

January 2014

# Rehabilitating Portugal

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# Executive Summary

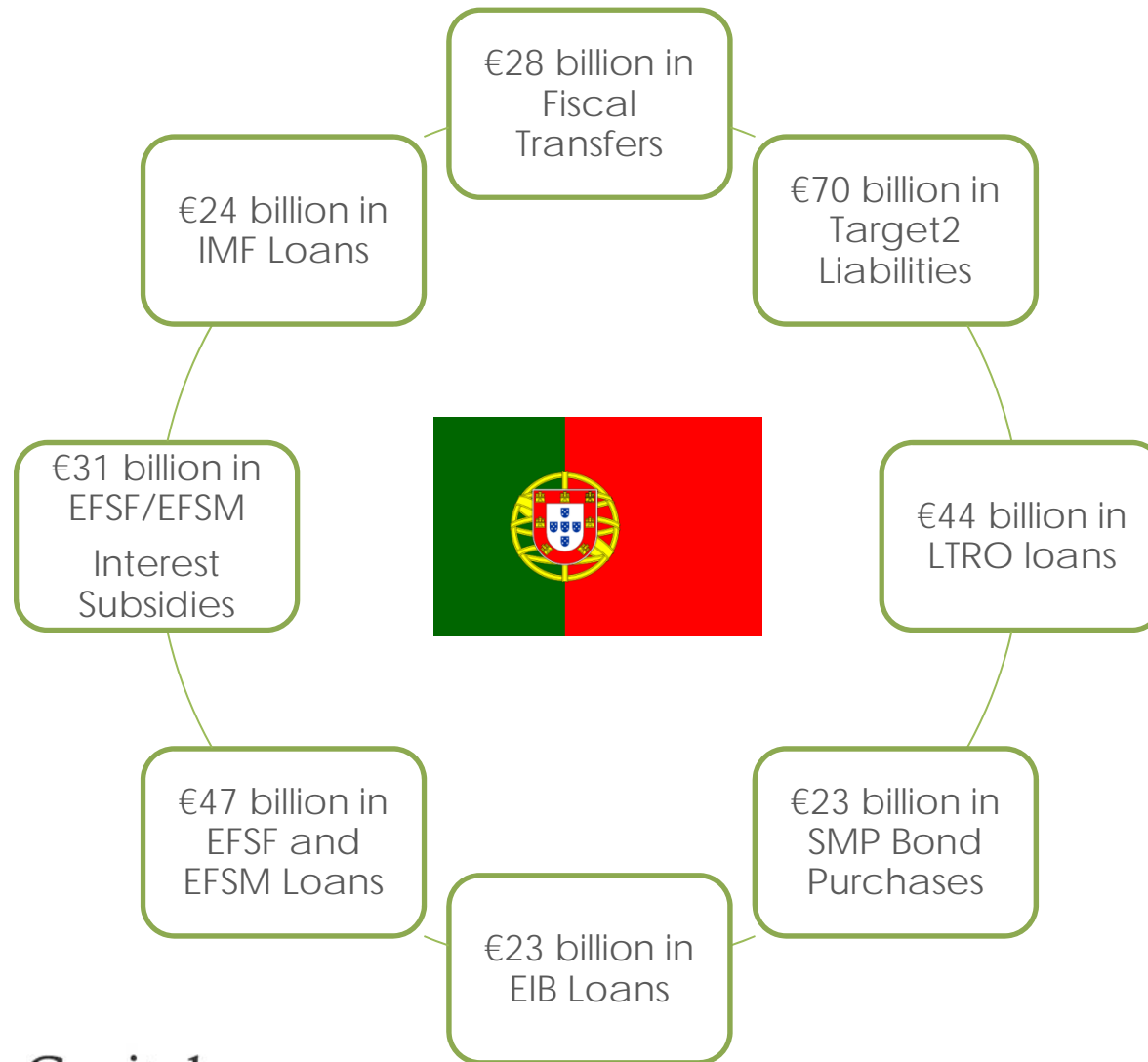
# The Status Quo Is Not Sustainable



# Portugal's Sovereign Debt Is Not Sustainable



# Portugal Already Benefits from Extraordinary Levels of Solidarity

































# Common Misconceptions

Myth	Reality
Growth Has Turned The Corner	Not when Adjusting for Exceptional Items
Exports Can Save Portugal	Stagnant Competitiveness. Low Growth Markets
Bond Exchange Was A Success	Similar to a Ponzi Scheme?
PSI Would Destroy Portuguese Banks	Bills Are Not Bonds. Banks Have Buffers
PSI Would Create Contagion Risk	Euro Banks Own Few Bonds + OMTs
Portugal Is Not Hiding Debt	PPE & SOE Debt + Off-Market Swaps
Greek PSI Was A Mistake	Not According to Greek Bonds & Equities



# Review of Alternatives - PSI Is the Best Rehabilitation Option

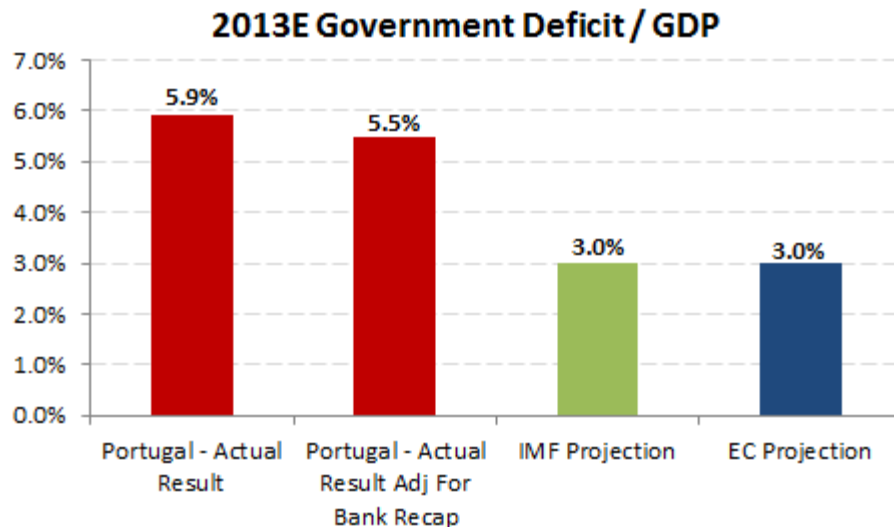
	Sustainable Solution	Return of Sovereignty	Debt Sustainability	Return to Growth	Financial Risk Mitigation
Program Extension/Credit Line					
Capital Market Borrowing					
Reprofiling of Debt					
Debt Restructuring By Legislative Act					
<b>PSI Through Debt Exchange</b>					
Euro Exit					

The Status Quo is Not Sustainable

# The Troika Calls the Portuguese Program “On Track” But It Is Actually Very Much “Off Track”

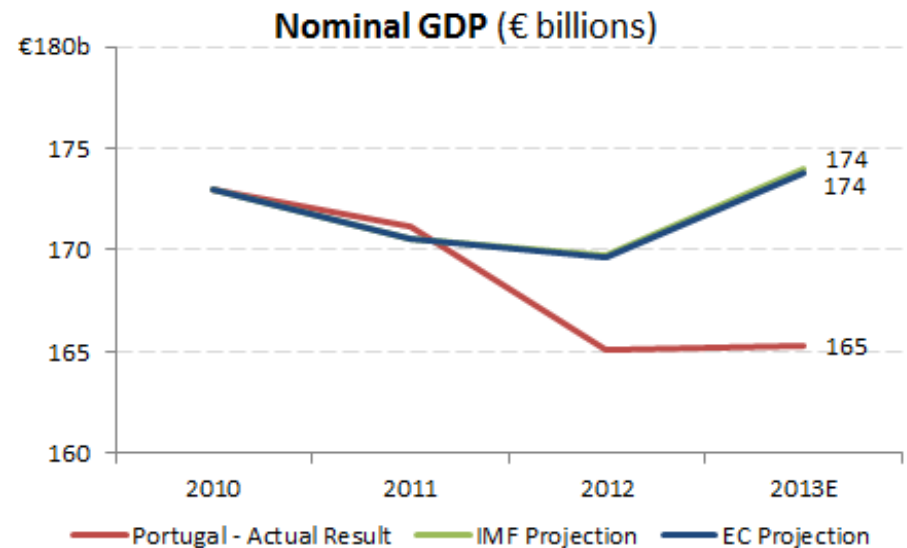
## Portugal Has Dramatically Missed Its Deficit Target

- The IMF and the European Commission expected the government deficit to reach 3% of GDP in 2013
- The 2013 deficit is now likely to be 5.9% of GDP or 5.5% excluding bank recap



## Portugal Has Dramatically Missed Its GDP Growth Target

- At the beginning of the program, the IMF and the European Commission estimated that nominal GDP would be €174 billion in 2013 or over 5% higher than where it actually will be

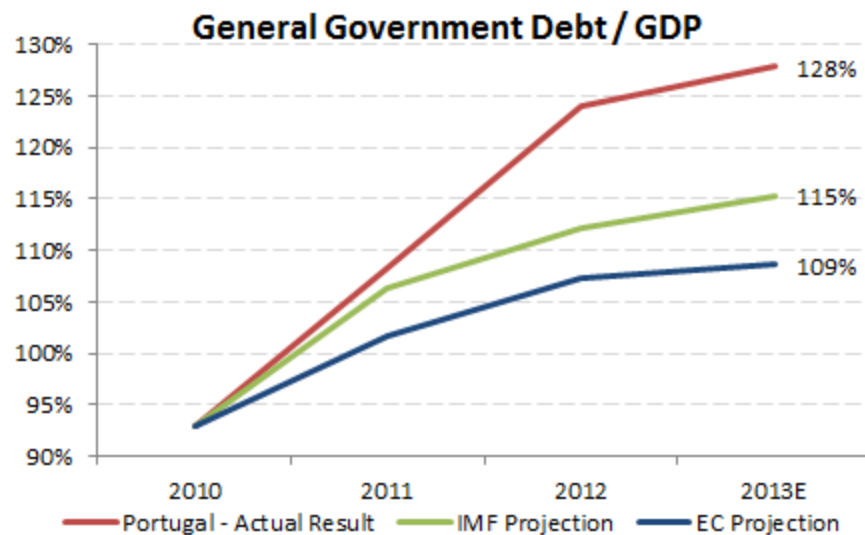


Source: Ameco, IMF June 2011 – Request for a Three-Year Arrangement Under the EFF, European Commission June 2011 - The Economic Adjustment Programme for Portugal

# The Troika's Forecast of Falling Debt/GDP Starting 2014 is Wishful...

## Portugal Has Dramatically Missed Its Debt/GDP Target

- At the beginning of the program, the IMF and the European Commission expected Debt/GDP to reach 115% and 109% respectively in 2013. Portuguese government debt will actually reach 128% of GDP

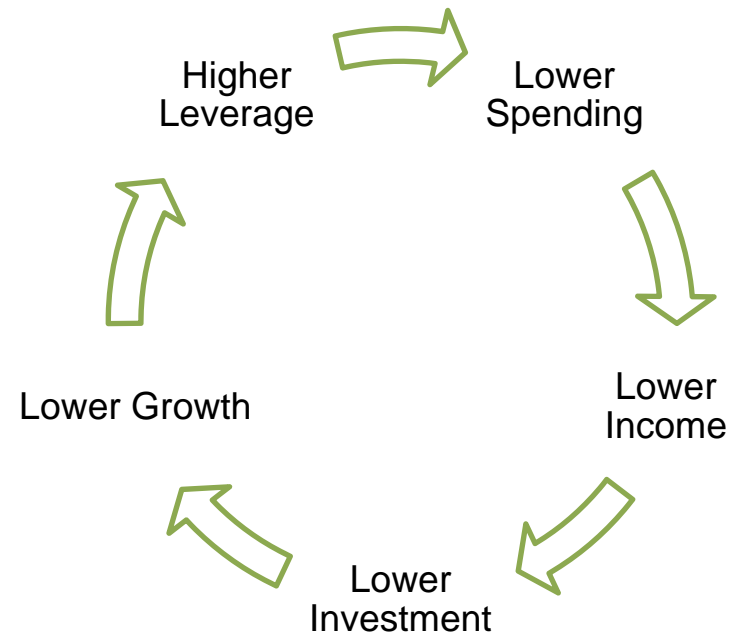


## Net Debt/GDP Will Likely Never Fall

- The IMF and European Commission both expect Debt/GDP to start falling in 2104
- We believe that Debt/GDP may never fall, assuming constant cash levels
- Indeed, even assuming a primary budget balance (ie no government budget deficit before interest), debt snowballs at the average interest rate of 3.5%
- As a result, Debt/GDP will only fall if nominal growth rates exceed 3.5%, which is likely to be unattainable in the next few years

# ...but Not Attainable Because “Kicking the Can Down the Road” Has Made the Problem Worse

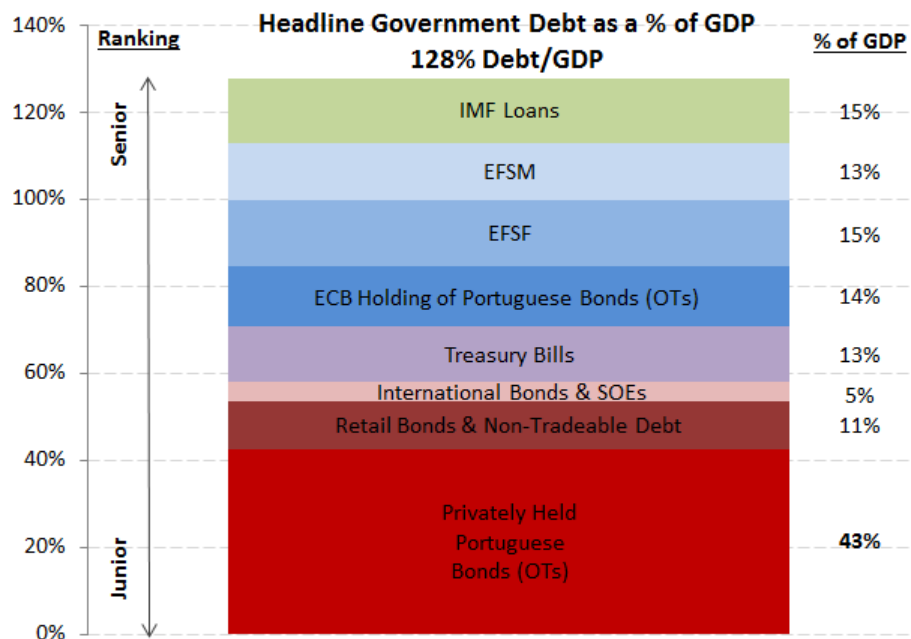
- The Troika fails to recognize that the lessons learned from Greek program apply to Portugal as well
  1. Delaying the sovereign debt restructuring in Greece was a mistake as it led to bigger haircuts but lower debt relief
  2. Cutting government expenditures and raising taxes has a disproportionately large negative impact on the economy and leads to higher, not lower, leverage



# Portugal's Government Bonds Are Subordinated To A Mountain of Debt...

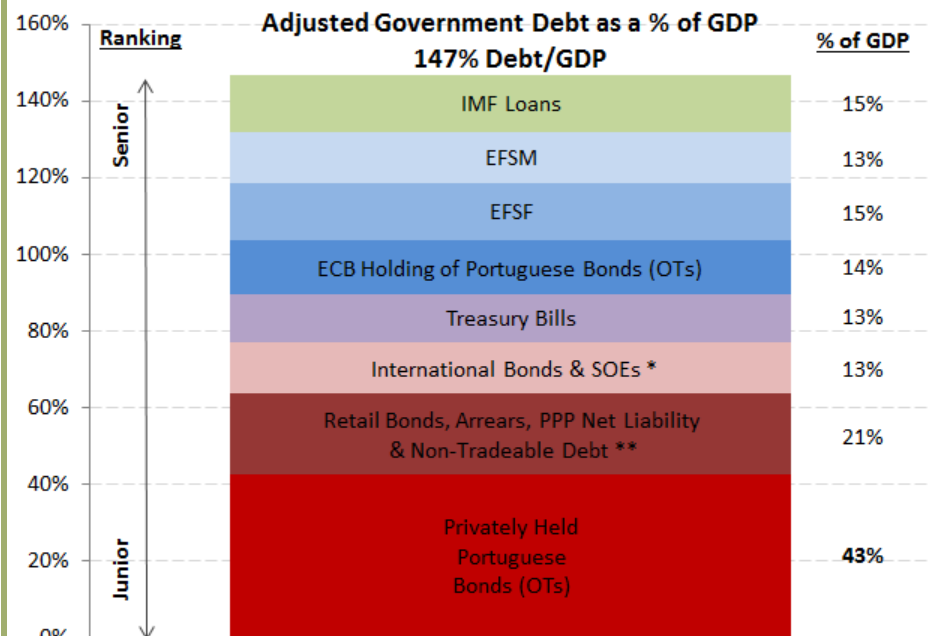
## Headline Debt Figures

- Headline government debt adds up to 128% of GDP, of which slightly less than half can be subject to a sovereign restructuring



## Adjusted Debt Figures

- Actual government debt adds up to 147% of GDP when including non-consolidated SOE debt, PPP liabilities and arrears

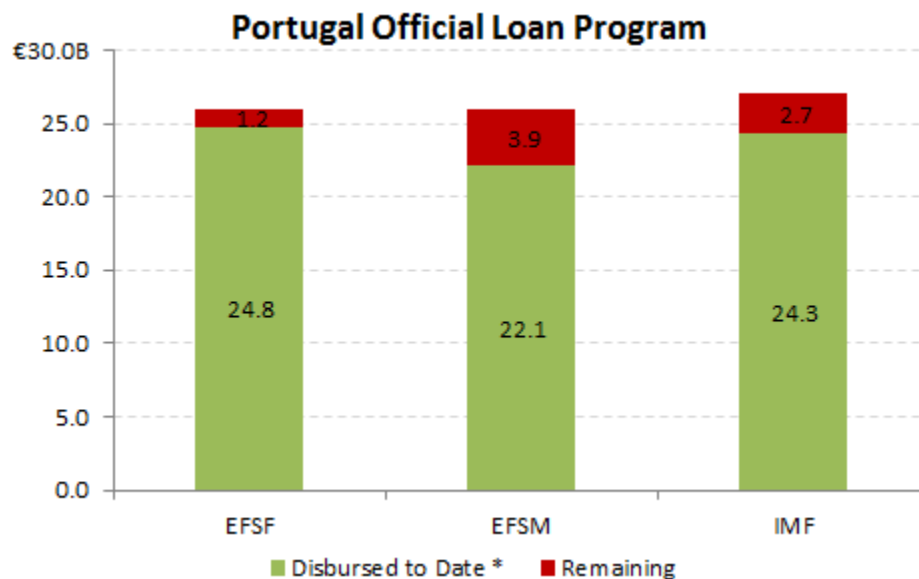


Source: IGCP, Banco de Portugal, IMF, European Commission, Tortus Capital  
 \* Includes non-consolidated debt from State Owned Enterprises. \*\* Includes non-consolidated arrears and State liabilities for Public Private Partnership projects, net of projected income

