

Charlotte-Mecklenburg Hospital Authority (Carolinas HealthCare System), North Carolina; Joint Criteria; System

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Credit Profile		
US\$128.305 mil rev & rfdg rev bnds ser 2013A due 01/15/2039		
<i>Long Term Rating</i>	AA-/Stable	New
Charlotte Mecklenburg Hosp Auth		
<i>Unenhanced Rating</i>	AA-(SPUR)/Stable	Affirmed
Charlotte-Mecklenburg Hosp Auth		
<i>Long Term Rating</i>	AA-/Stable	Affirmed

Rationale

Standard & Poor's Ratings Services has assigned its 'AA-' long-term rating to the \$128.5 million series 2013A fixed-rate revenue and refunding bonds to be issued by the Charlotte-Mecklenburg Hospital Authority, N.C. Standard & Poor's has also affirmed its 'AA-' long-term rating and underlying ratings (SPURs) on the authority's previously issued bonds. The authority does business as Carolinas HealthCare System (CHS).

Three letters of credit (LOCs; 'AAA/A-1') from US Bank N.A. support the series 2005B, 2005C, and 2005D bonds. We based the long-term rating component on the application of joint criteria, which reflects the rating on US Bank (AA-/A-1+) and the 'AA-' SPUR on CHS. The short-term rating component reflects the 'A-1' short-term rating on US Bank. The LOCs supporting the series 2005B, 2005C, and 2005D bonds expire Feb. 17, 2016.

Supporting the series 2007B and 2007C bonds, which we rate 'AA-/A-1', are standby bond purchase agreements (SBPA) from JPMorgan Chase Bank N.A. The long-term rating component reflects the 'AA-' long-term rating on CHS, and the short-term rating component reflects the 'A-1' short-term rating on JPMorgan Chase Bank. The SBPAs supporting the series 2007B and 2007C bonds expire May 4, 2017.

Assured Guaranty Municipal Corp., formerly known as Financial Security Assurance Inc. insures the series 2007D, 2007E, 2007F, and 2007G bonds. In addition, three Dexia Credit Local SBPAs support the 2007D, 2007E, and 2007F bonds, while a Bank of America LOC supports the series 2007G bonds. The 'A-2' short-term rating on the series 2007D, 2007E, and 2007F bonds reflects liquidity support provided by Dexia Credit Local. The SBPAs supporting the series 2007D, 2007E, and 2007F bonds expire Sept. 18, 2017.

An LOC provided by Bank of America ('A/A-1') supports the series 2007G variable-rate demand bonds, which we rate 'AAA/A-1'. We based the long-term rating component on insurance from Assured Guaranty Municipal Corp., and the application of joint criteria between Bank of America ('A/A-1') and the 'AA-' SPUR on CHS. The short-term rating component reflects the 'A-1' short-term rating on Bank of America. The LOC expires Jan. 1, 2016.

An LOC provided by Wells Fargo Bank supports the series 2007H variable-rate demand bonds, which we rate 'AAA/A-1+'. We based the long-term rating component on the application of joint criteria reflecting the rating on Wells Fargo Bank (AA/A-1+) and the 'AA-' SPUR on CHS. The short-term rating component reflects the 'A-1+' short-term rating on Wells Fargo Bank. The LOC supporting the series 2007H bonds expires June 18, 2018..

The overall financial profile has improved steadily to healthy levels consistent with the 'AA-' rating, fully recovering from margin compression during 2008 and 2009. Operating results reached a peak in 2012, surpassing 2007 levels due to continued volume and revenue growth and cost controls, particularly labor, benefits, and supplies expenses. In March, CHS guaranteed the bonds of component unit Cleveland County HealthCare System (CCHS); the rating also reflects the CCHS debt currently guaranteed by CHS. In addition, the rating also reflects the additional new money debt from the series 2013A bonds. The additional debt represented by the series 2013A issuance will compress certain pro forma balance sheet ratios for at least the next few years; in particular, pro forma cash to debt will be a bit weak while the organization absorbs the additional debt. In our opinion, though pro forma debt service coverage was solid in fiscal 2012 due to the strong operating results, CHS' balance sheet has limited capacity for substantial future debt at the current rating. Management has indicated that it has no future debt plans beyond the series 2013A bonds.

