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Research Update:

Outlook On South Africa Revised To Negative On Continued Slow Growth; Ratings Affirmed

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Table Of Contents

Overview

Rating Action

Rationale

Outlook

Key Statistics

Ratings Score Snapshot

Related Criteria And Research

Ratings List

Regulatory Disclosures

Glossary

Research Update:

Outlook On South Africa Revised To Negative On Continued Slow Growth; Ratings Affirmed

Overview

- South Africa's pace of economic growth remains slow. External demand is weak, with low commodity prices, and the country faces domestic constraints including an inadequate electricity supply and overall weak business confidence inhibiting substantial private sector investment.
- Nevertheless, the National Treasury is broadly maintaining its prudent fiscal consolidation through hard expenditure ceilings. We forecast fiscal deficits to gradually reduce, with net debt stabilizing at around 45% of GDP over 2015-2018.
- We estimate that the current account deficit will have been smaller in 2015 than in 2014 owing to lower oil prices, weak domestic demand, and import compression from the weaker rand, while external portfolio inflows have remained fairly stable. We expect external deficits will moderately increase in the next few years as the economic environment improves. The country's financing will remain subject to changes in investor sentiment.
- We are therefore revising the outlook on South Africa to negative from stable, and affirming our 'BBB-' foreign currency and 'BBB+' local currency ratings on the country.
- The negative outlook reflects our view that GDP growth might be lower than we currently expect, or that fiscal flexibility might reduce owing to contingency risks from state-owned entities with weak balance sheets.

Rating Action

On Dec. 4, 2015, Standard & Poor's Ratings Services revised the outlook on the Republic of South Africa to negative from stable. We affirmed the long- and short-term foreign currency sovereign credit ratings on the Republic of South Africa at 'BBB-/A-3'. We also affirmed the 'BBB+/A-2' long- and short-term local currency ratings.

At the same time, we affirmed the 'zaAAA/zaA-1' South Africa national scale ratings.

Rationale

The outlook revision reflects South Africa's still-slow pace of economic growth, which we have revised down further to 1.4% for 2015 from our June estimate of 2.1%. This is due to a combination of weak external demand, with low commodity prices, and domestic constraints including an inadequate electricity supply and overall weak business confidence inhibiting substantial private sector investment. This highlights a prolonged period of low growth for a country with per capita GDP of just below US\$6,000 in 2015 and population growth averaging at least 1.5% over the last six years.

We expect GDP growth in 2016 to remain around 1.6% and only increase above 2% from 2017 as the capacity of electricity supply improves thanks to new power plants. Business confidence may improve if the government takes the necessary steps to improve policy coordination and implement delayed legislation, which may help to bolster the muted private-sector fixed investment.

Economic growth over the next few years will also depend on the absence of prolonged labor strikes, and limited negative spillover effects from the likely U.S. interest rate hikes, or the impact of lower demand from China on commodity prices and export volumes.

We think that President Jacob Zuma's second administration will maintain broad policy continuity, although there have been legislative delays and policy direction still lacks clarity in some areas. Legislation that has been delayed includes items related to mining sector investment, much-needed labor market reforms, trade negotiations, and industry interventions. In our view, this impairs business confidence and ultimately leads to a weak private-sector investment contribution to growth.

While fiscal targets are exposed to the risk of low GDP growth, we expect that a combination of conservative tax revenue forecasts and the hard expenditure ceiling will ensure that the Treasury remains close to its revised fiscal consolidation targets. The 2014/15 fiscal outturn was slightly better than we had expected thanks to tax revenue buoyancy and strong expenditure controls. The 2015/16 budget has facilitated higher revenues through a hike in income tax and fuel levy, while maintaining a strict control on expenditures. We therefore expect the annual growth of general government debt to be just below 4% of GDP on average over 2015-2018, assuming exchange rate fluctuations are more modest.

General government debt, net of liquid assets, increased to 43% of GDP in 2015 from 22% in 2008, and we expect it to stabilize at around 45% by 2017. Although less than 10% of the government's debt stock is denominated in foreign currency, nonresidents hold about 34% of the government's rand-denominated debt, which could make financing vulnerable to foreign investor sentiment. We project interest spending to increase to 11% of government revenues this fiscal year.

