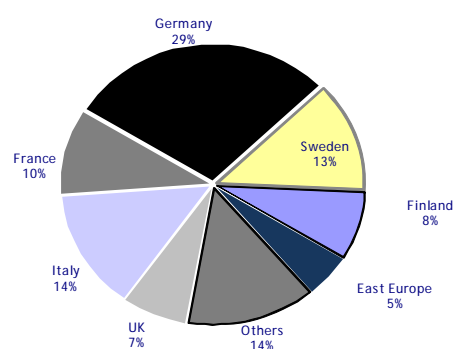
- ◆ **Fragmented ownership.** Real estate assets are fragmented among various owners as the central government controls only 17% of public assets, while 60% is owned by municipalities and 21% by other public entities. This makes the disposal process very complex.

- ◆ **Sale and lease-back to penalise deficit.** In spite of the astonishing number (€425bn state-owned real estate, more than France and Germany combined) only a small 10% is immediately available for sale, while the rest is in use by the public sector. This would require an aggressive cost-cutting plan given square meter per employee at 50 in Italy, twice the private sector and versus 12 for international best practice. Without optimising space occupancy, the risk would be that in having to lease back such buildings Italy would end up penalising its deficit post sale and lease-back. That requires time.
- ◆ **Low yields.** Yields of public real estate are generally low, especially for the assets directly controlled by the State, hardly yielding more than 1%.
- ◆ **Poor track record.** Past experience has shown that selling public real estate in Italy is not an easy process. Relevant public real estate sales started at the beginning of the 2000s with the securitisation of assets owned by public pension funds, followed by the launch of some funds. Securitisations Scip 1 and 2 disappointed both in size and on the deconsolidation from the public debt. FIP securitisation showed that in order to be appealing to institutional investors, public real estate must offer instruments with attractive yields. In the current phase of the Italian real estate, attractive yields would require large discounts on expected market values.
- ◆ **ESA 95 constraint.** However, an excessive discount on market value would run the risk of undermining the overall goal of debt reduction as the ESA95 (European System of Accounts) allows for deconsolidation only if assets are sold at a price not lower than 85% of their market value.
- ◆ **Anaemic real estate market.** The Italian real estate market is still weak and illiquid and is expected to remain so at least throughout the whole of 2013. A few figures on the Italian commercial real estate sector and on European public real estate sales may represent an interesting reality check for any assumption on possible sales of Italian public real estate. In 2012 the whole Italian commercial real estate investment activity amounted to around €2.0bn, roughly 50% below the level recorded in the period 2009-2011. The drop in investment volumes was essentially due to the disappearance of foreign capital, which fell from 80% to some 20% of the total. As shown in the chart below, volumes of public real estate sales declined in the last three years, with 2012 touching a new low.

Public sector property sales in Europe 2003-12E



Public sector property sales, 2006-11



Source: Mediobanca Securities, Scenari Immobiliari

- ◆ **Real estate funds can hardly help.** Any hypothesis of the implications of massive asset sales directly in the market should deal with these figures. However, the creation of real estate funds to sell public assets also cannot be seen as a panacea. Selling the funds to investors looks challenging as the whole Italian real estate fund sector is worth around €50bn in terms of assets, and is facing a difficult period as many funds are approaching their deadlines given the very illiquid market.

- ◆ **Too many 'stakeholders' around CDP.** We remain convinced of our view that CDP could be the best vehicle to implement such actions. Admittedly something happened last year in the direction we advocated, i.e. CDP buying state-owned assets and allowing for deconsolidation. However, this involved only the state credit insurer SACE, the state export credit company Simest and Fintecna, which are still subject to due diligence and are having a very limited impact on public debt reduction. The problem to us in properly leveraging the role of the CDP as a vehicle for deconsolidating state-owned assets relates to the too many 'stakeholders' potentially involved in such a process: foundations (controlling 30% of CDP), Italian Treasury, Demanio, Italian banks, Bank of Italy, etc. This makes decision-making virtually impossible in a country historically unable to share common decisions in the interest of the country and the inclination to clash on everyone's own specific interest.
- ◆ **Gold mystery.** Italy holds the third largest gold reserves in the world (€125bn). We admit that our idea of selling gold (i.e. what countries like the UK have done in the past) to cut debt was clearly a provocative one. However, the debate we generated with such an idea leaves us unsure on whether Italy is free to dispose of such asset or if it is not allowed to do so in the interest of its EU partners, representing gold a sort of guarantee buffer on Italy's high public debt.
- ◆ **Assets disposals versus 'Euro covered bonds'.** This last point could be extended to all the state-owned assets. Italy could use these assets to cut its debt. Or it could keep them as collateral almost naturally required by Germany as a back-up for whatever Eurobond project might be considered in the future. One of the two has to happen, in our view: Italy uses its own assets to cut its own debt or to set up a collateral for Eurobonds. We think any future government would need to play its cards on this table as it is no longer acceptable to remain in limbo: either forcing Germany to officially open up to some sort of Euro Covered Bonds for which such assets will be used as collateral or going it alone in a credible asset disposal plan.

Fiscal Compact forces cuts to debt and expenditure

Debt cut and balanced budget are the pillars of the Fiscal Compact. We think the European Redemption Fund (ERF) proposal from Germany best shows how these two constraints would work for Italy. We have simulated a roadmap towards a debt cut for Italy for the portion exceeding the 60% of GDP level, i.e. €950bn debt cut on a time horizon of 30 years. The funding costs savings would amount to €24bn pa, i.e. roughly 1.5% of GDP. The price to pay for that though would be a total annuity of €62bn per year at the beginning of the plan – almost equally split between capital paid down for 1/30 (€32bn) and interest payment. This gives an idea of the budget constraint that Italy is currently facing: assuming the ERF at work would absorb some 8.3% of Italy's current government revenues at the beginning of the process. With the stock of debt reducing over time, the interest component is expected to halve after 15 years, and the total fiscal constraint to become less stringent. If the ERF had been implemented in 2011, EU 17 countries would have been forced to spend 12% less than that which they effectively spent in 2011, with Italy suffering a more drastic cut of 16%. In summary, a virtuous roadmap towards a debt cut and balanced budget requires for Italy 4 p.p. of sustained primary surplus – twice the EU average.

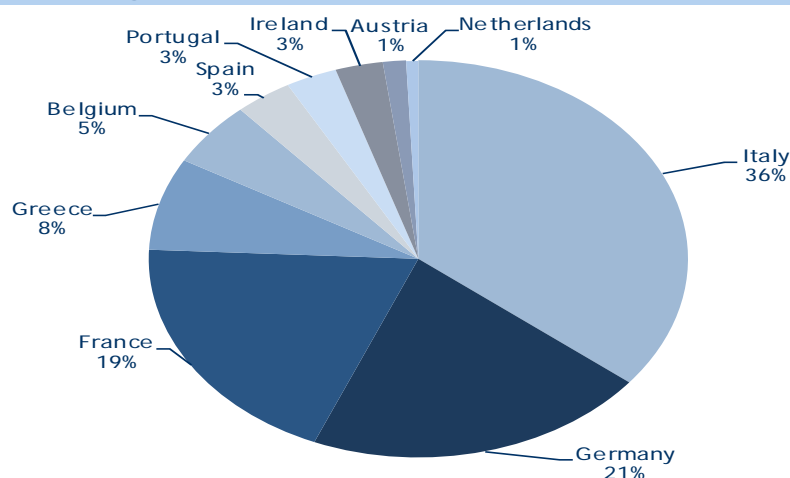
Don't count on OMT – Debt/GDP ratios remain unsustainable in periphery

The EU sovereign crisis taught us that beyond certain thresholds of indebtedness it has become virtually impossible for any EU country to refinance itself in the market. Owing to the OMT announcement, the pressure on the cost of funding has recently softened somewhat. However, we think that peripheral countries cannot simply relax and rely on the OMT. It remains crucial to assure the market with a credible trajectory towards debt reduction and fiscal discipline, in our view.

We think this is particularly urgent for Italy as the country has experienced a significant cost of funding increase since 2010 only recently capped by the Draghi intervention. Targeting successful fiscal austerity for Italy with 10 yrs refinancing cost in the region of 5% and €2 trillion of debt looks to us like a herculean task without a more stringent commitment towards a debt cut or without a more sustainable funding cost.

The European Redemption Fund offers a good example of the effort required

Debt cut and balanced budget should, we believe, remain at the heart of the fiscal policy of any future Italian government. The European Redemption Fund (ERF) is perhaps the best way to estimate the combined effect of both debt cut and balance budget on the Italian accounts. The ERF, first proposed by the German Council of Economic Experts, would eventually be set up in order to receive the portion of debt exceeding the 60% ceiling Debt-to-GDP ratio from each Eurozone country member. Including Greece, Ireland and Portugal, the ERF could amount to a total €2.7tn. As shown below, Italy, Germany and France combined would account for 76% of funds transferred, with Italy keeping the lion's share.

Debt/GDP exceeding 60% – Some €2.7trn ERF


Source: Eurostat, Mediobanca Securities

By offloading the debt currently in excess, all Eurozone members would have the opportunity to be fully compliant with the Maastricht criteria, i.e. with the Fiscal Compact, which is forcing debt in excess of 60% to be reduced by 1/20 per year over the next 20 years.

Funding cost benefit would amount to some 150bps of GDP pa for Italy

Italy would effectively represent almost €1trn of ERF debt. The reward for such a debt cut commitment would be a significant funding cost benefit, which in the table below we estimate to be roughly 1.5p.p. of GDP per annum for Italy. The aggregate funding cost benefit for European countries would be in the region of 70 bps of GDP.

In the table (below) we have assumed that the ERF will issue bonds at 3.25%, in line with the 3-3.5% cost of funding of supranational bodies such as the EFSF, which benefits from the joint guarantee of all Eurozone governments.

Some findings:

- ◆ The cost of funding of Italy on the 60% debt/GDP portion to be brought under the ERF umbrella (€949bn) would decrease to €31bn from €55bn.
- ◆ Such €24bn funding cost savings amounts to roughly 1.5% of GDP, and would have resulted in a pro forma 2011 deficit improving to 2.5% from the reported 4%.
- ◆ The benefit for Spain would be in the region of 30bps debt/GDP ratio due to the much lower size of the Spanish debt to be brought under the ERF surveillance.
- ◆ The price paid for Germany would be in the region of 40bps GDP given ERF funding costs assumed to be above the current German equivalent yield.
- ◆ Overall, for the EU 17 countries in our panel, the funding cost benefit in 2011 would have amounted to 70bps of GDP, i.e. €66bn.

ERF Funding benefit (€bn) assuming 3.25% cost of funding, 2011 simulation

Country	Public debt (€bn)	Normalised debt (60% GDP) (€bn)	Excess debt transferred to ERF (€bn)	ERF cost of funding (3.25%)	Country cost of funding without ERF	ERF funding Benefit	ERF Funding benefit % GDP (2011)	Fiscal deficit % GDP (2011)	Post ERF Pro forma Fiscal deficit % GDP (2011)
Greece	329	129	200	-7	-52	45	21.0%	-10.2%	10.8%
Italy	1,897	948	949	-31	-55	24	1.5%	-4.0%	-2.5%
Ireland	169	94	75	-2	-5	3	1.7%	-10.0%	-8.3%
Portugal	184	103	82	-3	-7	5	2.7%	-5.9%	-3.2%
Belgium	362	221	140	-5	-4	0	0.0%	-4.7%	-4.7%
France	1,717	1,200	517	-17	-13	-3	-0.2%	-5.7%	-5.9%
Germany	2,088	1,542	546	-18	-9	-9	-0.4%	-1.0%	-1.4%
Austria	217	181	37	-1	-1	0	-0.1%	-3.7%	-3.8%
Malta	5	4	1	0	0	0	-0.4%	-2.9%	-3.3%
Cyprus	13	11	2	0	0	0	-0.4%	-7.1%	-7.5%
Spain	735	644	91	-3	-6	3	0.3%	-8.5%	-8.2%
Netherlands	393	373	19	-1	-1	0	0.0%	-4.0%	-4.0%
Finland	93	115	-	0	0	0	0.0%	-2.1%	-2.1%
Slovenia	17	21	-	0	0	0	0.0%	-6.0%	-6.0%
Slovakia	30	41	-	0	0	0	0.0%	-5.6%	-5.6%
Luxemburg	8	26	-	0	0	0	0.0%	0.0%	0.0%
Estonia	1	10	-	0	0	0	0.0%	0.0%	0.0%
Total	8,258	5,663	2,659	-86	-152	66	0.7%	-4.8%	-4.1%

Source: Eurostat, ECB, Mediobanca Securities

ERF – a catalyst for structural reforms

In exchange for getting the benefits of lower cost of funding for the transferred debt to the ERF, the EU members would need to comply with strict conditionality not significantly different from what is already required by the Fiscal Compact:

- ◆ Devoting part of their tax revenues to repay the maturing part of the debt transferred. Each country would have to make annual payments to the ERF, which would be used to repay the portion of the debt maturing each year, hence forcing the cutting of general expenses.
- ◆ The amount of the debt to be repaid each year will be a constant percentage of the debt transferred in order to guarantee that after a period of 25-30 years, all the debt transferred to the ERF will be fully repaid.
- ◆ Collateral amounting to 20% of the transferred debt will have to be pledged specifically to the ERF in order to cover the payment obligation made to service the debt. Such collateral will be taken from the country's currency and/or gold reserves, or other kind of collateral that might, however, suffer a haircut.
- ◆ It is worth noting that as a result, the collaterals brought in by each country serve as a liability only for the debt originated through this country, hence no pooling of collateral is to occur.
- ◆ Each member has to agree that should it fail to honour its commitments, it would forfeit the collateral deposited with ERF.
- ◆ Commit to structural reforms, as cutting expenses is critical to offset the payments to the ERF and at the same time to comply with the debt cap. Each country will therefore have to implement a debt cap for the non-ERF debt, as requested by the fiscal compact, i.e. with structural deficit required to stand below 0.5% GDP.

