

EDP Energias do Brasil S.A.

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Table Of Contents

Credit Highlights

Outlook

Our Base-Case Scenario

Company Description

Business Risk

Financial Risk

Liquidity

Covenant Analysis

Group Influence

Environmental, Social, And Governance

Reconciliation

Ratings Score Snapshot

Related Criteria

EDP Energias do Brasil S.A.

Credit Highlights

Issuer Credit Rating

None

Overview

Key strengths	Key risks
Integrated electricity group operating in the generation and distribution segments, and increasing its presence in the transmission segment.	Energy losses at its distributors still above regulatory targets.
Limited exposure of the generation segment to hydrology risk, given insurance and that a portion of its assured capacity is uncontracted.	Poor hydrology conditions could affect its distributors, because higher energy costs are not immediately incorporated into tariffs.
Brazil's regulations provide adequate framework.	Debt temporarily increasing with investments, especially in the new transmission lines, but credit metrics should recover as soon as these assets come on stream.

Increasing presence in the transmission segment. EDP Energias do Brasil S.A. (EDP Brasil)--which controls the two distribution companies EDP São Paulo Distribuição de Energia S.A. (EDP São Paulo) and EDP Espírito Santo Distribuição de Energia S.A. (EDP Espírito Santo)--focuses on electricity distribution and generation. Its presence in the market has increased recently after it delivered almost 350 megawatts (MW) of additional capacity during 2016-2018. In 2016, the group entered into the transmission segment, which should consume about R\$3.5 billion of investments, concentrated in 2019 and 2020. We expect this entry to result in a temporary increase in debt, but credit metrics should improve as soon as the bulk of the transmission lines start operating and the group begins to benefit from the stable and strong cash flows of this business.

Improving asset quality metrics. EDP Brasil continues to make significant investments at its electricity distributors to improve their operating efficiency. Overall, duration and frequency of service interruptions are improving and complying with regulatory standards. However, we still see some challenges in terms of the non-technical electricity losses for EDP Espírito Santo, which were 12.36% as of September 30, 2019, especially after the regulatory target was reduced from 10.74% in 2019 to 9.58% in 2021.

Outlook

The stable outlook on EDP Espírito Santo and EDP Sao Paulo reflects that on the sovereign rating on Brazil, given that we cap the ratings on both companies at the sovereign rating level, considering the regulated nature of their businesses.

Downside scenario

Given that we cap the ratings on EDP Espírito Santo and EDP Sao Paulo at the sovereign level, if we were to downgrade Brazil in the following 12 months, we expect a similar rating action on both companies.

Currently, we do not envision a scenario in the next 12 months that could lead to a downgrade of the distributors driven by their own fundamentals. However, a downgrade could occur if we believe that the parent has less incentive to provide support to the Brazilian operations and if EDP Brasil's credit metrics worsen significantly, such as funds

from operations (FFO) to debt below 12% and debt to EBITDA above 5.0x, which could result from a large debt-financed acquisition.

Upside scenario

An upgrade of EDP Espirito Santo on the global scale in the following 12 months would be contingent to a positive rating action on the sovereign rating of Brazil, everything else remaining equal. In addition, if parent EDP - Energias de Portugal (EDP Portugal; BBB-/Stable/A-3) demonstrates explicit support towards its Brazilian operations, we could also upgrade EDP Espirito Santo's global scale ratings.

The Brazil national scale ratings on EDP Espirito Santo and EDP Sao Paulo are already at the top of the Brazil national scale, so there is no upside scenario in this case.

