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Credit FAQ:

Why Europe's Top 15 Telcos' Credit Quality Is Fading

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The cuts that Europe's top 15 telecommunications companies are making in shareholder payouts and their generally improved performance in emerging markets are not enough to fully offset the adverse credit effect of weak economic conditions, regulatory changes, and competition.

The largest debt issuers in the sector, these telcos will likely spend twice as much on capital investments than on dividends this year and next, in Standard & Poor's Ratings Services' opinion. But even with dividends scaled back, in some cases firmly, these companies face deteriorating creditworthiness, especially now that the eurozone has slipped back into recession.

Negative rating actions on these companies have outnumbered positive actions so far in 2012 (see table 1). And the trend could continue into 2013.

Table 1

| Corporate Credit Ratings On The Top 15 European Telecom Companies* | | | | | |
|--|----------------|-----------------|---------------------------|---|-------------------------|
| Company | Unchanged | Downgrade | Downgrade and CreditWatch | Downward outlook revision or CreditWatch§ | Upward outlook revision |
| Belgacom S.A. | | A/Stable/A-2 | | | |
| BT Group PLC | BBB/Stable/A-2 | | | | |
| Deutsche Telekom AG | | | | BBB+/Stable/A-2 | |
| France Telecom S.A. | | | | A-/Negative/A-2 | |
| Koninklijke KPN N.V. | | BBB/Stable/-- | | | |
| Portugal Telecom SGPS S.A. | | BB+/Negative/-- | | | |
| Swisscom AG | A/Stable/-- | | | | |
| TDC A/S | | | | | BBB/Positive/A-2 |
| Telecom Italia SpA | | | | BBB/Negative/A-2 | |
| Telefonica S.A. | | | BBB/Watch Neg/A-2 | | |
| Telekom Austria AG | BBB/Stable/A-2 | | | | |
| Telenor ASA | A-/Stable/A-2 | | | | |
| TeliaSonera AB | A-/Stable/A-2 | | | | |
| Vivendi S.A. | | | | BBB/WatchNeg/A-2 | |
| Vodafone Group PLC | A-/Stable/A-2 | | | | |
| Total | 6 | 3 | 1 | 4 | 1 |

*Rating/Outlook/CreditWatch actions since Sept. 26, 2011. All ratings as of Oct. 16, 2012. §Without a rating downgrade.

Our updated aggregate forecasts for the largest 15 telecom operators point to weaker performance and deleveraging potential in 2012-2013 than we projected about one year ago (see table 2).

Below, we address frequent investor questions about how economic conditions, sovereign rating changes, financial policies, and technology changes are affecting the ratings on these 15 companies.

We view the dynamics for large borrowers headquartered in Eastern Europe (such as VimpelCom Ltd.) or the Middle East (Qatar Telecom (Qtel) Q.S.C. or Emirates Telecommunications Corp. (Etisalat) as somewhat different and therefore exclude them from this report.

Frequently Asked Questions

Why is your credit outlook for Europe's largest 15 telecom operators weaker than a year ago?

Broadly speaking, credit quality is deteriorating because of the combined impact of the recession in the eurozone (European Economic and Monetary Union), regulatory issues, and mounting competition.

Since September 2011, we've downgraded four telcos in our top 15 pool, and upgraded none. The downgrades included one "fallen angel," Portugal Telecom SGPS S.A. (PT), going to speculative-grade from investment-grade.

Moreover, we see credit quality potentially deteriorating further. In the past year, we assigned negative outlooks to two companies, and placed the ratings on two others on CreditWatch with negative implications (see table 1). In contrast, we only have one new positive outlook.

A year ago, our top 15 pool included two negative outlooks and one positive outlook. We have since downgraded the two companies on negative outlook, Belgacom S.A. and PT. We revised the positive outlook on Deutsche Telekom AG (DT) to stable because the company's plans to sell its U.S. operation to AT&T collapsed.

Two of the three negative outlooks we have currently--on PT and Telecom Italia SpA (TI)--chiefly reflect tough macroeconomic conditions in Southern Europe. For similar reasons, we placed our ratings on Telefonica S.A. on CreditWatch negative (see "Telefonica And Three Subsidiaries 'BBB/A-2' Ratings On CreditWatch Negative On Spain Downgrade," published Oct. 12, 2012) following our two-notch downgrade of Spain on Oct. 10, 2012. The negative outlook on France Telecom S.A. (FT) factors in the stiffening competition in the French market. The negative CreditWatch placement for Vivendi S.A. is based on company-specific credit issues, notably the potentially adverse impact of the company's strategic review, and follows uncertainty on the company's response to the sharply deteriorating performance of its French telecom business SFR.

