ARC Changes Outlook to Negative for Portugal's BBB- Rating

ISSUER	RATINGS DATE
Republic of Portugal	September 9, 2016

ISSUER RATINGS - FOREIGN CURRENCY		ISSUER RATINGS - LOCAL CURRENCY	
BBB-	Medium and Long Term (BBB-, with negative outlook)	BBB-	Medium and Long Term (BBB-, with negative outlook)
A-3	Short Term (A-3)	A-3	Short Term (A-3)

COUNTRY CEILING - FOREIGN CURRENCY		COUNTRY CEILING - LOCAL CURRENCY	
A	Foreign Currency (A)	A	Local Currency (A)

London, September 9, 2016, ARC Ratings, S.A. (ARC) has changed the outlook to negative from stable on Portugal's "BBB-" long-term foreign and local currency issuer ratings. In addition, the agency affirmed Portugal's foreign currency and local currency country ceilings of "A" and short-term sovereign ratings of "A-3". All ratings assigned are unsolicited.

In accordance with ESMA policies, ARC's next scheduled announcement on Portugal's sovereign ratings is 3 March 2017. The outlook carries a two-year time horizon. ARC's rising concerns over sluggish growth in the context of a large debt are factored into its outlook change. ARC's ratings also reflect concerns about the quality of Portugal's growth. Portugal's growth momentum is heavily reliant on private consumption, rather than investment, which prints just 15% of GDP. The slow and more costly-than-expected banking sector restructuring process, the exposure of the banking sector to Portuguese sovereign debt, increased global uncertainty following the Brexit referendum, as well as difficulties in important export markets for Portugal all negatively impact ARC's credit assessment of the country.

ARC's expectations for broad commitment to fiscal discipline to be sustained is a stabilizing factor as is continued support from European Union institutions, including European Central Bank via its quantitative easing program. A considerable credit strength for Portugal has been its commitment to fiscal consolidation and the successes it has achieved on this front, despite the tailwinds provided to growth. The country's comprehensive reform program has provided support for its ratings and has been key to its post-crisis stability. The steady improvements in governance and competitiveness are also reflected in Portugal's sovereign ratings, even though some of these reforms have been diluted. Policy changes on the TAP privatization, the corporate tax rate, and the minimum wage hike that outstrips inflation indicate the challenges of sustaining a market friendly and competitiveness-oriented thrust of policies in the context of low growth by the minority left-of-center government. The agency notes that restructuring of the banking sector, while costly and destabilizing in the short-term, will assist longer-term gains for the economy.

Portugal's credit ratings are based on ARC's sovereign methodologies as available on our website (www.arcratings.com). The methodologies utilized are "ARC's Sovereign Rating Methodology" dated June 20, 2016 and "Criteria for Assessing Country Ceilings" dated May 13, 2016. ARC's full credit analysis on Portugal is also available on the agency's website.

RATING RATIONALE

The key rating drivers supporting Portugal's "BBB-" foreign and local currency ratings are:

- Institutional strengths that have underpinned Portugal's crisis management successes in stabilizing its economy.
- Continued commitment to fiscal consolidation by the new government, but likely at a slower pace than originally envisioned.
- A proven willingness and capacity to safeguard the stability of a financial system that has been vulnerable to crisis and years of imprudent credit policies.
- Proactive debt management that contains the risks associated with Portugal's large government debt of 131.6% of GDP.
- Improving employment statistics, although below pre-crisis levels.
- Continued access to liquidity from the ECB and the financial markets.
- A policy environment in the Eurozone that is cognizant of deflation risks.
- Eurozone membership that provides the institutional framework for economic management, and a proven source of emergency liquidity.

The key constraints on Portugal's credit ratings are:

- A history of lacklustre growth performance even in the pre-crisis period when liquidity (and borrowing) was buoyant. The post-crisis rebound remains sluggish. The economy is more reliant on exports, but also consumption rather than investment, and the trajectory of policy has turned more populist, potentially eroding nascent competitiveness gains.
- A generally uncompetitive economy that has manifested itself in large current account deficits pre-crisis. Recession and improved competitiveness has broadly eliminated these deficits, a trend that has also been assisted by low oil prices. Signs of greater longer-term equilibrium for the current account deficit are evident, and increasingly becoming a positive ratings factor.
- A large government debt that renders the country vulnerable to swings in market confidence. The combination of a large debt, exposure to this debt by resident banks, and weak growth prospects means Portugal's vulnerabilities are likely to remain high.
- An over-leveraged economy with high levels of corporate indebtedness and an historical bias towards debt accumulation rather than equity financing (albeit, slowly, this is changing). Corporate indebtedness and high NPLs (16.2% of corporate loans in June 2016) dampen prospects for investment and growth.
- Effects of Brexit and contagion risks related to questions about the durability of the Eurozone project itself could exacerbate formidable liquidity pressures.

