

## Credit Analysis



March 2008

## Lebanon

Lebanon's government bond ratings are currently B3, a low sub-investment grade level. Moody's rates obligations in the B category that are considered speculative and subject to high credit risk.

In March 2008, Moody's changed the outlook on Lebanon's sovereign ratings to stable from negative (see press release linked below). The change of outlook was justified by the resilience of Lebanon's public finances in the face of numerous political shocks since Moody's assignment of a negative rating outlook in November 2006.

In fact, the health of the country's public finances has improved modestly during this period and the government's short-term funding needs are manageable. Hence, despite the possibility of further adverse political events, Moody's believes that Lebanon's sovereign ratings can withstand considerable political volatility at their current low level. Ratings below B3 are usually reserved for governments that are very close to or are already in default.

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This Credit Analysis provides an in-depth discussion of credit rating(s) for Lebanon and should be read in conjunction with Moody's most recent Credit Opinion and rating information available on Moody's website. [Click here to link.](#)



**Moody's Investors Service**

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## Macroeconomic Performance

The performance of Lebanon's real sector remains well below potential despite having recovered from the nadir of 2005 and 2006. Output remains depressed by ongoing political turmoil which is adversely affecting consumer and investor confidence, deterring tourists, encouraging the departure of skilled workers, and hindering the implementation of much needed structural reforms. Inflation has also picked up, as in other emerging markets, putting downward pressure on real incomes.

The authorities estimate that real GDP growth accelerated to 4% in 2007 and are projecting that growth will be around 3% in 2008. This compares with average annual growth of 0.6% in 2005 and 2006. Although a clear improvement (albeit from a low base), the current rate of activity is significantly below potential. For example, the economy grew at 7.5% in 2004, a year that was relatively calm on the political front. Lebanon is not benefiting to the extent that it might from the upsurge in oil-driven liquidity in the Gulf countries, which has led to huge rises in FDI to other countries in the region such as Egypt, Morocco, and Jordan.

Having said that, the country's export sector has performed strongly over the past year, benefiting from the decline in the value of the US dollar to which the Lebanese pound is pegged and booming regional demand. Exports (according to the IMF's classification) surged by 28% in 2007 and even grew by 23% in 2006, the year of a devastating month-long war between Israel and Hezbollah. Spending on post-war reconstruction, partly financed by inflows of aid from external donors, and high levels of remittances from Lebanese workers abroad have also acted as stimulants.

The country's important financial sector has continued to prosper despite the sluggish domestic context. The level of deposits in Lebanese banks increased by around 11% in 2007, an important statistic given that bank deposits ultimately provide the main source of financing for the government through the intermediation of financial institutions. Bank depositors in Lebanon tend to be stalwart and are not easily spooked by political events. Witness the fact that bank deposits have grown in each of the past three years of political turbulence. As explained in our previous reports on Lebanon, this is due to the unique nature of bank depositors in Lebanon. These include Lebanese residents, members of the large Lebanese Diaspora, and wealthy citizens of Gulf countries with holiday homes or other ties to the country.

As in other emerging markets, especially those with currencies pegged to the US dollar, inflation has picked up in Lebanon over the past two years, although it seems to have eased somewhat in 2007. The authorities estimate that consumer price inflation averaged 4.1% last year and are projecting an inflation rate of around 5.5% in 2008. This compares with an average inflation rate of 0.7% between 2001 and 2005. Given that nominal wage growth remains lackluster amid slow job creation and elevated unemployment, real incomes are gradually slipping.

Despite these challenges, the average level of GDP per capita in purchasing power terms remains, on average, higher than most other emerging markets at a similar rating level. The IMF estimates that Lebanon's PPP GDP per capita averaged around \$6,000 in 2007, a similar level to that of Jordan (Ba2) and Morocco (Ba1), and above the median for countries rated between B1 and C, of approximately \$5,000. For Moody's cross-country comparative ratios, please see the latest Moody's Statistical Handbook linked below.