Growth in telecom companies' emerging market operations hasn't been enough to offset slowing economies globally and continued deterioration in macroeconomic conditions and country risk, notably in Europe. The main aspects of country risk that have affected telecom operators in their European markets have been the sharply more volatile and costly access to capital (notably bank lending and bond issuance), and more unpredictable and generally more demanding tax environment. For our latest economic forecasts for the eurozone, see "The Eurozone's New Recession--Confirmed," published Sept. 26, 2012, on RatingsDirect on the Global Credit Portal.

We no longer anticipate a pick-up in aggregate revenues for our top 15 pool in 2013, but rather a slight decline, following a 3% drop in 2012, given the generally weak economic trends, coupled with negative impact of intense competition and regulatory changes (see table 2). Meanwhile, growth in emerging markets has ebbed, including in Brazil, which represented 7% of the top 15's aggregate revenues in 2011.

Table 2

| Standard & Poor's Aggregate Forecasts For The Top 15 European Telecom Companies | | | | | |
|--|--------------|--------------|--------------|--------------|--------------|
| (Bil. €) | 2013f | 2012f | 2011a | 2010a | 2009a |
| Revenues | 358 | 359 | 371 | 364 | 356 |
| Operating cash flow | 96 | 99 | 101 | 95 | 95 |
| Capital expenditure (capex) | (55) | (59) | (56) | (58) | (48) |
| Free operating cash flow | 41 | 40 | 45 | 37 | 47 |
| Dividends | (26) | (27) | (33) | (29) | (26) |
| Discretionary cash flow | 16 | 12 | 11 | 7 | 21 |
| Standard & Poor's adjusted | | | | | |
| Revenue growth (%) | (0) | (3) | 2 | 2 | (1) |
| EBITDA | 120 | 121 | 126 | 126 | 127 |
| EBITDA revenues | 33.6 | 33.6 | 34.0 | 34.7 | 35.5 |
| Operating cash flow / revenues (%) | 27.0 | 27.6 | 27.2 | 26.1 | 26.6 |
| Capex revenues (%) | 15.4 | 16.5 | 15.2 | 16.0 | 13.5 |
| Free operating cash flow (FOCF; unadjusted) revenues (%) | 11.6 | 11.1 | 12.0 | 10.1 | 13.2 |
| Funds from operations | 103 | 106 | 109 | 103 | 103 |
| Debt | 323 | 331 | 342 | 335 | 340 |
| Debt/EBITDA (x) | 2.7 | 2.7 | 2.7 | 2.6 | 2.7 |
| FOCF (unadjusted) debt (%) | 12.9 | 12.0 | 13.0 | 11.0 | 13.8 |
| Discretionary cash flow (unadjusted)/debt (%) | 4.9 | 3.7 | 3.3 | 2.2 | 6.1 |
| Debt/EBITDA (unweighted average; x) | 2.6 | 2.6 | 2.6 | 2.4 | 2.7 |

Ratios represent a weighted average unless otherwise specified. f--Standard & Poor's forecast. a--Actual.

How might further sovereign rating downgrades in the eurozone periphery affect your top 15 telecom pool?

Answering this question requires us to consider two groups of factors: mechanical impacts from our criteria on rating nonsovereign issuers above the sovereign in the eurozone; and other factors, such as weakening domestic demand, more shaky or expensive capital markets, or government tax hikes.

Our criteria state that the maximum rating that a company domiciled in a eurozone country can achieve depends on the relevant sovereign rating and the company's exposure to the domestic economy. For instance, we have applied these criteria to TI, PT, and Telefonica (see table 3). But as the table shows, the rating caps are rarely a constraint at the current sovereign rating levels, because telecom companies' stand-alone creditworthiness (and especially their financial leverage) would not support a higher rating anyway. PT is the only company that we currently rate at the sovereign rating cap, all others are rated lower than their relevant sovereign. That said, if we lower the rating on Portugal by one notch, we would, all else being equal, automatically downgrade PT by one notch.

Our ratings on Telefonica are not constrained by the current 'BBB-' long-term rating on Spain, because Telefonica's in our view moderate exposure to the domestic economy could allow us to rate the company as high as 'A-' if we considered its creditworthiness to be sufficient. Still, we placed Telefonica's ratings on CreditWatch negative following the Spain downgrade. The CreditWatch chiefly factors in our perception that Telefonica's heavy refinancing needs could become more difficult or expensive to meet given the lower sovereign ratings, while domestic economic stress--mainly high unemployment and weakening consumer spending power--increases.

