The resilience of food retail…

… in a challenging Iberian market

We have fine-tuned our Sonae’s estimates since the last 9M12 Postview comment, based on latest data and new estimates. Our price target was revised upwards from €0.70 to €0.99 for YE13, though we have kept our BUY recommendation, representing now a 37% upside vs. current price.

Sonae has a strong link to Portugal and is still significantly levered, although showing ability to reduce debt and roll-over; we expect strong correlation and volatility associated with the country’s ability to recover.

Sonae MC has been showing very resilient results despite the tough macro situation, presenting improvements in EBITDA margin (80bp increase in 9M12 YoY), as well as gains in market share, thus consolidating its leadership position. Start-date of Angola operations is still uncertain, estimations pointing to 2013-14.

Sonae SR is suffering from consumer contraction in Iberia, strongly impacting top-line and margins. Expansion in Spain has been halted and international growth will mostly be done employing a capital-light strategy.

Sonae RP has not been able to close any S&LB deals in the last 2 years due to the deterioration of real estate market. We expect a gradual freehold decreased aligned with the company’s strategy.

Sonae Sierra is showing significant operational resilience, with rentals and occupancy rates being very solid, positively impacting direct results. Indirect results are expected to be negative until 2013 as a consequence of yields expansion in Europe, with recovery expected in 2014.

Sonaeom has been benefiting from cost savings resulting from the integration of fixed and mobile businesses, as well as decreasing MTR’s by ANACOM. The merger between Zon & Optimus has potential to unlock significant value for Sonae’s shareholders.

Company description
Sonae SGPS is a Portuguese conglomerate, operating mainly in the food and specialized retail segment, with a leadership position in its domestic market. The Company has two major partnerships: Sonaeom, a Portuguese telecom company; and Sonae Sierra, an international specialist in the development and management of shopping centres.
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Company overview

Sonae SGPS is a Portuguese conglomerate that manages a portfolio of different businesses. The company's main focus and value lies on the retail segment, which is comprised of food-retail and specialized retail, together making up the company's core business. Sonae also operates in the shopping centre and telecom sectors, with controlling stakes in its two core partnerships: Sonae Sierra and Sonaeom. Sonae started off in 1959 as a small family-owned company operating in the engineered wood business. It experienced a phase of rapid growth from the 1980’s, achieving a number of important landmarks such as the public listing of its shares in 1985, and the opening of the first regional shopping centre in Portugal – CascaiShopping – in 1991. Its current structure is a result of various corporate reorganizations over the years as well as new business ventures.

Sonae’s strategy today is to focus in the retail segment, by consolidating its leadership position in the Portuguese market, as well as continuing the internationalization of its operations, employing a capital-light policy – decreasing investment in CapEx by lowering the ownership rate of the assets it operates. Despite its internationalization efforts, the business is still overwhelmingly dependent on the Portuguese market, representing 90% of total Revenue1. Sonae also intends to improve its capital structure by reducing financial debt in the short-term, either through operational cash flow generation, or proceeds from future Sale & Lease-back (S&LB) operations.

Exhibit 2: Sonae’s organizational chart

Core Business

- Sonae MC

Sonae MC represents Sonae’s division in food retail, which enjoys a leadership position in the national food retail market. It operates under a number of

1 As of 2011 – still includes the effect of Sonae Sierra.
different formats, serving specific market needs, all of which are associated with the same distinctive features: quality products with competitive prices.2

Sonae’s hypermarkets operate under the Continente brand, and offer the Portuguese customer a large choice in terms of store keeping units (SKUs) – about 70 thousand – and selling area – average 7.4 thousand m\(^2\). Since the launch of its first hypermarket in 1985 (Continente Matosinhos), Sonae has been able to open numerous others in prime strategic locations: mainly locations with large population density or incorporated in large shopping centres, which are usually managed by the company itself.

Continente Modelo is a chain of supermarkets typically located in small shopping centres or medium sized population centres, currently offering on average 2 thousand m\(^2\) of selling area. The concept is associated with convenience and mainly targets the needs of daily shoppers. This unit, together with Bom Dia, was rebranded in 2011 under one name (Continente) in an attempt to reduce operational costs. These formats are highly associated with Continente’s loyalty card (over 3.1 million active cards in Portugal and over 90% sales realized through the card) and a growing private label, which now represent 31% of total FMCG3 sales.

The other formats in this division include Bom Bocado (cafeterias and restaurants), Well’s (para-pharmacies), Book.it (bookstores/stationery) and Meu Super (franchised local food retail stores).

- Sonae SR

Sonae Specialized Retail (SR), Sonae’s non-food retail arm, started off in 1995 as an expansion move of the company’s core business. Currently, it operates several own brands such as: Worten, the leading consumer electronics store in Portugal; Worten Mobile, which specializes on mobile telecommunications’ equipment; Sportzone, also a leading chain in the Portuguese sports clothing and equipment market; and Modalfa, Zippy and Loop, operating in the clothing, kids apparel and footwear markets.

Sonae SR’s activity is mainly located in Iberia, with two thirds of its Revenue being generated in Portugal. The main internationalization target of SR has been the Spanish market: Sonae identified opportunities arising from market fragmentation and region proximity, and invested heavily since 2007. However the consumer retraction and funding restrictions have led Sonae SR to reduce

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2 Deco Proteste’s 2011 study mentions Continente as one of the most relevant distributors to offer good quality products at low prices. Its 2012 study classifies Continente and Modelo as the 2\(^{nd}\) cheapest retailer, comparing a 100 product basket among several retailers. Continente’s private label has received international quality certifications by SGS ICS.

3 Fast Moving Consumer Goods.
significantly its expansionary rhythm in this region. In addition, in an attempt to accelerate growth without significant investment costs, Sonae SR has expanded to other international regions following a more capital light strategy. The company has engaged in numerous franchising and joint venture agreements, with over 140 stores present in 18 countries, under these alternative investments.

Related Business

• **Sonae RP**

Sonae Retail Properties (RP) is the unit in charge of managing the portfolio of real estate assets related to the retail business. The unit has as its objectives the development, enhancement and management of the real estate assets, with its main revenue source being rents from Sonae MC and SR, allowing the latter two to focus solely on their core retail business. The portfolio includes, among others, 33 Continente hypermarkets, 96 Modelo supermarkets and 1 distribution centre, bringing total freehold to 78% in food retail and 27% in non-food.

As an attempt to follow the announced capital-light strategy, as well as to redeem some of its outstanding debt, Sonae RP has managed to perform a number of Sale and Lease-back operations, enabling it to cash-in €153m\(^4\). The company admits to do more of these operations in the future, in order to reduce its ownership rate of the assets utilized (release capital). However this will be done cautiously, since Sonae has no immediate balance sheet pressures and the current economic environment is not helpful for sellers in the real estate market.

Core Partnerships

• **Sonae Sierra**

Sonae Sierra is a 50:50 Joint-Venture (JV) partnership with the British company, Grosvenor. It was founded in 1989 and the unit focuses on designing, developing and managing shopping centres in partnership with local companies. This approach allows the company to split investments costs, mitigate risk, as well as gain knowledge from local markets and create new business opportunities.

With over 20 years’ experience in this market, Sierra has built a strong international reputation by earning a number of awards and prizes\(^5\) – more than any other company in this sector. It currently has stakes in 51 shopping centres, over 2.0 million m\(^2\) GLA\(^6\) ownership, and presence in Portugal, Brazil, Spain, Italy, Germany, Greece and Romania.

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\(^4\) 8 Sale & Leaseback transactions completed in 2010/2011, representing a cash-in of €153m, and capital gains of €56m.

\(^5\) Company claims to have received over 100 awards to date, more than any other firm in the industry.

