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# U.S. Gaming Defaults Reach Record Levels: What Happened To This "Recession-Resistant" Industry?

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# U.S. Gaming Defaults Reach Record Levels: What Happened To This "Recession-Resistant" Industry?

The U.S. gaming industry has experienced a record number of defaults in 2008, and we predict that more are on the way. Defaults have been driven by multiple factors, including:

- Weak industry fundamentals, as casino visitors have tightened their belts in response to lower home values, higher gas prices, and generally weak economic conditions;
- Highly leveraged capital structures resulting from development spending and acquisitions, all financed with the abundance of debt capital that was available prior to the summer of 2007; and
- Significantly tougher credit markets in which debt capital is now harder to access and more expensive, and where lenders are much more demanding when covenants are violated.

## Reversal Of Fortune

Up until the end of 2007, the North American gaming industry performed well, with nearly all major markets able to routinely boast annual revenue growth, barring market disruptions (such as when hurricane Katrina hit Mississippi and Louisiana in 2005). Still, despite many years of favorable industry trends, our credit ratings for casino companies were nearly all speculative grade due to highly leveraged balance sheets, the capital-intensive nature of the business, the sector's reliance on consumer discretionary spending, a high degree of competition, and the relatively aggressive financial policies of most management teams. In fact, as of Dec. 31, 2007, 95% of our gaming industry ratings were speculative grade, compared to about 72% for U.S. based corporations (excluding utilities and financial institutions).

As industry performance started to deteriorate in 2008 at a pace well beyond historical levels, defaults surfaced, beginning with Legends Gaming LLC late in the first quarter. While rising defaults have been the most severe consequence for rated gaming companies under existing operating and credit market conditions, rating activity has been significantly negative in the first nine months of 2008, as highly leveraged balance sheets have not been able to tolerate the unprecedented operating declines, often leading to covenant problems.

Through the first nine months of 2008, we downgraded the ratings of 22 gaming companies, or about one-third of our rated universe. Of these downgrades, 19 related to commercial gaming companies, while only three were Native American issuers. Generally speaking, Native American issuers entered the downturn with less leverage, and many operate in markets with limited competition. Thus, about 15% of our total rated Native American issuers have been downgraded, versus more than 40% of our rated commercial gaming issuers. Still, one of the larger Native American markets, Connecticut, has fared poorly in 2008, with slot revenue down 5% through the end of August. Our ratings on the Mashantucket Western Pequot Tribe (BB+/Watch Neg/--) are on CreditWatch with negative implications, and our rating outlook is negative for the Mohegan Tribal Gaming Authority (BB-/Negative/--).

In order to reflect the impact of our downgrades, table 1 compares our gaming industry ratings by category at Dec. 31, 2007 to those at Sept. 24, 2008.

**Table 1**

Ratings Category Comparison--Yesterday & Today*		
Rating Category	Dec. 31, 2007	Sept. 24, 2008
BBB	5%	5%
BB	30%	25%
B	60%	54%
CCC	5%	10%
D	0%	6%

\*Excludes two companies for which ratings were withdrawn after being lowered to 'D'.

### A little history

Until 2008, gaming industry defaults were rare and typically associated with greenfield development projects. In fact, in the 10 years from 1997 to 2007, only nine rated gaming companies defaulted, five of which were greenfield projects (see table 2).

**Table 2**

Historical defaults		
Year	Issuer(s)	Comment
2007	None	
2006	Premier Entertainment Biloxi LLC	Greenfield project destroyed by Hurricane Katrina
2005	None	
2004	Trump Entertainment Resorts Inc.	Multiple properties in Atlantic City and midwest
	Hollywood Casino Shreveport LLC	Greenfield project in Shreveport, LA (partially supported by parent)
2003	None	
2002	Windsor Woodmont Blackhawk Resort Group	Greenfield project in Blackhawk CO (now owned by Ameristar)
2001	Aladdin Gaming Enterprises Inc.	Greenfield project on Las Vegas Strip
2000	President Casinos Inc.	Multiple properties in midwest and south
	The Resort at Summerlin Inc.	Greenfield project in Las Vegas suburbs
1999	Fitzgeralds Gaming Corp.	Multiple properties in south and west
	Claridge Hotel & Casino Corp.	Single property in Atlantic City
1998	None	
1997	None	

In the first nine months of 2008, the ratings on six gaming companies were lowered to 'D' (see table 3).

