KINGDOM OF SPAIN

Rating Analysis - 1/5/11
Debt: EUR560.6B, Cash: EUR119.7B

EJR Sen Rating(Curr/Prj) A-/ BBB+
EJR CP Rating: A1
EJR's 1 yr. Default Probability: 1.8%

In Q3 2010, Spain's GDP remained flat over Q2 2010 while rising 0.2% YoY. Both exports and imports declined during the quarter. Registered unemployment fell by 10,221, or 0.25%, to 4.1 million in December 2010, marking the first decline in five months. Rates fell in agriculture and services and rose in construction and industry. The HICP is expected to reach 2.9% in December 2010, up from 2.2% in November and well above the ECB's 2% limit.

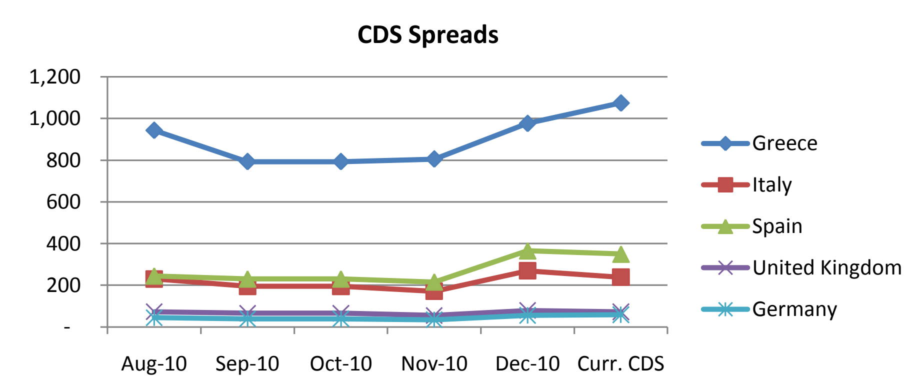
The European Banking Authority is planning a new round of stress tests in 2011. Spain's Prime Minister has warned that savings banks in need of capital will have limited use of the state's multi-billion euro FROB bank-rescue fund as merely a last resort, urging lenders to obtain necessary capital via the markets. Stress tests in July 2010 revealed that Spanish savings banks were undercapitalized by €1.8 billion. Final agreements on criteria of the 2011 tests and the date for results to be published have yet to be announced. The tests are expected to be broader and more transparent than those of 2010.

CDS spreads have risen in recent weeks and are currently trading nearly 280bps above comparable German CDS spreads. Yields on 10-yr debt rose to 5.446% in December 2010. China, which currently owns approx. 10% of Spanish sovereign debt, has pledged to continue to buy bonds issued by the government in 2011.

	Annual Ratios					
INDICATIVE CREDIT RATIOS	Dec-08	Dec-09	Dec-10	Dec-11	Dec-12	Dec-13
Debt/ GDP (%)	35.7	50.5	62.7	67.8	72.7	77.9
Govt. Sur/Def to GDP (%)	-4.2	-11.1	-7.8	-7.5	-7.4	-7.4
Adjusted Debt/GDP (%)	40.4	55.6	68.0	73.4	78.4	83.8
Interest Expense/ Taxes %	7.5	9.6	9.1	11.5	11.8	12.2
GDP Growth (%)	-3.0	0.2	-4.0	-4.0	-3.0	-3.0
Foreign Reserves/Debt (%)	1.9	1.6	1.3	1.2	1.1	1.1
Implied Sen. Rating	A-	BBB	BBB-	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	76.2	-11.4	95.0	6.9	-4.9	B+
Federal Republic Of Germany	AAA	69.5	-3.0	76.0	10.7	3.9	BB+
Kingdom Of Spain	AA	50.5	-11.1	55.6	9.6	0.2	BB+
Italian Republic	A+	109.7	-5.3	115.9	15.9	1.1	B+
Hellenic Republic (Greece)	BB+	118.7	-15.4	121.9	25.8	-4.6	CCC+



