

ANALYSIS

Swisscom AG

Switzerland

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Corporate Profile

Swisscom is the leading fixed-line and mobile operator in Switzerland

Swisscom AG (A2, stable) is the leading telecommunications operator in Switzerland, servicing 5.6 million fixed lines, of which almost 1.8 million are fixed-line broadband connections, and more than 5.6 million mobile customers as of fiscal year-end 2009. Swisscom has a nationwide presence, delivering a full range of services and products, including telephony, data exchange, interactive content, TV and ICT solutions. The group is also present in one of the most attractive broadband markets in Europe via the Italian provider Fastweb, which Swisscom acquired in May 2007. Fastweb is the second-largest broadband telecoms company in Italy and operates its own network, via which it offers products and services for voice, data, internet and TV. Moody's considers that Fastweb fits well with Swisscom's strategy to diversify into broadband assets with substantial growth potential.

Swisscom's most significant division is Residential, which contributed more than 50% of the group's EBITDA during 2009 (see Figure 1). The Wholesale revenues decline was primarily driven by price reductions from roaming by foreign customers on the Swisscom mobile network as well as from lower prices for (broadband) services for other telecommunications providers. This reduction in revenue could not be offset by additional revenue from the unbundling of the local loop. Fastweb's growth continued in 2009 and Moody's expects both sales and EBITDA to increase by 5% in 2010. Currently Fastweb is under investigation because of some illegally termination fees applied in Italy back in 2004 and 2005. We expect Fastweb to set aside a maximum provision of €70 million (CHF100 million) based on the financial risks (VAT credits and possible fines).

This Analysis provides an in-depth discussion of credit rating(s) for Swisscom AG and should be read in conjunction with Moody's most recent Credit Opinion and rating information available on [Moody's website](http://www.moody.com).

FIGURE 1

Operational Highlights

(CHF MILLION)	REVENUES			EBITDA		RELATIVE (%) CONTRIBUTION		EBITDA MARGIN	
	2009	2008	CHANGE	2009	2008	2009	2008	2009	2008
Residential	4,722	4,774	-1.1%	2,908	2,962	62.3%	61.9%	61.6%	62.0%
Small & Medium Size Enterprises	1,101	1,097	0.4%	850	816	18.2%	17.0%	77.2%	74.4%
Corporate	1,678	1,750	-4.1%	951	943	20.4%	19.7%	56.7%	53.9%
Wholesale	877	975	-10.1%	477	603	10.2%	12.6%	54.4%	61.8%
Fastweb	2,783	2,698	3.2%	831	864	17.8%	18.0%	29.9%	32.0%
Other	840	904	-7.1%	-1,351	-1,340	na	na	na	na
Total Swisscom (consolidated)	12,001	12,197	-1.6%	4,666	4,789	100.0%	100.0%	38.9%	39.3%

Source: Swisscom.

Moody's expects a better outlook for Swisscom in 2010, driven by better economic conditions. The group has lost revenue on its high-margin core domestic assets and it will have to be compensated with growth in low-margin businesses such as IT and IPTV.

Government-Related Issuer Methodology

Swisscom is a government-related issuer according to Moody's methodology

Given its 56.9% ownership by the Swiss government, Swisscom qualifies as a government-related issuer (GRI) under Moody's methodology for such entities.¹ This methodology formally disaggregates the rating of a GRI into four components: (i) the GRI's baseline credit risk; (ii) the credit risk of the supporting government; (iii) the default dependence between the GRI and the government; and (iv) the likelihood of government support for the GRI. In accordance with this methodology, Swisscom's A2 rating reflects the combination of the following inputs:

- » A baseline credit assessment (BCA) of 8, reflecting Swisscom's leading positions in the Swiss market for wireline and wireless services.
- » The Aaa local currency rating of Switzerland, whose government supports the company.
- » The low default dependence between Swisscom and the government, reflecting the weak correlation between the strength of the company's credit profile and Swiss economic trends (despite Swisscom's importance to the national economy).
- » A medium level of government support, reflecting the Swiss government's history of support towards GRIs and the strategic importance of Swisscom to the Swiss state. The state holds a majority stake of 56.9% in Swisscom, which leads Moody's to assume that the Swiss government would intervene in the event of the group encountering financial stress. The government demonstrated its readiness to intervene in 2005, when it objected to a foreign expansion strategy. As long as the state holds a substantial equity stake in Swisscom, Moody's would expect there to be no major change in government behaviour, especially in cases of financial stress. The

