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## French Mid-Market Companies Display Financial Conservatism In Challenging Economic Times

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# French Mid-Market Companies Display Financial Conservatism In Challenging Economic Times

*(Editor's Note: This report is the first in a series in which Standard & Poor's analyzes the credit characteristics of mid-market companies in a selection of countries in Europe.)*

France's mid-market companies are the backroom engine of the French economy. These enterprises--which we define as companies with revenues of between €100 million and €1.5 billion per year--are six times greater in number than the country's large and better-known corporate names and generated around €200 billion in aggregate turnover in 2012. In common with most European peers, French companies are being compelled to diversify their funding sources as tighter regulations force banks, their traditional lenders, to adopt a more selective lending policy. In fact, Standard & Poor's Ratings Services estimates France's mid-market will need to raise up to €800 billion of debt within the next five years.

Although mid-market firms in France have a greater presence in growth industries such as information technology and services relative to their larger peers, a majority of them remain concentrated in such pro-cyclical industries as consumer discretionary and industrial sectors, specifically construction and engineering. This exposure leads to lower profit margins and greater volatility of cash flow relative to large company peers in France and Europe overall. However, our study shows that many mid-market firms tend to offset this higher volatility by maintaining more conservative financial policies. This is illustrated by lower leverage ratios compared to large French and European corporates and larger cash holdings on average compared to large European corporates. Our study also found that some mid-market companies exhibit a solid business profile on the back of an established competitive position in growing niche and low risk markets.

## Overview

- We estimate France's mid-market companies will need to issue €800 billion in debt over the next five years for refinancing and capital investments.
- As banks, their main lenders, scale back loans to corporations to meet regulatory requirements, these companies are increasingly seeking new sources of funding and we believe private placements will increasingly fill this gap.
- Some mid-market companies exhibit solid business profiles on the back of strong competitive positions in growing niche markets, but many companies operating in low margin-driven or capital-intensive industries are exposed to greater challenges due to the small scale of their operations.
- However, in terms of leverage, cash-to-total assets, and interest cover, mid-market companies in France tend to exhibit more conservative financial profiles than their larger peers.

Looking ahead, our economic outlook for the French economy remains sub par, and this will continue to put pressure on all businesses in France, including midsize companies. On the funding side, investors, particularly insurance companies--important contributors to the development of the nascent Euro private placement market--are showing a growing interest in lending to these mid-market companies. Yet, barriers to this new market remain. To speed this

growth and create a coherent and transparent marketplace, participants need more information on the financial performance and creditworthiness of French mid-market companies.

## **Who Are The French Mid-Market Companies?**

For the purpose of this report, we studied an overall dataset of nonfinancial parent companies operating in France, for which we found over 30,000 listed and unlisted companies tracked by S&P Capital IQ. While large businesses, with annual revenues of greater than €1.5 billion, are well-known in the global financial markets, generating 74% of total sales in France, they constitute less than half a percentage of the French corporate landscape, numbering 103 businesses. Mid-market companies are six times more numerate, comprising 631 companies. They generated €203 billion in aggregate turnover for 2012, which represents 11% of total sales for French companies, according to the S&P Capital IQ data.

Mid-market companies are also well represented in growing industries. While in general they mirror the larger market with strong exposure to the consumer discretionary sector, a higher percentage of mid-market companies operate in growth sectors relative to larger companies, particularly in the information technology and services sectors (see chart 1). They are less highly represented in the broad industrial sectors, which we believe is because the capital investment needed for industrial companies is very high, particularly as traditional industries have consolidated. That said, they are strongly present in the construction and engineering industrial subsector, which requires less capital expenditure than other industrial subsectors (see chart 2).

Chart 1

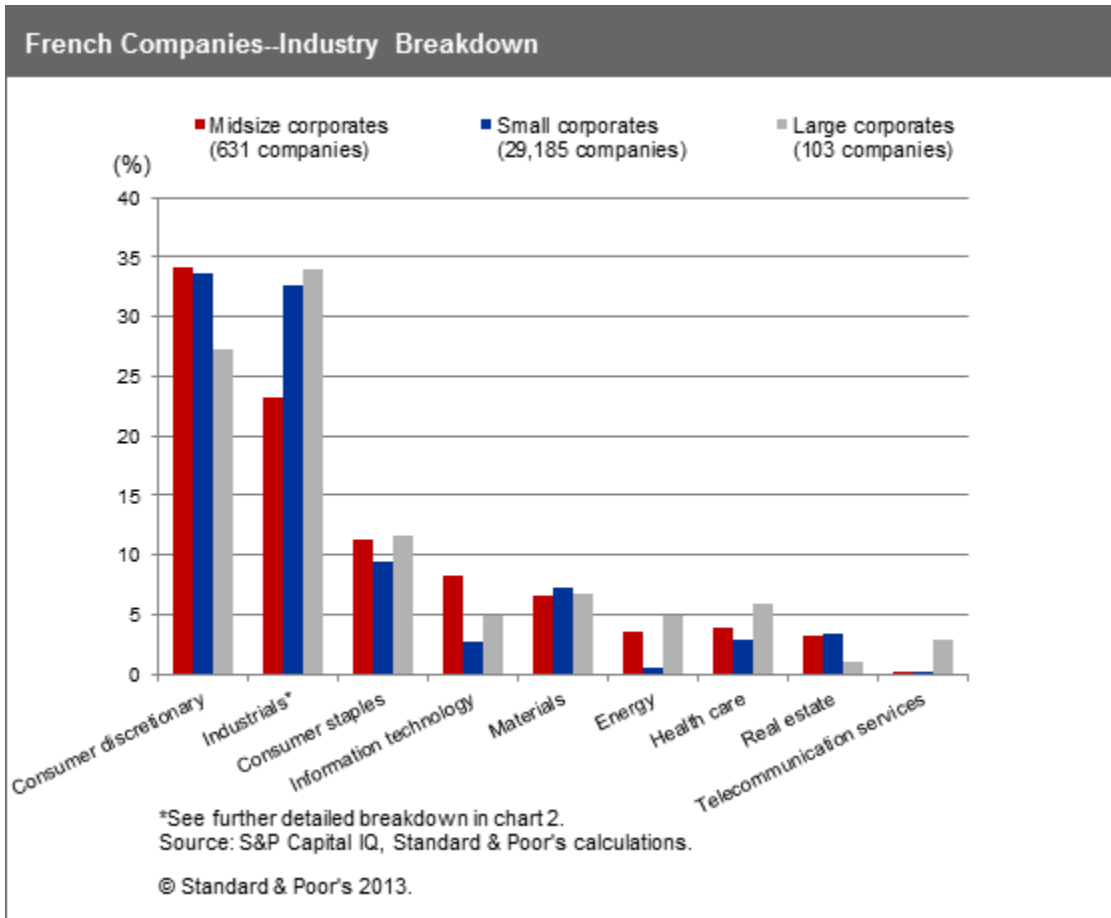
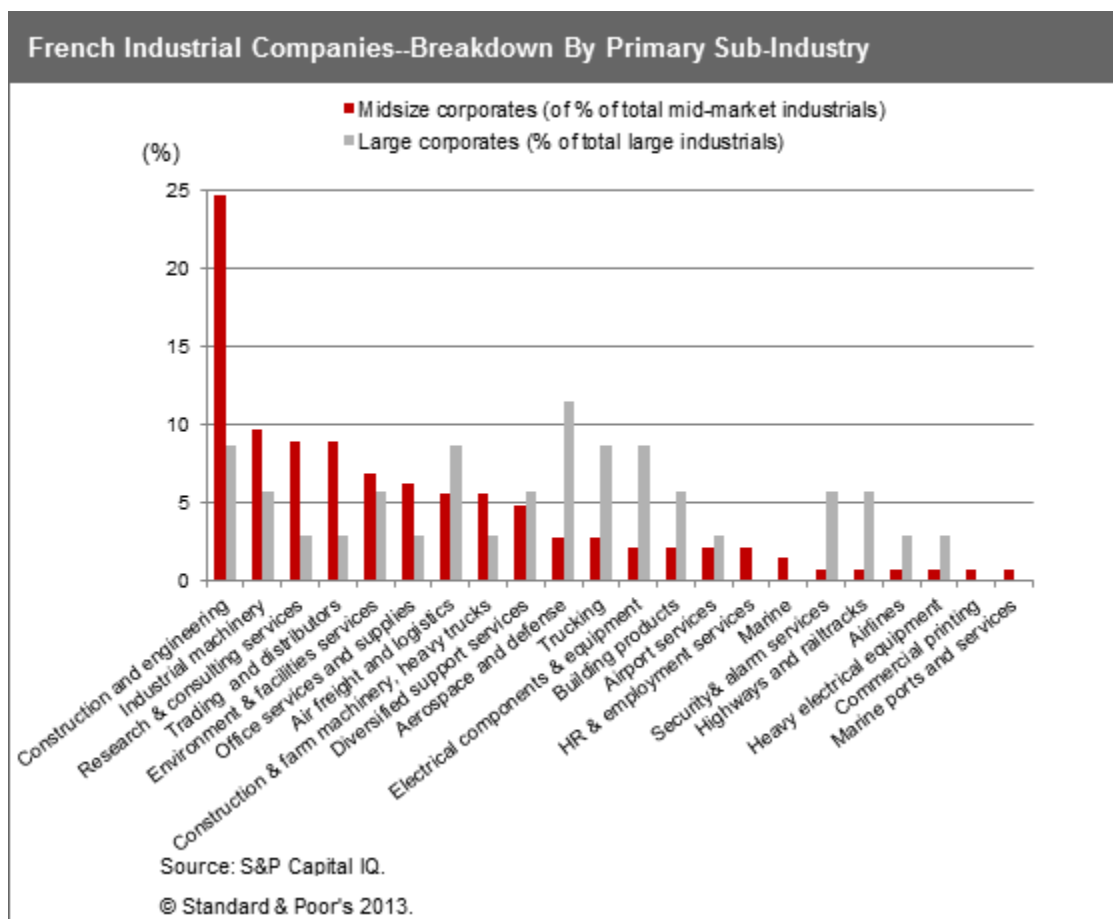


