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Odyssey Re Holdings Corp.

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Odyssey Re Holdings Corp.

Rationale

The insurer financial strength rating on certain Odyssey Re Holdings Corp.'s operating re/insurance subsidiaries (collectively Odyssey Re) reflects the entities' status under our group methodology criteria as core to Fairfax Financial Holdings Ltd. (TSX:FFH; BBB-/Stable/--). Because S&P Global Ratings views Odyssey Re as core to Fairfax, it has equalized the ratings on these companies with the group credit profile on Fairfax. Therefore, much of our analysis is from a Fairfax perspective rather than Odyssey Re specific. (For additional

information on Fairfax, see the analysis published May 17, 2017, on RatingsDirect.)

Holding Company:
Odyssey Re Holdings Corp.

Counterparty Credit Rating

Local Currency
BBB-/Stable/--

**Operating Companies
Covered By This Report**

Financial Strength Rating

Local Currency
A-/Stable/--

Business Risk Profile

- Strong group competitive position based on diversified property/casualty (P/C) re/insurance operations, which Odyssey Re contributes to
- Volatile earnings primarily related to the investment strategy partially offset by good underwriting performance. Odyssey Re's underwriting performance has historically been stronger than that of Fairfax overall and similar to that of its global peers, with a strong focus on underwriting discipline
- Intermediate industry and country risk

Financial Risk Profile

- Very strong capital adequacy at Odyssey Re, which is in line with our assessment of Fairfax capitalization
- Moderate risk position for Fairfax reflecting property-catastrophe exposure and relatively high tolerance for investment risk
- Less-than-adequate financial flexibility, highlighting constrained investments earnings and moderately high leverage that pressure debt servicing at the consolidated Fairfax group level

Other Factors

- Odyssey Re's adherence to the parent's total return investment strategy, which puts significant emphasis on generating capital gains from its investment portfolio. Fairfax has an acquisitive business strategy and active approach to investment management that can heighten volatility over an extended period

Outlook

Odyssey Re is a core entity of Fairfax, so the stable outlook reflects that on Fairfax. We expect the ratings on Odyssey Re would move in tandem with those on Fairfax.

Our stable outlook on Fairfax and its subsidiaries is based on our expectation that the group's capital adequacy will remain very strong post Allied World Assurance Company Holdings AG acquisition, reflecting the structure and capital-raising initiatives to help finance this transaction and other smaller acquisitions over 2017-2018. We also expect the earnings volatility attributable to investments strategy to subside due to the unwinding of macro hedges late in 2016. However, investment earnings are likely to remain constrained in the near term as the group looks to reposition its portfolio. In the long term, we believe, the potential for increased volatility remains, based on the investment strategy that the group pursues.

Downside scenario

We could lower the ratings on Fairfax and consequently on Odyssey Re over next two years if, contrary to our expectations, capital adequacy or operating results deteriorate significantly. We could also lower the ratings if we perceive that Fairfax's risk management practices have not satisfactorily evolved to assess the risks of an ever-increasing and complex organization, risk tolerance expands, or execution risks heighten in pursuit of an aggressive growth strategy.

Upside scenario

We are unlikely to raise the ratings in the next two years, but we could if Fairfax's underwriting and investment performance shows sustained improvement, leading to stronger operating performance, an improved volatility profile, and better fixed-charge coverage.

Base-Case Scenario

Macroeconomic Assumptions

- U.S. real GDP growth of about 2.2% in 2017 and 2.3% in 2018
- Ten-year U.S. treasury rate remaining low, at 2.4% in 2017 and to increase to 2.7% in 2018
- U.S. core CPI at 1.8% in 2017 and 2.1% in 2018
- Neutral industry economic outlook for P/C insurers; challenging operating environment for the global P/C reinsurance sector

Company-Specific Assumptions

- Very strong capital adequacy for Fairfax over the outlook period
- Fairfax's gross premiums written (GPW) to grow 20%-25% in 2017 and 2018 from Allied World and other smaller acquisitions and accounting for low-to-mid single digit organic growth rate. For Odyssey Re, we expect flat-mid single digit GPW growth in 2017-2018, reflecting increased competitive and pricing pressures in re/insurance lines, partially offset by growth in specialty lines business
- Fairfax's combined ratio of 94%-97% in 2017-2018. For Odyssey Re, we expect a combined ratio of 92%-96%, assuming normalized catastrophe losses and benefit from favorable loss development, albeit less than before. We expect catastrophe losses to contribute around 10 percentage points on average to the Odyssey Re loss ratio
- Constrained investment performance (total return)
- Moderate financial leverage for consolidated Fairfax to remain between 30%-35% and fixed-charge coverage (excluding net realized and unrealized capital gains/losses) in the range of 2x-4x.

