

South Africa
Credit Analysis

Santam Limited

Ratings (National Scale)

Santam Limited

Insurer Financial Strength.....AA+(zaf)

Rating Outlook

Stable

Affiliate Ratings (National Scale)

Sanlam Limited

Long-Term.....AA-(zaf)

Sanlam Life Insurance Limited

Insurer Financial Strength.....AA+(zaf)

Long-Term.....AA(zaf)

Short-Term.....F1+(zaf)

Sovereign Ratings

Republic of South Africa

Foreign Currency BBB+

Local Currency A

Outlook Stable

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■ Summary

Santam Limited's (Santam) upgrade to 'AA+(zaf)' from 'AA(zaf)' reflects Fitch's view that Santam occupies a core position within the Sanlam group. Although the Sanlam group's shareholding will reduce to approximately 51% from 56%, to accommodate Santam's black economic empowerment (BEE) scheme, the agency views positively the Sanlam group's intention to increase its shareholding in Santam going forward. The rating also considers Santam's strong underwriting performance, number one domestic market position and strong capitalisation. Offsetting factors include the competitive South African market, the impact of a deteriorating claims environment and the company's limited diversification outside of South Africa.

Santam has a long history of underwriting profitability and at FYE06 reported a combined ratio of 93.9% (FYE05: 91.3%). The deterioration in the combined ratio was due to the deteriorating claims environment, which was exacerbated by several large claims. The claims ratio increased to 69% at FYE06 from 65.3% at FYE05, but underwriting performance was supported by Santam's strong focus on efficiencies, which resulted in its expense ratio improving to 24.9% from 26%. At FYE06, Santam reported a return on equity (ROE) of 33% (FYE05: 34%).

Santam is the largest general insurer in South Africa, with a market share of about a quarter, in terms of gross written premiums (GWP). However, increasing competition, particularly in its personal lines business, has placed pressure on both its profitability and market share. Offsetting the latter is the growth potential stemming from a growing economy and the insurance needs of the emerging black middle class.

Fitch considers Santam's capital levels to be strong and at FYE06 Santam reported a regulatory solvency ratio (net asset value/net premiums written) of 62% (FYE05: 61%).

Although Santam has some international exposure, this is currently of limited scale, representing only 7% of FYE06 GWP. Fitch considers Santam's measured approach towards broadening its international operations to be a prudent one and believes that profitable growth of international business has the potential to enhance its credit quality by way of diversification.

■ Expectations

Fitch expects Santam's earnings to remain robust, but to reflect the deteriorating claims environment and increased competition. In particular, Fitch expects Santam's personal lines business to come under pressure from direct insurers.

In spite of the competitive environment, Fitch expects Santam to maintain its overall number one position. Net premium growth is expected to be assisted by reinsurance optimisation and entry into new markets, such as the lower-income segment in South Africa.

The agency understands that Santam expects to manage its capital to target a solvency ratio of about 40% and introduce hybrid capital in its capital structure. Notwithstanding these changes, Fitch expects Santam's capital levels to remain strong.

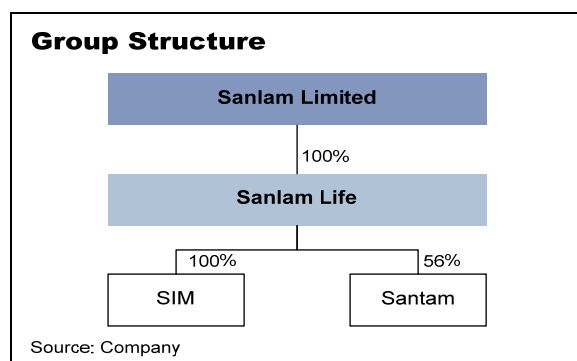
■ Group Overview

Santam is the general insurance subsidiary of the Sanlam group, a South African financial services group that provides life and general insurance, investment management, capital markets services and other personal lines services (See “*Sanlam Limited and Sanlam Life Insurance Limited*” published on 1 June 2007 and available at www.fitchratings.com).

