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## University Of Kentucky; Public Coll/Univ - Unlimited Student Fees

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# University Of Kentucky; Public Coll/Univ - Unlimited Student Fees

## Credit Profile

US\$14.22 mil General Receipts Rfdg Bnds ser 2019A dtd 02/25/2019 due 11/01/2024

*Long Term Rating*

AA/Stable

New

## Rationale

S&P Global Ratings assigned its 'AA' long-term rating to University of Kentucky's (UK) \$14.22 million series 2019A tax-exempt general receipts bonds. In addition, S&P Global Ratings affirmed its 'AA' long-term rating and underlying rating on almost \$1.1 billion in various existing general receipts bonds issued for and by UK. The outlook is stable on all rated issues.

As of UK's fiscal year end, June 30, 2018, its outstanding long-term debt, inclusive of capitalized leases and notes, totaled \$1.20 billion, and with the issuance of the series 2019A and an additional, planned, series 2020 bond issue totaling approximately \$127.93 million, that we are factoring into this analysis, we estimate pro forma long-term debt will rise to \$1.32 billion.

The rating reflects our view of UK's very strong enterprise and financial profile. The enterprise profile is characterized by a healthy market position and demand with positive year-over-year growth in FTE enrollment and rising applications in most recent years. The enterprise profile also reflects a slightly elevated industry risk profile due to exposure to health care in addition to higher education as UK HealthCare (UKHC) accounts for about half of the university's total adjusted operating revenue. Nevertheless, UKHC enjoys a favorable patient utilization trend. The financial profile reflects recurring positive financial operating surpluses, good revenue diversity largely due to UKHC, excellent financial resources and healthy debt and contingent liabilities with a low debt burden. In addition, in our view, UK's management and governance is robust and as Kentucky's flagship higher education institution, the university enjoys the commonwealth's support for its operations and for some capital needs, although the support for operations has declined in each of the past five years. UK also enjoys very strong philanthropic support. Combined we believe these credit factors lead to an initial indicative rating of 'aa' and final bond issue rating of 'AA'.

In our view, UK's reputation as a comprehensive research-based university with diverse educational offerings and a first class health system enables it to attract about one-third of its students from beyond the state's border.

The long-term rating and stable outlook reflect our assessment of the university's:

- Flagship status within the Commonwealth of Kentucky higher education system and its broad program offerings and nationally recognized academic medical center;
- Rising student enrollment with total full-time equivalent (FTE) enrollment increasing 1.1% in fall 2018 to 28,851 from 28,550 in fall 2017;
- Favorable revenue diversity with its health system accounting for 53.5% of total adjusted operating revenue in fiscal

2018, 14.5% of tuition and fees, 8.9% of grants and contracts, and 7.5% of commonwealth operating support;

- Positive financial operating performance on a full accrual basis with surpluses realized in each of the last five fiscal years and an average 4.2% net operating margin over this period;
- Excellent financial resources for the rating with adjusted unrestricted net assets as of fiscal year-end 2018 equal to 36.9% of adjusted operating expenses and 94.9% of pro forma debt coupled with a relatively low pro forma maximum annual debt service (MADS) burden of 3.2%;
- Robust management and governance that budgets conservatively, utilizes an enterprise risk management program, and plans proactively for hypothetical disruptive environment scenarios and follows sound investment practices; and
- Impressive philanthropic support as it has realized gifts, non-exchange grants, capital grants and gifts and additions to permanent endowment that have averaged \$194.57 million annually over the past five fiscal years and with a relatively new capital campaign launched in September 2018 that seeks to raise a total of \$2.1 billion.

Credit factors offsetting some of the preceding credit strengths include:

- State budgetary pressure in Kentucky resulting in declining state operating appropriations to \$264.42 million in fiscal 2018 from a recent yearly high of \$297.6 million in fiscal 2012 (fiscal 2019's appropriation is budgeted at \$258.6 million); and
- University budgetary pressure with a 4.89% increase in the \$3.89 billion budget for fiscal 2019 compared with the prior year's revised \$3.71 billion budget while capital spending remains high to address infrastructure and deferred capital needs.