Company Description

Odyssey Re is a diversified P/C specialty insurance and reinsurance company with gross premiums written of \$2.4 billion (split between approximately 54% in reinsurance and 46% in insurance) and with shareholders' equity of \$3.8 billion as of Dec. 31, 2016. The company has a diversified franchise by product, geography, and sector. It operates through five divisions (North America, Latin America, EuroAsia, London Market, and U.S. Insurance) and under three brands. Odyssey Re offers reinsurance globally, while specialty insurance is underwritten via the Hudson Insurance Group in the U.S. and through Newline Group internationally. Newline's suite of casualty products is offered through two underwriting platforms, Newline Syndicate 1218 and Newline Insurance Co. Ltd.

Odyssey has been a part of the Fairfax group of companies for more than 20 years. Fairfax is a diversified P/C re/insurance group headquartered in Canada, but with substantial insurance operations domiciled in the U.S., including Odyssey Re. The Fairfax group had approximately \$9.5 billion in GPW and consolidated shareholders' equity of \$11.8 billion as of Dec. 31, 2016.

Business Risk Profile

Fairfax's strong business risk profile is built on the company's strong competitive position, enhanced by its large geographic presence and sector diversification, and our intermediate insurance industry and country risk assessment for its combined insurance operations.

Insurance industry and country risk

Fairfax and Odyssey Re face intermediate industry and country risk stemming from the low country risk, intermediate risk for its non-life primary insurance operations and moderate risk for its reinsurance operations. We view country risk as relatively low given the diversified book of business, mainly in developed countries. Our view of industry risks for non-life primary operations primarily reflects inherent product risk and consequent susceptibility to reserve and property catastrophe volatility. The litigious environment in the U.S. can also affect claims amounts and payment

patterns. But the stability of the insurance markets' profitability, growth prospects, and overall institutional framework partially offset this weakness. Our view of the global P/C reinsurance sector stems primarily from the industry's exposure to property-catastrophe volatility and weak business conditions, which are pressuring competitive positions and earnings. Low growth, low interest rates, and increasing levels of competing capital from traditional players and alternative capital providers continue to define the challenging operating environment for the global P/C reinsurance sector. Reinsurance pricing continues to decline in 2017, but at a slower rate than in 2016, as reinsurers adapt to "softer for longer" business conditions.

Competitive position

As part of the Fairfax Group, Odyssey Re contributes significantly to the group's strong competitive position in our view, given its sizable geographic footprint and sector diversification. Insurance constitutes about 46% of Odyssey Re's GPW, with reinsurance accounting for 54% (compared with a 16%-84% split in 2001). The improved diversification by sector has resulted mainly from growth in specialty insurance writings.

Geographically, the business is well-diversified, with about 39% of GPW coming from the U.S. insurance division, 28% from the North America division, 19% from the EuroAsia division, 10% from the London market, and the remainder from Latin America. The U.S. accounted for almost 63% of the group's gross premiums.

The breakdown between short- and long-tail classes has substantially changed since Odyssey Re's inception. For instance, for 2011, property represented almost 47% of total writings; specialty was around 17% and remainder in casualty. For 2016, the business mix is now more balanced with property contributing 33% of total writings (35% in 2015), casualty 36% (35% in 2015), and specialty 31% (30% in 2015). The shift by sector, geography, and class has been a strategic move. Odyssey Re reacted to substantial pricing and margin deterioration in the U.S. casualty reinsurance market by shifting its product offerings away from commoditized products and more toward specialty, where margins are higher, underwriting expertise is more recognized, and client relationships are stronger. Odyssey Re distributes its products primarily through the broker channel, but direct relationships are significant as well, particularly in its specialty insurance and non-U.S. reinsurance businesses.

