SPAIN

Rating Analysis - 10/2/10
Debt: EUR559.7B, Cash: EUR120M

EJR Sen Rating(Curr/Prj) A+/ N/A
EJR CP Rating: A1
EJR's 1 yr. Default Probability: 1.3%

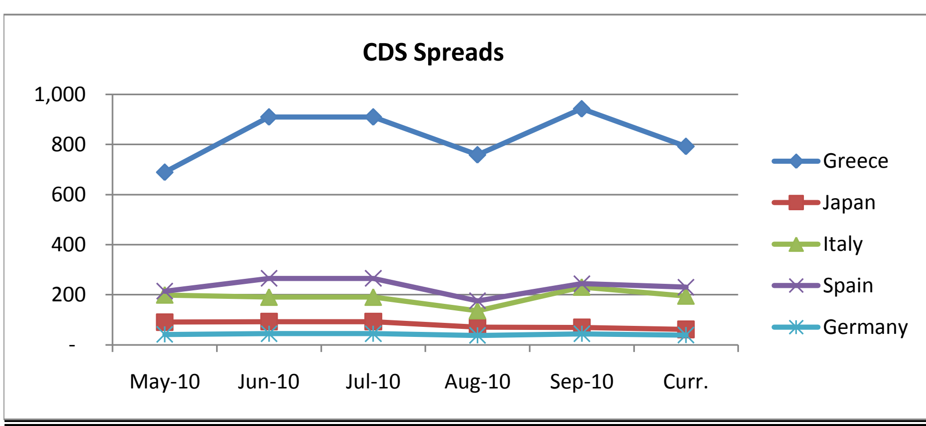
Spain's Q2 GDP rose 0.2% from Q1 2010 (0.2% YoY), meeting the Bank of Spain's projections for the quarter. The second consecutive quarter of upturn is expected to be short lived with currently high public sector debt and a troubled banking sector. However, growth is expected to continue as the economy is forecast by the Bank of Spain to grow 1.3% next year. We believe this forecast is overly optimistic in light of the poor condition of many of the country's macroeconomic indicators, mainly unemployment, as well as its exceedingly high general government budget deficit. Unemployment rose to 20.09% during Q2 2010, the highest rate in the developed world. Average EU unemployment measured 9.6%. Spain's large budget deficit (estimated at 11.2% of GDP) and weak economy have made investors nervous about its ability to fund debt. Spending cuts are expected to total €15B in 2010 and 2011 with more than €6B to be cut from public investments. Public sector wages will be cut by 5% this year. Spain's 2010 deficit target is currently 9.3% of GDP (versus 11.2% in 2009). Economists expect deficit-cutting measures will be to blame for the expected fall in GDP growth during the second half of 2010.

The uncertainty and fear of the European debt crisis continue to trouble European sovereign credits, although Ireland is now the primary focus. The country's CDS spreads, are currently trading below many of its EU peers, but we expect more problems in the banking sector.

	Annual Ratios					
INDICATIVE CREDIT RATIOS	Dec-08	Dec-09	Dec-10	Dec-11	Dec-12	Dec-13
Debt/ GDP (%)	37.2	52.9	56.7	60.9	65.4	70.2
Govt. Sur/Def to GDP (%)	-4.1	-11.2	-11.9	-12.0	-12.0	-12.0
Adjusted Debt/GDP (%)	40.8	56.8	60.9	65.3	70.0	75.1
Interest/ Taxes %	7.5	9.6	11.8	12.2	12.4	12.5
GDP Growth (%)	3.9	3.1	-1.4	-3.0	1.0	1.0
Foreign Reserves/Debt (%)	1.7	1.5	1.4	1.4	1.4	1.4
Implied Sen. Rating	A+	A-	A	BBB+	BBB	BBB