Fitch considers Santam as core to the Sanlam group. Although the Sanlam group’s shareholding will reduce to approximately 51% from 56%, after Santam’s BEE scheme, Sanlam’s intention is to increase its shareholding in Santam (See *Recent Developments*). The intention to increase its shareholding in Santam is consistent with the Sanlam group’s strategy to develop its diversified business position within the South African financial services market into that of a world-class financial services group.

Santam is the largest general insurer in South Africa, with a market share of about a quarter of GWP, and it is listed on the Johannesburg Securities Exchange. Santam has limited international exposure, through its operations in the UK and Europe and at FYE06 these operations contributed 7% towards GWP, with the balance coming from South Africa (and Namibia).

The diagram below illustrates the Sanlam group’s structure in simplified form. Fitch has assigned National Ratings to the Sanlam group’s primary life insurance subsidiary, Sanlam Life Insurance Limited (Sanlam Life). Sanlam Investment Management (SIM) is the primary investment operating subsidiary of the group.



Strategy

In line with its “Project 2010” plan, conceived in 2004, Santam will focus on capital management, BEE and will explore options to enhance its competitive position during 2007. The company will also focus on brand positioning, and enhancing its distribution model and IT systems.

The ultimate aim of Project 2010 is to deliver results in each of the following six areas:

1. Client focus
2. Market expansion
3. Distribution channel development
4. Increased efficiency
5. Exploiting technology
6. Focus on human capital

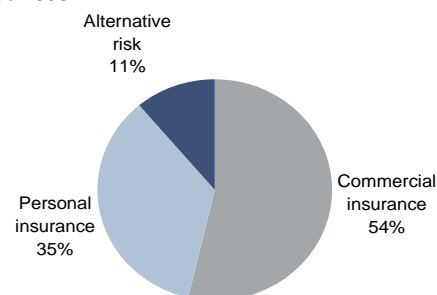
Fitch considers Santam’s strategy to be prudent in view of the necessary focus on developing the company’s business position. This is in view of the competitive South African general insurance market and the cyclical nature of general insurance. Santam’s strategy is broadly in line with the Sanlam group’s strategy.

Business Mix

The following two charts illustrate the distribution of Santam’s FYE06 GWP of ZAR12,736m in terms of business lines and insurance classes, respectively.

Gross Written Premiums Per Business Line

31 Dec 2006

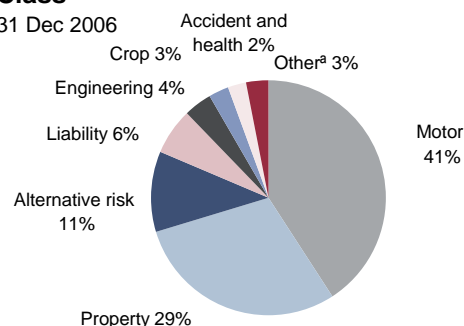


Source: Company

Santam’s business mix, which is strongly weighted towards commercial lines, enables the company to produce higher margins than those of its peers.

Gross Written Premiums Per Insurance Class

31 Dec 2006



^a Includes Guarantee, Miscellaneous and Transportation (2%)

Source: Company

In line with the South African general insurance industry, motor and property business comprise about two-thirds of GWP.

Recent Developments

Sanlam and Santam Joint Announcement

In February 2007, Sanlam and Santam jointly announced the following transactions:

1. Santam intends to make a pro-rata offer to repurchase up to a maximum 10% of its shares (voluntary repurchase offer);
2. to the extent that the Santam shareholders' acceptances of the voluntary repurchase offer exceed 10%, Sanlam Limited intends to make an offer to acquire the excess shares tendered, subject to the Sanlam group not holding more than 80% of Santam, currently 56% (Sanlam offer); and
3. Santam has resolved to enter into a Black Economic Empowerment (BEE) transaction that will result in a BEE consortium acquiring 10% of Santam on a pro-rata basis.

