KINGDOM OF SPAIN
Rating Analysis - 4/17/12
Debt: EUR563.9B, Cash: EUR95.1B

EJR Sen Rating(Curr/Prj) BBB-/ N/A
EJR CP Rating: A2
EJR's 1 yr. Default Probability: 2.3%

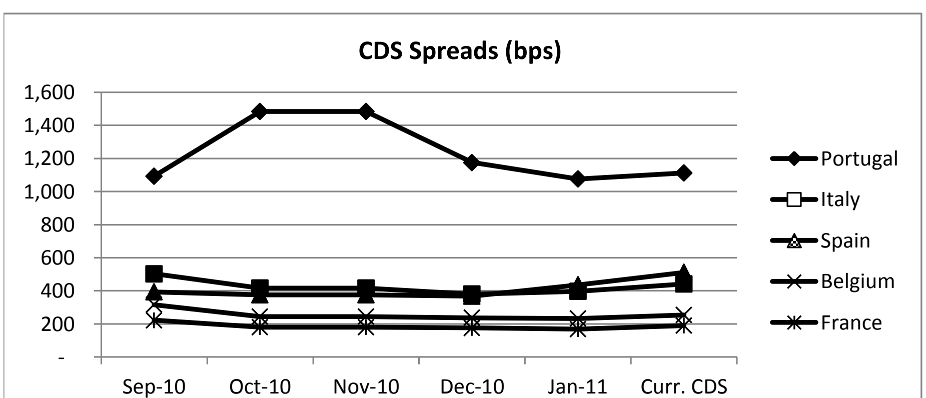
Miserable trend - over the past three fiscal years (i.e., from 2008 to 2010), Spain's GDP declined from EUR1.09 trillion to EUR1.07 trillion. Meanwhile, its debt mushroomed from EUR381 billion to EUR563 billion. The recently-reported quarters are of little comfort since the debt has risen to EUR 641B while GDP has been more or less flat resulting in a 61% debt to GDP. Increased social benefits are a major problem; while payments to the govt have been more or less flat over the past four years (up EUR 8 billion), payments from the government have been up EUR 44 billion). As a result, Spain is short about EUR50B per year for social payments, EUR20B per year for interest, and an additional EUR 30B for asset growth; hence the EUR100B per annum increase in debt. Unemployment is near depression levels of 23+% while adjusted wage rates have declined.

In addition to its social payment/ unemployment problem, Spain is likely to be faced with payments to support a portion its banking sector and for its weaker provinces. Assets of Spain's largest two banks exceed its GDP. We are slipping our rating to "BBB-"; watch for requests for support from the banks.

	Annual Ratios					
INDICATIVE CREDIT RATIOS	2008	2009	2010	P2011	P2012	P2013
Debt/ GDP (%)	35.1	41.6	52.5	66.1	75.2	86.4
Govt. Sur/Def to GDP (%)	-4.5	-11.2	-9.3	-8.6	-8.5	-9.0
Adjusted Debt/GDP (%)	35.5	42.0	52.9	66.5	75.6	86.8
Interest Expense/ Taxes (%)	7.6	9.4	9.5	9.0	10.9	10.9
GDP Growth (%)	-3.1	0.7	0.3	0.5	0.5	-1.5
Foreign Reserves/Debt (%)	2.2	2.0	1.8	1.4	1.3	1.1
Implied Sen. Rating	BBB-	BBB	BBB+	BBB	BBB	BBB-

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	34.1	-5.0	57.5	14.1	1.9	A-
French Republic	AA+	81.6	-7.1	81.6	9.5	1.3	BB-
Kingdom Of Belgium	AA	95.3	-4.1	95.3	11.9	1.0	BB
Republic Of Italy	BBB+	117.9	-4.6	117.9	15.4	-0.4	B
Portugal Republic	BB	92.5	-9.8	92.5	13.0	-2.8	B+



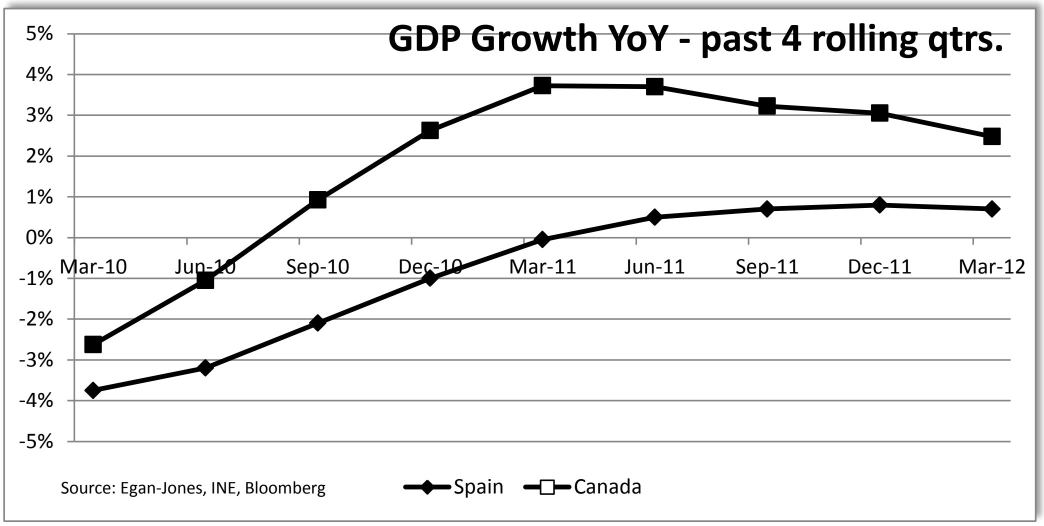
Country (EJR Rtg*)	Current CDS	Targeted CDS
Portugal (CCC+)	1,112	1,500
Italy (BB)	442	800
Spain (BBB-)	512	400
Belgium (BBB-)	254	400
France (A-)	190	120