# ...but the Troika Program Had Protected Portuguese Government Bonds Until Now...

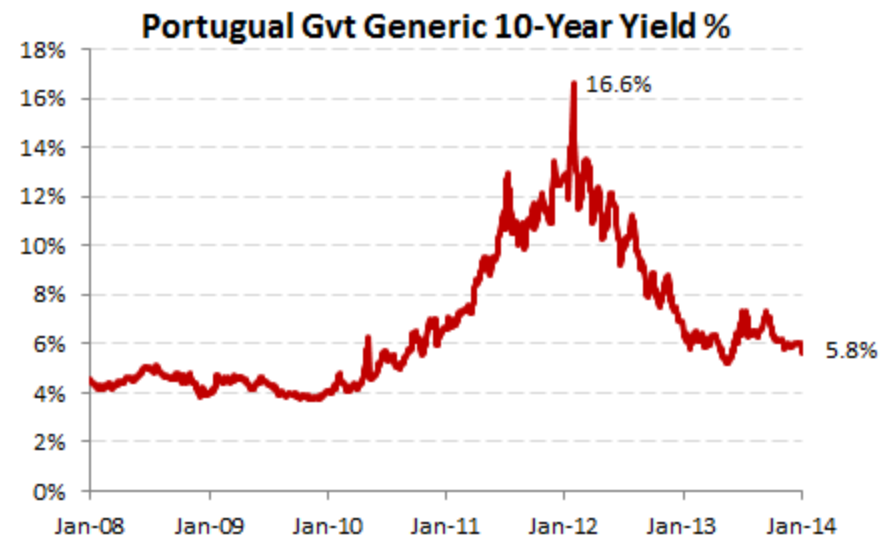
## Portugal Is Running Out of Official Funding

- Only 10% of the official loans designated for Portugal's program are yet to be approved and disbursed
- This leaves only €7.8 billion of official funding or less than 5% of GDP



## Portugal Government 10Y Bond Yields Are Artificially Low

- The Troika program has helped keep government bond yields in Portugal in check by insulating the country from market forces and external financing needs



Source: IMF, European Commission, Bloomberg

\* Includes €3.7 billion approved for disbursement from the EFSF and €1.9 billion approved for disbursement from the IMF, in relation to the 8<sup>th</sup> and 9<sup>th</sup> reviews

# ...And Now The Portuguese State Is Left to Issue Excessive Levels of Debt in the Markets...

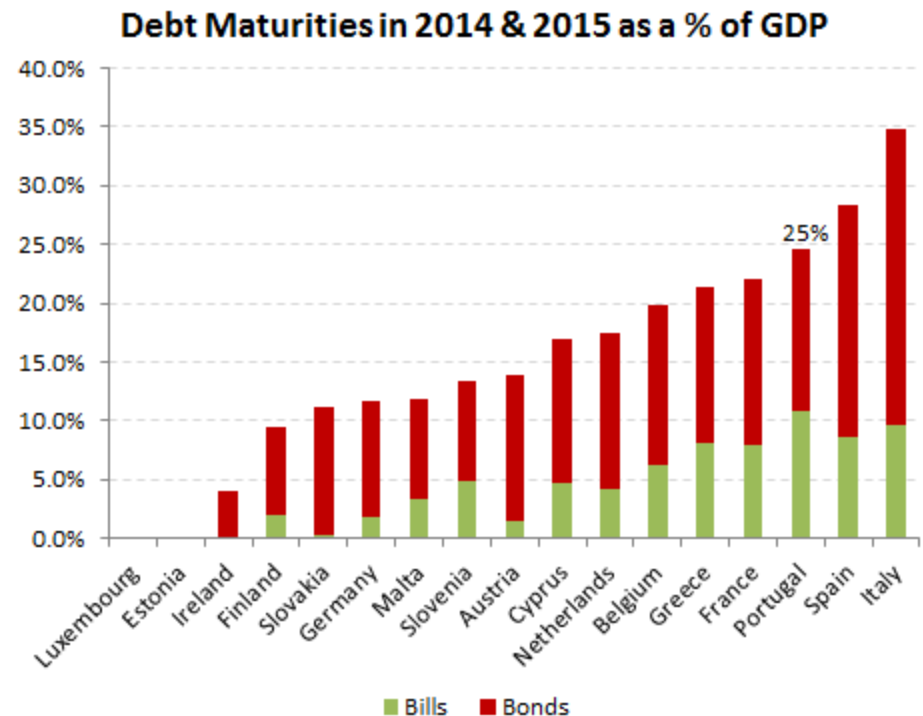
## Short Term Debt Issuance Requirements for Portugal

- The government will need to issue almost 30% of GDP in new debt over 2014 & 2015

	2014	2015
<b>Uses Of Funds</b>		
Overall Deficit	€7.4	€4.3
Other Acquisitions of Financial Assets	4.5	1.1
Net Financing Need	11.9	5.4
Bond Redemptions	11.1	10.3
Bill Redemptions	17.1	0.8
IMF Loan Repayment		0.5
Redemptions	28.2	11.6
<b>Total Uses Of Funds</b>	<b>€40.1</b>	<b>€17.0</b>
<b>Sources Of Funds</b>		
EU-IMF Financing	€7.8	€0.0
Privatizations	0.1	-
Financing Needs from Debt Issuance	32.3	17.0
<b>Total Sources Of Funds</b>	<b>€40.2</b>	<b>€17.0</b>
Estimated GDP	€168.2	€172.3
<b>Financing Needs from Debt Issuance / GDP</b>	<b>19.2%</b>	<b>9.9%</b>

## Short-Term Debt Refinancing Needs in the Euro Area

- Portugal has very high debt refinancing needs in 2014 and 2015, amounting to 25% of 2013 GDP



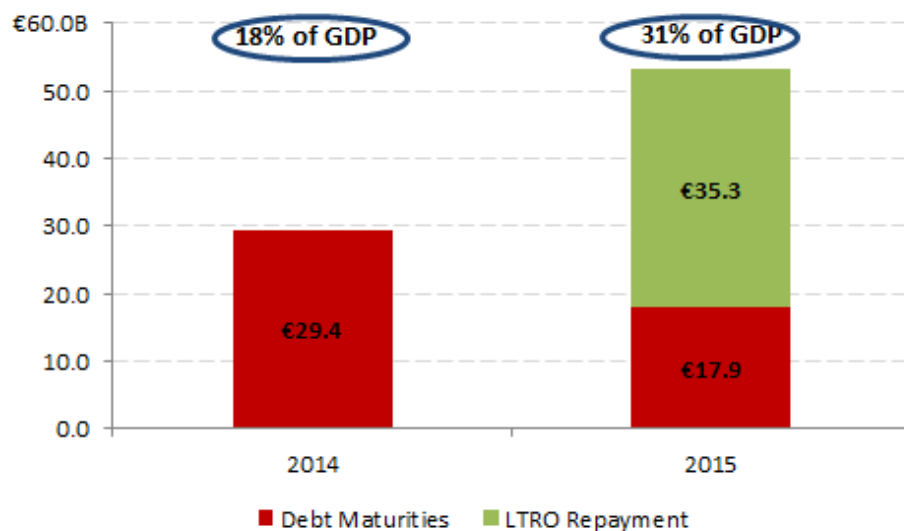
Source: IGCP, Eurostat, Ameco



# ...While Competing With Portuguese Banks and Corporations For Funding...

## Funding Needs

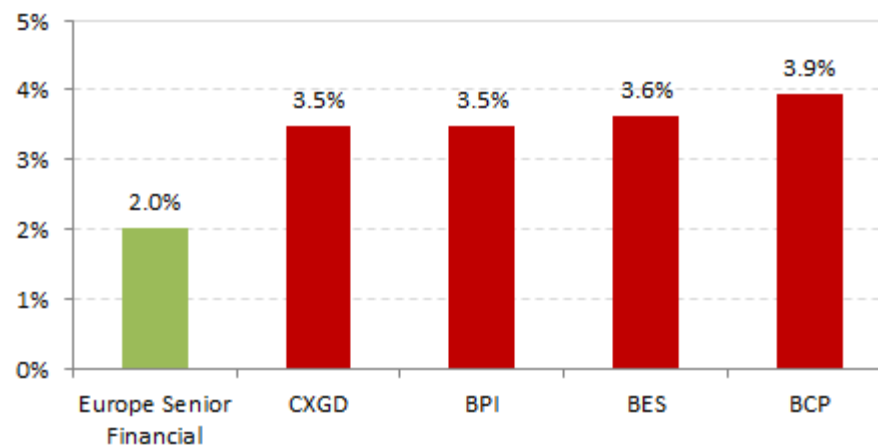
- Portuguese Banks and corporations will be competing with the Portuguese sovereign for funding
- Banks will need to refinance the equivalent of 18% and 31% of GDP respectively in 2014 and 2015 or €83B



## Funding Cost

- Portuguese banks borrow at almost double the yield of the average European bank

### Senior Bonds 5y Yield



# ...And As Fundamentals Start To Matter the Capital Market Window May Face Pressure

## Euro Area Credit Ratings

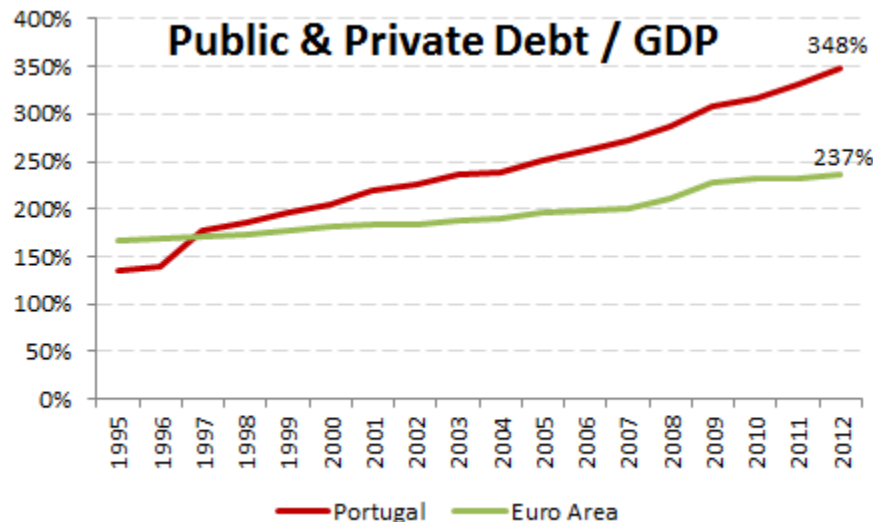
- Portugal is the only Euro Area country to be rated junk and for which the outlook is negative at both credit agencies
- It is likely that Portugal's capital market window will close during the course of 2014, to be in line with other junk rated Euro Area sovereigns

Country	S&P Rating	S&P Outlook	Moody's Rating	Moody's Outlook	Capital Market Window
Finland	AAA	Stable	Aaa	Stable	Opened
Germany	AAA	Stable	Aaa	Stable	Opened
Luxembourg	AAA	Stable	Aaa	Watch Negative	Opened
Austria	AA+	Negative	Aaa	Negative	Opened
Belgium	AA+	Negative	Aa3	Negative	Opened
Netherlands	AA+	Stable	Aaa	Watch Negative	Opened
France	AA	Stable	Aa1	Negative	Opened
Estonia	AA-	Stable	A1	Stable	Opened
Slovakia	A	Stable	A1	Stable	Opened
Slovenia	A-	Stable	Ba1	Negative	Opened
Ireland	BBB+	Positive	Ba1	Stable	Opened
Italy	BBB+	Negative	Baa2	Negative	Opened
Malta	BBB+	Stable	A1	Stable	Opened
Spain	BBB-	Negative	Baa3	Negative	Opened
Portugal	BB	Negative	Ba3	Negative	Temporarily Opened?
Cyprus	B-	Stable	Caa3	Negative	Closed
Greece	B-	Stable	Caa3	Stable	Closed

# Portugal Has Excessive Public and Private Sector Debts, Highly Financed by Foreigners...

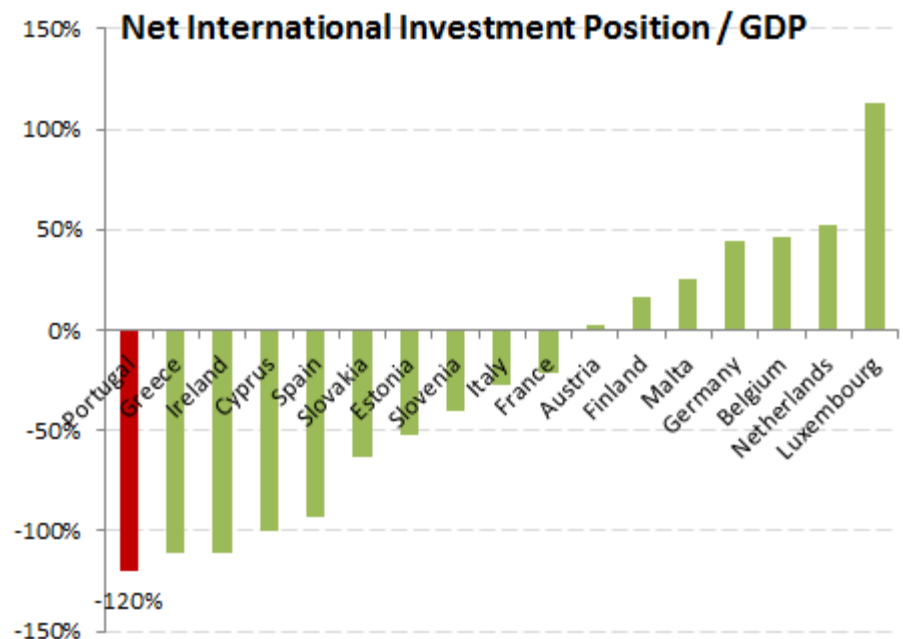
## Public & Private Sector Debt

- The debt of Portugal's Government and Private Sector (Non-Financial Corporations and Households) has risen significantly faster than for the Euro Area
- Portugal is now c. 50% more levered than the Euro Area



## Portugal Is An Abnormally Large Borrower from Abroad

- Portugal's net international is the worst in the Euro area at -120% of GDP
- With a 2013 current account surplus of 0.9% of GDP, it would take 128 years for Portugal to return to balance



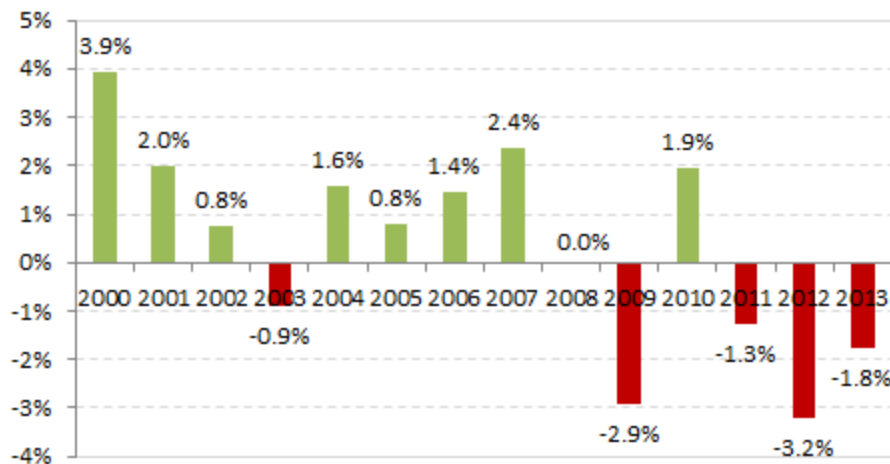
Source: Eurostat, Ameco, Tortus Capital

# ...Which It Can Neither Outgrow Nor Devalue

## Real Growth Rates

- The Portuguese economy has seen negative real growth rates for four out of the past six years
- Portuguese growth underperformed that of the U.S. during the Great Depression or that of Japan during its lost decade \*

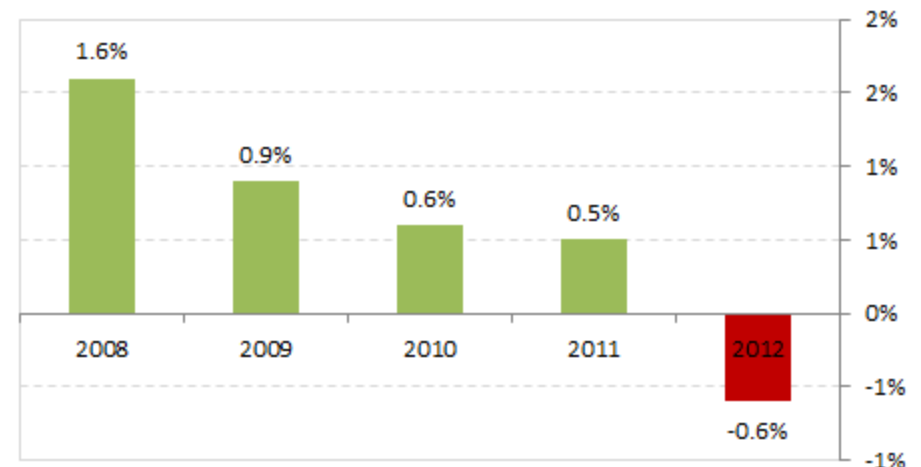
### % Real Growth



## Inflation Rates

- Deflationary forces have resulted from the deleveraging efforts of the public and private sector
- Inflation rates have been very low, despite significant increases in taxes

