PORTUGAL REPUBLIC

Rating Analysis - 1/12/12
Debt: EUR161.3B, Cash: EUR7.6B

EJR Sen Rating(Curr/Prj) B+/ B
EJR CP Rating: B
EJR's 1 yr. Default Probability: 6.0%

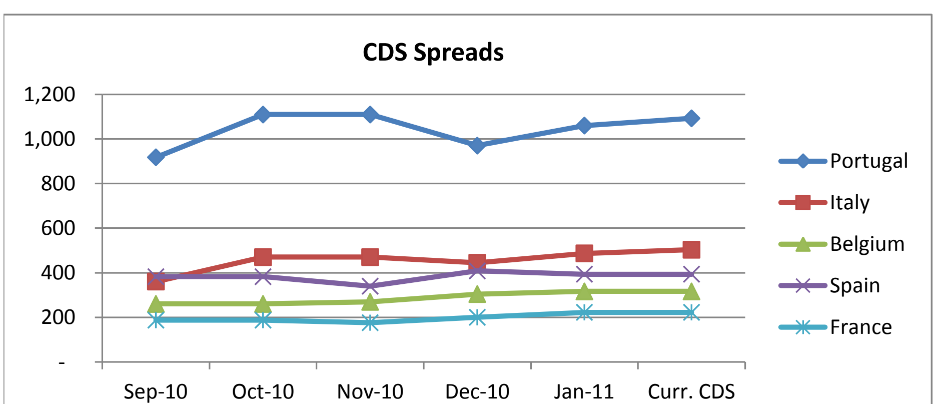
Both Greece and Portugal are relatively small EU countries in Southern Europe both of which are running massive deficits; 10.6% in the case of Greece and 9.8% in the case of Portugal. The similarity continues with the tough credit position of each country. The upshot is likely to be the ESFS stepping in to fund a large portion of Portugal's needs. As can be seen below, Debt to GDP has grown regularly over the past three years; over the 3 years, debt has grown by 31% while GDP has been more or less flat.

Portuguese banks have relied heavily on funding lines from the ECB this year as the country has been largely shut out of inter-bank lending markets. Yields on two year govt. paper have been near 6.0%, a level which is likely to prove unsustainable. The overriding question is how the country will be able to reach stability. We remain very concerned about Portugal's credit quality and are cutting our rating. Watch the ECB's liquidity efforts.

	Annual Ratios					
INDICATIVE CREDIT RATIOS	2008	2009	2010	P2011	P2012	P2013
Debt/ GDP (%)	71.6	83.0	93.3	107.1	125.5	138.6
Govt. Sur/Def to GDP (%)	-3.6	-10.1	-9.8	-10.9	-15.0	-15.6
Adjusted Debt/GDP (%)	81.2	92.8	102.9	117.0	135.6	148.5
Interest Expense/ Taxes (%)	13.0	13.4	13.6	14.2	16.5	17.2
GDP Growth (%)	-1.5	1.0	-1.7	-3.0	-3.0	2.0
Foreign Reserves/Debt (%)	0.6	0.4	0.9	0.8	0.7	0.6
Implied Sen. Rating	B+	B	B+	B	B-	CCC+

INDICATIVE CREDIT RATIOS	AA	A	BBB	BB	B	CCC
Debt/ GDP (%)	40.0	50.0	60.0	80.0	120.0	150.0
Govt. Sur/Def to GDP (%)	5.0	3.0	0.5	-2.0	-5.0	-9.0
Adjusted Debt/GDP (%)	45.0	55.0	65.0	85.0	125.0	155.0
Interest Expense/ Taxes (%)	7.0	9.0	12.0	15.0	22.0	26.0
GDP Growth (%)	5.0	4.0	2.0	1.0	-1.0	-5.0
Foreign Reserves/Debt (%)	25.0	20.0	15.0	12.0	9.0	7.0

PEER RATIOS	S&P Sen.	Debt as a % GDP	Govt. Surp. Def to GDP (%)	Adjusted Debt/ GDP	Interest Expense/ Taxes %	GDP Growth (%)	Ratio-Implied Rating*
Federal Republic Of Germany	AAAu	83.4	-4.3	91.5	11.2	2.6	BB
French Republic	AAAu	82.4	-7.1	101.6	9.5	1.5	BB-
Kingdom Of Belgium	AAu	96.2	-4.1	121.3	11.9	1.7	BB-
Kingdom Of Spain	AA-	60.4	-9.3	68.7	9.5	0.8	BB
Republic Of Italy	Au	119.1	-4.6	128.0	15.4	0.2	B



