Precarious environment

Pursuit for the long-term stability

- Millennium bcp is facing several challenges, mainly driven by the European Sovereign crisis. Portuguese and Greek operations are pressuring the group results downward, due to a severe loss of margins (NIM in 9M2012 averaged 1.2% against 09-2011 1.7%) high operating costs (C/I at 66% in 9M2012 vs. 59% averaging 2008-2011) and rising imparity charges (net loan impairment of EUR 1.237mn in 9M2012, 62% increase yoy)

- To meet capital requirements, the bank resorted to Public funds, with a Portuguese State subscription of EUR 3.000mn CoCos. Allied with a new share issuance (EUR 500mn), BCP attained the required levels (CT I 11,9% at 3Q2012), but is now operating under the menace of nationalization and paying a demanding yield for the hybrid instruments

- BCP continues to rely heavily on the ECB to have access to liquidity lines. Its exposure remains above EUR 13bn, but the dependence is decreasing along with the commercial gap (L/D ratio stood at 138% at 3Q2012 against 152% in 3Q2011.)

- International operations (ex-Greece) have brought relief to the group’s results and continue growing. For 9M2012 BCP drawn NI of EUR 54mn, EUR 45mn and EUR 12mn from Polish, Mozambican and Angolan activities respectively.

- We value Millennium bcp share at EUR 0.10. Given the current value of EUR 0.077, our recommendation is to buy.

Company description

Founded in 1985, Millennium bcp is the largest Portuguese private bank, spanning its domestic operations throughout all the main banking areas. BCP is also present abroad, namely with its subsidiaries in Poland, Mozambique and Angola where the operations have assumed a critical role in the activity of the bank.
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Company Overview

Millennium bcp is the largest private Portuguese financial institution, with a market share of over 20% in loans and 19% in customer deposits. It was founded as Banco Comercial Português in 1985 following the deregulation of the Portuguese financial system. By the end of the third quarter of 2012 the group managed over EUR 89bn in assets under its various domestic and international operations.

History

Ever since its foundation, BCP’s strategy has been steered by an expanding ambition and by 1994 a solid organic growth rate enabled the institution to gather a market share of almost 9% in deposits and loans to residents. Subsequent years emphasized this strategy of the group, primarily with the acquisition of Banco Português do Atlântico - at the time being, the largest commercial bank in Portugal. The incorporation of Banco Mello and Banco Pinto & Sottomayor ensued in the pursuit of the expansion plan, while in 2007 a public tender offer over BPI ended unsuccessfully. In order to reinforce its domestic position in the insurance business Millennium bcp forged a partnership with Ageas Group (formerly known as Fortis), which currently has a majority stake (51%) over Millenniumbcp Ageas.

With its position consolidated in the domestic market, BCP sought to leverage its expertise on an international campaign. Millennium bim – currently the market leader in Mozambique - was founded in 1995, setting upon an alliance with state-owned agencies. In 1998 a partnership with the Polish BBG financial group led to the creation of a retail bank named Millennium. In 2000, the group developed a venture in Greece, with the foundation of NovaBank, a retail bank which resulted from the partnership agreed with Interamerican Hellenic Life Insurance Company. Following the unsuccessful bid of BCP in the privatization process of Banco Comerciala Romana, the bank launched a Greenfield operation in Romania. Later, in 2008 the group signed a strategic partnership with one of its core shareholders – Sonangol – motivating the conception of Banco Millennium Angola (BMA). The bank also developed branches in France, Luxembourg, Canada, Turkey and United States, all of which were disposed in the wake of the banking crisis.

The growth strategy enabled the group to reap rewards. The institution thrived during most of the 2000s, delivering an impressive ROE of over 20% averaging throughout 2000 to 2007. This golden period abruptly came to an end when Millennium bcp was caught in the midst of an internal upheaval,
under allegations of using off-shore companies to buy its own shares inflating its price. These charges were followed by the onset of the banking and sovereign crisis, contributing to a drastic change in the bank’s outlook and to the plummeting of its share price (Fig. 5).

In 2012 the bank nominated Nuno Amado as CEO, who will be in charge to lead the path of BCP during a recapitalization period and under the menace of nationalization from the EUR 3bn CoCos held by the Portuguese State.

Shareholder Structure

On October 4th 2012, Millennium bcp concluded a rights issuance process which reinforced the capital structure of the bank in EUR 500mn, fully subscribed by private investors, even though the placement was guaranteed by the Government. The aftermath of the process accentuated the diversity of the shareholder structure of bcp, with the number of investors standing at 190.703.

This episode and subsequent developments stirred some changes in the group’s shareholder base with a qualified status. Sonangol has the largest stake in BCP and consolidated its position with purchases in the secondary market to 15.1%. On the other hand, Teixeira Duarte and CGD had their participation diluted, with the latter shifting below the threshold of 2% that borders the qualified rank. This reduction was offset by the debut of a new qualified shareholder, Grupo Estevão Neves which presently holds a 3.2% stake in the bank.

Some further changes may happen in the next periods, namely in the case of conversion of the hybrid instruments held by the Government. Assuming a conversion rate of EUR 0.04 per share (later detailed) and the full conversion of the EUR 3bn in CoCos, the Government would assume the control of the group with a 79% participation.

Economical Context

The Eurozone is facing the biggest challenge since its foundation. The problems initially reasoned as the ensuing effects of the financial crisis soon were interpreted as a major structural problem in the roots of the Euro system and in several of its members. Arguably, the banking crisis motivated a significant impact in the balance sheet of many Governments (Fig. 8), which strive against the recessive mood of the economy with public investments and liquidity injection. Nonetheless, the financial crisis unveiled
concealed problems in some Euro members, particularly in the ‘periphery countries’, including Greece, Portugal, Ireland, Spain and Italy which raised doubts over the sustainability of the monetary union and the policies carried.

There is a wide diversity of explanations for the causes that paved the way towards the current setting, but some forces are plainly identified. Initially, southern countries benefited from the integration in the monetary union and the strong credibility associated with it. Access to vast international sources of borrowing became available and along with it cheap credit conditions.

The ever-low cost of credit indulged the periphery countries to accumulate historically high levels of external indebtedness, especially in Portugal, Spain and Greece, stemming construction and credit bubbles in some regions, encouraging Governments to increase spending and private indebtedness levels and progressively raising prices and wages. This combination played a harmful role in the economics of the affected regions by significantly reducing their competitiveness - observable in the gap between the growth of Portuguese labour cost and the Eurozone average in Fig. 12 - and widening the trade imbalance. These structural issues are deemed as the core drivers for the anaemic growth rates displayed by periphery economies in the past decade and remained unpunished and unsolved by the lenience of international lenders - comforted in the credibility safeguarded by the monetary union – and by the impossibility in resorting to monetary mechanisms to ease the burden.

Although the situation was not foreseen, as soon as some economies showed signals too evident to overlook there was a hasty change in the market’s perception triggering a sudden reversal in the conditions that prevailed in former years. Credit rating agencies began a downgrade sequence upon sovereign and private debt from distressed regions, as can be seen for the Portuguese and Greek case in Fig. 13. Investors and lenders fled and the easiness of access to international credit dulled, disrupting the liquidity of Governments and financial institutions.

The shrinkage in international credit was coupled with mounting yields, aggravating the downturn of periphery economies, reducing tax revenues and magnifying budget deficits, soon triggering a fiscal crisis which further tightened the depressed landscape of these members. With bankruptcy looming some countries inevitably resort to bail-out. First Greece, followed by Ireland and Portugal requested the assistance of the European...
Union, European Central Bank and the International Monetary Fund to rebalance their financial situation. Meanwhile Spain has also appealed for assistance, though it was provided to aid its financial sector. The assistance programs imposed severe adjustments and targets for these nations to meet in a determined timeframe, promoting numerous austerity measures to comply with the conditions established.

Even though monetary authorities have taken action, Greece is still enclosed in uncertainty - even after another round of elections - since it successively failed to meet the agreed conditions and has already imposed two ‘haircuts’ to sovereign bondholders. In spite of having recently benefited from an ease in the targets and in the conditions of debt service, the spectrum of being the first country to leave the Euro is still looming. The financial system is taking a hit, with the funding structure undermined by the shutdown of the wholesale debt market and deposits flee.

Portugal is also striving to balance its financial situation, so far being more successful than Greece in reaching the goals established. Economic contraction has not been as extensive, partially through the contribution of a boost in external demand for its goods and services, especially from nations outside the EU which are naturally showing greater resilience to the sovereign crisis. Notwithstanding, the impact of the austerity measures towards fiscal consolidation are conducting a surge in unemployment and domestic demand (see Fig. 15). This has been driven by cuts in public spending and the shutdown of several enterprises, particularly in the non-tradable sector more reliant in the domestic market – as is the case of construction and real estate activities - a problem exacerbated by the shrinkage of funding provided by banks.

