

Sunderland Marine Mutual Insurance Co. Ltd.

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Sunderland Marine Mutual Insurance Co. Ltd.

Major Rating Factors

Strengths:

- Reduced investment risk tolerance.
- Good and consistent underwriting performance for a mutual in a competitive market.
- Good competitive position based on sustained market leadership in key, albeit niche, business lines.

Weaknesses:

- Capital adequacy unlikely to support a higher rating.
- Historically volatile investment returns.

Operating Company Covered By This Report
Financial Strength Rating
<i>Local Currency</i>
BBB+/Stable/--

Rationale

The ratings on Sunderland Marine Mutual Insurance Co. Ltd. (SMMI) reflect reduced investment risk tolerance and good and consistent operating performance, deriving from a good competitive position in its chosen niche markets. These strengths are offset to a degree by capital which does no more than support the present rating and by historically volatile investment returns.

SMMI's operating performance is considered both good and consistent, buttressed by a proven capacity to actively manage the cycle by withdrawing from unprofitable lines. We expect that SMMI's future operating performance will remain more stable than competitors', as a result of how selective it is in writing risks and its greater geographic diversification, which provides some insulation from the extremes of the pricing cycle.

SMMI's competitive position is considered good, given the company's clear and sustained leadership in core niche segments of the marine insurance market. The company has been able to demonstrate a defensible position in its key business lines because of the strength and long-standing nature of its relationships with clients, its depth of technical expertise, and its geographic reach.

While severe investment losses were incurred in 2008, we believe that the current allocation is more suitable for a company of SMMI's size and capital strength. We expect the new investment mix to be relatively stable going forward, which should have the effect of lowering regulatory capital requirements, as well as reducing direct market risk.

While SMMI's capitalization is considered good, and is backed by comprehensive reinsurance protection, it is unlikely to support a higher rating level in the near term, especially as the absolute amount of capital remains small.

Outlook

The stable outlook reflects our expectation that SMMI's stringent underwriting will continue to generate strong underwriting performance. We believe that the combined ratio for 2010 may well be below that of 2009, given the company's low loss experience in the year to date. In addition, the company is expected to maintain its dominant

position in the fishing segment and to continue to develop its aquaculture and brokerage arms.

The outlook could be revised to positive if the company can generate sufficient retained earnings to improve capital adequacy to a level supportive of a higher rating through ongoing strong underwriting performance. We regard this as possible over the longer term. Moreover, although it is diversifying, SMMI remains a highly focused company compared to many 'BBB+' rated peers.

The outlook would be revised to negative if the company were to suffer significantly greater losses than currently expected on either underwriting or investments, which would lead to its capital adequacy not supporting the current ratings. We currently consider this unlikely given the degree of reinsurance protection, SMMI's proven cycle management skills, and its reduced investment risk.

Corporate Profile: Marine Mutual Insurer, With A Focus On Fishing And Aquaculture Risks

SMMI is a mutual organization with a focus on risks related to the fishing industry, although in recent years it has expanded its nonfishing offering. For 2008, gross premium written (GPW) was split as follows: hull and machinery (H&M) 63%; aquaculture 14%; protection and indemnity (P&I) 23%, with the remainder forming a small personal accident (PA) book. Of the hull business, 70% relates to fishing vessels. Brokerage income has grown through the acquisition of three marine brokers from 2008-2010. Noninsurance business, chiefly broking, now comprises 25% of total income.

The company has a broad geographic reach. It assumes business from over 50 countries and has representation in 10 locations on four continents. Premiums are well spread geographically with 31% originating in the U.K. and Europe, 38% from North America, 15% from Australasia and 16% from the rest of the world.

Competitive Position: Market Leader In Its Key, But Niche, Business Lines

Table 1

Sunderland Marine Mutual Insurance Co. Ltd./Competitive Position					
--Year ended Dec. 31--					
(Mil. £)	2009	2008	2007	2006	2005
Gross premiums written	76.8	67.2	67.9	70.4	75.7
Annual change (%)	14.2	(1.0)	(3.6)	(7.0)	2.4
Net premiums written	60.2	55.0	52.2	55.1	59.5
Annual change (%)	9.5	5.2	(5.2)	(7.4)	3.8
Gross premiums earned by class (%)					
Class 1 & 2 (marine)	62.7	65.9	64.7	64.7	68.0
Class 3 (P&I)	22.5	19.3	18.9	20.1	18.9
Class 4 (personal accident)	1.2	1.0	1.0	1.1	1.1
Class 5 (aquaculture)	13.6	13.9	15.4	14.1	12.0
Total	100	100	100	100	100

SMMI's competitive position is considered good, given the company's clear and sustained leadership in core niche

segments of the marine insurance market. The company has been able to demonstrate a defensible position in its key business lines because of the strength and long-standing nature of its relationships with clients, its depth of technical expertise, and its geographic reach.

