FEDERAL REPUBLIC OF GERMANY

Rating Analysis - 9/12/12
Debt: EUR2.1B

EJR Sen Rating(Curr/Prj) A+/ A-
EJR CP Rating: A1
EJR's 1 yr. Default Probability: 1.7%

High Court ruling upholds the German participation in the ESM with a EUR190B limit which can easily be increased by the German representative on the ESM Board; given the stance of the German government regarding the Euro we believe the German government would agree to additional funding for Southern Europe, regardless of whether the German population agrees. This ruling is likely to radically expend Germany's liability in the ESM. The ruling did not cover the ECB so any monetary actions the ECB may force on Germany will continue unabated. The end result will be higher liabilities for Germany, and a decline in overall credit quality. However, we believe the market will see this as a positive, although from an economic and fiscal standpoint significant damage will be done to Germany. With the ESM, we expect to see higher debt levels in the Eurozone as few of the EU governments have yet to follow through on plans to reduce spending.

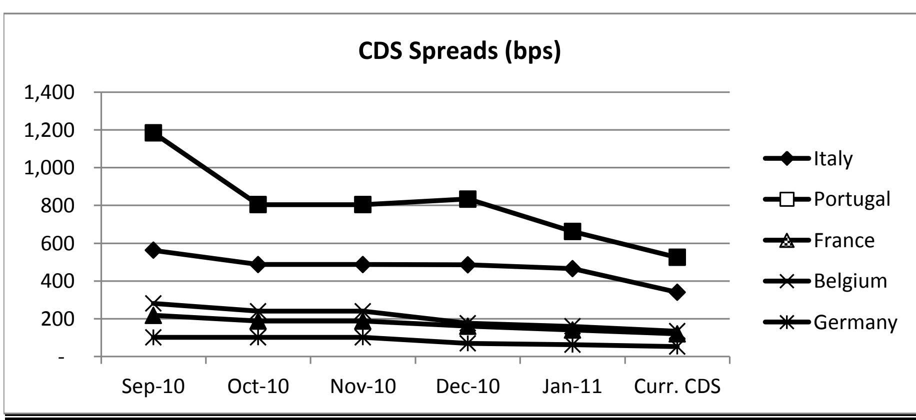
Germany's debt to GDP was 87% as of 2011. However, increasing Germany's debt by EUR700B to EUR2.9T for its indirect exposures raises the adjusted debt to GDP to 114%. The funding of the debt will be through monetization and the cost to Germany will be lower employment, and higher inflation. We expect to cut as Germany's adjusted debt to GDP grows.

Annual Ratios (source for past results: IMF)

INDICATIVE CREDIT RATIOS	2009	2010	2011	P2012	P2013	P2014
Debt/ GDP (%)	74.5	83.2	81.4	86.6	91.0	97.2
Govt. Sur/Def to GDP (%)	-3.2	-4.3	-1.0	-2.8	-1.9	-3.5
Adjusted Debt/GDP (%)	74.5	94.1	91.8	96.9	101.1	107.2
Interest Expense/ Taxes (%)	11.6	11.2	11.1	11.7	12.4	12.8
GDP Growth (%)	-2.3	4.2	1.9	1.5	1.5	1.4
Foreign Reserves/Debt (%)	1.6	1.2	1.3	1.2	1.2	1.1
Implied Sen. Rating	A-	A-	A-	BBB+	BBB+	BB

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*
Government Of Canada	AAA	31.4	-4.5	31.5	14.1	1.9	A+
French Republic	AA+	88.9	-5.2	113.5	9.5	1.2	BB-
Kingdom Of Belgium	AA	102.1	-3.7	102.1	11.9	0.9	BB
Republic Of Italy	BBB+	120.0	-3.9	130.8	16.7	-0.5	B+
Portugal Republic	BB	106.8	-4.2	117.0	13.0	-3.0	BB-



