

*Sao Paulo, Brazil*

**Ratings**

Category	Moody's Rating
Outlook	Stable
Bank Deposits	B1/NP
NSR Bank Deposits -Dom Curr	Baa2.br/BR-3
Bank Financial Strength	E+

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**Key Indicators**

**Banco Paulista S.A. (Unconsolidated Financials)[1]**

	[2]9-10	[2]12-09	[2]12-08	[3]12-07	[3]12-06	Avg.
Total Assets (BRL billion)	1.59	1.40	1.18	0.92	0.50	[4]33.70
Tangible Common Equity (BRL billion)	0.10	0.11	0.12	0.11	0.06	[4]14.46
Total Assets (USD billion)	0.94	0.81	0.51	0.52	0.23	[4]41.65
Tangible Common Equity (USD billion)	0.06	0.06	0.05	0.06	0.03	[4]21.27
PPI / Avg RWA	1.02%	4.12%	2.93%	14.31%	4.71%	[5]2.69%
Net Income / Avg RWA	-2.28%	-1.62%	1.82%	10.31%	2.77%	[5]-0.70%
(Market Funds - Liquid Assets) / Total Assets	-11.87%	-16.05%	-5.04%	-9.48%	12.73%	[6]-5.94%
Core Deposits / Average Gross Loans	193.19%	139.47%	97.67%	111.36%	71.74%	[6]122.69%
Tier 1 Ratio	--	11.82%	13.95%	15.64%	11.00%	[5]12.88%
Tangible Common Equity / RWA	11.22%	13.42%	14.80%	16.13%	12.31%	[5]13.15%
Cost / Income Ratio	88.12%	64.56%	71.58%	36.11%	62.67%	[6]64.61%
Problem Loans / Gross Loans	4.60%	10.37%	4.33%	4.39%	0.02%	[6]4.74%
Problem Loans / (Equity + Loan Loss Reserves)	14.42%	21.44%	11.59%	11.91%	0.06%	[6]11.89%

Source: Moody's

[1] All ratios are adjusted using Moody's standard adjustments [2] Basel II; LOCAL GAAP [3] Basel I; LOCAL GAAP [4] Compound Annual Growth Rate based on LOCAL GAAP reporting periods [5] Basel II & LOCAL GAAP reporting periods have been used for average calculation [6] LOCAL GAAP reporting periods have been used for average calculation

**Opinion**

**SUMMARY RATING RATIONALE**

Moody's assigns an E+ bank financial strength rating to Banco Paulista S.A. (Paulista). This rating reflects the challenges related to Paulista's small banking franchise, focused on providing brokerage services to companies and individuals, currency exchange services and trade finance products to companies, as well as on enhancing its presence in the segment of commercial lending to small and medium sized companies. The rating additionally incorporates the bank's limited financial flexibility. This latter constraint is now becoming more evident, as indicated by the modest recurring profitability, poorly diversified funding sources, and tight capital structure -- all factors that may cut off growth prospects.

In the past two years, Paulista's shifts from commercial lending to payroll lending, and then to vehicle financing, sacrificed asset quality, at least when indicators were measured against the bank's prior history of few delinquencies. In addition, Paulista's thin capital prompted management to lever its origination capability by securitizing loans in the local capital markets. Nevertheless, as of September 2009, there was another significant change in the bank's operation as management sold Paulicred - the consumer financing operation - to Banco Fibra.

The bank's business-diversification efforts are positive from a credit perspective because the bank has a well-recognized operation that furnishes financial and clearing services to Brazilian brokerage houses. The bank's traditional foreign exchange business contributes to steady its fee-based earnings, which are supported by a prudent risk and compliance framework.

The B1 global local-currency deposit rating incorporates Paulista's Baseline Credit Assessment of B1, as well as Moody's conviction that no systemic support would be available in case of stress because of the bank's limited market share in terms of deposits.

### **Rating Drivers**

- Well-recognized brand in the financial clearing, trust/fiduciary, and foreign exchange services, a stable source of fee-income
- Prudent and experienced management team led by the main shareholder, but there's still room to improve corporate governance practices and transparency
- Borderline capital levels and limited funding diversification with prevalence of short-term deposits restricting business flexibility
- Asset quality indicators are still high because of vehicle financing portfolio sold with recourse to financial institutions

### **Rating Outlook**

All ratings have stable outlooks.

