

## Research

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### Summary:

## OAO NOVATEK

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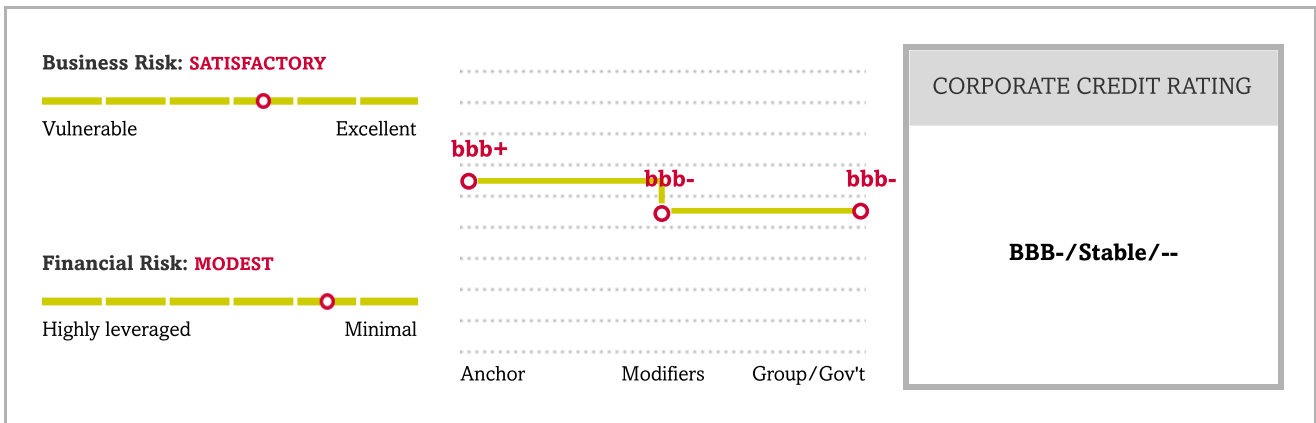
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Summary:

# OAO NOVATEK



## Rationale

| Business Risk: Satisfactory   | Financial Risk: Modest  |
|---|---|
| <ul style="list-style-type: none"> <li>• Position as Russia's largest independent gas producer, with a solid reserve base.</li> <li>• Strong profitability stemming from high-quality onshore reserves, low production costs, an increased share of higher value-added products, and a high share of lower-taxed condensate.</li> <li>• Exposure to Russia-specific country risks. These include taxes, regulations, U.S. dollar/Russian ruble (RUB) exchange rate volatility, and current U.S. sanctions against the company and one of its large shareholders.</li> </ul> | <ul style="list-style-type: none"> <li>• Modest debt level, with funds from operations (FFO) to debt well above 60% on average.</li> <li>• Positive free operating cash flow (FOCF), which should continue despite increased capital expenditure (capex).</li> <li>• Material unconsolidated joint ventures, including large liquefied natural gas (LNG) projects, with limited visibility of cash outflow and inflow.</li> </ul> |

### Outlook: Stable

S&P Global Ratings' stable outlook on Russia-based OAO Novatek, reflects our expectation that its credit metrics will remain robust, despite increased capex associated with its ambitions to be involved in more LNG projects. We assume that Novatek's FFO to debt will remain at above 60%, with sufficient headroom against the minimum rating-commensurate level of 45%. We also assume the company will continue to generate positive FOCF and that there will be no meaningful cash outflow to any of its joint ventures, including current and future LNG projects. We assume that financial sanctions against Novatek will have no immediate impact since it does not rely on external financing for growth.

#### Downside scenario

We would likely lower the rating on Novatek if its FFO to debt were to drop to below 45% without near-term improvement prospects. This could happen if the management takes a more aggressive stance on growth, with higher investments and M&A, or significantly increases shareholder distributions. For example, we could lower the rating if Novatek were to finance the new LNG projects from its balance sheet, or take any financial risk regarding these projects.

#### Upside scenario

The upside potential for the rating would likely stem from a combination of such factors as reduced country risks in Russia, more predictability in the company's growth strategy, including more clarity regarding financing of joint ventures, and stronger access to capital markets.

