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Summary:

DEMIRE Deutsche Mittelstand Real Estate AG

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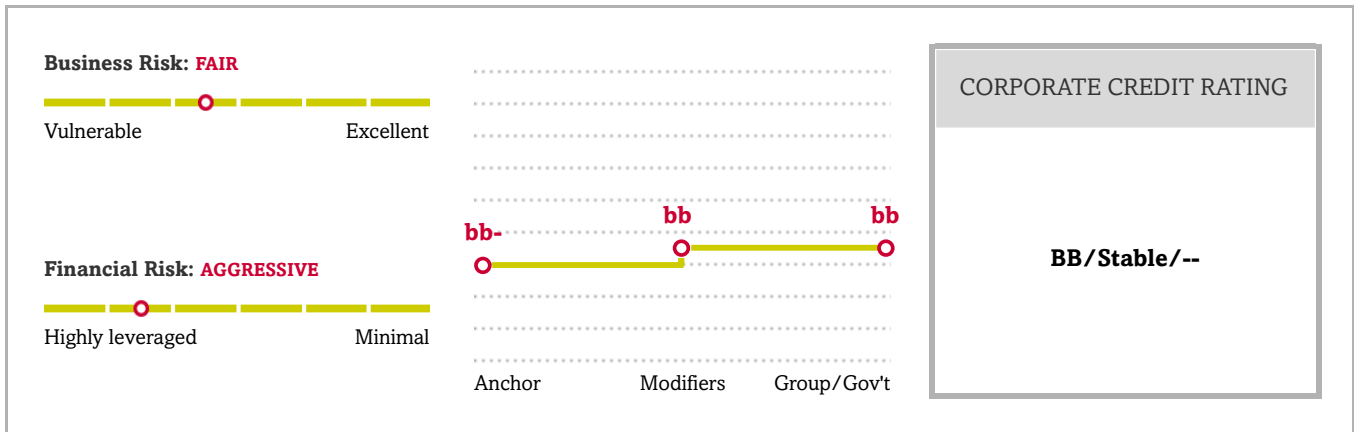
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Summary:

DEMIRE Deutsche Mittelstand Real Estate AG



Rationale

Business Risk: Fair	Financial Risk: Aggressive
<ul style="list-style-type: none"> • Stable strategy of long-term investments in office and retail properties with very limited exposure to development activities. • Small portfolio size compared with peers, at about €1.1 billion, spread across secondary locations in Germany. • Some tenant concentration on Deutsche Telekom, albeit spread across several lease agreements. • Vacancy rate of about 8.6%, excluding buildings vacant for renovation needs. 	<ul style="list-style-type: none"> • Relatively high leverage with adjusted ratio of debt to debt-plus-equity currently above 60%. • EBITDA interest coverage below 1.8x, which is low compared with peers, albeit improving thanks to recent refinancing activities. • Good access to bank financing and capital markets.

Outlook: Stable

The stable outlook on German commercial real estate company DEMIRE Deutsche Mittelstand Real Estate AG (DEMIRE) reflects S&P Global Ratings' view that the company's property portfolio across different segments should generate stable cash flows over the next 12 months. Our view is based on the fact that the majority of DEMIRE's properties in secondary locations are near metropolitan areas across Germany where demand trends are favorable and where occupancy should improve further, in line with the company's strategy.

The outlook also reflects our expectation that the company will continue to execute its announced strategy in the next few months. We forecast EBITDA interest coverage will improve to about 1.8x and debt to debt-plus-equity will decrease to approximately 58% in the next 12 months.

Downside scenario

We could lower the rating if the company fails to achieve a debt-to-debt-plus-equity ratio below 60% and EBITDA interest coverage of at least 1.8x in the next 12 months. This situation could materialize if DEMIRE were to alter its publicly announced policy to reduce leverage or if the company undertook more debt-financed acquisitions or was unable to execute its announced deleveraging strategy.

We could also lower the rating if the company's business strategy did not materialize, resulting in a decline in the overall portfolio size to well below €1 billion or investment in less favorable secondary locations away from metropolitan hubs. Ratings downside could also develop if the vacancy rate increases again to 10% or above, due for example to weak demand or the acquisition of highly vacant premises.

Upside scenario

We would raise the rating if DEMIRE increased its EBITDA interest coverage to 2.4x or above on a sustainable basis while reducing its leverage, with the ratio of debt to debt-plus-equity falling well below 55%. This could result from unexpectedly high rental growth, significant reduction in portfolio vacancy, or debt repayment.

In addition, an upgrade would also depend on the enhanced scale and scope of DEMIRE's portfolio, similar to that of rated peers in the investment grade category with vacancy levels of well below 10%, including newly acquired assets, and locations with solid underlying macroeconomic fundamentals.