One of the main discussions since the onset of the crisis has been the possibility of a contagion effect to a larger economy. In 2012 this apprehension gained shape, particularly in Spain and Italy. The first has formally requested assistance for its financial sector which is battling the consequences of a real estate bubble, but the threat of asking for a wider bail-out package is imminent and has been more evident as the Spanish economy slips deeper into recession (see Fig. 17) and the chances to meet the fiscal targets dim. On the other hand, Italy has accumulated alarming levels of indebtedness, although these are mostly from national lenders and is facing economic growth problems. But the problems do not seem to be narrowed to these periphery countries. As the 2nd largest economy of the Eurozone, France as assumed a co-leadership position along with
Germany in guiding the policies and unity of the Euro group. As so, if the spillover effects spread to this member, it could form a heavy blow for the aspirations of the single currency. In the past months, this hazard seems to have increased, awaken by rating agencies cutting France’s rate, justified by economic problems resembling the ones afflicting Southern Europe.

This dismal outlook precludes one to neglect the possibility of a member leaving the Eurozone. The lack of power from these troubled nations over monetary decisions has prevented the use of exchange rate as an instrument to recover competitiveness and return to prosperity. By imposing these structural reforms, members are aiming to reduce prices and wages to offset the increases in former years. Still, this path is precarious and features inevitably high levels of unemployment, promising an extended period of economic contraction. If an afflicted country leaves the Eurozone, its new currency devaluation would help expanding exports, while quantitative easing mechanisms could once again be deployed and boost domestic demand. Conversely, there would be an array of additional problems to face, as would be the case of raising costs in essential imports, primarily energy-related products, while the redenomination of external debt would ensure an intricate clash in the legal field. The immediate consequences of a departure from the community could lead to the collapsing of the banking system, affected by the unavoidable closure of international funding sources.

However, it is noteworthy the dimension of foreign claims in these euro countries (vide Fig. 19). As of June 2012, foreign investors had an exposure of EUR 141bn in Portugal, of which EUR 115bn were held by European banks. This systemic risk should contribute for the policy-makers in the Eurozone to strive towards the unity of the group, under the risk of carrying wide losses with the devaluation of a new currency and probable default.

The standstill witnessed in countries that are lacking results from the measures implemented and the fear of contagion to wider economies increases the importance of the upcoming political decisions to guide the destiny of the Eurozone. The recent commitment of integrating a central supervisory body for the Euro largest financial institutions carried through the ECB and the empowering of banks to have direct access to recapitalization mechanisms without State intervention provides evidence of policy makers’ ambition to recover the stability of the Euro system and to reassert its unity. Nonetheless, more measures are being discussed – such as the development of ‘Eurobonds’ – which could be crucial to prove the solidity of the single currency. The developments in the next periods will
undoubtedly be decisive for the Eurozone, but until then uncertainty will continue to surround its fate.

**Effects on the Banking Sector**

With the consequences of the banking crisis - taking roots in the subprime mortgage market of the United States - still affecting the banking sector, new challenges arose for financial firms with the European sovereign crisis. The subprime emerged concerns about the soundness of the financial system and stemmed a tightening pressure on the lending of banks, leading to a slowdown in the global economy, which affected more acutely the European and North-American regions.

Since then, many European financial institutions have been experiencing the consequences of the **shutdown of the interbank lending system**, driven by a change in the trustworthiness between banks. Financial firms hitherto dependent from these liquidity lines to meet its increasing commercial gap between the loans conceded and the deposits captured, found themselves struggling in the midst of a liquidity crisis. This sentiment turned out to be keener towards the ‘periphery countries’ with the triggering of the sovereign crisis.

To avoid the bankruptcy of several institutions and to prevent a full-scale contagion to the global banking system, monetary authorities supplied instruments to ease the contraction of the interbank market. The mechanisms applied by the ECB spanned from the provision of abundant liquidity to the lowering of reference interest rates (Fig. 22) to soothe the resultant financial obligations. The deposit rate at the ECB plunged to 0%, in an attempt to encourage Northern European banks’ lending to other banks. Despite some opposition from Germany, the ECB broke the deadlock of the wholesale debt system, by injecting EUR 1.019 bn in 2011 and 2012 through Long-Term Refinancing Operations (LTRO) with a maturity of 3 years.

Additionally, in order to ease the selling pressure in the government debt yields, the ECB intervened directly in the secondary debt market and Mario Draghi – ECB President – launched the **Outright Monetary Transactions** - an unlimited bond-buying program aimed at lowering the borrowing costs of struggling countries.

The problems emerging from the banking and sovereign crisis called for a revision of the regulatory demands of banks by the supervisory bodies. This led to the development of the Third Basel Accord by the Basel Committee on Banking Supervision which provides standards and guidelines...
for the banking system. This accord is oriented to the promotion of the stability in the banking system and seeks to repair the weaknesses revealed in the financial regulation in the aftermath of the subprime crisis. Basel III main amendments endorse a stronger capital base (Table 1) along with new and stricter regulatory requirements over bank leverage and liquidity, which should be phased in until 2018.

Additionally, given the fragile conditions of the periphery countries’ financial system, extraordinary regulatory measures were imposed by regional central banks and the European Banking Authority to be met in a shorter timeframe, in order to protect the banking system under distressed scenarios. The banks operating in these countries are facing alarmingly high levels of overdue loans associated with the current economic environment which is revealed in the escalating volumes of provisions constituted. The scope of the regulatory procedures encompass the strengthening of the capital base, which is aimed in improving the capacity of banks to withstand potential losses and the reduction of the commercial gap, in order to diminish the exposure to market volatility and liquidity constraints of the system.

Even though the purpose of these changes is tilted to encourage a more resilient banking system, there are risks in this conservative strategy. Basel III and extraordinary regulations are negatively influencing lending volumes and interest rates, which is acting as a further catalyst for the downturn of the economy. In addition, higher levels of capital ratios require the raising of funds among shareholders - a difficult task under the current climate. This has led to the access of public funds by some banks, which represents an additional risk in the stability of the structure of these banks.

**Regulatory Capital**

**Capital Ratios**

The poor performance of the Portuguese banking sector in recent years is indissociable from the sovereign crisis, spanning from the losses induced by rising sovereign yields to the sharp increase in the credit at risk and consequent level of impairments. During 9M2012, BPI was the only bank able to increase results, while the total Net Income of Portuguese 6th major banks stood at negative EUR 752mn (Fig. 25). In light of these events, the Economic Adjustment Program (EAP) set upon the assistance request by the Portuguese Government foresaw conditions to be met by financial institutions envisioning a more solid and resilient banking system.

With respect to the framework adopted, Portuguese banks had to attain a
Core Tier I capital ratio higher than 10% according with the Bank of Portugal criterion by the end of 2012 and 9% pursuant to the European Banking Authority comprising a buffer for exposures to sovereign debt by the end of June 2012.

The concern in reaching the capitalization levels aforementioned has been paramount in actions undertaken by the major Portuguese banks in recent developments. Millennium bcp has resorted to the Fund created upon the adjustment program to assist banks, by issuing EUR 3bn in Contingent Convertible Bonds (CoCos) fully subscribed by the Public State and issued new shares which allowed raising EUR 500mn. BPI also resorted to hybrid instruments – EUR 1.5bn, with EUR 200mn already repaid – while BES complied with the regulations internally, through a share issuance which raised EUR 1.010mn. CGD benefited from a capital injection from Public funds in the order of EUR 1.65bn while Banif has recently finished its recapitalization plan, which involved EUR 1.1bn of Public resources.

The recapitalization measures undertaken by the banking system allied with deleveraging efforts that posed a descending pressure in the RWA (Fig. 27), allowed all the major banks to accommodate solvency levels above the regulatory demand. As of 3Q2012, BCP presented a 12.8% CTI capital according with BoP and 10.3% pursuant to EBA, while BES, BCP, CGD and Totta revealed a 10.7%, 14.8%, 11.8% and 12% CTI levels respectively.

Pension Fund

Millennium bcp as well as other Portuguese banks are required to pay its employees pensions upon retiring, in case of disability and other obligations. Yet, on the end of 2011 the liabilities related to bank’s pensioners as of 31 December 2011 were transferred to Social Security, a measure targeting the objectives set forth in the EAP. This transfer entailed a different discount rate (4%) and mortality tables compared with those used by banks, which led to a negative impact on net results of EUR 117mn in BCP, EUR 107mn for BES and EUR 71mn for BPI.

Still, banks continue to be responsible for increases in pensions, death benefits and contribution to the Heath System (SAMS). In June 2012 the present value of the projected benefit obligations of BCP were EUR 2.393mn, against EUR 5.322mn of December 2010, reflecting the effect of the transfer to SS of EUR 2.747mn. The value of the assets of the Fund stood at EUR 2.221mn in the end of 1H2012, but EUR 280mn of the liabilities were financed through an Extra Fund, generating a surplus of EUR 108mn and coverage...
ratio of 105%. BES and BPI pension systems have a smaller dimension than BCP’s, and present a higher coverage ratio (110%), hence we believe Millennium BCP is still more exposed to the behaviour of the pension fund and has a higher probability of incurring in actuarial losses that can further penalize the group’s results.