A pledge of the university's general receipts, and for the university's series 2009B and 2010B bonds only, the federal subsidy for the Build America Bonds and Qualified Energy Conservation Bonds, secure the bonds. General receipts are defined as certain operating and non-operating revenues of the university, including student tuition and fees; nongovernmental grants and contracts; recoveries of facilities and administrative costs; sales and services; hospital revenues; housing and dining revenues; and auxiliary enterprises, which includes athletics and other auxiliaries, other operating revenues, state appropriations for general operations, gifts and non-exchange grants, investment income, and other non-operating revenues.

We understand proceeds from the series 2019A general receipts bonds will refund the series 2009A bonds currently outstanding.

The university continues to invest heavily in capital as part of its campus transformation initiative. Capital spending in fiscal 2018 and 2017 totaled \$420.2 million and \$370.9 million, respectively, while the annual cash flow realized from depreciation for each of these years totaled \$164.4 million and \$151.4 million. We understand that over \$2.3 billion in investment has occurred on the campus since July 2011. Some of this investment has been funded by public-private partnerships--for example, since 2013, UK has extensively overhauled its student residence facilities through a privatized housing program with a third-party developer, Education Realty Trust (EdR) with a total of 14 new residence halls opening containing 6,850 new beds, which have come on line since that time at a cost of \$449.3 million funded by EdR. Similarly, in 2014, UK entered into a 15-year P3 arrangement with Aramark valued at \$250 million by UK for its dining services that has resulted in Aramark providing \$70 million in capital for new and existing facilities

improvements. More recently in the summer of 2018 UK opened a \$265 million multi-disciplinary research building. The other major project that constitutes a significant portion of the overall capital spend is a \$412.6 million multiphase expansion and renovation of UKHC's facilities that are expected to be fully completed by 2022.

The University of Kentucky is a comprehensive land-grant and flagship institution of the commonwealth's higher education system located in Lexington. The university has more than 200 academic programs spread across 16 degree-granting colleges in addition to the Lewis Honors College, Graduate School and the UK Library system. The colleges include Agriculture, Food & Environment; Arts & Sciences; Business & Economics; Communications and Information Studies; Dentistry; Design; Education; Engineering; Fine Arts; Health Sciences; Law; Medicine; Nursing; Pharmacy; Public Health; and Social Work. We also understand that during the last academic year the university awarded over 7,000 undergraduate and graduate degrees.

## **Outlook**

The stable outlook reflects our belief that over the next two years, UK's enrollment will increase modestly, its health care system will continue to experience strong patient utilization growth and profitable financial operations while financial results for the entire university on a consolidated basis should remain positive. In addition, we anticipate additional debt issuance will be balanced with financial resources growth.

### **Downside scenario**

A negative rating is possible if enrollment or patient volumes decline significantly or if financial performance weakens or financial resources to operations or debt decline relative to median ratios for the rating category.

### **Upside scenario**

A higher rating, while not likely over the two-year outlook period in our view due to continued state operating appropriation cuts that have led to ongoing university budgetary constraints, could be considered if the enrollment trend improves considerably and the patient utilization trend remains firm. In addition, UK's financial performance would need to remain positive with significant financial resource growth while additional debt issuance is modest.

## **Enterprise Profile**

### **Industry Risk**

Industry risk addresses the higher education sector's and the health care sector's overall cyclicity and competitive risk and growth by applying various stress scenarios and evaluating barriers to entry, levels and trends of profitability, substitution risk, and growth trends in each industry. We believe the health care services and higher education industries represent a low-to-intermediate credit risk when compared with other industries and sectors.

### **Economic fundamentals**

In our view, the university has good geographic diversity; however, it is mostly regional. About two-thirds of its students are from Kentucky. As such, our assessment of the university's economic fundamentals are anchored by the local GDP per capita.

## **Market position and demand**

The university celebrated its 150th anniversary in 2015 and in our view continues to grow in stature among comparable comprehensive research based institutions.