INDICATIVE CREDIT RATIOS	B	BB	BBB	A	AA	AAA
Debt/ GDP (%)	120.0	80.0	60.0	50.0	40.0	30.0
Govt. Sur/Def to GDP (%)	17.0	13.0	8.0	5.0	-4.0	-9.0
Adjusted Debt/GDP (%)	125.0	85.0	65.0	55.0	45.0	35.0
Interest/ Taxes %	18.0	15.0	12.0	9.0	7.0	5.0
GDP Growth (%)	1.0	2.0	3.0	5.0	7.0	8.0
Foreign Reserves/Debt (%)	30.0	50.0	70.0	90.0	110.0	130.0

PEER RATIOS	S&P Sen.	Debt as a % GDP	Govt. Surp. Def to GDP (%)	Adjusted Debt/ GDP	Interest/ Taxes %	GDP Growth (%)	Ratio-Implied Rating*
Greece	BB+	114.3	-13.6	117.5	25.8	1.0	BB-
Japan	AA	244.1	-2.7	250.0	14.6	-2.5	CCC+
Italy	A+	114.9	-5.3	120.7	15.9	-4.1	B-
Spain	AA	52.9	-11.2	56.8	9.6	-2.8	BB+
Germany	AAA	72.6	-3.3	79.5	10.7	-3.0	B+

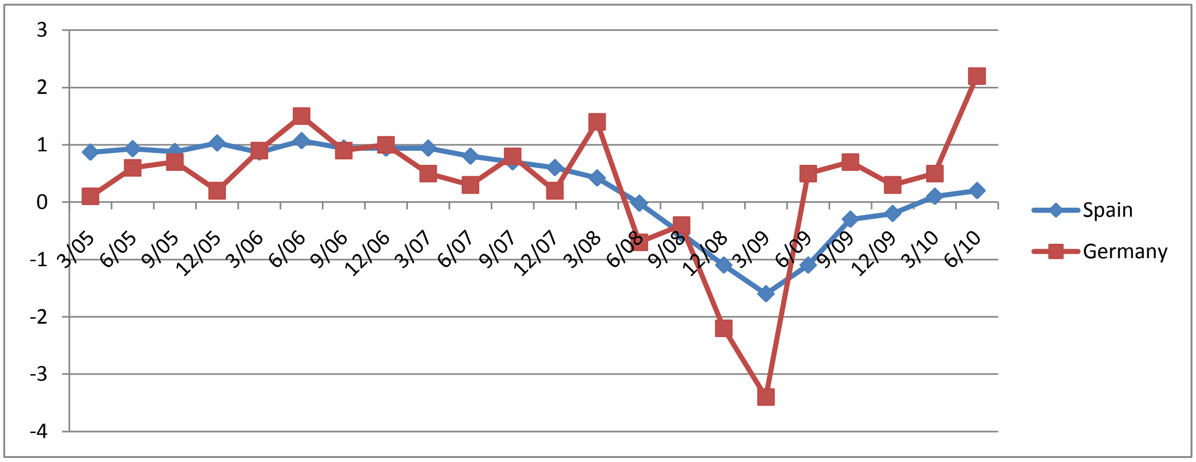


Country (EJR Rtg)	Current CDS	Targeted CDS
Greece (BB)	793	350
Japan (BB+)	62	300
Italy (A)	195	75
Spain (A+)	230	60
Germany (AA)	39	30

Economic Growth

Spain constitutes the world's 12th largest economy in terms of purhcasing power parity. 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

During Q1 2010, GDP rose 0.1% from the previous quarter after six consecutive quarters of contraction. GDP continued to trend upward with a Q2 2010 quarterly growth rate of 0.2%, surpassing analyst's expectations. However, in light of pending austerity measures and a rise in VAT levels, GDP is expected to decline again during the second half of 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.

After boasting a general government surplus of 2% of GDP in 2007, 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. Spain's recent commitment to do so through increased fiscal consolidation has increased investor confidence in the country.

Meanwhile, foreign trade has been trending downward in recent months. The country's trade deficit widened 32.7% YoY in July to 4.3 billion euros (US $5.6 billion). Imports rose 16.7% while exports rose 12.2%. The overall recovery of exports has been diminished as Spain's European partners continue to recover from the economic downturn.

