COMMERZBANK

Banco Espirito Santo (BES)

9 July 2014

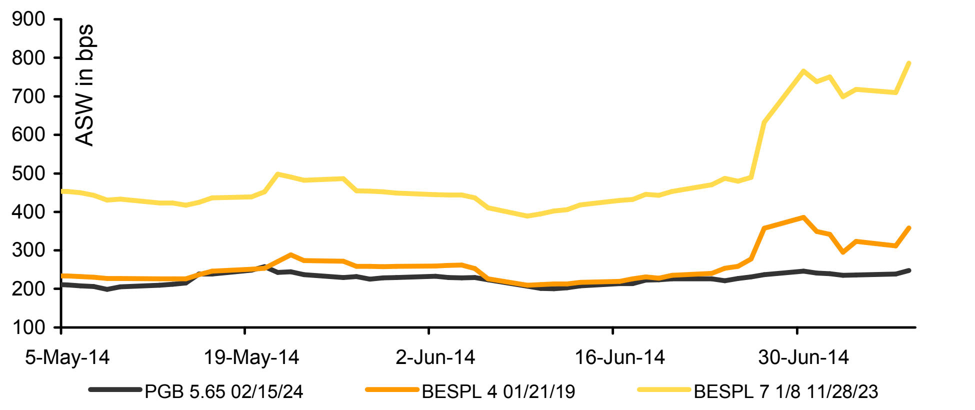
More upside than downside

The BES saga continues with the missed payment of commercial papers issued by Espirito Santo International SA (ESI). Subsequently, BES's senior and subordinated spreads widened sharply. Although we expect negative headlines for BES to persist for a while we place an Overweight on BES, which we would trade mainly via senior bonds. BES's saga is not straightforward and the way to tighter levels could be a bumpy ride. News on further deconsolidation of BES from the Espirito Santo group should finally trigger a repricing though.

Regulator's push for independent management at BES is credit positive

The missed orderly CP payment of ESI reinforces market fears about further problems coming out of the top of the group. However, we expect BES will continuously be isolated from issues further up in the group structure. The Bank of Portugal has already enforced a new independent senior management at BES which clearly reduces the influence of the Espirito Santo family in BES. On 31 July, shareholders are expected to approve the new CEO and CFO. Besides, the Bank of Portugal has taken actions to ensure BES is "adequately isolated" from problems in other group entities but no further details were given.

CHART 1: **Renewed negative headlines around BES drive spreads to attractive levels**



Source: Commerzbank Corporates & Markets; Bloomberg

Catalysts: Q2 results, shareholder meeting, further restructuring, stress test

The next major catalyst for spreads could be an announcement of ESFG, the major shareholder of BES and 50% owned by ESI, to restructure its group. This could include selling assets like its Tranquilidade insurance unit to strengthen its capital which would render possible support from BES less necessary. BES's Q2 results on 25 July could give further insights. Next, at the general meeting on 31 July the proposed new CEO and CFO will be approved. While the implementation of the new management is positive any further balance sheet clean up subsequently could result in spread volatility in the short term. The results of the AQR/stress test in October and the ECB taking over as the new regulator in November leave potential for more surprises but also should allow more transparency.

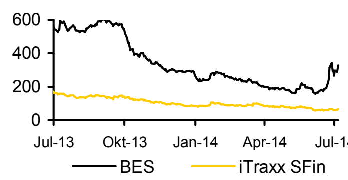
We Overweight BES and would trade this mainly via seniors

We Overweight BES senior bonds as we can hardly imagine a scenario where seniors would suffer losses in the short term. Seniors trade with a spread pick up in terms of c. 300bp-430bp vs. peripheral peers yielding 4.7%-6.2% p.a.. We also Overweight BES Tier 2 (7.125 11/28/2023) though risks are clearly higher here. An ASW spread of 860bp gives investors an attractive spread pick up versus peripheral AT1 bonds (c. 250bp-450bp). However, further negative headlines on BES are possible. Should additional capital needs materialise the way to bail-in of subordinated debt is much shorter than for senior debt.

