

BPI

BANKING SECTOR

STUDENT: MADALENA TELO
GONÇALVES

COMPANY REPORT

03 JUNE 2013

Capital Reinforcement

Extraordinary Times Call for Extraordinary Measures

- We value BPI's shares at 1.20 €, which gives us an upside of 16% from their current value. Hence, **our recommendation is to buy.**
- In the following years we expect a **decrease on BPI's total assets** (-3.5% YoY in 2013 and -2.1% YoY in 2014), since the bank will have to sell some of its non-core assets to accomplish the CoCos schedule payment.
- BPI repaid in the 1Q 2013, 200 million euro of CoCos (of the 1.5 billion euro subscribed by the Portuguese State in June 2012, under the recapitalization plan). We expect that **until the end of the year, the bank will be able to repay more 175 million of euro.**
- BPI already announced that it will **close more 47 branches until the end of the 1H 2013.** We expect a **decrease of 50% YoY on the operating expense** in the end of 2013. The cost-to-income is expected to rise 2 bps from 2012 to 2013, since we expect a decrease of 3% YoY of the operating income from banking activity – in 2012 this income was mostly driven by gains from its sovereign exposure.
- BFA will continue to be crucial for BPI's good performance, in terms of liquidity and solvency, as well growth perspectives.

Company description

BPI is one of the largest private banks in Portugal. The bank offers services in Investment Banking, Financial Investment, Private Equity, Domestic Commercial Banking, and International Commercial Banking in Angola and Mozambique. It has a market share in Portugal of closely to 10% of deposits, 9% loans, and above of 16% in asset management.

Recommendation: BUY

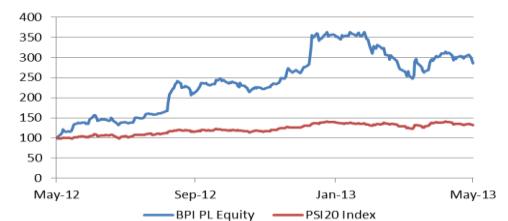
Price Target FY11: 1.20 €

Price (as of 31-May-2013) 1.03 €

Reuters: BBPI.LS, Bloomberg: BPI PL

52-week range (€)	0.37-1.38
Market Cap (€mn)	1,433.1
Outstanding Shares (mn)	1,390
YtD Change (%)	9.33%

Source: Bloomberg



Source: Bloomberg

(Values in € millions)	2011	2012	2013E
NII	543	549	517
Operating Expenses	131	20	10
Net Income before tax	(356)	400	275
Net Income	(285)	249	179
EPS	(0.29)	0.18	0.13
ROA	0.6%	0.4%	0.4%
ROE	(35%)	12%	9%
Cost-to-Income	67%	48%	50%
Loans-to-Deposits	114%	102%	98%
RWA	25,152	24,512	24,292
CT1 ratio	9.2%	15.0%	14.4%

Source: Company data, NOVA Equity Research

THIS REPORT WAS PREPARED BY "STUDENT'S NAME", A MASTERS IN FINANCE STUDENT OF THE NOVA SCHOOL OF BUSINESS AND ECONOMICS, EXCLUSIVELY FOR ACADEMIC PURPOSES. THIS REPORT WAS SUPERVISED BY ROSÁRIO ANDRÉ WHO REVIEWED THE VALUATION METHODOLOGY AND THE FINANCIAL MODEL. (SEE DISCLOSURES AND DISCLAIMERS AT END OF DOCUMENT)

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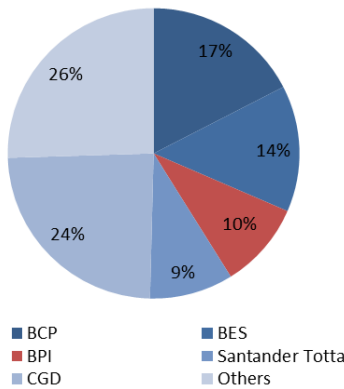
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Fig. 1 – Market Cap and Total Assets

	Market Cap	Total Assets
BPI	1.433	43.129
BES	3.066	84.946
BCP	2.109	89.474

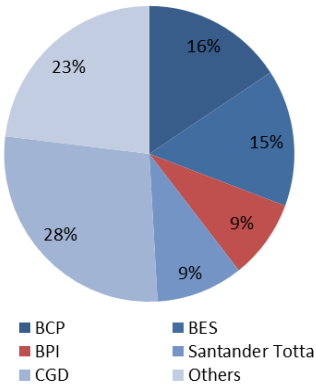
As of 31st May 2013 in million of euro
 Source: Bloomberg, companies' data

Fig. 2 – Loans Market Share in Portugal



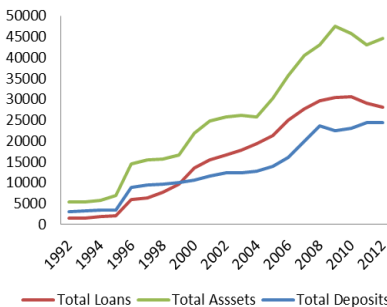
Source: APB

Fig. 3 – Deposits Market Share in Portugal



Source: APB

Fig. 4 – BPI – total loans, total deposits and total assets



Source: Bloomberg, company data, NOVA Equity Research

Company overview

BPI is the 4th major financial group in Portugal, and market leader in Angola. With a market cap of 1.433,1 million of euro¹ it has in Portugal a market share of close to 10% of loans, 9% of deposits, and above to 16% in asset management. In Angola, BFA has a market share of 9,7% in loans, 16% in deposits and 17% in branches, as of February 2013.

According to data of March 2013, BPI Group has total assets closely to 43 billion of euro, 1.7 million customers in Portugal and 1,1 million in Angola, which allows it to be placed it in the 4th and 2nd country positions respectively, ranked by market share.

History

The bank was founded in 1985 substituting a Portuguese Investment Society created originally in 1981 – *Sociedade Portuguesa de Investimento* (SPI). In 1986 BPI opened its capital to the public, listing its shares on the Lisbon and Oporto Stock Exchanges. In 1991, the bank started to direct its business for the commercial banking segment by the acquisition of the Fonsecas & Burnay Bank. In 1995, the bank was converted in a SGPS (holding company) becoming then, the first Portuguese financial group to be listed in the stock exchange.

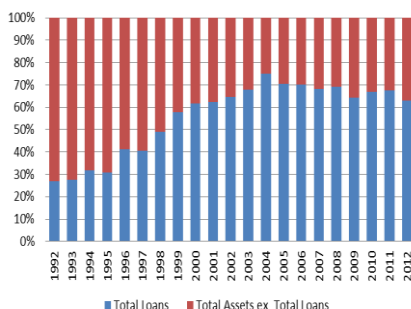
At the beginning, as SPI, its main activity was to finance investment projects from private companies. Only in 1985, when it converted into a bank it became able to collect deposits and grant loans. Even so, until 1991, BPI was mainly an investment bank.

Since the bank became a SGPS, it decided to orient its business more to the commercial area. From 1992 until now, the bank increase its loans from 1.5 billion euro in year end 1992 to 28.1 billion euro in year-end 2012, and it increased its deposits from 3.1 billion in year end 1992 to 24.4 billion euro in year-end 2012 (Figure 4). As a consequence of the growth of the commercial business, the total loans have gained weight in the bank's total assets. While at the end of 1992, the total loans accounted only 27% of the total assets, since 2000 the total loans represent more than 60% of the total assets in the balance sheet (Figure 5).

In the year end of 2012, the income from commercial banking was responsible for close to 60% of the total operating income from banking activity of the group.

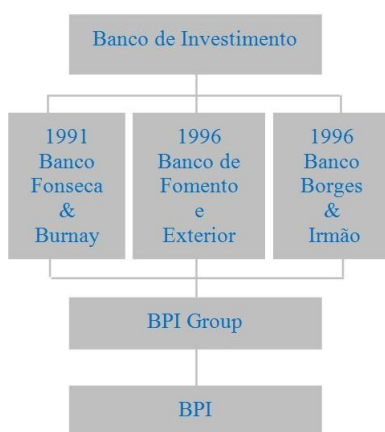
¹ As of 31st May, 2013

Fig. 5 – BPI – total loans % total assets



Source: Bloomberg, company data, NOVA Equity Research

Fig. 6 – BPI’s acquisitions



Source: Company data

In which refers to the activity in Portugal, the loans portfolio of the bank is highly composed by mortgages loans (44% in 2012). BPI in Portugal is recognized as a strong player on home loans bank.

In general, the services offered by the bank are Investment Banking, Financial Investments, Private Equity, Asset Management, Insurances, Domestic Commercial Banking and International Commercial Banking.

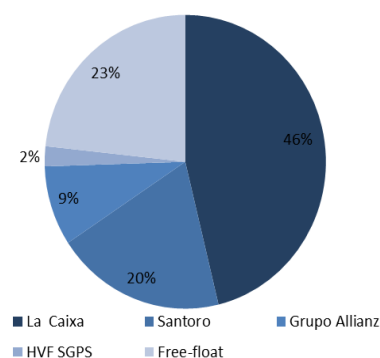
International Presence

Already in the beginning of the bank as a holding company, the group started to extend its activity abroad. Today, the most relevant sources of income in the international activity are the stake of 50,1% on the equity capital of *Banco Fomento de Angola* (BFA), in Angola, and the 30% interest held in *Banco Comercial e de Investimento* (BCI), in Mozambique. Taking into account the macroeconomic context and banking system in Portugal and the perspectives of growth and development in Angola, we strongly believe that BFA has a crucial role in the survival and growth of the group in the future. BFA is a commercial bank mainly focused in corporate banking, and it is inserted in an emerging market where the banking activity still has potential to increase a lot its profitability.

BPI was originally an investment bank, all the commercial activity was acquired (both national and international) (Figure 6). Thus, despite nowadays its main activity to be the commercial business, it still has a strong position in the Portuguese market in which respects the assets management – 16% market share.

Shareholder structure

Fig. 7 – BPI’s Shareholder Structure



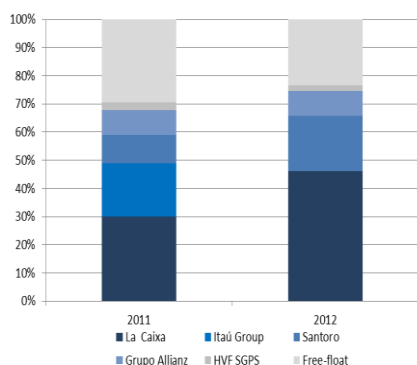
Source: Company data

Even with some fluctuations in 2012, we define the BPI Shareholder Structure as strong and cohesive, which is a positive variable when valuing the bank, since means stability and solidity. Today, the core shareholders holding BPI’s share capital are La Caixa (46.2%), Santoro (19.5%), Grupo Allianz (8.8%) and HVF SGPS (2.2%), (Figure 7). The bank has a share capital of 1,190 million euro made up by 1,390 million shares listed on the Euronext market.

