NOVO BANCO

What good out of a bad bank?

Index

Synopsis 1
The Problem 2
The Initial Solution 2
  Differendum in Strategy 3
  No Difference between the Old and the New 4
    The hardships of Novo Banco's frontline workers 4
  Sale Attempt – Round 1 4
  Some more bad news… 5
New government and Strategy reviewal 6
  Sale Attempt – Round 2 6
  Third President for Novo Banco 7
  End of 2016 and still no deal 7
Novo Banco's Stakeholders 8
What next? 9
Financial Data and KPIs 10
  Novo Banco's Financial Statements 10
  BES' Financial Statement 13
  KPIs from other Banks 14
  Accompanying Excel File 14
Annex A - Bank of Portugal i
  From nationalization until 1997 i
  Economic and Monetary Union i
  From financial crisis to Banking Union ii
Annex B – Marketing for Novo Banco iii
Annex C – BES Board of Directors' Message at the end of 2014 v
  Context – The Resolution Measure v
  Unique Situation vi
  Working Conditions for the BES Management Team vi
  Best-Effort Situation viii
Annex D – Portugal's Outlook after its Financial Assistance Program ix
Annex E – Portuguese Banking Crisis xi
Annex F – Case Questions xiii
  Strategy xiii

Finance xiii
Marketing xiii
Ethics xiv
Politics xiv
References xv

NOVO BANCO

What good out of a bad bank?

Synopsis

This business case portrays the collapse of the Bank Espírito Santo (BES – Banco Espírito Santo), once the biggest private bank in Portugal [BES 2014A].

After the BES' failure, the Portuguese regulator (Bank of Portugal) decided that the best thing to do was to inject capital into the bank and salvage the good assets, creating a new bank out of the old. BES (the old name was kept by the "bad bank") retained the "toxic" assets, whereas this new bank (Novo Banco) inherited the client-base and the BES, best quality assets. The plan was to sell this new bank for a value similar or higher than the injected capital, but the situation proved hard to accomplish. With outside pressure from the European Commission to sell and from potential buyers interested in a good deal, facing a world-wide economic crisis and monthly losses due to operating inefficiency, it was not possible to conclude a deal by the end of 2016. At the beginning of 2017, how should the Bank of Portugal proceed, after more than 2 years trying to sell the bank without success?

Keywords: bank insolvency, bankrupcy, imparities, Government intervention, rebranding, nationalization, privatizing

The Problem

The bank named "Novo Banco" (New Bank in Portuguese) was created because of an emergency intervention by the Bank of Portugal to save the "good" assets of the once great but bankrupt BES (Banco Espírito Santo) in the 4th of August 2014. The toxic assets remained in BES (dubbed "bad bank").

BES was one of the biggest private banks in Portugal, with origins mounting back to the year 1869. In 2013, it was headed by the founder's great-grandson, Ricardo Salgado, when an external audit revealed several problems with the bank's accounting and concluded that BES had a severe financial problem (the risky credit represented 11,1% of the bank's accounts). The bank underwent a public capital increase (endorsed by several public figures, including the Portuguese president at the time, Cavaco Silva), of 1.045M€ to reposion itself, that was 100% successful (demand of about 160% [BES 2014B], with a significant part of foreign investors).

However, continued amounts of suspicions led Ricardo Salgado to be replaced by Vitor Bento (via a settlement between BES's shareholders and the Bank of Portugal) in July 2014. At the end of that same month, BES announced imparities totalling the amount of 4.253,5 M€. This led the European Central Bank to suspend BES's access to the financial operations, forcing it to reimburse its credit to the Eurosystem in the value of 10.000M€. In 2 days, the stock prices dropped by 80% to around 0,03€ per share. It was later proven that the administration led by Ricardo Salgado had disobeyed the Bank of Portugal 21 times between December 2013 and July 2014, apparently acting against the institution's best interests. Some carousel schemes with companies within the Espirito Santo Group (GES) were also detected in BES' financial movements in order to improve the bank's financial statements [Carousel 2014].

The Initial Solution

In 3 August 2014, the Bank of Portugal announced a bailout of 4.900M€ towards the institution, putting an end to BES as a private bank. The non-toxic assets were transferred to a new institution, Novo Banco, funded by the "Resolution Fund". This fund was created in December 2012 as an imposition from "Troika" (Portugal underwent a bailout measure from May 2011 to June 2014, led by 3 parties; European Commission, European Central Bank and International Monetary Fund; these 3 entities together were dubbed as Troika[1]). It was the fund's purpose to provide financial support to the measures adopted by the Bank of Portugal – imposing that the problems created by the financial system would be taken care of by that same system – however, since it was still in its early stages (only started collecting money in June 2013), the Bank of Portugal had to intervene with a

[1] Troika is the Russian word for a committee of 3 members; its origin stems from a sled pulled by 3 horses side-by-side.

loan of 3.900M€, while 1.000M€ came from the Portuguese Banks[2] and financial institutions). The Resolution Fund became the effective new owner of Novo Banco [Fundo Resolucao] – this solution was naturally agreed with the European Comission, that still had Portugal under watch [EC 2014] . Meanwhile, the "toxic" assets were to remain in BES (mainly assets relating to credits to the rest of the Espirito Santo group, that was basically worthless; subordinate bonds[3], and the worthless share capital) – since the liquidation of the "bad bank" BES had assets of only a residual worth, this would mean that shareholders and subordinate bondholders would lose their investments in full.

Novo Banco maintained the new administration that had just entered the old BES, BES lost its banking license, and all BES's shareholders and creditors lost their investments. Novo Banco was to be sold (in 2 years, maximum, as defined by the European Commission's legislation on bank's resolutions) for the Portuguese government to recoup its losses, but it was hard to find a buyer willing to pay the price. The main question here was obviously "what is a fair price to sell the bank for?", since it depended on its client-basis and credit quality – and these two factors were hard to quantify.

Differendum in Strategy

Meanwhile, a month and a half after presiding over BES / Novo Banco, Vitor Bento left Novo Banco in September 2014 due to not agreeing to a "quick sale" of the bank; he insisted on a long term solution [Bento 2014]. In August 2014, Bento launched a new campaign for Novo Banco, creating a new brand for the institution. The campaign had as a symbol a butterfly, representing a new beginning. Vitor Bento was replaced by Eduardo Stock da Cunha in September 2014, whose mission was clear: "to sell the bank for the highest price as quickly as possible", to minimize the Portuguese public's exposure to it.

[2] 700M€ were loaned from the banks CGD, BCP, BPI, Santander Totta, Caixa Económica Montepio Geral, Banco Popular, Banco BIC and Caixa Central do Crédito Agrícola Mútuo, to be added to the 300M€ that the fund had gathered.
[3] Senior bond-holders were happy to be placed in Novo Banco

Trying to avoid the mass exodus of clientele, Novo Banco kept operating through the branches of BES, while progressively changing its image. On 3 December 2014, Novo Banco had in its balance sheet assets in the order of 72.400M€, with a solvency ratio of 9,2% (higher than the 8% imposed by the European Central Bank and 7% demanded by the Bank of Portugal). The client's resources amounted to 27.200M€, and conceded credit in the amount of 38.500M€ (70% of these were directed to companies, which historically have a higher risk than personal credits).

No Difference between the Old and the New

2015 was hard for Novo Banco from the start – constant protests from retail share and bondholders from BES were heard besides many agencies from Novo Banco, claiming they were deceived by assurances from their account managers that the investment was 100% safe (case of bondholders) and by the Portuguese president himself that BES met all conditions to operate and was a solid bank (case of the shareholders - it was later proven that the Bank of Portugal knew of several irregularities from the bank at least since the end of 2013) [Bank of Portugal 2017].

The hardships of Novo Banco's frontline workers

Many stories of Novo Banco's frontline workers with psychologic depressions [Drama 2015a][Drama 2015b] also came to surface. BES' clients were now Novo Banco's clients, and it took some time before all agencies were rebranded from BES to Novo Banco. It was hard for clients to understand that the bank agency, maintaining the BES brand and with the same workers that have been working there for years was now a different bank, and that a substantial part of their (lifetime, for some) savings was gone.

For some of these workers (most of whom had also invested in BES' financial products), life was a living hell, since they had to explain repeatedly that BES ceased to exist with its bankruptcy, and that the BES financial product once deemed "safe" that their client invested on, lost all its money or had its assets frozen – this was a very complicated situation, especially in the cases when it was the same employee that advised (and insisted) that his client put his/her savings into such product (frontline workers from BES had been instructed and heavily persuaded, as part of their performance review and commissions, to sell BES' financial products as low-risk with higher returns than saving accounts). There was some violence and many workers went into deep depressions and sick leaves.