Our Base-Case Scenario

Assumptions	Key Metrics				
<ul style="list-style-type: none"> Brazil's GDP growth, which we link to energy consumption, of 0.8% in 2019, 2.0% in 2020, 2.2% in 2021, and 2.5% in 2022 and onwards. Inflation, which we link to electricity tariffs and contracts, of 3.4% in 2019, 3.9% in 2020, and 4.0% in 2021 and onwards. Electricity losses gradually decreasing, following the investments especially at EDP Espirito Santo, converging to its regulatory target. Tariff readjustments of negative 4.84% in 2019 for EDP Espirito Santo (announced in August) and negative 5.33% for EDP São Paulo (announced in October), and pegged to inflation from 2020 on. Energy prices increasing according to inflation in Brazil, except for the portion supplied by bi-national hydro-plant Itaipu (brAAA/Stable) that is pegged to the U.S. dollar. Generating Scaling Factor (GSF) of 82.5% in 2019, 85.0% in 2020, and 87.5% in 2021 and onwards. Most of the cash flow from the transmission segment coming on stream between 2021 and 2022. Consolidated investments of about R\$2.5 billion in 2019 and about R\$2.0 billion in 2020, most of it in the transmission segment. We assumed that EDP Brasil will have a dividend payout of 50% of previous year's net income. <p>Based on these assumptions, we expect EDP Brasil to present the following adjusted credit metrics (which don't consider the regulatory accounts flowing to the income statement, but we incorporate them in our projections based on our expectation of monetization, if it's an asset, or as cash outflow, if it's a liability):</p>	2018a	2019f	2020f	2021f	
	EBITDA (Mil. R\$)	2,447.2	2,900-3,200	2,900-3,200	3,200-3,500
	FFO (Mil. R\$)	1,710.1	1,800-2,00	1,800-2,000	2,000-2,200
	Debt/EBITDA	3.0x	2.7x-3.0x	2.7x-3.0x	2.4x-2.7x
	FFO to debt	23.1%	22%-25%	22%-25%	25%-28%
	a--Actual. f--Forecast.				

Base-case projections

We analyze EDP Espírito Santo and EDP Sao Paulo based on EDP Brasil's consolidated figures, given our view that the group adopts an integrated financial strategy and actively manages its subsidiaries' operations.

Company Description

EDP São Paulo and EDP Espírito Santo are two distribution companies controlled by the electric power integrated group EDP Brasil (not rated) that generate, distribute, trade, and transmit electricity.

EDP São Paulo has monopoly rights to serve the captive market of 28 cities in the state of São Paulo until October 2028. In the rolling twelve months ended on Sept. 30, 2019, EDP São Paulo distributed approximately 16,100 gigawatt hours (GWh) to its 1.9 million clients. EDP Espírito Santo has the monopoly rights to provide electricity to the captive market of 70 cities in the state of Espírito Santo until July 2025, and distributed 11,300 GWh of electricity in the twelve months ended in Sept. 30, 2019. Because of the monopolistic characteristics of the electric power distribution services in Brazil, market share doesn't necessarily indicate efficiency, given that the concession areas are determined by the contracts with the granting authority - the Ministry of Mines and Energy.

The generation segment, through hydro and thermal power generation, is the most relevant for the group in terms of cash flow. Its portfolio amounts to 2.32 GW of installed capacity, out of which 720 MW are from thermal generation and the remaining portion is hydro. It also has non-controlling stakes in three operating hydro plants: Cachoeira Caldeirão (219 MW), Jari (393 MW), and São Manoel (700 MW).

EDP Brasil entered in the transmission segment in 2016, when it started to participate in auctions led by the regulator to build and operate transmission lines. Construction of the bulk of the lines that it won should be concluded in the next few years and should start contributing to cash flows from 2020 onwards.

EDP Brasil is controlled by the Portuguese power group EDP Portugal, which has 51.2% of its shares. The remaining shares are free float.