We view South Africa's contingent liabilities as currently limited. Nevertheless, in our view, the government faces risks from nonfinancial public enterprises with weak balance sheets, which may require more government support than we currently assume. Eskom, the largest state-owned enterprise that currently requires government support, benefits from a government guarantee framework of South African rand (ZAR) 350 billion (US\$25 billion)--about 8% of GDP. Eskom has utilized around ZAR160 billion of this guarantee amount to date. The government is in the process of providing an additional support package in the form of a ZAR23 billion equity injection over three tranches, and it has already converted its ZAR60 billion loan to Eskom into equity. In our view, if Eskom were to fail to secure some of its funding then the government may be expected to do more than currently planned. Other state-owned entities that we consider may pose a risk to the fiscal outlook include Sanral, a national road agency, which we understand faces revenue collection

challenges with its Gauteng tolling system, and South African Airways, which faces financial challenges to continue its operations without additional government support. Both entities have a combined government guarantee framework of over ZAR50 billion (US\$3.6 billion), of which they have utilized over ZAR40 billion to date.

The size of the current account deficit has reduced in 2015 owing to the lower price of oil (which constitutes about one-fifth of South Africa's imports), weak domestic demand, and import compression from the weaker rand exchange rate. Although the rand floats and is an actively traded currency (according to the Bank of International Settlements' triennial survey of foreign exchange dealing, it is traded in 1.1% of global foreign-exchange contracts), the portfolio and other investment flows that finance these deficits can be volatile. Such volatilities could result from global changes in risk appetite; foreign investors reappraising prospective returns in the event of growth or policy slippage in South Africa; or rising interest rates in advanced markets. We expect external debt net of liquid assets will average below 50% of current account receipts over 2015-2018.

South Africa continues to pursue a floating exchange rate regime. The South African Reserve Bank does not have any exchange rate targets or defend any particular exchange rate level. We consider the rand to be vulnerable to the level and direction of portfolio flows between South Africa and the rest of the world and to changes in investor sentiment due to its liquidity and its use as a proxy for emerging-market trades. The South African Reserve Bank has a track record of operational independence, in our view. It uses an inflation-targeting framework for its monetary policy. The bank also uses open market operations to manage liquidity, including to sterilize its purchases of foreign exchange inflows. The repo rate is the bank's most important monetary policy instrument.

Despite lower oil prices, a weaker exchange rate and higher electricity prices have increased inflationary pressures. The central bank now expects inflation to exceed its 3%-6% target range temporarily in parts of 2016. The bank has started monetary tightening, with the most recent hike of 0.25% in November 2015 providing a cumulative hike of 1.25% since January 2014. Domestic capital markets are well developed, in our view, with depository corporation claims on residents in local currency and nonsovereign bond market capitalization combined accounting for around 20% of GDP. Government bonds account for another 40% of GDP.

The long-term local currency sovereign rating on South Africa is two notches above the long-term foreign currency sovereign rating. This is because we believe that the sovereign's flexibility in its own currency is supported by the independent monetary policy of the the South African Reserve Bank and a large and active local currency fixed-income market.

South Africa remains a middle-income country with a diversified economy and wide income disparities. The ratings are supported by our assumption that South Africa will experience continued broad political institutional stability and macro policy continuity. We also take into account our view that South Africa will maintain fairly strong and transparent macro institutions and deep financial markets. The ratings are constrained by lackluster reform efforts, low GDP growth, volatile

sources of financing, the structural current account deficits, and sizable general government debt.

Outlook

The negative outlook reflects our view that GDP growth might be lower than we currently expect; for instance, due to persistent electricity shortages, continued weak business confidence, or labor disputes escalating again. The outlook also reflects our view that fiscal flexibility might reduce owing to contingency risks from state-owned entities with weak balance sheets.

We could lower the ratings if GDP growth does not improve in line with our current expectations, or if state-owned enterprises require higher government support than we currently expect.

We could also lower the ratings if external imbalances increase, or funding for South Africa's current account or fiscal deficits becomes less readily available. A reduction in fiscal flexibility could also lead us to lower the local currency ratings, potentially by more than one notch.

We could revise the outlook back to stable if we observe policy implementation leading to improving business confidence and increasing private sector investment, and ultimately contributing to higher GDP growth.

