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Analysis

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Sparebanken Nord-Norge

SpareBank 1 Nord-Norge (SNN, rated A3/P-2/C) is the leading savings bank in northern Norway. The ratings reflect this strong regional position, as well as the bank's beneficial membership of the SpareBank 1 alliance. The outlook for the ratings is positive, based on the visible improvements in SNN's financials and asset quality. However, given the intensely competitive environment SNN operates in, the sustainability of these improvements will have to be proved over time.

Company Background, Strategy and Competition

A LEADING BANK IN NORTHERN NORWAY...

SNN enjoys the largest overall regional market shares in the arctic region of Norway (population around 500,000), with 25% in retail lending and 30% in corporate lending, as well as 32% and 48% respectively in retail and corporate deposits. The bank's largest competitors are DnB NOR (the largest Norwegian player), Nordea (the largest pan-Nordic financial institution) and Fokus Bank (a subsidiary of Denmark's Danske Bank). Despite the presence of these large players in the market, SNN has successfully defended its franchise, which is based on (i) a strong brand name, (ii) proximity banking and (iii) a good product range. In common with most other rated Nordic banks, SNN also offers a highly sophisticated multi-channel distribution network.¹

...BUT FACES INTENSIFYING COMPETITION

Intense competition is an increasing challenge for all local and regional banks in Norway. SNN's hopes of gaining customers from DnB NOR during the latter's post-merger integration process failed to materialise, and going forward we expect DnB NOR to enjoy a high level of pricing power due to its increasing economies of scale. Recently, DnB NOR has publicised its interest in the shipping, fishing and energy sectors in northern Norway and Russia, posing a growing threat to SNN in these areas of competence. Additionally, Fokus Bank is pursuing an aggressive retail growth strategy based on price competition that is facilitated by its parent's systems and support. SNN also in some areas faces competition from the other local savings banks.

1. See Issuer Profile for more detailed information.



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CONSISTENT STRATEGY WITH FOCUS ON RETAIL AND CROSS-SELLING

To defend its position, SNN has concentrated on cross-selling and improving its competitive advantage as a local and competent player. Service quality, staff competence, profitability and risk profile are all focus areas and improvements in each are partly enabled by its membership in the SpareBank 1 alliance (see below).

In the past three years SpareBank 1 Nord-Norge has committed to the difficult exercise of cross-selling additional products – namely savings, insurance and payment solutions – to both retail and corporate customers. These product segments have been identified as prominent growth areas because (i) retail savings disintermediation is still in its early stages in Norway and (ii) the up-coming pension reform, according to which by year-end 2006 it will be compulsory for all Norwegian employers to offer their staff pension insurance. Currently, about 30% of all SMEs lack such a policy, and SNN is in good position to utilise its large SME customer base. In order to achieve a 30% market share in all product segments, seen as the SNN's natural market position, the bank hopes to further increase the cross-selling by enhancing competence, enforce more effective decision making and improve distribution – in 2005 a customer centre was established for the retail segment. Nevertheless, the comparative success of all SpareBank 1 Group members in selling these products - visible in the sales figures and increased revenue diversification of the banks - is also fundamentally a result of their joint efforts, including staff training, some financial sales incentives, the establishment of an interactive sales unit and active usage of a Customer Relationship Management (CRM) system.

Growth is expected to stem largely from the retail and SME markets in the future. In particular, SNN is looking to improve its relatively weak market share in the southern part of its operating area, where the competing local bank is currently involved in a merger.

The successful delivery of a consistent strategy has enhanced SNN's risk profile and revenue diversification, both of which we see as positive rating drivers. We do not expect drastic deviation from the current strategic lines in the future.

