REPUBLIC OF ITALY
Rating Analysis - 6/1/12
Debt: EUR1,891.2B, Cash: EUR90.0B

EJR Sen Rating(Curr/Prj) B+/ B
EJR CP Rating: B
EJR's 1 yr. Default Probability: 6.0%

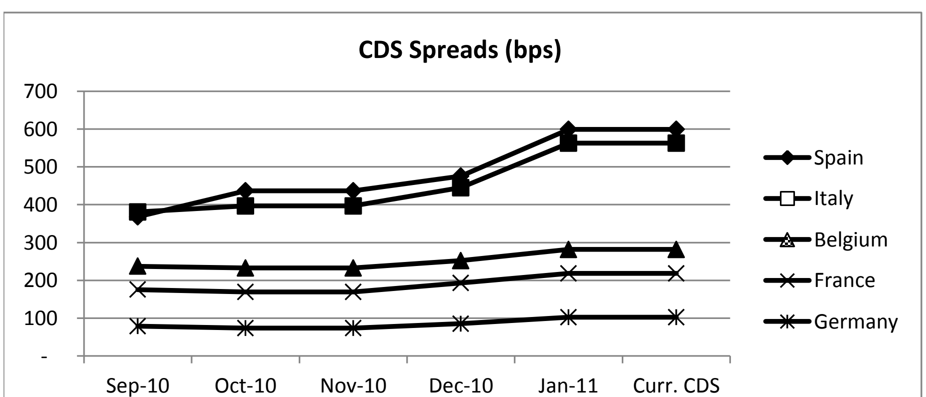
La Acido Vita - from La Dolce Vita, life in Italy has become sour of late; even without the concerns about Spain and Greece, Italy is in miserable shape. From 2007 to 2011, debt rose 8.6% while during the same period GDP rose only 1.7%. The annual government deficit of EUR63B and the debt to GDP of 120% place additional pressure on credit quality. Furthermore, Italy will probably have to provide additional support to its banks and will see some pressure on its economy. Italy's independent ability to support its banks is questionable given the country's weak condition.

Italy needs to finance approximately EUR64B of additional debt and is likely to experience increasing yields and restricted access without external intervention. Yields on the 10 year bonds are near 6.0%; rates have been rising despite prior ECB purchases. Future intervention by the ECB and IMF will provide some liquidity but will effectively subordinate existing creditors. Italy cannot support all of its debt if the EU economy falters. Debt/GDP will continue to rise and the country will remain pressed.

	Annual Ratios					
INDICATIVE CREDIT RATIOS	2009	2010	2011	P2012	P2013	P2014
Debt/ GDP (%)	127.7	126.5	119.6	118.8	127.4	136.0
Govt. Sur/Def to GDP (%)	-5.4	-4.6	-3.9	-6.7	-6.5	-7.3
Adjusted Debt/GDP (%)	127.7	126.5	119.6	118.8	127.4	136.0
Interest Expense/ Taxes (%)	15.8	15.5	16.7	20.6	19.8	20.6
GDP Growth (%)	-3.5	2.2	-0.4	-2.0	-2.0	-1.8
Foreign Reserves/Debt (%)	1.3	1.2	1.4	1.5	1.4	1.3
Implied Sen. Rating	B+	BB-	BB-	BB-	B+	B+

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	32.4	-5.0	54.6	14.1	1.9	A
Federal Republic Of Germany	AAA	79.1	-5.2	79.1	11.2	2.0	BB+
French Republic	AA+	83.3	-5.2	83.3	9.5	1.2	BB
Kingdom Of Belgium	AA	95.7	-3.7	95.7	11.9	1.2	BB-
Kingdom Of Spain	BBB+	64.9	-8.5	65.2	9.5	0.3	BB+