Table 3

| | Telefonica S.A. | Telecom Italia SpA | Portugal Telecom SGPS S.A. | Hellenic Telecommunications Organization S.A. |
|--|------------------------|---------------------------|-----------------------------------|--|
| Corporate credit rating (CCR) | BBB-/Watch Neg/A-2 | BBB-/Negative/A-2 | BB+/Negative/B | B-/Negative/B |
| Business risk profile | Strong | Strong | Fair | Weak |
| Financial risk profile | Significant | Significant | Significant | Highly leveraged |
| Liquidity | Adequate | Adequate | Adequate | Less than adequate |
| Country of domicile | Kingdom of Spain | Republic of Italy | Republic of Portugal | Greece (Hellenic Republic) |
| Sovereign rating | BBB-/Negative/A-3 | BBB+/Negative/A-2 § | BB-/Negative/B | CCC-/Negative/C |
| Notches of difference between the sovereign ratings and CCRs | 1 | (1) | 1 | N.M. |
| Exposure to domestic country risk † | Moderate | High | High | High |
| Maximum difference in notches between the sovereign ratings and CCRs | 3 | 2 | 1 | N.M. |
| Theoretical cap based on sovereign rating | A- | A | BB+ | No rating cap |
| Gross reported debt at year-end 2011 (bil. €) | 66.3 | 42 | 12.3 | 4.9 |
| BICRA | Group 5 | Group 4 | Group 7 | Group 10 |

*Ratings and assessments as of Oct. 16, 2012. § Unsolicited publica information ratings. † Based on our assessment of country risk exposure for the telecom operator and the current sovereign rating. BICRA--Banking Industry Country Risk Assessment. N.M.--Not meaningful.

For more information, see "Credit FAQ: How Sovereign Credit Quality Affects The Ratings On Southern European Telecoms Incumbent Operators," published May 17, 2012.

All else rarely remains equal, however, in the event of sovereign and economic stress. Numerous additional factors can prompt us to rate a telecom company lower than the rating cap derived from the sovereign rating, including:

- Weakening domestic demand, including increasingly price-sensitive consumers, leading to heightened revenue and margin erosion;
- Additional government levies, notably in the form of taxes;
- Reduced or significantly more expensive access to the capital markets, which may be because the market benchmarks companies close to the sovereign rating level, or because of asset managers' inability to buy corporate bonds of that under their guidelines have insufficient credit quality; and
- Deterioration in the domestic banking system, which constrains a company's ability to economically roll over

existing bank commitments, or secure fresh ones, and weakens protection for the company's cash balances. For example, we may only rate a company whose liquidity position we assess as "less-than-adequate" under our criteria at 'BB+' or lower. Given Telefonica's large debt maturities and its generation of moderate discretionary cash flow after dividends, therefore, the ability to refinance or roll over debt is all the more important.

The past few weeks, during which PT and Telefonica returned to the bond markets, have provided positive, albeit somewhat mixed signals. The return was a large relief from a liquidity standpoint--and all the more so since market demand for both companies' bonds was strong. But at the same time these issues set PT's and Telefonica's cost of funds at new levels, slightly above and slightly below 6% per year, respectively. This is at the high end of Telefonica's 5%-6% guidance for its cost of debt, and implies an increase from the 4.91% adjusted average rate disclosed in the company's 2011 annual report. That said, the company shortly thereafter took advantage of improved market conditions and raised a bond at a coupon below 5%. The €2.2 billion total of Telefonica's two latest bond issues remains, however, well below the company's annual debt maturities of €7 billion-€8 billion. PT also returned to the public bond market, and refinanced some of its debt maturities with a bond paying a 6% coupon. Even more positive in our view was TI's recent issue of five-year notes at a 4.5% coupon, well within our expectations for the company's cost of funds.

Over time a familiar place for telecom companies, the 'BBB' rating category is likely in our view to continue to see fierce competition for capital in the coming months. This is especially the case given the large debt issuers that have recently joined the category, including Spanish, Italian, and Irish sovereigns, utilities, and banks.

Meanwhile, refinancing has been easy and quite affordable by historical standards for large telecom companies based in higher rated eurozone countries, (FT and DT, for example) or outside the eurozone (TeliaSonera AB, Vodafone Group PLC, Swisscom AG). Still, many of these companies--including Vodafone, FT, and DT--also suffer from heightened competition, weak demand at home, and sizable revenue and profit exposure to countries in Europe's periphery.

Do you believe that margins for telecom companies in Europe have stabilized?

In general, yes. We have for some time pointed to a convergence in EBITDA margins in the sector, to slightly below 35%, and we expect that trend to continue in 2013.