STRATEGIC MEMBERSHIP IN SPAREBANK 1 ALLIANCE

SNN's role as one of the four founding members of the SpareBank 1 Group, formed in 1996, has proved an important competitive advantage. Having succeeded in its initial objectives of (i) joint marketing, (ii) common IT/Internet platforms and (iii) creation of joint product companies, the group's activities have been extended. They now include staff training, risk management and the implementation of balanced scorecards, aimed at achieving economies of scale, transfer of know-how and enhanced staff competence. For example, members have been working together on the implementation of new International Financial Reporting Standards (IFRS), as well as preparations for Basel II, both of which tend to be a non-negligible burden for smaller financial institutions. Going forward, the SpareBank 1 alliance has also established a mortgage company that is planning to issue covered bonds in order to allow member banks access to competitive funding.

The member banks remain strongly committed to the Sparebank Alliance, which they see as representing strategic value in terms of branding, synergies and expertise. Although there is no joint and several liability guarantee legally binding the members, we believe that a reputation-based obligation exists, due in part to common branding – SpareBank 1 is among the most recognised names in Norway – as well as the financial improvements members have benefited from.

SpareBank 1 Group was restructured after a difficult year in 2002, resulting in a remarkable turnaround. The group broke even at the end of the first quarter of 2004 and financial results have continued to improve, with record figures reported for the first half of 2005. Profitability remains at the heart of the group strategy, and we expect that new distributors and/or new members may join the alliance in the future, although possibly with different levels of involvement.

The positive outlook on SNN's ratings is partly underpinned by the benefits it derives from the SpareBank 1 alliance membership, which we expect to continue going forwards. Any departure from the alliance, although not anticipated at this point, would be likely to put downward pressure on the SNN's ratings.

Financial Fundamentals

INCREASED PROFITABILITY

SNN's profits rose to NOK4364 million (€44 million) in 2004 from NOK210 million in 2003, largely due to cost containment, lower provisioning and an increase in fee and commission income. The trend has continued in 2005, with profit for the first three quarters exceeding that of full-year 2004. Going forward, maintaining good cost efficiency and asset quality – both of which remain strategic aims – as well as continued good performance by the SpareBank 1 Group, will remain crucial for SNN's profitability. We positively note the increase in the risk-weighted profitability measure² to 1.75% in 2004 from 1.01% in 2003.

PRESSURE CONTINUES ON INTEREST INCOME ...

SpareBank 1 Nord-Norge's net interest margin remains under pressure in 2004. Nevertheless, due to lending growth of 2.9% and re-pricing efforts, a slight increase on net interest income was evident in 2004. Additionally, savings banks have been exempted from contributing to the deposit guarantee fund between 2004 and 2006 following the merger of their fund with the commercial banks' fund. As such, SNN benefits from a temporary reduction in interest expenses of NOK33 million per year.

In the first three quarters of 2005 the bank was not able to compensate low interest rates and competitive pressures with volume growth (+8.5%). Going forward, interest rates should develop more favourably, but competitive pressures and SNN's portfolio mix will continue to exert pressure on net interest income, which accounts for over 70% of the bank's operating income.

... BUT IS LARGELY COMPENSATED BY GROWING FEES AND COMMISSIONS

SNN's cross-selling efforts have resulted in good growth in fees and commissions, which were up by 14% in 2004 and by 11% year-on-year at the end of September 2005. Growth is driven by the good penetration of the bank's wealth management, insurance and payment services. Nevertheless, transaction fees remain the bulk of this income line. At the end of September 2005, fees and commissions accounted for 21% of total operating income. We expect SNN's fees and commission income to continue growing at a good rate due to market conditions in Norway and to close the gap with the level of other rated SpareBank 1 Group members. We continue to view fees and commissions as key to securing future growth and balance of revenue in Norway's competitive and low interest environment.