## Our Base-Case Scenario

| Assumptions   | Key Metrics     |       |         |         |         |
|---|-----------------|-------|---------|---------|---------|
| <ul style="list-style-type: none"> <li>Brent oil price of \$60 per barrel (bbl) for 2018, and \$55 from 2019. We also assume that condensate prices will strongly correlate to oil prices.</li> <li>Limited increase (not more than 2%-3%) in domestic gas prices in 2018-2019, but we do not expect any material increase in gas transportation tariffs.</li> <li>A 3%-4% decline in liquids production in 2018, and flat to slightly declining gas production, compared to a production decline of 5%-7% in 2017. We expect production of both liquids and gas to increase by 3%-7% in 2019.</li> <li>No material changes to the Russian tax regime.</li> <li>An exchange rate of close to 61-62 ruble to one U.S. dollar in 2018-2019.</li> <li>Capex of RUB70 billion-RUB90 billion in 2018 and RUB100 billion-RUB130 billion in 2019.</li> <li>Dividends of about 30% of net profit under International Financial Reporting Standards.</li> <li>No material acquisitions.</li> <li>Adjusted EBITDA of RUB150-RUB160 billion in 2018, down slightly from 2017. We do not forecast any increase in dividends from joint ventures.</li> </ul> |                 |       |         |         |         |
|   |                 | 2016a | 2017e   | 2018f   | 2019f   |
|   | FFO/debt (%)    | 83.6  | >60     | >60     | >60     |
|   | Debt/EBITDA (x) | 1.0   | 0.5-1.0 | 0.5-1.0 | 0.5-1.0 |
| FOCF(RUB bil.)  | 125.4           | 70-90 | 30-50   | 0-10    |         |
| a--Actual. e--Estimate. f--Forecast.  |                 |       |         |         |         |

## Company Description

Novatek is Russia's largest independent natural gas and liquids producer and its second-largest holder of natural gas resources after Gazprom OAO. As of Jan. 1, 2017, Novatek had 12.8 billion barrels of oil equivalent (BOE) of proved reserves, with most reserves located onshore, or in areas that can be developed from onshore locations. Novatek's principal operating areas are concentrated in the Yamal-Nenets Autonomous Region in Western Siberia. In the first nine months of 2017, total production amounted to 375 million BOE, or an average daily production of 1.4 million BOE.

## Business Risk: Satisfactory

Our assessment of Novatek's business risk profile recognizes the company's large and high-quality oil and gas reserves and profitable low-cost production. However, by law, Novatek cannot export its gas and must sell it on the domestic market. Therefore, it is increasingly focused on liquids production, including condensate, which the company can export. The company's production declined in 2017 and we expect this to continue in 2018. However, the company should be able to reverse this trend in 2019, when several large green fields in the Yamal and Gydan peninsula come on stream.

In addition to its fully owned operations, Novatek is developing a number of fields with Gazprom Neft, such as Arctic Gas and Northgas. Novatek also has 50.1% in a large Yamal LNG project, along with its partners Total and China National Petroleum Corporation. Like most of the global LNG projects, Yamal LNG is operationally and financially self-sufficient and therefore we see limited risk of cash outflow from Novatek to Yamal LNG. Novatek recently said it plans to invest up to \$45 billion in capex for new LNG projects and has already started constructing the yard that would produce the modules for the LNG plants. Our rating on Novatek assumes that the LNG projects will remain ringfenced from Novatek's balance sheet, and will require very limited, if any, cash outflow from the company.

The scale of these projects is very significant compared to Novatek's balance sheet, with total capacity of 16.5 million tons of LNG per year and estimated cash flow of around \$5 billion per year. When fully operational, the Arctic LNG-2 should produce 18.2 million tons of LNG.

Our assessment of Novatek's business is that it is primarily constrained by Russia-specific country risk, including the high sensitivity of profits to potential changes in the tax system, and that Russian government revenues are significantly dependent on the oil and gas sector. We believe there are risks to the stability of the current tax system, although in our base-case scenario, we do not anticipate significant changes in 2018-2019.