Ratings

	LT	ST	Outlook
Moody's	Ba3	NP	RWN
S&P	BB-	B	negative
Fitch	NR	NR	NR

CDS EUR Senior 5Y



Source: Bloomberg

Financial calendar 2014

25 July	Q2 results
31 July	Extraordinary shareholder meeting
31 October	Q3 results

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How to trade?

Strong Overweight on seniors…

A loss scenario for senior bonds is unlikely in the short term

We recommend buying BES senior bonds as we could hardly imagine any loss scenarios for senior bondholders to realise by 2016. Spreads for BES senior bonds range from c. 400bp-580bp, which is unmatched in the peripheral senior area and very attractive in our view (left chart below). Although we expect spread volatility to persist for the time being we see little bail-in risk for senior bonds. Given BES's high systemic importance in Portugal, the bank would very likely receive external support, either via Portugal or the EU, if needed. Until senior bail-in comes into effect in 2016, only subordinated debt should take losses in such a scenario. Over the next months, as more clarity on BES's deconsolidation from the Espirito Santo group materialises and possible issues of the AQR/stress test will be addressed, the reduced uncertainty should be further priced out of senior spreads. While a bail-in of senior bonds would be theoretically possible from 2016 onwards, as the BRRD comes into force, we see the need for additional negative triggers to make this happen. Current issues should be addressed by then.

… and cautious Overweight on Tier 2

Positive on Tier 2 as long as no new capital shortfall arises at BES

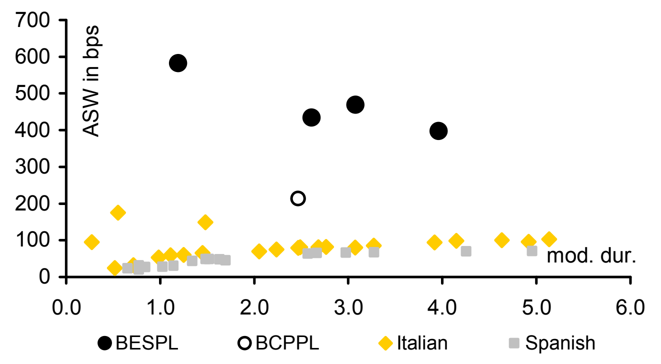
The story for Tier 2 is less straightforward in our view but should also be positive. While we see further progress on deconsolidation from the Espirito Santo family as good news, the new management could add some spread volatility in the short term. This is because the new independent management should have a strong incentive to clean up the balance sheet radically after taking over responsibility. Together with the pending results from the AQR/stress test, further negative surprises cannot be ruled out. Any possible capital shortfalls arising here from an associated participation of European or domestic sovereign funds should trigger a burden-sharing with Tier 2 debt according to EU state aid rules. While this is not our base case scenario, the impact would be material on Tier 2, as the BES 7.125% 11/28/2023 is the only relevant Tier 2 bond outstanding, increasing the possible haircut in such a scenario. While we remain Overweight the Tier 2 bond for now we would change it to Underweight in case BES requires further capital injections in the next months.

TABLE 1: **We Overweight BES senior and Tier 2 bonds**

Ticker	Rank	Coupon	Maturity	ISIN	Mod. Dur.	YTM	ASW bp	Price	Recommendation
BESPL	senior unsec.	5.875	09.11.2015	PTBESWOM0013	1.2	6.2	582	99.57	Overweight
BESPL	senior unsec.	2.625	08.05.2017	PTBEQKOM0019	2.6	5.0	434	93.96	Overweight
BESPL	senior unsec.	4.75	15.01.2018	PTBENJOM0015	3.1	5.2	469	98.42	Overweight
BESPL	senior unsec.	4	21.01.2019	PTBENKOM0012	4.0	4.7	398	97.25	Overweight
BESPL	Tier 2	7.125	28.11.2023	PTBEQJOM0012	3.4	8.4	859	90.66	Overweight

