

Primus Guaranty Ltd.

Major Rating Factors

Strengths:

- Well-known player in a highly fragmented credit default swap (CDS) market
- Strong portfolio management underpins rapidly growing CDS portfolio
- Liquidity and subsidiary cash flows readily cover parent debt obligations

Weaknesses:

- Pressure on earnings due to narrowing revenue diversification in the near term
- Launch of hedge-fund effort was poorly timed and ultimately costly
- Declining non-GAAP economic results

Rationale

The ratings on Primus Guaranty Ltd. are based on the company's position as a well-known player in the highly fragmented CDS market, with strong portfolio management underpinning a rapidly growing CDS portfolio. The portfolio demonstrates liquidity and subsidiary cash flows that readily cover parent debt obligations. Offsetting these strengths are the company's pressured earnings due to narrowing revenue diversification in the near term; costly and untimely launch of a recent hedge-fund effort that has been abandoned; and declining non-GAAP economic results. Headquartered in Bermuda, Primus Guaranty Ltd. is a leading provider of credit default protection through its principal operating subsidiaries, Primus Financial Products LLC (PFP; AAA/Stable/—) and Primus Asset Management Inc. (PAM; not rated), notwithstanding its relatively small portfolio size of \$24 billion in comparison with a fragmented and burgeoning \$45 trillion market.

Despite its portfolio size, Primus is a leading provider of credit protection. Management formed this consolidated company and structured the first derivative product company (DPC),

Counterparty Credit Rating

BBB+/Negative/—

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PPF, in 2002, during the first credit cycle when risk transfer came into vogue. Management's experience and exposure to corporate and financial counterparties has served the company well. Recent entrance to the market in 2007 by numerous peers adds a measure of credence to the business idea and some market validation to the company's business model.

Primus' portfolio more than doubled to \$24 billion in 2007 from \$10.5 billion in 2004. The company has stuck with its strategy of writing protection on single-name corporate issuers. Discrete single names comprise 80% of the portfolio's notional value. These same single names provide the foundation for its "bespoke" tranches that are based on pools of multiple reference obligations that make up the other 20% of its business. The company can terminate positions, but absent significant credit deterioration in the reference obligation, Primus is a dedicated buy-and-hold investor. In addition to a solid market position and sound portfolio management, the management team intends to maintain two years' worth of annual debt service coverage (currently \$17.5 million) to demonstrate adequate parent company liquidity absent any cash flows from the subsidiaries. At the end of 2007, Primus Guaranty had \$85 million in cash on hand.

In the current market, investor liquidity has waned. While the integrity of Primus' DPC subsidiary, PFP, has not been jeopardized by market conditions, the flight of liquidity (i.e. investors and capital) from the markets in the past year has precluded the launch of new structured products. Primus' revenue diversification counted, in part, on the addition of new assets under management for incremental management fees. Currently, management fees for the existing five structures comprise approximately 10% of revenues, which we expect to decline in proportion as the CDS portfolio and related premiums increase faster. Management would like to grow these fees to approximately 15% of revenues.

Also in 2007, management attempted to launch Harrier, a hedge fund designed to break from the company's bread-and-butter CDS business. Although the venture was ill-fated, management had the intestinal fortitude to recognize the poor timing in short order and shut it down in fourth-quarter 2007 after some investment and operational losses. Harrier is now in the past, and the capital has been reallocated to the DPC. Nevertheless, the benefits of incremental revenue diversification through that vehicle have been eliminated.

Economic results came under pressure in fourth-quarter 2007 since Primus took a provision for credit events (which the company posted for the first time), which brought economic results into the red. Primus' actual earnings performance is better reflected through economic results than through GAAP results since the mark-to-market losses in the investment portfolio caused by spread widening and noncredit events are unrealized and have no immediate cash effect.

Standard & Poor's Ratings Services believes that the current rating on the parent company is appropriate, given that it is separated structurally from the bankruptcy-remote DPC. However, although there does not appear to be any fundamental deterioration in the credit portfolio of the DPC, the rating on Primus offers a cautious view of future economic performance at the primary subsidiary and its potential subsequent impact on the holding company.

Outlook

The negative outlook reflects our opinion that deteriorating economic results, spread widening, management's recent ill-timed foray and subsequent rapid shutdown of the Harrier hedge-fund subsidiary, and difficult market conditions thwart the launch of incremental structured products that would reenergize revenue diversification, particularly in the short to medium term. Continuing declines

in net revenues, evidence of tightening liquidity, or capital constraint could result in negative pressure on the current ratings. Conversely, if Primus stabilizes its economic results while maintaining satisfactory liquidity and capital levels, the outlook could revert to stable.

Profile: Leader In Credit Default Swap Market

Headquartered in Bermuda, Primus operates out of New York and is a leader in the credit default swap market through its derivative product company, PFP, and its asset management subsidiary, PAM. PFP is a bankruptcy-remote subsidiary that houses the \$24 billion CDS portfolio. The 'AAA' counterparty credit rating assigned to PFP is based on our assessment of Primus' legal and financial structure, portfolio composition, and operating procedures and controls. PAM houses the infrastructure that selects, deploys, monitors, and manages the CDS portfolio held within PFP. PAM also manages \$1.6 billion of assets among five structured products (CLOs and synthetic CDOs) for third parties.

