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European Banks 9 August 2017

Outperform Price **€1.28** Target **€1.43**

Unicaja Banco, S.A. [UNI.SM]

Southern comfort; initiating coverage

Assumption of Coverage
Estimates Change
Rating Change
Price Target Change

Changes	Current	Previous
Rating	Outperform	–
Target Price	€1.43	–

Year-end	2017E	2018E	2019E
KBW op EPS new (€)	0.10	0.07	0.11
Net Profit (€)	122.00	109.00	172.00
NAVPS (€)	2.48	2.54	2.63
DPS (€)	0.01	0.02	0.04
RONAV (%)	3.6	2.8	4.3
KBW op P/E	12.8	18.3	11.6
P/NAV	0.52	0.50	0.49
Yield (%)	0.8	1.6	3.1
Shares (mn)	**1,548.0**		
Market Cap (€bn)	**2.1**		

Prices are as of: 8 August 2017 12:30 EDT

We initiate coverage Unicaja Banco (UNI.SM) with a price target of €1.43 per share and an Outperform rating. We estimate a 5.6% underlying level of RoTE, which discounts success in implementing additional cost synergies and some success in changing the loan mix and loan growth (although below management targets). Although we do not explicitly include higher interest rates in our EPS estimates / RoTE, we partially include this in the valuation (c. €0.19 per share fully discounting the potential for higher levels of Euribor by 2020). The high levels of non-performing asset coverage and ongoing improvements in the Spanish economy / housing market have seen provision charges already move close to normalised levels. With a conservative capital and liquidity profile, Unicaja is well above all regulatory requirements and has one of the lowest SREP requirements in Spain.

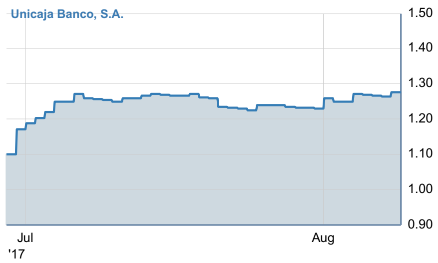
Strategy. Unicaja has an ambitious four-year plan to improve profitability from the current mid-single digit level of ROE (return on equity) to >8% by 2020. The foundation for this plan is a strong and conservative level of capital, maintaining its traditional conservative approach to credit risk and leveraging the franchise of a Spanish savings bank with strong regional market share in its core regions. With a focus on the regions of Andalucía and Castilla y León, the plan aims to improve margins, strengthen and broaden the fee base, accelerate loan growth in SMEs and consumer loans and complete the synergies from the 2014 acquisition of EspañaDuero.

Cost synergies / stronger NIM (and higher rates). Having already delivered 46% of the targeted synergies, Unicaja is still targeting €100m of cost synergies. This represents c. 15% of the 2016 cost base. Higher interest rates and a change in loan mix should all contribute to an improved outlook for net interest income and margins. UNI is targeting c. 6% pa loan growth over the next 4 years, which we believe is very ambitious. For the moment we remain more cautious at 2.7% pa.

Profitability and valuation. With more modest loan growth vs. the business plan and without including higher interest rates, we estimate a 2020 RoTe of 5.6%. Including higher interest rates, we believe this could rise to c. 6.5%. We use this scenario to calculate our price target of €1.43 per share (€1.34 of underlying earnings/dividends and excess capital; with €0.19 partially included for potentially higher rates). If management were to hit its targets we believe RoTE would be close to 10%. We estimate UNI is trading on a 2019e P/E of 11.2x and a 2017e P/NAV of 0.5x vs. our target price valuations of 12.9x 2019 and 0.6x. Including excess capital we estimate a P/E of 10.4x and also including higher rates in earnings a P/E of 8.5x.

Investment Thesis

With a conservative balance sheet, both in asset quality and capital, UNI is in a positive to benefit from higher European interest rates and stronger loan growth in Spain. Additional cost savings from a recent merger should also be supportive to profitability.



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Please refer to important disclosures and analyst certification information on pages 74 - 78.

Unicaja – southern comfort

Investment summary and key risks

Unicaja – one of the few surviving savings banks

We initiate coverage Unicaja Banco (UNI.SM) with a price target of €1.43 per share and an Outperform rating. We estimate a 5.6% underlying level of RoTE, which discounts success in implementing additional cost synergies, some success in changing the loan mix and loan growth (although below management targets). Although we do not explicitly include higher interest rates in our EPS estimates and RoTE, we include c. €0.19 per share to account for the potential for higher levels of Euribor by 2020.

Unicaja Banco is primarily a retail financial group comprising a number of regional savings banks, led by the original savings bank franchise of Unicaja, headquartered in the southern Spanish province of Málaga. Unicaja is the eighth largest bank in Spain by assets and its national loan market share is 2.4%. In its core regions, Unicaja has a higher market share, reaching 10% in Andalucía and 16% in Castilla y León (2016 loan market share). It is one of the few former savings banks not to have received or required any state aid, although in 2014 it did acquire another savings bank group (the combination of Caja España and Caja Duero) that received aid. Having recently completed an IPO, the Unicaja Foundation now controls 49.3% of the bank. The capital raised from the IPO (€756m in total including the green shoe) is being used to repay the government CoCos in EspañaDuero and absorb the capital impacts from the re-organisation of the group’s insurance business.

Strategy and targets

Unicaja has an ambitious four-year plan to improve profitability from the current mid-single digit level of ROE (return on equity) to a high single-digit level by 2020 (>8%). The foundation for this plan is a strong and conservative level of capital, maintaining its traditional conservative approach to asset quality / credit risk and leveraging the franchise of a Spanish savings bank with strong regional market share in its core regions. With a focus on the regions of Andalucía and Castilla y León, the plan aims to improve margins, strengthen and broaden the fee base, accelerate loan growth in SMEs and consumer loans and complete the synergies from the 2014 acquisition of EspañaDuero.

- **Efficiency gains from integration of EspañaDuero.** Having recently raised the targeted synergies, Unicaja still has c. €100m of cost synergies to deliver. The total synergies from the integration of EspañaDuero represent c. 26% of the pro-forma cost base pre acquisition. The total restructuring costs associated with the integration amount to €409m, of which 84% or €344m have already been booked through the P&L. The remaining cost synergies will largely come from the reduction of employees, with c. 500 current employees having already agreed to take early retirement or redundancy. The remaining €100m cost synergies represent c. 15% of the 2016 cost base.

- **Loan growth and market share gains.** Management targets 6% CAGR growth over the period 2016-2020, with particularly strong growth in SMEs (14% CAGR) and consumer loans (19% CAGR). It targets faster growth than the market across all major loan segments and, as a result, increased market share. By geographic region, Unicaja is in particular looking to increase its market share in “natural expansion regions” to the mid-single digits. In its leadership regions, Unicaja is targeting reaching mid-teens market share levels in corporate/SME and mortgage lending, whilst increasing its market share in consumer loans from c. 7% to 10%. (see page 27 for breakdown and detail of leadership / natural expansion provinces).

- **Improving net interest margin from change in loan mix and higher interest rates**. Although interest rates are currently low, which has had a negative impact on margins, Unicaja believes it has a number of levers with which to improve margins. These include short- and long-term repricing potential of term deposits, repayment of CoCos (which will save a coupon of €59m a year), deployment of TLTRO (Targeted longer-term refinancing operations) funding (€3.4bn taken up in March 2017 at a cost of -40bps) and maturing expensive wholesale debt issuance. Unicaja is also targeting stronger loan growth in higher yield segments of Consumer loans and SME loans, where the average front book yield is currently 2.4% and 5.3%, respectively. This compares to an aggregate back book yield of 2.4%.

- **Conservative risk profile (asset quality and capital)**. Using the proceeds of the IPO to repay the government CoCos in EspañaDuero, Unicaja targets maintaining a capital ratio in excess of 12%. Its current CET1 fully loaded ratio is 11.8%, one of the highest in Spain. It is also worth highlighting that Unicaja's conservative balance sheet is reflected in one of the lowest SREP ratios. Although Unicaja does have relatively high levels of non-performing assets (NPA ratio of 16.2%, third highest of the peer group – see page 38), the levels of coverage are also some of the highest in Spain. From Unicaja's perspective, the best in class coverage ratios are a management decision and reflect the long-standing conservative approach to risk (they are not a reflection of weaker underlying collateral). The current Texas ratio of 94% should be below 90% post the IPO and we estimate, based on the business plan targets, should be c. 55% in 2020.

Figure 1: Summary of Unicaja business plan targets vs. KBW estimates

Financial	2016	Target 2020	KBWe 2020
RoE / RoTE	4.9%	>8.0%	5.6%
Cost:income ratio[1]	56%	<50%	53%
Cost of risk	25bp	<30bps	0.26%
NPA coverage	55%	>62%	57%
NPL ratio	9.8%	c. 4%	5.8%
CET1 FL	11.8%[2]	>12%	12.5%
Cash pay-out	12%	40%	45%

Loan growth (2016-2020 CAGR)	Spain - Unicaja est.	Unicaja target	KBWe 2020
Total	2%-4%	c. 6%	2.7%
Public Sector	-	c. 4%	0.4%
Corp. / SME	4%-5%	c. 12%	6.5%
Consumer	8%-10%	c. 19%	11.2%
Mortgage	1%-2%	c. 1%	0.6%

Other	2016	Target 2020	KBWe 2020
NPAs (€bn)	5.8	3.5	3.7
Fee % assets	35bp	c. 40bp	0.40%
AuM growth (16-20)	6.0%	10.0%	7.4%

Source: Company data, KBW Research [1:] *excludes depreciation/amortisation*

Figure 2: Unicaja financials overview

	Unicaja					
	2015a	2016a	2017e	2018e	2019e	2020e
Revenues:						
NIM (ATA)	*1.07%*	*1.05%*	*1.01%*	*1.07%*	*1.06%*	*1.12%*
Total revenue/ATA	2.46%	1.85%	1.73%	1.53%	1.54%	1.64%
Total revenue/Business volume	*1.60%*	*1.14%*	*1.06%*	*0.93%*	*0.93%*	*0.98%*
NII/Total revenue	*44%*	*57%*	*58%*	*70%*	*68%*	*68%*
Non interest income/Total revenue	*56%*	*43%*	*42%*	*30%*	*32%*	*32%*
Costs:						
Costs/ATA	1.06%	1.12%	1.10%	1.03%	0.98%	0.95%
Costs/Business volume	*0.69%*	*0.69%*	*0.67%*	*0.63%*	*0.59%*	*0.57%*
Cost-Income Ratio	43.3%	60.2%	63.5%	67.3%	63.5%	58.2%
Business volume/employee (m)	*12.4*	*12.6*	*12.8*	*13.3*	*13.8*	*14.3*
Profitability:						
Operating Income/ATA	1.39%	0.74%	0.63%	0.50%	0.56%	0.68%
Effective Tax Rate	26.4%	34.6%	18.0%	27.6%	29.4%	28.6%
RoA	0.29%	0.24%	0.21%	0.19%	0.29%	0.39%
Leverage (RoE/RoA)	22.1x	20.3x	16.9x	14.8x	14.6x	14.3x
RoE	6.4%	4.9%	3.6%	2.8%	4.3%	5.6%
RoNAV	6.4%	4.9%	3.6%	2.8%	4.3%	5.6%
RoRWA	0.6%	0.5%	0.4%	0.4%	0.7%	0.9%
RCET1 FL of 12%	5.8%	4.6%	4.1%	3.6%	5.5%	7.3%
Credit quality:						
LLC/NII	62.2%	13.5%	15.6%	13.5%	13.8%	13.6%
LLC % avrg. Loans	*1.13%*	*0.24%*	*0.27%*	*0.25%*	*0.25%*	*0.26%*
NPL ratio	9.8%	9.6%	8.8%	7.8%	7.1%	5.8%
NPL Coverage	66%	62%	62%	64%	64%	66%
NPA ratio	16%	16%	15%	14%	12%	10%
Texas ratio	97%	94%	79%	73%	67%	58%
Balance sheet:						
Loans/Assets	59%	59%	58%	58%	58%	59%
Loans/Deposits	77%	71%	68%	67%	67%	68%
B3 fully loaded core capital	11.1%	11.8%	12.1%	12.2%	12.3%	12.5%

Source: Company data, KBW Research

Key risks

Here we have identified what we believe are some of the key risks facing Unicaja:

- **Interest rates could remain at historical lows.** European interest rates remain at a historically low level, which has had a negative impact on the yield of Unicaja's loan book. Current market expectations (as reflected in current interest rate futures) are discounting an increase in rates over the coming four years, starting from 2018. This should help improve profitability at Unicaja. Were interest rates to remain lower for longer, we believe this would represent a material headwind to profitability for the bank.

- **Valuation of real estate assets and Spanish housing market.** Although Unicaja is currently selling real estate assets with a gain, updating the valuations of the assets on the balance sheet remains a drag on profitability. Spanish house prices are currently improving, however, were they to stagnant or to go into reverse, this could see the bank's provisioning needs increase. In this scenario, the regulator (i.e. the ECB) could also push Unicaja for a faster disposal of non-core real estate assets, which could generate additional provisioning requirements. Unicaja finished 2016 with €2.59bn of foreclosed real estate assets, and a coverage ratio of 62%. In 1Q17 it sold €93.5m of gross real estate assets for a gain of €25.5m, although this was partially offset by €-20m of provisions to cover lower valuations on the remaining real estate assets.

- **Consumer credit risk.** Asset quality indicators for both Spain and Unicaja continue to improve. However, NPLs in the consumer segment have started to rise again. It is worth highlighting that personal bankruptcy cases are also on the increase. This is in tandem with relatively strong consumer loan growth. Unicaja currently targets a significant increase in its consumer loan book. This change in risk profile could see an increased credit charge. Consumer lending for Unicaja currently accounts for c. 10% of the loan book and, based on the business plan, will reach c. 15% of loans by 2020. The current NPL ratio of the consumer loan book is 11.9% vs. 8.9% for the Spanish banking system (2016).

- **Legal risks.** Spanish and European courts have ruled against numerous Spanish banks (although not specifically against Unicaja) that mortgage floor clauses are illegal and the banks have to repay the amounts overcharged to clients (see Mortgage Floor section – page 70 for details). Unicaja has subsequently made provisions to cover these client refunds totaling c. €370m. Unicaja still has c. €4.7bn of mortgage loans with mortgage floors in place. Although the business plan assumes that the mortgage floors are removed, additional legal action / court cases could see the removal of these clauses at an accelerated pace. Unicaja has also hired an external advisor (EY) who has confirmed that the expected pay-out is in line with the €370m provisions currently provisioned (this compares to a maximum potential liability of c. €0.9bn).

- **Political / economic risks.** As a pure domestic Spanish bank, Unicaja is highly exposed to economic conditions in Spain. The Spanish economy is currently growing strongly, with the IMF forecasting GDP growth of 2.6% y-o-y for 2017. And, although at high levels, the unemployment ratio continues to improve, having reached 18.75% in 1Q 17 vs. a peak of 26.9% in 1Q 2013. Whilst house prices are still well below peak levels (c. 35%), they have been increasing by the low single digits over the last couple of years. A weaker (stronger) recovery in economic activity would impact the bank's asset quality, loan growth and revenues, adding downside (upside) to the outlook for both profitability and valuation.

- **Governance risks.** Unicaja's main shareholder is currently the Unicaja Banking Foundation. The board of the foundation is chaired by Mr. Braulio Medel, who was the executive chairman of Unicaja from 1991 until 2011. Strict corporate governance will be needed to safeguard minority shareholders' interests and focus on value creation for all shareholders, financial discipline, and independence of management from the controlling shareholder. The approved capital increase will dilute the ownership of the founding caja to c. 50%. Currently five of the 13 board members of Unicaja are independent.

Valuation and sensitivity analysis

To calculate our price target for Unicaja we use a Gordon Growth model based on KBW forecasts for net income and profitability. This valuation methodology and its assumptions are based on KBW's long term assumptions for both Unicaja and the Spanish banking market. We value Unicaja at €2.2bn or €1.43 per share (12.9x 2019e P/E and 0.6x 2017e P/NAV). This valuation has been calculated using a combination of underlying earnings estimates and the positive impact on profitability from higher European interest rates.

Figure 3: Valuation summary

	Valuation (€ per share)	2019e P/E multiple	2017e P/NAV multiple
Unicaja	1.43	12.9x	0.6x

Source: KBW Research

Gordon growth valuation

This valuation methodology is based on the following formula: tangible book value * (RoTE – g) / (CoE – g). In this case, we have used the KBW estimate for profitability in 2020 and discounted back by three years to today. We also estimate the potential increase in value from the impact of higher European interest rates (in this case based on 12M Euribor), taking the weighted average of both valuations. In addition to this we add the present value of the dividends paid over the forecast period and the present value of any excess capital (which we have estimated as any CET1 in excess of 12%).

- RoTE (%) is the return on tangible equity, i.e. net income divided by shareholders' equity minus intangible assets and goodwill..
- g is the long-term growth rate. We note that, when the RoTE is below the CoE, applying a growth factor reduces the valuation.
- CoE is the cost of equity. Usually, the cost of equity is calculated based on the CAPM model ($r_a = r_f + b*(r_m - r_f)$), where:
  - *r_f is the rate of return on risk-free securities (typically government bonds), r_m is the market's overall rate of return, b is the inherent risk of an investment, calculated through the correlation of an investment vs. an index.*

Despite the current low-yield of the 10-year Spanish bond (1.61%), we use as our base case a CoE of **10%**, which we believe is consistent with the CoE used by both the peer group and investors. Similarly, we use zero growth (g) (%) as levels of profitability do not warrant the inclusion of a growth premium.

Using KBW forecasts for expected levels of profitability and including the value of cash dividends and excess capital, we estimate a valuation of €2.2bn or €1.43 per share (12.9x 2019e P/E and 0.6x 2017e P/NAV).

Figure 4: Gordon growth valuation table

Unicaja - valuation 2020E (€m)	NAV	CoE	Growth	Net profit	Adj ROE	P/E	P/NAV	Valuation
Unicaja	4,248	10.0%	0.0%	233	5.6%	10.2	0.56	2,381
Total	**4,248**			**233**	5.6%	**10.2**	**0.56**	**2,381**
Number of shares (Mn)								1,548
€								1.54
NPV per share, €								1.16
NPV of current interest curve								0.19
NPV per share, €								1.35
Weighted avrg.								1.25
NPV 2017-20E DPS								0.11
Excess capital per share								0.07
Target price								**1.43**
							Last price	1.25

Source: KBW Research

Sensitivity analysis

Aside from our base case scenario for profitability of c. 5.6% in 2020, we also run a sensitivity analysis, where three different scenarios (in all scenarios we assume UNI delivers on costs synergies and the cost of risk remains stable):

- Scenario a) a conservative scenario that assumes a lower level of loan and fee growth vs. management's target. This scenario also assumes no increase in European interest rates.
- Scenario b) assumes some loan growth and the current implied interest rate curve for the 12M Euribor
- Scenario c) assumes that Unicaja's loan growth and fee targets are met (and also higher interest rates).

Figure 5: Sensitivity analysis

€ m	2016 A	2017 E	Scenario A 2018 E	2019 E	2020 E
P&L					
Net interest income	620	571	570	581	597
Fees income	207	200	199	199	199
Other revenues	262	199	49	61	75
Total revenues	**1089**	**971**	**818**	**841**	**871**
Operating expenses	-656	-629	-595	-573	-569
Pre-provision profit	**433**	**342**	**223**	**269**	**303**
Impairment losses	-84	-90	-83	-83	-88
Other income & impairments	-158	-135	-55	0	10
PBT	**191**	**117**	**86**	**185**	**225**
Income tax	-66	-21	-23	-49	-55
Net profit	**125**	**96**	**63**	**136**	**170**
Minorities & other adjustments	17	10	0	0	0
KBW Adj. net attributable profit	**142**	**106**	**63**	**136**	**170**
Balance sheet					
Average total assets (ATA)	58,776	57,131	56,977	56,991	56,884
Gross loans	33,330	32,997	33,162	33,493	33,996
Customer deposits	48,532	48,961	49,788	50,928	52,198
Tangible book value	2,952	3,743	3,789	3,883	3,991
Avg. TBV	2,892	3,348	3,766	3,836	3,937
KBWe B3 fully loaded CET1	2,952	3,043	3,088	3,183	3,291
B3 RWA	25,188	25,025	25,291	25,701	25,756
Sensitivity (Metrics)					
NIM/ATA	1.05%	1.00%	1.00%	1.02%	1.05%
Fees related income/ATA	0.35%	0.35%	0.35%	0.35%	0.35%
Cost of risk (avg. loans)	24	27	25	25	26
Loan growth	-8.2%	-1.0%	0.5%	1.0%	1.5%
Other main ratios					
C/I ratio	60%	65%	73%	68%	65%
RoA	0.21%	0.17%	0.11%	0.24%	0.30%
RoTE	4.9%	3.2%	1.7%	3.5%	4.3%
KBWe B3 fully loaded	11.8%	12.2%	12.2%	12.4%	12.8%
Valuation					
CoE					10%
g					0%
NPV valuation (RoTE - g)/(CoE-g)					1,295
NPV dividends 2017e-20e					112
NPV excess capital (>12%)					150
Total valuation					1,557
NPV per share					1.01

€ m	2016 A	2017 E	Scenario B 2018 E	2019 E	2020 E
P&L					
Net interest income	620	576	622	642	721
Fees income	207	214	219	224	235
Other revenues	262	199	49	61	75
Total revenues	**1089**	**990**	**891**	**927**	**1031**
Operating expenses	-656	-629	-595	-573	-569
Pre-provision profit	**433**	**361**	**296**	**354**	**462**
Impairment losses	-84	-90	-83	-85	-91
Other income & impairments	-158	-135	-55	0	10
PBT	**191**	**136**	**158**	**269**	**382**
Income tax	-66	-24	-42	-72	-93
Net profit	**125**	**112**	**116**	**198**	**288**
Minorities & other adjustments	17	10	0	0	0
KBW Adj. net attributable profit	**142**	**122**	**116**	**198**	**288**
Balance sheet					
Average total assets (ATA)	58,776	57,285	57,634	58,380	59,563
Gross loans	33,330	33,086	33,544	34,310	35,597
Customer deposits	48,532	48,961	49,788	50,928	52,198
Tangible book value	2,952	3,844	3,935	4,075	4,248
Avg. TBV	2,892	3,398	3,889	4,005	4,161
KBWe B3 fully loaded CET1	2,952	3,032	3,113	3,234	3,374
B3 RWA	25,188	25,093	25,582	26,328	26,969
Sensitivity (Metrics)					
NIM/ATA	1.05%	1.01%	1.08%	1.10%	1.21%
Fees related income/ATA	0.35%	0.37%	0.38%	0.38%	0.40%
Cost of risk (avg. loans)	24	27	25	25	26
Loan growth	-8.2%	-0.7%	1.4%	2.3%	3.8%
Other main ratios					
C/I ratio	60%	64%	67%	62%	55%
RoA	0.21%	0.19%	0.20%	0.34%	0.48%
RoTE	4.9%	3.6%	3.0%	4.9%	6.9%
KBWe B3 fully loaded	11.8%	12.1%	12.2%	12.3%	12.5%
Valuation					
CoE					10%
g					0%
NPV valuation (RoTE - g)/(CoE-g)					2,211
NPV dividends 2017e-20e					176
NPV excess capital (>12%)					103
Total valuation					2,490
NPV per share					1.61

€ m	2016 A	2017 E	Scenario C 2018 E	2019 E	2020 E
P&L					
Net interest income	620	603	703	774	920
Fees income	207	234	252	260	268
Other revenues	262	199	49	61	75
Total revenues	**1089**	**1036**	**1005**	**1094**	**1264**
Operating expenses	-656	-629	-595	-563	-559
Pre-provision profit	**433**	**407**	**410**	**532**	**705**
Impairment losses	-84	-91	-86	-89	-97
Other income & impairments	-158	0	0	0	0
PBT	**191**	**317**	**324**	**442**	**608**
Income tax	-66	-57	-85	-118	-149
Net profit	**125**	**260**	**238**	**325**	**459**
Minorities & other adjustments	17	0	0	0	0
KBW Adj. net attributable profit	**142**	**260**	**238**	**325**	**459**
Balance sheet					
Average total assets (ATA)	58,776	58,516	60,100	61,900	63,915
Gross loans	33,330	33,797	34,980	36,379	38,198
Customer deposits	48,532	48,961	49,788	50,928	52,198
Tangible book value	2,952	3,875	4,046	4,272	4,564
Avg. TBV	2,892	3,414	3,960	4,159	4,418
KBWe B3 fully loaded CET1	2,952	3,174	3,346	3,571	3,863
B3 RWA	25,188	25,632	26,677	27,915	28,940
Sensitivity (Metrics)					
NIM/ATA	1.05%	1.03%	1.17%	1.25%	1.44%
Fees related income/ATA	0.35%	0.40%	0.42%	0.42%	0.42%
Cost of risk (avg. loans)	24	27	25	25	26
Loan growth	-8.2%	1.4%	3.5%	4.0%	5.0%
Other main ratios					
C/I ratio	60%	61%	59%	51%	44%
RoA	0.21%	0.44%	0.40%	0.52%	0.72%
RoTE	4.9%	7.6%	6.0%	7.8%	10.4%
KBWe B3 fully loaded	11.8%	12.4%	12.5%	12.8%	13.3%
Valuation					
CoE					10%
g					0%
NPV valuation (RoTE - g)/(CoE-g)					3,567
NPV dividends 2017e-20e					306
NPV excess capital (>12%)					293
Total valuation					4,166
NPV per share					2.69

Source: KBW Research

We also show the sensitivity of the valuation to varying levels of cost of equity. As the RoTE is below the CoE, varying the long-term growth assumption does not have a positive impact on the valuation.

Figure 6: CoE / g sensitivity analysis

		CoE	
€ per share	9.0%	10.0%	11.0%
Scenario A	1.1	1.0	0.9
Scenario B	1.8	1.6	1.5
Scenario C	2.9	2.7	2.5

Source: KBW Research

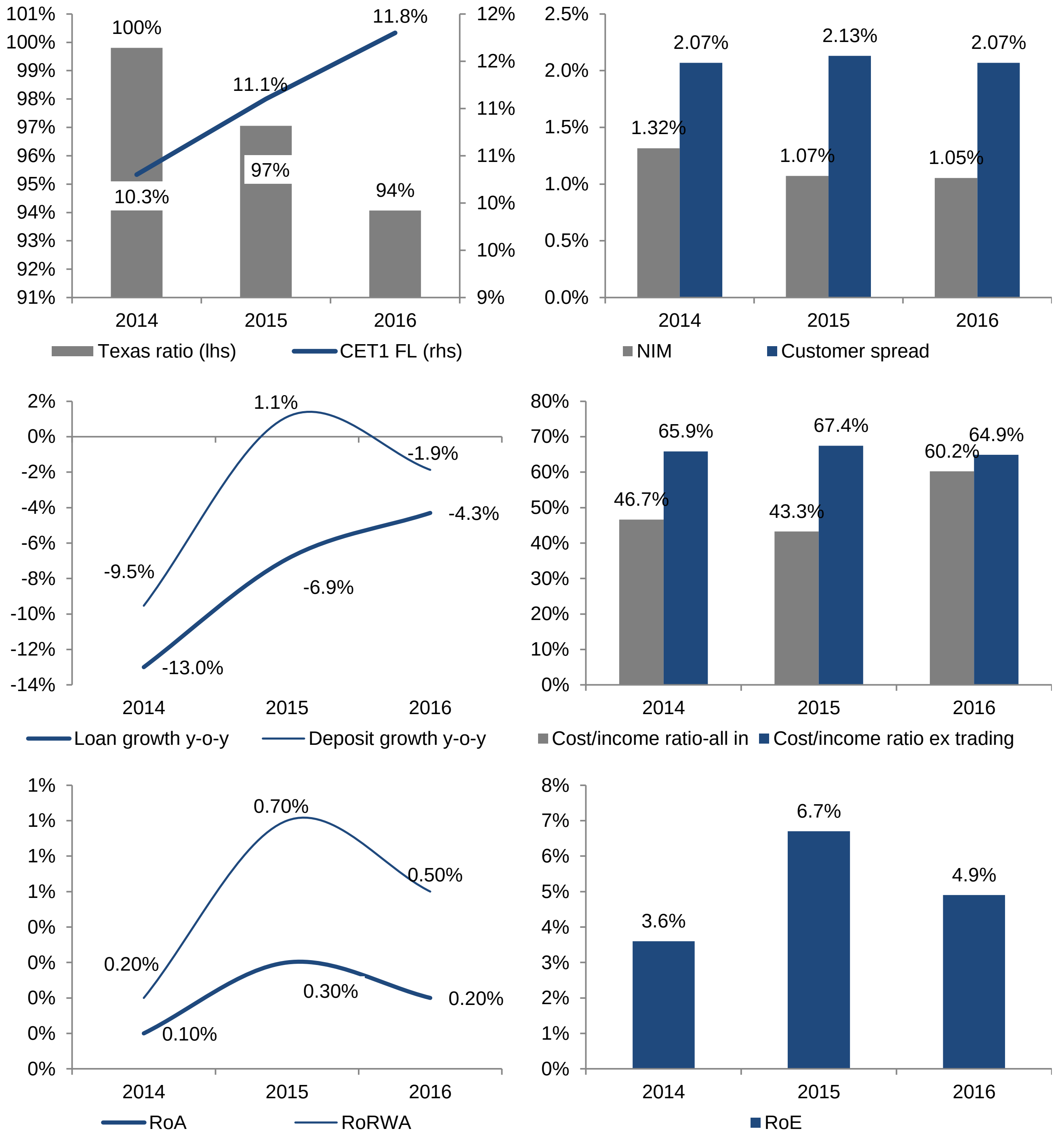
Unicaja – Overview

Unicaja Banco is a financial group comprising a number of regional savings banks, led by the original savings bank franchise of Unicaja, headquartered in the southern Spanish province of Malaga. In terms of size, it is the eighth largest Spanish banking group with assets of €57.2bn, equivalent to c. 2.2% of the Spanish banking system (2016 Bank of Spain data). Unicaja is one of the few former savings banks not to have received or required any state aid, although in 2014 it did acquire another savings bank group (the combination of Caja España and Caja Duero) that received aid.

In terms of profile, like the vast majority of Spanish banks, Unicaja Banco is effectively a pure retail bank, in this case with a particular focus on residential retail mortgages. Despite its location in the heavily touristic region of Spain, the bank has primarily focused on first-time residential mortgages. However, as we examine in detail later in this report, the bank is increasingly looking to diversify its loan book, with greater exposure to small/medium-sized enterprises (SMEs) and consumer loans.

Unicaja, in our view, has historically been one of the more conservative and risk-averse financial institutions in Spain. As already indicated, it did not require any financial assistance from the Spanish state during the banking crisis, which saw most of the savings banks disappear. Exposure to real estate loans is, and has been, below average. Exposure currently stands at c. 4% of the loan book (versus c10% for the Spanish banking system, 2016 Bank of Spain data). The NPL ratio is in line with Spanish banking system at c. 10% (although it is higher across the various loan segments) but the coverage ratio is one of the highest in the system. We believe this is a reflection of the prudent approach to risk by both the current and previous management teams.