BCP group changed the accounting policy used to recognize the actuarial difference between the present value of liabilities and the value of the assets of the Pension Fund – previously it used the corridor method – and as of 2011 these differences are registered against Other Comprehensive Income. During 1H2012, the negative return of 4.1% contributed for an actuarial loss of EUR 155mn.

Funding Position

Ratings

The liquidity constraints faced by Portuguese banks directly reflect the worsening ability of the Portuguese Republic to service its own debt obligations, an evolution easily perceived by observing the close relationship in their credit ratings (see Fig. 29 and Fig. 30). A downgrade of the long-term rating of the Republic has been successively followed by a reduction of the grade in Portuguese banks. The deterioration of the credit quality assessment has serious implications for the banking system, since it motivates additional haircuts in the assets of the banking system which act as collateral in funding operations. In a period where the sector is deeply reliable on ECB provisions, a downgrade produces a heavy toll, since it decreases the collateral eligible and can compromise the access to other sources of funding.

Liquidity sources

The sovereign crisis exacerbated the liquidity restrictions of banks with the closing access to the wholesale debt market. In order to overcome these difficulties, the EAP devised a reduction in the commercial gap of banks by endorsing a transformation ratio of 120% to be attained until the end of 2014 and supplied EUR 35bn in guarantees to be provided by the Government to banks for issued bonds.

The source of funds provided by the ECB has been essential and systematically exploited by financial institutions, having increased from under EUR 2bn in the beginning of 2008 to over EUR 56bn in October 2012, surpassing the EUR 60bn mark in July of the same year (see Fig. 31). This
dependence could have adverse consequences if the monetary authorities change their policies, even though the ECB has been promoting additional measures to encourage market liquidity in the Euro area, by extending the eligibility criteria of assets that may act as collateral in monetary operations, lowering the main reference rate and increasing the maturity of the loans conceded.

Nevertheless, the return of Portuguese banks to the international markets may happen sooner than anticipated. BES achieved an important milestone by issuing EUR 750mn in senior debt not guaranteed by the Public State in November 2012, a scenario not repeated since April 2010. Fitch has already transpired that this event could be replicated by other banks.

Millennium bcp has been one of the banks most reliant from the funds of ECB, a consequence of its dimension and funding structure. On 3Q2012 the bank had a net exposure of EUR 13.1bn to the ECB, reflecting a reversal of the trend compared with the EUR 15.3bn accumulated in the same period of the previous year (Fig. 32). In addition, there has been a shift in the funding profile of BCP, provided by the resort to ECB’s LTRO with a maturity of 3 years. The pool of assets eligible as collateral for monetary operations presented a buffer of EUR 6.4bn in the end of 3Q2012 (see Fig. 32) and has been reinforced with the issuance of State guaranteed bonds, which amounted EUR 4bn as of 3Q2012. In our positive scenarios, we are assuming that Millennium bcp will assemble the necessary conditions to return to markets in 2014, which should draw a higher funding cost in the mid-term due to the risk associated with the Portuguese market.

The decreasing trend witnessed in 2012 in the exposure to the ECB was mainly led by the reduction in the commercial gap and the inflow of EUR 3bn from the issuance of hybrid instruments. This strategy also contributed for the reimbursement of EUR 5.4bn of medium and long term debt, however the refinancing needs of the bank until 2015 will ensure some challenges as can be seen in Fig. 33.

Loans

The main efforts employed by banks for the convergence of the transformation ratio towards the threshold of 120% featured a widespread deleveraging policy followed by the system. As can be analysed in Fig. 34, lending has tightened in both the household (housing and consumption) and the corporate segment, leading to a reduction of 6% and 10% respectively, from their highest points in the last 2 years.
However, the constricted lending of the corporate sector has afflicted with greater incidence the SME segment, which represents the majority of the Portuguese business spectrum, while large and exporting companies display more resilient indicators, maintaining fairly the same levels of indebtedness prior to the crisis.

BCP’s has been reducing its loan exposure in Portugal ever since the 2nd quarter of 2010, falling from EUR 61.0bn to their lowest level on 3Q2012 of EUR 51.8bn, which comprises a 15% decrease. Management has provided guidelines that it will continue to conduct this strategy, in order to comply with the regulatory goals.

**Deposits**

Traditionally, deposits have been the major source of financing for the banking system. Nonetheless, the onset of the single currency eased the access to the interbank lending system, which allowed banks to resort to cheap short-term international credit lines used to fund their long-term assets in Portugal. The crisis exhausted this strategy for Portuguese banks which have reasserted the importance of capturing deposits for their funding structure.

Particularly in the household segment, deposits have increased **successively since 2010** despite the reversing trend observable in 2012 (see. Fig. 36), as opposed to corporate loans, which have decreased since September 2011 after a surge in 2010. **This behaviour was steered by an aggressive campaign of banks to capture on-balance sheet customer resources**, increasing the interest rates offered from February 2010 (0.82% average for households) until September 2011 (4.51%), **coupled with an increasing aversion in holding risky off-balance sheet securities.** After reaching a more sustainable situation and given the harmful effect of high deposit rates in the margins of banks - as identified by the BoP, imposing capital penalties for those who surpass a limit rate - the interest offered has decreased (1.01% in October 2012).

However, this pattern was not uniform for the whole banking industry. BCP’s deposits have increased in 2011 and beginning of 2012 (EUR 33.1bn), but have reduced since then, dropping to EUR 30.7bn in the end of 3Q2012, penalized by the repurchase of institutional deposits. We believe this discrepancy is accentuated due to the **riskiness associated with Portuguese private banks**, which does not have the same extent in a State-owned bank as CGD (deposits increased 2.3% during 9M2012).
Transformation Ratios

As of 3Q2012 The 120% target transformation ratio was yet to be attained by BCP (138%) and BES (142%), while BPI already crossed the threshold and developed a significant buffer (105%). Given the restraints of BoP and the negative effects of another price war, we deem that BCP and BES will emphasize their deleveraging strategy to meet the target until 2014.

Financial Assets

Another source of liquidity relief for Portuguese banks may arise from the disposal of financial assets. However, this procedure has not been consistently adopted by the major private banks as can be witnessed in the trend displayed in Fig. 40. Further, some criticism has emerged from the application of ECB funds to finance the acquisition of sovereign debt, which has been the leading driver for the evolution of the financial assets held. These securities refer mostly to Portuguese sovereign debt, traded at a much higher yield than the interest paid in monetary operations, but conversely is accepted as collateral in rediscount operations and does not affect the transformation ratio. Although BCP holds the largest sovereign debt portfolio, it is composed with 68% of periphery countries government debt, while in BES and BPI portfolio it represents 77% and 100% respectively. We consider that this increasing pattern can jeopardize the sector systemic risks, since it magnifies the exposure of the system to the sovereign crisis and opposes banks’ necessity of risk diversification.

Domestic Operations

The scope of Millennium bcp’s operations in Portugal embrace different banking areas, from retail and investment banking to private banking and asset management. Despite the increasing importance of international operations, Portuguese activity still represents the core market of Millennium bcp. As of 3Q2012 these operations managed approximately EUR 70bn in assets, accounting for 75% of the group’s total, through a network of 861 branches (50% of the total) and despite the increasing trend of banks engaging in various businesses and diversifying its income sources, Millennium bcp main focus remains in the traditional commercial role of banks, benefiting from the biggest branch network existent in Portugal. This profile is observed in the revenues of 9M2012, with 76% having originated from NII and banking fees and commissions.

After years of positive results, the Portuguese banking sector situation
reversed in 2011 (see Fig. 42), with Millennium bcp presenting a net loss of EUR 971mn, penalized by the deterioration of sovereign debt and reinforcement of impairment charges and the effects ensued in 2012, with BCP exhibiting a net loss of EUR 378mn in Portugal. The deterioration of profitability has been generalized in the banking sector has can be observed in Fig. 42, with BCP, BES, CGD and Banif the most penalized and BPI and Totta the most resilient.

**BCP’s NIM has been dropping steadily since 2010** – standing at 0.3% in 3Q2012, the lowest value since the banking crisis burst. This decline was justified by the raising funding costs from deposits, the lowering of the Euribor rates – most loans are linked to this reference rate - increasing imparities and in more recent events the interest expenses attributed to liability management operations and cost of CoCos. These drivers contributed for the decrease of 15% in NII between 2008 and 2011 to EUR 999mn and the decrease yoy of 52% from EUR 762mn to EUR 366mn in 9M2012. According with BoP data, NII for the Portuguese banking system illustrates a similar pattern - although not to the same extent, with a decrease of 10% between 2008 and 2011 and a negative change yoy of 39% in the first 3 quarters of 2012.