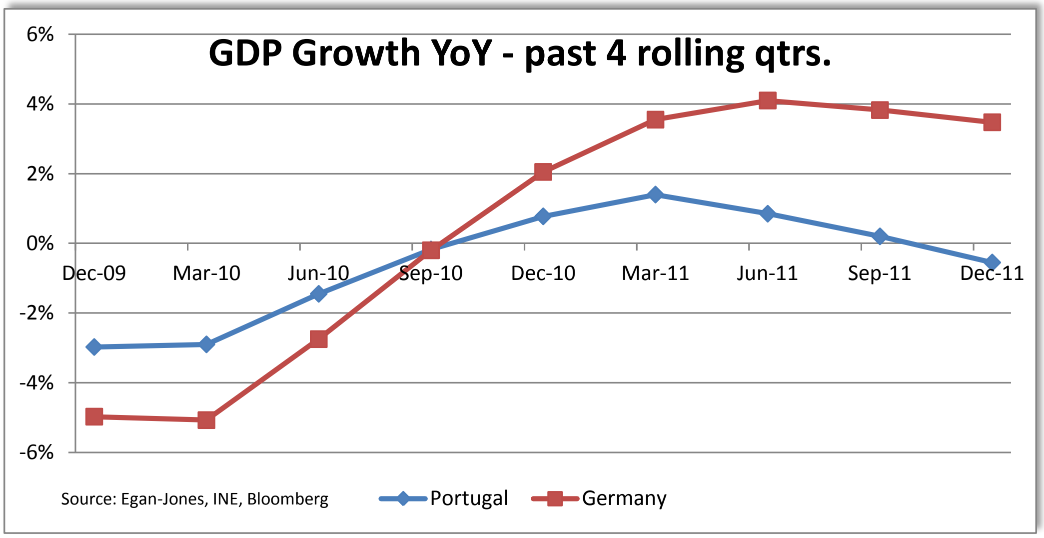
Country (EJR Rtg*)	Current CDS	Targeted CDS
Portugal(B)	1,093	1,200
Italy(BB)	503	800
Belgium(BBB-)	316	400
Spain(BBB-)	394	400
France(A-)	222	120

* Projected Rating

Economic Growth

Portugal is among Europe's poorest nation with GDP per capita of only $24,800. However, it has a somewhat well-diversified, increasingly service-based economy. Over the past two decades, many state-controlled firms have become private and key areas of the economy have been liberalized, including the financial and telecommunications sectors. The five largest banks in Portugal (only one of which is government regulated) account for 80% of the sector's total assets.

The basic problem of Portugal is that its GDP is not growing, nor are its taxes, while government expenses, government deficits, and government debt are growing. Over the past two years taxes have shrunk by 6% while total expenses grew by 12%. A poor education system and under-skilled labor force continue to be significant factors in preventing greater productivity and growth.



As can be seen from the above chart, Portugal's four rolling GDP growth has been less than impressive over the past several quarters; Portugal has shrunk in the Dec. 2011 quarter while Germany grew slightly less than 4%. Portugal's economy is geared to the the tourist and vacation-related building industries, both of which remain depressed. With the austerity measures of many EU countries and increased taxes, discretionary expenditures such as leisure with continue to be pressured.

Fiscal Policy

Portugal's deficit to GDP at 9.8%, which is at the high end of other peers. Given the lack of GDP growth reported recently, it is hard to envision the Country will be able to significantly improve its budget. Furthermore, with the rise in borrowing costs, and relatively high debt, we expect the deficit to remain above 7% for the next couple of years.

	Deficit/ to GDP	Debt-to-GDP	5 Yr CDS Spreads
Portugal	-9.8	90%	1,093
Germany	-4.3	79%	104
France	-7.1	79%	222
Belgium	-4.1	93%	316
Spain	-9.3	58%	394
Italy	-4.6	114%	503

Source: Bloomberg

Unemployment

Portugal's unemployment rate has long been among the highest in the Euro zone. Since July 2009, the levels have been at their highest in nearly two decades averaging well above 10%. After reaching a relative high of 12.4% in 2010; is among the highest for the 24 OECD countries. Meanwhile, the euro area average remains near 10%. Rates in Portugal have been highest among citizens with basic levels of education (13.0%) and lowest among citizens with higher education (6.3%). Citizens with no level of education record the median rate of 9.4% of unemployment.

