



Moody's Investors Service

## Credit Opinion: Macquarie Group Limited

Global Credit Research - 28 Sep 2009

Sydney, New South Wales, Australia

### Ratings

Category	Moody's Rating
Outlook	Negative
Issuer Rating	A2
Senior Unsecured	A2
Subordinate MTN	A3
ST Issuer Rating	P-1
Other Short Term	P-1
<b>Macquarie Financial Holdings Limited</b>	
Outlook	Negative
Issuer Rating	A2
ST Issuer Rating	P-1
<b>Macquarie Bank Limited</b>	
Outlook	Negative
Bank Deposits	A1/P-1
Bkd Deposit Note/CD Program -Dom Curr	Aaa/--
Bank Financial Strength	C+
Issuer Rating	A1
Senior Unsecured	A1
Subordinate	A2
Commercial Paper	P-1
Other Short Term	P-1

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### Opinion

#### SUMMARY RATING RATIONALE

As a non-operating holding company, Macquarie Group Limited's (MGL) A2 / Prime-1 ratings are as much a reflection of the credit profile of its subsidiaries as of itself. The key rating drivers are:

[1] the ratings assigned to its principal operating subsidiaries Macquarie Bank Limited (MBL), rated A1 / P-1 for deposits and debt and carrying a bank financial strength rating of C+, and Macquarie Financial Holdings Limited (MFHL), which carries an A2 issuer rating

[2] the liquidity and capital strength of the consolidated group - as well as the low double leverage of MGL on a non-consolidated basis

[3] the structural subordination of MGL (which is a non-operating holding company) to the cashflows of its operating subsidiaries, and the regulatory ring-fencing of MBL

[4] the indirect benefit to MGL of the systemic support that we believe would be available to MBL, if required

#### Credit Strengths

[1] robust capital position that can accommodate substantial adverse shocks - as well as permit MGL to take advantage of M&A or organic growth opportunities that arise from the global financial crisis

[2] strong liquidity that provides a substantial cushion against credit market dislocations. MGL has also raised substantial long-term wholesale funding, and deposit growth is further reducing MGL's reliance on short-term debt.

[3] highly diversified earnings by product and geography. However, the global and coordinated nature of the current downturn is currently offsetting the benefit of this credit strength

[4] strong risk management track record: aside from mark to market write-downs arising from MGL's funds management related activities, the level of the Group's asset impairment has been very low relative to the global wholesale / investment banking peer group during the global financial crisis

[5] established track record of continual self re-invention through incremental, multi-line expansion

### **Credit Challenges**

[1] earnings: in the shorter-term, the potential for ongoing economic weakness to weigh on revenues and bank asset quality. Mid-term, MGL's ability to satisfy investor return requirements in a low-growth environment, without taking on material additional balance-sheet risk

[2] managing the accelerated reorientation of MGL's franchise as it exits crisis-hit business lines - of which listed infrastructure funds management is the most high profile - and acquires new operations through M&A, which additionally presents integration challenges

[3] the potential for market reversals and economic weakness to further impair MGL's investment holdings, although the Group's substantial regulatory capital surplus provides a significant buffer

[4] risk management - a traditional Macquarie strength - will nevertheless remain challenging, given the firm's complex and constantly evolving operations

### **Rating Outlook**

The rating outlook is negative on the long-term rating of A2 and stable on the short-term rating of Prime-1. The negative outlook addresses the potential for an extended, global economic and capital markets slowdown - and the associated exit of the firm from a number of business lines - to negatively affect MGL's earnings in calendar 2009 and beyond. The outlook also reflects the challenges to wholesale banking business models created by the current environment, which may continue to some degree, even post-crisis.

In other respects, MGL's credit profile remains very robust. It has strong capital and liquidity, a very good risk management track record and it is well positioned to take advantage of business opportunities arising out of the crisis.

The stable outlook on the short-term rating reflects the strong liquidity profile of MGL on a consolidated basis, as well as the Australian government's (and regulators') strong support for the financial system.