Chart 2



## A Slow Shift Toward Capital Market Funding

While traditionally French mid-market companies have relied overwhelmingly on bank loans for their funding, the current financial and economic situation is forcing them to seek alternative funding sources. One reason is that banks are reining in lending in response to the regulatory requirements on them to hold higher capital ratios. We expect this disintermediation trend will be a very gradual process lasting many years. In 2012, net lending by banks to the nonfinancial corporate sector contracted slightly and was compensated for by a noticeable increase in bond issuance and private placements (see chart 3). In the 12 months to June 2013, the stock of net lending to the French corporate sector contracted by 1% year on year (€8 billion), while over the same period corporate bond issuance and private placements increased by 4% (€24 billion). We believe net bank lending will continue to decline over the next few years on the back of tightening capital requirements for banks under Basel III. That said, we expect the contraction to be less pronounced in France than in Italy, Spain, and the U.K. (see chart 4), where banks face heavier deleveraging pressures. For more detail on trends in bank funding, see "Despite Relatively Calmer Markets, Systemic And Specific Funding Risks For Banks Have Not Gone Away," published July 18, 2013.

Chart 3

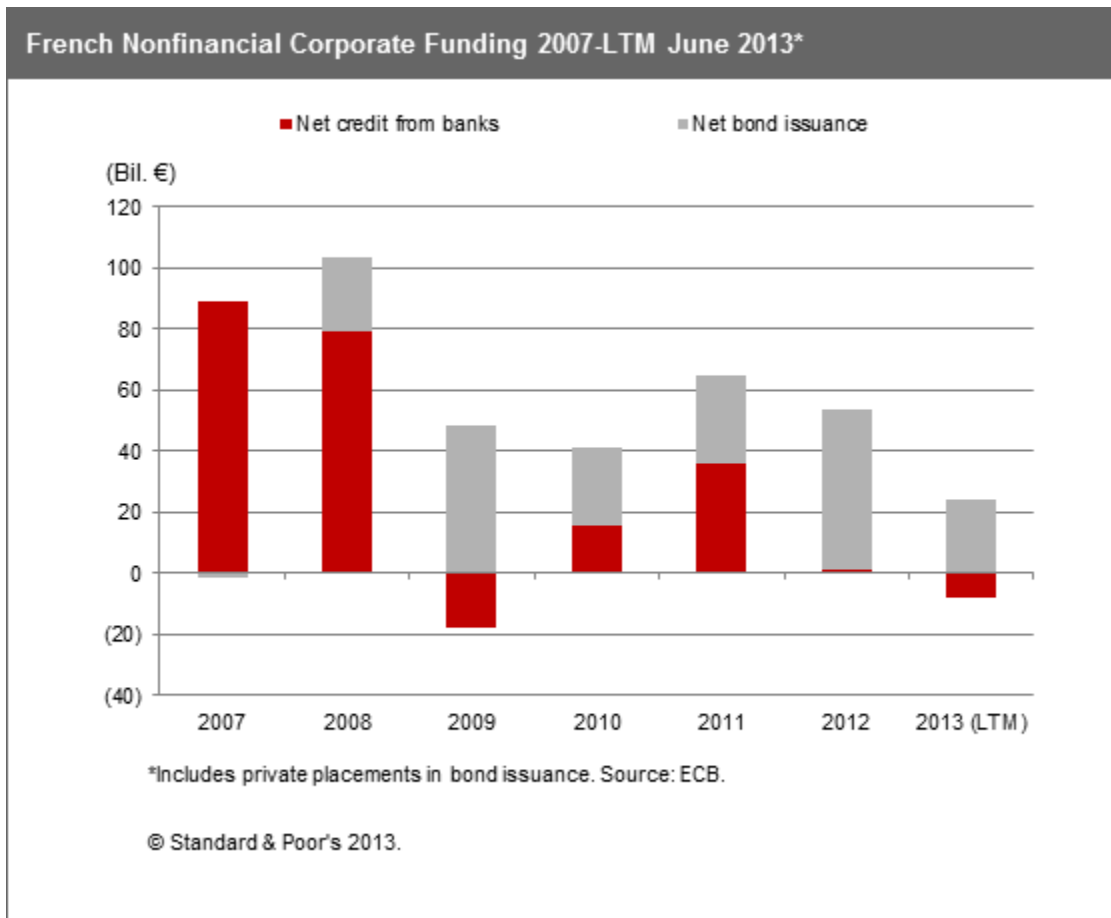
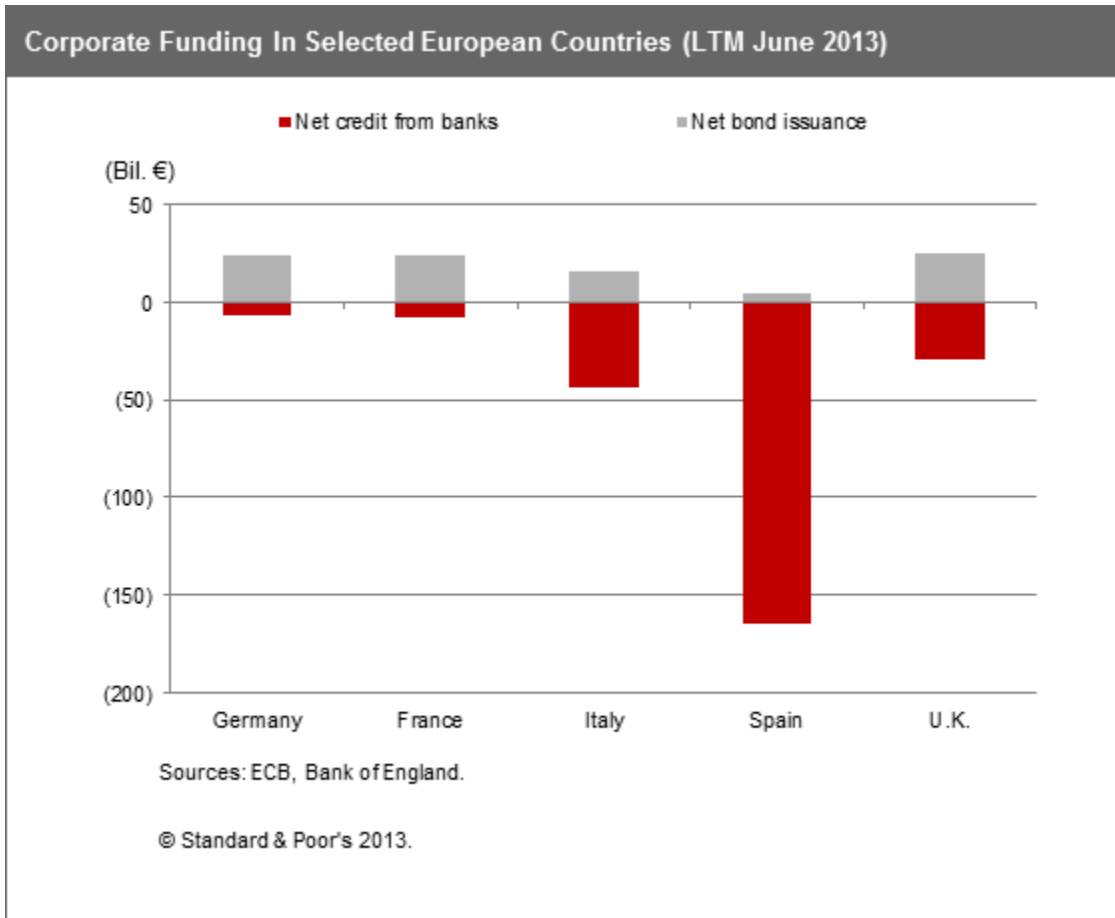
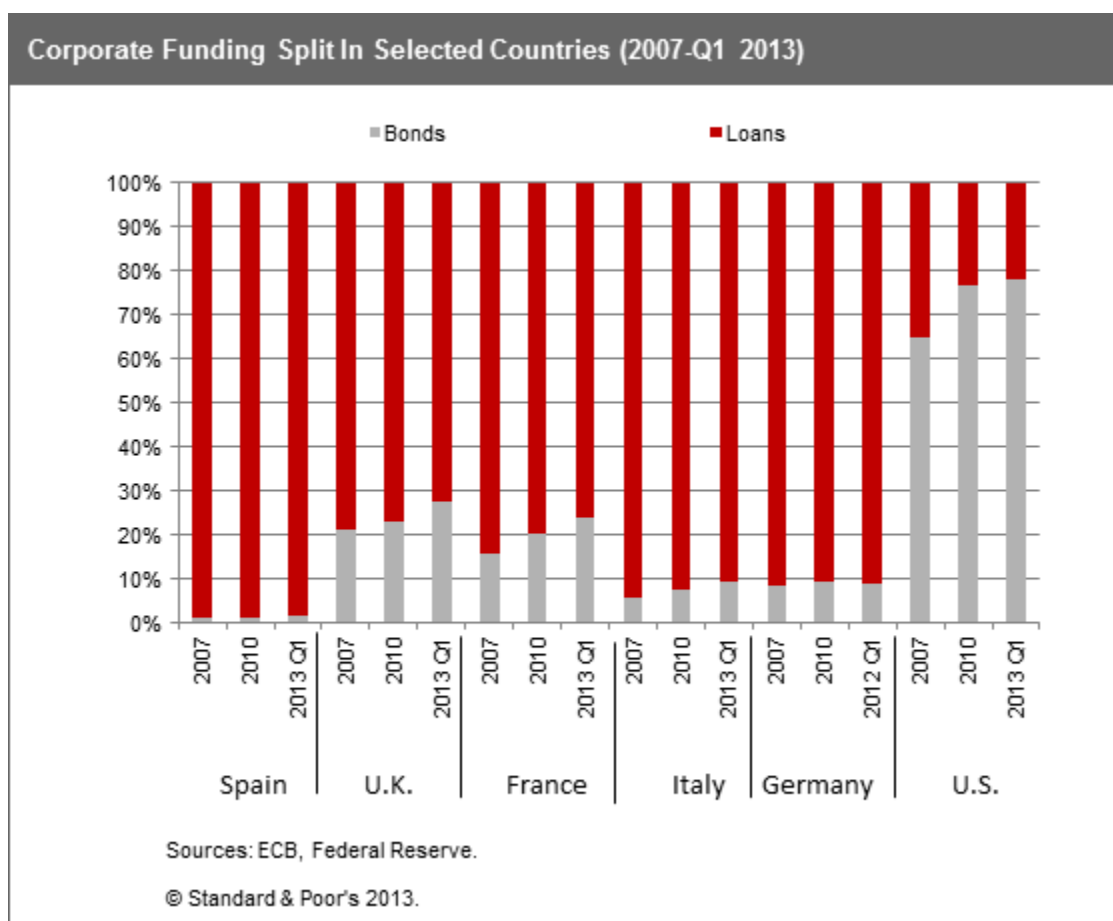


