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## Klabin S.A.

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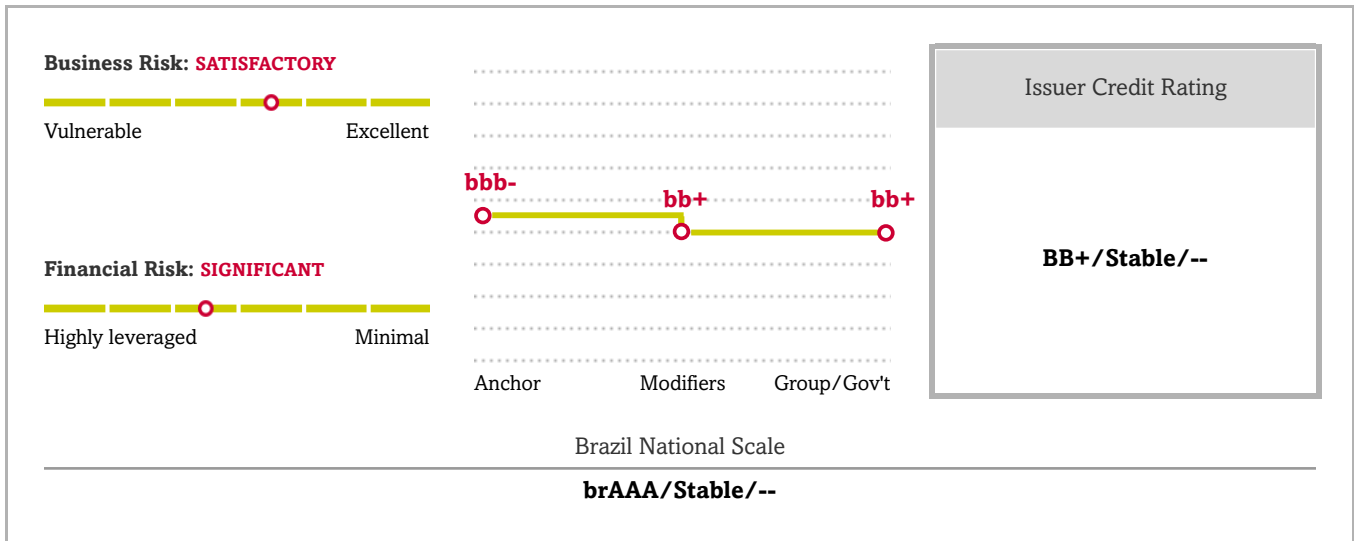
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# Klabin S.A.



## Credit Highlights

### Overview

Key strengths	Key risks
Leading position in Brazilian paper packaging production.	Exposure to cyclicality in the forest and paper products industry, which has volatile input and selling prices.
Ability to change sales mix and manage export volumes based on market demand.	Lack of clear leverage targets during investment cycles.
Longstanding relationships with clients and vertical integration.	
Strong liquidity position.	

**Klabin's ability to change sales mix towards paper and packaging compensate for persistently weaker pulp prices.** Since April 2019, the U.S.-China trade war, lower margins from paper producers, high inventories, and weak demand in Europe have significantly driven down pulp prices. Although we believe prices have likely bottomed out given that they have reached levels below the cash cost of less efficient producers, the still high inventory levels and the global economy deceleration risks point to a slow recovery next year, with average prices about 5%-10% lower than 2019. In Klabin's case, however, we expect that better paper and packaging results and higher pulp sales volume should mitigate the low pulp prices and result in slightly higher EBITDA in 2020.

**The new investment cycle should weaken cash-flow generation and increase leverage in 2020.** Klabin expects to spend R\$9.1 billion in capital expenditures (capex) between 2019 and 2023 related to its new investment phase (Puma II: construction of two new paper machines capable of adding 920,000 tons to the company's capacity). We believe that investments will peak in 2020, resulting in negative free operating cash flow (FOCF) and net debt to EBITDA above 4.0x that year. However, Klabin's investments for this cycle are flexible, and we believe the company would have the ability to postpone the second phase of the investment under very adverse industry conditions. We view this flexibility as a positive factor given the current challenging pulp conditions that could pressure the company's margins and elevate leverage metrics next year.