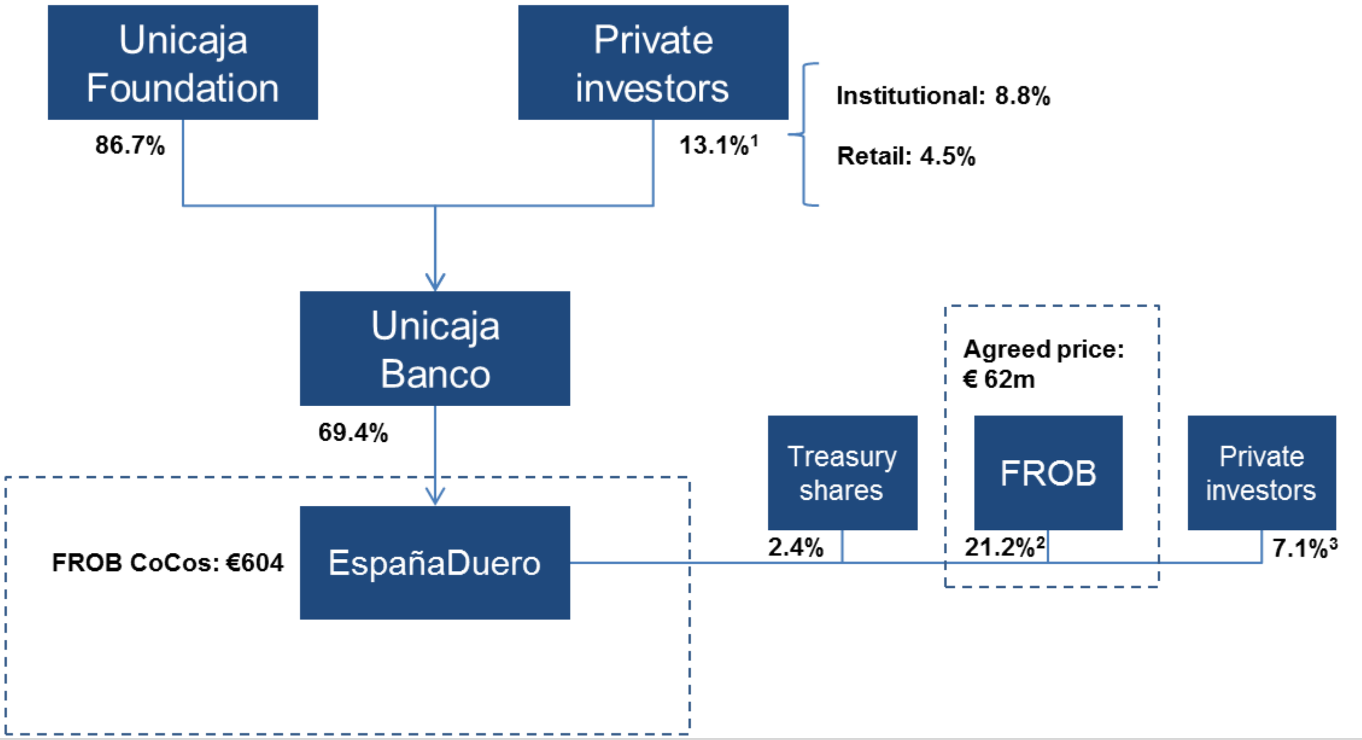
Figure 7: Overview



Source: Company data, KBW Research

Unicaja Banco is majority owned by the Unicaja banking foundation (post-deal ownership at 49.7% / pre-deal at 86.7%). The other 13.3% pre-deal ownership (where the shareholders do not have preferential subscription rights in the IPO) comprised both the retail and institutional owners of the EspañaDuero CoCos who accepted the exchange offer from Unicaja when EspañaDuero was acquired. At the Unicaja Banco level, the firm is currently a 69.4% owner of EspañaDuero, with the FROB (Fund for Orderly Bank Restructuring – Spanish state aid vehicle for banks) owning 21%. A 7.1% stake is held by minority investors, owners of hybrid debt that did not accept the exchange offer of Unicaja. Unicaja has indicated that part of the proceeds from the IPO will be used to repay the FROB the €604m of CoCos (Contingent convertible bonds) at EspañaDuero. In addition, Unicaja Banco will pay €62m to acquire the 21% equity stake of EspañaDuero.

Figure 8: Group structure (pre-deal)

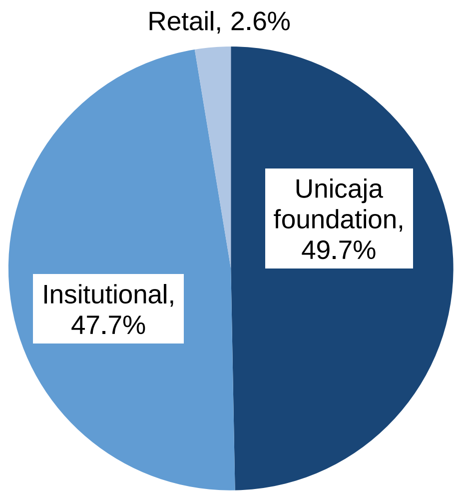


Source: Company data, KBW Research

(1) Former EspañaDuero shareholders and holders of EspañaDuero CoCos who accepted Unicaja's exchange offer for the acquisition of EspañaDuero. (2) The FROB had a 18.5% stake (21.1% pro-forma the amortisation of 145m treasury shares) in EspañaDuero following the full use of the so-called "Mecanismo de Compensación" (arising from legal proceedings initiated by EspañaDuero shareholders or holders of EspañaDuero CoCos not accepting Unicaja's exchange offer) (3) Stake held by former holders of EspañaDuero CoCos who did not accept Unicaja's exchange offer for the acquisition of EspañaDuero

Following the IPO, Unicaja increased its capital by €756m issuing 623m shares and a further 62.5m following the exercise of the greenshoe. The total number of shares post-deal is 1,610m. The IPO was priced at €1.10 per share. The Unicaja foundation ownership has been diluted following the IPO to 49.7%. The remaining 50.3% free float is primarily held by institutional shareholders (47.7%), with retail shareholders owning 2.6%.

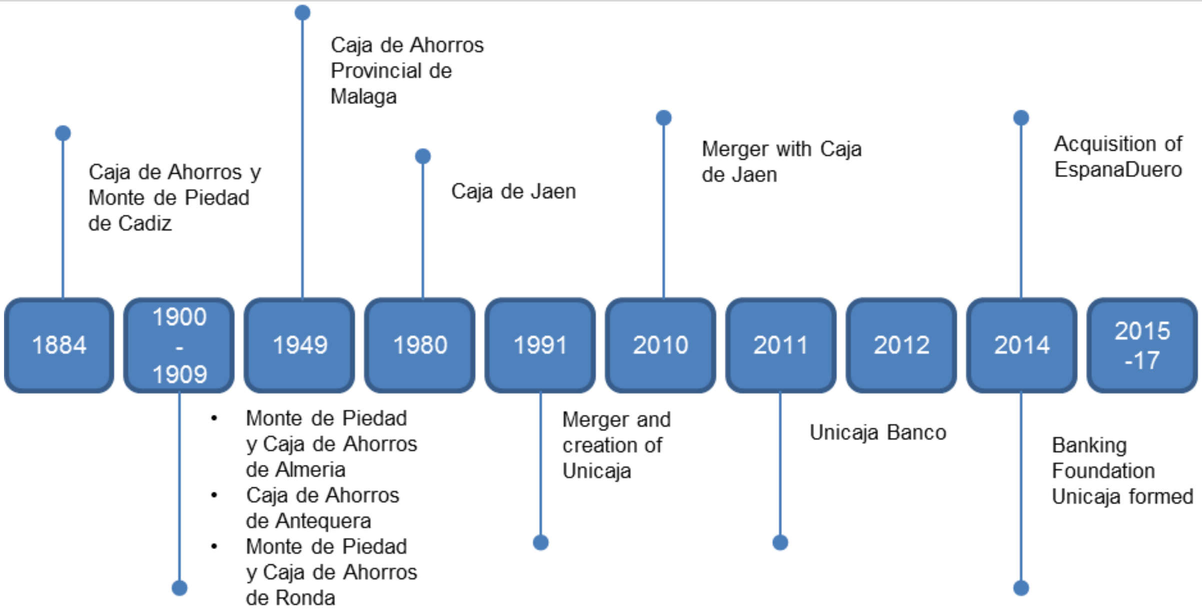
Figure 9: Shareholder structure post-deal



Source: Company data, KBW Research

The original savings banks that today make up Unicaja were, in some cases, founded over 130 years ago. A series of mergers in 1980s culminated in the creation of the savings bank (or Caja de Ahorros) Unicaja. Since the financial crisis in Spain, Unicaja has acquired a number of savings banks, including the small Caja de Jaén (also in Andalucía) and the combination of Caja España and Caja Duero (the market-leading savings bank in Castilla y León). The changes to the legislation and legal framework of the savings bank have seen the creation of Unicaja Banco, with the savings bank foundation, *Unicaja banking foundation*, the main shareholder of the bank.

Figure 10: History of Unicaja

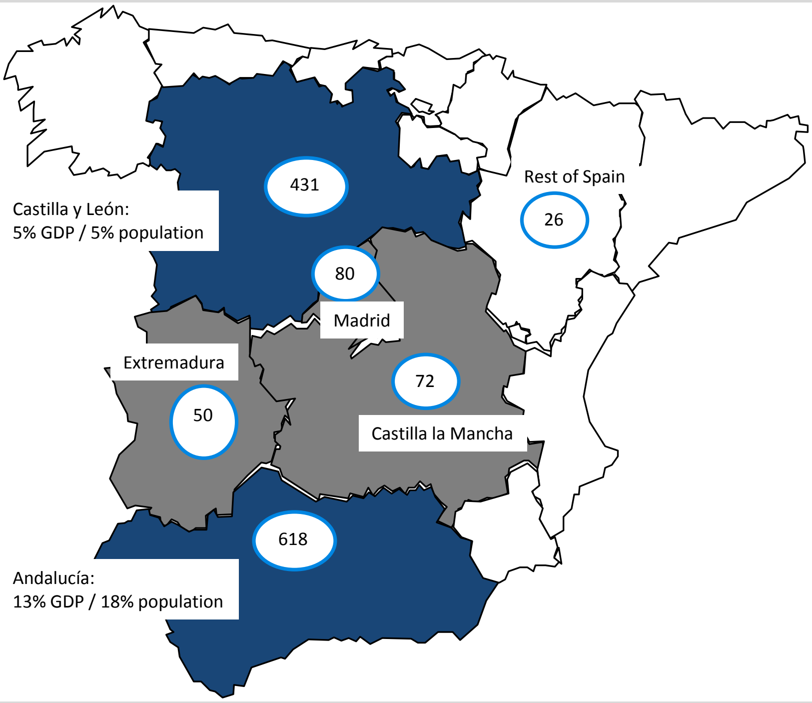


Source: Company data, KBW Research

Unicaja has a branch network of 1,320 branches, concentrated in Andalucía and Castilla y León (82% of the branch network is located in these two regions). The national market share of Unicaja is 2.4% in loans and 4.0% in deposits. However, the market share is significantly higher in the core regions. In Andalucía, it is 10% of loans and 15% for deposits, whilst in Castilla y León it is 16% for loans and 23% in deposits.

Looking in more detail at the regional distribution of the group, we can see that it has a top three position in more than 12 provinces. Unicaja classifies 13 provinces as "leadership markets", where it has a leading market share (Málaga, Almería, Cádiz, León, Valladolid, Salamanca, Jaén, Ciudad Real, Palencia, Zamora, Cáceres, Soria and Ceuta & Melilla). These provinces are the core franchise of the bank. In addition, the bank identifies an additional five provinces as "natural expansion markets" (Sevilla, Córdoba, Granada, Burgos and Huelva), considering the rest of Spain as non-core. It is worth noting that, as part of its strategic plan, the bank is looking to increase its market share in Madrid.

Figure 11: Distribution network concentrated in two key regions: Andalucía and Castilla y León



Source: Company data, KBW Research

An experienced management team

Unicaja has evolved from a Caja de Ahorro (Spanish savings bank) to a financial group. A new senior management team has been put in place, with significant experience in the Spanish financial industry and within the Unicaja group.

Figure 12: Unicaja senior management team

Management Team	Title	Joined Unicaja	Experience
Manuel Azuaga Moreno	*Executive Chairman*	*2011*	
Manuel Atencia Robledo	*Executive Vice-Chairman*	*2011*	
Enrique Sanchez del Villar	*CEO*	*2016*	- >25 yrs experience and numerous senior executive roles - Previously CEO at Ahorro Corporacion (and other senior positions within the group) - Other positions inclue Managing Director of the School of Applied Finance - Member of International Finance Analysts (AFI)
Pablo Gonzalez	*CFO*	*1996*	-Previously an auditor in Arthur Anderson - Unicaja 1996 director of Administration and Control - Unicaja: 1997 to 2004 Director of Capital markets - Unicaja: 2004 to 2015 Director of Treasury and capital markets - Degree in Economics and Business from the University of Malaga. Masters in Quantitative Finance from AFI. Executive MBA - INSEAD. BA in Business studies University of Greenwhich
Angel Rodriguez	*Real-estate / non-core*	*1992*	- 1977 - 1985 manager financial entities Arthur Anderson - 1985 - 1988 Financial Director Finamersa - 1988 - 1992 Caja de Ahorros de Granada Administrative Director - 1992 - 2000 Unicaja Director of operations and control - 2000 - 2002 Unicaja Director of Development Division - 2002 - 2010 Unicaja Director Retail Banking - Degree in Economics and Business Universidad Complutense de Madrid
Isidro Rubiales	*Control, strategy and supervisor relations*	*1990*	- Unicaja; several technical positions 1990 - 2005 - Unicaja; 2005-2014 accounting director - Degree in Economic and Business Universidad de Malaga (specialising in Public Finance)
Cedric Blanchetiere	*Chief Risk Officer*	*2006*	- Societe Generale; 1996-1998 Credit Analyst (Buenas Aires / Paris) - KPMG; 1998-2005 Audit Manager (Paris, London and Malaga) - Unicaja; 2006-2010 auditor - Unicaja; 2010-2013 Manager of Internal Control and Global Risk Control - Degree in Business Reims Management School.

Source: Company data

Strategy and financial targets

Unicaja has an ambitious four-year plan to improve profitability from the current mid-single digit level of ROE (return on equity) to a high single-digit level by 2020 (>8%). The foundation for this plan is a strong and conservative level of capital, maintaining its traditional conservative approach to asset quality / credit risk and leveraging the franchise of a Spanish savings bank with strong regional market share in its core regions. With a focus on the regions of Andalucía and Castilla y León, the plan aims to improve margins, strengthen and broaden the fee base, accelerate loan growth in SMEs and consumer loans and complete the synergies from the 2014 acquisition of EspañaDuero.

The foundation – a strong balance sheet and market-leading franchise in core regions.

- *A strong regional franchise*. Although Unicaja has a mid-to-low single digit market share at a national level, it is a leading franchise in the regions of Andalucía in the south of Spain and Castilla y León in the north, where it has branch market shares of 13% and 20% respectively (see page 25).

- *A conservative level of capital*. Using the proceeds of the IPO to repay the government CoCos in EspañaDuero, Unicaja targets maintaining a capital ratio in excess of 12%. Its current CET1 fully loaded ratio is 11.8%, one of the highest in Spain.

- *Conservative asset quality profile*. Although Unicaja does have relatively high levels of non-performing assets (NPA ratio of 16.2%, third highest of the peer group – see page 38), the levels of coverage are also some of the highest in Spain. From Unicaja's perspective, the best in class coverage ratios are a management decision and reflect the long-standing conservative approach to risk (they are not a reflection of weaker underlying collateral). This conservative approach to risk gives the bank confidence when it forecasts maintaining relatively low loan loss provisions over the period 2016-2020 (at under 30bp).

The next stage – a return to loan growth, margin expansion, improved level of fees and completion of cost synergies.

- *Ambitious loan growth target*. The loan book is still contracting both for Unicaja and the Spanish banking system. However, Unicaja is targeting a strong turnaround over the coming four years. Management targets 6% CAGR growth over the period 2016-2020, with particularly strong growth in SMEs (14% CAGR) and consumer loans (19% CAGR). Unicaja targets faster growth than the market across all major loan segments and, as a result, increased market share. Based on its loan growth targets, Unicaja plans to improve its market share from the current level of 2.4% to c. 2.7% by 2020. Although not explicit in the targets, we believe that a lot of this growth will be back-ended to the second half of the period covered by the plan. Unicaja believes that c. 50% of the loan growth can be delivered by the supportive economic conditions of the Spanish economy. The IMF currently forecasts GDP growth of 2.6% for 2017 and average growth of 2.0% for the period 2018-2020. The other 50% is to be delivered by the strong regional franchise and synergies/best practices of EspañaDuero.

- *Margin expansion – self-help and higher rates*. Although interest rates are currently low, which has had a negative impact on margins, Unicaja believes it has a number of levers with which to improve margins. These include short- and long-term repricing potential of term deposits, repayment of CoCos (which will save a coupon of €59m a year), deployment of TLTRO (Targeted longer-term refinancing operations) funding (€3.4bn taken up in March 2017 at a cost of -40bps) and maturing expensive wholesale debt issuance. Unicaja is also targeting stronger loan growth in higher yield segments of Consumer loans and SME loans, where the average front book yield is currently 2.4% and 5.3% respectively. This compares to an aggregate back book yield of 2.4%.

- *Targeting fee growth*. Unicaja is looking to increase the importance of fee income for the bank. There will be a new focus on growing assets under management (AuM). Traditionally not a high area of focus for the bank, the AuM franchise has focused on low-risk, non-complicated products. The new approach will look to gradually incorporate more attractive off-balance sheet products, which Unicaja expects will contribute to improving fee income performance. There is also a low penetration of insurance products with existing clients and Unicaja is targeting an increase in the level of insurance products sold to the existing client base. It also targets increasing the distribution of credit cards for its clients. At the moment only 38% of its cards are credit cards versus 65% for the rest of the Spanish banking system (Unicaja estimates).

- *Completing the cost synergies*. On the back of the acquisition of EspañaDuero in 2014, Unicaja initially targeted total pre-tax synergies of €156m (representing c. 22% of the combined cost base pre-merger). Management has recently increased the synergy target to €188m by 2020 (or 26% of the pre-merger combined cost base). By the end of 2016, some 45% of the synergies had already been achieved, leaving some €100m of gross cost reductions still to be delivered (representing 16% of the 2016 cost base). These gross savings will be partially offset by underlying wage growth, which management expects to be in line with Spanish inflation. The IMF is currently forecasting Spanish inflation to average c. 1.8% over the next four years. A large part of the cost reduction is based on a reduction in the number of employees. Already, the average number has fallen by 11% since 2014. However, when measured against 2008 levels, the pro-forma reduction in the number of employees now stands at -37%. Unicaja aims to reduce this number by at least another 9%, or 640 employees, by 2020. The bank has already reached agreements on the exit of c. 500 employees.

Figure 13: Unicaja – 2020 targets

Financial	2016	Target 2020
RoE / RoTE	4.9%	>8.0%
Cost:income ratio[1]	56%	<50%
Cost of risk	25bp	<30bps
NPA coverage	55.00%	>62%
NPL ratio	9.80%	c. 4%
CET1 FL	11.8%[2]	>12%
Cash pay-out	12%	40%

Loan growth	Spain	Unicaja
Total	2%-4%	c. 6%
Public Sector	-	c. 4%
Corp. / SME	4%-5%	c. 12%
Consumer	8%-10%	c. 19%
Mortgage	1%-2%	c. 1%

Market share	2016	Target 2020
Leadership regions		
Corp. / SME	14%	c. 16%
Mortgage	15%	c. 15%
Consumer	7%	c. 10%
Natural expansion		
Corp. / SME	2%	c. 4%
Mortgage	4%	c. 5%
Consumer	2%	c. 5%
Madrid		
Corp. / SME	<1%	>1%
Mortgage	3%	c. 3%
Consumer	1%	c. 2%

Other	2016	Target 2020
NPAs (€bn)	5.8	3.5
Fee % assets	35bp	c. 40bp
AuM growth	6.0%	10.0%
Branch reduction	further -9% by 2020	
Branch reduction	further -11% by 2020	

Source: Company data

Loans – mortgage history / SME & consumer future?

Residential mortgages main focus of Unicaja Banco

Unicaja has a loan book of €32.7bn (as of 2016), which accounts for c. 2.4% of the total in Spain. As we can see in Figure 14, c. 55% of Unicaja's loans are mortgages. This compares to a system average of 39%. Within the mortgage book of Unicaja, c. 95% are residential, first-home mortgages.

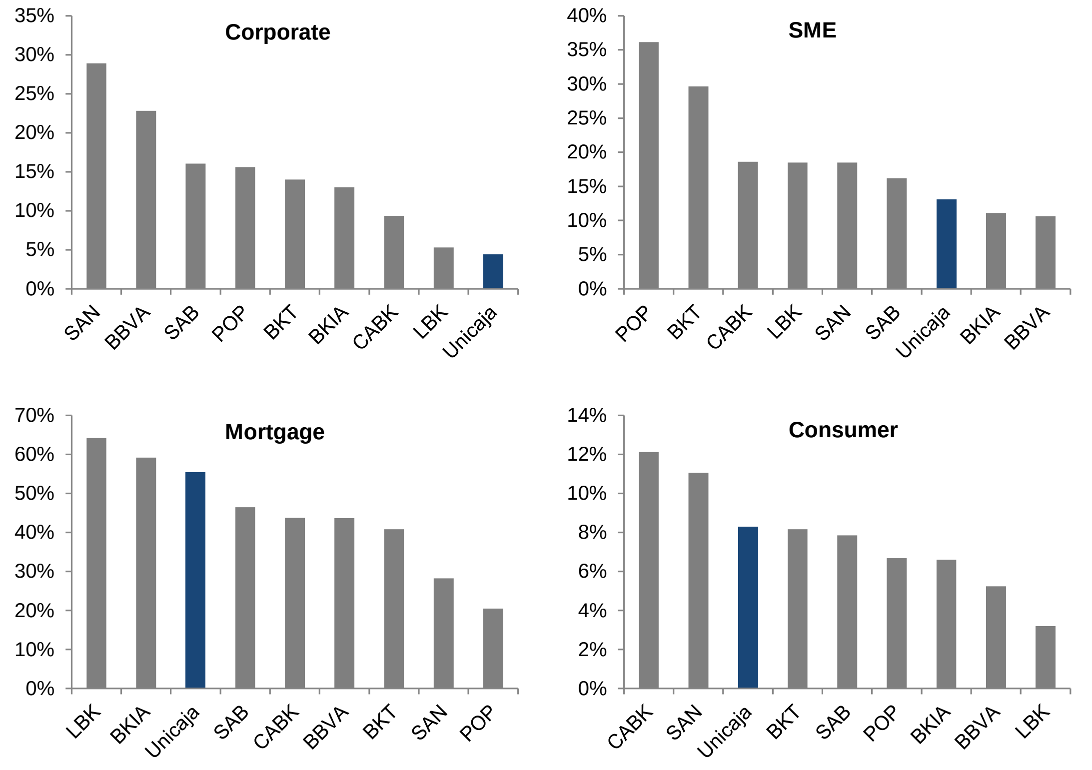
Figure 14: Distribution of the loan book (2016)

EUR m	Unicaja	Spain	Unicaja	Spain
Public sector	2,160	88,471	6.6%	6.5%
Corporate loans	7,262	604,822	22.2%	44.3%
Real estate	1,175	120,805	3.6%	8.9%
SME	4,289	184,309	13.1%	13.5%
Larger corp. loans	1,435	259,810	4.4%	19.0%
Public works	363	39,898	1.1%	2.9%
H/hold lending	20,844	652,470	63.7%	47.8%
Mortgages	18,127	535,365	55.4%	39.2%
Other/consumer	2,717	117,105	8.3%	8.6%
Other	2,463	18,848	7.5%	1.4%
Total	32,729	1,364,611	100.0%	100.0%

Source: Company data, Bank of Spain, KBW Research

When we compare the structure of Unicaja's loan book to key domestic peers and the main listed Spanish banks, we see again its greater relative exposure to residential mortgages. It is worth noting that historically the old Spanish savings banks were more focused on retail clients and mortgages. This is the origin of banks like Caixabank, Liberbank and Bankia. However, both BBVA and Sabadell acquired savings banks during the crisis, increasing their relative exposure to mortgages.

Figure 15: Composition of loan book versus peers (% of total loan, 2016 – Spain)

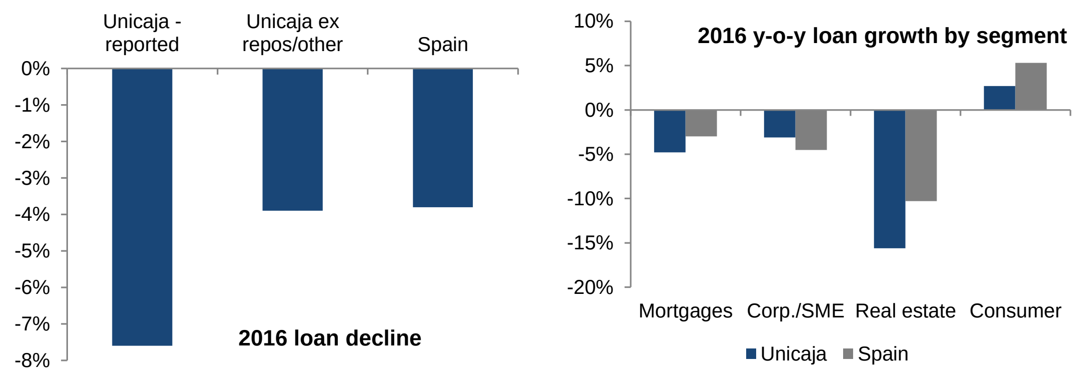


Source: Company data, KBW Research

Loan growth

Like the rest of the Spanish banking sector, Unicaja has been going through a period of de-leveraging. Excluding the incorporation of EspañaDuero in 2014 (and other acquisitions) the loan book has now been contracting for more than five years. The gross loan book contracted by -7.6% YoY in 2016 or -3.9% (excluding other loans/repos and valuation adjustments). This compares to the Spanish banks system, which declined by -3.8% YoY in 2016. The main component of the loan book, mortgages, contracted by -4.8% versus the system at -3.0% (2016, YoY).

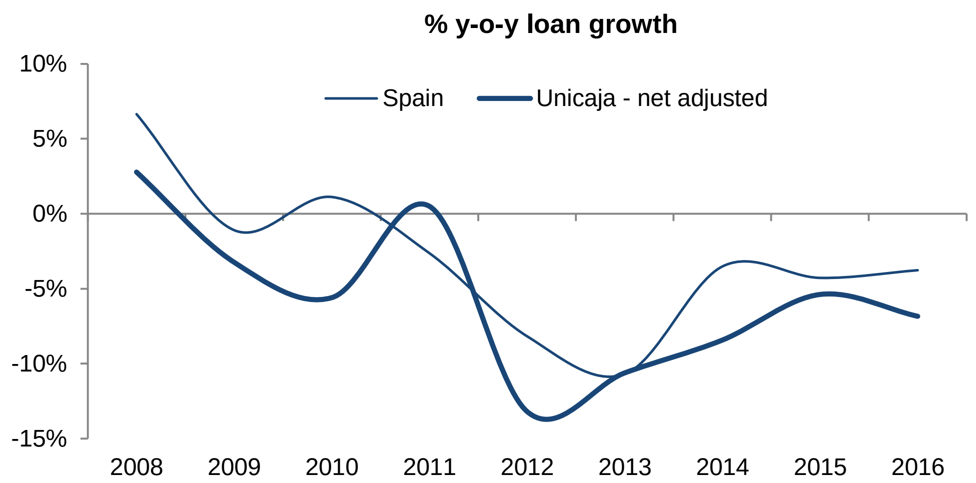
Figure 16: 2016 y-o- y loan growth. Unicaja versus Spanish banking system



Source: Company data, KBW Research

The loan growth of the group has been impacted by a number of mergers, including the 2010 merger of the small savings bank, Caja Jaen. In 2014, there was the much more significant acquisition of, and subsequent merger with, EspañaDuero. The acquisition of the banks and integration of the loan books has distorted the reported loan growth rates of Unicaja vs. the sector. In Figure 17 below we look at the net loan book of the various savings banks that currently make up the group to get an approximation of the underlying loan growth seen by the current group over the last eight years. Although not directly comparable, we show this growth relative to the growth rates in the system based on gross loans (public and private sector).

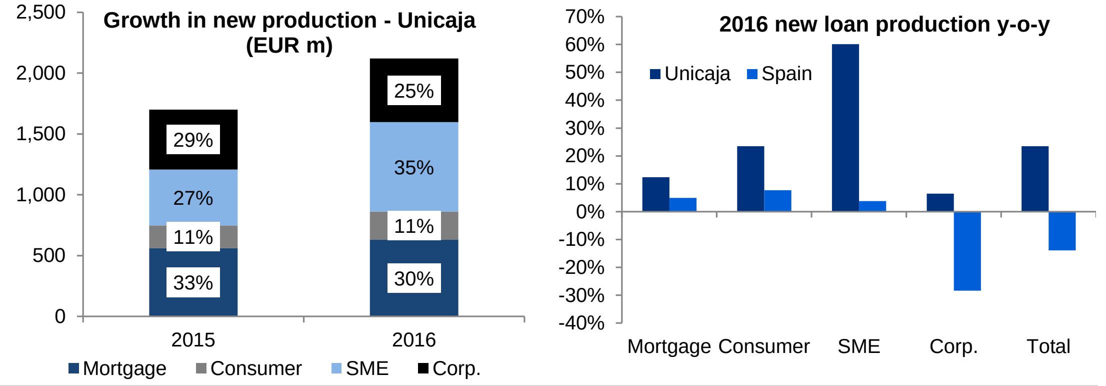
Figure 17: Historical evolution of loan growth



*Source: Company data, CECA, KBW Research *Unicaja net loan growth adjusted for acquisitions versus gross Spanish public sector lending and private sector lending*

Despite the ongoing decline in the loan book, we believe there are some signs of improvement. If we look at the levels of new loan production, we see that overall new loan volumes increased by 24% YoY in 2016 to reach €2.1bn (which represents 7% of the 2015 loan book). At a system level we see a different trend, where the decline in corporate loan volumes had a negative impact on overall new volume growth in 2016. For Spain as a whole, new loan production declined by 14% YoY and, at €403bn volumes, represented c. 33% of the 2015 loan book. The new loan data also shows the change in mix currently underway at Unicaja. Whilst mortgages represent c. 55% of the back book, new lending production is driven more by corporate lending (primarily SMEs) and consumer lending. New mortgage lending accounted for 30% of new loan volumes in 2016.