## Political/Social Developments

The political situation remains extremely fragile. Lebanon's opposing factions have yet to agree on filling the presidency after the former president, Emile Lahoud, stepped down at the end of his term in November 2007. This impasse fans an inflammable political environment that periodically erupts in hostile rhetoric, protest marches, assassinations, and street battles.

Yet there is still some sense of restraint, with no party seemingly ready to risk an escalation that could spark uncontrolled civil conflict. Memories of the 1975 to 1990 civil war are still fresh. Hence, barring a negotiated settlement over the issue of the presidency and the composition of the cabinet which currently seems unlikely, the current stalemate could last until the next parliamentary elections, which are slated to take place in the first half of 2009. This does not bode well for the government's reform programme.

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The effectiveness of the government has been severely curtailed since the withdrawal of six opposition ministers from the 24-member cabinet in November 2006 in a dispute over the balance of power in the cabinet and a UN-sponsored tribunal that will try those suspected of involvement in the assassination of former prime minister, Rafiq al-Hariri, and of several prominent anti-Syrian figures since then. The opposition, including the speaker of parliament Nabih Berri, has declared the government, led by Prime Minister Fouad Siniora, unrepresentative and therefore illegitimate and are refusing to cooperate with it.

The non-convening of parliament has blocked the passage of laws and their ratification, which has stymied the government's programme of structural reforms. As part of their negotiations over the replacement of the president, the opposition parties (mainly the Shia parties Hezbollah and Amal together with Michel Aoun's Free Patriotic Movement) are demanding an increase in the number of seats they control in the cabinet in order to enable them to veto cabinet decisions if required.

As ever, Lebanon's travails cannot be divorced from their regional context given the heavy influence exerted by outside powers on Lebanon's various parties. Hence, a solution to the current impasse depends as much on relations between Syria, Iran, Saudi Arabia, and the US as much as the progress of discussions between Lebanon's political leaders themselves. The short-term prognosis for regional politics is rather gloomy. Much will depend on the outcome of presidential elections in the US in November and the development of US-Iranian relations after that date.

In the meantime, the most probable scenario is that the current stalemate between Lebanon's factions will endure until parliamentary elections are held. Yet there is a significant risk of a further deterioration and more violence given the uncertainty inherent in such a tense atmosphere. There is also a material risk of another armed confrontation between Hezbollah and Israel that again could escalate if other regional players, such as Syria, were to become directly involved.

## Government Finance and Debt

Notwithstanding a series of negative political events, the public finances have improved modestly over the past 18 months. The overall fiscal deficit narrowed to 10.3% of GDP in 2007 from 13.3% of GDP in 2006, while the primary balance posted a surplus of 3% of GDP last year versus a slight deficit in 2006. Although 2006 was an exceptionally poor year and therefore an unreliable comparator, the overall fiscal deficit was still below the average level between 2001 and 2005, of 12.5%.

The recent fiscal amelioration has mainly been driven by buoyant revenue growth, particularly in tax revenues, with income and consumption levels recovering following their slump in 2006. Tax administration has also improved with enhanced collection rates. Taxes on international trade were boosted by the robust growth in imports and non-tax revenues rose on the back of profit transfers from state-owned enterprises such as the casino, the Beirut port, and the two mobile telecoms companies. Meanwhile, expenditure growth was restrained, with the ratio of government expenditure to GDP actually easing slightly.

Lebanon's fiscal health nevertheless remains very weak, even in comparison with other low rated countries (see below). Interest payments on the huge public debt consumed a striking 57% of total revenues in 2007, or around 13% of GDP. The state-owned electricity company is another persistent drain on the government's coffers. Transfers to Electricite du Liban rose to LL1.5 trillion in 2007 (almost \$1 billion or 4% of GDP). Government efforts to reform this dilapidated institution continue to be hampered by political infighting.

