



Fitch Ratings

Perspectives on the Western  
and Central European  
Oil, Gas and Utilities Sectors

November 17, 2011



Perspectives on the Western and Central European Oil, Gas and Utilities  
Sectors  
Warsaw, 17 November 2011

**Fitch**Ratings

## **Credit Outlook for the Oil & Gas Industry in 2012**

**Erwin van Lümich, Managing Director  
Energy, Utilities & Regulation**

## Topic Agenda

Fitch's EMEA Ratings Universe

Shale Gas in Europe

Nordstream Start-up

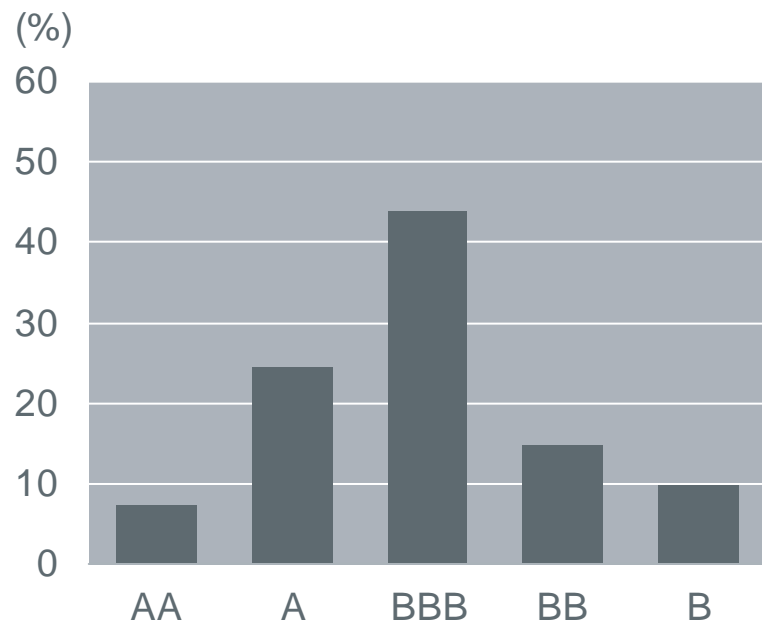
Future of Deepwater Oil & Gas

Arab Spring and Oil Prices

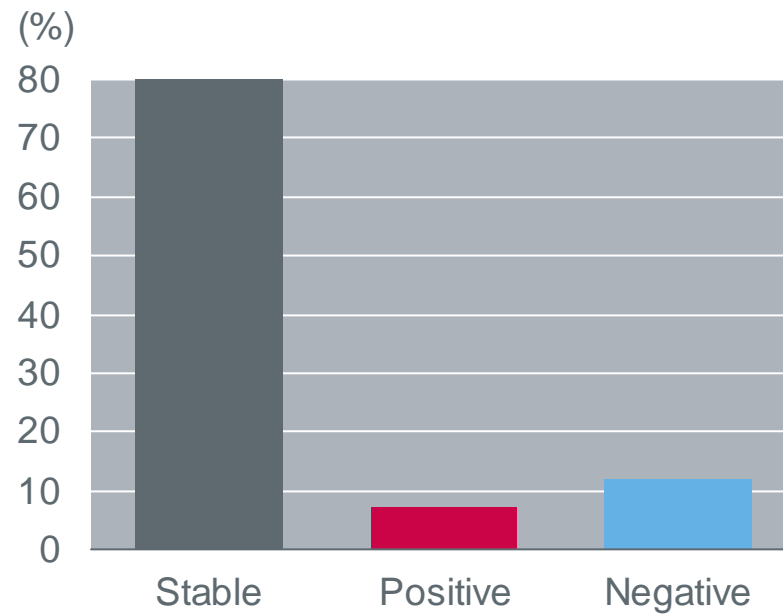
European Refining Capacity Reductions

# Fitch's EMEA Oil & Gas Ratings Universe

## Ratings Distribution



## Rating Outlook

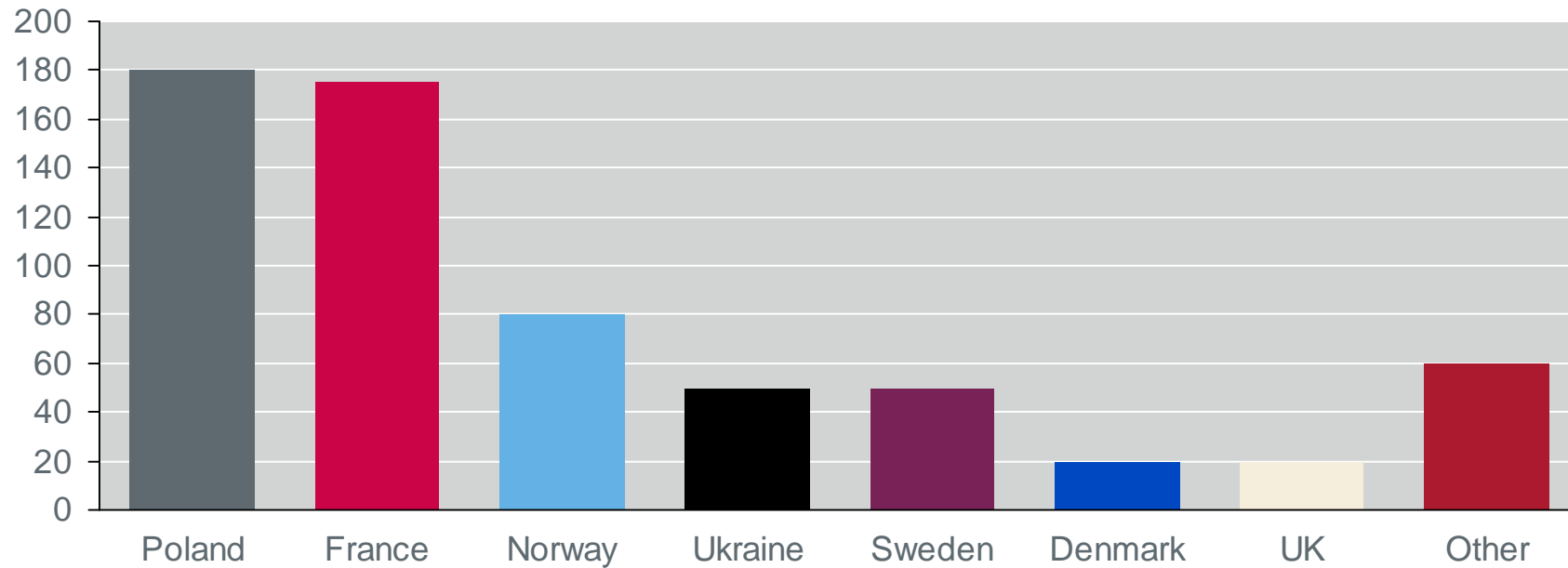


Source: Fitch: based on Long-Term IDRs at 9 November 2011

# The Future of Shale Gas in Europe Seems Doubtful

## European Recoverable Shale Gas Resources

(trn cubic feet)



Source: US Energy Information Administration

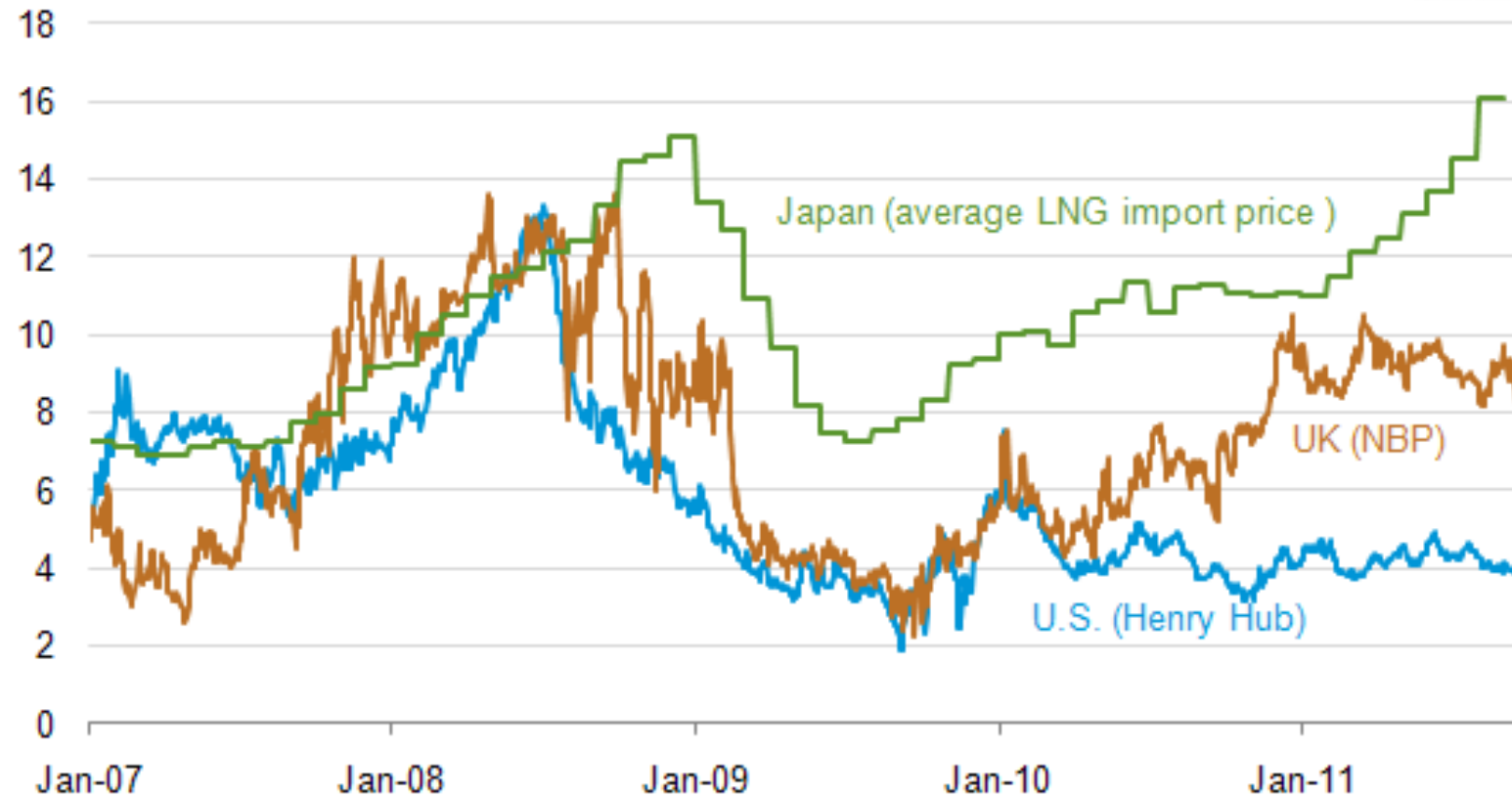
# The Future of Shale Gas in Europe Seems Doubtful

Possibly even a non-starter ...

- Poland would be a major player in the European Shale Gas story
- Unconventional gas could mean cheap gas for Europe
  - Long-term gas pricing could drop as we have seen in the US (chart on next page)
- Could dramatically reduce European import dependence
- Production in Europe could be as high as 60 billion cubic meters per year by 2030 according to Wood Mackenzie's European Gas and Power Service
- However, breakeven costs for some European shale-gas plays are high, making them uneconomic, so development could be slow, keeping prices higher for longer
- Environmental challenges are considerable in the EU (especially France), but Poland calls EU regulation "unfeasible"

# The Future of Shale Gas in Europe Seems Doubtful

Trends in natural gas spot prices at major global markets  
U.S. dollars per million British thermal units (MMBtu)



Source: EIA

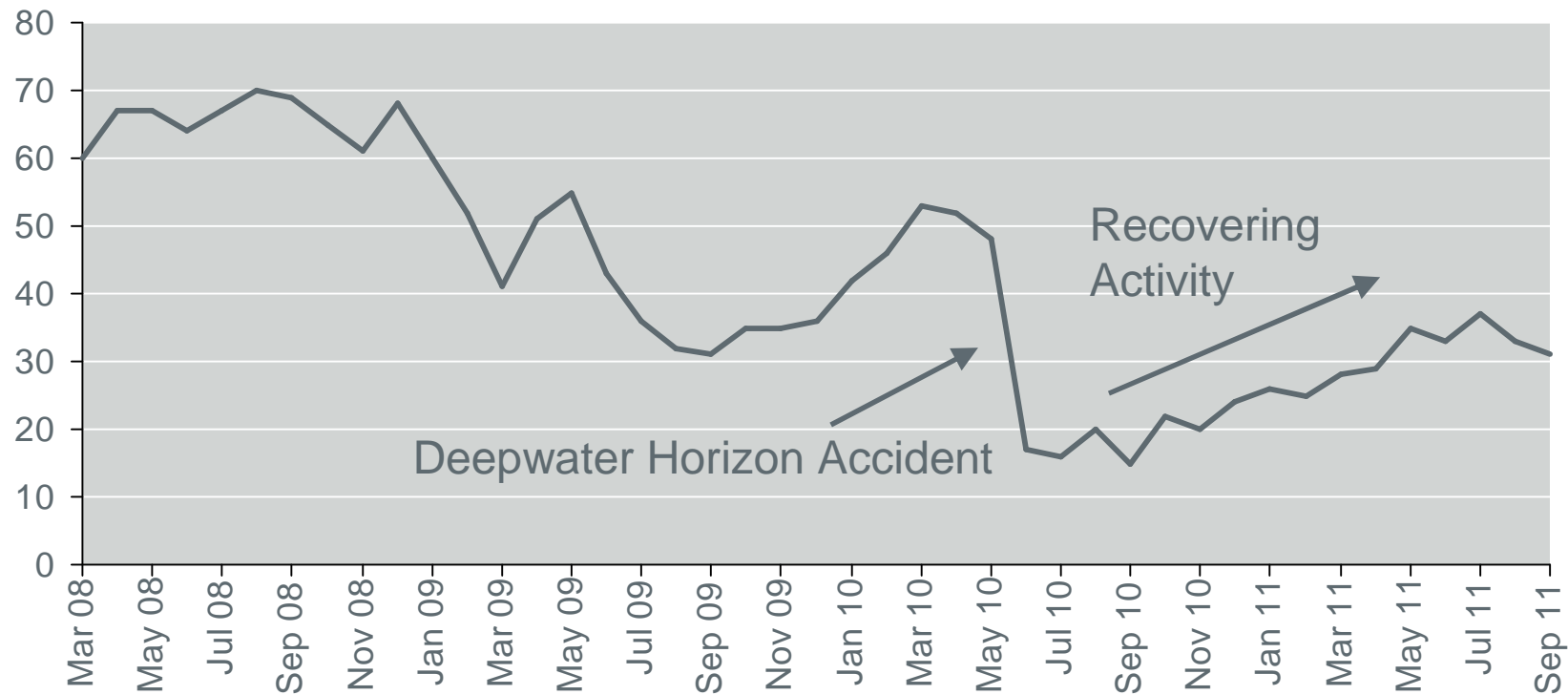
# Nordstream Start-up Matters to Europe

## Nordstream Pipeline

- The first direct link between the major Russian reserves in Siberia and the European natural gas market was completed August 2011
- First gas deliveries to Germany began in October 2011
- The second stage of the pipelines is scheduled to become operational in late 2012, thereby doubling the transport capacity to 55 bcm (~20% of EU annual demand)
- This is a material volume and is positive for European gas consumers and negative for Eastern European gas transportation companies
- Nordstream bypass affects Ukraine's Naftogaz ('CCC') more than SPP ('A'/Negative) or PGNiG due to the larger volume going through Ukraine

