

## Swisscom AG

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# Swisscom AG

## Major Rating Factors

### Strengths:

- Switzerland's leading fixed-line and mobile telecom operator.
- Strong operating margins and free operating cash flow generation.
- Strong liquidity and proactive treasury management.
- Our belief that Swisscom will exercise financial discipline aimed at using discretionary cash flow to reduce debt.
- Moderate likelihood of extraordinary government support from the Swiss Confederation.

### Weaknesses:

- Wealthy, but mature domestic service area with low growth prospects.
- Potential for mounting regulatory and competitive pressure.
- Growth execution risks at Fastweb.

### Corporate Credit Rating

A/Stable/--

## Rationale

The ratings on Swisscom AG are supported by the group's position as the leading integrated provider of telecommunications services in Switzerland. The ratings also reflect our view of Swisscom's strong domestic free operating cash flow (FOCF) generation, strong liquidity, and proactive treasury management. In addition, the ratings are underpinned by our belief that Swisscom's financial policy will remain moderate over the long term, notably regarding its shareholder distribution policy and capitalization.

The company's stand-alone credit profile (SACP), which we assess at 'A-', is lifted by one notch to 'A' based on our view that there is a "moderate" likelihood that the Swiss government would provide timely and sufficient extraordinary support to Swisscom should Swisscom encounter periods of financial distress.

The ratings remain constrained by the limited growth prospects of the Swiss telecoms market as a result of increasing market saturation. In addition, we believe the competitive and/or regulatory pressure could increase as a result of the announced merger of alternative network operator Sunrise with the mobile operator Orange Switzerland. The merger is expected to close in the second quarter of 2010. We are also mindful that Swisscom's 82% owned Italian subsidiary, Fastweb SpA, could find it increasingly difficult to maintain its growth momentum.

### Key business and profitability developments

In 2009, Swisscom posted solid results, in our view. Revenues and EBITDA declined slightly by 1.6% and 2.6%, respectively, year on year. This was mainly because price erosion at Swisscom's domestic operations and adverse Swiss franc/euro exchange rate developments offset the continued revenue growth at Fastweb and the continued, albeit slowing broadband Internet and mobile subscriber growth. Based on constant exchange rates, group revenues fell by only 0.5% and EBITDA by 1.7% year on year.

Swisscom Switzerland's revenues and EBITDA declined by 2.5% year on year in 2009. This was mainly due to

continued revenue erosion of its traditional fixed network business as well as competitive and regulatory pressure on mobile and fixed-line telephony revenues. Efficiency improvements did not offset lower earnings.

In local currency (euro), Fastweb recorded solid revenue growth of 8.5%, primarily due to higher revenues from corporate customers and Italian government agencies. Nevertheless, EBITDA (excluding a €70 million provision to cover financial risks associated with ongoing legal proceedings at Fastweb) increased only slightly by 0.5% year on year. This was primarily due to a marked increase of bad debt allowances and lower nonrecurring compensation payments from the settlement of legal proceedings concerning illegal solicitation of customers by Telecom Italia.

We currently expect that Swisscom should be more or less able to meet its EBITDA guidance for fiscal 2010, which assumes a slight EBITDA decline of about 2.3% year on year for the group excluding Fastweb and an EBITDA increase of about 5% for Fastweb. Nevertheless, a continued weakening of the euro against the Swiss franc could likely offset the expected EBITDA growth at Fastweb. In addition, we currently have limited visibility to what extent Fastweb's operating and financial results could be negatively affected in 2010, in addition to the €70 million provision in 2009, by any findings and rulings following the current investigations of Italian authorities.

### **Key cash flow and capital-structure developments**

In 2009, Swisscom generated strong FOCF of Swiss franc (CHF) 2.2 billion (€1.5 billion), up from CHF1.7 billion in 2008. This was because the modest EBITDA decline was more than offset by lower capital expenditures, financing costs and cash taxes, and a significantly positive working capital change. We believe that Swisscom will continue to generate resilient FOCF over the medium term. In our opinion, increasing FOCF at Fastweb and efficiency improvements at Swisscom Switzerland are likely to largely offset further moderate competitive and regulatory pressure on domestic revenues and EBITDA. At the same time, we do not expect a material increase in network investments.