Chart 4



In spite of this recent trend, the proportion of capital market funding to corporates in France and other European countries is still far smaller than in the U.S. In the first quarter of 2013, corporate bonds comprised 76% of debt securities outstanding in the U.S., compared with just 24% in France and 28% in the U.K. (see chart 5). This nonetheless represents a speedy increase in recent years for these two countries specifically: for example, in 2007, only 15% of corporate debt capital was raised through the bond market in France. For more information disintermediation in Europe, see “Underwriting The Recovery: Europe’s Mid Market Seeks New Ways To Fund Growth,” published April 22, 2013.

Chart 5



## Private Placements And Direct Lending Are Developing

Mid-market companies are particularly hit by the corporate funding shift. While larger corporates have easier access to capital markets, and smaller companies are the focus of French authorities through funding initiatives, mid-market enterprises need to find alternative funding sources to their traditional relationship banks, on which they heavily rely. Standard & Poor's estimates that French mid-market companies will need to raise around €800 billion over the next five years to refinance €600 billion in debt and to fund capital investments of about €200 billion.

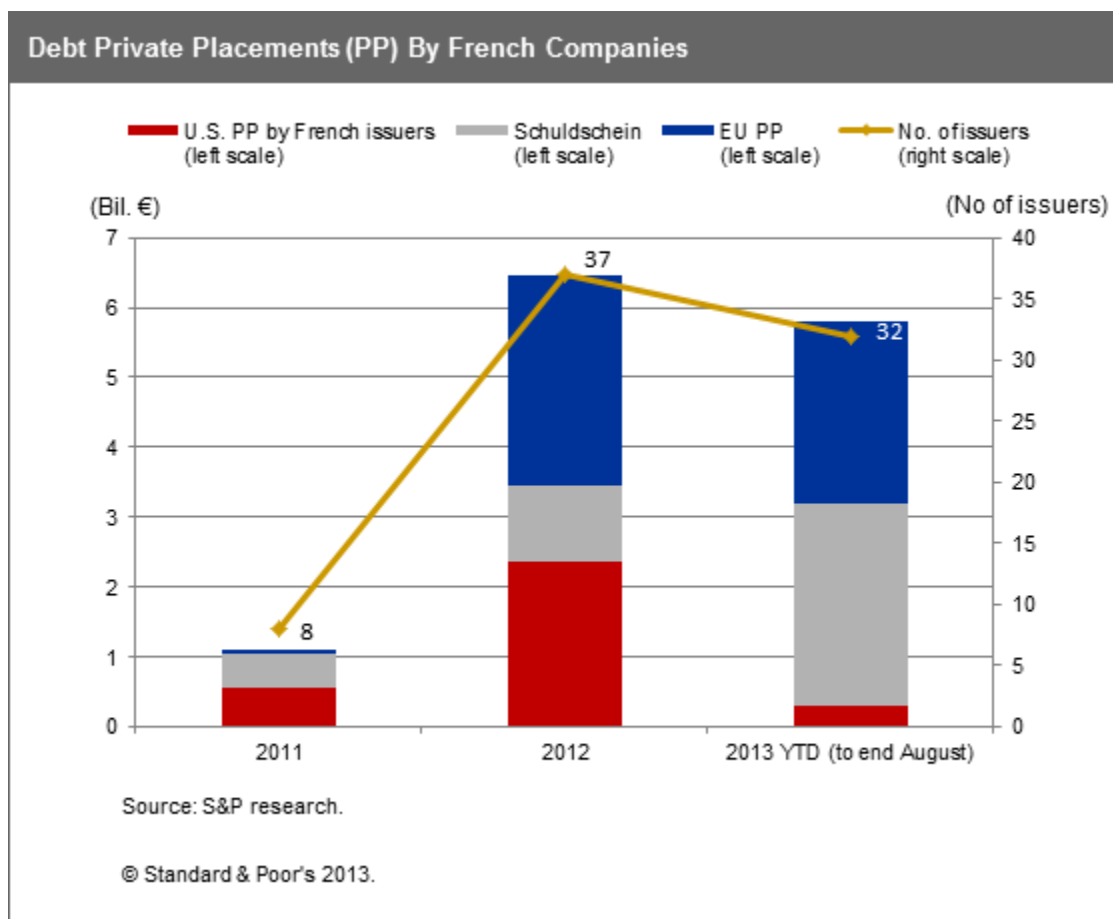
On the plus side, investors in search of higher yields in the low interest rate environment are increasingly looking for ways to diversify their investments, and are showing a growing interest in lending to mid-market companies. Insurance companies in particular have been an important contributor to the development of a private placement market in France and other European countries such as the U.K. over the past few years.

In 2012, in a period of significant uncertainty and volatility in the European capital markets, French companies tapped the U.S. private placement (PP) markets. Now, we see evidence that they are increasingly turning to the European PP and German Schuldschein markets (see chart 6). Nevertheless, Euro PPs remain in their infancy compared with the



U.S. PP market and the Schuldschein market. Furthermore, corporations larger than mid-market companies still issue the majority of Euro PPs, although this fell from 96% of the total issued in 2012 to 79% so far in 2013.

**Chart 6**



In 2012, 37 French companies placed more than €6 billion on Euro PP, German Schuldschein, and U.S. PP markets, which was a six times higher sum than in 2011. The rapid rise is continuing this year with nearly €6 billion issued by 32 companies in just the first eight months of the year. Although growing, these numbers show that this market is still nascent in Europe. In contrast, the U.S. PP market was worth \$50 billion in 2011, expanded to \$55 billion in 2012, and totaled \$28 billion in 2013 to the end of August. We believe private placement issuance in France will continue growing rapidly on the back of disintermediation and increasing investor appetite. We estimate that even if French mid-market companies funded only 10% of their estimated needs through this market, it would represent a volume of €16 billion per year. (For more details on the development of the European PP market, see Appendix 1 "The Development Of The Euro PP Market.")