The general government's extraordinarily large debt shrank slightly in 2007, to 158% of GDP or 670% of revenues, from 168% of GDP or 787% of revenues in 2006. Apart from the improvements in the denominators explained above, nominal growth in the general government's debt stock was limited by the following transactions. Public entities such as the National Social Security Fund increased their holdings of government debt by 45% in 2007 (this is netted out from our calculation of general government debt). Meanwhile, the central bank wrote off LL2.4 trillion of treasury bills against an upward revaluation of its gold reserves.

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Despite a wide deficit and an outsized debt, the government does not seem to be facing any immediate financing difficulties. This is largely because local commercial banks, whose deposits are growing, remain willing and able to purchase and roll over government securities in both local and foreign currencies. Government Eurobond coupons exceeding 9% offer an attractive yield for banks relative to opportunities abroad and given the limited scope for domestic private sector lending.

The gradual inflow of financial assistance from external donors also provides relief. Out of a total of \$4.7 billion pledged by donors for budgetary support at the January 2007 "Paris III" conference, the government has so far received \$1.3 billion, mostly in the form of soft loans or debt restructuring.

The structure of the general government's debt stock provides some reassurance from a rating perspective given that very little of it is held by volatile creditors. Around 80% of the total debt stock is owed to domestic creditors, mainly the commercial banks and the central bank. As mentioned above, domestic banks have a proven resilience to political shocks and have little interest in offloading government paper given that a government default would prove devastating to their own financial wellbeing. The commercial banks in Lebanon have around half of their total assets invested in the sovereign (government plus central bank). The portion of government debt owed to external creditors is largely accounted for by official creditors, mostly on concessional terms.

It is nevertheless a concern that around half of the government's debt stock is denominated in foreign currencies, mostly US dollars. In the event of a significant exchange rate depreciation, the value of this debt would jump in local currency terms, inflating the government's debt servicing requirement.

### Peer Comparisons

Lebanon's government finance metrics tend to compare very poorly with other countries in the B1 to C rating category. In 2007, the government's overall fiscal deficit was around 10% of GDP, compared with a median deficit for the rating category of just 0.8% of GDP. The government's gross general government debt to GDP was around 158% of GDP in 2007, four times the median for the rating category of 39%. The gross general government debt to revenue ratio in 2007, of 670%, was almost five times the median for the rating group, of 138%.

However, these ratios do not capture the peculiarities of the structure of Lebanon's public finances, namely the deep and resilient sources of funding open to the government and the availability of foreign official soft loans. For example, the ratio of gross general government debt to M3 in Lebanon is around 65% because of the large size of the banking system. This compares with a median ratio for the B1 to C rating group of around 95%.

### External Vulnerability and Liquidity

Lebanon's external liquidity remains adequate in spite of the maintenance of a wide current account deficit, which is estimated at around 11% of GDP in 2007. The central bank's gross foreign exchange reserves amounted to \$9.8 billion at the end of 2007, equivalent to around 40% of GDP. The central bank held gold reserves at end-2007 worth approximately \$7.6 billion (31% of GDP), although these cannot be liquidated without parliamentary approval that would be difficult to obtain. Although the gold reserves cannot therefore be regarded as liquid, they do provide psychological reassurance to bank depositors. Meanwhile, the country's commercial banks' held net foreign assets worth \$7 billion at the end of 2007 according to official data.

The current account is structurally weak in Lebanon owing to the country's narrow export base and heavy external debt servicing requirement, which offsets the boon of large inflows of workers' remittances and periodically high tourism receipts. Lebanon has one of the highest ratios of worker remittances to GDP in the world (second only to Haiti according to a 2008 IMF paper). The country also attracts substantial capital inflows. Net inward FDI is estimated to have exceeded 10% of GDP in each of the past four years despite pronounced political turbulence. Furthermore, inflows of soft loans, grants and deposits from official creditors have provided valuable support to the balance of payments since mid-2006.

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It is difficult to calculate the exact level of external debt in Lebanon, largely owing to confusion over the definition of resident versus non-resident Lebanese bank depositors. Also, there are no official estimates of the amount of government debt held by non-residents. However, based on International Financial Statistics data for commercial banks' foreign liabilities, the assumption that around 20% of the government's debt is held by non-residents, and BIS data for the foreign liabilities of the non-bank private sector - we estimate that Lebanon's gross external debt amounted to around 110% of GDP at end-2007, one of the highest levels in the world.