\(^6\) Gross Leasable Area
Despite a strong focus on internationalization since the 1990’s, the group’s exposure to Portugal is still significant, with 44% of the shopping centre’s open market value (OMV) located in this country.

The company’s recent focus has been one of capital recycling, by selling stakes in existing investments (while maintaining management) to finance others in emerging markets – mainly in Brazil.

- **Sonaecom**

Sonaecom is a Portugal-based holding company operating primarily in the telecommunication industry. It is a listed company on Euronext Lisbon and Sonae SGPS is its largest shareholder, owning a 53% controlling stake. The company divides into two main units: Optimus, which is an integrated telecommunications operator, and the unit of Software and Systems Information Services (SSI). Additionally, the company has an Online & Media unit, which includes the daily newspaper Público and the online auction website Miau.pt.

Optimus is the most valuable unit of the company, contributing with over 98% of total EBITDA. It is the third largest operator in Portugal, capturing 14% of the market. It is focused on mobile technologies and has a convergent approach to the corporate and SMEs segments.

**Active Management**

- **Investment Management**

The Investment Management unit is responsible for supporting the implementation of corporate and business strategies. It creates value for Sonae by actively supporting core business mergers and acquisitions’ (M&A) planning and execution. Currently, the portfolio includes MaxMat (DIY company), and MDS (insurance), while GeoStar (travel agency), which had been previously part of this unit, has been deconsolidated from the beginning of 2012.

**Shareholder structure**

Sonae is considered to have a very stable shareholder structure. The company’s main shareholder with a 52.7% stake is Efanor Investimentos, a company fully controlled by Belmiro de Azevedo, Sonae’s chairman and a key figure associated with the company’s growth and success over the years. Other large stakes are owned by a few financial groups as strategic investments, such as BPI with 8.9% and Bestinver with 7.7%. Remaining shareholders account for approximately 26.3% of total outstanding shares.
Macroeconomic Analysis

Sonae is present mainly in Portugal, Spain and Brazil

- Portugal

During the last decade, Portugal experienced a sluggish growth, and presented signs of recurring macro-economic imbalances and structural weaknesses which became highlighted during the sovereign debt and Eurozone crisis, namely: the unsustainability of public finances, over-indebtedness and low productivity.

In mid-2010, Moody’s Investors Service cut Portugal’s sovereign bond rating down two notches to A1, arguing the country’s debt to GDP had increased sharply. By the end of the year, the country reached high unemployment rate of nearly 11% and risk premiums on Portuguese bonds hit historical highs as investors and creditors were worrying the country would fail to reduce its budget deficit and general government debt. With yields on sovereign bonds reaching prohibitive levels and successive rating downgrades, access to debt markets became unsustainable and Portugal was forced to ask for economic and financial assistance in the first half of 2011. A package of €78 billion from the IMF-EU was agreed to help the country stabilise its public finances. The funds were agreed to be distributed in tranches, following a number of evaluations by Troika (IMF, EU and ECB) to assess the progress of the country in meeting specific guidelines in terms of budget deficit, public spending and fiscal reform.

Up to this point, Portugal has received 6 positive evaluations from Troika, and significant progress has been made: the financial sector is stabilized with all Portuguese banks meeting EBA’s capital requirement as of June 2012; a number of fiscal reforms imposed to reduce public spending and promote growth; and the gradual return to the markets by the Portuguese government (with two short-term debt issuances in the end of 2012) and by a number of Portuguese listed corporations – which is being reflected in a steady decline of Portuguese sovereign bond yields since the middle of 2012.

Nevertheless, it is important to point out, yields still show a significant spread compared to the German Bund and the country has been given an additional year, until 2014, to be able to reduce its budget deficit to a level below 3% of GDP. The 2013 state budget, recently approved by the parliament in late 2012, highlights a number of fiscal tightening reforms and austerity measures, which allied to an expected increase in unemployment rate in coming years, will surely be affecting the population’s disposable income and purchasing power.
Recent forecasts show the recession will expand to 2013 with GDP declining 3.0% and 1.0%, in 2012 and 2013, respectively, returning back to growth in 2014.

For Sonae, this presents significant challenges in recent years to come, since more than 90% of the company’s revenue as of 2011 was coming from its domestic operations.

- Spain

Spain, unlike Portugal, showed a steadier GDP growth up to 2007, despite some fundamental problems in its economy which were becoming increasingly evident in the years approaching the financial crisis. The government was able to maintain a relatively low debt relative to GDP mostly by taxing revenue from a growing housing bubble, which helped to fund years of increased government spending without accumulating debt. This bubble eventually burst when the crisis hit, and the country experienced two consecutive years of negative GDP growth7.

On top of that, Spain spent large amounts of taxpayer’s money on bank bailouts and eventually received a €100bn “bank recap” package in June 2012 by the European Union. Like Portugal, Spain has been implementing tough austerity measures, to build up trust in the financial markets and overcome its high deficit and debt levels. As a consequence it has seen its unemployment rates rising, with particular concern to its young unemployment which has reached an overwhelming rate of 50%. This is indeed an added challenge for Sonae, since a large part of its International division for Specialized Retail is located in Spain. Recent economic forecasts show GDP will contract in 2012 and 2013 by 1.5% and 1.3% respectively and unemployment rate should reach 25% by end of 2012, meaning it will take some time for Spanish consumers to restore their confidence and return to normal spending levels.

- Brazil

Brazil is becoming an increasingly important region for Sonae, mainly to its shopping centres division. Comparing it to the more developed European countries, Brazil had a very healthy economic growth in the last decade (GDP CAGR of 3.2% between 2000-2008) and despite a deceleration in 2009 due to the financial crisis, it quickly returned to growth in 2010, hitting a 7.5% increase in GDP and becoming the sixth largest economy of the world by the end of 2011. Future predictions indicate a continuing growth, mainly as a consequence of increasing foreign investment in this country.

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7 Spain entered recession in 2009 with GDP declining 3.7% and 0.3% the year later.
Segments Valuation

We value Sonae SGPS using a **Sum of the parts approach**, combining a number of different methods to value each segment: **For the retail business, we have valued each unit separately through a DCF model**, which discounts the free cash flows to all investors at a rate which considers the risk of investment, and by deducting the market value of the net debt of these units. For the core partnerships, we have taken the forecasted **Net Asset Value of Sonae Sierra and the expected market capitalization of Sonaecom post-merger**. Finally we value the **Investment Management unit through the book value of its equity**.

Retail

- **Food Retail Market Overview**

The market for food retail in Portugal is considered to be very mature, and highly concentrated, with **6 large groups accounting for roughly 77% of total market share**. The sector has experienced a polarization in recent years, with the top two players (Sonae and Jerónimo Martins) gaining overall market share, while most foreign players losing market share or even divesting. With **increased challenges associated with the economic downturn**, this phenomena has become more evident in recent years, with the bankruptcy of the supermarket chain AC Santos in 2011; the reported insolvency problems in gruppo Sá that led to the divestiture of its mainland business, and the closure of one hypermarket by the Auchan group earlier in 2012. Retail trade in Portugal is dominated by hypermarkets – representing 43% of the market. These hypermarkets are characterized by the fact that they sell not only food products, but also domestic products. Sonae and Auchan are now the main players in the large hypermarket segment, following Carrefour’s disposal of this format in 2007 and Jerónimo Martins downsizing most of its Feira Nova hypermarkets and their subsequent conversion to Pingo Doce supermarkets.