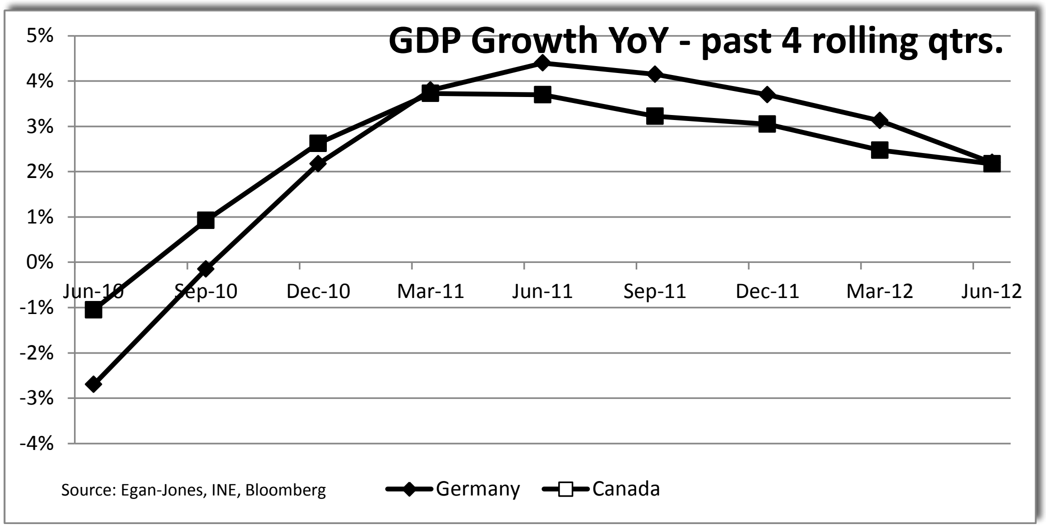
Country (EJR Rtg*)	Current CDS	Targeted CDS
Italy (C+)	340	4,300
Portugal (CCC+)	526	1,500
France (BBB-)	120	400
Belgium (BBB-)	134	400
Germany (A-)	53	120

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

Economic Growth

From an economic perspective, Germany is among the strongest EU countries with GDP growth of near 1.0% for the June 2012 quarter, which is stellar in moribund Europe. The softness in the euro will help the major exporters in Germany such as the auto manufacturers, chemical and pharmaceutical firms. However, any gains will be negated by sluggish to negative global economic growth, and higher import costs. The economies of other EU countries are likely to remain weak and Germany will be expected to contribute support.

As can be seen from the below chart, Germany's recent GDP growth has been above Canada's although as of the end of 2009 and beginning of 2010 growth was below Canada's. We expect the GDP growth for 2012 to be positive but slower than 2011. Perhaps the more relevant factor is the growth of the weaker EU countries.



Fiscal Policy

Germany's deficit to GDP of 1.0% is reasonably strong for a top tier country. From 2009 to 2011, total sovereign revenues rose 7% because of tax increases while total expenses rose 2.6%; in prior years the country had to spend to support citizens as a result of the 2008 slowdown. As can be seen from the chart at right, Germany's deficit to GDP was 1.0% (because of tax increases) and its debt to GDP was 81.4% using Eurostat data. Note, Germany will be providing indirect support to Spain and other weak countries.

	Deficit-to-GDP (%)	Debt-to-GDP (%)	5 Yr. CDS Spreads
Germany	1.0	81.4	63
Canada	4.5	31.4	N/A
France	5.2	88.9	140
Belgium	3.7	102.1	160
Italy	3.9	120.0	466
Portugal	4.2	106.8	662

Sources: Bloomberg and IFS

Unemployment

Germany's unemployment rate has long been among the lowest in the Euro zone. As can be seen from the chart at right, Germany is at the lowest rate of the peer countries and declined by 60 basis points from 2010 to 2011. For the more recent periods, Germany's unemployment rate has been near 6.7%. With the low unemployment rates relative to other EU countries, Germany is not under a great deal of pressure to employ fiscal stimulus measures.

