

Research

Turk Telekom

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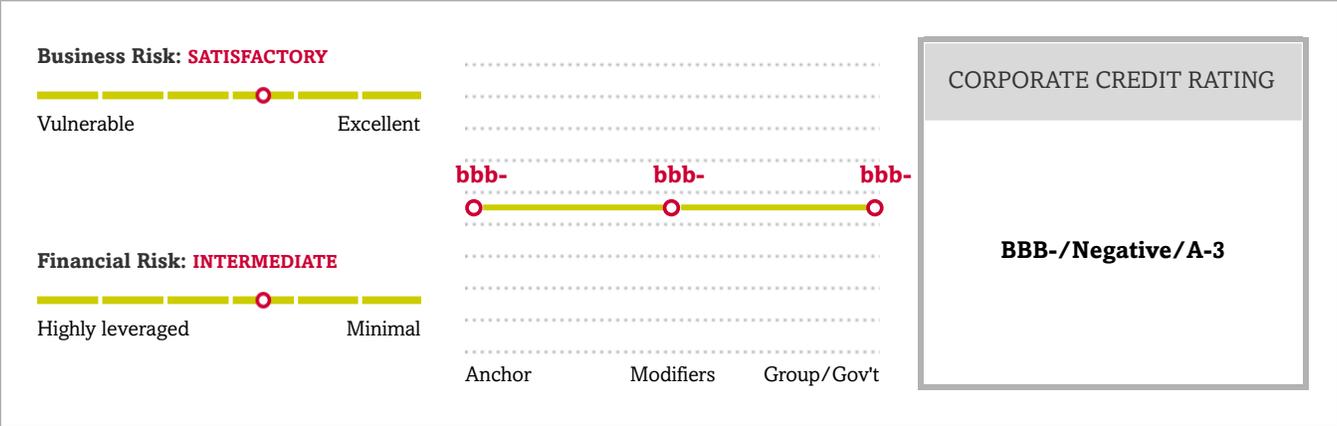
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Turk Telekom



Rationale

Business Risk: Satisfactory	Financial Risk: Intermediate
<ul style="list-style-type: none"> • Dominating position in Turkey's fixed-line segments, with an 86% market share in voice, and 62% in retail broadband. • Extensive network infrastructure, with 98% fixed-line household coverage and 77% long-term evolution (LTE) population coverage. • Strong profitability, with an EBITDA margin in the 36%-37% range. • Exposure to country risks in Turkey. • Challenger, position, albeit expanding, in the competitive Turkish mobile telephony market, with a 25% market share. 	<ul style="list-style-type: none"> • Moderate financial leverage, with adjusted debt to EBITDA temporarily above 2x, supported by a conservative financial policy. • Weak free operating cash flows in 2017, mainly due to high capital expenditures, including spectrum fees. • Exposure to foreign exchange risk, primarily because only about 15%-20% of its U.S. dollar- and euro-denominated gross financial debt is hedged (as of second-quarter 2017).

Outlook

S&P Global Ratings' negative outlook on Turk Telekom reflects the negative outlook on the Republic of Turkey (foreign currency BB/Negative/B, local currency BB+/Stable/B), meaning that a negative rating action on the sovereign could lead to a downgrade of Turk Telekom.

Downside scenario

In addition to a negative rating action on the sovereign, we could also downgrade Turk Telekom if we lowered our transfer and convertibility (T&C) assessment on Turkey, due to deterioration in Turkish corporations' access to domestic and external liquidity, or if we believed the business risk of operating in Turkey had materially increased.

Furthermore, we could also lower the rating on Turk Telekom if the S&P Global Ratings' adjusted debt-to-EBITDA ratio increased beyond 2.25x for a prolonged period, with adjusted funds from operations (FFO) to debt below 40%. We think this could be caused by weaker-than-expected operating developments, for instance material adverse foreign exchange movements or fierce price competition, coupled with market share losses.

Upside scenario

We could revise our outlook to stable if we raised the sovereign rating on Turkey or revised our outlook on the sovereign to stable.

