

Krafringen Energi AB (publ)

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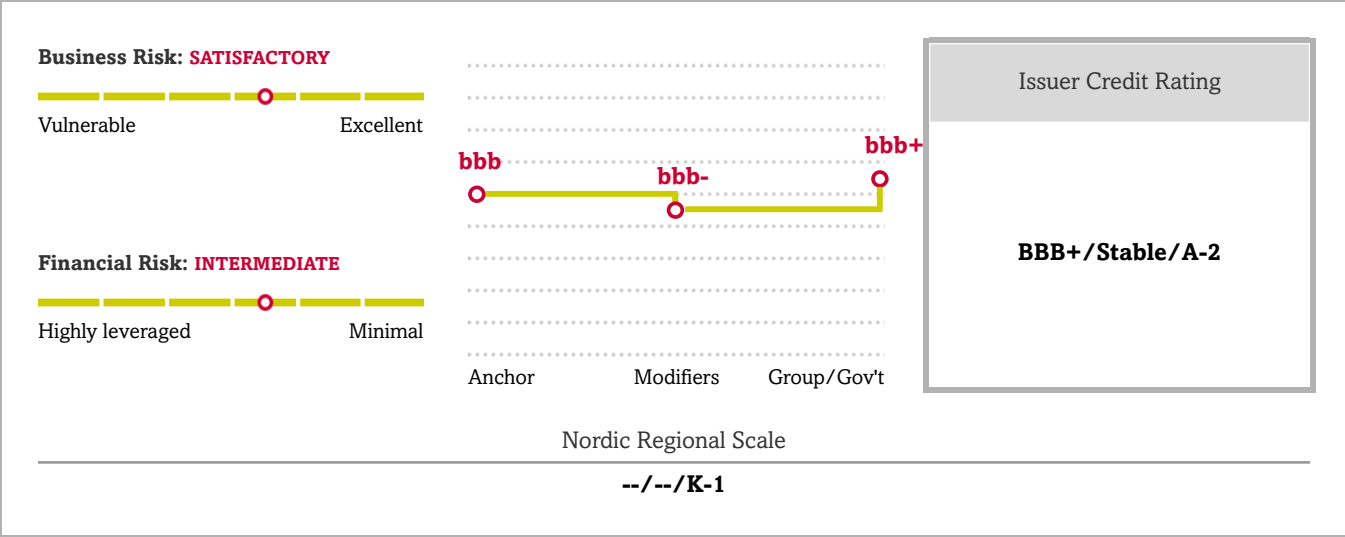
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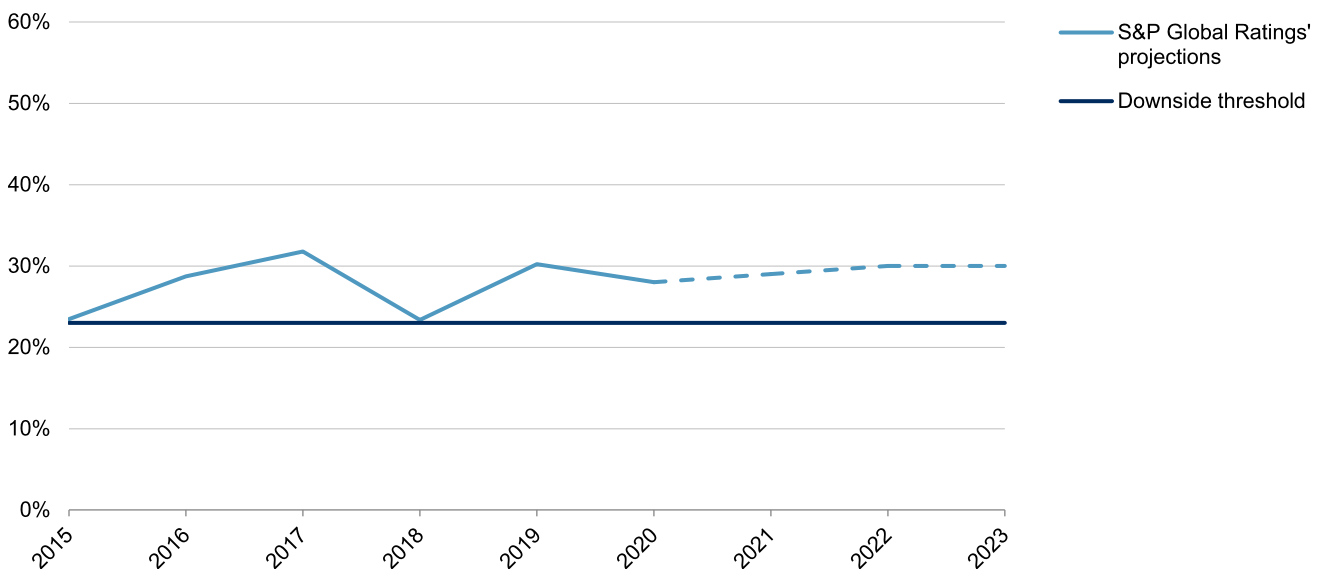
Credit Highlights