Unemployment (continued)

Excluding Spain, Portugal has unemployment at the top of its peer group. Given the fact that much of the economy is geared to tourism and building, which will remain depressed for the foreseeable future, it will be difficult for the country to reduce its unemployment much in the near future. The most likely outcome is an increase in unemployment as EU countries implement austerity measures.

Unemployment

	2009	2010
Portugal	11.1	12.4
Germany	7.4	6.8
France	9.7	9.7
Belgium	7.6	7.2
Spain	20.3	21.5
Italy	8.3	8.1

Source: International Finance Statistics

Banking Sector

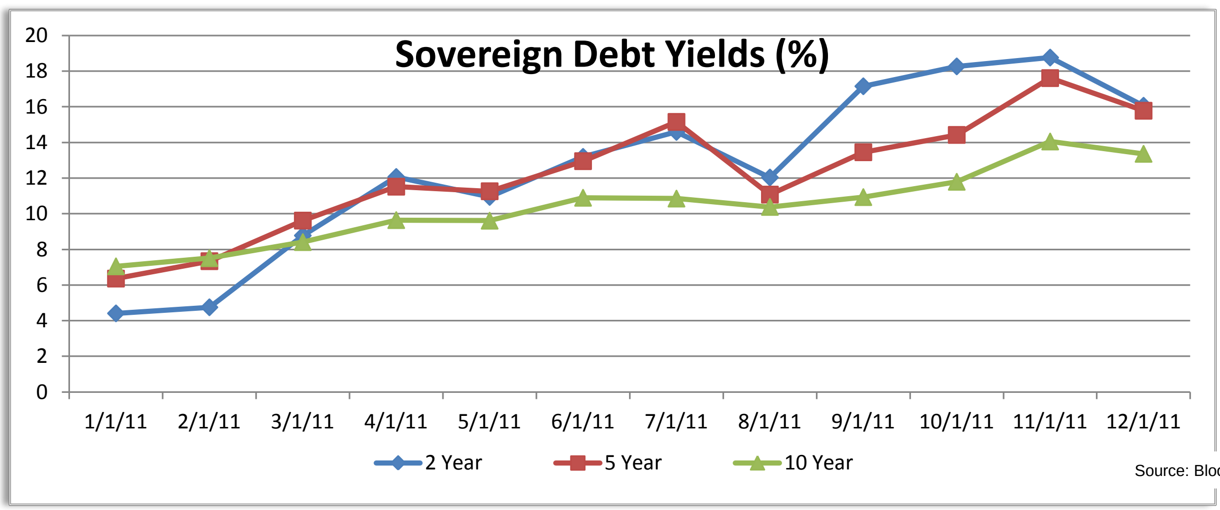
The five largest banks have combined assets of EUR248B which equates to 143% of Portugal's GDP. If Portugal's banking sector needs support, any such support will place pressure on the Country's credit quality. Essentially, the banks are supporting the country and the country is supporting the banks.

Bank Assets (millions)

	Assets
Banco Commercial Port	100,010
Banco Espirito Santo S/	83,655
Banco BPI SA	45,660
BANIF SGPS SA	15,711
Finibanco Holding SGP	3,155
Total	248,191
Portugal's GDP	172,799

Funding Costs

The costs of funding the country's debt is prohibitively high; as can be seen from the below chart, over the past year, Portugal's funding cost has risen from near 5% to near 15%.
Our view is that funding costs in excess of 2% in a low to no growth environment is too high; a rate near 15% is disastrous particularly given the rapid rise over the past year.
If the country pays 15% for ten year debt, then the local businesses is probably faced with costs over 20% and a reduction in availability. A final item of interest is the recent decline in the two and five year yields, which reflect the ECB's aggressive liquidity support program.



Source: Bloomberg

Ease of Doing Business and Economic Freedom

A major factor for growing the economy is the ease of doing business and the economic freedom; although not the sole factor for determining economic growth, a country which makes it easy for businesses to operate and provides a reasonably free environment to conduct business has a good chance for growth. The charts on the attached pages indicate that Portugal is more or less average.

Ease of Doing Business and Economic Freedom (cont.)

As can be seen below, Portugal is average in its overall rank of 30.

The World Bank Group - Doing Business Survey: Portugal

Ease of Doing Business	2012 Rank	2011 Rank	Change in Rank
Overall Rank	**30**	**30**	**0**
Starting a Business	26	59	33
Dealing with Construction Permits	97	107	10
Getting Electricity	34	33	-1
Registering Property	31	30	-1
Getting Credit	126	116	-10
Protecting Investors	46	44	-2
Paying Taxes	78	77	-1
Trading Across Borders	26	24	-2
Enforcing Contracts	22	23	1
Resolving Insolvency	22	20	-2

* Measures 183 countries, based on a scale of 1 to 183 with 1 being the highest ranking.

