Generali

Overview of Assicurazioni Generali

- **We recommend being Overweight Generali versus Italian banks under the assumption that Italian government bonds do not receive a haircut. In a muddle-on-through scenario Generali senior debt looks relatively cheap to the senior debt of Italian banks which are likely to be more exposed to a low growth environment in Italy.** Whilst both banks and insurers are likely to remain highly correlated to the sovereign, we believe that Generali's diversification across multiple European countries as well as into CEE will put it in good stead in comparison to the banks like ISPIM that have a more domestic focus. We caveat that due to the long dated nature of Generali's government bond holdings, an Italian sovereign haircut would result in significant losses given that holdings represent 311% of shareholders equity. In our opinion, this is unlikely given the financial repercussions of a haircut on the wider European Economic Area.
- **We remain Neutral on Generali within the insurance sector (Senior CDS 274/284) given its primary revenue stream (30% of 2011 Gross Written Premiums) continues to come from Italy, which is likely to face a tougher economic environment than the likes of the UK or Germany for example.** However, we expect that there is potential to tap the growing non-life markets in Germany and CEE which should partially offset a weaker performance out of Italy. We view Generali's solvency position as adequate; however, we expect that management could announce some strategic decisions that could provide for shorter term outperformance if these measures are deemed credible to substantially raise Generali's solvency levels over the medium term.
- **Although highly correlated with each other we prefer the ASSGEN 6.416% £22P from the selection of Generali Tier I instruments because we believe current trading levels compensate the investor for our worst case redemption scenario at 2025 whilst still providing for potential upside in an earlier than expected call.** More generally the Tier I instruments seem fair value given the lack of a proven “track record” for the calls of insurance institutional Tier I instruments. We expect that current insurance hybrids that do not contain mandatory deferral language referencing the SCR will no longer be able to contribute to either Tier I or Tier II capital levels following the end of the grandfathering period. As such, we would price the Generali hybrids to 2025 at worst (assuming 1yr delay in Solvency II entry to 1st Jan 2015) when we would expect non compliant instruments to be refinanced for compliant Tier I or Tier II instruments.

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Prices in this report as of COB 10/10/12.

With this report, we transfer coverage of Generali to Alan Bowe

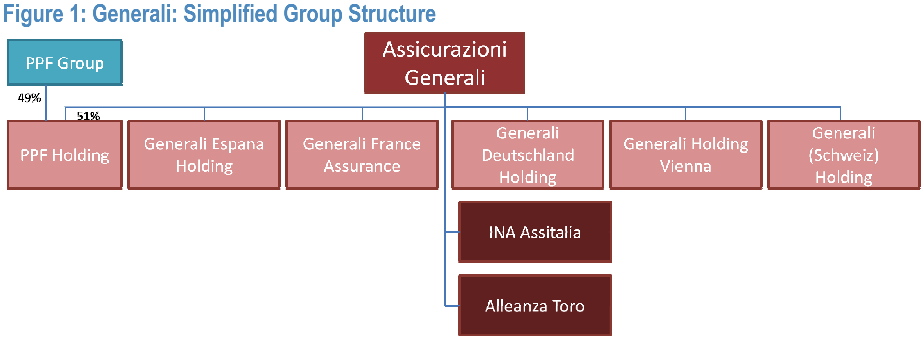
See page 25 for analyst certification and important disclosures.

Assicurazioni Generali

The group's Gross Written Premiums (GWP) are skewed towards its life business

Assicurazioni Generali was founded in 1831 in Trieste and is now a diverse global insurer with a diverse product range. Figure 1 highlights a simplified group structure for Generali with its main holding companies that operate (from right to left) in CEE, Spain, France, Germany, Austria and Switzerland. The group's core business focus is on life insurance where it offers savings and protection policies, amongst other products. In 2011, life products represented 65% of gross written premiums with non life products representing 35%. We note that the non life contribution to premiums has gradually been increasing as Generali continues to grow its non life business and life products face increasing competition from banking products. In addition, Generali offers financial and real estate services as well as asset management.

Figure 1: Generali: Simplified Group Structure



Source: Company reports and J.P. Morgan.

Recommendations

We expect insurance with exposure to stronger economies to perform better in the medium term

We remain Neutral on Generali within the insurance sector (Senior CDS 274/284) given its primary revenue stream (30% of 2011 Gross Written Premiums) continues to come from Italy which is likely to face a tougher economic environment than the likes of the UK or Germany. However, we expect that there is potential to tap the growing non-life markets in Germany and CEE which should partially offset a weaker performance out of Italy. We view Generali's solvency position as adequate; however, we expect that management could announce some strategic decisions that could provide for shorter term out performance if these measures are deemed credible to substantially raise Generali's solvency levels over the medium term. Some of these expected measures are discussed below.

In a muddle-on-through scenario we expect Generali's broad diversification to help mitigate austerity in Italy

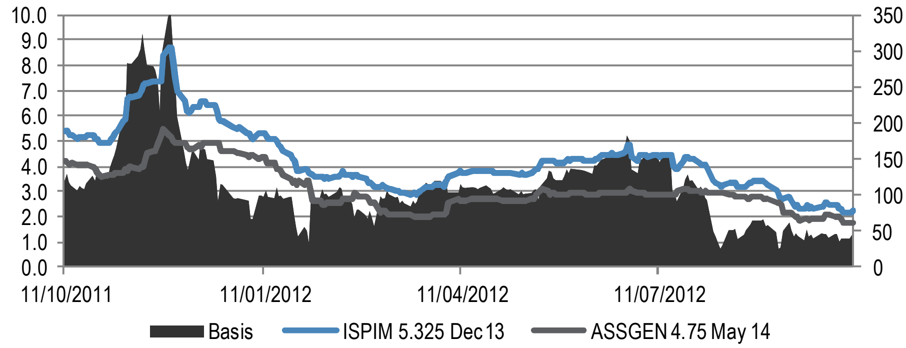
We recommend being Overweight Generali versus Italian banks under the assumption that Italian government bonds do not receive a haircut. In a muddle-on-through scenario Generali senior debt looks relatively cheap to the senior debt of Italian banks which are likely to be more exposed to a low growth environment in Italy. Whilst both banks and insurers are likely to remain highly correlated to the sovereign, we believe that Generali's diversification across multiple European countries as well as into CEE will put it in good stead in comparison to banks like ISPIM that have a more domestic focus. We caveat that due to the long dated nature of Generali's government bond holdings, an Italian sovereign haircut would result in significant losses given that holding represents 311% of shareholders' equity. In our opinion, this is unlikely given the financial repercussions of a haircut on the wider European Economic Area.

Table 1: Generali: Senior Debt

ISIN	Issuer	Coupon	Maturity	Amt	Ccy	Spread
XS0097245244	GENERALI FINANCE BV	4.75	12/05/2014	1500	EUR	162
XS0416215910	ASSICURAZIONI GENERALI	4.875	11/11/2014	750	EUR	195
XS0218469962	GENERALI FINANCE BV	3.875	06/05/2015	500	EUR	168
XS0452314536	ASSICURAZIONI GENERALI	5.125	16/09/2024	1750	EUR	390

Source: Company reports.* Guaranteed by Parent Company

Figure 2: ISPIM 5.325% Dec 13 versus ASSGEN 4.75% May 14 (% - LHS, bp –RHS)

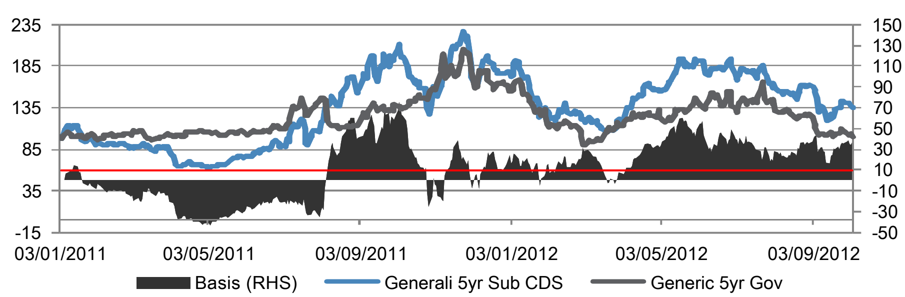


Source: Company reports.

We highlight that Generali Sub debt has underperformed Italian government bonds since the start of 2011. However, in our opinion, the actions taken by the ECB should continue to remove tail risks from Italian financial institutions, and as such this relative underperformance should correct. Furthermore, credible strategic decisions designed to improve the long-term solvency position of Generali are likely to help compress spreads over the medium term, with increased focus on growth of non-life products in Germany and CEE likely to offer support against a deteriorating Italian economic outlook.

Figure 3: Generali 5yr Sub CDS versus Generic 5yr Govt bond, rebased to 100, Jan 2011.

bp



Source: Bloomberg

ASSGEN 6.416% £22P compensates investors for our worst case redemption scenario.

