

Elenia Verkko Oyj

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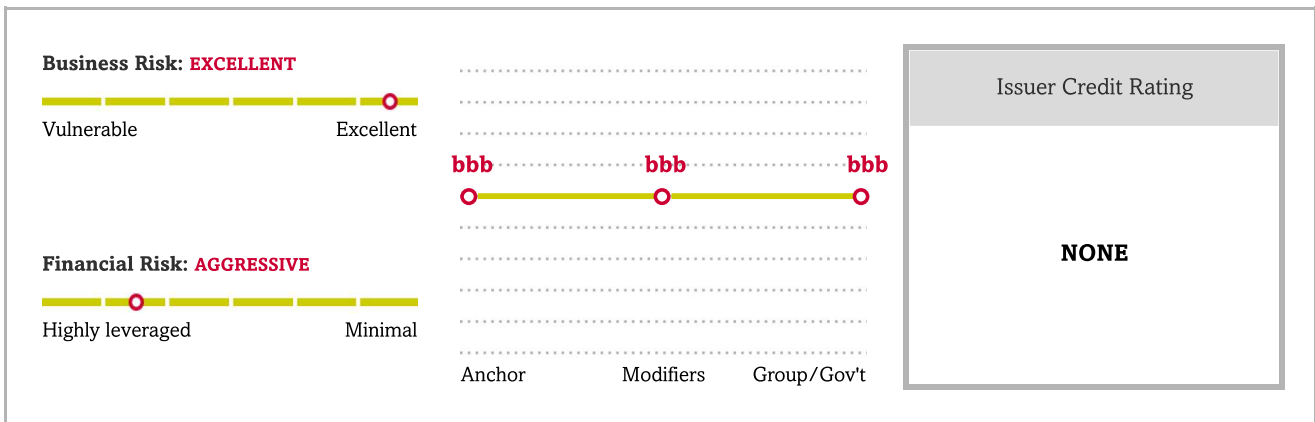
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Elenia Verkko Oyj



Credit Highlights

Overview	
Key strengths	Key risks
Finland's second-largest electricity distribution system operator, with a natural monopoly in its markets, with expected EBITDA of about €200 million for 2021.	Potential changes to the regulatory period that could affect regulatory stability and result in lower weighted-average cost of capital (WACC) and lower earnings than expected.
Stable and predictable operating cash flow within a supportive regulatory framework which account for almost 100% of EBITDA.	Operating cash flows that don't cover capital expenditure (capex) and dividends over 2021-2023, increasing leverage by almost €200 million by 2023.
Our expectation that the company will be flexible in shareholder distributions to maintain credit metrics commensurate with the rating.	High leverage and dividend payments constrain the rating with S&P Global Ratings-adjusted funds from operations (FFO) to debt around 9% and debt to EBITDA slightly below 9x over 2021-2023.
Protective financing structure.	

Negative discretionary cash flow (DCF) results in high leverage and constrains the rating. S&P Global Ratings forecasts that Elenia Verkko Oyj will spend annual capex of €140 million-€160 million to continue with network investments, including underground cabling. Although this is less than the heavy investment phase 2016-2020 that been completed, it implies significant investment is still required. Combined with shareholder distributions of about €80 million annually, we therefore forecast that DCF will remain negative and for 2021-2023 amount of about €180 million over the period. As a result, we forecast S&P Global Ratings-adjusted debt to increase by the same amount. This should, however, not lead to any material changes in Elenia's credit metrics, which we expect to remain stable, with FFO to debt close to 9% and debt to EBITDA slightly below 9x over our forecast period. This is mainly driven by investments, which consequently increases the regulated asset base (RAB). We expect RAB close to €2.3 billion by 2023, compared with €1.4 billion in 2016. We expect the company and its owners will show great flexibility in shareholder distributions, maintaining an FFO-to-debt close to 9%.

