



Moody's Investors Service

Credit Opinion: Banco Paulista S.A.

Global Credit Research - 08 Oct 2009

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.

	[1]Dec-08	Jun-08	Dec-07	Jun-07	Dec-06	Avg.
Total Assets (US\$B)	0.51	0.83	0.52	0.33	0.23	[2]47.14
Share Equity (US\$M)	53	81	63	37	26	[2]40.86
Pre-Provision Profit/Tt.Avg. Assets	2.19	6.00	12.62	8.69	4.16	6.73
ROAA	1.36	3.29	9.09	5.03	2.44	4.24
NIM	17.58	19.18	30.10	27.71	11.92	21.30
Oper Expenses/Gross Op. Revenues	29.70	25.07	22.96	25.81	51.07	30.92
NPL/Gross Loans & Lease	9.72	5.56	5.84	4.94	0.05	5.22
BIS Ratio	13.95	11.00	15.64	13.33	11.00	12.98

[1] As of December 31. [2] Compound annual growth rate.

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 developing banking franchise as its management focuses on the consumer finance segment, particularly on vehicle financing. 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, have sacrificed asset quality, at least when indicators are 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.

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 Banco 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 FX 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
- Rapid deterioration of its vehicle financing portfolio affected profitability structure

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 consumer 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 fierce competition in consumer lending could fail to ease. If management chooses to adopt aggressive lending practices - specifically, those that could adversely affect profitability and asset quality indicators -- ratings could undergo negative pressure. With operations so tightly focused on the medium-term vehicle financing segment, funding disruption and increasing costs may hurt the ratings.

Recent Results and Company Events

As of today, the bank had not released its first and second quarter's financial statements.

After a sour fourth quarter, Banco Paulista posted a net income of R\$15 million for the year of 2008, a 74% decline compared to 2007. This modest bottom line resulted in ROAA of 1.4% and pre-provision income over assets of 2.2%, compared to 9.1% and 12.6%, respectively in year-end 2007. The 2008 performance was sensitive to two times: (1) a first semester of fierce competition in vehicle financing segment and expensive funding dynamics starting 2008, factors that pressured margins, and (2) a second half marked by a difficult liquidity situation when investors' resources were taken out of midsize banks, like Paulista, and the economic deceleration translated into asset quality deterioration. Paulista suffered 22% of deposit withdrawn in 2H09, and prioritized cash liquidity to portfolio growth, same posture adopted by other midsize banks in times of uncertainties.

In order to manage liquidity, Paulista sold credits, an expensive tool, while it suspended new loans given difficult funding scenario. In the last quarter, the bank sold roughly R\$135million of auto finance loans, and related revenues responded for 23% of credit income in the period (28% in 2007). Margins slipped to levels of 17.6% in December 2008 from 30.1% in 2007. Credit costs, measured by provisioning expenses % of pre-provision income, increased to 85% from 23% in 2007. Operating expenses related to the rise in delinquency level of credits sold were largely responsible for the 70% year-on-year decline in pre-provision expenses, as the bank reverted revenues anticipated by the time the credit was assigned to third-party (recourse clause against Banco Paulista).

The bank's loan portfolio reduced 28% in the 2H09, roughly flat compared to 2007. As of year-end 2008, the NPL ratio reached 9.7% from 5.8% in 2007, with modest reserve coverage of 55.3% (109.2% in 2007), when compared to other midsize banks in the same niche. Net charge-offs increased 3 times in 2008 to R\$23.2million in 2008.

Capital adequacy ratio improved to 14% 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.

On September 24th, 2009, Banco Paulista announced the exit from the vehicle finance business, by selling its vehicle financing portfolio and its sister-company Paulicred Promotora de Negócios, that performed origination and servicing, to Banco Fibra (D BFSR / Ba2 GLC). With this transaction, Banco Paulista exited the vehicle financing segment it started to operate by the end of 2006.

According to management, the bank will turn its focus back to its traditional business segment of financial clearing, trust/fiduciary, and FX servicing, and develop the SME portfolio, another core business of the bank since inception.

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 four notches below the C - aggregate score produced by our scorecard. This rating incorporates Banco Paulista's small franchise and the challenges to reposition the bank back on its tradition path of FX 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 behind the spike in NPL 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 platform is high delinquency ratio that should remain a concern as the bank sold the operation with a recourse clause. Capital is another point of concern. Paulista's internal replenishment capacity might reduce in the coming quarter as the bank repositions its franchise.