¹ Please refer to Moody's Rating Methodology entitled "[The Application of Joint Default Analysis to Government-Related Issuers](#)", published in April 2005, and its accompanying press release. Please also refer to Moody's Special Comment entitled "[Rating Government-Related Issuers European Corporate Finance](#)" for a detailed discussion of the application of the GRI rating methodology to issuers in Europe.

government indicated as long ago as autumn 2005 that it would seek to exit as a shareholder to give Swisscom full strategic autonomy in a market facing increasing competition. However, privatisation has been postponed, signalling that privatisation remains a politically sensitive issue that still lacks consensus in Switzerland. The government is concerned about three issues related to the privatisation of Swisscom: (i) the impact it would have on the company's universal service obligation; (ii) the company's shared infrastructure with the military; and (iii) the government's residual ownership and the company's future owner.

The A2 rating of Swisscom is most sensitive to changes in the BCA, followed by changes in the probability of government support, while Switzerland's Aaa rating and the default dependence are less likely to change. If the BCA were to improve, Swisscom's rating would not automatically be upgraded; however, a one-notch downward revision of the BCA would be likely to trigger a one-notch downgrade of the final rating, provided all of the other inputs were unchanged.

Moody's might be prompted to adjust its assessment upwards, which could itself trigger a rating upgrade for Swisscom, if privatisation plans were shelved as a result of political and/or public objections, demonstrating high political sensitivity to matters related to the group and substantial reputational risks for the Swiss government. The same would apply in the event of an increase in the state's stake in Swisscom. Conversely, a concrete timetable for a substantial reduction in the state's stake in Swisscom, signalling a potentially irreversible privatisation process, could prompt us to adjust downwards our assessment of the probability of support, which could trigger a rating downgrade of one notch – or an upgrade of two notches in the hypothetical event of the support factor being reduced to zero.

Key Rating Considerations

Swisscom's rating balances qualitative and quantitative factors according to the methodology

Moody's Global Telecommunications Industry Rating Methodology² sets out how we analyse the credit risk of telecoms companies and arrive at their ratings. This rating methodology replaces that published in February 2005. While following the same core principles of the former methodology, the revised version incorporates refinements that better reflect the changing telecoms landscape and the way that Moody's applies its industry methodologies.

Under the methodology grid, the suggested rating for Swisscom is A3, as summarised in Figure 2 and based on the group's 2009 financial statements. The methodology grid output and the rating are different because of GRI factors and because of the execution risk derived from its investment in Italy.

Measurements are quantitative where Moody's can define an appropriate metric. However, for some sub-factors, qualitative judgment or empirical observation is necessary to determine the appropriate category. Of the 13 sub-factors, four are qualitative and nine are quantitative. However, it is important to note that two of the qualitative sub-factors (Business Model and Competitive Environment, and Technology Risk) include quantitative measures that guide the overall qualitative assessment.

The qualitative factors mostly reflect the benefits associated with Swisscom's status as a fixed-line incumbent. As a general point, Moody's would not expect any significant rating migration in the

² Please refer to [Moody's Global Telecommunications Industry Rating Methodology](#), published in December 2007.

qualitative factors of Swisscom or its peers; any medium-term change in the rating outcomes under the methodology grid is more likely to result from changes in the quantitative metrics.

Regarding Swisscom's financial strength factors, Moody's notes that the group has begun to recover from the Fastweb acquisition and in 2009 had strong financial ratios as a result of its stable underlying cash flows and the continued maintenance of its prudent financial policies and its investment strategy, established two years earlier. We expect the company to maintain ratios at this current level.

FIGURE 2

Telecoms Methodology Grid Inputs

Swisscom

RATING FACTORS	Aaa	Aa	A	Baa	Ba	B	Caa
Factor 1: Size, Scale and Business Model							
a) Size and scale				X			
b) Business model and Competitive Environment		X					
Factor 2: Operating Environment							
a) Regulatory and Political			X				
b) Technology Risk				X			
c) Market Share		X					
Factor 3: Strategy and Financial Policies							
a) Management's Financial Strategy				X			
Factor 4: Operating Performance							
a) EBITDA Margin			X				
b) EBITDA Trends			X				
Factor 5: Financial Strength							
a) Total Debt / EBITDA				2.5x			
b) RCF / Adjusted Debt				26.55%			
c) FCF / Adjusted Debt				11.03%			
d) (FFO + Interest Expense) / Gross Interest Expense		10.8x					
e) (EBITDA - Capex) / Gross Interest Expense			6.2x				
Rating:							
a) Indicated Rating from Methodology			A3				

* Based on 2009 Results

The rating outlook is stable, based on the strength of Swisscom's operations, the implicit support from the government and our expectation that the group will remain prudent in terms of taking advantage of its financial flexibility. Moody's expects that changes in Swisscom's credit metrics will be the key drivers of any future changes in the BCA.