Our Base-Case Scenario

Assumptions	Key Metrics			
<ul style="list-style-type: none"> • Low GDP growth for Germany of 2.4% in 2018, and 1.9% in 2019, with unemployment remaining below 5%. • Approximately 1.5%-2% like-for-like rental income growth, stemming mainly from improved occupancy in DEMIRE's existing portfolio and some minor rent increases from new lets or existing lease contracts, as well as favorable supply and demand conditions in the German commercial market. • Annual acquisitions of about €100 million-€200 million. In line with the company's strategy, we estimate that the income-producing portfolio will grow to about €2 billion in the next few years, though we believe it will take one to two years longer for DEMIRE to reach its target than originally assumed. • Mid-single-digit like for like portfolio revaluation for DEMIRE's properties for full-year 2018 with about 3% already reached in first-quarter 2018, and low-single-digit like-for-like revaluation the following years, reflecting the company's focus on midsize secondary locations where real estate prices are growing less than in large metropolitan areas. • Average cost of debt of about 3.0%. 	2017A	2018E	2019E	
	EBITDA margin (%)	~65	66-67	~67
	EBITDA/interest (x)	1.7	1.8-1.9	~2
	Debt to debt-plus-equity (%)	~60	58-59	56-58
A--Actual. E--Estimate				

Company Description

DEMIRE is a German commercial real estate company, focusing on office (67% of portfolio value on March 31, 2018), retail (24%), and logistic/other assets (9%). On March 31, 2018, the company's portfolio was valued at about €1.1 billion, comprising 86 properties. Its strategy is to focus on midsize secondary locations in Germany, bordering metropolitan areas.

The company is listed on the Frankfurt stock exchange. The main shareholders are Wecken & Cie. and Apollo with approximately 80% of shares.

Business Risk: Fair

DEMIRE's business risk profile reflects the company's relatively small scale and portfolio size compared with rated peers in the commercial real estate segment, and its exposure to a single economy, Germany. On March 31, 2018, the

company's property portfolio consisted of 86 buildings with a gross asset value of €1.1 billion, including four assets held for sale amounting about €13 million.

The company is one of Germany's 10 largest commercial property companies in terms of market capitalization in a highly fragmented property market. Although we view market dynamics, such as rental growth potential and demand-supply trends in metropolitan areas as more favorable, we believe that the majority of midsize cities in which DEMIRE operates are close to metropolitan areas with similar market dynamics, such as Darmstadt or Bonn. We consider about 80% of

DEMIRE's portfolio to be located in cities with good infrastructure and favorable macroeconomic fundamentals, including low unemployment rates, and GDP growth in line with the German average. We believe that about 15%-20% of the portfolio is located in less favorable areas, such as Trappenkamp and Lichtenfels, where it may take longer to find replacements for departing tenants. DEMIRE has some concentration on its main tenant Deutsche Telekom AG (BBB+/Watch Neg/A-2), which represents about 30% of its annual rental income. We understand that the exposure is spread across several lease contracts and that Deutsche Telekom subleases some of its exposure.

DEMIRE reported a European Public Real Estate Association (EPRA) vacancy ratio of 8.6% on March 31, 2018, which is in line with most rated peers in the European office and retail market. The company has established a track record in improving the ratio from over 11% at year-end 2016, in line with its strategy. We expect this ratio will improve further over the next two years, including newly acquired premises.

We assess DEMIRE's overall portfolio as being of average quality, with some capital expenditure needs of approximately €10 million-€12 million annually. DEMIRE benefits from a long average lease length of close to five years. In our view, the company's strategy to increase its income-producing portfolio to about €2 billion in the medium term should help enhance its asset and tenant diversification. We understand that its new shareholder Apollo supports the company's strategy and there is only a limited risk of a major shift in the company's strategy following the change in shareholder structure earlier this year (see "Research Update: German Real Estate Company DEMIRE 'BB' Rating Affirmed Following Updated Shareholder Structure; Outlook Still Stable," published March 29, 2018, on RatingsDirect). Nevertheless, we believe it may take longer to reach this target than previously anticipated.

