Creditreform Sovereign Rating

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Rating Object	Rating Information	
REPUBLIC OF PORTUGAL	Assigned Ratings/Outlook: **BB+ /stable**	Type: Follow-up Rating, unsolicited
Long-term sovereign rating Foreign currency senior unsecured long-term debt Local currency senior unsecured long-term debt	Initial Rating Publication Date: Rating Renewal: Rating Methodologies:	28-10-2016 27-10-2017 “Sovereign Ratings”

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Rating Action

Neuss, 27 October 2017

Creditreform Rating has raised its unsolicited long-term sovereign rating on the Republic of Portugal to “BB+” from “BB”. Creditreform Rating has also raised Portugal’s unsolicited ratings for foreign and local currency senior unsecured long-term debt to “BB+” from “BB”. The outlook is stable.

Key Rating Drivers

1. Economic recovery continued in 2016 and GDP is set to grow at the highest rate in ten years this year; medium-term growth prospects improved somewhat on the back of favorable labor market developments, and a prospective recovery in investment from low levels
2. While fiscal consolidation progressed and is set to continue, public debt levels are among the highest in the EU-28; prudent debt management operations and lower financing costs have mitigated medium-term fiscal sustainability risks
3. Portuguese large banks succeeded in strengthening their capital position and contingent liability risks have somewhat receded; however, fiscal risks related to relatively weak asset quality in the banking sector remain
4. Although still exhibiting a highly negative NIIP, the external position of the economy improved in 2016 as the Portuguese government has continued to reduce its external liabilities

Reasons for the Rating Decision

Creditreform Rating has raised its ratings on the Republic of Portugal to BB+ from BB. The upgrade is underpinned by (i) a significant improvement of Portugal’s near to medium term growth prospects; (ii) notable progress regarding fiscal consolidation in 2016, our expectation being that the government’s headline deficit will continue to narrow in 2017-2018; and (iii) improvements in the country’s external position, mainly driven by external deleveraging of the government.

Above all, the high quality of its institutional setting continues to support the Republic of Portugal’s creditworthiness. As highlighted by the World Bank’s World Governance Indicators (WGI), Portugal remains well-positioned in a worldwide comparison and its institu-

tional set-up is stronger than in other program countries such as Greece and Cyprus. Assessing the WGIs rule of law and control of corruption, Portugal is ranked 32 and 41, in line with the respective euro area median rank. With regard to government effectiveness, which mirrors the perception of the quality of civil services and policy formulation, the World Bank ranks Portugal at 31 out of 209 economies, which compares well with the euro area's median (rank 35).

Our assessment of Portugal's macroeconomic performance balances an improvement of the economy's near to medium term growth prospects on the back of strengthening export growth and a faster-than-expected recovery in employment against low levels of investment. To be sure, a recovery in investment activity is underway. However, private investment is still among the lowest in the EU-28 as measured by GDP (see below).

As regards 2016, the Portuguese economy continued its recovery with domestic demand remaining the main driver of economic expansion. However, as compared with 2015 (1.8%) real GDP growth slowed somewhat, posting at 1.5%. While spending of households recorded robust growth (+2.1%), supported by vivid employment growth and the low-inflation environment, growth in investment dropped sharply from 5.8% in 2015 to 1.6%. Last year's modest investment activity was mainly a result of sluggish construction activity (-0.3%). In addition, the government's investment accounts were negatively impacted by one-off operations conducted in 2015, resulting in a negative base effect (see below). Low investment was also mirrored by a significant deceleration in import growth, which was reported at 4.1% in 2016 (2015: 8.5%), expanding in line with exports (+4.1%). Exports benefited from strong tourism arrivals; standing at 21.3m, the number of guests saw a strong increase (2016: +11.1%).

As indicated by strong growth rates of 2.8 (Q1) and 3.0% (Q2) in the first half of 2017, Portuguese real GDP growth is set to accelerate notably this year. Robust private consumption accompanied by a surge in investment should lift GDP growth to 2.6%. While household spending should maintain its growth momentum against the backdrop of the ongoing labor market recovery and continuing wage growth, investment is set to rebound strongly due to rising corporate profit margins, increasing capacity utilization and a higher absorption of ESI funds which is expected for this year. The recovery in investment, which already started in the second half of 2016, further strengthened in 2017. In Q1 and Q2 y-o-y growth rates of 9.9 and 10.3% were recorded, with investment in equipment and construction both contributing to the expansion. Strong investment performance was accompanied by dynamic export activity, which benefited from the ongoing recovery in Portugal's main trading partners. While intra-EU exports of goods expanded by a strong 9.8% (y-o-y) in the first half of 2017, demand from outside the European Union rose even more sharply (+27.5%). Also, tourism continued to boost Portugal's exports. According to data provided by Statistics Portugal, tourism receipts were up 19.1% in first six months of 2017 as compared with the same period last year. Taking into account that imports should respond to stronger investment activities, the growth impact of net exports should be broadly neutral again this year.