# Deepwater Oil Exploration Will Continue

## United States Offshore Rotary Rig Count



Source: Baker Hughes

# Deepwater Oil Exploration Will Continue

US offshore industry should improve in 2012

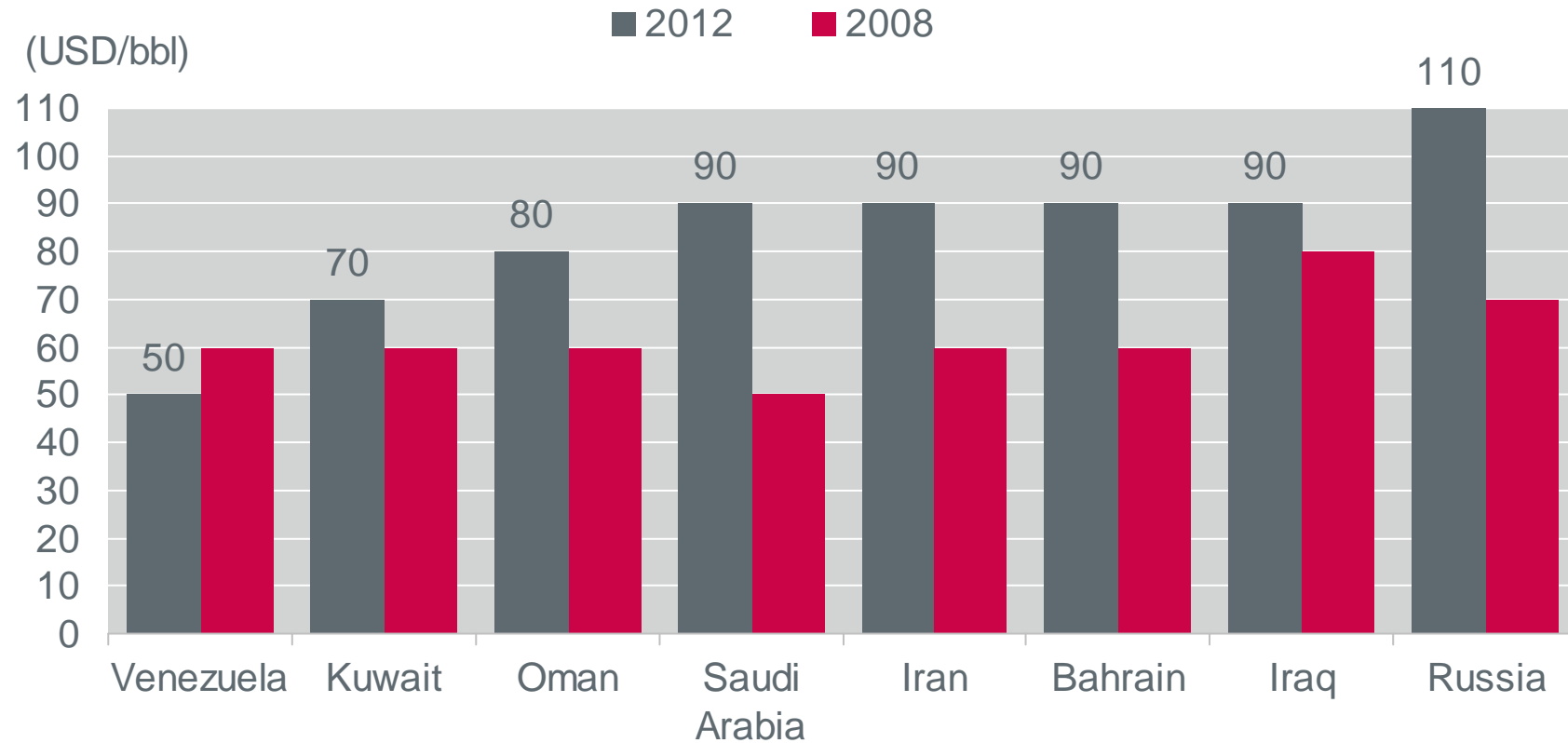
- Drilling activity in the Gulf of Mexico steadily increased in 2011
- US Gulf States formed the 'Outer Continental Shelf Governor's Coalition' to encourage Federal agencies to increase the pace of drilling permit issuance
- Persistently low drilling permit issuance could quicken the pace of drill rig departures from the Gulf of Mexico in 2012. This has positive ramifications for other offshore drilling areas such as Brazil and West Africa
- BP ('A'/Stable) has filed a plan with US regulators seeking approval to drill deepwater wells in the Gulf of Mexico, marking its first attempt to explore for hydrocarbons in the region since Deepwater Horizon oil spill

# Arab Spring Will Continue to Impact Oil Prices

The lasting impact of political change

- Gulf states have increased social spending to quell unrest
- Resulting in a higher required oil price to balance stretched budgets
  - In 2008, oil exporting countries required a price of \$60/bbl on average
  - In 2012, oil exporting countries require a price of \$90/bbl on average
- Inflation rates could increase which would negate the desired impact
- Future supply disruptions can not be ruled out (perhaps Saudi Arabia)
- However, spare production capacity still above 10 year average

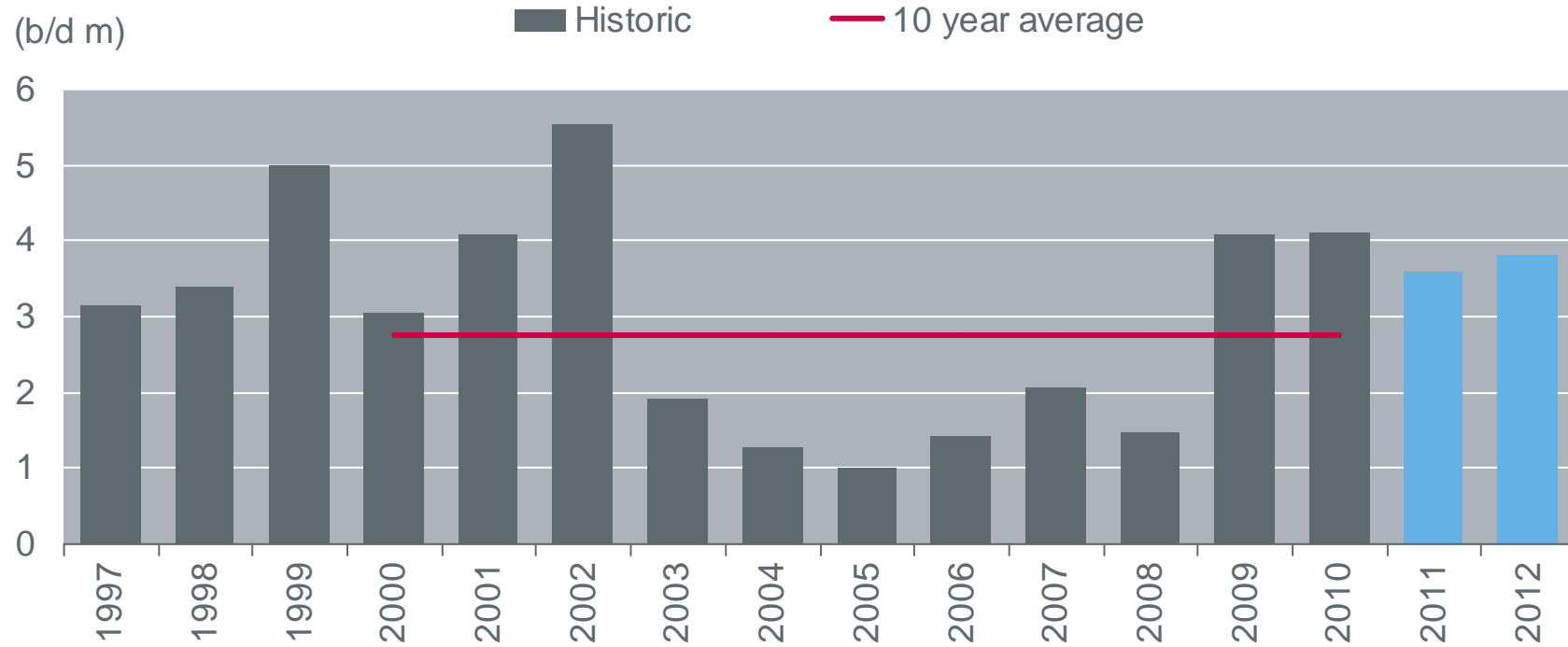
# Sovereign Price Requirements to Balance Budgets



Source: Factiva, Fitch, IIF

# OPEC Surplus Crude Oil Production Capacity

As of September 2011



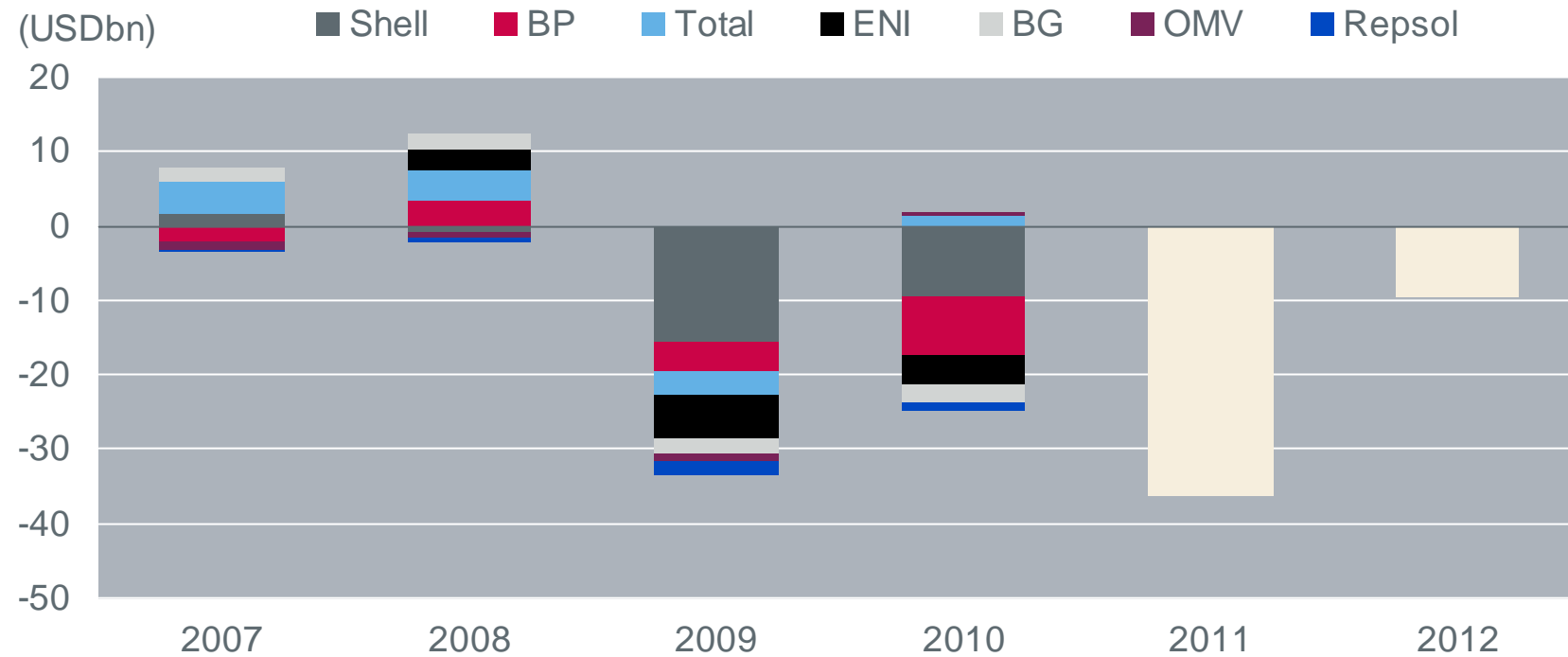
Source: EIA short-term energy outlook, September 2011

# European Refining Environment Remains Challenged

## Fitch expectations in 2012

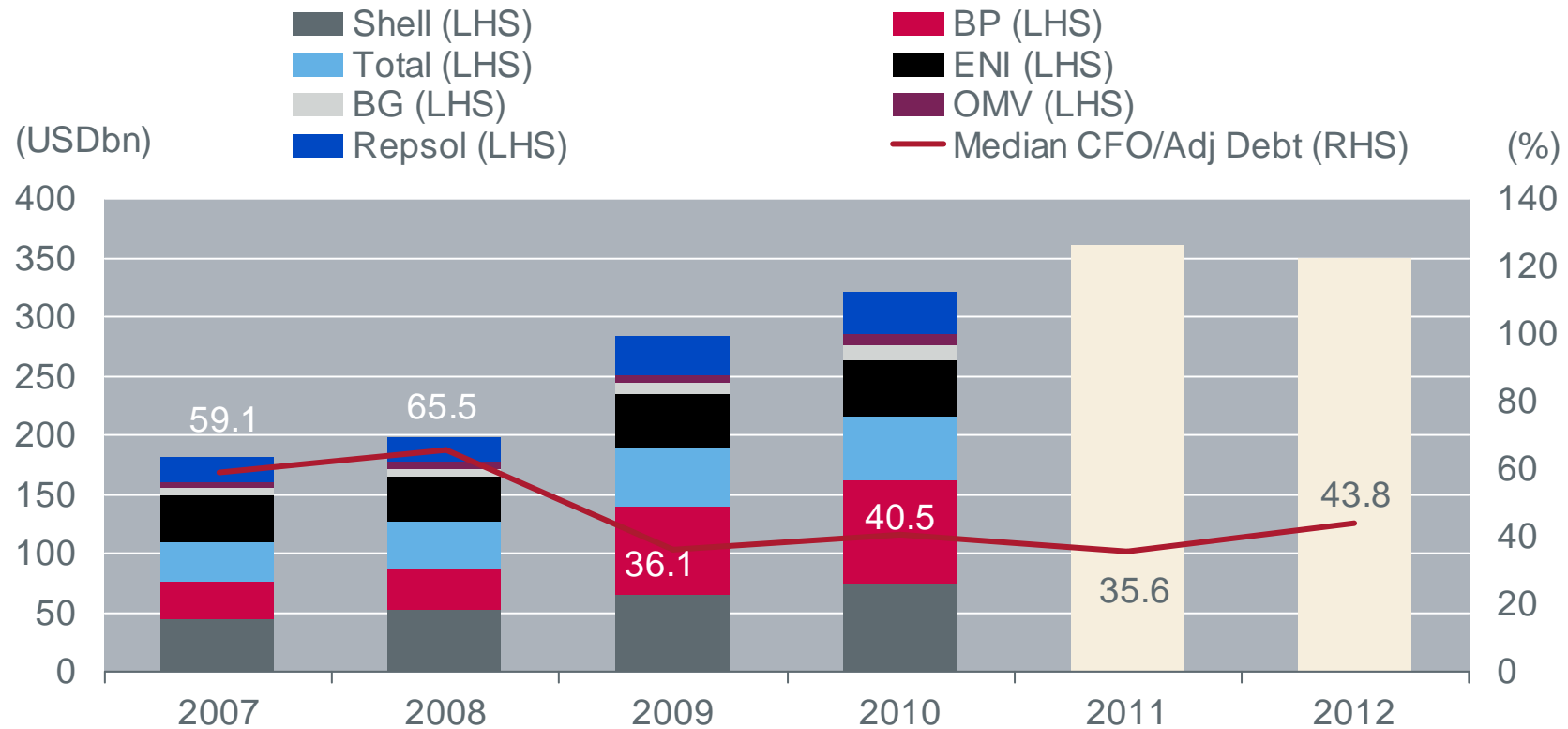
- Fitch anticipates persistently weak demand for oil products in Europe
- Refining utilisation rates remain depressed compared to the 10 year average of almost 90%
- Slow improvement or possible contraction in refining run rates on the back of slow European economic growth out to 2012
- 2011 is another difficult year for European refiners after 2010 and 2009
- Companies have adopted a more prudent stance towards long-term capex plans and have also focused on fixed cost reductions
- Long-term structural growth in European diesel demand remains in tact
- Closure of less efficient refineries or conversion to storage helps
- Integrated companies still “rationalising” their downstream portfolios

