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Analysis

LEBANON
Europe/M.East/Africa

March 2007

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Lebanon

Lebanon's foreign currency government bond rating is currently B3, a low sub-investment grade rating. Its country ceiling for foreign currency bonds is one notch higher, at B2. This differential reflects our assessment that there is a moderate risk that an external payments moratorium would be imposed in the event of a government default (please see link below to our revised methodology on foreign currency ceilings, published in May 2006).

The outlook on Lebanon's sovereign ratings is negative. This was changed from stable in November 2006, largely owing to a marked deterioration in the domestic political environment. We have since been encouraged by the successful outcome of the Paris III donors' conference and tentative signs of a resolution to Lebanon's debilitating political deadlock. Until an enduring political resolution is achieved, however, thereby enabling growth to resume and economic reforms to be implemented, there seems little chance that the long-term trend of deteriorating public finances can be stabilized or reversed.

Macroeconomic Performance

Lebanon's economy has been hit hard by the devastation wreaked by last summer's war between Hezbollah and Israel and the subsequent escalation of domestic political tensions, which continues to sap confidence and hinder recovery. The government estimates the total direct economic cost of the month-long war at around \$2.8 billion (12% of GDP), with an additional indirect cost of around \$2.2 billion (10% of GDP) in 2006 alone. The indirect cost of the war will extend into 2007 and beyond given the time needed to recover from such a severe shock.

Real GDP growth is estimated to have accelerated to between five and six percent during the first half of 2006 as the tourism and construction sectors rebounded following their poor performance in 2005 when they were affected by the political upheaval triggered by the assassination of the former prime minister, Rafiq Hariri. Yet the full-year growth estimate for 2006 is zero percent (recently revised upwards from minus five percent), reflecting the extent of damage inflicted by the conflict with Israel. Not only did the war cause widespread human and physical destruction but it also prompted an outflow of people, particularly from the more skilled and therefore more mobile sections of the labour force. Those who can be persuaded will no doubt take time to return. Supply shortages during the conflict also caused a jump in inflation, which averaged 5.6% in 2006, according to recent estimates provided by the government, compared with an average of just 0.3% during the previous five years. The unemployment rate is also likely to have risen considerably.

The extent and pace of recovery are clearly dependent on the political situation, which remains tense and fluid. However, if a sustainable solution can be found to Lebanon's domestic political crisis before this year's tourism season gets underway and there are no more clashes with Israel, economic activity could potentially pick up quickly. The Lebanese economy has shown a remarkable degree of resilience in the face of previous crises — witness the rapid recovery following Hariri's assassination in 2005 — although this latest shock is likely to prove the most severe since the end of Lebanon's 15-year civil war in 1990.

Recovery will be aided by a substantial amount of grants and soft loans pledged by external donors. Lebanon received pledges worth a total of \$940 million at a conference in Stockholm in August 2006 and then \$7.6 billion at the "Paris III" donors' conference in January 2007. This was in addition to around \$1 billion pledged by various Arab countries and \$1.5 billion in long-term deposits placed in Lebanon's central bank by the governments of Saudi Arabia and Kuwait shortly after the war began. The government of Lebanon is still in the process of analysing the likely payment schedule and structure of this assistance. A significant, but as yet undefined portion of the pledges are contingent on economic reforms, which will be difficult to achieve in the current political climate.

The government is hoping, however, that the reform effort will be bolstered by an imminent IMF programme, the first in Lebanon's history. This will take the form of an Emergency Post-Conflict Assistance (EPCA) programme, under which the IMF will provide technical assistance, economic policy advice, and limited financial support amounting to around \$75 million.

Political/Social Developments

The political situation remains extremely fragile and volatile. However, there are some encouraging signs that Lebanon's opposing factions are working towards a compromise that may restore functionality to the country's political institutions. These have largely been paralysed since the withdrawal of six opposition ministers from the 24-member cabinet in November 2006 in a dispute over the balance of power in the cabinet and a UN-sponsored tribunal that would try those suspected of involvement in the assassination of Hariri and several prominent anti-Syrian figures since then. Both the president, Emile Lahoud, and the speaker of parliament, Nabih Berri, have declared the government, led by Prime Minister Fouad Siniora, unrepresentative and therefore illegitimate and are refusing to cooperate with it.

This has blocked the passage of laws through parliament and their ratification, which threatens to stymie the government's planned programme of structural reforms. The opposition parties (the Shia parties Hezbollah and Amal together with Michel Aoun's Free Patriotic Movement) are demanding an increase in the number of seats they control in the cabinet in order to enable them to veto cabinet decisions if required. The Shia parties, fearful that the UN tribunal could be used as a political tool to undermine them, are also demanding changes to the tribunal's structure and remit. It remains to be seen whether a lasting compromise can be reached on these issues that will allow the government to function effectively.