**Market related fees have decreased gradually in recent years.** This behaviour has been influenced fundamentally by two different forces. Firstly, the necessity of Millennium bcp to reduce the gap between loans and deposits compelled the bank to attract this source of funds from clients, by offering more captivating rates, motivating a shift from off-balance sheet customer resources to deposits. Secondly, the uncertainty in capital markets has contributed to an increasing aversion in holding riskier market securities reducing the off-balance sheet funds held (observe Fig. 44 and Fig. 45). Comparing this category of fees accumulated in 9M2012 with 9M2008, we observe a decline of 71% in total value.

Net trading income is mainly influenced by the evolution of the financial markets and the composition of the financial assets held. Given the aforementioned hefty exposure of the banking sector to sovereign debt past years’ trading income has been penalized by the deteriorating quality of the credits held, but the positive evolution of yields (particularly of Portuguese debt) coupled with gains arising from the repurchase of debt securities at a discount led to an increase in trading gains of the sector in 2012. The aggregated trading gains increased 3.5x yoy in 9M2012, while the income of BCP rose 2x (Fig. 46).
In an effort to return to profitability, the new management team has outlined the urgency in containing operating costs. An adjustment program is underway, which is expected to reduce staff and administrative costs, providing savings of EUR 100mn in the mid-term (see Table 4). In comparison with its peers (Fig. 47), we can observe that the efficiency ratio of BCP has been fairly in line with the average, whereas BES has constantly delivered lower C/I ratios and BPI presented higher indicators. However, this trend modified in 9M2012, with BCP exhibiting the highest C/I (62%), mostly due to a reduction in banking product yoy (-17%) not complemented with a similar reduction in operating costs (-3%).

The adverse economic context in Portugal continued to deteriorate banks’ loan portfolio in 2012. This strain has affected more severely corporate loans particularly from the SME universe - where BCP has a leadership position - and in the non-tradable sector, while delinquency levels remained fairly low for mortgage credits. In 9M2012 BCP’s domestic loan impairments reached approximately EUR 628mn, representing a cost of risk of 1.62% compared with the 1.46% displayed in 9M2011. Overdue loans are increasing covering 7% of the Portuguese portfolio in 9M2012, above the 6% overdue loans of the banking system. As a result, credit coverage ratios have been pressured, with the provisions of BCP covering 84% of loans overdue for more than 90 days in September 2012, dropping from 96% attained in the same period of 2011. BPI has displayed the strongest credit portfolio, primarily due the concentration of its loans on the low-delinquency household segment.

The negative returns drawn by pension funds have also harmed the profitability of banks in the past years, especially in the case of BCP. As pictured in Fig. 50, the income of pension funds’ assets has been extremely volatile and did not correspond to the asserted expected return of 5.5%. In the past 4 years, BCP only attained a positive return in 2009 (EUR 467mn) and accumulated losses of EUR 813mn. BES and BPI results have oscillated, suffering a heavy loss in 2008 with the onset of the financial crisis. Despite the partial transfer to the Social Security, the magnitude of pension funds – asset value corresponded to 3.1x market capitalisation of BCP, 0.6x of BES and 1.7x of BPI – makes this an additional source of risk for the banking system and can significantly influence the groups’ results in the future. However, for the last semester of 2012, we do not anticipate any loss drawn from the Fund, mainly due to the soaring of the markets.
International Operations

The prominence of Millennium bcp’s international activity has been intensified by the domestic struggle in recent years. Foreign subsidiaries emerged as an increasing source of diversification and income, substantiating the success of the Group’s internationalization strategy carried along the past decades.

However, the bank’s international coverage still represents a double-edged sword. On one hand it controls subsidiaries in the fast-growing economies of Poland, Angola and Mozambique which managed to alleviate the net losses from Portugal, combining positive results of over EUR 111mn in the first 9 months of 2012. In contrast, the bank has two underperforming subsidiaries within its group, Greece and Romania. The most severe case transpires from Greek operations, which single-handily drew a negative impact of over EUR 554mn up to 30 September 2012 (Fig. 52), mainly through the provision for extraordinary loan losses in the future.

Greece

Greece is deemed as the epicentre of the sovereign crisis and the deepening of its problems has affected this region more severely than any other in the Eurozone. GDP is expected to end 2012 with a yearly real decrease of 6% and to plunge 4% in 2013, as a result of the fiscal discipline imposed by the adjustment program. Naturally, the banking sector has been one of the most afflicted by the recessive behaviour of the economy - striving amid the erosion and haircut of Greece’s public debt, the increasing delinquency of companies and amid a liquidity crisis expanded by the deposits outflow surge and the mistrust of international lenders.

Currently Millennium Bank in Greece accounts for 6% of the group’s total assets, but despite its inferior dimension it has been the main responsible for the losses of bcp in 2012. Although the subsidiary has managed to contain operating costs, stemming essentially from the operational downsize - closure of 57 branches (32%) and the lay-off of 321 employees (21%) since 2010 - it has been striving against a rapidly deteriorating banking income and increasing provision charges (Fig. 54). Notwithstanding, in spite of the dismal outlook the provision of EUR 450mn registered in 2Q2012 is considered by management to be wide enough to cover further impurities in the credit of the bank and the EUR 1.3bn senior funding of Millennium bcp to the subsidiary is collateralized through credit securitization.

The Greek banking sector has suffered in recent years, striving against increasing provision charges, as illustrated in Fig. 55. 2011 was particularly
difficult for the returns of the sector, penalized by the accounting of the Greek Government debt restructuring (Fig. 56). The problems faced by the industry led to a consolidation spree, particularly with foreign groups who sought to dispose its subsidiaries, as the case of Société Générale sale of Geniki Bank and Crédite Agricole disposal of Emporiki Bank in 2012.

Poland

In the past years, Poland became the fastest growing economy in the EU, evidencing its resilience in 2009 as the only country within the Union to display economic growth - despite the difficulties imposed by the banking crisis. The 6th most populous country in the EU is already well integrated within the group, being the largest beneficiary of the cohesion funds provided by the community. Estimations of GDP real growth stand above 2% for the next years, despite the expected lasting effects from the sovereign crisis in Europe. Adding to the positive economic prospects, the penetration level of banking services in Poland is still low when compared to other EU members, which increases the growth potential for the banking industry.

Millennium Bank is the subsidiary held by Millennium bcp (stake of 65.5%) and responsible for its Polish activity. It is currently the 6th largest bank in Poland in terms of loans to customers and accounted for 14% of the group’s assets as of 3Q2012, managed under its network of 449 branches. Despite transpiring rumours in 2011 of an interest in selling its stake in Millennium Bank, the Group has thereafter asserted the importance of its Polish operations, emphasizing its role as a growth driver for the group. Truly, Millennium Bank has been providing a steady stream of inflow for the group reflecting its conservative risk approach (loan portfolio composed by 66% of mortgage credit against 43% average of the group) but also a lower return on equity than most of its polish peers which focus endeavours in the profitable corporate segment (see Fig. 59).

The subsidiary has been consolidating its position, which is reflected in the steady growth of revenues since 2009 and the improvement of the C/I ratio (Fig. 60), reaching an historical low of 56.4% in 3Q2012. Impairment charges have been slightly affected by the exposure to the construction sector, but in overall the low overdue loans ratio – 3.1% of total loans in 3Q2012 - and the strong coverage ratio (101%) convey encouraging signals for the resilience of Millennium Bank and its ability to capture the imminent progress of the Polish economy.
Mozambique

Mozambican economic growth has been fuelled by an increase in foreign investments and is considered one of the most attractive destinations for mining and natural gas developments. The opulence of natural resources allied with a stable political situation and estimated infra-structure spending in mega projects ensure the continuity of high levels of growth for the economy, which was unharmed by the recent crises (Fig. 61).

Millennium bcp’s roots in Mozambique date back to 1995, upon the creation of Millennium bim. Currently, the group holds a valuable stake of 66.7% in the subsidiary, which is the market leader in the banking system of the country, with a 36% market share in loans granted, according with data collected from Bank of Mozambique. BIM benefits from its strong presence through a network of 150 branches, being the largest employer - 2,490 workers - and taxpayer of the Mozambican banking industry (Table 5). Undoubtedly, along with Polish operations, BIM has been a crucial source of income for the group, despite its dimension (accounted for 8% of BCP’s international assets). This is explained by the attractive conditions of Mozambique environment and the consolidated market position of BIM, leading to efficiency ratios below 50%, low impairment charges and high levels of ROE (Fig. 62).

The low banking penetration levels of Mozambique place Millennium bim in a privileged position to benefit from the promising future of this emergent economy.

Angola

Angola is currently the 3rd largest economy in Africa, benefiting from the strong post-civil war growth figures, mostly originated from the abundance of natural resources, especially petroleum reserves. The richness of Angola’s soil and the investment focus in large infrastructures and agriculture shall underpin future economic real growth, which according with estimations should stand above 5% in the following years.