### **What Could Change the Rating - Up**

As the negative outlook indicates, we do not anticipate an upgrade in the near term. To move the rating back to a stable outlook, we would probably require:

[1] increased comfort with regards to the likely operating environment trend in 2010

[2] evidence that MGL can (re-)build earnings via its traditional fee-driven model in its emergent business lines, without taking on significant proprietary positions

[3] successful reduction in illiquid risk assets, notably co-investments in listed funds, relative to earnings and equity

[4] a stable rating outlook on other Macquarie group companies

### **What Could Change the Rating - Down**

One or more of the following could create negative rating pressure:

[1] A downgrade of either MBL or MFHL

[2] Mark to market write-downs that significantly erode MGL's buffer over regulatory capital requirements

[3] Prospects for sustained earnings weakness and/or an increase in the Group's risk appetite

[4] Lack of progress in ongoing reductions in risk concentrations, such as co-investments in listed funds

[5] An increase in double leverage to over 110%

### **Recent Results and Developments**

MGL does not report quarterly, but has provided a 1Q FY2010 update indicating improved operational performance from all major business lines except Macquarie Capital (corporate finance and equity capital markets). Guidance on 1H FY2010 earnings was mid-way between 1H and 2H FY2009.

With strong cash and capital resources, MGL has been active in M&A (as it has in prior downturns) acquiring offshore corporate finance, asset management and gas trading operations and has indicated a particular interest in growing its position in the US market in targeted niches.

MGL reported a FY2009 profit of A\$871m in March 2009, down 52% on FY2008, and while there were some positive credit developments beneath the headlines, the earnings and growth challenges set to persist in the short- to medium-term remain reflected in Moody's negative outlook on the Group's A2 rating (MBL at A1).

In effect, the global nature of the downturn has eroded the traditional benefits of Macquarie's considerable geographic and product

diversity, as it reported weaker results in most business lines. Nevertheless, pre-provision income -- excluding one-off items -- was down only 14%, highlighting MGL's flexible expense structure.

And while MGL has avoided exposures to virtually all the asset classes that have driven losses at major international banks, it has had to make significant valuation write-downs on items such as co-investments in the equity funds that it manages, and property exposures related to its funds management activities.

MGL aims to further reduce its positions in its listed "specialist funds", whose market prices remain significantly lower than pre-crisis. Asset sales would provide support to the Group's ratings by reducing sensitivity to market swings - this consideration currently outweighs the loss of diversity. For example, in July 2009 Macquarie Communications Infrastructure Group was sold to the Canadian Pension Plan Investment Board. At the same time, management fees from this business line may also decline: in July 2009, Macquarie Leisure Group announced that it would internalize its management. Despite its high profile, however, this business line contributed only 13% of FY2009 operating income, limiting the impact of any decline on MGL's ratings. Moreover, underlying demand in the non-listed funds sector appears to persist; notably MGL has engaged in joint ventures to establish new infrastructure funds in China, India and during 2009.

Despite the negative news, Macquarie - as indicated - reported some positive credit developments in its FY2009 results:

-- Funding and liquidity: cash and liquid asset cover of debt maturities in the next 12 months more than trebled to 2.1x. Macquarie Bank has also taken advantage of a government guarantee to considerably lengthen the weighted average term of the Group's debt.

-- Deposits: grew rapidly, to 25% of the Group's funded balance sheet and further reducing its reliance on short-term wholesale debt.

