KINGDOM OF SPAIN

Rating Analysis - 9/27/12
Debt: EUR735.0B

EJR Sen Rating(Curr/Prj) CC/ C
EJR CP Rating: D
EJR's 1 yr. Default Probability: 35.0%

Hoover-esque. Spain's has unemployment near 25% and yet the govt is proposing tax increases and a raiding of social security funds in an effort to rein-in its budget deficit. (The deficit was 4.77% for the first 8 months.) The rub is whether Spain will be able to cut enough to obtain EU support (probably) and whether there will be an eventual haircut for current debtholders (probably). Catalonia, Valencia and other regions will probably need $20B of aid, the sen. debtholders of the weak banks will be forced to take losses, and there might be some sharing of losses among all banks. An estimated decline in GDP of 1.7% (per the Economy Ministry), the IIF's recent estimate of addl bank loan losses up to EUR260B, and depositor flight hurt. From 2008 to 2011, Spain's debt jumped from EUR436B to EUR735B while its GDP declined from EUR1.09T to EUR1.07T.

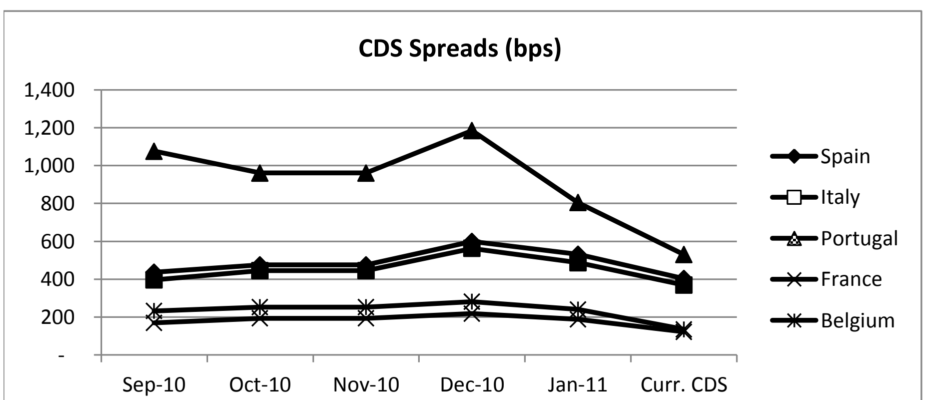
Social benefits are a prob; while pmts to the govt have been more or less flat over the past four years (up EUR 3B), payments from the govt. have been up EUR 45B. As a result, Spain is short about EUR50B per year for social payments, EUR20B per year for interest, and an addl EUR 20B for asset growth; hence the EUR90B per annum increase in debt. Spain will inevitably be faced with addl pmts to support a portion its banking sector and for its weaker provinces. Assets of Spain's largest two banks exceed its GDP. We are downgrading our rating to "CC".

Annual Ratios (source for past results: IMF)

INDICATIVE CREDIT RATIOS	2009	2010	2011	P2012	P2013	P2014
Debt/ GDP (%)	53.9	61.2	68.5	84.2	103.1	123.7
Govt. Sur/Def to GDP (%)	-11.2	-9.3	-8.5	-11.1	-13.6	-15.6
Adjusted Debt/GDP (%)	53.9	73.7	80.8	96.9	116.1	137.0
Interest Expense/ Taxes (%)	9.4	9.5	12.3	12.6	15.6	16.3
GDP Growth (%)	-3.1	0.7	0.3	-2.8	-2.8	-2.0
Foreign Reserves/Debt (%)	1.5	1.4	1.4	1.1	0.9	0.8
Implied Sen. Rating	B-	B-	CCC+	CCC	CCC-	CCC-

INDICATIVE CREDIT RATIOS	AA	A	BBB	BB	B	CCC
Debt/ GDP (%)	45.0	55.0	75.0	85.0	95.0	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 (%)	4.0	3.0	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	AAA	75.2	-1.0	85.1	11.4	2.0	BBB-
French Republic	AA+	79.6	-5.2	101.8	9.5	1.2	BB-
Kingdom Of Belgium	AA	90.9	-3.7	90.9	11.9	1.2	BB+
Republic Of Italy	BBB+	111.1	-3.9	121.4	16.7	-0.5	B+
Portugal Republic	BB	99.7	-4.2	109.7	13.0	-2.9	BB-