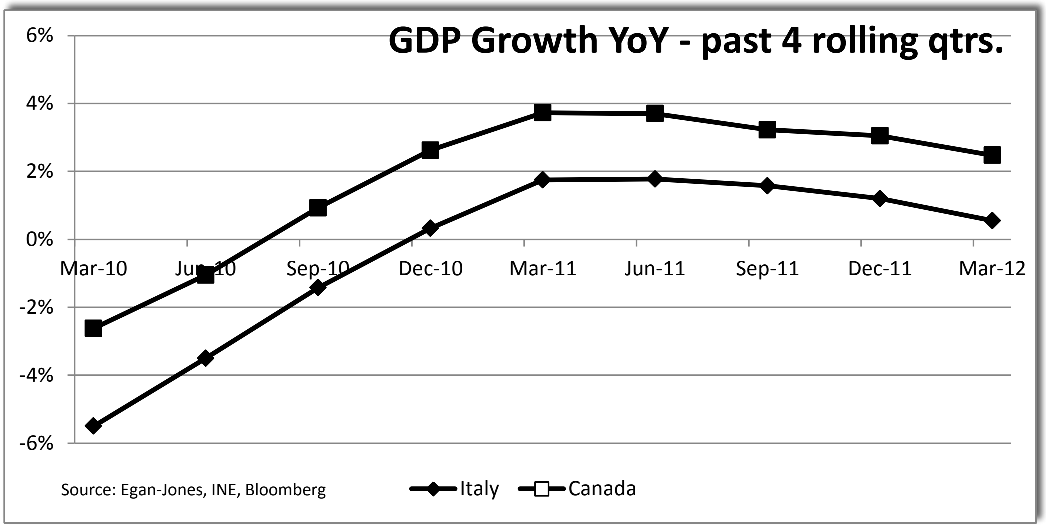
Country (EJR Rtg*)	Current CDS	Targeted CDS
Spain (CCC)	599	2,000
Italy (B)	563	1,200
Belgium (BBB-)	282	400
France (A-)	219	120
Germany (A+)	102	80

* Projected Rating
* EJR's targeted CDS based on rating

Economic Growth

No growth - Italy was hobbled by the global financial crisis of 2007 and did not show signs of a recovery until Sept. of 2010. The country's growth has been tepid at less than 2% over the last couple of quarters. We expect GDP growth will slip over the next couple of quarters regardless of government actions.

As can be seen from the below chart, the Italy's rolling four quarter GDP growth has been less than stellar over the past year; Italy is barely growing while Canada has recorded growth near 4%. A large portion of Italy's economy is geared to the the tourism and light manufacturing industries. The continued weakness in the EU limit's growth in the economy.



<u>Fiscal Policy</u>

The Italy's deficit to GDP of 3.9% is not comforting and is likely to grow over the next couple of years. From FYE 2009 through 2011, total sovereign revenues rose 1.5% while expenses excluding interest rose 0.4% The major problem for Italy is its high Debt to GDP and support needed for its banks. As can be seen from the chart to the right, none of the listed countries have a worse Debt to GDP than the Italy. Italy's attempts to implement austerity measures and provide real bank relief are likely to fall short and will increase debt.

	Deficit-to-GDP (%)	Debt-to-GDP (%)	5 Yr CDS Spreads
Italy	3.9	114.5	445
Canada	5.0	30.3	#N/A
Germany	5.2	78.0	86
France	5.2	77.5	193
Belgium	3.7	90.2	252
Spain	8.5	56.8	476

Source: Bloomberg using yr end data other than CDS data

<u>Unemployment</u>

The Italy's unemployment rate of 9.1% is higher than the other peers other than Spain as indicated in the chart at right. Furthermore, as of the March 2012 quarter, the rate rose to 9.8%. The weak level of employments will impede the government's attempts to reduce the budget deficit. We expect unemployment to remain high and to climb over the next year.

Unemployment (%)	2010	2011
Italy	8.3	9.1
Canada	7.6	7.5
Germany	7.4	6.8
France	9.7	9.8
Belgium	7.6	7.2
Spain	20.3	22.9