## Peer comparison

Table 1

| OAO NOVATEK -- Peer Comparison                      |                |               |                   |                               |
|---|----------------|---------------|-------------------|-------------------------------|
| Industry Sector: Oil & Gas Exploration & Production |                |               |                   |                               |
|   | OAO NOVATEK    | LUKOIL PJSC   | Gazprom Neft PJSC | MOL Hungarian Oil and Gas PLC |
| Rating as of Jan. 11, 2018                          | BBB-/Stable/-- | BBB/Stable/-- | BB+/Positive/--   | BBB-/Stable/--                |
| --Fiscal year ended Dec. 31, 2016--                 |                |               |                   |                               |
| <b>(Mil. \$)</b>                                    |                |               |                   |                               |
| Revenues  | 8,803.3        | 85,613.8      | 27,774.9          | 12,204.8                      |
| EBITDA  | 3,100.4        | 13,046.4      | 6,311.8           | 2,086.7                       |
| Funds from operations (FFO)                         | 2,513.1        | 11,159.8      | 5,287.4           | 1,791.8                       |
| Net income from cont. oper.                         | 4,222.4        | 3,387.1       | 3,278.7           | 899.6                         |
| Cash flow from operations                           | 2,561.8        | 11,670.5      | 5,196.3           | 1,592.8                       |
| Capital expenditures                                | 508.2          | 7,985.0       | 6,076.2           | 988.1                         |
| Free operating cash flow                            | 2,053.6        | 3,685.5       | (879.9)           | 604.7                         |
| Discretionary cash flow                             | 1,371.4        | 1,544.3       | (943.0)           | 432.8                         |
| Cash and short-term investments                     | 791.1          | 4,280.9       | 1,240.4           | 924.6                         |
| Debt  | 3,004.7        | 10,311.0      | 11,938.3          | 3,755.2                       |
| Equity  | 10,772.8       | 52,865.9      | 23,654.0          | 6,150.8                       |
| <b>Adjusted ratios</b>                              |                |               |                   |                               |
| EBITDA margin (%)                                   | 35.2           | 15.3          | 22.8              | 17.1                          |
| Return on capital (%)                               | 31.6           | 10.8          | 13.6              | 10.5                          |
| EBITDA interest coverage (x)                        | 11.1           | 12.5          | 7.3               | 13.3                          |
| FFO cash int. cov. (x)                              | 10.2           | 12.1          | 7.5               | 9.3                           |
| Debt/EBITDA (x)                                     | 1.0            | 0.8           | 1.9               | 1.8                           |
| FFO/debt (%)  | 83.6           | 108.6         | 44.3              | 47.7                          |

Table 1

| OAO NOVATEK -- Peer Comparison (cont.) |      |       |       |      |
|--|------|-------|-------|------|
| Cash flow from operations/debt (%)     | 85.3 | 113.5 | 43.6  | 42.4 |
| Free operating cash flow/debt (%)      | 68.3 | 36.1  | (7.3) | 16.1 |
| Discretionary cash flow/debt (%)       | 45.6 | 15.3  | (7.8) | 11.5 |

## Financial Risk: Modest

Our assessment of Novatek's financial risk profile reflects our forecast of solid credit metrics, with FFO to debt of above 60%. Novatek's capex should increase as the company undertakes several LNG-related investment projects. Although the projects will be ringfenced, Novatek is investing in the infrastructure and the LNG module-producing factory Kola Yard. However, we still expect Novatek to generate positive FOCF. We also understand that the cash flow from the joint ventures to Novatek, which is currently minimal, will increase from 2019. However, debt service at joint ventures will limit the amount that can be distributed to Novatek.

Given the currently low leverage, the key risks to Novatek's financial profile lie with strategic decisions on growth and higher shareholder returns. We also note Novatek's sizable unconsolidated joint ventures at various stages of their development, as an area of risk. These ventures could require additional cash outlays for Novatek, although this is not our base-case expectation. Novatek currently requires no any additional financing for its day-to-day operations and should be able to finance capex with limited additional debt. However, the U.S. financial sanctions against the company generally constrain its access to the capital markets and limit its financing options. For this reason there was a delay in organizing the financing of Yamal LNG, although it was ultimately arranged successfully.