Overview

Key strengths	Key risks
Significant headroom for the rating in its credit metrics, with S&P Global Ratings-forecast funds from operations to debt at about 28% year 2020, well above our rating downside threshold at 23%	Risk that DSOs in Sweden will not transfer unused revenues from previous periods to the current period (2020-2023) and upcoming period as the cut in remuneration is significant
Stable and predictable cash generation from electricity distribution and district heating. Together, they represent about 90% of total EBITDA	Political risk related to environmental factors, such as additional taxes or policies affecting Kraftringen's district heating business
Leading position in transforming its business to environmental friendly heat generation, with no fossil fuel use as of 2019	Increased operating costs, because of issues with integrating Skånska Energi AB, additional material debt-funded investments, or operational underperformance
Two notches of uplift in the rating stem from supportive ownership by the municipality of Lund (AAA/Stable/A-1+; K-1)	

S&P Global Ratings expect Kraftringen Energi AB (publ)'s credit ratios to stabilize in 2020-2022, with significant credit headroom. In particular, we expect FFO to debt above 28% (see chart). Given the typically very stable operations, with only limited variation, we view this as well above our downside rating threshold of 23%. We therefore also expect the company's credit ratios to withstand the less favorable regulatory framework for distribution system operations (DSO) that come into effect as of January 2020.

Kraftringen Energi AB (publ)--FFO-To-Debt Threshold



FFO--Funds from operations. Source: S&P Global Ratings.

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We understand that Kraftringen will not be affected significantly by COVID-19-related issues, because DSO activities have minimal volume exposure, and its district heating would not be imposed by significant demand drop. We do not expect Kraftringen to suffer from significant creditor losses either, as its customer concentration is very low in its main activities.

S&P Global Ratings views positively the high share of contribution from regulated electricity distribution and district heating, about 90% of EBITDA, because this type of operations are very stable. About 50% of EBITDA stems from DSO activities and about 40% stems from its district heating business. We expect the DSO business to continue to generate stable EBITDA of Swedish krona (SEK) 700 million-SEK750 million annually (excluding regulated activities contribution from Skånska Energi AB), with very little volatility. In addition, we view its district heating business as stable with monopoly like features, as barriers to entry are high. Pipes are buried in cities, and it would require extensive work and high costs to challenge the company as the heat provider in its region.

Kraftringen expects to mitigate the cut in remuneration in the new regulatory period by transferring unused revenue from prior periods. We expect limited effect from the change in regulation, as Kraftringen has unused revenues from previous periods to roll over to the low weighted-average cost of capital (WACC) period. This comes as the company has not used its revenue frames. In total, Kraftringen has about SEK800 million to roll over to the current period, which will partly mitigate the lower WACC. We expect DSO activities to represent about 50% of total EBITDA for the upcoming regulatory period, 2020-2023. On June 24, 2019, the regulator announced its decision to reduce WACC to 2.16% for the next regulatory period. This is materially lower than the 5.85% WACC for the current regulatory period and lower than we expected, and because of the new Swedish regulatory framework for DSOs starting 2020 (see "Are Regulatory Framework Changes Threatening The Credit Quality Of Swedish DSOs?" published Aug. 21, 2019, on

RatingsDirect). We understand that DSOs will be able to transfer unused revenue from previous periods, but the regulator has yet to outline the requirements for doing so. Uncertainties therefore remain regarding the regulatory framework for DSOs in Sweden.

Kraftringen's 100% fossil fuel-free production shows resilience against newly introduced environmental tax implementation. The company has put in efforts to achieve fossil fuel-free production, well earlier than its peers, and has increased investments historically. In the district heating business, it only uses fossil free fuels such as bio mass (wood pellets), and Kraftringen does not use waste as fuel and was therefore not exposed to the tax on waste as fuel, which was introduced in April 2020. The new taxation is based on a metric ton (Mt) of waste used as fuel, with a taxation of SEK75 per Mt (/Mt) in 2020, increasing to SEK100/Mt in 2021 and SEK125/Mt in 2022. For example, in 2018, Tekniska verken i Linköping AB (A+/Stable/A-1) used about 600,000 tons of waste as fuel. The recent tax implementation on waste that have affected other district heating providers such as Tekniska verken and Stockholm Exergi, but only to a small extent.