In line with its focus on capital management, the voluntary repurchase offer is the first step towards managing its solvency ratio to about 40% and the company intends to introduce hybrid capital into its capital structure (See *Capital and Solvency*). The net effect of the Sanlam offer and the BEE transaction would have been an increase of Sanlam's shareholding in Santam to about 72% from 56%. However, in light of the fact that the voluntary repurchase offer has resulted in Santam acquiring less than 10% of its own shares (about 6% was tendered), Sanlam's shareholding in Santam will not increase under this transaction.

In 2003, the Financial Sector Charter (FSC) was published in South Africa under the framework of BEE. It sets out targets for black involvement in financial services companies. Fitch views the FSC positively, in the context of the country's social and structural challenges. The agency recognises that Santam does not view its BEE initiatives, including the sale of 10% of its shareholding to a BEE consortium, as merely a "box ticking" exercise to satisfy BEE requirements – it is a key part of Santam's strategy to grow its business and strengthen its business position.

Direct Insurers

Historically, distribution in the South African general insurance industry had been primarily through intermediaries. Direct sales however, are now nearing 20% of the personal lines market, and

as a consequence, a number of the established intermediary players are now developing their own direct distribution.

As part of its strategy, Santam is exploring options to enhance its competitive position in the personal lines business and Fitch believes that Santam will be able to leverage off the Sanlam group in this regard.

Financial Condition Reporting

In line with international trends, the Financial Services Board (FSB) is following a risk-based regulatory approach. In this regard, the FSB is in the process of developing its method of statutory financial reporting for general insurers – Financial Condition Reporting (FCR) will be implemented by all general insurers operating in South Africa in the near future. Fitch will continue to monitor the developments in this regard.

The salient feature of FCR is that general insurers will be required to use economic capital models and will have a choice of using their own internal model, a prescribed model or a certified model.

Fitch welcomes the use of economic capital models, as an important part of the enterprise risk management of insurance companies. The agency believes that these models can often promote superior understanding of risks in addition to their quantitative estimation. Furthermore, the agency expects that capital modelling techniques can, if used correctly, improve risk mitigation, allocation of resources, pricing and product design.

Fitch views positively Santam's use of its own internal capital model in support of management decisions such as capital allocation, reinsurance levels and asset allocation.

■ Financial Review

At FYE06, Santam reported a ROE of 33% (FYE05: 34%). This was predominantly due to strong investment income resulting from buoyant investment markets, tempered by a weaker underwriting performance. The table below highlights Santam's financial performance.

Financial Highlights

(ZARm)	FYE06	FYE05	Change (%)
Gross written premium	12,736	11,355	12
Net written premium	10,684	9,344	14
Underwriting result (Before technical interest)	627	775	(19)
Non-life underwriting result	906	1,016	-(11)
Net profit	1,844	1,778	(4)

Source: Company

Result From Insurance Activities

At FYE06, Santam's net insurance result decreased by 11% to ZAR906m from ZAR1,016m at FYE05. The deterioration was largely due to weaker underwriting performance, which saw underwriting profit decline by 19% to ZAR627m from ZAR775m (See *Underwriting Performance*). Supporting Santam's net insurance result was the 14% higher average float level, which generated interest on insurance funds of ZAR279m at FYE06 (ZAR241m).

Underwriting Performance

Despite a weaker underwriting performance, Fitch considers Santam's underwriting capabilities to be a key factor supporting its rating. Santam has a long history of underwriting profitability and at FYE06 reported a combined ratio of 93.9% (FYE05: 91.3%).