Elenia operates under a regulatory framework that we see as supportive, ensuring stable and predictable cash flows and credit metrics. Finnish electricity distribution companies have historically benefited from a stable and predictable operating environment resulting in high revenue to compensate for increasing investments needs. However, we expect Elenia's revenue to remain close to €320 million-€340 million, as WACC is downwards trending following the change of risk-free rate used in the WACC calculation. This is offset by investments and increasing RAB. We also see a risk of regulations being amended, because the Finnish government submitted changes to the Finnish Electricity

Market Act (EMA) and the Act on the Supervision of the Electricity and Natural Gas Markets. The bill includes four changes that could affect the regulatory framework for DSOs in 2022. If the bill is implemented then (in the middle of the regulatory period), with a significant and retroactive effect, resulting in material decrease of the DSO's revenue for 2022-2023, this could lead us to revise downward our assessment of the regulatory framework from strong currently. However, this is not our base-case scenario, because the regulator has historically been balanced in its updates to the framework.

Supporting features in the senior secured debt continue to uplift the rating. The rating remains one notch above the senior secured debt's stand-alone credit profile thanks to the structural features designed to increase cash flow certainty for debtholders. These include restricted payment conditions and a covenanted liquidity structure that should, in our opinion, enable Elenia to manage temporary cash flow shocks. Debtholders benefit from features that include:

- Two levels of financial covenants (trigger events and events of default) and an automatic 12-month standstill period after an event of default; and
- A €60 million liquidity facility available to draw on if the group enters a standstill, and is sufficient to cover finance charges.

Outlook: Stable

The stable outlook signifies that we expect stable earnings and credit metrics in the regulatory period, despite a falling WACC, fueled by declining interest rates. We expect FFO to debt above 8% and debt to EBITDA below 9x throughout that period, which we consider commensurate with the 'BBB+' issue rating.

Downside scenario

We could lower the rating if Elenia's FFO to debt falls below 8% or debt to EBITDA rises above 9x without clear signs of recovery. This could occur if the company increased investments or shareholder remuneration beyond our expectations.

The rating could also come under pressure if the regulator imposes and implements a substantial change to the regulatory framework during the current period (2020-2023) that would result in significantly lower remuneration, for example changing the risk-free rate component, and resulting in a lower WACC and imposing a retroactive cut to the company's RAB.

Upside scenario

We see a positive rating action as unlikely, especially given our belief that Elenia will use its additional flexibility to either expand its investment pipeline or increase shareholder remuneration. We could, however, consider an upgrade if the company were to commit to a deleveraging plan, resulting in FFO to debt sustainably above 10% and debt to EBITDA below 8x. We view this as unlikely over the outlook horizon, given the group's business plan.

Our Base-Case Scenario

Assumptions

- Finland's GDP to increase by about 2.0% in 2021, 1.7% in 2022, and 1.5% in 2023.
- Stable contribution from predictable distribution system operator activities, with the next regulatory reset date in 2024; that is, no changes to the framework in the existing period included in the base case.
- Pretax WACC at 5.35%, 4.94%, and 4.67% for 2021, 2022, and 2023, respectively.
- No tariff increases from 2021-2023.
- Shareholder distributions of about €100 million during 2021, and €60 million-€70 million in each of 2022 and 2023.
- No material acquisitions.

Key metrics

Elenia Verkko Oyj--Key Metrics*					
--Fiscal year ended Dec. 31--					
(Mil. €)	2019a	2020a	2021e	2022f	2023f
EBITDA	183	195	200-210	210-220	210-220
Funds from operations (FFO)	105	148	155-165	160-170	165-175
Capital expenditure	166	164	150-160	140-160	140-160
Discretionary cash flow	(221)	(113)	(75)-(65)	(65)-(55)	(50)-(40)
Debt	1,627	1,731	1,750-1,850	1,850-1,950	1,850-1,950
Debt/EBITDA (x)	8.9	8.9	8.5-9.0	8.5-9.0	8.5-9.0
FFO/debt (%)	6.4	8.5	8.5-9.0	8.5-9.0	8.5-9.0

*All figures adjusted by S&P Global Ratings. a--Actual e--Estimate. f--Forecast.

Company Description

Elenia's main business operation is electricity distribution. It is the second-largest electricity distribution operator in Finland behind Caruna, with a 12% market share and network of about 75,500 kilometers serving about 432,000 end users. In 2020, the company reported EBITDA of €195 million.

Elenia's main owners are Valtion Eläkerahasto, Allianz Capital Partners (ACP) on behalf of the Allianz Group, together with Allianz subsidiaries and investment vehicles managed or advised by ACP and Macquarie Super Core Infrastructure Fund.