In 2012 we assisted to some changes on the BPI’s shareholders structure (Figure 8):

- In April 2012, the Brazilian bank Itlaú - one of the oldest shareholders of BPI – sold its participation in the group. This resulted in a less dissolved

Fig. 8 – BPI's Shareholder Structure in 2011 and in 2012



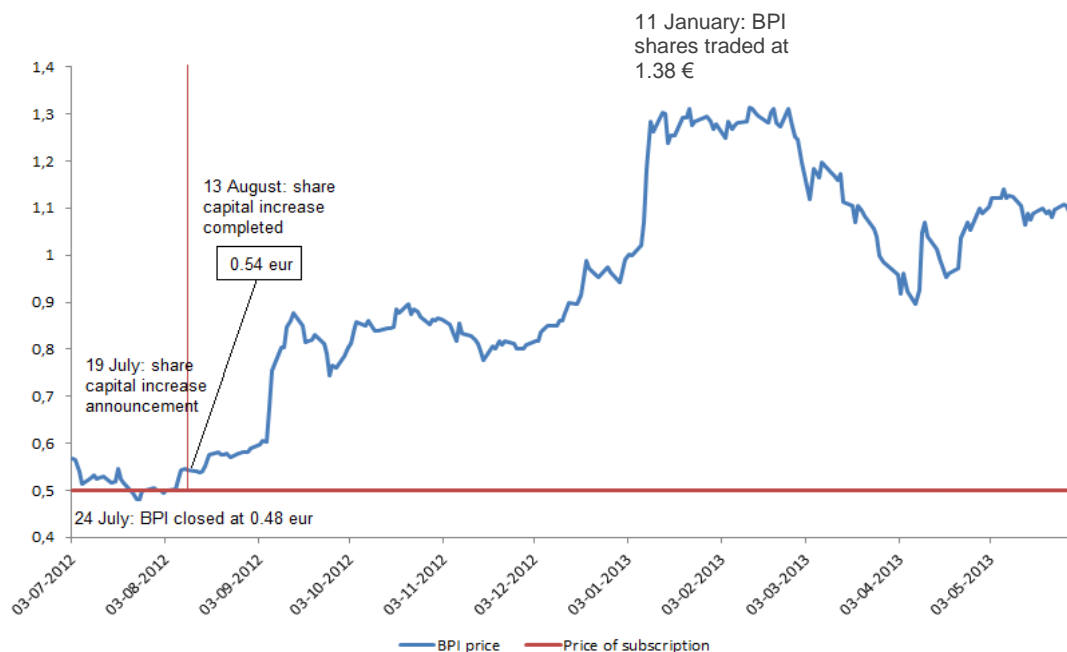
Source: Company data

shareholders structure but even so protected by CMVM (Securities Market Commission) for any control by La Caixa.

- In August 2012, BPI issued 400 million shares with a nominal value of 50 cents, entirely subscribed by BPI's shareholders. BPI's share capital increased from 990 million euro to 1.190 million euro, which resulted in an increase from 990 million to 1.390 million shares outstanding.

Since the recapitalization plan in August 2012, the market price of BPI shares has been always above the 50 cents (price of subscription), meaning it has been rewarding for the shareholders who subscribed the share capital increase. After the announcement of the increase of its share capital (19th July), BPI shares were traded below 50 cents in the secondary market. This determined which shareholders have subscribed the shares issuance – strong shareholders against the smaller ones. La caixa, Isabel dos Santos through Santoro, and Allianz subscribed more than 90% of the share capital increase. Nevertheless, the 400 million new shares were entirely subscribed and, in the beginning of this year, BPI shares traded at a high of 1.38 euro which means 176% return for those who subscribed by 50 cents in the share capital increase (Figure 9).

Fig. 9 – BPI's share price following the share capital increase



Source: Bloomberg, company data, NOVA Equity Research

Therefore, there are only four big shareholders who have more than 2% of its share capital. The three bigger shareholders - La Caixa, Santoro and Allianz - have 74.5% of BPI's share capital. Historically, La Caixa and Allianz are key shareholders since 1995, while Isabel dos Santos became a significant

BPI's shareholder structure is strong and cohesive – 3 shareholders have 75% of the share capital

shareholder in 2008, through Santoro. Close to three quarters of the share capital of the bank is controlled by only three big shareholders, and two of them are in the bank since the beginning. We then do not expect any significant changes in the strategy of the bank that could lead to instability and could compromise the confidence of the smaller investors.

Geographically known, Spain has 58.50%, Portugal 26.41%, Germany 10.98%, and the US 0.60%. In terms of ownership type, 85.35% belongs to investment advisors, 10.99% insurance companies, 1.01% holding companies, 0.86% to individuals and 0.67% to mutual funds.

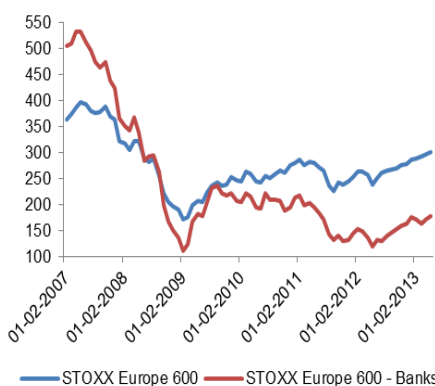
Macroeconomic Context

A few years ago, the sub-prime crisis was a turning point in the banking system. The financial markets were strongly blamed by the crisis and consequently emerged the need to better regulate the banking sector through the requirement of higher capital ratios and a tighter control in the assets quality of each bank. Naturally, these measures have having a great impact on the banks' profitability and activity.

For many years, a low equity-to debt ratio was not a concern factor, actually it was seen as a sign that the bank, or any other company in another industry, was being more productive. High amounts of equity were seen as money tied up in assets. Also, illiquid assets with high levels of risk associated, are expected to give the bank higher margins, so banks with high liquidity ratios was a sign that they were in some way compromising their profitability. The sustainability of that approach went down when toxic assets started to come out. The risk of default of one security would infect all the system, and banks did not have reserves to cover their losses.

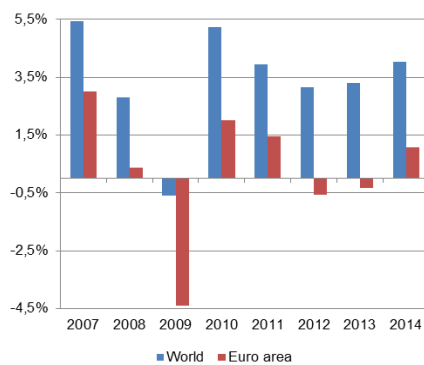
The economy in general started a deleveraging process which has been transversal to all economy, including banks, companies, individuals and government states. That has had a huge impact in the banking sector as well in the stock markets, and all over the developed countries we have seen the deterioration of the macroeconomic indicators. As illustrative of the deleveraged process and dropped in the stock market, the Total Debt to Total Equity and the Total Debt to Total Assets of the STOXX Europe 600² have decreased from 356.09% in 2007 to 226.59% this year and from 34.13% in 2007 to 26.38% this year respectively. Also, Total Debt to Total Equity and the Total Debt to Total

Fig. 10 – STOXX Europe 600 and STOXX Europe 600 Banks



Source: Bloomberg

Fig. 11 – GDP % change – World and Euro area



Source: IMF

² Index composed by 600 large, mid and small capitalisation companies across 18 European companies.

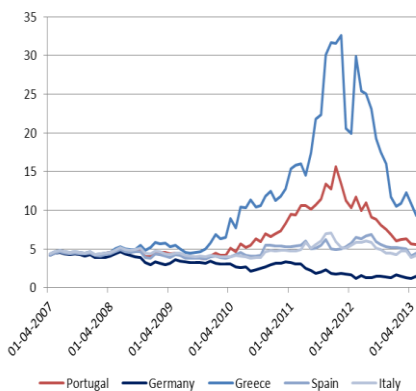
Assets of Euro STOXX Banks Index have decreased from 1,204.94% in 2007 to 753.78% and from 45.64% in 2007 to 37.49% this year respectively.

Especially the banking activity, it is greatly dependent on investors' confidence, all of bank's activity is built on confidence. Pre-crisis, investors used to believe that since big banks were supporting the entire economy, they always be protected by the governments. In fact, the successful development of an economy is greatly dependent on the banking system as source of credit. In 2008, the Lehman Brothers bankruptcy uncovered the vulnerability of the high leverage ratios and high risk exposures of banks.

In Europe, the global macroeconomic deterioration put in evidence the unsustainability of rising government deficits and debt levels across some European countries. The concerns among investors and the risk-aversion context created huge spreads between the peripheral government bonds yields and core government yields (Figure 12). These high spreads created an uncertainty environment around the preservation of the single currency. It emerged a serious crisis of confidence all over Europe, which intensified the downtrend of the stock market and put in risk the capability of some European economies get funds in the debt market.

The ECB has intervened in a way to guarantee funds to the distressed economies and at the same time preserve the harmony between its member-states. We can see some confidence back to the European Union since the end of 2012 through the decreasing of the spread between peripheral and core government bonds yields and through the recovery of the stock market.

Fig. 12 – 10-year Government Bonds yields



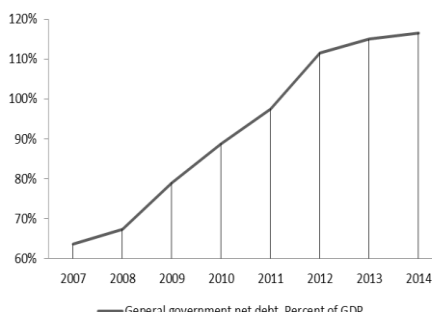
Source: Bloomberg

Portuguese Context

BPI is headquartered in Portugal, and in spite of the activity in Angola has a growing role in the profits of the BPI group, the bank is still very dependent on the Portuguese macroeconomic conditions. In Portugal, the sovereign debt crisis has having a tremendous impact on the country's economic evolution and especially in the banking industry. Portugal is now facing several adjustments through painful austerity measures headed for budget consolidation. Considering the role of the banking system in the Portuguese economy, it becomes vital to reinforce its capability to face the current global adverse conditions by increasing the bank's capital ratios. Also in order to anticipate the new capital standards required by the Basel III, that will be introduced from 2013 until 2018.

Looking for the evolution of the debt levels in Portugal we see that in the year end of 2012 the general government debt accounted 112%³ of the GDP, and it is

Fig. 13 – Portuguese general government debt in % of GDP



Source: IMF

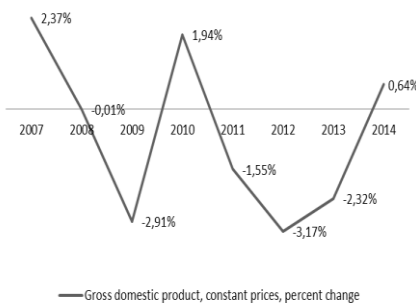
³ According to International Monetary Fund, World Economic Outlook Database, April 2013

Fig. 14 – BPI and Portuguese Republic evolution

		BPI	Portuguese Republic
June 2007	Moody's	A1	Aa2
	Fitch	A+	AA
	S&P	A	AA-
Dec 2010	Moody's	A2	A1
	Fitch	A-	A+
	S&P	A-	A-
Apr 2011	Moody's	Baa2	Baa1
	Fitch	BBB-	BBB-
	S&P	BBB-	BBB-
March 2012	Moody's	Ba3	Ba3
	Fitch	BB+	BB+
	S&P	BB-	BB

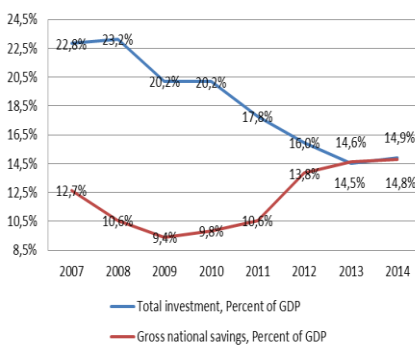
Source: Bloomberg and company data

Fig. 15 – Portuguese GDP, constant price, % change



Source: IMF

Fig. 16 – Portuguese total investment and gross national savings, in % of GDP



Source: IMF

expected that this percentage continue to increase in the next years (Figure 13). When a few years ago, the global economy started to collapse, the high level of debt of Portugal became a concern factor for the investors. The uncertainty around its public finances moved away foreign investors, and the yields on public debt rallied for levels that put the country closed to bankruptcy. Rating agencies downgraded the Portuguese Republic, and the uncertainty around the country increased a lot the funding costs. Ultimately Portugal has needed an external rescue combined with a readjustment program. In May of 2011, Portugal signed an agreement with the Troika (European Commission, European Central Bank and the International Monetary Fund), where Portugal received a bailout of 78 billion of euro and compromised to apply a package of austerity measures in order to increase the investors' confidence and be able to obtain funds in the market debt again.

