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Summary:

Heathrow Funding Ltd.

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Summary:

Heathrow Funding Ltd.

Rationale

Business Risk	Financial Risk
<ul style="list-style-type: none">• Excellent competitive position as the largest airport in the London area, and the only hub airport in the U.K. with a near monopoly on long-haul flights.• A supportive regulatory environment, ensuring recovery of investment and good predictability of cash flows over five-yearly resets.• Above average profitability among transportation infrastructure companies.	<ul style="list-style-type: none">• Aggressive leverage and relatively weak credit metrics, with S&P Global Ratings-adjusted funds from operations (FFO) of above 8% for the Class A notes and above 6% for consolidated debt (excluding the intercompany loan with Heathrow Finance Plc).• Negative free operating cash flow (FOCF) from FY2019 due to increasing capital investment of about £3 billion in FY2017-FY2019.• Distributions of £400 million-£600 million annually.• Structural enhancements that reduce the default risk of notes issued by Heathrow Funding Ltd. (HFL) by allowing the noteholders to take control of the business ahead of an insolvency of Heathrow (SP) Ltd.

Outlook: Stable

The stable outlook on debt issued by HFL and secured on the assets of Heathrow (SP) Ltd. reflects our expectation that weighted-average FFO to debt for the rest of the current price control period (Q6, April 1, 2014 to Dec. 31, 2020) is likely to stay above 8% for the Class A and above 6% for consolidated debt (excluding the intercompany loan with Heathrow Finance Plc). In our view, Heathrow is likely to benefit from the excellent competitive position supporting the resilience of its traffic volumes and strong management team, which is focused on increasing retail revenue and delivering cost efficiencies. Debt issuance in the current regulatory period is likely to remain moderate.

Downside scenario

We could lower the ratings if weighted-average adjusted FFO to debt on a consolidated basis was to deteriorate to below 8% for the Class A debt or below 6% on consolidated basis (excluding the intercompany loan with Heathrow Finance Plc), or if adjusted debt to EBITDA were to increase above 7x for the Class A debt or above 7.5x for consolidated debt (excluding the intercompany loan). This could happen if the company's financial policies were more aggressive than we currently expect, leading to higher leverage or higher distributions, and/or the operating performance was not as strong as we currently envisage, with weaker-than-we-forecast commercial revenues or higher costs than we forecast, unmitigated by lower distributions.

Weakening financial metrics could also stem from the company incurring in Q6 costs related to the Development Consent Order (DCO) and construction costs of the third runway, if these costs are not adequately and in a timely manner compensated for through the regulatory framework.

Upside scenario

Ratings upside is limited, in our view, as we expect HFL will be issuing more debt to fund capital expenditure (capex), including to cover preparatory costs of the third runway, and will also likely be increasing distributions to allow for debt service above HFL.

Latest Developments

- The National Policy Statement, which sets out the government's proposals for developing a new runway by 2030, is expected to be voted by the parliament in the first half of 2018. If approved, Heathrow will submit a planning application (Development Consent Order; DCO), in early 2020, which the government would be expected to grant by the end of 2021. If the planning and construction run according to the timetable, the third runway would be operational around 2026. Due to the long lead time before construction starts, and uncertainties as to its cost and cost recovery via regulation, we do not consider its impact in our base-case forecast.
- The regulator, the Civil Aviation Authority (CAA), has extended the 2014-2018 control period, Q6, to Dec. 31, 2020, to align it with the runway expansion timetable. Aeronautical charges will continue to be set under the RPI-1.5% formula. We view as positive for continuity and transparency that during the next price control period (H7; 2021-2025) the CAA intends to continue the core Q6 framework with the RAB-based RPI indexation, and the same operating costs incentives.
- The CAA has confirmed costs incurred in connection with obtaining the DCO (category B costs) in excess of £10 million per year will be capitalized into Heathrow's Regulated Assets Base (RAB) and recovered through charges from 2020 onward, although Heathrow would recover only 85% of these costs if the DCO is not granted, leaving it exposed to about £50 million, representing 15% of the investment. The CAA is still to decide on the strengthening of economic incentives for capex and commercial revenue, cost of debt calculation, and treatment of Category C costs (construction costs), therefore potentially negatively affecting Heathrow if it starts incurring Category C costs earlier.
- The U.K.'s vote to leave the EU (Brexit) creates uncertainty, but in our view a significant drop in passenger numbers is unlikely given only 34% of traffic served by Heathrow is EU-bound. If an economic downturn followed, we believe the impact on traffic would also be limited. Historically, the airport has shown significant resistance to economic downturns; in 2009, passenger (pax) numbers fell by only 1.5% in response to a 5% drop in GDP--the lowest pax drop among U.K. airports. Long-term effects of a drop could be partially mitigated by a regulatory reset due at the end of 2020.