Tier I

Although all highly correlated with each other, we prefer the ASSGEN 6.416% £22P and ASSGEN 8.5% €19P (illiquid) from the selection of Generali Tier I instruments because we believe current trading levels compensate the investor for our worst case redemption scenario whilst providing for potential upside in an earlier than expected call. We expect that current insurance hybrids that do not contain mandatory deferral language referencing the SCR would no longer be able to contribute to either Tier I or Tier II capital levels following the end of the grandfathering period. Whilst we view the 10yr non amortising grandfathering period expected for insurance capital instruments as highly generous, following the end of this grandfathering period it is likely that insurers would want to replace legacy instruments with compliant instruments. As such, we would price the Generali hybrids to 2025 at worst (assuming 1yr delay in Solvency II entry to 1st Jan 2015). We note that any issuance by Generali of a perpetual would be taken as a positive sign even if it were a Solvency I instrument that would ultimately be grandfathered. There is little "track record" for institutional Tier I instruments to date; however, in our opinion, increased capital market activity suggests an issuer is more likely to be investor friendly than not.

Tier II debt refinancing at uneconomical levels will continue to provide support for the Tier I instruments

We highlight that the decision to call and refinance Tier II debt provides support for the Tier I instruments which currently trade at a discount to the call date. Furthermore, given current trading levels of Generali Tier II debt, Generali could feasibly refinance the Tier I hybrids by issuing Tier II debt at an incremental cost of €143m (difference between average coupon on Tier I and trading level of Tier II). However, although still feasible the opportunity cost would be much higher than this given the average back end spread is circa 240bps.

Table 2: Generali: Subordinated Debt

Tier	ISIN	Issuer	Coupon	Cal Date	Maturity	Amt	Ccy	Back End	Px	SpTC	ZT25
T1	XS0256975458	GENERALI FINANCE BV*	5.317	16/06/2016	Perp	1275	EUR	+210	78.0	1309	577
T1	XS0256975888	GENERALI FINANCE BV*	6.214	16/06/2016	Perp	700	GBP	+208	71.0	1640	743
T1	XS0283629946	GENERALI FINANCE BV*	5.479	08/02/2017	Perp	1250	EUR	+214	76.75	1268	637
T1	XS0416148202	ASSICURAZIONI GENERALI	8.5**	06/03/2019	Perp	350	EUR	+609	83.2	1215	942
T1	XS0283627908	ASSICURAZIONI GENERALI	6.416	08/02/2022	Perp	495	GBP	+220	68.0	1042	920
T1	XS0257010206	ASSICURAZIONI GENERALI	6.269	16/06/2026	Perp	350	GBP	+235	67. 0	880	n/a
T2	XS0802638642	ASSICURAZIONI GENERALI	10.125	10/07/2022	10/07/42	750	EUR	+918.1	109.0	782	911

Source: Company reports.* Guaranteed by Parent Company, €1.5bn of private placements, **illiquid. Priced as of cob 10/10/12.

Strategic update

As of the August 1, 2012, Mario Greco was officially appointed Group CEO of Generali. We understand the new CEO has undertaken a full strategic and financial review of Generali in light of current market conditions. We expect that one of the key subjects will be on solvency levels given the weakness, exposed by the sovereign debt crisis, to large swings in AFS reserves, especially given the transition to Solvency II expected with the next 1-2yr period (depending on delays). We look at the following potential options with regards to increasing solvency on a forward looking basis.

ESR based on a 99.5% confidence level whilst not perfect is a good indication of where their SII SCR ratio would be.

Dividend management

In our opinion a payout ratio of 40% may not be compatible with an Economic Solvency Ratio (ESR) (99.5% confidence) of 151% or a Solvency I ratio of 130% given the expected low interest rate environment and worsening European economic outlook. As such we would expect an adjustment of the payout ratio that better reflects a more conservative approach to capital retention. For example if they were to halve their payout ratio, based on the 1H 2012 run rate this could improve Generali's Solvency I ratio by 2ppts.

Divestments

Update on Sale of BSI – Banca de Gottardo – book value of €2.3bn and goodwill of €555.7m as of 1H 2012.

We expect Generali to continue to consider divestments as a method to improve efficiency and potentially improve solvency. We note the recent agreement to sell Migdal, Generali's Israeli insurance operations, to Eliahu Insurance Company for €705m. This is expected to improve Generali's Solvency I ratio by 2.2ppts once the deal closes by the end of October. We expect there to be an update with regards to the potential sale of Generali USA and BSI, and also a strategic update with regards to the future of the PPF joint venture. We note that if Generali and PPF fail to agree an extension to their joint venture then Generali would face a difficult decision with regards to the future of the PPF business.

We note insurers have been attempting to sell capital intensive US life businesses in the face of SII concerns. EIOPA has been assessing those regulatory regimes which will be treated as "equivalent" for the purposes of SII. However, given the state-level regulation of insurance in the US, a bespoke approach to the US is required with the scope and the shape of any transitional regime for the US yet to be decided. It seems as though European insurance companies have opted for an easier route involving divesting their US operations. For example, Aviva has been attempting to sell its US life insurance business and in May, Swiss Re sold its capital-intensive US closed life assurance business for $600m to Jackson National Life Insurance. We expect there to some focus on asset sales to avoid the need to raise capital in the open market.

Portfolio

Risk reduction in financials via switches into covered bonds out of senior unsecured

We highlight Generali's move to increase the weight of covered bonds versus financial senior unsecured bonds. We would expect this trend to continue, although perhaps at a slower pace than previously. This strategy should have multiple benefits for the company from a risk and solvency perspective; however, it is likely to reduce income on the investment portfolio. From a risk perspective, the average rating of covered bonds is AAA and ratings are expected to remain stable, this is in contrast to the average single A rating of senior unsecured financial bonds. Furthermore, we expect that with the implementation of resolution and recovery regimes across

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Covered bonds are likely to have a more stable ratings profile over the medium term

Europe, it is likely that we continue to see further downgrades of senior unsecured bank bonds as the systemic support notching is reduced by rating agencies. (See "The Great Bank Downgrade" series of publications, latest publish on 2nd April 2012). Under this scenario we believe a strategic move to increase the allocation to covered bonds would benefit Generali in the long run and should also attract a lower capital charge under Solvency II.

We note Generali has moved to reduce cross-border exposures between portfolios and operations in separate jurisdictions. We expect this to also benefit Generali under Solvency II and their economic capital model. This will come from the reduction of risk capital that Generali allocate where government bonds are held cross border. As of 1H 2012, the cross border exposure reduced by €9bn to €13bn and this released €200m in associated risk capital; therefore, the expected improvement from this avenue is fairly limited.

Rights Issue

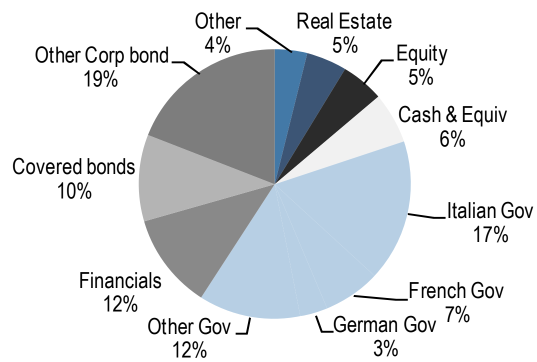
Though this could be an obvious route to improve solvency we believe that management will pursue alternative routes such as those mentioned above in order to avoid a capital call from investors. We note that recent comments made at 1H 2012 results would suggest this to be the case.

Investment Portfolio

Generali has a similar amount of allocation to financials as other European insurers

Generali continues to maintain relatively high cash balances in comparison to other multiline insurers, and with continued growth opportunities in the non-life sector we would expect this to remain the case. The gearing towards financials makes up more than 50% of its "corporate" bond portfolio; however, as we highlight below the quality of their financials book has improved over the past few periods.

Figure 4: Generali: Investment portfolio



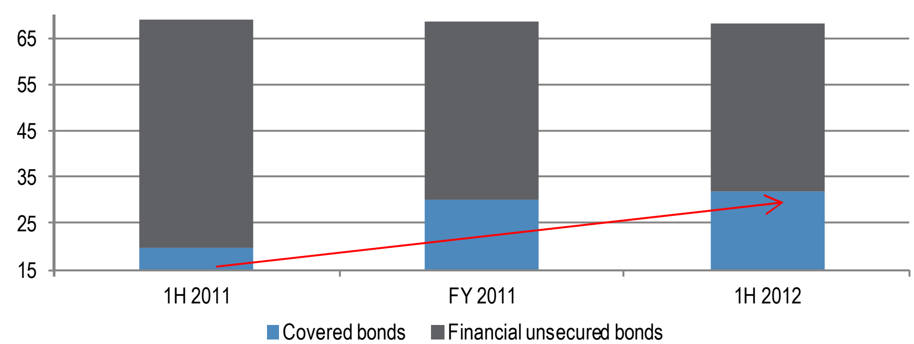
Source: Company reports. 1H 2012

Increasing quality

Movement towards covered bonds should impact solvency positively from a SII perspective

We highlight the change in strategy to move from senior unsecured financial bonds to secured financial bonds such as covered bonds. We view this as a positive move given the reduction in risk profile and reduced associated capital charge under Solvency II. Furthermore, we highlight the increased downgrade risk from financial unsecured bonds as rating agencies look to remove systemic support assumptions from these bonds (currently 2-3 notches). Therefore, whilst it is likely that Solvency II is to be delayed, we view the migration towards covered bonds as positive from a portfolio stability point of view.