Management intends to spend \$1.4 billion on capital between 2013 and 2017. Management indicates that CHS is able to accommodate the annual spending due to its operating cash flow levels and because the plan's focus is on revenue-enhancing projects. CHS has spent, on average, 1.9 times depreciation expense for the past four years, whereas management expects to spend at a rate of 1.1 times depreciation expense, which should help to grow the balance sheet from 2013 through 2017. Funding sources for the capital plan are cash from future operations (including American Recovery and Reinvestment Act funding), philanthropy, future monetization of office space, and bond proceeds from the upcoming series 2013A bonds.

In our view, additional positive rating factors include:

- Solid pro forma debt service coverage in 2012;
- Favorable balance sheet, with pro forma days' cash on hand as of Dec. 31, 2012, that is consistent with the rating;
- Maintenance of a significant business position within the states of North and South Carolina as the largest health care provider;
- An experienced management team that has a long record with the organization; and
- Robust population growth with very strong economies in the county and Charlotte, N.C.

Partly offsetting credit factors include CHS':

- Continued exposure to underlying variable-rate debt though the degree of the exposure has lessened in light of the 2009 restructuring; and
- Light pro forma cash-to-debt ratio in 2012.

The rating reflects the soon to be eliminated guarantee of \$35.4 million series 2004A and \$37.8 million series 2011A Cleveland County HealthCare System bonds.

CHS' unrestricted cash equates to 352% of \$727.9 million of puttable debt in the event of repurchase. However, notwithstanding favorable repayment provisions in the SBPAs and LOCs for the repurchased bonds, any substantial

repurchase of variable-rate debt could limit CHS' ability to spend on future capital needs due to the comprehensive nature of the five-year plan.

Beyond the series 2013A bonds, management does not plan to issue significant additional debt within the next several years. Management will use the series 2013A bond proceeds to refund the outstanding Cleveland County HealthCare System bonds that CHS currently guarantees, and fund \$50 million of various capital projects. Management expects to use future operating cash flows to strengthen the balance sheet further. We based the pro forma debt service calculation on CHS' maximum annual debt service (MADS) of \$115.3 million. CHS' pro forma debt structure will be 39% underlying variable-rate and 61% fixed rate, with a total of \$1.9 billion of pro forma long-term debt as of Dec. 31, 2012.

Upon closure of the series 2013A bonds, Cleveland County Health System (CCHS) will be a part of the obligated group, which includes CHS' primary enterprise and the foundation. A gross revenue pledge of the obligated group secures all bonds, and all ratios cited within this report refer to the obligated group, unless otherwise noted. We based the numbers and ratios cited for 2012 on unaudited numbers because the final audit is not yet available.

Outlook

The stable outlook reflects our assessment of CHS' very strong business position and strengthening overall financial profile. We also expect that management will likely sustain operating profitability at or near current levels of 3% to 4% operating margins and maintain overall financial flexibility in light of the capital spending program, with days' cash on hand no lower than 200, and cash to debt of at least 130%.

We could consider a positive rating action beyond the outlook period if CHS absorbs the debt and capital plan successfully, with a trend of coverage sustained at greater than 5x, and days' cash on hand and cash to debt sustained at greater than 250 days' and 200%, respectively. A negative outlook or lower rating during the next one to two years is unlikely due to the strength of the financial profile and business position. Should operating profitability or liquidity decrease to levels not commensurate with the current rating, with coverage sustained at levels less than 3.5x, or cash to debt lower than 130%, we could consider a negative outlook or rating change during the next two years.

