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Transaction Update: Dwr Cymru (Financing) Ltd.

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Transaction Update: Dwr Cymru (Financing) Ltd.

(Editor's Note: On July 18, 2017, we have updated some data in this article, originally published on July 14, 2017.)

Rationale

None

Business Risk	Financial Risk
<ul style="list-style-type: none">• Focused on low-risk, U.K. water regulated monopoly activities.• Transparent, credit-supportive regulatory framework that results in financial stability during regulatory periods.• Adequate performer under the range of regulatory measures set and monitored by Ofwat.• Some regulatory reset risk because the current regulatory period (AMP6) runs until March 31, 2020.	<ul style="list-style-type: none">• Relatively weak cash flow ratios, with limited headroom, due to high capital expenditures and additional spending on discretionary projects.• Increasing leverage to reach to the company's internal target of 60% adjusted debt to regulatory capital value (RCV) for AMP6.• Various structural features designed to increase cash flow certainty for debtholders.

Outlook

The stable outlook on U.K.-based Dwr Cymru (Financing) Ltd. reflects S&P Global Ratings' expectation that utility company Dwr Cymru Cyfyngedig (Welsh Water) will be able to maintain funds from operations (FFO) to debt above 7% throughout the current regulatory period ending March 2020. It also reflects our view that the company will maintain debt to regulatory capital well below the maximum allowed in its legal documentation (85%), although it will increase toward 60% from current levels of 56%, in line with the company's financial policy. We also expect Welsh Water to continue to deliver adequate operational performance and a good track record as an asset operator in both the short and medium term.

Downside scenario

We could lower our rating if the company's cash flow coverage ratios were more aggressive than we expected or if we saw evidence of further pressure to increase balance-sheet leverage beyond its current policy. We would also consider lowering the rating if we saw weaker operational performance, which could lead us to revise our assessment of the company's business risk profile to strong from excellent.

Upside scenario

At this stage, we consider there to be limited scope for a higher rating on the outstanding debt because the financial covenants in the documentation for the medium-term note program allow the group to operate with high leverage. However, if the company commits to substantially reduce leverage and this translates into sustainably stronger credit metrics throughout the regulatory period, we would view this as supportive of underlying credit quality.