Peer comparison

Table 1

DEMIRE Deutsche Mittelstand Real Estate AG -- Peer Comparison					
Industry Sector: Real Estate Investment Trust or Company					
	DEMIRE Deutsche Mittelstand Real Estate AG	Alstria Office REIT-AG	Globalworth Real Estate Investments Ltd.	Summit Germany Limited	EPP Finance B.V.
Ratings on July 2, 2018	BB/Stable/--	BBB/Stable/--	BB+/Positive/--	BB+/Stable/--	BB/Positive/--
--Fiscal year ended Dec. 31, 2017--					
(Mil. €)					
Revenues	55.6	172.3	77.9	60.5	152.2
EBITDA	35.3	150.4	36.8	48.1	92.5

Table 1

DEMIRE Deutsche Mittelstand Real Estate AG -- Peer Comparison (cont.)						
Industry Sector: Real Estate Investment Trust or Company						
	DEMIRE Deutsche Mittelstand Real Estate AG	Alstria Office REIT-AG	Globalworth Real Estate Investments Ltd.	Summit Germany Limited	EPP Finance B.V.	
Funds from operations (FFO)	2.7	115.1	(0.3)	33.6	74.1	
Interest Expense	33.4	36.2	37.6	12.7	20.9	
Net income from cont. oper.	13.8	297.0	24.4	100.7	128.3	
Cash flow from operations	(10.6)	122.3	9.9	36.1	96.3	
Capital expenditures	6.5	59.4	50.1	1.2	366.6	
Dividends paid	0.0	79.7	19.9	9.3	66.9	
Cash and short-term investments	73.9	102.1	263.6	22.7	99.5	
Debt	644.5	1,385.7	606.8	390.2	888.3	
Equity	305.2	1,954.7	1,136.5	566.1	833.8	
Debt and equity	949.7	3,340.4	1,743.3	956.3	1,722.1	
Valuation of investment property	1,035.8	3,392.1	1,792.4	938.9	1,772.0	
Adjusted ratios						
Annual revenue growth (%)	(5.0)	(3.8)	14.1	5.9	57.7	
EBITDA margin (%)	63.6	87.3	47.2	79.5	60.8	
Return on capital (%)	3.7	5.6	2.8	5.4	6.7	
EBITDA interest coverage (x)	1.1	4.2	1.0	3.8	4.4	
Debt/EBITDA (x)	18.2	9.2	16.5	8.1	9.6	
Debt/debt plus equity (%)	67.9	41.5	34.8	40.8	51.6	

Financial Risk: Aggressive

DEMIRE's financial risk profile is characterized by relatively high debt leverage, with S&P Global Ratings-adjusted debt to debt-plus-equity of 66.3% and low EBITDA interest coverage of 1.2x for the 12 months ended March 31, 2018. We note that the company's credit metrics have not improved to the extent we previously anticipated, though we believe that DEMIRE is on its way to reach credit metrics commensurate with the current rating level. Following a 10% capital increase earlier this year, together with the conversion of the mandatory convertible bond in May, as well as early conversion of the convertible bond 2013/2018 in June 2018, we estimate the ratio of debt to debt-plus-equity to be around 65% as of second-quarter 2018. We project the ratio to be around 60% by year-end 2018, benefitting from mid-single-digit portfolio revaluation and additional capital support from its shareholder Apollo for any upcoming acquisitions.

In addition, we anticipate that the company's EBITDA interest coverage will move to about 1.7x by the end of 2018

and closer to 2x in the next 12-18 months. We understand the delay in achieving a coverage ratio closer to our target ratios is due to the late repayment of its secured debt with the proceeds from an earlier issued bond of nominal €400 million last year. The full contribution of DEMIRE's 3% average cost of debt compared with 4.1% before issuance will be reflected in its ratios in 2018.

DEMIRE is committed to deleveraging, and its financial policy stipulates a target net loan-to-value of ratio of approximately 50% in the medium term.

In addition, we note that DEMIRE has a redeemable minority interest of about €78 million as of first-quarter 2018, related to inter alia closed-end funds of its subsidiary Fair Value REIT AG (FVR), where FVR owns in most cases about 50% or more of the funds. We do not adjust our credit metrics for the minority interest, since we understand that termination of the partners of the funds is complicated and it may take several years until settlement payments are made. The termination right relates solely to the respective fund and not to DEMIRE or its subsidiary FVR. Also, DEMIRE has no direct control over how the termination rights are exercised, and a majority decision is required for any sale of the assets within the fund. In addition, the funds have been in place for more than 20 years and only a small amount has been terminated so far.

We adjust our calculations for any exercised termination and include these amounts in our debt figure. We may change our view if we believe the likelihood of the termination of a large portion of the minority interest had increased, leading us to include the full redeemable minority interest amount in our adjusted debt figure.