In March 2013, the Eurozone ministries of finance decided to give seven years extension for Portugal repay their loans. It allows Portuguese republic to extend the maturities on their public debt and recover the credit rating of Portuguese Republic. However the international credit rating agencies maintain their outlook negative for Portugal and also for BPI.

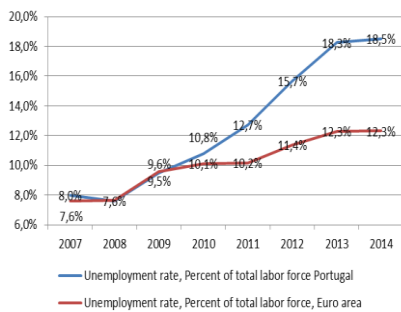
Long Term Rating	Moody's	Standard & Poor's	Fitch
BPI	Ba3	BB-	BB+
BES	Ba3	BB-	na
BCP	B1	B+	BB+
Portuguese Republic	Baa3	BB-	BB+

Source: Bloomberg and company data

The downgrade of Portuguese Republic has a great impact on the rating of BPI, and we assume that the bank can only recover its credit rating when the Portuguese republic recovers it.

The austerity measures that are being implemented right now are unsurprisingly compromising the economic growth (Figure 15). According to the International Monetary Fund (IMF), World Economic Outlook Database of April 2013, it is expected an economic deceleration in Portugal of 2.3% YoY for 2013 and a YoY growth of 0.6% in 2014. The unemployment rate is expected to continue to rise (Figure 17), while the consumption and public investments should continue their downtrends. In 2012, the Portuguese GDP decreased 3.2% YoY, the household consumption fell 5.3% YoY, and it was registered an unemployment rate of 15.7% in the year-end of 2012. Also the investment has been decreasing, not only the national investment as also the foreign investment. The total investment in Portugal, in percentage of GDP went from 18% in 2011 to 16% in 2012. It is

Fig. 17 – Unemployment rate in Portugal and in the Euro area

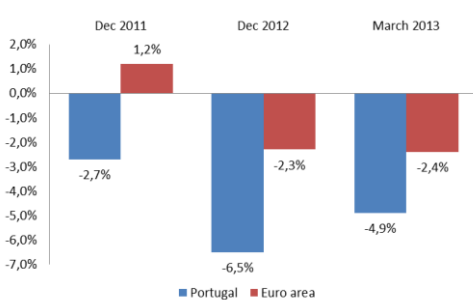


Source: IMF

expected to decrease to 15% in 2012. The European economic deceleration reduces the investments made all over Europe. Also, the uncertainty around the country makes other economies more attractive for investment. This economic contraction increases the probability of default of companies and individuals, since reduces the income disposable to accomplish their obligations. Consequently the non-performing loans and insolvencies increase and banks have then to increase the amount of provisions in their balance sheets in order to cover the losses of loans in default. At the same time, as we already mentioned, the ideal debt-to-equity ratio of companies in all industries is not the same as it was in a few years ago. Now, with the current economic environment of uncertainty, companies try to decrease the risk of their companies, increasing the proportion of capital which finances their assets. Firstly, banks are more concern about their assets quality and then are requiring high warrants before grant a loan, secondly companies are deleveraging their balance sheets and then they are not asking as much credit as before. As result, the banks' revenues decrease and the funds for new lends are also reduced.

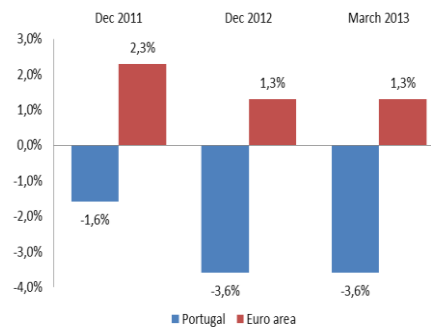
In the first quarter of 2013, the credit downtrend continued in place: consumption loans decreased in March 9.4% YoY, the housing loans fell 3.6% YoY, and the loans to non-financial corporations fell 4.9% YoY. The household deposits also decreased 0.3% YoY, and the deposits of non-financial corporations dropped 15.1% YoY.

Fig. 18 – Non-financial corporations loans YoY% growth



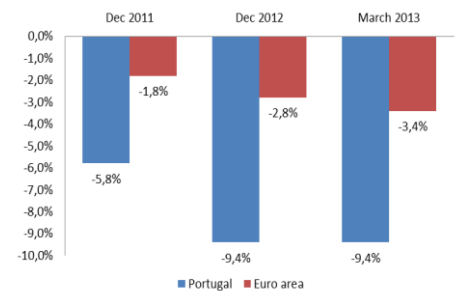
Source: Bank of Portugal

Fig. 19 – Housing loans YoY% growth



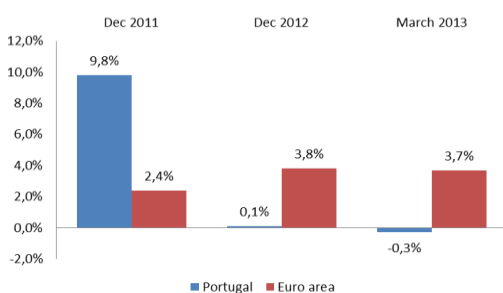
Source: Bank of Portugal

Fig. 20 – Consumer loans YoY% growth



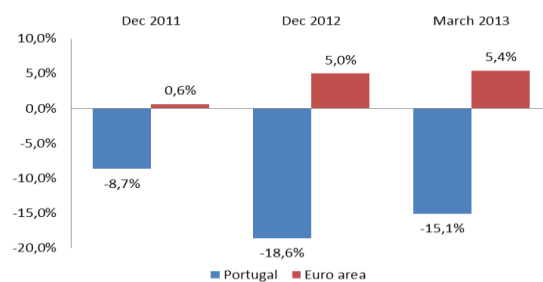
Source: Bank of Portugal

Fig. 21 – Deposits of non-financial corporation YoY% growth



Source: Bank of Portugal

Fig. 22 – Deposits of households YoY% growth



Source: Bank of Portugal

The Portuguese bank's exposure to ECB funds decreased 1Q 2013 driven by the ability of some banks to issue senior debt

Once the funding costs in the debt market achieved unbearable levels, banks have financed their operations with low costs ECB funds.

BPI took 4 billion of the Long-Term Refinancing Operations (LTRO) issued by the ECB in the end of 2011 and beginning of 2012. These operations will be used to refinance the next 2 years, and they are being used also for carry trades purposes.

With the recovery of the European confidence crisis and the improvement of macro indicators, it is expected that the ECB intervention will reduce and then the exposure of Portuguese banks to ECB funds will decrease.

In fact, with the back of markets' confidence, this reliance is already going down. In the first quarter of the year, the Portuguese banks' exposure to ECB funds accounted 47.79 billion of euro, according to BoP. That amount corresponds to a decrease of 3.46% MoM from February. The ability of some banks to issue senior debt also contributed to the decrease of that exposure. In the future we expect this value will continue to decline, once the economy will restore and banks will be able to finance themselves.

Value Drivers

Nowadays, BPI is mainly a commercial bank, being the net interest income from loans and deposits the main source of profit. The evaluation of the loans as source of interest income, and the deposits as users of interest expense is consequently one of the most relevant aspects under study in our valuation. The real GDP growth plus the inflation expected for a country in a specific period influences the volume of loans and deposits that we should expect. In normal circumstances, the demand of loans and deposits explains the interest rate applied on them. Apart of other factors, the higher the demand of loans, the higher the ability of banks increase the interest rate charged on the, and the higher the demand on deposits, the higher the ability of banks decrease the interest rate paid on them. Naturally, the larger the spread on those interest rates, the higher is the margin and the value creation for the bank. Besides the growth of the country, the stock market trend can also indicate the demand of deposits we should expect. In periods of bearish market, investors tend to allocate their money on deposits instead of invest it in the stock market, and vice-verse on periods of bullish market. In this era, regulation is a factor with increasingly importance when value a bank: it determines the interest rates as well the amounts of capital and reserves, which determines the bank's performance.

Fig. 23 – Breakdown of domestic total assets, total liabilities and net income

Domestic Activity			
<i>million of euro</i>	2010	2011	2012
Total Assets	41.088	38.325	39.659
Commercial Banking	42.781	39.822	40.414
Investment Banking	4.258	3.217	2.576
Equity Investments	142	128	137
Total Liabilities	39.809	38.088	38.216
Commercial Banking	47.709	39.845	39.166
Investment Banking	4.184	3.125	2.492
Equity Investments	9,0	- 41.276	27
Net Income	87	- 375	163
Commercial Banking	51	- 438	153
Investment Banking	6,8	- 1,4	6,3
Equity Investments	29	65	4,6

Source: Company data, NOVA Equity Reserach

Fig. 24 – Banking Interest Rates - Loans

	Dec- 11	Dec- 12	Mar- 13
Non-financial corporations			
Portugal	6,5%	5,7%	5,7%
Euro area	3,5%	2,7%	2,6%
Housing			
Portugal	4,3%	3,4%	3,3%
Euro area	3,8%	3,2%	3,1%
Consumption			
Portugal	10,0%	9,7%	10,1%
Euro area	6,5%	6,3%	6,6%

Annualized agreed interest rates

Portugal

Loans Portfolio

BPI is a strong player in the mortgage loans market in Portugal. In the end of 2012, 44% of its customer loans in Portugal were mortgage loans (Figure 25).

We consider this proportion high and a concerning factor in which regards the sustainability of the bank. The housing loans market in Portugal continues to slide (-3.6% YoY in March 2013 – Figure 19), and the interest rate charged on them is much lower than other types of loans (Figure 24). According to the Bank of Portugal (BoP), the annualised agreed interest rates on housing loans stood at 3.31% in March 2013 in Portugal, and 3.14% in the Eurozone. Even with the decrease of Euribor to lowest historical levels, the spread on those loans is still tight since most of them are charged at variable rates.

In 2012, the average interest rate charged on BPI's mortgage loans in Portugal stood at 1.94%, and the average interest rate charged on the portfolio of all customer loans in Portugal stood at 2.99% (Figure 26).

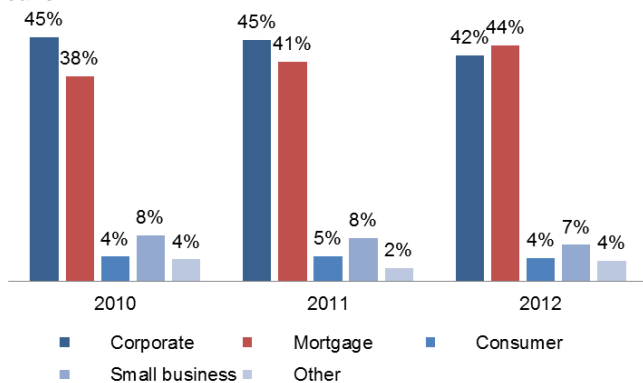
We believe that in the next years the bank will tend to diversify its loans portfolio getting higher portions of other types of loans where it can obtain higher interest margins. In terms of risk management, the bank should opt to diversify its portfolio by geographical area, sector, segment, counterparty, currency and maturity. Looking for the past, one of the errors that originated the subprime crisis was exactly the concentration of risk by some banks. The big financial institutions that ignited the global crisis in 2008 were overexposures to an asset class. Nevertheless, in the short-term we do not expect great changes in the proportion of loans segmentation.