We view Swisscom's financial policy overall as slightly supportive for the ratings, although we consider that leverage still remains significant for the rating level. The group paid lower dividends than foreseen under its shareholder remuneration policy in 2009 in the light of the macroeconomic downturn and announced only a mild increase in dividends in 2010 to build up headroom under its 2x net debt-to-EBITDA leverage target for potential acquisitions. As a result, in our base case, Swisscom's adjusted net debt-to-EBITDA ratio is likely to improve slightly to 2.3x over 2010, from 2.4x as of year-end 2009.

### **Liquidity**

Swisscom's liquidity is strong, reflecting healthy cash balances, moderate debt maturities until the end of 2010, proactive treasury management, and solid FOCF generation.

On Dec. 31, 2009, cash and unrestricted short-term investments totaled CHF0.6 billion. Swisscom also had an undrawn CHF500 million committed syndicated revolving credit facility (RCF) maturing in March 2012, and an undrawn CHF550 million RCF maturing in December 2011. The group's bank syndicate currently comprises about 40 banks. In addition, the company has arranged a committed €350 million loan (fully undrawn) from the European Investment bank (due 2015) as well as uncommitted long-term credit facilities totaling CHF850 million (fully undrawn) to partly refinance its significant upcoming debt maturities of CHF0.7 billion in 2010 and CHF2.2 billion in 2011.

Furthermore, in 2009, Swisscom generated solid discretionary cash flow (FOCF minus dividends) of CHF1.15 billion. In 2010, Swisscom guided it would generate CHF2.6 billion in operating free cash flow (defined as EBITDA

minus investment expenditure plus/minus changes in net working capital minus minority interests), down from CHF2.67 billion in 2009, and proposed to pay dividends of CHF1,036 billion to common shareholders (CHF984 million in 2009). As a result, the company is likely to continue to generate solid discretionary cash flow generation in 2010, in our view.

## Outlook

The stable outlook reflects our belief that Swisscom will continue to successfully defend its core domestic market positions, maintain solid operating margins, and consequently generate sustainable, robust FOCF in Switzerland. In addition, we believe it reasonable to anticipate further modest EBITDA growth and positive FOCF generation at Fastweb. Furthermore, we expect that the Swiss Confederation (AAA/Stable/A-1+) will maintain its majority ownership of Swisscom over the medium term.

We would consider a positive outlook or rating upgrade if Swisscom's net debt-to-EBITDA ratio improved to about 2x on a Standard & Poor's-adjusted basis as a result of a more conservative financial policy. At the same time, we consider an upgrade would have to be supported by sustainable revenue and EBITDA growth prospects at Fastweb and expectations of strong and resilient domestic free cash flow generation.

We consider a negative outlook or downgrade would be possible--although we view it as unlikely at this stage given the existing headroom at the current rating level--if Swisscom's operating measures and/or domestic competitive positions were to weaken materially, or if management adopted a more aggressive financial policy leading to persistently weaker credit measures or our perception of a less predictable financial policy.

## Business Description

Swisscom is Switzerland's leading telecoms provider. It offers a wide range of products and services for mobile, landline, and Internet protocol (IP)-based voice and data communication and TV services via its main division Swisscom Switzerland (100% owned). On Dec. 31, 2009, Swisscom Switzerland had 5.6 million mobile customers, 3.5 million fixed telephony lines, and 1.5 million retail broadband Internet connections.

Swisscom's 82% owned subsidiary Fastweb SpA is the second-largest fixed network operator in Italy. It offers fixed-line broadband, voice, and TV services for residential and corporate customers. In addition, it acts as a mobile virtual network operator (MVNO). On Dec. 31, 2009, Fastweb had 1.6 million customers.

Swisscom IT services and various participations are reported under the division Other.

Swisscom AG was 56.9% owned by the Swiss Confederation as of Dec. 31, 2009.