Business Risk

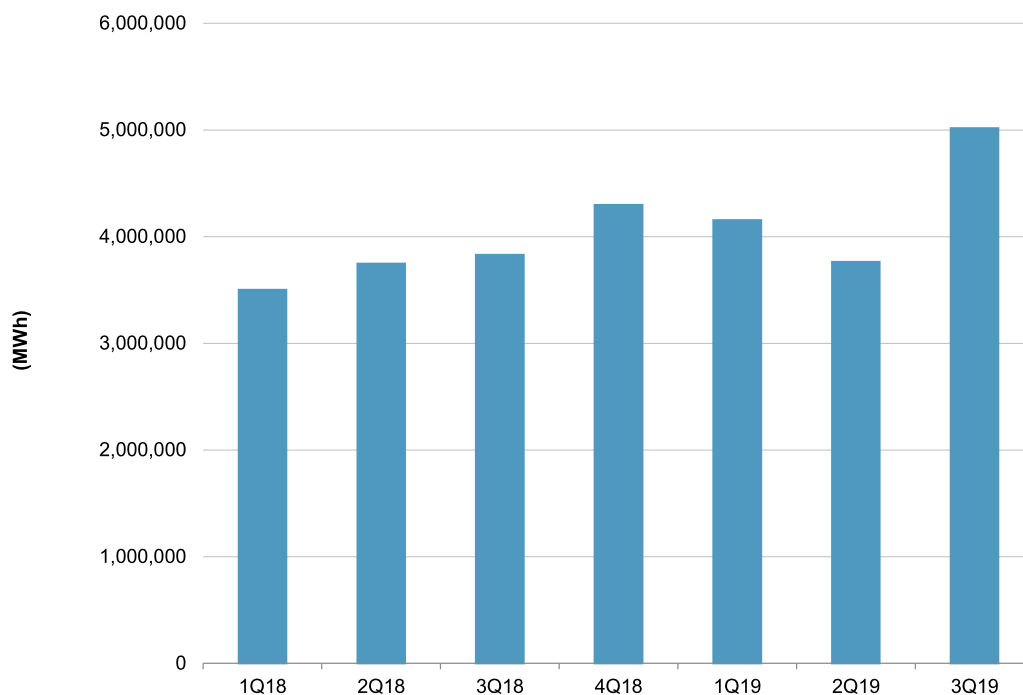
Proven federal regulatory framework. We view the regulatory framework in Brazil as credit supportive. ANEEL, the federal regulator, is responsible for setting the rates for distribution and transmission companies. Rates are set in order to remunerate the investments made in the concession area. Rate setting for transmitters is simpler, because these companies receive revenues according to their availability to the system. Given that the distribution companies currently operate under a model of pass-through costs, along with the remuneration of their investments, they have annual rate readjustments every three to five years (depending on the concession contract). Rate readjustments allow the companies to pass through to the clients the electricity costs incurred and general and administrative-related

expenses, which are pegged to inflation. Rate reviews incorporate efficiency gains during the cycle, which are shared with the customers. In each cycle, the regulator sets a new weighted average cost of capital (WACC) to remunerate the investments during the concession. Distribution companies also have the right to request an extraordinary rate review in order to recover the financial and economic rebalancing of the concession contract.

We believe that power generators tend to mitigate cash flow volatility through long-term power sale contracts to distribution companies and large users. The generation segment of EDP Brasil has a diversified asset base with hydro and thermal power plants, combining short and long-term power purchase agreements signed in the free and regulated market, respectively. In 2016, EDP Brasil adhered to a law to protect its generation from hydrology risks whenever the Generation Scaling Factor (GSF) falls below 92%, which helps make cash flows more predictable. For the free market, it maintains about 15% of its assured energy uncontracted, showing a conservative energy hedge strategy.

Chart 1

Energy Sold By Generation Companies



Source: S&P Global Ratings.