BPI is a strong player in the mortgage market in Portugal

BPI domestic activity – 44% of the customer loans in the BS were mortgage loans in 2012

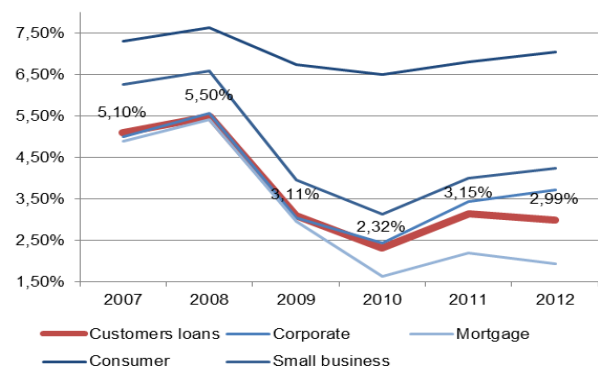
Risk factor regarding the sustainability of the bank

Fig. 25 – BPI domestic activity – breakdown customer loans



Source: company data, NOVA Equity Research

Fig. 26 – BPI domestic activity – Average interest rates on customer loans



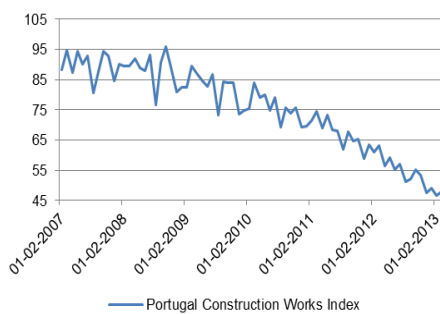
Source: company data, NOVA Equity Research

Fig. 27 – STOXX Europe 600 and STOXX Europe 600 Real Estate



Source: Bloomberg

Fig. 28 – Portugal Construction Works Index



Source: Statistics of Portugal (INE)

Extraordinary law to protect mortgage debt holders in difficult economic situation

The construction sector was one of the sectors which have suffered the most with the current conjuncture in the developed countries.

If we look through the market values returns in Europe we can see that the banking sector and Real Estate were the sectors with a higher decrease in their total returns since before the crisis, in Europe. In the Euro Stoxx 600, the total returns in the Banking sector since 2007 fell around 66%, in the Real Estate sector they declined around 49%, while in the Euro Stoxx 600 as a whole they fell 19% (as of 31st May, 2013).

Also in Portugal, the construction sector was one of the sectors more affected by the crisis. According to INE (Statistics of Portugal), the average price per square meter of private residential property and the number of residential buildings have been decreasing along the last years, reflecting the downtrend of the sector and resulting in less demand for mortgage loans. The Construction Works Index fell 17.6% YoY in the end of 2012, and 19.2% YoY in May 2013. We believe the construction sector will continue its downtrend while the economy is stabilizing.

In terms of credit, the slowdown of the construction sector decreases the demand of credit by construction sector and also it contributes for the slowdown of the Real Estate sector, which naturally pushes down the mortgage loans market.

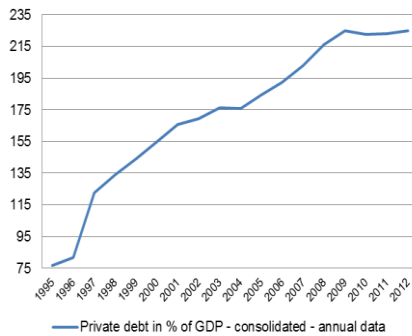
In practical terms for BPI, the impact of the mortgage loans market is the one who most affects the performance of the bank. BPI is a strong player on the housing loans markets in Portugal, while the credit for construction is not its core activity.

In the next years, we expect a mortgage loans markets more conservative than in the past. In the scenario of economical macro indicators recovery, banks will still be cautious granting mortgage loans in order to avoid impairment losses again as they are facing right now. In the short and medium-term, liquidity will be the main aspect banks will follow.

We believe that in the next years the mortgage market will continue to deteriorate, and BPI will not have the possibility to increase the margin on this kind of loans. Additionally, in December 2012, the Government restricted the bank's possibilities to increase the spreads on mortgage loans. After the revision of the regulation on mortgage loans, it was established that banks cannot increase the spread in several cases, as for example if one of the credit members got unemployed. These measures pretend to help Portuguese families who cannot pay their loans, but on the banks' side it limits even more the banks' profitability which has these loans on his portfolio.

The high proportion of corporate loans is also a concerning factor, it has a great impact on the assets quality of the bank. Following the current economic situation of the country, corporates are still in a deleverage course. At the end 2012, the private debt in percentage of GDP in Portugal was still higher than in the previous

Fig. 29 – Portuguese private debt % GDP



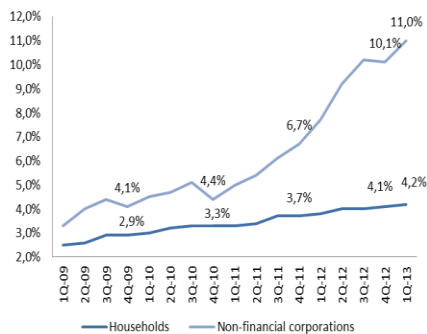
Source: Eurostat

year - 224.7% vs. 223.2% (Figure 29). Besides that, companies are still facing an increase on their financing costs (cost of debt higher than in a few years ago) and lower profitability (lower consume).

In order to get risk diversification, the bank should restructure its loans portfolio, decreasing the proportion of mortgage loans. This will result in higher interest margins. However it would need to accumulate higher provisions, since mortgage loans are usually protected with some collateral. BPI in Portugal has building an image of trust by the maintenance of a low risk profile. We expect that if occur a restructuring on its loans portfolio this will be slowly in order to maintain its low risk profile and getting advantage of the recovery of the Portuguese economic. Also this kind of loans (mortgage loans) usually has long-term maturities. So in the next years, we do not expect a great variation on loans composition proportion. Nevertheless, in perpetuity years we believe in a lower weight on mortgage loans, and higher weights on consumer and small business loans. Corporate loans we believe will take more advantage from the recovery of the macro indicators. Consequently, we consider the high amount of corporate loans a risk factor in the short-term while the high amount of mortgage loans will stuck the bank in the long-term, not allowing it to increase its NII.

Assets Quality

Fig. 30 – Portuguese NPL ratio of borrowers



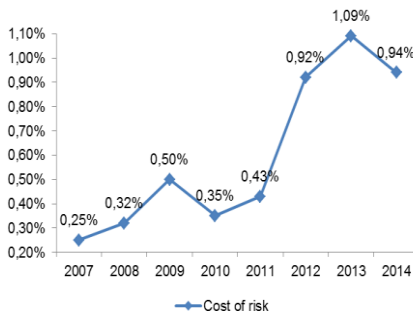
Source: Bank of Portugal

Taking into account the current macro context, one of the focus while looking for a bank, is the quality of its assets. As we already related, the deterioration of the macroeconomic indicators results in an up-trend of the Non-performing loans. Following the higher amounts of defaults, banks feel the need to increase their credit provisions which obviously has a substantial impact on the bank's profitability. It influences the availability of the banks grant new credits: higher provisions mean a reduction on funds for new lending, and at the same time new lends could mean higher need of provisions. Then it affects the criteria of granting loans and reduces the profitability of the bank. BPI great exposure to the depressed real estate sector brings uncertainty about its assets quality. In the next years the austerity measures in place in Portugal, will continue to break the economic growth, meaning that BPI will remain with high level of provisions for bad loans. This constrains bank's earnings and profits.

In the end of 2012 the NPL ratio in Portugal increased from 7.5% to 9% YoY. Regarding the segmentation of the NPL ratio, the household segment NPL ratio climbed from 4.1% in the end of 2012 to 4.2% in the end of the first quarter of 2013. The uptrend on the non-financial corporations sector is more aggressive, it went from 10.1% in the end of 2012 to 11% in March 2013 (Figure 30).

According to our estimations the NPLs will continue to rise in the next years following the expected high unemployment rate, and increase of companies insolvents. BPI's cost of risk will be 1.09% in the end 2013 (vs 0.99% in 2012 and 0.75% in 2011 - Figure 31). The major impacts on bank's operational activity:

Fig. 31 – BPI cost –of-risk

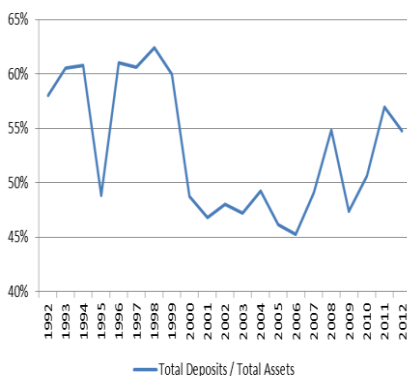


Source: Company data, NOVA Equity Research

- Necessity to retain more capital that could be invested in earning assets – lower profitability;
- Deterioration of credit rating – decrease the ability of the bank get funds – higher costs.

Despite the great correlation with the macroeconomic indicators, we believe that the restructuring of the banking system will make that banks stabilize on more conservative approaches while granting credit, and with more tied money on reserves than before the crisis.

Fig. 32 – BPI total deposits % of total assets



Source: Bloomberg, company data, NOVA Equity Research

Deposits

Portugal is going through a stabilization program. The deleveraging process will continue in place until the country gets a sustainable equilibrium, and the markets get confidence back. The current context leads to banks in general look for more liquidity, increasing their deposits and decreasing their loans. However, the BoP in order to preserve the profitability of the national banks, increased in 2012, the penalties for banks that paid interest rates on deposits higher than some limits on spreads established in accordance with maturities and amounts of deposits. This policy jointly with the ECB monetary policy, have made the deposits less attractive. In the last years the ECB had to face a difficult climate in Europe. The sovereign debt crises across several member states have weakened the European economy. In response to that, the ECB has lowered its benchmark interest rates through an expansionary monetary policy. Therefore BPI's deposits that are indexed to Euribor became less attractive. BPI faces an interesting time regarding the deposits, from one point of view it wants to increase their deposits to increase its liquidity, though there are several factors making harder to collect resources from clients: the economic deceleration that reduce the disposable income of families and then decrease their savings, and the monetary policy of ECB and conservative policy of BoP that limits the interest paid on the deposits making them less profitable for clients and consequently reduces their willingness to save money as deposits.

Fig. 33 – Banking Interest Rates - Deposits

	Dec- 11	Dec- 12	Mar- 13
Non-financial corporations			
Portugal	2,9%	1,3%	2,1%
Euro area	1,5%	1,1%	0,9%
Households			
Portugal	3,6%	2,3%	2,4%
Euro area	2,8%	2,7%	2,3%

Annualized agreed interest rates
With agreed maturity, up to 1 year

Source: Bank of Portugal

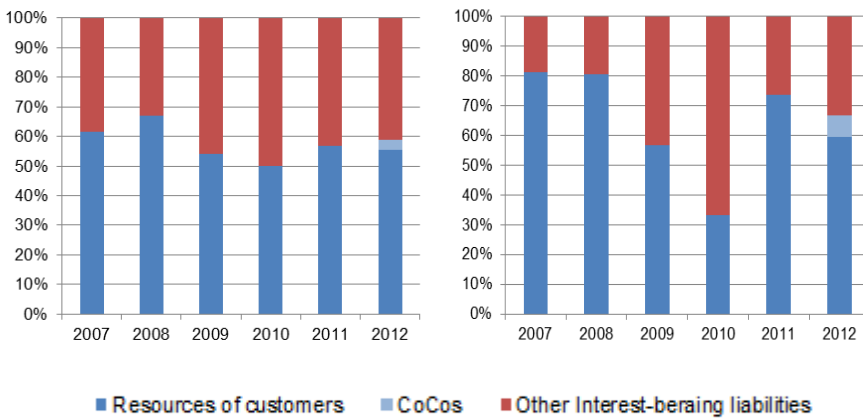
Fig. 34 – Euribor (2004 – 2013, 1st day of the year)

	3-month	6-month	12-month
2004	2,12%	2,15%	2,28%
2005	2,15%	2,21%	2,34%
2006	2,49%	2,64%	2,86%
2007	3,73%	3,86%	4,03%
2008	4,67%	4,70%	4,73%
2009	2,86%	2,95%	3,03%
2010	0,70%	1,00%	1,25%
2011	1,00%	1,22%	1,50%
2012	1,34%	1,61%	1,94%
2013	0,19%	0,32%	0,54%

Source: euribor-rates.eu

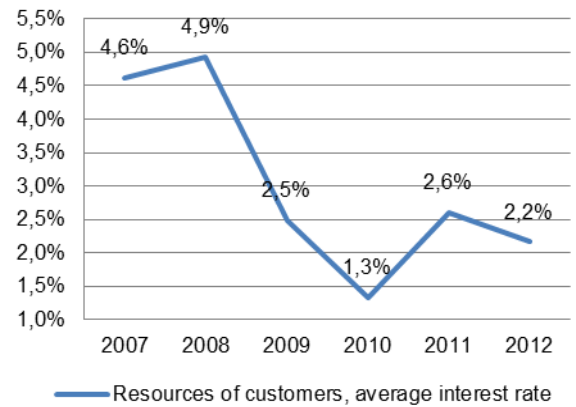
For the following years we believe that ECB and the BoP will continue with their current policies. The ECB has announced to continue its plan to buy government bonds easing the borrowing costs of the Eurozone countries. So the Euribor will remain at low levels and there will be no room to increase the interest rates paid on deposits. In that way, in the short-term it will be difficult for BPI increase their deposits. Nevertheless, with the recovery of the European economy, and assuming that Portugal will be able to honour the commitments made with Troika, the national economy will start to accelerate and the bank will be able to increase its deposits without compromising its profitability.