## Rating Methodology

The 'A' rating on Swisscom is based on the company's stand-alone credit profile (SACP), which we assess at 'A-', and on our view that there is a "moderate" likelihood that the Swiss government would provide timely and sufficient extraordinary support to Swisscom if it encountered periods of financial distress.

In accordance with our criteria for government-related entities (GREs), our view of a "moderate" likelihood of

extraordinary government support is based on our assessment of Swisscom's:

- "Strong" link with the Swiss Confederation, primarily because the latter defines Swisscom's strategic goals and is unlikely, in our view, to reduce its majority ownership stake in the medium term; and
- "Limited" role as the Swiss government is primarily interested by the stability of Swisscom's operations and not so much by its credit standing.

For further details of our criteria on GREs see "Enhanced Methodology And Assumptions For Rating Government-Related Entities," published June 29, 2009.

## Business Risk Profile: Strong Market Position And Profitability, But Limited Growth Prospects In Switzerland

The main strengths supporting Swisscom's "strong" business risk profile, according to our terminology, are:

- An established and strong domestic position in its business and residential customer segments. As of year-end 2009, Swisscom had relatively high and sustainable market shares for fixed-line telephony (about 87%, down from 89% at year-end 2008), fixed-line broadband Internet (54%, up from 52%), and mobile telephony (stable at about 62%) subscriptions, according to company estimates. Furthermore, Swisscom estimated that it had a quickly growing subscriber market share of about 17% for pay-TV services through its IP TV offer. In addition, Swisscom is among the first telecom operators in Europe that started to invest significantly in fiber to the home (FTTH) networks--in cooperation with local Swiss utility companies--in order to sustain its competitive position against cable operators in the medium to long term. As of year-end 2009, the FTTH network was rolled out to about 120,000 households. By year-end 2015, Swisscom targets to connect more than 1.0 million households (about one-third of the Swiss population) to its fiber network.
- Swisscom's strong profitability and operating free cash flow generation compared with other European telecom incumbents. Swisscom's EBITDA margin was relatively strong and stable at 39% in 2009, despite the lower profitability of Fastweb (30% EBITDA margin), which accounted for about 18% of group EBITDA. This is because, in our view, Swisscom has significant competitive advantages over its competitors and has benefited from a relatively moderate regulatory environment. Together, this has resulted in relatively strong fixed-line and mobile market positions and above-average margins, in our view. Swisscom's competitive advantages include a large installed customer base, a modern and extensive infrastructure, a strong brand, sound technology skills, and a large distribution network, in our opinion. In addition, we view Swiss customers as less sensitive to prices of telecom services, and more sensitive to service quality compared with customers in other European countries.
- Moderate regulatory pressure. Currently, Swisscom faces less regulatory pressure than many other European telecom incumbents, in our view. This is because regulation in Switzerland continues to be retroactive, and complaints and rulings through legal instances significantly delay the implementation of regulatory measures. This creates high price uncertainty and is an advantage for Swisscom, in our opinion. The introduction of an ex-ante regulation (in cases where telecom operators are deemed to have a dominant market position) would require a change of the current law on telecommunications ("Fernmeldegesetz") and the legislative process could take more than two years. For example, local loop unbundling (LLU) was introduced in April 2007, but at a very high price. The monthly unbundling fee for the so-called last mile was initially set at CHF31. In September 2008, the Swiss regulator reduced the LLU fee to CHF18.18 (€11.96) for the year 2008, which was, however, still significantly higher than the average fee in the EU of €9.28 at October 2008. In addition, at the start of 2009,

Swisscom increased the LLU price by about 3% based on a long-run incremental cost (LRIC) calculation and LLU does not apply to VDSL (very high bit-rate digital subscriber lines) or FTTH networks.

- Fastweb's fully IP-based and triple-play-ready network covering about 11.4 million homes passed or 50% of Italy's broadband market. A potential key competitive advantage for Fastweb is that it has already rolled out an extensive FTTH network to about 2 million homes passed, through which it can offer significantly higher bandwidth speeds without further significant infrastructure investments. In addition, there is no competition from cable operators in Italy.

