



RATING ACTION REPORT

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Dagong Global Upgrades the Long-Term Credit Rating of Novo Banco, S.A. to 'B', Outlook 'Stable'

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Dagong Global has upgraded the Long-Term Credit Rating of Novo Banco, S.A. (Novo Banco) to 'B', with Outlook 'Stable'. The Short-Term Credit Rating is upgraded to 'B'.

RATING RATIONALE

The Long-Term Credit Rating takes into account the Individual Financial Strength Assessment (IFSA) at 'b', and our External Support Assessment (ESA) of 'Moderate' potential to receive Parent Support.

The improved IFSA to 'b' from 'ccc+' reflects in our view the fact that Novo Banco is no longer a transitional bank and that the capital injections made by Lone Star and the contribution by the Resolution Fund have allowed it to maintain a strong capital level, despite recognising large losses on NPL in 2017. The main considerations for the IFSA are laid out below.

Strengthened franchise and governance framework

Novo Banco focuses on traditional banking services, with a balance sheet dominated by loans and deposits. It is the third largest bank in Portugal, with strategic presence in Spain. During the period in which the bank was fully owned by the Resolution Fund, we considered its franchise and governance weakened by its status of a transition bank. This is no longer the case and the bank has been able to defend its market shares in both loans and deposits. The governance framework has now been aligned with that of a typical large commercial bank.

Still very weak asset quality

NPL, according to the EBA definition, have been reduced from 33.4% as of YE16 to 30.5% as of YE17, a level that is still extremely high in our view. During the same period, coverage improved from 49.3% to 58.7%, which we generally regard as satisfactory. However, in this case net NPL remain very high, amounting to 96% of Tier 1 capital. Even if this is a significant improvement compared to YE16, when net NPL exceeded Tier 1 capital by 41.3%, we consider that the bank's asset quality is still very weak.

The bank has made good progress on reducing the industry and single name concentration, which we consider positive. The loan portfolio is therefore better diversified compared to previous years. While we expect the positive trend to continue, asset quality in our view will remain very weak in the short term.

Improved funding structure

Novo Banco's funding stems largely from deposits, with average deposits to average total funding ratio of 71.3% as of YE17, up from 65.6% as of YE16, partially as a result of the Liability Management Exercise (LME) completed in October 2017. Deposits stem mainly from retail clients, without significant single name concentrations, which we consider positive. Reliance on funds from the ECB has been reduced significantly. Market funding plays only a negligible role after the LME.

Reinforced capitalisation

The capital injections completed in two tranches by Lone Star for a total of EUR 1Bn and the contribution by the Resolution Fund of EUR 791.7Mn under the Contingent Capital Agreement (CCA), allowed the bank to post an improved phased-in Tier 1 ratio of 12.8% as of YE17 (12.0% as of YE16) and a fully implemented Tier 1 ratio of 12.0%, despite recording large credit losses and a net loss of EUR 1.4Bn in 2017. Under the CCA, the Resolution Fund is committed to contribute up to EUR 3.9Bn over a period of 8 years, in case capital ratios decrease below a predefined threshold (not disclosed) and losses are recorded on a delimited portfolio of assets. The net book value of the delimited portfolio of assets is EUR 5.4Bn as of YE17 (EUR 7.9Bn in June 2016). Both conditions have to be fulfilled for the CCA to be triggered.

We expect that with further contributions under the CCA, Novo Banco's capital ratios will remain above the regulatory requirements in the near future. However, it has to be acknowledged that CCA assets, most of which are classified as NPL, account only for about half of total NPL and losses on other assets will not trigger a contribution from the Resolution Fund, even if the capital ratios fall below the threshold.

Profitability

For the year 2017 Novo Banco recorded a loss of EUR 1.4Bn, compared to a loss of EUR 788.3Mn in the previous year. The major reason were loan loss provisions of EUR 2.1Bn (2016: EUR 1.4Bn). The contribution of EUR 791.7Mn under the CCA and the write-down of tax assets of EUR 445.1Mn also significantly influenced the results. Net operating income, excluding the CCA, amounted to EUR 341.7Mn, down from EUR 386.6Mn in 2016, as a result of lower interest income that was only partially compensated by lower operating expenses. In the medium-term we expect net operating income to improve slightly, from a stabilised interest income, lower interest expenses and improved efficiency. However, bottom line results are expected to remain negative, due to still high loan loss provisions.