Fig. 35 – BPI domestic activity – Interest-bearing Liabilities and Interest expense



Source: Company data, NOVA Equity Research

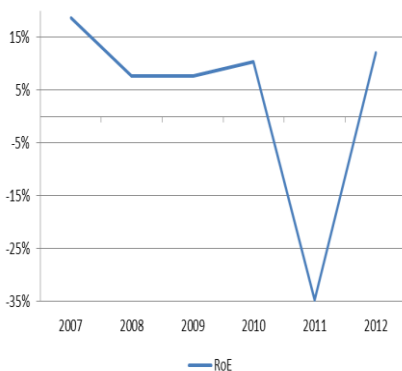
Fig. 36 – BPI domestic activity – average interest rate on resources of



Source: Company data, NOVA Equity Research

Solvency and Profitability

Fig. 37 – BPI - Return on Equity



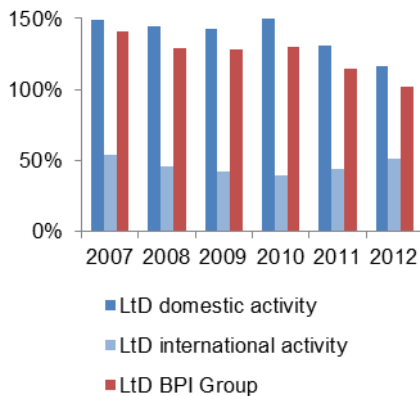
Source: Company data, NOVA Equity Research

Banks in Portugal, as well all over Europe, have reinforced their balance sheets to become more solvents. Through a decreasing on credit granted and more conservative approaches while granting new loans, as well through an increase in the deposits or the sale of non-core assets. This readjustment has a tremendous impact on the profitability of the bank. In 2011, BPI had a net income negative, for the first time in its history.

Liquidity and sustainability became more vital to a banks' balance sheet, which is naturally compromising their profitability. The inability for banks access to international funds has led to a capture of deposits in order to achieve solvency needed and still save its productivity.

As part of the deleveraging process, and the crisis of confidence in Europe, it became crucial for a bank to present good liquidity ratios. According to our calculations, at the end of 2012, BPI presented a LtD of 102% (vs. 114% in December 2011 and 141% in December 2007 – Figure 38). The Bank of Portugal

Fig. 38 – BPI Loans-to-Deposits

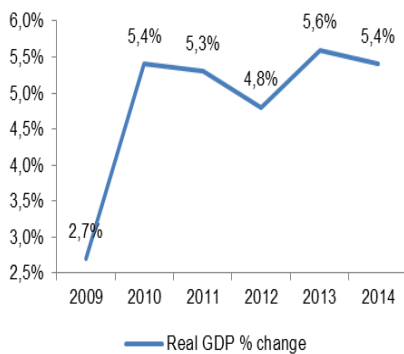


Source: Company data, NOVA Equity Research

set a maximum indicative level of 120% for Portuguese banks by 2014, under the Economic and Financial Assistance Programme. BPI has presented a comfortable ratio below the BoP target level, even so it is important to refer the importance of the international activity for the liquidity of the group. The international activity in December 2012 reported a LtD of 51% while the domestic activity reported a LtD of 116%. While the domestic activity is driving a downtrend of net credit in percentage of the deposits, the international activity is expected to increase it. In terms of efficiency, the cost-to-income decreased from 67% in 2011 to 48% in 2012. This has resulted from a decrease of 22% in personnel costs, but more important, it accounts the extraordinary profit on financial operations the bank had from its sovereign exposure. In the next years we expect a continued cost-cutting either by close of branches as also by reducing the personnel costs.

Angola

Fig. 39 – Angolan GDP % growth



Source: IMF

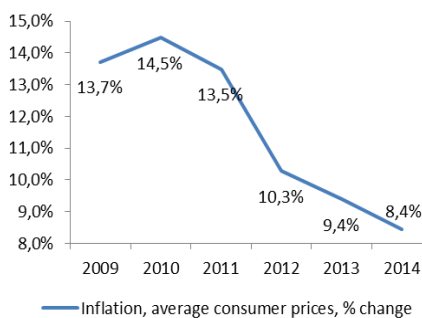
The 50.1% stake on Banco Fomento Angola (BFA) is a crucial resource of income for the Portuguese bank. The exposure to an emerging market is a key-factor for the sustainability of the bank. While developed countries are facing times of economic retraction, the emerging markets are in beginning of a long way of economic expansion.

The deterioration of European and US economies, since 2008, have had a clearly impact on the emerging markets. The main driver of Angola's economic growth is the oil exportation, which it ended to be a decisive channel for contagion all over the world. The lower demand and lower investment rate from developed countries had a negative impact on the exporter countries. Nevertheless, after the failure of the developed system, the multinationals corporates and large funds are all focus on the emerging markets as resource of growth and investment user.

According with IMF predictions, the Angolan GDP is expected to grow 5.6% in 2013 and 5.4% in 2014. This corresponds to a deceleration of the economic growth from the last years, which comes from a slowing on growth rate of oil production.

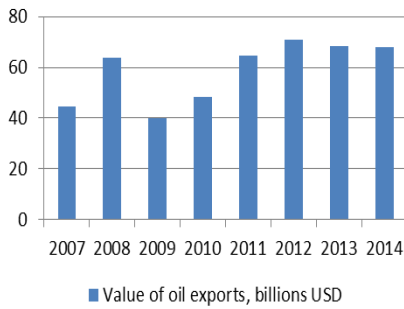
In the long-term, the oil sector is expected to continue to be a strong source of economic growth for Angola. Even with a decline of the industrial production and oil consumption on Europe and US, globally the oil demand will continue to grow. China has being the main exporter for Angola oil production, and it expects a rapid growth rate on its oil demand. Moreover, in the last years, the government has made great efforts to diversify the country's production, through public investments that are pushing up the activity in non-oil sectors. In that way, the

Fig. 40 – Inflation, % change of average consumer prices



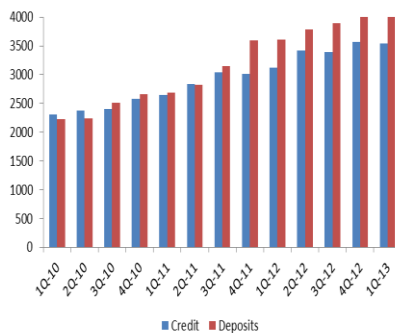
Source: IMF

Fig. 41 – Angola – value of oil exports



Source: IMF

Fig. 42 – Angola – total credit and total deposits in billions of KWZ



Source: BNA

government intends to substitute importations by national production, diversify the exportations and lastly reduces the GDP's correlation with the oil market.

Nevertheless, the expectation of economic growth in Angola is still greatly dependent of the trend of the oil sector.

Banking sector

The banking system in Angola is in a completely different stage than Portugal. The evolution of the banking activity in Angola has improved a lot in the last years, and it is expected to continue its fast growing trend as disposable income in population rise and new investments emerge. In opposition to Portugal, in Angola there is a lot of room to increase the NII from new loans and deposits: 1) middle class development, 2) bankarization, 3) higher income disposable in population, 4) comfortable solvency ratios. According to the *Banco Nacional de Angola* loans and deposits in Angola rose in the first quarter of 2013, 14% YoY and 11% YoY respectively (Figure 42).

In our valuation we expect a CAGR (2013-2019) of 6% in loans and 4% in deposits. The development of the banking industry in Angola is an opportunity for BFA increase its loans and deposits, even though, we took conservative assumptions to taking into consideration the increase of competitiveness in the market. BFA have been losing its market share in the Angolan market. The deterioration of the developed countries has turned the emerging markets more attractive. In the current stage of the Angolan economy, and with the increase of foreign investment in the country, we naturally expect an increase of competitiveness of the banking industry. Not only by increase of scales of the banks in that market, as well by the introducing of new financial institutions.

Taking all of that into consideration, we expect the weight of BFA's Net Income will be growing in the BPI group's Net Income.

A risk factor regarding the activity in Angola, is the dependency on the oil exportations. Despite the government's announcement of efforts to reduce the correlation between the Angolan real GDP growth and the oil production, the economic growth is still strongly reliant on the oil exportations.

Extraordinary Times

The banking sector performance is greatly dependent on future regulatory requirements which will be following European Union integration developments, either monetary either political. The sustainability of the monetary union has been topic of a lot political discussions. In our analysis we always assume a persistence

When will the Portuguese banking system recover its self-efficiency?

How profitable it will be out of the extraordinary context?

Basel III – stronger capital ratios, constraints banks leverage and imposes minimum liquidity ratios

Fig. 43 – Portuguese banking system recapitalization exercise

Public Injection of CT1 capital

CGD	1.65 € bn
BCP	3.5 € bn
BPI	1.5 € bn
Banif	1.1 € bn

Source: Bank of Portugal

of the European monetary union. However it is important to refer the reintegration of the monetary policies into the sovereign policies context, and how it could be bringing a lot of changes into the system that are difficult to predict.

Europe has made several efforts to avoid a contagion effect all over Europe through its monetary policy that it has been done mostly by temporary measures. The European Central Bank has introduced liquidity into the system and has funded the restructuring of the banking system all over Europe, in order to preserve the availability of credit for households and companies among the members of the Eurozone. It has reduced the interest rates to historically low levels and it has implemented several non-standard provisional measures. According to the central bank, these temporary measures will be gradually dismissed in line with the recovery of the financial markets and macroeconomic indicators. Since the end of 2012 the market has shown more confidence in the ECB action – investors are more confident that the central bank will be supporting the Portuguese banks as last resource of credit. Nevertheless it is coming a long way of restructuring measures to the banking system. The question now is when will the banking system recover its self-efficiency? And how profitable it will be out of the extraordinary context?

Extraordinary Regulation

In which concerns regulation and supervision to the banking system, it was published in December 2010 the new Basel Accord - Basel III, which demands for stronger capital ratios and constrain banks' leverage and liquidity ratios. Even though, the European authorities felt the need to quickly restore stability and confidence in the markets through the creation of a temporary authority. Therefore, the European Parliament established the European Banking Authority (EBA), a regulatory agency which officially started its activity in January 2011. Its main role is to monitor bank's capital structures through stress tests in order to increase transparency and stability in the European financial system. EBA imposed capital targets coming into force at the end of June 2012. This intervention submitted 27 banks all over Europe to a recapitalization exercise.

These banks were given to plans in order to strengthen their capital position by €116 billion, and in that way achieved the EBA's goals.

In Portugal, besides EBA capital requirements, banks also have to accomplish the ratios required by the Economic and Financial Assistance Program imposed by the Troika. In Portugal, the banking system recapitalization plan was composed by: €1.65 billion injection of core tier 1 capital to CGD, €3.5 billion injection of core

tier 1 capital to BCP and €1.5 billion injection of core tier 1 capital into BPI. In that way, the Portuguese banks would fulfill EBA and BoP requirements.