Sale Attempt – Round 1

Novo Banco was put up for sale by the Resolution Fund (with financial advisory from BNP Paribas, and asset evaluation from Deutsche Bank) under some very specific conditions, such as describing in detail the affiliation that the purchasing institution had with BES, what the finance model would be, the capital ratio objective and value of proposal. At the end of 2014, 17 Investors had a proposal to purchase Novo Banco, though the Bank of Portugal only valued 15 investors for the second phase in February 2015 [Zap 2015]. In March 2015, 5 institutions reached the third phase for the bank's purchase, namely Santander, Fosun, Apollo, Cerberus and Anbang Insurance Group. The 5 candidates had until 30 June 2015 to deliver their final proposals, including a capital increase to Novo Banco (actually, this date was later extended to 7 August 2015, with the candidates discussing terms with the Bank of Portugal). Of the 5, only 3 groups presented a proposal, namely Fosun, Anbang and Apollo, none of which were a bank; Apollo was an investment fund that controlled the insurance company "Tranquilidade" (from the former Espirito Santo group); Fosun was a Chinese conglomerate that purchased the Portuguese insurance company Fidelidade and the health sector of the Espirito Santo Group (Espirito Santo Saúde), and Anbang was a Chinese financial group with a strong presence in the insurance area.

Angbang and Apollo were the two chosen groups with best offers to discuss terms (Apollo improved on its offer of 30 June 2015). Angbang had the best financial offer, and was chosen as the prime candidate; however, it demanded that the Bank of Portugal should provide insurances of bad credits, taking a great part of the risk from the riskier assets. Hard negotiations were underway (the Chinese summer crash didn't help [China 2015]), and after the Bank of Portugal's deadline of 31 August 2015 (for reaching a deal with Angbang), and initial days of September 2015 (to reach a deal with Apollo or Fosun), it was decided to cancel the sale until after Portugal's legislative elections [End Sale 2015]. Part of Novo Banco, BES Investimentos, was sold to the Chinese group Haitong and called Haitong Bank in September 2015, for 379M€.

Some more bad news…

Meanwhile, in November 2015, the European Central Bank announced that Novo Banco failed on its stress tests, and needed an extra 1.398 M€ to meet all requirements by 2017. In December 2015, the Bank of Portugal ordered that 1.985M€ in senior bonds (those that are paid first in case of bankrupcy) would move from Novo Banco to BES (with the bond-holders losing their credits). It was very controversial since the Bank of Portugal deliberately chose some senior bonds emissions (5 out of a total of 43 emissions that had transited from BES to Novo Banco), namely those whose institutions weren't Portuguese. The Bank of Portugal said that this measure was safeguarded from the beginning, in which it was stated that the possibility of the regulator to transfer assets from Novo Banco to BES would be open, to assure that BES's losses are absorved by its shareholders and creditors, and not by the banking system or the Portuguese people [Bank Portugal 2015]. The Bank of Portugal also decided that this procedure would be a one-time deal, and issued a statement saying that no further transfers of assets would occur between Novo Banco and BES. With this measure, Novo Banco's capital ratio rose to 13%, with its debt dropping the corresponding amount (1.985M€). This measure (alongside similar measures taken in 2014) was contested by ongoing lawsuits ([Novo Banco 2017B] – naturally the affected institutions accused the Bank of Portugal from descrimination, breaking the *pari-passu*[4] – equal footing with all other senior bonds), whose responsibility belongs to the Resolution Fund, protecting the value of Novo Banco. The senior bonds that remained in Novo Banco were being negotiated at 85% value, quantifying the market's concern and lack of trust on the matter.

[4] From investopedia.com, we have the definition: "Pari-passu is a Latin phrase meaning "equal footing" that describes situations where two or more assets, securities, creditors or obligations are equally managed without any display of preference. An example of pari-passu occurs during bankruptcy proceedings when a verdict is reached: all creditors can be regarded equally and will be repaid at the same time and at the same fractional amount as all other creditors."

New government and Strategy reviewal

The Portuguese government changed significantly since the final of November 2015, with the center-right-wing party formed by PSD (Social Democrats) and CDS (Democratic Center) being replaced by a left-wing coalition formed by PS (Socialists), BE (left-wing block) and PCP (Communist party). This essentially left-winged block (PS formed a minority government with parlamentary support from BE and PCP) was somewhat divided in its internal objectives (it was called by opposing parties as "geringonça", meaning a crudely build machine), with the BE and PCP defending the nationalization of Novo Banco.

The year 2016 started with a restructuring plan for Novo Banco, with a forecast of laying off 500 to 1000 workers, to reduce operational costs in at least 150M€. The possibility of nationalizing the bank was also gaining strength. There was much political debate over it, and the government wasn't happy with the Bank of Portugal's decision on the senior bonds.

February came to add a further 600M€ of debt from bad credit (inherited from the old BES) due to the results of 2015. There was much unrest in Portuguese politics, with some arguing that Carlos Costa, governor of the Bank of Portugal, should resign (due to the poor supervision and the bond transfer), and before the real possibility that Novo Banco would bring a big blow to Portugal's deficit figure.

Sale Attempt – Round 2

Stock da Cunha announced in March 2016 that Deutsche Bank was invited to provide financial advisory to the second round of trying to sell Novo Banco (replacing BNP Paribas). The sale would try to place stock on institutional investors and issue an IPO (Initial Public Offering) later. Concurrently, the collective firing of 150 workers was announced, with about 350 accepting friendly resolutions and others (towards the 1000 people figure) accepting early-retirement access [Observador 2016].

April 2016 was filled with news of the opening of cases in court against the Bank of Portugal by the holders of the bonds transferred to BES and holders of other assets from BES, and May 2016 ended with losses of 249,4M€ for Novo Banco since the beginning of the year, explained in part with 109,6M€ of costs with the restructuring plan. At the end, only 69 people were to be fired, with the other 900+ accepting a friendly resignation.

At the end of June 2016, the Bank of Portugal received four proposals to the purchase of Novo Banco (or part of its assets). The date wasn't the best due to the outcome of the "Brexit" referendum [Brexit 2016], and its impacts on all financial institutions (somewhat like the Chinese crash of 2015). The proposals were confidential, but it was later known that the institutions envolved were BCP and BPI (two Portuguese banks), the Consortium Apollo/Centerbridge and the Lone Star fund (these last two are private equity funds), on the direct sale front. The Chinese holding Minsheng proposed to buy part of the bank, namely a bit over 50% of its shares, with the rest being dispersed in the stock market.

The Portuguese government had to negotiate with the European Commission an additional year to sell Novo Banco, with the deadline of August 2017. The capital that the Portuguese government put into the resolution fund still had its book value, but those guarantees would have to be accounted for when the bank was effectively sold. If the sale were to prove unsucessfull, the government would have to liquidate the bank (although further negotiations with the European commission were possible, namely requiring an additional extra year).

Third President for Novo Banco

António Ramalho (former president of the board of "Infraestruturas de Portugal" – Portuguese infrastructures) replaced Stock da Cunha as president of Novo Banco (returned to his former employer, Lloyds Banking Group) in the beginning of August 2016. Meanwhile, the Chinese group Haitong said it was also available to purchase about 30% of Novo Banco, maintaining the resolution fund as the major partner, and CaixaBank, BPI's possible future majority shareholder, stated publicly to be against BPI's bid on Novo Banco.

End of 2016 and still no deal

The 3 last months of 2016 were hot in news about Novo Banco; in terms of restructuring, after all accounting done, only 49 out of the 1034 workers that were to be laid off were effectively fired (originating 3 cases in court). Although the negotiated number with Brussels was to reduce 1500 workers until August 2017, António Ramalho wasn't worried, since the remaining workers were going to be naturally leaving from retirements and voluntary leaves, which happened at a mean rate of 40 workers / month. Novo Banco also agreed with Brussels to close an additional 75 agencies, from 550 to 475 in the first semester of 2017 [Fecho 2016]. The plan warranted a reduction of 230M€ in operational costs in the first semester of 2017. Novo Banco's financial performance was also getting better, with fewer losses than in the previous year (359M€ in losses for the first 9 months compared to 418,7M€ in the previous year).