# Free Cash Flow Position to Remain Challenged



Footnote: Includes other non-operational cash flows; forecast years are converted into USD at mid consensus FX rate for the respective year and reflect net FCF  
 Source: Fitch, Bloomberg, company financials

# Adjusted Gross Debt Continues Rising



Footnote: Forecast years are converted into USD at mid consensus FX rate; Repsol includes proportionally consolidated debt of Gas Natural SDG, S.A.  
Source: Fitch, Bloomberg, company financials

## Credit Ratings Reflect New Reality

Company	FC IDR 2008	FC IDR 2011
Royal Dutch Shell	AA+	AA
BP plc	AA+	A
Total SA	AA	AA
ENI SpA	AA-	A+
BG Energy	A+	A
OMV AG	A-	A-
Repsol YPF	BBB+	BBB+

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**Fitch**Ratings

## **Central European Oil and Gas: 2012 Outlook**

**Arkadiusz Wicik, Director  
Energy, Utilities & Regulation**

## 2012 – Challenges Remain for European Refiners

- Weak margins and low utilisation rates dent refining profits in Europe
- Weak demand for fuels due to slow GDP growth and rising fuel efficiency
- Persistent overcapacity likely to lead to refinery closures or conversion to storage
- Large, complex refineries in a better position than smaller, simple refineries
- Improved market fundamentals in Asia and, to a lesser extent, North America

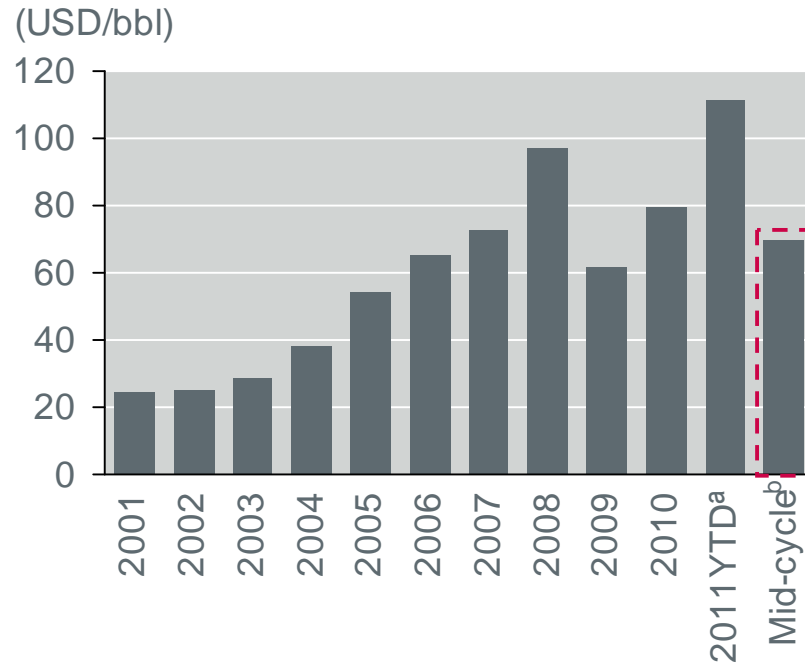
### Oil Demand Change (%)

	2009	2010	2011	2012
World	-1.1	3.2	1.1	1.4
Asia	1.8	5.4	3.3	2.9
Europe	-4.5	-0.7	-1.2	-0.7
North America	-3.7	2.0	-0.9	-0.6

Source: IEA

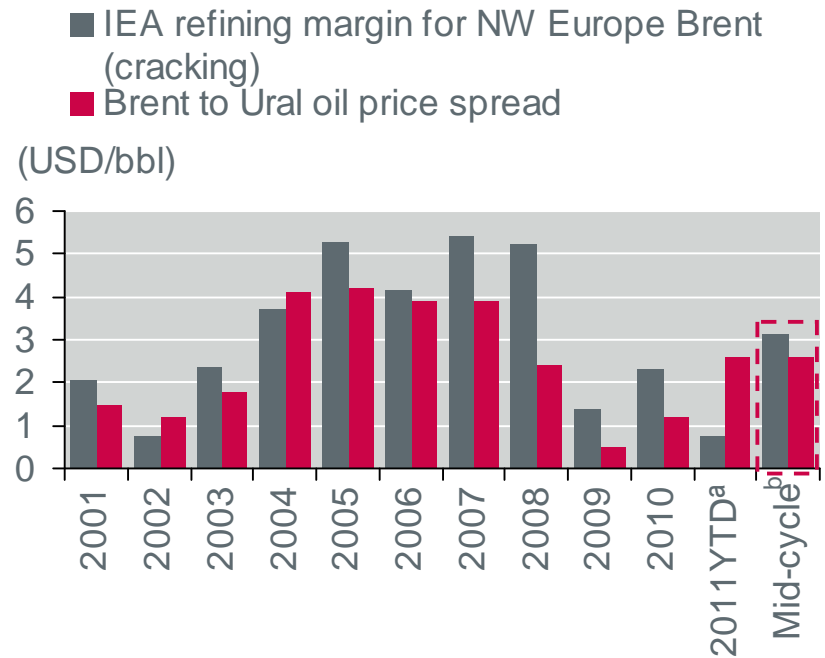
# Much Better Conditions in Upstream than Downstream

## Healthy Oil Prices



<sup>a</sup> Jan-Oct 2011  
<sup>b</sup> Fitch's long-term price deck  
 Source: BP after Platts

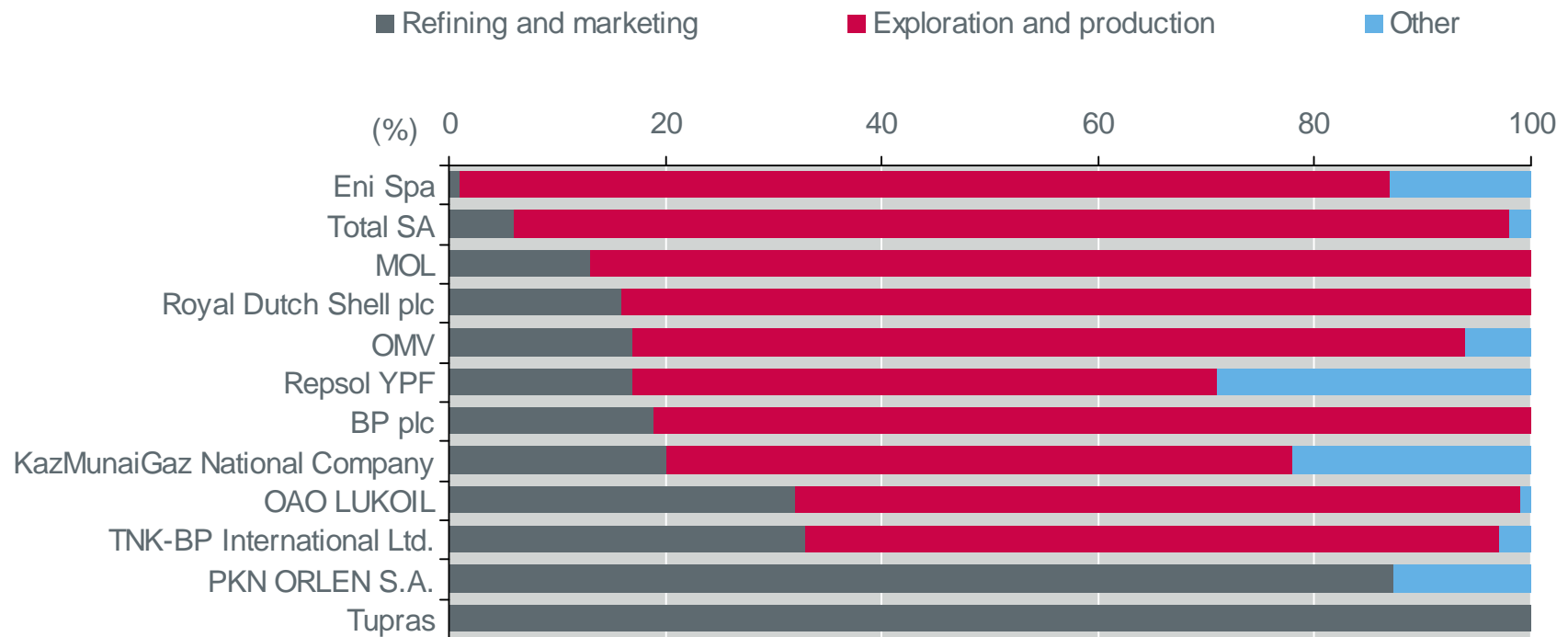
## Weak Refining Margins



<sup>a</sup> Jan-Oct 2011  
<sup>b</sup> Long-term average  
 Source: IEA, BP, MOL, Fitch calculations

# Exposure to Refining

## Share of Refining and Marketing in Total Profit in 2010



Source: Fitch based on company reports

# How are Companies Coping with the Downturn?

- Integrated players focus on upstream at the expense of downstream due to better prospects (Shell, BP, Total, OMV)
- Several oil majors reduce and optimise their downstream portfolios
- Separation into an upstream and downstream company (Marathon, ConocoPhillips)
- Development of less cyclical, non-refining business segments – power generation (OMV, MOL, PKN)
- Postponement of new, large investment projects in refining
- Prudent approach to M&A

# Fitch Rated CE Oil & Gas Companies

- Business profile: From integrated to refining and marketing (R&M)
- Country risk captured mainly in the sovereign rating cap (country ceiling)
- Financial profile: Several companies improved their credit ratios in 2011

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<b>Issuer name</b>	<b>Business profile</b>	<b>Issuer rating/Outlook</b>	<b>Country/Sovereign rating</b>
SPP	Gas	A/Negative	Slovakia/A+
OMV AG	Integrated	A-/Stable	Austria/AAA
MOL	Integrated	BBB-/Stable	Hungary/BBB-
Tupras	R&M	BBB-/Stable	Turkey/BB+
PKN Orlen	R&M	BB+/Stable	Poland/A-
Rompetrol Group	R&M	B+/Negative	Romania/BBB-

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Source: Fitch

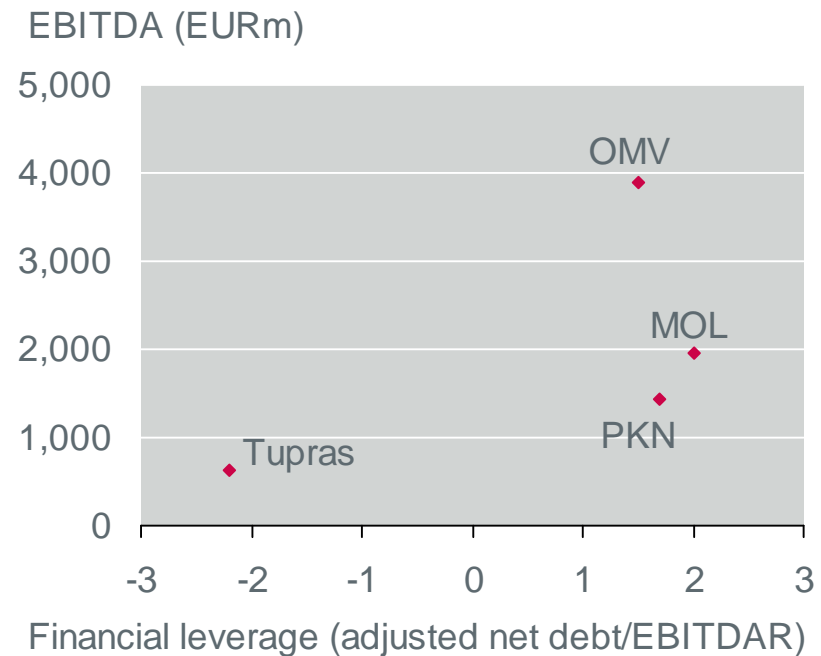
# 2012 Outlook for CE Oil & Gas

- **Largely Stable Outlook:** Most large CE companies with a strong market position should be able to maintain their credit profiles and ratings in 2012.
- **Integrations Better Positioned than Refiners:** Improved pricing fundamentals for oil and gas should result in solid cash flows for integrated companies in 2012. Refining companies are likely to continue to face challenges.
- **Focus on Cash Flow:** CE oil and gas companies will continue their disciplined approach to operating costs and capital expenditure implemented in 2009.
- **Improved Credit Metrics Provide a Buffer:** Several companies improved their credit metrics in 2011 thanks to better cash flow, working capital optimisation, asset disposals or equity increase.
- **Large M&A Transactions Unlikely:** CE companies are not likely to pursue large debt-funded acquisitions, because many are close to, or exceeding their targeted gearing ratios.

