KINGDOM OF SPAIN

Rating Analysis - 6/13/12
Debt: EUR805.9B

EJR Sen Rating(Curr/Prj) CCC+/ CC
EJR CP Rating: C
EJR's 1 yr. Default Probability: 18.0%

Spain continues to be weakened by high funding costs (6.75% for 10yr today), the gov. deficit of 9.6%, an estimated decline in GDP of 1.7% (per the Economy Ministry), the 24.4% unemployment, the IIF's recent estimate of additional bank loan losses up to EUR260B, and possible depositor withdrawals. Over the past four fiscal years, that is from 2008 to 2011, Spain's GDP declined from EUR1.09 trillion to EUR1.07 trillion. Meanwhile, its debt mushroomed from EUR519B to EUR806B. With the EUR100B infusion for Spain's banks, the debt to GDP will rise to 90% plus future additions for the government deficit, support for its regions and additional support for its banks. Social benefits are a major problem; while payments to the govt have been down EUR 3B (2008 to 2011), payments from the government have been up EUR 29B). As a result, Spain is short about EUR50B per year for social payments, EUR35+B per year for interest, and an additional EUR 30B for asset growth; hence the EUR110+B per annum increase in debt.

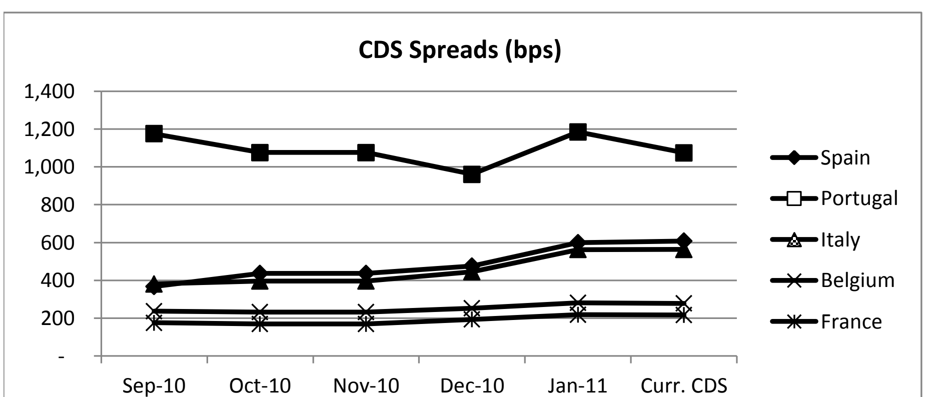
As we expected, Spain requested support for its banking sector and will probably need cash for weaker provinces. Assets of Spain's largest two banks exceed its GDP. We are slipping our rating to "CCC+"; watch for more requests for support from the banks and money creation.

Annual Ratios (source for past results: IMF)

INDICATIVE CREDIT RATIOS	2009	2010	2011	P2012	P2013	P2014
Debt/ GDP (%)	62.7	66.8	75.1	91.0	110.9	142.7
Govt. Sur/Def to GDP (%)	-11.2	-9.3	-8.5	-12.0	-14.9	-17.5
Adjusted Debt/GDP (%)	63.1	67.2	75.4	91.4	111.3	143.1
Interest Expense/ Taxes (%)	9.4	9.5	12.3	15.8	18.8	19.6
GDP Growth (%)	-3.1	0.7	0.3	-5.0	-5.0	-4.5
Foreign Reserves/Debt (%)	1.3	1.3	1.2	1.1	0.9	0.7
Implied Sen. Rating	CCC+	B+	B+	B+	B-	CCC+

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*
Federal Republic Of Germany	AAA	79.7	-1.0	79.7	11.4	2.0	BBB-
French Republic	AA+	84.0	-5.2	84.0	9.5	1.2	BB-
Kingdom Of Belgium	AA	96.5	-3.7	96.5	11.9	1.2	BB
Republic Of Italy	BBB+	115.3	-3.9	115.3	16.7	-0.5	B
Portugal Republic	BB	101.0	-4.2	101.0	13.0	-2.9	BB-