Elenia's financing structure is ring-fenced, and the financing group is delinked from its ultimate parent. The financing group's issued debt includes structural enhancements designed to reduce the likelihood of default and risk to creditors.

Peer Comparison

Table 1

Elenia Verkko Oyj--Peer Comparison			
Industry sector: Electric			
	Elenia Verkko Oyj	Caruna Networks Oy	Ellevio AB
Issuer credit rating as of June 17, 2021	NR	BBB+/Stable/--	NR
–Fiscal year ended Dec. 31, 2020–			
(Mil. €)			
Revenue	309.9	475.3	675.9
EBITDA*	195.1	304.5	372.2
Funds from operations (FFO)	147.8	236.3	258.7
Interest expense	40.9	50.7	240.7
Cash interest paid	42.0	57.0	112.2
Cash flow from operations	164.7	167.6	309.1
Capital expenditure	164.4	150.9	343.3
Free operating cash flow (FOCF)	0.3	16.6	(34.2)
Discretionary cash flow (DCF)	(112.7)	(62.2)	(34.2)
Cash and short-term investments	113.8	60.1	1.4
Debt	1,731.0	2,503.4	3,948.4
Equity	(259.8)	688.9	2,983.8
Adjusted ratios			
EBITDA margin (%)	63.0	64.1	55.1
Return on capital (%)	6.9	5.4	2.7
EBITDA interest coverage (x)	4.8	6.0	1.5
FFO cash interest coverage (x)	4.5	5.1	3.3
Debt/EBITDA (x)	8.9	8.2	10.6
FFO/debt (%)	8.5	9.4	6.6
Cash flow from operations/debt (%)	9.5	6.7	7.8
FOCF/debt (%)	0.0	0.7	(0.9)
DCF/debt (%)	(6.5)	(2.5)	(0.9)

*Elenia and Ellevio do not report connection income the same way as Caruna, resulting in somewhat lower EBITDA for the two. NR--Not rated. S&P Global Ratings maintains issue ratings on Elenia's and Ellevio's debt.

Elenia, similar to its Nordic peers, operates within a stable regulatory environment with historical transparency and predictability. It has about a 12.7% market share in terms of network length, behind Caruna's 20.6% and Ellevio AB operating in Sweden. All three companies face similar weather conditions, so they have large capex programs to reduce outages through underground cabling and increased security of supply. However, Ellevio's capex plan is twice as large as that of Caruna and Elenia, emphasizing the need for investment in Sweden.

In addition, following the 2019 repayment of Elenia's shareholder loans, only Caruna and Ellevio have shareholder loans that we expect will not be repaid in the medium term.

Business Risk: Excellent

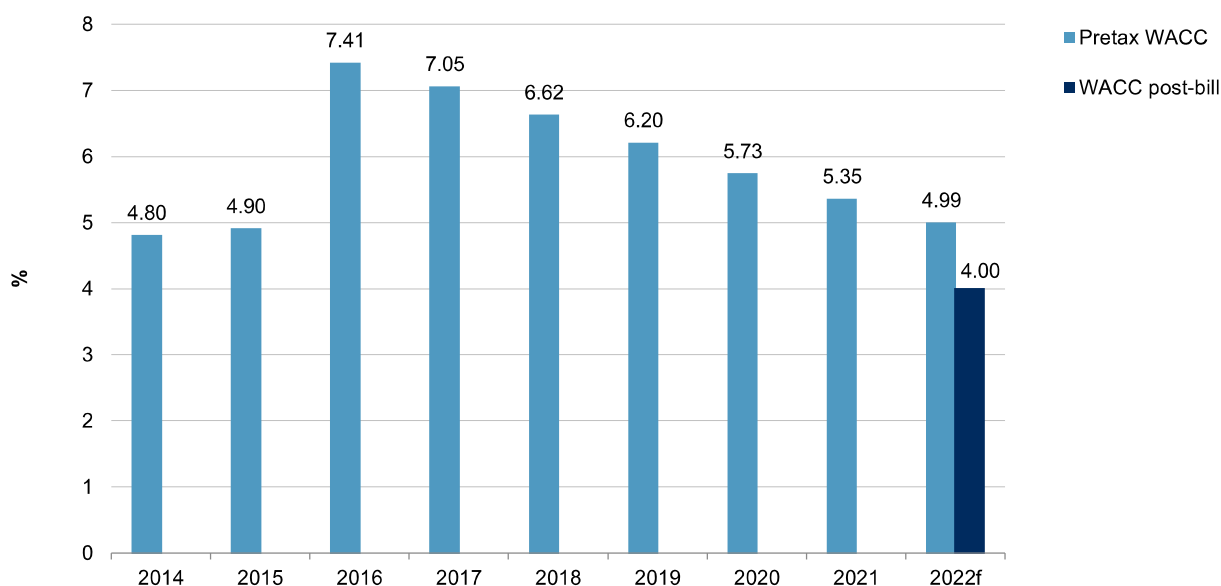
Elenia benefits from low risk, stable network operations within a framework we view as credit supportive

