PORTUGAL REPUBLIC

Rating Analysis - 3/5/12
Debt: EUR161.3B, Cash: EUR7.6B

EJR Sen Rating(Curr/Prj) B-/ CCC+
EJR CP Rating: C
EJR's 1 yr. Default Probability: 14.0%

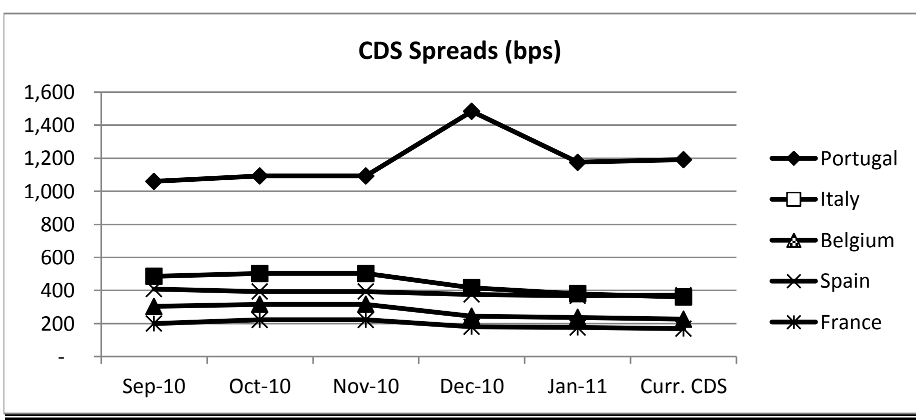
Slipping - Portugal's basic problem is that debt is growing and GDP is not. Over the past two years debt has grown 31% from EUR123B to EUR161B while the GDP has remained at EUR172B. With an annual federal government deficit near EUR15B, debt to GDP has risen from 72% to 93% over the past two years. The upshot is likely to be the ESFS stepping in to fund a large portion of Portugal's needs.

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. The overriding question is how the country will be able to reach stability. Portugal can manage funding costs near 3% in good times; currently Portugal's 2 year yields are near 15%. The ECB has provided massive support which has both reduced yield and provided liquidity. Even with LTRO and ECB support, Portugal is increasingly vulnerable. 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 to "B-". Watch the ECB's liquidity efforts.

	Annual Ratios					
INDICATIVE CREDIT RATIOS	2008	2009	2010	P2011	P2012	P2013
Debt/ GDP (%)	71.6	83.1	93.4	111.5	135.5	160.4
Govt. Sur/Def to GDP (%)	-3.6	-10.1	-9.8	-13.6	-18.7	-19.3
Adjusted Debt/GDP (%)	80.0	91.7	101.9	120.3	144.7	170.1
Interest Expense/ Taxes (%)	13.0	13.1	13.0	30.6	36.3	37.9
GDP Growth (%)	-1.5	1.0	-2.7	-4.5	-4.5	-4.1
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 (%)	35.0	45.0	55.0	75.0	115.0	145.0
Govt. Sur/Def to GDP (%)	4.0	1.0	-2.0	-5.0	-8.0	-10.0
Adjusted Debt/GDP (%)	40.0	50.0	60.0	80.0	120.0	150.0
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*
Government Of Canada	AAA	34.1	-5.0	34.1	14.1	1.8	A
French Republic	AA+	82.0	-7.1	100.6	9.5	1.4	BB-
Kingdom Of Belgium	AA	95.8	-4.1	115.2	11.9	0.9	BB-
Kingdom Of Spain	A	60.2	-9.3	68.0	9.5	0.3	BB
Republic Of Italy	BBB+	118.6	-4.6	126.1	15.4	-0.5	B



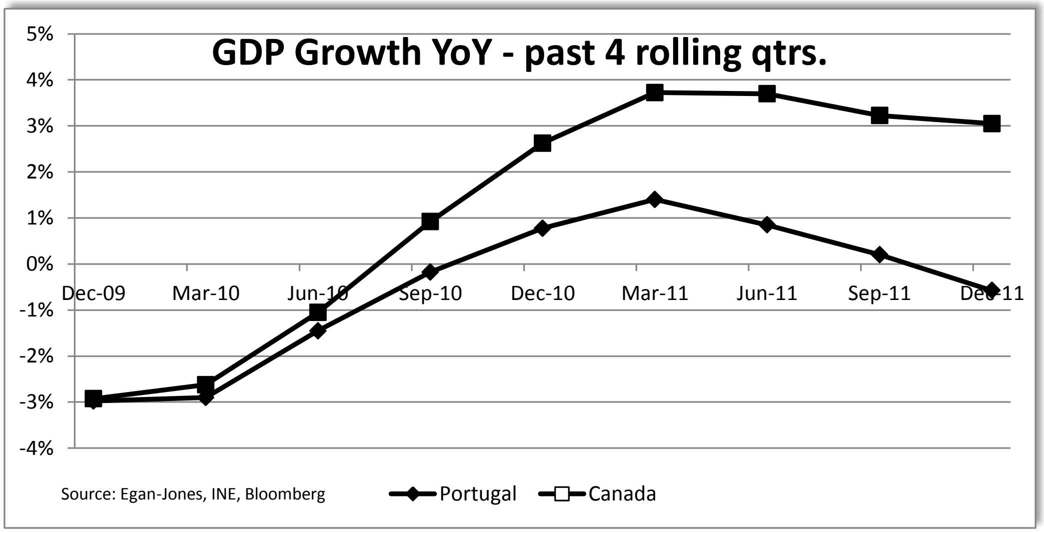
Country (EJR Rtg*)	Current CDS	Targeted CDS
Portugal (CCC+)	1,192	1,500
Italy (BB)	361	800
Belgium (BBB-)	227	400
Spain (BBB-)	371	400
France (A-)	169	120