Total FTE enrollment rose 1.1% in fall 2018 to 28,851 students from the prior year's 28,550 students. In the four fall enrollment periods prior to fall 2016 annual FTE enrollment growth exceeded 2% annually, however, since that time, enrollment growth has been more modest. Management indicated that students have taken actions to shorten the time to degree completion and this has had some impact on FTE enrollment. Undergraduate, graduate, and professional (and other) students make up 75%, 21%, and 4% of FTE enrollment, respectively.

Freshman applications increased 2.2% in fall 2018 to 19,341 from the 18,925 applications received for the fall 2017 enrollment period. However, freshman applications declined by 7.6% in fall 2017. Prior to fall 2017, in each of the three fall enrollment periods applications increased nearly or in excess of 10%.

Selectivity has improved somewhat decreasing to 94.5% in fall 2018 from 95.8% in fall 2017. Typical matriculation rates have been in the 25% to 30% range. Student quality is above average with an average 25.9 ACT score for the entering freshman class in fall 2018.

The university enjoys favorable philanthropic support, securing gifts and non-exchange grants of \$157 million and \$192 million in fiscal 2018 and 2017, respectively. We understand the university received its largest single gift ever, \$23 million, in 2015 and more recently in December 2018 announced the receipt of a \$10 million gift. The university completed its last capital campaign in fiscal 2007 and raised \$1.1 billion, all of which has been collected in cash. The university launched a relatively new capital campaign in September 2018 that seeks to raise a total of \$2.1 billion and through December 2018 had raised \$1.1 billion.

## **Management and governance**

Dr. Eli Capilouto became the 12th President of the University of Kentucky on July 1, 2011. Dr. Capilouto was previously the Provost of the University of Alabama at Birmingham (UAB), an organization that is one of the nation's leading academic medical centers. Dr. Capilouto's current contract runs through 2021. In December 2017, Dr. David Blackwell became the university's new provost effective Jan. 8, 2018. Dr. Blackwell had been dean of the university's Gatton College of Business and Economics since 2012 and replaces Dr. Timothy Tracy who served in that position for a short time following his tenure as the Dean of the Pharmacy Program. Also, on Sept. 18, 2017, UKHC welcomed Dr. Mark F. Newman as UKHC's new executive vice president for health affairs replacing Dr. Michael Karpf who retired from that position after a long and distinguished career at UKHC. Dr. Newman is a native of Kentucky and formerly was associated with Duke University Medical Center. Other senior management positions have generally been stable with what we view as normal turnover.

We believe UK's management and governance are healthy and follow conservative budgeting practices and fully embrace a risk-based enterprise management approach to running the institution. We also understand in mid-October of 2015, the university finalized its new strategic plan that runs through 2020. This plan focuses on undergraduate student success, graduate education, diversity and inclusion, research and scholarly work and outreach and community engagement.

## University of Kentucky HealthCare System

University of Kentucky HealthCare is a major component of the overall university, constituting 53.5% of fiscal 2018 total adjusted operating revenue and supports approximately \$568.3 million of the university's overall pro forma debt, including leases. UKHC is a 945-licensed-bed tertiary and quaternary facility consisting of two hospitals: UK Albert B. Chandler Hospital and Good Samaritan Hospital, located on the campus of the University of Kentucky in Lexington. At fiscal year-end 2018, UKHC staffed a total of 914 available beds at an 82.6% occupancy rate that we consider strong.

UKHC is a leading health care provider in central and southern Kentucky and owing to its growing clinical affiliations, has expanded its market to include portions of West Virginia, eastern Tennessee, southern Ohio, and western Kentucky. We understand in 2018 UK opened a new medical school campus in Bowling Green and in 2019 plans on opening an additional medical school campus in northern Kentucky.

Over the past four years, inpatient discharges have increased 16.3% to 40,909 in fiscal 2018 from 35,180 in fiscal 2014. Strong patient utilization growth and a generally favorable payor mix have enabled UKHC to produce strong financial results and transfer an increasing amount of funds in support of campus purchased services and increase clinical faculty support for growing volume in both discharges and outpatient visits. Over the past three fiscal years beginning with fiscal 2016 through fiscal 2018 these transfers totaled \$78.3 million, \$92.0 million, and \$136.7 million, respectively.