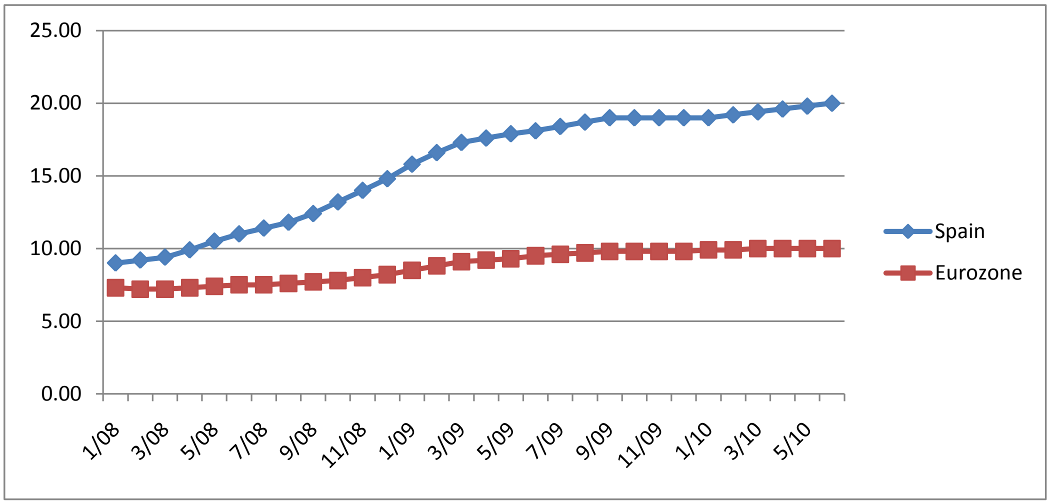
PIIGS	Deficit-to-GDP	Debt-to-GDP	5 Yr SR CDS Spreads
Portugal	9.4	76.9	315.32
Italy	5.3	115.2	225.7
Ireland	14.3	57.7	323.82
Greece	13.6	113.4	917.81
Spain	**11.2**	**53.2**	**241.51**

Source: Bloomberg

Growing Trend: Unemployment

Spain has suffered from high unemployment levels for several decades. The current rate of 20.09% (up from 20.05% in Q1 2001 and 18.83% in Q4 2009) has surpassed government forecasts. It is the highest unemployment rate in the EU and Spain's highets since 1997, having prevented retail sales from recovering to date and leaving economic growth dependent on foreign demand of exports which have benefited from the gradual recovery of the world economy. These 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 this month that will reduce the country's cost of hiring and firing, another key factor behind the country's historically high unemployment rate. The OECD expects unemployment to decline in 2011.

Spain v. Eurozone Unemployment 2008-2010 Monthly



Source: Bloomberg

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.