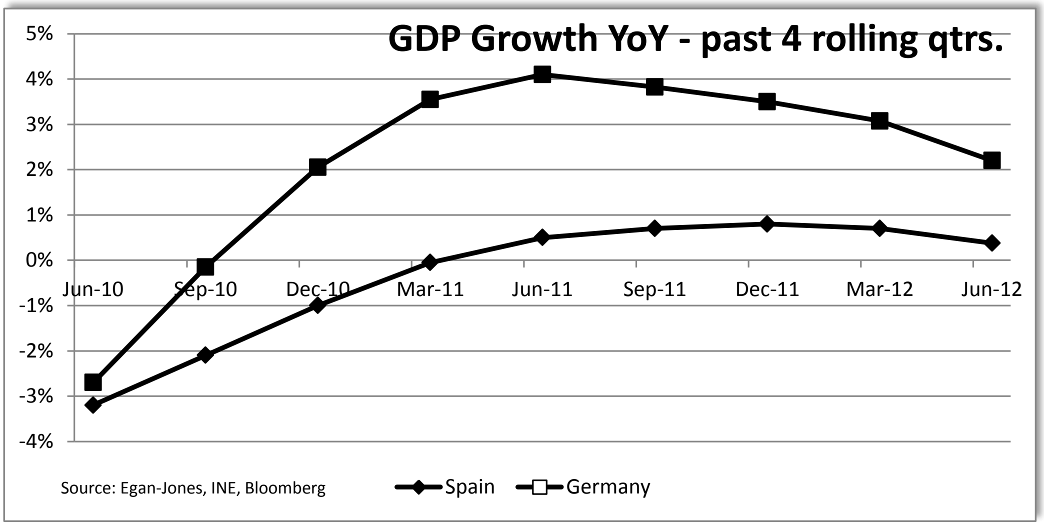


Country (EJR Rtg*)	Current CDS	Targeted CDS
Spain (C)	403	5,000
Italy (C+)	370	4,300
Portugal (CCC+)	531	1,500
France (BBB-)	122	400
Belgium (BBB-)	135	400

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

Economic 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 been tepid at less than 1% over the last couple of quarters. We expect GDP to drop by 2% or more in 2013.

As can be seen from the below chart, Spain's rolling four quarter GDP growth has been less than stellar over the past year; Spain is currently shrinking while Germany has recorded growth above 2%. 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.



Fiscal Policy
The Spain's deficit to GDP of 8.5% is not particularly comforting and is likely to grow in 2012. Over the last couple of full fiscal years (that is 2008 and 2010), total sovereign revenues declined 5.1% while total expenses rose 7.7%; the country had to spend to support citizens as a result of the 2008 slowdown. As can be seen from the chart to the right, none of the listed countries have a worse deficit than Spain. Spain has shown no willingness to implement substantive budget cuts and therefore debt is likely to grow with the result debt monetization.

	Deficit-to-GDP (%)	Debt-to-GDP (%)	5 Yr CDS Spreads
Spain	8.5	68.5	531
Germany	1.0	71.4	102
France	5.2	75.5	189
Belgium	3.7	86.3	240
Italy	3.9	105.5	488
Portugal	4.2	94.7	805

Sources: Bloomberg and IFS

Unemployment
Spain has suffered from high unemployment for several decades. As of July 2012, the unemployment rate increased to 24.6%. The high unemployment rate is driving the relatively high and increasing social benefit payments. The austerity measures and economic weakness in Spain and the EU make it difficult to substantially reduce unemployment over the next couple of years (new taxes will exacerbate unemployment).

Unemployment (%)	2010	2011
Spain	20.3	22.9
Germany	7.4	6.8
France	9.6	9.8
Belgium	7.6	7.1
Italy	8.3	9.1
Portugal	11.1	14.0