With regard to 2018, we expect growth to moderate to 2.1% as somewhat weaker domestic demand should not be fully offset by improving net exports. In particular, we believe

that private consumption should expand at a slower pace, as the expected pick-up in inflation and the low level of savings should dampen household spending. In Q1-17, the savings rate stood at a low 3.8% (Q1-16: 4.0%, Q1-15: 5.3%), thus leaving households with limited room to expand consumption in the absence of robust wage increases. Meanwhile, investment is set to support output expansion in the next year. The economic sentiment indicator of the EU Commission climbed to its highest level in seventeen years, signaling robust investment activity going forward.

In view of negative net migration, an ageing society and subdued investment dynamics (see below), Portugal's medium-term growth prospects appear modest although recent developments, namely the faster-than-expected recovery in the labor market, should have been supportive to the economy's potential growth. The unemployment rate continued to decline for the third consecutive year in 2016 and posted at 11.2%, down from 12.6% in 2015. Throughout 2017, unemployment remained on a downward trajectory, reaching a quarterly average of 9.2% in Q2-17 (total, s.a., Eurostat data). Thus, unemployment was in line with euro area levels for the first time since Q1-06. More importantly, the recent decline in unemployment was matched by brisk job creation. Employment growth accelerated from 1.8% y-o-y in Q4-16 to 3.4% in Q2-17, with both the industrial and the service sectors adding significantly more jobs. Notwithstanding the ongoing labor market recovery, which we believe is set to continue in 2017-18, the Portuguese labor market is still facing significant structural challenges. Standing at 19.1% in 2016, the share of employees (15-64y) with temporary contracts is higher only in Spain (21.8%) in the EA-19. In particular, younger workers are affected by labor market segmentation. According to Eurostat data, two out of three employees (62.8%) at age 15-24 have fixed-term working contracts. At the same time, youth and long-term unemployment remain disproportionately high. Although youth unemployment (15-24y) has decreased by 9.9 p.p. since 2013 (38.1%), it still posted at a high 28.2% in 2016. In order to tackle youth unemployment and to reduce labor market duality, the government has recently introduced some new measures. According to these, employers who hire a young professional will only have to pay 50% of the social security contributions for a period of five years. What is more, the government has started to subsidize the conversion of fixed-term contracts into open-ended ones.

So far, wages have only slowly been responding to improving labor market conditions. After two years of contraction, compensation per employee increased by a moderate 1.4% last year. As productivity growth stalled (-0.2%), unit labor costs deteriorated by 1.6% and the ULC gap vis-à-vis the euro area somewhat widened (Banco de Portugal data). As of now, risks related to cost competitiveness appear limited against the backdrop of the favorable export performance in H1-17 and gains in export market shares recorded in previous years. Portugal's global export market share rose by 10.8% in 2012-16 – with only few EA-19 members reporting stronger growth over this period. Nevertheless, the trajectory of wages and productivity should be monitored carefully. In our view, the alignment of wage and productivity growth in the medium term is a prerequisite to safeguard the gains in cost competitiveness achieved in 2010-15.

In contrast to the labor market, investment in both the public and the private sector has not yet recovered to pre-crisis levels, thus hampering the economy's future growth potential. Multiple years of anemic growth coupled with the need to correct the budget deficit under the economic adjustment program are reflected by the development of the government's investment-to-GDP ratio. As highlighted by EU Commission data, the investment-to-GDP ratio of the public sector halved from 3.2% in 2007 to only 1.5% in 2016, the lowest level in the EU-28. Private investment was also on a downward trajectory, falling from 19.3 to 13.3% of GDP. As regards the corporate sector, a stronger rebound in investment is impeded by multiple factors. First and foremost, firms' capacity to invest is constrained by ongoing deleveraging efforts. As measured by GDP, non-consolidated debt of Portuguese corporates fell from 216.0% (Q4-2012) to 181.1% in Q1-17, but debt levels are still substantially higher than in the euro area (134.3% of GDP). Furthermore, structural bottlenecks continue to impede investment. Although Portugal's business environment was found to be generally favorable, as documented by the World Bank's 2017 Doing Business report (rank 25/190), weaknesses persist in the areas of taxation and access to finance. Admittedly, the Portuguese authorities are gradually implementing measures to address these issues. Regarding taxation, the government lowered corporate income tax rates, enhanced the online filing system, and broadened the scope of the allowance for corporate equity. Meanwhile, the "Capitalizar" and "Semente" programs, which were launched in 2016, aim to improve corporates access to finance. While Capitalizar makes available new credit facilities to SMEs, Semente is tailored to support start-ups, i.e. investors who purchase equity in start-ups can obtain tax deductions for at least two years.