**Table 3**

'D' Ratings in 2008		
Company	Date rating lowered to 'D'	Reason for downgrade to 'D'
Legends Gaming LLC	March 14, 2008	Bankruptcy filing
French Lick Resorts & Casino LLC	April 30, 2008	Tendered for notes at a discount to par
Tropicana Entertainment LLC*	May 6, 2008	Bankruptcy filing
Herbst Gaming Inc.	May 19, 2008	Missed interest payment on its subordinated notes
Greektown Holdings LLC	May 30, 2008	Bankruptcy filing
UTGR Inc.	Sept. 19, 2008	Missed interest payment on its second-lien notes

\*The rating on Tropicana Las Vegas Resort & Casino LLC, a wholly owned subsidiary, was also lowered to 'D' on this date.

When 2008 began, we rated 67 North American-based gaming companies, thus about 9% of rated gaming companies defaulted in the first nine months of the year. By comparison, our preliminary estimate for the U.S. speculative-grade default rate was 2.68% for the trailing 12 months ended September 2008. Defaulted gaming debt currently represents about 5% of total rated gaming debt, reflecting the relatively small size of the issuers that have so far defaulted.

### **What has changed?**

In the past, defaults were largely related to company-specific issues, such as a challenging location (for example The Resort at Summerlin--now the JW Marriott Las Vegas Resort & Spa) or the failure to invest in properties to drive demand (President, Claridge, and Fitzgeralds). However, in 2008, broad industry trends are compounding company-specific issues to drive defaults.

#### ***Increased competitive pressures.***

With the consumer pulling back, gaming revenue is down across the U.S. at unprecedented levels. We are currently experiencing the most significant consumer driven downturn since 1990-1991, and gaming companies are not immune this time. Whereas 18 years ago, casino gaming was largely concentrated in Nevada and New Jersey, it is now available in about three-quarters of U.S. states. Today, casinos exist in 37 states (including racetracks with slot machines), while in 1990, commercial casinos were operating in only three, and Native American gaming was just starting to emerge in a meaningful way. The expansion of the gaming industry has far exceeded the growth of its customer base, as the U.S. population grew at a compounded annual rate of only 1.1% between 1990 and 2007. Thus, gaming operators now must compete much more heavily for the increasingly empty wallets of consumers.

#### ***Weak balance sheets.***

Moreover, the balance sheets of gaming operators have entered this period in bad shape. With easy and inexpensive debt capital available to gaming companies prior to the summer of 2007, balance sheet debt grew substantially to levels that could not tolerate dips in visitor demand to the extent now being experienced. Expansion-related spending, acquisitions, share repurchases, and leveraged buyouts have all contributed to highly leveraged financial profiles. As we stated earlier, however, a general distinction can be made between commercial and Native American gaming operators. Commercial operators, for the most part, entered the downturn with less balance sheet flexibility than their Native American counterparts.

#### ***Credit crunch.***

As conditions in the financial service industry deteriorated beginning in the Summer of 2007, creditors tightened their lending standards and began demanding higher rates of interest. Covenant violations no longer led to easy amendments, and new deals often struggled for commitments as investors tried to get a grasp of the new landscape. Legends Gaming was among the first to stumble in this environment, as poor performance at its second-tier casinos led to a covenant violation, which shortly resulted in a bankruptcy filing, presumably as the company could not agree on amended financing terms with its lenders.

Difficulties remaining in compliance with covenants also led to defaults by Herbst Gaming, Greektown, and UTGR. In the case of Herbst, heavy debt balances, in large part a result of past acquisitions, could not be supported as the company's operating model shifted due to a smoking ban at its slot route facilities and a number of its casinos struggled in the weakening economy. For Greektown, economic pressure also led to a cash flow shortage. Greektown was in the midst of building an expanded permanent facility when covenant violations led to a funding shortfall. The company tried to find an equity partner to bolster its liquidity position--and almost succeeded, before the deal fell apart. Like Greektown, UTGR's balance sheet was highly leveraged, stemming from an expansion. In

the case of UTGR, the expansion was finished and revenue growth was reasonable; however, substantial state tax payments and higher-than-anticipated operating costs prevented EBITDA from growing to a level needed to avoid a covenant breach.