* 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 since slowed to levels far below the 2% minimum enjoyed by the nation for a decade before the crisis.

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 barely growing while Germany has recorded growth near 4%. 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 9.3% is not particularly comforting for a top tier country. 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, only Portugal has a worse deficit than Spain. As Spain implements austerity measures and provides further support for its banks, debt to GDP will rise.

	Deficit/ Surplus to GDP	Debt-to-GDP	5 Yr. CDS Spreads
Spain	-9.3	#N/A	437
Canada	-5.0	#N/A	N/A
France	-7.1	#N/A	169
Belgium	-4.1	#N/A	233
Italy	-4.6	#N/A	397
Portugal	-9.8	#N/A	1,076

Source: Bloomberg using year end data excluding CDS data

Unemployment

Spain has suffered from high unemployment for several decades. In the first quarter in 2011, the unemployment rate increased 1% to 21.3%. 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.

Unemployment (%)	2009	2010
Spain	20.3	22.9
Canada	7.6	7.5
France	9.7	9.8
Belgium	7.6	7.1
Italy	8.2	8.8
Portugal	11.1	14.0

Source: Intl. Finance Statistics

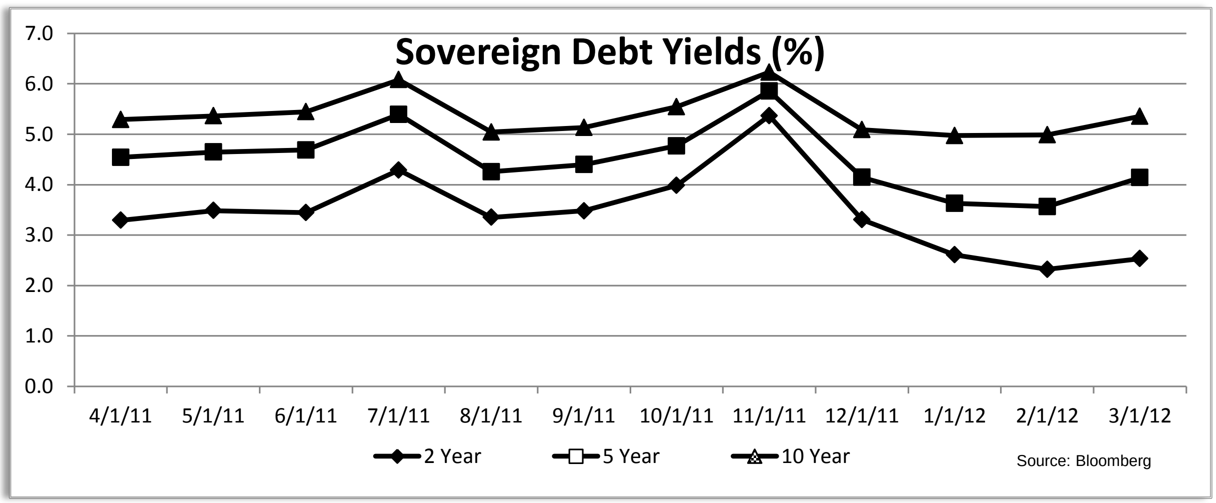
Banking Sector

History has shown that country and bank obligations are linked during times of economic distress. Spain has significantly more exposure to its banking sector because the bank's aggregate size measured in assets The top five banks have assets equal to 156% of GDP compared to 125% for Germany. We expect that Spain will be forced to provide financial support to its banks over the next couple of quarters because of 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 ten year debt yield has declined since Nov. 2011, but have risen 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 well 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.
** Based on a scale where 100 is best, 1 is worst.