The deterioration in the combined ratio was due to the deteriorating claims environment, which was exacerbated by several large claims, these included floods in Namibia and some parts of South Africa, and some commercial claims as a result of fires. The claims ratio increased to 69% at FYE06 from 65.3% at FYE05, but underwriting performance was supported by Santam's strong focus on efficiencies, which resulted in its expense ratio improving to 24.9% from 26%.

Competitive pressure continued to affect underwriting profitability, particularly in Santam's personal lines business, which has seen direct insurers gain market share in the personal lines business over the past couple of years. At FYE06, Santam's net earned premiums increased 15% to ZAR10,203m from ZAR8,871m at FYE05, whilst the underwriting margin deteriorated to 6.1% from 8.7% at FYE05. Fitch considers Santam's underwriting margin to be competitive in relation to its peers, largely due to its high-margin, underwriting-intensive commercial business.

The table below illustrates that, apart from Santam's property business, all insurance classes reported underwriting profit at FYE06. The underwriting profit reported for most of the various insurance classes were however lower than FYE05, and is largely as a result of the deteriorating claims environment and competitive pressures.

Fitch expects Santam's underwriting margins to remain under pressure, particularly in its personal lines business. Notwithstanding a recurrence of a number of large claims, the agency expects the company's operating performance to remain robust, although reflecting the deteriorating claims environment and increased competition.

Underwriting Profit Per Insurance Class

(ZARm)	FYE06	FYE05	Change (%)
Accident and health	20	14	43
Alternative risk	18	12	50
Crop	40	39	3
Engineering	77	80	(4)
Liability	58	99	(41)
Motor	254	293	(13)
Property	(1)	118	(101)
Transportation	64	59	8
Other ^a	97	61	59
Total	627	775	19

^a Includes Guarantee and Miscellaneous
Source: Company

Fitch expects operating performance to be assisted by reinsurance optimisation and entry into new markets such as the lower-income segment in South Africa. Furthermore, growth potential stemming from a growing South African economy and the insurance needs of the emerging black middle class will further assist premium growth.

Asset Quality and Liquidity

Fitch considers Santam's investment policy for assets backing policy reserves to be conservative. The company's long-term strategic asset allocation policy is to roughly match insurance reserves by cash and fixed-income instruments.

The company does utilise derivatives to hedge some of its equity exposure and the use of derivatives is limited to hedging purposes only. The buoyant equity markets during FY06 have resulted in strong investment returns, as a result of Santam's high level of equity investments. Santam's investment mix at FYE06 is provided in the table below.

Investment Mix

(ZARm)	FYE06	(%)
Property	17	0.1
Equities	5,435	42.0
Investment in associates	215	1.6
Bonds	1,385	10.7
Loans	766	5.9
Cash and cash equivalents	5,142	39.7
Total	12,960	100

Source: Company, Fitch

Reinsurance

Fitch considers Santam's reinsurance programme to be sufficiently prudent and the agency considers Santam's reinsurers to be of a high credit quality.

In line with the company's strategy to further improve efficiency and exploit technology, the company has been in the process of optimising its

reinsurance programme under the guidance of, among other factors, its internal economic capital model.

Under the existing reinsurance programme, the company is seeking to decrease its use of proportional cover. In setting the reinsurance programme, the company considers all the usual factors, such as available capital, understanding of and appetite for risk, reinsurance terms and modelling results. At FYE06, the level of reinsurance earned premium declined to 17.2% of gross earned premiums compared with the 19.2% at FYE05.

Reserves

Fitch believes that the company's reserving policy is prudent. As a result, and also due to the short-tail nature of most of the business written, adverse reserve developments have not been a feature of Santam's past performance. Santam does not discount its reserves.

At FYE06, Santam held ZAR5.6bn of reserves, and, in line with regulatory requirements, its reserves were at least adequate, at a 75% level of sufficiency. The table below shows the split of net technical reserves for Santam.