Enterprise Profile

Organization

CHS is the larger of two health care systems serving the Charlotte region and offers area residents convenient access to all primary and secondary services, in addition to a broad tertiary and quaternary service mix, including its recognized strength in key specialties such as pediatrics, cardiology, orthopedics, and neurosciences. CHS' primary enterprise, including the addition of CCHS, consists of 13 hospitals (two tertiary and quaternary, three tertiary, and five acute-care hospitals with a total of 2,339 licensed beds, one behavioral health facility with 66 licensed beds, and two rehabilitation facilities with 169 licensed beds), four long-term care facilities with 482 licensed beds, and a large physician network of primary and specialty physicians and faculty at Carolinas Medical Center.

CHS' strategy is to broaden its geographic outreach through a network of nonobligated entities, including 29 hospitals and eight related nursing homes. These entities make up the component units and managed entities. The component units are separately included in the CHS' audit. CHS has its direct management expenses reimbursed and receives a network development fee of 7% to 11% of cash flow from these component units. The primary enterprise received roughly \$5 million in network development fees last year from the component units, which are treated as a net assets transfer and are not added back into CHS' income or debt service coverage.

Utilization

Overall combined group acute-care adjusted inpatient discharges increased to 276,306 in 2012 from 265,898 in 2011. The increase stems from growth at Carolinas Medical Center, continued expansion of CHS' physician network through recruitment, and programmatic growth associated with recent capital investments (CMC-Pineville expansion, Levine Cancer Institute, and outpatient Health Pavilions), all of which has contributed to greater downstream admissions and outpatient volume. Surgery volume for the acute-care facilities increased to 85,368 in 2012 from 84,777 in 2011. Management reports that CHS inpatient volume growth during 2012 outpaced that of other providers in the service area.

Market position and physician network

CHS' inpatient market share (including all facilities owned, leased, or managed) in the service area--consisting of the 34-county region--remained strong at 36.1%, with the balance shared by Winston-Salem-based Novant Health, which includes Forsyth Memorial Hospital, as well as by individual community hospitals that have strong positions in their home counties. CHS has strong market share in key service lines, which we view as an institutional strength. Competition comes largely from the 531-licensed bed Novant Health Presbyterian Medical Center and its affiliates, which have a market share of 22.3% in CHS' primary service area compared with CHS' 49.5%. CHS' market share has grown since the mid-1990s at the expense of providers in the primary service area. Managed care accounts for approximately 40% of revenue of CHS contracts with all substantive managed-care payors in the region. CHS competitors have experienced some payor-mix erosion because CHS' Medicaid and uncompensated care inpatient market share has decreased in recent years.

Large multispecialty and single-specialty medical groups characterize the Charlotte region. CHS' physician network remains a core business strength, in our opinion, with 1,307 community based and faculty physicians, generating roughly 4.4 million visits annually. Carolinas Medical Center is one of five academic medical center teaching hospitals designated by the State of North Carolina, with approximately 287 medical residents in 14 specialties.

County relationship

Population growth in the county and metropolitan region remains healthy, with a regional growth rate of more than 2% annually, which is projected to continue through at least the next five years. Mecklenburg County historically funded the operating deficits of Carolinas Medical Center's outpatient indigent care clinics, as well as other indigent care provided to Mecklenburg County residents. The commitment, including to behavioral health, amounted to \$37.7 million annually. CHS settled its litigation with the county regarding the early termination of the contracts, and as stipulated by the settlement, ownership of CMC-Randolph real estate will be turned over to CHS in 2013, and the county will no longer pay CHS the \$37.7 million in funds annually.

Management

The management team has been in place for more than 15 years, which we believe promotes the organization's stability. Senior management has focused on a strategy of growth, clinical quality, geographic expansion, and programmatic growth, and, as a result, has produced consistent volume and revenue growth. CHS has become the market leader due to the successful execution of its strategy. Its large scale and management expertise has allowed CHS to produce strong results across the total enterprise.