Key Statistics

Table 1

Republic of South Africa Selected Indicators										
	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
ECONOMIC INDICATORS (%)										
Nominal GDP (bil. LC)	2,508	2,748	3,025	3,263	3,534	3,796	4,015	4,308	4,631	5,027
Nominal GDP (bil. \$)	296	375	417	397	366	350	316	310	331	359
GDP per capita (000s \$)	5.9	7.4	8.1	7.6	6.9	6.5	5.8	5.6	5.9	6.3
Real GDP growth	(1.5)	3.0	3.2	2.2	2.2	1.5	1.4	1.6	2.1	2.5
Real GDP per capita growth	(3.0)	1.5	1.7	0.6	0.6	(0.1)	0.0	0.2	0.7	1.1
Real investment growth	(6.7)	(3.9)	5.7	3.6	7.6	(0.4)	1.1	1.3	2.4	1.0
Investment/GDP	20.2	19.5	19.8	20.8	21.4	21.0	20.5	20.8	21.0	20.9
Savings/GDP	17.5	18.0	17.6	15.9	15.6	15.5	16.5	16.6	16.6	16.7
Exports/GDP	27.9	28.6	30.4	29.7	31.0	31.3	31.2	32.9	32.8	33.1
Real exports growth	(17.0)	7.7	4.3	0.1	4.6	2.6	7.4	2.9	5.0	3.0
Unemployment rate	23.7	24.9	24.8	24.9	24.7	25.1	25.5	25.8	25.9	25.9
EXTERNAL INDICATORS (%)										
Current account balance/GDP	(2.7)	(1.5)	(2.2)	(5.0)	(5.8)	(5.4)	(4.0)	(4.2)	(4.4)	(4.2)
Current account balance/CARs	(9.3)	(5.0)	(6.8)	(15.9)	(17.6)	(16.3)	(12.1)	(11.9)	(12.5)	(12.0)

Table 1
Republic of South Africa Selected Indicators (cont.)

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Trade balance/GDP	1.1	2.2	1.7	(1.0)	(1.9)	(1.8)	(0.9)	(1.4)	(1.5)	(1.4)
Net FDI/GDP	2.1	1.0	1.1	0.4	0.5	(0.4)	0.6	0.6	1.0	1.0
Net portfolio equity inflow/GDP	3.7	2.7	1.1	2.6	1.6	1.3	1.3	1.3	1.6	1.6
Gross external financing needs/CARs plus usable reserves	107.7	98.9	100.5	104.1	109.3	107.8	101.5	101.5	103.0	104.0
Narrow net external debt/CARs	(4.8)	1.4	3.7	21.4	19.0	24.4	27.7	33.4	36.3	37.0
Net external liabilities/CARs	64.9	84.0	31.2	42.6	11.1	23.7	36.3	47.1	57.0	64.1
Short-term external debt by remaining maturity/CARs	40.7	28.9	27.1	29.3	37.9	37.3	36.7	32.8	32.1	31.0
Reserves/CAPs (months)	4.3	4.0	3.7	4.1	4.3	4.4	5.0	4.6	4.3	4.0
FISCAL INDICATORS (% , General government)										
Balance/GDP	(6.4)	(4.3)	(3.7)	(4.2)	(3.9)	(3.6)	(3.8)	(3.5)	(3.4)	(3.2)
Change in debt/GDP	7.1	6.8	6.5	5.5	6.2	5.6	3.8	3.4	3.5	3.2
Primary balance/GDP	(4.1)	(1.9)	(1.1)	(1.5)	(1.0)	(0.6)	(0.6)	(0.2)	(0.0)	0.3
Revenue/GDP	26.5	27.8	27.8	27.9	28.5	28.8	30.4	30.3	30.6	30.7
Expenditures/GDP	32.9	32.0	31.5	32.0	32.4	32.4	34.2	33.8	34.0	33.9
Interest /revenues	8.6	8.7	9.1	9.7	10.0	10.5	10.5	10.9	11.1	11.3
Debt/GDP	32.1	36.0	39.3	41.9	44.8	47.4	48.6	48.6	48.7	48.1
Net debt/GDP	26.8	29.9	32.7	36.2	39.6	42.4	43.9	44.4	44.7	44.4
Liquid assets/GDP	5.3	6.2	6.5	5.6	5.2	5.0	4.7	4.3	4.0	3.8
MONETARY INDICATORS (%)										
CPI growth	6.7	4.3	5.0	5.6	5.7	6.1	4.6	5.9	5.6	5.4
GDP deflator growth	7.5	6.4	6.7	5.5	6.0	5.8	4.3	5.6	5.3	5.9
Banks' claims on resident non-gov't sector growth	0.0	6.1	5.6	10.6	6.0	9.0	8.0	8.0	10.0	10.0
Banks' claims on resident non-gov't sector/GDP	81.3	78.7	75.6	77.5	75.8	76.9	78.5	79.0	80.9	81.9
Foreign currency share of claims by banks on residents	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A