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**	79.0	2.3	64.3
Trade Freedom	**87.1**	88.0	-0.9	74.8
Fiscal Freedom	**61.3**	60.0	1.3	76.3
Government Spending	**37.1**	50.0	-12.9	63.9
Monetary Freedom	**81.5**	82.0	-0.5	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**	52.0	-0.2	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	Issuer	Base Case	
Income Statement	**Median**	**Average**	**Yr 1&2**	**Yr 3,4,5**
Taxes Growth%	4.2	7.5	**5.0**	**5.0**
Social Contributions Growth %	1.4	0.0	**0.0**	**0.0**
Grant Revenue Growth %	0.0	0.0		
Other Revenue Growth %	6.8	(3.4)	**(3.0)**	**(3.0)**
Other Operating Income Growth%	0.0	0.0		
Total Revenue Growth%	3.1	3.7	**1**	**(1.5)**
Compensation of Employees Growth%	2.0	(0.7)	**(0.7)**	**(0.7)**
Use of Goods & Services Growth%	4.0	(4.2)	**2.0**	**2.0**
Social Benefits Growth%	2.4	4.1	**4.1**	**4.1**
Subsidies Growth%	3.9	2.6		
Other Expenses Growth%	(8.3)	(8.3)	**3.0**	**3.0**
Interest Expense	0.0	3.6	**4**	
Balance Sheet				
Currency and Deposits (asset) Growth%	12.5	(20.6)	**4.5**	**4.5**
Securities other than Shares LT (asset) Growth%	5.0	12.0	**6.0**	**6.0**
Loans (asset) Growth%	7.5	17.6	**5.0**	**5.0**
Shares and Other Equity (asset) Growth%	(1.7)	2.1	**2.1**	**2.1**
Insurance Technical Reserves (asset) Growth%	0.0	0.0		
Financial Derivatives (asset) Growth%	0.0	0.0		
Other Accounts Receivable LT Growth%	1.8	(10.5)	**1.0**	**1.0**
Monetary Gold and SDR's Growth %	0.0	0.0	**5.0**	**5.0**
Other Accounts Payable Growth%	3.3	(10.5)	**1.0**	**1.0**
Currency & Deposits (liability) Growth%	0.0	3.3	**3.3**	**3.3**
Securities Other than Shares (liability) Growth%	5.3	5.6	**3.9**	**3.9**
Loans (liability) Growth%	5.7	18.4	**3.0**	**3.0**
Insurance Technical Reserves (liability) Growth%	0.0	0.0		
Financial Derivatives (liability) Growth%	0.0	0.0		
Addl debt. (1st Year) million EUR	0.0	0.0		

Base Case
ANNUAL REVENUE AND EXPENSE STATEMENT (MILLIONSEUR)

	Dec-08	Dec-09	Dec-10	PDec-11	PDec-12	PDec-13
Taxes	227,937	197,751	212,501	223,126	234,282	245,996
Social Contributions	143,104	140,144	140,170	140,196	140,222	140,248
Grant Revenue	0	0	0	0	0	0
Other Revenue	31,037	29,766	28,756	27,893	27,057	26,245
Other Operating Income	0	0	0	0	0	0
Total Revenue	402,078	367,661	381,427	391,215	401,561	412,489
Compensation of Employees	118,514	125,710	124,781	123,859	122,944	122,035
Use of Goods & Services	60,185	61,834	59,249	60,434	61,643	62,876
Social Benefits	165,181	185,314	192,833	200,657	208,799	217,270
Subsidies	11,896	11,838	12,147	12,148	12,149	12,151
Other Expenses	44,486	45,236	41,471	46,593	42,715	47,991
Grant Expense	0	0	0	0	0	0
Depreciation	18,206	18,508	19,685	19,685	19,685	19,685
Total Expenses excluding interest	406,572	436,602	438,019	463,376	467,934	482,008
Operating Surplus/Shortfall	-4,494	-68,941	-56,592	-72,161	-66,373	-69,518
Interest Expense	17,399	18,520	20,120	20,120	25,458	26,730
Net Operating Balance	-21,893	-87,461	-76,712	-92,281	-91,831	-96,249

Base Case
ANNUAL BALANCE SHEETS (MILLIONSEUR)

ASSETS	Dec-08	Dec-09	Dec-10	PDec-11	PDec-12	PDec-13
Currency and Deposits (asset)	101,935	119,749	95,114	99,394	103,867	108,541
Securities other than Shares LT (asset)	34,412	28,048	31,408	33,292	35,290	37,407
Loans (asset)	23,440	30,801	36,230	38,042	39,944	41,941
Shares and Other Equity (asset)	88,319	91,900	93,828	95,796	97,806	99,858
Insurance Technical Reserves (asset)				0	0	0
Other Accounts Receivable LT	24,906	28,733	25,716	25,973	26,233	26,495
Monetary Gold and SDR's						
Additional Assets						
Total Financial Assets	273,012	299,231	282,296	292,498	303,140	314,242
LIABILITIES						
Other Accounts Payable	24,906	28,733	25,716	25,973	26,233	26,495
Currency & Deposits (liability)	3,420	3,468	3,584	3,584	3,584	3,584
Securities Other than Shares (liability)	378,259	498,340	526,433	547,207	568,800	591,246
Loans (liability)	76,871	88,582	104,923	233,736	314,358	399,005
Insurance Technical Reserves (liability)						
Financial Derivatives (liability)						
Other Liabilities	35,346	39,592	44,087	(3,274)	(3,274)	(3,274)
Liabilities	518,802	658,715	704,743	807,226	909,699	1,017,050
Net Financial Worth	(245,790)	(359,484)	(422,447)	(514,728)	(606,559)	(702,808)
Total Liabilities & Equity	273,012	299,231	282,296	292,498	303,140	314,242

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