Our Base-Case Scenario

Assumptions	Key Metrics			
<ul style="list-style-type: none"> • Top-line growth of about 8% to 10% for 2017 and 2018, mainly driven by solid average revenue per user (ARPU) growth in fixed broadband and mobile segments. • Rebound in adjusted EBITDA margin by about 3 percentage points to about 36%-37% in 2017 compared with 2016, which was negatively impacted by Turkish lira (TRY) 430 million (about \$122 million) in foreign-exchange losses. • Gradual decline of the capital expenditures (capex)-to-sales ratio from 29% in 2016 to below 20% in 2018, as the remaining spectrum fees were paid in the second quarter of 2017, and the majority of the network upgrade and expansion has been completed. • No dividends for 2017. • Depreciation of the lira against the U.S. dollar of 11% in 2017 and 6% in 2018, following a depreciation of 20% in 2016. 		2016a	2017e	2018e
	EBITDA margin* (x)	33.6	36-37	36-37
	Debt to EBITDA (x)*	2.8	2-3	2-3
	FFO to debt (%)*	29.5	37-38	39-40
	FOCF to debt (%)*	1.7	6-7	10-11
<p>*S&P Global Ratings adjusted ratios. A--Actual. E--Estimate. FFO--Funds from operations. FOCF--Free operating cash flow.</p>				

Company Description

Turk Telekom is a former telecom incumbent operator and provides integrated telecommunication and technology services to residential and commercial customers, primarily in Turkey. It primarily offers fixed-line telephony, broadband Internet, TV, corporate data, and mobile telephony services, as well as infrastructure and wholesale voice and data services. As of June 30, 2017, Turk Telekom reported 9.4 million fixed voice lines, 9.1 million broadband internet subscribers, and 18.8 million mobile subscribers.

Following privatization in 2005 and an IPO in 2008, 55% of the company is owned by holding company, Oger Telecom, which is a joint venture between two Saudi companies--Saudi Oger and Saudi Telecom (A-/Stable/A-2). The Turkish government holds a 31.7% stake in Turk Telekom.

Business Risk: Satisfactory

Our assessment of Turk Telekom's business risk profile is supported by the company's strong leadership position in domestic fixed-line business, its extensive network infrastructure, good growth prospects, and solid profitability. Turk Telekom almost fully controls the fixed-line voice segment, and is the dominant player in the fixed-line broadband market, where it had captured a 62% retail market share as of March 31, 2017, including an increasing presence in fiber, given fixed-line household coverage of 98%. As a result, we expect Turk Telekom to benefit from broadband internet penetration growth in Turkey, which currently stands at 48%, and from increasing demand for higher

broadband speed and quota packages and corporate data, and to a lesser extent from increasing revenues from TV services. This should more than offset the predicted decline in revenues from traditional fixed-line voice, which comprised 15% of revenues in second-quarter 2017, compared with about 30% in first-quarter 2014. Furthermore, a change in regulations, such as a potential revision of the Special Telecommunications Tax for mobile, could improve margins further. Currently, the tax on mobile voice services stands at 25%, one of the highest rates globally.

These strengths are partly offset by the company's exposure to meaningful country risks, such as higher uncertainty of consumer spending or foreign exchange volatility, which would lead to inflationary pressures (expected consumer price index (CPI) growth between 7.5% and 9.5% in 2017 and 2018), and the smaller scale of its mobile operations in the mature domestic mobile telephony market. There are three players in this market: Turkcell dominates with a 44% market share, and Turk Telekom is still the smallest operator with a subscriber market share of 25% as of March 31, 2017, 6.5 percentage points behind the No. 2 player, Vodafone. Although Turk Telekom is gradually increasing its market share in the mobile market, its scale and profitability in the segment are still significantly weaker than those of its competitor, Turkcell. That said, given Turk Telekom's spectrum purchase in 2015 and its high investments in the mobile business in recent years--notably providing 77% of the population with LTE coverage on March 31, 2017--we think its market position and profitability could further improve in coming years.

Our Base-Case Operating Scenario

- Annual real GDP growth of Turkey of 2.6% in 2017 and 2.8% in 2018, compared with about 2.9% in 2016. Still some inflationary pressure, with CPI expected to increase 9.5% and 7.5% in 2017 and 2018, respectively, compared with 7.8% in 2016.
- Top-line growth of about 8% to 10% in 2017 and 2018. Growth in broadband between 17% and 18%, driven by increased data usage, upselling capabilities to higher speeds, and a new plan to target rural areas and provide services to new customers. Strong growth in the mobile segment of 13% in 2017 and 12% in 2018, supported by increased contribution of postpaid customers, and gradually increasing market share. This will more than offset the continued, albeit easing, pressures in the fixed voice segment.
- Rebound in profitability, after a drop in 2016 caused by cost-reduction actions and lira depreciation.