These supporting factors are partially offset by:

- Limited growth prospects in the wealthy, but relatively small and mature Swiss telecoms market--with about 7.7 million inhabitants and 3.4 million households. Switzerland has a high broadband Internet penetration rate of about 34% per capita at year-end 2009, which is one of the highest in Europe. Mobile phone market penetration at about 119% was about in line with the EU average at the end of 2009. As in other European countries, the fixed telephony market is on the decline both in terms of access lines and traffic, but at a much slower pace as elsewhere in Europe.
- Growth execution risks at Fastweb as a result of a less favorable regulatory environment and increasing competition in Italy. We believe that Fastweb's solid revenue growth rates are likely to slow down as broadband market penetration increases from its still relatively low level of 47% (per household) as of year-end 2009 and due to meaningful price pressure for fixed-line telecom services in the Italian market. In addition, the increase of the monthly LLU fee by 11% to €8.49, effective from Jan. 1, 2009, somewhat weakened Fastweb's competitive position against its main competitor incumbent operator Telecom Italia SpA (BBB/Stable/A-2) for residential customers. With an overall subscriber market share of about 13% as at Dec. 31, 2009, both Fastweb and integrated operator Wind Telecomunicazioni SpA (B+/Stable/--) have a significantly smaller broadband Internet market share than the Telecom Italia SpA, which controls about 57% of the broadband Internet market. In addition, Fastweb faced significant competition from attractively priced broadband Internet and telephony offerings from Vodafone AG's (A-/Negative/--) Italian subsidiary in 2009.
- Potential for mounting regulatory and competitive pressure. To date, Swisscom's three main competitors--the cable TV operator Cablecom (its network covers about 1.9 million or 56% of Swiss households as of June 30, 2009), fixed and mobile network operator Sunrise, and mobile network network Orange, a subsidiary of France Telecom S.A.--(A-/Stable/A-2), have only marginally affected Swisscom's competitive position. Nevertheless, the announced merger of Sunrise and Orange could create a competitor that has the scale and financial strength to compete more effectively with Swisscom. As a result of this merger, there are only two mobile network operators in Switzerland, which compete with a few mobile resellers such as Cablecom Mobile, Mobilezone Net, or CoopMobile. Hence, we are mindful that the Swiss regulator might become more aggressive if there is not enough competition among these operators.

## Financial Risk Profile: Strong Cash Flow Protection, Partly Offset By Policy Of Relatively High Shareholder Distribution

The main strengths of the "modest" financial risk profile, according to our terminology, are:

- Strong cash flow protection measures, owing to Swisscom's healthy and sustainable domestic FOCF generation. We expect Swisscom to continue to generate strong FOCF despite meaningful investments in mobile network

capacity and the FTTH network roll-out in Switzerland and a modest EBITDA erosion at Swisscom Switzerland primarily owing to our expectations of increasing positive free cash flow generation at Fastweb.

- Our belief that Swisscom will exercise financial discipline. We believe it will use discretionary cash flow to reduce debt and remain conservative in the event of unforeseen extraordinary circumstances. For instance, Swisscom prudently adjusted its shareholder remuneration policy in 2009 and paid 20% less than targeted in dividends to support faster debt reduction in light of the significant economic downturn and limited visibility. Furthermore, the group has consistently reduced its indebtedness and thereby improved its credit measures since the Fastweb acquisition in May 2007 (see table 3). In 2010, the group announced it would pay out only 39% of its flow to build up a strategic flexibility of about CHF1.0 billion for potential acquisitions.
- Strong liquidity and proactive treasury management.

These strengths are moderated by:

- A financial policy governed by its principal shareholder, the Swiss Confederation that aims for relatively high shareholder distributions and somewhat limits the group's ability to quickly reduce debt, if fully applied. The policy also dictates that dividend payments should remain at least stable. Furthermore, the group targets a ratio of about 2x net debt to EBITDA, which equates to a Standard & Poor's adjusted net debt-to-EBITDA ratio of about 2.5x, which is the at the upper end of what we view as a compatible leverage ratio for the current SACP.
- A moderate pension deficit that could negatively affect the group's adjusted debt ratios in case of materially deteriorating pension asset values. On Dec. 31, 2009, plan assets amounted to CHF6.8 billion, of which 26% had been invested in equity instruments.

