Profits might be delayed

- A successful rights issue of 2.1 billion euros in July 2014 provided Millennium Group with enough capital to pass ECB stress tests and sustain eventual losses over the next few years.

- The Portuguese operation is set to benefit from stabilization in the credit market’s quality, a significant cut in future staff costs, historically cheap funding due to the collapse of GES and aggressive monetary policy from the ECB, and a recovery in the real estate market. Non-recurrent assets of more than 4.5 billion euros create high uncertainty around this operation’s value.

- Poland’s will suffer from the conflict in Ukraine and a deep economic shock in Russia. We expect deterioration in polish operation’s credit quality standards and a NIM decrease due to central bank’s active policy to fight the economic drag down. Due to current high consolidation propensity in the Polish banking sector, there is a possibility that part of this operation is alienated.

- The recent oil’s price fall is certain to be a heavy weight for African operations. Taking the impact it will have on the economy, we expect Banco Millennium Angola to have net income decrease of around 70% over the next years.

Company description

Millennium BCP is a Portuguese retail bank, founded in 1985, with its main operation in Portugal and with relevant operations in Poland, Mozambique and Angola. On a consolidated basis it has over 80 billion euros in assets.
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Executive summary

This report aims at thoroughly understand Millennium BCP and estimate its value for the year of 2015 by carefully analysing the past performance of its different operations, relating it to the macroeconomic environment of the respective country and the sector's performance, by screening the current relevant macroeconomic situations, operational and sector wide current trends and based on sound fundamentals extrapolate the future ones. Given the group’s complexity and range of possibilities we thought reasonable to compute different scenarios (optimistic, neutral and pessimistic) in which we cover what we see as the most probable future. Having determined what we expect to be the group’s future fundamentals we use established and widely accepted valuation methods to arrive at a nominal share price target.

Company overview

Banco Comercial Português, founded in 1985, is currently the largest listed bank in Portugal with significant operations in Portugal, Poland, Mozambique and Angola.

BCP history can be divided into three main phases related to its strategic approach. From 1985 to the beginning of 1990s it maintained an organic growth approach which was enough for it to become a relevant player in the national market and settle operations in international markets. From the beginning of 1990s BCP changed into a more aggressive stance and started expanding both in domestic and international markets through mergers and acquisitions which allowed gaining significant size. Once the group established itself as a main player in Portugal (around 2000) it started building what would be the starting point of its international position, the Millennium brand. Recently Millennium group started focusing more on Portugal (where it has become a reference bank) and affinity markets (Mozambique and Angola) which is where it sustains a competitive advantage. Nowadays the group has around 1600 branches, 18 thousand employees and 5.5 million customers worldwide.

In spite of these seemingly good numbers and history, if an investor invested in BCP’s IPO, back in March 1993, the returns are not rosy at all. BCP was listed in 1993 at 2100 escudos with almost 110 million shares outstanding. Today it has almost 54.2 billion shares outstanding and has been pricing at around 0.07 euros. In total there were eight rights’ offerings and five equity’s offerings which amounted to a capital increase of over 10.5 billion euros over the past 20 years.
(over 2 times current market capitalization). An investor that invested in the IPO, sold all the rights’ offerings that were conceded to him, and retained all dividends would have a negative return of 58.3% on his investment. If he had invested in all the rights’ offerings, he would have a negative return would be even bigger at -66.4%. Still we would like to refer that a big part of the dilution and BCP’s bad performance took part in the last 3 years. In addition to that, the rights’ offering of 1998 was also a particularly bad investment for those who participated and inversely a good deal for those who sold the rights and BCP itself. As of 2010, those that sold all the rights conceded to them would have a negative return on their investment of 34.1% and those that exercised all the rights would have a negative return of 57.4%.

The past three years have been difficult ones not only for BCP but for the banking sector as a whole. The group presented losses of 759, 1137 and 657.75 million euros in the years of 2011, 2012 and 2013 respectively, which together would wipe out around 45% of total equity the Group had in 2010 year end, but still, through a series of rights issues and state aid it managed through the storm and is expects to show a profit in 2015.

From our point of view, what differentiates BCP from its Portuguese peers is its international reach. In spite of international operations being responsible for a big loss since 2011, we are confident that such international set up might still be a vector of growth for the group.

Shareholder structure

BCP has a fairly fragmented shareholder structure, from its 54,194.7 million shares outstanding around 47,470 million are floating (87.6%). Its biggest shareholder by December 2014 was Sonangol who held 7.07% of outstanding shares, followed by Banco de Sabadell SA, who held 5.53% of outstanding shares. Qualified shareholders that held above 2% of outstanding shares (but below 2.5%) were Blackrock, Interocéanico Capital SGPS and Ocidental – Cia Portuguesa Segur. By December 2014 there were also some relevant short positions held by Abaco Financials fund (-0.55%), Marshall Wace LLP (-1.49%) and Lansdowne Partners ltd (-1.51%).

As of January 2015, BCP had 204 institutional owners that owned 13.61 billion shares (25.1% of outstanding shares), of these, 21.5% are Angolan, 19.8% are Portuguese, 19.3% Spanish and 16.9% from the US. It is also worth noting that among the institutional owners only 1.77% is represented by governments.
Overall BCP has a very fragmented shareholders’ structure, not only close to 75% of the bank is owned by retail investors as no shareholder holds more than 10% of the shares. We can therefore say that this makes BCP a more probable takeover target than if its shareholder structure was less fragmented because retail investors have close to no negotiation power and tend to be psychologically receptive to takeovers.

Valuation

Method

When valuing banks we should take into account the active use banks make of their balance sheet (asset and liability side) into creating value. Differing from most businesses, debt and funding is an integrant part of a bank’s operations, business model and value creation. In addition to that, banks are nowadays heavily scrutinized in regulatory terms having to comply with strict capital requirement norms which imply certain restrictions in cash flows to equity.

Given this and the difficulty in finding good comparable banks that could provide a proxy in terms of market multiples, business model, interest rate and regulatory risk, we see an income approach valuation through a free cash flow on equity model as the most appropriate method to value BCP.