We see continued downside risks to margins, though. This is mainly because of ongoing, brutal repricing in several large European mobile markets. Also, antitrust concerns still curtail any significant in-market consolidation in the region. This confines carriers to cross-border mergers and acquisitions (M&A), which we see as more risky and offering much more limited cost synergy potential.

The polarization of the device market between expensive, highly subsidized handsets and low-cost voice and texting "feature phones" is progressing very fast and is triggering a boom of subsidies in markets such as the U.K. This contributes heavily to mobile margin decline.

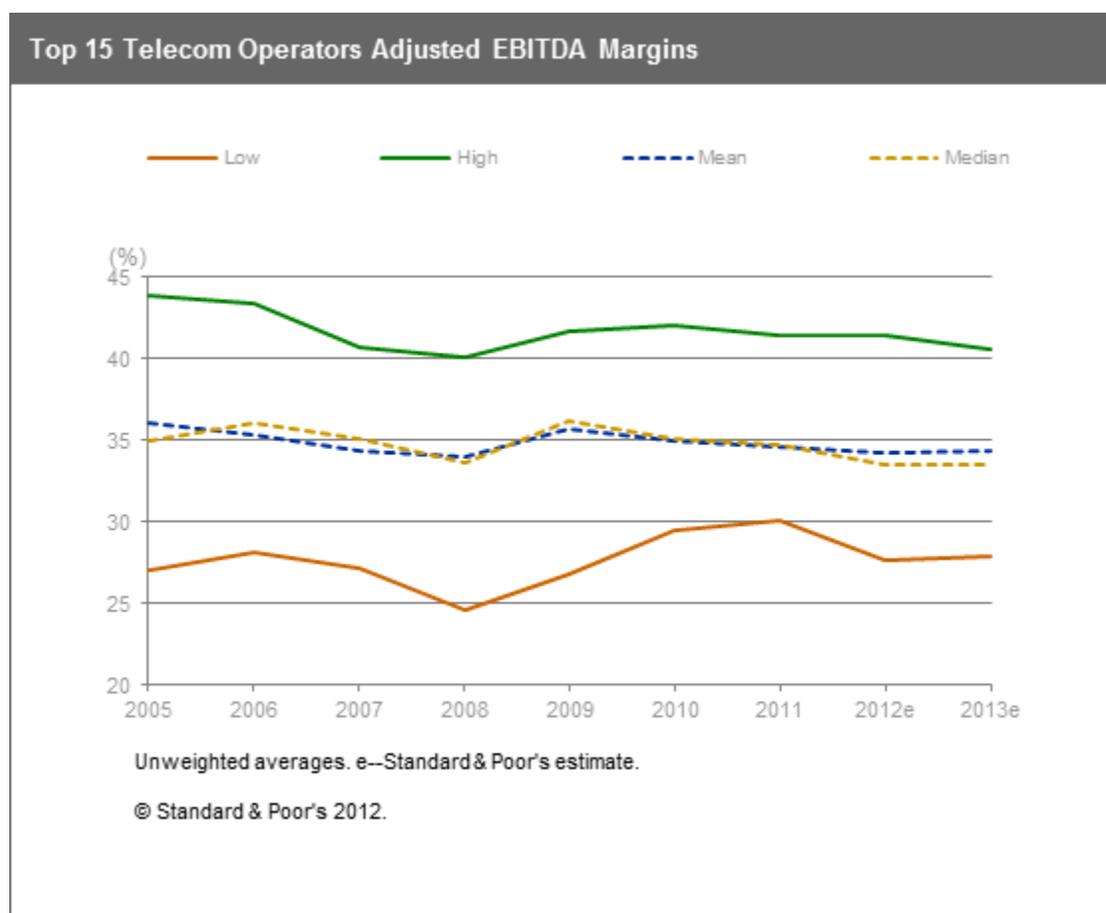
While there could be customer loyalty benefits to growing the post-paid (contract) base in the next few quarters profitability usually suffers because carriers subsidize more expensive smartphones to lure customers. In addition, the rapid pace of introduction of new smartphones, combined with consumer protection regulations, means that subsidies

tend to keep consumers loyal only for the short term, rather than over the long run.

We have additional concerns about the long-term outlook. As we have long anticipated, the monetization of booming data traffic, mainly through offerings with different volumes and download speeds of data, is difficult. A good example is Iliad, France's successful new mobile entrant, and its low-priced monthly offer of three gigabytes of data, which is likely to comfortably cover the needs of a vast majority of users on third-generation (3G) networks. In our view, Iliad's offer significantly reduces the potential for the French mobile market to monetize data growth. As data traffic by user grows, especially when fourth-generation (4G) long-term evolution (LTE) networks and handsets will be widely available across Europe, we see a significant risk that all-inclusive offers will cover a growing chunk of monthly data without raising prices significantly.