The group's bank loans, bonds, and private placements contain change-of-control clauses. The bank loans would be due for immediate repayment if the Swiss Confederation's ownership stake in Swisscom were to fall below 35% or if another shareholder were to take control over the company. Bondholders would be entitled to sell the bonds if a another shareholder gained a majority share in Swisscom and at the same time the corporate credit rating on Swisscom fell below "BBB-".

## Financial Statistics/Adjustments

Swisscom produces consolidated financial statements in accordance with International Financial Reporting Standards.

In its assessment of the company's financial leverage, we make adjustments to Swisscom's reported figures (see table 1). Most importantly, financial debt is adjusted by operating leases, unfunded pension liabilities, asset-retirement obligations, and defeased cross-border tax lease obligations, which have been converted into bank loans over 2009.

Swisscom does not rely on any cash position to finance its ongoing operations, owing to its strong FOCF generation and ample undrawn credit facilities. Therefore, we consider nonrestricted cash and current financial assets as surplus cash and deduct it from gross debt in our calculations.

Table 1

Reconciliation Of Swisscom AG Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. CHF)*							
--Fiscal year ended Dec. 31, 2009--							
Swisscom AG reported amounts							
	Debt	Shareholders' equity	Operating income (before D&A)	Operating income (before D&A)	Interest expense	Cash flow from operations	Capital expenditures
Reported	10,010.0	6,409.0	4,666.0	4,666.0	301.0	4,380.0	1,987.0
Standard & Poor's adjustments							
Operating leases	1,100.7	--	237.0	51.0	51.0	186.0	346.0
Postretirement benefit obligations	715.9	(408.9)	28.0	28.0	6.0	113.9	--
Surplus cash and near cash investments	(625.0)	--	--	--	--	--	--
Capitalized interest	--	--	--	--	15.0	(15.0)	(15.0)
Share-based compensation expense	--	--	--	2.0	--	--	--
Asset retirement obligations	439.0	--	--	--	--	--	--
Reclassification of interest, dividend, and tax cash flows	--	--	--	--	--	(200.0)	--
Reclassification of working-capital cash flow changes	--	--	--	--	--	(140.0)	--
Minority interests	--	319.0	--	--	--	--	--
Pledged long-term financial assets to cover bank loans, which have been cross border tax lease obligations previously	(368.0)	--	--	--	--	--	--
Total adjustments	1,262.7	(89.9)	265.0	81.0	72.0	(55.1)	331.0
Standard & Poor's adjusted amounts							
	Debt	Equity	Operating income (before D&A)	EBITDA	Interest expense	Funds from operations	Capital expenditures
Adjusted	11,272.7	6,319.1	4,931.0	4,747.0	373.0	4,324.9	2,318.0

\*Please note that two reported amounts (operating income before D&A and cash flow from operations) are used to derive more than one Standard & Poor's-adjusted amount (operating income before D&A and EBITDA, and cash flow from operations and funds from operations, respectively). Consequently, the first section in some tables may feature duplicate descriptions and amounts.

Table 2

Swisscom AG -- Peer Comparison*					
Industry Sector: Diversified Telecom					
	Swisscom AG	TeliaSonera AB	Koninklijke KPN N.V.	Belgacom S.A.	Telenor ASA
Corporate credit ratings¶	A/Stable/--	A-/Stable/A-2	BBB+/Stable/A-2	A+/Stable/A-1	A-/Negative/A-2
--Fiscal year ended Dec. 31, 2009--					
(Mil. €)					
Revenues	8,092.2	10,655.8	13,451.0	6,064.0	11,783.9
EBITDA	3,200.9	4,222.4	5,324.7	2,066.6	3,724.3
Operating income (bef. D&A)	3,325.1	4,222.4	5,618.5	2,133.0	3,900.6
Operating income (after D&A)	1,859.1	2,960.1	2,949.7	1,360.6	1,594.2
Net income from cont. oper.	1,300.0	1,840.4	2,178.0	904.0	1,132.9