External Support Assessment

The moderate level of support reflects the low likelihood of receiving additional support from the parent, Lone Star. Support can be expected only from the Resolution Fund subject to the conditions stated in the CCA, which formed part of the deal for the sale of the bank. Considering that the CCA covers only losses on a segregated pool of assets, and is not an unconditional guarantee, the moderate level of support does not lead to a notching uplift from the IFSA. Extraordinary support from the government is also unlikely, considering that the bank falls under the scope of the Banking Recovery and Resolution Directive (BRRD).

RATING OUTLOOK

The 'Stable' outlook reflects our view that the bank will continue to record losses in the short to medium-term, while reducing NPL, but these losses will be partially covered by the CCA, without affecting significantly the bank's capital. Beside loan loss provisions, we expect the operating performance of the bank to improve slightly, with stable to slightly increasing operating income and decreasing operating costs following the sale of non-core operations.

RATING SENSITIVITIES

We would consider a positive rating action if we see a material and sustainable improvement in asset quality and profitability levels under a more resilient and growing economic environment, without material negative effects on capital levels. Enhanced clarity of the strategy and financial targets of the bank, could also lead to an upgrade, following evidence of material improvements in corporate governance, development strategy or competitive position.

We would consider a negative rating action if capital ratios weaken, most likely triggered by a worse-than-expected evolution of the bank's asset quality and hence weaker-than-expected profitability.

COMPANY PROFILE

Novo Banco was created as a new legal entity following the resolution measure applied by the Bank of Portugal to Banco Espirito Santo S.A. (BES, not rated) on 3 August 2014. BES's core banking activities were transferred to Novo Banco, while problematic assets mainly from its exposure to Espirito Santo Group entities and BES Angola subsidiary were retained at BES, together with equity and subordinated debt. The bank was fully owned by the Portuguese Resolution Fund, and a sale process started in order to resolve its transition condition.

The sale was completed on 18 October 2017, through a 75% stake sold to Lone Star and a 25% remaining with the Resolution Fund. At the sale, the bank received a capital injection of EUR 1.0Bn from Lone Star (in two tranches, October and December) and ceased to fall under the status of transition bank. In addition to the capital injection, a CCA was agreed between Lone Star and the Resolution Fund that considers a capital injection from the Resolution Fund in case additional losses from a specific portfolio of assets are recognised.

Novo Banco is the third largest retail and commercial bank in Portugal, and mainly provides traditional banking services to corporates and retail clients. The bank operates mainly in Portugal (about 88% of total loan book), but also runs activities in others countries, principally Spain, France and UK.

FULL LIST OF SOLICITED RATINGS ASSIGNED

Novo Banco, S.A.

Long-Term Credit Rating (FC&LC)	B
Short-Term Credit Rating (FC&LC)	B
Outlook	Stable
IFSA	b
ESA	Moderate, Parent Support

Novo Banco S.A. Madeira Branch

Long-Term Credit Rating (FC&LC)	B
Short-Term Credit Rating (FC&LC)	B
Outlook	Stable

Novo Banco S.A. Spain Branch

Long-Term Credit Rating (FC&LC)	B
Short-Term Credit Rating (FC&LC)	B
Outlook	Stable

Novo Banco S.A. London Branch

Long-Term Credit Rating (FC&LC)	B
Short-Term Credit Rating (FC&LC)	B
Outlook	Stable

Novo Banco S.A. Luxembourg Branch

Long-Term Credit Rating (FC&LC)	B
Short-Term Credit Rating (FC&LC)	B
Outlook	Stable

Novo Banco S.A. Cayman Branch

Long-Term Credit Rating (FC&LC)	B
Short-Term Credit Rating (FC&LC)	B
Outlook	Stable

FC&LC: Foreign Currency and Local Currency;

RATINGS HISTORY

Ratings upgraded on 23 October 2017

Novo Banco, S.A.	CCC+/C/Positive
Novo Banco S.A. Luxembourg Branch	CCC+/C/Positive
Novo Banco S.A. London Branch	CCC+/C/Positive
Novo Banco S.A. Spain Branch	CCC+/C/Positive
Novo Banco S.A. Madeira Branch	CCC+/C/Positive
Novo Banco S.A. Cayman Branch	CCC+/C/Positive