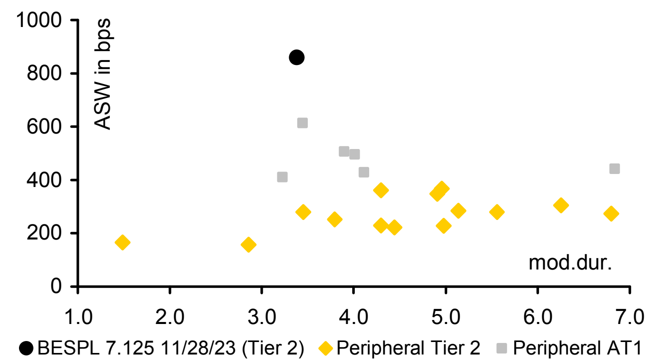
Source: Commerzbank Corporates & Markets

CHART 2: **BES senior spreads unmatched in peripheral area – large spread pick up versus other peripheral seniors**



Source: Commerzbank Corporates & Markets

CHART 3: **BES Tier 2 trades significantly above Spanish/Italian Tier 2 and even AT1**



Source: Commerzbank Corporates & Markets

The BES saga: What to expect in the next weeks and months

Further deconsolidation of BES from Espirito Santo family would be positive

Less influence from and interdependence with the Espirito Santo family is positive

ESFG is expected to present a restructuring plan in due course. We expect a further deconsolidation of BES from the Espirito Santo family and its holding structure. This would be clearly a supportive move for BES, in our view. Our expectations are supported by comments from the Bank of Portugal that BES has been “adequately isolated” from financial problems in some entities of the Grupo Espirito Santo. However, no further details were given on actions taken. Reportedly, the Espirito Santo Financial Group could sell assets to strengthen its capital and render support needed from BES less likely. Latest media reports suggest that ESFG is seeking a buyer for 100% of its Tranquilidade insurance unit. Previously, ESFG was only willing to sell a minority stake. Media reports also speculated BES could reduce its stake in BES Angola from c. 56% to below 50% in a possible capital increase in that unit, reducing the impact from further possible turmoil in that unit.

Exchange of senior management as requested by the regulator

Bank of Portugal substitutes BES’s senior management with independent managers

Pressured by the Portuguese regulator, ESFG has proposed outsider Vito Bento, an economist and ex-director of the Bank of Portugal, to replace Ricardo Espirito Santo Salgado. Previously, ESFG proposed BES’s CFO, Amilcar Morais Pires, who is a close confidante of the Espirito Santo family, as the new CEO but faced headwinds from the regulator which pushed for an independent management. Furthermore, ESFG also agreed to replace Amilar Morais Pires as CFO to meet the concerns of the Bank of Portugal. Given the expected changes for the CEO and CFO, as well as the resignation of five board members representing ESFG, the Bank of Portugal will change the perimeter of consolidated supervision, which will now be Banco Espirito Santo. So far, ESFG was the relevant consolidated level for regulatory supervision and ESFG is also the entity to be considered in the AQR and stress test. We would not rule out that the scope of the regulator in the AQR/stress test is shifting towards BES. We expect shareholders to approve the new management at the shareholder meeting on 31 July, as Credit Agricole has already stated its commitment to the new management. This would be a positive step for BES.

Risks we see in the next months

Further balance sheet clean up a major risk for BES

Headline risk for BES is unlikely to abate soon. While the approval of the new management at the shareholder meeting on 31 July should be rather a formality, the implications could be more far-reaching. The new and independent management could take decisive steps as it should have a strong incentive to provide a clearer view on BES and regain the trust of investors. This could include potential changes to the bank’s strategy, reviewing the entire balance sheet and BES’s interdependence with the Espirito Santo family entities. This could potentially lead to further one-off charges over the next months.