Source: Intl. Finance Statistics

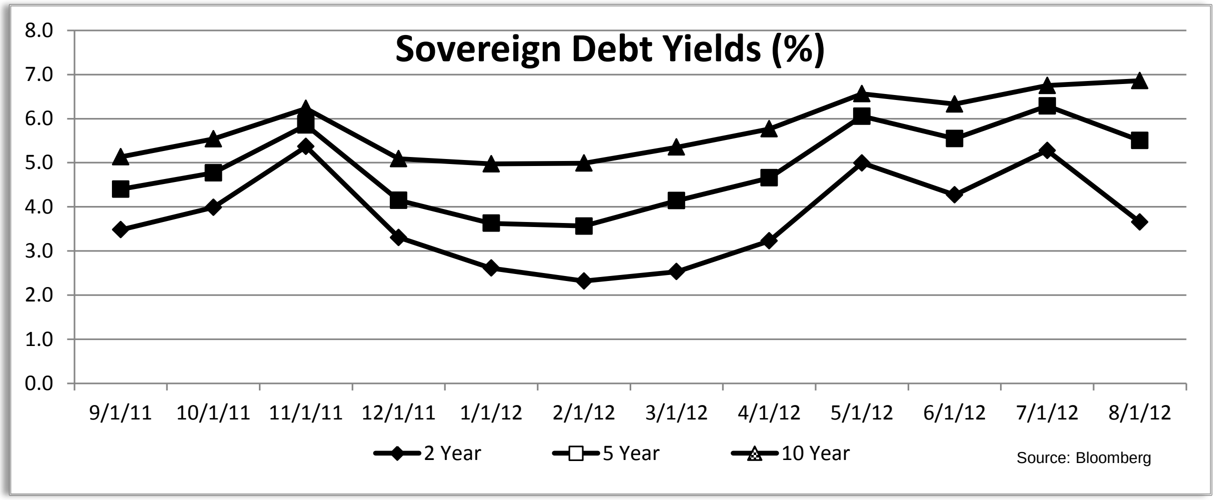
Banking Sector

The bank bailout proposal that includes a provision that senior debtholders sustain losses will be disasterous for the Spanish banking sector. Confidence in Spain's banks will continue to decline and will have a particularly negative impact on BBVA and Santander. The proposed plan might trigger the very default Spain and the EU is trying to avoid. The top five banks have assets equal to 204% of GDP compared to 125% for Germany. Spain will be expected to provide support to its banks which are suffering from declines in home values, austerity measures and increased unemployment.

Bank Total Assets (billions of dollar's)	Assets
BANCO SANTANDER	1,252
BBVA	598
BANESTO SA	109
BANCO POPULAR	131
BANCO SABADELL	100
Total	2,189
Spain's GDP	1,073

Funding Costs

As a result of the waning of the LTRO and weakening credit metrics, Spain has seen a rise in its funding costs over the past couple of months. As can be seen in the below graph, the bond yields have declined since Nov. 2011, and especially recently. The Spanish government has requested that the ECB purchase the government's debt.



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 chart on the right indicates that with an overall rank of 44 (1 is best) is above average.

The World Bank's Doing Business Survey*	2012 Rank	2011 Rank	Change in Rank
Overall Country Rank:	**44**	**45**	**1**
Scores:			
Starting a Business	133	148	15
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

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

Economic Freedom

As can be seen below, Spain is above average in its overall rank of 69 for Economic Freedom with 100 being best.

Heritage Foundation 2012 Index of Economic Freedom
World Rank 69*

	Rank**	2011 Rank	Change in Rank	World Avg.
Business Freedom	**81.3**	77.2	4.1	64.3
Trade Freedom	**87.1**	87.6	-0.5	74.8
Fiscal Freedom	**61.3**	61.0	0.3	76.3
Government Spending	**37.1**	49.3	-12.2	63.9
Monetary Freedom	**81.5**	82.4	-0.9	73.4
Investment Freedom	**80.0**	80.0	0.0	50.2
Financial Freedom	**80.0**	80.0	0.0	48.5
Property Rights	**70.0**	70.0	0.0	43.5
Freedom from Corruption	**61.0**	61.0	0.0	40.5
Labor Freedom	**51.8**	53.0	-1.2	61.5

*Based on a scale of 1-100 with 100 being the highest ranking.