GOOD COST CONTROL

Efficiency has been crucial for the bank's profitability over recent years because of revenue pressures. In line with its strategic plans, management has managed to downscale costs, which accounted for 1.98% of average assets at year-end 2004 compared with 2.07% at year-end 2003. However, despite voluntary staff redundancies in 2004 as part of a restructuring programme, SNN's cost base has not decreased in absolute terms, mainly due to an increase in wages. Excluding the establishment of the new customer centre, staff numbers have continued to fall in 2005. Cost containment and good revenue growth improved the bank's cost-to-income ratio to 54.7% in 2004, and to about 53% at the end of September 2005 – well below the 55% medium-term target. Going forwards, we expect the bank to continue to focus on cost containment, which will be vital for its survival – especially from 2007, when DnB NOR Bank's merger will be fully completed.

IMPROVED ASSET QUALITY INDICATORS

After peaking in 2002, SNN's asset quality indicators have rebounded to pre-2000 levels driven by management's decision to diversify the lending portfolio and tighten origination criteria as well as the economic upturn in northern Norway. Additionally, active benchmarking and joint development projects (including Basel II initiatives) with other members of SpareBank 1 Group have resulted in the hiring of risk specialists and enhanced risk management systems, which were introduced in 2004 and continue to be validated across the group. In common with other local banks, SNN's close relationship with its customers also allows for more proactive management.

2. Post-provision profit as a percentage of average risk weighted assets.

SNN's risk profile is a key factor for the positive rating outlook. We note particularly that:

- Following tightened origination criteria after 2002 and 2003 losses, corporate loans had come down to 37% of the total lending at end-June 2005 (40% in June 2004 and 45% at end-2002). Although the corporate segment is looking attractive again with the good current economic conditions, this proportion will not be allowed to rise above a 40% limit. In addition, the quality of credits should be well assessed and monitored under the bank's new risk systems. Retail lending remains mainly for mortgage purposes with a conservative overall loan-to-value ratio.
- Recognising the vulnerability arising from large exposures, these have been reduced in both number and size. In June 2005, there were two exposures exceeding the NOK400 million limit, compared with five in June 2004. In total, exposures of over NOK 100 million accounted for 205% of core capital in June 2005 compared with 262% in 2003.
- Industry concentration is small, especially after new lending was temporarily frozen to volatile sectors such as fish farming and fishing industry in 2004. The largest sector exposure, commercial real estate, remained at around 9% of total lending (131% of core capital) as of June 2005 and has a moderate risk profile. Building and construction, carrying higher risk, accounts for less than 2% of lending. Despite the higher reliance of the local economy on fishing-related activities, these (fish farming, fishing vessels and other fishing industry) accounted for only 6% of total lending as of June 2005, down from 7% in June 2004.
- As a result of above improvements, problem loans decreased to 1.4% of gross lending at the end of September 2005 (1.9% at end-2004, 3.2% in 2002 and 1.6% in 1999), and are sufficiently (82%) covered by reserves. The loans are additionally backed with good quality collateral. Actual loan losses in the first three quarters of 2005 were marginal at 0.15% of gross lending, well within the bank's 0.5% internal limit.

LOW MARKET RISKS

Market risks, mainly interest and exchange rate, are modest. The bank has limited proprietary market activities. In June 2005, all equity-related securities accounted for less than 1% of total assets and about 12% of core capital, complying with regulatory authority rules (trading securities may not exceed 4% total assets).

We note that SNN is indirectly exposed to capital markets via its joint ownership of the product companies of SpareBank 1 Group, including life and property & casualty insurance, and asset management. In 2002 and 2003, the bank had to cover losses made by the life insurance company due to a relatively high proportion of equity investments. Since then, risk management practices have been strengthened and the exposure limit to inherently more volatile instruments reduced. We note that, with the capital market picking up, an increasing amount is again being invested in equities. However, thus far we are comfortable with the portfolio.