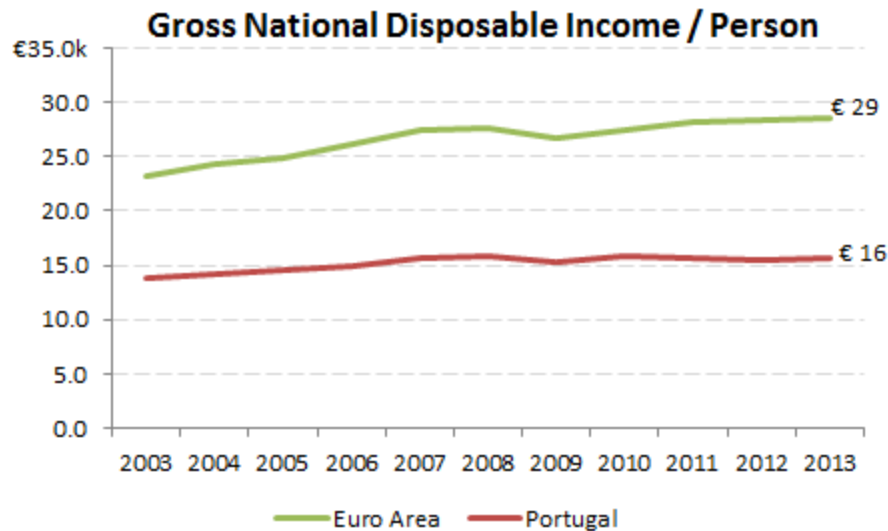
### Inflation (GDP Deflator)



# The Alternatives For Portuguese Workers Are Lower Pay or Fewer Jobs...

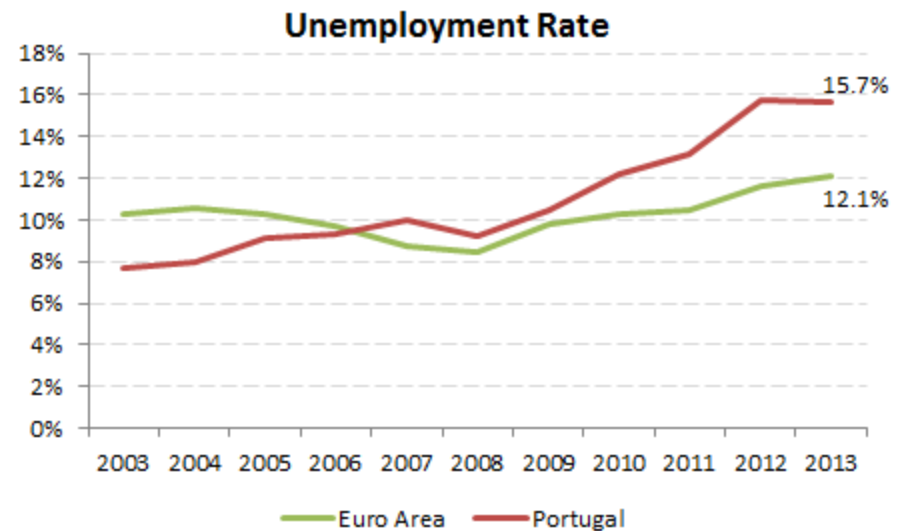
## Gross National Disposable Income / Person Is Low

- Portuguese people earn only slightly more than half the Eurozone's average disposable income at €16k/year vs. €29k
- Instead of catching up to the Eurozone's average, the gap continues to widen as its disposable income stagnates



## Yet Lower Wages Are Needed to Fight Unemployment

- "Absent greater wage flexibility, this could portend more labor shedding and lower aggregate income" (IMF 7<sup>th</sup> Review)
- Employment has declined 13% from its 2008 peak

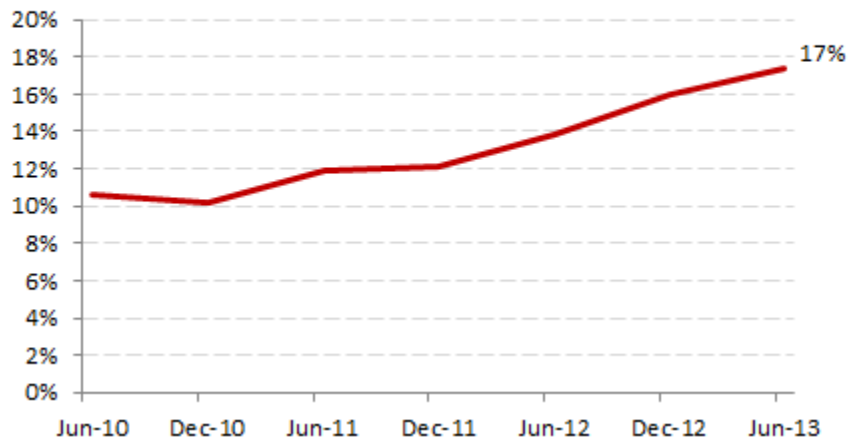


# ...Putting the People In Precarious Financial Positions

## Default Rate on Consumption & Other Loans Skyrocketing...

- Default rates on consumption and other loans have skyrocketed in the past three years, to reach 17% of the amount outstanding

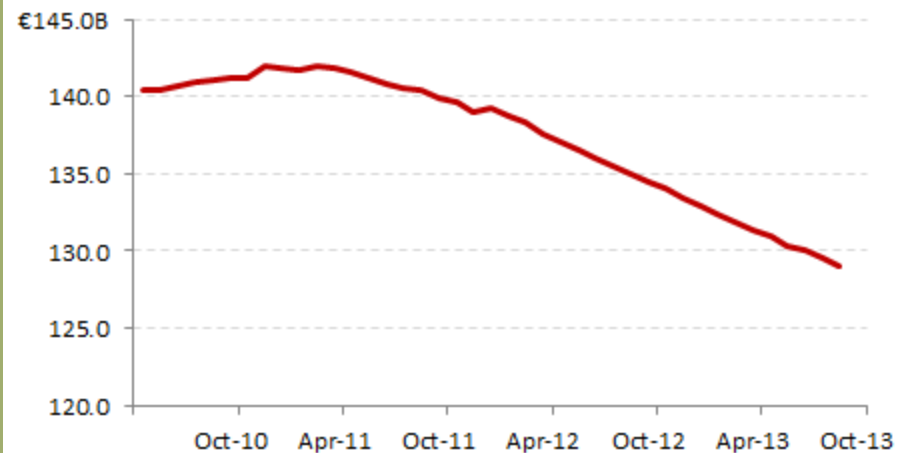
**Portugal Consumption & Other Loans  
Default Rate\***



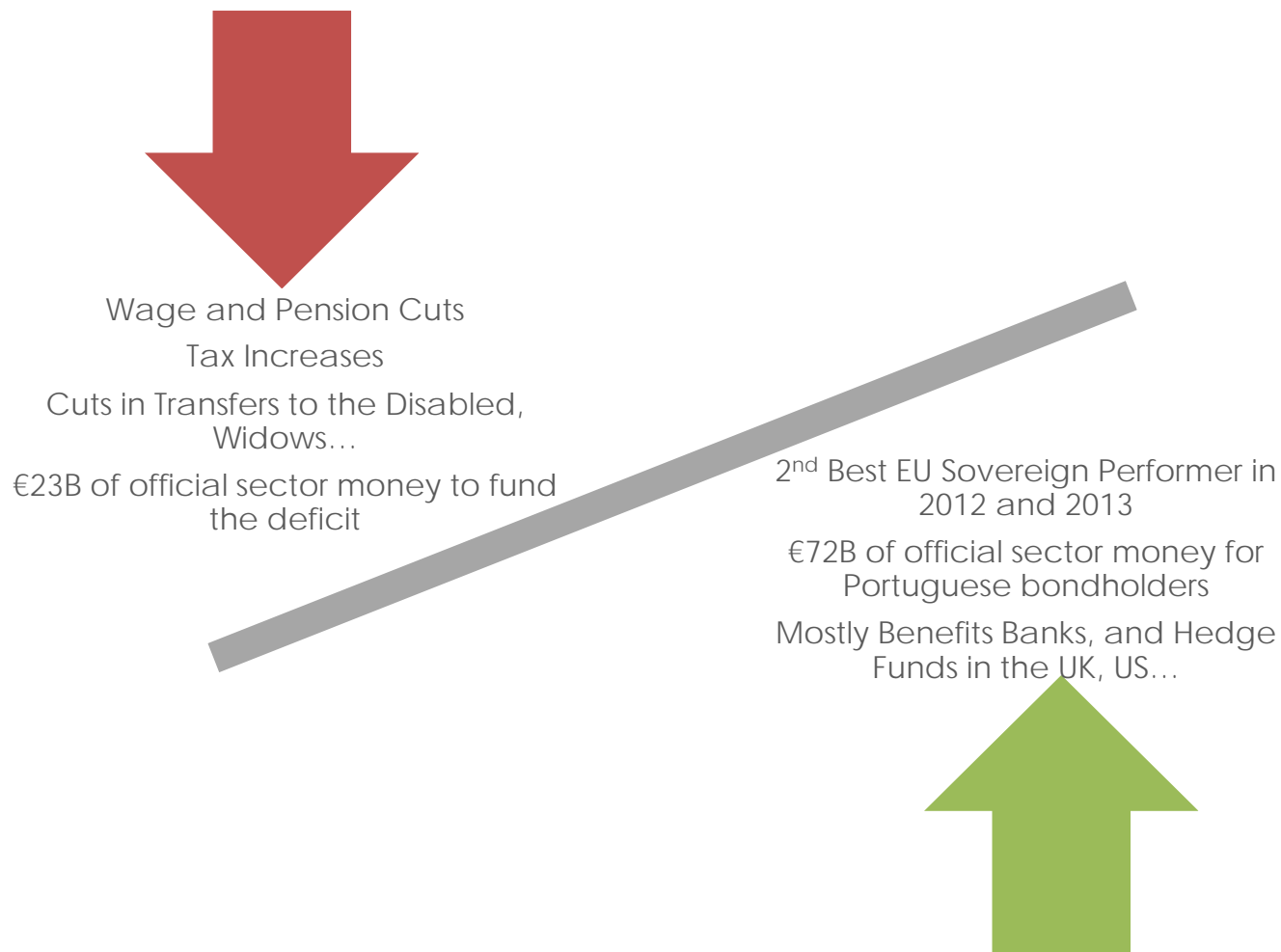
## ...While Credit To Households Contracts

- The total amount of loans outstanding to individuals has contracted by 9% over the past three years

**Total Loans to Individuals**



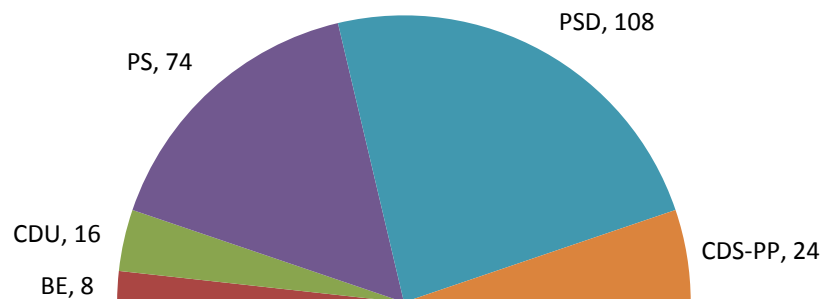
# Portuguese People Unfairly Carry The Full Burden of The Adjustment While Speculators Profit...



# ...which Has Caused a Loss in Political Consensus...

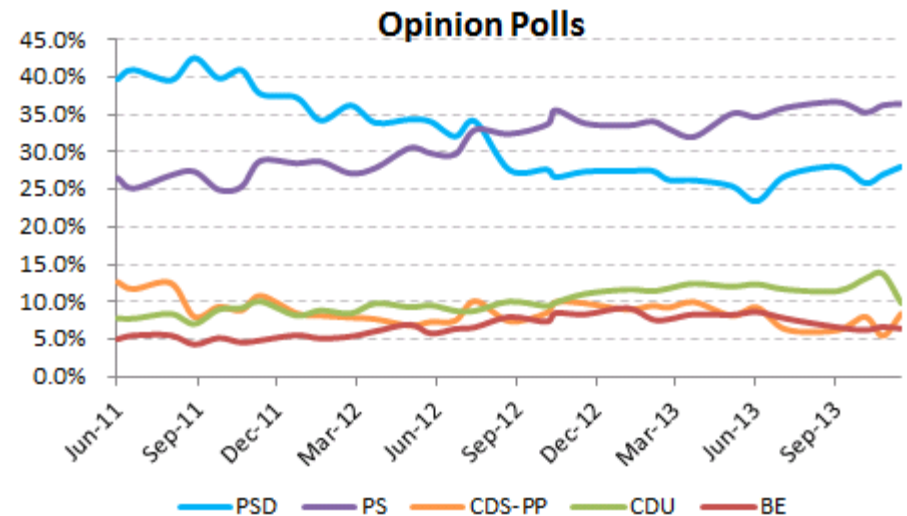
## Current Government

- The PSD and CDS coalition still has a majority in parliament
- President Aníbal Cavaco Silva's call for a "national salvation" pact failed in July 2013
- The government may rule until 2015 but it no longer has the support of the people



## Current Polls

- Opinion polls show the Socialist opposition party PS will have a clear victory in the next parliamentary elections, to be held in 2015 at the latest
- PS's votes are expected to exceed the votes of PSD and CDS combined





# ...and Forcing the Constitutional Court to Reject the Government Budget Repeatedly...

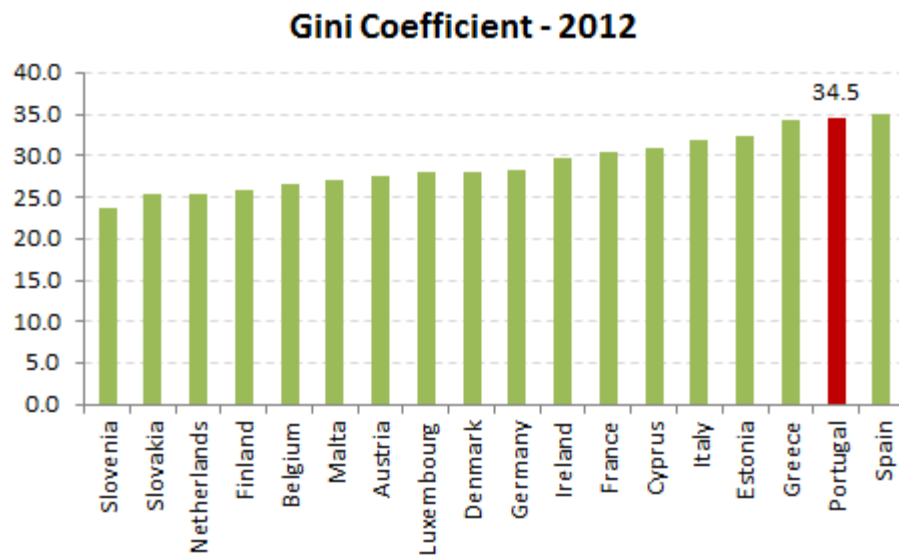
- Eight out of the past fourteen government measures submitted to the Constitutional Court have been rejected, including €3.2 billion out of proposed government spending cuts of €5.0 billion, on grounds of trust in the state, job security, proportionality and equality

Date	Bills	Value (EUR M)	Verdict
	<u>2014 budget</u>		
<b>Dec-13</b>	<b>Pensions convergence scheme</b>	<b>€ 388</b>	<b>Unconstitutional</b>
Nov-13	Convergence of working hours	153	Constitutional
<b>Sep-13</b>	<b>Labour market reform</b>	-	<b>Unconstitutional</b>
<b>Aug-13</b>	<b>Requalification/mobility</b>	<b>119</b>	<b>Unconstitutional</b>
	<u>2013 budget</u>		
Apr-13	New tax scales of IRS	2,075	Constitutional
Apr-13	Wage cuts for public sector employees	1,243	Constitutional
Apr-13	IRS Surcharge 3.5%	735	Constitutional
<b>Apr-13</b>	<b>Holiday allowance suspension (civil servants)</b>	<b>610</b>	<b>Unconstitutional</b>
<b>Apr-13</b>	<b>Holiday allowance suspension (pensioners)</b>	<b>540</b>	<b>Unconstitutional</b>
Apr-13	Solidarity contribution for pensioners	421	Constitutional
<b>Apr-13</b>	<b>Unemployment/sickness benefits cuts</b>	<b>150</b>	<b>Unconstitutional</b>
Apr-13	Overtime payment reduction	30	Constitutional
<b>Apr-13</b>	<b>Teaching and research contracts</b>	-	<b>Unconstitutional</b>
	<u>2012 budget</u>		
<b>Jul-12</b>	<b>Cuts of the 13th/14th salaries</b>	<b>1,334</b>	<b>Unconstitutional</b>
Total worth of measures submitted for review		€ 7,798	
of which cost saving measures		€ 4,988	
Total worth of measures ruled unconstitutional		€ 3,141	
Percentage of measures ruled unconstitutional		40%	
Percentage of cost saving measures ruled unconstitutional		63%	

# ...to Restore Some of the Lost Equality

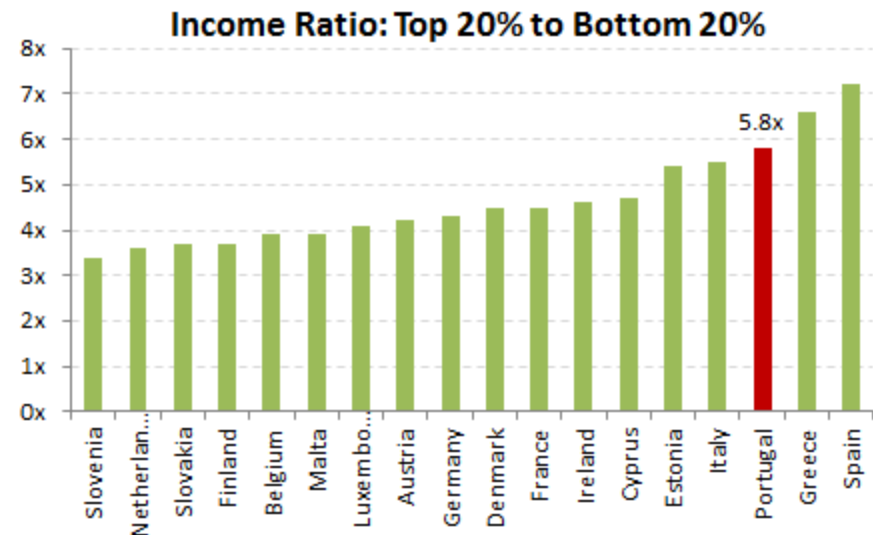
## Inequality of Disposable Income

- Portugal has the second highest Gini coefficient in the Euro Area, indicating high inequality



