European Corporate Credit Outlook 2019

Running Out Of Time

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S&P Global Ratings

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December 18, 2018

Key Takeaways

- **Out of time:** With the current credit cycle drawing to an end, European corporates face a difficult 2019. Financing conditions will become more testing as the ECB ends QE.
- **Operating pressures:** Still-positive economic momentum will support further cash flow expansion, but pressures on costs are growing and tariff conflict, regulatory changes, slowing emerging markets, Brexit uncertainty, and political risks are all exacting a toll.
- **Higher risk premiums:** The period of calm in credit markets is likely to end as investors demand higher premiums to compensate for deteriorating credit quality, greater risks, and more uncertain outcomes. M&A is likely to remain subdued.

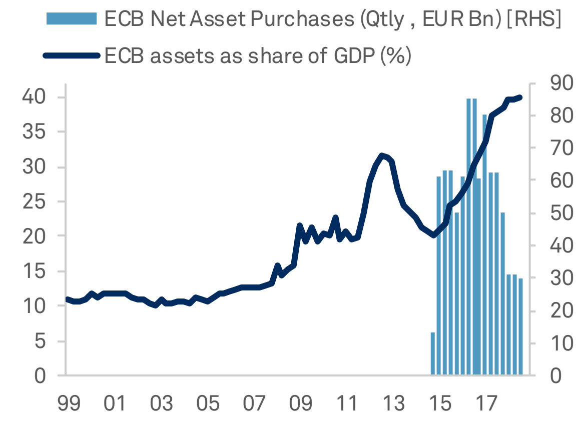
European credit markets face a challenging year ahead

European financial markets will move into the next phase of their long post financial crisis rehabilitation in 2019, as an extraordinary era of financial stimulus provided by the European Central Bank (ECB) comes to an end (see charts 1 and 2). This will reveal whether, to paraphrase John F. Kennedy, the roof was repaired while the sun was shining.

In S&P Global Ratings' view, the answer is that while much has been done, in Europe at least, it is far from clear that this will be enough to limit the risk of financial turbulence in the year ahead. Despite the huge scale of ECB asset purchases and a multi-year period of near-zero interest rates, the impact on eurozone growth and inflation has been modest. Moreover, the financial architecture of the single-currency bloc remains far from complete and is still vulnerable to fragmentation and the associated political turmoil. Financing conditions will inevitably become more difficult as the stimulus is withdrawn and markets adjust to this new reality. The U.K., meanwhile, is scheduled to leave the EU on March 29, a profound shift in direction with still great uncertainty as to what the final destination will be and how it will get there. Significant political and economic change and uncertainty is likely under almost any conceivable scenario.

Chart 1

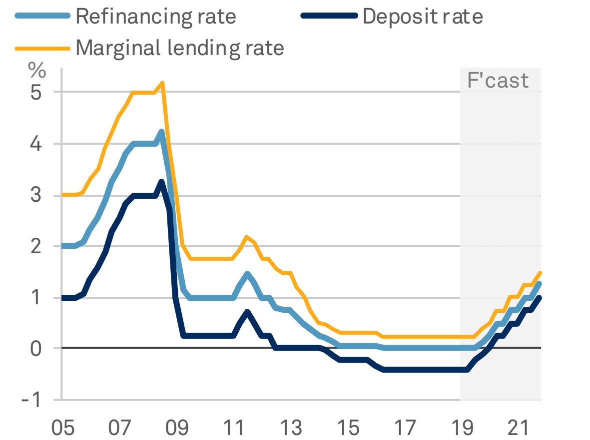
Quantitative Easing Has Seen European Central Bank Assets Expand To Over 40% Of Eurozone GDP



Source: Refinitiv, ECB, S&P Global Ratings

Chart 2

Eurozone Interest Rates Are Likely To Start Normalizing in 2019



Source: Refinitiv, ECB, S&P Global Ratings

Our base-case economic assumptions are that these difficulties will not tip Europe into recession, but we will nevertheless see a continuing ebbing of economic momentum as the rate of growth of most European economies continues to slow (see table 1) with only Spain likely to grow by more than 2%.

Table 1

GDP growth and unemployment forecasts for selected European countries

(%)	Real GDP Baseline forecast 2019f	2020f	2021f	Unemployment Baseline forecast 2019f	2020f	2021f
France	1.6	1.6	1.5	8.9	8.7	8.5
Germany	1.6	1.4	1.3	3.0	3.0	3.0
Italy	0.7	0.9	0.8	10.2	10.0	9.8
Netherlands	1.9	1.9	1.6	3.8	3.8	4.0
Spain	2.3	2.1	1.8	14.1	13.0	11.9
Eurozone	**1.6**	**1.6**	**1.5**	**7.7**	**7.5**	**7.2**
Switzerland	1.6	1.5	1.4	2.4	2.3	2.2
U.K.	1.3	1.5	1.3	4.2	4.4	4.5

Source: S&P Global Economics

Slowing growth is reflected in modest revenue and EBITDA growth forecasts

Slower growth and a gradual tightening in financing conditions are reflected in the aggregate forecasts of S&P Global Ratings' analysts, which point to relatively weak, albeit still positive, revenue and EBITDA growth through to 2020 (see charts 3 and 4). Among the most common factors we have cited in explaining this loss of momentum (see table 2) are:

- Incipient **cost pressures** (both labor and non-labor);
- **Uncertainty created by trade conflict**, particularly in relation to the threat of the U.S. imposing higher auto tariffs, and **Brexit**. These both threaten confidence, loss of competitiveness, and forced adjustment of supply chains (e.g. BMW's decision to start manufacturing engines in the U.S.);
- Signs of a **slowdown in China**, such as weak passenger vehicle sales;
- **Regulatory change**; for example, upcoming regulations to cut sulphur emissions drawn up by the U.N. International Maritime Organization (IMO) come into force in January 2020, and pose significant challenges for shipping and oil production and refining companies;
- **Technological changes and costs**; for example the transition to renewable energy for utilities and the shift towards electrification and automated driving for autos.