Peer comparison

Compared with operators in Gulf Cooperation Council countries, Turk Telekom has benefited from more pronounced growth, but relatively weaker margins as the gulf operators generally benefit from stronger revenue share, lower taxes, and more government involvement in most operators and to a lesser extent from diversified geographic presence.

We consider Turk Telekom's business risk profile as relatively similar to Turkcell's, which has a dominating position in the mobile market (44% market share) but a weaker position in fixed line. Compared with Western European peers, Turk Telekom has lower leverage, but this is more than offset by modest free operating cash flow (FOCF), higher country risk, and its exposure to foreign exchange volatility.

Table 1

Turk Telekom -- Peer Comparison					
Industry Sector: Diversified Telecom					
	Turk Telekom	Turkcell Iletisim Hizmetleri A.S.	Koninklijke KPN N.V.	Ooredoo Q.S.C.	Telekom Austria AG
Rating as of Aug. 10, 2017	BBB-/Negative/A-3	BBB-/Negative/--	BBB-/Positive/A-3	A-/Watch Neg/A-2	BBB/Positive/A-2
(Mil. TRY)	--Fiscal year ended Dec. 31, 2016--				
Revenues	16,108.6	14,100.9	25,258.5	31,408.8	15,641.1
EBITDA	5,406.8	4,525.0	9,444.4	13,486.5	4,882.3
Funds from operations (FFO)	4,464.9	4,489.7	7,411.1	10,482.5	4,213.4
Net income from cont. oper.	(724.3)	1,534.3	1,348.2	2,118.7	1,533.2
Cash flow from operations	4,931.6	1,285.9	7,497.5	9,512.3	3,904.4
Capital expenditures	4,667.3	3,350.6	4,527.3	8,077.4	3,007.0
Free operating cash flow	264.3	(2,064.7)	2,970.2	1,434.9	897.4
Discretionary cash flow	(576.5)	(2,116.1)	1,198.5	284.6	710.3
Cash and short-term investments	2,616.3	6,052.4	4,898.7	15,946.2	1,724.0
Debt	15,155.6	5,086.2	29,957.3	34,824.2	12,395.8
Equity	3,386.6	16,068.4	12,484.8	28,024.6	9,074.1
Adjusted ratios					
EBITDA margin (%)	33.6	32.1	37.5	43.0	31.3
Return on capital (%)	14.3	15.0	8.2	9.7	7.2
EBITDA interest coverage (x)	8.2	10.1	3.8	5.8	7.6
FFO cash int. cov. (x)	11.9	9.7	5.7	6.3	6.9
Debt/EBITDA (x)	2.8	1.1	3.2	2.6	2.5
FFO/debt (%)	29.5	88.3	24.8	30.1	34.1
Cash flow from operations/debt (%)	32.5	25.3	25.1	27.4	31.6
Free operating cash flow/debt (%)	1.7	(40.6)	10.0	4.2	7.3
Discretionary cash flow/debt (%)	(3.8)	(41.6)	4.1	0.9	5.8

TRY--Turkish lira.

Financial Risk: Intermediate

Our assessment of Turk Telekom's financial risk profile is supported by our assumption that its S&P Global Ratings adjusted debt-to-EBITDA ratio, after a temporary peak at about 2.8x in 2016 caused primarily by the lira depreciation and spectrum obligations, will decline significantly in 2017 and 2018. This is in line with our understanding that the company would like to maintain reported net debt to EBITDA at about 1.5x in the medium term, although we think it could take a few years before Turk Telekom returns to this level. We also expect S&P Global Ratings-adjusted FFO to

debt to recover to above 40% from 2018, and increase gradually thereafter.

These strengths are partly offset by Turk Telekom's temporary weak FOCF in 2017 as it continues significant investments in mobile and fiber fixed networks, including large spectrum instalments (the final installment of TRY902 million out of the total TRY3 billion was paid in April). Moreover, we take into account the company's limited discretionary cash flow generation, due to its dividend policy, which aims to maximize the distribution of Turk Telekom's available profit (based on the Capital Markets Board of Turkey's regulations). While there is no dividend for 2017 due to net losses incurred from the currency devaluation, we expect the dividend payout ratio to resume at 90% of the previous year's net income from 2018. We understand that Turk Telekom's majority owner, Oger Telecom, has faced issues in servicing its debt. That said, we consider that Turk Telekom's articles of association constrain Oger Telecom's influence on Turk Telekom's dividend policy. The articles stipulate that when Turk Telekom's board of directors decides on the dividend distribution proposal, it needs to maintain the group's sound financial standing, consider Turk Telekom's investment needs and trading prospects, and take into account covenants agreed with lenders.