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

Source: The Heritage Foundation & Wall Street Journal

Assumptions for Projections

	Peer Median	Issuer Average	Base Case Yr 1&2	Base Case Yr 3,4,5
Income Statement				
Taxes Growth%	4.9	(1.1)	**(3.0)**	**0.5**
Social Contributions Growth %	2.0	(0.2)	**0.5**	**0.5**
Grant Revenue Growth %	0.0	0.0		
Other Revenue Growth %	12.1	(5.7)	**(3.0)**	**(3.0)**
Other Operating Income Growth%	0.0	0.0		
Total Revenue Growth%	5.8	(1.1)	**(3)**	**(2.0)**
Compensation of Employees Growth%	2.0	(1.5)	**1.0**	**1.0**
Use of Goods & Services Growth%	4.0	(2.1)	**2.0**	**2.0**
Social Benefits Growth%	2.4	0.4	**5.0**	**5.0**
Subsidies Growth%	(3.8)	(6.8)		
Other Expenses Growth%	(4.8)	(4.8)	**3.0**	**3.0**
Interest Expense	0.0	3.5	**4**	
Balance Sheet				
Currency and Deposits (asset) Growth%	(3.5)	0.0	**0.9**	**0.9**
Securities other than Shares LT (asset) Growth%	(2.2)	(23.4)	**1.2**	**1.2**
Loans (asset) Growth%	14.4	30.1	**1.0**	**1.0**
Shares and Other Equity (asset) Growth%	(2.0)	7.2	**2.1**	**2.1**
Insurance Technical Reserves (asset) Growth%	3.6	0.0		
Financial Derivatives (asset) Growth%	0.0	0.0		
Other Accounts Receivable LT Growth%	1.8	46.7	**1.0**	**1.0**
Monetary Gold and SDR's Growth %	0.0	0.0	**5.0**	**5.0**
Other Assets Growth%	0.0	0.0		
Other Accounts Payable Growth%	0.2		**1.0**	**1.0**
Currency & Deposits (liability) Growth%	(1.8)	2.8	**2.8**	**2.8**
Securities Other than Shares (liability) Growth%	5.3	15.7	**3.9**	**3.9**
Loans (liability) Growth%	5.7	14.4	**2.0**	**2.0**
Insurance Technical Reserves (liability) Growth%	0.0	0.0		
Financial Derivatives (liability) Growth%	0.0	0.0		
Addl debt. (1st Year) billion EUR	0.0	0.0		

Base Case

ANNUAL REVENUE AND EXPENSE STATEMENT (BILLIONS EUR)

	Dec-09	Dec-10	Dec-11	PDec-12	PDec-13	PDec-14
Taxes	198	213	210	204	198	199
Social Contributions	140	140	140	141	141	142
Grant Revenue	0	0	0	0	0	0
Other Revenue	30	29	27	26	26	25
Other Operating Income	0	0	0	0	0	0
Total Revenue	368	381	377	371	364	365
Compensation of Employees	126	125	123	124	125	127
Use of Goods & Services	62	59	58	59	60	62
Social Benefits	185	193	194	203	213	224
Subsidies	12	12	11	11	11	11
Other Expenses	45	41	39	43	41	44
Grant Expense	0	0	0	0	0	0
Depreciation	19	20	20	20	20	20
Total Expenses excluding interest	437	438	434	461	471	488
Operating Surplus/Shortfall	-69	-57	-57	-90	-107	-123
Interest Expense	19	20	26	26	31	32
Net Operating Balance	-87	-77	-83	-116	-138	-155

Sources: Historical - IMF, Projections - EJR

Base Case

ANNUAL BALANCE SHEETS (BILLIONS EUR)

ASSETS	Dec-09	Dec-10	Dec-11	PDec-12	PDec-13	PDec-14
Currency and Deposits (asset)	120	95				
Securities other than Shares LT (asset)	28	31	24	24	25	25
Loans (asset)	31	36	47	48	48	49
Shares and Other Equity (asset)	92	94	101	103	105	107
Insurance Technical Reserves (asset)				0	0	0
Other Accounts Receivable LT	29	26	38	38	38	39
Monetary Gold and SDR's						
Additional Assets			78			
Total Financial Assets	299	282	287	290	293	297
LIABILITIES						
Other Accounts Payable						
Currency & Deposits (liability)	3	4	4	4	4	4
Securities Other than Shares (liability)	498	526	609	633	657	683
Loans (liability)	90	106	121	237	375	530
Insurance Technical Reserves (liability)						
Financial Derivatives (liability)						
Other Liabilities	67	69	74	53	53	53
Liabilities	659	705	808	927	1,068	1,227
Net Financial Worth	(360)	(423)	(521)	(637)	(775)	(930)
Total Liabilities & Equity	299	282	287	290	293	297

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