BCP’s different operations, in spite of being independent businesses, do transact between themselves and from our point of view, this adds value to the group through funding diversification and exposure to more investing and lending opportunities. Taking this into account, we used the regional consolidated accounts provided in BCP’s consolidated accounts as the historical base to our valuation.

Regarding the discounting rate, we consider that the stock’s beta provides a good measure of both group’s systemic risk and the investors’ perception of it. BCP’s beta comparing to the MSCI World has consistently increased over the years reflecting the growing struggle of the sector and uncertainty around it. We calculated BCP’s moving beta for 3 different time ranges, 1 year, 3 years and 5 years and obtained the results seen in chart “BCP’s moving Betas VS MSCI World”. Our opinion is that the longer term moving betas do not reflect the recent structural changes the sector has suffered but also that the shorter term ones reflect a historically high instability and uncertainty around BCP that should not
We therefore computed the moving average of the moving betas in order to grasp a smoother picture of what BCP’s systemic risk has been. As of December 2014, the moving betas’ moving average stood at around 1.8 (a historically high level). Although this represents very high systemic risk, which might not seem right considering historical levels, we believe this provides a good representation of BCP’s vulnerability to both good and bad global conditions, and the share’s price volatility that might come from that. It is interesting to note that STOXX Europe 600 Banks has also shown a sustained Beta (comparing to the MSCI World) increase over time as we can see from graph. By computing the same Betas we computed for BCP, we can see that the STOXX Europe Banks’ Beta increased from below 1 in 2005 and 2006 to around 1.4 over the past three years. This confirms that the increase in systemic risk is indeed sector wide.

We will account for specific regional risks in a scenario based analysis. As to the risk free rate, we consider that the German Bund is the safest option in euros and we will use current yield rates as the risk free rate. Regarding market risk premium, we shall compute scenarios that account for market risk premium ranging from 5 to 6%. As for the growth rate in the terminal value we took into account what would be a reasonable GDP growth rate for each region, the leverage each operation has on its deposits (which is the key driver for balance sheet growth and directly related to GDP) and the capital requirements required for each region. By computing what will be a necessary equity retention rate for the different branches to keep up with their country’s economic growth we arrived at the sustainable growth rate. Our final growth rates were: 1.6% for Portugal; 2.8% for Poland; 6.2% for Mozambique; 2.3% for Angola. We averaged out the growth rates considering the contribution its regions give to the final value and arrived at a global sustainable growth rate of 3.16%.

As BCP is spread mainly through four different, reasonably independent regions, we have done separate analysis for each region compromising the macroeconomic outlook, a sector overview and an analysis of the region’s Millennium operation. It is worth reminding that in spite of this regional spread, the group acts as a whole and therefore the regional benefits that a certain region generates might sometimes be absorbed by the negative performance and needs of other region. We therefore finalize with the analysis of the group as a whole.
PORTUGAL

Macroeconomic overview

Portugal’s economy has been in recession since 2011 due to a serious sovereign debt crisis which almost led the country into bankruptcy (real GDP growth of -1.3%, -3.2% and -1.4% in 2011, 2012 and 2013 respectively). The country has undergone an austerity program that was designed to rebalance public finances, improve the economy’s competitiveness and avoid government’s bankruptcy. By this time we can say that the goals were broadly achieved but also that the economy is still fragile and highly dependent on ECB aggressive monetary policy to sustain its public finances. From our point of view current low yields on Portuguese sovereign debt are mainly fuelled by the expectation of further monetary easing in Europe, because as we can see, public finances are still shaky with a historically high level of public debt comparing to GDP (131.6% as of September 2014), and even though the negative budget deficit is mainly due to interest expenses, we do not think it justifies current levels of sovereign yield spread on German Bunds. Such easing would be very welcome by the banking sector, which not only is exposed to sovereign debt as will always be happy receiving cheap funding.

Currently, the main risk for the Portuguese economy and the banking sector is that ECB intervention fails to spur inflation. If aggressive monetary policy will not spur inflation it will be difficult to find something that will, which might result in the country entering a long period of stagnant economic activity (Banco de Portugal estimates that inflation will be 0% in 2014 and 1% in 2015 in Portugal). What Japan experienced during the 90s and 2000s is the closest scenario we have of what could happen to the Eurozone in the medium term. Japan experienced an average growth of 1.3% in the 90s, from 2000 to 2013 lost 6.15% of its GDP and experienced deflation in most of the 2000s decade (as we can see in the graph). The impact of this Japanese depression was very profound to the banking sector. The main banking sector in Japan, consisting of all the banks listed in Nikkei, experienced a market top in 1990 at around 30,000 points from which it is still down almost 90% (quoting below 200 points). Banks’ returns on equity were awfully scary during the late 90s and early 2000s as shown in the graph “TPNBNK Return on Equity”. It is hard to imagine such a scenario occurring in Europe but it is definitely a reference.

A second risk for the Portuguese economy is its exposure to the Angolan economy. Angola has been an important trade partner for Portugal (in 2013 Portugal exported around USD 4.4 billion to Angola which accounted for around
10% of total exports) and the impact the current oil’s price will have in Angola will certainly be felt in Portugal. We talk more deeply about what assumed for Angola’s macroeconomic inputs in a pessimistic case of the oil’s price not recovering too much from current levels (below USD 60 a barrel) but in the case of Portugal, which will suffer mainly through less exports and tourism, we assumed an impact on GDP of 440 million euros (10% of exports to Angola in 2013), which represents close to 0.2% of GDP and an increment of 0.1% in the cost of risk for the banking sector.

The main macroeconomic assumptions are included in the appendix.