The acquisition of Skånska Energi is strategic with great potential for synergies within DSO activities, but timing is uncertain. Kraftringen announced that it has increased its total stake in Skånska Energi to 63% from 10% for SEK323 million (€31.3 million) in November 2018. Today, Kraftringen owns about 72% of Skånska Energi. We view the acquisition as strategic and have a great potential for synergies within DSO activities because the location is in between current grids, and maintenance and personnel costs could easily decrease. However, the full effect could only be reached if Skånska Energi becomes 100% integrated with Kraftringen, and there are uncertainties on the timing because the owner of the remaining 26.4% stake. The reasons for the acquisition:

- Skånska Energi has 19,000 DSO customers, and it will increase Kraftringen DSO customers by about 18% to 125,000.
- We expect Kraftringen to find synergies and efficiency effects with full consolidation, because of similar businesses in the same region.

The utility has a strong link to Municipality of Lund. Kraftringen is a regional multi-utility company, majority-owned (82%) by the municipality of Lund (AAA/Stable/A-1+; K-1 Nordic scale rating). We see Lund as a strong and stable shareholder, and has a dominating influence on Kraftringen's strategy and business plans. We understand that there are no political incentives to privatize the company.

Outlook: Stable

The stable outlook reflects our expectation that Kraftringen will have the possibility to transferring unused revenue from prior periods, it will smoothly integrate Skånska Energi, and it will continue to benefit from its regulated and stable electricity distribution operations and fairly steady district heating operations. We estimate FFO to debt of 28%-30% in 2020-2021.

Downside scenario

We could lower our ratings on Kraftringen if credit ratings weakened materially in contrast to our forecasts, for example if FFO to debt protractedly stayed below 23%. This could stem from additional material debt-funded investments, or operational underperformance such as issues with integrating Skånska Energi. We could also lower the rating if the utility's liquidity deteriorated below our thresholds for an adequate liquidity assessment.

Furthermore, given that the likelihood of extraordinary government support is an important element of our ratings on Kraftringen, we could lower the ratings if assumed support from Lund weakened due to the municipality significantly diluting its ownership in the company. However, we view this as unlikely.

Upside scenario

We could consider an upgrade if Kraftringen's FFO to debt rose sustainably above 30% and together with positive discretionary cash flow. We do not expect this to occur in the next two-to-three years because of the recent debt-funded acquisition and its fairly large capital expenditure (capex) program.

Our Base-Case Scenario

Assumptions	Key Metrics			
<ul style="list-style-type: none"> Price increase of about 1% annually for district heating, and negative 1% in 2020 and no change in 2021 for DSOs WACC at 2.16% for the 2020-2023 regulatory period, but mitigated by the possibility to transfer unused revenues of about 800 million to be used for the period The 100% consolidation of Skånska Energi. However, we have not assumed the acquisition of the minority share will happen in 2020-2021 so the utility might not benefit fully from synergies Warmer weather to be mitigated by increased revenue in the district heating activities 		2019A	2020F	2021-2022E
	EBITDA (mil. SEK)	796	830-880	880-930
	FFO (mil. SEK)	716	730-780	740-840
	Debt (mil. SEK)	2,370	2,500-2,600	2,450-2,600
	Capex (mil. SEK)	457	500-550	500-550
	Dividend (mil. SEK)	117	147	135-160
	FFO/debt (%)	30	28-30	28-32
	Debt/EBITDA (x)	3.0	2.8-3.1	2.5-3.0
	DCF/debt (%)	5.9	(2)-2	0-4
<p>A--Actual. F--Forecast. E--Estimate. SEK--Swedish krona. FFO--Funds from operations. Capex--Capital expenditure. DCF--Discretionary cash flow.</p>				

- Investments of SEK500 million-SEK 550 million annually in 2020 and 2021
- Annual dividends of about SEK150 million in 2020 and 2021

Base-case projections

Distribution and district heating remain the key contributors to EBITDA. We expect EBITDA and FFO to remain near SEK800 million and SEK700 million in 2020 and 2021, respectively. This is despite pressure on earnings for Swedish DSOs and warmer weather that lowers the need for district heating, because we expect that Krafringen could compensate for the lower WACC by transferring unused revenues from prior periods. Furthermore, we expect margins to remain strong in its district heating business, at 33%-35%. Krafringen's district heating production is 100% fossil-free, so we expect it to be unaffected by the recent tax implementation on waste, that negatively affected other district heating providers in Sweden, because it could be problematic to pass through the costs in full.

