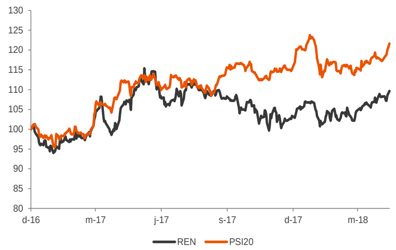
REN

Recommendation: **Accumulate**

Share details (EUR)	
Current price	2.63
Target price	2.83
Beta	0.83
52w max	2.82
52w low	2.348
1y return (%)	-3.65
3m return (%)	6.31
Market cap (mn)	1,754.7
Free float	53.4%
Avg daily volume (30d)	2,619,843

Financial highlights (EUR million)	2017	2018E
Revenue	748	707
EBITDA	488	470
EBIT	266	249
Net profit	126	106
Net debt	2,768	2,675
EPS	0.19	0.16
DPS	0.171	0.171

Price graph (2017=100)



Recommendation	Date	PT
Accumulate	15/05/18	2.83

Main shareholders	
State Grid of China	25%
Oman Oil	12%
Lazard Asset Management	7%

Note: data as of 14/5/2018

Source: Bloomberg; BiG Research; Company Data

REN – REDES ENERGETICAS NACIONAIS

Acquisitions provide growth in a new interest rate environment

We initiate REN's coverage with a recommendation to accumulate and a price target of EUR 2.83.

Growth through Acquisitions. With the share rights issue well past, REN is ready to begin reaping the benefits of the successful acquisitions of Electrogas and Portgás. These companies provide REN with much needed growth, as shown by the stable asset base (and consequently revenues) of its mature assets.

Rising interest rates is one of the risks. A new market framework is increasingly near – the normalization of monetary policy by the ECB – with rising interest rates being one of the main risk factors for REN. We perceive REN to be well prepared to face this new framework.

As well as taxes. The extraordinary levy on the energy sector has been quite negative for the company's results, leading the company to face a tax burden of near 40% since its inception. The decision of the Constitutional Court about the tax, expected to occur this year, is one of the main catalyst for the shares.

Dividend is still very attractive. REN's dividend yield continues to be one of the main attractive factors, with yield well above the average values in the market and the utilities sector.

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TABLE OF CONTENTS

Investment case

Mature Market

Growth through Acquisitions

High Dividend Yield at Periphery Discount

Valuation

Current affairs

Increasing Interest Rates as a Risk

Regulation and Taxes

Company history & description

History

Description

Appendix

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INVESTMENT CASE

- **Mature Market**
- **Growth through acquisitions**
- **High Dividend at periphery discount**
- **Valuation**

Mature Market

REN's main activities are the transmission of electricity and transportation of gas in Portugal. As both the electricity and gas networks are relatively mature, the company faces the problem of not only not being able to grow, but in fact, facing a declining regulated asset base (RAB), and consequently revenues (which are derived from the RAB). Thus, REN opted to counteract this effect by acquiring a 42.5% stake in the Chilean company Electrogas and the full operations[1] of Portgás, a gas distributor in the North of Portugal. Before analyzing those acquisitions, we will look into the transmission of electricity and transportation of gas units.

We will start by the Electricity Transmission Segment, which is regulated by ERSE. REN is the sole transmission system operator in Portugal, with a concession until 2057, with a remuneration scheme based on allowed revenues set by ERSE for a regulatory period of 3 years: REN revenues are defined by a rate of return (RoR, indexed to the 10-year yield of Portuguese sovereign debt) which is applied to the RAB, recovery of net operational costs, recovery of depreciation, interest of tariff deviations, and incentives for capex, operational costs and use of assets at end of life. The electricity segment still is the largest segment of its operations (as it represents around 59% of the RAB).

The new regulatory period for electricity assets has begun this year and will be in place until 2020. Under the regulatory scheme, the RoR continues to be indexed to the 10Y Portuguese yield, and is adjusted annually based on those, with a cap RoR of 9.75% (for yields at or above 13.332%), and a floor RoR of 4.75% (for yields at or below 0.822%). REN's electricity assets are divided into two groups: regulated assets without premium (RAB before 2009) and regulated assets with premium[2] (RAB after 2009). The latter benefits from a premium of 0.75% to base RoR. As such the

[1] Excluding EDP Gás SU, the last resort operator
[2] Premium applied if REN is able to achieve CAPEX costs below a reference level defined by ERSE, applicable only to RAB added after 2009.