The defaults by Tropicana and French Lick were a bit different. Tropicana was heavily indebted from its acquisition of Aztar Corp., which it won in a bidding war against Pinnacle Entertainment Inc. (Tropicana's name was Columbia Entertainment when it won the bid for Aztar). The company was certainly under pressure as the operating environment weakened, but then it lost the right to operate its highest cash flow producing property when New Jersey regulators placed the Tropicana Atlantic City under control of a trustee for various violations. Indiana later followed suit, and with operating conditions still challenging, bankruptcy resulted. French Lick bet it could attract people to its destination resort located about 135 miles from Indianapolis, but demand did not live up to management's expectations. The Cook family, which owns 100% of the company, ended up purchasing 47% of the outstanding bonds at a 22% discount to par, resulting in a default under our criteria. A further restructuring still remains a possibility here, barring additional support from the owner.

## Future Expectations

We anticipate many more defaults in the gaming sector before this downturn is over. Standard & Poor's economists are predicting that GDP will decline modestly in the fourth quarter of 2008 and the first quarter of 2009, and a further pullback by the consumer is one of the expected causes. We do not see a catalyst for higher gaming revenue for the next several months, and will continue to factor revenue declines into our forecasts through mid 2009. While each market is different, we would expect industry declines over the next few quarters to be aligned with what the sector has experienced in the past few months. We currently expect gaming revenue to begin growing modestly once again in the second half of 2009. This prediction assumes that the housing market is now close to a bottom, financial markets and energy prices stabilize in the next few months, and there are no other shocks to the economy that affect the consumer. Of course, these qualifications may prove to be significant given recent events in the financial markets.

With the operating climate expected to remain challenging during the next few quarters, it is useful to consider our lowest rated gaming companies, as these are the ones most likely to experience trouble ahead (see table 4).

**Table 4**

Weakest Links	
Company	Rating <sup>††</sup>
155 East Tropicana LLC*	CCC-/Negative/--
Mount Airy #1 LLC	CCC/Watch Neg/--
Progressive Gaming International Corp.	CCC/Negative/--
Black Gaming LLC	CCC/Negative/--
Majestic Star Casino LLC	CCC+/Negative/--
Fontainebleau Las Vegas Holdings LLC	B-/Watch Neg/--
Gateway Casinos & Entertainment Inc.	B-/Negative/--
MTR Gaming Group Inc.	B-/Negative/--
Downstream Development Authority	B-/Negative/--
Trump Entertainment Resorts Holdings L.P.	B-/Negative/--
Station Casinos Inc.	B-/Negative/--

**Table 4**

Weakest Links(cont.)	
Little Traverse Bay Bands of Odawa Indians	B-/Negative/--

\*Unsolicited rating. ¶As of Sept. 30, 2008.

## Recovery Prospects

Standard & Poor's maintains recovery ratings on about 140 publicly rated debt instruments issued by 37 gaming companies and their subsidiaries. We do not currently assign recovery ratings to Native American financings, as there are sufficient uncertainties surrounding the exercise of creditor rights against a sovereign nation. These include (1) whether the Bankruptcy Code would apply, (2) whether a U.S. court would ultimately be the appropriate venue to settle such a matter, and (3) to what extent a creditor would be able to enforce any judgment against the sovereign nation. Although as a practical matter, we believe it is possible that secured creditors would fare better than general unsecured creditors, the uncertainties prevent us from determining the amount of recovery with any precision, though we will continue to monitor these issues. Also, we do not assign recovery ratings to firms with investment-grade corporate credit ratings.

### Recovery ratings

Recovery ratings are a gauge of Standard & Poor's projections for recovery of principal and pre-petition interest if a company defaults on a specific debt issue. Our scale ranges from '1+' (highest expectation for full recovery) to '6' (negligible recovery). (See table 5.)

**Table 5**

Recovery Rating Scale		
Recovery rating	Recovery description	Recovery expectation*
1+	Highest expectation, full recovery¶	100%
1	Very high recovery	90%-100%
2	Substantial recovery	70%-90%
3	Meaningfull recovery	50%-70%
4	Average recovery	30%-50%
5	Modest recovery	10%-30%
6	Negligible recovery	0%-10%

\*Recovery of principal plus accrued but unpaid interest at the time of default. ¶Very high confidence of full recovery resulting from significant overcollateralization or strong structural features.

Recovery prospects for both secured and unsecured gaming industry lenders rank in the top one-third of the 16 industrial sectors (see table 6) followed by our Industrial Ratings group (gaming issues represent roughly two-thirds of our ratings in the Hotel, Gaming, and Leisure sectors). These favorable recovery prospects are attributable to our expectation that gaming companies would be reorganized in the event of a bankruptcy, rather than liquidated, and that a reorganized entity would be valued at the higher end of the emergence EBITDA multiples that Standard & Poor's typically uses for industrial companies. In addition, many of our gaming recovery ratings benefit from the presence of junior debt in a firm's capital structure, which enhance the recoveries on the senior obligations.