Odyssey Re is one of Fairfax's larger and better performing insurance operations. It has had an average combined ratio of approximately 86% for 2012-2016 compared with 93% for Fairfax consolidated (excluding the run-off segment and corporate expenses). We expect Odyssey Re to continue to exhibit discipline through the underwriting cycle. We expect flat-to-mid single digit GPW growth in 2017 and 2018 in part due to pricing and competitive pressures in the property-catastrophe reinsurance market and softness in casualty reinsurance, though partially offset by the company's efforts to increase its specialty writings.

Table 1

Odyssey Re Holdings Corp. -- Competitive Position					
	--Year ended Dec. 31--				
(Mil. \$)	2016	2015	2014	2013	2012
Gross premiums written (GPW)	2,380.7	2,404.0	2,739.5	2,715.5	2,773.2
Change in GPW (%)	(1.0)	(12.2)	0.9	(2.1)	14.6
Net premiums written	2,100.2	2,095.0	2,393.8	2,376.9	2,402.3
Change in net premiums written (%)	0.2	(12.5)	0.7	(1.1)	15.0

Table 1

Odyssey Re Holdings Corp. -- Competitive Position (cont.)					
	--Year ended Dec. 31--				
(Mil. \$)	2016	2015	2014	2013	2012
P/C: net premiums earned	2,074.1	2,204.1	2,356.6	2,373.6	2,315.3
Reinsurance utilization (%)	11.8	12.9	12.6	12.5	13.4
Business segment (% of GPW)					
Life	0.0	0.0	0.0	0.0	0.0
P/C	100.0	100.0	100.0	100.0	100.0
Other	0.0	0.0	0.0	0.0	0.0

Financial Risk Profile

We regard Fairfax's financial risk profile as moderately strong overall, reflecting its very strong capital and earnings, moderate risk position, and less-than-adequate financial flexibility.

Capital and earnings

We assess Fairfax's capital and earnings as very strong, and we expect this to continue under our base-case scenario. We estimate capitalization remained redundant at the 'AA' level for 2016 year-end despite investment-related losses of approximately \$1.2 billion in 2016.

For year-end 2016, Odyssey Re's capitalization was redundant at the 'AA' level as well, as measured by our risk-based capital model. We believe Odyssey Re's reserving practices are prudent and that its claims reserves are adequate. The company has had a consistent track record of net favorable reserve development. On average, net reserve releases have benefited the combined ratio by roughly 9 points.

Table 2

Odyssey Re Holdings Corp. -- Capital					
	--Year ended Dec. 31--				
(Mil. \$)	2016	2015	2014	2013	2012
Common shareholders' equity	3,833.2	3,958.2	3,983.2	3,730.7	3,678.8
Change in common shareholders' equity (%)	(3.2)	(0.6)	6.8	1.4	10.3
Total reported capital	3,923.0	4,048.0	4,197.8	3,995.4	4,127.7
Change in total capital (reported) (%)	(3.1)	(3.6)	5.1	(3.2)	9.2

Table 3

Odyssey Re Holdings Corp. -- Earnings					
	--Year ended Dec. 31--				
(Mil. \$)	2016	2015	2014	2013	2012
Total revenue	2,289.2	2,421.2	2,573.4	2,583.1	2,477.4
EBIT adjusted	374.8	545.5	560.5	605.9	424.4
Net income (attributable to all shareholders)	160.9	299.3	590.7	136.9	282.5
Return on revenue (%)	16.4	22.5	21.8	23.5	17.1

Table 3

Odyssey Re Holdings Corp. -- Earnings (cont.)					
	--Year ended Dec. 31--				
(Mil. \$)	2016	2015	2014	2013	2012
Return on shareholders' equity (reported) (%)	4.1	7.5	15.3	3.7	8.1
P/C: net expense ratio (%)	32.4	31.1	30.3	29.0	27.6
P/C: net loss ratio (%)	56.5	53.8	54.5	55.2	61.1
P/C: net combined ratio (%)	88.9	84.9	84.8	84.2	88.7

Fairfax manages Odyssey Re's investments. Fairfax's total return-focused, contrarian investment strategy has proven to be a double-edged sword, which has also affected Odyssey Re's investment performance. In 2016, Odyssey Re reported a net realized loss of about \$202 million. From 2010-2016, Fairfax lost about \$4.4 billion on equity and equity index total return swaps, which were purchased to hedge its long equity positions against a decline in equity markets, negating gains on their equity and fixed income portfolios. In fourth-quarter 2016, Fairfax discontinued its equity hedging strategy and closed out short positions effected through equity index total return swaps. Although the losses from their hedge positions were largely offset by gains on their long equity positions, the opportunity cost for Fairfax and Odyssey Re during this bull market period has been substantial.