## Income Inequality

- Portugal has one of the most regressive market income distributions among OECD countries

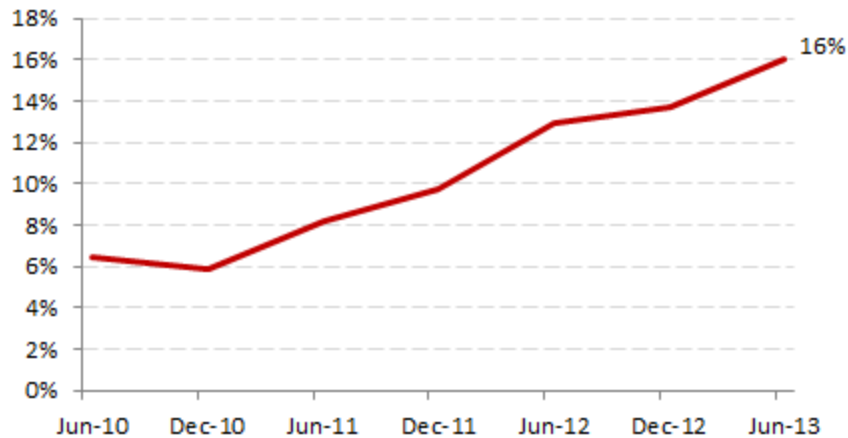


# High Debt Is Also Killing the Corporate Sector...

## Default Rate by Amount Outstanding Skyrocketing

- 16% of the amount lent to non-financial corporations is non-performing
- Consumption and other personal loans also have a 16% default rate while mortgages have held up better at 6%

**Portugal Non-Financial Corporate Loans Default Rate\***



## Default Rate by Number Even Higher

- A deeper look into the statistics shows that 31% of the total number of loans granted to non-financial corporations is non-performing

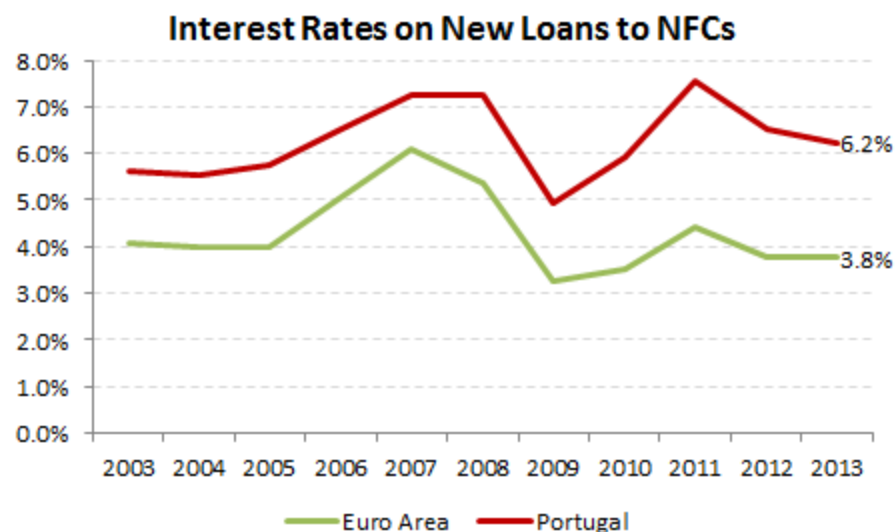
**Portugal Non-Financial Corporates Loan Default Rate - by Number**



# ...As an Increasing Majority of Portuguese Corporations Cannot Sustain Their Debt Burdens...

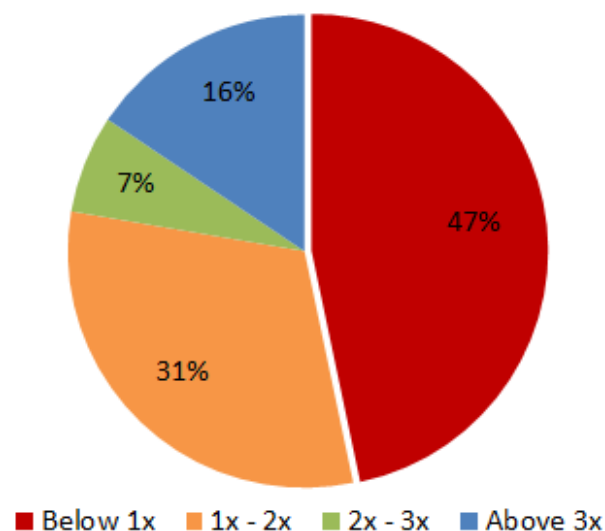
## Interest Rates on Bank Loans To Non-Financial Corporations

- Portuguese corporations are paying significantly higher interest rates than their Eurozone peers at 6.2% per annum vs. 3.8%



## Interest Coverage of Portuguese Corporations

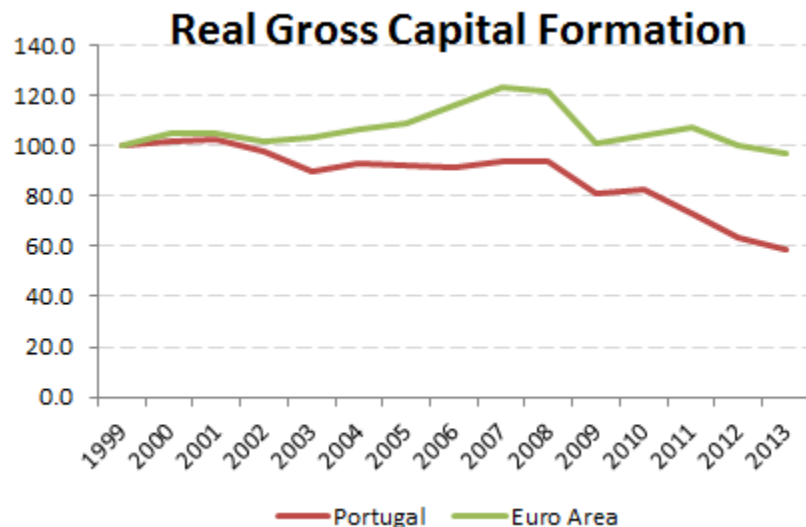
- 47% of the Portuguese corporate debt is to corporations whose earnings before interest and taxes do not cover their interest expense (interest coverage <1x)
- Only 23% of the loans outstanding have an interest coverage ratio above 2x



# ... Leading to Continuously Lower Investments and More Aggressive Accounting

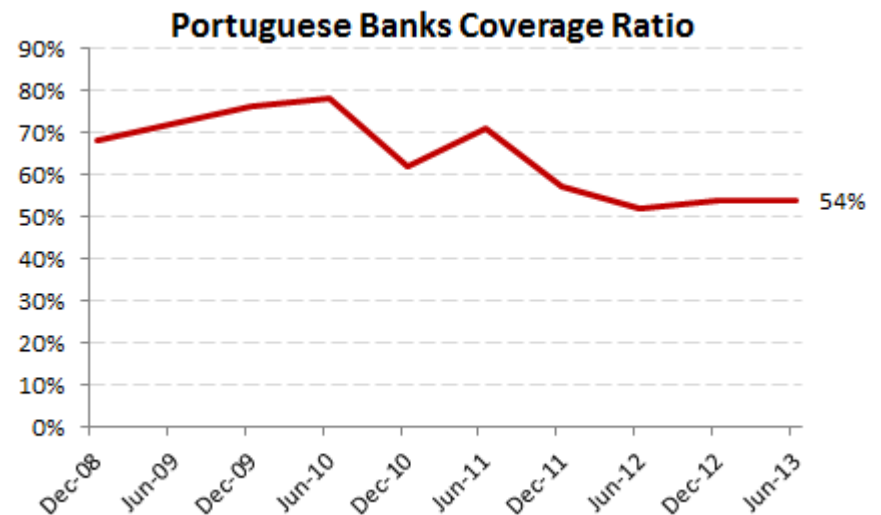
## Investment

- Since joining the Euro, gross capital formation has dropped 42% in real terms in Portugal while it was flat in the Euro Area



## Change in Coverage Ratio

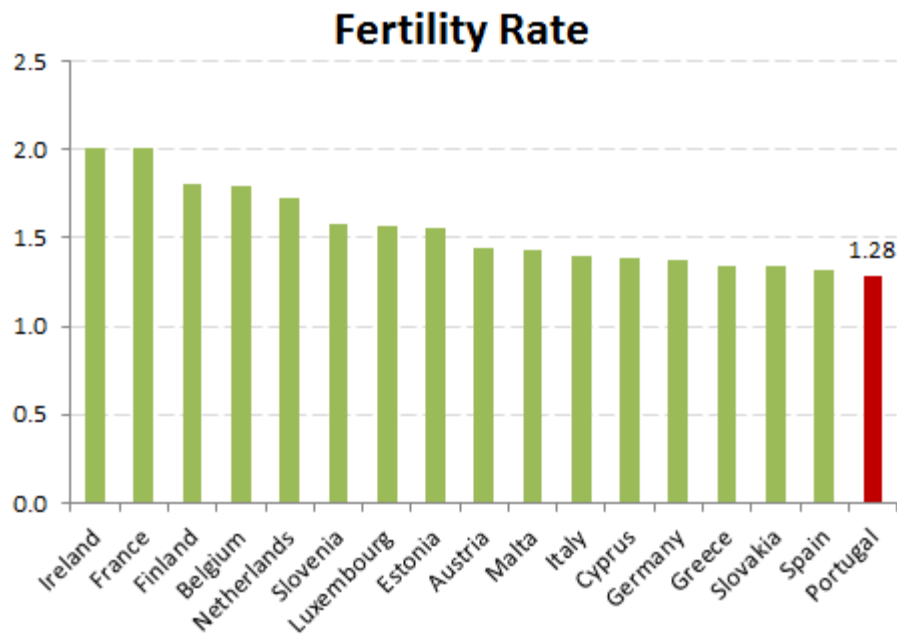
- Portuguese banks reserve on average 54 cents for each euro of defaulted loans
- This ratio is down from 78% in the first half of 2010



# The Long-Term Growth Outlook Is Even Bleaker

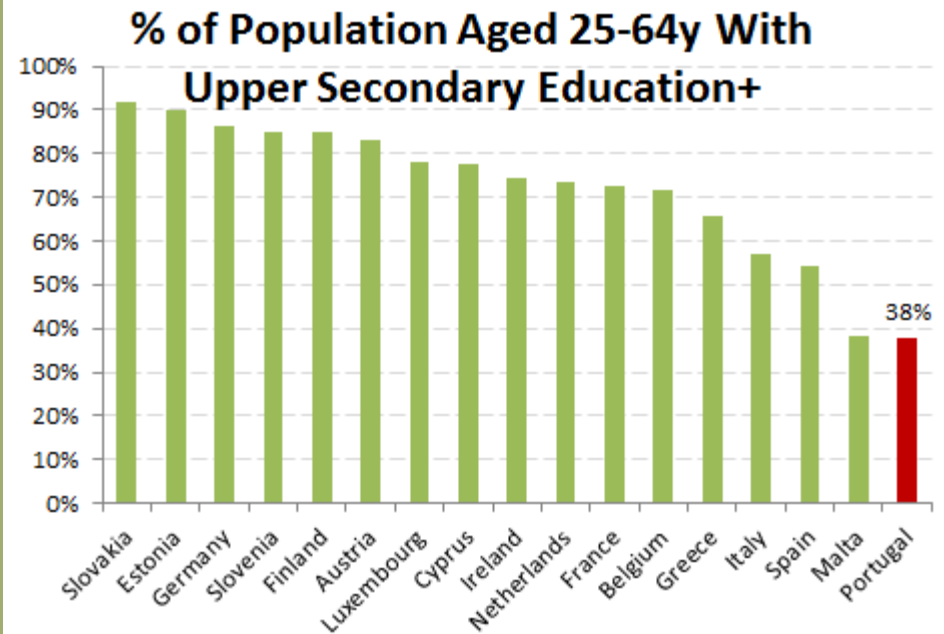
## Shrinking Population

- Portugal has the lowest fertility rate in the Euro Area
- Its population has shrank 1.3% in the past three years



## Low Education Levels

- Portugal only has 38% of its 25-64 year old population having attained at least upper secondary education
- This is the lowest level in the euro area

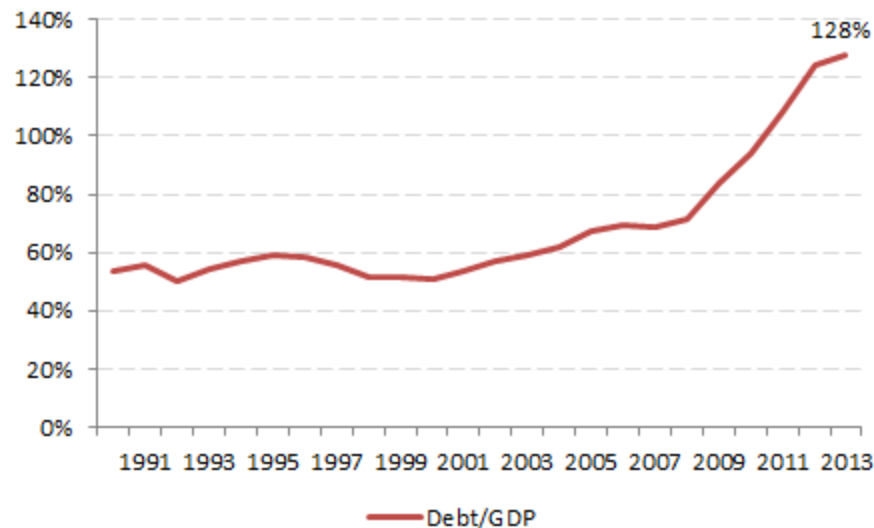


# Portugal's Sovereign Debt Is Not Sustainable

# Debt/GDP is the Most Commonly Used Metric...

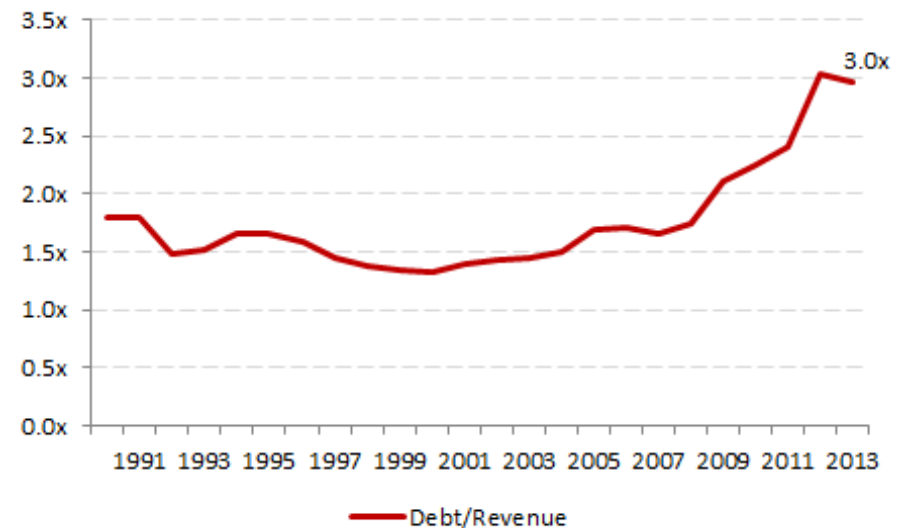
## Debt/GDP

- Portuguese sovereign debt is currently at 128% of GDP
- Since 2009, the Portuguese Debt/GDP ratio has been increasing at an average rate of one percentage point (1%pt) per month



## Debt/Revenue

- Portuguese sovereign debt amounts to 3x the sovereign's revenue
- The ratio of Debt/Revenue has doubled in the past 10 years



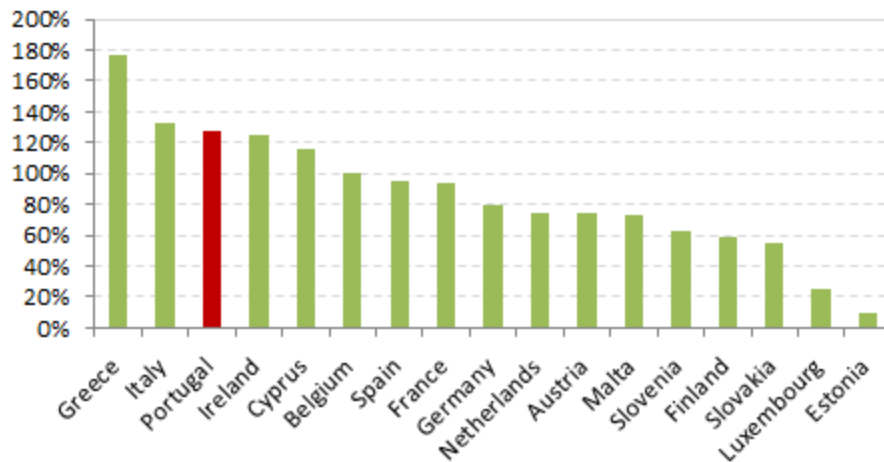


## ...and Portugal Ranks Poorly on that Metric...

### Debt/GDP Portugal vs. Peers

- Portugal has the third highest Debt/GDP in the Euro Area, behind Greece and Italy

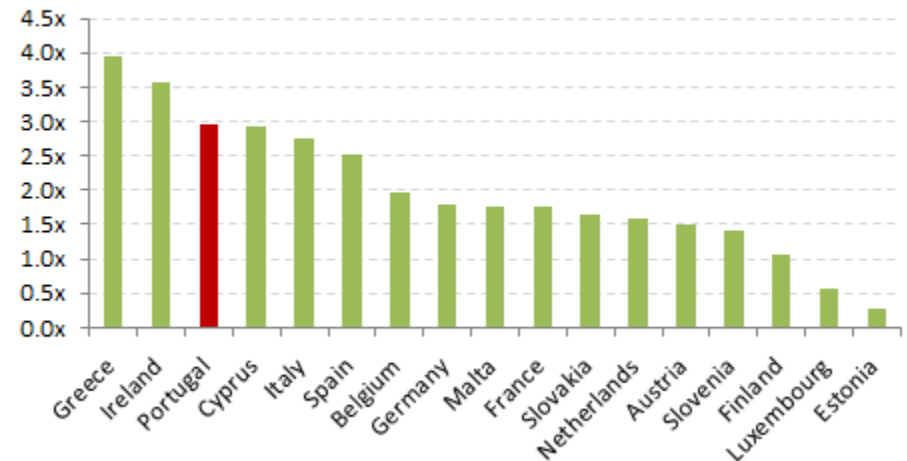
**Debt/GDP 2013**



### Debt/Revenue Portugal vs. Peers

- Portugal has the third highest ratio of debt to revenue in the Eurozone, behind Greece and Ireland