**Higher volumes should push debt back down in 2021.** As the successful ramp-up of the first machine of the Puma II project is completed, we expect debt metrics to drop. Although we expect prices to start rising in 2020, the entry of about 450,000 thousand tons of new capacity should also boost EBITDA generation in 2021. We expect FOCF to return to positive values and net debt to EBITDA below 4.0x.

### Outlook: Stable

The stable outlook on Klabin reflects our view that although the company will have higher leverage metrics in 2019 and 2020 due to the investment cycle, we expect the company to be able to maintain net debt to EBITDA of about 4.0x in the next 12 months. In our base case, we consider a gradual rebound in pulp prices, a still weak local currency exchange rate, and higher volumes from the ramp-up of Puma II starting in 2021.

### Downside scenario

We would downgrade Klabin in the next 12 to 18 months if leverage metrics significantly deviate from our current expectations, with net debt to EBITDA persistently above 4.0x and funds from operations [FFO] to debt below 12%. This could, for example, follow a scenario of pulp prices at (or below) \$500 per ton for 2020 and 2021 or a more aggressive growth strategy. We could also downgrade the company if its share of domestic business increases, limiting our view of the maximum differentiation between Klabin and the sovereign ratings in the event of a sovereign downgrade.

### Upside scenario

A higher rating is currently limited by the company's leverage and risk tolerance to leverage peaks, which, in our view, is greater than that of its investment-grade peers. For an upgrade, we would expect Klabin's financial risk profile to strengthen consistently. We would also need to see that Klabin has clear and sustainable financial policies supporting conservative leverage (net debt to EBITDA below 3x and FFO to debt above 30%) through the investment cycle.

## Our Base-Case Scenario

Assumptions	Key Metrics				
<ul style="list-style-type: none"> <li>Brazil's GDP growth of 1.0% in 2019, 2.0% in 2019 and 2.2% in 2021, with average exchange rates of R\$3.94 per \$1 in 2019, R\$4.11 per \$1 in 2020, and R\$4.16 per \$1 in 2021, somewhat mitigating lower pulp prices.</li> <li>Annual pulp production around 1.4 million tons (mt) and 1.5 mt this year and next, respectively.</li> <li>Average bleached eucalyptus kraft pulp (BEKP) listing in Europe at \$825 per ton in 2019, \$800 in</li> </ul>					
		<b>2018A</b>	<b>2019E</b>	<b>2020E</b>	<b>2021E</b>
	EBITDA margin (%)	40.7	36-39	37-40	39-42
	FFO to Debt (%)	22.7	15-18	17-19	21-23
FOCF (bil. R\$)	1.8	0.4-0.8	(1.7)-(1.4)	0.5-0.8	
Debt/EBITDA (x)	3.2	3.6-4.1	3.8-4.3	3.4-3.7	

2020, and \$850 in 2021, compared with \$1035 in 2018. We apply up to 35% discount in listed prices.

- Increasing paper and packaging prices according to inflation and Brazilian real depreciation.
- Expected cash cost per ton of products sold of R\$1,550-R\$1,650 in 2019 and 2020 from R\$1,540 in 2018, following inflation and the depreciated real.
- Annual capex of about R\$2.5 billion in 2019, R\$4.7 billion in 2020, and R\$3.15 billion in 2021, compared with R\$1 billion in 2018. The capex relates to investments in the Puma II project.
- Dividends distribution of about R\$850 million in 2019 and R\$600 million-R\$700 million in 2020 and 2021.

### Base-case projections

*Downside risks include lower-than-expected pulp prices.* A negative outcome from the U.S.-China trade war or still weak economic rebound in Brazil could result in lower demand for pulp and paper products, which, along with the already low pulp prices could create additional pressure for the company's cash flow generation and consequently leverage metrics.

## Company Description

Klabin is one of the largest Brazilian pulp and paper producers, currently focused on several forest products, and is the leading producer and exporter of paper packaging in the country. The company operates 19 plants in Brazil and one in Argentina. It owns 431,000 hectares of land with 248,000 hectares (ha) with planted forests (out of which 156,000 ha are destined for long fiber and 92,000 for short fiber), enough to supply its current production. Klabin's business units include forestry (wood planted from pine and eucalyptus), paper (coated boards, commoditized kraftliner, and recycled paper), market pulp (hardwood, softwood, and fluff), and packaging (industrial bags and corrugated boxes).