Figure 5: Historical: Change in Covered bond and financial unsecured bonds holding, bn



Source: Company reports.

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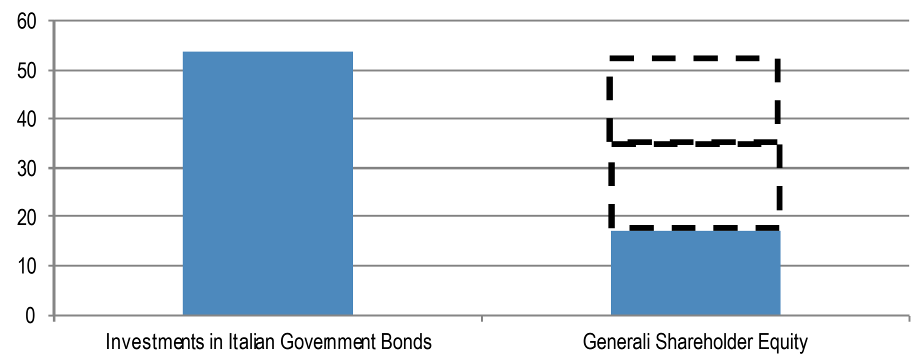
Generali's government bond holdings are longer dated than that of the banks, thus in a haircut scenario Generali would likely experience much greater losses…

…However, we do not expect an Italian haircut scenario to be realised

Italian bond exposure

We highlight that whilst the sovereign crisis lingers the holdings of Italian government bonds is still likely to be topical and a concern for investors. Like the Italian banks, Generali suffers from a high level of exposure to Italian government bonds with holdings that currently equate to 311% of total shareholder's equity. Furthermore, due to the nature of the business, the holdings of Government bonds tend to be of longer duration. More specifically if we assume that the average duration across the entire government bond portfolio is applied proportionally across the Italian holdings then 87% of their holdings would be for the Life business which equates to circa €46.7bn with an average duration of 7.4 (roughly equivalent to a 10yr Italian bond). This is in contrast to the average life on holdings at banks that have an average life of 3-4yrs (based on recent EBA data). Thus, whilst Generali holds similar levels of Italian government bonds to Intesa and Unicredit on an absolute basis (€69.7bn and €47.9bn respectively versus €53.6bn), we note that Generali's holdings are much longer dated and therefore potentially more sticky in a situation where a fast disposal is required. Furthermore, in comparison to shareholder equity Generali stands out, with Intesa and Unicredit's holdings representing 206% and 103% of core capital respectively. Given this exposure it is unlikely that Generali will continue outperform other insurers at these levels until concerns over the Italian Sovereign subside.

Figure 6: Italian Government bonds compared to Shareholders Equity



Source: Company reports.

In our opinion, the likelihood of a haircut on Italian sovereign bonds has been much reduced following the intervention by the ECB; however, due to the size of the holding as a proportion of shareholders equity, Generali's solvency is extremely sensitive to large movements in Italian government bonds, as can be highlighted by the improvement in solvency from FY 2011 and 1H 2012 due to changes in the AFS reserve (Figure 7). We expect that Q3 2012 solvency will also be positively impacted by the further rally in Italian government bonds.

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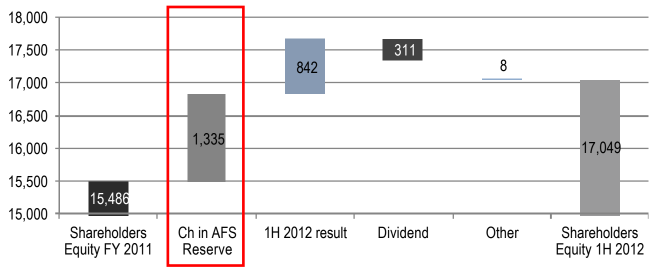
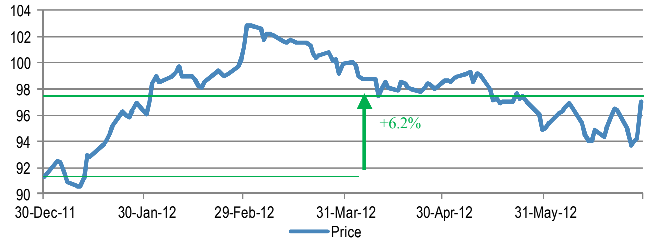
Figure 7: Generali: Change in Shareholders Equity, €m



Source: Company reports. 1H 2012

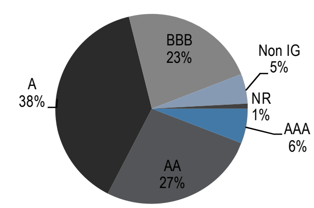
Figure 8: Generic 5yr Italian Government Bond



Source: Bloomberg

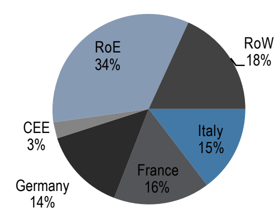
We highlight that financial bonds including covered bonds make up 22% of the overall investment portfolio. Whilst this may seem a high proportion, we note that the skew towards financial companies is similar across other European insurers and thus do not expect Generali to be heavily penalised for this. Furthermore, we note the relatively limited allocation to Italian financial unsecured bonds with the absolute amount equating to €5bn. As we note above Generali is strategically trending to a greater proportion of covered bonds which we believe will benefit the solvency of the company on a forward looking basis.

Figure 9: Assgen: Investment portfolio: Financial bonds by Rating



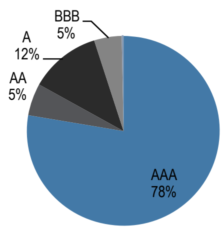
Source: Company reports. 1H 2012

Figure 10: Assgen: Investment portfolio: Financial bonds by Region



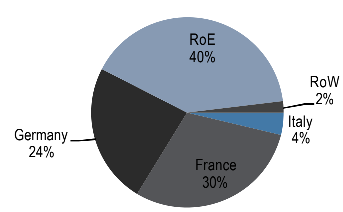
Source: Company reports. 1H 2012

Figure 11: Assgen: Investment portfolio: Covered bonds by Rating



Source: Company reports. 1H 2012

Figure 12: Assgen: Investment portfolio: Covered bonds by Region



Source: Company reports. 1H 2012

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Table 3: ASSGEN: Solvency Ratios

	Q2 12
Solvency I ratio	130%
Economic Solvency*	151%

Source: J.P. Morgan.* Group proxy for SII SCR

Capital

Generali reports a comparatively lower solvency I ratio than most other insurers and subsequently also trades at wider associated spreads. However, we note the Italian regulator applies caps and filters on off-balance sheet unrealized gains on real estate which can sometimes be substantial. For example in FY 2011 this would have been worth as much as 10ppts to the Solvency I ratio. Including these unrealized gains would allow Generali's solvency ratio to be more comparable to that of its European peers[1]. Furthermore we note recent "anti crisis regulation" allows Italian insurance companies to limit the impact from falls in EU government bonds which if used would have provided a further 6ppts boost to Generali's FY 2011 Solvency I ratio. Whilst this lighter touch approach from the regulator would be positive from the perspective of reducing the likelihood of regulatory intervention, we expect the market to discount both of these potential uplifts to solvency and thus would expect Generali to continue to seek alternative methods to improve its Solvency ratios over the medium term.