Chart 3

European Non-Financial Corporate Revenue Growth

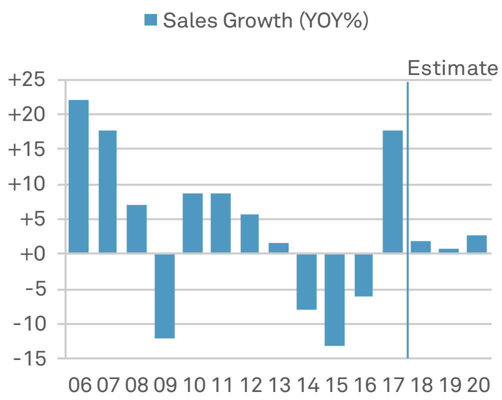
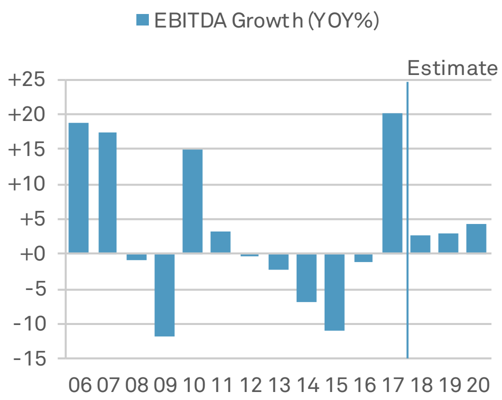


Chart 4

European Non-Financial Corporate Revenue Growth



Source: S&P Global Market Intelligence, S&P Global Ratings. Includes non-financial corporations rated by S&P Global Ratings, excluding real estate. Expressed in U.S. Dollar terms.

Despite these challenges, positive economic momentum means that most European sectors are expected to deliver positive revenue growth in 2019, along with further, if slight, improvements in profit margins (see chart 5).

Table 2

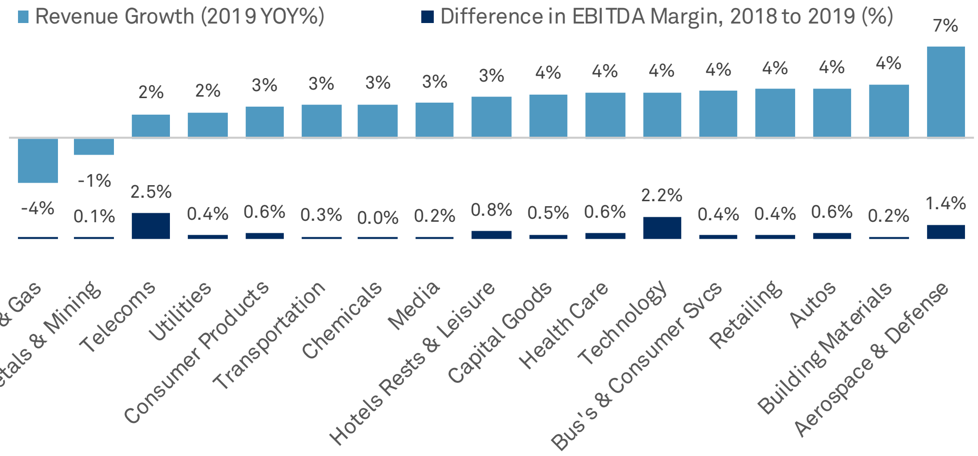
Corporate Sector Risk And Opportunity Map

Sector	Sub-sector/Region	Risk/opportunity '1'	Risk/opportunity '2'	Risk/opportunity '3'
Aerospace and Defense	Commercial aerospace	Under-capacity	Trade wars	2019 downturn
	U.S. defense	Defense spending	M&A	2019 downturn
	European defense	Brexit and supply chain	UK role in European defense	2019 downturn
Autos	OEMs	Trade wars	Brexit	2019 downturn
	Suppliers	R&D Costs	Supply chain changes	Consolidation
Building Materials	N.America	Housing affordability	Interest rates	Financial policies
	EMEA	Financial policies	Politics and Brexit	Interest rates
	Latin America	Politics	Weaker financing conditions	Asset sales and M&A
	Asia-Pacific	Trade wars	Liquidity and refinancing	Overcapacity
Capital Goods		Capex dependency	Interest rates	2019 downturn
Chemicals		Trade wars	2019 downturn	
Consumer products	Packaged foods	Credit quality	Margins	Internet
	Beverages	Premium segment	Margins	M&A absorption
	Agribusiness and commodity foods	Trade wars	M&A	Sugar market
	Household products	Input costs and FX volatility	Spending patterns	EM v DM market needs
	Cosmetics	Social media and internet	New brand disruption	Premium segment
	Tobacco	Global sales volumes	Alternative products	M&A
	Luxury goods	Travel retail	Chinese consumers	M&A
Health care		Vertical integration	New entrants	Pricing transparency
Homebuilders and developers	U.S.	Housing slowdown	Housing affordability	Margins
	Europe	Brexit	Politics - Spain, Italy	Commodity prices
	Asia-Pacific	Sales decline	Financing conditions	Demand in Indonesia
	Latin America	Mexico - new government	Brazil housing policy	2019 downturn
Hotels, Gaming, and Leisure	Gaming	U.S. sports betting	European regulation	2019 downturn
	Hotels	M&A	European event risk	2019 downturn
	Cruise	Shareholder returns	Chinese consumers	2019 downturn
Media and entertainment	Television	Post-acquisition performance	M&A	2019 downturn
	Local media (radio, outdoor)	M&A outlook mixed	Leverage	2019 downturn
	Internet/online	Regulation	Reputational risks	2019 downturn
	Advertising agencies	Personalization	New entrants	2019 downturn
Metals and mining		Trade wars	Price volatility	2019 downturn
Oil and gas	Exploration and production	IMO 2020	Financing conditions	2019 downturn
	Oilfield services	Hydocarbon prices	Margins	2019 downturn
	Refining	IMO 2020	Over-capacity	2019 downturn
	Contract drilling	Lower costs	Rig scrapping	2019 downturn
	Midstream	Business rationalization	Regulatory pressure	2019 downturn
Real estate		Pressure on retail	Favorable logistic demand	Flexible working
		EM politics	Brexit	2019 downturn
Retail and restaurants		Consumer preferences	Politics and regulation	2019 downturn
Technology		Trade wars	LBO credit quality	2019 downturn
Telecommunications		5G	Digital disruption	2019 downturn
Transportation	Airlines	Geopolitics	Brexit	2019 downturn
	Shipping	Over-capacity	IMO 2020	2019 downturn
	Railroads	Trade wars	Trucking competition	2019 downturn
	Equipment leasing	Weak consumers	Financing conditions	2019 downturn

Source: S&P Global Ratings.
Risks and opportunities have been simplified and standardized relative to the originals for cross-section clarity. No rank ordering is implied between the risks/opportunities. S&P Global analysts were asked to consider a 2019 downturn as a general risk, so its prevalence does not imply inherent risk.