-- Capital: the Group's capital buffer over the minimum regulatory requirement grew to 44% from 41%. Additional capital raised after financial year-end has taken that buffer to around 60% pro forma, as Macquarie positions itself not only to weather any further volatility, but also for M&A and organic growth opportunities

-- Balance-sheet restructuring: Macquarie has sold off on schedule some A\$15bn in low-yielding assets that were funding- and capital-intensive

-- Listed specialist funds: Macquarie marks the funds on the basis of the value of the underlying assets, not the funds' equity prices. In 2H FY2009, the Group sold a range of assets from its funds - and one fund - at or above book, lending some support to its asset impairment methodology

-- Market risk: remained very low by industry standards

Analysis

Relationship to operating subsidiary ratings

MGL's A2 rating is positioned one notch below the A1 weighted-average of its principal operating subsidiaries: MBL at A1 and MFHL at A2. MBL dominates the group both in terms of assets and, in the current environment, earnings. MGL's rating is positioned in line with Moody's usual notching practice for holding companies that recognizes the structural subordination of MGL's creditors to those of its operating subsidiaries. It also reflects the regulatory ring-fencing of MBL: there are regulatory restrictions on MGL's ability to draw on the bank's capital and liquidity.

However, the high degree of operational and financial integration between MGL and its operating subsidiaries, as well as the generally supportive regulatory environment in Australia, are likely to mean that despite the above considerations, there will always be a relatively tight rating relationship between them. Please refer also to the systemic support section below.

MGL was created in 2007, when MBL adopted a holding company structure. Under the reorganization, MBL became an operating subsidiary of the new non-operating holding company MGL.

Franchise

MGL is the only Australian wholesale / investment bank of size, and is engaged in a broad range of financial markets activities in its home country and abroad. It has very strong links into the Australian corporate and financial sectors, where it has traditionally enjoyed a strong advisory and equity underwriting franchise. It is well known for its wide range of funds management activities, with particular strength in managing infrastructure and real estate assets. The Group also enjoys a strong cash equities brokerage position in Asia and is building niche capability in Europe and the US.

The global financial crisis has led MGL to scale back and/or exit a number of business lines, including listed "specialist funds" management, residential mortgage securitization and margin lending. While this fact is reflected in the negative outlook currently assigned to MGL's ratings, it is counterbalanced by the diversity of the Group's other business lines, and its established track record of continual self re-invention through incremental, multi-line expansion.

Indeed, the crisis is affording the cash-rich MGL an opportunity to grow by means of acquisition - and the Group has a track record of making transformational acquisitions during prior downturns. In North America MGL has made acquisitions in the field of corporate finance, funds management and energy trading, and has highlighted the US market as being of particular interest for further initiatives.

The Group's position in its home market will likely be reinforced, as foreign competitors scale back their activities. For example MBL has been able to build on its wealth management base to grow deposit market share: household deposits grew from 0.1% to 0.6% in the year to May 2009.

Of the businesses MGL is scaling back, listed specialist funds management is probably the most significant. However, there appears

to be continued demand from long-term infrastructure investors in the non-listed sector, for which MGL raised over A\$7.5bn in FY2009. Notably MGL has engaged in joint ventures to establish new infrastructure funds in China, India and during 2009.

#### Earnings

MGL enjoys earnings that are highly diversified by product and geography. Individually, many of its business lines have been relatively volatile over time, as is characteristic for a wholesale / investment bank. Yet the high degree of diversification has historically stabilized MGL's earnings to a remarkable degree relative to the industry peer group.

However, the synchronized downturn in global financial markets and economies is currently affecting the majority of the Group's business lines. This fact is recognized in the negative rating outlook. MGL's FY2009 earnings were down 52% on the prior year as a result of provisioning costs, principally relating to its funds management activities, and the operating environment outlook remains challenging. At the operating subsidiary level, the earnings of MBL and MFHL remain in line within an acceptable range for the bottom of the cycle, but probably not for an extended period. The ability of the Group to rebuild earnings within a reasonable time-frame, say 12-18 months - and the level of risk it assumes in the process - will therefore constitute important inputs to MGL's future rating trend.

Nevertheless, on a pre-provision basis earnings declined less: 36% (or only 14% excluding one-off items) highlighting MGL's flexible expense structure, approximately 30% of which is accounted for by the variable component of staff compensation. The firm also managed to reduce non-compensation expenses considerably in FY2009, offsetting the income drop.