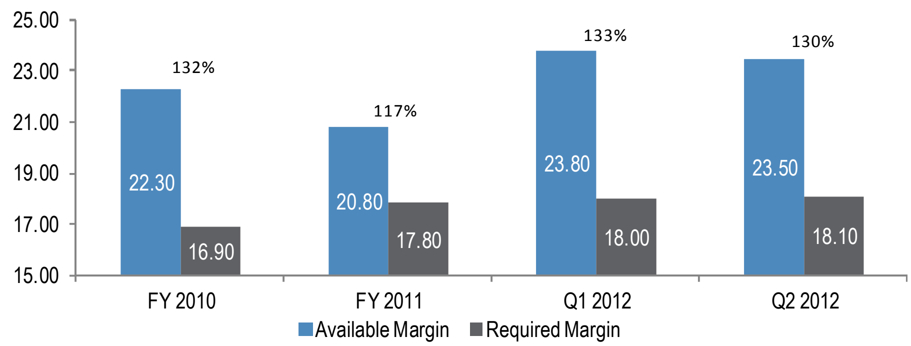
Table 4: Historical: Generali Solvency I Ratio

%	Q3 2009	Q4 2009	Q1 2010	Q2 2010	Q3 2010	Q4 2010	Q1 2011	Q2 2011	Q3 2011	Q4 2011	Q1 2012	Q2 2012
Solvency I Ratio	132	128	129	140	150	132	140	134	137	117	133	130

Source: Company reports. Excludes unrealised gains on real estate and "anti-crisis regulation" - including these ratio – E.g. FY 2011 would have been 134%

As we highlight above, Generali's Solvency ratio has been relatively volatile in recent periods due to its exposure to Italian Government bonds and translation through the AFS reserve. We expect this volatility to be reduced following actions taken by the ECB to stabilise the European Economy and as such the fluctuations in Generali's AFS reserve should fall within a much narrower range. Thus it would appear to be less likely that Generali would need to utilise the "anti crisis regulation" in future periods.

Figure 13: Generali: Solvency I Position



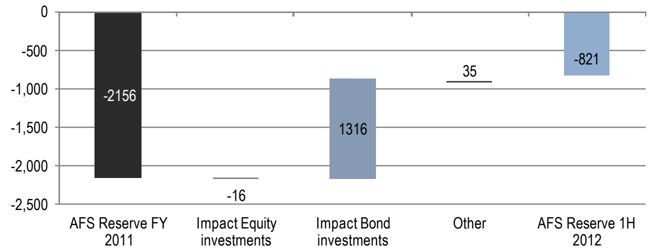
Source: Company reports.

We highlight in Figure 15 that since August 2011, Generali's risk has been influenced by Italian Government bond spreads substantially more than historically observed. We expect, whilst sovereign tensions remain high, that this is likely to continue; however, in our opinion as the sovereign risk premia decreases, the diverse nature of Generali's business across Germany and CEE should offer additional

[1] Fitch, Sept 2012

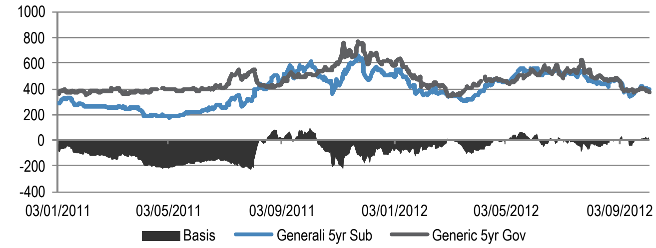
upside uncorrelated to Italy. Notwithstanding the above, if sovereign risks were to rise, it is likely that Generali would continue to follow suit.

Figure 14: Generali: Movements in AFS reserve



Source: Company reports.

Figure 15: Generali 5yr Sub CDS versus Generic 5yr Govt bond, bp



Source: Bloomberg

Estimated Solvency II sensitivity

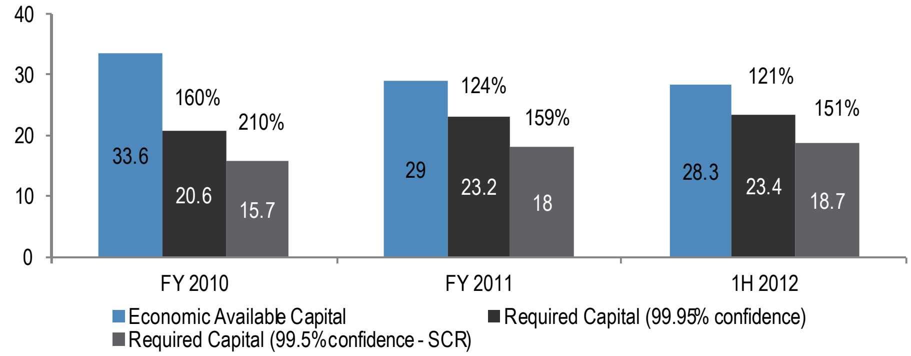
Whilst we highlight that Generali's Economic Solvency Ratio (at 99.5% confidence) is not directly comparable to the SCR under Solvency II, it should give investors a proxy with regards to what to expect under the current understanding of Solvency II. However, as we highlight below Solvency II continues to be a fluid situation and it is likely that current capital charges and definitions may differ to those that are finally adopted. In Table 5 we use the sensitivity analysis disclosed in the Embedded Value (EV) report to understand to what extent we would expect volatility in the SCR from the same underlying scenarios. Whilst not perfect, much like the SCR, the EV provides an estimate for the economic value of an insurance business as such movements in the EV due to the different in scenarios should give a reasonable estimate for the impact on a Solvency II ratio, as the rules are currently understood. We highlight that the factor which has the largest impact on solvency is the removal of the liquidity premium from the reference rates. This further explains the industry's push for a further impact study with regards to the reference discount rate.

Table 5: Generali: Economic Solvency Ratio Sensitivity based on sensitivity to Embedded Value

	Total	Italy	Germany	France	CEE	RoE	RoW
Yield Curve + 100bps	173%	164%	163%	164%	160%	164%	161%
Yield Curve -100bps	142%	157%	157%	154%	160%	155%	160%
Equity value +10%	166%	163%	161%	162%	160%	161%	161%
Equity value -10%	155%	158%	160%	159%	160%	160%	160%
Property value -10%	157%	160%	160%	159%	160%	160%	160%
Equity implied vol +25%	159%	160%	160%	160%	160%	160%	160%
Swaption implied Vol +25%	156%	159%	159%	159%	160%	160%	160%
Reference rates without Liquidity premium	123%	145%	153%	151%	160%	155%	161%
Reference rates with Liquidity premium +10bps	163%	162%	161%	161%	160%	161%	160%
Maintenance expenses -10%	164%	161%	161%	161%	161%	161%	161%
Lapse rate -10%	164%	161%	161%	161%	161%	161%	161%
Lapse rate +10%	157%	159%	160%	160%	160%	160%	160%
Mortality for risk business -5%	164%	161%	161%	161%	160%	161%	162%
Mortality for annuity business -5%	159%	160%	160%	160%	160%	160%	160%
Economic Capital (€bn)	29.0						
Required Capital (€bn)	18.0						
ESR	160%						

Source: Company reports and J.P. Morgan estimates. FY 2011

Figure 16: Generali: Economic Solvency Position



Source: Company reports.* Note rounding Errors

Update on Solvency II

Parliament is likely to wait for the results of the latest Impact Study before concluding on Omnibus II

On the 15th October EIOPA launched its impact assessment with regards to Long Term Guarantees. It is also expected that within this impact assessment EIOPA will look at the matching adjustment and transitional measures amongst other subject matters (See "Navigating Solvency II" 3rd Sept 2012) with the study expecting to last approximately 8 weeks to mid December. The results are then to be presented to the Commission by Jan 2013 with the final report expected in March 2013 at which point the trialogue (the European Commission, the European Parliament and the European Council) are likely to resume discussions on Omnibus II when the results of the impact assessment are known. Given this extended timeline we continue to expect delays to the entry into force for Solvency II beyond the 1st Jan 2014.

Further delays to Solvency II are likely to benefit the insurance industry

Furthermore, we highlight a recent letter to EIOPA from the Commission asking EIOPA to assess the possibility of reducing the capital charge for certain "long-term finance" assets such as infrastructure, SME and project bonds. In our opinion, this highlights that Solvency II is far from being set in stone and is still subject to some potentially large changes. We believe the latest request is a reaction to the continued deleveraging from banking institutions which the IMF have recently estimated could be as high as $4.5tr until the end of 2013 under their bear case scenario. Thus it appears as though this latest proposal would concentrate on European insurers picking up the slack that banks have left. Ultimately, whilst insurers are likely to continue to prepare for the worst, it is likely that we continue to see regulatory forbearance and delays which ultimately are likely to be positive for the insurance industry as a whole.

Debt structure

Generali has no refinancing requirements until 2014

Generali had circa €12bn in financial debt outstanding with the split between senior and subordinated shown in Table 7. We highlight in Figure 18 there are no large scale refinancing requirements until 2014 where €2.25bn worth of bonds mature (€1.5bn and €750m). We do not view this refinancing as a high risk given the relative absence of senior debt in the insurance market. We expect new issues are likely to be well received and a small amount could be refinanced using internal measures.