A further political challenge is the prospect of presidential elections, with the current president's term of office due to expire in November 2007. According to constitutional custom, the president should be a Christian Maronite. Candidates for the presidency are put forward and then voted upon by the members of parliament. However, it is unclear at this stage whether a candidate can be found that is acceptable to all parties. It is also unclear whether the current president will willingly step aside at the end of his term of office or whether he will attempt to remain in office in defiance of the constitution. Additional complexity stems from a constitutional requirement that the prime minister and his cabinet resign when a new president is selected and that a new government then be formed by the new president in agreement with the parliament. A solution to these challenges can no doubt be found but it will first require a *modus operandi* to be reached between the government and the opposition parties.

The need for such a compromise has grown ever more urgent as sporadic terrorist attacks and protests have continued. In November 2006, the Christian minister of industry, Pierre Gemayel, was assassinated (the most recent of several assassinations of anti-Syrian figures) and then in February, eleven people were killed in a bomb attack on two buses in a Christian area. Such attacks seem designed to exacerbate sectarian divisions. In January 2007, opposition protests sparked civil unrest during which several people were killed, there was damage to property, and the road to the airport was closed.

As ever, Lebanon's political travails cannot be divorced from their regional context given the heavy influence exerted by outside powers on Lebanon's various factions. Hence, a solution to the current crisis depends as much on how relations develop between Syria, Iran, Saudi Arabia, and the US as much as the progress of discussions between Lebanon's political leaders themselves. While the current signals of a regional compromise over Lebanon are positive, with mediation being led by Saudi Arabia, cooperation could swiftly deteriorate given flashpoints such as the civil war in Iraq and the ongoing dispute between the US and Iran over the nuclear issue. Relations with Israel are another wild card. Tensions over Lebanon's southern border remain high. In February, Lebanese and Israeli troops clashed for the first time since the Lebanese army was deployed to the south following last summer's war and Israeli jets continue to encroach into Lebanese airspace despite protests from UN forces on the ground.

Government Finance and Debt

After five years of steady improvement, the fiscal account deteriorated sharply in 2006, hit by the effects of the war and the two-month air and sea blockade imposed by Israel, which the government estimates had a direct budgetary impact of around \$850 million (3.7% of GDP). The overall fiscal deficit widened to around 13% of GDP last year, from 8.5% of GDP in 2005, and a similar scale of deficit is expected this year. Notably, the primary balance registered a deficit in 2006 for the first time since 2000. The fiscal account has also been hit by a large increase in debt servicing caused by the maturation of zero-coupon bonds purchased by local commercial banks as part of their contribution to the Paris II donors' conference in late 2002.

The marked increase in the fiscal deficit last year contributed to a further rise in the public debt burden, which is extreme. We estimate that the general government's debt burden (which excludes central government debt owed to other government entities but includes that owed to the central bank), climbed to around 170% of GDP at end-2006, the second highest level of any rated country except Japan. In terms of revenues, Lebanon's public debt burden is by far the highest of any rated country, at an estimated 814% at end-2006. Interest payments also consume the highest portion of government revenues of any rated country, at an estimated 63% in 2006. Around half of the government's debt continues to be held in foreign currencies.

The main explanation behind the Lebanese government's remarkable ability to withstand such a high debt burden even when faced with severe economic shocks is the size and resilience of the country's bank deposits, which are mostly owned by Lebanese residents and expatriates. Domestic commercial banks hold around 50% of the government's total debt stock. They are therefore highly exposed to the sovereign and have a strong interest in preventing a government default — witness their voluntary contribution to the 2002 Paris II donors' conference. The foremost factor governing banks' ability to purchase and roll over government debt is the size of their customer deposits. Although customer deposits in Lebanon dipped briefly following the outbreak of the war with Israel in July 2006, they recovered strongly and ended the year up 7% compared to the end of 2005. Lebanon's banking system continues to be well managed and well supervised. In a recent paper, the IMF judged Lebanon's financial sector to be the second most developed in the region after that of Bahrain.

The central bank also plays an important quasi-fiscal role, stepping in to provide liquidity for the government in both local and foreign currency during periods of stress, as per last summer. It tends to sterilise such support through the issuance of Certificates of Deposit in local and foreign currencies to domestic commercial banks. The central bank holds around 20% of the government's total debt stock. The central bank's successful maintenance of the fixed exchange rate peg to the US dollar is an additional factor explaining the government's ability to withstand its high debt burden. Clearly, any depreciation of the Lebanese pound would rapidly increase the servicing cost of the government's foreign currency debt in local currency terms.