The Italian 'Expiation' Fund

The ERF would absorb some 8.3% of government revenues at the beginning for Italy

The table below shows a possible roadmap towards redemption for Italy assuming in 30 years time. Assuming 2012 to be the starting point and the ERF to fund itself at 3.25% would mean for Italy a total annuity of €62bn per year at the beginning of the plan, almost equally split between capital paid down for 1/30 (€32bn) and interest payment. Based on the assumptions of our simulation, Italy would be forced to allocate some 8.3% of its current government revenues to the ERF at the beginning of the process. With the stock of debt reducing over time, the interest component is expected to halve after 15 years, and the total fiscal constraint to become less stringent as soon as the material benefit of debt reduction in terms of lower interest payments will kick in. As we called it in our *Redemption on the way to Brussels* (25 June 2012), the Fiscal Compact looks designed as a 'tailor made straightjacket' aimed at forcing Italy into severe consolidation.

Italy – debt exceeding 60% GDP brought to zero in 30 years, €bn

	Residual capital	Interest payment	Capital payment	Total annuity	Gvt revenue (3% CAGR)	as % of government revenues
2012	949	(31)	(32)	(62)	750	8.3%
2013	917	(30)	(32)	(61)	773	8.0%
2014	886	(29)	(32)	(60)	796	7.6%
2015	854	(28)	(32)	(59)	820	7.2%
2016	823	(27)	(32)	(58)	845	6.9%
2017	791	(26)	(32)	(57)	870	6.6%
2018	759	(25)	(32)	(56)	896	6.3%
2019	728	(24)	(32)	(55)	923	6.0%
2020	696	(23)	(32)	(54)	951	5.7%
2021	664	(22)	(32)	(53)	979	5.4%
2022	633	(21)	(32)	(52)	1,008	5.2%
2023	601	(20)	(32)	(51)	1,039	4.9%
2024	569	(19)	(32)	(50)	1,070	4.7%
2025	538	(17)	(32)	(49)	1,102	4.5%
2026	506	(16)	(32)	(48)	1,135	4.2%
2027	475	(15)	(32)	(47)	1,169	4.0%
2028	443	(14)	(32)	(46)	1,204	3.8%
2029	411	(13)	(32)	(45)	1,240	3.6%
2030	380	(12)	(32)	(44)	1,277	3.4%
2031	348	(11)	(32)	(43)	1,316	3.3%
2032	316	(10)	(32)	(42)	1,355	3.1%
2033	285	(9)	(32)	(41)	1,396	2.9%
2034	253	(8)	(32)	(40)	1,438	2.8%
2035	221	(7)	(32)	(39)	1,481	2.6%
2036	190	(6)	(32)	(38)	1,525	2.5%
2037	158	(5)	(32)	(37)	1,571	2.3%
2038	127	(4)	(32)	(36)	1,618	2.2%
2039	95	(3)	(32)	(35)	1,667	2.1%
2040	63	(2)	(32)	(34)	1,717	2.0%
2041	32	(1)	(32)	(33)	1,768	1.8%
2042	(0)	0	(32)	(32)	1,821	1.7%

Source: Mediobanca Securities

Some 16% lower public spending in 2011 for Italy with the ERF

Regarding the 'redemption map' above, it is interesting to quantify the budget constraint that such a debt reduction plan would put on peripheral countries. In the table below, we have made the following assumptions:

- ◆ Countries would repay the debt transferred in 30 years; we have factored in our calculations an annual fixed capital amortisation of 1/30.
- ◆ Revenues related to collateralised assets to remain in each country's hands, hence not penalising the total government revenues.
- ◆ We have also assumed that collateral is paid back by the ERF to each country only at the end of the full repayment of the debt transferred, i.e. it is not going to be used to pay down debt.
- ◆ We assume government revenues for each country to grow at a 3% nominal CAGR, which is derived from a growth rate of real GDP of 1-1.5% and an average inflation rate of 1.5-2%, in line with the inflation target of the ECB;
- ◆ We have not included in our calculations the potential benefits that countries could enjoy if their own cost of funding were to fall as a result of the ERF implementation. This should in fact allow each country to refinance the debt kept outside the ERF at a lower cost than that currently experienced.
- ◆ We assume each country to keep a balanced budget as required by the fiscal compact.

The results are shown below. If the ERF had been implemented this in 2011 and assuming EU member to comply with a balanced budget, the EU 17 countries would have been forced to spend 12% less than that which they effectively spent in 2011, with Ireland (-33%), Greece (-31%), Spain (-21%) and Italy (-16%) suffering the most drastic cuts.

ERF Impact on Eurozone countries spending (€bn), 2011

Countries	Excess debt transferred to ERF	ERF related expenses	<i>o/w</i> Interest payment	<i>o/w</i> capital payment	Gvt revenue	Post ERF Gvt expenditure	Reported expenditure	Expenditure contraction
Greece	200	-13	-7	-7	88	-75	-108	-31%
Italy	949	-62	-31	-32	728	-666	-789	-16%
Ireland	75	-5	-2	-3	56	-51	-76	-33%
Portugal	82	-5	-3	-3	76	-71	-84	-15%
Belgium	140	-9	-5	-5	182	-173	-197	-12%
France	517	-34	-17	-17	1,014	-980	-1,118	-12%
Germany	546	-36	-18	-18	1,149	-1,113	-1,172	-5%
Austria	37	-2	-1	-1	144	-142	-152	-7%
Malta	1	0	0	0	3	-3	-3	-8%
Cyprus	2	0	0	0	7	-7	-8	-15%
Spain	91	-6	-3	-3	377	-371	-468	-21%
Netherlands	19	-1	-1	-1	283	-282	-312	-10%
Finland	-	0	0	0	102	-102	-103	-1%
Slovenia	-	0	0	0	16	-16	-18	-13%
Slovakia	-	0	0	0	23	-23	-26	-13%
Luxemburg	-	0	0	0	18	-18	-18	-1%
Estonia	-	0	0	0	6	-6	-6	0%
Peer group	2,659	-175	-86	-89	4,273	-4,098	-4,658	-12%

Source: Eurostat

The ERF locks Italy into 25 years of primary surplus

If the ERF is set to relieve the burden of servicing debt, the need for structural reforms remains critical in most Eurozone countries. The currently high funding cost forces peripheral countries into primary surpluses in order to maintain a sustainable debt trajectory. Hence for peripheral countries agreeing to redeem their ERF debt, and to keep the remaining debt below the 60% threshold while complying with

a balanced budget constraint, means that they commit to restore their primary fiscal surplus for a long time horizon. The table below shows a static picture on 2011 accounts of what that effectively means.

We proceed as follows:

- ◆ We start from the 2011 government expenditure adjusted for the potential impact of the ERF on 2011 accounts.
- ◆ We then calculate the cost of funding on the non-ERF debt at today's funding cost.
- ◆ This leaves us with 2011 expenditure adjusted both for the ERF cost and for the cost of refinancing the non-ERF debt component at today's rates.
- ◆ Comparing such a number with the disclosed government revenues in 2011, we are left with a pro forma implicit primary surplus required to comply with the ERF and the fiscal compact.

ERF to restore primary surplus as a pre condition to redemption (€bn), 2011

Countries	Post ERF authorized Gvt expenditure	Normalised debt (60% GDP)	Interests on norm. debt	Post ERF expenditure pre interests	2011 Gvt revenue	Post ERF Primary fiscal surplus (deficit)	as % GDP
Greece	-75	129	-33	-42	88	46	21%
Italy	-666	948	-55	-611	728	118	7%
Ireland	-51	94	-7	-44	56	12	7%
Portugal	-71	103	-10	-61	76	16	9%
Belgium	-173	221	-7	-166	182	16	4%
France	-980	1,200	-32	-948	1,014	66	3%
Germany	-1,113	1,542	-24	-1,089	1,149	60	2%
Austria	-142	181	-4	-138	144	7	2%
Malta	-3	4	0	-3	3	0	1%
Cyprus	-7	11	0	-7	7	0	1%
Spain	-371	644	-44	-326	377	50	5%
Netherlands	-282	373	-8	-274	283	9	1%
Finland	-102	115	-2	-100	102	2	1%
Slovenia	-16	21	-1	-15	16	1	3%
Slovakia	-23	41	-2	-21	23	2	2%
Luxemburg	-18	26	0	-18	18	0	0%
Estonia	-6	10	0	-6	6	0	0%
Peer group	-4,098	5,663	-229	-3,869	4,273	404	4%

Source: Eurostat, 2011 figures

- ◆ It can be seen that the implementation of the ERF would have capped the 2011 aggregate EU17 Government expenditure to €3.9tn. Given €4.2bn reported government revenues, this translates into a required surplus of 4% GDP at EU level.
- ◆ Such an exercise shows a 7% surplus requirement for Italy at the start of the process.

Clearly our findings are more stringent than what the reality will be. Our simulation above is based on a static picture of the 2011 situation. In a dynamic approach, i.e. considering the stock of ERF debt to be reduced over time, we calculate the required primary surplus for EU 17 countries would be in the region of roughly 2% and that required for Italy would be in the region of 4% versus the 7% reported above for the first year.

The 'hot dossiers' on the next government table

In this last section, we focus on the sectors and stocks potentially most exposed to the likely political newsflow ahead. We scrutinise here the relevant open topics that our Italian coverage could bring to the table of the new government. These relate to potential fiscal interventions, governance issues, management changes and/or stock-specific situations. Our cautious stance on the uncertain electoral outcome ahead and its potential negative impact on the spread lead us to prefer Telecom, Oil, Industrial and Branded & Consumer over Banks, Asset gatherers, Insurance and Real estate. On an intra-sector perspective, we also propose some pair trades that try and capture our expectations of political impact on the stocks: Long PMI and UBI vs short ISP, Azimut vs MED and BGN, El Towers vs Mediaset, ENI vs Saipem, Ferragamo and Prada vs Geox, Fiat vs Finmeccanica. We finally propose a list of core holdings in case we are wrong, i.e. in case of material delivery from the coming government on several themes.

A lot is cooking in the kitchen of the new government

The spread reaction will surely be the first test for the new government in signaling if and how the market is reassured by the commitment of Italy to the EU project. We believe that the level of conviction of Italy on this front will be dependent on the different 'souls' that will make up the new government. This is clearly not going to be easy. Even assuming the base case scenario of a PD plus Monti coalition, we believe it will still be difficult to 'square the circle' between the growth initiatives promised to the voters from the left and the austerity focus promised to Europe from the center.

Recent negative news did not please the market . . .

A succession of relevant news from the corporate world gained media attention recently, and its timing, just ahead of the elections, remains a surprising coincidence, in our view. The MPS saga, the management issues at Saipem, ENI and Finmeccanica are just the most visible and recent examples. If at first sight such newsflow might have concerned investors, we stress here how important and positive it is for the future credibility of the country that these stories are finally emerging. The common link of the newsflow above is essentially related to two pillars:

- ◆ The poor governance of many Italian companies.
- ◆ The inevitable strong link between business and politics.

. . . but long term this can only help: from denial to contrition

Both problems are deeply rooted in Italian history and call into question the role of the foundations, the shareholders' pact, the spoil system, the management issues, the lack of generational change in the key roles, etc. More generally we would refer it the poor market friendly approach of the Italian corporate world. For this reason, we actually welcome the recent scandals as they are most likely going to trigger a virtuous circle by effectively forcing the Italian establishment to become more transparent to the market and to the regulators. After the 1992 corruption scandals, the reputation of the country is at stake again. We think Italy can only benefit from this and any strong future government will have a crucial role in supporting such a transition from denial to contrition.

In the following sections we attempt to propose what we consider the relevant unresolved topics affecting our Italian coverage that sooner or later will need an answer from the new government. We use a by-sector approach to identify potential winners and losers from the new government when considering changes in the fiscal policy, growth initiatives or simply looking at how to fix some open stock-specific topics or management changes. Our conclusions based on the cautious stance of this report point to the trades listed below:

Italy – Intra sector pair trades based on our cautious stance ahead of the elections

Sector	Long	Short
Banks	PMI, UBI	ISP
TMT	EI Towers	Mediaset
Asset gatherer	Azimut	MED, BGN
Oil	ENI	Saipem
Industrials	FIAT	Finmeccanica
Branded goods	Ferragamo, Prada, Luxottica	Geox, Tod's

Source: Mediobanca Securities

What if we are wrong? The stocks to own in case of government delivery

Should our central cautious stance prove wrong and the coming government positively surprise us in terms of strength and delivery, we also list here below what we would consider the best stocks to own by theme.

What if we are wrong? Core holdings in case of government delivery, by theme

Theme	Stocks to own
IMU tax cut	Beni Stabili
IVA tax cut	Autogrill, De Longhi
IRAP tax cut	MPS, UBI, Espresso, Mondadori
Tax credit on advertising	Mediaset, Espresso
Export incentive	FIAT, Fiat Industrial, Ferragamo, Prada, Luxottica
Real estate disposal	Beni Stabili
Spread narrowing	MPS, MED, Generali, BGN, Beni Stabili
Foundations 'shake up'	ISP, MPS
Bad bank	UCG, MPS, BP
Popolari governance	PMI, UBI, BPER, BP
Lower LLP from growth initiatives	MPS, UBI, BP, UCG
TMT network spin off regulation	Telecom Italia
Management change	ENI

Source: Mediobanca Securities

Banks: a long list of pending issues

We have written extensively on the many issues affecting the Italian banking sector and calling for some sort of clarity from Rome. In this section, we flag what we consider the most relevant ones, namely:

- ◆ The future of the banking foundations;
- ◆ The potential nationalisation of MPS;
- ◆ The governance issues potentially triggered by the Banking Union;
- ◆ The bad bank;
- ◆ The fiscal treatment of provisioning;

The Bersani Decree is a reference point for more liberalisation to come

Before exploring the above topics in detail, let us recollect what Bersani already introduced in his previous government experience. In April 2007 the Italian Parliament converted the Italian Decree-Law 7/2007 (the so-called “Decreto Bersani *bis*”) on liberalisation into law. As far as the banking sector is concerned, the decree affects the regulations on residential mortgages, introducing four new articles.