LONGER FUNDING PROFILE AND REDUCED LIQUIDITY RISK

SNN's proportion of deposit funding rose to over 60% in September 2005 and has been maintained at over 57% of total funding over the past three years. Nevertheless, common to all European markets, savings disintermediation remains a challenge for bank funding in Norway. As lending growth exceeds that of deposits, banks are becoming more reliant on wholesale funding. SNN has decreased its proportion of interbank funding since 2003 and also increased the maturity profile of other wholesale funds – short-term funds accounted for 26% of total funds at the end of June 2005, compared with 60% in 2002. Going forward, some alleviation of funding pressures will stem from the SpareBank 1 alliance's joint effort in the covered bond market that is being established in Norway.³

Liquid assets accounted for 8.4% of SNN's total assets at year-end 2004 (about 7.3% at the end of September 2005). While this ratio is low compared with other rated savings banks in Europe, we consider SNN's liquidity risk as moderate. Liquid assets cover short-term funds by approximately 0.96 times. In addition, the bank's strict management guidelines were further enhanced in 2004. No net refinancing is allowed within one month while the maximum limit over three months was reduced and is more than 100% covered by liquid assets. If needed, SNN also has access to a back-up line facility. Finally, we believe that the bank's liquidity risks are mitigated by its increased diversification of funding by market and instrument.

Given SNN's absolute liquidity level, **maintaining strict liquidity management and improvements in the funding profile are important factors towards upward potential in the rating.**

3. On 18 August 2005, the SpareBank 1 member banks established a mortgage company for granting mortgage loans within 60% LTV and for issuing covered bonds.

ECONOMIC CAPITALISATION IS GOOD

SNN enjoys good economic capitalisation, based on its good recurring earnings capacity and risk profile. At the end of September 2005, the bank reported core and total capital ratios of 8.78% and 10.35% respectively, compared with 9.7% and 11.3% at year-end 2004. In 2003, the bank issued hybrid capital instruments amounting to US\$60 million, equivalent to around 14% of its core capital base. SNN's targets remain 9% and 12% respectively, including hybrids.

Related Research

Analyses:

[SpareBank 1 Group AS, August 2005, #93713](#)

[Sparebanken Vest, March 2005, #91983](#)

[Sparebanken Midt-Norge, November 2005, #95301](#)

[Sparebanken Rogaland, July 2005, #93497](#)

Banking Statistical Supplement

[Norway, July 2005, #93564](#)

Banking System Outlook:

[Norway, July 2004, #88087](#)

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Sparebanken Nord-Norge (Consolidated)