We view Finland's regulatory framework as stable and predictable. The methodology for calculating allowed profit has been in place since 2005, with only minor adjustments. The regulator implemented positive modifications in 2016, resulting in a higher WACC and stronger cost recoverability. The WACC is now linked to the higher of the 10-year average or previous year's (April-September) average of the Finnish government's 10-year bond.

The WACC for 2021 is 5.35%, compared with 5.73% in 2020 and 6.20% in 2019 (see chart 1). Although we expect a gradual decline in the current period because the risk-free rate is declining and WACC reset annually, we believe the framework is supportive and allows for good cost recoverability. For more information, see "Finland's Electricity Transmission And Distribution Regulatory Frameworks: Very Supportive," published May 11, 2021, on RatingsDirect.

Chart 1

Pretax WACC Evolution For Finnish DSOs



WACC--Weighted-average cost of capital. DSO--Distribution system operator. f--Forecast. Source: Finnish Energy Authority.
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We foresee only minor changes to the regulatory framework if the bill is approved

On Jan. 28, the Finnish government submitted changes to the EMA and the Act on the Supervision of the Electricity and Natural Gas Markets. The bill includes four changes that could affect the regulatory framework:

- A ceiling on annual tariff increases;
- WACC: The authority's report stresses the need for a risk-free interest rate to reflect changes in market interest rates quickly enough;
- Cut in the unit price list. We understand that the updated price list is not set and the change is not approved. But it could be applied to all distribution network components in use and could be retrospective and implemented already in 2022; and
- The authority's statement that a security of supply incentive is no longer necessary because the timeframe for security of supply targets have been extended.

It is highly unusual for the framework to be amended in the middle of the regulatory period; this goes against our view of a stable framework. However, we view the changes to the WACC parameter as more of a correction and the tariff increase ceiling will not constitute an issue for Elenia, because WACC is decreasing. We also believe that the security of supply incentive has a limited effect. Still, an update of the unit price list could have a material effect on Elenia's RAB, and other DSOs', especially if the change is applied retroactively, starting in 2022. However, we understand that discussions about a new unit price list are ongoing.

If a new price list is implemented retroactively in the middle of the regulatory period, resulting in a material decrease of the DSO's revenue for 2022-2023, this could lead us to revise downward our assessment of the regulatory framework from strong currently. However, this is not our base-case scenario, because the regulator has historically been balanced in its updates to the framework.