The challenges faced by MGL's specialist funds management division have received the most publicity during the crisis, but have relatively low impact on the firm's ratings from an earnings perspective (they are more significant from a risk perspective). As originator of the "Macquarie model", our assumption had always been that the firm was enjoying an innovator's super-normal returns, and that these would decline over time as (i) more competitors entered the segment (which had already occurred pre-crisis), and (ii) the equity bull market slowed. For these reasons we have historically discounted the earnings from this business line, and so there is relatively little impact on MGL's rating as a result of their decline. Pre-crisis, if all associated income is included, the specialist funds' contribution to MGL's operating income peaked at around 20%, but by FY2009 this had declined to around 13%. And as noted, while the listed fund model is certainly very challenged, there appears to be ongoing demand for unlisted funds.

MGL's continual evolution is apparent in the composition of its earnings, 40% of which at FY2009 were derived from new business lines entered into over the prior 5 years.

#### Risk Appetite

MGL has a clearly defined risk appetite that measures risk relative to forward earnings and capital. It is supported by stress-testing based on a range of macro-economic linkages, whose predictive performance has held up well during the severe test of the global financial crisis. Moreover, the Group has exhibited negligible exposure to troubled asset classes and counterparties during the global credit crisis.

Relative to the global wholesale / investment banking peergroup, MGL tends to run a low level of balance sheet risk, with notably little proprietary trading activity. The firm's high degree of diversification by business line and geography also sets it apart from the peergroup.

Nevertheless, it does retain some notable exposure concentrations, which management is currently addressing. As we note in our October 2008 report "Impact of the Credit Crisis on Moody's Rating Methodology and the Credit Profiles of Investment Banks",

MGL has traditionally focused on advisory / merchant banking, with a low appetite for balance-sheet risk. However, during the pre-crisis years of cheap and plentiful liquidity, the Group did at times take on exposures that were large relative to earnings and capital. Principally, these related to the acquisition by the Bank of infrastructure assets, for the purpose of on-selling them to one of the Group's managed funds ("seed assets"). This activity was being wound down even before the crisis started.

MGL retains exposure concentrations in its specialist funds as a result of co-investments made as part of the business model. In the case of the listed funds, these stakes are not marked to market, but rather look through to the value of the underlying assets. MGL's valuations have exceeded the market value of the funds during the worst of the crisis period. From a rating perspective we therefore take some comfort that, to date, book valuations have indeed been borne out by the realized sale prices of both individual assets and whole funds. Furthermore, and in addition to provisions taken to date, considerable coverage of MGL's co-investments is afforded by the Group's sizeable buffer over its regulatory capital requirement and the high risk-weighting of these assets.

Importantly, from a rating perspective, MGL has a track record (that extends well before the current crisis) of not supporting its funds' performance during periods of stress - and we consequently believe that the contingent liabilities associated with this business line are low. MGL did increase its stake in Macquarie Infrastructure Group early in the crisis, but remained below the pre-crisis approved co-investment level of 20%. MGL's key principle is that funds should obtain credit from third parties. Accordingly, MGL has almost no loans to its funds, and its lending to the fund's assets is also limited and on the basis that MGL acts only as a minority lender. While the level of gearing at the investee level may not be sustainable in all cases during the current economic downturn, we would expect issues to be resolved at the fund level by means such as asset sales, not by direct assistance from MGL. Indeed, this has been the Group's approach to date.

Moreover, MGL has indicated that it intends to continue to sell down positions in its listed funds over the course of the current financial year. For example, in July 2009 Macquarie Communications Infrastructure Group was sold to the Canadian Pension Plan Investment Board. At the same time, management fees from this business line may also decline: in July 2009, Macquarie Leisure Group announced that it would internalize its management. Despite its high profile, however, this business line contributed only 13% of FY2009 operating income, limiting the impact of any decline on MGL's ratings.