Odyssey Re's underwriting performance in 2016 as measured by the reported combined ratio remained very strong at 88.9% but was higher than in 2015 (84.9%), mainly driven by higher catastrophe losses due to Europe flooding, Fort McMurray wildfires and other attritional losses for 2016. As a result, catastrophe losses contributed 9.3 points to the combined ratio in comparison to 4.9 points for 2015. This was slightly offset by better prior year reserve development for 2016. The earnings were also negatively affected by realized investment losses. For year-to-date second quarter 2017, Odyssey Re reported a combined ratio of 90.8% compared to 92.9% for prior year period helped by relatively lower cat losses and benefitting from favorable loss reserve development.

Under our base case, we expect Fairfax's combined ratio to be in the range of 94%-97%. We believe Odyssey Re's prospective underwriting performance for calendar 2017 will decline somewhat but expect strong combined ratios in 2017 and 2018 at 92%-96%, assuming normalized catastrophe losses of about 10 percentage points.

Risk position

We assess Fairfax's risk position to be moderate in view of the inherent volatility from substantial exposure to natural and man-made catastrophes, primarily emanating from Odyssey Re, Brit and Allied World business, and to long-tail casualty lines of business.

Furthermore, we believe that in the long term there remains the potential for increased volatility based on the group's investment strategy. In line with that of the Fairfax, Odyssey Re's investment portfolio is defensively positioned, with 37% fixed-income securities, 33% short-term investments and cash and cash equivalents, 21% preferred and common equities, and the rest in other assets as of year-end 2016. To mitigate the exposure to interest rate risk, the company sold some long-dated U.S. treasury, state, and municipal bonds; and entered forward contracts on remaining long-dated U.S. treasury bonds, which reduced the portfolio's overall duration.

Table 4

Odyssey Re Holdings Corp. -- Risk Position					
(Mil. \$)	--Year ended Dec. 31--				
	2016	2015	2014	2013	2012
Total invested assets	7,766.7	8,045.4	8,820.2	8,537.8	9,013.3
Net investment income	215.1	217.2	216.9	209.5	162.2
Net investment yield (%)	2.7	2.6	2.5	2.4	1.9
Net investment yield including realized capital gains/(losses) (%)	0.2	1.2	6.6	(2.5)	2.6
Investment portfolio composition (%)					
Cash and short term investments (%)	33.0	17.0	16.5	21.4	24.9
Bonds (%)	36.7	51.4	49.4	47.7	49.7
Equity investments (%)	20.6	22.6	26.5	21.0	21.0
Investments in affiliates (%)	0.6	0.0	0.0	0.0	0.0
Investments in partnerships, joint venture and other alternatives investments (%)	8.9	8.9	7.5	7.3	4.3
Other investments (%)	0.1	0.1	0.1	2.6	0.2