**Debt/Revenue 2013**



# ...but the Debt Burden Matters More...

## Interest Expense/Revenue

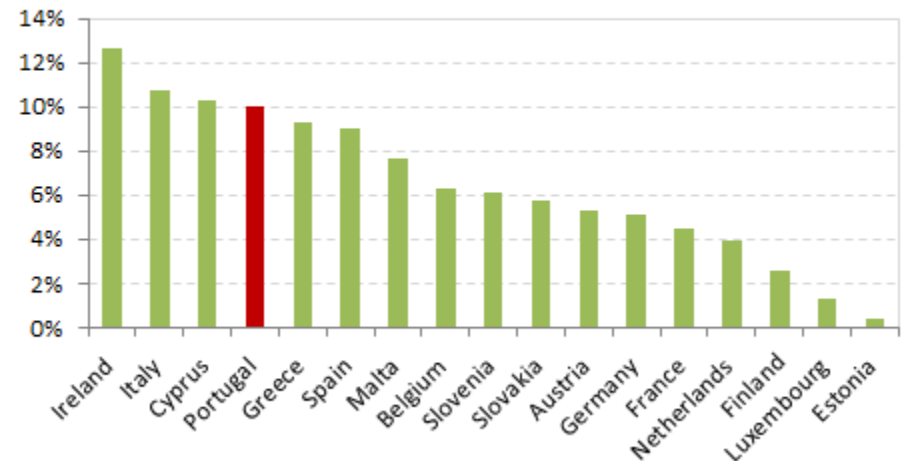
- The Portuguese state's interest expense accounts for more than 10% of the state's revenue



## Interest Expense/Revenue

- Portugal's interest burden will worsen as the country borrows from markets.
- Portugal's average rate of interest is 3.5% (as it is subsidized by the EFSF at 2.4% and the EFSM at 3.0%), but its current 10-year borrowing rates are 5.4% vs. 3.5% for Ireland and 3.9% for Italy

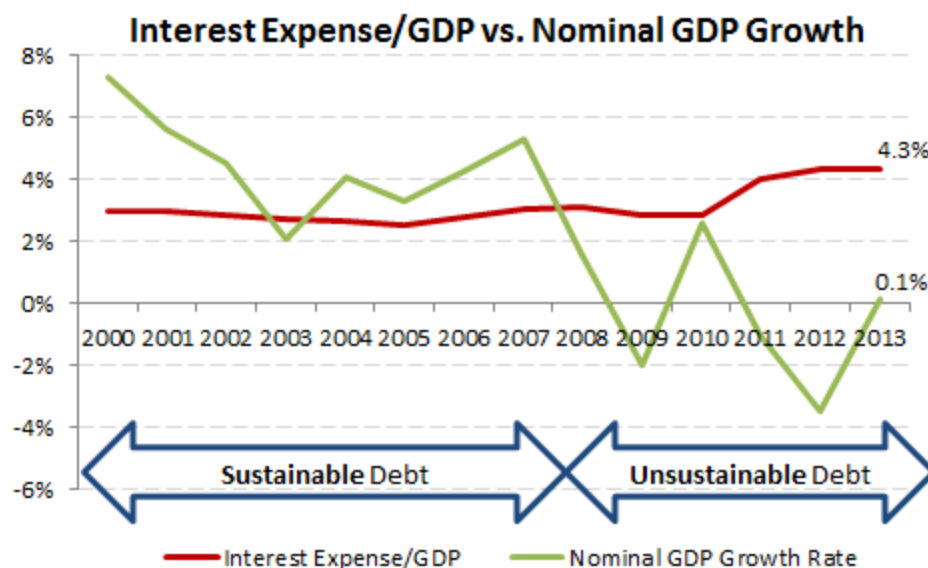
## 2013 Interest/Revenue



# ...and Portugal's Debt Burden is Too High...

## Rule of Thumb

- When interest expense as a percentage of GDP exceeds the nominal growth rate of GDP, the debt burden becomes unsustainable



## The Golden Rule

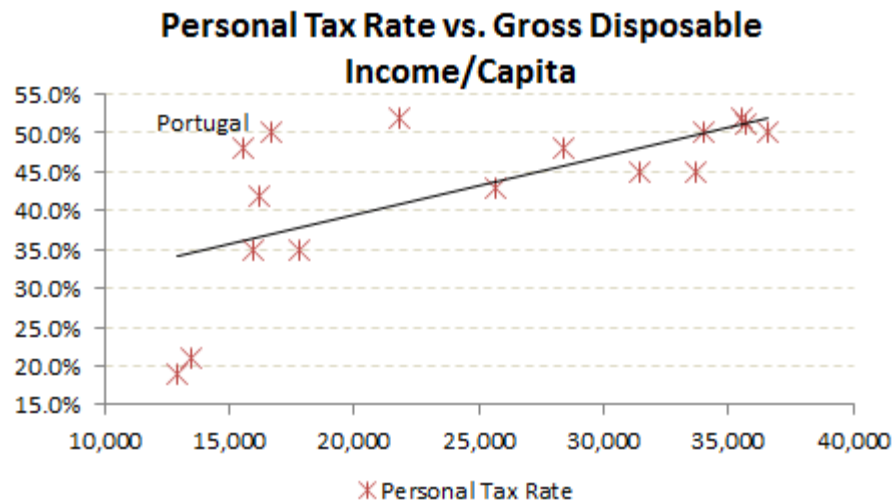
- If borrowing rates exceed nominal growth rates, Debt/GDP will head toward infinity, without a primary surplus
- Italy's primary surplus is +2.3% of GDP, while Portugal's primary deficit is -1.6%

	Nominal GDP Growth CAGR Last 10 years	Avg. Paid Interest Rate on Debt	Growth - Interest Rate Differential
	[A]	[B]	[C] = [A] - [B]
Estonia	7.8%	1.6%	6.2%
Luxembourg	5.8%	2.6%	3.2%
Slovakia	6.0%	3.6%	2.4%
Finland	3.0%	2.6%	0.4%
Belgium	3.4%	3.3%	0.1%
France	2.7%	2.6%	0.0%
Malta	4.4%	4.4%	0.0%
Netherlands	2.4%	2.5%	-0.1%
Austria	3.4%	3.6%	-0.2%
Germany	2.5%	2.9%	-0.4%
Cyprus	3.4%	3.9%	-0.5%
Spain	2.7%	3.8%	-1.1%
Slovenia	3.3%	4.6%	-1.3%
Greece	0.7%	2.4%	-1.8%
Ireland	1.7%	3.7%	-2.0%
Portugal	1.4%	3.5%	-2.0%
Italy	1.5%	4.0%	-2.4%

# ...Especially Considering its Inability to Further Increase Tax Rates...

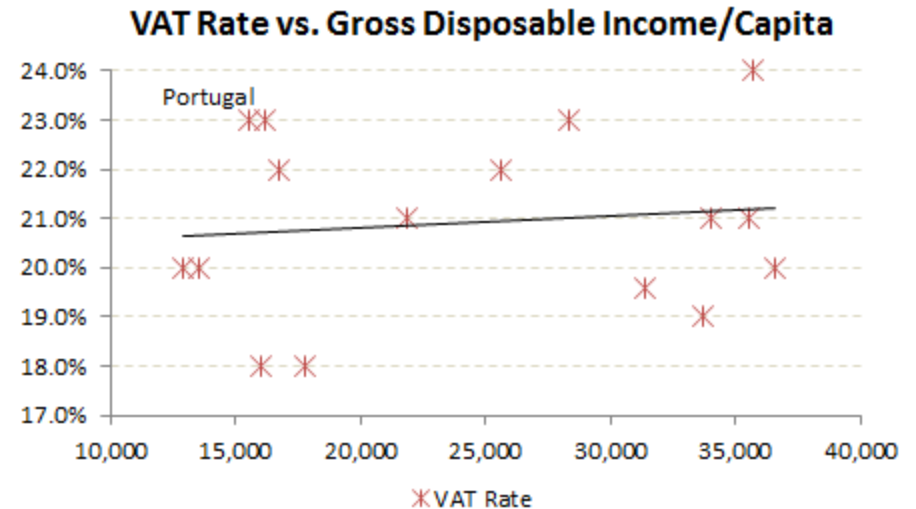
## Personal Income Tax Rate Relative to Income/Capita

- The Portuguese State's tax intake amounts to 43% of the economy, up from 37% in 1995
- Portugal has a disproportionately high personal income tax rate relative to its population's income level



## VAT Rate Relative to Disposable Income/Capita

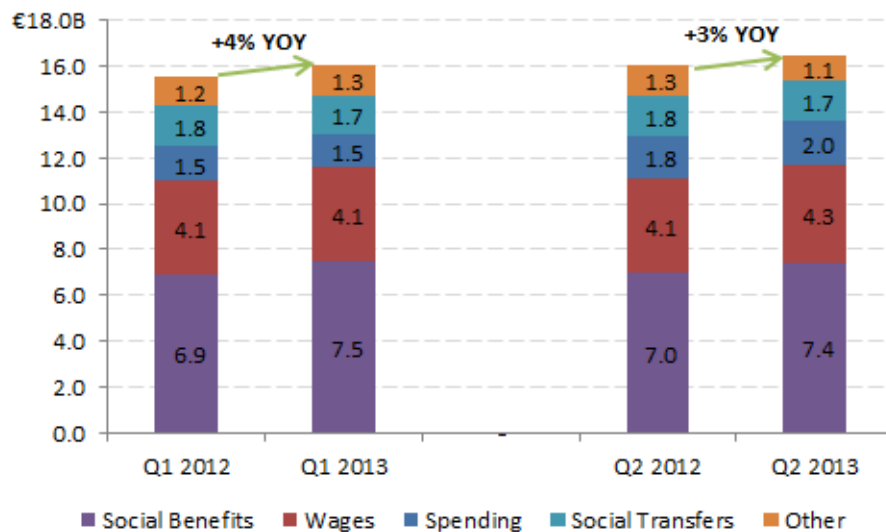
- Portugal has a disproportionately high Value Added Tax rate relative to its population's income level



# ...Or Cut Government Expenditures.

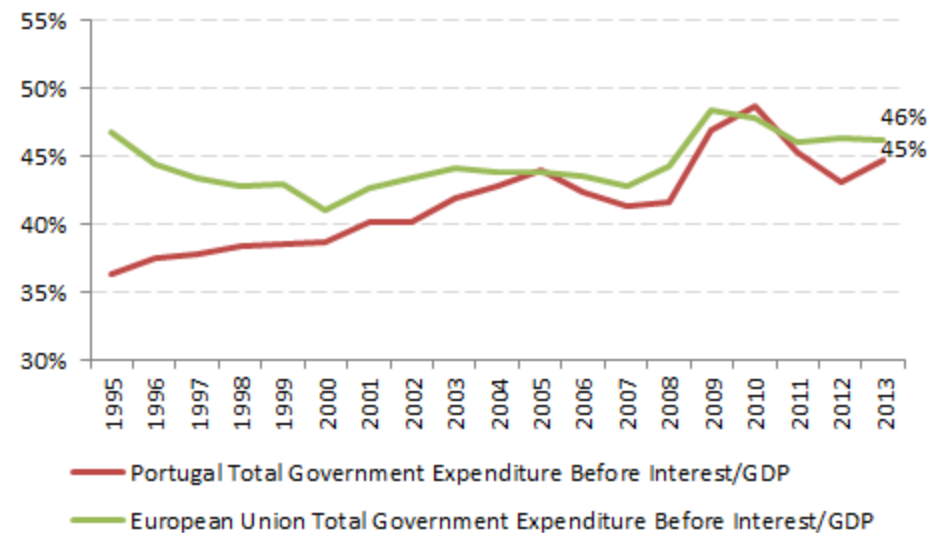
## Gvt Expenditures Are Increasing

- Despite painful austerity measures, Portugal has witnessed an increase in its total government expenditures of 3% year to date, compared to last year, partly due to constitutional restrictions



## Gvt Expenditures/GDP

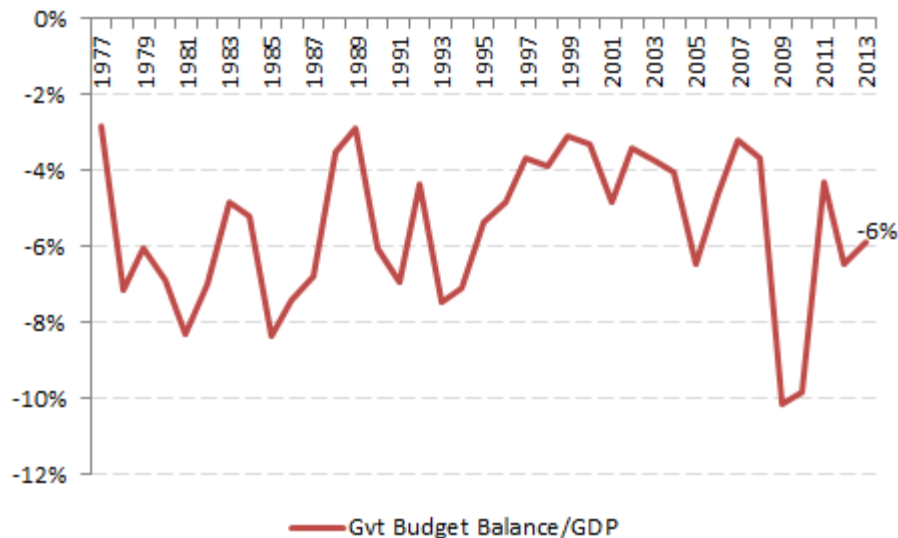
- The Portuguese State spends approximately 45% of the country's GDP
- The Constitutional Court is preventing cuts to wages and social benefits, which account for 70% of government expenditures, making meaningful government savings unlikely



# The Debt Servicing Capacity is Low...

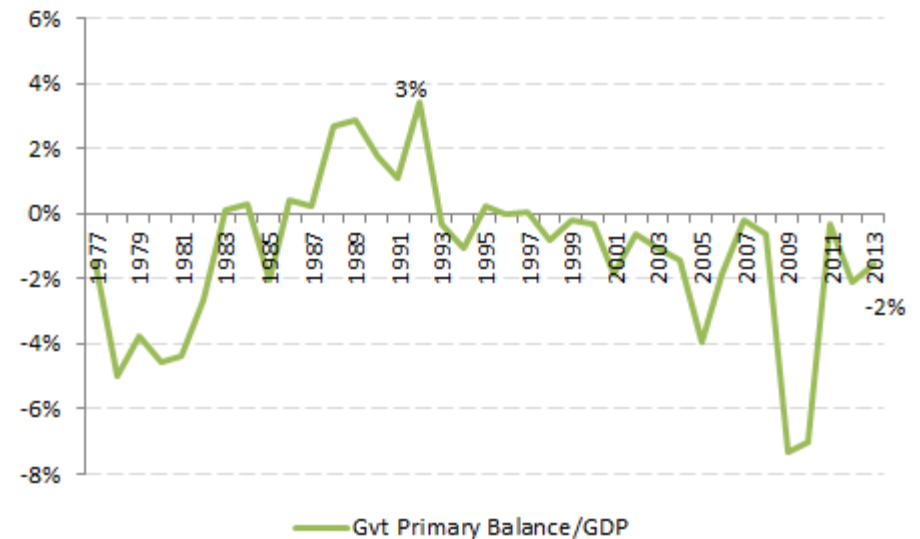
## Government Budget Balance

- The Portuguese sovereign has suffered a government deficit for 40 consecutive years



## Government Primary Budget Balance

- Portugal's primary budget balance has been negative since 1995
- The primary budget balance is the government deficit before debt interest expense or the Unlevered Cash Flow

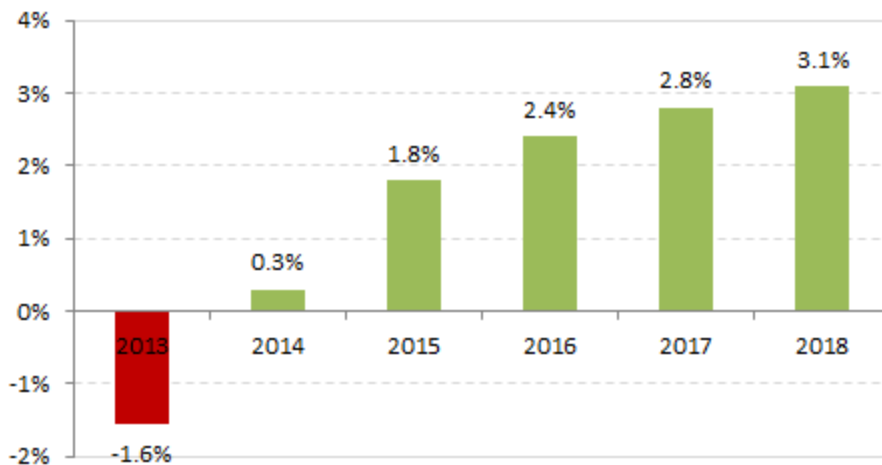


# ...However Growth & Structural Reforms can Increase Debt Servicing Capacity...

## Best Case Primary Balance

- The IMF assumes that in 2018, the primary balance will return to its peak level of 3% of GDP reached in 1992
- This is likely an optimistic assumption but it will help us determine how much debt Portugal can sustain in a bull case

### Portugal Primary Balance/GDP



## Debt Servicing Capacity

- There is no universally agreed methodology to define how much debt a sovereign can sustain
- The "government's budget constraint" states that the net present value of all future primary balances must be sufficient to pay back debt principal and the interest accumulated along the way
- We believe that at the very least, a government must have the potential to generate enough primary budget surplus (unlevered cash flow) to cover its interest expense. In other words, the country cannot eternally rely on borrowing more debt in order to cover its interest payments on the existing debt
- We consider historical peak primary balances as being a good estimate of a "best case" primary balance

# ...But Only Enough to Service 70% of the Existing Debt Outstanding...

## Best Case Debt Servicing Capacity

- In the most optimistic of cases, we believe that Portugal can only generate a €5 billion primary surplus and therefore should not have to sustain more than €5 in interest payment from its existing debt
- With a current interest burden of debt of over €7 billion, the interest coverage ratio is 0.7x, implying that Portugal has approximately 30% excess leverage, in the best of cases