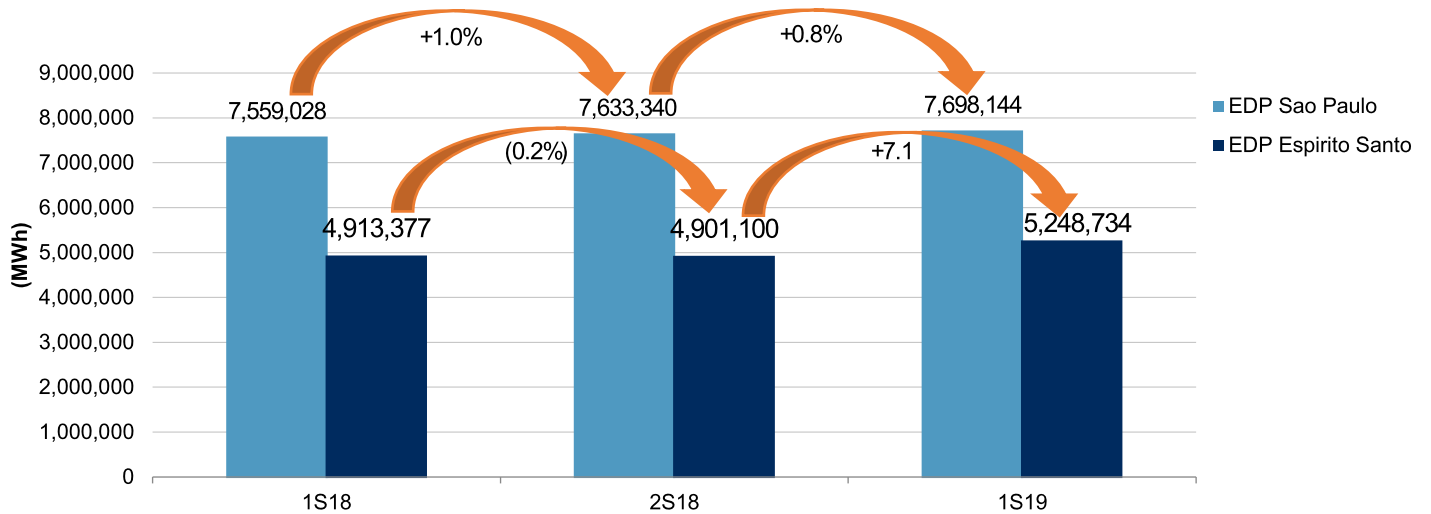
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The customer base of EDP Brasil's distributors is mainly composed of residential clients, a category that is less exposed to economic downturns. Both distribution companies are not significantly exposed to spot market prices, nor to a specific supplier with the exception of Itaipu (which we do not consider a risk). Following the investments in the last years, EDP Brasil's distributors are improving the quality metrics in their concession areas, with average duration and frequency of service interruptions complying with the regulatory standards. However, losses at EDP Espírito Santo are consistently above ANEEL's standards for the concession area, so the gap between regulatory and effective losses,

although falling, isn't being passed on to the rates.

Chart 2

Distributed Volume (MWh)

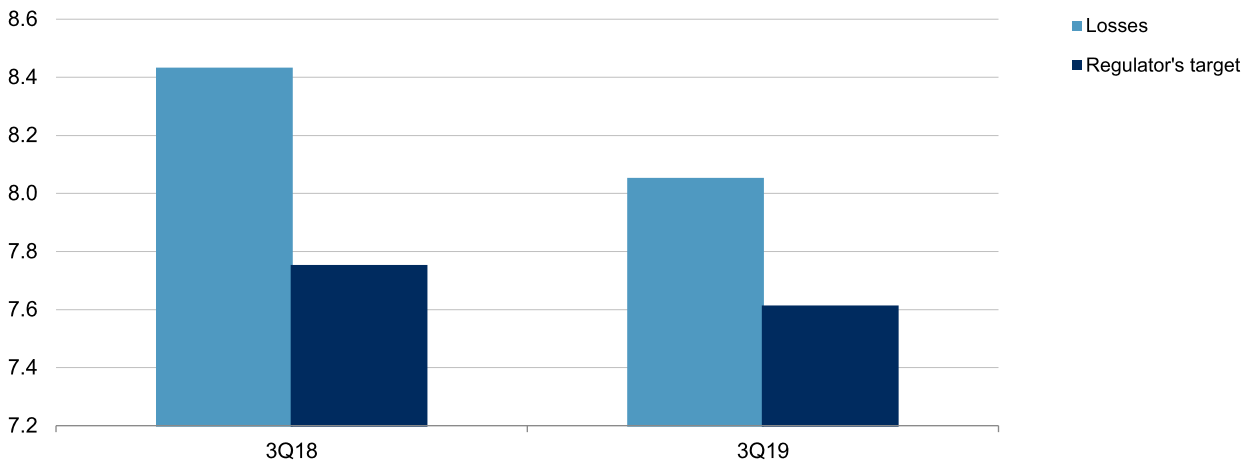


S--Semester. Source: S&P Global Ratings.