Additionally, the AQR/stress test could uncover further capital needs in October, given BES’s still moderate credit metrics. This includes BES’s problems in Angola, where loan loss provisions rose unexpectedly in Q1. BES holds a 56% stake in BES Angola which has a total of €6bn loans on its balance sheet, of which c. 70% are covered until mid 2015 by a guarantee of the Republic of Angola. Reportedly, BES has €2bn cash invested in BES Angola which might be hard to get back if the situation in Angola worsens seriously.

Besides, a possible revealing of stronger linkages with the rest of the Espirito Santo entities as currently disclosed should add to spread volatility. Given statements from the Portuguese government that BES had adequately been isolated by the Bank of Portugal from problems in other entities of the group, this risk should be somewhat reduced now.

What has happened so far?

€1bn capital increase strengthens balance sheet and reduces family influence…

Capital increase and reduced family influence are credit positives

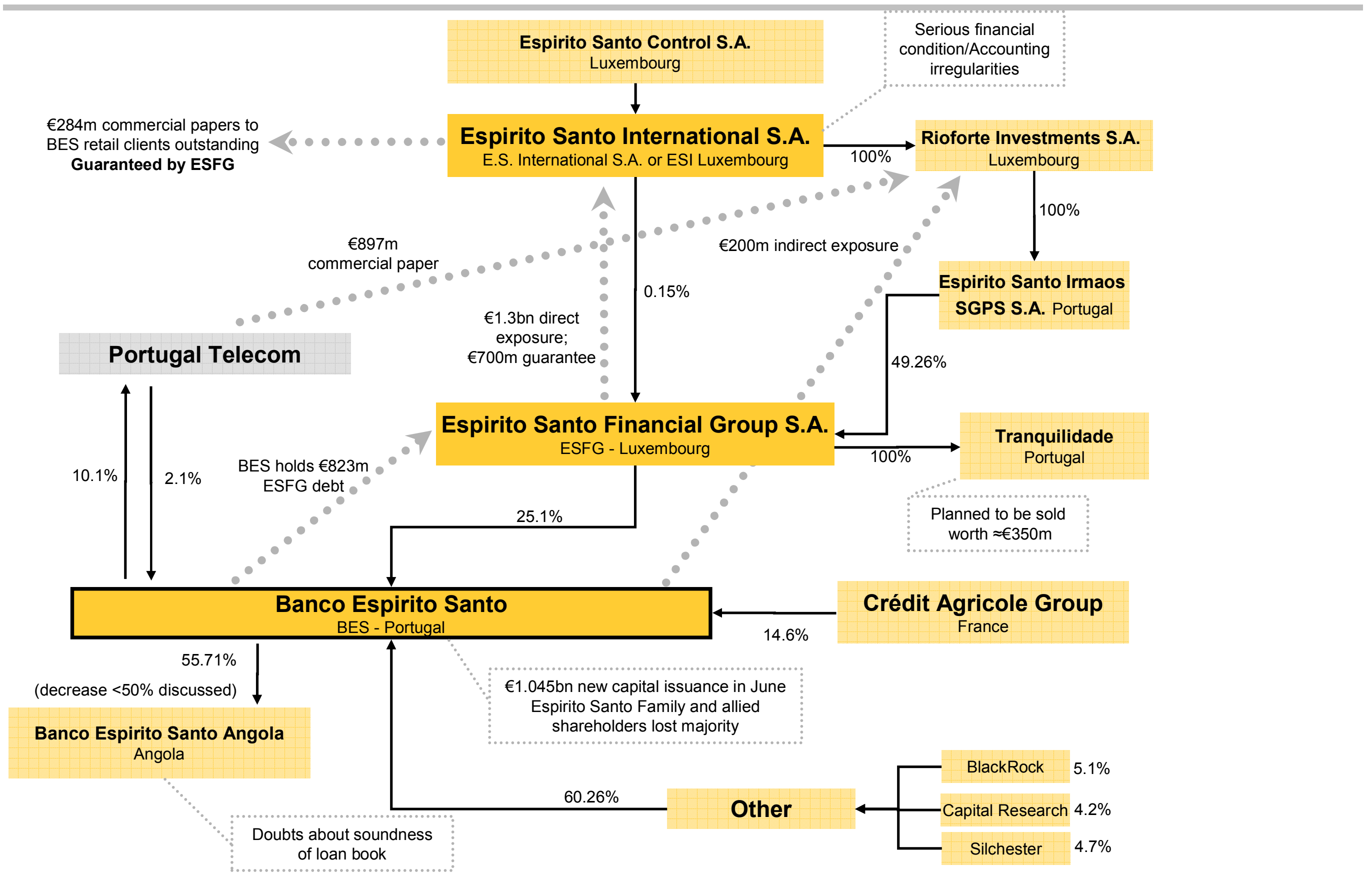
In June Banco Espirito Santo concluded its €1bn capital increase after the Bank of Portugal requested higher loan loss provisions and asked the bank to strengthen its capital base. The capital increase reduced the influence of the Espirito Santo family on BES, as its stake in the bank was reduced from 27% to 25%. Along with a reduction of ESFG's allied shareholders' stake in BES, mainly Credit Agricole, which saw its stake falling from 20% to 15%, their aggregate share dropped below 50%. The Espirito Santo family effectively lost control over BES, which we see as positive.

