PORTUGAL REPUBLIC

Rating Analysis - 3/23/11
Debt: EUR127.9B, Cash: EUR6.8B

EJR Sen Rating(Curr/Prj) BB/ BB-
EJR CP Rating: A3
EJR's 1 yr. Default Probability: 4.0%

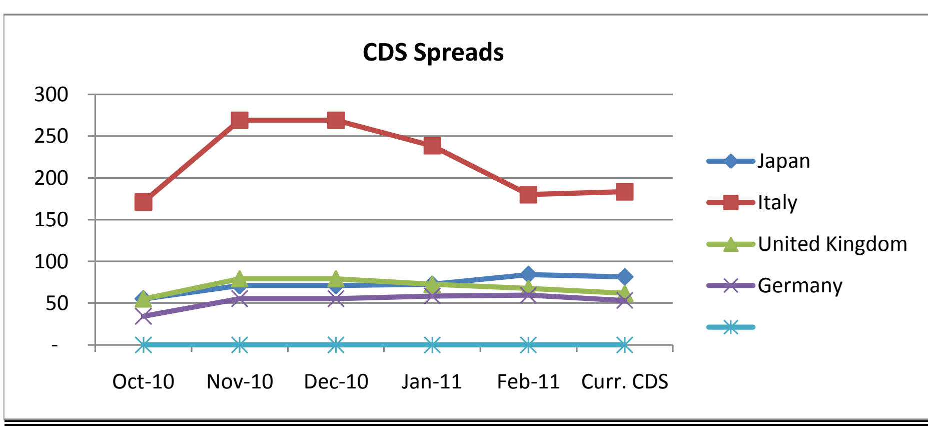
Festering - Parliament's rejection of austerity measures, the resignation of Prime Minister Socrates, the collapse of the government, and the need to fund EUR10+B shortly hurts. The upshot is likely to be the ESFS stepping in to fund a large portion of Portugal's needs. As can be seen below, Debt to GDP has grown regularly over the past three years. The government forecasts a budget deficit of 7.3% of GDP by year- end 2010, following a deficit of 9.3% in 2009. The current deficit of €12.94B dropped €100M YoY in the first 11 months of 2010.

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 has been near 6.0%, a level which is likely to prove unsustainable. The over-riding question is how the Company will be able to reach stability. It has been reported that China plans to buy €4-5B in Portuguese debt in the first quarter of 2011 in order to help the country refinance its debt.

	Annual Ratios					
INDICATIVE CREDIT RATIOS	Dec-08	Dec-09	Dec-10	Dec-11	Dec-12	Dec-13
Debt/ GDP (%)	62.9	77.4	83.2	89.3	93.5	97.9
Govt. Sur/Def to GDP (%)	-2.9	-9.3	-5.9	-5.6	-5.6	-5.6
Adjusted Debt/GDP (%)	69.4	84.4	90.5	97.0	101.4	105.9
Interest Expense/ Taxes (%)	12.4	13.1	14.3	15.7	16.4	17.1
GDP Growth (%)	-1.0	1.2	-4.5	-4.5	-2.0	-2.0
Foreign Reserves/Debt (%)	0.7	0.4	0.4	0.4	0.4	0.3
Implied Sen. Rating	BB	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*
United Kingdom	AAA	79.9	-11.4	100.9	7.0	-4.9	B+
Federal Republic Of Germany	AAA	74.5	-3.0	82.5	10.7		BB
Government Of Canada	AAA	33.7	-4.9	33.7	14.3	3.2	A-
Japan	AA-	265.1	-7.1	270.9	14.6	-1.5	CC
Italian Republic	A+	117.7	-5.3	123.6	15.9	1.5	BB-



Country (EJR Rtg*)	Current CDS	Targeted CDS
Japan(BB+)	81	333
Italy(BBB+)	183	158
United Kingdom(AA)	62	30
Germany(AA)	53	30

* Projected Rating

Economic Growth

Portugal is Europe's poorest nation. However, it has a 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 country's financial sector has been relatively unaffected by the financial crisis, eliminating the need for the government to put excessive capital into the banks. Furthermore, the sector has undergone considerable consolidation recently. The five largest banks in Portugal (only one of which is government regulated) account for 80% of the sector's total assets.