From an accounting standpoint, we see the potential for new business models to distort numbers (particularly margins) and make comparisons more difficult between players. For example, we expect KPN to keep margins at the top end of our top 15 pool, but this masks a sharp jump in investments in smartphones that we expect KPN will make as it acquires and aims to retain customers through its lease plans (see chart 1). We also see customer financing building up in some markets, such as Israel, where smartphone penetration is very high but subsidies are low. We believe Telefonica could experience wide swings in margins at its various divisions, reflecting on the one hand continued pressure in the U.K., where smartphone subsidies are very high, and on the other the discontinuation of handset subsidies for new clients in its home market.

Chart 1



Have telecom operators' recent shareholder policy changes not supported balance sheets enough?

Recent cuts in shareholder distributions have only partially offset declining margins (see table 4 and chart 2). Recently, many companies have announced more modest shareholder payout policies, citing weaker prospects for free cash flow generation, leverage reduction, or refinancing.

Table 4

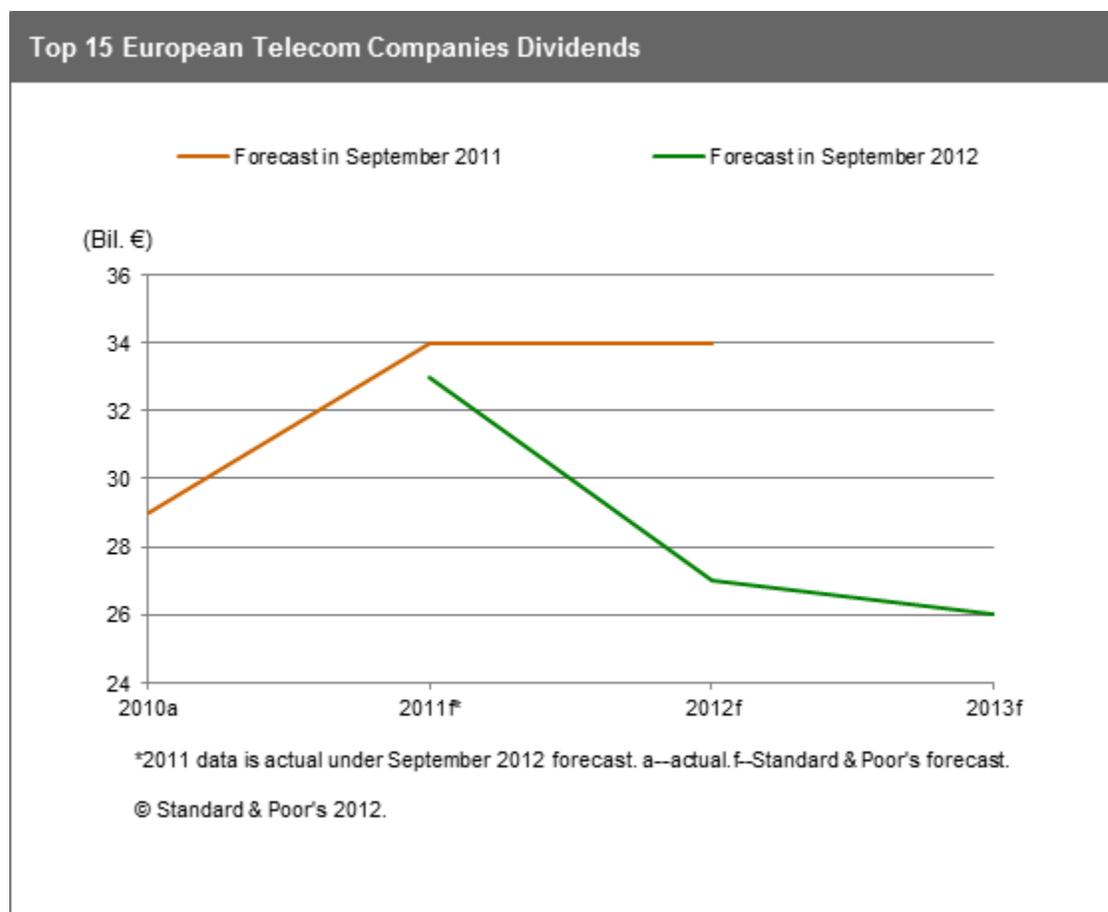
| Some Recent Changes In Telecom Operators' Shareholder Policies | | |
|--|----------------------------------|---|
| | Date | Change |
| France Telecom | June 2012 | 2012 DPS reduced to €1.21-€1.35 from €1.40. In December 2011 FT also announced that disposal proceeds would not be returned to shareholders, contrary to previous expectations. |
| KPN | July 2012 | DPS of €0.35 for 2012, down from the previously expected €0.90. Savings of €0.8 billion. |
| Portugal Telecom | June 2012 | DPS of €0.325 for 2012-2014, down from €0.65 for 2011. |
| Telecom Italia | February 2012 | €0.9 billion cash payout for 2012, down from €1.2 billion in 2011, with guidance of 15% annual growth. |
| Telefonica | July 2012 | Suspension of dividend payments in November 2012 and May 2013. Savings of €6.8 billion. This followed a scrip dividend announcement in June 2012. |
| Telekom Austria | December 2011/ September 2012 | DPS floor halved to €0.38 per share for 2011 and 2012. DPS cut to €0.05 per share for 2012 and 2013 in September 2012. |
| Vivendi | March 2012 | DPS cut to €1.00 for 2011 plus one share for each 30 owned, down from €1.40 for 2012. |