Figure 18: Unicaja new loan production

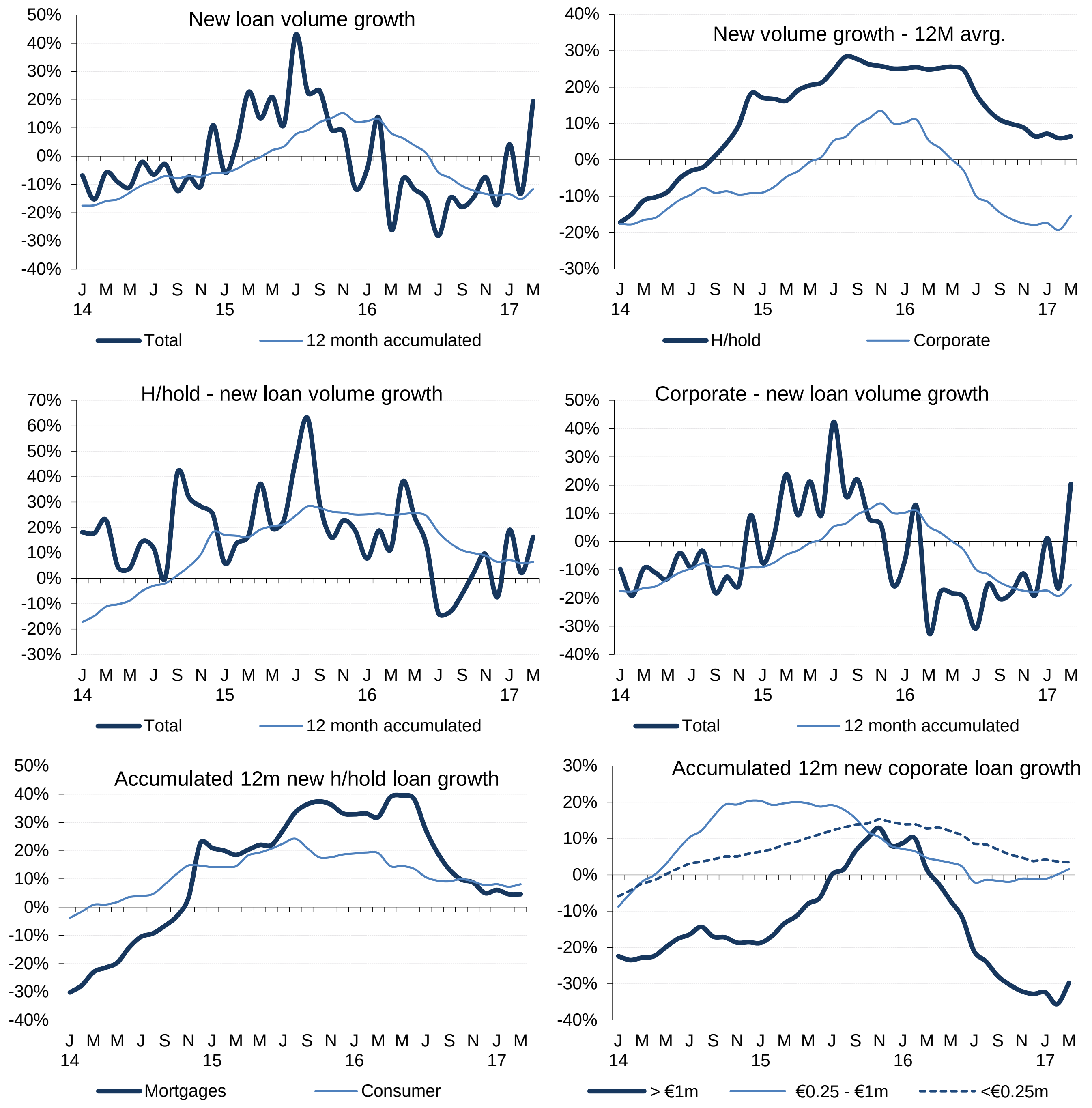


Source: Company data, Bank of Spain, KBW Research

New loan production starting to grow

Loan data for Spain remained in negative territory in 2016, with the loan book contracting by c. 3% YoY. However, there have been some signs of improvement in the early part of 2017. New loan volume production has started to increase. In fact in 2016 new loan volume was positive for mortgages, consumer loans and SMEs. However, this growth was not enough to offset the c. 28% decline in larger corporate new loan production. But, as already indicated, 2017 has started on a stronger footing, with total new loan production growing c. 3% YoY in 1Q 2017. However, given the ongoing maturities of the back book, we think overall loan growth is likely to remain negative in 2017 for the Spanish banking system.

Figure 19: New loan production improving (% YoY) Spanish banking system data

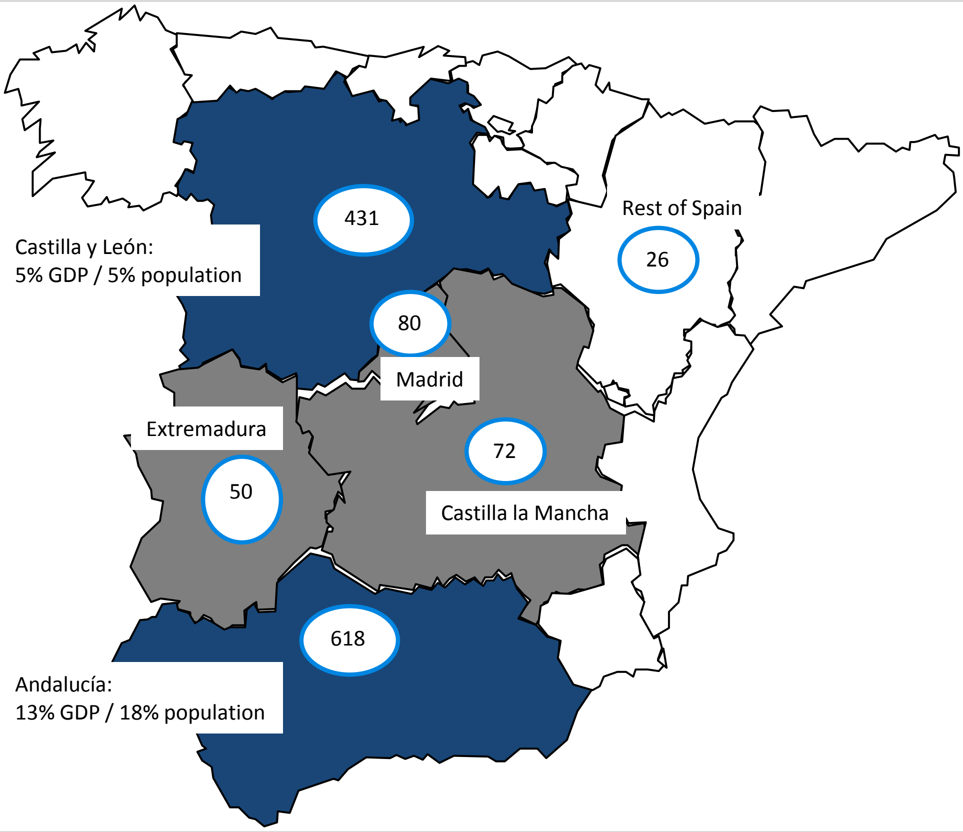


Source: Bank of Spain, KBW Research

Market share – a regional focus

As previously indicated, Unicaja currently has a c. 2.4% national market share of loans. In terms of branches the market share increases to 4.4%. However, given the geographic distribution and focus on a smaller number of core regions, we believe the national market share does not reflect the true profile of the group. Unicaja is essentially focused on two key regions: Castilla y León and Andalucía.

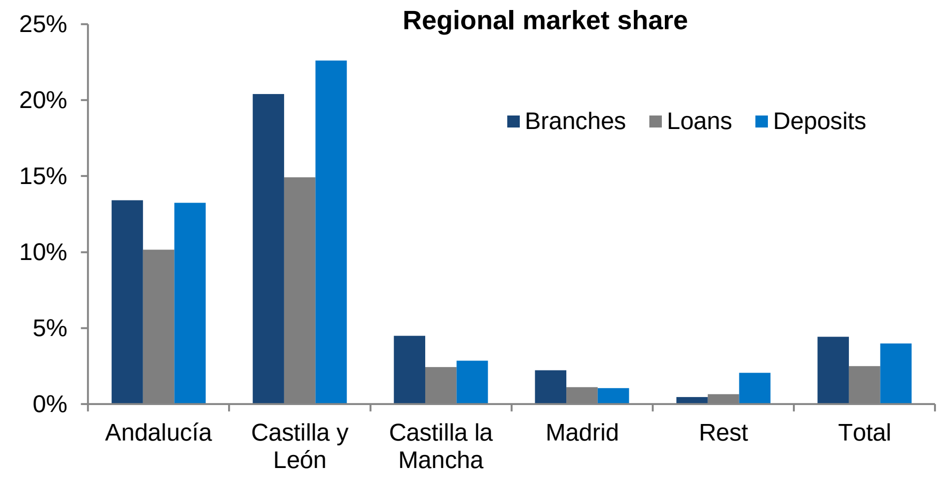
Figure 20: Distribution network concentrated in two key regions



Source: Company data, KBW Research

In these key regions the market share in branches increases significantly, reaching 13.4% in Andalucía and 20.4% in Castilla y León. In the region of Castilla y Leon, the loan market share reached 14.9% in 2016. In Andalucía the group also has a loan market share at 8.8%. So although overall national market share is c. 2.4%, the market share in the core markets is significantly higher at over 8%.

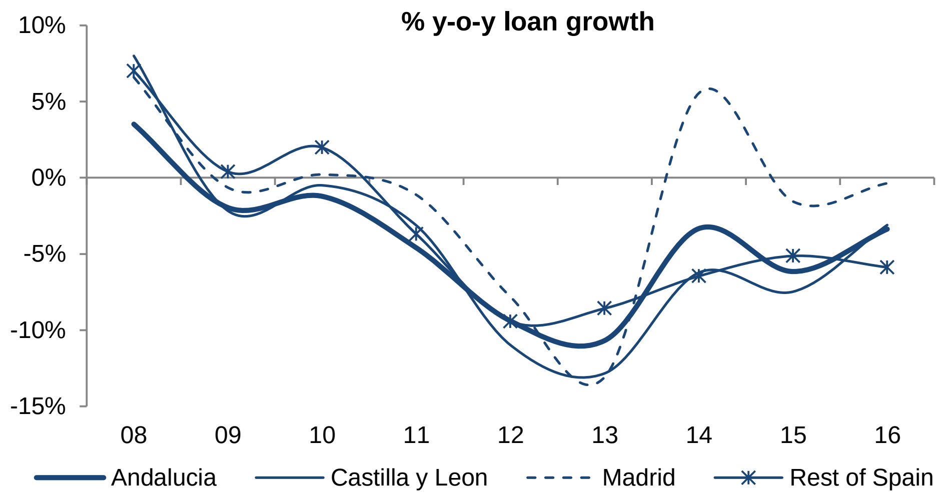
Figure 21: Regional market share – 2016



Source: Company data, Bank of Spain, KBW Research

In terms of relative size within the Spanish banking system, Andalucía accounts for 12% of total loans in the system, Castilla y Leon for c. 4%, Castilla la Mancha c. 6% and Madrid accounts for 28% of the total. Figure 22 below shows the yearly loan growth in the key regions where Unicaja has exposure.

Figure 22: Regional loan growth – Spain



Source: Company data, Bank of Spain, KBW Research

Looking in greater detail at the regional distribution, we can see the provincial distribution of Unicaja's branch network and the relative position of Unicaja versus peers. The strong market shares in core provinces is another reflection of the bank's focused regional platform. Unicaja estimates that it has a top two market share in 12 provinces.

Figure 23: A top-two player in 12 provinces (branch market share)

	Castilla y Leon	# ranking		Andalucia	# ranking
León	26.0%	1	Málaga	24.9%	1
Palencia	30.9%	1	Cádiz	15.4%	2
Valladolid	25.7%	1	Jaén	18.1%	2
Soria	30.4%	1	Almería	22.9%	2
Zamora	32.7%	2			

	Other	# ranking
Cáceres	12.6%	2
Ciudad Real	17.9%	2
Melilla	15.0%	3

Source: Company data, KBW Research

Part of the strategic plan is targeting loan growth of 6% p.a. over the period 2016 to 2020. The bank views the outlook for loan growth as containing two components (50/50 split) of: 1) improved loan growth from the ongoing economic recovery and growth in the Spanish economy and 2) gaining market share in the loan segments of corporates/SMEs and consumer lending. We believe Unicaja has set itself a challenging target, in particular growing the corporate/SMEs and consumer loans at double the market rate.

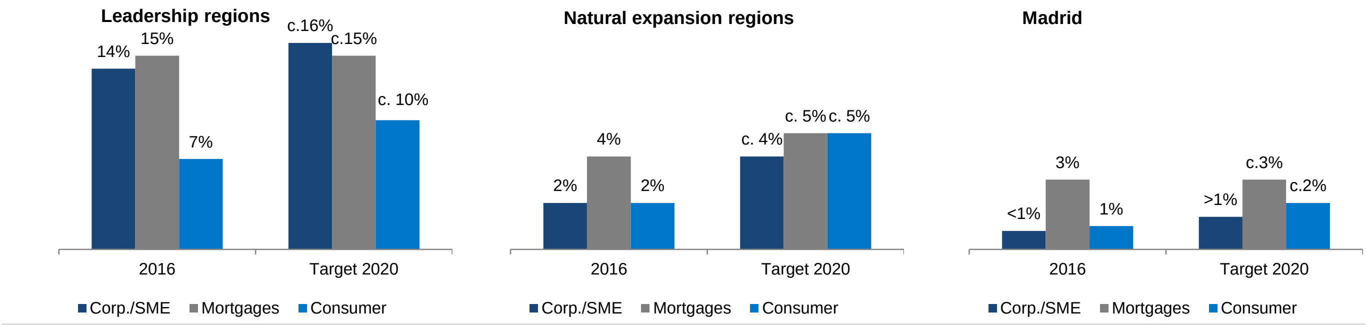
Figure 24: Ambitious loan growth targets

	Market*	Unicaja target
Total	2-4%	c. 6%
Public sector	-	c. 4%
Corporate / SME	4-5%	c. 12%
Consumer	8-10%	c. 19%
Mortgages	1-2%	c. 1%

*Source: Company data / estimates**

In terms of market share and regional exposure, Unicaja aims to strengthen its market share in those provinces that it defines as “leadership” regions and gaining market share in “natural expansion regions”. Finally, although it has relatively modest exposure to the Madrid regional market, Unicaja aims to improve its market share in corporates and consumer lending in that region.

Figure 25: Regional market share targets (loan market share)



Source: Company data

Leadership regions. Where branch market share >10%: Málaga, Almería, Cádiz, León, Valladolid, Salamanca, Jaén, Ciudad Real, Zamora, Cáceres, Soria, Ceuta and Melilla.

Natural expansion regions. Where branch market share is <10%: Sevilla, Córdoba, Granada, Burgos and Huelva.

Based on the above data, and taking into account the current outlook for the Spanish banking system we show in the table below our forecasts for loan growth at Unicaja over the period 2016-2020. Although below the current forecasts made by management, we acknowledge that the risks are skewed to the upside. If Unicaja can effectively leverage its strong regional branch market share, then the outcome should be stronger loan growth over the period.

Figure 26: KBW outlook for loan growth

€ m	2015	2016	2017e	2018e	2019e	2020e
Public sector	2,009	2,160	2,128	2,149	2,170	2,192
Corporate loans	7,887	7,263	7,454	7,702	8,028	8,608
Real estate	1,385	1,166	1,026	923	877	877
SME	4,855	4,259	4,472	4,696	4,930	5,325
Larger corp. loans	1,164	1,473	1,591	1,718	1,856	2,041
Public works	483	365	365	365	365	365
Non-real estate corp.	6,019	5,732	6,063	6,414	6,786	7,366
H/hold lending	21,747	20,843	20,730	21,215	21,849	22,906
Mortgages	19,438	17,767	17,500	17,500	17,763	18,207
Other	2,309	3,076	3,230	3,714	4,086	4,699
Total	**31,643**	**30,266**	**30,312**	**31,066**	**32,047**	**33,706**

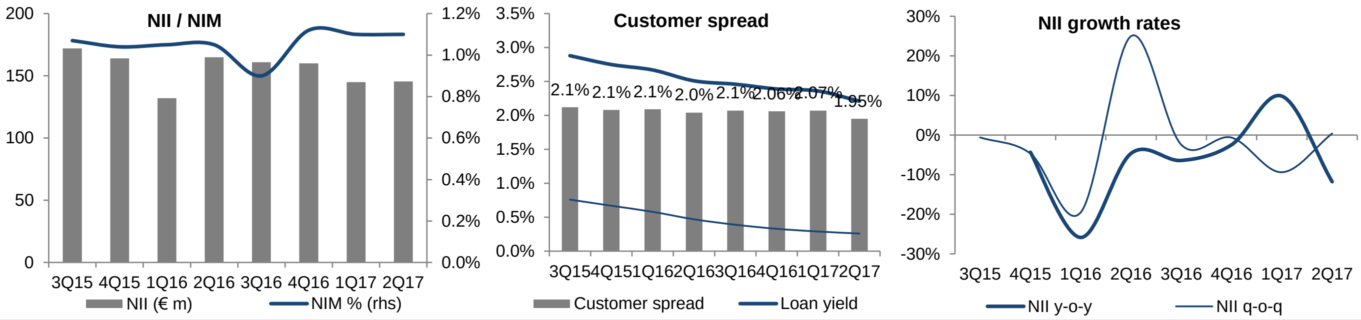
% y-o-y	2015	2016	2017e	2018e	2019e	2020e	16-20 CAGR
Public sector	-1.1%	7.5%	-1.5%	1.0%	1.0%	1.0%	0.4%
Corporate loans	-18.3%	-7.9%	2.6%	3.3%	4.2%	7.2%	4.3%
Real estate	-27.8%	-15.8%	-12.0%	-10.0%	-5.0%	0.0%	-6.9%
SME	-18.3%	-12.3%	5.0%	5.0%	5.0%	8.0%	5.7%
Larger corp. loans	-6.0%	26.5%	8.0%	8.0%	8.0%	10.0%	8.5%
Public works	-13.1%	-24.4%	0.0%	0.0%	0.0%	0.0%	0.0%
Non-real estate corp.	-16.1%	-4.8%	5.8%	5.8%	5.8%	8.5%	6.5%
H/hold lending	-5.7%	-4.2%	-0.5%	2.3%	3.0%	4.8%	2.4%
Mortgages	-5.2%	-8.6%	-1.5%	0.0%	1.5%	2.5%	0.6%
Other	-9.3%	33.2%	5.0%	15.0%	10.0%	15.0%	11.2%
Total	**-8.9%**	**-4.4%**	**0.2%**	**2.5%**	**3.2%**	**5.2%**	**2.7%**

Source: KBW estimates

Margin analysis – turnaround is key to profitability

As with any retail bank, net interest income (NII) and net interest margin (NIM) are key components of the P&L and one of the main drivers of profitability. We believe this is particularly so at this stage of the cycle, when asset quality issues are abating and interest rates are potentially about to increase. In the case of Unicaja, NII accounts for 75% of revenues and each additional basis point of margin equates to a c. 2% increase in net income. At the moment NII and margins are under pressure from the low interest rate environment and ongoing deleveraging. In 2016 NII contracted by almost 10% YoY, with the NIM reaching 1.05%, down -2bp YoY. We note that the rate of decline in NII has improved though, driven by the ongoing benefits of deposit repricing and lower funding costs.

Figure 27: NII under pressure; margin relatively stable



Source: Company data, KBW Research

The key components of NII are interest income from the loan book and securities portfolio, and, on the liabilities side, funding costs from the customer deposit book and wholesale funding costs (which currently include the FROB CoCos). Gross interest income in 2016 was €1,011m – the loan book generated 69% of this versus the securities portfolio, which generated 25%. Loan income is under pressure from lower yields (lower Euribor and progressive removal of mortgage floors). The yield on the securities portfolio is also falling; a reflection of the lower yield on Spanish government bonds. On the funding side, there has been an improvement, although the repricing of term deposits takes longer (versus loans).

Figure 28: NIM structure

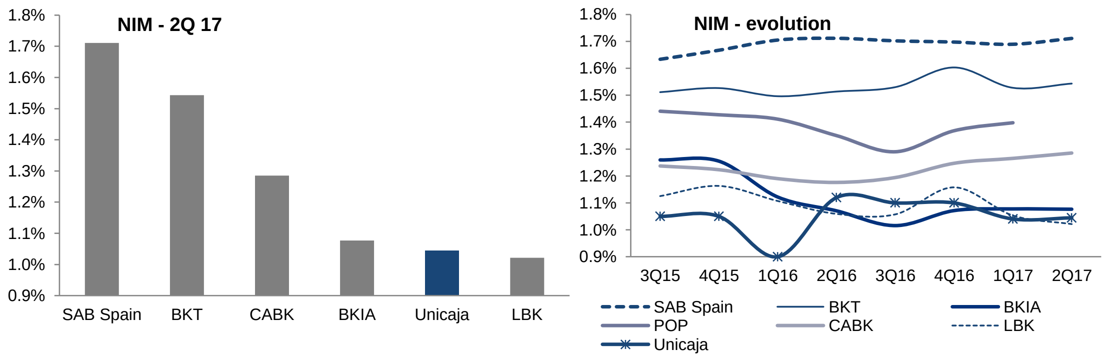
	2015				2016			
	% of avrg. assets	% yield / cost	€ m	€ m	% of avrg. assets	% yield / cost	€ m	€ m
Intermediation/other	5.41%	0.13%	3,481	4.4	5.05%	-0.06%	2,964	-1.7
Loans (performing)	44.95%	2.97%	28,925	858	47.38%	2.51%	27,827	700
Securities portfolio	33.29%	1.81%	21,421	387	31.69%	1.36%	18,608	254
Other	16.36%	0.29%	10,525	31	15.88%	0.64%	9,328	59
Total assets	**100.0%**	**1.99%**	**64,352**	**1,280**	**100.0%**	**1.72%**	**58,727**	**1,011**
Intermediation	15.34%	0.17%	9,873	16	10.59%	-0.15%	6,219	-9
Deposits	58.85%	0.87%	37,870	330	65.07%	0.47%	38,212	179
Marketable debt securities	14.02%	1.96%	9,022	177	12.12%	1.86%	7,119	132
Subordinated debt	0.97%	8.82%	625	55	1.04%	9.52%	610	58
Other	10.82%	0.21%	6,962	14	11.18%	0.48%	6,567	31
Total liabilities	**100.0%**	**0.92%**	**64,352**	**592**	**100.0%**	**0.67%**	**58,727**	**391**
Avrg assets (€ m)				64,352				58,727
Net interest income (€ m)				688				620
Net interest margin %				1.07%				1.06%
Customer spread				2.10%				2.05%

Source: Company data, KBW Research

NIM stable as lower funding costs offset asset yield pressure

Over the last few of quarters, the NIM has remained relatively stable as the continued repricing of the deposit book now offsets the lower loan and asset yields. Higher funding costs, which currently include expensive government CoCos (from EspañaDuero), means that Unicaja has a relatively low NIM versus peers in Spain.

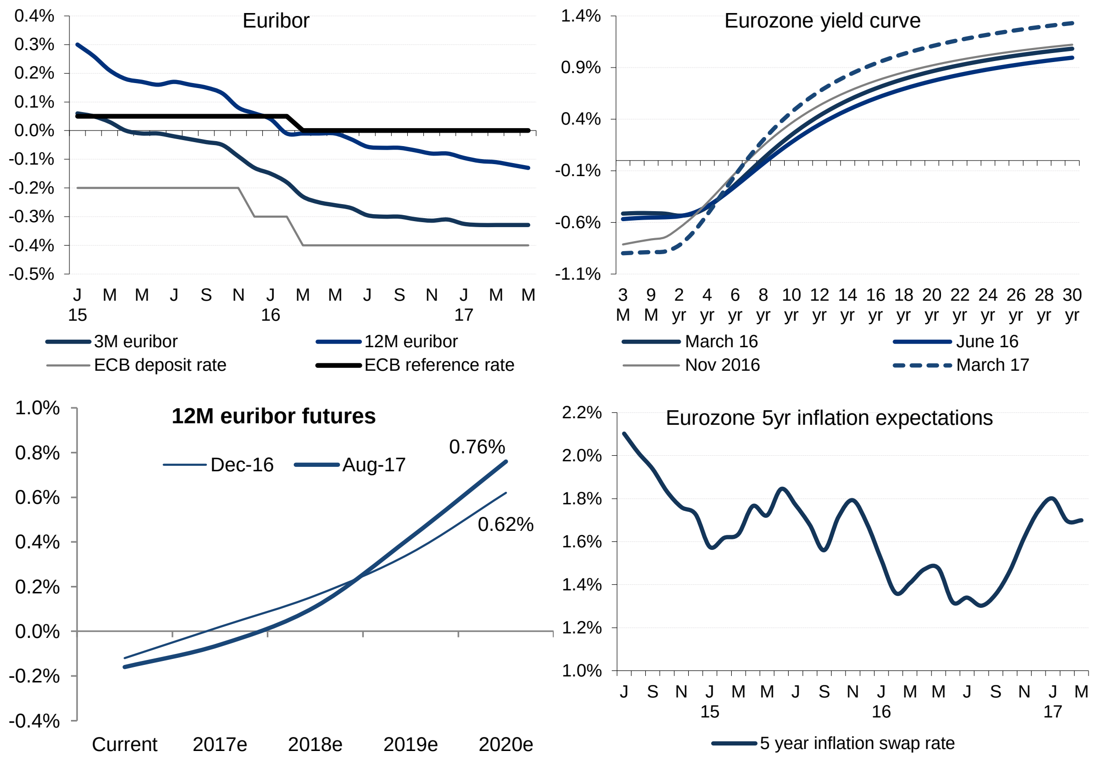
Figure 29: NIM comparison and recent evolution



Source: Company data, KBW Research

As with most Spanish banks, the bulk of loans and mortgages for Unicaja are re-priced automatically versus 12M Euribor. The impact of this will be limited initially by the mortgage loans that currently have mortgage floors in place (c. 20%). In any case, the ongoing decline in the 12M Euribor is still a negative headwind to NII, although, based on the current levels and the outlook for European interest rates, we believe the negative impact of re-pricing should come to an end this year. As inflation expectations have improved, so has the outlook for European rates, and currently the 12M Euribor is expected to be 0.62% by 2020. Euribor is anchored by the ECB deposit facility (currently at -40bps) and so the ECB would have to start raising this rate before Euribor can begin to increase.

Figure 30: European interest rates

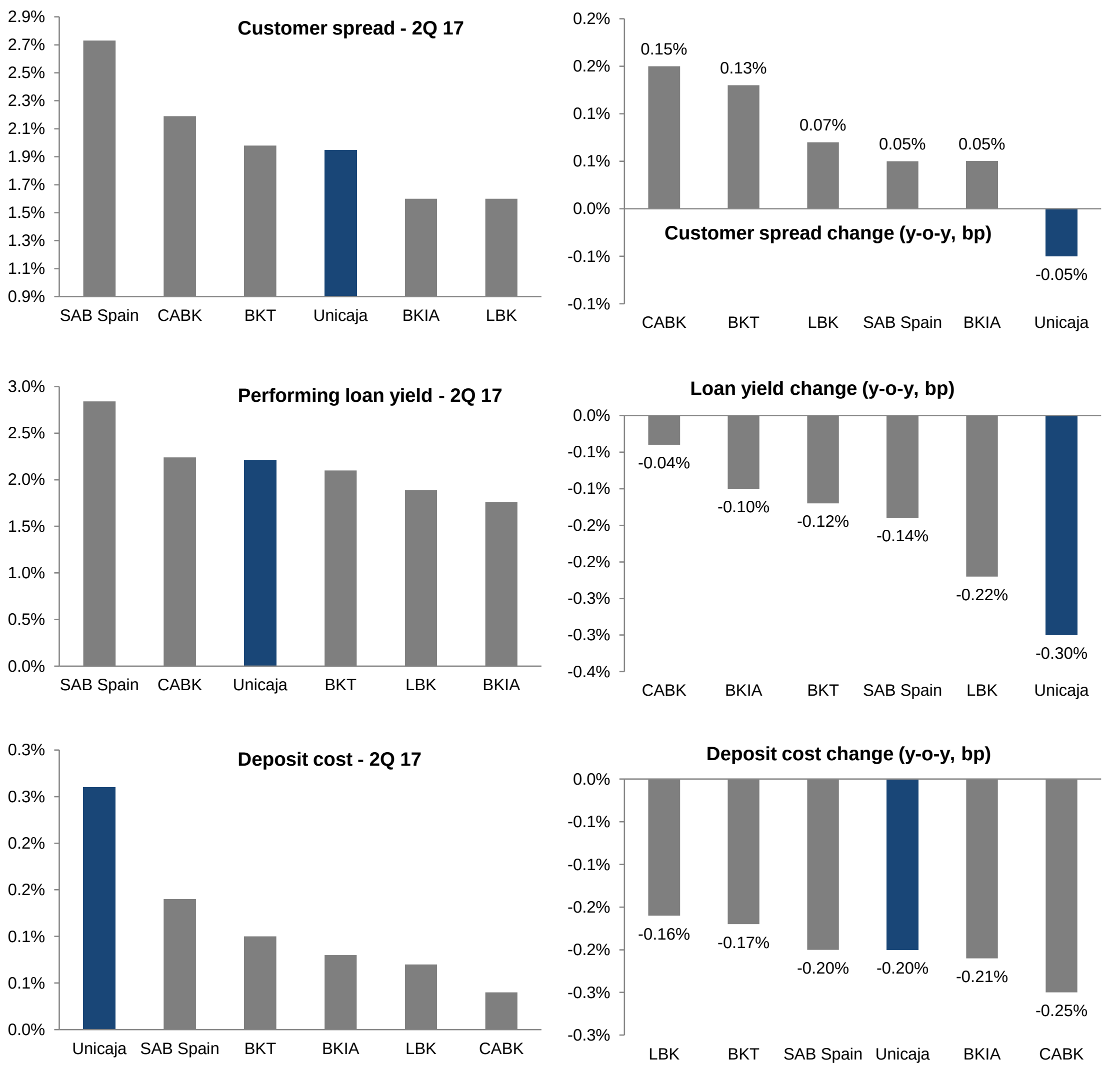


Source: ECB, Bloomberg, KBW Research

Customer spread

Despite having a relatively large mortgage book, Unicaja's customer spread compares well versus Spanish peers (customer spread is the result of subtracting from the loan yield the cost of deposits). And this is despite having the highest cost of deposits of the peer group. In part, we believe this is a result of some expensive fixed term deposits (PICS) issued by EspañaDuero during the financial crisis that don't mature until 2020 and 2021. Although the yield on the loan book has fallen by 36bp YoY, this has been almost completely offset by a 34bp YoY drop in the cost of deposits. It is also worth highlighting that the yield on the loan book has been supported by c. 20% of mortgages that still have mortgage floors in place.