The sector

Over the past ten years, the Portuguese banking sector experienced the best and the worst. Until the year of 2008, when the subprime crisis broke in the US, the sector enjoyed a relatively good performance with low non-performing loans (standing between 1 and 2% of Gross loans), decent capitalization (Assets to Equity ratio stood at around 15 times), high (and increasing) leverage on deposits with an LTD ratio above 1.4, which at the time was not a problem given the low NPL to Gross Loans and consequent low cost of risk (around 0.5%), net interest margins above 1.7%, overall ROE above 10% and considerable total assets growth (from 2004 to 2008 the sector’s total assets grew by 77%). After 2008, things started to drastically change. Even though the Portuguese banking sector was not as exposed to the subprime credit market as banks in other countries, nor did Portugal have a real estate bubble, the global financial crisis certainly hit the country. From 2008 onwards the main changes was that non-performing assets started to slowly increase in a trend that still has not reversed (non-performing loans to gross loans are today close to 8% comparing to below 2% before 2008) and the sector’s net interest margin started to decline. In 2008, the aggregate ROE fell sharply to 1.9% but still recovered to 3.7% in 2010, which was when the European crisis erupted. Portuguese banks not only were exposed to Portugal but also to other European periphery economies such as Greece, Italy and Spain and therefore were deeply impacted by the crisis. The main causes for losses since 2011 were: exposure to sovereign debt of European periphery countries, continuing increase in non-performing loans in Portugal and a further squeeze in the net interest margin (which stood at 1.2% in 2013 – 0.5% below the pre-crisis levels). Aggregate ROE were -5.6%, -3.5% and -9.8% in 2011, 2012 and 2013 respectively. Even though Portuguese banks cleaned up their balance sheets regarding to sovereign exposure to European periphery countries other than Portugal, a stagnant European economy, with very low
growth and inflation, has persisted and weighted on the performance of loans. Low inflation is a particularly bad incentive for debtors to repay their debts because if prices are decreasing, the weight of debt will actually increase over time. In addition to that, the fact that most of the major players in the sector enjoyed state aid of some sort (mainly through expensive debt instruments – Contingent convertible bonds), has also weighted significantly on net interest income during these years.

As of 2013, there were three banks with deposits’ market shares above 10% in the Portuguese market. Millennium BCP with 16.3%, BES with 15.6% and CGD at 27.2%, in addition to those, Santander Totta and Banco BPI are also major players in the domestic market in spite of their smaller deposits’ market shares of 9.7% and 8.7% respectively. On a consolidated basis these five banks presented very diverse results with ROEs ranging from -22.6% (BCP) to 3.3% (Santander Totta). Among these, Santander Totta was not only the bank with the highest ROE but also the one that in our opinion showed the most desired results for a retail bank, meaning: high net interest margin at 1.24%, lowest cost of risk at 0.73%, the best efficiency ratio of 34.8% and a residual weight of net trading gains on results (only 0.02% of total assets). Regarding other peers, CGD seems to be the less efficient operationally with the lowest net interest margin (0.76%), the lowest net fees & commissions to total assets ratio at 0.46% and the highest efficiency ratio at 51.7%, BES seems to have taken disproportionate risks in its lending activity as it cost of risk stood at 2.02% and BPI seems to rely on its trading activity for an above average ROE.

During 2014, the Portuguese banking sector suffered a tremendous shake up that will completely reshape not only the sector but also the country. After years of financing its holdings in a doubtful and opaque way, through Banco Espirito Santo and most importantly, through its clients, Grupo Espirito Santo finally collapsed during August 2014. Thankfully, and in spite of failing to spot such scheme, the regulators and the government managed to contain the potential contagion effect by splitting Banco Espirito Santo into two entities, one where the “good assets” would be held, owned by a resolution fund (owned by the Portuguese banking sector) to which the government lent € 4.9 billion (the entity owning the “good assets” was named Novo Banco), and another holding the “bad assets” owned by Banco Espirito Santo shareholders. No depositors lost any of their savings and although the markets reacted very badly, after a few months things seem to have normalized.

One direct impact that this event will have on the banking sector is that all the banks will have to repay the € 4.4 billion the government lent to the resolution fund in proportion to their market share in Portugal. Conditions to the repayment
of this loan are still foggy but it is expected that the government will somehow try
to ease this burden on the banks. The amount each bank will have to repay will
directly depend on the price for which the resolution fund is able to sell Novo
Banco to an eventual investor. Due to the opaqueness of the BES split the
estimates for this price are naturally very doubtful but a rough guess points to a
value of € 2.5 billion for Novo Banco, which would imply losses of € 1.9 billion at
least for the Portuguese banking sector as a whole. This loss is distributed
among the banks depending on market share. Since BCP has around 20% deposits’
market share, we will assume this will be the portion of the loan amortization
BCP will have to assume. We talk more deeply about what losses we assumed for
BCP in the Non-recurrent items section.

It is difficult to establish what will be a recurrent operational activity in the future
for the Portuguese banking sector given the instability and structural changes the
sector experienced since 2010 but overall the sector trends that we are most
confident about for the next couple of years are: an improvement in net interest
margin due to historically low interest rate references and redemption of
expensive debt instruments, a fading but continuing increase in efficiency (due to
staff cuts), a materialization of gains from Portuguese sovereign debt portfolios
and an improvement in new non-performing assets due better economic
conditions.

**Millennium BCP**

The operation in Portugal, in addition to the already discontinued Greek
operation, has been the main drag down to Millennium Group since 2011. High
leverage, relaxed lending standards and some exposure to sovereign debt are
the reasons this branch has had to absorb significant losses which ultimately led
to a big rights issue in 2014 (2.1 billion euros). The Portuguese branch has made
an effort to deleverage and cut costs over this period (which the management
signals will continue) comparable to the losses it experienced. The structure cost
cuts have been made mainly through staff reduction which actually has increased
staff & administrative costs per employee due to early reform and lay off
compensations (The Group’s costs with early retirement programs and other staff
costs were 175.5 million euros in 2013 – around 100 million euros more than in
2012). We believe this is a vector through which Millennium BCP will be able to
create value over the next years as staff & administrative costs per employee
decrease. Cost of risk has also been considerably high (due to already referred
extraordinary conjuncture) and therefore we expect that as the branch cleans up
its balance and improves its lending standards this figure also improves. We also
expect Millennium BCP to have cheaper funding in the next years thanks to a higher deposits market share (on a consolidated basis, BCP’s amounts owed to costumers increased by 1.15 billion euros in the third quarter), the redemption of very expensive debt instruments during 2014 (BCP redeemed around 1.85 billion euros of CoCos during the third quarter, which implied a saving of around 300 million euros in interest expenses) and 2015 (BCP expects to redeem more 750 million euros of CoCos until 2016), and due to loose monetary policy. Net interest margin of Portuguese operations is expected to be around 1% in 2014 and 1.2% in 2015 when comparing to 0.6% in 2013. We expect the efficiency ratio to stabilize between 50 and 60% for the years to come and the cost of risk to still increase during 2014 but to start declining from 2016 onwards which shall be the main reason for the Portuguese operation to restart showing a profit (after 5 negative years) in 2016.