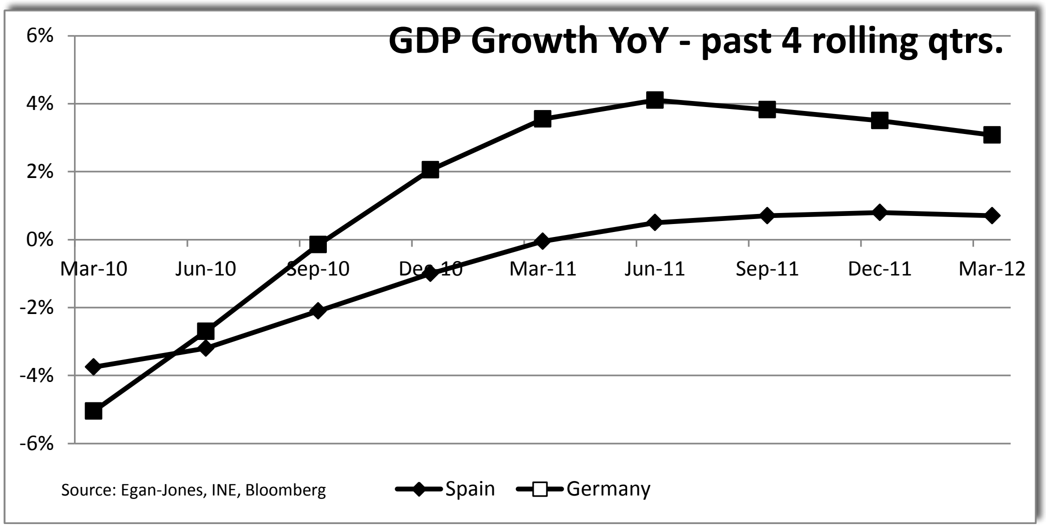
Country (EJR Rtg*)	Current CDS	Targeted CDS
Spain (CC)	608	3,000
Portugal (CCC+)	1,074	1,500
Italy (B)	564	1,200
Belgium (BBB-)	278	400
France (A-)	217	120

* 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 been tepid at less than 2% over the last couple of quarters. We expect GDP to continue to be weak over the next couple of years.

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 above 3%. 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 8.5% is not particularly comforting and is likely to grow in 2012. Over the last couple of full fiscal years (that is 2009 and 2011), total sovereign revenues rose 2.6%, operating expenses declined .5% and interest rose 40% thereby stoking the deficit. As can be seen from the chart to the right, none of the listed countries have a worse deficit than Spain. Ncreases in Spain's funding costs have more than offset budget cuts and therefore debt is likely to grown with the result likely to be monetization.

	Deficit-to-GDP (%)	Debt-to-GDP (%)	5 Yr CDS Spreads
Spain	8.5	65.4	599
Germany	1.0	78.5	102
France	5.2	78.0	219
Belgium	3.7	90.8	282
Italy	3.9	111.9	563
Portugal	4.2	88.3	1,185

Source: Bloomberg using yr end data other than CDS data

Unemployment

Spain has suffered from high unemployment for several decades. As of May 2012, the unemployment rate increased to 24%. The high unemployment rate is driving the relatively high and increasing social benefit payments. The economic weakness in Spain and the EU make it difficult if not impossible to substantially reduce unemployment over the next couple of years.