Portugal's GDP grew by 1.1% QoQ (1.8% YoY) in Q1 2010. By Q2 2010, growth slowed to 0.2% QoQ (1.4% YoY). The slowdown was due in large part to decreased demand, both internal and external. Growth picked up only slightly in Q3 2010, with GDP rising 0.4% as a result of strong exports during the period. Overall, the Bank of Portugal predicts growth of 0.9% this year and at least 0.2% in 2011. Government forecasts remain slightly higher, predicting 1.2% this year and stagnation in the next. A poor education system and under-skilled labor force continue to be significant factors in preventing greater productivity and growth.

Containing the Deficit

Portugal's towering budget deficit continues to climb, hindering the country's financial stability and overall investor confidence in the nation. The country's current rate of 9.3% is simply unsustainable. The government currently aims to reduce its budget deficit to 7.3% of GDP by the end of 2010 and 4.6% in 2011. Official data providers including the OECD and the IMF have forecast that the country's targets are reasonable. Specifically, the OECD forecasts the budget deficit will fall to 7.4% of GDP this year and 5.6% next year. In the past, Portugal has been successful in implementing deficit-reduction strategies. After reaching a then all-time high of 6% of GDP in 2005, the government successfully reduced the deficit to 2.6% in 2007, one year ahead of schedule.

Doing Business Survey - Business Environment

Portugal currently ranks 48th among nations worldwide in terms of overall ease of owning and operating a business, remaining unchanged from the year prior. As seen below, the country's regulatory environment allows for relative simplicity in starting, operating, and closing a business. Starting takes an average of 6 days while the world average is currently 35 days. However, obtaining a business license is a lengthier process in Portugal as compared to most other countries with the world average being 18 procedures and 218 days. Furthermore, Portugal has a high income tax rate and a moderate corporate tax rate, the top rates being 42% and 26.5%, respectively.

The World Bank Group - Doing Business Survey 2010: Portugal

Ease of*…	2010 Rank	2009 Rank	Change in Rank
Doing Business	**48**	**48**	**0**
Starting a Business	60	39	-21
Dealing with Construction Permits	112	129	17
Employing Workers	171	172	1
Registering Property	52	82	30
Getting Credit	87	84	-3
Protecting Investors	41	38	-3
Paying Taxes	80	72	-8
Trading Across Borders	19	19	0
Enforcing Contracts	25	32	7
Closing a Business	22	22	0

Source: The World Bank Group - Doing Business
*Based on a scale of 1 to 183 (countries measured) with 1 being the highest ranking.

Foreign Trade and Investment

Despite the country's small geographical size, Portugal conducts a significant amount of foreign trade. The country's main trading partners are EU member states, with Spain, Italy, Germany, France and the United Kingdom being its principal trading partners. Important non-EU trading partners include the United States, Brazil and Angola. Portugal's imports from these partners and others historically exceed exports. The country's trade deficit widened in the two months from June to August to €5.1 billion, up from €4.9 billion during the same period of the year prior. In the month of August, imports declined by 11.7% over the month prior (to €4.04 billion) while exports fell 27% (to €2.5 billion).

EU member states (particularly Spain, France, Germany, the UK and the Netherlands) also constitute Portugal's main sources of FDI. Foreign investors have long been attracted to Portugal's low labor costs. However, nations are now turning to central and eastern European states with higher skill levels, lower wage rates and locations conveniently closer to the northern European markets. As a result, Portugal has established the AICEP (Agência Para O Investimento e Commercio Externo Portuguesa) to attract investment involving technology transfer in sectors including information and communication technologies (ICT), biotechnology and renewable energy sources.

Unemployment

Portugal's unemployment rate has long been among the highest in the Eurozone. Since July 2009, the levels have been at their highest in nearly two decades averaging well above 10%. After reaching a relative high of 11% in May and June of 2010, the rate has slightly yet steadily declined. It's current rate of 10.7% is the fifth highest among the 24 OECD countries. Meanwhile, the euro area average remains 10.1%. 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%. Portugal has become an increasingly service-based economy since joining the European Community in 1986 and to date the services sector continues to be the country's largest source of employment.

Ten Economic Freedoms of Portugal

Portugal is currently the 28th freest nation in Europe and the 62nd freest in the world as measured by the Heritage Foundation's 2010 Index of Economic Freedom. The country's overall score of 64.4 is above the world average. Policy reforms and restructurings have increased overall economic activity. Still, high government spending, low fiscal freedom, and a rigid labor market continue to limit overall economic freedom.