Figure 31: Customer spread, loan yield and deposit cost

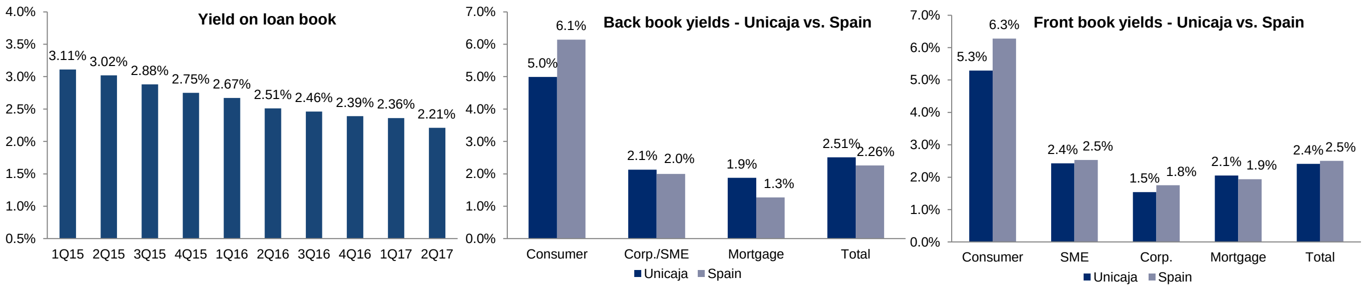


Source: Company data, KBW Research

Pricing dynamics: deposits to get cheaper versus SME price competition

The loan yield on the current stock of loans, or the back book, has fallen to 2.39% as of 4Q 16. This compares well against the wider sector in Spain, with the aggregate back book yield for 2016 at 2.51% versus 2.26% for the sector. We estimate that this is largely a result of the yield on the mortgage book being significantly above the sector. However, normalizing for mortgage floors, we believe the yield on the mortgage book would be in line with that of the sector. Looking at the nominal rates for new loans, we can see that Unicaja remains relatively conservative / disciplined regarding mortgages. However, in the segments of consumer loans and SMEs, Unicaja is pricing more aggressively versus peers (although we cannot take the potential risk profiles into consideration).

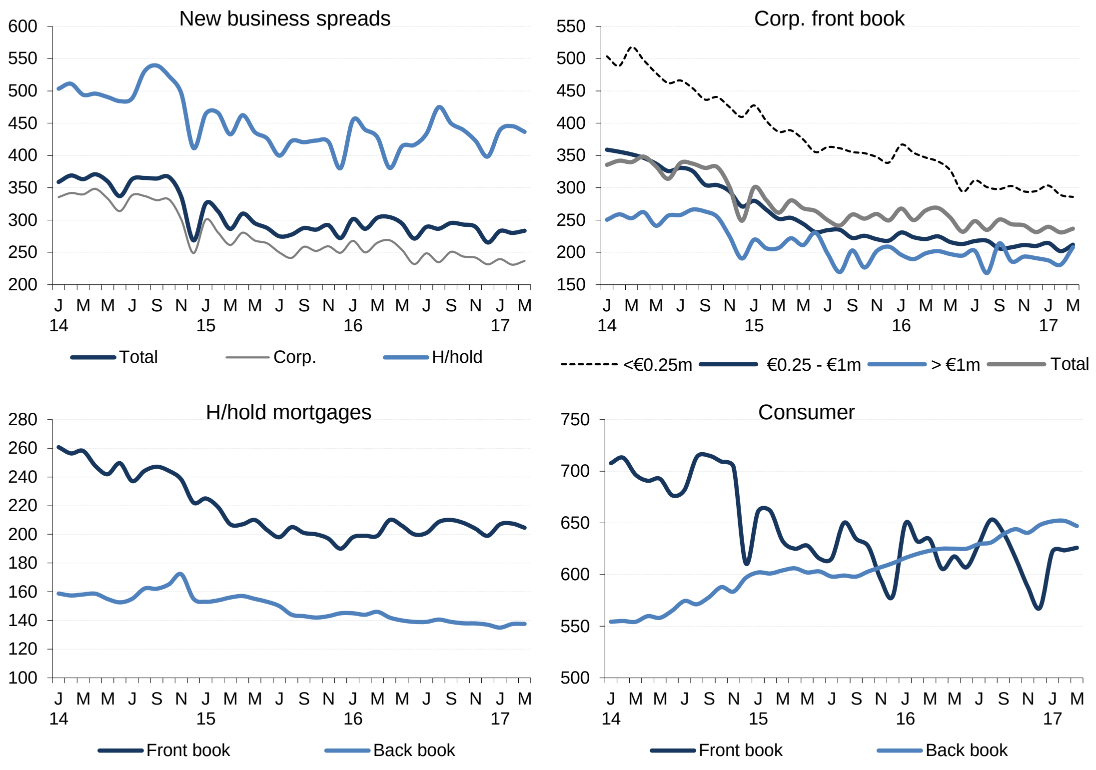
Figure 32: Loan book pricing



Source: Company data, KBW estimates

Looking at the evolution of lending spreads at a system level (i.e. loan yields minus Euribor –12M for mortgages, 3M for everything else), SME spreads are under some pressure, whilst remaining relatively stable for the rest of loan segments. With the Spanish banks having taken significant drawdowns of TLTRO 2 funds, we believe the SME segment will remain under pricing pressure as the banks look to secure sufficient volume growth in this segment.

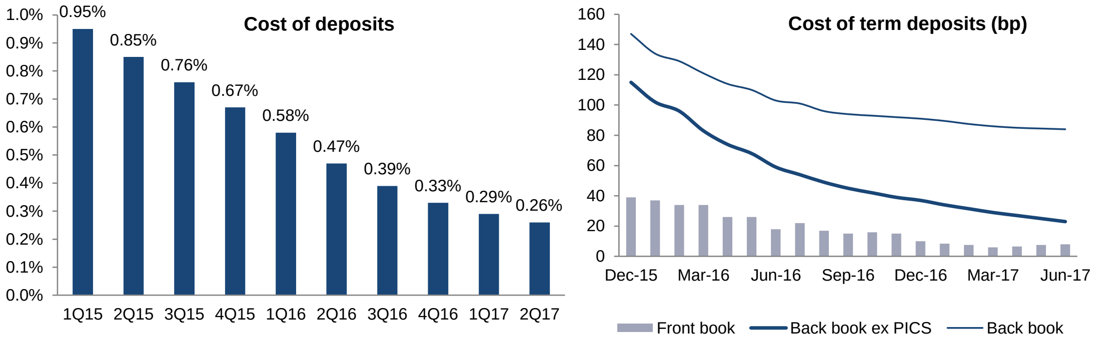
Figure 33: Bank of Spain Loan book pricing (bp versus Euribor)



Source: Bank of Spain, KBW Research

The cost of deposits, although still relatively high versus peers, has improved significantly over the last two years. The cost of the stock of deposits has fallen to 0.33% from 0.95% at the beginning of 2015. There is room for further improvement as currently front book deposits are being priced at c. 8bp.

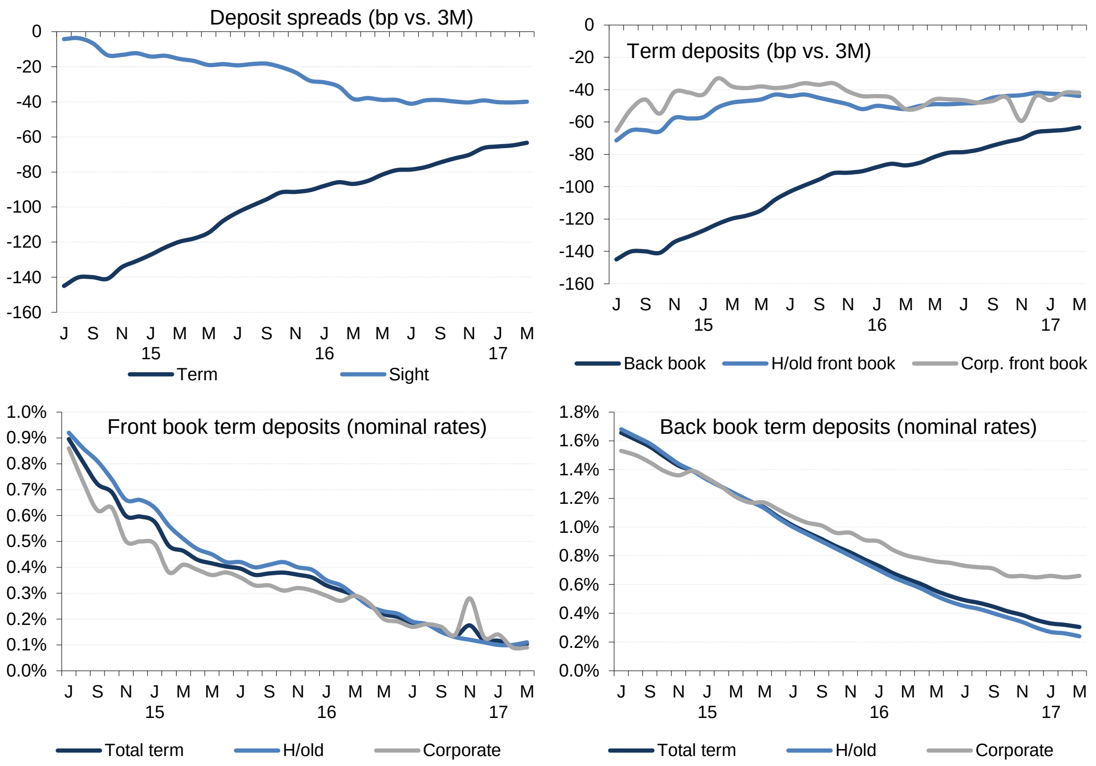
Figure 34: Improved cost of deposits



Source: Company data, KBW Research

This improvement in the cost of deposits can also be seen at a sector level. New term deposit costs look to have settled at around 10bp. The back book of corporate term deposits is taking slightly longer to reprice, suggesting longer dated deposits have been issued relative to household term deposits.

Figure 35: Bank of Spain – front book spreads stabilising

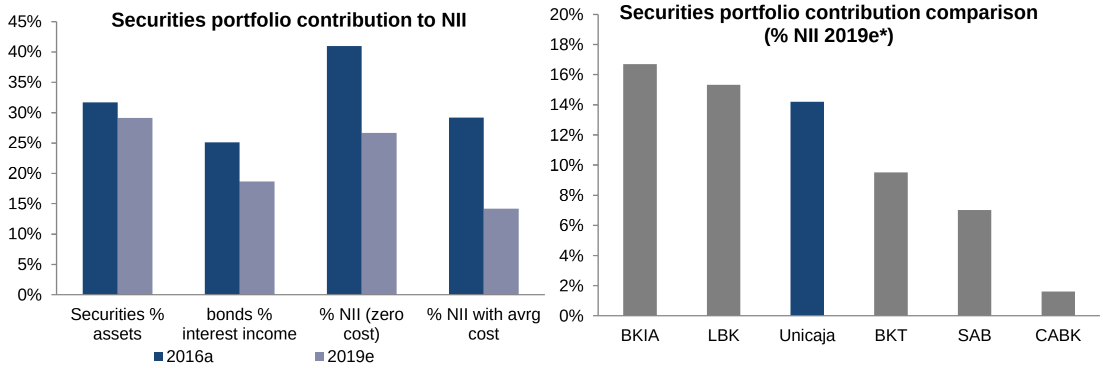


Source: Bank of Spain, KBW Research

Strong contribution from bond portfolio will moderate over time

The bond portfolio currently makes a significant contribution to NII, at c. 29%. Over the next few years though, we believe that funding costs should improve and the yield of government bonds will be lowered (as new maturities come in at lower yields). As a result, we estimate that by 2019 the contribution to NII will have moderated significantly to just under 14% of NII.

Figure 36: Contribution from securities portfolio will diminish over time



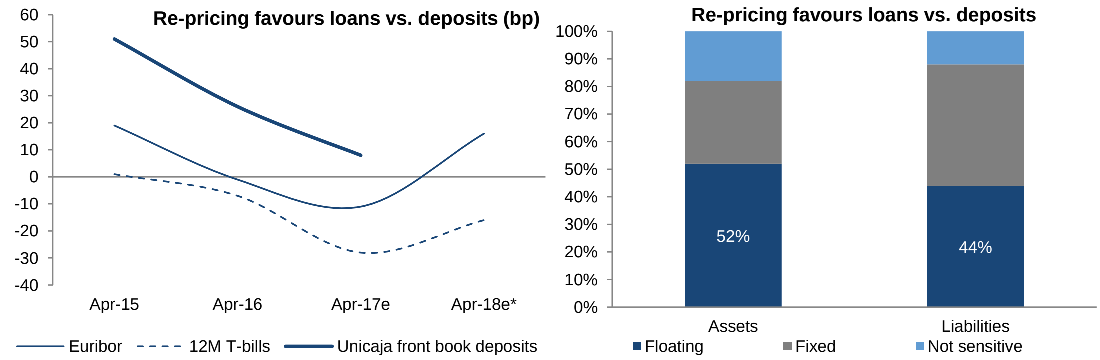
Source: Company data, KBW Research

Sensitivity to higher rates: balance sheet structure and Unicaja calculations

Given the structure of the balance sheet, Unicaja expects higher European interest rates to have a positive impact on both NII and profitability. This impact would be both in the short term but especially in the medium term. The key repricing mechanism for the loan book is the level of the 12M Euribor, with an effective duration of c. six months (i.e. those loans that re-price do so twice a year). Almost 35% of total assets are linked to the 12M Euribor. Overall more assets are more rate sensitive than liabilities, with 52% of assets at floating rates versus 44% of liabilities. Management estimates that a 50bp increase in rates would have a positive impact on NII of more than 6.5%. This assumes one-for-one re-pricing of term deposits.

We believe that in practice the re-pricing of deposits is less automatic versus loans. When term deposits mature, it is management that determines the new pricing levels (obviously within market constraints). Historically in Spain, term deposits have had more of an implicit link with the level of yield on Spanish T-bills. We believe it is likely that the rate increases in Spanish T-bills will be more moderate / slower versus European interest rates. This is illustrated by the fact that current futures point to the 12M Euribor increasing by c. 27bp through to the end of 2018, whilst Spanish T-bills are expected to remain in negative territory and only increase by 12bp over the same period.

Figure 37: Positively geared to higher rates



Source: Company data, KBW Research

KBWe sensitivity to rates and forecasts for NII

Base case forecasts

Our base case forecasts point to a significant recovery in NII over the next four years. We expect the NIM to increase to 1.12% and for growth in NII of c.2% CAGR over the period 2016-2020. This includes the benefit from higher Euribor but also assumes that, aside from the increase in interest rates, the main drivers of the increase are lower funding costs (particularly in the first two years of the period), the benefit from c. 8% total growth in performing loans and an increase in the loan yield from a change in the mix. We believe a key challenge for Unicaja will be achieving the significant growth rates in SME and consumer loans, whilst maintaining pricing discipline.

Figure 38: Positively geared to higher rates

	2015	2016	2017e	2018e	2019e	2020e
NII (€m)	688	620	576	615	617	666
% y-o-y	*-4%*	*-10%*	*-7%*	*7%*	*0%*	*8%*
NIM %	1.07%	1.05%	1.01%	1.07%	1.06%	1.12%
Customer spread	2.10%	2.05%	1.85%	1.93%	2.00%	2.10%
Performing loan yield	2.54%	2.23%	1.95%	1.99%	2.02%	2.06%
Term deposit cost		1.06%	0.71%	0.70%	0.68%	0.37%
Term PICS		3.89%	3.76%	3.62%	3.46%	1.18%
Securities % NII	27.6%	20.9%	23.6%	18.2%	16.0%	11.5%

Source: Company data, KBW Research

Sensitivity to rates – KBW peer group comparison and sensitivity analysis

We have simulated an increase of 50bps across loans and liabilities based on our 2020 forecasts to gauge the potential impact on NII, net income and profitability.

- Interbank. We have excluded TLTRO and central bank funding but increased the yield and cost of other interbank positions by 50bps.

- Loans. We have considered two scenarios. 1) a 50bp increase across all loans, except consumer loans and mortgages with floors, and 2) a 50bp increase for mortgages (ex-mortgages with active floors), no impact on consumer and only a 35bp increase for corporate/SME loans.

- Bond/securities portfolios. We assume maturities over the next two years at a yield of +50bp versus our current assumptions.

- Deposits. We assume the distribution between sight and term deposits remains the same. As with the loan book we have considered two scenarios. 1) a linear increase in the cost of term deposits (i.e. by 50bp), and 2) as re-pricing could be more linked to the price of Spanish T-bills rather than Euribor levels, we only increase the cost of term deposits by 35bps.

- Wholesale funding. We assume a 50bp increase.

In conclusion this gives us three different sensitivities for NII:

- Scenario A: Whereby a 50bp increase in both assets and liabilities is passed through the P&L. We estimate a positive impact on our 2020e for NII of 8.4%.

- Scenario B: The same as scenario A, except we assume corporate lending only reprices at 35bp (rather than 50bp). We estimate a positive impact on our 2020e for NII of 6.8%.

- Scenario C. The same as scenario B, except we assume term deposits only reprice by 35bp. We estimate a positive impact on our 2020e for NII of 9.3%.

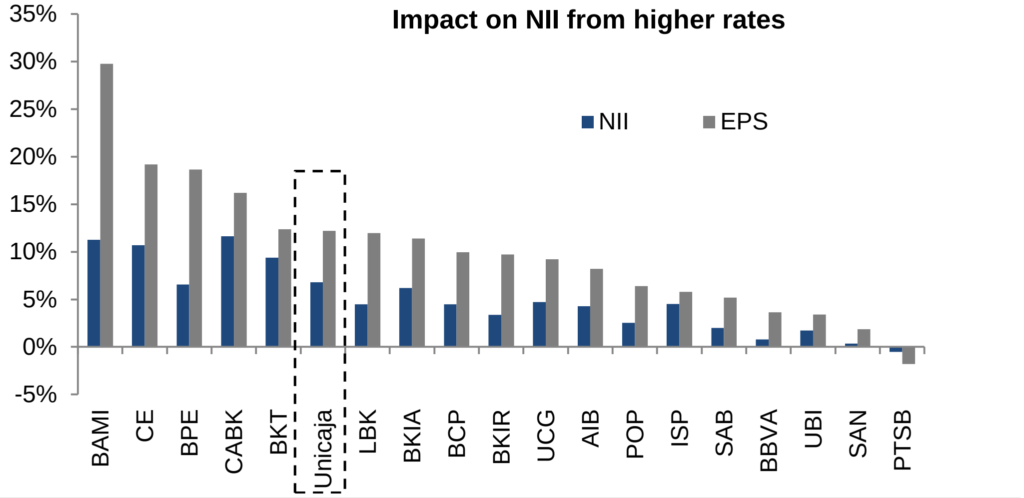
Figure 39: NII and profitability to higher rates

2020e	Scenario A	Scenario B	Scenario C
Impact on NII	8.4%	6.8%	9.3%
Impact on net income	15.2%	12.2%	16.7%

Source: KBW Research

How does this compare with Spanish and European peers? In Figure 40 below we compare the impact for Unicaja in scenario B (i.e. with some of the increase in rates absorbed by the bank for corporate loan spreads) versus other European banks using the same assumptions.

Figure 40: Higher rates impact comparison

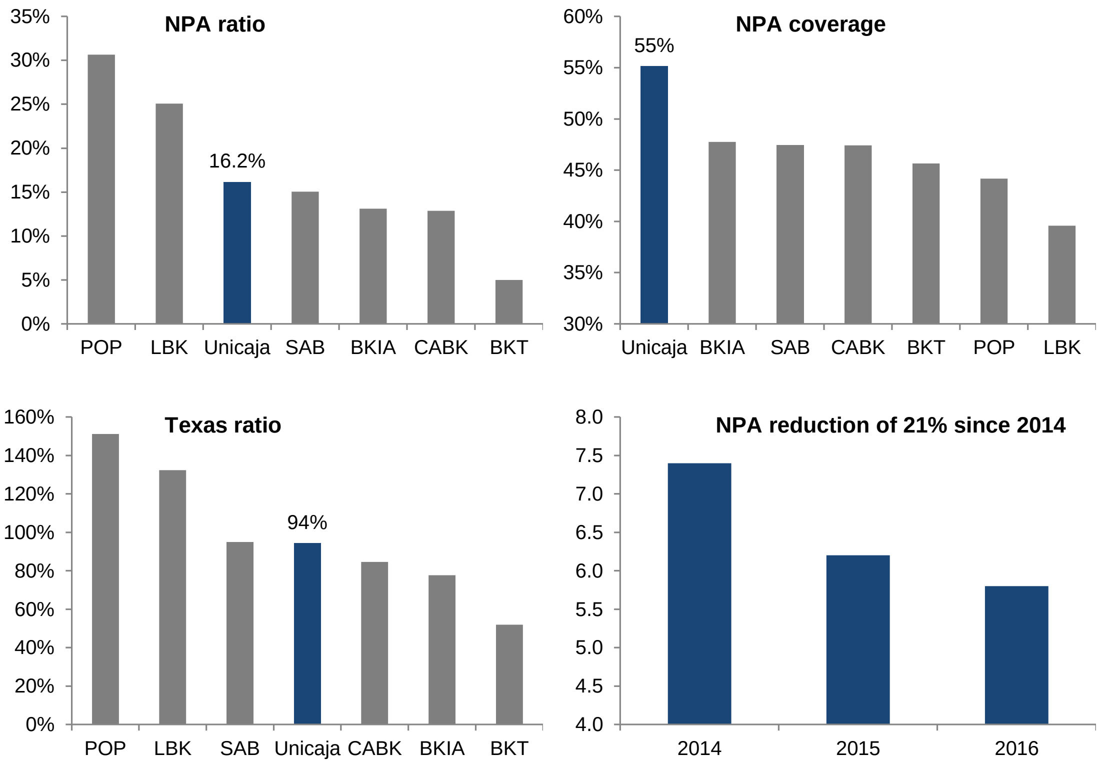


*Source: KBW Research *Impact on Net income for Unicaja in 2020 versus EPS for peer group 2019*

Asset quality – Strongest level of coverage

In our view asset quality is one of the relative strengths of Unicaja. Although the absolute levels of non-performing assets (NPA) remain elevated, they are in line with the peer group average. The relative strength comes from the best-in-class coverage ratios and from the risk profile of the NPAs themselves (with a higher proportion of residential mortgages). Taking both non-performing loans and foreclosed real estate assets (NPAs), Unicaja finished 2016 with a ratio of 16.2%. Since 2014 there has been a reduction of more than 21% in NPAs, which ended the year at €5.8bn. We estimate the Texas ratio of the group at 94% in 2016, which should fall to below 90% post the incorporation of the funds from the IPO (see forecasts page 42).

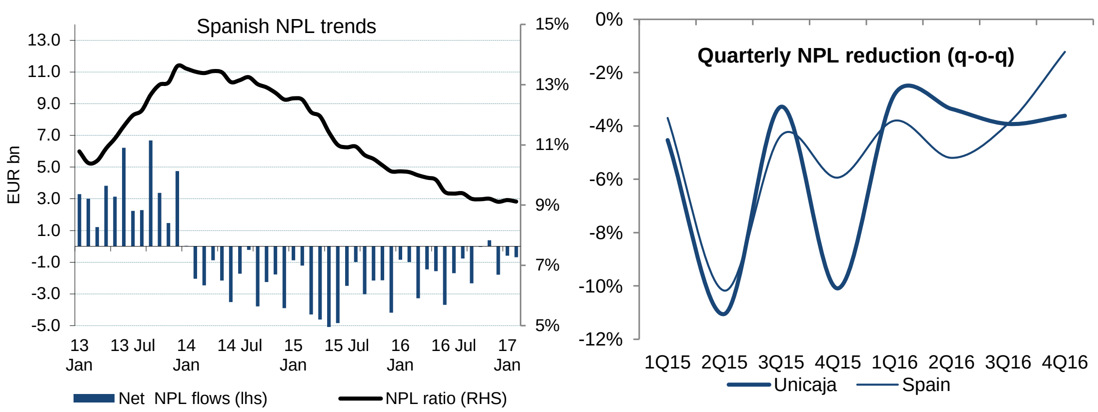
Figure 41: Strong asset quality profile (2016 – % and €bn for NPAs)



Source: Company data, KBW Research

As shown in Figure 42 below there has been a strong improvement in asset quality in Spain over the last few years, with the Non-performing loan (NPL) ratio currently at 9.1% (February 2017) versus a peak ratio of 13.6% reached at the end of 2013. Since 2014 Unicaja has reduced its stock of NPLs by 33.2%, which is in line with the 32.6% reduction seen at the sector level over the same period. It is worth noting that part of this reduction in NPLs has been from inflows into foreclosed assets. Given the current economic conditions (including the ongoing recovery in the Spanish housing market), we expect this trend of NPL reduction to continue over the coming years.

Figure 42: Ongoing reduction in NPLs



Source: Company data, Bank of Spain, KBW Research

The stock of NPLs at Unicaja has fallen from €4.8bn in 2014 to just over €3.2bn in 2016. Excluding the provisions associated with mortgage floors, the coverage ratio stands at 50%. And while NPLs fell in 2016, it is worth noting that the pace of improvement slowed. In part this was because of some additional NPL entries from the change in regulation introduced by the Bank of Spain (which meant additional inflows of €123m in 4Q 2016). Adjusting for this, net entries were negative (i.e. reducing NPLs) at c. 1.1% of loans, although below the 3.3% net entry of NPLs recorded in 2015.

Figure 43: NPLs continue to reduce, albeit at a slower pace

EUR m	1Q15	2Q15	3Q15	4Q15	1Q16	2Q16	3Q16	4Q16
BoP	4,814	4,596	4,088	3,954	3,555	3,455	3,339	3,208
Gross NPL entries	201	149	199	263	203	167	175	308
Recoveries	-326	-282	-287	-316	-209	-219	-210	-238
ow cash recoveries	-143	-149	-175	-172	-176	-127	-156	-140
ow foreclosed assets	-152	-121	-103	-140	-32	-89	-45	-89
Write-offs	-93	-375	-46	-346	-94	-64	-95	-63
Net NPL entries	-218	-508	-134	-399	-100	-116	-130	7
EoP	4,596	4,088	3,954	3,555	3,455	3,339	3,208	3,215

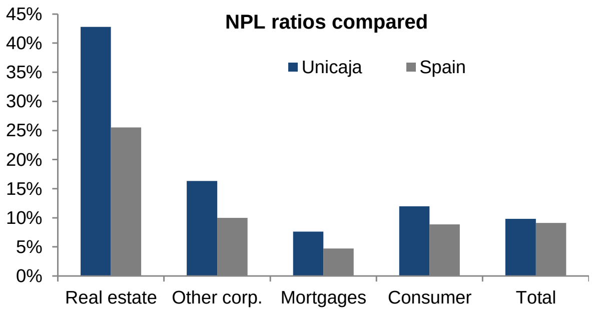
EUR m / %	2015	2016	2016 adj.
Gross entries	812	853	730
Net entries	-1,259	-339	-462
Gross % loans	2.1%	2.5%	2.1%
Net % loans	-3.3%	-1.0%	-1.3%

Source: Company data, KBW Research

The overall NPL ratio at Unicaja is broadly in line with that of the sector, although it is higher across most of the key loan segments. This higher level of NPL is offset by the mix effect, with greater exposure to household mortgages and low real estate exposure relative to the sector.

Figure 44: NPL / coverage by loan exposure (2016)

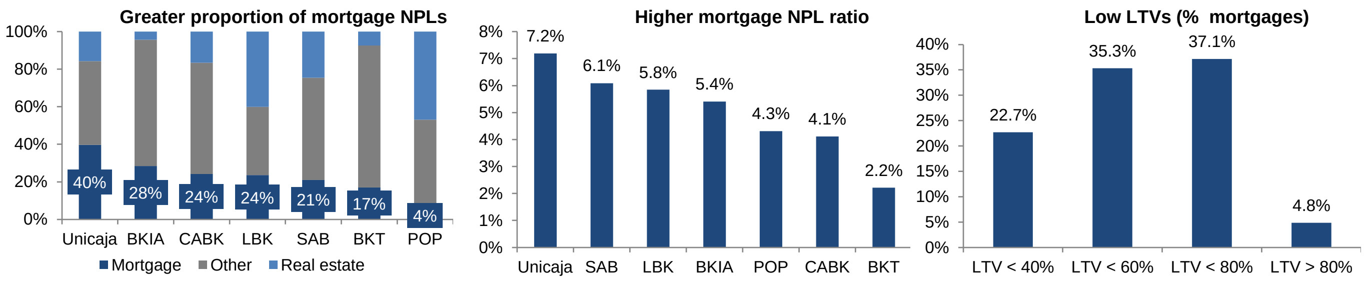
€m	Loans	NPLs	%	Provisions	Coverage
Public sector	2,160	10	0.4%	0	0.0%
Corporate loans	7,262	1,498	20.6%	884	59.0%
Real estate	1,175	503	42.8%	364	72.4%
SME	4,289	832	19.4%	408	49.0%
Larger corp. loans	1,435	94	6.6%	56	59.6%
Public works	363	69	19.0%	56	81.2%
Non-real estate corp.	5,724	926	16.2%	464	50.1%
H/hold lending	20,844	1,707	8.2%	725	42.4%
Mortgages	18,127	1,382	7.6%	527	38.1%
Other	2,717	325	12.0%	198	60.8%
Repos / other	2,463				
Total	**32,729**	**3,214**	**9.8%**	**1,607**	**50.0%**



Source: Company data, Bank of Spain, KBW Research

Unicaja has one of the strongest coverage ratios in the sector. Although the headline ratio is in line with peers, it is worth highlighting that more than 40% of the stock of NPLs at Unicaja are from primary residential mortgages. This compares to a peer average of just 20%. Unicaja does have a higher NPL ratio on its mortgage book, at c. 7.2%, but more than 58% of its mortgages have Loan-to values (LTVs) (at origination) of less than 60%, and less than 5% have LTVs in excess of 80%. The overall level of coverage of mortgage NPLs at Unicaja is 38%.

Figure 45: Greater exposure to mortgage NPLs (2016)



Source: Company data, KBW Research

As with many of the other Spanish banks, part of the work-out of NPLs results in real estate assets being recovered and held on the balance sheet. The gross exposure of Unicaja to foreclosed real estate assets, as of 2016, stands at €2.6bn. This represents just 4.5% of total assets and with net exposure (i.e. including provisions) of just 1.7%. Within this the land portfolio accounts for c. 36% of the total. However, whilst this is broadly in line with peers, Unicaja has the highest level of coverage in the system, at 76%. Overall coverage of foreclosed assets stands at 62%, again, the highest level among Spanish banks. Over 75% of the land bank is intended for 1st residential projects. And for land plots with a value in excess of €0.5m, Unicaja expects to see more than 65% developed within the next two years.