Net Technical Reserves

(ZARm)	FYE06	FYE05	Change (%)
Long-term insurance contracts			
Claims reported and loss adjustment expenses	2	2	-
Incurred but not reported reserve	11	7	57
Short-term insurance contracts			
Claims reported and loss adjustment expenses	2,482	1,907	30
Incurred but not reported reserve	842	705	19
Unearned premium reserve	2,277	1,792	27
Total reserves	5,614	4,413	27

Source: Company

Capital and Solvency

Fitch considers Santam's capital levels to be strong and the agency understands that Santam intends to optimise its capital structure to target a solvency ratio of about 40% and introduce hybrid capital in its capital structure. Notwithstanding this change, Fitch expects Santam's capital levels to remain strong and considers the company's action to be in line with its strategy of improving efficiency. The introduction of hybrid capital will serve to reduce the cost of capital while supporting its solvency position. At FYE06, Santam reported a regulatory solvency ratio of 62% (FYE05: 61%).

Santam has returned ZAR711m through the voluntary share offer, and issued ZAR600m of unsecured subordinated bonds on 11 May 2007. This debt issue receives 100% credit for regulatory solvency purposes but only 50% equity credit under Fitch's treatment of hybrid debt instruments. Fitch expects Santam to maintain a solvency ratio in excess of 40%.

Santam utilises a stochastic asset and liability management model in its economic capital modelling. The model targets a 99.6% level of confidence over a one-year horizon.

Santam has a progressive dividend policy, and under "normalised" conditions, targets a dividend cover of about two times. However, this is subject to any threats to the solvency ratio and also considers long-term growth prospects.

Balance Sheet

(ZARm)	IFRS			SA GAAP	
	2006	2005	2004	2003	2002
Assets					
Investments					
Real estate	17	13	10	17	6
Shares	5,435	4,305	3,570	2,218	2,173
Affiliates	215	239	230	150	31
Bonds (public sector stocks and loans)	1,385	863	1,613	1,444	1,003
Loans (debentures, ins. policies and other loans)	766	741	18	22	0
Cash & bank deposits	5,142	4,927	3,927	3,203	2,272
Deposits with Cedants	0	0	0	0	0
Other invested assets	0	0	0	0	0
Total investments (non-linked)	12,960	11,088	9,368	7,055	5,486
Insurance receivables	921	887	369	279	270
Reinsurance receivables	182	131	140	110	237
Other receivables	246	231	538	787	769
Deferred acquisition costs	211	181	146	154	145
Other acquisition costs	0	0	0	0	0
Differences from consolidation	0	0	0	0	0
Tangible assets	42	44	45	53	36
Goodwill	108	80	87	109	33
Other intangible assets	0	0	0	0	0
Accruals	0	0	0	0	0
Other assets	66	22	10	14	14
Total assets	14,736	12,664	10,703	8,561	6,989
Liabilities					
Technical reserves					
Unearned premium reserve	2,726	2,375	1,909	2,036	1,695
Reinsurers' share	(449)	(583)	(637)	(865)	(834)
Less deferred acquisition costs	74	109	115	131	139
Outstanding claims reserve	4,952	4,219	3,174	2,989	2,393
Reinsurers' share	(1,628)	(1,607)	(1,196)	(1,283)	(1,093)
Other technical provisions	0	0	0	0	0
Reinsurers' share	0	0	0	0	0
Total non-life technical reserves	5,675	4,513	3,365	3,008	2,300
Mathematical reserve	0	0	0	0	0
Reinsurers' share	0	0	0	0	0
Life claims reserve	16	13	0	0	0
Reinsurers' share	(3)	(4)	0	0	0
Other technical provisions	0	0	0	0	0
Reinsurers' share	0	0	0	0	0
Total life technical reserves	13	9	0	0	0
Total technical reserves (non-linked)	5,688	4,522	3,365	3,008	2,300
Unit linked liabilities	276	250	0	0	0
Reinsurance deposits	265	243	414	355	548
Insurance payables	0	0	0	0	0
Reinsurance payables	0	0	0	0	0
Provisions for other risks & charges	148	145	113	46	88
Short-term debt	0	0	0	0	0
Long-term debt	0	0	0	0	0
Subordinated debt – Liability	0	0	0	0	0
Secured lending	0	0	0	0	0
Other creditors	948	1,102	753	841	443
Accruals	0	0	0	0	0
Other liabilities (incl. cell owners interest)	661	550	576	302	197
Total liabilities	7,986	6,812	5,221	4,552	3,576
Equity					
Ordinary share capital	71	42	1,171	1,130	1,091
Share premium	0	0	0	0	0
Revaluation reserve	0	0	0	0	0
Other reserves	1,119	763	636	964	836
Reserve for own shares	0	0	0	0	0
Profit and loss account	5,437	4,922	3,615	1,862	1,449
Total shareholders' funds	6,627	5,727	5,422	3,956	3,375
Claims equalisation reserve	0	0	0	0	0
Minority interests	123	125	60	53	39
Total equity	6,750	5,852	5,482	4,009	3,414