# Four Leading CE Players

- OMV (A-) and MOL (BBB-) rated higher than PKN (BB+) thanks to their integrated profile
- Growth strategies: OMV and MOL acquired both upstream and downstream assets, PKN acquired only downstream assets
- Downstream profitability: MOL, PKN's Polish operations and Tupras report higher-than-average refining margins
- All companies proved they are willing and able to reduce capex and dividends in a period of weaker cash flow

## Size and Leverage (2010 Data)

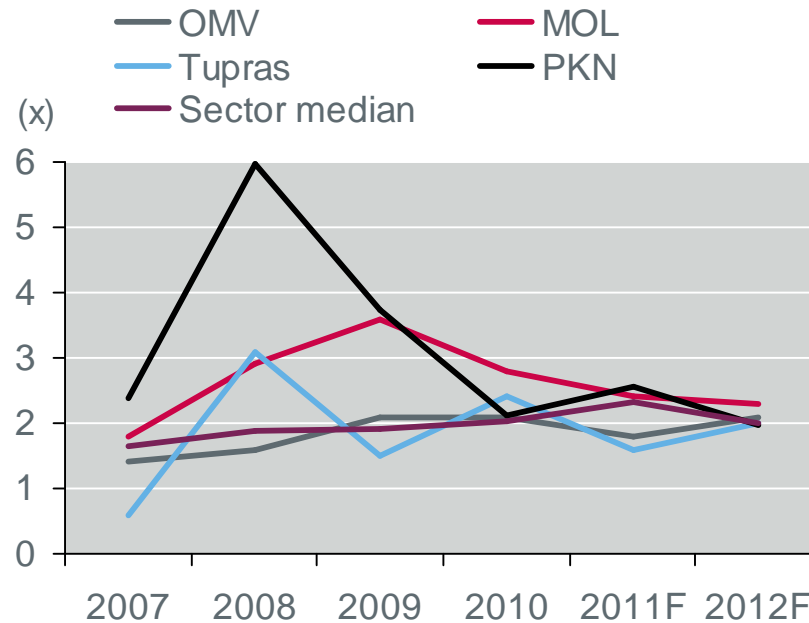


Source: Fitch based on company reports

# Financial Profile

- All four companies have a Stable Outlook
- Rating through-the-cycle: Mid-cycle assumptions used for projections
- Fitch’s expectations are based on the agency’s internally produced, conservative rating case forecasts
- Leverage of four CE players trending towards the Oil & Gas sector median by 2012

## Leverage Including Fitch Expectations<sup>a</sup>

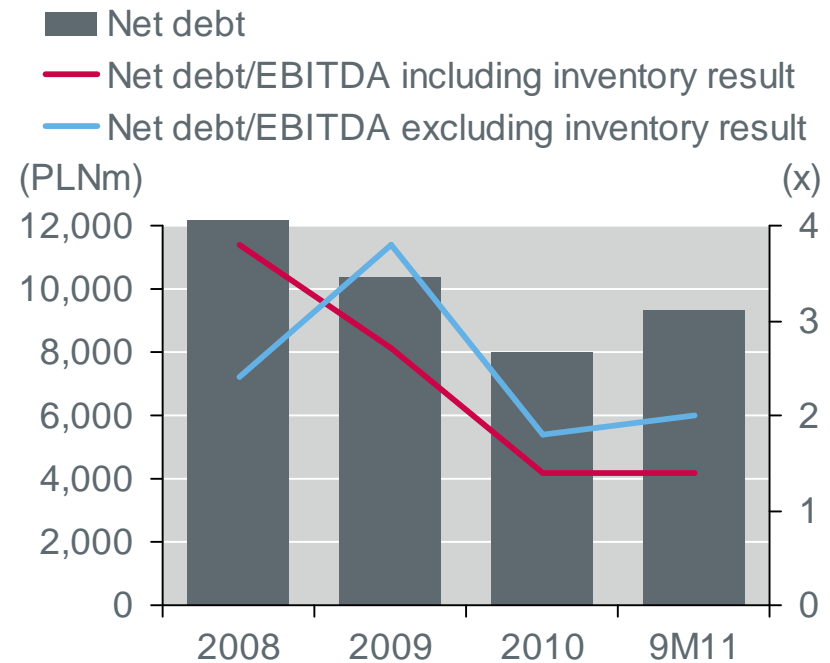


<sup>a</sup> Leverage: Adjusted debt to FFO plus interest  
Source: Fitch calculation and projections

# Credit Profile of PKN (BB+, Stable Outlook)

- Improved financial profile in spite of difficult industry conditions
- Debt refinancing done in 2011 allows PKN to cover its funding needs for the next few years
- The Polkomtel disposal provides additional financial flexibility regarding debt and working capital management
- A substantial part of debt is related to unfavourable regulations regarding compulsory stock in Poland
- A positive rating action would depend on the company's ability to consistently maintain credit ratios at improved levels
- Ratings will also depend on the planned strategy update, industry conditions and non-core asset disposals

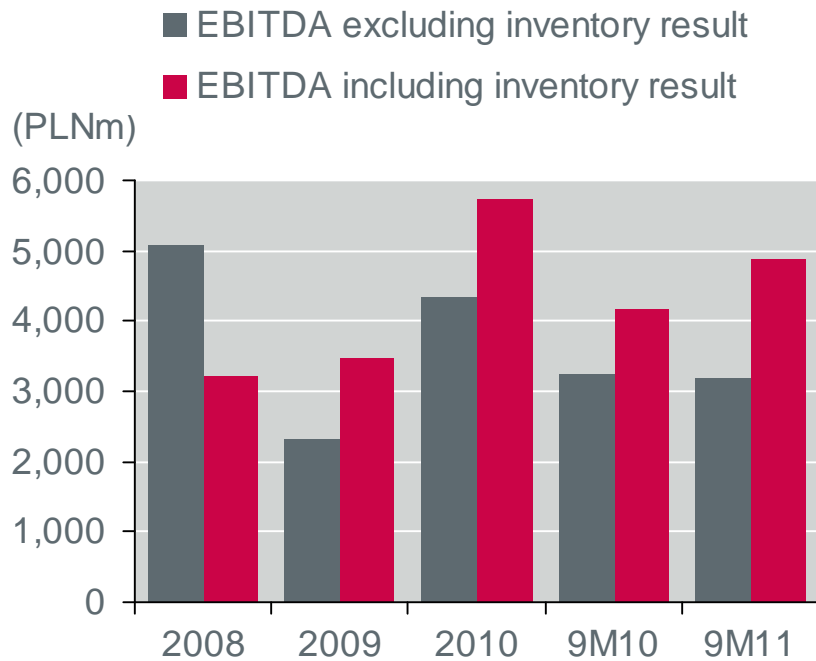
## PKN's Debt and Leverage



Source: PKN, Fitch

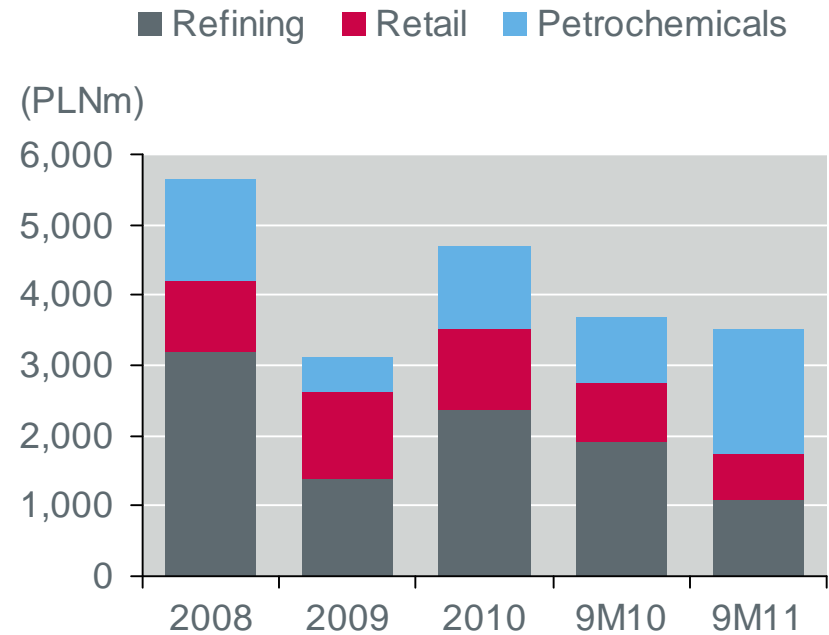
# PKN EBITDA

## Large Exposure to Inventory Result



Source: Fitch based on company reports

## Benefits of Diversification<sup>a</sup>



<sup>a</sup> EBITDA excluding inventory result (without the Corporate Functions segment)

Source: Fitch based on company reports

# Conclusions

- European refining to remain under pressure in 2012
- Integrated companies better positioned than pure refiners
- Focus on cash flow and credit metrics expected to continue
- Stable Outlook for four leading CE players

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**EMEA Utilities  
Credit Outlook 2012**

**Erwin van Lümich, Managing Director  
Energy, Utilities & Regulation**

# Agenda

Fitch's Utilities Ratings Universe in the EMEA Region

FCF and Leverage Expectations for the Sector

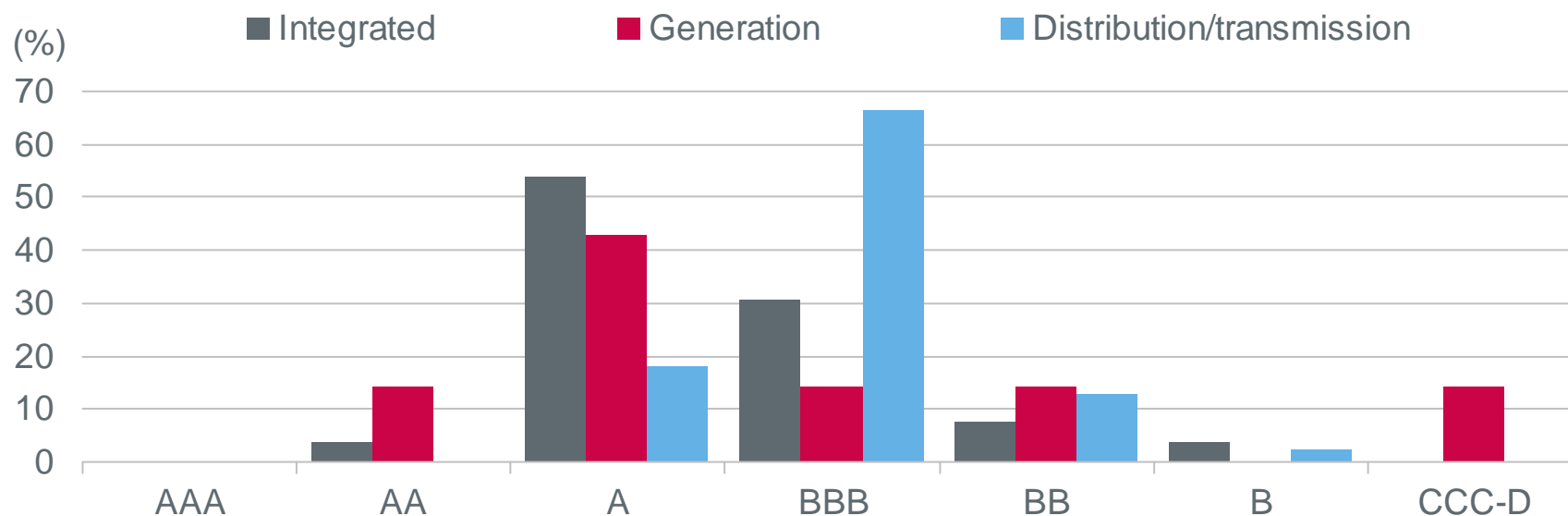
Utility Credit Drivers – Key Risks

Credit Risk Mitigants

# Fitch's Utilities Ratings Universe in the EMEA Region

# Ratings of EMEA Utilities

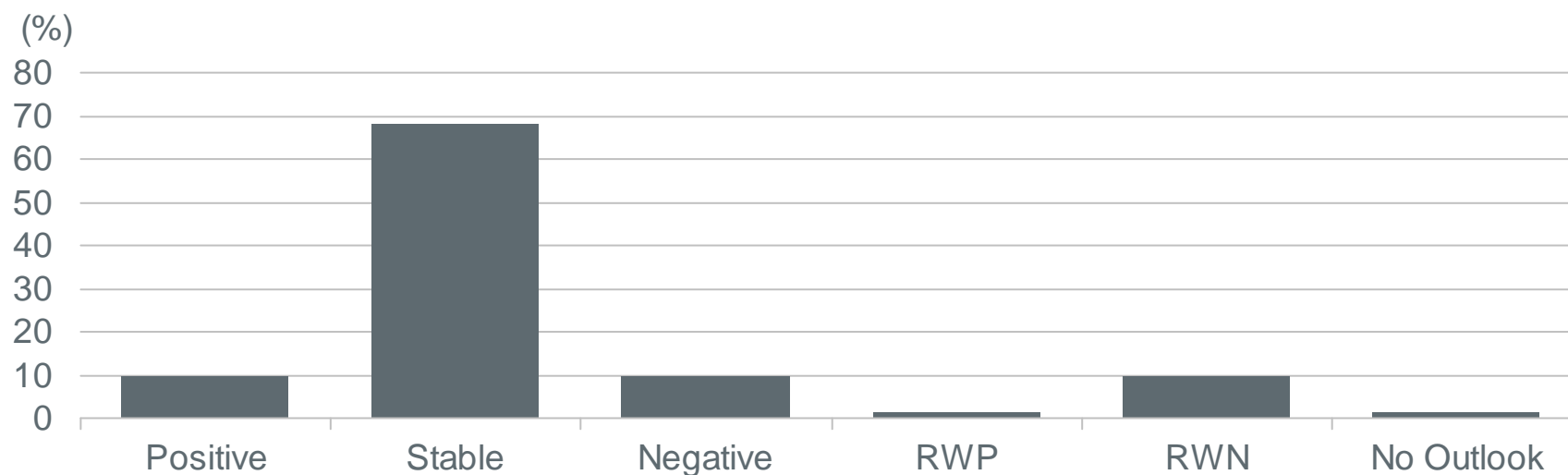
- The bulk of the utilities portfolio is investment grade, mainly in the 'A' to 'BBB' range
- Downward rating migration in the past decade
- 2011YTD: 7 new ratings, 10 downgrades, one upgrade, 52 affirmations



Source: Fitch; based on Long-Term IDRs at 31 October 2011

# Outlooks of the EMEA Utilities Portfolio

- 68% of utilities ratings on Stable Outlook (77% at YE10)
- 10% on Negative Outlook (close to 40% at end-2009)
- 10% on Positive Outlook
- One issuer is on Rating Watch Positive, seven on Rating Watch Negative