At the end of 2016, another injunction to the sale of Novo Banco was put in court by a group of 232 shareholders of BES (adding to previous injunctions in 2014 and 2015). Meanwhile, the Chinese holding Minsheng was unable to provide the necessary guarantees needed to finance its proposal, asking until the end of January 2017 to provide such guarantees. The Lonestar fund was the candidate with the best proposal (and guarantees), and thus was chosen for a one-to-one negotiation phase with the Bank of Portugal.

Novo Banco's Stakeholders

The following figure displays Novo Banco's main stakeholders. Notice that the Resolution Fund was sole responsible for the International Court's ruling, and thus whoever bought Novo Banco, would buy it "clean" of court proceedings that resulted from the breakdown of BES. Notice also that the potencial buyers were in direct communication with the Resolution Fund and Novo Banco itself, in order to assertain all financial and operational issues.

Another pertinent group of outside observers were the credit rating agencies; Portugal had a "garbage" rating in all major agencies except DBRS (that still kept Portugal in "investment grade"), but further increase in Portugal's overall debt with Novo Banco could offset this.

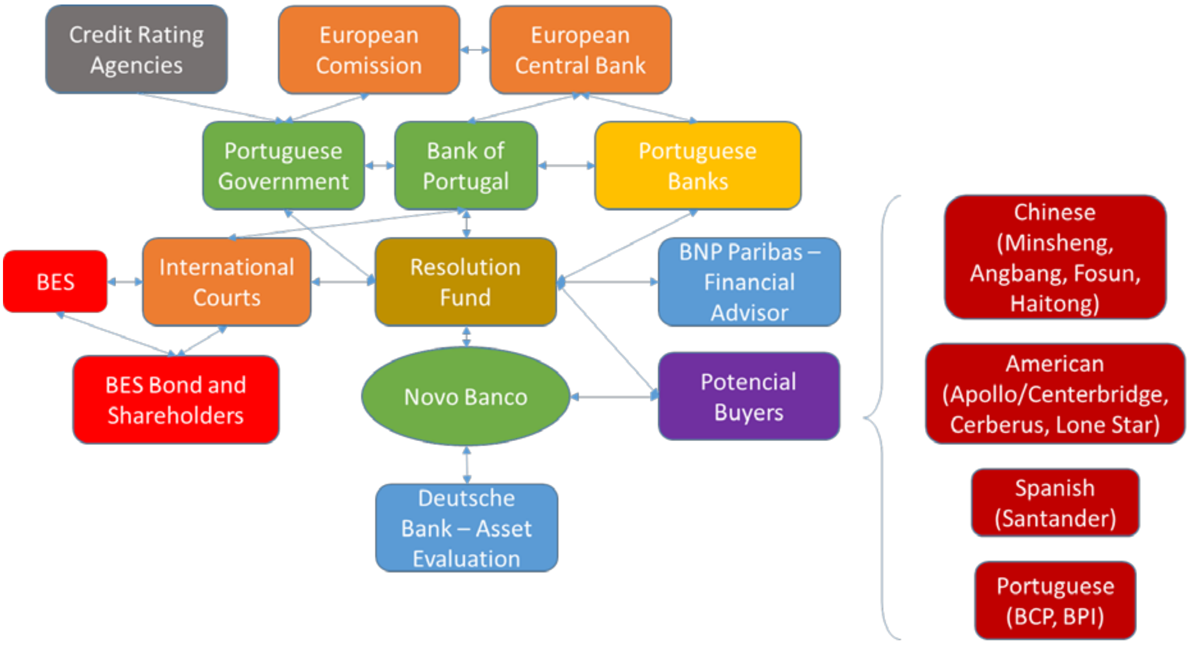

Figure 1- Novo Banco's main stakeholders

What next?

The question remained: would the negotiations come to good term? Was Novo Banco worth the original 4900M€? Should the government nationalize the bank? Or should it liquidate the bank? Was it feasible to assume that some institution would buy the bank without any state guarantees, when there are some many uncertainties (potencial buyers have been constantly asking questions regarding its assets and operations [Novo Banco 2017A]) surrounding it (even though the Resolution Fund is responsible for settlements of court deliberations)? Meanwhile the Canadian service rating agency DBRS, the only agency that had Portugal's rating as "investment grade", allowing Portugal to finance itself in the European Central Bank, warned Portugal that if it would nationalize the bank, its financial balance could be seriously affected, and would probably see its rating downgraded to the status of "garbage" [DBRS 2017] – Caixa Geral de Depósitos, the Portuguese public bank, was also "downsizing" [CGD 2016], and thus a nationalization of Novo Banco seemed improbable. Things were getting complicated…

Financial Data and KPIs

This section introduces some market data indispensable for valuation and competitive analysis purposes. Portuguese banks were all struggling (including the public bank CGD – Caixa Geral de Depósitos), and public trust on banks (including bankers and supervisors) were diminishing.

Novo Banco's Financial Statements

The following statements describe public financial data of Novo Banco until 30 June 2016, having been translated from [Novo Banco 2016]. It is intended that the students use solely these statements to analyze the bank's financials. Notice that, by Portuguese law, the deferred tax assets had a validation of 12 years, and that a 5% cost of equity was usually used for the banking sector (taken from [Equity 2017] on March 2017).

Table 1 – Income statement on 30 June 2015 and 30 June 2016

NOVO BANCO, S.A.

INCOME STATEMENT on 30 JUNE 2015 and 2016 (1)

thousands Euro

	30.06.2015	30.06.2016
Interest and similar income	784 572	621 556
Interest and charges similare	569 854	395 512
Financial margin	**214 718**	**262 044**
Income from equity instruments	6 485	31 766
Fee and Commission income	251 065	189 068
Fee and Commission expenses	67 057	55 662
Results of assets and liabilities measured at fair value through results	(107 479)	(28 385)
Results of available-for-sale financial assets	167 250	76 130
Foreign exchange revaluation results	25 706	(8 727)
Results of sale of other assets	13 448	-841
Reinsurance premiums	18 655	22 086
Claims expenses net of reinsurance	145 527	95 812
Changes in technical provisions net of reinsurance	113 932	65 608
Other operating result	(98 237)	(50 382)
Activity product	**382 959**	**406 893**
Personnel costs	204 401	156 980
General administrative expenses	149 017	118 216
Depreciation for the year	43 540	28 980
NET reserves value re-adjustments	(77 009)	59 262
Credit impairment net of reversals and recoveries	252 340	282 362
Impairment of other financial assets net of reversals and recoveries	98 304	125 468
Impairment of other assets net of reversals and recoveries	(2 066)	109 607
Negative consolidation differences	-	-
Result of associates and joint ventures (equity method)	5 971	2 706
Result before taxes and non-controlling interests	**(269 597)**	**(471 276)**
Taxes on income		
Current	35 124	6 323
Deferred	(63 153)	(106 975)
Result after tax and before non-controlling interests	**(241 568)**	**(370 624)**
Of which: Result after tax from discontinued operations	10 188	(5 637)
Result after tax of discontinued activities	13 460	741
Non-controlling Interests	10 369	(8 004)
Consolidated result	**(251 937)**	**(362 620)**

(1) in accordance w ith instruction No. 18/2005 of the Bank of Portugal

Table 2 –Consolidated Balance sheet on 31 December 2015 and 30 June 2016

NOVO BANCO, S.A.