Source: Company, Fitch

Profit & Loss Account

(ZARm)	IFRS			SA GAAP	
	2006	2005	2004	2003	2002
Non-life technical account:					
Gross written premiums	12,736.0	11,355.4	9,738.2	9,513.1	8,197.4
Premiums ceded	(2,052.0)	(2,011.6)	(2,011.8)	(2,491.3)	(2,562.2)
Net written premiums	10,684.0	9,343.8	7,726.4	7,021.8	5,635.2
Change in UPR	(481.0)	(472.8)	(77.9)	(266.4)	(86.9)
Net premiums earned	10,203.0	8,871.0	7,648.4	6,755.4	5,548.3
Gross claims paid	(8,089.0)	(6,904.8)	(5,014.1)	(5,076.3)	(4,832.8)
Reinsurance recoveries	1,052.0	1,112.2	652.8	882.1	1,075.8
Net claims paid	(7,037.0)	(5,792.6)	(4,361.2)	(4,194.2)	(3,756.9)
Change in claims case reserves	0.0	0.0	0.0	(180.4)	(168.1)
Change in IBNR	0.0	0.0	0.0	0.0	0.0
Net claims incurred	(7,037.0)	(5,792.6)	(4,361.2)	(4,374.6)	(3,925.1)
Premium refunds	0.0	0.0	0.0	0.0	0.0
Acquisition costs	(1,764.0)	(1,586.3)	(1,428.9)	(1,328.3)	(1,271.2)
Increase in deferred acquisition costs	0.0	0.0	0.0	9.3	49.7
Administrative expenses	(1,117.0)	(1,121.1)	(1,222.9)	(1,061.8)	(783.0)
Renewal commission	0.0	0.0	0.0	0.0	0.0
Reinsurance commission & profit participation	342.0	403.6	486.2	530.0	523.0
Total underwriting expenses	(2,539.0)	(2,303.8)	(2,165.6)	(1,850.8)	(1,481.4)
Technical interest	279.0	241.3	202.5	204.8	114.8
Non-life underwriting result	906.0	1,015.9	1,324.1	734.9	256.6
Non-technical account:					
Investment income	494.0	439.9	438.8	413.0	315.4
Realised capital gains/(losses)	1,102.0	263.0	202.0	70.6	294.8
Less technical interest	(279.0)	(241.3)	(202.5)	(204.8)	(114.8)
Finance cost	(7.0)	(12.0)	(14.0)	0.0	0.0
Net investment income	1,310.0	449.6	424.3	278.8	495.3
Operating result	2,216.0	1,465.5	1,748.4	1,013.6	752.0
Non-insurance activities	105.0	116.6	37.5	(11.6)	(0.6)
Amortisation of goodwill and intangibles	(2.0)	(3.6)	(2.3)	(36.4)	(3.3)
Pre-tax income	2,319.0	1,578.5	1,783.6	965.6	748.0
Tax	(615.0)	(520.0)	(603.8)	(355.9)	(115.6)
Net income (before unrealised capital gains/(losses))	1,704.0	1,058.5	1,179.8	609.7	632.4
Unrealised capital gains/(losses)	163.0	742.5	595.3	218.9	(316.6)
Reported net income	1,867.0	1,801.0	1,775.1	828.6	315.9
Attributable to:					
Equity holders of Santam	1,844.0	1,777.8	1,751.5	806.5	302.2
Minority interests	23.0	23.2	23.6	22.1	13.6