The history of Millennium bcp in Angola has been recent, stemming from the partnership of the group with one of its main shareholders – Sonangol – which led to the creation of BMA - held in 50.1% by BCP. Given its recent existence, BMA is yet to attain a prominent position in the banking setting, but it has been showing strong growth indicators. As of 3Q2012 it was represented through 66 branches disseminated along the most important regions of the country, a network that has been constantly increasing since the foundation
the subsidiary (see Table 6). BMA has already attained a profitable position – 17% ROE on 9M2012 – but not the same dimension of its Portuguese subsidiaries counterparts, namely BES Angola and BFA (Fig. 64).

Other Operations

Additionally, Millennium bcp’s international operations encompass activities in Romania, Switzerland and Cayman Islands.

The group launched a Greenfield operation in 2007 in Romania, a small subsidiary that in the end of the 3Q2012 was responsible for 1.5% of the assets of BCP. It is not considered a core market by the current management, translating worries about the potential of these operations. In fact, Millennium Bank in Romania has been underperforming since its foundation, displaying consecutively net losses (Fig. 65). The poor achievements of the subsidiary were conducted by low banking revenues and high operating costs.

As for the activity in Switzerland and Cayman Islands, these subsidiaries focus their activity in the area of Private Banking provided to clients with a high net worth. Despite some volatility these operations have been modestly profitable in the past, but are not part of the main strategy of the bank.

Valuation

To construct the valuation of Millennium bcp we used the method of Discounted Cash Flow to Equity (DCFE), a variance of the traditional DCF model assembling some specific components to adjust to the bank reality. An example is provided by the fact that debt for financial firms is, rather than just a source of capital, a raw material for banks to mold into another financial product and to sell yielding a profit. Additionally, banks are strongly regulated having to comply with compulsory capital levels to withstand eventual losses and promote the stability of the financial system. These requirements are related to the amount of assets held, so contrary to non-financial firms if a bank sought expansion, its major investment is neither in capital expenditures nor working capital but on the increase in equity necessary to enlarge the firm’s asset base.

We have chosen the DCFE model to assess the value of Millennium bcp as we trust it depicts the most robust representation of a financial firm’s value and provides flexibility to devise and incorporate estimations made. Instead of developing a single model to assess the operations of the bank has a whole, we have chosen for a Sum-of-the-Parts valuation,
valuing separately all the different geographic operations of the bank, in order to grasp the complexity of the different regions that entail different economic and market fundamentals. After ascertaining the value of the different businesses we summed the individual parts into the whole, obtaining our estimation of the fundamental value for the Millennium bcp group.

We have embedded in the valuation of the core operations of the bank **Probability-Weighted Scenarios**. Instead of adding a country risk premium to the cost of equity, we affected directly the cash-flows by materializing the consequences of events and weighted them by a corresponding probability. This was the case for Portugal, Poland, Greece, Angola and Mozambique, owing to the reasoning that these activities operate in a climate involved by a certain level of uncertainty. Additionally, we believe that by assessing the impact of several events, we **provide a framework for investors to evaluate BCP’s in their own perspective, by shaping the probabilities according with their expectations**.

For the foreign activities of BCP operating under a different currency, we developed projections based on the local currency of those regions and in nominal values. Our forecasts were converted to Euros based on the evolution of the corresponding exchange rate grounded on the Purchase Power Parity formula, using the estimations of inflation for the respective countries and the Eurozone.

Our cost of equity was modelled incorporating a risk-free rate based on German Bunds with a 30 year maturity, while the market risk premium used stood at 5%. For Portuguese, Polish, Greek and Romanian activities the beta used was estimated based on the beta of a panel of banks from those regions, while for African operations, given the scarcity of public stock exchange information (using a panel of South African banks we obtained a beta of 0.6 which we did not trust suitable to illustrate the correlation of this sector with the market), we used the same estimate as obtained for Portugal. Additionally, for the emergent economies of Poland, Romania, Angola and Mozambique we factored for an inflation premium, provided by the differential between the inflation anticipated for these countries and for Germany (due to the risk-free rate employed).

**Portugal**

With a large exposure to its native geography, the valuation of Millennium bcp’s Portuguese operations symbolizes a fundamental stage to assess the value of the group. However, the uncertainty resultant from the sovereign

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**Table 7 - Foreign currencies used in the valuation**

<table>
<thead>
<tr>
<th>Country</th>
<th>Currency</th>
</tr>
</thead>
<tbody>
<tr>
<td>Poland</td>
<td>Zloty</td>
</tr>
<tr>
<td>Mozambique</td>
<td>Metical</td>
</tr>
<tr>
<td>Angola</td>
<td>Kwanza</td>
</tr>
<tr>
<td>Romania</td>
<td>New Leu</td>
</tr>
<tr>
<td>Switzerland</td>
<td>Swiss Franc</td>
</tr>
<tr>
<td>Cayman Is.</td>
<td>US Dollar</td>
</tr>
</tbody>
</table>
crisis adds a layer of complexity in the modelling of the activity, particularly with respect to the assumptions concerning the extension of the effects stemming from the crisis and an estimation of a conceivable recovery. Given the instability involving Portugal, devising different scenarios and corresponding probabilities helps insulating the effects if any event takes place.

The model incorporates 4 different scenarios (Table 8): 1) Basis Case, mainly underpinned by analyst expectations and a macroeconomic scenario pursuant to the previsions of global institutes as the IMF and Eurostat; 2) Leaving the Eurozone, which assumes the return to the old currency – the Escudo; 3) Optimistic Scenario, supported by bright macroeconomic expectations and management operational estimations; 4) Conservative Scenario, reflecting a deterioration in the economic and operational conditions and a sovereign debt restructuring process.

### Main indicators for each scenario

<table>
<thead>
<tr>
<th>Scenario</th>
<th>Basis</th>
<th>Portugalexit</th>
<th>Optimistic</th>
<th>Conservative</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year</td>
<td>2013</td>
<td>2018</td>
<td>2013 2018</td>
<td>2013 2018</td>
</tr>
<tr>
<td>GDP growth</td>
<td>-1.2%</td>
<td>1.8%</td>
<td>-6.0% 3.0%</td>
<td>-0.6% 2.0%</td>
</tr>
<tr>
<td>Inflation</td>
<td>0.2%</td>
<td>0.9%</td>
<td>15.0% 3.0%</td>
<td>0.2% 0.9%</td>
</tr>
<tr>
<td>NIM</td>
<td>0.8%</td>
<td>1.6%</td>
<td>0.8% 1.2%</td>
<td>0.9% 2.0%</td>
</tr>
<tr>
<td>C/I</td>
<td>78%</td>
<td>53%</td>
<td>86% 80%</td>
<td>72% 45%</td>
</tr>
<tr>
<td>ROE</td>
<td>-26%</td>
<td>7%</td>
<td>-40% -16%</td>
<td>-18% 14%</td>
</tr>
<tr>
<td>Cost of Risk</td>
<td>1.6%</td>
<td>0.7%</td>
<td>2.7% 1.2%</td>
<td>1.4% 0.6%</td>
</tr>
</tbody>
</table>

### CoCos and capital needs

For the period covered by the model, the 4 scenarios illustrate different paths for the capital needs of the Portuguese activity of BCP in order to meet a standardized ratio of Equity and Hybrid Instruments to Risk Weighted Assets of 10% - RWA are calculated as a fixed percentage of assets, assuming the credit composition and risk profile of the bank remain stable along the years. We have contemplated in the Basis and Optimistic scenario the full repayment of CoCos, though we do not anticipate that the group will be able to organically generate enough cash-flows to reimburse under the defined schedule. Our reasoning argues that under these circumstances the convertibility would not be activated, as we anticipate that BCP would be able to return to profitability in 2015, providing additional credibility that could foster the development of alternative solutions, such as an additional capital increase or a soothing in the instruments’ conditions, as it would be the case of a deadline extension.

Conversely, in the case of Leaving the Eurozone or in the Conservative Scenario, capital requirements would increase due to the accumulation of net
losses and in the case of returning to the Escudo from the imbalance in the redenomination of assets and liabilities, triggering the conversion of CoCos and diluting the stake of the current shareholders’ of the bank.

**Liquidity**

Despite the present dependency of BCP to ECB resources, the amount borrowed to the central bank has been decreasing, which reflects improvements in the reduction of the commercial gap. The different scenarios in general assume that the Bank will be able to continue reducing its commercial gap and attain a ratio of L/D below the 120% threshold recommended in due time (at a consolidated level), an anticipation sustained by the declared pursuit of a deleveraging strategy by the bank (see Fig. 73). Due to the longer maturity of house loans, we estimate that the strategy will affect more thoroughly the volume of corporate and consumer loans – particularly to the non-tradable sector – however, we anticipate a rebound on loans granted from 2015 onwards, which should benefit the latter segments and offset the initial adjustment. The evolution of deposits should be in line with the nominal growth of the Portuguese economy – market share of deposits should not significantly shift due to the restrictions imposed to offered rates - and the bank should be able to resort to the interbank lending system as of 2014, which shall increase average funding costs given the riskiness perception that should linger towards Portuguese securities.

