

CEZ a.s.

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CEZ a.s.

Major Rating Factors

Strengths:

- Strong market position as electricity generator with above-average profitability.
- Vertically integrated utility with diverse, low-cost generation fleet and rising share of low-risk regulated activities.
- Adequate cash flow debt protection for the rating level with some headroom on credit metrics.
- Potential extraordinary support from the state as a majority shareholder.

Weaknesses:

- Exposure to volatile wholesale power markets.
- Nuclear operating risk.
- Negative discretionary cash flows.

Corporate Credit Rating

A-/Stable/--

Rationale

The rating on Czech-based, nearly 70% state-owned, electricity utility CEZ a.s. is based on the company's stand-alone credit profile (SACP), which Standard & Poor's Ratings Services assesses at 'bbb+', based on a "strong" business risk profile and an "intermediate" financial risk profile. The ratings also reflect our opinion that there is a "moderately high" likelihood that the Czech Republic (foreign currency AA-/Stable/A-1+; local currency AA/Stable/A-1+) would provide timely and sufficient extraordinary support to CEZ in the event of financial distress. Our opinion is based on our assessment of CEZ's "important" role for and "strong" link with the Czech government.

CEZ's SACP benefits from the company's strong market position as a vertically integrated utility and a dominant generator of electricity in the Czech Republic, as well as the increasing revenues from its low-risk, regulated distribution network businesses. Further rating strength comes from the company's competitive, low-cost, and diverse asset fleet, which supports CEZ's above-average profitability compared with peers.

We consider these strengths to be offset by the merchant risk from CEZ's exposure to inherently volatile wholesale power markets, which applied to about 70% of EBITDA in 2010. Further constraints include the nuclear operating risk related to one-quarter of installed capacity and, to a smaller extent, the company's exposure to higher-risk Eastern European markets. In addition, from 2013 CEZ faces added carbon costs on its relatively carbon-intensive generation portfolio, which will gradually impair its profitability in the longer run.

CEZ's intermediate risk profile is supported by our forecast of adequate cash flow metrics at its current SACP of 'bbb+'. The key constraint is our expectation of large negative discretionary cash flows, which will require further borrowing.

Standard & Poor's base-case operating scenario

We anticipate CEZ's adjusted EBITDA in 2011 will decline to about CZK 86.0 billion from CZK 93.2 billion in 2010 as the forward-sale contracts concluded during the economic downturn unwind. Nevertheless, CEZ's competitive position in the medium term has strengthened, in our view, following the accelerated phase-out of nuclear capacity in Germany, which resulted in higher German, and therefore higher Czech, power prices. To take advantage of these prices, the company accelerated its forward sales and has now sold forward almost all of its 2012 generation output and 41% of its 2013 output (as of Oct. 31, 2011). However, Central European power prices as well as carbon prices have started to decline, driven by the gloomier economic outlook for the eurozone. In our base-case scenario, we assume that CEZ will sell its uncontracted output at current forward power prices, which are lower than the company's achieved power prices, earlier in the year.

Based on the Czech government's National Allocation Plan, we now see greater likelihood that CEZ will receive a portion of free carbon allowances by 2020. This is positive, in our view, as the carbon cost is factored into CEZ's profit margins more gradually than for some of its peers. In this way, the company is granted time to transition to a more carbon-light portfolio by investing in clean technologies. In our base-case scenario, we do not yet factor in CEZ's ambitions for new nuclear units at Temelin until and if the company makes a final investment decision toward the end of 2013. Although nuclear is favorable as a zero-carbon-emission type of generation, we believe that it introduces significant construction, operating, and market-exposure risks, especially in liberalized markets.

Standard & Poor's base-case cash flow and capital-structure scenario

In our base-case scenario, we project that CEZ's adjusted funds from operations (FFO) will decline over the medium term compared to the Czech koruna (CZK) 77.2 billion achieved in financial year 2010. We also anticipate debt to increase as the dividend distributions result, partly, in negative discretionary cash flows. As a result, we expect a decrease in adjusted FFO to debt from the 45.7% achieved in 2010. We believe, however, that the ratio will exceed 30% even at its weakest point in 2012, which provides some degree of headroom to our expectation at the current SACP of 'bbb+' of 25% FFO to debt.

After 2013, CEZ's profit margin will be determined, in our view, by carbon prices because the company needs to procure its carbon requirements on the market. Based on current forward carbon prices, which are at historical lows, we forecast that the resulting deterioration in the generation segment profit margin will be offset by new capacity coming on stream. Based on carbon prices increasing to the range of €18-€20 per metric tonne, we still see CEZ posting credit metrics above 30% FFO to debt after 2013, all else remaining the same.