CONSOLIDATED BALANCE SHEET ON 31 DECEMBER 2015 AND 30 jUNE 2016

thousands Euro

	31.12.2015	30.06.2016
ASSETS		
Cash and deposits in central banks	775 608	2 116 615
Cash and cash equivalents in other credit institutions	340 209	295 717
Financial assets held for trading	775 039	774 900
Other financial assets at fair value through results	1 526 193	1 317 560
Available-for-sale financial assets	11 810 712	10 809 376
Applications in credit institutions	1 690 628	682 346
Loans and advances to customers	31 583 759	28 940 788
Assets with repurchase agreement	-	-
Held-to-maturity investments	-	-
Hedging derivatives	318 596	259 129
Non-current assets held for sale	3 182 479	2 879 699
Active units in discontinuation	40 327	1 399 634
Investment properties	54 625	113 489
Other tangible assets	312 437	227 264
Intangible assets	221 168	202 563
Investments in associates and subsidiaries excluded from consolidation	405 486	393 767
Current tax assets	38 848	43 404
Deferred tax assets	2 535 423	2 476 605
Technical provisions of reinsurance ceded	7 696	6 733
Other assets	1 910 126	2 351 396
Direct insurance and reinsurance debtors	3 019	1 092
Other	1 907 107	2 350 304
TOTAL ASSETS	**57 529 359**	**55 290 985**
LIABILITIES		
Features of central banks	7 632 794	7 510 137
Financial liabilities held for trading	743 860	770 491
Other financial liabilities at fair value through results	-	-
Funds from other credit institutions	4 157 132	4 718 102
Customer resources and other loans	27 582 142	25 395 830
Liabilities evidenced by certificates	4 224 658	3 455 361
Financial liabilities associated with assets transferred	-	-
Hedging derivatives	77 846	107 128
Investment contracts	4 043 488	3 767 375
Non-current liabilities held for sale	162 709	157 705
Liabilities in discontinued units	92 893	719 149
Provisions	465 114	308 652
Technical provisions	1 344 216	1 370 797
Current tax liabilities	38 643	41 215
Deferred tax liabilities	12 336	16 607
Equity instruments	-	-
Other subordinated liabilities	56 260	47 185
Other liabilities	947 625	1 341 012
Lenders by direct insurance and reinsurance	17 301	13 728
Other	930 324	1 327 284
TOTAL LIABILITIES	**51 581 716**	**49 726 746**
CAPITAL		
Capital	4 900 000	4 900 000
Share premium	-	-
Other equity instruments	-	-
Own shares	-	-
Revaluation reserves	(249 748)	(255 583)
Other reserves and retained earnings	2 221 368	1 238 436
Return for the financial year	(980 558)	(362 620)
Anticipated dividends	-	-
Non-controlling Interests	56 581	44 006
TOTAL CAPITAL	**5 947 643**	**5 564 239**
TOTAL LIABILITIES + CAPITAL	**57 529 359**	**55 290 985**

The certified accountant The Board of Directors

Table 3 – Key Performance Indicators on 31 December 2015 and 30 June 2016

MAIN INDICATORS	31/dez/15	30/jun/16
Activity (million Euro)		
Assets	57 529	55 291
Loans and advances to customers (gross)	37 417	34 614
Deposits from Customers	27 364	25 061
Equity and quasi-equity	5 947	5 564
SOLVENCY [1]		
Common EquityTier I / Risky Assets	13,5%	12,0%
Tier I / Risky Assets	13,5%	12,0%
Total own funds/ Risky Assets	13,5%	12,0%
LIQUIDITY (million Euro)		
NET financing with the ECB	7 040	5 548
Eligible portfolio for *Repos* (ECB and others)	12 740	13 244
(Total credit-provisions for loans)/customer Deposits [1]	113%	113%
Liquidity Coverage Ratio (LCR)	77%	94%
ASSET QUALITY		
Overdue Loans > 90 days/Loans and Advances to Customers (gross) [1]	14,5%	15,7%
Non-performing loans/Total loans [1]	15,8%	17,4%
Non-performing loans, net/Total loans, net [1]	0,2%	1,3%
Credit ar Risk/Total Credit [1]	22,8%	23,9%
Credit at Risk, net/Total Credit , net	8,6%	9,0%
Provisions for non-performing loans/credit > 90 days	107,8%	104,3%
Provisions for loans/loans and advances to customers (gross)	15,6%	16,4%
Cost of risk	1,98%	1,63%
PROFITABILITY		
Result for the period (EUR millions)	-980,6	-362,6
Results before Taxes and non-controlling interests/average net Assets [1]	-1,6%	-1,6%
Banking income/average net Assets [1]	1,4%	1,6%
Results before taxes and non-controlling interests/average Equity [1]	-17,4%	-14,3%
EFFICIENCY		
Operating costs + Depreciation/banking product [1]	85,8%	68,1%
Personnel costs/banking product [1]	45,2%	35,2%
EMPLOYEES (number)		
Total	7 311	6 325
-Domestic Activity	6 571	5 885
-International Activity	740	440
NETWORK of BRANCHES (No.)		
Total	635	606
-Domestic	596	576
-International	39	30

[1] According to the instruction nº 16/2004 of the Bank of Portugal.

Table 4 – Credit Quality on 31 December 2015, 31 March 2016 and 30 June 2016

million Euro

CREDIT QUALITY	31/dez/15	31/mar/16	30/jun/16	Changes in the 1st trimester		Changes in the 2nd trimester	
				absolute	relative	absolute	relative
Credit to customers (gross)	37 417	35 207	34 614	-2 803	-7,5%	-593	-1,7%
Overdue Credit	5 791	5 824	5 878	87	1,5%	54	0,9%
Outstanding credit > 90 days	5 412	5 321	5 437	25	0,5%	116	2,2%
Credit at Risk (1)	8 547	8 114	8 283	-264	-3,1%	169	2,1%
Restructured credit (2)	6 634	6 760	6 657	23	0,3%	-103	-1,5%
Restructured credit not included in credit at risk (2)	3 927	4 086	3 721	-206	-5,2%	-365	-8,9%
Credit Provisions	5 833	5 894	5 673	-160	-2,7%	-221	-3,7%

(1) According to the definition in instruction nº 23/2011 of the Bank of Portugal.

(2) According to the definition in instruction nº 32/2013 of the Bank of Portugal.

BES' Financial Statement

It is also pertinent to analyse BES' financial statement before and after its resolution (Table 5), for posterior discussion and analysis. Notice that the central bank's resources were restored, and that most assets and liabilities transferred to Novo Banco.

Table 5 – BES' Consolidated Balance Sheet on the 31st December 2013 and 2014

(Thousands of euros)

	Notes	31.12.2014	31.12.2013 (1)
Assets			
Cash and availabilities in central banks		-	916 143
Availabilities in other banks	13	20 863	147 211
Financial assets detained for negotiation	14	-	1 102 113
Other financial assets with a fair value through results		-	2 937 434
Assets available to be sold	15	8 505	5 949 475
Applications in banks	16	50 076	9 583 337
Credit to clients	17	104 294	35 872 194
Investments detained until maturity		-	1 152 456
Derivatives for risk management		-	325 021
Non-current assets detained to be sold		-	1 356 013
Other tangible assets	18	10	327 135
Intangible assets	19	22	109 777
Investment in associates and branches	20	11 350	2 617 839
Assets regarding current taxes		-	14 727
Assets regarding deferred taxes		-	1 003 735
Other assets	21	1 485	2 752 951
Asset`s total		**196 605**	**66 167 561**
Liabilities			
Central banks`resources		-	9 305 318
Financial liabilities detained for negotiation	14	10 418	999 839
Resources of other banks	22	26	5 470 806
Clients`resources and other loans	23	696 277	33 446 504
Responsibilities represented by titles		-	8 245 875
Financial liabilities associated to transferred assets		-	635 609
Derivatives for risk management		-	86 419
Provisions	24	1 126 851	505 472
Liabilities regarding current taxes		1	6 721
Liabilities regarding deferred taxes		-	55 417
Subordinate liabilities	25	934 258	1 034 748
Other liabilities	26	107 949	673 149
Total of Liabilities		**2 875 780**	**60 465 877**
Equity			
Capital	27	6 084 696	5 040 124
Issuing premiums	27	1 038 923	1 059 700
Other capital instruments	27	191 571	191 734
Own shares	27	(801)	(801)
Reserves, retained earnings and other comprehensive income	28	(796 573)	(126 505)
Net result of the exercise		(9 196 991)	(462 568)
Total of Equity Capital		**(2 679 175)**	**5 701 684**
Total of Equity and Liability Capital		**196 605**	**66 167 561**

(1) For comparison effects shall be taken into consideration the information stated in Note 31, which Included the balance of August 4, 2014 after the application, by the Bank of Portugal, to BES of the resolution measure

KPIs from other Banks

It is interesting to analyse the price to book value of other reference banks (Table 6). Notice the big difference between the group BCP, Popular and Banif to the rest. It is normal to expect a P/B ratio of 1 when there is trust in the bank's accounts and predictions; lower values represent the market's distrust as to the estimated risk pertaining to certain assets in the books. Bankinter is the exception, with the market expecting it to grow and increase its revenues.