Historical

SMMI remains a leader in its core markets, which principally comprise fishing vessels in Europe, North America, and the South Pacific region. Client retention has been consistently strong and remained over 90% in 2010. Equally significant is the high proportion of applicants whose requests for cover are declined: 60% in 2010. Together, these metrics indicate that SMMI has a good knowledge of its book and that it maintains its underwriting standards. Nevertheless, SMMI still had to show restraint on pricing increases in its 2010 renewals to retain business. Its competitive position is not strong enough to grant it sufficient pricing discretion to reliably achieve a combined ratio below 100%. That said, as a mutual, SMMI does not face the same profit imperative as a listed company.

In addition to its core fishing business, in recent years the company has expanded its offering to cover nonfishing risks. In 2008, nonfishing risks represented around 30% of the marine book. This business has become increasingly important for the company's H&M and P&I accounts in recent years, reflecting the trend toward reducing global fishing fleets.

In line with this aim, in 2008 the company acquired 49% of Knighthood, a broker specializing in inland waterway business, and in 2009 it acquired two U.S. brokers. As a result, brokerage income increased to £2 million in 2009 from £1.25 million, predominantly sourced from the U.K., U.S., Canada, and The Netherlands. In addition, 25% of underwriting premiums come through group brokers.

SMMI continues to write a P&I account, primarily as an adjunct to its H&M business. In some areas, P&I cover is offered on a stand-alone basis, where the company believes this gives it an entry into the H&M markets. General increases from some members of the International Group of Protection & Indemnity Clubs (IG), SMMI's main competitor in this line, have made SMMI's proposition in this area more attractive.

Historically, the size and structure of the aquaculture account have tended to mirror those of the industry itself; for 2009, this book accounted for 13% of total GPW. 2009 saw a major reworking of this account after aquaculture production in Chile collapsed. Equivalent premiums were sourced from other geographies.

Overall premium growth in 2009 was exaggerated by foreign exchange movements. While headline premiums increased by 14%, this was only 2.6% at constant rates of exchange. Aquaculture apart, the book of business written was relatively steady.

Prospective

Standard & Poor's expects that SMMI will maintain its leading position in its core fishing markets. However, the global fishing market is mature and global fishing fleets continue to decline. SMMI is countering the erosion of this market by expanding its offering outside its core fishing expertise by building up its nonfishing portfolio. We expect further small acquisitions.

Although it faces competitive pressures, which have limited its capacity to increase premium rates, we see no reason why SMMI should not continue to write a stable book of business with a high renewals ratio. We regard positively SMMI's preparedness to scale back or withdraw from unprofitable markets, demonstrated in Latin America, the South Pacific, and Korean aquaculture in 2010, and to do so even when the SMMI group is broking the business

itself. This augurs well for future underwriting discipline and should allow the group to maintain its competitive underwriting offering, even if top-line growth is limited. Overall, we expect premiums in 2010 to be largely unchanged from 2009.

Management And Corporate Strategy: Stable And Experienced Management Team

Management is considered to be a marginally positive factor for the ratings due to its extensive knowledge of, and strategic commitment to, the niche sector in which SMMI's comparative advantages lie. In addition, the company is taking a prudent approach to developing its noncore business. Historically, we have raised concerns over management's high investment risk tolerance but it addressed this by reallocating its investment portfolio in 2009. We consider the stability of the management team to be a strength.

Strategy

SMMI is committed to providing its members with stable pricing and a superior level of service. While the company focuses on underwriting performance, as a mutual it has lower profitability targets than proprietary peers. Continuity of service and rewarding accounts well remain strategic objectives. Management does not plan to expand the core business actively, as demonstrated by the high refusal rate for new clients. Nonfishing business has been targeted more actively, as shown by the successful reorientation of the aquaculture portfolio away from Chile and South Korea and by the company's willingness to expand the broking arm through selective acquisition.

Operational management

The experienced management team has focused on consolidating the account when necessary, while providing continuity and consistency to members. Succession planning is being addressed more actively than hitherto, which we regard as positive. Staff and management stability are a key strength of SMMI, with cross-postings of staff to overseas branch offices helping to tie the branches into the group and to support the branches' local knowledge with the group's technical expertise.