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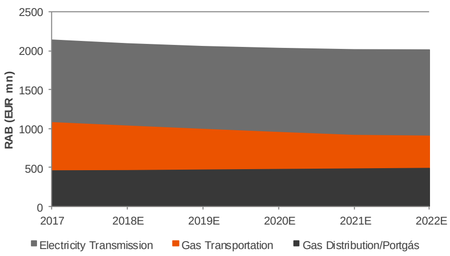
electricity RoR is a simple weighted average (by type of RAB) of the base RoR and the RoR with premium.



Source: BiG Research

REN's recent capital markets day (CMD), past 4th of May, reflected the conundrum of lack of growth that the company faces in its domestic market, as the relative lack of expansion opportunities constrains the expansion of the asset base. In fact, the company estimates a regulated asset base of around EUR 2.2 bn – 2.3 bn, relatively unchanged vs. the current EUR 2.3 bn, with the effect of the lower capex (around EUR 90 mn – EUR 110 mn in the period) in the asset base being compensated by lower depreciations and amortizations (D&A). The highlight of potential growth in the electricity segment is an interconnection to Morocco, which is still only a possibility and not an actual project. REN was recently mandated (alongside its Moroccan peer ONEE) to present in six months a proposal for the interconnection, yet it is still uncertain if it will actually be realized.

REN's gas transportation segment is also regulated by ERSE, with a regulatory scheme similar to electricity assets, with REN receiving revenues from regulated asset base derived from a rate of return (RoR), interest on tariff deviations, recovery of net operating costs and efficiency incentives for operating costs plus recovery of depreciation. The gas transmission concession will end in 2046 and its current assets account for around 28% of the total RAB.

The rate of return of gas assets is also indexed to the 10-year government yield with annual updates. The current regulatory scheme will be in place until 2019, and the RoR has a cap and floor of 9% (yields at or above 10.532%) and 5.4% (yields at or below 1.532%), respectively. Unlike electricity assets, all assets are remunerated at the same RoR, as there is no premium for capex efficiency.

The regulated asset base for natural gas assets has also begun a decreasing trend as expansion opportunities are scarce, and thus for the period of 2019-2021, REN projected a decrease of the RAB from EUR 1.1 bn (in 2017) to around EUR 0.9 bn – 1.1 bn, with a yearly capex of around EUR 10 mn.

Due to the lack of organic growth opportunities it is no surprise that the company turned to inorganic acquisitions to derive growth. We will look into those acquisitions in the following section.

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Growth Through Acquisitions

We will start by the 1st acquisition performed by REN – a 42.5% stake in Electrogas; and then analyze Portgás.

Electrogas is a Chilean company that operates a reversible natural gas pipeline of 165.6 km between Quintero's LNG terminal the Santiago metropolitan region and the Valparaiso port. Electrogas also operates a diesel oil pipeline of 20.5 km. While its operations, unlike REN's, are not regulated, Electrogas long term take-or-pay gas transportations contracts provide stability to its cash flows, and entrench well in REN's business model. The acquisition was announced in late 2016 and concluded in the 1st quarter of 2017. REN bought the stake from Enel Generación Chile for USD 180 mn (EUR 169 mn). Electrogas is a private company, with Colbún (an electricity generation and transmission Chilean company) and ENAP (state-owned company) representing the remaining shareholders with stakes of 42.5% and 15%, respectively. REN does not indicate that is interested in increasing its stake in Electrogas, highlighting the partnership model of the investment as preferable.

Electrogas was already incorporated (using the equity method) in the 2017 results of REN, with a proportional value of net profit of EUR 7.2 mn. While the amount incorporated in 2017 was above the EUR 3 mn to EUR 5 mn presented by the company when the investment was announced, we opted to more conservatively assume, in our estimates, the contribution of Electrogas to the P&L in line with the initial forecasts. Yet, the contribution of Electrogas to REN's results should increase in the long-term, with the potential growth of Electrogas results coming from higher gas demand which should increase gas penetration in the region. We do not foresee high currency risks coming from Electrogas results, as 75% of its revenues are generated in US dollar and only 25% in Chilean peso. In our valuation model, due to lack of public information regarding Electrogas as it is a private company, we opted to value the company at book /acquisition cost (EUR 169 mn).