## Financial summary

Table 2

| OAO NOVATEK -- Financial Summary                    |           |           |           |           |           |
|---|-----------|-----------|-----------|-----------|-----------|
| Industry Sector: Oil & Gas Exploration & Production |           |           |           |           |           |
| --Fiscal year ended Dec. 31--                       |           |           |           |           |           |
| (Mil. RUB)  | 2016      | 2015      | 2014      | 2013      | 2012      |
| Revenues  | 537,472.0 | 475,325.0 | 357,643.0 | 298,158.0 | 211,109.0 |
| EBITDA  | 189,291.0 | 160,436.0 | 142,299.0 | 122,609.0 | 99,393.0  |
| Funds from operations (FFO)                         | 153,435.8 | 134,607.4 | 120,349.4 | 92,300.4  | 76,807.8  |
| Net income from continuing operations               | 257,795.0 | 74,396.0  | 37,296.0  | 110,006.0 | 69,458.0  |
| Cash flow from operations                           | 156,406.8 | 119,318.4 | 102,151.4 | 81,238.4  | 72,549.8  |
| Capital expenditures                                | 31,027.0  | 44,537.0  | 58,203.0  | 57,781.0  | 39,316.0  |
| Free operating cash flow                            | 125,379.8 | 74,781.4  | 43,948.4  | 23,457.4  | 33,233.8  |
| Discretionary cash flow                             | 83,726.8  | 39,141.4  | 14,981.4  | 1,455.4   | 13,515.8  |
| Cash and short-term investments                     | 48,301.0  | 29,187.0  | 41,320.0  | 7,925.0   | 18,430.0  |
| Debt  | 183,448.1 | 340,760.9 | 213,880.4 | 165,878.9 | 123,963.7 |
| Equity  | 657,720.0 | 428,171.0 | 387,124.0 | 373,057.0 | 291,195.4 |
| <b>Adjusted ratios</b>                              |           |           |           |           |           |
| EBITDA margin (%)                                   | 35.2      | 33.8      | 39.8      | 41.1      | 47.1      |

Table 2

| OAO NOVATEK -- Financial Summary (cont.)            |                               |      |      |      |      |
|---|-------------------------------|------|------|------|------|
| Industry Sector: Oil & Gas Exploration & Production |                               |      |      |      |      |
| (Mil. RUB)  | --Fiscal year ended Dec. 31-- |      |      |      |      |
|   | 2016                          | 2015 | 2014 | 2013 | 2012 |
| Return on capital (%)                               | 31.6                          | 17.1 | 17.1 | 22.0 | 22.3 |
| EBITDA interest coverage (x)                        | 11.1                          | 10.7 | 14.7 | 13.8 | 16.6 |
| FFO cash int. cov. (x)                              | 10.2                          | 11.3 | 14.9 | 12.8 | 16.5 |
| Debt/EBITDA (x)                                     | 1.0                           | 2.1  | 1.5  | 1.4  | 1.2  |
| FFO/debt (%)  | 83.6                          | 39.5 | 56.3 | 55.6 | 62.0 |
| Cash flow from operations/debt (%)                  | 85.3                          | 35.0 | 47.8 | 49.0 | 58.5 |
| Free operating cash flow/debt (%)                   | 68.3                          | 21.9 | 20.5 | 14.1 | 26.8 |
| Discretionary cash flow/debt (%)                    | 45.6                          | 11.5 | 7.0  | 0.9  | 10.9 |

RUB--Russian ruble.

## Liquidity: Adequate

We view Novatek's liquidity as adequate, with a ratio of sources to uses exceeding 1.2x for the 12 months beginning Sept. 30, 2017. Our assessment is supported by the company's positive FOCF generation, limited debt maturities, and potential support of Russian banks, which in our view partly offset constrained capital market access due to sanctions. Novatek has very solid headroom under its financial covenants, which exist in only some of its credit facilities.

| Principal Liquidity Sources  | Principal Liquidity Uses  |
|--|---|
| <p>Principal liquidity sources as of Sept. 30, 2017, include:</p> <ul style="list-style-type: none"> <li>Cash and short-term investments totaling RUB27 billion.</li> <li>Expected FFO of about RUB120 billion.</li> </ul> | <p>Principal liquidity uses as of Sept. 30, 2017, include:</p> <ul style="list-style-type: none"> <li>Short-term debt of about RUB44 billion due in the next 12 months.</li> <li>Capex of about RUB70 billion-RUB90 billion.</li> <li>We consider dividends to be generally discretionary for Novatek. However, in our base-case scenario we project they will be RUB30 billion.</li> </ul> |

## Ratings Score Snapshot

### Corporate Credit Rating

BBB-/Stable/--

### Business risk: Satisfactory

- Country risk: High
- Industry risk: Intermediate

- **Competitive position:** Satisfactory

#### Financial risk: Modest

- **Cash flow/Leverage:** Modest

Anchor: bbb+

#### Modifiers

- **Diversification/Portfolio effect:** Neutral (no impact)
- **Capital structure:** Neutral (no impact)
- **Financial policy:** Negative (-1 notch)
- **Liquidity:** Adequate (no impact)
- **Management and governance:** Satisfactory (no impact)
- **Comparable rating analysis:** Negative (-1 notch)

## Issue Ratings

### Capital structure

Novatek's capital structure consists of two Eurobonds issued via LPNs by Novatek Finance Ltd. and a number of unsecured bank loans at the parent level.