Financial summary

Table 2

DEMIRE Deutsche Mittelstand Real Estate AG--Quarterly Data					
Industry Sector: Real Estate Investment Trust or Company					
12 months ended	Mar-18	Dec-17	Sep-17	Jun-17	Mar-17
(Mil. €)					
Revenues	54.9	55.6	56.4	56.1	59.3
EBITDA	36.3	35.3	42.3	40.5	43.6
Funds from operations (FFO)	2.4	2.7	7.7	11.3	7.7
Interest expense	31.3	33.4	33.7	32.4	35.8
Net income from cont. oper.	31.8	13.8	25.5	23.0	21.8
Cash flow from operations	(9)	(10.6)	(3.7)	(1.5)	1.2
Capital expenditures	0.1	6.5	0.4	1.2	2.1
Dividends paid	0.0	0.0	0.0	0.0	0.0
Cash and short-term investments	69.5	73.9	130.2	37.6	43.5
Debt	641.4	644.5	659.4	643.1	640.2
Equity	325.6	305.2	302.4	299.3	295.5
Debt and equity	967.0	949.7	961.8	942.4	935.8
Valuation of investment property	1,068.0	1,035.8	1,020.3	990.1	996.1
Adjusted ratios					
Annual revenue growth (%)	(7.4)	(5.0)	1.4	13.8	50.4
EBITDA margin (%)	66.0	63.6	75.0	72.2	73.4

Table 2

DEMIRE Deutsche Mittelstand Real Estate AG--Quarterly Data (cont.)					
Industry Sector: Real Estate Investment Trust or Company					
12 months ended	Mar-18	Dec-17	Sep-17	Jun-17	Mar-17
Return on capital (%)	3.4	3.7	4.3	4.7	4.7
EBITDA interest coverage (x)	1.2	1.1	1.3	1.3	1.2
Debt/EBITDA (x)	17.7	18.2	15.6	15.9	14.7
Debt/debt plus equity (%)	66.3	67.9	68.6	68.2	68.4

Liquidity: Adequate

We assess DEMIRE's liquidity as adequate. We estimate that the company's liquidity sources will likely cover liquidity uses by about 2x for the next 12 months. This mainly reflects the recent share issuances while committed capital expenditure (capex) and dividend requirements are limited.

Principal Liquidity Sources	Principal Liquidity Uses
<ul style="list-style-type: none"> Unrestricted cash balances of about €70 million on March 31, 2018. Our forecast of cash funds from operations (FFO) of about €15 million-€20 million. About €23.6 million of equity, resulting from the capital increase of 10%, fully subscribed by Apollo in April 2018. 	<ul style="list-style-type: none"> About €33 million of debt maturities, related to the tendered amount of its nominal €400 million outstanding bond and approximately €12.5 million of amortizing debt. About €10 million-€12 million of capex, including tenant improvements, of which we understand most is not committed. About €6.4 million of dividend payments related to its subsidiary FVR and minority interest.

Covenant Analysis

DEMIRE has covenants under the documentation for its outstanding mortgage debt and promissory notes. We expect that the company will maintain adequate headroom (greater than 10%) under all remaining covenants.

Other Credit Considerations

Our rating on DEMIRE incorporates one notch of uplift from the anchor, based on our comparable ratings analysis. In our view, DEMIRE's financial risk profile will move toward the stronger end of our aggressive category in the next 12 months, following the successful issuance of the unsecured bond and improvement of its average cost of debt to 3% in first-quarter 2018 from 4.1% same period previous year. We forecast that the company will significantly deleverage in the next few years, in line with its plan. Our assessment also reflects DEMIRE's growth strategy, which should enhance

and diversify its portfolio further.

Ratings Score Snapshot

Corporate Credit Rating

BB/Stable/--

Business risk: Fair

- **Country risk:** Very low
- **Industry risk:** Low
- **Competitive position:** Fair

Financial risk: Aggressive

- **Cash flow/Leverage:** Aggressive

Anchor: bb-

Modifiers

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

Issue Ratings--Recovery Analysis

Key Analytical Factors

- The issue rating on DEMIRE's senior unsecured nominal €400 million notes is 'BB+', one notch above the issuer credit rating. The recovery rating is '2', reflecting the valuable asset base consisting of investment properties. However, our recovery prospects are constrained by the unsecured nature of the debt instrument and its contractual subordination to the current amount of secured debt (such as mortgage loans). For asset-intensive companies, such as real estate companies, we cap our recovery rating on senior unsecured debt at '2'. We expect recoveries will be about 85%. We also take into account the company's strategy to add further unsecured debt to its capital structure.
- In our hypothetical default scenario, we envisage a severe macroeconomic downturn in Germany, resulting in market depression and exacerbated competitive pressures.
- We value the group as a going concern. Our stressed valuation figure comprises the stressed value of the company's property portfolio
- Recovery prospects for the senior unsecured notes are very sensitive to a small change in the amount of senior secured debt or any other priority debt outstanding at default. Since there is no limitation on the incurrence of additional debt in the bond documentation, recoveries could be much lower if the amount of secured debt at default

differs from our projections.