* Projected Rating
* EJR's targeted CDS based on 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.



Fiscal Policy

Portugal's deficit to GDP of 9.8% is the worst among the countries listed. Over the last couple of full fiscal years (that is 2008 and 2010), total sovereign revenues rose 1.3% while total expenses rose 12.5%; the country had to spend to support citizens as a result of the economic slowdown. As can be seen from the chart below the deficit to GDP for countries such as Spain at 9.3% and the debt to GDP of 114% for Spain are of great concern since it will be difficult for Portugal to prosper while its neighbors suffer.

	Deficit/ Surplus to GDP	Debt-to-GDP	5 Yr. CDS Spreads
Portugal	-9.8	93%	1,175
Canada	-5.0	32%	N/A
France	-7.1	82%	176
Belgium	-4.1	96%	238
Spain	-9.3	60%	368
Italy	-4.6	119%	381

Source: Bloomberg

Unemployment

Portugal's unemployment rate has long been among the highest in the Euro zone. As can be seen from the chart at right, Portugal's 14% unemployment is higher than the other peer countries. For the more recent periods, Portugal's unemployment rate has been near 12%. With the high unemployment rates, Portugal is under pressure to employ fiscal stimulus measures, which will only further add to the nation's debt problems.

Unemployment (%)

	2009	2010
Portugal	11.1	14.0
Canada	7.6	7.5
France	9.7	9.8
Belgium	7.6	7.2
Spain	20.3	22.9
Italy	8.3	8.1

Source: Intl. Finance Statistics

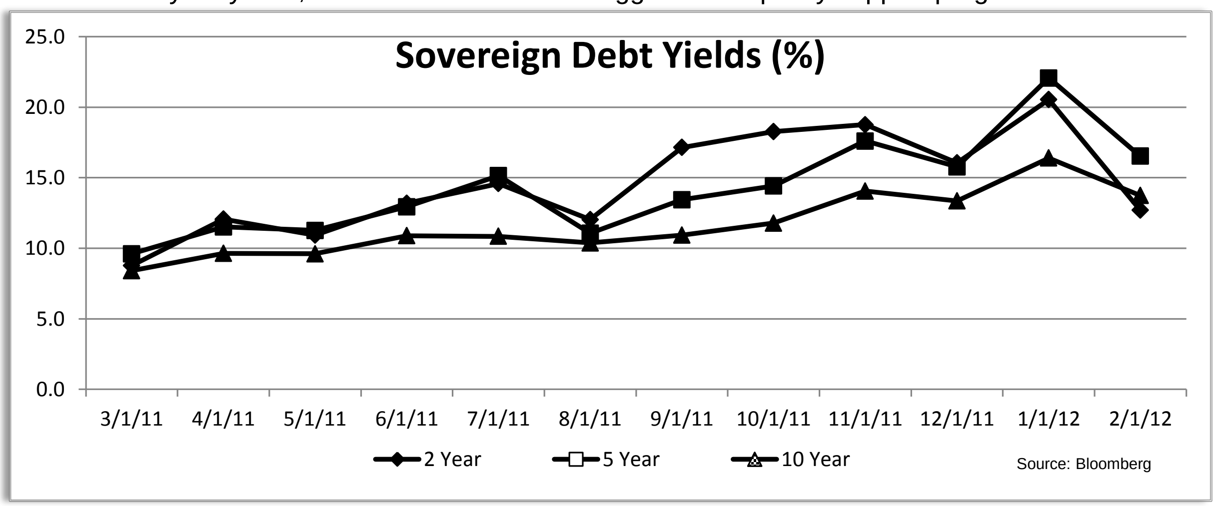
Banking Sector

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

Bank Total Assets (millions of EUR's)	
	Assets
Banco Commercial Portuguese SA	100,010
Banco Espirito Santo SA	83,655
Banco BPI SA	45,660
BANIF SGPS SA	15,711
Finibanco Holding SGPS SA	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 10% 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.



Ease of Doing Business

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.