### Analytical conclusions

The two outstanding senior unsecured Eurobonds are rated 'BBB-', the same as the corporate credit rating, because no significant elements of subordination risk are present in the capital structure.

## Reconciliation

Table 3

### Reconciliation Of OAO NOVATEK Reported Amounts With S&P Global Ratings' Adjusted Amounts (Mil. RUB)

--Fiscal year ended Dec. 31, 2016--

#### OAO NOVATEK reported amounts

|  | Debt       | Shareholders' equity | EBITDA    | Operating income | Interest expense | EBITDA     | Cash flow from operations |
|--|------------|----------------------|-----------|------------------|------------------|------------|---------------------------|
| Reported   | 216,765.0  | 648,350.0            | 260,075.0 | 225,266.0        | 10,983.0         | 260,075.0  | 173,791.0                 |
| <b>S&amp;P Global Ratings' adjustments</b>               |            |                      |           |                  |                  |            |                           |
| Interest expense (reported)                              | --         | --                   | --        | --               | --               | (10,983.0) | --                        |
| Interest income (reported)                               | --         | --                   | --        | --               | --               | 18,732.0   | --                        |
| Current tax expense (reported)                           | --         | --                   | --        | --               | --               | (35,577.0) | --                        |
| Postretirement benefit obligations/deferred compensation | 2,249.0    | --                   | 201.0     | 201.0            | 201.0            | 44.4       | (177.6)                   |
| Surplus cash   | (43,470.9) | --                   | --        | --               | --               | --         | --                        |



Table 3

| Reconciliation Of OAO NOVATEK Reported Amounts With S&P Global Ratings' Adjusted Amounts (Mil. RUB) (cont.) |             |               |               |             |                         |                              |                                  |
|---|-------------|---------------|---------------|-------------|-------------------------|------------------------------|----------------------------------|
| Capitalized interest  | --          | --            | --            | --          | 5,314.0                 | (5,314.0)                    | --                               |
| Asset retirement obligations  | 6,084.0     | --            | --            | --          | 587.0                   | (469.6)                      | (469.6)                          |
| Exploration costs   | --          | --            | 2,087.0       | --          | --                      | --                           | --                               |
| Nonoperating income (expense)   | --          | --            | --            | 109,571.0   | --                      | --                           | --                               |
| Reclassification of interest and dividend cash flows  | --          | --            | --            | --          | --                      | --                           | (16,737.0)                       |
| Noncontrolling Interest/Minority interest   | --          | 9,370.0       | --            | --          | --                      | --                           | --                               |
| Debt - Accrued interest not included in reported debt   | 1,821.0     | --            | --            | --          | --                      | --                           | --                               |
| EBITDA - Income (expense) of unconsolidated companies   | --          | --            | (73,072.0)    | (73,072.0)  | --                      | (73,072.0)                   | --                               |
| Depreciation and Amortization - Impairment charges/(reversals)  | --          | --            | --            | 178.0       | --                      | --                           | --                               |
| Total adjustments   | (33,316.9)  | 9,370.0       | (70,784.0)    | 36,878.0    | 6,102.0                 | (106,639.2)                  | (17,384.2)                       |
| <b>S&amp;P Global Ratings' adjusted amounts</b>   |             |               |               |             |                         |                              |                                  |
|   | <b>Debt</b> | <b>Equity</b> | <b>EBITDA</b> | <b>EBIT</b> | <b>Interest expense</b> | <b>Funds from operations</b> | <b>Cash flow from operations</b> |
| Adjusted  | 183,448.1   | 657,720.0     | 189,291.0     | 262,144.0   | 17,085.0                | 153,435.8                    | 156,406.8                        |

RUB--Russian ruble.

## Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, Sept. 21, 2017
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The Oil And Gas Exploration And Production Industry, Dec. 12, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Methodology For Crude Oil And Natural Gas Price Assumptions For Corporates And Sovereigns, 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

| <b>Business And Financial Risk Matrix</b> |                               |               |              |             |            |                  |
|---|-------------------------------|---------------|--------------|-------------|------------|------------------|
| <b>Business Risk Profile</b>              | <b>Financial Risk Profile</b> |               |              |             |            |                  |
|   | Minimal                       | <b>Modest</b> | 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-                          | <b>bbb+</b>   | bbb/bbb-     | bbb-/bb+    | 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-               |

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