As referred, it is difficult to understand what the recurrent operation of the Portuguese branch will be as we feel that historical averages are very misleading due to very high instability. We feel that particularly the last three years should not weight too much in measuring what will be a recurrent activity in Portugal. We took into consideration what was the banking sector performance in Japan during the stagnant decade between the 90s and the 2000s in our pessimistic scenario and computed a continuing ROE of 1.5%. In our neutral scenario we looked more at what the sector and BCP’s pre-crisis profitability was and built from there to arrive at a continuing ROE of close to 5%. Finally in our optimistic scenario we improved the main operational inputs taking into account past variability (an improvement between half and one standard deviation) and computed a continuing ROE of slightly above 10%. Details on other assumptions regarding the main value drivers are included in the appendix.

**NON-RECURRENT ITEMS**

One of the main question marks around BCP is the impact that non recurrent items will have on its results. Due to the significant losses and higher than expected non-performing loans over the past years, BCP has accumulated in its balance sheet excessive amounts of non-recurrent assets. In the annual report of 2013, on a consolidated basis, BCP reported 2181 million euros of deferred income tax assets (which have been changed into tax credit during 2014, allowing for lower capital requirements), 1506 million euros of non-current assets available for sale (of which 347 million euros refer to Closed Real estate Funds) and 1040 million euros of investment fund units related to the participation units of funds specialized in recovery loans. It is not clear what benefits BCP will
extract from these assets in the coming years, but given the weight of such
assets (4.7 billion euros is more than the current market capitalization of BCP),
we believe it is important to consider them when valuing BCP. Most of these non-
recurrent items were derived from the Portuguese operation and therefore we
include it in this section.

Deferred tax assets (now tax credit)

A deferred tax asset is an asset that may be used to reduce future income tax
expenses. Examples of situations from which a deferred tax asset can arise are:
a company might incur in a provision expense related to bad debt but tax relief on
this expense will only occur when the provision is actually utilized (when the
debtor defaults); a company might incur tax losses which it will be able to carry
forward.

The Portuguese banking sector as a whole has been accumulating impressing
amounts of deferred tax assets over the past few years. By the end of 2013 there
were over 6.5 billion euros in deferred tax assets in Portuguese banks’ balance
sheets (BCP accounts for almost one third of those). Deferred tax assets would
not be a problem if the circumstances satisfied a set of conditions, being them:
the banks being comfortably profitable, allowing for margin to use deferred tax
assets; the Portuguese state not being struggling with its public finances (6.5
billion euros represents around 3.5% of national GDP or around 70% of the
annual public deficit); and finally but probably most importantly, there was not a
limit date until which the deferred tax assets could be used.

In 2014 the banks were given the option by the government of transforming
deferred income tax assets into fiscal credit. This would directly benefit the banks
as capital requirements on fiscal credits will be lower than on deferred tax assets.
Even though after this change the Portuguese state recognizes these assets as
actual debt, the benefits BCP will extract from this transformation in addition to
lower capital requirements are not certain as details on this agreement between
the sector and the government are still not known. Given the current shaky
condition of both public finances and politics we will assume that these assets will
benefit the bank the same way they would do in case they were deferred tax
assets. Still, overall this is beneficial for the share price as it reduces the risk the
bank will have to increase its capital due to regulatory requirements, which would
dilute current shareholders. It is important to note that it is not the hypothesis of
the bank having lower capital that adds value but the decreased probability that
the bank will have to go out of its way to submit to regulatory requirements that
would dilute current shareholders.
We will increment the tax credit value in separate of the model as we see this as a non-recurrent item. In an optimistic scenario we will assume that these assets will be able to be used over a twenty year span, in a neutral scenario a fifteen year span and in a pessimistic scenario ten year span. It is unlikely that banks will have to assume a loss on these assets given it being a sector wide issue and given the lobby power banks can exercise and most likely what will happen is that there will be found a way to roll over these assets over time in case but we still think it is reasonable to assume a certain discount on the book value of these assets in neutral and pessimistic scenarios. We therefore assumed that in an optimistic scenario, tax credit increments 795 million euros to BCP’s equity value, in a neutral scenario 645 million euros and in a pessimistic one 460 million euros. These are indeed very significant values comparing to the Group’s current market capitalization but we still see them as reasonable given the reported deferred tax assets.

Non-current assets available for sale and investment units

Most of these assets arise from recovered loans and therefore correspond mainly to real estate property and participation in companies under restructuring. BCP has already incurred in impairment losses related to these assets and was able to show a profit on the sale of some of them in 2014 but still, it is not certain whether such assets will be sold above book value or not. This possibility will naturally be closely linked with both the real estate market and investment in Portugal. Given the profit that was shown related to these assets during 2014, that the Group had already provisioned close to 19.8% of its non-current assets and that the Portuguese continental real estate market already showed a recovery in 2014 (from 2009, the real estate prices in continental Portugal fell 21.6% until 2012 and recovered 4.3% in 2013 according to INE), we will assume that only under a pessimistic scenario additional impairments will have to be made related to these assets and that under neutral and optimistic conditions, BCP will be able to show a profit on the sale of some of these assets in the next couple of years.

