KINGDOM OF SPAIN

Rating Analysis - 12/13/11
Debt: EUR641.8B, Cash: EUR95.1B

EJR Sen Rating(Curr/Prj) BBB/ BBB-
EJR CP Rating: A2
EJR's 1 yr. Default Probability: 2.3%

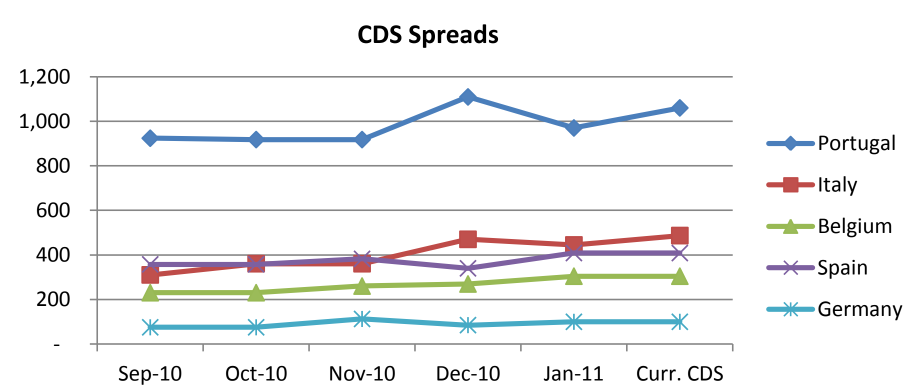
Miserable trend - over the past three fiscal years (i.e., from 2008 to 2010), Spain's GDP declined from EUR1.29 trillion to EUR1.05 trillion. Meanwhile, its debt mushroomed from EUR435 billion to EUR642 billion. The recently-reported quarters are of little comfort since the debt has risen to EUR 743B while GDP has been more or less flat. Increased social benefits are a major problem; while payments to the government have been more or less flat over the past four years (up EUR 8 billion), payments from the government have been up EUR 44 billion). As a result, Spain is short about EUR50B per year for social payments, EUR20B per year for interest, and an additional EUR 30B for asset growth; hence the EUR100B per annum increase in debt. Unemployment increased 5% QoQ to 21.3% while adjusted wage rates have declined.

In addition to its social payment/ unemployment problem, Spain is likely to be faced with payments to support a portion its banking sector and for its weaker provinces. Assets of Spain's largest two banks exceed its GDP. We are slipping our rating to "BBB"; watch for support for its banks.

	Annual Ratios					
INDICATIVE CREDIT RATIOS	2008	2009	2010	P2011	P2012	P2013
Debt/ GDP (%)	35.6	50.2	59.4	64.3	67.6	70.0
Govt. Sur/Def to GDP (%)	-4.5	-11.2	-9.3	-5.1	-4.7	-4.6
Adjusted Debt/GDP (%)	43.2	58.4	68.0	72.5	75.6	77.7
Interest Expense/ Taxes (%)	7.6	9.4	9.5	8.8	9.2	9.0
GDP Growth (%)	-1.4	-3.1	0.7	3.7	3.7	3.4
Foreign Reserves/Debt (%)	1.7	1.5	1.4	1.2	1.2	1.2
Implied Sen. Rating	BBB	BB	BB+	BB	BB+	BB+

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	81.2	-4.3	89.1	11.2	3.7	BB
Kingdom Of Belgium	AAu	95.0	-4.1	119.9	12.1	2.1	BB-
Kingdom Of Spain	AA-	59.4	-9.3	68.0	9.5	0.7	BB
Republic Of Italy	Au	117.1	-4.6	125.8	15.4	1.5	B+
Portugal Republic	BBB-	91.9	-9.8	101.5	13.6	1.0	B+



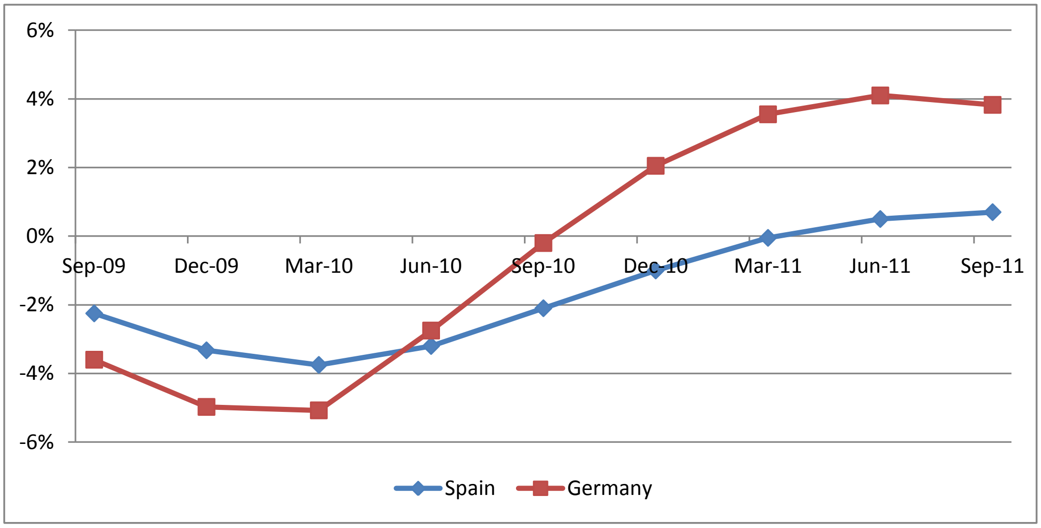
Country (EJR Rtg*)	Current CDS	Targeted CDS
Portugal(BB-)	1,060	1,000
Italy(BB)	487	800
Belgium(BBB-)	304	400
Spain(BBB-)	408	400
Germany(AA)	99	50