Liquidity

We view CEZ's liquidity position as adequate under our criteria on the basis of our expectations that available liquidity resources will cover expected cash outflows by at least 1.2x in the next 12 months.

CEZ's liquidity resources consist of:

- Unrestricted cash and securities of CZK 34.5 billion (about €1.38 billion) as of Sept. 30, 2011, according to management data;
- Available headroom of CZK 21.7 billion under committed bank lines, half of which have now been extended to three years of maturity, with an option to draw down for another year.
- Broadly similar FFO as our forecast for 2011 of about CZK65-66 billion.

Expected cash outflows include:

- Debt maturities of about CZK10.64 billion over the next twelve months to Sept. 30, 2012.
- Annual capital expenditure of about CZK60 billion as per the company's guidance. In the short term, we believe there is limited flexibility for further reductions in CEZ's planned capex due to long project lead times and largely mandatory investments in the regulated networks.
- Dividend payout ratio of 50%-60% of 2011 profits.

Looking ahead, we anticipate that the company will maintain full coverage of its liquidity needs over the next 12 months, and that there will be no significant shortfall in liquidity over the next two years; under this scenario, we would consider CEZ's liquidity to be sufficiently robust.

Outlook

The stable outlook reflects our view that CEZ will be able to maintain its market position and deliver adequate operational performance. We consider a ratio of adjusted FFO to debt of more than 25% as being commensurate with the current SACP of 'bbb+'. In line with our methodology on government related entities, a one-notch downward revision of CEZ's SACP would not affect the rating.

Negative pressure on the SACP could develop on weaker market conditions than we currently expect, free CO2 allowances being lower than we currently expect, or credit-diluting opportunistic acquisitions. Furthermore, consistently negative cash flows, particularly if we believe these are not covered sufficiently by back-up liquidity sources, could jeopardize CEZ's liquidity position and lead to ratings downside. In addition, signs of increased political risk--for example, policies that aim to extract cash from power utilities in the Czech Republic either through dividends or windfall taxes--could have adverse implications for CEZ's SACP. Such evidence of negative government intervention will also lead us to reassess our opinion on extraordinary state support.

Rating upside could result in an environment of sustainable, structurally attractive, power market fundamentals in domestic and Western European markets, and if CEZ continued to build a consistent track record under its consolidation strategy.

We will factor in the implications of new nuclear construction in Temelin if and when the company decides to invest. In the absence of offsetting factors, new nuclear construction could weaken both the business risk profile (due to high construction and operational risk), and the financial risk profile (due to high capital costs).

Business Description

CEZ is a Czech-based vertically integrated power utility with a strong position in each of its key areas of operation: power generation, regulated distribution activities, and supply. Generation is the company's most profitable area of operation, providing over 70% of EBITDA in 2010. As of year-end 2010, CEZ had 15,018 megawatts of installed production capacity, split between lignite (39%), black coal (19%), nuclear (26%), and renewables (16%). The company has about a 70% market share of the generation segment in the Czech Republic, and its activities are supported by its ownership of the Czech Republic's largest mining company, which provides 60% of CEZ's lignite needs. The balance of EBITDA comes predominantly from regulated distribution activities and end-user sales. CEZ controls about 61% of the Czech Republic's electricity distribution, owning the largest distribution company in the Czech Republic. It also has an overall market share of 41% in the competitive Czech supply market.

During its expansion phase between 2004 and 2009, CEZ acquired assets across the value chain in neighboring electricity markets, specifically in Bulgaria, Romania, Poland, and Albania. In 2010, the contribution by fully consolidated foreign subsidiaries was limited to less than 7% of EBITDA.

Government Support And GRE Methodology Impact

We view CEZ as having an important role for the Czech government as both a provider of an essential service and a key player in the implementation of state energy policies. The company produces more than 70% of the domestic power output, which is sufficient to cover domestic consumption requirements, and distributes electricity to more than 60% of customers in the Czech Republic.

We see the company's link to the Czech government as strong, as the latter is actively involved in key strategic decisions through its representation on CEZ's supervisory board. The Ministry of Finance owns about 70% of CEZ, and the remaining shares are publicly held. Although the state may eventually sell part of its stake in CEZ to fund state pension reforms, we understand that the current government is not contemplating such an action at present. We anticipate that the state will retain its strategic control over CEZ and will remain a supportive shareholder by avoiding negative interventions, such as raising the dividend payout ratio or implementing windfall taxes on power companies.