Turk Telekom has exposure to foreign-exchange risk, primarily because it had about \$3.4 billion-equivalent of unhedged gross financial debt as of June 30, 2017, denominated in U.S. dollars and euros (\$3 billion after deducting hard currency cash). However, it generates almost all of its revenues and EBITDA in lira.

Our Base-Case Cash Flow And Capital Structure Scenario

- A capex-to-sales ratio (including spectrum fees) of 23% in 2017 and 17% in 2018.
- Dividends distribution to resume from 2018, at about 90% of the previous year's net income.

Financial summary

Table 2

Turk Telekom -- Financial Summary					
Industry Sector: Diversified Telecom					
(Mil. TRY)	--Fiscal year ended Dec. 31--				
	2016	2015	2014	2013	2012
Revenues	16,108.6	14,522.9	13,601.6	13,190.0	12,706.1
EBITDA	5,406.8	5,725.0	5,393.0	5,269.3	5,321.3
Funds from operations (FFO)	4,464.9	5,040.6	4,360.0	4,547.4	4,350.3
Net income from continuing operations	(724.3)	907.4	2,007.4	1,303.0	2,637.1
Cash flow from operations	4,931.6	4,547.7	4,381.9	3,938.1	3,489.0
Capital expenditures	4,667.3	3,319.6	2,169.3	2,293.2	2,347.6
Free operating cash flow	264.3	1,228.1	2,212.6	1,644.9	1,141.4
Discretionary cash flow	(576.5)	(612.7)	1,300.5	(768.4)	(755.1)
Cash and short-term investments	2,616.3	2,514.4	2,270.8	697.4	571.4
Debt	15,155.6	12,301.5	8,430.7	9,607.6	7,413.4
Equity	3,386.6	4,993.4	6,303.3	5,327.6	6,455.1

Table 2

Turk Telekom -- Financial Summary (cont.)					
Industry Sector: Diversified Telecom					
(Mil. TRY)	--Fiscal year ended Dec. 31--				
	2016	2015	2014	2013	2012
Adjusted ratios					
EBITDA margin (%)	33.6	39.4	39.6	39.9	41.9
Return on capital (%)	13.6	21.2	22.4	23.2	27.5
EBITDA interest coverage (x)	8.2	10.7	11.1	13.9	12.4
FFO cash int. cov. (x)	11.9	16.3	17.2	18.2	15.4
Debt/EBITDA (x)	2.8	2.1	1.6	1.8	1.4
FFO/debt (%)	29.5	41.0	51.7	47.3	58.7
Cash flow from operations/debt (%)	32.5	37.0	52.0	41.0	47.1
Free operating cash flow/debt (%)	1.7	10.0	26.2	17.1	15.4
Discretionary cash flow/debt (%)	(3.8)	(5.0)	15.4	(8.0)	(10.2)

TRY--Turkish lira.

Liquidity: Adequate

We assess Turk Telekom's liquidity as adequate, because we anticipate in our base case that its sources of liquidity will cover its uses by more than 1.2x in the 12 months from June 30, 2017.

In our view, the company has sound relationships with its banks. However, we view its liquidity management as less prudent than that of its international peers, because it doesn't have significant debt maturities in foreign currencies before 2019. Furthermore, its average remaining debt term improved to 3.8 years in 2016 from 3.5 years in 2015.

Principal Liquidity Sources

As of June 30, 2017, principal liquidity sources for the next 12 months include:

- Cash balances of about TRY2.1 billion (including cash of TRY0.4 billion deposited at banks related to collection protocols and automated teller machine (ATM) collection).
- Undrawn credit lines (excluding credit lines with Turkish banks) of about TRY0.3 billion.
- FFO of about TRY4.3 billion.

Principal liquidity uses

For the same period, principal liquidity uses include:

- Short-term debt maturities of about TRY1.8 billion.
- Modest working capital requirements.
- Capex (excluding spectrum costs) of about TRY3.1 billion.