The chart on the right indicates that with an overall rank of 30 (1 is best) Portugal is above average but not outstanding.

The World Bank's Doing Business Survey	2012 Rank	2011 Rank	Change in Rank
***Overall Country Rank:**	**30**	**30**	**0**
Individual Ranks:			
Starting a Business	26	59	33
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

* Based on a scale of 1 to 183 with 1 being the highest ranking.

Economic Freedom

As can be seen below, Portugal is above average in its overall rank of 63 for Economic Freedom with 100 being best.

Heritage Foundation 2010 Index of Economic Freedom - Portugal

Overall Score: 63 of 100 (best)*

	Rank	2011 Rank	Change in Rank	World Avg.
Property Rights	**70.0**	70.0	0.0	64.3
Freedom from Corruption	**60.0**	62.0	2.0	74.8
Fiscal Freedom	**59.0**	56.9	-2.1	76.3
Government Spending	**25.5**	14.8	-10.7	63.9
Business Freedom	**83.0**	85.9	2.9	73.4
Labor Freedom	**32.5**	30.3	-2.2	50.2
Monetary Freedom	**82.6**	82.9	0.3	48.5
Trade Freedom	**87.1**	86.6	-0.5	43.5
Investment Freedom	**70.0**	70.0	0.0	40.5
Financial Freedom	**60.0**	60.0	0.0	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	4.9	**(4.0)**	**0.5**
Social Contributions Growth %	1.4	0.6	**0.4**	**0.4**
Grant Revenue Growth %	0.0	0.0		
Other Revenue Growth %	1.8	33.1	**(3.6)**	**(3.6)**
Other Operating Income Growth%	0.0	0.0		
Total Revenue Growth%	3.1	7.4	**(5)**	**(4.1)**
Compensation of Employees Growth%	2.0	(1.4)	**(0.9)**	**(0.9)**
Use of Goods & Services Growth%	1.8	4.0	**4.0**	**4.0**
Social Benefits Growth%	3.2	2.4	**2.4**	**2.4**
Subsidies Growth%	3.9	(6.1)		
Other Expenses Growth%	34.4	34.4	**3.0**	**3.0**
Interest Expense	0.0	3.1	**7**	
Balance Sheet				
Currency and Deposits (asset) Growth%	(20.6)	12.5	**1.0**	**1.0**
Securities other than Shares LT (asset) Growth%	7.0	(2.2)	**2.0**	**2.0**
Loans (asset) Growth%	7.5	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%	0.0	(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	21.2	**(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%	2.5	(4.4)	**0.5**	**0.5**
Securities Other than Shares (liability) Growth%	5.7	5.3	**3.7**	**3.7**
Loans (liability) Growth%	5.7	22.5	**22.5**	**20.2**
Insurance Technical Reserves (liability) Growth%	0.0	0.0		
Financial Derivatives (liability) Growth%	21.9	43.7	**3.0**	**3.0**
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	36,633	38,428	36,891	35,415	35,593
Social Contributions	20,503	21,031	21,166	21,251	21,336	21,421
Grant Revenue	0	0	0	0	0	0
Other Revenue	9,328	9,042	12,035	11,601	11,184	10,781
Other Operating Income	0	0	0	0	0	0
Total Revenue	70,697	66,707	71,629	69,743	67,935	67,795
Compensation of Employees	20,677	21,386	21,093	20,903	20,715	20,529
Use of Goods & Services	7,637	8,390	8,724	9,070	9,431	9,806
Social Benefits	33,184	37,008	37,884	38,782	39,701	40,642
Subsidies	1,168	1,271	1,193	1,193	1,194	1,194
Other Expenses	6,818	7,007	9,419	7,218	9,702	7,434
Grant Expense	0	0	0	0	0	0
Depreciation	3,573	3,585	3,777	3,777	3,777	3,777
Total Expenses excluding interest	71,890	77,375	80,898	80,944	84,520	83,382
Operating Surplus/Shortfall	-1,192	-10,668	-9,268	-11,201	-16,585	-15,587
Interest Expense	5,311	4,808	4,977	11,288	12,862	13,506
Net Operating Balance	-6,504	-15,476	-14,245	-22,489	-29,447	-29,092

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	8,110	8,539	10,347	10,036	9,735	9,443
Monetary Gold and SDR's						
Additional Assets	(0)	0	0	0	0	0
Total Financial Assets	45,709	48,587	58,634	59,552	60,514	61,520
LIABILITIES						
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	48,704	74,470	99,754
Insurance Technical Reserves (liability)						
Financial Derivatives (liability)	2	18	26	27	27	28
Other Liabilities	5,550	6,516	8,401	(0)	(0)	(0)
Liabilities	138,765	157,244	168,294	191,701	222,110	252,208
Net Financial Worth	(93,056)	(108,657)	(109,660)	(132,148)	(161,596)	(190,688)
Total Liabilities & Equity	45,709	48,587	58,634	59,552	60,514	61,520

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