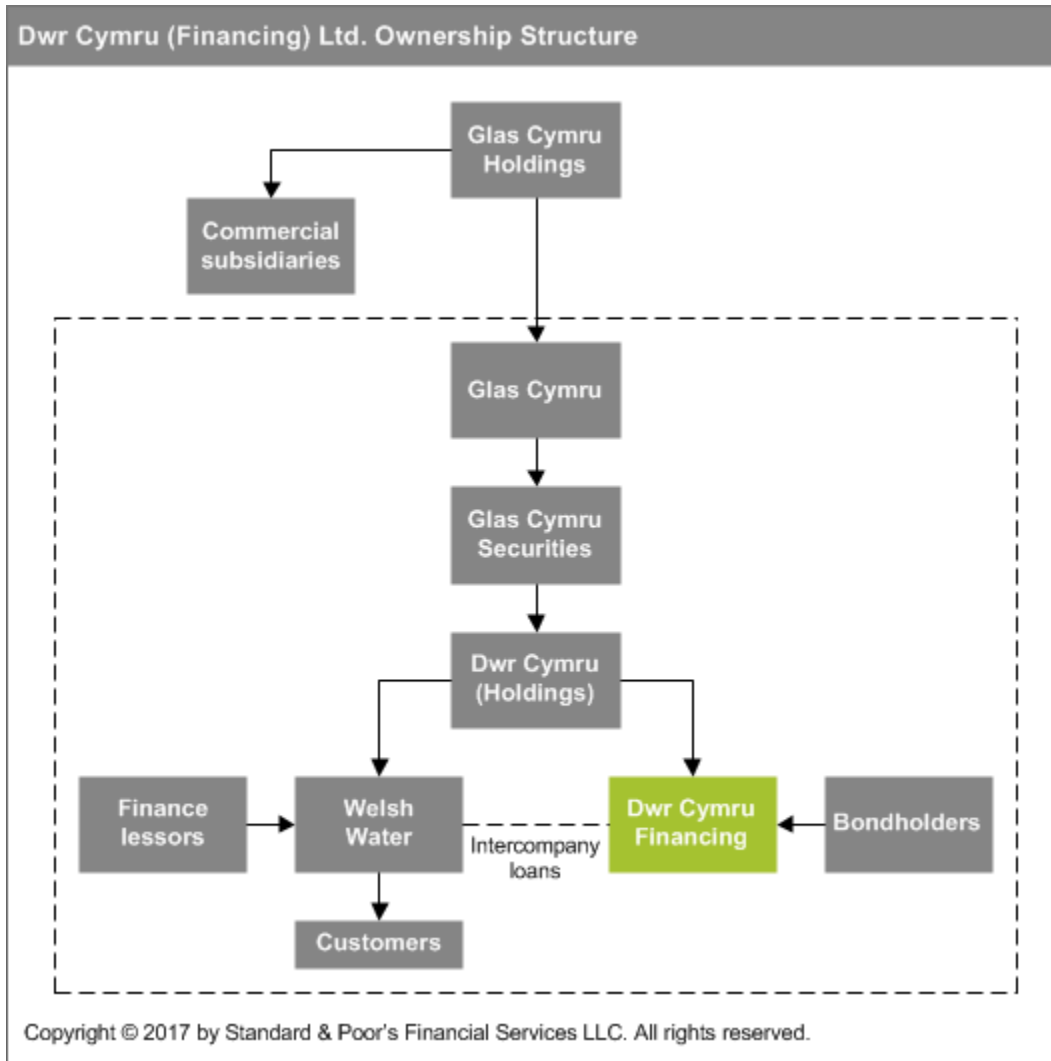
S&P Global Ratings' Base-Case Scenario

Assumptions	Key Metrics			
<ul style="list-style-type: none"> Revenue growth to be around 2%-3% from 2018 onwards. This is due to a combination of real price declines and our retail price index (RPI) assumption. Adjusted EBITDA margins of approximately 48%-49%, on average, over the remainder of AMP6. No outperformance on total expenditures against an already tight regulatory allowance, as per the company's track record. Regulatory capital expenditure (capex) of about £340 million a year on average over the remainder of AMP6. Dwr will also be spending approximately £230 million of additional capex, beyond regulatory requirements, over AMP6 to return value to customers (its owners) and re leverage closer to 60% debt to RCV. An increase in leverage from current levels of around 56% debt to RCV toward 60% for AMP6, as per the company's internal policy. 		2017A	2018	2019
	EBITDA margin (%)	48.6	45-50	45-50
	FFO/debt (%)	7.1	7-8	6.5-7.5
	Debt/EBITDA (x)	8.2	8-9	8-9
	FFO/cash interest (x)	2.9	3.0-4.0	3.0-4.0
A--Actual. FFO--Funds from operations.				

Company Description

Welsh Water is the sixth largest of the 10 regulated water and sewerage companies in England and Wales, according to the RCV (regulatory capital value), which was £5.2 billion as of March 31, 2017. It supplies water and wastewater services to 1.4 million properties across most of Wales and some adjoining areas of England.

Dwr Cymru (Financing) is a financing vehicle that is ultimately owned by Glas Cymru, a Welsh non-profit company (see chart inserted below). Glas Cymru is controlled by members with no financial interest in the company. The financial beneficiaries of outperformance are primarily the customers and, to a lesser extent, investors, although the latter also bear some underperformance risk. This unique ownership structure distinguishes Glas Cymru from other U.K. water utilities because it eliminates pressure to pay dividends and other shareholder returns.



Ratings Rationale

The 'A' ratings on the senior secured debt reflect our assessment of the Dwr Cymru (Welsh Water) financing group's 'a-' SACP plus one notch of uplift for structural enhancements. The 'BBB+' rating on the subordinated debt program (Class C) reflects the group's 'bbb+' subordinated SACP. We note Welsh Water currently does not have subordinated debt outstanding.

Welsh Water's SACP reflects our view of its excellent business risk profile and aggressive financial risk profile. We also give further credit for Welsh Water's unique ownership structure and the company's track record of decreasing leverage. Our assessment is further underpinned by its financial policy to maintain leverage well below the maximum allowed in its legal documentation. The higher SACP for senior debt also incorporates our view of the better positioning of senior creditors in terms of security enforcement and decision-making power.