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Chart 3

EDP São Paulo's Total Losses (%)

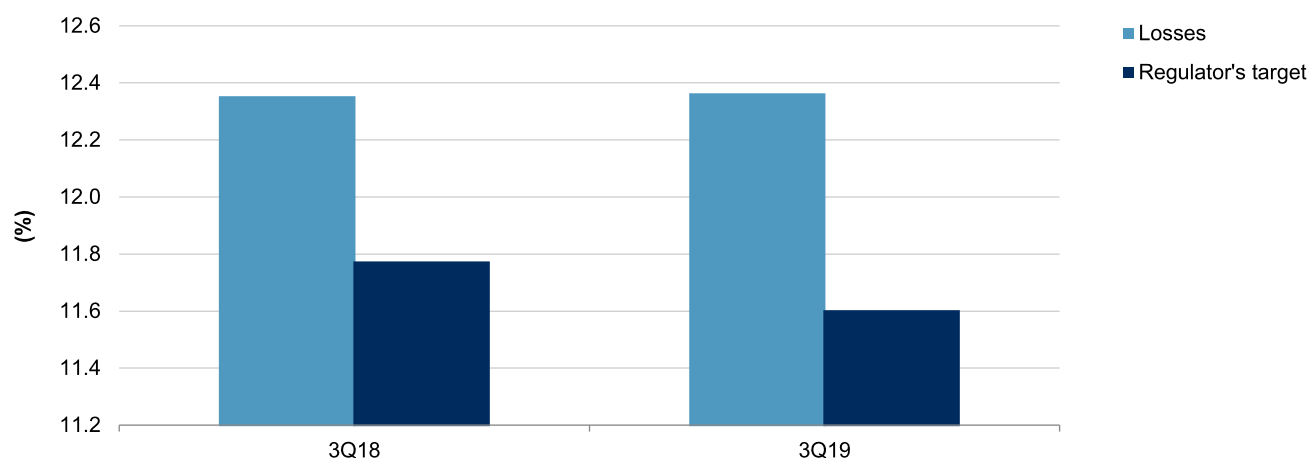


Source: S&P Global Ratings.

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Chart 4

EDP Espírito Santo's Total Losses



Source: S&P Global Ratings.

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Peer comparison

Table 1

EDP Energias do Brasil S.A. -- Peer Comparison

Industry Sector: Electric Utility

	EDP Energias do Brasil S.A.	CPFL Energia S.A.	Neoenergia S.A.	EDP - Energias de Portugal S.A.
Ratings as of Oct. 4, 2019	BB-/Stable/--	BB-/Stable/--	BB-/Stable/B	BBB-/Stable/A-3
--Fiscal year ended Dec. 31, 2018--				
(Mil. \$)				
Revenue	3,303.4	6,779.8	5,940.7	17,491.8
EBITDA	632.1	1,417.0	1,313.4	3,671.7
Funds from operations (FFO)	441.7	849.1	983.7	2,810.9
Interest expense	174.4	420.1	334.5	811.3
Cash interest paid	116.8	357.0	329.7	786.4
Cash flow from operations	336.7	213.9	343.2	2,745.7
Capital expenditure	280.1	525.4	1,070.2	1,917.5
Free operating cash flow (FOCF)	56.5	(311.5)	(727.0)	828.1
Discretionary cash flow (DCF)	(78.4)	(394.7)	(865.1)	(178.7)
Cash and short-term investments	614.2	488.6	1,021.7	1,969.5
Debt	1,908.5	4,934.6	4,370.3	20,776.9
Equity	2,499.0	3,237.2	4,540.3	15,198.9
Adjusted ratios				
EBITDA margin (%)	19.1	20.9	22.1	21.0
Return on capital (%)	14.1	15.2	13.2	5.5

Table 1

EDP Energias do Brasil S.A. -- Peer Comparison (cont.)				
EBITDA interest coverage (x)	3.6	3.4	3.9	4.5
FFO cash interest coverage (x)	4.8	3.4	4.0	4.6
Debt/EBITDA (x)	3.0	3.5	3.3	5.7
FFO/debt (%)	23.1	17.2	22.5	13.5
Cash flow from operations/debt (%)	17.6	4.3	7.9	13.2
FOCF/debt (%)	3.0	(6.3)	(16.6)	4.0
DCF/debt (%)	(4.1)	(8.0)	(19.8)	(0.9)

We chose peers that also operate in the Brazilian electric sector, such as CPFL Energia S.A. and Neoenergia S.A., which operate in the distribution, generation, and transmission segments. When comparing the three groups, we view EDP Brasil as the most exposed to the generation segment, which could be riskier if the company hasn't contracted hydrology insurance. Additionally, going forward we believe that EDP Brasil will report lower leverage than Neoenergia and similar leverage to CPFL. EDP Brasil began investing in the transmission segment earlier, and because of that will start collecting the benefits in 2020, which should increase the predictability of the cash flows and to reduce leverage before its peers do.

