Investing in Portugal

Friday December 5 2014

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The old order loses its grip in painful times of change

Fall of Espírito Santo may hold promise for more productive areas of economy, writes *Peter Wise*

Three months after the Lisbon government celebrated Portugal's successful exit from a punishing three-year bailout programme, the country watched appalled this summer as the family business empire controlling Banco Espírito Santo unravelled and collapsed. It was one of Europe's largest financial failures.

If a rigorous programme of reform and fiscal tightening overseen by the EU and the International Monetary Fund had failed to detect the imminent downfall of one of the country's largest banks, what confidence could Portugal have that its deep-rooted structural problems were being adequately addressed?

This question, and other pressing uncertainties about the future of the Portuguese economy, will be at the heart of the campaign for next October's general election, in which the anti-austerity opposition Socialists are leading in the polls over the fiscally conservative parties of Portugal's centre-right government coalition.

António Costa, the mayor of Lisbon and recently elected Socialist leader who hopes to become the next prime minister, describes the bailout as an abject failure, saying "all it has produced is poverty."

Pedro Passos Coelho, the prime minister, says framing the debate as a simple choice between austerity and growth is "childish" and warns that Portugal will need several more years of tight fiscal control to secure a prosperous future. "It was not through lack of finance that the country failed to grow in the past," he told parliament recently.

Last month an unexpected element was introduced into the political calculations being made ahead of the 2015 election when José Sócrates, Portugal's Socialist prime minister from 2005 to 2011, was detained at Lisbon airport and held as a suspect in a tax fraud, money laundering and corruption investigation.

Export-led: the trade balance recently recorded a rare surplus — Dreamstime

His detention came in a year of unprecedented judicial action against top establishment figures. In separate cases, courts found two former ministers guilty of corruption or misconduct. Another case saw Ricardo Espírito Santo Salgado, head of the 145-year-old banking dynasty, released on bail of €3m after being made an official suspect in an investigation into tax evasion.

Suspected of corruption linked to the granting of "golden visa" residence permits, the head of Portugal's border agency and other top civil servants were also detained in November.

The fallout from the investigation into Mr Sócrates could prove damaging for the Socialists and increase the likelihood of next year's vote producing a hung parliament. At the same, Portugal's often slow-moving justice system will be put to the test by a series of high-profile cases.

Beyond the party political arguments and whatever the outcome of these judicial investigations, however, the perception is growing that the bitter economic hardship caused by the adjustment programme and the traumatic collapse of the Espírito Santo group are part of the same painful process – an attempt to allow the more successful areas of the economy to flourish in place of the outworn and the unproductive.

"The demise of the Espírito Santo group is positive news in that it symbolised every thing that was, and partly still is, wrong with the Portuguese economy," says Pedro Santa-Clara, a professor of finance at Lisbon's Nova School of Business and Economics. "Its collapse will free up resources to be better deployed elsewhere."

The Espírito Santos, until recently Portugal's most powerful bankers, have

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Inside

Espírito Santo collapse reveals wider weaknesses

Banking

Losses and bad loans continue to mount, as further rationalisation is likely, says *Peter Wise*

Banco Espírito Santo, once Portugal's best-known bank, is defunct. But its spectre will long haunt a country still trying to come to terms with how a 145-year-old pillar of the business establishment could collapse so rapidly, leaving a trail of ruined investments, companies and reputations in its wake.

Out of the collapse of the Espírito Santo empire, of which BES was the jewel, a reshaped banking sector will eventually emerge, probably with fewer big institutions and a redoubled focus on risk.

But as the dust settles on one of Europe's biggest financial scandals, "doubts remain", as Fitch, the rating agency, puts it, "about the underlying strength of the Portuguese banking sector and the effectiveness of monitoring by national authorities".

The recent European Central Bank stress tests have helped dispel some misgivings. Millennium BCP, the largest listed lender, failed under the "adverse" scenario based on 2013 figures, but will not need to raise more capital, as it has already redressed the shortfall. Otherwise, the three biggest banks, including BCP, were found to have adequate solvency ratios.

However, stress tests of Novo Banco, the "good" bank created out of BES in August, were postponed. Moody's, the rating agency, says this was a "missed opportunity" to shed light on "significant uncertainties" about its creditworthiness and financial profile.

The planned sale of Novo Banco will change the balance of power in the sector. Banco BPI, the second-largest listed lender, and Spain's Santander have both acknowledged an interest, with Brazilian lenders, other Spanish banks and Chinese investors also viewed as potential bidders.

Fashioned from the healthy assets of BES, but stripped of its toxic loans and liabilities, Novo Banco has received a €4.9bn injection of new capital from Portugal's bank resolution fund. The corporate loan portfolio and related expertise it inherited from BES is considered its most attractive asset.

At its height, BES controlled about 20 per cent of the banking market. In terms of market share, acquiring Novo Banco could put BPI or Santander Totta, the Spanish lender's local subsidiary, roughly on a par with BCP and state-owned Caixa Geral de Depósitos, currently the two biggest banks.