Source: Fitch; based on Long-Term IDRs at 31 October 2011

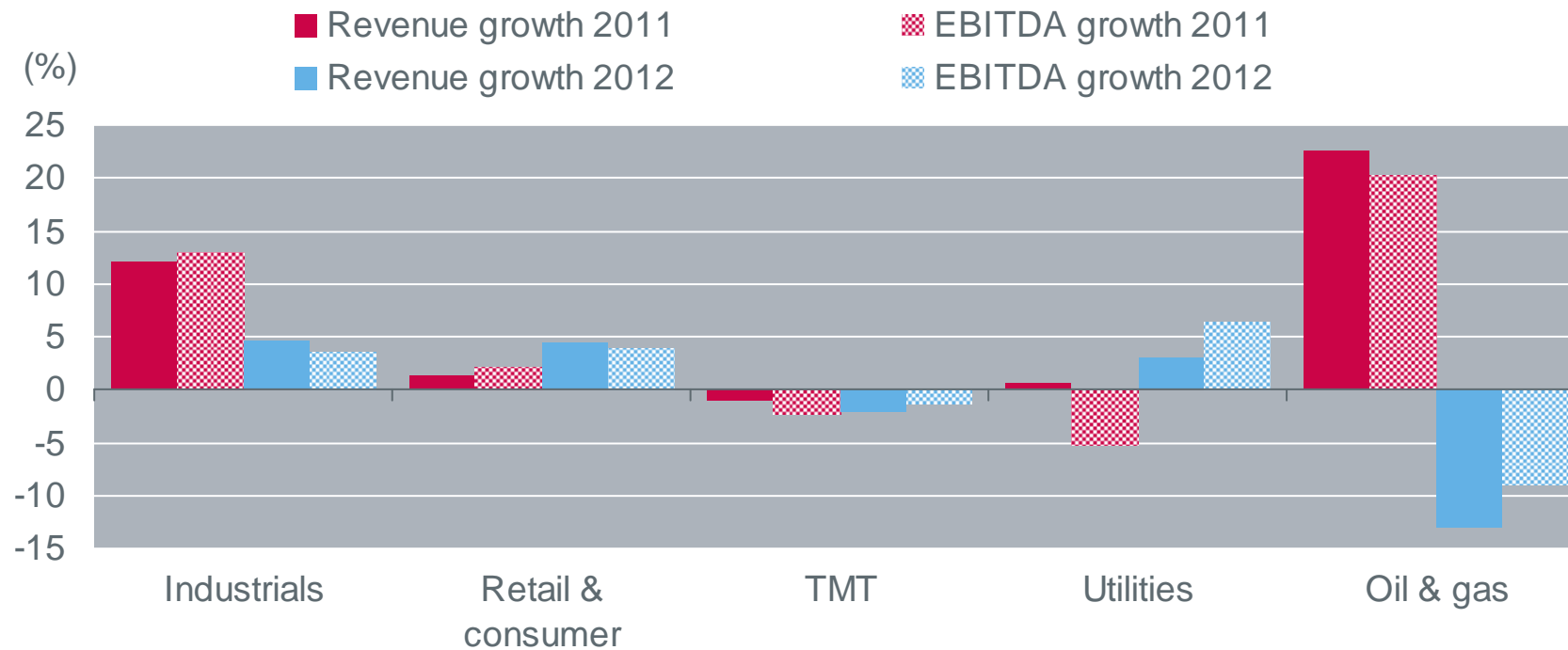
# Main Drivers for Recent Negative Rating Actions

- Sovereign Risk:
  - Portugal: EDP, SA ('BBB+' on RWN)
- Regulation / Changes in Law:
  - Germany: RWE ('A' / Negative Outlook) and EnBW ('A-' / Stable Outlook) – nuclear decision
  - Italy: Acea SpA ('A' on RWN) and Aquedotto Pugliese, SpA ('BBB-' on RWN) - referendum
- Business fundamentals / Market conditions
  - Italy: Edison SpA ('BBB-' on RWN) – exposure to market volatility and uneconomic long-term gas contracts
- Credit Metrics Weakening
  - Russia's OJSC Territorial Generation Company No.2 ('CCC'), Sweden's Vattenfall ('A-' on Stable Outlook), UK's SSE ('A-' on Stable Outlook), Finland's Fingrid ('A' on Stable Outlook)

# FCF and Leverage Expectations for the Sector

# EMEA Corporates – Slow Earnings Growth

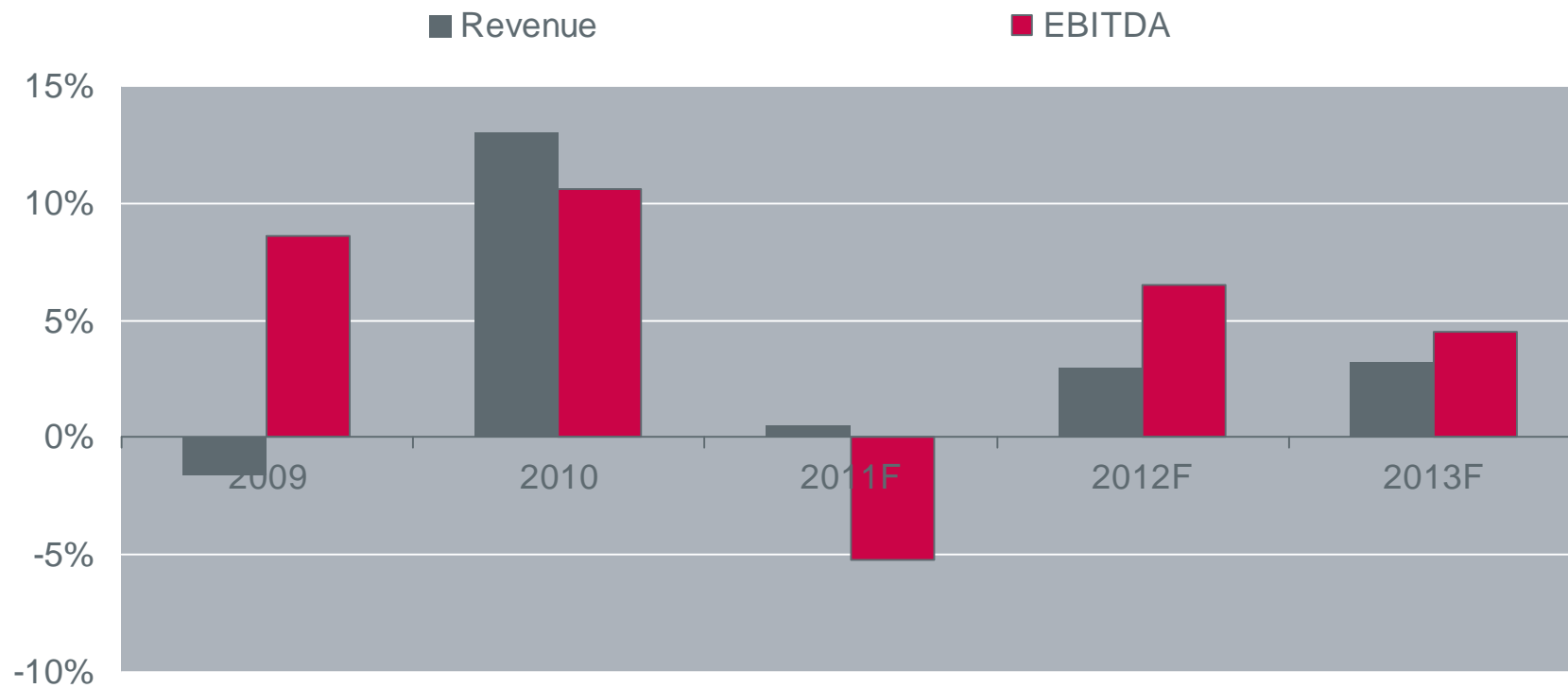
Revenue and EBITDA Growth 2011 and 2012 – Total Portfolio



Source: Fitch forecasts

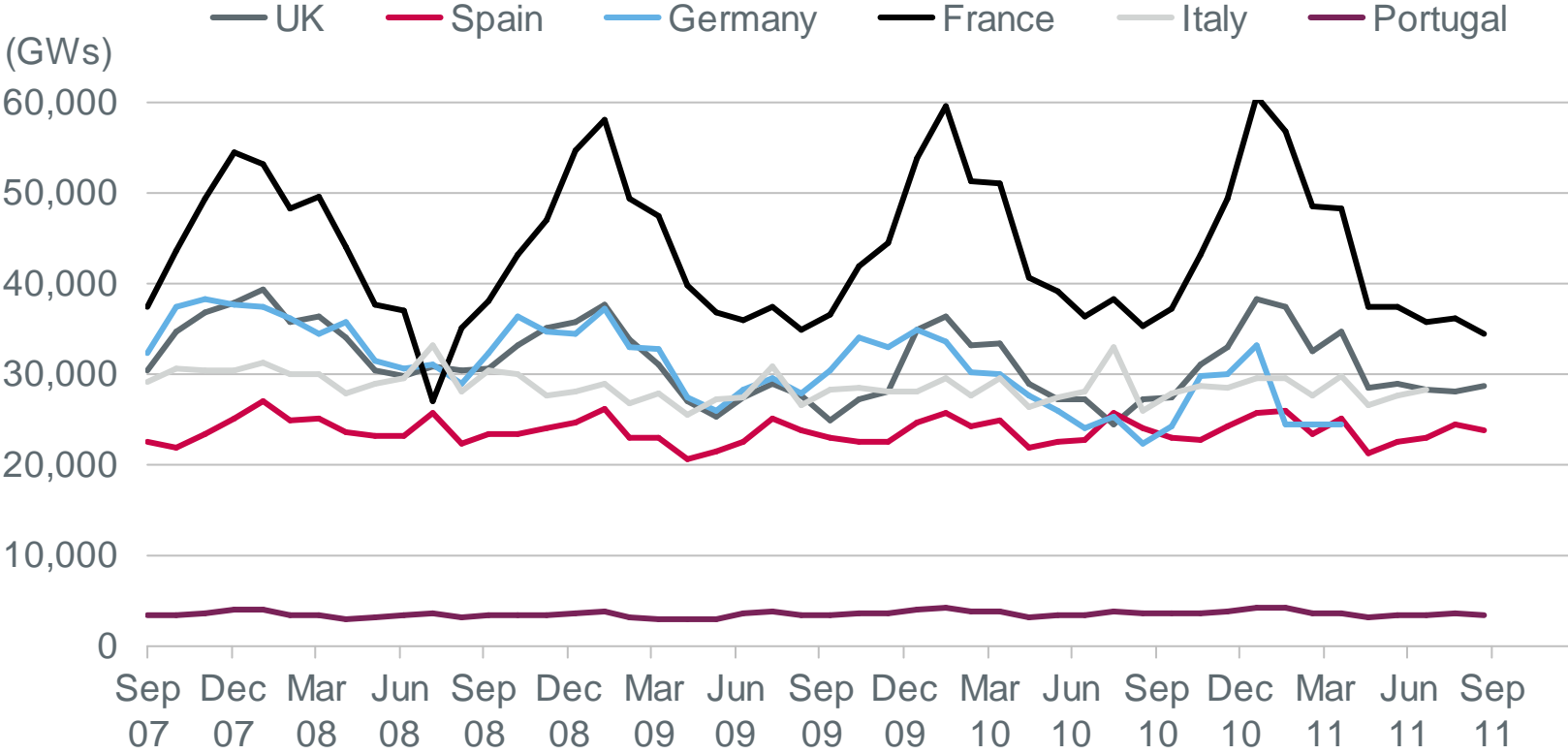
# Moderate Earnings Growth Expectations for EMEA Utilities