- ◆ Article 7 prohibits the application of penalty clauses and/or fees when an early repayment occurs, and applies only to new residential mortgages to individuals (including sole proprietorship and freelancers). For mortgages already in place, an agreement between the Italian banking association and the consumers’ union sets a maximum amount on such fees.
- ◆ Article 8 states that the bank that has originally provided the mortgage may be replaced, on the borrower’s initiative, by a new bank providing a new mortgage. This rule aims to facilitate the replacement of mortgages; however, the amount of the new mortgage cannot exceed that of the old one.
- ◆ Article 13 makes it easier to cancel a mortgage once it has been repaid. With this new rule that applies to everyone, the bank is responsible for all the procedures required to cancel a mortgage and a solicitor is no longer required.
- ◆ Article 8-*bis* brings the new regulations to a close, imposing a rule of compliance to prevent banks from not applying or obstructing implementation.

The general tone was for more liberalisation to be introduced in the sector. The outcome of the above did not prove particularly penalising for the banks, but it shows that the sector can hardly count on a potential ‘friendly’ Bersani government for the future.

Foundations: more diversification outside the banks, too hot for the coming government

Our key conclusions in ‘*Re-foundation* (28 May 2012) remain intact and have actually gained ground in light of the recent MPS events. The link between banks and controlling foundations remains too strong. In the interest of both sides, we advocate foundations exiting the banks. This would allow the former to better diversify their net worth and the latter to gain strategic freedom. This is admittedly a hot topic in Italy, perhaps the climax of the link between politics and business. Hence, touching on this subject is extremely difficult – even for the analyst attempting to explain the situation in a transparent way. Indeed, we doubt the coming government will manage to properly tackle this topic. However, we think it is just a matter of time before Italian foundations can move their core business outside of the banks. In the long term this could mean overhang risk on some Italian banks (MPS, ISP in particular), but we would rather focus on the friendly governance premium that such a market-friendly approach would most likely originate. The price foundations will pay for not diversifying their activities sufficiently is a further cut to their grant making activity, and risk of erosion in their net worth so to generate unhappiness among their stakeholders, i.e. the cities where they are based.

MPS: Nationalisation or M&A

As we argued in our note *The Fog is Lifting* (8 February 2013), we think that MPS management capped the downside of its undisclosed (so far) losses and is even exposed to potential upside from damage action request. Still, it is the spread that really drives the stock given that MPS is the EU bank with the highest gearing into government bonds, and this is not in the hands of the management. The bank is de facto already nationalised, and given the limited earnings power and restructuring potential the 9% coupon payment is destined to cap the RoTE of the group, in our view. This is why we think any sensible government would consider nationalising the bank and buying the appropriate time to fix it and selling its stake at a later stage. This would not be much different from what we have seen in many EU countries. However, we think this action would be virtually impossible from a Bersani-led government. Following the aggressive media campaign highlighting the link between his PD party and the PD-tainted council of Siena expressing the BoD of the Foundation, it would be even more controversial if such a government were to take full control of the bank. This is why we recently ended up flagging the M&A angle as a potential way out, and pointing to BNPP as the most natural buyer of MPS (see *French Banks – Capital optimisation: high risk, low return*, 6 February 2013).

Governance issues in clash with the Banking Union: Popolari on fire

Shareholders' pacts and savings shares are two key Italian characteristics that could be seen as essentially creating preference status among certain shareholders, and potentially clashing with an EU banks' level playing field that the Banking Union is trying to achieve. However, it is on the popolari that this governance peculiarity is most exemplified, as Italy remains the only EU country with listed one-man one-vote banks. This view brings us to flag the need for M&A and governance change in *Popolari – the M&A trigger in 2013* (12 December 2012). The events that followed at PMI confirm these themes seem to be at play even sooner than we thought. We think any new government would have to support the ongoing debate on the governance change and / or M&A in the space with the likely back-up of the Bank of Italy (see *PMI - The value of a change in the governance*, 15 February 2013).

Bad bank – The €32bn asset quality issue in Italy

Distress in Italy is captured one way or another within the four categories

The definition of impaired loans in Italy is broader than in most European countries, as it comprises insolvency, temporary financial difficulty, restructuring (with or without a loss for the lender) and payment overdue. On past due loans, Italy also looks to be in line with if not ahead of its European peers. Current Bank of Italy guidelines specify that, after 90 days of arrears, a loan must be classified at least as past due, in line with EU best practice. However, management has the discretion to classify it as *incaglio* or *sofferenza* after just one day of delay in the loan payment. Hence, we believe that the possibility of not capturing a situation of distress in one of the four Italian categories is limited (NPLs, doubtful, restructured and past due). This is why we do not agree too much with the argument of late recognition of problem loans in Italy.

Italian banks coverage ratio

At aggregated level, we calculate that the sample of Italian Banks under our coverage reported a 46% cash coverage ratio of doubtful loans (*sofferenze, incagli, ristrutturati/in corso di ristrutturazione, scaduti*) in 2011, when adjusted for our EU homogeneous methodology including the portfolio-based provisions to the allowance for impaired assets. The range goes from 30% at BP and CRG to 53% at ISP. Such a 46% average does not differ from that found in Germany (CBK at 46% and DB at 44%) and would position Italy slightly ahead of the Nordic average.

Italy's problem lies in the size of stock of the deteriorated assets

In Italy the asset quality problem does not lie in the definition of deteriorated assets or the coverage ratio per se, but in the absolute amount of doubtful loans. Setting a maximum threshold with respect to regulatory capital would attempt to evaluate the hypothetical capital position of any bank if it were required to resolve its problem loans over the near term. The ratio we proposed in *European Banks - Harmonising EU banks' asset quality* (15 October 2012) is shown below:

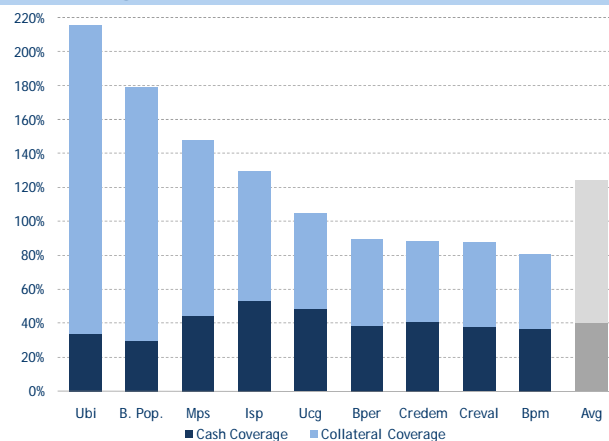
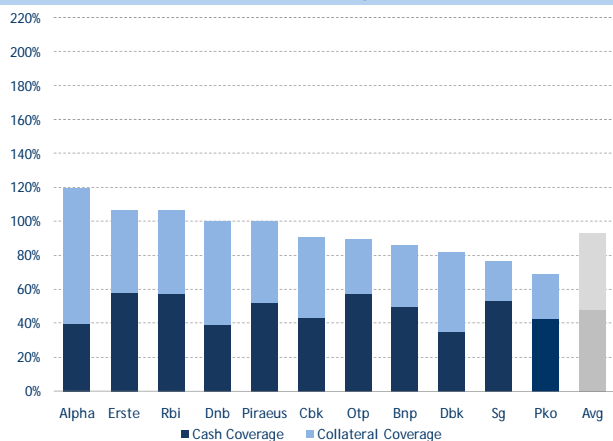
$$(Harmonised\ Gross\ Doubtful\ Loans - Total\ Allowance) / (CT1 - State\ Hybrid\ Capital) \leq 40\%$$

We calculate that reducing the amount of deteriorated loans as a percentage of Core Capital to 40% would require c.€48bn of additional provisions for Italian banks, equal to c.€32bn impact on the equity post tax as shown in the landscape table on the following page. Such post-tax impact would cost the Italian banking system some 270bps of capital, by our calculations. At European level, the average impact of realigning the coverage ratio to 2008 levels and harmonisation to more prudential levels (as percent of CT1 and net loans) would erode €80bn of capital post tax at sector level, i.e. 100bps of CT1 ratio, with Italy being the most impacted country. Eight out of the fifteen banks most negatively affected would be Italian.

Fair value of collateral is crucial for assessing Italian banks' asset quality

The fair value of collateral backing deteriorated assets is information that most of the banks in our coverage do not disclose, with the exception of Italian banks. We calculate below that the coverage ratio including the fair value of collateral, where available, hovers over 95% outside of Italy, with the coverage ensured by the collateral averaging 45%. We neglect the PSI provisions in Greece. We note Italian banks' fair value of collateral (see chart below right) covers approximately 85% of the Gross Doubtful Loans, a value almost double the average calculated for EU peers scrutinised above.

Italian and EU Banks – Coverage Ratio of Doubtful Loans Including Fair Value of Collaterals, 2011



Source: Company Data, Mediobanca Securities analysis

European Banks – Regulatory Capital Impact from Harmonisation of Asset Quality to Maximum Threshold on Core Capital and Net Loans, €bn

€bn	BPM	BP	CE	BPER	ISP	MPS	UBI	UCG	BNP	CASA	SG	KBC	CBK	DBK	EBS	RBI	OTP	PKO	Danske	DNB	NDA	SEB	SHB	Sweda	BARC	HSBC	LLOYDS	RBS	SAN SP	BBVA	SAB	POP	BKT	SECTOR
Gross Loans	37	98	20	51	399	157	103	595	694	416	413	144	305	417	135	82	26	33	158	167	340	135	179	138	530	738	710	567	226	218	75	103	44	8,500
Net Loans	36	93	20	48	377	147	100	560	666	399	397	138	297	413	128	77	22	32	151	165	337	133	179	136	517	725	677	544	215	210	73	97	43	8,198
Harmonised Gross Doubtful	3	14	1	7	42	23	9	74	58	31	31	13	20	12	12	9	6	3	17	4	6	2	1	3	38	37	82	52	25	20	7	13	2	680
Harmonised Net Doubtful	2	10	1	4	20	13	6	38	29	14	14	8	11	8	5	4	3	2	11	2	4	1	1	2	30	28	59	34	11	8	5	7	1	394
CT1	3	6	1	4	33	9	8	46	59	29	33	7	23	36	9	6	3	4	14	13	21	10	9	9	52	147	45	55	56	32	5	9	2	803
RWA 2014E	34	81	16	48	336	105	82	462	708	361	382	107	240	506	120	97	29	38	140	146	208	89	70	63	482	972	365	530	678	353	55	113	31	8,090
Gross Doubtful to Loans	8.5%	14.2%	4.6%	12.9%	10.5%	14.7%	8.4%	12.4%	8.3%	7.4%	7.4%	9.2%	6.5%	2.8%	9.1%	10.8%	22.9%	9.0%	11.0%	2.3%	1.9%	1.5%	0.7%	2.5%	7.1%	5.0%	11.6%	9.2%	10.9%	9.4%	9.4%	12.8%	4.9%	8.0%
Net Doubtful to Loans	5.6%	10.4%	2.8%	8.4%	5.2%	8.7%	5.7%	6.7%	4.3%	3.6%	3.6%	5.8%	3.7%	1.8%	4.0%	4.9%	11.3%	5.4%	7.1%	1.4%	1.1%	0.5%	0.4%	1.3%	5.8%	3.8%	8.7%	6.2%	4.9%	3.8%	6.3%	7.3%	2.1%	4.8%
Net Doubtful to CT1	63%	154%	38%	109%	59%	140%	73%	82%	49%	50%	44%	116%	48%	21%	57%	62%	80%	46%	78%	17%	18%	7%	8%	20%	58%	19%	129%	61%	19%	25%	91%	80%	40%	49%
HARMONISATION ON CT1 THRESHOLD																																		
Target Net Doubtful Loans to CT1	40%	40%	40%	40%	40%	40%	40%	40%	40%	40%	40%	40%	40%	40%	40%	40%	40%	40%	40%	40%	40%	40%	40%	40%	40%	40%	40%	40%	40%	40%	40%	40%	40%	
Intervention Required	YES	YES	NO	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	NO	YES	YES	YES	YES	YES	NO	NO	NO	NO	NO	YES	NO	YES	YES	NO	NO	YES	YES	NO	
Required Increase in Provisions	(0.7)	(7.2)	0.0	(2.6)	(6.2)	(9.1)	(2.6)	(19.2)	(5.3)	(2.9)	(1.2)	(5.3)	(1.9)	0.0	(1.6)	(1.3)	(1.3)	(0.2)	(5.2)	0.0	0.0	0.0	0.0	0.0	(9.1)	0.0	(40.4)	(11.7)	0.0	0.0	(2.6)	(3.5)	0.0	(143)
Tax Rate	33%	33%	33%	33%	33%	33%	33%	33%	35%	35%	35%	31%	30%	30%	23%	20%	19%	21%	25%	28%	26%	26%	26%	26%	23%	23%	23%	23%	25%	25%	25%	25%	25%	
Post-Tax Impact	(0.5)	(4.8)	0	(1.7)	(4.2)	(6.1)	(1.7)	(12.9)	(3.4)	(1.9)	(0.8)	(3.6)	(1.3)	0.0	(1.2)	(1.1)	(1.0)	(0.2)	(3.9)	0.0	0.0	0.0	0.0	0.0	(7.0)	0.0	(31.1)	(9.0)	0.0	0.0	(1.9)	(2.7)	0.0	(103)
RWA 2014E	34	81	16	48	336	105	82	462	708	361	382	107	240	506	120	97	29	38	140	146	208	89	70	63	482	972	365	530	678	353	55	113	31	8,090
As % of RWA	-1.4%	-6.0%	0.0%	-3.6%	-1.2%	-5.8%	-2.1%	-2.8%	-0.5%	-0.5%	-0.2%	-3.4%	-0.5%	0.0%	-1.0%	-1.1%	-3.5%	-0.4%	-2.8%	0.0%	0.0%	0.0%	0.0%	0.0%	-1.5%	0.0%	-8.5%	-1.7%	0.0%	0.0%	-3.5%	-2.4%	0.0%	-1.3%
HARMONISATION ON LOANS THRESHOLD																																		
Target Net Doubtful to Loans	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%	
Intervention Required	YES	YES	NO	YES	YES	YES	YES	YES	YES	NO	NO	YES	NO	NO	YES	YES	YES	YES	YES	NO	NO	NO	NO	NO	YES	NO	YES	YES	YES	NO	YES	YES	NO	
Required Increase in Provisions	(0.6)	(6.0)	0.0	(2.1)	(4.5)	(6.8)	(1.7)	(15.3)	(2.3)	0.0	0.0	(2.5)	0.0	0.0	(0.0)	(0.7)	(1.6)	(0.4)	(4.7)	0.0	0.0	0.0	0.0	0.0	(9.1)	0.0	(31.5)	(12.1)	(1.9)	0.0	(1.7)	(3.2)	0.0	(110)
Tax Rate	33%	33%	33%	33%	33%	33%	33%	33%	35%	35%	35%	31%	30%	30%	23%	20%	19%	21%	25%	28%	26%	26%	26%	26%	23%	23%	23%	23%	25%	25%	25%	25%	25%	
Post-Tax Impact	(0.4)	(4.0)	0.0	(1.4)	(3.0)	(4.6)	(1.1)	(10.2)	(1.5)	0.0	0.0	(1.7)	0.0	0.0	(0.0)	(0.6)	(1.3)	(0.3)	(3.5)	0.0	0.0	0.0	0.0	0.0	(7.0)	0.0	(24.3)	(9.3)	(1.5)	0.0	(1.3)	(2.4)	0.0	(80)
RWA 2014E	34	81	16	48	336	105	82	462	708	361	382	107	240	506	120	97	29	38	140	146	208	89	70	63	482	972	365	530	678	353	55	113	31	8,090
As % of RWA	-1.1%	-5.0%	0.0%	-2.9%	-0.9%	-4.4%	-1.4%	-2.2%	-0.2%	0.0%	0.0%	-1.6%	0.0%	0.0%	0.0%	-0.6%	-4.6%	-0.9%	-2.5%	0.0%	0.0%	0.0%	0.0%	0.0%	-1.5%	0.0%	-6.6%	-1.8%	-0.2%	0.0%	-2.3%	-2.2%	0.0%	-1.0%