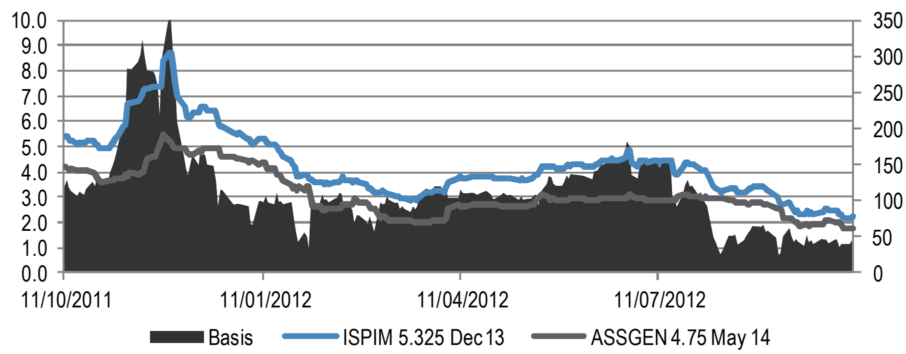
Table 6: Generali: Senior Debt

ISIN	Issuer	Coupon	Maturity	Amt	Ccy	Spread
XS0097245244	GENERALI FINANCE BV*	4.75	12/05/2014	1500	EUR	162
XS0416215910	ASSICURAZIONI GENERALI	4.875	11/11/2014	750	EUR	195
XS0218469962	GENERALI FINANCE BV*	3.875	06/05/2015	500	EUR	168
XS0452314536	ASSICURAZIONI GENERALI	5.125	16/09/2024	1750	EUR	390

Source: Company reports.* Guaranteed by Parent Company

In our opinion, Generali senior debt looks relatively cheap to the senior debt of Italian banks. Whilst both banks and insurers are likely to remain highly correlated to the sovereign, we believe that Generali's diversification across multiple European countries as well as into CEE will put it in a better position in comparison to banks like ISPIM that have a more domestic focus. We would expect in a muddle-on-through scenario for Generali senior to begin to outperform ISPIM senior.

Figure 17:Generali: Senior Debt (% - LHS, bp –RHS)



Source: Company reports.* Guaranteed by Parent Company

We note in July 2012 Generali, refinanced a callable Tier II instrument which had a back end coupon of €6month euribor + 200bp. At current rates this is would be equivalent to paying a coupon of 2.4%. Generali refinanced the Tier II bond by offering a coupon of 10.125%, thus increasing the amount it would have had to pay by €58m per annum. We highlight that this decision regarding Tier II debt provides support for the Tier I instruments which currently trade at a discount to the call date. Furthermore, given current trading levels of Tier II debt, Generali could feasibly refinance the Tier I hybrids by issuing Tier II debt at an incremental cost of €143m (the difference between the average coupon on Tier I and trading level of Tier II). However, although still feasible the opportunity cost would be much higher than this given the average back end spread is circa 240bps.

Table 7: Generali: Financial Debt

Financial Debt	FY 2011	1H 2012	Average Cost
Senior	4,461	4,462	4.8%*
Sub/Hybrid	6,436	6,608	6.5%*
Other	1,528	1,055	
	12,425	**12,124**	
Average Cost	5.39%	5.40%	

Source: Company reports.* Weighted average cost of listed debt available on Bloomberg

Insurers are incentivised to make full use of the generous grandfathering period.

As we highlighted in our note "Navigating Solvency II" 3rd Sept 2012, the amount of Tier I hybrids that can contribute towards the MCR of an insurance company in Solvency II is much more limited at 20% of the total Tier I funds, this is in contrast to the previous regime where Tier I hybrids could make up to 50% of the required solvency margin. Outstanding public hybrids amount to €4.8bn which would be equivalent to 26.5% of Generali's required solvency margin, suggesting Generali is well within their limits under Solvency I. However, under Solvency II it is less clear whilst the technical specifications are still to be fully determined how efficient Generali's solvency margin would be. However, we expect that any hybrids that exceed the Tier I limit for the MCR would be eligible to meet the SCR. Thus, at worst, Generali would be incentivized to keep the hybrids outstanding at least while they count as Tier I or Tier II for the SCR. Generali is currently aiming for an MCR that is 45% of the SCR (or Economic Solvency equivalent) as such the MCR would be €8.4bn as of 1H 2012. Assuming a more conservative top down approach to the capital requirement, this would mean that only €1.6bn of the hybrids (20% of MCR) would be available to meet the MCR with the remainder available to meet the SCR.

The current stock of existing subordinated instruments are unlikely to count as Tier I or Tier II under Solvency II due to the lack of reference to the SCR

We expect that current insurance hybrids, that do not contain mandatory deferral language linked to the SCR, would no longer be able to contribute to either Tier I or Tier II capital levels following the end of the grandfathering period. Given that the SCR is a new concept this would capture most of the existing stock of sub-debt. Whilst we view the 10yr non amortising grandfathering period expected for insurance capital instruments as highly generous, following the end of this grandfathering period it is likely that insurers would want to replace legacy instruments with compliant instruments. As such, we would price the Generali hybrids to 2025 at worst (assuming 1yr delay in Solvency II entry to 1st Jan 2015). On this basis, we prefer the ASSGEN 6.416% £22P and ASSGEN 8.5% €19P (illiquid) out of the Tier I instruments because we believe current trading levels compensate the investor for our worst case redemption scenario whilst providing for potential upside in an earlier than expected call.

Table 8: Generali: Subordinated Debt

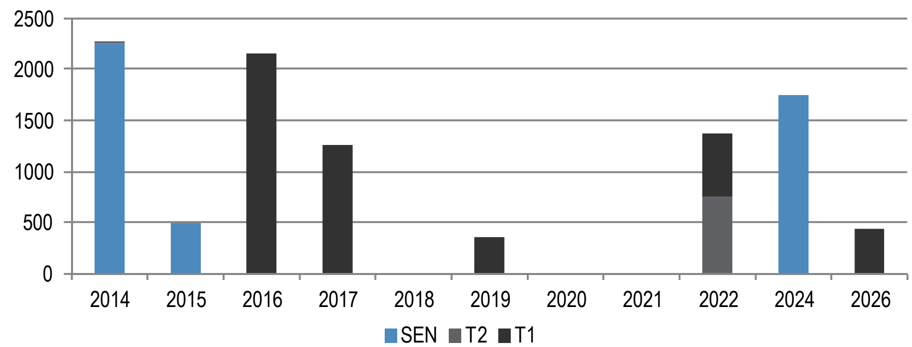
Tier	ISIN	Issuer	Coupon	Cal Date	Maturity	Amt	Ccy	Back End	Px	SpTC	ZT25
T1	XS0256975458	GENERALI FINANCE BV*	5.317	16/06/2016	Perp	1275	EUR	+210	78.0	1309	577
T1	XS0256975888	GENERALI FINANCE BV*	6.214	16/06/2016	Perp	700	GBP	+208	71.0	1640	743
T1	XS0283629946	GENERALI FINANCE BV*	5.479	08/02/2017	Perp	1250	EUR	+214	76.75	1268	637
T1	XS0416148202	ASSICURAZIONI GENERALI	8.5**	06/03/2019	Perp	350	EUR	+609	83.2	1215	942
T1	XS0283627908	ASSICURAZIONI GENERALI	6.416	08/02/2022	Perp	495	GBP	+220	68.0	1042	920
T1	XS0257010206	ASSICURAZIONI GENERALI	6.269	16/06/2026	Perp	350	GBP	+235	67. 0	880	n/a
T2	XS0802638642	ASSICURAZIONI GENERALI	10.125	10/07/2022	10/07/42	750	EUR	+918.1	109.0	782	911

Source: Company reports.* Guaranteed by Parent Company, €1.5bn of private placements, **illiquid. Priced as of cob 10/10/12.

We expect, like banks, stronger insurers would look to differentiate themselves by calling Tier I instruments

There is currently little in the way of a "track record" with regards to insurer behaviour when it comes to calling hybrid perpetual instruments. However, regulatory changes suggest that Tier II capital will be much more important for insurers when it comes to meeting their SCR requirement. As such, we find it unsurprising that Generali paid more to refinance its Tier II capital than extend it to the maturity (also considering loss of S&P equity treatment). When it comes to Tier I hybrids we make the assumption that those stronger issuers will continue to differentiate themselves and call their Tier I hybrids much like banking institutions did. We would not rule out LME on the Tier I instruments, however, these transactions have been relatively limited in the insurance space given that the regulator does not distinguish between "core" and "non-core" capital, thus the timing is likely to be the largest uncertainty. We expect that LME could come more from a perspective to mange investor expectations with regards to the call rather than as a capital raising exercise.