* Projected Rating

Economic Growth: "Slight Recovery"

Spain constitutes the world's 12th largest economy in terms of purchasing power parity, and Europe's fifth-largest with GDP of EUR1.05 trillion. After nearly 15 years of steady growth, the country was hobbled by the global financial crisis of 2007, eviscerating the nation's GDP and causing the economy to enter into a recession during the third quarter of 2008. As seen below, growth has since slowed to levels far below the 2% minimum enjoyed by the nation for a decade before the crisis.

GDP Growth Year over Year - Past Four Rolling Quarters



Source: Egan-Jones, INE, Bloomberg

As can be seen from the above chart, Spain's rolling four quarter GDP growth has been less than stellar over the past year; Spain is barely growing while Germany has recorded growth near 4%. A large portion of Spain's economy was geared to the tourist and vacation trade and related construction. We do not see the vacation industries improving over the next couple of years until excess building is absorbed.

Spain's Fiscal Policy

Spain's government deficit is currently in the double-digits, nearing four times the EMU limit of 3% of GDP. As a result, financial markets and the EU have put intense pressure on the sovereign to lower its deficit. The government has so far succeeded in lowering its deficit for 2010 to just under its 9.3% target. In 2011, the government aims to cut its deficit further to 6% of GDP before slashing further to the euro zone limit of 3% by 2013. Spanish debt remains below the EU's limit of 60% of GDP or less.

	Deficit-to-GDP (%)	Debt-to-GDP (%)	5 Yr CDS Spreads
Spain	(9.3)	59.4	408
Germany	(4.3)	81.2	99
Belgium	(4.1)	95.0	304
Spain	(9.3)	59.4	408
Italy	(4.6)	117.1	487
Portugal	(9.8)	91.9	1,060

Source: Bloomberg

Unemployment Remains Highest in EU

Spain has suffered from high unemployment for several decades. In the first quarter in 2011, the unemployment rate increased 1% to 21.3%. The high unemployment rate is driving the relatively high and increasing social benefit payments. The austerity measures throughout the EU make it difficult to substantially reduce unemployment over the next couple of years.

Unemployment Continued

Unemployment (%)	2009	2010	Change
Spain	18.8	20.3	1.5
Germany	8.1	7.4	(0.7)
Belgium	8.2	7.7	(0.5)
Spain	18.8	20.3	1.5
Italy	8.3	8.3	0.1
Portugal	10.1	11.1	1.0

Source: International Finance Statistics

As can be seen in the chart at left, Spain realized a 1.5% increased in its unemployment rate over the past two fiscal years which is substantially greater than its peers.

The underground economy distorts the unemployment rate.

Banking Sector Concerns

The two largest Spanish banks have combined assets of EUR1.7 trillion which equates to 105% of Spain's GDP. The banking sector is heavily exposed to the country's real estate sector which in many ways resembles the real estate bubble which hit the US in 2007 and 2008.

Doing Business

Spain has improved slightly over the past year in its ease of doing business according to the World Bank.

The World Bank Group - Doing Business Survey: Spain

Ease of Doing Business	2012 Rank	2011 Rank	Change in Rank
Overall Rank	**44**	**45**	**-1**
Starting a Business	133	148	15
Dealing with Construction Permits	38	39	1
Getting Electricity	69	70	1
Registering Property	56	45	-11
Getting Credit	48	45	-3
Protecting Investors	97	93	-4
Paying Taxes	48	76	28
Trading Across Borders	55	57	2
Enforcing Contracts	54	53	-1
Resolving Insolvency	20	21	1

* Measures 183 countries, based on a scale of 1 to 183 with 1 being the highest ranking.
Source: Doing Business - The World Bank Group

Austerity Measures

To date, Spain has been the slowest among its peers in emerging from the global recession. As the economy continues to recover, Spain has followed in the footsteps of many of its fellow EU nations in announcing an austerity program designed to restore confidence in the economy. The country's approved 2011 budget has proven tougher than expected as it promises a 7.9% overall decline in spending and forecasts a 5.4% increase in revenue. The budget also includes a number of measures to increase taxes for Spain's highest earners, including an increase in the central government's income tax rate from 21.5% to 22.5% for those earning more than €120,000 (approx. $163,596) per year, and from 21.5% to 23.5% for those earning more than €175,000 (approx. $238,593) per year. The government hopes to raise €170-200m per year from these tax rate increases. Further measures include the long anticipated elimination