Chart 5

Estimated European Non-Financial Sector Revenue Growth And EBITDA Margin Change In 2019



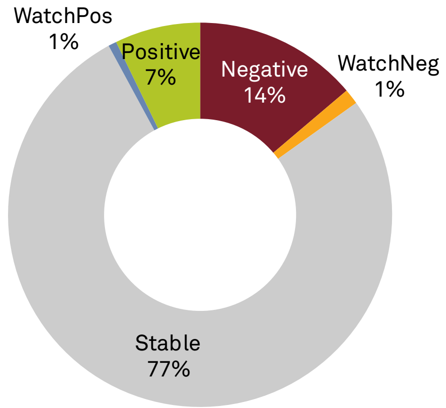
Source: S&P Global Ratings, Data expressed in U.S. Dollar terms.

Ratings trends point to a deterioration in credit quality

Nonetheless, we are starting to see a deterioration in credit quality with the net outlook bias – the percentage of ratings with positive outlooks less the percentage with negative outlooks – deteriorating again globally in Q4 2018, and bringing an end to eight consecutive quarters of improvement (see charts 6 and 7). The deterioration in U.K. non-financial corporate bias has been even more acute, although at this stage this is mainly a reflection of the intense pressure on the U.K. retail industry rather than being directly Brexit-related.

Chart 6

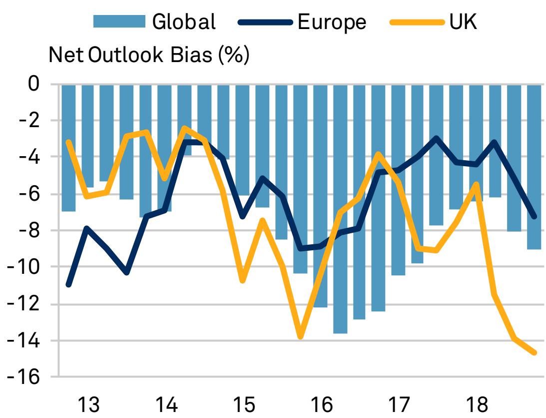
Ratings Outlook Distribution For European Non-Financial Corporate Ratings



Source: S&P Global Ratings. Data as of end-November, 2018.

Chart 7

Net-Outlook Bias Trend For Non-Financial Corporate Ratings

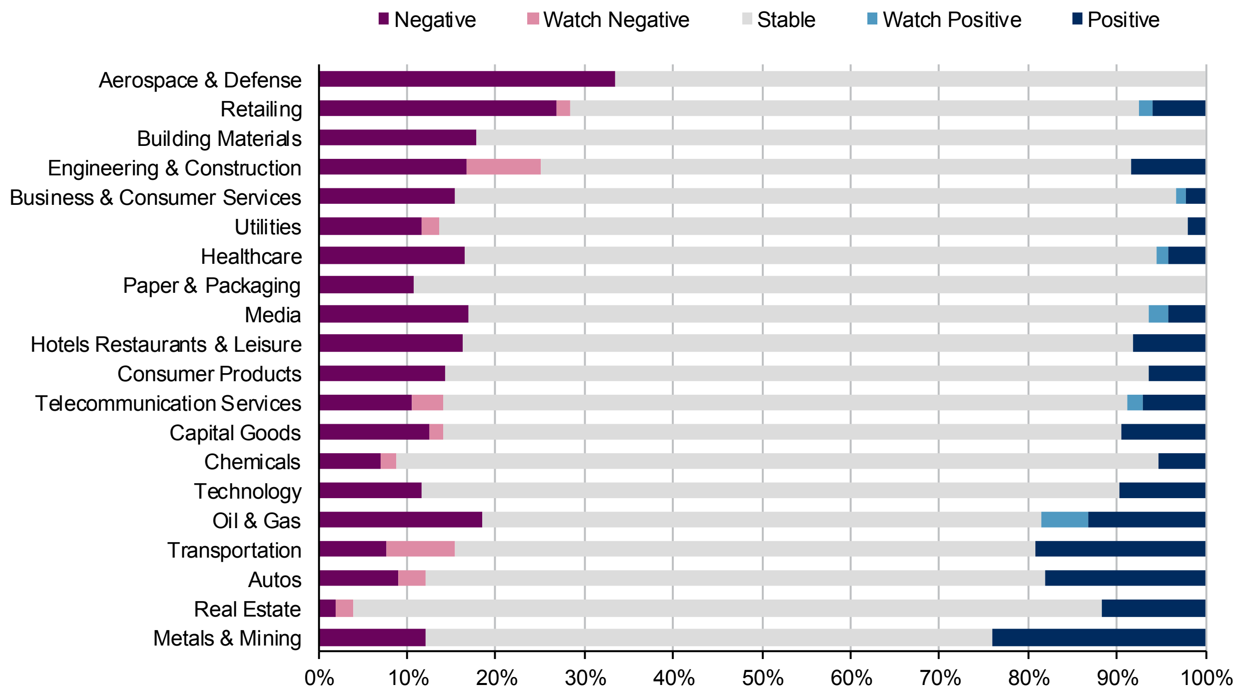


Source: S&P Global Ratings
Net outlook bias shows the percentage of positive outlooks for the rated universe less the percentage of negative outlooks. Shown quarterly expect for latest data which are for end-November 2018.

Chart 8 shows the industry breakdown of the net outlook bias, highlighting those with the greatest credit pressures currently, including aerospace and defense, retailing, building materials, engineering and construction, and business and consumer services. If there is a pattern here, it is one of pressure on more domestically-focused cyclicals which stands in contrast to the more positive trends in global, commodity-linked cyclicals. Despite the significant recovery in European economies over the past five years, the benefits to domestic cash flow have been modest.