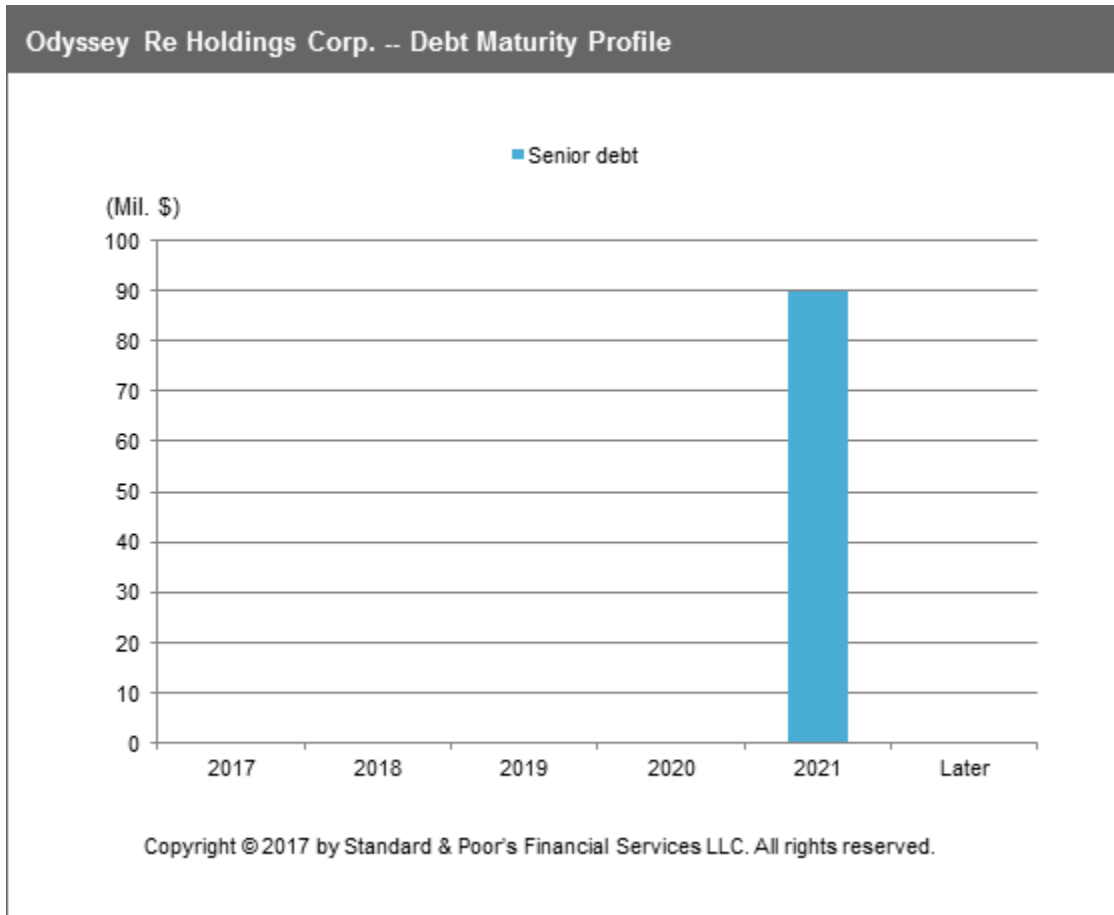
Financial flexibility

Odyssey Re has low stand-alone leverage, which along with robust earnings lead to strong fixed-charge coverage at its level. However, being part of the larger group, Odyssey Re relies on its parent for additional capital including access to capital markets. Fairfax provided additional capital in the past to Odyssey Re to retire maturing debt.

Fairfax's financial flexibility is less than adequate, in our opinion. While the group has demonstrated adequate access to capital markets and bank credit facilities, and can access reinsurance markets, we believe it is constrained by low fixed-charge coverage in recent years and moderately high financial leverage. Fairfax's investment strategy has depressed net investment income and earnings, while debt-service expenses reflect its relatively high level of financial leverage. We expect the consolidated Fairfax financial leverage to reduce to 30%-35% for 2017-2018 and some improvement in the coverage ratio to 2x-4x. Mitigating this low coverage is the substantial amount of liquid assets at Fairfax.

Table 5

Odyssey Re Holdings Corp. -- Financial Flexibility					
	--Year ended Dec. 31--				
	2016	2015	2014	2013	2012
EBITDA fixed-charge coverage (x)	41.6	45.1	27.4	20.1	12.5
Financial leverage including pension deficit as debt (%)	6.4	5.3	7.2	8.7	12.4



Other Assessments

We regard Fairfax's enterprise risk management (ERM) and management and governance practices as consistent with the ratings.

Enterprise risk management

We view Fairfax's ERM, which we regard as of high importance to the rating, as adequate, reflecting the neutral scores for all major sub-factors in our analysis. Risk management and controls, with the exception of investments, are primarily handled at operating groups and are well-developed at major operating groups, although the degree of sophistication may vary depending on the nature of business (for example, Odyssey Re, Brit, and Allied World have more evolved risk practices). The group focuses on defining group-wide risk tolerance/appetite, aggregation of risks, and oversight functions. We observe significant progress in the group's effort to formalize its ERM framework over the past couple of years as the group has grown. To align with the requirements of a bigger and complex group, Fairfax will, we expect, continue to enhance its risk culture in terms of governance, definition of risk tolerances, and communication of those to internal stakeholders while strengthening its control environment to ensure key risks can be managed within tolerance levels.