Figure 18: Assgen: Maturity profile of listed debt securities, €10bn of €12bn outstanding



Source: Bloomberg, J.P. Morgan

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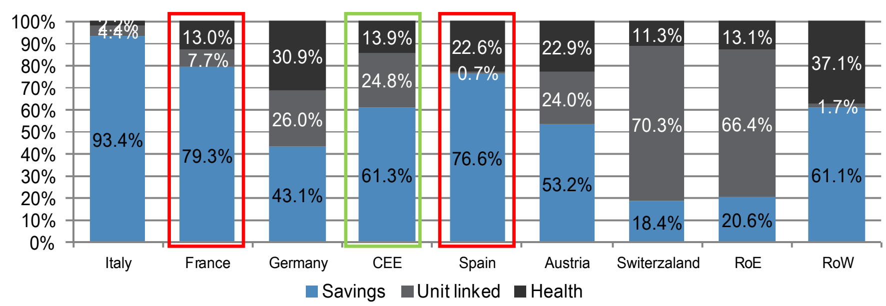
Life

Market penetration defined as GWP/GDP

Generali primarily operates in the mature savings markets of Italy, France and Germany where penetration of life products is relatively high (5.8%, 7.4%, and 3.6% respectively (2010). These countries accounted for over 75% of Life Gross Written Premiums (GWP) in 2011; however, we note life products are likely to continue to face increased competitive pressures from the retrenchment of banks into their domestic markets and focus on deposit gathering. In Italy and France the leading life product distributed is the savings products whereas there is somewhat more scope for Unit-linked products in Germany.

Figure 19: Assgen: Life insurance Distribution by Gross Written Premiums

%



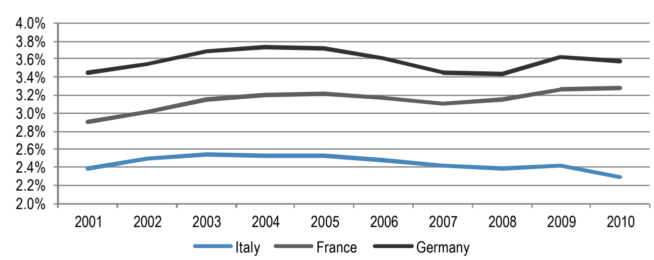
Source: Company reports. 1H 2012

Generali has limited bancassurance agreements still active in core Europe

During the 1H 2012 we have continued to see decreasing trends in GWP in core Europe, it is unlikely that this trend reverses in any meaningful way in the short term given the increasing competition against banking products. Increasingly, core European banks are looking to shore up their balance sheets by gathering deposits and in doing so have cannibalised the savings based products offered by insurers. Furthermore, traditional distribution channels such as bancassurance continue to be affected by the banking crisis as banks give less focus to insurance product distribution. We note, however, Generali has limited bancassurance agreements still active in core Europe with primarily Mexico and CEE still having important Bancassurance ties.

Figure 20: Non-Life insurance Penetration: GWP/GDP

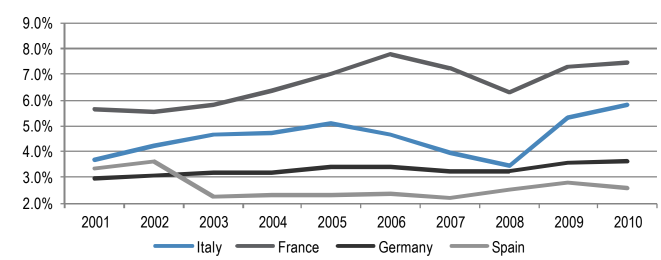
%



Source: Insurance Europe

Figure 21: Life insurance Penetration: GWP/GDP

%



Source: Insurance Europe

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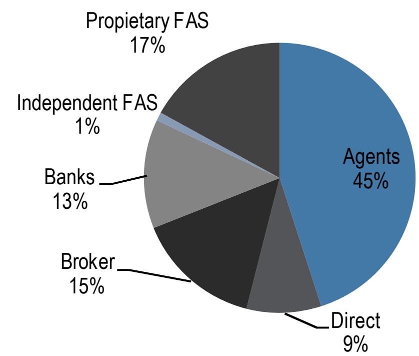
Figure 22: Generali: 2010 Life Annual Premium Equivalent by distribution channel

%



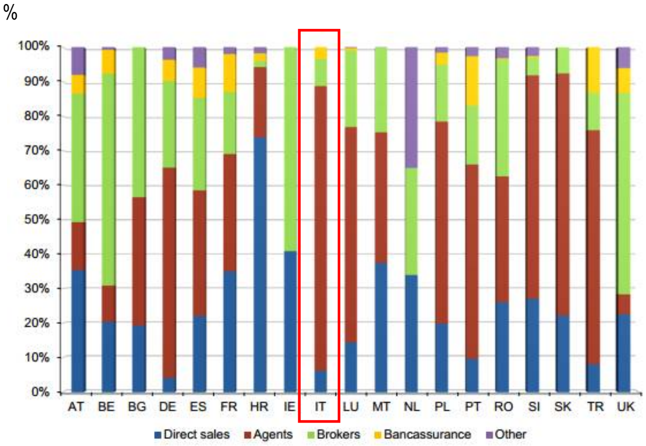
Source: Company Reports

Italy

Generali's main distribution channel is through a number of agencies both contracted and internal. In Italy, the group distributes through the Generali, INA-Assitalia, and Alleanza Toro brands. Generali relies less on bancassurance in Italy following the sale of its bancassurance joint venture Intesa Vita and therefore should continue to be less affected than its competitors that depend more on this distribution channel, (Figure 24) as banks remain more focused on balance sheet funding. However, we note that Italy's economic slowdown is not likely to go unnoticed and competition from government debt distribution and bank deposits will likely weigh on new business volumes.

Figure 23: Non-Life insurance Distribution by Gross Written premiums

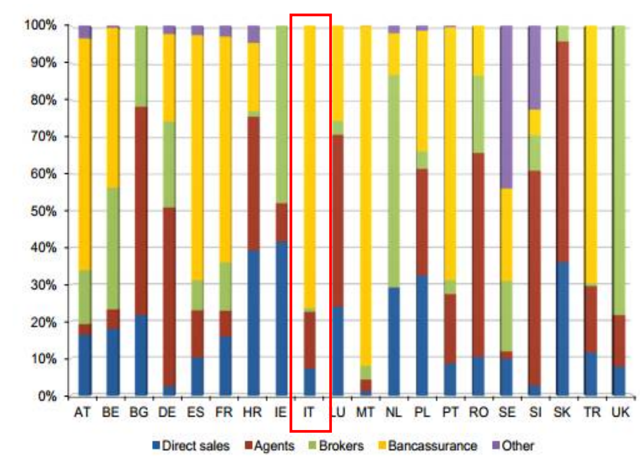
%



Source: Insurance Europe, 2010

Figure 24: Life insurance Distribution by Gross Written Premiums

%



Source: Insurance Europe, 2010

France

We note the recent proposals by President Francois Hollande to remove the special capital gains and dividend taxation regimes and allow them to be taxed along with income tax removes specific incentives to save using investment products. Whilst the precise impact of these changes is yet to be determined we note that it currently appears as though life saving products will not see their tax rate changed. This is also the case for savings products that are not taxed currently. The implications of this could mean that life savings products become much more attractive to the average investor. Whilst this is subject to change, if left un-touched this would be a positive development in a recently tough market. Generali has recently faced above average surrender rates with its products over the past 12 months; however, the budget for 2013 is likely to passed by the Upper and Lower House by the end of October which could mean that we start to see improving trends out of France as early as 1H 2013. We caveat that current untaxed products can still provide an alternative investment to Life savings products; however, we would expect some capital flows into Life products to help the recent weaker trend.

Generali's retains a strong competitive presence in Germany

Germany

Generali operates in Germany primarily through its subsidiary Generali Deutschland which is the second-largest primary insurance group in Germany. Deutschland's strong competitive position is based on a diverse set of operating units (including AachenMunchener (Life), Generali Versicherungen (Life & Non-Life) and Central Krankenversicherung (Health). Furthermore, we note the partnership with the largest financial advisory network in Europe, the DVAG, which has existed since the 90's. This network of financial advisors continues to help Generali remain highly competitive in the German market. However, we expect profitability to remain under pressure given the low interest rate environment in comparison with legacy guaranteed rates on its book. Furthermore, the refocus of many of the German banks on the German economy is likely to provide for increased competition amongst life savings products, which continue to see a decline in GWP yoy to 1H 2012 (down 8.1%).

Table 9: Generali: Total provisions by level of guarantee

Provisions by level of guarantee	2010	2011
Liabilities with guarantee interest		
0-1%	40,682	43,828
1-3%	88,135	94,079
3-4%	57,879	56,729
4-5%	39,368	36,716
>5%	2,651	3,254
	228,714	**234,606**
Provisions without guaranteed interest	61,632	60,377
Provisions matched by specific assets	8,658	8,152
Total	301,135	299,003

Source: Company reports.

Other

We highlight that the banking crisis is Spain is likely to have a negative impact for GWP in this region. Whilst GWP from Spain only represented 3.5% of total GWP in 2011 we expect that trends in this country will continue to be negative. Most notably distribution through the bank assurance channels involving Caja’s are likely to continue to decline. Whilst we’ve highlighted that the retrenchment of European banks back to their core markets is likely to increase competition for Generali’s life products, conversely the pull back of banks out of CEE should help benefit Generali in the markets that offer the most growth opportunity. We highlight that, as of FY 2011, CEE accounted for 5.7% of GWP and we would expect the share in 2012 to have increased with a current run rate just above 5.7% at 5.9%.