Heritage Foundation 2010 Index of Economic Freedom - Portugal
World Rank: 64; Regional Rank: 28 of 43*

	2010 Rank	2009 Rank	Change in Rank	World Average
Business Freedom	**80.5**	81.1	-0.6	64.6
Trade Freedom	**87.5**	85.8	1.7	74.2
Fiscal Freedom	**61.0**	61.6	-0.6	75.4
Government Spending	**37.1**	35.4	1.7	65.0
Monetary Freedom	**79.7**	79.9	-0.2	70.6
Investment Freedom	**70.0**	70.0	0	49.0
Financial Freedom	**60.0**	60.0	0	48.5
Property Rights	**70.0**	70.0	0	43.8
Freedom from Corruption	**61.0**	65.0	-4.0	40.5
Labor Freedom	**37.0**	40.3	-3.3	62.1

*The ten economic freedoms are based on a scale of 0 (least free) to 100 (most free).
**Based on a scale of 1-183 with 1 being the highest ranking.
Source: The Heritage Foundation & Wall Street Journal

Government Bond Market

Borrowing costs have risen to levels not seen since the creation of the euro as investors remain fearful of the country's towering deficit. Spreads on Portugal's ten-year government bond yields vis-à-vis their German counterparts have increased as investors demand more for keeping their investments in the debt ridden country. In a recent bond auction, the government was forced to pay high yields of 4.69% and 6.24% on 4- and 10-year Portuguese bonds, respectively. Still, demand remains healthy for the debt instruments.

Crisis of Greek Proportions

Portugal has come under increased scrutiny from the financial markets as the weight of its public debt and budget deficits have prompted fear that it might follow in the footsteps of Greece. The country's deteriorating public finances no doubt pose long-term economic challenges. As the cost of borrowing continues to rise, lending to Portugal continues to become increasingly risky. The country has had to increase their reliance on ECB funding in recent months, as did Greece prior to its EU/IMF bailout in early 2010, due to growing investor reluctancy to lend to the country. However, economists argue that Portugal is better positioned than Greece to fix its finances and is therefore unlikely to slide into a similar debt crisis. Furthermore, the Portuguese govenrment is expected to borrow around €20 and €22 billion from the bond markets this year, less than *half* of Greece's borrowing needs. To date, Portugal has paid all of its current debt redemptions in full, including 4.4 billion euros ($5.46 billion) of a 10-year bond recently matured.

Austerity

The country is undergoing increased pressure from the eurozone countries and financial markets to restore investor confidence in its finances. To date, Portuguese banks have been forced to become increasingly reliant on the European Central Bank for financing as market concerns have closed off access to international funding for the country's banks. In response, Portugal has set forth new austerity measures aimed specifically at reducing the country's towering deficit. Support or abstention from Portugal's main opposition party, the Social Democratic Party (PSD), is required in order for the measures to pass. As a result, the government has declared the terms of the measures to be flexible in hopes of diverting opposition.

Among the proposed measures are an increase in the VAT from 21% to 23% and a 5% cut in public sector wages beginning in 2011. Overall, one third of the deficit reduction plan hinges on tax hikes while the remainder comes from spending and wage cuts. If passed, the budget aims to reduce the country's deficit from 9.3% to 7.3% this year and further to 4.6% in 2011. Though the measures remain the crutial tool to regaining creditor confidence in the country, they will slow down economic growth. Projections for economic growth in 2011 have decreased from a previous forecast of 0.5% to 0.2%. Portugal's main opposition party has set forward conditions for supporting the budget.