There are mitigating factors, however. Over half of the country's external debt is accounted for by the foreign liabilities of the commercial banks, which are offset by foreign assets (as mentioned above, the commercial banking system is a net foreign creditor). Also, the government's external debt (i.e. that owed to non-residents) has a healthy structure, with the bulk owed to official creditors at relatively low interest rates and in long maturities. The high level of Lebanon's gross external debt is also offset by the considerable foreign assets of the monetary authorities.

### Peer Comparisons

As with its public finance ratios, Lebanon's main external indicators tend to compare poorly with other countries in the B1 to C rating group. Lebanon's current account deficit is estimated at around 11% of GDP in 2007, compared with a median deficit for the rating group of around 3%. The country's gross external debt to GDP, of 110% in 2007, is almost three times the median level for the rating group, of 40%. Lebanon's gross external debt to current account receipts ratio is also very high, at around 150% in 2007, versus a median of 84% for the rating group.

Yet these ratios do not take account of the country's sizeable foreign assets, including the official foreign currency reserves of the central bank (40% of GDP at end-2007), the gold reserves of the central bank (31% of GDP at end-2007), the foreign assets of the commercial banks (84% of GDP at end-2007), and the foreign assets of the non-bank private sector (unknown). With the caveat that the liquidity of these assets varies.

### Rating History

Lebanon			Foreign Currency Ceilings				Government Bonds	
Action	Date	Outlook	Bonds and Notes		Bank Deposits		Foreign Currency	Local Currency
			Long-term	Short-term	Long-term	Short-term		
Outlook Changed	Mar-2008	Stable	—	—	—	—	—	—
Outlook Changed	Nov-2006	Negative	—	—	—	—	—	—
Rating Raised	May-2006	—	B2	—	—	—	—	—
Rating Lowered	Mar-2005	Stable	B3	—	B3	—	B3	—
Rating Lowered	Jul-2001	Negative	B2	—	—	—	B2	B3
Review for Downgrade	Sep-2000	—	—	—	—	—	—	—
Outlook Changed	Sep-2000	Negative	—	—	—	—	—	—
Rating Assigned	Aug-1999	—	—	—	—	—	—	B1
Rating Assigned	May-1997	—	—	—	B2	NP	—	—
Outlook Assigned	Mar-1997	Stable	—	—	—	—	—	—
Rating Assigned	Feb-1997	—	B1	NP	—	—	B1	—