Source: Mediobanca Securities estimates

The bad bank would need the ESM back-up

The Bank of Italy is advocating higher provisioning from the sector, we suspect in preparation of NPLs disposal or the implementation of a bad bank. Although the high level of non-cash collateralisation could help mitigate the problem, we think the magnitude of the bad bank would hardly be affordable by Italy on a standalone basis in case of no investors' appetite. ISP and UCG could use their excess capital following recent rights issues to cope with it if they wish (see *UCG - Pekao stake sale potentially opening to UCG's new phase*, 30 January 2013), but for smaller or non listed banks this seems hardly feasible. This is where we think the topic becomes very political. Italy contributes with roughly €125bn commitment to the ESM. With the ESM banking up the real estate clean-up of the Spanish banks, there is a paradox of Italy contributing to help Spanish banks and left alone with its own bad bank problem. We think any sensible government would find strong arguments to advocate equal treatment in this regard. The Italian bad bank backed by the ESM could be the next request from Italy on the ECB table, but only a strong and credible government can decide to go that way. Clearly we would consider such a move to be extremely bullish for the sector.

IRAP – The reason of Italian banks' fiscal gearing to loan losses

The fiscal treatment of provisioning is a major negative for Italian banks relative to their EU peers. Banks' IRAP taxable income is computed by adding to IFRS revenues non-deductible items, such as:

- ◆ Staff costs.
- ◆ Loan losses.
- ◆ 10% of Other Administrative Expenses, Depreciation and Amortisation costs.

As a consequence, IRAP inflates the tax rate (calculated Taxes/GAAP PBT), when staff costs and loan losses have a high weight on PBT. Despite the bracket being only c.5.5%, the base on which the 5.5% is calculated can be extremely large under certain circumstances, resulting in an IRAP taxable income being a multiple of the GAAP PBT.

IRES – The myth of 30bps loan loss deductibility

The taxable income for IRES purpose is given by Net Income increased by some non tax-deductible items. The most important of such non-deductible items comprises a portion of loan losses, as those are deductible as long as they do not amount to more than 0.3% of the loans held in the balance sheet. If losses exceed such an amount, they are deductible only up to the 0.3% threshold, while the remaining part is going to be deducted over the following 18 years, on a straight-line basis. In this case the taxable income would be equal to:

$$\text{Net Income} + (\text{Loan Losses} - (\text{Loans} * 0.3\%)).$$

The product between the IRES tax rate of 27.5% and the taxable income results in the "CURRENT IRES FOR THE YEAR", which is the amount due to tax authorities (i.e. a negative number included in taxation). In order to compensate for the disadvantage the banks suffer in the year, they take the charges (i.e. when credit losses are more than 0.3% of Loans) in each of the following 18 years a "tax benefit" arises, resulting in a reduction of the tax base. Concerning the amount of Loan Losses which is not possible to deduct, they are multiplied by 27.5% and the resulting amount represents "ADVANCED TAXES", a figurative figure aiming at reducing future cash outflows (i.e. a positive number reducing the tax burden). The difference between CURRENT IRES FOR THE YEAR and ADVANCED TAXES gives the NET TAXATION. In other words, the deductibility of loan losses up to 30bps of the loan does not affect the accounting value of the taxation, as it just affects the cash outflow to the tax authorities.

An illustration of the fiscal distortion generated by the peculiar Italian tax regime

To better illustrate the fiscal distortion generated by the IRAP tax regime, we compare the tax burden of the same bank if operating in Italy and France, where all loan loss provisions are fiscally deductible. We make the following assumptions:

- ◆ We assume the two banks to have exactly the same structure of Profit and Loss.
- ◆ We assume the two banks have the same amount of NPL and coverage ratio at the beginning of the period.

- ◆ For the sake of simplicity, we assume the IRES taxable income equal to the PBT without any further adjustments.
- ◆ For the sake of simplicity, we assume the IRAP taxable income equals to Revenues minus 90% of Other Expenses and D&A, without any further adjustments.
- ◆ We assume 36.6% corporate tax rate in France, including 3.3% tax surcharge for large companies.

In the example below, the distortion generated by the IRAP tax regime in Italy brings to a net profit 12% lower for the same bank operating in Italy rather than in France. A taxable income in excess of 3x the IFRS PBT boosts the overall tax burden to 45% in Italy versus 37% in France, despite the aggregate of the Italian brackets being largely below the French ones.

Italy vs France – Illustration of Different Fiscal Burden and Impact on Profitability

Tax Rate Calculation - €m	IT BANK	FR BANK
NII	2,000	2,000
Other Revenues	1,000	1,000
Total Revenues (A)	3,000	3,000
Staff Costs	(1,250)	(1,250)
Other Costs (B)	(500)	(500)
D&A (C)	(250)	(250)
Operating Profit	1,000	1,000
Credit Losses	(250)	(250)
Profit Before Tax (D)	750	750
Taxes	(323)	(275)
Net Profit	415	475
Tax Rate	44.6%	36.6%
Tax Burden Calculation - €m	IT BANK	FR BANK
IRES Taxable Income (IT = D)	750	0
IRAP Taxable Income (IT, A - 90%*(B+C))	2,325	0
Corporate Taxable (FR)	0	750
Corporate Tax Surcharge Taxable Income (FR)	0	750
IRES Bracket (IT)	27.5%	0.0%
IRAP Bracket (IT)	5.5%	0.0%
Corporate Tax (FR)	0.0%	33.3%
Corporate Tax Surcharge (FR)	0.0%	3.3%
IRES Taxes (IT)	(206)	0
IRAP Taxes (IT)	(128)	0
Corporate Tax (FR)	0	(250)
Corporate Tax Surcharge (FR)	0	(25)

Source: Mediobanca Securities estimates

If we assume the two banks to have the same amount of NPLs (€5bn) and coverage ratio at the start of the period (50%), and assume unchanged amount of NPLs over the period, we conclude the following:

- ◆ The French bank would achieve the same coverage ratio of the Italian one (55% after adding €250m provisions), but with a profitability 12% above that of its Italian rival.
- ◆ Alternatively, in lowering its profitability to the same level of its Italian rival, the French bank could increase its provisioning by c.€95m pre tax, adding 190bps to its coverage ratio.

Italy vs France – Illustration of Fiscal Distortion on Coverage Ratios

€m	IT BANK	FR BANK
Gross NPL (Start of Period and Eop)	5,000	5,000
NPL Coverage (Start of Period)	50%	50%
NPL Coverage (Eop - Different Profitability)	55%	55%
Potential of Increasing Provisions (€m)	0	94
NPL Coverage (Eop - Same Profitability)	55%	57%

Source: Mediobanca Securities estimates

We have discussed in previous chapters how relevant the debate on IRAP is in the current electoral campaign. We think the above example shows the importance for the coming government of removing such a distorting factor. Clearly the above situation shows its half glass full in recovery time, i.e. the higher gearing of Italian banks to lowering provisions when they benefit from write-backs as we show below.

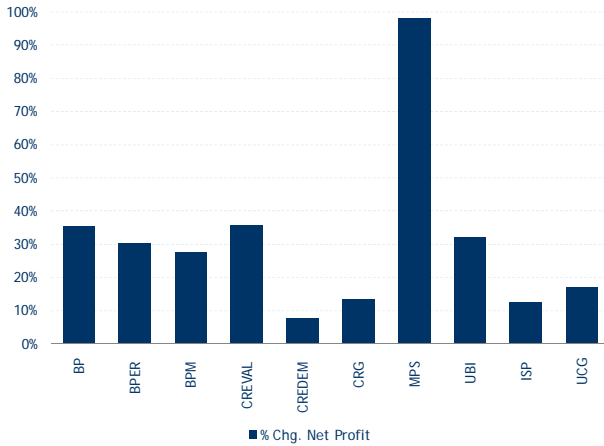
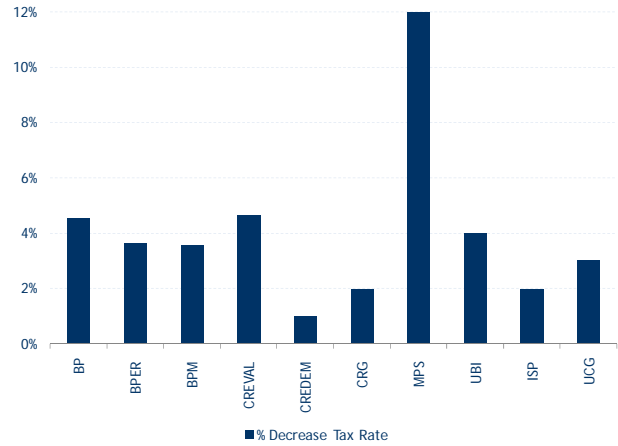
Sensitivity of Italian Banks' profitability to improvement in loan losses

In this paragraph, we simulate the earnings impact of a 20% decline in loan losses in 2013E generated by the Italian operations for the Italian banks under MB coverage. Our simulation works in the following way:

- ◆ The decline in loan losses would increase the Pre-Tax Profit by an equal amount.
- ◆ The increase in Pre-Tax profit is taxed for IRES purposes (27.5%). As the deductibility of loan losses up to 30bps impacts the cash flow of banks but not their accounting IRES tax burden, the improvement in loan losses increases the IRES taxable income and the IRES taxation.
- ◆ Being loan losses not fiscally deductible for IRAP purposes, the improvement in loan losses does not affect the IRAP taxable income and the IRAP taxation.

The conclusions can be summarised as follows:

- ◆ With the exception of Credem, the smaller banks would benefit the most, being generally less efficient than ISP and entirely concentrated in Italy (unlike UCG and ISP, although the latter at a lower extent).
- ◆ MPS is the bank that would benefit the most from a decrease in loan losses. Being the weight of loan losses on PBT the highest among Italian banks, MPS would benefit the most from a reduction in impairments (increase in PBT estimated in the 50% region) and from a lowering tax rate (from 63% to 51%), leading to an increase in Net Profit close to c.100%.
- ◆ Focusing on UCG Italian operations, the tax rate is lowered from 61% to 48%, with Net Income more than doubling and PBT increasing by c.60%. However, we note a much milder impact at Group level, as Italian operations account for c.40% of the Group. Indeed, the Group Net Profit would increase by 17% and tax rate would reduce by only 3%.
- ◆ Among Popolari Banks, we flag a decrease in the tax rate by 5% for BP and CREVAL and by 4% for BPER, BPM and UBI. In particular, BP and CREVAL both experience an increase in Net Income by 36% (24% at PBT level).

Italian Banks – Estimated Sensitivity of Net Profit to 20% Lower Loan Losses, 2013E

Italian Banks – Estimated Sensitivity of Tax Rate to 20% Lower Loan Losses, 2013E


Source: Company data, Mediobanca Securities analysis and estimates

In conclusion, our sensitivity analysis shows that a 20% drop in loan losses would have a very significant impact on Italian banks' profitability (including a sudden drop in tax rate), peaking at almost +100% at MPS.

Trade idea: long small (PMI, UBI) short large (ISP)

The generally cautious tone of this note ahead of the Italian elections would suggest to navigate the political uncertainty we foresee outside of financials, real estate and insurance stocks for the time being. This is not only due to potential negative impact on the spread, but also to the many sector-specific open question marks. That said, we think that the best way to position within the Italian banking space at the moment would be to stay long smaller names versus large caps.

Long UBI, PMI vs short ISP

- ◆ We have high conviction in the governance and M&A catalysts surrounding the popolari space. Both the BoI and the coming government would have an interest in supporting the momentum that PMI is triggering in the space and smoothing the governance issues that could clash with the Banking Union.
- ◆ Additionally, in the (although unlikely) event of IRAP reduction, the higher weight of staff cost and provisioning on the PTP of the smaller names brings to a natural higher gearing of these banks on the bottom line.
- ◆ The same being true in the event of asset quality improvement: the LLP reduction creates higher bottom line gearing in the smaller Italian banks.
- ◆ Should the foundation debate gather pace substantially post the MPS story to bring the market pricing in overhang risk from Foundations exiting the banks, the Popolari would be immune, in our view.