> 'Banks will have to adjust further to take into account changes in consumer behaviour'

Despite these apparent advantages, investment bankers warn the sale of Novo Banco could fall well short of raising its equity book value of €4.9bn. Fernando Ulrich, BPI chief executive, has said he is "certain Novo Banco is not worth €4.9bn". Other bankers say it may not even fetch half that amount.

Whatever the relative merits of Novo Banco, Portugal's banks as a whole are far from flourishing. Last year was an annus horribilis for the sector, with Santander Totta the only lender not to record a loss for its domestic operations.

There have been improvements since, but both BCP and BPI made net losses in the first nine months of 2014 and the sector's credit ratings remain among the weakest in Europe. According to Moody's, Portuguese banks are among the least profitable in Europe, but also among the most efficient, having significantly cut back on operating costs.

Lenders have been hit hard by three years of recession. Almost one in three Portuguese companies is overdue with bank loan payments. Bad loans continue to rise and currently account for about 11 per cent of total bank lending.

The OECD says the level of non-performing loans (NPLs) could be underestimated, as many banks prefer to keep rolling over what should be classified as bad loans, rather than increase their provisioning costs.

"There are many firms that can only meet their interest payments but cannot afford to pay down their debt," says Joaquim Souza, chief executive of Caixa, Banco de Investimento, CGD's investment bank. "The vulnerability of banks depends on how well they provision for those loans."

More than half the sector's NPLs are covered by provisions, but the OECD urges a tougher approach to cleaning up loan portfolios, saying "orderly debt restructuring" in the corporate sector would reduce private sector indebtedness and enable banks to "repossess collateral before it loses value".

In return for extensive restructuring, BCP, CGD, BPI and the smaller Banco Internacional do Funchal (Banif) received more than €7bn in state aid during Portugal's bailout, most of which has already been paid back. BCP, for example, has cut its staff numbers by more than a third over the past decade and shrunk its branch network by a quarter.

Further streamlining is inevitable, especially if BPI or Santander were to acquire Novo Banco. "Banks will have to adjust further to take into account changes in consumer behaviour," says Mr Souza.

The old order loses grip in painful times of change

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come to represent the backward-looking face of an economy that has achieved only meagre growth over the past two decades and is slowly recovering from its worst recession in 40 years.

The economic wrongs that the Espírito Santos are seen to embody include excessively cosy relations between the private and government spheres, borrowing heavily to expand despite having limited capital, investing poorly and contriving to influence big companies from minority positions.

"For too long, our smartest kids have been employed by groups like Espírito Santo, essentially to appropriate resources generated elsewhere in the economy, rather than to create real value," says Prof Santa-Clara. "When that happens, it's a big loss to society."

Some economists see the episode as one of "creative destruction". The Espírito Santos' fall, they say, has unlocked assets – unproductive in the hands of a highly leveraged banking group – that can be better managed by new, better capitalised investors.

The shift matches the economic transition the EU-IMF rescue sought to engineer through a painstaking programme of reforms and cutbacks, agreed to by Lisbon as the condition for a €78bn bailout. In three years of austerity measures, the programme helped transform a current account deficit equivalent to 12 per cent of gross domestic product in 2012 to a surplus in 2013.

The trade balance moved from a deficit of almost 10 per cent of GDP to a surplus of 2.1 per cent over the same period. This was the first time in more than half a century that Portugal has exported more than it imports.

Since 2011, the government has succeeded in cutting the budget deficit by a total of 6.4 percentage points to an

€78bn	3 years
The total amount of the EU-IMF bailout of Portugal	of austerity has changed a deficit of 12 per cent of GDP to a surplus

expected 4.8 per cent of GDP this year. Government borrowing costs, in keeping with trends in the rest of Europe, have fallen to historical lows.

The social cost of these gains has been brutal. Unemployment soared to record highs amid a wave of bankruptcies. Living standards plummeted as wages were frozen, taxes increased and social transfers cut. Emigration is at levels unknown since the 1960s and now includes highly qualified young graduates.

Nor is the overall success of the adjustment programme guaranteed. In November, Portugal's international borrowers sternly criticised the government for allowing the pace of reform to flag and putting at risk the progress that had been made.

The constitutional court has reversed several government measures aimed at cutting public spending. But since the end of the programme, the government itself had been delaying necessary fiscal cuts, the IMF says. It urges Mr Passos Coelho to tackle bottlenecks to growth with "more energy and purpose".

What is at stake in the Portuguese economy is a struggle to shift resources from non-export sectors such as energy, construction and telecommunications to export-led companies competing in global markets.

Serving the domestic market, sheltered from competition and often dependent on state contracts, such non-export companies have absorbed excessive investment and talent at the same time as they have diminished Portugal's international competitiveness by driving up costs for exporters.

Inputs such as energy and telecoms account for about 16 per cent of costs for Portuguese exporters, almost as much as labour (19 per cent). They have risen faster than export prices for almost 15 years. The OECD warned in October that expanding exports would depend on further reforms to strengthen competition in the non-export sector.

The other faultline dividing the economy between old and new is debt. Many undercapitalised, poorly managed companies that thrived in Portugal's debt-fuelled domestic market before the global financial crisis were hit hard when the credit dried up.

Rather than being wound up or sold off, many are being kept artificially alive by banks that would rather roll over loans than take the hit to their equity and bottom lines that enforcing liquidations would incur. These "zombie" companies do not invest, grow or create jobs.