Financial Risk: Aggressive

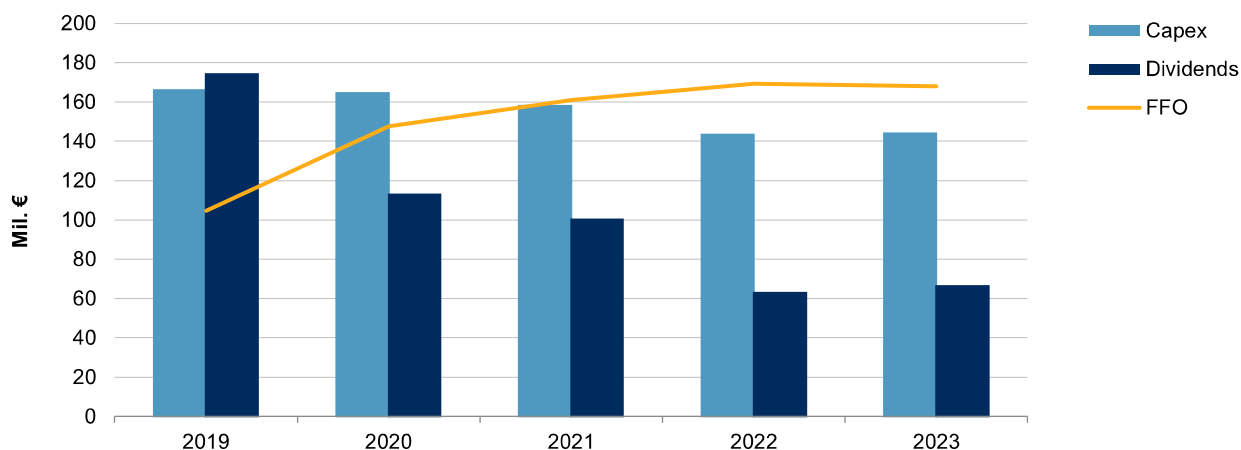
Investments and dividends lead to negative DCF while credit metrics remain stable. Elenia submitted its electricity network development plan to Finland's Energy Authority in June 2020 with the target being to increase the underground cabling rate of the electricity distribution network to 75% by 2028. To meet this target, the company needs to continue to invest heavily, and it expects capex to consume more than 85% of FFO during 2021-2023 (see chart 2). We understand that Elenia plans to invest about €150 million annually. We estimate this, along with the generous remuneration to the owners, exceeding €200 million in 2021-2023, will lead to a DFC deficit.

Capex will consume 85%-95% of annual funds from operations, and adding shareholder distributions, result in a resulting in a cumulated cash deficit of about €180 million for 2021-2023 and increasing debt with equal amount. We foresee Elenia's S&P Global Ratings-adjusted debt at nearly €1.9 billion by the end of 2023, but we also expect debt to EBITDA at around 8.8x.

While we expect all available funds to be distributed to owners, we understand that the company is committed to FFO to debt above 9% and will adjust shareholder distributions accordingly.

Chart 2

Elenia's Forecast FFO Don't Cover Projected Capex And Dividends



FFO--Funds from operations. Capex--Capital expenditure. Source: S&P Global Ratings.
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Financial summary

Table 2

Elenia Verkko Oyj--Financial Summary

Industry sector: Electric

	--Fiscal year ended Dec. 31--				
	2020	2019	2018	2017	2016
(Mil. €)					
Revenue*	309.9	298.6	353.7	342.3	318.7
EBITDA	195.1	182.7	194.6	188.1	169.2
Funds from operations (FFO)	147.8	104.6	146.9	144.2	132.0
Interest expense	40.9	64.8	47.5	42.9	37.5
Cash interest paid	42.0	66.4	47.6	43.8	37.2
Cash flow from operations	164.7	118.9	119.6	101.5	67.1
Capital expenditure	164.4	166.1	158.7	146.3	125.3
Free operating cash flow (FOCF)	0.3	(47.2)	(39.1)	(44.8)	(58.2)
Discretionary cash flow (DCF)	(112.7)	(221.4)	(73.8)	(87.3)	(119.0)
Cash and short-term investments	113.8	29.2	17.4	24.5	14.9
Gross available cash	113.8	29.2	17.4	24.5	14.9
Debt	1,731.0	1,627.3	1,737.6	1,514.3	1,337.5
Equity	(259.8)	219.7	115.2	282.4	398.0
Adjusted ratios					
EBITDA margin (%)	63.0	61.2	55.0	55.0	53.1
Return on capital (%)	6.9	5.4	5.8	5.8	5.0

Table 2

Elenia Verkko Oyj--Financial Summary (cont.)					
Industry sector: Electric					
	--Fiscal year ended Dec. 31--				
	2020	2019	2018	2017	2016
EBITDA interest coverage (x)	4.8	2.8	4.1	4.4	4.5
FFO cash interest coverage (x)	4.5	2.6	4.1	4.3	4.6
Debt/EBITDA (x)	8.9	8.9	8.9	8.0	7.9
FFO/debt (%)	8.5	6.4	8.5	9.5	9.9
Cash flow from operations/debt (%)	9.5	7.3	6.9	6.7	5.0
FOCF/debt (%)	0.0	(2.9)	(2.2)	(3.0)	(4.3)
DCF/debt (%)	(6.5)	(13.6)	(4.2)	(5.8)	(8.9)

*Elenia sold its district heating business in 2019 and represented about 15% of EBITDA in 2018.