As far as the two large Italian banks are concerned we propose the following trade

Long UCG vs short ISP

- ◆ Lower Italian exposure from UCG;
- ◆ Overhang from the foundations potentially more pronounced on ISP;
- ◆ Market oriented investors in UCG (Aabar, Pamplona, etc) versus higher weight of the Foundations in ISP;
- ◆ More cost cutting and gearing into the bad bank topic for UCG.

Insurance and asset gatherers: focus on the spread

The three key topics where the new government could potentially affect the insurance and asset gatherers space are, in our view:

- ◆ Spread sensitivity.
- ◆ Regulatory changes.
- ◆ Tax issues affecting savings.

Sensitivity to the spread . . .

In the table below, we summarise the exposure to Italian Government bonds of the listed insurance companies and asset gatherers in our coverage. We allocate the approx €100bn of outstanding bonds to the Life, P&C and banking segments, and have assumed that 80% of the exposure to IT Govies backing life technical reserves belongs to policyholders. The results show a relevant sensitivity for BGN and MED with 13x and 9x the tangible equity, respectively. The insurance companies Generali, Cattolica and Unipol range between 2x-3x. We would not put much emphasis on the 5.8x ratio of FondiariaSAI, as this will be subject to relevant changes after the merger with Unipol in 1H13. In addition, AZM is the only name with no direct exposure to IT Govies.

IT Government bonds as a % of tangible equity – IT listed insurance companies and asset gatherers

	Overall exposure	Life	P&C	Banking	Exposure ex p/h interest	Tangible Equity @ 9M12
Insurance companies						
Assicurazioni Generali (*)	53.6	46.7	4.7	2.2	16.3	9.3
Unipol	10.0	6.6	3.4	-	4.7	2.8
Fondiaria-SAI	15.9	11.4	4.5	-	6.7	1.2
Cattolica	7.7	6.3	1.4	-	2.7	0.9
Asset gatherers						
Mediolanum	11.0	2.4	-	8.7	11.0	1.2
Azimut	0.0	-	-	-	0.0	0.2
Banca Generali	3.8	-	-	3.8	3.8	0.3

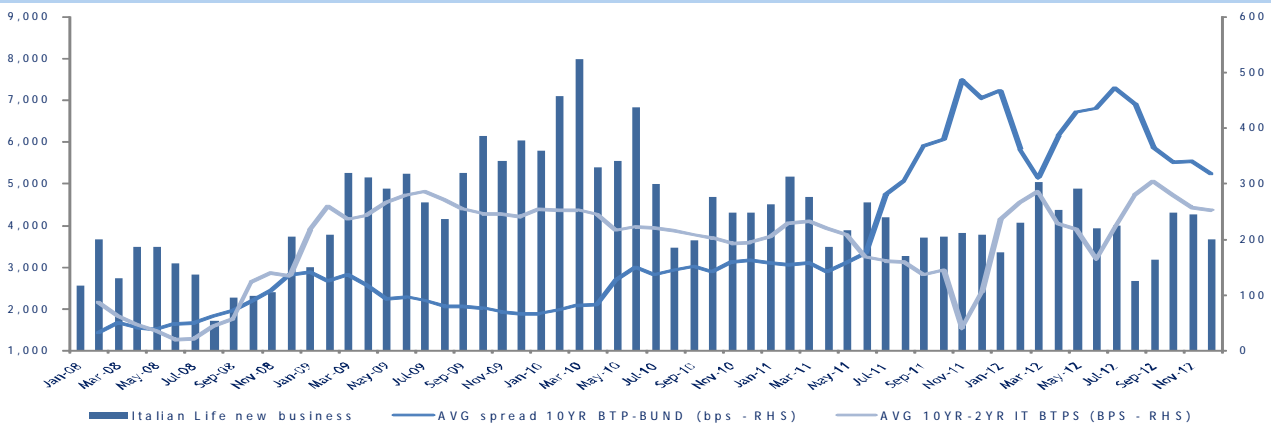
Note: Overall exposure at 9M12 (1H12 for Generali). Allocation between P/h interest estimated at 80% Tangible equity calculated at 9M12

Source: company data, Mediobanca Securities estimates

. . . and to the steepness of the curve

In addition to the spread sensitivity, we think there is a second impact on the sales of Life insurance policies. The lesson learned in the past few quarters and illustrated in the chart below is that the level of new business premiums has also been driven by the level of rates, particularly for traditional insurance products.

Italian Life new business premiums vs BTP-BUND spread and flattening/steeping IT yield curve



Source: Mediobanca Securities

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We have observed a correlation with the steepening/flattening of the Italian BTP yield curve for the life insurance products. The experience of the past few years clearly proved that an increasing (or a high level) of spread has a negative effect on the sale of Life traditional policies. Hence should spreads widen again, the market should be prepared for a double-negative effect, in our view: AFS impact and lower life traditional policies. The good news is that such a negative second effect is amplified in the case of flattening of the curve. With the OMT at work, we think that such an event would be unlikely as we could expect higher market pressure on the long side of the curve driving to a steepening that would mitigate the above negative factor.

Regulatory changes unlikely

- ◆ The most controversial reform carried out in the insurance sector over the past decade came from the same Bersani who is now leader of the PD and who was Minister of Economic Development during the Prodi government in 2006-2008. He introduced the multi-mandate and the cancellation of the tied-agents structure. However, we did not notice any visible benefit as all companies tried to defend their franchise – discouraging their agents to take other companies' mandates.
- ◆ Most recently, in his second growth decree called "Decreto Crescita 2.0", Mr Monti favoured agents belonging to different companies to distribute other companies' products in respect of the mandate they had. In addition to that, the decree introduced some new rules on Motor TPL, such as the obligation to also offer coverage through the internet channel, explicitly outlining every single cost linked to a policy. Finally, automatic renewals were officially cancelled.

In our view, all the attempts to make agents become a sort of brokers (with the Bersani decree first, and with the Monti government thereafter) have not really changed the rules of the game. We also believe that the lobbying by all Italian insurers to protect their franchises has been effective to-date, and we do not expect disruptive changes on the distribution networks to materialise under a new Government.

Tax issues driving savings

- ◆ **Wealth tax.** A threat on the asset gathering sector could be represented by the often speculated wealth tax. A small wealth tax is actually already in place, as starting from January 2013 a 15bps tax is being applied on financial assets (e.g. mutual funds, unit-linked, index linked, equities, bonds etc..) with the exclusion of current accounts (subject to a flat tax of €34.2) and some life insurance policies (e.g. pension funds and traditional policies). Despite the increasing taxation on financial assets and AM products in particular, the strong net inflows reported by the three listed Italian asset gatherers in January (and mainly into asset management products) make us confident that the overall effects for the sector of the recently introduced tax will be limited. Of course we cannot rule out a more potent wealth tax in future. As a rough indication, we note that current accounts represent just 8% of Banca Generali's total assets and 13% of Mediolanum's assets (including deposit accounts too). Azimut does not distribute current accounts directly, but provides third parties current accounts (namely Che Banca! and Banco Popolare).
- ◆ **Tax amnesty under scrutiny.** Several politicians have recently referred to the opportunity to re-open the file of the Italians that benefited from the tax amnesty in 2009. Under the last Berlusconi government, Italians holding funds outside the country had the opportunity to legalise their money through a 5% taxation. The amnesty was a success as some €100bn were indicated to be declared (approx. 60% kept in Switzerland under the so-called "rimpatrio giuridico" while the remaining 40% was physically repatriated). Even though we are not even convinced that applying retroactively higher taxation on that money would be legally feasible, we highlight that Banca Generali and Azimut benefited the most from the amnesty (€2.1bn and €1.0bn, respectively), while Mediolanum lagged behind with some €700m.

Long Azimut vs short MED and BGN

Based on our central case of a weak governing coalition potentially penalising the spread we think AZM could be winner vs MED and BGN for the following reasons:

- ◆ Zero exposure of AZM to IT BTPs versus the other two super geared.
- ◆ In the remote case of a wealth tax on current accounts (similar to that made by Amato in 1992), Azimut does not have current accounts. The other two Cos offer C/C.

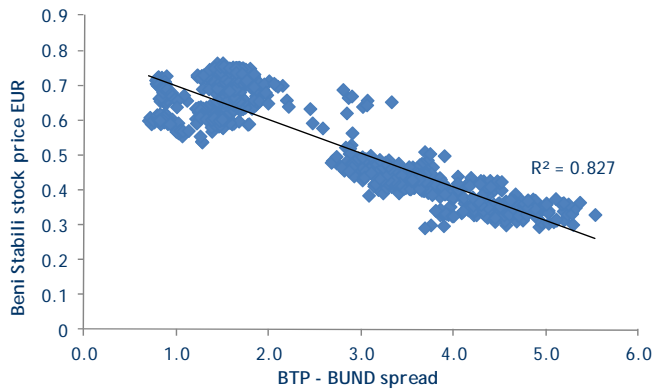
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- ◆ In the very unlikely case of the new government opening the file of people that used the tax amnesty in 2009, AZM would have a problem as they gathered €1.0bn from the amnesty, but BGN would have a bigger one as they benefited to the tune of €2.1bn.

Real estate: focus on Beni Stabili

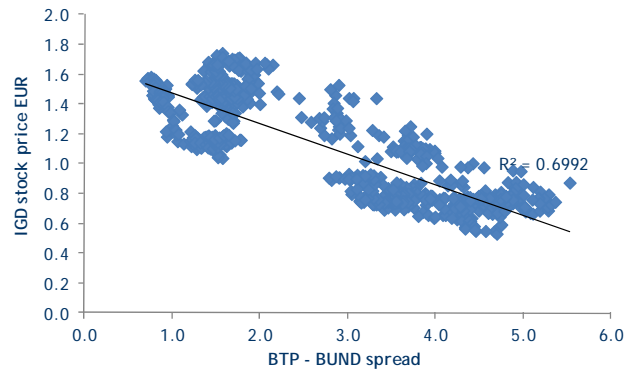
Our previous discussions show that we do not expect major changes in the IMU tax after the forthcoming elections.

- ◆ In 2012 IMU determined a reduction in cash flows and in assets' valuation. First figures available are those of Beni Stabili for which IMU had a negative impact of 10% on recurring cash flows and of 2.3% on assets valuations.
- ◆ At the same time, we do not expect that the new government will be able to finalise sales of public real estate in a size sufficient to change the landscape of the sector in Italy or to boost the real estate asset management industry.
- ◆ The real estate stocks, and Beni Stabili in particular, are perceived as strongly correlated to the trends of the Italian economy and reflect the overall level of risk attached to the country. Therefore, as a "pure" play, Beni Stabili is exposed to the risk of widening spreads in the case of a weak electoral result as witnessed by the high correlation shown in the chart below.

Correlation Beni Stabili price vs BTP-Bund spread



Correlation IGD price vs BTP-Bund spread



Source: Mediobanca Securities, Bloomberg

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Telecom and Media: ads, RAI, TV auction and NetCo

We think the most important topics for the new government in the TMT space are: the continued weakness of the domestic advertising market, the auction for the new frequencies, the tough situation of the state-owned RAI TV and the possible Spin-off of the Network Business from Telecom Italia.

Advertising market back to 1990s, Upa asks for a 10% tax-credit

Our estimates call for 14% YoY decline for the domestic advertising market in 2012 and -3.4% in 2013. This would reduce the Italian advertising market to €7bn in 2013, the lowest level of the last ten years. The Upa (Media Association) has asked the new Government a 10% tax credit to support the advertising investments. For the time being, we note no one has replied to this request and we doubt such request will be accommodated hence we remain cautious in the space.

RAI and Mediaset

- ◆ **Conflict of interest.** Twenty years of Berlusconi political activity left a proper regulation of the media versus politics conflict of interest unresolved, leaving Italy lumbered with a unique and anachronistic situation. We think that whatever new government comes to power cannot escape from taking a harsh view on this topic, which should we believe naturally end up penalising Mediaset.
- ◆ **Privatisation.** The other relevant unresolved issue relates to the privatisation of at least one out of the three RAI public channels. Only Five Star seems to have a clear idea on this, or at least has made public disclosure of its views: 1) limits for the State ownership of channels to a maximum two channels; 2) a widespread shareholder base for the other national channels; and 3) a 5% share limit in the national advertising collection for the privately-owned companies.

TV auction needed to avoid EU fine

The EU Commission opened a case against Italy in 2005, stating the Italian rules in terms of TV pluralism were not compliant with the European regulatory framework. In response, the Monti government suggested an auction process to assign the six national frequencies, or at least a part of them, but it will be now the next government to finalise the process. We continue to believe that such an auction could raise up to €1bn when considering the appeal for international players (note the recent acquisition of Switchover Media by Discovery Channel), especially if the auction will be open to both telecom operators and private equity funds. Should the new government deliver on such a front, the result should be more fragmentation in the TV audience and advertising collection, again at the expense of Mediaset in the listed media space.

Netco spin-off from Telecom

During the conference call held to present its 2012 preliminary figures and the 2013-15 business plan, Mr Franco Bernabè, Executive Chairman of Telecom Italia, confirmed talks with CDP on the possible Network spin-off. This should allow Italy to speed up the transition to fibre technology and benefit from an adequate infrastructure. For Telecom Italia, the Network separation would represent a viable option to reduce its debt pile and to achieve the 2x Net Debt/EBITDA leverage target (forecasted by the management in 2015) ahead of schedule. The Monti government has been quite open to this topic, but as we see it this will hardly be a priority of the new government, or at least not much has been discussed during the electoral campaign.

Long EI Towers – short Mediaset

- ◆ The potential turnaround of RAI TV, the law on the media conflict of interest, the increasing audience fragmentation identify Mediaset as the short side of our media trade.
- ◆ EI Towers has clear options for emerging as a winner in the space, as the new owner of frequencies will need a tower company to broadcast the signal and the option of a national tower company could represent a game changer in the industry. EI Towers seems well-positioned to benefit from the potential TV Auction and the disposal of RAI Way, in our view.

