

Italy at the Crossroads?

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Brunswick looks at the main factors influencing the forthcoming general elections in Italy, possible outcomes and their impact on business

Italians are heading to vote for the country's new Parliament and leadership on March 4 in what is regarded as a crucial test for the European Union at a time when it is undermined by a rise of Euroscepticism, waves of national separatism and poor management of the migration crisis. International investors are also carefully looking at the possible outcomes, as the country is regaining attractiveness on the back of an incipient economic recovery, which is at its strongest since 2010, with declining unemployment, a banking system emerging from troubled waters and a positive push towards reforms.

The vote's outcome is uncertain, and the ballot is marked by three main characteristics: a brand new electoral system; the crisis of traditional political parties and a campaign seen as failing from all sides to address some key hurdles such as lowering the country's heavy public debt, simplifying a dysfunctional bureaucracy and a complex legal system.

On the right track to economic growth

Italy approaches the elections showing the first signals of recovery after a lengthy and painful crisis. The International Monetary Fund has estimated that the Italian economy should grow for the 2017-2019 period by +1.6%, +1.4%, +1.2% respectively. This recovery, driven by a strong performance of export and investments, is due partly to positive global trends and partly to policies implemented in recent years.

The labour market is also showing encouraging signs, with the employment level steadily over 23.1 million people (equal to pre-crisis levels).

Financial markets are soaring too: in January, the Milan Stock Exchange recorded the world's best performance with an 8.7% surge (followed by US at +6.2% and Germany at +5%).

Italy's chances to remain competitive and create new growth opportunities will largely depend on the next government's commitment to some crucial measures: setting the country's debt on a clear downward path; shoring up a banking sector still loaded with Non-Performing Loans, ensuring consistency and stability to the legal system; reducing the length of judicial proceedings and launching an effective de-bureaucratisation process.

A three-party competition

The Italian party system has changed in the last ten years from a bipolar to a three-party system, with the presence of an anti-establishment party (Five Star Movement) in addition to the traditional party blocs on the left and the right.

Additionally, this electoral campaign sees the advent of a fourth contender, Free and Equal, born as a spin-off of some leftwing dissidents. Their goal is to capture disillusioned leftwing voters who did not appreciate Mr. Renzi's leadership style and winking to the centre-right.

The new electoral system: The Rosatellum

The new electoral system was approved by a large coalition in November 2017. The Rosatellum - named after Ettore Rosato, an MP from the ruling centre-left Democratic Party, who authored the law - is a mixed electoral system, under which 1/3 of representatives will be elected in single-member constituencies under a *first-past-the-post* system, while 2/3 of the seats will be awarded by national proportional representation.

Every party can decide to run independently or to be part of a coalition. In the second case, parties are required to find a common candidate for each single-member constituency.

To reduce fragmentation the law establishes that single parties must reach at least 3% and coalitions at least 10% of the national vote to gain a share of the proportional seats.



	PARTY	LEADER	FOCUS
Centre-right coalition	Forza Italia (FI)	Silvio Berlusconi	<ul style="list-style-type: none"> Open to Brussels 3% threshold Against custom-duties
	League (Lega)	Matteo Salvini	<ul style="list-style-type: none"> Eurosceptic, against Brussels 3% threshold Protectionist
	Brothers of Italy (Fdi)	Giorgia Meloni	<ul style="list-style-type: none"> Against the current pension system Against immigration
	Five Star Movement (M5S)	Luigi Di Maio	<ul style="list-style-type: none"> Inconsistent on European integration Fights against political privileges and remuneration Fosters minimum salary for all citizens Ultra-environmentalist
Centre-left coalition	Democratic Party (PD)	Matteo Renzi	<ul style="list-style-type: none"> Europe as the only possible dimension for citizenship, peace and global cooperation
	+Europa	Emma Bonino	<ul style="list-style-type: none"> Priority on employment, attention to tax burden Environment and sustainability Civil rights and <i>ius soli</i>
	Free and Equal (LeU)	Pietro Grasso	<ul style="list-style-type: none"> State control over the economic system State support to the poorest

Outcomes and Takeaways for Businesses

A single-party government: what are the obstacles?

The combination of the party system described above and an electoral law without a significant majority premium will make it hard for a single party or coalition to form a government autonomously. According to political analysts' calculations, a single party or a coalition would only ensure a parliamentary majority by winning at least 40% of the votes in the national proportional representation and 70% of the seats in the single-member constituencies.

Looking at the latest polls, a single party government led by the Five Star Movement seems unlikely. This is the scenario most feared by international investors since it is strongly oriented to increasing state expenditure and supporting anti-European policies. As a matter of fact, as it rules out the chance of entering a coalition, Five Star is heavily penalised by the electoral system; moreover, it has a shallow penetration and very few experienced candidates at local level, which may prevent its success in the single-member constituencies.