"There are two economies in Portugal," says Joaquim Souza, chief executive of investment bank Caixa – Banco de Investimento. "One is expanding, restructuring, finding new export markets and has no trouble in accessing credit. The other is too heavily indebted to nurture any growth."

Slowing rate of recovery raises fears over ability to service debt

Economy Leading lenders warn about slack pace of reforms to stimulate growth, writes *Peter Wise*

Restaurants that not long ago were wildernesses of white linen are beginning to fill up. The ad breaks on TV are growing longer. Young faces are appearing in works canteens. Cranes in the Lisbon docks are moving more containers, and the rush-hour traffic is getting thicker.

After three years of recession, Portugal's austerity-battered economy is picking up. The International Monetary Fund forecasts gross domestic product will increase 0.8 per cent in 2014, the first full year of growth since 2010, and edge up to 1.2 and 1.3 per cent in 2015 and 2016 respectively.

In October, consumer confidence was at its highest for 12 years. A readiness to see brighter days ahead is understandable. Between 2008 and 2013, Portugal's index of material wellbeing fell 13 percentage points, reflecting how a shrinking economy, record unemployment, tax increases and public spending cuts eroded living standards.

The turnround came in the second quarter of 2013, when Portugal began to emerge from recession at one of the fastest growth rates in Europe. But the pace of expansion has faltered in 2014 and sanguine projections for the coming years have been repeatedly trimmed back, as the European economy stagnates and global demand slows.

"A deceleration of external demand is clearly one of the biggest risks," says José Brandão de Brito, chief economist at Millennium BCP. "Europe accounts for about 70 per cent of Portuguese exports, while the emerging markets into which our exporters have been diversifying are slowing down."

International lenders praise Portugal for its progress in tackling longstanding obstacles to growth and job creation during its three-year adjustment programme, which ended in May.

Substantial fiscal consolidation has been achieved. Steps have been taken to improve export competitiveness. A formidable current account deficit was turned into a surplus.

Pedro Santa-Clara, a professor of finance at Lisbon's Nova School of Business and Economics, comments: "The real tragedy is not that we're growing relatively slowly now, but how little we grew between 1995 and 2010, when we had budgets deficits of up to 10 per cent of GDP and external deficits close to 20 per cent of GDP."

Ricardo Reis, a professor of economics at Columbia University in the US, has calculated that between 2000 and 2012, the Portuguese grew poorer at a greater rate in terms of GDP per capita than Americans after the Depression (1929-

Waiting game: expansion has faltered in 2014
Mario Proenca/Bloomberg

1941). Prof Santa-Clara says: "We were borrowing tremendously from the rest of the world, but still not growing. If the money had been invested properly, it would have generated growth."

An inability to service that burden of accumulated debt forced Portugal into negotiating its €78bn bailout in 2011. Public debt has continued to rise and is expected to peak this year at 128 per cent of GDP. But in November, the "troika" of lenders – the European Commission, IMF and European Central Bank – warned the level of growth needed to sustain that level of debt was under threat.

Condemning a post-bailout slackening in the pace of reform, the IMF has urged the government to be more forceful in addressing "bottlenecks to export-led growth" or face the prospect of more workers emigrating and the unemployed permanently losing their skills.

Although the economy is growing again, the recovery is slow "even by the standards of Portugal's past record of weak expansions", the IMF says. Unemployment remains at "historically unprecedented levels" and the medium-term prospects for growth are "insufficient to make a decisive dent in Portugal's labour market slack".

Employment has picked up, expanding 1.1 per cent in the third quarter. Unemployment has dropped for six consecutive quarters from a peak of more than 17 per cent in early 2013 to just above 13 per cent. But the IMF warns that fresh policy initiatives are needed to bring the rate significantly below this level. Youth unemployment remains above 32 per cent, while a wave of emigration continues to depress the jobless figures.

> 'Clearly, a deceleration of external demand is one of the biggest risks'

The troika's warnings on the diminishing pace of reform came as Portugal enters an election year. The anti-austerity opposition Socialists are ahead in the polls for the October 2015 ballot and the centre-right government has been easing back on fiscal consolidation.

"The coming election might tempt the contending political parties to make promises about fuelling growth, but the next cabinet will also continue to face the restraints of debt consolidation," says Mr Brandão de Brito. "There is a risk the uncertainty created will affect borrowing costs, with repercussions for consumption and investment."

Pedro Passos Coelho, the prime minister, has made it a "point of honour" to cut the budget deficit to 2.7 per cent of GDP next year, below the 3 per cent threshold above which Portugal could be penalised under the EU's budget rules. But the troika is not convinced his fiscal measures will be enough and is projecting a deficit of 3.3 per cent of GDP in 2015.

Reforms bring improved rankings but hurdles remain

Business environment

Government extols climb up competitiveness tables but bureaucracy and tax are concerns, reports *Paul Ames*

In football-obsessed Portugal, attention is usually fixed on league tables and the ups and downs of Benfica or FC Porto. Lately, however, tables of a different kind have been hitting the headlines.