Reconciliation

Table 3

Elenia Verkko Oyj--Reconciliation Of Reported Amounts With S&P Global Ratings' Adjusted Amounts (Mil. €)						
--Fiscal year ended Dec. 31, 2020--						
Elenia Verkko Oyj reported amounts						
	Debt	Operating income	Interest expense	S&P Global Ratings' adjusted EBITDA	Cash flow from operations	Dividends
Reported	1,831.1	111.7	40.6	195.1	165.0	–
S&P Global Ratings' adjustments						
Cash taxes paid	–	--	–	(5.4)	–	–
Cash interest paid	–	--	–	(41.7)	–	–
Reported lease liabilities	5.9	--	–	–	–	–
Incremental lease liabilities	7.5	0.3	0.3	(0.3)	(0.3)	–
Postretirement benefit obligations/deferred compensation	0.3	--	0.0	–	–	–
Accessible cash and liquid investments	(113.8)	--	–	–	–	–
Nonoperating income (expense)	–	3.1	–	–	–	–
Dividends: Other	–	--	–	–	–	113.0
Total adjustments	(100.1)	3.4	0.3	(47.4)	(0.3)	113.0
S&P Global Ratings' adjusted amounts						
	Debt	EBIT	Interest expense	Funds from operations	Cash flow from operations	Dividends paid
Adjusted	1,731.0	115.1	40.9	147.8	164.7	113.0

Liquidity: Strong

We view Elenia's liquidity as strong. We believe that available liquidity sources will exceed forecast near-term cash

outflows by about 2.0x. In our assessment of liquidity, we view the company as having solid relationships with its banks and a high standing in credit markets, as demonstrated by the €500 million issuance in February 2020, four bank facilities with an undrawn amount of €510 million, and no debt maturities in the next two years. Due to negative cash flow, new financing is not required. We assume the company will maintain adequate headroom under its financial covenants because its regulated activities show limited volatility to EBITDA.

Principal liquidity sources	Principal liquidity uses
<p>Elenia's liquidity sources as of March 31, 2021, comprise:</p> <ul style="list-style-type: none"> • Available cash and marketable securities of about €150 million • Forecast FFO of about €158 million • Access to committed credit lines of €510 million 	<p>Elenia's liquidity uses over the same period comprise:</p> <ul style="list-style-type: none"> • Capex of about €155 million over the next 12 months • Shareholder distributions of about €100 million in 2021 and €60 million-€70 million in 2022

Debt maturities

- No debt maturities until 2026

Covenant Analysis

Elenia has two covenants: an interest coverage ratio and a leverage ratio (debt to EBITDA), with two different trigger ratios: a lock-up trigger (for shareholder distributions) and a default trigger.

There are two levels of financial covenants (trigger events and events of default) and an automatic 12-month standstill period after an event of default. These covenants provide creditors with significant control over Elenia at an early stage of financial or operational difficulty, or following material changes in business circumstances. The covenants reduce the borrower's probability of default and create an additional credit cushion.

A liquidity facility provided by suitably rated counterparties is available if the group enters a standstill, and is sufficient to cover finance charges. The €60 million facility was undrawn as of March 31, 2021. Protecting debtholders is strong covenant package, including limitations on additional debt, a defined cash waterfall of payments giving senior debt priority, a minimum level of financial performance, and restrictions on distributions.

We forecast Elenia will have significant headroom over the next two years under both covenants. We also believe the company has significant flexibility to reduce shareholder distributions even before reaching lock-up covenants (see table 4).