In January of this year, Banif was added to the list of Portuguese banks submitted to a recapitalization plan (€1.1 billion injection of core tier 1 capital).

Fig. 44 – BPI Recapitalization Plan



Source: Company data, NOVA Equity Research

BPI's Recapitalization Plan

The BPI's recapitalization plan was concluded in two stages:

- In June 2012, the Portuguese State fully subscribed the issue of 1.5 billion euro of CoCos – Contingent Convertible bonds, accounted as core tier 1 instrument that it will convert in equity if the bank will not achieve the Core Tier 1 ratio established by the Troika and the EBA, or if it will not repay them until maturity (2017).
- In August the bank increased the share capital, from 990 million euro to 1.190 million euro, through the issuance of 400 million ordinary shares, which the cash proceeds the bank used to repay 200M of the 1,5B Eur of the CoCos subscribed by the Portuguese State in June. Therefore, the amount of CoCos on BPI's balance sheet were immediately reduced to 1,3 billion euro by directing the cash incomes of the capital increase.

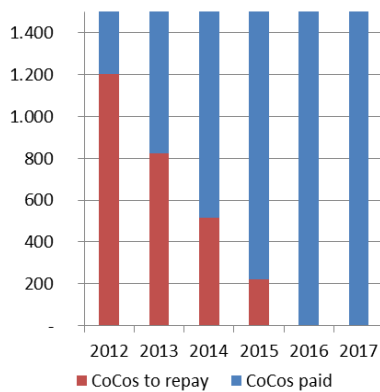
This capital injection was supported by the 12 billion euro Bank Solvency Support Facility established under the Economic and Financial Assistance Program of the Troika.

According to this agreement the bank has to repay the entire amount of convertible instruments until 2017. The scheduled presented by the bank predicted the repayment of 150 million in 2013, 270 million in 2014, 310 million in 2015, and 295 million in 2016 and 275 million in 2017. Meanwhile the annual interest rate defined was, 8.5% in 2012 and 2013, and 9% in the remaining years.

In the next five years the bank will have to consolidate its capital structure in order to continue to be a 100% private bank. In our valuation we assume the bank will take advantage from the Portuguese economy recovery, through increase in NII as well through its sovereign exposure, to repay the CoCos and still maintain solid capital ratios. Also the activity in Angola will be crucial to bank respond to its original repayment plan. Nonetheless, we reinforce the idea that we believe that the bank, even in a distressed scenario, will repay the convertible instruments even if it had to compromise other components of its activities. Ultimately the bank will not become a public bank.

BPI first priority is now to repay the CoCos

Fig. 45 – Estimated Repayment Schedule



Source: Company data, NOVA Equity Research

At 4th December of 2012, after the Portuguese government's permission, BPI repaid 100 million euro of CoCos in advanced from the original repayment schedule. At the end of the year it had in its balance sheet 1.2 billion of euro in CoCos subscribed by the Portuguese State. In 13th March 2013, BPI repaid more 200 million of euro having now in its accounts 1 billion of euro of contingent convertible bonds. BPI has already asked permission to repay more 100 million of euro in advance. We believe at the end of the first semester the bank will have only in its accounts 900 million of CoCos. In our valuation we assumed the bank will be able to pay more 75 million until the end of the year (half of the 150 million scheduled), and after that it will end the year 2013 with 825 million of euro contingent convertible bonds subscribed the Portuguese state, and from there on the bank will follow the initial schedule. In that way it will have repaid all the CoCos at the end of 2016. In order to accomplish this last schedule payment, the bank will have to originate cash flows through its activity, always keeping the core capital ratio above the limits of the BoP and the EBA. In the following years we expect a decrease of the total assets of the bank, driven by the repayment of the convertible instruments. Through our analysis we assumed that there will not be any more repayment in advance from the original plan. The good performer of the bank in the last quarter of 2012 it was mainly from one-off gains from profits from financial operations – it allowed the bank to repay CoCo's above the amount predicted without compromising its core assets.

The ability of the bank repay the CoCo's in advance has two positive impacts:

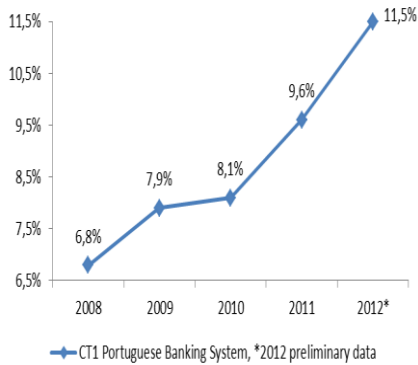
- It has shown to investors that the bank is in a comfortable position to fulfill the Troika requirements, and it will not allow that the convertible bonds will be converted in State's shares;
- It has decreased the costs with those instruments, initially planned. In the table below we can see the costs reduction from the original repayment plan the one we estimated with the repayments already made in advance.

<i>million of euro</i>	2012	2013	2014	2015	2016	2017
Original Repayment Plan (as of September 2012)	1.300	1.150	880	570	275	0
Estimated Repayment Plan (including the advanced repayments already made, as of May 2013)	1.200	825	515	220	0	0
Cost Reduction	4,2	18,1	29,3	29,3	27,0	2,4

Source: Company data, NOVA Equity Research

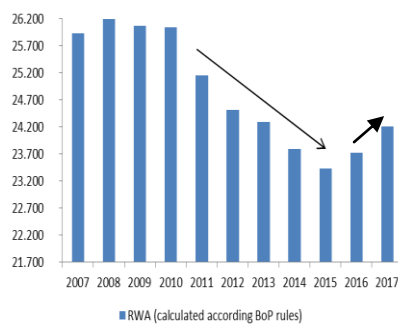
Capital Requirements

Fig. 46 – CT1 ratio – Portuguese Banking System



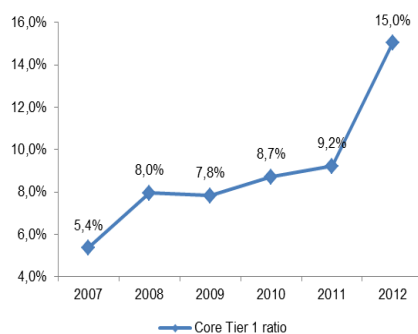
Source: Bank of Portugal

Fig. 47 – BPI – RWA (calculated according BoP rules)



Source: Company data, NOVA Equity Research

Fig. 48 – BPI – Core Tier 1 (calculated according BoP rules)



Source: Company data, NOVA Equity Research

- EBA required that at the end of June 2012, banks should have Core Tier 1 ratio of 9% including a sovereign buffer that considers the valuation of sovereign debt at market prices on 30th September of 2011.
- The Bank of Portugal required, at the end of 2012, banks should have a Core Tier 1 ratio of at least 10%.

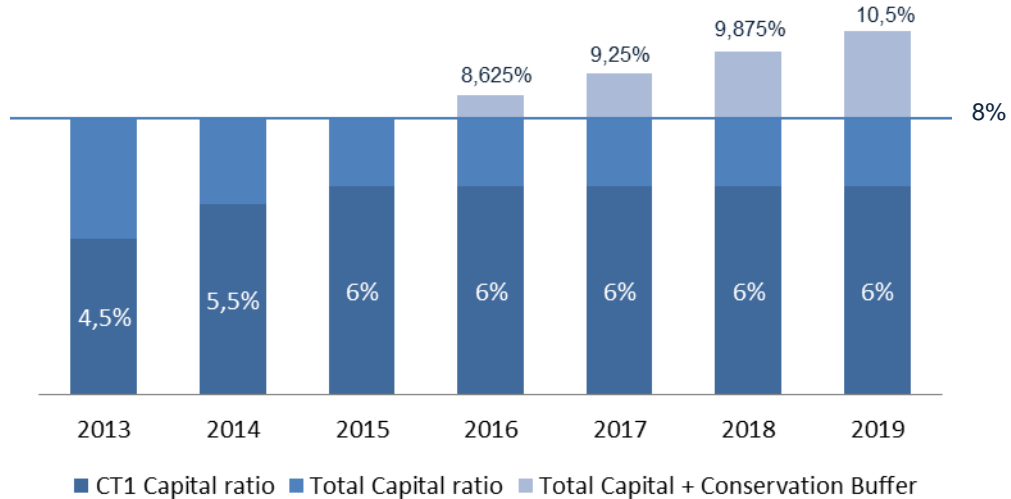
At the end of June 2012, **BPI had a Core Tier 1 of 9.4% by EBA calculations, and 14.5% by BoP calculations.** On the sovereign buffer BPI, at that time, BPI had an exposure of 1,389 million euro at market prices. Meanwhile the bank recognized in its accounts an impairment loss related to Greek public debt, which resulted on a reduction the sovereign buffer to 1,184 million euro. As of 31th March 2013, the bank has informed the investors, that the temporary sovereign buffer calculated at the current market prices would be only 544 million. Nevertheless, the buffer was constituted in order to cover losses banks may have in distressed times. In the next years, the EBA will maintain the buffer as market prices of September 2011 since it represents the distress scenario where yields will rise to those levels. Banks with large exposures will face higher losses, so in order to avoid critical situations as we are living now, banks should conserve amounts of capital to cover the losses may occur in those situations. In the next years, the regulatory framework will continue to be under extraordinary times, where the risk on sovereigns is still too high. Therefore we do not assume any reduction on the EBA's buffer requirement.

At the end of 2012, BPI reported a Core Tier I capital of 3,7 billion euro which corresponds a 15% of its risk-weighted-assets (RWA). The BoP demanded the Portuguese banks to have 10% of RWA at that time, which should be close to 2,5 billion of euro. The bank reported 1,2 billion of euro of core tier 1 capital above the required by the BoP.

Out of the extraordinary times, the Basel Committee on Banking Supervision decided to change the guidelines for capital, leverage and liquidity standards to reinforce the banking regulation and supervision, substituting the Basel II by Basel III. The procedures recommended: i) minimum Tier 1 capital ratio change from 4% to 6%. Banks should have a core Tier 1 capital ratio of 4.5% at the end of 2013, 5.5% at the end of 2014, and 6% at the end of 2015. The restructuring of the Basel also proposes ii) new capital conservation buffer to be used to absorb losses during periods of financial distress. This capital should be met with common equity. Therefore the minimum common equity ratio should be 3.5% at

the end of 2013, 4% at the end of 2014, 4,5% at the end of 2015, and it will have to increase more 2.5% in the next years in order to be 7% at the end of 2019.

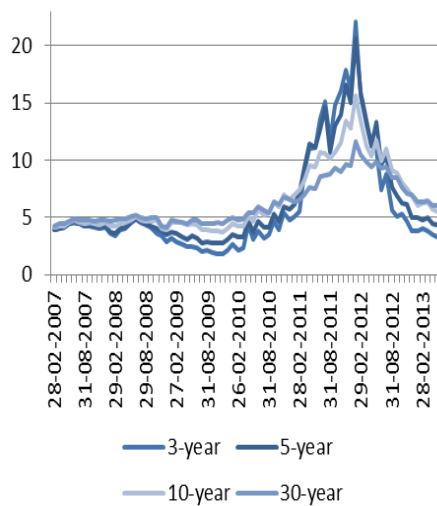
Fig. 49 – Basel III – Capital ratios



Source: Bank of Settlements, Basel Committee on Banking Supervision

ECB Funding

Fig. 50 – Portuguese government bonds yields



Source: Bloomberg

With the aim of preserve the access to credit for households and companies, the ECB has injected liquidity into the system through several procedures. The sovereign debt crisis in Europe has brought great gaps between north and south countries in which respects their ability to finance themselves in the debt market. The peripheral countries have seen their government bonds climbed to high levels, following the investors' uncertainty around the future of their public finances. In order to reduce the yields spreads between core and peripheral countries, the ECB has issued two 3-year Long-Term Refinancing Operations (LTRO) at reduced cost (0.75%). In December 2011 the central bank issued 489.2 billion of euro and in February 2012 it issued another 529.5 billion of euro. BPI took close to 2 billion of the first LTRO issue and another 2 billion in the second. The bank has used this ability to have cheaper funding (0.75% interest rate) to get gains from carry trade strategies. Basically, BPI has get funds at 0,75% of costs and used that funds to invest in sovereign government bonds which returned higher rates. We have seen BPI increased its sovereign exposure. The bank will have refinancing needs in 2014 and 2015 and we have concerns regarding the sustainability of its earnings in the future. It will decrease its dependence from ECB and it will have to substitute these one-off earnings by operational sustainable earnings. Nevertheless we expect that the ECB will slowly reduce its

Low cost ECB funds being used for carry trade strategies

support to the banking system, while it could recover from the improvements in the macroeconomic indicators.