Table 4

Some Recent Changes In Telecom Operators' Shareholder Policies (cont.)

DPS--Dividend per share.

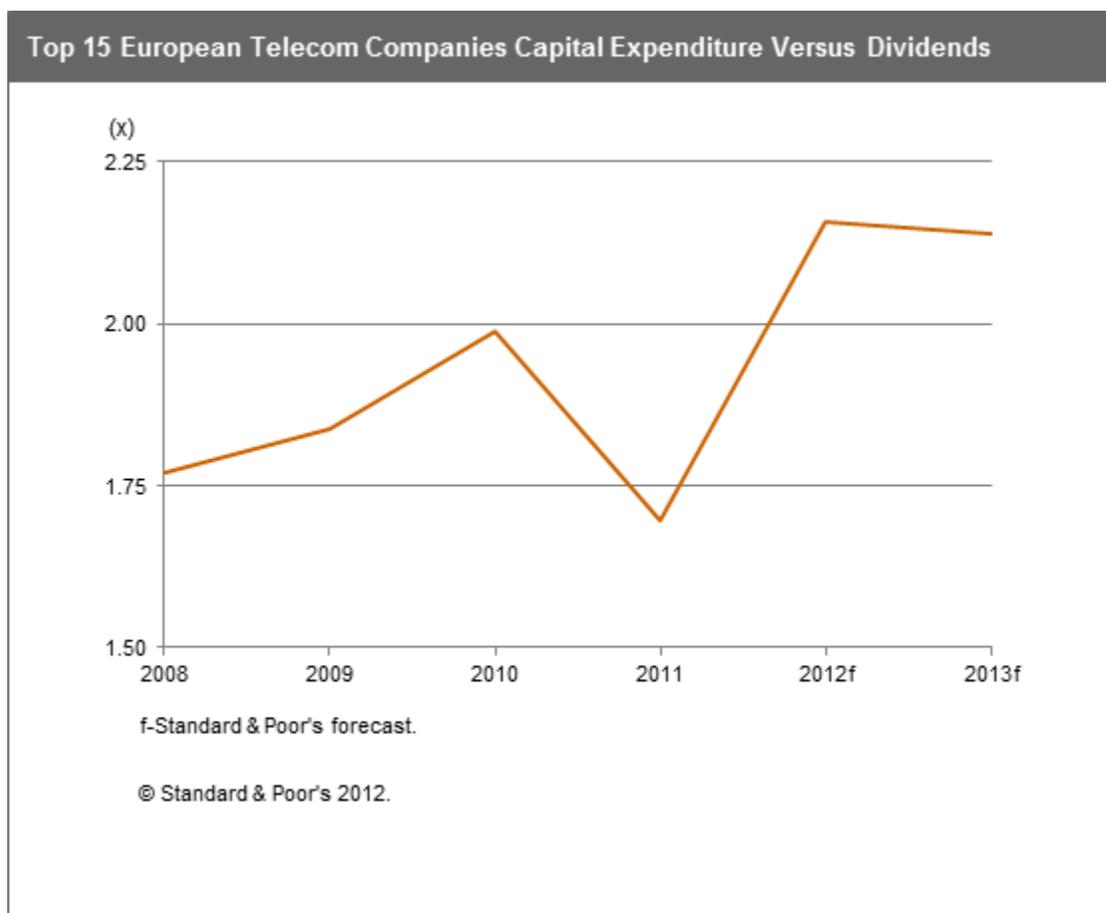
Chart 2



While the large telecom companies are on the whole trimming dividends, capital expenditure remains high. This reflects the increased pressure to roll out fiber networks to defend market shares against superior cable technology compared with traditional copper, as well as ongoing regulatory and political scrutiny on the deployment of next generation networks. On the mobile side, not yet completed spectrum acquisitions as well as spending on faster and extended 3G networks and 4G roll-outs will also likely weigh noticeably on investments.