## Business Risk: Satisfactory

Our view of Klabin's business risk profile reflects the company's solid market position in the paper and packaging segments and its longstanding relationships with clients. The vertically integrated structure also allows the company to benefit from operational efficiencies that translate to better margins when compared to international peers.

Despite these strengths, the volatile nature of the cyclical forest and paper products industry constrains the company's business. The company does manage to somewhat offset volatility through its capacity to increase exports or change its diverse mix of products sold based on what is more profitable.

Although we believe Brazil's paper and packaging segment is a very fragmented and competitive market, Klabin has a leading market share of about 40%-50% in kraftliner, paperboard, and industrial bags. In this segment, we believe that longstanding relationships and the resilient nature of end markets (mainly focused on food and consumer goods) mitigates client concentration risk. In addition, Klabin's access to fast growing and high quality fiber gives it an advantage over international players in the paperboard and kraftliner markets. Domestically, the company's higher quality and better product mix mainly drive its leading position.

### Peer comparison

We divided the peer analysis by the two main sectors in which Klabin operates: forest products and packaging and containers.

In the forest products segment, we choose regional companies as Klabin's peers because their costs are affected by the same climate conditions, and they benefit from access to superior natural resources.

Compared with peers, although it has a smaller capacity than Suzano S.A. (the company resulting from the merger of Suzano Papel e Celulose S.A. and Fibria S.A), CMPC, and Celulosa Arauco y Constitucion, Klabin posts stable and high margins (mainly when compared with non-Brazilian companies) thanks to its strong presence in resilient end markets (both regionally and globally) and its self-sufficient and integrated production lines towards the paper and packaging sectors, which also grants it a more diversified range of products.

Regarding packaging and containers, Klabin ranks behind peers in terms of geographic diversification and size of production and revenue base. However, Klabin's integrated and self-sufficiency production lines again help boost its efficiency and margins.

**Table 1**

<b>Klabin S.A. -- Peer Comparison</b>					
<b>Industry Sector: Paper/Forest Products</b>					
	<b>Klabin S.A.</b>	<b>Celulosa Arauco y Constitucion S.A.</b>	<b>Empresas CMPC S.A.</b>	<b>Suzano S.A.</b>	<b>WestRock Company</b>
Ratings as of Dec. 18, 2019	BB+/Stable/--	BBB-/Negative/--	(BBB-)/(Stable)/--	BBB-/Negative/--	BBB/Negative/A-2
	<b>--Fiscal year ended Dec. 31, 2018--</b>	<b>--Fiscal year ended Dec. 31, 2018--</b>	<b>--Fiscal year ended Dec. 31, 2018--</b>	<b>--Fiscal year ended Dec. 31, 2018--</b>	<b>--Fiscal year ended Sep. 30, 2018--</b>
<b>(Mil. R\$)</b>					
Revenue	10,016.5	23,053.1	24,290.5	13,437.3	65,166.6
EBITDA	4,073.5	7,109.9	7,106.6	6,913.1	11,676.7
Funds from operations (FFO)	2,981.3	6,329.8	5,539.0	5,737.4	10,512.9
Interest expense	1,209.6	744.7	894.7	1,274.2	1,341.1
Cash interest paid	1,092.1	730.7	683.2	848.5	1,303.5
Cash flow from operations	2,897.6	4,937.2	3,369.8	5,232.8	10,033.1
Capital expenditure	1,096.3	3,412.6	1,141.8	2,414.4	3,968.4
Free operating cash flow (FOCF)	1,801.2	1,524.6	2,228.1	2,818.5	6,064.7