Chart 8

European Ratings Outlook Distribution By Industry (Ranked By Net Outlook Bias)



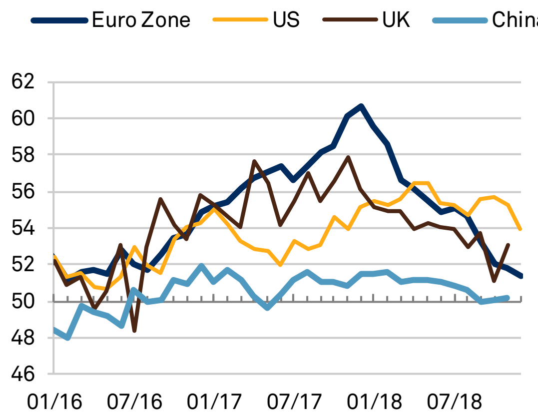
Source: S&P Global Ratings. Ratings data as of end-November, 2018.

An economic cycle running out of time

The likely duration of the current economic cycle is perhaps the most pressing economic issue facing credit, particularly in the context of the ECB ending its asset purchase programs (except for the reinvestment of maturing holdings). Downward pressures are apparent in indicators such as purchasing managers indices for manufacturing (see chart 9) and in the sharp decline in new European passenger car registrations, now accompanied by a dropping off of commercial vehicle sales too (see chart 10). This is adding to the challenging environment face by Europe's automakers, which are wrestling with pressures on profitability, rising regulatory costs, the need for R&D to respond to the challenge of electrification and automation, and the threats to global supply chains posed by Brexit and the risk of the imposition of tariffs by the Trump administration.

Chart 9

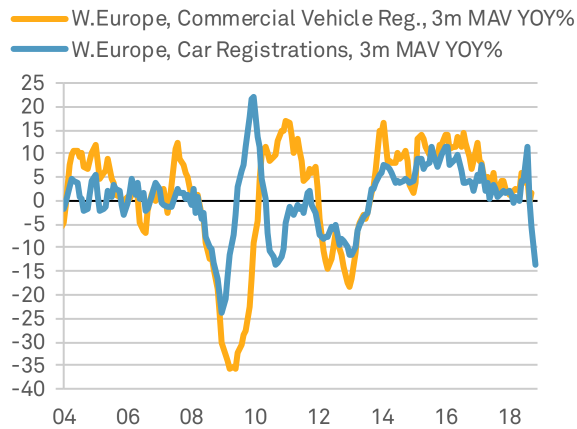
Global Manufacturing Purchasing Manager Indices



Source: Markit, Refinitiv

Chart 10

Western European Auto Registrations

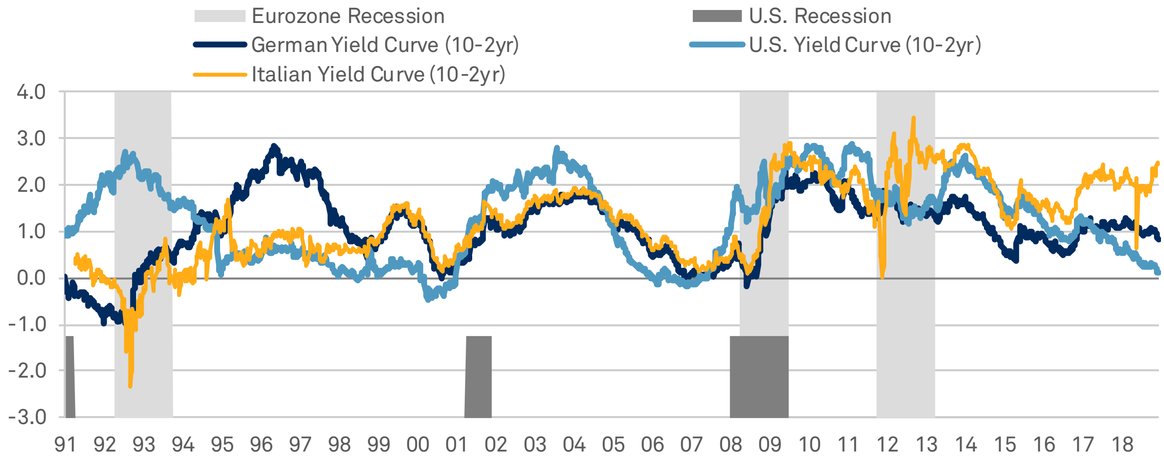


Source: Refinitiv, S&P Global Ratings

Although the U.S. economy continues to power ahead, aided and abetted by a non-textbook late-cycle fiscal stimulus, the seemingly inexorable progression to an inverted yield curve (see chart 9) is giving cause for concern given this measure's perceived ability as an early harbinger of recession. However, even if an overheating U.S. economy and the associated monetary policy response does eventually trigger a downturn in that economy, it is not necessarily the case that Europe will follow. Europe avoided a recession when technology stocks crashed in the early 2000s, for example. That said, the lack of room for maneuver in eurozone monetary and fiscal policy will be a particular cause for anxiety should such a U.S.-led downturn take hold. Options for new or renewed stimulus do, of course, remain but interest rates near zero is not the ideal position ahead of a downturn.

Chart 11

Eurozone and U.S. yield curves and recessions

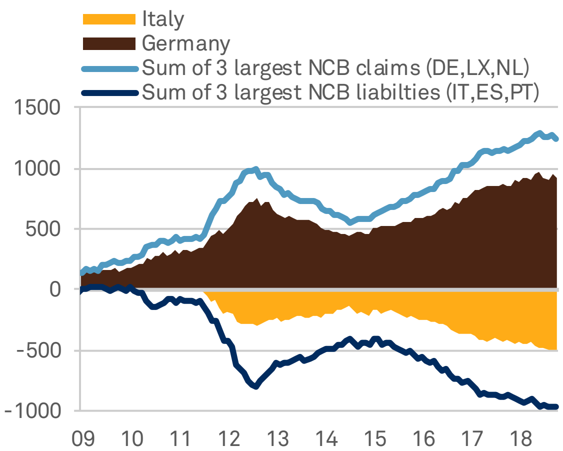


Source: Thomson Reuters Datastream, National Bureau of Economic Research (NBER), Centre for Economic Policy Research (CEPR), S&P Global Ratings. Shaded areas denote recessions for the eurozone (light gray) as determined by the CEPR and for the U.S. (dark gray) as determined by the NBER. Yield curves calculated as 10-year minus 2-year yields for Thomson Reuters government bond indices.