Savings is defined as investment plus the current account surplus (deficit). Investment is defined as expenditure on capital goods, including plant, equipment, and housing, plus the change in inventories. Banks are other depository corporations other than the central bank, whose liabilities are included in the national definition of broad money. Gross external financing needs are defined as current account payments plus short-term external debt at the end of the prior year plus nonresident deposits at the end of the prior year plus long-term external debt maturing within the year. Narrow net external debt is defined as the stock of foreign and local currency public- and private- sector borrowings from nonresidents minus official reserves minus public-sector liquid assets held by nonresidents minus financial-sector loans to, deposits with, or investments in nonresident entities. A negative number indicates net external lending. LC--Local currency. CARs--Current account receipts. FDI--Foreign direct investment. CAPs--Current account payments. The data and ratios above result from Standard & Poor's own calculations, drawing on national as well as international sources, reflecting Standard & Poor's independent view on the timeliness, coverage, accuracy, credibility, and usability of available information.

Ratings Score Snapshot

Table 2

Republic of South Africa Ratings Score Snapshot

Key rating factors

Institutional assessment	Neutral
Economic assessment	Weakness
External assessment	Neutral
Fiscal assessment: flexibility and performance	Weakness
Fiscal assessment: debt burden	Neutral
Monetary assessment	Strength

Standard & Poor's analysis of sovereign creditworthiness rests on its assessment and scoring of five key rating factors: (i) institutional assessment; (ii) economic assessment; (iii) external assessment; (iv) the average of fiscal flexibility and performance, and debt burden; and (v) monetary assessment. Each of the factors is assessed on a continuum spanning from 1 (strongest) to 6 (weakest). Section V.B of Standard & Poor's "Sovereign Rating Methodology," published on Dec. 23, 2014, summarizes how the various factors are combined to derive the sovereign foreign currency rating, while section V.C details how the scores are derived. The ratings score snapshot summarizes whether we consider that the individual rating factors listed in our methodology constitute a strength or a weakness to the sovereign credit profile, or whether we consider them to be neutral. The concepts of "strength", "neutral", or "weakness" are absolute, rather than in relation to sovereigns in a given rating category. Therefore, highly rated sovereigns will typically display more strengths, and lower rated sovereigns more weaknesses. In accordance with Standard & Poor's sovereign ratings methodology, a change in assessment of the aforementioned factors does not in all cases lead to a change in the rating, nor is a change in the rating necessarily predicated on changes in one or more of the assessments.

Related Criteria And Research

Related Criteria

- Criteria - Governments - Sovereigns: Sovereign Rating Methodology - December 23, 2014
- General Criteria: Standard & Poor's National And Regional Scale Mapping Tables - September 30, 2014
- General Criteria: National And Regional Scale Credit Ratings - September 22, 2014
- General Criteria: Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers - May 07, 2013
- General Criteria: Methodology: Criteria For Determining Transfer And Convertibility Assessments - May 18, 2009

Related Research

- Sovereign Risk Indicators, Oct. 12, 2015. An interactive version is available at www.spratings.com/SRI.
- Default Study: Sovereign Defaults And Rating Transition Data, 2013 Update, Sept. 17, 2014

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision. After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative

and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee agreed that the economic assessment weakened while all other key rating factors were unchanged.

The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria and Research').

Ratings List

	Rating	
	To	From
South Africa (Republic of)		
Sovereign credit rating		
Foreign Currency	BBB-/Negative/A-3	BBB-/Stable/A-3
Local Currency	BBB+/Negative/A-2	BBB+/Stable/A-2
South Africa National Scale	zaAAA/--/zaA-1	zaAAA/--/zaA-1
Transfer & Convertibility Assessment	BBB+	BBB+
Senior Unsecured		
Foreign Currency [#1]	BBB-	BBB-
Foreign Currency	BBB-	BBB-
Local Currency [#2]	BBB+	BBB+
Local Currency [#1]	BBB+	BBB+
Local Currency	BBB+	BBB+
Short-Term Debt		
Foreign Currency	A-3	A-3
Republic of South Africa Sukuk No. 1 Trust		
Senior Unsecured		
Foreign Currency	BBB-	BBB-

[#1] Issuer: Transnet SOC Ltd., Guarantor: South Africa (Republic of)

[#2] Issuer: Development Bank of Southern Africa Ltd., Guarantor: South Africa (Republic of)

Regulatory Disclosures

- Primary credit analyst: Gardner Rusike, Associate Director
- Rating committee chairperson: Moritz Kraemer
- Date initial rating assigned: Oct. 3, 1994
- Date of previous review: June 12, 2015

Disclaimers

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This credit rating is solicited. The rated entity participated in the credit rating process. Standard & Poor's Ratings Services had access to the accounts, financial records and other relevant internal, non-public documents of the rated entity or a related third party. Standard & Poor's Ratings Services has used information from sources believed to be reliable but does not guarantee the accuracy, adequacy, or completeness of any information used.