**Table 1**

<b>Klabin S.A. -- Peer Comparison (cont.)</b>					
Discretionary cash flow (DCF)	961.2	528.0	1,767.5	2,616.8	3,386.4
Cash and short-term investments	7,047.2	4,165.3	3,789.6	25,486.0	2,548.2
Debt	13,146.7	13,772.0	12,174.5	12,609.1	25,570.0
Equity	6,533.2	28,411.5	31,915.2	12,025.9	45,964.9
<b>Adjusted ratios</b>					
EBITDA margin (%)	40.7	30.8	29.3	51.4	17.9
Return on capital (%)	16.8	13.2	11.9	24.1	8.5
EBITDA interest coverage (x)	3.4	9.5	7.9	5.4	8.7
FFO cash interest coverage (x)	3.7	9.7	9.1	7.8	9.1
Debt/EBITDA (x)	3.2	1.9	1.7	1.8	2.2
FFO/debt (%)	22.7	46.0	45.5	45.5	41.1
Cash flow from operations/debt (%)	22.0	35.8	27.7	41.5	39.2
FOCF/debt (%)	13.7	11.1	18.3	22.4	23.7
DCF/debt (%)	7.3	3.8	14.5	20.8	13.2

## Financial Risk: Significant

The recent decrease of international pulp prices, combined with the expected higher capex related to additional Kraftliner machines, have changed the previous downward trend of Klabin's leverage metrics of the past three years. While lower pulp prices have hampered margins, Klabin has been also issuing new debt to fund its recently announced new investment phase. Given that, we expect net debt to EBITDA to be about 4.0x in 2019 and 2020.

The investment plan involves constructing two new paper machines, with production of integrated pulp, in the same industrial plant where Puma I is located. The company announced a total cost of R\$9.1 billion and will execute the investments in two phases:

- In the first stage, the company will build a fiber line for producing unbleached pulp, integrated in a Kraftliner and White Kraftliner paper machine that's able to produce 450,000 tons per year. The construction began in the first semester of 2019 and the company expects it to be finished in the second quarter of 2021. We estimate capex of about R\$1.5 billion in 2019 and about R\$3.8 billion in 2020. We expect R\$400 million-R\$500 million of additional EBITDA related to this phase to contribute to funding the planned investment spending from 2021 onwards.
- The second stage involves constructing a complementary fiber line for producing unbleached pulp integrated in a Kraftliner paper machine, with the option to change for coated boards. The second machine is expected to begin operating in the second quarter of 2023 and could increase Klabin's production by 470,000 tons per year. The company plans to begin investments in 2021 and we estimate that the potential EBITDA generation from the second stage is about R\$500 million-R\$600 million per year.

In our view, the successful ramp-up of the Puma II project could improve business strength and boost cash flow to support expected deleverage, as well as reduce cash flow volatility that's inherent to the pulp sector.

## Financial summary

Table 2

Klabin S.A. -- Financial Summary					
Industry Sector: Paper/Forest Products					
(Mil. R\$)	--Fiscal year ended Dec. 31--				
	2018	2017	2016	2015	2014
Revenue	10,016.5	8,373.4	7,090.8	5,687.6	4,893.9
EBITDA	4,073.5	2,689.7	2,216.0	1,917.9	1,642.5
Funds from operations (FFO)	2,981.3	1,681.2	1,106.5	838.9	1,175.4
Interest expense	1,209.6	1,162.3	1,283.0	1,329.3	669.7
Cash interest paid	1,092.1	1,008.4	1,109.5	1,079.0	467.1
Cash flow from operations	2,897.6	2,459.7	1,119.8	1,485.6	1,729.4
Capital expenditure	1,096.3	925.3	2,436.0	4,313.2	2,871.4
Free operating cash flow (FOCF)	1,801.2	1,534.4	(1,316.2)	(2,827.7)	(1,142.0)
Discretionary cash flow (DCF)	961.2	1,015.9	(1,787.9)	(3,238.3)	(1,479.8)
Cash and short-term investments	7,047.2	8,271.6	6,464.0	5,610.9	5,743.4
Gross available cash	7,047.2	8,271.6	6,464.0	5,610.9	5,743.4
Debt	13,146.7	11,966.2	12,964.6	13,274.0	6,120.6
Equity	6,533.2	7,234.2	6,664.7	4,916.7	6,618.4
<b>Adjusted ratios</b>					
EBITDA margin (%)	40.7	32.1	31.3	33.7	33.6
Return on capital (%)	16.8	11.3	11.7	14.9	19.4
EBITDA interest coverage (x)	3.4	2.3	1.7	1.4	2.5
FFO cash interest coverage (x)	3.7	2.7	2.0	1.8	3.5
Debt/EBITDA (x)	3.2	4.4	5.9	6.9	3.7
FFO/debt (%)	22.7	14.0	8.5	6.3	19.2
Cash flow from operations/debt (%)	22.0	20.6	8.6	11.2	28.3
FOCF/debt (%)	13.7	12.8	(10.2)	(21.3)	(18.7)
DCF/debt (%)	7.3	8.5	(13.8)	(24.4)	(24.2)