Non-Life

Penetration of non-life products outside of Italy where Generali operates is comparatively high, with Austria (3.2%), Switzerland (4.5%), Germany (3.6%) and France (3.3%) all appearing in the top 10 European penetration rates. These countries accounted for 40% of non-life gross direct premiums in 2011 with Italy contributing 33% where penetration rates have remained historically low at less than 2.3% (2010). We note the decline in Life premiums over the last 2 years has been partially offset by the growth in the non-life business as Generali's strong competitive position has allowed it to carry out price increases in line with those of peers without losing significant business.

Figure 25: Generali: Consolidated Expense Ratio

Year	Expense Ratio
2005	9.8%
2006	10.2%
2007	11.1%
2008	11.2%
2009	10.5%
2010	10.4%
2011	11.6%

Source: Company reports.

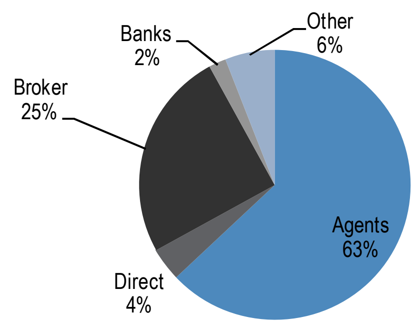
The distribution of non life policies is heavily reliant on intermediaries primarily agents. Agents can consist of:

- **Contracting agencies** whose independent agents are mandated to develop an insurance portfolio in an exclusively designated area focused on individuals and SMEs

- **Internal agencies** whose agents and employees are employed by Generali group companies. This is the typical structure in Austria, Switzerland and for the sales network of Alleanza in Italy, Volksfursorge in Germany and Gernerali IARD in France. Generali also have five further internal agencies located in major Italian cities with a focus on the corporate segment.

The structure of Generali's distribution should allow for a more controlled expense ratio and indeed we note this has been relatively stable over previous years.

Figure 26 Generali: 2010 P&C premiums by distribution channel
%



Source: Company Reports

We note that the Earthquakes in Northern Italy in May 2012 and snowfall in February led to an increased total combined ratio for the 1H 2012. However, excluding the minor Nat Cats (Natural Catastrophes) the FY 2012 combined ratio should be more in line with Q1 2012, as guided by management. We expect the non-life business to continue to partially offset declining life premiums with improvements expected to come particularly from motor insurance in 2013 versus 2012.

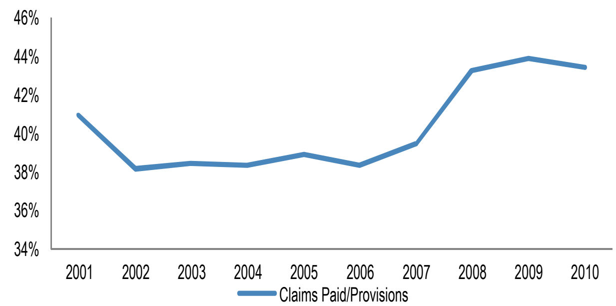
Table 10: Historical: Generali Combined Ratio, by main jurisdiction

	2004	2005	2006	2007	2008	2009	2010	2011	Q1 2012	1H 2012
Italy	98.5%	97.7%	97.2%	95.0%	98.9%	102.4%	99.6%	96.8%	95.0%	99.7%
France	100.2%	98.9%	97.7%	96.7%	97.9%	99.0%	101.3%	98.7%	97.2%	98.4%
Germany	99.4%	97.0%	95.8%	95.9%	95.9%	95.6%	95.2%	94.4%	95.5%	95.8%
CEE	93.9%	95.6%	92.8%	91.2%	84.6%	87.9%	93.2%	89.5%	91.0%	87.5%
Total	**98.9%**	**97.9%**	**96.3%**	**95.8%**	**96.4%**	**98.3%**	**98.8%**	**96.5%**	**95.4%**	**97.1%**

Source: Company reports.

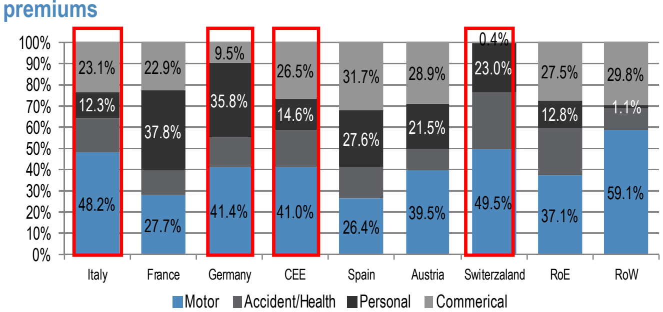
We note that broader industry trends bode well for the sector, as claims frequency in Italy looks to have peaked in 2009 and motor claims frequency (a large portion of non nonlife business) also peaked in 2009 and fell significantly during 2011. This would tend to support our thinking that non-life premiums are likely to contribute an increasing amount to the total GWP for Generali as a whole.

Figure 27: Historical: Italian Non Life Claims Paid/Provisions



Source: Insurance Europe

Figure 28: Assgen: Non-Life insurance Distribution by Gross Direct premiums



Source: Company reports. 1H 2012

Fall in 2013 new car registrations are likely to be lower than 2012

Motor insurance

We highlight that motor insurance constitutes a significant part of Gross direct premiums especially in Italy, Germany, CEE and Switzerland contributing in total 41% towards the 1H 2012 gross direct premiums. We therefore highlight Germany and certain CEE countries as potential areas of growth for Generali. In Italy we expect remaining pressure due the continued austerity; however, we note that 2013 is likely to be an improvement on 2012 with new car registrations likely to fall at a slower rate than in 2012 where new car registrations fell 20% "Spinning Our Wheels" 12th August 2012 (Renegar, Ward). We note that management has given guidance with regards to future tariffs in Italy, stating that due to the increases made in the previous years they expect tariffs to flatten out. Whilst we highlight that this could put pressure on the combined ratio we note the steep decline in motor vehicle claims frequencies over the last 3 years. Nevertheless, we expect non domestic countries to contribute more to the non-life business on a forward looking basis with Generali likely to benefit from the growing non-life market in Germany.

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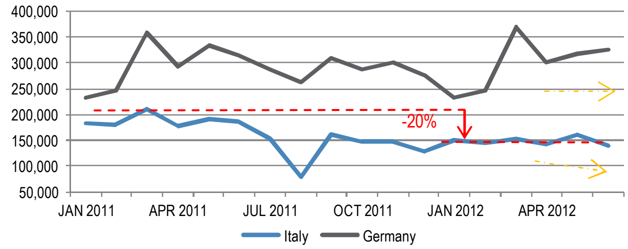
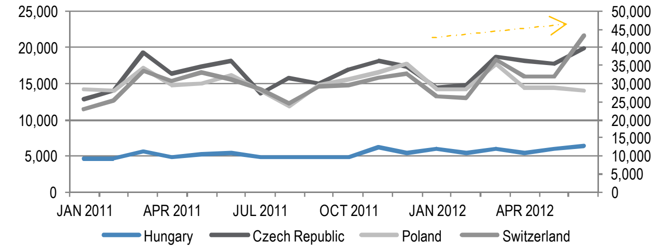
Figure 29: Historical: New Motor vehicle registrations, Italy & Germany



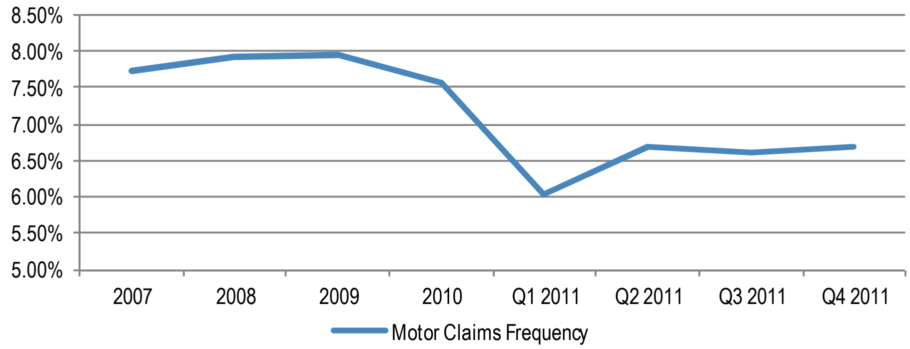
Source: Insurance Europe, 2010

Figure 30 Historical: New Motor vehicle registrations, Smaller markets



Source: Insurance Europe, 2010

Figure 31: Historical: Italian motor vehicle claims frequency



Source: ANIA

PPF JV

PPF Holding is a Joint Venture between Generali and the PPF Financial Group set up in 2008 to help expand into CEE where growth is expected to outperform that of Europe over the coming years. However, if PPF Financial Group and Generali cannot agree an extension to the joint venture then there could be a difficult decision for Generali to make with regards to the CEE business. Generali group operations in CEE represented 6% of the group's GWP and 10% of the insurance operating result in the first-half 2012.