**Table 6**

<b>Average Recovery Rating By Sector*</b>			
<b>Secured debt</b>		<b>Unsecured debt</b>	
<b>Industry sector</b>	<b>Average recovery rating</b>	<b>Industry sector</b>	<b>Average recovery rating</b>
Utilities, Energy, & Project Finance	1.07	Oil & Gas	3.93
Oil & Gas	1.85	Utilities, Energy, & Project Finance	3.97
Auto	1.88	Metals & Mining	4.10
Hotel, Gaming, & Leisure	2.04	Telecommunications	4.23
Aerospace & Defense	2.06	Hotel, Gaming, & Leisure	4.41
Chemicals	2.07	High Technology	4.57
Transportation	2.19	Transportation	4.64
Building Materials & Forest Products	2.20	Restaurants & Retail	4.72
Health Care	2.23	Consumer Products	4.74
Consumer Products	2.27	Chemicals	4.86
High Technology	2.27	Building Materials & Forest Products	4.88
Restaurants & Retail	2.27	Auto	4.89
Capital Goods	2.39	Media & Entertainment	4.90
Media & Entertainment	2.45	Aerospace & Defense	5.10
Metals & Mining	2.61	Capital Goods	5.14
Telecommunications	2.69	Health Care	5.29
Overall	2.02	Overall	4.61

The average secured recovery rating for the gaming sector (excluding lodging and leisure issues) was 2.09 (see table 7), which would indicate that lenders can expect substantial (70% to 90%) recovery of principal and pre-petition interest in the event of a payment default. This compares to the overall industrial average of 2.02 and median of 2.21. However, when analyzing secured gaming recovery ratings by priority of the collateral position, the average rating for first-lien debt was 1.48 (recovery in the 80% to 95% range--this represents the midpoints for recovery ratings '1' and '2'). The average rating for second- and third-lien obligations was substantially lower at 4.80 (recovery in the 10% to 30% range) because the recovery on these instruments is after the first-lien claims are satisfied.

**Table 7**

<b>Gaming Companies--Average Recovery Ratings</b>		
<b>Debt Type</b>	<b>Average recovery rating</b>	<b>Expected recovery</b>
<b>Secured debt</b>		
First lien	1.48	80%-95%¶
Second lien*	4.80	10%-30%
Total	2.09	70%-90%
<b>Unsecured debt</b>		
Senior unsecured	3.91	30%-50%
Subordinated	4.74	10%-30%
Total	4.25	30%-50%

\*Includes third lien. ¶Midpoints of recovery ratings '1' (90%-100%) and '2' (70%-90%). Note: Data as of Sept. 30, 2008.

The average unsecured gaming recovery rating was 4.25, which would indicate that lenders can expect average (30% to 50%) recovery. The overall industrial average was 4.61, with a median of 4.73. The average gaming senior unsecured debt and subordinated debt recovery ratings were 3.91 and 4.74, respectively, which, in most cases, reflect the presence of secured debt in the capital structure. The senior unsecured and total unsecured averages are skewed because they include the senior unsecured debt issued by MGM MIRAGE and its subsidiaries (all with a recovery rating of '3'), which accounts for about half of the sector's rated senior unsecured issues. In addition, MGM's senior unsecured obligations are the senior-most debt in the company's capital structure. Excluding MGM's issues, the average senior unsecured recovery rating was 4.76 and the total unsecured average was 4.65.

### **Emergence multiples and capital structure considerations**

#### ***EBITDA multiples.***

Standard & Poor's uses emergence multiples of 5x to 8x EBITDA to value gaming companies, with an average multiple of 6.7x. This compares with the 5x to 7x used for most industrial sectors. Our gaming multiples reflect the type and quality of a company's properties, its locations, and the diversity of its portfolio. We typically use 6.5x to 8.0x for traditional casinos and 6.0x to 6.5x for racinos. In addition, despite the current operating weakness in most gaming markets, our use of multiples at the higher end of the scale for an average industrial company reflects the generally favorable long-term prospects for the industry. Gaming remains a popular and accepted form of entertainment, and the highly regulated nature of the industry restricts the number of competitors in a given market.