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## Annual Statistics

Lebanon	1999	2000	2001	2002	2003	2004	2005	2006	2007E	2008F
<b>Economic Structure and Performance</b>										
Nominal GDP (US\$ Bil.)	17.01	16.82	17.21	18.72	19.80	21.46	21.56	22.73	24.64	26.77
Population (Mil.)	3.38	3.43	3.47	3.52	3.56	3.61	3.66	3.70	3.75	3.80
GDP per capita (US\$)	5028	4910	4959	5323	5559	5949	5898	6138	6569	7046
GDP per capita (PPP basis, US\$)	4279	4391	4637	4810	5050	5510	5671	5775	5965	-
Nominal GDP (% change, local currency)	0.0	-1.1	2.3	8.7	5.8	8.4	0.4	5.4	8.4	8.6
Real GDP (% change, local currency)	-0.8	1.7	4.5	3.3	4.1	7.5	1.1	0.0	4.0	3.0
Inflation Rate (CPI, % change, dec/dec)	-0.1	-0.4	0.7	1.6	2.2	2.0	0.5	7.2	6.0	5.0
Gross Investment/GDP (%)	23.1	20.2	22.8	18.2	19.2	22.0	21.1	13.6	14.3	13.6
Gross Domestic Saving/GDP (%)	-1.1	-2.8	-2.5	-1.2	-1.8	-1.8	-0.3	-6.2	-8.8	-9.4
Nominal Exports of G & S (% change, US\$ basis)	14.4	10.1	12.5	6.6	16.5	19.7	7.6	18.3	9.4	7.8
Nominal Imports of G & S (% change, US\$ basis)	-5.5	2.4	14.6	-2.3	8.6	21.3	-2.1	7.4	17.7	7.8
Openness of the Economy (%) [1]	33.4	37.2	40.9	40.1	44.1	48.7	52.2	58.6	59.1	58.7
<b>Government Finance</b>										
Gen. Gov. Revenue/GDP (%)	19.0	18.8	17.9	20.7	22.3	23.2	22.8	21.4	23.6	23.6
Gen. Gov. Expenditures/GDP (%)	33.0	41.9	34.2	35.9	35.5	32.6	31.4	34.7	33.9	32.9
Gen. Gov. Financial Balance/GDP (%)	-14.0	-23.1	-16.3	-15.3	-13.2	-9.4	-8.6	-13.3	-10.3	-9.4
Gen. Gov. Primary Balance/GDP (%)	0.2	-6.5	0.3	1.1	3.1	3.1	2.3	0.0	3.0	3.0
Gen. Gov. Direct Debt/GDP (%)	122.9	139.0	152.6	156.1	159.9	160.4	170.9	167.9	157.8	154.6
Gen. Gov. Direct Debt/Gen. Gov. Revenue (%)	646.8	739.4	851.6	755.7	717.1	690.6	750.0	786.5	669.9	656.5
Gen. Gov. Int. Pymt/Gen. Gov. Revenue (%)	74.4	88.0	92.8	79.3	73.2	53.5	47.7	62.3	56.5	52.4
Gen. Gov. FC & FC-indexed Debt/Gen. Gov. Debt (%)	26.4	30.7	36.5	49.9	49.1	53.4	51.9	53.3	54.7	56.0
Gen. Gov. Direct Debt (US\$ Bil.)	20.91	23.39	26.26	29.22	31.66	34.42	36.84	38.17	38.88	41.39
GG Direct Debt Owed to Non-residents/GG Direct Debt (%)	19.1	16.9	14.6	18.2	21.8	20.3	19.9	20.7	21.6	21.6
<b>External Payments and Debt</b>										
Current Account Balance (US\$ Bil.)	-3.20	-2.85	-3.28	-2.84	-2.62	-3.33	-2.93	-1.37	-2.64	-2.64
Current Account Balance/GDP (%)	-18.8	-17.0	-19.0	-15.2	-13.2	-15.5	-13.6	-6.0	-10.7	-9.9
External Debt (US\$ Bil.)	13.28	13.96	14.88	15.24	19.52	22.64	21.99	23.31	27.07	29.06