In May 2011, a new lobby, concourse, and two patient care floors of UK Albert B. Chandler Hospital's new Pavilion A opened (phase 1A). Pavilion A is a facility of more than one million square feet and is the cornerstone of a 20-year, \$2.5 billion plan to construct the commonwealth medical campus of the future. Pavilion A expands the original Chandler Hospital and serves as the centerpiece of the longer term expansion of the medical campus according to university sources.

UKHC is now in its sixth year of a contract with the commonwealth to operate and manage the \$129 million, 239-licensed bed psychiatric facility that Kentucky funded and built on UK's 735-acre Coldstream Research Campus; a campus that includes over 60 companies on site in biotech, pharmaceutical, equine health, and service industries that also includes a hotel, several restaurants and a 225-acre park. Also, UKHC in 2014 finalized an agreement with the Shriners Hospital for Children (SHC) that resulted in SHC building a new \$40 million five-story health facility that was completed and opened on UK's campus in 2017. UKHC is leasing two of those stories for their ophthalmology practice and provides orthopedic physicians for the SHC pediatric services.

## Financial Profile

### Financial management policies

UK has formal policies for endowment, investments, and debt. It operates according to a five-year strategic plan, and has a formal reserve liquidity policy and both cash and debt are centrally managed. The university meets standard annual disclosure requirements. The financial policies assessment reflects our opinion that, while there may be some areas of risk, the organization's overall financial policies in our view in no way inhibit its future ability to pay debt service. Our analysis of financial policies includes a review of the organization's financial reporting and disclosure, investment allocation and liquidity, debt profile, contingent liabilities, and legal structure and a comparison of these

policies with comparable providers.

### **Financial performance**

Commonwealth budgetary pressure has resulted in gradually declining funding for higher education over the past several years and UK's appropriation declined to \$264.4 million in fiscal 2018 from a recent high of \$297.6 million in fiscal 2012. We understand the current year's appropriation was reduced to \$258.5 million. While the university has managed to shoulder reductions in state operating support without incurring deficits we believe, with only modest growth in net tuition revenue and grants and contracts expected, narrower margins are a distinct possibility in the future. This presumption on our part reflects our view that health care reimbursement is likely to become more stringent with several key contracts up for renewal in 2019. While the declining state operating appropriation remains a credit concern, UK has received considerable state support on the capital front. The state funded over half of the cost of a new \$265 million 306,000 square foot medical research facility that opened in the summer of 2018. Also, the state is funding almost two-thirds of the estimated \$56 million total cost for a renovation/expansion of the college of law building.

The University of Kentucky's financial operations, in our view, are robust on a full accrual basis, with net adjusted operating income of \$102.7 million (3.1%) in fiscal 2018 and \$64.2 million (2.0%) in fiscal 2017. Operations are much stronger on a cash flow basis. Total adjusted operating revenue has increased 38.1% over the past five years to \$3.5 billion in fiscal 2018 from \$2.5 billion in fiscal 2013 as the university has grown in stature.

Net tuition revenue increased 1.0% to \$342.9 million in fiscal 2018 from the level received in 2017 due to enrollment growth and a 4% increase in tuition and mandatory fees for residents and a 6.5% increase for non-residents. For fall 2018 (fiscal 2019), resident tuition and mandatory fees increased 2.5% for residents and 3.8% for non-residents. Management believes UK's tuition and fees are competitive with its peer group schools. Tuition and fees for residents were \$12,244, and for non-residents were \$29,098 for fall 2018.

UK is a major research university and research grants and contracts have increased approximately 7.9% over the past three years to \$313.1 million in fiscal 2018 from \$290.2 million in fiscal 2015.

### **Available resources**

Financial resource levels are excellent in our view, with adjusted unrestricted net assets totaling \$1.3 billion at fiscal year-end 2018 equating to 36.9% of adjusted operating expense and 94.9% of pro forma debt (104.9% of debt outstanding at fiscal year-end 2018).