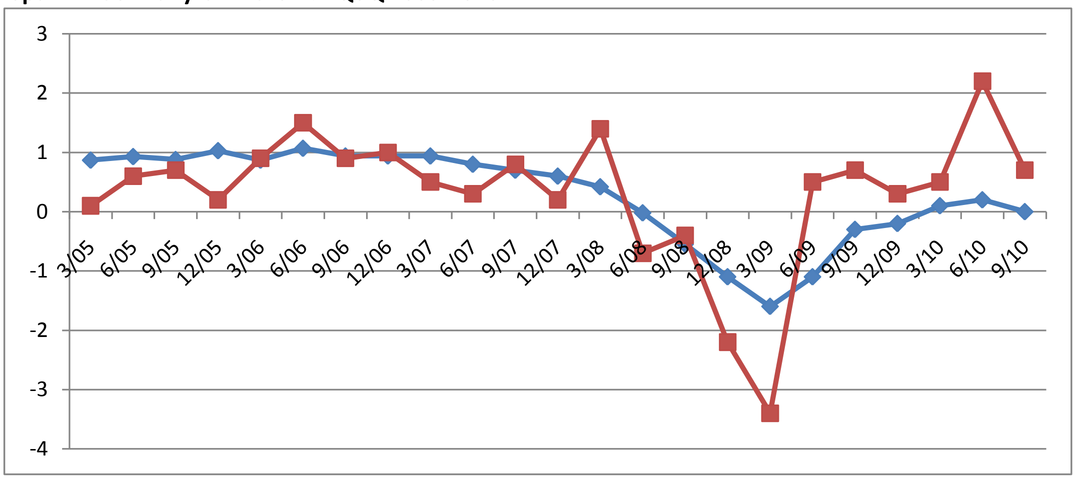
Country (EJR Rtg*)	Current CDS	Targeted CDS
Greece(B+)	1,074	600
Italy(BBB+)	238	158
Spain(A-)	350	117
United Kingdom(AA)	72	30
Germany(AA)	58	30

* Projected Rating

Economic Growth: "Slight Recovery"

Spain constitutes the world's 12th largest economy in terms of purhcasing power parity, and Europe's fifth-largest with GDP of US$1.39 trillion (2009). After nearly 15 years of steady growth, the country was hit considerably by the global financial crisis of 2007, exacerbating 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.

Spain v. Germany GDP Growth QoQ 2005-2010



Source: Bloomberg

After six consecutive quarters of economic contraction, GDP rose 0.1% in the first quarter of 2010. GDP continued to trend upward with a Q2 2010 quarterly growth rate of 0.2%, surpassing analyst's expectations. However, growth remained flat in the third quarter. In light of pending austerity measures and a rise in VAT levels, GDP is not expected to pick up by year-end 2010. Spain's financial markets have also been volatile as investor concern has spread from Greece to other countries with large budget deficits and poor economic growth prospects. The OECD has forecast Spain's GDP to fall 0.2% in 2010 before rising 0.9% in 2011 and 1.8% in 2012.

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 eurozone limit of 3% by 2013. Spanish debt remains below the EU's limit of 60% of GDP or less.

PIIGS	Deficit-to-GDP	Debt-to-GDP	5 Yr CDS Spreads
Portugal	9.4	76.9	498
Italy	5.3	115.2	238
Ireland	14.3	57.7	629
Greece	13.6	113.4	1018
Spain	**11.2**	**53.2**	350

Source: Bloomberg

Unemployment Remains Highest in EU

Spain has suffered from high unemployment for several decades. The rate fell slightly to 19.79% in Q3 2010 from 20.1% in Q2 2010. Still, the rate remains the highest rate in the EU at nearly double the blocks average and is Spain's highest since 1997.

In December 2010, the number of people registering for jobless benefits fell by 10,221, or 0.25% from the month prior, to 4.1 million persons. The move marked the first decline in jobless claims in five months. In annual terms, jobless claims rose 4.5%.

The high levels are attributed in part to the country's rigid labor regulations, generous unemployment benefits and rapid modernization, which have resulted in declining employment in the agricultural sector and other traditional industries. The government has pledged an overhaul of labor rules that will reduce the country's cost of hiring and firing, another key factor behind the country's historically high unemployment rate. Specifically, the government plans to do away with a €426 per month subsidy for the long-term unemployed which benefits almost 200,000 individuals. The OECD expects unemployment to decline in 2011.

Financial Stability

Overall, Spain has a well-developed financial sector which encourages entrepreneurial activity. Regulation is consistent with international norms and has proven to be transparent. Furthermore, regulation provides a friendly environment for starting and operating businesses.

The World Bank Group - Doing Business 2010 Survey: Spain

Ease of…*	2010 Rank	2009 Rank	Change in Rank
Doing Business	**62**	**51**	**-11**
Starting a Business	146	139	-7
Dealing with Construction Permits	53	50	-3
Employing Workers	157	154	-3
Registering Property	48	46	-2
Getting Credit	43	41	-2
Protecting Investors	93	88	-5
Paying Taxes	78	86	+8
Trading Across Borders	59	52	-7
Enforcing Contracts	52	52	0
Closing a Business	19	19	0

* Measures 183 countries, based on a scale of 1 to 183 with 1 being the highest ranking.
Source: DoingBusiness - 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 recently 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 of the €2,500 "baby bonus" for babies born from January 1, 2011 onward and an average cut on Ministry spening of 16%.

Spain's austerity measures appear to be a step in the right direction as budget data shows the government is on track to meet 2011 deficit targets. Such reports have helped to ease the fears of investors. Still, Spain's recovery is slow and fragile. Its large government deficit along with record high unemployment and instable financial markets will undoubtedly take year to resolve.