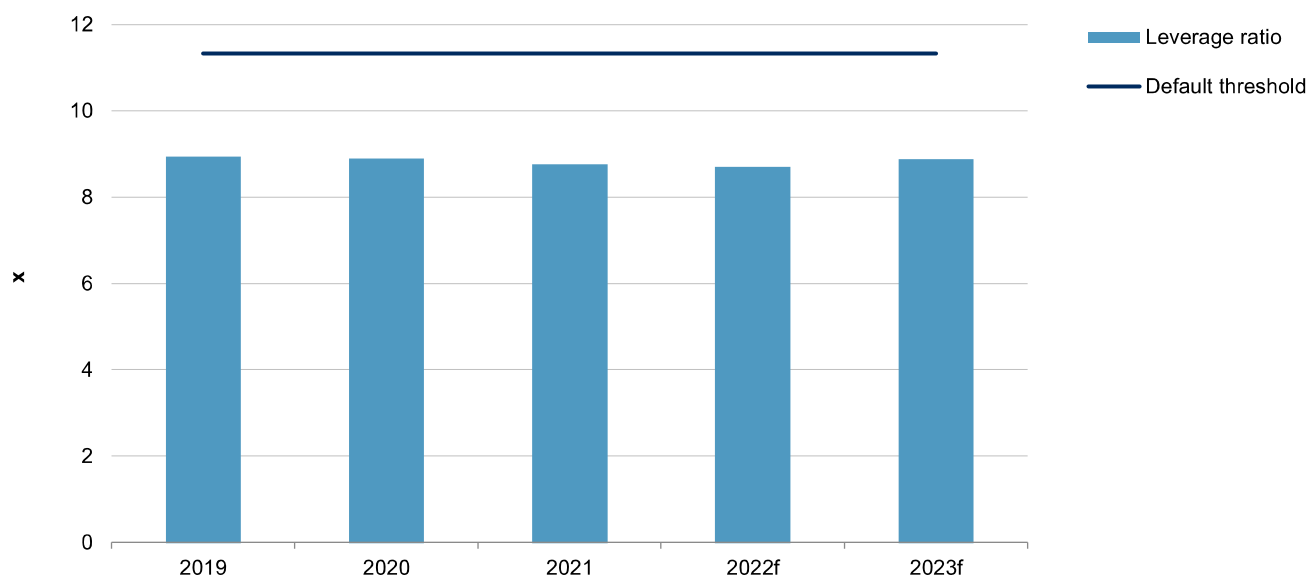
Table 4

Elenia Covenant Triggers				
	--Debt to EBITDA--		--Interest coverage ratio--	
	Lock-up	Default	Lock-up	Default
Covenant (x)	10.18	11.33	1.46	0.96
Reported ratio				
2020 ratio (x)	8.84		4.68	
2019 ratio (x)	8.65		3.55	
2018 ratio (x)	8.87		4.05	

According to Elenia's calculations, as of Dec. 30, 2020, the ratios were 8.84x and 4.68x, respectively, showing headroom at both covenant levels, and we believe headroom will continue to increase.