### **What Could Change the Rating - Up**

In the medium term, the bank's rating level could rise if management is able to uphold profitability ratios and asset quality in the midst of intense competition for small and medium-sized company lending and pressured net interest margins. Continued success in diversifying funding would also benefit the ratings as it would support Paulista's capacity to retain loans. Conservative liquidity management, as the loan book lengthens, would also send positive rating signals.

### **What Could Change the Rating - Down**

The currently strong competition in small and medium-sized company lending could fail to ease; at the same time the bank intensifies efforts to increase market participation in that segment. If management chooses to adopt aggressive lending practices - specifically, those that could adversely affect profitability and asset quality indicators -- ratings could undergo negative pressure. Ratings could also be hurt by increase in funding costs, particularly in a likely scenario of liquidity tightening.

## Recent Results and Company Events

On September 24th, 2009, Banco Paulista announced it was leaving the vehicle finance business by selling its portfolio of auto loans and its sister-company Paulicred Promotora de Negócios, that performed origination and servicing, to Banco Fibra (D BFSR / Ba2 GLC). After Paulicred's sale, as stated by management, the bank returned its operational focus to its traditional business segment of financial clearing, trust and fiduciary services, and foreign exchange servicing, and strengthened its lending activity to the SME segment, another core business since its inception.

In September 2010, Paulista reported net losses of R\$13.8 million, representing its third negative quarterly result in the year. The bank's profitability has been hit by losses generated in the sale of past-due loans, on a non-recursive basis, to its subsidiary Paulista Companhia Securitizadora de Créditos Financeiros, a securitization company. These past-due loans are still related to the bank's former vehicle financing operation. The bank's high operating expenses, responsible for an efficiency ratio of 88.1% in September 2010, also compressed bottom-line results.

The bank's loan portfolio reached R\$366.5 million in the 9M10, representing a 35.7% increase relative to the same period in 2009. Most of this growth derived from operations with small and mid-sized companies, which answered for roughly 85% of the loan book after the bank discontinued vehicle financing. As of September 2010, the ratio of non-performing loans to total loans stood at 4.6% from 10.4% in year-end 2009.

Paulista reported a capital adequacy ratio of 11.84%, which was significantly close to the minimum regulatory requirement of 11%. BIS ratio, as the bank sold credits and stopped origination. However, we believe the bank's modest capital continues to be critical point going forward, as profitability prospects reduces the ability to replenish capital.

## DETAILED RATING CONSIDERATIONS

Detailed considerations for Paulista's currently assigned ratings are as follows:

### Bank Financial Strength Rating

Moody's assigns an E+ (E plus) BFSR, or three notches below the D+ aggregate score produced by our scorecard. This rating incorporates Paulista's small franchise and the challenges to reposition the bank back on its traditional path of foreign exchange servicing and trustee business. After a later entrance in the aged-car-financing segment in 2006, which grew rapidly until the 1H08, Paulista decided to sell the business in September 2009 based on the abrupt rise in non-performing loan ratios that evidenced the high risk nature of the portfolio.

As anticipated, the positive performance posted in 2007 proven not to be sustainable through the cycle, as the rapid growth seasoned under a less benign economic scenario and as funding conditions squeezed. The legacy of the retail business, in the form of high delinquency ratios, should remain as a concern even after Paulicred's sale because the bank sold the operation with a recourse clause. Capital is another point of concern. Paulista's internal replenishment capacity might be reduced in future quarters as the bank repositions its franchise in an environment of increased competition for mid-sized company lending.

The rating also encompasses the bank's vulnerable funding structure, which relied on loan securitization during the years it was generating auto loans as well as on an expensive-professional deposit base. Currently, management is challenged to expand Paulista's deposit base in a period in which funding expenses are going up due to liquidity constrains in the system.

Qualitative Rating Factors (70% weighting)

Factor: Franchise Value

Trend: Neutral

Paulista was originally established in 1990, following the conversion of a traditional broker house - Socopa Corretora Paulista - into a commercial bank, focused on SME lending. The bank's E score for franchise value is attributable to its small-niche profile centered on commercial lending, brokerage activity and foreign exchange servicing. Paulista had less than 0.05% of the total industry deposits as of September 2010.