**Profitability**

Our scenarios incorporate extensive variations in the income fundamentals of the bank. Generally, we are assuming that the Euribor will fluctuate accordingly with the forward rates implied in Future instruments traded in NYSE Euronext. Interest spread on loans vary in line with the evolution of the Euribor, taking into consideration that the transmission of an increase in spreads is easier under an environment of low interest rates and factoring the endeavours of the bank in loans repricing, while deposit spreads shall improve slightly due to BCP’s toil to recover a profitable NIM and institutional deposit repurchase programs.

We believe that these efforts will also bear results in the commissions and fees received by the bank, an estimation not contemplated under the 2nd and 4th scenarios. Regarding operational costs, we embodied the adjustment program of bcp, namely the dismissal of 600 employees and 300 early retirements in 2012 and cuts in administrative costs that together should yield annual savings of EUR 80mn by 2013 and EUR 100mn in the midterm, but

![Fig. 72 – Core Tier 1 Capital ratio and RWA expected evolution](image)

**Table 9 – Shareholder’s composition with and without convertibility**

<table>
<thead>
<tr>
<th>Shareholders</th>
<th>Current</th>
<th>Conversion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Government</td>
<td>0%</td>
<td>79%</td>
</tr>
</tbody>
</table>

**Table 10 – EURIBOR 3-month future implied rate**

<table>
<thead>
<tr>
<th>Year</th>
<th>Euribor 3-Month Forward</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013</td>
<td>0.183%</td>
</tr>
<tr>
<td>2014</td>
<td>0.326%</td>
</tr>
<tr>
<td>2015</td>
<td>0.574%</td>
</tr>
<tr>
<td>2016</td>
<td>0.956%</td>
</tr>
<tr>
<td>2017</td>
<td>1.395%</td>
</tr>
<tr>
<td>2018</td>
<td>1.674%</td>
</tr>
</tbody>
</table>

**Fig. 74 – Banking product (EUR mn)**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans</td>
<td>1224</td>
<td>1087</td>
<td>1224</td>
<td>1087</td>
<td>1224</td>
<td>1087</td>
<td>1224</td>
</tr>
<tr>
<td>Deposits</td>
<td>1670</td>
<td>1800</td>
<td>1670</td>
<td>1800</td>
<td>1670</td>
<td>1800</td>
<td>1670</td>
</tr>
</tbody>
</table>

Source: Scenarios pooled, analyst estimates
should be lessened by the severance costs implied. We also assume additional lay-off programs undertaken under the Conservative and Leaving the Euro scenario.

**Provision charges** are anticipated to increase in 4Q2012, mostly due to EUR 187mn arising from the exposure of the bank to the construction and real estate segments, in the follow-up of the inspection of BoP to the major Portuguese institutions. Additionally, we anticipate imparities remaining high in 2013, due to the harmful effects of the economic downturn, followed by an ease in the cost of credit risk from 2014 beyond.

The possibility of a Portuguese Government debt restructuring process is considered under the 2nd and 4th scenarios. We assume that a managed restructuring of sovereign credits would have a negative impact of 15% in the value of the bank’s portfolio which registered an exposure to these securities of EUR 4.788mn as of 3Q2012.

**Leaving the Eurozone**

**Exiting the single currency** has been one of the most discussed topics of economists since the crisis burst, generating opinions spanning from the consequences and probabilities of the event to the level of devaluation associated with the new currency – the Escudo. We consider that the argument of leaving the Euro should not be neglected, due to the economic outlook of some Euro members. As so, and given the lack of historical examples on the impact of a country abandoning a monetary union, we have anchored our estimates in the Argentinean case of 2001-2002. During this period, Argentina abandoned the parity of peso-dollar that subsisted in the former 10 years. We trust that this illustration provides reasonable similarities, such as the recessive mood of the economy accompanied by low inflation rates, weak competitiveness, high public deficit and levels of public indebtedness, rising bond yields, credit downgrades, the resource to IMF funds and a set of unpopular austerity measures towards fiscal consolidation that erupted social protest and political succession.

We focus on the repercussions of this event, to establish a framework for the Portuguese case, which would occur in 2013. As so, we are considering a drastic transitional period featuring an accentuated contraction of the economy in 2013 accompanied by high levels of inflation and rising delinquency levels. The currency immediate devaluation would stand at 30%, and would from then on evolve according with the purchase-power parity, sparking a flee from deposits to foreign institutions and an imbalance in the redenomination of assets and liabilities, since it would...
not be guaranteed that international obligations would shift to the Escudo or remain in Euros. However, as the Argentinean case we anticipate a hasty return to economic growth for 2014 and beyond, due to the soothing of the austerity measures, increased competitiveness and a more advantageous trade balance, driven by increasing exports and the encouragement for imports substitution.

However, banks would have to struggle with an impaired balance sheet – losses motivated by asset devaluation against euro denominated international credits and extraordinary provision charges – and the complete shutdown of international sources of funding. Given these difficulties, we expect that BCP would not be able to avoid the conversion of CoCos.

To estimate the probability of occurrence of this event, we devised our own comprehension of its likelihood, since the opinions of several experts range in a wide interval and are not updated by recent developments of the economy and the Euro group. Hence, we underpinned our reasoning in the probability of default of the Portuguese Government, triangulating estimates from Rating Agencies and implied in Credit Default Swaps, as we believe that the non-servicing of debt could suggest the withdrawal of support from the Euro group and motivate the abandonment from the single currency. We provided an adjustment variable to factor the possibility of Portugal defaulting without leaving the union or leaving the Euro without defaulting (less likely). We reasoned that Portugal has a 5% probability of returning to the Escudo.

We estimate that by 2018 operations would be more stabilized and as so we formulated a perpetuity value to represent operations from 2019 beyond. For the growth rate we assumed the different estimates of GDP real evolution as of 2018, which are represented in Table 11.

Taking all scenarios into account, we value the Portuguese activity at EUR 0.026 per share.

Foreign Business

Poland

With an imperative need for income diversification and liquidity relief, Millennium Bank in Poland is placed in a strong position to lighten bcp’s accounts for the upcoming years. For this operation we considered the possibility of occurrence of three different events which could impact its value: 1) Basis Case, mainly following management guidelines and
institutional macroeconomic expectations; 2) Entering the Eurozone, and its consequences in terms of growth; 3) Disposal of Operations, a scenario which is grounded in the possibility of selling assumed by the bank in 2011.

The Basis Case features essentially the maintenance of the bank’s good performance, entailing a slight increase in NIM derived from increasing focus of loans in the corporate segment (see Fig. 82) and with the Polish reference rate – the WIBOR – remaining stable. Given the present low transformation ratio, we are considering a slight increase in the leverage of the subsidiary, through an expansion of its loan base.

The 2nd scenario foresees Poland adopting the Euro. The main consequences perceived by the model include the harmonization of reference interest rates – which we expect would have a slight negative effect in the NIM of the subsidiary, since the reduction of the interest rate would be more rapidly transmitted to loans than deposits - and an increase in economic growth rates estimations, as the result of increasing openness of the country to foreign partners which should promote trade. Though this episode was considered indisputable a few years ago (the 2003 referendum approved by majority the single currency), this decision has been in a standstill since the crisis burst and the support levels reached a record low of 12% in a recent survey. Nonetheless, Polish authorities have reasserted their desire to enter the Euro area, but only after other members solved their unbalances. We consider that Poland could enter the Eurozone in 2017, after 2 years of pegging its currency to the Euro, by adopting the Exchange Rate Mechanism (ERM-2).

The last scenario stems from the actions of the previous management which admittedly sought for interested parties in the acquisition of the controlling stake of bcp in Millennium Bank. Even though the administrative bodies are not the same, the possibility of selling this subsidiary should still hover in the horizon of the group, especially due to the potential complications of the group at a liquidity level. To assess a potential value for the subsidiary in the case of alienation, the model considers a panel of comparable transactions and respective multiples – Net Income, Revenue and Book Value selling multiples - and applied the resulting inputs to the fundamentals of the firm, reaching a potential selling value.

For the perpetuity we assumed that the estimated Polish GDP growth rate of 3.6% was a plain approximation for the growth rate of the operations of BCP in this country, given its positive prospects. Pooling the values attained with the different scenarios, we obtained a EUR 0.055 value per share.
The recent developments of Millennium Bank in Greece and its negative impact in the Group’s results increases the importance in obtaining precise estimations of the effects it could draw in the future for Millennium bcp’s operations. Anticipating to what extent the provision of EUR 450mn can cover future loan impairments will be crucial to ascertain the value of this subsidiary. Additionally, attention will continue to be centered in the decisions made at a political level, which can decisively influence Greece’s path within the single currency.

To address these matters, the model incorporated the possibility of three distinct events: 1) Basis Case, encompassing a tight economic regime, continuing to drive negative results for the subsidiary; 2) Leaving the Eurozone, compelling the return to the Drachma; 3) Disposal of the Subsidiary.

In the base case scenario, the model assumes that the difficulties lived by Greece will continue tightening the banking income and will continue pressuring provisions charges with the deterioration of loan quality (see Fig. 84). Despite efforts in reducing operational costs, these factors shall continue to drive negative results in the following years.