Rating Factor Analysis

Factor 1: Size, Scale and Business Model

Sub-factor (a): Size and Scale (Baa)

A key determinant of a company's credit quality is its size and total annual revenues. Specifically, larger companies are generally more broadly diversified, which allows them to reduce volatility and provides

them with the flexibility to generate cash from the divestiture of certain operations, if needed. Larger companies also benefit from greater financial resources and economies of scale. In light of Swisscom's annual revenues of around CHF12 billion (USD11.5 billion), Moody's ranks the group in the Baa category, which is afforded the single heaviest weighting in the methodology grid (15%).

Factor 1 (sub-factor b): Business Model and Competitive Environment (Aa)

Moody's views an integrated telecoms business model as more robust than either a stand-alone fixed-line operation or a wireless business because of the ongoing pace of technological change. Swisscom follows an integrated business model, with its wireless business contributing around 50% of total domestic revenues.

Moody's assesses how competitive a particular telecoms market is by examining the industry structure and number of players. The Swiss telecoms market is one of the most highly developed markets in the world and is characterised by a wide range of voice and data communications services and permanent innovation. Swisscom's operational momentum both in the fixed and mobile segments continues, with the group gaining further share in the digital pay TV market.

The Swiss wireline telephony market is largely saturated and highly competitive, a result of the liberalisation of the market and introduction of carrier pre-selection in 1998. Given that the number of lines that use pre-selection and are fully unbundled has recently increased, there is now greater competition to provide telephone, television and internet services.

Other than Swisscom, only cable network operators have their own fixed-line infrastructure in Switzerland. Cable TV operators are amongst the most dynamic operators in the fixed-line voice market due to relatively attractive 3-play bundle offers (TV/broadband/voice). The performance capability of Switzerland's cable networks has been steadily improving, with infrastructure now covering 85% of the country's households. Although Cablecom, the Swiss cable operator and main competitor to Swisscom, continues to struggle in the market, Moody's expects a re-launch of the company at some point during 2010.

Moody's believes that the most significant challenge for Swisscom is broadband, given the market's relative immaturity, although specialised companies such as Skype are posing new challenges to the classical voice communications market. Swisscom's ability to offer superior content and convergent services, such as video on demand, is therefore fundamental to its product differentiation and technology leadership.

Switzerland is a good example of a mobile market that appears mature (over 113% population) on the surface, but on closer inspection is surprisingly dynamic. New services are being created and old ones are being given a second chance, with operators continually redefining what they offer. The country has three operators of third generation mobile networks: Swisscom, with an overwhelmingly leading position; Sunrise; and Orange. Without the expected merger Orange/Sunrise (prohibited by the Swiss Competition Commission as of 22 April 2009), Swisscom's dominant position in the Swiss telecommunications market would be maintained.

In Italy, unlike Switzerland, there is no full scale infrastructure competition in the broadband market between digital subscriber line (DSL) providers and cable network operators. The Italian broadband market is still a low penetrated market, with only around 47% of households and businesses covered. Fastweb is the second-largest broadband provider in Italy, after Telecom Italia.

Moody's has therefore assigned a Aa score to Swisscom for this factor.

Factor 2: Operating Environment

Sub-factor (a): Regulatory and Political Framework (A)

Moody's scores Swisscom A for this sub-factor, reflecting the long-established, predictable regulatory environment, which is unlikely to change, and the established political environment.

In fixed line, although the unbundling process was introduced in 2007, the unbundled local loop (ULL) is still to be fully implemented. Unbundling was deliberately restricted to existing networks, i.e. copper wire and cable ducts, to avoid modern fibre-optic networks being subject to existing regulation and to provide certain incentives for companies to make investments in such technology.