Since inception in 2002, when PFP became the first derivative product company, Primus has been well recognized within the industry as a leading provider of default protection of single-name corporate reference entities despite low market share in a fragmented \$45 trillion CDS market. Primus has 47 counterparties. PFP's portfolio currently has transactions with more than 30 of them. International Swaps and Derivatives Association (ISDA) documents are in place for all of them. Primus also packages and parcels "bespoke" tranches of CDS on pools of multiple reference entities consisting largely of these single name corporates, thereby leveraging its underwriting efforts for improved efficiency.

Strategy: Maximize Revenues And Profitability

Primus' objective is to maximize the revenues and profitability of its earnings platform by selling credit protection to various counterparties and creating a diversified revenue stream by managing "bespoke" CDS tranches that are "manufactured" from these same names. Primus' counterparties and investors are typically banks that are hedging either their loan and/or trading books or hedge funds. Primus has executed ISDA documents with all 47 of its counterparties and is capable of trading at any time.

Central to the success of its strategy, Primus uses its expertise in fundamental credit analysis to appropriately price and sell CDS on single-name corporate reference obligations through PFP. PAM determines the names of the reference obligors to be included in PFP's portfolio and diligently adds appropriately sized and priced investments to a maximum acceptable leverage. Upon entering a trade, PFP collects premiums on the CDS commitments quarterly in arrears until the trade matures, unwinds, or defaults (at which time Primus would buy the reference obligation at par, if put to it, and manage its disposition). Primus is a "buy-and-hold" CDS provider, which helps preserve the integrity of its revenue stream. The corporate credits also serve as the foundation, or raw materials, for the "bespoke" CDS tranches where single names are pooled for diversification of risk across multiple reference entities. Management believes that maximum acceptable leverage is approximately 40x capital. PFP is currently levered at about 31.5x capital, leaving growth capacity at approximately \$6.5 billion under current parameters. Preservation of the 'AAA' rating at PFP is critical to the firm's existence since the rating precludes the company from having to post margin on any negative mark-to-market positions. Having to deliver collateral on swap positions could devastate the company's liquidity position.

Primus earns management fees of 25 basis points (bps)-75 bps on assets under management. Currently, \$1.6 billion is under its management in five structures (three synthetic CDOs and two high-yield and leveraged-loan CLOs). While all the structures are performing and paying appropriately, the

investor base has at least temporarily dried up, hampering the launch of any new structures and, therefore, precluding incremental revenue increases for the earnings stream.

Risk Management: Adequate

We view Primus' risk management as adequate for the rating. Market risk is taken daily through trading positions, and mark-to-market unrealized losses have mounted as credit spreads have widened since the individual transactions were written. Typically, this reflects deteriorating credit, but to a large extent, current mark to markets have been driven by lack of liquidity in the market. The supply/demand mismatch has driven fair values down even though assets are performing as expected. These unrealized losses are mitigated by Primus' buy-and-hold strategy that has prevented permanent impairments in economic results. This explains why non-GAAP economic results are more reflective of Primus' overall performance. Credit risk is appropriately underwritten through fundamental credit analysis and added to the portfolio if positive relative values are discovered.

The company's chief risk officer must approve any noninvestment-grade or nonrated credit default swap counterparties. Management has stuck to its risk tolerance appetite (credit quality remains at or above 'A' levels) instead of chasing yields to lower quality prior to the market debacle in 2007. The company has generally written its business on a weighted average spread in the mid 40 bps area for 'A' rated and better counterparties. Currently, the same or better quality business is being written in the 50 bps-52 bps range due to the lack of liquidity in the market. The company's liquidity and capital management are both adequate to support portfolio expansion and to support Primus' holding company obligations through cash on hand even if earnings were to evaporate.

Credit risk

We consider credit risk management, level, and appetite as appropriate for the rating. Primus' credit quality is prudently managed, with the company having experienced no realized losses to date. The current \$24 billion CDS portfolio consists of single-name credit swaps (80%); "bespoke" CDS tranches (20%); and a \$35 million subprime residential mortgage-backed securities (RMBS) portfolio (originally \$80 million). The 1,200 single-name corporates in the portfolio were all added as investment-grade reference entities through the portfolio. Less than 2% have migrated to noninvestment grade from investment grade via downgrade.

To date, Primus' only credit missteps involve a small portfolio of subprime RMBS initially totaling \$80 million across 11 bonds in either \$5 million or \$10 million positions that Primus had accumulated since inception. Recent downgrades in the subprime sector triggered technical defaults on six of the bonds. Primus immediately set aside \$41 million in credit provisions, reflecting deterioration of the fair value of \$45 million notional principal. The bonds continue to perform and pay as agreed. Only one of the \$5 million bonds has actually been put to Primus, although the remaining five can be put to it at any time.