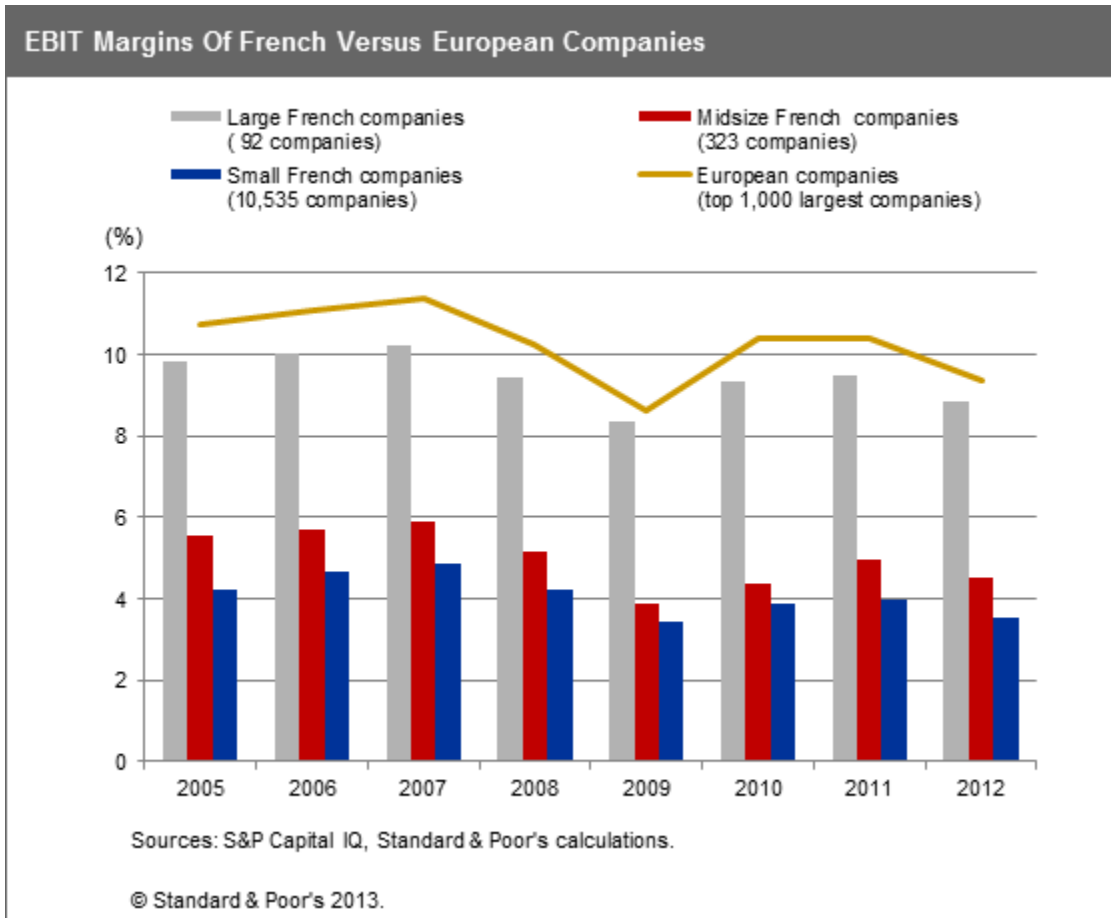
## **Some French Mid-Market Companies Exhibit More Volatile Margins, But More Conservative Financial Profiles**

For the purpose of this report, we studied two groups of companies. The first group offers an overview of the financial performance of companies for which financial data was available on S&P Capital IQ dating back to 2005. This group consists of 92 large companies (with revenues of greater than €1.5 billion), 323 midsize companies (with revenues of between €100 million and €1.5 billion), and 10,535 small companies (those with revenues of less than €100 million). The second group that we analysed consists of a sample of 90 midsize companies on which we performed a more detailed credit analysis, as part of the launch of our Mid-Market Evaluations (MME) service (for further details see "Some French Mid-Market Companies Exhibit Strong Business Profiles Despite Size Constraints," below).

The first group we studied shows that, on average, mid-market companies' profit margins and cash flow from operations are consistently lower and more volatile than those of larger companies. However, we also found that in terms of leverage and interest cover, mid-market companies in France tend to exhibit more conservative financial profiles than their larger peers.

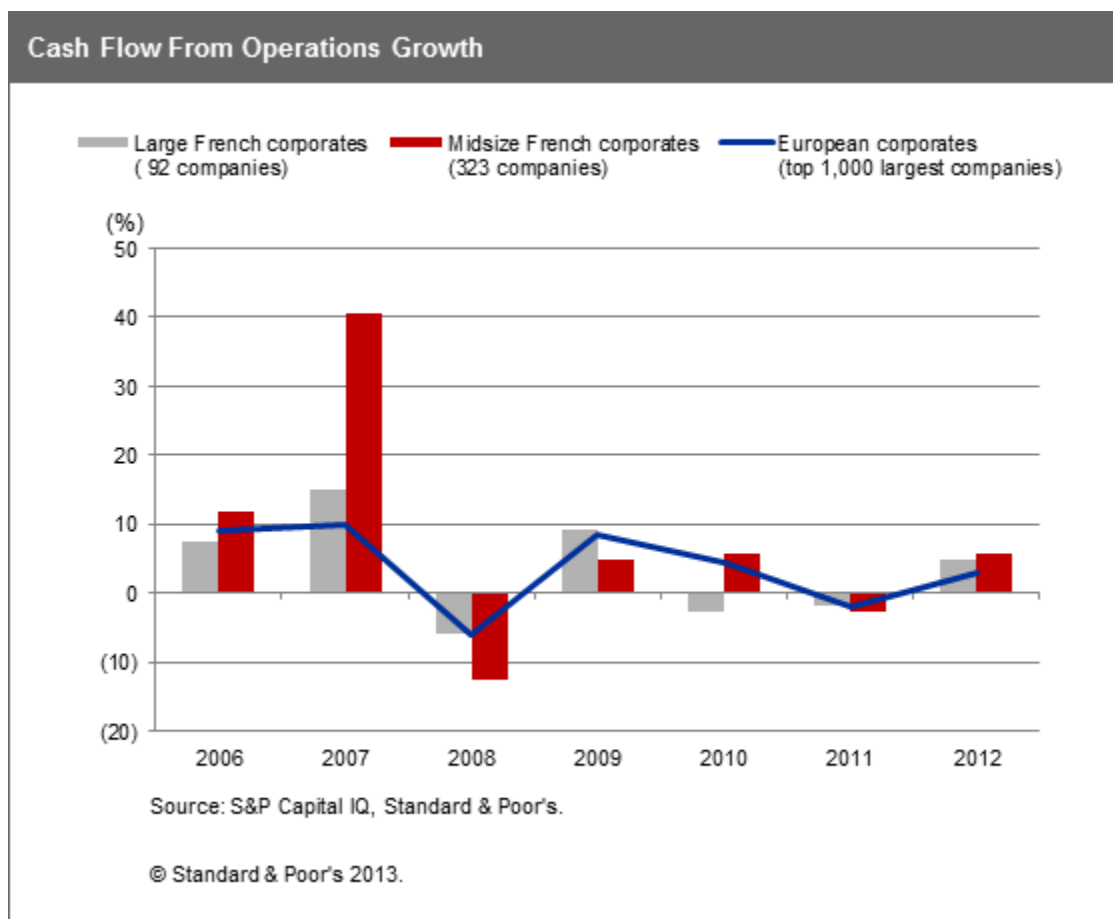
In terms of EBIT margins, we found that the margins generated by mid-market companies have been consistently lower and more volatile than those of larger companies both in France and in Europe (see chart 7). We believe that the differences in profit margins between midsize and larger corporates in France can be explained to some extent by the differences in industries in which they tend to operate. For example, a higher percentage of them are consumer discretionary and industrial companies than larger firms (see chart 1). This is likely to affect their profit margins, particularly during downturns, and could explain the greater difference in margins in our data as well as greater cyclicality.

Chart 7



An examination of data on cash flow from operations, shows that companies operating in France have fared marginally better than their large European counterparts since 2006. However, mid-market companies in France also tend to experience more volatile cash flow generation than larger enterprises (see chart 8).

Chart 8



On the other hand, French corporates—including mid-market companies, but excluding LBOs—have exhibited overall a more conservative financial profile than large corporations in Europe over the past seven years, with a higher percentage of cash and short-term assets to total assets. This is particularly noticeable for the smallest companies, which need to preserve a higher liquidity buffer in a context of higher volatility (see chart 9). In addition, French large and midsize enterprises have been in a better position than large peers overall in Europe when it comes to the degree of interest cover, or EBIT-to-interest expense (see chart 10). However, this is not the case for the smallest companies, most likely due to their higher cost of debt relative to their cash flow.