Unemployment (%)	2010	2011
Germany	7.4	6.8
Canada	7.6	7.5
France	9.7	9.8
Belgium	7.6	7.1
Italy	8.3	9.2
Portugal	11.1	14.0

Source: Intl. Finance Statistics

Banking Sector

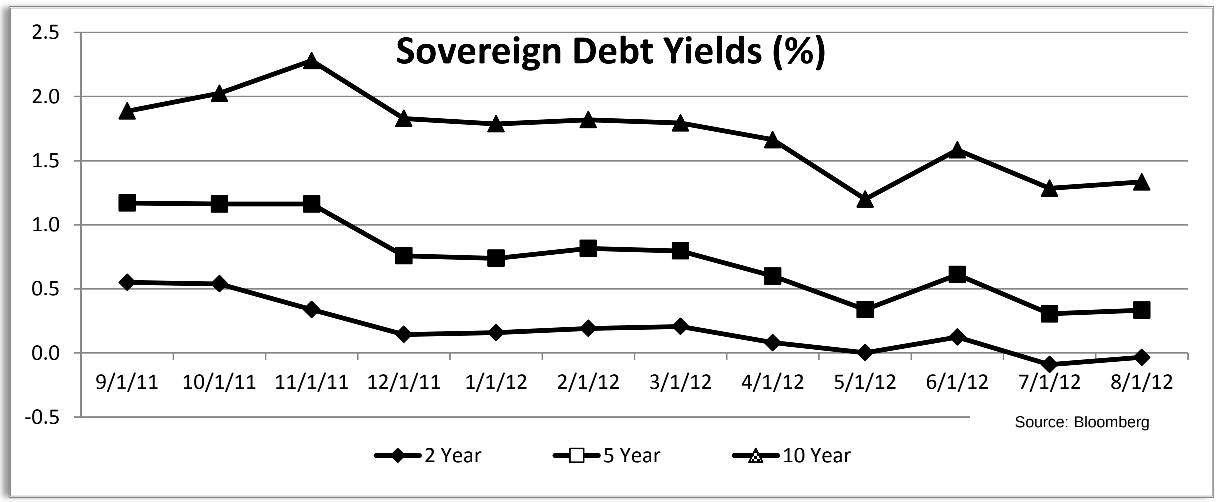
History has shown that country and bank obligations are linked during times of economic distress. Germany has significantly exposure to its banking sector because the bank's large aggregate size measured in assets The top 5 banks have assets equal to 124% of GDP versus 477% for the UK (which is at the high end). Our major fear is Germany will be expected to provide indirect financial support to weaker EU banks over the next couple of years to ameliorate asset quality problems and replace fleeing deposits.

Bank Assets (billions of local currency)

	Assets	Cap/ Assets %
DEUTSCHE BANK-RG	2,164	2.5
COMMERZBANK	662	3.7
DEUTSCHE POSTBANK	192	3.0
LANDESBANK BERLIN	131	1.8
IKB DEUT INDBANK	32	1.3
Total	3,181	
EJR's est. of cap shortfall at 10% of assets less market cap		269
Germany's GDP		2,567

Funding Costs

A Flight to Supposed Quality - with the problems of the periphery EU countries, capital has migrated to the supposed safe havens. As can be seen in the below graph, the bond yields have plunged particularly since Nov. 2011. A major issue is whether Germany belongs in the top-tier of credit quality given its exposure via the ECB.



Ease of Doing Business

Major factors for growing the economy are 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 19 (1 is best) is strong.

The World Bank's Doing Business Survey*

	2012 Rank	2011 Rank	Change in Rank
Overall Country Rank:	**19**	**19**	**0**
Scores:			
Starting a Business	98	89	-9
Construction Permits	15	16	1
Getting Electricity	2	2	0
Registering Property	77	70	-7
Getting Credit	24	21	-3
Protecting Investors	97	93	-4
Paying Taxes	89	85	-4
Trading Across Borders	12	13	1
Enforcing Contracts	8	7	-1
Resolving Insolvency	36	35	-1

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

Economic Freedom

As can be seen below, Germany is above average in its overall rank of 71 for Economic Freedom with 100 being best.