Business Risk Profile: Strong Due to Vertical Integration And Competitive Low Cost Fleet Offset By Wholesale Market Exposure

- Dominant domestic market position as a vertically integrated utility across the value chain. CEZ produced 74% of Czech electricity in 2010 with the rest coming from independent power producers. The coal supply risk is, in our view, low because of its ownership of the largest Czech mining company Severoceske Doly, which covers about 60% of CEZ's lignite needs. CEZ also owns the largest distribution company in the country, which connects 61% of customers in the Czech Republic. In addition, the company has a strong, albeit declining, 41% share of the end customer supply market.
- Rising share of low-risk regulated monopoly activities. CEZ's share of earnings from regulated distribution is rising on the back of increased tariffs to gradually adjust upwards the regulated asset base. We view the Czech regulatory framework as supportive in that it provides good earnings predictability until the end of the third regulatory period in Dec. 31, 2014. However, we view the regulatory regimes affecting CEZ's distribution businesses in Southeastern Europe, which contributed just 4% of group EBITDA for the first half of 2010, as less predictable.
- Low cost generation fleet, providing a competitive advantage. CEZ has a diverse fleet along the load curve, spread across lignite and black coal power plants, hydro, and nuclear assets. The company's strategy is to build highly efficient and less carbon-intensive plants to replace a portion of its thermal plants at the end of their economic lives. Through technological solutions, we understand that CEZ aims to optimize the load factors of its nuclear assets in its relatively new Czech-based Temelin and Dukovany nuclear power plants.
- Above-average profitability. This comes on the back of low variable costs and a strategic location that benefits from well-integrated links with Western European markets. We believe CEZ has historically posted better profit margins than peers due to its competitive cost advantage and continuous focus on efficiency. In addition, ample transmission capacity on the borders with Slovakia, Germany, and Austria, combined with declining capacity

margins in Central Europe, have led to near full convergence with German wholesale power prices (EEX) in recent years, as well as yielding higher margins for CEZ.

- Strategy focused on core competences in domestic generation and reduced acquisition appetite for expansion in higher-risk southern European markets.

These strengths are partly offset by:

- Majority of earnings exposed to inherently volatile wholesale market power prices. These prices depend on macroeconomic conditions and are linked to commodity feedback prices, such as coal and oil and, to a lesser extent, carbon. CEZ actively sells its power output three years forward, which we think reduces exposure to spot power prices and provides a high degree of earnings predictability over the coming years, especially for the next 12 months.
- Higher market risk than that of some peers due to generation output significantly exceeding retail supply requirements. CEZ's overall share of supply to end-users was 41% in 2010, down from 56% in 2005, caused by market liberalization and intense competitive pressures from alternative electricity suppliers entering the market. Although we regard the financial impact of a declining market share as minimal, given the low margins available in this segment, we view a robust supply base as providing resilience from a demand perspective.
- Nuclear operating risk that applies to 3.8 gigawatts (GW) of installed capacity. We understand that the company's nuclear ambitions for up to 3.3 GW of new capacity at the Temelin nuclear power plant will crystallize after selecting, and signing a contract with, a supplier. We expect this by end-2013 at the earliest. We see new nuclear construction as risky, given the long construction lead times, possible budget overruns, and substantial upfront capital costs.
- Uncertainties about future carbon costs. We now see greater likelihood that the Czech government will allocate a portion of free CO₂ emission allowances to CEZ with the start of the third phase of the EU's emissions trading scheme after 2013. Such a move would be in line with the gradual transition to full auctioning and is allowed by the EU. In any event, we think that CEZ's success in preserving its competitive edge, when factoring in the added carbon costs over the longer term, will crucially depend on the company's ability to implement its carbon-intensity-reduction strategy.

Financial Risk Profile: Intermediate, With Some Headroom On Credit Metrics

The main strengths of CEZ's "intermediate" financial risk profile are:

- Adequate cash flow debt protection at its current SACP of 'bbb+'. We expect CEZ's credit metrics to decline from historically strong levels over the near term as a result of lower locked-in power prices during the economic downturn. However, we now think the company will see headroom to our guidance of 25% FFO to debt, which we see as commensurate with its current SACP.
- Moderate financial policy. This is illustrated by CEZ's credit-driven policy that aims to contain leverage at up to 2.3x (ratio of net debt to EBITDA).
- A degree of financial flexibility. We believe this is possible through deferral of investments and dividends or, if necessary, through disposal of noncore businesses. For instance, as a response to aggravating power market conditions, CEZ cut its capital program over 2010-2015 by 20%.