A main threat to wireless operations comes from the continued decline in mobile termination rates (MTRs). MTRs remain relatively high in Switzerland, with the last cut in January 2010, of 10%, lowering Swisscom's rate to CHF0.14 (€0.097, compared with a European average rate of €0.085 at the end of 2008). Meanwhile, rates in the rest of Europe are falling by around 15-20% per annum in 2010, with larger declines expected in the future.

The main outstanding issue for Swisscom is the potential for a review of the Swiss Telecom Act, which sets out a number of the main principles for the regulation of telecoms in the Swiss market. The act needs to provide clarity and certainty in the market, especially at a time when there is significant investment in fibre in the Swiss market (with fibre being excluded from regulation under the current act).

Factor 2 (sub-factor b): Technology Risk (Baa)

Moody's ratings take into account how exposed a company may be to technological advancement and how well positioned it may be to handle such developments. Switzerland has one of the most advanced telecommunications infrastructures in Europe. In order to develop the infrastructure to the highest level, Swisscom operates a fixed network with copper and fibre-optic lines, as well as a latest-generation mobile communications network.

While setting up its new high-speed network, Swisscom continues to upgrade its asymmetric digital subscriber line (ADSL) infrastructure, thereby increasing the speed of DSL lines for broadband internet access. Another key technology issue is the group's investment in a fibre-optic network. Swisscom plans to progressively invest in a fibre to the home (FTTH) network that would give it more bandwidth than its current copper-based infrastructure. By the end of 2015, the group will have invested some CHF2 billion in expanding its fibre-optic network.

Swisscom's mobile broadband network is also becoming increasingly powerful. The group's position at the forefront of the development of mobile broadband has undoubtedly been driven by the extremely bullish approach of operators to high-speed packet access (HSPA). The upgrade to HSPA+, which began in September 2009, will enable transmission speeds of up to around 28.8 Mbps.

Moody's recognises the high quality of Swisscom's network, which the group has supported with large investments in the past. While this assessment is largely qualitative, a quantitative measure that can prove helpful in the evaluation of the group's technology risk is its capital expenditure (capex)/revenues ratio, which was 16.6% as of December 2009. Therefore, Moody's has scored Swisscom Baa for this sub-factor.

Factor 2 (sub-factor c): Market Share (Aa)

The relative positioning of a telecoms operator within any given segment is important to its rating outcome, as it is indicative of the likely sustainability of its operating position and of the company's ability to exercise control over the nature and pace of development. Moody's has scored Swisscom Aa for this sub-factor, based on its leading positions in the fixed-line and wireless markets.

As the incumbent telecoms provider in Switzerland, Swisscom continues to lead the fixed-line residential and business services market, although the market is relatively competitive since Swisscom has a lower market share than the European average, with 67% in terms of traffic volume.

The Swiss broadband market, where access is offered mainly via ADSL and cable modems, has one of the highest access penetration rates in Europe (around 82% of households). Fibre-optic lines still make up less than 1%. Swisscom has one of the highest retail broadband market shares in Europe, with 54% in terms of broadband access lines as at the end of December 2009.

The Swiss mobile market exhibits certain features that distinguish it from other markets in Europe. Swisscom is a long-standing operator with one of the highest market shares in Europe – 62% in 2009 (well above the European average of around 42%). Indeed, the situation in Switzerland in 2009 regarding market share was similar to that in other European countries before 2000, which makes it more difficult for Sunrise (20% market share) and Orange (18% market share) to increase its market share, even if the merger had occurred.

Moody's does not view the entry of mobile virtual network operators (MVNOs) – which buy access to operators' networks and resell mobile phone services under their own brands – as a threat in the short term in a market where service quality (rather than price) is paramount. Indeed, Swisscom itself is Switzerland's largest MVNO as a result of its co-operation with Migros for the M-Budget plan.

Factor 3: Strategy and Financial Policies

Sub-factor (a): Management's Financial Strategy (Baa)

Swisscom's strategy and financial risk will directly affect its debt levels and credit quality, and hence is a key rating determinant. Moody's has scored Swisscom Baa for this factor, based on its predictable financial policy balanced between stockholders and creditors. However, there is potential for rating migration in the event of the group making sizeable acquisitions.

Going forward, Swisscom's financial policy is focused on:

- » Limiting its net debt to a maximum of around 2x EBITDA.
- » Acquiring or consolidating adjoining businesses both in Switzerland and in Italy. Swisscom has stated that it will seek consolidation opportunities in both the Swiss IT services market and the Italian wireline market. The group has also indicated that it has around CHF1 billion of funds for potential M&A, given the expected 2010 net debt levels and the group's leverage limit of 2x net debt/EBITDA. However, in reality, Moody's expects available funds for M&A to be somewhat higher, given that any acquired asset is likely to make some EBITDA contribution, even before we consider the scope for operating synergies.