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

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

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%	(4.6)	(14.3)	**(1.0)**	**0.5**
Social Contributions Growth %	(0.4)	(1.9)	**0.5**	**0.5**
Grant Revenue Growth %	0.0	0.0		
Other Revenue Growth %	0.1	(7.1)	**(3.0)**	**(3.0)**
Other Operating Income Growth%	0.0	0.0		
Total Revenue Growth%	(2.4)	(9.4)	**(5)**	**(5.0)**
Compensation of Employees Growth%	4.5	5.6	**4.0**	**4.0**
Use of Goods & Services Growth%	7.5	2.1	**2.1**	**2.1**
Social Benefits Growth%	8.7	12.1	**5.0**	**5.0**
Subsidies Growth%	2.3	(1.1)		
Other Expenses Growth%	7.5	7.5	**5.0**	**5.0**
Special Items (millions EUR)	0.0	0.0		
Balance Sheet				
Currency & Deposits Growth%	17.5	17.5	**(1.0)**	**(1.0)**
Financial Derivatives Growth%	0.0			
Other Accounts Receivable Growth%	10.1	31.2	**5.0**	**5.0**
Securities other than Shares (% of Revs)	9.9	(18.4)	**2.0**	**2.0**
Loans Growth%	2.4	30.5	**5.0**	**5.0**
Shares and Other Equity Growth%	14.8	5.2	**(1.0)**	**(1.0)**
Insurance Technical Reserves Growth%	0.0	0.0		
			5.0	**5.0**
Nonfinancial Assets Growth%	0.0	0.0		
Other Accounts Payable Growth%	7.4	NMF		
Currency & Deposits Growth%	1.4	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%	1.7	15.5	**2.0**	**2.0**
Insurance Technical Reserves Growth(%)	2.8	0.0		
Shares and Other Equity Growth%	0.0	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	194,971	193,021	193,986
Social Contributions	136,752	143,043	140,361	141,063	141,768	142,477
Grant Revenue	0	0	0	0	0	0
Other Revenue	31,429	29,832	27,718	26,886	26,080	25,297
Other Operating Income	0	0	0	0	0	0
Total Revenue	432,808	402,677	365,019	346,768	329,430	312,958
Compensation of Employees	107,835	117,641	124,285	129,256	134,427	139,804
Use of Goods & Services	55,406	59,829	61,103	62,404	63,733	65,090
Social Benefits	148,368	163,636	183,458	192,631	202,262	212,376
Subsidies	11,315	11,687	11,560	11,560	11,560	11,560
Other Expenses	29,914	33,531	36,062	10,210	10,691	11,197
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	435,779	435,779	435,779
Operating Surplus/Shortfall	62,470	-2,342	-70,760	-89,011	-106,349	-122,821
Interest Expense	16,932	17,202	18,826	23,043	23,504	23,974
Net Operating Balance	45,538	-19,544	-89,586	-112,054	-129,853	-146,795

ANNUAL BALANCE SHEETS (MILLIONS EUR)

ASSETS	Dec-07	Dec-08	Dec-09	PDec-10	PDec-11	PDec-12
Currency & Deposits	101,116	101,935	119,749	118,552	117,366	116,192
Financial Derivatives						
Other Accounts Receivable	15,543	17,005	22,308	23,423	24,595	25,824
Securities other than Shares	22,845	34,407	28,078	28,039	28,000	28,019
Loans	20,471	22,399	29,234	30,696	32,230	33,842
Shares and Other Equity	90,100	91,444	96,202	95,240	94,288	93,345
Insurance Technical Reserves				0	0	0
Nonfinancial Assets						
Additional Assets						
Total Assets	250,075	267,190	295,571	295,949	296,478	297,222
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
				0	0	0
Loans	64,085	73,281	84,651	163,963	268,213	388,313
Insurance Technical Reserves						
Shares and Other Equity			2,250	2,250	2,250	2,250
Other Liabilities				8,232	8,232	8,232
Liabilities	445,216	516,106	657,505	769,937	900,319	1,047,858
Net Financial Worth	(195,141)	(248,916)	(361,934)	(473,988)	(603,841)	(750,636)
Total Liabilities & Equity	250,075	267,190	295,571	295,949	296,478	297,222

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 sove (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 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. One nuance is a sovereign's ability to print its own currency; a default is normally unlikely if the sovereign can pay its debts in newly-printed currency. Our view is that a substantial monetization of debt is a de facto default since investors are being repaid in weaker currency. Additional nuances are "off-balance sheet" liabilities such as retirement and healthcare obligations. A related issue is the distinction between hard and soft defaults. A sovereign has the ability to unilaterally change the terms of its obligations to some creditors such as pushing back the age for collecting retirement benefits. Although these are real issues, the main audience for our ratings is institutional investors and therefore we concern ourselves mainly with a sovereign's likelihood of paying their obligations to institutional investors on time and in full value reflecting market and world events at the time of the rating. Ultimately the rating assigned is judgmental and is aimed at providing an investor with a guide for the true credit quality.