Table 2

Swisscom AG -- Peer Comparison* (cont.)					
Funds from operations (FFO)	2,916.3	3,120.3	4,221.7	1,736.3	3,470.5
Capital expenditures	1,561.3	1,363.4	1,780.0	663.4	2,322.6
Free operating cash flow	1,449.5	1,661.8	2,451.7	880.9	1,109.1
Discretionary cash flow	748.9	597.8	1,412.7	196.9	924.5
Cash and short-term investments	57.3	2,195.2	317.0	200.0	241.3
Debt	7,601.1	7,012.0	14,465.7	2,828.6	5,174.8
Equity	4,260.9	13,910.0	3,877.5	2,406.6	10,340.9
Debt and equity	11,862.0	20,922.0	18,343.2	5,235.1	15,515.8
<b>Adjusted ratios</b>					
Oper. income (bef. D&A)/revenues (%)	41.1	39.6	41.8	35.2	33.2
EBITDA interest coverage (x)	12.7	18.4	5.8	11.6	8.8
Return on capital (%)	15.9	13.2	15.0	26.2	12.5
FFO/debt (%)	38.4	44.5	29.2	61.4	67.3
Free operating cash flow/debt (%)	19.0	23.7	16.9	31.1	23.6
Discretionary cash flow/debt (%)	9.8	8.5	9.8	7.0	20.0
Debt/EBITDA (x)	2.4	1.7	2.7	1.4	1.4
Total debt/debt plus equity (%)	64.1	33.5	78.9	54.0	33.4

\*Fully adjusted (including postretirement obligations). Excess cash and investments netted against debt. ¶Ratings as of April 13, 2010.

Table 3

Swisscom AG -- Financial Summary*					
Industry Sector: Diversified Telecom					
--Fiscal year ended Dec. 31--					
(Mil. CHF)	2009	2008	2007	2006	2005
Revenues	12,001.0	12,198.0	11,089.0	9,653.0	9,732.0
EBITDA	4,747.0	4,778.5	4,503.1	3,818.3	4,235.3
Operating income (bef. D&A)	4,931.0	4,854.0	4,574.0	3,863.5	4,274.5
Net income from continuing operations	1,928.0	1,756.0	2,068.0	1,563.0	2,013.0
Funds from operations (FFO)	4,324.9	4,029.8	3,948.9	3,335.4	3,607.7
Capital expenditures	2,318.0	2,111.2	2,304.7	1,414.7	1,115.4
Free operating cash flow	2,146.8	1,831.6	1,325.2	2,012.7	2,631.3
Discretionary cash flow	1,107.8	783.6	343.2	808.7	1,403.3
Cash and short-term investments	85.0	146.0	142.0	174.0	0.0
Debt	11,272.7	12,253.5	12,489.7	7,264.4	1,001.0
Equity	6,319.1	5,276.2	5,844.3	3,819.0	5,907.6
<b>Adjusted ratios</b>					
Oper. income (bef. D&A)/revenues (%)	41.1	39.8	41.2	40.0	43.9
EBITDA interest coverage (x)	12.7	9.9	10.3	21.1	23.8
Return on capital (%)	15.9	15.3	17.5	27.0	40.1
FFO/debt (%)	38.4	32.9	31.6	45.9	360.4
Free operating cash flow/debt (%)	19.0	14.9	10.6	27.7	262.9
Discretionary cash flow/debt (%)	9.8	6.4	2.7	11.1	140.2

Table 3

Swisscom AG -- Financial Summary* (cont.)					
Debt/EBITDA (x)	2.4	2.6	2.8	1.9	0.2
Debt/debt and equity (%)	64.1	69.9	68.1	65.5	14.5

\*Fully adjusted (including postretirement obligations). Excess cash and investments netted against debt.

#### Ratings Detail (As Of April 13, 2010)\*

##### Swisscom AG

Corporate Credit Rating	A/Stable/--
Senior Unsecured (9 Issues)	A

##### Corporate Credit Ratings History

30-Jun-2009	A/Stable/--
12-Mar-2007	A-/Stable/--

##### Business Risk Profile

Strong

##### Financial Risk Profile

Modest

\*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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