

Analysis

Moody's Global Corporate Finance

April 2009

Swisscom AG

Switzerland

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 5.4 million fixed lines, of which almost 1.8 million are fixed-line broadband connections, and over 5.4 million mobile customers as of year-end 2008. Swisscom has a nationwide presence, delivering a full range of services and products, including telephony, data exchange, interactive contents, TV and ICT solutions. Swisscom is also present in one of the most attractive broadband markets in Europe via the Italian provider Fastweb, which Swisscom acquired in May 2007 for a total purchase price of €4.1 billion, including assumed net debt of Fastweb of €1.1 billion

Moody's recognises the merits of the acquisition of Fastweb, which is a rapidly growing broadband telecoms company with an attractive network, well-balanced customer base, good brand name, strong franchise with substantial growth prospects and positive free cash flow, and which was self-funding prior to being acquired by Swisscom. In addition, 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 around 61% of the group's EBITDA during 2008 (see Figure 1).

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This Credit 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. [Click here to link.](#)



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Figure 1

Operational Highlights									
(CHF million)	Revenues			EBITDA		Relative (%) contribution		EBITDA margin	
	2008	2007	Change	2008	2007	2008	2007	2008	2007
Residential	4,771	4,787	-0.3%	2,913	3,023	60.8%	67.2%	61.1%	63.2%
Small & Medium Size Enterprises	1,098	1,072	2.4%	843	805	17.6%	17.9%	76.8%	75.1%
Corporate	1,733	1,715	1.0%	914	892	19.1%	19.8%	52.7%	52.0%
Wholesale	994	1,036	-4.1%	591	638	12.3%	14.2%	59.5%	61.6%
Fastweb	2,698	1,473	83.2%	868	498	18.1%	11.1%	32.2%	33.8%
Other	903	1,006	-10.2%	-1,340	-1,355	na	na	na	na
Total Swisscom (consolidated)	12,197	11,089	10.0%	4,789	4,501	100.0%	100.0%	39.3%	40.6%

Source: Swisscom

Government-Related Issuer Methodology

Swisscom is a Government-Related Issuer According to Moody's Methodology

Given its 55.2% 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, the company's supporting government.
- 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 government holds a majority stake of 55.2% in Swisscom, which leads Moody's to assume a significant motivation for government intervention in the event of the company encountering financial stress. The government demonstrated its readiness to intervene in 2005, when it objected to a foreign expansion strategy. As long as the government 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 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, the privatisation issue has been postponed, signalling that privatisation remains a politically sensitive issue that still lacks consensus in Switzerland. The Swiss government is concerned about three issues – the impact on the company's universal service obligation, the shared infrastructure with the military, and the government's residual ownership and the company's future owner.

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.

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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 likely trigger a one-notch downgrade of the final rating provided all of the other inputs were unchanged.

If privatisation plans were shelved as a result of political and/or public objections, demonstrating high political sensitivity to Swisscom matters and substantial reputational risks for the Swiss government, this might lead us to raise our assessment of the probability of government support, which could itself trigger a rating upgrade for the company. The same would apply in the event of an increase in the government's stake in Swisscom. Conversely, a concrete timetable for a substantial reduction in the government's stake in Swisscom, signalling a potentially irreversible privatisation process, could prompt us to lower our assessment of the probability of support, which could trigger a rating downgrade of one notch – or up to 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 New Methodology

Moody's rating methodology for the global telecoms industry² sets out how we analyse the credit risk of telecoms companies and derive their ratings. This rating methodology explains Moody's approach to assessing credit risk in the global telecoms industry, and replaces the rating methodology published in February 2005. While reflecting the same core principles of the former methodology, it incorporates refinements that better reflect the changing telecoms landscape and the way that Moody's applies its industry methodologies.

The suggested rating under the methodology grid for Swisscom is Baa1, as summarised in Figure 2 and based on the 2008 financial statements. The difference between the model output and the rating are the GRI factors.

Measurements are quantitative where we 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) articulate quantitative measures that guide the ultimate qualitative assessment.

The qualitative factors mostly reflect the benefits associated with the company's status as a fixed-line incumbent. As a general point, in common with its peers, we would not expect any significant migration in Swisscom's qualitative factors over the rating horizon; any medium-term change in the rating outcomes under the model is more likely to result from changes in the quantitative metrics.

Regarding the group's financial strength factors, Moody's notes the expectation that Swisscom will continue to pursue a conservative financial risk and investment strategy, despite the deterioration in metrics due to share buybacks and debt-financed acquisitions.

² Please refer to Moody's Global Telecommunications Industry Rating Methodology, published in December 2007.

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Figure 2

Telecoms Model Inputs							
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				2.7x			
b) RCF / Adjusted Debt					22.96%		
c) FCF / Adjusted Debt					6.07%		
d) (FFO + Interest Expense) / Gross Interest Expense			7.8x				
e) (EBITDA - Capex) / Gross Interest Expense				4.5x			

* Based on 2008 Results

The rating outlook is stable, based on the strength of Swisscom's operations, the implicit support from the government and the expectation that the company will remain prudent in terms of making use 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.