Chart 9

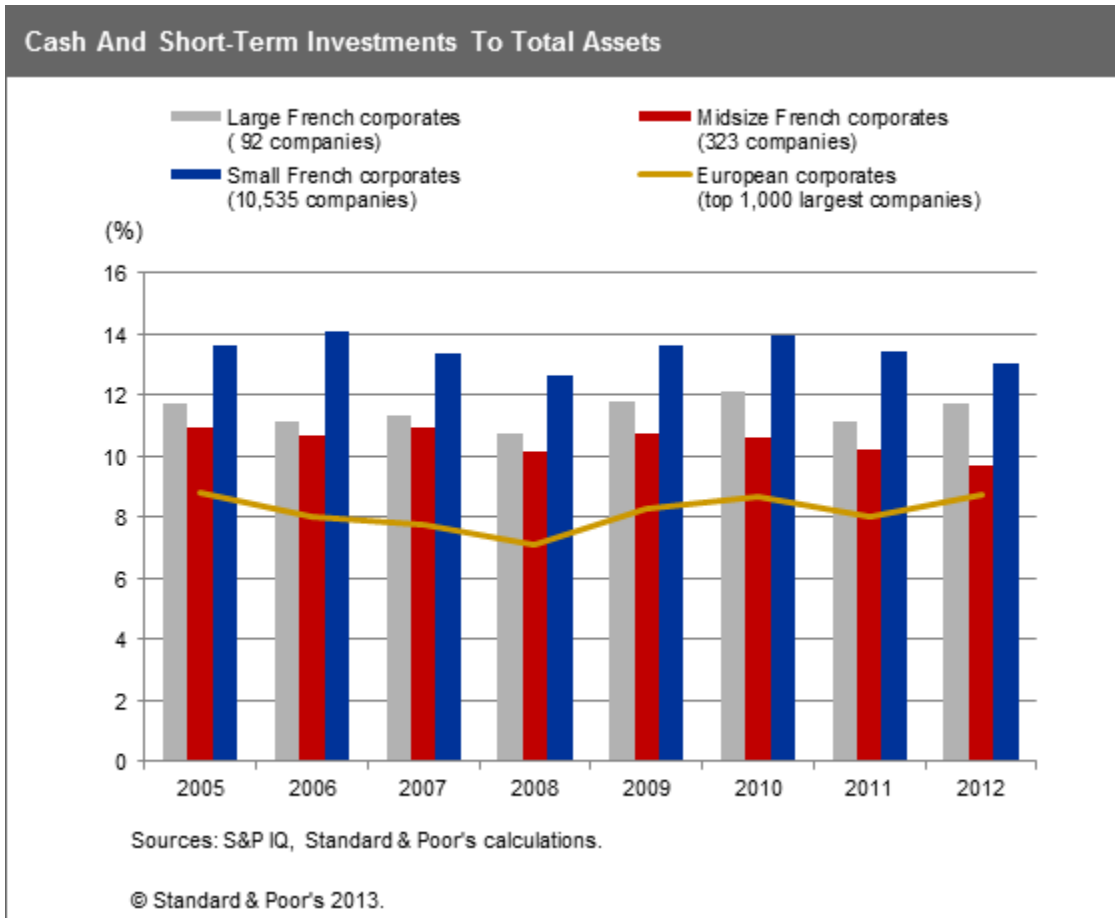
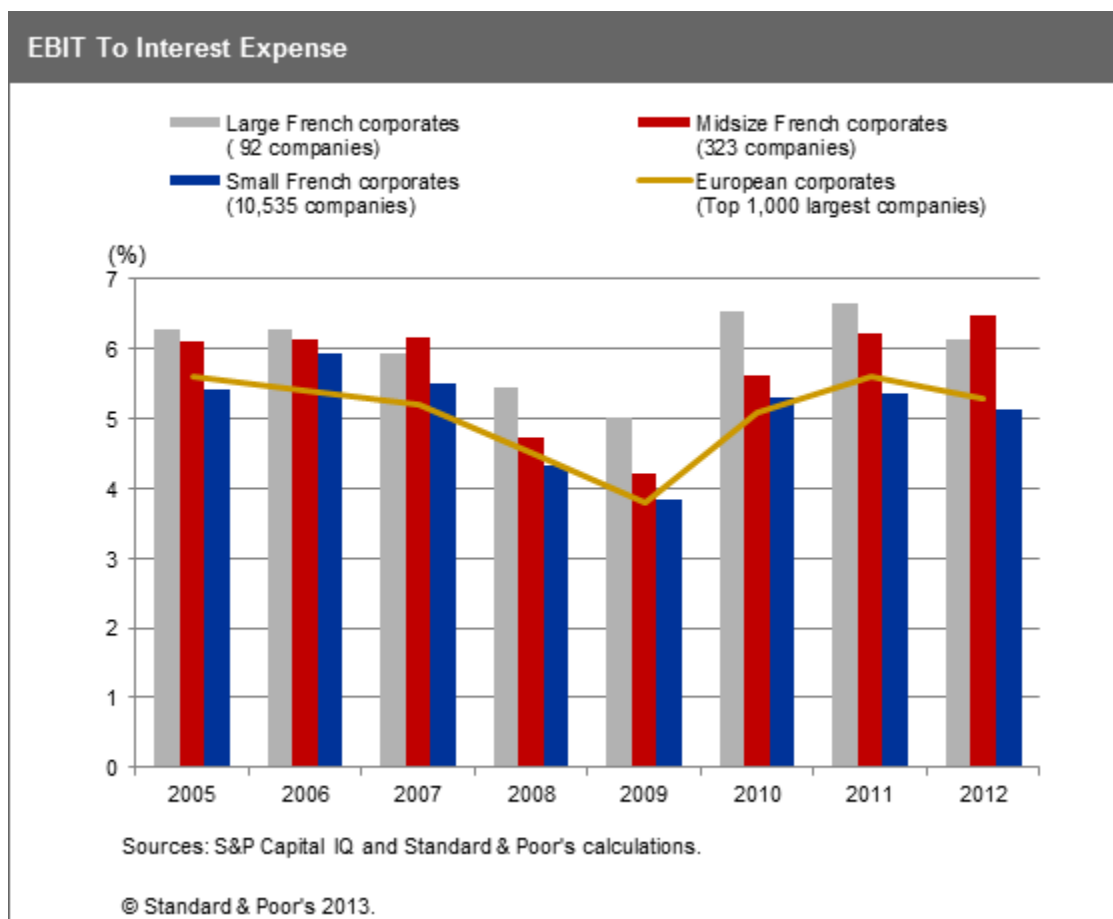
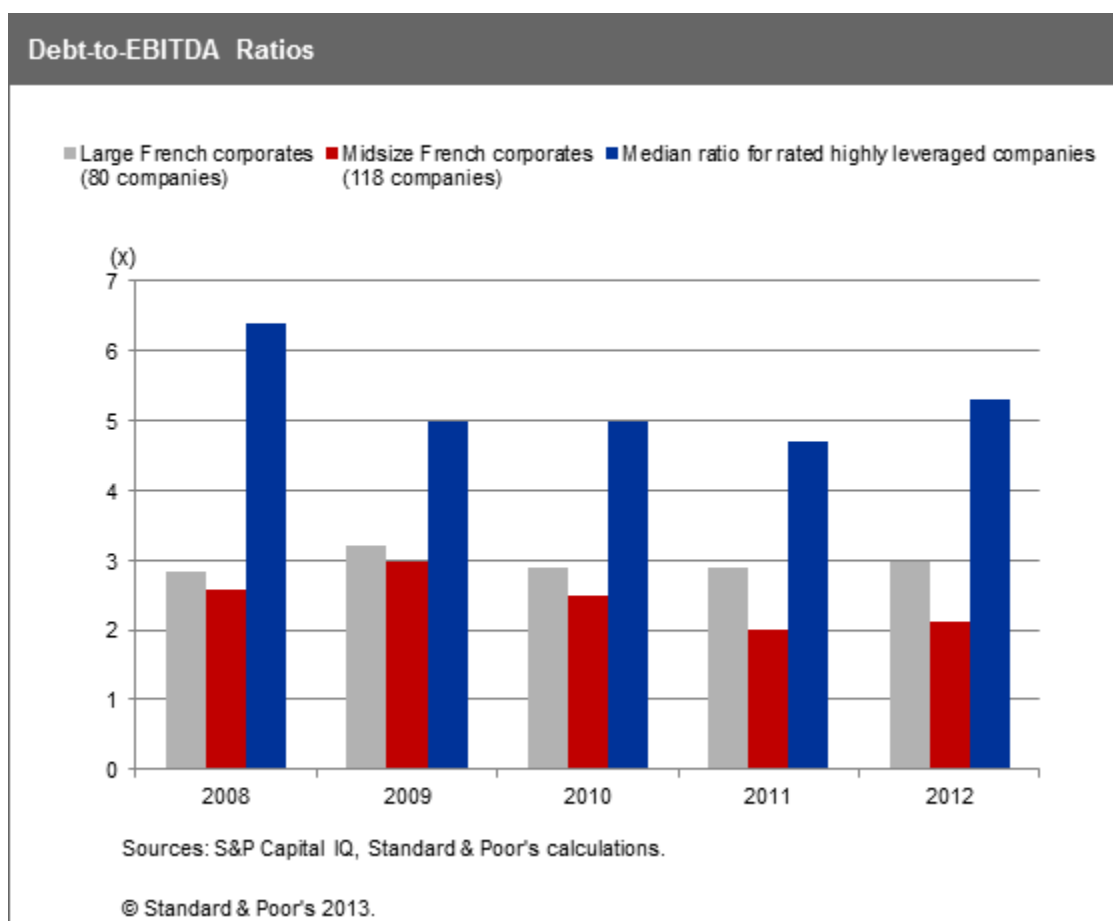


Chart 10



Mid-market companies also tend to exhibit on average a more conservative capital structure, with much lower leverage ratios at around 2x (see chart 11). Traditional midsize corporations generally have lower leverage than private equity-owned companies (with a median leverage of about 5x)--which is to be expected given that management of these businesses by financial sponsors usually results in a more aggressively leveraged capital structure.