It is commonly accepted that Greece presents the strongest possibility of exiting the Euro area. The effects for the banking industry with the materialization of this event should be devastating, namely with the disequilibrium in the redenomination of assets/liabilities and the necessity of Public funds injection to suppress liquidity and capital needs. We adopted the same procedures as we did in the Portuguese scenario and reached a probability of 20% for this event.

Due to the downward pressure in results of Millennium bcp arising from this subsidiary, we consider that its disposal could represent an interesting opportunity for the group. It was formally disclosed the reception of 4 non-binding offers for the bank, which could increase the odds for this scenario to happen. In order to assess the value of such a transaction, we based our estimates in the disposal of the Greek subsidiaries by Crédit Agricole – sold Emporiki for EUR 1 - and Société Générale – disposed Geniki by EUR 1 mn. Both operations entailed symbolic prices, reflecting the dismal outlook of the units, an act which we believe may mirror the outcome of Millennium Bank.

Underpinned by the intentions of the group in this region, we assumed for the
The extraordinary performance of Millennium bim in Mozambique was reflected in the strategy of the Group which appraises the activity in this region as vital for the institution. In addition to the sound historical performance of BIM, the group’s expectations for this subsidiary lie in the remarkable growth perspectives of this emergent economy. Millennium bim may leverage from its strong placement in the Mozambican market, a growth that can be nourished by the market leadership and wide retail network already established in the country.

Accordingly, these assumptions were incorporated in the model, which also contemplates the possibility of occurrence of a negative scenario characterized by the occurrence of a political crisis and economical disturbances. Although this setting may seem improbable, Mozambique is an emergent country with abundant riches, which in previous comparable situations has led to a poor distribution of wealth and political turmoil. If these difficulties arise, it would be natural to expect that the banking sector would be heavily afflicted, possibly facing enforced nationalization and restrictions in capital outflows.

Given these circumstances, in the base case the expansion of Millennium bim’s assets is expected to occur in parallel with the growth of the economy and with an increase in the banking products penetration levels. This expansion is reflected in the increase of the loan base of the subsidiary, with the capital required to level this growth being fundamentally garnished by retained earnings derived from the prosperous condition of BIM. In terms of profitability, the model anticipates that high levels of ROE should prevail in the short to mid-term, but as a consequence of being an attractive market, competition in the banking industry of the country should emerge leading to an erosion of the return levels.

In the case of economic distress, the model anticipates a rapidly deteriorating performance featuring a more fragile economy and escalating inflation. This event would lead to a decrease in the banking income and a rise in provision charges, while it also studies the effect of a partial dilution of Millennium bcp’s stake in the subsidiary with the entry of the state in the capital and administration of the subsidiary (30% takeover). We assessed the probability of this event at 8%, through a combination of default rate probabilities implied...
in credit ratings and the score attributed by an African Governance Index (see Table 19), which ranks Mozambique above the African average in terms of corruption, public management and business environment.

For the 1st scenario we assumed a 5.6% growth rate for the continuation value, replicating the inflation expected for 2018, since the 7.8% expected GDP real growth was too great to last in perpetuity – while for the 2nd scenario we assumed a lower growth rate of 4.7%. We value Millennium bim in EUR 0.037 per share.

Angola

Along with Poland and Mozambique, Angola is reckoned as one of main growth markets for Millennium bcp. However, BMA is considerably smaller than the Mozambican and Polish enterprises, holding a low market share in Angola. The tremendous growth perspectives for the Angolan economy combined with the rapidly expanding network of BMA makes this region a core part of the strategy for the Millennium bcp group and a welcomed source of financial relief for the troubled years to come.

As covered in the valuation of Mozambique, the model also incorporates two different scenarios for BMA, the first where the bank manages to benefit from the economic growth of the country and the consolidation of its position in the market, whereas the second admits the possibility of a political crisis.

In spite of not having attained the same levels of profitability than its Mozambican counterpart, BMA has already shown an attractive ROE, which encourage an optimistic prevision for the future of this activity. Hence, the model anticipates the maintenance of high NIM and a stabilization of the operational costs relative to the revenues generated. As in BIM’s case, loans are expected to evolve according to the economic growth and an increasing banking penetration level, natural in cases of a developing economy and increasing middle-class.

For the negative scenario, the same assumptions regarded in the case of Millennium bim were made, namely the partial nationalization of the bank (30%), while the probability of the event stood at 10% - despite better financial conditions than Mozambique, we attributed this probability given the lower rank in terms of governance – the succession of the President Eduardo dos Santos may lift disturbances - and the great dependence of the economy and Public finances to commodity prices.

The perpetuity growth rate assumed stood at 5.3% and 3.2%, for the 1st and 2nd scenario respectively, reproducing the expected real GDP growth rate...
under each event. We are valuing Angolan operations at EUR 0.006 for each share.

Other Operations

The objective of valuing less significant operations of Millennium bcp was to have a more comprehensible and knowledgeable assessment of the whole entity. This was the case for the activity of bcp in Romania, Switzerland and in the Cayman Islands. The model values more simplistically these activities, not contemplating a scenario-based approach, but rather applying a country risk premium.

Romanian activity has been unsuccessful since its foundation in 2007, displaying low banking revenue generated for the operational costs assumed. In the following years, the model estimates that the operational situation of the subsidiary will be slightly stabilized, but that should not prevent net losses to continue figuring in its reports. Growth perspectives should be rather scarce, as the bank has clearly indicated that Millennium Bank in Romania is not part of its core strategy. We believe that if an opportunity arises, BCP should sell this unit.

The scope of the activity of BCP’s subsidiaries in Switzerland and in the Cayman Islands resides in the provision of Private Banking services to wealthy customers. These subsidiaries have been drawing moderately positive results and the model anticipates a continuing stream of profits to arise from these activities.

Given the dependence of the Cayman Islands and Swiss operations to the Portuguese situation, we assumed a growth rate for perpetuity of 1.8% - translating the expected GDP growth rate of Portugal in 2018 – while for Romanian operations we incorporated the expected inflation for that year as a suitable growth rate (2.6%).

Pooling the value of these subsidiaries, we obtain a value per share of EUR 0.001.

Valuation Summary

The uncertainty over the convertibility of the EUR 3bn CoCos held by the Government will continue to linger on Millennium bcp’s future. If such an event is triggered, the Public State would obtain control over the group and current shareholders would suffer from a heavy dilution of their position. Due to the heavy exposure of the group to Portuguese operations, we consider that the evolution of the sovereign crisis will be the main force behind a possible
recovery of the bank’s profitability.

Our estimations predict that there is an 80% probability of domestic operations returning to positive results in 2015, whether we suggest a 20% prospect in which the bank would not overcome the difficulties and net losses would continue to emerge. We have grounded our model under these assumptions, since the dilution of the shares would not only affect the value of Portuguese operations, but the whole activity of the group. To calculate the dilution, we are assuming a conversion price of EUR 4 for each share, despite the agreement setting the value at a 35% discount of the market price at the time of the event, as we contemplate that if it is triggered the share price would already be below the present state.

With this framework, we value Millennium bcp share without conversion of CoCos at EUR 0.148 whereas with conversion we consider the share has a negative value of EUR 0.089. Weighted by the respective probabilities, our valuation of the bank’s share is EUR 0.10.

**Risks**

The banking business is inherently risky, a characteristic exacerbated by its leveraged nature. It follows closely the path of the economy and as so it strives against a recessive mood and thrives in light of economic growth. The main risk involving Millennium bcp will continue to be the uncertainty of the Portuguese condition and the sovereign crisis, given the hefty exposure of bcp to this market and its credit profile – the bank is a market leader in loans to the less resilient SME segment – ensuring a high degree of sensitivity to the evolution of the country. Particularly concerning would be the disturbing levels of delinquency generated with the worsening of the economic downturn. Additionally, the Portuguese sovereign debt held by the bank – EUR 4.8bn in the end of the 3Q2012 – leverages its exposure to the outcome of the sovereign crisis and can critically jeopardize BCP’s recovery under a Public debt restructuring scenario. We believe that the evolution of the Portuguese economy in the next few years will dictate the outcome over the conversion of the hybrid instruments.

A further downgrade of the Portuguese Republic and of Millennium bcp’s rating would also hamper considerably the group’s outlook, triggering additional haircuts in the pool of assets eligible for discount in refinancing operations with the ECB and eroding the possibilities of the bank returning to the wholesale market. The dependence from the liquidity lines of ECB adds another layer of risk for the bank, since its liquidity management could
be seriously affected with a change in the central monetary policies, despite insofar being leaning towards increasingly beneficial conditions for struggling banks.

**Actuarial losses** provided by the Pension Fund, could also compromise the capital stability of the bank, despite the 105% coverage ratio displayed in the end of the 2nd semester of 2012. The uncertainty surrounding the Pension Fund is fuelled by the historical negative income drawn by its investments and the continuing deterioration of global financial markets. Nonetheless, the transfer of more than half of the value of the fund and associated liabilities to Social Security managed to reduce the risks of Millennium bcp in the future.