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	1999	2000	2001	2002	2003	2004	2005	2006	2007E	2008F
External Debt/GDP (%)	78.1	83.0	86.4	81.4	98.6	105.5	102.0	102.6	109.9	108.6
External Debt/CA Receipts (%) [2]	174.6	168.6	157.4	156.8	174.8	169.4	163.5	146.4	152.4	151.3
Net Foreign Direct Investment/GDP (%)	8.2	6.5	6.9	7.4	8.7	10.9	12.2	12.0	10.8	10.0
Official Forex Reserves (US\$ Bil.)	7.60	5.75	4.36	5.07	10.20	9.49	9.85	10.21	9.78	9.79
Nominal Exchange Rate (local currency/US\$; end-year)	1508	1508	1508	1508	1508	1508	1508	1508	1508	1508
Short-term External Debt/Total External Debt (%)	48.1	51.5	49.4	48.3	47.8	53.4	52.9	52.3	54.6	56.0
Interest Paid on External Debt (US\$ Bil.)	0.81	1.07	0.70	0.48	0.41	0.66	1.12	1.43	1.54	1.43
Amortization Paid on External Debt (US\$ Bil.)	1.12	1.18	1.25	1.36	1.57	1.72	1.86	2.00	2.18	2.28
Net Foreign Assets of Domestic Banks (US\$ Bil.)	-0.48	0.97	1.27	2.14	0.58	1.46	1.65	4.26	7.00	-
<b>Monetary, Vulnerability and Liquidity Indicators</b>										
Domestic Credit (% change, dec/dec)	13.8	17.5	11.8	6.4	4.0	9.7	4.3	10.4	5.5	-
Domestic Credit/GDP (%)	142.9	169.8	185.5	181.4	178.3	180.4	187.3	196.2	190.9	-
M3/Official Forex Reserves (X)	3.9	5.7	8.0	7.5	4.2	5.0	5.0	5.2	6.2	-
Debt Service Ratio (%) [3]	25.4	27.1	20.6	18.9	17.7	17.8	22.2	21.6	21.0	19.3
External Vulnerability Indicator (%) [4]	84.2	125.1	168.5	145.2	91.5	127.4	118.1	119.3	151.2	166.1
Liquidity Ratio (%) [5]	16.0	14.7	21.0	13.3	12.1	14.6	11.8	11.0	13.9	-
"Dollarization" Ratio (%) [6]	56.6	62.2	69.0	65.6	60.9	64.9	68.5	72.3	74.0	-
"Dollarization" Vulnerability Indicator (%) [7]	120.7	141.9	183.3	166.6	126.7	130.0	143.1	141.1	145.9	-
M3 (% change, dec/dec)	11.7	9.8	7.5	8.1	13.0	10.1	4.5	7.8	13.7	-
Short-Term Nominal Interest Rate (% dec)	14.6	14.6	14.6	9.4	8.0	7.9	8.7	8.7	8.7	-
Total External Debt/Forex Reserves (%)	174.9	242.9	341.1	300.6	191.5	238.4	223.3	228.3	276.8	296.7
Total Liabilities due BIS Banks/Total Assets Held in BIS Banks (%)	22.9	19.9	17.1	14.9	16.4	20.7	16.9	14.7	15.6	-

## Notes:

[1] Sum of Exports and Imports of Goods and Services/GDP (%)

[2] Current Account Receipts

[3] (Interest + Current-Year Repayment of Principal)/Current Account Receipts (%)

[4] (Short-Term External Debt + Currently Maturing Long-Term External Debt)/Official Foreign Exchange Reserves (%)

[5] Liabilities to BIS Banks Falling Due Within One Year/Total Assets Held in BIS Banks (%)

[6] Total Foreign Currency Deposits in the Domestic Banking System/Total Deposits in the Domestic Banking System (%)

[7] Total Foreign Currency Deposits in the Domestic Banking System/(Official Foreign Exchanges Reserves + Foreign Assets of Domestic Banks) (%)

## Lebanon

## Moody's Related Research

### Rating Actions:

- Moody's changes Lebanon's ratings outlook to stable, March 2008

### Statistical Handbook:

- Moody's Country Credit Statistical Handbook, November 2007 (105704)

### Banking System Outlook:

- Banking System Outlook Lebanon, September 2007 (104833)

### Rating Methodologies:

- Sources and Uses of Statistical Data in Moody's Sovereign Credit Analysis, December 2006 (101207)
- The Local Currency Deposit Ceiling, August 2006 (98554)
- Revised Foreign-Currency Ceilings to Better Reflect Reduced Risk of a Payments Moratorium in Wake of Government Default, May 2006 (97555)
- Sovereign Rating Methodology Handbook, February 2004 (78529)

### Special Comments:

- Sovereign Default and Recovery Rates, 1983-2007, March 2008 (107687)
- Inside Moody's: Focus On The Middle East, March 2008 (107967)
- Bank Ratings and Government Bond Ratings, August 2007 (103903)
- Analyzing the Tradeoff between Ratings Accuracy and Stability, September 2006 (99100)
- A Guide to Moody's Sovereign Ratings, August 2006 (98177)
- A Quantitative Model for Foreign Currency Government Bond Ratings, February 2004 (81176)
- A Quantitative Model for Local Currency Government Bond Ratings, September 2003 (79404)

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## Lebanon

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