## Liquidity: Strong

We view Klabin's liquidity as strong. We expect its cash sources to exceed uses by more than 100% in the next 12 months. We believe that the company's very large cash balance of R\$12.1 billion as of September gives it financial flexibility for unexpected downturns and to deal with the investment phase started this year. In addition, Klabin isn't subject to financial covenants on its debt and enjoys well-established, solid relationships with banks.

Principal Liquidity Sources	Principal Liquidity Uses

- |                                                                                                                                                                                                                                                      |                                                                                                                                                                                                                                                                                     |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <ul style="list-style-type: none"> <li>• Cash reserves of R\$12.1 billion as of September 2019;</li> <li>• Undrawn credit facility of about R\$2 billion; and</li> <li>• Annual FFO near R\$3.3 billion in 2019 and R\$4 billion in 2020.</li> </ul> | <ul style="list-style-type: none"> <li>• Short-term debt maturities of R\$1.8 billion as of September 2019;</li> <li>• Annual capex of R\$2.5 billion in 2019 and R\$4.7 billion in 2020; and</li> <li>• Dividends of R\$840 million in 2019 and R\$600 million in 2020.</li> </ul> |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|

## Rating Above The Sovereign

The ratings on Klabin are two notches above our foreign currency rating on Brazil (BB-/Positive/B), reflecting our view that there is a notable likelihood that the company won't default upon a hypothetical sovereign default. In our view, Klabin has only a moderate sensitivity to the domestic economy due to its export-oriented business. As a result, per our criteria and given the company's asset concentration in Brazil, we may rate Klabin up to three notches above the Brazil sovereign rating. Below are our main assumptions for a hypothetical Brazilian sovereign default scenario:

- Both GDP and paper and packaging domestic volumes decline by 10% in 2020;
- Inflation doubles, and the company is unable to pass through all the resulting higher costs by raising domestic prices;
- A 50% depreciation of the real, which would double Klabin's debt-service costs related to foreign currency debt (in local currency terms) but would raise its export revenue;
- Hardwood pulp prices of \$550 per ton, in line with those in mid-2009, when prices reached a 10-year low;
- A doubling of interest rates for floating loans;
- A haircut of 70% applied to investments in Brazilian government securities or Brazilian banks that aren't systemically important; and
- Capex at maintenance levels of about R\$650 million.

In our view, in this scenario the company would maintain liquidity sources over uses of more than 1x in the next 12 months. We believe that Klabin's partly export-oriented business, its ability to redirect its paper production to other markets if the domestic market deteriorates, and the fact that the bulk of its costs are denominated in reais partly insulate the company from a potential Brazilian economic downturn.

## Issue Ratings - Recovery Analysis

### Key analytical factors

- The issue-level rating on Klabin Finance's senior unsecured notes is 'BB+'.
- The '3' recovery rating indicates that we expect a recovery of about 65% for unsecured lenders under a hypothetical default scenario.



- In our default scenario, EBITDA would decline by about 50%-60% from currently projected EBITDA in 2023.
- We've valued the company on a going-concern basis, using a 5.0x multiple applied to our projected emergence-level EBITDA, which results in an estimated gross emergence value of about R\$17.8 billion.
- Our recovery analysis assumes that under a hypothetical default scenario, the senior unsecured notes would rank pari passu to the company's existing and future senior unsecured debt, which is also subject to statutory priorities like tax and labor obligations.