Simulated Default Assumptions

- Year of default: 2022
- Jurisdiction: Germany

Simplified Waterfall

- Gross enterprise value at emergence: €754 million
- Net enterprise value at emergence after administrative costs: €716 million
- Estimated priority debt (mortgages and other secured debt): €288 million
- Net enterprise value available to senior unsecured bondholders: €429 million
- Senior unsecured debt claims: €360 million
- Recovery expectation: 70%-90% (rounded estimate: 85%)

*All debt amounts include six months' prepetition interest.

Reconciliation

Table 3

Reconciliation Of DEMIRE Deutsche Mittelstand Real Estate AG Reported Amounts With S&P Global Ratings' Adjusted Amounts (Mil. €)

--Fiscal year ended Dec. 31, 2017--

DEMIRE Deutsche Mittelstand Real Estate AG reported amounts							
	Debt	Shareholders' equity	EBITDA	Operating income	Interest expense	EBITDA	Cash flow from operations
Reported	694.9	285.4	36.1	84.7	49.7	36.1	35.8
S&P Global Ratings' adjustments							
Interest expense (reported)	--	--	--	--	--	(49.7)	--
Interest income (reported)	--	--	--	--	--	0.9	--
Current tax expense (reported)	--	--	--	--	--	(0.3)	--
Operating leases	0.6	--	0.2	0.0	0.0	0.2	0.2
Surplus cash	(66.5)	--	--	--	--	--	--
Share-based compensation expense	--	--	(0.1)	--	--	(0.1)	--
Non-operating income (expense)	--	--	--	0.9	--	--	--
Reclassification of interest and dividend cash flows	--	--	--	--	--	--	(46.5)
Non-controlling Interest/Minority interest	--	33.7	--	--	--	--	--
Debt - Contingent considerations	0.4	--	--	--	--	--	--

Table 3

Reconciliation Of DEMIRE Deutsche Mittelstand Real Estate AG Reported Amounts With S&P Global Ratings' Adjusted Amounts (Mil. €) (cont.)							
Debt - Equity component of convertible debt	14.4	--	--	--	--	--	--
Debt - Other	0.7	--	--	--	--	--	--
Equity - Other	--	(13.9)	--	--	--	--	--
EBITDA - Income (expense) of unconsolidated companies	--	--	(0.1)	(0.1)	--	(0.1)	--
EBITDA - Gain/(Loss) on disposals of PP&E	--	--	(0.9)	(0.9)	--	(0.9)	--
EBITDA - Valuation gains/(losses)	--	--	0.2	0.2	--	0.2	--
D&A - Asset Valuation gains/(losses)	--	--	--	(48.6)	--	--	--
EBIT - Income (expense) of unconsolidated companies	--	--	--	0.1	--	--	--
Interest expense - Other	--	--	--	--	(16.4)	16.4	--
Total adjustments	(50.4)	19.8	(0.7)	(48.3)	(16.4)	(33.4)	(46.4)
S&P Global Ratings' adjusted amounts							
	Debt	Equity	EBITDA	EBIT	Interest expense	Funds from operations	Cash flow from operations
Adjusted	644.5	305.2	35.4	36.4	33.4	2.7	(10.6)

Related Criteria

- Criteria - Corporates - Industrials: Key Credit Factors For The Real Estate Industry, Feb. 26, 2018
- Criteria - Corporates - General: Recovery Rating Criteria For Speculative-Grade Corporate Issuers, Dec. 7, 2016
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
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- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Insurance - General: Hybrid Capital Handbook: September 2008 Edition, Sept. 15, 2008

Related Research

- Research Update: German Real Estate Company DEMIRE 'BB' Rating Affirmed Following Updated Shareholder Structure; Outlook Still Stable, May 29, 2018

Business And Financial Risk Matrix						
Business Risk Profile	Financial Risk Profile					
	Minimal	Modest	Intermediate	Significant	Aggressive	Highly leveraged
Excellent	aaa/aa+	aa	a+/a	a-	bbb	bbb-/bb+
Strong	aa/aa-	a+/a	a-/bbb+	bbb	bb+	bb
Satisfactory	a/a-	bbb+	bbb/bbb-	bbb-/bb+	bb	b+
Fair	bbb/bbb-	bbb-	bb+	bb	bb-	b
Weak	bb+	bb+	bb	bb-	b+	b/b-
Vulnerable	bb-	bb-	bb-/b+	b+	b	b-

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