The eurozone's inherent challenge of being a monetary union without being a fiscal union poses particular risks should a downturn come sooner than our base case assumes. Financial fragmentation remains apparent in Target 2 balances (see chart 12) and in the renewed divergence of government bond yields in the wake of attempted shifts in fiscal policy by Italy's new governing coalition (see chart 13). The nexus between Italian sovereign bonds and its commercial banking system creates the potential for a rapid deterioration in financing conditions for the Italian corporate sector should political tensions escalate but, of course, the broader ramifications would be much wider given Italy's pivotal role in the eurozone.

Chart 12

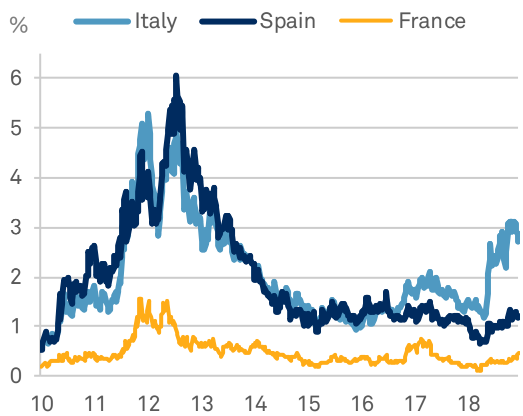
Eurozone Target 2 Balances



Source: Refinitiv, ECB, S&P Global Ratings

Chart 13

10-Year Government Bond Yield Spreads Versus Germany



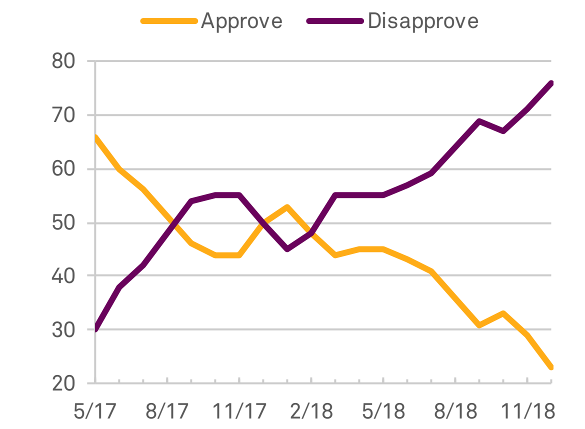
Source: Refinitiv, S&P Global Ratings

European politics remains a potent risk factor

European politics remains a major source of credit risk for the corporate sector. This has been a risk that has never quite escalated in the way it might have done in recent years, but the litany of concerns remains long: tensions between the EU and Itay's government over fiscal and immigration policy, the collapse in support for President Macron (see chart 14) and the rise of the gilets jaunes (yellow-jackets) movement, the looming end of Chancellor Merkel's era in Germany, forthcoming EU elections that are likely to see further gains for populist parties (see chart 15), the ongoing Brexit saga (see charts 16 and 17), not to mention the broader uncertainties around trade and international relations. A "no deal" Brexit has the potential to cause the most immediate market response, but faltering confidence in Europe and uncertainty over trade relations are major threats.

Chart 14

Domestic Approval Ratings Of President Macron

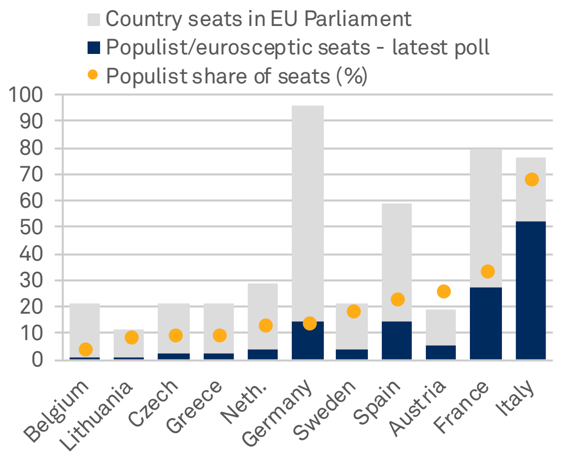


Source: Ifop-Fiducial pour Paris Match et Sud Radio

The question asked is "Do you approve or not approve of the actions of Emmanuel Macron as President of the Republic?"

Chart 15

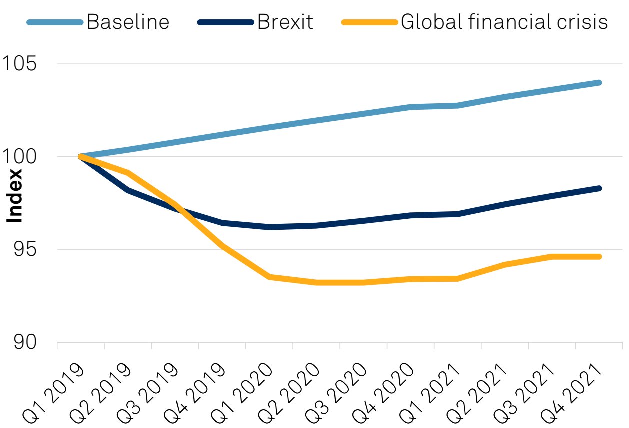
Opinion Poll Projections Of Seats For Populist And Eurosceptic Parties In May 2019 EU Parliament Elections



Source: PollOfPolls.eu, S&P Global Ratings calculations. Poll data is latest estimate for each country with readings as of December
The specific parties are those mostly found within the EFD (Europe of Freedom and Direct Democracy) and ENL (Europe of Nations and Freedom) groups within the European Parliament. Podemos from Spain is the only leftist populist grouping shown here.
Specific parties are Italy (Lega, M5S), France (FN, France Arise), Austria (Freedom Party), Spain (Podemos, Vox), Sweden (Sweden Democrats), Germany (AfD), Netherlands (PVV), Greece (XA), Czech (SPD), Lithuania (TT) and Belgium (Vlaams Belang).