Portugal's growth for 1H2016 has been recorded at 0.9%, and a rate of at most 1.2% is likely for the full year. The performance reflects declining investment (from an already low base of 15% of GDP) and a slowdown in export growth, partly because of difficult conditions in Angola. This performance also reflects the ongoing deleveraging and the restructuring of the banking system, which will reap gains over the longer-term. The recovery in employment, falling savings to a historical low, rising disposable income and continued tourism vibrancy have enabled growth to be in positive terrain. Portugal's ability to sustain a growth rate in the range of 1.5-2.0% is a key rating issue, critical to the country's ability to grow out of its large debt load, which stands at just above 130% of GDP. Local confidence indicators as well as the successes in the export sector suggest that this downturn in growth may be temporary, although the international environment and weak investment may not align with those expectations.

Weak revenue performance to date has prompted lower-than-budgeted expenditures, especially capex, but the target is still likely to be overshot. A relaxed budget target of -2.5% of GDP is probable. First half 2016 results point to an improvement in the fiscal deficit in what is normally the worse half of the year. The primary balance was sustained in positive territory, in place since 2015 (0.2% of GDP). Weaker than expected growth (likely 1.0-1.2% instead of 1.8% in the budget), the public servant salary reversal and the cut in restaurant VAT are adversely impacting the accounts. It also remains unclear if and how the up to EUR 5.2 billion recapitalization process (expected maximum expense) of Caixa Geral de Depósitos will impact the fiscal accounts, but it is not predicted to exceed 1.5% of GDP in terms of augmenting public debt. At the current vantage point a 3% of GDP ceiling for 2016 seems reachable, allowing the country to exit the Excessive Deficit Procedure. The presentation of the 2017 Budget Proposal and of the plan requested by the EC by mid October are expected to confirm the government's commitment to fiscal consolidation, as well as, the resiliency of the minority government, incorporated into ARC's ratings stance.

The exposure of the banking system to government debt is another rating concern. While the holdings as a percentage of total government debt have stayed roughly stable, as a percentage of the sector's assets the ratio has risen as bank balance sheets have contracted. Other European countries' banking systems share these characteristics and the accompanying vulnerabilities that would exacerbate a crisis too.

Rating Triggers

The trigger for a change in the outlook to stable or a further upgrade would come from sharply improved competitiveness of the real economy, whereby much faster paced growth would be achieved (>2% pa on average), also contributing to the rapid reduction in the country's government debt burden (<100% of GDP) and overall leverage in the economy. Such a scenario would likely involve a more rapid transformation of the structure of the economy, including corporate sector consolidation, as well as sharply improving prospects for investment. The corporate sector in Portugal is highly reliant on small and fractured SMEs, many of which are overleveraged, not very profitable, and which do not generate gains from scale. Larger, export-oriented firms, while less important to the economy, are more profitable and dynamic.

Triggers that could prompt a rating downgrade over the next two-year window would include fiscal loosening that would impede government debt reduction, and signs economic dynamism would be further weakened. Sustained GDP Growth <1% pa, Government deficit >3% of GDP would be qualitative benchmarks. Exclusion from participation in the ECB's bond buying and quantitative easing program would exert downward pressure on Portugal's credit ratings. The scope for increased political or policy instability and the possibility of a significant derailment of a market-friendly policy agenda continue to be monitored by ARC.

Ratings Affected

ARC is monitoring the impact of this rating adjustment on other global ratings and will announce any changes in the next few weeks. At the current vantage point no ratings appear to be impacted, but this would be determined by panel discussions.

ABOUT ARC RATINGS

ARC is a global ratings agency based in London and Lisbon that was formerly known as Companhia Portuguesa de Rating, SA. ARC has partnered with rating agencies in India (CARE Ratings), Malaysia (MARC), Brazil (SR Ratings), and South Africa (GCR). ARC is focused on carving out a niche based on the local knowledge and expertise of its partners across the globe. ARC is registered with European Securities and Markets Authority (ESMA). Please visit www.arcratings.com for further details.

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