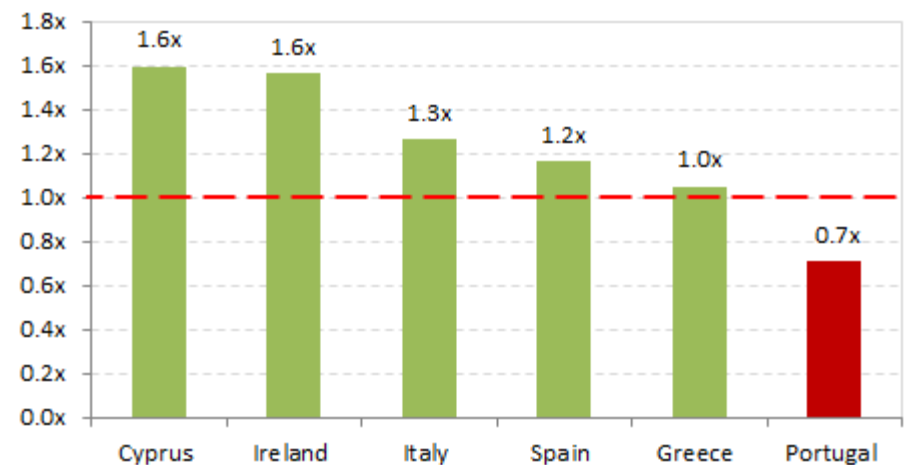
*in € billions, unless otherwise stated*

Current GDP	€ 165.3
Best Case Primary Surplus/GDP	3.1%
Best Case Primary Surplus	€ 5.1
Current Interest Expense	€ 7.2
<b>Interest Coverage</b>	<b>0.7x</b>
<b>Sovereign Debt Excess Leverage</b>	<b>29%</b>

## Comparable Best Case Interest Coverage Ratios

- Within the European peripheral sovereigns, only Portugal is unable to generate enough primary surplus to cover its interest expense, even in the most optimistic case

### Interest Coverage Ratio





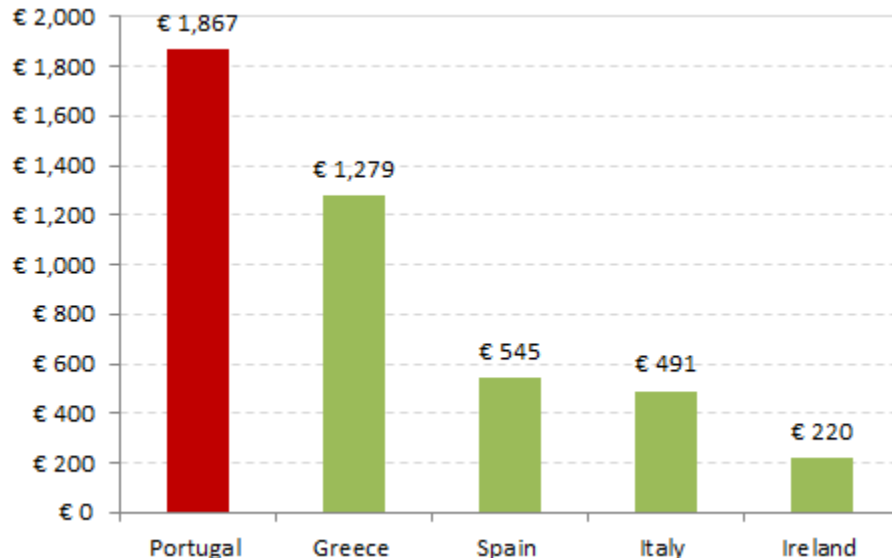
# Portugal Already Benefits from Extraordinary Levels of Solidarity



# Portugal Already Benefits from Very Generous Fiscal Transfers from the European Union

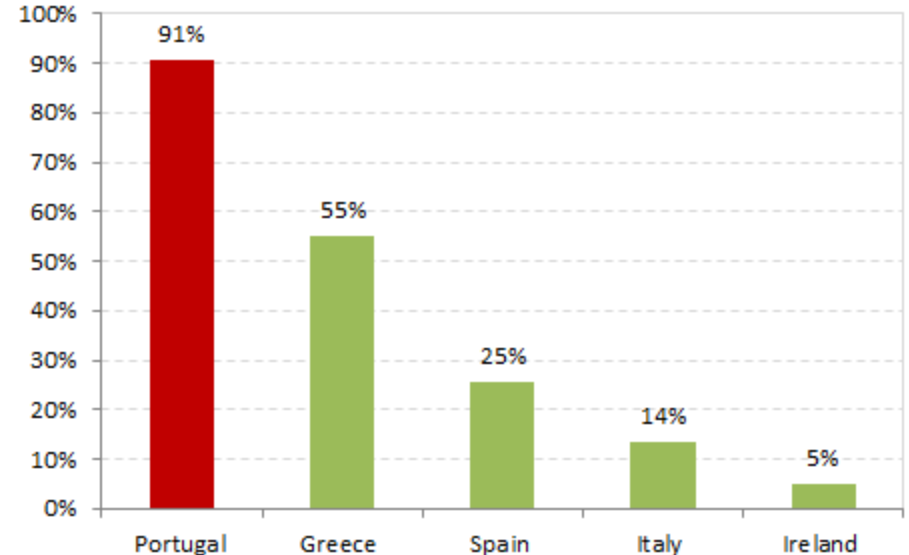
## Cohesion Funds/Capita

- Portugal will be allocated €19.6B in cohesion funds between 2014-2020, down from €21.4B between 2007-2013
  - This represents €1,867/capita
- Portugal will also benefit from €8 billion of Common Agricultural Policy transfers



## Cohesion Funds/Government Gross Capital Formation

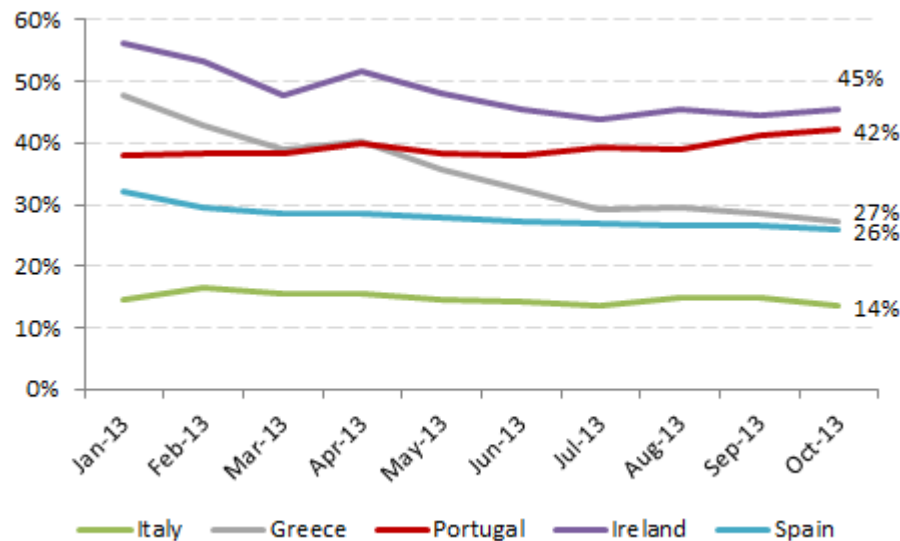
- 91% of the annual government capital expenditures will be financed by annual cohesion fund transfers or 1.7% of annual GDP
- This is significantly higher than in the rest of the European periphery



# Euro-Area Central Banks Are Providing Significant Funding through the Target2 System

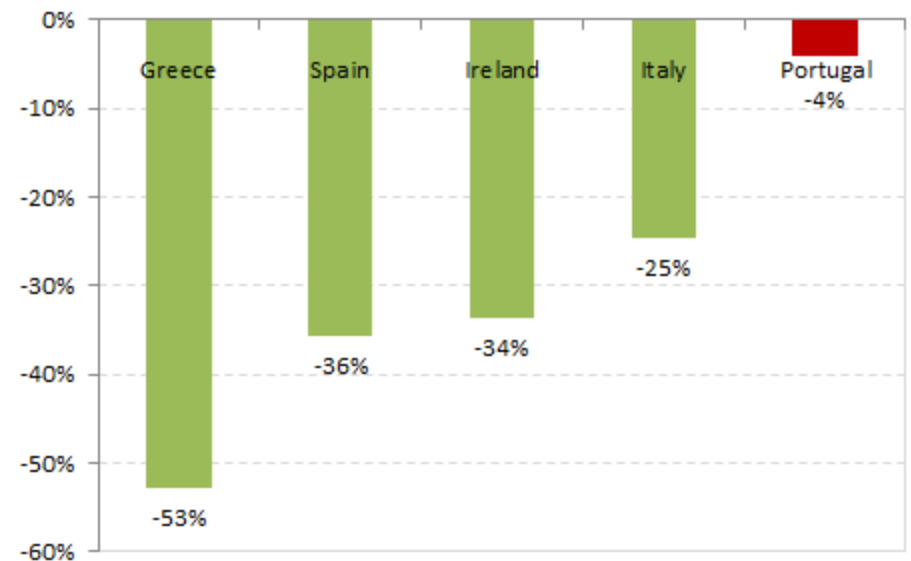
## Target2 Liabilities/GDP

- Portugal's Target2 liabilities show that Banco de Portugal borrowed €70B from other euro-area central banks to cover its current and capital account deficits
- This amounts to 42% of Portugal's GDP, among the highest in the Eurozone



## Change in Target2 Liabilities Since OMT Announcement

- "A decrease in Target2 balances is the best sign we have that there has been a gradual return of confidence" Mr. Draghi
- Since the ECB's OMT announcement, Portugal's Target balances have barely changed



# The ECB's LTRO Program Finances 9% of The Portuguese Bank's Liabilities

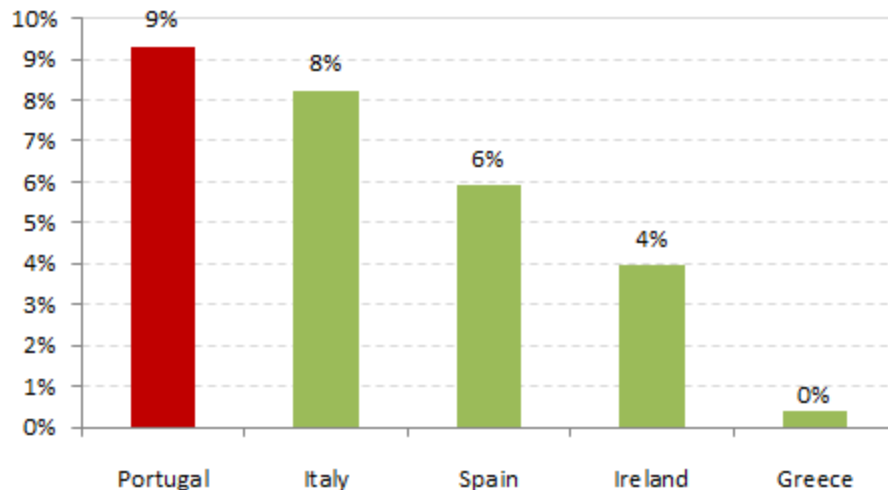
## LTRO Loans as a % of Total Banking Assets per Country

- Portuguese banks have financed 9% of their total national assets through LTRO loans, higher than their peers
- The banks used that money to speculate in the bond market as opposed to lending to households and businesses

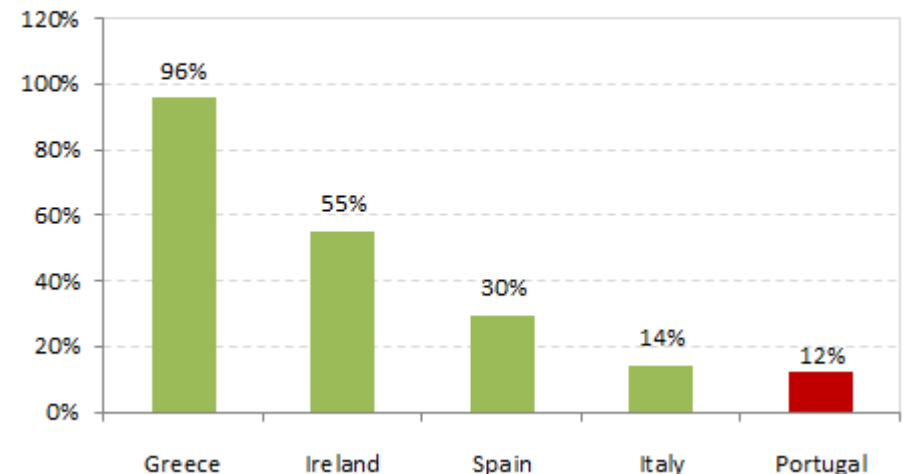
## Change in LTRO Loans

- Portuguese banks have only reimbursed 12% of the LTRO loans outstanding as at March 2012
- Other Eurozone banks were able to repay a higher percentage of their LTRO borrowings

**LTRO Loans / National Banking Assets**



**LTRO Reimbursement %**

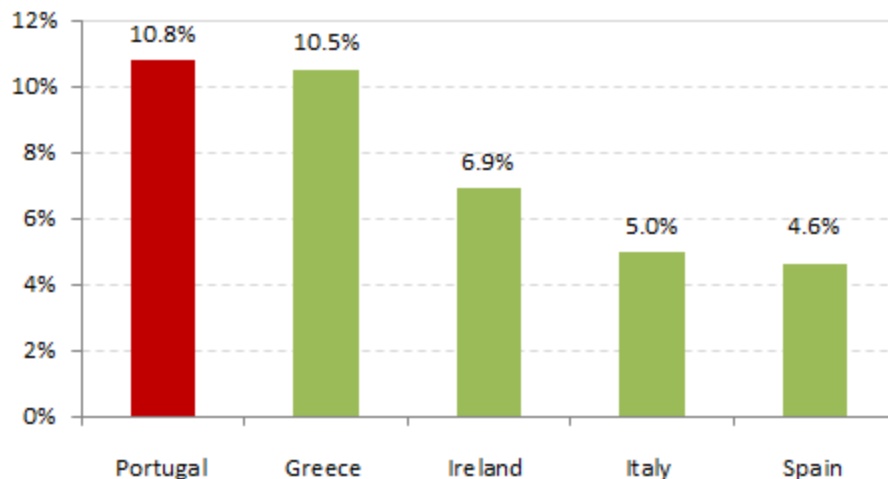


# The ECB Already Purchased 11% of Portugal's Sovereign Debt and 23% of its Bonded Debt

## Sovereign Bonds Held under the Securities Markets Program

- The ECB purchased €23 billion of Portuguese Sovereign bonds during 2010-12 to support private bondholders
- This represents 11% of Portugal's total sovereign debt (the highest in Europe), but also 23% of the bonded debt

### % of Sovereign Debt Held by the ECB



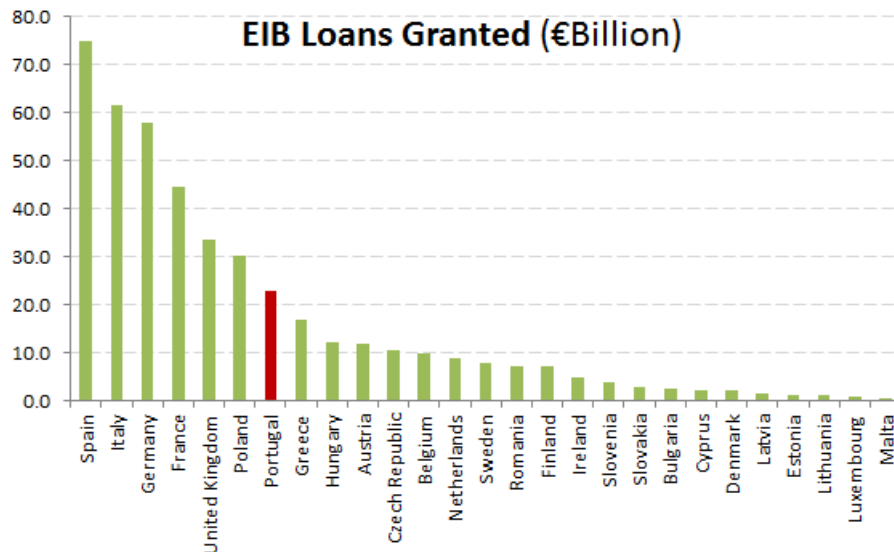
## Impact of the ECB's Bond Purchases

- The ECB's bond purchases under the SMP program had no positive impact on Portuguese bond yields because the ECB's SMP holdings are senior to those of private creditors
- The Outright Monetary Transaction ("OMT") is meant to address the SMP's short-comings by making new bond purchases pari-passu with those of private creditors but Portugal does not qualify for the OMT program

# The EIB Has Lent More Funds to Portugal than to Any Other Country Relative to GDP

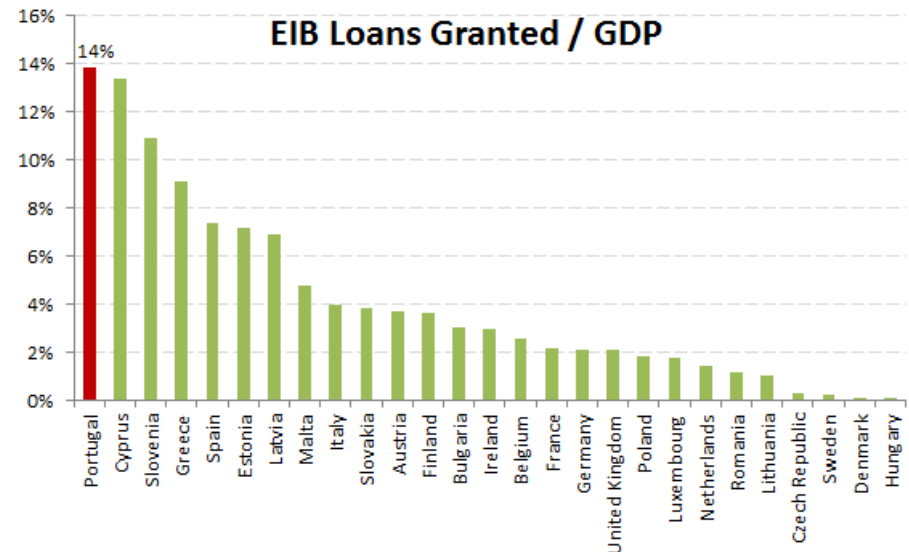
## EIB Loans

- The European Investment Banks ("EIB") has lent €23 billion to Portugal to date



## EIB Loans / GDP

- EIB's loans to Portugal amount to 14% of GDP, the highest in the entire European Union