Financial Risk

After peaking in 2019 and 2020, we expect EDP Brasil's consolidated leverage to gradually improve in the next few years with the addition of cash flows from the transmission lines currently under construction, while the distributors of the group recover their regulatory assets. Nevertheless, we expect debt to EBITDA to stay close to 3.0x and FFO to debt to remain above 22% in the next two years.

Financial summary

Table 2

EDP Energias do Brasil S.A. -- Financial Summary					
Industry Sector: Electric Utility					
--Fiscal year ended Dec. 31--					
(Mil. \$)	2018	2017	2016	2015	2014
Revenue	3,303.4	3,393.0	3,086.3	2,441.8	3,013.9
EBITDA	632.1	556.6	1,004.4	462.4	380.5
Funds from operations (FFO)	441.7	304.4	786.8	304.3	286.7
Interest expense	174.4	215.4	242.4	177.4	198.1
Cash interest paid	116.8	192.1	217.6	158.1	93.8
Cash flow from operations	336.7	223.8	498.5	237.7	170.3
Capital expenditure	280.1	228.8	186.4	102.5	133.7
Free operating cash flow (FOCF)	56.5	(5.1)	312.1	135.2	36.6
Discretionary cash flow (DCF)	(78.4)	(133.5)	139.4	55.4	(116.9)
Cash and short-term investments	614.2	517.8	619.8	290.3	311.3
Gross available cash	614.2	517.8	619.8	290.3	311.3

Table 2

EDP Energias do Brasil S.A. -- Financial Summary (cont.)					
Industry Sector: Electric Utility					
	--Fiscal year ended Dec. 31--				
(Mil. \$)	2018	2017	2016	2015	2014
Debt	1,908.5	2,108.3	1,782.9	1,788.4	2,072.4
Equity	2,499.0	2,727.8	2,759.9	1,890.3	2,472.3
Adjusted ratios					
EBITDA margin (%)	19.1	16.4	32.5	18.9	12.6
Return on capital (%)	14.1	9.3	21.4	17.5	9.5
EBITDA interest coverage (x)	3.6	2.6	4.1	2.6	1.9
FFO cash interest coverage (x)	4.8	2.6	4.6	2.9	4.1
Debt/EBITDA (x)	3.0	3.8	1.8	3.9	5.4
FFO/debt (%)	23.1	14.4	44.1	17.0	13.8
Cash flow from operations/debt (%)	17.6	10.6	28.0	13.3	8.2
FOCF/debt (%)	3.0	(0.2)	17.5	7.6	1.8
DCF/debt (%)	(4.1)	(6.3)	7.8	3.1	(5.6)

Liquidity

We assess EDP Brasil's liquidity as adequate. We expect the group's sources of liquidity to surpass its uses by more than 20% in the next 12 months, even considering the still high level of investments. We also expect the difference between sources and uses of cash to remain positive even if the expected EBITDA is 15% lower than in our base-case scenario.

The group has good relationships with banks and access to debt markets, as shown by the recent issuances made by the group's subsidiaries, such as the 8th debentures issuance from EDP Espirito Santo and the 10th of EDP Sao Paulo. We believe the group has the appropriate mechanisms in place to face any high-impact, low-probability event with limited need for refinancing, given its flexibility to reduce the dividend payout and postpone investments under stressful periods. In addition to that, the company has flexibility to postpone the capital expenditures (capex) of the transmission lines if needed, because EDP Brasil already made most of the investment requirements.

Principal Liquidity Sources

- R\$2.7 billion in cash and equivalents as of Sept. 30, 2019.
- R\$1.77 billion in cash FFO in the next 12 months.

Principal Liquidity Uses

- R\$1.89 billion in debt maturities in the next 12 months, as of Sept. 30, 2019.
- Minimum dividend payouts of 25% of the previous year's net income, as required by law.
- About R\$1 billion of maintenance capex.