The government's immediate financing needs are likely to be well covered by donors' funds received since the war with Israel. Around \$2 billion of the money pledged at Paris III was earmarked for the financing of maturing foreign currency government debt. The government has around \$400 million in Eurobonds maturing over the remainder of 2007, and around \$2 billion maturing in 2008. Additional direct fiscal relief will depend on the proportion of donors' funds that are allocated for budgetary use and the timing of disbursements, which remains uncertain given that a substantial portion of pledges are contingent on the implementation of economic reforms.

The government's reform package, as presented at the Paris III conference, has three main fiscal elements — privatization of the two state-owned mobile telephone networks, restructuring the loss-making state-owned power company Electricite du Liban (EdL), and raising taxes (specifically the rate of VAT, the tax on interest income, and the gasoline excise tax). If implemented, these reforms could provide significant fiscal support. However, as mentioned above, it remains to be seen whether they will be implemented and therefore whether donors' funds linked to reforms will materialise. In the absence of their implementation and a significant pick-up in GDP growth, it is difficult to envisage a reversal in the long-term rising trend of public debt.

External Vulnerability and Liquidity

Lebanon's external liquidity has remained robust, despite the maintenance of a wide current account deficit, a brief period of capital outflows following last July's outbreak of war with Israel and a subsequent increase in the rate of dollarisation. Although the large trade deficit shrank marginally last year as imports were suppressed by Israel's blockade and the fall in economic activity, the current account deficit, which averaged around 15% of GDP between 2001 and 2005, is likely to have widened somewhat as tourism receipts fell. The number of tourist arrivals declined by around 7% in 2006 despite a robust increase over the first six months of the year. The current account is structurally weak in Lebanon owing to the country's narrow export base and heavy external debt servicing requirement.

It is difficult to calculate the exact level of external debt in Lebanon, largely because there are no official estimates of the amount of government debt held by non-residents. However, on the assumption that around 20% of the government's debt is held by non-resident entities (mostly in the form of Eurobonds), we estimate that Lebanon's gross external debt amounted to around 95% of GDP at end-2006, one of the highest levels in the world and the second highest in the B1 to C rating group bar Nicaragua. Although, in Lebanon's case, it should be noted that around half of the country's external debt is accounted for by the foreign liabilities of the commercial banks, which are offset by foreign assets (the commercial banking system is a net foreign creditor).

The central bank's gross foreign currency reserves stood at \$10.2 billion at end-2006 (an estimated 45% of GDP). This was enough to cover around 8 months of estimated imports of goods, services and income or 66% of the domestic currency money supply (M3 less foreign currency deposits). This means that reserves would be sufficient to cover an approximate 20% increase in the rate of dollarisation of M3, which at end-2006 stood at around 71%. The rate of dollarisation in Lebanon can be volatile, however. This was witnessed in the aftermath of Hariri's assassination, when the level of M3 dollarisation increased from 63% at end-January 2005 to 74% at end-March. In addition to its foreign currency reserves, the central bank holds a substantial amount of gold (worth \$5.8 billion at end-2006). However, the liquidity of the gold is limited by national law, which prohibits the sale of gold without prior parliamentary legislation.

Rating History: Lebanon

Action	Date	Outlook	Foreign Currency Ceilings				Government Bond	
			Bonds and Notes		Bank Deposits		Foreign Currency	Local Currency
			Long-term	Short-term	Long-term	Short-term		
Outlook Changed	November-06	Negative	—	—	—	—	—	—
Rating Raised	May-06	—	B2	—	—	—	—	—
Rating Lowered	March-05	Stable	B3	—	B3	—	B3	—
Rating Lowered	July-01	Negative	B2	—	—	—	B2	B3
Review for Downgrade	September-00	—	—	—	—	—	—	—
Outlook Changed	September-00	Negative	—	—	—	—	—	—
Rating Assigned	August-99	—	—	—	—	—	—	B1
Rating Assigned	May-97	—	—	—	B2	NP	—	—
Outlook Assigned	March-97	Stable	—	—	—	—	—	—
Rating Assigned	February-97	—	B1	NP	—	—	B1	—

Related Research

Country Credit Statistical Handbook:

[Moody's Country Credit Statistical Handbook, November 2006 \(100689\)](#)

Banking System Outlook:

[Banking System Outlook: Lebanon, March 2006 \(97083\)](#)

Special Comments:

[A Guide to Moody's Sovereign Ratings, July 2006 \(98177\)](#)

[A Quantitative Model for Local Currency Government Bond Ratings, September 2003 \(79404\)](#)

[A Quantitative Model for Foreign Currency Government Bond Ratings, February 2004 \(81176\)](#)

Rating Methodologies:

[Piercing the Country Ceiling: An Update, January 2005 \(91215\)](#)

[Revised Foreign-Currency Ceilings to Better Reflect Reduced Risk of a Payments Moratorium in Wake of Government Default, May 2006 \(97555\)](#)

[Sources and Uses of Statistical Data in Moody's Sovereign Credit Analysis, December 2006 \(101207\)](#)

[The Local Currency Deposit Ceiling, August 2006 \(98554\)](#)

[Sovereign Rating Methodology Handbook, February 2004 \(78529\)](#)

[Analyzing the Tradeoff between Ratings Accuracy and Stability, September 2006 \(99100\)](#)

[Middle East Conflict: Negative Implications for Both Israel and Lebanon but No Immediate Rating Impact, July 2006 \(98504\)](#)

[Default and Recovery Rates of Sovereign Bond Issuers, 1983-2005, April 2006 \(97086\)](#)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

Lebanon

	1999	2000	2001	2002	2003	2004	2005	2006E	2007F	2008F
Economic Structure and Performance										
Nominal GDP (US\$ Bil.)	17.01	16.80	17.21	18.71	19.80	21.66	21.94	23.17	24.38	25.96
Population (Mil.)	3.52	3.56	3.61	3.66	3.71	3.75	3.80	3.85	3.90	3.95
GDP per capita (US\$)	4833	4712	4766	5115	5342	5771	5771	6016	6247	6568
GDP per capita (PPP basis, US\$)	5230	5339	5623	5812	6146	6601	6681	—	—	—
Nominal GDP (% change, local currency)	0.0	-1.3	2.5	8.7	5.8	9.4	1.3	5.6	5.2	6.5
Real GDP (% change, local currency)	-0.8	0.9	4.4	2.6	4.1	6.0	1.0	0.0	3.0	4.0
Inflation Rate (CPI, % change, dec/dec)	-0.1	-0.4	0.7	1.6	0.0	-0.5	3.0	3.9	2.4	2.5
Gross Investment/GDP (%)	23.1	20.2	22.8	18.2	19.2	20.7	19.4	17.5	18.3	19.2
Gross Domestic Saving/GDP (%)	-1.1	-2.8	-2.5	-1.2	-1.8	-3.2	-1.2	-2.7	-2.2	-1.3
Nominal Exports of G & S (% change, US\$ basis)	14.4	10.1	12.5	6.6	12.7	18.4	6.9	-2.0	4.9	5.1
Nominal Imports of G & S (% change, US\$ basis)	-5.5	2.4	14.6	-2.3	9.8	21.7	-4.2	0.6	6.0	6.0
Openness of the Economy (%) [1]	33.4	37.2	40.9	40.1	42.7	46.2	48.8	45.3	45.1	44.5
Government Finance										
Gen. Gov. Revenue/GDP (%)	19.0	18.8	17.9	20.7	22.3	23.0	22.4	20.9	20.9	21.5
Gen. Gov. Expenditures/GDP (%)	33.0	41.9	34.2	35.9	35.5	32.3	30.8	34.0	33.8	33.9
Gen. Gov. Financial Balance/GDP (%)	-14.0	-23.1	-16.3	-15.3	-13.2	-9.3	-8.5	-13.1	-12.9	-12.4
Gen. Gov. Primary Balance/GDP (%)	0.2	-6.5	0.3	1.1	3.1	3.0	2.2	-0.1	-0.1	0.5
Gen. Gov. Direct Debt/GDP (%)	122.9	139.2	152.6	156.2	159.9	158.8	167.9	170.0	174.5	176.3
Gen. Gov. Direct Debt/Gen. Gov. Revenue (%)	646.8	739.4	851.6	755.7	717.2	690.1	750.0	814.0	835.5	819.8
Gen. Gov. Int. Pymt/Gen. Gov. Revenue (%)	74.4	88.0	92.8	79.3	73.2	53.5	47.7	62.5	61.4	60.4
Gen. Gov. FC & FC-indexed Debt/Gen. Gov. Debt (%)	26.4	30.7	36.5	49.9	49.1	53.4	51.9	51.9	51.9	51.9
Gen. Gov. Direct Debt (US\$ Bil.)	20.91	23.39	26.26	29.22	31.66	34.40	36.84	39.39	42.53	45.76
GG Direct Debt Owed to Non-residents/GG Direct Debt (%)	19.1	16.9	14.6	18.2	22.3	20.6	19.9	19.9	19.9	19.9
External Payments and Debt										
Current Account Balance (US\$ Bil.)	-3.20	-2.85	-3.28	-2.84	-3.03	-3.97	-2.58	-3.01	-3.28	-3.57
Current Account Balance/GDP (%)	-18.8	-17.0	-19.0	-15.2	-15.3	-18.3	-11.8	-13.0	-13.5	-13.8
External Debt (US\$ Bil.)	13.28	13.96	14.88	15.24	19.71	22.75	21.97	22.10	23.29	24.52
External Debt/GDP (%)	78.1	83.1	86.4	81.5	99.5	105.0	100.1	95.4	95.5	94.4
External Debt/CA Receipts (%) [2]	174.6	168.6	157.4	156.8	180.7	176.2	168.4	168.9	168.7	169.6
Net Foreign Direct Investment/GDP (%)	8.2	6.5	6.9	7.4	7.9	6.8	7.7	3.9	4.5	5.0
Official Forex Reserves (US\$ Bil.)	7.60	5.75	4.36	5.07	10.20	9.49	9.85	10.21	10.21	10.21
Nominal Exchange Rate (local currency/US\$; end-year)	1508	1508	1508	1508	1508	1508	1508	1508	1508	1508
Short-term External Debt/Total External Debt (%)	48.1	51.5	49.4	48.3	47.3	53.2	52.9	50.9	50.7	50.6
Interest Paid on External Debt (US\$ Bil.)	0.77	1.03	0.69	0.42	0.39	0.56	1.02	1.36	1.37	1.41
Amortization Paid on External Debt (US\$ Bil.)	1.12	1.18	1.25	1.36	1.58	1.73	1.87	2.00	2.15	2.22
Net Foreign Assets of Domestic Banks (US\$ Bil.)	-0.48	0.97	1.27	2.14	0.58	1.46	1.65	3.29	—	—