Oil sector: ENI and the best solution for SPM's issue

Alleged bribes could drive management changes

The recent investigations into ENI's subsidiary Saipem for alleged bribes in Algeria (contracts totalling €11bn under investigation) have led Milan-based prosecutors to place ENI's CEO on the register of 'persons under investigation', together with SPM's former senior management. While denying any involvement in the corruption case, ENI's CEO has been attacked by the press and asked to resign.

We are obviously not in the position to take any view on this alleged fraud, and the involvement of ENI's CEO, but the recent turmoil around ENI and its subsidiary Saipem might force the new government to insist on a management reshuffle. We think the risk for a sudden change in ENI's CEO is related to the mounting investigations on the Algerian scandal. As a reminder, we note that ENI's Board (appointed in 2011) will expire in 2014, but the likelihood of seeing ENI's current board serve to the natural end of its mandate is limited, in our view.

Three scenarios for ENI management

The new government will play a key role in deciding who will be the next CEO of ENI and the related investors' perceptions on the Group's long-term strategy:

- ◆ The appointment of a new Group CEO from the E&P industry (from internally in particular) could be very positively perceived by investors, in our view. It would represent a clear sign that the company is fully involved in its core business, with limited or even no political interference. It would accelerate the group's break-up, with the disposal of the "loss-making" gas marketing activity, which has no rationale/synergies among ENI's assets after the decision to sell down its stake in Snam. ENI would also be perceived as a pure E&P player, a further contribution to the re-rating of the implied multiples of the E&P stub, i.e. the key to the equity story, in our view.
- ◆ A "political" appointment, i.e. the appointment of a CEO with no background in the oil industry, but solely justified by political connections, would be negatively perceived by investors, in our view. ENI would run the risk of being perceived as a conglomerate (with an alleged discount), with few opportunities to speed up the refocus on the core business of E&P.
- ◆ Confirmation of Mr Scaroni until the natural end of his mandate might be perceived by investors as no news. ENI will keep following the asset deconsolidation and refocus on the core business of E&P, appreciated during the whole 2012, but without any change in gear.

Long ENI/short SPM pair trade reiterated

Despite the outstanding performance of the trade (22% relative performance since inception – see *Cautiousness with a pinch of M&A*, 15 Jan 2013) we are still suggesting the long ENI/short SPM pair trade. Our reasons include:

- ◆ **ENI:** Recent statements from ENI's CEO on the future of Saipem ("ENI may consider disposing its stake in the controlled Saipem in the long term") can be read as ENI's intention to reduce its stake from the current 42% to below 30% in order to de-consolidate it. This would be positive for ENI, in our view, allowing the company to further deconsolidate some €4.3bn debt, increasing market perception of ENI as an oil player rather than an integrated company, with the implied re-rating of the multiples of the E&P business.
- ◆ **SPM:** On a fundamental perspective, we see two main risks behind the supposed recovery of profitability after the recent warning and, in particular, the time needed to come back to the €1.5bn peak in EBIT, i.e. 1) further delays in the award of the rich blockbuster contracts; 2) even assuming these contracts take place in 2014, profitability will not benefit for at least three or four years. As such, expectations that Saipem will be back to the €1.5bn EBIT by 2015 are overly optimistic, in our view. Even assuming a more bullish stance on profitability and its recovery occurring earlier than we had forecast, SPM multiples are still demanding, in our view, trading at between 12x P/E on 2014E (best case based on some €1.25bn EBIT in 2014E) and 14.7x (on our assumption of €1.05bn). In addition, recent investigations on the supposed Algerian corruption might lead to material fines, according to the Italian 231 law.

SPM's capital increase and break-up likely

We believe a capital increase from Saipem aiming at allowing the entry of an industrial/financial partner (e.g. a National Oil Company of the Middle East) would allow ENI to dilute itself from the current 42% to below 30%, thus achieving the target hinted by Mr Scaroni. In addition, we see the disposal of the pure drilling business of Saipem as likely. The bottom line would be that:

1. ENI's stake in Saipem would reduce from 42% to 29%, if assuming a capital increase of some €3bn, with a full deconsolidation of SPM's net debt from ENI's figures.
2. The disposal of the drilling business would substantially erase SPM's net debt, together with the capital increase mentioned above.
3. The move would allow ENI to deconsolidate Saipem, but keep in-house the engineering know-how in the meantime, which is we believe key to developing ENI's main asset, i.e. the giant gas field in Mozambique.

We think these are the key options on the table today for the current management team or for any future management appointment. The new government might have a crucial role in setting the pace of change at ENI. We believe there is plenty of valuable optionality in the hands of ENI investors, which is why we would recommend remaining in the stock waiting for future political events in Italy with a fairly relaxed view.

Industrials: Long FIAT short Finmeccanica

A new CEO is negative news

Following the recent arrest of Mr Orsi (CEO of Finmeccanica), it is now clear that the new government will have to appoint a new CEO. This means:

- ◆ The disposal process will be stopped (awaiting a new strategic plan).
- ◆ High risk of additional write-downs when new management will be appointed.

Reputational risk and capital increase

But probably the biggest negative impact is that the continuous news on legal investigations culminated with the CEO's arrest would make more difficult for Finmeccanica to gather new important orders. The reference market is already tough, and FNC has already seen its intake declining from €22.5bn in 2010 to €17bn last year. Furthermore, the company has an €800m bond expiring in December 2013, which is backed by €1.3bn of cash in hands (which, however, cannot go below certain limits), €3bn credit line (which, however, is committed to working capital financing) and €1.9bn bank bonding lines which, however, are intended to support the execution of bidding and orders activity. We cannot rule out that the new CEO/Government might have to raise capital on the market.

FIAT by contrast could benefit from any export-support acts by the new government

In its new BP presented back in November 2012, FIAT decided to use its Italian production footprint for export. This is a benefit that could affect many industrial stocks, but the main names (FIAT Industrial, Pirelli, Piaggio) have a huge chunk of their production base abroad, while FIAT has five plants in the country. The IRAP that FIAT pays in Italy amounts to €64m, plus the company has a significant amount of fiscal credits (accumulated losses in Italy), which are difficult to be utilised at the moment.

Long FIAT/Short FNC

Depending on the elections' outcome, if one wants to play the stabilisation in the Italian political/social scenario, having shares in Italian industrials could be a sound move, in our view. In this case, and based only on the top down political scenario, we suggest a pair trade where one goes long FIAT and short FNC.

Branded & Consumer: stay light on exposure to Italy

The branded goods sector is, in our view, the least exposed to the uncertainty related to the forthcoming Italian political elections given its limited exposure to the “Italian risk”. This is due to the low weight of the business generated in Italy in terms of the total turnover of the sector and the lack of governance/management issues, since no company has public /government representatives in its shareholder base.

- ◆ On average, 25% of the sector’s turnover is generated in Italy, and this percentage falls below 10% for Luxottica and Ferragamo, while it is in the region of 50% for Tod’s.
- ◆ For most of the luxury companies, the contribution to the turnover generated in Italy by local customers is below 50% and some companies have declared that this percentage is approx 30% (Ferragamo and Prada). This means that luxury demand in Italy is mostly driven by travellers’ flows, especially from Asia and China, and appetite for buying luxury products in Italy is mainly supported by the existing gap in retail price between Asia (and China in particular) and Italy.

Based on our estimates, local demand generates some 20% of the sector’s turnover, with Tod’s and GEOX as the most exposed to domestic purchases, and Ferragamo and Prada the least exposed.

Branded & consumers goods: Exposure to domestic consumption

	REVENUES IN ITALY	o/w domestic
BRANDED	26%	20%
AEFFE	42%	38%
BRUNELLO CUCINELLI	31%	20%
FERRAGAMO	8%	2%
GEOX	38%	38%
LUXOTTICA	5%	5%
PRADA	18%	5%
SAFILO	20%	20%
TOD’S	50%	35%
YOOX	20%	20%
CONSUMERS	21%	21%
AUTOGRILL	23%	23%
CAMPARI	32%	32%
DE LONGHI	13%	13%
INDESIT	15%	15%
AVERAGE	24%	20%

Source: Mediobanca Securities

Rather we see some potential upside from tax cuts and incentives, which might either increase personal disposable income, therefore driving the purchase of consumers’ and unessential goods by local customers, or let a product to be perceived as cheaper for the final customer.

Moreover, the removal of the VAT increase foreseen by the last Stability Law (from 21% to 22% from 1 July), which seems to be the only clear point of convergence for the main parties (although as per Chapter X we consider it unlikely at least for the short term), might benefit companies in the mass markets/durable goods sector (GEOX, AUTOGRILL INDESIT and DE LONGHI) rather than luxury companies, where the final retail price is not a driver for purchase.

Regarding the potential changes to IRAP, its potential reduction might mainly help companies having most of their production activities in Italy such as LUXOTTICA (50% of its production is in Italy), TOD’S (the vast majority), CAMPARI, AMPLIFON, INDESIT and DE LONGHI.

In summary, on the basis of the different Italian risks, we would be buyers of Luxottica, Ferragamo and Prada versus Tod’s, Geox and Campari.

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A2A INITIAL COVERAGE AS OF 21/03/2003. MEDIOBANCA S.P.A. OR ONE OR MORE OF THE COMPANIES BELONGING TO ITS GROUP MAY, FROM TIME TO TIME, DEAL IN, HOLD OR ACT AS MARKET MAKERS OR ADVISERS, BROKERS OR BANKERS IN RELATION TO THE FINANCIAL INSTRUMENTS, OR DERIVATIVES THEREOF, OF PERSONS, FIRMS OR ENTITIES MENTIONED IN THIS DOCUMENT, OR BE REPRESENTED ON THE GOVERNING BODIES OF SUCH FIRMS OR ENTITIES. EMPLOYEES OF MEDIOBANCA S.P.A. OR ONE OR MORE OF THE COMPANIES BELONGING TO ITS GROUP, OR INDIVIDUALS CONNECTED TO THEM, MAY FROM TIME TO TIME HAVE A POSITION IN OR BE HOLDING ANY OF THE INVESTMENTS OR RELATED INVESTMENTS MENTIONED IN THIS DOCUMENT. APPLIES TO ACEA, ACEGAS, ACSM, AEDES, AEGON, AEROPORTO DI FIRENZE, AKBANK, ALLIANZ, ALLIED IRISH, ALPHA BANK, AMPLIFON, ASCOPIAVE, ASTALDI, A-TEST, AXA, AZIMUT, BALOISE, BANCA IFIS, BANCA POP. ETRURIA E LAZIO, BANCA POP. INTRA, BANCA POP. MILANO, BANCA PROFILO, BANCO DESIO & BRIANZA, BANCO POPULAR, BANCO REAL, BANCO SABADELL, BANK OF AMERICA, BANK OF IRELAND, BANKIA, BANKINTER, BANORTE, BBVA, BIANCAMANO, BNP PARIBAS, BP EMILIA ROMAGNA, BRADESCO, BREMBO, BUZZI UNICEM, CAIXABANK, CALTAGIRONE, CAMPARI, CARRARO, CEMENTIR, CREDEM, CREDIT AGRICOLE SA, CREDIT SUISSE, CREDITO BERGAMASCO, D'AMICO INTERNATIONAL SHIPPING SA, DANSKE BANK, DELCLIMA, DEUTSCHE BANK, DIASORIN, DNB NOR, EDISON, EFG EUROBANK, EFG INTERNATIONAL, EMAK, ERG, ERSTE BANK, EXOR, FERRAGAMO, FIAT, FIAT INDUSTRIAL, GARANTI, GEOX, GJENSIDIGE, GOLDMAN SACHS, HANDELSBANKEN, HANNOVER RE, HELVETIA, HERA, HSBC, IMA, IMMSI, ING GROUP, IREN, ITAU, JP MORGAN CHASE, JULIUS BAER, KBC GROEP, LANDI RENZO, LLOYDS BANKING GROUP, MAIRE TECNIMONT, MARCOLIN, MARR, MORGAN STANLEY, MUNICH RE, NATIONAL BANK OF GREECE, NICE, NORDEA, OTP, PIAGGIO, PININFARINA, PIQUADRO, PIRAEUS, PKO BANK POLSKI, POLIGRAFICI EDITORIALE, POLTRONA FRAU, PRADA, RAIFFEISEN INT., RECORDATI, RISANAMENTO, ROYAL BANK OF SCOTLAND, SABAF, SAMPO, SARAS, SAVE, SCOR, SEB AB, SOGEFI, STANDARD CHARTERED, STMICROELECTRONICS, SWEDBANK, SWISS LIFE, SWISS RE, TALANX, TENARIS, TERNA, TESMEC, THE ROYAL BANK OF SCOTLAND GROUP, TISCALI, TOD'S, TOPDANMARK, TRYG, UBS, UNIONE DI BANCHE ITALIANE, WELLS FARGO, ZURICH. ACEA INITIAL COVERAGE AS OF 03/02/2004. AEDES INITIAL COVERAGE AS OF 18/06/2007. AEFEE INITIAL COVERAGE AS OF 17/09/2007. AEGON INITIAL COVERAGE AS OF 17/09/2012. IN THE PAST 12 MONTHS, THE RATING ON AEGON HAS BEEN CHANGED. THE PREVIOUS RATING, ISSUED ON 06/12/2012, WAS OUTPERFORM. AEROPORTO DI FIRENZE INITIAL COVERAGE AS OF 18/09/2006. ALITALIA INITIAL COVERAGE AS OF 03/02/2006. ALLIANZ INITIAL COVERAGE AS OF 14/04/2011. IN THE PAST 12 MONTHS, THE RATING ON ALLIANZ HAS BEEN CHANGED. THE PREVIOUS RATING, ISSUED ON 06/08/2012, WAS OUTPERFORM. ALPHA BANK INITIAL COVERAGE AS OF 16/03/2011. AMPLIFON INITIAL COVERAGE AS OF 05/07/2006. IN THE PAST 12 MONTHS, THE RATING ON AMPLIFON HAS BEEN CHANGED. THE PREVIOUS RATING, ISSUED ON 27/04/2012, WAS OUTPERFORM. ANSALDO STS INITIAL COVERAGE AS OF 04/07/2006. IN THE PAST 12 MONTHS, THE RATING ON ANSALDO STS HAS BEEN CHANGED. THE PREVIOUS RATING, ISSUED ON 29/12/2012, WAS OUTPERFORM. ASCOPIAVE INITIAL COVERAGE AS OF 14/03/2007. ASTALDI INITIAL COVERAGE AS OF 22/06/2009. ATLANTIA INITIAL COVERAGE AS OF 10/04/2003. AUTOGRILL INITIAL COVERAGE AS OF 21/02/2003. IN THE PAST 12 MONTHS, THE RATING ON AUTOGRILL HAS BEEN CHANGED. THE PREVIOUS RATING, ISSUED ON 09/11/2012, WAS NEUTRAL. AUTOSTRADA TO-MI INITIAL COVERAGE AS OF 08/09/2003. AXA INITIAL COVERAGE AS OF 17/09/2012. AZIMUT INITIAL COVERAGE AS OF 01/08/2005. BALOISE