Assumptions for Projections

	Peer	Issuer	Base Case	
Income Statement	**Median**	**Average**	**Yr 1&2**	**Yr 3,4,5**
Taxes Growth%	(4.8)	(14.3)	**(4.8)**	**0.5**
Social Contributions Growth %	(1.8)	(1.9)	**(3.0)**	**(3.0)**
Grant Revenue Growth %	0.0	0.0		
Other Revenue Growth %	0.1	(7.1)	**(7.0)**	**(7.0)**
Other Operating Income Growth%	0.0	0.0		
Total Revenue Growth%	(6.4)	(9.4)	**(4)**	**(3.0)**
Compensation of Employees Growth%	5.2	5.6	**5.6**	**5.6**
Use of Goods & Services Growth%	5.4	2.1	**2.1**	**2.1**
Social Benefits Growth%	8.7	12.1	**12.1**	**12.1**
Subsidies Growth%	2.3	(1.1)		
Other Expenses Growth%	7.5	7.5	**7.5**	**7.5**
Special Items (millions EUR)	0.0	0.0		
Balance Sheet				
Currency and Deposits Growth%	0.4	17.5	**(4.8)**	**(4.8)**
Securities other than Shares LT Growth%	7.8	(18.4)	**1.0**	**1.0**
Loans Growth%	2.4	30.5	**3.0**	**3.0**
Shares and Other Equity Growth%	14.8	5.2	**5.2**	**5.2**
Insurance Technical Reserves Growth%	2.8	0.0		
Financial Derivatives Growth%	0.0	0.0		
Other Accounts Receivable LT Growth%	8.0	31.2	**(4.8)**	**(4.8)**
Monetary Gold and SDR's Growth %	0.0	0.0	**5.0**	**5.0**
Other Accounts Payable Growth%	9.2	NMF		
Currency & Deposits Growth%	4.5	1.4	**1.4**	**1.4**
Securities Other than Shares Growth%	16.3	31.6	**5.0**	**5.0**
Growth%	0.0	0.0		
Loans Growth%	0.8	15.5	**15.5**	**14.0**
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	264,627	229,802	196,940	187,487	178,488	179,380
Social Contributions	136,752	143,043	140,361	136,150	132,066	128,104
Grant Revenue	0	0	0	0	0	0
Other Revenue	31,429	29,832	27,718	25,778	23,973	22,295
Other Operating Income	0	0	0	0	0	0
Total Revenue	432,808	402,677	365,019	349,415	334,526	329,779
Compensation of Employees	107,835	117,641	124,285	131,304	138,720	146,554
Use of Goods & Services	55,406	59,829	61,103	62,404	63,733	65,090
Social Benefits	148,368	163,636	183,458	205,681	230,596	258,529
Subsidies	11,315	11,687	11,560	11,561	11,562	11,563
Other Expenses	29,914	33,531	36,062	16,398	36,062	38,784
Grant Expense	0	0	0	0	0	0
Depreciation	17,500	18,695	19,311	19,311	19,311	19,311
Total Expenses	370,338	405,019	435,779	446,660	499,984	539,832
Operating Surplus/Shortfall	62,470	-2,342	-70,760	-97,245	-165,458	-210,054
Interest Expense	16,932	17,202	18,826	17,144	20,440	21,239
Net Operating Balance	45,538	-19,544	-89,586	-114,389	-185,898	-231,292

ANNUAL BALANCE SHEETS (MILLIONS EUR)

ASSETS	Dec-07	Dec-08	Dec-09	PDec-10	PDec-11	PDec-12
Currency and Deposits	101,116	101,935	119,749	114,001	108,529	103,320
Securities other than Shares LT	22,845	34,407	28,078	28,359	28,642	28,929
Loans	20,471	22,399	29,234	30,111	31,014	31,945
Shares and Other Equity	90,100	91,444	96,202	101,208	106,474	112,014
Insurance Technical Reserves				0	0	0
Financial Derivatives						
Other Accounts Receivable LT	15,543	17,005	22,308	21,237	20,218	19,247
Monetary Gold and SDR's						
Additional Assets	0	0	0	0	0	0
Total Financial Assets	250,075	267,190	295,571	294,916	294,877	295,454
LIABILITIES						
Other Accounts Payable	54,424	61,146	69,378	69,378	69,378	69,378
Currency & Deposits	3,307	3,420	3,468	3,468	3,468	3,468
Securities Other than Shares	323,400	378,259	497,758	522,646	548,778	576,217
Loans	64,085	73,281	84,651	167,515	327,242	531,672
Insurance Technical Reserves						
Financial Derivatives						
Other Liabilities			2,250	8,232	8,232	8,232
Liabilities	445,216	516,106	657,505	771,239	957,098	1,188,967
Net Financial Worth	(195,141)	(248,916)	(361,934)	(476,323)	(662,221)	(893,513)
Total Liabilities & Equity	250,075	267,190	295,571	294,916	294,877	295,454

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