At the end of 2006, the bank decided to enter the vehicle financing segment, focusing on used cars, as management attempted to diversify Paulista's product base leveraging on its small and flexible business model. Retail lending products reached 70% of the bank's credit book in 2008, rapidly rising from 31% in 2005. As with other niche players operating in the same segment, Paulista's business model sought to address the scale limitations by relying on the sale of loan operations; nevertheless, management decided to exit the retail operation after delinquency rose abruptly as result of the economic downturn initiated in the last quarter of 2008. The decision also entailed returning to the bank's established niche operation.

With a traditional middle market-lending platform, Paulista targets medium and small companies with annual revenues from R\$20million to R\$350million, primarily providing these entities with short-term financing supported by self-liquidating assets. As of September 2010, the bank's on-balance loan book contained roughly 85% of loan operations with the middle market, while retail operations reached approximately R\$56 million, including R\$7.7 million in mortgage. Paulista's retail portfolio is complemented by a portfolio of R\$212 million in payroll loans sold on a recursive basis.

In addition, the bank is recognized for the long-established clearing and foreign exchange servicing activities that it offers to banks and brokers in the local market; an operation proven to be a stable source of fee income to the bank.

Factor: Risk Positioning

Trend: Neutral

The risk positioning score of E is influenced by the bank's limited governance structure. Paulista is a privately-held institution owned by two financier entrepreneurs. Although the bank is managed by a team of market professionals that have a long history at the institution, we note that its brand image still relies on the acknowledged capacity of the main shareholder, who is actively involved in the day-to-day business, Mr. Alvaro Augusto Vidigal. As a result, the overall corporate governance and risk positioning scores are capped at the E level, despite the bank's relatively conservative risk management capacity and restricted market risk appetite.

Risk management practices are in line with other peers' of similar size, centering on efforts to control credit risk and monitor the liquidity profile of its collateral portfolio. Paulista's risk management systems are evolving, in line with the bank's increased efforts to upgrade and modernize its infrastructure in recent years.

The bank's financial statements (as with all commercial Brazilian banks) are prepared under local GAAP and provide some level of detail. However, they still lack important disclosures, such as borrower and depositor concentration. The bank releases condensed results on a quarterly basis containing limited information about asset quality, capital requirements, business lines, and earnings generation.

In terms of credit risk concentration, Paulista scored E indicating its adequate industry-wise granularity with no major industry concentrations. There has been an increase in credit concentration by client as a result of the transfer of retail assets to Banco Fibra and the predominance of the SME loan portfolio; nevertheless such concentration should be mitigated by the secure nature of the portfolio. The 10 largest credit exposures, added to the exposure to government securities, net of repos, accounted for 32x pre-provision income (PPP) and 262% of the bank's Tier 1 equity as of September 2010.

The bank has a concentrated funding structure on short-term deposits, having roughly 51% of them maturing in less than three months, and with relative reliance on deposits from related parties - 17% in September 2010, 24% in 2009 and 27% in 2008. Nevertheless, we note that Paulista's liquidity position is satisfactory, as it maintains minimum cash liquidity of between 80% to 120% equity base equivalent, although its liquidity risk information systems need further upgrading to provide timely and sufficiently

detailed information about the true liquidity position across the whole bank.

In terms of market risk appetite, Paulista's treasury activity is centered on managing liquidity, so the bank is mainly exposed to interest rate risk through its fixed rate assets while its equity and foreign currency risks are very limited. Moody's expects Paulista's management to continue improving its risk management systems and infrastructure, which will allow the bank to monitor its risk positioning increasingly effectively.

Factor: Regulatory Environment

Moody's will comment on the Brazilian regulatory environment in a separate report.

Factor: Operating Environment

Trend: Neutral

The Brazilian operating environment receives a D on the scorecard. The D derives from a score of E for economic stability (measured as nominal GDP volatility over the 20-year period) and a D for integrity and corruption. (The integrity and corruption index is based on data from the World Bank, which ranks approximately 200 countries worldwide.) The legal system's score of C reflects the average length of time required for the execution of guarantees in Brazil in the absence of reliable references for mortgage foreclosure.