Novo Banco sale

As explained before in the sector’s section the sale of Novo Banco will most probably imply a certain loss for BCP. The limit date for interested parties to
show their interest was the 31st of December 2014 and by then 17 parties came up to show their "interest". Most of them might not actually be potential buyers as we have to take into account that it is of Portuguese banking sector’s dearest interest to create as much fuss around Novo Banco’s sale as possible. Overall we believe the more serious contenders are (not necessarily in this order): Fosun Group (Chinese), Apollo Global (American), BPI, Banco Popular and Santander Portugal (the last two backed up by their Spanish parents). BPI is a particularly strong interest in buying Novo Banco because their Portuguese retail banking business is barely profitable (which would be well complemented by Novo Banco’s SME focus) and because of recent new capital requirements on Angolan exposures (consolidation of Novo Banco’s balance sheet would dilute this exposure) and therefore we believe there might be a tendency to bid up from the initial rough estimate of 2.5 billion euros. The Portuguese state lent 4.4 billion euros to the resolution fund (the entity that recapitalized Novo Banco) at an interest rate of 2.95% that would raise 5 basis points every quarter in order to incentivize a quicker redemption. We assumed that in an optimistic scenario Novo Banco would be sold for 4 billion euros, in a neutral scenario 2.8 billion euros and in a pessimistic one 2.3 billion euros. This would imply repayments of 80, 320 or 420 million euros respectively for BCP. Taking into account the loan terms and that in an optimistic scenario BCP would repay the loan on the first year, in a neutral one in three years and in a pessimistic scenario five years we assumed that the following equity value deductions in the different scenarios: optimistic: minus 52 million euros; neutral: minus 195 million euros and for pessimistic minus 247 million euros in the final equity value. This values account for tax shield inherent from this liabilities and are discounted at the equity’s discount rate.

**ECB’s aggressive stance**

Central policy is of tremendous importance for the banking sector. Not only authorities regulate as the central bank actively influences the monetary market in order to achieve goals it perceives as beneficial for price stability and employment fostering. The ECB has been one of the main agents fighting against European stagnant economy and an eventual euro break up through aggressive monetary policy. Close to zero interest rates, cheap financing (through LTRO and TLTRO) and asset purchases (ABS are being bought with certain criteria by the ECB) are now the normal reality and this is something that deeply affects the banking business. In a way, ECB is nowadays acting as a main lender to the economy as it both finances banks and buys assets from them, where banks may
be considered merely agents or intermediaries. This might be beneficial for banks in the short term as they will lock a profit in this seemingly risk-free transaction, but it certainly creates an unhealthy and unsustainable precedent. We therefore see the using of ECB funds as a negative signal in terms of a bank’s stock price as it shows a certain degree of dependence on aggressive monetary policy, but on the other hand, we see the banking sector as a whole benefiting from this as funding rates will certainly remain low. Concluding, we see this ECB policy as beneficial for the banking sector as a whole but as a bad signal for the banks which overuse it. On a consolidated basis, BCP has improved its independence in this sense. As of December 2013, it had around 11.2 billion euros in deposits from the ECB, which was reduced in September 2014 to 6.7 billion euros, which emphasizes BCP’s regained capacity to tap the wholesale market. Was BCP not to have access to such liquidity line during 2014, and had to recur to other kinds of interest bearing liabilities instead, its interest expenses would increase by more than 100 million euros on a consolidated basis.

In fact, asset buying programs have not had the intended impact and reception. It seems that banks are unwilling to renew their balance sheet (through the sale of ABS), which reveals where the problem might lie, in the loans’ demand. Since the problem might lie in the loans’ demand, the banking sector’s and BCP’s performance is therefore more dependent on the economy’s performance than on ECB’s policy.

**MOZAMBIQUE**

**Macroeconomic overview**

Mozambique has also experienced robust growth over the past years, constantly growing real GDP by around 7% for the last 4 years, and is estimated by the IMF to continue this trend in 2014 and 2015 with real GDP growth of 8.3% and 8.2% respectively. Inflation also seems to be under control and watch when compared to the two digit inflation levels when compared to the first years of 2000s decade (inflation was 4.2% in 2013 and is estimated by the IMF to be 4.6% and 5.6% in 2014 and 2015 respectively).

The main risk that could invalidate these growth expectations is the possibility of a political conflict between the two main political parties (FRELIMO and RENAMO), which in spite of have peace agreement signed have recently been involved in some low intensity confrontations derived from uneven distribution of benefits from oil and gas discoveries in the north of Mozambique. If a more
serious conflict was to arise the economy would naturally be severely disrupted which would have direct impact to the banking sector.

We adopted the IMF’s growth and inflation estimates as our assumption for the neutral scenario, incremented a 1% growth per year in our optimistic scenario and cut the growth estimates by 1% in a pessimistic scenario.

The sector

The Mozambican banking sector as experienced a very high growth period in the last decade due in part to economic growth but more importantly, to an active approach by the government to improve the population access to financial services (from December 2007 to October 2014 total assets grew by a factor of almost 3.8x). In spite of this effort, by November 2014, only 20% of the population had access to financial services provided by regulated financial institutions (total assets of the financial sector were only $ 10 billion). Mozambican authorities are aiming for this access to increase to 35% by 2022 and therefore growth expectations for the sector are high. We cannot take into account what the sector wide profitability of the banking sector is like in Mozambique since the available data (by Banco de Mozambique) only accounts for the historical balance sheet, still by looking at the bigger banks we think we can have a good approximation of the sector’s profitability. From the provided data we can see two important trends developing since 2007. Both foreign assets and credit to the government have been decreasing as a percentage of total assets and total credit respectively. As of December 2007, foreign assets represented 30% of total assets (in October 2014 this percentage was only 6%) and credit to government to total credit decreased from 22.7% by the end of 2007 to 18.5% by October 2014. We see this as a sign that the domestic economy is gaining steam of its own, which is good. The sector’s LTD ratio has ranged between 70% and 85% over the past five years which reveals certain conservatism but we suspect that as the domestic economy keeps on growing this ratio will tend to increase.