Investments will focus on regulated activities, but we foresee a decreasing trend. We expect investments will peak in 2020 at about SEK550 million, then gradually decrease year by year to about SEK400 million by 2023. The main investments over the next few years include the following:

- About 60%-65% of annual total investments are directed into its DSO activities. We expect total DSO-related investments at about SEK1.2 billion-SEK1.3 billion from 2020-2023.
- District heating-related investments represent 30%-35% of total annual investments. We expect the utility to invest SEK600 million to be invested into the district heating businesses, mainly into the grid but also additional capacity investments for peak periods.
- The rest is directed into fiber and gas related investments, but also other smaller projects.

We expect credit ratios to remain solid as cash flows increase. Krafringen exceeded our expectations in 2019, with adjusted FFO to debt of 30%. We expect the company to maintain financial headroom, with ample headroom to our downside threshold of 23% with forecast FFO to debt of 28%-32% for 2020-2022.

Company Description

Krafringen is a regional multi-utility company, majority-owned (82%) by the Municipality of Lund. The company generates, distributes, and sells electricity. It also provides district heating and cooling services; photovoltaics services; gas, including natural gas and biogas; and fiber optic network services, such as black fiber, internet, and telephony services, as well as energy-related services. In 2019, S&P Global Ratings-adjusted EBITDA amounted to SEK796 million (about €73 million). Its DSO and district heating business account for 85%-90% of total EBITDA. It supplies power to approximately 125,000 connections in Skåne, Blekinge, and Småland. Its district heating services provide heat to about 9,000 customers. The company was formerly known as Lunds Energikoncernen AB (publ) and changed its name to Krafringen Energi AB (publ) in November 2013. It is headquartered in Lund, Sweden.

Business Risk: Satisfactory

Krafringen's stable and predictable cash flows from regulated electricity distribution and stable district heating account for 85%-90% of EBITDA, and support our view of the company's business risk. DSO activities have been the main contributor to EBITDA, at about 50% historically. District heating represents 35%-40%.

We see the regulatory framework for electricity in Sweden as stable and transparent, but WACC for the current regulatory is among the lowest in Europe. Krafringen is a local distributor and has limited scale within the electricity distribution grid, but also limited geographic and asset concentration increase vulnerability to weather and any operational difficulties in its district heating business. However, the company's district heating business is connected to neighboring district heating grids, which leads opportunities for its cost-efficient production.

Peer comparison

Table 1

Krafringen Energi AB (publ)--Peer Comparison			
Industry sector:			
(Mil. €)			
	Krafringen Energi AB (publ)	Stockholm Exergi Holding AB (publ)	Tekniska verken i Linköping AB
Rating as of April 29, 2020	BBB+/Stable/A-2	BBB+/Stable/A-2	A+/Stable/A-1
Revenue	3,215.30	8,754.50	5,063.30
EBITDA	707.5	7,010.30	1,386.70
FFO	637.5	2,532.50	1,318.40
Net income from continuing operations	307.4	933	221.7
Cash flow from operations	643.5	2,416.50	1,347.40
Free operating cash flow	165.8	700.5	556.7
Discretionary cash flow	54	17.1	307.4
Cash and short-term investments	141.5	101	290.7
Debt	2,265.50	12,130.00	1,952.70
Equity	3,065.50	12,028.70	4,891.30
Adjusted ratios			
EBITDA margin (%)	22	41.3	27.4
Return on capital (%)	8.6	5.3	11.6
EBITDA interest coverage (x)	12.8	15.3	24.7
FFO cash interest coverage (X)	12.1	15.9	24.4
Debt/EBITDA (x)	3.2	4.2	1.4
FFO/debt (%)	28.4	20.9	67.7
Cash flow from operations/debt (%)	28.7	20	69.5
Free operating cash flow/debt (%)	7.3	5.8	28.9
Discretionary cash flow/debt (%)	2.3	0.2	16.2

We view Tekniska verken i Linköping AB (TvAB) and Stockholm Exergi Holding AB (publ) as Kraftringen's closest rated peers. Tekniska verken is also a municipality-owned multi-utility, with a presence in electricity distribution, district heating, electricity supply and electricity generation. Stockholm Exergi's main business line consists of district heating with larger scale and in the growing Stockholm area compared to Kraftringen and TvAB. TvAB's EBITDA is about twice as high as Kraftringen's. Kraftringen has about 50% of its EBITDA stemming from DSO activities from a strong regulatory framework. However, this is offset by its smaller scale business compared to other peers. The company and TvAB have similar business risk profiles, while we view Stockholm Exergi as having a slightly stronger business risk profile because of its size and streamlined business model with less exposure from volatile activities.