The debt Dwr Cymru (Financing) has issued is backed by the future cash flows of Welsh Water's fully regulated and

relatively low-risk water assets. Dwr Cymru (Financing) has lent the proceeds of its debt issuance to Welsh Water.

We rate Dwr Cymru (Financing)'s long-term senior secured debt, the subordinated debt on its medium-term note program, the class A debt guaranteed by MBIA U.K. Insurance Ltd., and the outstanding class B debt, which is unwrapped and ranks pari passu with class A debt. The rating on monoline-insured debt reflects the higher of the rating on the monoline insurer and Standard & Poor's underlying rating or SACP. Therefore, the rating on the class A bonds guaranteed by MBIA U.K. Insurance Ltd. reflects the higher SACP (see table 1).

Structural Features

Table 1

Dwr Cymru (Financing) Ltd. -- Supporting Ratings	
Institution/role	Rating*
Lloyds Bank PLC as swap counterparty	A/Negative/A-1
BNP Paribas as liquidity facility provider	A/Stable/A-1
HSBC Bank PLC as swap counterparty and liquidity facility provider	AA-/Negative/A-1+
National Australia Bank Ltd. as liquidity facility provider	AA-/Negative/A-1+
JP Morgan Chase Bank N.A. as liquidity facility provider	A+/Stable/A-1
Royal Bank of Scotland as a swap counterparty	BBB+/Stable/A-2
MBIA U.K. Insurance Ltd. as guarantor of Class A debt	BB/CW Positive/--

*As of June 2017.

The ratings on the debt also reflect various structural features (see table 2). These are designed to increase cash flow certainty for debtholders, including restricted payment conditions and a covenanted liquidity structure that should, in our opinion, enable Dwr Cymru to manage temporary cash flow shocks. In particular, debtholders benefit from:

- Ring-fencing of the financing entity, which is achieved through Dwr Cymru (Financing)'s special-purpose status; significant independent representation on the Dwr Cymru board (six of the nine members); and some business, legal, and regulatory restrictions.
- Three levels of financial covenants (a restricted payment condition, trigger events, and events of default) and an automatic 18-month standstill period after an event of default. These provide creditors with significant control over Dwr Cymru at an early stage of financial or operational difficulty or following material changes in business circumstances. The covenants minimize the probability of default and create an additional credit cushion.
- Liquidity facilities of £135 million available to cover a standstill, provided by suitably rated counterparties (see table 1). These facilities are sufficient to cover finance charges, and are dedicated to drawings if the company enters a standstill. The facilities remain undrawn and the amounts available are unchanged.
- A 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.
- Subordination of the class C debt, the nonpayment of which cannot create an event of default for the class A debt. Dwr Cymru (Financing) currently has no outstanding class C debt.

Table 2

Dwr Cymru (Financing) Ltd. -- Debt Key Features	
Closing date	May 10, 2001

Table 2

Dwr Cymru (Financing) Ltd. -- Debt Key Features (cont.)	
Collateral	Dwr Cymru (Financing) Ltd.'s debt is secured by first fixed and floating charges on assets to the extent permitted by the Water Industry Act 1991 and Welsh Water's Instrument of Appointment. Security includes Welsh Water's accounts receivable, contracts, bank accounts, and all assets except protected land. In addition, the other entities in the Glas Cymru structure--Glas Cymru, Dwr Cymru (Holdings) Ltd., and Glas Cymru (Securities)--guarantee Welsh Water's obligations.
Country of origination	U.K.
Financial covenants	Senior and class C RAR: 95.0%; Senior interest cover ratio: 1.6x
Trigger events	Senior interest cover ratio: 2.0x; Senior post-maintenance interest cover ratio: 1.0x; Senior post-maintenance interest cover ratio: 1.0x; Senior and Class C RAR: 85%
Liquidity facility size (mil. £)	135
European Investment Bank loan facility (mil. £)	250

Business Risk

Our assessment of Welsh Water's business risk profile as excellent reflects the stable and predictable revenue and cash flow streams from the low-risk regulated water and wastewater businesses, Welsh Water's natural monopoly in its service area, and a generally supportive and transparent regulatory framework. The strength of the Water Services Regulation Authority (Ofwat) and its framework is reflected in our assessment of Ofwat providing a strong regulatory advantage (see "Why U.K. Utilities' Regulatory Frameworks Merit A "Strong" Regulatory Advantage Assessment," published Dec. 11, 2013, on RatingsDirect).