Chart 16

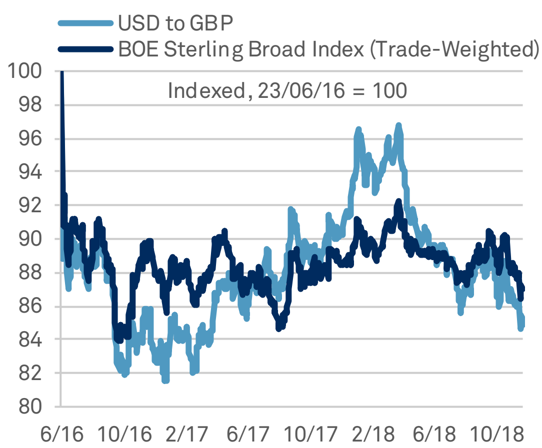
A No-Deal Brexit Could Be 60% As Damaging To The U.K. Economy As The Global Financial Crisis



Source: ONS, S&P Global Ratings,
Note: Index=100 in quarter before the shock. GDP index has been transformed for the global financial crisis so that is consistent and can be compared with our baseline forecast.

Chart 17

Sterling Acts As A Brexit Barometer And Has Lost 12% Versus The U.S. Dollar Since April



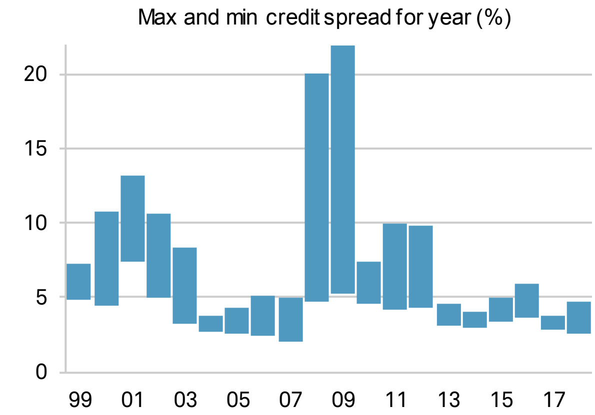
Source: Refinitiv, S&P Global Ratings

A period of calm in credit markets is coming to an end

In our view, even without a political trigger, the preternatural calm of European credit market is unlikely to be sustained in 2019, as concerns around the impact of a turn in the credit cycle grow and the comforting balm of ECB QE is removed. While credit spreads remain in a relatively contained range (see chart 18), they have moved sharply higher in recent months (see chart 19). While our base case economic assumptions do not suggest a dramatic widening of spreads is warranted economically, myriad factors give grounds for markets demanding a higher risk premium: sharp declines in equity markets, concerns around overheated U.S. credit markets, U.S.-China trade conflict and further escalations, European political risks, the impact on global financial conditions of rising U.S. and (likely later in 2019) European interest rates, amongst others.

Chart 18

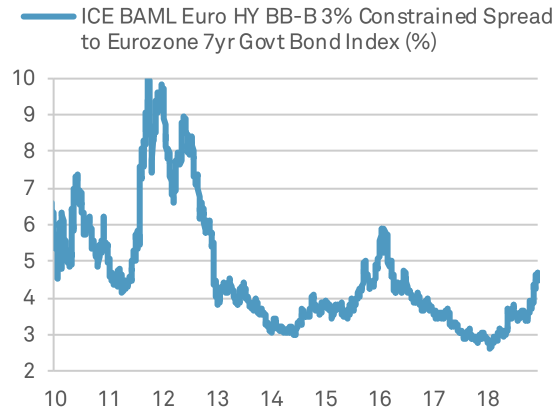
Credit spreads (BofAML Euro High Yield BB/B constrained) remain in a relatively contained range...



Source: S&P Global Ratings

Chart 19

...but have risen sharply in recent months

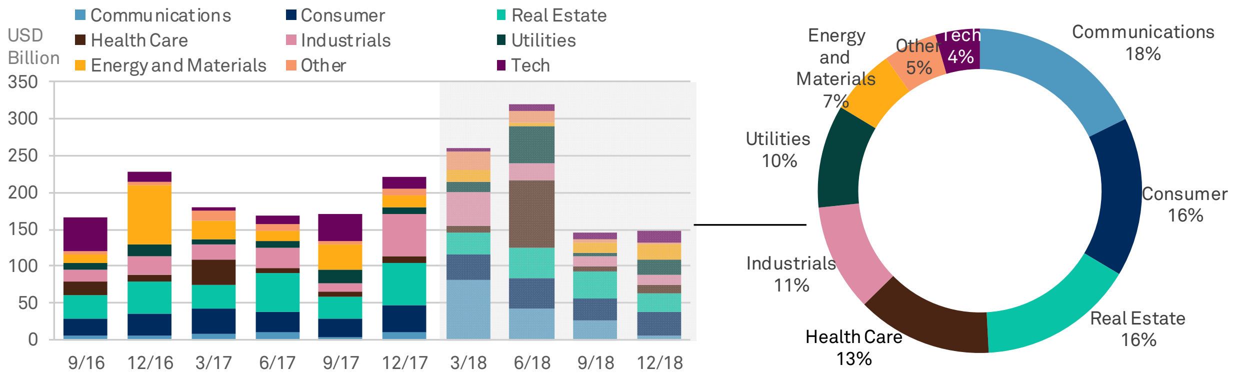


Source: S&P Global Ratings

In this context, S&P Global Ratings also expects that M&A activity levels will not return to the large volumes seen in the first half of 2018 (see chart 20). While M&A features significantly in the expectations for many industries (see *Industry Top Trends 2019*, Dec. 6, 2018), notably aerospace and defense, consumer products and hotels, there are a number of sectors (communications, healthcare), that have been very active in M&A that appear likely to go through a period of absorbing new acquisitions and looking to deliver on the financial targets that have accompanied the financing of these deals.