TvAB's financial profile is stronger than its peers--its FFO to debt is at about 60% in 2019, while Kraftringen's FFO to debt is about 30% and Stockholm Exergi's is at 20%.

Kraftringen has the lowest stand-alone credit profile at 'bbb-'; TvAB has the strongest stand-alone credit profile at 'bbb+'; while Stockholm Exergi is at 'bbb'.

The difference in likelihood of timely and sufficient extraordinary support from its owner, is the municipality guarantee for debt issuance for TvAB, which Kraftringen does not have. Stockholm Exergi's 50% ownership from the City of Stockholm is weaker compared with Kraftringen's 82% municipality ownership.

Financial Risk: Intermediate

We expect Kraftringen to benefit from stable cash flow generation from its fully regulated electricity distribution business and its stable district heating operations. District heating profitability is supported by the modern CHP plant and a cost-efficient fuel mix. We forecast that adjusted FFO to debt will be 28%-32% over the next three years. In addition, we forecast that debt to EBITDA will decrease toward 2.5x by the end of 2022.

We positively expect that Kraftringen will cover its planned investments with cash flow, although its investments will peak this year at about SEK550 million, up from SEK480 million-SEK490 in 2018-2019. Investments are mainly because of environmental and efficiency investments in current plants, and to maintain its large investments into the electricity grid. We forecast that the company will increase its dividends to shareholders in the coming years, following stronger operating results. In our view, a high capex program and planned dividend program constrain our assessment of the company's financial risk profile. We expect debt to peak at SEK2.5 billion-SEK2.6 billion in 2020-2021, then to gradually decline.

Liquidity: Adequate

Kraftringen's adequate liquidity position indicates that, over the next 12 months, available liquidity sources in terms of cash, committed credit facilities, and operating cash flow should be about 1.3x the forecast near-term cash outflows such as debt repayments, capex, and dividends. We also expect that sources will exceed uses even if EBITDA declines by 10%, and that the company will maintain adequate headroom under its financial covenants (equity to total assets of more than 30%).

We also believe that the company has sound relationships with its banks, a satisfactory standing in the credit markets, as Kraftringen benefit from its municipality ownership in addition to its prudent risk management.

Principal Liquidity Sources	Principal Liquidity Uses
<p>According to our calculations, Kraftringen's liquidity sources as of March 31, 2020, comprise:</p> <ul style="list-style-type: none"> • Forecast FFO of about SEK730 million in 2020 and SEK770 million in 2021 • Access to committed unused credit lines of about SEK1.4 billion: Two facilities of a combined SEK1 billion that mature in 2024, a SEK300 million facility that matures in June 2021, and the SEK120 million facility provided by Municipality of Lund that mature in March 2022 	<ul style="list-style-type: none"> • Capex of about SEK 460 million annually • Debt maturities of SEK580 million in the next 12 months, and SEK 785 million in the following year. In the next 12 months, all SEK580 million of debt maturing is commercial paper • Dividends of about SEK 150 million annually

Environmental, Social, And Governance

Kraftringen is a front-runner in the Nordic region in terms of using only fossil-free fuels in its district heating business. The company has lowered its annual carbon dioxide footprint by 90% since 2007. It reached its fossil fuel-free goal in 2018, and had a fossil fuel-free production year in 2019. Thanks to this, Kraftringen is in our view less exposed to political risks. Swedish politicians are increasing their focus on major industries that drive carbon dioxide pollution, and have raised taxes on district heating in the past couple of years. The most recent tax implementation was to increase taxes on using waste as fuel for district heating, although Kraftringen does not use waste as fuel. The company's shift away from fossil fuels has increased investments, resulting in increased costs for end customers. Although Kraftringen has not increased prices as much as others, its district heating tariffs are now more expensive than the average in Sweden according to "Nils Holgersson Rapporten 2019." This said, the company has not reached its allowed income for regulatory electricity distribution, and therefore have the possibility of transferring underrecovered revenues to the upcoming regulatory period, which is positive for its credit metrics.