Quantitative Rating Factors (30% weighting)

Factor: Profitability

Trend: Weakening

Paulista posted weak profitability indicators during 2010 as a result of the high expenses still related to the bank's former consumer lending operation. Provision expenses continue to represent a significant burden on bottom-line results and add complementary pressure to an operating structure that also presents high costs.

With the sale of its consumer financing platform, profitability ratios are likely to remain compressed, provided that margins on SME lending are expected to be pressured by effects of competition and stable real interest rates. On a positive note, the traditional broker-dealer operations is a source of steady fee income to the revenue stream.

Our score for profitability in the scorecard is D+, considering average ratios calculated over three years (2007-2009). The negative performance of net income throughout 2010 should add pressure to this score, which explains the weakening trend for profitability. Paulista's profitability may be further challenged by the current trend of increase in funding costs, which is expected to affect medium and small sized banks in the system.

Factor: Liquidity

Trend: Neutral

Paulista scores a C+ for liquidity management, reflecting the bank's adequate position with regard to liquid assets that would be available to pay market funds in case of an unexpected market downturn. However, our assessment of liquidity management still indicates the implied vulnerability at Paulista's predominantly short-term wholesale deposit base. During recent disruptions in domestic liquidity conditions Paulista's deposit base have suffered less than those of similar small banks; a fact that can be explained fundamentally by local investors' confidence at the bank's renowned shareholders. In addition, there has been a sizeable participation of deposits from shareholders, which have proven to be an important source of funds in times of stress. The lack of international funding on the bank's balance also mitigates Paulista's liquidity situation, since it reduces pressure on its currently squeezed cash position.

In 2007, Paulista took advantage of the marketability of its consumer banking portfolio and issued an investment fund linked to auto-finance receivables. Another auto-finance FIDC in the amount of R\$100million was issued in the 2H08.

Factor: Capital Adequacy

Trend: Weakening

Despite the A score for capital adequacy, which results from capital ratios at high levels according to international standards, capital is a point of concern for Paulista's ratings. The bank has been operating under a stringent capital base since 2007, reporting a BIS ratio in September 2010 at 11.84%, close to the minimum 11% requirement. We see steady pressure on leverage coming from the bank's current net losses caused by provision expenses still related to its former consumer financing portfolio.

In addition, the robust earnings generation in 2007 that replenished the bank's capital base is unlikely to be repeated, expensive funding costs, as well as nonperforming loans related to the sold assets, should still pressure capital levels as it will require provisions until the credit mature in 2011.

Factor: Efficiency

Trend: Weakening

Paulista's efficiency has been affected by high losses derived from the sale of past-due loans to the bank's securitization company. On the top of that, the bank's inherently high cost structure contributed to the efficiency ratio of 88.1% reported in September 2010. We note, however, that the bank is expected to realign its administrative structure as it return to its traditional business. Moreover, negative pressure on efficiency has been mitigated by the good performance of Paulista's securities trading portfolio, although a volatile component in the bank's earning structure.

Moody's assigns a C score of efficiency to Paulista, resulting from a three-year average ratio of 57.42%

Factor: Asset Quality

Trend: Neutral

Asset quality indicators have shown relative improvement through the year following the sale of Paulista's consumer finance operation; however, the ratio of non-performing loans to total loans was still at 4.6% as of September 2010. Delinquency is likely to decrease as the bank expand the portfolio of loans with SME and the consumer financing operations sold on a recursive basis come close to maturity.

Moody's scores Paulista's asset quality as C.

### **Global Local Currency Deposit Rating (Joint Default Analysis)**

Moody's long-term global local currency rating of B1 for Paulista derives from a baseline credit assessment of B1 and is supported by the commitment of its shareholders to the institution's operations. Moody's assigns no probability of systemic support to the bank's deposit ratings in local currency because of Paulista's very small footprint in the industry. In the short-term, Moody's assigns a global local currency rating of Not Prime to the bank.

### **National Scale Rating**

Paulista is rated Baa2.br and BR-3 by Moody's on Brazil's National Scale. The rating reflects its brand image and recognized management built since inception, but also carries the current volatility of performance and uncertain outlook for success in the new business.