Transaction multiples have been at the higher end or above our range of multiples in recent years. However, more challenging operating conditions lately, along with higher capital costs, support our more conservative estimates. Also, our recovery methodology generally assumes that a company experiences a payment default (i.e., EBITDA is less than or equal to the firm's fixed charges (interest expense, required amortization, and minimum maintenance capital expenditures)). This payment default assumption typically envisions a severe deterioration in the company's cash flow due to operating weakness, which would depress its emergence multiple.

#### ***Capital structure considerations.***

The capital structures of gaming companies also contribute to the relatively stronger recovery ratings, particularly for our rated secured issues. In general, the gaming industry is highly levered and, thus, it would take a less significant decline in EBITDA to generate a payment default compared to a less levered company. This level of EBITDA, combined with our emergence multiples, results in relatively higher levels of emergence enterprise value.

The presence of junior debt in the capital structures of our rated gaming universe has resulted in higher recoveries for the loans senior to these obligations because senior lenders would have a priority claim to the total enterprise value of a firm. Some 28 of our 37 gaming companies have such debt structures--11 with first- and second-lien debt, 15 with secured loans and one or more classes of unsecured borrowings, and two with senior unsecured and subordinated debt. The average recovery rating for the senior obligations was 1.82, with the junior loans averaging 4.98. For the remaining nine companies with only one class of secured debt, the average recovery rating was 2.05.

### **Recovery rating distribution**

The distribution of recovery ratings for the 82 secured gaming loans was fairly comparable to the overall industrial universe (see charts 1 and 2). The percentage of secured issues with recovery ratings in the '1+' to '2' categories was about the same for gaming companies (74%) as for all industrials (72%). However, based on dollar volume, the percentage of secured gaming issues in the top three categories (86%) was somewhat higher than the percentage of all industrial issues (78%).