Table 6 – Price to Book Value of Reference Banks[5]

Banks	P/B
BCP	0,18
Banco Popular	0,25
Banif	0,09
CaixaBank	0,95
BBVA	0,96
BankInter	1,65
BPI	0,73
Santander	0,98

Table 7 portrays the credit at risk / total credit for some reference banks. Notice that, as expected, Bankinter has the lowest credit risk, and BBVA, CGD and BCP have values a bit over 10%. When compared to the 23,9% of Novo Banco, something seems odd – in spite of being a "good" bank, a significant number of troublesome credits remained in Novo Banco, with high probability to default (basically institutional credit, since consumer credit was deemed much safer). It was this credit that had most potential buyers demand some sort of Government guarantee for buying Novo Banco.

Table 7 – Credit at risk /Total credit for reference banks[6]

CGD	BPI	BCP	Popular	Santander	BBVA	Bankinter
11.50%	4.60%	11.30%	8.30%	4.80%	12.10%	4,13%

Accompanying Excel File

This case has an accompanying excel file to calculate Novo Banco's cost of equity, the WACC, the real worth of the Deferred Tax Assets and perform a valuation based on FCFEs (Free Cash Flows to Equity). The Excel sheet should be straightforward to use, with built-in formulas and self-explanotary reasoning. It is intended to be a didactic tool.

[5] All banks except CaixaBank operate in Portugal. Notice however that CaixaBank was in the process of buying BPI Bank.

[6] Taken from consolidated reports of the year 2015.

Annex A - Bank of Portugal[7]

From nationalization until 1997

After the Portuguese revolution of 25th April 1974, turning the government into a democracy, the Bank of Portugal had its functions and statutes redefined through the Organic Law published on 15 November 1975, giving it the role of a central bank and, for the first time, powers to supervise the banking system. Due to social changes, monetary policy became more active the Bank of Portugal took on important responsibilities in terms of monetary and credit control, as well as organizing and regulating the money markets, especially after Portugal joined the European Community in 1986. As budgetary policy tightened, and since there was growing integration in European markets, the Bank of Portugal's functions became more similar to those performed by the other European central banks.

A new Organic Law was approved in October 1990. Its main changes included imposing constraints on the financing of public deficits and granting greater independence to the Bank's Board of Directors. Economic policy underwent substantial changes in 1992, reflecting the option to pursue policies seeking nominal stability. In April of the same year, the Portuguese monetary coin, the escudo, joined the Exchange Rate Mechanism of the European Monetary System. Capital movements were completely liberalized in December, making the escudo fully convertible.

The Bank of Portugal's Organic Law underwent profound changes in 1995 as part of the preparation for Economic and Monetary Union. Price stability became the Bank's main mission. It was granted greater autonomy in the conduct of monetary policy, and it was given more responsibilities in payment systems.

Economic and Monetary Union

The Organic Law of the Bank of Portugal went through major changes once again in January 1998 to reinforce its independence as a central bank, under the terms required for Portugal's participation in Stage Three of Economic and Monetary Union, and to prepare its integration in the European System of Central Banks.

On 2 May 1998, the Heads of State or Government of the European Union decided that Economic and Monetary Union would begin on 1 January 1999 with 11 participating Member States, including Portugal. At the same time, the ministers of the Member States adopting the euro as their single currency, the governors of their central banks, the European Commission and the European

[7] Extracted and adapted from https://www.bportugal.pt/en/page/history

Monetary Institute reached agreement on how to determine the irrevocable conversion rates for the euro.

The Bank of Portugal joined the European System of Central Banks on 1 June 1998. On 1 January 1999, following the adoption on the previous day by the Council of the European Union of the irrevocable conversion rates between the euro and the currencies of the 11 participating Member States, the third stage of Economic and Monetary Union began, and was marked by a single monetary policy and a single currency – the euro. The currencies of the 11 participating Member States, including the escudo, became national denominations of the euro. Euro banknotes and coins were put into circulation on 1 January 2002. The Bank of Portugal had a preeminent role in the physical introduction of the euro in Portugal, including in the accompanying information campaign.

From financial crisis to Banking Union

The international financial crisis that began in 2008 exposed a number of vulnerabilities in the architecture of Economic and Monetary Union. The legislation passed to rectify these shortcomings once again resulted in great changes to the Bank of Portugal 's responsibilities.

In 2012, the Bank was granted powers to intervene in supervised institutions in situations of structural financial imbalance, with a view to maintaining financial stability. As part of the conclusions of the European Council and the Euro Area Summit Statement in June 2012, the European Commission presented a package of legislative proposals to create a Single Supervisory Mechanism, formed of the European Central Bank and national banking supervisors. This mechanism would be the first step to creating a Banking Union in Europe to ensure the consistent application of banking system rules, thus reinforcing Economic and Monetary Union.

To safeguard the Bank of Portugal's participation in the new Single Supervisory Mechanism, the Organic Law was amended again in 2013. The Bank was simultaneously designated Portuguese macroprudential authority and became formally responsible for identifying, monitoring and assessing risks to financial stability and for adopting corresponding preventive and mitigation measures. With the entry into force of the Single Supervisory Mechanism, the first pillar of the Banking Union, in November 2014, the Bank began to exercise its banking supervision competencies in a shared model with the European Central Bank and the other national competent authorities.

The second pillar of Banking Union, the Single Resolution Mechanism, entered into force in 2016. The Bank of Portugal's resolution responsibilities then started to be exercised within the framework of this mechanism.

Annex B – Marketing for Novo Banco

Marketing for Novo Banco was done with the symbol of a butterfly and subtitle "A good start" – the idea was to create a fresh brand, created from the good assets of BES, providing this new bank with an excellent start, since it would start off with a big number of clients and the same countrywide coverage that BES had. Massive campaigns were made so that people felt safe with the bank. The butterfly represented the ability to transform and renew.

The butterfly was then replaced by a symbol of its wings, at the end of the bank's name, representing a matehmatical power [Mkt NB 2014]. This symbolized "the future growth and assumed compromise of the Novo Banco's team to put it back into a leadership position", as stated in its press release.

NOVO BANCO

This next picture is translated as "new bank, old habits". This message might seem awkward, especially since Novo Banco came from BES, and BES went bankrupt due to bad management and corruption. However, BES was previously seen and perceived as a very good bank, where account managers followed their clients closely. The intended message was to instruct its clients that they can and should continue to use Novo Banco exactly the same way they used BES.

NOVO BANCO

VELHOS HÁBITOS

i 23/09/2015

Annex C – BES Board of Directors' Message at the end of 2014[8]

Context – The Resolution Measure

The current Board of Banco Espírito Santo, S.A. (BES) was appointed by the Bank of Portugal on August the 3rd 2014, with one year term, respecting the framework of the applied resolution, on the same date, to this Institution, being its term extended by the Bank of Portugal on July the 30th 2015, with effect from August 3rd of the same year, until the date of BES`s authorization revocation towards the exercise of the activity or until a maximum deadline of one year.

BES is an institution with its roots in the 19th century being one of the oldest banking institutions in Portugal. Due to the work, capacity and dedication of its mentors and of all who all these decades worked in it, it is one of the most prestigious banks in Portugal, being nationally and internationally well known. Unfortunately, however, the result of a range of events which gave rise to a dramatic crisis in the Institution, ushering to its resolution, many people are suffering with the major losses which were verified, in different levels, in different titles and with different latitudes, and these people feel, in a very understandable way, that their trust was betrayed.

With the application of the resolution measure the nature of BES, as an institution and its legal status were deeply changed. Since then, and based on the effect of the resolution applied by Portugal Bank on August the 3rd 2014, almost all Assets, liabilities, off-balance-sheets elements and managed Assets of BES were transferred to a new bank, the transition one - Novo Banco, S.A. In the sphere of BES was kept a residual group of Assets, identified in the deliberations of the Bank of Portugal regarding the resolution. Such assets are, essentially, credits over entities of Espírito Santo Group, most with a very low recovery rate, and the three subsidiaries, all, for different reasons, with very complex situations (Banco Espírito Santo Angola, with its headquarters in Luanda, Espírito Santo Bank, in Miami, United States and a participation of 40% of Aman Bank for Commerce and Investment, in Tripoli, Libya).

In the liabilities the responsibilities regarding the subordinated bonds holders and the contingent liabilities regarding Oak Finance Luxembourg, S.A. (according to the deliberations of Portugal Bank of December the 22nd 2014 and of September the 15th 2015) have been increasing substantially and, also, the entities and private deposits especially related to BES.

All the human resources, logistics and operations which previously belonged to BES, were also moved to Novo Banco, S.A. On the other side, since August the 3rd 2014, accomplishing a determination of the Bank of Portugal, BES is forbidden to receive deposits and grant credits and use funds in any kind of Assets, except in the measure with the application of funds deems to be necessary towards the preservation and valuation of its asset. Besides this, it is not obliged to accomplish the applicable prudential norms.