Due to the maturity of the market, the on-going problems with the economic crisis, and an increased intervention from the competition authority regarding new store openings, growth prospects are becoming relatively low for the large groups, with **like-for-like sales growth (LFL)** becoming a very important **source of value**. In fact, this year, we have observed very aggressive pricing strategies from the top-players, which demonstrate the current level of

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8 Jumbo de Santarém was closed in June 2012, with Auchan reporting it did not generate enough attractiveness.
9 Growth adjusted for the effects of expansion and store closures.
10 Jerónimo Martins held a promotional campaign on a bank holiday in May 2012, comprising of a flat 50% discount on all purchases. Other food retailers followed with similar campaigns, generating a price war for few months.
competition for market share. These large players frequently demand their distributors and suppliers to share the burden of the discounts, and smaller retailers do not have the power to follow.

Confidence indicators have been severely hit in Portugal during the last months, leading to a contraction in the domestic retail trade. Despite food being a first need requirement and generally less volatile to economic cycles, consumption patterns seem to be changing and families are looking for convenience, while rationalizing their food related expenditure by being more selective and attentive to price/quality ratios. This explains another trend that has been noticeable, which is the increasing importance of private labels in the Portuguese market. AC Nielsen’s report on value shopping from 2011 highlights consumers in the most hard-hit economic countries have turned to private label to help ease their financial burdens. Portugal appears in the top-10 ranking for private-labels, with a market share of 25% (over FMCG), compared to a weighted global average of 14.9%. The study shows the upward trend is likely to continue, as over 95% of the respondents in Portugal stated they will continue to buy private labels even when the economy recovers. Since all the big players in food retail have now an established and growing private label, the future trend seems to be challenging for several discount retailers, such as Lidl, Minipreço and Leclerc that are likely to lose importance in the Portuguese market, which also helps explaining the recent years’ losses in market share from these groups.

- Valuation – Sonae MC

Despite the tough macro environment and solid competition, Sonae’s food division has been performing quite strongly. The company has benefited from its increasing market share and higher logistics efficiencies and marketing costs savings after the merger of its two main food concepts (Continente and Modelo) under one single brand. As a consequence, sales have been quite resilient in recent years and EBITDA margin has expanded 80bp in the first 9 months of 2012, compared to the same period in the previous year.

Brand awareness and MC’s pricing policy play a very important role in maintaining this level of performance in challenging times. Continente has repeatedly been considered one of the most trusted brands in Portugal by consumers\(^\text{11}\) and number 1 in Marktest’s reputation index for large distributors. The unit offers numerous discounts through its Continente loyalty card, providing “credit” in repeated purchases. With over 3.1 million of active cards (3 out of 4 Portuguese households) and close to 90% sales associated with the card, it

\(^{11}\) Survey of “Trusted Brands” carried out by Reader’s Digest has awarded Continente as most trusted brand for 10 consecutive years.
clearly enables the company to obtain valuable customer insights in terms of consumer habits.

Recent trends also show a strong investment in the company’s own label, with sales over FMCG growing from 23% in 2009 to 31% by 9M12, and an expansion in the overall range of products offered. The private label is managed internally and the company has taken advantage of the current economic conditions to offer more choices to its customers at a lower price (usually 20% cheaper than the category leader). Though these products are cheaper, we are aware they offer a better margin to MC since the costs tend to be considerably lower; therefore we expect a continued investment in the private label segment.

The total turnover represents the sum of all formats’ turnover under the Sonae MC umbrella. It results from the projection of sales area, and average sales/m² for each concept. Top-level growth is expected to be very moderate in the next few years, due to consumption retraction in Portugal as a result of macroeconomic conditions and the on-going austerity measures being adopted by the government. Overall, Lfl growth is expected to be relatively flat in 2013, and steadily increase in the following years, when the Portuguese economy is expected to return back to growth. We estimate a CAGR for Lfl in the region of 0.3% for the period of 2011-15 and 1.9% for the following 5-year period.

The benefits of the convergence of Continente and Modelo formats are evident and have allowed the unit to realize substantial savings in operating costs and to spread a well reputed brand name across the country. As a result, EBITDA margin is expected to climb close to 40bp in 2012. However, we take a more conservative approach for the following periods and expect it to remain at around 7.1%, as we believe these efficiency gains will be temporary and such high margins will be unsustainable in the long-term, as Sonae MC’s strategy encompasses consolidating and increasing its market share in the future, which we believe will have to be done mostly by offering discounts and competitive pricing, consequently shrinking margins.
Within the different formats, Continente hypermarkets and Modelo supermarkets are the main contributors to Sonae MC’s Turnover, expected to reach over 96% of the unit’s total sales by the end of 2012. The hypermarkets sector in Portugal is considered to be very mature and reaching a saturation point, thus we do not expect a sizeable number of store openings, with most value generated through Lfl sales growth. The supermarkets on the other hand, which are in the small to mid-size format, offer convenience to the consumer, and thus are likely to grow both through store openings and Lfl growth – we are estimating two store openings per year in the forecast period.

The remaining formats (Bom Bocado, Well’s, Book.it and Meu Super), although representing a smaller slice of total revenue, have larger growth potential and we estimate revenue CAGR of 2.3% between 2011-15 and 4.4% between 2016-20.

Overall, notwithstanding the challenges in the domestic market, we expect Sonae’s food retail formats to continue succeeding and add market share, even despite its strong weight of hypermarkets (51% of food retail selling area). Contrary to what we are seeing in most western European countries, MC’s hypermarkets have been very successful, mostly due to their prime locations in large urban areas and their integration in several large shopping centres.

The unit’s CapEx will be mostly linked to store revamping and investments related to new store openings. In regards to working capital needs, despite some investment in 2012 and 2013, we expect it to be negative and stable in the long-run, due to the mismatch in number of days between receivables and payables, which is a major characteristic of this business.

We have applied a WACC\textsuperscript{12} of 8.0% to this DCF valuation model. The figures show the base case expected cash flows for the forecast period, which already incorporate the effects of consumer contraction in the mid-term and low growth.

\textsuperscript{12} Weighted Average Cost of Capital of all sources of funding
prospects following the government’s on-going implementation of austerity measures. However due to the perceived risk of investing in a company that operates in a more uncertain country, as a result of the greater variance of future cash flows, we believe an investor should be compensated and demand a higher return. Thus we add a premium to the cost of capital, translated into a country beta: this is obtained by performing a regression of returns of the Portuguese main stock index (PSI-20) against the returns of the MSCI World index.13

Our estimates value Sonae MC at an EV of € 1.807 million which implies an EV/EBITDA of 7.1x for 2012. In context, Sonae MC’s trading multiples appear to be slightly above the sample average, though this is explained by the unit’s apparently low EBITDA as a consequence of rentals. Despite having an asset freehold above average, MC pays rents on all assets it operates in, part of it going to Sonae RP. For this reason, comparison should be done cautiously, with EBITDAR metrics being a useful tool for this exercise.

### Specialized Retail Market Overview

Unlike Sonae’s food division, the non-food sector is less resilient during recessive times, thus the consumer spending contraction has a more severe effect in this unit. This is a direct consequence of the factors affecting Iberian consumers at the moment: public and private sector employees’ pay cuts; increasing unemployment rates, higher taxes, and higher restriction to consumer loans.

**These items are considered to be discretionary and are therefore among the first ones to be cut in families’ budgets.**

The non-food unit comprises subsidiaries engaged in very different segments, ranging from electronics to clothing and apparel. Looking firstly at Portugal,
Sonae SR’s brands benefit from good brand recognition\(^{15}\) which alleviate in part the breakdown in demand. In the electronics and home appliances sector, Worten is clearly the dominating player with its main direct competitors being Rádio Popular and Media Markt, together making less than half of Worten’s total sales in 2010. In the sports equipment market, Sportzone is also the leading brand in a very concentrated market – with its only main competitor being Decathlon, which has been increasing sales volume as a result of new store openings\(^{16}\). Modalfa, on the other hand, operates in a much more fragmented market, competing with the likes of C&A, H&M and the Inditex brands. The sector has witnessed the appearance of some internationally popular low cost retailers such as Primark and Sports Direct, which although still have a small market share, will pose a threat to SR’s leading positions and a challenge to its margins in the future, as the chains admit to continue investing in store openings\(^{17}\).