In our opinion, Welsh Water's operational performance remains weaker than its peers', based on the level of profitability. This is partly attributable to the retail business, which has higher-than-average costs to service and planned expenditures on projects such as IT for the current regulatory period. We also view the total expenditure allowance for the current regulatory period as very tight, and do not expect any outperformance on costs. This reduces any flexibility the company could have had to achieve any cost outperformance, particularly compared to peers.

That said, for the regulatory year ending March 2017, the company improved operating performance in key areas like water supply interruptions, safety of drinking water and leakages, while there were marginal increases in pollution incidents. In addition, Dwr Cymru has received £2.8 million of outperformance rewards in some key indicators measured by Ofwat.

Like all water companies, Welsh Water is exposed to regulatory reset risk every five years. Based on the determination for 2015-2020 under AMP6 and Welsh Water's business plan, we still believe that the targets are achievable, but there is limited scope for substantial outperformance, particularly with respect to costs.

S&P Global Ratings Base-Case Operating Scenario

- Our assumption of RPI inflation of 2.1% in 2017, 3.2% in 2018, and close to 3.0% thereafter.

Peer comparison

Table 3

Dwr Cymru (Financing) Ltd. -- Peer Comparison			
	Dwr Cymru (Financing) Ltd.	Yorkshire Water Services Finance Ltd.	Anglian Water Services Financing PLC
	--Fiscal year ended March 31, 2017--	--Fiscal year ended March 31, 2016--	
(Mil. £)			
Revenues	743.6	975.8	1,185.4
EBITDA	361.7	550.9	638.8
Funds from operations (FFO)	211.3	291.4	359.5
Net income from cont. oper.	(70.0)	236.2	331.0
Cash flow from operations	221.8	381.6	410.0
Capital expenditures	271.2	236.7	258.5
Free operating cash flow	(49.4)	144.9	151.5
Dividends paid	0.0	90.9	152.7
Discretionary cash flow	(49.4)	54.0	(1.2)
Debt	2,958.6	4,573.3	5,747.9
Preferred stock	0.0	0.0	0.0
Equity	1,115.9	1,148.0	3,014.1
Debt and equity	4,074.5	5,721.3	8,762.0
Adjusted ratios			
EBITDA margin (%)	48.6	56.5	53.9
Return on capital (%)	2.5	3.7	5.5
EBITDA interest coverage (x)	2.4	2.1	2.4
FFO cash int. cov. (x)	2.9	2.3	2.7
Debt/EBITDA (x)	8.2	8.3	9.0
FFO/debt (%)	7.1	6.4	6.3
Cash flow from operations/debt (%)	7.5	8.3	7.1
Free operating cash flow/debt (%)	(1.7)	3.2	2.6
Discretionary cash flow/debt (%)	(1.7)	1.2	(0.0)
Net cash flow/capex (%)	77.9	84.7	80.0
Return on capital (%)	2.5	3.7	5.5
Return on common equity (%)	(6.4)	10.9	10.6
Common dividend payout ratio (unadjusted) (%)	0.0	0.0	134.4

Financial Risk

Our rating on Dwr Cymru (Financing)'s debt is constrained by Welsh Water's relatively weak credit metrics. In particular, we expect adjusted FFO to debt to be at about 7% on average throughout the current regulatory period under the weight of relatively low profitability, the negative impact of RPI inflation on index-linked debt and the intention to increase leverage from current levels through additional capital expenditures.

Welsh Water has lower balance-sheet leverage than peers, where debt represented about 57% of the company's RCV

at the end of March 2017, compared to the peer average of around 80%. This is the result of the nonprofit ownership by Glas Cymru, which eliminates the pressure to increase leverage through shareholder distributions. Following a consultation with customers, the company now plans to increase leverage toward 60% and return value to customers by investing in the water infrastructure in Wales beyond its regulatory commitment. As a result, we see very limited headroom in cash flow ratios, particularly in 2019, and substantially negative discretionary cash flows. We note that the additional spending should ultimately result in an improvement in asset quality longer term, but we will continue to monitor the cash flow ratios closely in light of the limited headroom.