Heritage Foundation 2012 Index of Economic Freedom

World Rank 71*

	Rank**	2011 Rank	Change in Rank	World Avg.
Business Freedom	**90.5**	89.6	0.9	64.3
Trade Freedom	**87.1**	87.6	-0.5	74.8
Fiscal Freedom	**61.3**	58.5	2.8	76.3
Government Spending	**32.2**	42.7	-10.5	63.9
Monetary Freedom	**83.5**	83.9	-0.4	73.4
Investment Freedom	**85.0**	85.0	0.0	50.2
Financial Freedom	**60.0**	60.0	0.0	48.5
Property Rights	**90.0**	90.0	0.0	43.5
Freedom from Corruption	**79.0**	80.0	-1.0	40.5
Labor Freedom	**41.4**	40.6	0.8	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	Issuer	Base Case	
Income Statement	**Median**	**Average**	**Yr 1&2**	**Yr 3,4,5**
Taxes Growth%	4.2	7.1	**2.0**	**2.0**
Social Contributions Growth %	1.4	3.9	**2.0**	**2.0**
Grant Revenue Growth %	0.0	0.0		
Other Revenue Growth %	6.8	12.3	**1.6**	**1.6**
Other Operating Income Growth%	0.0	0.0		
Total Revenue Growth%	3.1	6.4	**2**	**1.4**
Compensation of Employees Growth%	2.0	2.7	**3.0**	**3.0**
Use of Goods & Services Growth%	4.0	5.9	**4.0**	**4.0**
Social Benefits Growth%	2.4	0.1	**2.5**	**2.5**
Subsidies Growth%	2.9	(3.7)		
Other Expenses Growth%	(28.7)	(28.7)	**1.0**	**1.0**
Interest Expense	0.0	3.2	**3**	
Balance Sheet				
Currency and Deposits (asset) Growth%	(20.7)	0.0		
Securities other than Shares LT (asset) Growth%	5.0	(7.2)	**1.5**	**1.5**
Loans (asset) Growth%	14.4	(3.1)	**2.0**	**2.0**
Shares and Other Equity (asset) Growth%	(1.7)	(1.7)	**2.0**	**2.0**
Insurance Technical Reserves (asset) Growth%	3.0	3.6	**3.6**	**3.6**
Financial Derivatives (asset) Growth%	0.0	0.5	**0.5**	**0.5**
Other Accounts Receivable LT Growth%	1.8	3.4	**2.0**	**2.0**
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%	2.4			
Currency & Deposits (liability) Growth%	(1.8)	6.0	**6.0**	**6.0**
Securities Other than Shares (liability) Growth%	5.3	8.1	**5.7**	**5.7**
Loans (liability) Growth%	5.7	(4.6)	**0.5**	**0.5**
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	551	553	593	604	616	629
Social Contributions	410	419	435	444	453	462
Grant Revenue	0	0	0	0	0	0
Other Revenue	105	108	121	123	125	127
Other Operating Income	0	0	0	0	0	0
Total Revenue	1,066	1,080	1,149	1,171	1,194	1,217
Compensation of Employees	190	195	200	206	212	218
Use of Goods & Services	115	120	127	132	137	143
Social Benefits	623	632	633	649	665	681
Subsidies	27	27	26	26	26	26
Other Expenses	84	115	82	116	83	117
Grant Expense	0	0	0	0	0	0
Depreciation	42	43	44	44	44	44
Total Expenses excluding interest	1,081	1,132	1,112	1,173	1,167	1,230
Operating Surplus/Shortfall	-15	-52	37	-2	27	-13
Interest Expense	64	62	66	71	77	81
Net Operating Balance	-79	-114	-29	-73	-50	-93

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)				2	2	2
Securities other than Shares LT (asset)	45	148	138	140	142	144
Loans (asset)	73	128	124	127	129	132
Shares and Other Equity (asset)	248	303	298	304	310	316
Insurance Technical Reserves (asset)	1	1	1	1	1	1
Other Accounts Receivable LT	99	97	100	102	104	107
Monetary Gold and SDR's						
Additional Assets	197	235	257			
Total Financial Assets	666	898	904	918	931	944
LIABILITIES						
Other Accounts Payable						
Currency & Deposits (liability)	10	10	11	11	11	11
Securities Other than Shares (liability)	1,363	1,480	1,601	1,692	1,788	1,890
Loans (liability)	460	652	623	695	745	838
Insurance Technical Reserves (liability)						
Financial Derivatives (liability)						
Other Liabilities	4	4	4	(73)	(73)	(73)
Liabilities	1,837	2,147	2,238	2,325	2,388	2,494
Net Financial Worth	(1,171)	(1,248)	(1,334)	(1,407)	(1,457)	(1,550)
Total Liabilities & Equity	666	898	904	918	931	944

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