The PPF JV allows for the minority shareholder (PPF Group & PPF BV) that own 49% of the joint venture to exit its investment in the PPF shareholding under three circumstances:

1. **Between 1st and 10th July 2014** in the event the JV is not extended by way of IPO of 75% of shares or sale to a 3rd party or Generali.

2. **Before 10th July 2014,** by way of sale to a 3rd party or to Generali (Generali's discretion), if PPF BV is obliged to repay its banking facility early.

3. **At any time**, if a 3rd party acquires 30% or more of the share capital of Generali by sale to a 3rd party or Generali (Generali's discretion).

Our concern would be if Generali were to consider purchasing the minority holding as this would likely entail an estimated financial outflow between €2.3bn and €2.7bn which would represent 14ppts (an average €2.5bn) reduction in Solvency I margin. We consider CEE an important strategic geography for Generali representing future potential growth; as such, as part of the up and coming strategic review we would expect management to provide some details with regards to the expected plan for this Joint Venture.

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Bond Descriptions

	ASSGEN 10.125 22-42	ASSGEN 5.317 16-P	ASSGEN 5.479 17-P
ISIN	XS0802638642	XS0256975458	XS0283629946
Issue Date	10/07/2012	16/06/2006	08/02/2007
Ratings	Baa3/BBB+/BBB-	BBB-/BBB/Ba1	BBB-/BBB/Ba1
Ccy	EUR	EUR	EUR
Amt	750	1275	1250
Maturity	10/07/2042	Perp	Perp
Call Date		16/06/2016	08/02/2017
Maturity conditions	Redemption subject to no regulatory intervention and regulatory approval if required	n/a	n/a
Coupon	10.125	5.317	5.479
Coupon Type	Fixed/Floating	Fixed/Floating	Fixed/Floating
Back End	3m+918.1	3m+210bp	3m+214bp
Step-up	Y	Y	Y
Coupon Deferral	**Optional:** if no dividend declared on junior/parity securities and no repurchase of junior/parity securities, or if only a partial distribution has been made on parity instruments.(carve out for below par repurchases and mandatory coupons). **Mandatory:** Regulator intervention and no dividend declared on ordinary shares, or insolvency	A regulatory intervention has occurred. Negative income in two consecutive reporting periods and adjusted equity has declined by more than 10% in prior 2 years to lagged reporting date and adjusted capital has declined by 10% compared to the adjusted equity amount in 30 months prior to current date. Can become optional	A regulatory intervention has occurred. Negative income in two consecutive reporting periods and adjusted equity has declined by more than 10% in prior 2 years to lagged reporting date and adjusted capital has declined by 10% compared to the adjusted equity amount in 30 months prior to current date. Can become optional
Compulsory Payment Event	If a dividend has be declared on junior of parity securities during look back period or if partial distribution has been made on parity instrument	if payments or set-asides have been made to junior or parity instruments or public repurchase of junior or parity instruments	if payments or set-asides have been made to junior or parity instruments (1Y pro rata - save if mandatory) or public repurchase of junior or parity instruments
Compulsory Payment Event			
Look Back	6 months	12 months	12 months
Cumulative	Yes	Y - ACSM	Y - ACSM
Compounding of deferred interest	Yes	No	No
Deferred Coupons	Arrears must be paid on the earliest of: i) payment to pari passu claims, ii) dividends on junior/parity instruments paid, iii) repurchases of junior/parity instruments (not carved out), iv) regulatory intervention no longer present, v) no mandatory deferral event continuing, vi) date fixed for optional or mandatory redemption, vi) liquidation	May be paid in whole or part optionally - pro rata if any payment made to parity instruments. Arrears of interest become payable in full on the earlier of, dividend on junior or parity instruments, public repurchase of junior or parity instruments (ex permitted repurchase), cessation of regulatory event, redemption, wind-up, **10 years** have passed - satisfied by ACSM, or cancelled if funds cannot be paid with ACSM.	May be paid in whole or part optionally - pro rata if any payment made to parity instruments. Arrears of interest become payable in full on the earlier of, dividend on junior or parity instruments, public repurchase of junior or parity instruments (ex permitted repurchase), cessation of regulatory event, redemption, wind-up, **5 years** have passed - satisfied by ACSM, or cancelled if funds cannot be paid with ACSM..
Regulatory Call	At any time, at Make Whole	Reg call at greatest of make whole and par with deferred payments subject to regulatory approval.	Reg call at greatest of make whole and par with deferred payments subject to regulatory approval.
Ratings Call	At Any time, at par		
Additional Comments		Optional deferral if not a compulsory payment date	Optional deferral if not a compulsory payment date
Law	English/Italian	English	English
Tier	Tier II	Tier I	Tier I

Source: Bond Prospectuses

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	ASSGEN 6.214 16-P	ASSGEN 6.269 26-P	ASSGEN 6.416 22-P
ISIN	XS0256975888	XS0257010206	XS0283627908
Issue Date	16/06/2006	16/06/2006	08/02/2007
Ratings	BBB-/BBB/Ba1	BBB-/BBB/Ba1	BBB-/BBB/Ba1
Ccy	GBP	GBP	GBP
Amt	700	350	495
Maturity	Perp	Perp	Perp
Call Date	16/06/2016	16/06/2026	08/02/2022
Maturity conditions	N/A	N/A	N/A
Coupon	6.214	6.269	6.416
Coupon Type	Fixed/Floating	Fixed/Floating	Fixed/Floating
Back End	3m+198	3m+201	3m+200
Step-up	Y	Y	Y
Coupon Deferral	A regulatory intervention has occurred. Negative income in two consecutive reporting periods and adjusted equity has declined by more than 10% in prior 2 years to lagged reporting date and adjusted capital has declined by 10% compared to the adjusted equity amount in 30 months prior to current date. Can become optional	A regulatory intervention has occurred. Negative income in two consecutive reporting periods and adjusted equity has declined by more than 10% in prior 2 years to lagged reporting date and adjusted capital has declined by 10% compared to the adjusted equity amount in 30 months prior to current date. Can become optional	A regulatory intervention ahs occurred. Negative income in two consecutive reporting periods and adjusted equity has declined by more than 10% in prior 2 years to lagged reporting date and adjusted capital has declined by 10% compared to the adjusted equity amount in 30 months prior to current date. Can become optional
Compulsory Payment Event	if payments or set-asides have been made to junior or parity instruments or public repurchase of junior or parity instruments	if payments or set-asides have been made to junior or parity instruments or public repurchase of junior or parity instruments	if payments or set-asides have been made to junior or parity instruments (1Y pro rata - save if mandatory) or public repurchase of junior or parity instruments
Compulsory Payment Event Look Back	12 months	12 months	12 months
Cumulative	Y - ACSM	Y - ACSM	Y - ACSM
Compounding of deferred interest	No	No	No
Deferred Coupons	May be paid in whole or part optionally - pro rata if any payment made to parity instruments. Arrears of interest become payable in full on the earlier of dividend on junior or parity instruments, public repurchase of junior or parity instruments (ex permitted repurchase), cessation of regulatory event, redemption, wind-up, **10 years** have passed - satisfied by ACSM, or cancelled if funds cannot be paid with ACSM.	May be paid in whole or part optionally - pro rata if any payment made to parity instruments. Arrears of interest become payable in full on the earlier of dividend on junior or parity instruments, public repurchase of junior or parity instruments (ex permitted repurchase), cessation of regulatory event, redemption, wind-up**, 10 years** have passed - satisfied by ACSM, or cancelled if funds cannot be paid with ACSM.	May be paid in whole or part optionally - pro rata if any payment made to parity instruments. Arrears of interest become payable in full on the earlier of, dividend on junior or parity instruments, public repurchase of junior or parity instruments (ex permitted repurchase), cessation of regulatory event, redemption, wind-up, **5 years** have passed - satisfied by ACSM, or cancelled if funds cannot be paid with ACSM.
Regulatory Call	Reg call at greatest of make whole and par with deferred payments subject to regulatory approval.	Reg call at greatest of make whole and par with deferred payments subject to regulatory approval.	Reg call at greatest of make whole and par with deferred payments subject to regulatory approval.
Ratings Call			
Additional Comments	Optional deferral if not a compulsory payment date	Optional deferral if not a compulsory payment date, Soft loss absorption	Optional deferral if not a compulsory payment date, Soft loss absorption
Law	English	English	English
Tier	Tier I	Tier I	Tier I

Source: Bond Prospectuses

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Generali - J.P. Morgan Recommendation History

Date	Rating	Instrument
11 Oct 06	Neutral	CDS

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