Sovereign Exposure

2H 2012 and 1Q 2013 BPI registered a YoY increase of 42% and 81% in financial gains – that came from its sovereign exposure

BPI has had considerable gains from its sovereign exposure since the middle of 2012.

More recently, ECB has implemented another tool to respond to the sovereign debt crisis. It used the European Stability Mechanism and European Financial Stability funds to realize Outright Monetary Transactions (OMT) - the Central Bank buys government-issued bonds with maturities between 1-3 years, once the certain issuers' countries implement several austerity measures. Through OMT the ECB is pushing the Government Bond's market and giving confidence to investors. Since November 2012, the Portuguese 10-year government bond yield has already decreased 332 bps (as of 3th April, 2013).

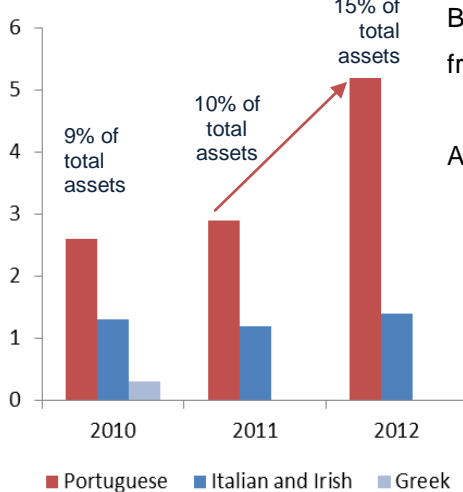
BPI has increased its Portuguese sovereign exposure and it is taking advantage from the downtrend of Portuguese yields.

As of 31 the December of 2012, the bank had in its bonds and T-bills portfolio:

- 2.2 billion euro of Portuguese T-bonds (vs 2,0 billion in year-end 2011);
- 3.3 billion euro of Portuguese T-bills (vs 0,9 billion in year-end 2011);
- 1.4 billion euro of Italian and Irish public debt (vs 1,2 billion in year-end 2011);
- 1.1 billion euro of corporate bonds (vs 1.1 billion in year-end 2011).

The **Portuguese sovereign exposure accounts close to 12%** of its assets, which we consider to be too high to assume in the long-term. The OMT make part of a temporary plan of stabilization of the European debt crisis. Once economy restores its growth prospects, peripheral countries will be able to finance themselves in the debt market and their government bonds' yields will not go back to the high levels we have seen in the beginning of 2012. As soon as it stabilizes, it will flow in a smaller range, and then the bank could not take as much profits as they have been taking. Even though, the total confidence on Portuguese market was not restored yet, the country has shown strong compromise with Europe and great effort to achieve their goals, which has attracted foreign investment. Also the ECB intervention has pushed down the yields on Portuguese government bonds and t-bills. Nevertheless, the yields on public debt are still far from the "risk-free level". We believe we are in the turning point, and the way will be made with a

Fig. 51 – BPI - Sovereign debt in billion euro



Source: Company data, NOVA Equity Research

BPI should not increase its Portuguese sovereign exposure

decreasing ECB role while Portuguese economy restores the market confidence. In that road, there will be room to BPI get profits from its sovereign exposure.

As we said in the beginning of this report, we totally assume the maintenance of the European Union and the persistence of the single currency. Even though, we are conscious about the uncertainty around the European Union evolution. The large sovereign exposure has a negative impact on the capital ratios as well in its systemic risk - the higher exposure to sovereign debt increases the bank's dependence on country's recover. As matter of fact we recognize that BPI's volume of sovereign exposure exceeds the advisable levels. Therefore, we recognize it as a risk factor.

Pension Funds

Banks in Portugal usual have funds established to pay retirement benefits to employees, the so called Pension Funds. These funds are composed by assets that are totally independent of the general assets of the bank. In that way, the bank cannot use these assets to finance any other liability besides the pension liabilities.

At the end of 2011 BPI transferred 60% (1.3 billion euro) of its pension fund to the Social Security under the financial assistance program from Troika. Four Portuguese banks transferred a total of 5.6 billion euro of assets from their pension funds – BPI, BES, BCP and Santander Totta.

After the transference of part of the fund to the Social Security, 27% of the funds' assets were Portuguese equities, and 26% were real estate assets. The pensions' obligations funding are consequently very dependent of the market tendencies.

Since the liabilities side is quite stable while the assets side has a great volatility associated to it, the higher the pension fund the higher the systemic risk of the group BPI. We considered then, that the decrease on the fund size had a positive impact decreasing the systemic risk of the bank as a whole and decreasing the pension costs. On the other hand, banks used to use in the previous regulation, the corridor method to account the differences between the present value of the assets and liabilities of the pension funds, that now it will be deducted from capital – 25% of the actuarial differences will have to be covered with core capital.

Transference of the Pension Funds – lower systematic risk

25% of actuarial differences between pension funds liabilities and assets should be covered with core capital

Valuation

We identified two distinct segments in terms of valuation - domestic operations and international operations. We valued them separately and then we used the sum-of-the-parts model to get the fair value of BPI.

To value international segment we considered the Angolan market since operations from Banco Fomento de Angola (BFA) accounted 95% on average, of international's Net Income, in the last 5 years.

Each one of the segments – Portugal and Angola - is in a different stage of development, with different growth perspectives, different macroeconomic environments and different capital regulations. The growth assumptions and the country risk premium expected by investors are then different in both countries. In spite of Portugal is under a bailout program because it could not finance itself in the debt market, we still believe investors will expect for a higher return while investing in an emerging market than in Portugal.

Domestic Activity

<i>Million of euro</i>	2011	2012	2013E	2014E	2015E	2016E	2017E	2018E
Financial Margin	379	401	367	386	413	486	429	472
Operating income from banking activity	715	1.018	960	903	807	845	812	877
Net Income before tax	(536)	233	102	92	96	163	156	224
Net Income	(375)	163	97	90	93	147	141	196

International Activity

<i>Million of euro</i>	2011	2012	2013E	2014E	2015E	2016E	2017E	2018E
Financial Margin	198	181	183	200	197	212	256	326
Operating income from banking activity	305	312	326	352	359	368	427	515
Net Income before tax	180	167	173	188	184	183	239	324
Net Income	90	87	81	93	88	85	134	208

Methodology

After estimated separately the net income of the two segments for an explicit period of 7 years (2013 – 2019), we used the Free Cash Flow to Equity Model to estimate our target price. We opted by this model, since we are not able to separate the financing activity from the operational activity. We then discounted the cash flows to equity (cash flows available to shareholders) to the cost of

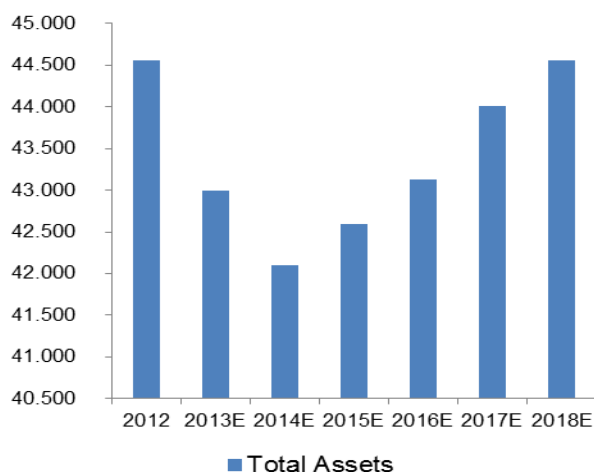
$$\begin{aligned} &\text{Net Income} \\ &+ \Delta \text{ Shareholders' Equity} \\ \hline &= \text{Cash Flow to Equity} \end{aligned}$$

equity. To compute the cash flow available to shareholder in one period, we adjusted the Net Income of the period deducting the changes in Equity. In the case of BPI, we are assuming that the changes in Equity in the next years will correspond to the reinvestment in regulatory capital needed for the Bank accomplish the capital ratios required by the BoP and by the EBA.

$$\begin{aligned} \Delta \text{ Shareholders' Equity} \\ = \\ \text{Reinvestment in} \\ \text{Regulatory Capital} \end{aligned}$$

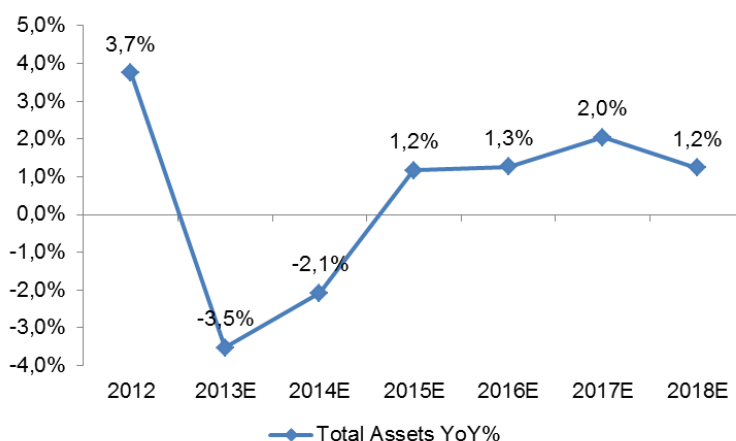
BPI operates under a regulatory framework - it has to respect capital ratios which affects the way they can invest and shrinks the room to act. The regulation under the bank operates has then a key-impact on the bank valuation. Banking system is now engaging an extraordinary regulatory framework, and the standard measures to be respected after the extraordinary time are suffering changes, from what is very difficult to predict how tight capital requirements will be in the future and how bank will improve. The horizon of the extraordinary time is also hard to estimate, since there are several factors influencing how will be the enhancement of the banking sector. Additionally, the Portuguese banking system is under a recapitalization program, and BPI received public funds through the subscription of Contingent Convertible Bonds by the Portuguese State. We assume in our valuation that the first priority for the bank now is to repay those bonds and avoid at any cost that it will convert in equity. Following the estimated repayment plan of CoCos, the bank will have to retain some earnings in the business as well it will have to reduce its assets, in order to respect the core tier 1 capital ratio required by regulators.

Fig. 52 – BPI – Estimated total assets



Source: Company data, NOVA Equity Research

Fig. 53 – BPI – Estimated total assets YoY%



Source: Company data, NOVA Equity Research

Reinvestment in regulatory capital results in an increase in the book value of equity and a decrease in the equity cash flow, because it corresponds to either a capital increase in a form of shares' issuance – high dilution, or it means that the bank had to retain earnings that otherwise could be distributed to shareholders.

In the first four years (2013 - 2016) of our valuation we have a negative cash flow to equity, because the reinvestment in regulatory capital is higher than the consolidated net income (Figure X) – which results in a negative flow for the equity value.

Cost of Equity

After calculated the Cash Flows to Equity we discounted at the cost of equity, since it reflects the return expected by equity investors and implies a premium for the equity risk in the investment. We used the CAPM to calculate the cost of equity for both segments. For calculate the cost of equity to discount the FCFE from domestic operation, we used the 30-year German bund as risk-free (2.36%), 5% of market risk premium, a sector beta of 1.5, and a country risk premium of 3.53%⁴. For the international segment, we computed the cost of equity using a risk free of 10% based on the Angolan inflation rate⁵, 5% market risk premium, a sector beta of 1.5, and a country risk-premium of 4%⁶. We achieved a cost of equity of 13.39% for Portugal and a cost of equity of 21,33% for Angola.