Between August the 3rd 2014 and August the 3rd 2015 was exempt of the punctual

accomplishment of obligations contracted prior to the resolution date, except if this

accomplishment reveals itself important towards the preservation and valuation of its Assets, in this case the Bank of Portugal can authorize, following a proposition of BES, the necessary operations for

[8] Extracted (and adapted in some parts) from [BES 2014C]

that effect. From August the 3rd 2015, this aspect is regulated by the disposed in article 145th - L, No. 7 of the General Regime of the credit institutions and financial societies (RGICSF), as indicated by the Decree-law no. 140/2015 of July the 31st, due to which the bonds contracted prior to the application of the resolution measure which have not been transferred to the transition institution "are non-demandable to the institution which is the object of the resolution, with the exception of the one whose accomplishment, the Bank of Portugal determines to be important to the preservation and valuation of its asset." BES keeps the bank license, since the same was not (yet) revoked however, the scope of its activity is deeply restricted in virtue of the prohibitions and dismissals which target nuclear aspects of the banking activity.

However, such revoking will necessarily occur, because that is one of the commitment assumed by the Portuguese State regarding the Decision of the European Commission which approved the help of the Government which helped the resolution of BES to Novo Banco, S.A. [Decision no. SA.39250 (2014/N)]. When the license be revoked, BES will be, by the operation of law, in a process of judicial winding-up.

Unique Situation

The resolution of BES was the first resolution of a bank in Portugal. It was performed regarding the law created in 2012, even before the Directive 2014/59/UE of the European Parliament and of the European Council of May the 15th 2014, which established a European frame towards the recovery and resolution of credit institutions and investment companies. Its transposition, performed by the Law no. 23-A/2015 of March the 26th represented an important step towards the implementation of the European bank union but, to what concerns BES resolution, it was not an additional aspect of the process of complexity in virtue of the problems which come from the succession of the legislation and its application in time.

It is therefore correct to state that the resolution of BES constitutes a unique situation, not only in Portugal but even in the European Union, with the extra difficulty of being applied in a bank of big dimensions, the third one operating in Portugal. Therefore, it creates a difficulty to its members, including the Board of Directors, but also the stimulation, of pioneer happenings, in which there is no previous experience to deal with the challenges faced.

Working Conditions for the BES Management Team

The context in which the current BES management team must perform their duties is strongly restrictive in several aspects and very atypical. These constraints relate at a great extent to the issues arisen to comply with the required resolution of the legal framework in which, the powers are conferred to the Bank of Portugal, as well as those resulting from the European Commission decision referred to above.

Therefore, the protection of the interests of BES' shareholders and creditors can only be exercised when there is a legal framework for the resolution, in particular taking into account the guiding principles and aims of the measure determined by the Bank of Portugal. The greatest difficulty of management is the fact that the current BES have to start work immediately without being provided with a structure. So we had to set up a new structure – a new BES - and at the same time comply with the obligations of various kinds, to which we were linked.

Given this overall framework, in the first meeting of the Board of Directors held on August 5, 2014, we defined the following lines of priorities:

- Give BES an operation structure which allows the development of its new mission;
- Assure the accomplishment of all legal obligations, namely, tax and regulatory obligations to which BES is bound;
- Preserve and value of its Assets whenever is possible;
- Collaborate, in the applicable legal framework, with the entities that are investigating the previous BES management team in order to identify any harmful acts of the institution, and proceed with the instruments at its disposal, the evaluation thereof, in order to trigger the relevant initiatives.

Our management has been centered in the accomplishment of these aims. The Management Report which is now presented explains, in a very detailed way, the way such aims were achieved and signals the main management results.

Therefore, we consider it is important to explain some aspects. First, it should be noted that the delay in reporting cannot be dissociated from the extreme complexity and the innovative character of the current BES situation, and noted that only on August 7, 2015 there were conditions to disclose to the market the accounts on 4 August 2014, the indispensable basis for the submission of accounts to December 31, 2014, now published, which state all relevant developments subsequently occurred. It is also important to note that the action of this administration is object of monitoring not only by the normal powers of the supervisory body - the Supervisory Board - and the external auditor, but also by the powers that the law gives the Bank of Portugal to deal with banks object of resolution and also for monitoring the position of an independent entity, the way that the commitments are being implemented which result for BES of the European Commission Decision previously referred, which involves the bi-annual reports to be submitted to this Commission.

The situation that led to the resolution of BES caused huge losses to thousands of people and entities, and also generated, as would be normal in such a situation, an intense emotional context. Aware of the importance of responding to the clearing needs of the interests of holders in BES, this administration from the beginning of their duties, sought dialog with all those who wanted explanation, exposing the resolution measure contours and answering numerous questions. To make the most effective response to this request for information, BES institutionalized specific channels of communication, through various e-mail addresses, so as not to let anyone unanswered. We also created a new website, adapted to the new BES organization.

On the other hand, this Board of Directors understands that the best way to deal with the uniqueness and complexity of its mandate is to address all the issues it faces taking having as a decisive criterion of action the rule of law and observance of structural principles of the rule of Right. In fact, if such a criterion of performance is key in any circumstance, it becomes even more imperative for an institution with the current legal status of BES. It should also be noted, on another level, that one of the guiding principles for the implementation of the resolution measure [cf. Article 145-B, paragraph 1, point c) of RGICSF, in the wording in force at the measurement date of resolution] is that no creditor can assume a bigger damage than the one which would take in case, instead of being the object of the resolution, BES had entered immediately into liquidation. To give effect to this principle, the law provides that an assessment is made, in charge of an independent body designated by the Bank of Portugal, at the expense of BES, to carry out an estimate of the level of recovery of claims of each class of creditors, according to the order of priority established by law, a BES liquidation scenario immediately prior to the implementation of Resolution measure (cf.145-F articles, paragraph 6, and 145-H, n. No. 4, both of the RGICSF in the wording in force at the measurement date of termination). Such an assessment is ongoing and is a very important element for the outcome of the resolution of measurement. Indeed, the provisions of Article 145-B, paragraph 3, of RGICSF also in the wording in force at the date of the resolution, follows that if at the end of BES settlement is found that the creditors of the institution whose non credits have been transferred to Novo Banco assumed a higher loss to the amount estimated in the above mentioned assessment, namely that received less than they would if BES had gone into liquidation immediately prior to the resolution measure, are entitled to receive, in the Resolution Fund, this difference.

In terms of management results, we believe it is important to stress that, despite all the difficulties, this administration has, in little more than a year to recover significant amounts of credit, thus increasing in a very expressive way, their cash holdings face to the value of EUR 10 million that remained in the institution because of the implementation of the resolution measure. The taxation issues, in its many implications, regarding a legal framework that leaves room for many doubts are also a generator topic of great difficulties, as you realize in this report. Besides this, the situation of BES subsidiaries has always been a central preoccupation. Indeed, everything less good to pass this plan, in addition to negative effects on BES, could lead to additional losses, reputational, for the Portuguese financial system, which required the greater diligence to avoid such a scenario. In this sense, we do not fail to point out the fact that we have achieved in extremely difficult conditions, the sale of the stake in Aman Bank and, also, the agreement made for the sale of ES Bank in Miami, which is still awaiting approval the regulatory authorities of the United States, but whose most recent signs are very encouraging.

Best-Effort Situation

We accepted the charge of BES`s Management in this very special situation with a clear notion of the enormous difficulties of the mission, but we cannot anticipate all of them, to the extent that it is an experience that, as already noted, is unparalleled. We set out to do the best that we were able, looking at the size of the mission that fell in, to make a contribution to resolving the delicate situation in which the financial system was confronted in August 2014. That is what we are going to continue doing.

Annex D – Portugal's Outlook after its Financial Assistance Program

In May of 2014, the Government announced the conclusion and withdrawal of the Economic and Financial Assistance Program - EFAP (agreed with the EU and the IMF in May 2011), without having to resort to additional external financial assistance, regaining access to finance in international debt markets. After three years of the Economic and Financial Assistance Program, the Portuguese economy made important progress in correcting several macroeconomic imbalances, and structural measures have been implemented in several areas. According to the Bank of Portugal, the objectives of the EFPA were fulfilled globally, with some fundamental impacts on the Portuguese economy, such as the net external financing capacity, the primary structural adjustment (of the order of 8% in the period 2010-2014, according to IMF), the fiscal consolidation, as well as the transfer of resources from the non-tradable to the tradable sector, all of which are elements favourable to the process of sustainable growth.