The Spanish market follows closely the reality seen in Portugal and the data shows us Spanish consumer confidence levels have been very low in the past few years. This is reflected in the region’s non-food sales which on a YoY basis have not been positive since mid-2010. The demand for discretionary products is falling sharply in Spain for the same reasons as in SR’s domestic market, but we are expecting these levels to hit a bottom in 2013, and return to positive numbers when the economy starts to grow.

Unlike in its domestic market, despite the aggressive store openings witnessed during the last few years, SR’s brands do not have a leading position in Spain. Worten and Sportzone face stiff competition from market leaders Media Markt and Decathlon, which have sales in the region of € 1.793 million (2010) and € 979 million (2008) respectively.

- **Valuation – Sonae SR**

We take the same approach to value the SR division as we did with MC, however we analyze and value the International and domestic operations separately due to its different characteristics regarding profitability margins and expansion plans.

Starting with Portugal, despite its leadership position in some formats, sales and margins have been declining since 2010, clearly reflecting the spending contraction in the country. Lfl sales are expected to be -2.8% in the 2011-15E period and return to positive levels in the following 5-year period. Within the different formats, even though Sonae does not publish results by unit, we are aware Worten has been very resilient in Portugal and steadily gaining market

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\(^{15}\) Worten received in 2012 its third consecutive award as the most trusted brand in the non-food retail segment by Portuguese consumers

\(^{16}\) It has 22 stores in Portugal and recently opened a new Logistics Center in Setúbal to help manage store supply

\(^{17}\) Primark has 6 stores in Portugal and plans to continue opening stores. SportsDirect aims to reach 20 stores by the end of 2012.
SR also decided to close all of its Vobis stores in 2012 and integrate its products within the Worten format. The reasoning was that the business and its products were overlapping in many ways with Worten and the shutdown served as a means to cut cost as well. The situation has not been so rosy for the clothing and sports businesses: SR buys collections in advance, and was not able to predict such a high spending contraction, which on top of a decline in sales, had to witness a decline in margins due to the accumulation of inventory.

In terms of store openings, we expect a deceleration of investment in Portugal, with cash flow being prioritized to the international expansion. Overall, the non-food business is a very cyclical one, and will return back to growth when the economy starts to recover: top-line CAGR will come to -1.8% in 2011-15E, and 6% for 2016-20E.

The international expansion to Spain in 2008 came as a response to the limited growth opportunities arising from the maturing Portuguese market. We believe the strategic move did make sense at the time, and SR could not have predicted such a widespread downturn. Due to the rapid and capital intensive growth in the neighbour country, the business is still bearing the heavy entry costs and has not been able to break-even with the Portuguese business being responsible for offsetting the negative results of Spain.

In terms of formats, SR has only implemented its most successful brands abroad (Worten, Sportzone and Zippy), but the reality is very similar to the domestic one regarding the first two concepts: Worten has been resilient but Sportzone is struggling with the tough competition from Decathlon and we do not rule out the closure of some less performing stores. The company recently engaged in the expansion of its Zippy brand to other countries such as Saudi Arabia, Egypt and the Canary Islands, but it still represents less than 2% of total SR sales area.

The business should continue growing its top-line with revenue CAGR of 14.2% and 12.7% for the 11-15E and 16-20E periods, though the majority of this growth will be driven by new store openings. In terms of margins, we take a more conservative approach and predict a break-even only in 2015, which means despite the rapid growth, in our estimates the division will not be adding value for shareholders any soon.
Nonetheless, we do not expect a break in the expansion plans, though these will lose pace and will follow a more capital light strategy (through renting, joint ventures and franchising agreements, rather than ownership of properties). Therefore we expect a steady fall in CapEx investment in relative terms, with CapEx / sales ratio decreasing from 4.6% in 2012E to 2.6% in 2020E.

The DCF valuation for the SR division is the sum of both domestic and international divisions. The WACC inputs are similar, with the tax rate and country risk being the only inputs that change in each individual valuation. We therefore value Sonae SR at an EV of € 298 million, out of which, € 229 million account for operations in Portugal – highlighting in this way the discrepancy in value between the two divisions. The valuation implies an EV/Sales multiple of 0.2x which is much lower than its peer companies. This is in large a consequence arising from the international division of SR which despite generating revenue, does not generate as much value – also the reason why remaining multiples are negative, and inconclusive for comparison purposes.
Sonae RP (Retail Properties) is the unit in charge of managing the real estate assets related to the retail business. RP was created in 2009 with the goal of managing Sonae’s retail asset base more efficiently as well as to release part of the invested capital and better support expansion. Its main source of income relates to rents (set at market rates) received from the properties owned and operated by Sonae MC and SR.

As of September 2012, total invested capital in real estate assets amounted to €1.343 million, representing a freehold of 78% in the food-retail division and 27% in non-food. The initial strategy for this unit consisted in an asset monetization program aimed at reducing the retail real estate invested capital by €300 – 400 million in order to free up capital to support the internationalization effort and/or to reduce debt. This would be carried out by a number of S&LB operations which encompass the operational leaseback of properties upon its sale for periods between 15-20 years. These operations allow the company to remove the assets and respective liabilities from the balance sheet, thus giving the impression of a less indebted firm. With the sale of the assets, the ownership risk is transferred and the corresponding proceeds result in a cash infusion, while lease payments can be treated as expenses and shield the company from high corporate taxation. In terms of valuation impact, S&LB deals have no impact on the retail units (there is only a change in ownership, while the tenant remains the same), though the RP unit will reduce rental income.

Sonae RP was able to close a number of these deals on a Triple Net basis in 2010/11 at surprisingly attractive yields, with the sale of its Azambuja logistics platform, 6 Modelo supermarkets and few stores located in shopping centres. However, the company has not closed any deal ever since and the process has been halted following the spike of real estate yields in Portugal. As a result, Sonae RP is now limited to an opportunistic approach, analysing deals on a case by case basis. Despite the transactions carried out in the last two years, Sonae still has a level of freehold retail real estate well above other retailers in Europe.

Nevertheless, we should point that Sonae has completed the refinancing program of its medium and long-term credit facilities and thus is not under pressure to make unfavourable S&LB operations.

We can value the unit through a simple DCF model by assuming that its present value of cash flows arise from future rent payments after deducting its operating and investment costs. The EBITDA figures for RP are close to

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19. Rents, operating expenses, insurance, tax and maintenance costs assumed by the tenant.
20. European food retail average is 55% and general retail is 18%. – Sonae Investor Presentation: November, 2012.
Turnover mostly due to the low operating costs associated with this business. In the recent outlook, we do not account for any additional S&LB operations, though we assume a steady decline in the overall ownership rate of assets, as a result of the capital light policy associated with new floor space at both MC and SR. We forecast Turnover and EBITDA to grown in line with inflation rates.