Source: Intl. Finance Statistics

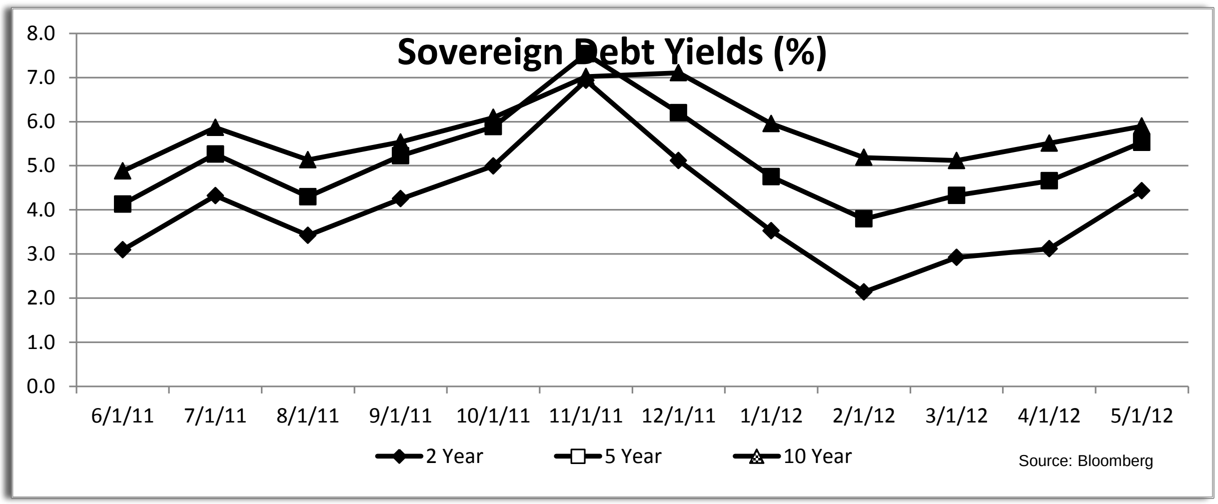
Banking Sector

History has shown that country and bank obligations are linked during times of economic distress. Italy has significantly exposure to its banking because the bank's large aggregate size measured in assets The top five banks have assets equal to 131% of GDP versus 125% for Germany. Italy will probably be expected to provide financial support to its banks over the next couple of years quarters to ameliorate asset quality problems. Italy's banks appear to be undercapitalized and equity is diluted by reserve shortfalls.

Bank Assets (billions of local currency)		
	Assets	Cap/ Assets %
UNICREDIT SPA	927	5.9
INTESA SANPAOLO	639	7.5
BANCA MONTE DEI	241	4.6
BANCO POPOLARE S	134	7.0
UBI BANCA SCPA	130	7.6
Total	2,071	
EJR's est. of cap shortfall at 10% of assets less market cap		190
Italy's GDP		1,581

Funding Costs

As a result of the waning of the ECB's LTRO and weakening of EU credit metrics, Italy has seen a slight decline 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. Other EU governments have requested that the ECB, EFSF, and IMF 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 87 (1 is best) is weak.

The World Bank's Doing Business Survey*	2012 Rank	2011 Rank	Change in Rank
Overall Country Rank:	**87**	**83**	**-4**
Scores:			
Starting a Business	77	67	-10
Construction Permits	96	93	-3
Getting Electricity	109	108	-1
Registering Property	84	82	-2
Getting Credit	98	96	-2
Protecting Investors	65	60	-5
Paying Taxes	134	131	-3
Trading Across Borders	63	63	0
Enforcing Contracts	158	158	0
Resolving Insolvency	30	30	0

* Based on a scale of 1 to 183 with 1 being the highest ranking.

Economic Freedom

As can be seen below, Italy is above average in its overall rank of 59 for Economic Freedom with 100 being best.