In our view, CHS' approach to debt the past few years has moderated with modest debt issuances following a fairly aggressive 2007 issuance that doubled its long-term debt load as it brought CMC-Northeast into the organization. Though the income statement has absorbed the additional debt effectively at the current rating, the balance sheet has not yet recovered its former strength due to the size of the debt load. We expect that management's growth strategy, which has been producing increasing volumes and revenue, will help strengthen the balance sheet in the next few years.

Financial Profile

Change in accounting for bad debt

In accordance with the publication of our article, "New Bad Debt Accounting Rules Will Alter Some U.S. Not-for-Profit Health Care Ratios But Won't Affect Ratings," on Jan. 19, 2012, we noted a change in our analysis of CHS' 2012 audit, including the adoption of Financial Accounting Standards Board (FASB) Accounting Standards Update 2011-07 in 2012, but not in prior periods. Since CHS' audit is done according to the GASB standard, bad debt expense was already treated not as an expense, but as a deduction from net patient revenue, which reflects the new industry accounting treatment for audits done according to the FASB standard. Before the accounting change, Standard & Poor's adjusted net patient revenue and expenses to reflect the historical FASB presentation. The new industry accounting treatment means that CHS' fiscal 2012 and subsequent financial statistics are not directly comparable with the results for 2011 and prior years, and are also not directly comparable with the 2011 median ratios. For an explanation of how each financial measure is affected by the change in accounting for bad debt, including the direction and size of the change, please see the previously cited article.

Income statement

Profitability for the obligated group has improved steadily since 2008, rebounding to stronger than prerecession levels due to volume and revenue growth, as well as continued expense controls. CHS' cost-control program is highlighted by sharply controlled labor, pharmacy, and supplies expenses that increased just marginally during the past few years, compared with a national average annual percentage increase in the low teens. Pension expense increased in 2012 due to the growth in plan participants and the ongoing actuarial smoothing of investment gains and losses incurred since 2008. We view the increasing profitability as a source of stability at the current rating, and a key factor in CHS' ability to absorb the series 2013A bonds. Operating income increased to \$149.8 million (3.3% margin) in 2012 from \$134.4 million (3.4% margin) in 2011. When normalized for the industry change in accounting for bad debt, the operating margin increased slightly in 2012 to 3.6%. Management expects to earn an estimated \$62 million from operations in 2013.

Excess income decreased in 2012 despite greater operating cash flow, due to a dip in realized investment returns, to \$244.6 million (5.7% margin) from \$307.8 million (7.5% margin). When normalized for the bad debt accounting change, the excess margin for 2012 also decreased to 5.3%. Excess (net) income excludes \$140.2 million of unrealized gains in 2012. Pro forma debt service coverage was adequate for the rating at 4.6x in 2012, compared with 4.8x in 2011. The pro forma debt burden was consistent with the rating at 2.7% of operating revenue in 2012.

Balance sheet

CHS' core strength has historically been its balance sheet. Since 2009, favorable investment returns, sound operations, a continued low balance of accounts receivable, and improved revenue-cycle management have increased cash on an absolute basis. In addition, CHS contributed a large amount, \$70.3 million, to its pension plan in 2012 compared with a contribution of \$61.8 million in 2011.

Unrestricted reserves increased to \$2.6 billion as of Dec. 31, 2012, compared with \$2.2 billion on Dec. 31, 2011, due to favorable investment returns and greater operating cash flow. Days' cash on hand increased slightly to 234 days' cash compared with 226 days (under the old bad debt accounting method) during the same period, as the expense base increased. Under the new bad debt accounting method, days' cash on hand at Dec. 31, 2012, totaled 245 days'. Pro forma unrestricted reserves include the unrestricted cash and investments of CCHS, and equaled \$2.7 billion, equal to 258 days' cash on Dec. 31, 2012 (under the new bad debt accounting method). Pro forma debt includes the series 2013A bonds, as well as a capital lease of \$15.5 million and a note payable of \$49.1 million, equal to \$1.9 billion on Dec. 31, 2012. Pro forma unrestricted cash to debt was, in our opinion, a bit weak for the rating at 144% as of Dec. 31, 2012, due to the series 2013A issuance, while we considered pro forma leverage moderate for the rating at 34% as of Dec. 31, 2012.