# The European Rescue Funds EFSF and EFSM Represent 22% of Portugal's Sovereign Debt

## EFSF

- The EFSF loans represent 15% of Portugal's GDP and €2,362 per capita
- We estimate that the subsidized interest rate will result in total interest savings of €18.5 billion over the life of the loan

EFSF Loan Program	
<b>Disbursed to Date *</b>	<b>€24.8b</b>
% Disbursed	95%
As a % of GDP	15%
As a % of Headline Debt	12%
As a % of Adjusted Debt	10%
Per Capita	€2,362
<b>Average Interest Rate</b>	<b>2.4%</b>
As a % of Interest Expense	8%
Market Based Interest Rate	6.0%
Estimated Total European Subsidy	€18.5b
<b>Average Maturity</b>	<b>21y</b>

## EFSM

- The EFSM loans represent 13% of Portugal's GDP and €2,105 per capita
- We estimate that the subsidized interest rate will result in total interest savings of €12.5 billion over the life of the loan

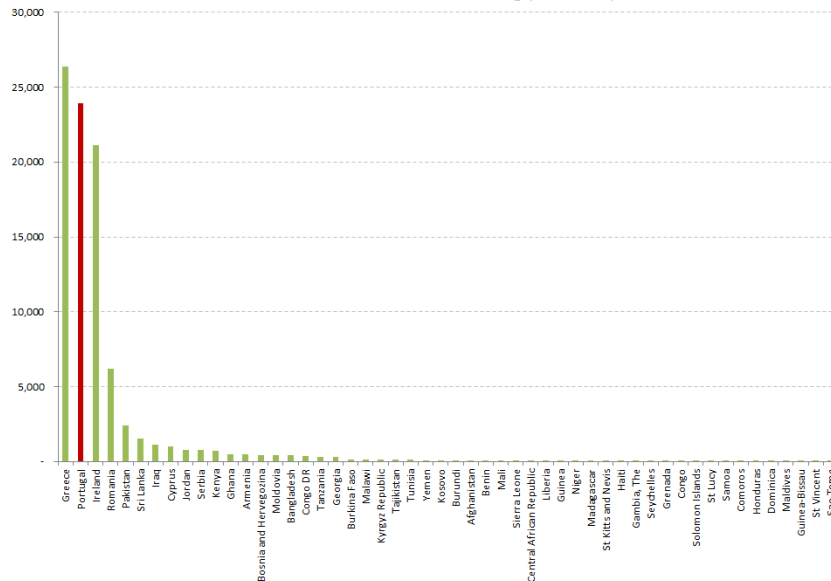
EFSM Loan Program	
<b>Disbursed to Date *</b>	<b>€22.1b</b>
% Disbursed	85%
As a % of GDP	13%
As a % of Headline Debt	10%
As a % of Adjusted Debt	9%
Per Capita	€2,105
<b>Average Interest Rate</b>	<b>3.0%</b>
As a % of Interest Expense	9%
Market Based Interest Rate	5.9%
Estimated Total European Subsidy	€12.5b
<b>Average Maturity</b>	<b>20y</b>

# The IMF Already Represents 12% of Portugal's Sovereign Debt

## IMF Loans

- The IMF has lent Portugal over €24 billion, representing 12% of Portugal's debt
- Excluding Greece and Ireland, the Portuguese loans are higher than the sum of all loans made by the IMF worldwide, to 50 countries

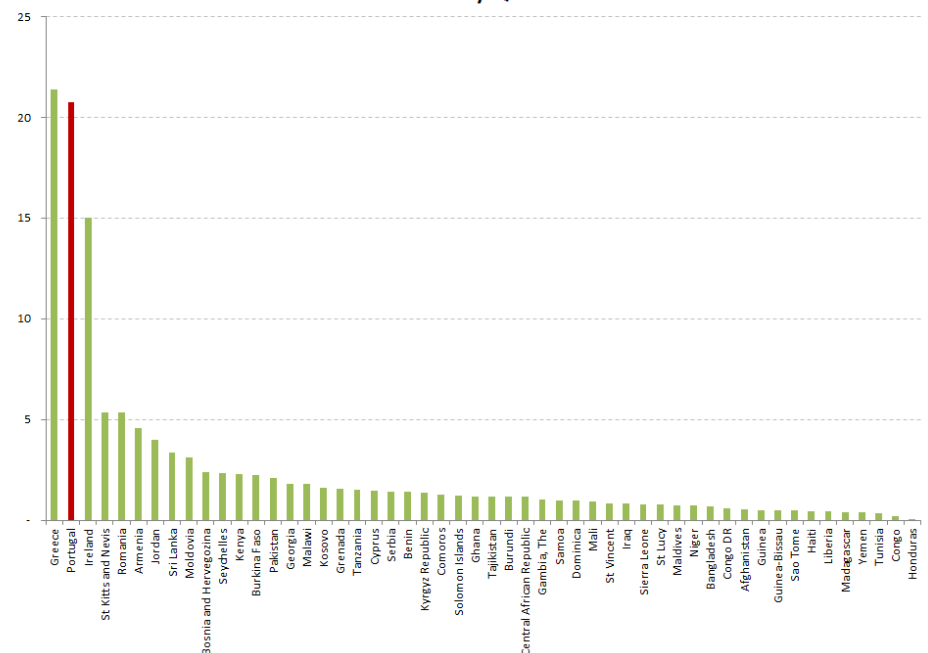
IMF Loans Outstanding (€ Million)



## IMF Loans as % of Quota

- The IMF dissociated the amount it lent to Portugal, Greece and Ireland from these countries quotas
- Portugal's IMF loans add up to 21x its quota vs. 1.5x for the rest of the world

IMF Loans / Quota





# Europe Has Already Given Portugal an OSI Without Asking for Concessions From the Private Sector

## EFSF/EFSM Maturity Extension

- In July 2011, the EFSF and EFSM postponed their loan maturities to Portugal by five years from 7.5 years to 12.5 years. In June 2013, the maturities were pushed an additional seven years from 12.5 years to 19.5 years
- Portugal expects the EFSM maturities to be extended again, past 2026
- Without a PSI, Europe would be structurally subordinating its own tax payers to Portuguese private sector creditors as 93% of the bonded debt would have matured by 2026. This would be a violation to the comparability of treatment clause which “is designed to ensure that claims of taxpayers in the lender countries are not subordinated to those of other, private-sector creditors”

## EFSF/EFSM Interest

- In July 2011, the EFSF and the EFSM changed the interest margins charged to Portugal from 2% above their funding costs to 0% on both previously disbursed and future tranches
- This was close to violating the “no-bailout clause” and the principle that European loans require “an appropriate margin”
- We believe that the subsidized interest rate results in a transfer of wealth of €31 billion over 20 years from the European taxpayers to the Portuguese state

# Common Misconceptions

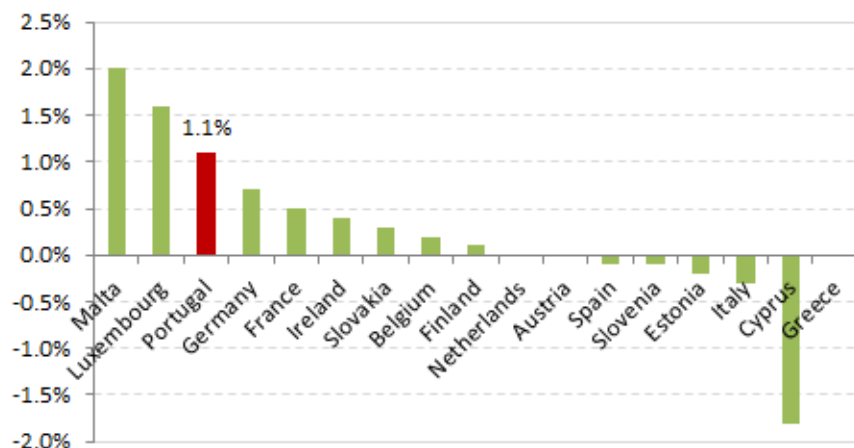


# Misconception #1: Portuguese Growth Has Turned the Corner

## GDP Growth Data Appears Positive...

- Portuguese politicians claimed victory following Q2 2013, stating that economic growth had been restored
- Indeed, a 1.1% real GDP growth QoQ was an impressive result
- Q3 2013 growth is estimated at 0.2% but the details have not yet been released

**Q2 QoQ Growth%**



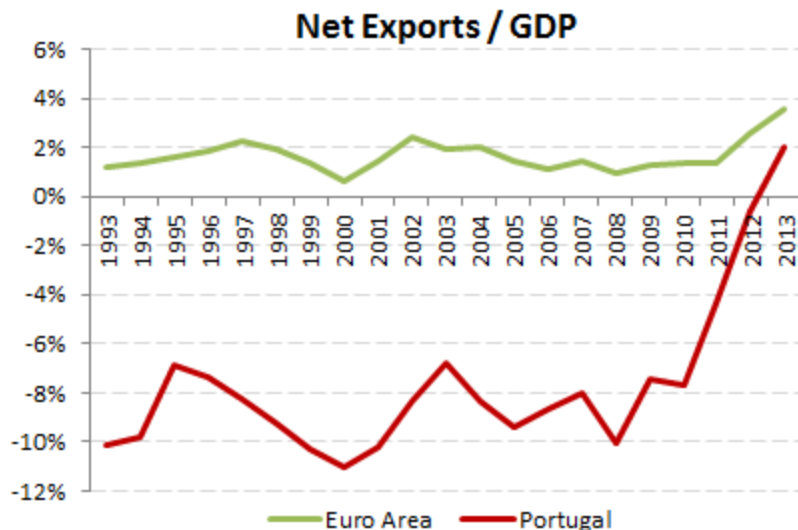
## ...but the Growth Was due to Exceptional Items

- The Portuguese Constitutional Court had ordered the reversal of certain expenditure cuts, most notably, the reinstatement of the 13th and 14th month bonus salaries worth €1.3b/annum
- Other exceptional items included the calendar impact of Easter and the one-time increase in investments due to the opening of the a new diesel unit at the Galp oil refinery in Sines
- When adjusting for these exceptional items, we believe that growth would have been negative throughout the year

# Misconception #2: Exports Can Save Portugal

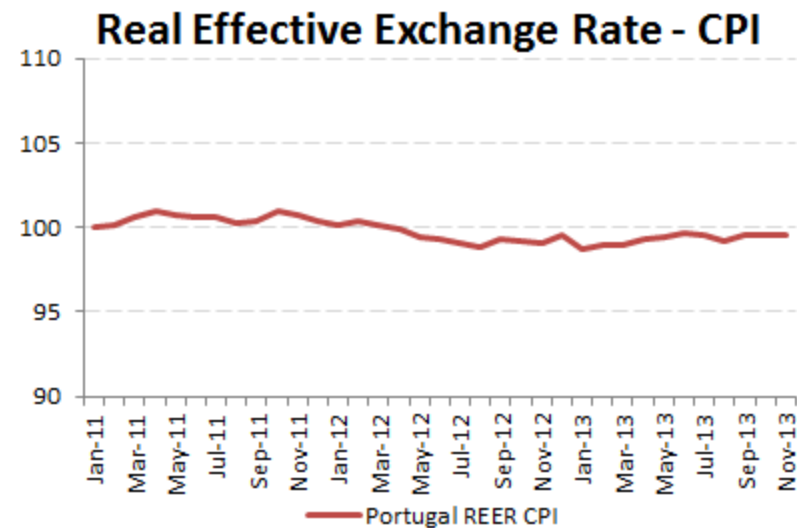
## Net Exports Contribution to GDP Has Turned Positive...

- Portugal's trade balance has improved dramatically over the last two years
- But Portuguese firms have largely been substituting foreign demand for domestic demand due to the latter's weakness



## ...but the Adjustment Is Unlikely to Be Permanent

- Portugal has experienced minimal real exchange rate (REER) improvement vis-à-vis its 21 key trading partners, especially in the private sector
- Export gains would have been more meaningful if REER had been the driver

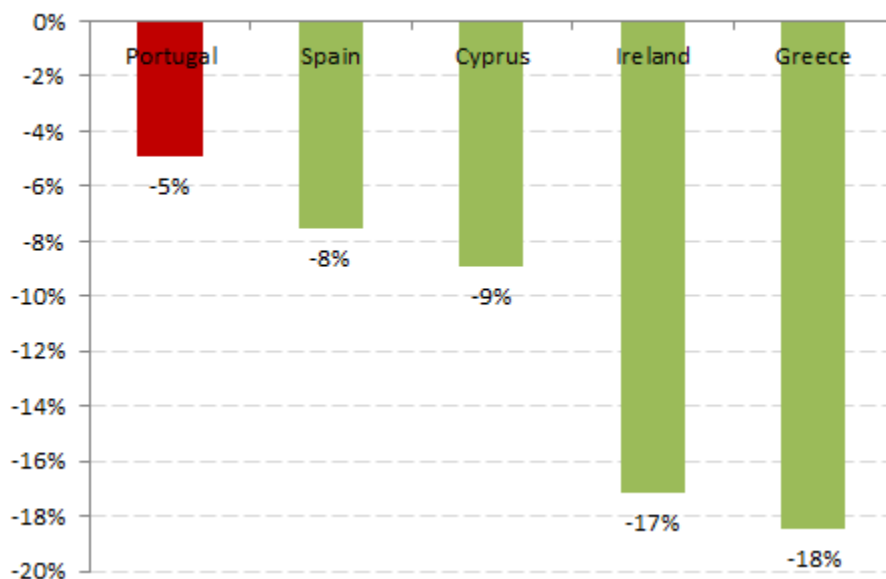


# Misconception #2: Exports Can Save Portugal (Cont'd)

## Portugal Has Not Restored Competitiveness

- Portugal has only witnessed minor improvements in unit labor costs, significantly less than its peers undergoing a program in Europe

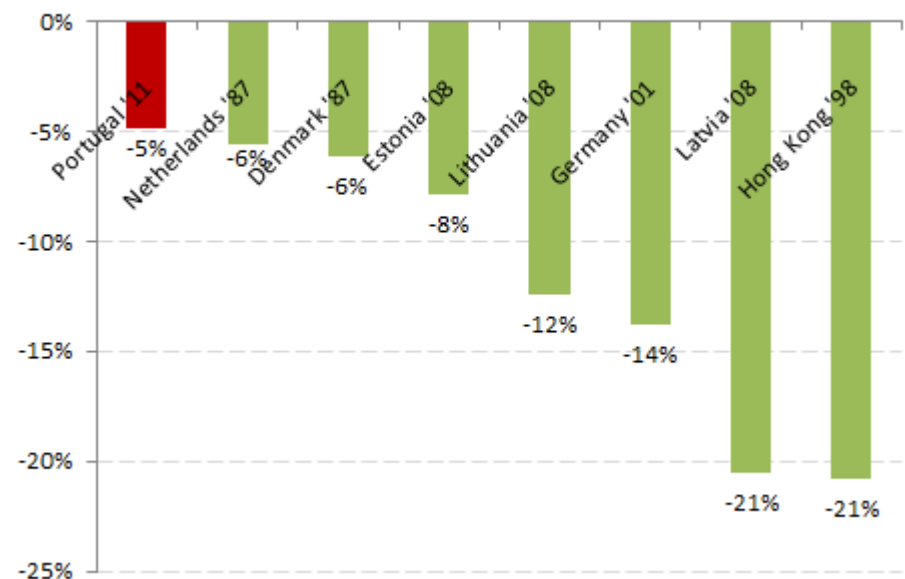
**Drop in ULC from Peak (2008-Today)**



## External Adjustment vs. Countries with Fixed Exchange Rates

- Portugal has also witnessed a smaller adjustment in its unit labor costs than other countries undergoing an external adjustment with rigid nominal exchange rates

**Peak to Trough Drop in ULC**

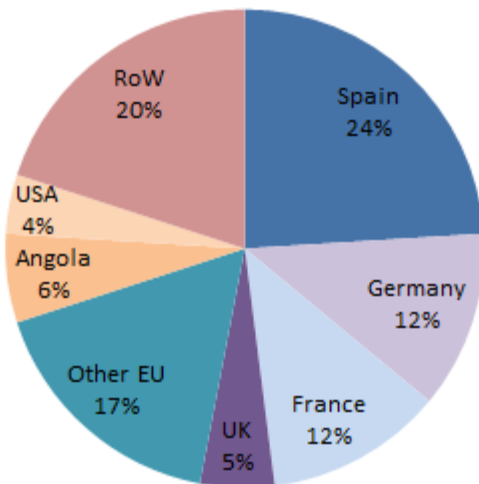


# Misconception #2: Exports Can Save Portugal (Cont'd)

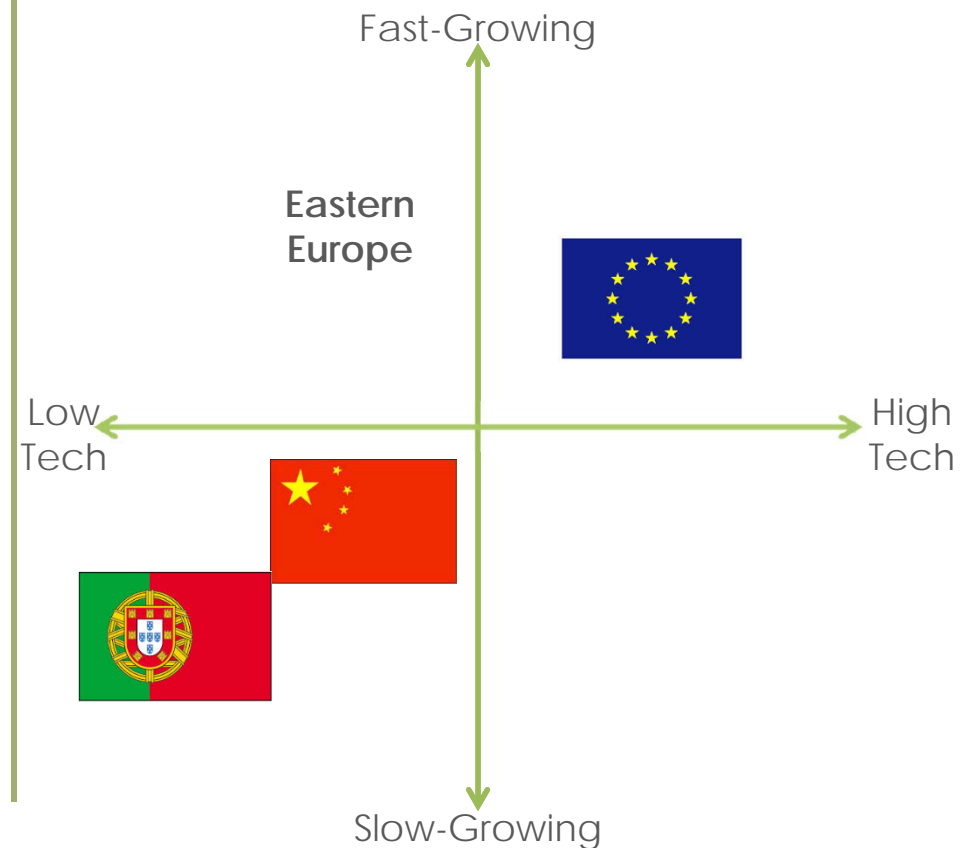
## Slow Growing Geographic Destinations

- 70% of Portugal's goods exports are destined for the European Union
- EU trade has been growing slower than world trade