REN announced and completed the acquisition of Portgás (also known as EDP Gás), a gas distribution company in the North of Portugal, from EDP last year. The acquisition in the value of EUR 532 mn was financed through a debt issuance and a EUR 250 mn share increase. Portgás business model is very similar to REN's, with the revenues being fully regulated by ERSE for 3-year periods and with the concession ending in 2047. The rate of return of gas distribution enjoys a 30 b.p. premium over REN's RoR in gas transportation. Portgás has the 2nd largest gas distribution network in the country, and its integration in REN's increased the regulated asset base of the

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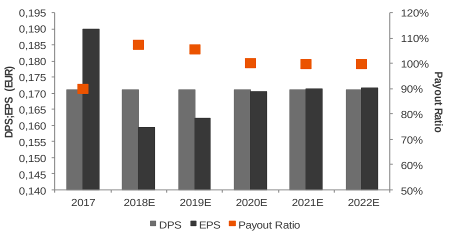
latter by 13% (addition of EUR 455 mn). While the initial addition to RAB will be the most impactful, the lower gas penetration rate in Portgás area will provide some growth to RAB in the next years, with REN projecting a yearly capex of around EUR 25 mn between 2019-2021, which shall increase Portgás RAB from EUR 455 mn (in 2017) to EUR 490 mn in the 2018-2021 period.

In REN's capital markets day the company has put aside around EUR 400 mn to be invested in what the company called 'additional growth opportunities' – this includes the interconnection to Morroco and other developments in the domestic market. In fact, the company highlighted the goal of focusing its investments in Portugal, but not discarding the possibility of increasing its position in Latin America. As there is low visibility about these investments as of right now, we opted to not consider the impact of those in the valuation model.

High Dividend at periphery discount

REN present's the highest dividend yield, when compared to its peers, with the rate of 6.6%, well above the 4.91% of average dividend yield of the sector (multiples table can be found in Appendix). Additionally REN has multiples that are below the average of its sector, which leads to name REN as a high dividend yield stock at a periphery discount.



Source: BiG Research

REN has assumed the compromise of maintaining a gross dividend of EUR 0.171 per share in the period of 2018-2021, a value which is unchanged vs. past years payments. In the case of REN finding itself with a lack of investment opportunities or with a windfall of extra cash not currently expected (if the extraordinary tax is reversed), the dividend, could be, in our opinion, revised upwards. Thus, and even though the payout ratio of dividends may be around 100% to slightly above profits in the next years, the commitment of the company to dividend stability as well as the ability to sustain the payments without tapping into debt markets, makes the risk of dividend payments of REN to the upside, and not to the downside. Only a significant change in the regulatory or tax framework could, in our view, increase the risks to the downside for the dividend.

Valuation

We valued REN through a sum-of-the-parts (SOTP) analysis of the different segments of the company. We used a discounted cash flow (DCF) model to the several units, excluding Electrogas, which is valued at book/acquisition value, and some financial

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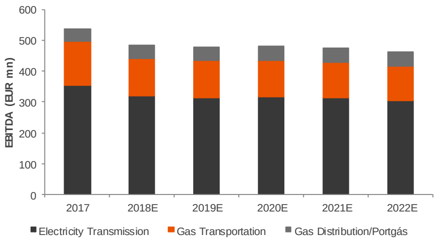
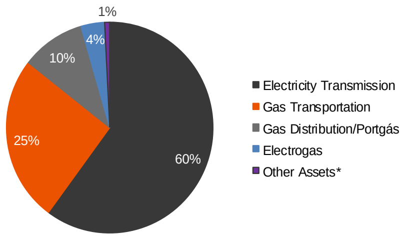


Source: BiG Research

Enterprise Value



Source: BiG Research

stakes which are also valued at book value[3]. The electricity transmission, gas transportation and gas distribution units were valued throughout the entirety of the remaining concession period, with the net RAB at the end of that concession being discounted (as the company is entitled to receive the value of the net RAB if concession is not renewed). We assume that the extraordinary tax on the energy sector will be applied until 2023 (for one more government mandate[4]). Applying a 4.4% WACC, REN's total enterprise value (EV) adds to EUR 4,566 mn, with electricity transmission accounting for 60% of EV, gas transportation representing 25% of EV, Portgás 10% of EV and Electrogas 4% of EV. With a projected net debt at end of 2018 of EUR 2,675 mn, our target price for REN is EUR 2.83 per share, which represents an upside of 8% vs. closing price of REN at 14th of May and a recommendation of accumulate.