These strengths are partly offset by:

- Increased leverage on the back of past acquisition. As part of its consolidation strategy, however, we understand that CEZ is now refraining from opportunistic acquisitions.
- Our expectation of negative discretionary cash flow (DCF: after capex and dividends) in the near term resulting in new borrowing needs. After several years of strong coverage of investment needs (before acquisitions) from internally generated operating cash flows, we expect the company's DCF to turn negative; this, we think, could incrementally compound its cash deficit alongside debt maturities and generate a need for additional borrowing.

Financial Statistics/Adjustments

CEZ reports under the International Financial Reporting Standards (IFRS).

CEZ has nuclear asset retirement obligations (ARO), which include being responsible for, and covering all costs of, the interim storage of radioactive waste and spent fuel until final handover to the state, as well as decommissioning activity. The state guarantees final storage and keeps a fund for this, into which CEZ pays a regular fee per kilowatt-hour. We treat the reported ARO provision as debt and make an adjustment to FFO to account for the movement in provision (see table 1). CEZ records no pension liabilities because, under the Czech system, they are the state's responsibility.

We have treated as surplus cash CZK16.65 billion in bank notes and deposits, about CZK5.0 billion in debt securities available for sale, and CZK11.97 billion of financial assets restricted for asset retirement obligations.

Table 1

Reconciliation Of CEZ a.s. Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. CZK)										
--Fiscal year ended Dec. 31, 2010--										
CEZ a.s. reported amounts										
	Debt	Shareholders' equity	Revenues	EBITDA	Operating income	Interest expense	Cash flow from operations	Cash flow from operations	Dividends paid	Capital expenditures
Reported	164,444.0	221,611.0	198,848.0	89,089.0	65,057.0	3,484.0	77,165.0	77,165.0	28,783.0	63,018.0
Standard & Poor's adjustments										
Surplus cash and near cash investments	(33,608.0)	--	--	--	--	--	--	--	--	--
Capitalized interest	--	--	--	--	--	3,034.0	(3,034.0)	(3,034.0)	--	(3,034.0)
Share-based compensation expense	--	--	--	100.0	--	--	--	--	--	--
Asset retirement obligations	35,231.8	--	--	--	--	1,065.4	814.1	814.1	--	--
Reclassification of nonoperating income (expenses)	--	--	--	--	3,670.0	--	--	--	--	--
Reclassification of working-capital cash flow changes	--	--	--	--	--	--	--	2,250.0	--	--

Table 1

Reconciliation Of CEZ a.s. Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. CZK) (cont.)										
Minority interests	--	5,440.0	--	--	--	--	--	--	--	--
Debt - Accrued interest not included in reported debt	2,801.0	--	--	--	--	--	--	--	--	--
Revenues - Fair values on commodity derivatives	--	--	280.0	280.0	280.0	--	--	--	--	--
EBITDA - Amortization of nuclear fuel	--	--	--	3,705.0	3,705.0	--	--	--	--	--
D&A - Amortization of nuclear fuel	--	--	--	--	(3,705.0)	--	--	--	--	--
Total adjustments	4,424.8	5,440.0	280.0	4,085.0	3,950.0	4,099.4	(2,220.0)	30.0	0.0	(3,034.0)

Standard & Poor's adjusted amounts

	Debt	Equity	Revenues	EBITDA	EBIT	Interest expense	Cash flow from operations	Funds from operations	Dividends paid	Capital expenditures
Adjusted	168,868.8	227,051.0	199,128.0	93,174.0	69,007.0	7,583.4	74,945.1	77,195.1	28,783.0	59,984.0

Table 2

CEZ a.s. -- Peer Comparison

Industry Sector: Electric Utility

	CEZ a.s.	Verbund AG	Fortum Oyj	Statkraft AS
Rating as of Dec. 15, 2011	A-/Stable/(A-2)	A-/Stable/(A-2)	A/Negative/A-1	A-/Stable/A-2
--Fiscal year ended Dec. 31, 2010--				
(Mil. €)				
Revenues	7,943.0	3,307.9	6,296.0	3,750.0
EBITDA	3,716.6	1,085.9	2,408.4	1,945.2
Net income from cont. oper.	1,884.0	400.8	1,300.0	909.4
Funds from operations (FFO)	3,079.2	788.0	1,388.0	1,803.6
Capital expenditures	2,392.7	661.2	1,193.9	404.8
Free operating cash flow	596.8	118.3	232.2	1,335.1
Dividends paid	1,148.1	455.3	888.0	1,020.9
Discretionary cash flow	(551.3)	(337.0)	(655.8)	314.2
Cash and short-term investments	0.0	80.3	556.0	2,624.9
Debt	6,736.0	4,365.8	8,349.2	5,508.1
Preferred stock	0.0	0.0	0.0	0.0
Equity	9,056.8	4,782.2	8,689.5	9,653.1
Debt and equity	15,792.8	9,148.0	17,038.7	15,161.2
Adjusted ratios				
EBITDA margin (%)	46.8	32.8	38.3	51.9
EBIT interest coverage (x)	9.1	3.4	7.3	8.5