The sovereign's key credit weakness continues to lie in its high general government debt levels and a comparatively weak banking sector, which represents a contingent liability risk for Portugal's public finances. We do, however, acknowledge that significant headway was made with regard to fiscal consolidation last year. Driven by the economic recovery, one-off receipts (EFSF repayments and tax debt settlement scheme PERES), and declining government expenditures, the government's headline deficit fell from 4.4% of GDP in 2015 to 2.0% of GDP in 2016, outperforming the deficit target in the 2016 Stability Program (2.2% of GDP). More precisely, lower interest and capital expenditures provided budgetary relief. The slump in government investment (-32.4% y-o-y) partly reflected base effects resulting from the real estate acquisitions by Oitante related to the BANIF resolution in 2015. In addition, the government's capital spending was negatively affected by a weaker take-up of funds from the EU. Together, savings on investment and interest expenditures more than offset higher employee compensation. Spending on public servants displayed positive growth for the first time since 2013, mirroring the reduction of weekly working hours from 40 to 35 and a somewhat higher number of public employees. Concurrently, the revenue side of the budget experienced only modest growth (+1.2%), thus lagging GDP growth. The reversal of the personal income tax surcharge and the lower statutory tax rate for corporates had a dampening effect on tax receipts.

We expect budget consolidation to continue in 2017. According to the government's recent budget proposal for 2018, the deficit is expected to amount to 1.4% of GDP this

year. Contrary to last year, revenue and primary expenditure measures should contribute equally to fiscal consolidation. State revenues should benefit among others from a new tax on soft drinks, higher levies on diesel, and the introduction of a new property tax applying to assets from properties with a value of more than EUR 0.5bn, as well as from the prolongation of PERES. The PERES program, already adopted in Nov-16 (Decree Law No. 67/2016), is providing incentives to settle tax and social security debt. One-off items, namely higher dividends from the Banco de Portugal and a bond repayment of Banco Privado Portugues, are expected to generate additional revenue in the amount of EUR 0.75bn. Turning to the expenditure side, the implementation of a 2:1 replacement ratio for state employees, as well as savings identified in the 2016 spending review, should yield about EUR 0.2bn. Even though the aforementioned measures are partly needed to finance additional expenditures such as the envisaged pension indexation, we assume that Portugal will reach its fiscal target in 2017 against the backdrop of solid economic growth.

Next year, the pace of budget rebalancing should lose momentum. While the government plans to gradually unfreeze promotions for public servants and provide low-income earners with some tax relief by the introduction of two new personal income tax brackets, fiscal effort should mainly be delivered by a nominal freeze in current expenditure and intermediate consumption. Alongside expenditure containment, robust GDP growth and lower spending on debt service, should lower the budget deficit to 1.2% of GDP in 2018.

Despite the gradual reduction of the government's budget deficit in recent years, the sovereign still displays high general government debt levels. In 2016, the debt-to-GDP ratio continued to climb and reached 130.1% (2015: 128.8%). However, it has to be emphasized that last year's increase in public debt was not fueled by a primary deficit but was mostly due to the recapitalization of Caixa Geral de Depósitos (CGD) in early 2017. Going forward, government debt should gradually decrease and fall below 120% of GDP by 2020. However, debt consolidation could be impeded by the materialization of contingent liability risks which are mainly related to the banking sector (see below). To be sure, these risks have somewhat receded as public guarantees are expected to decrease to 8.1% of GDP in 2017. Further fiscal risks include arrears in the hospital sector which grew to EUR 850m by the end of Jul-17, around 0.5% of 2016 GDP. Moreover, SOEs piled up a debt stock in the amount of 16.9% of GDP (Q4-16), although only approx. 3% of GDP are not included in General Government debt (IGCP data), yet. Also, a loss of investor confidence may result in a sharp increase in bond yields, implying higher expenditure on debt service.