The sector is dominated by the four largest banks which have around 80% of the total assets and are largely owned by Portuguese and South African investors and the Mozambican state. In the year of 2013 the returns on equity of the six largest banks have ranged from -35.7% (Barclays Bank Mozambique) to 22.3% (Millennium bim) which suggests the dissimilar nature of the sector in Mozambique. Net interest margins ranged from 4.4% to 6.3% and cost to income ranged from 43.6% to 133.9% but if outliers are excluded (Banco Unico and Barclays Bank Mozambique) the top of this range was only 87.8%.
Regarding future trends, one of the challenges the sector faces is a low supply of qualified labour and the unavailability of infrastructures outside the main cities. We are afraid these barriers will be responsible for future higher operational costs comparing to total income even as the sector enjoys economies of scale from expansion. Regarding the possible political unrest already referred in the macroeconomic overview, it is important to take into account which regions are more prone to such unrest since banks more focused in such area are naturally more vulnerable.

There is a possibility that Mozambique follows the same path as other African countries and widely adopts electronic banking which would have very positive impact on the banking sector’s profitability but we think that due to the lack of quality infrastructure in Mozambique, this is still a very long term goal.

One detail that should be taken into account is that accounting standards for the Mozambican banking sector are different to international ones regarding non-performing loans and therefore this figure is not comparable to other international banks. Given this difference, loan loss reserves should not be compared as well.

**Millennium bim**

Millennium bim, founded in 1995, is a partnership between BCP and the Mozambican state where BCP holds around 60% of outstanding shares and control. The bank is the largest player in the sector holding a market share of over 30% in both loans and deposits’ markets. Millennium bim is a top performer in many profitability and credit quality measures. In 2013 its return on equity was the highest in the sector at 22.3%, its cost of risk also stood below sector median average at 0.93% and its net interest margin was also the highest in the sector at 6.28%. Millennium bim also seems to be the most efficiency with costs per employee standing at 765 thousand Mozambican meticais per year (the lowest in the sector).

Taking into account both the macroeconomic and sector overview, the main changes that we expect to see in Millennium bim results over the next years are: lower net interest margins due to lower reference rates established by the central bank, higher cost to income ratio due to the referred difficulties regarding the labour market and infrastructures and lower Other net operating income due to revenues from non-recurring items like the sale of real estate (215 million meticais in 2013). In a neutral scenario we assumes Millennium bim would offer a continuing ROE of 22.3% (way below the last five years’ average of around 35%) mainly due to higher staff and administrative costs in the future. In an optimistic
scenario, where staff and administrative costs do not grow so much and the cost of risk is slightly lower, we arrived at a continuing ROE of 28.1%. As for the pessimistic scenario, where we assumed higher staff and administrative costs and cost of risk, the continuing ROE was 19.5%.

Millennium bim has only 24 branches in the provinces of Zambézia and Sofala (last two provinces where political confrontations took part) which represent 15% of total branches in the country. Taking into account that the situation has been controlled by the end of 2014 and that only a few branches are exposed to conflict provinces, we believe this is a minor risk for Millennium bim.

**POLAND**

**Macroeconomic overview**

Poland’s economy has been robust performer throughout the past few years, especially when compared to the rest of Europe. Even after a disrupting conflict in Ukraine, which directly affected two important economic partners (Russia was responsible for 5% of Poland’s exports in 2012 and Ukraine for 3%), Poland is still estimated to grow 3.3% in 2015 and 3.5% in 2016 by the IMF, still non-performing loans will most probably increase among exporting companies. Millennium bank is mostly exposed to private individuals in terms of credit (78% of total net loans in 2013) but also has relevant exposure to companies (21% of total net loans in 2013). Regarding inflation, Poland seems vulnerable to European anaemic prices and could also approach the zero inflation level if the European situation worsens (NBP survey shows inflation expectations of 0.2% in 2014, 1.2% in 2015 and 2.1% in 2016).

On the other hand, the National Bank of Poland still has margin to fight negative economic conditions through monetary policy, which is what it has been doing (the reference interest rate was reduced to 2% in October). Looser monetary policy should squeeze banks’ net interest margins but is definitely preferable to a deflationary scenario. Since such monetary tools are still available and expected to be effective, growth and inflation estimates are expected to be met, either with current interest rates or lower ones. Therefore we assume IMF’s growth and inflation estimates in neutral and optimistic cases with lower interest rate references and assume lower inflation in a pessimistic one (which shall results in higher NPL).
The sector

In spite of the financial crisis since 2008, the Polish banking sector enjoyed a very decent performance since 2007. Its total assets grew by over 77% from 2007 to 2013 while its LTD ratio stood at around 1 and its assets to equity ratio remained between 9 and 10, its net interest margin, standing at above 3% in 2007 have been slowly decreasing to a still high 2.5% in 2013, non-performing loans stayed relatively stable since 2010 in a range between 10 and 11%, the efficiency ratio has been slowly improving from 56.6% in 2007 to a low of 51% in 2011 and 54.5% in 2013. Return on equity has been good considering recent European standards with levels close to 10% over the past 4 years. Overall we think that the Polish banking sector has benefited both from the good performance of its economy and the fact that it maintained conservative business model over this time with low leverage and stable lending standards.

The banking sector in Poland is fairly fragmented, the top eight listed banks had only about 55% loans market share and about 60% deposits’ market share by the end of 2013 and among those only two had market shares above 10% in both loans and deposits markets (Bank Pekao and PKO Bank Polski). One of the setbacks of polish banking sector is that banks tend to lend relevant amounts in foreign currency which exposes the banks to foreign exchange risk. This is a characteristic of the Polish banking sector that has been fading away but still is a source of risk (by the end of 2009 33.6% of total loans were in foreign currency, as of October 2014, only 28.9%). As with Bank Millennium, a considerable part of polish banks’ shareholders are foreign, this is the result of a sudden sector privatization during the 1980s.