Chart 11



## Some French Mid-Market Companies Exhibit Strong Business Profiles Despite Size Constraints

Given a lack of comparable information about European mid-market companies for willing investors, we believe that credit analysis providing an independent benchmark for mid-market companies' creditworthiness is fundamental to the further development of the Euro PP market. For this reason, Standard & Poor's in June this year launched its Mid-Market Evaluation (MME) service, Europe's first credit benchmark aimed specifically at increasing the transparency and comparability of midsize companies. An MME offers an independent and private opinion of midsize companies' relative creditworthiness and the drivers behind this assessment. We rank the evaluations on a specific scale ranging from 'MM1' (highest) to 'MM8' (lowest) and 'MMD' (default). MME are not credit ratings and they are not substitutes for credit ratings (for details of our criteria see "Mid-Market Evaluation: Definition And Scale," and "Credit FAQ: Standard & Poor's Mid-Market Evaluations Explained," published June 24, 2013; for the scale, see Appendix 2).

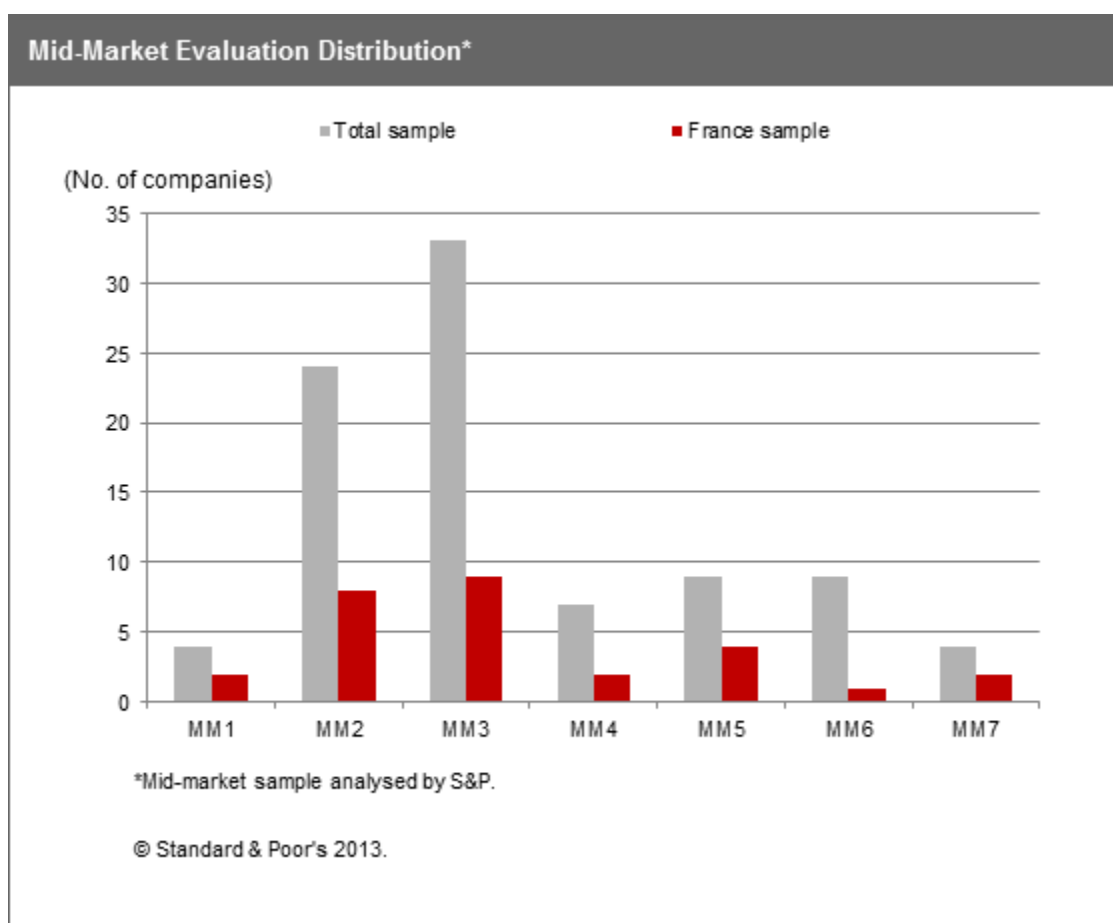
Since launching our purpose-built MME scale, we have analysed the creditworthiness of a sample of 90 unrated companies in Europe that meet our definition of a mid-market company. Our analysis included 38 companies in the U.K., 28 in France, 22 in Germany, and two based in Southern European countries. Twenty-two of these companies

have recently issued private placements either on the U.S. PP, Euro PP, or German Schuldschein markets. Our dataset includes only listed companies, and incorporates businesses of various sizes.

The key findings of our sample companies were as follows:

**Most French companies in our sample rank at the higher end of our MME scale.** Although our sample as a whole shows a very broad credit span, a majority both in Europe (63%) and in France (61%) fall within our 'MM2' and 'MM3' categories (see chart 12). This represents relatively strong creditworthiness on our scale for mid-market companies, suggesting they have good to strong capacity to meet their financial commitments relative to other mid-market companies. We believe this could support their access to alternative sources of funding. We note, though, that our sample may have a slightly positive bias given its focus on stronger Northern European economies and listed companies.

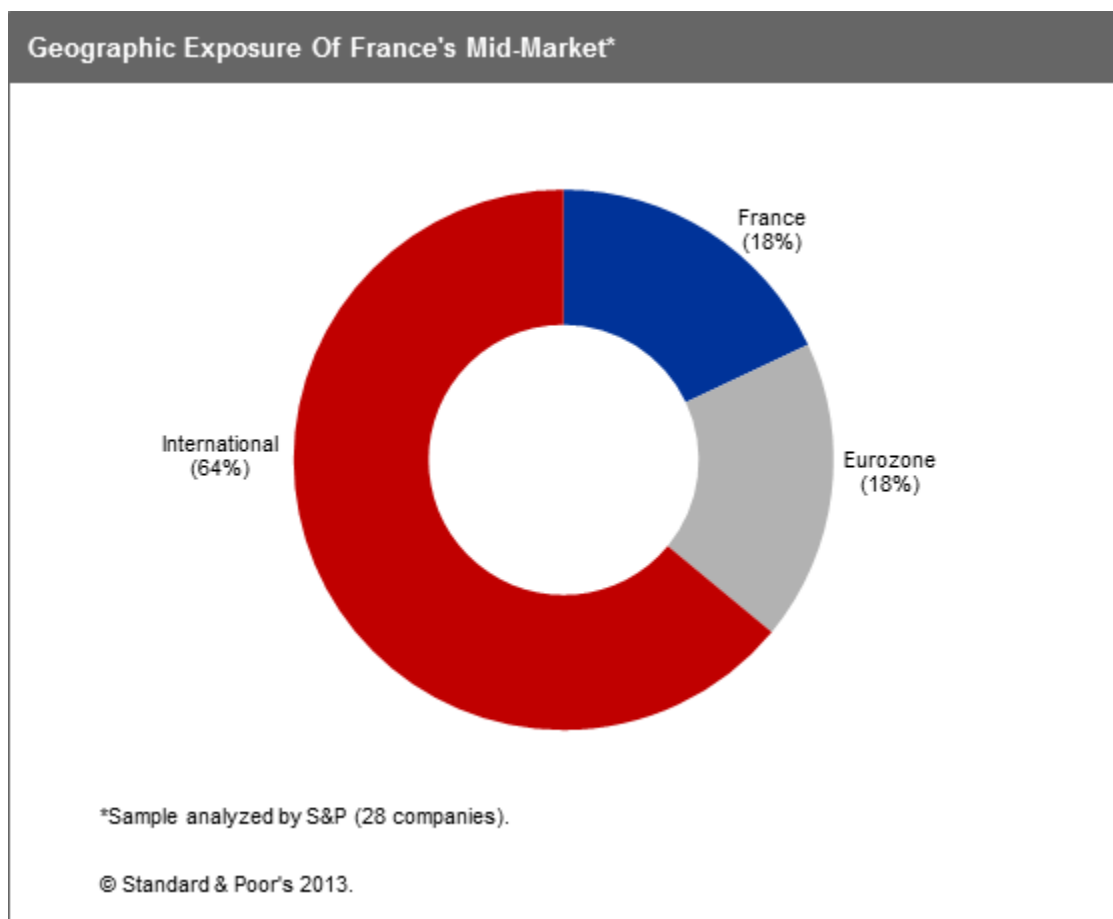
**Chart 12**



**Many mid-market French companies are internationally diversified.** Contrary to the perception that midsize companies are largely national players, 64% of the 28 French companies in our study have operations on more than one continent (see chart 13). Only 18% of French mid-market companies generate revenues exclusively in France. This is positive for their credit quality because an international focus mitigates their exposure to the challenging French economic conditions. The remaining 18% operate in the eurozone, but generate revenues largely in France.