The centre-right government has pointed to Portugal's performance in a series of international business rankings as a clear indication that reforms to boost competitiveness and lift the economy out of recession are bearing fruit.

In September, Portugal rose 15 places in the World Economic Forum's Global Competitiveness ranking. Four months earlier, the country reversed years of decline to climb three places in the World Competitiveness rankings of IMD, the Swiss business school.

Although the World Bank's Doing Business index in October was ambiguous, because of to a change in methodology, Portugal's 25th place was enough for the government to claim success.

"This ranking puts us ahead of such nations as the Netherlands, France, Spain, Italy, Poland and Japan," says António Pires de Lima, economy minister. "The Portuguese are better at doing business than all these countries, including economies in southern Europe that are our direct competitors."

Government officials put the advances down to a reform programme that has cut red tape, making the country one of the fastest in the world to set up a business; the easing of labour and product market restrictions (the OECD ranks the labour market in Portugal as more flexible than that of Germany or the Netherlands); and streamlined judicial procedures.

Parliament has set in motion a gradual reduction of the corporate tax rate to 17 per cent by 2018, from last year's 25 per cent starting level.

"The climate is increasingly more positive," says Miguel Frasquilho, head of Aicep, Portugal's trade and investment agency. "We've pushed forward

Driving change: VW has big plans

important structural reforms – changes that have made the environment more business-friendly – and we are starting to see the benefits in terms of positive international visibility."

The impact of reform on foreign direct investment is hard to judge. It actually rose during the darkest years of the eurozone crisis, reaching €47.7bn in 2012, but fell by more than a third last year, according to Aicep.

In 2014, it has been creeping up again and registered an increase of 15 per cent in the first six months of the year to €17.8bn.

Big-money deals, such as the €2.7bn purchase by China Three Gorges of a 21 per cent stake in Energias de Portugal, the dominant power utility, in 2011, or Volkswagen's recent announcement of a €677m investment in its AutoEuropa plant south of Lisbon, have gained attention. But Portugal is also seeking to lure small and medium-sized investors.

When French-born Ana Sofia Oliveira told friends and family in France she was opening a café serving traditional Brittany-style pancakes in Portugal, her parents' recession-hit homeland, they said she was crazy.

A year on, La Crêperie da Ribeira packs in the crowds at the heart of Lisbon's hip Cais do Sodré neighbourhood and Ms Oliveira and her husband are poised to open a second outlet. But her assessment of Portugal's business-oriented reforms is mixed.

"It was super-easy to create the business; it took half an hour. After that things got complicated," she says. "There are some things you can do online, which is good, but there's the fiscal side. It's not only that taxes are so high, it's the complexity of the bureaucracy. The time you spend dealing with it can strangle a small business."

Despite the planned cut in corporate tax rates, business leaders consistently point to Portugal's high fiscal burden as the main internal dampener on the investment climate. The tax burden is 45.2 per cent of gross domestic product, up from 38.5 per cent in the late 1990s.

Bernardo Meyrelles, head of Deutsche Bank in Portugal, says the country deserves greater recognition for recent reforms and longer-term improvements that have endowed it with a well-educated workforce, modern infrastructure and a dynamic innovation culture. Failure to lighten the tax burden, however, is an own goal, he says.

"Trimming the state has become all the more crucial. Cutting state spending would reduce the fiscal burden, creating growth and employment, increasing consumption," he says.

"Because Portugal is so highly decapitalised, we need to attract foreign investors and the way to get them is to reduce taxes."

Euro crisis fails to undermine faith in the two-party state

Politics Some new forces have emerged but have had little effect on the duopoly, writes *Tony Barber*

As the whirlwind of the sovereign debt and financial sector emergency tore through Europe in 2010-2011, Portugal's economy and bond market buckled. But the nation's two-party political system stood as unmoved as the cliffs of Cape St Vincent on Portugal's southwest coast that are battered day and night by Atlantic waves.

Now, Portuguese voters are preparing for parliamentary elections, due to be held next October. For the first time, there are signs that four years of upheaval are propelling small but significant changes to the party political scene.

New on the left is Livre ("Free"), a moderate, pro-EU party with environmentalist leanings that is closer in outlook to Podemos in Spain than Syriza in Greece. The party is led by Rui Tavares, a former European Parliament member (MEP) who, rather than pursuing the unrealistic goal of displacing the dominant Socialist party, hopes to build Livre into one element of a reshaped left.

To the right has emerged the Democratic Republican party, founded in early October by António Marinho e Pinto, a newly elected MEP and former head of the Portuguese professional lawyers' association. He has a reputation as a formidable critic of Portugal's political and judicial establishment.

These new forces are too untested to stand much chance of preventing the ruling centre-right Social Democrats and the opposition Socialists from occupying the top two places in next year's polls. However, neither of the traditional victors can be sure of winning an outright majority.

Smaller parties, such as the centre-right CDS-PP, the Communists and the two new movements, may attract sufficient votes to push the Social Democrats and Socialists into a German-style grand coalition. But apart from one experiment in 1983-85 under Mário Soares, a former prime minister, the two main parties have preferred to stay at arm's length since the country replaced authoritarianism with democracy in its 1974 Carnation Revolution.