Debt maturities

On June 30, 2017:

- 0 to 1 year: TRY1.8 billion
- 1 to 2 years: TRY2.5 billion
- 2 to 5 years: TRY6.6 billion
- After 5 years: TRY3.7 billion

Covenant Analysis

Turk Telekom must comply with two financial covenants: a net leverage ratio below 2.5x and an interest coverage ratio above 4x. In our base case, we estimate that Turk Telekom will have sufficient headroom of more than 20% in 2017-2019.

Rating Above The Sovereign

Our rating on Turk Telekom is higher than the sovereign foreign currency rating on Turkey because Turk Telekom passes our hypothetical sovereign default stress test, which, among other factors, assumes a 50% devaluation of the lira against hard currencies and a 15%-20% decline in organic EBITDA.

We currently assess that Turk Telekom's rating can exceed the sovereign rating by two notches. This is because we understand that management keeps almost one-half of its cash in hard currencies, and aims at keeping sufficient cash reserves to serve its next 12-month debt obligations. Therefore, in the hypothetical case of depreciation of the lira, we think the appreciation of the cash balance would offset the increase in unhedged short-term debt maturities and capital expenditures.

Ratings Score Snapshot

Corporate Credit Rating

BBB-/Negative/A-3

Business risk: Satisfactory

- **Country risk:** High
- **Industry risk:** Intermediate
- **Competitive position:** Satisfactory

Financial risk: Intermediate

- **Cash flow/Leverage:** Intermediate

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)

Stand-alone credit profile : bbb-

- **Related government rating:** BB

Reconciliation

Table 3

Reconciliation Of Turk Telekom Reported Amounts With S&P Global Ratings' Adjusted Amounts (Mil. TRY)						
--Fiscal year ended Dec. 31, 2016--						
Turk Telekom reported amounts						
	Debt	EBITDA	Operating income	Interest expense	EBITDA	Cash flow from operations
Reported	15,041.2	5,044.5	2,196.0	501.3	5,044.5	4,932.4
S&P Global Ratings' adjustments						
Interest expense (reported)	--	--	--	--	(501.3)	--
Interest income (reported)	--	--	--	--	125.9	--
Current tax expense (reported)	--	--	--	--	(405.8)	--
Operating leases	1,534.3	292.2	97.5	97.5	194.7	194.7
Postretirement benefit obligations/deferred compensation	561.3	60.5	60.5	60.5	(2.8)	11.0
Surplus cash	(2,616.3)	--	--	--	--	--
Share-based compensation expense	--	9.5	--	--	9.5	--
Non-operating income (expense)	--	--	125.9	--	--	--
Reclassification of interest and dividend cash flows	--	--	--	--	--	(304.2)
Debt - Derivatives	(266.8)	--	--	--	--	--
Debt - Other	902.0	--	--	--	--	--
OCF - Derivatives	--	--	--	--	--	97.6
Total adjustments	114.4	362.2	283.9	158.0	(579.6)	(0.8)
S&P Global Ratings' adjusted amounts						
	Debt	EBITDA	EBIT	Interest expense	Funds from operations	Cash flow from operations
Adjusted	15,155.6	5,406.8	2,479.8	659.2	4,464.9	4,931.6

TRY--Turkish lira.

Our adjustment for Turk Telekom's operating leases is based on our assumption that about 80% of the operating lease expenses are related to the network infrastructure, which are unlikely to be economically replaced by network

investments in the near to medium term. As a result, we have assumed higher ongoing lease obligations than the company's stated minimum lease obligations under International Financial Reporting Standards.

Our cash and short-term investments exclude collection protocols and ATM collection (TRY0.4 billion for 2016), as well as other restricted amounts (TRY0.02 billion for 2016).

Related Criteria

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The Telecommunications And Cable Industry, June 22, 2014
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Corporates - General: 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

Related Research

- Turkey Foreign And Local Currency Ratings Affirmed; Outlook Remains Negative, May 5, 2017
- Turk Telekom Outlook Revised To Negative After Similar Action On Sovereign; 'BBB-/A-3' Ratings Affirmed, Feb. 1, 2017

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-

Ratings Detail (As Of August 10, 2017)

Turk Telekom

Corporate Credit Rating	BBB-/Negative/A-3
Senior Unsecured	BBB-

Corporate Credit Ratings History

01-Feb-2017	BBB-/Negative/A-3
10-Nov-2016	BBB-/Stable/A-3
22-Jul-2016	BBB-/Negative/A-3
11-May-2016	BBB-/Stable/A-3
24-Jul-2014	BBB-/Negative/A-3
04-Jun-2014	BB+/Watch Pos/B

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.

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