S&P Global Ratings' Base-Case Cash Flow And Capital Structure Scenario

- Adjusted FFO to debt of around 7% over 2018-2020.
- Negative discretionary cash flows of £90 million to £165 million over 2018-2020.
- Leverage increases up to the company's target debt to RCV ratio of 60%.

Financial summary

Table 4

Dwr Cymru (Financing) Ltd. -- Financing Summary					
	--Fiscal year ended March 31--				
	2017	2016	2015	2014	2013
(Mil. £)					
Revenues	743.6	743.2	752.5	735.1	714.6
EBITDA	361.7	408.4	381.2	368.4	344.2
Funds from operations (FFO)	211.3	283.8	232.5	207.4	183.2
Net income from continuing operations	(70.0)	85.9	(80.1)	155.3	1.6
Cash flow from operations	221.8	237.3	252.4	230.5	203.5
Capital expenditures	271.2	220.0	275.5	260.1	232.3
Free operating cash flow	(49.4)	17.3	(23.1)	(29.6)	(28.8)
Dividends paid	0.0	0.0	0.0	0.0	0.0
Discretionary cash flow	(49.4)	17.3	(23.1)	(29.6)	(28.8)
Debt	2,958.6	2,852.8	2,903.3	2,821.2	2,770.1
Preferred stock	0	0	0	0	0
Equity	1,115.9	1,083.3	(4.9)	101.2	(73.9)
Debt and equity	4,074.5	3,936.1	2,898.4	2,922.5	2,696.2
Adjusted ratios					
EBITDA margin (%)	48.6	55.0	50.7	50.1	48.2
EBITDA interest coverage (x)	2.4	3.1	2.5	2.2	2.0
FFO cash int. cov. (x)	2.9	3.2	3.1	3.0	2.9
Debt/EBITDA (x)	8.2	7.0	7.6	7.7	8.0
FFO/debt (%)	7.1	9.9	8.0	7.4	6.6
Cash flow from operations/debt (%)	7.5	8.3	8.7	8.2	7.3
Free operating cash flow/debt (%)	(1.7)	0.6	(0.8)	(1.0)	(1.0)
Discretionary cash flow/debt (%)	(1.7)	0.6	(0.8)	(1.0)	(1.0)
Net cash flow/capex (%)	77.9	129.0	84.4	79.7	78.8

Table 4

Dwr Cymru (Financing) Ltd. -- Financing Summary (cont.)					
	--Fiscal year ended March 31--				
	2017	2016	2015	2014	2013
Return on capital (%)	2.5	4.5	6.6	6.9	6.6
Return on common equity (%)	(6.4)	16.0	(171.2)	1,213.3	(2.1)
Common dividend payout ratio (un-adj.) (%)	0	0	0	0	0

Liquidity

We assess Dwr's liquidity as strong under our criteria. According to our projections, sources of funds exceed uses by more 2.1x over the next 12 months and by more than 1.9x in the subsequent 12-24 months. Our liquidity assessment is further underpinned by Dwr Cymru's high standing in the capital markets and its good relationship with banks.

Principal Liquidity Sources	Principal Liquidity Uses
<p>We estimate that Dwr's liquidity sources over the next 12 months will be approximately £830.8 million, including:</p> <ul style="list-style-type: none"> • Available cash balances of £100.6 million; • FFO of about £276 million; and • Access to £400 million of undrawn credit facilities comprising a loan from the European Investment Bank and the operating and maintenance reserve. 	<p>We estimate that Dwr's liquidity needs over the next 12 months will be about £386 million, including:</p> <ul style="list-style-type: none"> • Upcoming short-term debt maturities of approximately £22 million; • Expected capital spending of approximately £338 million; • Working capital outflows of approximately £19 million; and • Flexible return to customers in line with management's commitment to maintaining debt to RCV at 60%.

Debt Maturities

Table 5

Dwr Cymru (Financing) Ltd. -- Debt Maturity Schedule	
	(Mil. £)
2017-2018	32
2018-2021	461
After 2021	2,361

Note: Fiscal year end is March 31.

Covenants

In addition, the company must maintain a liquidity facility that will be available if it goes into default and is unable to pay interest charges. This facility amounted to £135 million as of March 31, 2017, equivalent to the next 12 months of cash interest payable. Drawing on the liquidity facility results in a distribution lock-up.