## EMEA Utilities Revenue and EBITDA Growth 2009 - 2013



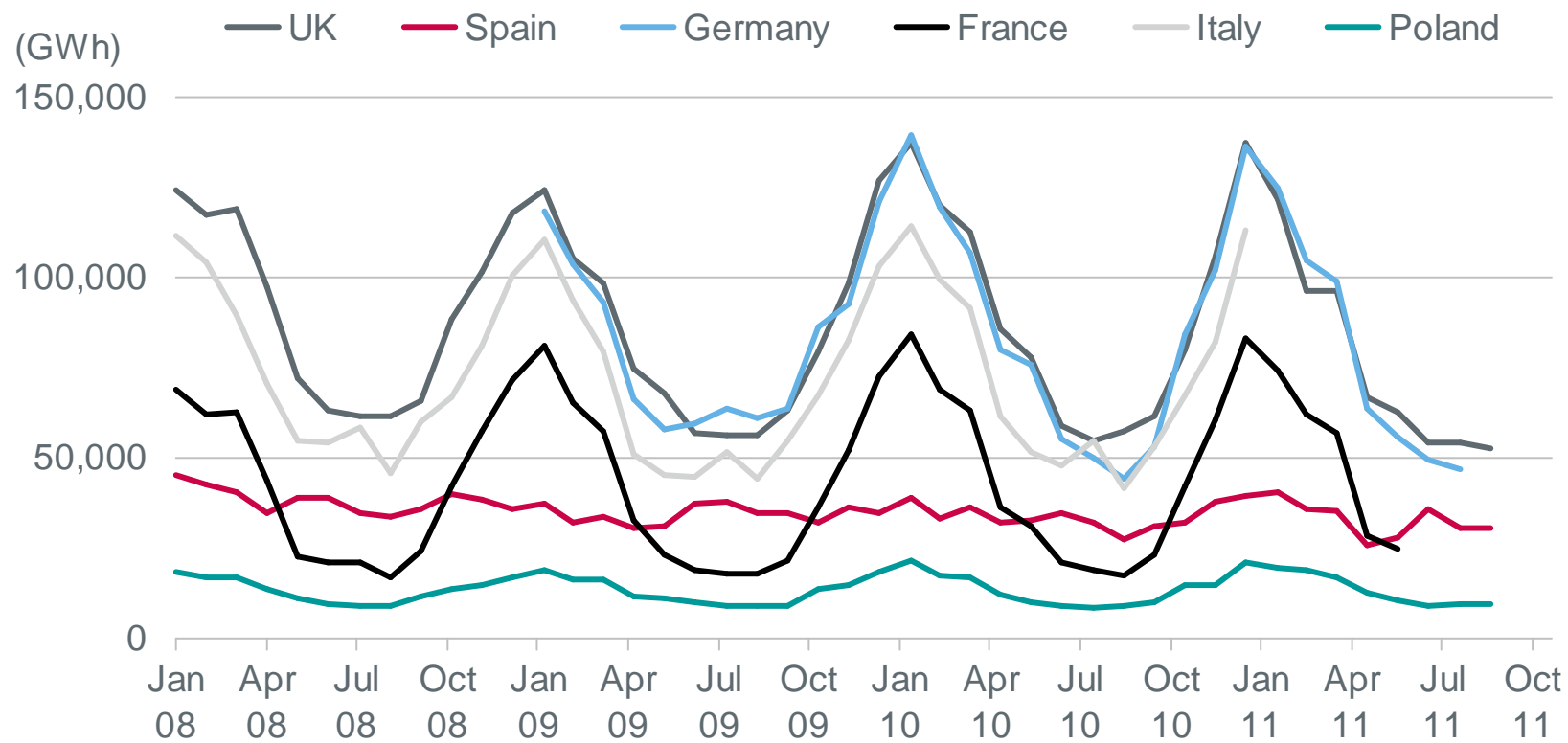
Source: Fitch forecasts

# Driven by Weak Electricity Demand,



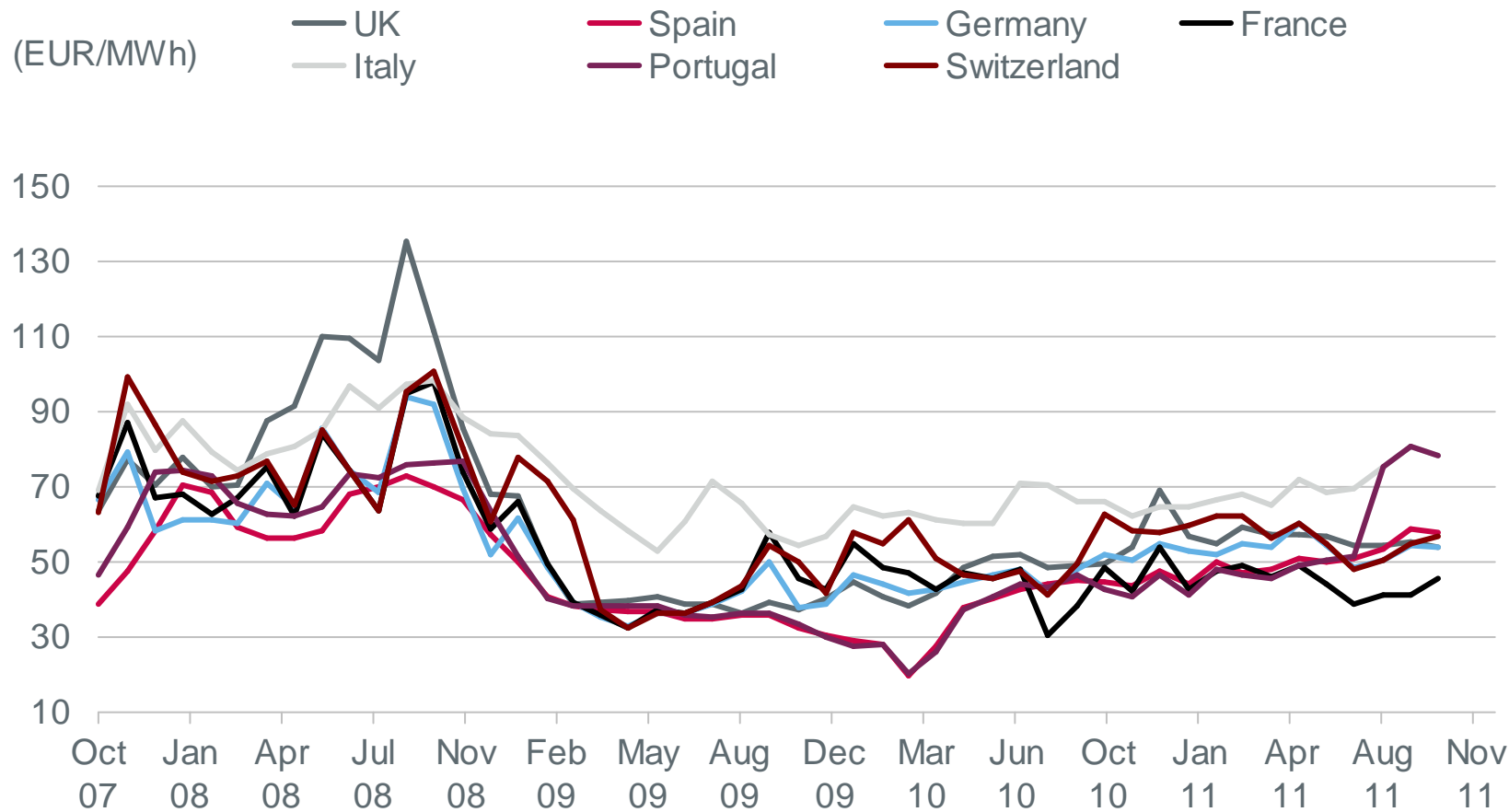
Source: Bloomberg, Fitch

# Weak Gas Demand...



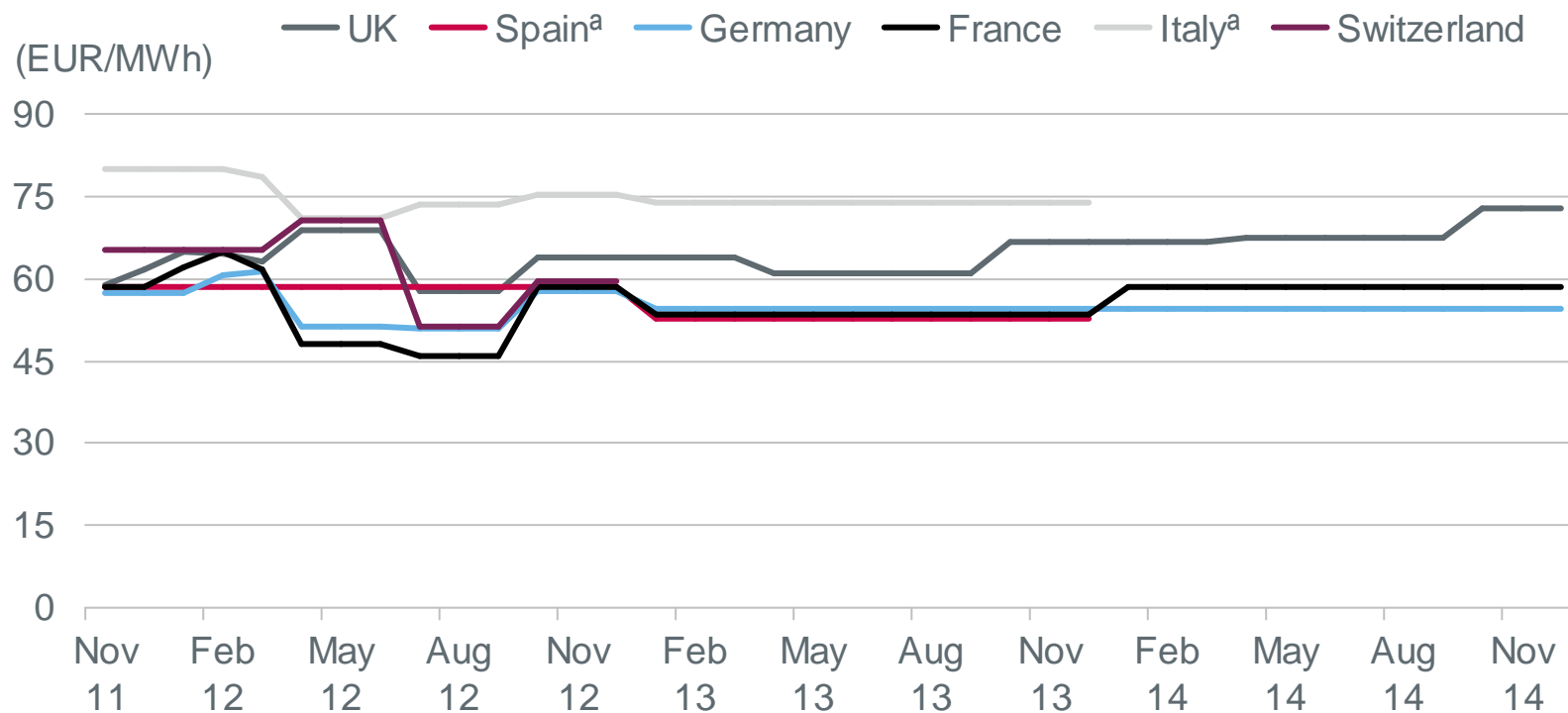
Source: Bloomberg, Fitch

# And Weak Pricing (I)



Source: Bloomberg (Electricity Price One Day Ahead), Fitch

## And Weak Pricing (II)



<sup>a</sup> Data for Spain and Italy until Dec 2013 and for Switzerland until Dec 2012

<sup>b</sup> FX GBP/EUR rate: 1.1684 as of 01/11/2011

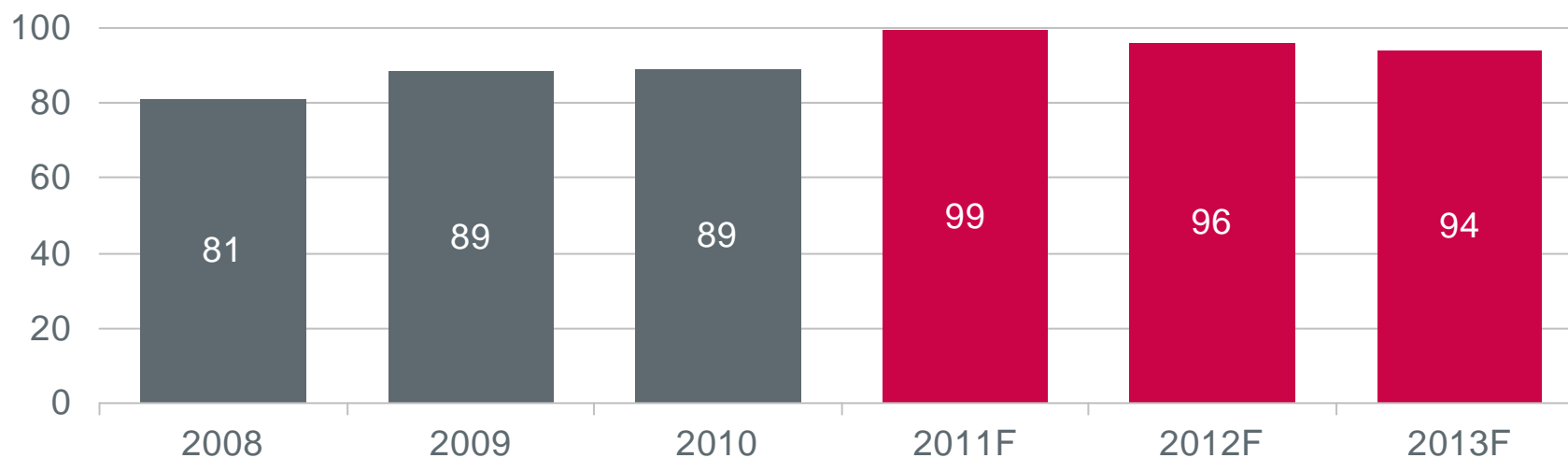
Source: Bloomberg (Electricity Forward Prices), Fitch

# High Capital Expenditure Burden

- EMEA utility capex spend is relatively constant, reflecting its asset-intensive nature
- Long project lead times and strategic nature of assets limit capex discretion
- Close to 75% of capex spend is developed market related, with the remainder in emerging markets

## EMEA Utilities Capex

(EURbn)



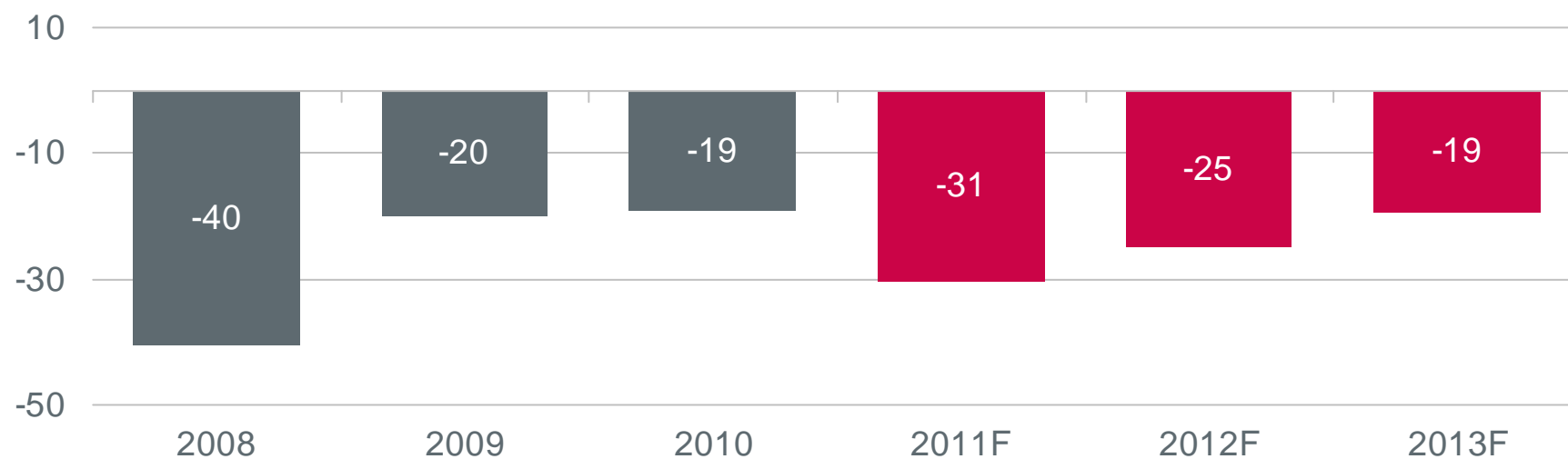
Source: Fitch

# Negative Free Cash Flow

- Weak earnings and large investment programmes drive sustained negative FCF
- Fitch does not anticipate a return to the lows of 2008
- About 50% of negative FCF is derived from emerging market issuers