Government Influence

The long-term rating on Kraftringen is two notches higher than our assessment of the 'bbb-' stand-alone credit profile we have on the utility, reflecting our view that there is a high likelihood that Lund would provide timely and sufficient extraordinary support to the company in the event of financial distress. This is based on Kraftringen's:

- Strong link to the municipality, primarily reflecting 100% ownership by Kraftringen AB (not rated), a holding

company owned by the municipalities of Lund (82%), Eslov (12%), Horby (4%), and Lomma (2%). Kraftringen's operations are strongly aligned with the interests of the four municipalities and, in particular, Lund, which has a strong affiliation with, and controlling influence over, the group; and

- Important role for Lund, given its focus on providing critical public services and contributing to Lund's environmental agenda.

Reconciliation

Table 2

Kraftringen Energi AB (publ)--Reconciliation Of Reported Amounts With S&P Global Ratings' Adjusted Amounts (Mil. SEK)

--Fiscal year ended Dec. 31, 2019--

Kraftringen Energi AB (publ) reported amounts

	Debt	Shareholders' equity	EBITDA	Operating income	Interest expense	S&P Global Ratings' adjusted EBITDA	Cash flow from operations
Reported	2,398.4	3,121.7	776.7	445.0	52.5	796.5	699.2
S&P Global Ratings' adjustments							
Cash taxes paid	--	--	--	--	--	(22.5)	--
Cash interest paid	--	--	--	--	--	(53.7)	--
Operating leases	33.4	--	19.8	2.4	2.4	(2.4)	17.4
Incremental lease liabilities	27.2	--	--	1.9	1.9	(1.9)	(1.9)
Accessible cash and liquid investments	(88.8)	--	--	--	--	--	--
Nonoperating income (expense)	--	--	--	35.0	--	--	--
Noncontrolling interest/minority interest	--	238.0	--	--	--	--	--
Total adjustments	(28.2)	238.0	19.8	39.2	4.3	(80.5)	15.5

S&P Global Ratings' adjusted amounts

	Debt	Shareholders' equity	EBITDA	Operating income	Interest expense	S&P Global Ratings' adjusted EBITDA	Cash flow from operations
Adjusted	2,370.2	3,359.7	796.5	484.2	56.8	716.0	714.7

SEK--Swedish krona.

Ratings Score Snapshot

Issuer Credit Rating

BBB+/Stable/A-2

Business risk: Satisfactory

- **Country risk:** Very low
- **Industry risk:** Low
- **Competitive position:** Satisfactory

Financial risk: Intermediate

- **Cash flow/leverage:** Intermediate

Anchor: bbb

Modifiers

- **Diversification/portfolio effect:** Neutral (no impact)
- **Capital structure:** Neutral (no impact)
- **Financial policy:** Neutral (no impact)
- **Liquidity:** Adequate (no impact)
- **Management and governance:** Satisfactory (no impact)
- **Comparable rating analysis:** Neutral (-1 notch)

Stand-alone credit profile : bbb-

- **Likelihood of government support:** High (+2 notches from SACP)

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Corporate Methodology: Ratios And Adjustments , April 1, 2019
- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The Unregulated Power And Gas Industry, March 28, 2014
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- Criteria - Corporates - Utilities: Key Credit Factors For The Regulated Utilities Industry, 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 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

- Recent Rating Reviews On EMEA Utilities Reflect The Sector's Strength Against COVID-19 Shock, April 7, 2020
- EMEA Utilities Should Withstand COVID-19 Better Than Most Sectors, March 24, 2020
- ESG Industry Report Card: Regulated Utilities Networks , Feb. 11, 2020
- Are Regulatory Framework Changes Threatening The Credit Quality Of Swedish DSOs? , Aug. 21, 2019

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 May 12, 2020)*

Kraftringen Energi AB (publ)

Issuer Credit Rating	BBB+/Stable/A-2
<i>Nordic Regional Scale</i>	--/--/K-1
Commercial Paper	
<i>Nordic Regional Scale</i>	K-1

Issuer Credit Ratings History

01-Feb-2019		BBB+/Stable/A-2
23-Nov-2018		BBB+/Watch Neg/A-2
22-Feb-2017		BBB+/Positive/A-2
01-Feb-2019	<i>Nordic Regional Scale</i>	--/--/K-1
23-Nov-2018		--/Watch Neg/K-1
05-Feb-2010		--/--/K-1

*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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