	31/12/2004	31/12/2003	31/12/2002	31/12/2001	31/12/2000
Summary Balance Sheet (NOK million)					
Cash & central bank	294	548	436	345	335
Due from banks	132	101	289	184	269
Securities	3,124	2,807	2,782	2,735	2,282
Gross loans	37,931	36,869	33,574	30,973	29,237
Loan loss reserves (LLR)	(641)	(825)	(679)	(526)	(421)
Insurance assets	0	0	0	0	0
Fixed assets	520	553	565	591	588
Other assets	885	839	912	964	853
Total assets	42,245	40,892	37,879	35,266	33,143
Total assets (USD million) [1]	6,980	6,097	5,447	3,901	3,780
Total assets (EUR million)	5,122	4,857	5,197	4,404	4,015
Demand deposits	19,581	16,498	17,337	15,837	14,415
Savings deposits [2]	3,418	5,168	2,845	2,592	2,902
Due to banks	2,790	3,366	4,452	3,142	2,552
Market funds	11,738	11,171	9,298	9,772	9,530
Insurance liabilities	0	0	0	0	0
Other liabilities	933	828	835	794	699
Total liabilities	38,460	37,031	34,767	32,137	30,098
Subordinated debt	1,194	1,502	871	885	902
Shareholders' equity	2,587	2,355	2,237	2,240	2,142
Total capital funds	3,785	3,861	3,112	3,129	3,045
Total liabilities & capital funds	42,245	40,892	37,879	35,266	33,143
Derivatives - notional amount	-	-	-	-	-
Derivatives - replacement value	-	-	-	-	-
Contingent liabilities	906	1,073	941	919	766
Risk weighted assets (RWA)	29,189	29,009	26,602	24,988	24,570
Assets under management (NOK million) [3]	-	-	-	-	-
Number of employees	758	888	950	944	932
Summary Income Statement					
+Interest income	1,753	2,452	2,965	2,880	2,530
-Interest expense	650	1,414	1,944	1,948	1,601
=Net interest income	1,103	1,038	1,021	932	929
+Trading income	29	46	24	0	2
+Fee & commission income	306	269	243	238	190
+Insurance income (net)	0	0	0	0	0
+Dividend income and other operating income	64	59	71	24	49
=Operating income	1,502	1,412	1,359	1,194	1,170
-Personnel expenses	407	389	370	350	337
-Other operating expenses	364	366	355	327	411
= Operating funds flow	731	657	634	517	422
-Amortisation/depreciation	51	59	68	70	65
(Total operating expenses)	822	814	793	747	813
=Preprovision income (PPI)	680	598	566	447	357
-Loan loss provisions	170	318	245	138	102
+Impairment of goodwill, fixed assets and investments [4]	1	0	0	0	249
+Result of subsidiaries and associates	22	(7)	(163)	0	0
+Non-recurring items	0	0	0	0	0
=Pretax income	533	273	158	309	504
-Taxes	167	62	94	104	120
=Net income	366	211	64	205	384
-Minority interests	2	1	1	1	0
=Net income (group share)	364	210	63	204	384
Growth Rates (%)					
Gross loans	2.88	9.81	8.40	5.94	17.40
Total assets	3.31	7.95	7.41	6.41	15.77
Customer deposits (demand and savings)	6.15	7.35	9.51	6.42	19.49
Net interest income	6.26	1.67	9.55	0.32	7.77
Fee and commission income	13.75	10.70	2.10	25.26	28.38
Operating expenses	0.98	2.65	6.16	(8.12)	16.81
Preprovision income	13.71	5.65	26.62	25.21	(19.23)
Net income	73.33	233.33	(69.12)	(46.88)	30.61

Sparebanken Nord-Norge (Consolidated)