The rating also encompasses the bank's vulnerable funding structure, which has relied on loan securitization as well as on an expensive-professional deposit base. The stability of the bank's deposit base after the past crisis depended on the recognition of its shareholders and some reliance on related-parties deposits.

Good performance and capital ratios lifted the financial fundamentals score until 2007. The high scores on Regulatory Environment also boosted the ratings.

Qualitative Rating Factors (70% weighting)

Factor: Franchise Value

Trend: Neutral

Banco 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 and consumer lending. Paulista has less than 0.04% of the total industry deposits as of September 2009.

At the end of 2006, the bank decided to enter the vehicle financing segment, targeting the aged cars, as management attempted to diversify the product base, considering the bank's small and flexible business model and seize market opportunities. The expansion of credit activities into consumer-lending products has been essentially through a strong origination of used car financing (15 years usage), and payroll-deductible loans. 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 addresses the scale limitations. After the recent economic downturn, management decided to exit the retail operation after a hike in delinquency level. Decision was to return to 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. This portfolio currently composes 29% of Paulista's credit book, and it comprises 350 active companies with exposures 80% covered by collateral.

In addition, the bank is recognized for the long-established clearing and FX servicing activities that it offers to banks and brokers in the local market. This has proven to be a stable source of fee income that makes up roughly 25% of its net revenue generation, which is strong compared with other small players' in Brazil.

Factor: Risk Positioning

Trend: Neutral

The risk positioning score of E is influenced by the 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 its infrastructure and modernize in recent years to support its entrance into the consumer-lending segment.

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 risk-weighted assets, and information about market-risk measurements. 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 C indicating its adequate industry-wise granularity with no major industry concentrations. In 2008, the portfolio was composed 65% by consumer loans, largely vehicle financing, and the low scores reflect this distribution. However, we anticipate that as these assets are transferred to Banco Fibra, the SME loan portfolio should reflect some exposure concentration by client, which should be mitigated by the secure nature of the portfolio. The 20 largest credit exposures accounted for 31.3% of 2008 pre-provision income (PPP) or 61% of the bank's Tier 1 equity, while exposure to government securities, net of repos, accounted for 18.1% of PPP and 36% of Tier 1 equity.

The bank has a concentrated funding structure on short-term deposits, averaging six months, with relative reliance on shareholders' resources over the last years - 27% in 2008, 43.7% in 2007 and 23% in 2006. With its good portfolio quality, Paulista has been opportunistically using securitization through investment funds or credit assignment to third parties. That said, the bank has adequate liquid assets and other maturing loans to meet its obligations in a timely manner over a 12-month period without resorting to the capital markets or sustaining a significant reduction in its business activities. In addition, 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. These parameters have been sustainable over the last three months following the heightened volatility.

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

With the sale of its consumer financing platform, profitability ratios should return to historical low but recurring levels. Margins on SME lending are expected to be pressured by effects of competition and stable real interest rates. The traditional broker-dealer operations add steady fee income to the revenue stream.

Banco Paulista posted good profitability indicators in 2006, 2007 and 1H08 boosted by the high-yield vehicle financing business, leveraged by active credit sales, with upfront revenues from credit assignment accounting for roughly 30% of total credit income in 2007 and 37% in June 2008.

While revenues diversification was positive, it proven not to be sustainable through the cycle, as its lacks scale and this asset class is highly vulnerable to economic deceleration and labor market.

Our score for profitability in the scorecard is A, considering the 3-year average (2006-2008). As a refinement to our bank analysis, the negative 2009 performance impacted by asset quality deterioration should add pressure to this score. This explains the weakening trend for profitability.

In another refinement is made adjusting Paulista's risk-weighted assets by assigning a 50% weight to government securities instead of the 0% weight required by Brazilian regulators. With such an adjustment for securities, both profitability ratios (PPP % of Avg RWA and Net Income % Avg RWA) decline, but they are still well positioned in the A score.

Factor: Liquidity

Trend: Neutral

Paulista scores a C+ for liquidity management, reflecting the bank's comfortable position with regard to liquid assets that would be available to pay market funds in case of any unexpected market downturn. However, our assessment of liquidity management still indicates the implied vulnerability at Paulista's predominantly short-term wholesale deposit base. One of the bank's central challenges is related to the management of a longer-tenor asset profile, mostly encompassed by auto loans that average 42 months. Historically and tested over the last two liquidity disruptions - in 2004 and current -- Paulista's deposit base suffered less than those of similar small banks, which can, fundamentally, be explained by local investors' confidence at the renowned shareholder. In addition, there has been a sizeable participation of deposits from shareholders, which has proven to be an important source of funds in times of stress.