Financial management

Management's twin strategic financial goals are to rebuild SMMI's capital base to the level enjoyed in 2007 and to reduce financial volatility. It aims to achieve the latter by increasing diversification within the underwriting book as well as reducing the investment risk profile.

The company's mutual status means that it aims to underwrite at around a break-even level. Although underwriting performance has been relatively stable over the last six years, technical performance in 2007-2009 has been less good than that of 2004-2006. Given that the company has reduced the risk in its investment portfolio, we expect that there will be greater emphasis on achieving technical profitability than hitherto.

Standard & Poor's believes that SMMI's new risk tolerance is more suitable for a company of its size and capital strength and expects financial risk tolerance to remain more conservative than in the past, even as the company's capital base strengthens.

Given the geographical diversity of the organization, the company has exposure to fluctuations in foreign currency. The company hedges these using forward currency contracts.

Enterprise Risk Management: Adequate, Improving In Line With Increased Requirements

SMMI's enterprise risk management (ERM) is viewed as adequate, and as such the company is unlikely to experience losses outside its tolerances. ERM is considered of moderately low importance to the assessment, as risks relating to the geographic spread of the business are offset by the relatively straightforward nature of the insurance risks assumed and the group's strong reinsurance cover. The company's key risks are those relating to underwriting through pricing and reserving. It is also exposed to investment and operational risks associated with the company's many branch offices. Dealing with increased regulatory demands, such as the European Commission's Solvency II directive, is an emerging ERM factor. Although in absolute terms ERM within the group is improving, this should be seen in the context of increasing regulatory requirements.

SMMI's risk management culture is adequate, reflecting the long-standing use of a risk register, low staff turnover, the extent to which risk is a consideration in day-to-day decision-making, and the level of public disclosure on risk issues. Risk management has become significantly more high-profile within the company. In 2009, a risk committee was set up, supporting the dedicated risk manager appointed in 2008. The management team has also been bolstered with an increased emphasis on risk ahead of the introduction of Solvency II. A consultant now heads up internal audit and reports to the board audit committee and an actuary has been seconded to aid preparation for Solvency II and to assist with capital management and forecasting.

The company's underwriting risk controls are adequate, with clear underwriting guidelines, annual reviews of risks including a peer review process, and regular exception reporting. In addition, the company has developed sophisticated proprietary tools to monitor exposures and aggregations on its aquaculture book. Reserves are monitored internally and are also subject to external review by group auditors KPMG.

Investment risk controls are considered adequate. The reduction in investment risk after the 2008 losses reduces the necessity for fundamental changes in investment risk controls. The company continues to monitor exposures, makes significant use of outside consultants to advise on strategy, and uses derivatives opportunistically to protect against volatility.

SMMI's consideration and assessment of its strategic risk continues to develop. While the business model remains relatively uncomplicated, a risk strategy framework is under development. The new risk committee meets monthly and gap analysis is performed against Solvency II requirements. Roles and responsibilities are being defined more exactly and the risk appetite of the group is being enumerated and considered more explicitly.

Accounting: Prepared According To U.K. GAAP Using Annual Basis Of Accounting

SMMI is audited by KPMG. All recent audit opinions have been unqualified. When SMMI acquired its management company in 2006, it took on responsibility for the pension scheme (which is closed to new members). The company's defined-benefit pension scheme currently has an actuarial deficit; as this deficit is held on the balance sheet, no further adjustment is made for this in our capital model. Although the potential impact on ongoing capital adequacy of movements in the pension deficit is examined as part of the rating process, the deficit is small in absolute terms (£1.26 million in December 2009) and is not considered a key rating factor.

Operating Performance: Investment Recovery, Stable Underwriting

Table 2

Sunderland Marine Mutual Insurance Co. Ltd./Operating Statistics					
--Year ended Dec. 31--					
(Mil. £)	2009	2008	2007	2006	2005
Total revenue	64.3	57.8	55.1	59.2	61.4
Pretax operating income	1.3	3.1	1.7	8.5	7.2
Net income	0.5	3.4	1.2	7.2	6.0
Return on revenue (%)	2.0	5.3	3.0	14.4	11.7
Return on shareholders' equity (%)	1.2	7.3	2.4	15.4	15.1
Loss ratio (%)	67.6	68.6	68.1	58.1	62.6
Expense ratio (%)	36.9	34.3	36.9	33.1	31.1
Combined ratio (%)	104.5	102.9	105.0	91.2	93.7

SMMI's underwriting performance is strong and consistent. While it compares favorably with the marine hull market as a whole, it was outperformed in 2009 by many P&I clubs in the same rating range. That said, it enjoys fewer economies of scale than its peers and has more-diverse income streams.