INITIAL COVERAGE AS OF 17/09/2012. BANCA CARIGE INITIAL COVERAGE AS OF 24/07/2007. BANCA GENERALI INITIAL COVERAGE AS OF 17/01/2007. BANCA MONTE PASCHI SIENA INITIAL COVERAGE AS OF 12/02/2004. BANCA POP. ETRURIA E LAZIO INITIAL COVERAGE AS OF 22/01/2003. BANCA POP. MILANO INITIAL COVERAGE AS OF 05/03/2003. BANCO DESIO & BRIANZA INITIAL COVERAGE AS OF 06/03/2006. BANCO POPOLARE INITIAL COVERAGE AS OF 25/07/2007. BANCO POPULAR INITIAL COVERAGE AS OF 10/03/2011. IN THE PAST 12 MONTHS, THE RATING ON BANCO POPULAR HAS BEEN CHANGED. THE PREVIOUS RATING, ISSUED ON 30/07/2012, WAS UNDERPERFORM. BANCO SABADELL INITIAL COVERAGE AS OF 10/03/2011. BANKIA INITIAL COVERAGE AS OF 29/09/2011. IN THE PAST 12 MONTHS, THE RATING ON BANKIA HAS BEEN CHANGED. THE PREVIOUS RATING, ISSUED ON 01/03/2012, WAS NEUTRAL. BANKINTER INITIAL COVERAGE AS OF 20/01/2011. BARCLAYS INITIAL COVERAGE AS OF 30/06/2010. BBVA INITIAL COVERAGE AS OF 30/06/2010. BENI STABILI INITIAL COVERAGE AS OF 18/06/2007. BIANCAMANO INITIAL COVERAGE AS OF 13/04/2011. BNP PARIBAS INITIAL COVERAGE AS OF 30/06/2010. IN THE PAST 12 MONTHS, THE RATING ON BNP PARIBAS HAS BEEN CHANGED. THE PREVIOUS RATING, ISSUED ON 03/08/2012, WAS UNDERPERFORM. BP EMILIA ROMAGNA INITIAL COVERAGE AS OF 06/06/2012. BREMBO INITIAL COVERAGE AS OF 01/08/2007. IN THE PAST 12 MONTHS, THE RATING ON BREMBO HAS BEEN CHANGED. THE PREVIOUS RATING, ISSUED ON 17/01/2013, WAS NEUTRAL. BRUNELLO CUCINELLI INITIAL COVERAGE AS OF 12/06/2012. BUZZI UNICEM INITIAL COVERAGE AS OF 21/03/2003. CAIRO COMMUNICATION INITIAL COVERAGE AS OF 12/02/2003. CAIXABANK INITIAL COVERAGE AS OF 10/10/2012. CAMFIN INITIAL COVERAGE AS OF 27/03/2012. IN THE PAST 12 MONTHS, THE RATING ON CAMFIN HAS BEEN CHANGED. THE PREVIOUS RATING, ISSUED ON 14/09/2012, WAS OUTPERFORM. CAMPARI INITIAL COVERAGE AS OF 21/03/2003. IN THE PAST 12 MONTHS, THE RATING ON CAMPARI HAS BEEN CHANGED. THE PREVIOUS RATING, ISSUED ON 03/09/2012, WAS OUTPERFORM. CATTOLICA ASSICURAZIONI INITIAL COVERAGE AS OF 11/04/2005. CEMENTIR INITIAL COVERAGE AS OF 23/01/2003. CIR INITIAL COVERAGE AS OF 12/03/2003. COFIDE INITIAL COVERAGE AS OF 27/03/2012. COMMERZBANK INITIAL COVERAGE AS OF 30/06/2010. CREDEM INITIAL COVERAGE AS OF 21/03/2003. CREDIT AGRICOLE SA INITIAL COVERAGE AS OF 30/06/2010. CREDIT SUISSE INITIAL COVERAGE AS OF 30/06/2010. IN THE PAST 12 MONTHS, THE RATING ON CREDIT SUISSE HAS BEEN CHANGED. THE PREVIOUS RATING, ISSUED ON 21/11/2012, WAS NEUTRAL. CREDITO VALTELLINESE INITIAL COVERAGE AS OF 18/12/2007. DADA INITIAL COVERAGE AS OF 16/01/2003. D'AMICO INTERNATIONAL SHIPPING SA INITIAL COVERAGE AS OF 03/09/2007. DANIELI INITIAL COVERAGE AS OF 23/05/2006. IN THE PAST 12 MONTHS, THE RATING ON DANIELI HAS BEEN CHANGED. THE PREVIOUS RATING, ISSUED ON 22/10/2012, WAS OUTPERFORM. DANSKE BANK INITIAL COVERAGE AS OF 13/10/2011. DE LONGHI INITIAL COVERAGE AS OF 28/01/2003. DELCLIMA INITIAL COVERAGE AS OF 02/01/2012. DEUTSCHE BANK INITIAL COVERAGE AS OF 30/06/2010. IN THE PAST 12 MONTHS, THE RATING ON DEUTSCHE BANK HAS BEEN CHANGED. THE PREVIOUS RATING, ISSUED ON 14/01/2013, WAS UNDERPERFORM. DIASORIN INITIAL COVERAGE AS OF 11/09/2007. IN THE PAST 12 MONTHS, THE RATING ON DIASORIN HAS BEEN CHANGED. THE PREVIOUS RATING, ISSUED ON 08/11/2012, WAS OUTPERFORM. DNB NOR INITIAL COVERAGE AS OF 13/10/2011. EDISON INITIAL COVERAGE AS OF 24/09/2003. EFG EUROBANK INITIAL COVERAGE AS OF 16/03/2011. EFG INTERNATIONAL INITIAL COVERAGE AS OF 30/06/2010. EI TOWERS INITIAL COVERAGE AS OF 24/10/2006. EMAK INITIAL COVERAGE AS OF 19/07/2012. ENEL INITIAL COVERAGE AS OF 09/05/2003. IN THE PAST 12 MONTHS, THE RATING ON ENEL HAS BEEN CHANGED. THE PREVIOUS RATING, ISSUED ON 08/03/2012, WAS OUTPERFORM. ENEL GREEN POWER INITIAL COVERAGE AS OF 26/01/2011. ENI INITIAL COVERAGE AS OF 25/02/2004. ENIA INITIAL COVERAGE AS OF 27/09/2007. ERG INITIAL COVERAGE AS OF 13/03/2003. ERSTE BANK INITIAL COVERAGE AS OF 30/06/2010. EUROTECH INITIAL COVERAGE AS OF 09/03/2006. EXOR INITIAL COVERAGE AS OF 13/09/2004. FERRAGAMO INITIAL COVERAGE AS OF 18/07/2012, WAS OUTPERFORM. FIAT INITIAL COVERAGE AS OF 07/07/2003. IN THE PAST 12 MONTHS, THE RATING ON FIAT HAS BEEN CHANGED. THE PREVIOUS RATING, ISSUED ON 01/08/2012, WAS OUTPERFORM. FIAT INDUSTRIAL INITIAL COVERAGE AS OF 04/01/2011. FINMECCANICA INITIAL COVERAGE AS OF 28/03/2003. IN THE PAST 12 MONTHS, THE RATING ON FINMECCANICA HAS BEEN CHANGED. THE PREVIOUS RATING, ISSUED ON 01/08/2012, WAS NEUTRAL. FONDIARIA-SAI INITIAL COVERAGE AS OF 11/09/2003. GEMINA INITIAL COVERAGE AS OF 18/09/2006. GENERALI ASS. INITIAL COVERAGE AS OF 23/01/2003. IN THE PAST 12 MONTHS, THE RATING ON GENERALI ASS. HAS BEEN CHANGED. THE PREVIOUS RATING, ISSUED ON 04/06/2012, WAS OUTPERFORM. GEOX INITIAL COVERAGE AS OF 01/03/2005. IN THE PAST 12 MONTHS, THE RATING ON GEOX HAS BEEN CHANGED. THE PREVIOUS RATING, ISSUED ON 03/05/2012, WAS NEUTRAL. GJENSIDIGE INITIAL COVERAGE AS OF 17/09/2012. GOLDMAN SACHS INITIAL COVERAGE AS OF 30/06/2010. HANDELSBANKEN INITIAL COVERAGE AS OF 13/10/2011. HANNOVER RE INITIAL COVERAGE AS OF 24/01/2013. HELVETIA INITIAL COVERAGE AS OF 17/09/2012. IN THE PAST 12 MONTHS, THE RATING ON HELVETIA HAS BEEN CHANGED. THE PREVIOUS RATING, ISSUED ON 17/09/2012, WAS UNDERPERFORM. HERA INITIAL COVERAGE AS OF 30/07/2003. HSBC INITIAL COVERAGE AS OF 30/06/2010. IL SOLE 24 ORE INITIAL COVERAGE AS OF 08/02/2008. IMA INITIAL COVERAGE AS OF 16/07/2003. IMMOBILIARE GRANDE DISTRIBUZIONE INITIAL COVERAGE AS OF 18/06/2007. IMMSI INITIAL COVERAGE AS OF 07/06/2004. IMPREGILO INITIAL COVERAGE AS OF 24/06/2005. INDESIT INITIAL COVERAGE AS OF 16/02/2006. ING GROUP INITIAL COVERAGE AS OF 03/10/2012. INTERPUMP INITIAL COVERAGE AS OF 12/07/2004. INTESA SANPAOLO INITIAL COVERAGE AS OF 16/04/2007. IREN INITIAL COVERAGE AS OF 20/07/2010. IRIDE INITIAL COVERAGE AS OF 20/10/2008. ITALCEMENTI INITIAL COVERAGE AS OF 31/01/2003. ITALMOBILIARE INITIAL COVERAGE AS OF 27/03/2012. JP MORGAN CHASE INITIAL COVERAGE AS OF 30/06/2010. IN THE PAST 12 MONTHS, THE RATING ON JP MORGAN CHASE HAS BEEN CHANGED. THE PREVIOUS RATING, ISSUED ON 17/07/2012, WAS NEUTRAL. JULIUS BAER INITIAL COVERAGE AS OF 30/06/2010. KBC GROEP INITIAL COVERAGE AS OF 30/06/2010. LANDI RENZO INITIAL COVERAGE AS OF 14/08/2007. IN THE PAST 12 MONTHS, THE RATING ON LANDI RENZO HAS BEEN CHANGED. THE PREVIOUS RATING, ISSUED ON 18/04/2012, WAS NEUTRAL. L'ESPRESSO INITIAL COVERAGE AS OF 17/04/2003. LLOYDS BANKING GROUP INITIAL COVERAGE AS OF 19/09/2012. LOTTOMATICA INITIAL COVERAGE AS OF 15/03/2005. LUXOTTICA INITIAL COVERAGE AS OF 27/06/2003. MAIRE TECNIMONT INITIAL COVERAGE AS OF 15/09/2008. IN THE PAST 12 MONTHS, THE RATING ON MAIRE TECNIMONT HAS BEEN CHANGED. THE PREVIOUS RATING, ISSUED ON 28/09/2012, WAS NEUTRAL. MARCOLIN INITIAL COVERAGE AS OF 16/12/2010. MARR INITIAL COVERAGE AS OF 05/06/2006. MEDIASET INITIAL COVERAGE AS OF 19/03/2003. IN THE PAST 12 MONTHS, THE RATING ON MEDIASET HAS BEEN CHANGED. THE PREVIOUS RATING, ISSUED ON 14/11/2012, WAS UNDERPERFORM. MEDIOLANUM INITIAL COVERAGE AS OF 19/03/2003. MILANO ASSICURAZIONI INITIAL COVERAGE AS OF 19/12/2003. MONDADORI INITIAL COVERAGE AS OF 06/02/2003. IN THE PAST 12 MONTHS, THE RATING ON MONDADORI HAS BEEN CHANGED. THE PREVIOUS RATING, ISSUED ON 19/04/2012, WAS NEUTRAL. MORGAN STANLEY INITIAL COVERAGE AS OF 30/06/2010. IN THE PAST 12 MONTHS, THE RATING ON MORGAN STANLEY HAS BEEN CHANGED. THE PREVIOUS RATING, ISSUED ON 24/10/2012, WAS NEUTRAL. MUNICH RE INITIAL COVERAGE AS OF 24/01/2013. NATIONAL BANK OF GREECE INITIAL COVERAGE AS OF 16/03/2011. IN THE PAST 12 MONTHS, THE RATING ON NATIONAL BANK OF GREECE HAS BEEN CHANGED. THE PREVIOUS RATING, ISSUED ON 06/06/2012, WAS NEUTRAL. NICE INITIAL COVERAGE AS OF 28/07/2006. NORDEA INITIAL COVERAGE AS OF 30/06/2010. OTP INITIAL COVERAGE AS OF 30/06/2010. PARMALAT INITIAL COVERAGE AS OF 21/03/2003. PIAGGIO INITIAL COVERAGE AS OF 14/09/2006. IN THE PAST 12 MONTHS, THE RATING ON PIAGGIO HAS BEEN CHANGED. THE PREVIOUS RATING, ISSUED ON 13/09/2012, WAS NEUTRAL. PIQUADRO INITIAL COVERAGE AS OF 07/01/2008. PIRAEUS INITIAL COVERAGE AS OF 16/03/2011. PIRELLI & C. INITIAL COVERAGE AS OF 12/05/2004. IN THE PAST 12 MONTHS, THE RATING ON PIRELLI & C. HAS BEEN CHANGED. THE PREVIOUS RATING, ISSUED ON 20/07/2012, WAS NEUTRAL. PKO BANK POLSKI INITIAL COVERAGE AS OF 30/06/2010. POLIGRAFICI EDITORIALE INITIAL COVERAGE AS OF 17/10/2006. POLTRONA FRAU INITIAL COVERAGE AS OF 29/01/2007. PRADA INITIAL COVERAGE AS OF 21/02/2012. IN THE PAST 12 MONTHS, THE RATING ON PRADA HAS BEEN CHANGED. THE PREVIOUS RATING, ISSUED ON 08/06/2012, WAS NEUTRAL. PRELIOS INITIAL COVERAGE AS OF 20/02/2003. PREMAFIN INITIAL COVERAGE AS OF 09/04/2008. PRYSMIAN INITIAL COVERAGE AS OF 26/06/2007. IN THE PAST 12 MONTHS, THE RATING ON PRYSMIAN HAS BEEN CHANGED. THE PREVIOUS RATING, ISSUED ON 11/05/2012, WAS OUTPERFORM. RAIFFEISEN INT. INITIAL COVERAGE AS OF 30/06/2010. RCS MEDIAGROUP INITIAL COVERAGE AS OF 25/06/2003. IN THE PAST 12 MONTHS, THE RATING ON RCS MEDIAGROUP HAS BEEN CHANGED. THE PREVIOUS RATING, ISSUED ON 18/09/2012, WAS NEUTRAL. RECORDATI INITIAL COVERAGE AS OF 12/03/2003. IN THE PAST 12 MONTHS, THE RATING ON RECORDATI HAS BEEN CHANGED. THE PREVIOUS RATING, ISSUED ON 19/04/2012, WAS NEUTRAL. RISANAMENTO INITIAL COVERAGE AS OF 18/06/2007. ROYAL BANK OF