In terms of recent sector trends, in spite of keeping relatively high ROE, we see a slow fading of income power as net interest margin, net fees & commission to assets and other income to assets all slowly decrease. This has been compensated by a lower cost of risk over the past three years and so ROE were maintained. We believe that it is difficult for the cost of risk to keep decreasing and that income sources shall continue to slowly deteriorate resulting in slightly worst returns on equity than in the past.

As to other future trends, given the fragmented structure of the sector and the fact that efficiency improvements are slowing down and profitability is starting to give way, we believe there is a higher propensity for consolidation over the next years. Economies of scale are the safest bet for the polish banking sector to keep improving its profitability and we are confident that either mergers or acquisitions will be the most obvious solution in order to fight profitability deterioration once efficiency ratios stagnate.
Bank Millennium

Bank Millennium was one more case of foreign investment when the Polish government opened up the financial sector for privatization. BCP has 65.1% of total shares outstanding (giving it control over the bank) and part of the shares are floating in the Warsaw stock exchange. Over the past eight years, Bank Millennium has constantly been a worse than average performer in profitability, liquidity and capital measures only showing better indicators in credit quality measures. Overall its shares market price has reflected exactly that showing lower PE multiples than the sector over the same period.

On the bright side, in the year of 2013, Bank Millennium showed some signs of convergence towards the sector median average in some important measures. Its efficiency ratio decreased from 58.2% in 2012 to 55.8% in 2013 while the sector increased from 51.7% to 54.5%, its return on equity increased from 10% in 2012 to 10.5% in 2013 while the sector median average decreased from 10.55% to 9.9%. Its NPL percentage to total loans decreased from 5.1% to 4.4% over the same period while the sector’s decreased only from 11.3% to 10.7%. Its liquidity indicators also showed improvement in line with the sector. If this convergence is to continue, we are confident Bank Millennium’s share price will perform better than the sector during the next year.

The main risk for Bank Millennium is the possibility of deflation in Poland. Credit quality is something Bank Millennium has been better than its peers at and a deflationary scenario could have a surprising negative impact on this.

Following the considerations we have made in the sector overview regarding the possible sector consolidation, we believe that given its low market share, worse than average profitability and capital position, and the current condition of its parent, Bank Millennium is a probable target for either a merger or acquisition. There have inclusively been rumours (from Polish newspapers) regarding the eventual disposal from BCP of a part of its shares. We don’t see this as a good solution for BCP’s problems. It would be disposing its shares of a profitable business in a growing market, with little negotiating power, to eventually capitalize a currently unprofitable business in a currently stagnant market. Still it is a possibility that is taken into account.

The main changes we expect to see in Bank Millennium for the next years are decrease in net interest margin due to lower interest rate references from the NBP, higher non-performing loans due to lower inflation and an increase in efficiency towards the sector’s average.
In a neutral case we assumed Bank Millennium to provide a continuing ROE of 11.2%, in an optimistic one a ROE of 15.2% and in a pessimistic one 7.8%. We also assumed that in a pessimist scenario BCP would sell 15% of Bank Millennium (retaining 50.1%) during 2015 at current market price resulting in net cash inflow of close to 350 million euros. It is important to note that such cash flow would be destined to further capitalize the Group and therefore the only way it would increment in value would be by reducing the probability of further capital increase (and consequent shareholder dilution) to satisfy regulatory requirements. Since this cash is automatically absorbed in capital and not used in other operations the value it creates is highly arguable but we assumed that BCP would have to perform a capital increase in the same amount as the sale (350 million euros), which would imply a dilution of close to 10% taking into account current market prices. Since we assume the sale happen in a pessimistic scenario (where Bank Millennium’s profitability is also deteriorated) we estimate that such sale would have a negative impact on BCP’s current equity value of around 90 million euros which is way below a shareholder dilution of 10%.

Angola

Macroeconomic overview

Angola’s economy has enjoyed high growth and inflation over the past decade mostly due to oil. According to the Angolan government, dependence on oil has decreased over the same period, but still the weight of oil production in GDP is still above 40%. From its recent peak in June 2014, crude oil’s price in international markets fell over 50%. This is a very significant move and if oil’s price is to remain at these levels, the Angolan economy is expected to suffer accordingly. We therefore expect a significant slowdown in Angola’s economy already in 2014, which is to continue depending on oil’s price. In 2008/09, when the oil’s price had a similar fall, the Angolan economy decreased by 9% but quickly recovered in 2010 (in line with oil’s price). We are afraid this time it might be different. In 2008 the oil’s price fall was not directly derived from oil economics but from the global financial crisis the world was going through. This time the fall is intrinsically justified by oil’s fundamentals of oversupply, new substitutes (shale oil and gas), less global demand and most importantly, geopolitics (the OPEC seems to have divergent interests in contrary to what happened throughout history). We believe there is a higher chance the oil price will stay around this levels for a longer period when compared to 2008. We think it is reasonable to
assume a 5% GDP fall in a neutral scenario and an 8% fall in a pessimistic scenario.

**Banco Millennium Angola**

In spite of being a generally profitable operation over the past years (as we can see in the graph) for the Millennium Group, we are afraid Angola might become a source of problems in the years to come. There are two main characteristics regarding Angola’s operation that we see as noteworthy. First is that a significant portion of Banco Millennium Angola comes from trading, more specifically currencies trading (between 25% and 30% of total income over the past five years), which in a sense is relieving as it more resilient to general economic conditions. The second (more worrying), is that a big part of its credit is due in foreign currency (close to 40% of its total loans to customers in 2013). Since September, when oil’s price started falling, the Angolan Kwanza has lost around 6% of its value against the US dollar, which will most likely make it more difficult for such debtors to repay. We did not find any reference to foreign exchange hedging for such debtors in BMA’s annual report and therefore we assume there is none. BMA’s cost of risk in 2008 was 1.6% and increased to 2.2% in 2009 (an increase of over 35% percentage wise), and this is the reference we will use for our neutral scenario. In 2013, the cost of risk was 2.3% and we will assume that in 2015 it will be 3.1% (in a neutral scenario). Even though other operational inputs shall be deteriorated as well we think that the cost of risk will be the main driver of a worst profitability. Overall, in a neutral scenario assumed a continuing ROE of 7.1% for the Angolan operation and in an optimistic one 13% (the last six years average is 15.5%). In a pessimistic scenario, taking into account the situation’s seriousness and the recently discovered mess around BESA (Banco Espirito Santo Angola), where the branch used lent around 5.7 billion USD to several Angolan entities (most related to the branch’s management) without any kind of filter, criteria or even proper record, we did not find it disproportionate to assume a loss of the total equity and direct exposure to Banco Millennium Angola. By the end of 2013, Banco Millennium Angola had liabilities to its parent of around 90 million euros. We will assume that this amount did not grow nor decreased and that in addition to the equity loss, Millennium Group will lose these 90 million euros.
Conclusion and recommendation