CHS' asset allocation is fairly balanced, in our opinion, at 27% domestic equity, 23% international equity, 37% fixed income, 3% cash, and 10% alternative investments. CHS' unfunded private equity commitments as of Dec. 31, 2012, were, in our view, minimal at \$16.4 million.

Contingent liabilities

In May 2013, CHS plans to enter into three direct purchase agreements with SunTrust Bank, PNC Bank, and Banc of America Public Capital Group, respectively, to restructure the outstanding series 2007D, 2007F, and 2007G bonds by changing the mode from standby bond purchase agreement (SBPA) and letter-of-credit (LOC) supported to variable rate with a seven-year term for the series 2007G bonds and 10 year terms for the 2007D and 2007F series of bonds. Under the terms of the agreement, each bank will hold the bonds for either seven or 10 years, at which time, unless extended, the bank may remarket the bonds or, if they cannot be remarketed, CHS may repurchase some or all of the bonds. Covenants for the CHS direct purchase agreements include the obligated group's maintenance of a defined level of debt service coverage and unrestricted days' cash on hand. An event of default could occur, if not waived by the banks, should CHS breach any of the aforementioned covenants following a 30-day cure period. In the event of default, the banks have the right to accelerate the bonds, at which time CHS would have 180 days to repurchase some or all of the bonds from the bank, or to remarket the bonds.

In 2006, CHS entered into a floating to fixed rate swap on the series 2005B-D (uninsured) with Bank of America (A-) for an initial notional amount of \$93.9 million. In 2007, CHS entered into several floating to fixed-rate swaps on the

series 2007B-H bonds (insured) and series 2007L bonds (uninsured) with Wells Fargo Bank, Citigroup, and Bank of America for a total initial notional amount of \$709.1 million. The swap on the series 2007L bonds was terminated in 2009. The current total notional amount was \$727.9 million as of Dec. 31, 2012. Despite a significant mark to market of negative \$267.9 million as of Dec. 31, 2012, CHS has not had to post any collateral related to its swap portfolio because the collateral posting requirement for insured swaps is based on a simultaneous downgrade of both the insurers (Assured Guaranty Municipal Corp. or Ambac) to 'BBB+' and CHS to 'A'.

Charlotte Mecklenburg Hospital Authority (doing business as Carolinas HealthCare System) Selected Financial Statistics

	--Fiscal year ended Dec. 31--					AA- rated health care system medians
	2012*	2012§	2011	2010	2009	2011
Financial performance						
Net patient revenue (\$000s)	3,732,730	4,089,128	3,508,898	3,230,850	3,020,790	1,828,650
Total operating revenue (\$000s)	4,181,558	4,537,956	3,931,471	3,578,363	3,299,588	MNR
Total operating expenses (\$000s)	4,031,787	4,388,185	3,797,056	3,470,785	3,224,893	MNR
Operating income (\$000s)	149,771	149,771	134,415	107,578	74,695	MNR
Operating margin (%)	3.58	3.30	3.42	3.01	2.26	4.75
Net nonoperating income (\$000s)	94,794	94,794	173,400	74,968	(19,822)	MNR
Excess income (\$000s)	244,565	244,565	307,815	182,546	54,873	MNR
Excess margin (%)	5.72	5.28	7.50	5.00	1.67	5.74
Operating EBIDA margin (%)	10.48	9.66	9.78	9.57	9.68	10.75
EBIDA margin (%)	12.75	11.75	13.59	11.42	9.13	11.77
Net available for debt service (\$000s)	532,976	532,976	557,850	417,266	299,559	245,469
Pro forma maximum annual debt service (\$000s)	115,252	115,252	115,252	115,252	115,252	MNR
Pro forma maximum annual debt service coverage (x)	4.62	4.62	4.84	3.62	2.60	4.90
Pro forma operating lease-adjusted coverage (x)	N/A	N/A	N/A	N/A	N/A	3.50
Liquidity and financial flexibility						
Unrestricted cash and investments (\$000s)	2,561,580	2,561,580	2,233,594	2,197,270	1,971,487	1,264,323
Unrestricted days' cash on hand	244.5	233.7	225.6	243.4	236.4	229.50
Unrestricted cash/total long-term debt (%)	152.1	152.1	138.3	148.1	131.5	164.10
Average age of plant (years)	6.9	7.5	8.3	9.4	8.4	9.80
Capital expenditures/depreciation and amortization (%)	183.6	183.6	180.2	170.4	210.2	151.70
Debt and liabilities						
Total long-term debt (\$000s)	1,684,394	1,684,394	1,615,091	1,483,796	1,498,728	MNR
Long-term debt/capitalization (%)	31.9	31.9	35.3	32.8	37.5	33.10
Contingent liabilities (\$000s)	727,990	727,990	732,780	N/A	N/A	MNR
Contingent liabilities/total long-term debt (%)	43.2	43.2	45.4	N/A	N/A	MNR