As a result we forecast that our top 15 carriers will spend more than twice as much on capital expenditure than on dividends in the next two years (see chart 3).

Chart 3

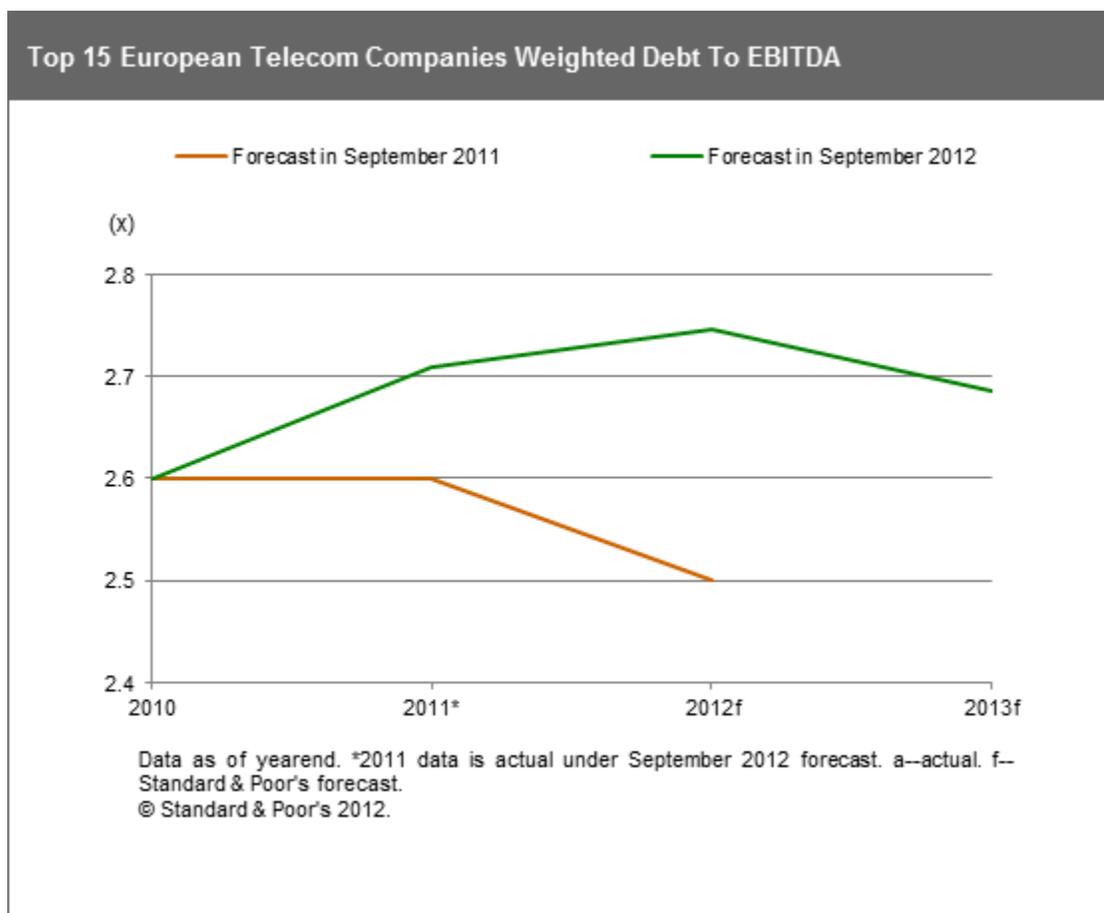


Your forecasts show broadly stable leverage for telecom operators, so why do so few have stable outlooks?

First, in contrast with our previous assumptions, we think that leverage, as measured by the ratio of debt to EBITDA, in the sector has not yet peaked. Still, weighted adjusted leverage was higher at year-end 2011 than we had anticipated (see chart 4). Although the discrepancy partly reflects the failure of just one large M&A transaction--DT's attempted sale of its U.S. business--the general trend shows that many operators had recorded significant leverage increases at year-end 2011.

In addition, coverage of debt by free operating cash flow (FOCF) will likely remain modest, in the low teen percents, while coverage of debt by discretionary cash flow (FOCF after dividends) should stay in the low single digits.

Chart 4



Moreover, at year-end 2011, some operators, notably FT and Telefonica, had leverage exceeding their own guidelines, while six telecom companies in our top 15 pool had leverage at or above our expectation for the ratings on these companies.