### Export Geographic Breakdown



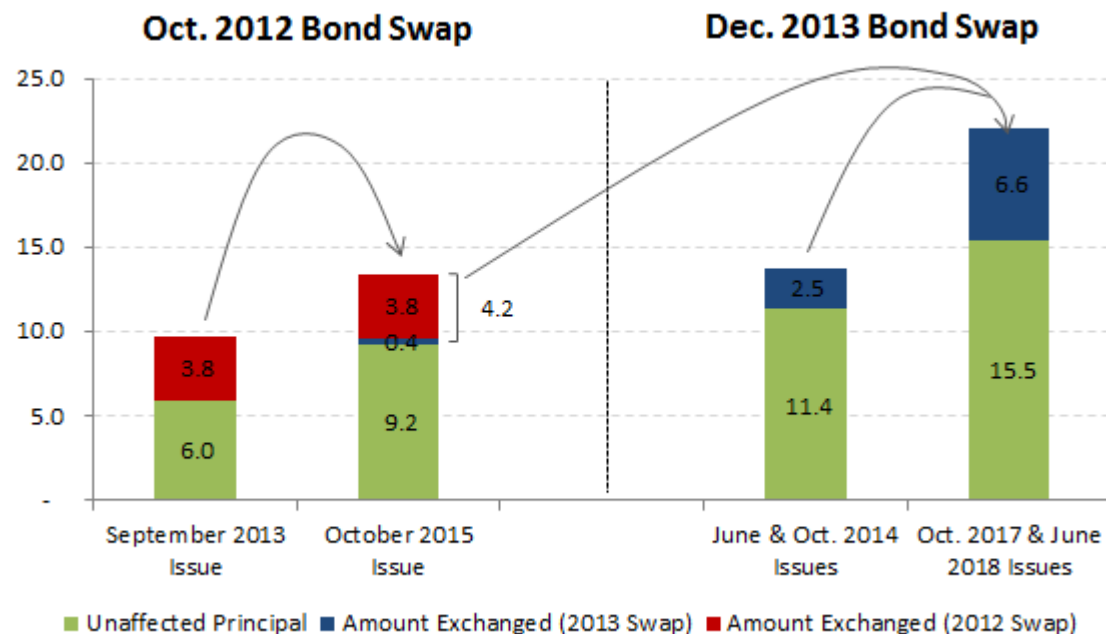
## Slow Growing Low-Value Add Products



Source: Tortus Capital

# Misconception #3: Portugal's Bond Exchange Was A Success

- In October 2012, Portugal exchanged €3.8 billion of liabilities due in 2013 and pushed these liabilities into 2015. In December 2013, Portugal pushed again those same €3.8 billion of liabilities into 2017 and 2018 along with €2.9 billion of other 2014 and 2015 liabilities
- While this debt rollover helps reduce the short-term financing needs, it sends an at least equally strong negative signal that Portugal is trying to avoid paying its debt on time and is attempting to service its debt by continuously issuing new debt – violating what is known as the “No-Ponzi Scheme Condition”.



# Misconception #4: A Portuguese PSI Would Lead to Portuguese Bank Recapitalizations

- A Portuguese PSI would not lead to any major recapitalization of Portuguese banks
- 43% of Portuguese banks' sovereign holdings are in the form of bills, which would be immune to a PSI
- Assuming a 50% haircut to the principal of Portuguese bonds, this would generate an after-tax loss of €5.1 billion but banks have already reserved for a sovereign buffer of €3.7 billion as part of the EBA stress test, leaving an incremental hit to capital of only €1.4 billion or only 0.4% of Portuguese bank assets

<i>In Billions of Euros</i>	BCP	BES	BPI	CGD	Banif	€ Total	% Total
<b><u>Portuguese Sovereign Holdings</u></b>							
Portuguese Bills Holdings	€2.9	€1.8	€3.5	€3.3	€0.2	€11.7	43%
Portuguese Bonds Holdings	€3.9	€3.5	€1.6	€5.1	€1.5	€15.6	57%
Total Portuguese Sovereign Holdings	€6.8	€5.3	€5.1	€8.4	€1.7	€27.3	57%
As a % of Bank Assets	8%	7%	12%	7%	12%	8%	
<b><u>PSI Scenario - Assuming 50% Haircut</u></b>							
Pre-Tax Loss on Portuguese Bills	€0.0	€0.0	€0.0	€0.0	€0.0	€0.0	
Pre-Tax Loss on Portuguese Bonds	-€1.9	-€1.7	-€0.8	-€2.6	-€0.7	-€7.8	
Tax Shield @ 35% Tax Rate	€0.7	€0.6	€0.3	€0.9	€0.3	€2.7	
After-Tax Loss on Portuguese Holdings	-€1.3	-€1.1	-€0.5	-€1.7	-€0.5	-€5.1	
Existing EBA Sovereign Buffer	€1.2	€0.1	€1.4	€1.1	€0.0	€3.7	
<b>Net Impact on Bank Capital</b>	<b>-€0.1</b>	<b>-€1.0</b>	<b>€0.8</b>	<b>-€0.6</b>	<b>-€0.5</b>	<b>-€1.4</b>	
As a % of Bank Assets	0%	-1%	2%	-1%	-3%	0%	

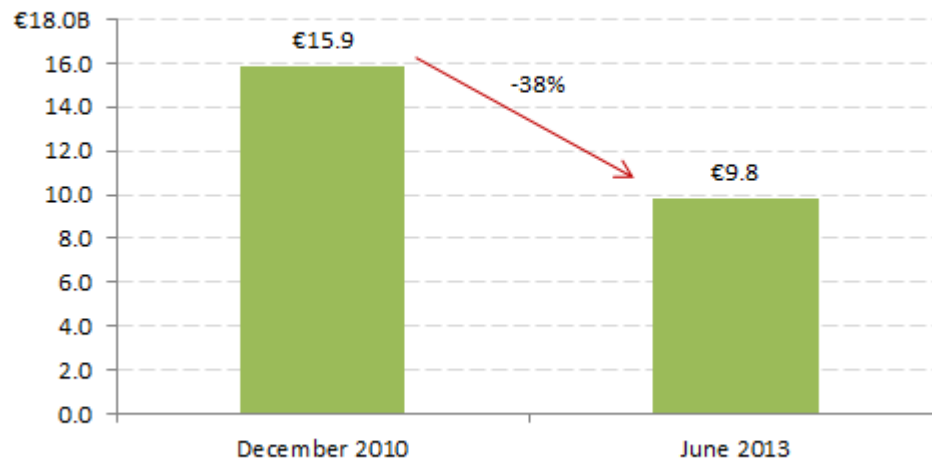


# Misconception #5: A Portuguese PSI Would Create Contagion Risk

## No Contagion Risk Through the Banking Channel

- Non-Portuguese European banks have reduced their holdings of Portuguese sovereign debt over the past three years to less than €10 billion

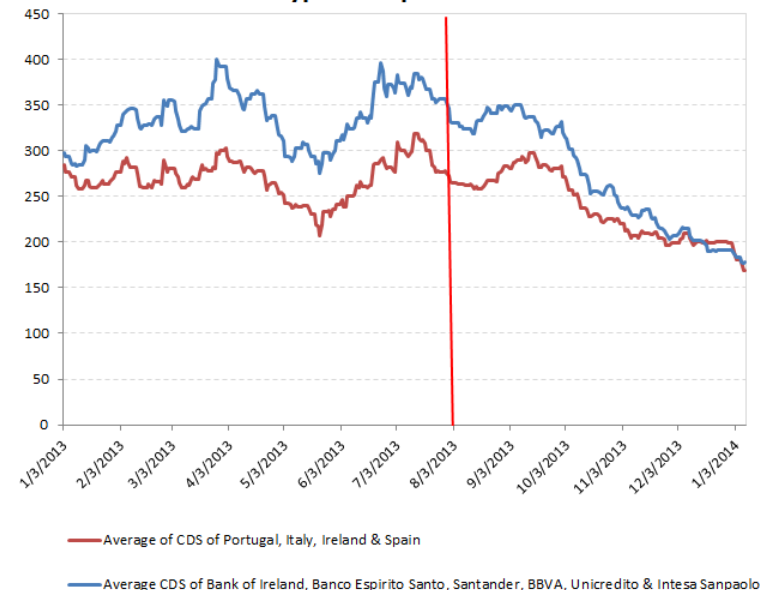
**Non-Domestic Bank Holdings of Portuguese Sovereign Debt**



## OMTs Protect Against Contagion

- The OMT program is designed to and has been successful at preventing contagion risk, as proven from the deposit haircut in Cyprus, which had no discernable contagion onto peripheral European countries or banks.

**Average CDS of Sovereigns and Banks before and after Cyprus' Deposit Haircut**

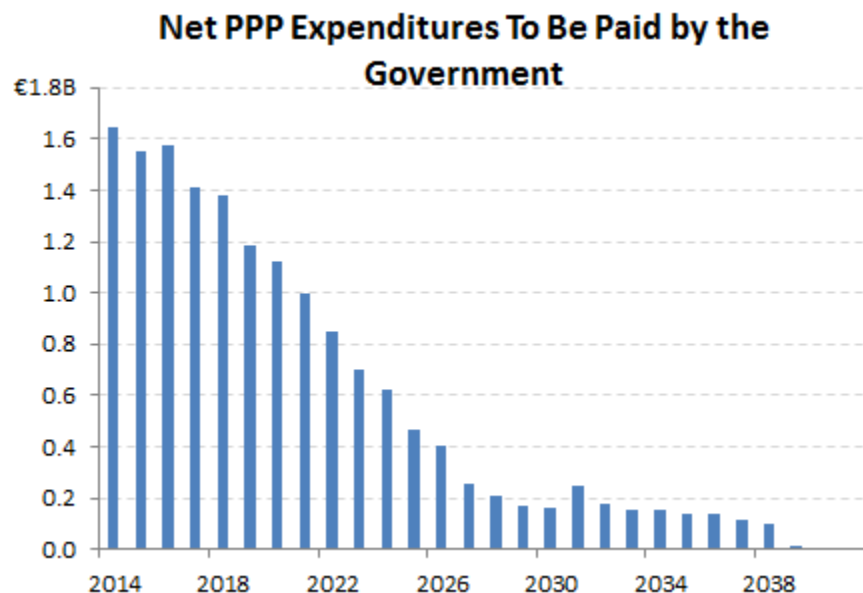


Source: European Banking Authority, Bloomberg

# Misconception #6: Portugal Is Not Hiding Debt

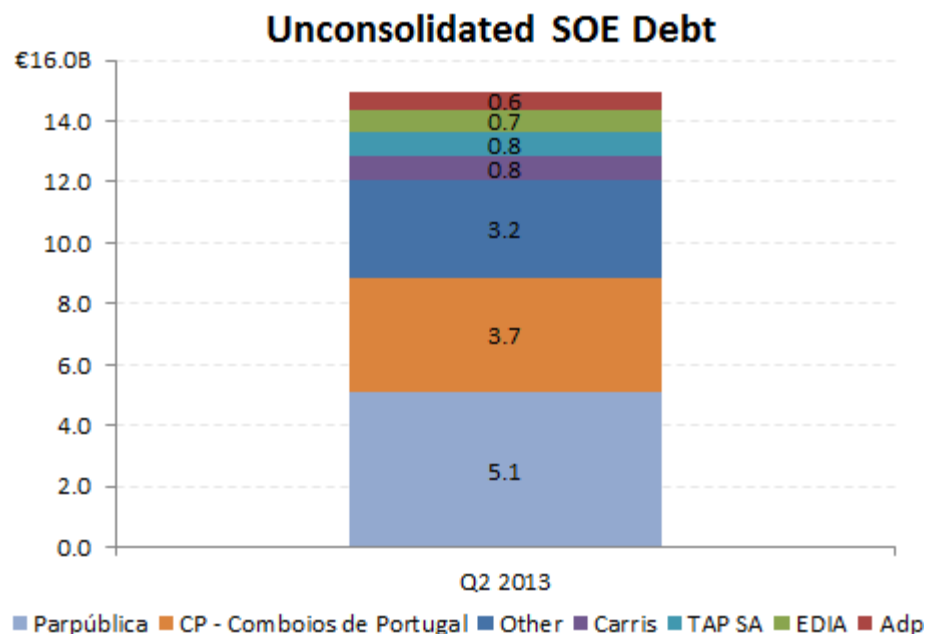
## Public-Private-Partnership Debt Is Real and High

- Portugal has one of the largest PPP programs in the world, with cumulative investments of about 15% of GDP
- The budgetary impact is 1% of GDP in 2014, but payments last until 2040 and add up to €16 billion or 10% of GDP



## Unconsolidated State-Owned-Enterprise Debt Is Real and High

- The unconsolidated state-owned-enterprise (SOE) debt represents 9% of GDP, or €14 billion
- ESA 2010 accounting rules in 2014 may lead to their inclusion



# Misconception #6: Portugal Is Not Hiding Debt (Cont'd)

## Off-Market Swaps

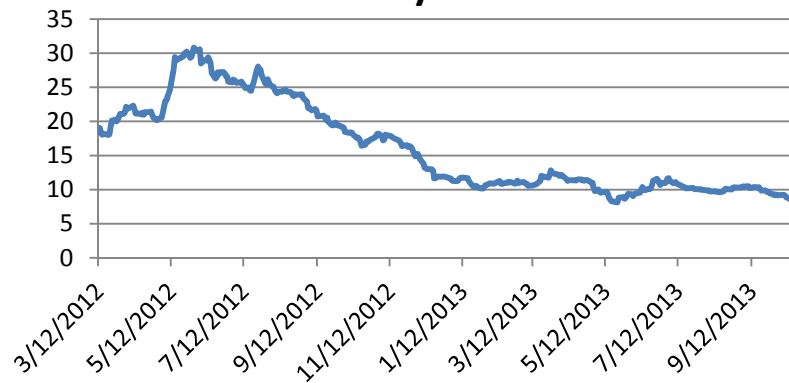
- In April 2013 the Portuguese Finance Ministry announced that a series of “speculative” derivative contracts (mostly interest-rate swaps) signed by 15 state-owned companies were off-market and out of the money with total potential losses of €3 billion
- The subway company alone faced an €800 million loss
- In the following months Portugal renegotiated or terminated some of these contracts with the bank counterparties and has since reduced the potential loss to €1.5 billion
- A number of public officials connected to the transactions have been replaced, including the Secretary of State for Treasury, Joaquim Pais Jorge, who resigned in August 2013
- The local press remains fixated on the issue and the Portuguese parliament is in the process of conducting an inquiry into all derivative contracts at state-owned companies, which could potentially uncover additional transactions and potential losses

# Misconception #7: The Greek Sovereign Restructuring (PSI) Was a Mistake

## Greece PSI Facts

- Greece's PSI restructured over €100 billion of debt and achieved debt relief of over 50% of GDP on a net basis
- The participation rate was an impressive 97% of the private debt thanks to certain legal techniques that would also be available in Portugal

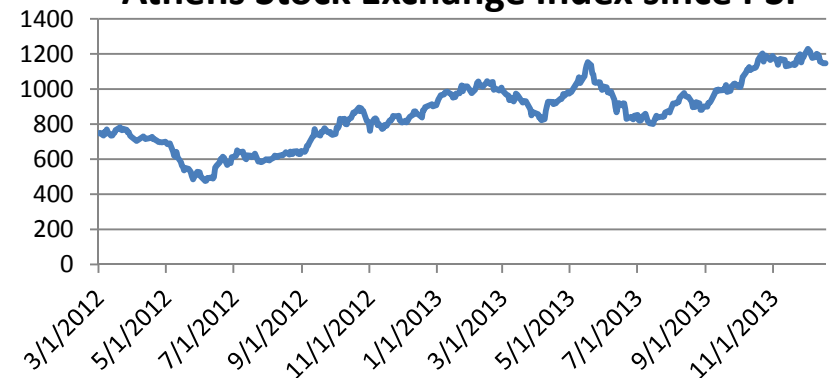
**Greece 10Y yield since PSI**



## Greece Post-PSI































- There was no meaningful disruption and no payment default
- Economic sentiment indicators and the stock market have skyrocketed since the PSI

**Athens Stock Exchange Index since PSI**



# Rehabilitation Plan

# Review of Alternatives - PSI Is the Best Rehabilitation Option

	Sustainable Solution	Return of Sovereignty	Debt Sustainability	Return to Growth	Financial Risk Mitigation
Program Extension/Credit Line					
Capital Market Borrowing					
Reprofiling of Debt					
Debt Restructuring By Legislative Act					
<b>PSI Through Debt Exchange</b>					
Euro Exit					

# PSI Roadmap

## Legislation

- Select new technocratic government with support from PS, PSD, CDS with one-year mandate to restructure Portugal's sovereign debt
- Pass law in parliament to retroactively introduce Collective Action Clauses into local law government bond contracts

## Bond Exchange

- Restructure all of the privately held bonds or approximately 50% of Portugal Republic's debt
- Exchange Old Bonds for New Bonds with 40%-50% lower principal, 2%-3% interest rates and 10-25 year maturities
- Offer warrants to participate in the recovery of the economy

## Commitments

- Portugal commits to pursuing structural reforms to boost potential growth and improve competitiveness while maintaining fiscal discipline
- Europe brings interest rates on EFSF and EFSM loans to 0% and commits to promoting growth and investment in Portugal

# CONTACT INFORMATION

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