Ratings downgraded on 18 October 2017

Novo Banco, S.A.	SD/SD
Novo Banco S.A. Luxembourg Branch	SD/SD
Novo Banco S.A. London Branch	SD/SD
Novo Banco S.A. Spain Branch	SD/SD
Novo Banco S.A. Madeira Branch	SD/SD
Novo Banco S.A. Cayman Branch	SD/SD

Ratings downgraded, placed on watch 'Negative' on 27 July 2017

Novo Banco, S.A.	C/C/Negative
Novo Banco S.A. Luxembourg Branch	C/C/Negative
Novo Banco S.A. London Branch	C/C/Negative
Novo Banco S.A. Spain Branch	C/C/Negative
Novo Banco S.A. Madeira Branch	C/C/Negative
Novo Banco S.A. Cayman Branch	C/C/Negative

Rating withdrawn on 12 June 2017

Novo Banco Asia S.A.	WR
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Ratings affirmed, placed on watch 'Evolving' on 20 April 2017

Novo Banco, S.A.	CCC+/C/Evolving
Novo Banco Asia S.A.	CCC+/C/Evolving
Novo Banco S.A. Luxembourg Branch	CCC+/C/Evolving
Novo Banco S.A. London Branch	CCC+/C/Evolving
Novo Banco S.A. Madrid Branch	CCC+/C/Evolving
Novo Banco S.A. Madeira Branch	CCC+/C/Evolving
Novo Banco S.A. Cayman Branch	CCC+/C/Evolving

Ratings affirmed on 24 March 2017

Novo Banco, S.A.	CCC+/C/Stable
Novo Banco Asia S.A.	CCC+/C/Stable
Novo Banco S.A. Luxembourg Branch	CCC+/C/Stable
Novo Banco S.A. London Branch	CCC+/C/Stable
Novo Banco S.A. Madrid Branch	CCC+/C/Stable
Novo Banco S.A. Madeira Branch	CCC+/C/Stable
Novo Banco S.A. Cayman Branch	CCC+/C/Stable

Ratings downgraded on 30 March 2016

Novo Banco, S.A.	CCC+/C/Stable
Novo Banco Asia S.A.	CCC+/C/Stable
Novo Banco S.A. Luxembourg Branch	CCC+/C/Stable
Novo Banco S.A. London Branch	CCC+/C/Stable
Novo Banco S.A. Madrid Branch	CCC+/C/Stable
Novo Banco S.A. Madeira Branch	CCC+/C/Stable
Novo Banco S.A. Cayman Branch	CCC+/C/Stable

Ratings affirmed on 30 March 2015:

Novo Banco, S.A.	B-/ B / Evolving
Banco Espirito Santo North America Cap Corp. (*)	B-/ B / Evolving
Espirito Santo plc (ESPLC) (Ireland) (*)	B-/ B / Evolving
Novo Banco Asia S.A.	B-/ B / Evolving
Novo Banco S.A. Luxembourg Branch	B-/ B / Evolving
Novo Banco S.A. London Branch	B-/ B / Evolving
Novo Banco S.A. Madrid Branch	B-/ B / Evolving
Novo Banco S.A. Madeira Branch	B-/ B / Evolving
Novo Banco S.A. New York Branch (*)	B-/ B / Evolving
Novo Banco S.A. Cayman Branch	B-/ B / Evolving

Ratings assigned on 25 August 2014:

Novo Banco, S.A.	B-/ B / Evolving
Banco Espirito Santo North America Cap Corp. (*)	B-/ B / Evolving
Espirito Santo plc (ESPLC) (Ireland) (*)	B-/ B / Evolving
Banco Espirito Santo do Oriente S.A.	B-/ B / Evolving
Novo Banco S.A. Luxembourg Branch	B-/ B / Evolving
Novo Banco S.A. London Branch	B-/ B / Evolving
Novo Banco S.A. Madrid Branch	B-/ B / Evolving
Novo Banco S.A. Madeira Branch	B-/ B / Evolving
Novo Banco S.A. New York Branch (*)	B-/ B / Evolving
Novo Banco S.A. Cayman Branch	B-/ B / Evolving

(*) withdrawn

CRITERIA APPLIED

Criteria for Rating Financial Institutions (10 July 2017)

OTHER REGULATORY DISCLOSURES

- The ratings above are solicited and Dagong has received compensation for providing these ratings.
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For any further information on rating criteria and procedures, please refer to the following links:

<http://www.dagongeuropa.com/procedures.php>http://www.dagongeuropa.com/rating_criteria.php

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