Chart 1

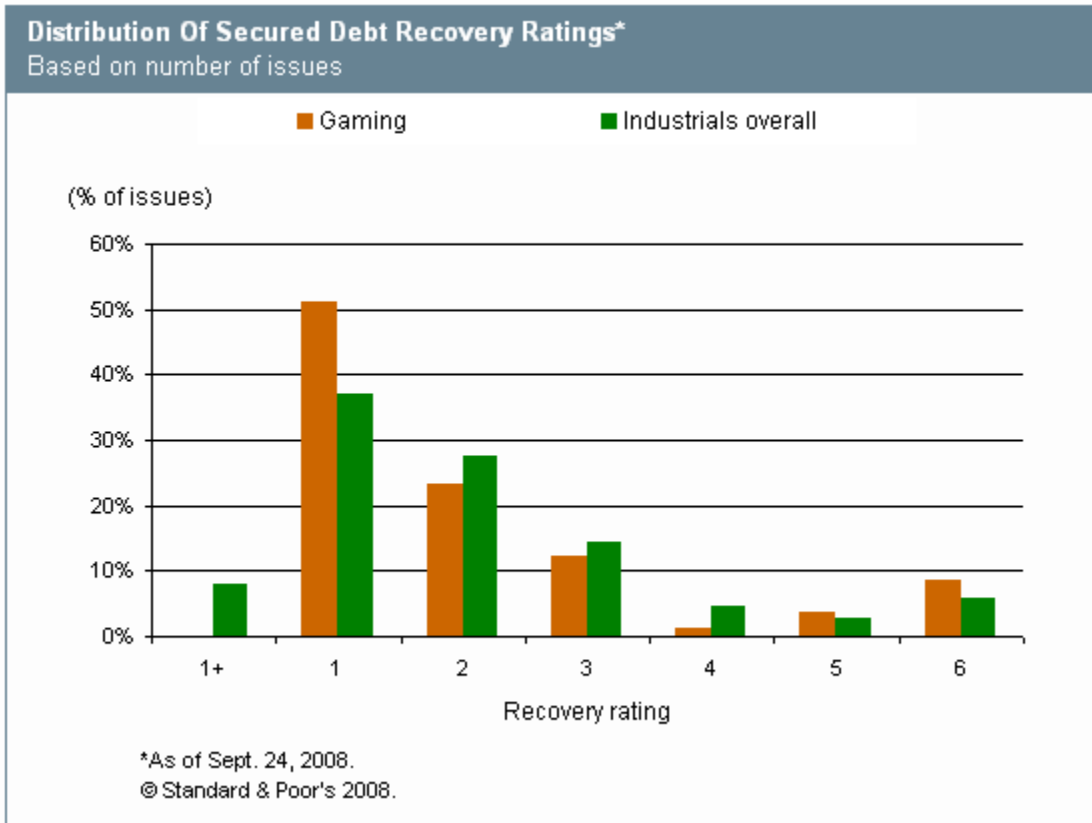
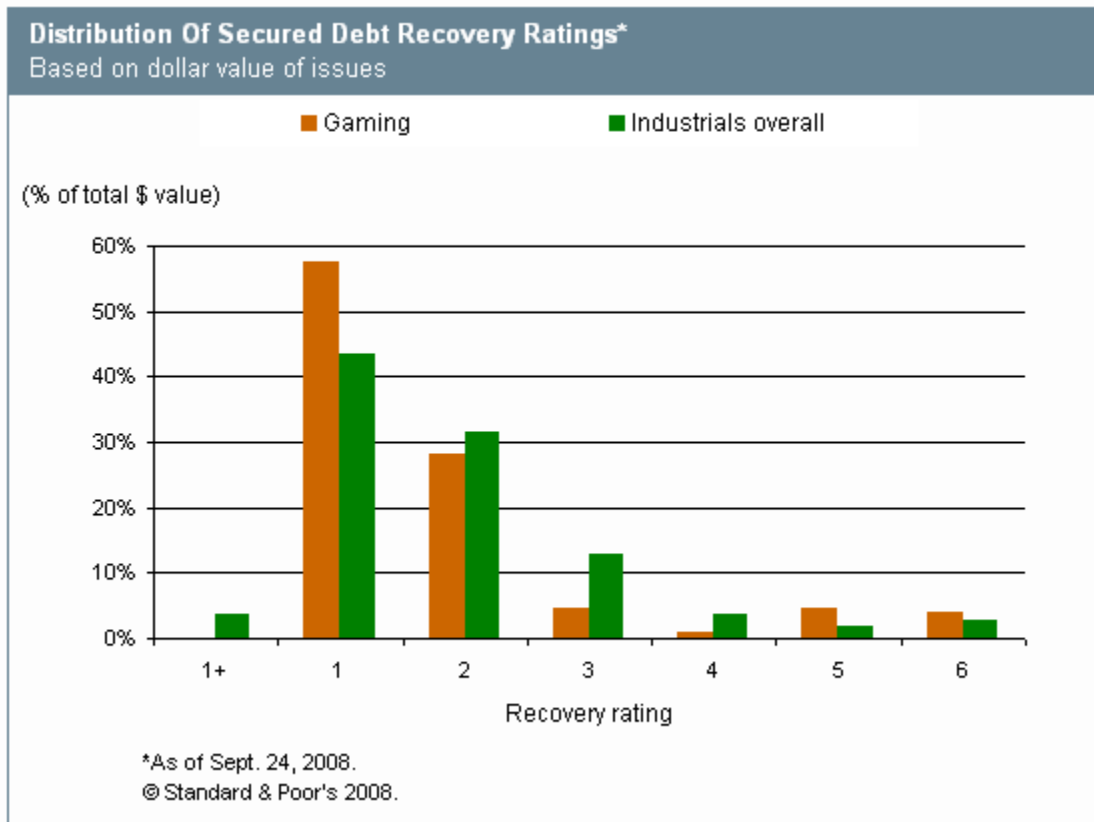


Chart 2



Of the 56 unsecured gaming issues, the largest groupings were around recovery ratings of '3' and '6' (see charts 3 and 4). The recovery rating of '3' accounted for 50% based on the number of gaming issues and 42% based on dollar value, while the recovery rating of '6' totaled 36% and 31%, respectively. The industrials average for the '3' recovery rating was 21% based on the number of issues and 24% based on dollar value. For the recovery rating of '6', overall industrials average about the same levels as gaming, at 38% based on issues and 36% based on dollar volume. As mentioned earlier, the large number of MGM senior unsecured debt issues with recovery ratings of '3' skews the gaming percentages in this grouping.