As we have previously explained, reducing leverage through asset disposals is difficult given current valuations and is unlikely to happen at all unless carriers commit to use full disposal proceeds to decrease leverage. All else being equal and excluding taxes, a company with leverage of 2.5x selling a subsidiary at an EBITDA multiple of 5x and returning half of the proceeds to shareholders doesn't deleverage. However, antitrust constraints and currently vibrant high-yield debt markets could help asset disposals by providing competitive bids from private equity owners.

Lately, companies based outside of the eurozone such as Swisscom, have commanded more robust valuations than their eurozone counterparts. This is even more true for non-eurozone companies with emerging market exposure such as Vodafone, Telenor ASA, and Teliasionera. These four companies were the only ones valued at more than 6x their EBITDA at the end of September 2012, based on data from Standard & Poor's Capital IQ, compared with about 5.5x on average for our top 15 pool.

Could shareholder unrest or M&A become a threat to credit quality in the sector?

Equity markets have so far absorbed dividend cuts relatively well, in our view, because the markets have largely anticipated them, and they have offset market concerns about rising leverage and liquidity risks.

There is the risk, though, that shareholder activism could result in credit-negative events such as increasing shareholder returns or M&A. We note, however, that the underperformance of KPN's and Telekom Austria AG's (TA) share prices has allowed a strategic foreign investor, America Movil, to build a large minority stake in Koninklijke KPN N.V. The initial reaction of KPN's management, which has tried to sell its Belgian business, may not necessarily have led to a deterioration in KPN's credit quality, although this could only be determined based any decision by KPN's management to reduce debt following the sale. In addition, TA has decided to cut dividends further to preserve its credit quality after America Movil bought a stake in TA.

The recent management changes and strategic review that led us to place Vivendi's ratings on CreditWatch with negative implications can, to some extent, be attributed to shareholder pressures.

We still see large acquisitions by large European players as unlikely in the near future, because we believe that valuation, regulatory, and funding constraints are likely to prevail. We still see potential for further occasional acquisitions by non-European players into selected European markets, however, primarily owing to more attractive valuation and funding dynamics.

Are Western European telecom operators becoming technology laggards?

We think this is a risk. Although 4G deployment is in its early days, we recognize that Western Europe, which was quick in adopting second- and third-generation technologies (centered around voice and data, respectively), is now trailing not only the U.S. and Asia, but also some parts of the Middle East and Eastern Europe. At June 30, 2012, the Global Mobile Technology Association, based on data from Informa, estimated that 56% of the world's LTE subscribers (who have access to superfast broadband) were in North America, 40% in Asia Pacific, and only 4% in Europe.

For Europe's telecom sector, this coincides with significant operating challenges for Nokia Corp., the continent's leading handset maker, and some of its suppliers such as STMicroelectronics N.V.. European carrier equipment firms, although widely diversified globally, are facing unabated margin contractions owing to continued weak demand in Europe and relentless Asian competition.

European telecom carriers are nonetheless focusing with renewed vigor on network investments, although large investment needs in terms of subscriber acquisition and retention costs due to competition constrain budgeted capex. Strategies aiming to maximize margins and shareholder returns, such as that of KPN for many years, are now more often competing with more long-term approaches to differentiate markets through heavy network investments, such as at Swisscom, for example.

In fixed line, the focus on investment doesn't seem so obvious, in our view, despite continuously stiff competition from cable players, in particular. The choice of many operators to enrich their fixed-line offering mostly by upgrading the copper infrastructure (through VDSL {very-high-bit-rate digital subscriber lines}, for example), as opposed to rolling out fiber networks, shows they have significant concerns on returns on investment, regulatory frameworks, and,

potentially, the long-term competitiveness of fixed infrastructures against mobile in some market segments. Still, we foresee continued robust investment in fixed line to upgrade networks.

This is why we project capital expenditures will remain above 15% of sales in 2013, even after large 4G license and spectrum (frequencies) acquisition investments that in our view peaked in 2012. Some countries still haven't sold 4G spectrum, including the U.K., which we now expect to be paid for in 2013. Other Western European countries yet to sell 4G spectrum include Austria, Belgium, and the Netherlands.

Related Criteria And Research

- Peer Comparison: Europe's Telecom Incumbents Preserve Strong Business Risk Profiles, For The Moment, Oct. 2, 2012
- Credit FAQ: How Sovereign Credit Quality Affects The Ratings On Southern European Telecoms Incumbent Operators, May 17, 2012
- Key Credit Factors: Business And Financial Risks In The Global Telecommunication, Cable, And Satellite Broadcast Industry, Jan. 27, 2009

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