Unemployment (%)	2010	2011
Spain	20.3	22.9
Germany	7.4	6.8
France	9.6	9.8
Belgium	7.6	7.2
Italy	8.3	9.1
Portugal	11.1	14.0

Source: Intl. Finance Statistics

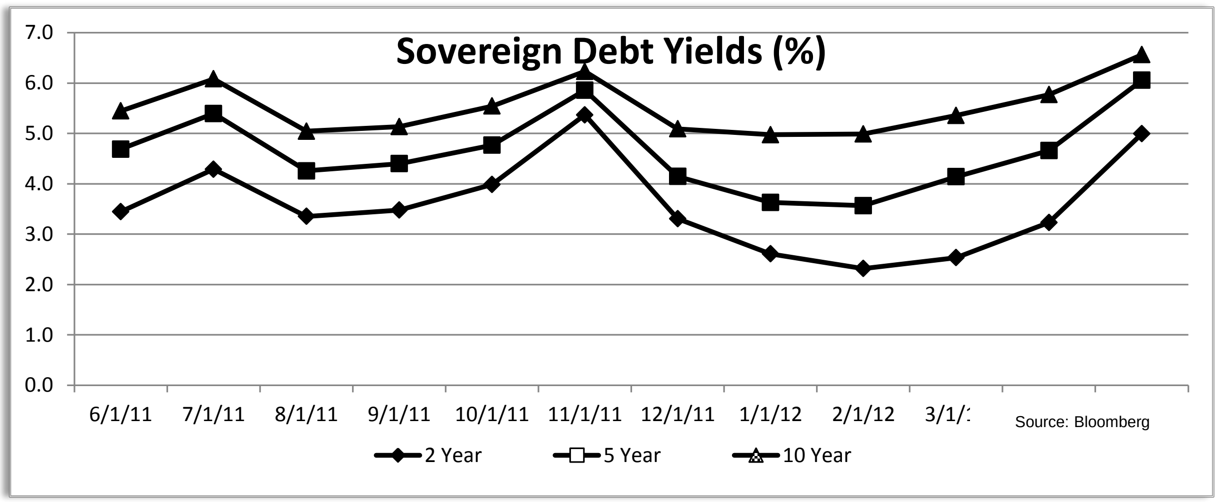
Banking Sector

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 204% of GDP compared to 125% for Germany. Spain will be expected to provide substantial financial support to its banks over the next couple of quarters because of declines in home values and high unemployment.

Bank Assets (billions of local currency)	Assets	Cap/ Assets %
BANCO SANTANDER	1,252	6.6
BBVA	598	6.7
BANESTO SA	109	5.0
BANCO POPULAR	131	6.1
BANCO SABADELL	100	7.2
Total	2,189	
EJR's est. of cap shortfall at 10% of assets less market cap		164
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 bond yields have 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 strong.

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.

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**	77.2	4.1	64.3
Trade Freedom	**87.1**	87.6	-0.5	74.8
Fiscal Freedom	**61.3**	61.0	0.3	76.3
Government Spending	**37.1**	49.3	-12.2	63.9
Monetary Freedom	**81.5**	82.4	-0.9	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**	53.0	-1.2	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%	4.9	(1.1)	**(3.0)**	**0.5**
Social Contributions Growth %	2.0	(0.2)	**0.5**	**0.5**
Grant Revenue Growth %	0.0	0.0		
Other Revenue Growth %	12.1	(5.7)	**(3.0)**	**(3.0)**
Other Operating Income Growth%	0.0	0.0		
Total Revenue Growth%	5.8	(1.1)	**(5)**	**(4.5)**
Compensation of Employees Growth%	2.0	(1.5)	**1.0**	**1.0**
Use of Goods & Services Growth%	4.0	(2.1)	**2.0**	**2.0**
Social Benefits Growth%	2.4	0.4	**5.0**	**5.0**
Subsidies Growth%	(3.8)	(6.8)		
Other Expenses Growth%	(4.8)	(4.8)	**3.0**	**3.0**
Interest Expense	0.0	3.2	**4**	
Balance Sheet				
Currency and Deposits (asset) Growth%	(3.5)	0.0	**0.9**	**0.9**
Securities other than Shares LT (asset) Growth%	(2.2)	(23.4)	**1.2**	**1.2**
Loans (asset) Growth%	14.4	30.1	**1.0**	**1.0**
Shares and Other Equity (asset) Growth%	(2.0)	7.2	**2.1**	**2.1**
Insurance Technical Reserves (asset) Growth%	3.6	0.0		
Financial Derivatives (asset) Growth%	0.0	0.0		
Other Accounts Receivable LT Growth%	1.8	46.7	**1.0**	**1.0**
Monetary Gold and SDR's Growth %	0.0	0.0	**5.0**	**5.0**
Other Accounts Payable Growth%	0.2		**1.0**	**1.0**
Currency & Deposits (liability) Growth%	(1.8)	2.8	**3.3**	**3.3**
Securities Other than Shares (liability) Growth%	5.3	15.7	**3.9**	**3.9**
Loans (liability) Growth%	5.7	14.4	**2.0**	**2.0**
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 (MILLIONS EUR)