Lastly, the international activity also carries risks noteworthy. The **uncertainty enclosing Greece** generates threats regarding the extent to which the provision of EUR 450mn created will be sufficient to cover the increasing credit delinquencies lived by the banking system. The **remaining international activities entail exchange rate risks**, where a devaluation of the local currency relative to the Euro derives a harmful effect in the results of the group (observe the volatility of important exchange rates for BCP in Fig. 96). In our opinion African operations present an additional degree of **political risk**, emphasized by the poverty and social imbalances of their economies, the risks inherent in a possible political succession and their dependency to commodity prices.

**Conclusion and Recommendation**

Our analysis of Millennium bcp provided a fundamental value for each share of **EUR 0.100**. Given the current market value of EUR 0.077, we believe the share presents a positive outlook and we reason that a shareholder can benefit from significant capital gains by holding it, hence our recommendation is to buy.

Millennium bcp lives in an ambiguous situation. On one hand, their heavy exposure to the sovereign debt crisis draws uncertainty and risks to its operations in Portugal and Greece. On the other, its subsidiaries in Poland, Mozambique and Angola are well established and can benefit from the expected growth of these markets and resilience to the financial crises. However, in spite of the strategy of the present administration in focusing henceforth in the expansion of these three main growth drivers, BCP’s activities in these countries account for only 18% of its total assets, whereas Southern Europe weighs 81% of its composition.

In light of this unbalance, the reversal of the deteriorated profitability in
domestic operations is in order, to add value for the group and regain shareholders trust. Nevertheless, the banking sector is still deeply intertwined with the fate of the country, which could hinder management’s endeavours towards recovery. Surrounded by this context, we consider that the evolution of the sovereign crisis will be determinant for the progress of the Portuguese banking sector and in tandem of Millennium bcp. Our valuation is steered by a substantial expectation of Portugal recovering from the distressed situation in which it dwells presently and the positioning of the bank to benefit from this outcome. Ultimately, we believe Millennium bcp’s share value is presently being pressured downwards by a short-ranged perception, but nonetheless our assessment of the long-term value of the group generates in our view an attractive investment opportunity.
## Appendix

### Net Income

<table>
<thead>
<tr>
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<tr>
<td>Interest Income</td>
<td>3 477</td>
<td>4 060</td>
<td>3 696</td>
<td>3 889</td>
<td>3 600</td>
<td>4 477</td>
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<td>Interest expense</td>
<td>1 967</td>
<td>2 481</td>
<td>2 697</td>
<td>2 830</td>
<td>2 524</td>
<td>2 780</td>
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<td>Net interest income</td>
<td>1 514</td>
<td>1 579</td>
<td>999</td>
<td>1 053</td>
<td>1 076</td>
<td>1 696</td>
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<tr>
<td>Net Fees and Commission Income</td>
<td>841</td>
<td>778</td>
<td>705</td>
<td>711</td>
<td>678</td>
<td>876</td>
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<tr>
<td>Net Trading Income</td>
<td>439</td>
<td>408</td>
<td>423</td>
<td>266</td>
<td>268</td>
<td>330</td>
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<tr>
<td>Equity Accounted Earnings</td>
<td>68</td>
<td>15</td>
<td>53</td>
<td>38</td>
<td>37</td>
<td>38</td>
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<tr>
<td>Other Income</td>
<td>31</td>
<td>(23)</td>
<td>(44)</td>
<td>(12)</td>
<td>21</td>
<td>26</td>
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<tr>
<td>Net Operating Revenues</td>
<td>2 902</td>
<td>2 570</td>
<td>2 132</td>
<td>2 049</td>
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<td>2 970</td>
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### Profit before income tax

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<tr>
<td>Staff costs</td>
<td>831</td>
<td>954</td>
<td>800</td>
<td>823</td>
<td>782</td>
<td>912</td>
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<td>Operating Costs</td>
<td>1 542</td>
<td>1 634</td>
<td>1 432</td>
<td>1 449</td>
<td>1 407</td>
<td>1 617</td>
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<tr>
<td>Operating profit bef. imp.</td>
<td>1 599</td>
<td>1 095</td>
<td>700</td>
<td>600</td>
<td>762</td>
<td>1 353</td>
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<tr>
<td>Loans impairment (net of recoveries)</td>
<td>713</td>
<td>1 332</td>
<td>1 166</td>
<td>1 010</td>
<td>766</td>
<td>569</td>
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<tr>
<td>Profit before income tax</td>
<td>418</td>
<td>(1 222)</td>
<td>(741)</td>
<td>(779)</td>
<td>(173)</td>
<td>663</td>
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<tr>
<td>Income tax</td>
<td>14</td>
<td>(459)</td>
<td>(141)</td>
<td>(177)</td>
<td>(54)</td>
<td>271</td>
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<tr>
<td>Profit after income tax</td>
<td>404</td>
<td>(763)</td>
<td>(599)</td>
<td>(602)</td>
<td>(119)</td>
<td>393</td>
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### Net income

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<tr>
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<tbody>
<tr>
<td>Non-controlling interests</td>
<td>59</td>
<td>86</td>
<td>84</td>
<td>77</td>
<td>89</td>
<td>118</td>
</tr>
<tr>
<td>Net income</td>
<td>344</td>
<td>(849)</td>
<td>(683)</td>
<td>(679)</td>
<td>(208)</td>
<td>(275)</td>
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</table>

### Balance Sheet

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<tr>
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<tbody>
<tr>
<td>Cash and Deposits in Banks</td>
<td>5 087</td>
<td>6 606</td>
<td>5 806</td>
<td>5 903</td>
<td>6 165</td>
<td>7 605</td>
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<tr>
<td>Loans and Advances to Customers</td>
<td>73 905</td>
<td>68 046</td>
<td>63 448</td>
<td>58 942</td>
<td>57 524</td>
<td>65 743</td>
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<tr>
<td>Financial Assets</td>
<td>14 945</td>
<td>12 576</td>
<td>12 946</td>
<td>12 692</td>
<td>13 084</td>
<td>15 682</td>
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<tr>
<td>Deferred Losses Carried Tax Assets</td>
<td>1 010</td>
<td>1 617</td>
<td>707</td>
<td>915</td>
<td>1 021</td>
<td>324</td>
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<tr>
<td>Other Assets</td>
<td>3 600</td>
<td>4 637</td>
<td>4 900</td>
<td>4 817</td>
<td>4 960</td>
<td>5 925</td>
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<tr>
<td>Total Assets</td>
<td>98 547</td>
<td>93 482</td>
<td>87 807</td>
<td>83 269</td>
<td>82 754</td>
<td>95 279</td>
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### Deposits from other credit institutions

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<tr>
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</thead>
<tbody>
<tr>
<td>Deposits from customers</td>
<td>20 077</td>
<td>17 723</td>
<td>12 252</td>
<td>11 976</td>
<td>11 178</td>
<td>12 995</td>
</tr>
<tr>
<td>Total Deposits</td>
<td>20 077</td>
<td>17 723</td>
<td>12 252</td>
<td>11 976</td>
<td>11 178</td>
<td>12 995</td>
</tr>
</tbody>
</table>

### Equity and non-controlling interests

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<tr>
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<tbody>
<tr>
<td>Total Equity and Liabilities</td>
<td>5 612</td>
<td>4 374</td>
<td>4 215</td>
<td>3 579</td>
<td>3 775</td>
<td>5 858</td>
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### Indicators

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<tbody>
<tr>
<td>Core Tier I Capital</td>
<td>6,7%</td>
<td>9,3%</td>
<td>13,4%</td>
<td>12,9%</td>
<td>13,0%</td>
<td>10,0%</td>
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<tr>
<td>Loans to Deposits</td>
<td>162%</td>
<td>143%</td>
<td>134%</td>
<td>127%</td>
<td>120%</td>
<td>116%</td>
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<tr>
<td>Net Interest Margin</td>
<td>1,7%</td>
<td>1,8%</td>
<td>1,2%</td>
<td>1,2%</td>
<td>1,3%</td>
<td>1,9%</td>
</tr>
<tr>
<td>Cost to Income</td>
<td>53%</td>
<td>65%</td>
<td>67%</td>
<td>71%</td>
<td>65%</td>
<td>54%</td>
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<tr>
<td>Cost of Risk</td>
<td>0,9%</td>
<td>1,8%</td>
<td>2,5%</td>
<td>1,8%</td>
<td>1,3%</td>
<td>0,9%</td>
</tr>
<tr>
<td>Return on Equity</td>
<td>10%</td>
<td>22%</td>
<td>-26%</td>
<td>-15%</td>
<td>-4%</td>
<td>-4%</td>
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<tr>
<td>Return on Assets</td>
<td>0,4%</td>
<td>-0,8%</td>
<td>-1,2%</td>
<td>-0,7%</td>
<td>-0,2%</td>
<td>0,3%</td>
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## Research Recommendations

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

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