In 2015, per INE (Portuguese Statistic Nacional Institute), the Portuguese economy recorded a 1.5% increase in GDP in year-by-year terms (after + 0.9% in 2014 and -1.1% in 2013). This recovery was driven by the favourable performance of internal demand (+ 2.5% than 2014), reflecting the acceleration of gross fixed capital formation (+ 4.1%) and private consumption (+ 2.6%) and Increase in public consumption (+ 0.6%, after several years of successive declines). Per the same source, real growth in exports of goods and services was 5.2% in the last year (with the goods component growing by 5.9% and services by 3.1%), while imports Increased by 7.6%. The combined current and capital account balance was positive in 2015, standing at 1.7% of GDP. In the second quarter of 2016, GDP recorded a year-on-year increase of 0.9%, per INE. Net external demand had a slightly positive contribution, reflecting the deceleration of imports of goods and services that was more pronounced than that of exports. It should be noted that the projections by the Bank of Portugal for 2016 pointed to a moderate recovery of the Portuguese economy, with a GDP growth of 1.3% (projections by the European Commission for Portugal and for the Euro Zone, were 1.5% and 1.6%, respectively), accelerating in 2017 to 1.6%.

The expected evolution, in the context of deteriorating international economic situation, was expected to be a result of lower domestic demand growth (+ 1.8% in 2016 and + 1.7% in 2017), gross fixed capital formation (+ 0.1%, accelerating in 2017, + 4.3%), and the deceleration of exports of goods and services in 2016 (+ 1.6%, then recovering + 4.7% In 2017). The latter would reflect, on the one hand, the evolution of fuel exports and, on the other hand, the lower growth of external demand directed at domestic exporters. In terms of components, both exports of goods and services were expected to decelerate in 2016, although the tourism component was expected to continue to grow much faster than exports, which, per the Bank of Portugal, was one of the sectors that most contributed to the Recovery of the Portuguese economy and for the maintenance of the foreign financing capacity. According to the Bank of Portugal, the weight of exports in GDP was expected to continue to increase in the following years, from 40% in 2015 to 42% in 2018 (31% in 2008). The financing capacity of the Portuguese economy was also expected to continue, with a combined current and capital account balance expected to be below 2% of GDP in the period 2016-2017 (1.9% in 2016 and 1.6% in 2017).

Per the European Commission (Economic European Forecast - Spring 2016), Portugal's employment growth slowed at the end of 2015, with an annual average of 1.4%, with a more moderate growth in the period 2016-2017 (0.9% and 0.7% respectively). The unemployment rate reached 12.6% of the active population in 2015 and was expected to continue to decline fall below 11% by 2017. The public-sector deficit was expected to decline to 2.7% of GDP in 2016 and 2.3% in 2017. The share of public debt in GDP was also expected to decline in this period (126% in 2016 and 124.5% in 2017).

Annex E – Portuguese Banking Crisis[9]

Portugal's economy had long been a source of some concern for European policymakers (especially since 2008), but the risks surrounding the country in 2016 were reaching a wider audience, as an ongoing banking crisis — not quite equal to the one in Italy, but significant nonetheless — and a generally sclerotic economy, dominated people's thinking in the Iberian state.

Numerous banks, international organizations, and economic research firms, including HSBC, Brown Brothers Harriman, and the IMF had already warned about the fragile state of Portugal's banks and its wider economy. Barclays analysts summed up the big problems facing Portugal in a research note, and provided a series of charts to illustrate just how bad those problems were. Here is a key extract from Barclays about the country's banking system:

"Several Portuguese banks are also in need of immediate attention. In addition to the sale of Novo Banco, the bigger and more pressing issue is the resolution of problem loans in the largest deposit-taker Caixa Geral. As a result of sizeable bank recapitalisation needs (c.EUR7.5bn), fiscal slippages and a worsening macro-economic outlook, we believe the funding needs for the Portuguese Treasury will be larger than the authorities currently estimate. The need for another programme for Portugal is a serious risk."

Barclays noted that a material slowing in the wider Portuguese economy was on its way, saying: "We are expecting Portuguese growth to decelerate further post-Brexit both this year and next. We forecast investment and private consumption to slow materially, pushing 2016 growth down to 0.7% and 2017 to 0.3%." (Figure 2).

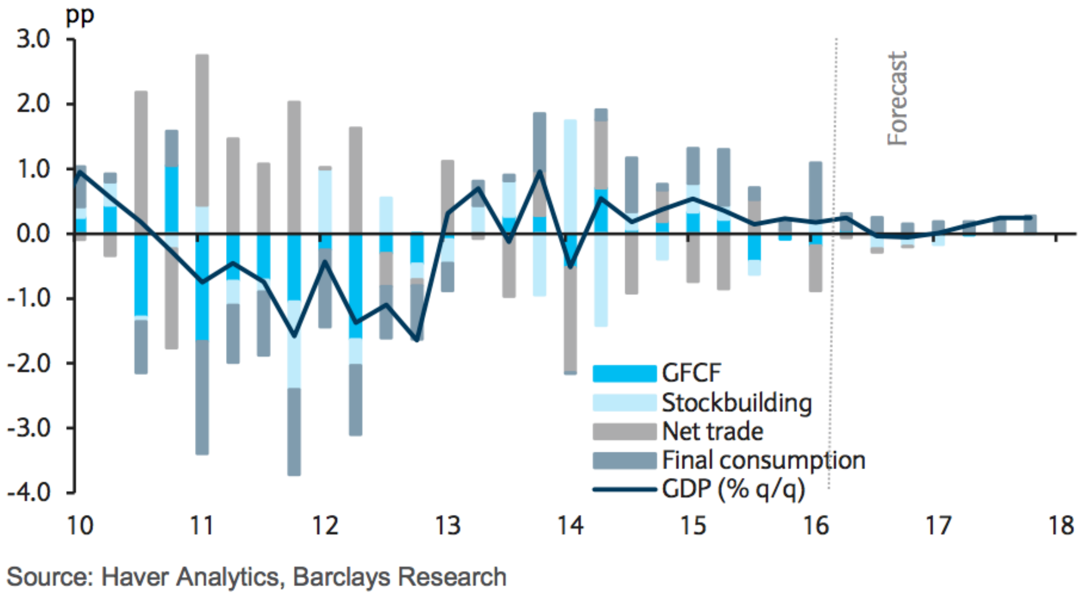

Figure 2 – Portuguese consumption-driven recovery likely to lose steam

Portugal also had massive problems with indebtedness. Barclays again: "We expect public debt to increase from 130% of GDP in 2015 to c.132% in 2016 and remain above 130% through 2020. We still think the government can achieve (and sustain) a primary fiscal balance slightly above 1% of GDP

[9] Extracted and adapted from [Barclays 2016]

over the medium term, which would be sufficient for stable debt dynamics. However, even moderate shocks to the medium-term growth or fiscal parameters would place the debt-to-GDP ratio on an ever-increasing path." (Figure 3).