The market value of the endowment as of June 30, 2018, increased 5.2% to \$1.33 billion from the \$1.27 billion value at fiscal year-end 2017 reflecting a positive investment return of 6.5% for fiscal 2018 and 10.3% for fiscal 2017. The university had followed a 4.25% spending policy based on a five-year-moving average for fiscal 2012 and 2013; however, beginning in fiscal 2014, it moved to a hybrid spending policy that was fully implemented in fiscal 2015 to take into account the market value of the endowment and the current level of inflation in determining spending each year. The draw from the endowment available to support operations was 3.4% or \$44 million in 2018. The university has a target asset allocation of 52% global equity, 16% global fixed income, 17% real assets, and 15% diversifying strategies.

## Debt and contingent liabilities

UK's debt issuance has been at a fairly rapid clip over the past few years, to support the university's corresponding growth, almost doubling to an estimated \$1.3 billion on a pro forma basis for fiscal 2018 (inclusive of the series 2019A and planned \$127.9 million series 2020A issuances) from \$647.8 million at fiscal year-end 2013. However, most recent debt issuances are self-supporting by either department of intercollegiate athletics revenues, UK HealthCare, private gifts, or general funds of the university or some combination thereof. In our view the university's debt management practices remain conservative evidenced by a low 3.2% pro forma debt burden based on MADS. In addition, UK's debt portfolio in our view is very conservative with no variable rate debt, swaps and direct placement debt outstanding.

UK has a defined-contribution pension plan and makes annual contributions at the required full funding amount. UK does not participate in the state's (underfunded) defined-benefit pension plan. The university's contributions and cost in fiscal 2018 was \$120.5 million, a 7.0% increase from the prior year's \$112.6 million contributions and cost.

UK has a net other postemployment benefits (OPEB) liability of \$236.9 million as of fiscal year end 2018, covering retiree health care and long-term disability benefits. In July 2007, UK implemented an OPEB trust. In addition, the University has a separate LTD trust. As of fiscal year end 2018, net trust fund assets totaled \$179.6 million up from \$162.7 million in the prior year. For each of the past three years UK has made contributions equal to or slightly in excess of 100% of its annual OPEB cost.

## University Of Kentucky Enterprise And Financial Statistics

	--Fiscal year ended June 30--					Medians for 'AA' rated public colleges and universities
	2019	2018	2017	2016	2015	2017
<b>Enrollment and demand</b>						
Headcount	30,255	30,473	30,761	30,720	30,131	MNR
Full-time equivalent	28,851	28,550	28,768	29,318	28,550	34,653
Freshman acceptance rate (%)	94.5	95.8	90.8	89.1	91.6	66.0
Freshman matriculation rate (%)	27.9	26.8	27.5	31.2	34.7	MNR
Undergraduates as a % of total enrollment (%)	73.2	73.6	73.5	73.9	73.8	79.2
Freshman retention (%)	84.5	83.3	81.7	82.7	82.2	86.0
Graduation rates (six years) (%)	66.2	65.0	64.0	61.7	60.6	MNR
<b>Income statement</b>						
Adjusted operating revenue (\$000s)	N.A.	3,505,696	3,288,092	3,173,653	2,986,886	MNR
Adjusted operating expense (\$000s)	N.A.	3,402,976	3,223,913	3,054,749	2,759,813	MNR
Net adjusted operating income (\$000s)	N.A.	102,720	64,179	118,904	227,073	MNR
Net adjusted operating margin (%)	N.A.	3.02	1.99	3.89	8.23	1.22
Estimated operating gain/loss before depreciation (\$000s)	N.A.	267,081	215,624	267,013	361,447	MNR
Change in unrestricted net assets (UNA; \$000s)	N.A.	(136,500)	48,843	106,002	203,600	MNR
State operating appropriations (\$000s)	N.A.	264,418	267,029	279,611	279,611	MNR
State appropriations to revenue (%)	N.A.	7.5	8.1	8.8	9.4	19.5