While we expect a very gradual tightening of monetary policy in the euro area, risks related to rising interest rates should be somewhat mitigated by recent debt management operations. In order to save costs on debt service, Portugal continued to buy back maturing bonds and replace IMF loans with cheaper market funding. Between January and August 2017, the government voluntarily repaid another EUR 5.252bn of its outstanding IMF loan before the maturity date, bringing the total sum of early repayments since 2015 up to EUR 18.197bn. In total, Portugal has redeemed more than 60% of funds received from the IMF so far. More importantly, debt management operations were facilitated by favorable market conditions. Throughout 2017, long-term bond yields were on a down-

ward trajectory, mirroring improving investor confidence in the country's economic recovery. As of Sep-17, Portuguese 10y bond yields stood at 2.4%, down from 4.2% (Jan-17) at the beginning of the year. Against the backdrop of sizeable financing needs in 2018-19, the recent improvement in funding costs should have a positive impact on the debt sustainability.

As regards the domestic banking sector, consolidation activities as well as recapitalization efforts have contributed to a strengthening of the capital positions in some of the country's largest banks. In Feb-17, Banco Comercial Portugues (BCP) successfully raised EUR 1.33bn capital in private markets, while Caixabank completed the takeover of Banco Portugues de Investimento (BPI). The Spanish bank paid EUR 0.645bn to increase its stake in BPI from 45 to 84.5%. In Mar-17, the European Commission approved Portugal's plan to recapitalize the fully state-owned CGD, the country's largest bank. Under the restructuring plan, which included the conversion of debt instruments as well as the acquisition of new shares by the state, the bank's capital was raised by EUR 3.9bn. Also, the government sold 75% of the state-owned Novo Banco to the private equity investor LoneStar (Apr-17), who has committed to provide the bank with additional funds worth EUR 1bn. It is expected that the deal will finally be closed in Nov-17.

Notwithstanding the progress that has been made in strengthening banks' capital, the sector as whole still exhibits comparatively low capital buffers. The CET1 ratio of Portuguese banks posted at 13.2% in Q2-17, which is somewhat higher than one year before (Q2-16: 12.1%), but below the EU-28 average. Weak asset quality and low profitability still weigh on banks' capacity to improve their capital positions. The NPL ratio of Portuguese banks declined from 17.9% (Q2-16) to 15.5% (Q2-17), though still one of the highest readings in the euro area. To be sure, measures were taken in order to facilitate the workout of NPLs. In particular, the efficiency of the insolvency and debt restructuring framework was improved. Both, out of court restructuring (SIREVE) and in court pre-insolvency restructuring (PER) were overhauled in order to identify viable firms which can be restructured. Still, the workout of NPLs should only gradually advance and in turn weigh on credit supply. According to ECB data, both lending to households and NFCs has continued to decline in 2017. While the outstanding volume of loans to NFCs shows no signs of recovery, reporting declines in the 5-7% range (y-o-y) since Oct-16, the contraction of credit to households has almost come to a halt. As of Aug-17, the outstanding volume of lending to households was only 1.7% below the previous year's level. In the same vein, the recent pick-up in house prices is not mirrored by stronger mortgage lending yet. While house prices grew vividly in Q2-17 (8.0% y-o-y), partly driven by strong external demand and supply constraints in the construction sector, the outstanding volume of mortgages continues to contract (Aug-17: -2.5% y-o-y).

As indicated by external metrics, Portugal's external position has somewhat improved recently; however, risks remain elevated. The current account, which was broadly balanced in 2014-15 (0.1% of GDP respectively), posted a surplus of 0.7% of GDP last year, with the goods, services, and primary income balances contributing equally to the improvement. While the trade in goods deficit is still significant (5.0% of GDP), Portugal's trade in services surplus surged to 7.2% of GDP, partly reflecting strong net receipts from

tourism. In 2016, travel accounted for about 40% of the country's trade in services surplus. Going forward, Portugal should continue to post moderate current account surpluses. However, a significant reduction of the country's sizeable net external liabilities would require larger surpluses. Although Portugal's net external liabilities decreased to 104.8% of GDP last year, down from 112.2% in 2015, external indebtedness remains among the highest in Europe. Alongside GDP growth, which contributed to the improvement of the NIIP, external rebalancing benefited from a reduction of the government's external liabilities last year. The NIIP of the government sector, which accounts for the bulk of the economy's negative NIIP, improved notably from -82.9 (2015) to -70.0% of GDP in 2016, as the government's external debt fell from EUR 158.8bn in Q4-15 to 139.3bn in Q4-16.

Rating Outlook and Sensitivity

Our Rating outlook on the long-term sovereign rating of BB+ is stable, as we assume that the risk situation underlying the key factors affecting sovereign credit risk – including macroeconomic performance, institutional structure, fiscal sustainability, and foreign exposure – will remain fundamentally unchanged over the next 12 months.