Model Rating Factor Analysis

Factor 1 (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 provide flexibility to generate cash from the divestiture of certain operations, if needed. Larger companies also benefit from greater financial resources and economies of scale. With annual revenues of around CHF12.2 billion (€8.2 billion), Moody's ranks Swisscom in the Baa category, which is afforded the single heaviest weighting in the methodology grid (15%).

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

We view 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 revenues.

Moody's considers the competitive environment for a particular telecoms market by looking at 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.

The Swiss wireline telephony market is largely saturated and highly competitive; this is a result of the liberalisation of the market and introduction of carrier pre-selection in 1998. Moody's expects that the number of lines that use pre-selection and are fully unbundled will increase in the short term. The greater the number of unbundled phone lines in the future, the greater the competition to provide telephone, television and Internet services. Other important players in the fixed market are cable providers. Cable TV operators are one of the most dynamic operators in the fixed voice market due to relatively attractive 3-play bundle offers (TV/broadband/voice). The performance capability of cable networks has been steadily improving; they have built their own access infrastructure covering 85% of households in Switzerland. We believe the most significant challenge for the company 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, and the operators keep redefining what they do. The country has three operators of third generation mobile networks: Swisscom, with an overwhelmingly leading position; Sunrise; and Orange. In November 2008, Sunrise acquired Tele2 Switzerland, which has a mobile licence and operates its own mobile network infrastructure in various Swiss cities.

The low number of new entrants partly reflects the challenges involved in gaining a foothold in a market suffering from a delay in the expansion of alternative operators – exacerbated by the fact that this is a sector in which coverage rates and service quality play a major role. In our view, the mobile market also highlights the unshakeable attachment of Swiss users to their national company.

The Italian broadband market is still a low penetrated market: only around 43% of households and businesses are covered. Fastweb is the second-largest broadband provider in Italy, after Telecom Italia.

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

Factor 2 (a): Regulatory and Political Framework (A)

Moody's scores Swisscom A for this factor, reflecting the predictable regulatory environment with a long track record that 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 coming under regulation and to provide certain incentives for investments in such technology.

A main threat to wireless operations comes from the continued decline in mobile termination rates (MTR), which will be incrementally reduced by 25% by 2009. Regulation on roaming, even though Switzerland is not part of the EU, could also have a negative impact on Swisscom, as approximately 15% of its mobile revenues come from roaming. The impact on margins is less severe than for most southern European operators, as Swisscom Mobile has significantly higher outbound than inbound traffic.

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Factor 2 (b): Technology Risk (Baa)

Moody's ratings consider how exposed a company may be to technological advancement and how well positioned it may be to handle such developments. Swisscom operates a fixed network with copper and fibre-optic lines, as well as a latest-generation mobile communications network.

While setting up the new high-speed network, the company continues to upgrade its ADSL infrastructure, thereby increasing the speed of DSL lines for broadband Internet access.

Another key technology issue is the company's investment in a fibre-optic network. Swisscom plans to progressively invest in a FTTH network that would give it more bandwidth than its current copper-based infrastructure (100,000 households connected at the end of 2009).

Switzerland's position at the forefront of the development of mobile broadband has undoubtedly been driven by the extremely bullish approach of operators to HSPA. Swisscom has enhanced its UMTS to HSPA technology, which permits transmission speeds of up to 3.6 Mbit/s.

Moody's recognises the high quality of Swisscom's network supported by high investments in the past. However, the need to increase further broadband capacity might require a larger investment in the future.

While this assessment is largely qualitative, a quantitative measure that can prove helpful in this evaluation is capital expenditure (capex)/revenues, which was 16.8% as of December 2008. Therefore, Moody's has scored Swisscom Baa for this factor.

Factor 2 (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 ability to exercise control over the nature and pace of development. Moody's has scored Swisscom Aa for this factor, based on its leading positions in the fixed-line and wireless markets.

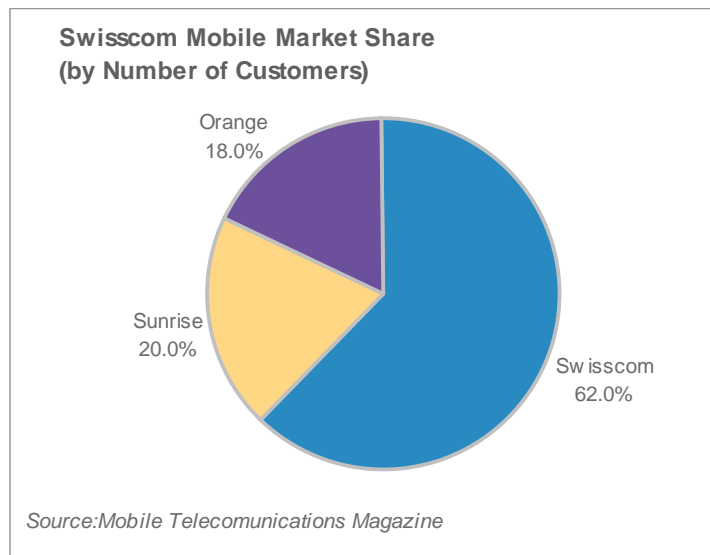
As the incumbent telecoms provider in Switzerland, Swisscom continues to lead the fixed-line residential and business services market, although the market is relatively competitive since Swisscom is situated below the European average with a market share of 67% in terms of traffic volume.