- » Paying out around 50% of annual operating free cash flow (FCF) to shareholders in the form of dividends, which Moody's expects Swisscom to do next year, assuming that it does not make a significant acquisition.
- » Reviewing annually the strategic flexibility of the group.
- » Containing capex (with a capex/sales ratio of around 16%, including Fastweb).

Factor 4: Operating Performance (A)

The level and stability of operating margins is a key consideration in assessing risk to debt holders. When considering scores for this factor, Moody's reviews the EBITDA margin trend, as well as the absolute level. Swisscom has one of the highest EBITDA margins (above 40%) amongst its peers in Europe. Therefore, Moody's has scored the group A for this factor.

The measurement of trends in EBITDA margins reveals the trajectory of a company's earnings, and so is a leading indicator of business performance.

Swisscom is facing significant challenges to grow in a saturated market, primarily as a result of structural rather than cyclical factors, and has also been affected by line and usage deterioration (fixed to mobile) and price erosion. The group continues to implement strategies with a view to seeking further growth, including:

- » Enhancing broadband usage with new services and products, such as Swisscom's IP television. In launching this package, the group's goal is to create an integrated user experience in which conventional TV channels, internet and contents are available and easy to access via multiple devices (IPTV incl VoD and PayTV now accessible through box at home, through PC and through mobile phone).
- » Integrating the network, whereby the group carries out a rationalisation of all its networks, resulting in the creation of a single IP platform that will also deliver cost savings.
- » Acquiring and retaining profitable mobile customers – rather than focusing strictly on market share growth – through its customer-focused service culture.
- » Reducing annual overhead expenditures.

Factor 5: Financial Strength

Swisscom currently displays credit metrics that are commensurate with its BCA of 8. The group's credit metrics deteriorated over the past two years as its acquisitions and share buybacks impacted its financial flexibility. Nevertheless, Moody's anticipates there being a steady improvement of the group's financial ratios over time, and expects Fastweb to meet management's objectives in the future.

Moody's expects that Swisscom will remain prudent in terms of taking advantage of its financial flexibility, making limited debt-financed acquisitions beyond the Fastweb transaction. We also expect that the group's capex requirements will be at the same level as in 2009 (CHF 2 billion), with the capex/sales ratio remaining around 16% in the medium term.

Other Credit Considerations

Liquidity Profile

Swisscom's liquidity profile for the next 12 months is sound. Moody's believes that internal sources will enable the group to cover its debt maturities and other expected cash demands over the next 12 months.

At the end 2009, Swisscom had approximately CHF532 million of cash. In addition, Moody's estimates that the group will generate around CHF2 billion of FCF before dividends.

Furthermore, Moody's expects Swisscom's internal cash flow generation to exceed operating needs, capex and regular dividend payments. The group does not have a large amount of debt maturing in 2010. The peak in debt maturities will occur in 2011, with around CHF2 billion due in November 2011.

Moody's Related Research

Special Comment:

- » [Liquidity of Non-Financial Corporate Issuers in EMEA: A Near-Term Challenge, November 2008 \(112417\)](#)
- » [European Telecom Emerging Market Investments: Vehicles for Offsetting Declining Growth with Varying Impacts on Credit Profiles, October 2008 \(111948\)](#)

Rating Methodology:

- » [Global Telecommunications Industry, December 2007 \(106465\)](#)
- » [The Application of Joint Default Analysis to Government-Related Issuers, April 2005 \(92432\)](#)
- » [The Incorporation of Joint-Default Analysis into Moody's Corporate, Financial and Government Rating Methodologies, February 2005 \(91617\)](#)
- » [Global Telecommunications Industry, February 2005 \(91460\)](#)
- » [Rating Government-Related Issuers in European Corporate Finance, June 2005 \(93145\)](#)
- » [The Application of Joint Default Analysis to Government Related Issuers, April 2005 \(92432\)](#)

Industry Outlook:

- » [European Telecoms Service Providers Resilient, but Revenue Pressures Persist, November 2009 \(120905\)](#)

Analysis:

- » [Government of Switzerland, February 2009 \(113050\)](#)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

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