Table 2

CEZ a.s. -- Peer Comparison (cont.)				
Return on capital (%)	17.8	10.4	10.9	12.1
FFO int. cov. (X)	10.9	3.6	5.9	9.1
FFO/debt (%)	45.7	18.0	16.6	32.7
Free operating cash flow/debt (%)	8.9	2.7	2.8	24.2
Discretionary cash flow/debt (%)	(8.2)	(7.7)	(7.9)	5.7
Net cash flow / capex (%)	80.7	50.3	41.9	193.4
Debt/EBITDA (x)	1.8	4.0	3.5	2.8
Total debt/debt plus equity (%)	42.7	47.7	49.0	36.3
Return on capital (%)	17.8	10.4	10.9	12.1
Return on common equity (%)	21.5	10.7	16.0	11.6
Common dividend payout ratio (un-adj.) (%)	59.8	47.7	68.3	112.3

Table 3

CEZ a.s. -- Financial Summary					
Industry Sector: Electric Utility					
--Fiscal year ended Dec. 31--					
	2010	2009	2008	2007	2006
Rating history	A-/Stable/--	A-/Stable/--	A-/Stable/--	A-/Stable/--	A-/Stable/--
(Mil. CZK)					
Revenues	199,128.0	199,007.0	182,504.0	174,563.0	159,580.0
EBITDA	93,174.0	96,618.0	90,024.0	78,154.0	67,735.0
Net income from continuing operations	47,232.0	51,547.0	46,510.0	41,555.0	27,697.0
Funds from operations (FFO)	77,195.1	78,743.6	69,141.1	60,576.7	61,199.6
Capital expenditures	59,984.0	68,710.0	44,921.0	33,334.0	23,218.0
Dividends paid	28,783.0	26,561.0	21,222.0	11,672.0	8,882.0
Debt	168,868.8	157,089.0	114,928.0	91,267.0	53,415.0
Preferred stock	0.0	0.0	0.0	0.0	0.0
Equity	227,051.0	206,675.0	185,410.0	184,226.0	207,653.0
Debt and equity	395,919.8	363,764.0	300,338.0	275,493.0	261,068.0
Adjusted ratios					
EBITDA margin (%)	46.8	48.6	49.3	44.8	42.4
EBIT interest coverage (x)	9.1	11.9	12.2	14.6	10.8
FFO int. cov. (x)	10.9	12.9	13.1	16.7	16.8
FFO/debt (%)	45.7	50.1	60.2	66.4	114.6
Discretionary cash flow/debt (%)	(8.2)	(6.7)	2.4	12.9	55.5
Net Cash Flow / Capex (%)	80.7	75.9	106.7	146.7	225.3
Debt/debt and equity (%)	42.7	43.2	38.3	33.1	20.5
Return on capital (%)	17.4	22.1	22.1	19.1	14.9
Return on common equity (%)	20.9	26.5	26.3	22.3	14.6
Common dividend payout ratio (un-adj.) (%)	59.8	41.2	57.3	51.3	42.5

Related Criteria And Research

- Principles of Credit Ratings, Feb. 16, 2011
- 2008 Corporate Criteria: Analytical Methodology, April 15, 2008
- Criteria Methodology: Business Risk/Financial Risk Matrix Expanded, May 27, 2009
- Rating Government Related Entities: Methodology and Assumptions, Dec. 9, 2010
- Methodology and Assumptions: Liquidity Descriptors for Global Corporate Issuers, Sept. 28, 2011

Ratings Detail (As Of January 11, 2012)	
CEZ a.s.	
Corporate Credit Rating	A-/Stable/--
Senior Unsecured (17 Issues)	A-
Corporate Credit Ratings History	
02-Oct-2006	A-/Stable/--
31-May-2005	BBB+/Positive/--
12-Nov-2003	BBB+/Stable/--
Business Risk Profile	Strong
Financial Risk Profile	Intermediate
*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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