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). Swisscom has one of the highest market shares in broadband amongst its peers in Europe, with 69% in terms of market value as at the end of December 2008.

Competition in the Swiss mobile market exhibits certain distinctive features compared with other markets in Europe. Swisscom is a long-standing operator with one of the highest market shares in Europe – 62% in 2008 (well above the European average of around 42%). Indeed, the situation in Switzerland in 2008 is similar to the situation typical in other European countries before 2000, which makes it more difficult for Swisscom's main competitors, Sunrise and Orange, to increase their market shares (although these are improving moderately as consumption levels increase).

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Figure 3



We do not view the entry of mobile virtual network operators (MVNOs), who 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) plays the major role. Apart from that, Swisscom itself is the country's largest MVNO through its co-operation with Migros via the M-Budget plan.

Factor 3: Management's Financial Strategy (A)

Management's strategy and tolerance for financial risk will directly affect debt levels and credit quality, and hence is a key rating determinant. Moody's has scored Swisscom A for this factor, based on its predictable financial policy balanced between stockholders and creditors – namely the absence of major shifts in public commitments to a strong investment-grade rating.

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

- Limiting its net debt to a maximum of around 2x EBITDA
- Paying out around 50% of annual operating free cash flow to Swisscom's shareholders in the form of dividends and possible share buybacks
- Reviewing annually the strategic flexibility of the company
- Growing in adjoining business both in Switzerland and abroad
- Containing capex (capex/sales ratio 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 the scores for this factor, Moody's reviews the EBITDA margin trend, as well as the absolute level. The company has one of the highest EBITDA margins (above 40%) amongst its peers in Europe. Therefore, Moody's has scored Swisscom A for this factor.

The trend in the EBITDA margin measures the direction of earnings, as it is a leading indicator of a company's business trajectory.

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Swisscom is facing significant challenges as it struggles to grow in a saturated market that is also affected by line and usage deterioration (fixed to mobile). The company is implementing several strategies with a view to seeking further growth in its wireline business, including:

- Enhancement of broadband usage with new services and products – the launch of Swisscom's IP television as an attractive package that could generate incremental broadband revenues.
- Integration of the network through a rationalisation of its several networks to converge towards a single IP platform that will also deliver cost savings.
- Cost constraints – a reduction in the annual overhead expenditures.

The Swiss mobile market is severely affected by both termination rate cuts and price declines, which are putting pressure on operators' revenues. Moody's expects Swisscom to continue to pursue the acquisition and retention of profitable customers, rather than to focus strictly on market share growth.

Factor 5: Financial Strength

Swisscom currently displays credit metrics commensurate with its BCA of 8. Swisscom's credit metrics have deteriorated during the past two years as the company has used up its financial flexibility due to acquisitions and share buybacks. Nevertheless, Moody's expects a gradual and smooth improvement of the financial ratios over time, and also expects Fastweb to meet management's objectives over time.

Moody's expects that the company will remain prudent in terms of making use of its financial flexibility, with limited debt-financed acquisitions beyond the Fastweb transaction. Moody's also expects that capex requirements will remain at the same level as in 2008 (CHF1.9 billion), with the capex-to-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 internal sources should enable the company to cover its debt maturities and other expected cash demands over the next 12 months.

At the end 2008, Swisscom had approximately CHF1 billion of cash. In addition, we estimate that Swisscom should generate around CHF2.2 billion of free cash flow before dividends.

The company's internal cash flow generation is expected to exceed operating needs, capital expenditure and regular dividend payments. The company does not have a large amount of debt maturing in 2009. The peak in debt maturities will occur in 2010 and 2011, with around CHF2.6 and CHF2.2 billion due, respectively, as per April 8, 2009.

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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)
- New Network Investments Generally Factored into Ratings of European Investment Grade Telecoms, July 2008 (110344)
- M&A in European Telecoms – Drivers and Credit Implications, May 2008 (109030)
- Moody's Accounting Observations on the 2007 Results of Europe's Telecoms Operators, March 2008 (108180)
- Asia Pacific Telecommunications Sector, March 2008 (107866)

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:

- EMEA Wireless Telecommunications Operators, November 2008
- EMEA Incumbent and Alternative Fixed-Line Telecommunications Operators, November 2008
- European Investment-Grade Telecoms Operators, January 2007 (101251)

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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Report Number: 116863

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