MGL appears committed to maintain its non-listed specialist funds business line, and also makes co-investments in these non-listed funds. They are obviously not subject to the same mark-to-market volatility as listed investments and, on a fundamental basis, the risks are likely to be well contained. The funds typically invest in regulated infrastructure and utility assets with favourable long-term

demand characteristics, and returns that are typically inflation-linked to some degree. MGL also has proven ability to manage assets of this type.

Relative to commercial banks, loans constitute a relatively low proportion of MBL's asset base. The majority of the loan portfolio is retail focused - principally leases and residential mortgages - and granular. The majority of the mortgage book is securitized - and we regard Australian securitizations as constituting relatively "clean" sales relative to other markets. The dollar value of residual non-securitized mortgage assets is not excessive relative to the Group's capital base and the assets of good quality. Probably greater credit risk is posed by MBL's financing of (i) selective commercial real estate projects, although the bank has an excellent track record of managing its asset quality in this sector, even through the sharp market correction of the early 1990's, and (ii) exposures relating to the Group's commodities (metals and mining) customers. Due to the Bank's healthy capital level, however, its current rating can withstand a reasonable level of asset quality deterioration.

As elsewhere, the crisis is affording MBL some unique opportunities: spreads have improved dramatically and it has the funding and capital to take selected lending opportunities. The nature of exposures taken, and the capital allocated against them may be significant from a rating perspective.

An important component of MGL's success has been its ability to foster a highly entrepreneurial culture - in which individual business units are able to function with great autonomy, and where the firm is constantly expanding its business scope - while maintaining tight, central risk control. The Group's incentive structures reward behaviours geared towards long-term sustainability, with performance pay linked to risk-adjusted measures and deferred out as far as 10 years, in order to place responsibility for risk back with the business line. And the Group's business line expansion has generally proceeded at a measured pace, to products or geographies that are extensions of existing operations. MGL also often gains experience through joint ventures with local operators before committing greater resources, when it frequently acquires specialist teams to spearhead its efforts. Nevertheless, maintaining the balance between growth and control will become increasingly challenging, and at the same time important, as the Group becomes ever more diverse and international in its operations.

#### Capital

MGL has traditionally held a high level of capital, on a consolidated basis, as management has viewed the strategic advantages of being able to respond to market opportunities to outweigh the cost of carry. Indeed, the Group has over its history been able to make some transformational acquisitions as a result of market downturns. From a rating perspective, MGL's capital buffer is an important source of strength.

At end March 2009, MGL's capital was A\$3.1bn, or 44% in excess of regulatory requirements, and a subsequent capital raising has taken that buffer to around 60% pro forma. The Group's regulatory capital requirement is the product of Basel II capital requirements for MBL (which we note are conservative relative to many jurisdictions: see Moody's Banking System Outlook for Australia) and a regulator-approved internal capital allocation model for MFHL. Both operating subsidiaries carry capital well in excess of their regulatory minima.

From disclosures by MGL, it appears that capital allocated to MFHL's equity risk exposures is high relative, for example, to regulatory bank capital requirements. We view this to be appropriate for the Group's rating, given the exposure concentrations at MFHL - for example the co-investments in its specialist funds. Furthermore, while write-downs on the Group's positions in its specialist funds (and the seed assets for such funds) have created a drag on earnings during the global financial crisis, the high risk-weightings applied to such assets mean that upon charge-off, there is simultaneously a meaningful reduction in risk-weighted assets that mutes the impact on MGL's capital adequacy.

During the global financial crisis, non-risk-weighted capital ratios have frequently proven to be a useful forward indicator to financial stress at wholesale / investment banks. In this respect we note that MGL's Equity / Assets (IFRS basis) was 6.4% at end FY2009, on a consolidated IFRS basis, which was at the upper end of the global peer group. Moreover, under IFRS this includes securitized mortgage assets, and we also note that Australian RMBS structures principally derive their credit enhancement from lenders mortgage insurance - accordingly, the originator (MBL) does not retain any first loss position in such structures.

At 105%, MGL's double-leverage position was within expectations for its rating (ie below 110%) at FYE 2009.