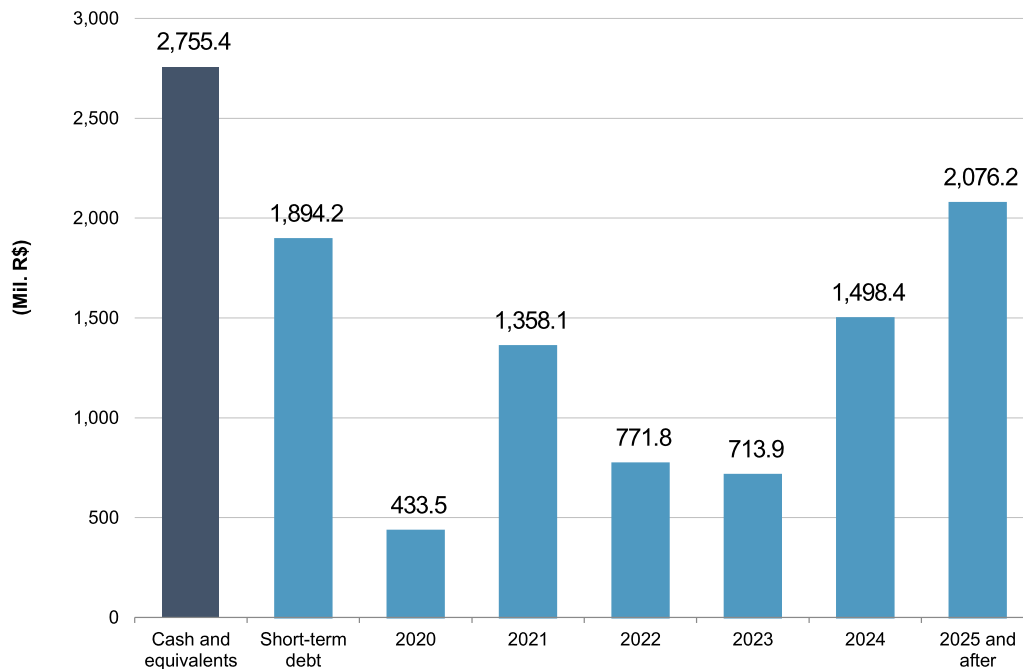
Debt maturities

EDP has the following consolidated debt maturity schedule as of Sept. 30, 2019:

Chart 5

Debt Amortization Schedule

As of Sept. 30, 2019



Source: S&P Global Ratings.

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Covenant Analysis

Compliance expectations

We expect EDP São Paulo and EDP Espírito Santo to remain in compliance with their financial covenants in the next three years based on the low debt metrics expected for these entities.

Requirements

Both EDP Espírito Santo and EDP São Paulo have financial covenants on some of their debt obligations that limit the subsidiary level net debt-to-adjusted-EBITDA ratio to 3.5x, measured annually with the end-of-year financial statements.

Group Influence

Both EDP SP and EDP ES are core subsidiaries of EDP Brasil, because they are fully owned and the distribution

segment represents about 40% of total EBITDA. EDP Brasil accounts for about 20% of the consolidated revenues of EDP Portugal, which mainly operates in Portugal, Spain, the U.S., Canada, and Brazil.

Environmental, Social, And Governance

We believe that one of the most important aspects in our analysis of EDP Brasil is the social factor, since an interruption in the distribution of electricity affects the population. EDP Espírito Santo and EDP São Paulo have certain requirements to comply with, in terms of maximum duration and frequency of service interruptions. If these requirements weren't met, it would hamper the cash flow generation of these companies. In addition to that, EDP Brasil operates the thermal plant PECEM (not rated), which could have a negative impact in the environment, given that it uses mineral coal as fuel. However, because it is only dispatched when hydrology is low, we don't consider it to be a major impact for the environment factor.