..but revealed financial difficulties and interdependencies within the group

Fears that troubles in holding company ESI punches through BES

During BES's capital increase the focus shifted to Espirito Santo International S.A. (ESI) where, on request of the Bank of Portugal, external auditor KPMG found "material irregularities" in ESI's accounts. ESI is a private company and does not publicly disclose financial results. As ESI owns nearly 50% in the Espirito Santo Financial Group, which in turn owns a 25% stake in BES, the market focused on any possible feedback from troubled ESI on BES. While BES has seemingly no direct exposure to ESI, it holds €823m in debt issued by ESFG and has a €200m exposure to Rioforte, which is owned by ESI. ESFG itself had a direct exposure of €1.3bn in ESI at the end of 2013 and gave a guarantee for ESI in the amount of €700m. This guarantee was used to cover commercial papers issued by ESI and distributed to retail clients of BES via the BES retail network. The bank of Portugal required ESFG to fully provision the €700m guarantee in its 2013 accounts after the irregularities at ESI were discovered. On 8 July it was reported that some of those CPs will not be orderly repaid and ESI is instead seeking to swap those papers into equity which could be considered a default. Although BES only participated as "distributor" in the issue of ESI's guaranteed CPs, any default would pose reputational risks for BES. Hence, BES's credit profile might suffer if it were to provide support to ESFG or ESI if needed to avoid negative headlines.

CHART 4: **Bank of Portugal is trying to isolate BES from troubles in the wider Espirito Santo organisation**



Source: Commerzbank Corporates & Markets

Bank of Portugal taking drastic measures is positive for BES

Regulator major driver behind envisaged changes in BES

The change in BES's management is likely strongly driven by Bank of Portugal as various media reports suggest. The Bank of Portugal will also review the bank's internal governance controls once shareholders approve the new management and strategy on 31 July. The Bank of Portugal regulator also triggered the external audit at ESI earlier, which disclosed material irregularities and kicked-off the turmoil at BES. On 3 July Parliamentary Affairs Minister, Luis Marques Guedes, said BES has been "adequately isolated" by the Bank of Portugal from the financial problems in some entities of the Grupo Espirito Santo. However, no details were given on actions taken by the Portuguese regulator. A spokesman of the Bank of Portugal added that *"The solvency situation of BES is solid, and it has been significantly reinforced with the recent capital increase",* and *"The Bank of Portugal has adopted a series of actions, aimed at specific decisions for ESFG and BES, to avoid risks of contagion for the bank coming from the non-financial arm of the Espirito Santo Group".* We argue that the rigorous steps from the Bank of Portugal and the decoupling from the leadership of the Espirito Santo family are necessary to strengthen BES's corporate governance.