Our Base-Case Scenario For FY2017-FY2019

Assumptions

- In 2017, 3.0% passenger numbers grew to 78 million mainly thanks to higher load factors. In FY2018-FY2019, a slight passenger decline (-0.2% on average) will reflect Heathrow's capacity constraints, but also a one-off disruption in 2019 (perhaps due to Brexit, BA strikes, or weather events).
- Aeronautical tariff growth at RPI as of April of the previous year minus 1.5%. The tariff decline in FY2017 was based on April 2016 inflation of 1.3%. RPI at April 2017 was 3.5% and we forecast RPI at 2.9% for April 2018.

- 4.3% growth in retail revenue per passenger in FY2017 on GBP depreciation, retail offering development, and increasing catering income thanks to growth in food outlets and an increasing number of airlines not offering free food on board. In FY2018-FY2019, we assume 3%-4% per year growth rates, based on the combined effect of S&P Global Rating's forecast GDP and the RPI growth.
- Car parking revenue growth at RPI growth rates. Heathrow Express revenue growth in line with passenger growth, except in 2020 when it drops following the launch of competing Crossrail services from end-2019.
- 0.5%-1.5% operational costs growth per year thanks to the implementation of £600 million cost efficiencies set as a target for Q6.
- 4.5% EBITDA growth in FY2017, and by 1.0%-2.5% per year in FY2018-FY2019 driven largely by retail on the revenue side, and cost efficiencies. EBITDA margin of about 62%-63%.
- Capex of £800 million-£900 million in FY2017-FY2018.
- £960 million Class A debt issuance in FY2017, about £800 million in FY2018.

Heathrow Funding Ltd. Key Metrics

	2016	2017f	2018f
FFO to Debt (%)			
Class A and B	6.2	6.5-6.9	6.5-6.9
Class A and B excluding the intercompany loan*		7.9-8.3	7.9-8.3
Class A only		10.1-10.5	9.6-10.0
Debt to EBITDA (x)			
Class A and B	7.9	7.7-8.1	7.8-8.2
Class A and B excluding the intercompany loan*		7.0-7.4	7.0-7.4
Class A only		6.0-6.4	6.3-6.7
FFO to cash interest coverage (x)			
Class A and B	2.8	2.4-2.8	2.4-2.8
Class A and B excluding the intercompany loan*		2.8-3.2	2.8-3.2
Class A only		2.8-3.2	2.8-3.2

*S&P Global Ratings-adjusted ratios. f--Forecast. *Intercompany loan with Heathrow Finance Plc.

Business Risk: Excellent

Heathrow's excellent competitive position results from it being the largest airport serving the London area--the largest aviation passenger market in the world and the most affluent area of the U.K. Heathrow is the U.K.'s only hub airport and has a near monopoly on long-haul flights. Heathrow operates under a predictable and supportive regulatory framework based on the RAB concept, which encourages investment by allowing recovery of capex costs via tariffs. A fair return over the RAB ensures the business' profitability and shareholder returns, which grow in line with capex. Heathrow's profitability, 61.9% S&P Global Ratings-adjusted EBITDA margin in FY2016, is not only above average for the transportation infrastructure industry but also the highest among rated European airports. This is the result of the high level of recent investments in the airport's infrastructure, and Heathrow's ability to recover investment costs. It has also been supported by Heathrow's success in increasing its commercial revenues per passenger, in particular from retail and car parking, and its focus on delivering operating efficiencies.