Chart 3

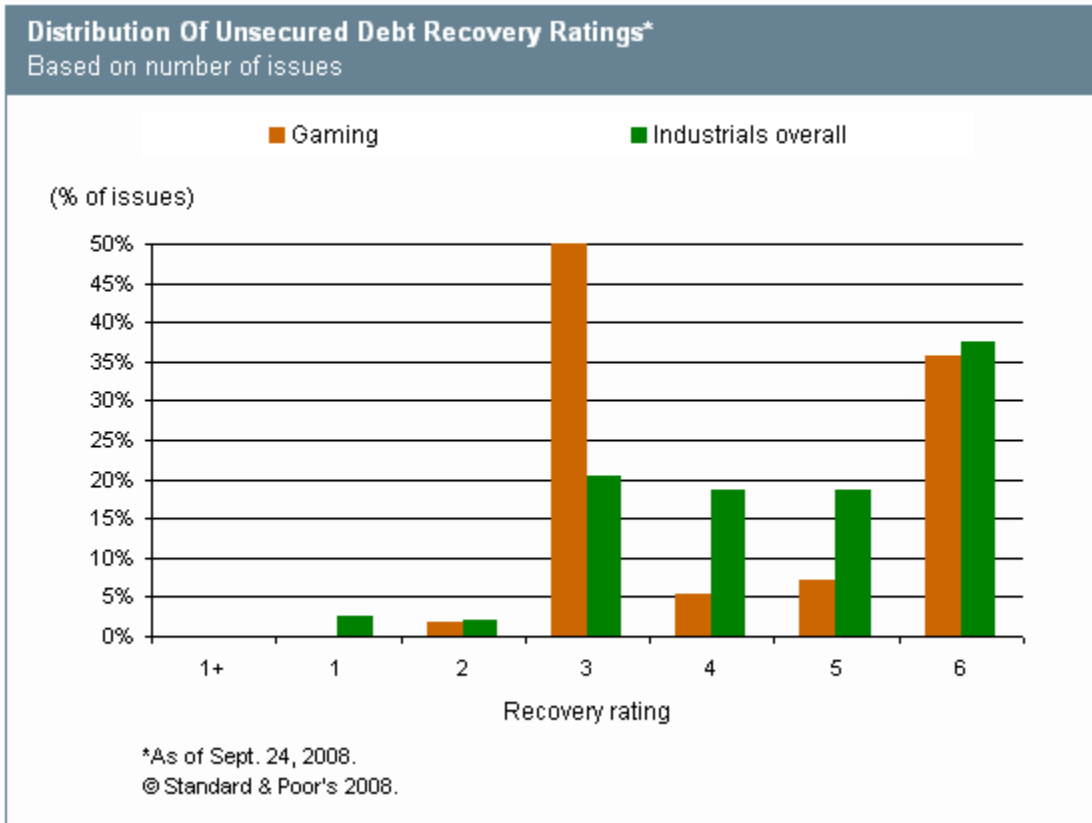
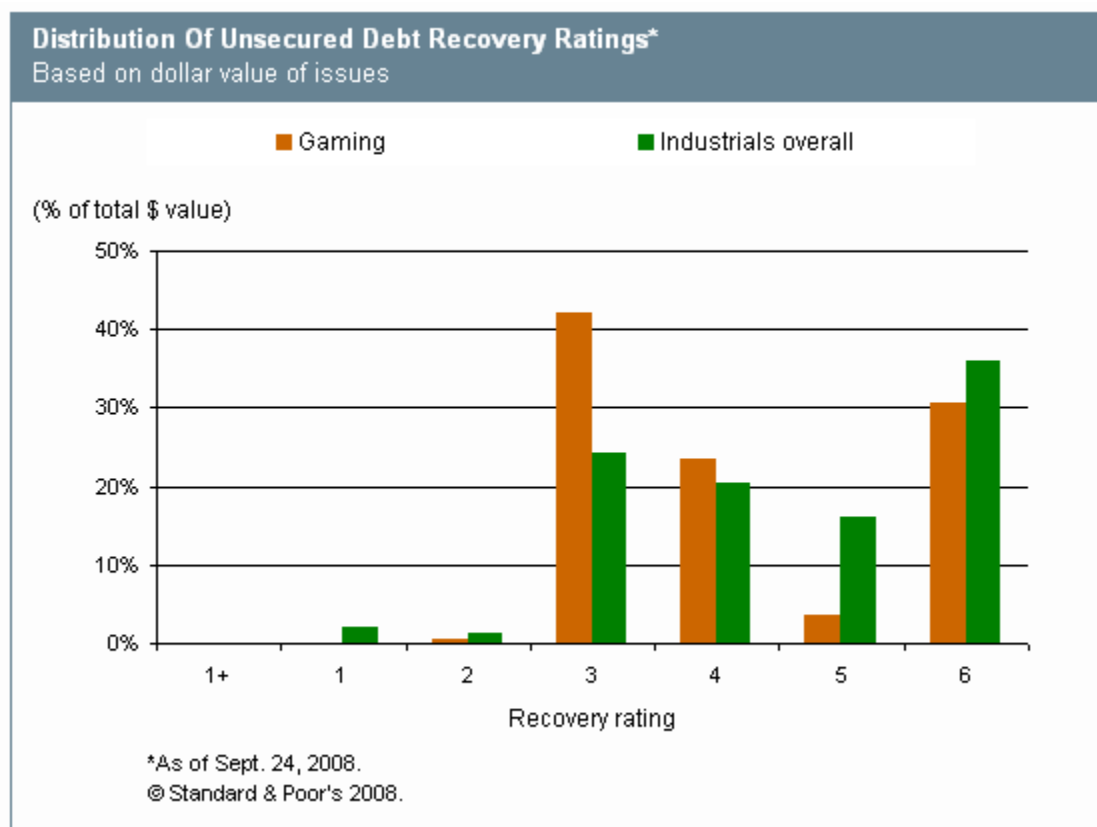