Heritage Foundation 2012 Index of Economic Freedom

World Rank 59*

	Rank**	2011 Rank	Change in Rank	World Avg.
Business Freedom	**77.4**	77.3	0.1	64.3
Trade Freedom	**87.1**	87.6	-0.5	74.8
Fiscal Freedom	**55.0**	55.4	-0.4	76.3
Government Spending	**19.4**	28.6	-9.2	63.9
Monetary Freedom	**82.0**	82.1	-0.1	73.4
Investment Freedom	**75.0**	75.0	0.0	50.2
Financial Freedom	**60.0**	60.0	0.0	48.5
Property Rights	**50.0**	50.0	0.0	43.5
Freedom from Corruption	**39.0**	43.0	-4.0	40.5
Labor Freedom	**43.0**	44.4	-1.4	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	1.7	**1.0**	**1.0**
Social Contributions Growth %	2.0	1.4	**1.0**	**1.0**
Grant Revenue Growth %	0.0	0.0		
Other Revenue Growth %	2.3	5.0	**1.0**	**1.0**
Other Operating Income Growth%	0.0	0.0		
Total Revenue Growth%	3.1	1.9	**(2)**	**(1.8)**
Compensation of Employees Growth%	2.5	(1.2)	**1.0**	**1.0**
Use of Goods & Services Growth%	4.5	1.2	**1.2**	**1.2**
Social Benefits Growth%	3.2	1.7	**1.7**	**1.7**
Subsidies Growth%	2.9	(6.3)		
Other Expenses Growth%	(4.4)	(4.4)	**1.0**	**1.0**
Interest Expense	0.0	4.0	**5**	
Balance Sheet				
Currency and Deposits (asset) Growth%	(20.6)	(3.5)	**0.9**	**0.9**
Securities other than Shares LT (asset) Growth%	7.0	9.3	**1.2**	**1.2**
Loans (asset) Growth%	17.6	14.4	**1.0**	**1.0**
Shares and Other Equity (asset) Growth%	2.1	(3.4)	**2.0**	**2.0**
Insurance Technical Reserves (asset) Growth%	3.0	6.2	**6.2**	**6.2**
Financial Derivatives (asset) Growth%	0.0	0.0		
Other Accounts Receivable LT Growth%	0.8	0.5	**0.5**	**0.5**
Monetary Gold and SDR's Growth %	0.0	0.0	**5.0**	**5.0**
Other Accounts Payable Growth%	2.4			
Currency & Deposits (liability) Growth%	2.5	(3.0)	**0.5**	**0.5**
Securities Other than Shares (liability) Growth%	7.3	(4.9)	**(3.4)**	**(3.4)**
Loans (liability) Growth%	7.2	3.1	**3.1**	**3.1**
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	PNov-12	PDec-13	PDec-14
Taxes	441,511	447,591	455,303	459,856	464,454	469,099
Social Contributions	212,555	213,398	216,340	218,503	220,688	222,895
Grant Revenue	0	0	0	0	0	0
Other Revenue	52,715	53,970	56,691	57,258	57,830	58,409
Other Operating Income	0	0	0	0	0	0
Total Revenue	706,781	714,959	728,334	735,617	742,973	750,403
Compensation of Employees	171,050	172,085	170,052	171,753	173,470	175,205
Use of Goods & Services	89,676	90,484	91,527	92,582	93,649	94,729
Social Benefits	336,211	344,032	349,721	355,504	361,383	367,359
Subsidies	16,743	17,786	16,673	16,675	16,676	16,678
Other Expenses	83,231	76,325	73,004	77,088	73,734	77,859
Grant Expense	0	0	0	0	0	0
Depreciation	30,118	31,359	31,293	31,293	31,293	31,293
Total Expenses excluding interest	710,286	714,285	715,597	744,895	750,206	763,122
Operating Surplus/Shortfall	-3,505	674	12,737	-9,277	-7,232	-12,719
Interest Expense	69,697	69,165	76,059	94,560	92,050	96,652
Net Operating Balance	-73,202	-68,491	-63,322	-103,838	-99,282	-109,371

Base Case
ANNUAL BALANCE SHEETS (MILLIONS EUR)

ASSETS	Dec-09	Dec-10	Dec-11	PNov-12	PDec-13	PDec-14
Currency and Deposits (asset)	81,951	93,271	90,000	90,810	91,627	92,452
Securities other than Shares LT (asset)	18,298	21,004	22,957	23,232	23,511	23,793
Loans (asset)	55,045	58,464	66,876	67,545	68,220	68,902
Shares and Other Equity (asset)	130,471	123,357	119,176	121,560	123,991	126,471
Insurance Technical Reserves (asset)	1,513	1,456	1,546	1,642	1,743	1,851
Other Accounts Receivable LT	125,899	125,538	126,151	126,767	127,386	128,008
Monetary Gold and SDR's						
Additional Assets	(902)	(894)	(16,758)			
Total Financial Assets	412,275	422,196	409,948	431,555	436,479	441,477
LIABILITIES						
Other Accounts Payable						
Currency & Deposits (liability)	220,713	220,740	214,182	214,182	214,182	214,182
Securities Other than Shares (liability)	1,526,411	1,542,773	1,467,340	1,417,119	1,368,616	1,321,774
Loans (liability)	135,843	136,902	141,175	141,175	282,350	423,525
Insurance Technical Reserves (liability)						
Financial Derivatives (liability)	646	646	646	646	646	646
Other Liabilities	56,796	62,162	68,511	244,177	244,177	244,177
Liabilities	1,940,409	1,963,223	1,891,854	2,017,299	2,121,504	2,235,874
Net Financial Worth	(1,528,134)	(1,541,027)	(1,481,906)	(1,585,744)	(1,685,026)	(1,794,397)
Total Liabilities & Equity	412,275	422,196	409,948	431,555	436,479	441,477

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