In our view, constructing a new runway at Heathrow will further improve its leading position as a U.K. hub. It will open up the possibility of new long haul routes, likely attracting a share of traffic from other European hubs. On the other hand, additional capacity will expose Heathrow to volume risk. Certain mitigation is likely to come from the regulatory framework for H8 (a regulatory period which will start when the third runway is operational), via a traffic and volume risk-sharing mechanism. However, the extent of the protection is unknown at this stage.

Peer Comparison

Table 1

Heathrow Funding Ltd. -- Peer Comparison					
Industry Sector: Infrastructure					
	Heathrow (SP) Ltd.	Aeroports de Paris	Royal Schiphol Group N.V.	Southern Cross Airports Corp. Holdings Ltd.	Gatwick Funding Ltd.
Rating as of Dec. 7, 2017	-/-/-	A+/Stable/(NR)	A+/Stable/A-1	BBB/Positive/NR	-/-/-
Country Risk	Low Risk	Low Risk	Very Low Risk	Very Low Risk	Low Risk
Industry Risk	Low Risk	Low Risk	Low Risk	Low Risk	Low Risk
Competitive Position	Excellent	Excellent	Excellent	Excellent	Strong
Business Risk Profile	Excellent	Excellent	Excellent	Excellent	Strong
Financial Risk Profile	Aggressive	Intermediate	Intermediate	Aggressive	Significant
Anchor	bbb	a	a	bbb	bbb
Diversification/Portfolio Effect	Neutral	Neutral	Neutral	Neutral	Neutral
Capital Structure	Neutral	Neutral	Neutral	Neutral	Neutral
Liquidity	Adequate	Strong	Strong	Adequate	Adequate
Financial Policy	Neutral	Neutral	Neutral	Neutral	Neutral
Management/ Governance	Satisfactory	Satisfactory	Satisfactory	Strong	Satisfactory
Comparable Rating Analysis	Senior: Positive (+1 notch); Junior: Neutral	Positive (+1 notch)	Neutral	Neutral	Neutral
sacp	Senior: bbb+; Junior: bbb	a+	a	bbb	bbb
Likelihood of Government Support	N/A	Moderate (no impact)	Moderate (+1 notch)	N/A	N/A
Issuer Credit Rating	N/A	A+	A+	BBB	BBB
Structural Features	Class A: +1 notch; Class B: N/A	N/A	N/A	N/A	Class A: +1 notch
Issue Credit Rating	Class A: A-, Class B: BBB	N/A	N/A	N/A	Class A: BBB+
--Average of past three fiscal years--					
(Mil. Mix curr.)	£	€	€	A\$	£
Revenues	2,754.7	2,884.7	1,443.9	1,252.4	681.0
EBITDA	1,663.5	1,215.7	646.5	1,016.7	323.6
Funds from operations (FFO)	780.6	876.1	493.6	567.6	232.3
Net income from cont. oper.	140.7	422.3	317.4	(110.3)	108.3
Cash flow from operations	1,030.3	871.1	484.5	619.1	239.5
Capital expenditures	718.0	563.3	375.6	332.2	215.0
Free operating cash flow	312.3	307.7	108.9	286.9	24.5

Table 1

Heathrow Funding Ltd. -- Peer Comparison (cont.)					
Industry Sector: Infrastructure					
	Heathrow (SP) Ltd.	Aeroports de Paris	Royal Schiphol Group N.V.	Southern Cross Airports Corp. Holdings Ltd.	Gatwick Funding Ltd.
Discretionary cash flow	(161.4)	56.4	(45.0)	(295.1)	(77.5)
Cash and short-term investments	366.7	1,550.3	272.0	172.3	3.1
Debt	13,611.5 (*)	3,218.9	1,864.6	7,409.1	1,889.8
Equity	(1,480.6)	4,132.5	3,676.0	(491.1)	546.0
Adjusted ratios					
EBITDA margin (%)	60.4	42.1	44.8	81.2	47.5
Return on capital (%)	7.7	10.1	8.2	10.6	7.3
EBITDA interest coverage (x)	2.0	9.7	7.2	2.2	3.5
FFO cash int. cov. (X)	2.7 (*)	7.2	6.1	2.5	3.3
Debt/EBITDA (x)	8.2 (*)	2.6	2.9	7.3	5.8
FFO/debt (%)	5.7 (*)	27.2	26.5	7.7	12.3
Cash flow from operations/debt (%)	7.6 (*)	27.1	26.0	8.4	12.7
Free operating cash flow/debt (%)	2.3 (*)	9.6	5.8	3.9	1.3
Discretionary cash flow/debt (%)	(1.2)	1.8	(2.4)	(4.0)	(4.1)