Chart 4



### Recovery prospects for the lowest rated credits

For the eight gaming companies with corporate credit ratings of 'B-' or in the 'CCC' category (see table 8) that have had recovery ratings assigned to their debt issues, recovery prospects are dependent on the kind of issues they hold in their respective capital structures. Most of these companies have both senior and junior debt. Thus, our recovery ratings on the senior obligations of these issuers are at the higher end of scale (primarily '1' and '2'), while the junior loans are rated at the lower end ('5' and '6').

Table 8

Recovery Ratings On Lower-Rated Gaming Credits			
Issuer	Corporate credit rating	Issue rating	Recovery rating
Fontainebleau Las Vegas Holdings LLC	B-/Watch Neg/--		
Secured first lien		B	2
Secured second lien		CCC	6
Gateway Casinos & Entertainment Inc.	B-/Negative/--		
Secured first lien		B+	1
Secured second lien		CCC+	5
MTR Gaming Group Inc.	B-/Negative/--		
Senior unsecured		B-	2
Subordinated		CCC	6
Station Casinos Inc.	B-/Negative/--		

**Table 8**

Recovery Ratings On Lower-Rated Gaming Credits(cont.)		
Secured	B+	1
Senior unsecured	B-	3
Subordinated	CCC	6
Majestic Star Casino LLC	CCC+/Negative/--	
Secured first lien	B	1
Secured second lien	B	1
Senior unsecured	CCC-	6
Black Gaming LLC	CCC/Negative/--	
Secured second lien	CCC	3
Subordinated	CC	6
Centaur LLC	CCC/Developing/--	
Secured first lien	CCC+	2
Secured second lien	CC	6
Mount Airy #1 LLC	CCC/Watch Neg/--	
Secured	CCC+/Watch Neg	2

Note: Ratings as of Sept. 30, 2008.

### Recovery ratings versus actual recoveries

Standard & Poor's Risk Solutions LossStats® database shows defaults on 54 gaming loans over the 1989 to 2004 period. The average recovery was 74% for first-lien secured loans and 69% for second-lien loans (see table 9). As discussed earlier, our average first-lien gaming recovery rating was 1.48, or an expected recovery in the 80% to 95% range (based on the midpoints of recovery ratings of '1' and '2'), and the second-lien average was 4.80, or an expected recovery of 10% to 30%. LossStats' average recovery for the senior unsecured loans was 93%, versus our average gaming recovery rating of 3.91, representing an expected 30% to 50% recovery, while the average subordinated debt recovery was 42%, contrasted by our gaming average of 4.74, representing a 10% to 30% recovery expectation.

**Table 9**

Gaming Companies--S&P LossStats Recovery				
Debt Type	S&P LossStats nominal recovery (all defaults)	S&P LossStats nominal recovery (bankruptcies only)	Average recovery rating	Expected recovery
<b>Secured debt</b>				
First lien	74%	71%	1.48	80%-95%¶
Second lien*	69%	69%	4.80	10%-30%
Total			2.09	
<b>Unsecured debt</b>				
Senior unsecured	93%	39%	3.91	30%-50%
Subordinated	42%	17%	4.74	10%-30%
Total			4.25	

\*Includes third lien. ¶Midpoints of recovery ratings '1' (90%-100%) and '2' (70%-90%). Note: Data as of Sept. 30, 2008.

We note that the LossStats data includes eight loans that defaulted, but were subsequently cured and recovered 100%. Excluding these loans, the first-lien recovery was 71%, senior unsecured 39%, and subordinated 17%. The

revised senior unsecured and subordinated debt recoveries are now more in line with our average gaming recovery rating expectation for the respective loan classes.

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