Management and governance

Fairfax's management and governance is satisfactory, in our opinion. The group combines disciplined underwriting with a total return value-investing strategy, which includes an active macroeconomic hedging strategy. Fairfax has built its insurance operations through acquisitions, with each segment operating autonomously with existing management teams insofar as they relate to underwriting operations; however, investments are handled at the group level. This allows individual operations a fair bit of flexibility to execute strategies they view as optimal for their respective markets without any pressure of managing the top line. Management at the parent company, Hamblin Watsa (the investments arm) and operating subsidiaries, including Odyssey Re, has been quite stable, and has long tenures and strong expertise. We have not identified any governance deficiencies in our assessment.

Liquidity

We believe Fairfax will extend capital and liquidity support to Odyssey Re as needed. We consider Fairfax's liquidity exceptional because of substantial cash and short-term investments at both the operating and holding company levels. The liquidity profile at the parent is further supported by a \$1 billion credit facility.

Support

Group support

The insurer financial strength and counterparty credit ratings on Odyssey Re reflect the company's core group status with Fairfax. As a result, we equalize the ratings on Odyssey Re with those on Fairfax's core entities under our group rating methodology. Odyssey Re is the largest contributor of operating earnings for Fairfax; for 2016, it contributed approx. 42% of consolidated operating income, about 24% of its total capital, and approximately 25% of gross premiums written. We view Odyssey Re as an integral component of Fairfax's strategy to build strong core insurance operations that can support Fairfax's investment strategies. In addition, there is a strong history of support between Fairfax and Odyssey Re: for example, Fairfax provided funds to pay maturing debt and Odyssey Re has provided dividends and intercompany loans to the rest of the group. Hence, we consider it highly unlikely that Fairfax will dispose of Odyssey Re.

Accounting Considerations

Odyssey Re has been a private company since 2009. Its U.S. GAAP consolidated financial statements are S&P Global Ratings' primary source of financial information as well as its statutory filings. In addition, we also rely on Fairfax's financial statements prepared in accordance with IFRS since 2011 (Canadian generally accepted accounting principles [GAAP] before that period), which also contains Odyssey Re's financials reported as a separate segment.

Under both IFRS and U.S. GAAP (for the most part) accounting, the unrealized fluctuations in equity holdings, derivative market prices, and fixed income (for assets classified as Held For Trading under U.S. GAAP) on the group's income statement and balance sheet introduce some volatility to its consolidated statement of income. Therefore, in our analysis, we split the net investment gains as reported into realized gains/losses and unrealized gains/losses, so those metrics that use net income as reported may understate or overstate the company's true performance in a specific year due to the benefit or damage that the unrealized loss position adds to reported figures.

Related Criteria

- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Insurance - General: Enterprise Risk Management, May 7, 2013
- Criteria - Insurance - General: Insurers: Rating Methodology, May 7, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Criteria - Insurance - General: Refined Methodology And Assumptions For Analyzing Insurer Capital Adequacy Using The Risk-Based Insurance Capital Model, June 7, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Insurance - General: Hybrid Capital Handbook: September 2008 Edition, Sept. 15, 2008

Related Research

- Fairfax Financial Holdings Ltd., May 17, 2017

Ratings Detail (As Of August 31, 2017)

Holding Company: Odyssey Re Holdings Corp.

Issuer Credit Rating

Local Currency BBB-/Stable/--

Preferred Stock

BB

Operating Companies Covered By This Report

Odyssey Reinsurance Co.

Financial Strength Rating

Local Currency A-/Stable/--

Counterparty Credit Rating

Local Currency A-/Stable/--

Hudson Specialty Insurance Co.

Financial Strength Rating

Local Currency A-/Stable/--

Issuer Credit Rating

Local Currency A-/Stable/--

Related Entities

Fairfax Financial Holdings Ltd.

Issuer Credit Rating

BBB-/Stable/--

Preferred Stock

Canada National Scale Preferred Share P-3

Preferred Stock

BB

Senior Unsecured

BBB-

Domicile

Connecticut

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