## University Of Kentucky Enterprise And Financial Statistics (cont.)

	--Fiscal year ended June 30--					Medians for 'AA' rated public colleges and universities
	2019	2018	2017	2016	2015	2017
Student dependence (%)	N.A.	20.2	20.8	20.5	20.1	42.4
Health care operations dependence (%)	N.A.	53.5	52.5	51.9	51.8	MNR
Research dependence (%)	N.A.	8.9	9.5	9.3	9.7	MNR
Endowment and investment income dependence (%)	N.A.	1.1	0.9	0.7	0.6	1.4
<b>Debt</b>						
Outstanding debt (\$000s)	N.A.	1,197,174	1,012,749	1,043,655	930,443	798,089
Proposed debt (\$000s)	N.A.	142,150	N.A.	N.A.	N.A.	MNR
Total pro forma debt (\$000s)	N.A.	1,324,379	N.A.	N.A.	N.A.	MNR
Pro forma MADS	N.A.	108,651	N.A.	N.A.	N.A.	MNR
Current debt service burden (%)	N.A.	2.80	2.96	2.90	3.07	MNR
Current MADS burden (%)	N.A.	2.92	2.94	3.65	2.65	3.51
Pro forma MADS burden (%)	N.A.	3.19	N.A.	N.A.	N.A.	MNR
<b>Financial resource ratios</b>						
Endowment market value (\$000s)	N.A.	1,334,530	1,268,396	1,101,772	1,231,557	858,805
Related foundation market value (\$000s)	N.A.	N.A.	N.A.	N.A.	N.A.	564,320
Cash and investments (\$000s)	N.A.	2,549,513	2,478,844	2,510,273	2,465,743	MNR
UNA (\$000s)	N.A.	1,015,979	1,152,479	1,103,636	997,634	MNR
Adjusted UNA (\$000s)	N.A.	1,256,381	1,152,479	1,103,636	997,634	MNR
Cash and investments to operations (%)	N.A.	74.9	76.9	82.2	89.3	58.2
Cash and investments to debt (%)	N.A.	213.0	244.8	240.5	265.0	167.8
Cash and investments to pro forma debt (%)	N.A.	192.5	N.A.	N.A.	N.A.	MNR
Adjusted UNA to operations (%)	N.A.	36.9	35.7	36.1	36.1	34.3
Adjusted UNA plus debt service reserve to debt (%)	N.A.	104.9	114.2	105.7	107.3	100.5
Adjusted UNA plus debt service reserve to pro forma debt (%)	N.A.	94.9	N.A.	N.A.	N.A.	MNR
Average age of plant (years)	N.A.	12.2	12.3	11.7	12.6	13.1
OPEB liability to total liabilities (%)	N.A.	8.4	10.4	N.A.	N.A.	MNR

N.A.--Not available. MNR--Median not reported. MADS--Maximum annual debt service. Total adjusted operating revenue = unrestricted revenue less realized and unrealized gains/losses and financial aid. Total adjusted operating expense = unrestricted expense plus financial aid expense. Net operating margin = 100\*(net adjusted operating income/adjusted operating expense). Student dependence = 100\*(gross tuition revenue + auxiliary revenue) / adjusted operating revenue. Current debt service burden = 100\*(current debt service expense/adjusted operating expenses). Current MADS burden = 100\*(maximum annual debt service expense/adjusted operating expenses). Cash and investments = cash + short-term and long-term investments. Adjusted UNA = Unrestricted net assets + unrestricted net assets of the foundation. Average age of plant = accumulated depreciation/depreciation and amortization expense.

## Ratings Detail (As Of January 8, 2019)

University of Kentucky PCU-USF

Long Term Rating

AA/Stable

Affirmed

## Ratings Detail (As Of January 8, 2019) (cont.)

University of Kentucky PCU-USF		
<i>Long Term Rating</i>	AA/Stable	Affirmed
University of Kentucky PCU-USF		
<i>Long Term Rating</i>	AA/Stable	Affirmed
University of Kentucky PCU-USF		
<i>Long Term Rating</i>	AA/Stable	Affirmed
University of Kentucky PCU-USF (BAM) (SECMKT)		
<i>Unenhanced Rating</i>	AA(SPUR)/Stable	Affirmed
University of Kentucky PCU-USF		
<i>Long Term Rating</i>	AA/Stable	Affirmed
University of Kentucky PCU-USF		
<i>Long Term Rating</i>	AA/Stable	Affirmed
<b>Univ of Kentucky</b>		
<i>Long Term Rating</i>	AA/Stable	Affirmed

Many issues are enhanced by bond insurance.

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