Similarly, the choice of the secretary of Democratic Party Matteo Renzi to run

as candidate for Prime Minister at the head of a centre-left coalition seems to have undermined its chances of winning a majority of Parliament, an outcome that would have been taken for granted only one year ago and would also be the preferred scenario for international investors and markets as a guarantee of further reforms, stability and European integration. Even a government led by a larger centre-left coalition including Free and Equal is unlikely, due to the above-mentioned conflicts with the members of the Democratic Party closer to Mr. Renzi and in consideration of Free and Equal low standing in polls.

The most plausible outcome is a government led by the centre-right coalition. Given its advantage in the polls, a further impulse could come from the so-called bandwagon effect, with undecided voters tending to choose the most likely winner. Moreover, the bottom-up strategy adopted for this term, as opposed to the past, which features selected local candidates, is a key move to succeed in the *first-past-the-post* constituencies.

Overall, international markets, though not enthusiastic, appear less concerned about such a scenario than that of a Five Star victory. The BTP-Bund spread would only moderately increase, and a reduction of the tax

burden on corporates, if implemented more gradually than the radical cut announced during the campaign, might benefit all businesses and promote investments. In addition, this coalition has already been tested at local level, governing the most prosperous Italian regions of Lombardy and Veneto.

However, this is more of a glass-half-full view. The potential strong presence of the nationalist-populist component represented by the League, which is drawing on Forza Italia in voting intentions (14% and 16% respectively), coupled with the common intents sustained by Brothers of Italy may trigger a harder stance against EU stability constraints and a push to dismantle the pension reforms introduced in 2012, creating significant difficulties in maintaining rigour in public finances. Moreover, the introduction of protectionist trade measures would lead to a surge in inflation and consequently to investor outflow from financial markets as well as to a reduction in the number of cross-border deals. Last but not least, the centre-right coalition has not yet signalled who it would back as Prime Minister, thus adding further uncertainty.





Towards a grand coalition: A numerical hurdle

If no single party or coalition wins a parliamentary majority, political groups that were opposed during the campaign will be required to form a coalition.

The most unsettling scenario from a financial markets and business perspective would see a “populist” government with the League, Brothers of Italy and Five Star Movement endorsing protectionist and anti-euro stances. But a range of conflicting views that is broader than the common ground that unites them and a hard-to-manage contest for leadership makes this scenario quite unrealistic.

Also, the attempt to find common understanding between the Five Star Movement and Democratic Party, which was unsuccessful in 2013, is even more doubtful today as differences have increased, as have personal differences between their respective leaders.

Finally, one should not be misled by the ostensible openness of the Five Star leader to post-election alliances. In fact, Mr. Di Maio’s proposal, in the event that his own party garners the highest share of votes but not the necessary majority, is for all parties to support a Five Star minority government, a solution which is very hard to envisage.

The only post-election grand coalition that looks consistent with current polls and programmes is represented by an enlarged alliance among Democrats, Forza Italia and centrist parties. This is the most desired scenario if we listen to rating agencies, which would maintain the spread on interest rates stable. This German-style grand coalition will be composed by leaders that foster a constructive dialogue on EU

constraints, are open to international investors and not inclined to take protectionist measures. But numbers are still far from securing such an outcome, with Forza Italia still quite far from 20% and the Democrats tumbling. Moreover, centre-right leaders had to reach agreements on candidates for the *first-past-the-post* constituencies who will be accountable to a larger electorate than their own party: the falling-out of a centre-right coalition could negatively impact the stability of local administrations where Forza Italia and the League govern together.

No government, what repercussions?

If no majority emerges after the vote and an agreement to form a government is not reached, President Mattarella may be forced to call new elections. International investors are quite concerned by such a scenario triggering prolonged political instability and legislative uncertainty. What would mostly affect business is the stalemate in which the interim government would fall: unable to take clear decisions on some relevant issues such as sustainable tax, job and pension measures, to implement reforms, including on education, justice and the banking system that Italy needs to maintain steady growth. Finally, the government would lack a clear mandate to affirm its position in the European Union integration process, leaving room to the leadership of the French – German axis.

In such a transitional phase, the Parliament would probably be driven by one main objective: draft a further electoral law to go, as soon as possible, to new elections.

Conclusions

Why international investors shouldn't be too worried by the election outcome

If Germany is maintaining strong M&A activity as well as excellent financial market performance even as it goes through the most trying period in the history of the Federal Republic, it is mainly due to the strong fundamentals of its economy.

The same is true for Italy. Even though the Italian economy is less robust than Germany's, two main factors bear out our confidence that Italy is well armed to face the election outcome from a business and financial point of view.

The first is the stability of some key institutions that have recently renewed their leadership. The Italian Financial Markets Authority (CONSOB) and the Bank of Italy are today led by two personalities (Mario Nava and Ignazio Visco, respectively) with deep expertise and knowledge of their functions and of Italy's role within the European institutions, distant from political interference, as well as highly respected by the international community. A further key role will be played by Italy's President Sergio Mattarella. Thanks to his neutral approach towards the electoral campaign and to his longstanding political expertise, he is the best symbol of Italy's ability to find solutions to political instability - nothing new for a country that has had 64 governments since 1946.