## EMEA Utilities FCF

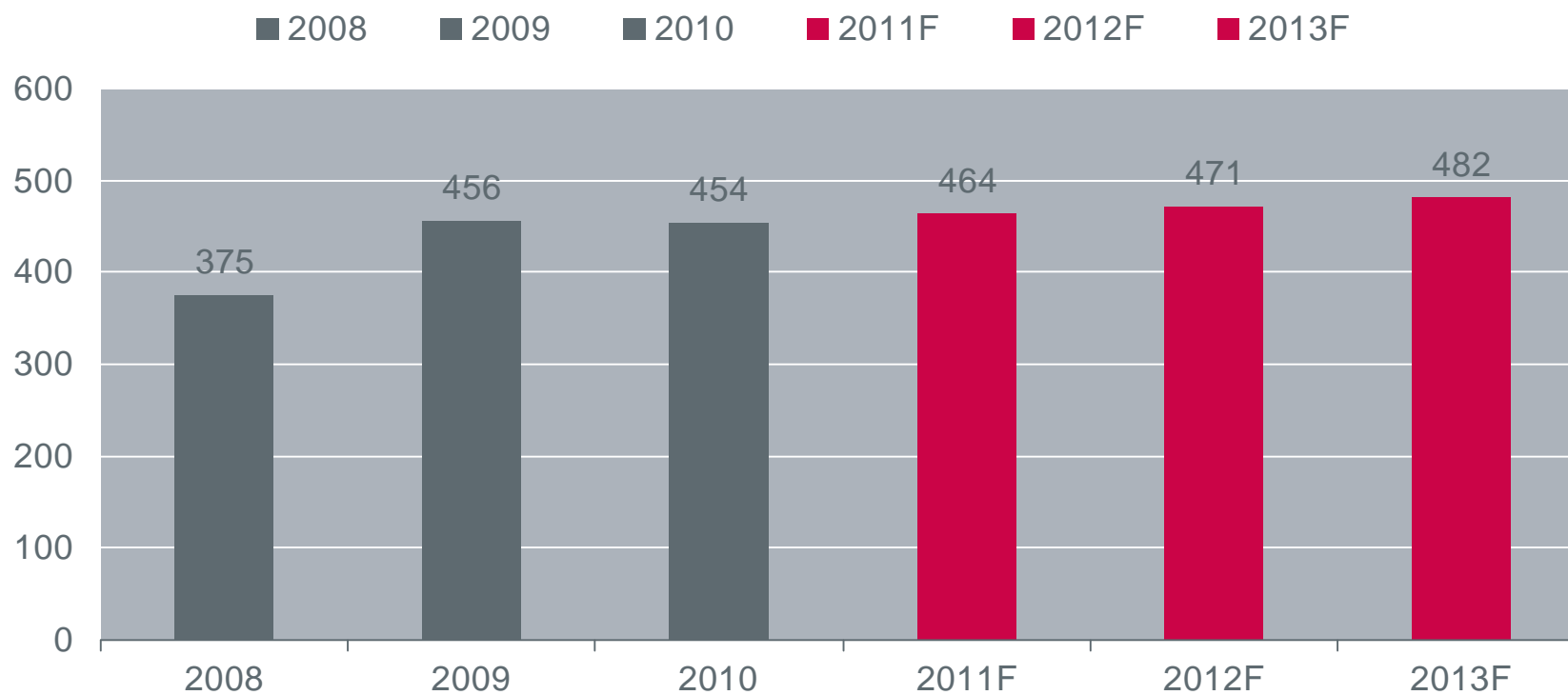
(EURbn)



Source: Fitch

# Limited Debt Reduction Potential

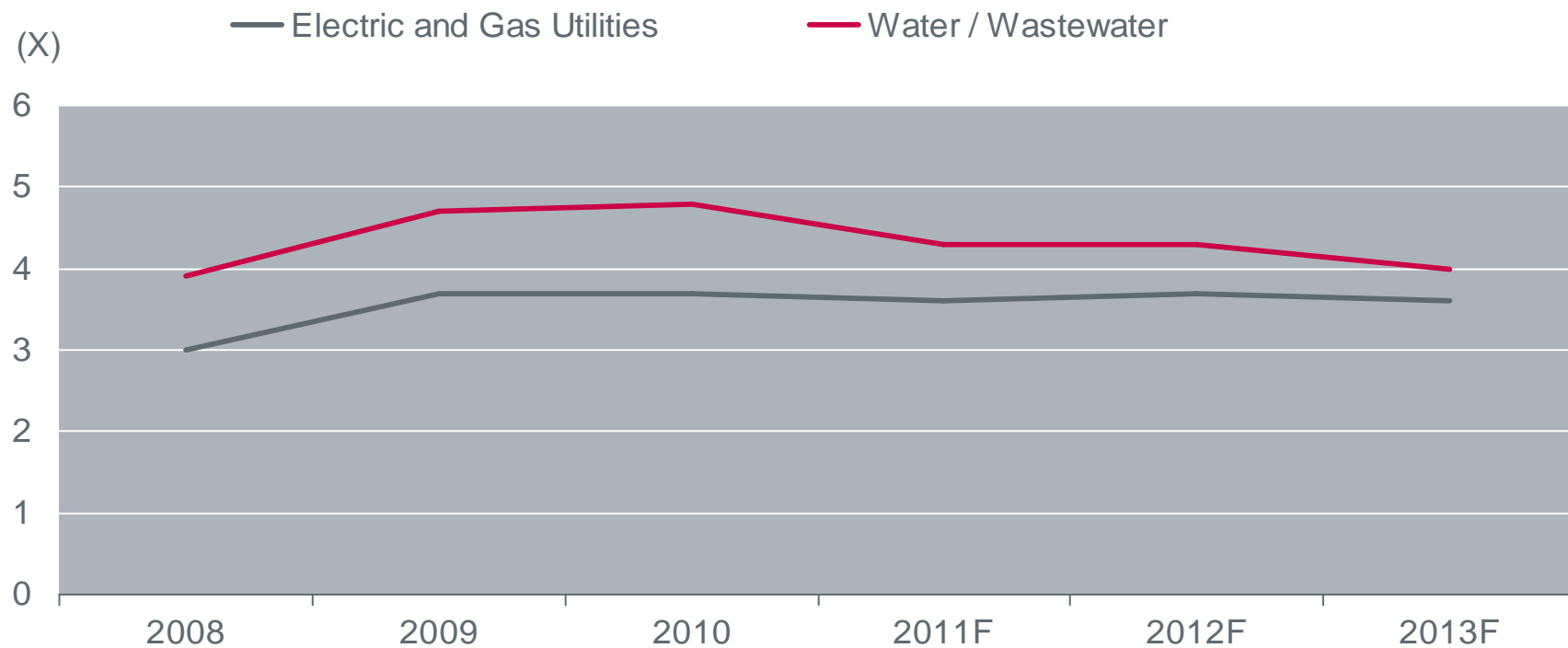
## Gross Debt Trend 2008 - 2013 (EURbn)



Source: Fitch forecasts based on rated portfolio

# Stubborn Leverage

## FFO Adjusted Net Leverage



# Utility Credit Drivers – Key Risks

# Negative Regulatory Intervention

- Recent examples include:
  - German nuclear tax and subsequent abolition of lifetime extension
  - Spanish tariff freeze
  - Northern Ireland: proposed retrospective regulatory value adjustment relating to outperformance in 1996-2006
  - Portugal: deferral in collection by EDP of costs related to cogeneration and renewables regimes and in recovery under CMEC mechanism
- Signs of a clamp down on renewables support mechanisms
- Remuneration formulas based on government yield plus a margin are likely to come under pressure

# Sovereign Credit Pressure

- Most European utilities still below sovereign ratings; exceptions EDP (Portugal) and ESB (Ireland)
- Sovereign-related rating constraints emerging in the Eurozone

## Impact of Sovereign Crises

- Windfall taxes & sector reform
- Higher funding costs
- Consumption ▼; Bad debt ▲

## Utility-Specific Risk

- Moderate: To be balanced with need for investment and employment
- Moderate: 200 additional bps on new debt factored in
- Moderate: Demand inelasticity

# Sovereign Rating Relationship to Corporates

- The “Rubber Band”

## Implications of Aggressive Deterioration in Euro-Zone Sovereign Ratings

Sovereign FC IDR	Likely Maximum Corporate FC IDR		
	Primarily Domestic	←-----→	Internationally Diversified
BBB	Potentially no impact	←-----→	Potentially no impact
BB+	BBB	←-----→	Potentially no impact
BB-	BBB-	←-----→	Potentially no impact
B+	BB+	←-----→	Potentially no impact
B-	BB	←-----→	Potentially no impact
CCC	BB	←-----→	Potentially no impact
RD	BB	←-----→	Potentially no impact

Source: Fitch

- Remember, these are indicative maximum ratings; they can always go lower!
- Disorderly sovereign default would have severe impact on utilities

# U-turn to Nuclear Revolution

- Japan incidents to delay roll-out of new nuclear; lifetime extensions at risk
  - Security of supply implications?
- Nuclear policy adjustments vary across Europe
  - Germany and Italy have turned their backs on nuclear
  - The likes of France and Finland unlikely to follow
- Consequences:
  - Rising costs and prices
  - The end-consumer will ultimately pay
  - Potential opportunity for thermal generators and renewables

# Choppy Gas Markets

- Recovery of European gas prices ; US prices pressured by shale gas plays
- Fitch's view
  - Europe to remain dependent on a handful of key gas suppliers, but LNG and pipeline development provide some diversification
  - Dislocation between gas and oil prices potentially a temporary phenomenon
  - Some success in long-term contract negotiations – final conditions are opaque
  - Connectivity and increased infrastructure to result in price convergence in the region
  - Potential gas margin squeeze if spot markets do not fully recover
  - Shale gas in Europe may be a “game changer” in the medium term

## Other Key Credit Risks

- Poor thermal utilisation rates and weak dark and spark spreads
  - Partially mitigated by decommissioning of coal plants
  - Renewable capacity build-out calls for higher reserve margins
  - Is re-regulation through capacity payments an option?
- CO2 prices post-2013
  - Potential merit order reversal – gas taking the place of coal
  - Generation mix crucial: Players with high carbon intensity are at risk
- Earnings stability affected by disposals of network businesses – The Third Energy Package
  - Implementation varies by country

# Credit Risk Mitigants

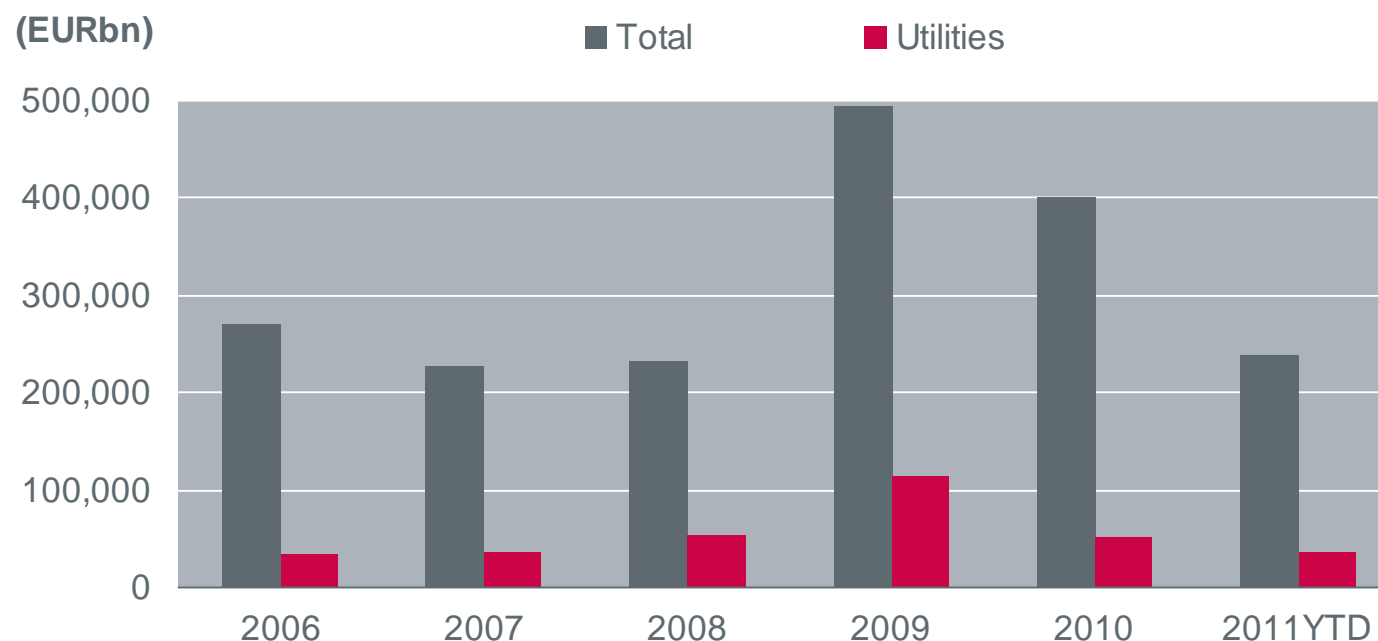
# Credit Risk Mitigants

- Balance sheet strength prioritised
  - Commitment to ratings, helped by a shift in funding mix from bank to bond market
  - Sector has strong track record of accessing debt capital markets
  - Limited market openings for unrated issuers
  - Hybrids, new equity and scrip dividends used to protect ratings
- Sound liquidity, despite negative FCF
  - Most utilities comfortably cover near-term financing needs
  - Liquidity scores adequate on average, but wide discrepancies for individual companies
  - Emerging market credits continue to face the toughest liquidity challenges

# Funding Considerations

- EMEA debt capital markets issuance reached record levels in 2009 but has since normalised
- The contribution of the utilities sector to corporate EMEA issuance was 15% in the 10 months to end-October 2011, from 13% in 2010

## EMEA Bond Issuance

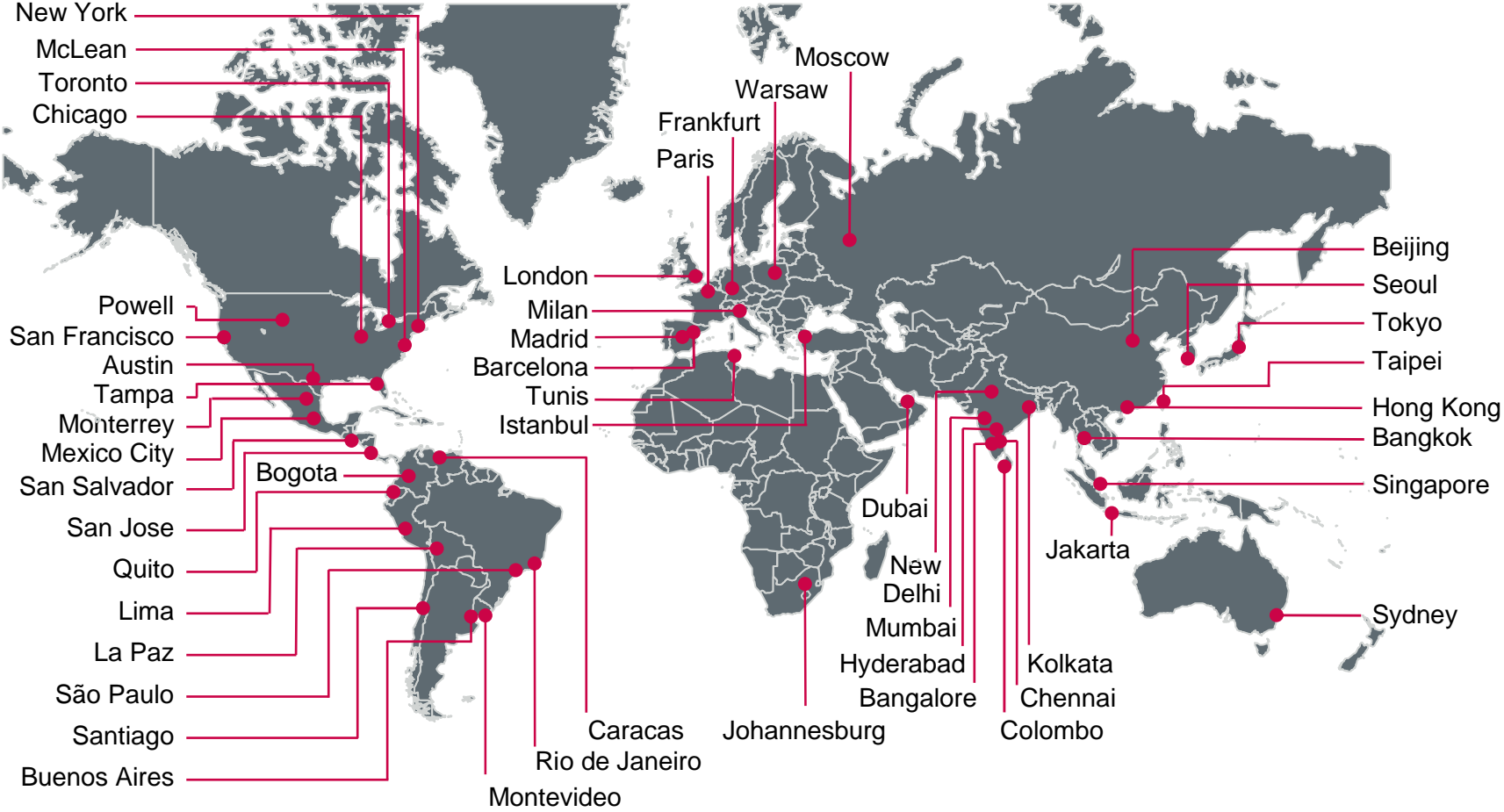


Source: Dealogic

## Credit Risk Mitigants (cont.)

- Transformational M&A not on the agenda
  - Political and balance sheet constraints
  - Bolt-ons still an option
- Disposal, IPO and asset swap potential
- Optimising costs / Opaque cost structures