Exhibit 42: Sonae RP Discounted Cash Flow Valuation - € millions

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Turnover</td>
<td>119</td>
<td>120</td>
<td>121</td>
<td>125</td>
<td>127</td>
<td>130</td>
<td>132</td>
<td>135</td>
<td>138</td>
</tr>
<tr>
<td>EBITDA*</td>
<td>112</td>
<td>112</td>
<td>113</td>
<td>116</td>
<td>118</td>
<td>121</td>
<td>123</td>
<td>126</td>
<td>128</td>
</tr>
<tr>
<td>EBIT</td>
<td>83</td>
<td>83</td>
<td>84</td>
<td>88</td>
<td>89</td>
<td>93</td>
<td>95</td>
<td>99</td>
<td>101</td>
</tr>
<tr>
<td>NOPLAT</td>
<td>59</td>
<td>58</td>
<td>59</td>
<td>62</td>
<td>63</td>
<td>66</td>
<td>67</td>
<td>70</td>
<td>71</td>
</tr>
<tr>
<td>(+) D&amp;A</td>
<td>28</td>
<td>28</td>
<td>28</td>
<td>27</td>
<td>27</td>
<td>27</td>
<td>26</td>
<td>26</td>
<td>25</td>
</tr>
<tr>
<td>Operating Cash Flow</td>
<td>87</td>
<td>86</td>
<td>87</td>
<td>89</td>
<td>90</td>
<td>92</td>
<td>93</td>
<td>95</td>
<td>97</td>
</tr>
<tr>
<td>(-) Capex</td>
<td>28</td>
<td>28</td>
<td>27</td>
<td>27</td>
<td>26</td>
<td>26</td>
<td>25</td>
<td>25</td>
<td>25</td>
</tr>
<tr>
<td>(-) Working Capital Changes</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Free Operating Cash Flow</td>
<td>59</td>
<td>59</td>
<td>60</td>
<td>62</td>
<td>64</td>
<td>66</td>
<td>68</td>
<td>70</td>
<td>72</td>
</tr>
<tr>
<td>Discount Factor</td>
<td>1,00</td>
<td>0,91</td>
<td>0,83</td>
<td>0,75</td>
<td>0,69</td>
<td>0,63</td>
<td>0,57</td>
<td>0,52</td>
<td></td>
</tr>
<tr>
<td>Discounted Cash Flow</td>
<td>59</td>
<td>55</td>
<td>51</td>
<td>48</td>
<td>45</td>
<td>43</td>
<td>40</td>
<td>37</td>
<td></td>
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<tr>
<td>PV of Terminal Value</td>
<td>486</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Enterprise Value</td>
<td>864</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Company Data and Analyst’s estimates / EBITDA* refers to Sonae RP’s EBITDA plus contribution from Eliminations and Adjustments

Our DCF translates an Enterprise Value of € 864 million for this unit. We have applied a WACC of 9.8% to this DCF valuation model, which we assume to be a more conservative rate compared to the rates Sonae was able to obtain by selling a number of its assets in 2010 and 2011. In fact, if we were to value the unit using a 7% rate for example, RP’s value would boost a staggering 54% to € 1.328 million. However, under the current macro environment, we do not expect the company to close more deals at those rates, which is probably the reason there have not been any S&LB operations since the first half of 2011.

Shopping Centres

- Market Overview

Investment in real estate and its attractiveness is driven by the evolution of two main factors: rents and yields. The evolution of rents is determined by inflation, occupancy rates, general demand and tenant sales. Yields, on the other hand, represent the risk of the particular real estate investment. These two factors, like most investments, are influenced by a number of economic, political, geographic, and financial variables such as: location, GDP growth, population density and migration trends, unemployment, interest rates, availability of finance, and so on.
Europe

Shopping Centre completion in Europe reached 6.5M m² GLA\(^{21}\), an increase from the year before (5.2 million), though still far from the numbers seen in 2008 and 2009 (9.1M and 7.4M respectively). According to Cushman & Wakefield, the year was characterized by delays in a number of markets, with actual figures falling short of projections made earlier in the year. The uncertain economic climate of recent times has led to muted consumer spending in many European markets. This economic slowdown, as well as growing difficulties in securing financing and governmental permits in many countries has limited new shopping centre development. The recent years have witnessed upward movements in property yields and lower rents per m² also due to lower occupancy rates – key factors of attractiveness in the property market. As a result of the economic slowdown, development activity is expected to be below average in the coming years. The most significant increases in modern shopping centre space will take place in the less developed European countries and in Turkey, where the relative undersupply of space is being addressed. Whilst in more mature markets, the focus will be on extensions, upgrades and regenerations rather than on new developments.

Shopping centre development and supply per capita varies greatly by country and city. The EU-27 average stands at around 250 m² GLA per 1.000 inhabitants, with Norway at the top of the table and Serbia at the bottom. The lack of shopping centre development in some markets can be due to a cultural preference for other retail formats or to difficulties in obtaining government permits.

Portugal is slightly above the EU-27 average and has close to 300 m² GLA per 1.000 inhabitants. The market for shopping centres in Portugal is considered to be mature and reaching a saturation point which aided by the recession, has contributed to its unattractiveness for investors and therefore to a steep growth decline in recent years. Solely in 2011, prime yields in Portugal came under strong upward pressure, moving out by 125bps – now having one of the highest yield rates among European peers. In terms of investment, volumes declined by 80% in 2011, achieving the lowest figure in more than a decade, while in 2012 no retail transactions had been reported, clearly highlighting the difficult context the sector is going through. No new centres or extensions have been completed in Portugal for the first half of this year, neither are any expected to be completed by the year end. However GLA is forecasted to increase by nearly 70.000 m² before the end of next year, thus showing some recovery signs.

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\(^{21}\) Gross Leasable Area
In Spain the reality is slightly different: its shopping centre GLA per 1,000 inhabitants’ ratio comes just below the EU-27 average at around 225 m². Despite being responsible for a great percentage of new m² GLA in 2010, we should highlight a great deal of these completions were actually delayed projects, which means the recession has also taken its toll in Spain. In 2011, it appeared again at the top of the table contributing nearly with 0.2 million m² of new shopping centre GLA, though this total is misleading, as it is highly skewed by Marineda City which makes up more than 70% of this figure. Investment has in fact decreased by 61% YoY, with only € 733 million of retail assets transacted – the lowest annual figure since 2004, while prime yields have expanded slightly by 25bps in the first half of 2012. The pipeline for H2 2012-2013 expects completions of 0.4M m² showing as well some recovery in the region.

Throughout the rest of Europe, the sector seems to be recovering as average prime shopping centre yields have been slowly shrinking – from 7.04% at 2010 year end, to 6.90% in the second quarter of 2012. Completion numbers seem more promising for 2012, with over 2.4M m² increase in GLA for the first six months of the year, and an additional 4.5M scheduled for completion before the end of the year – bringing the projected total to 6.9M m². Though the pipeline for 2013 currently stands at 5.5M m², delays have been reported in several markets, and some of the shopping centres scheduled for completion in the second half of 2012 may not be delivered on time and roll over to next year.

**Brazil**

On the other hand, Latin America has seen an explosion in new consumers emerge during the last decade as the region has undergone an economic transformation through strong exports and capital expenditures. A strong middle class has emerged with a tremendous untapped spending power and high consumption rates that translate into a strong retail customer base. In addition, a high percentage of the population lives in urban areas that have been under-retailed for some time. Consumer habits are also changing, and Brazilians, for example, tend to spend more time in malls and visit them more frequently. As a result, total shopping centre GLA has grown at a CAGR of 6.5% between 2006 and 2012, according to ABRASCE. The total number of shopping centres has increased from 351 to 430 in the same period, while shopping centre revenue increased over twofold from R$ 50 billion to R$ 108 billion between 2006 and 2011. Demand is strongly outweighing supply in this country, especially for tenants looking for larger space (preferred by international fashion retailers); therefore rent levels in prime locations are being pushed upwards. The share of

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22 Associação Brasileira de Shopping Centers
shopping centres per region is however very different, with most concentration found in the South and Southeast (73.8%), with the remainder being allocated to the North, Northeast and Midwest. The pipeline for 2013 shows no signs of a growth breakdown, with an estimation of 1.5M m² GLA to be added in the country by the end of that year.