Assumptions for Projections

	Peer	Issuer	Base Case	
Income Statement	**Median**	**Average**	**Yr 1&2**	**Yr 3,4,5**
Taxes Growth%	(4.8)	(10.8)	**(4.0)**	**0.5**
Social Contributions Growth %	(0.4)	0.2	**0.2**	**0.2**
Grant Revenue Growth %	0.0	0.0		
Other Revenue Growth %	0.1	(5.4)	**(5.0)**	**(5.0)**
Other Operating Income Growth%	0.0	0.0		
Total Revenue Growth%	(3.9)	(7.0)	**(5)**	**(2.0)**
Compensation of Employees Growth%	3.5	1.0	**1.0**	**1.0**
Use of Goods & Services Growth%	5.4	5.4	**5.4**	**5.4**
Social Benefits Growth%	5.5	9.8	**6.0**	**4.0**
Subsidies Growth%	4.4	(1.1)		
Other Expenses Growth%	2.5	2.5	**2.0**	**1.2**
Special Items (millions EUR)	0.0	0.0		
Balance Sheet				
Currency and Deposits Growth%	0.4	(6.9)	**1.0**	**1.0**
Securities other than Shares LT Growth%	7.8	20.4	**2.0**	**2.0**
Loans Growth%	1.7	(7.5)	**2.0**	**2.0**
Shares and Other Equity Growth%	18.8	9.7	**3.0**	**3.0**
Insurance Technical Reserves Growth%	0.0	(6.6)	**2.0**	**2.0**
Financial Derivatives Growth%	0.0	(31.9)	**(2.0)**	**(2.0)**
Other Accounts Receivable LT Growth%	4.4	(1.8)	**(3.0)**	**(3.0)**
Monetary Gold and SDR's Growth %	0.0	0.0	**5.0**	**5.0**
Other Accounts Payable Growth%	6.4	17.7	**3.0**	**3.0**
Currency & Deposits Growth%	2.1	(2.7)	**0.5**	**0.5**
Securities Other than Shares Growth%	8.8	16.7	**3.0**	**3.0**
Growth%	0.0	0.0		
Loans Growth%	1.7	11.7	**3.0**	**3.0**
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-07	Dec-08	Dec-09	PDec-10	PDec-11	PDec-12
Taxes	40,621	40,991	36,564	35,101	33,697	33,866
Social Contributions	19,621	20,032	20,073	20,113	20,153	20,194
Grant Revenue	0	0	0	0	0	0
Other Revenue	8,850	8,871	8,392	7,972	7,573	7,195
Other Operating Income	0	0	0	0	0	0
Total Revenue	69,092	69,894	65,028	63,186	61,424	61,255
Compensation of Employees	20,271	20,282	20,476	20,672	20,869	21,069
Use of Goods & Services	7,048	7,454	7,854	8,276	8,721	9,190
Social Benefits	31,284	32,786	36,004	38,164	40,454	42,881
Subsidies	1,421	1,264	1,250	1,250	1,250	1,250
Other Expenses	5,002	5,816	5,963	5,933	6,082	6,004
Grant Expense	0	0	0	0	0	0
Depreciation	3,257	3,396	3,377	3,377	3,377	3,377
Total Expenses	68,282	70,999	74,924	77,672	80,754	83,771
Operating Surplus/Shortfall	810	-1,104	-9,896	-14,486	-19,330	-22,517
Interest Expense	4,811	5,100	4,794	5,034	5,286	5,550
Net Operating Balance	-4,001	-6,204	-14,691	-19,520	-24,616	-28,067

ANNUAL BALANCE SHEETS (MILLIONS EUR)

ASSETS	Dec-07	Dec-08	Dec-09	PDec-10	PDec-11	PDec-12
Currency and Deposits	7,853	7,298	6,794	6,862	6,931	7,000
Securities other than Shares LT	2,106	1,545	1,860	1,897	1,935	1,974
Loans	2,253	2,978	2,753	2,808	2,865	2,922
Shares and Other Equity	25,626	27,711	30,394	31,306	32,245	33,212
Insurance Technical Reserves	20	20	19	19	19	20
Financial Derivatives	(57)	(69)	(47)	(46)	(45)	(44)
Other Accounts Receivable LT	6,937	6,911	6,784	6,580	6,383	6,191
Monetary Gold and SDR's						
Additional Assets	(0)	0	(0)	0	0	0
Total Financial Assets	44,738	46,394	48,557	49,427	50,332	51,275
LIABILITIES						
Other Accounts Payable	5,436	5,130	6,039	6,220	6,406	6,599
Currency & Deposits	20,007	19,480	18,948	35,144	57,083	82,402
Securities Other than Shares	82,278	94,366	110,094	113,397	116,799	120,303
Loans	10,356	8,508	9,501	9,501	9,501	9,501
Insurance Technical Reserves						
Financial Derivatives						
Other Liabilities	(24)	1	18	727	727	727
Liabilities	118,052	127,485	144,599	164,989	190,510	219,520
Net Financial Worth	(73,314)	(81,092)	(96,042)	(115,562)	(140,178)	(168,245)
Total Liabilities & Equity	44,738	46,394	48,557	49,427	50,332	51,275

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.

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