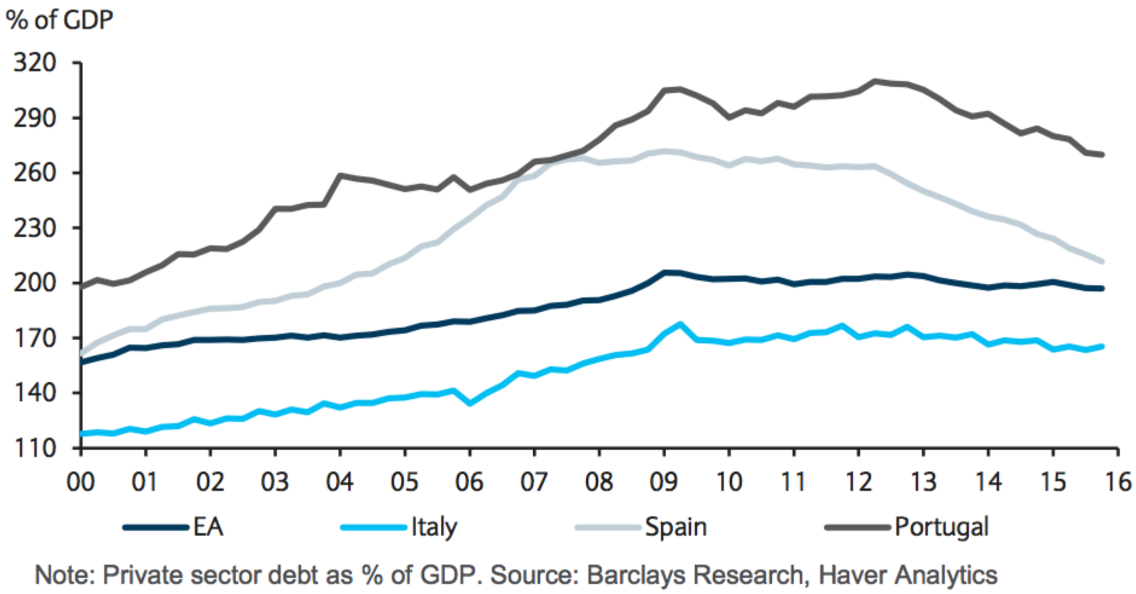

Figure 3 – Portuguese economy hampered by excessive private indebtedness

Portugal's economic performance had been less than stellar since the government exited its bailout program in 2014. Furthermore, there was the possibility of another potentially damaging event for the Portuguese economy — a possible fine from the European Commission. Both Portugal and Spain dodged fines for breaking EU-mandated targets for deficit reduction after Jean-Claude Juncker intervened to delay any fines. The fines had been delayed until the completion of the Spanish general election in June 2016, and placed on hold. Portugal could get slapped with a hefty fine for running a 4.4% budget deficit in 2015. The EU target set for the country was just 2.7%. Any fine would be another huge blow to the delicate state of Portugal's finances.

Annex F – Case Questions

This annex separates the case questions by topic:

Strategy

1) Did the government follow the correct strategy by delegating the problem to the Bank of Portugal, instead of nationalizing the bank as it did in previous situations?
2) Why did the Bank of Portugal choose to create a new temporary brand of the bank?
3) Did the EU proceed correctly by imposing a forced sale of the bank?

Finance

1) Calculate Novo Banco's cost of equity, based on the market share values of Montepio, BCP and Banif (provided in the student Excel file – use the CAPM model, via the unlevered betas of the 3 forementioned banks agains the Portuguese stock market, PSI-20).
2) Calculate Novo Banco's WACC, knowing that its cost of debt is 2%.
3) Should the bank be liquidated?
4) How much is the bank worth, in comparison to similar banks (since we don't have any details on the bank's future restructuring, use the comparable method for the Price to Book value of similar Portuguese Banks)?
5) What is the bank's corrected equity value, after the deferred tax assets are realistically valuated? (hint: calculate the realistic value of the deferred tax assets, assuming that they all have an expiry period of 12 years[10] and that the bank's projected results before tax for the upcoming 12 years are, in M€, the following values[11]: [-600; -300; -150; 50; 100; 150; 200; 200; 200; 200; 200; 200]).
6) Assuming the values from the previous question, a tax rate of 23%, CAPEX of 50M€ for the first 3 years and of 20M€ henceafter, calculate Novo Banco's worth based on discounted FCFE (Free Cash Flow to Equity) values, assuming there are no DTAs, changes in working capital nor changes in borrowings.
7) What's your opinion about left-wing political parties claiming the Lone Star fund to be a "vulture" fund, wanting to make big profits at Novo Banco's expense?
8) May European low key interest rates influence the current state of Portuguese (and european) banks?
9) Suppose that NovoBanco wanted to sell a risky asset, namely a 10 year credit of 10M€, paid yearly in equal installments at an interest rate of 10%. The potential buyer however thinks that the asset's risk is about twice as much as initially diagnosed (it should pay roughly twice the interest rate). How much could the buyer pay for this asset (valued at 10M€ in the books)?
10) How does a financial carousel scheme work (in BES' case)?

Marketing

1) What do you think of Novo Banco's marketing strategy?

---

[10] In truth, the value of the DTA (Deferred Tax Assets) in the balance sheet is the sum of all DTAs, each with a different expiry date, but for exercise purposes we can assume that they all have the same expiry date. There were also some legislation changes at this level in 2016 and 2017, but we will overlook that for simplicity.

[11] Since the case does not focus on DCF projection and valuation, these projections might be understood as a proxy, without the need to explore the corresponding rationale.

2) If you were a BES customer, would you risk keeping your savings and financial application on Novo Banco?

Ethics

1) Comment on Portugal's president actions by warranting BES public offering subscribers that the bank was stable and was a good investment.
2) Should the government pay for its president's actions?
3) Should the government give any money to people who were "deceived" by former BES consultants, with "risk-free" financial products?
4) Are senior-BES bondholders right to place the Bank of Portugal in court, after it decided to put the obligations back from Novo Banco to BES?

Politics

1) Should the government intervene in Private banks? How can the government protect its population deposits in a private institution? It it its job to do so? Who should pick up the tab?

References

[Bank of Portugal 2017] https://zap.aeiou.pt/banco-portugal-sabia-da-falencia-do-bes-17-meses-da-derrocada-150977

[Bank Portugal 2015] http://expresso.sapo.pt/economia/2015-12-29-Investidores-do-BES-perdem-mais-2-mil-milhoes

[Barclays 2016] http://www.businessinsider.com/barclays-analysis-on-portugal-economy-and-banking-crisis-2016-7

[Bento 2014] http://www.jn.pt/economia/interior/equipa-de-vitor-bento-confirma-saida-do-novo-banco-4122928.html

[BES 2014A] http://www.dn.pt/economia/interior/bes-ultrapassa-bcp-como-maior-banco-privado-portugues-3866303.html

[BES 2014B] http://expresso.sapo.pt/economia/aumento-de-capital-do-bes-totalmente-subscrito=f875118

[BES 2014C] BES Statement of Accounts 2014

[Brexit 2016] https://www.thebalance.com/brexit-consequences-4062999

[Carousel 2014] https://www.dinheirovivo.pt/invalidos/bes-injetou-dinheiro-na-esi-atraves-do-bank-of-panama-durante-dois-anos/

[CGD 2016] http://www.jn.pt/economia/interior/caixa-fecha-300-balcoes-e-corta-2500-postos-de-trabalho-5241709.html

[China 2015] https://www.idealista.pt/news/financas/fiscalidade/2015/08/26/28601-crash-na-bolsa-chinesa-afeta-novos-donos-do-besi-e-da-fidelidade-e-candidatos-ao

[DBRS 2017] http://observador.pt/2017/01/12/dbrs-nacionalizacao-do-novo-banco-ameaca-o-rating-de-portugal/

[Drama 2015a] http://observador.pt/2015/06/04/clientes-lesados-acusam-funcionarios-do-novo-banco-burla-qualificada/

[Drama 2015b] https://sol.sapo.pt/artigo/409268/funcionarios-do-novo-banco-resistir-as-ameacas-atras-do-balcao

[EC 2014] https://www.dinheirovivo.pt/banca/comissao-europeia-aprova-solucao-do-banco-de-portugal-para-o-bes/

[End Sale 2015] http://expresso.sapo.pt/economia/2015-09-15-Venda-do-Novo-Banco-so-depois-das-eleicoes

[Equity 2017] http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/wacc.htm

[Fecho 2016] http://observador.pt/2016/10/19/novo-banco-um-em-cada-quatro-balcoes-fecham-em-ano-e-meio/

[Fundo Resolucao] www.fundoderesolucao.pt/

[Mkt NB 2014] http://www.jornaldenegocios.pt/empresas/banca---financas/detalhe/novo_banco_muda_de_simbolo_e_fica_apenas_com_as_asas_da_borboleta

[Novo Banco 2016] "Relatório e contas intercalar, consolidade e individual, 1º semestre de 2016", Novo Banco's report for the first semester, 2016.

[Novo Banco 2017A] http://www.jornaldenegocios.pt/empresas/banca---financas/detalhe/venda-do-novo-banco-gera-100-questoes-so-em-2017

[Novo Banco 2017B] http://www.jornaldenegocios.pt/empresas/banca---financas/detalhe/obrigacoes-novo-banco-grandes-investidores-avisam-que-portugal-ganharia-com-um-acordo

[Observador 2016] http://observador.pt/2016/03/29/presindete-do-novo-banco-diz-despedimento-coletivo-ira-abranger-150-trabalhadores/

[Zap 2015] https://zap.aeiou.pt/banco-de-portugal-elimina-2-dos-17-candidatos-a-compra-do-novo-banco-58868