Our BB+ rating could be lowered if adverse developments lead to lower-than-expected growth in the medium term. A prolonged period of low growth would aggravate both private sector deleveraging and fiscal consolidation. With regard to the latter, we could also consider a downgrade if the Portuguese government should significantly fall short of its consolidation targets or if we see substantial backtracking on implemented reforms. In such a scenario, investor confidence could erode with adverse effects on the sovereign's financing conditions.

We could raise our ratings if Portugal were to make faster-than-expected progress in the reduction of its external, private and government debt. In the same vein, the implementation of comprehensive reforms targeted toward boosting investment – and thereby potential growth – could also translate into a higher rating. In particular, investment would benefit from a significant reduction of NPLs within the Portuguese banking sector, as we believe that this would strengthen bank's lending capacity.

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Ratings*

Long-term sovereign rating	BB+ /stable
Foreign currency senior unsecured long-term debt	BB+ /stable
Local currency senior unsecured long-term debt	BB+ /stable

*) Unsolicited

Economic Data

[in %, otherwise indicated]	2012	2013	2014	2015	2016	2017e	2018e
Real GDP growth	-4.0	-1.1	0.9	1.8	1.5	2.6	2.1
GDP per capita (PPP, USD)	26,093	26,359	27,218	28,057	28,916	30,258	31,576
Inflation rate, y-o-y change	2.8	0.4	-0.2	0.5	0.6	1.6	1.7
Default history (years since default)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Life expectancy at birth (years)	80.4	80.7	81.1	81.5	n.a.	n.a.	n.a.
Fiscal balance/GDP	-5.7	-4.8	-7.2	-4.4	-2.0	-1.4	-1.2
Current account balance/GDP	-1.8	1.6	0.1	0.1	0.7	n.a.	n.a.
External debt/GDP	244.0	235.6	216.1	218.7	205.4	n.a.	n.a.

Source: International Monetary Fund, World Bank, Eurostat, own estimates

Appendix

Regulatory Requirements

This sovereign rating is an unsolicited credit rating. The Portuguese Treasury and Debt Management Agency (IGCP) participated in the credit rating process as the IGCP provided additional information and commented on a draft version of the report. Thus, this report represents an updated version which was augmented in response to the factual remarks of IGCP during their review. However, the rating outcome as well as the related outlook remained unchanged.

The rating was conducted on the basis of CRAG´s “Sovereign Ratings” methodology. CRAG ensures that methodologies, models and key rating assumptions for determining sovereign credit ratings are properly maintained, up-to-date, and subject to a comprehensive review on a periodic basis. A complete description of CRAG´s rating methodologies is published on the following internet page: www.creditreform-rating.de.

To prepare this credit rating, CRAG has used following substantially material sources: International Monetary Fund, World Bank, Organization for Economic Co-operation and Development, Eurostat, European Commission, European Banking Authority, European Central Bank, Agência de Gestão da Tesouraria e da Dívida Pública – IGCP, Banco de Portugal and Instituto Nacional de Estatística.

A Rating Committee was called consisting of highly qualified analysts of CRAG. The quality and extent of information available on the rated entity was considered satisfactory. The analysts and committee members declared that the rules of the Code of Conduct were complied with and that the rating action was and is free of any existing or potential conflicts of interest. The analysts presented the results of the quantitative and qualitative analyses and provided the Committee with a recommendation for the rating decision. After the discussion of the relevant quantitative and qualitative risk factors, the Rating Committee arrived at a unanimous rating decision. The weighting of all

risk factors is described in CRAG´s “Sovereign Ratings” methodology. The main arguments that were raised in the discussion are summarized in the “Reasons for the Rating Decision”.

In the case of a rating outlook, the time horizon is provided during which a change in the credit rating is expected. This information is available within the credit rating report. There are no other attributes and limitations of the credit rating or rating outlook other than displayed on the CRAG website. In regard to the rated entity CRAG regarded available historical data as sufficient.

In case of providing ancillary services to the rated entity, CRAG will disclose all ancillary services in the credit rating report.

In accordance to Article 11 (2) EU-Regulation (EC) No 1060/2009 registered or certified credit rating agency shall make available in a central repository established by ESMA information on its historical performance data, including the ratings transition frequency, and information about credit ratings issued in the past and on their changes. Requested data are available on the ESMA website: https://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml. An explanatory statement of the meaning of CRAG`s default rates are available in the credit rating methodologies disclosed on the website.

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