Glossary

- Consumer price index: Index of prices of a representative set of consumer goods regularly bought by a typical household.
- Contingent liabilities: Obligations that have the potential to become government debt, or affect a government's credit standing if they materialize.
- Current account balance: Exports of goods and services minus imports of the same plus net factor income plus official and private net transfers.
- Current account receipts (CARs): Proceeds from exports of goods and services plus factor income earned by residents from nonresidents plus official and private transfers to residents from nonresidents.
- Date initial rating assigned: The date Standard & Poor's assigned the long-term foreign currency issuer credit rating on the entity.
- Date of previous review: The date Standard & Poor's last reviewed the credit rating on the entity.
- Debt burden assessment: Reflects a sovereign's prospective debt level, as indicated by the general government debt relative to GDP (including assessment of contingent liabilities), the interest cost of the debt relative to general government revenue, and debt structure and funding access.
- Depository corporation claims: Claims from resident depository corporations (excluding those of the central bank) on the resident nongovernment sector.
- Economic assessment: Based on the analysis of economic structure and growth prospects. Reflects income levels (GDP per capita), economic growth prospects, and economic diversity and volatility.

- External assessment: Based on the analysis of external liquidity and international investment position as well as the status of a sovereign's currency in international transactions. Reflects a country's ability to obtain funds from abroad necessary to meet its public- and private-sector obligations to nonresidents.
- Fiscal performance and flexibility assessment: Reflects the sustainability of sovereign's fiscal deficits. Based on the prospective change in general government debt, calculated as a percentage of GDP, taking into account long-term trends and a government's fiscal flexibility and vulnerabilities.
- Foreign direct investment (FDI): Direct investment by nonresidents.
- GDP per capita: GDP divided by population.
- General government: Aggregate of the national, regional, and local government sectors, including social security and other defined benefit public-sector pension systems, and excluding intergovernmental transactions.
- General government debt: Debt incurred by national, regional, and local governments and central bank debt.
- General government interest: Interest payments on general government debt.
- General government liquid financial assets: General government deposits in financial institutions (unless the deposits are a source of support to the recipient institution), widely traded securities, plus minority arms-length holdings of incorporated enterprises that are widely traded plus balances of defined-benefit government-run pension plans or social security funds (or stabilization or other freely available funds) that are held in bank deposits, widely traded securities, or other liquid forms.
- Gross domestic product (GDP): Total market value of goods and services produced by resident factors of production.
- Gross external financing needs: Current account payments plus short-term external debt at the end of the prior year, including nonresident deposits at the end of the prior year plus long-term external debt maturing within the year.
- Institutional assessment: An analysis of how a government's institutions and policymaking affect a sovereign's credit fundamentals by delivering sustainable public finances, promoting balanced economic growth, and responding to economic or political shocks. Reflects the effectiveness, stability, and predictability of the sovereign's policymaking and political institutions; transparency and accountability of institutions, data, and processes; the sovereign's debt payment culture; and security risks.
- Monetary base: Local currency in circulation plus the monetary authority's local currency liabilities to other depository corporations.
- Monetary assessment: The extent to which a sovereign's monetary authority can fulfil its mandate while supporting sustainable economic growth and attenuating major economic or financial shocks. Based on the analysis of the sovereign's ability to coordinate monetary policy with fiscal and other economic policies to support sustainable economic growth; the credibility of monetary policy, and the effectiveness of market-oriented monetary mechanisms.
- Narrow net external debt: Stock of foreign and local currency public- and private-sector borrowings from nonresidents minus official reserves minus public-sector liquid claims on nonresidents minus financial sector loans to, deposits with, or investments in nonresident entities.
- Net general government debt: General government debt minus general government liquid financial assets.
- Net external liabilities: Total public- and private-sector liabilities to nonresidents minus total external assets.

Research Update: Outlook On South Africa Revised To Negative On Continued Slow Growth; Ratings Affirmed

- Official reserves: Monetary authority liquid claims in foreign currency (including gold) on nonresidents.
- Real GDP per capita: Constant-price per capita GDP.
- Terms of trade: Price of goods exports relative to price of goods imports.
- Usable reserves: Official reserves minus items not readily available for foreign exchange operations and repayment of external debt.

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