- Valuation – Sonae Sierra

Sierra, Sonae's division responsible for shopping centre management, is present in 7 countries and holds a portfolio of 51 centres owned/co-owned. It has roughly 2.3M m² GLA under management (2.0M m² owned) and is largely exposed to three countries: Portugal, Spain and Brazil, making up over 80% of total GLA owned. **Sierra’s valuation is computed through a Net Asset Value (NAV) framework**, appraised by Cushman and Wakefield – an independent specialised entity which computes the fair value of its investment properties every 6 months, using the standard practices of the RICS appraisal and valuation manual. From the chart on the left, it is easy to understand the development of Sierra’s NAV as a consequence of yields deterioration in Europe, particularly Spain and Portugal. The smoothing of yields in Brazil has been unable to compensate entirely the effect in Europe, thus **NAV per share has had a declining trend, depreciating around 34% from 2007 to 3Q12**.

In order to analyze Sonae Sierra in detail we should make a distinction between two components: **direct results** – which are influenced by the performance of its shopping centres in terms of rents, occupancy rates and costs: and **indirect results** – which represent the recognition of the changes in valuation (non-cash) of its properties as a result of yields evolution.

**Direct results have shown resilience**, despite the tough macro situation: In 2011, occupancy rates have stayed around 97%, while rentals have only declined 1% in Iberia and grown in all other regions. Sales and EBITDA have grown as well for 9M12 YoY by 1.0% and 2.3%, respectively, reflecting the strong operational performance. Going forward, we expect the addition of new shopping centres to the portfolio will support the evolution of both sales and EBITDA.

**Exhibit 50: Sierra Pipeline projects**

<table>
<thead>
<tr>
<th>Project</th>
<th>Country</th>
<th>GLA '000m²</th>
<th>Capex € millions</th>
<th>Own. %</th>
<th>Expected Opening</th>
</tr>
</thead>
<tbody>
<tr>
<td>Boulevard Londrina</td>
<td>Brazil</td>
<td>47.8</td>
<td>88</td>
<td>28%</td>
<td>1Q13</td>
</tr>
<tr>
<td>Passeio das Águas</td>
<td>Brazil</td>
<td>78.1</td>
<td>167</td>
<td>33%</td>
<td>3Q13</td>
</tr>
<tr>
<td>Adora</td>
<td>Romania</td>
<td>59.0</td>
<td>111</td>
<td>100%</td>
<td>4Q13</td>
</tr>
<tr>
<td>Solingen</td>
<td>Germany</td>
<td>29.0</td>
<td>120</td>
<td>50%</td>
<td>1Q14</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td><strong>214</strong></td>
<td><strong>486</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Company Data

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23 as of September 2012
Sierra is currently developing 4 shopping centres which represent a total investment of about €486 million, and will add 214,000 m² of GLA to the company’s portfolio: i) In Brazil, it is developing two greenfield projects, Boulevard Londrina, located in the state of Panamá, and Passeio das Águas, located in the state of Goiás; ii) Solingen in Germany, in a 50% partnership with MAB Development, and iii) Adora Shopping Centre in Romania, which represents a €111 million investment and will have 59,000 m² GLA.

In terms of rentals and occupancy rates, we stay conservative in Iberia, expecting still some declines in 2013. In Brazil, we assume slightly lower occupancy rates, in order to accommodate the opening of new shopping centres. All in all, we expect revenues and EBITDA to increase by -0.8% and 2.0% in 2012, and 8.3% and 6.6% in 2013.

Regarding indirect results, these have been responsible for a great deal of volatility associated with the company’s earnings (50% attributable to Sonae), having to report losses of €116 million in 2008 and €111 million in 2009 as a result of strong upward movement on shopping centre’s yields, which had an impact on the fair value of properties held by Sierra. Indirect results in Brazil have been largely responsible for offsetting the negative results in Europe; though in recent years we have witnessed a smoothing of yields in Europe, which along with an improvement of direct results have allowed Sierra to return to positive earnings in 2010 and 2011.

Exhibit 51: Shopping Centre Yields evolution in Sierra’s regions

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Portugal</td>
<td>5.2%</td>
<td>5.8%</td>
<td>6.7%</td>
<td>6.8%</td>
<td>7.3%</td>
<td>7.5%</td>
<td>7.7%</td>
</tr>
<tr>
<td>Spain</td>
<td>5.5%</td>
<td>6.5%</td>
<td>7.1%</td>
<td>7.0%</td>
<td>6.8%</td>
<td>7.0%</td>
<td>7.1%</td>
</tr>
<tr>
<td>Italy</td>
<td>5.4%</td>
<td>6.4%</td>
<td>6.6%</td>
<td>6.7%</td>
<td>6.5%</td>
<td>6.6%</td>
<td>6.8%</td>
</tr>
<tr>
<td>Germany</td>
<td>5.5%</td>
<td>5.9%</td>
<td>6.1%</td>
<td>6.1%</td>
<td>6.1%</td>
<td>6.1%</td>
<td>6.1%</td>
</tr>
<tr>
<td>Romania</td>
<td>7.0%</td>
<td>8.0%</td>
<td>9.0%</td>
<td>9.0%</td>
<td>8.8%</td>
<td>8.8%</td>
<td>8.7%</td>
</tr>
<tr>
<td>Greece</td>
<td>n.a.</td>
<td>7.0%</td>
<td>7.0%</td>
<td>8.5%</td>
<td>10.0%</td>
<td>10.5%</td>
<td>10.5%</td>
</tr>
<tr>
<td>Brazil</td>
<td>9.7%</td>
<td>8.6%</td>
<td>8.5%</td>
<td>8.5%</td>
<td>8.5%</td>
<td>8.4%</td>
<td>8.2%</td>
</tr>
</tbody>
</table>

Source: Company Data, RREEF Real Estate and Analyst’s Estimates

Exhibit 52: Sonae Sierra NAV evolution

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012E</th>
<th>2013E</th>
</tr>
</thead>
<tbody>
<tr>
<td>NAV</td>
<td>1.228</td>
<td>1.251</td>
<td>1.173</td>
<td>1.128</td>
<td>1.118</td>
</tr>
<tr>
<td>NAV / share</td>
<td>37.78</td>
<td>38.47</td>
<td>36.97</td>
<td>34.68</td>
<td>34.39</td>
</tr>
<tr>
<td>NAV growth %</td>
<td>-13.2%</td>
<td>-7.8%</td>
<td>-6.2%</td>
<td>-3.9%</td>
<td>-0.8%</td>
</tr>
</tbody>
</table>

Source: Company Data and Analyst’s estimates

Going forward, we expect a slight yield increase in 2013 for Iberia which due to its weight in the portfolio, should still push indirect results to negative grounds, and a likely recovery happening in 2014 onwards.

We value Sonae Sierra through a forecast of its NAV for 2013 year end based on the projection of direct results and indirect results. Our Valuation reaches a NAV of €1.118 million representing a 1% discount to its 3Q12 reported NAV.

We should point out Sonae Sierra is as of the beginning of 2012 consolidated under the equity method by Sonae SGPS in an attempt to anticipate the
expected recommendations by IFRS 11\textsuperscript{24}. In accounting terms, Sierra is now considered as a financial investment in the company’s consolidated balance sheet, thus removing the debt that was previously consolidated. Despite harming historical results comparability, \textit{we believe this move is highly beneficial for the company in terms of business clarification to investors}. In addition, it goes in line with Sonae’s intention to be perceived as a retail company rather than a conglomerate and represents an attempt to reduce or eliminate the valuation discount it has been subject to.

Going forward, we expect Sonae to speed up its expansion in Brazil and other emerging markets, and exploit a capital recycling approach to accelerate the development of new projects – by selling stakes in existing investments. We expect Sierra to be more focused on developing and management activities, while trying to reduce ownership of shopping centres, with expansion plans being based more on partnerships, in order to spread investment risks.