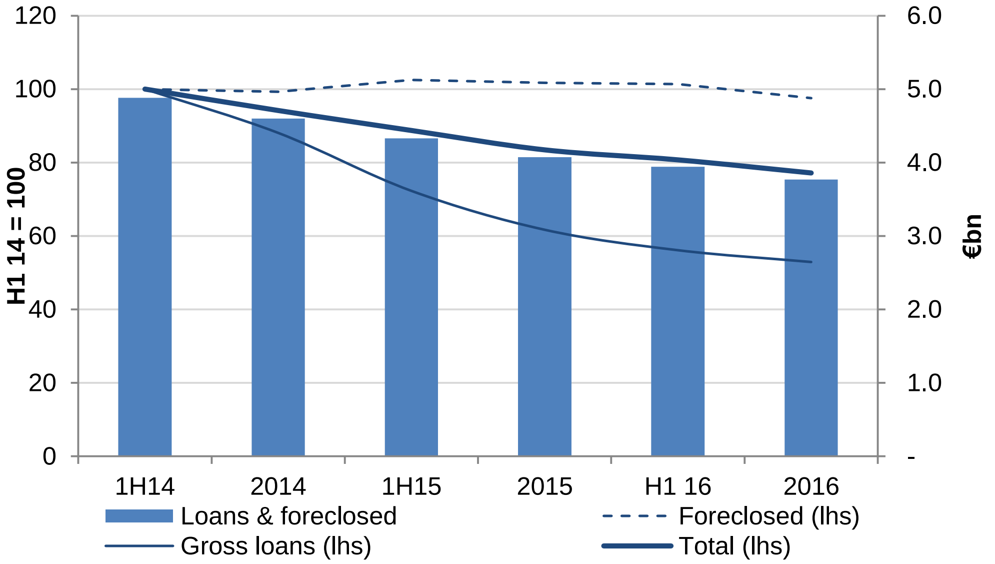
Figure 46: Foreclosed real estate – conservative levels of coverage

2016				Mix				Coverage	
	Total €bn	% loans/RE	Finished	Development	Land	Total	Finished	Development	Land
Unicaja	2.6	9.0%	42%	7%	36%	62%	51%	58%	76%
LBK	3.4	14.3%	42%	15%	31%	39%	39%	44%	40%
BKT	0.3	0.7%	43%	1%	16%	21%	23%	16%	21%
BKIA	3.5	3.4%	80%	1%	2%	35%	36%	33%	50%
CABK	13.3	6.6%	50%	6%	33%	48%	40%	57%	62%
SAB	9.9	9.5%	53%	6%	41%	37%	28%	31%	49%
BBVA	15.4	8.8%	45%	2%	31%	61%	57%	65%	74%
SAN	10.7	6.2%	44%	4%	20%	54%	46%	50%	62%
POP	16.9	15.5%	37%	7%	44%	37%	29%	35%	52%

Source: Company data, KBW Research

Since the incorporation of EspañaDuero in 2014, Unicaja has made progress in reducing the level of foreclosed real estate assets. Taking the gross exposure of real estate loans and foreclosed assets, this has fallen by 23% from €4.88bn in H1 2014 to €3.77bn at the end of 2016. As the Spanish real estate market continues to recover, we believe Unicaja will be able to continue to reduce its exposure to this portfolio. Given the above-average levels of coverage, we believe it is possible that the pace of deleveraging could be accelerated.

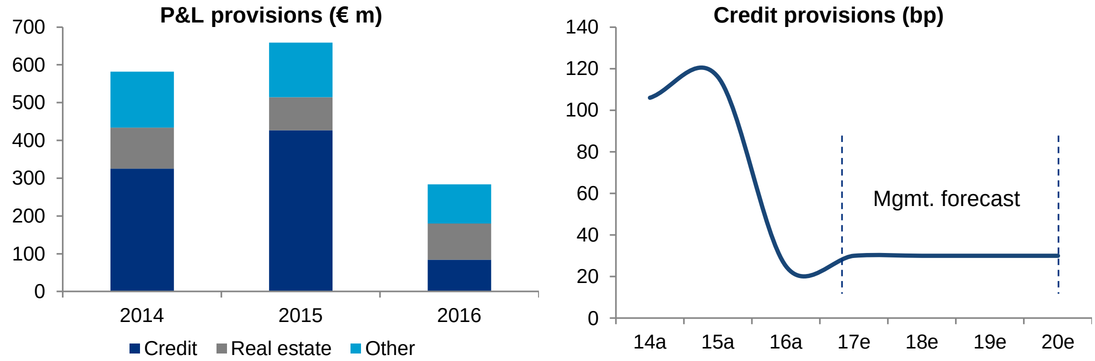
Figure 47: Unicaja – reduction in real estate exposure (loans + foreclosed assets)



Source: Company data, KBW Research

The cost of risk was over 100bp in both 2014 and 2015 but improved to 25bp in 2016. Unicaja believes that, based on current levels of coverage and the outlook for the Spanish economy, the LLC could be significantly below 30bp over the next couple of years. This is supported by the small real estate exposure of the group, a highly collateralized NPL loan book (more than 84%) and an improving trend in probability of default (which will reduce NPL formation). However, Unicaja has guided to a cost of risk of <30bp to account for the expected improvement in loan growth and the change in mix (more SME and consumer loans).

Figure 48: Cost of risk to remain at relatively low levels



Source: Company data, KBW Research

KBW outlook for LLC and asset quality

2016 saw a strong improvement in the level of provisioning, with a credit charge of just 24bp and only moderate provisions on foreclosed real estate assets. Management expects loan loss charges to remain below 30bp over the next four years. This target takes into account both upcoming regulatory changes (IFRS 9) and the change in loan mix that the bank is targeting. It is worth noting that real estate sales are being completed, with a net positive result for the bank. However, for the moment, this is still being offset by the negative impact from updating the appraisal values of the properties. Taking all of this into account, we provide below our estimates for the main asset quality indicators over the next four years.

We expect net NPLs to reduce by €1.2bn over the next four years and for foreclosed real estate assets to fall by €1.0bn over the same period. This should see an improvement in the total NPA ratio from 16.2% in 2016 to 9.9% in 2020. Whilst net sales of real estate have just started (with the stock reducing by 4% in 2016), we expect an acceleration in the coming years. As a result of this reduction in NPAs, we estimate that Unicaja's Texas ratio should improve significantly, from 94% in 2016 to c. 58% by 2020 (including a mid-point estimate of potential funds raised from the IPO).

Figure 49: KBW estimates for asset quality

	2014a	2015a	2016a	2017e	2018e	2019e	2020e
NPLs (€m)	4.8	3.6	3.2	2.9	2.6	2.4	2.1
Real estate assets (€m)	2.6	2.7	2.6	2.5	2.3	2.0	1.6
Total NPAs (€m)	7.4	6.3	5.8	5.4	4.9	4.5	3.7
NPL ratio %	12.2%	9.8%	9.6%	8.8%	7.8%	7.1%	5.8%
NPL coverage ratio %	62%	57%	50%	50%	50%	49%	48%
NPA ratio %	17.5%	16.0%	16.2%	15.1%	13.7%	12.3%	9.9%
NPA coverage ratio %	60%	58%	55%	55%	57%	58%	57%
LLC (bp)	102	113	24	27	25	25	26
Total NPA charge (bp)	126	127	48	33	32	24	22
Texas ratio %	100%	97%	94%	79%	73%	67%	58%

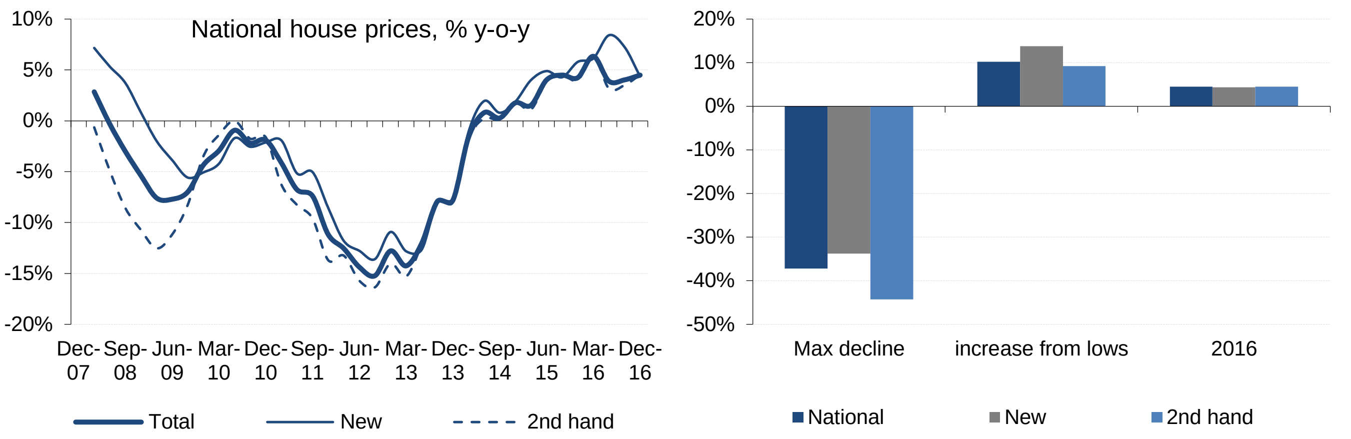
Source: Company data, KBW estimates

Spanish housing market recovery continues

House price evolution

The collapse in housing prices suffered by Spain has, over the last two years, shown signs of starting a period of recovery. At a national level, house prices have fallen, peak-to-trough, by more than -37% between 2007 and 2013. However, since June 2014, they have started to recover. In 2016, house prices increased by 4.5% YoY and have now risen by 10.2% since the low point in the middle of 2013 (reducing the peak-to-trough decline to 31%). The evolution of new house prices has been slightly better, falling by a total of -33.8%. Since the low point, new house prices have now risen by 13.7%, increasing by 4.3% during 2016. For second-hand prices, the total decline was -44.3%, although they have now risen 9.2% from the low point and grew by 4.5% in 2016.

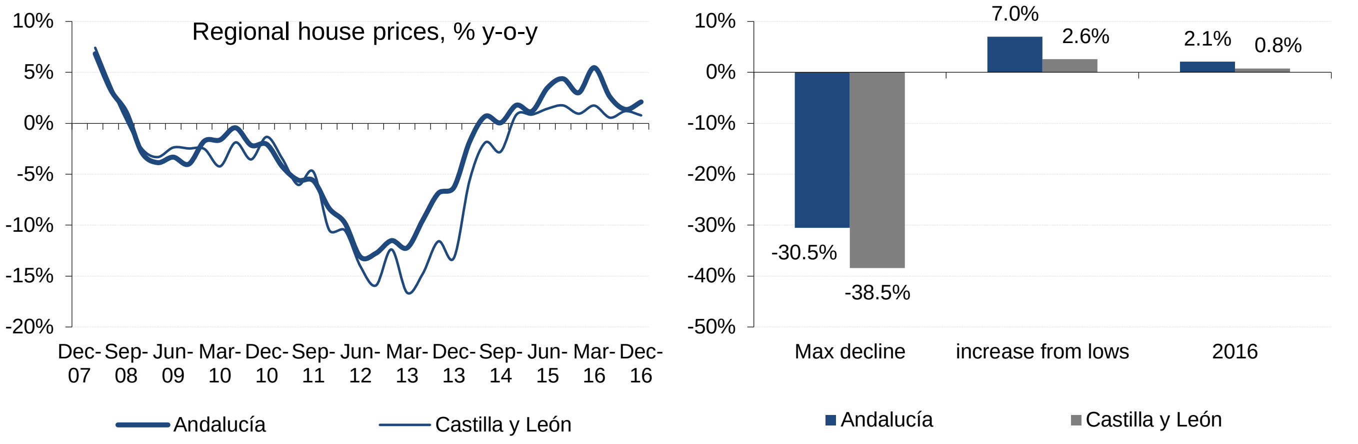
Figure 50: House price recovery continues



Source: INE, KBW Research

As we have noted (see page 14 – Unicaja an overview), the two key regions in Spain for Unicaja are Andalucía in the south and Castilla y León in the north. These two regions account for c. 7% of the bank's loan book. House prices in Andalucía have been growing over the last two years and increased by 2.1% in 2016. In Castilla y León, the recovery has been a little bit slower with prices increasing by 1.5% YoY in 2016. The total decline in prices in Andalucía was -31%, but they are now up +7% from the lows. In Castilla y León, prices had declined by a total of -38%, but by the end of 2016 had risen by +3%.

Figure 51: Stronger performance from house prices in Andalucía versus Castilla y León

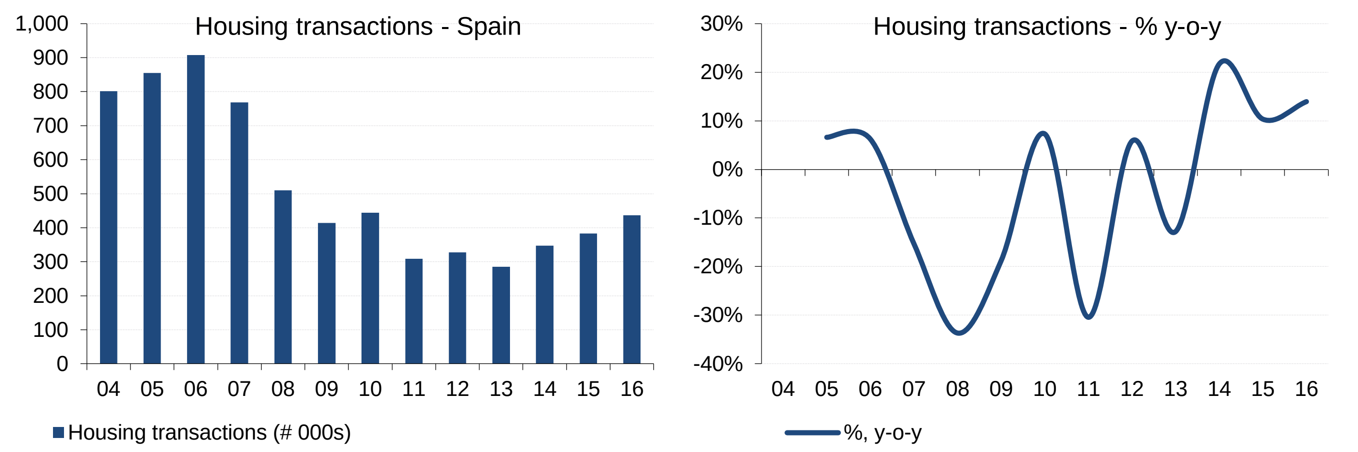


Source: INE, KBW Research

Increase in number of transactions / housing starts

The recovery in the housing market can also be seen in the increase in the number of both transactions and completed new houses. Volumes are increasing off a very low base but are likely, in our view, to remain structurally below pre-crisis levels.

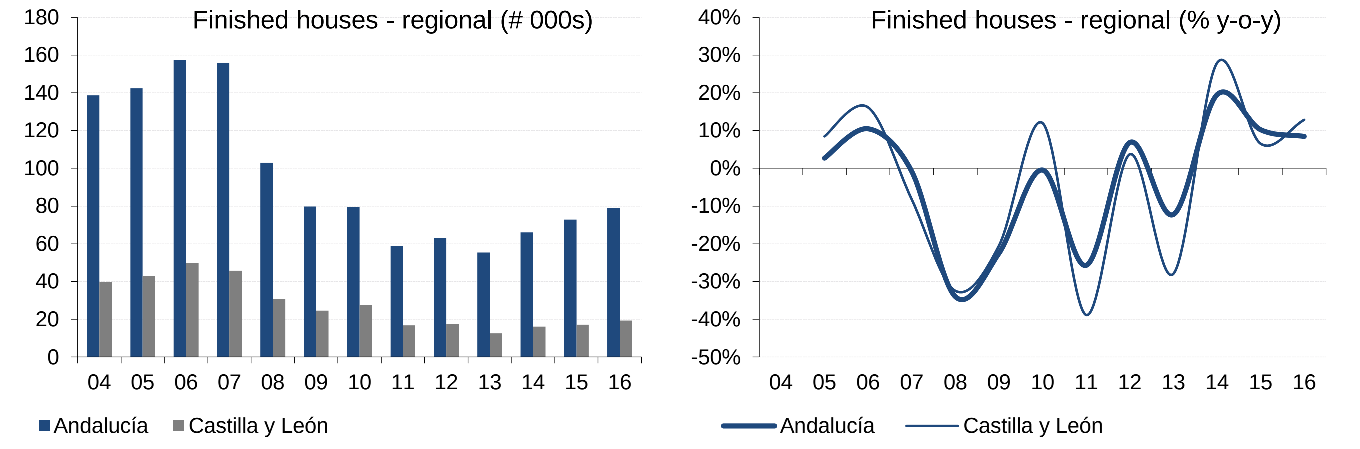
Figure 52: # housing transactions continues to improve



Source: INE, KBW Research

At a regional level, we can broadly see the same recovery trend, although it is worth noting the slower pace of recovery in Castilla y León.

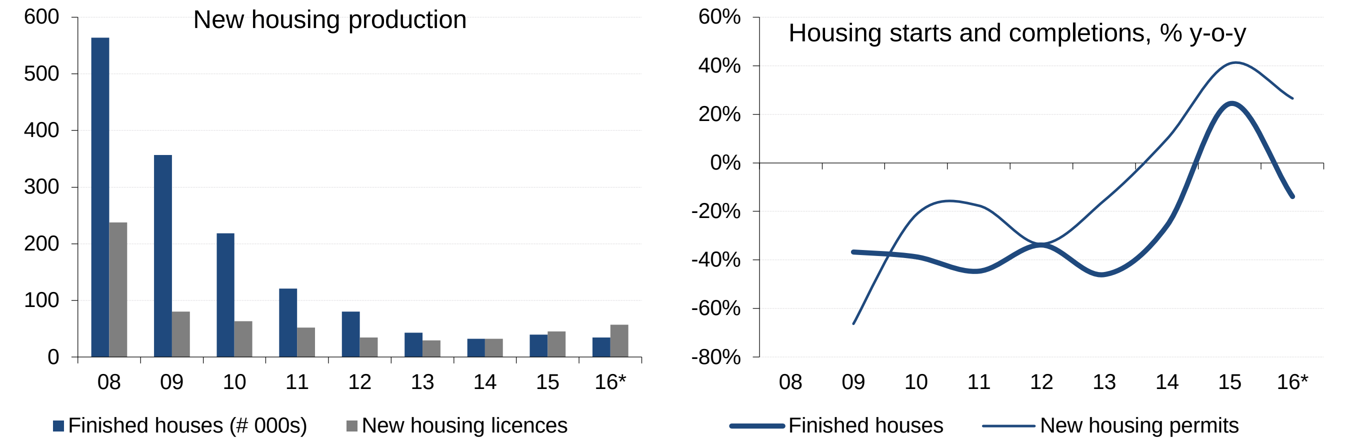
Figure 53: Stronger relative recovery in Andalucía versus Castilla y León



Source: INE, KBW Research

In terms of the number of new houses being finished, we believe the data is a little more mixed. Despite recovering slightly from the lows of 2014, new house construction declined again in 2016. However, it is worth noting that, whilst the number of new houses finished fell in 2016, the number of new housing permits has continued to increase.

Figure 54: Off a low base new housing production starts to increase

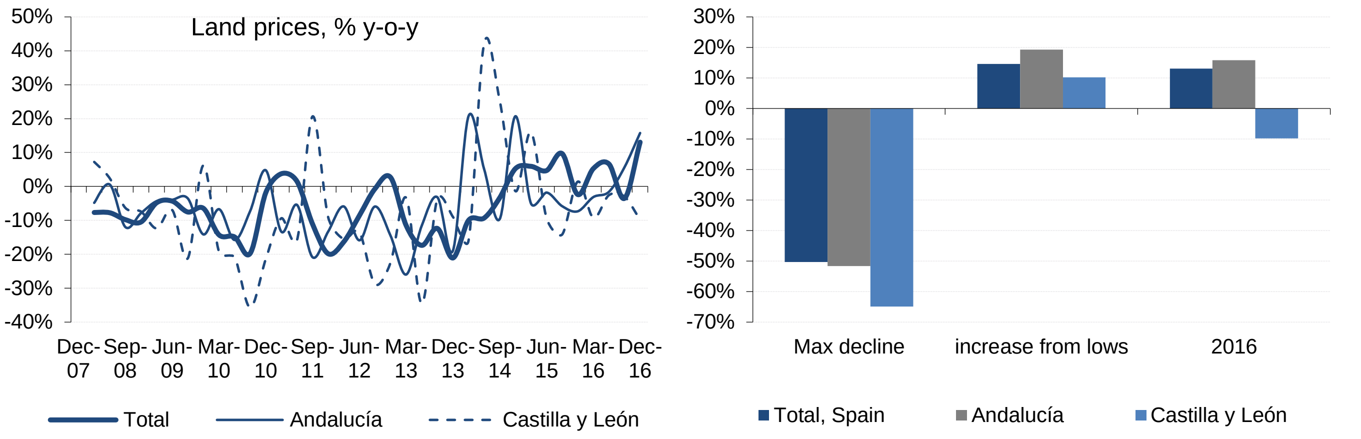


Source: Ministerio de Fomento, KBW Research

Land

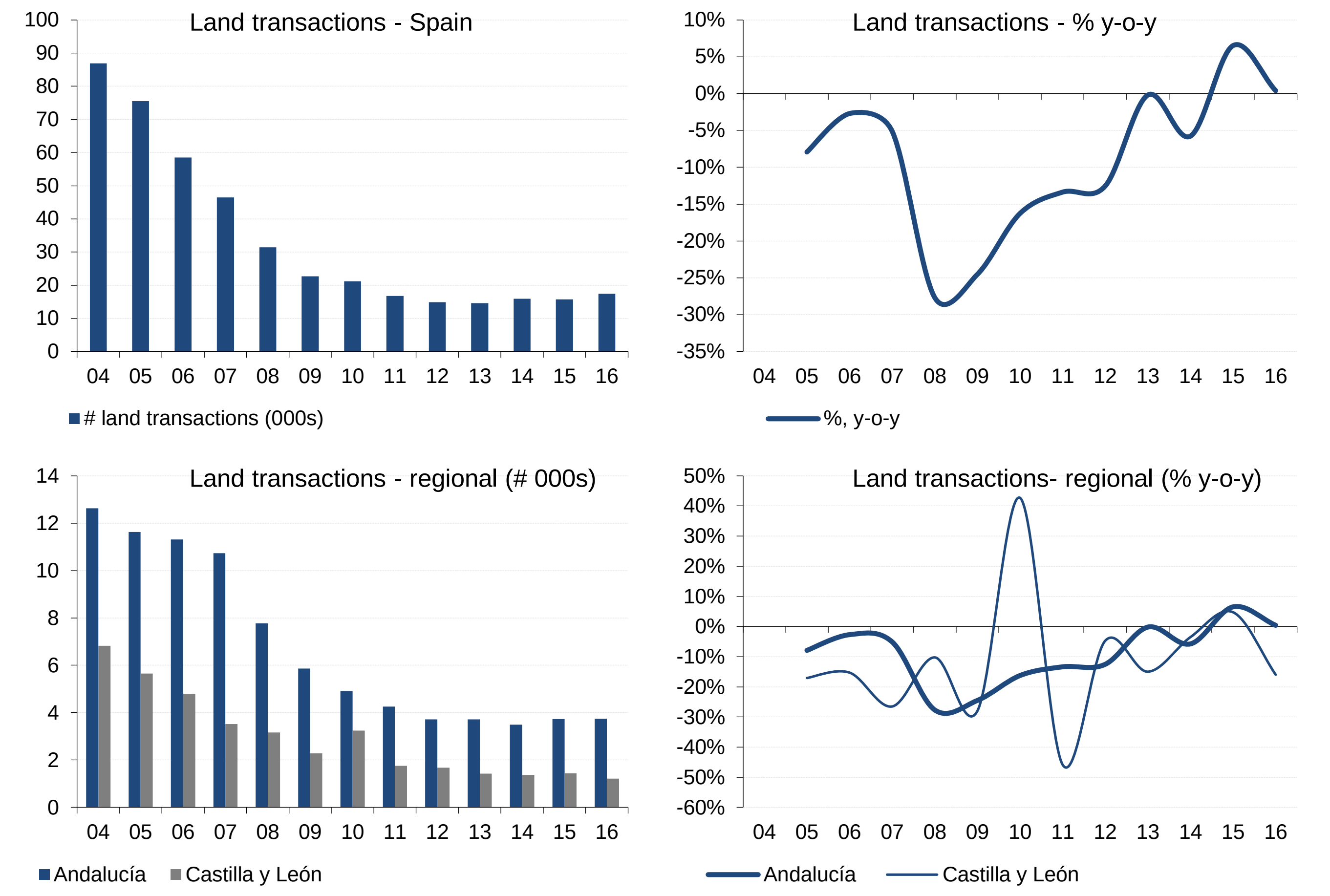
We believe that perhaps the most challenging part of Spanish banks' real estate portfolio is the land portfolio. It is here that the banks have taken the greatest write-downs and taken longer to run down their exposure. However, even here there are some signs of improvement. Nationally, land prices have fallen by 50% from the peak, although some banks (e.g. Unicaja, BBVA and SAREB) have made write-downs in excess of 70%. However, land prices have started to increase, rising by 5.3% in 2016. The recovery in the number of transactions is taking longer, although transaction levels are now remaining relatively stable. The performance and trends in Andalucía are stronger versus Castilla y León. This is a positive for Unicaja as the bulk of its foreclosed assets are located in Andalucía.

Figure 55: Land prices



Source: Ministerio de Fomento, KBW Research

Figure 56: Land transactions

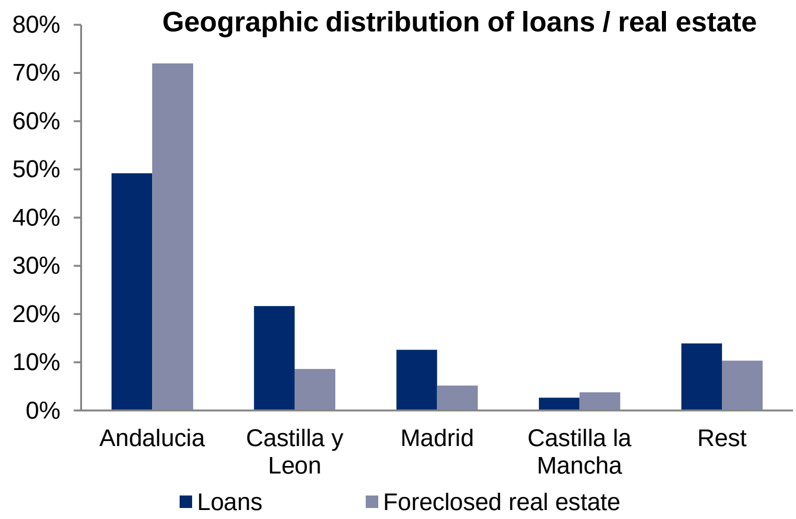


Source: Ministerio de Fomento, KBW Research

Regional distribution

Figure 57 below provides a summary of the gross loan and foreclosed real estate exposure by region. Contributing almost half of the loan book (49%) and 72% of foreclosed assets, Andalucía is the key region for Unicaja.

Figure 57: Unicaja – regional distribution of loans and foreclosed real estate assets



Source: Company data, KBW Research

Figure 58: Summary indicators – Spanish housing market

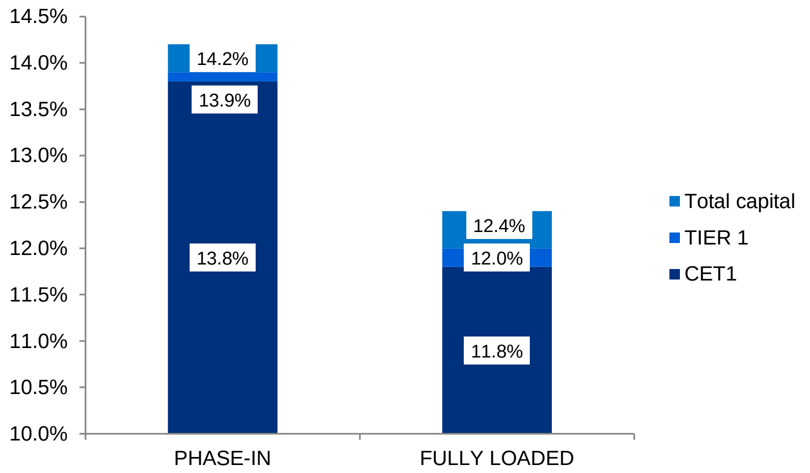
%	Spain	Andalucia	Castilla y Leon	Madrid	Castilla la Mancha
House price peak decline 2007-2014	-37%	-31%	-38%	-42%	-35%
House increase from lows	10%	7%	3%	21%	4%
House transactions 2016 y-o-y growth	14%	8%	13%	17%	16%
Housing starts y-o-y 2016	27%	11%	10%	37%	9%
Land prices peak to trough decline	-50%	-55%	-66%	-65%	-71%
Land price increase from lows	21%	29%	10%	51%	51%

Source: Company data, KBW Research

Capital

Unicaja's capital position remains strong relative to both peers and minimum regulatory requirements (SREP). Total capital ratios of 12.4% fully-loaded and 14.2% phased-in are predominantly composed of higher quality CET1. On a fully-loaded basis, Unicaja reported CET1 of 11.8% in 2016 with an additional 20bps of Tier 1 capital and 40bps of Tier 2. Like-wise, phased-in capital at 14.2% consists mainly of CET1 (13.9% ratio), with a further 10bps of Tier 1 capital and 30bps of Tier 2

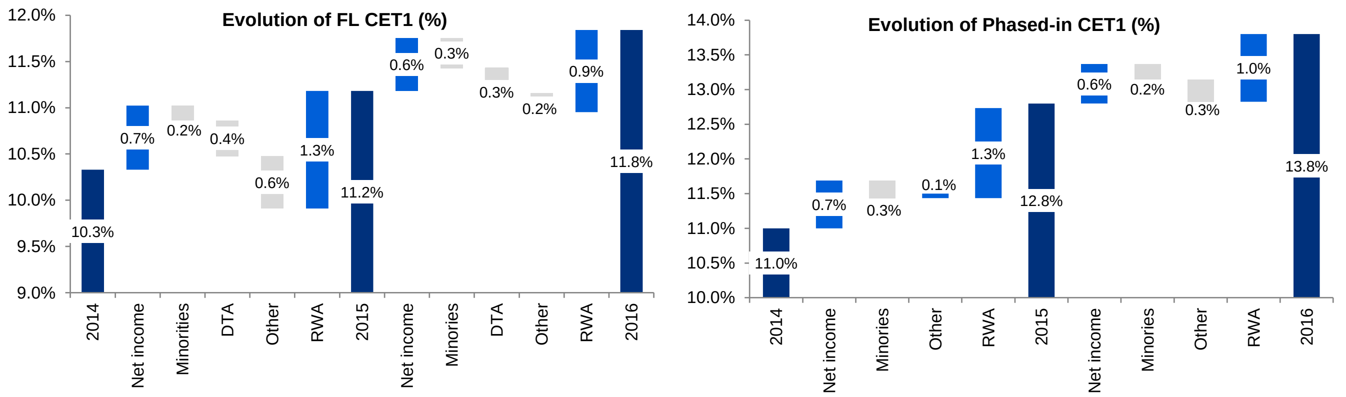
Figure 59: Capital structure



Source: Company data, KBW Research

In our view Unicaja's capital generation since 2014 has been strong. Fully-loaded CET1 ratio has grown by 150bps to now stand at 11.8% in 2016 and phased-in ratios have grown by 280bps to 13.8%. In Figure 60, we present the evolution of Unicaja's CET1 ratios on a fully-loaded and phased-in basis. On a fully-loaded basis, net income has generated 130bps of capital since 2014 and RWA reduction has increased capital by 200bps. Reduction in minorities have reduced capital by 50bps and other deductions by 130bps (mostly Deferred tax assets [DTAs]).