Chart 13



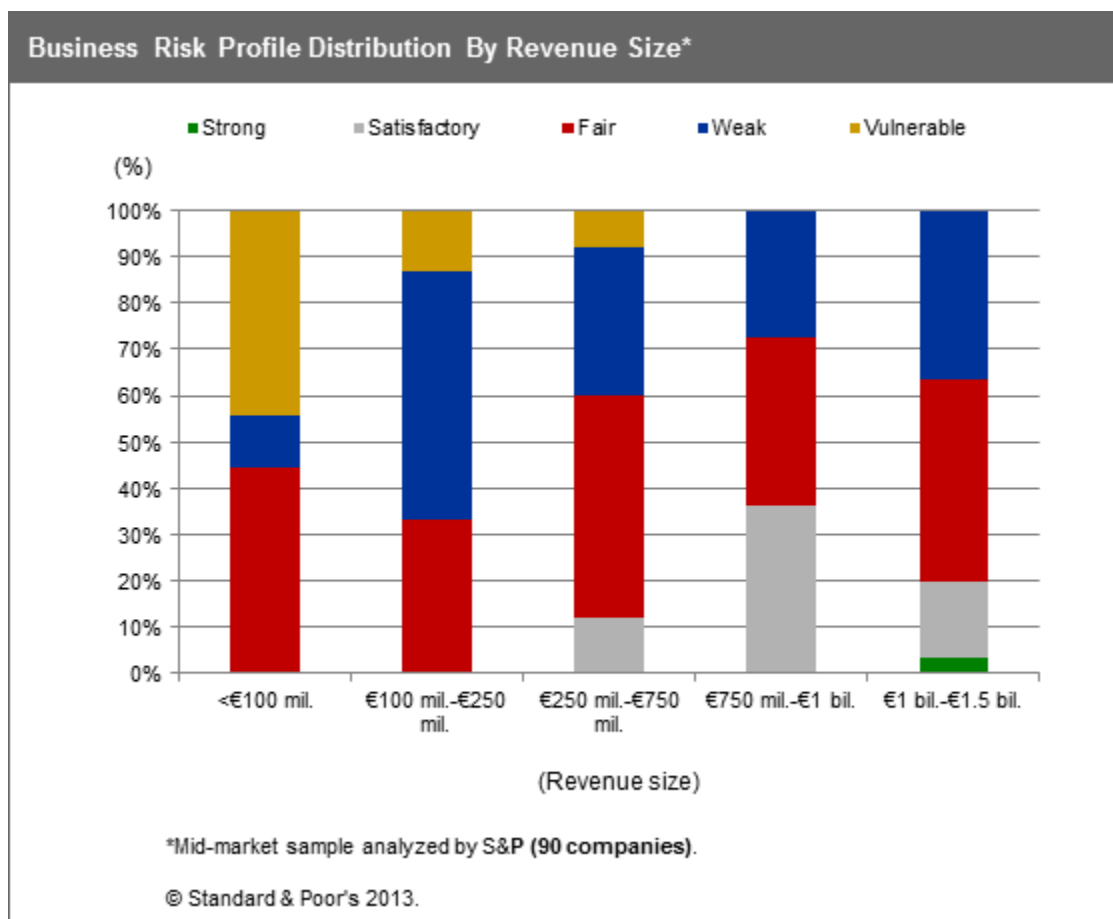
*Larger mid-market companies tend to have stronger business risk profiles, but it's not a systematic constraint.* Some mid-market companies exhibit a solid business profile. Nevertheless, our study reveals that many of these companies' business risk profiles are exposed to greater challenges due to concentration risk. Our MME methodology applies Standard & Poor's corporate rating methodology, but uses a simplified analytical process. Under this methodology, the assessment of a company's business risk profile is driven by the country risk and industry risk it faces, followed by an analysis of the company's competitive position and its profitability. This leads us to assess a company's business risk in six profile categories, from highest to lowest: "excellent", "strong", "satisfactory", "fair", "weak", or "vulnerable". Although we don't expect to use the same descriptors for business risk evaluations when assigning MMEs, we maintained the existing terminology for the purpose of this exercise.

In general, we find that most mid-market companies tend to be more vulnerable than larger and more diversified peers to cyclical and volatility for a variety of reasons: the scale of their operations is more limited; their activities are less diversified; and their operating margins are more volatile. Nevertheless, some mid-market companies benefit from good competitive advantages and strong margins because they hold dominant market positions. While the majority of European companies in our analysis present "fair" (42%) or "weak" (34%) business risk profiles according to our methodology, some of the largest have "satisfactory" or "strong" profiles (14% combined; see chart 14). What's more, even some of the smallest companies, with revenue of less than €100 million, have a "fair" business risk evaluation. This indicated to us that smaller mid-market companies can mitigate the impact of the small scale of their operations

on their overall competitive position if they have established a competitive advantage in their industry, and if their profitability is resilient.

We found that 20% of the French companies in our survey hold a leading position in a niche market and 40% have a good position in a niche market. Some of those companies operating in niche markets demonstrate a competitive advantage through a strong brand name or key technological know-how, leading to high barriers to entry, so mitigating competition and boosting their profitability. Meanwhile, 20% have a relatively good position in a global industry and the remaining 20% have a relatively weaker market position in a niche or global industry. French mid-market companies tend to operate in low- or medium-risk industries--23% and 66% respectively--such as health care or branded nondurables (low risk) or capital goods, technology, or leisure (medium risk). Nonetheless, about 50% of the French companies analysed are exposed to cyclical end-markets and economic downturns, and operate in fragmented and competitive markets with some customer concentration.

Chart 14



**Prudent financial policies offset more volatile profit margins.** French companies in our analysis on average reported prudent leverage positions, with debt to EBITDA of 2.1x for 2012. This somewhat offset the higher volatility in margins that mid-market companies tend to experience compared with larger companies. We found that 30% of the French companies in our analysis experience high to very high profit volatility.

We nevertheless observed that some companies have riskier financial profiles. For example, 25% of them have debt-to-EBITDA ratios above 5x. This includes companies that generated negative or low free operating cash flow (FOCF) either due to high capital expenditures coupled with low margins or high interest expenses, high working capital needs, or negative operating margins. We found only a few companies we analysed to be overly leveraged (above 8x) and that this was due to declining EBITDA rather than an aggressive financial policy.

*The majority of French companies in our sample are financed through mid- to long-term loans or bonds.* This applies to about two-thirds of the companies in our sample, while 30% rely on short-term liquidity lines. However, given that our analysis included only listed companies, we believe the share of mid-market companies relying on short-term loans is likely to be higher in the complete universe of midsize companies than in our analysis.

## Mid-Market Companies Are Operating In Challenging Economic Times

Latest economic data for France point to a broad improvement in economic conditions at midyear, leading to a stabilization in the second half of 2013. GDP grew by 0.5% quarter on quarter during the second quarter of the year, following contractions of 0.2% during the previous two quarters. Consumption was the main engine of growth, lifted by strong energy consumption as a result of unusually low temperatures in spring. But although we expect a modest uptick in 2014, the weak foundation for growth will lead to sub-par growth dragging into 2015, in our view (see table 1).

**Table 1**

France Macroeconomic Indicators							
(% change)	2009	2010	2011	2012	2013e	2014e	2015e
Real GDP	(3.1)	1.7	2	0	0	0.7	1.4
Consumer Price Index	0.1	1.7	2.3	2.2	1	1.5	1.4
Unemployment rate (%)	9.5	9.7	9.6	10.2	11	11.3	11

e--Estimate. Sources: Standard & Poor's, Eurostat.

After providing temporary support to economic activity in the second quarter, household consumption should remain stable in the second half of the year because spending still faces several headwinds. These headwinds include a difficult labor market situation, tax hikes on households due to fiscal tightening, and weakness in the housing market, all of which should prompt households to increase their savings rates and reduce consumption. Various supportive factors should nevertheless mitigate these difficulties. They include modest inflation and a slow housing correction. We therefore believe that demand conditions will remain weak for a prolonged period, with consumer spending expected to stagnate in 2013, and to rise by only 0.6% in 2014 and 1.2% in 2015, which is below the average of 2.3% between 2000 and 2007.