Chart 20

European non-financial corporate mergers and acquisitions -
Value of quarterly transactions by sector and share of 2018 total by sector (%)

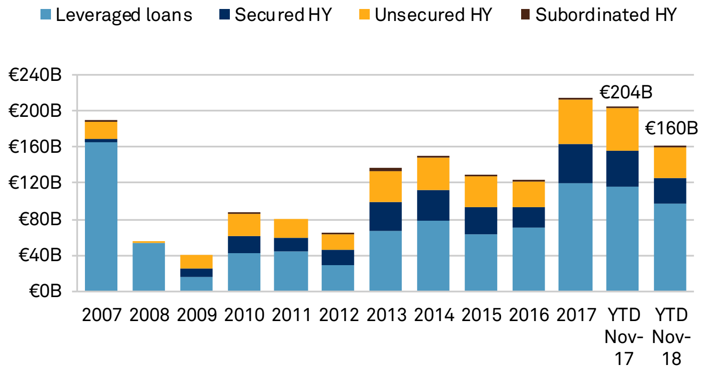


Source: S&P Capital IQ, S&P Global Ratings. Data as of December 17, 2018.

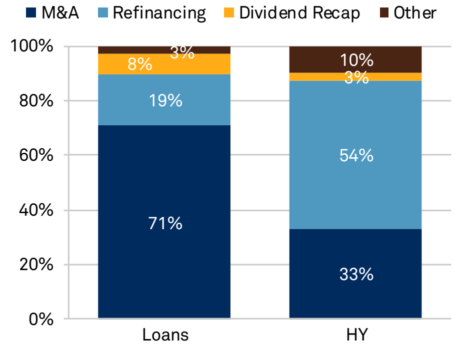
This is most likely to be reflected in moderating investment grade issuance. It may also mean lower new-issue volumes for European leveraged finance, where M&A accounted for some 71% of new leveraged loan issuance in 2018 and 33% of speculative-grade bond issuance (see chart 21). However, private equity investors retain significant dry powder, estimated at around €265 billion by Preqin, and they may well seek to take advantage of more difficult markets to deploy some of these funds. Uncertainties around Brexit are also likely to continue to crimp sterling-denominated issuance. According to LCD, sterling volume slumped to €4.9 billion-equivalent this year, from €12.6 billion-equivalent last year. The average sterling supply for 2010-2018 was €8 billion.

Chart 21

European Leveraged Finance New-Issue Volume



YTD European Leveraged Loan And HY Volume By Purpose



Source: LCD, an offering of S&P Global Market Intelligence

Assessing financing pressure if credit market volatility spikes

While our expectations for growth and interest rates do not suggest fundamental grounds for a significant downturn in credit markets, nor indeed any significant uptick in default rates, the potential for market disruption is clear given the battery risks to cash flow, the withdrawal of net asset purchases by the ECB, the prospect of rising U.S. and, later in the year, European interest rates, and elevated leverage levels (see chart 22) that have been made affordable by low interest rates. Bouts of market volatility are possible even without the trigger of a broader economic downturn, as illustrated by the recent slump in average bids for high-yield flow names identified by LCD (see chart 23).

Chart 22

European non-financial corporate leverage and cash interest cover

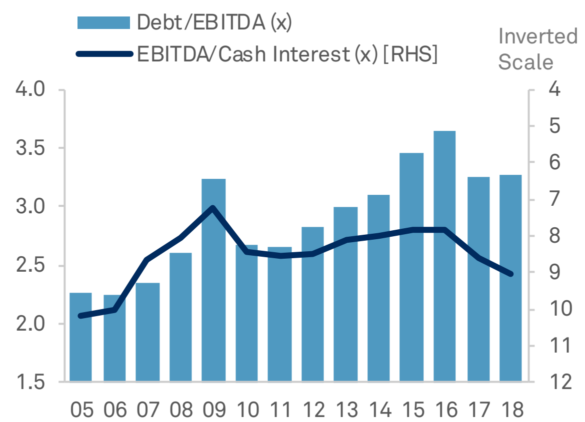
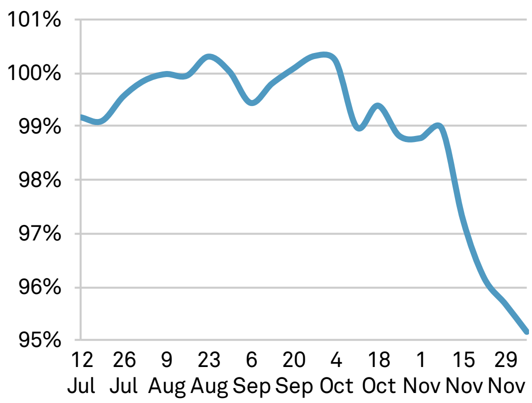


Chart 23

European average high-yield flow-name bid

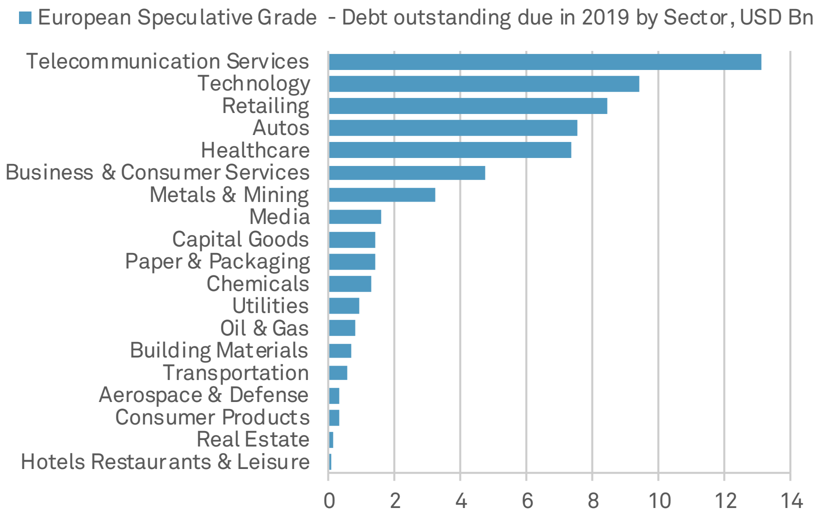


Source: S&P Global Market Intelligence, S&P Global Ratings. Data for 2018.Source: LCD, an offering of S&P Global Market Intelligence; Bloomberg is last 12 months. Figures are unadjusted financials.