Assumptions for Projections

	Peer Median	Issuer Average	Base Case Yr 1&2	Base Case Yr 3,4,5
Income Statement				
Taxes Growth%	5.2	7.5	**7.5**	**7.5**
Social Contributions Growth %	0.5	0.0	**0.0**	**0.0**
Grant Revenue Growth %	0.0	0.0		
Other Revenue Growth %	0.0	(3.4)	**(3.4)**	**(3.4)**
Other Operating Income Growth%	0.0	0.0		
Total Revenue Growth%	3.7	3.7	**4**	**3.4**
Compensation of Employees Growth%	0.5	(0.7)	**(0.7)**	**(0.7)**
Use of Goods & Services Growth%	3.7	(4.2)	**(4.2)**	**(4.2)**
Social Benefits Growth%	2.1	4.1	**4.1**	**4.1**
Subsidies Growth%	2.6	2.6		
Other Expenses Growth%	(8.3)	(8.3)	**(8.3)**	**(8.3)**
Interest Expense	0.0	3.1	**3**	
Balance Sheet				
Currency and Deposits Growth%	13.8	(20.6)	**(10.0)**	**(10.0)**
Securities other than Shares LT Growth%	8.3	12.0	**7.5**	**7.5**
Loans Growth%	41.5	17.6	**17.6**	**15.8**
Shares and Other Equity Growth%	2.1	2.1	**2.1**	**2.1**
Insurance Technical Reserves Growth%	0.0	0.0		
Financial Derivatives Growth%	0.0	0.0		
Other Accounts Receivable LT Growth%	0.8	(10.5)	**(10.5)**	**(10.5)**
Monetary Gold and SDR's Growth %	0.0	0.0	**5.0**	**5.0**
Other Accounts Payable Growth%	3.3	(10.5)	**(10.5)**	**(10.5)**
Currency & Deposits Growth%	0.0	3.3	**3.3**	**3.3**
Securities Other than Shares Growth%	5.3	5.7	**4.0**	**4.0**
Growth%	0.0	0.0		
Loans Growth%	18.6	18.4	**18.4**	**16.6**
Insurance Technical Reserves Growth%	0.0	0.0		
Financial Derivatives Growth%	0.0	0.0		
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	227,937	197,751	212,501	228,439	245,571	263,989
Social Contributions	143,104	140,144	140,170	140,196	140,222	140,248
Grant Revenue	0	0	0	0	0	0
Other Revenue	31,037	29,766	28,756	27,781	26,839	25,930
Other Operating Income	0	0	0	0	0	0
Total Revenue	402,078	367,661	381,427	396,416	412,633	430,167
Compensation of Employees	118,514	125,710	124,781	123,859	122,944	122,035
Use of Goods & Services	60,185	61,834	59,249	56,772	54,399	52,125
Social Benefits	165,181	185,314	192,833	200,657	208,799	217,270
Subsidies	11,896	11,838	12,147	12,148	12,149	12,151
Other Expenses	44,486	45,236	41,471	41,471	38,019	38,019
Grant Expense	0	0	0	0	0	0
Depreciation	18,651	18,864	19,735	19,735	19,735	19,735
Total Expenses excluding interest	407,017	436,958	438,069	454,642	456,045	461,335
Operating Surplus/Shortfall	-4,939	-69,297	-56,642	-58,226	-43,412	-31,168
Interest Expense	17,399	18,520	20,120	20,120	22,576	23,705
Net Operating Balance	-22,338	-87,817	-76,762	-78,346	-65,988	-54,873

ANNUAL BALANCE SHEETS (MILLIONS EUR)

ASSETS	Dec-08	Dec-09	Dec-10	PDec-11	PDec-12	PDec-13
Currency and Deposits	101,935	119,749	95,114	85,603	77,042	69,338
Securities other than Shares LT	34,412	28,048	31,408	33,764	36,296	39,018
Loans	23,440	30,801	36,217	42,585	50,073	57,998
Shares and Other Equity	87,782	91,253	93,181	95,150	97,160	99,213
Insurance Technical Reserves				0	0	0
Financial Derivatives						
Other Accounts Receivable LT	24,906	28,733	25,716	23,016	20,599	18,436
Monetary Gold and SDR's						
Additional Assets	0	0	0	0	0	0
Total Financial Assets	272,475	298,584	281,636	280,117	281,171	284,003
LIABILITIES						
Other Accounts Payable	24,906	28,733	25,716	23,016	20,599	18,436
Currency & Deposits	3,420	3,468	3,584	3,584	3,584	3,584
Securities Other than Shares	378,259	498,068	526,366	547,300	569,067	591,699
Loans	76,871	88,582	104,883	208,226	256,201	293,691
Insurance Technical Reserves						
Financial Derivatives						
Other Liabilities	35,346	39,856	44,432	(317)	(317)	(317)
Liabilities	518,802	658,707	704,981	781,809	848,850	906,556
Net Financial Worth	(246,327)	(360,123)	(423,345)	(501,691)	(567,679)	(622,553)
Total Liabilities & Equity	272,475	298,584	281,636	280,117	281,171	284,003

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