In ideological terms, the Social Democrats and Socialists are not poles apart. But they are natural competitors for power, making it an open question how comfortably they might work together in a coalition.

The present government almost fell apart in July 2013 because of differences between the Social Democrats and CDS-PP, their junior partner. During this crisis, neither Social Democrats nor Socialists responded with enthusiasm to the appeals of Aníbal Cavaco Silva, the president, to join forces in a "national salvation" government.

A degree of political uncertainty therefore hangs over next year's election. No matter who takes office after the vote, the next government may consist of awkward coalition partners, may lack a stable parliamentary majority and may be too weak to implement unpopular economic reforms.

On the other hand, there appears to be little risk Portugal will be rattled by the anti-EU, anti-euro and anti-immigrant populism that has arisen in Austria, Finland, France, Greece, Hungary, Italy, the Netherlands and the UK.

"There is growing bitterness and resentment that the EU is forcing the country to adopt irrational, counter-productive and mean-spirited policies," wrote Ricardo Cabral and José Viriato Soromenho-Marques, two university professors, in March for the Heinrich Böll Stiftung, a left-leaning think-tank.

Parliament in action: two main parties will stay dominant
Reuters/Hugo Correia

Yet a Eurobarometer poll, undertaken in October for the European Commission, showed 50 per cent of Portuguese thought the euro was a "good thing" for their country and 38 per cent "a bad thing". A year ago, it was much closer, with 46 per cent calling the euro a "good thing" and 44 per cent a "bad thing".

Faith in Portugal's two-party system, like faith in the euro, has taken a hit during the eurozone crisis. But it is bruised rather than knocked out. Comparing Portugal with Greece illustrates the point.

In Greece, which received its first EU-International Monetary Fund bailout in May 2010, the humiliating collapse into the arms of international creditors caused a decline in support for the two parties that had alternated in power since the end of military rule in 1974.

Each party haemorrhaged votes to new forces on the radical left and far right that gave voice to public anger with the discredited establishment.

'Parties in Portugal are strong in their ability to frame the attitudes of society'

In Portugal, where the EU and IMF stepped in with a three-year, €78bn rescue one year after the Greek bailout, the two-party system held up more strongly – as, until recently, it did in Spain. One reason is that modern Greek politics has been rooted in clientelism – politicians dishing out perks such as public sector jobs in exchange for votes – to a much greater extent than in Portugal.

Another factor is that Portugal's two big parties are highly centralised machines, with power concentrated in the hands of the leader, especially if he happens to be prime minister as well.

"Political parties in Portugal are weak in terms of their roots in civil society but strong in their ability to frame the attitudes of society," says António Costa Pinto of Lisbon university's institute of social sciences.

Naturally, the relative stability of party politics is no guarantee that the two dominant parties will succeed in modernising the economy, judicial system and education to the extent required. But it does, at least, suggest Portugal will stick to the path of political moderation charted over the past 40 years.

Golden tickets for foreign purchasers underpin revival

Property

Changes in the law add spirit to the residential market and urban renovation, writes *Alison Roberts*

After years of stagnation, Portugal's property market is reviving. Attractive returns are to be had on prices that are generally below pre-recession levels, residential purchases are rising, and there is the prospect of big commercial deals.

In the residential segment, the residence permit for investment scheme or "golden visa" programme – a fast track for non-EU citizens, primarily through purchase of properties worth at least €500,000 – has been hugely successful. In two years it has brought in €1bn, €972m of that in property purchases, according to the Immigration and Borders Service. Eighty per cent of the 1,775 permits have been issued to Chinese citizens.

A separate regime offering tax-free residence for EU citizens who move to Portugal is drawing buyers from traditional markets, such as the UK, and new ones, such as France.

"The French market is new for Portugal, and the special tax regime is one factor," says José Roquette, director for business development at Pestana, Portugal's largest tourism group. "But the Algarve is seeing a revival: demand is meeting supply."

In other regions, the potential for residential tourism is limited, the exception being Pestana's Troia resort, an hour south of Lisbon. Its early phases sold well in the recession, thanks to its prime location. Mr Roquette says construction was accelerated to finish villas for the third and final phase, launched this month.

"The location is very strong – 100 hectares right on the beach – this doesn't exist any more," he says. "We worked with the concept of an eco-resort, so the product is completely different."

According to Apemip, the estate agents' association, in the first nine months of 2014 foreigners accounted for 23 per cent of residential transactions and the pace has been increasing. Apemip sees foreign purchases topping €1.5bn this year.

Before the crisis, developers in Lisbon and Porto threw up out-of-town complexes with abandon, but today's foreign buyers are only interested in city-centre residential and commercial property. Recent legal changes mean rental contracts can be upgraded gradually to near-market rates; where buildings desperately need refurbishment, tenants can be moved out if they are rehoused and compensated.

"We're busiest in developing buildings to be sold for residential," says Eric van Leuven, Lisbon managing partner at Cushman & Wakefield, an estate agent. "You don't see cranes in Lisbon but lots of single buildings being renovated. That's a result of the change in the law."

Some Chinese developers are buying properties to renovate them and sell to golden-visa candidates.