Lebanon

	1999	2000	2001	2002	2003	2004	2005	2006E	2007F	2008F
Monetary, Vulnerability and Liquidity Indicators										
Domestic Credit (% change, dec/dec)	13.8	17.5	11.8	6.4	4.0	9.7	4.3	10.4	—	—
Domestic Credit/GDP (%)	142.9	170.0	185.5	181.4	178.3	178.7	184.0	192.4	—	—
M3/Official Forex Reserves (X)	3.9	5.7	8.0	7.5	4.2	5.0	5.0	5.2	—	—
Debt Service Ratio (%) [3]	24.9	26.6	20.5	18.3	18.0	17.7	22.2	25.7	25.5	25.1
External Vulnerability Indicator (%) [4]	84.2	125.1	168.5	145.2	91.5	127.4	118.2	110.2	115.7	121.5
Liquidity Ratio (%) [5]	16.0	14.7	21.0	13.3	12.1	14.6	11.8	10.6	—	—
"Dollarization" Ratio (%) [6]	56.6	62.2	69.0	65.6	60.9	64.9	68.5	72.3	—	—
"Dollarization" Vulnerability Indicator (%) [7]	120.7	141.9	183.3	166.6	126.7	130.0	143.1	152.0	—	—
M3 (% change, dec/dec)	11.7	9.8	7.5	8.1	13.0	10.1	4.5	7.8	—	—
Short-Term Nominal Interest Rate (% dec)	14.6	14.6	14.6	9.4	8.0	7.9	8.7	8.7	—	—
Total External Debt/Forex Reserves (%)	174.9	242.9	341.1	300.6	193.2	239.6	223.2	216.5	228.1	240.2
Total Liabilities due BIS Banks/Total Assets Held in BIS Banks (%)	22.9	19.9	17.1	14.9	16.4	20.6	16.9	14.9	—	—

Notes:

[1] Sum of Exports and Imports of Goods and Services/GDP (%)

[2] Current Account Receipts

[3] (Interest + Current-Year Repayment of Principal)/Current Account Receipts (%)

[4] (Short-Term External Debt + Currently Maturing Long-Term External Debt)/Official Foreign Exchange Reserves (%)

[5] Liabilities to BIS Banks Falling Due Within One Year/Total Assets Held in BIS Banks (%)

[6] Total Foreign Currency Deposits in the Domestic Banking System/Total Deposits in the Domestic Banking System (%)

[7] Total Foreign Currency Deposits in the Domestic Banking System/(Official Foreign Exchanges Reserves + Foreign Assets of Domestic Banks) (%)

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Report Number: 102547

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