Reconciliation

Table 3

Reconciliation Of EDP Energias do Brasil S.A. Reported Amounts With S&P Global Ratings' Adjusted Amounts (Mil. \$)

--Fiscal year ended Dec. 31, 2018--

EDP Energias do Brasil S.A. reported amounts

	Debt	Shareholders' equity	Revenue	EBITDA	Operating income	Interest expense	S&P Global Ratings' adjusted EBITDA	Cash flow from operations
	1,926.7	2,201.8	3,573.5	619.0	558.8	153.1	632.1	453.5
S&P Global Ratings' adjustments								
Cash taxes paid	--	--	--	--	--	--	(73.6)	--
Cash taxes paid: Other	--	--	--	--	--	--	--	--
Cash interest paid	--	--	--	--	--	--	(116.8)	--
Accessible cash and liquid investments	(614.2)	--	--	--	--	--	--	--
Income (expense) of unconsolidated companies	--	--	--	(0.8)	--	--	--	--
Nonoperating income (expense)	--	--	--	--	30.9	--	--	--
Reclassification of interest and dividend cash flows	--	--	--	--	--	--	--	(116.8)
Noncontrolling interest/minority interest	--	297.3	--	--	--	--	--	--
Debt: Guarantees	350.8	--	--	--	--	--	--	--
Debt: Workers compensation/self insurance	225.4	--	--	--	--	--	--	--
Debt: Tax liabilities	19.8	--	--	--	--	--	--	--

Table 3

Reconciliation Of EDP Energias do Brasil S.A. Reported Amounts With S&P Global Ratings' Adjusted Amounts (Mil. \$) (cont.)								
Revenue: Other	--	--	(270.1)	(270.1)	(270.1)	--	--	--
COGS: Other nonoperating nonrecurring items	--	--	--	250.7	250.7	--	--	--
EBITDA: Other income/(expense)	--	--	--	(0.8)	(0.8)	--	--	--
EBITDA: Other	--	--	--	34.1	34.1	--	--	--
Interest expense: Other	--	--	--	--	--	21.2	--	--
Working capital: Taxes	--	--	--	--	--	--	--	73.6
Working capital: Other	--	--	--	--	--	--	--	24.6
Operating cash flow: Taxes	--	--	--	--	--	--	--	(73.6)
Operating cash flow: Other	--	--	--	--	--	--	--	(24.6)
Total adjustments	(18.2)	297.3	(270.1)	13.1	44.8	21.2	(190.4)	(116.8)
S&P Global Ratings' adjusted amounts								
	Debt	Equity	Revenue	EBITDA	EBIT	Interest expense	Funds from operations	Cash flow from operations
	1,908.5	2,499.0	3,303.4	632.1	603.6	174.4	441.7	336.7

Ratings Score Snapshot

EDP Espírito Santo:

- Global Scale: BB-/Stable/--
- National Scale: brAAA/Stable/--

Business risk: Satisfactory

- Country risk: Moderately High Risk
- Industry risk: Intermediate Risk
- Competitive position: Satisfactory

Financial risk: Significant

- Cash flow/Leverage: Significant

Anchor: bb+

Modifiers

- Diversification/Portfolio effect: Neutral/Undiversified
- Capital structure: Neutral

- Liquidity: Adequate
- Financial policy: Neutral
- Management and governance: Satisfactory
- Comparable rating analysis: Neutral

Stand-alone credit profile (SACP): bb+

Group rating methodology:

Between EDP Espirito Santo and EDP Brasil: Core

EDP São Paulo:

- National Scale: brAAA/Stable/--

Business risk: Satisfactory

- Country risk: Moderately High Risk
- Industry risk: Intermediate Risk
- Competitive position: Satisfactory

Financial risk: Significant

- Cash flow/Leverage: Significant

Modifiers

- Diversification/Portfolio effect: Neutral/Undiversified
- Capital structure: Neutral
- Liquidity: Adequate
- Financial policy: Neutral
- Management and governance: Satisfactory
- Comparable rating analysis: Neutral

Group rating methodology:

Between EDP Sao Paulo and EDP Brasil: Core

Related Criteria

- General Criteria: Methodology For National And Regional Scale Credit Ratings, June 25, 2018
- 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
- 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
- ARCHIVE | General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Ratings Above The Sovereign—Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- ARCHIVE | Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, 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

Ratings Detail (As Of December 3, 2019)*

EDP Energias do Brasil S.A.

Related Entities

EDP Espirito Santo Distribuicao de Energia S.A.

Issuer Credit Rating

BB-/Stable/--

Brazil National Scale

brAAA/Stable/--

EDP Sao Paulo Distribuicao de Energia S.A.

Issuer Credit Rating

brAAA/Stable/--

Brazil National Scale

*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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