Separately, the CDOs and CLOs under management continue to perform and pay as agreed with no losses taken.

Liquidity risk

We consider Primus' liquidity position to be satisfactory, with the maintenance of adequate cash balances at the parent company at the end of 2007. In addition to cash balances, Primus' management

team intends to maintain two years' worth of annual debt service coverage (currently representing \$17.5 million) to demonstrate adequate parent company liquidity absent any cash flows from the subsidiaries. At the end of 2007, Primus Guaranty had \$85 million in cash on hand.

Liquidity for DPCs is viewed somewhat differently than that for conventional financial companies. DPCs commit to purchase a defaulted asset at par and, therefore, do not fund the asset upfront. Consequently, Primus must maintain adequate liquidity to cover any defaulted bonds put to it at par. Primus' liquidity is enhanced by a \$37.5 million credit facility. This facility has been sized to provide a sufficient amount of liquidity in the event obligations need to be purchased and disposed of based on the company's largest contract from an 'A' rated counterparty.

Profitability: Weaker, But Still Adequate

Primus' economic results have weakened, but remain adequate for the current rating. Until the second half of 2007, Primus had generated uninterrupted positive earnings momentum through benign credit markets since 2002. Management has focused on blending a revenue stream that remains highly concentrated in CDS premium collection, with lucrative and steady asset management fees (that require no capital support). While credit costs (\$41 million) for prospective losses in the small subprime RMBS portfolio drove GAAP earnings into the red (\$28 million loss) in fourth-quarter 2007, they had no cash effect on non-GAAP results.

With the recent liquidity seizure in the capital markets, investment banking partners that originate structured products for Primus to manage have been unable to launch them to investors. We believe that the inability to launch new structures will keep Primus' asset management fee contribution from rising in the near future toward management's goal of 15% of revenues from its current level of about 10%. Moreover, at least in the near term, we expect this level to gradually decline since, concurrently, the liquidity squeeze has widened spreads, which are a boon for writers of credit default swaps growing the CDS portfolio. Because Primus' CDS portfolio has grown 14% to \$24 billion in the past four months alone, its contribution to total revenues has increased, further diminishing the proportion of asset management fees.

Capital: Adequate For The Rating

We consider Primus' capital, in absolute terms, to be adequate for the current rating level. Total capital of \$845 million is appropriately dispersed for the management of the company's operations. Of the total, approximately \$730 million is included at PFP. The bankruptcy remoteness of PFP permits us to view its 31.5x leverage as neither inappropriate nor troubling to the condition of the consolidated entity. We believe the company has the flexibility to leverage up to 40x (implying growth capacity of another \$6.5 billion to \$30 billion) without impairing the 'AAA' rating at the DPC. Nevertheless, lower leverage would obviously be more prudent in the current market environment.

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Financial Statistics (cont.'d)					
	—Year ended Dec. 31—				
<i>(Mil. \$)</i>	<i>2007</i>	<i>2006</i>	<i>2005</i>	<i>2004</i>	<i>2003</i>
Assets under management	26,199,117	16,513,164	14,997,840	12,217,665	N.A.
Total revenues	(492,532)	147,864	38,202	53,755	106,050

Financial Statistics (cont. 'd)

	—Year ended Dec. 31—				
<i>(Mil. \$)</i>	<i>2007</i>	<i>2006</i>	<i>2005</i>	<i>2004</i>	<i>2003</i>
% Management fees	(0.71)	0.85	0.50	0.03	0.00
% Shareowner servicing fees	0.00	0.00	0.00	0.00	0.00
% Other	100.71	99.15	99.50	99.97	100.00
Net income	(563,541)	94,891	4,083	23,685	78,471
EBITDA	(533,444)	113,982	12,777	28,701	84,130
EBITDA/interest expense (x)	(25.73)	10.51	4.80	32.58	N.A.
Total assets	887,742	902,468	673,082	542,718	321,429
Total equity	(93,462)	462,091	361,851	360,997	214,838
Total debt	422,617	423,521	298,521	173,521	98,521
Total tangible equity	(93,462)	462,091	361,851	360,997	214,838
Pretax income/assets under management (%)	(2.60)	0.64	0.06	N.A.	N.A.
Total expenses/assets under management (%)	0.30	0.30	0.22	N.A.	N.A.
Intangible/total assets (%)	0.00	0.00	0.00	0.00	0.00
Total debt/assets under management (%)	1.61	2.56	1.99	1.42	N.A.
Total debt/tangible assets (%)	47.61	46.93	44.35	31.97	30.65

N.A.-Not available.

Ratings Detail (As Of 29-Feb-2008)*

Primus Guaranty Ltd.

Counterparty Credit Rating BBB+/Negative/—

Senior Unsecured

Local Currency BBB+

Counterparty Credit Ratings History

06-Feb-2008 BBB+/Negative/—

06-Dec-2006 BBB+/Stable/—

Sovereign Rating

Bermuda AA/Stable/A-1+

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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