While extensive refinancing by the European corporate sector in recent years means that issuers are fundamentally well placed to cope with a rise in financing costs, bouts of credit market volatility are likely nonetheless to pose refinancing risks for more highly leveraged issuers. Chart 24 shows the amount of debt coming due for European speculative grade sectors in 2019, based on data provided by S&P Global Market Intelligence. The aggregate amount due is $63.5 billion, with the largest nominal repayments expected for telecoms, technology, retailing, autos, and healthcare.

Chart 24

European Speculative Grade – Debt Maturing In 2019 By Sector

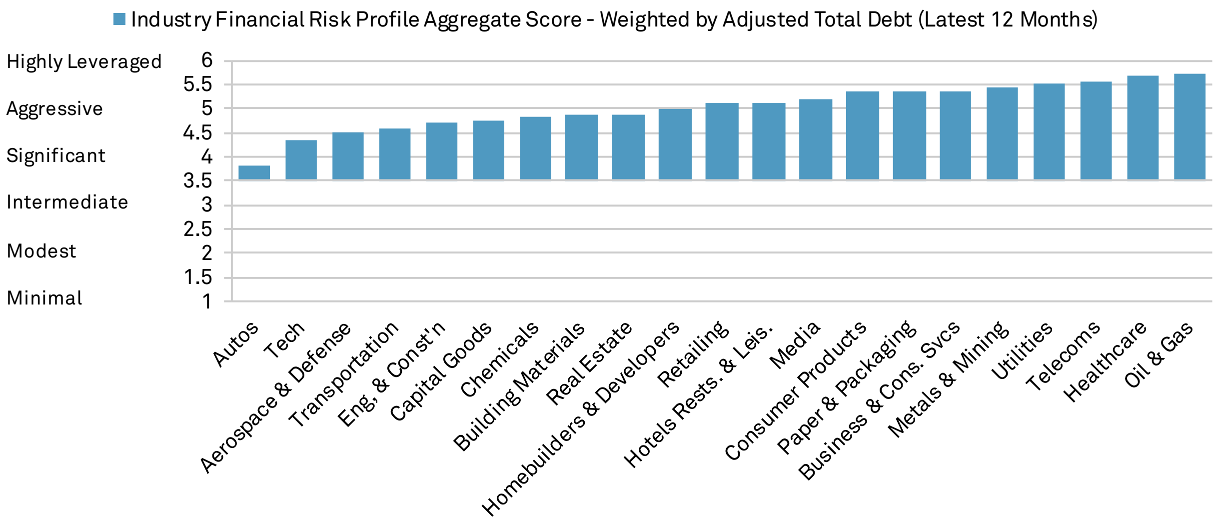


Source: S&P Global Market Intelligence. Refers to rated universe as of November 30, 2018. Data as of December 17, 2018.

To put the refinancing risk in a credit context, Chart 25 shows aggregated S&P Global Ratings financial risk profile scores for European speculative-grade credits, weighted by total debt. Amongst the speculative-grade sectors with the highest refinancing needs in 2019, healthcare, telecoms, metals and mining, and business and consumer services also have the most highly-leveraged financial risk profile.

Chart 25

European Speculative-Grade Industries – Debt-Weighted Aggregated Financial Risk Profile



Source: S&P Global Ratings

Conclusion

S&P Global Ratings expects that European corporate credit will endure a more difficult year in 2019, as both financing and operating conditions become more testing. The current credit cycle is increasingly running out of time. Although positive economic momentum is likely to sustain further increases in operating performance, markets are likely to demand higher premiums to compensate for the deterioration in conditions and intensifying risks. Ratings trends already point to a deterioration in credit quality, as companies wrestle with growing cost pressures, the impact of trade conflicts on confidence and supply chains, uncertainty around Brexit, signs of a slowdown in Chinese markets, and a battery of regulatory and technological changes.

European financing conditions will become more difficult as the ECB ends its net asset purchase programs, including the Corporate Sector Purchase Program through which the ECB had acquired a total €177 billion of corporate bonds by end-November 2018. In September 2019, S&P Global Ratings expects the ECB to raise interest rates for the first time since its rapidly aborted tightening phase in 2011. While a gradual return to normal financial policy ought to be something to celebrate, markets are likely to struggle with the removal of a source of regular demand for assets and, more fundamentally, the inherent contradictions of the single currency are continuing to create market and political tensions, such as those apparent in Italy. Tightening financing conditions may make those tensions worse and provide fuel to the growing electoral success of so-called populist parties. European elections in May will provide an important barometer of these tensions.

The U.K. meanwhile continues to wrestle with Brexit, with profound political disagreements about the process and end state of the country’s intended withdrawal from the EU at the end of March 2019. It remains possible that the U.K. may leave the EU without signing off on the Withdrawal Agreement that has been negotiated with the EU, something likely to prompt significant market volatility and an adverse initial economic impact both in the U.K. and in closely linked EU economies such as Ireland, Denmark, and the Netherlands.

The U.S. will also continue to increase interest rates as it seeks to normalize policy rates and prevent a powerful recovery getting out of hand. This is already exerting significant pressure on financial conditions in emerging market economies that are reliant on U.S. dollar financing. Moreover, there is growing evidence –weaker vehicle sales, for example – that the Chinese economy is being affected by the ongoing trade conflict with the U.S.

Against such a backdrop, we expect that M&A activity will be relatively subdued. While some industries do expect to see continued merger activity, the motivations are often as much to do with coping with cost pressures and weak growth as positive expansion. For industries that have seem very active M&A, the focus is likely to turn to absorbing acquisitions and delivering on financial targets that have accompanied the financing of deals and often higher leverage.

Related Research

- Compendium Of 23 "Industry Top Trends 2019", Dec 7, 2018
- Credit Conditions EMEA: Bracing For Turbulence, Nov. 29, 2018
- Economic Research: Economic Research: The ECB's New Normal And How We Might Get There, Nov. 29, 2018
- Countdown to Brexit: No Deal Moving Into Sight, Oct. 30, 2018
- Recent Market Transactions Weigh On The Average Credit Quality Of The European Leveraged Finance Market, May 2, 2018
- In the firing line: Trump, trade and EU corporate credit, May 1, 2018

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