Lisbon's emergence as a trendy leisure destination is attracting more hands-on players. In Príncipe Real, its hippest neighbourhood, a subsidiary of EastBanc, a US developer, has begun an ambitious project to polish the area's unique, but in places shabby, charms, to plans by Eduardo Souto Moura, Portugal's Pritzker prizewinning architect.

'You don't see cranes in Lisbon but lots of single buildings being renovated'

The first stage was turning two mansions into shopping galleries. The neo-Moorish Palacete Ribeiro da Cunha has become Embaixada, a showcase for Portuguese fashion and design. A few doors down at Entre Tanto, in the architecturally soberer Palacete Castilho, retail tenants sell toys and home decor.

For sale: Chinese buyers are active

Nearby, the Palácio Faria is the first of a score of buildings awaiting conversion into luxury flats. EastBanc is taking things slowly, testing the market reaction, but committed itself before the eurozone crisis and has already spent some €50m – half the projected total.

Its founder, Anthony Lanier, is an Austrian national born in Brazil and married to a Portuguese. He has dubbed his approach of turning dilapidated town houses into upscale stores and offices "a conveyor belt for renovation"; in Washington, the company has transformed the Georgetown and West End markets over the past two decades.

For Mr van Leuven, though, it is not such projects that will drive Portugal's market but "the sheer weight of money" from the likes of Blackstone, the US buyout group, searching for returns. "There are at least three deals in progress worth €400m," he says, citing the prospective sale of chunks of two Algarve resorts by the banks that own them. "So far this year, we've seen €250m in transactions, but €1.5bn is in negotiation."

In retail, whereas malls had to renegotiate leases in the recession, for a year stores have enjoyed month-on-month sales growth, paving the way for sustainable rent increases. Big German funds such as Commerz Real and Deka are also back and looking to buy – a sign that Portugal's risk premium is shrinking.

The market is small and illiquid, and faces uncertainties arising from a relatively weak economic recovery. But property looks to be bouncing back despite this, and in most segments it remains a buyer's market, with returns among the highest in Europe.

Corporate tax reforms offer chance to expand the base while making rate cuts

COLUMN

Carlos Loureiro *and* William Cunningham

Portugal's tax and structural reforms have boosted its business profile. It rose from 51st to 36th in the World Economic Forum Global Competitiveness Report 2014-2015, while the World Bank's Doing Business 2015 report put it 10th out of 189 countries for ease of starting a business and resolving insolvency.

Despite this good news, room for improvement remains in the field of business taxation. In the World Bank ranking, Portugal dropped from 56th to 64th for ease of payment of taxes.

The full effects of the tax reforms have yet to be seen, as an ambitious increase of 4.7 per cent in tax revenue is envisaged in the government's 2015 budget proposals, following a strong increase in 2014.

A corporate tax reform came into effect in January 2014, improving the competitiveness of the tax system with a wide range of measures.

Among these are a phased-in reduction of the corporate tax rate from 25 per cent in 2013 to 19 per cent in 2016 and the reintroduction of a simplified corporate tax reporting system for companies with annual turnover below €200,000 and a balance sheet total below €500,000.

Surcharges on the basic tax rate are to be phased out. The rate for 2014 was set at 23 per cent and a further reduction to 21 per cent is scheduled to come into effect in January 2015.

However, the 2014 surcharge of 7 per cent on corporate profits exceeding €35m was retained for 2015. This additional tax burden is likely to affect only a small number of companies, because of the high level of internationalisation of the largest Portuguese groups and the relatively small average size of other large and medium-sized companies.

Tax losses may now be carried forward for 12 (previously four) years, and a new "patent box" regime similar to that already available in other EU member states has been introduced.

Internationalisation of Portuguese companies has been boosted by significant improvements in the taxation of inbound and outbound intercompany dividends, with the introduction of a participation exemption regime, and in the taxation of capital gains on share disposals. This has brought Portuguese corporate taxation to a level competitive with other comparable economies.

One route to increased tax yields may be Portugal's drive to combat tax evasion

Can Portugal succeed in expanding the corporate tax base while continuing with its tax rate reduction programme? The answer is probably "yes" – if governments maintain a steady and consistent national tax policy.

The headline tax rate is only one of many aspects considered by inward investors when selecting a location, but sudden changes in that rate and surprise surcharges and extraordinary taxes tend to discourage inward investment, or drive national champions to migrate to more stable tax environments.

One route to increased tax yields may be the drive to combat tax evasion. Of the €37bn planned tax revenue in 2014, €754m is expected to come from the anti-evasion programme.

By providing incentives to individuals to demand invoices from providers of goods and services, the state has been able to accumulate details of 4.8bn invoices issued during the first half of 2014. By January 2014, 2.4m taxpayers had requested invoices bearing their fiscal number (figures that will be greatly exceeded by year-end).

Self-employed professionals are obliged to issue their invoices via the tax authorities' web portal, ensuring compliance with personal tax reporting obligations. The cross-checking and data mining of the resulting database will facilitate a progressive clampdown on the "parallel economy", resulting in the entry of thousands of previously unregistered businesses into the tax net.

This imaginative combination of incentives that appeal to individual self-interest and innovative use of data storage and mining technology places Portugal at the forefront of efficient corporate tax enforcement.