Domestic Activity		International Activity	
Risk-free	2.36%	Risk-free	10%
Sector beta	1.5	Sector beta	1.5
Market risk-premium	5%	Market risk-premium	5%
Country risk-premium	3%	Country risk-premium	4%
Cost of Equity	13.39%	Cost of equity	21.33%

After discounted the FCFE to the cost of equity for the explicit period, we calculated the terminal value using a growth rate of 2.14% for Portugal and 4.40% for Angola. We calculated both growth rates through IMF predictions of real growth in 2018, in the respective countries. Summing the equity value of domestic operations with the equity Value of international operations we got a group equity value of 1.7 billion euro, which corresponds to 1.20 euro per share as target price.

⁴ Portuguese risk-premium = 10Y Portuguese GB yield – 10Y German GB yield

⁵ Risk-free in Angola = (1 + 10Y German bund) x ((1 + Inflation rate in Angola) / (1 + Inflation rate in Germany)) - 1

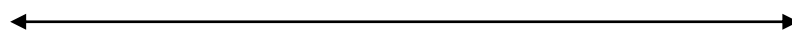
⁶ Angolan risk-premium = 7Y Angolan GB in USD yield – 7Y US T-bill yield

Valuation Summary

	2013	2014	2015	2016	2017	2018	2019
Net Income Domestic Activity	97	90	93	147	141	196	276
Net Income International Activity	81	93	88	85	134	208	218
Reinvestment in Regulatory Capital	389	285	324	264	0,6	0,8	1,0
Domestic Activity							
FCFE	(292)	(195)	(231)	(117)	141	196	275
DFCFE	(92)	(172)	(180)	(80)	85	105	130
Terminal Value	1.180						
Equity Value	775						
Price per share	0,56						
International Activity							
FCFE	81	93	88	85	134	208	218
DFCFE	81	77	60	48	62	79	69
Terminal Value	424						
Equity Value	899						
Price per share	0,65						
Group							
Equity Value	1.674						
Price per share	1,20						

Key Indicators

	2007	2011	2012	2013E	2014E	2015E	2016E	2017E	2018E
EPS	0,47	(0,29)	0,18	0,13	0,13	0,13	0,17	0,20	0,29
Dividends per share	0,19	0,00	0,00	0,00	0,00	0,00	0,00	0,08	0,12
ROA	0,9%	(0,7%)	0,6%	0,4%	0,4%	0,4%	0,5%	0,6%	0,9%
ROE	18,6%	(34,6%)	12,1%	8,9%	9,0%	8,9%	11,1%	12,8%	17,8%
Cost-to-Income	54%	67%	48%	50%	51%	56%	54%	53%	47%
Cost-of-Risk	0,3%	0,4%	0,9%	1,1%	0,9%	0,6%	0,6%	0,5%	0,5%
Loans-to-Deposits	141%	114%	102%	98%	99%	101%	102%	102%	102%
RWA	25.925	25.152	24.512	24.292	23.788	23.428	23.723	24.206	24.505
CT1 capital ratio	5,4%	9,2%	15,0%	14,4%	14,3%	14,0%	13,3%	13,8%	14,6%



Extraordinary Context

Risks Factors

1 bn € CoCo's subscribed by the Portuguese State

➤ BPI has 1 billion of Contingent Convertible bonds, subscribed by the Portuguese State, in its balance sheet that it will convert in equity if the bank: a) do not repay them before maturity – 2017; b) do not have a minimum CT1 capital ratio of 10%. The conversion of these bonds, not only means high dilution, as well it means that the Portuguese Estate would become a shareholder;

High dependency on the Portuguese economy

➤ The BPI's dependency of the Portuguese economy pressure down the BPI shares. Despite of the significant role of international activity on BPI net income, 96% of the loans portfolio belongs to the Portuguese activity. The correlation between the bank's performer and Portugal is then very strong. The current debt crisis of Portugal brings a lot of uncertainty regarding the future of the country and of BPI;

44% of mortgage loans in loans portfolio

➤ The proportion of 44% of mortgage loans in BPI's domestic loans portfolio is considerable high in which concerns the risk management of the bank. The downtrend of the Real Estate market compromises the BPI's performance;

Uptrend of NPL ratio in the Portuguese banking system

➤ The uptrend of the NPL ratio in the Portuguese banking system will continue to bother the Portuguese banks – rising needs of provisions and growing impairment losses. The evolution of the NPL ratio is strongly correlated with the evolution of the Portuguese economy;

High exposure to Portuguese sovereign debt

➤ The high exposure to Portuguese sovereign debt is a risk factor for our valuation. The ECB intervention has helped to decrease the Portuguese government bond yields since is giving confidence to the market. Nevertheless the instability of the market right now, could change this scenario quickly, and we could assist to rally on the government bonds yields again;

ECB refinancing needs

➤ BPI has financed a high proportion of its operations with cheap ECB funds. The central bank will not be injecting liquidity into the banking system forever. The reduction of ECB support will create refinancing needs in the next years. The ability of the bank get funds by itself is strongly dependent of the evolution of the Portuguese credit rating;

Angolan Real GDP strongly dependent on oil exportations

➤ Concerning the activity in Angola, we point three main risk factors: the dependency of the oil exportations to the GDP growth of the country; the

possibility of changes in the Angola's government – increase of transparency and democratisation; and the opportunity for increase of competitiveness in the Angolan market could compromise the BFA's growth perspectives.

Conclusions and Recommendation

Our **target price for BPI's shares is 1.20 €**. Currently, BPI's shares are trading at 1.03 €, which gives us an upside of 16%. From our analysis we consider that the market is undervaluing the stock and consequently **our recommendation is to buy**.

We are aware of the uncertainty environment where BPI is passing through and the value effect of the great dependency on Portuguese economy for the success of the bank.

We are now facing not durable times. The European banking system is now being defined for the future, and the BPI's position on that system is unreliable.

The possibility of a European banking integration is closer – the recent sovereign crisis across the peripheral countries alerted for the failures of the single currency. The sentiment that a banking union is needed to avoid similar crisis in the future, is growing among the European governors.

The banking union aims to separate the bank's interests from the local governments' interests and create a stronger banking system globally. The creation of a single authority will avoid dispersion between fund conditions across the Euro-members again and the completely banking integration will generate a more centralized Europe.

In practical terms for BPI, we believe that the banking union could originate synergies valuables for the bank and the harmonization between peripheral and core economies will bring confidence to invest in the weaker economies (like Portugal).

Nevertheless, we are aware about the uncertainty of how an eventual European banking will occur and how will be the BPI's position in the middle of that process.

Appendix

Income Statement Domestic Activity	2011	2012	2013E	2014E	2015E
Financial margin	379	401	367	386	413
Net commission income	254	282	255	226	233
Net income on financial operations	143	326	313	267	136
Operating income	107	11	16	19	21
Operating expenses	(131)	(20)	(9)	(11)	(12)
Net operating income	(30)	(14)	1	2	3
Operating income from banking activity	715	1.018	960	903	807
Personnel costs	(365)	(310)	(307)	(304)	(301)
General administrative costs	(183)	(180)	(178)	(176)	(175)
Depreciation and amortisation	(26)	(20)	(21)	(19)	(17)
Overhead costs	(573)	(510)	(506)	(499)	(492)
Recovery of loans, interest and expenses	17	13	11	11	13
Impairment losses and provisions for loans and guarantees, net	(204)	(254)	(290)	(265)	(185)
Impairment losses and other provisions, net	(492)	(34)	(74)	(59)	(47)
Net income before income tax	(536)	233	102	92	96
Income tax	148	(82)	(19)	(17)	(18)
Net Income	(375)	163	97	90	93
Income Statement International Activity	2011	2012	2013E	2014E	2015E
Financial margin	198	181	183	200	197
Net commission income	43	50	53	56	59
Net income on financial operations	63	76	83	87	91
Operating income	2	6	9	11	15
Operating expenses	(1)	(0)	(1)	(1)	(1)
Net operating income	0	4	7	9	13
Operating income from banking activity	305	312	326	352	359
Personnel costs	(53)	(63)	(66)	(72)	(77)
General administrative costs	(48)	(54)	(56)	(60)	(65)
Depreciation and amortisation	(11)	(13)	(13)	(13)	(13)
Overhead costs	(112)	(129)	(134)	(145)	(156)
Recovery of loans, interest and expenses	3	3	3	3	3
Impairment losses and provisions for loans and guarantees, net	(9)	(15)	(15)	(16)	(16)
Impairment losses and other provisions, net	(6)	(3)	(6)	(6)	(6)
Net income before income tax	180	167	173	188	184
Income tax	(6)	(6)	(9)	(11)	(13)
Net Income	90	87	81	93	88

Consolidated Income Statement	2011	2012	2013E	2014E	2015E
Financial margin	577	583	549	586	610
Net commission income	297	332	309	282	291
Net income on financial operations	206	401	397	354	227
Operating income	109	17	25	30	36
Operating expenses	(131)	(20)	(10)	(12)	(14)
Net operating income	(30)	(9)	9	11	15
Operating income from banking activity	1.020	1.330	1.286	1.256	1.166
Personnel costs	(418)	(373)	(373)	(376)	(378)
General administrative costs	(231)	(233)	(234)	(236)	(240)
Depreciation and amortisation	(37)	(33)	(33)	(32)	(30)
Overhead costs	(686)	(639)	(640)	(644)	(648)
Recovery of loans, interest and expenses	20	16	13	13	16
Impairment losses and provisions for loans and guarantees, net	(213)	(269)	(305)	(280)	(201)
Impairment losses and other provisions, net	(498)	(37)	(80)	(65)	(53)
Net income before income tax	(356)	400	275	280	280
Income tax	141	(88)	(28)	(29)	(31)
Net Income	(285)	249	179	183	181

Consolidated Balance Sheet	2011	2012	2013E	2014E
Assets				
Cash and deposits at central banks	1.145	1.269	1.083	346
Deposits at other credit institutions	385	453	330	271
Financial assets held for trading and at fair value through profit or loss	937	1.112	1.112	1.112
Financial assets available for sale	6.778	10.253	10.253	10.253
Loans and advances to credit institutions	2.338	1.711	1.369	1.095
Loans and advances to Customers	28.318	27.345	26.540	26.844
Held to maturity investments	766	445	356	249
Hedging derivatives	280	281	270	251
Other tangible assets	225	211	211	211
Intangible assets	10	14	14	14
Investments in associated companies and jointly controlled entities	179	202	171	171
Tax assets	904	618	618	618
Other assets	691	650	669	669
Total assets	42.956	44.565	42.995	42.103
Liabilities				
Resources of central banks	2.499	4.271	4.698	4.698
Resources of other credit institutions	2.072	2.568	1.312	1.147
Resources of Customers and other debts	24.671	24.621	24.254	23.914
Debt securities	6.692	3.788	3.788	3.788
Financial liabilities relating to transferred assets	1.415	1.591	1.591	1.273
Hedging derivatives	662	815	590	815
Provisions	128	138	149	155
Technical provisions	2.625	2.255	2.505	2.461
Tax liabilities	33	120	120	120
Contingently convertible subordinated bonds	-	1.200	825	555
Other subordinated loans	214	156	156	156
Other liabilities (including held for trading)	1.122	979	998	998
Total Liabilities	42.134	42.504	40.988	40.079
Total shareholders' equity	822	2.061	2.008	2.024
Total liabilities and shareholders' equity	42.956	44.564	42.995	42.103

Disclosures and Disclaimer

Research Recommendations

Buy	Expected total return (including dividends) of more than 15% over a 12-month period.
Hold	Expected total return (including dividends) between 0% and 15% over a 12-month period.
Sell	Expected negative total return (including dividends) over a 12-month period.

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