Chart 3a

Elenia Has Significant Headroom Under Its Covenants

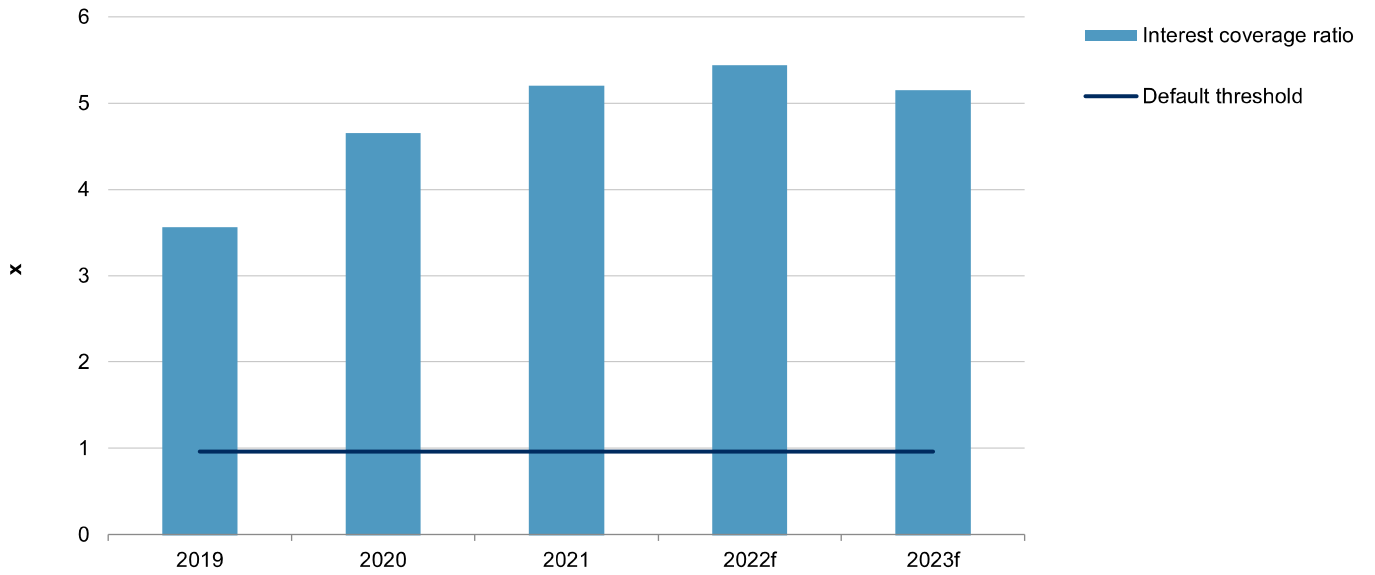


f--Forecast. Source: S&P Global Ratings.

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Chart 3b

Elenia's Interest Coverage Ratio Is Well Above The Default Threshold



Source: S&P Global Ratings.

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Environmental, Social, And Governance

In 2011, Finland was hit by a major storm, Tapani, which led to extensive outages in electricity networks resulting in important changes to the Electricity Market Act (2013) regarding security of supply in the country. Since then, Finnish DSOs, including Elenia, have executed a significant investment program to weatherproof the network and better secure supply resulting in a higher debt burden and pressure on financial metrics.

Investments related to the network's weatherproofing are added to the RAB, which allows collection of higher revenue and supports cash flow. We believe that Finnish electricity DSOs are now better prepared for storms, and less sensitive to weather interruptions and exposure to substantial fines.

Elenia's network resilience improved significantly, for example, following the Aila storm of 2020, where the number of people without electricity reached 35,000 (compared with 100,000 during Tapani in 2011). Outages are fewer and less severe because of underground cabling. The improvement has also been assessed through the ranking of Elenia within the top 30 of 100 network companies in terms of network resilience.

The company has transparent and achievable performance targets for customer and employee safety, minimization of adverse effects on the environment, customer satisfaction, sustainable sourcing of materials, and local economic impact. We expect Elenia to execute its sustainability strategy. Our assessment is further supported by the excellent score the company received from the GRESB 2020 with a result of 96% (versus 89% in 2019), ranking it ninth of 406 infrastructure companies assessed.

Ratings Score Snapshot

Issuer Credit Rating

NONE

Business risk: Excellent

- **Country risk:** Very low
- **Industry risk:** Very low
- **Competitive position:** Strong

Financial risk: Aggressive

- **Cash flow/leverage:** Aggressive

Anchor: bbb

Modifiers

- **Diversification/portfolio effect:** Neutral (no impact)
- **Capital structure:** Neutral (no impact)

- **Financial policy:** Neutral (no impact)
- **Liquidity:** Strong (no impact)
- **Management and governance:** Satisfactory (no impact)
- **Comparable rating analysis:** Neutral (no impact)

Stand-alone credit profile : **bbb**

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | Utilities: Rating Structurally Enhanced Debt Issued By Regulated Utilities And Transportation Infrastructure Businesses, Feb. 24, 2016
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | Project Finance: Project Finance Framework Methodology, Sept. 16, 2014
- Criteria | Corporates | Project Finance: Project Finance Transaction Structure Methodology, Sept. 16, 2014
- Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

Business And Financial Risk Matrix						
Business Risk Profile	Financial Risk Profile					
	Minimal	Modest	Intermediate	Significant	Aggressive	Highly leveraged
Excellent	aaa/aa+	aa	a+/a	a-	bbb	bbb-/bb+
Strong	aa/aa-	a+/a	a-/bbb+	bbb	bb+	bb
Satisfactory	a/a-	bbb+	bbb/bbb-	bbb-/bb+	bb	b+
Fair	bbb/bbb-	bbb-	bb+	bb	bb-	b
Weak	bb+	bb+	bb	bb-	b+	b/b-
Vulnerable	bb-	bb-	bb-/b+	b+	b	b-

Ratings Detail (As Of June 17, 2021)*

Elenia Verkko Oyj

Senior Secured

BBB+/Stable

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.

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