Charlotte Mecklenburg Hospital Authority (doing business as Carolinas HealthCare System) Selected Financial Statistics (cont.)

Pro forma debt burden (%)	2.69	2.48	2.81	3.15	3.51	2.40
Defined benefit plan funded status (%)	75.24	75.24	80.05	86.47	90.84	74.30
Pro forma ratios						
Unrestricted days' cash on hand	258.0	N/A	N/A	N/A	N/A	N/A
Unrestricted cash/total long-term debt (%)	144.30	N/A	N/A	N/A	N/A	N/A
Long-term debt/capitalization (%)	34.21	N/A	N/A	N/A	N/A	N/A

*New Accounting method applied for 12-month interim results ended Dec. 31. §Old accounting method applied for 12-month interim results ended Dec. 31. N/A--Not applicable. MNR--Media not reported.

Related Criteria And Research

- USPF Criteria: Contingent Liquidity Risks, March 5, 2012
- USPF Criteria: Not-For-Profit Health Care, June 14, 2007
- USPF Criteria: Municipal Applications For Joint Support Criteria, June 25, 2007
- USPF Criteria: Bank Liquidity Facilities, June 22, 2007
- USPF Criteria: Standby Bond Purchase Agreement Automatic Termination Events, April 11, 2008

Ratings Detail (As Of April 19, 2013)**Charlotte Mecklenburg Hosp Auth**

<i>Unenhanced Rating</i>	AA-(SPUR)/Stable	Affirmed
<i>Long Term Rating</i>	AAA/A-1+	Affirmed

Charlotte Mecklenburg Hosp Auth Series 2007C

<i>Long Term Rating</i>	AA-/A-1/Stable	Affirmed
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Charlotte Mecklenburg Hosp Auth Series 2007D,E&F

<i>Unenhanced Rating</i>	AA-(SPUR)/Stable	Affirmed
<i>Long Term Rating</i>	AA-/A-2/Stable	Affirmed

Charlotte Mecklenburg Hosp Auth Series 2007H

<i>Unenhanced Rating</i>	AA-(SPUR)/Stable	Affirmed
<i>Long Term Rating</i>	AAA/A-1+	Affirmed

Charlotte-Mecklenburg Hosp Auth

<i>Unenhanced Rating</i>	AA-(SPUR)/Stable	Affirmed
<i>Long Term Rating</i>	AAA/A-1+	Affirmed

Charlotte-Mecklenburg Hosp Auth Series 2007B

<i>Long Term Rating</i>	AA-/A-1/Stable	Affirmed
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Charlotte-Mecklenburg Hosp Auth Series 2007G

<i>Unenhanced Rating</i>	AA-(SPUR)/Stable	Affirmed
<i>Long Term Rating</i>	AAA/A-1	Affirmed

Ratings Detail (As Of April 19, 2013) (cont.)

Many issues are enhanced by bond insurance.

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