Source: Company, Fitch

Ratios

Premiums data (ZARm)	IFRS			SA GAAP	
	2006	2005	2004	2003	2002
Total gross written premiums	12,736.0	11,355.4	9,738.2	9,513.1	8,197.4
Annual change (%)	12.2	16.6	2.4	16.0	32.1
Total net written premiums	10,684.0	9,343.8	7,726.4	7,021.8	5,635.2
Annual change (%)	14.3	20.9	10.0	24.6	23.2
Operating data					
Total revenue	12,280.0	10,046.7	8,367.2	7,505.4	6,245.4
Operating result	2,216.0	1,465.5	1,748.4	1,013.6	752.0
Net income (before unrealised capital gains/(losses))	1,704.0	1,058.5	1,179.9	609.7	632.4
Return on revenue (incl. gains) (%)	18.0	14.6	20.9	13.5	12.0
Return on assets (incl. gains) (%)	12.4	9.1	12.2	7.8	9.9
Return on adj. equity (incl. gains) (%)	27.0	18.7	24.9	16.4	19.0
Incurred loss ratio (%)	69.0	65.3	57.0	64.8	70.7
Commission ratio (%)	17.4	18.0	18.7	19.5	22.0
Expense ratio (%)	10.6	12.0	15.8	15.1	13.9
Reins. comm., profit participation, other ratio (%)	(3.1)	(4.0)	(6.3)	(7.5)	(9.3)
Combined ratio (%)	93.9	91.3	85.2	91.9	97.4
Portfolio composition (%):					
Real estate	0.1	0.1	0.1	0.2	0.1
Shares	42.0	38.8	38.1	31.4	39.6
Affiliates	1.6	2.2	2.5	2.1	0.6
Bonds	10.7	7.8	17.2	20.5	18.3
Loans	5.9	6.7	0.2	0.3	0.0
Mortgages	0.0	0.0	0.0	0.0	0.0
Cash & bank deposits	39.7	44.4	41.9	45.4	41.4
Deposits with Cedants	0.0	0.0	0.0	0.0	0.0
Other invested assets	0.0	0.0	0.0	0.0	0.0
Total (non-linked)	100.0	100.0	100.0	100.0	100.0
Unit-linked investments	0.0	0.0	0.0	0.0	0.0
Total	100.0	100.0	100.0	100.0	100.0
Financial data					
Total assets	14,736.0	12,664.0	10,703.0	8,561.3	6,989.3
Non-life technical reserves/non-life NPW (%)	53.2	48.3	43.6	42.8	40.8
Non-life claims reserves/non-life NPW (%)	32.2	28.0	25.6	24.3	23.1
Liquid assets/technical reserves (%)	209.5	238.9	270.7	228.2	237.0
Investment leverage (%)	98.6	91.0	69.5	59.4	63.8
Affiliated investment leverage (%)	102.4	95.3	74.0	63.4	64.7
Debt/capital (%)	0.0	0.0	0.0	0.0	0.0
Non-life reinsurance utilisation ratio (%)	16.1	17.7	20.7	26.2	31.3
Tax rate (%)	41.6	32.9	33.9	36.9	15.5
Minority interests/net income (%)	2.7	2.2	2.0	3.6	2.2

Source: Company, Fitch

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