WACC	
Ke	9%
Rf	2%
MRP	8%
Beta	0.8
Kd	3%
Tax Rate	29%
Debt/EV	64%
WACC	4.4%

Valuation (SOTP)	EV (EUR mn)	%EV
Electricity Transmission (DCF)	2,745	60%
Gas Transportation (DCF)	1,162	25%
Gas Distribution/Portgás (DCF)	453	10%
Electrogas (Book Value)	169	4%
Other Assets*	36	1%
Total EV	4,566	100%
Net Debt (at YE18)	2,675	
Equity Value	1,890	
# shares outstanding (mn)	667	
Target Price Per Share (EUR)	2.83	

Source: BiG Research; Bloomberg; Company Data
* Includes Holding, Telecom and Consultancy Services (valued through DCF) plus Financial Stakes (valued at book value excluding REE valued at market value)

Besides our base case scenario valuation of EUR 2.83 per share, we also devised a bear and bull scenario.

Scenario	Price-Target (EUR)	Up(down)side
Bear	2.12	-19%
Base	2.83	8%
Bull	3.31	26%

Source: BiG Research

On the bear scenario, we project a higher cost of debt (4% vs. 3%) with implications on the WACC (increases to 4.9%), along with a decrease in the RoR of 1%. Under this scenario, the target price of REN is 2.12 per share, which represents a downside of 19% to closing price of REN at 14th of May.

In our bull scenario we model an increase in the RoR of 1%, along with the immediate removal of the extraordinary tax on the energy sector[5]. Under this framework, the target price per share increases to EUR 3.31 which represents an upside of 26%.

[3] Excluding the 1% stake in Red Electrica (REE) in which we consider market values.
[4] The removal of the extraordinary tax in a government framework as the one in Portugal right now (i.e the socialist party (PS) with the support of far left-wing parties BE and PCP) is, in our view, less likely. We are assuming a scenario where the socialist party does not get the majority of the vote in the 2019 elections, and opts for the current framework. In the case of a majority victory for the socialist party or a coalition with the right wing Social Democrats, the extraordinary tax is more likely to be extinguished.
[5] The Constitutional Court defines the tax unconstitutional, but does not mandate the recovery of the amount paid by the companies.

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INITIATION OF COVERAGE

Key Financial Data

(EUR mn)	2017A	2018E	2019E	2020E	2021E	2022E
Income statement						
Revenues	748	707	713	724	721	743
EBITDA	488	470	464	467	461	449
o.w. Electricity Transmission	356	321	313	317	314	306
o.w. Gas Transportation	142	121	122	119	115	112
o.w. Gas Distribution (Portgás)*	9	44	45	46	47	47
o.w. Other	-19	-16	-16	-16	-16	-16
D&A	222	221	216	212	208	196
EBIT	266	249	248	255	253	253
Financial Results	-61	-62	-59	-59	-57	-57
Income Tax	53	54	55	57	57	57
ESEC	26	27	26	25	25	25
Net Profit	126	106	108	114	114	114
Earnings Per Share	0.19	0.16	0.16	0.17	0.17	0.17
Balance Sheet						
Fixed Assets	4,310	4,198	4,148	4,110	4,080	4,072
Current Assets	605	698	773	840	904	928
Current Liabilities	1,128	603	885	898	602	602
Net Debt	2,768	2,675	2,600	2,534	2,470	2,445
Shareholder's Equity	1,429	1,421	1,416	1,415	1,416	1,416
Cash Flow Statement						
Net Income	126	106	108	114	114	114
(+) Depreciation	222	221	216	212	208	196
(-) Change in NWC	-69	0	0	0	0	0
(=) Operating Cash Flow	279	327	324	326	323	311
(-) Capex	-156	-120	-135	-145	-145	-172
Electricty Transmission	135	90	100	110	110	111
Gas Transportation	14	10	10	10	10	36
Gas Distribution (Portgás)	6	20	25	25	25	25
(=) Investing Cash Flow	-156	-120	-135	-145	-145	-172
(+/-) Increase/Decrease of Debt	315	0	0	0	0	0
(+/-) Increase/Decrease of Equity	133	0	0	0	0	0
(-) Dividends Paid	-91	-114	-114	-114	-114	-114
(=) Financing Cash Flow	357	-114	-114	-114	-114	-114
Other	-306	0	0	0	0	0
Net increase/decrease in cash and cash equivalents	51	93	75	67	64	25
Cash and cash equivalents at beginning of period	11	61	154	230	296	360
Cash and cash equivalents at end of period	61	154	230	296	360	385
Operating and financial indicators						
Revenue growth	1%	-5%	1%	2%	0%	3%
EBITDA margin	65%	67%	65%	65%	64%	60%
Profit margin	17%	15%	15%	16%	16%	15%
DPS	0.171	0.171	0.171	0.171	0.171	0.171
Payout	90%	107%	105%	100%	100%	100%
ROE	8.8%	7.5%	7.6%	8.0%	8.1%	8.1%
Net debt/EBITDA (x)	5.7	5.7	5.6	5.4	5.4	5.4