**Telecommunications**

- Market Overview

Sonaecom is Sonae’s holding company which operates in the Portuguese communications sector, though most of its value resides in Optimus – the telecom operator. In 2012\textsuperscript{25}, Optimus contributed with 90% of total revenue and over 98% of total EBITDA and for this reason, our analysis is more focused in the telecommunication sector, as Optimus is clearly the main cash generator for Sonaecom.

Optimus has been the 3\textsuperscript{rd} player for some time in a highly concentrated market – dominated by TMN with a 43% market share, closely followed by Vodafone with a 42% share, leaving Optimus with a mere 14%. The mobile sector in Portugal is believed to be reaching a saturation point, evidenced by its high mobile penetration rate\textsuperscript{26} of 158 as compared to the EU 25 average of 127. This means future growth for these companies will be a challenge and will inevitably be done through market share gains, driving stronger price competitions. In fact, the market has witnessed this type of fierce competition in recent years, with the launch of calling plans aimed at the youth segment by all three main network providers – these plans allow free calls between plan-holders which significantly

\textsuperscript{24} IFRS 11 requires a joint venturer to recognize an investment and to account for that investment using the equity method in accordance with IAS 28 \textit{Investments in Associates and Joint Ventures}, unless the entity is exempted from applying the equity method as specified in that standard.

\textsuperscript{25} Figures for the first 9 months of 2012, obtained from Sonaecom’s quarterly results.

\textsuperscript{26} Number of subscribers per 100 inhabitants.
drives ARPU’s\textsuperscript{27} downwards. On top of this, Anacom – the Portuguese communications authority – has been consistently decreasing MTR’s\textsuperscript{28} for some time, in order to comply with one of Troika’s requirements, to foster competition and align rates with what is being practiced in other European countries. The immediate impact of such move is a decrease in ARPU’s, though at an operational level, operators with a lower market share are benefited, as they will be required to pay less as a result of calls being made to other providers outside their network. For this reason, and as a result of cost-cutting efforts arising from a stronger integration of the fixed and mobile business, Sonaecom’s margins have been very resilient and steadily improving despite the notorious challenges associated with the Portuguese market.

Going forward, we expect the communications landscape in Portugal to change as a result of the recently announced merger between Zon and Optimus. \textit{We are strong believers that a merger will benefit both companies}, since not only there are significant cost synergies, there is also a clear strategic fit. Optimus has been the 3\textsuperscript{rd} player in mobile for a long time and the triple play market is mostly a duopoly now. Zon does not have a mobile unit and with data becoming increasingly mobile, it will naturally lag behind PT in the future. In addition, a merger between Zon and Sonaecom would create a robust integrated player with the ability to pose a clear threat to PT’s dominance. Though in mobile, the market shares would be relatively unaffected, – with TMN and Vodafone making up close to 85% of the market – in wireline we expect things to become more levelled. Furthermore, a larger company would have more financial muscle to compete with PT in an increasingly regulated and capital intensive sector.

\textit{Sonaecom Valuation – Impact post M&A announcement}

\textbf{Talks of a potential merger between Sonaecom and Zon have been around for over 5 years}, with analysts consistently saying a deal would make sense. One of the main obstacles had always been the shareholder structure of Zon, which had common shareholders with PT – the main competitor of a potential entity created as a result of the merger – and other shareholders aiming to obtain control of Zon. Another considerable obstacle had to do with the shareholder statuses, which required that no single shareholder could have more than 10% of voting rights in Zon. Finally, Prime-Minister José Socrate’s cabinet at the time, did not seem favourable towards a merger, a position which received large criticism from Belmiro de Azevedo, main shareholder of the Sonae holding.

\textsuperscript{27} Average Revenue Per User
\textsuperscript{28} Mobile Termination Rates
However, most of these obstacles fell over by 2012: Portugal had a new Prime-
Minister since 2011; there was a change in the shareholder statuses which
allowed single shareholders to have over 10% voting rights in Zon; and Angolan
businesswoman Isabel dos Santos reinforced her position in the company,
becoming the major shareholder after buying CGD’s 10% stake and other smaller
transactions which saw her position rise to 28.8%. The final tipping point came
from Optimus’ CEO, who stated in September 2012 that a merger between Zon
and Sonaecom would make sense, not because of a change in merits of a
potential merger, but mostly because of the shareholder situation of Zon.
Following this statement, merger news intensified in the press and culminated in
a joint public announcement by Isabel dos Santos’ holding companies and
Sonaecom affirming negotiations had started for the incorporation of Optimus
in Zon with a base valuation of Zon corresponding to 150% of Optimus,
leaving Media and SSI out of the merger.

With a merger scenario becoming very much certain, we deemed it necessary to
calculate the valuation impact of this deal relative to Sonae – by valuing
Sonaecom post-merger. Firstly, we have computed Zon’s average share price for
the 3 months preceding the announcement of the merger. By multiplying it by the
number of shares outstanding we obtain an equity value of € 758 million and an
implicit equity value of € 505 million for Optimus – which we assume to be a fair
value of both firms. The simple combination of these two firms would have a total
equity value of approximately € 1.264 million.

Under the proposed deal, the merged entity will be controlled by an
investment vehicle (ZOPT) which will have a 50.1% stake in this company,
and will be owned in equal parts by Isabel dos Santos and Optimus. Since Isabel
dos Santos’ current position in Zon is insufficient to obtain parity in this
investment vehicle, we estimate the businesswoman to acquire a portion of
Optimus\(^{29}\) in order to obtain the referred parity – leaving Sonaecom with a direct
position of 7.2% in the new merged entity. In addition to ZOPT and Sonaecom,
other shareholders will own 42.7% of the new Zon + Optimus. Finally analyst’s
consensus estimate synergies resulting from the merger to be around € 385
million\(^{30}\) and we assume these to be equally attributable to the shareholders of
the new company. This allows us to obtain an equity value for Sonaecom of €
679 million, to which we apply a holding discount of 10%, as Sonaecom will now
become a conglomerate with the Media and SSI units, as well as a minority stake
in a telecommunications company. This attributes € 325 million to Sonae as a
result of its 53.17% stake in Sonaecom.

\(^{29}\) We estimate this acquisition to be close to €98 million, representing a cash inflow to Sonaecom.

\(^{30}\) Average figure of 7 research reports post-merger announcement.
Nonetheless, since the deal talks are still at an early stage we should point out a number of risks/challenges that both companies will have to overcome for the merger to succeed: (1) there needs to be a clarification of BES, France Telecom and other major shareholders’ positions regarding the merger; (2) a request needs to be submitted for an exemption of the duty of a public takeover bid to the Securities Market Commission; (3) the firms need authorization from the competition authority to be able to merge; (4) and finally there is potential (although small) for a hostile takeover bid of Vodafone for Zon, as its position in the Portuguese market will become much weakened after the merger.

Investment Management

The Investment Management portfolio currently includes two companies: Maxmat, operating in DIY retail and MDS, operating in the insurance brokerage sector. GeoStar, the travel agency company, was deconsolidated at the beginning of the year along with Sonae Sierra, being now accounted under the equity method.

Due to the relative lack of information regarding this business unit, for valuation purposes, we have taken Sonae’s 3Q12 reported numbers for its book value of equity, which is computed by deducting the net debt to the invested capital, reaching a **BV of equity** of €32 million.

**Sonae SGPS Valuation**

**Scenario Analysis**

In order to capture the risk of different outcomes to the investment, we have built **three different scenarios** – a worse case, base case and best case – in which we change several value driver inputs to estimate the cash flows under those conditions. The final equity value represents the expected value of the probability weighted average of the cash flows under each of the three scenarios.