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Internet-based strategy helps boost visitor numbers

Tourism Online marketing and investment in hotels and services help create more buoyant sector, writes *Alison Roberts*

Tourism has long been a key sector in Portugal's economy and its importance is growing; having held up well in the recession, it is rapidly diversifying away from traditional beach holidays. According to the World Travel and Tourism Council, by 2024 the industry should account for 20 per cent of jobs in Portugal, 13 per cent of investment and 21 per cent of exports and services income.

Lisbon, which overtook the Algarve in terms of visitor numbers in the wake of the Euro 2004 football championship, is a prime city-break destination. Porto, the second city and a hub for low-cost airlines, has carved out a similar niche.

Around the country, 19th-century spas and rural guesthouses have been given contemporary makeovers and are drawing customers keen to try out new experiences.

Between January and July, according to Turismo de Portugal, the national tourist board, the number of overnight guests was up 11.6 per cent on the same period of 2013. All southern Europe has benefited from the impact of the Arab spring on tourism in north Africa, but Portugal seems to be winning more business than its rivals.

The French, in particular, are arriving in unprecedented numbers; in Lisbon they are now the largest group, with some hotels reporting a 30 per cent rise.

At a time when good investment returns are hard to find, the response has been enthusiastic.

Deloitte, the consultancy, has forecast 12 hotels will have opened this year in Lisbon, four in central Portugal and 10 in Porto and the north. Algarve resorts are to add six; even the rural Alentejo expects two, both five-star. Despite pressure on rates as capacity expands, revenue from all accommodation to July was up 10 per cent at €5.35bn.

Centre of attraction: Lisbon's Rossio Square
Dreamstime

Lisbon's inclusion in budget airlines' networks – first EasyJet, now Ryanair – has helped, but the country's smart approach to promotion in austere times has also been a factor. Eschewing costly advertising campaigns, its marketers woo foreign opinion makers while wringing all they can out of online analytics and social media.

The way prospective tourists research their travel plans has changed radically, says João Cotrim Figueiredo, president of Turismo de Portugal. "You start by thinking you may want something before knowing exactly what, and are immediately online, looking for inspiration," he says.

"We have a chance to be present when people start their research. Once they are ready, by clever use of online marketing, you can put yourself on the shortlist."

The team then actively tries to manage what happens afterwards, as tourists share their experiences online.

"The first part – the choice – we do with search engine optimisation: we pay for it," Mr Figueiredo says. "The sharing part, on social networks, we don't. But we try to make it viral whenever possible, and it's that buzz that's invaluable in ensuring that the next potential tourist has Portugal at the top of their mind when starting the process."

Success is predicated on visitors enjoying their stay: the Portuguese talent for hospitality and a balmy climate help, but the industry offer has also been transformed by a huge reduction in red tape. As secretary of state for tourism since early 2013, Adolfo Mesquita Nunes (described by one enthusiastic columnist as "the government's only liberal") has abolished licences for most tourist services; now, mere notification of premises or vehicle used, plus proof of insurance, suffice.

> 'By clever use of online marketing, you can put yourself on the shortlist'

Meanwhile, programmes to stimulate new tourism concepts are positioning Portugal as a European start-up hub.

The result? A thousand flowers blooming in the form of funky hostels and other local accommodation, specialist tours and, in Lisbon, fleets of tuk-tuks offering tourist rides.

This proliferation of services and the tourism boom itself have prompted concerns over potential friction with locals of the kind seen in Barcelona. In general, though, the new enterprises have simply parted tourists from more of their money than they would otherwise have spent.

Elsewhere, there has been strong growth in wine and eco-tourism. Douro Azul, a river-cruise operator, is focusing on the lucrative upstream business in the Douro wine region; last year it launched two new vessels, each with more than 100 berths.

Portugal faces some challenges, such as the lack of direct flights from growth markets such as China and, in the short term, the limitations of Lisbon's airport, which is in a very built-up central area.

"By the end of 2015 it will hit capacity and they'll have to do something," says Nicolas Roucos, general manager of Lisbon's Inspira Santa Marta Hotel. While the global financial crisis scotched plans for a shiny new facility, he is among those who see bolt-on alternatives in the form of regional airfields.

Solutions to such problems will have to be found if officials are right to hope that the boom can be extended with the help of an online strategy.

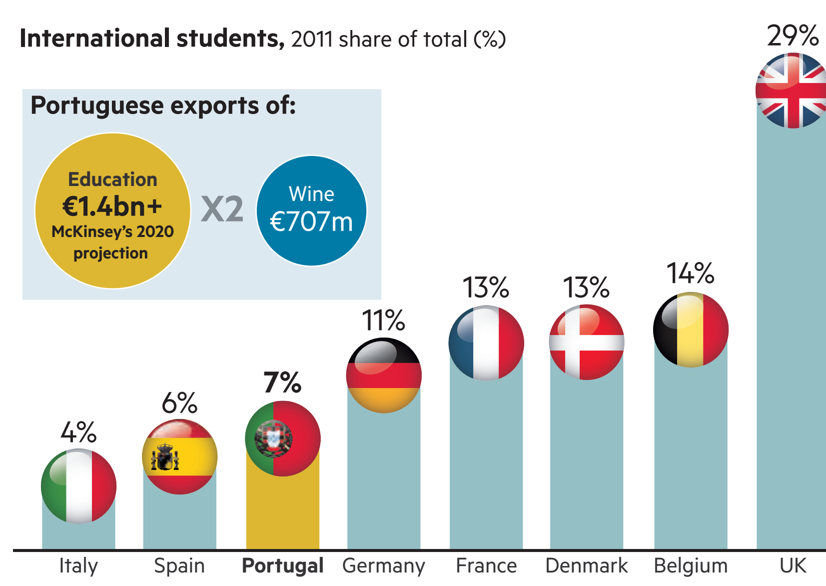
"It's no secret that we're working closely with Google, Amazon and Facebook, so their knowledge of the consumer can be used to fine-tune our marketing effects," says Mr Figueiredo.