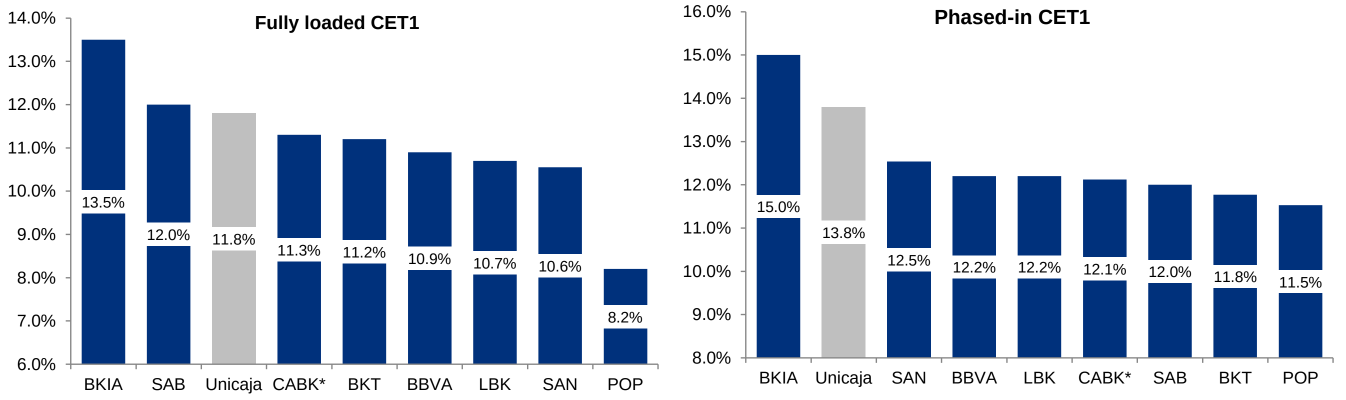
Figure 60: Capital generative balance sheet



Source: Company data, KBW Research

Unicaja's capital ratios are relatively strong versus the listed Spanish banks. At year-end 2016, the Spanish banks had on average fully-loaded capital ratios of 11.0% versus Unicaja at 11.8% and phased-in ratios stood at 12.4% on average versus Unicaja at 13.8%. Capital generation has also been stronger since 2014 versus peers. Spanish banks have increased fully-loaded CET1 ratios by 11bps on average (21bps excluding POP) versus Unicaja at 150bps. While RWAs have declined for most as a result ongoing deleveraging, Unicaja remained profitable during the period and acquisitions made by BKT, CABK and SAB impacted fully-loaded CET1 ratios.

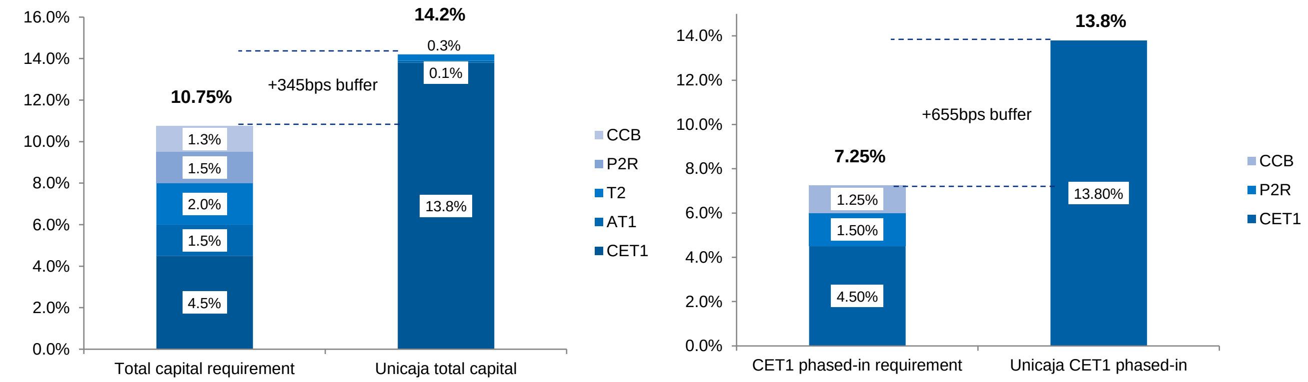
Figure 61: Capital ratios versus peers (2016)



*Source: Company data, KBW Research. *CABK pro forma acquisition of BPI. BKIA incl. unrealised AFS gains*

Unicaja's capital ratios at the end of 2016 are comfortably in excess of its minimum regulatory capital requirements (SREP) for 2017 set by the ECB. The CET1 phased-in ratio of 13.8% gives a 655bp buffer above the minimum SREP of 7.25% required in 2017. Unicaja's total capital ratio of 14.2% is also comfortably above the minimum requirement of 10.75%, with a 345bp buffer. Similar to other banks, Unicaja's CET1 requirement consists of a 4.5% Pillar 1, a 1.25% countercyclical buffer that will rise to 2.5% in 2019, and a Pillar 2 requirement (P2R) of 1.5%. Total capital requirements include in addition an AT1 requirement of 1.5% and a Tier 2 requirement of 2.0%, which has been covered with CET1.

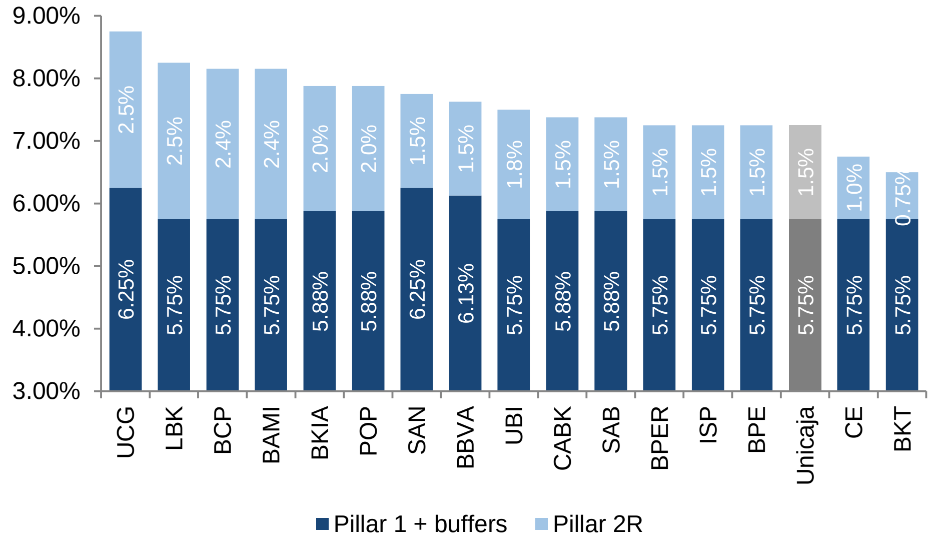
Figure 62: Total capital and CET1 phased-in versus regulatory minimum requirements (SREP)



Source: Company data, KBW Research

Unicaja's SREP requirements for 2017 are lower than most Spanish, Italian and Portuguese peers. Its P2R, which is set by the European regulator (the SSM), is relatively low. The P2R is determined using both quantitative and qualitative aspects. This can include factors such as the depletion of capital in an adverse scenario in the stress test, the risk profile of an institution and / or the sensitivity to stress scenarios. Unicaja's P2R of 1.5% is at the low end of southern European peers.

Figure 63: SREP requirements lower versus selected southern European peers



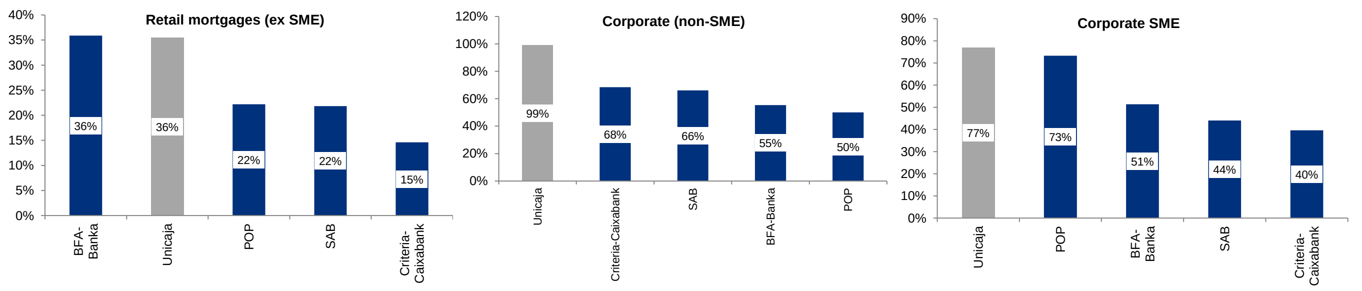
Source: Company data, KBW Research

We would also note that, in common with all banks, the SREP requirement includes a total 5.75% of Pillar 1 (4.5%) and countercyclical buffer (1.25%). Unlike larger institutions, Unicaja has not been designated as a systemically important institution and, as such, has no additional systemic buffers. G-SIFIs and systemically important Spanish banks have an additional phased-in buffer in their 2017 SREP, while for banks deemed systematically important in Italy and Portugal, buffers will be phased in at a later stage.

Potential transition to IRB could offer strategic and capital advantages

Unicaja uses standardised risk-weight models and, as a result, has higher risk-weighted asset (RWA) densities than its peers who use IRB (Internal ratings-based) models. Unicaja is in the process of transitioning to IRB models and expects to obtain approval by 2020, although management has not included any potential benefits in its business plan. Given the relative size of Unicaja's mortgage portfolio, we believe the potential reduction in RWA and benefit to capital could be significant. Under its current standardized model, Unicaja's mortgage book has a risk weight density of 36%. Peers using IRB models for mortgages have capital requirements that are, on average, a third lower (RWA density of 24%). The potential benefit to capital requirements for SME and corporate portfolios would also be similar, as our scenario analysis demonstrates below. We believe moving to IRB models might not only potentially benefit capital, but could also provide Unicaja with further commercial levers. This could include targeted marketing campaigns, improved knowledge of current and future clients and enhancement of the credit process.

Figure 64: Unicaja's RWA densities are higher than peers using internal models



Source: EBA transparency exercise 2016, KBW Research

Unicaja's RWA densities are higher than peers currently using IRB models. Migrating from standardized models to RWA could potentially result in lower RWAs. For mortgages, peer RWA densities range from a high of 36% to a low of 15%, averaging 24% versus Unicaja at 36%. Similarly for corporate exposures, peers range from a high of 68% to a low of 50%, averaging 60% versus Unicaja at 99%. In the corporate SME portfolio, peers range from a high of 73% to a low of 40%, averaging 50% versus Unicaja at 77%.

Management expects transitioning to IRB in 2019 / 2020 could increase capital by 150-200bps, which from our scenario analysis below implies moving to risk-weight densities in line with the average of its peer group already using IRB. However, visibility on the exact timing and impact of using IRB models is still limited and Unicaja does not include any potential gains in its business plan. In Figure 65, we illustrate the potential RWA reduction and capital benefit under three scenarios whereby Unicaja's RWA densities decline to the highest in the peer group, the average of the peer group and the lowest of the peer group. In total our scenario analysis shows a range of capital benefits from 40bps-350bps, with an average of 200bps.

Figure 65: Scenario analysis – moving to peer RWA densities would increase capital

	Unicaja			Potential RWA reduction		
€bn	Exposure	RWA	RWA density	High	Avg	Low
Retail mortgages	17.2	6.1	36%	0.00	2.04	3.59
Corporate (non-SME)	2.0	2.0	99%	0.61	0.77	0.97
SME	3.2	2.4	77%	0.11	0.78	1.17
Potential RWA reduction				0.72	3.60	5.74
FL CET1	2.95			2.95	2.95	2.95
RWA	24.9			24.2	21.3	19.2
Capital ratio	11.8%			12.2%	13.8%	15.4%
Potential capital benefit				**0.35%**	**2.00%**	**3.54%**

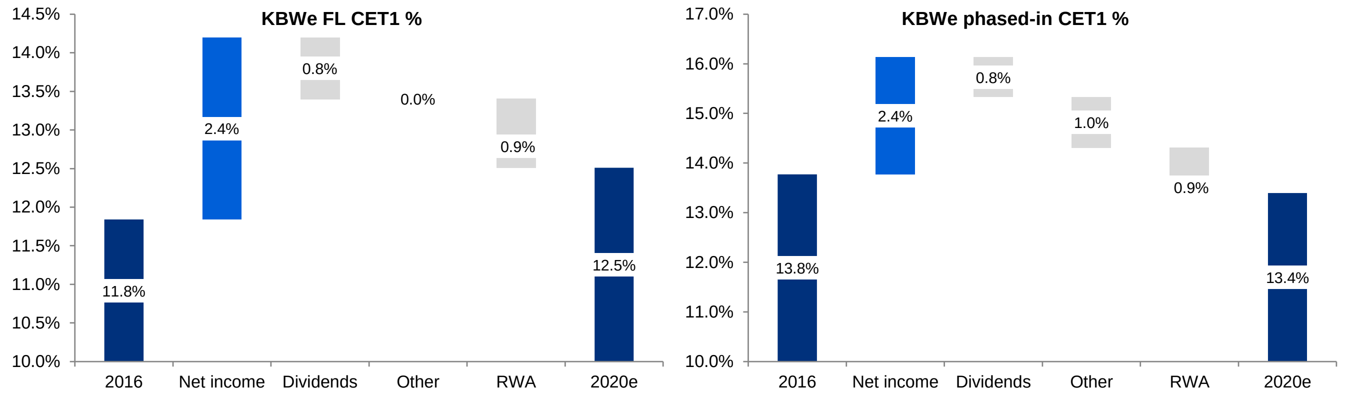
Source: KBW Research

KBW outlook for capital progression

In Figure 66, we present our estimates of Unicaja's capital generation from 2016-2020e. We believe earnings will generate 260bps of capital given our forecasts for cumulative net income of €0.7bn in the period, of which we expect 100bps of capital to be paid out in dividends (cumulative €0.26bn). We expect RWAs to grow by 3% to 2020e, reaching €26.9bn, given our expectations for both the level and mix of loan growth with some offset from NPA reduction.

Transitional arrangements for phased-in CET1 will end in 2018, except for DTAs where the arrangement will continue until 2024. As a result, our phase-in capital estimate declines to 13.8%, although it remains above our fully-loaded estimate of 12.9%. We have assumed no benefits from a transition to IRB models. Moving to IRB models could generate as much as 150bp to 200bp of additional capital. However, for the moment we remain cautious about including this in our estimates as the timing and magnitude from moving to IRB is still uncertain. The implementation of IFRS 9 will likely have a negative (although not quantified yet) impact on capital in 2018.

Figure 66: KBWe capital generation



Source: KBW Research

Below we present our outlook and estimates for fully loaded CET1. We forecast an increase in FL CET1 of 11.8% to 12.5% in 2020e.

Figure 67: Fully loaded CET1 estimates

	2016 A	2017 E	2018 E	2019 E	2020 E
Tier I:					
Capital	923	923	923	923	923
Reserves	1839	2751	2855	2931	3043
Capital & reserves	2762	3674	3778	3854	3966
Net Attributable Income	142	122	109	172	233
less Dividends	0	18	33	60	105
Prefs	49	49	49	49	49
Pref deductions	-49	-49	-49	-49	-49
Other (FROB)	604	0	0	0	0
Minority Interests	192	30	30	30	30
Goodwill	-33	-33	-33	-33	-33
DTAs	-626	-623	-618	-609	-597
Other	-84	-120	-120	-120	-120
Deductions	-743	-776	-771	-762	-750
Other	-5	0	0	0	0
CET1	2952	3032	3113	3234	3374
CET1 ratio	11.8%	12.1%	12.2%	12.3%	12.5%

Source: KBW Research.

Below we present our outlook and estimates for phase-in CET1. We forecast a decrease in CET1 from 13.8% to 13.4% in 2020e.

Figure 68: Phased-in CET1 estimates

	2016 A	2017 E	2018 E	2019 E	2020 E
Tier I:					
Capital	923	923	923	923	923
Reserves	1839	2751	2855	2931	3043
Net Attributable Income	142	122	109	172	233
less Dividends	0	18	33	60	105
Prefs	49	49	49	49	49
Pref deductions	-20	-35	-49	-49	-49
Other (FROB)	604	0	0	0	0
Minority Interests	174	30	30	30	30
Goodwill	-20	-27	-33	-33	-33
DTAs	-20	-27	-33	-33	-33
Other	-54	-90	-120	-120	-120
Deductions	-213	-303	-400	-457	-511
Other	0	0	0	0	0
CET1	3498	3519	3484	3539	3613
CET1 ratio	13.8%	14.0%	13.6%	13.4%	13.4%

Source: KBW Research.

Funding – Simple retail business model

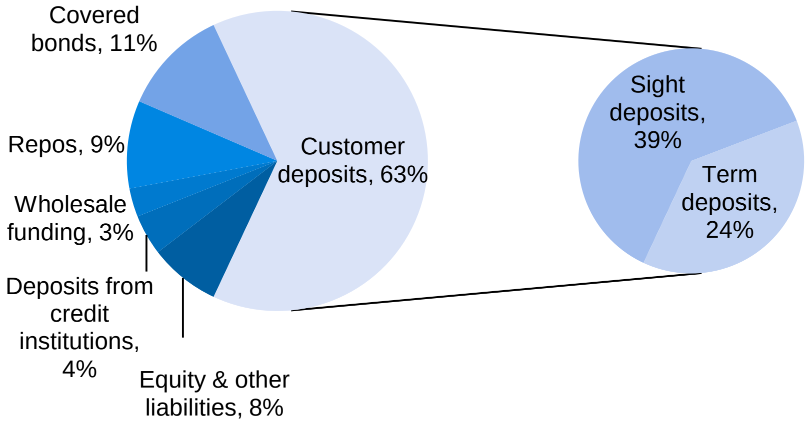
Unicaja is a pure domestic retail bank with a low risk balance sheet profile typical of a Spanish savings bank. Net loans account for 54% of the total assets with retail funding accounting for 70% of the balance sheet. The bank has maintained a comfortable liquidity position. The Loan to deposit (LTD) ratio of 83% at FY16 has remained relatively stable and below 100% over the past three years. We believe Unicaja's liquidity ratios are comfortably above regulatory requirements. It has a Liquidity coverage ratio (LCR) of 410% versus a requirement of 60% and Net stable funding ratio (NSFR) of 125% versus a requirement of 100%.

Figure 69: Assets and liabilities breakdown

Source: Company data, KBW Research. Data as of 31 December 2016

Unicaja has a retail-focused funding structure. Customer deposits and covered bonds make up 70% of the balance sheet. Reliance on wholesale funding is relatively low, accounting for only 3% of liabilities. Covered bonds make up 11% of the balance sheet, with additional capacity to issue a further €7bn (double the current amount issued), and repos account for 9%. While there was no central bank funding in 2016, Unicaja opportunistically took up €3.3bn of TLTRO2 in the final auction in March 2017 at -40bps, to fund a matched investment portfolio.

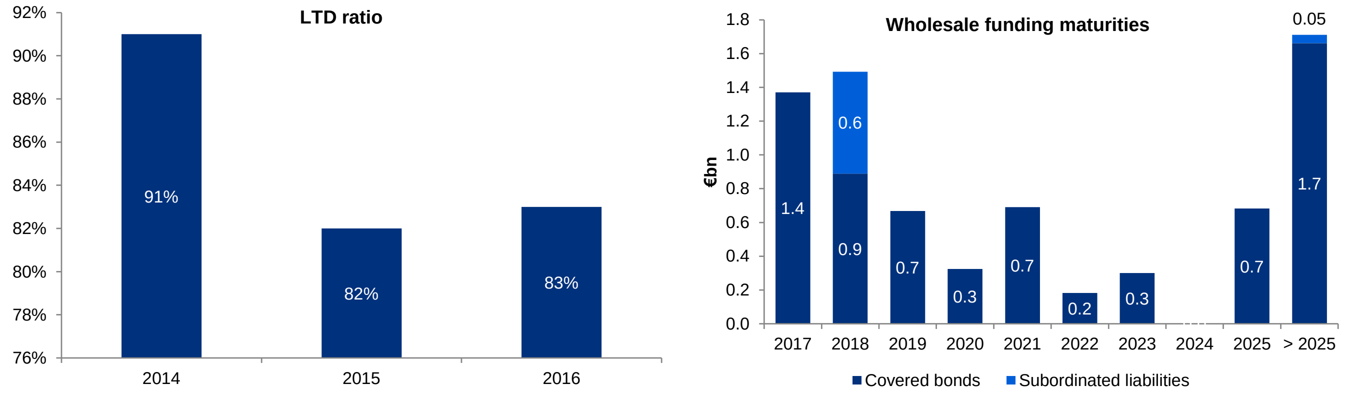
Figure 70: Funding structure



Source: Company data, KBW Research.

Unicaja has maintained a comfortable liquidity position. It has improved its LTD ratio to 83% from 91% in 2014 and maintained ratios below 100%. While wholesale funding remains a smaller part of the balance sheet, wholesale maturities are spread. Forty-eight percent of maturities are after 2020. The proceeds of the IPO will be used to fully repay €604m of Cocos issued by EspañaDuero maturing in 2018.

Figure 71: Comfortable liquidity position

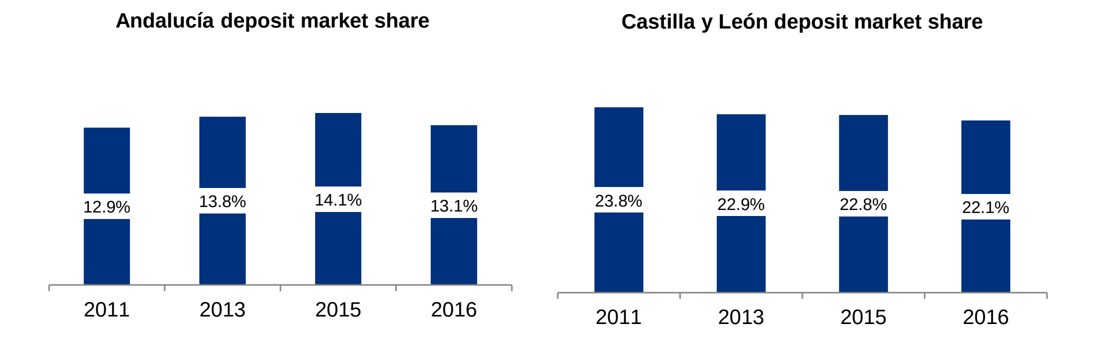


Source: Company data, KBW Research

Solid deposit franchise, dominant in core regions

The bank's leading position in core markets has provided it with a structurally loyal deposit base. Eighty-eight percent of clients have a deposit tenure of over five years. The bank is a leading deposit gatherer in its core markets. In Castilla y León, it has maintained a relatively stable deposit market share of between 22-24% since 2011, and in Andalucía it has maintained a share between 13-14% during the same period. The drop in market share in Castilla y León has been a conscious decision by management, which has sought to reduce some of the less-profitable deposit/client exposures.

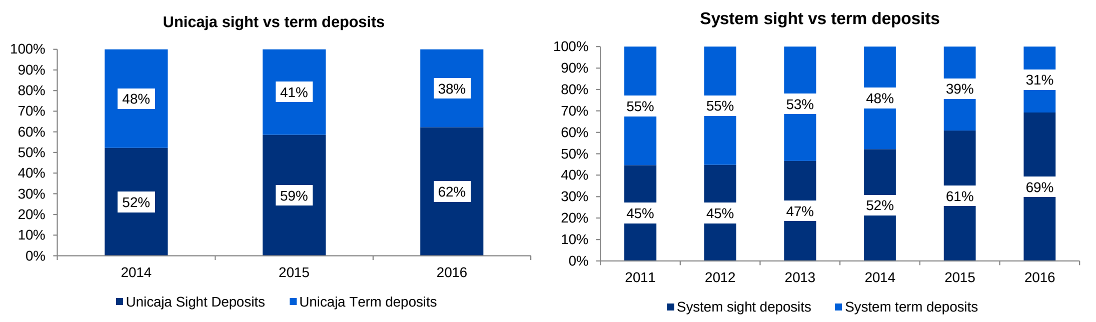
Figure 72: Leading deposit share in core regions



Source: Company data, KBW Research

In the current low interest rate environment, Spanish banks have looked to switch customer funds into lower cost sight deposits and fee-generating off-balance products. Unicaja has been successful in growing both. While the stock of customer funds has remained relatively stable at €48bn, sight deposits have grown 20% since 2014 and now stand at €22.4bn versus €18.7bn in 2014. Unicaja has also been successful in switching term deposits into sight deposits. Term deposits have decreased by €3.5bn to €13.6bn since 2014, while sight deposits increased by €3.7bn. As a result, the weight of sight deposits versus term deposits has also increased to 62% from 52% in 2014. We would note that, from 2014-15, this matches trends in the sector. In 2016, Spanish sight deposits continued to grow and accounted for 69% of customer deposits, compared to a more stable mix for Unicaja.

Figure 73: Weight of sight deposits increases

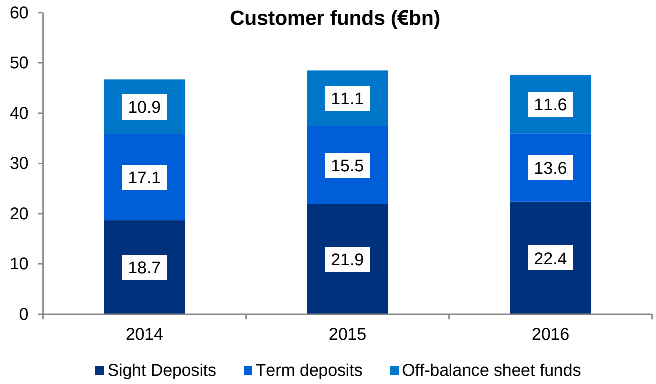


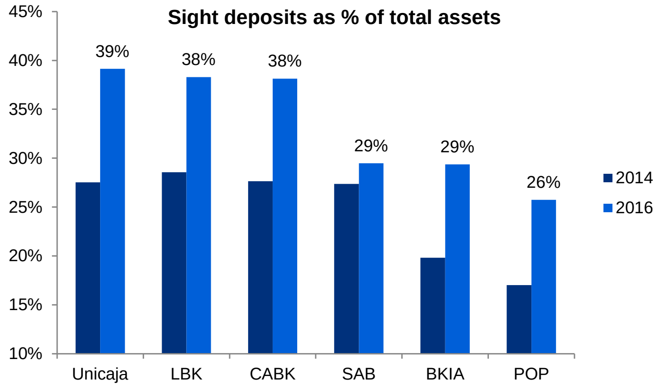
Source: Company data, KBW Research

Unicaja's growth in sight deposits compares favorably with peers. In Figure 74, we compare sight deposits as a percentage of total assets with Spanish peers. After a strong period of growth since 2014, Unicaja now has the highest weighting of sight deposits amongst peers at 39% of total assets.

We would note that Unicaja's weighting of sight deposits versus term deposits would increase if we were to exclude €1.3bn of PICS deposits (Pasivos de Interés Creciente) inherited when it acquired EspañaDuero, which currently cost 4.3% and mature after 2020. Excluding this, underlying term deposits would have declined by 22% since 2014 to €12.3bn and the weight of sight versus term deposits would stand at 65% versus 35%, more in line with the system.

Figure 74: Growing stock of sight deposits versus peers





Source: Company data, KBW Research

Off-balance sheet customer funds have also grown, showing a 5.1% YoY increase, driven by 7.7% growth in mutual funds. While off-balance sheet funds have increased to €11.6bn, this remains below Unicaja's natural market share. Management sees scope to increase market share in mutual funds and life insurance to 3.6% from 1.4% and 1.8% respectively.

Unicaja's listed debt is rated by Fitch and Moody's. Fitch has issued an investment grade rating, BBB-, with a stable outlook that has remained unchanged since 2013. Moody's has issued a non-investment grade rating of Ba3, which has remained unchanged since 11 July, 2013. However, Moody's outlook for Unicaja recently changed to positive versus stable in May 2017.

Estimates

We estimate total deposits to grow by 1.9% CAGR, reaching €51.4bn, and for wholesale funding to decrease to €0.26bn, with FROB CoCos repaid following the IPO. We forecast customer deposits to grow by 4.3% CAGR, reaching €39.9bn by 2020e. We expect sight to deposits to grow at a 5.7% CAGR and, while still decreasing, have assumed that the rate of reduction in term deposits slows to compensate for maturities in covered bonds – where management expects no further issuances – and lower levels of wholesale funding post-IPO.