N.M. - Not Meaningful. (*) Class A & B

Financial Risk: Aggressive

In 2017-2019, we expect Heathrow (SP) Ltd. to maintain a ratio of S&P Global Ratings-adjusted FFO to debt above 8% for the Class A and above 6% for consolidated debt (excluding the intercompany loan with Heathrow Finance Plc). Over the period, we expect HFL to issue about £3 billion. While from FY2020 onward the issuance will increase to cover financing needs related to the construction of the third runway; its impact on the financial metrics will depend on the way costs are compensated for through the regulatory framework.

Due to increasing capex, we expect Heathrow (SP) Ltd. will generate negative free operating cash flows from FY2019 onward.

We expect Heathrow (SP) Ltd. to distribute £400 million-£600 million annually, excluding prepayments of the intercompany loan. In addition to shareholder dividends, the distributions will serve debt service of a £1,312 million bond and loan facilities at Heathrow Finance Ltd.

Table 2

Heathrow (SP) Ltd. -- Financial Summary

Industry Sector: Infrastructure

	--Fiscal year ended Dec. 31--	
	2016	2015
Rating history	-/-/-	-/-/-
(Mil. £)		
Revenues	2,807.0	2,765.0
EBITDA	1,736.5	1,660.0
Funds from operations (FFO)	854.0	821.2
Net income from continuing operations	(144.0)	664.0
Cash flow from operations	1,048.0	1,049.2
Capital expenditures	674.0	627.0
Free operating cash flow	374.0	422.2
Discretionary cash flow	(222.0)	42.2
Cash and short-term investments	660.0	172.0
Debt	13,780.3	13,469.4
Equity	(1,979.0)	(1,075.0)
Adjusted ratios		
EBITDA margin (%)	61.9	60.0
Return on capital (%)	8.1	7.3
EBITDA interest coverage (x)	2.1	2.2
FFO cash int. cov. (x)	2.8	2.6
Debt/EBITDA (x)	7.9	8.1
FFO/debt (%)	6.2	6.1
Cash flow from operations/debt (%)	7.6	7.8
Free operating cash flow/debt (%)	2.7	3.1
Discretionary cash flow/debt (%)	(1.6)	0.3

N.M. - Not Meaningful.

Reconciliation

Table 3

Reconciliation Of Heathrow (SP) Ltd. Reported Amounts With S&P Global Ratings Adjusted Amounts (Mil. £)

	--Fiscal year ended Dec. 31, 2016--					
Heathrow Funding Ltd. reported amounts						
	Debt	EBITDA	Operating income	Interest expense	EBITDA	Cash flow from operations
Reported	14,192.0	1,726.0	1,057.0	754.0	1,726.0	1,592.0
S&P Global Ratings adjustments						
Interest expense (reported)	--	--	--	--	(754.0)	--
Interest income (reported)	--	--	--	--	5.0	--

Table 3

Reconciliation Of Heathrow (SP) Ltd. Reported Amounts With S&P Global Ratings Adjusted Amounts (Mil. £) (cont.)						
Current tax expense (reported)	--	--	--	--	(59.0)	--
Operating leases	386.3	52.5	35.9	35.9	16.6	16.6
Postretirement benefit obligations/deferred compensation	114.0	2.0	2.0	--	(1.6)	30.4
Surplus cash	(660.0)	--	--	--	--	--
Capitalized interest	--	--	--	35.0	(35.0)	--
Non-operating income (expense)	--	--	5.0	--	--	--
Reclassification of interest and dividend cash flows	--	--	--	--	--	(591.0)
Debt - Accrued interest not included in reported debt	289.0	--	--	--	--	--
Debt - Derivatives	179.0	--	--	--	--	--
Debt - Foreign currency hedges	(727.0)	--	--	--	--	--
Debt - Other (home loss provision)	7.0	--	--	--	--	--
EBITDA - Other (revaluation gain on investment property)	--	(44.0)	(44.0)	--	(44.0)	--
Total adjustments	(411.7)	10.5	(1.1)	70.9	(872.0)	(544.0)
S&P Global Ratings adjusted amounts						
	Debt	EBITDA	EBIT	Interest expense	Funds from operations	Cash flow from operations
Adjusted	13,780.3	1,736.5	1,055.9	824.9	854.0	1,048.0