"We hope to [stay at] the forefront of this approach for years. Because these big players tell us that not many [other countries] are trying to do the same thing."

Climate and lifestyle draw funds to education and healthcare

Services

The country is using its natural advantages to help the balance of payments, reports *Peter Wise*



FT graphic Source: Nova School of Business and Economics

Under a warm November sun, the courtyard café at Lisbon's Nova School of Business and Economics is crowded with students. Some groups are chatting in Portuguese, several in English and others in German.

In the eyes of a growing number of economists, the relaxed, summery scene is a snapshot of the future for Portuguese exports. "Education, like other services we don't traditionally think of in that way, can be a huge export industry," says Pedro Santa-Clara, a professor of finance at Nova.

Consultants at McKinsey estimate providing educational services to foreign students could be worth €1.4bn a year to Portugal by 2020, double the current export earnings of the wine or cork industries and close to those of the footwear sector, three traditional pillars of Portuguese exports.

Similar potential is seen for services such as healthcare, retirement villages and the so-called nearshoring of European back-office, marketing and research operations by international companies.

A small country with few resources, Portugal, many economists believe, can turn its climate and lifestyle into an asset that extends beyond tourism, which accounts for 20 per cent of exports. "Our most important natural resource is that Portugal is a great place to live," says Prof Santa-Clara.

Nova, which receives 40 per cent of its applications from overseas candidates and has 200 German students, the largest national group after the Portuguese, highlights Portugal's "cool" factor and "Californian lifestyle" in its prospectus for a €38m campus due to open in 2017.

The campus also draws inspiration from the US in that it will be one of the first in Europe to raise most of the investment required from private corporate donations in a €50m fundraising campaign that has so far raised €30m.

"Portugal has the Californian niche in Europe," says Prof Santa-Clara, who taught for 10 years at the University of California at Los Angeles. "London, Paris and Berlin are attractive capitals to study in, but if you want to buy into the Californian lifestyle, there's really only Lisbon and Barcelona."

The qualities that draw foreign students to Portugal hold true for potential consumers of other services. Well-qualified doctors and nurses and a welcoming culture are viewed as the basis for building an export industry in medical treatment and convalescence.

Potential is seen in developing retirement homes and sports training facilities for foreigners. "Imagine a Danish person having their hip replaced in Portugal and being able to walk on the beach as they recover," says Prof Santa-Clara.

In October, Fosun International, the privately owned Chinese conglomerate, spent €460m to acquire Espírito Santo Saude, which runs private hospitals. Nine months earlier, Fosun had paid €1bn for 80 per cent of Caixa Seguros, the largest Portuguese insurance group. The purchases are part of a €5bn wave of Chinese investment in Portugal over the past four years.

McKinsey predicts that educational services for foreign students could be worth €1.4bn a year by 2020

"Chinese investors are seeking know-how in sectors that are crucial for their domestic market," says Pedro Siza Vieira, head of the Lisbon office of Linklaters, the law firm. "The acquisition of a hospital group and an insurance company in Portugal reflects the huge potential they see for developing healthcare and pension businesses in China."

Investors from emerging markets see geographic location as another strong advantage. "In Europe, we tend to view Portugal as small and under-developed," says Mr Siza Vieira. "But investors from Asia and Latin America see a platform in a strategic position inside the EU at the crossroads of shipping lanes and air routes connecting the US, Latin America, Africa and Europe."

That the platform is, by European standards, competitively low-cost is another factor. The average net monthly salary of about €985 in Portugal is less than half that in Ireland, Italy or France. Over the past five years, nominal unit labour costs have fallen 4.4 per cent in Portugal, compared with a 3.8 per cent increase in the eurozone as a whole.

The availability of skilled engineers and other professionals at comparatively low salaries is an important draw for nearshore investments in the communications and technology sector. The World Economic Forum ranks Portugal eighth out of 144 countries for the availability of scientists and engineers and 11th for access to the latest technologies.

In recent years, companies such as Siemens, Fujitsu and SAP have made nearshore investments in operations centres, research units, technology platforms and service desks that cover large international regions from Portugal, creating thousands of skilled jobs.

"People have tended to neglect the export of services," says Mr Siza Vieira. "But given the cost of living in Portugal, the availability of low-cost skilled labour, the climate and our language skills, it could, with tourism and nearshoring, prove very important for our future."