# Global Presence



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**CE Utilities: Outlook 2012**

**Jacek Kawałczewski, Associate Director  
Energy, Utilities & Regulation**

# Market Structure

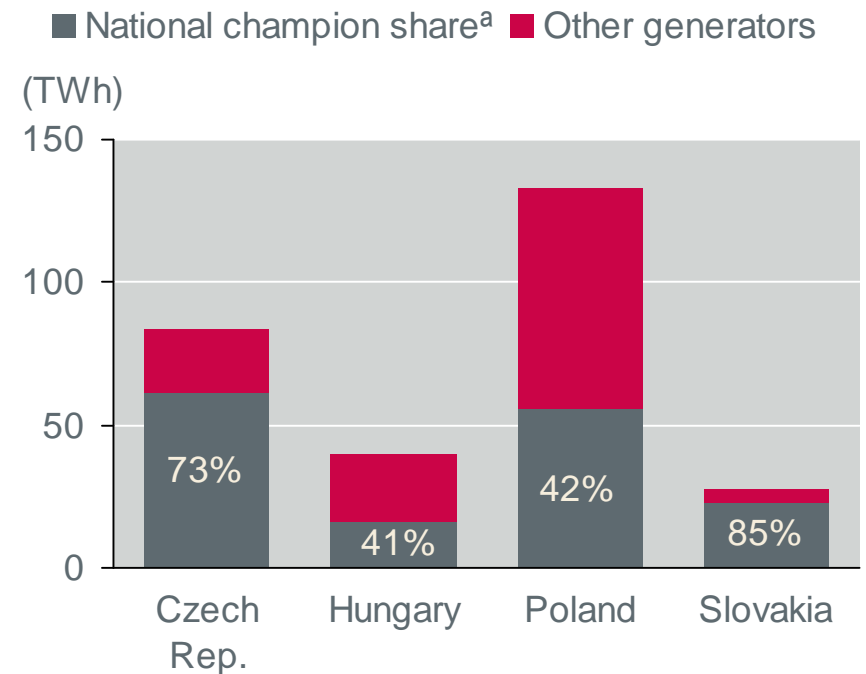
National champions play focal role in the CE region (CEZ, PGE, SE and MVM)

Consolidation of Polish power in the past few years and being continued

CEZ and PGE have a vertically-integrated position from mining, through generation to distribution and supply

Larger, diversified players have better access to debt markets than smaller utilities

## National Champions' Share in Power Production



<sup>a</sup> CEZ (Czech Republic), MVM (Hungary), PGE (Poland) and SE (Slovakia)  
Source: Companies, Fitch calculation

# Focus on Domestic Market and Future Generation Mix

Increased focus on domestic market rather than international expansion

Large capex period ahead for CE utilities in 2011-2015

EU regulations (renewables, CO2) important drivers for capex decisions and future generation mix

Capex decisions delayed because of electricity and fuel price uncertainties

Substantial capex for 15GW-20GW of new nuclear capacity

Large capex for coal-fired plants in Poland

Renewable energy – wind farms are taking off

 **Fitch's view:** Diversification of generation mix is positive and reduces business risk

# Key Rating Drivers 2012

Stable operating cash flows in 2012

Growing proportion of regulated earnings positively affects the business profile

Continued operational and financial integration of the Polish integrated groups

Uncertainties regarding electricity and fuel prices

Funding costs might jeopardize some of the strategic projects

Still lacking full liberalisation of electricity prices

 **Fitch's view:** Improved integration of the vertically integrated utilities will positively influence the business profiles

# High Capex Drives Up Leverage

Leading CE utilities enter capex-intensive period in 2011-2015

- Capex in generation (conventional power plants and renewables)
- Capex in transmission and distribution (network modernisation and development)

Expected increase in financial leverage of main CE players

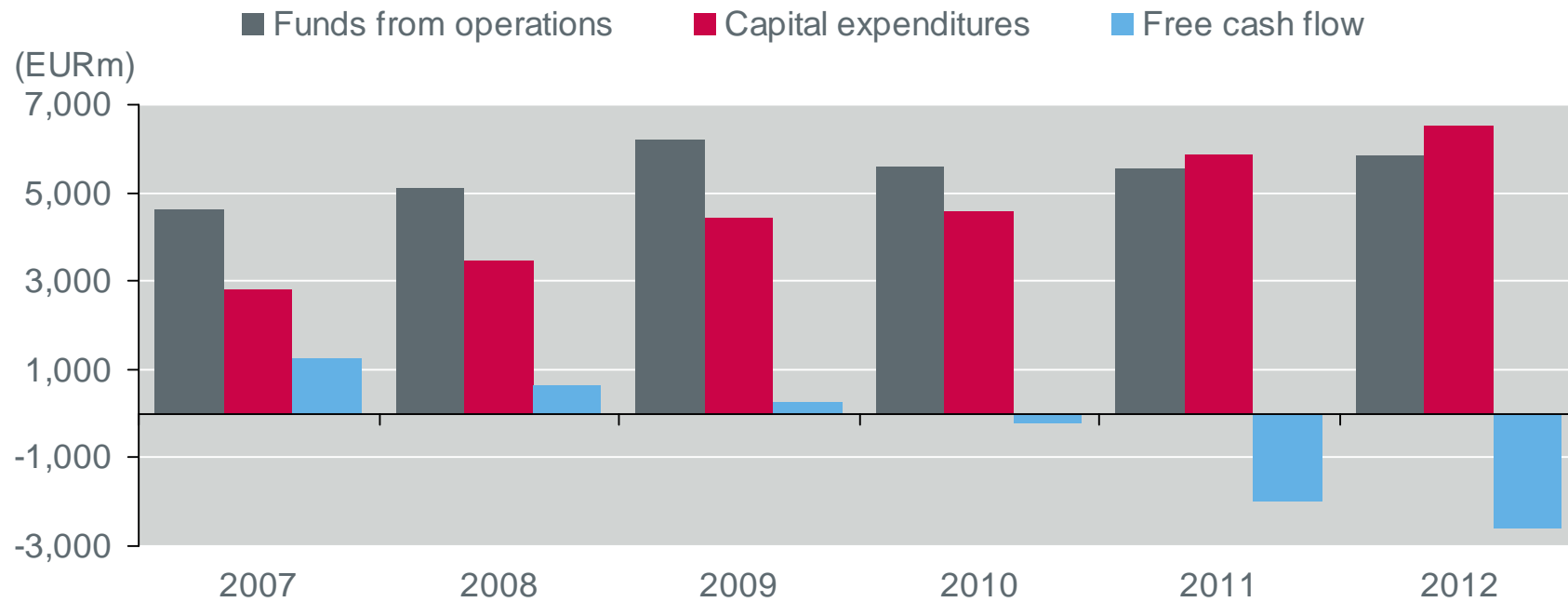
- Increase in mid-term capex expected to result in negative free cash flow and a need to raise debt
- Bonds expected to be an important part of new debt

Capex flexibility reflected in ratings

M&A activity may constrain capex growth at the end of the rating horizon

## ... and How it Looks in Numbers

### Aggregated Cash Flow of Five Leading CE Utilities<sup>a</sup>



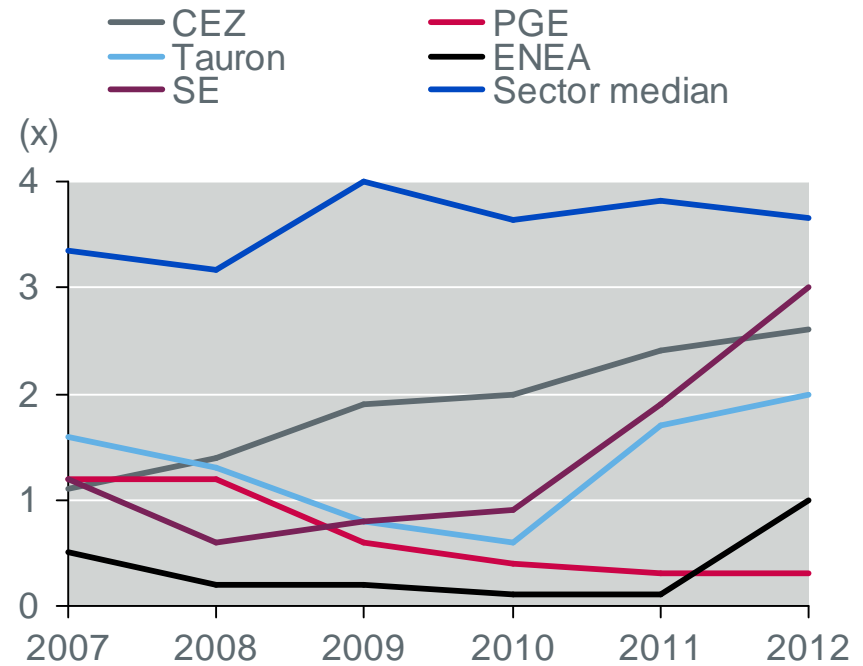
<sup>a</sup> CEZ, PGE, Slovenske Elektrarne, Tauron, ENEA  
Source: Company reports and Fitch expectations

# Stable Outlook Despite Rising Leverage

- Five rated CE utilities have low leverage compared with the European utilities sector median
- Fitch expects leverage to rise to about 2x-2.5x in the medium term

**➔ Fitch's view:** No rating downgrades are expected, as this leverage level is commensurate with the current ratings

## Leverage Including Fitch Expectations<sup>a</sup>



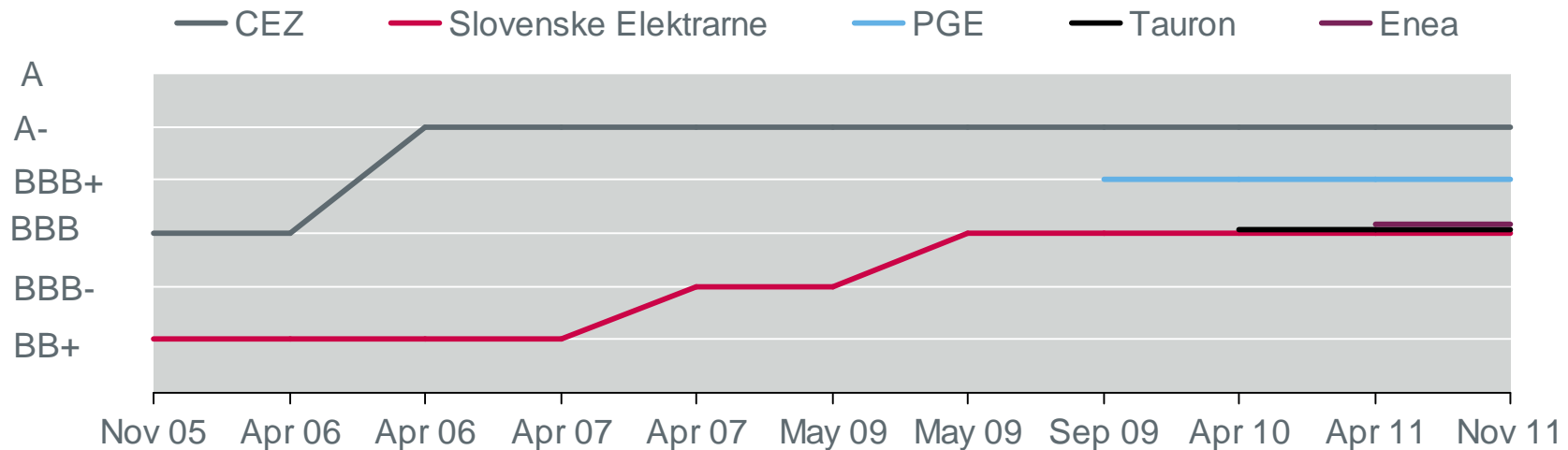
<sup>a</sup> Leverage: Adjusted debt to FFO plus interest  
Source: Fitch calculation and projections

# Rating Changes for CE Utilities

Low rating volatility typical for defensive sectors

Rating upgrades in the past mainly due to improved business and financial profiles

## Rating Changes



Source: Fitch

# Comparison of Leading CE Electric Utilities

	<b>CEZ</b>	<b>PGE</b>	<b>Tauron</b>	<b>SE</b>	<b>ENEA</b>
Rating/outlook	'A-'/stable	'BBB+ '/stable	'BBB' /stable	'BBB' /stable	'BBB' /stable
Headroom within current rating level	Limited	Large	Large	Medium	Large
Country/rating and outlook	Czech Republic A+/positive	Poland A-/stable	Poland A-/stable	Slovakia A+/stable	Poland A-/stable
Vertical integration	Full (from mining to supply)	Full (from mining to supply)	Full (from mining to supply)	Low	Advanced (from generation to supply)
Generation mix diversification	Medium 42% nuclear, 45% lignite, 10% hard coal	Limited 68% lignite, 25% hard coal	Limited 93% hard coal	Medium 43% hydro, 32% nuclear and 25% coal	None 98% hard coal
Regulated business (share in EBITDA) (%)	19	21	41	0	42
Liquidity position	Adequate	Ample	Adequate	Adequate	Ample

Source: Fitch

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