### Simulated default assumptions

- Simulated year of default: 2024
- EBITDA at emergence: R\$3.6 billion
- Implied enterprise value (EV) multiple: 5.0x
- Estimated gross EV at emergence: R\$17.8 billion

### Simplified waterfall

- Net EV after 5% administrative costs: R\$16.9 billion
- Senior secured debt: R\$1.0 billion
- Unsecured debt: R\$22.7 billion
- Recovery expectation: 65%

## Reconciliation

**Table 3**

### Reconciliation Of Klabin S.A. Reported Amounts With S&P Global Ratings' Adjusted Amounts (Mil. R\$)

--Fiscal year ended Dec. 31, 2018--

<b>Klabin S.A. reported amounts</b>						
	<b>Debt</b>	<b>EBITDA</b>	<b>Operating income</b>	<b>Interest expense</b>	<b>S&amp;P Global Ratings' adjusted EBITDA</b>	<b>Cash flow from operations</b>
	19,445.7	4,651.0	2,977.6	1,184.7	4,073.5	2,787.0
<b>S&amp;P Global Ratings' adjustments</b>						
Cash taxes paid	--	--	--	--	--	--
Cash taxes paid: Other	--	--	--	--	--	--
Cash interest paid	--	--	--	--	(1,067.2)	--
Operating leases	404.1	65.4	25.0	25.0	(25.0)	40.4
Accessible cash and liquid investments	(7,047.2)	--	--	--	--	--
Nonoperating income (expense)	--	--	279.8	--	--	--
Debt: Other	344.1	--	--	--	--	--
EBITDA: Gain/(loss) on disposals of PP&E	--	(15.4)	(15.4)	--	--	--

**Table 3**

<b>Reconciliation Of Klabin S.A. Reported Amounts With S&amp;P Global Ratings' Adjusted Amounts (Mil. R\$) (cont.)</b>						
EBITDA: Valuation gains/(losses)	--	(628.4)	(628.4)	--	--	--
EBITDA: Other	--	0.9	0.9	--	--	--
EBIT: Other	--	--	628.4	--	--	--
Working capital: Other	--	--	--	--	--	70.2
Total adjustments	(6,299.0)	(577.5)	290.2	25.0	(1,092.1)	110.6
<b>S&amp;P Global Ratings' adjusted amounts</b>						
	<b>Debt</b>	<b>EBITDA</b>	<b>EBIT</b>	<b>Interest expense</b>	<b>Funds from operations</b>	<b>Cash flow from operations</b>
	13,146.7	4,073.5	3,267.9	1,209.6	2,981.3	2,897.6

## Ratings Score Snapshot

### Issuer Credit Rating

BB+/Stable/--

### Business risk: Satisfactory

- **Country risk:** Moderately high
- **Industry risk:** Moderately high
- **Competitive position:** Satisfactory

### Financial risk: Significant

- **Cash flow/leverage:** Significant

Anchor: bbb-

### Modifiers

- **Diversification/portfolio effect:** Neutral
- **Capital structure:** Neutral
- **Financial policy:** Neutral
- **Liquidity:** Strong
- **Management and governance:** Fair
- **Comparable rating analysis:** Negative (-1 notch)

## Related Criteria

- General Criteria: Methodology For National And Regional Scale Credit Ratings, June 25, 2018
- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, Sept. 21, 2017
- Criteria - Corporates - General: Recovery Rating Criteria For Speculative-Grade Corporate Issuers, Dec. 7, 2016

- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The Forest And Paper Products Industry, Feb. 12, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The Containers And Packaging Industry, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, 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

### 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
<b>Satisfactory</b>	a/a-	bbb+	bbb/bbb-	<b>bbb-/bb+</b>	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 December 26, 2019)\*

#### Klabin S.A.

Issuer Credit Rating  
*Brazil National Scale*

BB+/Stable/--  
brAAA/Stable/--

Senior Unsecured  
*Brazil National Scale*

brAAA

#### Issuer Credit Ratings History

29-Jun-2016

BB+/Stable/--

27-Oct-2015

BBB-/Negative/--

10-Sep-2015

BBB-/Watch Neg/--

16-Aug-2017 *Brazil National Scale*

brAAA/Stable/--

29-Jun-2016

brAA/Stable/--

27-Oct-2015

brAA+/Negative/--

10-Sep-2015

brAA+/Watch Neg/--

**Ratings Detail (As Of December 26, 2019)\*(cont.)**

\*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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