Figure 75: KBWe for funding

€ m	2015	2016	2017e	2018e	2019e	2020e
Public sector	1,907	2,311	2,279	2,300	2,321	2,343
Private sector	46,712	45,399	45,861	46,666	47,785	49,033
Sight deposits	20,239	22,397	24,189	25,398	26,668	28,002
Term deposits	22,775	17,684	16,354	15,950	15,799	15,713
Retail term deposits	15,375	11,314	10,748	11,017	11,458	11,893
Covered bonds	*7,400*	*6,370*	*5,606*	*4,933*	*4,341*	*3,820*
Repos	3,698	5,318	5,318	5,318	5,318	5,318
Customer deposits (adj	35,614	33,711	34,937	36,415	38,126	39,895
Commercial paper	659	200	150	100	0	0
Total	**49,278**	**47,910**	**48,289**	**49,066**	**50,106**	**51,376**

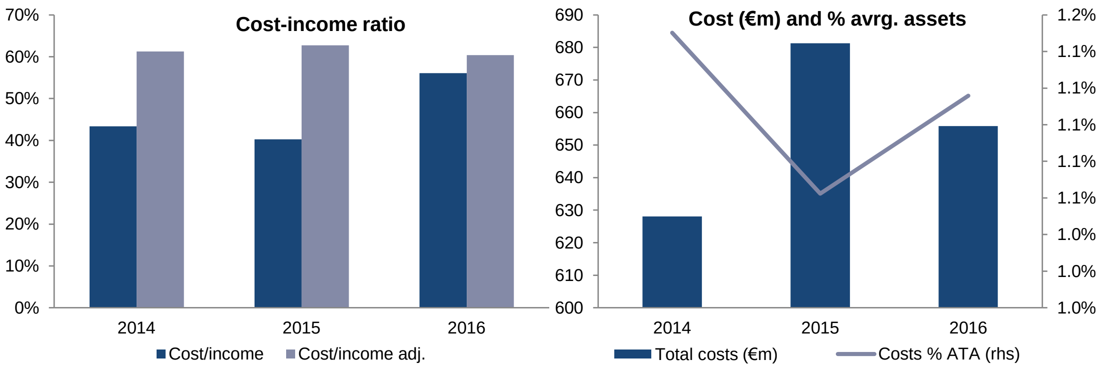
% y-o-y	2015	2016	2017e	2018e	2019e	2020e	16-20 CAGR
Public sector	12.9%	21.2%	-1.4%	0.9%	0.9%	0.9%	1.9%
Private sector	0.7%	-2.8%	1.0%	1.8%	2.4%	2.6%	1.9%
Sight deposits	17.5%	10.7%	8.0%	5.0%	5.0%	5.0%	5.7%
Term deposits	-10.5%	-22.4%	-7.5%	-2.5%	-0.9%	-0.5%	-2.9%
	-8.0%	*-26.4%*	*-5.0%*	*2.5%*	*4.0%*	*3.8%*	*1.3%*
Covered bonds	*-15.3%*	*-13.9%*	*-12.0%*	*-12.0%*	*-12.0%*	*-12.0%*	*-12.0%*
Repos	-0.9%	43.8%	0.0%	0.0%	0.0%	0.0%	0.0%
Customer deposits (adj	5.0%	-5.3%	3.6%	4.2%	4.7%	4.6%	4.3%
Commercial paper		-69.7%	-25.0%	-33.3%			
Total	**2.5%**	**-2.8%**	**0.8%**	**1.6%**	**2.1%**	**2.5%**	**1.8%**

Source: Company data, KBW Research

Cost analysis

Unicaja is still in the process of completing its integration of EspañaDuero, acquired in 2014 and a key reason for the increase in costs over the last few years. The IT integration and execution is now finished, with the operational synergies c. 55% complete. The focus now for Unicaja, from a cost perspective, is to complete the integration and reduce costs over the next few years. The total restructuring costs of €409m are already 84% accounted for, with the final €65m to be booked before 2018. Almost 88% of these restructuring costs relate to employee reduction.

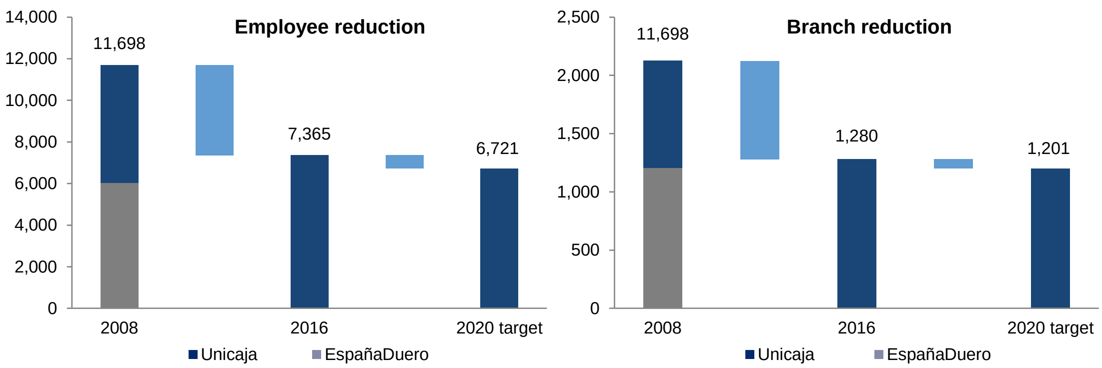
Figure 76: Cost overview



Source: Company data, KBW Research

As part of the integration plan, Unicaja has already started materially reducing both the number of employees and branch network. The branch network has been reduced by c. 10% since 2014, whilst the reduction in the average number of employees has been greater still, at c. 11% (over the same period). The number of employees in the group, as of the end of 2016, stands at 7,365. Unicaja's target is to reach 6,721 by the end of 2020. This will see an additional reduction of c. 9% of the workforce, or 644 employees. Unicaja has reached agreements with c. 500 employees regarding their departure (through redundancy and early retirements). In terms of the branch and distribution network, more than 845 branches have already been closed following the integration. The target is for a further gross reduction of 88 branches (partially offset by the planned opening of c. nine new branches), to finish 2020 with a branch network of 1,201.

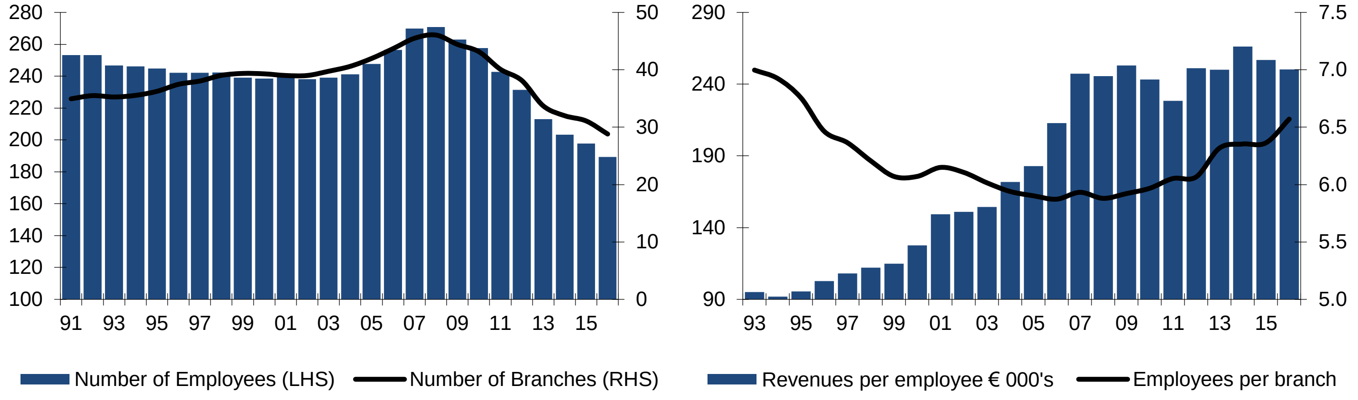
Figure 77: Employee and branch reductions….and targets



Source: Company data, KBW Research

This reduction in distribution capacity and number of employees can also been seen at a sector level in Spain. In our view this is both as a consequence of the significant consolidation in the banking system and the changing distribution capacity needs of the banks as they adapt and implement new digital technologies. The number of branches and employees in the Spanish banking system continues to fall, with employees falling -4.3% YoY in 2016 and branches declining by -7.3% YoY. We estimate that this reduction in capacity has enabled the banking system to maintain relatively stable levels of revenue per employee despite the decline in revenues as a consequence of the low interest rate environment and loan book deleveraging.

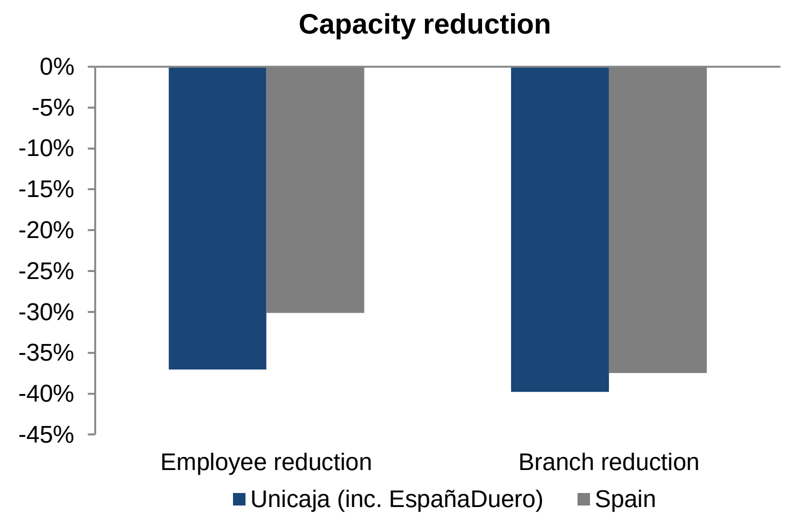
Figure 78: Ongoing capacity reduction in the Spanish banking system



Source: Bank of Spain, KBW Research

Since 2008 the reduction in capacity for the overall system has been c. -30% in number of employees and c. -37% in branches. Taking the starting point as the combined networks of Unicaja and EspañaDuero, the reduction since 2008 has been -37% in employees and almost a -40% reduction in branches. Based on Unicaja's targets, by 2020 the number of employees and branches will have fallen by c. 42% (versus 2008).

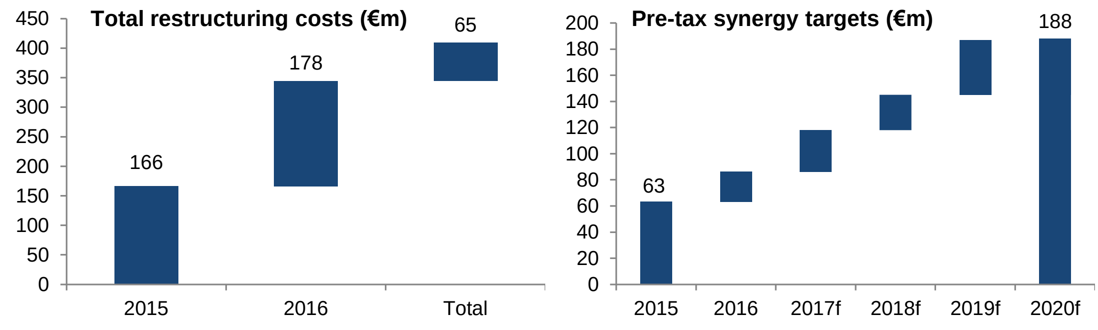
Figure 79: Significant reduction in capacity since 2008 (%, 2016 versus 2008)



Source: Company data, KBW Research

As part of the acquisition of EspañaDuero in 2014, Unicaja has identified c. €188m in total pre-tax cost synergies. This is a 21% increase from the original target of €156m. The bulk of the savings come from reduction in employees, for which total restructuring charges of €409m will be made. More than 84%, or €334m, of the restructuring charges have already been provisioned. The cost synergies are significant, representing c. 26% of the combined pro-forma group in 2013.

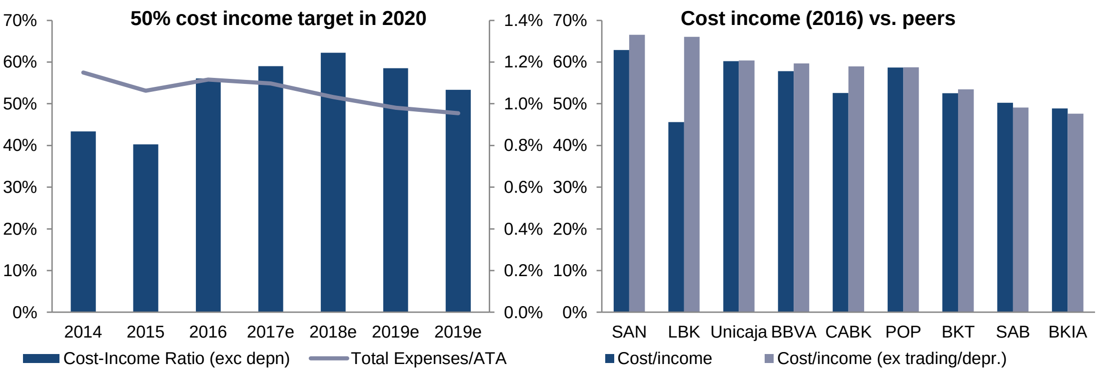
Figure 80: Restructuring costs (84% booked) and synergy targets (another €100m to go)



Source: Company data, KBW Research

As a result of these cost savings, Unicaja aims to reduce the cost-income ratio to below 50% by 2020 versus the current level of 56% (calculated as operating expenses excluding depreciation and amortization). As of now the bank remains on track and is delivering on its cost savings targets. The objective in 2016 was to achieve incremental cost synergies of €23m versus 2015 (bringing total cost synergies achieved over the two years to €86m). Total costs for 2016 declined by exactly €23m. However, gross cost savings would have been higher as there are built-in wage inflation agreements.

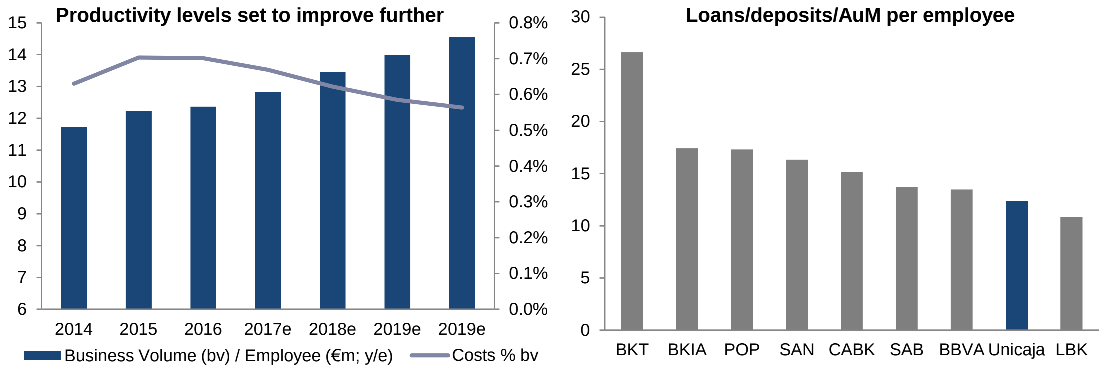
Figure 81: Delivering on cost synergies will drive significant improve in costs



Source: Company data, KBW Research

We have estimated productivity levels by looking at the amount of business volume per employee. For business volume we have taken the aggregate volume of gross customer loans, customer deposits and off-balance sheet assets under management (AuM). Although Unicaja is at the low end versus peers for 2016, the planned reduction in employees coupled with improving business volumes should see an 18% improvement in this metric over the next four years.

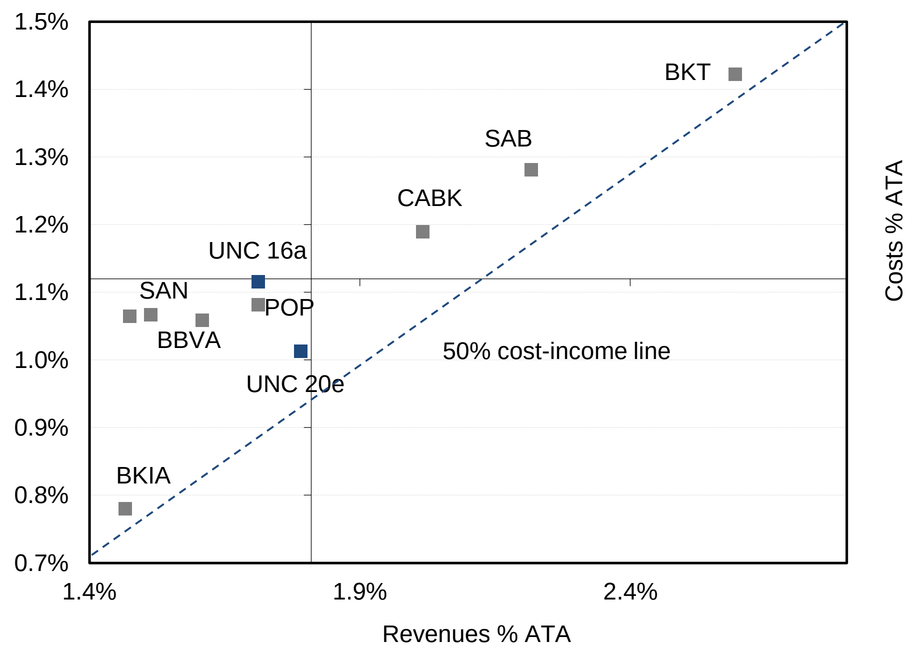
Figure 82: Productivity levels currently below average but set to improve



Source: Company data, KBW Research

The scatter chart below in Figure 83 shows the level of costs versus revenues (ex-trading revenues). Those banks to the left, above the dotted line that indicates a 50% cost-income level, have higher cost income ratios. In the case of BKIA, although revenues are low, this is offset by the lowest cost base in the sector. On the other hand, for the banks in the top right quadrant, while they have above-average costs, this is accompanied by above-average levels of revenues. To improve efficiency levels the banks towards the bottom left face more of a revenue issue. Based on the current cost synergy targets of Unicaja, further improvements to profitability from efficiency improvements would have to come from revenue improvement.

Figure 83: Revenue or cost opportunity?



Source: Company data, KBW Research UNC - Unicaja

Figure 84: Unicaja – key cost efficiency metrics

	Unicaja						Avrg - Spain peers		
Cost / efficiency analysis	2015	2016	2017e	2018e	2019e	2020e	Avrg. 12-15	2016	2019e
Cost-Income Ratio (exc depn and trading)	62.7%	60.4%	64.7%	63.7%	59.9%	54.4%	57.9%	57.6%	54.1%
Cost-Income Ratio (all)	43.3%	60.2%	63.5%	67.3%	63.5%	58.2%	51.2%	54.1%	55.8%
Operating costs/ATA	1.06%	1.12%	1.10%	1.03%	0.98%	0.95%	1.09%	1.11%	1.11%
Operating costs/Business volume	0.70%	0.70%	0.67%	0.62%	0.58%	0.56%	0.82%	0.80%	0.75%
Personnel Costs/average Employee (EUR)	56,203	56,418	55,255	52,976	51,094	50,320	63,807	67,321	66,857
Personnnel Costs as % Total Costs	65.4%	65.0%	64.4%	63.3%	62.5%	61.4%	57.7%	56.4%	54.5%
Business Volume / Branch (EURm; y/e)	69.9	71.0	74.4	77.4	80.7	83.9	99.9	115.0	122.8
Business Volume / Employee (EURm; y/e)	12.2	12.4	12.8	13.5	14.0	14.5	13.6	15.6	16.9
Total employees per branch	5.9	5.9	5.9	5.8	5.8	5.8	6.8	7.0	6.8
Number of branches	1,354	1,280	1,248	1,223	1,205	1,201	4,021	3,446	3,275

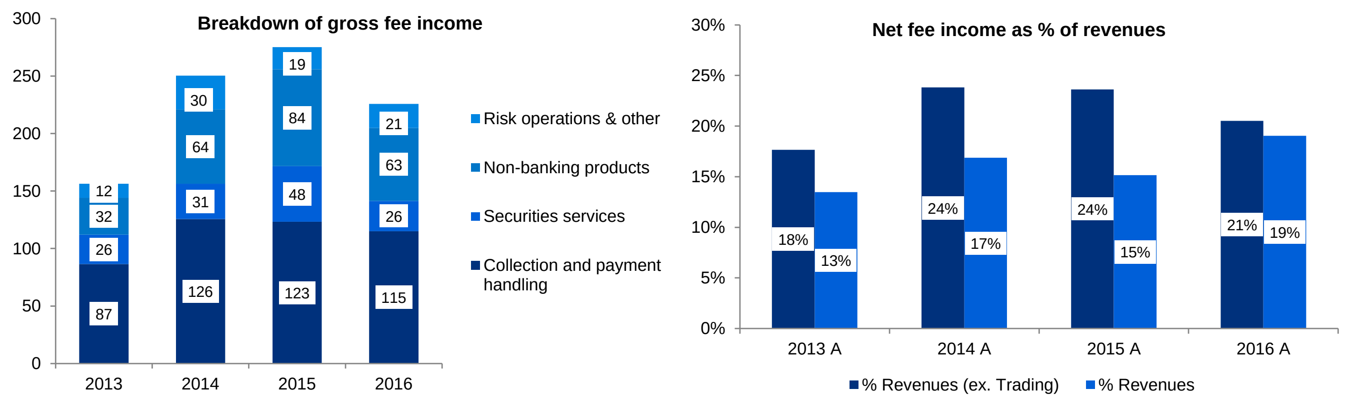
Business volume=gross loans, customer deposits and AuM

Source: Company data, KBW estimates Spanish peers = BBVA, SAN, SAB – Spain only, CABK, BKIA, BKT, POP and LBK

Ambition to grow fees

Fee and commission income accounted for 21% of revenues (ex-trading income) in 2016. Unicaja primarily generates fees from collection & payment services and from the sale and distribution of asset management and insurance products. Following 5% YoY growth in 2015, fee and commission income in 2016 decreased by 13% YoY to €207m. This was largely the result of a disposal and the amortization of high yielding off-balance sheet funds. Fee growth recovered in 2H16, growing by 2% in the last two quarters of the year.

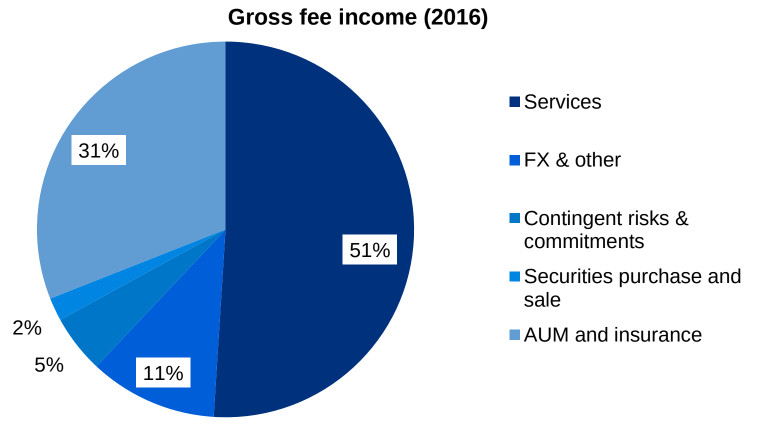
Figure 85: Evolution fee and commission contribution



Source: Company data, KBW Research

The largest contributor of fee income is collection and payment services, accounting for 51% of total gross fee income. The next largest source of fee income comes from the distribution of non-banking products, which makes up 28% of the total. Revenues in this segment primarily relate to the sale of asset management products, such as mutual funds, and the distribution of insurance and pension products. The remaining source of fee income are securities services and fees on contingent risks and commitments.

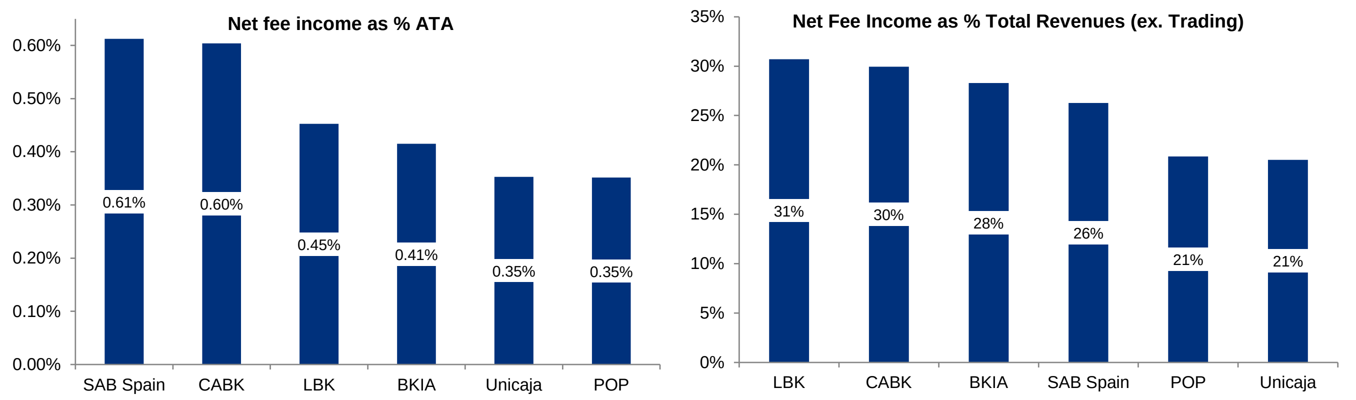
Figure 86: Breakdown of fee and commission income



Source: Company data, KBW Research

We believe the contribution of Unicaja's net fee income is low relative to peers. Net fee income as a percentage of average total assets, at 35bps, is one of the lowest amongst listed domestic peers. Sabadell and Caixabank generate fee income (as a percentage of average total assets – ATA) that is nearly double that of Unicaja. Likewise, fee income contributes a relatively low amount to revenues versus peers (excluding trading income). Fees contributed 21% to revenues in 2016, whereas for Liberbank and Caixabank fees contributed almost a third of revenues (ex trading).

Figure 87: Scope to improve fee income to peer levels

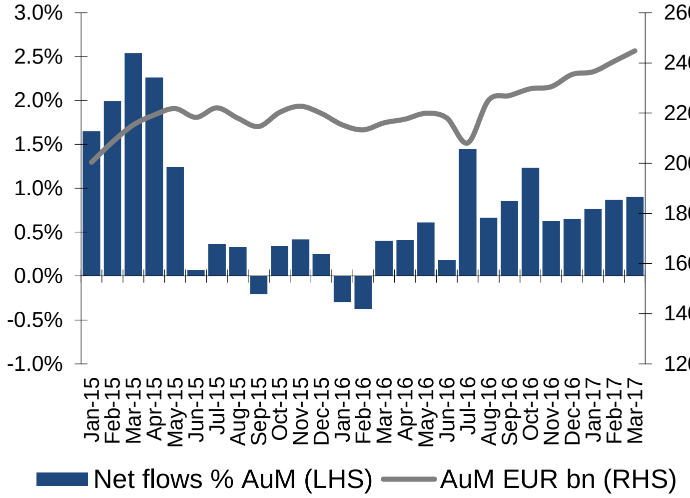


Source: Company data, KBW Research

Inflows returning in Spain and AUM growing

Assets under management (AuM) for the Spanish banks have grown significantly in recent years, increasing by almost 25% over the last two years to €245bn, a level last seen in 2007. While inflows between Jan-May 2015 were relatively strong, averaging 1.9% of total AUM, inflows in 2H15 and early 2016 were weak and at times negative during periods of political uncertainty and market volatility. Since 2H16, monthly inflows have returned to the sector and have averaged 0.9% of AUM.

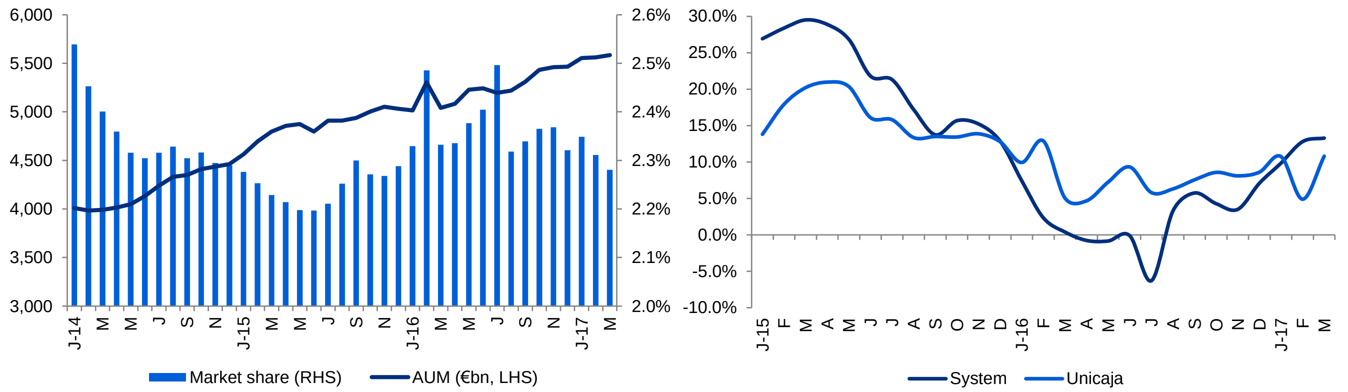
Figure 88: System net inflows improving in 2017, following weakness in 2016



Source: Bank of Spain, Inverco, KBW Research

AUM in Spain has been growing at 13% YoY following a period of flat to negative growth in 1H16. At the start of 2015, YoY growth rates were higher at almost 30%, a similar level to 2014 where growth averaged 30%. Unicaja has also experienced strong growth in AUM, with the latest data pointing to 10% YoY growth. We would note that AuM growth has been relatively resilient. While the system saw periods of declining AUM in 2016, Unicaja was still able to grow, albeit at relatively low levels.

Figure 89: Unicaja has grown AUM, while market share of 2% is relatively low



Source: Bank of Spain, Inverco, KBW Research

Strategy & targets

Unicaja is looking to increase fee and commission income by growing in higher margin products and increasing penetration in markets where it is below its natural market share. While fees are expected to grow together with increased volumes, management's focus is on increasing revenues from the distribution of asset management and insurance products and growing collection & payment service fees.

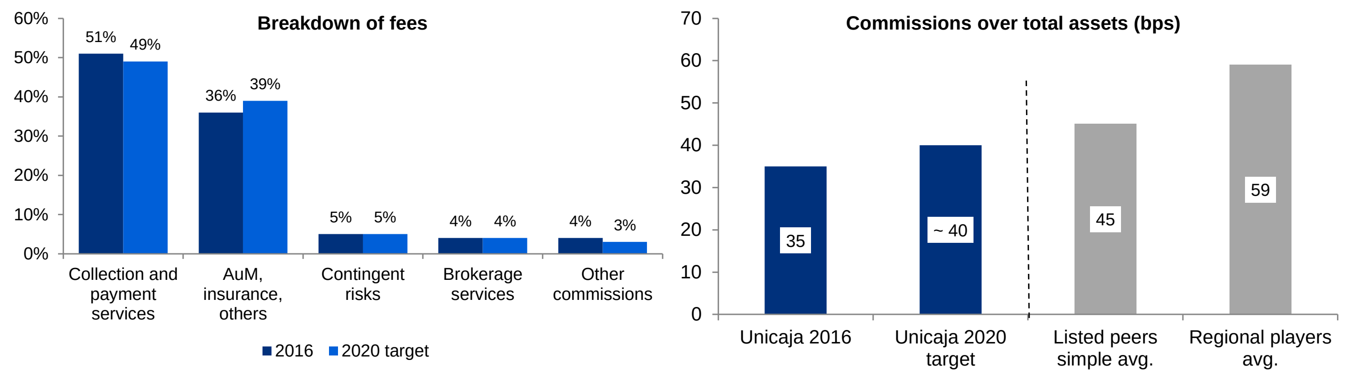
Figure 90: Summary of key management targets (2020e)

Target	2016	2020e
Commissions / Total assets	35bps	~40bps
Fees from payment services / sight deposits	52bps	Around current levels
AuM and distribution of non-banking services	6% CAGR (2012-16)	~10% CAGR
Off-balance assets / Client resources	24%	~29%
% fees from non-banking products (AuM, Insurance)	36%	39%
% fees from payment services	51%	49%

Source: Company data, KBW Research

In terms of mix, the bank expects to increase the weight of income from asset management and insurance products, which generate higher margins, from 36% of fees to 39% by 2020. Growing, collection & payment service fees are expected to contribute 49% of income versus 51% in 2016. As a result of both increased margins and volumes, fee and commission income as a percentage of total assets is expected to increase in c.40bps compared to 35bps currently.