The other key drivers of economic growth--foreign trade, and investment--are still in the wings, and we believe it will be a while before they start playing their part again. In particular, corporate spending, generally a leading indicator of recovery, is lagging. We don't expect business investment to return to its 2007 level in real terms until 2015. A recovery in construction activity will be more difficult as a result of sluggish house price growth. Besides, as the capacity utilization rate is currently well below its historical average, most investment spending will be for replacement purposes, while spending to expand productive capacity is likely to be limited.

The low profitability of French firms is a further drag on productive investment, which is why companies have relied on external financing instead of self-investment, which demonstrates that access to funding remains a key issue.

## Mid-Market Funding Growth Requires A More Transparent Marketplace

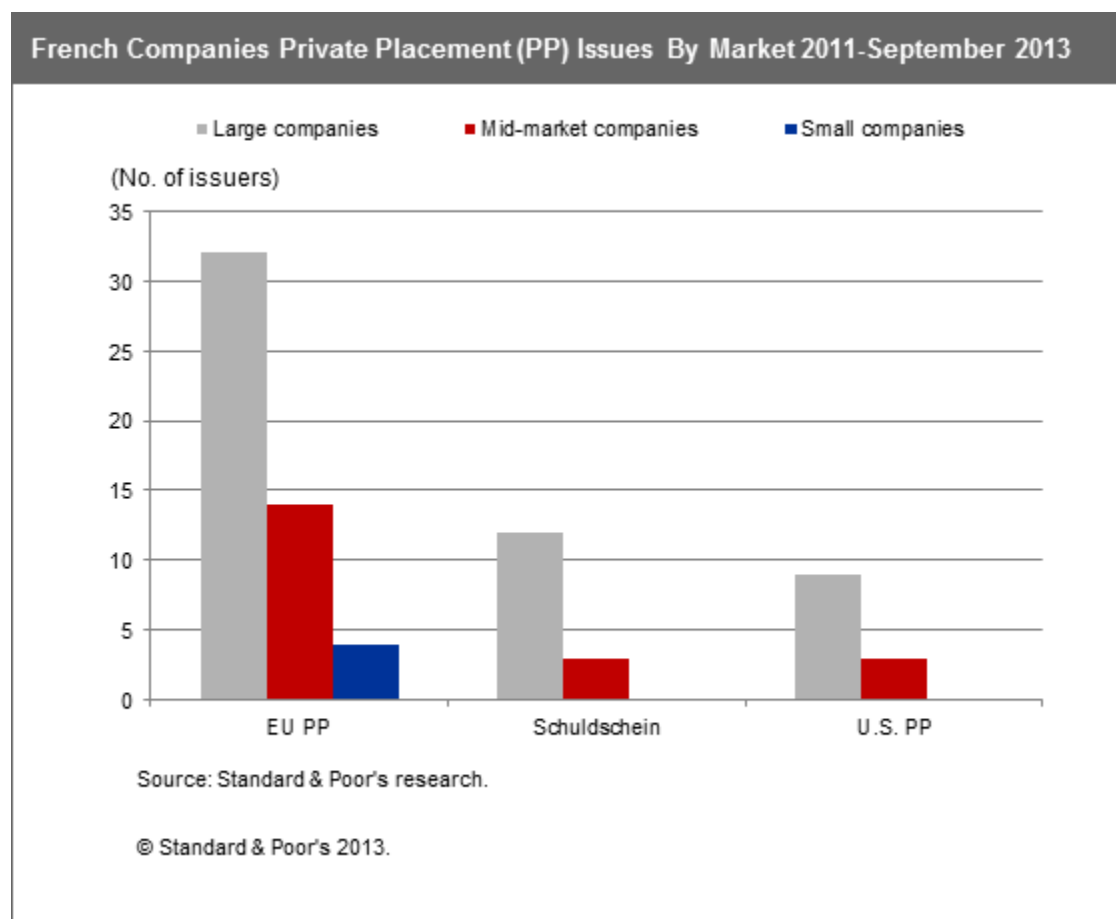
Continuing difficult economic times, tighter regulation on banks, the resulting need for mid-market enterprises to seek new funding sources, and the presence of willing investors suggest that the European private placement market will continue to expand. Yet, barriers to this new investment market remain. To speed this growth and create a coherent and transparent marketplace, participants need more information about the creditworthiness of these companies.

*The authors would like to acknowledge the contribution of Silvia Platzer in the preparation of this article.*

## Appendix 1: The Development Of The Euro PP Market

French mid-market companies appear to prefer the Euro PP market, when compared to the German or U.S. markets (see chart 15). The size of the private placements issued in all of these markets over the past two years has ranged widely from €3 million to more than €900 million, but averaging about €150 million.

Chart 15



French companies' preference for the Euro PP market appears to be encouraging market developments in France. In June 2012, Société Générale and AXA Group formed a partnership, followed by others, notably Credit Agricole CIB, supporting the development of the Euro PP market. Both these banks operate an "originate-to-distribute" PP model, whereby they underwrite debt using their credit expertise and their close relationships with companies, and distribute them to insurers looking to diversify their investments into more corporate lending at a time when sovereign debt currently bears low yields. This model limits the impact on the banks' capital requirements.

A change to the French insurance code in August 2013 took a further step in the development of alternative sources of funding. Insurance companies are now allowed to invest up to 5% of their regulated liabilities in unlisted companies, either directly or through special funds--so called loan-to-real economy funds or "Fonds de prêts à l'économie". Previously, regulations limited their investments to listed companies only. We estimate, based on data produced by the French insurers' federation the Fédération Française des Sociétés d'Assurance (FFSA), that this change could free up around €90 billion in potential funding from French insurers, representing 5% of their total assets in market value. Following this new legislation, economic development agency Caisse des Dépôts and a group of insurance firms have established two new funds called "Fonds Novo" for a total of €1 billion. One is managed by BNP Paribas IP, the other by Tikehau Investment Management.

A further step forward for the development of alternative sources of funding was NYSE-Euronext's establishment of a bond exchange platform in France in 2012. This enables retail investors to buy into individual small-denomination corporate bonds of midsize companies. This funding form is still at a very early stage of development, and only four companies have so far made initial bond offerings (IBO): AgroGénération S.A., Groupe Capelli, Homair Vacances, and Groupe Realités SAS. Each issue was below €15 million.

In spite of these efforts to link mid-market companies looking for financing with willing investors, there are still obstacles to overcome to achieve an efficient market in France, as is the case for other private placement markets in Europe. The first barrier is pricing, as investors and lenders have different expectations. Furthermore, investors need better access to company information, particularly if an investor is small and hasn't had the means to build internal research and risk management capacities. The lack of standard private placement documentation also makes it an uphill struggle to establish a cohesive funding market. What's more, we believe that issuers, for their part, can find it difficult to make the cultural shift to expand beyond their long-term banking relationships and offer broader disclosure of their financial situation to potential investors.

## Appendix 2: Standard & Poor's Mid-Market Evaluation Scale

**Table 2**

The Mid-Market Evaluation Scale	
MM1	The company has a very strong capacity to meet its financial commitments relative to other mid-market companies. Companies rated at this level are less susceptible to the adverse effects of changes in circumstances and economic conditions than other mid-market companies.
MM2	The company has a strong capacity to meet its financial commitments relative to other mid-market companies. However, the company is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than entities in the higher category.

**Table 2**

<b>The Mid-Market Evaluation Scale (cont.)</b>	
MM3	The company has a good capacity to meet its financial commitments relative to other mid-market companies. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the entity to meet its financial commitments.
MM4	The company has an adequate capacity to meet its financial commitments relative to other mid-market companies. However, it is more exposed to adverse economic conditions or changing circumstances than companies with a higher MME.
MM5	The company has a reasonably adequate capacity to meet its financial commitments relative to other mid-market companies. It faces ongoing uncertainties or exposure to adverse business, financial, or economic conditions, which could result in an inadequate capacity on the part of the entity to meet its financial commitments.
MM6	The company has a weak capacity to meet its financial commitments, although it is less vulnerable than mid-market companies with a lower MME. Adverse business, financial, or economic conditions are likely to impair the entity's capacity or willingness to meet its financial commitments.
MM7	The company is currently vulnerable to defaulting and is dependent upon favorable business and financial conditions to meet its financial commitments. In the event of adverse business, financial, or economic conditions, the obligor is not likely to have the capacity to meet its financial commitments.
MM8	The company is currently highly vulnerable to nonpayment of its financial commitments. We expect default to be a virtual certainty, either through a missed payment, a distressed exchange, or a similar debt restructuring, or a bankruptcy filing.
MMD	The company has either failed to pay one or more of its financial obligations when due, or it has been placed into bankruptcy, or it has completed a distressed exchange or similar debt restructuring.

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