#### Liquidity

MGL has excellent liquidity characteristics on a consolidated level - now further supported by the Australian government's guarantee of MBL's deposits and specific debt securities, and by expanded access to central bank repo facilities.

MGL has considerably increased its liquidity resources on a consolidated basis to over 2 times the level of wholesale debt maturities coming due over the following 12 months. The Group's standard liquidity policy is to ensure that 12 months' maturities can be met from internal sources, which we would view as appropriate for its rating in more "normal" operating conditions.

MGL's funding model has historically contrasted to that of many wholesale/investment banks (in particular in the US) in that it has only relied to a very small degree on secured funding for its regular business operations. The proportion of funding by means of short-term repos in the commercial market has always been low, and the firm has ensured that alternative funding options have been available at all times.

MGL has also been cautious in the provision of liquidity lines to third parties - and accordingly was not materially affected when the closure of the securitisation market caused originators to draw on all available funding lines.

The high level of MGL's operational integration with its principal operating subsidiaries is immediately apparent from an analysis of its liquidity and funding profile. The legal entity MGL does not itself carry any liquid assets, despite being a legal entity undertaking some borrowing for the broader group. Liquid asset coverage of MGL's debt is effectively maintained at the operating subsidiary level. MGL's operating subsidiaries are currently very liquid, and even in non-crisis conditions are subject to the group's strict liquidity policy requirements.

As at end March 2009, the legal entity MGL had A\$7.4bn in borrowings under a senior credit facility from a panel of banks, which was raised principally to fund MFHL. Balancing this, MGL recorded A\$10.4bn "due from subsidiaries", principally MFHL. Separately, MGL also recorded A\$3.9bn (the remaining balance was approximately A\$1.5bn at end August 2009) remaining of an intergroup bridge-loan from MBL, also to fund MFHL, which was drawn upon the conversion to a holding company structure. In 1H FY2010 MGL also issued its first A\$1.7bn (US\$1.5bn) of long-term public debt securities.

The Group's external funding is chiefly raised by MBL - recently reinforced by the Australian government's guarantee, which covers debt issued by the Bank, not the Group. The guarantee covers maturities out to 5 years, which has facilitated MBL's efforts to lengthen its wholesale funding profile - and consequently that of group. The Bank has also successfully grown its deposit base on the back of its private client business, with notable growth achieved before the introduction of the government guarantee, underlining the value of this franchise. (In effect, MGL has probably been re-intermediating savings from its cash management trust product, which was popular pre-crisis). Retail deposits grew 103% over FY2009.

The net impact of these measures has been a sharp decrease in the Group's reliance on short-term wholesale funding.

#### Systemic Support

Moody's continues to assign ratings to the obligations of banks - and their parents - independent of the Australian government's guarantee of certain deposits and debt instruments. (MBL's obligations are covered, MGL's are not). This is because our ratings address a time horizon that may extend beyond the life of the extraordinary support measures put in place for the duration of the global financial crisis. The rationale for these non-guaranteed ratings is discussed in this research report. Individual bank obligations that are covered by the government guarantee will separately be assigned "backed" ratings, on a case by case basis.

Nevertheless, Moody's ratings do incorporate the potential for systemic support in a post-crisis world.

MGL's ratings incorporate an element of such systemic support, through its ownership of MBL. MBL's A1 deposit and debt ratings are lifted one notch above the bank's baseline credit assessment of A2 (its stand-alone rating, derived off its BFSR of C+) because of the potential for systemic support in case of need. Please refer to Moody's Credit Opinion on MBL.

Because of the close integration between MGL and its operating subsidiaries, and because we view the Australian regulatory environment to be highly supportive, we believe that any support which the bank might enjoy - if required - would to some degree benefit MGL. Regulation restricts MBL from extending intergroup funds in excess of 35% of its own capital base. Nevertheless, we note that in the past the regulatory focus in Australia has been heavily on the preservation of systemic stability and that MGL has a significant presence in Australia's financial market. Please refer to Moody's Banking System Outlook for Australia.



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