Source: Doing Business - The World Bank Group

As can be seen below, Portugal is above average in its overall rank of 64 with 100 being best.

Heritage Foundation 2010 Index of Economic Freedom - Portugal

World Rank: 64 of 100 (best); Regional Rank: of 32*

	Rank	2011 Rank	Change in Rank	World Avg.
Business Freedom	**32.0**	81.1	-0.4	64.3
Trade Freedom	**12.0**	85.8	0.1	74.8
Fiscal Freedom	**162.0**	61.6	0.1	76.3
Government Spending	**153.0**	35.4	-0.9	63.9
Monetary Freedom	**19.0**	79.9	2.6	73.4
Investment Freedom	**38.0**	70.0	0	50.2
Financial Freedom	**38.0**	60.0	0	48.5
Property Rights	**26.0**	70.0	0	43.5
Freedom from Corruption	**35.0**	65.0	-4.0	40.5
Labor Freedom	**169.0**	40.3	-2.3	61.5

*The ten economic freedoms are based on a scale of 0 (least free) to 100 (most free).

**Based on a scale of 1-179 with 1 being the highest ranking.

Source: The Heritage Foundation & Wall Street Journal

Assumptions for Projections

	Peer	Issuer	Base Case	
Income Statement	**Median**	**Average**	**Yr 1&2**	**Yr 3,4,5**
Taxes Growth%	4.2	5.1	**(4.0)**	**0.5**
Social Contributions Growth %	2.0	0.4	**0.4**	**0.4**
Grant Revenue Growth %	0.0	0.0		
Other Revenue Growth %	1.8	31.2	**(3.6)**	**(3.6)**
Other Operating Income Growth%	0.0	0.0		
Total Revenue Growth%	3.1	7.2	**(3)**	**2.0**
Compensation of Employees Growth%	2.0	(0.9)	**(0.9)**	**(0.9)**
Use of Goods & Services Growth%	1.8	4.1	**4.1**	**4.1**
Social Benefits Growth%	3.2	2.5	**2.5**	**2.5**
Subsidies Growth%	3.9	(11.1)		
Other Expenses Growth%	27.0	27.0	**27.0**	**24.3**
Interest Expense	0.0	3.2	**3**	
Balance Sheet				
Currency and Deposits (asset) Growth%	13.7	12.5	**1.0**	**1.0**
Securities other than Shares LT (asset) Growth%	8.3	(2.2)	**2.0**	**2.0**
Loans (asset) Growth%	17.6	56.3	**2.0**	**2.0**
Shares and Other Equity (asset) Growth%	(1.7)	20.0	**3.0**	**3.0**
Insurance Technical Reserves (asset) Growth%	3.0	(8.0)	**2.0**	**2.0**
Financial Derivatives (asset) Growth%	0.0	(337.6)	**(2.0)**	**(2.0)**
Other Accounts Receivable LT Growth%	0.5	0.0	**(3.0)**	**(3.0)**
Monetary Gold and SDR's Growth %	0.0	0.0	**5.0**	**5.0**
Other Accounts Payable Growth%	2.4		**3.0**	**3.0**
Currency & Deposits (liability) Growth%	0.0	(4.4)	**0.5**	**0.5**
Securities Other than Shares (liability) Growth%	5.7	5.3	**3.7**	**3.7**
Loans (liability) Growth%	7.2	22.5	**22.5**	**20.2**
Insurance Technical Reserves (liability) Growth%	0.0	0.0		
Financial Derivatives (liability) Growth%	21.9	43.7	**(5.2)**	**(5.2)**
Addl debt. (1st Year) million EUR	0.0	0.0		

Base Case

ANNUAL REVENUE AND EXPENSE STATEMENT (MILLIONS EUR)