Rating Rationale and Structural Features

HFL's Class A debt rating incorporates a one-notch rating uplift from Heathrow (SP) Ltd.'s senior stand-alone credit profile (SACP) to reflect structural features designed to increase cash flow certainty for debtholders. Due to the stronger senior-only ratios, senior SACP of 'bbb+' is one notch higher than our assessment of its subordinated SACP. The rating on the subordinated Class B debt reflects its subordinated SACP. HFL's structural features include:

- Restrictions on business activities, mergers, acquisitions, and business transformation.
- Covenants restricting dividends and other subordinated payments from the financing group and restriction on raising further additional senior debt.
- Dedicated liquidity facility sized to cover 12 months of senior interest and six months of junior interest available to the issuer, HFL, and the borrower, HAL.
- Prudent hedging policy and provisions mitigating refinancing risk.

We apply our rating-to-principles approach to HFL, using our criteria "Rating Structurally Enhanced Debt Issued By Regulated Utilities And Transportation Infrastructure Businesses," published on Feb. 24, 2016 (the SED criteria). HFL is not in scope of the SED criteria due to primarily higher risk of competition and the absence of a credit remedy period during which creditors take control of the business and either stabilize its credit quality or sell the company's shares. However, HFL benefits from the majority of the structural enhancements listed in the SED criteria, and has additional risk mitigating factors such as the right for creditors to step in and appoint an administrative receiver while

the business may still retain significant value. The combination of these factors leads, in our view, to a marginal reduction in the default risk of HFL similar to the marginal default risk reduction which SED senior bondholders can benefit from.

Liquidity

We expect Heathrow (SP) Ltd.'s liquidity to be adequate, supported by our expectation that its liquidity resources will exceed its funding needs by more than 1.2x in the 12 months to Dec. 31, 2018.

We anticipate the following liquidity sources and uses over the period:

- Unrestricted cash and short-term investments of about £0.5 billion;
- FFO of about £1.0 billion; and
- Access to about £1.2 billion of undrawn credit facilities expiring in 2020-2025.

We estimate the following liquidity needs over the same period:

- Expected capex of approximately £0.9 billion;
- Debt maturities of approximately £0.9 billion; and
- Distributions of about £0.3 billion.

Ratings Score Snapshot

Class A issue credit rating: A-/Stable

Business risk: Excellent

- Country risk: Low
- Industry risk: Low
- Competitive position: Excellent

Financial risk: Aggressive

- Cash flow/leverage: Aggressive

Anchor: bbb

Modifiers

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

Senior SACP: bbb+

Structural features: +1 notch

Issue credit rating: A-

Class B issue credit rating: BBB/Stable

Business risk: Excellent

- Country risk: Low
- Industry risk: Low
- Competitive position: Excellent

Financial risk: Aggressive

- Cash flow/leverage: Aggressive

Anchor: bbb

Modifiers

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

SACP: bbb

Structural features: N/A

Issue credit rating: BBB

Related Criteria

- Criteria - Corporates - Utilities: Rating Structurally Enhanced Debt Issued By Regulated Utilities And Transportation Infrastructure Businesses, Feb. 24, 2016
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - General: The Treatment Of Non-Common Equity Financing In Nonfinancial Corporate Entities, April 29, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The Transportation Infrastructure Industry, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers,

Nov. 13, 2012

- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Heathrow Funding Ltd. Class A And Class B Debt Affirmed At 'A-' And 'BBB' On Criteria Revision; Outlook Stable; Off UCO, June 26, 2017.
- Are Airports Ready For Airline, Retail, And Mobility Disruption, Dec. 6, 2007

Ratings List

As of Jan. 31, 2018

Class A	A-
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Class B	BBB
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