If the short-term ratings on the liquidity facility providers are lowered to below 'A-1', the providers must be replaced within 30 calendar days or the funds available under the facility must be fully drawn.

Covenant Analysis

Dwr Cymru continues to comply with the debt-maturity limitations stipulated in the documentation. The next significant maturity is that of £325 million of class B notes in 2021. There are no mandatory break clauses in the index-linked swaps. Dwr Cymru does not have any outstanding class C bonds.

Dwr Cymru has continued to perform well under the covenants and improve the headroom since the debt transaction closed on May 10, 2001. On March 31, 2017, the senior and class C regulated asset ratio was, well within the trigger level of 85%. This has been helped by consistently high inflation in the U.K. Although the same factor makes meeting interest cover ratio covenants more difficult, because pay-as-you-go swaps are settled in cash each year, Dwr Cymru has still managed to maintain lower ratios than the trigger level during periods of higher inflation (see table 7). The covenants are calculated on a consolidated basis at the level of Glas Cymru, the ultimate parent company.

Table 6

Dwr Cymru (Financing) Ltd. -- Key Covenants				
Financial covenant	Restricted payment condition*	Actual performance March 31, 2015	Actual performance March 31, 2016	Forecast performance March 31, 2017
Senior and class C regulated asset ratio (%)	85	60	57	60
Senior ICR (x)	2	3.8	4.2	3.8
Senior PMICR (x)	1	2.4	2.9	2.5

*For ICR ratios, trigger event covenant is displayed. ICR--Interest cover ratio. PMICR--Post-maintenance interest cover ratio.

Other Credit Considerations

Welsh Water's underlying credit quality is underpinned by its nonprofit ownership structure and lack of pressure to increase balance-sheet debt, which is lower than peers'.

Reconciliation

Table 7

Reconciliation Of Dwr Cymru (Financing) Ltd. Reported Amounts With S&P Global Ratings' Adjusted Amounts						
--Fiscal year ended Mar. 31, 2017--						
Dwr Cymru (Financing) Ltd. reported amounts						
	Debt	EBITDA	Operating income	Interest expense	EBITDA	Cash flow from operations
Reported	2978.1	361.3	104.7	142.4	361.3	213.4
S&P Global Ratings adjustments						
Interest expense (reported)	--	--	--	--	(142.4)	--

Table 7

Reconciliation Of Dwr Cymru (Financing) Ltd. Reported Amounts With S&P Global Ratings' Adjusted Amounts (cont.)						
Interest income (reported)	--	--	--	--	3.6	--
Current tax expense (reported)	--	--	--	--	0.9	--
Postretirement benefit obligations/deferred compensation	76.7	0.4	0.4	1.8	(2.6)	4.6
Surplus cash	(100.6)	--	--	--	--	--
Capitalized interest	--	--	--	9.5	(9.5)	--
Non-operating income (expense)	--	--	3.6	--	--	--
Reclassification of interest and dividend cash flows	--	--	--	--	--	3.8
Debt - Unamortised capitalized borrowing costs	4.4	--	--	--	--	--
Total adjustments	(19.5)	0.4	4.0	11.3	(150.0)	8.4
S&P Global Ratings adjusted amounts						
	Debt	EBITDA	EBIT	Interest expense	Funds from operations	Cash flow from operations
Adjusted	2,958.6	361.7	108.7	153.7	211.3	221.8

Related Criteria

- 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 Transaction Structure Methodology, Sept. 16, 2014
- Criteria - Corporates - Project Finance: Project Finance Framework Methodology, Sept. 16, 2014
- Criteria - Corporates - Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria - Structured Finance - General: Counterparty Risk Framework Methodology And Assumptions, June 25, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Why U.K. Utilities' Regulatory Frameworks Merit A "Strong" Regulatory Advantage Assessment, Dec. 11, 2013
- Ofwat Water 2020: Rising Volatility And Decreasing Earnings Could Pressure Ratings On U.K. Water Utilities, June 23, 2016

Ratings Detail (As Of July 14, 2017)

Dwr Cymru (Financing) Ltd.

Senior Secured	A
Senior Secured	A/Stable
Subordinated	BBB+

*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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