## **Foreign Currency Deposit Rating**

Moody's assigns foreign currency deposit ratings of B1 and Not Prime to Paulista.

## **ABOUT MOODY'S BANK RATINGS**

### **Bank Financial Strength Rating**

Moody's Bank Financial Strength Ratings (BFSRs) represent Moody's opinion of a bank's intrinsic safety and soundness and, as such, exclude certain external credit risks and credit support elements that are addressed by Moody's Bank Deposit Ratings. Bank Financial Strength Ratings do not take into account the probability that the bank will receive such external support, nor do they address risks arising from sovereign actions that may interfere with a bank's ability to honor its domestic or foreign currency obligations. Factors considered in the assignment of Bank Financial Strength Ratings include bank-specific elements such as financial fundamentals, franchise value, and business and asset diversification. Although Bank Financial Strength Ratings exclude the external factors specified above, they do take into account other risk factors in the bank's operating environment, including the strength and prospective performance of the economy, as well as the structure and relative fragility of the financial system, and the quality of banking regulation and supervision.

Moody's uses the Baseline Credit Assessment (BCA) to map BFSRs onto the 21-point Aaa-C rating scale and like the BFSR, it reflects a bank stand-alone default risk. Each point on the Aaa-C scale represents a specific probability of default and therefore allows Moody's to use the BCA as an input to Moody's Joint Default Analysis (JDA), described below. The baseline credit assessment reflects what the local currency deposit rating of the bank with the given BFSR would be without any assumed external support from a government or third party.

### **Global Local Currency Deposit Rating**

A deposit rating, as an opinion of relative credit risk, incorporates the Bank Financial Strength Rating as well as Moody's opinion of any external support. Specifically, Moody's Bank Deposit Ratings are opinions of a bank's ability to repay punctually its deposit obligations. As such, Moody's Bank Deposit Ratings are intended to incorporate those aspects of credit risk relevant to the prospective payment performance of rated banks with respect to deposit obligations, and includes: intrinsic financial strength, sovereign transfer risk (in the case of foreign currency deposit ratings), and both implicit and explicit external support elements. Moody's Bank Deposit Ratings do not take into account the benefit of deposit insurance schemes which make payments to depositors, but they do recognize the potential support from schemes that may provide assistance to banks directly.

According to Moody's joint default analysis (JDA) methodology, the global local currency deposit rating of a bank is determined by the incorporation of any external elements of support into the bank's Baseline Credit Assessment. In assigning the local currency deposit rating to a bank, the JDA methodology also factors in the rating of the various potential support providers (parent company, cooperative group, regional or national governments), as well as the degree of dependence that may exist between each one of them and the bank. Moody's assessment of the probability of systemic support (by a national government) is derived from the analysis of the capacity of a government and its central bank to provide support on a system-wide basis. The systemic support indicator is determined for a particular country and serves as an input for all bank ratings in that country. The support indicator can be set at, above or, in rare cases, below the government's local currency bond rating for that country.

### **National Scale Rating**

National scale ratings are intended primarily for use by domestic investors and are not comparable to Moody's globally applicable ratings; rather they address relative credit risk within a given country. A Aaa rating on Moody's National Scale indicates an issuer or issue with the strongest creditworthiness and the lowest likelihood of credit loss relative to other domestic issuers. National Scale Ratings, therefore, rank domestic issuers relative to each other and not relative to absolute default risks. National ratings isolate systemic risks; they do not address loss expectation associated with systemic events that could

affect all issuers, even those that receive the highest ratings on the National Scale.

Moody's National Scale Ratings (NSRs) are intended as relative measures of creditworthiness among debt issues and issuers within a country, enabling market participants to better differentiate relative risks. NSRs differ from Moody's global scale ratings in that they are not globally comparable with the full universe of Moody's rated entities, but only with NSRs for other rated debt issues and issuers within the same country. NSRs are designated by a ".nn" country modifier signifying the relevant country, as in ".mx" for Mexico. For further information on Moody's approach to national scale ratings, please refer to Moody's Rating Implementation Guidance published in August 2010 entitled "Mapping Moody's National Scale Ratings to Global Scale Ratings."