The mutual nature of the company means that underwriting profit is not the key consideration; the company is willing to write at around break-even and rely on investment gains to deliver moderate profits. The reduction of risk in the investment portfolio should give more stable, if possibly lower absolute returns going forward and this could limit overall profitability.

The pricing cycle that remains a feature of the marine sector and SMMI's mutual status will perpetuate fluctuations in its prospective underwriting earnings. Increases of 5%-10% by line were achieved in the January 2010 renewals. Nevertheless, Standard & Poor's expects that SMMI's future operating performance will remain more stable than competitors', as a result of its careful selection of risks and greater geographic diversification, which provides some insulation from the extremes of the pricing cycle.

Historical

SMMI's profitability recovered notably to a net positive result of £4.3 million in 2009, following the £11.6 million loss of 2008. The recovery was chiefly due to the recovery in investment return to £5.7 million from a loss of £10.4 million. Bolstered by acquisitions, brokerage profit also increased to £2.00 million from £1.25 million.

Technical performance was more stable. The combined ratio slid slightly to 104.5% from 102.9% in 2008. Premiums increased by a nominal 14%, of which only 2.6% was not caused by currency factors.

Conversely, claims were largely unchanged at £51.8 million, although the higher premiums were set off by lower reinsurance recoveries and expenses, which were also inflated by foreign exchange factors. The net loss ratio was largely stable at 67%, reflecting the stability of the SMMI book and the group's experience of its portfolio. Instead, a 3% increase in the expense ratio in 2008-2009, due in part to exchange rate movements, led to the combined ratio increase.

Within the portfolio, the smaller and more volatile aquaculture book was the most profitable for the 2009 year of account. The hull book returned a technical profit in 2009 for both direct and indirect business, but the P&I book

experienced an underwriting loss. Major losses in 2010 to date have been limited, especially in aquaculture.

Prospective

Rate increases in early 2010 varied between 5% and 10% by line. Market competition precluded further price rises. The strongest increases were in U.K. P&I and Australasian hull business.

Given the continued absence of major loss events, the combined ratio is expected to show a modest improvement over 2009's 104%, but to remain above 100%. This would represent very stable performance over the period 2007-2010. It is likely that profit from brokerage activities will exceed that from underwriting. We expect investment income in 2010 to be more stable than previously following a reduction in risk in the portfolio.

Investments: Revised Strategy Following Large Losses

Table 3

Sunderland Marine Mutual Insurance Co. Ltd./Investment Statistics					
	--Year ended Dec. 31--				
(%)	2009	2008	2007	2006	2005
Portfolio performance					
Net investment income (mil. £)	4.5	2.3	2.7	2.8	2.7
Net investment yield	2.0	2.4	3.4	3.0	3.2
Net investment yield including all capital gains/(losses)	6.0	(5.9)	6.5	4.2	6.5
Portfolio composition					
Fixed-interest securities	71.9	45.3	49.3	47.0	50.7
Properties	9.9	8.5	8.4	7.9	8.2
Equities	4.3	22.2	32.2	26.4	18.4
Deposits	13.9	24.0	10.1	18.7	22.7
Total	100.0	100.0	100.0	100.0	100.0

SMMI enjoyed its best-ever investment return in 2009, achieving a return on investment of 8.79% and enjoying unrealized gains of £4.2 million compared to unrealized losses of £9.2 million in 2008. This was achieved even though the company reduced risk in its investment portfolio by selling off all direct equity holdings and increasing the proportion of investments held in bonds to 73% in December 2009 from 45% in December 2008. Within the bond portfolio, there was a move to shorten the average duration--only 5% were longer than five years in March 2010.

Standard & Poor's believes that the current allocation is more suitable for a company of SMMI's size and capital strength. Limited risk exposure remains through exposure to derivatives and multi-asset funds of funds. We expect the new investment mix to be relatively stable going forward, which should have the effect of lowering regulatory capital requirements as well as reducing direct market risk.

Credit risk

At year-end 2009, fixed-income securities represented approximately 73% of SMMI's invested assets (45% in 2008). The quality of SMMI's portfolio remained high, with limited exposure (6%) to speculative-grade bonds, and stringent limits on lower-rated individual counterparties. Cash deposits represented a further 13% of invested assets in 2009 (24% in 2008).