Source: BiG Research; Company Data
* 2017 data relative to Gas Distribution/Portgás only consolidates three months.

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CURRENT AFFAIRS

- Increasing Interest Rates as a Risk
- Regulation and Taxes

Increasing Interest Rates as a Risk

Utilities are underperformers in a rising interest rates environment due to their more leveraged balance sheets. As the normalization of the monetary policy by the ECB approaches quickly, one can assume that the time for extremely low yield is past, and both the core and periphery countries of Europe shall experience higher yield. REN, operating in a periphery country (Portugal) and with financing costs highly intertwined with Portuguese sovereign yield is therefore exposed to this risk. Its regulatory model, with the rate of return indexed to the 10-year Portuguese yield, is one form of protection for the company in this environment. As the financing costs increase due to higher yields, so does the return on the RAB. In our view, the major risk in what relates interest rates is an increase in short-term (ST) interest rates without an increase in long-term (LT) interest rates (a flattening or inverted yield curve), impacting the variable rate loans (often indexed to ST rates like Euribor). Still, the 60%/40% fixed/variable rate loan distribution of REN partly mitigates this risk, which we perceive as relatively low. We consider more likely the framework of higher yields in all points of the yield curve, with the higher RoR then mitigating the higher financing costs. Still, we modeled in our bear case scenario (above) an increase in ST rates (cost of debt increasing) along with a decrease in LT Rates (RoR declining). The scenario has a negative impact on the valuation of 0.71 per share, reducing the target price to EUR 2.12/share.

Regulation and Taxes

The revision of gas assets for the period of 2020-2023 is the nearest regulatory risk, with the ERSE publishing the proposal in the summer of 2019 and the final version in December of the same year – we expect no major changes in the regulation, only an adjustment to the RoR for values closer to the electricity assets. We believe that if major changes were to occur, it could be on the method of regulation to a total expenditure (TOTEX) model, but as of right now there is no indication that the regulator will change the regulatory framework.

More so than regulation, taxation has been the major negative factor for REN. The introduction of the Energy Sector Extraordinary Contribution (more commonly known by its Portuguese acronym CESE) in 2014 has been quite negative for the company as it relates

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to assets (levy of 0.85% in the net assets) and not operating profits (the large asset base of REN goes thus against the company), especially as the levy has occurred for several years, becoming more ordinary than extraordinary. The company has contested in courts its application and in its CMD it indicated that a decision from the constitutional court could occur in the next months. As the court decision is unpredictable, we opted to consider in our model that the CESE will remain as an extraordinary tax until 2023. However we have modeled both the impact of i) the immediate removal and recovery of the payments made so far (EUR 102.2 mn); and ii) the definition of the tax as perpetual; vs. our base case scenario valuation.

Tax Levy	Impact on EV	Price-Target (EUR)	vs. Base Case
In Perpetuity	-381.6	2.26	-20%
Immediate Removal and Recovery	541.0	3.64	29%

Source: BiG Research

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HISTORY & DESCRIPTION

- History
- Description

History

REN's history dates back to 1947, when CNE – Companhia Nacional de Electricidade developed the first electricity network in Portugal. REN was then created in 1994, when CNE had already been merged with other companies to become EDP, and its constitution occurred due to a split of EDP's business areas. REN was deconsolidated from EDP in 2000, as the deregulation of the European energy market defined that the companies that operated the production, transportation and supply of electricity must be separate legal entities, with the Portuguese state acquiring 70% of REN. EDP's stake in REN was reduced along the years, with EDP fully disinvesting from REN last year, through the sale of the remaining 3.5% stake.