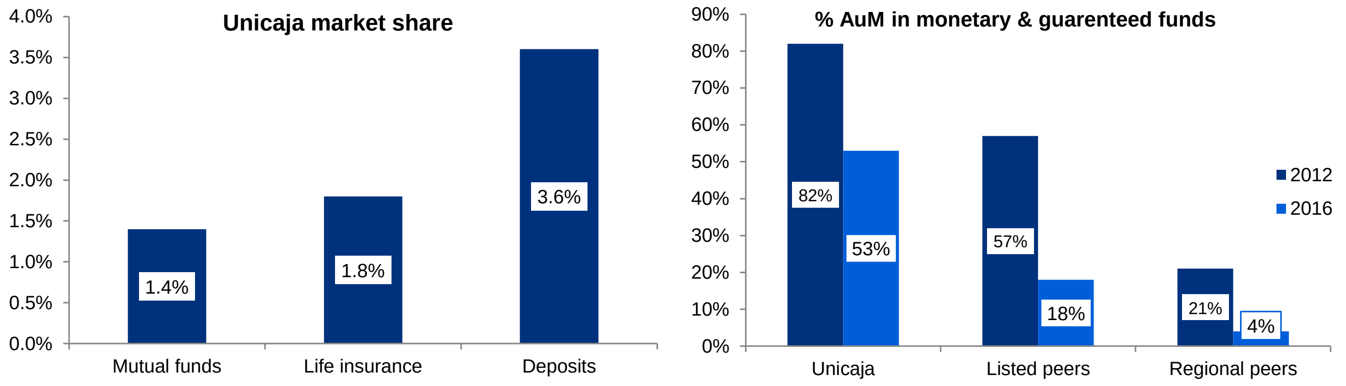
Figure 91: Targets for fees and commissions



Source: Company data

Unicaja's market share in mutual funds and life insurance products is low relative to its natural market share in deposits. In mutual funds, it has 1.4% of the market and in life insurance a 1.8% share, compared to its deposits market share of 3.6%. Whilst looking to grow market share, Unicaja will also look to decrease the proportion of AuM in lower margin monetary and guaranteed funds and achieve similar levels of AuM mix to peers. Fifty-three percent of Unicaja's AuM consist of guaranteed products, compared to listed peers at 18% and regional peers at 4%.

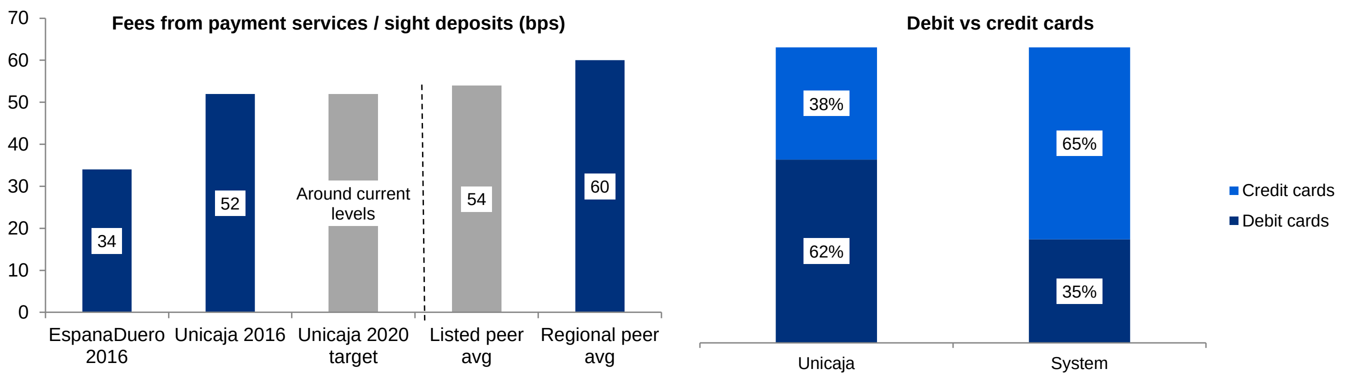
Figure 92: Potential to increase market share in asset management and life insurance products



Source: Company data

Fees from payment and collection services are expected by Unicaja to grow through increased volumes and improvement in fees at EspañaDuero, where margins are currently below Unicaja's. While competitive pressure exists in services, margins (fees as a percentage of sight deposits) are expected to remain at around current levels. This is due to management's focus on increasing margins at EspañaDuero, which are currently at 34bps, to similar levels to Unicaja at 52bps. And second, by increasing product penetration in areas where there is currently a gap compared to market levels, such as cards.

Figure 93: Payment and collection fee targets



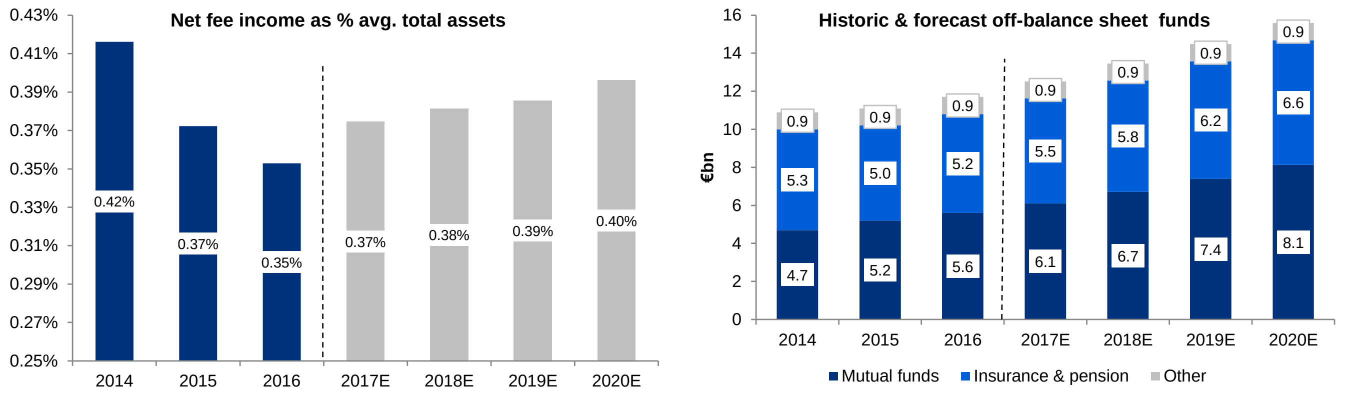
Source: Company data

Unicaja has a significantly higher mix of debit cards issued to clients versus credit cards when compared to the Spanish banking system. Of the 1.7m cards Unicaja has issued, 38% are credit cards (versus 65% for the system) and 62% debit cards (versus 35% for the system). Credit cards generate higher fees of €86 on average per card compared to debit cards at €15. Unicaja intends to increase the mix of credit cards and plans to issue 200k credit cards by 2020.

KBW outlook for fee income

We forecast net fee income to grow to €235m in 2020e compared to €207m in 2016, a CAGR of c. 3%. The key drivers are higher fee income from the distribution of off-balance sheet products and increased service fees from collections and payments. We estimate that fee margins (net income as a percentage of average total assets) will increase to 40bps in 2020e compared to 35bps in 2016.

Figure 94: KBW estimates for fee margins and off-balance sheet funds



Source: KBW estimates

We expect growth in AuM and insurance to increase fees from non-banking products to €83m in 2020e versus €63m in 2016. We estimate off-balance sheet funds will grow by 33% to reach €15.6bn in 2020e, increasing from €11.7bn in 2016 (CAGR of 7.4%). Within our estimates, we expect mutual funds to grow at 10% p.a. and insurance and pension funds to grow at 6% p.a. Given our expectations of 23% growth in sight deposits to 2020, we estimate fees from collection and payment handling will increase to €146m from €115m in 2016.

Figure 95: Fee income – actuals and KBW estimates

Key Model Drivers	2014 A	2015 A	2016 A	2017 E	2018 E	2019 E	2020 E
Change in Net Fee Income	65.9%	5.1%	-13.1%	3.4%	2.4%	2.4%	4.9%
Sight deposits y-o-y	131.8%	17.5%	10.7%	8.0%	5.0%	5.0%	5.0%
Collection fee / sight deposits	0.73%	0.61%	0.51%	0.52%	0.52%	0.52%	0.52%
Mutual funds y-o-y		10.6%	7.7%	9.0%	10.0%	10.0%	10.0%
Mutual fund margin			0.3%	0.27%	0.27%	0.27%	0.27%
Insurance & pension funds y-o-y		-5.7%	4.0%	6.0%	6.0%	6.0%	6.0%
Insurance fee margin			0.9%	0.93%	0.93%	0.93%	0.93%
Off-balance sheet funds y-o-y		1.8%	5.4%	7.0%	7.5%	7.6%	7.7%
Off-balance sheet fee margin	0.59%	0.76%	0.54%	0.54%	0.54%	0.54%	0.53%
Securities fee y-o-y	20.3%	56.9%	-45.6%	3.0%	2.0%	2.0%	2.0%
Risk fees y-o-y	139.9%	-35.1%	9.1%	3.0%	2.0%	2.0%	2.0%
Commission cost / income	-9%	-13%	-8%	-10%	-12%	-14%	-14%
Net fee income / ATA	0.42%	0.37%	0.35%	0.37%	0.38%	0.39%	0.40%

Fee income	2014 A	2015 A	2016 A	2017 E	2018 E	2019 E	2020 E
Risk operations	*10*	*10*	*8*	8	8	8	8
Collection and payment handling	*126*	*123*	*115*	126	132	139	146
Securities services	*31*	*48*	*26*	27	27	27	27
Non-banking products	*64*	*84*	*63*	68	72	78	83
Mutual fund & other fee			*15*	17	18	20	22
Insurance fees			*48*	51	54	57	61
Other	*20*	*9*	*13*	*10*	*10*	*10*	*10*
Total	*250*	*275*	*226*	238	250	262	274
Commissions paid	*-23*	*-36*	*-18*	-24	-30	-37	-38
Net Fee Income	227	239	207	215	220	225	236
% change	*65.9%*	*5.1%*	*-13.1%*	*3.4%*	*2.4%*	*2.4%*	*4.9%*

Source: Company data, KBW Research

Associate companies – insurance

Unicaja generated €101.9m from insurance in 2016. €53.7m was generated from stakes in insurance business and €48.2m in fees from the distribution of insurance products through both Unicaja and EspañaDuero's network. Unicaja holds stakes in three insurance companies. Unicorp Vida generated the highest level of insurance income in 2016, where Unicaja has a 50% direct holding with a book value of €82m. Unicaja also has an 34.7% indirect holding in Caja Espana Vida through EspañaDuero (which holds 50%). The business has a book value of €125m and generated €16.2m of insurance income in 2016. Similarly Unicaja also indirectly owns 34.7% of Union Duero Vida & Duero Pensiones (EspañaDuero holds 50%), which has a BV of €109m and contributed €11.2m.

Figure 96: Insurance income and fees

Insurance business	Unicaja holding	BV €m	Pre-tax income €m
Unicorp Vida	50.0%	82	26.4
Caja Espana vida	34.7%	125	16.2
Union Duero Vida & Duero Pensiones	34.7%	109	11.2
Total life and pensions		315.9	53.7

Insurance Distribution	€m
Unicaja's network	24.0
EspanaDuero's network	24.2
Total fees & commissions	48.2

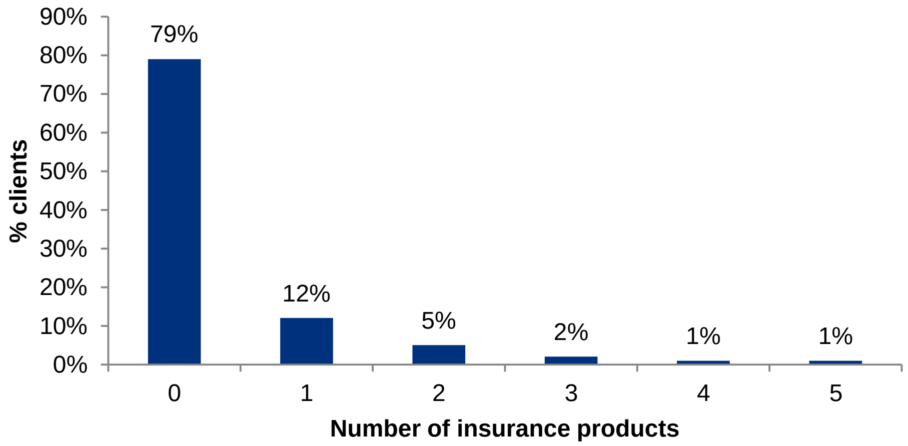
Source: Company data, KBW Research

In May 2017, as part of its reorganization of the insurance business, Unicaja terminated its distribution agreement with Aviva, which was bought by Santa Lucia S.A. Unicaja has signed an agreement to develop and distribute Pension Plans and life insurance products with Santa Lucia on an exclusive basis through the Unicaja and EspañaDuero network. Santa Lucia is one of the largest insurance companies in Spain with 95 years of experience, €5.0bn of assets under management, €1.3bn in premiums and c.1m home insurances policies. Unicaja has stated that it will cover the valuation difference between the price agreed by Santa Lucia and Aviva. This should generate a negative impact of c. 20m in 2017 (this is not yet included in our estimates).

The insurance subsidiaries of EspañaDuero, which were classified available for sale in 2016, are currently under strategic review. This could see Unicaja retain 100% in both companies. Alternatively we believe Unicaja could consider selling a 50% stake to an insurance partner. Unión Duero Vida and Unión Duero Pensiones are currently partnered with Mapfre. Assuming Unicaja were to fully buy out Mapfre, this would generate an additional negative impact of €30m on net income, as well as a 20bp negative impact on capital (from additional regulatory deductions arising from ownership of insurance subsidiaries).

Unicaja believes it has the potential to increase sales of insurance products to its client base. The number of clients with either no or a limited number of insurance products is high. Seventy-nine percent of Unicaja's customers have no insurance products, while a further 12% only have one product. Customers with more than one or multiple insurance products total 9% of the client base.

Figure 97: Potential to increase client penetration



Source: Company data, KBW Research

Non-insurance associates

In Figure 98, we present the five largest non-insurance associates and joint ventures by book value. Hidralia, a water company, is the largest with a book value of €48m at 31 December, 2016, and contributing €4.5m to Group earnings. Banco Europa de Finanzas with a book value of €39m is a joint-venture based in Andalucia where both Caixabank (39.5% holding) and Banco Mare Nostrum (19.8%) are also shareholders. Unicaja also has holdings in Deoleo, a food company, and two highway companies with a combined book value of €74m and a combined negative contribution to earnings of €5.6m in 2016.

Figure 98: Selected associate companies and joint-ventures

Associates and JVs	Book value	Earnings contribution	Unicaja holding	Activity
Hidralia, Gestión Integral de Aguas de Andalucía, S.A.	48.3	4.5	35% (indirect)	Water industry
Banco Europeo de Finanzas, S.A.	38.7	0.0	41% (o/w 39.5% indirect)	Financial institution
Deoleo, S.A.	37.7	-3.2	10%	Food industry
Autopista del Sol, Concesionaria España, S.A.	22.1	-1.0	20%	Highways
Autopista del Guadalmedina, Concesionaria Española, S.A.	14.2	-1.4	30%	Highways

Source: Company data, KBW Research

Managing mortgage floors

In May 2013, the Spanish Supreme Court ruled against BBVA, Cajamar and NCG in a case relating to mortgage contracts with 'interest floor' clauses where there is a lack of transparency, rendering the clauses null and void. The ruling did not definitively apply to all floor clauses or to all other banks. There has been no definitive ruling against Unicaja, which has declared its clauses to be generically null and void. Any retroactive action had been taken on individual basis and was initially limited to the date of the ruling on May 2013. Subsequently, the European court of justice ruled in December 2016 that time limits on repaying customers for mortgage floors are illegal. In January 2017, a Royal Decree was issued, establishing a negotiation and claim process. Spanish banks, including Unicaja, may offer clients compensation, although this may be non-cash compensation such as re-negotiating the mortgage contracts or offering deposit accounts with favorable terms. If clients do not accept the offer, they may subsequently appeal through the courts, which might result in higher legal costs over time. We believe the current political and judicial environment in Spain will limit the potential impact for banks.

Figure 99: Unicaja exposure to mortgage floors (31/12/16)

Type of floor	Exposure	Max impact	Company view
Mortgage loans with active clauses	€3.6bn	€371m	Clauses in force, not renegotiated, not doubtful, not affected by sentence
Subrogated mortgages	€1.1bn	€119m	Terms of these loans were agreed with a third party, as such Unicaja expect a lower final impact
Cancelled loans		€39m	Unicjaja expect a very limited impact given the high density of loans close to their amortization or with very low amount for claim
Loans that have already been the subject of a binding judgment of a Spanish court	€0.8bn	€38m	Final impact expected to be very limited owing to the basic principle of 'res judicata' under Spanish law
NPLs	€1.1bn	€59m	In most of these cases the relevant clause was not activated and, even when the clause is active, the amount to be refund would apply to pay part of the loan itself
Renegotiated loans	€4.0bn	€274m	Unicaja expect potential risk should be limited, since negotiations have been carried out with full knowledge of the client of the content of the floor clause, with its express agreement, in simple and clear terms
Total (max.)		€0.9bn	
Provisions		€392m	

Source: Company data, KBW Research

In Figure 99, we present Unicaja's exposure to mortgages with floor clauses. Unicaja currently has €3.6bn of mortgage loans with active clauses in force. The maximum exposure of these mortgages to full retroactivity would be €371m. In addition Unicaja has exposure to mortgages where it expects a lower impact. These include renegotiated mortgages where the client has given express agreement that he/she understood the content of the floor, subrogated mortgages where the terms were agreed with a third party, and NPLs. Unicaja had booked provisions of €392m as at 31 December, 2016, to cover the potential risks. Following a €0.3bn reduction in mortgages with floors during Q1, provisions now stand at €370m. Unicaja has separately sought independent analysis from a specialist (EY) aimed at ensuring that the mortgage floors provisions booked are sufficient to cover any reasonably expected payouts. In this regard, the analysis performed by the specialist leads to a mid-point which is in line with the existing €370 million provisions at 31 March, 2017.

Headwind to NII as floors renegotiated

Unicaja's floor clauses are activated on average with an interest rate of 3.15%. The floor clauses contributed an additional €130m of NII in 2016 and Unicaja expects it to contribute less than €100m in 2017. We would note that Unicaja has already factored the removal of floors from its mortgage contracts in its business plans. In Figure 100 below we show a scenario analysis where we assume the €3.6bn of mortgages with active floors at 31 December, 2016, are renegotiated at Unicaja's front-book rate. We estimate that if mortgages with active floors are renegotiated at Unicaja's current front book yield (for a mortgage with no floor), a differential of 112bps, it would result in a €40m headwind to NII.

Figure 100: Scenario analysis – potential impact on NII from renegotiating floors

	€m
Mortgages with active floors (31/12/16)	3600
Avg interest rate floor	3.15%
NII	113
Front book mortgage yield (1Q17)	2.03%
NII	73
Difference	40

Source: KBW Research

Appendix: KBW earnings forecasts

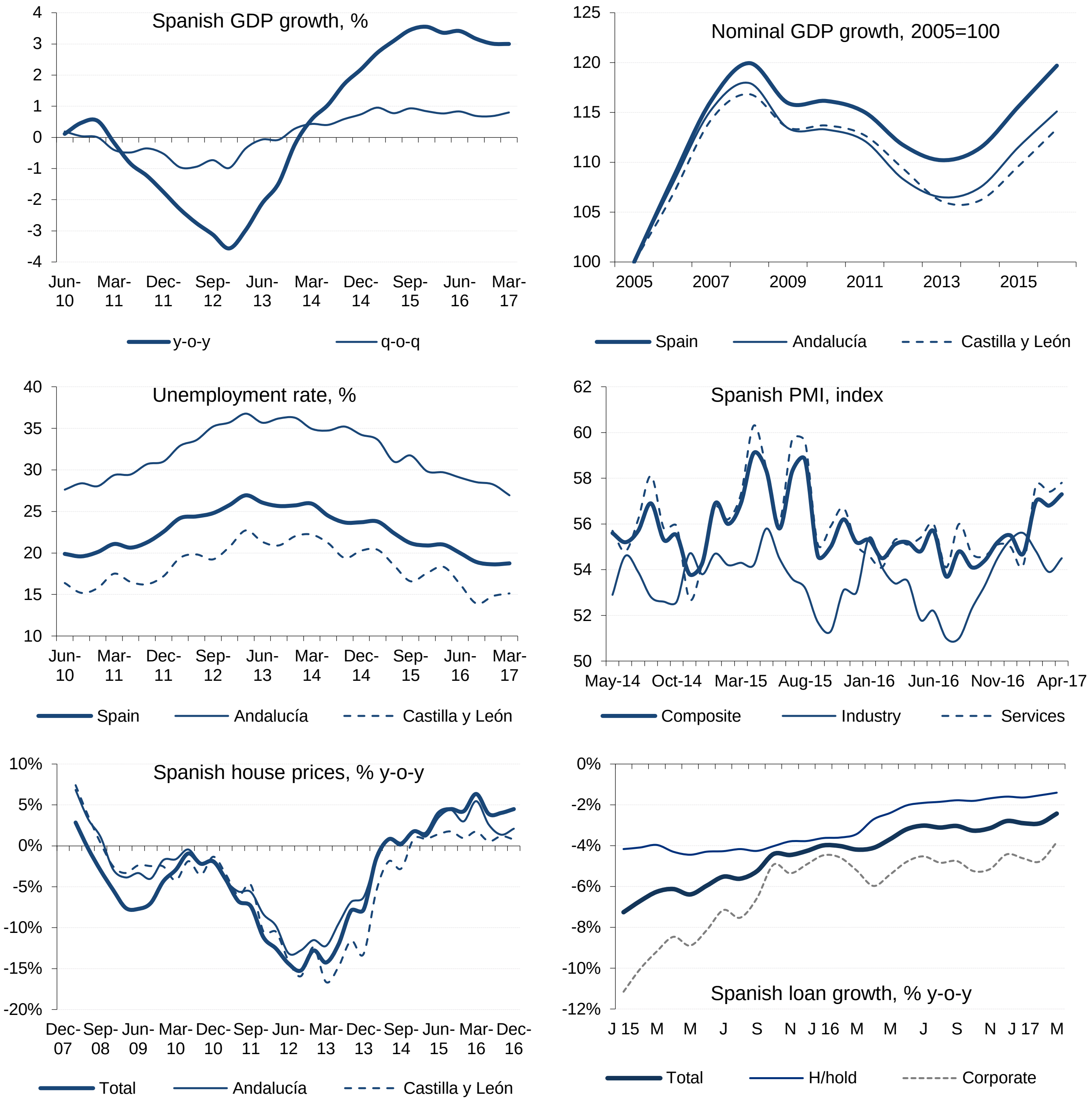
Figure 101: Unicaja's recent results and KBW earnings estimates

Unicaja	2014 A EURm	2015 A EURm	2016 A EURm	2017 E EURm	2018 E EURm	2019 E EURm	2020 E EURm
Net Interest Income	719	688	620	576	615	617	666
% change		*-4.3%*	*-9.9%*	*-7.0%*	*6.8%*	*0.2%*	*8.0%*
Dividends	36	35	27	23	17	23	28
Net Income Equity Method	11	24	35	50	40	45	48
Net Fee Income	227	239	207	214	219	224	235
% change		*5.1%*	*-13.1%*	*3.2%*	*2.4%*	*2.4%*	*4.9%*
Other net income	-40	25	121	39	-28	-28	-22
Trading Income	393	564	78	87	20	20	20
Total Revenue	**1,347**	**1,575**	**1,089**	**990**	**884**	**901**	**976**
% change		*17.0%*	*-30.8%*	*-9.1%*	*-10.7%*	*2.0%*	*8.3%*
General Admin Expenses	-584	-634	-611	-584	-550	-528	-521
Depreciation and Amortisation	-44	-47	-45	-45	-45	-45	-48
Total Costs	**-628**	**-681**	**-656**	**-629**	**-595**	**-573**	**-569**
% change		*8.5%*	*-3.7%*	*-4.1%*	*-5.4%*	*-3.7%*	*-0.7%*
Operating Income	**718**	**894**	**433**	**361**	**289**	**329**	**407**
% change		*24.4%*	*-51.5%*	*-16.7%*	*-20.0%*	*13.8%*	*24.0%*
Net Loan Loss Provisions	-325	-427	-84	-90	-83	-85	-91
Other Provisions	-148	-145	-104	-30	-30	0	10
Other	229	-104	-54	-105	-25	0	0
Pre-tax Profit	**475**	**217**	**191**	**136**	**150**	**244**	**327**
Corporate Income Tax	-48	-57	-66	-24	-42	-72	-93
Net Income	**427**	**160**	**125**	**112**	**109**	**172**	**233**
Discountinued / other	21	24	10	0	0	0	0
Minority interests	27	3	7	10	0	0	0
Net Attributable Income (stated)	**475**	**187**	**142**	**122**	**109**	**172**	**233**
% change		*-60.7%*	*-23.9%*	*-14.4%*	*-10.5%*	*58.0%*	*35.5%*
EPS stated (€)	0.51	0.20	0.15	0.08	0.07	0.11	0.15
EPS adjusted - (€)	0.51	0.20	0.15	0.10	0.07	0.11	0.15
DPS (€)	0.00	0.00	0.02	0.01	0.02	0.04	0.07
Stated equity per share	3.2	3.1	3.2	2.5	2.5	2.6	2.7
Net Asset Value per share (adjusted)	3.2	3.1	3.2	2.5	2.5	2.6	2.7
Main Balance Sheet Measures							
Shareholders' Equity	2,966	2,834	2,953	3,845	3,936	4,075	4,248
Net Lending	36,552	33,894	31,286	31,216	31,823	32,708	34,189
% change yoy	*60.0%*	*-7.3%*	*-7.7%*	*-0.2%*	*1.9%*	*2.8%*	*4.5%*
Customer Deposits	49,171	49,537	48,532	48,961	49,788	50,928	52,198
Assets Under Management	10,938	11,072	11,635	11,984	12,344	12,714	13,095
Risk Weighted Assets	30,308	27,108	25,188	25,093	25,582	26,328	26,969
NPLs	4,814	3,556	3,215	2,926	2,633	2,423	2,059
Foreclosed real estate	2,567	2,699	2,588	2,458	2,262	2,036	1,628
Total NPAs	7,381	6,255	5,803	5,384	4,895	4,458	3,688
Efficiency							
Net Interest Margin	1.32%	1.07%	1.05%	1.01%	1.07%	1.06%	1.12%
Customer spread		2.10%	2.05%	1.85%	1.93%	2.00%	2.10%
Cost-Income Ratio (inc depn and other costs)	46.6%	43.3%	60.2%	63.5%	67.3%	63.5%	58.2%
Cost-Income Ratio (ex depn)	43.4%	40.3%	56.1%	59.0%	62.2%	58.5%	53.3%
Effective Tax Rate	10.0%	26.4%	34.6%	18.0%	27.6%	29.4%	28.6%
RoRWA	1.41%	0.56%	0.48%	0.44%	0.43%	0.66%	0.87%
RoA	0.78%	0.25%	0.21%	0.19%	0.19%	0.29%	0.39%
RoE (stated)	19.0%	6.4%	4.9%	3.6%	2.8%	4.3%	5.6%
RoE (adjusted)	0.0%	6.4%	4.9%	3.6%	2.8%	4.3%	5.6%
Asset Quality							
Non-performing loans/Gross lending	12.2%	9.8%	9.6%	8.8%	7.8%	7.1%	5.8%
Coverage of non-performing loans	62%	66%	62%	62%	64%	64%	66%
Net LLP/Gross Loans (average)	1.02%	1.13%	0.24%	0.27%	0.25%	0.25%	0.26%
Write-offs as % last year's NPLs		17.9%	8.9%	8.0%	8.0%	8.0%	8.0%
NPA ratio	17.5%	16.0%	16.2%	15.1%	13.7%	12.3%	9.9%
NPA coverage	60.0%	57.8%	55.4%	55.3%	56.7%	57.7%	56.9%
Capital - Group:							
Fully loaded B3 CET1	10.3%	11.1%	11.8%	12.1%	12.2%	12.3%	12.5%
Texas ratio	100%	97%	94%	79%	73%	67%	58%

Source: Company data, KBW estimates

Appendix: Spanish economic overview

Figure 102: Summary economic indicators



Source: Bloomberg, Bank of Spain, INE, KBW Research

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Risks to our price targets include, but are not limited to, economic conditions in Spain and Europe

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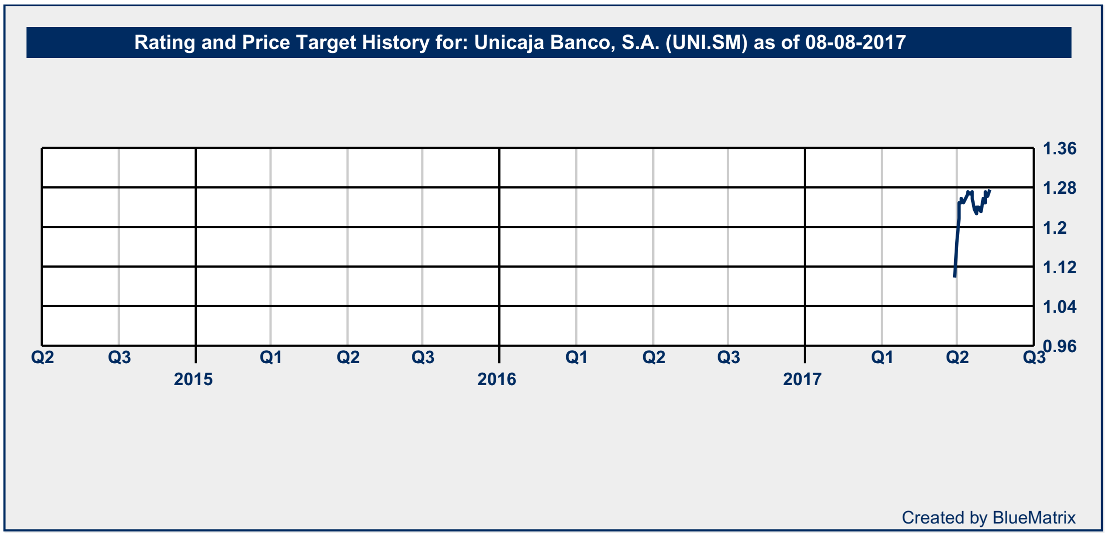

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