	31/12/2004	31/12/2003	31/12/2002	31/12/2001	31/12/2000
Income Statement in % Average Risk Weighted Assets					
Net interest income	3.79	3.73	3.96	3.76	4.07
Trading income	0.10	0.17	0.09	-	0.01
Fee and commission income	1.05	0.97	0.94	0.96	0.83
Insurance income	-	-	-	-	-
Operating income	5.16	5.08	5.27	4.82	5.13
Operating expenses	2.82	2.93	3.07	3.01	3.56
Preprovision income	2.34	2.15	2.19	1.80	1.57
Loan loss provisions	0.58	1.14	0.95	0.56	0.45
Extraordinary profit	-	-	-	-	-
Net income	1.26	0.76	0.25	0.83	1.68
Liquidity, Funding (incl. sub debt) & Balance Sheet Composition					
Avg. liquid assets % avg. total assets	8.43	8.84	9.26	8.99	9.38
Avg. gross loans % avg. total assets	89.97	89.43	88.25	88.01	87.65
Avg. customer deposits % avg. total funding	58.44	57.72	57.60	57.17	56.34
Avg. interbank funds % avg. total funding	8.05	10.78	11.33	9.11	9.22
Avg. market funds (excl. interbank) % avg. total funding	29.98	28.23	28.45	30.87	31.56
Avg. sub debt % avg. total funding	3.53	3.27	2.62	2.86	2.88
Avg. liquid assets % avg. customer deposits	15.69	16.64	17.54	17.20	18.21
Avg. gross loans % avg. customer deposits	167.47	168.33	167.17	168.44	170.21
Avg. market funds reliance [5]	21.33	19.21	19.18	21.87	22.27
Avg. RWA % avg. total assets	70.00	70.60	70.53	72.44	73.85
Breakdown of Operating Income in %					
Net interest income % operating income	73.44	73.51	75.13	78.06	79.40
Trading income % operating income	1.93	3.26	1.77	0.00	0.17
Fee & commission income % operating income	20.37	19.05	17.88	19.93	16.24
Insurance income % operating income	0.00	0.00	0.00	0.00	0.00
Other operating income % operating income	4.26	4.18	5.22	2.01	4.19
Profitability					
Yield on avg. earning assets (%)	4.31	6.38	8.39	8.68	8.48
Cost of interest bearing liabilities (%)	1.70	3.90	5.80	6.23	5.67
Net interest margin (%) [6]	2.72	2.71	2.93	2.81	3.11
Recurring earning power (Pre-prov. inc. [PPI] % avg. assets)	1.64	1.52	1.55	1.31	1.16
Risk-weighted recurring earning power (PPI % avg. RWA)	2.34	2.15	2.19	1.80	1.57
Post-provision income % avg. assets	1.23	0.71	0.88	0.90	0.83
Post-provision income % avg. risk weighted assets	1.75	1.01	1.24	1.25	1.12
Return on average assets (%)	0.88	0.54	0.17	0.60	1.24
Return on avg. RWA (%)	1.26	0.76	0.25	0.83	1.68
Post-provision income % tier 1 capital	18.01	10.69	15.33	14.65	12.55
Return on equity (period end) (%)	14.07	8.92	2.82	9.11	17.93
Net interest income coverage of loan loss provisions	6.49	3.26	4.17	6.75	9.11
Loan loss provisions % preprovision income	25.00	53.18	43.29	30.87	28.57
Pre-tax income % operating income	35.49	19.33	11.63	25.88	43.08
Internal capital growth (%)	20.76	5.27	(0.13)	3.64	10.96
Dividend payout ratio (%)	34.34	43.81	104.76	61.76	47.14
Efficiency					
Cost/income ratio (op. expenses % op. income) [7]	54.73	57.65	58.35	62.56	69.49
Adjusted cost/income ratio (incl. non-operating items)	54.66	57.65	58.35	62.56	48.21
Operating expenses % average assets	1.98	2.07	2.17	2.18	2.63
Operating income / employee (NOK thousand)	1,981.53	1,590.09	1,430.53	1,264.83	1,255.36
Operating expenses / employee (NOK thousand)	1,084.43	916.67	834.74	791.31	872.32
PPI / employee (NOK thousand)	897.10	673.42	595.79	473.52	383.05
Asset Quality and Risk Measurement					
Problem loans % gross loans	1.99	3.11	3.20	2.11	1.76
LLR % problem loans	85.13	71.93	63.22	80.31	81.75
LLR % gross loans	1.69	2.24	2.02	1.70	1.44
Loan loss provisions % gross loans	0.45	0.86	0.73	0.45	0.35
Problem loans % (shareholders' equity + LLR)	23.33	36.07	36.83	23.68	20.09
Replacement value % shareholder's equity	-	-	-	-	-
Capital Adequacy (Period End)					
Tier 1 ratio (%)	9.70	9.03	7.87	8.44	8.27
Total capital ratio (%)	11.33	11.82	9.99	10.58	10.36
Shareholders' equity % total assets	6.12	5.76	5.91	6.35	6.46
Equity participations % shareholders' equity	12.33	10.96	11.89	14.24	16.11

[1] Historical exchange rates are applied accordingly for USD and EUR figures.

[2] Full disclosure may not be available for all years. The amount is then included in "demand deposits".

[3] As reported by the bank

[4] Includes goodwill amortisation (pre-IFRS).

[5] Avg. [(market funds-liquid assets) % (earning assets-liquid assets)]

[6] Although not part of net interest income calculation, the NIM includes dividend income.

[7] Cost/income ratio excludes goodwill amortisation, which is included together with net non-operating income in the adjusted cost/income ratio.

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