	Dec-09	Dec-10	Dec-11	PDec-12	PDec-13	PDec-14
Taxes	197,751	212,501	210,111	203,808	197,693	198,682
Social Contributions	140,144	140,170	139,868	140,567	141,270	141,977
Grant Revenue	0	0	0	0	0	0
Other Revenue	29,766	28,756	27,106	26,293	25,504	24,739
Other Operating Income	0	0	0	0	0	0
Total Revenue	367,661	381,427	377,085	370,668	364,468	365,397
Compensation of Employees	125,710	124,781	122,926	124,155	125,397	126,651
Use of Goods & Services	61,834	59,249	57,982	59,142	60,324	61,531
Social Benefits	185,314	192,833	193,566	203,244	213,407	224,077
Subsidies	11,838	12,147	11,325	11,326	11,327	11,328
Other Expenses	45,236	41,471	39,464	42,715	40,648	43,997
Grant Expense	0	0	0	0	0	0
Depreciation	18,508	19,685	20,381	20,381	20,381	20,381
Total Expenses excluding interest	436,602	438,019	434,319	460,963	471,484	487,965
Operating Surplus/Shortfall	-68,941	-56,592	-57,234	-90,296	-107,016	-122,567
Interest Expense	18,520	20,120	25,867	32,235	37,127	38,983
Net Operating Balance	-87,461	-76,712	-83,101	-122,530	-144,143	-161,550

Base Case

ANNUAL BALANCE SHEETS (MILLIONS EUR)

ASSETS	Dec-09	Dec-10	Dec-11	PDec-12	PDec-13	PDec-14
Currency and Deposits (asset)	119,749	95,114				
Securities other than Shares LT (asset)	28,038	31,399	24,047	24,336	24,628	24,923
Loans (asset)	30,801	36,217	47,121	47,592	48,068	48,549
Shares and Other Equity (asset)	91,900	93,828	100,545	102,656	104,812	107,013
Insurance Technical Reserves (asset)				0	0	0
Other Accounts Receivable LT	28,707	25,690	37,689	38,066	38,447	38,831
Monetary Gold and SDR's						
Additional Assets			77,525			
Total Financial Assets	299,195	282,248	286,927	212,650	215,955	219,316
LIABILITIES						
Other Accounts Payable						
Currency & Deposits (liability)	3,468	3,584	3,685	3,685	3,685	3,685
Securities Other than Shares (liability)	498,068	526,433	608,955	632,704	657,380	683,018
Loans (liability)	89,787	106,177	121,427	219,978	341,405	561,383
Insurance Technical Reserves (liability)						
Financial Derivatives (liability)						
Other Liabilities	67,399	68,828	74,047	(0)	(0)	(0)
Liabilities	658,722	705,022	808,114	856,367	1,003,815	1,168,727
Net Financial Worth	(359,527)	(422,774)	(521,187)	(643,717)	(787,860)	(949,411)
Total Liabilities & Equity	299,195	282,248	286,927	212,650	215,955	219,316

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