The recent deposit run off, roughly of 30%, has been addressed through intensified credit sales activities, using part of the stimulus package put in place by regulator in October to ease liquidity pressure, especially on mid-size bank's liquidity management. Another mitigant on Paulista's liquidity situation is the lack of external funding, which 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, current with net asset value of R\$126million and subordination of 15.5% with 4% of excess spread. Another auto-finance FIDC in the amount of R\$100million was issued in the 2H08.

Factor: Capital Adequacy

Trend: Neutral

Score of A has a neutral trend, considering the high levels for international standards. However, capital is a point of concern for Banco Paulista's ratings. The bank has been operating under a stringent capital base since 2007, reporting a BIS ratio in June and September 2008 at the minimum 11% requirement. We see steady pressure on leverage coming from the implementation of the stricter accounting rules for credit sales, which are expected to be implemented on January 2010. In June 2009, Paulista recorded 13.7% of BIS ratio.

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

The cost base is high, but it improved over the last two years through greater profitability on the back of the Paulista's entrance into high-yield consumer lending activities and the good performance of its securities trading portfolio, although this is a volatile earning component. In October and November, management has moved to adjust and reduce operational structure and staff, while reevaluating strategy and operations, as it anticipates a difficult year. In the last quarter of 2008, the bank reduced its working force in the car loan platform by 40% and shut down 4 branches, from a total of 11.

We note, however, that the bank is expected to realign its administrative structure as it return to its traditional business. Efficiency is critical in an environment of low interest margins.

Factor: Asset Quality

Trend: Weakening

Asset quality deterioration in 2007 was an effect of the rapid expansion into consumer, primarily into the aged vehicle finance segment, which on the other hand is a high-spread product.

The portfolio has proven to be highly sensitive to labor market and the lien on vehicle less effective, given the age of the cars (15 to 20 years). This should continue to hit the Asset Quality score as the bank manages its exist from the segment at the end of 2009.

Moody's scores Paulista's asset quality as C, with a weakening trend.

Global Local Currency Deposit Rating (Joint Default Analysis)

Moody's global local currency rating of B1 for Banco Paulista 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.

National Scale Rating

Paulista is rated Baa2.br/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 a B1 foreign currency deposit rating to Banco Paulista. The rating is constrained by the foreign currency deposit ceiling for Brazil.

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.

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
Qualitative Factors (70%)						D+	
Factor: Franchise Value						E	Neutral
Market Share and Sustainability					x		
Geographical Diversification					x		
Earnings Stability					x		
Earnings Diversification [2]							
Factor: Risk Positioning						E	Neutral
Corporate Governance [2]					x		
- Ownership and Organizational Complexity				x			
- Key Man Risk					x		
- Insider and Related-Party Risks					x		
Controls and Risk Management				x			
- Risk Management					x		
- Controls		x					
Financial Reporting Transparency				x			
- Global Comparability				x			
- Frequency and Timeliness		x					
- Quality of Financial Information					x		
Credit Risk Concentration				x			
- Borrower Concentration				x			
- Industry Concentration			x				
Liquidity Management				x			
Market Risk Appetite			x				
Factor: Operating Environment						D	Neutral
Economic Stability					x		
Integrity and Corruption				x			
Legal System			x				
Financial Factors (30%)						B-	
Factor: Profitability						A	Weakening
PPP % Avg RWA - Basel II	9.40%						
Net Income % Avg RWA - Basel II	6.12%						
Factor: Liquidity						C+	Neutral
(Mkt funds-Liquid Assets) % Total	-						

Assets	14.68%						
Liquidity Management				x			
Factor: Capital Adequacy						A	Neutral
Tier 1 ratio (%) - Basel II	13.67%						
Tangible Common Equity / RWA - Basel II	13.67%						
Factor: Efficiency						A	Weakening
Cost/income ratio	34.58%						
Factor: Asset Quality						C	Weakening
Problem Loans % Gross Loans				5.20%			
Problem Loans % (Equity + LLR)		14.03%					
Lowest Combined Score (9%)						C	
Economic Insolvency Override						Neutral	
Aggregate Score						C-	
Assigned BFSR						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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