SCOTLAND INITIAL COVERAGE AS OF 19/09/2012. SAFILO INITIAL COVERAGE AS OF 19/12/2006. SAIPEM INITIAL COVERAGE AS OF 20/02/2003. IN THE PAST 12 MONTHS, THE RATING ON SAIPEM HAS BEEN CHANGED. THE PREVIOUS RATING, ISSUED ON 15/01/2013, WAS NEUTRAL. SAMPO INITIAL COVERAGE AS OF 17/09/2012. SANTANDER INITIAL COVERAGE AS OF 30/06/2010. IN THE PAST 12 MONTHS, THE RATING ON SANTANDER HAS BEEN CHANGED. THE PREVIOUS RATING, ISSUED ON 27/04/2012, WAS NEUTRAL. SARAS INITIAL COVERAGE AS OF 22/05/2012. IN THE PAST 12 MONTHS, THE RATING ON SARAS HAS BEEN CHANGED. THE PREVIOUS RATING, ISSUED ON 13/08/2012, WAS NEUTRAL. SAVE INITIAL COVERAGE AS OF 14/10/2005. SCOR INITIAL COVERAGE AS OF 24/01/2013. SEAT PAGINE GIALLE INITIAL COVERAGE AS OF 05/02/2003. SEB AB INITIAL COVERAGE AS OF 13/10/2011. SIAS INITIAL COVERAGE AS OF 21/05/2003. SNAM INITIAL COVERAGE AS OF 21/02/2003. SOCIETE GENERALE INITIAL COVERAGE AS OF 30/06/2010. SOGEFI INITIAL COVERAGE AS OF 09/03/2007. IN THE PAST 12 MONTHS, THE RATING ON SOGEFI HAS BEEN CHANGED. THE PREVIOUS RATING, ISSUED ON 27/02/2012, WAS OUTPERFORM. SORIN INITIAL COVERAGE AS OF 10/03/2004. STANDARD CHARTERED INITIAL COVERAGE AS OF 06/10/2010. IN THE PAST 12 MONTHS, THE RATING ON STANDARD CHARTERED HAS BEEN CHANGED. THE PREVIOUS RATING, ISSUED ON 02/08/2012, WAS OUTPERFORM. STMICROELECTRONICS INITIAL COVERAGE AS OF 20/01/2003. SWEDBANK INITIAL COVERAGE AS OF 13/10/2011. SWISS LIFE INITIAL COVERAGE AS OF 17/09/2012. SWISS RE INITIAL COVERAGE AS OF 24/01/2013. TALANX INITIAL COVERAGE AS OF 24/01/2013. TELECOM ITALIA INITIAL COVERAGE AS OF 12/02/2003. TELECOM ITALIA MEDIA INITIAL COVERAGE AS OF 13/02/2004. TENARIS INITIAL COVERAGE AS OF 15/04/2003. IN THE PAST 12 MONTHS, THE RATING ON TENARIS HAS BEEN CHANGED. THE PREVIOUS RATING, ISSUED ON 15/10/2012, WAS NEUTRAL. TERNA INITIAL COVERAGE AS OF 27/08/2004. TESMEC INITIAL COVERAGE AS OF 21/09/2010. IN THE PAST 12 MONTHS, THE RATING ON TESMEC HAS BEEN CHANGED. THE PREVIOUS RATING, ISSUED ON 15/03/2012, WAS NEUTRAL. TISCALI INITIAL COVERAGE AS OF 06/02/2003. TOD'S INITIAL COVERAGE AS OF 28/01/2003. TREVI FINANZIARIA INITIAL COVERAGE AS OF 06/03/2006. IN THE PAST 12 MONTHS, THE RATING ON TREVI FINANZIARIA HAS BEEN CHANGED. THE PREVIOUS RATING, ISSUED ON 24/02/2012, WAS UNDERPERFORM. UBS INITIAL COVERAGE AS OF 30/06/2010. IN THE PAST 12 MONTHS, THE RATING ON UBS HAS BEEN CHANGED. THE PREVIOUS RATING, ISSUED ON 01/08/2012, WAS UNDERPERFORM. UNICREDIT INITIAL COVERAGE AS OF 30/06/2003. UNIONE DI BANCHE ITALIANE INITIAL COVERAGE AS OF 16/04/2013. UNIPOL INITIAL COVERAGE AS OF 21/07/2003. YOOX INITIAL COVERAGE AS OF 21/01/2010. IN THE PAST 12 MONTHS, THE RATING ON YOOX HAS BEEN CHANGED. THE PREVIOUS RATING, ISSUED ON 20/09/2012, WAS NEUTRAL. ZURICH INITIAL COVERAGE AS OF 17/09/2012. MEDIIOBANCA S.P.A. ACTS AS SPECIALIST OF THE FOLLOWING COMPANIES, IN COMPLIANCE WITH THE OBLIGATIONS SET FORTH BY THE RULES OF THE MARKETS ORGANIZED AND MANAGED BY BORSA ITALIANA S.P.A. MEDIIOBANCA S.P.A. EXPECTS TO PREPARE RESEARCH REPORTS ON THE FOLLOWING COMPANIES AT LEAST ON A SEMI-ANNUAL BASIS: AEFPE, AION RENEWABLES, ANSALDO STS, DADA, EI TOWERS, YOOX. MEDIIOBANCA S.P.A. ACTS AS SPONSOR OF THE FOLLOWING COMPANIES, IN COMPLIANCE WITH THE OBLIGATIONS SET FORTH BY THE RULES OF THE MARKETS ORGANIZED AND MANAGED BY BORSA ITALIANA S.P.A. MEDIIOBANCA S.P.A. EXPECTS TO PREPARE RESEARCH REPORTS ON THE FOLLOWING COMPANIES AT LEAST ON A SEMI-ANNUAL BASIS: BRUNELLO CUCINELLI. MEDIIOBANCA S.P.A. OR ONE OR MORE OF THE COMPANIES BELONGING TO ITS GROUP ARE PARTIES TO ONE OR MORE AGREEMENTS WITH EUROTECH RELATING TO THE PREPARATION OF RESEARCH REPORTS ON EUROTECH. 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THE FOLLOWING COMPANIES OWNS A "MAJOR HOLDING" (AS DEFINED IN THE REGULATIONS OF THE COMMISSIONE NAZIONALE PER LE SOCIETA E LA BORSA) IN MEDIIOBANCA S.P.A. OR ONE OR MORE OF THE COMPANIES BELONGING TO ITS GROUP. PLEASE CONSULT THE WEBSITE OF COMMISSIONE NAZIONALE PER LE SOCIETA' E LA BORSA (WWW.CONSOB.IT) FOR DETAILS: FONDIARIA-SAI, MEDIOLANUM, UNICREDIT. THE FOLLOWING COMPANIES HAS A REPRESENTATIVE ON ONE OF THE GOVERNING BODIES OF MEDIIOBANCA S.P.A. OR ONE OR MORE OF THE COMPANIES BELONGING TO ITS GROUP: INTERPUMP, SANTANDER, SOCIETE GENERALE, TELECOM ITALIA, UNICREDIT. MEDIIOBANCA S.P.A. OR ONE OR MORE OF THE COMPANIES BELONGING TO ITS GROUP HAVE A SIGNIFICANT LENDING RELATIONSHIP WITH FOLLOWING COMPANIES OR ONE OR MORE OF THE COMPANIES BELONGING TO ITS GROUP: ATLANTIA, AUTOGRILL, AUTOSTRADA TO-MI, BANCA GENERALI, ENEL, ENEL GREEN POWER, FONDIARIA-SAI, GENERALI ASS., MILANO ASSICURAZIONI, PREMAFIN, SIAS, SNAM, TELECOM ITALIA, TELECOM ITALIA MEDIA, UNIPOL. MEDIIOBANCA S.P.A. OR ONE OR MORE OF THE COMPANIES BELONGING TO ITS GROUP HOLD MATERIAL OPEN POSITIONS IN FINANCIAL INSTRUMENTS, OR DERIVATIVES WHOSE UNDERLYING FINANCIAL INSTRUMENTS ARE MATERIALLY REPRESENTED BY FINANCIAL INSTRUMENT, ISSUED BY THE FOLLOWING COMPANIES: GENERALI ASS.. MEDIIOBANCA S.P.A. OR ONE OR MORE OF THE COMPANIES BELONGING TO ITS GROUP ARE CURRENTLY PROVIDING CORPORATE FINANCE SERVICES TO THE FOLLOWING COMPANIES OR ONE OR MORE OF THE COMPANIES BELONGING TO ITS GROUP: A2A, AION RENEWABLES, BANCA MONTE PASCHI SIENA, BANCO POPOLARE, CATTOLICA ASSICURAZIONI, ENEL, ENI, ENIA, FINMECCANICA, FONDIARIA-SAI, GENERALI ASS., IMMOBILIARE GRANDE DISTRIBUZIONE, IMPREGILO, IRIDE, ITALCEMENTI, L'ESPRESSO, MILANO ASSICURAZIONI, TELECOM ITALIA. IN THE PAST 12 MONTHS, MEDIIOBANCA S.P.A. OR ONE OR MORE OF THE COMPANIES BELONGING TO ITS GROUP HAVE ENTERED INTO AGREEMENTS TO DELIVER CORPORATE FINANCE SERVICES TO THE FOLLOWING COMPANIES OR ONE OR MORE OF THE COMPANIES BELONGING TO ITS GROUP: BENI STABILI, DE LONGHI, PARMALAT, UNICREDIT. MEDIIOBANCA S.P.A. OR ONE OR MORE OF THE COMPANIES BELONGING TO ITS GROUP ARE CURRENTLY FULFILLING AGREEMENTS TO ISSUE FINANCIAL INSTRUMENTS LINKED TO FINANCIAL INSTRUMENTS OF THE FOLLOWING COMPANIES: MEDIASET. IN THE PAST 12 MONTHS, MEDIIOBANCA S.P.A. HAS ACTED AS LEAD MANAGER, CO-LEAD MANAGER, BOOKRUNNER OR IN SIMILAR ROLES IN THE CONTEXT OF A PUBLIC OFFERING OF FINANCIAL INSTRUMENTS OF THE FOLLOWING COMPANIES: BRUNELLO CUCINELLI. IN THE PAST 12 MONTHS, MEDIIOBANCA SECURITIES USA LLC HAS NOT ACTED AS LEAD MANAGER, CO-LEAD MANAGER, BOOKRUNNER OR IN SIMILAR ROLES IN THE CONTEXT OF A PUBLIC OFFERING OF FINANCIAL INSTRUMENTS OF THE FOLLOWING COMPANIES: BRUNELLO CUCINELLI. MEDIIOBANCA S.P.A. IS CURRENTLY ACTING AS LEAD MANAGER, CO-LEAD MANAGER, BOOKRUNNER OR IN SIMILAR ROLES IN THE CONTEXT OF A PUBLIC OFFERING OF FINANCIAL INSTRUMENTS OF THE FOLLOWING COMPANIES : COMMERZBANK. MEDIIOBANCA SECURITIES USA LLC DOES NOT ACT AS LEAD MANAGER, CO-LEAD MANAGER, BOOKRUNNER OR IN SIMILAR ROLES IN THE CONTEXT OF A PUBLIC OFFERING OF FINANCIAL INSTRUMENTS OF THE FOLLOWING COMPANIES: COMMERZBANK. MEDIIOBANCA S.P.A. IS COMMITTED TO PURCHASE FINANCIAL INSTRUMENTS REMAINING UNSUBSCRIBED IN THE CONTEXT OF FINANCIAL INSTRUMENTS OFFERING OF THE FOLLOWING COMPANIES: COMMERZBANK.

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