Rating pressure on BES will likely persist…

Moody's and S&P have a negative outlook on BES

Rating agencies share a rather tarnished opinion of BES. Moody's and S&P revised their rating outlooks on BES from stable to negative on 26 June and 1 July, respectively. Both rating agencies identify as a key reason the recent and unanticipated resignation of BES's chairman and several board members, as well as the upcoming extraordinary meeting of the board on 31 July. This may threaten management stability and focus.

S&P further highlights potential risks from accounting irregularities that were detected at BES's holding company, Espirito Santo Financial, and potentially undermine the bank's financial soundness. These recent developments coincide with more fundamental imbalances at Banco Espirito Santo. In 2013 Portugal's tough operating environment led to a loss in the domestic operations of €517.6m. This also creates solvency pressures to which BES had to respond in June 2014 with a €1.045bn capital increase.

Moody's identifies relatively more upside potential in BES's domestic operations and highlights, despite severe losses, improvements in the liquidity provision and deleveraging.

The rating agencies would consider actual downgrades in the short term if the domestic operating conditions deteriorate further or revenue generation remains weak. In addition, further accounting discrepancies can play a role. In the medium term especially lengthy restructuring and corporate governance chances can depress the rating as they will take months to be implemented and even longer before effects materialise.

…while Moody's has already downgraded ESFG

Today, Moody's downgraded BES's parent ESFG to Caa2. This was triggered by the increasing lending exposure of ESFG towards its subsidiaries, ESI and Rio Forte (lending exposure in 2013: €1.37bn vs. current €2.35bn). ESFG's creditworthiness has been particularly under pressure due to these two subsidiaries. Moody's states that this exposure could rise even more and result in another deterioration of the credit profile. The lack of transparency within the group and the possibility for more support from other ESFG subsidiaries contributes to this. Additionally, a downgrade of BES would also result in a rating downgrade of ESFG.

BES's credit metrics in a nutshell: improving from low levels

Further potential capital needs are a major risk for BES

We see BES's credit profile as weak to moderate but improving over recent quarters. The recovery of the Portuguese economy (Commerzbank forecast: 1.5% GDP growth both in 2014 and 2015 after a 1.4% decline in 2013) will help to stabilise BES's balance sheet. Major risks in our view are further potential capital needs due to AQR/stress test or a balance sheet clean up of the new management including a reassessment of liabilities to the other entities of the Espirito Santo family.

SWOT analysis Banco Espirito Santo (BES)

Strengths / opportunities	Weaknesses / threats
• Capitalisation post capital increase is good with a fully loaded Basel 3 CET1 ratio of 10.5%, taking expected benefits from DTAs (90bp) into account. Very high RWA density (over 70%) provides some buffer for AQR/stress test.	• Asset quality is deteriorating and poses risks to profitability and capital of BES. Problem loans stood at a high 11.1% in Q1 2014 covered with a good 64% of reserves though.
• Waning influence of Espirito Santo family strengthens corporate governance at BES. Bank of Portugal took actions to shield BES from troubles in other entities of the Espirito Santo family.	• Significantly increased its peripheral Sovereign exposure in Q1 2014 to €6.8bn or a high c. 112% of its CET1 capital. The short duration mitigates the risk somewhat as 47% of the exposure matures within one year.
• Liquidity/Funding is adequate. Wholesale maturities of €2.2bn in 2014 and €3.0bn in 2015 should be easily manageable, considering also upcoming TLTROs.	• Low international diversification (72% of loans are domestic, c. 12% in Angola and c. 6% in Spain) cannot offset loss-making domestic operations.
• Systemically important bank in Portugal which renders external support likely if needed. This is positive for seniors but not for subordinated debt.	• Negative rating outlook at Moody's and S&P indicates further rating pressure. Catalysts for downgrades are further asset quality deterioration and capital erosion.
• Still depressed net interest margin (1.51%) but recovering from low levels due to declining funding costs.	

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