The second element is the soundness of an economic framework helped by an initial phase of reforms and the renewed interest of foreign investors towards Italian assets and businesses.

Above and beyond potential limitations coming from legislative instability, in December 2017, the Parliament approved the 2018-2020 Budget Law including tax relief measures for business that are expected to support youth employment, innovation and technology and energy efficiency. In addition, in the last five years, Italy has approved fiscal norms aimed at attracting foreign investments and facilitating business development: new incentives and measures aimed at providing legal certainty, tax advantages for companies and high-net-worth individuals moving to Italy – in particular after Brexit.

Investments and M&A activity are also on the rise, primarily thanks to the return of private equity, attracted by multiples of Italian companies returning to pre-crisis levels. Buyout activity saw its fourth successive yearly increase by deal count, spreading out €7.8 billion across 94 transactions – thanks to the large amounts of low-cost cash available and favourable tax reforms – representing 17.3% of Italian M&A deals.

Italian M&A is also soaring: the total deal value – over €50 billion for the third successive year – was €59.5 billion in 2017, for a total of 544 deals announced, increasing by 19.1% versus 2016 and contributing 7.2% of European M&A (€826.4 billion). Italy closed the year with its highest inbound deal count since 2001, with 262 deals worth €38.4 billion.

Additionally, Italian companies are again expanding internationally. Several companies, that have emerged from the crisis sounder and stronger, are now better structured to develop abroad. Thus, after aggregating internally, they have started to make cross-border acquisitions. But even when Italian companies were a target for international players, their value significantly increased: the average value of an Italian company acquired in 2017 has been 9.4 times EBITDA, which is the highest registered multiple since 2007 (when value was 7.7 times EBITDA) and 50% higher than the value registered in 2010 (6.6 times EBITDA).

In conclusion, the increase of competitiveness and exports combined with unemployment at its lowest point in five years, the current reforms and Europe's overall favourable environment are key drivers to the resilience of investments and M&A activity in Italy this year, which started already with a €2 billion acquisition by the US fund Global Infrastructure Partners of Italo, the first Italian and European private railway operator, at the beginning of February. All signals that lead us to take on 2018 with cautious optimism, notwithstanding the election uncertainty.

Parties and Coalitions

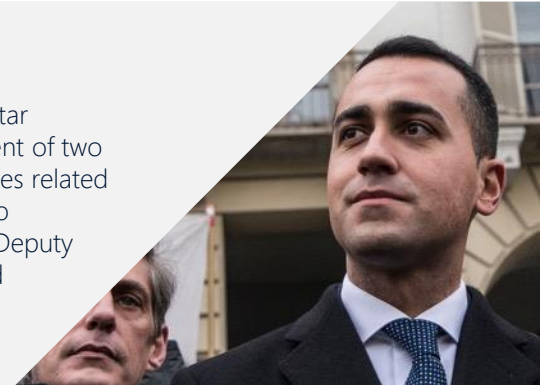
Centre-right coalition (35-37%)

The centre-right has regained support in the latest months throughout the country, but the coalition suffers from internal divisions among the nationalist and populist factions led by the League and Brothers of Italy on one hand, and Forza Italia on the other, which may trigger instability and further breakup. In addition, Forza Italia's founder and powerbroker Silvio Berlusconi is banned from public office because of a tax fraud conviction that makes his election to Parliament as well as his candidacy as Prime Minister impossible.



Five Star Movement (27-29%)

Symbol of the anti-establishment, following its entry into Parliament in 2013, the Five Star Movement also achieved significant electoral wins at local level, winning the government of two large municipalities Rome and Turin. Nevertheless, the movement is facing several issues related to a crisis of leadership following the death of the Movement's co-founder Gianroberto Casaleggio, only partly resolved by the appointment of Luigi Di Maio (who is also the Deputy Chair of the Lower Chamber) and a severe lack of credibility, mainly due to the alleged inexperience of Di Maio himself and of other members of the party.



Centre-left coalition (27-28%)

The Democratic Party, at the core of the governing coalition, has significantly changed over the past 5 years. It benefited from a spectacular rise in 2014, when party leader and former Prime Minister Matteo Renzi gained the party leadership and became head of the government in the space of a few months, winning support from a large moderate voting bloc and obtaining more than 40% of votes in European elections. The faster his rise, the steeper his decline, however. Amid rising criticism and failing to win consensus on the referendum aimed at modifying the Italian Constitution in 2016, Renzi resigned and passed the helm to the current Prime Minister Paolo Gentiloni.



Free and Equal (~6%)

Free and Equal is a new political force born from the spin-off of the leftwing dissidents of the Democratic Party that also gathered a relevant portion of the traditional leftists. The party is led by the President of the Senate and former anti-mafia prosecutor Pietro Grasso.



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