REN's entry in the gas segment occurred in 2006, through the acquisition from Galp of assets related to the transport and underground storage of natural gas, and the acquisition of the LNG terminal and regasification facilities in Sines.

The 1st stage of REN's privatization occurred in 2007, with 19% of its share capital being placed in the markets. The 2nd stage occurred in 2012, with the state selling 25% of REN to State Grid (the current majority shareholder of REN) and 15% to Oman Oil. The 3rd and final stage of privatization occurred in 2014, with the state placing in the markets the remaining 11% stake it held.

REN's most recent milestone was its first foray in international markets through the 2016 acquisition of a 42.5% stake in Electrogas, a Chilean company, and the entry in the gas distribution segment through the 2017 acquisition of Portgás.

Description

REN operates and manages the national electricity and gas system of Portugal, under a natural monopoly with its activities being regulated by ERSE. Under the energy value chain REN is present in the transmission of electricity and transportation and distribution of gas (the last through the recent acquisition of Portgás). All of these business areas of REN are regulated. REN also holds a 42.5% stake in Electrogas a Chilean operator of a natural gas and diesel oil pipeline, which while not regulated, benefits from high cash flow visibility due to the long-term duration of their contracts. Moreover, REN also operates: i) RENTELECOM,

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a segment created in 2002 to explore the surplus capacity of its networks for the telecommunications sector; ii) Enondas, a concession, provided by the Portuguese government, to explore a pilot area for generating electricity from sea waves; iii) REN – Trading, which trades electricity and power system services as part of the management of the long-term power purchase agreements (PPAS); and iv) REN Serviços, which provides consultancy and commercial services. These 4 areas are relatively small in size and contribution relative to the main operations in the electricity and gas systems.

APPENDIX

Multiples

Multiples	P/E 18E	P/E 19E	EV/EBITDA	Div. Yield	Net Debt/EBITDA	EBITDA Margin
REN (BiG)	16.5	16.2	9.7	6.5	5.7	67%
REN (Market)	14.1	13.9	9.2	6.5	5.7	86%
National Grid	14.6	14.6	14.3	5.2	5.8	28%
Red Electrica	13.3	12.8	n.a.	5.3	n.a.	79%
Elia System	14.3	15.0	15.3	3.1	7.3	44%
Fluxys Belgium	31.6	32.9	11.4	4.4	5.1	57%
Snam SpA	13.7	13.6	12.0	5.5	5.7	79%
Enagas SA	13.4	13.8	10.6	5.9	4.9	75%
Terna SpA	14.4	14.0	10.7	4.5	4.7	73%
Average Peers	16.5	16.7	12.4	4.9	5.6	62%

Source: BiG Research; Bloomberg

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- Clarification of the qualitative terms implied in the recommendations:
  - Buy, expected absolute return above 15%;
  - Accumulate, expected absolute return between +5% and +15%;
  - Keep/Neutral, expected absolute return between -5% and +5%;
  - Reduce, expected absolute return between -5% and -15%;
  - Sell, expected absolute return below -15%;

The investment framework aforementioned is merely indicative and not globally strict.

- Unless otherwise specified, the price-targets of the investment recommendations issued by BiG's Research Team are valid for 12 months.

- The update of the investment recommendations models and respective price-targets will occur, usually, in a period of 6 to 12 months.

- BiG may have, in the present and/or future, some commercial relationship with the companies mentioned in this report, namely providing investment advisory services.

- The records of the investment recommendations of the Research Team are provided below. The detailed external consultation of the respective performances may be provided if so requested.

PSI20 Notes in the last 12 months as of 31st of March of 2018:

	Number of Recomendations	%
Accumulate/Buy	2	66,7%
Keep/Neutral	0	0,0%
Reduce/Sell	1	33,3%
Total	3	100,0%

Trading Ideas in the last 12 months as of 31st of March of 2018:

	Number of Recomendations	%
Profit Taking	7	63,6%
Stop Loss	0	0,0%
In Place	4	36,4%
Total	11	100,0%

Pair Trades in the last 12 months as of 31st of March of 2018:

	Number of Recomendations	%
Profit Taking	0	0%
Stop Loss	0	0%
In Place	0	0%
Total	0	0%

Source: BiG Research

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