Market risk

SMMI's disposal of its equity portfolio reduces market risk materially. In addition, market risk is further reduced by the geographical spread of assets and the spread of funds used.

Liquidity: Liquid Assets Comfortably Cover Technical Reserves

SMMI's liquidity position is considered a strength for the rating. This is reflected in its ratio of liquid assets to outstanding claims, which remained strong at 147% in 2009 (157% in 2008).

SMMI has access to a £5.5 million overdraft facility, which it could use as a source of working capital.

Capitalization: Good Capitalization Supported By Conservative Approach To Reserving And Strong Reinsurance Program

SMMI's capitalization is considered good, based on the company's good capital adequacy, strong reserves, and the comprehensive reinsurance protection it has in place. The group's capitalization, as measured on Standard & Poor's proprietary model, improved over 2008 and is forecast to improve further. Nevertheless, capitalization has not reached management's target of returning to the 2007 year-end position. As measured by our proprietary model, capital remains only in line with the rating and is unlikely to support a higher rating level in the near term, especially as the absolute amount of capital remains small.

Capital adequacy

On a risk-adjusted basis, SMMI's capital adequacy is good. This reflects a lower absolute level of capital, offset by lower capital requirements due to the reduction in risk in the investment portfolio. The quality of SMMI's capital base is strong. Goodwill has increased as a result of acquisitions, but remains modest. The company is preparing for Solvency II and developing an internal model with the aid of a seconded actuary. A capital management tool purchased from an accounting firm will be used to internally manage capital in the future. We expect that capitalization will improve only slowly in 2010-2012, in line with forecast steady growth in retained profit.

Reserves

SMMI continues to maintain a conservative approach to the estimation of its loss reserves. At year-end 2008, SMMI's external reviewing actuary, KPMG, attested to the conservatism of the company's aggregate loss reserves, identifying a significant surplus over the company's own calculation. This surplus has not been included in our capital model. The average tail of reserves is relatively short at a weighted-average of 12 months.

Reinsurance

The level of protection afforded to SMMI by its reinsurers is strong and increased still further in 2010 with the addition of a 25% quota-share treaty covering hull and liability risks up to £1 million. This is in addition to the existing whole-account program that covers 75% of losses between £250,000 and £1 million, to an overall cover limit of £10 million. The gross probable maximum loss in respect of a catastrophic loss is approximately £70 million; the company's net exposure to such an event is capped at less than 3% of its free reserves on Dec. 31, 2009. There is an unlimited ceiling on the hull excess-of-loss treaty and an extremely high £500 million cap on the excess-of-loss liability treaty. The reinsurance program is considered a strength for the rating.

SMMI has protection against an unusual frequency of large claims via whole-account cross-class cover in respect of

P&I as well as the shorter-tailed H&M and aquaculture business. The quality of SMMI's reinsurers is strong, with none of them rated lower than the 'A' category by Standard & Poor's. The SMMI reinsurance program has been profitable for reinsurers every year since 2002. The group is prepared to cede this proportion of its profit, not only because of the protection the program affords to an organization with a small capital base in absolute terms, but also because it encourages the strong reinsurance players who supply its cover to stay on the account and so reduces capital requirements under the impending Solvency II legislation.

Financial Flexibility: Limited, But Adequate For Current Requirements

Table 4

Sunderland Marine Mutual Insurance Co. Ltd./Financial Statistics					
--Year ended Dec. 31--					
(Mil. £)	2009	2008	2007	2006	2005
Total assets	130.7	134.8	132.1	126.1	123.2
Shareholders' equity	43.7	41.0	53.2	50.3	43.8
Reinsurance utilization ratio (%)	21.5	18.3	23.0	21.7	21.3

SMMI's access to external funding is currently limited by its mutual status, although the company has adequate access to capital relative to its likely needs, which we assess to be low. Over the medium term, Standard & Poor's expects that most of SMMI's financial flexibility (defined as the ability to source capital relative to capital requirements) will be derived from retained earnings and contingent reinsurance capacity.

Ratings Detail (As Of October 11, 2010)*

Operating Company Covered By This Report

Sunderland Marine Mutual Insurance Co. Ltd.

Financial Strength Rating

Local Currency

BBB+/Stable/--

Counterparty Credit Rating

Local Currency

BBB+/Stable/--

Domicile

United Kingdom

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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