#### Foreign Currency Deposit Rating

Moody's ratings on foreign currency bank obligations derive from the bank's local currency rating for the same class of obligation. The implementation of JDA for banks can lead to a high local currency ratings for certain banks, which could also produce high foreign currency ratings. Nevertheless, it should be noted that foreign currency deposit ratings are in all cases constrained by the country ceiling for foreign currency bank deposits. This may result in the assignment of a different, and typically lower, rating for the foreign currency deposits relative to the bank's rating for local currency obligations.

#### Foreign Currency Debt Rating

Foreign currency debt ratings are derived from the bank's local currency debt rating. In a similar way to foreign currency deposit ratings, foreign currency debt obligations may also be constrained by the country ceiling for foreign currency bonds and notes; however, in some cases the ratings on foreign currency debt obligations may be allowed to pierce the foreign currency ceiling. A particular mix of rating factors are taken into consideration in order to assess whether a foreign currency bond rating pierces the country ceiling. They include the issuer's global local currency rating, the foreign currency government bond rating, the country ceiling for bonds and the debt's eligibility to pierce that ceiling.

#### About Moody's Bank Financial Strength Scorecard

Moody's bank financial strength model (see scorecard below) is a strategic input in the assessment of the financial strength of a bank, used as a key tool by Moody's analysts to ensure consistency of approach across banks and regions. The model output and the individual scores are discussed in rating committees and may be adjusted up or down to reflect conditions specific to each rated entity.

## Rating Factors

### Banco Paulista S.A.

Rating Factors [1]	A	B	C	D	E	Total Score	Trend
<b>Qualitative Factors (70%)</b>						<b>D+</b>	
<b>Factor: Franchise Value</b>						<b>E</b>	<b>Neutral</b>
<b>Market Share and Sustainability</b>					x		
<b>Geographical Diversification</b>					x		
<b>Earnings Stability</b>					x		
<b>Earnings Diversification [2]</b>							
<b>Factor: Risk Positioning</b>						<b>E</b>	<b>Neutral</b>
<b>Corporate Governance [2]</b>					x		
- Ownership and Organizational Complexity				x			

- Key Man Risk					x		
- Insider and Related-Party Risks					x		
<b>Controls and Risk Management</b>				x			
- Risk Management					x		
- Controls		x					
<b>Financial Reporting Transparency</b>				x			
- Global Comparability				x			
- Frequency and Timeliness		x					
- Quality of Financial Information					x		
<b>Credit Risk Concentration</b>					x		
- Borrower Concentration					x		
- Industry Concentration				x			
<b>Liquidity Management</b>				x			
<b>Market Risk Appetite</b>			x				
<b>Factor: Operating Environment</b>						D	Neutral
<b>Economic Stability</b>					x		
<b>Integrity and Corruption</b>				x			
<b>Legal System</b>			x				
<b>Financial Factors (30%)</b>						C+	
<b>Factor: Profitability</b>						D+	Weakening
<b>PPI / Average RWA - Basel II</b>		3.52%					
<b>Net Income / Average RWA - Basel II</b>					0.10%		
<b>Factor: Liquidity</b>						C+	Neutral
<b>(Mkt funds-Liquid Assets) / Total Assets</b>	- 10.19%						
<b>Liquidity Management</b>				x			
<b>Factor: Capital Adequacy</b>						A	Weakening
<b>Tier 1 Ratio - Basel II</b>	12.89%						
<b>Tangible Common Equity / RWA - Basel II</b>	14.11%						
<b>Factor: Efficiency</b>						C	Weakening
<b>Cost / Income Ratio</b>			57.42%				
<b>Factor: Asset Quality</b>						C	Neutral
<b>Problem Loans / Gross Loans</b>				6.36%			
<b>Problem Loans / (Equity + LLR)</b>		14.98%					
<b>Lowest Combined Score (9%)</b>						C-	
<b>Economic Insolvency Override</b>						Neutral	
<b>Aggregate Score</b>						D+	
<b>Assigned BFSR</b>						E+	

[1] - Where dashes are shown for a particular factor (or sub-factor), the score is based on non public information [2] - A blank score under Earnings diversification or Corporate Governance indicates the risk is neutral



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