For the past three years the Group has been wasting the cash flow generated by its international operations in keeping the Portuguese afloat. It is in Portugal that the Group has most of its operational and asset value locked up and so it makes sense to follow this strategy but still, it severely penalizes the share price. Not only that, the longer it takes for the Portuguese operation to get back to its recurrent activity, the less certain it is how much it will generate.

We expect the Group to keep following this path and the longer it does the bigger the value it locks in non-recurrent items like tax credit, real estate and restructuring funds, and the less likely it seems the Group will extract the expected benefits from them (in a neutral scenario we estimate the current equity value of non-recurrent items to be over 400 million euros which is more than 10% of current market capitalization). As this happens we do not expect the Group to distribute dividends until 2017 (in a neutral and pessimistic scenario) and 2016 in an optimistic scenario, even though international operations will generate them.

From there on, we expect Mozambique to be the Group’s main growth vector, Portugal to be the main source of equity value but to have low growth power due to high capital requirements and low profitability and Poland to be stable source of decent cash as it requires a lower retention rate to keep up with the economy’s growth. Finally, Angola seems to be a relevant question mark in the Group’s future as the impact that lower prices will have in the economy are still widely unknown. The scenarios we computed allow for both the operation’s bankruptcy in a pessimistic scenario, it having close but below historical profitability in an optimistic scenario and somewhere in between in a neutral case but we find it difficult to pick the most probable. Overall what drives our BCP’s share price target up is the small but real possibility that in a case of economic recovery, BCP has a wide domestic and international set up that should allow it to widely profit from recovery.

On our final estimate, we see the locked value of the Portuguese operation and assets to be worth over 50% of the Group’s total equity value. A big part of this value (460 million euros) is derived from the expected benefits the Group will extract from its tax credit assets. Given that there is so much uncertainty around these main sources of value for the group and that two of the Group’s operations are in volatile markets we are confident the high beta is not only fundamentally but also rationally justified.

Our price target is 0.07 EUR as we give slight more weight to a pessimistic scenario when compared to an optimistic one. Over the past months the share
price seems to have been discounting the scenarios we hereby describe and expect and therefore our overall recommendation is to hold the stock.
## Appendix

### Consolidated financial statements

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<td><strong>BALANCE SHEET</strong></td>
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<td>63,392</td>
<td>62,618</td>
<td>56,802</td>
<td>57,564</td>
<td>57,639</td>
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<td>Reserve for loan losses</td>
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<td>3,485</td>
<td>4,243</td>
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<td>3,597</td>
<td>3,437</td>
<td>2,742</td>
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<td>4,362</td>
<td>4,046</td>
<td>4,515</td>
<td>4,308</td>
<td>3,475</td>
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<td>Gross loans</td>
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<td>71,533</td>
<td>66,861</td>
<td>60,222</td>
<td>61,161</td>
<td>61,076</td>
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<td>14,669</td>
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<td>10,083</td>
<td>11,394</td>
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<td>6,202</td>
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<td>87,118</td>
<td>89,744</td>
<td>82,007</td>
<td>80,513</td>
<td>79,690</td>
<td>80,920</td>
<td>83,565</td>
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<td>Deposits from credit institutions</td>
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<td>15,266</td>
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<td>49,404</td>
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<td><strong>Total equity and liabilities</strong></td>
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<td>80,513</td>
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### INCOME STATEMENT

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<td>Net interest margin</td>
<td>1,390</td>
<td>1,389</td>
<td>998</td>
<td>848</td>
<td>1,049</td>
<td>1,170</td>
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<td>Other net income</td>
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<td>774</td>
<td>635</td>
<td>632</td>
<td>660</td>
<td>615</td>
<td>618</td>
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<td>437</td>
<td>264</td>
<td>425</td>
<td>424</td>
<td>366</td>
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### CASH FLOW

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<td><strong>Cash flow from assets:</strong></td>
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<td>Loans &amp; advances to credit institutions</td>
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<td>26</td>
<td>180</td>
<td>477</td>
</tr>
<tr>
<td>Depreciation</td>
<td>83</td>
<td>79</td>
<td>77</td>
<td>77</td>
</tr>
<tr>
<td>Impairments and provisions</td>
<td>1,216</td>
<td>1,047</td>
<td>826</td>
<td>515</td>
</tr>
<tr>
<td><strong>Total cash flow from operations</strong></td>
<td>1,147</td>
<td>1,153</td>
<td>1,083</td>
<td>1,069</td>
</tr>
<tr>
<td><strong>Cash flow from/(to) equity</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Free cash flow from/(to) equity</td>
<td>2,396</td>
<td>-146</td>
<td>-86</td>
<td>-395</td>
</tr>
<tr>
<td><strong>Change in cash</strong></td>
<td>888</td>
<td>85</td>
<td>139</td>
<td>64</td>
</tr>
<tr>
<td>check</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>
Disclosures and Disclaimer

Research Recommendations

<table>
<thead>
<tr>
<th>Buy</th>
<th>Expected total return (including dividends) of more than 15% over a 12-month period.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hold</td>
<td>Expected total return (including dividends) between 0% and 15% over a 12-month period.</td>
</tr>
<tr>
<td>Sell</td>
<td>Expected negative total return (including dividends) over a 12-month period.</td>
</tr>
</tbody>
</table>

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