	Dec-08	Dec-09	Dec-10	PDec-11	PDec-12	PDec-13
Taxes	40,866	36,561	38,428	36,891	35,415	35,593
Social Contributions	20,503	21,090	21,166	21,242	21,319	21,395
Grant Revenue	0	0	0	0	0	0
Other Revenue	9,328	9,315	12,222	11,782	11,358	10,949
Other Operating Income	0	0	0	0	0	0
Total Revenue	70,697	66,967	71,817	69,916	68,092	67,937
Compensation of Employees	20,677	21,295	21,093	20,893	20,695	20,498
Use of Goods & Services	7,637	8,322	8,667	9,025	9,399	9,788
Social Benefits	33,205	36,975	37,884	38,816	39,770	40,748
Subsidies	1,168	1,342	1,193	1,193	1,194	1,194
Other Expenses	6,818	7,410	9,414	9,414	11,960	11,706
Grant Expense	0	0	0	0	0	0
Depreciation	3,573	3,528	3,669	3,669	3,669	3,669
Total Expenses excluding interest	71,910	77,531	80,728	83,011	86,687	87,603
Operating Surplus/Shortfall	-1,213	-10,564	-8,911	-13,095	-18,595	-19,666
Interest Expense	5,311	4,904	5,236	5,236	5,831	6,123
Net Operating Balance	-6,524	-15,468	-14,147	-18,331	-24,426	-25,788

ANNUAL BALANCE SHEETS (MILLIONS EUR)

ASSETS	Dec-08	Dec-09	Dec-10	PDec-11	PDec-12	PDec-13
Currency and Deposits (asset)	7,298	6,794	7,647	7,723	7,800	7,878
Securities other than Shares LT (asset)	1,545	1,879	1,837	1,874	1,912	1,950
Loans (asset)	2,978	2,751	4,300	4,386	4,474	4,563
Shares and Other Equity (asset)	25,828	28,650	34,373	35,404	36,467	37,561
Insurance Technical Reserves (asset)	20	20	19	19	19	20
Financial Derivatives (asset)	(69)	(47)	112	110	107	105
Other Accounts Receivable LT				0	0	0
Monetary Gold and SDR's						
Additional Assets	8,110	8,539	10,347	0	0	0
Total Financial Assets	45,709	48,587	58,634	49,516	50,779	52,077

LIABILITIES	Dec-08	Dec-09	Dec-10	PDec-11	PDec-12	PDec-13
Other Accounts Payable						
Currency & Deposits (liability)	19,480	18,948	18,112	18,112	18,112	18,112
Securities Other than Shares (liability)	98,051	114,312	120,383	124,858	129,500	134,314
Loans (liability)	15,683	17,449	21,372	34,512	55,561	77,834
Insurance Technical Reserves (liability)						
Financial Derivatives (liability)	2	18	26	25	23	22
Other Liabilities	5,550	6,516	8,401	(0)	(0)	(0)
Liabilities	138,765	157,244	168,294	177,507	203,196	230,282
Net Financial Worth	(93,056)	(108,657)	(109,660)	(127,991)	(152,417)	(178,205)
Total Liabilities & Equity	45,709	48,587	58,634	49,516	50,779	52,077

Sovereign Rating Methodology

Egan-Jones takes the perspective of the investor as its primary point of view when developing the ratings it issues for sovereigns. Therefore, in the case of sovereign ratings, we attempt to take a more holistic view of credit quality to include not only analytic comparisons of various sovereign issuers but also the impact on our quantitative and qualitative analyses by current global, sovereign, governmental and market events, including the effects of government investments in speculative, volatile or other high risk investment products. For example, many sovereign issuers have taken on significant exposures of major financial institutions over the past several years. Hence, we calculate the under-funding of financial institutions and include this amount in the total indebtedness of sovereigns. (We use a base assumption that no country can afford to allow its major banks to fail and therefore we believe that there will almost always be an intervention by either a host or allied nation should financial institutions or markets require support at some measurable level.)

Generally we devise modeling calculators and do an analysis that examines the debt load of a country with respect to its GDP and other economic indicators. The analysis is then adjusted to reflect the outlook on a myriad of factors that reflect the firm’s overall view of the sovereign debt and the quality of the country’s ability to meet and thrive under such load. Some of the qualitative factors that impact our ultimate assessment of credit quality such as the flexibility, stability and overall strength of the economy, ease of tax collection, acceptance of contract law, ease of doing business, and prospects for future growth and health. The non quant issues are generally subjective and a moving target, so each rating of a sovereign may differ because of the non-quantitative nuances being addressed. Note, debt levels for many sovereign issuers have increased over the past decade and has accelerated recently, effecting the implied ratings.

Nota Bene

History has proven that defaults on domestic public debt do occur. In fact, seventy out of three hundred twenty defaults since 1800 have been on domestic public debt (1). Egan-Jones does not view a country's ability to print its own currency as a guarantee against default. Additionally, Egan-Jones generally views cases of excessive currency devaluation as a de facto default.

1. "This Time Is Different: Eight Centuries of Financial Folly", Reinhart & Rogoff, p.111, 126