In the **worst case scenario (1)**, we assume a lengthier recovery of the economy; delayed and lower number of store openings; and lower margins and sales/m² – we give this scenario a 25% probability, since Sonae’s main geographic markets are still in recession, and there is large uncertainty regarding expected economic recovery. In the other extreme, in the **best case scenario (3)**, we assume a faster than expected macroeconomic recovery, with more store openings: higher

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31 BES has a 10.86% stake in Zon and France Telecom has a 20% stake in Sonaeem.
32 If the exemption is not granted, the deal would turn into an acquisition and would likely become more expensive to complete. We believe in this case, the negotiations would fall through.
margins and a higher growth of sales/m² – we give this scenario a lower probability of 5%, since we deem it very unlikely, as recent forecasts point to more Eurozone countries being likely to be troubled in the future which could cause collateral damage to Portugal and Spain and impact negatively consumers’ discretionary income. The base case scenario (2), has a 70% probability, and represents our most likely view of the market, and the basis for the report. A summary of the main performance indicators under each scenario can be examined in the chart below:

Exhibit 61: Turnover € millions and EBITDA margin % under each scenario

Source: Analyst’s estimates

Valuation Summary

The table below represents our Sum-of-the-parts valuation summary for Sonae SGPS at 2013 year-end. We compute the value of equity as a weighted average of the three scenarios, taking into account Sonae’s stake in each unit and by deducting the 2012E net holding debt.

We have applied a 10% discount to the fair equity value, mainly because we still consider Sonae to be a holding company, despite its increasingly strong retail focus. Since the merger in the telecom unit is not with Sonaecom, but solely with Optimus, Sonae won’t have a direct minority position in the new merged entity, and will still hold a majority stake in Sonaecom. Thus, we believe the value of equity should be lower than the pure sum of the parts, since the holding has costs of managing the entire group and investors have the ability to hold a well-diversified portfolio at lower costs.

We value Sonae’s shares at € 0.99, and reinforce our buy recommendation. The stock has built good momentum since sovereign yields have started to decline, as a sign that the market now believes there is a lower probability of default by the country, which translates into an appreciation of the stock price

33 Cruchant (2008) estimates fair discounts applied to European Conglomerates between 2002-2007 were on average close to 10%.
due to an improvement of the expected future cash flows. In addition to this, the capital gains are also attributed in part to the merger speculation which intensified from July-12 onwards, as a result of businesswoman Isabel dos Santos’ capital reinforcement in Zon. Even so, from ours prospects, the stock is still being penalized and we believe there is some value to be captured.

Debt

Sonae has recently refinanced its debt maturing in 2012-13 and part of 2014 in a year that saw debt markets re-open for many PSI-20 companies. These operations have allowed Sonae to increase the average maturity of its debt and secure its commitments for the short and mid-term, with the bulk of refinancing needs carried forward to 2015.

Sonae’s position regarding debt is a very clear one: it intends to de-leverage and has been doing so for the past 12 consecutive quarters, cutting debt on average by €150m per year, since 2009 – this has been possible through a strong cash generation, decrease in CapEx and proceeds from S&LB transactions.

Sonae appears to be more leveraged compared to its retail peers and the reason for this has to do with the company’s higher than average freehold rates. Sonae owns most of its retail real estate assets which are usually backed up with debt, thus giving a more indebted view of the company.

Net debt is expected to be €1.9bn in 2012 (€2.7bn34 in 2011) and Net debt / EBITDA is expected to reach 3.1x for 2012 (4.0x in 2011). Going forward, despite the high debt profile, we estimate net debt to continue declining, both in absolute and relative terms, as a result of the company’s policy regarding capital light investments, strong free cash flow generation for the next years mainly from the food retail unit, and possible S&LB operations.

34 This figure contains Sierra’s debt, and clearly explains the reason that led Sonae to de-consolidate it.
Entering Angola

Sonae MC recently signed an €80 million joint-venture agreement contract with Condis, an Angolan company, aimed at developing and operating a modern distribution company in that country. Under the announced agreement, Sonae will have a 49% ownership of the new company – which is an unusual move for a company that has always favoured holding majority positions – with Condis owning the remaining 51%, following in a way the capital-light business structure trend set by Sonae. The company plans to open 4 to 5 hypermarkets in an initial phase, as well as a distribution centre to support them (with the first store opening planned for 2013). Given the announced characteristics of the new company, Sonae will probably consolidate it through the Equity Method, thus preventing the Angolan business from impacting the Group’s operational figures.

This move is part of Sonae’s internationalization efforts, as a way to grow outside of a mature domestic market with increasingly low growth prospects. In fact, we have witnessed this trend from its major food retail competitor – Jerónimo Martins – which already has an established business in Poland and recently announced plans to enter in Colombia. Emerging markets represent a good source of top-line growth, and Angola seems to be a very interesting market due to some distinctive characteristics: it is the 6th largest economy in Africa, with an expected GDP CAGR of 5.6% between 2012 and 2017 and also a high population growth rate. It shares the same language as Portugal and it is largely under-retailed in terms of supermarkets and hypermarkets35, thus making it an attractive region for Sonae’s food concepts.

In our previous valuation of Sonae MC, we have not incorporated the impact of the Angola entry, as the situation is still surrounded with uncertainty, despite Sonae reaffirming that it is reaching the last stages of the negotiation and about to start operations. Nonetheless, we have computed an estimated impact to Sonae’s share price, in case things go ahead. In this exercise, we compute a standalone DCF valuation of this business, assuming the opening of 5 Continente hypermarkets in two stages – two in 2014 and three additional in 201536. We assume sales per m² to start at a low level and pick up in the following years, while store sizes to be the same as the average Continente format in Portugal. We expect an initial equity commitment of 30%, with the

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35 According to Sonae’s press release in April-11, modern organized retail in Angola accounted for less than 10% of all food retail.
36 We take a more cautious view and only forecast the first opening to happen in 2014, instead of 2013 as announced by Sonae.
remainder being locally financed through debt. Finally, we perform the valuation in Euros, discounting the cash flows with a consistent equity premium. By performing a sensitivity analysis to the growth and discount rates used in the DCF Valuation model, we obtain an Enterprise Value range between €88M and €300M. The reason for such a wide range in the EV has to do with the weight of the terminal value in the EV: the initial forecasted cash flows are mostly negative, which increase the sensitivity of the EV to these two variables.

By deducting the net debt and taking Sonae’s stake of the equity value, this translates into an upside to Sonae’s share price between €0.01 and €0.06. As we can see, the impact is not a very large one yet. However, we should not forget this valuation was only performed assuming the opening of 5 hypermarkets, and we would expect a gradual expansion, if things work out.

Final Remarks

Sonae is suffering the consequences of being a Portuguese company operating mainly in Portugal. Besides the Sonae Sierra business, which has been expanding internationally for some years, Sonae’s business areas are mostly dependent on Portugal and Spain, and both economies have been and will be undergoing some severe structural changes. Nevertheless, Sonae’s operations, know-how and focus make it relatively resilient in weathering the difficult macro environment. The task of estimating future performances in the current environment is severely conditioned by uncertainty, leading us to be conservative in our estimates of future growth as we have been in Sonae’s case. But even using conservative assumptions the stock seems to be significantly undervalued, thus we are expecting a steady correction along with the depreciation of Portuguese long-term sovereign yields, as well as gradual improvement of general macro conditions.

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37 Cash flows estimated in euros and local inflation rate is incorporated in the growth rate. Cash flows are then discounted using a WACC which incorporates local tax rate, country risk premium, and cost of debt through Angolan sovereign rating. – *Volatility Rules: Valuing Emerging Market Companies* – Prof. Aswath Damodaran.
### Financial Statements

#### Income Statement

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#### Balance Sheet

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#### Cash Flow Statement

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2011 RST – Refers to Company Restated data following the consolidation of Sonae Sierra and GeoStar under the Equity Method as of Jan-12
Disclosures and Disclaimer

Research Recommendations

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